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THE TREASURY HUB
Banking and Treasury Markets

September 2020 Report

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1.1 Introduction

Welcome to the September edition of THE TREASURY HUB Banking and Treasury Markets Bulletin. Having experienced a surreal Q2 when the country effectively shutdown for the first part of it, Q3 has seen recovery to varying degrees. However, the period to the end of the year will be more challenging and many expect that the full fall out won't be seen until H1 2021.

On the currency front, the past few weeks have seen USD stabilise after a Summer weakening and break out of a downward (i.e. strengthening dollar) range that has existed for almost two years. However, there appears to be a growing (slow) view) that further USD weakening is likely in the months ahead.

And while EUR/GBP has continued within the range that we had indicated would likely persist for the Summer, the last few days have seen an element of strengthening of GBP. UK/EU trade negotiations continue, albeit not making a lot of ground yet. The appointment of former Australian PM as a Brexit advisor by the UK has met a very mixed reaction.

From an investment perspective all three equity indices that we track (ISEQ, FTSE and DOW) have eased off their post COVID lockdown recovery. Nasdaq suffered a material correction on September 3rd (from 12234 to 11662) but is still well ahead of the February peak (pre-Covid) of 9736.

Q4 will see US presidential election, Brexit decision one way or the other and the unwinding of unemployment supports in many countries from which the true unemployment position will emerge. The holidays are over!

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

Table 1. Key Metric Movements: 2020

Heading	Metric	YTD move	From	To
Interest	3-m euribor	-0.0990%	-0.3790%	-0.4780%
Interest	EUR 3-year	-0.1900%	-0.2600%	-0.4500%
Interest	GBP 3-year	-0.6940%	0.8140%	0.1200%
Interest	USD 3-year	-1.4260%	1.6560%	0.2300%
FX	EUR/GBP	4.7195%	0.8459	0.8878
FX	EUR/USD	5.4248%	1.121	1.1853
Equities	ISEQ	-12.741%	7315	6383
Equities	FTSE 100	-22.607%	7604	5885
Equities	Dow Industrial	-1.999%	28869	28292
Gilts	IE 10-yr	-0.220%	0.098%	-0.122%
Gilts	GB 10-yr	-0.5370%	0.794%	0.257%
Gilts	US 10-yr	-1.2245%	1.882%	0.658%

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.

We continue to keep the report short and focused on key aspects that companies need to manage from a financial perspective.

On the corporate activity front, the general view emerging is that examinerships and receiverships are unlikely to have momentum before H1 next year as banks will be under pressure NOT to pull the plug on businesses over the Winter. But, as casualties will be inevitable as a result of the economic slowdown, such decisions cannot be deferred forever. The impact of Brexit will also be clearer by that stage. Some evidence emerging of Irish companies looking more closely at UK acquisitions where the UK market is and will likely remain a key market for their product/service.

We iterate our key messages from the last bulletin, namely:

Business Owners in their late 50s+ would be strongly advised to start considering their medium-term exit strategies and all owners should look to improve the quality of their long-term funding. It has been a weakness for many companies that the pandemic has exposed.

Banking will become more challenging in Q4 as the banks could struggle to deal with the sheer scale of the intervention required for companies and sectors that will find themselves challenged. Please continue to avail of the financial planning grants from Enterprise Ireland and LEOs.

1.3 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. Mixed month in Ireland where the Service outlook improved but the Manufacturing figure worsened. The UK fared better with both of these readings improving although the Construction figure deteriorated. Housing bounce in the UK has been strong – it remains to be seen if it sustains momentum.

Table 2. Irish and UK PMI readings

Variable	Ireland	UK
Manufacturing PMI	52.3	55.2
Services PMI	52.4	58.8
Construction PMI	53.2	54.6

1.4 Brexit

The range of EUR/GBP0.88 to EUR/GBP0.92 for the Summer that we called in June remains intact. Meetings between Mr Barnier and David Frost have not produced progress and the latest UK idea of reneging on parts of the Withdrawal Agreement imply that the risk of no deal is as high as ever. The three key areas remain a level (trade) playing field, fisheries and governance. Regardless of the outcome, there will be more paperwork required so exporters to and importers from the UK must start preparation for this now.

1.5 Treasury Hub Activities

The next quarterly meeting of The Treasury Hub is later this month and we will continue to provide clients with market "learnings" from the meeting as we share market intelligence among the group. Our focus is likely to be on the evolution of the banks thinking about credit risk, especially in the area of hospitality.

1.6 Conclusion

The Summer represented a bounce back in consumer spending after lockdown and staycationing gave a much-needed boost to the hospitality sector over the past few months. However, the Winter will tell a different tale – how quickly will towns and cities recover, will working from home remain a long-term trend and what are the real unemployment figures like? October budget will a tough one… difficult not to see some tax hikes emerging.

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2. Interest and Economic Review

2.1 EUR rates

Background

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

ECB has continued to maintain high levels of liquidity in the markets. As a result, the 3-month euribor rate has fallen again and at -0.478% is still close to the all-time low of -0.489%.

Given that these lower rates are not being passed on by the banks, the benefit of this continuing strategy by the ECB is becoming questionable. But negative deposit rates have not yet discouraged depositors. A recent article in The Currency online business publication highlighted that Eurozone households and businesses increased their deposits by 7.4% and 20.4% respectively in July. In the US, a record amount of cash was deposited in banks between January and June 2020.

The trend of rising deposits would be consistent with low consumer confidence in the economy. It is also consistent with low inflation. In Ireland, inflation has been negative for 4 months in a row now with the July reading at -0.4%. The equivalent figure in the Eurozone was +0.4% in July with an expectation that it will turn negative to -0.2% in August. Unfortunately all of these trends are negative for the economy for the most part. And finally, as mentioned previously, low interest rates are causing problems for banks (one of the main banks estimates the direct cost at being in excess of €200m in 2020 alone).

The main beneficiary is the government with the cost of borrowing for 10 years currently standing at -0.12%. However, the interest cost on State borrowings for the period January to August was €3.9 billion. This was €211 million lower than the same time last year and ought to continue falling, despite the growth in Government borrowing, as higher coupon debt is replaced by lower coupon debt.

Bond prices in the US have ticked up slightly in the past month. But bond prices in general are artificially low due to the printing of money and buying of bonds by central banks.

Graph 1. 3-m Euribor: five-year trend

The first thing to note about Graph 1 is that all of the readings (which are since September 2015) are BELOW 0%. There has been relative volatility in 3-month Euribor since March but it has stabilized in the past week or so. One trend that we are noticing is that Banks are not always prepared to offer Euribor as a cost of funds. We can elaborate on what can be done to protect interest costs if you require further assistance in this space. We would still have a concern that margins will be under upward pressure in the coming months as banks seek to plug a hole in their P&L from negative interest rates and we will continue to monitor this closely across banks and sectors in The Treasury Hub.

Graph 2. EUR 3-year swaps: ten-year trend

Graph 2 shows the trend in 3-year (fixed) rates (pre-margin) over the past decade. The white line is 0%. A key comment on current interest rates is that when fixed (longer-term) rates are close to short-term rates, it is generally seen as a signal that upward pressure on interest rates is UNLIKELY to arise in the short-term. As a result, fixing interest rates for as along as possible at 0% (pre-margin) is probably as good as one will achieve for the next while, absent a major shock in the markets.

2.2 UK and US interest rates

UK and US interest rates are now stabilised. UK core inflation at +1.8% is relatively high and although 3-month libor rates are now down at 0.06%, negative interest rates remain unlikely in the UK. Core inflation in the US is also relatively high at +1.6%.

Graph 3. GBP 3-year swap rates: five-year trend

Graph 4. USD 3-year swap rates: twelve-month

2.3 UK Economic Outlook

While PMI readings remain strong (see Section 1.3) government pandemic assistance has hidden the impact on other variables. For example, unemployment remains at 3.9% due to the furlough scheme. This is forecast to rise to 6.9% by the end of the quarter as the scheme is unwound but their labour participation rate is very high at 76.4%. Whether the UK can use its immigration policy to "manage" this in any way post-Brexit remains to be seen. A hard Brexit will only likely exacerbate the unemployment problem in the short-term at least.

We continue to hold a pessimistic view of the outlook for the UK for now.

2.4 US Economic Outlook

US unemployment rate fell further in August to 8.4% from 10.2% the previous month. It was 3.5% in February to give an indication of the pre-Covid gap. Despite the weakness of the USD, the trade gap deficit in July at $63.6billion was the highest deficit since July 2008. Federal borrowing continues to rise and as a % of GDP, is on track to break through the record levels set after World War II. Good article in the New York Times on this here. https://www.nytimes.com/2020/09/02/business/us-federal-debt.html

No progress in the US/China trade talks.

2.5 Political Outlook

While early polls in the US presidential race put Joe Biden ahead and in the key swing states in particular, Hilary Clinton was also performing better in the early stages in 2016. We have a sense that this will be a lot tighter than currently thought and that would put USD at risk of further weakening. We see this USD risk as growing and requiring increased vigilance as a result.

In the UK, the parliament is back and Keir Starmer is making life tough for the Prime Minister in parliamentary exchanges. One paper last week suggested that he is still struggling in his post-Covid recovery and that he could resign by the end of the year although this was vehemently denied by Downing Street. While the latter may not be true, there is evidence in the UK that 10% of those that suffered from Covid struggle with low energy levels amongst other symptoms on an ongoing basis. Smoke without fire? We shall see!

3. Foreign Exchange Review

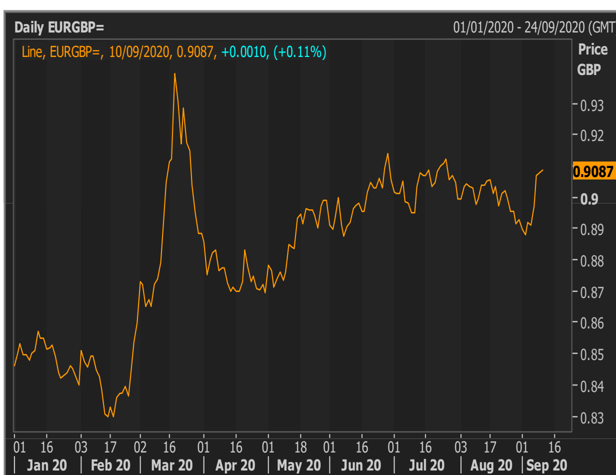
3.1 EUR/GBP

The "holding pattern" of 88p to 92p previously identified as the likely Summer range has remained intact to the end of the Summer. There was a brief retrenchment as low as EUR/GBP0.8870 recently but it "bounced" off that level and hit EUR/GBP0.9130 since.

As we stated in the last bulletin, we expect the above range to be challenged in September as trade talks between the EU and UK continue and gradually come to a conclusion by October, for better or worse. Mr Barnier has reinforced the end of October as the latest date for a deal in the past few days. Furore over UK plan to change elements of the Withdrawal Agreement that pertain to Northern Ireland has weakened GBP by 2p in the past 8 days.

Therefore, the risk of current levels being either very good buying or selling opportunities is high as it is difficult to see GBP remaining around current levels once the outcome of the Brexit talks becomes apparent. The question remains will it be higher or lower? On balance we remain of the view that there is greater potential for GBP weakness than strength. Consider the appropriate use of FX options for the coming 2 months from a strategic perspective but get in touch if we can help. **Be careful to structure them properly if using them and get some independent advice.**

Graph 5. EUR/GBP in 2020



As previously mentioned, the outcome of the Brexit talks will have a material impact on banking discussions where exporters (and, possibly, importers) are either borrowing new money or refinancing existing loans. Thus the financial ramifications will extend well beyond currency.

Get in touch if you require further details on the development of currency hedging strategies.

3.2 EUR/USD

The downward (USD strengthening) trend which has prevailed since Q1 2018 in EUR/USD has reversed. From 2 July to 18 August, it weakened from EUR/USD1.1238 to EUR/USD1.1929. This was the highest level since May 2018.

Graph 6. EUR/USD: five-year trend

Exporters to the US have had a very strong run in that period, in many cases softening the blow where they also exported to the UK. But the pace and scale of the recent weakening is sufficient to reduce the profit on sales of $100,000 by over €5,000!

The adverse trend would certainly be reflective of a lot of uncertainty in the US and not just in an economic sense. A recent podcast from a leading and seasoned hedge fund manager stated that if you did not know that the data applied to the US, a dispassionate look at it would says it exhibits all the signs of the early stages of a country on the brink of implosion! Two months ago we suggested that exporters needed to move the monitoring of EUR/USD from "do nothing" to "monitor" status. We hope that view was given consideration.

3.3 Summary

We reiterate our view that it is time to push currency management back to the top of the agenda given the knock-on effect of adverse currency movements on cashflows, debt repayment ability and investment capacity.

4. Wealth Management

4.1 Oil

Graph 7. Oil prices: two-year trend

Recovery in oil price has been faster than some previously expected but recent commentary suggests that it looks overdone as the economic outlook/pace of post-Covid recovery is worse now than a month ago and that floating storage is on the point of making a comeback (any speculation in oil markets is not like derivatives: the buyer must take actual possession of the product). $50 looks like a challenging target for now, retracement having already started (down $5 in one week).

4.2 Gold Price Trends

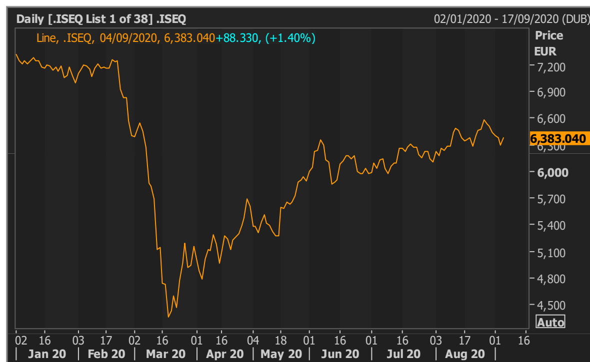
Graph 8. Gold prices: two-year trend

Gold as a hedge against economic slowdown has been a pretty effective investment over the past 14 months since we first started covering it for that very reason. Equity markets have not had a serious retracement since the recovery up to this week when the NASDAQ dropped from 12,420 to 11,068 before recovering slightly. Looks like Gold might continue to hold up around $1,800 or thereabouts for now.

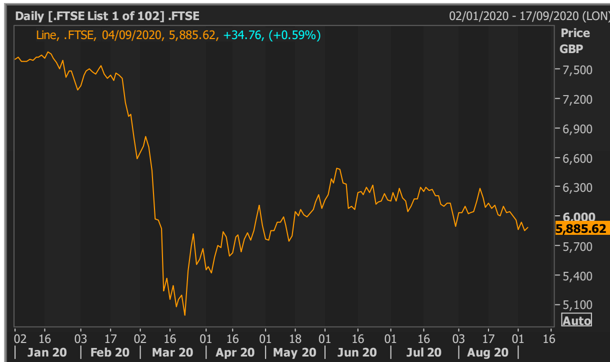
4.3 Equity Markets

Graphs below are 2020 trends for ISEQ, FTSE and DOW. All three have recovered to varying degrees and taken time recently as the Q2 results season kicks in (although NASDAQ took a hit this week). Equity markets have benefitted from loosening fiscal policy as underlying economic prospects would not appear to underpin current valuations. We referenced the possible value of equity options against a stock market decline in January. FT article last week highlighted that Softbank has taken huge option positions on US tech stocks in a massive bet that was sure to lead to further market volatility. Tesla peaked at $502.14 on September 1st and hit $368.74 at one point on the 8th (source: Refinitiv). So take note.

Graph 9. ISEQ



Graph 10. FTSE



Graph 11. DOW

5. Post-Covid Investment

The post-Covid investment outlook suggests both changing trends on many fronts including in the asset management industry and also various social and business dynamics that are likely to remain for some time with other changes being permanent. Below we capture various trends that we have identified in recent times and also share some thoughts on how the investment world may change.

5.1 New Retail and City Norms

- High Street retail (non-food) looks permanently impacted unless shops become "experiential"
- Opening up of cafes/pubs onto streets. See example of Princes Street in Cork which has become pedestrianized and will probably see some element of "cover from the elements" in due course to facilitate trading outside of Summer. This may become a trend in other towns with a possible concentration of such operations being encouraged (easier for local authorities to assist if it applies to fewer streets)
- Banking was already under pressure from fintech and others pre-Covid. Retail presence under further pressure – Co-op Bank in UK closing 18 of 68 branches
- In August 2020, 2/3 of UK retailers reported falling employment (per CBI)
- It took Tesco 20 years to grow online sales to 9% of their total grocery sales. Now reported to be 16% since the pandemic (Source : FT)
- Google has decided not to proceed with renting another space in Dublin for 2,000 staff. However, Stephen Kinsella in The Currency highlights that the tide for commercial property in Dublin peaked in Q2 2017
- Pret-a-Manger to close 10% of its stores and axe 2,800 jobs. Admitted it focused too much on London.

5.2 Socio-economic Norms

- Migrating back to parents. 2/3 of all Italians aged 18 to 34 still live at home
- 24 million Americans have provided financial support to their adult kids since the start of the pandemic
- Emergence of what is termed the "sandwich generation" – 47% of UK population aged 40-50 have BOTH dependent kids and a living parent aged over 65
- 10th largest mortgage provider in the UK is BOMAD (Bank of Mom and Dad)
- Impact of Covid varies so much by sector. Data from article in The Currency shows the change over Q2 as being -61.2% in Accommodation and Food and -39.3% in Arts and Entertainment to 3% in industry and 4% in Health and Social. Will have varying geographic impact also
- Harvard economist Ben Friedman in 2006 stated "Economic stagnation causes increased intolerance, insularity and populism. That threatens further political uncertainty".

5.3 Investment Trends - Advisory

- Stock markets as a source of capital have been diminishing in importance. Net capital raising in public markets is negative although this may change in 2020 and 2021 as companies repair their balance sheets or take on more liquidity e.g. Dalata and Ryanair both raised equity funds recently
- General move towards passive investment
- Recent analysis shows that all excess returns in world markets since 1990 has come from just 1.3% of companies. IN other words, excess returns are concentrated in a relatively small number of stocks
- This, in turn, may beg a question as to the value of paying management fees for investing in blue-chip companies – would ETFs be a lower cost but similar return alternative?
- FT pointed out recently that investors need to assess the active stock picking within funds (using total deviation from the benchmark index). It stated that if one assumes that the index can be bought (as a tracker fund which does not require stock picking), then one is really paying for that % of outperformance that is due to stock picking….even though a management fee is based on the fund total. The point made was that if a fund deviates from benchmark by 20% and an annual management fee of 0.75% is paid, the cost of stock picking is actually 0.75%/0.20% or 3.75%
- Robinhood has been attracting attention as providing a commission-free investing model. However a recent article from UBS highlighted how they make their money – 70% of their revenues come from selling data to Wall Street firms highlighting, in particular, the scale and level of options trading being undertaken on the platform. Again another example of making profits from your data as pioneered by the social media giants. But there is nothing illegal in it. It is simply their business model.

5.4 Summary

While low interest rate are pushing some investors to private equity and private debt, the move towards index-tracking is reducing fee income and commission and forcing global wealth management advisors to spend more time on financial planning, developing plans and retirement goals. **Might be time for financial MOT on both your financial plans and how your investments are managed?**