(currently ex-dividend), 10·25% Nov 99 (also XD), 10% Feb 01 or even the illiquid 13% Jul 00. Those willing to extend along the curve should prefer the 9·75% Aug 02 and 10% Sep 03, or the callable 11·75% Jan 03|07.

- Some holders of the 6% 99*f* like its low coupon for taxation reasons, and wish to minimise simple yield (as this is taxed). A duration & cash neutral reverse barbell from the 6% 99*f* and 9·5% Apr 05 into the 7% Nov 01*f* or 8% Jun 03*f* gains yield whilst dropping simple yield (hence reducing tax liability). Those not owning the 9·5% 05 can use the future as a proxy, of which it is the CTD.
- Those investing cash into gilts with a high liquidity requirement should buy the two forthcoming benchmarks. These will outperform the retiring stocks until early-’95.
- Arbitrageurs without a holding of 6% 99 should short it synthetically by selling a call and buying a put. This can be done at an effective repo rate of ≈LIBOR-40. Hedge the outright market risk by investing in a neighbouring stock.
- The new 8%00 trading is 16 bp rich to ‘fair value’. This bond is less expensive than the 6%99 (18 bp dear), so we advise switches from the old to the new benchmarks. However, we do not recommend that traders attempt to respond to the richness of the new issue by shorting it. As a forthcoming benchmark it may hold or even increase its premium over the next few months. Further, the possibility that it and only a small number of other gilts will become STRIPable may support its price even after it loses its benchmark status in late ’95.

For further gilt anomalies and details see *Gilt Anomalies II: Repo Anticipation*, 18 Aug 94 and *Gilt Anomalies III: FOTRA Switches*, 31 Aug 94.

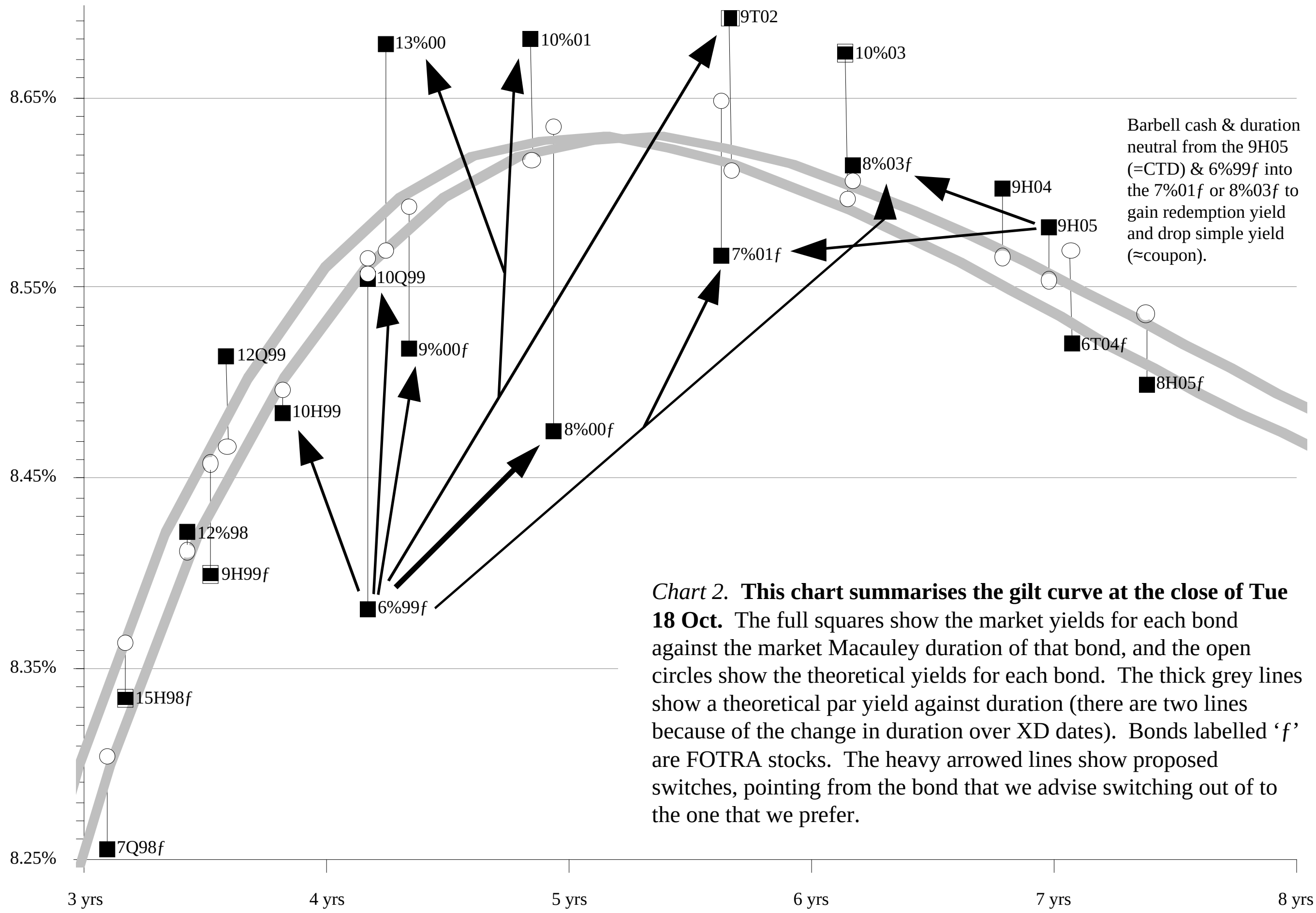


Chart 2. **This chart summarises the gilt curve at the close of Tue 18 Oct.** The full squares show the market yields for each bond against the market Macauley duration of that bond, and the open circles show the theoretical yields for each bond. The thick grey lines show a theoretical par yield against duration (there are two lines because of the change in duration over XD dates). Bonds labelled ‘*f*’ are FOTRA stocks. The heavy arrowed lines show proposed switches, pointing from the bond that we advise switching out of to the one that we prefer.

London
19 October 1994

J.P. Morgan Securities Ltd.
European Fixed Income Research
Julian Wiseman (44 71) 325 5823.

J.P. Morgan Sterling Securities Ltd.
Gilt Sales
David Boal (44 71) 779 3099.

JPMorgan

European Fixed Income Research: Sterling

Anomalies IV: 8%00, 6%99 and STRIPS?

- **8% 07 Dec 2000 FOTRA stock will be next year's 5 year benchmark. Replace holdings of 6%99 with this.**
- **Maturity date of 07 Dec matches new 10 year (8·5% 07 Dec 2005). Is the BoE planning a STRIP market?**
- **No STRIP without repo: good for high coupon gilts.**

The BoE has announced that the October auction will be of £2,500m of a 8% 07 Dec 2000 FOTRA stock. During early-'95 this will become the new 5-year benchmark. Last month the announcement of a new 10 year benchmark was disastrous for the retiring 10 year: chart 1 shows how badly the 6·75% 26 Nov 04ƒ performed. This pattern will be repeated at 5-years as holders of the 6% 10 Aug 99ƒ switch into the new issue.

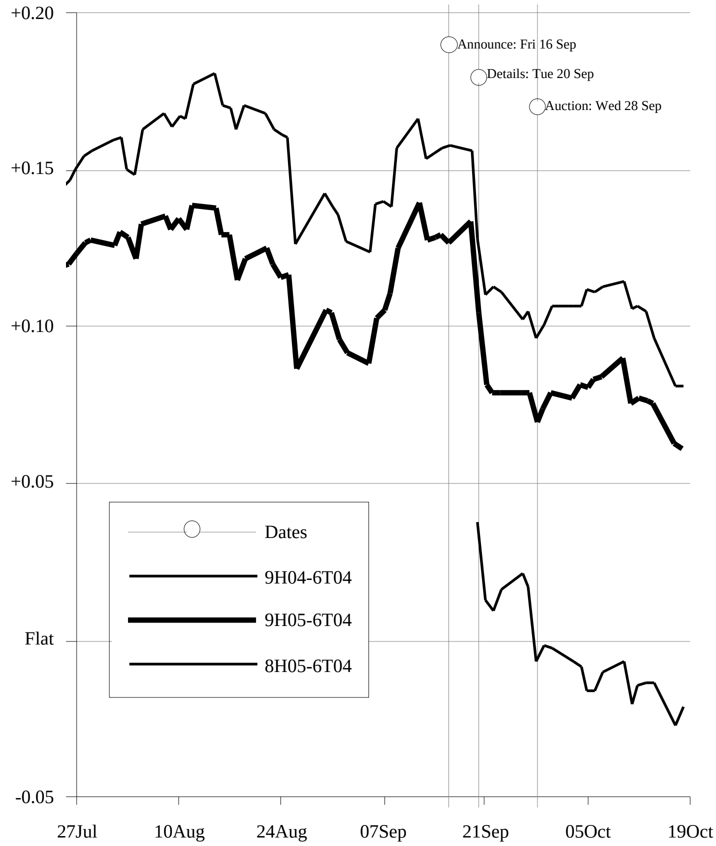
Chart 2 overleaf shows the relative cheapness or dearness of the 5 to 10 year part of the curve (3 to 8 year Macauley duration). As of the close of 18 Oct the 6% 99ƒ is about 18 bp expensive to fair value, whilst the 6·75% 04ƒ is only 5 bp expensive. We suspect that the 6%99ƒ will eventually trade close to fair value: switch out of this bond into neighbouring stocks including the 8% Dec 00ƒ or the 9% Mar 00ƒ.

There is one unusual feature of this auction announcement. The maturity date of the next year's 5-year and 10-year benchmarks are both 07 Dec. Historically it is very rare for the Bank to issue gilts with the same maturity date; she usually endeavours to separate the coupon dates. What motivation might the Bank have for matching the dates? In the US, Canada, France, Belgium, Netherlands certain bonds can be broken into **S**eparately **TR**aded **I**nterest & **P**rincipal, known as STRIPS. In order to maximise liquidity in the individual coupons (which only have small issue sizes) it is necessary to ensure that STRIPable bonds have the same coupon dates; the coupons are then fungible.

Perhaps the BoE is planning a STRIP market, and in preparation is ensuring that new benchmarks have matching coupon dates. If this is so then STRIPing of these benchmarks will eventually be permitted, in which case the 07 Dec stocks will be much in demand: those who believe that the probability of a STRIP market has increased should buy the two new benchmarks (8% 2000ƒ and 8·5% 2005ƒ).

In practice a STRIP market requires a functional repo market. Repo markets permit arbitrageurs to take advantage of

Chart 1. **This underperformace of the 6·75% 26 Nov 2004ƒ when after the announcement of the new 10-year.** The yield spread of the 6·75% 04ƒ is shown against the similar maturity 9·5% Oct 04, the similar duration 9·5% Apr 05 and the new 10-year, the 8·5% Dec 05ƒ. The retiring benchmark underperformed all three of these when the new 10-year was announced.



stocks that trade anomalously; in effect 'tidying' the curve. If the Bank really is preparing for a STRIP market then this adds weight to our view that a repo is coming. See previous *Gilt Anomalies* articles for details of the consequences of this.

So what should be done?

- Holders of the 6% Aug 99ƒ should switch into any nearby stock — this retiring benchmark is 18 bp expensive. Those preferring FOTRA stocks should acquire the 8% Dec 00ƒ or the 9% Mar 00ƒ; whilst those without this requirement should select from the 10·5% May 99