

24 June 2022

Meeting of the Bond Market Contact Group (BMCG) on 23 June 2022

Summary of the discussion

1) Review of bond market developments

Marco Brancolini (Nomura) reviewed the main bond market developments since the last BMCG meeting on 17 March 2022, with a particular focus on market liquidity.

Members discussed market functioning, given the recent periods of high volatility. There was a consensus that bond market liquidity had deteriorated of late (albeit with heterogeneity continuing to be observed both over time and across asset classes). Members pointed to a structural change in the market as central banks embarked on a normalisation of policy. Participants remarked that such a transition was always going to present challenges for markets. Many investors had looked to position themselves for a rise in yields, which meant that the market had become fairly one-sided. Nonetheless, members were of the view that the functioning of the market was not impaired and generally remained orderly, despite these challenges. One supporting factor was the fact that euro-denominated fixed income funds had not experienced any significant outflows during this period.

Heightened market volatility had impacted not only the intermediation capacity of dealers, but also investors' ability to conduct large trades. Some members suggested that market liquidity would improve when those investors who were currently reluctant to buy and choosing to stay on the side lines returned to the market. Technical factors affecting dealers' ability to hedge were also thought to have contributed to the decline in liquidity. Uncertainty as to which bond would be the cheapest to deliver under German Bund futures contracts had made hedging more challenging. Here, members praised the transparent approach adopted by Deutsche Finanzagentur, which had recently publicly communicated the coupon on its upcoming new ten-year benchmark issuance. Some members suggested that Debt Management Agencies might need to be more active in their respective markets as the risk of technical dislocations became more pronounced.

On the subject of intra-euro area yield spreads, members highlighted the lack of a widely understood definition of fragmentation, with the ECB's public communication in this respect regarded as somewhat vague thus far. As regards the ECB's plans for an anti-fragmentation tool, members emphasised the need for a credible instrument, which should ideally be supported by fiscal authorities. More generally, members also pointed to the need for more consistent communication from the ECB. As regards

discussions around terminal rates, it was felt that, while some official guidance would be helpful, central bank communication should not be very specific given the high level of uncertainty involved.

2) Primary market dynamics in the context of declining asset purchases

Siegfried Ruhl (European Commission) reviewed developments in public sector markets, while Tatjana Greil-Castro (Muzinich & Co) provided an assessment of private sector markets.

Members noted that price discovery for new issuances remained difficult. This could be seen in new issuance premia, which continued to trend higher. For some market segments, screen prices were not a true reflection of the market, which was further complicating the pricing of new primary issuances. Another factor contributing to increases in new issuance premia was poor secondary market liquidity. Investors who were looking to sell older bonds in their portfolios on the secondary market to make room for allocations in new primary deals would ask for higher new issuance premia if the execution of secondary market transactions was difficult.

The impact on primary market activity varied across issuers and market segments. There was also a substitution effect in an environment of rising yields, whereby investors were potentially favouring issuers and market segments where credit quality was perceived to be higher, with relative value considerations also arising.

The combination of market conditions and concerns about increases in credit risk meant that issuance had become very challenging for high-yield companies. Conversely, issuance of covered bonds had been very strong this year, already surpassing the annual total seen in 2021. A return to a more stable market environment should facilitate an increase in issuance volumes and allow a wider range of issuers to access the market.

3) Impact of central banks normalising their monetary policies

Alessandro Tentori (AXA IM) gave a presentation on the impact of the world's central banks normalising their monetary policies.

The BMCG briefly considered the question of how liquidity provided through any future purchases under an anti-fragmentation tool might be sterilised. The group also asked whether it was possible to address rising inflation without quantitative tightening. Finally, it was noted that the impact of central banks normalising their monetary policies at different speeds – while evident in fixed income markets – was most apparent in foreign exchange markets. The recent strength of the US dollar was highlighted.