Briefing note

Update on the UK gilt market - 29 September 2022

Key messages:

- Against a global backdrop of rising yields, increases in UK government bond yields accelerated in the wake of the government's mini budget on the 22 September
- The speed and scale of yield rises has placed immense pressure on UK pension schemes to find cash at short notice to meet collateral calls on LDI programmes
- On 28 September, the Bank of England halted planned gilt sales and commenced the purchase of £5bn of long-dated bonds per day for 13 days, citing material market risks to UK financial stability
- This time-limited intervention has improved liquidity and reduced yields, providing a window for LDI investors to re-position portfolios and ensure they are in a strong collateral position

Bank of England restarts temporary bond purchases in response to significant rises in gilt yields and reduced market liquidity following the government's mini-budget on Friday

Technical headwinds intensified following mini-budget

A short-term boost to demand from increased spending and tax cuts, requiring a significant increase in borrowing, at a time when inflation is flirting with double digits has shaken confidence in UK assets. Fundamental concerns have been raised about medium-term inflation pressures, and the likely greater degree of interest rate rises potentially required by the Bank of England (BoE) to control inflation and inflation expectations over the medium-term. However, the technical picture has become intensely challenging as the market anticipates large additional issuance to fund the extra spending and tax cuts announced and the BoE prepares to begin the process of selling a portion of the gilts it has accumulated over successive rounds of asset purchases over the last decade or so (so-called quantitative tightening).

Impact on UK pension schemes

While higher yields are ultimately beneficial to pension schemes as they increase the rate at which liabilities are discounted, schemes with interest rate hedging placed via an LDI solution (pension schemes typically pay the floating-leg of an interest rate swap, and receive fixed interest payments, to hedge against a decline in rates and yields which would coincide with a rise in liabilities) have been required to find cash to meet collateral calls at increasing short notice as large upwards moves in yields occurred in quick succession.

Clients will have so-called collateral waterfalls in place, a pre-defined set and order of assets to be used to meet expected increases in cash collateral requirements, but these sources of liquidity will have become increasingly depleted given the scale and speed of the upwards move in rates and yields year to date, which intensified in the wake of Friday's budget. If schemes are unable to meet collateral calls, they face the prospect of being required to reduce leverage, and hedging levels, within their LDI solution. The potential for multiple pension schemes unwinding hedges concurrently within a short time frame, would result in selling more gilts into the market. This would exacerbate the existing technical headwinds noted above, placing additional upwards pressure on yields, triggering further collateral calls, and reducing market liquidity.

Bank of England response

The BoE initially issued a statement on Monday 26 September noting that they were monitoring developments closely in light of a significant repricing of financial assets but avoided any emergency action at that point.

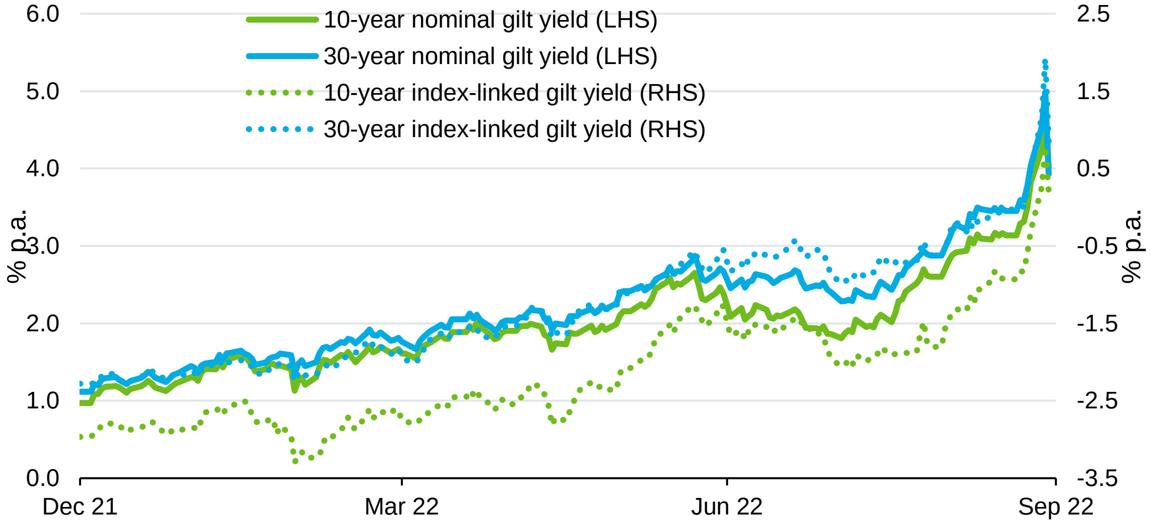
On Wednesday 28 September the BoE announced a temporary plan to purchase long-dated UK government bonds, highlighting the material risk to UK financial stability posed by dysfunction in the gilt markets. The BoE will initially purchase up to £5 bn in gilts, of at least 20 years' maturity, in the secondary market for 13 business days, ending on the 14 October. However, the BoE committed to purchasing at the scale required to ensure smooth market functioning and financial stability.

In light of this development, the BoE has also put on hold planned reductions in the stock of gilts held in their Asset Purchase Facility, postponing gilt sale auctions which were due to begin the week commencing 3 October until 31 October.

Gilt market moves

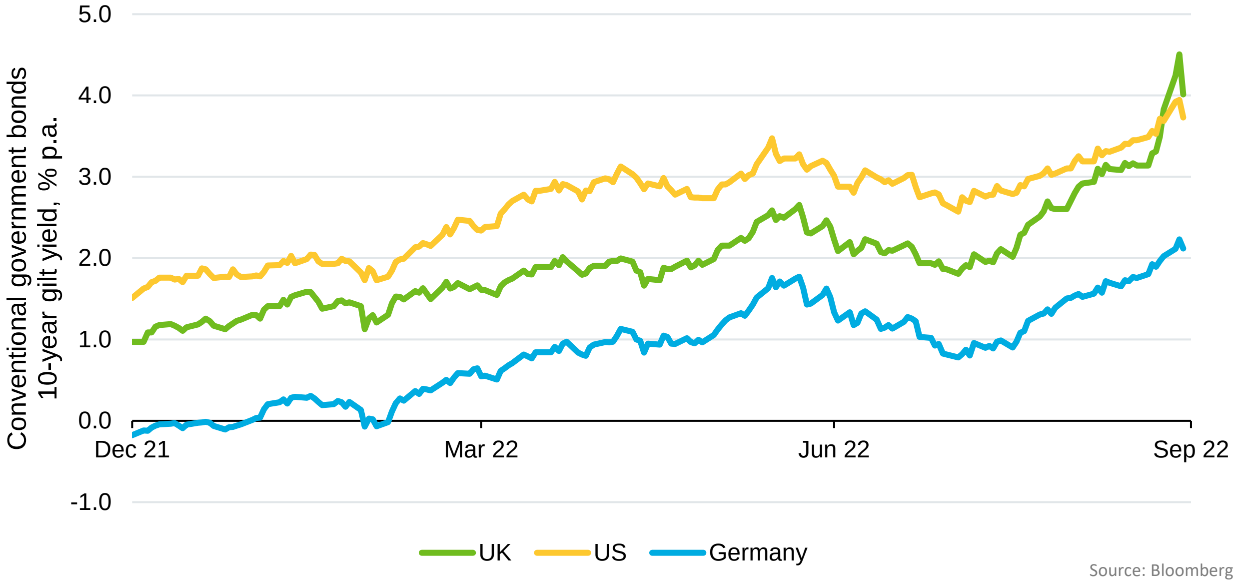
Following the Government's mini budget on 22 September, real and nominal yields rose sharply across the curve with 10-year nominal yields rising 0.6% p.a. in two days, to 4.5% p.a., and real yields rising from 0% p.a. to 1.1% by the close of business on 27 September. Larger increases were observed for longer-dated nominal and real yields (Chart 1). After the BoE postponed gilt sales and announced the re-start of long-dated bond purchases on the 28 September, market liquidity improved, and yields fell back, though remain materially higher quarter-to-date. This has compounded significant rises in yields seen year-to-date as major central banks have raised rates in an attempt to rein in high inflation.

Chart 1: Yields on UK government bonds have risen across the curve



While rises in gilt yields and falls in sterling are set against a broader global backdrop of rising yields and dollar strength, the more recent underperformance of UK bonds appears to be driven, at least in part, by the government's mini budget on Friday. As of 28 September, UK 10-year gilt yields had risen 1.8% p.a. quarter-to-date, with over 0.5% p.a. of that rise following the announcement of the mini-budget. This compares with quarter-to-date rises in equivalent US and German yields of 0.7% p.a. and 0.8% p.a., respectively (Chart 2).

Chart 2: Yields on government bonds have been rising globally but rise in UK yields has been particularly severe

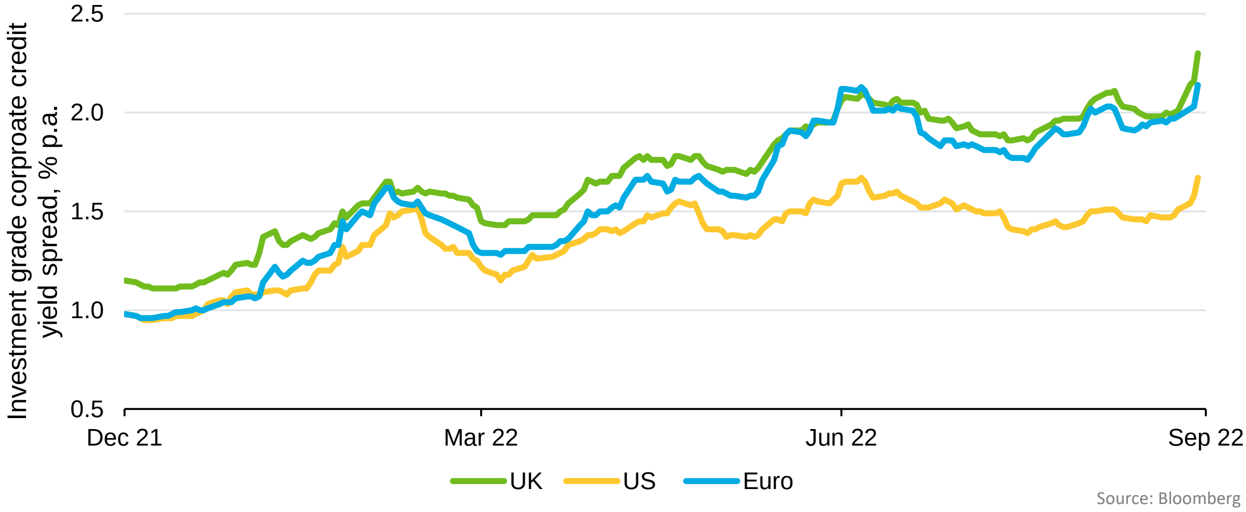


Source: Bloomberg

Wider market impacts

The selling of liquid bond and credit assets to meet collateral calls has contributed to spread widening across credit markets, which we note has not been limited to the UK market (Chart 3).

Chart 3: The selling of high quality, liquid collateral has contributed to credit spread widening



Source: Bloomberg

We anticipate there may be wider technical pressure on bond, credit, and other liquid markets as schemes continue to liquidate assets to meet collateral calls and de-leverage their LDI solutions. The most common forms of collateral – short duration investment-grade, asset-backed securities, absolute return bond funds, and buy and maintain credit funds – may continue to see acute technically-driven selling pressure in the coming days and weeks.

Next steps

The time-limited intervention by the BoE has improved liquidity and reduced yields, providing some relief with regards further urgent collateral calls. However, the BoE is ostensibly not going to support liquidity beyond this short window. It is also our expectation that LDI managers may seek to adopt more prudent frameworks for leverage management going forward to account for a more volatile gilt market environment. As such, we believe clients should continue to assess collateral sufficiency and reposition portfolios to ensure they are in a strong collateral position, with sufficient liquidity to meet agreed minimum requirements by 13 October.

We will continue to actively engage with clients over the coming days and weeks to re-assess minimum protection levels and access to liquidity, re-positioning portfolios where required, and ensuring robust processes are in place ahead of the withdrawal of emergency liquidity support. We encourage Trustees to engage with all their advisors and LDI manager, ensuring a holistic view of their scheme's funding position is maintained.

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