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IR and FX Newsletter

October 2024

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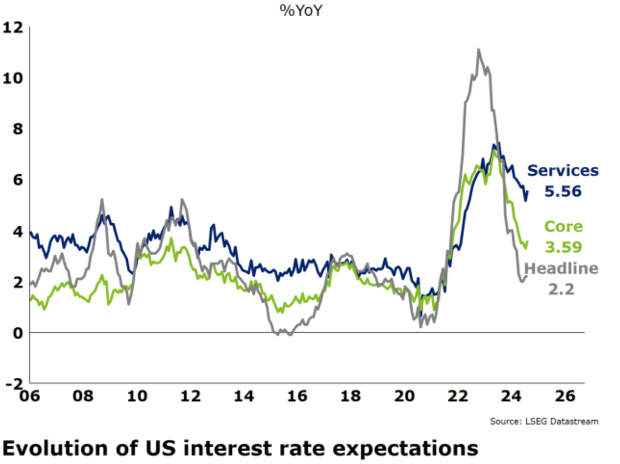
A Macro View: Rate expectations ease further in September

Economic data releases in September point to a slowing of UK growth after a surprisingly strong first half. Purchasing managers indices remain in expansionary territory, despite easing somewhat, but monthly GDP data show that the economy failed to grow in June and July. Consumer confidence has also moved downwards, as households anticipate tax rises in the upcoming Budget and turn less confident on the UK's economic prospects. But real wages continue to rise and should help support demand. We expect slightly slower but continued growth in the UK, with consumer spending picking up in the next six months.

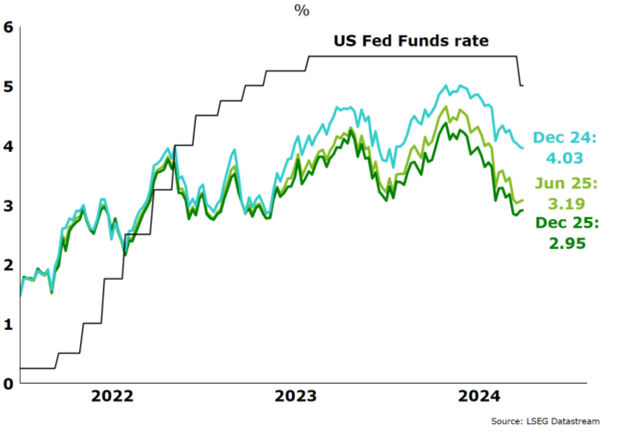
UK headline inflation remained steady in August at 2.2% but is expected to rise over the winter months as earlier declines in energy prices fall out of calculations. Measures of underlying price pressure – services and core inflation (adjoining chart) – are expected to ease further, despite the slight uptick in August. This should create room for two further interest rate cuts at the remaining MPC meetings this year.

UK: Headline & alternative measures of inflation



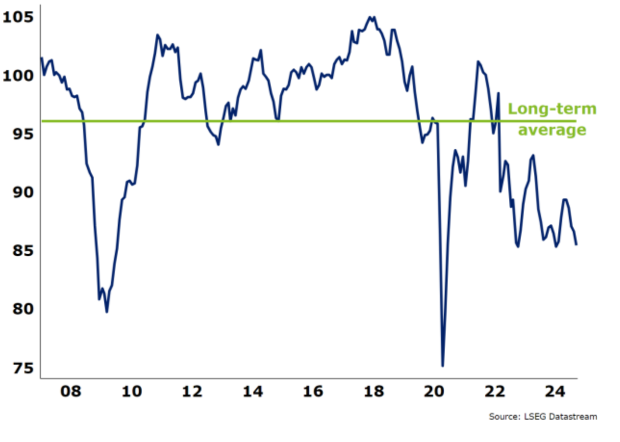
After a 'jumbo' 50-basis-point rate cut by the Federal Reserve last month, markets have lowered their US rate expectations (adjoining chart) further. With US growth forecast to slow to below its long-term trend next year, investors now expect six further rate cuts between now and June 2025.

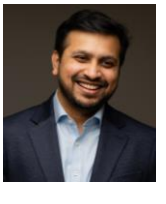
Evolution of US interest rate expectations



Euro area headline inflation is expected to have dropped below 2% for the first time since mid-2021, in September. The German economy – Europe's largest – remains in the doldrums, with a prolonged slump in business confidence (adjoining chart) and likely in a second recession in two years. Growth seems to be picking up in other northern European economies but slowly and from a low base. As a result, markets expect the ECB to match the Fed with six further rate cuts between now and the middle of next year.

German IfO Business Climate Index





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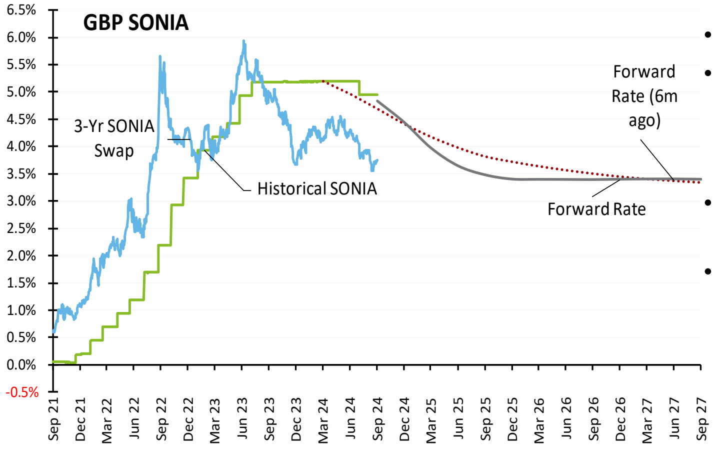
Interest Rate Markets

In September 2024, the Bank of England ("BoE"), the European Central Bank ("ECB"), and the Federal Reserve ("Fed") took differing stances on interest rates.

The Fed implemented a 50bps reduction in its Fed Funds target rate, bringing it down to the 4.75%-5.00% range from the previous 5.25%-5.50%. This marked its first rate cut since March 2020. The ECB also opted for a rate cut, albeit a more modest one of 25bps, to 3.50%. Conversely, the BoE elected to maintain its interest rate at 5.00%, a decision broadly in line with market expectations.

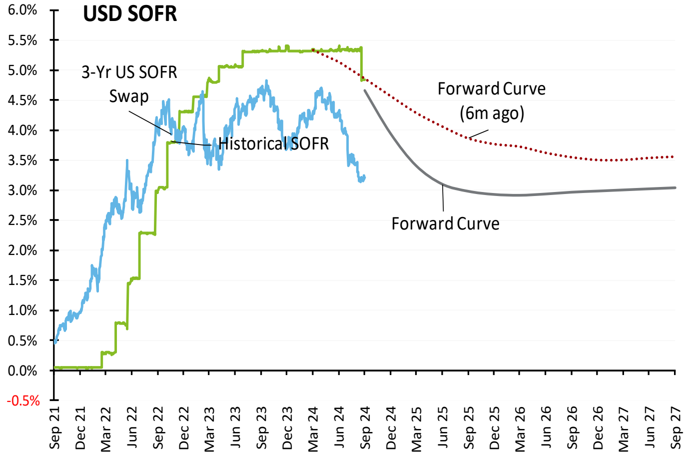
Prevailing market consensus anticipates a 25bps rate cut by all three Central Banks at their respective upcoming policy meetings.



- The underlying SONIA is 4.95%.
- Following the BoE decision to hold rates in September, markets are pricing in an 85% chance of a 25bps rate cut at their next policy meeting on 7th November, vs. 15% Hold.
- The 3-year SONIA Swap rate is 3.68% vs. 4.11%, 6 months ago.
- The forward curve remains inverted through summer 2025.

	2-year	3-year	5-year
Swap rate (mid level)	3.81%	3.68%	3.57%
Cap @ 5.00% (premium)*	£0.20m	£0.51m	£1.42m
Cap @ 5.50% (premium)*	£0.12m	£0.36m	£1.11m

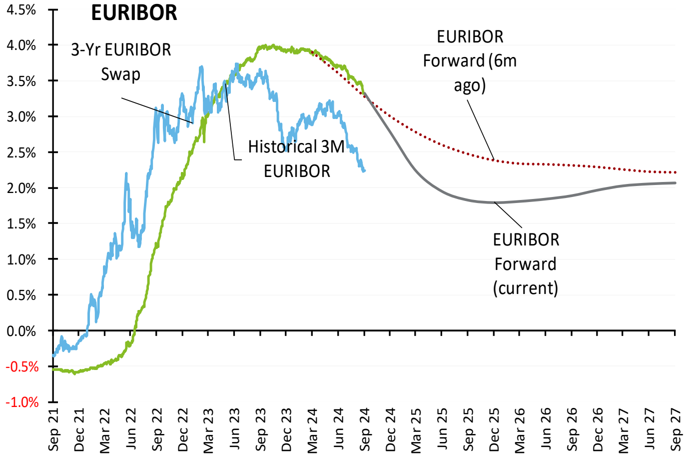
*£100m hedge notional



- SOFR is inside the Fed Funds current target rate range of 4.75%-5.00%, at 4.83%.
- The Fed cut rates at their policy meeting by 50bps on 19th September. Markets are pricing in an 62% chance of a 25bps rate cut at their next policy meeting on 7th November, but a 38% probability of a second 50bps cut.
- The 3-year SOFR Swap rate is 3.23% vs. 4.32% 6m ago, though 25bps lower MoM.

	2-year	3-year	5-year
Swap rate (mid level)	3.34%	3.23%	3.18%
Cap @ 4.50% (premium)*	$0.23m	$0.51m	$1.37m
Cap @ 5.00% (premium)*	$0.11m	$0.31m	$1.0m

*$100m hedge notional



- 3-month EURIBOR is 3.33%.
- The ECB cut rates at their policy meeting by 25bps on 12th September. Markets are anticipating a further 25bps cut on 17th October.
- The 3-year EURIBOR Swap rate is currently 2.13%, vs. 2.88% 6 months ago, down 30bps in the last month.
- 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)	2.21%	2.13%	2.15%
Cap @ 3.50% (premium)*	€0.06m	€0.25m	€0.92m
Cap @ 4.00% (premium)*	€0.03m	€0.15m	€0.64m

*€100m hedge notional

Data source: Refinitiv and ICE Data Services, as of 30th September 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 4.81% and a vanilla 5y Swap is 3.57%. On a GBP 100m financing, swapping to fix reduces interest costs in year 1 by GBP 1.24m.
- SOFR 3m at 4.55% and a vanilla 5y Swap is 3.18%. On a USD 100m financing, swapping to fix reduces interest costs in year 1 by USD 1.37m.
- EURIBOR 3m at 3.33% and a vanilla 5y Swap is 2.15%. On a EUR 100m financing, swapping to fix reduces interest costs in year 1 by EUR 1.18m.

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 that they then flatten or rise slightly thereafter.

- GBP swap: 2-year: 3.81%, 3-year: 3.68%, 5-year: 3.57%
- USD swap: 2-year: 3.34%, 3-year: 3.23%, 5-year: 3.18%
- EUR swap: 2-year: 2.21%, 3-year: 2.13%, 5-year: 2.15%

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:

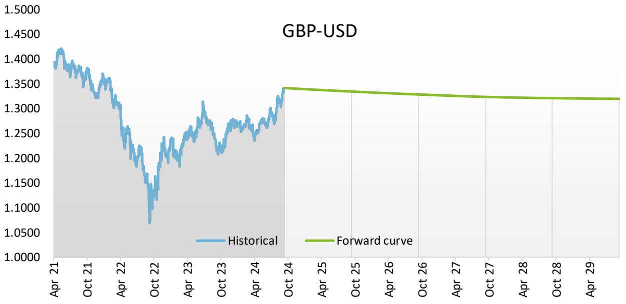
- GBP 5-year Swap starting in 6 months: 3.44%
- USD 5-year Swap starting in 6 months: 3.07%
- EUR 5-year Swap starting in 6 months: 2.07%

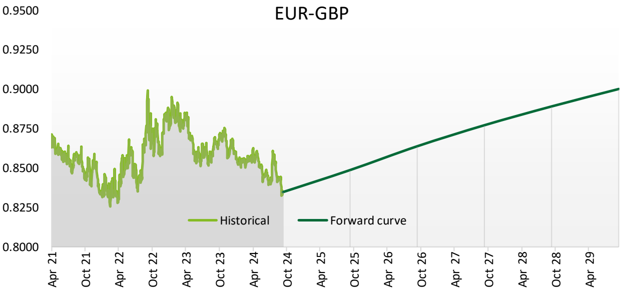
Funding of Hedging costs can be done at favourable rates

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.

Data source: Refinitiv and ICE Data Services, as of 30th September 2024

Currency Markets





- GBP-USD has moved 2% higher over the month on the back of expected near term rate cutting from the Fed.
- The cost of hedging via options for GBP-USD rose by up to 8% depending on the level of protection sought.
- The relative stability of FX forward rates over the 5-year horizon suggests expectations of a broadly similar interest rate environment across the two jurisdictions.

- The decrease in the EUR-GBP exchange rate is likely due to the ECB's recent rate cut, contrasting with the BoE's decision to maintain its rate at 5%.
- The cost of hedging via options for EUR-GBP rose by up to 6% depending on the level of protection sought.
- EUR sellers continue to benefit from favourable FX forward rates across the 5-year horizon. This is driven by the expectation of a sustained interest rate differential between the BOE and ECB policy rates, with the former expected to remain higher.

GBP-USD Spot Rate: 1.340	6mo	12mo	18mo
Forward rate	1.338	1.334	1.330
GBP Put Option* (ATMS**)	$2.87m	$4.19m	$5.25m
GBP Put Option* (5% OTMS***)	$0.83m	$1.88m	$2.77m

* GBP 100m Put option premium
** At-the-money Spot rate: 1.340
*** 5% Out-of-the-money vs Spot rate: 1.273

EUR-GBP Spot Rate: 0.832	6mo	12mo	18mo
Forward rate	0.841	0.849	0.856
GBP Put Option* (ATMS**)	€ 2.17	€ 3.60	€ 4.83
GBP Put Option* (5% OTMS***)	€ 0.35	€ 1.11	€ 1.96

* GBP 100m Put option premium
** At-the-money Spot rate: 0.832
*** 5% Out-of-the-money vs Spot rate: 0.874

Data source: Refinitiv and ICE Data Services, as of 30th September 2024

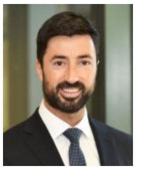
Hedging Advisory and Derivatives Execution team

Hedging Strategy Advice

Outsourced Derivative Execution

Financial Market Knowledge

Derivative Pricing Expertise



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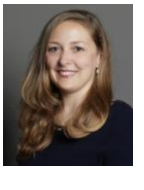

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