



## Fixed Income Special

NORD/LB Markets Strategy & Floor Research

27 July 2023

Marketing communication (see disclaimer on the last pages)

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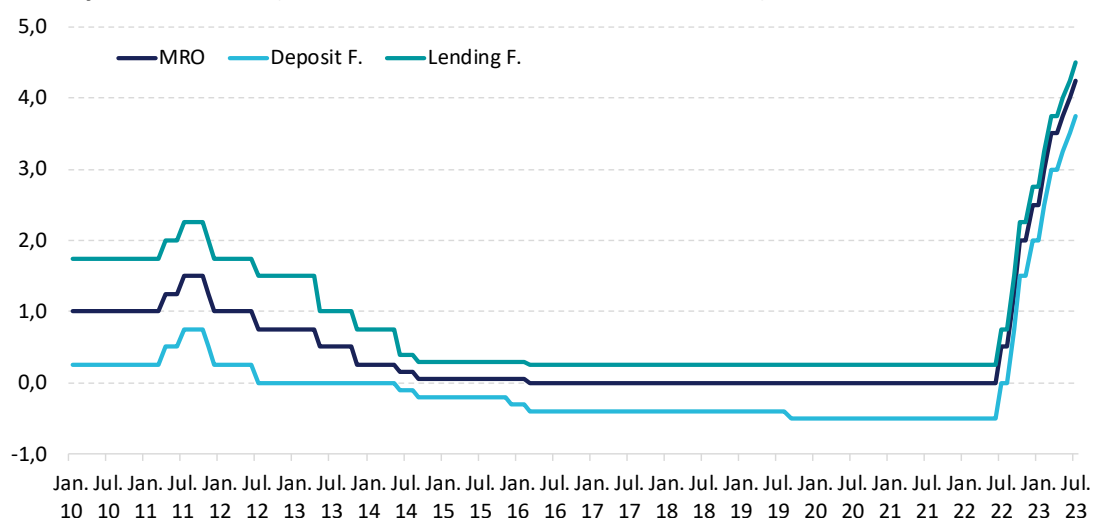
## ECB: From the bottom to the top – time to stop? Nobody knows it

Authors: Dr Norman Rudschuck, CIAA // Christian Ilchmann // Dr Frederik Kunze

### ECB interest rate decision: Is this the summit? Or not yet?!

The decision mainly came in as expected: In the course of today's key interest rate meeting, the ECB Governing Council announced the increase of all three reference rates by 25 basis points. Accordingly, the interest rate for the main refinancing operations will be 4.25% with effect from 02 August 2023, while the marginal lending operations will be at 4.50% and the deposit facility at 3.75%. As already outlined in our [ECB preview \("About scrambling and hiking to the terminal rate"\)](#) on 18 July, various questions were preoccupying many market observers: With today's (more or less) predetermined hike of "another 25 basis points" – have we reached the summit? Or do we have to prepare for another hike in September? How do central bankers assess current and future price pressures? And how high is the risk of doing too much or too little? In preparation for today's press conference our specific questions were as follows. To what extent will the ECB Governing Council grant us a look in their cards? And furthermore, to what extent will this provide an indication for the next key interest rate meeting in seven weeks? From our perspective, we would say that the staff projections in September clearly gained more attention. The statements made by ECB chief economist Lane in the run-up to the meeting still echo quite well in our ears. He finally turned attention to the banking channel, talking not only about the effects of a general reduction in central bank liquidity, but also about the implications of a deteriorating economic cycle on lending and default risks in banks' balance sheets. There has been no threat of a hard landing so far, so the fight against inflation in 2023 should not end in July. Just before the summer break and a historic cycle of rate hikes in the retrospective, the ECB is sending market participants into what could be another brief lull and putting at least a few cards on the table. Below we would like to look at the ECB's written statement and assess Christine Lagarde's tongue-lashing from the press conference – yes and no at the same time or 50:50 all over the show.

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



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

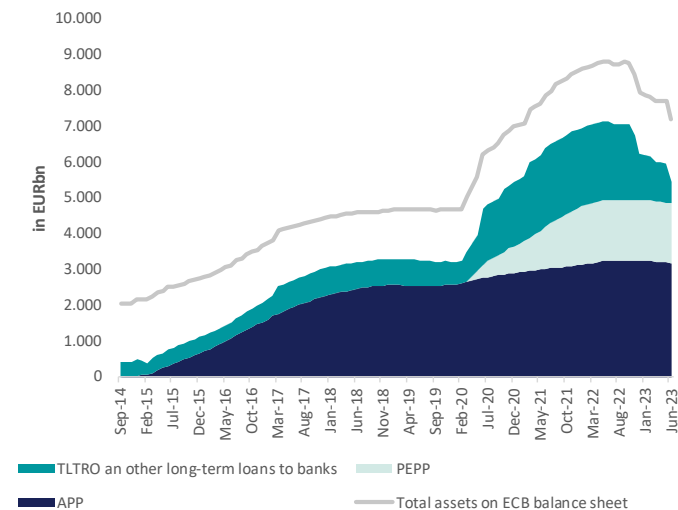
**Statement and press conference: Clear announcements for September? Missing**

The mixed situation in which the central bankers have to make their decisions is simultaneously shaped by the braking effects of the previous interest rate decisions. As a result, the ECB experts also adjusted their expectations for further economic activity in the EEA. Developments observed since the last meeting support the expectation that inflation will continue to fall over the remainder of the year, but will remain above target for an extended period (so-called disinflation). Underlying inflation remains high overall, even if some measures show signs of weakening. Interest rate hikes to date continue to have a strong impact: Financing conditions have tightened again and are increasingly dampening demand. This is an important factor in bringing inflation back to target. Nevertheless, we see a difficulty: the ECB does not seem to know the destination on its own journey. The move regarding the minimum reserve was also exciting and at the same time unexpected: Indeed, the Governing Council of the ECB has decided to set the interest rate on minimum reserves at 0% in the future – as of 20 September. This decision would preserve the effectiveness of monetary policy by maintaining the current degree of control over the monetary policy stance and ensuring the full pass-through of interest rate decisions to the money markets. At the same time, the decision would make monetary policy more efficient by reducing the total amount of interest payable on reserves required to implement the appropriate stance ([details](#)). Looking ahead: In September, there will either be a rate hike (50%) or the ECB will pause (50%). This was actually the subject of almost every question from the crowd of journalists present or joining virtually – always asked differently or paraphrased, but never answered. Everything stands and falls with the next data points and the updated staff projections in September.

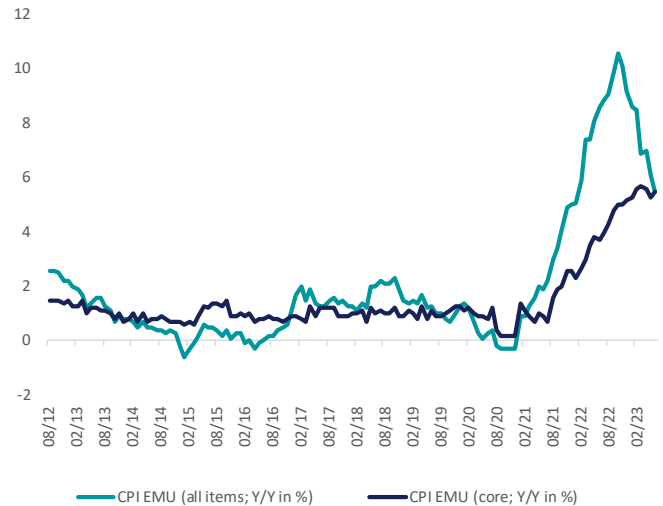
**ECB decision taken: Consequences for public issuers (SSA)...**

The interest rate step of +25bp was already expected by most market participants and was thus priced in once more. The accelerating balance sheet reduction (so-called QT) by the end of the year due to higher maturities will especially affect 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 concentrate on the secondary market over the past eight years. After all, around EUR 148bn of bonds will mature in the second half of 2023. As is also well known, not a single euro of this will be reinvested. This is of about two and a half times the non-reinvested volume, compared to the first half of the year. The former reduction of EUR 15bn per month was disproportionate to the sums moved by APP and PEPP (volume: more than EUR 5,000bn). We now see a clear acceleration of the balance sheet reduction of the Eurosystem. From January 2024 till the end of June – more data is currently not available – the APP will be reduced by at least another EUR 184bn in the context of maturities. What we have observed in eight years of APP is that some investors have adequately covered themselves with 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 already. What we are looking at in the second half of the year: No more artificially depressed secondary market spreads, real money investors continuing to return at further rising interest rates and spread levels, unchanged high supply - especially from the EU, which has now put its funding plan for H2/2023 at "only" EUR 40bn.

## ECB balance sheet



## Inflation development



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

### ... and for the covered bond market

As the ECB's balance sheet shrinks and the unconventional monetary policy measures are cut back, the distorting influence of monetary policy on the global covered bond segment is also fading. We regard the ECB-induced repricing cycle as almost over. As it was already the case at the June meeting, we see the implications of the interest rate hike increasingly on the side of the changed attractiveness of covered bonds for some investors. The comparatively robust spreads and the outlook of rather stable prices until the end of the year speak in favour of the asset class. Even if we do not expect any fundamental deterioration in credit quality on the part of issuers or in the cover pools, challenges in the environment of rising interest rates are increasing both for the values of the assets covered and for bank balance sheets as a whole. Rising interest rates may have a positive impact on earnings as well. On the other hand, the ability to service payments can be perspective burdened. Ultimately, the interest rate turnaround also remains responsible for weakening economic activity in the common currency area. In this respect, a specific statement on reaching the interest rate summit by President Lagarde was a "Yes and no" today and leaves it clearly open for September. More "50:50" has never been seen before at the ECB!

### Conclusion and comment

Once again with almost no surprises – as announced today, all three key interest rates were raised by 25 basis points. But where do we go from here? In the orographic fog of a cooling economy, visibility is veiled. On top of that, corporate credit demand is travelling 20 years back in time, while core inflation is rising slightly. Whether we are now actually at the interest rate peak – Lagarde failed to provide any real enlightenment on this question today. Allegoric: Due to renovation work, the ECB headquarters will remain dark in August as well. Meanwhile, the internal ECB controversy about the future course of action is gaining momentum. Throughout the week, even convinced hawks could be observed engaging in dove's mimicry. As the indications become stronger and the inflation data do not hold any nasty surprises, an interest rate pause on 14 September does not seem implausible. This would also provide the previous interest rate hikes with the necessary time to take effect, as probably nobody is obsessed with a real economy landslide.

## 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 view: About scrambling and hiking to the terminal rate](#)

[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!](#)

## Appendix

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