Information for UK investment professionals only

COLUMBIA THREADNEEDLE INVESTMENTS®

LDI Survey – First Quarter 2024

LDI | April 2024

Rosa Fenwick
Head of Core LDI
Portfolio Management

Summary

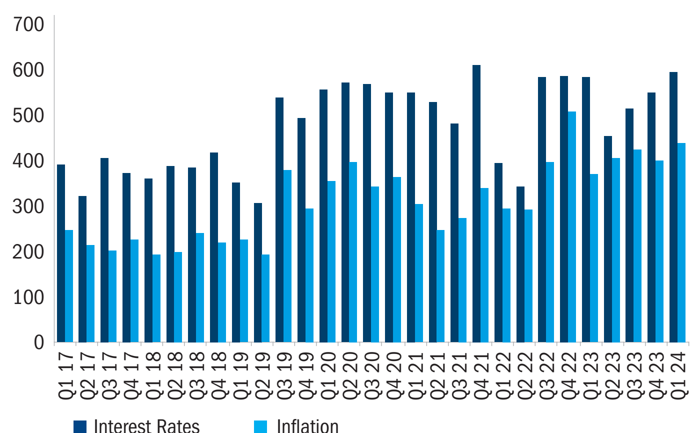
In the quarterly Columbia Threadneedle Investments LDI Survey we poll investment bank trading desks on the volumes of quarterly hedging transactions. 2024 started off with a bang, incorporating pent up hedging demand from December, and hedge funds positioning themselves for volatility around the delivery of the expected rate cutting cycle. Inflation hedging rose by 10% quarter on quarter, whilst interest rate hedging activity increased by 8% from the previous quarter.

This year is likely to be another year where central banks take centre stage. The previous quarter's rapid fall in global yields, which had followed the expectation that the Fed would move swiftly into a rate cutting cycle, reverted at the start of the year – more because of liquidity and supply returning to the market than a significant change in sentiment. Indeed, throughout January, markets priced in aggressive rate cuts for the US, Europe and the UK, offering opportunities for attractive funding for those who believed this reaction was overdone. For our LDI clients, this made longer dated repo pricing more attractive than that for shorter term repo. As the quarter progressed, inflation seemed stickier and economies more resilient than anticipated, providing scope for central banks to delay the commencement of the monetary tightening cycle. To provide context, at the start of the year the market was pricing in 1.3% of cuts in the UK by the end of 2024, which has now reduced to c.0.45% (now potentially swinging the other way and under-pricing the risk of rate cuts).

Total interest rate liability hedging activity increased to £45.4 billion, whilst inflation hedging also rose to £44.1 billion. These numbers primarily represent outright hedging activity in each case, especially as some pension fund hedging activity spilled over from the previous year end, happily taking advantage of more attractive yield levels. Hedge asset switching (e.g. between gilts and swaps) was somewhat muted over the quarter, as despite significant buy-out activity, relative value between gilts and swaps remained within a tight range, albeit with some small gilt outperformance seen over the quarter.

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

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 March 2024

risk traded by each counterparty per quarter, it allows the introduction (or removal) of counterparties in the survey.

The index published by the Pension Protection Fund showed an improvement in funding levels quarter-on-quarter (146.5% at end March vs 142.8% at end December). This was driven by the rise in yields, resulting in a fall in the value of liabilities. Strong funding positions have prompted further discussion as to what is the ideal end-game for each individual scheme. While some will continue to opt for full buy-out or self-sufficiency, more schemes are considering run-on, which has the potential to deliver a surplus that can be used for the benefit of scheme stakeholders. Partly to protect against adverse movements in equity markets, there has been renewed interest in equity option strategies, giving up some potential upside in exchange for protecting against equity falls. There is significant uncertainty in the economic and political landscape across the globe with elections in the US, UK and the EU (amongst many other countries) this year. With the UK election a foregone conclusion in most minds, the most risk premia focus is on the US election which sits on a knife-edge with considerable differences in governing outcome depending on which side wins and whether they can take control of all three centres of power – the Presidency, the Senate and the House of Representatives.

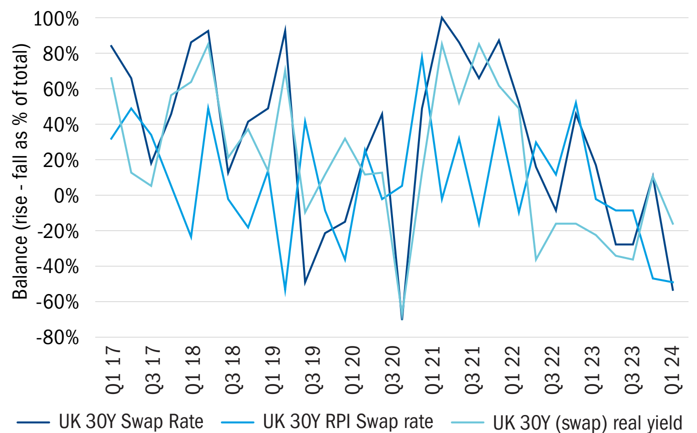
Market Outlook

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.

Last quarter our counterparties expected inflation to fall but nominal and real yields to rise. However, demand for long-dated inflation hedging proved them wrong and gains were seen in all three metrics as market liquidity and issuance picked up from the end of the prior year.

Chart 2: Change in swap rates over the next quarter



Source: Columbia Threadneedle Investments. As at 28 March 2024

Our counterparties now expect all three metrics to fall by the end of the first half of 2024 with particular confidence as regards nominal and inflation rates. The view that nominal rates will decrease is predicated on the expectation that the UK is well on its way to starting its monetary tightening cycle. Whilst current market pricing favours September for the likely first cut, as the year progresses this will be reflected in longer term yields. Also, in favour of yields falling sooner, are those banks who expect the Bank Rate to undergo its first cut before September, with some suggesting June could be possible if economic data continues to weaken. Arguments against lower nominal yields centre upon the heavy issuance schedule required by the DMO – although noted that this is less impactful for longer dated bonds than it could have been given the skew in issuance to shorter maturities (where extensive supply is more likely to be digested well). On the inflation side, term premia in longer-dated inflation remains substantial, particularly as LDI buying of inflation has regained momentum in the past few months. However, this is expected to diminish as LDI demand becomes more two-way and because of upcoming issuance. This will need to be substantial however to offset current demand from overseas investors (mainly insurers) buying index-linked gilts on asset swap.

To find out more visit **columbiathreadneedle.com**

© 2024 Columbia Threadneedle Investments

For professional investors. For marketing purposes. Your capital is at risk. Columbia Threadneedle Investments is the global brand name of the Columbia and Threadneedle group of companies. Not all services, products and strategies are offered by all entities of the group. Awards or ratings may not apply to all entities of the group.

This material should not be considered as an offer, solicitation, advice, or an investment recommendation. This communication is valid at the date of publication and may be subject to change without notice. Information from external sources is considered reliable but there is no guarantee as to its accuracy or completeness. Actual investment parameters are agreed and set out in the prospectus or formal investment management agreement.

In the UK: Issued by Threadneedle Asset Management Limited, No. 573204 and/or Columbia Threadneedle Management Limited, No. 517895, both registered in England and Wales and authorised and regulated in the UK by the Financial Conduct Authority.