THE TREASURY HUB
Banking and Treasury Markets Bulletin

May 2022

1. Executive Summary

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1.1 Introduction

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

The Russian invasion of Ukraine continues to impact on financial markets but there is a lot of volatility in other areas also since our bulletin last month:

- Inflation story won't go away
- Interest rates have steadied somewhat after a sustained period of increasing
- Energy prices remain stubbornly high
- FX rates have also bounced around a lot with USD making significant gains
- Crypto currencies have taken a bashing
- Tech stocks have also suffered more than most other sectors in 2022
- While an oil company (Saudi Aramco) replaced Apple as the world's largest company by market cap…. who said fossil fuels are a thing of the past?

We have warned for some time in this bulletin that the key inflation metric to watch is food inflation given the impact of it on everyone and we see it as the main driver of wages hike pressures.

Consumer habits will also change as a result and discretionary spend is already taking a hit with subscriptions to the likes of Netflix and Peloton being adversely impacted.

Last month we stated that 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.

This is a view that we continue to hold.

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	0.17%	-0.5720%	-0.4030%
Interest	EUR 3-year	1.19%	-0.1500%	1.0400%
Interest	GBP 3-year	1.03%	1.2722%	2.3000%
Interest	USD 3-year	1.68%	1.1512%	2.8300%
FX	EUR/GBP	1.06%	0.8400	0.8490
FX	EUR/USD	-9.26%	1.1368	1.0405
Equities	ISEQ	-16.31%	8444	7067
Equities	FTSE 100	0.92%	7385	7453
Equities	Nasdaq	-25.04%	16320	12233
Commodities	Brent Crude	38.737%	77.78	107.91
Commodities	Gold	-0.93%	1828	1811
Commodities	Wheat	64.51%	758	1247
Gilts	IE 10-yr	1.2990%	0.249%	1.548%
Gilts	GB 10-yr	0.7590%	0.972%	1.731%
Gilts	US 10-yr	1.3480%	1.510%	2.858%

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 interest rates have continued on their slow climb upwards. **Increase in the variable rate cost of funds is a matter of time now.**
- Economic trends tend to be lagging indicators. Tightness in labour markets remains a trend in most geographies. We will watch retail sales data with increasing interest.
- Long-term interest rates have come off recent highs but are still well above levels at the start of the year.
- The outlook remains challenging with an increasing number of commentators calling a recession of some sort inevitable due to inflation, geo-political issues, etc.
- Where climate change initiatives rest in all of this remains anyone's guess as that problem is not going to go away either.

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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
- Biggest move in Irish PMI figures was a falloff of over 6 points in the Construction reading
- UK trends remained broadly positive – Services PMI was back a bit in the month.

Table 2. Irish and UK PMI readings

	Ireland	UK
Manufacturing PMI	**59.1**	**55.8**
Services PMI	**61.7**	**58.9**
Construction PMI	**52.5**	**58.2**

1.3 Inflation

Table 3. Selected Inflation Rates

	CPI	Producer Prices
ROI	**7.0%**	**4.4%**
EUROZONE	**7.4%**	**36.8%**
UK	**9.0%**	**14.0%**
US	**8.3%**	**9.7%**

Irish inflation in April was at its highest level since 1984.
Eurozone producer prices were driven by energy (+104%). Excluding energy, the figure was still a high +13.6%.
UK inflation was at its highest since 1982 while the US equivalent was just off a 41-year high. The UK figure is the highest in the G7, an accolade they won't want to hold for too long!

Food inflation continues to creep up and as we have already mentioned in the bulletin we see this as a critical metric.

We have included the price of wheat in Table 1 for now as this is a key commodity. The impact on global supply of the war in Ukraine will be felt later in the year, with poorer countries probably impacted the most.

IMF now predicts global GDP growth to be 3.6% in 2022, down from its January forecast of 4.4%.

The UK is forecast to be the best G7 performer in 2022 at 3.7% but falling to the bottom of that league in 2023 at 1.2%.

2. Foreign Exchange, Oil & Carbon

2.1 EUR/GBP

- The 12-month trend in Graph 1 shows that the strengthening channel which has persisted since Brexit came under threat recently with a brief move to EUR/GBP0.8619 before dropping back to EUR/GBP0.8440 in a matter of days.

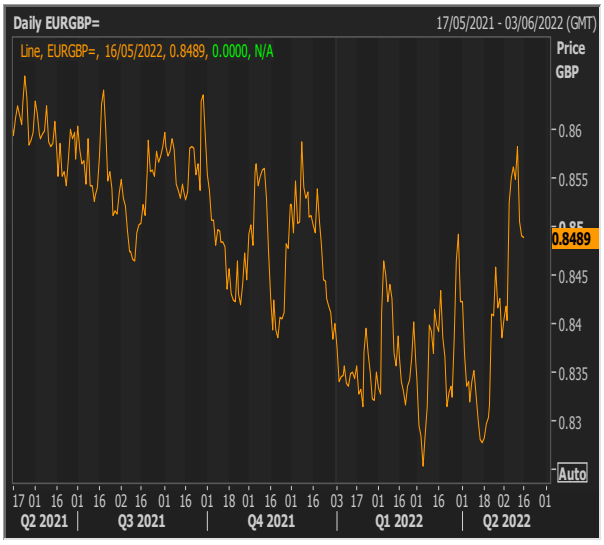
- The FX markets are watching the inflation and interest rate trends very closely – higher interest rates tend to attract increased investment in assets which exhibit higher yields thereby strengthening a currency.

- While the average rate for the year is EUR/GBP0.8377, the average for May to the middle of the month was EUR/GBP0.8490. Last month we suggested that exporters to the UK should watch this rate given the very positive run for GBP since January of last year with the benefit falling to their bottom line. You have been warned.

- The interest rate section which follows in Section 3 looks at trends in UK and Eurozone rates in more detail.

- The outlook for EUR/GBP in the short-term remains unclear due to political events.

Graph 1. EUR/GBP: 12-month trend



2.2 EUR/USD

- **Graph 2 is the 5-year trend in EUR/USD and is probably the graph of the month to review**
- Dollar has bounced around quite a lot over the past few years with two periods of relative weakness followed by two periods of relative strength
- The move over the past 2 months has been large – the rate was at EUR/USD1.1150 at the end of March but fell as low as EUR/USD1.0350 recently
- While the rate was close to this in 2015 and 2017, you would have to go back to the start of 2003 for the actual level being reached!
- Looks like exporters to the US are in a good space for hedging but it is bad news for importers of USD-denominated goods and services. Will also adversely impact on importers of USD-denominated commodities including oil and energy.

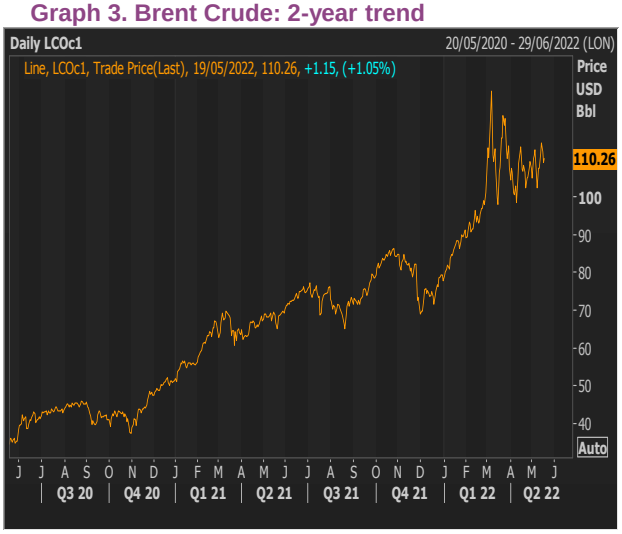
Graph 2. EUR/USD: 5-year trend

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 remain very volatile. There have been a couple of attempts to break back down through $100 but it has bounced back off it again. One would think that talk of a possible recession would have had a negative impact on this price but not so to date. Carbon prices have also been volatile but have retreated off recent highs. As the graph below is the EU Allowances price for Carbon Credits, monitoring it can give companies an idea of the cost of carbon offsets should they become a real cost for them.

Graph 3. Brent Crude: 2-year trend



Graph 4. Carbon: 12-month 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 – the rate has moved below -0.40% yesterday – and so this trend will continue
- If this trend continues at this pace, then we could expect a move out of negative territory in Q3
- **And some are also talking of 3 Base Rate hikes by the ECB in 2022. Relief 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. It bounced back off 1.38% in recent days
- This represented a rise of 1.50% in this rate since the start of the year
- Graph 6 shows how pronounced this rise has been in 2022
- **We have seen an increase in the amount of firms that are starting to fix some debt**
- **Please bear in mind that when long-term interest rates increase by 1%, it is 1% for every year of the long-term period**
- **And with growing worries globally about inflation trends, it looks like the days of sub-zero interest rates are well and truly over.**

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

- So, borrowers will have to get used to managing the cost of debt again, something that they haven't had to deal with for more than a decade (as the default position of holding variable rate debt was both the lowest cost option and a relatively risk-free one for many years)
- Today, variable rates at 0% would be a good deal
- We warned earlier in the year of the potential for surprises on the upside on interest rates
- All rates from 2 years up are now 1% or higher
- But the curve doesn't rise above 2% yet……looks too good to be true.

3.4 UK and US Interest Rates

- Bank of England hiked the Base Rate again in May to 1.00% on a 6-3 vote with the 3 dissenters seeking a hike to1.25%!
- The Bank now sees UK inflation peaking at 10% in Q4 2022
- As Graph 7 below shows, the UK 3-year rate hit 2.65% recently against a 2021 low of 0.07%
- Looks too low also versus inflation outlook?

Graph 7. GBP 3-year swaps: 2-year trend

Graph 8. USD 3-year swap rates: 20-year trend

- As previously mentioned, US rates dropped at the start of the pandemic as with interest rates in all jurisdictions but the economic recovery in the US was faster than elsewhere
- As highlighted in Section 1.3, current US inflation rate is just off the 41-year high of the previous month
- Looking at the graph above, the 2021 low in this 3-year swap rate was a shade under 0.20%. It has gone as high as 3.20% in the past few weeks before easing back again
- So the talk in the US remains how far and how fast will the Fed hike rates in 2022. It hiked by 50bp at the May meeting and two further hikes of a similar size at the next two meetings look likely. The Fed will also start its balance sheet reduction in June
- The US economy continues to hold up well. While unemployment remains at 3.6%, the pace of hiring is slowing due to both labour shortages and rising wage demands to offset the impact of higher inflation.

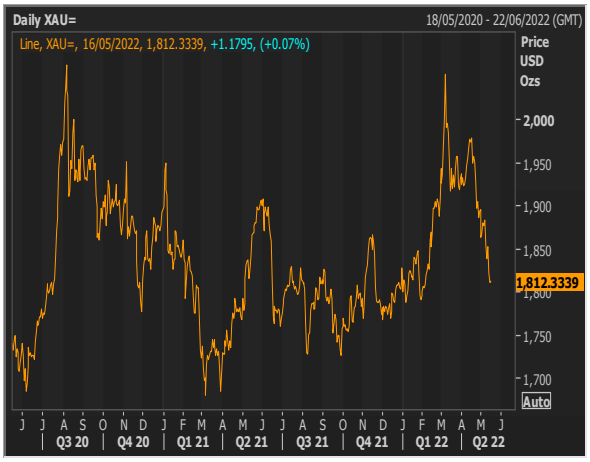
3.5 Summary

- **Base rate hikes will be regular occurrences in both the UK and US for the remainder of the year**
- **There are calls emerging for the first ECB hike to be as early as July to stem inflationary pressures in the single currency area**
- **And the prospect of three ECB rate hikes in 2022 increases, the earlier the date of the first rate hike**
- **As mentioned last month, we have started to devise fixed rate debt strategies for clients for the first time in many years as a result of the recent movements. There are matters to be aware of, financial and documentary, 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**
- **Rising interest rates also impact on the cost of debt to be used in new investment proposals as they increase the cost of capital/hurdle rate to be used in evaluating such proposals**
- **And as previously mentioned, they will also impact on the cost of inputs and, in a tight labour market, on the wage rates hikes that may be expected to both retain existing staff and to recruit new staff.**

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) but has continued to ease back since
- Expect portfolio managers to continue to hold an element of gold as a hedge against stagflation.

4.2 Wheat

Graph 10. Wheat prices: 6-month trend

- The spike in this commodity price was attributed to the start of the war
- But as further information on the huge impact on supply later this year emerges, this price is likely to be supported
- And this is before we see how yields will trend depending on summer weather globally
- The problem with rising wheat prices is that they impact disproportionately on poorer countries
- And this, in turn, could lead to other crises
- The prospect of famine where richer countries cannot provide grain as global supplies are impacted would likely lead to huge humanitarian problems and, probably, civil unrest in the third world.

4.3 Equity Markets

- Equities had a poor start to 2022, dipped further after the Russian invasion of Ukraine but bounced back in March
- The rally was short-lived
- UK FTSE is unchanged in the year but the Nasdaq is 25% off
- We look at these and other trends in more detail in Section 5.

Graph 11. ISEQ: 10-year trend

Graph 12. FTSE: 10-year trend

Graph 13. NASDAQ: 10-year trend

5. Macro Trends

There is so much happening at the minute in so many asset classes and markets it is difficult to pinpoint where it might all lead to.

We have pulled together some information on various topics that we think may be of interest to you.

5.1 Equity Markets

The recent headline in the Financial Times said it all: **"Silicon Valley gets to grips with cashflows after investors hit sell".**

As Central Banks flooded the market with cheap money, asset prices across the board rose. Tech stocks and growth stories attracted most of the attention. But with interest rates rising and Central Banks reining in their balance sheets again, cheap money (and an abundance of it) is a thing of the past….for now at least. The problem with growth stocks is that they tend not to generate cash….and Wall Street is refocusing back on basics.

As of mid-May, DoorDash (US market leader for restaurant deliveries) stock price was down 60%. Affirm, one of the "buy now pay later" participants was down 85% while the ecommerce operator Shopify was down 77%.

Even the big players have started to address cashflow with Meta stopping its aggressive growth in recruitment in a bid to reduce spending by several billion dollars while the CEO of Uber stated "the goalposts have changed. Now it's all about free cashflow".

Back to basics would appear to be the message.

5.2 Private Equity and high yield bonds

Large Private Equity funds have been beneficiaries of the "cheap money" era, especially in the US. However, there is a sense among some that a few of these funds are very leveraged, very exposed to rising interest rates and that a failure of a high-profile fund in this space could be on the cards as a result.

It also means that company valuations, especially of private companies, may have to be readjusted downwards against this backdrop as the PE funds become more conservative in their valuations.

And while the failure of a major fund in this space is not the same as the failure of a major bank, it could have reverberations around the financial markets. The Financial Times also ran a recent article on the proposed takeover of Twitter by Elon Musk and the manner in which he was able to rally a relatively small number of wealthy individuals to help fund the proposed takeover. This development was not necessarily seen as good given the large sums and small number of players involved potentially reducing the ability of retail investors to participate in such investment as the number of listed companies falls as they are taken private by ultra high net worth individuals.

On the high yield debt market, a lot of US acquisitions were made utilizing the $1.5trillion of debt available. For "High Yield" you can substitute "Junk". This market has been tapped by a variety of companies. And chunks of debt in this space are now trading at significantly less than 100 cent in the dollar. As these bonds attract higher coupons, it's a market that would be hit quite early in any stagflationary environment as debt service could come under pressure quickly in a slowing economy.

5.3 Crypto

This market took a hammering in the form of the value of Luna and the stablecoin terra which suffered massive falls in value wiping billions off the wealth of individuals.
Bitcoin is down 50% since November last and Coinbase, the crypto exchange, also suffered large falls in the past few weeks.

The party in this space would appear to be over for now.

5. Macro Trends

5.4 Consumers

Irish consumers and companies are relatively lowly leveraged as the experiences of the last financial crisis remain in the public consciousness. However, this is not the same elsewhere in the world.

In the US, household debt rose to a record $15.84trillion at the end of Q1,driven by higher levels of home loans. UK spending is also up but banks there are starting to pull certain mortgage products from the market as consumers shop for good value before more mortgage rate hikes emerge.

On the consumer demand side, there is a view that shoppers will seek less choice in the coming 12-24 months as the cost of groceries increases. Simultaneous increase in energy bills hasn't helped and there is a sense that consumers will start to shop more at the discounters and will also spend less on experimental products. The CEO of Danone has stated "we will go back to fundamentals, rather than what was fashionable at one time or another".

Unfortunately this could work against smaller food producers and producers of niche/artisan products could suffer disproportionately.

The same has already started to apply to non-food companies such as grocery delivery, fitness apps and entertainment.

It would appear that the back to basics that we mentioned in the equity space will apply to many industries and sectors.

5.5 Government

Government will also come under increasing pressure, even at home in Ireland:

- Government debt which had ballooned after the 2008 crisis took another hit in the pandemic. Now there is a need to grow revenue streams to start balancing budgets
- But a slowing economy tends to result in lower tax revenues. So the upward pressure on minimum corporation tax rates is inevitable…but that may not be bad news here as an increase from, say,12.5% to 15.0% is unlikely to lead to many firms leaving our shores – they will have to accept that they need to pay more. And that could lead to higher tax revenues in this space at least
- Meanwhile the upward move in interest rates will drive up the cost of borrowing for governments…hence why a balanced budget becomes even more desirable
- The role of the State continues to grow globally. Look at the pressure here for government to commence large scale housebuilding projects again as just one example
- This, in turn, means politicians have a greater say in how our lives are impacted…but the polarity in politics has also been steadily increasing while the ability of incumbents is not exactly viewed as being at an all time high in most places globally
- And all of this against a backdrop of an urgent need to tackle climate change which in itself will require large amounts of investment now to prevent future climate and other crises.

ALL OF THE ABOVE ARE EXAMPLES OF WHY WE BELIEVE THAT MOST OF US ARE VERY MUCH OPERATING IN A "RISK ON" ENVIRONMENT AND ARE LIKELY TO REMAIN SO FOR A FEW YEARS.