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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: Summer and interest break until September

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

Back to the meeting-by-meeting approach

So here it is: The "small" interest rate turnaround – announced far too early and partly carried out against one's own convictions. And here it is again: the often-quoted meeting-by-meeting approach. In our opinion, this was neglected in June and, contrary to the eternal preaching (catch phrase: "We never pre-commit!"), a reduction in June was decided far too early. Patience is the order of the day again in July: little new data, the first reduction has hardly been digested or is hardly more than a signal effect anyway. The only thing that will be more boring is August, because there is no meeting scheduled there. So, everyone is actually looking to September – and December again. But let's stay in the here and now. Admittedly, things are not easy for the ECB at the moment: downgrade of France, difficult election results or no clear majorities in Belgium, France and after the European elections, the EU is sending blue letters to various debt offenders, and at the same time Brussels is reprimanding Germany for not investing enough. "Fiscal consolidation is likely to weigh on domestic demand and potentially hamper public investment," the Brussels authority report said. In addition, everyone is always looking at the USA: What will the Federal Reserve do until the end of the year and how is the presidential election campaign of the old white men on the other side of the Atlantic going?

And now?

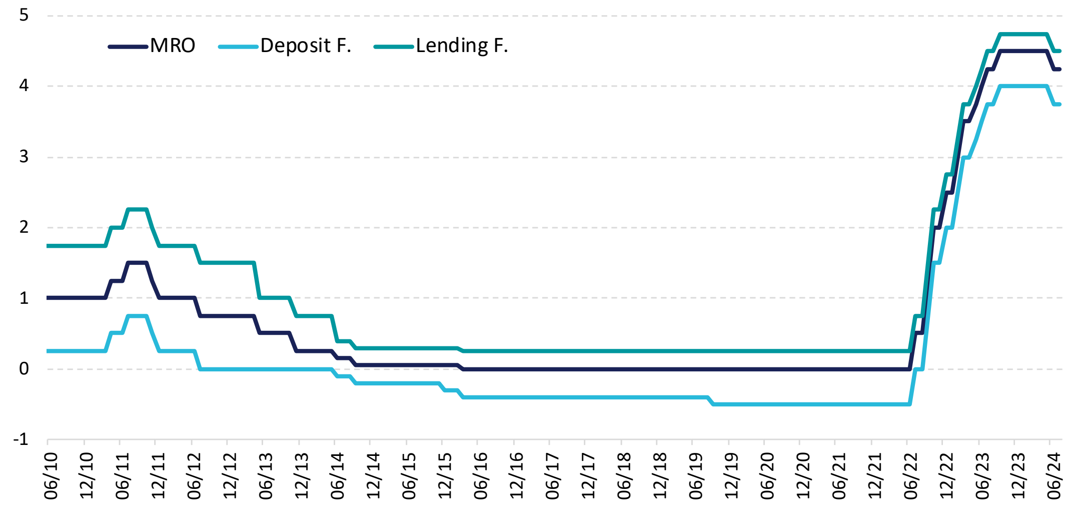
The (further) path has rarely been as unclear as it is currently. In our opinion, anyone who, after the interest rate cut in June, relies on another one in July, might be building on sandy ground. But even those who – like us – expect the second reduction in 2024 in September could be disappointed. October was never really on the table. And what is the Fed actually doing until December, in contrast to the ECB? Today, as part of this edition of our preview, we are looking at why we believe in a maximum of two further interest rate cuts by the end of the year. Why we always expect at least one break after taking a step. Why the PEPP still has a certain relevance (keyword: quantitative tightening). And why we really hope that the TPI stays where it belongs – in the drawer. In addition, there is no "F" in "TPI", which makes it seem completely inappropriate for France, as the "I" always stood for Italy behind closed doors.

The roadmap for the remainder of 2024

The year of interest rate cuts continues to cast its shadow ahead. In our opinion, the music plays in the second half of the year. During this period the ECB will meet on the following dates:

- 18 July
- 12 September – incl. new *staff projections*
- 17 October
- 12 December – incl. new *staff projections*, then for the first time for 2027

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



Source: ECB, Bloomberg, NORD/LB Floor Research

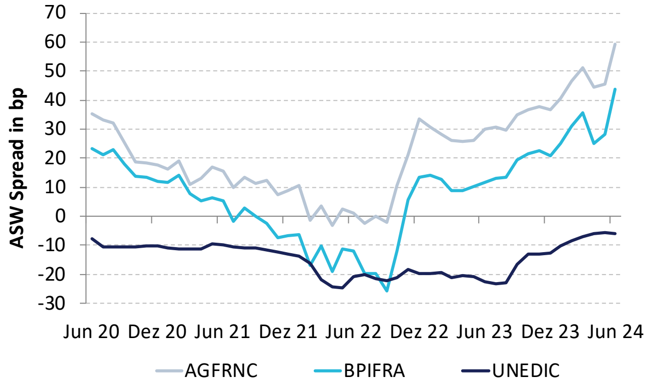
Opinions from the inner ECB circle: Taking stock in July

Given the political developments of the past few weeks, July 1st almost seems like a distant past. On that day in Sintra, ECB President Christine Lagarde once again emphasized the data-dependent meeting-by-meeting approach. She confirmed this a few days later: “We need a lot of data. I'm not sure whether we'll get this data at every single meeting of the ECB's monetary policy council.” We see a clear indication here of a pause in interest rates. Ultimately, the data situation in advance cannot be viewed as really extensive. Council member Joachim Nagel recently shared the usual mantra and made it clear that interest rate decisions would not be made on “autopilot”. But what does the data tell council members in detail? For ECB chief economist Lane, 2024 is the last year of “high wages” and he sees wage increases in 2025 at a more “normal level”. Opinions from central bankers who discuss the dangers of “undershooting” the 2% target are also likely to provide an exciting discussion. Mario Centeno recently highlighted the development of producer prices. We would rather view the danger of inflation falling too quickly in the common currency area as an outsider's opinion. There are different opinions from the camp of monetary policy hawks. Pierre Wunsch was actually not very convinced that more than two interest rate cuts in 2024 would be adequate. In addition, the July date was too early for a further step and therefore spoke of at best a “theoretical option” for the next meeting. The head of the French central bank, François Villeroy de Galhau, commented on the situation in France. The monetary politician, who spoke to the press with a surprisingly short time before the next council meeting, appealed to reason and cited two “golden rules” in a radio interview with “Franceinfo” last Thursday. Firstly, the country's companies should not have their competitiveness burdened. Secondly, deeper deficits cannot be “digged” as these would cause more costs and place a strain on one’s own sovereignty. The council member also sees the danger that the “inflation shock” could now be followed by an “uncertainty shock” with consequences for growth and employment. In our opinion, there is little to suggest that the meeting in July will serve more than to take stock of the situation. Time also brings new data and helps to assess the disruptive potential of uncertainty.

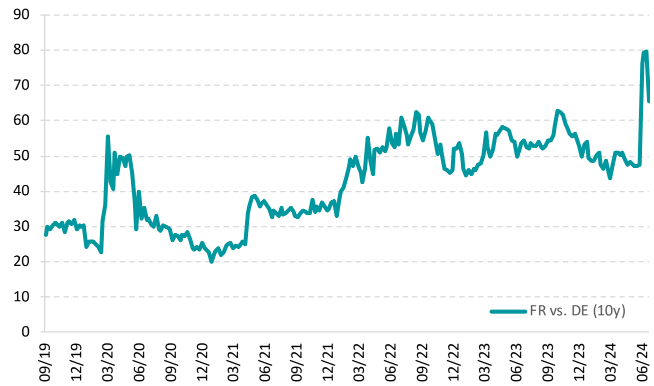
Minutes from the June meeting: Not everyone without a stomachache?

On July 4th, the ECB published the minutes of the central bank meeting on June 5th and 6th. What we did not really find surprising in the wake of the interest rate cut in June was the fact that the only dissenter who spoke out against the move was Robert Holzmann. Against this background, in our opinion it is at least remarkable when looking at the Minutes that other council members also expressed their concerns. In this context, the protocol refers more to “greater uncertainty in the outlook” and “not increased their confidence” with regard to achieving the 2% inflation target by 2025. In our opinion, a real contradiction to the propagated data dependency can even be seen because, according to the minutes, “these considerations suggested that cutting interest rates was not fully in line with the principle of data-dependence, and that there was a case for keeping interest rates unchanged at the current meeting.” In our opinion, it is also worth emphasizing at this point the Council's growing confidence in the ECB projections. Given the increased uncertainty, greater forecast accuracy would of course be a welcomed support in decision-making. We have regularly highlighted this important set of topics in the past and see the most recent minutes on “diminishing projection errors” and “renewed confidence” as an indication that the relevance of the projections has become more important in the decision-making of the Governing Council of the ECB. The minutes do not, in principle, indicate any change in the stance of the Governing Council regarding future meetings: “In view of continuing uncertainty surrounding the disinflationary process and the bumpy path ahead, it was seen as important to maintain a data-dependent and meeting-by-meeting approach to determining the appropriate level and duration of restriction, and there should be no pre-commitment to a particular rate path, so that full optionality could be retained.”

French agencies (10y)



Spread: OATs minus Bunds (10y, in bp)



Source: Bloomberg, NORD/LB Floor Research

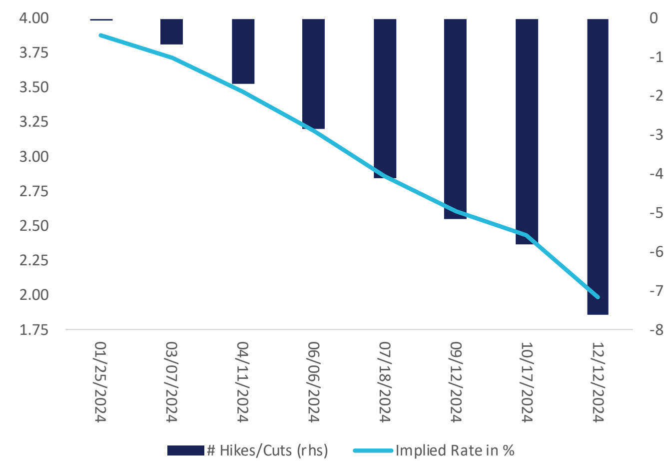
French tensions

First France's downgrade, then Macron's perceived defeat in the European elections, followed by snap elections at record speed – things are currently getting tough for France. A widening of the spreads can be seen with the naked eye for the French agencies. UNEDIC is comparatively stable; the regulatory advantage (risk weighting: 0%) over Bpifrance and AFD plays a role here.

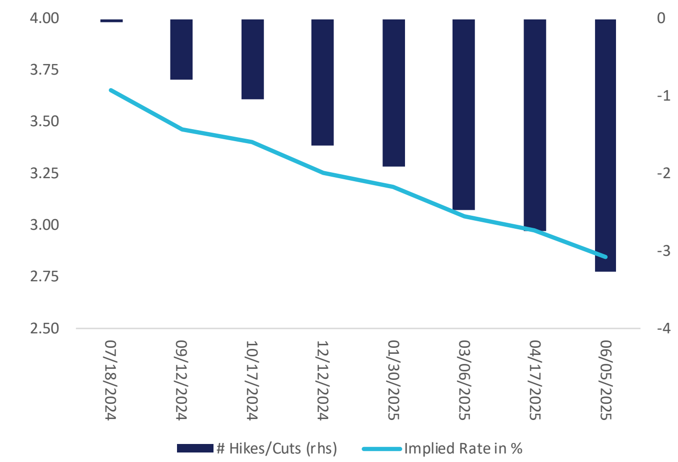
Just don't even think about activating the TPI, please

The movements of BPIFRA and AGFRNC (the two tickers visible in the graphic) from negative territory to over 40bp and almost 60bp respectively have been coupled with the above-mentioned downgrade of the French state and the resulting cascade of downgrades for the French agencies gained further momentum with the snap elections. In the meantime, we had even noticed a calming down (dip before the last sharp rise). The spread between German and French government bonds was last this high at over 80bp in 2012. We would describe this as a significant tension, but due to the home-made problems we see no reason for the ECB to even think about activating the Transmission Protection Instrument (TPI). After the election, things have calmed down (spread: around 65bp). After all, two French agencies, BPIFRA and SFILFR, were directly active on the primary market once the run-off elections were over and before the big French summer break began. Since the TPI was not created for the covered bond market or banks, we will focus here exclusively on the public sector as debtors.

Implied Overnight Rate 27.12.2023



Implied Overnight Rate 11.07.2024



Source: Bloomberg, NORD/LB Floor Research

Our expectations for July 18th: sensible interest rate break

We assume that the ECB Council will pause interest rates on all three main rates - and then meet again in September with an open mind. As we expected and as communicated by the ECB, the meetings remain data-based so as not to use “data-driven” again. As a result, we expect a maximum of two interest rate cuts by the end of the year, most likely in September and December. On December 14, 2023, the Governing Council of the ECB already announced that it would continue to fully reinvest the principal payments from maturing securities purchased in H1/2024 under the PEPP and decrease the PEPP portfolio on average by EUR 7.5bn per month from July 1, 2024. At the same time, the Governing Council of the ECB announced that it would end reinvestments under the PEPP at the end of 2024. And then we would have the request we have already made: the TPI remains in the drawer. There has been no talk about the minimum reserve: a few months ago some were calling for an increase in the quota, which was usually 2% before 2011. Robert Holzmann even brought 5% or 10% into play. The rate currently stands at 1% and is increasingly rarely the subject of discussion lately.

Conclusion and outlook

July and August, the months of the big summer and interest break this year. In our opinion, the ECB Governing Council should pause at the next meeting and not cut interest rates. He was not supposed to do this again until September. We are looking forward to all meetings with new *"staff projections"* with excitement. At the end of 2023, we had already decided on very few interest rate cuts in 2024 and also pointed out that cutting too quickly could be more damaging. The most likely timetable includes at most two further cuts in 2024, namely in September and December. This would therefore always be part of the new *"staff projections"*. There would be something varied: one session down, one session off – and then all over again. 2025 is currently still a black box for us, as the first step of the reductions has only just been taken. We are also wondering where the discussion has gone about the minimum reserve ratio, which not so long ago should at least have been doubled from 1% to 2% or, according to individual opinions, should have even reached levels of 5% or even 10%. We would also very much like it if the TPI remained on the shelf with a view to France. After all, the interest rate difference between German and French government bonds (10y) recovered by more than 15bp to around 65bp after previously being over 80bp.

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 Q1/2024 (quarterly update)
- Transparency requirements §28 PfandBG Q1/2024 Sparkassen (quarterly update)

SSA/Public Issuers:

- Issuer Guide – German Laender 2023
- Issuer Guide – German Agencies 2023
- Issuer Guide – Canadian Provinces & Territories 2024
- Issuer Guide – European Supranationals 2023
- Issuer Guide – French Agencies 2023
- Issuer Guide – Nordic Agencies 2024
- Issuer Guide – Dutch Agencies 2024
- Issuer Guide – Non-European Supranationals (MDBs) 2024
- Beyond Bundeslaender: Belgium
- Beyond Bundeslaender: Greater Paris (IDF/VDP)
- Beyond Bundeslaender: Spanish regions

Fixed Income Specials:

- ESG-Update 2024
- Decision Day: One swallow does not make an ECB summer!

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