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Q1 2025 repo update

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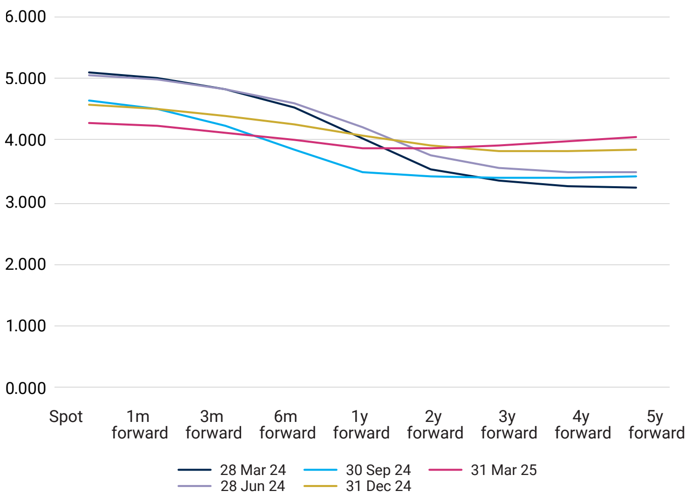
All predictions pointed to President Trump's approach to geopolitics and economics causing volatility in the market; however, he has exceeded expectations on this front. During the election campaign we were treated to his views on the beauty of tariffs with varying reasons as to their perceived utility in protecting the US consumer; enforcing border controls, providing revenue and of course as a negotiating tool. Global attention has been laser focused on the tariff discussion, with tariffs announced and some quickly removed or lessened in return for border concessions e.g. with Canada and Mexico and musings on other forms of tariffs to punish countries who in the administration's view have particularly egregious trade balances. Despite President Trump's protestations, tariffs are almost universally derided as inflationary and negative economically as they protect less efficient producers. A trade war with other countries retaliating can quickly spiral making the whole world poorer (including America). The quarter ended with the world nervously awaiting 'Liberation Day' on 2 April; hoping that, as previously, tariffs were to be used as an opening gambit in a negotiation and that President Trump's first term concern about the stock market would temper some of the threats that had been bandied about. Unfortunately, the universal and specific tariffs announced on 2 April dashed hopes as immediate implementation reduced the potential for negotiated amendments with a consequent negative sentiment on growth and higher inflation. US average tariffs have moved from c. 2.4% in 2024 to 24% - levels not seen since the late 1800s otherwise known as the "Gilded Age" – an age characterised by monopolies and protectionism, materialism and conspicuous consumption and ultimately political corruption.

Meanwhile, in the UK Chancellor Reeves' wafer-thin fiscal space was eroded by adverse market moves, resulting in policy measures to cut spending, in particular targeting welfare – something that has raised accusations of forgetting what Labour stands for. This was unfortunately necessary due to the Chancellor's self-imposed rule on balancing spending with income and hemmed in by promises not to raise income tax, VAT or employee national insurance. Similarly to the Budget last year, most of the measures in the Spring Statement were well signposted, reducing uncertainty for the market. As anticipated, the Office of Budget Responsibility downgraded growth in the near term. As a corollary of the Statement the market also received the remit for fiscal year 2025/26. Gilt sales have been held below the emotional bound of £300bn at £299.2bn by increasing the allocation to T-bills. The expectation was clear that the Debt Management Office would tilt issuance towards shorter maturities, the reality was even more stark with the share of long issuance falling from 20% to 14%, even before considering the impact of issuing shorter bonds within the longer dated bucket.

The market's view of where long-term rates could move to in the future is encapsulated in forward rates. The chart below shows where the six-month SONIA swap rate is currently (spot) and at various forward rates out to five years. As can be seen from the chart, markets have reflected the February rate cut but now show a close to flat line across 5 years. Inflationary concerns from a tariff war are currently outweighing the threat of an economic recession requiring central bank support. One-year forward rate expectations have fallen by 0.19% within the last three months.

SONIA – Sterling Overnight Index Average

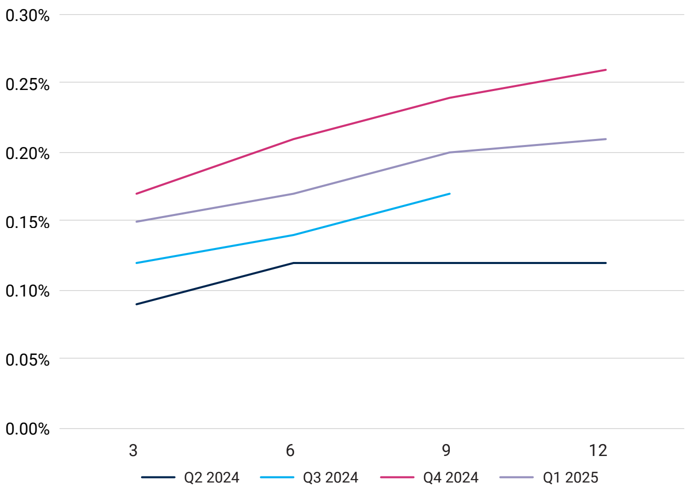
Chart 1: Six month SONIA rate



Source: Barclays Live, as at 31st March 2025

Repo rates are expressed relative to SONIA, and the chart below displays the average repo rates that we have achieved over the past four quarters for three, six, nine and 12-month repos, shown as a spread to average SONIA levels at the time. Repo costs in the previous quarter were skewed by year end window dressing impacts; these have in turn dissipated, resulting in repo rates falling in the new year. However, the slow grind of diminishing liquidity from the reduction in the Bank of England's balance sheet persists. Despite this, through judicious use of axes and netted repo opportunities, Columbia Threadneedle Investments were able to access attractively tight repo spreads, thereby keeping the costs incurred by our clients down.

Chart 2: Spread to SONIA



Source: Columbia Threadneedle Investments, as at 31st March 2025

Excluding the temporary year end window dressing impacts to repo, repo costs have inexorably ground higher over the past year. This reflects also the greater competition for balance sheet particularly in global banks. As a finite resource, it is a balance between allocating balance sheet to maximise profit (by for example deploying it in the US to support equity activity) and maintaining traditional asset class relationships – to bolster EMEA based activity in related asset classes such as fixed income. As repo spreads increase in the UK, it also follows that it becomes a more attractive proposition thereby inviting more balance sheet to return. It is a delicate balance and promotes the need to interact with counterparties across multiple jurisdictions and with varying competencies and foci. The recent news from the US that banks will potentially need to hold less regulatory capital would also free up balance sheet, exerting downward pressure on repo pricing.

Following the gilt crisis in 2022, we are seeing interest from clients in credit repo and appetite from more and more banks to support the same. Credit repo allows portfolios with directly held credit to raise cash to support hedging without selling their credit once their gilt positions are depleted. Pricing is highly bank and bond dependent and as a corollary can also be 'special' or in high demand. Recent corporate bond repo trades at Columbia Threadneedle Investments have focused on these special bonds and the appropriate counterparties, allowing repo spreads of SONIA – 0.05% and SONIA -0.10% to be achieved (between 0.15-0.20% better than conventional gilt repo). Specials in the corporate bond market are typically fleeting rather than persistent as is seen in the gilt market, and as such, means that credit repo should be thought of as a short-term contingency solution rather than a long-term funding tool. However, it is a beneficial addition to the toolbox and something we are putting in place for relevant portfolios. It has now grown from a niche offering to one with relatively widespread availability; however, pricing and appetite varies considerably, necessitating engagement to ensure the appropriate access to counterparties in the event of credit repo being needed. An alternative to credit repo is to margin gilt repo with corporate bonds; however, for this to have use in a crisis it means paying the cost of the less liquid collateral on an ongoing basis, thereby increasing the overall cost of funding in the portfolio.

We welcome the efforts of the Bank of England to create a repo facility for Non-Bank Financial Institutions (NBFIs) – known as the Contingent NBFI Repo Facility (CNRF). In January the Bank of England released more details of the facility and eligibility criteria. At the outset the client or fund must own over £2bn of gilts, there is a concentration limit of £500m of a specific gilt and each client has a borrowing limit of 50% of gilt holdings rounded to the nearest billion. Participants will need to pay an annual fee for access as well as committing to participate in periodic test trades and providing regular information to the Bank. Technically, the facility will be structured as a secured borrowing arrangement rather than a traditional repo so investors will need to ensure they have the appropriate permissions for regular borrowing to use the facility. Please get in touch if you would like to know more about this developing facility.

Repo funding generally remains cheaper for creating leveraged exposure to gilts over the lifetime than the equivalent total return swap (TRS) and so continues to be used within our LDI portfolios. However, pricing for total return swaps can be very bond specific and, where the bank counterparty can obtain an exact netted position, the rate can be extremely competitive. TRS can be longer dated, with maturities ranging from one to three years and even five years, as compared to repo which typically vary in term from one to 12 months. Hence, TRS can be beneficial for locking in funding costs for longer and for minimising the roll risk associated with shorter-term repo contracts. On the other hand, repo facilitates tactical portfolio adjustments more easily and tends to be slightly cheaper. We ensure portfolios have access to both repo and TRS for leveraged gilt funding, so we can strike the right balance between cost, flexibility, and minimisation of roll risk. It is essential to maintain a range of counterparties to manage the funding requirements of a pension fund. We have legal documentation in place with a diversified suite of 24 counterparties for GMRA (Global Master Repo Agreement) and ISDA (International Swaps and Derivatives Association).

Indicative current pricing shows leverage via gilt TRS for a six-month tenor is very bank dependent but is on average 0.01% more expensive for TRS – this depends on the bank's view of the repo market and whether they are impacted by Net Stable Funding Ratio regulations (NSFR). Part of the reason for higher costs for TRS is a reflection of the lack of straight-through-processing available. Columbia Threadneedle are engaging with various market providers and participants to redefine TRS and the way it is traded and confirmed. Another way to obtain leverage in a portfolio is to leverage the equity holdings via an equity total return swap (or equity futures). An equity TRS on the FTSE 100 (where the client receives the equity returns) would indicatively price around 0.28% higher than the repo (also as a spread to six-month SONIA). Clearly, this pricing can vary considerably from bank to bank and at different times due to positioning, which gives the potential for opportunistic diversification of leverage.

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