

Video conference of the ECB's Bond Market Contact Group

18 April 2023

Summary of the discussion

Review of bond market developments

Snigdha Singh (Bank of America) reviewed the main bond market developments since the start of the market tensions around the collapse of Silicon Valley Bank (SVB).

While the banking stress in March resulted in extreme market moves, in particular at the shorter-end of the bond markets, there was broad consensus that markets stabilised rapidly with levels of implied volatilities mostly back to pre-SVB levels. Members felt that one sided positioning in interest rate and bond markets ahead of the event amplified the moves and explained why these markets reacted with a stronger increase in volatility than equity markets to the financial stability concerns.

Members highlighted the resilience of intra euro area sovereign bond spreads to the surge in volatility, which surprised positively. They reported solid investor demand for duration, which has helped to absorb the increase in bond net supply in the first quarter and they expected this support to continue into Q3, irrespective of the future run-off rate for the APP Portfolio after June. The start of the partial APP reinvestment period in March was widely seen as smooth or very smooth. One member highlighted that the orderly market reaction to APP run off, may in part be explained by the perception that the ECB has the tools and the flexibility to maintain smooth market functioning, together with the continuation of PEPP full reinvestment until at least the end of 2024.

In contrast to the resilience observed in the sovereign space, the banking stress has led to increased tensions in credit markets. Despite some of these tensions having receded, vulnerabilities are perceived to remain. In particular, the primary market shows a mixed picture with, on the one hand, a promising re-start of issuance on covered bond and corporate bond markets, but on the other hand a limited reopening of unsecured bank funding markets, with only the strongest issuers having issued bonds since SVB. The group discussed the outlook for the AT1 segment and buy-side participants reported that many clients were no longer willing to invest into AT1 bonds. On a positive note, the covered bond market was seen as being mostly immune to the recent turbulences. Members finally emphasised that European banks are perceived as solid, not least because regulation and supervision in Europe are

stricter and more evenly implemented than in the US, which helped to prevent longer lasting spillovers from the US into European banks.

The group also discussed potential vulnerabilities of European Pension Funds and Insurance Companies to interest rate risk and members agreed that those vulnerabilities have declined compared to 2022, as leverage was reduced and cash buffers were increased after the turbulences related to the use of liability-driven investment (LDI) strategies in the UK in September 2022.

Persistently high inflation was seen as a major risk for markets going forward. Members also stressed that any tightening in financing conditions will be very closely tracked, with close attention being paid to the dynamics of bank deposits. Members reported that, so far, there is little sign in the euro area of a shift of bank deposits into money market funds or investment funds, while retail government bonds and bills, which are available in a small number of countries, offer attractive returns.