Q3 2023 repo update

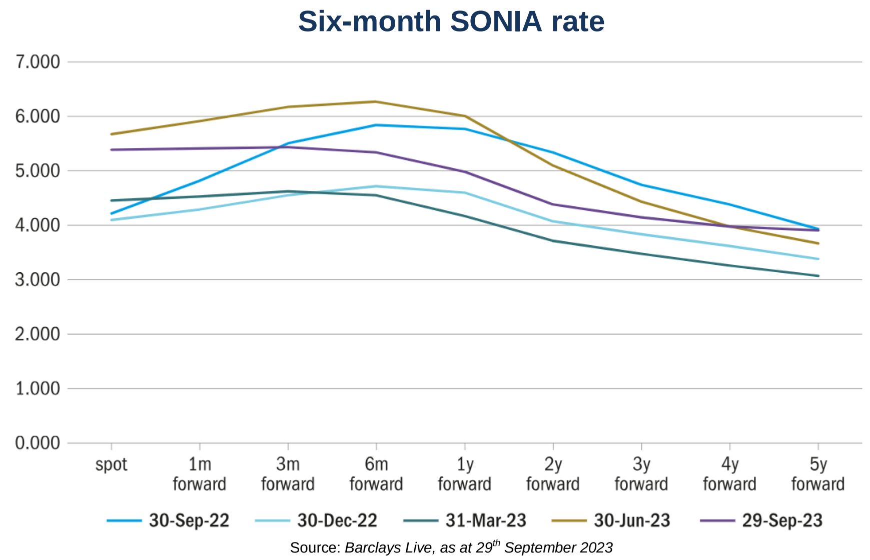
LDI | October 2023

Rosa Fenwick
Head of Core LDI Portfolio Management

The peak or close-to-peak rate environment prevailed across Europe and the US during the third quarter as inflationary fears receded. Yet, yields trended upwards over the period, interspersed with volatility around data releases, central bank press communications and meetings. In September, the UK's inflation figures came in distinctly below expectations – with the most marked difference in core inflation (excluding volatile food and energy) which showed a 6.2% year-on-year increase vs economists' predictions of 6.8% and a significant drop from the prior release of 6.9%. Despite the potential for a slowdown in the Bank of England's rate hiking cycle, the choice to keep the Bank Rate at 5.25% in September still caught many by surprise. Now the question is whether this is the peak of rates in this cycle or whether this was simply a pause in the ongoing tightening environment. Irrespective of the difficulty of calling the peak, in the current environment it is likely that base rates have limited space to rise further without risking a recession.

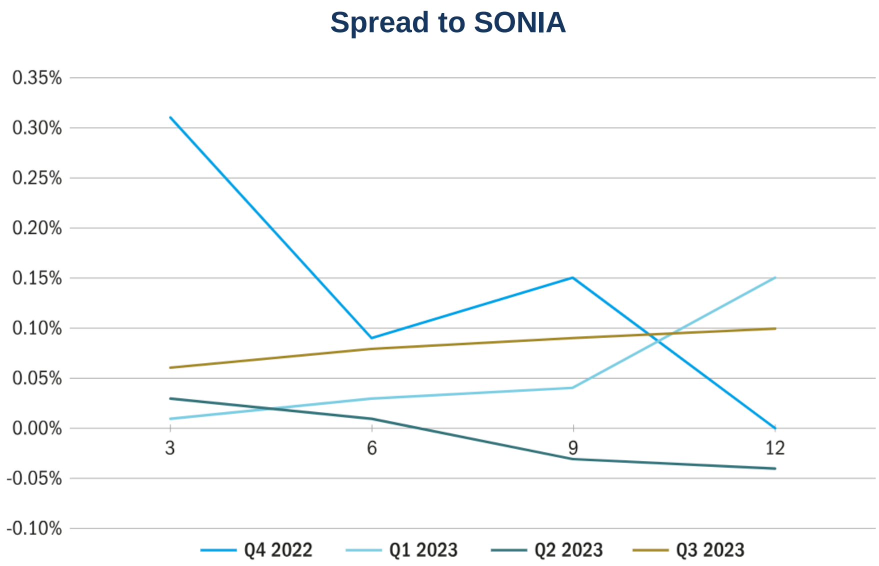
Long-dated yields have risen to around the levels seen in the previous year's gilt crisis, precipitated by the ill-fated 'mini-Budget' from Kwasi Kwarteng and Liz Truss. However, this rise in yields has been gradual, or at least paced – permitting already better cushioned pension funds the time to replenish their collateral without provoking a crunch in the funding markets. In reality, even the events of the last year did not necessarily result in a reduction in total funding supply to the market but more a reconsideration of risk exposures faced by different entities. However, the threat of a crisis in the repo market requires us to continue to explore alternatives and backstops. In that light, the announcement by the Bank of England that they intend to offer a collateralised lending facility to pension funds and insurance companies to manage financial stability risks during a crisis was received positively as a further step to support pension scheme risk management programmes and funding ratios.

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 become shallower with less of a tipping point anticipated but also a slower fall in rates. One-year forward rate expectations have fallen by 1.0% within the last three months.



Source: *Barclays Live, as at 29th September 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. The unpredictability of the rate environment mixed with intra-day volatility contributed to a slight rise in the cost of repo during the third quarter – noting that this remains significantly below the long-term average of c. 0.20-25% over SONIA.



Source: Columbia Threadneedle Investments, as at *29th September 2023*

Despite headwinds from monetary policy uncertainty, repo liquidity remains ample and costs low in the broader sense. This is consistent with previous quarters, as despite the rising yield environment, most pension funds are using less leverage and thus their total funding requirement has diminished. Also, despite sales of gilts held by the Bank of England through quantitative tightening, much of the sub-10-year part of the nominal gilt curve remains in high demand, locked up on their balance sheet – i.e. trading 'special'. Columbia Threadneedle 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 -0.40% (i.e. the overall repo rate was less than SONIA).

Another consequence of the gilt crisis has been the upward 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 final quarter of 2022 volumes have moved away from cleared repo 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. 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 currently have legal documentation in place with 22 counterparties for GMRA (Global Master Repo Agreement) and 23 counterparties for ISDA (International Swaps and Derivatives Association).

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. It has now grown from a niche offering to one that can be obtained across the street; however, pricing and appetite varies considerably, necessitating engagement to ensure the appropriate access to counterparties in the event of credit repo being required.

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 0.37% 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.

All data and sources Columbia Threadneedle Management Limited, as at *29th September 2023*.