INFORMATION FOR INVESTMENT PROFESSIONALS

# LDI Survey – Final Quarter 2022

LDI | February 2023

**Rosa Fenwick**
**Director, LDI Portfolio Manager**

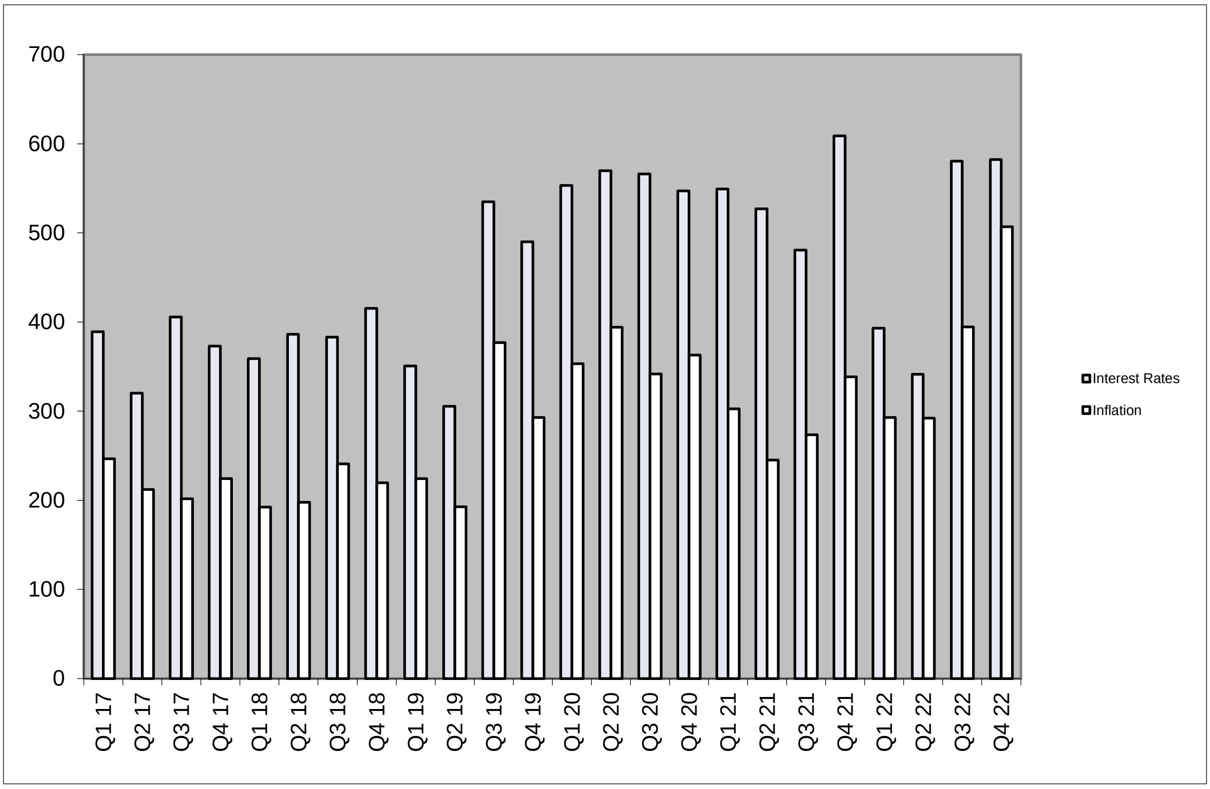
**Summary**
In the quarterly Columbia Threadneedle Investments LDI Survey we poll investment bank trading desks on the volumes of quarterly hedging transactions. The quarter began with further ructions in the markets despite the Bank of England intervention. Yields only settled once Jeremy Hunt was appointed the new Chancellor and quickly dropped all the 'growth' policies that had precipitated the crisis. Despite this, market conditions remained challenging throughout the fourth quarter with high volatility and consequentially higher transaction costs. Inflation hedging rose 28% quarter on quarter and achieved a new record of activity (since this survey began in 2008). Interest rate hedging activity remained consistent with the previous quarter at elevated levels.

As global central banks maintained their monetary tightening paths, the UK battled through extreme market ructions even with the resumption of a temporary bond buying programme instituted by the Bank of England to tackle the volatility and market dysfunction. This emergency bond buying was extended to index-linked gilts and served to take the edge off some of the worst daily moves in yields; providing time for LDI participants to recapitalise their portfolios and reduce overall leverage. However, the true remedy for markets was clearly seen in the replacement of the Chancellor and Prime Minister, resumption of austerity measures and reversal of the September Fiscal Event's 'growth' agenda. Yet the impact of Kwasi Kwarteng and Liz Truss' brief reign will continue to be felt for some time as regulators and market participants adjust to new data in volatility assumptions and a heightened focus on tail risk events. The disappointing element is that the UK does need a strategy to grow post Brexit. However, such a plan needs to be well thought out and costed appropriately, with the involvement of the Office of Budget Responsibility. Despite all this, the Bank of England was able to continue its inflation tackling Base Rate hikes, moving from 2.25% to 3.5% by the end of the year. In addition, the Bank was able to commence its Quantitative Tightening programme and to sell back a large portion of the gilts purchased to stabilise markets during September and October by the end of the year – even making a profit on these latter trades, which must have been gratefully received by the Treasury.

Total interest rate liability hedging activity stayed steady at £44.5 billion, whilst inflation hedging reached a new high at £51.0 billion, an increase of 28% from the previous quarter. These numbers represent primarily outright hedging activity in each case. Switching activity also grew as market yield volatility was reflected in relative value between swaps and gilts.

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 December 2022***

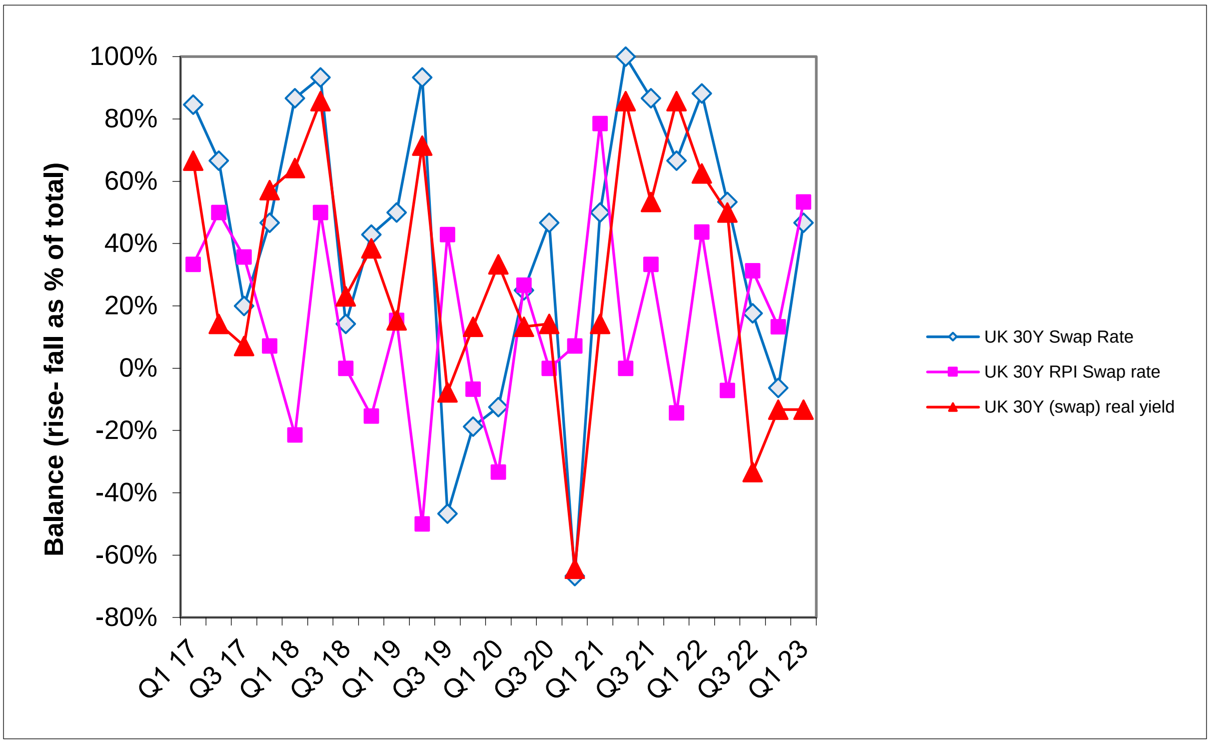
The funding ratio index run by the Pension Protection Fund showed some further improvement quarter-on-quarter (136.5% at end December vs 134.8% at end September), despite the market volatility – driven by rising yields. As pension funds will likely have significantly reduced their allocation to growth assets this then puts a move to buy-out even higher up the agenda. A bumper year is predicted by buy-out providers who are expecting £80-100bn of activity in the next 12-18 months.

**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 December 2022

Last quarter our counterparties had very low confidence due to the market volatility but despite that, they correctly called a decrease in nominal yields but were wrong on the other metrics. The movement in yields in December may have caught a few by surprise as the anticipated LDI hedging did not necessarily materialise, however the extreme levels seen at the end of September bore out their interest rate prediction.

For the first quarter of 2023 there is more conviction towards higher long-term interest rates and inflation expectations albeit with less consensus on real yields, but a bias towards lower real yields. For those in favour of higher interest rates the large gilt issuance programme is cited as a key driver, especially in combination with Active Quantitative Tightening which, following the successful completion of the sale of gilts purchased during the gilt crisis, has now adjusted to sell more longer dated gilts. A question mark remains over potential demand for this unprecedented supply of gilts and it is likely that LDI demand will need to be supplemented with overseas interest given the volumes. In addition, it is expected that the UK hiking cycle will persist through the first quarter of 2023 at least, with further activity becoming more nuanced upon data. Set against that, those who believe interest rates could fall note that given current market levels the UK looks attractive on a cross-market basis, and for curve extensions, which could counter the cheapening drive from issuance. There is also the possibility that the DMO could react to significant cheapening by tilting their issuance towards shorter maturities which could result in demand outstripping a dearth of long-end supply. In terms of inflation break-evens, predictions of higher levels centre around the lack of index-linked gilt issuance even in the face of lower realised inflation. There is also a sense of some LDI accounts choosing to hedge with higher duration bonds and to reduce their overall repo burden, which would be supportive of higher long-term inflation swap rates. Despite falls in natural gas prices, this will not pass through to the economy yet due to the Ofgem price cap. Wage discontent displayed through the furtherance of strike activity could increase pressure on realised inflation. As we reach the point of potential peak central bank rates in this cycle, the expectation for real yields is finely balanced and further volatility is likely. For those on a de-risking journey, trigger mandates can permit the opportunistic targeting of attractive but fleeting yield levels, resulting in a better overall outcome. Such triggers are best used to accelerate a gradual ongoing de-risking programme 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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