



# ECB Bond Market Contact Group

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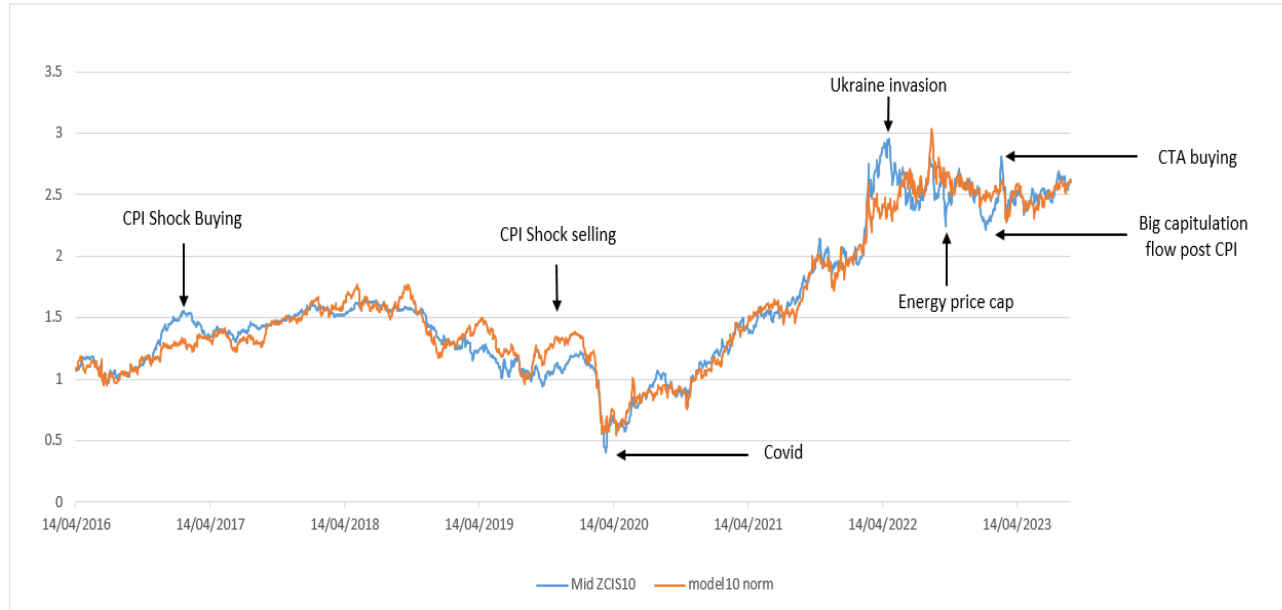
# Agenda

A deep dive into the **drivers** of inflation linked bond and swap markets

**Disentangling** the impact of inflation expectations from risk premia and technical factors

# Introduction

## HICP 10Y (Market) vs HICP 10Y (Model)



Source: HSBC

## Coefs Model 10y (norm)

Mid Brent  
 Last SX5E  
 Mid EURUSD  
 Mid Bund  
 Mid GAZ

## Regression Statistics

|                   |           |
|-------------------|-----------|
| Multiple R        | 0.9774423 |
| R Square          | 0.9553934 |
| Adjusted R Square | 0.9552775 |
| Standard Error    | 0.1202774 |
| Observations      | 1931      |

## Segmentation

### Short end

0y – 3y sector

- ◆ Dominated by **Hedge funds & couple of dealers**
- ◆ **Thin liquidity & higher volatility** give sensitivity to Macro events & shocks
- ◆ **Distortions are frequent but corrections are quick** as economic data/models and fundamental approach prevails

### Belly

3y – 10y sector

- ◆ **All player** are active
- ◆ **Most liquid** part of the curve
- ◆ **Limited volatility and distortions.** Reaction to shocks is less violent except in case of an important headline
- ◆ **Premium is frequent but repricing is relatively prompt**

### Long End

10y – 50y sector

- ◆ **Real Money** client with large liabilities and more uniform/stable views
- ◆ Trades often with **larger premium** as dealers offers tend to be too elastic given **no natural supply**
- ◆ Main driver are **depth of the demand** (for real yields for example)

# Inflation Linked Bonds Market

- ◆ Inflation linked bonds are probably a **less accurate measure** of Inflation expectations
- ◆ Inflation assumptions can be **determined by numerous factors** associated with bond market

Differential of liquidity between **ILB and Nominal Bond**

**Issuer credit**

**Supply / demand dynamics and mismatches** (Auctions, Syndications, or large buying programs that don't coincide with DMO supply events or sizes)

Balance Sheet **Constraints, Positioning, as well as bonds dropping out of Indexes**

**Convexity, risk off/risk on.** The iota operates as an arbitrage metric used mostly by RV desks (HF mainly)

**Pure Real Yield** demand and buying programs



# Inflation Linked Swaps Market

01

Swaps market reflects a **purer pricing of inflation expectations theoretically**; liquidity premium is to be taken into account though

02

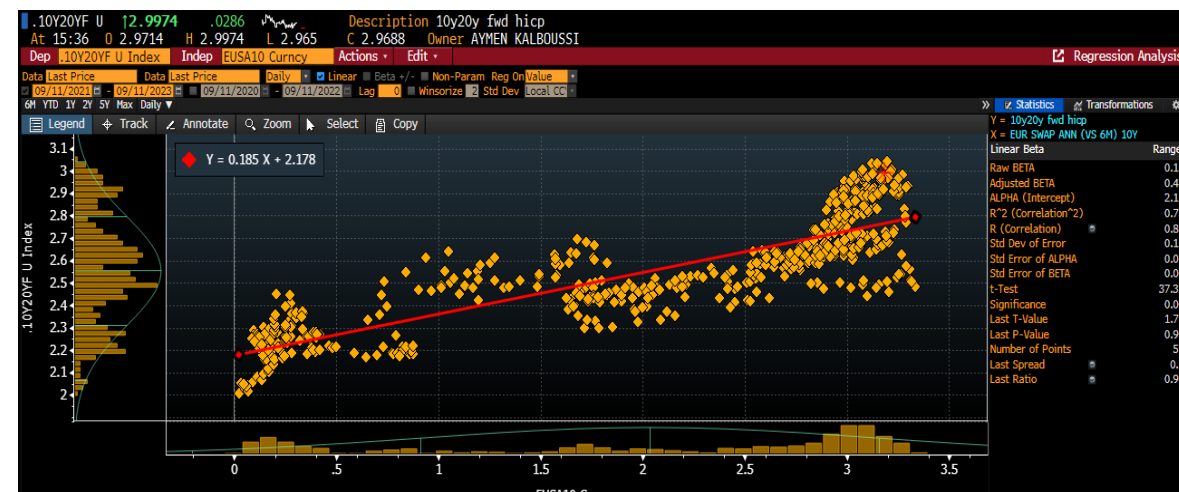
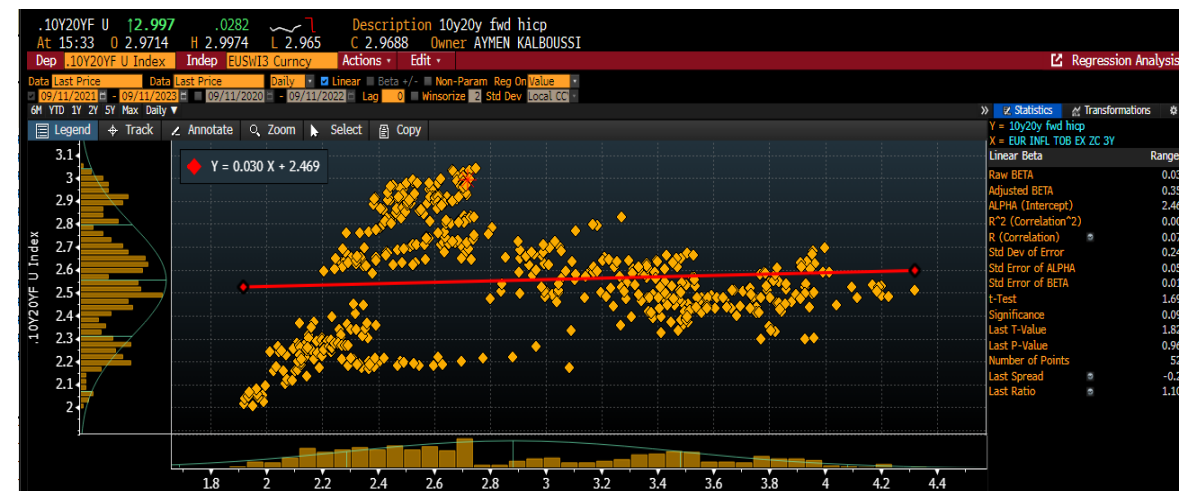
The **liquidity differential between IRS and ILS is not an issue**, because it is its own instrument

03

But there is a **structural issue** of supply/demand mismatch, that can skew the levels to be too high most often, as there is no natural supply for inflation swaps, and only natural demand

04

The inflation supply is **created “synthetically” via Asset Swap buying by investors**. But even those flows are dependent on the outright level of Asset Swaps, as well as the level of lotas



# Questions

1

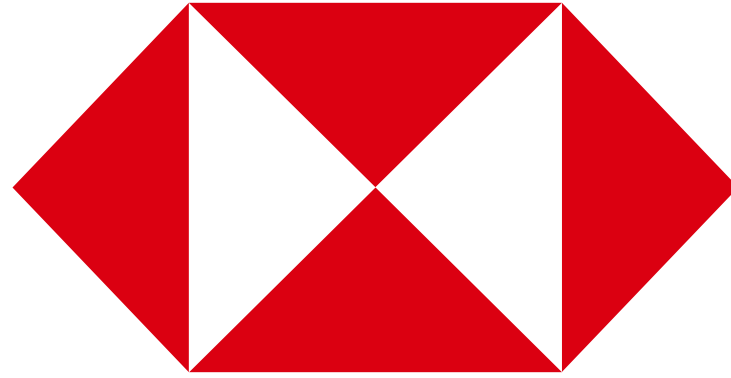
Can the debate about the cost of Linkers segment for the tax payer, and the potential reduction of ILB issuance from the DMOs increase this risk and liquidity premium due to the growing demand/supply mismatch?

2

Is it possible to accurately calculate the risk premium that is embedded in Inflation forwards?

3

What about the role of the growing influence of CTA accounts, and their momentum driven models that can push these risk premia higher?



Opening up a world of opportunity