Fixed Income Special

NORD/LB Floor Research

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Marketing communication (see disclaimer on the last pages)

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Floor analysts:

Covered Bonds/Banks

Dr Frederik Kunze
frederik.kunze@nordlb.de

Lukas Kühne
lukas.kuehne@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

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ECB preview: Don't be afraid of your own courage, please

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

„We never pre-commit“: That is (ancient) history!

No phrase would be big enough to herald the imminent turnaround in interest rates... "It comes as it comes." "The next rate cut is always the hardest." "Don't be afraid of your own courage." At least that's our plea for 6 June. Over the past few days, there have been growing signs that an interest rate cut is highly likely next week Thursday. Before we look at current events and the discussions in the ECB Governing Council, let's take a brief look back and remember the convictions of Jean-Claude Trichet and Mario Draghi. For years – if not decades – it seemed like an irrefutable dogma when they insisted: "We never pre-commit!" A lot has happened since then. This also applies to a series of external shocks, which put the central bankers from the Main in a position that actually only allowed them to react. Oh yes, forward guidance was also introduced by Mario Draghi. After all, it was almost impossible to think of a monetary policy path that could be followed stoically. The crisis measures also included extensive asset purchase programmes, which were initially often criticised for indirectly (or indiscreetly) financing government debt. The "bank rescue" was followed by more and more attractive measures to support refinancing via the Eurosystem, which also increasingly undermined wholesale funding. The pandemic ultimately turned the ECB into a crisis manager that could only provide support with even more "liquidity". In principle, there was no question of "predetermining" monetary policy if the only option was to react. Interest rates were at a historically low level anyway. The turnaround in interest rates then followed "with notice", so to speak, in the wake of escalating inflation rates, when the ECB Governing Council was "behind the curve" and could only react again. During the rate hike cycle, Christine Lagarde was still able to say at times that the interest rate path was not predetermined and still repeats this today. But June was actually decided quite early on, wasn't it?

And now?

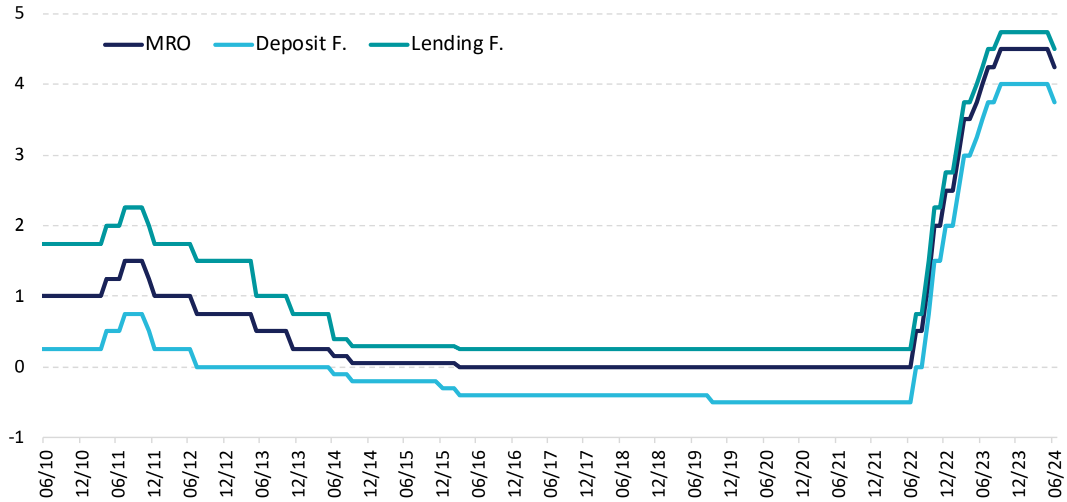
The Governing Council of the ECB seems almost stiff here. But just this once. Maybe. Probably. Rarely has the (future) path for the ECB been as unclear to predict as it is at the moment. Anyone betting on another rate cut in July after the one in June is banking on sand. Anyone expecting a further cut in September could be disappointed. October was never really on the table. And what will the Fed actually do between now and December? Today, in this edition of our preview, we shed light on why we believe in a maximum of three steps. Why we always expect at least one pause after a cut. And why it would be historic if the ECB were to cut before the Fed.

The roadtmap for 2024

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

- 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

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



Source: ECB, Bloomberg, NORD/LB Floor Research

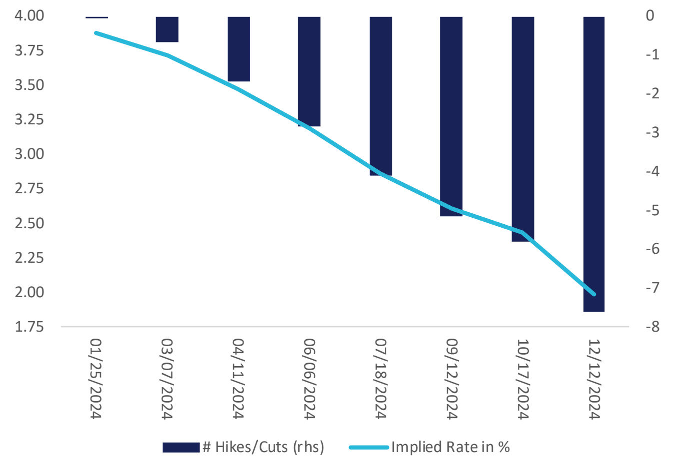
Opinions from the inner ECB circle: Interest rate cut? Yes, please! But carefully

ECB Director Isabel Schnabel commented on the upcoming interest rate meeting at a comparatively short notice and made it clear that if the Council's view was confirmed by the inflation forecasts or the new data, the cut would be likely in June. However, she also urged caution and vigilance, which, conversely, means that the data situation must be closely monitored. In principle, Schnabel's appearance is congruent with what we have perceived from those around us in terms of opinions or rather considerations since the last council meeting. Nevertheless, a certain diversity of perspectives remains. What is certainly more interesting than the question about the interest rate cut in June is how the future interest rate path can be predicted. ECB Vice President Luis de Guindos recently also announced a cut (by -25bp) for June, but at the same time highlighted the high level of uncertainty for the subsequent meetings. He also did not rule out interest rate increases, although these were very unlikely. However, in terms of an interest rate cutting cycle, it also remains vague, both in terms of the extent of the cuts and the number. Council member Olli Rehn also confirmed that there was no predetermination (beyond June). The Finnish central banker also sticks to his view from March, according to which the US Federal Reserve does not predetermine the ECB's steps with its key interest rate decisions. In the interview, he clearly underlined this point of view: “Even if we do not make policy in a vacuum, the ECB is not the 13th district of the Federal Reserve.” Gediminas Šimkus from Lithuania had remarked at the beginning of May that interest rates could be cut “back-to-back”. An unexpectedly pronounced disinflationary dynamic and a downward revision of the growth projections would argue in favor of a move in July. For Bundesbank’s Joachim Nagel the ECB is by no means “on autopilot”. For him, the interest rate cut in June is “plausible”, but it should not necessarily be followed by further cuts (not even in July). The call for a break in interest rates in July is by no means new. The proven hawk Robert Holzmann from Austria has been demanding this quite energetically since the end of April at the latest. Regardless of what will ultimately happen, we note that the “majority opinion” in the Governing Council has shifted towards the “just three more rate cuts in 2024” scenario. This would include the June step. The basic tone of ECB chief economist Philip R. Lane, who recently said that the ECB must remain “restrictive the entire year,” also seems cautious. However, for the June date he indicated that the “highest restriction level” could be left.

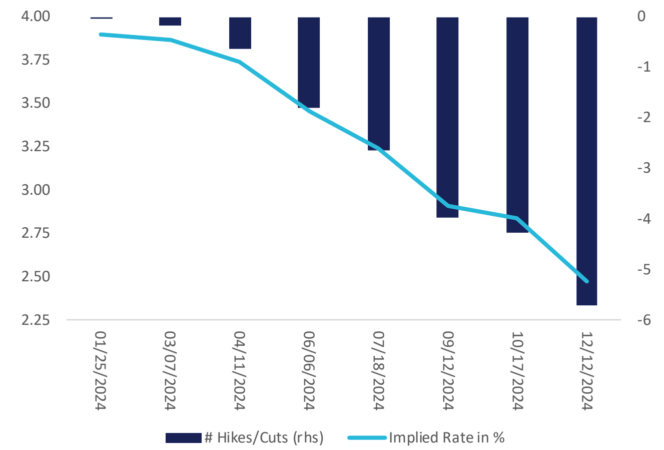
Minutes from the April meeting: Forecasting ability restored

The ECB already presented the minutes of the April meeting on 10 May. A review of the minutes of the Governing Council meeting does not reveal any real surprises, but completes the picture of the situation for us and confirms the expectations that were characterised by Lagarde's statement and words following the April meeting. In short, the interest rate cut in June – a baseline scenario – is supported by the discussions among central bankers. Looking through the minutes, it is also striking that the ECB's decision-makers appear to have regained confidence in their own projections. The statement asserts, for example: "With regard to the euro area economy, members widely agreed that latest information broadly vindicated the growth and inflation outlooks entailed in the March 2024 staff projections. This indicated that the forecasting ability of the quarterly projection exercises had been restored." This view, or rather this confidence, undoubtedly focussed the June meeting on the new projections to be presented. The summarised view of the inflation and growth path must ultimately provide the foundation for the interest rate move. The ECB Governing Council will then also have to factor out possible individual data points without ignoring the risk of inflation rates picking up again. Several risks are emphasised and discussed in the minutes. Wages and wage trends as well as the rate of inflation for services remain perennial hot topics. Unsurprisingly, the influence of developments in the US also once again occupied the Council. The influence of the exchange rate on price trends in the Eurozone remains within the focus here. With regard to the conclusions, we do not believe that the assessment in the minutes, according to which the inflation trend in the US and the Eurozone was seen as different, is free of risks. Even if the assessment that the trend in the US was driven more by demand factors and that in the Eurozone more by supply factors may be correct, a historical comparison certainly reveals that the price trend in the US also has a leading character for the Eurozone. However, this is unlikely to change the imminent move in June. Too little has fundamentally changed here after the April minutes stated: "It was seen as plausible that the Governing Council would be in a position to start easing monetary policy restriction at the June meeting if additional evidence received by then confirmed the medium-term inflation outlook embedded in the March projections."

Implied Overnight Rate 27.12.2023

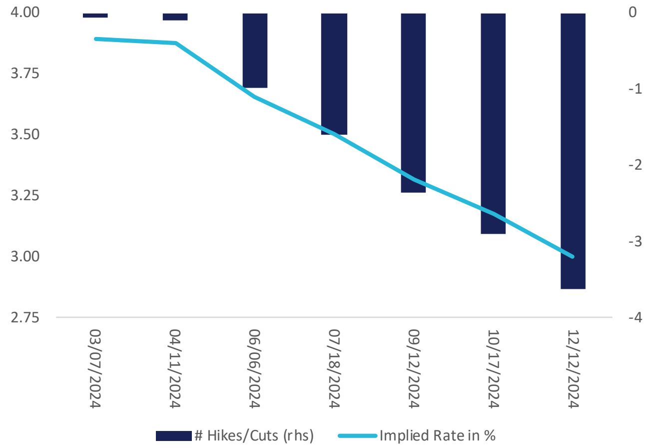


Implied Overnight Rate 24.01.2024

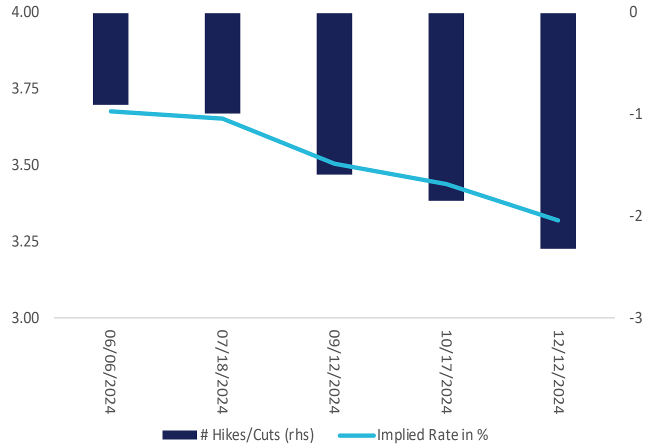


Source: Bloomberg, NORD/LB Floor Research

Implied Overnight Rate 26.02.2024



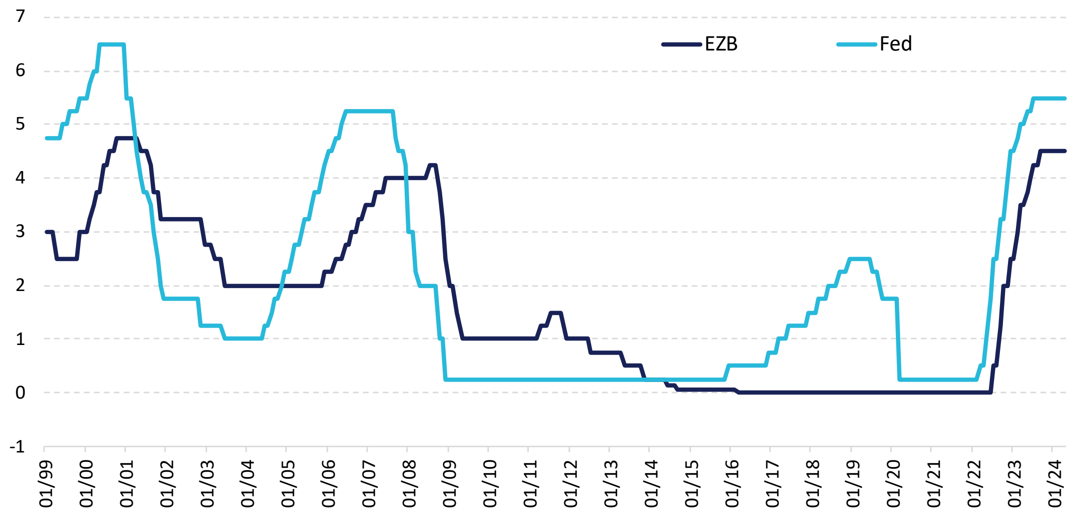
Implied Overnight Rate 24.05.2024



Source: Bloomberg, NORD/LB Floor Research

History in the making: Never since 1999 has the ECB cut interest rates before the Fed
With Congress's approval of the Federal Reserve Act, it came into force on December 23, 1913. This created the Federal Reserve System (Fed), the world's largest and most important central bank system and thus also a model and anchor for other central banks. Almost 85 years later – on June 1, 1998 – the ECB was founded. She was given the task of introducing the Euro and securing its value. Their primary goal is to ensure price stability. As the chart below shows, the ECB has never cut interest rates before the Fed in its almost 26-year history. So on June 6, 2024 it could be historic, the signs are becoming more and more intense. The ECB has made a major mistake twice in its history and reversed it afterwards: that was the interest rate hike in 2008, shortly before Lehman Brothers went bankrupt, and two hikes in 2011, shortly before Trichet's handover to Draghi. This time too, the ECB should be warned not to take too many or too big steps alone. Premature interest rate cuts by the ECB would make the US interest rate market appear even more attractive. This in turn would redirect capital flows to the USA and (negatively) influence the exchange rate. Keyword: imported inflation.

ECB versus Fed: A couple dance with a varying time lag



Source: ECB, Bloomberg, NORD/LB Floor Research

Our expectations for June 6th: The short end of a break

We assume that the ECB Council will cut interest rates on all three key main interest rates by 25bp each – and then pause. In our opinion, the ECB Council should then discuss: not whether interest rates will be cut again in 2024, but how often. As we expected and as communicated by the ECB, the meetings remain data-based so as not to use “data-driven” again. We are looking forward to all meetings with new *staff projections* with a certain excitement.

Public Issuers/SSA: The repricing appears to be barely complete

For some time now, the SSA segment has been finding it difficult to carry out necessary, “correct” and sustainable repricing. The cycle of interest rate hikes is long gone and it seems to be going down again in less than two weeks, but the different sub-markets for supranationals, regions such as German Laender, Belgian regions, but also Canadian provinces, national and regional German development banks, but also French ones, are still visible Agencies with 0% or 20% risk weight tend to be undecided about what their right price is. German Laender and KfW were recently trading at almost identical swap levels, which should not be the case. With the impending further downward turn in interest rates, a heterogeneous picture will once again emerge, which will slowly become more complete over time. The first issuers have already completed their funding activities for 2024. Some others might follow soon before the summer break.

Covered bond market: Relative attractiveness even after June 6th

The situation on the covered bond market is, unsurprisingly, largely determined by the ECB's monetary policy. The upcoming – albeit probably rather tentative – start to the renewed interest rate turnaround is also shaping the behavior of investors and issuers. This is hardly surprising simply due to the formation of expectations and the corresponding spread and return expectations. And that is exactly why we do not see any significant impetus coming from June 6th, so that there is unlikely to be a trend reversal, particularly in terms of issuances. With regard to investor demand, we see covered bonds as a key “selling point” due to their high relative attractiveness compared to, for example, government bonds and credits or corporates. This should not be washed out even after a -25bp interest rate cut. In the longer term, in the event of a significantly flattened interest rate reduction path, it cannot be ruled out that investors will once again focus more on credit quality aspects. This could lead to a spread widening.

Conclusion and outlook

We assume that the ECB Council will do something historic on June 6th: the first interest rate cut before the Fed. We expect that all three key interest rates will be reduced by 25bp each – and paused in July. In our opinion, the ECB Council should then discuss: not whether interest rates will be cut again in 2024, but how often. We are looking forward to all meetings with new *staff projections* with some 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 roadmap includes a maximum of three cuts in 2024, namely in June, 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 to be taken first. Then we can see further – and more clearly. Because the ECB cannot be afraid of its own courage on June 6th, please!

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 – 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 2023

ECB decision: Between interest rate-Scylla and inflation-Charybdis

Appendix
Contacts at NORD/LB

Floor Research

Dr Frederik Kunze
Covered Bonds/Banks

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

Lukas Kühne
Covered Bonds/Banks

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

Dr Norman Rudschuck, CIIA
SSA/Public Issuers

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

Christian Ilchmann
SSA/Public Issuers

+49 157 851 64976
christian.ilchmann@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
Governments	+49 511 9818-9660
Länder/Regionen	+49 511 9818-9660
Frequent Issuers	+49 511 9818-9640

Origination & Syndicate

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Origination Corporates	+49 511 361-2911

Sales Wholesale Customers

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

Treasury

Collat. Management/Repos	+49 511 9818-9200
Liquidity Management	+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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