

Gilt Relative Value

(Succeeding the 'Gilt Anomalies' series)

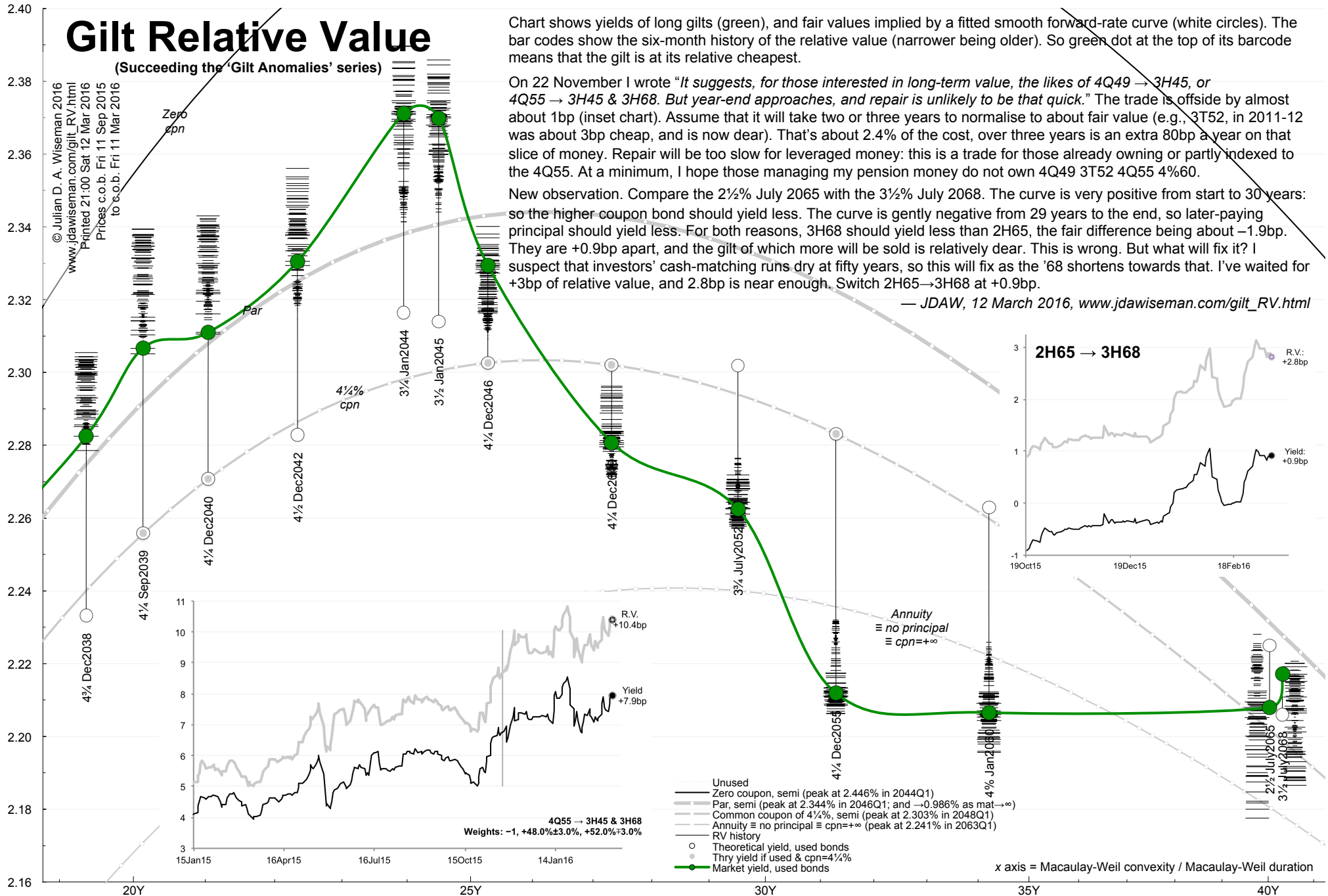


Chart shows yields of long gilts (green), and fair values implied by a fitted smooth forward-rate curve (white circles). The bar codes show the six-month history of the relative value (narrower being older). So green dot at the top of its barcode means that the gilt is at its relative cheapest.

On 22 November I wrote "It suggests, for those interested in long-term value, the likes of 4Q49 → 3H45, or 4Q55 → 3H45 & 3H68. But year-end approaches, and repair is unlikely to be that quick." The trade is offside by almost about 1bp (inset chart). Assume that it will take two or three years to normalise to about fair value (e.g., 3T52, in 2011-12 was about 3bp cheap, and is now dear). That's about 2.4% of the cost, over three years is an extra 80bp a year on that slice of money. Repair will be too slow for leveraged money: this is a trade for those already owning or partly indexed to the 4Q55. At a minimum, I hope those managing my pension money do not own 4Q49 3T52 4Q55 4%60.

New observation. Compare the 2 1/2% July 2065 with the 3 1/2% July 2068. The curve is very positive from start to 30 years: so the higher coupon bond should yield less. The curve is gently negative from 29 years to the end, so later-paying principal should yield less. For both reasons, 3H68 should yield less than 2H65, the fair difference being about -1.9bp. They are +0.9bp apart, and the gilt of which more will be sold is relatively dear. This is wrong. But what will fix it? I suspect that investors' cash-matching runs dry at fifty years, so this will fix as the '68 shortens towards that. I've waited for +3bp of relative value, and 2.8bp is near enough. Switch 2H65→3H68 at +0.9bp.