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Euro LDI Survey – Fourth Quarter 2023

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Summary

In the quarterly Columbia Threadneedle Investments LDI Survey, we poll investment bank trading desks on the volumes of quarterly hedging transactions. The final quarter of 2023 was focused on the potential timing and magnitude of the rate cutting cycle, which in turn gave impetus to interest rate hedging activity. Inflation hedging fell by 5%[1] quarter on quarter, whilst interest rate hedging activity increased 7% from the previous quarter.

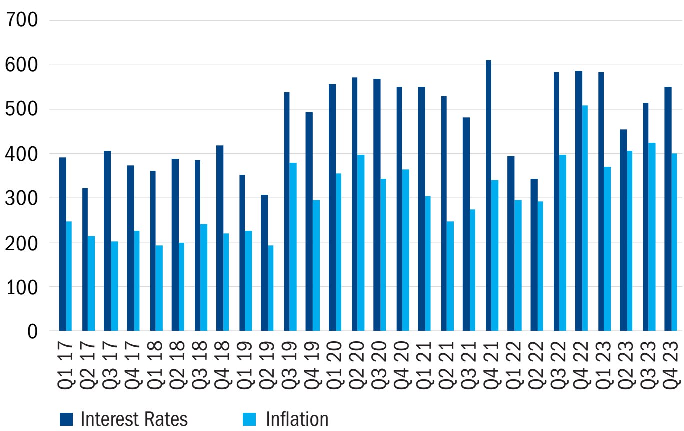
Main Body

The markets' eyes were firmly on both the data and the members of the various central bank committees – watching for any intimation of the timing or size of the anticipated monetary easing cycle. As higher base rates bite and growth figures disappoint, expectations soar as to the rapidity of such a cutting cycle, particularly when inflation continues to fall and looks benign (all things in context, in the UK 3.9% is still close to double the target). There is an understanding that there is a significant lag between raising interest rates and then seeing the impact in economic releases, making policymakers wary of downside to come. However, equally, there is an understandable reluctance to move too early and end up having to reverse decisions if inflationary pressures were to rear their head again. Bearing in mind that the rhetoric from most central banks indicates a slow and steady approach to monetary tightening, the markets are predicting a far earlier and more aggressive bout of rate cutting, suggesting volatility to come.

Total interest rate liability hedging activity increased to £41.9 billion, whilst inflation hedging fell to £40.0 billion. These numbers primarily represent outright hedging activity in each case, particularly as pension funds took advantage of higher yields to de-risk and lock into improved funding ratios. Asset swap activity was somewhat muted over the quarter, partly as the flurry of bulk purchase annuity activity into the end of the year didn't necessarily translate into the sale of gilts and purchase of credit (due to availability and relative yields). However, the gradual grinding cheaper of gilts relative to swaps did attract some significant flows towards year end as specific targets appeared to be met, creating a resistance level.

The chart below describes hedging transactions as an index based on risk. Note that transactions include switches from

Chart 1: Index of UK pension liability hedging activity (based on £ per 0.01% change in interest rates or RPI inflation expectations i.e. in risk terms).



Source: Columbia Threadneedle Investments. As at 29 December 2023

[1] Columbia Threadneedle Investments, as at 29 December 2023

one hedging instrument into another. It should be noted that as the index is constructed by using the rate of change of risk traded by each counterparty per quarter, it allows the introduction (or removal) of counterparties in the survey.

The index published by the Pension Protection Fund displayed a retracement in funding levels quarter-on-quarter to 142.8% at end December (from 147.5% at end September). This was despite a welcome increase in assets, but a consequence of falling yields increasing liabilities faster than assets.

The perceived pivot in US Federal Reserve monetary policy drove an extended rally across all geographical regions; with the further impact of making the yield curve steeper as interest rate cuts were priced into the front end. This curve steepening drove much of the weakness in gilt relative value, providing opportunities at the resistance level of 0.80% spread over swaps (i.e. gilts yielding 0.8% more than equivalent swaps) which prompted buying action to come back into the market. Our analysis of hedging activity hides an interesting and ongoing trend – that of collateral upgrade or collateral hedging activity. This takes the form of protecting collateral positions against higher yields, often by pairing two offsetting trades with different collateral terms. These offsetting trades can take many forms, including repo/TRS, paired swaps and even paired swaptions. The main market for this type of transaction tends to be the larger pension funds who may have limited access to liquid (i.e. gilt and cash) collateral. In the event of higher yields, the investor would post less attractive collateral such as corporate bonds where the trades are at a loss, meanwhile receiving liquid collateral such as cash on the paired trade which is in the money. This strategy does not come for free, but does permit a hedge against the tail risk event of a rapid increase in yields.

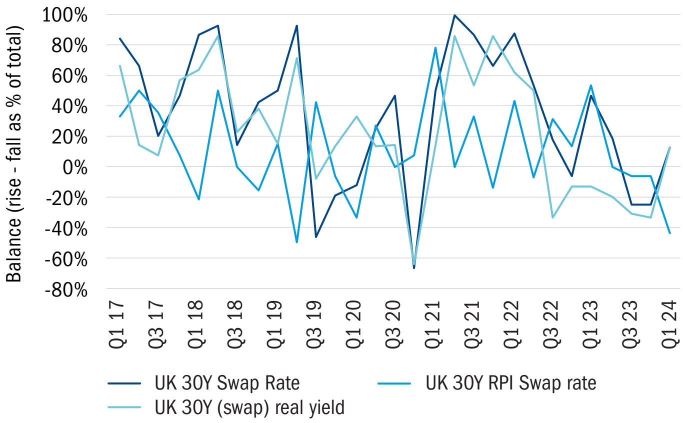
Market Outlook

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. The aim is to get information from those closest to the market to aid trustees 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.

In the prior quarter our counterparties called for a fall in all three metrics, albeit with low confidence particularly on inflation. For once our counterparties were correct! We saw significant falls in all three metrics because of the global fall in yields, as expectations built for central banks cutting rates, and demand remained subdued for inflation-linked assets.

Chart 2: Change in swap rates over the next quarter.



Source: Columbia Threadneedle Investments. As at 29 December 2023

For the first quarter of 2024 there is little agreement on the directionality of rates moves, with just over half opting for a rise in yields; but a fairly high conviction that long-dated inflation expectations will continue to fall. The reasoning around inflation levels is that 30-year inflation rates are largely driven by trading activity rather than inflation releases, and it seems that demand for inflation protection is rather muted – add to this an index-linked gilt syndication at the end of March, putting further cheapening pressure on levels. Following the same logic but applying an alternative view are those calling for higher inflation pricing due to demand from insurance clients, particularly offset with low issuance from corporates. There are also views that the current level of 30-year RPI is too low as the fall has been overdone and therefore could be due a correction.

In terms of interest rates, those who predict lower yields are counting on a return of LDI demand, to deepen the move. Coupled with this potential demand is the skew in gilt issuance towards short and medium maturities, meaning a lack of supply in the long end and possibly working together to drive yields down. On the other side, many feel that the market has been too aggressive and too early in pricing in rate cuts. A few higher-than-expected inflation releases (such as December which posted a small rise to 4%[2]) whilst the argument for delaying monetary easing gains prominence, could result in a repricing higher of long-end yields. However, any repricing is likely to be temporary as, whilst the pace and timing of rate cuts is unknown, there is a strong bias towards global monetary easing taking place during 2024 such that lower yields over the longer term are the likeliest outcome, despite the overwhelming burden of significant government debt issuance.

[2] Source: UK Office for National Statistics

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