

Fixed Income Special

NORD/LB Markets Strategy & Floor Research

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ECB ready for lift-off: Every journey starts with a first step

Authors: Dr Frederik Kunze // Dr Norman Rudschuck, CIIA

ECB decision: New cards are now on the table for 2022

At its regular meeting today, the European Central Bank confirmed that it will end net purchases under the Asset Purchase Programme (APP) after ending net purchases under the Pandemic Emergency Purchase Programme (PEPP) already in March 2022. However, back then this has been given a game changer: In April, the APP was doubled to EUR 40bn, in order to reduce this purchasing pace to EUR 30bn already in May. On 01 June, the ECB reduced the APP to the initial level (EUR 20bn per month). Consequently, the ECB is scaling back its purchases – as we postulated in our scenario analyses of recent weeks – even more quickly than we thought possible. There was no end date for the APP until today, now we have certainty. An end of the APP in Q3 was the most likely scenario anyway, but the ECB now made this data-dependent and stops net purchases under the APP on 01 July. So the first interest rate step can follow on 21 July. APP reinvestments will continue beyond that point and will be maintained for as long as necessary, thereby maintaining favourable liquidity conditions and extensive monetary policy accommodation.

Key interest rates unchanged as expected

As expected, no key interest rate adjustment was decided today. Accordingly, the interest rates for the main refinancing operations, the marginal lending facility and the deposit facility remain unchanged at 0.00%, 0.25% and -0.50%.

What do we expect, what does the rest of the year hold?

The following paragraphs are intended to address a wide variety of discussion points:

- When will the first interest rate step be taken?
- How high will it be?
- How many more will follow in 2022?
- Which interest rate will move first?
- How long will reinvestments under the APP continue?

When will the first interest rate step be taken?

Based on today's meeting, question 1 has already been answered: The APP ends first on 01 July, so that the first interest rate step can be decided on 21 July – and would therefore fall into Q3. As far as we understand, this will not take effect immediately, but will come into force about a week later.

How high will it be?

The inflation data have long justified an interest rate hike. Opinions differ, however, on the number of steps and, above all, the size. Since everything is under consideration, small steps (e.g. 10 basis points) would also be conceivable. However, due to the ferocity of inflation rates, we have incorporated “normal” steps (25 basis points) in our baseline scenario. As the demands of some central bankers also show, even isolated large steps (50 basis points) are more likely than small ones. Here, the question of obtaining a majority remains, which we doubt for now and will review in September.

How many more steps will follow in 2022?

Most probably four – this seems to be a foregone conclusion (not quite yet), and there are exactly these four more Council meetings left in the second half of the year for sufficient room for maneuver, two of them equipped with new projections (September and December). The move in July now even seems to include all three ECB key interest rates and not just the deposit rate as expected; at +25bp, the size has also already been clearly communicated. The further course of action in September depends mainly on the data and will definitely include another interest rate step. We expect that a +50bp hike will only happen if the inflation projection will show a "7" in front of the decimal point. The two subsequent meetings in 2022 are expected to continue gradually, most probably again +25bp each. The question we are currently asking ourselves is which interest rates will move and when, and by how much.

Which interest rate will move first? And how to go ahead?

The clear favourite for the first increase has been the deposit facility rate – until today. It has been at -0.50% since September 2019 and is mainly responsible for negative interest rates on current and business accounts. The main purpose of the interest rate is, of course, the overnight deposit at the ECB and has a corresponding signalling function. Therefore, we envisage a hike of 25 basis points here. The main refinancing rate and thus the key rate in the narrower sense (MRO; main refinancing operations rate) has already been at 0.00% since March 2016. It was preceded by a value of 0.05%, which shows that steps above or below 25bp are always conceivable in either direction. The marginal lending rate, i.e. borrowing money overnight from the central bank, has also been at its lowest level of 0.25% since March 2016. Our baseline scenario for July envisaged that a symmetrical corridor of the three interest rates would be re-established. This symmetry would not be achieved if all three interest rates were actually raised by +25bp in July. For September, we also expect that negative interest rates on the part of the central bank will be a thing of the past. Whether, for example, the deposit rate then rises by "only" 25 basis points and the other two by +50bp is ultimately no longer so important – it would just be more symmetrical.

How long will reinvestments under the APP continue?

As unclear as the data situation and reporting by the Eurosystem within the framework of the PEPP (Pandemic Emergency Purchase Programme) may seem, the cards are clearly on the table in terms of reinvestments. Although the programme stopped its net purchases at the end of March before exhausting its self-imposed envelope of EUR 1,850bn, maturities of partly (still) unknown amounts will be reinvested until the end of 2024. This means that we have been dealing with the PEPP for further 2.5 years with no reduction in the balance sheet total. This aspect is currently much more cryptic under the APP. "The Governing Council also intends to continue to reinvest, in full, the principal payments of the maturing securities acquired under the APP for an extended period of time after the date when key ECB interest rates start to rise and, in any event, for as long as necessary to maintain favourable liquidity conditions and a wide degree of monetary accommodation." At the moment, we think anything from six months to more than 24 months is conceivable and we hope to have some information at the press conference after next ECB Governing Council meeting in July. Today it was not actively addressed and not specified at all.

ECB projections: Inflation revised upward for all years and ...

With a view to the *ECB Staff Projections*, our focus is once again on the assumptions regarding inflation developments. After all, these expectations serve as a guideline for the monetary policy course in Frankfurt. As expected, they have been revised significantly upward for 2022. For the current year, after only three months, the central bank now expects an inflation rate of 6.8% (previously: 5.1%), while the ECB projections here are 3.5% for 2023 (previously: 2.1%) and 2.1% for 2024 (previously: 1.9%). The figure for 2025 will be communicated for the first time in December. The ECB is thus painting a clear picture with regard to its own projections on future price developments and underlines a temporary increase in inflation rates. In September, we expect another upward revision of the projections, as the duration of the war in Ukraine seems questionable, the minimum wage in Germany will still be raised twice this year (01 July and 01 October) as well as food and energy prices will remain at high levels.

... GDP growth now expected to weaken

The ECB sees growth in the euro zone of 2.8% in 2022 (previously: 3.7%). For 2023 and 2024 it expects 2.1% (previously: 2.9%) and 2.1% (previously: 1.6%) respectively. A positive here is clearly that the recovery should be boosted by the actual opening strategies due to the waning pandemic. As with the inflation projections, the expectations for the pickup in real economic activity have yet to be assessed or fully taken into account in the light of the war in Ukraine and the economic setbacks beyond that. In this respect, the upward revisions in the inflation rate are also accompanied by downside risks to the GDP projections. Higher inflation and lower growth in the past often reflexively stoked fears of stagflation. We prefer to speak of a SLOWflation, as we cannot read any stagnating growth from the data. We still do not expect a recession in any year of the observation period.

Old ECB projections for growth and inflation in the Eurozone*

	March 2022 projections				Adverse scenario				Severe scenario			
	2021	2022	2023	2024	2021	2022	2023	2024	2021	2022	2023	2024
Real GDP	5.4	3.7	2.8	1.6	5.4	2.5	2.7	2.1	5.4	2.3	2.3	1.9
HICP inflation	2.6	5.1	2.1	1.9	2.6	5.9	2.0	1.6	2.6	7.1	2.7	1.9

* Change versus previous year in %

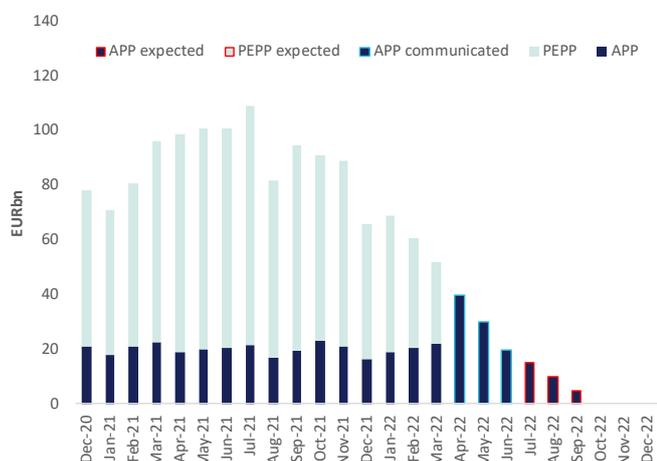
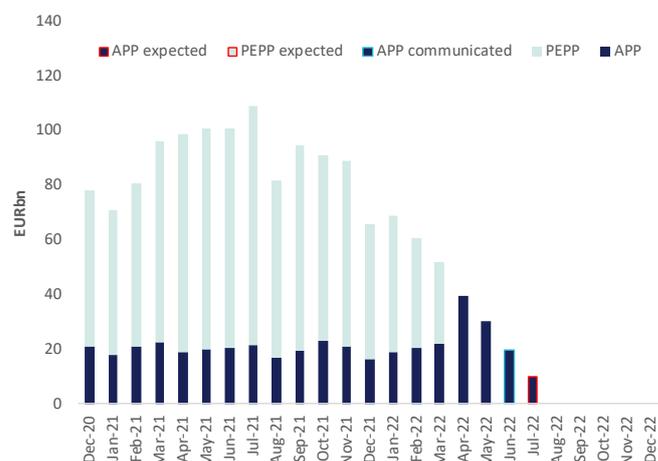
Source: ECB, NORD/LB Markets Strategy & Floor Research

New ECB projections for growth and inflation in the Eurozone*

	June 2022 projections				Adverse scenario				Severe scenario			
	2021	2022	2023	2024	2021	2022	2023	2024	2021	2022	2023	2024
Real GDP	5.4	2.8	2.1	2.1	-	-	-	-	-	-	-	-
HICP inflation	2.6	6.8	3.5	2.1	-	-	-	-	-	-	-	-

* Change versus previous year in %

Source: ECB, NORD/LB Markets Strategy & Floor Research

APP and PEPP: purchases and baseline scenario (old)**APP and PEPP: purchases and baseline scenario (new)**

Source: ECB, Bloomberg, NORD/LB Markets Strategy & Floor Research

TLTRO: Once more pass-through item in the statement?

In its June statement, the ECB also stands by its decision to allow the particularly attractive conditions under TLTRO III to end on June 23, 2022. However, the statement also makes clear that the Governing Council will continue to monitor the refinancing conditions of commercial banks in the common currency area. In particular, it points to the potential impact of maturing TLTRO III tenders. The central bankers will not stand idly by and watch if the transmission channel of their own monetary policy is obstructed in this context. Once again, however, we do not believe that this in any way implies a change of direction with regard to the ECB's (unconventional) refinancing operations.

Conclusion and comment

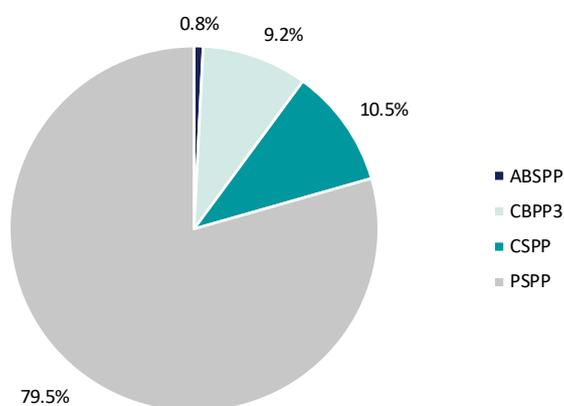
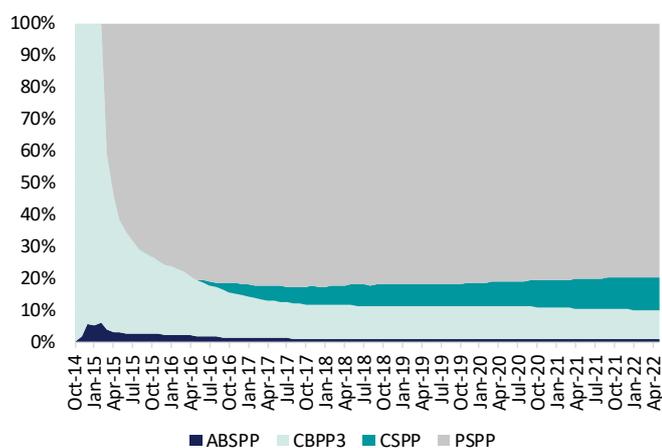
The end of net purchases under the APP will be sealed in three weeks. According to the current decision situation, the Eurosystem will then only be active in the market through reinvestment, both in the context of the PEPP and of the APP respectively. This reinvestment will take place for the pandemic purchase program at least until the end of 2024. For the APP, the Governing Council again does not commit itself. Unsurprisingly, today's statement on the interest rate decision remains well filled with references to the fact that, especially under stress conditions, the central bank's flexibility will remain an essential element of its own monetary policy. As we understand it, this salvatory clause is also applicable to the outlined entry into the phase of interest rate hikes. It also fits into the picture that the first interest rate step of a longer journey is specifically pre-formulated in the ECB statement for the shorter term and that the extent is linked to the further inflation path or this outlook for the September meeting. The fact that uncertainty remains high here, just as with expectations regarding economic activity, is once again demonstrated by the extensive adjustments that obviously had to be made to the ECB's projections. Beyond September, the ECB's decision-makers are merely swearing in financial market participants to a "gradual but sustainable" path of interest rate hikes. The fact that all three interest rates will be raised in July is certainly the biggest surprise of the day.

ECB tracker

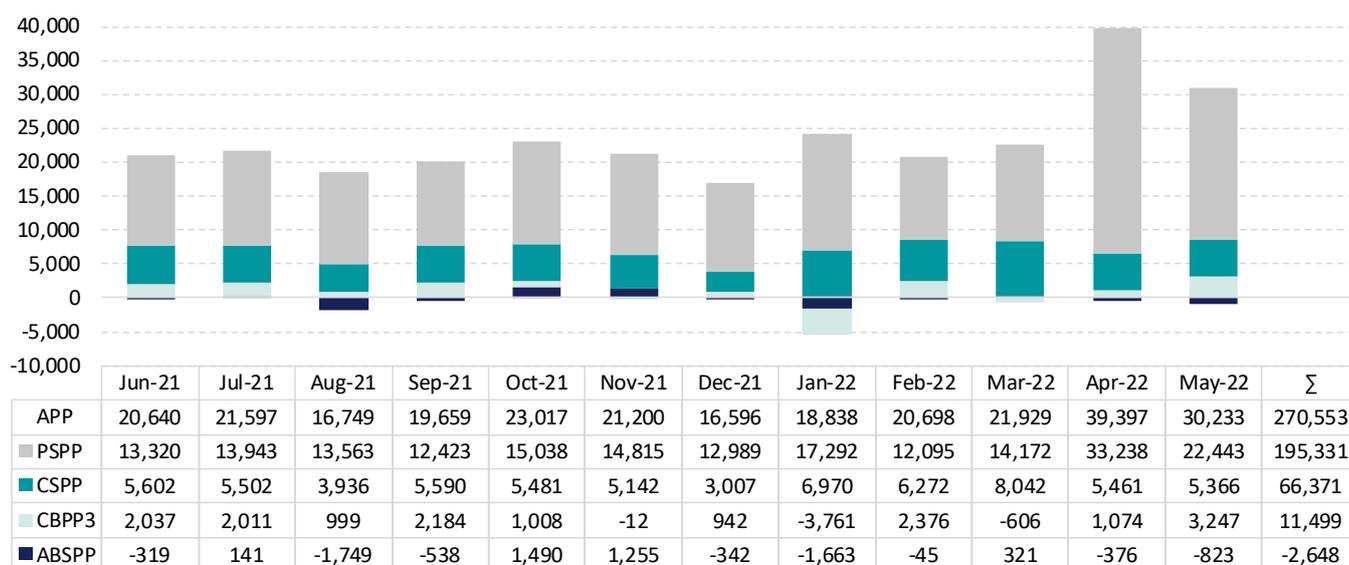
Asset Purchase Programme (APP)

	ABSPP	CBPP3	CSPP	PSPP	APP
Apr-22	26,603	296,924	336,066	2,558,848	3,218,441
May-22	25,780	300,171	341,432	2,581,291	3,248,674
Δ	-823	+3,247	+5,366	+22,443	+30,233

Portfolio structure

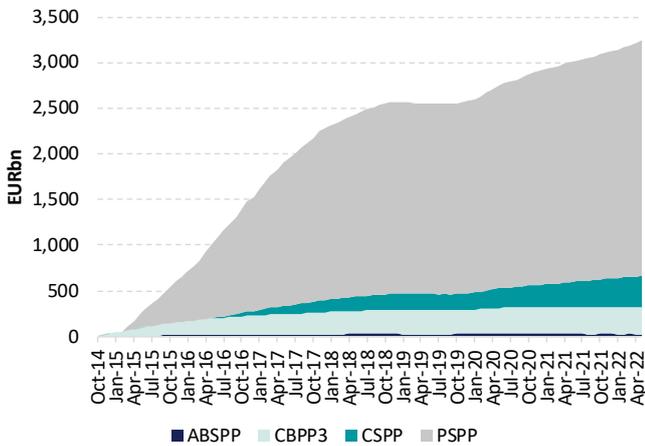


Monthly net purchases (in EURm)

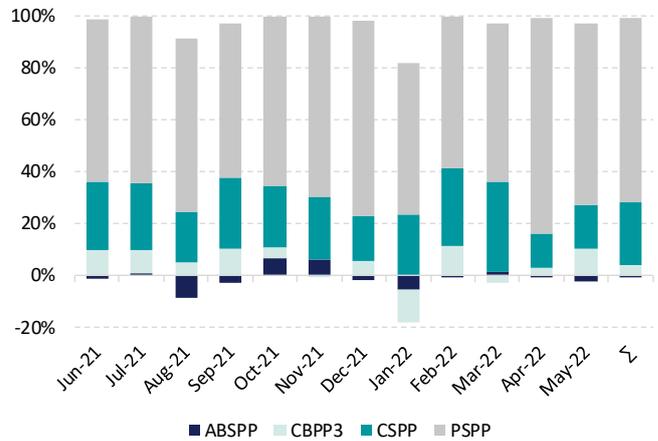


Source: ECB, NORD/LB Markets Strategy & Floor Research

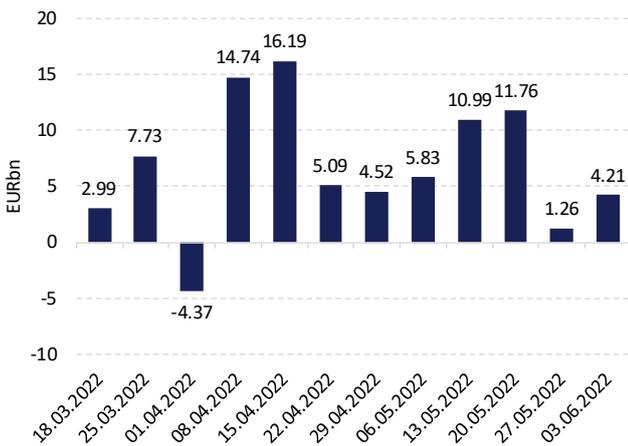
Portfolio development



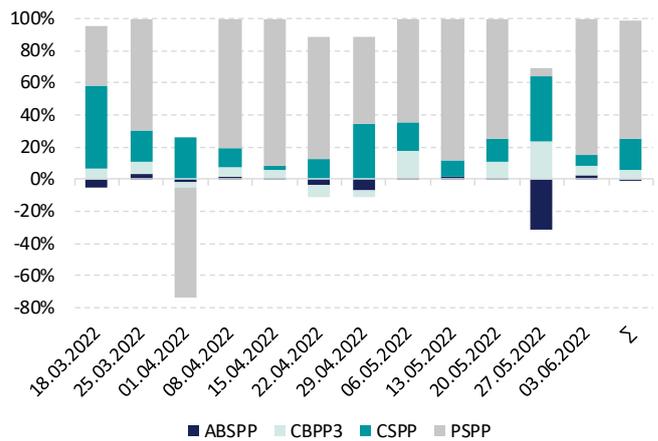
Distribution of monthly purchases



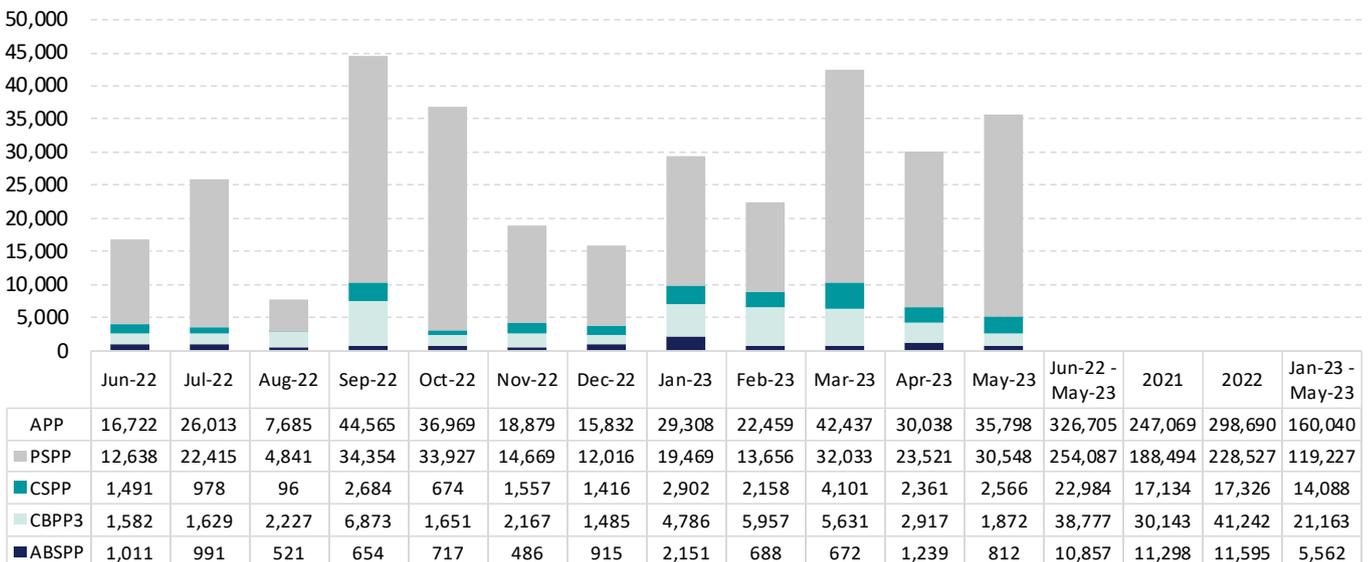
Weekly purchases



Distribution of weekly purchases



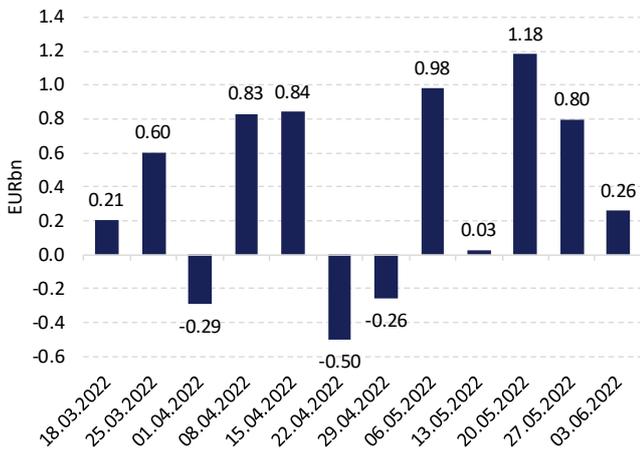
Expected monthly redemptions (in EURm)



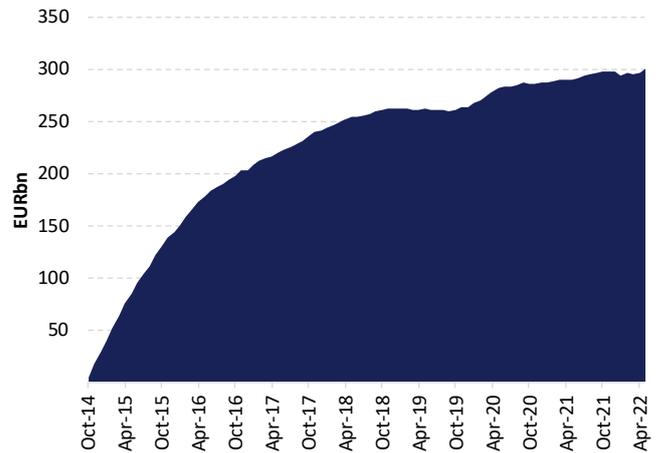
Source: ECB, Bloomberg, NORD/LB Markets Strategy & Floor Research

Covered Bond Purchase Programme 3 (CBPP3)

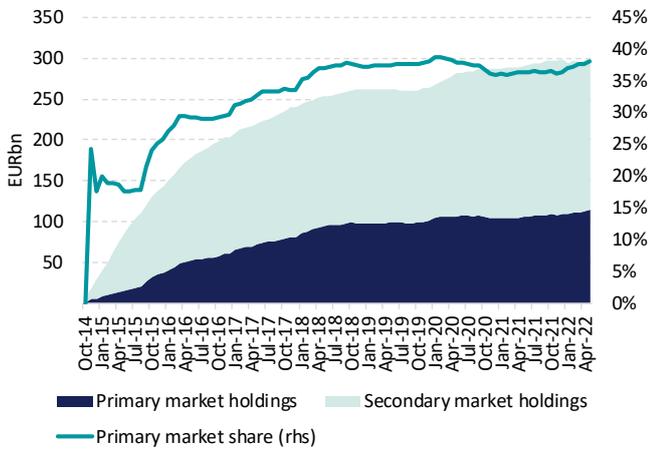
Weekly purchases



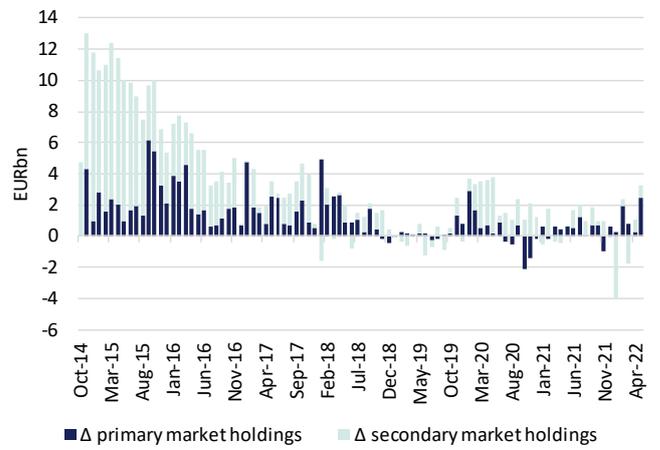
Development of CBPP3 volume



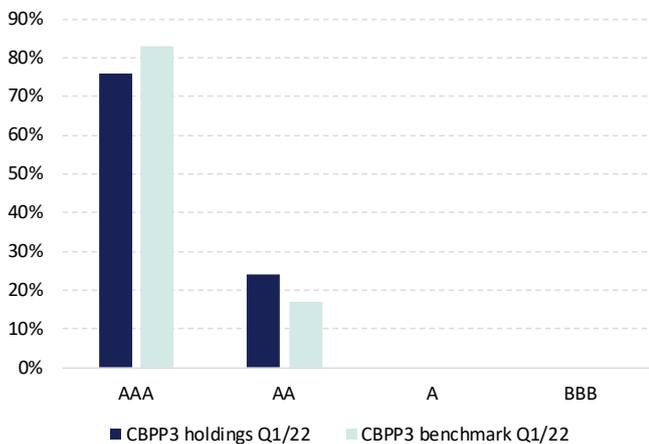
Primary and secondary market holdings



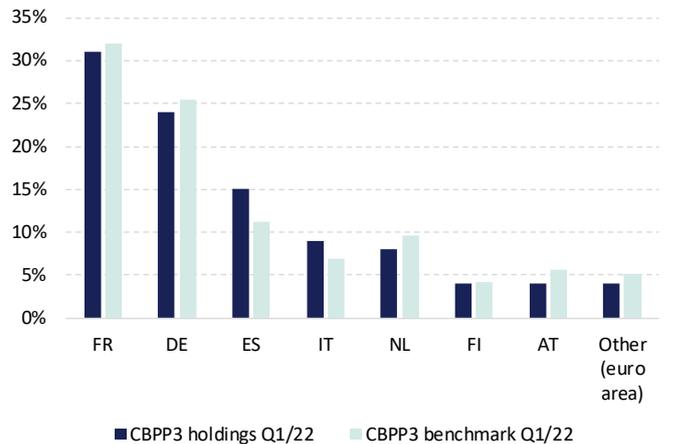
Change of primary and secondary market holdings



Distribution of CBPP3 by credit rating



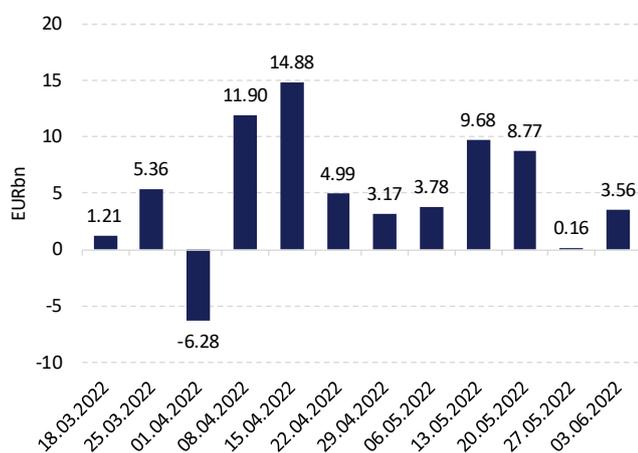
Distribution of CBPP3 by country of risk



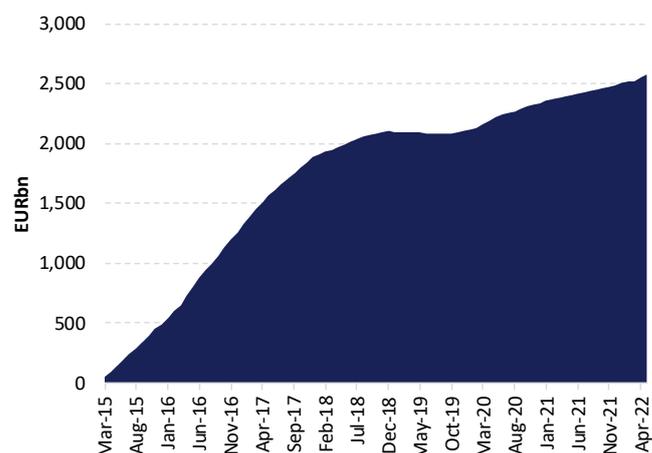
Source: ECB, Bloomberg, NORD/LB Markets Strategy & Floor Research

Public Sector Purchase Programme (PSPP)

Weekly purchases



Development of PSPP volume



Overall distribution of PSPP buying at month-end

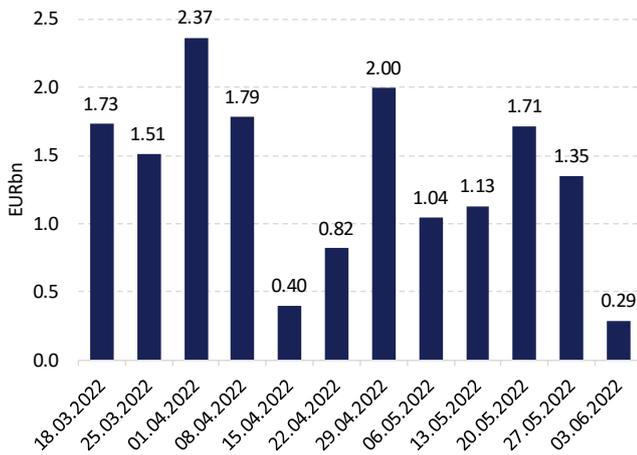
Jurisdiction	Adjusted distribution key ¹	Purchases (EURm)	Expected purchases (EURm) ²	Difference (EURm)	Avg. time to maturity ³ (in years)	Market average ³ (in years) ³	Difference (in years)
AT	2.7%	76,789	73,747	3,042	7.3	8.1	-0.8
BE	3.4%	94,131	91,796	2,335	7.5	9.9	-2.4
CY	0.2%	4,199	5,422	-1,223	8.5	8.9	-0.5
DE	24.3%	666,481	664,213	2,268	6.7	8.0	-1.3
EE	0.3%	438	7,098	-6,660	8.1	8.1	0.0
ES	11.0%	312,269	300,456	11,813	8.0	8.2	-0.2
FI	1.7%	43,170	46,282	-3,112	7.9	8.9	-1.0
FR	18.8%	526,667	514,618	12,049	6.9	8.4	-1.5
GR	0.0%	0	0	0	0.0	0.0	0.0
IE	1.6%	41,978	42,667	-689	8.4	10.1	-1.7
IT	15.7%	447,877	428,048	19,829	7.2	7.8	-0.7
LT	0.5%	5,791	14,583	-8,792	10.6	10.4	0.1
LU	0.3%	3,719	8,300	-4,581	5.8	6.1	-0.3
LV	0.4%	3,751	9,818	-6,067	9.5	9.4	0.1
MT	0.1%	1,403	2,643	-1,240	11.1	9.8	1.3
NL	5.4%	131,267	147,661	-16,394	7.7	9.3	-1.6
PT	2.2%	54,508	58,972	-4,464	7.5	7.9	-0.4
SI	0.4%	10,694	12,132	-1,438	9.7	9.9	-0.2
SK	1.1%	18,022	28,856	-10,834	8.1	8.8	-0.7
SNAT	10.0%	287,194	273,035	14,159	8.2	9.4	-1.2
Total / Avg.	100.0%	2,730,346	2,730,346	0	7.3	8.4	-1.1

¹ Based on the ECB capital key, adjusted to include supras and the disqualification of Greece² Based on the adjusted distribution key³ Weighted average time to maturity of PSPP portfolio holdings⁴ Weighted average time to maturity of the bonds eligible for purchasing under the PSPP

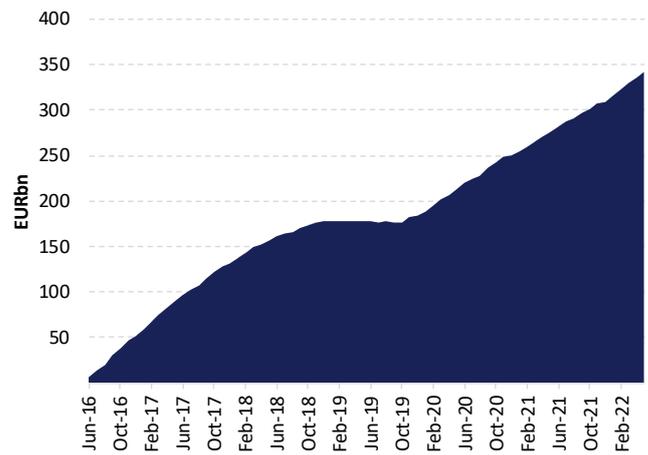
Source: ECB, NORD/LB Markets Strategy & Floor Research

Corporate Sector Purchase Programme (CSPP)

Weekly purchases

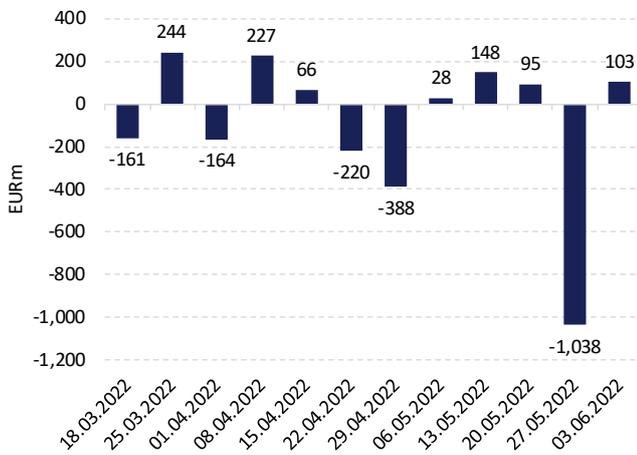


Development of CSPP volume

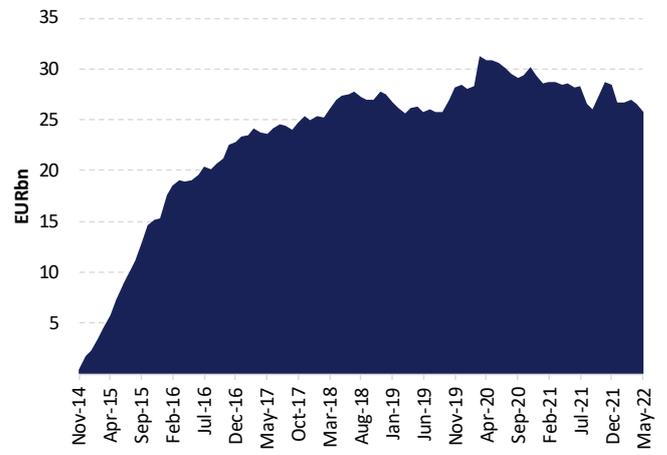


Asset-Backed Securities Purchase Programme (ABSPP)

Weekly purchases



Development of ABSPP volume



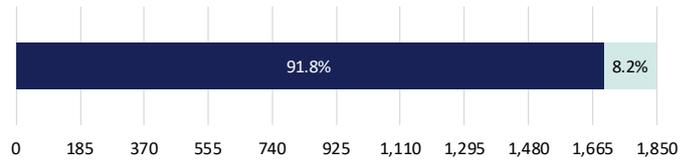
Source: ECB, Bloomberg, NORD/LB Markets Strategy & Floor Research

Pandemic Emergency Purchase Programme (PEPP)

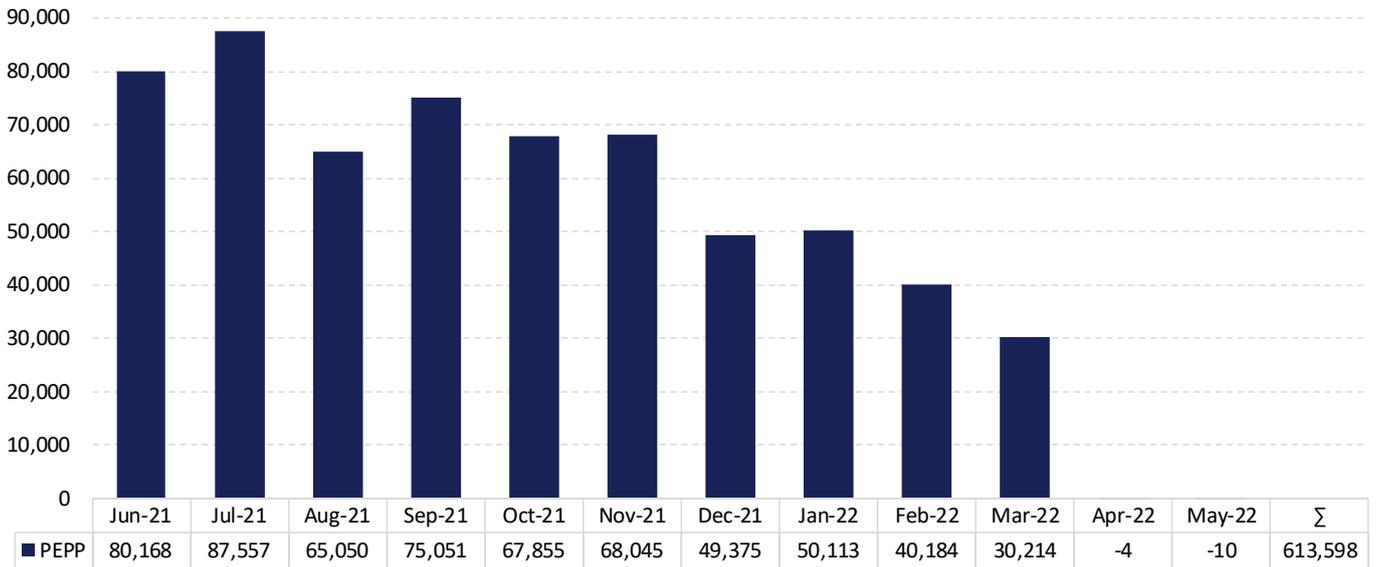
Holdings (in EURm)

	PEPP
Apr-22	1,718,071
May-22	1,718,061
Δ	-10

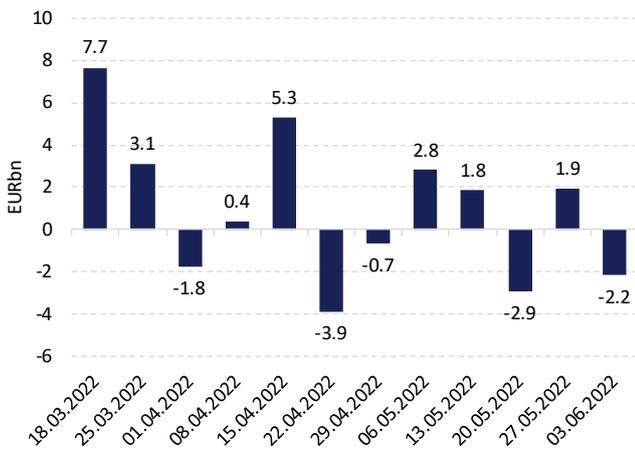
Volume already invested (in EURbn)



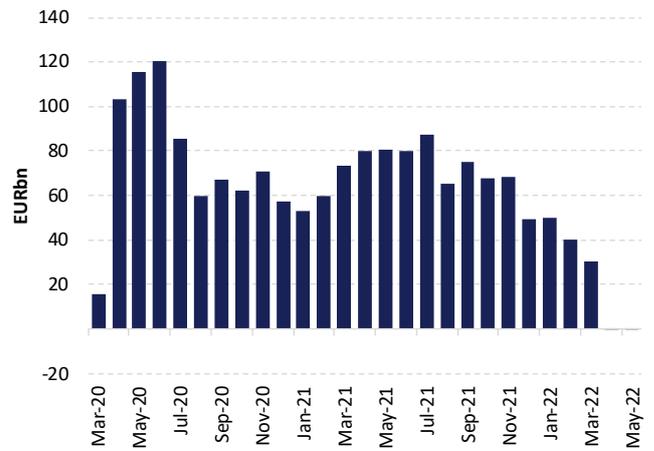
Monthly net purchases (in EURm)



Weekly purchases



Development of PEPP volume

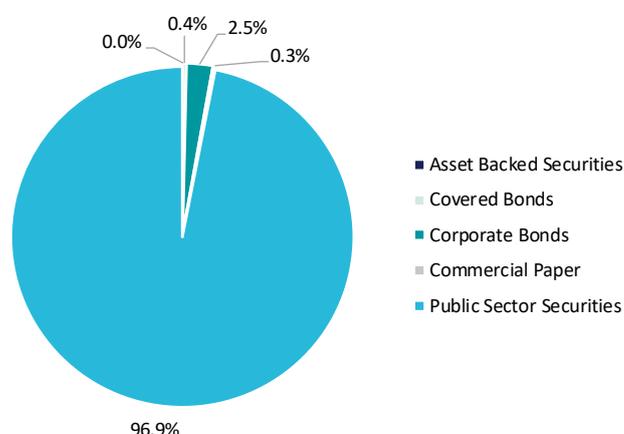
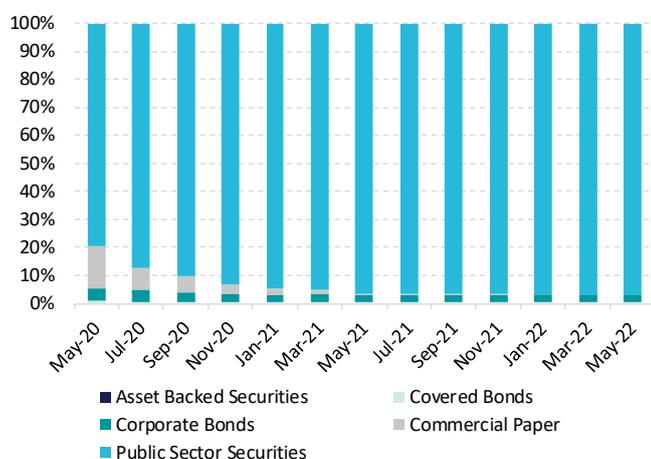


Source: ECB, Bloomberg, NORD/LB Markets Strategy & Floor Research

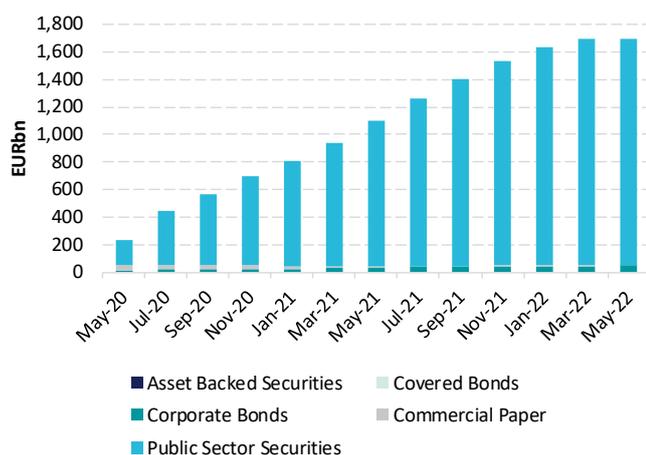
Holdings under the PEPP (in EURm)

	Asset-backed Securities	Covered Bonds	Corporate Bonds	Commercial Paper	Public Sector Securities	PEPP
Mar-22	0	6,067	40,313	5,862	1,644,247	1,696,489
May-22	0	6,067	41,825	4,352	1,644,230	1,696,474
Δ	0	0	+1,512	-1,510	-17	-14

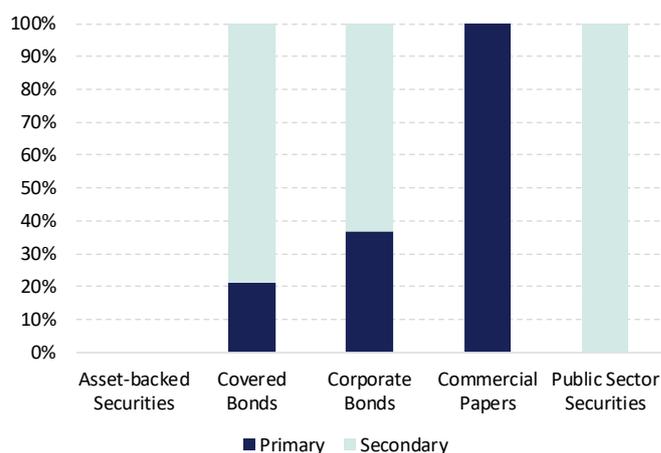
Portfolio structure



Portfolio development



Share of primary and secondary market holdings



Breakdown of private sector securities under the PEPP

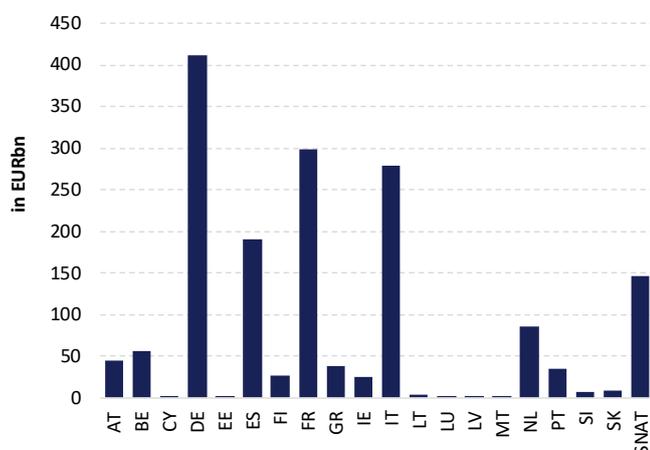
Jan-22	Asset-backed securities		Covered bonds		Corporate bonds		Commercial paper	
	Primary	Secondary	Primary	Secondary	Primary	Secondary	Primary	Secondary
Holdings in EURm	0	0	1,298	4,769	15,332	26,493	4,353	0
Share	0.0%	0.0%	21.4%	78.6%	36.7%	63.3%	100.0%	0.0%

Source: ECB, Bloomberg, NORD/LB Markets Strategy & Floor Research

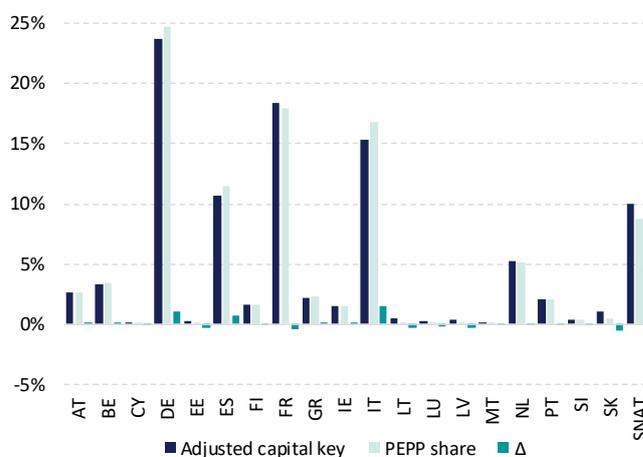
Breakdown of public sector securities under the PEPP

Jurisdiction	Holdings (in EURm)	Adj. distribution key ¹	PEPP share	Deviations from the adj. distribution key ²	Current WAM ³ (in years)	WAM of eligible universe ⁴ (in years)	Difference (in years)
AT	44,280	2.6%	2.7%	0.0%	7.8	7.3	0.5
BE	57,052	3.3%	3.4%	0.1%	6.5	8.9	-2.4
CY	2,464	0.2%	0.1%	0.0%	9.0	8.3	0.7
DE	412,492	23.7%	24.8%	1.0%	6.4	6.8	-0.4
EE	256	0.3%	0.0%	-0.2%	8.0	6.5	1.6
ES	190,463	10.7%	11.4%	0.7%	7.6	7.5	0.1
FI	26,918	1.7%	1.6%	0.0%	7.2	7.8	-0.6
FR	298,979	18.4%	17.9%	-0.4%	8.1	7.8	0.2
GR	38,677	2.2%	2.3%	0.1%	8.6	9.7	-1.0
IE	25,832	1.5%	1.6%	0.0%	9.0	9.2	-0.2
IT	279,302	15.3%	16.8%	1.5%	7.2	7.0	0.2
LT	3,216	0.5%	0.2%	-0.3%	10.1	9.6	0.5
LU	1,853	0.3%	0.1%	-0.2%	6.3	7.2	-0.9
LV	1,890	0.4%	0.1%	-0.2%	8.6	8.5	0.1
MT	609	0.1%	0.0%	-0.1%	10.9	9.1	1.8
NL	86,124	5.3%	5.2%	-0.1%	7.7	8.6	-0.9
PT	34,802	2.1%	2.1%	0.0%	6.8	7.1	-0.3
SI	6,532	0.4%	0.4%	0.0%	9.2	9.2	0.0
SK	7,966	1.0%	0.5%	-0.6%	8.8	8.3	0.5
SNAT	145,953	10.0%	8.8%	-1.2%	10.4	8.5	1.9
Total / Avg.	1,665,660	100.0%	100.0%	0.0%	7.6	7.6	0.0

Distribution of public sector assets by jurisdiction



Deviations from the adjusted distribution key

¹ Based on the ECB capital key, adjusted to include supras ² Based on the adjusted distribution key³ Current WAM of public sector securities holdings under the PEPP ⁴ WAM of eligible universe of public sector securities holdings under the PEPP

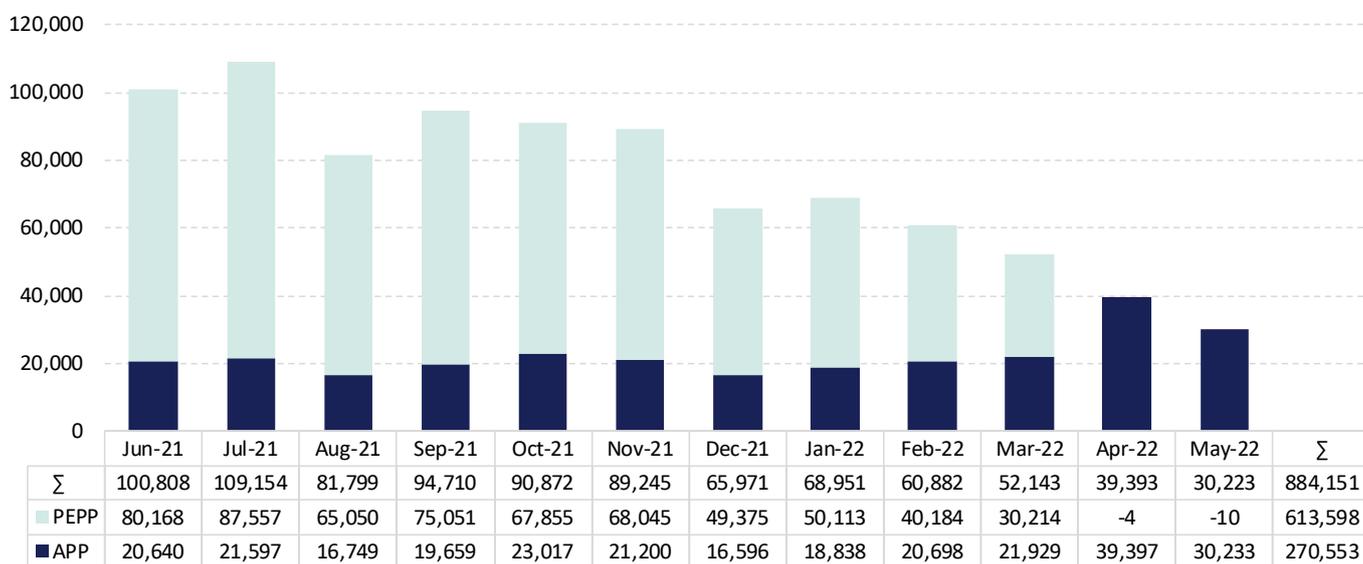
Source: ECB, Bloomberg, NORD/LB Markets Strategy & Floor Research

Aggregated purchase activity under APP and PEPP

Holdings (in EURm)

	APP	PEPP	APP & PEPP
Apr-22	3,218,441	1,718,071	4,936,512
May-22	3,248,674	1,718,061	4,966,735
Δ	+30,233	-10	+30,223

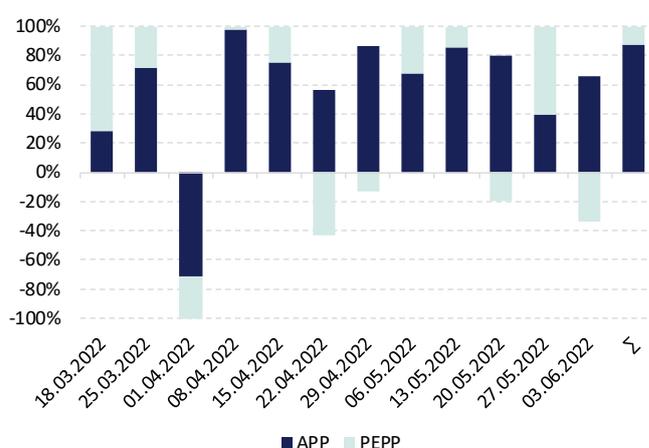
Monthly net purchases (in EURm)



Weekly purchases



Distribution of weekly purchases



Source: ECB, Bloomberg, NORD/LB Markets Strategy & Floor Research

Appendix Publication overview

Covered Bonds:

[Issuer Guide Covered Bonds 2021](#)

[Risk weights and LCR levels of covered bonds](#) (updated semi-annually)

[Transparency requirements §28 PfandBG](#) (quarterly update)

[Covered bonds as eligible collateral for central banks](#)

SSA/Public Issuers:

[Issuer Guide – German Laender 2021](#)

Issuer Guide – Canadian Provinces & Territories 2020

Issuer Guide – Supranationals & Agencies 2019 (update planned for 2022)

Issuer Guide – Down Under 2019

Fixed Income Specials:

[ESG-Update 2022](#)

[Face-saving ECB decision: Hawks have won – for now](#)

[ECB decision: PEPP benched for now, APP comes in as Point Guard](#)

[ECB holds course, but ups the ante – PEPP running until 2022](#)

Appendix

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Governments	+49 511 9818-9660
Laender/Regionen	+49 511 9818-9550
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