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IR and FX Newsletter
September 2024



A Macro View: US rate expectations ease in August

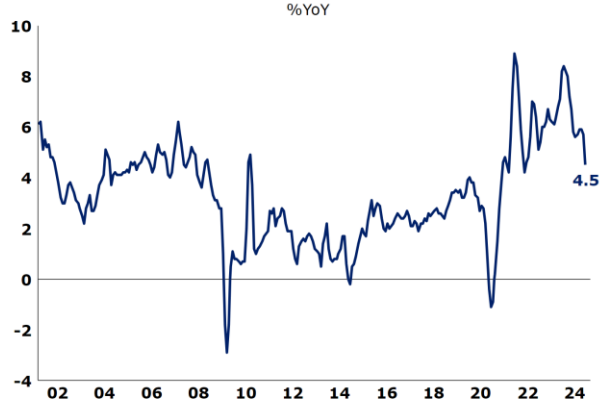
Economic data releases in August point to continued growth in the UK. While purchasing managers indices point to an established recovery in the manufacturing and construction sectors, services activity remains buoyant. Consumer confidence is up this year but a steady recovery in consumer spending remains elusive. Further rises in real wages should help consumers recover from this hangover from the inflationary period, with demand and spending expected to pick up over the next six months.

UK headline inflation has risen in July but it remains in line with the Bank of England's latest projections. Business sector surveys and slowing nominal wage growth (adjoining chart) point to some further easing in underlying price pressures. Nonetheless, headline inflation is expected to rise as earlier declines in energy prices fall out of calculations. We expect rates to be kept on hold in September but two further cuts remain likely in the subsequent meetings this year.

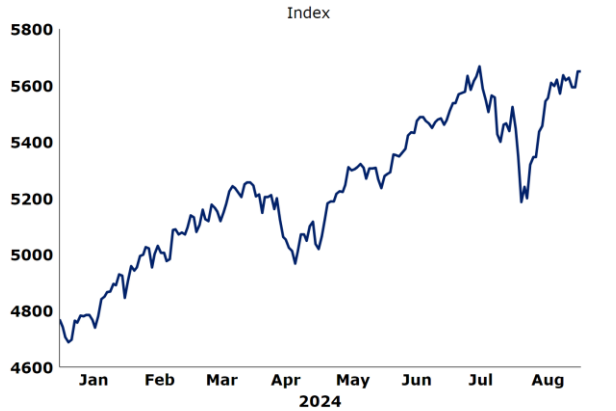
Alongside surprise monetary easing in Japan and a readjustment in tech stocks, concerns over US growth were seen to have driven the global sell-off in early August (adjoining chart). We expect a dovish tilt in the Federal Reserve's thinking as a result, partly reflected in Fed Chair Jay Powell's recent statement that the "time has come" for rate cuts. Markets have also lowered their US rate expectations over last month.

Euro area headline inflation is expected to have dropped to 2.2% in August although services inflation, followed closely by the European Central Bank, has edged up slightly (adjoining chart). While forecasts for Spanish growth have been upgraded over the last few months, prospects for growth in Germany – Europe's largest economy – remain weak. As a result, markets continue to expect the ECB to follow its June cut in interest rates with two further cuts this year.

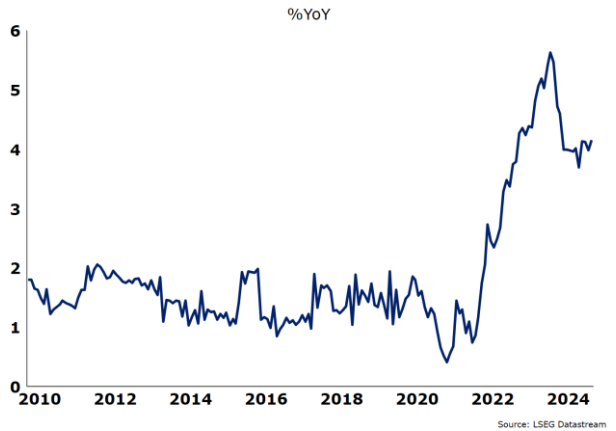
UK: Nominal wage growth



S&P 500 Composite



Euro area services inflation



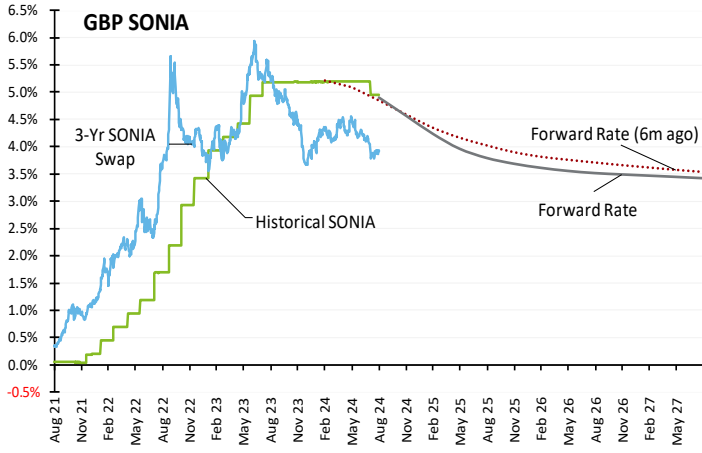
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Interest Rate Markets

While the Bank of England (“BOE”) commenced monetary easing with a 25bps rate cut at the end of July, markets anticipate no further action in September 2024. Conversely, market expectations suggest that both the European Central Bank (“ECB”) and the Federal Reserve (“Fed”) will implement a 25bps rate cut at their September meetings. Swap rates in Europe and the US show a notable decline in the last 30-days – by up to 41bps – while rates in the UK remain unchanged vis-à-vis the start of August.

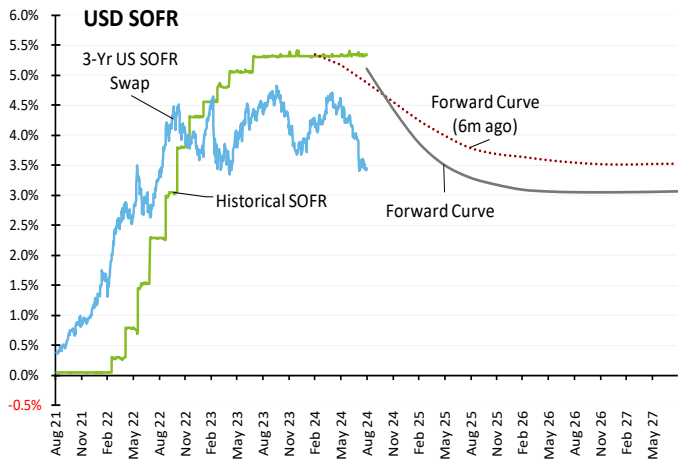
Eurozone inflation eased to 2.2% in August 2024, representing the lowest recorded rate since July 2021. Similarly, US inflation stood at 2.5% in July aligning closer to the Fed’s 2% target, signalling rate cuts are increasingly likely.



- The underlying SONIA is 4.95%.
- Markets are now pricing up to 50 bps of additional cuts by year end.
- The 3-year SONIA Swap rate is 3.86% vs.4.29%, 6 months ago.
- 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)	4.04%	3.86%	3.67%
Cap @ 5.00% (premium)*	£0.27m	£0.63m	£1.56m
Cap @ 5.50% (premium)*	£0.16m	£0.44m	£1.22m

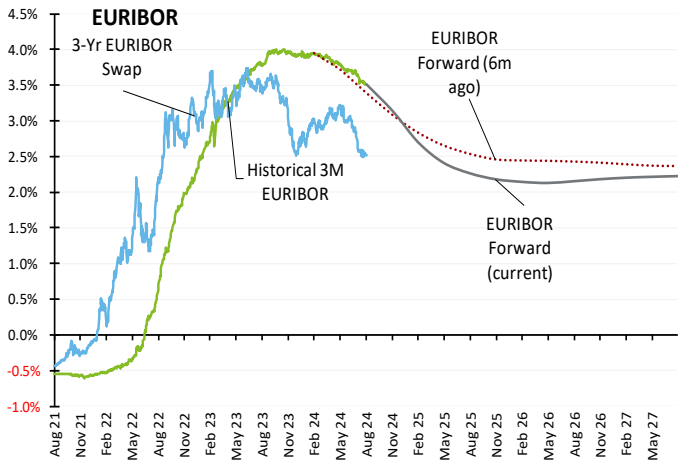
*£100m hedge notional



- SOFR is inside the Fed Funds current target rate range of 5.25%-5.50%, at 5.33%.
- Markets price almost 100bps of cuts between now and the end of 2024, across the remaining three scheduled monetary policy meetings.
- The 3-year SOFR Swap rate is 3.48% vs. 4.14% 6m ago, though 41bps lower MoM.

	2-year	3-year	5-year
Swap rate (mid level)	3.68%	3.48%	3.34%
Cap @ 5.00% (premium)*	\$0.17m	\$0.37m	\$1.02m
Cap @ 5.50% (premium)*	\$0.06m	\$0.21m	\$0.71m

*\$100m hedge notional



- 3-month EURIBOR is 3.51%.
- The ECB held rates at their policy meeting on 18th July. Markets are anticipating a 25bps cut on 12th September.
- The 3-year EURIBOR Swap rate is currently 2.47%, vs. 2.98% 6 months ago, down 20bps in the last month.
- The forward curve remains steeply inverted through summer 2025.

	2-year	3-year	5-year
Swap rate (mid level)	2.60%	2.47%	2.41%
Cap @ 3.50% (premium)*	€0.13m	€0.39m	€1.17m
Cap @ 4.00% (premium)*	€0.07m	€0.25m	€0.84m

*€100m hedge notional

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 4.88% and a vanilla 5y Swap is 3.67%. On a GBP 100m financing, swapping to fix reduces interest costs in year 1 by **GBP 1.21m**.
- SOFR 3m at 4.99% and a vanilla 5y Swap is 3.34%. On a USD 100m financing, swapping to fix reduces interest costs in year 1 by **USD 1.65m**.
- EURIBOR 3m at 3.50% and a vanilla 5y Swap is 2.41%. On a EUR 100m financing, swapping to fix reduces interest costs in year 1 by **EUR 1.09m**.



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: 4.04%, 3-year: 3.86%, 5-year: 3.67%
- USD swap: 2-year: 3.68%, 3-year: 3.48%, 5-year: 3.34%
- EUR swap: 2-year: 2.60%, 3-year: 2.47%, 5-year: 2.41%



Pre-hedging achieves even lower rates:

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

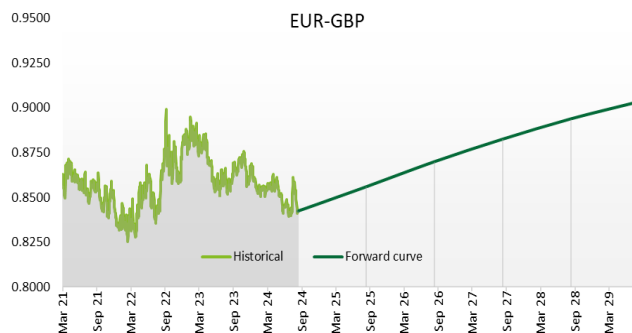
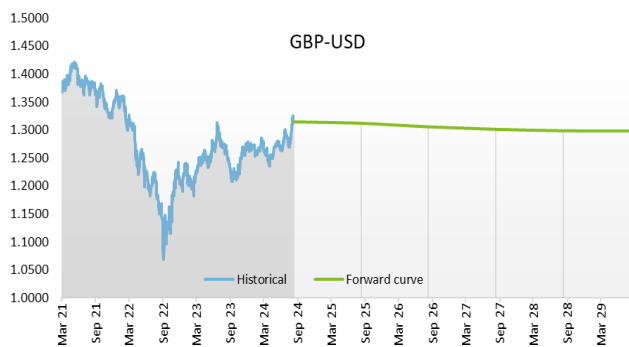
- GBP 5-year Swap starting in 6 months: 3.53%
- USD 5-year Swap starting in 6 months: 3.18%
- EUR 5-year Swap starting in 6 months: 2.28%



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.

Currency Markets



- GBP-USD has moved 3% 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 10% depending on the level of protection sought.
- Forward FX rates are near-enough flat through 5 years, indicating a similar interest rate environment across each jurisdiction.

- EUR-GBP is slightly lower amid geopolitical uncertainty in the eurozone, as well as anticipated rate cuts this month from the ECB.
- The cost of hedging via options for EUR-GBP rose by up to 13% depending on the level of protection sought.
- FX forward rates are still at a significant benefit for EUR sellers, out through 5 years, driven by the expectation of a continued high interest rate differential of the BOE's policy rate over that of the ECB's over that time frame.

GBP-USD Spot Rate: 1.314	6mo	12mo	18mo
Forward rate	1.315	1.312	1.309
GBP Put Option* (ATMS**)	\$2.65m	\$3.92m	\$4.90m
GBP Put Option* (5% OTMS***)	\$0.77m	\$1.79m	\$2.62m
* GBP 100m Put option premium			
** At-the-money Spot rate:	1.314		
*** 5% Out-of-the-money vs Spot rate:	1.249		

EUR-GBP Spot Rate: 0.842	6mo	12mo	18mo
Forward rate	0.849	0.856	0.862
GBP Put Option* (ATMS**)	€ 2.12	€ 3.46	€ 4.60
GBP Put Option* (5% OTMS***)	€ 0.35	€ 1.08	€ 1.85
* GBP 100m Put option premium			
** At-the-money Spot rate:	0.842		
*** 5% Out-of-the-money vs Spot rate:	0.884		

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

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