THE TREASURY HUB
Markets Bulletin

May 2023

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1. Executive Summary

1.1 Introduction

Welcome to the May edition of THE TREASURY HUB Markets Bulletin.

As set out in last month's bulletin, we have second part of our review of major developments in the banking markets, internationally and domestically, this month.

This month we focus on a small element of international developments but mainly on 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 the US looks like it may now have peaked.

- 3-month Euribor continues to climb in line with ECB Base Rates and is now above 3.4%. The last time that it was at this level was in 2008
- EUR and US yield curves are inverted after 1 year with the steepest drop being in US rates. UK curve is only inverted after two years
- Oil and Carbon prices are at the lower end of recent ranges
- EUR/GBP has traded in a very tight range so far this year. EUR/USD is now starting to strengthen after a period of relative weakness
- Stock markets, with the exception of the UK, 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	1.28%	2.16%	3.44%
Interest	EUR 3-year	0.21%	3.23%	3.43%
Interest	GBP 3-year	0.65%	4.54%	5.19%
Interest	USD 3-year	0.24%	3.98%	4.22%
FX	EUR/GBP	-1.86%	0.8850	0.8688
FX	EUR/USD	0.45%	1.0662	1.071
Equities	ISEQ	17.29%	7293	8554
Equities	FTSE 100	0.32%	7554	7578
Equities	Nasdaq	28.18%	10862	13923
Commodities	Brent Crude	-7.69%	82.10	75.79
Commodities	Carbon	-0.11%	81	80.91
Commodities	Gold	6.64%	1823	1944
Commodities	Wheat	-21.29%	775	610
Gilts	IE 10-yr	-0.05%	2.98%	2.93%
Gilts	GB 10-yr	0.73%	3.65%	4.38%
Gilts	US 10-yr	-0.01%	3.79%	3.78%

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 3.75% after 7 rate hikes since July 2022. Next ECB could see last hike for now.
- Longer-term interest rates have all shifted upwards in the past month as markets reassess the rate peak in the current cycle and react to higher than expected inflation figures.
- FX has been much less volatile in 2023 in the main currencies although JPY has had a year-to-date high/low spread of over 10.35% and currently sits just below EUR/JPY150.

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.

- Two of the three ROI indicators are negative with Services bucking the trend by moving higher in the past month
- In the UK, only one of readings is negative with Services also holding up there.

Table 2. Irish and UK PMI readings

	Ireland	UK
Manufacturing PMI	**48.6**	**46.9**
Services PMI	**58.4**	**55.1**
Construction PMI	**48.4**	**51.1**

1.3 Inflation

Table 3. Selected Inflation Rates

	CPI/Core Inflation
ROI	**6.4%**
EUROZONE	**5.6%**
UK	**6.8%**
US	**4.7%**

Core figures are looked at as they exclude energy, mortgages and food.

Irish rate has been above 6% for each of the past three months which is higher than the previous nine months. Energy prices are falling but food inflation remains stubbornly high at +13.1%

Eurozone core inflation has been climbing steadily for all bar one of the past 10 months. Food prices are actually falling across the Eurozone.

UK inflation remains higher than other major countries with the core reading being 0.6% higher than forecasts reaching a 31-year high. Food inflation is also very high at +19.0%.

The US core inflation rate slowed for the 7th month in a row while the headline inflation figure fell for the 11th month. The US was first to raise interest rates and it appears to be seeing the ultimate objective (lower inflation) being realised before the other major nations.

US rates look pretty certain to peak soon (if not already there) – some are forecasting two cuts by year-end…we don't see that as likely at this time, barring a major recession/banking crisis there.
Eurozone should also peak either after the next meeting or Q3 latest.
UK is in a tricker situation, especially with inflation still so high although their economic growth outlook is not good – prospect of stagflation?

2. Foreign Exchange, Oil & Carbon

2.1 EUR/USD

- We monitor the 5-year trend in Graph 1 to look at the EUR/USD rate trends in more recent times
- The rate had strengthened very quickly over 15 months from May 2021 breaching parity for 2 months in September/October 2022
- It subsequently weakened by 10% into Q1 2023 but has ranged between EUR/USD1.05 and EUR/USD1.10 since
- The dollar has strengthened recently versus EUR but this is attributable to EUR weakness rather than USD strength
- The future direction is quite difficult to predict for now as so much depends on interest rate peak points in the cycle, inflation and US banking fears. And that's before we start to focus on the 2024 US Presidential election!

Graph 1. EUR/USD: 5-year trend

2.2 EUR/GBP

- EUR/GBP is also subject to the influence of inflation, interest rates and politics with politics being the main driver over the past few years
- Thankfully this has moved into the background in 2023 and the result has been a remarkably stable trend in EUR/GBP
- **Graph 2 overleaf is the 1-year trend in EUR/GBP which highlights how this has settled into a narrower range in 2023.**

- This graph shows that the range this year is quite narrow: EUR/GBP0.8671 TO EUR/GBP0.8827
- The rate has started to test the lower end of the range in recent times, manly due to EUR weakness rather than GBP strength. Difficult to call future direction as it lacks momentum (in either direction). Politics will re-emerge as a driver in 2024.

Graph 2. EUR/GBP: 1-year trend

2.3 OIL & CARBON

Brent Crude having spiked after the invasion of Ukraine to USD127 has been pretty much in a downward trend since June 2022 and is currently almost 8% below the level at the start of the year.

The price of Carbon continues to remain very volatile. The gradual upward trend that prevailed from end Q3 2022 reversed in the middle of Q1 2023 and the rate is now just below where it started the year at under EUR81.

3. Interest and Economic Review

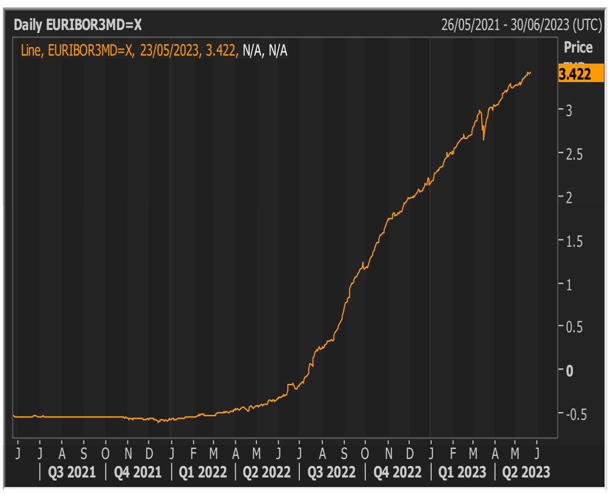
3.1 EUR Short-term Rates

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 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. The days of negative rates are now a part of the distant past as Graph 5 below shows, with gradual increases since the end of Q1 2022 in line with hikes in the ECB Base Rate
- The 6 and 12-month Euribor rates are currently 3.73% and 3.90% respectively which are up on the previous month
- ECB hiked by 0.25% at the May meeting as we predicted to 3.75% but we now expect one more 0.25% increase before Summer followed by a pause
- **Deposit rates remain very low and we think they will slowly increase in the second half of the year but not by much.**

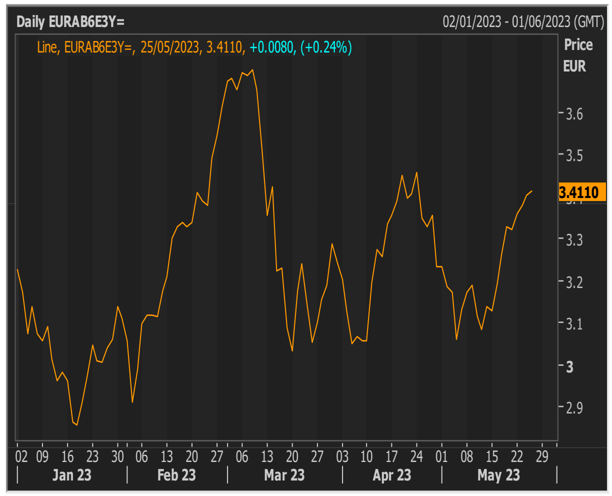
Graph 5. 3-month Euribor: 2-year trend



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 at 1-year meaning that longer-term rates (2-years +) are LOWER than shorter-term rates. As already mentioned above, the 1-year rate is 3.90% but the 3-year rate is 3.41%
- This inverted yield curve also indicates that rates are expected to peak within 12 months. We remain of the view that the rate of decline will be slow meaning we could see EUR interest rates remaining in the 3%-4% range for some time.

Graph 6. EUR 3-year swaps: 2023 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 although it can vary between banks and so is with talking to us about borrowing rates
- We continue to see the banks tightening credit and making loan applications more difficult as well as lending lower multiples of profits and taking longer to make lending decisions
- **Keep an eye on US banking developments as adverse events will have a contagion impact on banks globally, however briefly.**

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 been hiked on 12 occasions since December 2021 with the current rate at 4.50%, last seen in October '08
- **As Graph 7 below shows, the UK 3-year rate has risen by over 1% since the end of April in contrast to other countries**.

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

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

- US rates have risen again in the past month as the market continues to assess the probability of inflation falling and at what level it might "stick"
- One of the key features in the US yield curve is that US 1-year rate is currently 5.53% but the implied 1-year rate in 1 year's time is 3.89% which is a much faster predicted fall in rates than in either UK or Eurozone
- We believe that the possibility of US recession has increased based on these trends and also the concern that the US banking sector will have further fallout
- And previous talk of two rate cuts by the Fed in 2023 looks very optimistic
- The employment market remains tight with unemployment falling last month to 3.4% (5.67m unemployed). The labour participation rate remains just above 62% although job vacancies fell to 9.35m at the end of March
- Housing permits (planning applications) fell for the second month in a row, March retail sales were marginally higher at +0.4% after the fall of -0.7% the previous month
- In addition to the above, there is growing concern about a possible real estate problem with US banks which could contribute to a US economic slowdown.

3.5 Summary

- **Each month brings us closer to the end of the current interest rate hiking cycle by Central Banks**
- **UK rates are expected to rise further give that the implied 1-year rate in one year's time is higher than the current 1-year rate**
- **We still believe that ECB will hike by 0.25% before Summer but will have to pause thereafter to assess the situation. A Base Rate of 4% is only 0.25% off the previous peak in 2008 and it was generally accepted that the last hike to 4.25% then should not have happened. It remains to be seen if history repeats itself**
- **And inflation remains quite high, with an increase last month in the Eurozone rate and the UK still high after 7 months in double digit figures!**
- **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 which also had the added potential risk of more banking issues and a possible real estate bubble**
- **Interest rates are probably at levels which are more akin to "normal" as the negative interest rate environment that prevailed for so long should not be described as such. This new norm will prevail.**

4. Wealth Management

4.1 Gold

Graph 9. Gold prices: 1-year trend

- We have kept Gold on this bulletin as it's a perceived safe haven in turbulent times. The recent spike has also been boosted through buying by Central Banks and a shift by some investors away from dollars.

4.2 Wheat

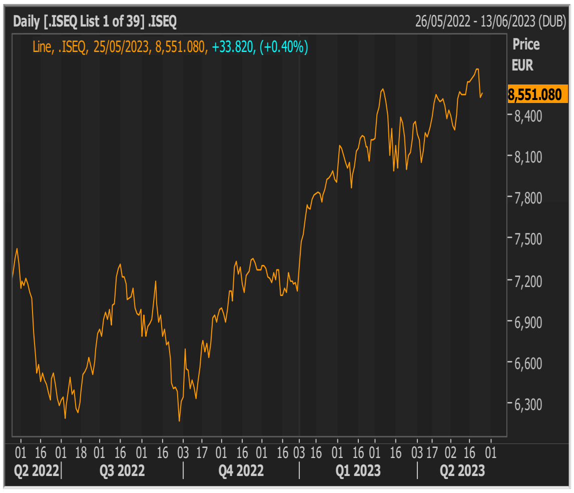
Graph 10. Wheat prices: 1-year trend

- Wheat has completely settled down over the past 2 quarters as there were no supply shocks over Winter
- The range over the past 6 weeks has been 610c to 710c
- The pressure looks to be off in the short-term.

4.3 Equity Markets

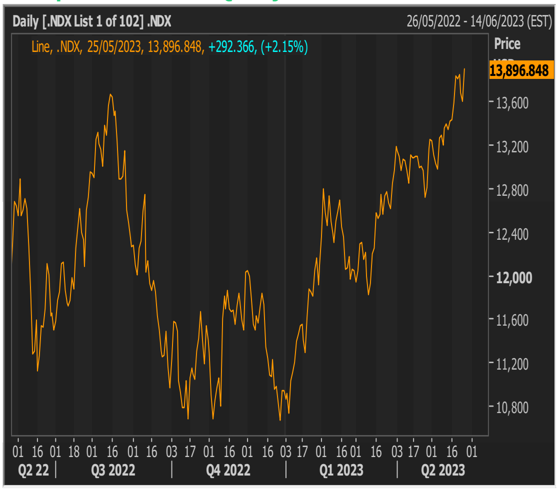
- Equity markets continue to hold this year's gains for the most part as we head into June with tech stocks posting the sharpest gains
- Most disappointing index would be the FTSE in London which is back to levels seen at the start of the year. The stock exchange is also losing business/volume to Paris and New York.

Graph 11. ISEQ: 1-year trend



Graph 12. FTSE: 1-year trend

Graph 13. NASDAQ: 1-year trend



5. Banking Developments

5.1 International Update

- Genuine feeling that US bank woes are not over (the Fed is also sitting on huge unrealised losses on its bond holdings but this is rarely mentioned)
- Deposits continue to flow out of regional banks into the main US banks
- JP Morgan acquired First Republic Bank which was the US's 14th largest bank however it will still cost the US deposit fund (which insures depositors up to $250,000) up to $13bn
- The risk of further contagion exists as does the risk of a real estate bubble
- Real estate issues are not confined to the US. In the UK for example, 8% of all office space (100m square metres) is unoccupied with older buildings almost impossible to sell due to their climate-unfriendly state
- And we have cited before that the banks internationally fear the challenge of non-banks due to their huge customer base and slick data analytics
- FT ran an article recently showing that Starbucks via their app, where customers can preload money into their accounts, now has $1.8bn in such cash balances making it larger than 90% of institutions covered by the Federal Deposit Insurance Corporation
- Arguably bigger news was the launch by Apple of a new deposit account via Apple Card in conjunction with Goldman Sachs at a rate of 4.15% and it was rumoured to have taken in almost $1billion within a week of its launch
- It is fair to say that this is the trend that banks feared the most.

5.2 Irish Banks

- The three Irish banks issued their 2022 results in recent times
- The table below summarises key data

Table 4. Irish Bank Data

	BOI 2021	BOI 2022	AIB 2021	AIB 2022	PTSB 2021	PTSB 2022
Net Interest Margin	1.86%	1.96%	1.58%	1.74%	1.51%	1.54%
Cost/Income	58%	54%	64%	57%	82%	84%
Customer Loans (€bn)	76.0	72.0	56.5	59.6	14.2	19.5
Customer Deposits (€bn)	93.0	99.0	92.9	102.4	20.0	21.7
Loan to Deposit	82%	73%	61%	58%	75%	90%
LCR	181%	221%	203%	192%	274%	178%
NSFR	144%	163%	160%	164%	170%	154%
CET 1	16%	15.4%	16.6%	16.3%	15.1%	15.2%
SME Lending ROI €bn	7.1	7.0	18.7	19.4	0.225	1.00

- Note:
  - LCR is Liquidity Coverage Ratio and measures the ability of the bank to react to a run on its deposits in the short-ter.
  - NSFR is the Net Stable Funding ratio a nd measures the stability of medium-term funding of the bank
  - CET 1 is the Common Equity Tier and measures the ratio of equity to a bank's risk-weighted assets
  - All of these were introduced as requirements following the last financial crisis
- The standout points are:
- Increasing net margin (gap between what they pay on deposits and what they charge on loans)
- There remains a large discrepancy in the cost: income ratio between the two major banks and PTSB

5. UK

5.2 Irish Banks continued..

- All banks have a surplus of deposits over loans with BOI and AIB surpluses being very material – over €40billion in the case of AIB
- They are likely to generate significant profits from these surplus deposits this year as they can deposit such funds with the ECB at a rate currently of 3.25% with no credit risk and no capital requirements
- The data would square with Central Bank data which shows Irish Banks in much better shape than during the last crisis. For example, SME loans at now less than 40% of 2010 levels, private household borrowings are now €95bn compared to a peak of almost €150bn in 2008 while the corresponding figures for deposits are €79bn in 2010 and almost €133bn in March.
- As was pointed out in the last bulletin, the loan:deposit ratio of European banks was over 100% at the end of 2022 compared to 58% for AIB
- So, the two main banks are almost the polar opposite of where they were in 2008
- The most recent Central Bank SME Lending report (March 2023) showed the weighted average interest rate on new SME drawdowns rising by 1.12% to 5.23%
- However, lending to Irish private-sector enterprises decreased by €1.6billion in Q4 2022 after three quarters of growth
- Meanwhile the deposits of these enterprises grew by €6.6billion in the quarter
- The fall off in borrowing could be attributed to a softening of appetite by customers against a backdrop of possible slowing economy and rising interest rates