INFORMATION FOR INVESTMENT PROFESSIONALS

Q4 2022 repo update

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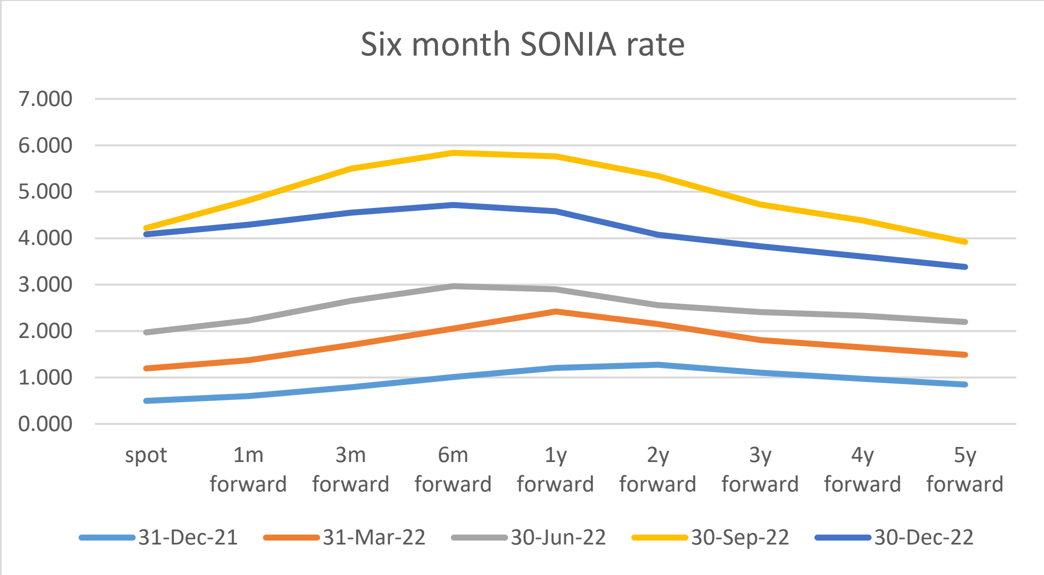
The final quarter of 2022 kicked off with a bang as, despite the Bank of England's market intervention via an emergency and temporary gilt purchasing programme, the crisis generated by Kwasi Kwarteng & Liz Truss' Fiscal Event continued to gather steam. The immediate reaction to the Bank of England stepping in was relief and a dramatic fall in yields but as Liz Truss hung in there (albeit whilst dropping each of the policies one by one) the markets simply were not satisfied, and yields climbed again reaching levels close to those seen prior to the 28th September. As yields rose and with little time to access additional collateral assets, the momentum of higher yields and hedge reductions built rapidly, necessitating further action from the Bank of England including their first ever purchases of index-linked debt. As the Bank of England's defined intervention period came to an end yet with yields still extremely elevated, the Chancellor was replaced with Jeremy Hunt who proceeded to do a full U-turn on all the previously announced fiscal measures, calming the markets and resulting in a c. 1.5% real yield fall at the 25-year point. Not long after, we had a new Prime Minister – Rishi Sunak – replacing Liz Truss as the shortest serving UK leader in history. Meanwhile the monetary tightening cycle continued with a 0.50% rate hike taking the Base Rate to 3.5% in December; and the start of the unwinding of gilt sales from the Bank of England's balance sheet in respect of both quantitative easing and the recent emergency purchases.

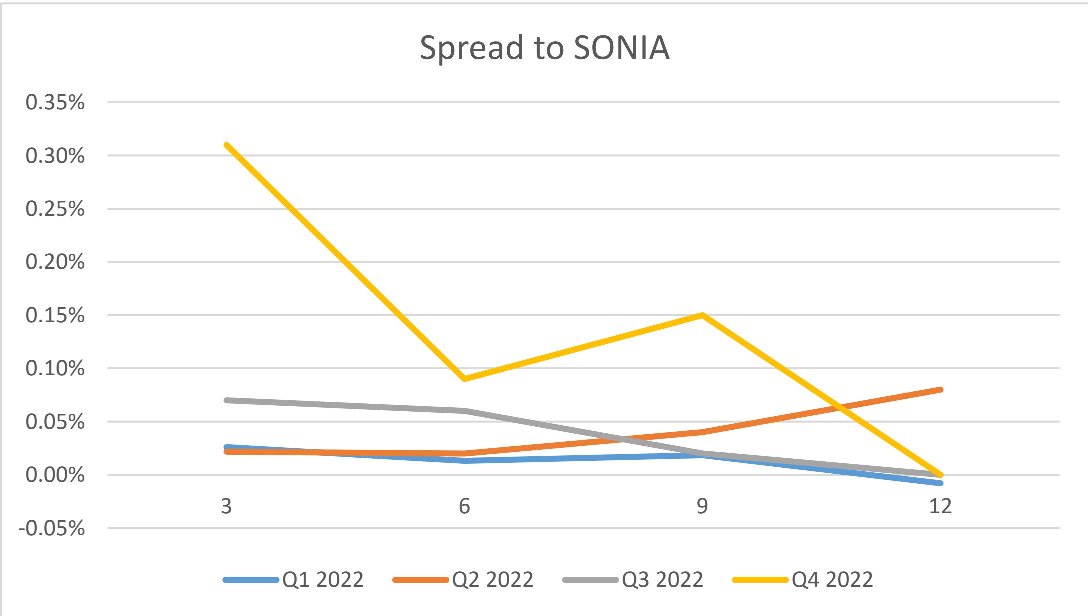
The secondary impact of the mini-Budget crisis centred around collateral and the velocity of movement; rather than a lack of balance sheet for repo funding (a la March 2020). Yet, the difficulties around collateral substitutions and settlements did in many cases prompt a review by individual banks' credit officers, resulting in a temporary reduction or hiatus in repo balance sheet provision in some cases. Once these reviews were completed balance sheet availability opened up again – some with the addition of haircuts to provide additional protection to the bank. Of course, the momentous lack of certainty in the future path of interest rates also impacted the typical repo spread to SONIA as trading a fixed rate forced the banks to take a conservative view on where yields could reach.

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, rate expectations have fallen significantly with the peak seen in June 2023 but much reduced. Note that rates are also predicted to fall at the end of 2023/start of 2024. This is due to the view that inflation may already have peaked and noting the challenge of hiking rates in a recessionary environment. One-year forward rate expectations have dropped by 1.2% within the last three months.



Source: Barclays Live, as at 30th *December 2022*

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 volatility and market uncertainty that resulted from the mini-Budget also weighed upon funding markets, particularly for shorter dated trades as can be seen from the achieved spreads below. Note that during the fourth quarter of 2022 no repos were traded with a 12m tenor so the chart reflects the previous quarter's value.



Source: Columbia Threadneedle Investments, as at 30th December 2022

The future path of interest rates has become ever harder to predict and significantly more volatile, with the consequence that banks need to increase their spread to account for the possibility of a measurable change. Intraday volatility in SONIA rates particularly at the start of October displayed a negative impact on our achieved repo levels this quarter in the main, with 0.10% swings during the day and the repo spread marked against the closing price. The commencement of Quantitative Tightening means a bias for repo spreads to SONIA to increase and come closer to normalising, as ready access to easy money has kept repo spreads suppressed for the last few years. Columbia Threadneedle Investments preferentially uses bonds that are in high demand or 'special' as primary collateral for repos, and this has helped reduce the average cost of repo with examples of traded levels around SONIA -0.40%. As the Bank of England releases these bonds back to the market and supply increases, the level of 'specialness' should reduce but this is expected to be relatively gradual, in spite of increased issuance in the 23/24 fiscal year.

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 accommodating bond and cash collateral or even credit collateral for maximum leverage flexibility. 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 pricing is very bank dependent and depending on the bank's positioning can be either 0.04% wider than repo or a similar amount tighter – this typically depends on their 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 0.03% 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.

SONIA – Sterling Overnight Index Average

All data and sources Columbia Threadneedle Management Limited, as at 30th December 2022.