

17 February 2023

Video conference of the ECB's Bond Market Contact Group

14 February 2023

Summary of the discussion

1) Review of bond market developments

Silke Weiss (ESM) reviewed the main bond market developments since the last BMCG meeting in November 2022, with a particular focus on the strong primary market activity since the start of 2023.

There was broad consensus among members that the high net supply in euro area bond markets at the beginning of the year was surprisingly well absorbed in all major segments. Members felt there was a combination of factors that led to a balanced outcome between high supply and strong demand in fixed income markets. On the demand side, the seasonal pattern and favourable development of swap spreads led investors to put money to work at the beginning of a calendar year and the attractive yield levels in high quality fixed income markets resulted in a more structural shift of investor demand out of less liquid and riskier investments into bond markets. With inflation numbers and interest rates expected to peak soon, the current nominal yield levels were told to look attractive for many investors and supported the increased allocation to fixed income markets. As yields started drifting lower, the reversal of short positioning of speculative accounts which had been built in anticipation of a congestion of net issuance amplified the rally. On the supply side, a more flexible approach by issuers that offered at times some generous new issue premia and issued at shorter maturities on average than last year also helped market absorption.

There was no clear view whether the strong bond demand witnessed in January should be taken as a template for equally strong absorption going forward into 2023. Most members were of the view that while occasional bottlenecks can lead to upward pressure on bond yields, the absorption of supply will not become a major challenge. Still, the risk of uncovered auctions was told to exist and be monitored by markets. Overall, the bond market context was seen as supportive ahead of the start of the decline of the APP portfolio in March. The detailed modalities of this decline, announced on 2 February, were seen by members as in line with expectations.

The market reaction to the February 2023 ECB Governing Council decision was seen by members as surprisingly dovish, while the message conveyed in the press release, the monetary policy statement and press conference was on the hawkish side. Some members attributed this disconnect to the fact that the market expected the message to be as hawkish as in December, also emphasising the differences with the US in terms of inflation outlook, and they felt that this expectation had not been fulfilled.

With regards to market developments, many members felt that markets were complacent on inflation, perhaps after so many years of perceiving a central bank put, with the main scenario pricing rate cuts very soon after monetary policy tightening peaks, ignoring the tail risk of inflation being more persistent. This one-sided positioning was also illustrated by the asymmetric market reaction to some recent economic data releases which led to an increase in market volatility.

2) Bond markets in an environment of monetary policy normalisation

Christoph Rieger (Commerzbank) presented his assessment on how the euro area bond markets adapt to the new environment of Eurosystem balance sheet run-off.

Members discussed recent shifts in the investor base, partly related to the monetary policy normalisation. They reported strong demand from bank treasuries in the euro area bond market, supported by the attractive level of swap spreads, and a return from reserve managers from outside euro area to the euro area government bond, covered bonds and supranational and agency (SSA) markets. Some members also mentioned a stronger demand for high quality fixed income from defined benefit pension funds, which have seen their funding ratios improve as rates have normalised.

While there was a wide consensus among the members that the primary market activity was well absorbed, and accompanied by robust secondary market trading volumes, some members felt that it had become more difficult and more costly for dealers to manage their positions. As one example, secondary market liquidity in the SSA market segment has become more fragile and one-sided recently. One member reported that they adjusted trading by selecting a small number of counterparties only for their trades, to make sure the trades get done.

Members welcomed the ECB early [announcement](#) on the remuneration of government and foreign central bank deposits as from 1 May 2023, which will be conducive to a gradual return of these deposits into the market, hence supporting market functioning. The run-off of the Eurosystem APP portfolio as from March was mentioned to increase the free-float of securities in the market and seen as a factor helping to ease specialness in repo markets. In combination with the ECB announcement on the remuneration of certain non-monetary policy deposits, most members expected swap spreads to tighten further.

3) As markets evolve, are underlying structures changing? The case of trading automation

Zoeb Sachedi (Citigroup) provided an update on the automation of trading and the group discussed whether algorithmic trading changes the landscape in euro area bond markets.

Members were of the view that the increase in automation of trading in euro area bond markets does not affect the structure of the markets. There was a consensus that algorithmic trading offers many advantages: it makes trading more efficient with prices refreshing faster and more accurately and the increase in automation allows traders to concentrate on large tickets, while small tickets are dealt with electronically. It also improves dealers' risk management thanks to auto-hedging functionalities.

At the same time some members raised concerns that automated trading creates an illusion of liquidity and can only be applied to small trades. In times of market stress, auto-pricing mechanisms are turned off and traditional bilateral trading and voice trading becomes dominant again. While some members argued that High Frequency Trading Firms contribute to higher liquidity, others highlighted that those market participants have no obligation to provide quotes in the same way as primary dealers do and tend to withdraw their quotes in times of stress, thereby potentially exacerbating market moves.