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Gilts vs. swaps – what's going down?

Paul Fulcher, Nomura International plc

June 2016

What's the issue ...



Source: Bloomberg



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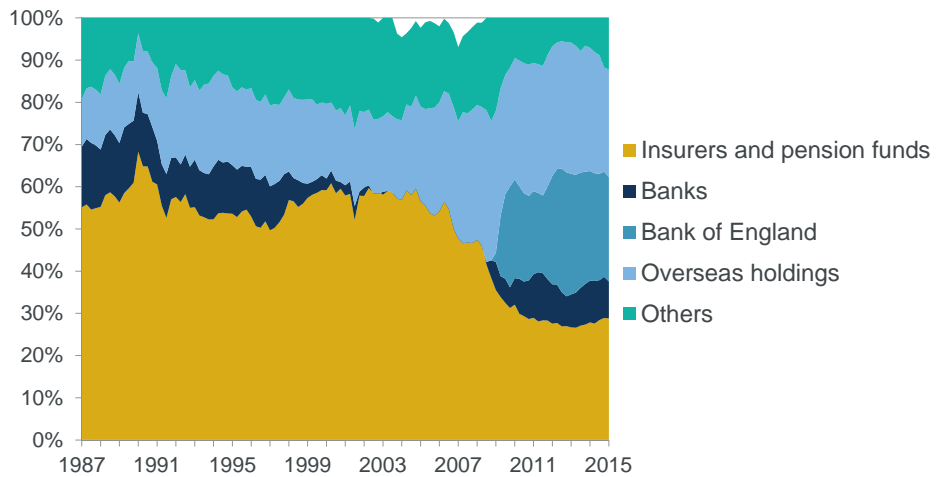
Why?



Or are the real culprits ... ?



Gilt market ownership - %

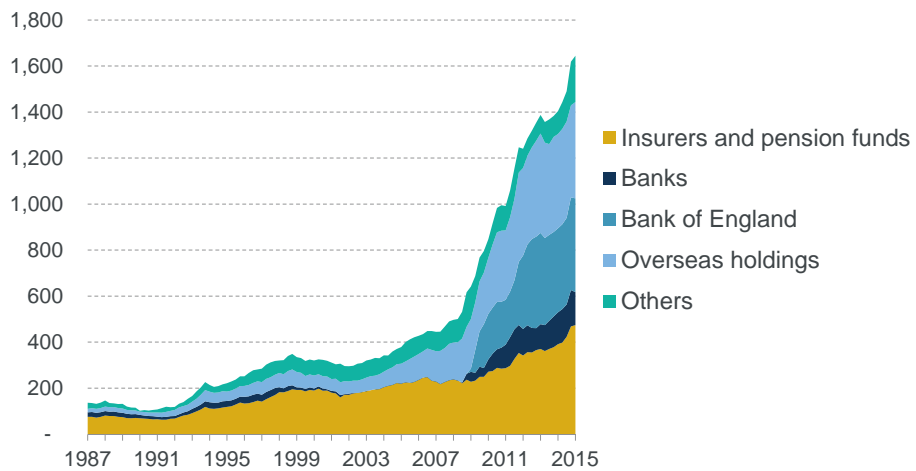


Source: DMO

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Gilt market ownership - £ amounts



Source: DMO

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Stating the obvious ?

	Pension funds	Life insurers Annuities	Life insurers With profits
Solvency II	No	Yes	Yes
Matching adjustment	n/a	Yes	No
Discount rate	Self-chosen (replicating portfolio)	Assets held	Gilts to swaps
Capital vs. gilt-swap risk	No	No	Yes
Inflation linked liabilities	Yes	Yes – buyout No – non-buyout	No
Conventionals (£bn)	£70bn ¹⁾	£40bn ¹⁾²⁾	£50bn ¹⁾²⁾
Linkers (£bn)	£160bn ¹⁾	£55bn ¹⁾²⁾	£15bn ¹⁾²⁾

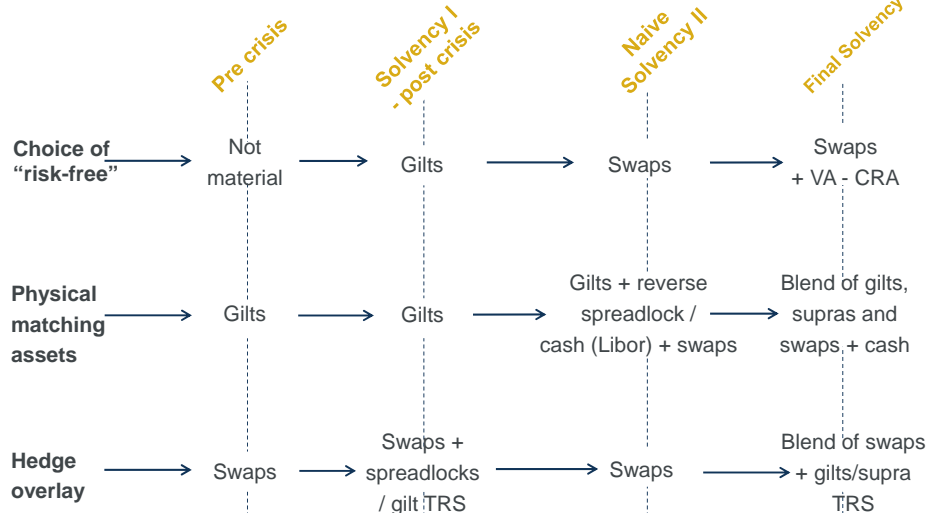
Source: ONS Statistical bulletin: Investment by Insurance Companies, Pension Funds and Trusts, Quarter 2 (17 Sep 2015) 2) split approx per Nomura analysis



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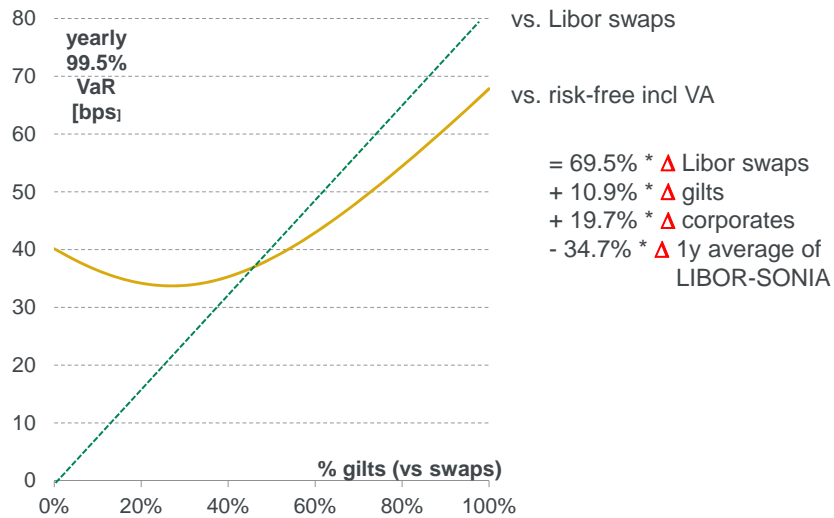
Evolution of the “risk-free” rate



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Why was the naive view naive?



But was the “naive” view right all along?

March 2015 (confirmed July 2015)

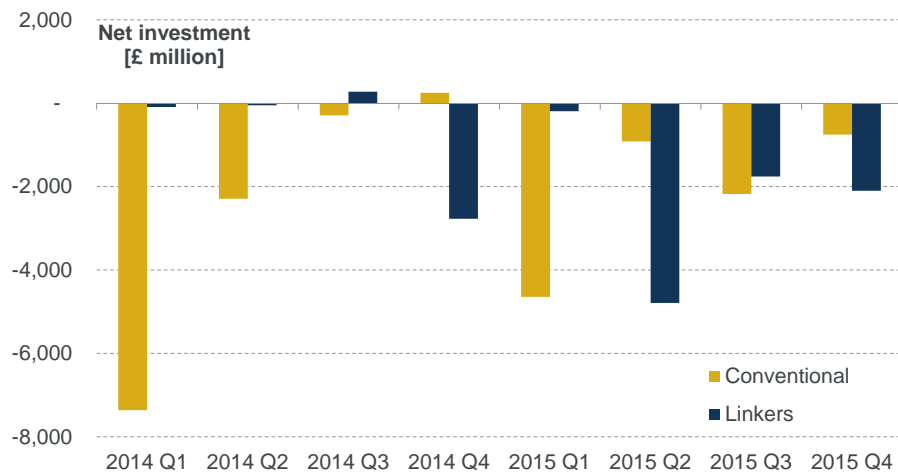
Consultation Paper | CP14/15
Solvency II: treatment of sovereign
debt in internal models
March 2015

June 2015



Volatility adjustment in the modelling of market and credit risk stresses

Flow of funds

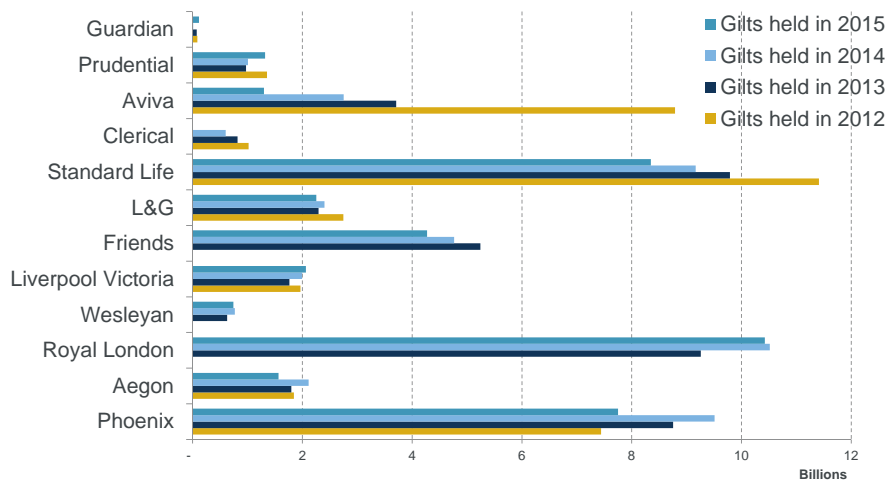


Source: ONS
<http://www.ons.gov.uk/economy/investmentspensionsandtrusts/datasets/investmentbyinsurancecompaniespensionfundsandtrusts>



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UK with profit fund holdings



Source: PRA Returns



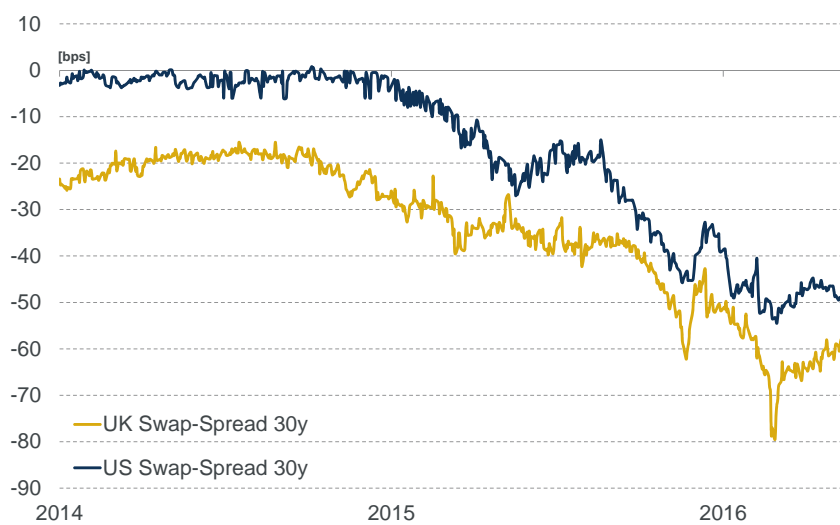
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When is a gilt an attractive RoCE asset



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But is it really Solvency II

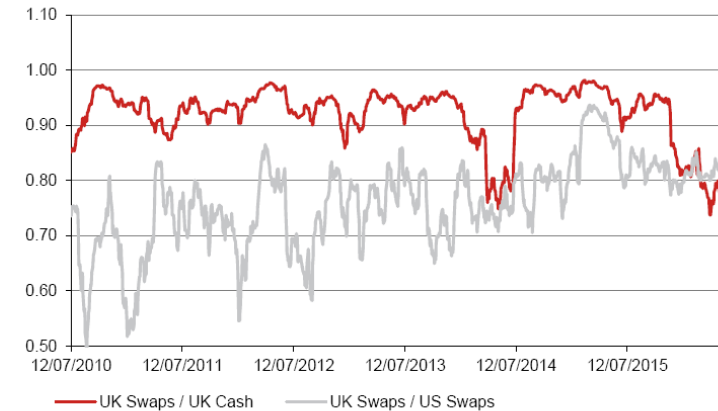


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Cash and swaps now different things

Fig. 1: Rolling 60-day correlation of 5-day moves

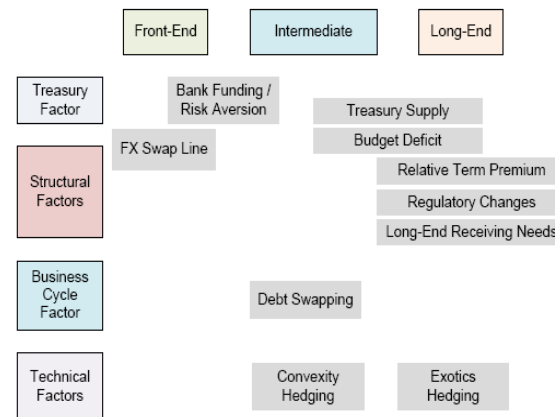
30y UK swaps now more correlated to 30y US swaps than 30y UK cash



Source: Nomura

Drivers of swap spreads

Fig. 4: Drivers of Swap Spreads



Source: Nomura

Perspectives from the eye of the storm

(International Capital Markets Association)

“People think that the rules of the game have changed.
The rules haven’t changed; it’s the entire game that has changed.”

“What’s changed?
Two words:
leverage ratio.”

“Once NSFR comes in,
then it’s game over.
We can all go home”

Source: CGFS Paper No 52 “Market making and proprietary trading: industry trends, drivers and policy implications”



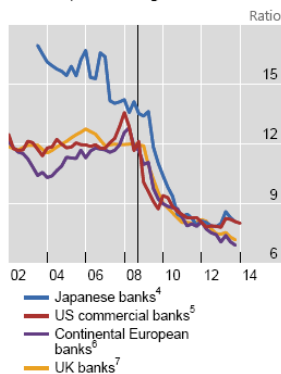
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Implications

Reduced leverage

Tier 1 capital leverage³



Falling inventory



“A reduction in banks and non-banks’ ability and willingness to put capital at risk in the face of large scale order flow imbalances”

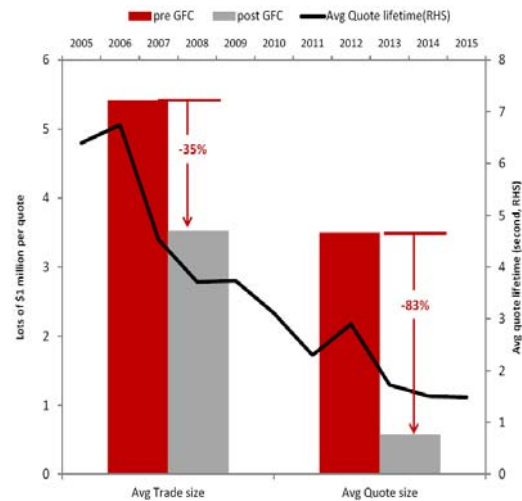
Source: CGFS Paper No 52 “Market making and proprietary trading: industry trends, drivers and policy implications”
Bank of England Deputy Governor speech, Dealing with change: Liquidity in evolving market structures, Oct 2015



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Market liquidity



Source: Nomura, BIS

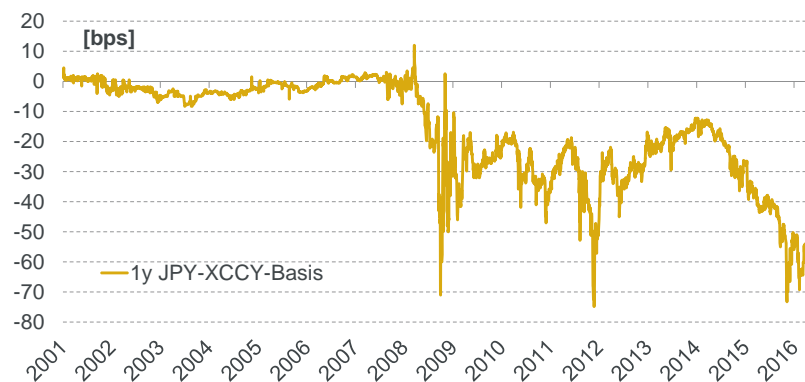


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‘Although liquidity may on average be higher, the risk that liquidity may not be available when it is needed most has also risen.’

Other “distorted” markets

- Bond-CDS “basis”
- Cross currency



Source: Bloomberg

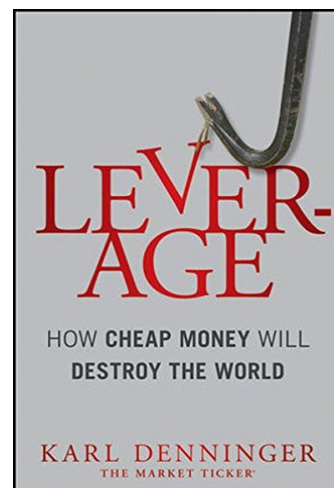
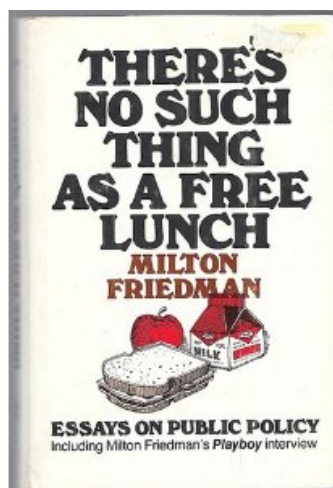


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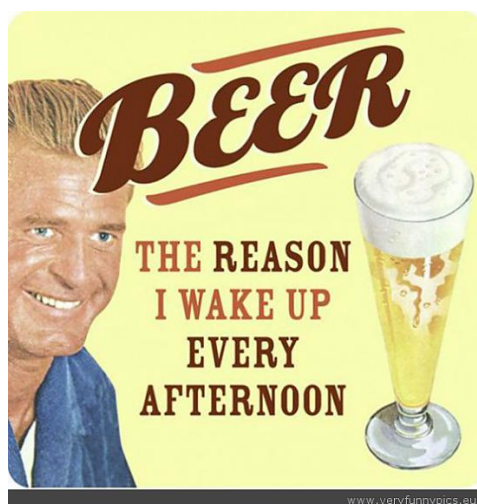
So what ...



For insurers and pension funds ...



... unless it's a liquidity lunch?



Further Reading

- Committee on the Global Financial System: "Paper No 52 - Market making and proprietary trading: industry trends, drivers and policy implications", Nov 2014
- Bank of England: "Deputy Governor speech: Dealing with change: Liquidity in evolving market structures", Oct 2015
- International Capital Markets Association: "Perspectives from the eye of the storm", Nov 2015
- Bank for International Settlements, "Hanging up the phone – electronic trading in fixed income markets and its implications", Mar 2016
- Nomura Research:
 - "Understanding Swap Spreads", Apr 2013
 - "US Swap Spreads: What's Going Down?", Nov 2015
 - "FX Basis Blazes into a New Regime?", Nov 2015
 - "The changing nature of market liquidity", Mar 2016
 - "UK Rates: 1 binary event, 2 curves, 3 new trades", May 2016

Questions

Comments

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