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THE TREASURY HUB
Banking and Treasury Markets Bulletin

February 2022

Disclaimer: All statements presented in the bulletin are based on the opinion of the author and facts. The author cannot be held responsible for any action taken on items discussed in the bulletin

1. Executive Summary

1.1 Introduction

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

This represents a review of the opening month of the year and, in Section 5, we have a look at the key topic of the moment: Inflation.

Key trends of January 2022 were:

- Very volatile equity markets. Although the table across shows only the NASDAQ dropped materially in the month, there was a lot of volatility throughout January as the markets assessed the likely pace of interest rate changes globally and the impact of the beginning of the end (hopefully) of the pandemic.
- Bank of England hiked Base Rase to 0.50% on February 3rd.
- GBP Libor has disappeared with effect from January 1st 2022. This has implications for all new GBP loans and overdraft facilities.
- Inflation continues to reach levels not seen in decades (see Section 5).
- GBP retains its strength versus EUR.
- USD has bounced around a bit against EUR (HIGH-LOW MOVE IN THE MONTH OF 3.26%).
- Oil prices continue to increase (currently up by 15% in the year after a rise of 50% in 2021).
- While gold prices eased off slightly at the start of the year.

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	0.03%	-0.5720%	-0.5470%
Interest	EUR 3-year	0.21%	-0.1500%	0.0630%
Interest	GBP 3-year	0.37%	1.2722%	1.6389%
Interest	USD 3-year	0.34%	1.1512%	1.4880%
FX	EUR/GBP	-0.60%	0.8400	0.8350
FX	EUR/USD	-1.20%	1.1368	1.1233
Equities	ISEQ	-1.10%	8444	8351
Equities	FTSE 100	2.72%	7385	7586
Equities	Nasdaq	-7.61%	16320	15078
Commodities	Brent Crude	15.107%	77.78	89.53
Commodities	Gold	-1.368%	1828	1803
Gilts	IE 10-yr	0.2810%	0.249%	0.530%
Gilts	GB 10-yr	0.2980%	0.972%	1.270%
Gilts	US 10-yr	0.2600%	1.510%	1.770%

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 – RATES HAVE MOVED NEGATIVELY (AND WILL LIKELY CONTINUE TO DO SO) FOR BORROWERS.**

- 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.

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 figure has continued to fall since July 2021 with Manufacturing and Construction PMI broadly following the same trajectory
- And the UK trends are quite similar.

Table 2. Irish and UK PMI readings

	Ireland	UK
Manufacturing PMI	**59.4**	**57.3**
Services PMI	**55.4**	**53.3**
Construction PMI	**53.7**	**54.3**

1.3 Inflation

Table 3. Selected Inflation Rates

	CPI	Producer Prices
ROI	**5.5%**	**4.5%**
EUROZONE	**5.1%**	**23.7%**
UK	**5.4%**	**9.3%**
US	**7.0%**	**9.7%**

Last year we focused on vaccine rates as a key metric to monitor. This year we will focus on inflation.

The reason this is important to monitor is because it impacts on so many variables: interest rates, exchange rates, equity and bond prices, wages, etc.

This topic is elaborated on in more detail in Section 5. It requires immediate and ongoing attention for businesses and investors alike given the large and material moves in such rates in recent times.

In a similar manner to managing interest rates, individuals and companies have not had to worry about this for over a decade so there could be a tendency to continue to adopt a "hands off" approach.

We would strongly advise against taking this stance in 2022.

2. Foreign Exchange

2.1 EUR/GBP

- The 12-month trend in Graph 1 below shows a strengthening channel since Brexit was (largely) removed from the equation as far as the financial markets are concerned.
- The current range/channel below is EUR/GBP0.8305 to EUR/GBP0.8560.
- This is also borne out by the trend in average rates. The 2020 average was EUR/GBP0.8896 whereas the 2022 year-to-date average is EUR/GBP0.8354.
- **To put these rates in perspective, GBP100,000 was worth €112.4k in 2020 but €119.7k in 2022 to date. That's an extra €7.3k profit on every GBP100k sales by doing nothing.**
- As noted in the previous bulletin, 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.
- However, Boris Johnson looks like he is under threat as leader (but that has also been said before!). We suspect that should Rishi Sunak succeed him, it would be GBP-positive, at least in the short term.
- Table 4 overleaf shows the range in EUR/GBP values since 2008.

Graph 1. EUR/GBP: 12-month trend

Table 4. EUR/GBP high, low and average rates: 2008-2022

EUR/GBP	High	Low	High to Low %	Average	Average Index 2000=100
2022	0.8422	0.8303	1.43%	0.8354	72.9
2021	0.9085	0.8365	8.61%	0.8601	70.9
2020	0.9500	0.8280	14.73%	0.8896	68.5
2019	0.9324	0.8274	12.69%	0.8775	69.4
2018	0.9099	0.8618	5.58%	0.8849	68.9
2017	0.9306	0.8313	11.95%	0.8765	69.5
2016	0.9365	0.7308	28.15%	0.8192	74.4
2015	0.7874	0.6930	13.62%	0.7263	83.9
2014	0.8400	0.7755	8.32%	0.8063	75.6
2013	0.8814	0.8083	9.04%	0.8493	71.8
2012	0.8505	0.7753	9.70%	0.8115	75.1
2011	0.9083	0.8283	9.66%	0.8681	70.2
2010	0.9148	0.8065	13.43%	0.8579	71.0
2009	0.9519	0.8397	13.36%	0.8915	68.4
2008	0.9803	0.7388	32.69%	0.7972	76.4

The above table shows the annual difference in EUR/GBP in each calendar year since 2008. The Average Index shows how the average rate has moved since 2000 with 2000 as a base of 100. Basically, GBP has weakened by 30% since we joined the EUR. **The key takeaway on this is that annual volatility is circa 10% whereas regular hedging should dramatically reduce this volatility. Currency hedging is all about linking the rate that impacts on commercial outcomes (sales/purchases) with a hedging strategy. The objective is NOT to make money on currency but it is to avoid material losses due to currency movements.**

2.2 EUR/USD

- Graph 2 is the 5-year trend in EUR/USD
- The trend appears to have been a three quarter period of weakening followed by much longer (but more gradual) period of strengthening. Should these trends continue, USD should stay strong for some time yet
- USD, similar to GBP, has probably benefitted (versus EUR) from faster upward interest rate moves, mainly linked to inflationary pressures
- However, the international banks appear to be calling weaker USD on the basis that the spectre of stagflation lurks (higher inflation, little or no economic grow)
- So exporters ought to remain alert to USD weakening.

Graph 2. 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

- 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.
- Expect these to stay negative in 2022 but banks in the Business Banking area seems to be pricing their cost of funds at circa 0.50% above the 3-month rate **so expect the variable rate cost of borrowing to start increasing this year.**

Graph 3. 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 has climbed from -0.46% in August last year to current levels around 0.09% (into positive territory (above 0%) for the first time since December 2018)
- So the rate has risen by over 0.5% since then and by 0.4% since Christmas….but it hasn't registered with most as the ECB Base Rate hasn't change yet
- **As a result, most firms have already missed the bottom of the cycle for fixing interest rates - see Graph 4.**

Graph 4. EUR 3-year swaps: 5-year trend

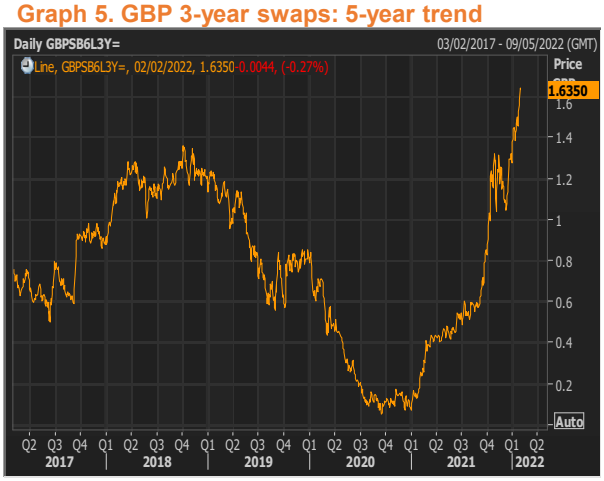
3.3 Summary

- Last year we suggested that clients may consider fixing at a swap (market) rate of 0% for as long as possible as the banks would not give the benefit of negative interest rates to borrowers. That would have been the optimal strategy
- We have been more bullish than others on the inflation outlook and increasingly look like being correct. Last month we "suggested potential for surprises on the upside" on interest rates
- The 0.40% move over January would reinforce this view.

3.4 UK and US Interest Rates

- Bank of England hiked the Base Rate by 0.25% to 0.50% having started hiking at the last meeting of 2021
- As Graph 5 below shows, the 3-year rate rose from 0.15% this time last year to 1.27% by year-end and 1.73% at the date of drafting this bulletin. That's a 1.50%+ move in 12 months
- Current levels were last seen in July 2014
- **EUR borrowers really need to note this trend as a result as the UK cycle is ahead of us.**

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



Graph 6. 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 almost 1.50% currently
- As highlighted in Section 1.3, US inflation rate increases have been faster and higher than other established economies (+7.0% in December was last seen in June 1982)
- Views on the number of rate hikes in the US by the Fed in 2022 vary from 3 times from Morgan Stanley to 7 times by Bank of America
- 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

- **Base rate hikes have now arisen for two months in a row in the UK while the number of rate hikes in the US in 2022 could be anywhere between 3 and 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. The key difference with SONIA is that the rate isn't known until the end of the interest period in question: with Libor, the rate was known at the start of the interest period**
- **In addition, although USD Libor will not cease to be used until 30 June 2023, all new contracts will NOT be based on USD Libor. So borrowers in USD will have to deal with this new basis from now on**
- **To date, the ECB has done nothing and although EUR swap rates are starting to increase, at worst markets currently believe that ECB won't hike the Base Rate until the end of this year**
- **And while there is also a view that rates will peak at a relatively low level compared to previous cycles, there is a complacency around managing interest rates due to the low level of interest rates over the past decade or longer**
- **And as we elaborate further in Section 5, inflation and interest rates are intertwined and the impact of rising rates is much wider than on the cost of borrowing**
- **So we strongly recommend that this is now prioritized as an area of attention for the first time since we started publishing this bulletin.**

4. Wealth Management

4.1 Oil

Graph 7. Oil prices: 10-year trend

- Just when we thought that 2021 was the year of high prices (year-end level of almost $78 was 50% higher than at the start of the year), the commodity starts 2022 in the same vein
- In fact, it has already touched $92 this year even though the economic outlook is mixed
- And, as previously noted, this adverse trend has been exacerbated by a stronger USD
- $100/barrel was predicted by Goldman Sachs in Q4 last year but it is increasingly a widely held view that this level is inevitable
- Nothing good to see here for now.

4.2 Gold

Graph 8. Gold prices: 2021 trend

- Gold price is holding relatively steady in early 2022 and given the economic uncertainty facing the world, we will continue to monitor this as a "safe haven" play for 2022.

4.3 Equity Markets

- While 2021 may have been a great year for equities, 2022 has not started well
- Tech which outperformed last year has suffered disproportionately this year so far
- Last month we said "We are still waiting for the correction"…… has it started??

Graph 9. ISEQ: 10-year trend

Graph 10. FTSE: 10-year trend

Graph 11. NASDAQ: 10-year trend

5. Inflation

This topic merits consideration in its own right for three reasons:

(i) The rates have moved upwards very quickly
(ii) Inflation has not been topical for well over a decade
(iii) The "domino" effect of consequences of persistent inflation.

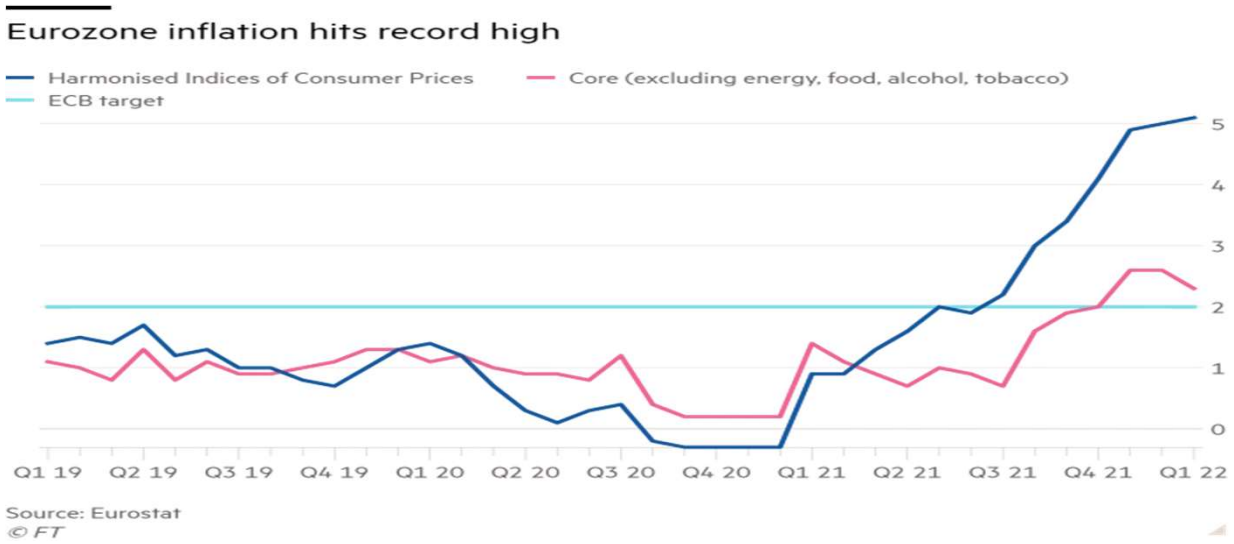
5.1 Recent Inflation Trends

Irish inflation obviously impacts on all Irish businesses but, as interest rates for the Eurozone are set by the ECB, it is Eurozone inflation that counts in that respect.

Graph 12. Irish Inflation: 25-year trend (source:tradingeconomics.com)

The graph shows that the last time inflation was at these levels was in the Celtic Tiger era. Interest rates needed to be higher but inflation was lower in the Eurozone resulting in interest rates being lower than required here. This is the first risk that could appear again. However, for now, Eurozone inflation is also quite high.

Graph 13. Eurozone Inflation (HCIP and Core) (source: Financial Times)



So, one of the key trends to monitor in the coming months is the possible divergence between Eurozone and Irish inflation rates as a repeat of the noughties would not be welcome.

5. Inflation

5.2 Which inflation figure should be used?
There are a number of inflation measures.

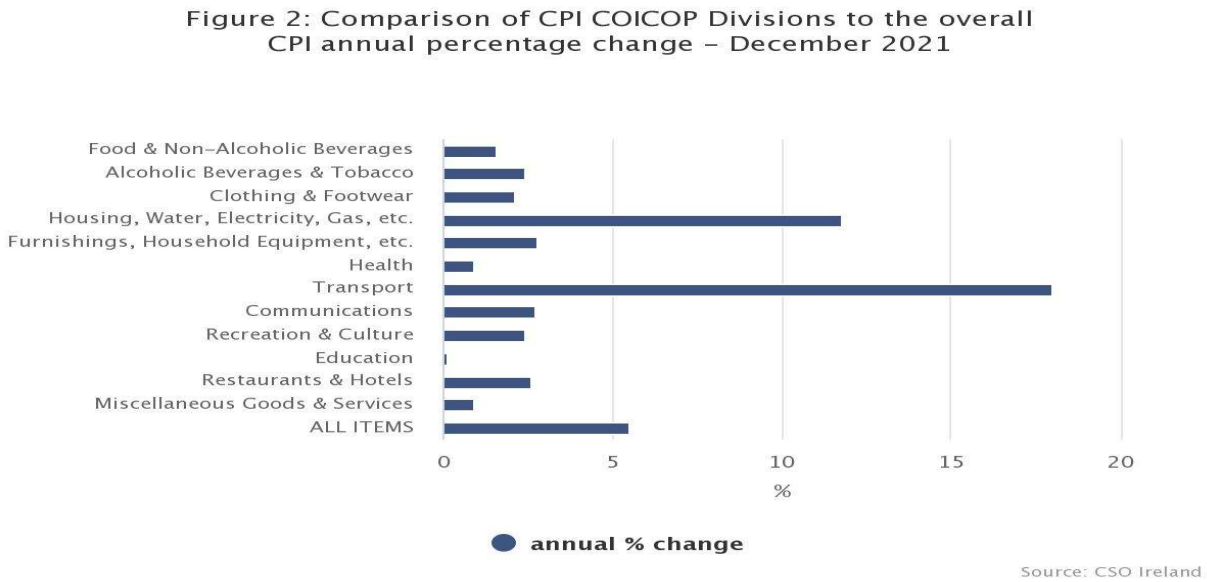
The one most watched is the Consumer Price Index (CPI). Within that some like to review the level excluding mortgage interest and energy.
The EU measure is known as the Harmonised Index of Consumer Prices (HICP).

Inflation, in turn, is a basket of variables that have different weightings and these are altered from time to time (both the variables being measured and their weighting in the basket).

This is important as the movement in the variables doesn't impact on everybody the same way. For example, the cost of childcare is of no consequence to someone with teenagers but the cost of education could be a material cost to that cohort, in turn.

Looking at the most recent data from the CSO, the headline CPI was up +5.5% but the variables went from +18% for Transport (e.g. diesel, petrol), +11.8% for Gas and Other Fuels and +2.7% for communications.

Graph 14 Changes in the price of Components of CPI for the year to December 2021 (source: CSO)

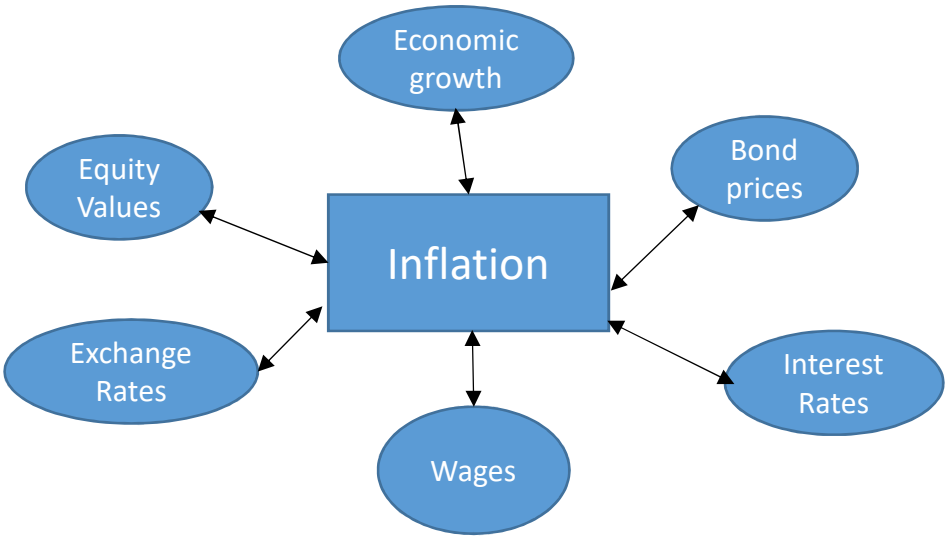


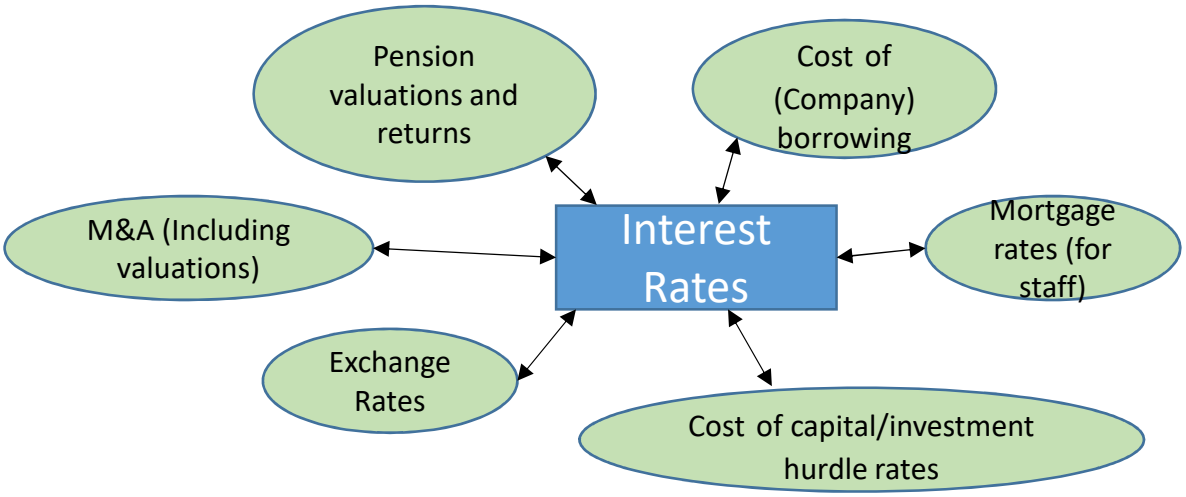
Why is this analysis important? Because your customers or employees could be proportionately disadvantaged (or not) depending on the relative move in the various components. The hike in energy and fuel is topical as it impacts on everyone, regardless of income (with the relative larger impact being on lower income earners - they spend a higher % of their income on this basic requirement). On the plus side, food inflation was only +1.6% for the year and since 2008 has been barely positive. It would be generally accepted that should food inflation start to increase along the lines of the CPI trends, then the pressure on wage growth demand would be huge.

5. Inflation

5.3 Broader Impact

Consider the two schematics below: the first looks at the broad impact of inflation, the second looks at how interest rate changes alone can impact. **PLEASE CONSIDER HOW THESE MAY IMPACT ON YOUR BUSINESS IN 2022 AND BEYOND.**





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