EUROPEAN CENTRAL BANK

EUROSYSTEM

15 March 2021

Video conference of the ECB's Bond Market Contact Group – 3 March 2021

Summary of the discussion

1) Review of bond market developments

Isabelle Vic-Philippe (Amundi) reviewed the main bond market developments since the last meeting on 14 December 2020. The discussion focussed on three aspects: (a) the rapid increase in bond yields in the United States and euro area; (b) market functioning during the recent sell-off in global bond markets and c) market participants' perception of central bank communication during the episode of rising yields.

Members were generally less concerned about the level of bond yields than about the speed and dynamics of yield increases, and the related bond market volatility. While the reflation theme had been a market driver for some time, the market movements of last week marked a shift as they were concentrated almost entirely on real yields and coincided with a sharp repricing of US interest rate hike expectations, questioning the Fed's commitment to keeping policy easy until inflation overshoots 2%. The spill-overs from the United States to euro area bond yields have been significant, and some members mentioned that some more decoupling could have been expected given differentiated growth and inflation outlooks. Some members saw credit markets and risky assets as vulnerable in the event of further increases in yields.

Regarding market functioning, there was a broad consensus that the most recent sell-off in euro area bond markets had not led to market dysfunctions reminiscent of March 2020. While members confirmed that the cost of trading had increased during the sell-off on 25 February, in particular in the cash market and in riskier assets, bond trading had remained orderly and participants had been able to transact continuously throughout the episode. It was mentioned that the heavy supply of bonds, in particular longer-maturity bonds, in the weeks prior to the sell-off had amplified the yield increase, at a time when market participants were seen as holding unusually long exposures versus their benchmarks.

Regarding central bank communication, while the general view was that the most recent verbal interventions by Governing Council members had helped to stabilise markets, some members felt that the communication was not clear enough. Markets would appreciate more clarity as to how the ECB defines and measures "favourable financing conditions" and intends to react to their changes. It was mentioned that in the absence of greater clarity, the publication of the purchase volumes is currently monitored "extremely closely" by market participants to gain insights into the reaction function of the ECB. While the low net purchase volumes published on Monday, 1 March had a muted market impact due to the large redemptions occurring during the period under review, members reported that market participants expect purchases to increase in the future.

2) Central bank tools to deal with market dysfunctions in the light of the "dash for cash" of 2020

Christian Kopf (Union Investment) shared his views on central bank tools and their reaction to market dysfunctions. The discussion concentrated mainly on potential ways to make bond trading and market liquidity more resilient, with participants taking stock of the "dash for cash" in spring 2020, and of the growing role of non-banks as bondholders.

Members exchanged views on how the current over-the-counter (OTC) regime for trading bonds could be strengthened in order to improve liquidity, if the dominant execution protocol remains OTC trading rather than trading via an exchange. Some members said that the role of market-makers needed to be better understood by regulators. It was felt that financial reforms and the increase in bank prudential requirements as a result of the Great Financial Crisis had had an adverse impact on market-making banks' capacity to warehouse bonds and had made market liquidity more fragile. Members stressed that euro area bond markets, which are of a more national nature than the large US Treasury markets, needed market-makers with firm quoting commitments to keep markets functioning in times of stress.

The role of buy-side firms was also discussed. The possibility for investors to move away from funds promising immediate liquidity into long-term investment funds was welcomed but would be slow to materialise. There were calls for buy-side firms to build up in-house market-making capacity, while participants also recognised the blurring of roles and the possible governance challenges.

Overall, with the current more limited capacity for market-making, it was seen as challenging to deal with market disruption episodes affecting core fixed income market segments such as government bonds, unless central banks were to act as a back stop.

3. Outlook for fiscal policies and their impact on the euro area bond markets, and changes in issuance patterns and the strategies of DMOs

Zoeb Sachee (Citigroup) gave an update on the issuance patterns of euro area Debt Management Offices (DMOs) and the impact of fiscal policies on the euro area on bond markets.

Members were of the view that the large supply at the long end of the yield curves in January and February 2021 was partly a reaction to the strong demand for longer-term bonds. In the current low yield environment asset managers are keen on extending their exposure along the yield curve, while pension funds and insurance companies are obliged to invest in longer maturities to contain their asset liability maturity mismatch.

In recent government bond issuances, order books for longer-dated issues rose to record high levels but at the same time the secondary market performance was mixed, because either the order books were inflated by speculative accounts or high allocations were given to less stable investors, which ultimately resulted in higher volatility and poorer liquidity.

The increase in syndicated issuances in 2020 was expected to last and was seen as important for good market functioning, while also contributing to better remuneration of primary dealers.