EUROPEAN CENTRAL BANK

EUROSYSTEM

28 May 2021

Video conference of the ECB's Bond Market Contact Group – 27 May 2021

Summary of the discussion

1) Review of bond market developments

Fabio Noacco (Mediobanca) reviewed the main bond market developments since the last meeting on 3 March 2021. The presentation and discussion focused on the impact of the most recent inflation data releases on inflation expectations and bond markets in the euro area and in the United States.

There were diverging views on the extent to which the most recent rise in headline inflation numbers in the euro area and the United States will generate second round effects and result in higher inflation expectations in the medium term. While the recent pick-up in inflation was noted, differences were highlighted between the size and type of fiscal stimulus in the United States and the euro area. Despite the uncertainty over the temporary nature of the increase in headline inflation data, members reported a significant increase in demand for inflation protection from retailers, wholesale and institutional clients, which could lead to a larger shift in asset allocation if inflation rose above 2%. In addition, they saw a decline in demand for duration as some investors reduced their exposures at longer ends due to the increase in inflation expectations and some uncertainty over how long central bank policies will remain as accommodative as they are at present.

Members also suggested that the decreased appetite for duration was evident in the recent widening of the asset swap spread for longer-tenor euro area sovereign bonds. This was also reflected in increased new issue premiums on some recent primary market issuances. A factor contributing to these moves was uncertainty over a potential change to the Eurosystem's pace of purchases at the June Governing Council meeting. Asset swap spreads have stabilised recently following reassuring communication from ECB policymakers, although uncertainty persists over future policy changes and how this will be communicated to the market. Some members mentioned that inflation expectations for the euro area had already increased substantially and the issue of the right exit strategy for the ECB will sooner or later become a topic for consideration.

One member raised the issue of the positive correlation between bond and equity markets, which is leading investors to look for alternative asset classes with potentially higher risk profiles (such as Chinese equity markets or emerging markets).

2) Repo market and securities lending developments – the impact on bond markets

Garry Naughton (Goldman Sachs) shared his views on the state of euro area repo markets and the spillover to bond markets. The discussion concentrated mainly on collateral scarcity in the repo markets, the role of debt management offices (DMOs) and the Eurosystem Securities Lending facilities. While it was acknowledged that the repo facilities of the DMOs and the Eurosystem Securities Lending facilities help to alleviate scarcity concerns, the general downward

pressure on repo markets illustrates the fact that repo market conditions remain relatively tight – they are worth monitoring, with further adjustments potentially being made in certain markets if signs of fragmentation arise.

Members welcomed the setting up of a repo facility by the Italian DMO (operational as of 24 May 2021) and agreed that the facility will support repo market liquidity going forward, in the way the repo facility of the German Finanzagentur does, although the primary objective of the facility is to improve the liquidity management of the Italian DMO.

3) The growing role of non-bank market-makers and all-to-all platforms

Michael Krautzberger (Blackrock) reviewed the growing role of all-to-all platforms in the bond market. While the overall importance and market share of all-to-all platforms is growing, the pace of growth was considered to be surprisingly slow. However, during the COVID-19 crisis their market share has increased to 10%, as market participants have been looking for new ways to find liquidity.

Despite the high expectations already in place for quite a number of years, all-to-all platforms have not risen to the level or role some people expected. For trading corporates and covered bonds the use of all-to-all platforms remains limited to trading between buy-side participants or between buy-side and sell-side participants, with specialised ETF non-bank market-makers very active on the platforms. Trading of sovereign bonds has so far remained broadly unaffected by the growth of the platforms and is not expected be affected any time soon, due to the prevalence of the primary dealership model in the euro area as well as other secondary market liquidity arrangements.

Among the reasons for the continuing relatively low market share of all-to-all platforms, some members mentioned the fact that in stressed markets participants on the platform are all on the same (selling) side and liquidity dries up quickly. Some members mentioned that markets will always need market-makers, such as primary dealers in the sovereign debt segment, and will need banks to use their balance sheets to provide liquidity. In addition, the all-to-all platforms operate more anonymously and in the absence of longer-term relationships and client servicing, so operational risks were considered to be high.

One member stressed that not only do all-to-all platforms provide an additional opportunity for finding liquidity, but they also offer the advantage of trading with a broader set of counterparties without needing to go through a lengthy counterparty onboarding process.