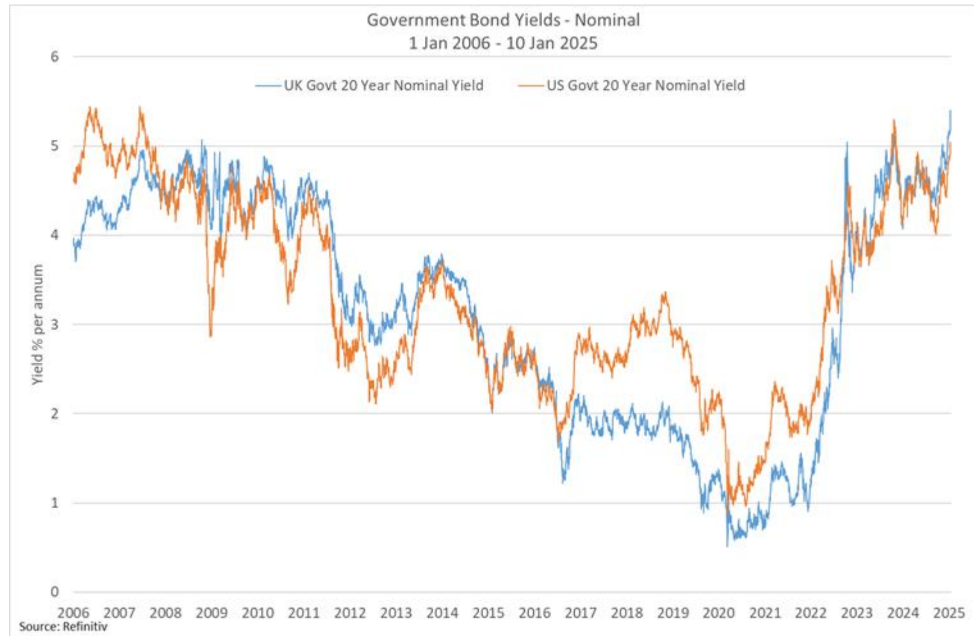
CARTWRIGHT
PENSION TRUSTS

Gilt Yields Hit New Peaks – Where is the Summit?

What is happening?

The rates of interest (or 'yield') on government debt (also known as 'gilts' in the UK) have been rising and have now reached levels not seen for decades. If we look over changes this century, you can see that the rise in yields has been marked across the last few years, reversing a near two decade trend of falling yields prior. While the events of 2022 were the most dramatic in speed, recent yield rises have taken us to even higher levels. This is not a specific UK issue, there is a high correlation across global markets, however UK 20 year nominal rates have been rising at a faster pace, overtaking the US over the past few weeks.

Similarly, but perhaps more importantly for UK pension schemes who have benefits linked to inflation, real yields (which typically provide a return in excess of the CPI inflation measure) have also been on the rise, reaching new multi-decade UK highs.

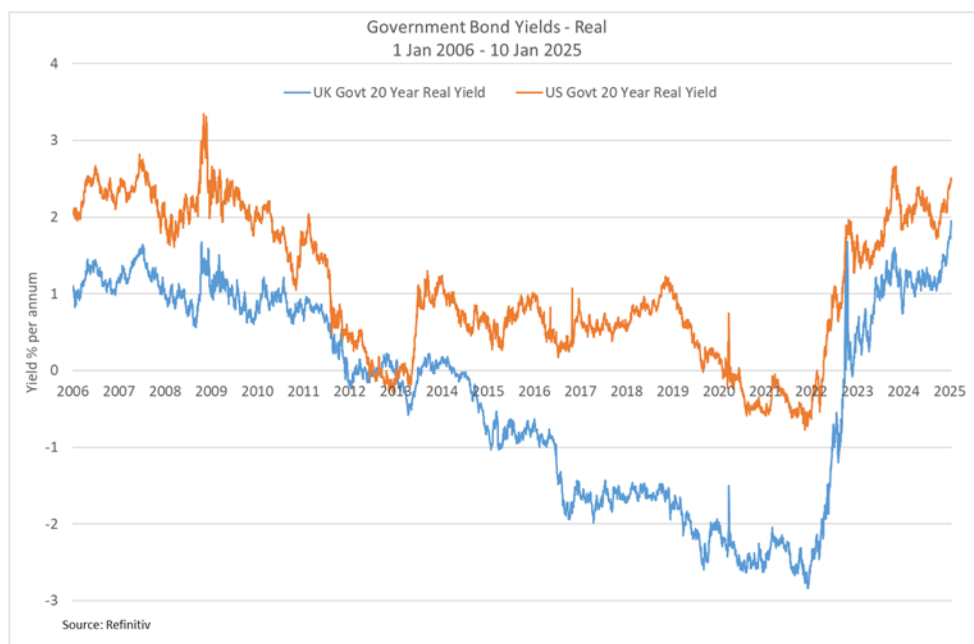


Why is this happening?

Reason 1. Inflation concerns

The yield available on longer-term (20 years, say) government debt is a result of supply (provided by the Debt Management Office in the UK)) and demand from investors. It is also influenced by the short-term (daily) rate which is set by the Bank of England. If investors expect the bank of England to keep short

term rates high (say at 5%) into the future then it makes sense for long term rates to be similarly high (say 5%). If they think the Bank of England may have to raise short-term interest rates further in order to cool the economy and curb inflation, then it makes sense for long-term rates to be higher too. Looking through this lens, the market is saying there may be more inflation worries ahead and monetary policy may therefore remain tighter for longer than previously thought. Whilst inflation roared back in 2023 and 2024 was much calmer, inflation is still above target and central bankers have been cautious of late in lowering interest rates for fear that inflation re-ignites.



Reason 2. High levels of existing debt

The high levels of government debt both in the UK and overseas will, all else being equal, make investors nervous about holding such investments and they will therefore need higher yields to compensate for the risks. In particular, since the UK/US government can create more money, the risk is not so much that the UK/US government defaults, but more a risk that they create new money to pay off old debts and in so doing greatly devalue the gilts currently in investors' hands. Added to this in the UK has been the Bank of England's policy of "Quantitative Tightening" – selling back into the market gilts that it had previously purchased through its "Quantitative Easing" programme. This additional supply causes prices to fall and thus yields to rise.

There is a circularity here in that higher yields makes the existing debt burden a greater concern as the interest cost becomes a greater burden. The Bank of England's reaction to this (if any) could be a significant factor in the degree to which this trend continues. If the Bank of England feel the need to step in, look out for more Quantitative Easing (aka money creation) to try to avoid a debt spiral. Whilst this may alleviate some symptoms, it would likely stoke the fire of inflation as the extra money supply seeps into the wider economy.

What are the risks to me as a UK pension scheme investor? Will there be another gilt crisis like in Autumn 2022?

During Liz Truss's term as prime minister there was a UK specific crisis in the gilt market. Gilt yields rose sharply in just a few days as a 'doom loop' of enforced selling took hold. In particular, as yields rose (which is to say the value of the gilts fell) pension schemes were forced to sell other asset to meet LDI collateral calls. Since some of the other assets they held included gilts (as these were often the most or only liquid assets available), some schemes were forced sellers of gilts driving the price down, and causing further yield rises and LDI calls in a vicious cycle. The Bank of England stepped in to provide emergency liquidity for a few days to provide LDI managers and schemes sufficient time to meet their LDI call requirements. This intervention calmed the markets and gilt yields fell for a while, ending the immediate crisis.

Since that crisis both pension schemes and LDI managers have improved their processes so that they are more resilient and will be quicker to respond. The Bank of England has reviewed its response too and has formalised a 'financial stability tool' to enable it to step in, in an emergency, to help asset managers and schemes. Whilst there is certainly some comfort to take from these improvements and the system as a whole is more robust, a more extreme rise in gilt yields could still result in a similar chain of events (it is a risk mitigated, not extinguished).

All gilt investors face a risk in rising yield environments of their investment value falling, but those who invest in leveraged gilts (e.g. leveraged LDI) are at particular risk due to the need to re-collateralise these holdings. We suggest some risk mitigation actions below.

Does this present any opportunities too?

Rising gilt yields usually means that the value of pension scheme liabilities are falling. Where schemes are not well hedged, they will have likely been seeing their funding levels improve, however even fairly well hedged schemes will have likely seen deficits falling in £ terms – especially on a prudent basis. This recent cheapening of gilts may provide an opportune time to lock in to better rates and de-risk the scheme towards their end game target.

Higher yields typically means that the cost of insuring benefits becomes cheaper. Whilst this could apply to a number of schemes it may be especially relevant for schemes with overseas parents, as the recent devaluation of sterling that has been happening concurrently makes any remaining shortfall lower in their local currency terms.

Actions for Trustees to consider

Risk mitigation:

- Make sure LDI collateral processes are in place and the funds to be used to source collateral are sufficiently liquid and well stocked.
- Keep an eye on collateral levels if / when any collateral calls happen and consider replenishing these ahead of time.

Opportunistic:

- Revisiting your investment objective in light of a new market reality may present opportunities to de-risk.
- Reaching out to sponsors to inform them of the changing position and gain a better understanding of their current ability / appetite to support a change in approach.

Other potential actions:

- Where scheme funding has improved there may be a reduced need for LDI leverage. This may be an opportune time to reduce allocations to leveraged LDI if affordable.
- It may also be worth considering an alternative to the traditional approach. By using physical gilts overlayed with equity options, it may be possible to arrive at a more robust investment solution that has less requirement for re-collateralisation from gilt yield volatility.
- Look out for a central bank response. These tend to be inflationary (perhaps not immediately so) and you may need to check your inflation protection through LDI hedging and/or well-diversified hard assets. In particular, while inflation hedging is complex and scheme specific given the multitude of different caps and collars applied to benefits, there may be an opportunity to sell/reduce inflation protection as the benefits become more fixed. This is due to the upper bound caps becoming more relevant.
- Consider reviewing the Scheme's commutation factors. The rise in gilt yields is leading to lower liability values. This is automatically reflected in transfer values (where the basis is reviewed every month) but other factors may have been set some time ago. Commutation factors are particularly sensitive to changes in yields. And factors which are based on market conditions when yields were much lower may no longer be appropriate. For example, they may now be overly generous to members, or cause a funding strain if exercised.

If you would like to discuss any of these matters further, please get in touch with your usual contact at Cartwright.

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