EUROPEAN CENTRAL BANK

EUROSYSTEM

5 December 2023

ECB Bond Market Contact Group

28 November 2023

Summary of the discussion

1) Review of recent bond market developments

Marco Brancolini (Nomura) reviewed the most recent developments in bond markets and provided an outlook for the months ahead.

Members highlighted the relatively swift change in the prevailing market narrative from a “higher for longer” outlook for interest rates to an environment where the market is now pricing significant cuts in key central bank interest rates next year. While such changes in narratives can happen relatively quickly depending on data releases and central bank communication, members were generally of the view that the recent market repricing of interest rate expectations may be somewhat excessive. It was also suggested that it seemed to be at odds with recent communication from the ECB Governing Council which indicated that policy rates would need to remain at current levels for a sustained period to ensure inflation returns to its 2% medium-term target. Members also highlighted that moves in intra-euro area yield spreads remain relatively contained, supported by stable to positive credit rating actions and by the growth enhancing potential of Next Generation EU funds.

Members suggested that recent market moves were synchronised and led by developments in the US. More divergence could emerge next year as central banks are confronted with different macroeconomic developments. The uncertainty around the growth outlook for the US was perceived as higher than that for Europe while the underlying drivers of inflation dynamics are also somewhat different between the regions.

Members discussed the outlook for reinvestments under the Pandemic Emergency Purchase Programme (PEPP). Some members suggested that a potential announcement on a discontinuation of full reinvestments under PEPP would put more focus on the ECB’s Transmission Protection Instrument (TPI).

2) Market absorption capacity in the euro area and US bond markets

Nathalie Fillet (BNP Paribas) presented on market absorption capacity in the euro area and the US bond market and risks linked to the fiscal outlook, net issuance trends and shifts in the investor base.

Members discussed the recent increase in retail demand for sovereign issuance. Most were of the view that retail demand could prove transitory as most of it was driven by the divergence between the current level of short-term rates and bank deposit rates. Moreover, funding via the wholesale market provides issuers with a higher ability to extend duration at longer maturities and supports market liquidity. However, certain jurisdictions offer tax incentives on retail government bond investments which will continue to support demand and allow debt management offices (DMOs) to continue diversifying their funding via this channel.

The discussion also highlighted the growing importance of hedge fund participants in euro area government bonds (EGBs), increasingly through relative value and arbitrage strategies. Members held a balanced view on the impact of such a trend. It can support market liquidity at a time when dealer intermediation capacity is somewhat constrained. Moreover, in the euro area, two factors can mitigate the risk that a correlated unwinding of hedge fund positioning could cause a systemic shock. Specifically, hedge funds active in European markets currently tend to employ a multi-strategy approach to investments (e.g. not solely focused on the cash-futures basis arbitrage trade) while repo transactions in EGBs have a longer average tenor vis-à-vis US Treasuries.

The recent decision by the German DMO to discontinue the issuance of inflation linked bonds (ILB) was seen as a negative for the market segment. However, it was added that German ILBs constitute a relatively small share of the overall euro area ILB market and that other jurisdictions (e.g. France, Italy) have a deeper more liquid ILB market which can be employed for hedging purposes.

Members also highlighted the relatively robust demand for bonds with longer maturities. Recently this demand has been supported by the indexation needs of pension fund accounts. Issuers have sought to meet this demand by the issuance of long-term debt although this demand can also be met via the derivatives market.

3) Trends in the supranational, sub-sovereigns and agency (SSA) market

Ronald Van Loon (Blackrock) presented an update on the European SSA market and trends related to liquidity and relative pricing.

This market segment is not homogeneous and is going through a transition, particularly since the emergence of the European Union (EU) as a major issuer, through its Next Generation EU programme. Members pointed to structural hurdles in investment policies which favour national sovereigns relative to SSAs regardless of their risk and liquidity characteristics. One possible way to address these obstacles could be the inclusion of some SSA issuers in investment indices that currently only include national sovereign bonds, but this is likely to take some time.

On the bright side, members highlighted the improvement in secondary market trading in SSA bonds, which is becoming more active. This enables investors to build positions in the asset class without necessarily relying on primary bond market allocations. Some members also highlighted the further benefits that a futures contract on EU bonds could have for hedging and liquidity.