THE TREASURY HUB
Banking Markets Bulletin

April 2023

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1. Executive Summary

1.1 Introduction

Welcome to the April edition of THE TREASURY HUB Banking Markets Bulletin.

There has been major developments in the banking markets internationally in 2023 and we will review these this and next month.

This month we will focus on international developments and how they may impact on Irish banks. Next month we will review the 2022 financial results of the Irish banks.

Inflation and its impact on interest rate trends continues to dominate commentary. Central Banks have maintained their tightening actions across the board but the pace is abating and speculation continues around when such rates may peak.

- 3-month Euribor continues to climb in line with ECB Base Rates and is now above 3.0%. The last time that it was at this level was in December 2008
- All three yield curves (EUR, UK and US) are inverted after 1 year with the steepest drop being in US rates
- Oil and Carbon prices are both up again in 2023
- EUR/GBP has traded in a very tight range so far this year. EUR/USD had followed a similar path but USD is now being impacted upon by expectation of falling interest rates
- Stock markets are having a good year after a poor 2022.

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

Table 1. Key Metric Movements: 2023

Heading	Metric	YTD move	From	To
Interest	3-m euribor	1.01%	2.16%	3.18%
Interest	EUR 3-year	0.17%	3.23%	3.39%
Interest	GBP 3-year	-0.10%	4.54%	4.44%
Interest	USD 3-year	0.14%	3.98%	4.12%
FX	EUR/GBP	-0.31%	0.8850	0.8823
FX	EUR/USD	2.85%	1.0662	1.0975
Equities	ISEQ	16.25%	7293	8478
Equities	FTSE 100	4.53%	7554	7896
Equities	Nasdaq	20.48%	10862	13087
Commodities	Brent Crude	2.90%	82.10	84.48
Commodities	Carbon	13.60%	81	91.55
Commodities	Gold	9.71%	1823	2000
Commodities	Wheat	-9.68%	775	700
Gilts	IE 10-yr	-0.12%	2.98%	2.86%
Gilts	GB 10-yr	0.06%	3.65%	3.71%
Gilts	US 10-yr	-0.21%	3.79%	3.58%

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 to climb along with ECB Base Rate hikes – the latter now at 3.50% after 6 rate hikes since July 2022. Next ECB meeting is on May 4th.
- Longer-term interest rates have more or less plateaued in most countries although likely timing of peak short-term rates remains debated as is the pace at which inflation will retreat.
- FX has been much less volatile in 2023 in the main currencies although AUD has had a year-to-date high/low spread of almost 8%.

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.

- All three indicators reflect broadly the same trends, positive Services sector with negative Manufacturing
- The negative trends in Ireland are marginal.

Table 2. Irish and UK PMI readings

	Ireland	UK
Manufacturing PMI	**49.7**	**47.9**
Services PMI	**55.7**	**52.9**
Construction PMI	**49.5**	**50.7**

1.3 Inflation

Table 3. Selected Inflation Rates

	CPI
ROI	**7.7%**
EUROZONE	**8.5%**
UK	**10.1%**
US	**5.0%**

Irish inflation has jumped around a little over the past year with a surprise increase in February to 8.5% from 7.8% the prior month. Food remains the most stubborn variable running at 13.1% in March.

Eurozone inflation has fallen for the 6th month in a row, down from a peak of +10.6% in October 2022.

UK inflation remains stubbornly high with it peaking at 11.1% in October, a 40-year high. Worryingly food in February was +18%, the highest since August 1977 which was a dim period economically for the UK.

The US has been ahead of the rest in tightening interest rates and now their inflation rate has slowed for the 10th month in a row having peaked at +9.1% in June 2022. While this trend is welcome, it needs to continue in order to justify stalling rate hikes by the US Fed.

Markets are now firmly of the view that interest rates will peak in 2023 so the key variable is how long do rates stay at these heights before retreating? Lot of US rate variability as markets also grapple with the specter of a possible recession.

2. Foreign Exchange, Oil & Carbon

2.1 EUR/USD

- We continue to monitor the 20-year trend in Graph 1 to put the current EUR/USD rate in a historic context
- One could argue that the trend (albeit with a lot of inter year and intra year moves), has been downward i.e. stronger USD since 2008.
- Annual volatility over that period was close to 13.5%
- The recent dollar weakness has been attributed to interest rates peaking (or expected to peak) before other jurisdictions
- There is scope for USD to weaken further and remain within this long-term downward range. It would require a break up through EUR/USD1.1750 to reassess it.

Graph 1. EUR/USD: 20-year trend

2.2 EUR/GBP

- EUR/GBP is also subject to the influence of inflation, interest rates and politics
- The first two items are interlinked and while the Bank of England ("BOE") hiked before the ECB and should be easing before it, inflation remains a sizeable problem in the UK and the longer it remains high, the more difficult it will be for the BOE to start cutting interest rates
- **Graph 2 overleaf is the 10-year trend in EUR/GBP**

- This graph shows that the medium-term range is still quite wide: EUR/GBP0.8250 TO EUR/GBP0.8920
- Future direction depends on the progress made by the UK in getting its inflation rate down in 2023. Politics, which dominated UK economic issues for a few years should take a back seat until the next general election which is expected to be held in Autumn 2024.

Graph 2. EUR/GBP: 10-year trend

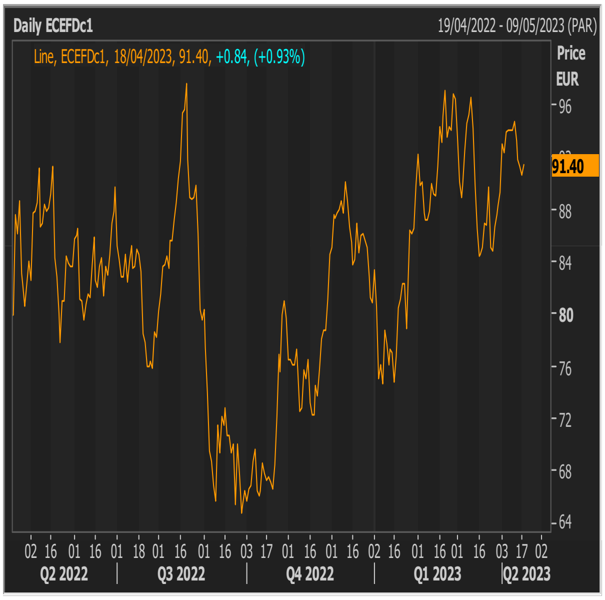
2.3 OIL & CARBON

Brent Crude spiked after the invasion of Ukraine but has been in a downward channel since last June. It recently bounced back off the top of the range at circa USD87.35 so it would require a break above USD86 to move out of this downward channel. OPEC has continued to manage production in order to maintain prices but if fears of a recession continue, the price would be expected to fall further.

The price of Carbon, by comparison has been very volatile over the past 12 months. On a few occasions, it has threatened but failed to break through EUR97 on a sustained basis. However, the retracing has been shallower with the most recent downward move stalling at EUR85. So, these trends, should they continue, suggest carbon prices holding in the EUR85-EUR95 range.

Graph 3. Brent Crude: 1-year trend

Graph 4. Carbon: 1-year trend



3. Interest and Economic Review

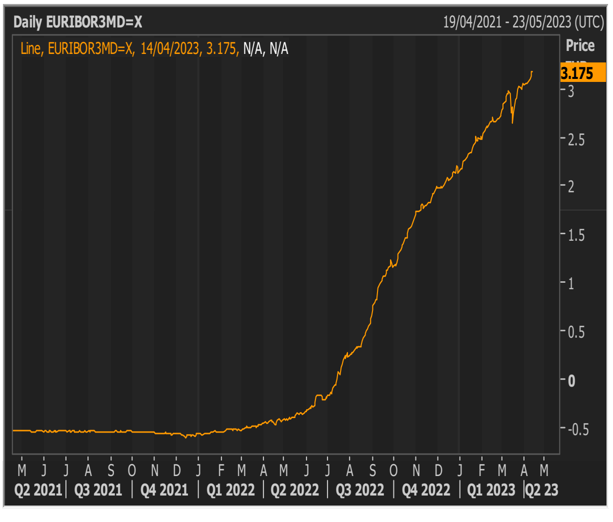
3.1 EUR Short-term Rates

Interest rates continue to be the main story of the markets since Summer 2022 having been benign for the best part of the previous 14 years. 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

- The 3-month rate drives the pricing of variable rate loans. This had been negative for a number of years but as Graph 5 below shows, the rate of increase since the end of Q1 2022 has been rapid in line with hikes in the ECB Base Rate
- The 6 and 12-month Euribor rates are currently 3.58% and 3.76% respectively
- We expect that the ECB will only hike by 0.25% at the next meeting bringing the rate to 3.75% and will then have to pause to assess the chances of economic slowdown
- **Deposit rates are very slow to move up as banks are using low deposit rates to fund competitive mortgage rates.**

Graph 5. 3-month Euribor: 2-year trend



3.2 EUR Medium-term Rates

- 3-year swap rates are a better indicator of the future direction of interest rates
- The EUR fixed rate curve (before margin) is inverted meaning that longer-term rates are LOWER than shorter-term rates. As already mentioned above, the 1-year rate is 3.76% but the 3-year rate is 3.34%
- The other significance of inversion is that it indicates rates are expected to peak within 12 months but the rate of decline currently expected by the market is also slow meaning we could see EUR interest rates remaining above 3% for some time.

Graph 6. EUR 3-year swaps: 1-year trend

3.3 Summary

- The cost of debt is now a material expense line for most businesses as with lending margins of between 3% and 4%, the all-in cost of debt is 7% on average
- This, in turn, ought to drive company valuations down as the cost of capital of investors, especially private equity, has increased
- We are also seeing the banks tightening credit and making loan applications more difficult as well as lending lower multiples of profits as a general rule
- **If there is further fallout on the international banking scene, expect this to get worse meaning credit could get very tight again.**

3.4 UK and US Interest Rates

- BOE Base Rate was as low as 0.10% in March 2020 due to the pandemic but it has since been hiked on 11 occasions since December 2021 with the current rate at 4.25%
- **As Graph 7 below shows, the UK 3-year rate is well off last years highs but isn't expected to fall below 4% in the coming 12 months**.

Graph 7. GBP 3-year swaps: 1-year trend

Graph 8. USD 3-year swap rates: 1-year trend

- US rates have been bouncing around quite a bit over the past few months
- The market continues to shift in its thinking around how slowly inflation will fall and at what level it might "stick"
- US rates are higher than in the UK or Eurozone with the 1-year currently at 5.12% but the implied 1-year rate in 1 year's time is 3.80% which is a much faster predicted fall in rates than in either UK or Eurozone
- And debate also rages around the possibility/probability of US recession
- While inflation shows signs of abating, the employment market remains extremely tight with unemployment still at 3.5% (5.84m unemployed). The labour participation rate remains just above 62% and job vacancies stood at 9.5m at the end of February. However, unemployment is a lagging indicator – the economy will slow before unemployment rises
- And while recent housing data was broadly ok, March retail sales disappointed
- In summary, there is increasing concern that recession can't be avoided.

3.5 Summary

- **All indications are that central banks are coming to the end of the current interest rate hiking cycle**
- **UK rates may increase once more but the market is currently split on that**
- **We believe that ECB will hike by 0.25% at the next meeting but will have to pause thereafter to assess the situation. Our previous prediction was that rates should "top out" at 3.50%/3.75%. The Base Rate is currently 3.50%**
- **And while inflation is coming down, it remains quite high in the UK and food inflation also seems to be higher than would be desirable**
- **PMI readings as set out in Section 1 are mixed with services sector holding up but manufacturing readings indicating contraction**
- **All in all, fears of recession remain, especially in the US and the real challenge would be a shrinking economy mixed with inflation**
- **Interest rate trends are also starting to impact on FX markets ref USD weakness on back of expectation of lower US interest rates in 2024**
- **But as mentioned earlier, the biggest concern in all of this is the tightening of credit conditions (banks make it harder to borrow) fueled by high interest rates, a slowing economy and possible further changes in the banking sector globally.**

4. Wealth Management

4.1 Gold

Graph 9. Gold prices: 1-year trend

- Gold prices are back up, quite steeply (+10%) since the end of February and as we have mentioned before, this tends to happen when fears of a recession increase.

4.2 Wheat

Graph 10. Wheat prices: 1-year trend

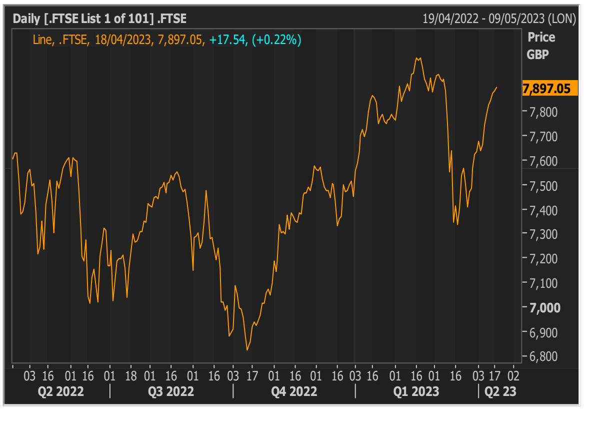
- Wheat has settled down over the past 2 quarters as supply issues didn't arise over Winter
- The range over the past 6 weeks has been 650c to 710c
- Should remain rangebound in the short-term.

4.3 Equity Markets

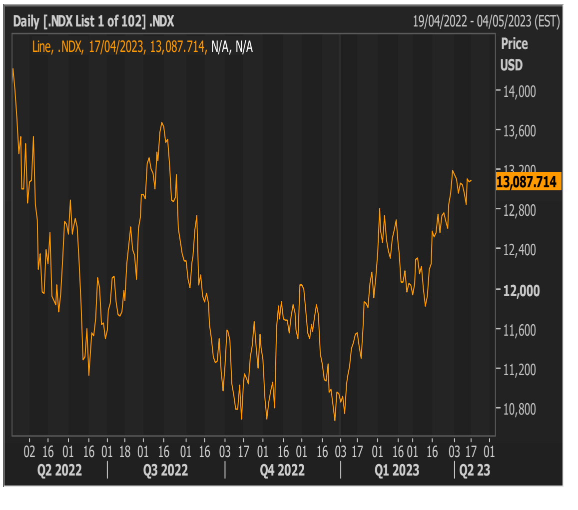
- After a generally poor 2022, equity markets have bounced back strongly this year with tech stocks which took a particular hammering making the sharpest gains
- Still looks a bit overdone against a backdrop of potential recession in the US later this year but pension funds will welcome the rally.

Graph 11. ISEQ: 1-year trend

Graph 12. FTSE: 1-year trend



Graph 13. NASDAQ: 1-year trend



5. International Banking Developments

5.1 Silicon Valley Bank ("SVB")

In light of the recent demise of SVB and its exposure to bonds in particular, we have summarised what we believe to have been the issues based on the publicly available information.

After the financial crisis regulators brought in new rules which stress tested the ability of every bank to meet a run on deposits which required a material % of their assets to be liquid assets that they could realise into cash very quickly.

Government bonds would be seen as highly liquid and also, assuming that they are issued by good credit quality countries, should be of an acceptable credit rating.

SVB invested in US government bonds but from a risk management perspective, there were two major question marks over their strategy.

Firstly, they invested in 10-year bonds. The price of such bonds can be quite volatile as if, for example, 10-year interest rates increase by 1%, it is 1% every year for 10 years. A 1% increase in 2-year bonds would be a lot less volatile as it only applies to a 2-year period. Because they invested before rates rose too much and as bond yields are fixed for their life, rising interest rates meant that the value of the bond portfolio fell and was apparently €1.8bn lower in value compared to the value initially invested. They said that they had designated them as "hold to maturity" bonds which meant that they didn't have to recognise this falling value in their P&L.
Which leads to the second point: if they were hold to maturity bonds then how could the bank be holding them in case of a liquidity squeeze as, by definition, if required for liquidity that would involve their potential sale?

By not having a mix of bonds with differing maturities they were also hostage to fortune on 10-year yields due to the concentration of investment in that 10-year part of the curve. There was also concentration risk on their deposit base as they had taken deposits from tech companies, especially start-ups (that raise equity, place the funds on deposit and draw from them to fund the business over time). Retail banks tend to have smaller deposits from a large number of customers – these were larger deposits from a smaller number of customers. Because the deposit insurance scheme is $250k max in the US (€100k is the equivalent here), most of the deposits would not be covered as they were well in excess of that so when the panic started and a number of firms withdrew their deposits, it started a run on the bank.

The moral of the story from an investment strategy perspective is only invest in short-dated gilts from a valuation and liquidity perspective. And as we have seen from the previous section, the extra yield for investing in longer-term bonds is not worth the valuation risk at this point in time.

5.2 Credit Suisse

In the case of Credit Suisse, the issues have been bubbling for a longer time, especially on the investment banking side, having made some significant and poor lending bets on the likes of Green sill where they are trying to recover $10bn and Archegos where they lost $5.5bn.

No doubt there will be serious question marks over the value of many investments on the balance sheet of the investment bank and this, in turn, is likely to require write-downs/losses which, in turn, would have an adverse impact on their capital. As part of the rescue package announced on March 19th last, $17bn of additional Tier 1 debt (subordinated bonds) would be written down to zero and capitalised as equity. These bonds would rank very low in a liquidation/restructuring and would have paid a higher coupon as a result an any case.

The impact of this activity will probably be on bond prices everywhere, especially subordinated and/or long-dated bonds and it is insurance companies and pension funds that could feel a lot of the pressure as much as any bank.

5. UK

5.3 General Comment

The banking sector was supposed to have been much more tightly regulated after the 2008 financial crisis. But it would appear in the case of SVB that regulations for regional banks were relaxed in the Trump era.

The irony for SVB is that the mistakes that were made were very basic. The worry is that the regulations permitted this to occur.

The larger US banks according to a recent report have no liquidity problems in the sense that their loan:deposit ratio is only 69% i.e. for every $1 deposit held, only $0.69 has been lent out. The question for these banks is how much of their “surplus” deposits are invested in long-term government bonds?

A couple of items of concern worth noting are:

1. European banks loan:deposit ratio is 109% per one of the Irish banks recent presentations implying that they are more open to a liquidity squeeze than Irish banks
2. The sector most open to a correction in the US is Commercial Real Estate (“CRE”). This has been adversely impacted by much higher interest rates, increased working from home, reduced headcount in tech in general and significant refinancing in the near-term (40% of all CRE loans are due to be refinanced, probably at much higher rates, by 2025). It is estimated that CRE loans account for 8-9% of bank assets in the US (value of $1.8trillion). Not enough to wipe out the banks but enough to cause difficulties and probably cause problems for banks that have a higher concentration of CRE loans in their loan portfolios
3. Interest rate mismatch. This caused the problem with trackers in 2008 as the basis of lending (ECB Base Rate) moved higher than the basis of borrowing (euribor) for banks. Assuming that we are correct in our reading of the Irish market in that banks are keeping deposit rates low to fund mortgages, then they are funding fixed rate long-term loans with floating rate short-term sources of funding. The refinancing risk on the funding is reduced to the extent that they have such high levels of “surplus” deposits but one could question why they are allowed to take the interest rate mismatch given that this, in part, led to SVB’s troubles.

In next month’s bulletin we will look at the 2022 results of the Irish banks and set out why we think they are in relatively good shape compared to their international peers.