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IR and FX Newsletter

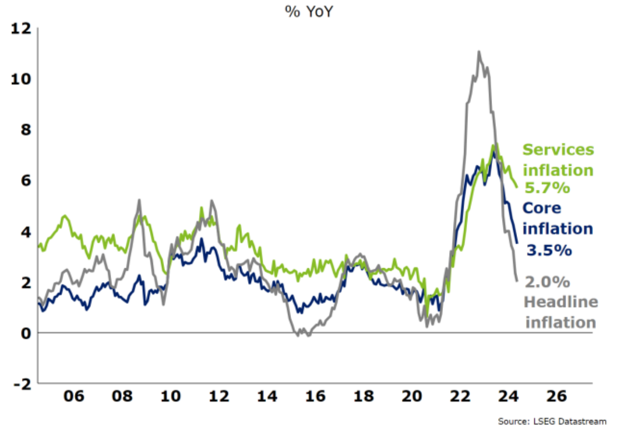
July 2024

A Macro View: Rate expectations ease slightly in June

Economic data releases in June point to continued improvement in UK activity, after what has been a long period of low-to-no growth. High–frequency purchasing managers indices showed that the ailing manufacturing and construction sectors are finally staging a recovery and retail sales data indicated an improvement in consumer spending after a long inflation-driven squeeze in demand.

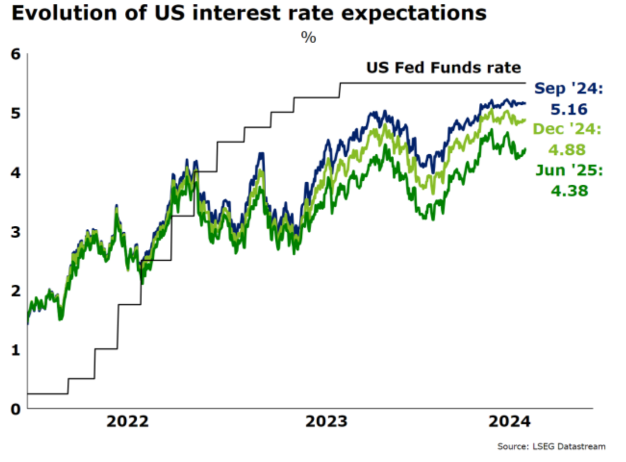
While activity is picking up, headline inflation in the UK has fallen back to the Bank of England's 2% target. This has driven a slight easing in market rate expectations over the last month. But measures of underlying price pressure, such as services price rises (see adjoining chart), remain in inflationary territory. Despite continued falls in vacancies and a slight uptick in unemployment, the labour market also remains tight by historical standards. Given these price pressures and a reviving economy, the Bank of England will likely be in no rush to cut rates.

UK: Headline and alternative measures of inflation



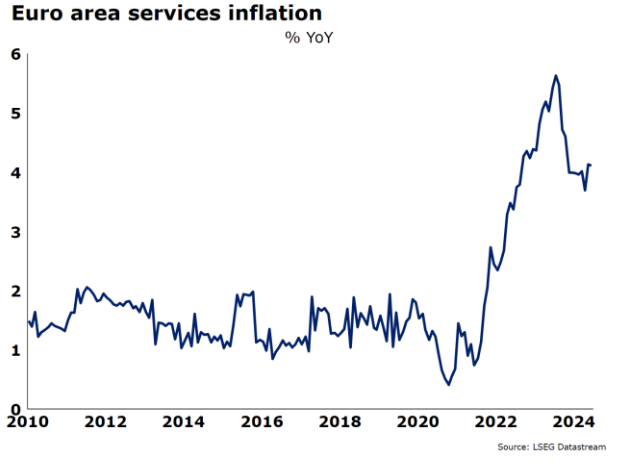
In the US, headline inflation remains above 3% but an alternative measure of inflationary pressure, closely watched by the Fed, shows a slight easing. With economists forecasting strong growth, headline inflation is set to approach the Federal Reserve's 2% target only around the end of this year. As a result, markets continue to expect (adjoining chart) just one rate cut by the Fed this year, down from expectations of six cuts in January.

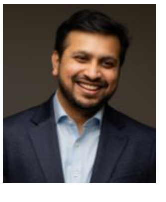
Evolution of US interest rate expectations



Euro area headline inflation has eased further to 2.5% in June although services inflation refuses to budge lower (adjoining chart). Growth is expected to slow this year in better-performing southern European economies such as Spain and Portugal. Meanwhile, prospects for growth in northern Europe, especially in Germany and the Netherlands, remain weak. As a result, the European Central Bank is expected, after a short pause, to follow its June cut in interest rates with another cut this year.

Euro area services inflation





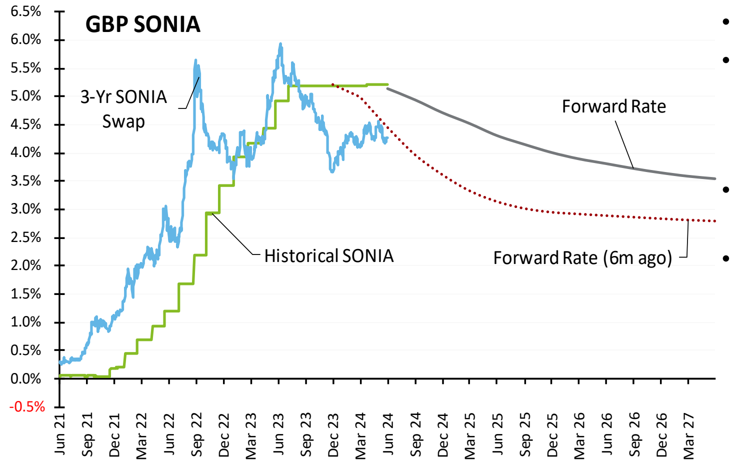
Debapratim De
Director, Economic Research

dde@deloitte.co.uk

Interest Rate Markets

The European Central Bank ("ECB") became the first of the three jurisdictions outlined below to cut rates this monetary policy cycle, lowering their deposit rate by 25bps during their policy meeting on 6th June. The Federal Reserve ("Fed") and Bank of England ("BOE") also met in June, with both central banks electing to hold rates at their current levels.

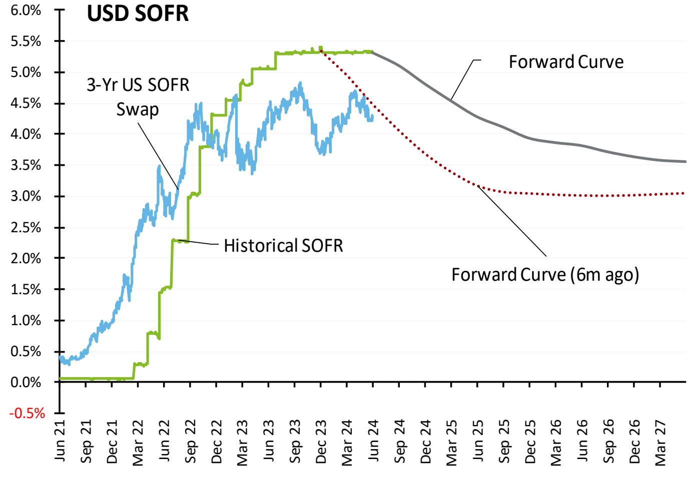
However, inflation data in the UK showed headline CPI finally falling to the BOE's target of 2% in May, with core inflation figures also lowering from 2.9% to 2.6% versus the prior month. Consequently, markets increased their estimates of near-term rate cuts from UK policymakers, assigning an 83% chance of a 25bps cut by September. Downside risks do remain; services inflation still hovers close to 6%.



- The underlying SONIA rate remains at 5.20%
- BofE policymakers held rates, as anticipated, at their 20th June 2024 meeting. The first 25bps cut remains fully priced in for 7th November, following the latest CPI data that aligned with the BOE's 2% target.
- The 3-year SONIA Swap rate is 4.22% vs. 3.72%, 6 months ago, and down 21bps month-on-month.
- Whilst the forward curve is still inverted, it is flatter than prior months, as price pressures persist.

	2-year	3-year	5-year
Swap rate (mid level)	4.47%	4.22%	3.94%
Cap @ 5.00% (premium)*	£0.48m	£0.88m	£1.88m
Cap @ 5.50% (premium)*	£0.25m	£0.57m	£1.39m

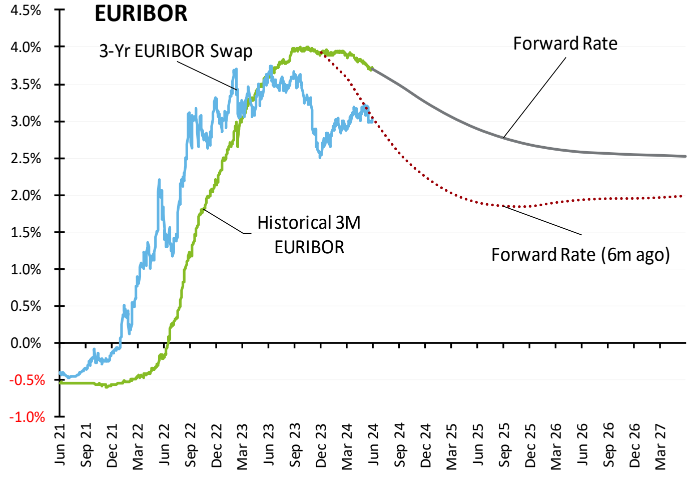
*£100m hedge notional



- SOFR is inside the Fed Funds current target rate range of 5.25%-5.50%, at 5.33%,
- Markets now anticipate the Fed will hold rates at their current level during the meeting on 31st July, with the first cut of 25bps now priced in for November this year.
- The 3-year SOFR Swap rate is 4.26% vs. 3.78% 6m ago, though 19bps lower MoM.

	2-year	3-year	5-year
Swap rate (mid level)	4.52%	4.26%	3.99%
Cap @ 5.00% (premium)*	$0.51m	$0.87m	$1.77m
Cap @ 5.50% (premium)*	$0.20m	$0.46m	$1.18m

*$100m hedge notional



- 3-month EURIBOR is 3.71%.
- Following a 25bps cut at their meeting on 6th June, the ECB are next expected to drop rates again in either September or October.
- The 3-year EURIBOR Swap rate is currently 2.91%, vs. 2.58% 6 months ago.
- The forward curve remains inverted, presenting tactical opportunities for prospective hedgers.

	2-year	3-year	5-year
Swap rate (mid level)	3.07%	2.91%	2.76%
Cap @ 3.50% (premium)*	€0.35m	€0.68m	€1.62m
Cap @ 4.00% (premium)*	€0.13m	€0.36m	€1.08m

*€100m hedge notional

Data source: Refinitiv and ICE Data Services, as of 28th June 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 well below the current floating rate:

- SONIA 3m is 5.12% and a vanilla 5y Swap is 3.94%. On a GBP 100m financing, swapping to fix reduces interest costs in year 1 by GBP 1.18m.
- SOFR 3m at 5.30% and a vanilla 5y Swap is 3.99%. On a USD 100m financing, swapping to fix reduces interest costs in year 1 by USD 1.31m.
- EURIBOR 3m at 3.71% and a vanilla 5y Swap is 2.76%. On a EUR 100m financing, swapping to fix reduces interest costs in year 1 by EUR 0.95m.

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: 4.91%, 3-year: 4.22%, 5-year: 3.94%
- USD swap: 1-year: 5.01%, 3-year: 4.26%, 5-year: 3.99%
- EUR swap: 1-year: 3.55%, 3-year: 2.91%, 5-year: 2.76%

Pre-hedging achieves even lower rates:

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

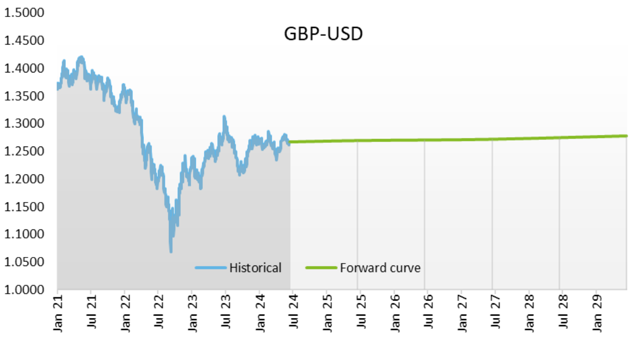
- GBP 5-year Swap starting in 6 months: 3.77%
- USD 5-year Swap starting in 6 months: 3.81%
- EUR 5-year Swap starting in 6 months: 2.65%

Funding of Hedging costs can be done at favourable rates

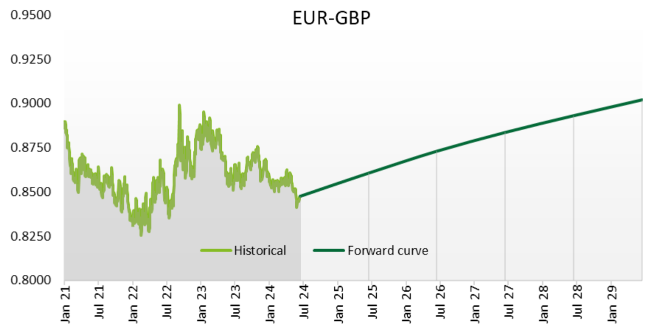
Hedging costs for Option products (such as Caps) are typically paid upfront, however these costs can be deferred over time. This cost deferral can be done via the derivative desks at favourable rates (at SONIA, SOFR or EURIBOR, without additional margin), rather than via additional borrowing under the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

Data source: Refinitiv and ICE Data Services, as of 28th June 2024

Currency Markets



- GBP-USD has moved slightly lower over the month amid the uncertainty around the UK general election.
- Option premia increased notably, up to 10%, depending on the level of protection sought, reflecting the increased likelihood of near-term rate cuts and geopolitical uncertainty.
- Forward FX rates remain slightly at a benefit for GBP sellers through 5 years, indicating a moderately higher interest rate environment towards the end of the 5-year period in the US.



- EUR-GBP is marginally lower MoM, on the back of the snap French election.
- The cost of hedging via options for EUR-GBP has risen up to 11% depending on the level of protection sought, with key elections occurring in both jurisdictions in the coming weeks.
- FX forward rates are still at a significant benefit for EUR sellers, out through 5 years, with markets clearly favouring higher rates in the UK over that timeframe.

GBP-USD Spot Rate: 1.264	6mo	12mo	18mo
Forward rate	1.266	1.267	1.267
GBP Put Option* (ATMS**)	$2.47m	$3.58m	$4.37m
GBP Put Option* (5% OTMS***)	$0.75m	$1.66m	$2.36m
* GBP 100m Put option premium			
** At-the-money Spot rate:	1.264		
*** 5% Out-of-the-money vs Spot rate:	1.201		

EUR-GBP Spot Rate: 0.847	6mo	12mo	18mo
Forward rate	0.854	0.860	0.866
GBP Put Option* (ATMS**)	€2.19m	€3.48m	€4.60m
GBP Put Option* (5% OTMS***)	€0.31m	€1.03m	€1.81m
* GBP 100m Put option premium			
** At-the-money Spot rate:	0.847		
*** 5% Out-of-the-money vs Spot rate:	0.889		

Data source: Refinitiv and ICE Data Services, as of 28th June 2024

Hedging Advisory and Derivatives Execution team

Hedging Strategy Advice

Outsourced Derivative Execution

Financial Market Knowledge

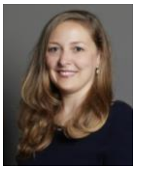
Derivative Pricing Expertise

Paolo Esposito
Lead Director

+44 20 7007 8964
pesposito@deloitte.co.uk

Mark Beckett
Director

+44 20 7303 7849
mbeckett@deloitte.co.uk



Svenja Schumacher
Director

+44 20 7007 9363
scschumacher@deloitte.co.uk

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