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IR and FX Newsletter
June 2024

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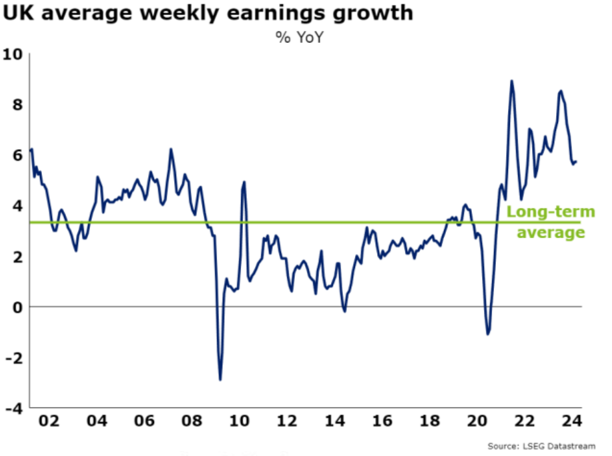
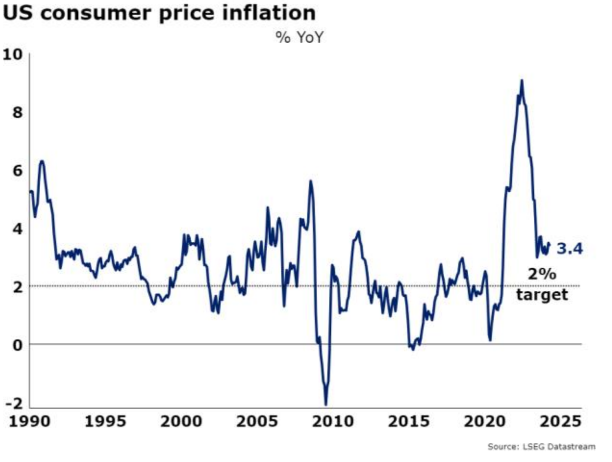
A Macro View: Inflationary pressures persist

Economic data releases in May confirmed what high-frequency indicators had been suggesting for the UK and European economies - that they are finally emerging from what has been a relatively long period of low-to-no growth. While growth is picking up, inflationary pressures haven't fully dissipated yet. As a result, investors' short-term interest rate expectations, which have risen over the last few months, remained largely unchanged through May.

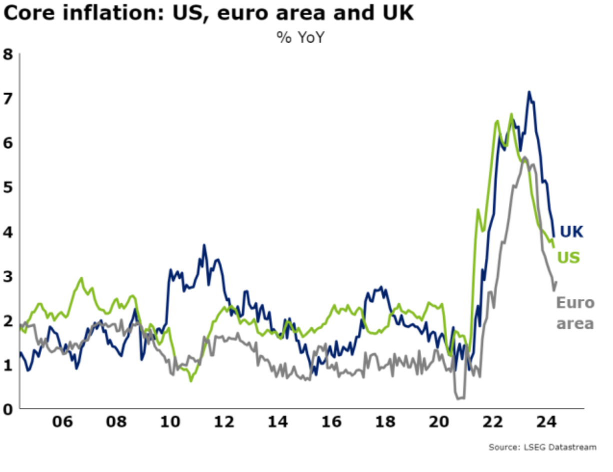
In the UK, the latest data showed a significant fall in headline inflation - to 2.3% in April - but economists had expected a sharper adjustment. Two key markers of underlying price pressure - services prices, which tend to be sticky, and average earnings growth (adjoining chart) - remain in inflationary territory. With economic activity reviving, the Bank of England can afford, and is likely, to wait for material easing in both areas before cutting rates.

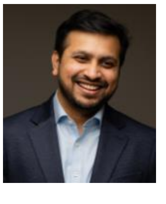


In the US, inflation has hovered between 3-3.5% since last summer (see chart). Given the strength of the US economy, with economists expecting an acceleration in growth this year and the relatively tight labour market, inflation is expected to approach the Federal Reserve's 2% target only around the end of this year. As a result, markets now expect just one rate cut by the Fed this year, down from expectations of six cuts through the year in January.



Headline inflation - at 2.6% in May - is closer to levels in the UK. But growth so far this year and prospects for short-term activity, especially in Germany are comparatively weaker. Also, core inflation, which strips out volatile food and energy prices and is a marker of underlying price pressures, is at lower levels than in the US and the UK (see chart). As a result, the European Central Bank is expected be the first to ease policy with up to three rate cuts this year, beginning in June.





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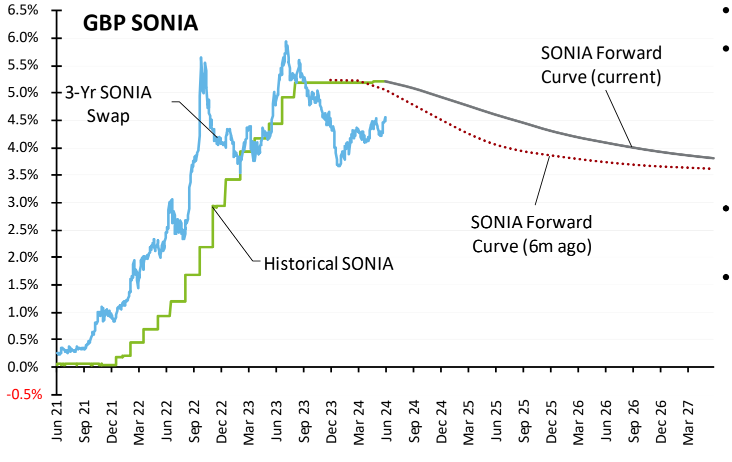
Interest Rate Markets

The Interest Rate Swaps market remains beholden to actual versus expected Inflation Rate publications, compounded by the meetings of the European Central Bank ("ECB"), Federal Reserve ("Fed") and Bank of England ("BOE") in June to determine the path of monetary policy. Pertinently, as is customary each quarter, the three central banks will also provide updated macroeconomic projections, which will provide a timely update on the state of their respective economies (and the prospects of base rate moves).

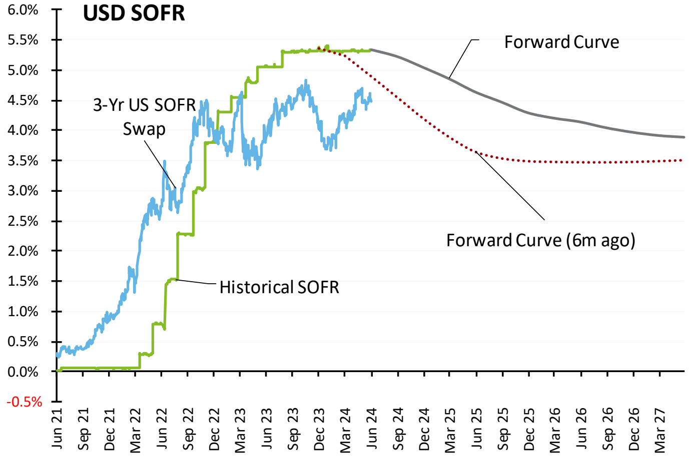
The ECB meet first – on 6th June – and are expected to cut their deposit rate by 25bps from record highs of 4%. The Fed and BOE are both expected to maintain the status quo for the summer.



- The underlying SONIA rate is currently at 5.20%
- BofE policymakers held rates, as anticipated, at their 9th May 2024 meeting. The first 25bps cut is now fully priced in for 7th November, following the latest CPI data that came in higher than market expectations.
- The 3-year SONIA Swap rate is 4.46% vs. 4.34%, 6 months ago, and down 9bps month-on-month.
- Whilst the forward curve is still inverted, it is flatter than last month, as price pressures persist.

	2-year	3-year	5-year
Swap rate (mid level)	4.68%	4.46%	4.17%
Cap @ 5.00% (premium)*	£0.62m	£1.09m	£2.17m
Cap @ 5.50% (premium)*	£0.33m	£0.69m	£1.58m

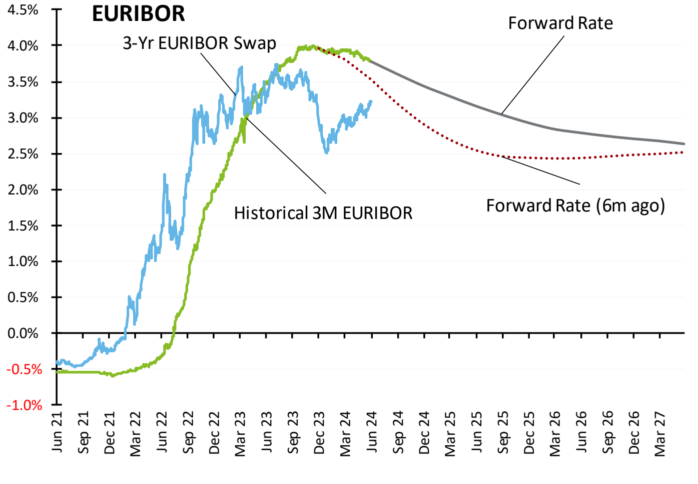
*£100m hedge notional



- SOFR is currently 5.33%, inside the Fed Funds target rate range of 5.25%-5.50%.
- Markets now anticipate the Fed will hold rates at their current level during the meeting on 12th June, with the first cut of 25bps now priced in for either November or December this year.
- The 3-year SOFR Swap rate is 4.53% vs. 4.01% 6m ago, and 11bps lower MoM.

	2-year	3-year	5-year
Swap rate (mid level)	4.77%	4.53%	4.30%
Cap @ 5.00% (premium)*	$0.71m	$1.14m	$2.19m
Cap @ 5.50% (premium)*	$0.32m	$0.65m	$1.49m

*$100m hedge notional



- 3-month EURIBOR is 3.79%.
- The ECB are widely expected to cut their deposit rate by 25bps at their meeting on 6th June, with a total of 50-60bps of cuts priced in by the end of the year.
- The 3-year EURIBOR Swap rate is currently 3.10%, vs. 2.83% 6 months ago.
- The forward curve remains inverted, presenting tactical opportunities for prospective hedgers.

	2-year	3-year	5-year
Swap rate (mid level)	3.27%	3.10%	2.90%
Cap @ 3.50% (premium)*	€0.47m	€0.85m	€1.80m
Cap @ 4.00% (premium)*	€0.16m	€0.43m	€1.15m

*€100m hedge notional

Data source: Refinitiv and ICE Data Services, as of 31st May 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 4.17%. On a GBP 100m financing, swapping to fix reduces interest costs in year 1 by GBP 1.02m.
- SOFR 3m at 5.33% and a vanilla 5y Swap is 4.30%. On a USD 100m financing, swapping to fix reduces interest costs in year 1 by USD 1.03m.
- EURIBOR 3m at 3.79% and a vanilla 5y Swap is 2.90%. On a EUR 100m financing, swapping to fix reduces interest costs in year 1 by EUR 0.89m.

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: 5.05%, 3-year: 4.46%, 5-year: 4.17%
- USD swap: 1-year: 5.18%, 3-year: 4.53%, 5-year: 4.30%
- EUR swap: 1-year: 3.67%, 3-year: 3.10%, 5-year: 2.90%

Pre-hedging achieves even lower rates:

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

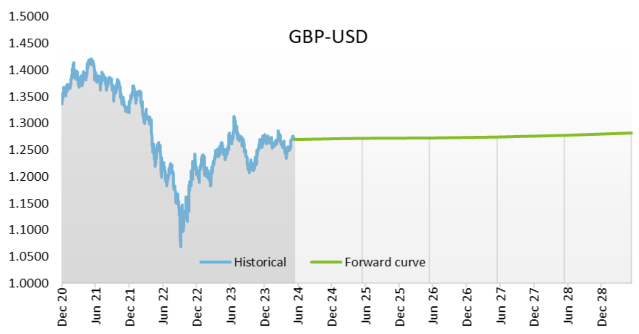
- GBP 5-year Swap starting in 6 months: 4.02%
- USD 5-year Swap starting in 6 months: 4.13%
- EUR 5-year Swap starting in 6 months: 2.79%

Funding of Hedging costs can be done at favourable rates

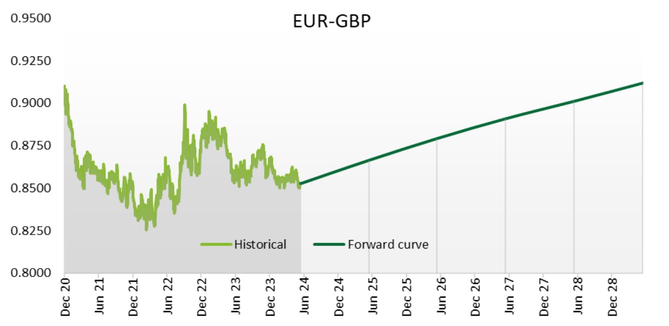
Hedging costs for Option products (such as Caps) are typically paid upfront, however these costs can be deferred over time. This cost deferral can be done via the derivative desks at favourable rates (at SONIA, SOFR or EURIBOR, without additional margin), rather than via additional borrowing under the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

Data source: Refinitiv and ICE Data Services, as of 31st May 2024

Currency Markets



- GBP-USD has moved marginally higher over the month amid the prospect of higher-for-longer rates in the UK.
- Option premia increased fractionally, up to 1.7%, depending on the level of protection sought, reflecting the higher volatility in the last month.
- 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.



- EUR-GBP is marginally lower MoM, on the back of higher-than-expected inflation data in the UK on 22nd May.
- The cost of hedging via options for EUR-GBP has fluctuated +/- 3% depending on the level of protection sought, suggesting higher volatility in the last 30 days.
- FX forward rates are still at a significant benefit for EUR sellers, out through 5 years, as markets price in the first rate cut from the ECB for June, versus November from the Bank of England.

GBP-USD Spot Rate: 1.274	6mo	12mo	18mo
Forward rate	1.275	1.276	1.276
GBP Put Option* (ATMS**)	$2.46m	$3.56m	$4.31m
GBP Put Option* (5% OTMS***)	$0.68m	$1.58m	$2.25m
* 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: 0.851	6mo	12mo	18mo
Forward rate	0.858	0.865	0.871
GBP Put Option* (ATMS**)	€1.97m	€3.27m	€4.28m
GBP Put Option* (5% OTMS***)	€0.28m	€0.99m	€1.70m
* GBP 100m Put option premium			
** At-the-money Spot rate:	0.851		
*** 5% Out-of-the-money vs Spot rate:	0.894		

Data source: Refinitiv and ICE Data Services, as of 31st May 2024

Hedging Advisory and Derivatives Execution team

Hedging Strategy Advice

Outsourced Derivative Execution

Financial Market Knowledge

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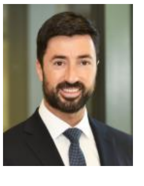

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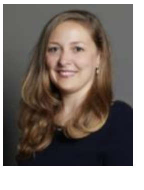

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