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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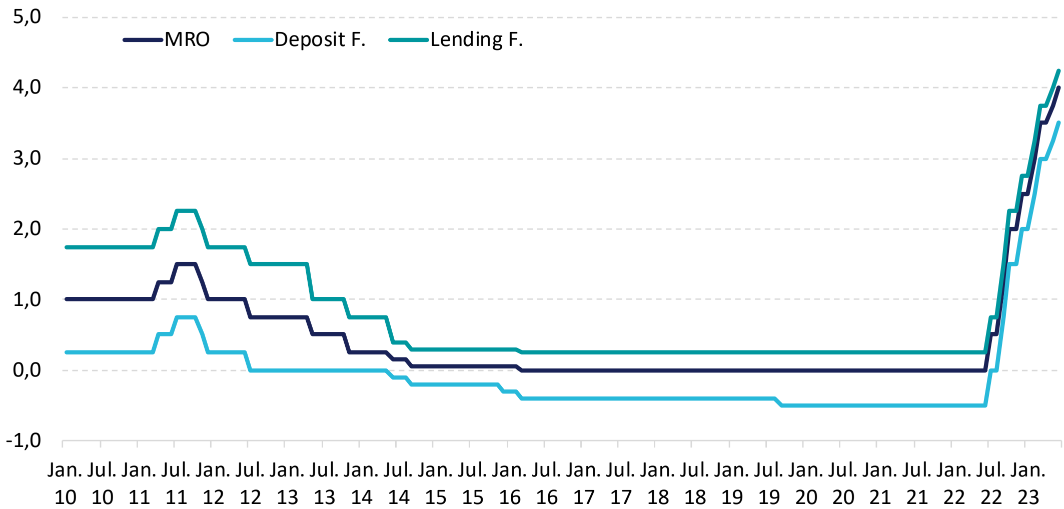
ECB preview: About scrambling and hiking to the terminal rate

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

ECB meets on 27 July: About hiking and other technical terms for alpinists

We are looking back on a historic cycle of interest rate hikes for the common currency area. And, hand on heart, who would have expected such a feat or tour de force from the central bankers in Frankfurt less than a year ago (the first rate hike took place on 21 July, 2022)? Now, there are indications that the ECB's Governing Council is deliberately heading for the end of this rate hike cycle. This is true at least if the battle against excessively high inflation in the Eurozone can be declared won. In fact, the question of what might happen after the "last" interest rate step is increasingly being asked on the current fringe. After all, 27 July could already play a significant role here. To use the technical jargon of alpinists, there are indications that the summit will soon be reached after the long and steep ascent. Then it will become clear whether we are on a plateau and how long it will take before the Governing Council invites us to descend together. Also the risk that the plateau turns out to be a saddle and thus it goes up again after a short descent cannot be ignored today. Certainly few expect a steep descent or slide and no one wants a fall from the pulpit. As a reminder: Almost exactly one year ago, the ECB was comparatively far behind the curve by its standards and supposedly camped out in the valley of low interest rates for too long. When the global weather turned and the opinion became widespread that inflation was not as transitory as once thought, the first climbs did not resemble a relaxed step-by-step journey. Rather, they went from base camp directly up the chimney. This happened for some portfolios without real protection. A narrow ridge from col to col – sometimes exhausting, sometimes grueling. And usually with the prospect of the next higher summit as soon as the fog of war and inflation, coupled with the threat of recession, vanished.

ECB key interest rates (in %)



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

Opinions (not only) from the ECB environment: Forum in Sintra...

As part of our ECB previews, we like to draw attention to the statements made by the members of the Governing Council in order to address the debate on the appropriate monetary policy stance, which has been carried to the outside in some quarters. At this point, we would like to take the ECB Forum of 28 June as an opportunity to place monetary policy in the euro area somewhat more in a global context. After all, unsurprisingly, their counterparts at the Federal Reserve and the Bank of England face similar challenges when it comes to combating inflation with interest rate tightening. In this respect, a panel discussion together with Kazuo Ueda may well yield some insights. Ueda was the clear "outsider" here, as the Bank of Japan also has challenges to deal with, but these have not yet triggered a move away from negative interest rates. In fact, inflation is also mostly a global problem, so policymakers in Tokyo also have an issue with price inflation. What united the other three central banks almost three weeks ago now was their commitment to the meeting-by-meeting approach to their own monetary policy and the – unsurprising – recognition that inflation was very persistent. What neither Jerome Powell, nor Andrew Bailey, nor even Christine Lagarde saw coming was a deep recession or even a "hard landing" induced by monetary policy. There is no sign of such a recession today. However, the pace is becoming more cautious. The BoE may have already reached the interest rate peak, even if a few market observers may still expect another +50bp. For the Fed, it is certainly anything but a foregone conclusion that we will see another move (+25bp) until the end.

... and more recent comments by central bankers from the euro area

And now the focus on the ECB Governing Council: Last week, Italy's central bank chief Ignazio Visco expressed his expectation in a newspaper interview that the ECB is moving ever closer to the interest rate summit. Thus, he said, this would definitely be reached by the end of the year. More recently, he said, the biggest risk for the ECB is doing both too much or too little. In addition, the reduction of the APP portfolio is not going too slowly for him. Yannis Stournaras (Greece), on the other hand, can almost be called a dissenter. After all, the central banker highlighted the recent weaker economic data, which would contradict the ECB's baseline scenario. He clarified that the interest rate step in July was not 100% fixed for him. For Croatia's central bank president, Boris Vujčić, at least the decision then remains entirely open in September. Among other things, the "used up" excess savings of the past two to three years could speak against further tightening. This observation ultimately dampens demand and thus also the price-setting leeway of companies. Most recently, ECB Chief Economist Philip R. Lane dealt with the importance of the banking channel for monetary policy transmission. In doing so, he emphasized that aggregate lending rates would only have an effect with a time lag due to maturities. In addition, "[t]he decline in liquidity due to the continued repayment of TLTRO funds and the downsizing of the APP portfolio [...] would further amplify transmission through the banking channel in the coming months." A deterioration in the macroeconomic environment could also impact the banking channel here via declining credit demand and rising default risks, Lane said. For some Council members, the mission of successfully fighting inflation remains achievable without evoking a hard landing in economic activity. Among them is Bundesbank President Nagel. For him, it is clear that quick action is needed to keep expectations in check. For François Villeroy de Galhau (France), the "soft landing" is also possible. Moreover, he does not expect a wage-price spiral in the euro area and sees key interest rates close to their peak and then remaining on a plateau.

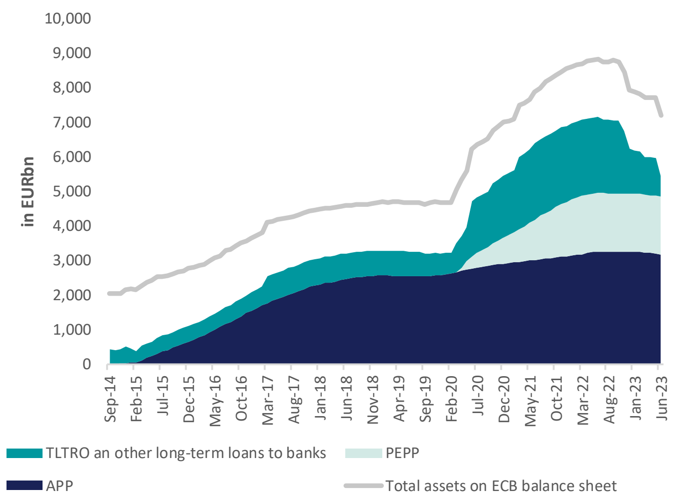
Minutes of the June meeting: Fighting inflation (again) as the main task!

On 13 July, the ECB released the minutes of its June meeting. From the very first lines of the summary of the last meeting of the ECB's Governing Council, it is clear that the focus on the financial markets has shifted away from the extreme scenarios of a crisis in the banking sector and the possible collateral damage of any failed settlement in the U.S. debt dispute. Instead, greater attention is now being paid (again) to the growth outlook in the Eurozone and the upturn in the inflation rate in the EMU. In the Governing Council, too, the main focus is on fighting inflation. This inevitably emerges from the "Minutes" of the June meeting and is not really surprising. The upward revision of the ECB experts' inflation projections underscored the already obvious conclusion that the inflation rate has been "too high for too long." Even the second decline in core inflation in a row was by no means interpreted here as an all-clear. Accordingly, the minutes stated that "while members considered that the second consecutive decline in core inflation was a positive signal, it was widely felt that there was as yet no sufficient or convincing evidence to confirm a turning point. It was emphasized that price dynamics remained strong for all components of inflation, with the exception of energy. Moreover, the outcomes for core inflation had proved stubborn and continued to be higher than projected, thus pointing to greater persistence." With regard to price-driving impulses from the direction of the labor market, it was certainly noted that the inflation rate could receive some upward impetus from higher wage settlements. At the same time, however, it was also said that there was no evidence yet of a wage-price spiral. An additional (future) concern preoccupied central bankers in the context of wage developments. The minutes state that rising wages could (in perspective) have a negative impact on the competitiveness of some member countries. With regard to the further course of monetary policy, the adherence to data dependency and the central bank's own reaction function, which has not been adjusted even by the correction of inflation expectations, is not really surprising. The 25 basis point interest rate hike was accepted by a majority, although some Council members favored the "50" to counter the threat of excessive persistence of inflation. However, this would still leave at least July, for which the Governing Council has already quite resiliently set "plus 25". However, as the minutes also show, the central bankers are also increasingly including the issue of the length of stay at the interest rate summit in the discussion. Here, the Council sees greater significance in the future with regard to the "trade-off" between interest rate level and length of stay at the summit. There is no doubt that it is still too early for interest rate cut fantasies today. Rather, the July meeting will see a further upward trend toward the summit.

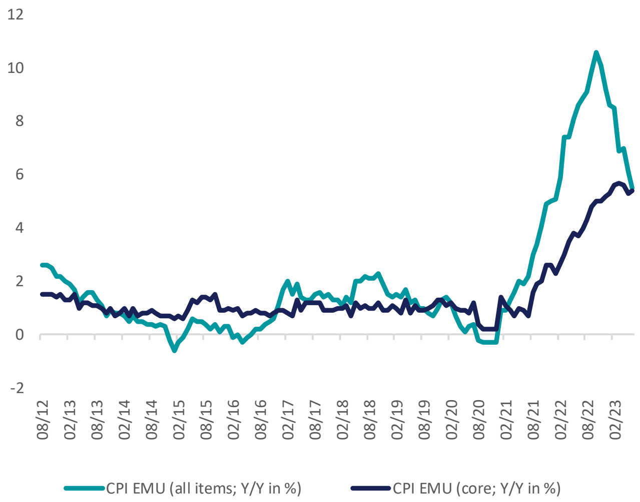
Time lags of monetary policy and the banking channel

We have already repeatedly addressed the impact and/or lag(s) of monetary policy. In this context, we also see a high relevance of Lane's above-mentioned statements on the banking channel. In this context, we are thinking not so much of the rise in lending rates as a consequence of rising key rates, but rather of the effects of a possible deterioration in the macroeconomic environment. Lower demand for credit, but also the resulting risks, could then intensify the downturn and promote recessionary tendencies. As a result, demand-side price buoyancy could lose substance and accordingly – faster than expected – take the ground out of the argument for further interest rate hikes.

ECB balance sheet



Development of inflation



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

Our expectations for 27 July: +25bp...

Now that the ECB had entered its last month of reinvestment under the APP in June, and QT is picking up comparatively considerable momentum on the one hand, while on the other hand the flag of QE is only being held aloft (a little) under the PEPP, the only focus is on the future interest rate path: 25 basis points have already been fully priced in for 27 July. As this is (probably!) not likely to be the last rate hike of the year, we do not see any downside surprise potential either ("No rate hike" scenario: probability <1%). We define our baseline scenario as follows: Small interest rate step in July and probably another one in September paired with the then upcoming latest projections. Here comes the "but": however, if the downturn intensifies and/or lending slows dramatically, we see less demand in economic terms paired with less demand-driven inflation. This would ensure to already have peaked in July and the journey would only be over in retrospect. In general, less liquidity will be available to the banking channel going forward. Here, we draw everyone’s attention in particular the reduction of the APP portfolios and the repayments made or still to be made under TLTRO III.

... and little to no surprise potential in sight

We also estimate that the rate hike would be greater than 25bp at <1% of probability. The residual risk remains that the day will come when not all three interest rates are raised in parallel. As is well known, we have often referred to the once broader corridor in the past and will not (yet) tire of doing so today. For 25 years, the ECB has set the interest rates on the money market for the marginal lending facility, the main refinancing instrument (commonly known as the key interest rate) and the deposit facility through the Governing Council. The range between the upper and lower limits is called the corridor or interest rate band. So we can look forward to seeing what the ECB has in its oft-used verbal quiver for us on 27 July.

Further roadmap: What else does the ECB have in its quiver for us?
Base case:

- ✓ All three key interest rates are raised by 25bp
- ✓ Another 25bp rate hike in the second half of the year (data-dependent, possibly in September with then latest projections)
- ✓ Sole focus on PEPP reinvestment as first line of defense
- ✓ No rate cuts in sight

Possible surprises:

- Not all three policy rates will be raised by the same amount (corridor)
- All three key rates rise by more than 25 basis points
- Interest rate pause in July
- Deviation from forward guidance with a view to PEPP
- Inflation rates not to fall further until fall
- Hard landing

In our view, this leaves the picture for the second half of the year reasonably predictable and yet still exciting in these turbulent times.

Conclusion and comment
Since we are currently halfway at the end with our hunter's Latin, today we have tried the language of alpinists. Sometimes it helps to look into the distance without losing sight of the short term or the beautiful. The hawks clearly see the goal of fighting inflation at risk should the terminal rate for the key interest rates be reached as early as July. For the doves (and some banks), the interest rate journey so far may have been too fast. We think that another +25 basis points are priced in and see little surprise potential for the coming week. Still in June, Christine Lagarde spoke at the press conference on the interest rate side in her own way in the plural. Here, however, we currently see more of a 50:50 decision in September for what will then be the last interest rate step in the second half of the year. It would also have a certain charm to take the last step of the journey in July and thus arrive at the destination exactly one year after the first rate hike. Moreover, the interest rate hikes since July 2022 could then finally start to have an effect and spread into the real economy due to the sluggish transmission mechanism. Effect lags are the rule rather than an exception here, 12-18 months is generally considered "normal". We rule out interest rate cuts until 2024. We wish the ECB a "good descent" if it has to embark on another journey. For the time being, we can see the peak dimly on the horizon – and somewhere behind it must be the plateau expected by market participants. Rest instead of haste and a certain dwell time are urgently recommended on our part.

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

ECB interest rate decision: All new in May... Or: The force of past rate hikes!

ECB interest rate decision: Backbone in times of turmoil?!

Appendix
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