EUROPEAN CENTRAL BANK

EUROSYSTEM

DIRECTORATE GENERAL MARKET OPERATIONS

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Meeting of the ECB's Bond Market Contact Group – 26 June 2018

Summary of the discussion

1) Welcome remarks by the Vice-President of the ECB

Luis de Guindos (ECB) welcomed the Bond Market Contact Group (BMCG) members, recalled the recent monetary policy decisions of the Governing Council, and raised a number of questions about the items on the BMCG agenda.[1]

2) Bond market outlook for the year ahead

Franck Motte (HSBC France) reviewed the main bond market developments over the last quarter and provided an outlook for the second half of the year.

BMCG members were of the view that the magnitude of the Italian sovereign bond market repricing and the volatility surrounding it were extraordinary and reflected a sudden change in market perception following the political developments. Some members were of the view that regulatory changes had decreased the capacity of dealer banks to engage in market-making activities, which exacerbated the market volatility. Some members also attributed the lack of intermediation to the prevalence of algorithmic quoting and trading. Such systems automatically switched off when volatility increased, requiring dealers to revert to manual quoting, which was more complex and time-consuming. Several other members were cautious about attributing too much importance to the market microstructure. In their view, such extraordinary episodes of market illiquidity and gapping could happen irrespective of regulation, as the market participants would need some time to find a new equilibrium price after major news.

Members generally agreed that the Italian sovereign bond market still seemed fragile and that secondary market liquidity was still below the levels prevailing before the repricing. At the same time, contagion to other jurisdictions or asset classes had been relatively contained. A few members were of the view that repricing moves were also possible in the corporate bond market, not least due to the anticipated reduction in net purchases under the ECB's corporate sector purchase programme.

[1] See also https://www.ecb.europa.eu/press/key/date/2018/html/ecb.sp180626_1.en.html

3) The global unwinding of quantitative easing (QE)

Jozef Prokes (Blackrock) and Christoph Rieger (Commerzbank) presented an analysis of the implications for bond markets of the reduction of stimulus from the world's major central banks.

Net purchases by the four major central banks taken together were likely to turn negative by end of 2018. Nevertheless, the stock of central bank holdings was likely to remain elevated for years to come. For the euro area, the impact on the yield levels was unclear, but some members did not rule out the possibility that spreads between euro area government bond yields could adjust.

Members cited the expectation of relatively low net issuances of government bonds in the euro area and the negative short-term interest rates as factors that were likely to keep euro area sovereign bond yields low for the foreseeable future. Some members cautioned that the ECB's asset purchases had contributed to low credit spreads on euro area corporate credit. According to some members, a withdrawal of the ECB presence in the market could contribute to a repricing. Some members also warned of possible displacement effects originating from the projected 25% increase in US government debt between 2017 and 2020. Such an increase would be unprecedented at a time when an economy was expected to expand strongly.

According to members, the Federal Reserve System's tapering experience could only serve as a very limited guide to the ECB, due to several differences in the market structure and financial conditions. These differences included: (i) the higher yield levels which had prevailed in the United States following the "taper tantrum", which helped attract investors at the time when tapering actually took place; (ii) the fact that the Federal Reserve System was tapering while the ECB and the Bank of Japan were still easing; (iii) the contained trajectory of sovereign net issuances in the euro area; (iv) the fact that US regulatory changes required banks to increase their holdings of high-quality liquid assets at the time of tapering; and (v) the larger variety of markets covered by the ECB's asset purchase programme (APP) compared with the Federal Reserve System's large-scale asset purchases.

Members stressed that the ECB's communication had become more important as net purchases under the APP were expected to come to an end. The market reaction to the recent Governing Council decisions showed that signals related to the key policy rates could at times be as effective in steering market conditions as additional purchases.

Several members raised the concern that there could be cliff edge effects in bond markets related to the TLTRO-II repayments. Once the remaining maturity of the operations had fallen below the one-year and six-month thresholds, the treatment of this type of funding from the perspective of the net stable funding ratio (NSFR) would change.

4) The hidden risks to bond markets

Peter Hegge (Allianz) and Zoeb Sachee (Citigroup) reviewed the hidden potential risks to bond markets.

Members were of the view that financial leverage had increased and was a source of concern at a time of global QE unwinding. Some financial market segments showed signs of bubbles, in particular those where margin debt had increased sharply.

A number of members also pointed out potential risks related to exchange-traded funds (ETFs). Market participants typically invested in ETFs because of the perceived higher liquidity and transparency. This could lead to adverse feedback loops in times of high volatility. In particular, in the event of large repricings the complex market structure underlying ETFs could, according to some members, become impaired, leaving market participants with positions they would be unable to sell, at least temporarily. According to these members, the ETF market would need to adopt available tools, such as gating, more decisively to better manage liquidity risks in ETF structures.

Several members cited increased automation and the increased adoption of artificial intelligence as another hidden risk, as these elements were typically procyclical. In good times, automation or artificial intelligence would generally be expected to improve liquidity further, whereas in volatile times, algorithmic trading strategies would tend to turn off automatically, which could amplify market downturns.

Some members also mentioned the interbank offered rates (IBOR) transition as a potential risk. If the transition was not managed properly by the regulators, supervisors and market participants, it could potentially lead to disruptions and fragmentation in the fixed income market.