



Fixed Income Special

NORD/LB Markets Strategy & Floor Research

20 October 2023

Marketing communication (see disclaimer on the last pages)

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Floor analysts:

Covered Bonds/Banks

Dr Frederik Kunze
frederik.kunze@nordlb.de

Melanie Kiene, CIIA
melanie.kiene@nordlb.de

SSA/Public Issuers

Dr Norman Rudschuck, CIIA
norman.rudschuck@nordlb.de

Christian Ilchmann
christian.ilchmann@nordlb.de

NORD/LB:
[Markets Strategy & Floor Research](#)

NORD/LB:
[Covered Bond Research](#)

NORD/LB:
[SSA/Public Issuer Research](#)

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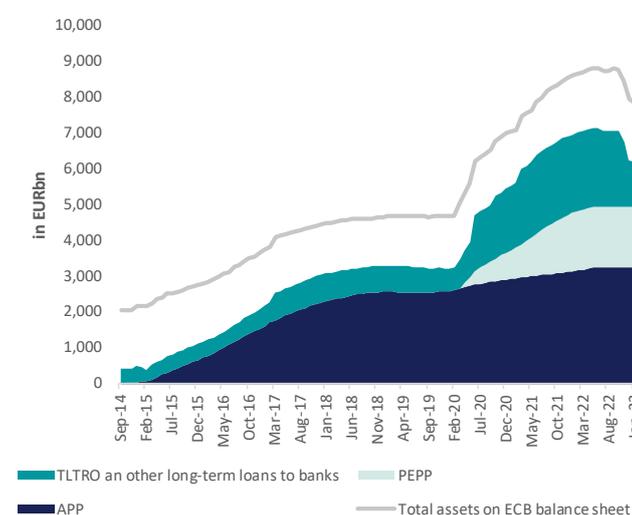
ECB preview: Wait and see without calling it a pause

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

Key interest rate decision ahead: Middle East, inflation, TPI and QT

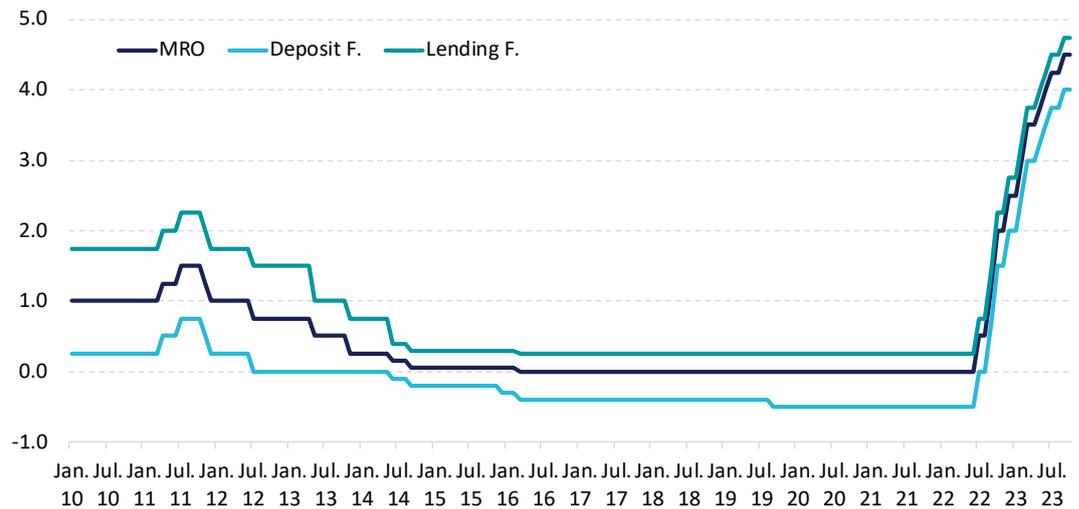
The environment in which the Governing Council will have to hold its next key interest rate meeting is once again characterized by a heightened degree of uncertainty. The geopolitical concerns associated with the dramatic developments in the Middle East are undoubtedly overshadowing the usual monetary policy parameters. With regard to the direct impact on the economy, the focus in recent days has certainly been on the price of crude oil. After all, there is an increased risk that a lift in the price of crude oil will fuel inflation and thus not only undermine the latest ECB projections, but also weigh on economic momentum in the euro area. On the other hand, a largely isolated view of the September figures on price developments reported this week could well lead to the conclusion that the ECB not only paused in October, but may actually have reached the interest rate peak. The headline rate fell to 4.3% Y/Y vs. 5.2% Y/Y in the reporting month of September (core rate: 4.5% Y/Y vs. 5.3% Y/Y). This confirmed the flash estimates from the end of September, which were lower than expected. For the upcoming meeting of the ECB Governing Council, the figures certainly underpin expectations that key rates will remain untouched. However, the discussion of the current imponderables is by no means likely to focus solely on the Middle East conflict. After all, the development of bond yields in the euro area paints an increasingly challenging picture. This is by no means exclusively true of the general interest rate environment. For example, the yield developments in Italy have drawn the focus of market participants to the *Transmission Protection Instrument* (TPI), which allows the purchase of government bonds of individual member states under certain conditions. In our view, how the pandemic purchase program (PEPP) will proceed is also related to this ("first line of defence"). But actually, the focus for the Council members is much more on balance sheet reduction, which should actually steer discussions more in the direction of an earlier end to PEPP reinvestment. If it were not for the "multiple crisis situation".

EZB balance sheet



Inflation development (in %)



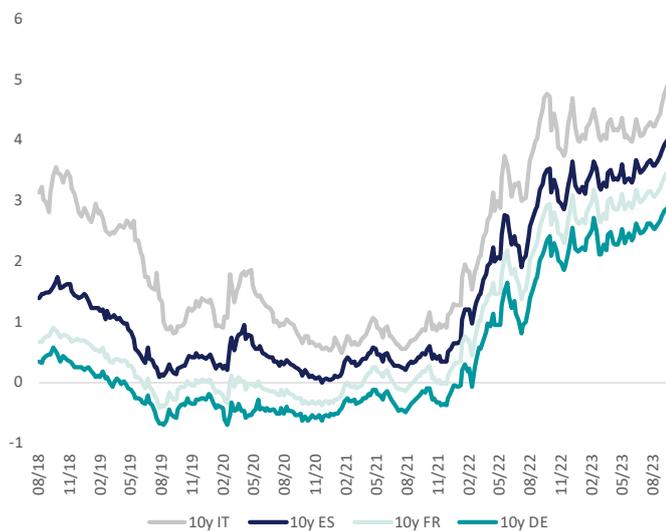
ECB key interest rates (in %; incl. interest rate pause expected by us)

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

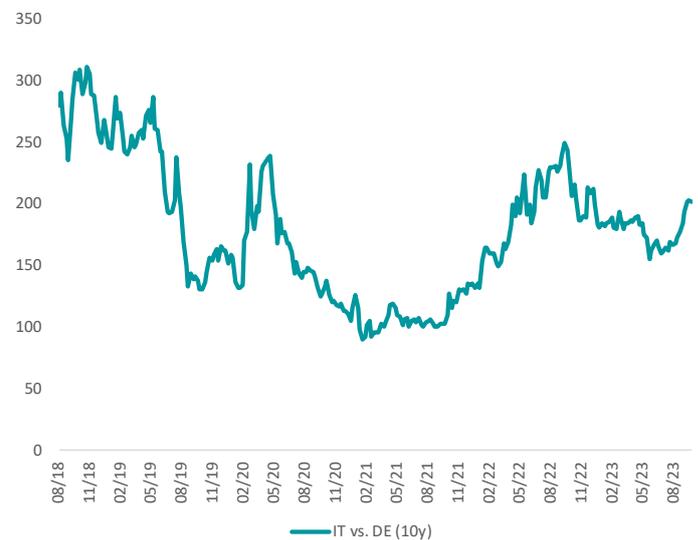
Opinions from the ECB environment: Middle East conflict also determining here

ECB President Christine Lagarde made it clear in Marrakech that the market was dealing with a tightening of financing conditions that had not been seen before. And the impact on economic activity had not yet fully unfolded. In addition, wages would have to be kept in mind. Next, she did not rule out a further interest rate hike and addressed the unpredictable influences on monetary policy. Unsurprisingly, the developments in the Middle East have also found their way into the more recent statements of the ECB decision-makers. The comments focus on both the threat of additional inflationary impetus and the downside risks to the economic expansion process. While there is certainly unanimous agreement on the dramatic humanitarian dimension, we note quite different emphases with regard to the significance for ECB monetary policy. From the perspective of Mario Centeno, the Portuguese central banker, the risk of burdening economic activity by excessive tightening should not be taken in the current situation. Yannis Stournaras' comments were in a similar vein. Among other things, the president of the Greek central bank pointed to the increased risk of stagflation and clarified that the "balance had shifted to the disadvantage of those who wanted further monetary tightening." The head of the Estonian central bank, Madis Muller, on the other hand, focused more on the dangers of additional inflation and called for "vigilance". For the well-known hawk Robert Holzmann from Austria, too, the danger of increased inflation is obviously in the foreground. For Pierre Wunsch of the Belgian National Bank, the necessary adjustments to September forecasts are rather limited for the time being. Nevertheless, he sees the base scenario as being "surrounded by greater uncertainty. On the sidelines of the annual meeting of the IMF and World Bank, Wunsch also commented on TPI and PEPP. He spoke in favor of at least reopening the discussion on an earlier than previously communicated end to reinvestment under the PEPP. In his opinion, it could do no harm to inform market observers in this way that the situation had changed. For him, the fact that the ECB has committed itself to the end of 2024 is the only reason for the ongoing re-investments. He sees the PEPP as asynchronous to the rest of the central bank's toolbox.

Yield development in the euro area (in %)



Spread development: Italy vs. Germany (in bp)



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

Minutes of the September meeting: "Close Call"

The [minutes](#) of the ECB's September meeting were released on October 12. Even from the opening statement, the problematic situation of the Eurozone is unmistakable. These words can be summarized succinctly: Stubborn inflation meets weak growth! The minutes also show that there was an increased upside risk for the inflation rate and a rather pessimistic outlook for growth – even though GDP projections were revised. The decision to raise interest rates was by all means a close one. This is clearly indicated by the wording. For example, it is written three times that the decision was a "close call", although Christine Lagarde spoke of a solid majority at the press conference. In the minutes, for example, we find the passage "[...] although the decision was generally seen as close, a solid majority of members were in favor of the proposed 25 basis point rate hike [...]" worth mentioning. The explicit reference by some panelists to a possible pause also indicates that it was a close call: "Given the uncertainties in model-based simulations, expert surveys, and market indicators, the choice between keeping the deposit facility rate at 3.75% and raising it to 4.00% was a very even one. However, given the highly uncertain environment and the significant disinflation still needed to return to the inflation target in time, it was safer to opt for another hike." We also see this statement as one of the key indications that the September rate move may have been the last (for now). The PEPP was hardly addressed by the Council in its September discussions. The debate, fueled by Pierre Wunsch, among others, may well take up more space at the upcoming meeting. Next week, some lines of argumentation will certainly be pulled out of the minutes currently on the table. Above all, the need to weigh the dangers of a hard landing of economic activity against the delayed achievement of the inflation target in favour of a soft landing is likely to be put forward far more loudly in the coming week than it was in September 2023 and thus fall on more open ears.

Our expectations for 26 October: "Pause"!

For the upcoming interest rate decision, we assume that the ECB Governing Council will take the pause already painted on the wall. In our view, there will be no further hike, even against the background of the heightened uncertainty caused by the latest geopolitical developments. The September figures on inflation in the Eurozone may also have helped. After all, the past interest rate hikes are still having an effect and in the current situation the risk of an overtightening of the interest rate screw and thus a hard landing of economic activity in the common currency area or in individual economies has probably increased significantly. We also expect that there will already be a stronger focus on the PEPP and the always postulated "first line of defence". However, the probability that a decision will be taken in October to shorten the phase of full reinvestments until (still) the end of 2024 is very low in our opinion. It would be questionable here what sense it would make to let the "first line of defence" crumble against the background of the current yield trends. But what happens to the key interest rates after that? Is it a pause to then (at some point) turn to the path of interest rate cuts? Or can even further interest rate hikes follow? As of today, one almost has to think in both directions. After all, the ECB is walking a fine line for the next few months. If the price of crude oil fuels inflation too much, further hikes would have to be considered. On the other hand, the crisis could increase the danger of a hard landing. All in all, everything continues to speak in favour of a meeting-by-meeting approach, which makes forward guidance from the ECB Governing Council extremely unlikely in the coming week as well. So it remains uncertain, although we remain fairly certain that rate cuts are still a long way off (i.e. in the second half of 2024). On average, this is also in line with market expectations, although there is no uniform picture here. Some financial market participants have apparently not quite finished with the interest rate hike cycle.

Conclusion and outlook

It would be a very big surprise if the ECB Governing Council were to make adjustments to the key interest rates at its October meeting. A pause is clearly to be expected. The wait-and-see attitude of the central bankers actually has some advantages. Once again, a wrong decision in an acute crisis situation would be avoided. Certainly, a wait-and-see attitude should not be confused with sitting back. There are enough topics for discussion. More hawkish central bankers would certainly like to have the topic of PEPP or even other monetary policy instruments such as minimum reserve requirements a little more prominently on the agenda. The discussions on the cyclical situation are likely to be just as spirited. Finally, against the background of current developments, many exits are conceivable. Here, emerging fears of inflation must be weighed against the threat of a hard landing. In the coming week, there will be "only discussions". In a meeting-by-meeting approach, it may not yet be necessary to think about December or the year 2024 – but then it is not that simple. For already today the ECB decision-makers are likely to be thinking about how the descent could take place without causing market dislocations. It will certainly not be a mirror image of the ascent.

Appendix Publication overview

Covered Bonds:

[Issuer Guide Covered Bonds 2023](#)

[Covered Bond Laws](#)

[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 Q2/2023](#) (quarterly update)

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

SSA/Public Issuers:

[Issuer Guide – German Laender 2023](#)

[Issuer Guide – European Supranationals 2023](#)

[Issuer Guide – French Agencies 2023](#)

[Issuer Guide – Dutch Agencies 2023](#)

[Issuer Guide – German Agencies 2022](#)

[Beyond Bundeslaender: Belgium](#)

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

[Beyond Bundeslaender: Spanish regions](#)

Fixed Income Specials:

[ESG-Update 2023](#)

[ECB: This rate terminates here – 99.9% sure](#)

[ECB preview: Knives out... It's edging-time](#)

[ECB: From the bottom to the top time to stop? Nobody knows it](#)

Appendix

Contacts at NORD/LB

Markets Strategy & Floor Research



Dr Frederik Kunze

Covered Bonds/Banks

+49 172 354 8977

frederik.kunze@nordlb.de



Melanie Kiene, CIAA

Covered Bonds/Banks

+49 172 169 2633

melanie.kiene@nordlb.de



Dr Norman Rudschuck, CIAA

SSA/Public Issuers

+49 152 090 24094

norman.rudschuck@nordlb.de



Christian Ilchmann

SSA/Public Issuers

+49 157 851 64976

christian.ilchmann@nordlb.de

Sales

Institutional Sales	+49 511 9818-9440
Sales Sparkassen & Regionalbanken	+49 511 9818-9400
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