THE TREASURY HUB
Banking and Treasury Markets Bulletin

January 2022

1. Executive Summary

1.1 Introduction

Welcome to the first edition of THE TREASURY HUB Banking and Treasury Markets Bulletin of 2022.

This bulletin presents a review of 2021 and in Section 5 we include our annual "trends to watch".

Highlights (or "low lights", depending on your view) of 2021 were:

- Interest rate hikes finally came onto the agenda for the first time in over a decade
- GBP Libor has disappeared with effect from January 1st 2022
- Inflation hit highest levels in decades in some countries
- GBP finally put its Brexit woes behind it and finished the year strongly versus EUR
- USD also had a strong year primarily drive by rising interest rates (and expectations of same)
- Stock markets had a very strong year again
- But the cost of borrowing for governments rose
- And oil prices rose by 50%, fueling the inflationary figures
- While gold prices eased off slightly over the course of the year.

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1.2 Markets in a Table: what's up and what's down?

Table 1. Key Metric Movements: 2021

Heading	Metric	YTD move	From	To
Interest	3-m euribor	-0.03%	-0.5460%	-0.5720%
Interest	EUR 3-year	0.32%	-0.5400%	-0.2200%
Interest	GBP 3-year	1.19%	0.0813%	1.2700%
Interest	USD 3-year	0.92%	0.2330%	1.1500%
FX	EUR/GBP	-6.39%	0.8937	0.8400
FX	EUR/USD	-7.74%	1.2248	1.1368
Equities	ISEQ	14.48%	7376	8444
Equities	FTSE 100	14.30%	6460	7384
Equities	Nasdaq	26.63%	12888	16320
Commodities	Brent Crude	50.154%	51.80	77.78
Commodities	Gold	-3.611%	1896	1828
Gilts	IE 10-yr	0.5490%	-0.300%	0.249%
Gilts	GB 10-yr	0.7650%	0.207%	0.972%
Gilts	US 10-yr	0.5800%	0.930%	1.510%

Please note that the % moves are in green if the metric has moved upwards and in red if it has moved downwards. It is NOT a statement as to whether this is a positive or negative move as one could be a borrower or depositor, a seller or buyer of currency, etc. Also, the % move for interest rates is in absolute terms while for currency and equities it is expressed in relative terms.

- Other than a plethora of green, the surprise was lower Euro short-term rates against an international backdrop of rising rates linked to rising inflation
- Economic trends were broadly positive but funded by huge government borrowings and Central Bank stimulus. Despite the pandemic, labour markets are very tight across many geographies and stock markets (as well as other asset classes) have been driven up by the availability of cheap money
- So who pays for this? And how will markets react to money supply starting to contract? And will the beneficiaries of such asset price inflation pay the price when the correction comes?
- Irish banking market review announced by Minister for Finance. Lack of competition becoming an obstacle to businesses and consumers?
- Finally, the geopolitical landscape looks as poor as it has been for some time.

1.2 Forward-looking Indices

Forward-looking indictors known as Purchasing Manager Indices or PMIs are useful to monitor the economic outlook for Ireland and the UK. Readings above 50 indicate expansion while below 50 denote contraction.

- Indicators, in general, remain in positive territory
- However, Irish Services PMI figure has fallen gradually since July and, with one exception, Manufacturing PMI is trending down since April
- And the UK trends are not dissimilar.

Table 2. Irish and UK PMI readings

Variable	Ireland	UK
Manufacturing PMI	58.3	57.9
Services PMI	55.4	53.2
Construction PMI	56.3	55.5

1.3 Economic Forecasts

- EU
  - 2021 – 14.6%
  - 2022 – 5.1%
- ESRI
  - 2021 – 13.6%
  - 2022 – 7.0%
- AIB
  - 2021 – ?% (saw 8% but looks too low)
  - 2022 – 5.5%
- Davy
  - 2021 – 15.5%
  - 2022 – 7.6%
- Bank of Ireland
  - 2021 – 16.0%
  - 2022 – 7.5%.

GDP is a somewhat crude measurement in Ireland due to the open economy. GNI or modified domestic demand are better measures although the latter is still in the 5%+ range for 2022 according to most of the above.

The bottom line is that Irish growth is expected to outperform most countries and the Eurozone in 2022. The growth rate is still expected to be above 3% in 2023.

It is probably fair to say that the forecasts assume continuing (albeit decreasing) government supports in 2022 and an improving pandemic outlook due to vaccinations rates, boosters and anti-viral drugs.

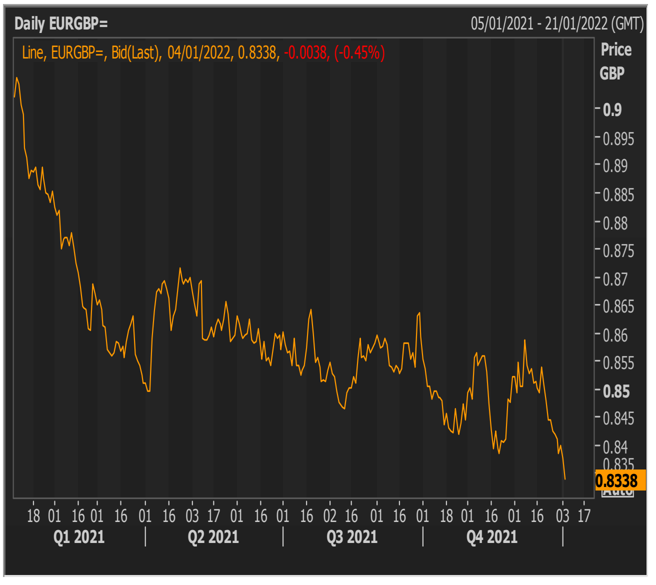
Strong demand, low unemployment and recent inflation all point, in our opinion, to higher costs across the board in 2022 which could eventually impact on wage rates.

2. Foreign Exchange

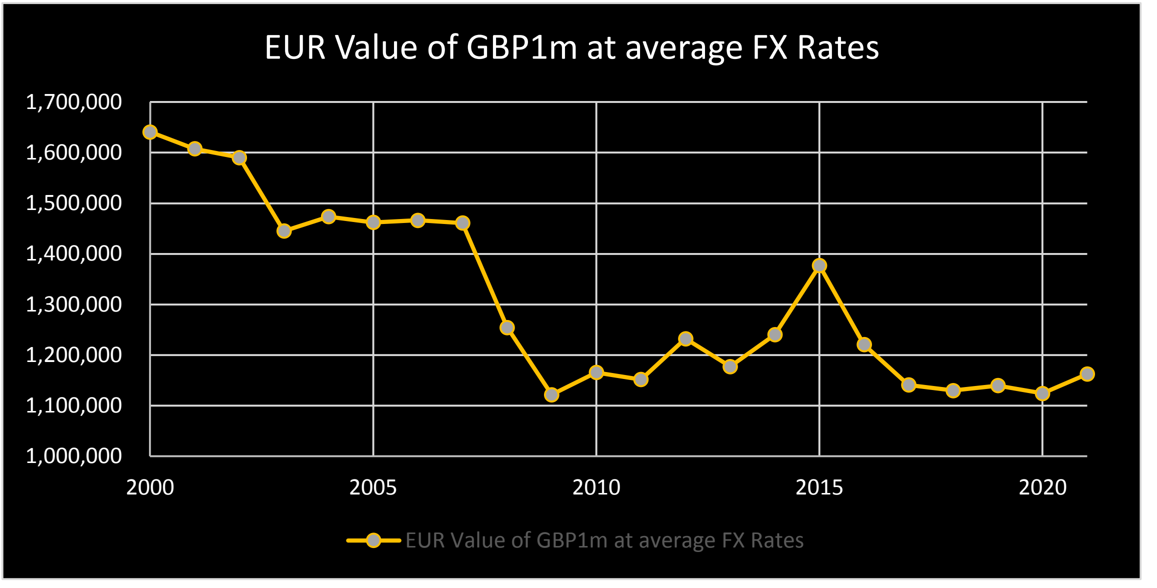
2.1 EUR/GBP

- The 2021 trend in Graph 1 below shows a strengthening channel over the course of the year since the end of Quarter 1 2021
- The rate had traded to the top and bottom of the channel and bounced off both
- The current range/channel below being EUR/GBP0.8340 to EUR/GBP0.8580
- So, it was finally was a good year for exporters to the UK after a couple of tough years on the currency front
- Current rates were last seen in February 2020 and reflect where rates were at in July 2016 just after the Brexit vote. So, we have come full circle in that respect
- The current period of strength is an interest rate expectation play – UK rates are expected to rise faster than Eurozone rates leading to better yields on GBP assets
- Political risk remains high in the UK. We still think that Boris Johnson is in trouble but the impact of his demise could be positive or negative for GBP!
- Graph 2 overleaf shows how, using the average exchange rate for each year, the value of GBP1m has fallen dramatically in EUR terms since the inception of the EUR.

Graph 1. EUR/GBP: 2021 trend



Graph 2. EUR value of GBP1m at average FX rate: 2000-2021



The above graph is important as unless an exporter has GBP costs, the loss in value of revenue flows straight to the bottom line! The annual changes are both material and stark.

2.2 EUR/USD

- Graph 3 is the 5-year trend in EUR/USD
- The 2021 high/low range in EUR/USD was 10.42% which is approximately 3% below the average over the past 20 years. Analysis of the high and low trends over the past 21 years shows that 75% of the annual highs and lows have been experienced in Quarters 1 and 4 so take note
- USD, similar to GBP, has probably benefitted (versus EUR) due to different interest rate trends and expectations, linked to inflationary pressures. It is difficult to see the latter changing in 2021 in the US given the planned (large) government stimulus programmes
- This would be good for exporters to US (and currencies linked to USD such as the Gulf States) but would be negative for the price of oil/energy and other commodity prices and other inputs that are derived from petrochemicals
- The 2021 strengthening trend bottomed out in November and has been in a tight range around EURUSD1.1350 since. 2022 direction will continue to be influenced by interest rates. Given that we think that inflation will likely remain high, supported by US government spending, the risk (for now) would appear to be on the strengthening of USD. Mid-term election results will likely impact also later in the year.

Graph 3. EUR/USD: 5-year trend

3. Interest and Economic Review

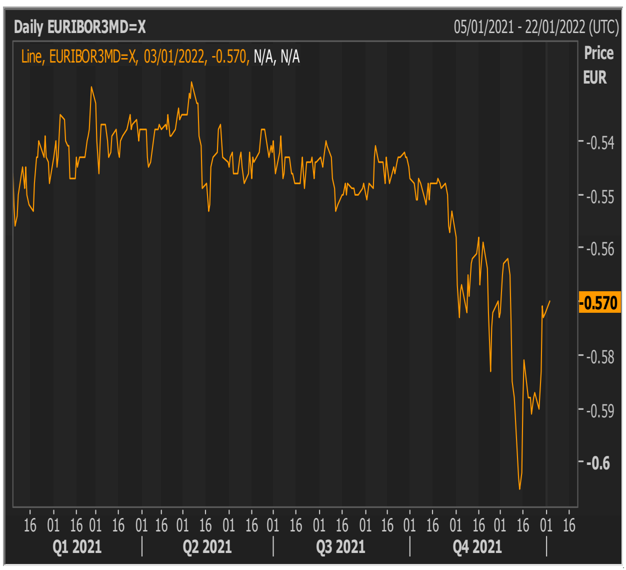
3.1 EUR Short-term Rates

The Euribor rate that we continue to monitor for the purposes of this bulletin (as it is the most relevant one for variable rate debt) is the 3-month rate.

Key Observations

- 3-month rate has remained surprisingly low during 2021 hitting a new all-time low of -0.605% in December
- The benefit of such low rates has not transferred to borrowers as Irish banks have maintained their cost of funds at zero at best (although they have charged negative rates on deposits)
- Rate has been below zero since April 2015!

Graph 4. 3-month Euribor: 2021 trend



3.2 EUR Medium-term Rates

- 3-year swap rates are a better indicator of the future direction of interest rates
- Unsurprisingly, similar to other currencies, this rate has climbed off lows from the start of the year. The rate climbed to -0.08% in October and having eased back to the end of the year, it is now rising again
- Graph 5 (5-year trend) seems to clearly show that the low point of this cycle has been reached and that we are now in an upward trend again
- The upward pressure is less pronounced than in the US and UK as Eurozone inflation has been more benign to date. But the ECB won't maintain bond buying at current rates into 2022
- This rate is 15bp higher in the past 3 weeks. Another move of that magnitude would bring it into positive territory (above 0%) for the first time since December 2018.

Graph 5. EUR 3-year swaps: 5-year trend

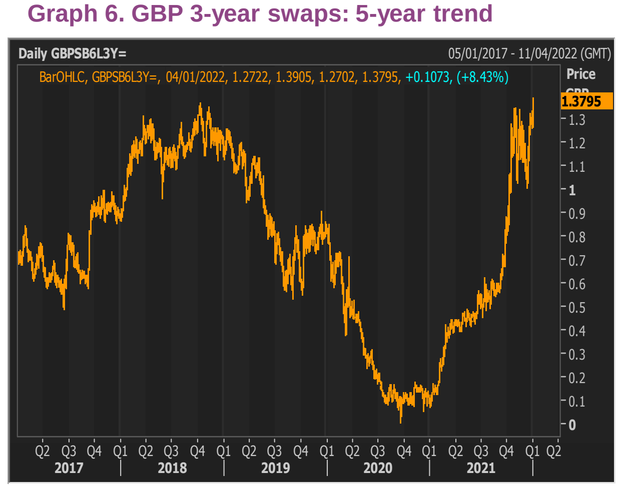
3.3 Summary

- We have been more bullish than others on the inflation outlook since the middle of last year. EUR rates likely to be heavily influenced by inflation and QE trends and we don't see inflationary pressures as transitory right now
- If, as currently appears to be the case, the pandemic will peak and then abate over the coming months, especially with anti-viral drugs coming on to the market, then consumption ought to hold up
- All this suggests potential for surprises on the upside.

3.4 UK and US Interest Rates

- Bank of England hiked by 15bp at the last meeting of 2021
- As Graph 6 below shows, the 3-year rate rose from 0.15% in January to 1.27% by year-end (and 1.43% since)
- And, as we have said before, this is the rate that moves 9 months+ before Central Bank moves short-term rates
- EUR borrower need to note as a result.

Graph 6. GBP 3-year swaps: 5-year trend



Graph 7. USD 3-year swap rates: 5-year trend

- US rates bottomed out before the UK and Eurozone – US 3-year rates hit their low point in July 2020
- This rate has jumped from 0.20% then to 1.29% currently (very similar trends and levels to the UK except over a longer period)
- The US inflation rate increases have been faster and higher than other established economies (+6.8% in November was last seen in June 1982) – see below in Graph 8. The language of the Fed is also now changing with less emphasis on the "transitory" nature of inflation
- A good article by Constantin Gurdgiev in The Currency recently highlighted that in November, the US Treasury issued inflation-indexed savings bonds at 7.12%. The previous issue in May 2021 was at 3.54% while the November 2020 issue was priced at 1.68%

Graph 8. US inflation: 25-year trend (source: www.tradingeconomics.com)

3.5 Summary

- **Rate hikes have started in the UK and are now seen as inevitable in the US in 2022**
- **Sterling LIBOR has now disappeared from 1/1/22 – the replacement methodology is more complicated with the rate not known until the end of, say, a 3-month period as opposed to at the start of it**
- **Impact of higher interest rates?**

I. Higher cost of funding (and cost of capital)

II. Proportional increase of a small % hike is large (as current rates are so low)

III. Interest-related financial covenants become more difficult to meet

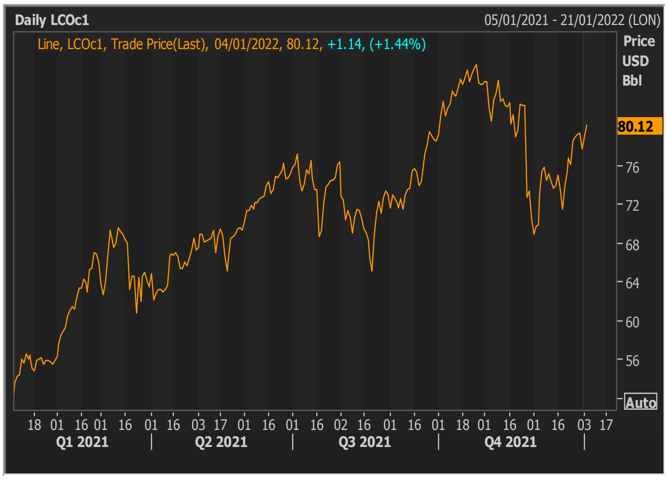
IV. Probable knock-on impact on rents – impact on mortgages not clear as although it makes them more expensive reducing affordability (absent wage hikes), the key issue in Ireland is supply / demand imbalance. A reduction in credit availability will probably mean more houses and apartments sold to institutional investors as they can always access capital more easily

V. Ramifications for pension funds and wealth management (impact on other asset classes including equities and bonds).

4. Wealth Management

4.1 Oil

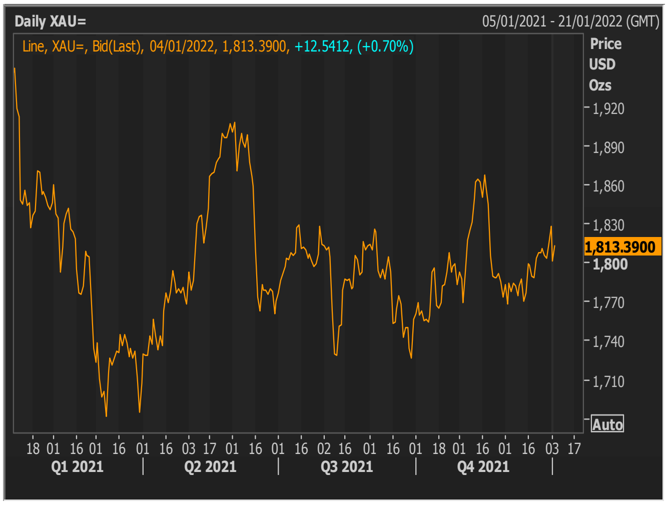
Graph 9. Oil prices: 2021 trend



- Mad year for oil prices – year-end level of almost $78 was 50% higher than at the start of the year…and the rate has since moved to $82
- Irish business has been hit by a double whammy of high oil prices and a stronger USD – price increase in EUR over the year was 62%!
- Looks very much like an asset class being driven by speculators as impossible to relate price trends to supply/demand dynamics
- Possible to fix prices on diesel, etc. but need to manage this carefully if considering it.

4.2 Gold Price Trends

Graph 10. Gold prices: 2021 trend

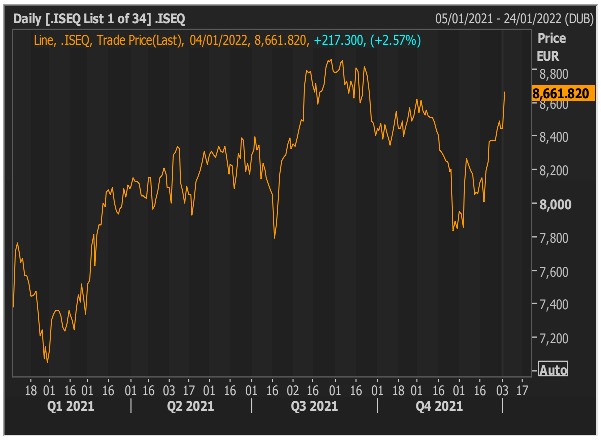


- Gold price has come off highs of last year ($2,063) as the "safe haven" play has not been required as much in 2021
- But with question marks continuing over how long high asset prices can last, worth keeping an eye on this for another while.

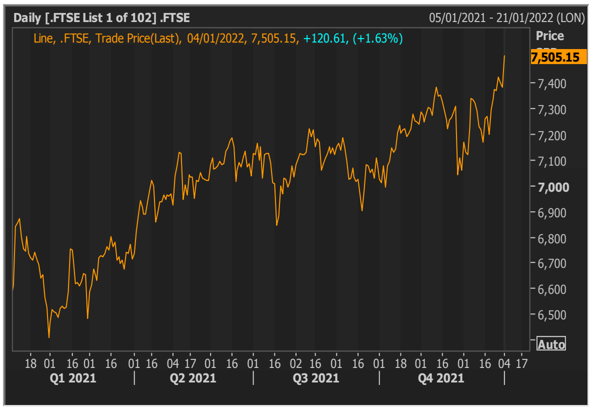
4.3 Equity Markets

- Generally good year for the stock markets (ISEQ, FTSE up 14%)
- Tech did particularly well (Nasdaq up 26%)
- But bumpy start to 2022 (Nasdaq off 3.3% by January 5th)
- We are still waiting for the correction…...

Graph 11. ISEQ: 2021 trend



Graph 12. FTSE: 2021 trend



Graph 13. NASDAQ: 2021 trend

5. 2022 Radar

5.1 Looking Back

We picked 5 trends to watch this time last year:

1. Year of the Deal
2. ESG (Environmental, Social, Governance)
3. Is there such thing as too much money in circulation?
4. Inequality
5. Is Capitalism as we know it dead? Politics and Big Government to the fore?.

Outcomes?

- Bloomberg cited 2021 as the biggest year for M&A activity
- ESG was very much to the fore in 2021. ESG funds had attracted $649bn to end of November versus $285bn two years earlier. ESG World Leaders index was also up 22% to end November versus 15% for World Leaders Index (per Refinitiv)
- We are still asking is there too much money in circulation. As you know we monitor options in this space i.e. are people hedging against market falls by buying put options (the right to sell). Reported in November 2021 that the notional value of daily single-stock options exceeded the value of daily stocks traded (per CBOE)
- The World Economic Forum reported in December that Covid has exacerbated existing inequalities – it has consequences, usually political initially
- Geo-politically, the world is probably more unstable than it has been for years (we recommend, again, reading "The Power of Geography" on this topic). The scale of government borrowing and Central Bank printing of money is enormous. Total assets held by the US Fed was below $3 trillion in 2013. It broke through $8 trillion during 2021.

5.2 Looking Forward

1. Something gives in 2022. But what?
NFTs? Meme stocks? Cryptocurrencies? Do you understand them? Will their values hold if/when Central Banks reverse their easy money stance? The last time that this feeling was in the gut was in 2007. Same feeling now that something will crash but there are so many asset bubbles that picking the first one to go is a needle in a haystack exercise. Last time around it was sub-prime mortgages. The returns were too good to be true.…..(we didn't know much about them in 2006…we knew plenty by 2008!). But there will be an asset price crash of some type in 2022.

2. Regulation
This is allied in some ways to the previous point. The banks appear to be well regulated, one could possibly say overregulated. This is one of the reasons why Irish mortgages are cited as being expensive versus other countries (legacy of capital requirements of the last financial crisis). Keeping up with fintech and other developments is a challenge - are they too focused on banks as it's easier to monitor them? Has it worked? Article in the FT on October 25th listed the number of "bumps" on the road for Credit Suisse since 2014 including payment of $2.6bn fine for aiding US clients to evade taxes (2014), fine of $5.3bn for alleged misselling of mortgage securities (2016) and the Greensill ($3bn) and Archegos ($4.7bn) losses in 2021. While some were legacy issues, the 2021 events were not. Regulatory issues could blow up in 2022…but it tends to make matters worse for banks, the innocent suffer as well as the guilty. It also applies in other areas – IORPS II will bring tighter regulations to pension funds, legal burdens on directors continue to increase, etc. Ironic that this is deemed necessary at the same time that good governance is supposed to be a high priority for all.

5. 2022 Radar

3. Irish Business Banking

This is likely to be a challenging year for a few reasons. Firstly, competition is almost non-existent. Secondly, redundancy programmes could lead to a shortage of lending staff – banks downsize to a staff level that they expect to be in line with their business activity in 5-10 years time. The problem is that they can reduce their headcount quickly but their business activity reduces over time…leaving smaller teams to deal with "outsized" number of clients for a period of a few years. Thirdly, losing "grey hairs" may be cost-efficient but it also results in a brain drain. Younger relationship managers will learn over time. But it takes time. Fourthly, there is a drive to commoditise lending in the business banking sector (loans up to €10m). This, again, is driven by cost. But this sector is also very important socio-economically. It is the likely engine for indigenous growth over the coming years. Poor/slow lending can create a financial disadvantage for Irish firms vis-à-vis their international competitors.

The likely consequences of this will be slower lending decisions, higher costs and reduced flexibility. The implications for borrowers are to:

- Start discussions as early as possible
- Identify the right people in the bank to deal with (it varies within and between banks)
- Focus more on documentation than pricing – get as much commercial flexibility as possible into your terms and conditions and
- Treat financing arrangements as a strategic imperative. Assume the economic backdrop will deteriorate and approach your negotiations in that frame of mind.

The real threat is from Big Tech, should that sector decide to (be allowed to?) compete in this space. To put them in perspective, Apple has a AAA credit rating. There is no commercial bank that we are aware of that has a similar rating (some State-owned banks have the credit rating of their State which could be AAA).

The top 15 non-financial companies in the S&P 500 had more than $1trillion in cash and investments at the end of last year, accounting for almost 40% of the cash held by the S&P500. They have the cash – can they get the momentum?

4. Swing back from the East?

Asia-Pacific banks, driven by China, account for 55% of global banking profits, up from 43.5% a year earlier. But Evergrande defaulted on debt which is estimated at $300billion. So, we could see a pullback from investment in this geographic area. There is anecdotal evidence that supply chains have also moved sourcing from China to other Asia-Pac countries and closer to home. And, of course, political developments are not helping matters either. At what stage is there trouble in the autocratic communist system in China? The population is better off and better educated than ever before. This would suggest a clash between the political system and the populus at some stage. Supply chain changes will present opportunities for Irish companies but productivity and market development will become more important as a result.

5. Inflation

We have already covered it off in the bulletin but this is likely to be a big news story in 2022 partly due to its absence for so long but also due to its ability to impact on interest rates, currencies, wages, stock markets etc. Understanding the interrelationships between all of these variables will be important for companies this year. This also implies that the downstream effects cold be material so it will be the catalyst but that manifest itself in many ways.

6. ESG

Can't get away from this. Firms will need a sustainability policy so you might as well start doing something abut it.