For professional investors only

COLUMBIA THREADNEEDLE INVESTMENTS

Q3 2024 repo update

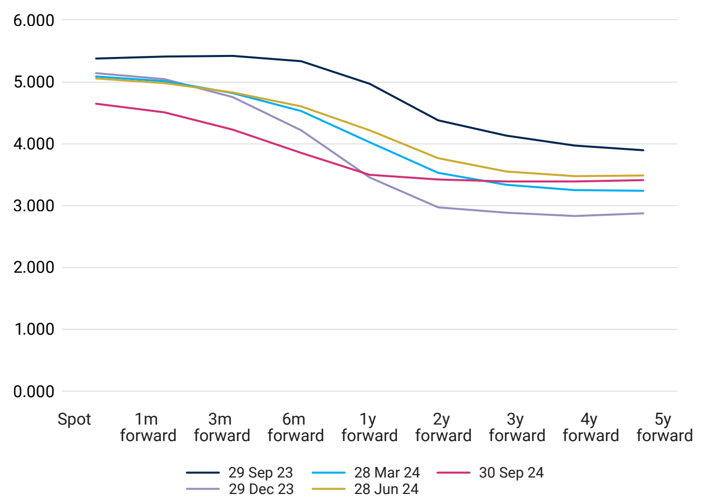
LDI | October 2024

Rosa Fenwick
Head of LDI Implementation

Fears of an economic slowdown and helpful falls in inflation rates opened the door to the first rate cuts in the US and the UK, and for a second in Europe. Whilst the Bank of England dipped its toe in the water with a 0.25% cut to 5.0%, the US impressed with a surprise 0.5% cut bringing their target range to 4.75-5.0%. Whilst the neutral rate is unlikely to be close to the levels seen during the COVID-19 crisis, the expectation is that short-term rates will continue to fall, as long as inflation remains under control. Meanwhile politics played its part in summer market volatility both in terms of worsening geopolitical risk in the Ukraine and Middle East, and the shock resignation of the Presidential nominee presumptive, President Biden. The US election remains on a knife-edge, which potentially complicates the ability of the US Federal Reserve to react to economic data in Q4 for fear it could be seen to be politicised – perhaps a driver of the steeper drop in September.

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 accelerated their expectations for the rate cutting cycle in the UK, with a greater degree of confidence now that it has begun. One-year forward rate expectations have fallen by 0.72% within the last three months.

Chart 1: Six month SONIA rate

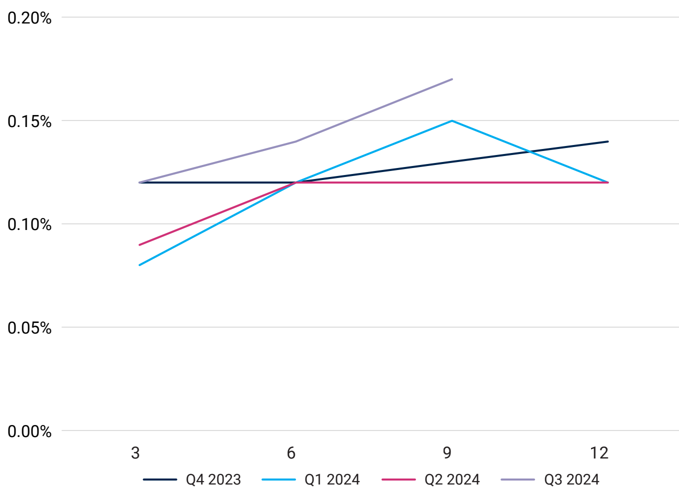


Source: Barclays Live, as at 30th September 2024

* SONIA – Sterling Overnight Index Average

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 the judicious use of dealers' positions and netted repo opportunities, Columbia Threadneedle Investments was 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 28th June 2024

The chart above does not include any data for the Q3 2024 at the 12-month tenor. This reflects the fact that market was slow to price in the expected path of rate cuts, resulting in relatively expensive repo costs and as a result we placed no trades at that maturity. Repo is typically described as a spread to SONIA as that allows comparison over time by removing base rate changes. However, it is traded as a fixed rate. If the market expectations of the monetary policy cycle are incorrect, the level is still locked in. Last quarter we described a reshuffle in appetite between varying repo counterparties. This trend has further developed over the quarter resulting in bank by bank repo balances migrating between counterparties as we seek to secure the most competitive rates for our clients.

The growth of the Bank of England's Short Term Repo facility (STR) continues apace, topping £44.5bn at its peak in September. As a reminder, this is designed to reduce the impact of Quantitative Tightening, borrowing bonds for a 1-week tenor at base rate. STR usage attracts no stigma and is described by the Bank of England as an unlimited facility. However, it is an indicator of reducing liquidity in the funding markets, reinforcing the (slowly) increasing cost of funding.

The new Bank of England levy, implemented on 1st March 2024 commences its reference period in Q4. It will sample the liability data from each of the month ends in October, November and December in order to determine individual bank contributions. Thus, counterparties will be incentivised to reduce balance sheet availability over month ends, potentially worsening availability and cost of funding, especially when taken in conjunction with year-end window dressing impacts.

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 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 less 0.05% and 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. For this to be useful 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.

We have continued to follow the development of the Bank of England's repo facility for Non-Bank Financial Institutions (NBFIs), which will go by the name of the CNRF or Contingent NBFI Repo Facility. In particular, we have provided feedback to the Bank on the operational design of the facility via both the Investment Association (IA) and Pensions & Lifetime Savings Association (PLSA). The facility is intended to provide liquidity directly to the market in times of stress and is aimed at pension schemes, insurers and LDI funds, allowing them to borrow directly from the Bank against gilt security. 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. We await further operational and pricing details and will keep clients informed as and when this becomes available. 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 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 the same across repo and TRS – this depends on the bank's view of the repo market and whether they are impacted by Net Stable Funding Ratio regulations (NSFR). 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 0.30% 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**

© 2024 Columbia Threadneedle Investments

For professional investors. For marketing purposes. Your capital is at risk.

Columbia Threadneedle Investments is the global brand name of the Columbia and Threadneedle group of companies. Not all services, products and strategies are offered by all entities of the group. Awards or ratings may not apply to all entities of the group.

This material should not be considered as an offer, solicitation, advice, or an investment recommendation. This communication is valid at the date of publication and may be subject to change without notice. Information from external sources is considered reliable but there is no guarantee as to its accuracy or completeness. Actual investment parameters are agreed and set out in the prospectus or formal investment management agreement.

In the UK: Issued by Threadneedle Asset Management Limited, No. 573204 and/or Columbia Threadneedle Management Limited, No. 517895, both registered in England and Wales and authorised and regulated in the UK by the Financial Conduct Authority.

In the EEA: Issued by Threadneedle Management Luxembourg S.A., registered with the Registre de Commerce et des Sociétés (Luxembourg), No. B 110242 and/or Columbia Threadneedle Netherlands B.V., regulated by the Dutch Authority for the Financial Markets (AFM), registered No. 08068841.

In Switzerland: Issued by Threadneedle Portfolio Services AG, an unregulated Swiss firm or Columbia Threadneedle Management (Swiss) GmbH, acting as representative office of Columbia Threadneedle Management Limited, authorised and regulated by the Swiss Financial Market Supervisory Authority (FINMA).

In the Middle East: This document is distributed by Columbia Threadneedle Investments (ME) Limited, which is regulated by the Dubai Financial Services Authority (DFSA). For Distributors: This document is intended to provide distributors with information about Group products and services and is not for further distribution. For Institutional Clients: The information in this document is not intended as financial advice and is only intended for persons with appropriate investment knowledge and who meet the regulatory criteria to be classified as a Professional Client or Market Counterparties and no other Person should act upon it.

Valid to: 31 December 2024 | WF2492498 (10/24)