LDI

H2 Outlook

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Steepening curves, ageing demographics, and selective yield enhancement solutions

In this half-year outlook, the LDI investment team at Generali Asset Management (Generali AM), part of Generali Investments platform, examines the following topics:*

- ***Global steepening trends**: LDI players across major developed markets remain cautious at the long end of the yield curve, as mirrored by the current market context featured by a steepening of yield curves.*
- ***Ageing populations**: Demographic shifts have the potential to drive a reshaping in asset allocation in the future, with ageing populations leading to a renewed interest in long-duration, income-generating, and inflation-protected assets, including annuities, real assets, and lifecycle funds.*
- ***Opportunity to exploit yield enhancement strategies during range bound rates phases**: Derivatives are playing an important role in enhancing LDI portfolio yield, as insurers use options and swaptions to tactically monetize range-bound phases while managing duration and reinvestment risk.*

LDI PLAYERS ON A STRIKE TOWARDS THE LONG END OF THE CURVE

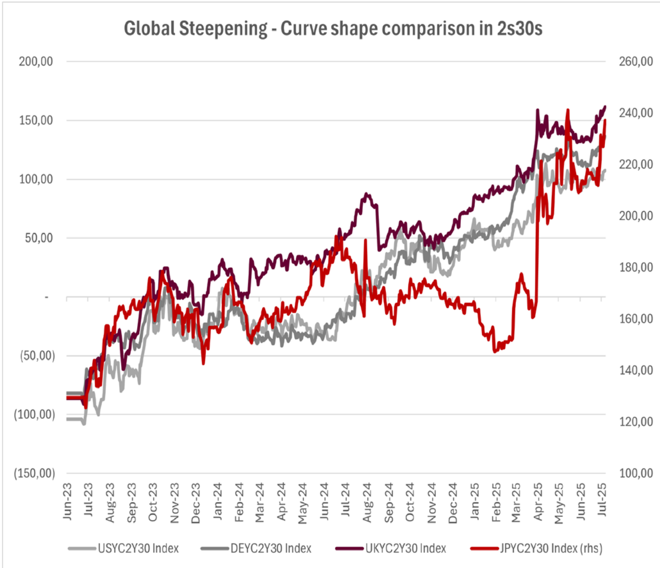
In the current market phase, one common feature within LDI players has been to adopt a cautious approach towards the long end of the curve. In fact, the magnitude of the global yield curve steepening trend seen across major developed markets, driven by monetary policy, growth, and fiscal sustainability, coupled with supply/demand, has proved to be a fundamental disincentive to buy long dated assets, and this trend is expected to continue.

Meanwhile, while at the short end markets are implying less than two rate-cuts in the US and one in Europe before the end of the year, in the longer end of the US curve further-term premia repricing could be required, mirroring concerns over fiscal sustainability and issuance ahead. In Europe, further clarity over the timing and extent of the issuance wall needed to fund defence and infrastructure spending in Germany will also influence market moves across the yield curve, in a context where, however, net Euro government bond issuance for H2 (net of QT) is currently seen as less impactful than in the first half of the year.

As a result, we expect that both US and EUR 10-year rates will continue to move within a range for the time being, while being more susceptible to upward pressure in the longer term. The recent pressure arising from Japan's long end of the curve will also likely continue to add steam to the global steepening trend.

In a context where competition to support longer end issuance will be key in the coming years, will Europe be in a position to profit from the end of US exceptionalism in attracting more demand? It is, of course, difficult to predict how global demand will turn. However, after a decade of significant capital flow from Europe to the US, the disruptive impact of US policies and the need for investors to diversify could present Europe with an opportunity.

The situation described above also contributes to a steady appetite for credit from LDI players , which is still supported by solid fundamentals. Risk appetite and carry remain especially strong in high grade credit, as reflected by supply absorption and contained NIPs. Of course, headline driven volatility cannot be ruled out and spread performance will likely depend on the extent to which yield-buying flows will offset future outflows. Technicals still remain a key short-term driver for high yield too, where the recent bear market rally has once again compressed valuations and volatility to levels at which credit hedges should be considered, barring some potential limited overshooting during the summer.



[1]Source: Boomberg, June 2025

AGING POPULATIONS, A DRIVER RESHAPING MARKETS AND AN OPPORTUNITY FOR LDI PLAYERS

The dynamics of an aging population could see insurers shift their focus over time back to long-duration, income-generating, and inflation-protected assets, in order to balance the need for stable returns, capital preservation, and long-term liability matching. A higher allocation to longer term fixed income, inevitably a function of market conditions assessment across cycles, could also result from a potential increase in the demand for annuities and long-term care insurance, which are strictly linked due to higher life expectancies. In parallel, disciplined duration management via matching strategies may become increasingly important, with initiatives that aim to hedge longevity risk across portfolios potentially adopted (instruments such as mortality and longevity swaps

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could gain traction in this context).

Increased allocation to alternative investments will also be important for ensuring higher returns and diversification, as well as providing inflation protection in forms other than the usual inflation-linked bonds (e.g. via commodities, infrastructure and real estate). This would also mitigate the lower income derived from deleveraging riskier assets as the retirement date approaches (see below).

Target Maturity Funds or, more specifically, Lifecycle Funds should remain popular as they offer a structured, risk-adjusted approach to portfolio management in an aging population context, making them suitable for retirement planning and insurance-backed asset management.

In fact, the automatic adjustment of asset allocation over time plays a key role here, as it is based on a predetermined target retirement date. It gradually shifts from a more aggressive mix (higher equity allocation) to a more conservative allocation (higher fixed income) as the target date approaches. The advantages of this kind of fund setup could also extend to simplified decision-making for the policyholder, minimizing behavioural risks. Moreover, it could be integrated with annuity-like features, to ensure retirees have a steady income when they need it most, alongside LDI strategies and real asset deployment.

In general, the ability to embed ancillary services for retirees will become an increasingly valuable customer retention driver, as competition develops.

Demographics aside, from a political perspective, an ageing population with a concentration of older voting generations might continue to require greater government spending. This could make it more burdensome to service the extra debt needed for health and pensions, boding well for a higher term premium in interest rate curves. Currently, solvency concerns arising from undisciplined budgetary expansion seem to be the main driver of curve positioning. Consequently, the pressure for collaboration between governments and insurers to develop so-called 'hybrid pension models' is high.

THE ADVANTAGES OF FLEXIBILITY IN THE USE OF DERIVATIVES TO EXPLOIT THE CURRENT PHASES OF RANGE-BOUND RATES TO GENERATE YIELD ENHANCEMENT ON LDI PORTFOLIOS

Since the beginning of the year, we have seen volatility and rates moves offer entry points to set up appealing yield enhancement strategies via options on insurance company portfolios. For example, among the several strategies that we implement at Generali AM selling call options on liquid EGBs within the portfolio during phases of low rates (targeting a strike at levels implying eventual sale of the bond with a flat-to-positive P&L), can allow us to monetize the premium while remaining exposed to reinvestment risk at levels compatible with clients' expectations with no accounting impact.

Subsequently exploiting an upward trend move in rates to close the position in gain can then allow us to minimize the risk of being exercised, while still cashing in a good portion of the preset premium. Similarly, selling put options during phases of high interest rates can allow us to earn premiums, while setting the strike to levels coherent with the target of the portfolio. Such a strategy, taking into account cash flow matching needs, could identify redemptions for funding the eventual purchase of the underlying bond.

Furthermore, the current rangebound phase in rates could offer opportunities to partially manage duration on a forward-looking basis while still earning a premium to yield enhance portfolios. Among the several available strategies for mandates with an above-target duration profile, we have for example looked at selling receiver swaptions in phases of lower rates with an appropriate strike level to reduce such long positioning. This strategy can allow us to earn a premium and, in the worst case at option maturity, enter a pay swap at a preset level. These trades can also be managed dynamically before the settlement date of the option, contributing to yield enhancing the portfolios.

At Generali AM we have all these strategies and more in our toolkit and we remain focused on helping clients navigate the market's complex shifts with tailored solutions that balance stability, yield and long-term resilience.