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# LDI market review and outlook
# Elections and market reform competing for attention

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**Whilst most central banks erred on the side of caution, reticent to commence the monetary easing cycle in response to falling inflation and slowing growth, the ECB was the first to take the plunge. With the downside risks to growth in Europe much higher now given the political and fiscal uncertainty in France, as well as a slowdown in German manufacturing growth, the ECB's deliberate vagueness on the path of easing has allowed it to retain optionality on future cuts. Our quarterly poll of investment bank trading desks on a range of topical questions helps support our narrative around market activity and outlook. Additionally, we also discuss developments in respect of market reform, specifically benchmark interest rates, and their potential impact.**

The uncertain global economic and political picture due to the elections in the US, UK and Europe dominated markets over the second quarter of 2024. In terms of monetary policy, Europe was the first mover with the ECB cutting interest rates by 0.25% at its June meeting, but giving no commitment on the pace of future cuts.

More specifically, France has been the centre of attention, first seeing its credit rating downgraded at the end of May. Following that, at the beginning of June, significant gains were made by France's far right at the European Union parliamentary elections at the expense of President Macron's party. A snap election was called in response, to take place just after quarter end. The market showed some concern with this unexpected decision, as 10-year French government bonds cheapened c. 0.3-0.4% relative to 10-year German bunds at the widest end of the range, but this was not sustained, and the market was by no means in panic mode. Market participants simply opted not to take any large positions given the volatility as the French election played out. Now in the face of a hung parliament, the possibility of any one party wreaking fiscal havoc has been eliminated, but the stalemate also means no significant policy changes can be implemented. Meanwhile, liquidity in European government bonds has worsened given French volatility, and investors continue to be cautious over any overweight positions to France, in particular to French inflation-linked bonds where Germany's decision to cease inflation-linked issuance would have seen some build-up in French exposure, but also mindful of any potential spillover effects to valuations of French sovereign, supranational and agency issues.

The ECB has stressed a reliance upon data and hence there is the possibility of greater uncertainty around the path and pace of interest rates after the June cut and possible policy divergence from other western economies (most specifically the US), if others remain reticent to commence monetary easing. The Fed's "dot plot" indicates only one cut this year, but the market is pricing in one or two more cuts in Europe. This differing forecast reflects contrasting macroeconomic conditions, however, due to greater perceived weakness in the EU economy which contrasts the US economy's persistent above-trend growth.

With policy rates kept on hold and rate guidance left unchanged at the July meeting, the ECB's president used language in the press conference that bore similarities to that used to prepare the market ahead of the rate cut in June. If data continues to support the medium-term inflation outlook being disinflationary and if the growth outlook remains weak, then this paves the way for a 0.25% rate cut in September, and potentially one more before the end of 2024.

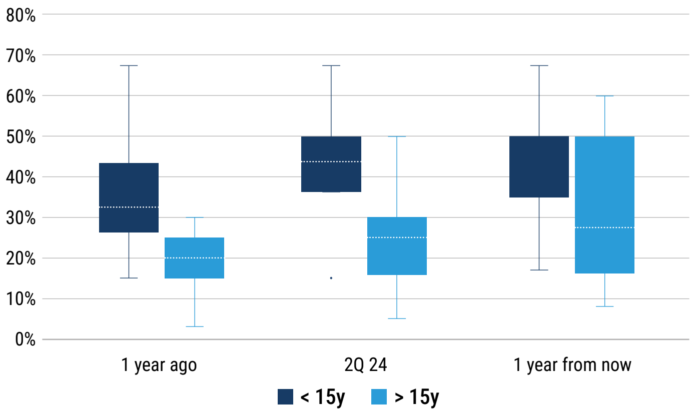
## Market Update

Apart from being the first mover in cutting rates, Europe is also an outlier in terms of its primary interest rate benchmark – as it continues to use Euribor – whilst most other developed market countries have transitioned away from Interbank Offered Rates (IBORs) to Risk-Free Rates (RFRs). The robustness of Euribor as the preferred benchmark index rate was questioned as it did not respond as quickly as the Euro Short Term Rate (ESTR or €STR) during the ECB's hiking cycle, resulting in the ESTR-Euribor basis turning negative (i.e. negative credit risk associated with banks).

Consequently, there is a consultation on the topic of Euribor reform to ensure that the index remains credible and reliable as a measure of banks' cost of funding; as well as a possible change to the European Insurance and Occupational Pension Authority (EIOPA) discount curve, which currently references Euribor as it is "deep, liquid and transparent" (DLT). The latter is contingent on the fulfilment of two criteria of "proximity" and "liquidity", the first of which has already been achieved. ESTR volumes have been increasing and if they reach 50% of total traded volume in all tenors across the curve, the liquidity condition will be satisfied to transition the EIOPA discount curve from Euribor to ESTR. If the switch were to happen, this could trigger a significant shift in LDI hedging from receiving fixed and paying 6-month Euribor to receiving fixed and paying ESTR, thus widening the ESTR-Euribor basis, especially for longer maturities. 6-month Euribor dominates across the curve except for the front end (2-year and shorter) and as long as it remains the standard for trading in the interdealer and broker markets, the liquidity gap between both discount curves will persist.

In the absence of publicly available data for ESTR-Euribor split by tenor, we polled our bank counterparties to get a sense of the current market split and how this might be expected to change in a year's time. Compared to data published by EIOPA in July 2021, where the proportion of swaps-based hedging referencing ESTR was c. 23% for maturities shorter than 15-year and c. 10% for longer maturities, the market share for ESTR has continued to grow. Our counterparties' responses indicate the median for ESTR swaps hedging accounts for c. 44% at sub-15-year tenors and c. 25% for longer maturities; and is expected to rise further to 50% and 28% respectively in a years' time.

**Chart 1: Swaps-based hedging referencing ESTR as discount curve***




Source: Columbia Threadneedle Investments. As at 28 June 2024
*10 bank responses were included within this survey

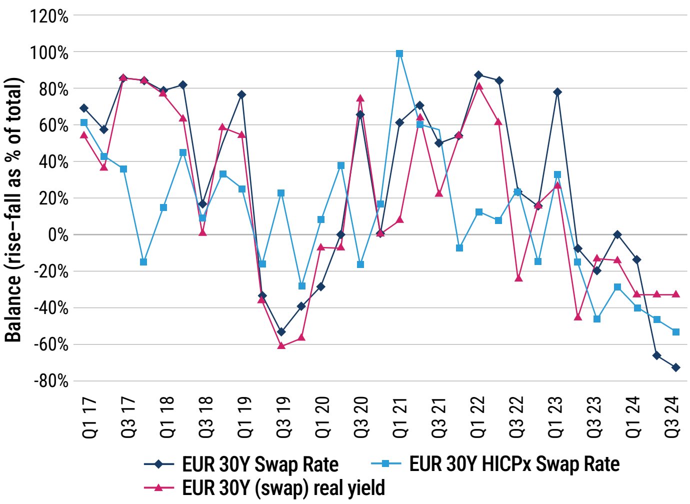
Around 80% of our counterparties expect the liquidity in ESTR to grow at both Eurex and LCH clearing houses, a change that will happen gradually. There is a regulatory bias for trades to be cleared via Eurex – the European Commission's European Market Infrastructure Regulation 3.0 (EMIR 3.0) is under review – which could result in prescriptive measures being introduced for those investors who are in scope to clear a minimum proportion of trades via an EU clearing house (e.g. Eurex). Market flows driven by said regulatory change could drive a wedge between levels to clear ESTR-based swaps via EU and via non-EU clearing houses, thus presenting another opportunity where investors could take advantage of the differential arising from shifts in liquidity.

## Market Outlook

We also asked investment bank derivatives trading desks for their opinions on the likely direction of key rates for pension scheme liability hedging.

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 2: Change in swap rates over the next quarter****




Source: Columbia Threadneedle Investments. As at 28 June 2024
**15 bank responses were included within this survey

In the prior quarter our counterparties expected a fall in all three metrics, with high conviction on all, in particular on the nominal swap rate. This proved to be wrong. There was consensus that a June rate cut would be announced, and although this did occur, it was not enough to offset the bond sell-off (which caused yields to rise). Long-end swap yields rose due to continued heavy supply, albeit not as sizeable as seen at the start of year. The reliable flow of Dutch pension scheme buying, usually receiving at the long end, saw reduced volumes, and was therefore insufficient to offset the leg higher in swap rates.

Looking ahead, our counterparties have even greater conviction in calling for a fall in all three metrics by the end of the third quarter of 2024 (the highest conviction seen in many years for a fall in the 30-year swap yield). The market has priced in a high probability of a September rate cut, with continued weakening global and domestic data supporting this narrative. That said, many remain cautious despite the strong conviction on the call for lower yields as there is potential for term premia to reprice strongly, consequent of political uncertainty in France (and hence its ability to effectively consolidate its debt, thus facing a further credit downgrade) and the major risk event of the year that is the US election. As we go into the summer months, EU issuance is set to slow and LDI buying likely to take a pause, hence there is potential for longer-dated yields to fall as our counterparties expect by the end of the third quarter of 2024.

In inflation, there continues to be a view that long-end inflation is structurally too high; and with falling inflation expectations, our counterparties broadly expect a fall in the inflation rate. It is noted that with French real yields and inflation volatility likely staying elevated in the near term, it will not be surprising if market participants close out positions / avoid initiating new positions in European inflation (bonds or swaps) until fiscal and political uncertainty normalises.

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