INFORMATION FOR INVESTMENT PROFESSIONALS

COLUMBIA THREADNEEDLE INVESTMENTS

Q2 2022 repo update

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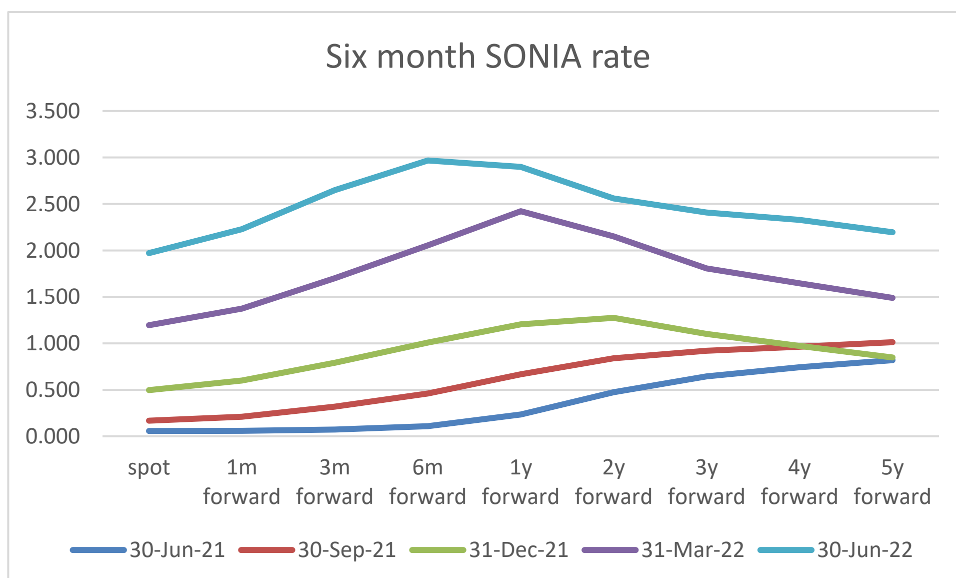
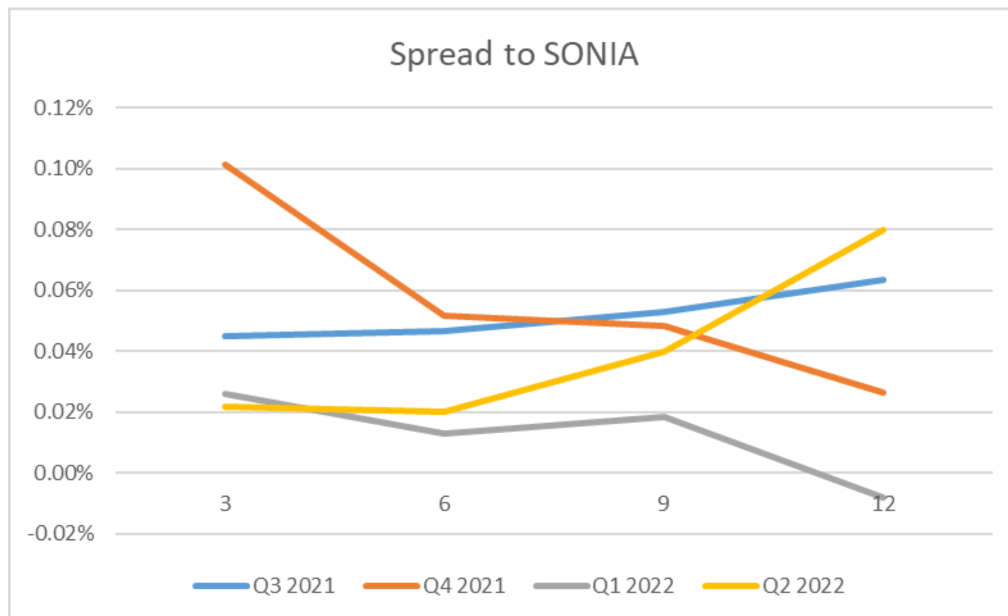
The combination of a rate hiking cycle, inflationary pressures and recessionary concerns all served to make the second quarter of 2022 a perfect storm of volatile markets and reduced liquidity. Commodities continued to outperform as the war in Ukraine persists, with little end in sight and an associated severe reduction in export volumes. The UK Retail Price Index (RPI) topped 11.7% in May year-on-year, prompting ever fiercer rhetoric from the Bank of England's (BoE) Monetary Policy Committee (MPC). So far this year the BoE has delivered continuous hikes with the market now predicting the base rate to peak at 2.8% in May 2023. There had been some expectation that the most recent hike, which brought the base rate to 1.25%, could have been a 0.50% rise instead of 0.25%. Despite the lower increase, the number of dissenters calling for 0.50% set the scene for the market to reprice higher, with the added driver of the US Federal Reserve's aggressive hiking schedule. Meanwhile, the cost-of-living crisis has developed further, with inflation in basic foodstuffs rising inexorably and another jump in the UK energy cap for domestic energy expected later this year. The UK Government has announced several measures to tackle these issues, particularly for those in most need, however it is unlikely that the current policies can close the gap. Rumours have now circulated about a possible cut to VAT and a summer of discontent looms with extensive strike action aimed at recouping at least some of the inflation adjustment via higher wages.

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. The anticipated rise is now steadier but with the peak seen at the 6m forward point. The one year forward rate rose by 0.48% over the quarter reflecting the firm tone of the MPC towards further action to combat inflation.



Source: Barclays Live, as at 30th June 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. Repo conditions remain good with plenty of liquidity available and active Quantitative Tightening still in the future.



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

Despite higher yields and margin movements resulting in a larger requirement for funding and repo, conditions have remained easy throughout the second quarter. Competition between banks has served to keep repo spreads tight to SONIA, albeit the volatility seen in SONIA has meant some variation between intraday and close pricing. As in prior quarters, the spread to SONIA for a standard bond has changed little from the third quarter of 2021, with perhaps a little more term structure (i.e. longer dated repo pricing higher than shorter dated repo) seen in the longer maturities to factor in the uncertainty around projected rate hikes. The reason that achieved repo spreads in the most recent quarter are below that from Q3 2021 is due to the 'specialness' or high demand for certain bonds, which we can therefore use for repo collateral to reduce the cost to our clients. Typical repo rates for a 'special' bond vary but have been as low as SONIA minus 0.44%, thus reducing our average repo spread to SONIA. The cause of bonds being viewed as 'special' are twofold, firstly there is limited natural supply as the Bank of England owns the vast majority in their APF holdings; secondly, as the base rate has risen, the corridor between this and the Standing Repo Facility (SRF) where banks can borrow these bonds in order to settle them has grown ever wider. However, the most recent rate hike in May held the difference between the two unchanged, thus reducing the impetus for these bonds to become even more scarce and in-demand.

Bilateral repo remains the optimal market access route for liability hedging investors. This is especially true at times such as now where the cost of bilateral repo is so low and thus there is little room for cleared repo to reduce it further. An added concern during this market cycle of higher yields and higher resultant leverage is the inefficiency of cleared repo as regards collateral. The high initial margin and haircut requirements do not compare favourably with the typical zero or <1% haircuts used in bilateral repo. This has served to put a dampener on take-up of alternative repo sources and consequently volumes remain low in such routes

as peer-to-peer, direct repo and centrally cleared repo. Electronic trading, however, is swiftly becoming the norm due to operational and pricing efficiencies. At Columbia Threadneedle Investments, our repo activity is now entirely managed via electronic platforms, bringing resource benefits to both our clients and our counterparties.

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 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 at the same level as repo on average (on a spread to six-month SONIA), although this is very bank dependent and indicative quotes provided can be much wider. 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 0.13% higher than the repo (also as a spread to six-month SONIA). However, 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

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