UK Base Rate Expectations – what does this mean for LDI?

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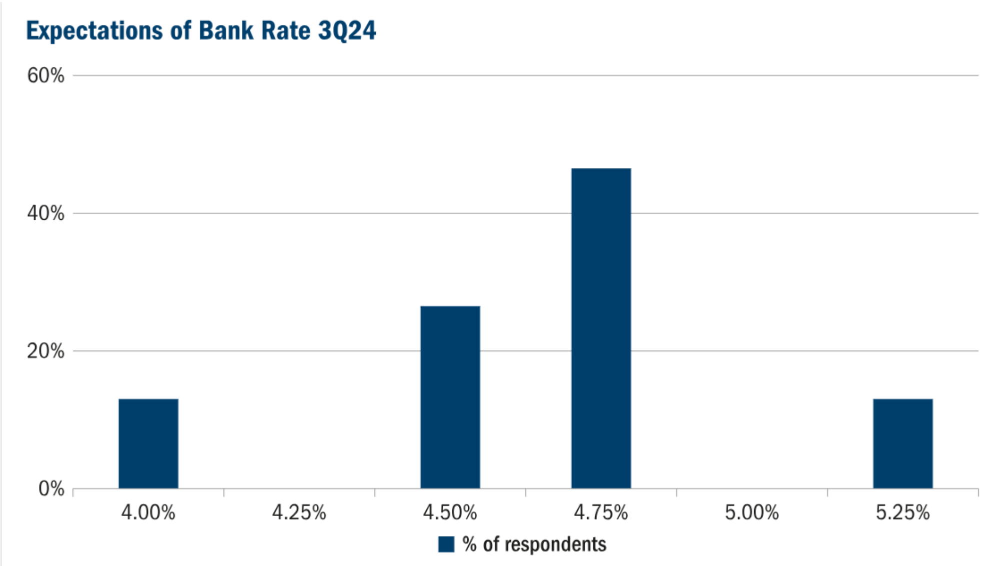
As we approach the peak of the UK base rate in this current cycle, uncertainty mounts as to the next phase and the impact it could have on longer dated yields. To that end, we asked our bank counterparties for their view of where the base rate could be at the end of the third quarter of 2024, and the results are reflected in the below chart:

Chart 1: Bank respondents' expectations of Bank Rate

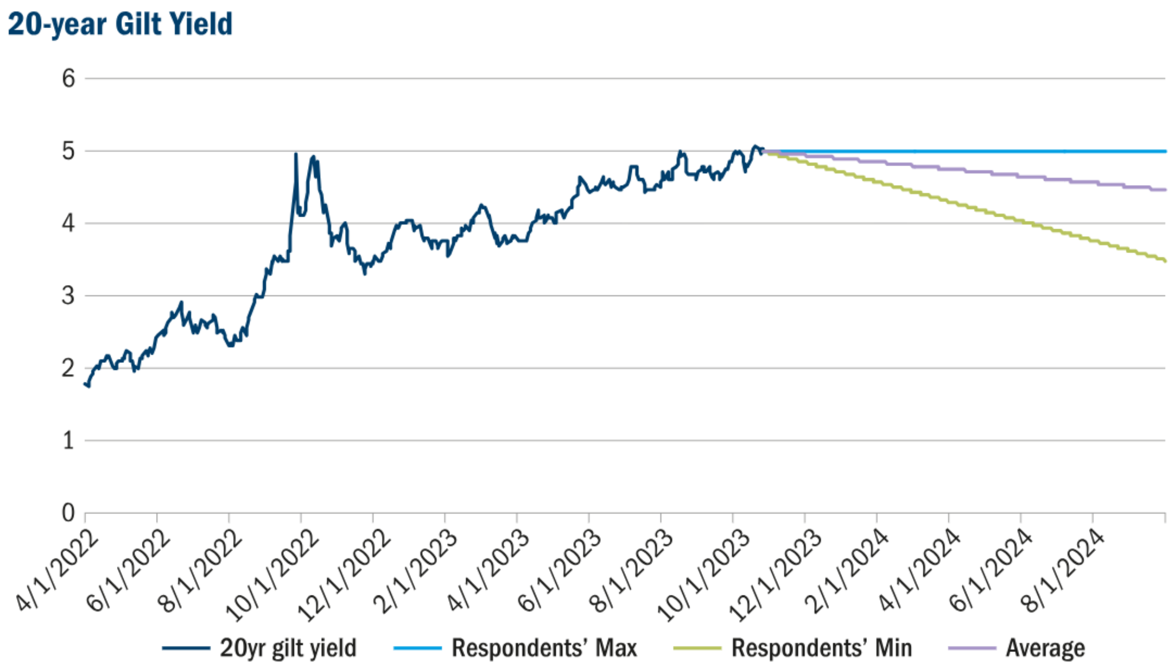


Source: Columbia Threadneedle Investments, as at *29 September 2023*

As can be seen, there is significant variability between different banks' views considering that the current level is 5.25%. The average expectation centres around 4.5-4.75% based on negative economic data and loosening of the labour market; all whilst inflation continues to fall. The Bank of England's (BoE) models are currently suggesting a 50% chance of recession, and this has resulted in a downward revision of growth estimates. Negative geopolitical developments could also result in larger or faster than expected cuts to the base rate. The risk to the consensus view is centred upon inflation persistence, which could ultimately lead to further hikes or holding at current levels for longer ('Table Mountain' analogy by Huw Pill, the BoE's Chief Economist). Key dates for reviewing the impact of wage inflation will be in the pay rounds in January and April.

For pension scheme investors, the base rate is only part of the picture. Ultimately how this feeds through into longer dated yields is what impacts the discounting of liabilities. Therefore, we also challenged our bank counterparties to predict where the 20-year gilt yield would be in one year's time; shown in the below chart:

Chart 2: 20-year gilt yield with predicted future movements



Source: Columbia Threadneedle Investments; Bloomberg as at 29 September 2023

There was a significant range in predicted levels for the 20-year gilt yield from our respondents. This is a difficult question with many factors feeding into their thought process. As above, rate expectations form part of this, but issuance schedules, quantitative tightening (QT) and global drivers must also be considered. What is interesting is the highest prediction is at today's current levels, no-one forecast an increase in yields from here and, instead, most were of the view that yields would fall over the coming year.

The 5% yield is seen as somewhat of a resistance level, as it hasn't reached levels higher than this since 1997 which for students of history is prior to the Bank of England receiving its independence. 2024 is anticipated to be a heavy year of gilt issuance which combined with a potential continuation of muted LDI demand has led to the average expected yield to be 4.5% in a year's time. However, if either or both the Debt Management Office and BoE skew to shorter maturities in issuance and QT, this would reduce the upward pressure, allowing yields to fall further.

Survey data within this report is based on responses from 15 counterparty banks.