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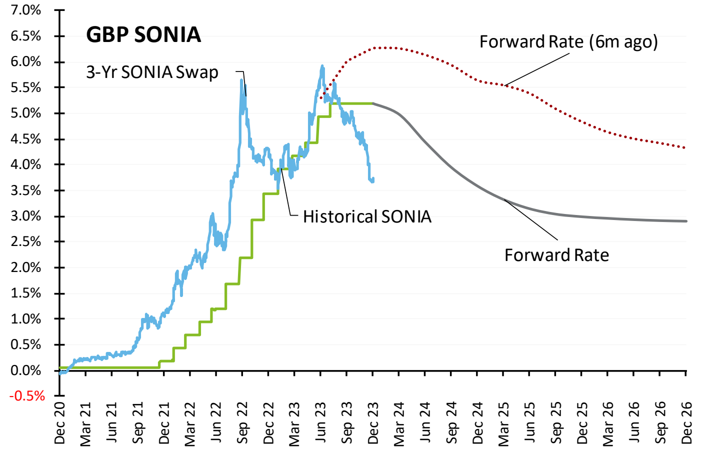
IR and FX Newsletter

January 2024

Interest Rate Markets

The final central bank meetings from the Federal Reserve ("Fed"), Bank of England ("BOE") and European Central Bank ("ECB") signalled a paradigm shift for rate expectations, with the Fed leading the way on 13th December, as US policymakers' median expectations – the Dot Plot – indicate 75bps of rate cuts in 2024. Markets, however, deem this to be an underestimation, with up to 150bps of cuts priced in.

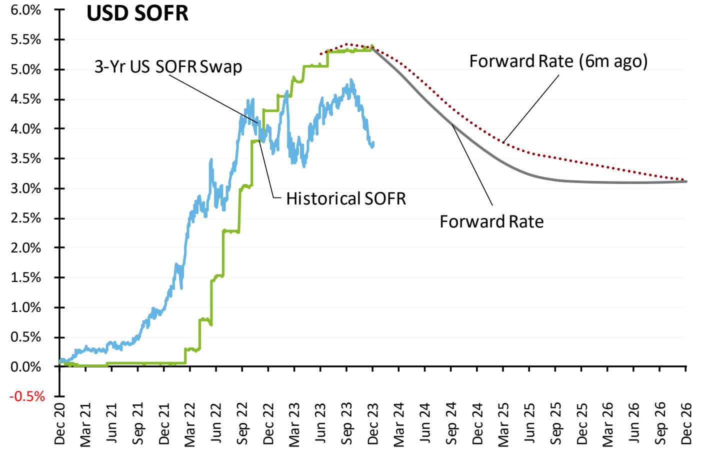
Falling inflation across the UK and Europe has also seen markets adopt a similarly aggressive stance on rate cut expectations in each jurisdiction, with up to 140bps and 150bps worth of cuts priced in, respectively. Notably, the UK's December's headline inflation print showed a sizeable drop in the level for November at 3.9% year-on-year, the lowest reading since October 2021 and against a forecasted 4.3%.



- The underlying SONIA rate is currently at 5.19%
- BOE base rate is at 5.25% following a pause at the BOE's meeting on 14th December, which marked the third consecutive rate hold.
- The 3-year SONIA Swap rate is 3.75%, vs. 5.82% 6 months ago, and down 67bps month-on-month ("MoM"), with markets anticipating the first 25bps cut in May 2024.
- The forward curve remains downward sloping from Q2 2024.

	2-year	3-year	5-year
Swap rate (mid level)	4.07%	3.75%	3.42%
Cap @ 4.50% (premium)*	£0.78m	£1.21m	£2.28m
Cap @ 5.00% (premium)*	£0.43m	£0.78m	£1.69m

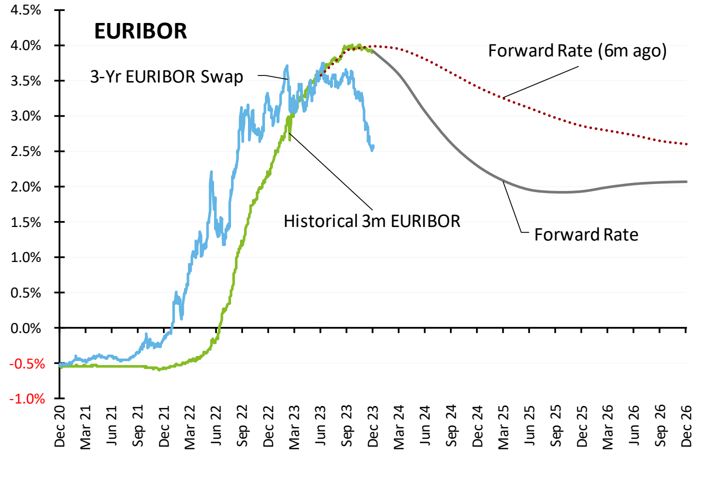
*£100m hedge notional



- SOFR is currently 5.38%, inside the Fed Funds target rate range of 5.25%-5.50%.
- The Federal Reserve held rates at their meeting on 13th December, with markets forecasting the first 25bps rate cut in March 2024.
- The 3-year SOFR Swap rate is 3.77%, vs. 4.44% 6m ago, and down 32bps MoM.
- The forward curve is steeply inverted from Q2 2024.

	2-year	3-year	5-year
Swap rate (mid level)	4.07%	3.77%	3.55%
Cap @ 4.50% (premium)*	$0.75m	$0.99m	$1.87m
Cap @ 5.00% (premium)*	$0.38m	$0.53m	$1.23m

*$100m hedge notional



- 3-month EURIBOR is 3.91%.
- The ECB held rates at 4.00% at their meeting on 14th December. Markets now look towards the ECB's first 25bps rate cut in March or April this year.
- The 3-year EURIBOR Swap rate is currently 2.58%, vs. 3.64% 6 months ago.
- The forward curve is inverted from Q2 2024.

	2-year	3-year	5-year
Swap rate (mid level)	2.84%	2.58%	2.47%
Cap @ 3.00% (premium)*	€0.68m	€1.02m	€1.97m
Cap @ 3.50% (premium)*	€0.31m	€0.54m	€1.26m

*€100m hedge notional

Data source: Refinitiv and ICE Data Services, as of 2nd January 2024

What can be done in the current Interest Rate markets?

Borrowers can fix rates below the current floating rate:

Not only is there no additional cost to fix floating rate exposure, but the current downward forward curve allows borrowers to fix rates at levels below the current floating rate:

- SONIA 3m is 5.19% and a vanilla 5y Swap is 3.38%. On a GBP 100m financing, swapping to fix reduces interest costs in year 1 by GBP 1.81m.
- SOFR 3m at 5.29% and a vanilla 5y Swap is 3.54%. On a USD 100m financing, swapping to fix reduces interest costs in year 1 by USD 1.75m.
- EURIBOR 3m at 3.91% and a vanilla 5y Swap is 2.49%. On a EUR 100m financing, swapping to fix reduces interest costs in year 1 by EUR 1.42m.

Longer- term hedges are cheaper than shorter-term hedges:

Because of the downward forward curve, long term hedges are cheaper than short term hedges:

- GBP swap: 1-year: 4.73%, 3-year: 3.70%, 5-year: 3.38%
- USD swap: 1-year: 4.72%, 3-year: 3.75%, 5-year: 3.54%
- EUR swap: 1-year: 3.47%, 3-year: 2.58%, 5-year: 2.49%

Pre-hedging achieves even lower rates:

Pre-hedging future debt (assumed closing is in 6 months) is cheaper than at current hedge rates:

- GBP 5-year Swap starting in 6 months: 3.14%
- USD 5-year Swap starting in 6 months: 3.34%
- EUR 5-year Swap starting in 6 months: 2.23%

Funding of Hedging costs can be done at favourable rates

Hedging costs for Option products (such as Caps) are typically paid upfront, however these costs can be deferred over time. This cost deferral can be done via the derivative desks at favourable rates (at SONIA, EURIBOR or SOFR, without additional margin), rather than via additional borrowing under the facility agreements (at SONIA, EURIBOR or SOFR plus margin).

Data source: Refinitiv, ICE Data Services and Deloitte Analysis, as of 2nd January 2024

Blend and Extend – Leveraging derivative assets to extend favourable swap rates

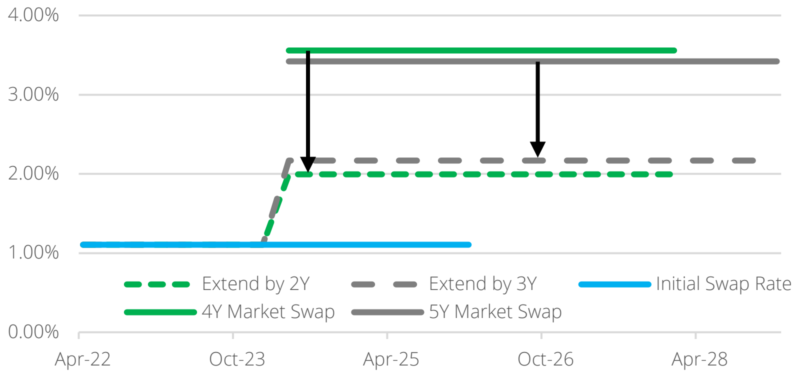
Executive Summary

Owing to the substantial rise in interest rates in the last two years, those who elected to hedge earlier in, or before, this monetary policy cycle (and are still in possession of the interest rate swap) will find themselves holding a large asset.

For example, those who executed a GBP 4-year swap in January 2022, at c. 1.1%, can restructure their hedge – incorporating the sizeable positive mark-to-market ("MtM") – through a "blend and extend" strategy, would cut current 4Y / 5Y market swap rates of 3.56% and 3.42% respectively by 125-160bps to 1.99% and 2.17% respectively. Such restructuring does not require any cash outflow and, on a £100m hedge, would result in instant cash savings of GBP 1.25m per year vis-à-vis the equivalent on-market 5Y swap.

Market commentary

The current market events have resulted in higher interest rates in most major economies. Since December 2021, the Bank of England has raised rates by over 500bps to a 15-year high of 5.25%. As a result, the SONIA fixing is currently at 5.19% and the 5Y GBP swaps steadied at rates of c. 3.40%. Leveraging a sizeable MtM can result in a blended swap rate well below the current 5Y market rate – evidenced by the black arrows from the market swaps to the corresponding dashed lines. On GBP 100m financing, extending the example hedge by 3Y can reduce interest expense by **GBP 1.25m in the first year.**



Source: Refinitiv, data as of 2nd January 2024

	Existing 4Y Hedge*	Extend by 2Y	Extend by 3Y
GBP Swap	1.11%	1.99%	2.17%

*Source: Refinitiv, data as of 2nd January 2024. *Hedge executed in January 2022, indicatively.*

	Current Hedge Levels		
	SONIA	4Y Swap	5Y Swap
GBP Rates	5.19%	3.56%	3.42%

Source: Refinitiv, data as of 2nd January 2024

The opportunity

These conditions present an opportunity for borrowers to consider so called "blend and extend" strategies, to immediately extend favourable hedge rates and minimise the strain on cash flow. Such strategies can be valuable when:

- interest rate swaps were put in place in lower rate environments
- the underlying debt runs longer than the current hedge term, or near-term maturing debt is expected to be extended

An example of such a restructured transaction could be as follows:

Current hedge:

£100m notional swap, executed in 2022, maturity 2026, at a rate of 1.10%.

Restructured into:

New hedge:

£100m notional swap, maturity extended to 2029, at an all-in rate of 2.17%, versus a new 5Y swap of 3.42%.

Advantages

Lower than market rate: from **2.17%** vs. **3.42%**

Ongoing Interest cost savings: **GBP 1.25m p/a**

Interest Rate protection: extended **until 2029**

Cash flow at execution: **none**

Key considerations

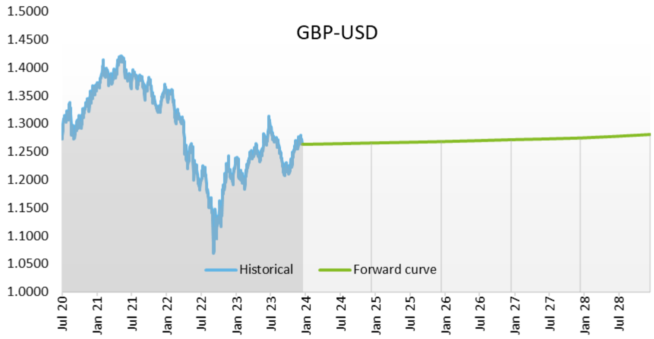
Derivatives pricing elements, such as forward rates and discounting curves, credit charges, liquidity and execution spreads, should be thoroughly negotiated with the banks. Leaving those negotiation points unaddressed will result in higher charges, larger derivative liabilities and higher applicable rates.

In the above example, every basis point on the new swap is worth GBP 45.5k, therefore even a few basis points of improvement in the negotiated rate could result in significant value for the borrower.

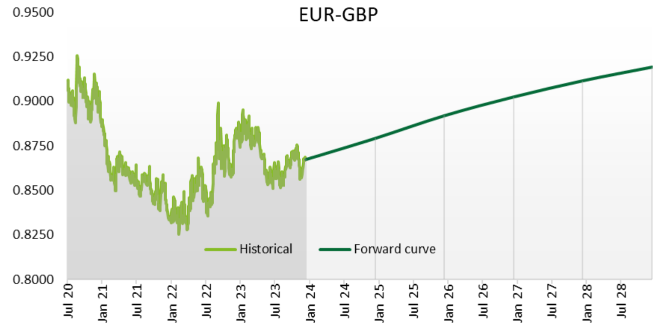
There are a plethora of alternate ways to utilise derivatives to adjust future cashflows. Our Hedging Advisory and Derivatives Execution team can help you assess the pros and cons of each strategy, determine the most appropriate structure for your business and lead the pricing negotiations with the banks, to execute the transaction efficiently.

Data source: Refinitiv, ICE Data Services and Deloitte Analysis, as of 2nd January 2024

Currency Markets



- GBP-USD is near enough flat month-on-month and up 6% on the year, with sterling the second best-performing major currency against the dollar, behind the Swiss Franc. However, this narrative is set to be tested in 2024, with inflation data in the UK expected to fall in-line with the US, as well as an expected UK General Election.
- Option premia was up as high as 8% on the month, with thinner holiday trading conditions and geopolitical uncertainty weighing on currency markets.
- Forward FX rates remain flat out through 5 years for GBP sellers, suggesting no deviation between interest rate environments across both countries.



- EUR-GBP appreciated marginally MoM as markets digested better-than-expected inflation data in both jurisdictions.
- The cost of hedging via options for EUR-GBP increased by up to 7.50%, depending on the level of protection sought – see grid below.
- FX forward rates have steepened for EUR sellers out through 5 years, as markets price in the first rate cut from the ECB for April, and c. 150bps in total by the end of 2024.

GBP-USD Spot Rate: 1.264	6mo	12mo	18mo
Forward rate	1.265	1.266	1.267
GBP Put Option* (ATMS**)	$2.65m	$3.89m	$4.75m
GBP Put Option* (5% OTMS***)	$0.82m	$1.88m	$2.66m
* GBP 100m Put option premium			
** At-the-money Spot rate:	1.264		
*** 5% Out-of-the-money vs Spot rate:	1.200		

EUR-GBP Spot Rate: 0.867	6mo	12mo	18mo
Forward rate	0.873	0.879	0.887
GBP Put Option* (ATMS**)	€2.22m	€3.58m	€4.69m
GBP Put Option* (5% OTMS***)	€0.44m	€1.30m	€2.16m
* GBP 100m Put option premium			
** At-the-money Spot rate:	0.867		
*** 5% Out-of-the-money vs Spot rate:	0.911		

Data source: Refinitiv, ICE Data Services and Deloitte Analysis, as of 2nd January 2024

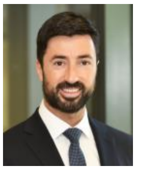
Hedging Advisory and Derivatives Execution team

Hedging Strategy Advice

Outsourced Derivative Execution

Financial Market Knowledge

Derivative Pricing Expertise



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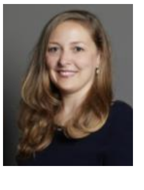

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