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Q2 2024 repo update

LDI | July 2024

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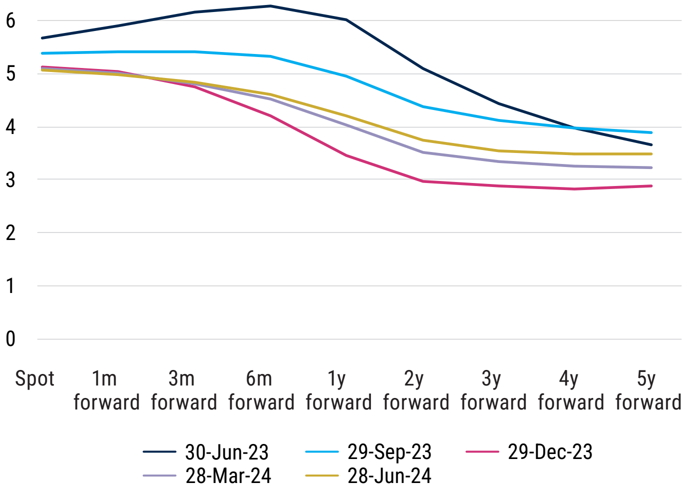
The second quarter of 2024 finally brought about the long-awaited commencement of the monetary tightening cycle, albeit not in the US or the UK; instead the ECB took the plunge cutting the deposit rate by 0.25% to 3.75%. The divergence in central bank activity acknowledges the differing challenges faced by each country, in terms of inflation persistence, economic woes and of course – political risk. A summer filled with sports is now also jampacked with politics, from the surprisingly early election called by the UK's Prime Minister Rishi Sunak to the visceral reaction and snap election from French President Macron, given his party's dire showing in the European elections. These political shenanigans somewhat stymie the ability of an avowedly apolitical group of central bankers to act, as it could be seen to be helping or hindering different agendas. The first rate cut is now priced in for the UK in September and for the US in November.

The market's view of where long-term rates could move to in the future is encapsulated in forward rates. Chart 1 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 slightly pushed out their expectations of the first rate cut in the UK from August to September, but otherwise show little change in their view of the depth of the cutting cycle. One-year forward rate expectations have risen by 0.19% 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. Whilst quantitative tightening (QT) continues, liquidity will continue to diminish over time, however through judicious use of axes and netted repo opportunities Columbia Threadneedle Investments

Chart 1: Six month SONIA rate

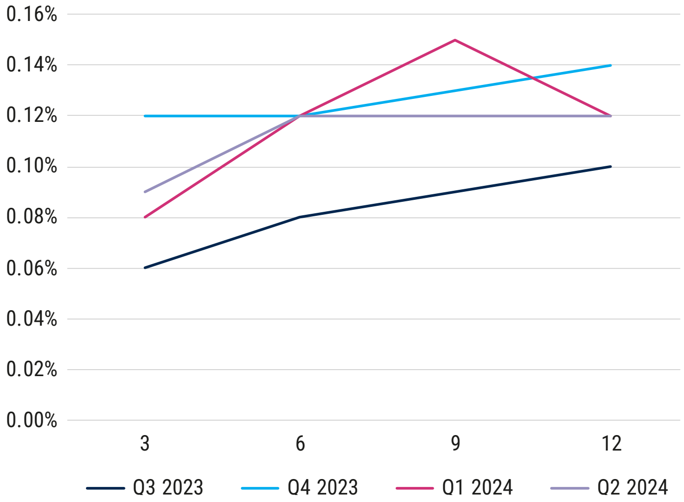


were able to access tighter repo spreads, thereby keeping client costs down.

The composition of bank counterparties that are winning the most repo has changed over the past few months. We have seen some market participants step back from the provision of repo balance sheet as they focus on other areas, however nature abhors a vacuum and other banks on our extensive repo panel have stepped in and stepped up, thus supporting the strong (low) cost outcome achieved over the quarter. The use of the Bank of England's (BoE) Short Term Repo facility (STR) has continued to accelerate. This facility is designed to provide reserves access to banks and building societies to support alignment between

* SONIA – Sterling Overnight Index Average

Chart 2: Spread to SONIA



SONIA and the Bank Rate. The STR is another part of the BoE's toolkit, aiming to reduce the impact of QT and how it can drain liquidity (and cause stress) in short-term markets. The fact that it is in use even before QT results in the BoE's reserves reaching the Preferred Minimum Range of Reserves (PMRR) is seen as a positive by Governor Bailey, as it shows that the stigma has been removed and it allows the market to become comfortable with the procedure through testing and usage of the facility.

Following the gilt crisis last year, 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, but this works in both directions, with some "special" or high demand bonds attracting notably lower credit repo costs. Recent trades at Columbia Threadneedle Investments have focused on these special bonds and the appropriate counterparties, allowing credit 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 associated with the less liquid collateral on an ongoing basis, thereby increasing overall cost of funding in the portfolio.

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.

Indicative current pricing shows leverage via gilt TRS for a six-month tenor is very bank dependent but is on average 0.03% more expensive for the TRS (relative to repo) – 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 0.52% 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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