

Bond Market Contact Group

Frankfurt am Main, Tuesday, 7 February 2017, 13:00-17:00

SUMMARY OF THE DISCUSSION

1. GDP-linked bonds and sovereign bond-backed securities

Christian Kopf (Spinnaker Capital) presented the case for governments issuing GDP-linked bonds as an alternative to fixed rate government debt in the current low yield environment. Giulio Nicoletti (ECB) then summarised the initial findings of the ESRB High-Level Task Force on Safe Assets, which is investigating the potential creation of sovereign bond-backed securities (SBS). Both were keen to receive feedback from members.

Members considered GDP-linked bonds to have a potential business case, but also noted a number of challenges. Members wondered if the GDP risk premium could be procyclical, e.g. in an economic downturn, the GDP risk premium would increase and make this funding instrument less attractive for the sovereign. In addition, investors would need to adapt their risk management framework given: (i) the higher price volatility of GDP-linked bonds (and likely higher capital requirements); (ii) the risk of principal losses (unless there would be a floor at zero nominal GDP growth); and (iii) the need to build GDP forecasting ability. Finally, some members mentioned that investor demand could also depend on the reliability of GDP data reporting – particularly for the less advanced economies – and the risk of creating a wrong incentive for sovereigns in terms of growth policies.

With regard to SBS, members were concerned about the expected low investor demand for the junior tranche, leading to a high yield required by junior investors. The latter would challenge the overall deal economics of SBS, as little remuneration would be left over for the senior tranche. In addition, the correlation of large parts of the SBS pool of sovereign assets was deemed to be potentially high and time-varying, which would also affect the stability of the value of the senior tranche and weaken senior investor demand. Finally, the issuing entity would be an important parameter for the credibility of such an instrument, as a public issuer was considered important to signal a long-term commitment to SBS issuance and possibly to support liquidity.

2. Impact of the ECB's asset purchase programme

Mariano Bengoechea (JP Morgan), Andreas Gruber (Allianz) and Natasha Brook-Walters (Wellington) analysed the impact of the ECB's asset purchase programme (APP).

Their flow analyses tentatively concluded that the APP had successfully achieved the intended portfolio rebalancing into lower-rated and longer-duration debt instruments, as well as across a broader range of economic regions. Insurance companies, pension funds and Japanese investors were said to be the exception, with broadly stable euro area bond holdings. Some members argued that the effects of the portfolio rebalancing over the long term were still inconclusive, mentioning some tentative signs that the APP was not only contributing to (intended) easier credit conditions for the real economy, but potentially also to

some unintended consequences such as in some cases distorted asset prices. As an example, it was mentioned that lender protection was weakening through lower covenant protection in new contracts and lower price differentiation between strong and riskier transactions. Another illustration mentioned was that according to some macroeconomic models the sovereign yields of some of the less stressed euro area jurisdictions were at artificially low levels and that real estate valuations appeared to be approaching excessively high levels in some regions and home-ownership affordability could be challenged if central banks were to tighten monetary policy at a fast pace.

3. Yield curve targeting

Garry Naughton (Goldman Sachs) and Michael Krautzberger (BlackRock) reviewed the first experience from the Bank of Japan's attempt to control the yield curve as well as other similar historical episodes.

Members discussed the experience of the US Federal Reserve with interest rate pegs and caps between 1935 and 1951, which was also seen to provide potential lessons for today. In particular, the experience evidenced some challenges in several fields, such as the clarity and communication of the targets, the choice of instruments, views on the rest of the yield curve, and exit.

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

Nathalie Fillet (BNP Paribas) presented the main bond market developments and the outlook for the market.

There was broad consensus that the increase in the yields on major government bonds from summer 2016 onwards signalled an upward repricing of global growth expectations (to around 5%, from 2.5% in summer 2016), which was typically accompanied by a pick-up in measures of inflation expectations; for example, five-year forward inflation swap rates five years ahead had also rebounded. While in the United States the rebound in inflation expectations was a response to the more expansionary fiscal policy announced by President Trump's administration, some members mentioned the late cycle in the United States and were sceptical about the sustainability of the recent pick-up in the euro area measures. These members warned that shorter-term measures of inflation expectations – which were more closely linked to domestic developments – remained at much lower levels, which was also consistent with core inflation levels, the output gap and rising political uncertainty in the euro area with several upcoming elections.