

Video conference of the ECB's Bond Market Contact Group

17 March 2022

Summary of the discussion

1) Review of bond market developments

Snigdha Singh (Bank of America) and Christoph Rieger (Commerzbank) reviewed the main bond market developments since the start of the year, placing a particular focus on the impact of recent geopolitical tensions on bond markets.

There was consensus that the reaction of bond markets to the outbreak of the war in Ukraine was orderly. Liquidity and market depth were negatively affected, with some metrics (e.g. in futures) worse than in March 2020, but still deemed sufficient to transact at any time.

It was highlighted that the first order impact, reflected in a sharp decline in equities and a repricing of monetary policy expectations, had played out and that markets had entered a second phase. High volatility in the initial reaction phase led to a "Value at Risk" (VaR) shock for dealers, which in turn constrained their intermediation capacity. While volatility indicators still point to high sensitivity to headline risks, the general view was that the focus will now shift increasingly to fundamentals. Initial dovish views on the implications of the war on central bank decisions were repriced and overall markets adjusted well to the recent central bank decisions, which have shown that priority is given to taming inflation relative to the growth impact.

Members generally felt that some market segments were relatively more affected by the increase in liquidity premia, for instance smaller/semi-core euro area sovereign bond markets (AT, BE, FI). The group also discussed the performance of micro relative value strategies by hedge funds, such as "on-the-run versus off-the-run", which contributed towards illiquidity and dislocations in certain interest rate curves.

The relative resilience of the Italian sovereign bond market was partly attributed to the closing of short positions, which were built up in anticipation of a faster monetary policy normalisation by the ECB and which came under pressure when the invasion started. Although members stressed that they do not currently see evidence of outright buying interest in the Italian sovereign bond market, several other factors explain the resilience so far: the existence of a liquid futures contracts for Italian debt, trust in

government stability beyond the next political elections, rumours of possible new common EU financing programmes similar to SURE/NGEU, and the strong unity demonstrated by EU leaders in imposing sanctions.

Finally, the discussion turned to repo markets and touched upon the impact of sanctions. It was concluded that a combination of factors contributed to the most recent increase in the Bund asset swap spread (difference between the swap yield and the equivalent maturity bond yield) to record levels, including the structural scarcity of collateral, positioning in the cash bond market and hedging activity in anticipation of higher interest rates.

2) The EU's development as a major borrower

Zoeb Sachedi (Citigroup) provided an assessment of the impact of the new safe asset on the euro area government bond market structure. The group praised the EU's remarkable and rapid progress on changing from a medium-sized supranational issuer into a "AAA Sovereign"-like benchmark issuer. Among the factors mentioned that helped to successfully place the large amount of EU bonds within just 1.5 years, were the conduct of auctions (alongside syndications) and the development of a primary dealer network.

Members discussed whether EU bond futures would be beneficial for secondary market liquidity. While there was consensus that this would help secondary market liquidity in the long run, most members felt that this would require larger outstanding amounts and would need some more time to develop. In the light of this, it was felt that priority should be given to the development of a repo market for EU bonds.

The inclusion of EU bonds in sovereign bond indices or exchange-traded funds was considered to add some extra dynamic on the way to becoming a benchmark issuer, but at the same time it was seen as being unrealistic since it could set a precedent for other supnationals and agencies.

Many members mentioned that the permanence of the EU programmes is crucial to establishing a longer-term oriented investor base and supporting robust demand.

Buy-side representatives mentioned that the previously discussed question of whether EU bonds are treated as sovereigns or supnationals is not of practical relevance to them, since both categories are traded from the same desk and use aggregate benchmark indices which include sovereigns and supnationals.