



Fixed Income Special

NORD/LB Markets Strategy & Floor Research

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Marketing communication (see disclaimer on the last pages)

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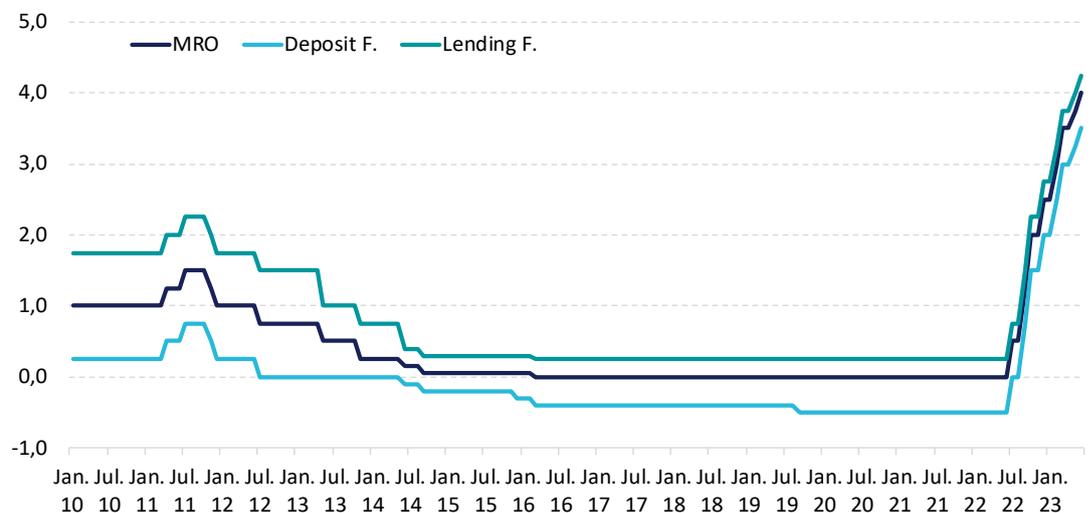
ECB rates: We can fly so high that we can touch the sky

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

Today's ECB key interest rate decision: Once again "+25"

The 25 basis point increase in all three reference rates announced today in the aftermath of the ECB key interest rate meeting came in anything but unexpected. According to the latest decision of the Governing Council, the interest rate on the main refinancing operations will be 4.00% with effect from 21 June 2023, while the marginal lending operations will be at 4.25% and the deposit facility at 3.50%. No further adjustments to the monetary policy management parameters were communicated within the framework of the official statement. With regard to the reduction of TLTRO III liquidity, the central bankers once again referred to their observing role. The ECB's "language" became somewhat clearer with regard to the APP. Whereas in May it was still "expected" that the reinvestment of the redemption amounts from the APP would end in July, today it says: "The Governing Council will discontinue the reinvestments under the APP as of July 2023." Unconventional monetary policy is thus unmistakably being further scaled back. Overall, however, current (and future) price pressures remain too high for the central bankers. The ECB Governing Council obviously cannot and will not take the recent decline in inflation rates as an opportunity to give the interest rate screw a rest. The projections for price development in the Eurozone, on which the latest interest rate decision is based, have been adjusted upwards. Headline inflation is now expected to reach 5.4% on average in 2023 (previously: 5.3%), while the ECB experts now expect 3.0% (2.9%) for 2024 and 2.2% (2.1%) for 2025. The 2% inflation target is thus by no means within reach, which is underlined by the fact that more significant adjustments have been made for the inflation rate excluding energy and food: For 2023, the ECB now assumes 5.1% (previously: 4.6%). The projections for 2024 3.0% (2.5%) and 2025 2.3% (2.2%) have also been adjusted upwards. With a view to 2025, this is "unpleasant" to say the least.

ECB key interest rates (in %; incl. current interest rate decision)



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

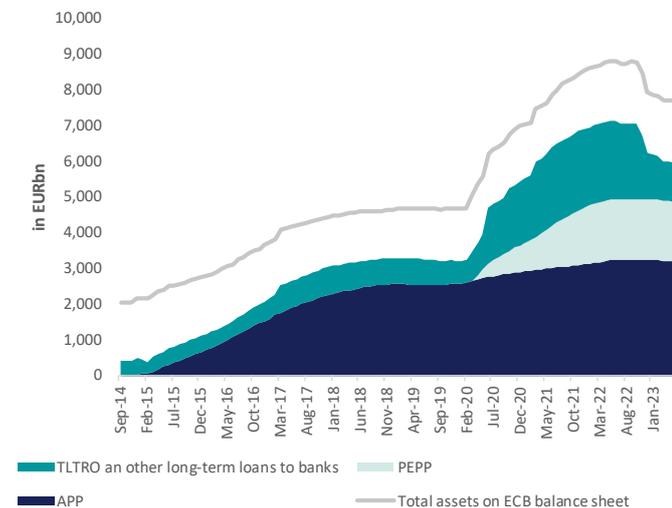
ECB statement and press conference: Straightforward messages?

The complex environment in which the central bankers have to make their decisions is simultaneously shaped by the economic impediments of the previous interest rate decisions. As a result, the ECB experts also adjusted their expectations for further economic activity in the common currency area. For the growth of economic output, discreet changes were made in the course of this, so that for 2023 GDP growth of 0.9% (previously: 1.0%) is expected, while the projection for 2024 1.5% (1.6%) was also slightly adjusted. For 2025, the experts foresee an unchanged 1.6%. However, this also means that the ECB still does not assign a high probability to the scenario of a "hard landing". On the other hand, the reduction of inflation towards the 2% target value as a direct consequence of the tighter financing conditions is again clearly underlined by the ECB Governing Council in the statement. The clear trend of disinflation (falling inflation rates, but also rates exceeding the target) is unmistakable. Nevertheless, we see a difficulty: the ECB does not seem to know the final destination on its own journey. As of today, we question the 3.75% terminal rate, as Lagarde has committed to another rate hike at least for July 2023, thus clearly rejecting a pause. "The Governing Council's future decisions will ensure that the key ECB interest rates will be brought to levels sufficiently restrictive to achieve a timely return of inflation to the 2% medium-term target and will be kept at those levels for as long as necessary." Thus, we believe that interest rate cuts in 2024 are already almost out of the question – provided that the ECB's recent shaky projections actually materialise in the forecast period.

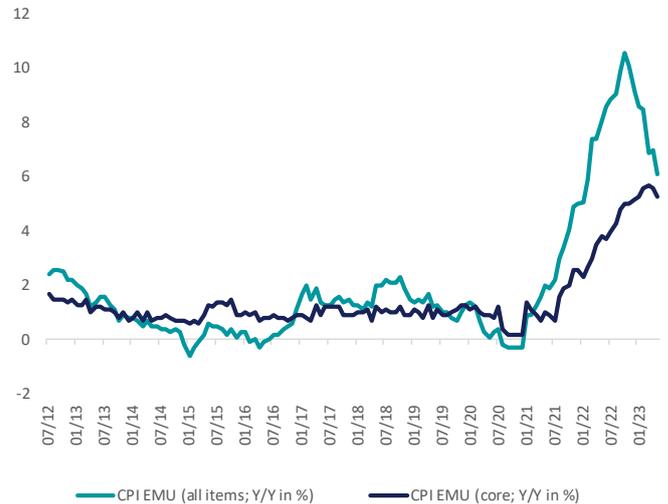
ECB decision taken: Consequences for public issuers (SSA)...

The interest rate hike of +25bp was already expected by most market participants and was thus priced in. The currently still slowly progressing balance sheet reduction (so-called QT) is arriving in relative terms especially in the SSA segment. As is well known, about 80% of the APP consists of public securities. Since direct government financing via the primary market has always been prohibited since 2015, the Eurosystem has only been able to focus on the secondary market over the past eight years anyway. The reduction of EUR 15bn per month is still disproportionate to the sums moved by APP and PEPP (volume: more than EUR 5,000bn). Here the QT is now definitely picking up speed in the second half of the year due to the omission of reinvestments, even though the balance sheet total of the Eurosystem is only slowly shrinking. After all, about EUR 148bn of bonds will mature in the second half of the year. Not a single euro of this will be reinvested. This is about two and a half times the non-reinvested volume in the first half of the year. We see a clear imminent acceleration of the Eurosystem's balance sheet reduction. From January 2024 until the end of May – more data is currently not available – the APP will be reduced by at least another EUR 162bn in the context of maturities. What we have observed in eight years of the APP is that some investors have adequately bought bonds in order to sell them very promptly to the Eurosystem at a profit. This has often led us to say that the ECB acts like a Hoover at virtually every spread level. However, these are all known facts and should therefore be priced in. Thus, we do not see any additional distortions of the spread landscape here – not even in the second half of the year. What we are looking at in the second half of the year: No more artificially compressed secondary market spreads, real money investors continuing to return to further rising interest rates and spread levels meeting unchanged high supply – especially from the EU, which will announce its funding plan for H2/2023 in the next two weeks.

ECB balance sheet



Inflation



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

... and for the covered bond market

Today's ECB decision does not really provide any new impulses for the covered bond segment either. Rather, in our view, it confirms the picture of the situation now that repricing on the covered bond market is coming to an end as a result of the central bank's withdrawal. The reduction of the central bank balance sheet is progressing and has already had its effect in the covered bond segment in the past months and quarters. We therefore continue to expect a high issuance volume in the EUR benchmark segment (EUR 193.5bn) for 2023. In the long term, the more real economic effects of the new interest rate level will be felt in particular in the real estate market and thus also in parts of the mortgage cover pools. We do not foresee any fundamental deterioration in credit quality over the next twelve to 18 months, but we would certainly expect more pronounced differentiations in spreads at the jurisdiction level. For the time being, however, this would be more due to sentiment or headline issues than to a significant divergence in the credit quality of covered bonds.

Conclusion and comment

Harmonious discussion. Very broad consensus. 25th anniversary, appropriately a 25 basis point hike in all three key interest rates. So far, so unspectacular. The press conference gave a clear indication of the future path: The ECB is on a journey whose destination it does not know. The next stop will be on 27 July and will be garnished with another interest rate hike. Will that be the final stop? We think "no". So fasten your seatbelts until September, the "4" in front of the decimal point will become visible and tangible. The main positive aspect of the projections presented today are the growth forecasts. We continue to see a "soft landing", which does not mean that it will not jolt again next autumn/winter. However, it did so last winter. We are concerned about the inflation forecasts. We do not see "2.0%" by 2025 and even a small step away from "2.0" is a step in the wrong direction. This means that no interest rate cuts by the ECB are to be expected in 2024. The labour market allows for this. Have a good flight and here's to the next 25 years of the ECB!

Appendix

Publication overview

Covered Bonds:

[Issuer Guide Covered Bonds 2022](#)

[Comparison table of covered bond legislations](#)

[Covered Bond Directive: Impact on risk weights and LCR levels](#)

[Risk weights and LCR levels of Covered Bonds](#) (updated semi-annually)

[Transparency requirements §28 PfandBG Q1/2023](#) (quarterly update)

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

SSA/Public Issuers:

[Issuer Guide – German Laender 2022](#)

[Issuer Guide – German Agencies 2022](#)

[Issuer Guide – Dutch Agencies 2022](#)

[Issuer Guide – European Supranationals 2023](#)

[Issuer Guide – French Agencies 2023](#)

[Beyond Bundeslaender: Belgium](#)

[Beyond Bundeslaender: Greater Paris \(IDF/VDP\)](#)

[Beyond Bundeslaender: Spanish regions](#)

Fixed Income Specials:

[ESG-Update 2023](#)

[ECB interest rate decision: All new in May... Or: The force of past rate hikes!](#)

[ECB interest rate decision: Backbone in times of turmoil?!](#)

[ECB interest rate decision: Roadmap to QT](#)

Appendix

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