EUROPEAN CENTRAL BANK

EUROSYSTEM

1 July 2024

ECB Bond Market Contact Group

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Summary of the discussion

1) Review of recent bond market developments

Sophie Landry (European Investment Bank) reviewed the most recent developments in euro area bond markets and provided an outlook for the months ahead.

The presentation highlighted some divergence in the market pricing of the expected future policy path in the US and euro area. While common global inflation drivers exist, the divergence in market pricing was in line with the differing inflation and growth outlooks for the US and euro area.

Members assessed the recent market movements as reflective of an orderly repricing, while markets continued to function well, although investors remain somewhat cautious ahead of the upcoming French legislative election. The recent bout of volatility and the widening in government bond yield spreads, notably in France, were not driven by significant selling flows, but reflected mainly the hedging of exposures through futures contracts, contributing to the outperformance of German asset swap spreads in June. Therefore, the recent widening of French sovereign spreads was mainly associated with a decrease in German yields, while French yields had remained relatively stable. Some contagion to French banks was evident but it was highlighted that “sovereign-bank nexus” concerns were not apparent as French banks hold a relatively low amount of French sovereign debt.

Contagion risks across different euro area jurisdictions were seen as limited. Investors look to avail of relative value opportunities when they arise and place a particular focus on the individual fiscal outlooks of euro area issuers. In this context, it was also highlighted that the market discriminates between different issuers based on their fiscal fundamentals, which was evidenced by spread movements in jurisdictions like Portugal and Spain. This may lead to changes in the prevailing hierarchy of spreads between various euro area issuers.

However, some members struck a more cautious note on the outlook for bond markets, particularly over a medium-term perspective. They suggested the market may be somewhat complacent and that a further deterioration in fiscal discipline combined with increasing political risk could lead to a more challenging environment for euro area bond markets. At the same time, it was noted that recent price developments – together with the experience of the mini-budget disruptions in the gilt market in 2022 – should incentivise governments to maintain fiscal discipline.

Overall, members suggested that the recent repricing in markets was orderly. Developments in repo and cross-currency funding markets, for example, have been relatively benign so far. However, members did caution that structure of the euro area bond market is changing. New market participants and increased use of high-frequency trading platforms, combined with the regulatory framework has seen the traditional model of liquidity provision evolve. The impact of this evolution on market liquidity is still not clear.

2) A deep dive into the role of hedge funds in euro area government bond markets

Olivier Herregods (HSBC) presented on the evolving role of hedge funds in euro area government bond market: the implications of their increased size and participation in the market; the trading strategies they employ; and the impact on bond and repo market liquidity and volatility.

Hedge funds have substantially increased their presence in euro area government bond markets, accounting for about 55% of secondary market trading. The trend accelerated in 2022 when interest rate volatility increased in the context of the start of the ECBs policy tightening cycle. The surge of hedge fund activity has been accompanied by a substantial migration of traders from banks and traditional asset managers to hedge funds.

Members highlighted the need to differentiate between the different trading strategies that hedge funds pursue. Dominant strategies pursued by hedge funds were, on the one hand, systematic trading strategies, notably around government bond auctions and, on the other hand, relative value strategies, exploiting mispricing in EGBs and related segments. In this context, it was highlighted that the traditional basis trade observed in the US market was not very prominent in the euro area. As regards macro strategies, while these strategies are based on hedge funds' analysis of macro trends, some caution was voiced about uni-directional nature of trades going based on momentum rather than fundamental macro views. The latter strategy can lead to crowded positioning which can amplify market moves and increase volatility. In fact, unwinding of crowded positions could lead to market mispricing which may impact the transmission mechanism. At the same time, members cited a number of stabilising factors, including that hedge funds active in the euro area are less leveraged, follow multi-asset strategies and have longer lock-in periods versus those active in US markets.

The increased trading activity of hedge funds is generally supportive of market liquidity. However, members cautioned about a possible mismatch between the risk capacity of banks' trading desks and the leverage employed by hedge funds. While a sudden correlated unwinding of hedge fund positioning could lead to strains on dealers' intermediation capacity and market liquidity, hedge funds themselves could take over intermediation functions. In this context, the question of what constitutes an appropriate regulatory framework for hedge funds was raised.

Members were generally casting some doubt on hedge funds becoming primary dealers in euro area sovereign bond markets owing to the specific requirements of such a role, such as relationship management, reporting, disclosures, etc. However, some members highlighted that it was important to draw a distinction between the role of a primary dealer and that of market-maker. In particular, as hedge funds have no commitments to make markets, they could significantly scale down liquidity during stress periods.