Fixed Income Special

NORD/LB Floor Research

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Marketing communication (see disclaimer on the last pages)

NORD/LB

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Floor analysts:

Covered Bonds/Banks

Dr Frederik Kunze
frederik.kunze@nordlb.de

Lukas Kühne
lukas.kuehne@nordlb.de

Alexander Grenner
alexander.grenner@nordlb.de

SSA/Public Issuers

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

Christian Ilchmann
christian.ilchmann@nordlb.de

Lukas-Finn Frese
lukas-finn.frese@nordlb.de

NORD/LB:	**NORD/LB:**	**NORD/LB:**	**Bloomberg:**
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ECB preview: Caution – rate cut at the gates

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

Groundhog day: The sermon of the meeting-by-meeting approach

So it continues in September: the "small but nice" interest rate turnaround. We will continue to refer to the often-quoted meeting-by-meeting approach even beyond 2024. In our opinion, this was neglected in June and, contrary to the eternal preaching (keyword: "We never pre-commit!"), a reduction was decided on far too early. The second coup is very likely to follow in September: an expanded database plus new *staff projections* are paving the way. Admittedly, things are not easy for the ECB at the moment: some issues cannot be resolved and open conflicts continue to be unsolved. Formation of a government in France, investment backlog in Germany coupled with an internationally noticed shift to the right in two East German Laender, the Russia-Ukraine conflict, the situation in the Middle East as well as the upcoming interest rate cut by the Federal Reserve and the fight for the White House there. Next Thursday, the ECB will probably have to answer questions again that have nothing or not directly to do with interest rates or the inflation rate.

Changes to the monetary policy framework

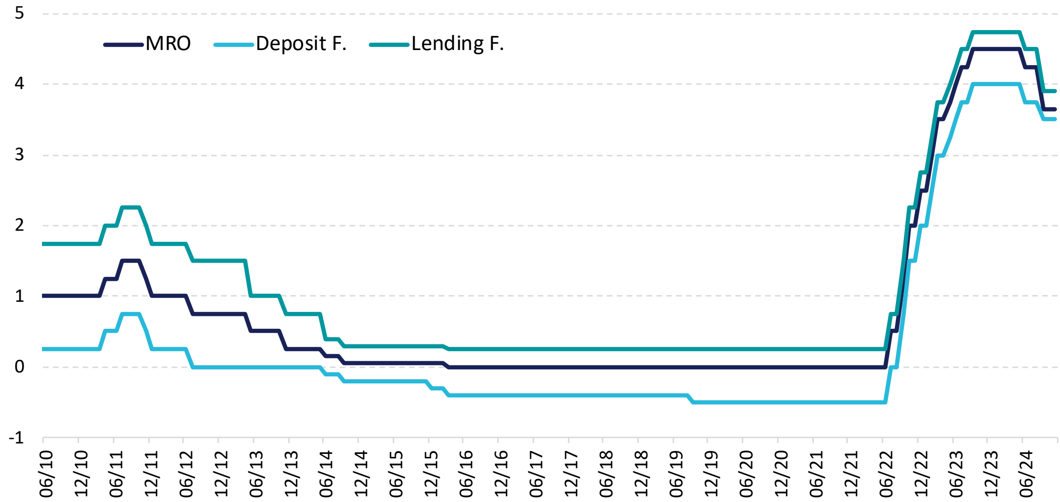
Today, as part of this edition of our preview, we are looking at why we expect a maximum of one further step by the end of the year after this upcoming interest rate cut. In addition, we mentally beam ourselves back to March 2024, when changes to the monetary policy framework were decided. At that time, the Council of the European Central Bank decided on adjustments to the monetary policy framework, which would impact how central bank liquidity is provided, given that excess liquidity in the banking system remains significant but gradually declining in the coming years. The framework for action is intended to control short-term money market rates in such a way that they are closely aligned with the monetary policy decisions of the ECB Council. The interest rate for the main refinancing operations will be adjusted so that the gap between the interest rate for the MROs and the deposit rate is reduced from the current 50 basis points to 15 basis points. These changes will apply from the beginning of the sixth reserve maintenance period of this year, i.e. from September 18th, 2024 and thus after the upcoming meeting.

The roadmap for 2024/25

The cycle of interest rate cuts continues to cast its shadow ahead. In our opinion, the music is playing in the current second half of the year and is unlikely to stop in 2025. The ECB is expected to meet on the following dates:

- 12 September – incl. new *staff projections*
- 17 October
- 12 December – incl. new *staff projections*, then for the first time for 2027
- 30 January 2025
- 06 March – incl. new *staff projections*
- 17 April
- 05 June – incl. new *staff projections*
- 24 July
- 11 September – incl. new *staff projections*
- 30 October

ECB key interest rates (in %; incl. interest rate cut and adjustment of the corridor)



Source: ECB, Bloomberg, NORD/LB Floor Research

Minutes of the July meeting: The specter of stagflation haunts – really?!

Already on August 22nd, the ECB published the minutes of the central bank meeting on July 17th/18th. In principle, the main key points of the meeting are quickly summarized: As expected, interest rates were not touched and no forward guidance of any kind was given. The final wording of the minutes underlines this "openness" in both directions: "The September meeting waas widely seen as a good time to re-evaluate the level of monetary policy restriction. That meeting should be approached with an open mind, which also implied that data dependence was not equivalent to being overly focused on specific, single data points. Finally, policy should continue to be based on the established elements of the reaction function." The ECB Council is thus securing options for action or is rather playing for time, which is by no means surprising given the mixed data situation and the possible interpretations associated with the "hard economic indicators". Nevertheless, we see signs that the central bankers are to some extent hoping for an environment that justifies an interest rate cut in September (and possibly another in December). The growth prospects have undoubtedly deteriorated recently. Against the background of the price dynamics that can be observed, the catchphrase "stagflation" apparently also comes to mind for the ECB Council: "The most recent data revealed that inflation was more persistent than previously anticipated, while activity indicators had disappointed on the downside. It was argued that the short-term outlook had thus become somewhat more "stagflationary". What is actually noteworthy, however, is evidence that Council members considered that "the short-term inflation outlook had remained broadly in line with the June projections, although pointing to somewhat higher profiles for services inflation and core inflation, partly associated with increases in tourism-related prices." In our opinion, this does not fit with the "stagflation specter".

Opinions from the ECB environment: “The big wave of inflation has been overcome”…

At this point we regularly summarize the comments of high-ranking central bankers from the Eurozone and members of the Council. Ultimately, the line that can be drawn between the “doves” and “hawks” can always be seen to some extent in the statements made by monetary politicians. In our ECB outlook today, we would like to open this passage with a quote from Bundesbank President Joachim Nagel, which certainly speaks volumes for a proven hawk: “The big wave of inflation has been overcome” – as stated in a recent interview with the Frankfurter Allgemeine Zeitung (FAZ). Nagel also prepares this statement by pointing out that it is possible to achieve the ECB's inflation target of 2%. Nagel also does not believe that the inflation rate will get out of hand again, but he also has words of warning: “We should not prematurely burst into celebration and pat ourselves on the back. We are not there yet. We must remain vigilant and keep an eye on the risks on the way back to stable prices; that is our task as a central bank.” The development of prices for services would also be taken seriously by the ECB Council. With regard to the question of an interest rate move at the upcoming meeting, he made it clear that he would not make a decision until next week, as only then he would have a “complete overview of all the data”. He then let a little bit of “forward guidance” shine through: “But I will say: I see inflation on the right track.” Council member Mārtiņš Kazāks (Latvia) is a little clearer here and states that at the approaching meeting all key interest rates are likely to be cut for the second time this year. This is remarkable because Kazāks belongs to the camp of hawks.

.. but what happens next?

Nevertheless, it must be noted at this point that the debate in the ECB Council is more likely to focus on the appropriate course with a view to the meetings following September in 2024. Kazāks makes it clear that interest rates must fall because most of the inflation problem has been solved. But he also added that the discussion only revolved around how quickly and how strongly. From the camp of monetary policy doves, ECB board member Piero Cipollone recently attracted attention with his statement that there was a “real risk” that the ECB's stance could become too restrictive. It must be ensured that inflation approaches the ECB target “without unnecessarily slowing down the economy”. After all, investment and growth are urgently needed in Europe and any delay in this regard would be a major disadvantage. The extent to which a line of conflict within the Council with other members will emerge over the course of the year can certainly be expected with some excitement. For ECB Council member Gediminas Šimkus (Lithuania), the step in September is largely a “clear case” – but the chances of a further reduction at the October meeting were rather slim. He also considers a move of more than 25 basis points to be unlikely (for September). Šimkus – who is more of a monetary policy hawk – also highlights the existing risks to growth. However, he draws completely different conclusions than, for example, Mário Centeno from Portugal, who wants to tame inflation with the “lowest possible sacrifice”. At the beginning of this week, ECB board member Isabel Schnabel warned against adopting an overly mechanistic monetary policy. Progress must be made “gradually and carefully” so that the council’s course of action does not endanger the disinflation process. Schnabel cited the upper range of the ECB’s own estimates of the neutral interest rate as a reference point.

Decided changes to the monetary policy framework in March 2024

The Governing Council of the ECB decided on changes to the monetary policy framework in March 2024. According to the ECB, as outlined above, these changes will impact how central bank liquidity is provided in the face of a continued significant but gradually declining excess liquidity in the banking system in the coming years. The framework for action is intended to control short-term money market rates in such a way that they are closely aligned with the monetary policy decisions of the ECB Council. About six months ago, the ECB has agreed on a series of principles that it defines on its homepage: effectiveness, robustness, flexibility, efficiency, open market economy and secondary objective. Essential parameters and characteristics for a new framework for action are derived from these principles.

Essential parameters and characteristics of the new framework

The Governing Council of the ECB will continue to control the monetary policy course via the deposit rate. The ECB expects short-term money market rates to remain close to the deposit rate, although some volatility can be tolerated as long as it does not distort the signal about the intended monetary policy stance. The Eurosystem will continue to provide liquidity through a wide range of instruments in the future. These include, among other things, short-term credit transactions (i.e. main refinancing transactions; MROs) and longer-term refinancing transactions (LTROs) with a three-month term as well as – at a later date – structural longer-term credit transactions and a structural securities portfolio. The MROs and LTROs are fixed-rate tenders with full allotment. The exciting point from March 2024 will now materialize in September: The interest rate for the MROs will be adjusted so that the gap between the interest rate for the MROs and the DFR will be reduced from the current 50bp to 15bp. According to the ECB, this narrower gap will provide an incentive to submit bids in the weekly tenders, which should keep short-term money market rates close to the deposit rate. In addition, the narrower gap is expected to limit the extent of potential fluctuations in short-term money market rates. At the same time, it leaves room for money market activities and offers banks incentives for market-based refinancing solutions. The interest rate on the marginal lending facility (MLF) will also be adjusted so that the spread between the interest rate on the MLF and the rate on the MROs remains unchanged at 25bp.

Differentiation of possible scenarios

Scenario 1 “baseline”: The ECB cuts the interest rate on the deposit facility rate (DFR) from the current 3.75% to 3.5%. Then the rate of the main refinancing operations (MRO) would fall from the current 4.25% to 3.65% to meet the new conditions of the corridor. The marginal lending facility (MLF) rate would also be reduced by 60bp to 3.9% from the current 4.5%.

Scenario 2 “surprise”: The ECB leaves the DFR at current 3.75%. Then the rate of the MROs would fall from the current 4.25% to 3.9% to meet the new conditions of the corridor. The MLF rate would also be reduced by 35bp to 4.15% from the current 4.5%.

Scenario 3 “utopia”: The ECB reduces the interest rate for MROs from the current 4.25% to 4%. The DFR would then **increase** from the current 3.75% to 3.85% to meet the new conditions of the corridor. The rate of the MLF would be reduced from the current 4.5% to 4.25%.

Our expectations for September 12th: rate cut at the gates

We assume that the ECB Council will hold another open-ended discussion next week, but will come to the conclusion of a reduction for all three key interest rates. We expect scenario 1 with a probability of at least 95%. This means that the DFR will fall to 3.5% from the current 3.75%; the rate on MROs from 4.25% to 3.65% and rate on the MLF from 4.5% also by 60bp to 3.9%. 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 at most one more interest rate cut by the end of the year (most likely in December).

Conclusion and outlook

July and August were the months of the big summer break and interest pause this year. In our opinion, the ECB Council should now cut interest rates again at the next meeting. This will be more complicated in September 2024 than in other months, as the ECB already decided to adjust the corridor six months ago. Therefore, one key rate should fall by 25bp and two by 60bp. We are looking forward to all meetings with new *staff projections* with excitement. The most likely timetable includes at most one further reduction in 2024, namely in December. This would therefore always have to be done again when updating the *staff projections*. It would have something varied: one session down, one session off – and then all over again in 2025. Things are currently very quiet on the subject of the minimum reserve ratio and TPI, which we like so as not to open up more construction sites.

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 Q2/2024 (quarterly update)

Transparency requirements §28 PfandBG Q2/2024 Sparkassen (quarterly update)

SSA/Public Issuers:

Issuer Guide – German Laender 2024

Issuer Guide – German Agencies 2024

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

ECB: Taylor Swift and the inflation, or...

Appendix
Contacts at NORD/LB

Floor Research

Dr Frederik Kunze
Covered Bonds/Banks

+49 172 354 8977
frederik.kunze@nordlb.de

Dr Norman Rudschuck, CIIA
SSA/Public Issuers

+49 152 090 24094
norman.rudschuck@nordlb.de

Lukas Kühne
Covered Bonds/Banks

+49 176 152 90932
lukas.kuehne@nordlb.de

Christian Ilchmann
SSA/Public Issuers

+49 157 851 64976
christian.ilchmann@nordlb.de

Alexander Grenner
Covered Bonds/Banks

+49 157 851 65070
alexander.grenner@nordlb.de

Lukas-Finn Frese
SSA/Public Issuers

+49 176 152 89759
lukas-finn.frese@nordlb.de

Sales

Institutional Sales	+49 511 9818-9440
Sales Sparkassen & Regionalbanken	+49 511 9818-9400
Institutional Sales MM/FX	+49 511 9818-9460
Fixed Income Relationship Management Europe	+352 452211-515

Trading

Covereds/SSA	+49 511 9818-8040
Financials	+49 511 9818-9490
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Origination & Syndicate

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

Sales Wholesale Customers

Firmenkunden	+49 511 361-4003
Asset Finance	+49 511 361-8150

Treasury

Liquidity Management/Repos	+49 511 9818-9620 +49 511 9818-9650

Relationship Management

Institutionelle Kunden	rm-vs@nordlb.de
Öffentliche Kunden	rm-oek@nordlb.de

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