IR and FX Newsletter

May 2024

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A Macro View: UK Growth Prospects Improve

High-frequency data suggest the technical recession the UK slipped into in the second half of last year is already over. Activity has picked up in the first quarter and a recovery is underway.

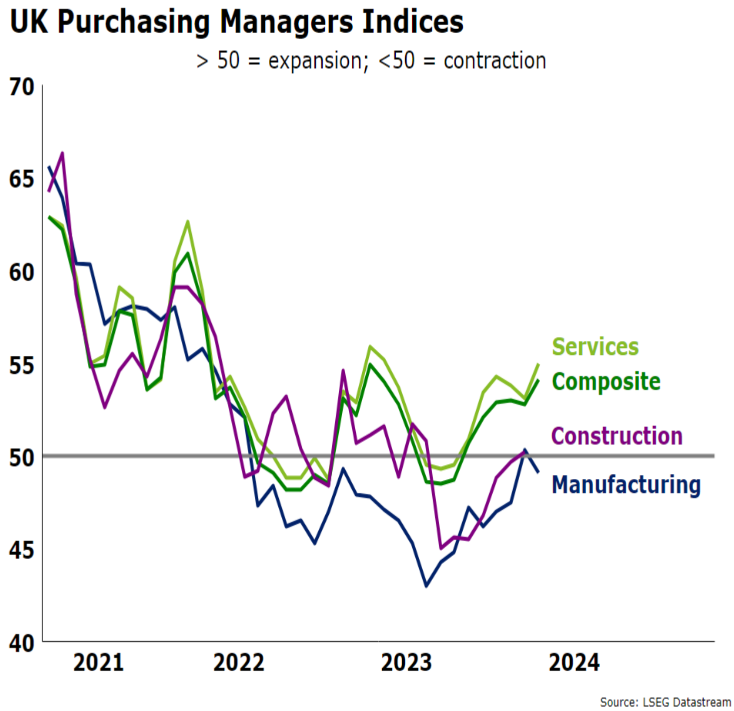
One of the key determinants of the duration and intensity of this recession has been sharply falling inflation. It has eased cost pressures for corporates and, thanks to a tight labour market, driven rises in real wages and consumer spending power. As a result, consumer and business confidence are up and point to improvements in capital expenditure and household consumption in the coming months. Rising mortgage approvals also indicate a stirring of housing market activity.

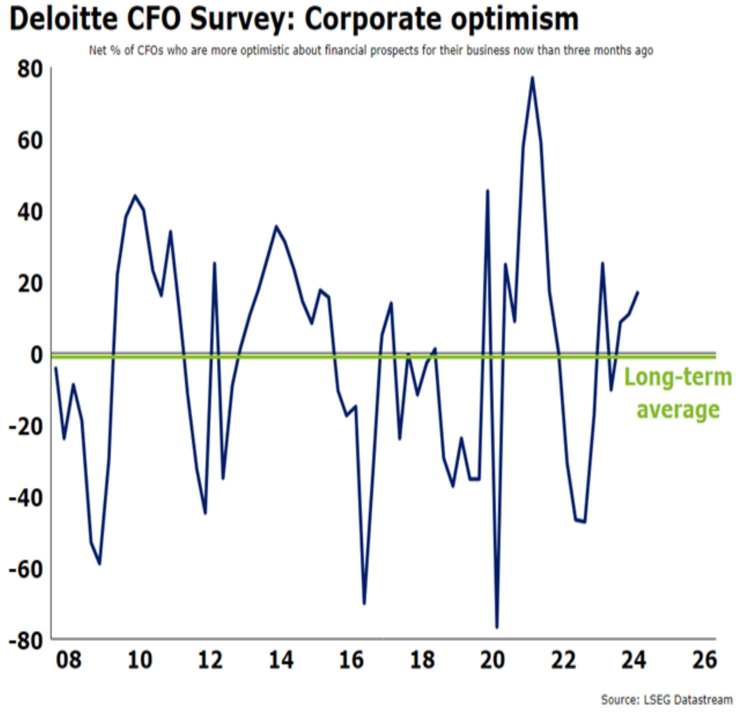
With headline inflation expected to decline further, touching the Bank of England's 2% target in May, the recovery should pick up steam over the summer. In fact, most economists expect quarterly GDP growth for the UK to accelerate to its long-term trend in the second half of this year.

This would, arguably, mean a soft landing for the UK economy. However, some risks remain. A tight labour market and strong wage growth imply underlying price pressures have not fully dissipated. Add to that the risk of an escalation in conflicts in the Middle East and Ukraine, potentially disrupting supply chains and raising energy prices, and a spike in inflation cannot be entirely ruled out.

This suggests greater caution in easing policy on the part of the Bank of England, despite inflation touching its 2% target. We expect it to wait for some further slowing in wage pressures and core inflation before cutting interest rates. Our view is roughly in line with market expectations now - of one 25 basis point cut in August and another similar cut in early winter.

A short-lived recession followed by a quick-ish recovery is good news. But it also means a less pressing need to ease monetary policy.





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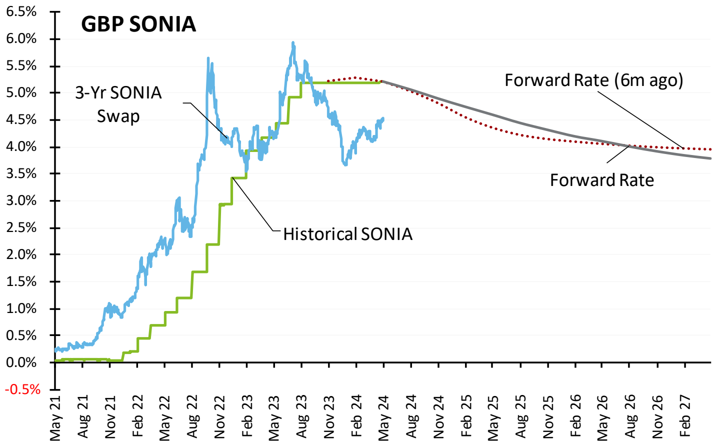
Interest Rate Markets

Interest rates have moved notably higher in the last month, as inflationary pressures and geopolitical concerns caused markets to price out rate cuts from each of the Federal Reserve, European Central Bank ("ECB") and Bank of England. Although the ECB met (and held rates) on 11th April, it was the US CPI print the day prior that culminated in the significant move higher in interest rates.

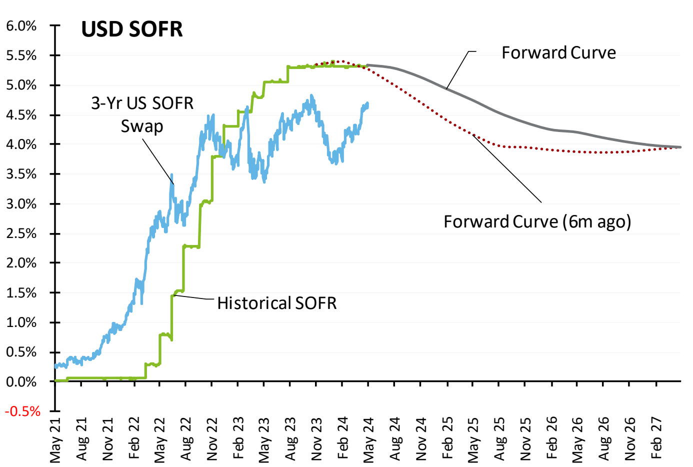
Subsequently, markets moved to price only c. 30bps of cuts from the Fed by year-end, down from approximately 150bps just three months ago. Similarly, the Bank of England is now only anticipated to cut its base rate by less than 40bps, down over 100bps from the start of the year. The Fed also met on 1st May, with their meeting offering little surprises; a rate hold and a push back against near-term rate cut expectations.



- The underlying SONIA rate is currently at 5.20%
- BofE policymakers held rates, as anticipated, at their 21st March 2024 meeting. The first 25bps cut is now fully priced in for 19th September, as inflation pressures persist.
- The 3-year SONIA Swap rate is 4.41% vs. 4.57% 6 months ago, and up 31bps month-on-month.

	2-year	3-year	5-year
Swap rate (mid level)	4.63%	4.41%	4.13%
Cap @ 5.00% (premium)*	£0.65m	£1.15m	£2.27m
Cap @ 5.50% (premium)*	£0.35m	£0.74m	£1.67m

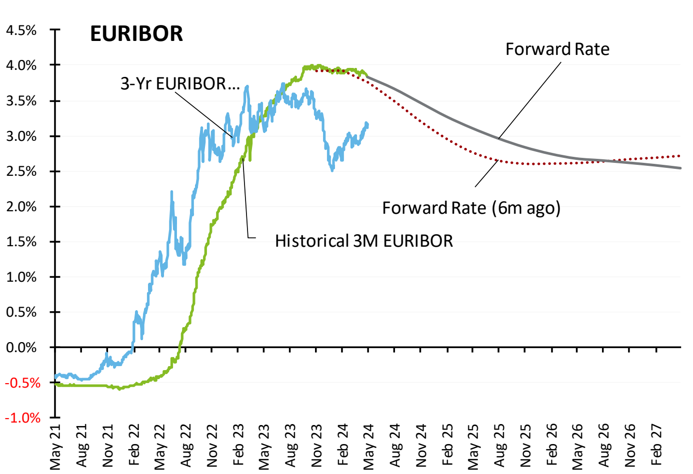
*£100m hedge notional



- SOFR is currently 5.34%, inside the Fed Funds target rate range of 5.25%-5.50%.
- The Federal Reserve held rates at their meeting on 1st May, with markets now forecasting the first 25bps rate cut in either November or December 2024.
- The 3-year SOFR Swap rate is 4.56% vs. 4.38% 6m ago, and 31bps higher MoM.
- The forward curve is still inverted, albeit notably less than 6-months ago.

	2-year	3-year	5-year
Swap rate (mid level)	4.79%	4.56%	4.33%
Cap @ 5.00% (premium)*	$0.76m	$1.24m	$2.37m
Cap @ 5.50% (premium)*	$0.36m	$0.73m	$1.65m

*$100m hedge notional



- 3-month EURIBOR is 3.83%.
- The ECB held rates at 4.00% at their meeting on 11th April. Markets still anticipate the ECB's first 25bps rate cut in either June or July.
- The 3-year EURIBOR Swap rate is currently 3.01%, vs. 3.25% 6 months ago.
- The forward curve remains inverted.

	2-year	3-year	5-year
Swap rate (mid level)	3.19%	3.01%	2.80%
Cap @ 3.50% (premium)*	€0.48m	€0.86m	€1.81m
Cap @ 4.00% (premium)*	€0.17m	€0.45m	€1.20m

*€100m hedge notional

Data source: Refinitiv and ICE Data Services, as of 2nd 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 5.18% and a vanilla 5y Swap is 4.13%. On a GBP 100m financing, swapping to fix reduces interest costs in year 1 by GBP 1.05m.
- SOFR 3m at 5.33% and a vanilla 5y Swap is 4.33%. On a USD 100m financing, swapping to fix reduces interest costs in year 1 by USD 1.00m.
- EURIBOR 3m at 3.83% and a vanilla 5y Swap is 2.80%. On a EUR 100m financing, swapping to fix reduces interest costs in year 1 by EUR 1.03m.

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: 5.00%, 3-year: 4.41%, 5-year: 4.13%
- USD swap: 1-year: 5.21%, 3-year: 4.56%, 5-year: 4.33%
- EUR swap: 1-year: 3.70%, 3-year: 3.01%, 5-year: 2.80%

Pre-hedging achieves even lower rates:

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

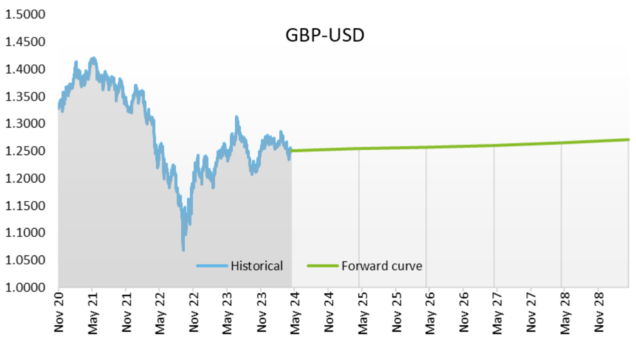
- GBP 5-year Swap starting in 6 months: 3.97%
- USD 5-year Swap starting in 6 months: 4.18%
- EUR 5-year Swap starting in 6 months: 2.71%

Funding of Hedging costs can be done at favourable rates

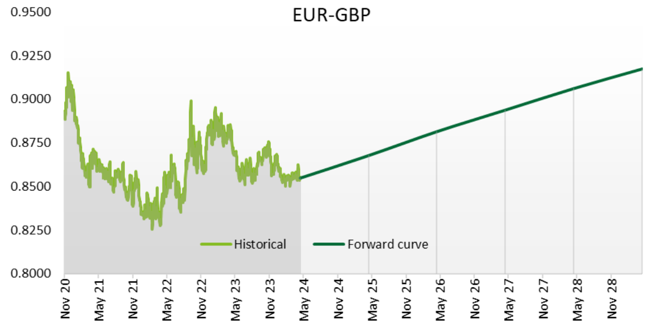
Hedging costs for Option products (such as Caps) are typically paid upfront, however these costs can be deferred over time. This cost deferral can be done via the derivative desks at favourable rates (at SONIA, SOFR or EURIBOR, without additional margin), rather than via additional borrowing under the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

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

Currency Markets



- GBP-USD has continued to move lower in the last month, as broad-based risk aversion gripped markets. Namely, higher inflationary pressures and geopolitical concerns drove price action.
- Option premia increased by up to 3% indicatively month-on-month, depending on the protection sought, due to higher volatility.
- Forward FX rates remain slightly at a benefit for GBP sellers through 5 years, indicating a moderately higher interest rate environment in the US over that period.



- EUR-GBP is marginally lower MoM as markets continue to predict when the ECB and BOE will begin lowering their respective rates.
- The cost of hedging via options for EUR-GBP held steady in the last 30 days, as volatility held steady in both jurisdictions.
- 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 / July, versus September from the Bank of England.

GBP-USD Spot Rate: 1.251	6mo	12mo	18mo
Forward rate	1.253	1.255	1.256
GBP Put Option* (ATMS**)	$2.43m	$3.53m	$4.24m
GBP Put Option* (5% OTMS***)	$0.68m	$1.60m	$2.25m
* GBP 100m Put option premium			
** At-the-money Spot rate:	1.251		
*** 5% Out-of-the-money vs Spot rate:	1.188		

EUR-GBP Spot Rate: 0.855	6mo	12mo	18mo
Forward rate	0.861	0.868	0.874
GBP Put Option* (ATMS**)	€1.94m	€3.24m	€4.28m
GBP Put Option* (5% OTMS***)	€0.29m	€1.01m	€1.74m
* GBP 100m Put option premium			
** At-the-money Spot rate:	0.855		
*** 5% Out-of-the-money vs Spot rate:	0.898		

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

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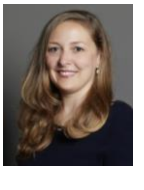

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