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COLUMBIA THREADNEEDLE INVESTMENTS®

LDI market review and outlook

Snap elections, all change but has anything changed?

UK LDI | July 2024

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The first half of 2024 disappointed markets as the large rate cuts reflected in market pricing at the start of the year failed to realise. Central banks erred on the side of caution, reticent to commence the monetary easing cycle in response to falling inflation and slowing growth. Add political risk to the mix – perhaps more so from the US and France than in the UK where the general election result was as expected – and we have greater uncertainty over the path and speed of monetary policy normalisation, which led to pension schemes taking more of a "wait and see" hedging approach. Both inflation hedging and interest rate hedging activity fell quarter on quarter, by 24% and 28% respectively. Our quarterly poll of investment bank trading desks on a range of topical questions helps support our narrative around market activity and outlook.

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. Europe was the first mover, cutting policy rates by 0.25% at its June meeting, but it gave no commitment on the pace of future cuts. Following significant gains made by France's far right at the European Union parliamentary elections and a poor result for his party, President Macron called a snap election in France. The unexpected decision saw the market show some concern but was by no means in panic mode. Market participants simply preferred not to warehouse any large outright risks given the volatility as the French election played out and resulted in a hung parliament. What this means for gilts is the scope to outperform on a cross-market basis with the Labour Party's landslide victory bringing stability to the UK political environment.

The limited fiscal headroom in the UK rather simplified the macroeconomic outcome, regardless of a Conversative or Labour win, hence the market reaction was muted. However, this does not detract from the fact that the new Labour government still needs to address significant fiscal challenges. With the election out of the way, the UK market turned its attention back to data and an August or September rate cut hangs in the balance. Gilts have historically rallied in the months following a general election. With markets currently pricing a gradual and shallow rate cutting cycle, this presents an opportunity for gilts to outperform.

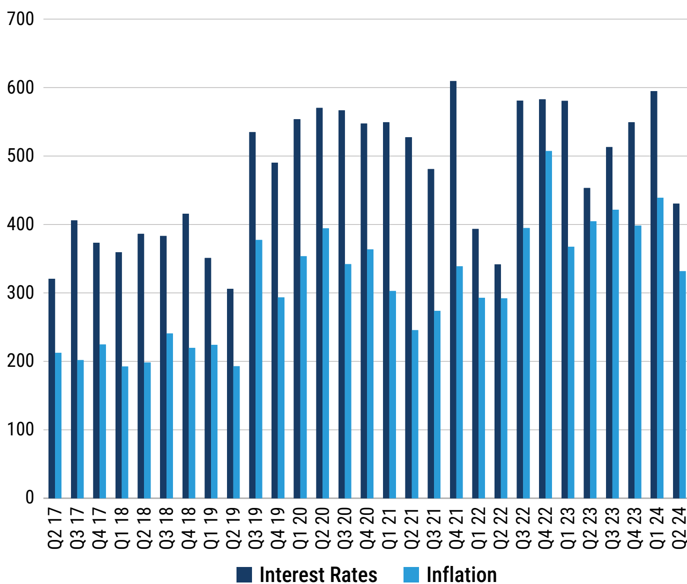
Firstly, there is the Autumn Budget which will take place on 30th October. Secondly, there is the US Election outcome. Risk is centred on this event which takes place on 5th November. If it results in a Trump / Republican victory, we will likely see higher US interest rates that may influence policy decisions in the UK. However, at time of writing, with President Biden pulling out of the race in favour of his vice president Kamala Harris, the contest appears reinvigorated and difficult to call.

Total interest rate liability hedging activity fell to £32.9 billion in the second quarter, whilst inflation hedging decreased to £33.3 billion. These numbers primarily represent a reduction in outright hedging activity, but there was still a healthy amount of relative value switch trades over a period of electoral uncertainty. The asset swap curve flattened over the quarter. For maturities of 15-years and shorter, gilts cheapened relative to swaps, whilst gilts outperformed swaps further out on the curve. This is a theme that could continue as gilt supply continues to be skewed to shorter maturities. The cheapness of UK gilt asset swaps (outright and on a cross-market basis), combined with the tightness of US investment grade

credit spreads and the unattractiveness of long-end GBP/USD cross currency basis (making it more expensive to hedge USD-denominated cashflows back into GBP), has led to insurers holding on to gilts they receive from pension schemes for longer, thus providing support for longer-dated gilts, in spite of strong pipelines for the bulk purchase annuity 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 (or removal) of counterparties in 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)*



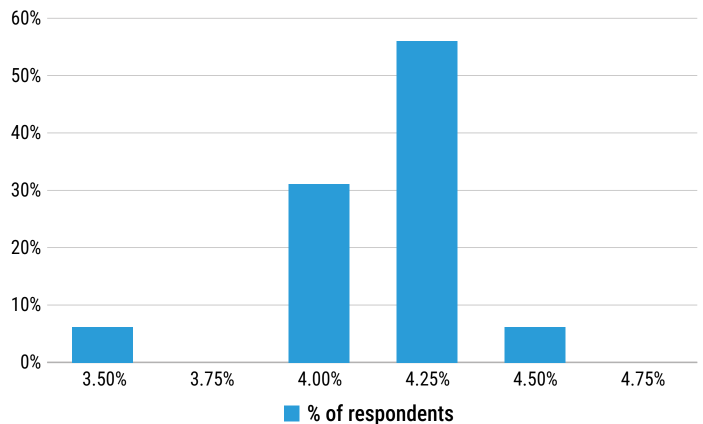
Source: Columbia Threadneedle Investments. As at 28 June 2024.
*13 bank responses were included within this survey

The funding ratio index published by the Pension Protection Fund showed an improvement quarter-on-quarter (149.4% at end June vs 146.5% at end March). This was driven by the continued move higher in yields resulting in a further decrease in the value of liabilities. In addition, the continued strength of equity markets saw some reallocating out of growth assets and into gilts. With the UK election now behind us, the LDI community can look forward to a review of the UK pensions regime. It is hoped that this can provide the pensions industry with greater certainty, in particular with the ratification of the Defined Benefit Funding Code, as well as details of how pension schemes will be incentivised to invest more in the UK economy by running-on rather than transferring to an insurer. The latter is expected to provide continuity from the Mansion House reforms proposed by the previous Conservative government. These developments may result in a boost to pension scheme activity across multiple asset classes.

Market Update

Post-election, the market's attention has turned back toward data for clues on the size and pace of the impending rate cutting cycle and the impact it could have on longer dated yields. To that end, we asked our bank counterparties for their view of where the base rate could be at the end of Q2 2025, and the results are reflected in the chart below:

Chart 2: Bank respondents' expectations of Bank Rate**



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

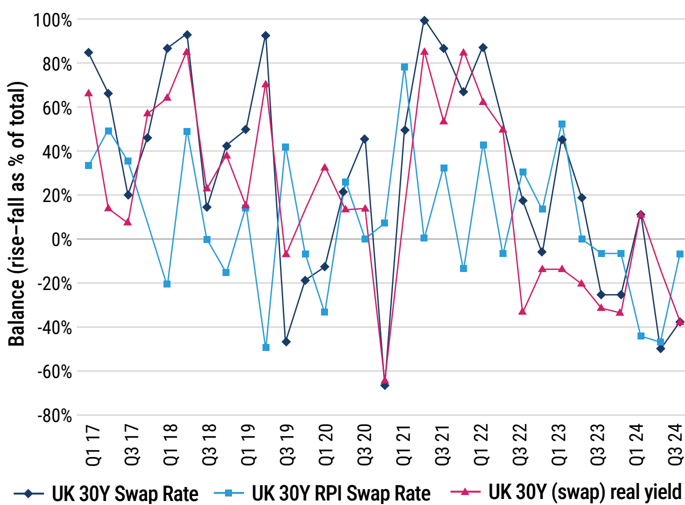
Market expectations have now broadly converged to around 4.0% or 4.25% as their prediction for where the base rate will sit at the end of Q2 2025, ie around 1.0% of cuts from current levels. Whilst headline inflation has slowed, the stickiness of wage and services inflation and the medium to longer-term growth outlook remain concerns for the Bank. The shift of power from the Conservatives to Labour was never expected to shift rate expectations, so the next risk event of significance will be the Autumn Budget and the extent to which this is funded through gilt issuance. If there is further fiscal easing announced at the Budget (unlikely in our view), this could slow the pace of monetary policy easing. That said, our base case is for the UK yield curve to steepen, led by shorter-dated maturities, which is dictated by policy, rather than supply which is something that typically drives longer-dated maturities.

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



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

Last quarter our counterparties expected all three metrics to fall, with particularly strong confidence on nominal and inflation rates. However, as the timing of rate cuts in the UK continues to be pushed out, partially led by inflation data surprising to the upside (particularly service sector inflation) and the announcement of an earlier than expected General Election in the UK, and further afield with the Fed's reticence to cut rates, their expectations did not entirely materialise.

Our counterparties have called for all three metrics to fall by the end of the third quarter of 2024 with a fairly high conviction on nominal and real rates. Those with a bias to lower yields in the UK expect data to weaken due to fiscal and monetary policy tightening, which should support a first base rate cut by September. Arguments against lower nominal yields cite inflation looking more embedded than initially anticipated domestically, if services inflation does not show signs of easing and wage growth remains elevated. Outside of this, unresolved geopolitical pressures and the US elections, which, if Donald Trump is successful, could result in more trade tariffs, and would therefore be an upside risk to inflation.

There was lower confidence on inflation rates falling by the end of the third quarter. 30-year inflation rates (i.e. longer dated inflation expectations as opposed to realised inflation) are generally trade activity-driven hence subdued demand for inflation (save for the 2054 inflation-linked gilt syndication in July where there was a significant concession). This together with the lack of inflation-linked supply longer than a 2045 maturity planned for the quarter means it is unsurprising that there is no strong conviction for the direction of inflation rates. Even with transactions involving switches from one hedging instrument into another, there is no clear direction. If there is a sustained rise in repackaged inflation-linked gilt trades, which will see buying of inflation-linked gilts on asset swap, this will weigh on long-end RPI swaps. Equally, if there is a significant pick up in bulk purchase annuity hedging, where insurers sell the inflation-linked gilts they receive and switch into RPI swaps to take advantage of the recent richness of gilt inflation, this would be supportive of RPI swaps.

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