EUROPEAN CENTRAL BANK

EUROSYSTEM

16 June 2023

ECB's Bond Market Contact Group

1 June 2023

Summary of the discussion

1) Review of bond market developments

Katharine Neiss (PGIM Fixed Income) reviewed the most recent developments in bond markets and provided an outlook for the weeks ahead.

There was a broad consensus that the fixed income market had undergone a renaissance owing to the higher yields now available to investors. Demand is very robust with some investor types returning to the market after an absence of many years during the low yield environment. Members also commented on the persistently strong demand for duration in euro area sovereign markets which combined with sizable central bank holdings limits scope for term premium to rise. Current positioning in euro area sovereign bonds was characterised as being relatively neutral. However, investors are seen to have cash balances that they will invest once the right opportunities present themselves.

Members also highlighted the resilience of euro area sovereign bond markets. This resilience can, in part, be attributed to the ECB's credibility. The ECB's Transmission Protection Instrument (TPI) helped convince markets of the ECB's focused pre-emptive approach to potential episodes of market dysfunction.

However, there is a need to avoid complacency and recognise that risks remain. Members, for example, emphasised the importance of market liquidity to investors as a persistent theme. The fact that the yield on some large euro area sovereign benchmark bonds traded below that of other smaller but better rated peers was seen as emblematic of this. Some highlighted lingering concerns on illiquid market segments (e.g., commercial real estate) and the possibility that problems there could spread to other supposedly more liquid market segments. The upcoming targeted longer-term refinancing operations (TLTRO) redemptions were not a major concern for members.

2) Bond markets in an environment of monetary policy normalisation

Isabelle Vic-Phillippe (Amundi) presented an assessment of recent episodes of market stress and how central banks reacted.

There was a wide-ranging discussion on recent episodes of market stress that examined the underlying reasons for the outbreak of volatility and the effectiveness of central bank measures to combat threats to market functioning. Members suggested that central banks are now perceived as having embraced their role as market makers of last resort, and that this serves to provide confidence to markets. Some members highlighted the necessity for central banks to continue to account for moral hazard considerations when designing and implementing such measures.

The effectiveness of central bank action can be significantly bolstered by being pre-emptive as this is key in maintaining confidence. However, such preventive measures may not always be possible. In such cases, reactive measures should be implemented quickly, if necessary, with central banks adopting an activist approach which generally implies over-insuring against the risks which are starting to crystallise, and therefore is more likely to generate moral hazard.

The necessity for interventions to be correctly targeted implies that central banks should engage with market participants to understand exactly where problems might arise. It is also very important to delineate central bank measures that are implemented to address market functioning issues from those that address the monetary policy stance.

3) Bank bond funding

Bryan Pascoe (ICMA) provided an update on the landscape for bank bond funding in the aftermath of the recent stress in the banking sector.

Members provided their views on a potential revival of the Additional Tier 1 (AT1) bond market. Members suggested that the buyside was not where the bottleneck lies given the recent repricing of the asset class. What is required is for stronger banks to test the market first with new issuances which will pave the way for other banks to issue, after which it is expected that AT1 spreads would tighten to a level where it once again becomes economical to issue them.

Members commented confidence in the AT1 asset class was supported by the joint statement from ECB Banking Supervision, the Single Resolution Board and the European Banking Authority which stated that common equity instruments are the first ones to absorb losses, and only after their full use would AT1s be required to be written down. Members added that a greater standardisation of AT1s is warranted.

Finally, members suggested it was not yet fully clear if second-tier banks had regained full access to other segments of the bank bond funding market. Most recent senior bond issuance was from stronger names. However, a recent Tier-2 bond issuance from a Portuguese issuer suggested that market access was available to a wider range of issuers amid a gradual return to normality.