INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

Q4 2023 repo update

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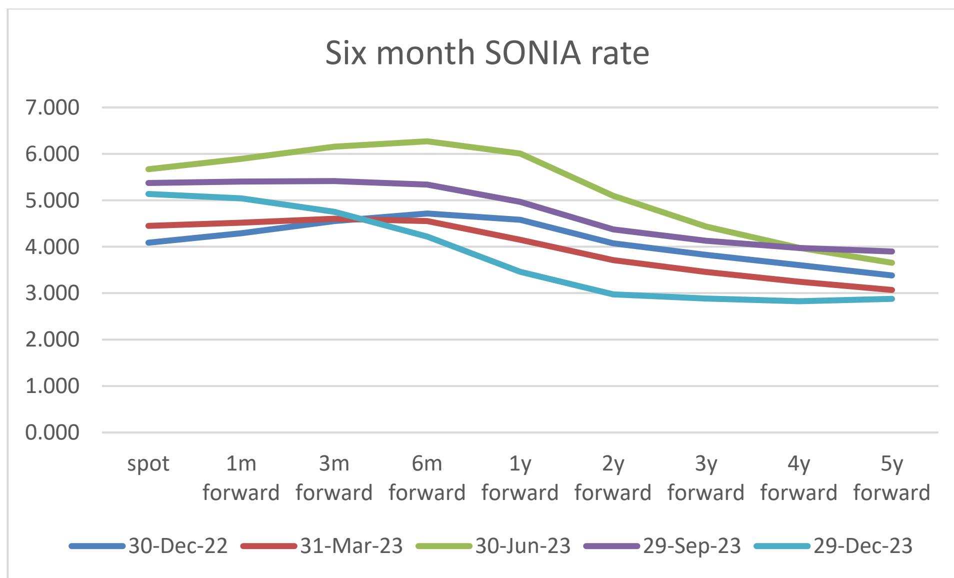
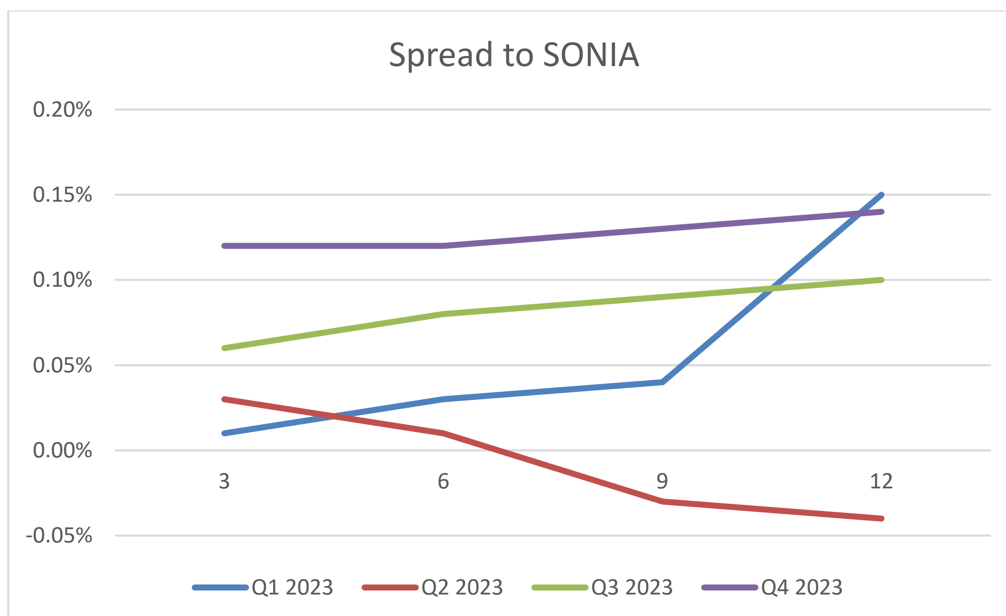
The fourth quarter of 2023 brought happy surprises, namely inflation falling faster than anticipated – thus giving central banks room to manoeuvre on the monetary front. This is especially important as growth in the UK has disappointed and some economists feel that support may be required. Inevitably, therefore, the markets priced in rate cuts, with expectations increasing that they would start sooner and go further. All this activity for front end yields had a knock-on impact to longer tenor bonds, resulting in a c.0.80% fall in 25-year real yields. Nevertheless, some believe the market has got too far ahead of itself, as rhetoric from central bank representatives continues to point to a softly softly approach to any monetary easing.

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, markets have significantly adjusted expectations of the first rate cut in the UK, which in turn has lowered longer term rate expectations. One-year forward rate expectations have fallen by 1.51% within the last three months.



Source: *Barclays Live, as at 29th December 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. Repo costs have risen over the fourth quarter, partly as liquidity continues to slowly dissolve from the system as a result of QT (quantitative tightening) and due to seasonal year-end window dressing and balance sheet constraints.



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

The fourth quarter is historically challenging in terms of balance sheet provision given the year end point and this quarter was no different. Most known funding requirements are tackled prior to December to reduce the impact of the lower liquidity; however, this year there were numerous late funding requirements which tilted achieved pricing to a slightly higher average. Despite the increase in repo costs, they remain significantly below their long-term average of SONIA + 0.25%. We expect that, as QT continues, repo spreads will continue to gently revert to this level. 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'. This effect has diminished in recent months; however, it is still possible to gain a benefit from using these bonds as a source for funding. This quarter a typical repo spread to SONIA for one of these high demand bonds was around -0.15%.

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 (IM) requirements for cleared repo; (note that swap-based initial margin requirements have also increased but not to the same extent). Recent developments have led to adjustments in the calculations thus lowering the IM requirement, however it remains extremely high at up to 50%, which compares to the 0-2% typical in bilateral trading.

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 23 counterparties for GMRA (Global Master Repo Agreement) and ISDA (International Swaps and Derivatives Association) and more are being negotiated.

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 or 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 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.

Astute readers may be aware that the Bank of England has announced that it plans to create a facility for offering gilt repo directly to non-bank financial institutions (i.e. pension schemes and insurers). This is anticipated to be a contingency facility for use in times of stress, rather than a day-to day facility, and will therefore most likely attract a higher than typical repo borrowing cost. The facility is currently in its design phase and we are in direct dialogue with the Bank on the operational details, as well as engaging with wider industry groups on the topic.

Indicative current pricing shows leverage via gilt TRS for a six-month tenor is very bank dependent but is roughly similar on average – 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 0.20% 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 December 2023*.

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