EUROPEAN CENTRAL BANK

EUROSYSTEM

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Bond Market Contact Group

Frankfurt, Tuesday, 21 January 2014, 1 p.m. – 5 p.m.

SUMMARY OF THE DISCUSSION

1. Bond market outlook and other topics of relevance

Karl Heinz Riehm reviewed the main developments that have affected bond markets since the last meeting, as well as Unicredit's outlook and main risks. Regarding the outlook, the factors determining the performance of bond markets in 2013 remained broadly unchanged, namely an improving macroeconomic outlook, progress in the process of European integration, changes in regulation and major central banks' forward guidance amid some removal of accommodation.

The start of the Federal Reserve System's tapering has removed some uncertainty from financial markets, and the progressive reduction of the size of the Federal Reserve's programmes for purchasing US Treasuries and mortgage-backed securities (MBSs) is expected to be well absorbed. Some (limited) spillovers to euro area government bond yields cannot be excluded. No particular risks are perceived with respect to the bonds of stressed euro area countries, given the underweight portfolio positions of non-European investors in these securities. These investors have started to return to the European markets and are still looking for opportunities to move to a more neutral stance. The beginning-of-the-year effect, coupled with portfolio imbalances and large redemptions in some of the relevant jurisdictions, have been contributing to the very positive performance in the year so far. Notwithstanding the more constructive consensus view, some members warned that the bull bond market could also end abruptly. In particular, the reduced balance sheet capacity of market-makers, resulting also from recent regulatory changes, would limit their capacity to buffer an exit of investors. Moreover, there were views that the functioning of the repo market is likely to change after new limits on leverage and other regulatory measures have been finalised. Overall, members were concerned that markets might not have adjusted to the impact of regulatory changes on market liquidity and behaviour, which could ultimately lead to higher liquidity premia and higher funding costs.

2. Sovereign funding challenges for 2014 and private sector bond issuance

Christoph Rieger analysed this year's outlook for the issuance of public and private sector bonds, with a particular focus on euro area developments. Jozef Prokes (Blackrock) presented the outlook and main challenges from the point of view of investors.

The outlook for euro area issuance in 2014 was summarised as follows: (1) sovereigns: lower net and gross bond issuance as a result of lower budget deficits, particularly in the case of Germany, Italy and Belgium; (2) a steady net supply from agencies; (3) covered bond issuance expected to contract further; (4) senior net bank bond issuance likely to turn positive again; and (5) asset-backed securities (ABSs) expected to continue to flag. The share of retained ABSs in total issuance remained very high, despite a significant contraction of issuance volumes over the past two years. Regarding the demand side, it was noted that mutual funds had become more defensive regarding their duration exposures, investing mainly in short-term maturities and floaters, as well as in short-dated high-yield bonds and credit. Flows into investment funds with flexible mandates had increased, pointing to more caution among investors regarding expected bond returns/trends. The outlook for euro area stressed countries still appeared constructive, with potential for improved ratings and a likely return of more stable investors like Asian institutional investors.

During the discussion, members agreed with the main views expressed. In particular, the prospects of a meaningful revival of the European ABS market were deemed to be low on account of the lack both of a sufficiently large investor base and of interest on the part of potential originators to issue at high yields. Institutional investors would need to change their guidelines to be able to re-invest in ABSs, which would often meet resistance from senior management and risk officers alike. For investors subject to capital adequacy regulations, such as insurance companies, the new (revised) capital charges remained punitive in comparison with those for other asset classes such as corporate or covered bonds. This notwithstanding, the low ABS issuance volume seemed also to be a result of a lack of supply, as members were not aware of any failed issuance. In this context, the announced amendments to the Italian and Spanish covered bond laws to enable loans to small and medium-sized enterprises (SMEs) to be included in the cover pools were tentatively seen as one of the potential ways to enable SMEs to access to capital market funding.

3. Review of the latest developments in electronic trading on bond markets

Thijs Aaten, Ingo Mainert and Ciaran O’Flynn reviewed the liquidity in bond markets in the context of electronic platforms, both business-to-customer (B2C) and business-to-business (B2B).

An increasing share of fixed-income trading is conducted through electronic platforms, with average daily volumes of around €85 billion for European bonds in 2013. The bulk of transactions are still conducted with so-called ‘traditional model’ platforms which use the request-for-quote model and utilise the balance sheet of market-makers, whereas the share of regulated markets/order books based on firm orders remains low for the time being. While the development of electronic trading in fixed-income assets is still in its early stages, the evolution path of electronic trading in foreign exchange and equities could indicate where fixed-income electronic trading is heading. For this to happen, however, fixed-income assets would have to become more standardised, in terms of both maturities and coupon structures, to enable the use of algorithm trading.

Members believed that preserving the primary dealership model remained important for issuers to reduce the risk of failed auctions and to ensure a dissemination of liquidity in secondary markets. Furthermore, some members thought that anonymity and the possibility to negotiate a price for the whole order size would prevent large flows from moving to central limit order books.

4. Risk metrics

Ciaran O’Flynn analysed the evolution and impact of different VaR model specifications on the ability of the market-maker community to take risks in fixed-income assets, as well as possible implications and lessons learned. Wider use of conditional VaR models could lead to a higher pro-cyclicality of fixed-income markets than in the past, when arithmetic VaR models were the norm, given that the former are more reactive to increases in volatility. The incorporation of credit risk management techniques and more complex measures of VaR by trading portfolios might also explain the strong correlation between the volatility and the level of spreads in some bond markets, such as that for Italian BTPs.

Members generally agreed with the conclusions, adding that these periods often coincide with changes in the perception of credit risk that make it difficult to attribute changes in market dynamics to a single factor. The latter are of particular importance to real money investors, reinforcing the pro-cyclicality of fixed-income markets in periods of extreme illiquidity.