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Bond Market Contact Group

Frankfurt am Main, Tuesday 27 January 2015, 1 p.m. to 5 p.m.

SUMMARY OF THE DISCUSSION

1. Bond market outlook, issuance outlook and other topics of relevance

Carl Norrey reviewed the main developments affecting bond markets since the last meeting, as well as JP Morgan's issuance outlook.

Members of the Bond Market Contact Group (BMCG) discussed the announcement impact of past quantitative easing (QE) programmes on yields and the likely implications for euro area government bond yields. While members generally expected that bond yield spreads would continue to narrow, there were mixed views about the impact on German Bund yields. On the one hand, some members expected yields to rebound from mid-2015 onwards, should the Federal Open Market Committee (FOMC) start tightening policy. An analysis of the impact of key QE announcements in the United States, the United Kingdom and Japan included in the presentation also showed that, on average, ten-year yields rebounded 60 days after QE announcements by around 40 basis points from the levels prevailing 20 days before the announcement. The yield rebound was largely attributed to the credibility of the programmes in pushing inflation expectations higher. On the other hand, some members expected euro area government bond yields to continue to decline owing to (i) the low net issuance of euro area government bonds, (ii) low oil prices, (iii) structural demand for highly-rated securities also stemming from regulation, (iv) collateral needs (e.g. for positions in derivatives), and (v) demand from risk-averse investor mandates. One member also noted that the rebound in yields after the QE announcements had been only temporary and that yields in those countries had come down again after the 60-day period analysed. Members also noted the relatively muted effect of the political uncertainty in Greece on the rest of the euro area bond markets so far. This was largely attributed to a more robust euro area institutional framework. Finally, the BMCG shared concerns with regard to the proposals on mandatory buy-ins of securities implementing the Central Securities Depositories Regulation (CSDR). These concerns related to (i) a reduction in market-makers' willingness to provide liquidity, (ii) a widening of bid-offer spreads, and (iii) the fact that this could lead to a split market between short and longer-term repos.

2. Analysis of October 2014 risk-off episode

Gene Frieda (Moore Capital) and Jan Lundström analysed the catalysts and implications for market liquidity and functioning of the risk-off episode concerning US Treasuries (UST) in mid-October 2014.

Among many factors, BMCG members agreed that high-frequency trading (HFT) has become a more important driver of short-term UST market movements. While it is difficult to estimate the volumes, anecdotal evidence suggests that HFT could account for 50% of the flows. These flows add a false sense of liquidity or market depth to fixed income markets, as they are fickle and are quickly withdrawn when market volatility increases. Instead, bond markets are now more vulnerable to volatility and price shocks given the lower inventory capacity of market-makers to absorb short-term volatility, increasing the likelihood of similar price jumps in the future. Furthermore, the lower market depth and the concentration of market-makers' inventories in the more liquid and higher-rated securities might be leading investors to change their hedging practices and to use the more liquid instruments as a proxy when volatility spikes. At the same time, technological advances and the wider access to more timely trading data and to correlations such as those used for HFT are changing the market structure and the way all market participants operate, while creating new opportunities.

The discussion focused on the rapid recovery of UST from the extreme price developments and attributed it to several factors. First, there were not many fundamental reasons for the large decline in UST yields. This temporary dislocation therefore created opportunities for market participants with a longer-term investor horizon and more focused on fundamental value. Second, central bank large-scale asset purchase programmes (LSAPs) are acting as a market stabiliser in periods of volatility spikes. Third, UST are the most liquid asset class and the UST market is likely to mean-revert faster than other markets, where the potential for dislocations could be larger or more long-lasting as the ability of market-makers to arbitrage might be lower.

3. Impact of ABSPP and CBPP3 and potential LSAPs

Christoph Rieger and Laurent Clamagirand discussed the design and initial impact of the ECB's expanded asset purchase programme (EAPP) announced on 22 January 2015, as well as the impact of the asset-backed securities and covered bond purchase programmes (ABSPP and CBPP3) on issuance, market prices, liquidity and investor base. Based on the assumption that the Eurosystem would purchase EUR 950 billion worth of government bonds until end-September 2016, the ECB's QE programme was similar to that of the Federal Reserve System in terms of percentage of GDP and the share of the expected outstanding amounts (10% and 15% respectively), but below that of the Bank of England and the Bank of Japan. However, the expected share of Eurosystem purchases in the expected annual gross supply was higher, particularly in some jurisdictions like Germany and Austria (100% and 90% of 2015 gross government bond supply respectively). The latter might have a large impact on bond valuations and relative value opportunities across euro area countries

The discussion focused on the design features and the calibration of the new programme. The general consensus was that the announced size was slightly above market expectations, with members welcoming its open-ended nature and the transparency on the operational modalities (the technical annex accompanying the press release announcing the EAPP). The inclusive nature of the programme, both in terms of securities and maturities (i.e. inclusion of inflation-linked and floating rate securities and maturities up to 30 years), was also welcomed and limited market distortions. The exclusion of corporate bonds from the EAPP had not created distortions and was seen as positive, given the limited size of this asset class. With regard to other elements of the EAPP design, members expressed some preference for ex ante transparency in the securities to be purchased – ideally through (Dutch) reverse auctions – as a means to improve price discovery for dealers and investors. Regarding the announced monthly disclosure of the amounts held, there was also a preference for a more detailed breakdown than is the case for the ABSPP and CBPP3, preferably including a breakdown by International Securities Identification Number (ISIN).

The ECB clarified that in the absence of specific decisions, the implementation of the EAPP aimed ex ante at market neutrality in the sense of avoiding specific dislocations in euro area government bond curves within the agreed maturity range. Second, the operational target – with an allocation of the purchases across euro area countries based on the ECB's capital key – had been defined on a monthly basis with possibly some flexibility to allow temporary deviations without compromising the overall pace of purchases. Third, it was repeated that the Eurosystem is willing to accept the same (pari passu) treatment as private investors. Also for this reason, it will apply issue limits to ensure that the application of collective action clauses (CACs) for a bondholder decision is not obstructed. Fourth, issue limits applied in the EAPP were set, according to the ECB's announcement, to be the same for bonds with CACs as for non-CAC bonds. Fifth, it was recognised that it would be beneficial that the ECB publish before the start of purchases a list of the agencies, international or supranational institutions eligible for the EAPP in the following weeks. The list would be based on the eligibility criteria for marketable assets in the context of the ECB's collateral framework, but it might not be identical. Sixth, in principle, all the Eurosystem central banks would lend their EAPP holdings, although the precise implementation features still need to be finalised. Members suggested that the conditions of the securities lending be harmonised and fully transparent in order to reduce the EAPP impact on secondary market liquidity. Seventh, in line with its design respecting the prohibition on monetary financing, the EAPP implementation will include black-out periods for certain securities around new primary sovereign issues, although the details will not be made public. This is consistent with previous Eurosystem monetary policy programmes involving purchases of government bonds.

The discussion on the impact of ABSPP and CBPP3 evidenced mixed views. A few members suggested that the Eurosystem should consider stopping purchases in other asset classes now that it had moved into a QE programme in order to limit the structural damage that the purchases are creating in the traditional investor base. Other members supported the continuation of the ABSPP and CBPP3 to ensure a level playing field between main fixed income asset classes. They believed that the EAPP would reduce the impact of Eurosystem purchases across all involved asset classes and expected investors to remain engaged in ABS and covered bonds, which possibly required a lower risk premium given the effect of Eurosystem purchases. Both programmes had been effective in contributing to a significant reduction of spreads, particularly for the more stressed jurisdictions, which improved the conditions for primary market issuance. However, in the ABS case, the constraints of the uncertainty around capital relief or the high cost for selling the mezzanine and equity tranches were still seen as potentially limiting the future issuance of euro area ABS.

4. Best practice framework for euro area government bond markets

Mathieu Gaveau presented the status of the euro area primary government bond markets and suggested a path towards further harmonisation. Maya Atig – Deputy of the Agence France Trésor – participated in this agenda item, representing the Economic and Financial Committee (EFC) Sub-Committee on EU Sovereign Debt Markets (ESDM).

Several proposals were put forward by the members and are intended to be further discussed at the April 2015 BMCG meeting. The current nature of the euro area sovereign bond market limits harmonisation, given the existing differences in the profile and seasonality of demand, the specific needs of issuers and constraints met by dealers. BMCG members noted that the euro area government bond markets were still not fully integrated and that further harmonisation could improve their liquidity and functioning. In particular, the following areas were considered to be worth further effort: (i) a better harmonised and coordinated issuance calendar agreed by all euro area debt management offices (DMOs), (ii) better communication between DMOs with regard to the timing of syndications, (iii) a unique auction system, and (iv) limits on overbidding.