EUROPEAN CENTRAL BANK

EUROSYSTEM

DG/MARKET OPERATIONS
BMI/EBM

ECB-PUBLIC
8 July 2015

Bond Market Contact Group

Frankfurt am Main, Tuesday 30 June 2015, 14:30-18:30 CET

SUMMARY OF THE DISCUSSION

1. Bond market outlook and other topics of relevance

Alessandro Tentori (Citi) reviewed the main developments affecting bond markets since the last meeting, as well as the outlook.

The members of the Bond Market Contact Group (BMCG) deemed that the low-yield environment prevailing in the first months of 2015 up to mid-April contributed to an increase in the issued duration of bonds and to the market risk borne by bond market participants. On the one hand, issuers took advantage of the low yields to lock in low funding costs by issuing more bonds with longer maturities. On the other hand, the overall risk processing capacity of bond investors and intermediaries declined, including their capacity to take contrarian positions, as: (1) banks' balance sheet capacity has shrunk as a result of the new regulation (mostly the Leverage Ratio and the Incremental Risk Capital Charge), affecting the smaller markets proportionately more; (2) the risk capacity of insurance companies and pension funds has declined due to the Solvency II and mark-to-market requirements; and (3) real money investors managing end-client portfolios have also adapted to the structural decline in market liquidity by trying to anticipate client demands to liquidate their portfolios, while in fact tending to follow trends. Asset managers can also no longer use the repo market and open short positions in bonds. These factors appear to have structurally increased herding behaviour and trend-following markets, with faster (and overshooting) price corrections. Value at risk (VaR) limits are also hit more easily and more strongly than in higher-yielding environments.

According to the views of the BMCG, the German bund sell-offs in mid-April and early June were partly the result of the excessive one-way positioning of market players in anticipation of the impact of the start of the Public Sector Purchase Programme (PSPP) purchases. These factors contributed to the fast and abrupt bond market repricing. Furthermore, the structurally lower liquidity and risk absorption of many market participants has resulted in the more extensive use of bond futures to quickly hedge any exposure in bond sell-offs, as the liquidity in cash bonds is too low. Overall, BMCG members saw the German bund sell-offs as a healthy, albeit painful, experience. Market positioning was now deemed to be leaner and more diverse.

The BMCG also exchanged views on the initial market reaction to the announced referendum in Greece. The rather limited market reaction thus far was seen as encouraging and as a combination of the following factors: (i) a more robust Economic and Monetary Union, with more effective mechanisms and instruments to limit contagion to other countries; (ii) improved macroeconomic and fiscal positions of euro area countries; (iii) largely contained/hedged risks to Greece; but also (iv) market expectations of a swift reaction from the ECB, which would contribute to stabilising government bond markets in the case of heightened volatility. Finally, most BMCG members thought that the risk of a "no" vote was not fully priced in, and that it could lead to (significantly) higher volatility and to forced selling from investors.

2. Implications of the end of tapering by the Federal Reserve and shift into "normal" mode

Peter Hegge (Allianz) analysed the implications for the functioning and liquidity of bond markets of the end of the US Federal Reserve's tapering and the expected start of the tightening cycle. The BMCG discussion showed that market participants appear to be positioned for a progressive tightening of monetary policy by the Federal Reserve, which has also increased its focus on communication to avoid excessive surprises. Some fair value models including Allianz's proprietary model tentatively showed that actual German bond yields were at low levels based on fundamentals. The historical correlation with US Treasuries could be an additional trigger for German bond yields to correct in the event of a sell-off in US Treasuries.

3. Liquidity in the bond and credit markets

Frank Engels, Jozef Prokes and Carl Norrey analysed the long-term implications of the ECB's Asset Purchase Programme (APP) for the European and global financial markets. Regarding the implications for the US Federal Reserve's and Bank of England's asset purchase programmes, the APP was expected to lead to: (1) market segmentation and larger bid-offer spreads for bonds with lower free-float (larger share held by central banks); (2) negligible changes in the composition of the investor base for the involved asset classes; and (3) potential market volatility, in particular around the end of the purchases, which would require careful communication.

A proxy for the changes in the market depth of US Treasury and German bund futures tentatively showed a larger reduction in the depth of the German futures market. BMCG members agreed that regulatory changes had played an important role in the low market depth, notwithstanding the negative impact of the PSPP. The latter was also the case for the Asset-Backed Securities Purchase Programme (ABSPP), with the competition from cheaper sources of funding such as the targeted longer-term refinancing operations (and retained asset-backed securities pledged as collateral) and covered bonds further limiting the impact of the ABSPP. In this regard, the ECB clarified that all ECB programmes were complementary and contributed to the overall policy accommodation. Finally, purchases under the third covered bond purchase programme in primary and secondary markets were seen as facilitating price discovery compared to that of APP-eligible sovereign, supranational and agency purchases.