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COLUMBIA THREADNEEDLE INVESTMENTS

# Euro LDI Survey – First Quarter 2024

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## Summary

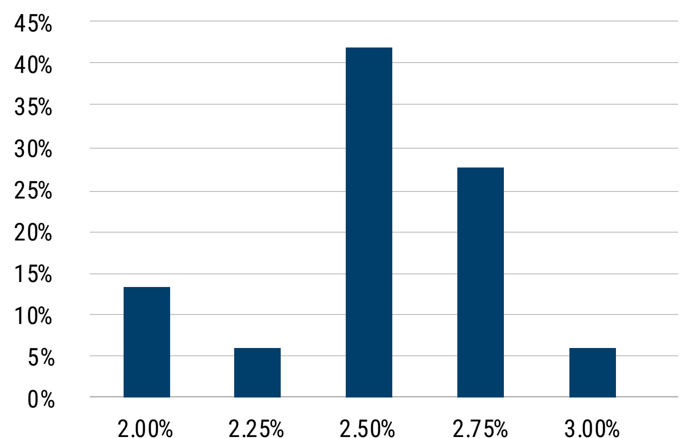
In the quarterly Columbia Threadneedle Investments Euro LDI Survey, we poll investment bank trading desks on various topical questions around monetary policy and longer-term rate and inflation expectations. A focus on central bank sentiment and activity is a global phenomenon and European markets were no different, although some might say that they are in a better position as the guidance from the members of the European Central Bank (ECB) has been less ambiguous than the data-first approach espoused by US and UK central banks.

The end of 2023 had brought a significant rally in global yields catalysed by the expectation that the US Federal Reserve would move swiftly into a rate cutting cycle. In Europe, this was perpetuated by strong hedging interest from the LDI community in reaction to Dutch pension fund reform. This rally reversed in early January not necessarily as market views changed, but more as consequence of a return of liquidity and bank appetite following year end window dressing. However, following stubborn inflation data, sentiment began to pull back from the expected aggressive US cutting cycle to a more nuanced data-led approach to monetary easing. This has resulted in a moderation of expectations to only one cut of 0.25% in 2024 in the US rather than the three priced in earlier in the quarter. Expectations for the EU however remained relatively consistent as a consequence of the greater perceived weakness in the EU economy, and three cuts remain priced in over the course of the year. The ECB is seen to be the first mover to loosen monetary policy with consensus around June for the first cut. Whilst the ECB are still reliant upon data, recent comments from board members support this assumption with the trends seen in data releases. Where there is more uncertainty is around the rate path post June and the speed at which the ECB could move, especially if they are alone in their easing cycle.

## Market Update – central bank rate

At the peak of the European deposit rate in this current cycle, uncertainty mounts as to the timing and magnitude of the next phase and the impact it could have on longer dated yields. To that end we asked our bank counterparties for their view of where the ECB policy rate could be at the end of Q1 2025, and the results are reflected in the below chart:

**Chart 1: Bank respondents' expectations of Bank Rate***



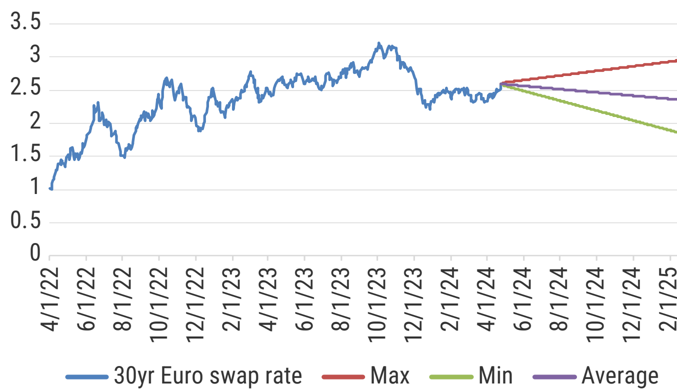

Source: Columbia Threadneedle Investments as at 28 March 2024
*15 bank responses were included within this survey

Compared to the previous quarter, market expectations have now largely coalesced around 2.5% or 2.75% as their prediction for where the ECB deposit rate will sit at the end of Q1 2025. For reference, the rate currently sits at 4.0%. The risks to their views are largely to fewer cuts and a shallower cycle, with concerns

around sticky inflation and lack of a global consensus on cuts coming to the fore. Whilst inflation has come down considerably in the Eurozone, both wage and services inflation are more persistent than the central bank would like, and there is the risk of contagion in the Middle East spilling over into energy prices and placing further upward pressure on inflation. As to 'going it alone', clearly the US, EU and UK have different internal market pressures resulting in individual approaches to monetary loosening. However, if the ECB are ready to commence the cycle in June with further cuts expected on a quarterly basis, these become harder to justify in a global context if the US Federal Reserve has not yet started. The delay in the US has very much been as a result of persistent inflation. The view had been that the higher CPI was merely a 'bump in the road', but now the wealth of data releases supports a different narrative, particularly given the election cycle. However, if economic data in the Eurozone continues to deteriorate then a shallower start may morph into a deeper cycle to support the economy.

For pension scheme investors, the deposit rate is only part of the picture, ultimately how this feeds through into longer dated yields impacts the discounting of liabilities. Therefore, we also challenged our bank counterparties to predict where the 30-year swap yield would be in one year's time; shown in the below chart:

### Chart 2: 30-year swap yield with predicted future movements




Source: Source: Columbia Threadneedle Investments; Bloomberg as at 28 March 2024

Our counterparties views are split as to the expected trajectory of the 30-year swap yield at the end of Q1 2025. Interestingly this split is almost even resulting in a mean reading that sits close to the midpoint. Partly this is a function of the disparity in expectations for the deposit rate, but here there is a greater emphasis on the potential for global risk-off sentiment because of geopolitical flare-ups, countered against renewed concern around the debt burden and bond supply resulting in yields being driven upwards (likely driven by the US).

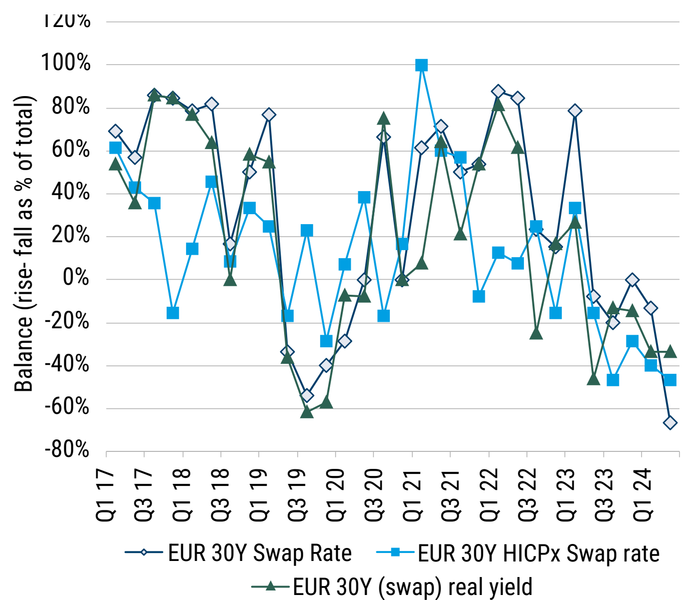
Expected inflation levels are significant in the context of providing leeway to the ECB to manage monetary policy to support the economy. On average our counterparties predict Eurozone inflation to reach c.1.9% at the end of Q1 2025, factoring in their rate cutting expectations. This therefore supports the ECB's anticipated easing cycle. The drivers of this reduction in inflation are focused on energy inflation and its continued normalisation, which in turn should temper wage demands and even drag down services inflation (over time). Less positively, our counterparties also cite weak demand and struggling growth as a cause of lower inflation. Indeed, if these are taken to the extreme, it might spark calls for sharper cuts to the deposit rate to avoid creating a risk that inflation undershoots target levels.

## Market outlook

The Columbia Threadneedle Investments LDI Survey also asks investment bank derivatives trading desks for their opinions on the likely direction of key rates for pension scheme liability hedging, over a shorter single quarter timeframe. The aim is to get information from those closest to the market to aid clients in their decision-making.

The results are shown below as the number of those predicting a rise less those predicting a fall, as a percentage of the number of responses. The larger the balance, the more responses predict a rise. The more negative the balance, the more responses predict a fall.

### Chart 3: Change in swap rates over the next quarter




Source: Columbia Threadneedle Investments. As at 28 March 2024

In the prior quarter our counterparties expected a fall in all three metrics, albeit with low conviction on the swap rate. With little difference in the start and end levels belying the volatility seen during the quarter, their nuanced views around rate cuts versus a deluge of supply ultimately bore fruit.

This quarter, our counterparties have more conviction in calling for a fall in all three metrics by the end of the first half of 2024 (indeed the highest conviction seen in many years for a fall in the 30-year swap yield). The challenge faced is the continued weight of issuance seen in the EU and whether the anticipated cuts to deposit rate can overcome this hurdle, perhaps with the assistance of further LDI buying particularly in the long end of the curve. The consensus around the first rate cut in June supports this narrative, and recent data releases displaying weakness in the Eurozone economy decouples expectations for the ECB from the US and UK. However, if LDI demand is muted there is a potential for longer end yields to remain high as term premia is priced in versus front end yields driven by rate cuts.

To find out more visit **columbiathreadneedle.com**

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