United Kingdom
Debt
Management
Office

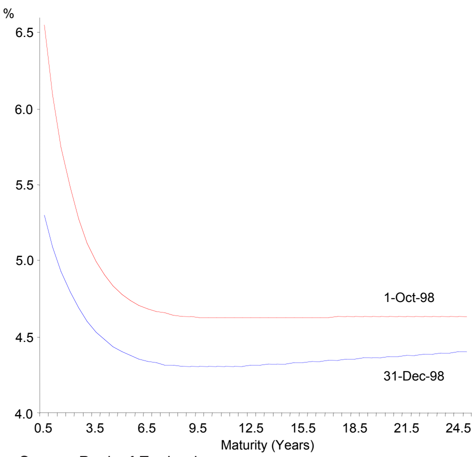
QUARTERLY

Gilts REVIEW

4th Quarter 1998 October – December

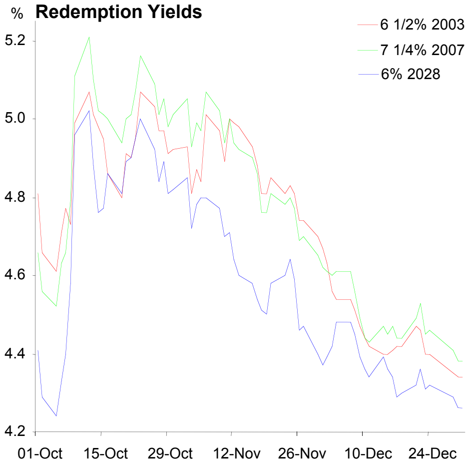
A turbulent fourth quarter of 1998 saw disinversion and a fall in the level of the gilt yield curve. Gilts finished the quarter at slightly lower yields than they began. Yields at the long end fell by 24 basis points while that on the ten-year benchmark fell by 36 basis points. These spot observations disguised a quarter mainly characterised by falling yields following a sharp rise in all major government bonds' yields in early October. This is illustrated in charts 2 and 3. Benchmark yields fell by around 80 basis points across all maturities from peak yields to troughs. The global economic backdrop over the quarter was supportive of bond markets, driven by increasing prospects of a synchronised global slowdown.

Chart 1: Zero-coupon UK Yield Curve



Source: Bank of England

Chart 2: Conventional Benchmark Gilt Redemption Yields



Source: DMO

Yields continued the fall of the third quarter to reach exceptionally low levels at the start of the fourth quarter. The fall occurred in all major government bond markets in response to an increased demand for fixed income products. Equity markets had fallen sharply during the previous quarter. The start of the fourth quarter saw the Dow Jones lose 2.7%, the DAX lose 4.8% and the FTSE lose 3.1% in single days' trading (see chart 4). The market further continued to seek safe-haven products in the wake of Asian and Russian developments.

The week beginning 5 October saw large reversals in bond yields. By the close of the following Monday, yields on the ten-year benchmark US Treasuries had risen 65 basis points, bunds had risen 51 basis points and the ten-year gilt had risen 69 basis points. The long end fared worse with yields on 6% Treasury 2028 rising 78 basis points.

This reversal was caused by changes in positions and liquidity rather than a change in economic fundamentals. However, the large shift in funds caused a great reduction in liquidity. This led to a ballooning of swap spreads to over twice their usual levels. These events were initially triggered by a sharp appreciation in the Japanese yen, appreciating by 13.1% against the US dollar in four days, see chart 5. Many investors seemed to have financed bond positions from cheap Japanese

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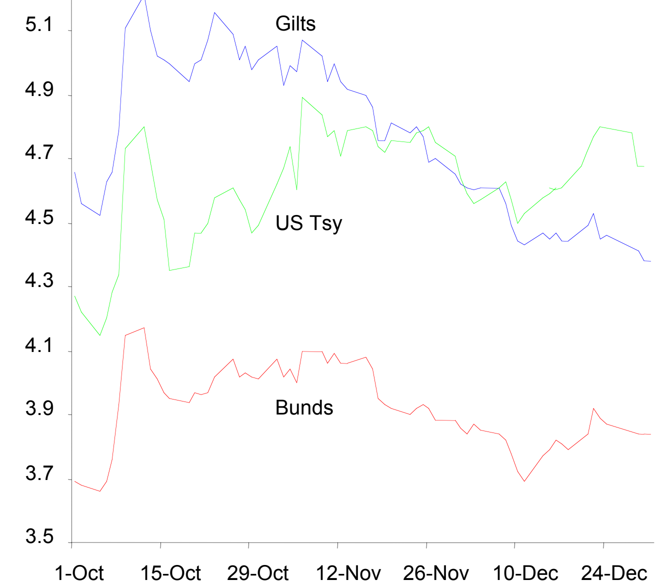
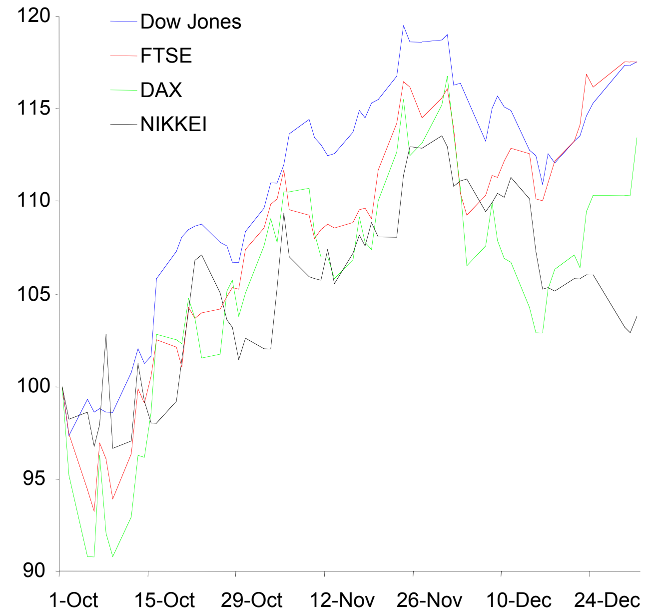
Comments would be welcome to the editor David Page, (0171) 862 6524.

Chart 3: International 10-year Government Bond Yields



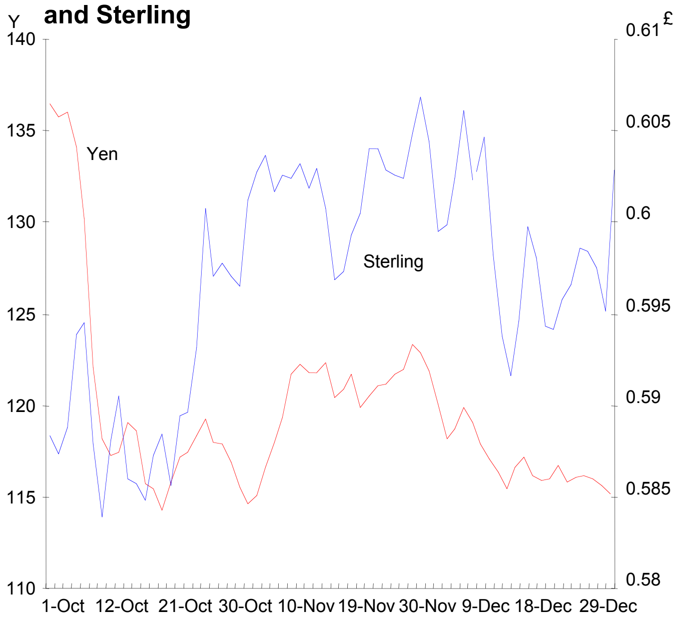
Source: DMO

Chart 4: Equity Indices



Source: Reuters. 1 October 1998 = 100.

Chart 5: Dollar Exchange Rates against the Yen and Sterling



Source: Reuters.

borrowing. The sudden increase in the yen caused an equally sharp need for a liquidation of bond positions.

Following this large reversal, yields drifted downwards. This reflected the market refocussing on economic fundamentals, though trading remained relatively thin. The UK and US bond markets lost some ground with European bond markets towards the end of October, as both the FTSE and Dow Jones rallied. Gilts and US Treasuries soon recovered in November.

Central banks around the world cut rates. The Federal Reserve reduced rates by 50 basis points over the quarter in two cuts. The first of these was outside of the usual cycle of FOMC meetings on 16 October. The central banks of the euro area co-ordinated a 30 basis point rate cut on 3 December, in response to subdued inflation and weakening growth prospects. The Bank of England's MPC cut the Bank's repo rate by 125 basis points over three successive meetings (see chart 6). Gilt yields fell after the surprise of the MPC's first 50 basis point rate cut, made in November. The other two cuts were largely anticipated and saw little reaction on the day.

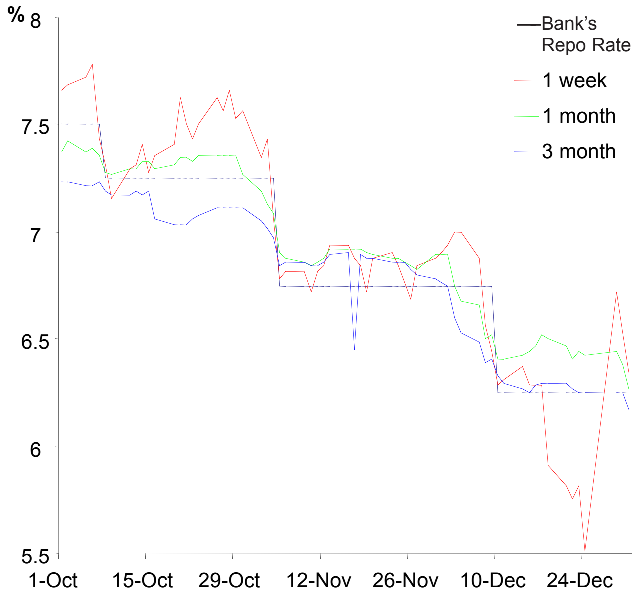
The spread of ten-year US Treasuries over gilts reduced over the quarter until gilts traded through Treasuries towards the end of November. Ten-year gilts ended the quarter trading 30 basis points below US Treasuries (see chart 7). The larger reduction of rate cuts in the UK and the appreciation of the dollar over the quarter drove this convergence.

The gilt/bund and OAT spreads fell over the quarter. Gilts lost ground in late October as the equity market rallied. Ten-year gilt spreads otherwise followed a downward trend as the differential in UK interest rates against mainland Europe fell. The thirty-year gilt yield has been below the bund equivalent since 14 September and finished the fourth quarter 53 basis points below.

Index-linked yields suffered a similar reversal to conventionals at the start of the quarter. Index-linked stocks, however, rallied with conventionals with real yields finishing the quarter at around the 2% level. These were the lowest recorded levels of real yields since index-linked gilts were first issued in 1981. Chart 8 illustrates that, over the quarter, real yields fell by 42 basis points at the long end. Shorter rates fell by more with the $2^1/_2$% IL 2003 yield falling by 51 basis points.

Real yields fell with the fall in UK growth expectations, the increased demand for real fixed income, relative to the available supply, and the institutional demand generated by the Minimum Funding Requirement on pension funds. The steady fall in real yields paused briefly towards the end of November with the prospect of new supply. The DMO carried out the first index-linked auction since the late 1980s on 25 November, when £450mn nominal of $2^1/_2$% IL 2013 was successfully auctioned. The auction was 2.29 times covered at a clearing real yield of 2.42%.

Chart 6: UK Interest Rates

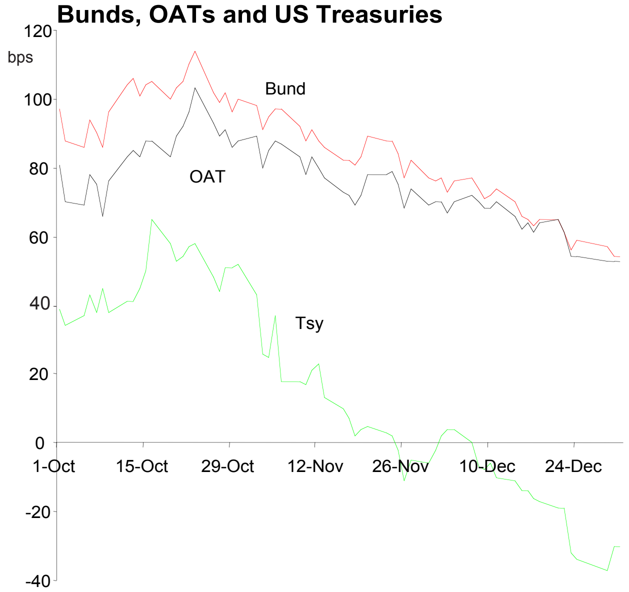


Source: Bank of England. The 1 week to 3 month rates refer to interbank mid-rates

During the quarter the DMO successfully converted £2.89bn of 8% Treasury 2009 into £3.38bn of 5¾% Treasury 2009 on 16 November. This converted 83.8% of the outstanding stock of 8% Treasury 2009, leaving £560mn outstanding. The take up ratio of the conversion was below the 90% level of previous conversions, a reflection of the unusually large size of the issue and the high number of holders of the 8% Treasury 2009.

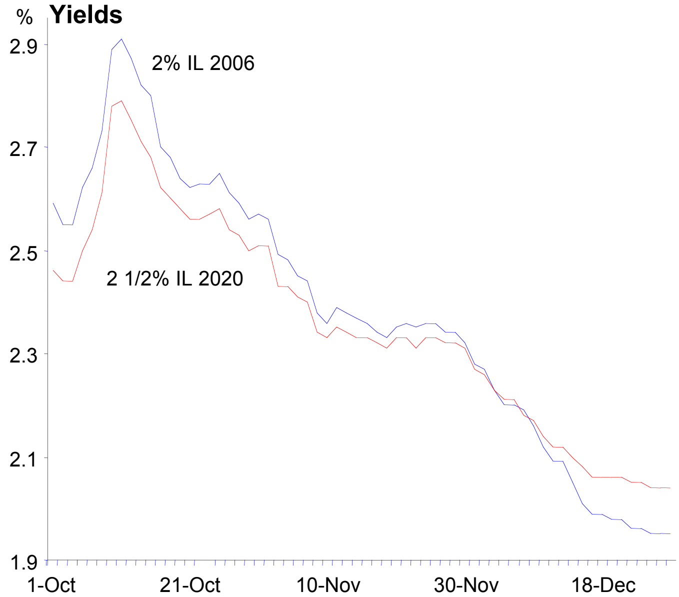
The gilt market also switched trading conventions on 1 November 1998. From that date the market has traded in decimals and has used an actual/actual daycount convention for the calculation of accrued interest. The market has also switched to using the DMO yield as its default yield convention. For further information refer to "Changes to Gilt Market Trading Conventions" (March 1998) and "Formulae for Calculating Gilt Prices from Yields" (June 1998), both available at the DMO website or from Gurminder Bhachu at the DMO.

Chart 7: Spread of 10-year Gilts against Bunds, OATs and US Treasuries



Source: DMO

Chart 8: Index-linked Gilt Real Redemption Yields



Source: DMO. 3% RPI assumption.

1998-99 Financing Requirement (£bn)

	EFSR (1) June 1998	PBR (2) November 1998	Sales to end of December	Remaining
CGNCR Forecast	3.5	-2.1	-	-
Gilt Redemptions	16.8	16.8	-	-
Gilt Sales Residual from 1997-98	-8.2	-8.2	-	-
Financing Requirement	**12.1**	**6.5**	**-**	**-**
Less net financing from:				
National Savings	0.5	0.1	-	-
Gross Gilt Sales Required	**11.6**	**6.4**	**-**	**-**
of which				
Ultra-short conventionals (1-3 years)				
Short conventionals (3-7 years)	2.5	0.0	0.03	0.00
Medium conventionals (7-15 years)	2.5	2.5	2.46	0.04
Long conventionals (>15 years)	3.1	3.1	3.05	0.05
Index-linked gilts	3.5	2.5 - 3.0	1.75	0.75 - 1.25
Total	11.6	8.1 - 8.6	7.29	0.81 - 1.31

Note: figures may not sum due to rounding
(1) Economic and Financial Strategy Report
(2) Pre-Budget Report

Auction Results 1998-99

Auction Date	Issue Amount	Stock	Cover	Tail	Lowest Accepted Price	Yield at Lowest Accepted Price
20 May 1998	£3bn	6% 2028	2.26	0	£102-30	5.79%
29 July 1998	£2.5bn	5 3/4% 2009	2.93	0	£100-05	5.73%
25 November 1998	£0.45bn	2 1/2% IL 2013	2.29	-*	£183.20	2.42%

Taps of Index-linked Gilts 1998-99

Date of Tap	Issue amount £mn	Stock	Price at Issue	Price when exhausted	Yield when exhausted
3 April 1998	150	2 1/2% IL 2024	£151-12	£151-12	2.84%
21 May 1998	150	2 1/2% IL 2016	£185-08	£185-08	2.88%
12 June 1998	150	4 1/8% IL 2030	£160-24	£160-24	2.53%
7 August 1998	150	4 3/8% IL 2004	£128-10	£128-10	2.92%

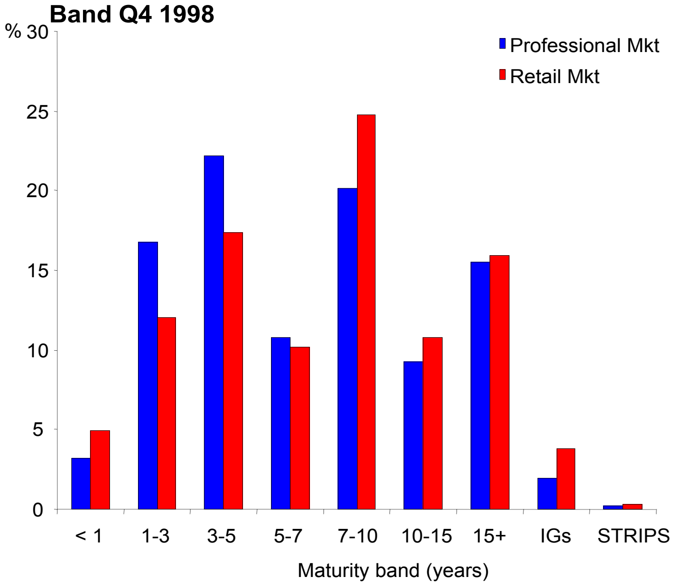
Conversions 1998-99

Date	Source Stock	Nominal Converted	Destination Stock	Nominal Converted into
22 July 1998	11 3/4% 2003-07	£2.9bn	6 1/2% 2003	£3.4bn
16 November 1998	8% 2009	£2.9bn	5 3/4% 2009	£3.4bn

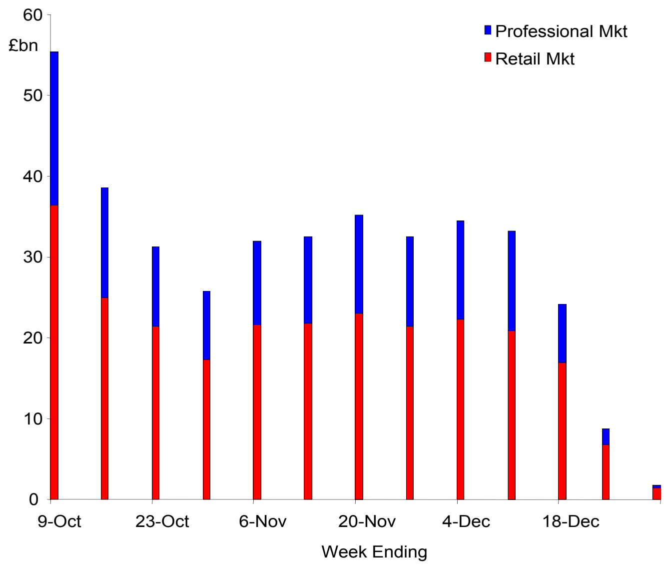
* Not applicable since Index-linked gilts are issued through a uniform price auction format.

Details of GEMM Market Turnover 4th Quarter 1998

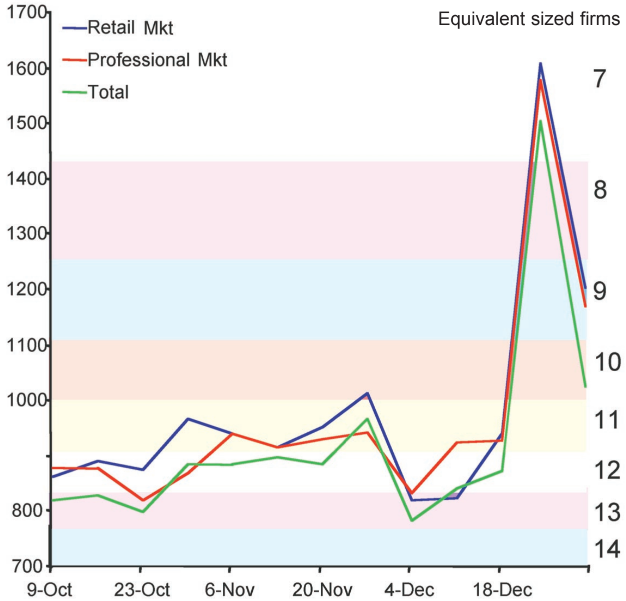
Percentage GEMM Market Turnover by Maturity Band Q4 1998



Total GEMM Market Turnover (nominal)



Herfindahl Index of GEMM Market Turnover



Explanatory Notes:

A Herfindahl Index is a statistical measure of concentration. The HI is calculated as the sum of firms' market share squared. It is compared against numbers of equal sized firms' market shares e.g. five equal sized firms have a Herfindahl number of 2,000, sixteen have 625.

Professional Trades are defined as GEMM trades with IDBs, other GEMMs, DMO and Bank of England.

Charts are based on data reported to DMO by GEMMs for the period starting 5 October and ending 31 December.

New Government Cash Management Arrangements

On Friday 4 December 1998 the DMO published "The Future of UK Government Cash Management - The New Framework" detailing the DMO's proposals for cash management. These proposals are firm but the DMO still welcomes comment from market participants.

The objective of the DMO's cash management will be to smooth the net daily cash flows that occur between the private sector and Central Government. The DMO's daily operations will neutralise the change in the Exchequer's cash position across Government accounts at the Bank of England. The DMO will not take speculative positions on the outcome of the MPC's interest rate decisions. The DMO will have no contact with the MPC or the non-voting HM Treasury representative with regard to interest rate decisions or thinking. Further, the DMO will receive no advance warning of market sensitive policy statements from HM Treasury, ONS or any other government department. The only exception to this shall be announcements, data and forecasts relating to the Government's financing needs.

The DMO intends to use Treasury bills to smooth the seasonal fluctuations in the Central Government Net Cash Requirement (CGNCR). The T-bill stock will be run down in periods of net cash inflow and increased in periods of higher net expenditure. A structured T-bill programme is envisaged with the following characteristics:
· Issuance of 1, 3, 6 and 12 month maturities, with the majority in 1 and 3 month maturities. (12 month maturity T-bills will be issued on a trial basis due to their limited role for in-year cash flow management).
· A minimum T-bill stock of £5 billion in issue at any one time.
· A minimum total weekly T-bill tender of £250 million.
· A quarterly calendar announcing maturities of T-bills to be auctioned. Quantities will be announced one week in advance.
· The DMO will consider establishing benchmarks in T-bills, by re-opening 12 month T-bills at 6 month, 3 month and 1 month maturities, if there was market interest in larger issues.
The DMO will also make use of Cash Management Bills of 1-27 days maturity. These will be used on an ad hoc basis.

The DMO will use a combination of money market tenders and bilateral dealings with cash management counterparties to neutralise the remaining net daily cash flows. The DMO will aim to do the bulk of its dealing when the cash markets are the most liquid. Changes late in the day to the Exchequer cash forecasts, however, may restrict this.

The DMO will focus its dealing in outright and repo transactions in UK government paper: gilts, gilt strips, Treasury bills and some highest rated foreign currency government debt instruments (for repo only). A clear separation between cash and debt management operational functions will be maintained. In addition, the DMO plans to take a wide range of other high credit quality instruments subject to prudential limits, liquidity criteria and settlement arrangements. This will include selected eligible bank bills, major highest-rated European government euro debt instruments and sterling debt instruments issued by highest-rated supranational bodies. This list will be periodically reviewed.

The DMO will seek to deal with a wide range of counterparties to facilitate overall market operations. Counterparties will be regular participants in markets in instruments in which they propose to deal with the DMO. They are therefore likely to be regulated financial intermediaries. The DMO does not envisage a formal market-maker system for T-Bills. The DMO will not publish a list of money market counterparties. Counterparties will be expected to bid regularly and competitively at T-bill auctions and money market tenders. Counterparties will have:
· The facility to bid by phone at structured T-bill auctions.
· Access to the DMO's ad hoc Cash Management Bill auctions.
· Access to competitive repo and outright tenders.
· Ability to deal with the DMO on a bilateral basis.
· Consultations with the DMO on the state of the money markets and direction of DMO policies.

The timetable for transition to the new framework presented in the July 1998 report is unlikely to be feasible. The DMO's cash management operation will not start before the third quarter of 1999. During the first quarter of 1999 the DMO will publish its Operational Market Notice for cash operations. This will provide details of Treasury bill tender procedures and of the daily cash management operations with counterparties.

The full version of this document is available from the DMO or can be seen on the DMO's website.

Exceptional Facility to Switch Holdings of 8% Treasury Stock 2009 into 5¾% Treasury Stock 2009

On 7 January the DMO announced that HM Treasury had created an additional £400 million of 5¾% Treasury 2009 available for switching from 8% Treasury 2009. This facility is exceptionally being made available in response to representations received from gilt market participants concerning illiquidity arising from last year's conversion of the two stocks.

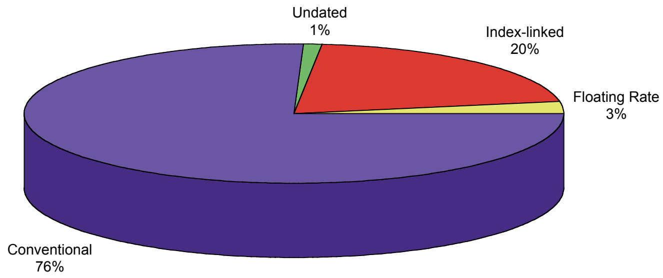
The DMO stated that they would initially be willing to receive offers from Gilt-Edged Market Makers (GEMMs) to switch holdings of 8% Treasury 2009 into 5¾% Treasury 2009. The DMO set rates at which they were prepared to make this stock available, based on a "dirty price" basis. These rates were effective between 9am on 11 January 1998 and 5pm on 15 January 1998. They were set out in the quoted Press Notice and are available from the DMO. The rates reflected the DMO's intention not to disadvantage those who accepted the original conversion terms. Successive rates will be as published on the DMO's wire service pages and will be set at terms that are progressively less generous. Should £310 million or more of 8% Treasury 2009 be offered by GEMMs and accepted by the DMO as part of this operation, the stock would be assigned "rump" status.

Bids to switch the stock may only be made by GEMMs to the DMO. Acceptance of bids will be entirely at the DMO's discretion. Further information can be found from the DMO website or the DMO directly.

Details of the Gilts Portfolio as of 31 December 1998

The following charts are based on nominal values. Index-linked gilts are uplifted to account for inflation.

Composition of Gilts Stock



Portfolio Summary Statistics

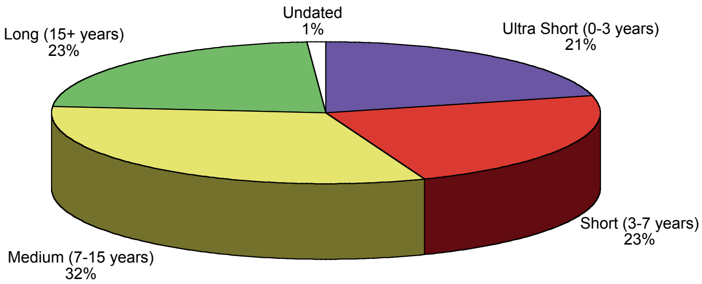
Portfolio Average Maturity: 9.3 years

Portfolio Average Modified Duration: 7.3 years

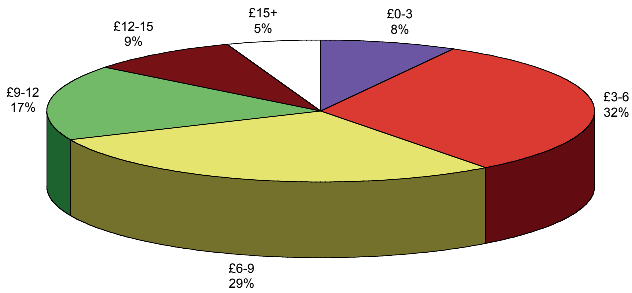
Portfolio Average Convexity: 101.5

Average Amount Issued of Largest 20 Gilts: £9.064bn

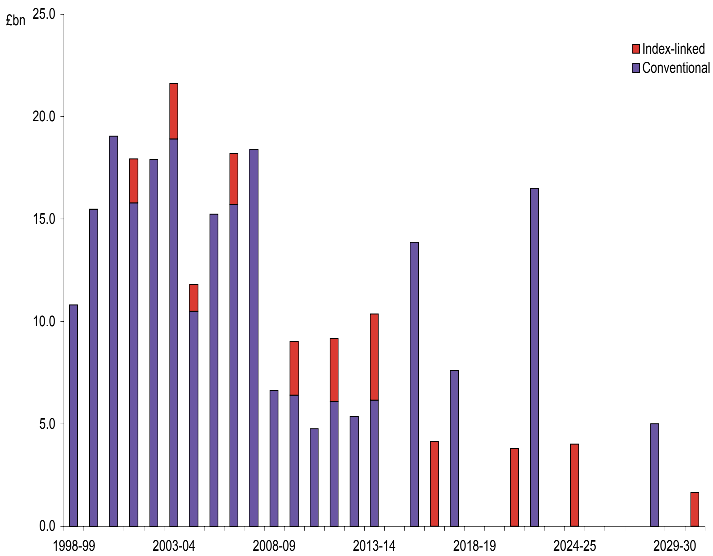
Gilt Portfolio's Maturity Split



Size of Issues in £ bn as Percentage of the Portfolio

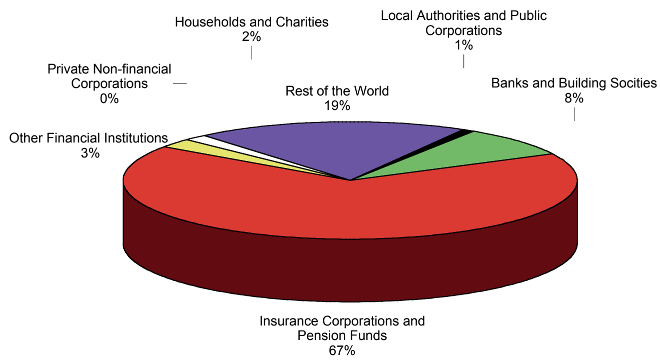


Gilt Redemptions (by Financial Year)



Double-dated issues currently above par are assumed to be called at first maturity. Index-linked gilts are not uplifted for inflation. Inflation uplift is scored in the CGNCR on maturity.
1998-9 figure refers to remaining redemptions.

Distributions of Holdings of Gilts in Market Hands Q3 1998



Source: ONS. Holdings of Gilts by Market Values.

Stock in Issue at 31 December 1998* (£mn)

Conventional Gilts

Stock	Redemption Date	Amount in Issue	Amount held in Stripped form	Central Government Holdings (end-September)+
9 1/2% Treasury 1999	15-Jan-99	1,900	-	34
Floating Rate 1999	11-Mar-99	5,700	-	225
12 1/4% Exchequer 1999	26-Mar-99	3,050	-	67
10 1/2% Treasury 1999	19-May-99	1,252	-	15
6% Treasury 1999	10-Aug-99	6,950	-	476
10 1/4% Conversion 1999	22-Nov-99	1,798	-	17
9% Conversion 2000	03-Mar-00	5,358	-	42
13% Treasury 2000	14-Jul-00	3,171	-	96
8% Treasury 2000	07-Dec-00	9,800	110	219
10% Treasury 2001	26-Feb-01	4,406	-	15
11 1/2% Treasury 2001-04	19-Mar-01	1,620	-	142
Floating Rate 2001	10-Jul-01	3,000	-	16
7% Treasury 2001	06-Nov-01	12,750	-	692
7% Treasury 2002	07-Jun-02	9,000	211	76
9 3/4% Treasury 2002	27-Aug-02	6,527	-	12
8% Treasury 2002-06	05-Oct-02	2,050	-	65
8% Treasury 2003	10-Jun-03	8,600	-	418
10% Treasury 2003	08-Sep-03	2,506	-	-
12 1/2% Treasury 2003-05	21-Nov-03	2,200	-	-
6 1/2% Treasury 2003	07-Dec-03	5,446	68	32
3 1/2% Funding 1999-2004	14-Jul-04	543	-	32
9 1/2% Conversion 2004	25-Oct-04	3,412	-	-
6 3/4% Treasury 2004	26-Nov-04	6,500	-	363
9 1/2% Conversion 2005	18-Apr-05	4,842	-	-
8 1/2% Treasury 2005	07-Dec-05	10,373	549	188
7 3/4% Treasury 2006	08-Sep-06	4,000	-	261
7 1/2% Treasury 2006	07-Dec-06	11,700	170	132
8 1/2% Treasury 2007	16-Jul-07	7,397	-	216
7 1/4% Treasury 2007	07-Dec-07	11,000	235	94
5 1/2% Treasury 2008-12	10-Sep-08	1,000	-	49
9% Treasury 2008	13-Oct-08	5,621	-	-
8% Treasury 2009	25-Sep-09	560	-	160
5 3/4% Treasury 2009	07-Dec-09	5,877	67	13
6 1/4% Treasury 2010	25-Nov-10	4,750	-	256
9% Conversion 2011	12-Jul-11	5,273	-	110
7 3/4% Treasury 2012-15	26-Jan-12	800	-	148
9% Treasury 2012	06-Aug-12	5,361	-	-
8% Treasury 2013	27-Sep-13	6,100	-	330
8% Treasury 2015	07-Dec-15	13,787	254	86
8 3/4% Treasury 2017	25-Aug-17	7,550	-	179
8% Treasury 2021	07-Jun-21	16,500	583	127
6% Treasury 2028	07-Dec-28	5,000	199	43
2 1/2% Treasury	Undated	474	-	-
3 1/2% War	Undated	1,909	-	-
2 1/2% Consolidated	Undated	275	-	-
4% Consolidated	Undated	358	-	-

Index-linked Gilts		**Nominal**	**Nominal Including Inflation Uplift**	
2 1/2% I-L Treasury 2001	24-Sep-01	2,150	4,466	17
2 1/2% I-L Treasury 2003	20-May-03	2,700	5,574	12
4 3/8% I-L Treasury 2004	21-Oct-04	1,300	1,559	-
2% I-L Treasury 2006	19-Jul-06	2,500	5,851	261
2 1/2% I-L Treasury 2009	20-May-09	2,625	5,419	160
2 1/2% I-L Treasury 2011	23-Aug-11	3,100	6,761	148
2 1/2% I-L Treasury 2013	16-Aug-13	4,200	7,656	330
2 1/2% I-L Treasury 2016	26-Jul-16	4,125	8,217	179
2 1/2% I-L Treasury 2020	16-Apr-20	3,800	7,447	-
2 1/2% I-L Treasury 2024	17-Jul-24	4,000	6,659	-
4 1/8% I-L Treasury 2030	22-Jul-30	1,650	1,986	-

* Stock of liquid issues. "Rump" stocks are excluded; a full list is obtainable from the DMO. Double-dated issues currently above par are assumed to be called at first maturity.
+ Includes holdings by National Investments and Loans Office (NILO) and DMO. Excludes local authority, public corporation and Bank of England holdings.

Announcements, Events and Contacts

Date	Notice	Title
8 October	Press Notice	Gilt-Edged Conversion: From 8% Treasury Stock 2009 into 5 3/4% Treasury Stock 2009: Announcement
22 October	Press Notice	Gilt-Edged Conversion: From 8% Treasury Stock 2009 into 5 3/4% Treasury Stock 2009: Offer Opened
3 November	Press Notice	Revision to the Government's Financing Requirement and the Debt Management Office Remit for 1998-99
13 November	Press Notice	Gilt-Edged Conversion: From 8% Treasury Stock 2009 into 5 3/4% Treasury Stock 2009: Announcement of Provisional Result
16 November	Press Notice	Gilt-Edged Conversion: From 8% Treasury Stock 2009 into 5 3/4% Treasury Stock 2009: Announcement of Final Result
17 November	Press Notice	Index-linked Gilt Auction
25 November	Press Notice	Sale by Auction of £450mn of 2 1/2% Index-linked Treasury Stock 2013
26 November	Operational Circular	Accrued Interest and Coupon Calculations for the Floating Rate Gilts
4 December	Proposal	The Future of UK Government's Cash Management - The New Framework
18 December	Press Notice	Gilt-Edged Auctions: January to March 1999

Date	Event
11 January	Opening of Switch Offer for 8% Treasury 2009 into 5 3/4% Treasury 2009
27 January	Auction of 2 1/2% IL Treasury 2024
28 January	Conversion Offer of 12 1/2% Treasury 2003-05 into 6 1/2% Treasury 2003 closes
17-18 February	Gilt Market Pre-Remit Meetings with the Economic Secretary
22 March	GEMMs Quarterly Consultation
23 March	End Investors Quarterly Consultation
31 March	Auction Schedule Announcement: April to June 1999
Q1 1999	Operational Market Notice for Cash Operations

Name	Position	Telephone No.
Mike Williams	Chief Executive	0171 862 6533
Paul Mills	Head of Primary Issuance	0171 862 6521
Hamish Watson	Chief Dealer	0171 862 6530
Jo Whelan	Manager Secondary Market	0171 862 6531
Jim Juffs	Press Officer	0171 862 6520
Robert Scott	Assistant Press Officer	0171 862 6527
David Page	Economic Analyst	0171 862 6524
Steve Whiting	Financing Remit	0171 862 6532
Martin Duffell	Market Liaison Officer	0171 862 6517
Mark Deacon	Quantitative Analyst	0171 862 6516
Gurminder Bhachu	Quantitative Analyst	0171 862 6512
Donna Russell	Primary Issuance Secretary	0171 862 6526

Information	Reuters/Bridge/ADP	Telerate	Bloomberg	Topic3/ASCII Broadcast	
Index		DMO/INDEX	DBTM		
Announcements	DMO/GILTS1 to 7	22550 to 2256	44700 to 44714	44715	
Shop window general info	DMOGILTS8	6615	44715	44715	
Shop window 1	DMO/GILTS9	6516	44716	44716	
Shop window 2	DMO/GILTS10	6517	44717	44717	
Shop window 3	DMO/GILTS11	6518	44718	44718	
				Stock ID	**ISIN code**
GEMMA ref prices (Conventionals)	GEMMA01 to 06	47216 to 47221	44800 to 44805	44800 to 44894	44806 to 44809
GEMMA ref prices (Index-linked)	GEMMA08	47223	44807	44805	44811
GEMMA ref prices (STRIPS)	GEMMA13 to 19	21291 to 21297	21291 to 21297	44850 to 44856	44850 to 44854

DMO temporary website: http://www.bankofengland.co.uk/dmo

The UK DMO can be found at

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138, Cheapside,
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