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IR and FX Newsletter
November 2024

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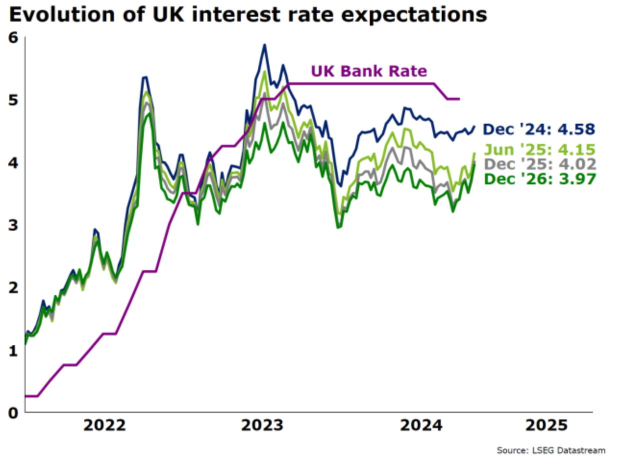
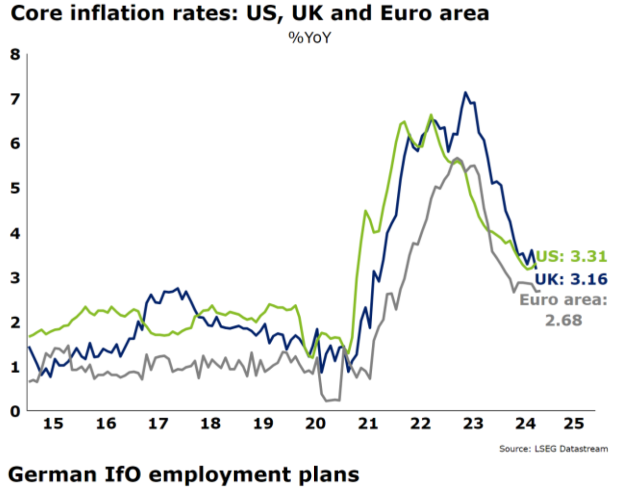
A Macro View: Rate expectations rise

Monthly GDP data confirmed a slowdown in UK growth over the summer months, after a strong start to the year. Purchasing managers indices suggest continued growth in the services and construction sectors, alongside slowing manufacturing activity in the third quarter. Consumer confidence also weakened over the period, with households bracing for tax rises and given growing concerns about the UK's economic prospects. The short-term growth outlook has improved since then, with last week's Budget unveiling the biggest post-election tax rises since 1993 and a significant increase in borrowing to fund public services and boost investment.

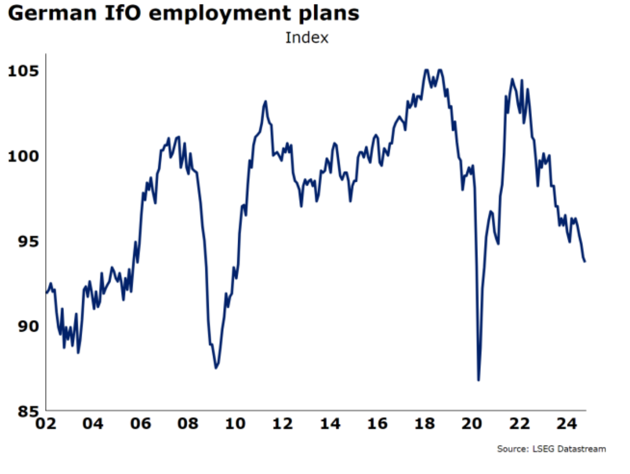
The short-term boost to growth is widely expected to slow the Bank of England's monetary easing cycle. Markets now expect one further cut this year and rates to settle at around 4% by the end of next year, up from 3.5% just a couple of weeks ago (adjoining chart). The substantial rise in employment taxes is also expected to act as a drag on growth in the medium-term, as businesses pass on the bulk of their higher employment costs to employees in the form of slower wage rises and weaker job growth.

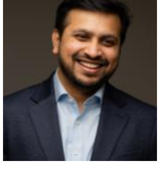


The US economy grew by an annualised 2.8% in the third quarter, driven by robust consumer spending. This, alongside a continued easing in inflationary pressure (adjoining chart), has allayed fears of a sharp slowdown. Economists' growth forecasts for 2025 have also edged up. As a result, rate expectations have risen slightly, with investors now expecting four 25 basis point cuts by June of next year, down from six at the beginning of last month. The US elections continue to pose an upside risk to rate expectations, especially as the imposition of further tariffs could be inflationary.



The euro area grew by a faster-than-expected 0.4% in the third quarter, although underlying momentum remains weak. Germany – Europe's largest economy – avoided a recession but business surveys point to a prolonged slump in activity and job creation (adjoining chart). Growth also picked up in France in the third quarter, supported by a rise in household consumption and government spending on the Olympic Games. Overall, the pickup in activity has resulted in a slight moderation in expectations of easing. Markets see the ECB matching Fed action with four 25 basis point cuts between now and the middle of next year.





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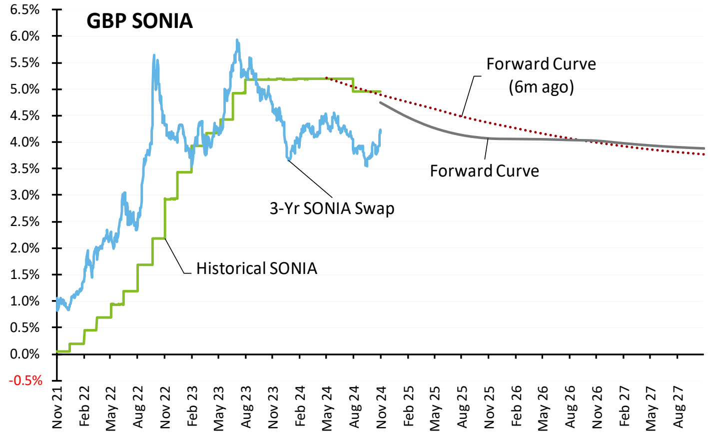
Interest Rate Markets

The European Central Bank ("ECB") kicked off the latest round of central bank policy meetings with an anticipated 25bps reduction to its key interest rate on October 17th. Market expectations for policy easing by the Bank of England ("BOE") and The Federal Reserve ("Fed") at their respective November meetings remain firmly in place, as both banks are widely expected to announce 25bps cuts to their key interest rates, echoing predictions from the previous month, albeit with increased conviction from market participants.

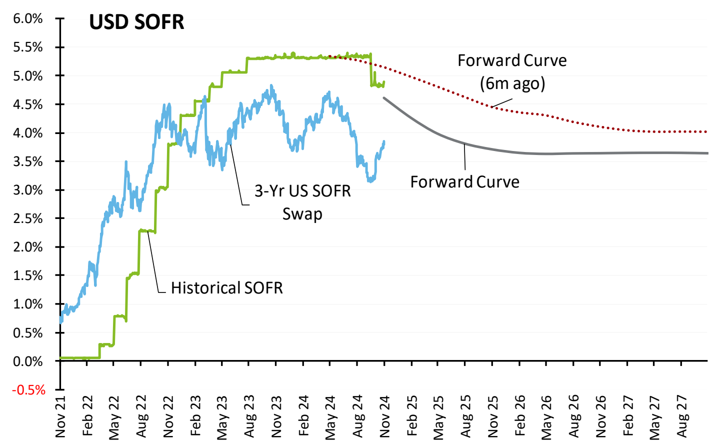
Despite previous rate cuts and expectations of further reductions, SONIA, SOFR, and EURIBOR swap rates have risen across maturities since last month. This is particularly evident in SONIA and SOFR, driven by heightened volatility surrounding the UK Autumn Budget and the US election, respectively.



- The underlying SONIA is 4.95%.
- Markets are pricing in an 84% chance of a 25bps rate cut by the BOE at their next policy meeting on 7th November, vs. 16% Hold.
- The 3-year SONIA Swap rate is 4.14% vs. 3.84%, 6 months ago, though 46bps higher MoM.
- The forward curve remains inverted through summer 2025.

	2-year	3-year	5-year
Swap rate (mid level)	4.23%	4.14%	4.03%
Cap @ 4.50% (premium)*	£0.72m	£1.30m	£2.66m
Cap @ 5.00% (premium)*	£0.40m	£0.84m	£1.95m
Cap @ 5.50% (premium)*	£0.25m	£0.58m	£1.49m

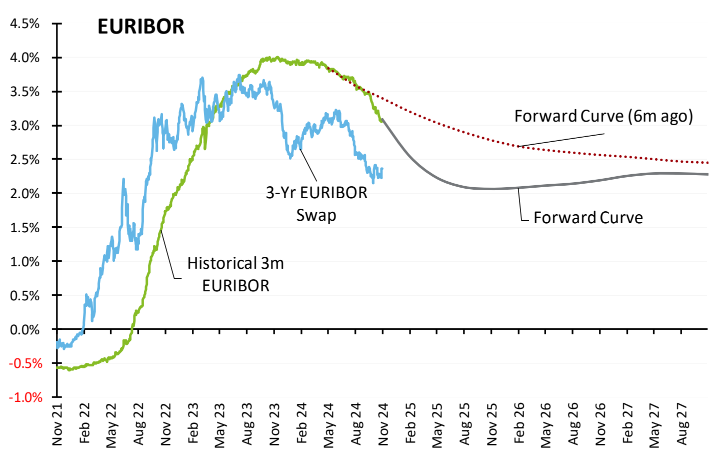
*£100m hedge notional



- SOFR is inside the Fed Funds current target rate range of 4.75%-5.00%, at 4.81%.
- Market expectations for a Federal Reserve interest rate cut at its upcoming policy meeting on November 7th remain high, with current pricing indicating a 99% probability. This aligns with market sentiment observed last month.
- The 3-year SOFR Swap rate is 3.82% vs. 3.68% 6m ago, though 59bps higher MoM.

	2-year	3-year	5-year
Swap rate (mid level)	3.90%	3.82%	3.75%
Cap @ 5.00% (premium)*	$0.27m	$0.62m	$1.56m
Cap @ 5.50% (premium)*	$0.16m	$0.43m	$1.19m
Cap @ 6.00% (premium)*	$0.11m	$0.31m	$0.94m

*$100m hedge notional



- 3-month EURIBOR is 3.06%.
- The ECB cut rates at their policy meeting by 25bps on 17th October to 3.25%. Market consensus indicates a 93% probability of a 25bps interest rate cut at the next meeting on 12th December.
- The 3-year EURIBOR Swap rate is currently 2.28%, vs. 2.62% 6 months ago, though 15bps higher MoM.
- The inverted forward curve still presents tactical opportunities to reduce near-term interest expense through derivative use.

	2-year	3-year	5-year
Swap rate (mid level)	2.29%	2.28%	2.29%
Cap @ 3.25% (premium)*	€0.14m	€0.45m	€1.32m
Cap @ 3.75% (premium)*	€0.08m	€0.29m	€0.94m
Cap @ 4.25% (premium)*	€0.05m	€0.19m	€0.68m

*€100m hedge notional

Data source: Refinitiv and ICE Data Services, as of 1st November 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 4.72% and a vanilla 5y Swap is 4.03%. On a GBP 100m financing, swapping to fix reduces interest costs in year 1 by GBP 0.69m.
- SOFR 3m at 4.50% and a vanilla 5y Swap is 3.75%. On a USD 100m financing, swapping to fix reduces interest costs in year 1 by USD 0.75m.
- EURIBOR 3m at 3.06% and a vanilla 5y Swap is 2.29%. On a EUR 100m financing, swapping to fix reduces interest costs in year 1 by EUR 0.77m.

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

Because of the downward forward curve, long term hedges remain cheaper than short term hedges in the UK and US, while the Eurozone drops rates sharply over the next 12 months they then flatten thereafter.

- GBP swap: 2-year: 4.23%, 3-year: 4.14%, 5-year: 4.03%
- USD swap: 2-year: 3.90%, 3-year: 3.82%, 5-year: 3.75%
- EUR swap: 2-year: 2.29%, 3-year: 2.28%, 5-year: 2.29%

Pre-hedging achieves even lower rates:

Pre-hedging future debt (assumed closing is in 6 months) is cheaper than at current hedge levels; most significantly in the UK though still materially in the US and Eurozone:

- GBP 5-year Swap starting in 6 months: 3.94%
- USD 5-year Swap starting in 6 months: 3.67%
- EUR 5-year Swap starting in 6 months: 2.24%

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 often be done via the derivative desks at favourable rates (at SONIA, SOFR or EURIBOR, without application of the similar financing margins); further, debt covenants are not so impacted from this cost deferral.

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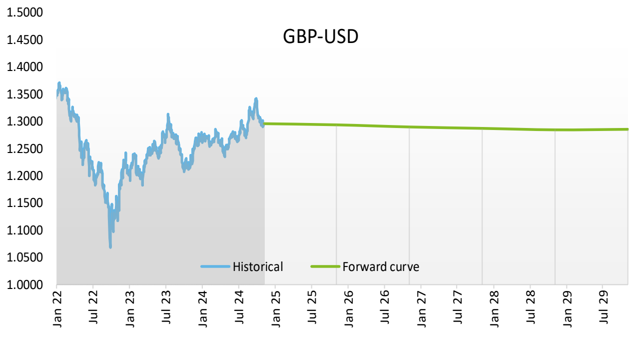
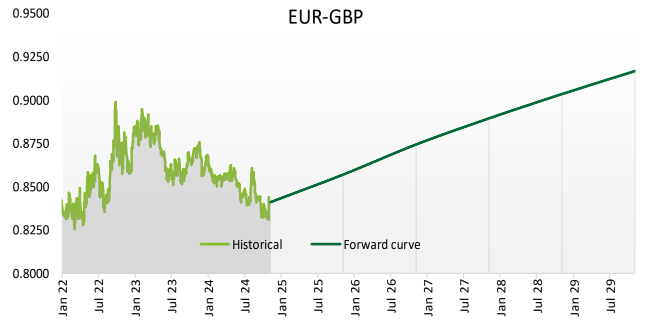
Currency Markets





- GBP-USD has moved lower over the month amid the UK autumn budget and geopolitical uncertainty.
- The cost of hedging via options for GBP-USD rose by up to 19% depending on the level of protection sought.
- Forward FX rates remain flat out through 5 years for GBP sellers, suggesting little deviation between interest rate environments across both countries.

- The EUR-GBP Spot rate is flat MoM as markets continue to gauge when the ECB and BOE will cut rates.
- Option premia increased by up to 43% indicatively MoM, depending on the protection sought, due predominantly to higher volatility
- Favourable forward exchange rates for EUR sellers persist over the 5-year horizon, driven by expectations of a sustained interest rate differential between the higher BOE and lower ECB policy rates.

GBP-USD Spot Rate: 1.293	6mo	12mo	18mo
Forward rate	1.292	1.290	1.288
GBP Put Option* (ATMS**)	$2.88m	$4.16m	$5.14m
GBP Put Option* (5% OTMS***)	$0.99m	$2.05m	$2.91m
* GBP 100m Put option premium			
** At-the-money Spot rate:	1.293		
*** 5% Out-of-the-money vs Spot rate:	1.228		

EUR-GBP Spot Rate: 0.838	6mo	12mo	18mo
Forward rate	0.846	0.855	0.864
GBP Put Option* (ATMS**)	€ 2.42	€ 3.90	€ 5.23
GBP Put Option* (5% OTMS***)	€ 0.50	€ 1.35	€ 2.29
* GBP 100m Put option premium			
** At-the-money Spot rate:	0.838		
*** 5% Out-of-the-money vs Spot rate:	0.880		

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

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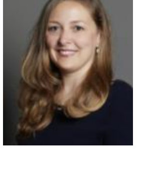

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