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Q1 2024 repo update

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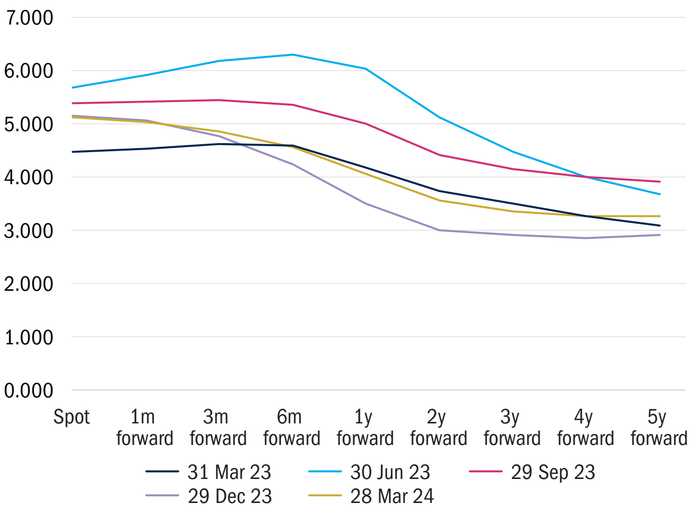
Rosa Fenwick
Head of Core LDI
Portfolio Management

All eyes remained focused on the commencement of the global monetary easing cycle; however, as the quarter progressed it became clear that the market had been overly aggressive in its expectations, both in terms of the speed and size of potential cuts for 2024. UK inflation continued to fall, albeit not as fast as may have been hoped, prompting a more dovish vote split than expected at the March Monetory Policy Committee meeting (rate left unchanged at 5.25%) with no members calling for a hike and Dr Swati Dhingra maintaining her call for a 0.25% rate cut. The market is currently pricing 0.73% of cuts by the end of 2024 in the UK, compared to 0.86% in the EU and 0.69% in the US. The consensus view in markets is that the EU is likely to be the first to cut rates, driven by relatively frank signposting from the ECB. Data has been somewhat challenging in the EU which, combined with softer inflation and tight fiscal policy, does encourage a first-mover approach to easing to support the economy. More accommodative fiscal policy in the US and potentially in the UK (as a precursor to the election) will raise the bar to both initiating and propagating the cycle. However, it is still very much a question of when not if, with the EU predicted to start in June with the UK and US following in the subsequent months.

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 below, markets have significantly pushed out their expectations of the first rate cut in the UK, and reduced the sharpness of the easing cycle. One-year forward rate expectations have risen by 0.57% within the last three months.

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. Liquidity has been draining slowly from the system as a consequence of the quantitative tightening (QT) regime from the Bank of England, resulting in funding spreads that are not dissimilar to those experienced at the end of the previous year. Achieved repo costs at the shorter tenors reflect the lack of a year-end cliff edge included within the pricing. The uncertainty around the pace and timing of UK base rate monetary policy is also a factor in the increased spreads vs SONIA.

Chart 1: Six month SONIA rate



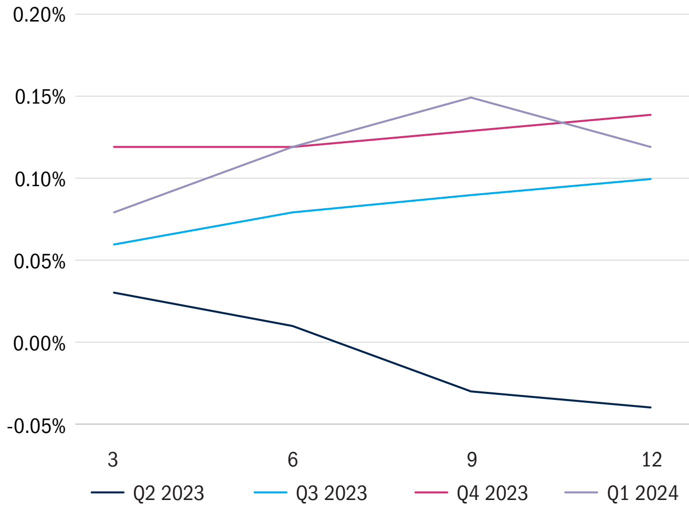
Source: Barclays Live, as at 28th March 2024

The start of the year brought a number of traditionally less active counterparties to the fore with aggressive pricing to gain market share. Having access to a wide range of counterparties allows us the opportunity to take advantage of short-term appetite and thereby to achieve a better outcome for our clients. Despite the increase in repo costs, they remain significantly below their long-term average of SONIA +0.25%; yet it is expected that, as QT continues, repo spreads will continue to gently revert to such levels. In previous quarters we have discussed the impact of bonds that are high in demand and trading 'special'. Desire for these bonds have diminished as QT progresses, with less of a benefit accruing from their use as a source of funding.

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 now have legal documentation in place with 24 counterparties for GMRA (Global Master Repo Agreement) and ISDA (International Swaps and Derivatives Association) and more are being negotiated.

Following the gilt crisis last year, we are seeing interest from clients in credit repo and appetite from some 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 can be anything from 2-50bps more than the cost of a traditional gilt repo, potentially rising to 65bps or more in a crisis. This 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

Chart 2: Spread to SONIA



Source: Columbia Threadneedle Investments, as at 28 March 2024

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 overall cost of funding in the portfolio.

The Bank of England recently provided an update on its plan to design a tool or repo facility to alleviate significant stress in the gilt market. It is intended to be contingent rather than a standing facility and given its function to tackle market disorder, it will be expensive and thereby not providing competition with existing suppliers of funding to the market. While the context of the tool has now been clarified, the operational characteristics have still to be worked through and we are in direct dialogue with the Bank on this topic, as well as engaging with wider industry groups.

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 the TRS – this depends on the bank's view of the repo market. Another way to obtain leverage in a portfolio is to leverage the equity holdings via an equity total return swap. An equity TRS on the FTSE 100 (where the client receives the equity returns) would indicatively price around 0.31% 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.

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

All data and sources Columbia Threadneedle Management Limited, as at 28th March 2024.