



EUROPEAN CENTRAL BANK
EUROSYSTEM

13 December 2021

Videconference of the ECB's Bond Market Contact Group

2 December 2021

Summary of the discussion

1) Review of bond market developments

Silke Weiss (ESM) reviewed the main bond market developments since the last meeting on 15 September 2021. The discussion focused on increased volatility and uncertainty in financial markets, potential drivers of the recent flattening of yield curves and tensions in the euro area repo markets.

Members highlighted that the global increase in uncertainty about future central bank policy stances as the year-end approaches had caused a sharp reduction in investor positioning, which has increased volatility in fixed income markets. This led many market participants to look for ways to invest their cash against high-quality collateral or in high-quality Treasury bills, which has caused strains in repo markets and at the short end of the yield curve.

Members were of the view that the tensions in the euro area repo markets could be attributed to a combination of factors, including early balance sheet management by banks ahead of the year-end, the build-up of short positions and a declining free float especially for German securities. These tensions were likely to persist as the year-end approaches and to remain most pronounced in German repo rates, where collateral was still particularly difficult to find. The recent increase of the Eurosystem's aggregate securities lending limit against cash collateral to €150 billion was welcome, but it may not be sufficient to ease tensions unless individual counterparty limits and maximum maturity limits are also eased. One member highlighted that a significant improvement in German repo market tensions would only take place if the three largest holders of German sovereign bonds – the German Finance Agency, the Eurosystem and large foreign central banks – made their securities more freely available for repo counterparties. This view was shared by other members.

There were mixed views on whether the main driver of the recent flattening of euro area yield curves was investor repositioning or a revised assessment of the economic outlook. On the one hand, some thought that the flattening of yield curves in November was mainly due to an unwinding of the curve steepening positions many market participants had previously entered into. On the other hand, concerns that central banks may increase policy rates prematurely and negatively affect growth were cited as a reason why the longer-term yields had declined the most, leading to a

compression of term premia. A decline in the expected terminal rate of interest relative to previous cycles of rate tightening was also seen as contributing to a flatter yield curve.

Overall, members agreed that uncertainty about the economic outlook makes it a difficult environment for both central banks and financial market participants. Members noted that the meetings of major central banks in mid-December (the Federal Reserve System, the ECB and the Bank of England) may lead to volatility in the market if surprises emerge. The lack of liquidity in the market at that time of the year might exacerbate moves but risks have been mitigated by central bank communication and the unwinding of positions in the past few weeks.

2) Recent developments in bond market liquidity

Ben Lewis (Morgan Stanley) provided an update on recent developments in bond market liquidity and shared his views on potential factors contributing to changes in liquidity conditions. While “top-of-book” liquidity conditions (i.e. best bid and ask) have remained stable, the sizes available to transact have gone down as volatility has increased in euro area bond markets. The discussion focused on the increase in fixed income volatility, as well as how issuers might best ensure secondary market liquidity in their bonds.

An increase in fixed income volatility should be a welcome development if it is not disruptive to market functioning. After a long period of historically depressed volatility, members thought it likely that volatility will remain elevated. Although higher volatility could imply slightly wider yield spreads, it may attract more investors to the market and offer more trading opportunities, which was seen as positive for fixed income markets.

From an issuer’s perspective, there may be a need to revisit allocation processes to better support secondary market liquidity. The need for a healthy balance between syndications and auctions was highlighted, given that syndications might provide the opportunity to shape the investor base in a more flexible way than auctions. As the year-end approaches, balance sheet constraints continue to limit dealers’ ability to provide good liquidity to their clients.

3) Assessing market-based inflation expectations

Alessandro Tentori (AXA Investment Managers) provided an assessment of market-based inflation expectations. The discussion focused on the need to complement market-based inflation measures with survey-based measures and the usefulness of doing so.

Several members highlighted the importance of complementing market-based measures of inflation expectations with other indicators, such as surveys of households and firms. One member added a word of caution on household surveys, which historically have tended to overstate realised inflation. Another member noted that recent developments in inflation options pricing had

highlighted the uncertainty about the inflation outlook and potentially reflected the market adjusting to the ECB's new symmetric policy goal. However, several members cautioned that the lack of liquidity in these instruments may lead to some pricing distortions.

4) Update on the ECB Survey of Monetary Analysts

Claus Brand (ECB) provided an update on the ECB Survey of Monetary Analysts (SMA). He reminded members about the role of the SMA, presented an overview of developments in response rates and noted that the next issue of the ECB's Economic Bulletin will feature an article on this topic.