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IR and FX Newsletter
August 2024

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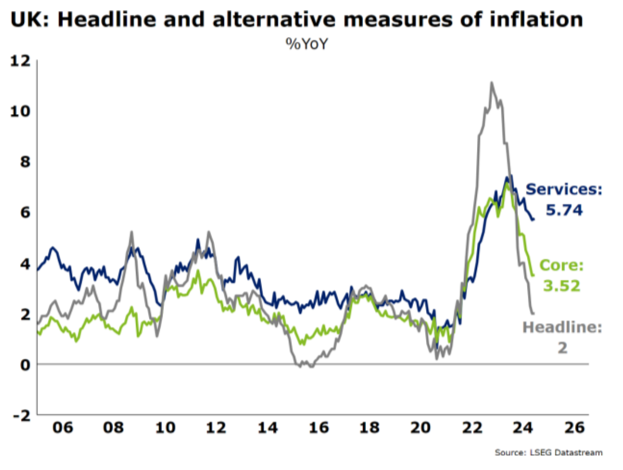
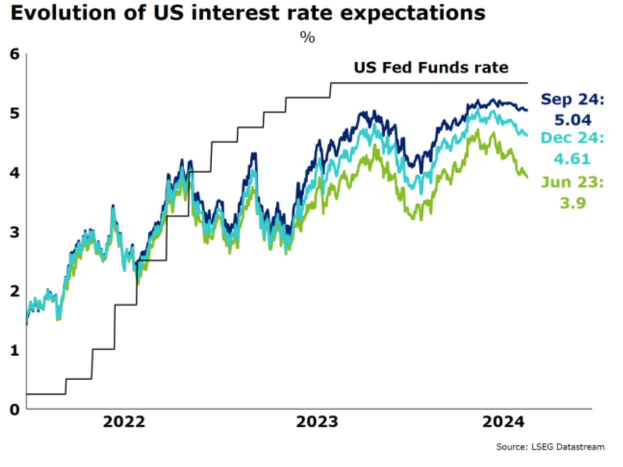
A Macro View: Rate expectations ease further in July

Economic data releases in July point to continued growth in the UK. High–frequency purchasing managers indices show that the recovery in manufacturing and construction sectors is gaining ground, while services activity remains buoyant. Falling inflation this year has boosted consumer confidence but a steady recovery in retail sales remains elusive. We expect continued real wage rises to help consumers recover from this hangover from the inflationary period, with demand and spending picking up reliably in the second half of this year.

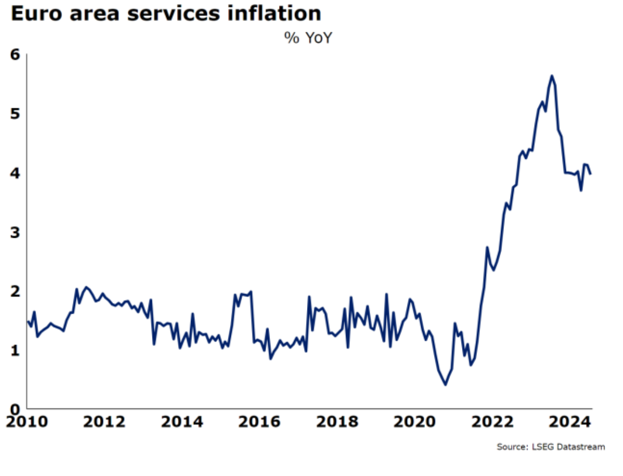
Headline inflation in the UK remains at the Bank of England's 2% target. With business sector surveys and a cooling jobs market suggesting that inflationary pressures should fade away over the coming year, the Bank of England has cut interest rates. But measures of underlying price pressure, such as services price rises (see adjoining chart), remain in inflationary territory. Wage growth also remains strong. Therefore, this is unlikely to be the beginning of a steady series of cuts. Markets expect just another 25-basis-point cut in rates before the end of this year.

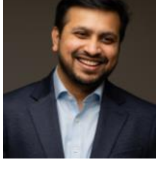


In the US, headline inflation edged lower to 3% in June and an alternative measure of inflationary pressure, closely watched by the Federal Reserve, also showed further easing. Given these developments and some concerns about a cooling labour market, the Fed has indicated it will be considering cutting rates in September. As a result, markets now expect (adjoining chart) two rate cuts by the Fed this year, up from expectations of one cut last month.



Euro area headline inflation is expected to have edged up to 2.6% in July although services inflation, followed closely by the European Central Bank, has eased slightly (adjoining chart). While activity has surprised on the upside in Spain, prospects for growth in major northern European economies such as Germany and the Netherlands remain weak. As a result, markets now expect the ECB to follow its June cut in interest rates with two further cuts this year.





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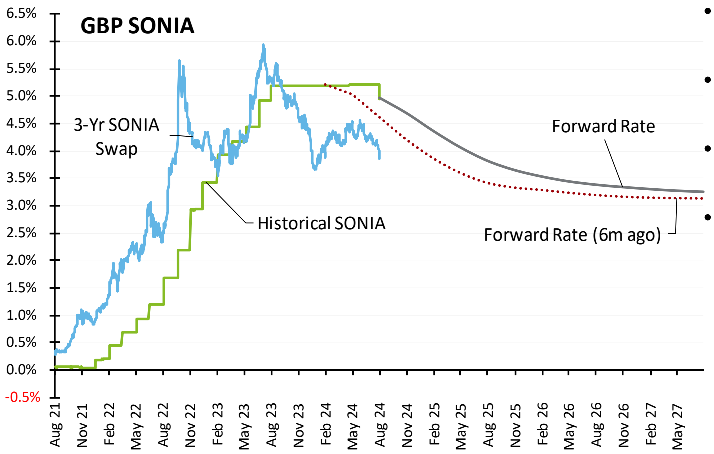
Interest Rate Markets

The last 30-day period has once again proven busy, with each of the European Central Bank ("ECB"), Federal Reserve ("Fed") and Bank of England ("BOE") meeting. The BOE commenced their monetary easing cycle on 1st August, cutting their base rate by 25bps from 5.25% to 5.00%. The Fed and the ECB both elected to maintain their current rates, with markets now anticipating a 25bps cut from each central bank in September.

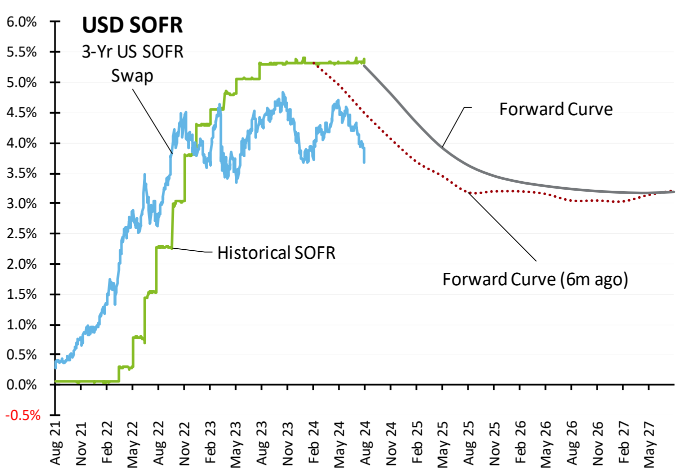
Tellingly, swap rates have fallen significantly in each jurisdiction, with markets ramping up expectations of near-term rate cuts. The 3-year swap rates for GBP, USD and EUR denominated debt have all fallen by 40bps or more in the last 30 days, presenting a strong entry point for floating rate borrowers considering the opportunity of hedging.



- The underlying SONIA is 4.95% following the 25bps rate cut at the BOE's meeting on 1st August.
- Following this cut, markets now anticipate up to a further 50bps of cuts by year-end.
- The 3-year SONIA Swap rate is 3.83% vs.4.06%, 6 months ago, and down 40bps month-on-month.
- The inverted forward curve still presents tactical opportunities for longer-dated hedging.

	2-year	3-year	5-year
Swap rate (mid level)	4.07%	3.83%	3.61%
Cap @ 5.00% (premium)*	£0.25m	£0.57m	£1.45m
Cap @ 5.50% (premium)*	£0.14m	£0.39m	£1.12m

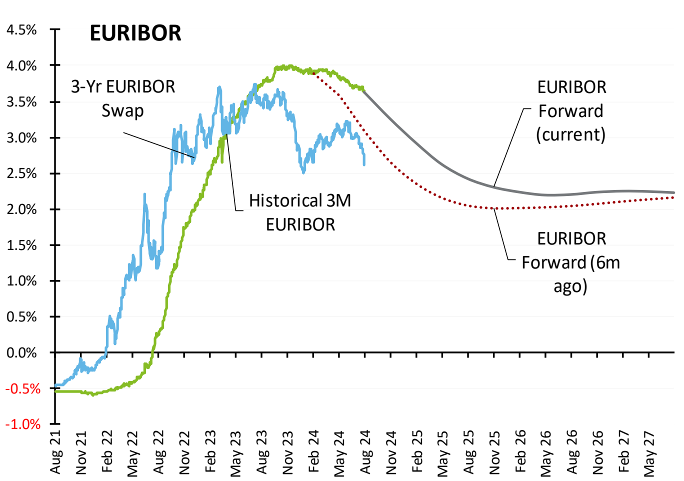
*£100m hedge notional



- SOFR is inside the Fed Funds current target rate range of 5.25%-5.50%, at 5.35%.
- Markets have now priced in over 100bps of cuts between now and the end of 2024, across *three* scheduled monetary policy meetings.
- The 3-year SOFR Swap rate is 3.75% vs. 3.91% 6m ago, though 58bps lower MoM.

	2-year	3-year	5-year
Swap rate (mid level)	4.01%	3.75%	3.56%
Cap @ 5.00% (premium)*	$0.25m	$0.49m	$1.22m
Cap @ 5.50% (premium)*	$0.09m	$0.26m	$0.84m

*$100m hedge notional



- 3-month EURIBOR is 3.64%.
- Following a 25bps cut at their meeting on 6th June, the ECB held rates at their policy meeting on 18th July. Markets expect another 25bps cut in September.
- The 3-year EURIBOR Swap rate is currently 2.55%, vs. 2.75% 6 months ago, down 42bps in the last month.
- The forward curve remains inverted.

	2-year	3-year	5-year
Swap rate (mid level)	2.71%	2.55%	2.44%
Cap @ 3.50% (premium)*	€0.19m	€0.47m	€1.27m
Cap @ 4.00% (premium)*	€0.08m	€0.27m	€0.88m

*€100m hedge notional

Data source: Refinitiv and ICE Data Services, as of 1st August 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 4.95% and a vanilla 5y Swap is 3.61%. On a GBP 100m financing, swapping to fix reduces interest costs in year 1 by GBP 1.34m.
- SOFR 3m at 5.17% and a vanilla 5y Swap is 3.56%. On a USD 100m financing, swapping to fix reduces interest costs in year 1 by USD 1.61m.
- EURIBOR 3m at 3.64% and a vanilla 5y Swap is 2.44%. On a EUR 100m financing, swapping to fix reduces interest costs in year 1 by EUR 1.20m.

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: 2-year: 4.07%, 3-year: 3.83%, 5-year: 3.61%
- USD swap: 2-year: 4.01%, 3-year: 3.75%, 5-year: 3.56%
- EUR swap: 2-year: 2.71%, 3-year: 2.55%, 5-year: 2.44%

Pre-hedging achieves even lower rates:

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

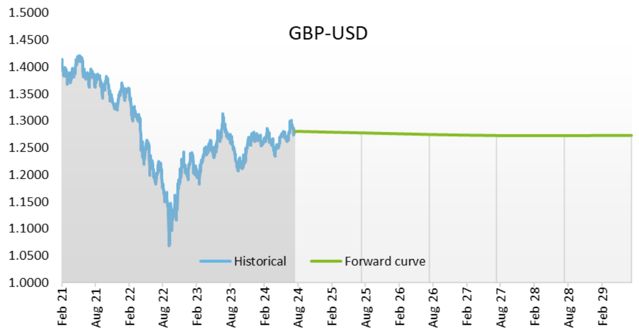
- GBP 5-year Swap starting in 6 months: 3.44%
- USD 5-year Swap starting in 6 months: 3.37%
- EUR 5-year Swap starting in 6 months: 2.32%

Funding of Hedging costs can be done at favourable rates

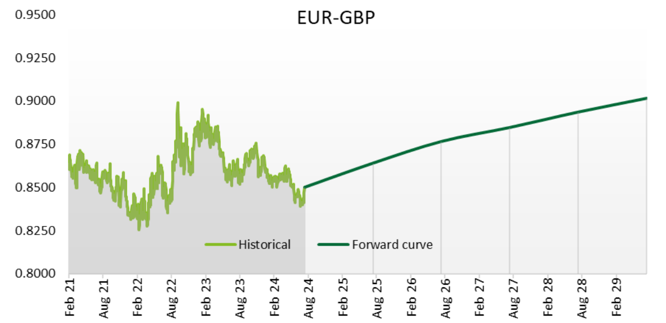
Hedging costs for Option products (such as Caps) are typically paid upfront, however these costs can be deferred over time. This cost deferral can be done via the derivative desks at favourable rates (at SONIA, SOFR or EURIBOR, without additional margin), rather than via additional borrowing under the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

Data source: Refinitiv and ICE Data Services, as of 1st August 2024

Currency Markets



- GBP-USD has moved slightly higher over the month amid the UK election aftermath and geopolitical uncertainty.
- Option premia varied notably, subject to the level of protection sought, reflecting the increased likelihood of near-term rate cuts and geopolitical uncertainty.
- Forward FX rates are near-enough flat through 5 years, indicating a similar interest rate environment across each jurisdiction.



- EUR-GBP is marginally higher MoM, on the back of the Bank of England's decision to cut rates by 25bps.
- The cost of hedging via options for EUR-GBP fell up to 5% depending on the level of protection sought.
- 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: 1.274	6mo	12mo	18mo
Forward rate	1.275	1.274	1.272
GBP Put Option* (ATMS**)	$2.46m	$3.69m	$4.57m
GBP Put Option* (5% OTMS***)	$0.70m	$1.67m	$2.44m

* GBP 100m Put option premium

** At-the-money Spot rate: 1.274

*** 5% Out-of-the-money vs Spot rate: 1.210

EUR-GBP Spot Rate: 0.847	6mo	12mo	18mo
Forward rate	0.853	0.860	0.866
GBP Put Option* (ATMS**)	€2.09m	€3.42m	€4.52m
GBP Put Option* (5% OTMS***)	€0.31m	€1.04m	€1.82m

* 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 1st August 2024

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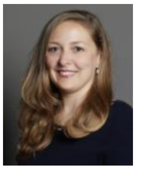

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