LDI Survey – Third Quarter 2023

LDI | October 2023

Rosa Fenwick
Head of Core LDI Portfolio Management

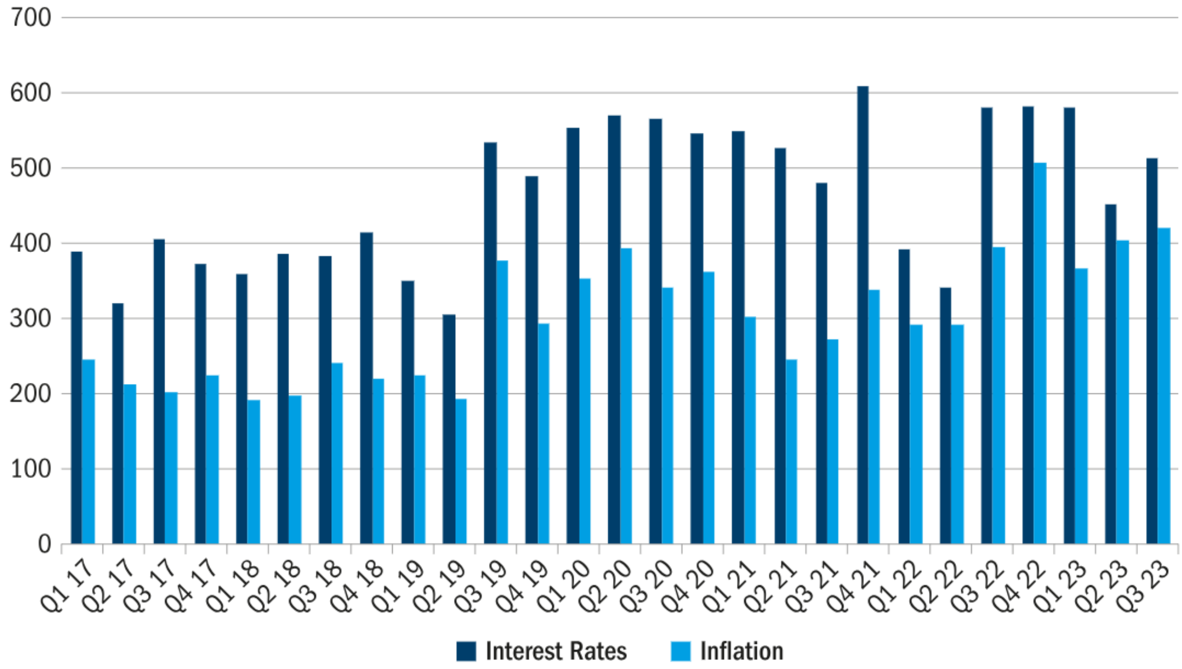
Summary
In the quarterly Columbia Threadneedle Investments LDI Survey, we poll investment bank trading desks on the volumes of quarterly hedging transactions. The second half of 2023 heralded a pick-up in activity as pension funds completed their reviews of the previous year's gilt crisis and determined their path forwards. Another factor driving activity was the belief that we have reached or are close to peak central bank rates. Inflation hedging rose by 4% quarter on quarter, whilst Interest rate hedging activity increased 13% from the previous quarter.

A welcome drop in inflation, even in the UK, presaged a clearer picture from central banks that base rates were at or close to their peak. However political and geopolitical risk remained significant, which alongside a high burden of debt in developed economies led long term yields to continue to climb. In the UK, 30-year real and nominal yields touched levels last seen in the throes of the gilt crisis. One year on from the black swan event, the path to the same yields this year has been very different, a gradual rise, supported by well-cushioned pension fund asset allocations, resulting in orderly market movements providing opportunity for those pension funds looking to de-risk.

Total interest rate liability hedging activity increased to £39.2 billion, whilst inflation hedging rose to £42.3 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 this, insurers then generally switch out of gilts, into credit and swaps as this better matches their liability discounting. This type of buy-out activity picked up in the third quarter, but interestingly, as credit markets grew more expensive relative to UK gilts, we also saw the opposite, where insurers bought UK gilts versus 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 *29 September 2023*

The funding ratio index published by the Pension Protection Fund showed a consistent improvement in funding levels quarter-on-quarter (147.5% at end September vs 145.8% at end June), because of the continued rise in long term yields reducing liability valuations.

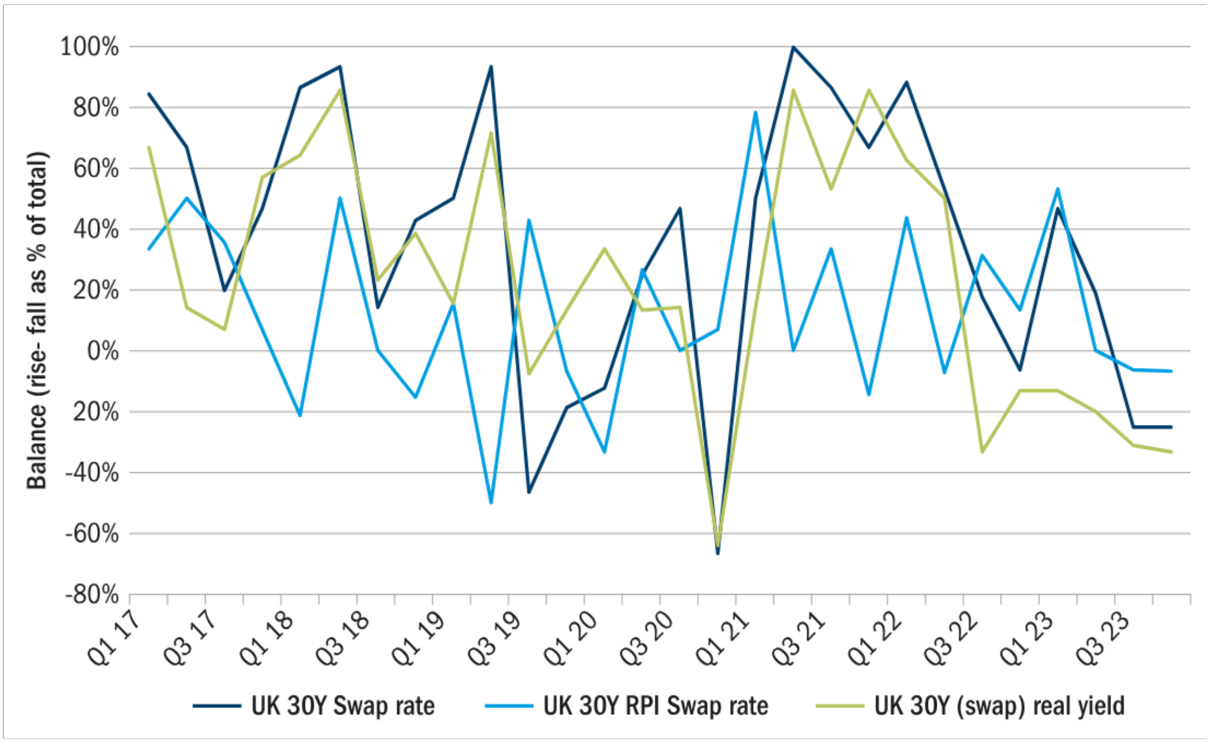
LDI activity in the first half of the year was muted, however de-risking activity picked up in the third quarter as pension funds had a greater understanding of their position and the regulatory environment. Improved funding ratios also concentrated the mind on the road to their end-game solution and what that might look like. Elements include getting all scheme data up to date and ready for review by a possible insurer and reviewing their investment and LDI portfolios with an eye to liquidity and transparency of valuations. Not every scheme will target buy-out, some will opt for an alternative self-sufficiency solution with low contributions. Yet for those with aspirations to move to buy-out, a highly complex portfolio with significant off-market bilateral positions will be a hindrance at the least, and at worst, if timelines are compressed, extremely expensive. For those considering such a flight path today, it is sensible to discuss this with your manager to ensure a smooth and effective transition to buy-out.

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 29 September 2023

In the prior quarter our counterparties called for a fall in all three metrics, albeit with low confidence. That call was borne out in inflation which fell marginally. However, the global sell-off in government bonds, due to the ongoing government debt burden weighing on the longer tenors and demanding a concession for the term structure for new issuance, resulted in a rise in nominal and real yields.

For the final quarter of 2023, there is little change in expectations from the previous quarter, low overall confidence yet calling for a reduction in interest rates, inflation pricing and real yields. Arguments for a higher 30-year swap rate focus on the issuance burden, exacerbated by the ramping up of interest payments on gilts and continued new issuance concession required given the supply and demand dynamics. However, if demand picks up into year end, coupled with a lack of long end issuance this could prompt a fall in long dated yields. There is also a question as to how much term premium is priced into long dated yields and whether the impact of anticipated rate cuts is priced in appropriately. Most are confident that the BoE has reached peak base rates in this cycle, but there is a risk that they may not be quite done if wage and inflation data remains sticky. Last quarter we mentioned that some had called for the BoE to skew their quantitative tightening schedule to reduce the impact on the longer maturity part of the curve. These voices have grown louder over the past quarter because of the significant steepening in the curve. Additionally, the poor growth outlook for the UK will weigh upon demand for gilts, potentially prompting more of a switch to the usage of swaps as a hedging asset. On the inflation side, it has largely been dictated by interest rates, however levels are high and, if appetite remains subdued, this would support a fall in 30-year inflation levels. Conversely if LDI demand were to return, given light issuance, it could lead to the opposite outcome. As real yields reach previous highs our counterparties anticipate LDI investors stepping in to take advantage of the opportunity and thus have confidence that hedging will mount into year end. This view is supported by the likely seasonal pick-up in activity that we usually see at the tail end of the year, as pension schemes seek to meet strategic objectives that were signed off earlier in the year.