LDI Survey – Second Quarter 2023

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Summary

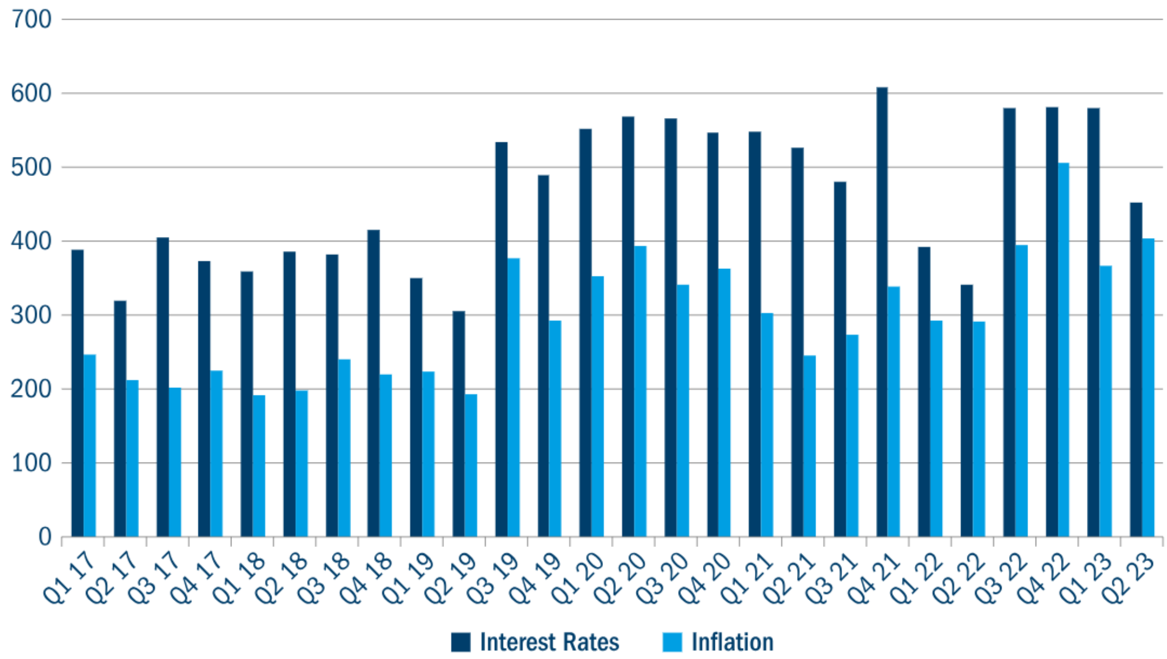
In the quarterly Columbia Threadneedle Investments LDI Survey we poll investment bank trading desks on the volumes of quarterly hedging transactions. Investors digested the previous quarter's banking crisis and the impact of monetary policy on growth prospects, resulting in a retrenchment in interest rate hedging activity. This was particularly pertinent for pension funds as higher yields prompted a further consideration of collateral preservation, potentially delaying contemplated hedge increases. Inflation hedging picked up by 10% quarter on quarter yet remained below the high levels seen in the fourth quarter 2022, whilst interest rate hedging activity dropped by 22% from the previous quarter.

The rhetoric from central banks over the quarter evolved towards a deceleration in tightening or even perhaps signalling a close to the hiking cycle; all that is apart from the UK's Monetary Policy Committee who felt driven by persistently high inflation to vote for a surprise 0.50% hike in June, drastically changing forward rate expectations in the UK. Whilst inflation has subsequently dropped slightly, the consensus is towards higher rates for longer in the UK, even in the face of a potential recession. Other economies have benefited from a faster fall in inflation, leaving space to tighten less aggressively and allow the delayed pass through to the broader economy to be felt, reducing the likelihood of a policy error driving a recession.

Total interest rate liability hedging activity decreased to £34.6 billion, whilst inflation hedging rose to £40.6 billion. These numbers primarily represent outright hedging activity in each case. Yet switching activity formed a portion of the activity, mainly for those clients approaching buy-out who typically switch out of swaps into gilts to prepare for the transition (following that insurers then often switch back out of gilts, into credit and swaps). Last quarter we remarked upon the greater interest seen in swap-based hedging – this theme continued this quarter as a form of diversification from gilt-based hedging and perhaps also related to the intricacies of buy-out pricing which is derived from the typical assets an insurer holds (corporate bonds and swaps).

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 *30 June 2023*

The funding ratio index run by the Pension Protection Fund revealed a welcome strengthening of funding levels quarter-on-quarter (145.8% at end June vs 133.2% at end March), primarily due to strong equity markets and the rise in real yields (c. 0.65% at the 30-year tenor). US stock markets, in particular, shrugged off the previous quarter's banking crisis with the help of the slowing pace of tightening dictated by the US Federal Reserve.

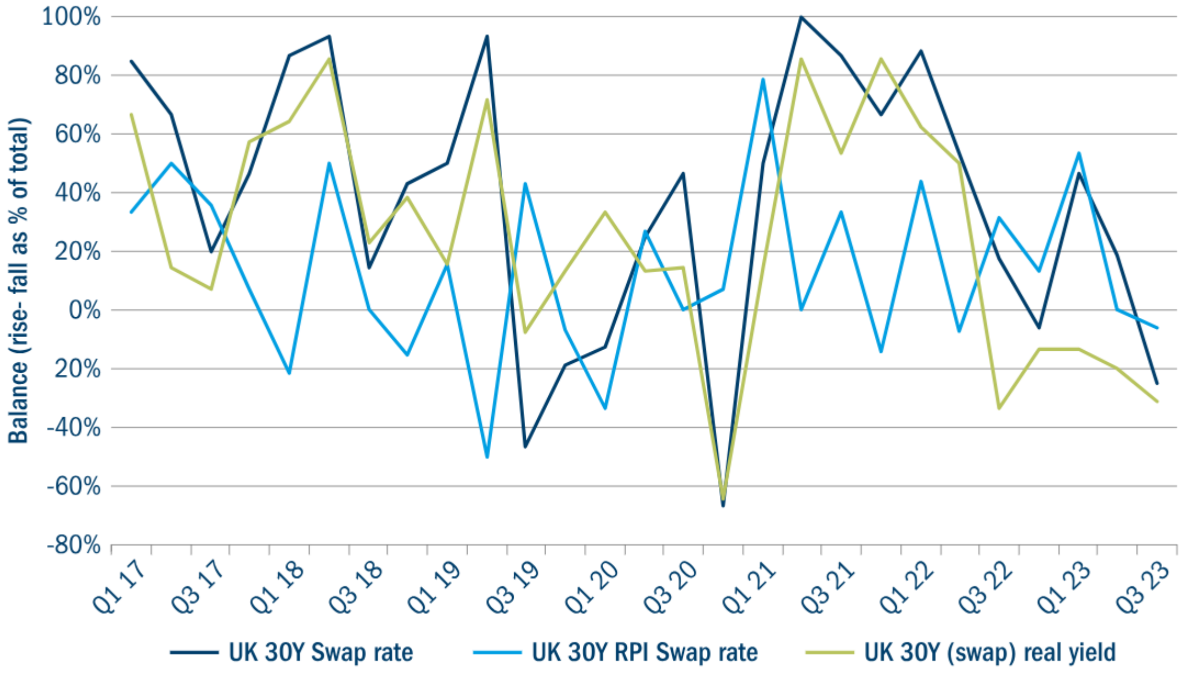
The ramifications of the UK's gilt crisis continue to percolate through the LDI market, with a sensible focus on liquidity waterfalls and alternative sources for liquidity such as corporate bond repo. As pension funds head towards self-sufficiency or buy-out, they typically hold higher allocations to physical credit. Using corporate bonds as collateral for swaps or for repo is not necessarily appropriate in normal market conditions given the higher costs and opacity of valuations because of margining with less liquid assets; however, it can be a suitable stop-gap option in times of market stress. Corporate bonds can also be used as principal for borrowing, to transform the less liquid asset into higher quality assets for margin such as government bonds or cash – this has the advantage of being more transparent in terms of cost, and being used for shorter timescales, rather than specifying credit as permitted collateral.

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 30 June 2023

In the previous quarter our counterparties in aggregate called for no change in inflation (half calling for higher inflation and half for lower) which was borne out. They had a low conviction of a rise in nominal yields and a corresponding low conviction for a fall in real yields – the surprise hike by the Bank of England in June put paid to the real yield prediction as nominal yields rose around 0.60% consequently pulling up real yields.

For the third quarter of 2023, there is a slight tendency towards reductions in all three metrics, albeit again with little certainty as to how inflation levels will develop. Largely this sentiment is driven by the view that the recent market sell-off (as a result of the Bank of England tightening aggressively) is somewhat overdone and that the market will calm as the summer ends and liquidity picks up. As inflation has now started to turn, it is possible that the Bank can come to the end of its hiking cycle, which coupled with de-risking flows could depress nominal yields. Another argument in favour of lower yields is the market reaction to a sustained rise in issuance. Could the pace or issuance profile of Quantitative Tightening (QT) be restructured to reduce its weight upon the market? Against these points are the heavy issuance schedule for the third quarter and the prospective concession required given supply demand dynamics. Additionally, there have been various speeches from Monetary Policy Committee members pointing to an increase in the speed of active QT which would only serve to worsen the situation. The arguments for a rise in inflation reference the recent pay deals causing wage inflation and the tight labour market; mixed with a potential for recent inflation de-risking activity to continue putting pressure on longer term inflation pricing. Further to this is the much-discussed limited supply of index-linked assets within the Debt Management Office's funding schedule. Against these views, others cite the recent fall in realised inflation, which, if a harbinger of further falls, should translate into lower longer term inflation pricing as the market adjusts.

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.