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The forthcoming fifty-year gilt, the 4Q55

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Key points:

Once upon a time a 50-year gilt seemed very very long, and some people said so. To refresh memories we quote some of what was written from Dec 2004 to May 2005 about the then-forthcoming then-scary 50-year gilt.

There might be a 100-year gilt, a 'super-long', as proposed by Société Générale. Before saying "a century is so long", I needed a reminder of what was said in 2005 when a half-century gilt was new.

This tale starts in December 2004, when the longest conventional was the 34-year 4¾ Dec 2038, with the UK DMO publishing Issuance of ultra-long gilt instruments: Consultation Document. This asked about "ultra-long (circa 50-year) conventional and index-linked gilts", and, replies received, the DMO's response came on 16 March 2005, Response to Consultation. This concluded that from "2005-06, the DMO may issue conventional and index-linked gilts with maturities of up to approximately 50-years". And on 17 May 2005, the DMO announced the first auction of the 4¼ Dec 2055.

All this attracted comment at the time, some prescient, some needlessly fearful. (Though just because a risk did not crystallise does not prove that there was no risk.)

(Throughout this essay quotations are in Times New Roman. Section titles link to the original material.)

The Financial Times *6 December 2004:*

Robert Parker, deputy chairman of Credit Suisse Asset Management, said: "Development of a 50-year market would be a very positive step. It fits with part of the pension funds' liability patterns. There will be big demand."

The Economist *10 February 2005:*

In December, Britain's Treasury floated the notion of issuing 50-year bonds. The response of pension funds and insurance companies was, broadly, a bowler-hatted cheer.

… Britain could announce a sterling-denominated Methuselah when it reveals its funding strategy for the year, probably next month. The betting among bankers in Paris is that France's 50-year bond will go ahead, perhaps as soon as March. Germany is watching the French decision beadily, while Italy has already expressed interest.

… Not everyone is convinced that 50-year bonds are necessary. Some point out that 30-year bonds are not very different from 50-year ones where "duration" (sensitivity to interest-rate movements) is concerned. The match between assets and liabilities can usually be achieved by buying 30-year bonds and adding credit swaps, they suggest. New 50-year bonds may take liquidity out of the market for 30-year bonds, while themselves proving illiquid and hard to trade. But more people reckon there is enough demand for both.

The Financial Times *11 March 2005:*

Karl Diller, German finance secretary, said in answer to a parliamentary question yesterday that the government was reviewing a long-dated issue.

The Financial Times *11 March 2005:*

But economists who have examined the issue carefully do not think the case for issuing long-dated bonds is as simple as it might look. David Miles, of Morgan Stanley, said that the government would be well-advised to issue index-linked rather than traditional bonds.

He said: "A government's ability to pay interest on its debt comes from its ability to collect taxes in the future. Tax revenues rise and fall with the real economy, so risk is minimised if debt servicing costs have similar risks." He warned that if the government borrowed at a nominal rate of 4.7 per cent today, but inflation fell to zero in the future, the borrowing would be expensive even if it seemed cheap when the gilts were issued.

The author strongly disagreed and disagrees with this argument. Governments should not buy insurance from the private sector against a weak economy, because the paying out of that insurance would further damage the private sector. Indeed, a sovereign — a true sovereign able to print money — should sell such insurance, because doing so stabilises the economy.

So a government should sell long-dated bonds, and in big size. If inflation were to collapse, bond valuations would rise, adding money to the economy. Surely good. And if inflation were to head polar north, capital losses would take money out of the system. People would have to save more and spend less, thus lessening inflation.

One can think of a long conventional bond as a form of stabilising insurance sold by the government to the real economy, and sold at a fair price.

Financial Times
15 March 2005:

The National Association of Pension Funds predicted that its members, which control assets worth £650bn, would invest in new 50-year bonds to help better match income flows to liabilities.

… David Gould, NAPF's director of investments, said: "Our members are very interested in these bonds and, depending on how they are structured, could devote up to 10 per cent of their assets towards them over the longer term."

(Neither the NAPF nor the web archive have any record of a press release, so the source might have been an interview.)

The Financial Times
16 March 2005:

Demos Papasavvas, insurance partner at Deloitte & Touche, said long-dated bonds were the "obvious" option for pension funds and insurance companies that face long-term liabilities.

The DMO's Response to Consultation
16 March 2005:

8. There was a clear consensus among respondents that there is demand for the issuance of ultra-long gilts in conventional and index-linked form and virtually all respondents were positive about the scale of ongoing demand. There was a hint of caution from one respondent who advised that the scale of demand might tail off for maturities beyond 2038. …

12. Few respondents provided quantitative estimates of the desirable stock of ultra-long gilts. Those who did mentioned figures ranging from a few billion pounds to 'tens of billions of pounds' and even for some stakeholders in excess of £100bn. […] While re-allocation of assets towards bonds was a common theme in responses, there was no homogeneity of views as to the magnitude or pace of such re-allocation …

17. One important element … was the desire expressed by a majority of stakeholders that any new ultra-long gilt should be included in the key indices tracked by asset managers (FTSE indices, iBoxx indices, and those provided by individual investment banks etc.). …

For the reason given in ¶17 any new super-long should be a vanilla conventional, not a perpetual.

20. A recurrent theme was the need to complete the yield curve and some concerns were expressed at the prospect of a gap between 2038 (the maturity of the longest currently existing gilt) and a new 50-year maturity – some respondents suggested an incremental approach to extending the curve gradually towards 50-year maturities.

21. Investors/pension industry participants' views were similarly mixed. The GEMMs' concerns about large gaps in the yield curve were echoed by some investors. One collective response said that ideally the gap between maturities should be no more than 5-years, but noted that this objective may take some time to achieve. It concluded that issuing a 50-year first might be the most effective way of addressing the shortage of duration (and assisting the swaps market).

The comments reported in ¶20-21 are directly contrary to those advocated by this author in Please, only one more long, 21 December 2011. I strongly disagree with these responses to the DMO.

23. […] there were also mentions of maturities beyond [50 years] and the longest maturity recommended (in an isolated case) was 99 years.

There are no prizes for guessing who sent the "isolated" call for 99 years (me!).

The Financial Times
17 March 2005:

Starting with a 50-year gilt, rather than a 40-year gilt, will leave a gap in the yield curve. With demand uncertain, caution suggests a small initial issue. But investors want liquidity, which argues for a big issue.

… it is hard to see why anyone should wish to buy [ultra-long-dated gilts], at what may well be the peak of a global liquidity bubble.

A 50-year index-linked gilt might in principle be attractive to investors. The problem is today's prices. Real interest rates are astonishingly low:

[in March 2005 the then longest ILG, the 2% Jan 2035, yielded about 1.6%]

Real interest rates are astonishingly low: about 1 percentage point lower than long-term growth rates, when theory suggests they should roughly match.

Why anyone would wish to buy a 50-year conventional gilt is still harder to discern. At a yield of about 5 per cent, such a security would provide very little compensation against the risk of future inflation - though it could be held as a deflation hedge.

Remember the length of the bet: half a century. This is a wager not on a government but on a state and on an economic paradigm that could change in ways unimagined today.

The Independent
18 March 2005:

What will you be doing on this date in 2055? Waving off the grandkids on their Easter holiday in space, perhaps. Heading to the pet shop for a new clone of your beloved feline companion of the past 50 years, maybe. Or simply hanging about waiting to be woken from a cryogenic freeze.

Unpredictable, isn't it? Yet the Government is about to start selling 50-year gilts, bonds for which it promises to pay a fixed interest rate until their redemption in 2055.

And the investment community is expected to bite its hand off when the debt is auctioned for the first time in May.

For the Government it is a no-brainer, locking billions of pounds of new debt at some of the lowest interest rates for a generation. For pension funds, crying out for ultra-long bonds, it will provide a predictable income with which to be more certain of meeting long-term pension liabilities.

But there is more than a sniff of worry that buyers of these bonds could lose a great deal of money.

… The last government bond with a redemption date five decades out was issued almost five decades ago, before the inflation of the Seventies shattered previous confidence. The corporate sector and governments had commonly used 50-year bonds in the 1800s to finance the building of the railways or municipal projects, but there were just three government issues in the 20th century.

The first was the most high-profile, the Funding Loan and Victory Bonds of 1919, aimed at paying the bills from the Great War. This fund raising brought in the equivalent of £14bn in today's money, and its sale was launched at the City's Guildhall by the then Chancellor, Austen Chamberlain. Although the Prime Minister, Lloyd George, could not attend, he sent a message of support, saying that in buying the bonds you "get the premier security of the world" - comments that, when read out by the Chancellor, were received with wild cheers. In addition, a floral fete was held in Trafalgar Square.

… Why is there such strong demand? "Since the collapse of Equitable Life, there has been regulatory pressure on insurers and pension funds to match their liabilities more closely, and as people are living longer and retiring earlier, these liabilities are lasting for longer," says Michael McKersie, the director of investor affairs at the Association of British Insurers.

… there is a shortage of ultra-long gilts with which insurers can match the liabilities of pensions and annuities bought by retirees - one of the reasons why annuities are more costly these days, giving a lower pension for a given lump sum. The situation is getting worse as the closures of defined-benefit pension schemes crystallise many liabilities that will become payable only when members retire in a few decades' time. Because of the shortage, the prices of bonds with far-distant maturities have stayed up in the UK, while they have ebbed and flowed more normally with changing economic assumptions in other countries.

John Ralfe - the independent pensions consultant who, while at Boots, moved the retailer's pension fund entirely into bonds - said the market is unlikely to be fussed whether the Government issues gilts with 50-year maturity or just more of the more traditional 35-year securities. "The question is whether the 50-year gilt is going to be more expensive, how much more expensive and whether fund managers are willing to pay up for it."

The trouble with the gilts rush is that pension funds may simply be throwing away money. The Government's last 50-year bond has paid 5.5 per cent annual interest to those who have held it since the beginning. A £100 investment in 1960 will have returned you £386, including the capital repayment, by the time it is finally redeemed in 2012. But the value of that cash has been whittled away by inflation and the real terms loss on the investment is a staggering 77 per cent.

The Financial Times
***29 March 2005*:**

As Adrian Grey, head of international fixed income at Insight Investment, the asset manager of HBOS, says: "[…]There is a structural demand for long-dated bonds from a variety of sources." A proliferation of 50-year bonds would help both issuers and investors because it allows greater liquidity at this point on the yield curve.

But expected new supply in the UK has hurt gilts with 30-year maturities, the longest issued in recent years. Since the government first announced its plans, their yields have experienced some of the highest rises in the UK market.

"It is a substitution effect," says Jason Simpson, government bonds strategist at ABN Amro. "If you bring in longer maturity bonds in, you are going to see some switching to longer."

The Financial Times
***1 April 2005*:**

Here's a date for your diary: December 7 2055. Any plans? Perhaps you will be buying the kids - sorry great-grandkids - their Christmas presents. No problem, buy the 50-year gilt-edged stock the government will offer in May this year, and you will get your money back just in time. By 2055 inflation may have eroded the value of the principal, but reinvesting the interest payments along the way will make up for the shortfall - or will it?

Now look back to 1960, the last time the UK government issued a 50-year stock. In that year the yield on Consols was 5.4 per cent. The following year, the yield was more than 6 per cent, it reached a peak of 14.7 per cent in 1975, and did not fall below 6 per cent again until 1998. True, the interest payments on that 1960 stock could be reinvested at much lower prices, but it would have been a brave investor who did that during the great inflation of the mid-1970s.

Surely Gordon Brown would not want to sell us such a poor investment? Certainly, locking into current interest rates for the distant future is an awfully good deal for the government, as it was in 1932 when War Loan - current price £75 - was reissued.

The Financial Times
***1 April 2005*:**

The first "super-long" auction will be held on May 26 and indications are that demand will be high, particularly from pension funds.

Consequently, the rate of interest the government will need to pay to investors is likely to be comparable to the 4.54 per cent level associated with 30-year government

bonds - possibly even lower. This is a remarkably cheap funding picture, given the risks entailed in making bets about the state of the economy in 50 years' time.

Nick Horsfall, senior investment adviser at Watson Wyatt, the pension advisory group, said: "I think this is an excellent thing for the government to be doing. There is a real need for this [among pension funds]."

The Financial Times
16 May 2005:

"This is absolutely the wrong time to take a bullish bet on long bonds," says […], global head of interest rates strategy at […]. He predicts that over the next two decades, as the baby-boomer generation retires, prices of goods and services will rise. …

… Marc Ostwald, analyst at Monument Securities, says: "[…] In the coming years, the debt burden of countries is likely to rise. That will make it even more attractive for governments to issue long debt. But it also means these instruments carry greater risk of potential default.

The rating agencies do not officially recognise this danger when they award ratings to long-term sovereign bonds: their credit ratings are based on a five-year view, irrespective of the maturity. Yet the agencies are nervous about the long-term future. Standard & Poor's recently warned that the debt of some of the world's richest countries could reach junk status within 30 years because of rising deficits. […] "Can you look at how the world has changed over 50 years and rule out a change in the status of even a G7 country?" asks Denis Gould, head of fixed income at Axa Investment Managers.

… "There is almost limitless demand in the long term" from UK institutions for the 50-year issue, says Andrew Roberts, chief European strategist at Merrill Lynch. Indeed, some bankers guess that there may be about £60bn of demand for long bonds. "Every indication we have received is that demand for the ultra-long bond is sustainable," says Arnaud Marès, head of portfolio strategy at the DMO.

… If it seems daunting to bet on the ability of a country such as France or the UK to pay back its debt in 50 years' time, consider doing the same for a telecommunications operator in Italy's weak economy.

But many investors recently did just that. In March, Telecom Italia became the first corporate borrower to issue a euro-denominated bond with a 50-year maturity

(The Telecom Italia 5¼ Mar 2055; ticker = TITIM.)

The Financial Times
26 May 2005:

"[The 50-year] is seemingly stubbornly expensive," […]. "A pension fund may not buy at [such low yield levels] because they are locking in actuarial losses for 50 years."

The Financial Times
27 May 2005:

The long-awaited auction of £2.5bn of 50-year gilts, the first such auction to be held in more than four decades, was met with reasonable demand, receiving 1.6 times the bids for the amount on offer. The cover was less than the average for past auctions of longer-dated gilts and analysts said this triggered selling.

"The market was looking for an excuse to sell off, said […]. But he added that the bond, which sold at an average yield of 4.21 per cent, was "expensive" and "did not represent good value for investors".

The moral?

Is there a moral to this raking though past comments?

Perhaps only that forecasting is difficult. This was, of course, the point of the sceptics.

But we still believe that a super-long gilt usefully increases the range of achievable portfolios, and bigger that increase in range, the better policy it is.

Explanation might be needed.

Assume that, soon, the government issues a new century gilt. Over a few re-openings it is built to the minimum basic size of £25bn. This new gilt might be cheap to the old 50-year, it might be dear. If it's cheap, HMT has an option to stop, to sell no more. But if it is dear HMT has the option to re-re-…re-re-open until it is much larger, perhaps several hundred billion (which would take a decade or more).

So the Treasury might borrow £25bn slightly expensively; the government might borrow many times this slightly cheaply. That is a good payoff ratio for HMT.

And it is very likely to pay out. The future is volatile and uncertain. So sooner or later the super-long will be dear to the old 50-year. At which time it can be re-opened. If the super-long is 100Y, it will remain a super-long for multiple decades. The probability that the super-long is dear to the ultra-long, for some while during those multiple decades, must be more than three-quarters.

So a super-long gives the government two options: the option to continue or stop; and then the option to resume or not. The greater the uncertainty, and the more different (the longer) is the new gilt, the greater is the value of these two options.

The author thanks the *Financial Times* for its permission to publish these multiple long extracts. Apparently the exception to the usual rule was granted because the material is old and limited in extent. Thank you.

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