INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

Q2 2023 repo update

LDI | July 2023

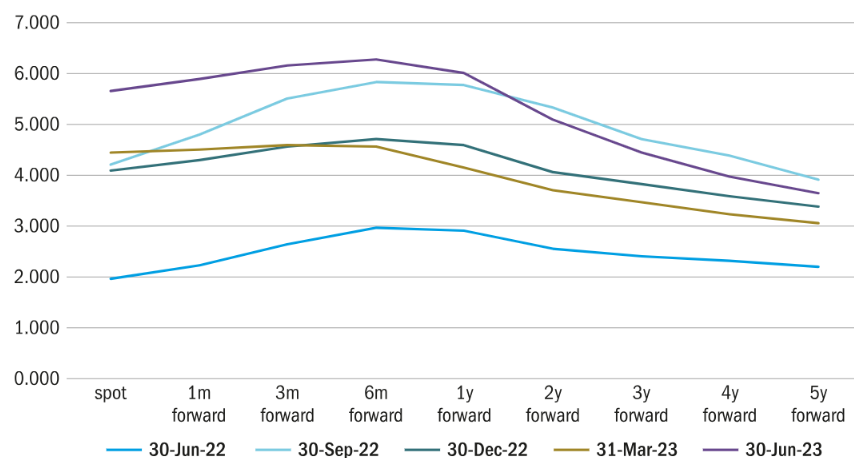
Rosa Fenwick
Head of Core LDI Portfolio Management

Volumes of trade activity remained below average in the second quarter of 2023 partly as a consequence of the evolving regulatory framework for UK pension funds; in particular around the appropriate level of resilience and the responsibilities of trustees and managers. However, this was not the full story. Despite the announcement of a number of significant buy-out deals, the traditional shocks to relative value between gilts and swaps were less in evidence, perhaps as buy-out providers were prepared to take more basis risk in order to smooth their trading activity. Volatility was centred on short tenors as changing inflation data releases and base rate expectations translated into significant moves triggering stop-outs from the hedge fund community.

As in prior quarters, the key focus and driver of markets were central bank activity and data releases. In the US and Europe, inflation has responded to monetary tightening, allowing their central banks leeway in their flight path resulting in slower rises to their official rates as they balance the risks of a recession against higher than desired inflation. Unfortunately, the same is not true of the UK. Stubborn inflation even in the core measure (which excludes volatile energy and food) sparked a surprise 0.5% hike in June by the Bank of England. The May release of inflation showed CPI at 8.7% (0.3% above expectations) and core inflation at 7.1% (vs 6.8% expected and the same for the previous release). This has led to a complete repricing of the terminal base rate, whilst concerns abound that monetary tightening may yet do little to impact supply-side inflation.

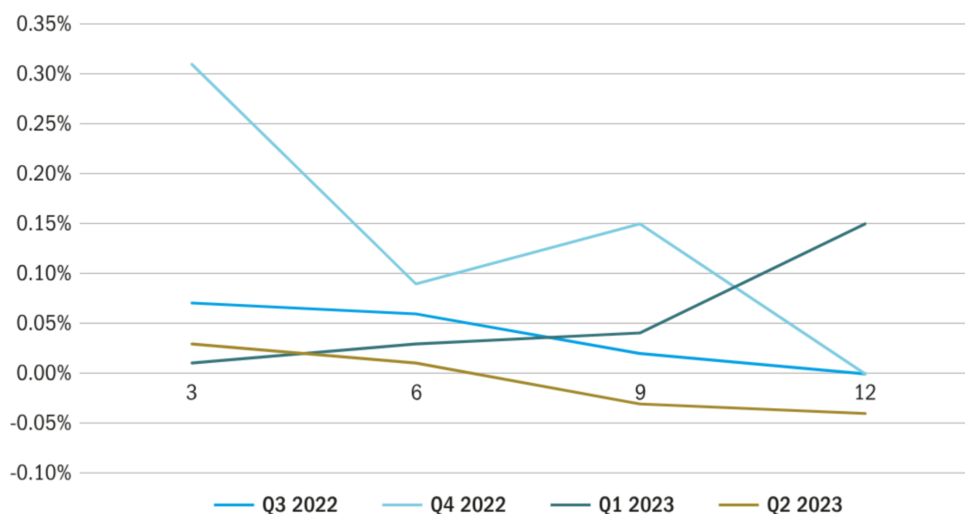
The market's view of where long-term rates could move to in the future is encapsulated in forward rates. The chart below shows where the six-month SONIA swap rate is currently (spot) and at various forward rates out to five years. As can be seen from the chart below, interest rate expectations have unsurprisingly risen significantly at the front end but are then falling faster in one year's time. One-year forward rate expectations have risen by 1.9% within the last three months.

Six month SONIA rate



Source: *Barclays Live, as at 30th June 2023*

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. Despite the uncertainty as to the future path of interest rates and a consequent slight increase in the standard spread over SONIA, the use of 'specials' to repo and netting exposure led to decreases in the average spread to SONIA paid for funding in the second quarter.



Source: Columbia Threadneedle Investments, as at *30th June 2023*

Despite the continuation of Quantitative Tightening, liquidity in repo funding is still ample, particularly as most pension funds are using less leverage and thus their total funding requirement has diminished. Also, despite QT, much of the sub-10-year part of the nominal gilt curve remains in high demand, locked up on the Bank of England's balance sheet – i.e. trading 'special'. Columbia Threadneedle preferentially looks to repo these special bonds to receive a material saving on repo funding costs; this quarter a typical repo spread to SONIA for one of these bonds in high demand was around -0.43%. Another factor that has contributed to the negative spread to SONIA seen in the longer tenors is the intraday upward shocks seen in the second quarter. Achieved rates are measured against the close of business SONIA level in the appropriate tenor. By trading early in the day, this was beneficial on several occasions this quarter resulting in lower achieved funding levels.

Another consequence of the gilt crisis has been the adjustment of expectations for volatility or value at risk assumptions, as it pertains to central clearing. This has resulted in extremely high initial margin requirements specifically for cleared repo; (note that swap-based initial margin requirements have also increased but not to the same extent). The upshot is that bilateral repo is far more attractive both from a cost and a collateral efficiency perspective. Therefore, since the last quarter of 2022 volumes have moved away from alternatives into traditional bilateral repo.

Repo funding generally remains cheaper at this moment 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 and has the advantage of using bond and cash collateral or even credit collateral. 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 22 counterparties for GMRA (Global Master Repo Agreement) and 23 counterparties for ISDA (International Swaps and Derivatives Association) and more are being negotiated.

Indicative current pricing shows leverage via gilt TRS for a six-month tenor is very bank dependent and can be either 0.02% wider than repo or a similar amount tighter – this typically 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.

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 10-50bps more than the cost of a traditional gilt repo, rising to 65bps 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.

SONIA – Sterling Overnight Index Average

All data and sources Columbia Threadneedle Management Limited, as at *30th June 2023.*

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