The European bond market is modernising

Natacha Blackman explores how the European bond market is adapting to changing needs – and the important role fixed-income ETFs have to play

The European bond market is modernising at a rapid pace – and fixed income exchange-traded funds (ETFs) have become the vehicle of choice for this modernisation. This reflects their liquidity, transparency and increasing versatility.

Over the past five years, the European corporate bond market has grown by 56 per cent to €2.8 trillion in debt outstanding [Source: Bloomberg Barclays, ICE benchmark indices, as at 30 Jun 2020].

Trading is increasingly done electronically. One driver is the EU's MiFID II directive, which came into force in 2018, moving trading onto regulated venues and imposing new obligations for regulatory trade reporting, trade transparency and best execution. This is all much easier to do via electronic markets.

Fixed income ETFs have grown rapidly too. The US$334 billion European UCITS-listed ETF market has shown a compound annual growth rate of 22 per cent over the past five years [Source: BlackRock, GBI, 31 Jan 2021].

The Covid-19 crisis was a big test of European fixed income ETFs' ability to remain open to institutional investors. During the March 2020 volatility in financial markets, ETFs proved their resilience, trading efficiently and offering liquidity, flexibility and price transparency. They continued to track their benchmarks closely.

UCITS fixed income ETFs traded an average of US$5.3 billion a day in March, almost twice the 2019 daily average [Source: BlackRock, Bloomberg, as at 30 June 2020]. Moreover, while secondary trading volumes fell in the European fixed income market as a whole in the months that followed, European ETFs kept setting new records.

As the ETF market grows, so too does its ecosystem. We see this in practice through the growth of lending and options markets.

Recent years have seen an increase in lending of fixed income ETFs. The stock of EMEA-listed fixed income ETFs available for borrowing has increased by more than 60 per cent in the past three years, to reach US$14 billion in June 2020. Balances on loan have more than quadrupled [Source: IHS Markit. Data as at 30 June 2020].

Looking to the future, another key driver of growth will come from investors' increasing transition to sustainable investing. As ESG adoption increases, we expect ESG ETFs to become the flagship funds.

Continued adoption of fixed income ETFs and other bond index tools, growth in electronic trading, algorithmic pricing capabilities and dramatic improvements in technology are revolutionising the way investors access European corporate bond markets. The recent Covid-19 selloff proved to be a catalyst for further adoption of fixed income ETFs, particularly by institutional investors.

Investors are increasingly managing their fixed income exposure through a portfolio lens, using a broader toolkit to access European corporate debt. The largest and most liquid ETFs are becoming the macro and scalable risk transfer tools of choice for investors. ETFs also offer a standardised index-based tool that allows for ESG integration. Market transparency is expected to continue to improve and positively feed into the liquidity of the underlying bond markets.

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