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COLUMBIA THREADNEEDLE INVESTMENTS

Euro LDI Survey – Third Quarter 2023

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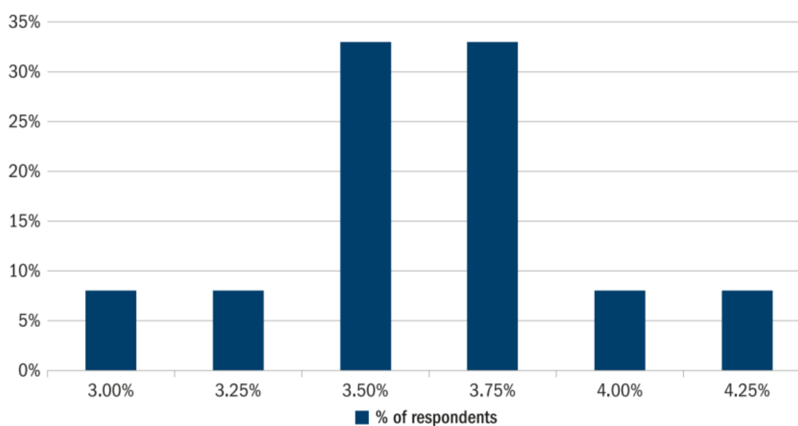
Summary
In the quarterly Columbia Threadneedle Investments LDI Survey we poll investment bank trading desks on various topical questions around monetary policy and swap spreads. European markets reacted to the global phenomenon of peak rates and digested the impact of various regulatory updates and their potential impact.

A welcome drop in inflation provided cover for central banks to relax their monetary tightening stance, whether merely to pause or as a consequence of reaching the peak. In Europe, core inflation fell from 5.5% in June to 4.5% in September resulting in only two hikes over the quarter, taking the deposit rate from 3.5% to 4.0%. Whilst this slowdown in the tightening cycle was largely expected; the statement by the ECB that they had not even started discussing potential changes to PEPP (Pandemic Emergency Purchase Programme) reinvestment forward guidance surprised markets in its accommodative stance. This is likely to be partly driven by recession leaning indicators in terms of PMIs (Purchasing Manager Indices) and the Q3 ECB Bank Lending Survey. This reported tighter conditions and weaker demand than central banks have anticipated, especially in relation to household credit. Looking forwards to the fourth quarter the survey does not expect any improvement and in fact further deterioration – all of which points towards the incomplete pass-through of monetary policy.

Market Update - central bank rate

As we approach the peak of the European base rate in this current cycle, uncertainty mounts as to 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 base rate could be at the end of the third quarter of 2024, and the results are reflected in the below chart:

Chart 1: Bank respondents' expectations of Bank Rate*



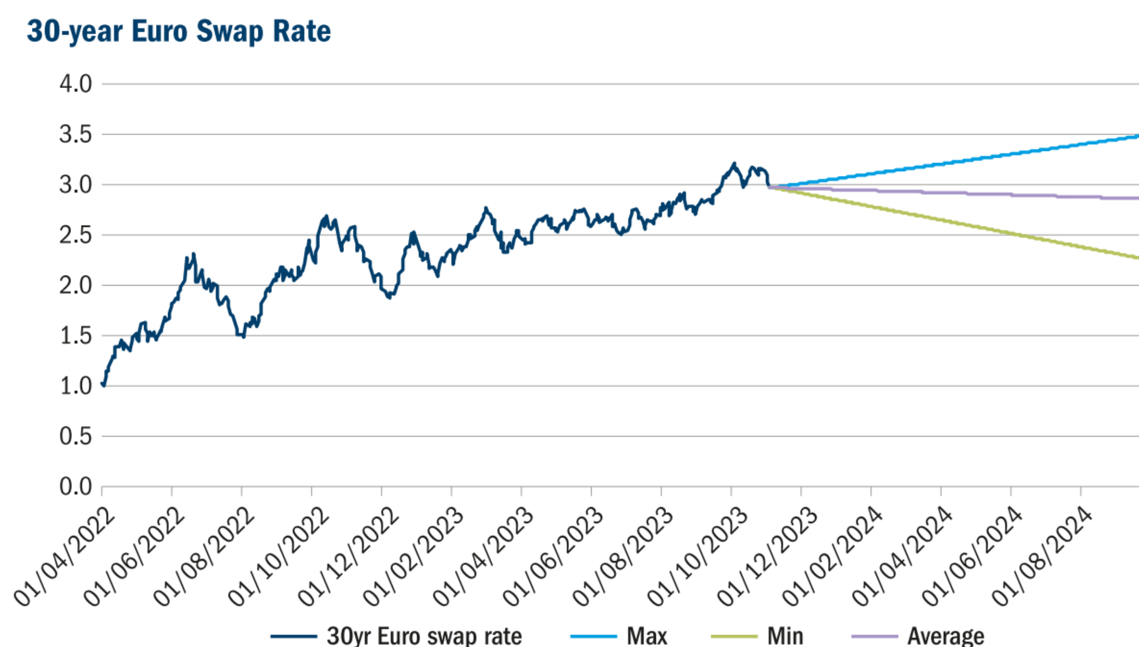
Source: Columbia Threadneedle Investments as at 29 September 2023

There is a clear expectation from most of our bank counterparties that the Bank Rate will fall from its current 4% level with an equal split between 3.50% and 3.75%. We do have a few outliers expecting another hike and then for rates to be held at that peak for longer. This is driven by the concern that inflation could be more persistent than anticipated, making it harder for the ECB to react to changes in the economic outlook. The next round of wage settlements is key here, which is likely to be in Q1 2024. Note that typical new loans in Europe have been for a 1-year tenor meaning that financing conditions can quickly ease unless rates are kept high. For those anticipating monetary easing, it is the scale that is hard to judge. For those anticipating slower falls, inflation rears its head again, particularly if it reignites because of geopolitical unrest. Alternatively, if these events overtake the Eurozone creating a deeper recession than anticipated then the ECB may have to cut rates sooner and faster! The same is true if inflation falls more quickly than expected or there is some form of credit event.

Market outlook – long-dated yields one-year from now

For pension scheme investors, the base 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 29 September 2023

There was a significant range in predicted levels for the 30-year swap yield from our respondents. This is a complex question with many factors feeding into their thought process resulting in the spread of responses! As above, rate expectations form part of this, but issuance schedules, quantitative tightening (QT) and global drivers must also be considered. On the side of elevated yield levels is the expectation that term premium will come to the fore, allowing long-dated yields to stay around current levels even if shorter-dated yields fall. Whilst the ECB has declined to comment on changes to PEPP forward guidance (see above), our counterparties anticipate that reinvestments must tail off prior to the end of Q4 2024; this will add pressure to the supply side picture alongside significant debt issuer contributions from countries such as Italy and France who have meaningful deficits. However, if Italy's fiscal outlook deteriorates more than anticipated this could lead to more volatility in country spreads resulting in a continuation of PEPP. In favour of falling yields is the consideration of the turn in monetary cycles, prompting a global risk-off trend, potentially inciting long-end receiving from pension funds. The recent announcements around Dutch indexation have served to support this view.

Market outlook – the quarter ahead

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. Unlike the responses above which focussed on views for yields one year from now, the responses below consider the outlook over the shorter term, specifically the next 3 months.

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

Source: Columbia Threadneedle Investments. As at 29 September 2023

Last quarter our counterparties had very low conviction given the volatility in markets and were incorrect in their belief that all three metrics would fall. The risk premium priced into longer-dated rates driven by the US put paid to their predictions and brought 30-year real yields into positive territory.

For the final quarter of 2023, once again our counterparties are struggling to find a consensus on predicted moves; indeed, they were split 50/50 between a rise and a fall in 30-year swap rates. This struggle to identify the expected market move is partly a function of positioning – market positioning, particularly in steepeners, has been a theme of the last few months and has driven noteworthy moves as either participants crowd the trade, take profits, or are stopped out. For those anticipating a fall in yields, they cite the expectation that the ECB has reached the peak of its tightening cycle and will be wary of tightening further given the worsening economic outlook. In addition, the drag effect from the US may be overdone meaning that bunds seem undervalued and thus have potential to rally outright and on a cross-market basis. Inflation is expected to remain sticky (albeit less so than the UK) yet there could be tension on the supply side as European DMOs have completed their long-dated inflation-linked bond taps for 2023; leaving nothing to satisfy long end real yield demand if it materialises into year end. This expected demand was noted by several our counterparties; there is often a rush into year end, one that could be exacerbated this year given the attractive level (and perhaps the peak) of yields.

All in all, there is likely to be significant volatility into year end. For those on a de-risking journey, trigger mandates can permit the opportunistic targeting of attractive but fleeting yield levels, resulting in better overall outcomes. Such triggers are best used to accelerate gradual ongoing de-risking programmes if attractive levels materialise, rather than being all or nothing implementation triggers. The risk with the latter is that an overly ambitious trigger is never hit, and the hedging never gets implemented.

*15 bank responses were included within this survey

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