EUROPEAN CENTRAL BANK
EUROSYSTEM

ECB – PUBLIC
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Meeting of the ECB's Bond Market Contact Group – 12 February 2019

Summary of the discussion

1) Bond market outlook

Ingo Mainert (EFAMA) reviewed the key bond market developments and provided an outlook for the year ahead, including the upcoming political events in Europe and their possible impact on markets.

With regard to monetary policy, members mentioned that the peak of global central bank liquidity provision was behind us and the aggregate size of the major central banks' balance sheets would continue to decline. However, members were of the view that the central bank balance sheet reduction would most likely materialise at a slower pace than previously anticipated due to a weakening of global economic growth. Overall, the group was divided on whether the US economy was on a clear downward trend, at the end of a robust growth phase, or in soft landing mode, but agreed that the shift in the Federal Reserve's communication to a more dovish stance in December had provided some support to financial markets.

The end of the net asset purchase phase of the asset purchase programme (APP) was widely regarded as a non-event for euro area sovereign bond markets. It was mentioned that term premia remained low. One member stressed that ECB communication on future rate hikes had become more challenging. Some members linked the developments in euro corporate bond markets closely to the developments in US short-term rates.

One member expressed the view that asset managers currently preferred to underweight their holdings in euro area bonds due to political uncertainty and possible event risk. In the absence of economic stimuli and any resolution of political issues, the situation in Europe seemed less stable and less attractive for asset managers compared to that of the United States. On the other hand, a different asset manager argued that moving to non-euro assets was no longer attractive due to the increased cost of currency hedging.

2) Developments in the euro area sovereign bond primary market – update on the Primary Dealership Model and issuance patterns of DMOs

Nathalie Fillet (BNP Paribas) and Bryan Gurhy (ECB) presented the changes to the issuance patterns of the Debt Management Offices (DMOs) in recent years and provided an update on the status of the Primary Dealership Model in Europe. The group's discussion focused on the current Primary

Dealership Model, and how it might be harmonised and improved upon. **While overall it seemed that the Primary Dealership Model seems still to work well and to play a very important role, members expressed some concerns, mainly about the ongoing reduction in the number of Primary Dealers**. Lower margins and higher balance sheet costs had reduced the attractiveness of Primary Dealership in recent years and had contributed to a concentration of the market, with domestic Primary Dealers becoming more important. Some members stated that Primary Dealership had become more of a brokerage market, with Primary Dealers taking up bonds in auctions and passing them on immediately. Some members called for further harmonisation of the currently fragmented rules. Auction discounts were seen as the most critical feature in the market, creating level playing field concerns. Some members expressed the view that guidance from DMOs on the appropriateness of auction discounts and overbidding would contribute to a level playing field. One member warned that liquidity in euro area bond markets was critically dependant on Primary Dealers, and would not necessarily benefit from a change in the rules to grant the buy side direct access to auctions. This could potentially lead to lower liquidity in secondary markets as the buy side would have no obligation to provide liquidity on the secondary market.

The group also reflected on the idea that DMOs should be able to set desired incentives and define rules in order to guarantee market functioning. Insights from issuers' perspectives nevertheless suggested that bidding behaviour is not always rational. Traders have a tendency to overbid for intrinsic reasons rather than being driven only by the desire to achieve top scores in the annual Primary Dealership rankings; this makes the steering of bids challenging.

3) Liquidity in euro area bond markets and the market impact of the end of net purchases under the APP

Mike Thorpe (Tradeweb) and Oliver Eichmann (DWS) assessed liquidity developments in the euro area bond markets following the end of net purchases under the ECB's APP.

The group started with the discussion of available standard measures of liquidity. There was broad consensus that bid-ask spreads alone were not an optimal indicator for liquidity, as quotes were not firm, can be withdrawn and are mostly not meant for sizeable trades. In order to obtain a reliable assessment of market liquidity, a combination of measures was preferable. Members reiterated the call for a "consolidated tape" of MiFID II data, which would allow for proper analysis of the market and of the liquidity situation. Given that MiFID II was aimed at increasing transparency and liquidity, a recalibration of the current framework should be considered, whereby the consolidated tape would be an essential step towards achieving the benefits that MiFID II was supposed to bring and that would better justify the costly data collection.

With regard to the impact of the APP on market liquidity, there was a common view that the end of net purchases under the public sector purchase programme (PSPP) had somewhat improved liquidity conditions in the sovereign bond market, albeit the negative effects of the APP on market liquidity had not been very strong either. By contrast, the group considered that the third covered bond purchase programme (CBPP3) had continued, including during the current

reinvestment phase, to reduce market activity because of the large share of CBPP3 stock. Views on the impact of the corporate sector purchase programme (CSPP) on market liquidity were divided, with some members pointing to a minor impact when looking at the spread development of eligible versus non-eligible bonds. Others noted the positive volume effect on the primary corporate bond market.

For the overall euro area bond market, trading volumes suggested that market activity had declined in recent years, which was attributed to a combination of factors (credit cycle, electronification of trading, regulation, APP). Overall, it was concluded that markets were able to generally adjust to central bank purchase programmes unless central banks trigger significant surprises on the financial markets. In addition, members did not generally expect a persistent significant impact on euro area bond market liquidity due to the likely exit of the United Kingdom from the European Union.