EUROPEAN CENTRAL BANK

EUROSYSTEM

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Bond Market Contact Group

Frankfurt am Main; Tuesday, 8 April 2014; 1 p.m. - 5 p.m.

SUMMARY OF THE DISCUSSION

1. Bond market outlook and other topics of relevance

Carl Norrey reviewed the main developments that had been affecting bond markets since the last meeting, as well as JP Morgan's outlook and main risks. The downward revisions to growth and inflation forecasts had remained confined to the first half of 2014 and to emerging markets, whereas the medium-term macroeconomic outlook remained positive for the United States and the euro area. Contrary to expectations, US and euro area government bond yields had declined in the first quarter of 2014, with stressed jurisdictions outperforming and spreads tightening sharply versus Germany. Regarding the outlook, members generally expected bond yields from the more stressed jurisdictions to tighten further led by the combination of positive macroeconomic developments; limited headline risk/dampened volatility; the expansion of the investor base helped by the progressive inclusion of Italy and Spain into investors' benchmarks; the search for yield environment and a positive credit outlook (e.g. CDS spreads pointed to further rating upgrades). Notwithstanding the sharp improvement in investor confidence, members noted that bond purchases had been mostly concentrated in the short-end of the curve, i.e. up to five-year maturities, which likely signalled some investor cautiousness. For instance, Italian and Spanish five-year/five-year forward government bond yields remained at around 4.85%.

Several members warned about complacency in credit markets and the indiscriminate search for yield, which was often not justified by fundamentals. The compression of credit spreads in the first quarter of 2014 had been the largest in the lowest-rated credits (e.g. the BBB vs. BB spread had tightened much more than the AAA vs. AA spread), while corporates' leverage ratios were at their highest since the crisis. In terms of the outlook for government bonds, low growth versus high debt was also a common concern, particularly in a disinflationary scenario.

2. Central banks' asset purchase programmes

Carlos Egea and Campbell Gilbert analysed the main parameters and market impact of the asset purchase programmes conducted by the Bank of Japan, the Bank of England and the Federal Reserve System. The analysis included aspects, such as purchase universe (private assets versus government bonds), maturity ranges, counterparties and channels of operation, timing within the rate cycle, end-investor behaviour and exit.

Overall, clear, transparent and uniformly communicated objectives with predictable implementation of the purchases were deemed to be important factors for the credibility and success of central banks' asset purchase programmes. These lessons had been progressively incorporated in central banks' recent asset purchase programmes.

3. Role of trading and liquidity in bond markets

Franck Motte and Zoeb Sachee analysed the role of market-making in fixed income markets and the impact of recent (and forthcoming) regulatory changes. The share of electronic trading in fixed

income markets had doubled in the last six years to 36%, although it remained significantly below the share for foreign exchange markets or equities. Four main differences were perceived to limit the use of Central Limit Order Books in fixed income markets compared with equity and foreign exchange markets, thus validating the role of market-making. First, the average size of a transaction in fixed income markets was around 850 times larger than for equity markets, which was mostly explained by the larger presence of (buy & hold) institutional investors. Second, the trading frequency of any individual bond/note was comparatively much lower and concentrated around the time of issuance. Third, European fixed income markets were characterised by a large number of competing issuers of varying sizes and credit. Fourth, the certainty of execution that the market making function provides was essential during times of stress and contributed to lower liquidity premia and to limiting volatility in periods of stress.

The transition to new regulation was seen to be introducing uncertainty and leading to higher capital usage for market-makers, further limiting the ability of market-makers and of clients to hedge risks in fixed income markets. Daily operations were affected by higher costs of inventories (higher risk-weighted assets and leverage ratios), constraints on inventories imposed by new regulation (the Incremental Risk Capital or IRC and the stress VaR), market fragmentation and increased uncertainty for market-makers regarding the likelihood to hedge large positions quickly. Finally, new regulatory changes and the parallel introduction of several changes required significant resources and investment from all fixed-income market participants, with a potential negative effect on market depth and liquidity, should a sharp sell-off unexpectedly develop. BMCG members believed that it was likely that the transition to the new regulatory regime would lead to higher liquidity premia and to thinner fixed income markets. To overcome the thinner secondary markets, larger issuers were expected to adapt by means of more stable issuance profiles and by a wider use of auctions by Debt Management Offices, while it was likely that smaller issuers would have to pay higher new issuance premia to attract investor demand.

4. SME funding

Annalisa Ferrando (ECB) gave an update on the new public initiatives aimed at improving funding for small and medium-sized enterprises (SMEs) in Europe and, in particular, the European Commission’s roadmap on long-term financing of the economy of March 2014 and the Green Paper on "Long-Term Financing of the European Economy" of March 2013. Linked to this, BMCG members, John Serocold, Laurent Clamagirand and Andreas Gruber, analysed selected initiatives that were aimed at providing funding to SMEs in Europe outside the banking channel from an investor point of view. The analysis included well-established markets, such as the German Schulscheindarlein market, as well as recently implemented initiatives, such as Spain’s trading platform for debt issuances between €10-25 million (MARF), Italian minibonds, and the French Charter for Euro Private Placement (EuroPP).

The investor analysis concluded that lending to small companies would continue to be predominantly a banking business given the typically small sizes of the loans involved, which made the due diligence process by specialised investors to buy these loans too costly compared with the size of the investment. Therefore, the success of funding/purchase programmes in improving SMEs’ funding conditions would mainly rely on their capacity to either grant capital relief to banks or to channel additional SME risk to other market players, freeing up capacity for banks to generate new lending.

From the investor point of view, the potential for success of the various initiatives relied on aspects such as retention rules of some economic risk from the originator of the loans/sponsor, which increased investor confidence given the future involvement of originators in the management of the loans. BMCG members agreed to return to this subject at the next meeting.