

## ECB's Bond Market Contact Group

19 September 2023

### Summary of the discussion

#### 1) Review of bond market developments

**Marion Le Morhedec (AXA IM) reviewed the most recent developments in bond markets and provided an outlook for the months ahead.**

Current market pricing points to a relatively benign outlook. However, members voiced concern about the risk of complacency. The current level of rates, relatively flat yield curves and narrow credit spreads may not adequately account for a deterioration in the macroeconomic outlook that could materialise in the months ahead, particularly if energy prices were to increase as winter approaches. This would have a negative impact on the balance between the inflation and growth outlook. While some resilience is apparent in the US, there was an increased concern about global recessionary risk. Some members also suggested that concerns about fiscal risks could re-emerge with deficits expected to improve next year but not enough to offset the impact of net debt supply.

It is difficult for investors to increase duration given the level of short-term rates and compressed term premia. Members highlighted that cash and cash equivalent investments are very competitive at present and would most likely remain so for an extended period, since central banks intended to maintain their key rates in restrictive territory for a sufficiently long time. Yield curves may have to steepen and credit spreads to decompress somewhat to support investment in longer tenors.

Following September's ECB Governing Council decision to increase rates by 25 bps, the market is now refocusing on channels of normalisation beyond interest rates. An announcement on a discontinuation of full reinvestments under the Pandemic Purchase Programme (PEPP) is seen as quite likely before end-June 2024. Some members highlighted however that such a step would remove the 'first line of defence' and therefore carries the risk of putting more focus on the ECB's Transmission Protection Instrument (TPI) for which the activation bar is perceived to be significantly higher. Some members also referred to the minutes of July's FOMC meeting and Chair Powell's July press conference and the clarification that balance sheet runoff need not end when the Fed eventually begins to cut rates.

Members highlighted that this clarification was welcome and contributed to reduce uncertainty on the normalisation process.

The recent increase in retail bond issuance by euro area governments broadens the investor base available to debt management agencies. However, there are possible negative spillovers to bank funding and to market liquidity in the short-term bill market, as issuance tends to be reduced in this segment to make space for retail issuance.

## **2) The stage of monetary policy normalisation and quantitative tightening around the globe**

**Tomasz Wieladek (T. Rowe Price) presented an assessment of how term premia are adjusting in the context of quantitative tightening around the globe.**

There was a wide-ranging discussion on the underlying drivers that may have contributed to the recent increase in term premia. Estimates of the magnitude of the contribution of quantitative tightening to the increase vary considerably. Multiple other factors may also contribute, including market volatility and central bank credibility. The impact of net bond supply was also discussed. While some members were of the view that it was an important contributory factor, others noted that the term premium in US Treasuries remains relatively compressed despite the high issuance volume over the past number of years. International spillovers were also seen to have an impact on term premium, particularly in the long end of curve, via the portfolio rebalancing channel.

## **3) A deep dive into inflation products**

**Olivier Herregods (HSBC) provided an update on inflation markets and the drivers of price movements in inflation linked bond and swap markets.**

Debt management offices that currently issue inflation linked bonds (ILBs) are expected to continue to support the product despite some recent concerns about the cost of servicing inflation-indexed debt. From a structural standpoint, the inflation market has relatively significant differences in investor base and trading behaviour across different maturity segments. The 3-year to 10-year part of the curve is generally where the investor base is most diverse, and liquidity is best. Overall, however, the inflation linked bond market remains a market that can be impacted by relatively small flows given its limited size. Demand for inflation protection in the long end of the curve remains strong with positive real yields continuing to attract real money investors.

Overall, break-even inflation rates derived from ILBs have a low explanatory power as a measure of inflation expectations. For inflation linked swaps, the supply/demand dynamics are somewhat less constrained. However, there is an indirect constraint as the only natural supply of inflation linked protection is from ILBs.