VAN LANSCHOT KEMPEN

INVESTMENT MANAGEMENT

The age of the Net Seller

Is the future of the UK bond market at stake?

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FOR PROFESSIONAL INVESTORS ONLY

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Executive Summary

Background

Pension schemes have been wedded to the use of UK government debt (gilts) because of the actuarial and accounting valuation metrics used in the industry. The appropriateness of this is well debated amongst professionals and not an argument for today, but importantly it has created - until now- a very large demand for gilts.

Our analysis in the 2020 paper "the Tipping Point" showed there were insufficient gilts in the market for all the buyers to meet their needs, creating an artificial bubble in these prices.

Age of the "net seller"

Since then, there has been a seismic shift in market dynamics within interest rates and the UK bond market.

Going forward, the net supply of gilts is expected to be nearly 3x the average of the last 10 years. Importantly, gilts will no longer find the same scale of automatic demand from key investors (BoE, UK schemes or insurers) who may now instead be net sellers of gilts (and corporate bonds). New, price sensitive, buyers will need to replace the old relatively price insensitive buyers, and that does not bode well for volatility.

More significant implications may be created by this shift, for example the issuers of GBP corporate bonds may increasingly look to issue overseas instead (following a trend seen in the equity markets), resulting in a further diminishing role in global importance of the UK capital markets. The solution to these trends will likely span successive governments, the current which has already embarked on ambitious proposals to change regulation (both Pension's "Mansion House" and Insurance Solvency II).

Implications for trustees

1. We believe savvy trustees should reconsider their portfolios today, ensuring suitable liquidity to weather a more volatile domestic bond market. But this is the obvious response, and hardly insightful.

2. More importantly, trustees should critically reassess their long term objective. Even those aiming for insurance should consider how the enormous market forces in play in this paper can be put to their advantage.

For those that are fully funded already and willing to run-on for a while longer (and use surpluses for members and sponsors to enhance value to UK plc), why be tied to assets if you expect them to lose value? After all, if the value lost from investing in UK bonds is no longer a mark to market effect, but true value possibly lost forever it suddenly becomes far more important.

Background

Concentration & scale

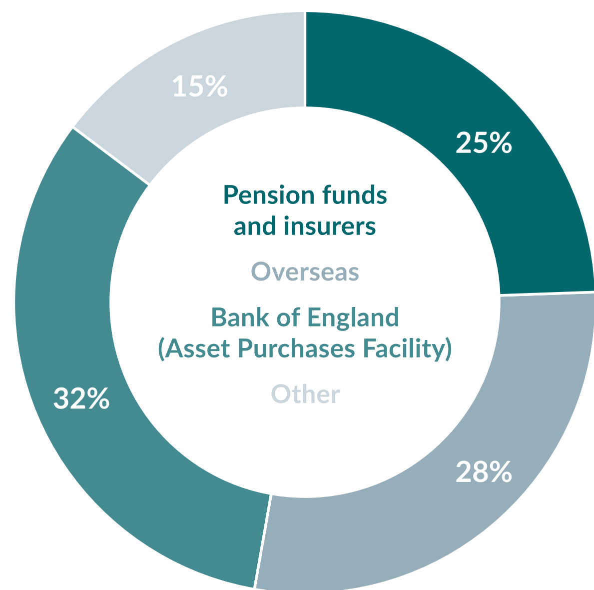
The UK gilt market is large – around £2.0 trillion (June 2023, DMO). Around a quarter is index linked, with the rest being conventional fixed income debt.

Its holders display a level of concentration – the UK has been largely funded over the past decade or two by a concentrated domestic group, with over 50% of its assets held by the BoE, UK pension funds (particularly private DB schemes) and insurers.

This concentration means that changes to the buying behaviours of these groups will have significant knock-on ramifications for the entire gilt market.

The UK Corporate Bond Market is far smaller in relative terms, at around £500bn (S&P, 31 August 2023). It is harder to determine the precise holders of a much broader market, but it's reasonable to assume a strong domestic bias from pension funds and insurers.

UK gilt holding by type

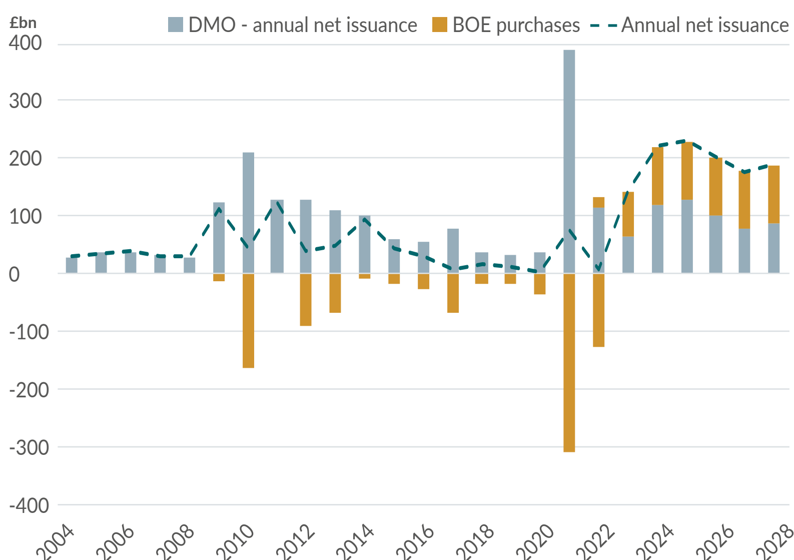


Source: DMO. Data as at 31 March 2023

Net supply of UK gilts

The UK Government is expected to run a substantial deficit over the coming years. Net gilt issuance from the DMO will be high (£120.8bn for the current fiscal year) and forecasts expect it will remain high with over £500bn of new net issuance expected by 2028. Accounting for the impact of the BOE's expected sales (which are more "optional" than DMO issuance and covered in the next section), it is expected that over £1trn could flood back into the market. Looking forward, the chart shows that net supply could **over 3 times the average of the last decade** – with the BOE no longer acting as a back-stop buyer with Quantitative Easing.

Net supply of UK gilts



Source: VLK, BOE, DMO

With all this new supply flooding the market, ideally those key market participants, who have been large buyers of gilts in the past, would want to add to their gilt holdings to absorb this greater issuance.

However, we now expect an imbalance between higher supply and lower demand in market:

- Key, domestic buyers are now aggregate sellers of gilts (notably the BoE, pension funds and to an extent, insurers). Historically they have been buyers who were relatively insensitive to price.
- New buyers will need to be found to meet this glut of supply of UK bonds (new issuance and the net sales noted above) – these new investors are likely to be highly price sensitive, have less bias in favour of the UK and so, as with any asset, **the price of gilts may need to fall (yields rise)** until their demand meets this increased supply.

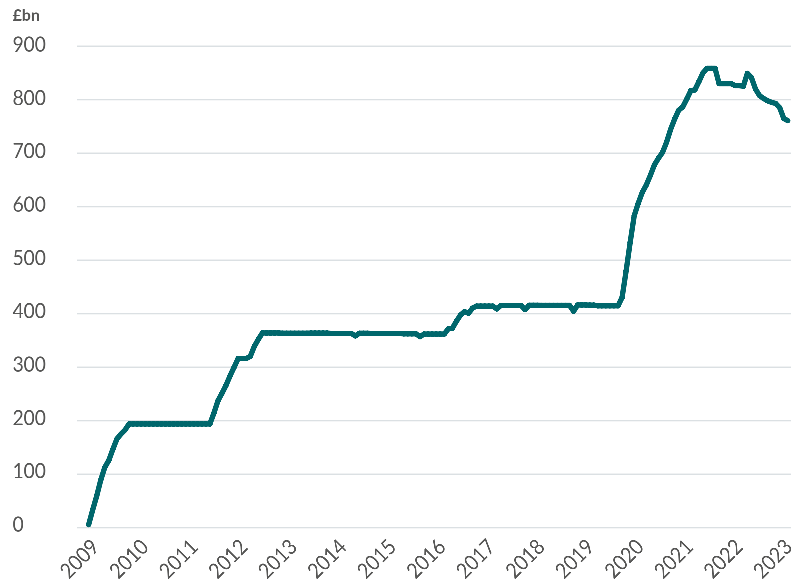
Analysis

1. Bank of England - enter quantitative tightening

The BOE's direct influence on the gilt market is very strong today, as since 2009 the BOE has pursued a policy of buying domestic government bonds to stimulate the economy, aka Quantitative Easing.

At its peak the Asset Purchase Facility ("APF") held nearly £900bn of UK gilts. This facility currently stands at approximately valued £758bn (as at 20 September 2023) – a combination of the BOE selling gilts and falling values as yields have risen over the last 18 months.

Bank of England - APF Holding

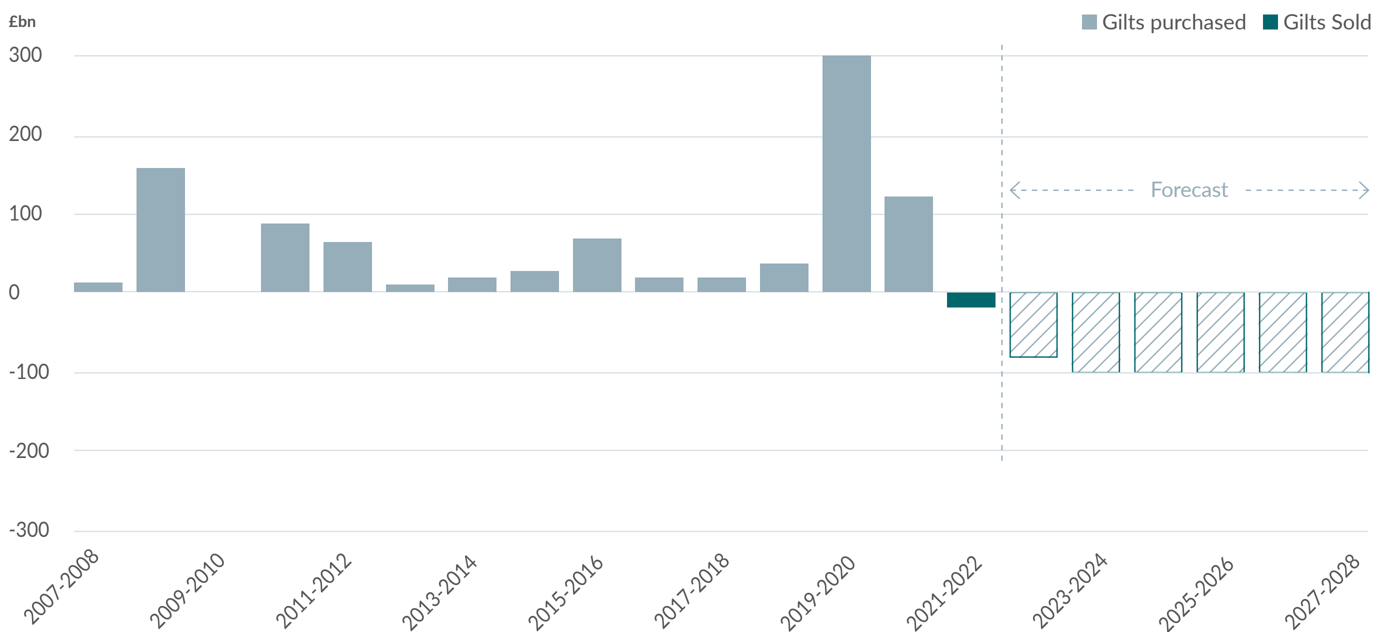


Source: VLK, BOE

In response to mounting inflation, the BOE started to raise rates and simultaneously began a period of Quantitative Tightening (reducing their holdings of UK gilts). The size of the reduction is significant and in September 2022, the BOE voted to reduce holdings by £80bn over the next 12 months.

Recently at the September 2023 meeting, they agreed to further reduce their holdings by £100bn over the period from October 2023 to September 2024.

Bank of England activity



Source: VLK, BOE

What is key?

- **Amount held by BOE** - The BOE holds approximately a third of all gilts in issuance and doesn't want to be holding them forever. It is looking to sell them back into the market.
- **Multi-year sales** - Any sales are likely to happen over a number of years and represent a medium-term structural trend in the market (and mass sale would significantly distort prices and be a danger to market stability).
- **No longer significant buyer** - Whilst the speed of divestment is important for the price of gilts, the big picture is the BOE will no longer be a significant buyer of new issuances – i.e. DMO and UK Government has lost a guaranteed source of funding for its new issuances.
- **Further pressure to issue more** - The BOE will not be overly concerned that these bonds are worth less than they paid for them, as they are supported by the UK Government, although at some point political pressure may arise if there are significant "losses". This is important: the BoE is itself immunised from losses on its holdings – the Government must make good such losses that might otherwise have occurred, which creates further pressure to issue new debt!
- **Material change in trend** - In 2020 all **new supply was effectively being absorbed by the BOE.** New issuance therefore will need to find new buyers, likely pushing prices down until alternative buyers are found at a price they will accept.

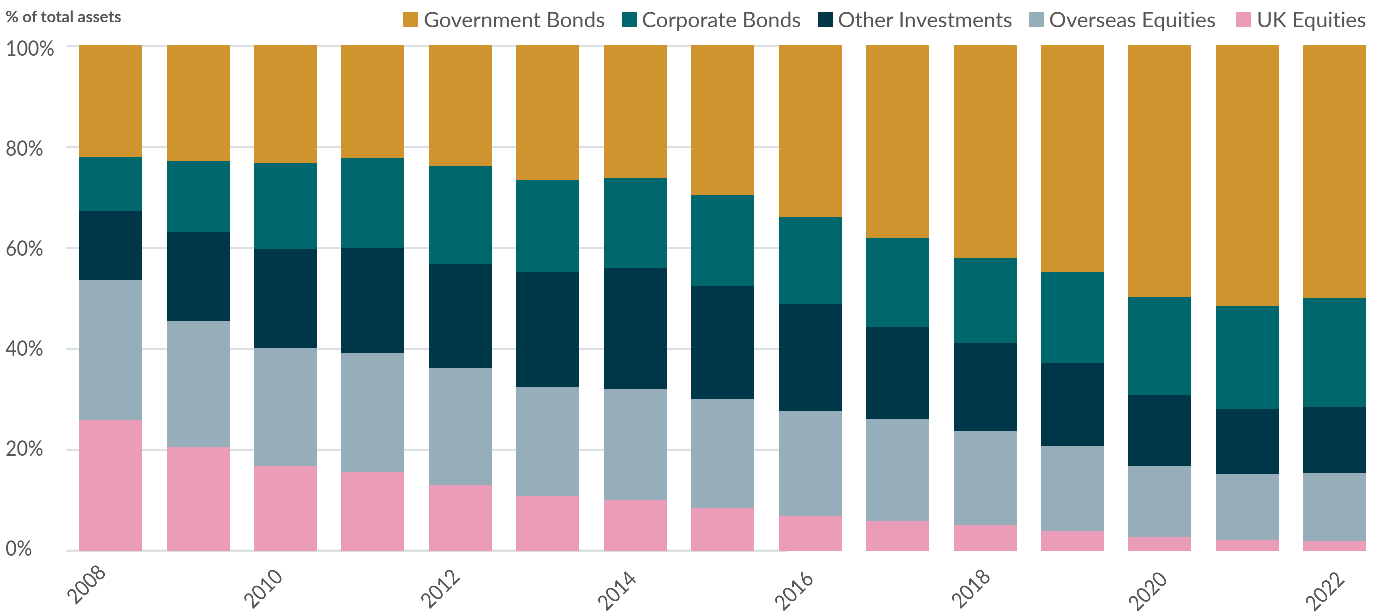
2. Pension funds - lowering demand

Defined Benefit ("DB") pension funds, most with a gilts derived actuarial discount rate, were natural investors in gilts. Investment in them offset an accounting risk associated with their ability to match the valuation of their liabilities.

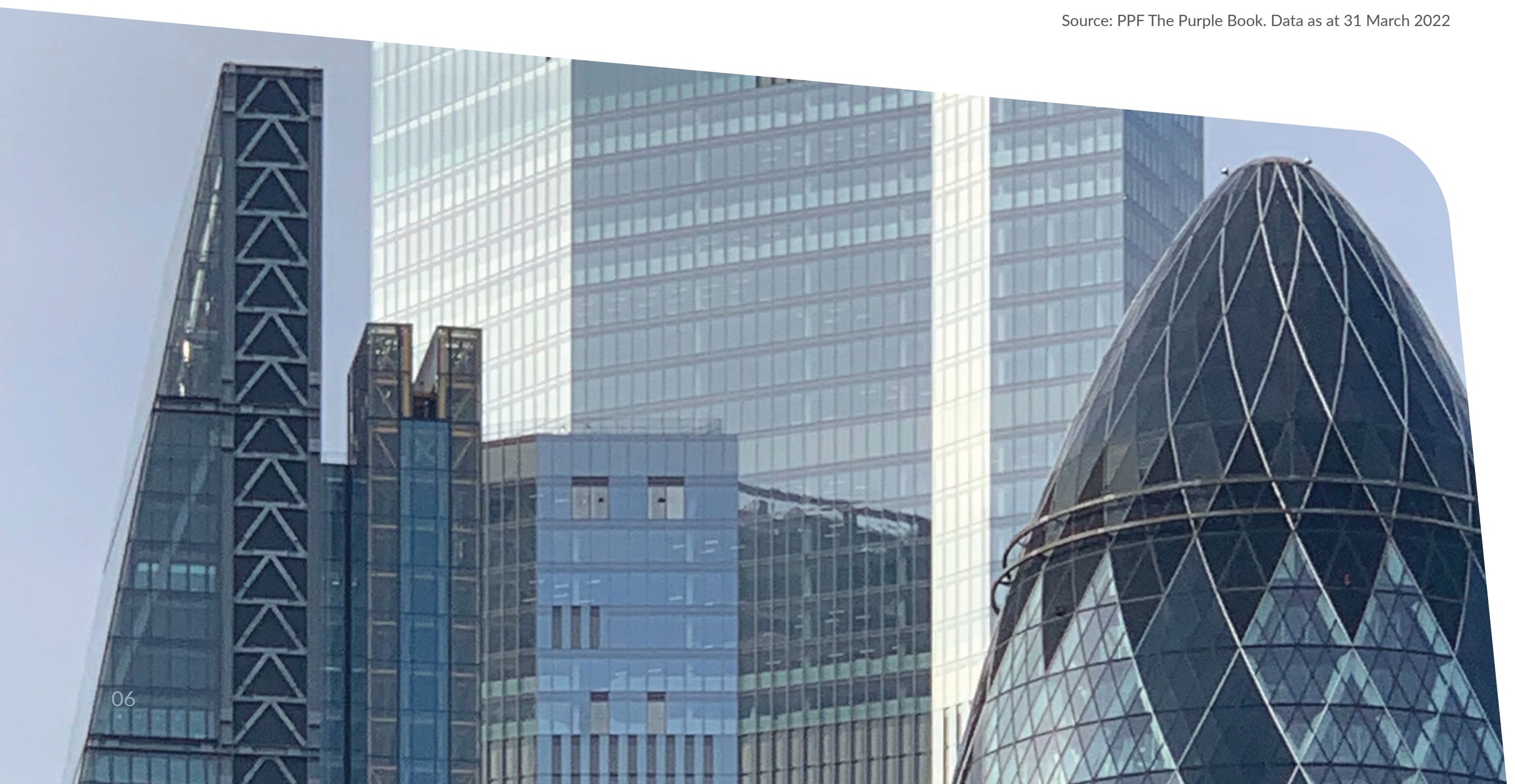
In 2023, around 70% of all their assets (this is equivalent to c£1 trillion) were invested in bonds – of which £750bn were gilts and the remaining £250bn in corporate bonds (source PPF Purple book).

These allocations have been increasing over time as a natural consequence of better funding ratios and ageing membership. These increases in bond holdings had come at the expense of higher returning assets, or in Mansion House speak, "productive assets". A related trend away from UK equities for global equities can also be clearly observed in these charts.

DB pension schemes - asset allocation



Source: PPF The Purple Book. Data as at 31 March 2022



Given strong demand from pension schemes and supply limited by DMO issuance, it created a dynamic which inflated gilt (and particularly the scarcer index-linked gilt) prices.

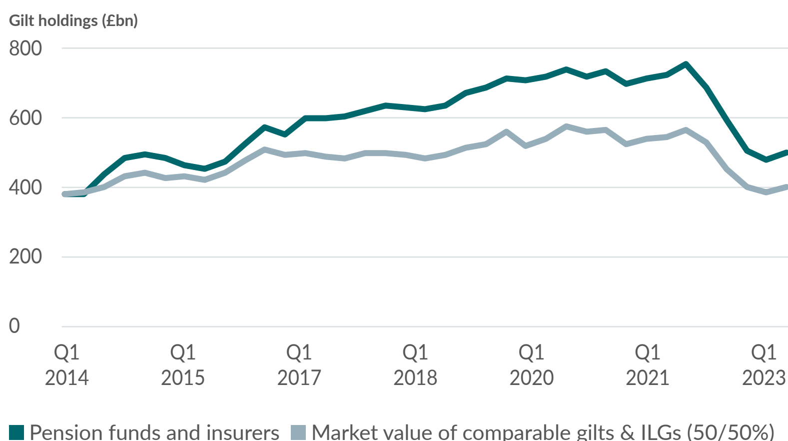
However, we believe this trend is likely to slow (at best), or most likely reverse for the following reasons:

- **Ability -** with 70 % of assets invested in bonds already, pension schemes allocations are already "bond heavy".

- **Need for more bonds is declining -** schemes held bonds (primarily) to hedge liabilities; these reduced by around a third post LDI crisis (£2.4tn to £1.5trn on an insurance buy-out basis). We estimate schemes now only needed a maximum of a further c.£400bn of bonds to hedge themselves against the interest rate and inflation sensitivities of their insurance liabilities. Importantly this represents a significant reduction in estimated need from the £1.3trn of bonds demanded in our 2020 paper.

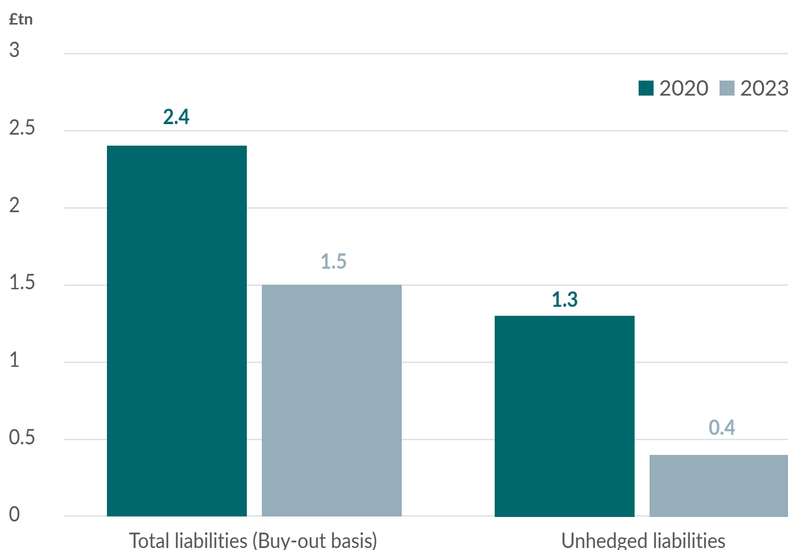
- **Impact of switching to insurer -** many schemes will switch to insurance and these assets are likely to be removed from pensions industry bond holdings. It is estimated around £300bn of assets will move from pension funds to insurers over the next 5 years. At the point of buy-out it is expected most schemes would be almost entirely invested in bonds and cash. As a result, we are unlikely to see significant £ bond holding increases in pension schemes – as any new bond investments are offset by assets flowing to insurance.

Change in UK gilt holdings



Source: VLK, DMO & Bloomberg

DB schemes - change in liabilities



Source: PPF & VLK calculations. Data as at June 2023

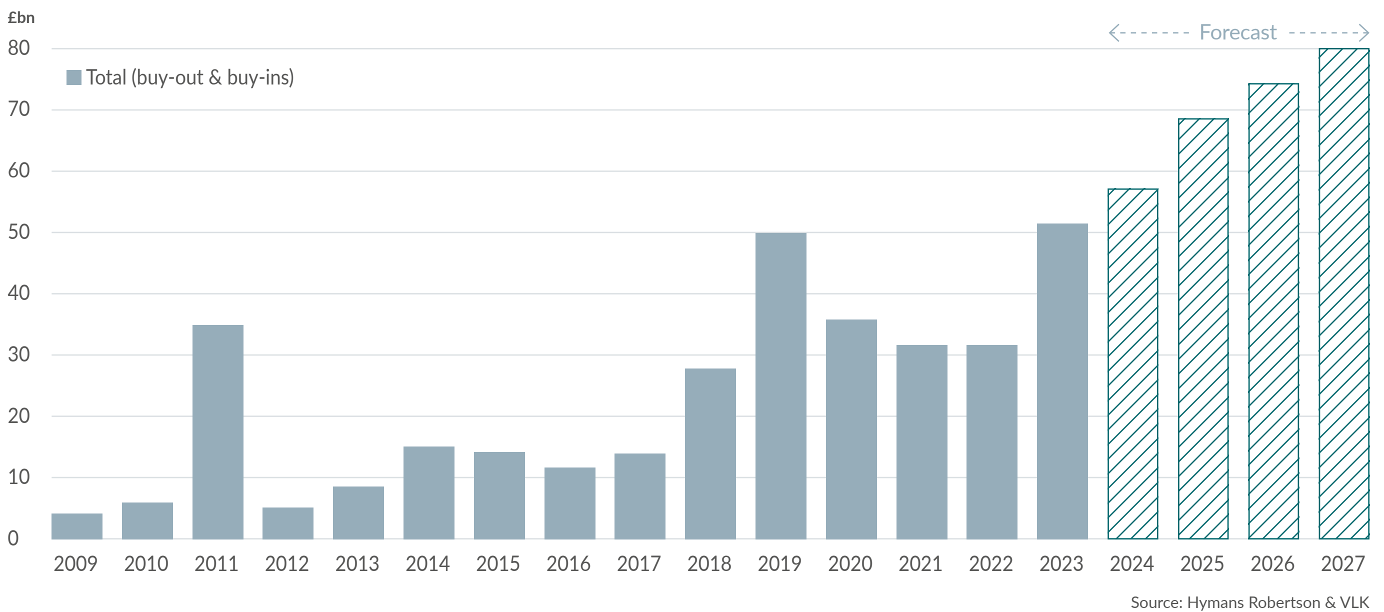
3. Insurers - increased risk transfer activity

Given the improvements in pension funding, this year is expected to be the highest in terms of bulk annuity deals, with over £20bn already concluded in the first half of 2023. It is expected that annual bulk annuity volumes has the potential to reach £70bn p.a. over the next few years.

Schemes nearing buy-out are likely to have asset allocations dominated by gilts and investment-grade credit. Insurers, with different time horizons, risk/return profiles and being subject to Solvency II regulation (which makes certain assets more attractive than other) will not have the same bias to gilts.

In simple terms, it is likely insurers will sell a material amount of the gilts they receive. Over the next 5 years if insurers received £300bn of pension assets they might reasonably disinvest around **£100bn+ of gilt holdings to buy higher returning assets which satisfy their own requirements.**

Insurer - bulk annuity activity

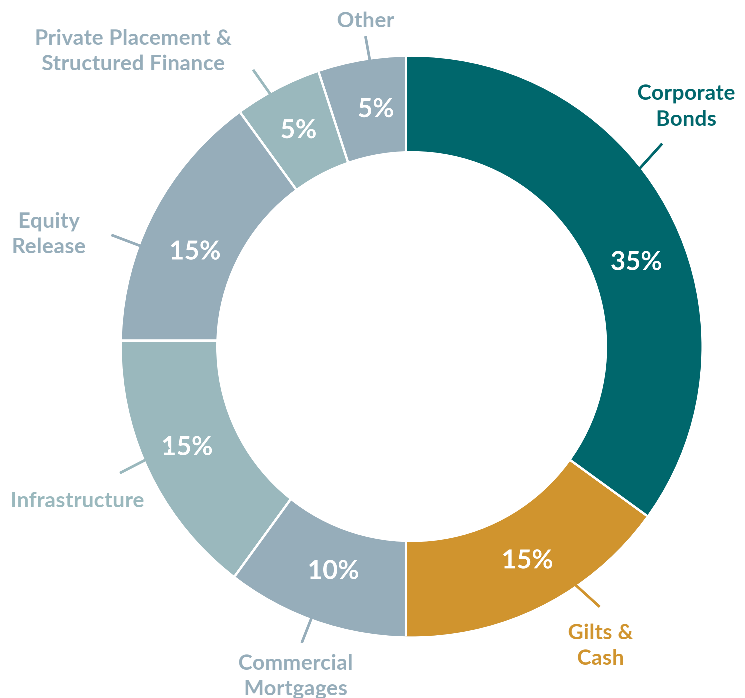


Source: Hymans Robertson & VLK

Potentially more relevant from a Mansion House perspective is the impact on the UK Corporate credit markets. Whilst insurers may on average keep the same broad amount of assets in corporate bonds, they tend to be more diversified by country than pension schemes (which focus on UK credit).

Assuming a UK 50% overseas split for an insurance portfolio this move **would see £50bn+ leaving UK credit markets**. Less demand would increase funding costs for these assets at a time when they have already increased sharply due to higher cash and government bond yields, which corporate issuers typically pay a margin above.

Asset Allocation - example pension insurer



Source: Hymans Robertson Risk Transfer Report 2023

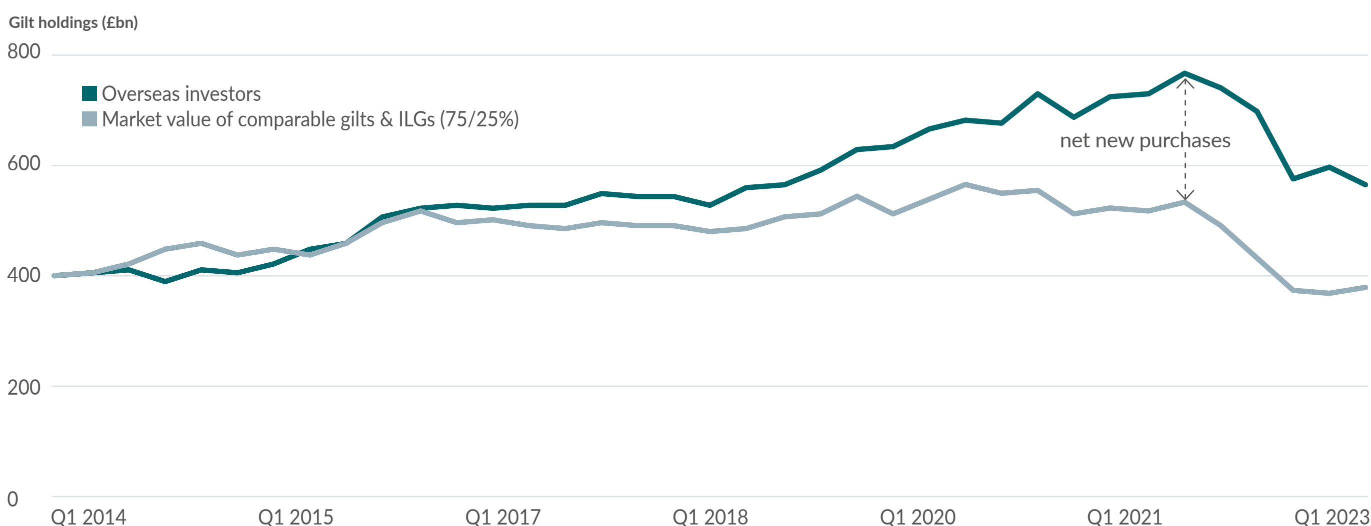
4. Foreign investors - what impact could they have?

Whilst not a core domestic market, we comment on overseas investors as a material holder (and probably the group to fill lost demand within the UK). Overseas investors are typically attracted to gilts based on views on UK yields, currency, inflation and an element of politics (overseas governments hold reserves in a number of currencies) and had been largely increasing their allocation to gilts over the past decade (shown chart below).

However, there are some caveats. Firstly, overseas domiciled (e.g. Irish) LDI funds are considered overseas investors in these figures – as a result the long-term true overseas investor demand trend is somewhat muddied by UK domestic pension demand via Ireland.

Further, the amount of demand and forces at play are hard to predict. Overseas investors have been "net sellers" of gilts since the start of 2022. This has been partially attributed to the perceived fiscal instability of the UK market. The current price of gilts is not yet enough to convince these investors back to the market.

Foreign Investors - change in UK gilt holdings



Source: DMO, Bloomberg & VLK

A turn away from London?

Market stability, Mansion House and an all-party political issue

All of this highlights a potentially seismic shift in the UK bond market – it is likely that gilts will no longer find as willing a set of relatively price insensitive buyers. Worse still, many historically reliable buyers of new gilt issuance are now net sellers looking to reduce exposures. For UK corporate bonds a not too dissimilar story can be told. Price, and resultant funding cost for UK Plc, will need to change as these forces play out.

Thinking to the Mansion House speech, significant focus was placed on how to make the UK pension assets more productive, but importantly without risking wider financial stability as a result of pension schemes taking excessive investment risk.

However, it potentially missed the risk of a growing accelerating trend facing a bedrock of financial stability in the strong UK gilt and corporate debt markets. Put equities to one side; any action which exacerbates this trend in the most fundamental part of capital markets would need to be carefully considered in this context. For example if bonds are encouraged, at scale, to be re-allocated to more productive assets (domestic equity, venture capital and so on) it could worsen this emerging net seller trend.

Any objectives of Mansion House reforms ought to be focussed on how to address a potential loss of stability in the far more important debt markets. If the UK government or UK Plc can no longer issue debt cost efficiently this may have far more serious implications for growth than would be outweighed by more "productive assets".

UK gilt market

The government ideally needs a strong and well subscribed gilt market – as this will keep yields (relatively) suppressed, avoiding a larger cost to society for the large debt to GDP ratio it holds. Ultimately it is likely the UK would find new net buyers of gilts, however they will likely demand higher yields as compensation. Therefore it is in the UK government's interest to avoid loss of capital in these markets. At best that would lead to increased costs, but at worse would undermine the stability of the entire UK capital market.

Corporate debt

More concerningly for the UK corporate bond market, there is a real danger the debt market follows the equity market in slowly becoming a backwater which investors shun in order to raise debt in bigger, cheaper and more liquid markets such as the Eurozone or US. As UK gilts yields increase so does the cost of issuing in the GBP and this may impact on which markets large corporates choose to issue their debt.

Summary

Importantly, if the reduction in capital in domestic bond markets is likely to be a longer-term trend, a single one-off fix is unlikely to rectify the issue at hand. The answer may not be simply to force UK pension assets (e.g. via Mansion House follow-ups) or insurance assets (UK government intends to tweak Solvency II) to allocate more to domestic markets, but could be aware of other new investors to fill the gap they leave (other forms of pensions in the UK, global pensions, individuals, foreign investors and so on).

The first step would be to appreciate that an issue exists.

Net seller effect

Asset	Market size today	Net seller effect (next 5 years – cumulative)	Future issuance
Gilts	£2trn	1) 500bn sales from BOE 2) £100bn sales from pensions & insurance	£500bn + of issuance by 2028 and no net buyers from pensions / BOE / insurance
Credit	£500bn	£50bn + from pensions and insurance switch	Dependent on cost of issuing – many issuers could look to raise funds in overseas vs UK if cheaper

Source: VLK 2023

How could this trend play out?

As with all structural trends, shorter-term market factors will influence the daily price of assets; recession fears, inflation, central bank policy etc and other factors will come into play (UK economic performance etc). However, longer-term effects should be considered across a number of scenarios.

Scenario 01

CENTRAL CASE
UK bond yields slowly push higher

- Government continues to issue over £500bn of debt by 2028
- Pension schemes / insurers reduce gilt holdings by £100bn; BOE does little and holds its reserves
- UK net credit holdings decline by £50bn
- New buyers are found but demand a higher premium on yields
- Mansion house reforms have little impact and Government fails to address long-term issues

IMPACT & ACTION

- UK cost of new debt increases as a result of higher yields
- UK gilt market becomes more volatile due to structural changes in market dynamics
- UK corporate credit market slowly shrinks as corporates find it cheaper to issue in other markets
- **Pension scheme deficits continue to shrink and transfer to insurers – in the coming years at rates suggested in this paper – those that expect to reach buy-out later, or are exploring alternative exit avenues such as consolidation, could benefit most as the net seller effect translates into pricing**

Scenario 02

BEST CASE (for gilts)
Stability remains and yields fall

- A combination of recession, good economic performance and slowing trend towards insurance finds natural replacement buyers of all UK bonds
- Yields fall modestly towards long-term levels (but not the effectively zero rates seen 2008-2022)
- Investor sentiment towards UK equity and debt markets improve
- Mansion house reforms implemented without any material impact to bond markets and more generally, stable politics assists in resolution of issues facing markets

IMPACT & ACTION

- UK cost of debt falls and increased interest costs for the UK are largely covered by more positive economic growth
- UK bond markets remain well funded and stable with corporates finding the UK an attractive place to issue debt
- **UK schemes funding levels are broadly unchanged and form an orderly queue to buy-out or explore other options**

Scenario 03

WORST CASE (or best for certain investors)
A doom loop

- The central scenario plays out at pace, aided by:
  - The BoE looks to reduce its of stockpile gilts (c. £750bn) more aggressively, pension schemes require fewer gilts still as funding improves and other investors also seek to reduce gilt holdings as the inevitable doom loop appears again
  - Government and BoE then is forced to re-intervene with stability measures, but ultimately investor confidence in gilts, and the pound, is damaged longer-term

IMPACT & ACTION

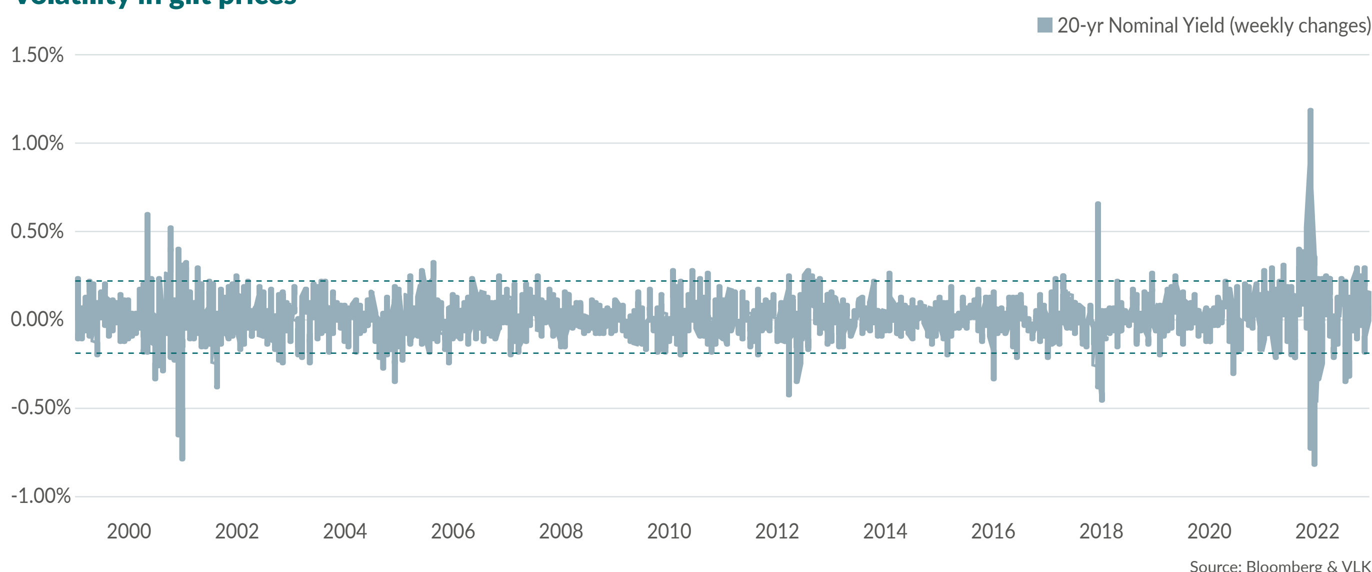
- Dramatic increase in the cost of borrowing feeds into wider domestic economic crisis
- The UK, or at least sterling insurance, increasingly loses its place as a significant currency for debt or equity issuance
- **UK pension schemes arrive at an uneasy surplus where it's unclear how to invest any new found surplus given bond market volatility and reduced confidence in these markets and limited insurance capacity**

Conclusion - What trustees should do?

1) Volatility is coming, prepare for it

Structural changes in supply/demand market dynamics mean that higher volatility has now become the norm. This is demonstrated in the charts below which compare the weekly change in the price of the 20 year nominal gilt. Our observations show that the significant rise in volatility has been persistent both pre and post-LDI crisis and is only likely to continue. Ensuring suitable collateral and liquidity in a portfolio will be key to address this.

Volatility in gilt prices



Source: Bloomberg & VLK

2) Consider if you can take advantage of these scenarios

The scenarios presented have quite different impacts not just on gilt yields, but also likely on a pension schemes funding level. Against this backdrop trustees should consider not just if further gilt allocations make sense, but if their existing gilts are worth holding onto. Any investor, and particularly pension schemes who are sensitive to gilts, can create a value advantage by being ahead of a market trend.

a) Buy-out route

For schemes who are aiming for buy-out as an objective, either due to size, covenant strength or risk management a few points are key.

- For those close to buy-out – insurer capacity is likely to remain constrained to take in new schemes and so ensuring your scheme is well placed to be attractive to insurers will be key. Schemes should also consider how to best hedge insurance pricing with the assets available to them, especially if they will be stuck in the portfolio for a number of years.
- For those further away from buy-out consider if you should place more weight on negative longer-term scenarios for the UK bond market when setting hedges (or other market positions). With the right governance there may be value to be added from these views; for those that require additional governance this could come in a number of forms, including bridge to buy out solutions which, amongst other things, have strong governance capabilities.

b) Alternative end-game options

For well-funded schemes not tied to buying-out imminently – even if they could afford it – exploring other end game options will be key. Some trustees and sponsors are looking at productively running on to a later buy out.

These alternative end games could either be within the existing Mansion House remit (e.g. superfunds and consolidators) or sit within the spirit of Mansion House, but without the need for additional legislation. Importantly balance the need for productive assets in their widest sense as well as the stability of the gilt market (which will be considered quite productive after all if things play out in our central scenario).

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