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 2025: Downhill with Lagarde, but no speeding, please

Authors: Dr Frederik Kunze // Dr Norman Rudschuck, CIIA // Lukas Kühne // assisted by Maximilian Lingenfelser

Interest rate cuts and (geo-)political upheavals will remain with us in 2025

What a year – again. And no topics has really been resolved; we are taking all monetary, geostrategic and political subjects into the new year.

- New elections in February instead of September in Germany, including expected unstable majorities.
- A resulting Bund-swap-spread that has historically reversed but now appears to have at least for now bottomed out.
- Developments in France that almost no one can keep up with. There is only no progress in budget consolidation.
- Ukraine, the EU and the U.S. – Europe would be at a loss on its own, not just financially, as raising more money would also mean a lack of money elsewhere.
- Reforming the German debt brake for more investment, etc.

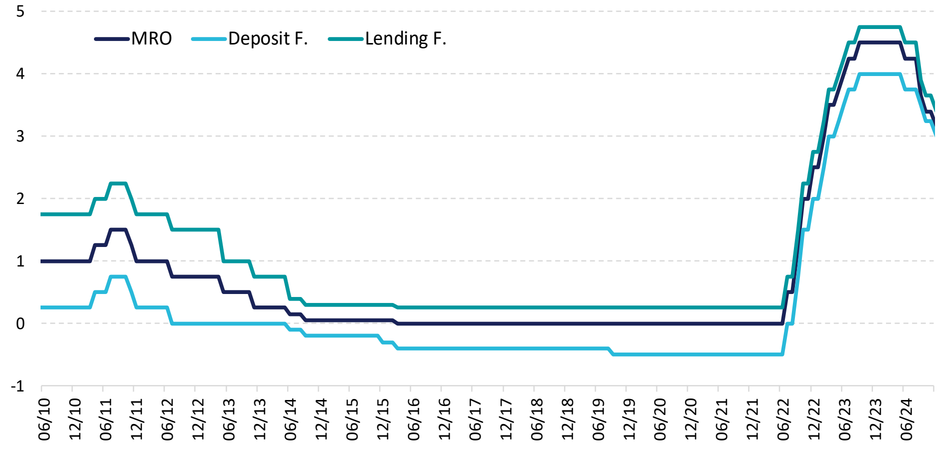
The ECB is therefore not to be envied for having to turn down the interest rate screw several times firstly next Thursday and then in 2025 if inflation rates are – not unexpectedly – rising again nowadays. Read our assessments for the next nine meetings here.

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:

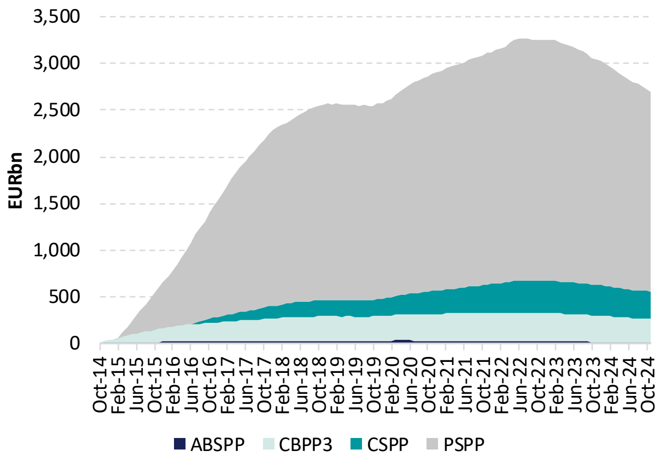
- 12 December 2024 – incl. new *staff projections*, then for the first time for 2027
- 30 January 2025
- 06 March – incl. new *staff projections*
- 17 April
- 05 June – incl. new *staff projections*
- 24 July
- 11 September – incl. new *staff projections*
- 30 October (host: Banca d'Italia)
- 18 December – incl. new *staff projections*, then for the first time for 2028

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

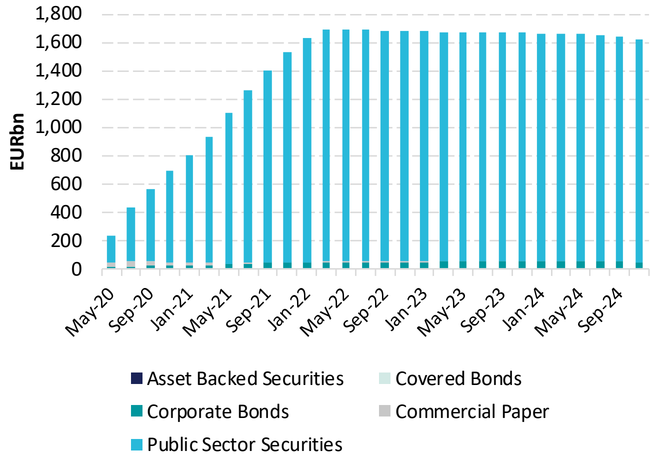


Source: ECB, Bloomberg, NORD/LB Floor Research

Portfolio development: APP



Portfolio development: PEPP

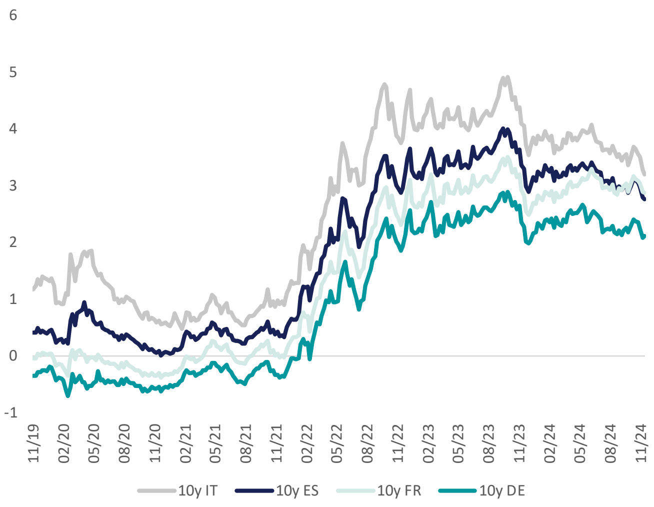


Source: Bloomberg, NORD/LB Floor Research

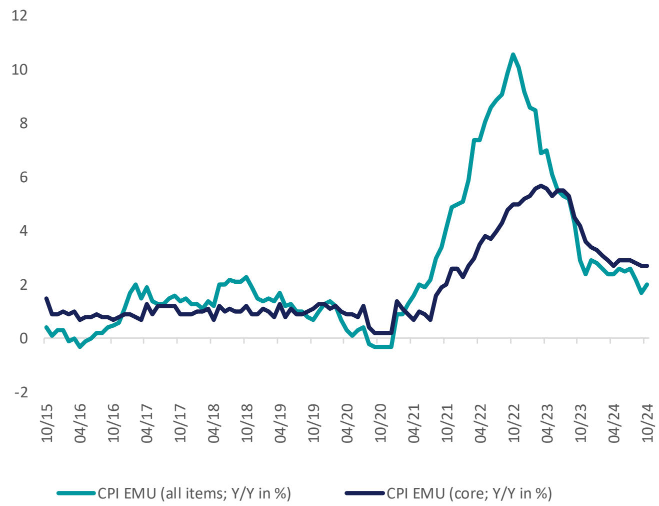
QT on the rise and the return of sovereign yields as an indicator

With the two charts above we would like to say goodbye to the last reinvestments as part of the purchase programs. While the balance sheet significance of the Asset Purchase Program (APP) has been losing importance for some time – albeit slowly – the last reinvestments in the Pandemic Emergency Purchase Program (PEPP) will end on 31 December 2024. As of 01 July 2024, the full maturities will no longer be reinvested, but instead a monthly reduction of EUR 7.5bn will be made. This only slowly becomes noticeable in the chart at the top right. In addition, since the PEPP no longer had to follow the capital key, it has long been seen as a flexible instrument to counteract short-term tensions on the capital market, i.e. to dampen or contain the rise in government bond yields. This so-called "first line of defence" no longer exists and the Transmission Protection Instrument (TPI) inevitably comes into focus. This is important because France's 10-year government bond yield is higher than Spanish or Portuguese bond yields, but on par with Greece's 10-year benchmark yield. On the one hand, this is a historical capital market anomaly, but on the other hand, it is "well-deserved". Hello, Macron!

Yield development in the euro area (in %)



Inflation development in the euro area (in %)



Source: Bloomberg, NORD/LB Floor Research

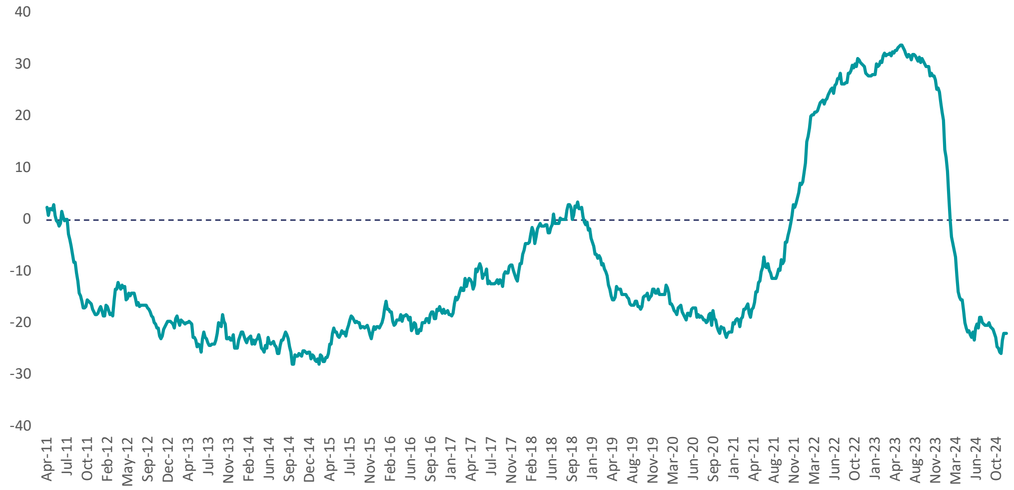
Minutes of the October meeting: Risk management aspects were convincing

On 14 November, the ECB has already presented the minutes of the central bank meeting on 16/17 October. Despite the unanimous decision to cut key interest rates in October, there were definitely contradictory views in the ECB Council, particularly with regard to inflation expectations. While the hawks do not expect inflation to fall significantly below the ECB's 2% target in the near future, the doves predict such an event for next year. Argumentatively, the majority of Council members highlighted a possible weaker economic development in growth in the Eurozone, which would represent a downside risk for inflation expectations. However, not all members shared this perspective and particularly referred to the lack of staff projections for the medium-term inflation forecast. Accordingly, these participants initially spoke out against a reduction in interest rates. These “dissenters” were able to be convinced of an interest rate move in October but with the aspect of better risk management with a view to the December meeting. If the downward trend in inflation proves to be only temporary, the interest rate cut in December would have already been anticipated, according to the ECB Council's line of argument.

Opinions from the ECB environment and…

At this point we would like to focus, as usual, on individual statements from the ECB environment. However, a clear dividing line between the doves and hawks remains difficult to identify this time. This is due, among other things, to the ongoing uncertainty characterized by sluggish economic growth and persistent inflation, particularly in the service sector in the Eurozone. Nevertheless, some central bankers have stated more or less clear positions. The market estimates that the probability of a further interest rate cut of -25 basis points in December is very high, which is likely to be influenced by statements from the dovish camp. Yannis Stournaras, President of the central bank of Greece, made it clear: “In December we will further cut interest rates.” This view is supported by other “doves”. François Villeroy de Galhau, Governor of the Banque de France, also called for openness and even did not rule out a larger reduction of -50 basis points. In contrast, representatives of the hawkish camp expressed themselves in a more nuanced manner. “Arch hawk” Robert Holzmann (ÖNB) admitted that a further interest rate cut cannot be ruled out, but added: “I assume it will only be moderate. The data so far does not indicate a major step.” It is noteworthy that in September Holzmann was the only council representative to vote against a rate cut – a sign of how the dividing line between hawks and doves is currently blurring. Bundesbank President Joachim Nagel pointed out that the slight increase in inflation had been expected in November and that the ECB's inflation target was still within reach. Despite his reminding words, particularly with regard to ongoing uncertainties caused by high wage increases and geopolitical tensions, Nagel's statements can also be interpreted as cautious support for a further interest rate cut. The potential economic consequences of US President-elect Donald Trump's announced tariff policy are also likely to play a role next week. Philip Lane, ECB chief economist, underlined the importance of the global trading system in this context: “It is crucial that the world trading system is preserved as much as possible. The global economy relies heavily on trade. Overall, fragmentation would have serious consequences.” Looking at the price path, Lane emphasized that no hasty conclusions should be drawn about the direction of inflation: “I can identify both deflationary and inflationary forces. However, what ultimately happens depends heavily on the exact sequence of events.”

Bloomberg NLP-Model: ECB Speak Index[1]

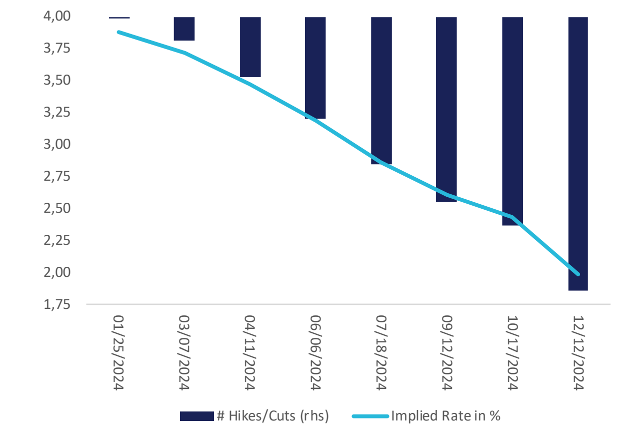


Source: ECB, Bloomberg, NORD/LB Floor Research
[1] NLP = Natural Language Processing

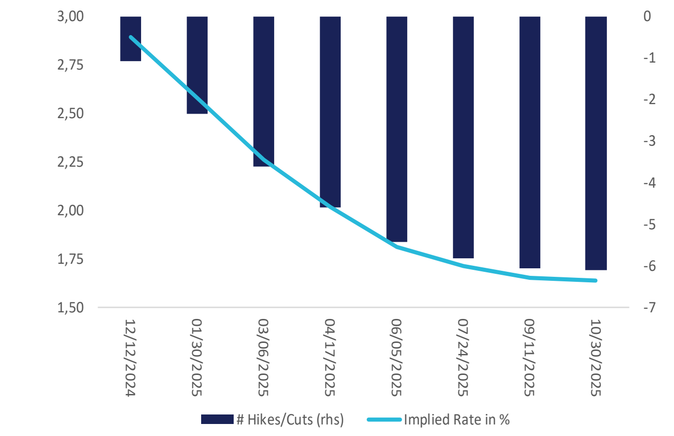
... how these can be condensed or what the market "expects" for 2025

The ECB statements and their "direction" result in a multitude of data points that are condensed into an indicator by Bloomberg, among others. In today's preview we are happy to use the "ECB Speak Index", which is based on a Natural Language Processing (NLP) approach. Based on this time series, the tongues of the central bankers in the euro area remain "dovish". A longer look shows an apparent correspondence with the ECB's actual course of action, which not least also fits with general market expectations. While on the investor side the probability of the small interest rate cut (-25bp) in December is 80%, at least 20% expect a "big" one (-50bp). However, what the central bankers' statements or market expectations "forecast" for a longer time horizon, i.e. for the year 2025 as a whole, remains subject to uncertainty. The "market opinion" – indicated by implicit interest rate probabilities – is therefore (too) susceptible to impulses or tends to exaggerate the current news situation. We remember that on 27 December 2023, almost eight interest rate cuts in 2024 to a key interest rate of 2% were "priced in". Against this background, the implicit interest rate probabilities must also be interpreted with a view to 2025. From yesterday to the end of October, six steps of 25 basis points each are "priced in". That would be a lot!

Implied Overnight Rate 27.12.2023



Implied Overnight Rate 05.12.2024



Quelle: Bloomberg, NORD/LB Floor Research

Our expectations for 12 December 2024…

We assume that the ECB Council will hold another open-ended discussion next week, but will come to the conclusion that all three key rates will be cut again. This means that the deposit facility rate will drop to 3% from the current 3.25%; the rate of the main refinancing operations from 3.4% to a still unusually round 3.15% and the rate of the marginal refinancing facility from 3.65% to 3.4%. As we expected and as communicated by the ECB, the meetings remain data-based. Attention, transition: We expect this from the ECB in the coming year as well.

… and for 2025

Cut, sleep, repeat – our regular readers know our new, beloved and, in our opinion, memorable mantra. This means that the ECB will cut interest rates at one meeting (December 2024), then pause a meeting (January 2025) in order to obtain more meaningful data points in order to be able to cut rates again at the following meeting (March 2025). Ideally, new staff projections will then be available. Following our mantra and this cycle, we would have a maximum of four further interest rate cuts in the new year, although the two cuts in H1/2025, despite all the political uncertainty with France and Germany, may appear clearer when looking at the interest rate valley than in the second half of the year. As of now, we do not expect interest rate cuts of 50 basis points in 2025. To stay in the language of ski fun: After every downhill race (-25bp in March, June, September and December), Madame Lagarde takes a break in the ski hut. We do not expect a big shot (-50bp) on any date, also due to foggy and severe weather conditions. We have already commented above on TPI (please never activate it!) and the end of the purchase programs. What remains are the somewhat larger topics beyond interest rates: a look at minimum reserve requirements, the “structural portfolio” from the operational review and longer-term refinancing transactions. The ECB is currently not showing its (poker) hand here. That's why we prefer to watch the goings-on from the edge of the piste instead of poking around in the fog.

Conclusion and outlook

Another interest rate cut in December seems to be a done deal – but, with all due respect, not because the markets are fully pricing it in. After all, according to Overnight Index Swaps, the majority of market participants expected seven to eight interest rate cuts for 2024. After the interest rate cut next Thursday, we expect a maximum of four interest rate cuts in the coming year. Increments of -25bp should always be used, at least we see no need for -50bp. At the turn of the year, we will also be adopting the last reinvestments in the PEPP, meaning that this actively managed portfolio will also be a thing of the past, even though it acted as the often-quoted “first line of defence” to keep certain government bond spreads low. Nonetheless, we do not expect to see an activation of the TPI in 2025, with the fiscal situation in many places appearing to be tight and the political situation appearing unbalanced. Here, due to the home-grown problems, particularly in France, we see no signs that the ECB should even think about activating its TPI. Questions could still be asked about this on Thursday. More questions could come at any press conference about the different pace between the ECB and the Fed. This is not necessarily a bad thing per se and is rarely commented on by the ECB President, as the Council and she do not steer the exchange rate. The questions will still be asked anyway. The topic of “minimum reserves” has also become quite quiet and almost contemplative. According to statements made, we also have the “Structural Portfolio” from the operational review on the list as well as possible new longer-term refinancing transactions. Happy New Year!

Appendix
Publication overview

Covered Bonds:

Issuer Guide – Covered Bonds 2024

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 Q3/2024 (quarterly update)

Transparency requirements §28 PfandBG Q3/2024 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 2024

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: An autumn of interest rate cuts that wasn't supposed to be?

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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 Corporates	+49 511 361-2911

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