

## Meeting of the ECB's Bond Market Contact Group – 20 November 2019

### Summary of the discussion

#### 1) Bond market outlook

Christian Kopf (Union Investment) reviewed the main bond market developments since the last meeting and provided an outlook for the upcoming months.

**Members noted that market participants' assessments of the economic outlook had improved over the past quarter.** During the summer of 2019, most market participants considered a recession in the euro area to be likely. However – following easing measures from a range of central banks, reduced concerns about Brexit and some easing of trade tensions – market participants are now of the view that the economic slowdown might have bottomed out, and that the expansion is likely to continue for a while.

**At the same time, members noted that uncertainty about the economic outlook was elevated, even though market-implied volatility measures remained low.** According to some members, the low market-implied volatility, underpinned by structural volatility selling strategies, was a puzzling feature in the current context.

**Members were divided on the effectiveness of recent monetary policy measures adopted by the European Central Bank, even though the implementation of these measures was perceived as smooth.** Some members considered the policy package to be complex but important: they saw it as a powerful signal to maintain very accommodative financial conditions in the euro area. Other members viewed these recent policy measures as, at best, ineffective and a source of serious challenges for the financial industry – particularly for pension funds and insurance companies. In terms of Asset Purchase Programme (APP) execution, members confirmed that the Eurosystem's securities lending facilities have enhanced market functioning. The special conditions observed in repo markets in 2016-17 caused many asset managers to lend bonds, which further eased repo market tensions. Some members noted renewed, strong, primary market bidding by the Eurosystem in the private sector purchase programmes.

## 2) Market-based and survey-based inflation expectations

Ingo Mainert (EFAMA) and Thomas Werner (ECB) reviewed market-based and survey-based measures of inflation expectations, including the uses and respective shortcomings of these measures of inflation.

**The significant drop in euro area inflation break-evens in 2019 was primarily driven by a decline in the inflation risk premium.** Actual expectations of future inflation fell to a lesser extent. Market-based measures now price a persistently weak inflation path going forward. While the recent decline in survey-based measures of inflation expectations of economists mirrored the move seen in market-based measures earlier in the year, it stood in contrast with surveys of inflation expectations of consumers, which remained elevated. Members also discussed why the inflation risk premium persists. One possible reason is that the market is becoming asymmetric with active sovereign issuance continuing despite the associated cost of a negative inflation premium, while demand from traditional investors has diminished.

**One member thought that actual price increases in the euro area may be understated by official consumer inflation measures.** The main reason cited for a potential underestimation of inflation is the exclusion of owner-occupied housing costs in euro area Harmonised Index of Consumer Prices (HICP) readings. Members also suggested that there was excessive focus on specific measures of market-based inflation expectations (e.g. 5y5y inflation swap forward); however, there is an ongoing debate about the usefulness of these measures in estimating actual inflation expectations. Members expressed the view that there is, in general, a need to examine a wide array of inflation measures.

**Some asset managers have resorted to hedging their inflation exposure through a portfolio of diversified real assets (e.g. equities, real-estate, etc.) rather than hedging directly through the purchase of inflation-linked products.** Liquidity risk is managed through other channels via separate portfolios.

## 3) Algorithmic trading in bond markets

Zoeb Satchee (Citi) and Andrew Millward (Morgan Stanley) provided an overview of the use of execution algorithms in bond markets, as well as the main trends and developments since 2016.

**Most of the innovation in algorithmic trading in bond markets has taken place on the investor trading side, rather than within dealers.** Investors can now choose from a range of automated execution techniques offered by electronic trading venues. The increased use of execution algorithms has led to a larger number of transactions taking place, albeit with a smaller average size. The algorithms available on electronic trading venues enable investors to split a larger transaction into multiple smaller transactions. These, in turn, can be executed over a longer period of time, reducing

the market impact and visibility of their actions. On the dealer side, algorithmic trading systems remain proprietary and typically segregated by market segment.

**Algorithmic trading was unlikely to become as ubiquitous in euro area bond markets as in FX or equity markets.** This is due to the heterogeneous nature of the bond market and the fundamental difference in the structure of the fixed income market, which is still a principal-based market centred on requests for quotes (RFQ) rather than a single limit order book. Algorithmic trading has been persuasive in the most liquid on-the-run bonds, rather than in low liquidity bonds. Some members were of the view that algorithmic trading in fixed income markets will increase cost efficiency in liquid market segments, but – for trades in less liquid securities or larger transaction sizes – the personal interaction between an investor and dealer will still remain important. The streaming of firm prices from dealers to investors, similar to the FX market, was likely to become available only for the most liquid bonds.

**Most members viewed algorithmic trading in bond markets as less prone to flash crashes than in the FX market.** This is because: the RFQ process is much slower, bond trading is still a principal business, and there are a number of circuit breakers in the fixed income markets. In particular, circuit breakers are widely used in futures markets, which are used for setting cash bond prices and hedging purposes. These could effectively prevent flash crashes that happen for no particular economic reason. Compared to the euro area government bond market, the FX market is much less regulated and does not contain such circuit breakers. Moreover, there has been an intensive focus on the risk management of execution and hedging algorithms in recent years. In part this was due to MiFID 2, but also due to local regulators imposing their own rules to create more transparency around the algorithms used in the euro area fixed income space. Some members suggested that one potential issue with algorithmic trading relates to the auto-hedging of positions on the futures market. If trading ceases in the futures market because of a circuit breaker, this will effectively shut down algorithmic trading as well. Without the futures market, pricing would become manual and therefore much slower.

**In the context of this discussion, members noted that the emergence of portfolio trading was an important trend in the fixed income market.** Portfolio trading allows customers to package multiple bonds or swaps in one package and negotiate a price for the entire portfolio with dealers, rather than executing multiple individual transactions.