EUROPEAN CENTRAL BANK

EUROSYSTEM

15 March 2024

ECB Bond Market Contact Group

12 March 2024

Summary of the discussion

1) Review of recent bond market developments

Zoeb Sachee (Citigroup) reviewed the most recent developments in euro area bond markets and provided an outlook for the months ahead. Georgios Tsapouris (GIC) provided an update on commercial real estate-related developments and their potential impact on bond markets.

Members highlighted recent developments in investor positioning. At the end of last year, there was a strong market consensus around trades designed to profit from a steepening of yield curves. However, this steepening has not materialised owing to a retreat in rate cut expectations combined with the smooth absorption of bond supply limiting any increase in the term premium. There is also some evidence to suggest that the leveraged investor community has been increasing long positions of late in euro area sovereign bonds, which so far contributes to bond market absorption but is more susceptible to abrupt unwinding. These positions are financed in the repo market which exerts upward pressure on repo rates. While the cash-futures basis trade is not as prevalent in euro area markets as in the US, a shift in that direction remains a possibility. Positioning from non-levered accounts is less directional and driven more by relative value considerations. This has supported the recent tightening of intra-euro area sovereign yield spreads and the strong performance of credit markets.

Members suggested that uncertainty on the inflation outlook has somewhat increased. Recent euro area inflation data releases point to core inflation components potentially being somewhat stickier than previously thought. This represents somewhat of a shift from late last year when there was more confidence that inflation would normalise quite quickly. It was added that the current market view of a high degree of synchronicity in global central bank easing cycles may not persist. While common global inflation drivers exist, the more challenging economic outlook in the euro area, for example, might eventually lead to some divergence.

There was a wide consensus among members that euro area risks related to commercial real estate (CRE) appear idiosyncratic, centred around a small number of specialised lenders, with little contagion apparent in bank funding. There was a suggestion that some re-financing risk related to CRE may emerge if rate cuts are delayed or scaled back. However, recent movements in covered bond spreads, for example, illustrate that there is a healthy differentiation across issuers with investors looking at

bank's individual CRE exposure. Moreover, demand for the wider covered bond asset class remains very strong, with very high bid-to-cover ratios and non-euro area banks increasing their issuance.

2) Market absorption update following the active start to the year in bond issuance

Silke Weiss (European Stability Mechanism) presented on market absorption capacity following the strong start to the year in euro area bond supply, against the backdrop of global central bank balance sheet reduction.

Members highlighted how the seasonal increase in issuance in Q1 has been extremely well-absorbed across asset classes. The current environment was characterised as supportive with investors being offered attractive yield levels combined with expectations that the future downward path of interest rates should ensure capital preservation. The market was seen as returning to a pre-QE configuration whereby yield and spread levels allow different investor bases to be active in specific maturity segments across the curve. Front-loading of issuance was particularly pronounced this year, reflecting the willingness to benefit from current benign market conditions.

Some members suggested that demand for long maturity bonds was comparatively weaker than other maturity segments. Members cited less asset liability matching investment flows both structurally as pension funds continue to shift from Defined Benefit to Defined Contribution and relative to 2023, when some investors already closed duration gaps.

Members cited various risks to market absorption going forward. These included: (i) the possibility that a tightening of monetary policy in Japan could lead to a repatriation of Japanese investor flows; (ii) an upward shift in the pricing of market-based measures of inflation expectations; (iii) market volatility related to upcoming elections and subsequent possible changes to fiscal outlooks, and (iv) Dutch pension fund reform.

3) Focus on the private debt market

Tatjana Greil Castro (Muzinich) reviewed developments in the private debt market, the strong recent growth, its drivers and its interaction with the corporate bond market.

The significant growth in the market comes amid a decrease in the reliance on bank lending for mid-size European companies. Growth drivers include: (i) a desire for customised funding solutions from borrowers; (ii) the significant yield pick-up for investors; (iii) smaller borrowers facing 'barriers to entry' in public markets, and (iv) regulation contributing to banks' retreat from corporate lending. While quite dynamic and innovative the private debt market is also relatively untransparent and lending activity is focused on highly levered companies.

Members acknowledged that the private debt market has experienced significant growth in recent years. However, there were differing perspectives on how the market might develop going forward. Some members suggested that institutional investors would continue to increase their exposure to the market and benefit from the large illiquidity premiums available. Such investors continue to put appropriate

infrastructure (risk management, pricing models etc.) in place to incorporate the segment into their asset allocation exercises.

Other members were more sceptical about the continued growth of the market citing: (i) the cyclical nature of demand whereby investors that can reach their nominal yield target in public markets are unlikely to go into private debt (ii) the concern that the market has not been probably tested from a default cycle perspective, and (iii) the lack of mark-to-market pricing data makes inclusion in asset allocation frameworks challenging for some investors.