INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

LDI Survey – First Quarter 2023

LDI | May 2023

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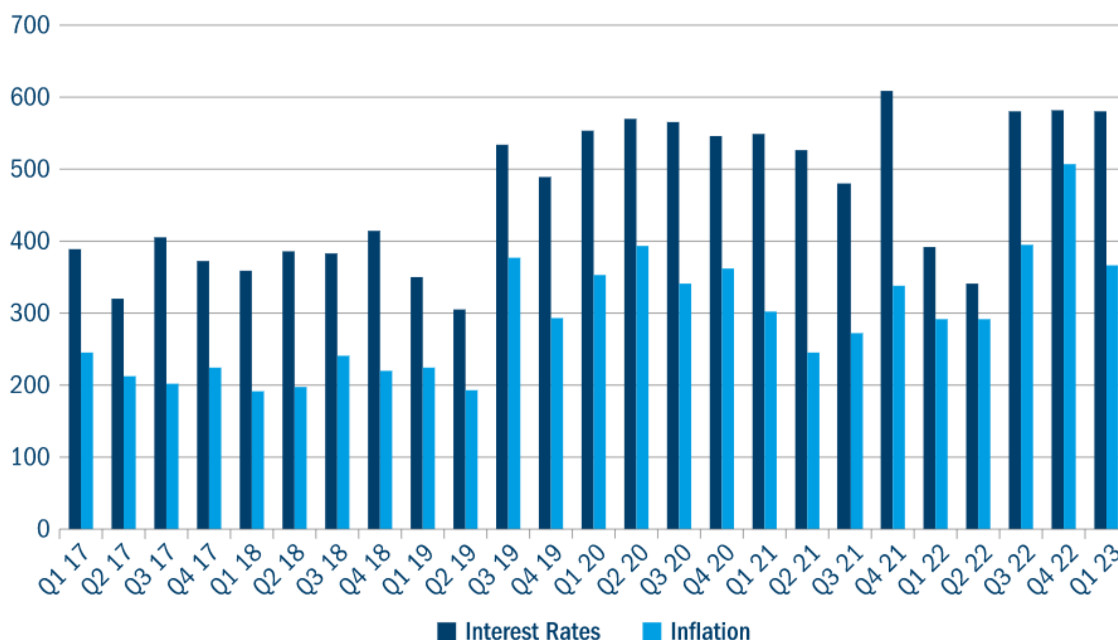
Summary
In the quarterly Columbia Threadneedle Investments LDI Survey, we poll investment bank trading desks on the volumes of quarterly hedging transactions. Confidence in markets was shaken by a series of bank failures and emergency takeovers mainly in the US, provoked by the continuation of the hiking cycle and investor fears. Inflation hedging fell 28% quarter on quarter after the high watermark of activity at the end of 2022. Interest rate hedging activity remained consistent with the previous quarter at elevated levels.

Throughout the first quarter of 2023, central banks maintained their monetary tightening paths, albeit with rhetoric indicating that the peak is soon to be reached. For European and US policymakers there was a retreat in inflationary pressures. The same can scarcely be said for the UK as inflation decreased yet remains stubbornly high. However, the rapid increase in rates has led to an issue, particularly for more leniently regulated US bank entities who are permitted to not mark their held-to-maturity investments to market. These books typically contain a significant amount of central bank debt, purchased in a lower yield environment, which has now diminished in value significantly given the higher rates. Whilst this approach may be acceptable when deposit balances are stable, once significant deposit outflows occur, these losses are realised. This precipitated the collapse of a number of mid-size US banks in fairly short order, with the most serious being the failure of Silicon Valley Bank. Central governments stepped in to enforce takeovers and extended protection for deposits beyond previous limits thus intending to stop the rout. However, since then, Credit Suisse has had a government arranged takeover by UBS and investor flight has continued, picking off a series of other vulnerable US regional banks. The consequences of accelerated monetary tightening have thus come home to roost and giving another prompt to central banks to slow down or end their hiking cycles.

Total interest rate liability hedging activity stayed steady at £44.3 billion, whilst inflation hedging dropped to £36.9 billion. These numbers primarily represent outright hedging activity in each case. Yet switching activity formed a significant part, mainly for those clients approaching buy-out who typically switch out of swaps into gilts to prepare for the transition (following that insurers then switch out of gilts, into credit and swaps). Interestingly there has been an uptick in new hedging activity in swaps (in recent years this has been absorbed in gilt-based hedging), partly this is to diversify forms of leverage away from repo funding but also as a view on the future expectations for the underperformance of gilts versus swaps given the high level of gilt issuance due to flood the market.

The chart below describes hedging transactions as an index based on risk. Note that transactions include switches from 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 of additional counterparties to the survey.

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 ***31 March 2023***

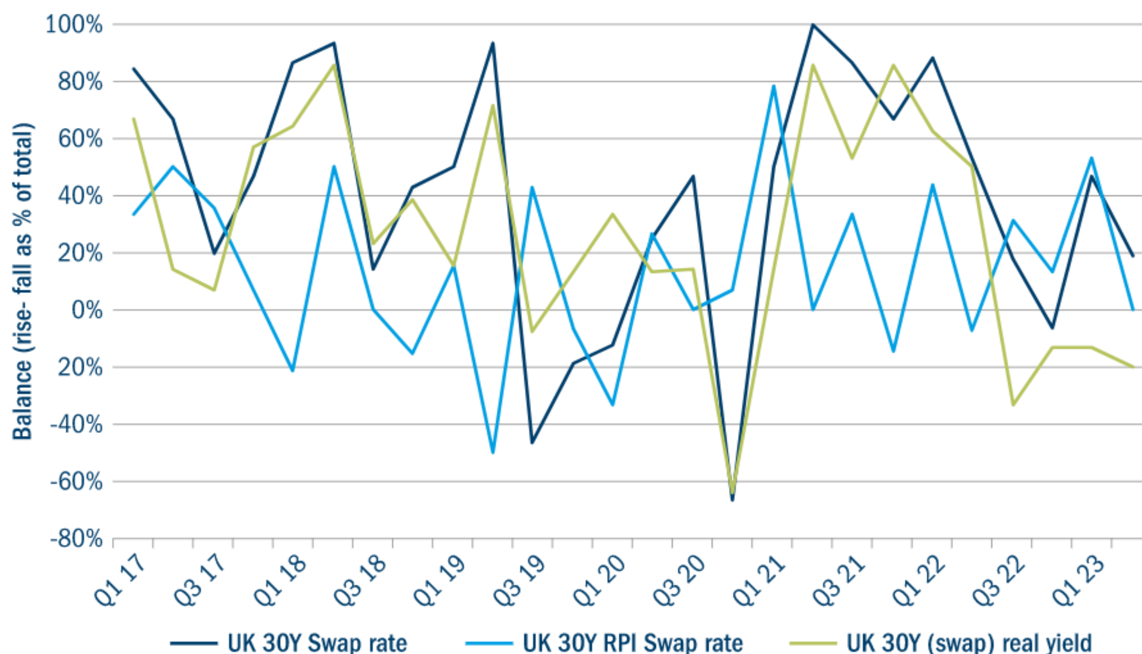
The funding ratio index run by the Pension Protection Fund displayed a slight weakening in funding levels quarter-on-quarter (133.2% at end March vs 136.5% at end December), in part due to the slight fall in yields. Nevertheless, the funding position remains strong and will mean that targeting buy-out is very much on the table for many pension schemes. In preparation, it is understood that some schemes are accelerating their actuarial valuations to lock down their position.

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.

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



Source: Columbia Threadneedle Investments. As at 31 March 2023

In the previous quarter our counterparties had a reasonably high conviction of an increase in both inflation expectations and nominal yields and little agreement as to how real yields would play out. The bank failures in the US impacted these predictions, resulting in a fall in nominal yields as it prompted a flight to quality, perhaps also with a view to the imminent end of the hiking cycles in key benchmark currencies.

For the second quarter of 2023, there is little conviction on any metric – the interplay between central bank actions and financial system disturbances are likely to result in higher volatility, thus lowering the predictability of market moves. For those who believe that nominal yields will rise, the sentiment focuses upon the magnitude of issuance coming to market, especially including the ongoing Quantitative Tightening programme from the Bank of England. New LDI hedging activity has been lower than might have been expected in the first quarter and therefore there are some fears around the natural buyers for the volume of supply. There is also disagreement as to when the UK's hiking cycle will end. Those who plumped for higher nominal yields at the end of Q2 anticipate it continuing for longer, especially given stubborn inflation; whilst those who expect lower yields believe that the peak will be seen imminently perhaps with rhetoric from the Bank of England to support its finality. In terms of inflation, the supply of index-linked gilts as a proportion of aggregate gilt supply has diminished providing support and perhaps driving long dated inflation pricing higher. On the other hand, the impact of the monetary tightening cycle could start to drive front end inflation lower, dragging the rest of the curve with it. Ultimately driven by events and without a buyer of last resort, this quarter is expected to be volatile across asset classes.

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.

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