Fixed Income Special

NORD/LB Floor Research

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Marketing communication (see disclaimer on the last pages)

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ECB preview: Delays in operations or full focus on June?

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

The slightly longer roadmap for 2024

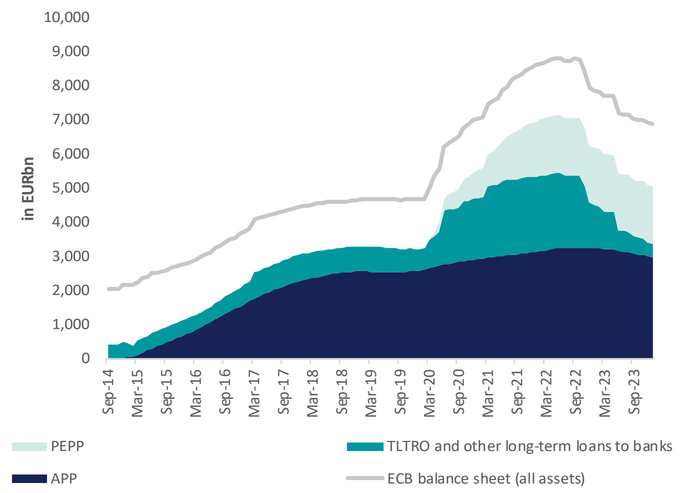
The year of interest rate cuts continues to cast its shadow ahead. The ECB meets on the following dates:

- 07 March – incl. new *staff projections*
- 11 April
- 06 June – incl. new *staff projections*
- 18 July
- 12 September – incl. new *staff projections*
- 17 October
- 12 December – incl. new *staff projections*, then for the first time for 2027

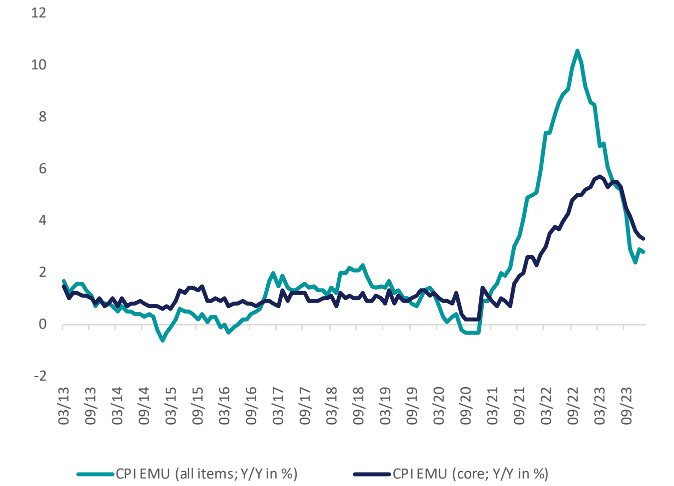
Key interest rate decision on 07 March: New projections on the way to a lower interest rate environment

The environment in which the Governing Council of the ECB must hold its upcoming key interest rate meeting continues to be characterized by a heightened level of geopolitical uncertainty. The geopolitical concerns in Ukraine and the Middle East are overshadowing the usual monetary policy considerations and we have inherited them unchanged from the previous year. However, other parameters are also increasingly causing us headaches: Due to the political shift to the right, the European elections (early June) and the three state elections in eastern Germany (Saxony, Thuringia and Brandenburg) as well as the US presidential election (05 November). 10y Bunds fell below 1.9% after Christmas and were even back at 2.5% last week. For the upcoming ECB Governing Council meeting, all factors underpin the fact that key interest rates will remain unchanged – for the time being. The roadmap for the PEPP is on the table and will be stoically implemented in 2024. Market participants are now wondering when the ECB Governing Council will dare to tackle the minimum reserve rate. And how quickly will the interest rate cuts really happen?

ECB balance sheet

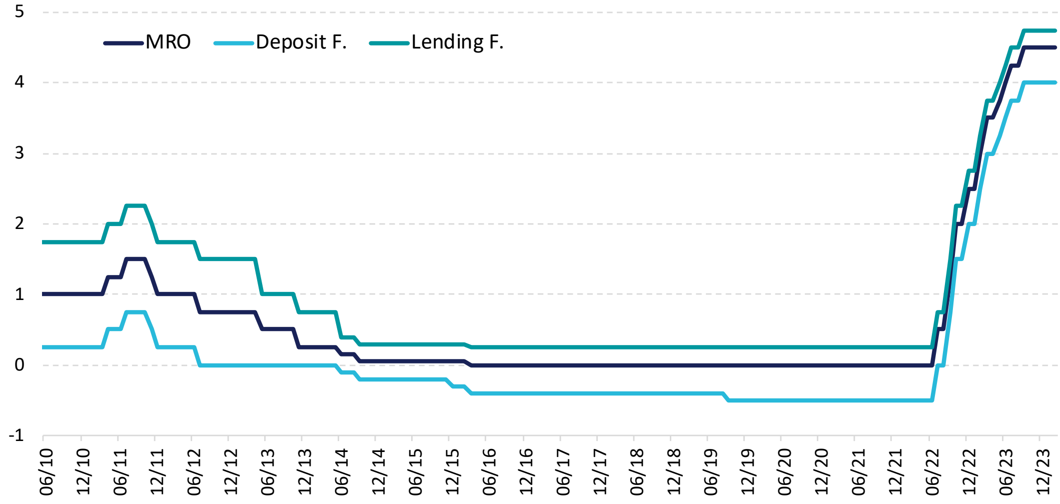


Inflation development (in %)



Source: ECB, Bloomberg, NORD/LB Floor Research

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

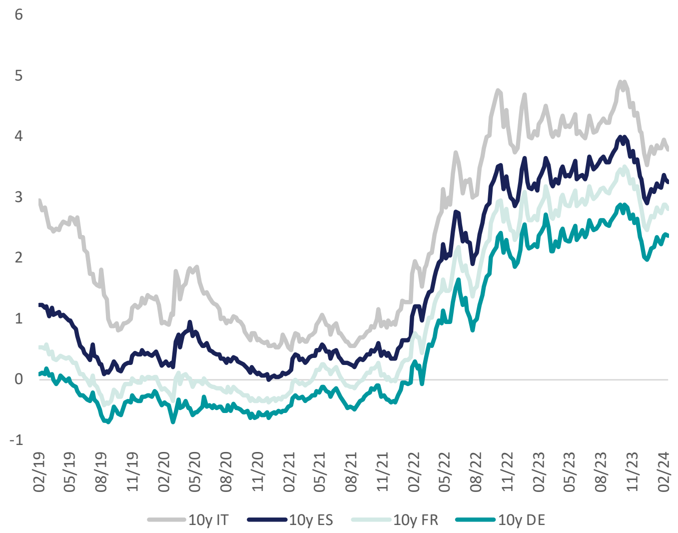


Source: ECB, Bloomberg, NORD/LB Floor Research

Opinions from the inner ECB circle: Afraid of their own courage?

What some market participants saw as a very likely scenario just a few trading weeks ago now seems to be increasingly going up in smoke. A rapid or timely turnaround in interest rates is now evidently receding somewhat further into the distance. The views of the ECB Governing Council members communicated to the outside world once again form the basis for some market observers to adjust their expectations with regard to the central bankers' next key interest rate decisions. Opinions from the ECB environment have by no means been homogeneous in recent days and weeks. However, we have noticed a certain preponderance of views warning against a premature interest rate move in the various lines of argument. Bundesbank President Joachim Nagel formulated a veritable appeal not to be "diverted from the path we have chosen". The "road ahead" may still be a long one, but perseverance must be shown, said the central banker. Meanwhile, ECB Executive Board member Isabel Schnabel noted that, based on her staff's model calculations, there were signs that the monetary policy-induced slowdown in economic activity was bottoming out. The "soft landing" could therefore be within reach. Gabriel Makhlouf from Ireland contributed his view of the labor market as an underpinning. He described it as "surprisingly resilient". In this context, we are also repeatedly struck by Christine Lagarde's focus on wage growth. The ECB President has recently been sympathetic to the slowdown in wage growth but has remained on alert with regard to wage settlements in the first quarter of 2024. This is hardly surprising. After all, the "wages and salaries" component is an important part of the demand-induced inflation rate, which is not only causing headaches for central bankers in the Eurozone. In this respect, it would be a natural reaction on the part of the ECB Governing Council to wait for further data to be published before taking any interest rate action. Not everyone shares this view unreservedly. Mario Centeno, for example, expects a certain willingness to consider a rate cut at the next meetings. The central banker from Portugal apparently believes that there will be sufficient data available in less than ten days – at least to start a substantive and data-based debate.

Yield development in the euro area (in %)



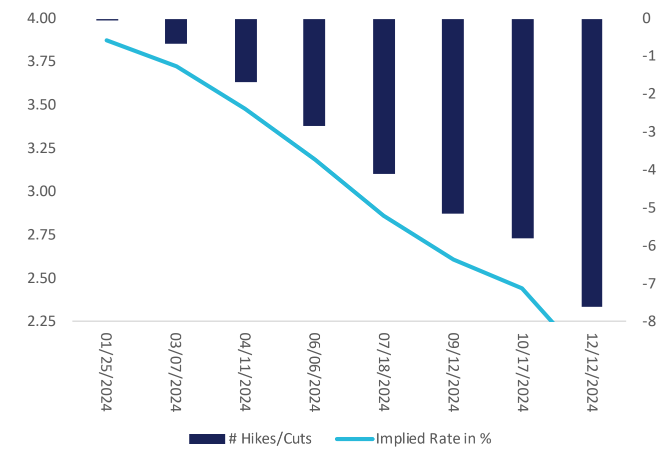
Spread development: Italy vs. Germany (in bp)

Source: Bloomberg, NORD/LB Floor Research

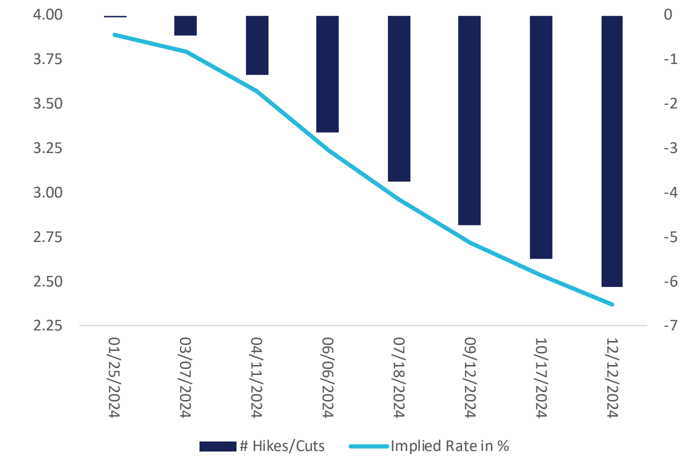
Minutes of the January meeting: Keeping their feet still for a bit?

On February 22, the ECB published the minutes of its first meeting of the year. Even though it was a few weeks ago, we believe that the discussions are very much in line with the current state of the debate. From the "ECB Minutes", we would first highlight the discussion situation with regard to the labor market. According to this, wage developments do not yet allow for a key interest rate cut or make such a debate appear premature. Considering future wage developments, the ECB minutes also pointed out that many negotiations should be concluded in February or March 2024. This initially draws attention to the meeting in April. At the same time, the focus should not be too strongly on salaries and the associated price increases alone. The minutes reveal that the discussion drew attention to "another reason why inflation could be falling in spite of increasing wages". It says: "Since wages amounted to only around 40% of firms' total costs and most indicators of intermediate costs were currently falling, when wages and intermediate costs were taken together, pressure on inflation from total costs was declining." And further: "As changes in producer prices typically led changes in consumer prices by a few quarters, this decline in cost pressure could be expected to be transmitted to consumer prices in the next couple of quarters." In our opinion, this differentiated view is essential, also to avoid misinterpretations. It was also put on record that continuity, caution and patience are still required. The disinflation process would still be too fragile and previous progress could be undone. "Inflation shock had largely reversed", but the challenges seemed to remain stubborn. On the other hand, there was confidence with regard to achieving the inflation target. Here, "for the first time in many meetings", there was more consensus in the discussion. However, after several years of "clearly exceeding the inflation target", the ECB Governing Council believes that the costs of exceeding it again are likely to be higher than the costs of falling short of it. So there remains a "hawkish" undertone!

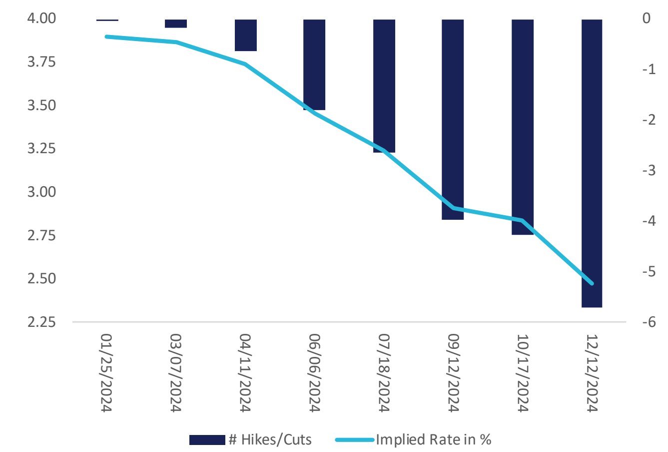
Implied Overnight Rate 27.12.2023



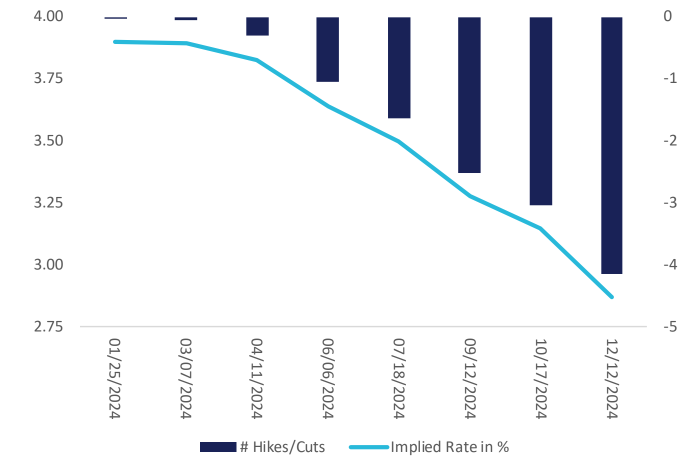
Implied Overnight Rate 12.01.2024



Implied Overnight Rate 24.01.2024



Implied Overnight Rate 26.02.2024



Source: Bloomberg, NORD/LB Floor Research

How "fickle" are market expectations?

Market expectations play a hardly negligible role for the ECB's central bankers, but should by no means be seen as the measure of all things. And indeed, it is fair to assume that the anonymous mass of market participants is quite "fickle". In our comments on the last ECB meeting, we already tried to incorporate this view into our assessment and accordingly looked at the implied interest rate changes derived from overnight index swaps from January 2024. If we extend the edges of this observation period both into the past (i.e. 27 December 2023) and closer to the current edge (26 February), the "turnaround" of market participants becomes quite obvious. Has the express train become a narrow-gauge railroad? We would by no means want to say that at this point. But the interest rate cut in March is off the table and the key interest rate level, which is now expected by the end of the year, is significantly higher than just a few weeks ago. Market expectations are undoubtedly difficult to forecast. Nevertheless, we dare to assume that it will become clear in the further course of the year that the (implied or actual) interest rate cuts will shift further back along the time axis than is still expected by some market participants (although no longer the majority).

Our expectations for March 7: Interest rate cut fantasies shelved?

For the upcoming interest rate decision, we assume that the ECB Governing Council will once again extend the pause on the elevated platform – to stay with the railroad metaphor. Interest rate hikes are a thing of the past, the cards are also on the table for the further course of the PEPP, so all market observers are focusing on two relevant questions: not whether interest rates will be cut in 2024, but when or how often? And when will the Council conclude the operational discussion of the minimum reserve ratio or double it from 1% to 2%? As we expect and as communicated by the ECB, the meetings will remain data-based so as not to be "data-driven" again. We are already looking forward to the months of March and June, as this is when the new staff projections will be published. It is too early to categorically rule out a rate cut for H1. We have made a forecast for very few interest rate cuts in 2024 and have also pointed out that we believe that the first cuts called for in Q1 are more than premature. APP and PEPP have been cleared thematically, QT is in full swing and will gain further momentum in the second half of the year. For the time being, this leaves the issue of minimum reserves and the minimum reserve ratio and, at some point, the resulting interest rate. We continue to expect that there will be a stronger focus on interest rate cuts both in internal discussions and at the press conference. All in all, everything continues to speak in favor of a meeting-by-meeting approach instead of forward guidance on the interest rate side. This also applies to the minimum reserve.

The influence of monetary policy on the Public Issuers/SSA and Covered Bonds

As part of our regular commentaries on the influence of the ECB's monetary policy on the asset classes we focus on, Public Issuers/SSA and Covered Bonds, we have always pointed out the distortions of the unconventional policy parameters in recent years. These had an impact on both the supply and demand side, while at the same time risk premiums were drastically reduced far beyond the two asset classes mentioned. In the course of the change in monetary policy, new distortions gained influence. For example, making general financing conditions for the banking sector more expensive was a key objective of the central bankers. Nevertheless, this not only depressed the development of new business at many commercial banks, but also increased refinancing costs for both the credit sector and the public sector as part of the general repricing process. There was also a long-suppressed but necessary differentiation within and between the various asset and sub-asset classes, which triggered overdue migration on the investor side. However, we are still a long way from being able to speak of a "distortion-free" spread or yield structure. This is particularly evident when looking at the yield curve or swap curve. As interest rates begin to fall, the course of these curves should normalize somewhat and both investors and issuers are likely to try to position themselves accordingly in advance. Investors who are more interested in "absolute yield" should therefore have an incentive to secure the still high interest rate level for the longer term. On the other hand, those investors who tend to base their investment decisions on the spread to the swap curve are more likely to make their investments on the basis of the possible impetus for change that could be triggered by a new change in monetary policy on the spreads. The question here is often to what extent the general sentiment or risk appetite could change. For the asset classes we are looking at, we expect spreads to move sideways (until the middle of the year) or narrow slightly (in the second half of the year) over the remainder of the year.

Conclusion and outlook

"The train has no brakes" – at least if the market is to be believed, the interest rate cut train could hardly be stopped in 2024. After all, some people thought they could find happiness in interest rate cuts that were completely premature for us. For the time being, we would therefore like to take a closer look at the implied interest rate probabilities and their "alignment" with reality. We continue to believe that nothing will happen until the summer, although a first small move in June (-25bp) would be the highest of feelings for us. To stay with the railroad image: Will there be delays in operations or is caution already required at the platform edge in the near future? There could also be a "strike" in the event of interest rate cuts and one or the other market participant would have bet on premature moves to the downside. It is also clear that if the ECB Governing Council gets on the interest rate cut train and buys its ticket for the journey, there will be no way to buy a return ticket in 2024 or 2025. Everyone is also in agreement for the March meeting: another interest rate pause on the elevated platform is clearly to be expected. The central bankers' wait-and-see attitude actually has some advantages. Certainly, this standstill should not be mistaken for sitting back. There are plenty of topics for discussion. Discussions on the economic situation are likely to be just as spirited. After all, against the backdrop of current developments, there are many conceivable outcomes. Against the backdrop of a meeting-by-meeting approach, discourse is once again the most effective means. We are looking forward to the meeting in March with great interest, as the new *staff projections* will be announced and are always somewhat explosive. These have once again gained in importance, as everyone is looking ahead to the data-based first interest rate cut around the middle of the year.

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 Q3/2023 (quarterly update)

Covered bonds as eligible collateral for central banks

SSA/Public Issuers:

Issuer Guide – German Laender 2023

Issuer Guide – German Agencies 2023

Issuer Guide – European Supranationals 2023

Issuer Guide – French Agencies 2023

Issuer Guide – Dutch Agencies 2023

Beyond Bundeslaender: Belgium

Beyond Bundeslaender: Greater Paris (IDF/VDP)

Beyond Bundeslaender: Spanish regions

Fixed Income Specials:

ESG-Update 2023

ECB: Scarf, dry cough and with less liquidity unwell into 2024

ECB preview: A silent, but holy summit meeting?

ECB: Now is not the time for forward guidance!

Appendix
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Fixed Income Relationship Management Europe	+352 452211-515

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Financials	+49 511 9818-9490
Governments	+49 511 9818-9660
Länder/Regionen	+49 511 9818-9660
Frequent Issuers	+49 511 9818-9640

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Origination FI	+49 511 9818-6600
Origination Corporates	+49 511 361-2911

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Asset Finance	+49 511 361-8150

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