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IR and FX Newsletter
April 2025

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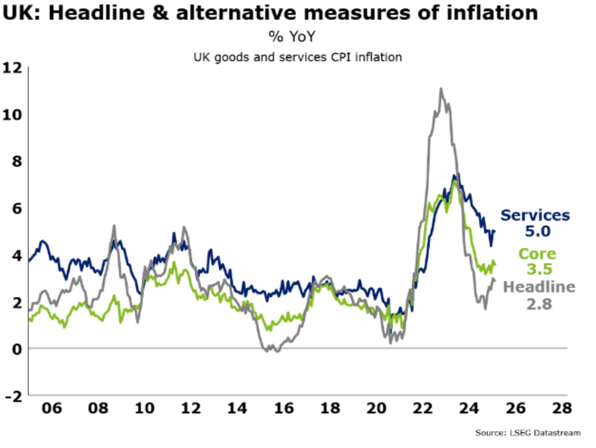
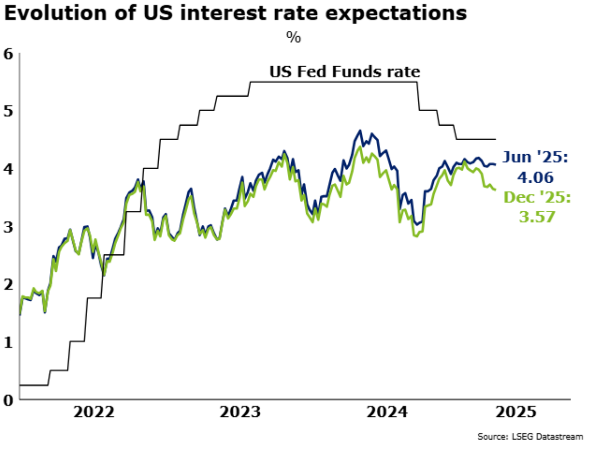
A Macro View: US rate expectations slide

UK GDP data and purchasing managers indices suggest anaemic growth over the first few months of this year, driven by continued weakness in the manufacturing and construction sectors. Consumer confidence is on the rise but remains at below-average levels. Business sentiment remains fragile. Despite cuts to government spending announced in March, day-to-day public expenditure over the next 12 months is set to rise faster than planned in October. This fiscal easing, alongside rising real wages and further interest rate cuts should support a modest acceleration in growth this year.

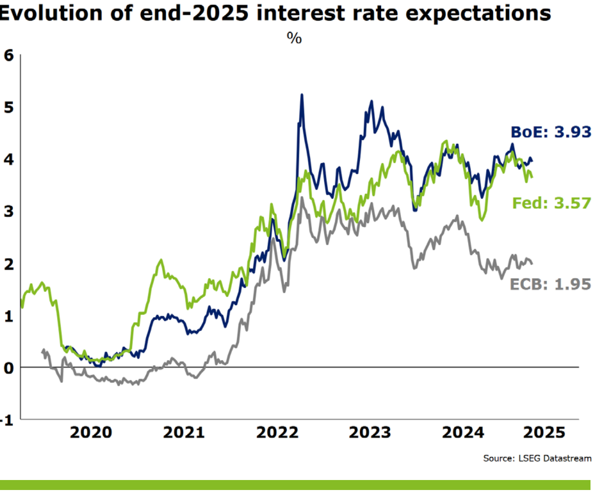
Inflation has eased from its recent high of 3% to 2.8% in February. But we expect higher energy prices to push it up to 3.5% in the third quarter. Despite this, relatively stable core and services inflation (adjoining chart) suggest underlying price pressures remain in check. As such, we continue to see room for two, if not three, additional rate cuts by the Bank of England this year.

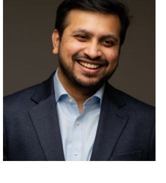


High-frequency data continue to point to a weakening US economy, with deteriorating consumer sentiment, lower than expected retail sales and an unexpected decline in manufacturing activity in March. Economists have also downgraded their US growth forecasts to 2.0% for this year, down from 2.2% in February. Alongside this, rate expectations have fallen (adjoining chart), with investors now expecting the Federal Reserve to lower its target rate to around 3.57% by the end of this year.



Euro area growth is set to remain unchanged this year. Growth is accelerating in Germany but after a sharp contraction last year. With the new government announcing Germany's biggest fiscal expansion in post-war history, economists are somewhat more optimistic about its medium-term prospects. But the short-term outlook remains weak for the region, with growth expected to slow in France and Italy this year. Spanish growth is also slowing but expected to remain well-above its long-term trend. Overall, persistent weakness and downside risks from further US tariffs mean markets continue to see three further rate cuts (adjoining chart) by the ECB this year.





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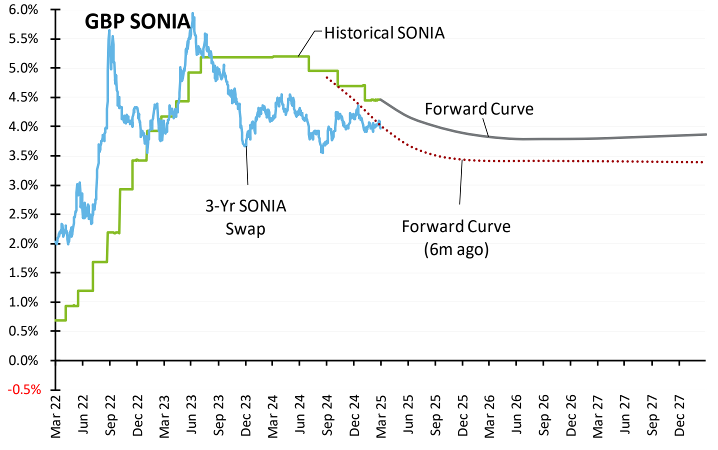
Interest Rate Markets

The European Central Bank (ECB) furthered its commitment to monetary easing with a widely anticipated 25bps rate cut on March 6th, marking its sixth overall reduction since June 2024. An easing in the Eurozone inflation (01 April) likely reinforces a cutting cycle, while Germany's recent decision to significantly increase spending on infrastructure and defence could, contrarily, stimulate economic growth and potentially stall the ECB's easing trajectory.

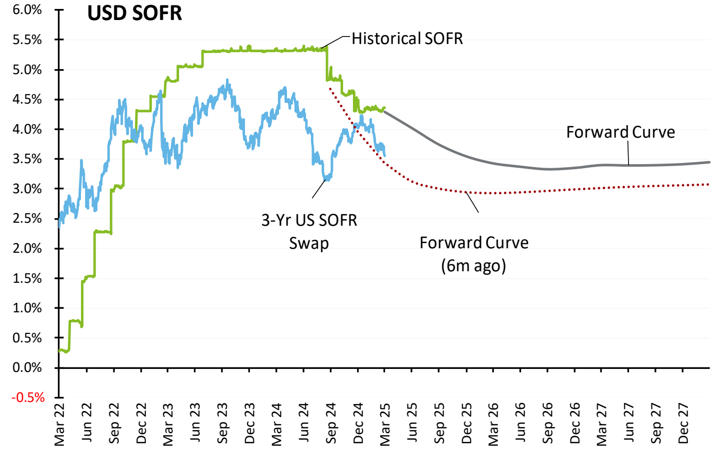
Both the Bank of England (BOE) and the US Federal Reserve (Fed) have taken more gradual approaches to their rate cutting, albeit with different timelines. Since August 2024, the BOE has implemented three 25bps rate cuts. The Fed, on the other hand, implemented a 50bps cut in September 2024 followed by two additional 25bps cuts later in the year. Market expectations for their upcoming May policy meetings diverge, with a rate cut priced in for the BOE and a hold anticipated from the Fed.



- The underlying SONIA is 4.46%.
- The BOE held rates at 4.50% at their policy meeting on 20th March.
- Market expectations are leaning towards a 25bps cut, with a 65% probability at its upcoming policy meeting scheduled for 8th May.
- The 3-year SONIA Swap rate is 3.91%, vs. 3.68% 6 months ago, though flat MoM.

	2-year	3-year	5-year
Swap rate (mid level)	3.95%	3.91%	3.92%
Cap @ 4.25% (premium)*	£0.51m	£1.08m	£2.61m
Cap @ 4.50% (premium)*	£0.36m	£0.85m	£2.21m
Cap @ 4.75% (premium)*	£0.27m	£0.69m	£1.91m

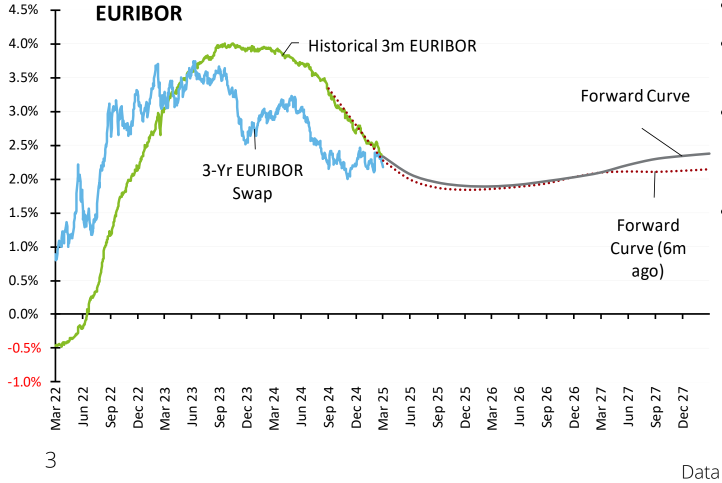
*£100m hedge notional



- SOFR is inside the Fed Funds current target rate range of 4.25%-4.50%, at 4.36%, following a decision to hold rates on 19th March.
- Market expectations are for another hold at its upcoming May 7th meeting with an 79% probability.
- The 3-year SOFR Swap rate is 3.56% vs. 3.24% 6 months ago, though 17bps lower MoM.

	2-year	3-year	5-year
Swap rate (mid level)	3.63%	3.56%	3.56%
Cap @ 4.25% (premium)*	$0.35m	$0.78m	$2.02m
Cap @ 4.50% (premium)*	$0.23m	$0.60m	$1.70m
Cap @ 4.75% (premium)*	$0.17m	$0.48m	$1.46m

*$100m hedge notional



- 3-month EURIBOR is 2.33%.
- The ECB cut rates at their policy meeting, on 6th March, by 25bps to 2.50%.
- Market consensus indicates an 89% probability of another 25bps interest rate cut at the next policy meeting scheduled for 17th April.
- The 3-year EURIBOR Swap rate is currently 2.08%, vs. 2.21% 6 months ago, and flat MoM.

	2-year	3-year	5-year
Swap rate (mid level)	2.01%	2.08%	2.25%
Cap @ 2.50% (premium)*	€0.24m	€0.76m	€2.28m
Cap @ 2.75% (premium)*	€0.16m	€0.60m	€1.92m
Cap @ 3.00% (premium)*	€0.12m	€0.47m	€1.61m

*€100m hedge notional

Data source: Refinitiv and ICE Data ICE Data Derivatives, as of 31st March 2025

What can be done in the current Interest Rate markets?

Borrowers can still fix rates below the current floating rate:

Not only is there no additional cost to fix floating rate exposure, but the current shape of the forward curve still allows borrowers to fix rates at levels below the current floating rate:

- SONIA 3m is 4.35% and a vanilla 3y Swap is 3.91%. On a GBP 100m financing, swapping to fix reduces interest costs in year 1 by GBP 440k.
- SOFR 3m at 4.28% and a vanilla 3y Swap is 3.56%. On a USD 100m financing, swapping to fix reduces interest costs in year 1 by USD 720k.
- EURIBOR 3m at 2.33% and a vanilla 3y Swap is 2.08%. On a EUR 100m financing, swapping to fix reduces interest costs in year 1 by EUR 250k.

Hedges tenors do not materially impact the hedged rate:

While the forward curves are not as downward sloping as was seen through much of 2024, there is still limited-to-no premium associated with hedging longer tenors, as would be typical in a 'normal' rate environment:

- GBP swap: 2-year: 3.95%, 3-year: 3.91%, 5-year: 3.92%
- USD swap: 2-year: 3.63%, 3-year: 3.56%, 5-year: 3.56%
- EUR swap: 2-year: 2.01%, 3-year: 2.08%, 5-year: 2.25%

Pre-hedging:

Due to the relatively stable medium- to long-term rate environment, pre-hedging future debt (assumed closing is in 6 months) allows for locking in swap rates in advance at similar levels to spot-starting trades:

- GBP 5-year Swap starting in 6 months: 3.89%
- USD 5-year Swap starting in 6 months: 3.51%
- EUR 5-year Swap starting in 6 months: 2.29%

Funding of Hedging costs can be done at favourable rates

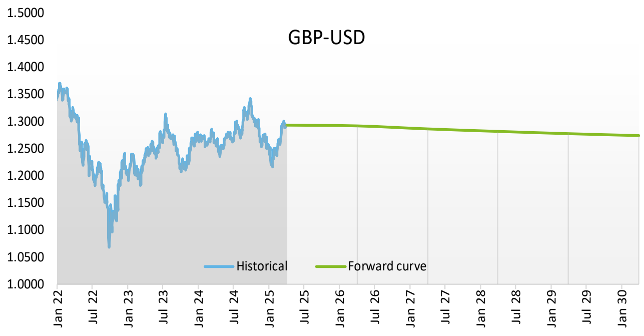
Hedging costs for Option products (such as Caps) are typically paid upfront, however these costs can be deferred over time. This cost deferral can often be done via the derivative desks at favourable rates (at SONIA, SOFR or EURIBOR, without application of the similar financing margins); further, debt covenants are not so impacted from this cost deferral.

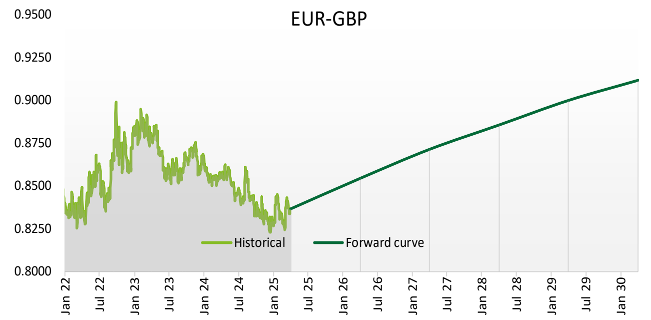
Structured Hedging solutions

Over the past few months many clients are incorporating two, or more, trades into their hedge solution; most commonly a combination of Swap and Cap trades, or trades with variable strike rates over time. The rationales for structuring more bespoke solutions varies, often to match uncertainties in business plans, or to reduce credit exposure to a bank counterparty, or even simply to overlay a degree of 'client view on rates outlook' without materially decreasing their risk management impact.

Data source: Refinitiv and ICE Data ICE Data Derivatives, as of 31st March 2025

Currency Markets





- GBP-USD strengthened over the course of March. This may be partly attributed to the US government apparently policy stance on trade, but also directly impacted by the relative strength of the UK rate environment with the BOE's decision to maintain the base rate at 4.50% on 20th March.
- Option premia decreased by up to 10.0% MoM, depending on the protection levels sought.
- Forward FX rates remain flat out through 5 years, suggesting little deviation between interest rate environments across both countries over the medium term.

- EUR-GBP exchange rate experienced a slight appreciation following the UK government's spring statement, which outlined plans for substantial spending cuts.
- Option premia increased by up to 18.0% MoM, depending on the protection levels sought.
- The widening interest rate differential between the EUR and GBP is pushing forward exchange rates beyond historical spot levels seen over the past 10 years. This presents a compelling opportunity for EUR sellers and GBP buyers, who may benefit by hedging, locking in such EUR strength, rather than remaining unhedged.

GBP-USD Spot Rate: 1.293	6mo	12mo	18mo
Forward rate	1.294	1.292	1.289
GBP Put Option* (ATMS**)	$2.75m	$4.03m	$4.96m
GBP Put Option* (5% OTMS***)	$0.81m	$1.85m	$2.65m

* GBP 100m Put option premium
** At-the-money Spot rate: 1.293
*** 5% Out-of-the-money vs Spot rate: 1.229

EUR-GBP Spot Rate: 0.837	6mo	12mo	18mo
Forward rate	0.845	0.854	0.863
GBP Put Option* (ATMS**)	€ 2.45m	€ 3.96m	€ 5.27m
GBP Put Option* (5% OTMS***)	€ 0.47m	€ 1.34m	€ 2.28m

* GBP 100m Put option premium
** At-the-money Spot rate: 0.837
*** 5% Out-of-the-money vs Spot rate: 0.878

Data source: Refinitiv and ICE Data ICE Data Derivatives, as of 31st March 2025

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