



EUROPEAN CENTRAL BANK

EUROSYSTEM

DG/MARKET OPERATIONS

14 July 2014

Bond Market Contact Group

Frankfurt am Main; Tuesday, 1 July 2014; 3 p.m. - 7 p.m.

SUMMARY OF THE DISCUSSION

1. Bond market outlook and other topics of relevance

Jon Ridgway reviewed the main developments that had been affecting bond markets since the last meeting and gave Barclays's outlook. The policy measures announced by the ECB's Governing Council on 5 June had reinforced expectations that monetary policy would remain accommodative for longer, while liquidity was also expected to remain very ample in the next few months. The two factors had contributed to pushing implied volatility levels lower across financial markets, with the strongest impact on short-dated yields.

The discussion revealed that market liquidity remained one of the main concerns, potentially exacerbating sell-offs and increasing gap risks. Low market liquidity had resulted from the combination of two forces: first, market makers maintained leaner inventories to adjust to the new regulations, and second, investors had reduced cash holdings and invested in short-term bonds on a buy-and-hold basis in reaction to the negative deposit facility rate decided by the ECB. This notwithstanding, the outlook for euro area bond markets remained positive, and the risk of sell-offs for the near future was deemed to be low by the majority of members. In fact, members generally concurred that current low yields were justified by fundamentals, given (i) risks of disinflation, (ii) weak but slightly improving economic fundamentals in the more stressed countries, (iii) the possibility of future quantitative easing by the ECB, and (iv) the excess liquidity and low-rate environment, which contributed to investors' search for yield. In addition, the compression of spreads versus Germany for the more stressed jurisdictions was expected to prevail and was seen as justified by (i) improving debt dynamics, (ii) further prospects of rating upgrades, (iii) the favourable regulatory treatment for sovereign bond holdings, and (iv) the improved purchasing capacity of domestic banks, enabling them to act as backstops in any sell-off, given the increase in the share of government bonds held by foreign investors in the last few months. The majority view was challenged by a few members, who deemed current bond valuations to be expensive for some euro area sovereign bond issuers.

2. Market making and trading

Julian von Landesberger (ECB) reviewed recent trends in market making and proprietary trading in fixed income markets, while Michael Krautzberger analysed the decline in secondary market liquidity for corporate bonds and put forward some proposals to address this market trend.

The discussion on the means to address the low liquidity prevailing in secondary markets, which was based on an internal survey among members, revealed divergent views regarding the costs/benefits of greater standardisation of issuance versus the increasing trend among issuers to use medium-term note (MTN) programmes and private placements to address individual investor preferences. The use of private placements by many issuers had led to a significant share of bonds being illiquid, owing to the small size of the issues and to the fact that they were not included in bond indices. Members agreed that increasing standardisation and transparency, including through the use of pre-defined issuance

calendars and fewer, but larger, issues by corporates, could reduce the liquidity premia paid by issuers, by increasing secondary market liquidity and lowering issuance costs. At the same time, members noted some disadvantages from such an approach, namely higher roll-over risks, less flexibility, and sometimes higher costs of funding, given that in some cases the coupons paid in private placements were lower in exchange for offering maturities that met investors' asset-and-liability preferences.

3. Investor base in euro area government bonds

Christoph Rieger looked at the changes in the investor base of euro area sovereign debt, applying a methodology from an IMF Working Paper for "tracking global demand for advanced economy sovereign debt". The official statistics showed that the domestic bank dependency of Italy and Spain had fallen, as foreign and domestic institutional investors had stepped in.

Members concluded that the improved purchasing capacity of domestic banks had increased the resilience of these jurisdictions' bond prices, as domestic banks could act as backstops and limit any bond market sell-off. Members also reported Asian (and in particular Japanese) buying of Italian and Spanish government bonds since 2014.

Regarding the possible application of indicators measuring the quality of the investor base, such as those proposed by the IMF Working Paper, members were cautious, and noted the possible drawbacks of relying heavily on foreign investors, which has in the past sometimes been a symptom of current account deficits.

4. The comprehensive assessment and the start of the Single Supervisory Mechanism in November 2014

Giacomo Caviglia (ECB) introduced the key processes and possible implications of the comprehensive assessment of selected euro area banks being undertaken by the ECB before the start of the Single Supervisory Mechanism (SSM).

The asset quality review and the stress tests were seen as useful for the three given objectives, i.e. transparency, repair (identifying and implementing necessary corrective actions) and confidence building. Some members saw a risk of complacency among market participants regarding the publication of the final results at end-October 2014, which could pose some communication challenges. In particular, members signalled the importance of careful communication (including details and corrective actions) regarding the banks having capital shortfalls and requiring corrective actions, in order to prevent any contagion to other parts of the euro area banking system. Members also welcomed the additional information to be provided in July about the disclosure template and the general transparency of the exercise.