THE TREASURY HUB
Banking and Treasury Markets Bulletin

March 2022

1. Executive Summary

1.1 Introduction

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

This represents a review of the past month and, in Section 5, we have a look at the 2021 results of the three main banks.

The past few weeks have been dominated by the invasion of Ukraine by Russia. The resultant loss of life, physical destruction of the country and creation of a huge refugee crisis in Europe seems almost unimaginable….except it has happened. Talking about financial and economic matters is trite against that backdrop but the event has and will have an impact on all of our lives to varying degrees in the weeks and months ahead. And yet the response at both human and corporate levels has been swift and widespread across the western world, including in Ireland. Adversity can often bring the best out in people…but it would be much more preferable to have avoided the adversity in the first instance. The innocent always suffer the most. I'm sure we can all play our part in a variety of ways in both the short and medium-term. Small efforts by a large number of people can have large positive effects.

- The impact of the crisis has been immediate in two areas: food and energy.
- Oil has jumped in price with Brent Crude hitting almost $140/barrel last week
- Wheat has jumped from $850 to $1252 in just over a week on the CBOT
- And all of this will feed into inflation, slowing economic growth whilst also creating a dilemma for central banks and interest rate management.
- Throw in the cost of sorting out the refugee crisis and assisting, hopefully, in the resolution of the conflict and rebuilding of Ukraine and 2022/23 will be challenging.

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

Table 1. Key Metric Movements: 2022

Heading	Metric	YTD move	From	To
Interest	3-m euribor	0.04%	-0.5720%	-0.5330%
Interest	EUR 3-year	0.23%	-0.1500%	0.0800%
Interest	GBP 3-year	0.36%	1.2722%	1.6360%
Interest	USD 3-year	0.40%	1.1512%	1.5500%
FX	EUR/GBP	-0.84%	0.8400	0.8330
FX	EUR/USD	-3.68%	1.1368	1.0965
Equities	ISEQ	-16.06%	8444	7088
Equities	FTSE 100	-3.13%	7385	7154
Equities	Nasdaq	-17.31%	16320	13495
Commodities	Brent Crude	42.710%	77.78	111
Commodities	Gold	8.425%	1828	1982
Gilts	IE 10-yr	0.6510%	0.249%	0.900%
Gilts	GB 10-yr	0.5180%	0.972%	1.490%
Gilts	US 10-yr	0.4700%	1.510%	1.980%

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. **PLEASE NOTE THAT INTEREST RATE TRENDS ARE FROM A DEPOSITOR PERSPECTIVE.**

ALSO WE HAVE MOVED OIL AND CARBON INTO SECTION 2.

- EUR short-term rates remain fairly static for now although action by the ECB (slowdown/stalling of bond purchases) will likely see this rise over the course of the year. **Expect Irish banks to increase variable rate cost of funds in 2022.**
- Economic trends remain broadly positive but funded by huge government borrowings and Central Bank stimulus. Labour markets are very tight across many geographies.
- All of this is expected to drive currency volatility in 2022, more so than in previous years.
- But leverage levels appear to vary from country to country - this will be important in the coming months and years in the context of rising interest rates. Geopolitics dominated by Russia/Ukraine tensions.

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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
- Irish Services PMI bounced back strongly in February as did the Construction reading although Manufacturing went into reverse
- UK trends were also broadly positive.

Table 2. Irish and UK PMI readings

	Ireland	UK
Manufacturing PMI	**57.8**	**58.0**
Services PMI	**61.8**	**60.5**
Construction PMI	**56.1**	**59.1**

1.3 Inflation

Table 3. Selected Inflation Rates

	CPI	Producer Prices
ROI	**5.6%**	**3.5%**
EUROZONE	**5.8%**	**30.6%**
UK	**5.5%**	**9.9%**
US	**7.9%**	**9.7%**

Producer prices going through roof in the eurozone and this was a January reading driven by energy costs. February figures will be worse again.

We started to monitor this as it has a wide-ranging impact. Similar to tracking gold prices a few years ago in this bulletin, it looks like it was a timely decision.

Energy prices will drive these figures much higher in the coming months (see Section 2 for graph of oil prices). As previously noted, food prices are key to watch as hikes in this variable almost inevitably lead to higher wage demands. We have included a graph of wheat prices in Section 4 this month to show the huge rise in this in the past week as Russia and Ukraine both produce large amounts of this plus Russia produces a lot of fertilizer used in Europe. Lower fertilizer usage results in lower yields…which pushes prices higher again.

With economic growth bound to suffer adversely from the conflict in Ukraine, all of this increasingly points to stagflation – higher inflation with stagnant growth and this will cause problems for Central Banks. Higher interest rates slow down inflation…but also slow growth. Tricky period for all of us ahead on a number of fronts.

2. Foreign Exchange, Oil & Carbon

2.1 EUR/GBP

- The 24-month trend in Graph 1 below shows arge volatility in 2020 as Brexit issues loomed large but, equally, a strengthening channel since Brexit was removed from the equation as far as the financial markets are concerned.

- The current range/channel below is EUR/GBP0.8220 to EUR/GBP0.8550.

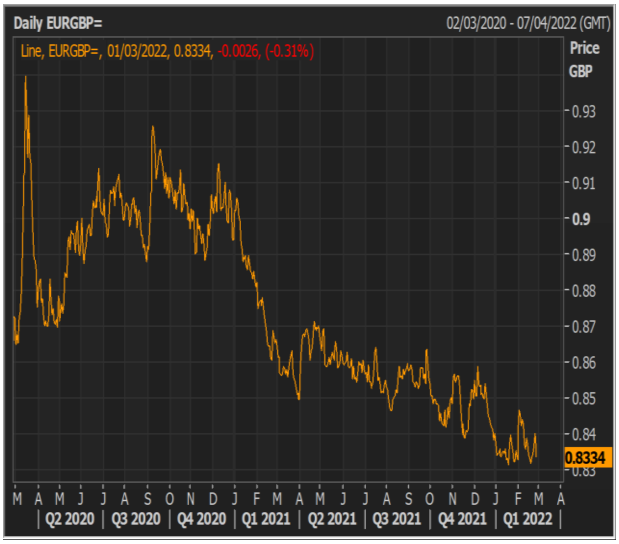
- The average rate also continues to fall. The war in Ukraine put pressure on the EUR with the currency falling against most of the majors.

- **As we noted last month, the strengthening of GBP delivers extra profits to exporters to the UK which may be useful in offsetting other higher costs.**

- And while we previously noted that the current period of strength was a combination of elimination of Brexit uncertainty plus an interest rate expectation play (UK rates expected to rise faster than Eurozone rates), the outlook for all currencies in the coming weeks is very uncertain due to the economic impact of the conflict, the likely time period for higher inflation as a result of it (on top of already emerging price pressures) and the reaction of Central Bank monetary policy to all of these.

- For now, the only beneficiary in all of this has been Boris Johnson as events have taken the focus away from his domestic political issues.

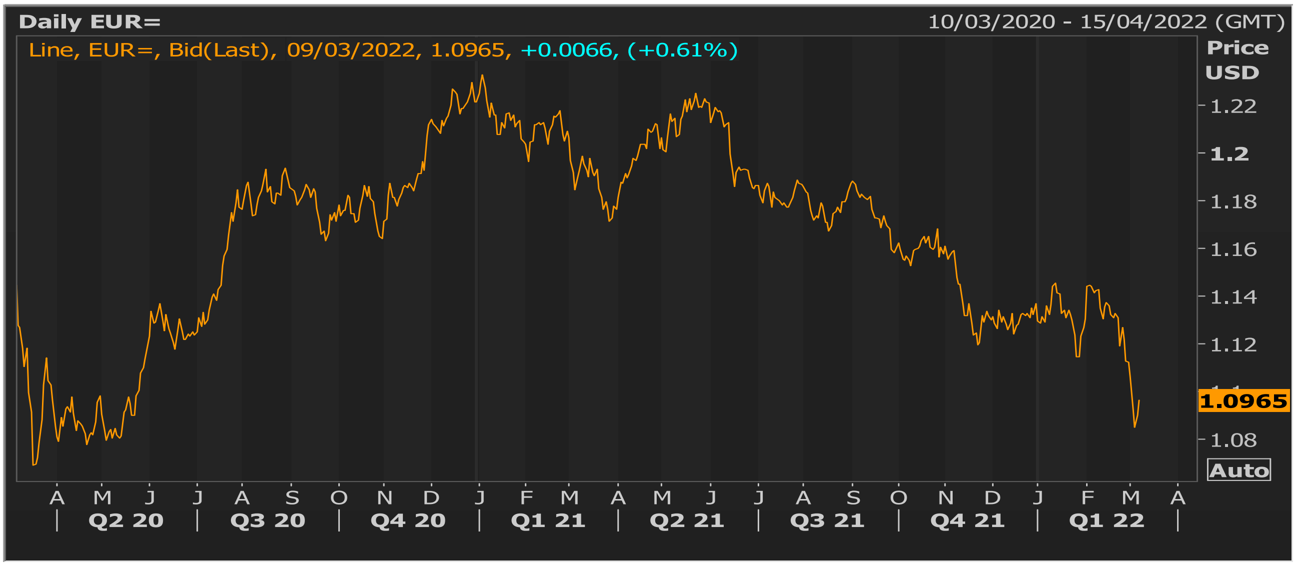
Graph 1. EUR/GBP: 24-month trend



2.2 EUR/USD

- Graph 2 is the 24-month trend in EUR/USD
- This currency pair tends to ebb and flow quite a bit
- Most companies are exposed to this indirectly even if not buying or selling in USD. Most commodities and fuel are USD-based. And, as petrochemicals are an input into many industries, the knock effect is also large in the supply chain.
- USD has benefitted (versus EUR and others) since the war started in Ukraine from its safe haven status – the high /low spread of 2022 is already 6.4% (EUR/USD1.1495 to EUR/USD1.0804)
- How it plays out in a “stagflationary” environment remains to be seen.

Graph 2. EUR/USD: 24-month trend



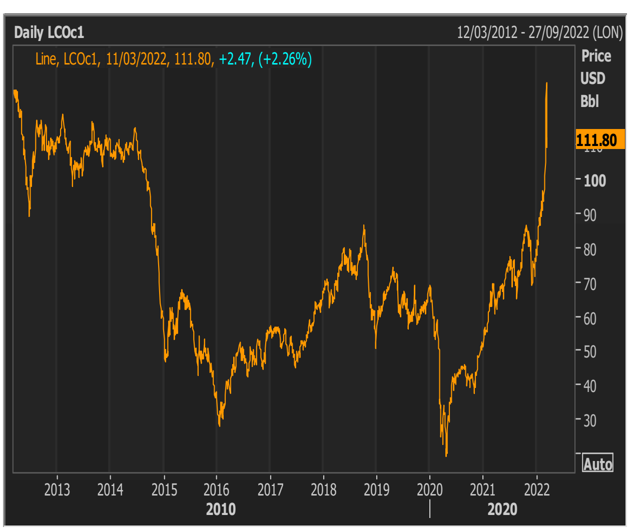
2.3 OIL & CARBON

We will look at these separately from now on as (i) oil prices have a wide impact on business and (ii) the cost of carbon credits is now a real cost and, because speculators have been pumping money into this as an asset class, it has been very volatile.

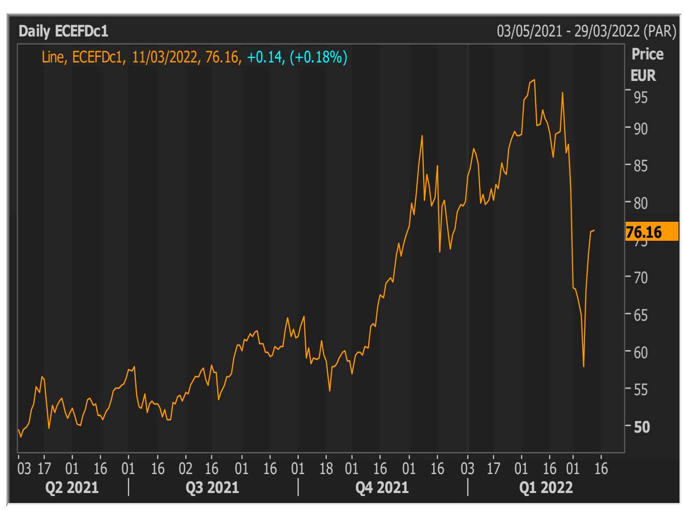
Oil prices impact directly business via energy and distribution/logistic costs but also indirectly through any input that is petrochemically-based and also impacts on standards of living thereby impacting on employee wage demands. The impact of these, in turn, varies by industry (less impact for services compared to manufacturers?) and for employees depending on their pay scale: food and energy costs impact disproportionately on those on lower pay and, indeed, on those dependant on social welfare.

Both Oil and Carbon can be hedged, the former through fixed price arrangements although there are some related considerations. We will follow these closely in 2022.

Graph 3. Brent Crude: 10-year trend



Graph 4. Carbon: 2-year trend



3. Interest and Economic Review

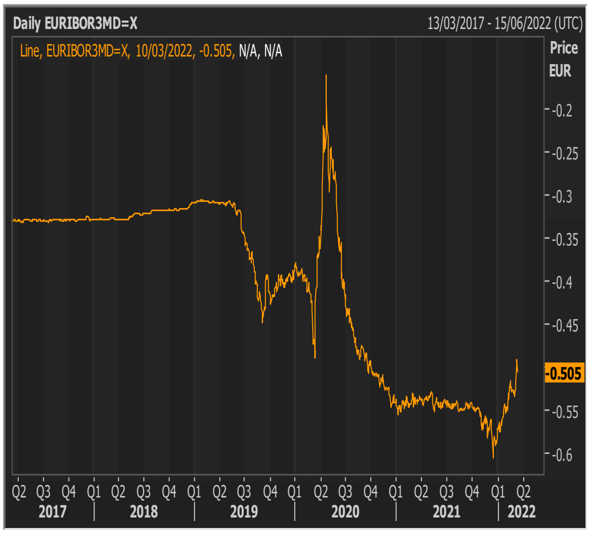
3.1 EUR Short-term Rates

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

- As we have mentioned on numerous occasions before, the 3-month rate is NOT the one to monitor for the future direction of interest rates
- However, it drives the pricing of variable rate loans (which have been “floored” at 0% by the banks rather than passing on negative rates, for the most part) for 5+ years now
- This will be driven by ECB actions on money supply and the ECB Base Rate
- Expect this rate to possibly move into positive territory by December 2022 but as banks in the Business Banking area are pricing their cost of funds at circa 0.50% above the 3-month rate, **the variable rate cost of borrowing will start increasing in the near-term**
- **Please note that in the past few days the rate has moved below -0.50% and ECB has announced the end of quantitative easing.**

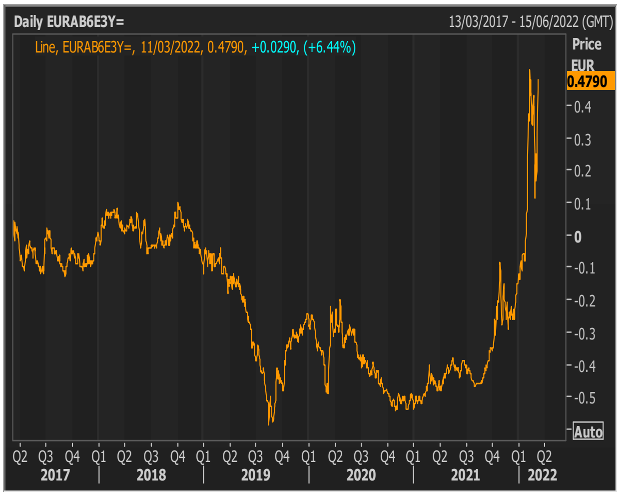
Graph 5. 3-month Euribor: 5-year trend



3.2 EUR Medium-term Rates

- 3-year swap rates are a better indicator of the future direction of interest rates
- This rate continues to climb from 0.09% last month to a current level of 0.50% after a brief dip last week due to developments in the Ukraine
- This more recent move may have been as a reaction to increasing inflationary pressures
- **But we reiterate what we said last month, we are past the bottom of the interest rate cycle - see Graph 6.**

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



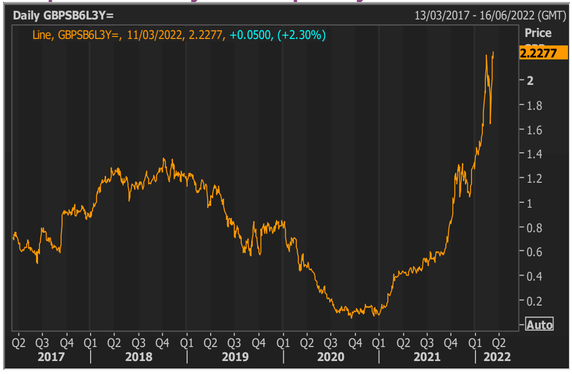
3.3 Summary

- Business has benefitted from abnormally lower interest rates for a decade now and that always leads to a risk of complacency i.e. that rates will remain low for the foreseeable future
- The first matter to recognize is that the optimal strategy of fixing at 0% (ex margin) for as along as possible has passed. And it is unlikely, at this juncture, to return again
- The inflation outlook along with the length of the Ukraine conflict are now the key drivers of future interest rate trends
- And, as already referenced, there is a real prospect of stagflation (stagnant growth, high inflation) being a core trend of 2022 and beyond.

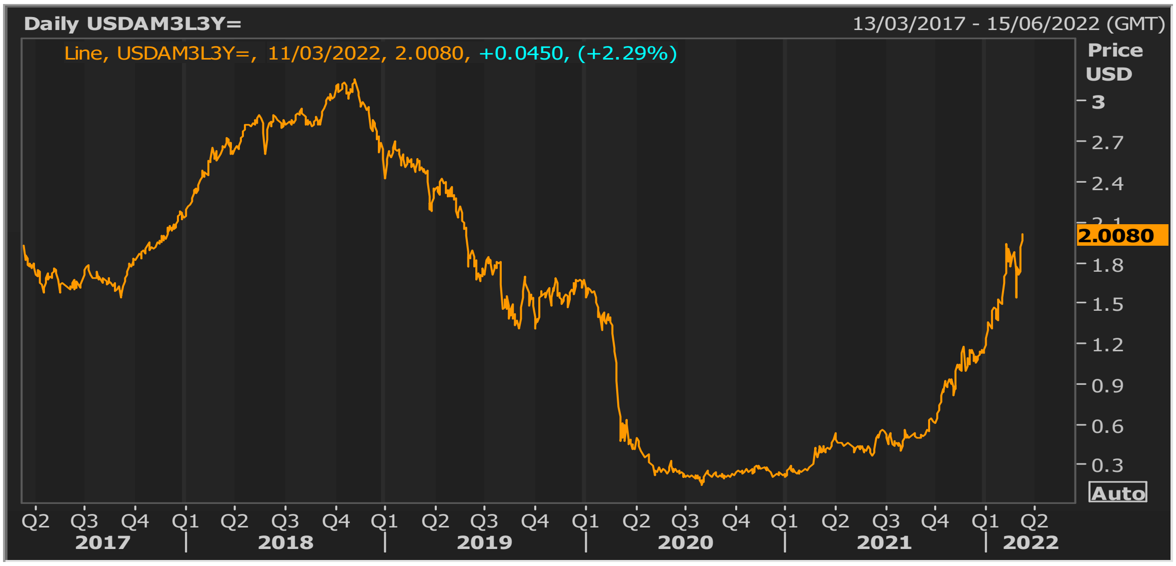
3.4 UK and US Interest Rates

- Although the Bank of England has commenced hiking the Base Rate, the real story is the trend in fixed rates
- The 3-year rate rose from 0.15% this time last year to 1.27% by year-end and 2.22% at the date of drafting this bulletin. That’s a 2.0%+ move in 12 months
- Current levels were last seen in 2011
- **EUR borrowers really need to note this trend as a result as the UK cycle is ahead of us.**

Graph 7. GBP 3-year swaps: 5-year trend



Graph 8. 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 1.17% by year-end to over 2.00% currently
- As highlighted in Section 1.3, US inflation rate increases have been faster and higher than other established economies (+7.9% in February was last seen in 1982)
- Views on the number of rate hikes in the US by the Fed in 2022 vary with the range increasing upwards (up to nine straight hikes now being called by JP Morgan)
- This large difference of opinion revolves around how high inflation will go and for how long will inflation persist
- But, as mentioned earlier, the worry emerging now is one of stagflation – higher inflation with little/no economic growth.

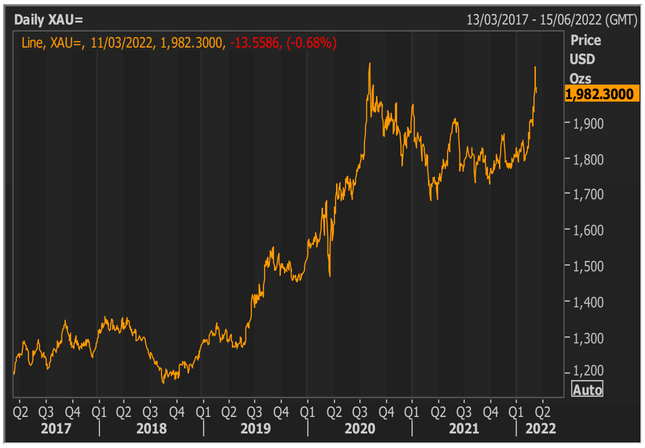
3.5 Summary

- **Last month we stated that we strongly recommend that this is now prioritized as an area of attention for the first time since we started publishing this bulletin**
- **Base rate hikes in the EUROZONE have now been placed firmly on the agenda with Commerzbank calling two 0.25% hikes by year end which would bring an end to negative deposit rates if passed on to customers by banks**
- **The number of US rate hikes is being touted as being up to 7 times based on current financial market views**
- **Sterling LIBOR has now disappeared requiring the use of an Alternative Reference Rate from 1/1/22. Most to date are using backward compounding SONIA**
- **USD Libor ceases to be used until 30 June 2023**
- **And while the increase in EUR swap rates has been slower than in the UK and US, the pace of increase in the latter rates has been somewhat surprising, albeit hastened by the hike in energy and other commodity prices since the invasion of Ukraine**
- **PLEASE BE CAREFUL IN ASSESSING THE IMPACT OF HIGHER VARIABLE RATES ON YOUR FINANCIAL COVENANT COMPLIANCE. THIS NEEDS TO BE FOCUSED ON IN A SHARP MANNER FROM NOW ON.**

4. Wealth Management

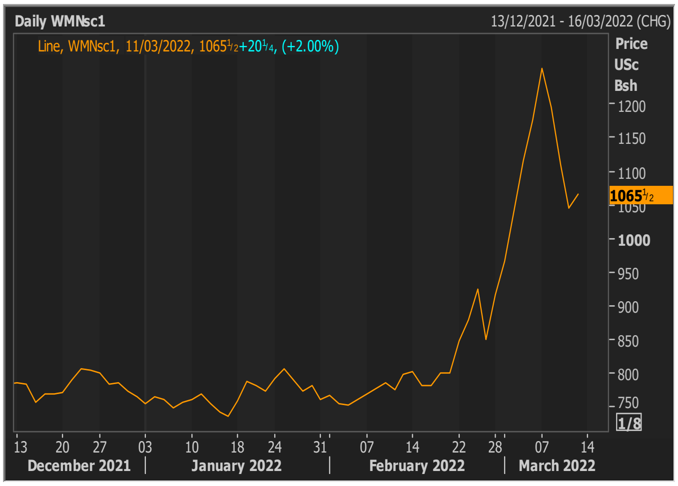
4.1 Gold/Weather

Graph 9. Gold prices: 5-year trend



- Gold price is holding relatively steady in early 2022 and has risen again over the past 3 weeks as the possibility of a recession increases. So, we will continue to monitor this as a "safe haven" play for 2022.

Graph 10. Wheat: 12-month trend

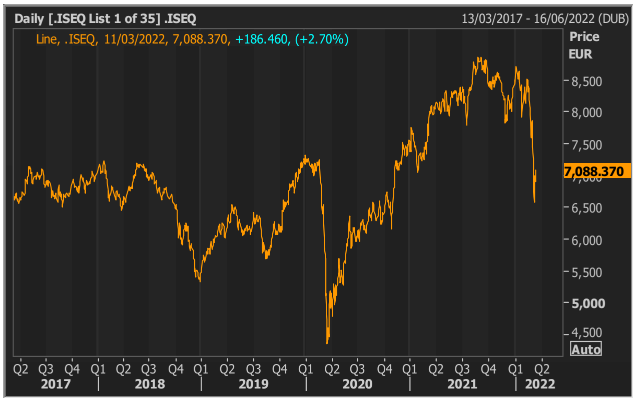


We will watch this for the remainder of 2022 as a bellwether for food pricing. The initial spike was huge and driven by the relative position of both Russia and Ukraine as grain producers. It appears that the Chinses winter harvest yields will not be great due to poor weather and with pressure on the production of fertilizer in 2022 due to gas shortages, there are a lot of reasons pointing to higher grain and food prices in 2022.

4.2 Equity Markets

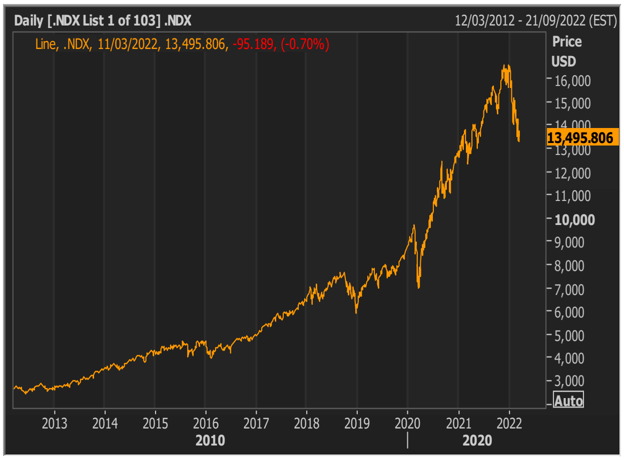
- Similar trends everywhere in global equity markets i.e. downward
- Tech looks like outperforming in a negative sense in 2022
- The hunt is on for growth and value stocks now and a move towards more defensive equites
- Whether the downward move is temporary or a longer-term trend remains to be seen but some else of defense in current portfolio management probably wouldn't go a miss to consider?

Graph 11. ISEQ: 12-month trend



Graph 12. FTSE: 10-year trend

Graph 13. NASDAQ: 10-year trend



5. 2021 Irish Banking Results

The three main banks issued results last week. We summarise the key headlines below.

Table 4. Summary Data

	BOI 2020	BOI 2021	AIB 2020	AIB 2021	PTSB 2020	PTSB 2021
Net Interest Margin	2.00%	1.86%	1.94%	1.58%	1.73%	1.51%
Cost/Income	64%	58%	64%	64%	73%	82%
Customer Loans (€bn)	77.0	76.0	59.4	56.5	14.2	14.2
Customer Deposits (€bn)	89.0	93.0	82.0	92.9	18.0	19.1
Loan to Deposit	86%	82%	69%	61%	79%	75%
LCR	153%	181%	193%	203%		274%
NSFR	138%	144%	148%	160%		170%
CET 1		16%	15.6%	16.6%	15.1%	15.1%
SME Lending ROI €bn	7.0	7.1	15.3	16.0	0.16	0.225

5.1 General Findings

- Net Interest Margins are falling. To maintain profitability, it requires higher levels of lending (price x volume=profits). The exit of Ulster Bank and KBC Bank Ireland plc will help to boost lending in the short term through the acquisition of parts of the loan and mortgage books
- However, this papers over the cracks to some extent as the core trend is downwards (see Graph 14)
- This is evidenced by the loan:deposit ratio. A 100% reading implies that the loan book is exactly funded by the deposit book (in broad terms). A figure of greater than 100% (which prevailed in the Celtic Tiger era) implies that banks need another source other than deposits to fund their loan book. In the past this was funded by borrowing from other banks in the interbank bank. The figures of all of the banks are well below 100% implying that their deposit levels are well in excess of their loan books
- The additional problem with this is that since the 2008 financial crisis, regulators have strict rules around liquidity
- LCR in the above table is the Liquidity Coverage Ratio which is designed to ensure that banks hold a sufficient level of high quality assets to survive a significant liquidity (cash outflow) stress lasting 30 days. It addresses funding risk over a short period of time
- NSFR is the Net Stable Funding Ratio and this measures the stability of funding over the medium term
- The practical implications of these is that holding higher levels of liquid assets means keeping them on deposit thereby incurring negative interest rates. This also explains, in part, why banks have been passing on these to customers in the form of negative rates that they charge on customer deposits
- The capital positions of the three banks is very strong. Based on these, even if there was another slowdown, their balance sheets appear to be in good shape
- A lot of the non-performing loans still relate to the previous financial crisis and are mortgage-related. Provisions made in 2020 relating to the pandemic were too prudent with writebacks of provisions for BOI
- Cost:Income is falling in BOI but rising in PTSB as the latter gears up for growth in its scale and lending
- **WE WOULD HAVE A CONCERN THAT ALL OF THIS WILL LEAD TO WORSENING CUSTOMER SERVICE, HIGHER COMPLAINTS AND LONGER NEGOTIATION TIME FOR SME LOANS.**

5. 2021 Irish Banking Results

5.2 Bank-specific Points

5.2.1 Bank of Ireland

- Underlying PBT of €1.4bn
- Expansion through acquisition of Davy and KBC portfolios
- Footfall in branches is down 36%
- UK business delivering higher margin and lower costs than ROI. 40% of loan book is in UK
- Of loan book of €77.9bn, SME/Corporate accounts for €20.8bn of which SME IS €8.6bn. ROI property development book is only €800m.

5.2.2 PTSB

- Acquiring €7.6bn loan book from Ulster Bank (450 staff may also move over)
- Underlying profit of €17m
- SME loan book is very low (new lending up from €48m in 2020 to €98m in 2021) of which wholesale/retail account for €24m
- But they say they have a €1bn fund available for SME customers over the next 3 years.

5.2.3 AIB

- Underlying PBT of €947m
- Pushing green lending as a core strength
- "Amalgamated" 21 branches with a further 22 now sales & advisory
- Reduction of 45 people in SME lending
- Sale of UK business completed with 8 branches also closed in Northern Ireland
- Integrating Goodbody Stockbrokers plus J/Vs with Great West Lifeco and on lease finance side
- Corporate and SME loan book of €18.7bn
- Property & Construction accounts for €7.4bn followed by €2.7bn on hotels, bars and restaurants.

5.3 Irish Lending Trends

Total lending to NFCS (non-financial corporations) has fallen from a peak of €144bn in 2008 to €31bn in January

Graph 14. Lending to Corporates in Ireland: 2003-2021