16 December 2024

ECB Bond Market Contact Group

21 November 2024

Summary of the discussion

1) Review of recent bond market developments

Marco Brancolini (Nomura) reviewed the most recent developments in euro area bond markets.

Following the US presidential election there has been a notable decoupling of the US and the euro area rate markets, both in terms of policy rate expectations and government bond yields. The divergence between the 10-year US Treasury and German Bund yield was highlighted as the being one of the most obvious impacts of the Trump electoral victory. Members generally agreed this US-euro area divergence was more likely to widen further than to revert to the pre-election regime.

In the US, members mentioned a number of factors which could potentially push US bond yields higher. First, further increasing fiscal deficits; second, the potential for a significant pick-up in US economic growth, particularly if US corporate tax is materially reduced; third, the inflationary impact of the high tariffs and hardline immigration policies of the Trump agenda. All in all, some members were of the view that several factors could contribute to an increase in bond term premium in the US, which could partly spill over to euro area bonds. Another potential implication of the Trump victory was the possible deregulation in the financial sector, which might lead to an uneven level playing field between US and European banks.

In the euro area, members highlighted opposing forces on bond yields. On one hand, policy uncertainty – both in the US and in a number of large euro area countries – was seen to be causing economic damage in and of itself, which many members believed would lead to swifter loosening of monetary policy by the ECB than currently priced in. One member noted that if China, post-US tariff imposition, were to divert exports to Europe, it could have the potential to meaningfully lower euro area goods inflation levels. However, there were a number of factors also seen by members as adding upward pressure to euro area government bond yields over the coming months, such as heavy net government bond supply, idiosyncratic fiscal worries, and spillovers from US bond markets.

2) A deep dive into swap spread developments

Tomasz Wieladek (T. Rowe Price) reviewed recent developments in euro area swap spreads.

The change in the differential between German government bond yields and their corresponding swap rates ("swap spread") was thoroughly discussed. Consensus emerged amongst members that upward pressure in repo rates in the US and also in several euro area countries was an "eye-opening" moment for investors, which put into crude light a number of underlying trends. Continued net issuance of government bonds, coupled with the progress of central banks in their Quantitative Tightening, is leading to an environment of collateral abundance, at a time where hedge fund positions are significant in the euro government bond markets, and are financed through leverage obtained in the repo market. At the same time, heavy demand for duration from particularly Dutch pension funds mostly via swaps rather than bonds contributed to move swap spreads.

Members noted that the hedge fund community also became active players in the swap trade, which served to accentuate the moves by transacting in larger sizes than dealers' balance sheets could accommodate without moving prices. Some members noted that there seemed to be comparatively stronger views amongst the hedge fund community that a meaningful German debt brake reform would lead to higher net issuance of German government debt.

Members were mostly of the view that recent developments in swap spreads were not the sign of a dislocation but could rather be described as a normalisation from the previous collateral scarcity situation evolving into collateral abundance. Members also added that such levels of rate spreads between bonds and swaps were the norm in the US and UK.

3) Market intermediation: developments and challenges

Julian Baker (JP Morgan) and ECB staff (Benoit Nguyen) presented a stock-take on dealer intermediation capacity and the impact of central clearing.

Members discussed the reasons why bond market intermediation has become so challenging for dealers over the past few years. One member described how the increase in the outstanding amount of euro area bonds has not been matched with a corresponding increase in dealer balance sheets because of regulatory constraints weighing on the banking sector, while the non-bank financial sector increased in size. This resulted in a situation of "balance sheet scarcity" whereby dealers need to rely on moving bonds on and off their balance sheets more quickly, acting more and more as agent rather than principal. Other more specific factors were mentioned. Some members were of the view that some aspects of the G-SIB score methodology, for instance the end of year cut off, was exacerbating the constraints. Other members noted that, within global banks, some dealer intermediation capacity has been recently shifted from the euro area to the US, as the set of opportunities in US markets was considered more attractive by dealers. Finally, different practices by Debt Management Offices in designing primary dealership and auction frameworks for government bonds implied higher or lower pressure on dealer intermediation.

The pros and cons of a deepening of central clearing in government bond and repo markets were also discussed. Benefits were seen to include wider netting possibilities which could free up dealer capacity, fewer failed trades, clear and transparent market-wide margin requirements, and reduced counterparty risk. Members also noted some challenges of central clearing, such as the lack of transparency and potential procyclicality of margin requirements of CCPs and the fact that the relatively high fragmentation amongst CCPs in the euro area would dilute the abovementioned benefits.

Members gave their views on the relative merits of a planned move to T+1 securities settlement in the UK and EU. While the attraction of aligning with other jurisdictions was clear, a number of members cautioned that the decentralised nature of the euro area would make its implementation more difficult and the potential impact on the repo market in particular was underlined.