The 100Y gilt: The Chancellor agrees

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Key points:

The Chancellor of the Exchequer, whilst on a plane to the USA, seems to have briefed journalists on the possibility of a 100Y gilt.

Hurray: in December 2011 SocGen advised that the UK issue a 100Y (Please, only one more long).

> *"if in the next decade there is to be another long conventional gilt, we hope that the authorities choose a maturity of Monday 7th December 2111."*

But the press has reports on the possibility of a perpetual: please don't.

We also hope that in the general enthusiasm for a new properly-long, the authorities do not forget semi-strippability.

The Press

■ The UK authorities have heard SocGen's request for a very long gilt. But a bad idea has been added to the mix; and a good one not mentioned.

The UK press has been covering the possibility of a new 100Y gilt.

The Financial Times: *The UK chancellor aims to launch an "Osborne bond" – a 100-year debt issue or even a perpetual gilt that never matures – to take advantage of the country's historically low interest rates.*

BBC: *The new plan is looking at issuing bonds with a 100-year repayment date, or even longer. In his Budget next week, Chancellor George Osborne will announce that he will consult on creating a new "super-long" gilt that could even be issued with no set redemption date.*

The Telegraph: *Britain is to offer 100-year gilts, meaning current Government borrowing will not be repaid until the next century, under a radical plan to be unveiled by George Osborne in next week's budget. … A Treasury source said tonight: "This is about locking in for the future the tangible benefits of the safe haven status we have today. The prize is lower debt interest repayments for decades to come. …"*

The annual UK Budget is both an economic event and a political event. It is rich with traditions—it is the only time that alcohol may be drunk in the chamber of the House—and each Chancellor of the Exchequer uses these traditions for political gain, and perhaps just for the enjoyment of the continuation of history.

So this press briefing should be seen as mostly pre-Budget self-promotion. Expect to hear in the Budget speech on 22 March much about how the Conservative's (or maybe the Coalition's) austerity has allowed low long yields, whereas the Opposition's plans, of course described as foolish, would have been worse. Politics, continued.

So these releases were not aimed at the technical folks in the gilt market. Nonetheless we have to work with what we have.

Perpetuals: please no

■ The press mentions the possibility of a new perpetual. Perhaps this idea comes from people in Her Majesty's Treasury who are more familiar with history than with modern fixed-income markets.

① The FT gilt indices include War Loan, and so would probably include a new perpetual. But the JPM indices do not; nor do most others. So the DMO should not issue a new perpetual.

② Further, not all investors' systems can cope with non-standard payment structures. So the DMO should not issue a new perpetual.

③ Callable or non-callable? A callable gilt entails investors selling an option to HMT. With modern risk-management, and credit-crisis risk-aversion, the sale price would be much lower. So the DMO should not issue a new perpetual.

④ But a non-callable perpetual is also a problem. Eventually, after a century or a few centuries, the DMO would still be making lots of small payments for a gilt that has become irrelevantly small. So, as this author has previously written, "perpetuals would be better with a 'sunset clause', the easiest example of which is for them to mature — but only eventually, not soon." Of course, this wouldn't really be a perpetual.

Indeed, the Dutch example is a warning. There are outstanding DSL perpetuals, and the DSTA has an ongoing repurchase programme to tidy this corner of the market. (There was also a campaign, from 1996 to 1 April 2006, to convert outstanding bearer bonds to registered form, with non-registered bonds then being cancelled.)

So if HMT wants a 'perpetual', it should issue a 200Y. But not an actual gilts-are-forever all-carbon perpetual.

Consultation as experiment

■ It may well be that the DMO believes that UK investors would not buy (much of) a gilt longer than 100Y.

Nonetheless, the DMO's consultation should ask about longer gilts, in particular 150Y and 200Y maturities.

If the investors reply as we believe the DMO believes, then fine, the DMO can be pleased that the DMO so-well understands investor preferences. But if the investors are keener on post-century gilts, then fine, the DMO can be pleased that something important was learnt. So we very much hope that the consultation will invite comment on maturities far beyond the DMO's current comfort zone.

Rephrased, a well-designed experiment allows the possibility of learning something new. Please do not excessively restrict the range of possible maturities: the DMO's questions should stretch to 200Y, even if the DMO expects the longer maturities to be too long.

Indeed, the list of candidate maturities should include precise maturity dates, in case there is unexpected reasoning about the minutiae. This list might include Fri 07 Jun 2086; Mon 07 Dec 2111; Wed 07 Dec 2112; Mon 07 Dec 2161; and Fri 07 Jun 2211. (The last of these admits the nickname "last orders"; not a reason not to consider it.)

Semi-strippability

■ The author has been advocating semi-strippability to the DMO for ages: for example see Please, only one more long of December 2011, or Issuance of ultra-long gilts of Jan 2005. So some readers might wish to skip this section.

A June 2111 coupon strip would have a price of about £4.74. So £100 cash would buy £2110 nominal, which would require stripping about £0.13m nominal of a 3Q2111. There is no realistic bid-ask spread on £100 cash that can pay for that balance sheet usage.

And it isn't even what a client wants in a long strip. Really, the purpose of a long strip is to be a non-derivative low-cash high-duration higher-convexity instrument.

So instead, or in addition, the DMO should make the new very-long gilt semi-strippable. That is, it should be strippable into two pieces, an 'annuity' comprising the coupons up to end-2037, and a '2038+ talon', comprising all the payments beyond.

Such a talon would have about 40% of the PV; about 79% of the DV01, so a Macaulay-Weil duration of almost 56 years; and about 94% of the convexity, so a Macaulay-Weil convexity-per-cash of 3695 years^2 (compared to the 4%60's 774 years^2).

Why 2037?

Why is the annuity to the end of 2037, and the talon 2038+?

The objective is that an investor putting £1m into one part, does not leave a GEMM with very much of the other. If the PV split were ninety-ten, then a purchase of the 'ten' part would leave the dealer with nine times as much of the other. Not so good.

So a PV split something like fifty-fifty would be ideal.

But there is drift. As coupons are paid the PV of the annuity drops; but the PV of the talon does not lose payments until after the annuity has ceased to exist (and the talon merged into the gilt).

So making the annuity slightly larger means that over the next decade it will approximately average a price similar to that of the talon. Hence the chosen split of about sixty-forty, which does not have to be precise. (And there is ease of nomenclature in not splitting a calendar year.)

Later, the DMO might make the 2038+ talon sub-strippable into a forward-starting annuity, perhaps of about 15Y, and a longer talon (e.g., perhaps 2053+). But this decision would be for later.

That fulfils the purpose of stripping, without destroying dealers' balance sheets. And would cost the DMO approximately zero to do.

But what trade?

■ The above is a recommendation to the UK DMO. What of the investor?

The yield spread 3¾ July 2052 → 4% Jan 2060 is now about –5bp, only 0.5bp less inverted since yesterday's close. But the longest-gilt premium of the 4%60 will surely lessen, later if not sooner. Investors should switch shorter from the 4%60, DV01-neutral.

The cash-constrained must switch shorter and longer. We recommend switching, cash- and DV01-neutral, from the 4¼ Dec 2046 and 4%60 into the 3T52.

There will be further comment on this trade in the *Fixed Income Weekly*, to be published on Thursday.

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