

ECB Bond Market Contact Group 19 September 2024

Summary of the discussion

1) Review of recent bond market developments

Antonio Cavarero (Generali Asset Management) reviewed the most recent developments in euro area bond markets and provided an outlook for the months ahead.

The US Federal Reserve's decision to reduce the target range for the federal funds rate by 50 bps was a larger cut than some members expected. The policy rate path implied by current market pricing, however, was not seen as excessive for either the US or the euro area. The Federal Reserve's policy decision did not lead to a significant repricing of bond yields and policy rate expectations in the euro area, although it was noted that a more aggressive easing cycle in the US may compel the ECB to be also somewhat bolder in its own policy decisions. A few members underlined that measures of market-based inflation expectations, after deducting risk premia, hint at risks of below target inflation in the medium term which, if they materialise, would accelerate the pace of rate cuts.

The uncertainty related to fiscal policies in several large economies, including the US and some jurisdictions of the euro area, was seen as an increasingly important driver for bond markets. Other factors contributing to uncertainty were the global economic outlook and the outcome of the US Presidential election. It was added that building up large open positions ahead of the US election is difficult given how close the polls are, but market positioning may increase after the elected candidate announces her/his economic agenda.

Members discussed the cheapening of government bonds on an asset swap basis. Concerns about fiscal deficits and sovereign credit profiles were highlighted but members also emphasised supply-demand dynamics. An environment of collateral abundance and quantitative tightening combined with moderate investor demand for duration has led to an underperformance of government bonds versus swaps.

Members generally expect sovereign yield curves to continue to steepen (except in Japan), also on the back of rising fiscal deficits. Dealers' balance sheet constraints into year-end were seen to put upward pressure on bond yields. Moreover, the assumption that the neutral rate remains above preCovid levels reportedly also tempers demand for longer tenors at current yield levels. However, a slowdown of primary market supply, reflecting current high levels of front-loading of issuance, may limit the steepening into year end.

Members also expressed some concern about the continued political uncertainty in France and the fiscal challenges it faces. At the same time, the French sovereign bond market offers high liquidity and market depth, a spread pick up over Germany as well as credit ratings which so far remain in the AA range, a combination which has very few alternatives in the euro area for real money investors. Therefore, the prospect of significant spread widening in the short-term is unlikely. In addition, the primary dealer system continues to support a smooth placement of bond auctions. However, some members underlined that the investor base for French bonds exhibits a strong reliance on foreign investors, some of which seem to have started to slowly shift away from participating in French bond auctions. While members saw little sign of any active selling of French bonds, they mentioned that some investors do not roll over their holdings while others reportedly stay on the sidelines and remain reluctant to increase their holdings at current spread levels.

2) Artificial Intelligence (AI): How will AI be further incorporated into bond markets and how will it be used by different market participants?

Marion Le Morhedec (AXA IM) and ECB staff (Fabian Gieseck and Federico Ferrara) presented on how AI and innovation are impacting bond markets and the financial sector.

Members discussed the transformational potential of AI tools and shared experience gathered from internal use cases. Identified applications ranged across front and back-office functions, including due diligence, requests for proposals, generation of fund commentaries, and parsing of internal and external research. Current and near-term benefits were mostly seen in operational efficiency and productivity gains and particularly in the ability to analyse vast and ever-growing amounts of information. Meanwhile, in the field of alpha generation and investment decision, AI tools were seen as complementing the traditional processes rather than fundamentally transforming them.

Members agreed on the need to retain human controls in the face of rising model risk and saw a possibility of increasingly correlated investment strategies and position crowding if industry-wide use of seemingly different, but at their core similar, models were to increase further. The discussion touched on several challenges, including adequate data protection, necessary compliance with existing and forthcoming regulation, controlling use of AI by younger generation and a very competitive job market for talented AI developers.

3) The growth of exchange-traded funds (ETFs) in fixed-income markets

Christian Kopf (Union Investment) presented on the growth of (ETFs) in euro area fixed income markets.

The main reasons identified for the strong growth in fixed-income ETFs were the ease of trading, increased liquidity for larger sized trades, the move from active to passive investment strategies and, as well as the increased attractiveness of fixed income in recent years.

Liquidity in the fixed-income ETF market has greatly improved in recent years also as more market participants enter the market. This facilitates pricing discrepancies to be arbitraged away. However, some members expressed caution about how the market would react to a significant risk event particularly given the presence of unregulated market participants among the market makers and authorised participants active on the ETF market. In addition, ETFs allow only long positions contrary to other instruments such as credit index futures which allow both long and short positions and are therefore more versatile. One member also highlighted a downside of ETFs whereby even if it is only very marginally exposed to a country, issuer, sector etc. in which the investor has zero limit, it makes the entire ETF non-investable. Another member highlighted the tax benefits for retail investors in some jurisdictions.