Fixed Income Special

NORD/LB Markets Strategy & Floor Research

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Marketing communication (see disclaimer on the last pages)

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ECB preview: Knives out… It's edging-time

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

ECB meets on September 14: High? Higher?? Higher for longer???

It won't be boring in the ECB Tower on the Main. Next week, at least, there will be another meeting that the members of the ECB's Governing Council cannot envy. It's all about the interest rate landscape in the Eurozone, the interpretive sovereignty for hawks and/or doves. The upcoming decision of the body, whatever it may be, will also ensure that the key ECB interest rates are set at a sufficiently restrictive level to achieve a timely return of inflation to the medium-term 2% target. We understand that this level will be maintained for as long as necessary. So at least as high as already achieved – or even higher. And then we will ask the question: Higher for longer because there will be no (early) rate cut in 2024? In determining the appropriate level and duration of the restrictive level, the Governing Council will continue to take a data-driven approach. In particular, the upcoming interest rate decision will continue to be based primarily on assessments of the inflation outlook against the background of current economic and financial data, the development of underlying inflation and the strength of monetary policy transmission. Here, the so-called *staff projections* in September will be of some importance.

What argues for a rate hike?

For weeks now, we have been racking our brains as to what the latest inflation data mean for the ECB. Because admittedly, they are rather worrying us. The necessary disinflationary tendencies are sometimes not strictly falling. Prices are indeed rising in the context of disinflation, but less slowly than before. Moreover, we do not fear a downward revision of the staff projections for inflation data in 2023, 2024 and 2025. This also argues in favor of an interest rate hike. In addition, the Council does not want to send the wrong signal of having ended monetary tightening too early or, with a possible pause, even risking that it might have already reached the turning point in terms of monetary policy.

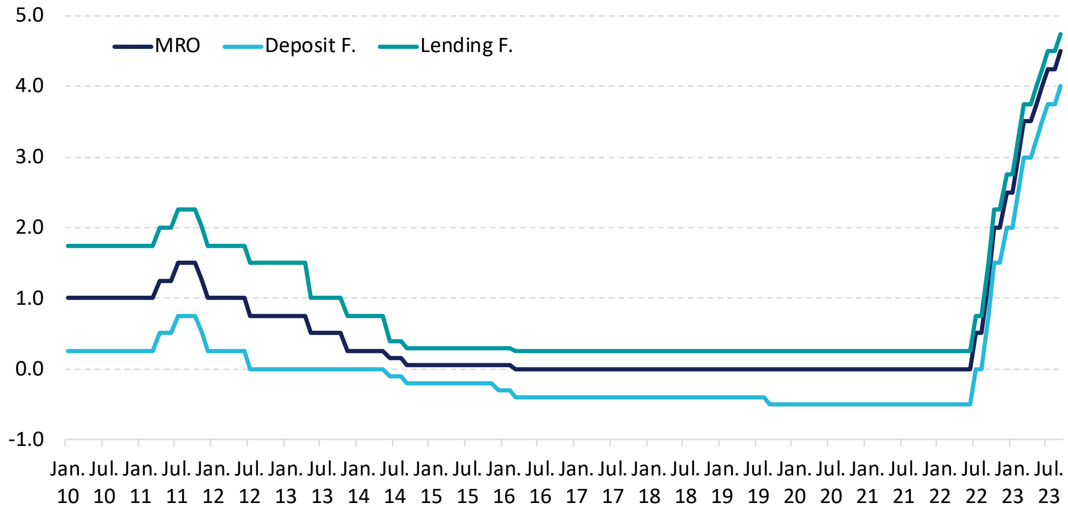
What are the arguments against a rate hike?

The Ghosts of Recession… Back again! A weakening economy or stagnating growth within the Eurozone would clearly argue against another interest rate hike. Here, hawks and doves will certainly engage in heated discussions. In our opinion, this is induced solely by the fact that various sentiment indicators are currently pointing downward – plenty of ammunition for the doves. Moreover, the falling demand for new loans cannot be dismissed out of hand. In our opinion, a certain "concern" in this respect applies to both private customers and companies. So the interest rate hikes so far are by no means missing their purpose.

Looking beyond the horizon: What do we consider conceivable in addition to or instead of interest rate steps?

The Governing Council of the ECB could raise the minimum reserve from 1% to 2%. The higher the minimum reserve requirement ratio, the more liquidity and capital is withdrawn from the market, because the banks cannot lend the minimum deposit to other customers in the form of loans, for example. Moreover, as of September 20, the minimum reserve will no longer earn interest. Active sales of securities under the APP or an early end to the PEPP would also be conceivable. As said, these are just ideas which we do not consider neither to be completely absurd nor particularly likely.

ECB key interest rates (in %; including our predicted hike)



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

Opinions from the ECB circle: Hawks speak out

Triggered by recently published figures on price developments in the single currency area, the majority of the capital market recently took the view that there would probably be no further interest rate hike in September. For the monetary policy hawks in the ECB Governing Council, this was a misjudgement. In this context, Governing Council member Klaas Knot, head of the Dutch central bank, made it unmistakably clear that the achievement of the 2% inflation target should not be pushed back any further (i.e. beyond the end of 2025). For Peter Kažimír from Slovakia, too, there is no way around a further increase. He also speaks of a "clearer and more efficient solution" because this would give market participants more clarity regarding the achievement of the interest rate peak. The central bank president from France, François Villeroy de Galhau, on the other hand, did not want to commit himself to September 14. In his opinion, the decision was open in both directions. He is therefore unlikely to be one of those who will be talking about a further interest rate hike. For Ignazio Visco (Italy), the point or level at which the ECB could end the rate hike cycle is getting closer and closer. The president of the Italian central bank also addressed the risk that the ECB's Governing Council might overtighten or overshoot the interest rate screw. With regard to the question of when the decision-making body could start thinking about interest rate cuts again, Bundesbank president Joachim Nagel recently warned against positioning the market promptly on reaching the interest rate peak and then at some point in the direction of subsequent easing. On the upcoming decision, however, Nagel did not yet verbally join "his" hawkish camp. Rather, the monetary policymaker referred to the upcoming discussion in the Council that would precede the decision-making.

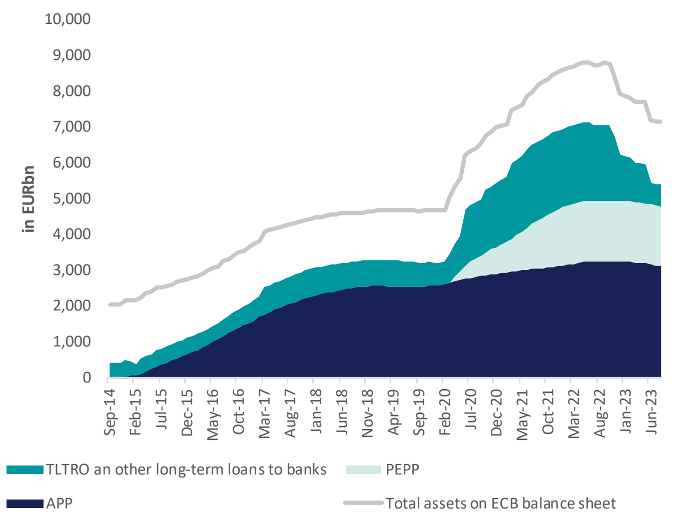
Minutes of the July meeting: doves with a little more dominance?

On August 31, the ECB published the minutes of the July meeting. Without a doubt, the documentation of the discussions within the Governing Council in the run-up to the last interest rate decision is also relevant for the upcoming meeting. And at first glance, we would indeed attribute a somewhat more dominant role to the doves in the central bank's highest decision-making body again. This is conspicuous not least by references to the risks to inflation developments being "more balanced": “The view was expressed that the combination of no surprises in inflation and lower than expected growth prospects implied that the risks to inflation had become more balanced […].” If this view could be applied to reality, it would result in much less need for "upward" adjustment, particularly in the ECB's projections of inflation developments, than has been the case in the past. In our view, it is worth noting a stronger perceived focus on the "side effects" of the monetary policy measures decided so far. Here, concerns were expressed that “the ongoing transmission of past monetary policy actions could lead to a more pronounced deceleration in economic activity than was necessary to achieve price stability.” Taken in isolation, these concerns could argue in favor of a pause in September. In this context, the question arises as to what extent the ECB Council can clearly attribute the current or expected short-term economic weakness to its own monetary policy. However, it remains to be seen whether the "hawks" in the decision-making body can be convinced of this view. Another possible concern is that market participants could mistake a pause for a turning point in monetary policy. This would clearly come too soon – and not only from the perspective of the hawks in the Council. After all, core inflation remains at a very high level, and the Council also identifies a "rotation" in the factors driving up prices. The decision-making body also identifies a "rotation" in the factors driving up prices, with less external causes (such as energy prices) and more domestic ones (wage developments and the state of the labor market). In essence, this also corresponds to a rotation from supply-driven inflation to demand-driven inflation, which should certainly play more into the hands of the hawks. Here, we think it is necessary to clarify once again that the Council evidently did not see the danger of a massive pickup in inflation again, but rather in July did not yet consider the 2% target to be within reach in the medium term. This view is unlikely to have changed significantly next Thursday – despite the rather dovish tongue-lashing.

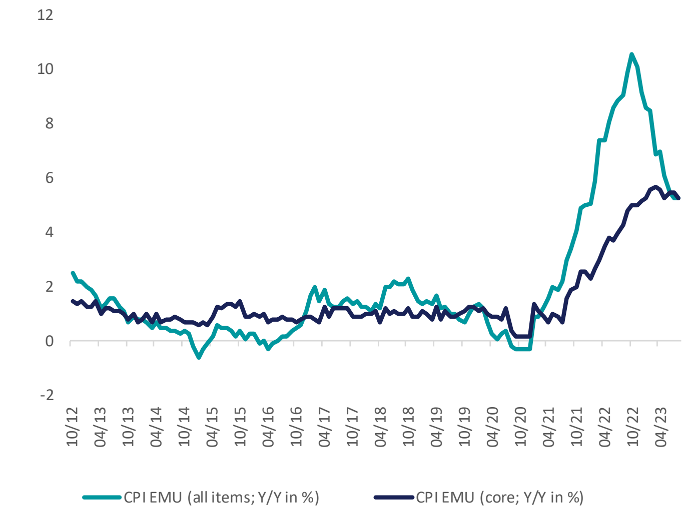
Our admittedly "shaky" expectations for September 14: +25bp

We are supposed to forecast something that the ECB itself does not yet know or has not yet discussed in sufficient detail behind closed doors. The last interest rate hikes were all priced in in advance. And we have already seen more moves than many market participants would have liked even at the end of 2022. So if you're just reading the text because you want a clear opinion from us, let's commit: rate hike. This goes along with all the points discussed above from our own opinion, to the staff projections, to the last meeting minutes. We strongly welcome that September is now the first meeting that truly follows a data-driven approach. Often the ECB has been scolded for pre-determination. Now we find the uncertainty to be salt in the soup and await the things to come.

ECB balance sheet



Development of inflation



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

Rarely has there been so much surprise potential in sight

We rule out the possibility of a rate hike of more than 25bp. We rate the possibility of a pause in interest rates at a maximum of 40%. The residual risk remains that the day will come when not all three interest rates will be raised in parallel. As is well known, we have often referred to the once broader corridor in the past and will not (yet) tire of doing so today. In addition, we have discussed three other scenarios above: Raising the minimum reserve requirement ratio from 1% to 2%, active securities sales under the APP, or even an early end to reinvestment under the PEPP.

Conclusion and comment

We continue to state to be on a journey. A data-driven journey. We have already used hunter's lingo and mountaineer's jargon in our commentaries. We've made use of movies and series ("House of Hikes"). We have also verbally exhausted the travel theme from the starting signal to the pace to the final destination. Therefore, quite soberly and objectively: The hawks clearly see the goal of fighting inflation at risk, should the target rate for the key interest rates have already been reached in July. For the doves (and some banks), the interest rate journey so far may have been too fast. The decision seems to be on a knife-edge. If we had to take a clear position: We currently see a final interest rate step of +25bp for the second half of the year ahead of the hawks and doves in the neck-and-neck race for September. We rule out rate cuts into 2024. Perhaps even beyond that. Therefore, we ask ourselves: High? Higher?? Higher for longer??? For us, it is quite clear – even after the last interest rate step – that the time spent at the peak will not be too short. A final show of strength of +25bp should therefore be followed by a "pause" at the following meetings. Discussions are likely to heat up in this direction already after the turn of the year. However, things won't get really exciting until the middle of 2024. We remain in the "camp" of those who expect the Governing Council to have staying power. This does not mean "Come what may!", but rather: "Talk the talk, walk the walk!".

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 – German Agencies 2022
- Issuer Guide – Dutch Agencies 2022
- Beyond Bundeslaender: Belgium
- Beyond Bundeslaender: Greater Paris (IDF/VDP)
- Beyond Bundeslaender: Spanish regions

Fixed Income Specials:

- ESG-Update 2023
- ECB: From the bottom to the top time to stop? Nobody knows it
- ECB rates: We can fly so high we can touch the sky
- ECB interest rate decision: All new in May… Or: The force of past rake hikes

Appendix
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