

Bond Market Contact Group

Frankfurt am Main, Tuesday, 21 April 2015, 13:00-17:00 CET

SUMMARY OF THE DISCUSSION

1. Bond market outlook and other topics of relevance

Ingo Mainert reviewed the main developments affecting bond markets since the last meeting, as well as the outlook.

The significant flattening of euro area sovereign bond yield curves during the first week of purchases under the ECB's Public Sector Purchase Programme (PSPP), led by a sharp decline in 10 and 30-year yields, was followed by a decoupling between the less and the more stressed jurisdictions in subsequent weeks. On the one hand, sovereign yields continued to decline in the less stressed jurisdictions, with an increasing share of these bonds trading at negative yields. On the other hand, 10 and 30-year yields rebounded for other jurisdictions and moved above the levels prevailing before the start of PSPP purchases. The members of the Bond Market Contact Group (BMCG) attributed this price differentiation to several factors: (i) the perceived scarcity of government bonds from the less stressed jurisdictions, exacerbated by the PSPP purchases and the low net supply due to the improvement in their fiscal positions; (ii) the frontloading of 2015 issuance by Italian, Spanish and Portuguese Treasuries; (iii) the structural demand for high-quality collateral arising from new regulation and from credit support annexes for derivatives, which generally require a minimum of AA-rated collateral to be posted by counterparties; and (iv) the risk of potential sovereign rating downgrades affecting some of the more stressed jurisdictions in view of upcoming elections or the slower pace of structural reforms. Many members considered the scarcity of high-quality collateral as being a consequence of certain regulatory changes, which were also seen as a possible contribution to pro-cyclicality. However, a few BMCG members expected euro area spreads to resume their narrowing trend in the second half of 2015, as the effect of some of the factors was deemed to be transitory. Finally, the steady reduction in US and euro area bond market term premia in the first quarter of 2015 was interpreted as a potential sign that an increasing number of market participants had established carry trade positions using the euro as a funding currency. This made euro area bond markets more vulnerable to a bond market sell-off.

The BMCG also discussed the impact of the PSPP on market functioning and liquidity, based on an internal survey circulated among members. The aggregate survey results pointed to a worsening of cash

bond market functioning in the euro area over the first quarter of 2015, although not necessarily attributable to the PSPP. This was particularly the case in the government bonds of the largest jurisdictions due to: (i) a widening of bid-offer spreads; (ii) the lower reliability of prices (measured by the ability to trade at expected/screen prices and the ability of counterparties to quote firm prices); (iii) a worsening in the ability of dealers to work on orders; (iv) a reduction in the average transaction size across all asset classes included in the APP; and (v) a deterioration in the conditions for borrowing government bonds. While the securities lending programme for PSPP holdings was expected to play a minor role at the start of the PSPP, BMCG members believed that it would become more prominent in subsequent months, particularly for German government bonds. The BMCG generally characterised the first weeks of PSPP implementation as smooth, with purchases generally seen as being in line with the eligible universe and well-spread across maturities.

The ECB gave further explanation of some of the technical aspects of the PSPP raised during the discussion. First, there is a possibility of using bonds issued by eligible supranationals as substitute bond purchases in jurisdictions that have a very low amount of government bonds outstanding. However, using substitute purchases in one or some of the largest jurisdictions in response to potential scarcity of PSPP-eligible government bonds (e.g. if a large share of the outstanding bonds were to trade at yields below the deposit facility rate) would be a change to the current specification of the programme and is currently not foreseen since a scarcity of bonds from a large jurisdiction is not expected to occur. Second, the weighted average maturity (WAM) of PSPP purchases is influenced by the impact of legacy SMP portfolios (which mostly mature in the coming years and which “consume” issue share limits for the respective ISINs), leading in some jurisdictions to a higher WAM, relative to the theoretically PSPP-eligible universe. Third, purchases of agency and substitute bonds in a given jurisdiction are included in the calculation of the capital key for PSPP purchases in any given month.

2. Global portfolio flows and their impact on European bond markets

Carlos Egea analysed recent global portfolio flows and the investment implications of a scenario of a protracted period of low euro area government bond yields. Margins between assets and liabilities were at decade lows for banks, insurance companies and pension funds, driving a global search for yield and increasing diversification both across regions and the credit spectrum. Notwithstanding its (likely) temporary nature, the extent of these flows was potentially very large and might have led to some distortions in market pricing compared with fundamentals.

The discussion revealed that diversification strategies were constrained by many factors, arising from regulation, industry infrastructure, investors’ risk tolerance and investor mandates. Some of these factors were seen to be contributing in the short to medium term to a squeeze in some asset classes with

comparatively high yields, such as corporate bonds, agencies and supranationals. Some members believed that the low yield environment would provide an incentive to diversify outside the euro area, which could lead to an increase in the supply of PSPP bonds until yields move back above the 2.5% level. Finally, the low-yield environment pushed the solvency ratios of pension funds lower, further constraining the ability of these long-term investors to diversify into mixed funds or other asset classes with higher volatility or a lower credit rating and hence higher capital consumption.

3. Liquidity in the bond and credit markets

Franck Motte, Pauli Mortensen and Thijs Aaten reviewed the recent trends in fixed income market liquidity. Both recent literature and market metrics pointed to the deterioration in European and US fixed income liquidity. Recent regulatory changes resulted in a significant reduction in banks' inventories and contributed to a perceived structural liquidity reduction.

The discussion focused on the consequences of the structural reduction in the trading volumes of bonds and derivatives markets, which rendered markets more vulnerable to sharp corrections. Members mentioned an increasing "liquidity bifurcation", whereby market liquidity increasingly concentrated on the most liquid securities. These two factors were possibly not yet factored into market participants' business models and hedging practices. Some of the proposed means to adapt to the new reality were: (a) at the industry level, by reducing the lag between the trade and settlement dates further – from the standard T+2 in European securities – and by creating alternatives platforms connecting the buy and sell sides in order to source liquidity (e.g. for trading corporate bonds); (b) at the sell-side area, by a stricter management of risk-weighted assets and a further reduction of unprofitable balance sheet usage; and (c) at the buy-side area, by engaging more actively in new trading protocols or by coordinating efforts to reach a critical mass for order matching.

4. Presentation of the ESDM and euro area primary government bond markets

Anne Leclercq presented the Economic and Financial Committee (EFC) Sub-Committee on EU Sovereign Debt Markets (ESDM), its mandate, main activities and organisational set-up. Mathieu Gaveau also presented the current shape of the euro area sovereign bond markets, with a particular focus on primary markets.

Members welcomed the progress made so far in the harmonisation and coordination of euro area primary market government bond issuance, although the majority of the BMCG saw, in some areas, scope for: (i) further harmonisation in the primary market issuance calendar and the timing and content of the disclosure of ex-post statistics, possibly by means of a document on best practice; (ii) closer coordination

between euro area debt management offices in order to reduce, on a best-effort basis, the coincidence of syndicated deals with auctions of similar issuers and maturity buckets. For the longer run, the BMCG also saw merits in further harmonising the processing of sovereign auctions in order to reduce operational risk. Finally, there was an exchange of views on systematic overbidding and the use of client discounts at auctions and possible means to discourage these practices.