Liquid Insight

The pensions cavalry isn't coming. Switch 10y UK linkers into Euro issues

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Rates and Currencies Research
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Global Rates & Currencies Research
MLI (UK)

Mark Capleton
Rates Strategist
MLI (UK)
+44 20 7995 6118
mark.capleton@bofa.com

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Emerging Asia FI/FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

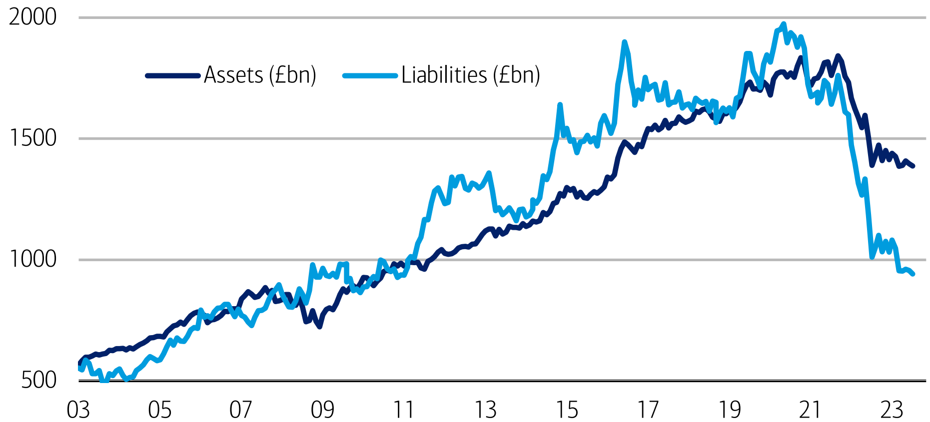
See Team Page for List of Analysts

Key takeaways

- The surge in UK DB pension fund solvency is a double-edged sword for Gilts. We don't see it arresting underperformance.
- The UK will need higher real policy rates than the Eurozone and its dependence on imported capital will also weigh.
- We recommend switching 10y UK linkers into Euro equivalents.

By Mark Capleton

Chart of the day: Aggregate UK defined benefit pension scheme solvency now in rude health
PPF7800 indices of (modelled) total defined benefit (DB) scheme asset and liability values.



Source: Pension Protection Fund

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The double-edged sword of pensions solvency

We are into the end-game for UK defined benefit pensions. Solvency hs surged, which might mean some schemes will accelerate derisking. But the overall portion left to derisk is small. And such robust solvency might mean greater tolerance for asset risk and reduced contributions. The Chart of the Day shows that DB pension liabilities have halved from the 2020 peak, so there's less to do in cash terms. As worrying is LCP's estimate that buyout activity will surge, prompting £100bn shift from Gilts to credit.

The dwindling importance of pension demand, the huge call on savings from the DMO and BoE combined, the likely shift shorter in Gilt supply (from both), the deteriorating IIP position and the need for tighter real policy rates to keep inflation in check should all contribute to materially higher 10y UK real yields relative to their Euro equivalents.

Sell 10y UK linkers to buy 10y OATei issues.

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Timestamp: 18 October 2023 02:44AM EDT

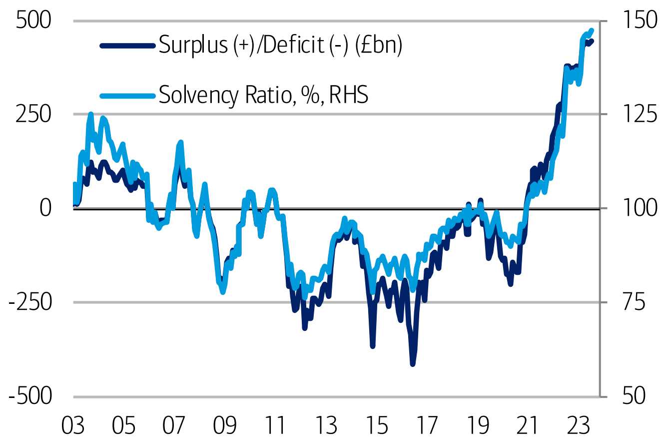
The swings and roundabouts of robust pension solvency in the UK

Another month, another record aggregate surplus reported for the UK defined benefit (DB) pension system by the Pension Protection Fund (PPF). The headline numbers for September were astonishing. The aggregate surplus of the 5,131 schemes in the PPF 7800 Index was estimated to have been £446.9bn at the end of the month, and the funding ratio increased to 147.5%. A rising tide really does lift all boats, with only 461 schemes in deficit by this measure, and the total deficit of those schemes in deficit at end September was only £2.2bn (which is frankly peanuts; the Bank of England crystalised losses of twice that in its Q3 QT operations alone).

We need to be a bit circumspect about these monthly PPF 7800 numbers, as we always say. They are modelled numbers using highly simplified asset allocation assumptions, out of necessity. And they measure the obligations as if they were taken on by the PPF (in which case payouts would be capped for the largest pensions), which reduces the liability. Even with these provisos, the swing in the solvency position (Exhibit 1) looks large given how far along the derisking "glidepath" pension schemes have come (Exhibit 2). We wouldn't have expected such a big change in solvency from what we typically think of as a now relatively well-matched pension system, even with the sharp rise in yields experienced.

Exhibit 1: PPF 7800 DB scheme solvency

Solvency ratio approaches 150%



Source: PPF

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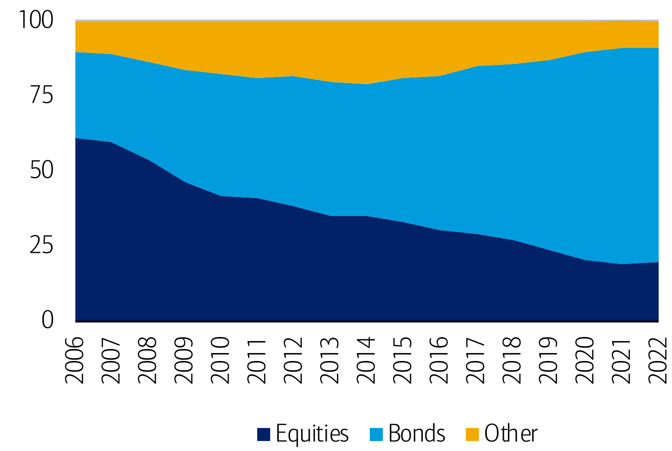
Exhibit 2: DB schemes' shift to bonds

Annual 'Purple Book' data shows bonds at 71.6% of assets in 2022.



Source: PPF/Pensions Regulator

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The debate about whether this means more Gilt buying by pension funds is akin to the economics of income and substitution effects (the 'swings and roundabouts' of our subtitle). We've said before that improved solvency might easily accelerate derisking of the as-yet unhedged portion of asset portfolios. However, that unhedged portion is a shrinking percentage of the total DB asset pool, so it's not clear whether it means more or less buying in value terms.

It's a lot more nuanced than that anyway. Such large surpluses (if they are a fair representation of reality) might increase scheme risk tolerance, softening the derisking imperative. It's also possible that surpluses allow for reduced pension contributions, which might adversely affect net buying of bonds. Perhaps the overarching adverse "income effect" is that the aggregate DB pension liability has halved from the mid-2020 peak and is now less than £1 trillion, so the market value of the unhedged "stub" of the pension system is a lot smaller than it was. The value of the hedging still to be done has collapsed.

Buyout knockout for Gilts?

Monday's press reported analysis from actuarial firm LCP which estimates that improved scheme solvency will accelerate the pace of pension schemes moving to a full buyout of their liabilities. It projects £360bn of scheme liabilities being passed to insurers over the next five years. Based on the comparison between the asset mix of hedged pension schemes and that of insurers' annuity books, LCP calculates that this five year transfer will see £100bn Gilts sold, to be replaced with spread product. Credit is more capital efficient thanks to the so-called "matching adjustment" component of credit spreads (raising the liability discount rate), and has often needed to be sourced overseas (becoming a dominant influence on long-dated XCCY spreads).

Although this does not reduce the need for duration, and linkers will continue to be almost the only source of the inflation paying needed to fabricate synthetic real cash flows, linkers will need to be sufficiently cheap on asset swap for the market to be prepared to warehouse the growing preference for inflation in swap form.

As we have mused over before, the DMO could conceivably short-circuit this market intermediation process by issuing only short-dated Gilts and paying long-dated nominal and inflation rates in the swap market, achieving its desired liability cash flow profile in a different way that potentially reduces its funding costs materially. This would give investors what they want but might raise other financial stability issues and is probably too radical to be considered.

The Gilt market will come to look more like other bond markets

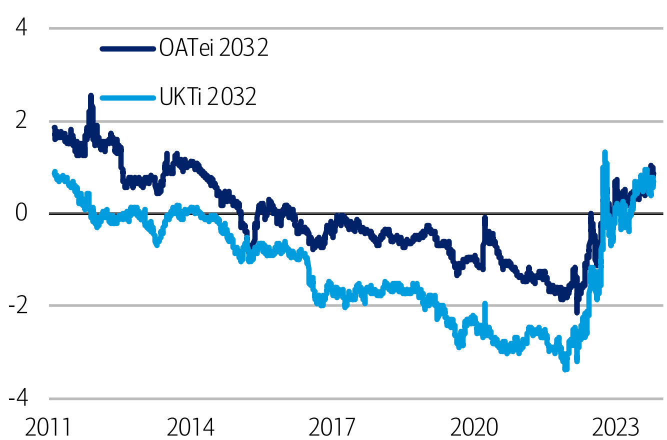
We expect this to mean that in future fiscal years, the DMO will shorten up the average maturity of its issuance further. The institutional bid for duration is not what it was and net demand for the long end is now highly uncertain. This is easily seen in the term structure of swap spreads – 5y5y Gilt yields are 57bp cheap to Sonia but 10y5y Gilt yields are 117bp cheap.

But the BoE is likely to move sooner. We have already expressed the view that the Bank of England should tilt its own QT sales shorter, for a host of reasons but primarily because the passage of time and the rise in yields has reduced the weighted average maturity (WAM) of its holdings drastically. We see this as likely as soon as next quarter.

Switch 10y linkers into Euro Area issues

If we're right, this will shift the burden of supply shorter on the curve. We also think that the cheapness of long Gilts versus swaps, the cross-currency basis swap level and the relative scarcity of long-dated credit might, in combination, mean that insurer replacement of Gilts with spread product is more prevalent shorter on the curve.

Exhibit 3: UKTi and OATei 2032 real yields converge, %
We don't think this UK underperformance is over.



Source: BofA Global Research, Bloomberg

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Exhibit 4: OATei 2032 less UKTi 2032 real yield spread, bp
Some of this narrowing represents RPI "wedge decay", given 2030 reform.

Source: BofA Global Research, Bloomberg

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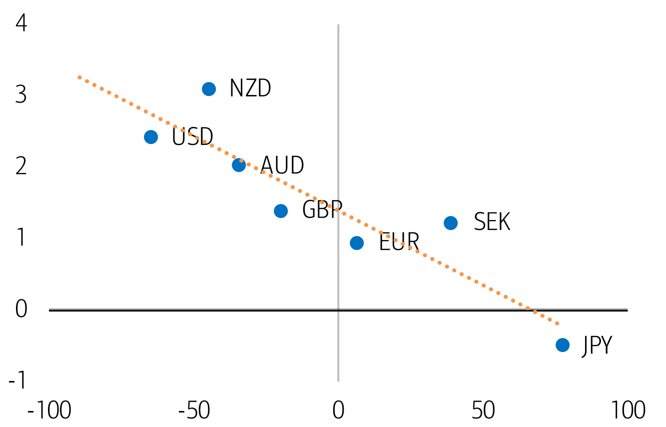
Since we maintain a longstanding bearish view of Gilts versus other markets, we would therefore prefer to express such cross market trades at the 10y point rather than the long end. So we find ourselves recommending switching 10y UK linkers into Euro linkers at what, on the face of it, look like very poor terms historically.

Why linkers rather than a straightforward nominal Gilt-Bund switch? We do believe that the UK has an inflation persistence problem that the Eurozone does not. However, whether these greater UK inflation pressures are realized is down to the Bank. We are therefore far from certain that a 10y inflation swap rate difference of 134bp is too tight, but we are more confident that the UK will need materially higher real policy rates than in the Eurozone to keep inflation in check (as was the case before the global financial crisis).

Then there is the issue of the UK's greater dependence on the kindness of strangers. We have talked before about the "home bias" issue (see for instance the Global Economic Viewpoint of 4 October 2023), whereby countries with persistent current account deficits and large net foreign liabilities need to offer higher prospective returns to attract and retain foreign capital. This is reflected in the inverse relationship between countries' International Investment Position (IIP)/GDP ratio and their real yields (Exhibit 5). The UK's IIP position is dramatically better than the US's despite a similar current account deficit persistence problem, thanks to long term weakness in Sterling (revaluing the UK's foreign assets). But if that continues to be the "cure" for an IIP problem, then that in itself should require additional real yield compensation, we would argue.

Exhibit 5: 10y real yields vs IIP/GDP ratios, %

Real yields interpolated where needed; GBP adjusted for RPI "wedge".



Source: BofA Global Research, Refinitiv

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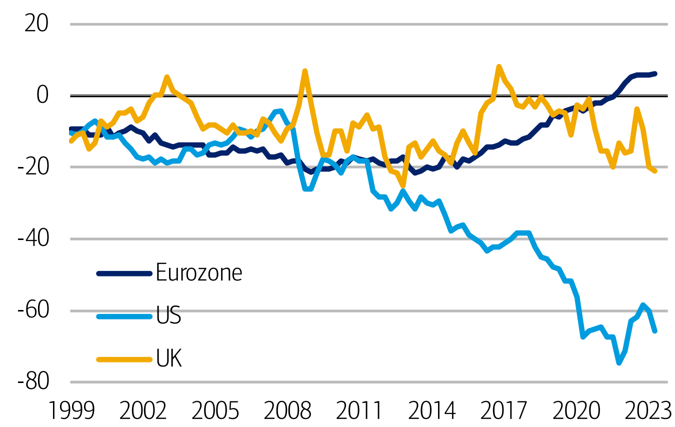
Exhibit 6: IIP/GDP histories. UK propped up by Sterling weakness

UK avoided a path like the US thanks to GBP drop, revaluing o'seas assets.



Source: BofA Global Research, Refinitiv

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The dwindiling importance of pension demand, the huge call on savings from the DMO and BoE combined, the likely shift shorter in Gilt supply, the deteriorating IIP position and the need for tighter real policy rates to keep inflation in check should all contribute to materially higher 10y UK real yields relative to their Euro equivalents.

We recommend selling UKTi 2033 (to be auctioned next week) to buy OATei 2034 at a spread of +26bp, targeting -25bp, with a stop-loss at +50bp. Risk to the trade is an increased pace of pension demand for UK linkers.

Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Central bank hopeful thinking **Global FX Weekly**, 13 Oct 2023
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US

Ralph Axel
Rates Strategist
BofAS
+1 646 855 6226
ralph.axel@bofa.com

Paul Ciana, CMT
Technical Strategist
BofAS
+1 646 855 6007
paul.ciana@bofa.com

John Shin
FX Strategist
BofAS
+1 646 855 9342
joong.s.shin@bofa.com

Vadim Iaralov
FX Strategist
BofAS
+1 646 855 8732
vadim.iaralov@bofa.com

Mark Cabana, CFA
Rates Strategist
BofAS
+1 646 855 9591
mark.cabana@bofa.com

Bruno Braizinha, CFA
Rates Strategist
BofAS
+1 646 855 8949
bruno.braizinha@bofa.com

Meghan Swiber, CFA
Rates Strategist
BofAS
+1 646 855 9877
meghan.swiber@bofa.com

Europe

Ralf Preusser, CFA
Rates Strategist
MLI (UK)
+44 20 7995 7331
ralf.preusser@bofa.com

Ruben Segura-Cayuela
Europe Economist
BofA Europe (Madrid)
+34 91 514 3053
ruben.segura-cayuela@bofa.com

Mark Capleton
Rates Strategist
MLI (UK)
+44 20 7995 6118
mark.capleton@bofa.com

Athanasios Vamvakidis
FX Strategist
MLI (UK)
+44 020 7995 0279
athanasios.vamvakidis@bofa.com

Sphia Salim
Rates Strategist
MLI (UK)
+44 20 7996 2227
sphia.salim@bofa.com

Kamal Sharma
FX Strategist
MLI (UK)
+44 20 7996 4855
ksharma32@bofa.com

Ronald Man
Rates Strategist
MLI (UK)
+44 20 7995 1143
ronald.man@bofa.com

Michalis Rousakis
FX Strategist
MLI (UK)
+44 20 7995 0336
michalis.rousakis@bofa.com

Pac Rim

Adarsh Sinha
FX Strategist
Merrill Lynch (Hong Kong)
+852 3508 7155
adarsh.sinha@bofa.com

Janice Xue
Rates Strategist
Merrill Lynch (Hong Kong)
+852 3508 8587
janice.xue@bofa.com

Shusuke Yamada, CFA
FX/Rates Strategist
BofAS Japan
+81 3 6225 8515
shusuke.yamada@bofa.com