THE TREASURY HUB
Banking and Treasury Markets Bulletin

April 2022

1. Executive Summary

1.1 Introduction

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

This represents a review of the first quarter of 2022 and, in Section 5, we have a look at the implications of rising interest rates.

The invasion of Ukraine by Russia continues to dominate financial markets along with inflationary pressures. The latter were already building before the invasion but have moved higher due to increasing energy prices in particular.

Consumer confidence also seems to be taking a hit while faster and/or larger interest rate hikes are now increasingly mentioned due to the highest levels of inflation in decades. All of this is against a backdrop of a possible slowdown in economic activity which can have a "double negative" impact on businesses: higher costs and lower sales/profits. In this scenario, financial covenant compliance in any loan agreements suddenly take on significance – see Section 5.

- Oil prices remain high but Brent Crude has eased back to $108/barrel
- But large volatility has been experienced in other commodity markets e.g. gas and nickel
- And all of this against inflation figures that continue to reach new heights with more and more people asking are the various Central Banks too far behind the curve now?
- From a risk management perspective, it looks like the most volatile period in markets, financial and otherwise, since 2008 and, in some cases, since the 1970s
- Anybody thinking that "this too shall pass" in the near term would be well advised to reconsider this approach.

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	0.11%	-0.5720%	-0.4580%
Interest	EUR 3-year	0.95%	-0.1500%	0.7950%
Interest	GBP 3-year	0.99%	1.2722%	2.2600%
Interest	USD 3-year	1.46%	1.1512%	2.6150%
FX	EUR/GBP	0.26%	0.8400	0.8422
FX	EUR/USD	-3.44%	1.1368	1.099
Equities	ISEQ	-14.91%	8444	7185
Equities	FTSE 100	1.77%	7385	7516
Equities	Nasdaq	-9.08%	16320	14838
Commodities	Brent Crude	38.737%	77.78	107.91
Commodities	Gold	5.963%	1828	1937
Gilts	IE 10-yr	0.8150%	0.249%	1.064%
Gilts	GB 10-yr	0.6400%	0.972%	1.612%
Gilts	US 10-yr	0.8350%	1.510%	2.345%

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.**

- EUR short-term rates have started to climb in the past 4 weeks. **Increases in the variable rate cost of funds is inevitable now.**
- Economic trends starting to be mixed but the tightness in labour markets across many geographies remains with strong data from the US last week.
- Long-term interest rate increases are the key trends of the past month and, indeed, of Quarter 1.
- The outlook is not particularly rosy it has to be said: war in Europe for the first time in decades, a need to invest heavily in climate change and a general reversal in globalization all point to higher prices and slower economic growth.

Chris Ball
Corporate Finance Partner

T: +353 (0)90 6480607
M: +353 (0)86 6075012
E: cball@rbk.ie
W: www.rbk.ie

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 despite the Ukrainian situation
- Irish Services PMI holding up well as are the Construction and Manufacturing readings
- UK trends were also broadly positive
- We expect these to start easing back soon.

Table 2. Irish and UK PMI readings

	Ireland	UK
Manufacturing PMI	**59.4**	**55.2**
Services PMI	**61.8**	**61.0**
Construction PMI	**58.4**	**59.1**

1.3 Inflation

Table 3. Selected Inflation Rates

	CPI	Producer Prices
ROI	**5.6%**	**2.8%**
EUROZONE	**7.5%**	**30.6%**
UK	**6.2%**	**10.1%**
US	**7.9%**	**9.7%**

Producer prices remain high in the eurozone.

US inflation remains at its highest since 1982. Energy prices are up +25.6% but the food inflation reading of +7.9% is the highest since 1981 and that trend is worrying.

In the eurozone, inflation hit a new record high for the 4th month in a row with energy prices up 44% although food inflation also crept up by +5%. The rate of 7.5% is over three times the rate that the ECB targets. Irish inflation was predominantly driven by rising energy costs.

In the following sections we look at the price of oil and wheat but with countries talking about building stocks of the former and the war hitting the planting of the latter in Ukraine, it is difficult to see these prices coming down any time soon.

On the economic front, the WTO now sees trade growth in 2022 at only +2.5%, down from previous forecast of +5.0%.

2. Foreign Exchange

2.1 EUR/GBP

- The 24-month trend in Graph 1 continues to show 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/GBP0.8235 to EUR/GBP0.8510.
- The average rate, which fell steadily in 2021, has stopped trending in that manner and in April to date is actually rising above EUR/GBP0.8400. We will watch this trend as exporters to the UK have a very positive run since January of last year with the benefit falling to their bottom line.
- The interest rate section which follows in Section 3 will show that UK rates have risen much more steeply than Eurozone rates. And while we previously noted that GBP strength was a combination of elimination of Brexit uncertainty plus a UK interest rate expectation play, the outlook for all currencies in the short-term is unclear due to political events.
- We haven't noticed any major trend in UK exporters increasing their hedging timeframes but, equally, experience shows that exporters tend to react to adverse moves rather than take proactive measures.

Graph 1. EUR/GBP: 24-month trend

2.2 EUR/USD

- Graph 2 is the 24-month trend in EUR/USD
- This currency pair has been broadly USD-positive over the course of last year and into this year but has bounced off a recent low (i.e. strong USD) of EUR/USD1.0804, a level last seen in May 2020. This level reflected a move into USD as a safe haven currency in the immediate aftermath of the Russian invasion of Ukraine
- These moves suggest that it may be worthwhile leaving orders with currency providers if there is a hedging strategy documented and adopted
- As we have previously mentioned, businesses are impacted indirectly even if not buying or selling in USD as most commodities and fuel are priced in USD or in currencies pegged to USD e.g. petrochemical currencies in the Gulf.

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 have proven to be very volatile in 2022. By way of example, Brent Crude price has moved by 5% or more 10 times in 2022: the comparable figure for all of 2021 was 6 times (gas prices have been even more volatile with 60% movement in one day recently). Carbon prices have also jumped around recently as per the Graph below. This is an active market for corporates who need to purchase offsets so the volatility is a material risk.

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 before, the 3-month rate 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
- The graph below for the past 12 months shows how this is now starting to climb
- If this trend continues at this pace, then we could expect a move out of negative territory by the start of Q4
- **So BAD NEWS FOR BORROWERS - the variable rate cost of borrowing will steadily increase this year**
- **And, finally, some good news for depositors.**

Graph 5. 3-month Euribor: 12-month trend

3.2 EUR Medium-term Rates

- 3-year swap rates are a better indicator of the future direction of interest rates
- This rate has climbed since last August and is now firmly positive, breaking through 0.90% last week, and as can be seen in Graph 6, is at its highest level in 5 years (current levels last seen in 2013)
- **As a result, banks are reporting an uplift in the amount of firms that are starting to fix some debt**
- **The current yield curve suggests that this rate will climb by another 0.45% or thereabouts and level off in 2-3 years**
- **This looks optimistic to us.**

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

3.3 Summary

- The best that any borrower could achieve on fixed rates over the past few years was 0% for periods up to and beyond 5 years
- Today, variable rates at 0% would be a good deal
- In February we suggested "potential for surprises on the upside" on interest rates and this momentum has followed through, although rates have stablised for now over the past week
- But with the yield curve showing the 1% rate (pre-margin) only available for periods of 3 years maximum, the upward move has caught many by surprise.

3.4 UK and US Interest Rates

- Bank of England, having hiked the Base Rate to 0.50%, now look like moving by another 25bp soon
- As Graph 7 below shows, the UK 3-year rate is up by over 2% from 0.15% this time last year
- Current levels were last seen in March 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 dropped at the start of the pandemic as with interest rates in all jurisdictions
- However, the economic recovery in the US was faster than elsewhere
- As highlighted in Section 1.3, current US inflation rate of +7.9% was last seen in 1982
- And there is now talk of 9 straight rate hikes in the US by the Fed in 2022 with suggestions that some may be for larger than 25bp
- The economy continues to hold up well. Unemployment fell in March to 3.6% with the labour force participation rate also increasing to 62.4%
- But, as mentioned earlier, the worry emerging now is one of stagflation – higher inflation with little/no economic growth.

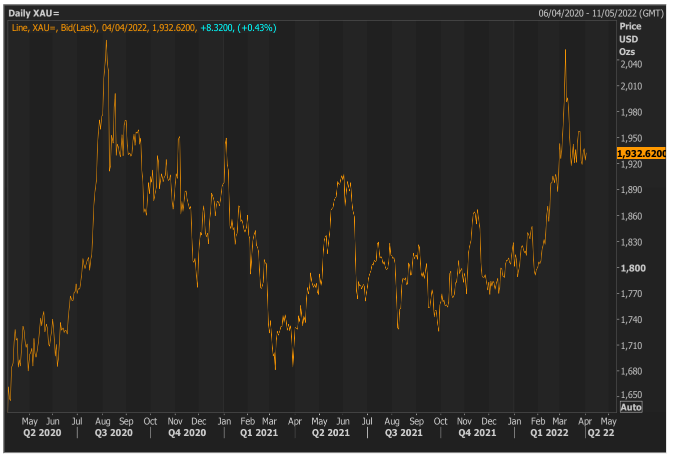
3.5 Summary

- **Base rate hikes are increasingly likely to be regular occurrences in both the UK and US for the remainder of the year**
- **From the Eurozone perspective, the question is : when will the first hike arise? The answer looks like it is “earlier than previously thought” with the start of Q4 now a real prospect (if not sooner)**
- **We have started to devise fixed rate debt strategies for clients as a result of the recent movements. There are matters to be aware of, financial and documentation, when fixing debt so please exercise caution**
- **It will also be necessary to assess the impact of rising interest rates (and slower growth?) on financial covenant compliance for those of you with loan agreements**
- **And rising interest rates mean that any new loan applications will need to address interest rate risk management of the loans**
- **So, we strongly recommend that this is now prioritized as an area for your attention – see Section 5.**

4. Wealth Management

4.1 Gold

Graph 9. Gold prices: 2-year trend



- Gold spiked as the Ukrainian war started (as a safe haven play). It has eased back since but, if stagflation fears become greater then this will probably come back into vogue.

4.2 Wheat

Graph 10. Wheat prices: 6-month trend

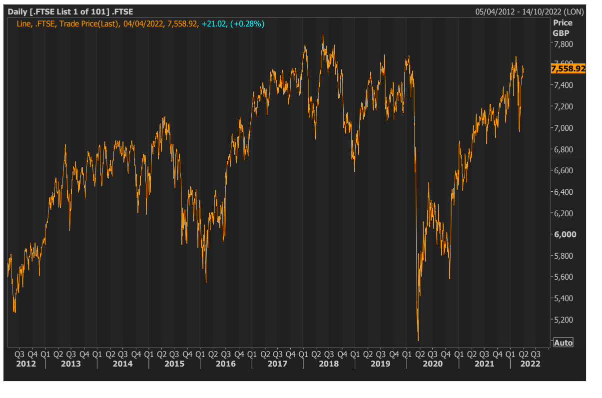
- The spike in this commodity price was attributed to the start of the war. The danger in this price having eased back is that it will start climbing again once there is better visibility on harvest volumes. We will continue to monitor as a result.

4.3 Equity Markets

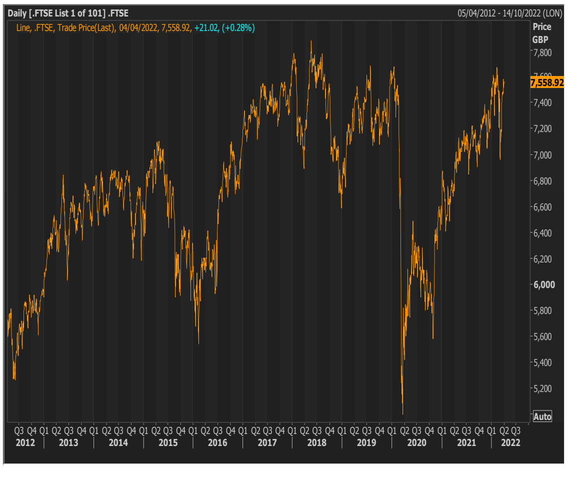
- Equities had a poor start to 2022 which was worsened by the Russian invasion of Ukraine
- However, all the main indices bounced back in March
- UK FTSE is actually up in the year
- Worsening economic outlook likely to keep lid on indices.

Graph 11. ISEQ: 10-year trend

Graph 12. FTSE: 10-year trend



Graph 13. NASDAQ: 10-year trend



5. Interest Rates

This is a topic that we have covered very little since the bulletin first issued.

However, given the recent increase in longer-term rates and the wide impact of rising interest rates we now touch on the subject in more detail.

The schematic below sets out how broadly interest rate hikes can impact on businesses, both directly and indirectly.

5.1 Financial Covenants

Interest costs are usually captured by either Interest Cover (ratio of Ebitda (or Operating Cashflow) to annual interest charge) or Debt Service Cover (ratio of Operating Cashflow to annual principal plus interest repayments). Two traits in particular to watch for here:

(i) The proportional increase in interest costs associated with small rate hikes. A borrower paying a margin of 3% on loans was probably borrowing at 3% all-in up to recently as the variable rate cost of funds ("COF") was 0%. If COF increases by 1%, then the cost of debt moves from 3% to 4% which is a 33% increase in the annual interest bill.
(ii) Stagflation could see interest costs rising while Ebitda falls. Thus, both interest-related ratios would see the top line decrease and the bottom line increase resulting in a negative "double-whammy" on the financial covenant headroom.

5.2 Where are rates going to and how fast?

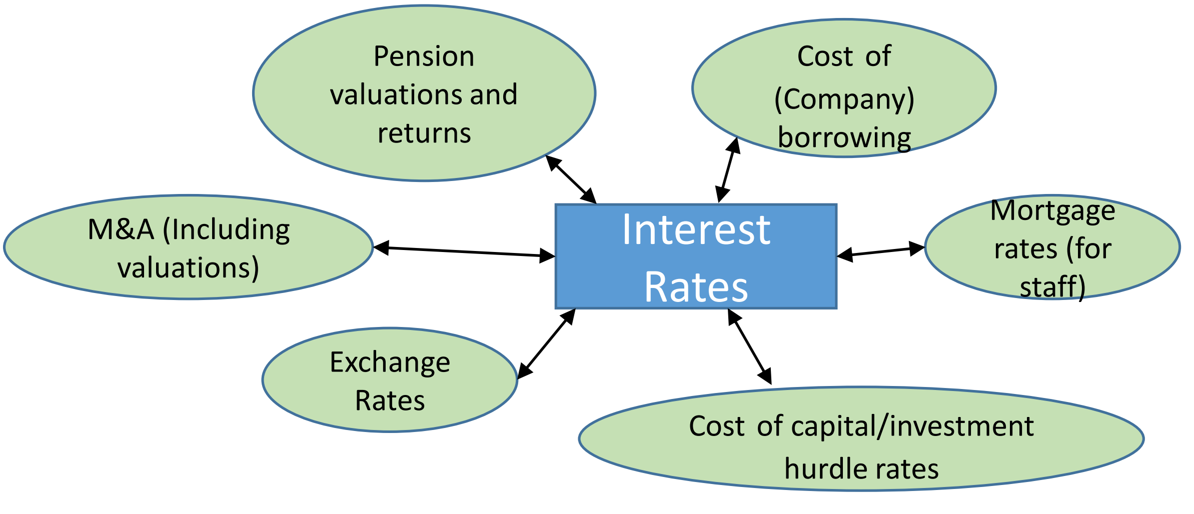
If we undertake what is know as forward/forward curve analysis, we can break down the current 5-year fixed rate into a series of 1-year rates (being the cost of debt for 1-year+ the cost of debt for 1 year in one year's time + the cost of debt for 1-year in two year's time etc.

These rates are currently:

Table 4. EUR Forward/forward Rates

	Now	1 Year	2 Year	3 Year	4 Year
1 Year	-0.040	1.325	1.422	1.501	1.400

This would suggest that rates will "top out" in 3 years time and that the peak will be circa 1.50%. We think that this currently looks optimistic..



5. Interest Rates

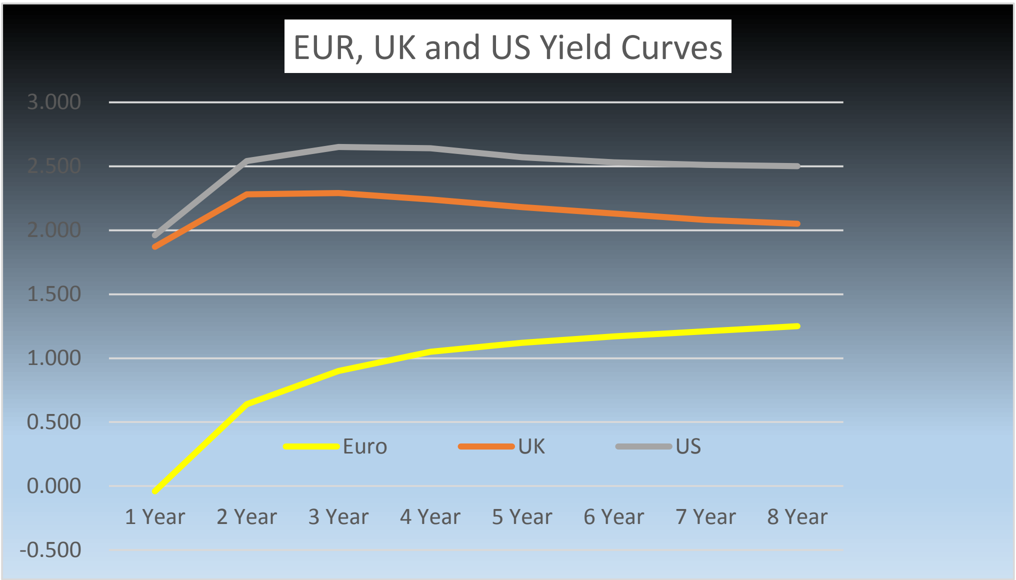
5.3 Jargon: what is meant by an inverted yield curve?

A yield curve is a line on a graph that joins short-term and long-term rates together. Most yield curves are referred to as normal yield curves i.e. short-term rates are lower than long-term rates.

An inverted yield curve is one where the longer-term rates are actually lower than (some) short-term rates on the same curve.

Current Eurozone, UK and US yield curves re as follows:

Graph 14. Eurozone, UK and US yield curves



What is notable about these curves is that both the UK and US curves are slightly inverted.

Why is this significant?

Markets tend to view inverted yield curves as a signal that a slowdown is coming. Basically, to interpret the curves, 1-year rates may climb by 1% or thereabouts but will peak in 2 years (in both UK and US) and start to decline thereafter. PLEASE NOTE THAT THIS IS WHAT THE CURVES ARE TELLING US TODAY – THEY MAY BE CORRECT OR INCORRECT IN DUE COURSE.

5.4 Stagflation and interest rates

The increasing chatter about stagflation surrounds the risk that high inflation is met with stagnant economic growth. The challenge then for Central Banks is that stagnant growth requires low interest rates but inflation requires higher rates. So which way will they sway? Historically, the US suffered from this in the 1970s and it has been on the minds of policymakers ever since.

5. Inflation

5.4 Stagflation and interest rates

Table 5. US Selected Economic Data

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	2022
GDP	3.29%	5.29%	5.65%	-0.54%	-0.20%	5.39%	4.62%	5.53%	3.16%	-0.26%	5.50%
Unemployment Rate (December each year)	6.00%	5.20%	4.90%	7.20%	8.20%	7.80%	6.40%	6.00%	6.00%	7.20%	3.90%
Core Inflation	4.70%	3.00%	3.60%	8.30%	9.10%	6.50%	6.30%	7.40%	9.80%	12.40%	4.50%
Fed Rate (December each year)	4.10%	5.30%	10.00%	8.50%	5.20%	4.70%	6.60%	10.00%	13.80%	18.90%	0.20%
Year-end Fed Rate-Inflation Rate	**-0.60%**	**2.30%**	**6.40%**	**0.20%**	**-3.90%**	**-1.80%**	**0.30%**	**2.60%**	**4.00%**	**6.50%**	

Sources: GDP - The World Bank, Inflation and Fed Rates - Investopedia

The key takeaways from the above are that interest rates were much higher and the gap between inflation and interest rates was both materially above and below zero during the period – Central Bank actions tend to "lag" trends.

The concern is that, if history is to be repeated, then interest rates have a lot higher to go. And we have the added challenge in 2022 of a very significant amount of monetary easing which needs to be reversed …with no real prior experience of how Central Banks manage this without having an adverse impact on asset prices. On top of this we have a really serious climate change challenge and agenda that will require investment and appropriate action for all businesses. Graph 4 highlights the cost of carbon credits to put a figure on the cost of carbon.

But if there is one word that we would reiterate to clients in 2022 it would AGILITY.

Need to be agile in monitoring and responding to challenges, to changes in market dynamics and to ensure that the company finances are built on solid foundations with sufficient flexibility inbuilt.

One of the key lessons of the 2008 financial crisis was that those that entered it in reasonable shape came out of it faster and better than those who didn't.

We think that clients should run a stagflation scenario on their numbers and assess if current finances and financial arrangements can withstand the associated metrics.