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Q4 2024 repo update

LDI | January 2025

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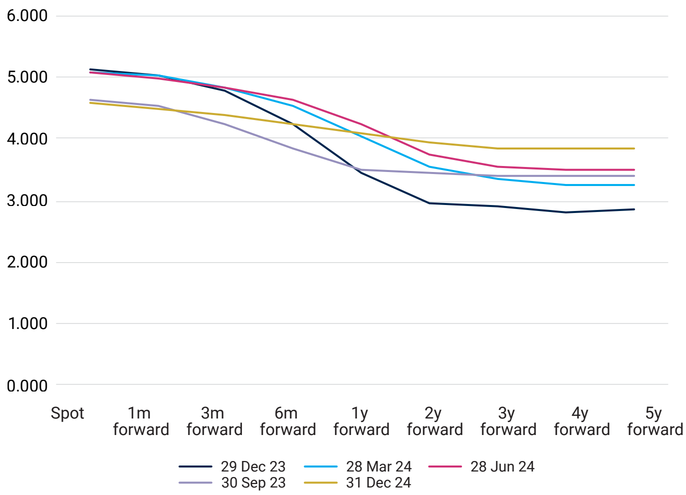
In the fourth quarter of 2024, political risk came to the fore, overtaking central banks in their impact on markets. In the UK, whilst most of the Budget was leaked prior to release, it still had the capacity to surprise, in particular with the higher borrowing burden not just in the 2024/25 fiscal year but in subsequent years, raising the issuance requirement by c.£140bn over the next five years. It was cheering to see capital investment, which all agree has been in short supply in the UK, however the positive impacts of such investments take years to come to fruition and in the meantime can raise inflation – as per the OBR's adjusted forecasts. This in turn impacts the Bank of England and their room to manoeuvre from a Bank Rate perspective; higher inflation will likely give less space to cut rates, resulting in a potentially slower and shallower monetary easing cycle. In other respects, the UK is relatively stable compared to its peers in Europe with both the French and German governments collapsing over debt profligacy. Prime Minister Barnier attempted to somewhat rein in debt, but his government fell in a vote of no-confidence, resulting in the yield on French 10-year debt briefly surpassing that of Greece; whilst the German government fell as they bid to remove the debt brake. Instability in the key nations of the EU has left a rudderless group. Meanwhile in the US, Donald Trump is now President-elect. His platform was long on promises but light on detail; once again policy will be released on X (formerly Twitter) and the threat of a tariff war is very real.

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 decelerated their expectations for the rate cutting cycle, with data and comments from MPC members pointing towards a higher neutral rate and a slower reduction in yields. One-year forward rate expectations have risen by 0.58% within the last three months, almost reverting to levels seen in the summer.

Chart 1: Six month SONIA rate

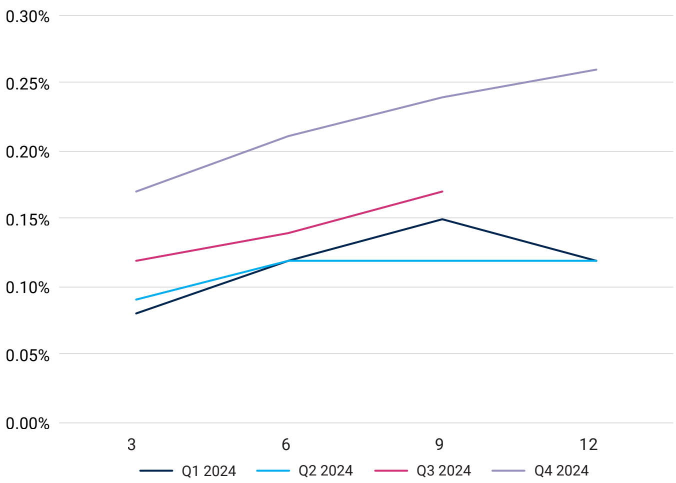


Source: Barclays Live, as at 31st December 2024

* 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. This quarter there was the added impact of year-end window dressing which pushed up repo spreads well before year-end, as banks endeavoured to reduce the regulatory impact of trading or to ensure they were compensated for such trading. However, through judicious counterparty selection and netted repo opportunities Columbia Threadneedle Investments were 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 31st December 2024

Repo spreads have risen across all tenors over the past quarter. The traditional strain in repo balances experienced in fourth quarters materialised in full force and even earlier than usual, perhaps because of the new bank levy calculations. As ever, there was a high demand for funding late in the year as clients adjusted their hedges or asset allocations to meet annual targets. By terming out repo funding early in the fourth quarter, we were able to lock-in advantageous funding rates. Whilst repo rates here are described as a spread to SONIA, it is traded as a fixed rate by convention, resulting in the realisation of prevailing trends in forward rate expectations. In prior quarters, we described a reshuffle in appetite between varying repo counterparties; this trend has persisted resulting in bank-by-bank repo balances migrating between counterparties as we seek to secure the most competitive rates for our clients.

Following the gilt crisis in 2022, 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 – 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 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. We have provided feedback to the Bank on the operational design of the facility directly and 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 a diversified suite of 24 counterparties for GMRA (Global Master Repo Agreement) and ISDA (International Swaps and Derivatives Association).

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 0.06% 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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WF2607848 (01/25)