Investec Europe Limited

Credit Union Newsletter - Q4 2020

1. Irish Economic Overview

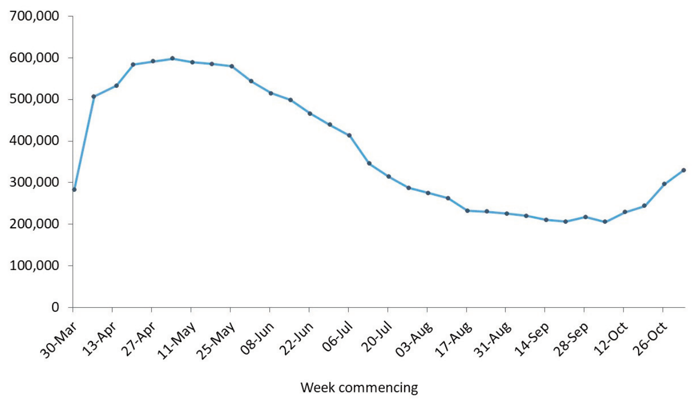
The introduction of Level 5 restrictions will set back the country's economic recovery but, assuming they are not extended further than currently envisaged, the economic damage will be limited and the lower rates of COVID transmission that will result should reinforce confidence heading into 2021. Conversely, if stringent restrictions are extended further or are reintroduced in the New Year, there are fears that so-called "scarring effects" could prompt permanent behavioural changes by households and companies that would stifle the economic recovery. As such, much still depends on the path of the virus.

Labour market best displays the economic stresses

Perhaps the greatest impact on the economy of heightened restrictions is on the country's labour market. At the peak in early May, almost 600,000 people were in receipt of the Pandemic Unemployment Payment (PUP), representing one quarter of the entire labour market. The situation gradually improved as restrictions were eased, although progress slowed during the latter part of the summer. By the end of August, there was 225,000 PUP claimants and a COVID-adjusted unemployment rate of 15%.

With virus case numbers escalating, the government then imposed Level 3 restrictions on some parts of the country which severely curtailed the hospitality industry in particular and set unemployment numbers on the rise again. Although the current set of Level 5 restrictions are not as strict as the initial spring lockdown, they have had a material effect on employment. As we write, there has been a 35% increase in the number of PUP recipients under Level 5 and the COVID-adjusted unemployment rate has increased to 19%. As with much of the economic indicators at present however, the path that COVID and the related restrictions take in the coming months holds the key to economic developments.

Chart 1: Pandemic Unemployment Payment recipients

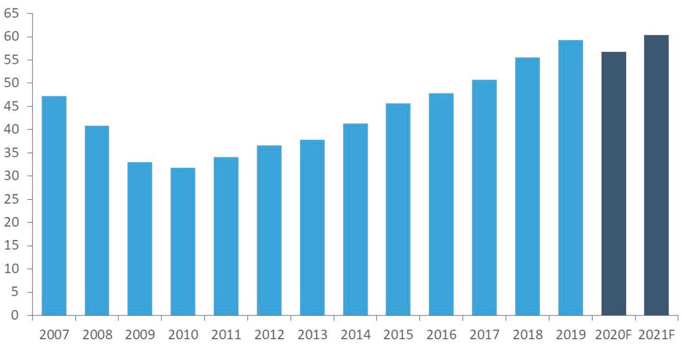


Public finances deteriorating, but not worryingly so

While some of the Minister for Finance's carefully planned budget-day arithmetic was quickly made obsolete by the announcement of Level 5 restrictions just six days later, Budget 2021 did highlight the financial capacity that is available to the government given a remarkably resilient tax base and an export sector that is heavily weighted towards the pharma and IT sectors.

Leaving aside the potential deterioration from the heightened restrictions (which will be limited in any case), Budget 2021 projected that tax revenues would fall by just 4.4% in 2020. This would still leave tax revenues this year higher than in 2018 and the decline pales in comparison to the 30% plunge in the tax take between 2007 and 2009. While forecasting beyond the short-term is fraught with difficulty, a full recovery in tax revenues is nonetheless expected in 2021.

Chart 2: Tax Revenues by year, €bn



An extraordinarily robust tax base in the face of such economic turmoil of course mitigates the impact to the public finances, but this negative impact is primarily coming from higher expenditure.

Unprecedented household and business supports has pushed spending in the Department of Employment Affairs and Social Protection higher by 71% (€6.3bn) in the ten months to the end of October. The cost of the PUP scheme is currently running at almost €100m per week (annualising at €5bn).

Health expenditure has understandably increased, but the 16% (€2.2bn) rise in the same period is considerably lower than the growth in Social Protection spending.

In total, Budget 2021 foresaw an increase of almost €20bn in government spending this year to €87bn and a deficit of €17bn (6% of GDP). Although the subsequent introduction of Level 5 measures will likely expand this deficit somewhat, it will be considerably inside the €25-30bn range mooted earlier in the year. A similar deficit is projected for 2021, although much uncertainty still prevails regarding next year.

While this is a significant shortfall in the public finances by any measure, as we described in the Q3 Newsletter, the country has made significant progress in reducing its debt burden in the past seven years which has provided the government with substantial borrowing headroom. There has been record demand this year for the NTMA's bond issues and it can raise long-term funding at essentially zero interest cost. With the ECB standing squarely behind Eurozone governments and national debt agencies, there are no indications that this favourable borrowing environment will not persist.

Other indicators are mixed but generally point to a resilient domestic economy

Other domestic economic indicators generally illustrate a much slower pace of recovery now than in prior months. Retail sales data continues to be very impressive however. Retail sales volumes rose for the fifth successive month in September and, buoyed by booming household goods sales, were almost 10% higher than year-earlier levels. However there have been indications that the sale of physical goods have benefitted from the lack of opportunities for consumption of services. Daily card spending data from the CBI show total spending in September was -1.4% y/y and, following a bounce right before Level 5 was introduced, card spending in the week to 25 October was almost 2% lower than a year earlier. Elsewhere, the latest readings from the PMI indices show that forward momentum in the Manufacturing and Service industries had stalled through September and October, but this is not out of line with similar readings from our neighbours in Europe and the UK.

2. Financial Sector Overview

The domestic banks have provided Q3 trading updates in recent days and weeks and they have generally struck a cautiously upbeat tone. Payment breaks have been significantly reduced, lending activity has picked up and capital levels remain more than adequate. Profitability metrics will remain under pressure for the foreseeable future and banks are examining their cost bases, but these concerns are not at the forefront of minds at the moment.

Some signs of upward pressure on house prices

Of significant support to the banking sector is the remarkable resiliency of the housing market, and housing prices in particular which have hardly budged according to official price indices. Indeed, some forward-looking indicators are pointing to some price growth in H2. Recent data from Daft.ie showed that the average listed price increased by 4.8% in Q3, the largest quarterly increase in five years, following a 1.9% decline in Q2. Data from myhome.ie have been very similar.

Mortgage data are also very encouraging from a price perspective. Both recent drawdown data, reflecting deals that were largely struck in the early stages of the pandemic, and approval figures, which are a more forward looking but imperfect indicator, have been surprisingly healthy. The average mortgage drawn down for a house purchase in Q320 was +5.2% y/y and the average mortgage approval for a house purchase in the same period was +7.5% y/y. This rise has been led by the first-time buyer (FTB) market, where the average mortgage drawdown in Q320 was 7.5% higher (at €245k) than one year previously. Some of this upwards step may be due to an increase in the credit strength of the average borrower as those most affected by the pandemic now find mortgage credit harder to obtain, but the buoyancy in the data is remarkable nonetheless.

Chart 3: Average listed prices on Daft.ie (y/y)

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Chart 4: Size of average mortgage drawdown (y/y)

Mortgage lending decline not as severe as feared

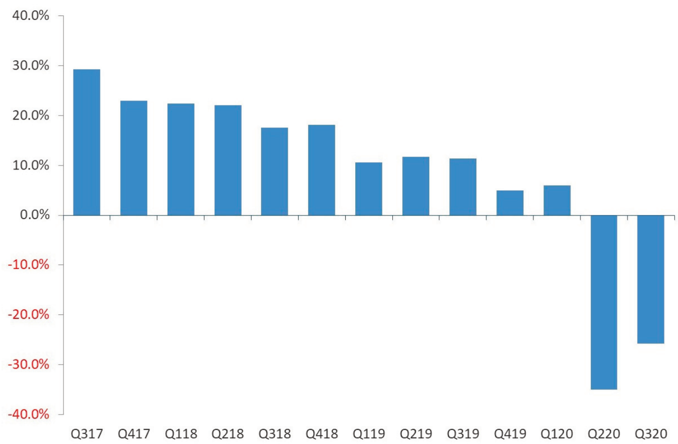
Despite the price resiliency, housing and mortgage market activity will clearly suffer a setback this year, although latest indications are that volumes bounced back as Q3 progressed. Total mortgage lending (by value) fell by 35% y/y in Q220 and by 26% y/y in Q3 – both somewhat better than our a priori expectations. Mortgage approval volumes (by value), which were -52% y/y in Q220, were just -3% y/y in Q3. Indeed, approvals in September alone were +35% y/y by value and +21% y/y by number. On foot of the recent data, we have revised upwards our forecast of full-year mortgage lending from €7.0bn to €7.6bn.

Again, it is the FTB segment that is recovering more quickly – FTB approvals were +7% y/y (value) and -1% y/y (number) in Q3. The €647m of FTB mortgages approved in September was the highest one-month total since these figures were first published in 2011.

Period of severe household deleveraging has come to an end

Lending to households returned to net growth in Q320, following two quarters of contraction. Although the growth was only marginal, the figures turned notably upward in September. Loans for house purchase expanded in net terms over the quarter and, although consumer lending contracted by €51m over the entire quarter, it expanded in both August and September – the first time that two successive months of credit growth had been recorded in more than a year and following a period of significant deleveraging during the height of the pandemic.

Chart 5: Mortgage lending by total value (y/y)



Deposit growth continuing but at a slower pace

Households continue to accumulate deposits at a significant rate, albeit not at the unprecedented rates seen during the summer months. Total household deposits stood at €121.2bn at the end of Q320 – €11.8bn higher than a year earlier and the greatest annual increase on record. It is no surprise however that the extraordinary month-on-month growth of up to €3bn (April 2020) has slowed (to €0.7bn in September) given the release of some precautionary saving and delayed consumption.

Chart 6: Household credit flows (3-month moving sum)

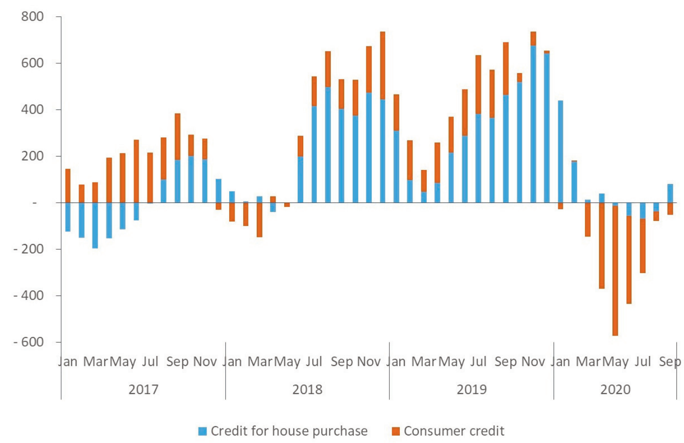
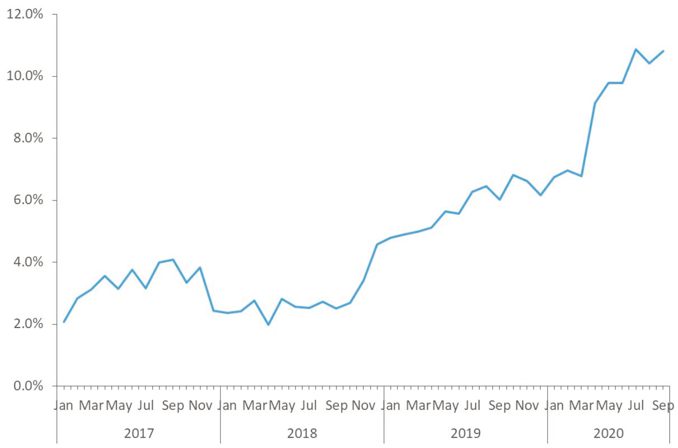


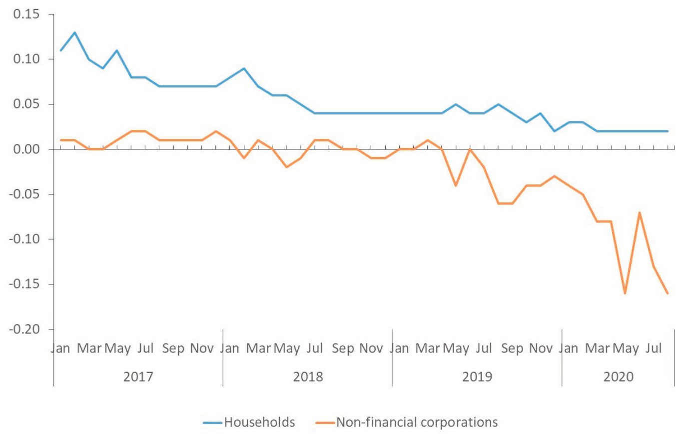
Chart 7: Annual growth in household deposits



Low, lower and negative

With a banking system rapidly accumulating deposits far in excess of requirements, it is no surprise to see further downward pressure on deposit rates. Negative interest rates are now a common feature of the corporate deposit market – indeed, the average new deposit rate for non-financial corporations has moved deeper into negative territory in recent months – but the retail market has not yet been hit with a charge for placing cash in the banking system. However, with the country's largest banks now applying negative rates to pension accounts and changing T&Cs to allow negative rates to apply to micro enterprises, it would no longer be a surprise to see negative interest rates extend to some personal accounts in due course.

Chart 8: Average deposit rates on new business (deposits with agreed maturity)



While there has been some downward movement in mortgage interest rates in the past year, this has been relatively modest and in line with similar modest decreases in average mortgage rates in the wider Eurozone. Irish mortgage rates remain amongst the highest in the Eurozone. There are some signs of an increase in competitive forces in the mortgage market, such as the entry of Avant Money with a headline-grabbing rate below 2%, but the potential exit of Ulster Bank would remove one of the five largest players in the market.

3. Investment Markets Review

Investment markets receive a double boost but worries linger

Equity markets have drawn considerable support in recent days from two events; the ultimately clear-cut Presidential election in the US and the encouraging vaccine trial results. Although the vaccine news has been met with significant relief, it is unlikely to come soon enough to halt the continued second wave of infections in many countries and this is still weighing on markets.

Markets reacted positively to the lifting of the fog of uncertainty that shrouded the period leading up to the US election. The S&P 500 recorded its best two-day post-election performance since 1900 and its highest weekly rise since April. In large part however these gains just reversed the drift lower that had taken place in the prior weeks as fears of disputed results and social unrest took hold. With the Democrats also maintaining control of the House of Representative, albeit with a reduced majority following their failure to win many of the tight “toss-up” races, sentiment would be further boosted should they succeed in taking control of the Senate. They face an uphill battle however and require to win both run-off races in Georgia on 5 January to leave the Chamber split 50/50 and Vice President-elect Harris with a deciding vote. A split legislature could well curtail not only what stimulus to expect, but the wider policy agenda and, with the disunity and polarisation that characterises US politics, investors had been looking to a “Blue Wave” to pave the way for more material fiscal stimulus.

A second boost came via the news last week that the double-dose COVID-19 vaccine from Pfizer/BioNTech appears more than 90% effective, well in excess of the US FDA’s 50% efficacy requirement. This has understandably generated much excitement and relief – the end may be in sight. However caution is warranted and timelines remain unclear. While further studies will be required before any widespread rollout, the two companies aim to secure emergency approval for the vaccine by the end of this month. The apparent success of this vaccine also bodes well for others that are still undergoing trials. Should other vaccines show similar potential, this could well mean that social distancing restrictions can begin to be gradually relaxed from early next year. Market risk sentiment has understandably been given a shot in the arm.

In fixed income markets, the broad direction of travel since mid-year has been modestly higher prices and still lower yields. Increased volatility has crept in to markets in recent weeks due to the high volume of newsflow discussed above, but this has not materially altered pre-existing trends. Although yields on long-dated US Treasuries moved a little higher through the second half of the year, this has not been replicated in core European markets which have seen deeper moves into negative territory. The Irish 10-year yield, which traded close to zero at the end of Q2, now trades below -20bps. This is also the level at which the NTMA raised €0.85bn of 10-year funding last week.

20x20

IF SHE CAN'T SEE IT, SHE CAN'T BE IT

4. 20x20 Update

- 20x20 was created by Sarah Colgan and Heather Thornton (Along Came A Spider), 20x20's objective is to create a shift in our perception of women's sport. Since its launch in October 2018 20x20 has called for real change in the value placed on women's sport with three measurable objectives: to increase media coverage, participation and attendances for women in sport by 20% by the end of 2020.

- 20x20 Impact Results from Nielsen and Behaviour and Attitudes: 20x20 exceeded all of its targets across media coverage, participation and attendances but there is still a lot more work to do!!

- In addition, out of Ireland's 30 national universities, 28 have signed the 20x20 Third Level Charter, and over 300 grassroots clubs (and counting!) across 24 different sports have signed up to the 20x20 Club Charter.

- The belief underpinning 20x20 is that by increasing our exposure to women's sport – not just in terms of seeing it in the media but also seeing the girls on your street playing or your mother coaching or seeing your family wanting to tune into a women's game – that it becomes 'normalised' as part of our culture.

Investec is proud to support the 20x20 movement with our Brand Ambassador Stephanie Meadow - LPGA Golfer, Olympian Entrepreneur & Role Model

- The Irish hockey team's success in 2018 and 2019 was so exciting (like Sonia O'Sullivan and Katie Taylor) because it was something that united us a nation and that something was women's sport. Traditionally, that is a spot reserved for men's sport. Men's sport has had a huge head start, so women's sport needs positive discrimination now so that it too can take up that role in the future.

- This investment is not just about money, everyone can make an impact – by watching women's games if you're a sports fan, giving female athletes a profile if you're a journalist, ensuring equity for women if you're a sporting organization and supporting girls to find the sport or physical activity they love if you're a parent or a teacher.

- It's about change and progress. It's showing our girls, and our boys, that that women playing sport are not inherently less worthy of our attention. As well as getting 50% of our population healthier and happier by increasing participation.

What is #ThinkItAskIt?

20x20 is calling on people to question themselves…

- People absolutely have to question things they've always thought or done when it comes to women's sport; real progress will only come about when bold steps are taken. This is true for those making decisions within their club, sporting governing body, media organisation, school, business or home. The changes that are going to push the dial are going to feel uncomfortable.

And to question what we see around us…

- To see change in Ireland, we need to get more confident about questioning things that deny equality – or situations that are denying a chance to be able to reach equality – for women in sport. We all need to use our voices to stand up against and question things that need to change.

Notable 20x20 Highlights

- In 20x20's first year, six official attendance records were broken across five sports for women's events: Six Nations Ireland v France, All-Ireland Ladies Football Final, All-Ireland Camogie Final, Euro 2021 Qualifier Ireland v Ukraine, Ireland v Canada Hockey Olympic Qualifiers x 2.

- Twitter reported #20x20 as the second most-used hashtag in Ireland for social issues in 2019.

- 20x20 has won three awards "Sporting Innovation of the Year" at the 2019 Sport Industry Awards, Irish Tatler's "Gamechanger Award" and for the campaign's messaging at the 2019 PRCA Awards, and was nominated for three more European ones.

20x20 is not a 'women for women' initiative, it's all society for all society

5. Desk View

Wrap up well, it gets cold sub- zero

The ECB, an institution not traditionally famed for their speedy response to what some might call glaringly obvious economic stress points, have certainly stepped up to the plate this time round and rightly so. Desperate times require desperate measures and from the outset of the pandemic, ECB President, Christine Lagarde and her team of monetary policy setters have been delving deep into their war chest of "unconventional" monetary policy tools. There are three main aims behind the implementation of the ECB's "non-standard" monetary policy tools:

(a) Provide vital liquidity to a strained financial sector.
(b) Stabilise financial markets.
(c) Keep real long term interest rates low which should in turn weaken the currency (euro), stimulate the export sector, housing markets and promote growth, employment and most importantly inflation.

Chart 9: Italy and Ireland 10 yr Government Bond Yield

Source: Bloomberg

The numbers so far have been nothing short of impressive: Since May, the ECB have already purchased €585bn (of a total €1.35tn PEPP QE envelope) worth of public and private sector European bonds and have pumped out a whopping €1.6tn (TLTRO III & PELTRO) in ultra-cheap loans to qualifying European financial institutions. This flood of liquidity has certainly had the desired effect across some of the ECB's checklist above, most notably on the targeted depression of long- term interest rates. Only last month (14 Oct), Italy's 10-year yield on their sovereign debt dropped to an all-time low and it successfully sold its very first portion of (3 year) debt with a coupon of 0% joining. The rate on our very own Irish benchmark 10-year bond also slumped to its lowest level ever in early November of in/around (negative) -0.30%. If all that isn't sobering enough, it is also worth noting that nearly a quarter of all investment grade bonds are now trading with negative yields.

As is the norm, in times of extreme monetary policy manoeuvers there are winners and losers. While this new twist in the ECB's ultra-loose monetary policy saga is tailored to be advantageous to the borrower (particularly EU sovereign governments'), it will definitely bring prolonged pain to the depositor/saver. As counter-intuitive as rewarding the profligate and penalising the responsible sounds, given the current "unconventional" environment, that is exactly what the ECB is setting out to do. So much so that the ECB is currently charging an overnight deposit rate of (negative) -0.50% to dissuade EU financial institutions from placing funds with them. In order for the economy to reboot, for growth to take hold and green shoots of inflation to begin to protrude, the ECB want us borrowing and spending as opposed to saving and hoarding.

Banks have been grudgingly passing on this ECB negative charge (in some shape) to larger, institutional type depositors for the last few years with retail depositors generally being spared the pain. The issue now is that the Irish 'spending classes' will have been tethered to the rolling lockdowns for nearly nine months by the time early December comes around. Some experts are suggesting that private consumption (e.g. dining out & travelling) has dropped by anywhere between 30%-40% since March. It's no real surprise therefore that recent data from the Central Bank of Ireland showed that Irish household deposits grew by an unprecedented €11.8bn (year to July), the largest increase on record, with €8.2bn of this increase occurring in the six months (to July).

The increase during July alone of €1.9bn was the second highest monthly increase on record (after April this year) and indicates that household income has remained extremely resilient even though households have become ever more restrained with their spending.

The ECB are fully aware that the cost of servicing their wall of freshly minted debt will be virtually unsustainable in the medium to longer term without them pushing and keeping real rates into uber-low/negative territory for years to come. This renewed commitment from the ECB to 'lower for longer' interest rates in tandem with this fresh glut of 'excess savings' will probably see negative deposit rates start to slowly trickle down to the Irish retail market. My fear is this will happen sooner rather than later.

A timely reminder coming from the Dutch Central Bank President and ECB Governing Council member, Klaas Knot; On 18 Oct he went on record saying that he does not "see any factors looming on the horizon that would make me think that interest rates will change significantly in the coming years."

Unfortunately, that puts the euro depositor squarely in the ECB's cross hairs for the foreseeable future and one of the weapons of choice in their arsenal of "unconventional" monetary policy tools is negative interest rates. Irish retail depositors should be fully prepared to go sub-zero in the near future.

6. Compliance Digest

The Senior Executive Accountability Regime

Note: Although the Senior Executive Accountability Regime ("SEAR") is proposed to apply to credit institutions, insurance undertakings and certain investment firms in the first phase, all Central Bank of Ireland regulated firms should keep a close eye on its implementation and assess their own internal processes accordingly.

Under increasing international pressure to apply individual accountability to individuals holding senior management and executive roles within regulated firms, The Financial Stability Board recommended that national competent authorities put mechanisms in place that hold these individuals accountable.

The introduction of the SEAR is part of a new framework (the "Individual Accountability Framework") by the Central Bank of Ireland ("CBI") which will work alongside the current Fitness and Probity rules and will go a long way to ensuring there is a significant focus on individual accountability in Ireland.

The SEAR aims to put a ocus on improved individual accountability through sound risk cultures, effective corporate governance processes and stronger individual accountability for conduct failings which fall outside the CBIs expectations for individuals in senior executive positions.

The proposed regime may include the following elements:

- Senior Executive Functions (SEFs) – this term may broadly correspond with Pre-Approval Control Function (PCF) roles under the fitness and probity regime but may be further expanded to include all executives reporting directly to the Board and heads of critical business areas.
- Prescribed Responsibilities - The CBI proposes publishing a general list of CBI-mandated responsibilities for firms which should ensure that there is an individual accountable for all key conduct and prudential risks.
- Responsibility Mapping – Firms will need to document clearly where the responsibility and decision making lie within the Firm.
- Increased enforcement powers – The SEAR will make it easier for the CBI to fine, reprimand or disqualify senior managers as well as executives of insurance and asset management companies for failings.

Regulated firms across Ireland have been preparing to review and enhance their senior management arrangements, governance processes and HR processes in advance of the introduction of the SEAR.

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