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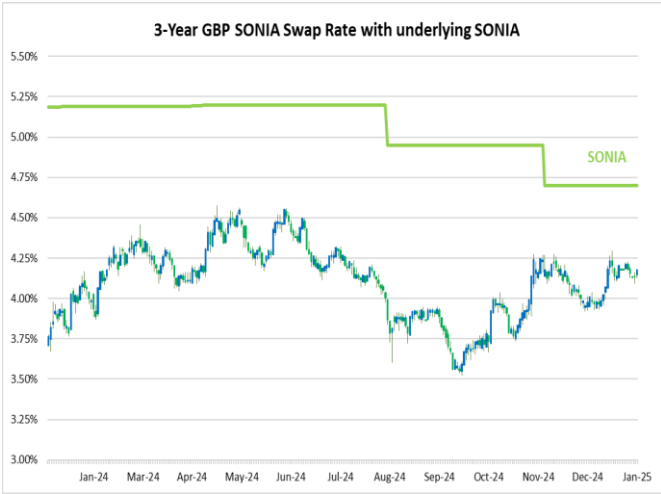


IR and FX Newsletter
January 2025



The past year of Interest Rate changes: a look back

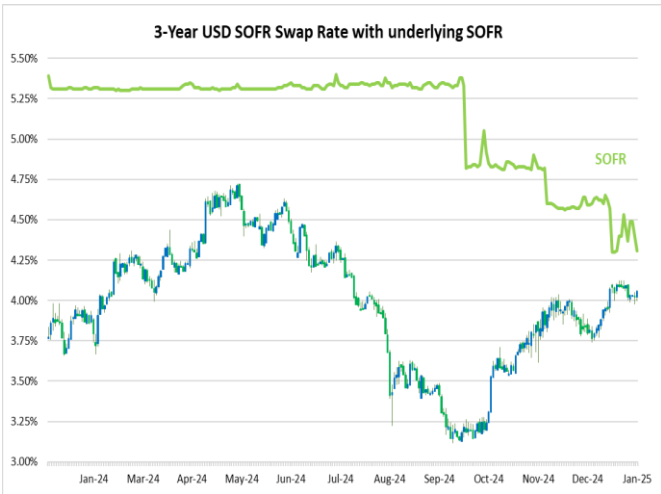
2024 saw Central Banks actively take on the competing challenges of bringing inflation under control while injecting economic stimuli as deemed necessary. The Bank of England ("BOE"), the US Federal Reserve ("Fed"), and the European Central Bank ("ECB") each made a number of interest rate cuts, though fewer than had been anticipated at the beginning of the year. Their evolving monetary policy throughout the year impacted borrowing costs and frequently altered the market outlook and economic forecasts.



One year ago, the markets expected the BOE to make 6-7 cuts to its Bank Rate, dropping it from a post-GFC high of 5.25% to 3.50-3.75%, with the first rate cut expected in May 2024. The Bank Rate was finally lowered by 25bps to 5.00% in August 2024, marking the first decrease since 2020; followed by a further cut to 4.75% in November.

Neither the bank rate, nor the related SONIA interest rate, fell in-line with the market forward curve during H1-2024, with market expectations always pricing in faster or deeper cuts than was ultimately set by the BOE. A 3-year swap in January 2024 was 3.75% and is now 4.11%. An inverted yield curve can present opportunities for borrowers, particularly if interest rate cuts are not implemented as swiftly as market expectations predicted.

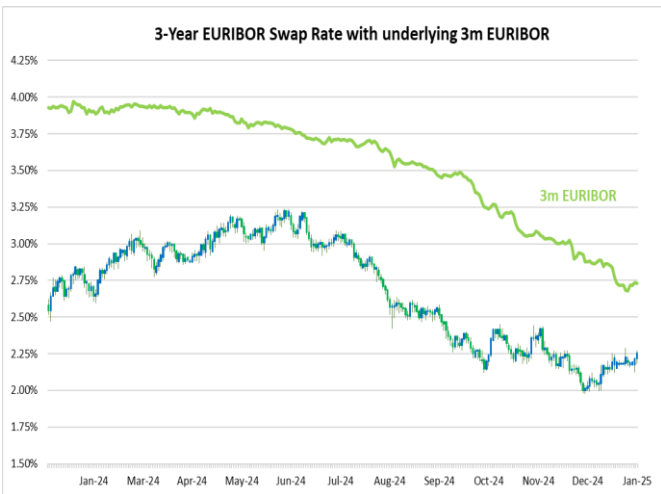
Inflation eased from 4.00% a year ago to 1.70% in September, rising again to 2.60% at year-end and above the BoE's 2.00% target, particularly in services (5.00%) and core (3.50%) inflation, which excludes volatile items like energy and food. Within the BOE MPC the 'hawks', focussing on inflation control, won out during 2024, over the 'doves' whose focus is economic stimulus, resulting in the higher-for-longer' rate stance.



The Fed implemented 3 interest rate cuts in 2024. Their first rate cut, in September, and later than the UK and Eurozone, reduced the federal funds rate by 50bps to a range of 4.75-5.00%. This cut, larger than anticipated, was deemed necessary to provide more substantial stimulus as economic growth exhibited signs of slowing.

Early in the year, the Fed maintained a cautious approach, keeping rates steady as inflation remained above its target, however, by Mid-year, despite inflation pressures showing limited signs of receding (3.00% vs 3.10% in Jan) the US economy was cooling, and the Fed began to pivot. The initial cut was followed by a 25bp cut in November and a further 25bp reduction in December, lowering the rate to 4.25-4.50% range. Inflation remains at 2.70% for November.

Akin to the UK, the interest rate forward curve did not evolve as expected back in January 2024. Markets had anticipated rates to fall to 3.50-3.75% range by the end of the year. A 3-year swap in January 2024 was 3.77% but is now 3.98%. The narrowing of the discount between swaps and underlying interest rates reflects a lower belief for further significant cuts from the Fed who are 'committed to supporting employment and hitting the 2.00% inflation target'.



The ECB followed the Swiss (Mar) and Swedish (May) Central Banks and cut their Eurozone Deposit Facility Rate by 25bps in June 2024 implementing 3 further rate cuts to address economic challenges specific to this wide economic zone. The ECB reduced its key interest rate four times throughout 2024, with the most recent cut occurring in December, when the deposit rate was lowered by 25bps to 3.00%.

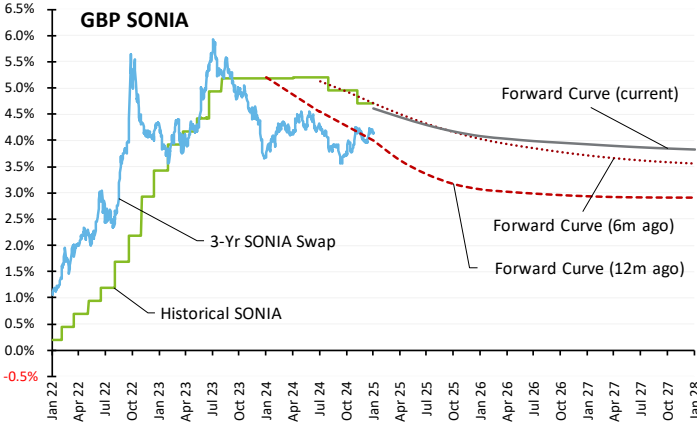
During the latter half of 2024, the short end of the EURIBOR forward curve presented an accurate reflection of the impending rate cuts, though longer-term forward rates beyond the immediate 6m tenor failed to reflect subsequent rate cut timings or frequency. Markets initially projected rates to fall to 2.25% by the end of the year. A 3-year swap in January 2024 was 2.58% and following the cuts made to-date is now only 2.09%; retaining a steep sharp inversion through summer 2025 contrasting with a full 21 months of cuts anticipated a year ago.

The Eurozone experienced an increase in the annual inflation rate, climbing to 2.20% from 1.70% in September, hinting that work is not yet over in the quest for price stability.

Interest Rate Markets

Although the Fed implemented a 25bps rate cut in the last month of 2024, markets anticipate no further action at its upcoming policy meeting in January 2025. Conversely, market consensus suggests that both the ECB and the BOE are poised to implement a 25bps rate cut at their respective first policy meetings of 2025.

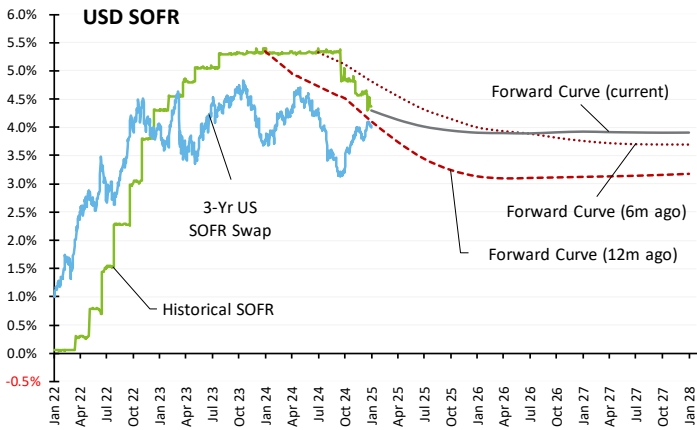
While 2024 has generally seen a downward trend in inflation, recent reports indicate a slight resurgence in headline inflation across key global economies, due mainly to recent energy price rises, and stronger consumer purchase expenditure. This has led to a reassessment of interest rate expectations, reflected in the upward movement of swap rates, particularly those with 2, 3, and 5-year maturities, within the Eurozone, UK, and US markets compared to the previous month.



- The underlying SONIA is 4.70%.
- The BOE held rates at 4.75% at their policy meeting on 19 December. Market consensus indicates a 68% probability of a 25bps interest rate cut at the next meeting on 6th February.
- The 3-year SONIA Swap rate is 4.11% vs. 4.27%, 6 months ago, although 13bps higher MoM.
- The forward curve remains inverted through summer 2025.

	2-year	3-year	5-year
Swap rate (mid level)	4.21%	4.11%	4.00%
Cap @ 4.50% (premium)*	£0.59m	£1.12m	£2.44m
Cap @ 5.00% (premium)*	£0.31m	£0.70m	£1.77m
Cap @ 5.50% (premium)*	£0.19m	£0.49m	£1.36m

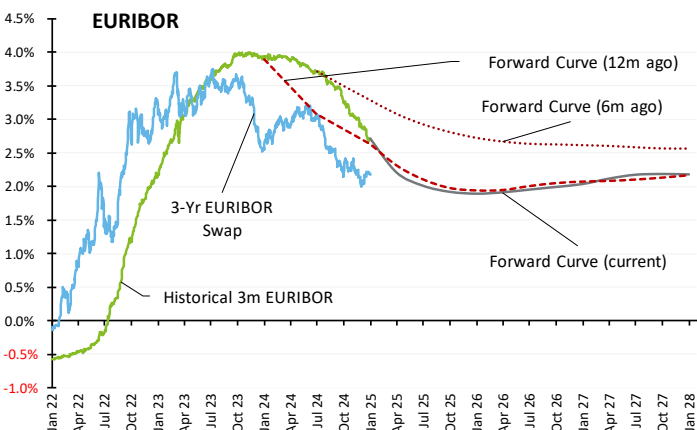
*£100m hedge notional



- SOFR is inside the Fed Funds current target rate range of 4.25%-4.50%, at 4.37%, following a 25bps rate cut on 18 December.
- Market expectations are leaning towards a hold at its upcoming January 29th meeting with an 89% probability.
- The 3-year SOFR Swap rate is 3.98% vs. 4.31% 6m ago, although 15bps higher MoM.

	2-year	3-year	5-year
Swap rate (mid level)	4.01%	3.98%	3.96%
Cap @ 4.50% (premium)*	\$0.45m	\$1.0m	\$2.31m
Cap @ 5.00% (premium)*	\$0.27m	\$0.68m	\$1.74m
Cap @ 5.50% (premium)*	\$0.18m	\$0.50m	\$1.35m

*\$100m hedge notional



- 3-month EURIBOR is 2.71%.
- The ECB cut rates at their policy meeting by 25bps on 12th December, to 3.00%.
- Market consensus indicates an 84% probability of another 25bps interest rate cut at the next meeting on 30th January.
- The 3-year EURIBOR Swap rate is currently 2.09%, vs. 3.05% 6 months ago, although 9bps higher MoM.

	2-year	3-year	5-year
Swap rate (mid level)	2.07%	2.09%	2.14%
Cap @ 3.00% (premium)*	€0.15m	€0.49m	€1.50m
Cap @ 3.50% (premium)*	€0.08m	€0.33m	€1.09m
Cap @ 4.00% (premium)*	€0.05m	€0.23m	€0.81m

*€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 4.61% and a vanilla 5y Swap is 4.00%. On a GBP 100m financing, swapping to fix reduces interest costs in year 1 by **GBP 0.61m**.
- SOFR 3m at 4.30% and a vanilla 5y Swap is 3.96%. On a USD 100m financing, swapping to fix reduces interest costs in year 1 by **USD 0.34m**.
- EURIBOR 3m at 2.71% and a vanilla 5y Swap is 2.14%. On a EUR 100m financing, swapping to fix reduces interest costs in year 1 by **EUR 0.57m**.



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: 4.21%, | 3-year: 4.11%, | 5-year: 4.00% |
| • USD swap: | 2-year: 4.01%, | 3-year: 3.98%, | 5-year: 3.96% |
| • EUR swap: | 2-year: 2.07%, | 3-year: 2.09%, | 5-year: 2.14% |



Pre-hedging:

Pre-hedging future debt (assumed closing is in 6 months) allows for locking in swap rates in advance with limited premium over spot-starting trades:

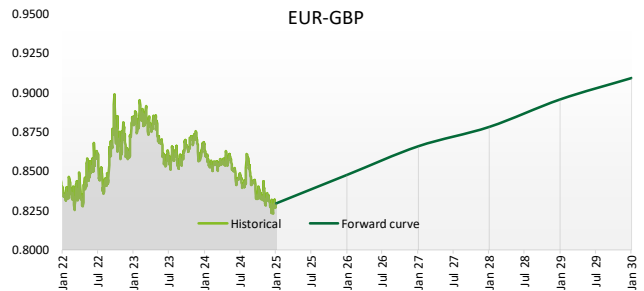
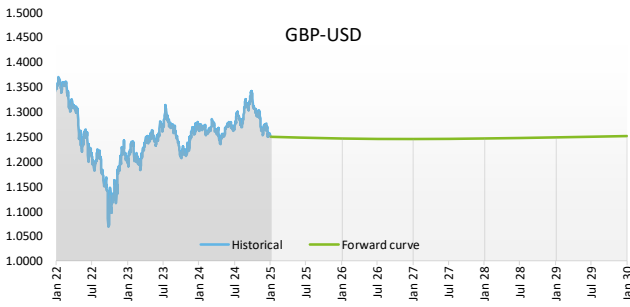
- GBP 5-year Swap starting in 6 months: 3.93%
- USD 5-year Swap starting in 6 months: 3.93%
- EUR 5-year Swap starting in 6 months: 2.13%



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 2% lower during December on the back of expected near term rate cutting from the BOE.
- Option premia increased by up to 8% MoM, depending on the protection levels sought.
- Forward FX rates remain flat out through 5 years for GBP sellers, suggesting little deviation between interest rate environments across both countries over the medium term.

- The EUR-GBP Spot rate has remained flat MoM as markets digest ongoing rate cuts by both the ECB and BOE.
- Option premia increased by up to 25% MoM, depending on the protection levels sought.
- Favourable forward exchange rates for EUR sellers persist over the 5-year horizon, driven by expectations of a sustained interest rate differential, with the BOE maintaining relatively higher rates compared to the ECB, which is expected to set rates below those in the UK.

GBP-USD Spot Rate: 1.250	6mo	12mo	18mo
Forward rate	1.248	1.247	1.246
GBP Put Option* (ATMS**)	\$3.01m	\$4.25m	\$5.15m
GBP Put Option* (5% OTMS***)	\$1.05m	\$2.12m	\$2.94m
* GBP 100m Put option premium			
** At-the-money Spot rate:	1.250		
*** 5% Out-of-the-money vs Spot rate:	1.188		

EUR-GBP Spot Rate: 0.829	6mo	12mo	18mo
Forward rate	0.837	0.848	0.858
GBP Put Option* (ATMS**)	€ 2.50	€ 4.14	€ 5.56
GBP Put Option* (5% OTMS***)	€ 0.45	€ 1.38	€ 2.39
* GBP 100m Put option premium			
** At-the-money Spot rate:	0.829		
*** 5% Out-of-the-money vs Spot rate:	0.871		

Data source: Refinitiv and ICE Data Services, as of 2nd January 2025

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