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NORD/LB Markets Strategy & Floor Research

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Floor analysts:

Covered Bonds/Banks

Dr Frederik Kunze
frederik.kunze@nordlb.de

Melanie Kiene, CIIA
melanie.kiene@nordlb.de

Stefan Rahaus
stefan.rahaus@nordlb.de

SSA/Public Issuers

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

Valentin Jansen
valentin.jansen@nordlb.de

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ECB interest rate decision: All new in May… Or: The "force" of past rate hikes!

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

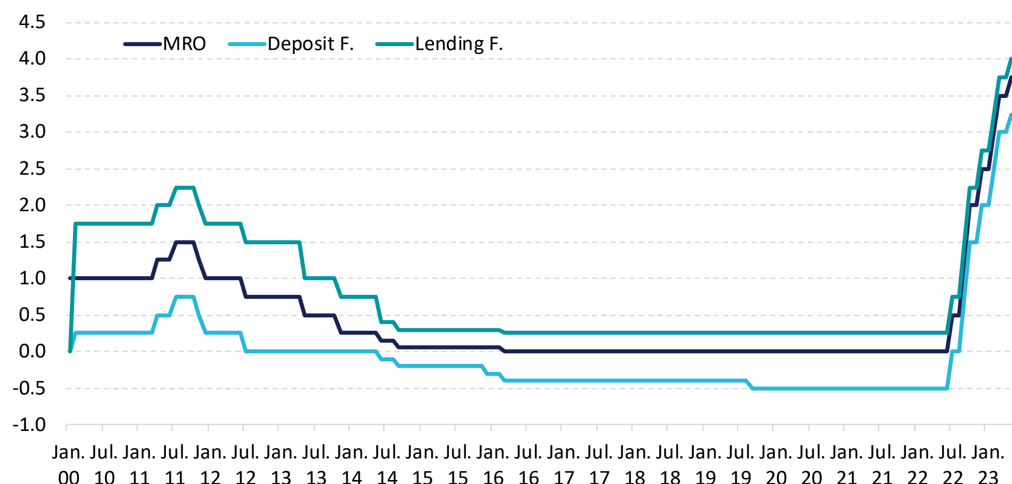
„May, the fourth" versus „May the force be with you"

Today is Star Wars day for fans worldwide. At least at first glance, the ECB did not reach for the stars, because as expected, the Governing Council decided at its most recent regular meeting to raise all three key interest rates by 25 basis points each. In today's press release, the central bankers once again refer at the outset to the need for this and further rate hikes (!), as they see it. For example, the outlook for consumer price inflation "remains clearly too high". The Governing Council also signaled that future interest rate steps would continue to follow the "meeting-by-meeting" approach and would be aligned with the outlook in terms of inflation and economic prospects. However, the statement immediately provides the rationale for the central bankers to now slow down the pace of interest rate hikes. Thus, it says today, "past rate increases are being transmitted forcefully to euro area financing and monetary conditions, while the lags and strength of transmission to the real economy remain uncertain." To stay in the semantics of Star Wars: The Governing Council is also feeling the "force" of previous interest rate hikes – but is indicating no pause at all and even more than one further step up.

Announcement to the APP: Surprising sentence with great effect?

While the interest rate step in the announced form is by no means a surprise for us, we had expected far less clarity than was now the case today with regard to the central bankers' further handling of the asset purchase programme (APP). The at first glance inconspicuous sentence "In line with these principles, the Governing Council expects to discontinue the reinvestments under the APP as of July 2023.", now also seals, with a very high degree of probability, the swift end of secondary market purchases under the PSPP, CBPP3, ABSPP and CSPP. However, the Council did not alter the reduction of the APP portfolio by an average of EUR 15bn per month, which is hardly surprising given the limited time remaining until end of June.

ECB key interest rates (in %; incl. current interest rate decision)

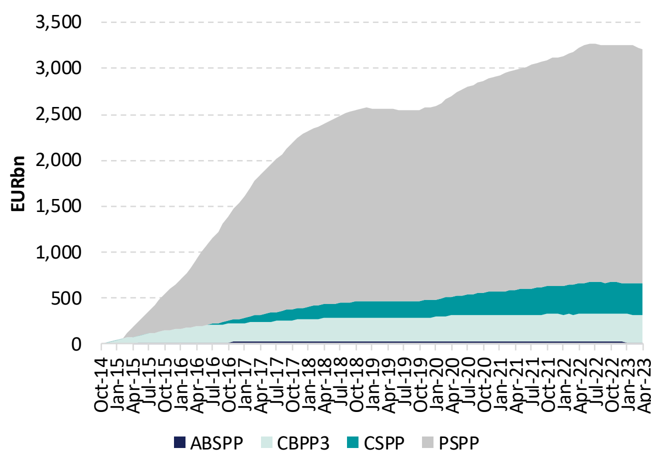


Source: ECB, Bloomberg, NORD/LB Markets Strategy & Floor Research

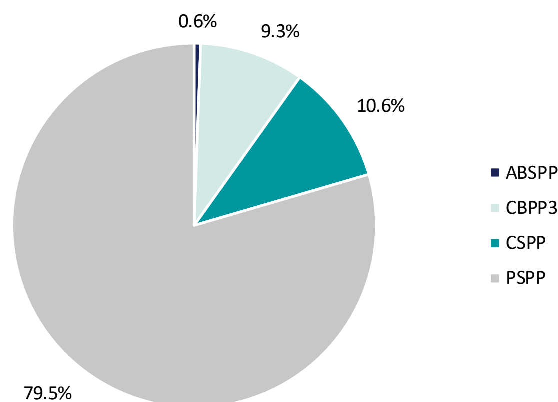
Plus 25: A "milder" step thanks to recent data points?

At this point, despite the "APP surprise", it seems to us to make perfect sense to place the latest interest rate move in a broader context, as this should also become somewhat more significant for future interest rate decisions. After the March meeting of the ECB Governing Council finally had to be held, so to speak, in the eye of a storm called "banking stress", we would rather speak of calmer waters for today's meeting, despite the announcement on the APP, which we did not expect in this way. This is at least true with regard to the acute stress conditions on the international financial markets. The latest key rate decision to be taken was not really easy, however. But the ECB's highest decision-making body had the chance to follow up its own words with concrete actions. We are thinking in particular of the phrases "data dependency" and the "meeting-by-meeting approach", which have already been used like a prayer mill. And it was precisely here that the Governing Council of the ECB was offered a stage this week. For several days now, the attention of capital market participants has been focused on the data now presented on the ECB Bank Lending Survey (see publication on May 2) and on details of price developments in the single currency area for the reporting month of April (see Eurostat Flash Estimate of May 2). In our view, the signal that lending in the single currency area is increasingly burdened by the ECB's interest rate path may initially have prompted the Governing Council to also give greater prominence to the negative consequences for real economic activity in the discussion. In our view, the latest price data from Eurostat, which were presented as flash estimates, fit in with the fundamental view that upward pressure on prices does not justify a further "major" interest rate hike at present. After all, the flash estimates for the reporting month of April did not show any further increase, especially with regard to the core inflation rate. The April figure (5.6%) exceeded the expectations of economists surveyed in advance by Bloomberg by 0.1 percentage points. However, the core inflation rate – which is repeatedly highlighted by high-ranking ECB central bankers as a linchpin in the decision-making function – fell from the previous month's value (5.7%). As part of our ECB preview the previous week, we already expected a rate hike of 25 basis points today. However, a "forecast risk" emerged in particular from the aforementioned data points on the ECB Bank Lending Survey as well as on price developments. Since May 02, we know: However, without a "nasty surprise" on the price side or an "all-clear" on credit dynamics in the euro area, there was little to suggest a big rate move today (by 50 basis points) or even a suspension of the rate hike cycle. So today's announcement to again raise all three main financing rates by 25 basis points obviously fits the mantra of "data dependence" and with corresponding discussions at the recent meeting, probably also the "meeting-by-meeting approach" of the Governing Council. According to Lagarde, there was no horse-trading between doves and hawks, "+25" plus early stopping of reinvestments. The question of whether, in view of an interest rate turnaround now amounting to 325 basis points with today's announcement, one can speak of a "milder" step, is answered by the Council itself today. This applies not least against the backdrop of the fact that the interest rate hikes that have taken place so far – as significant as they may be for the rather immediate formation of expectations on the financial markets – first had to find their way into the real economy via the monetary policy transmission mechanism and the central bankers are now feeling the "power" of their own decisions. The journey thus seems set to continue in June and beyond. However, we reinforce to argue for a short suspension of the rate hike cycle.

Portfolio development



Portfolio structure

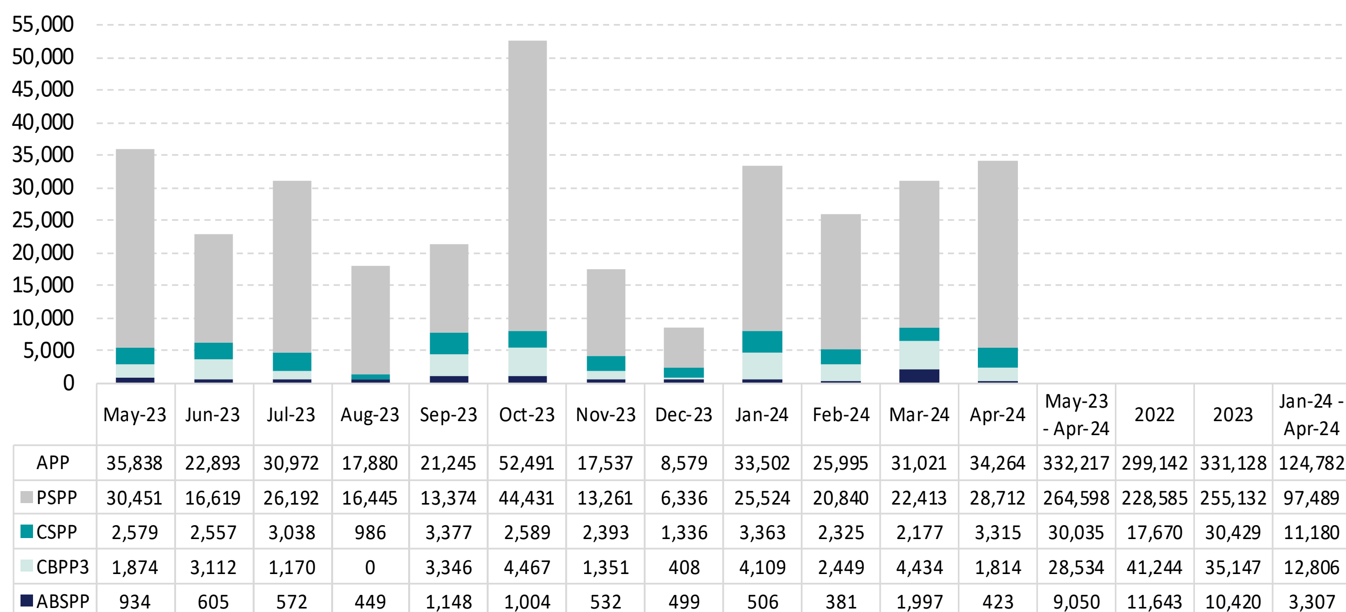


Source: ECB, NORD/LB Markets Strategy & Floor Research

APP reinvestments say goodbye, PEPP remains present

What is the starting situation for the APP phase-out? A look at the data shows that the APP volume still adds up to more than EUR 3,200bn. Two months of reduced reinvestments thus add up to EUR 30bn or less than 1% balance sheet reduction to date. Without selling bonds, however, the APP will remain on the Eurosystem's balance sheet for at least another 12-15 years. This would only be a start, as the chart above left suggests – but nothing more. A few meetings ago, all the groundwork was already laid for the remainder of the first half of the year: The reduction of APP holdings by an average of EUR 15bn per month until the end of Q2 2023 plus then a reassessment of the situation. For today's meeting, we had not expected any info on the APP. Perhaps we had become too accustomed to "sequencing" by the ECB and therefore expected a pause in the rate hike cycle for June as well as the full focus of the ECB Governing Council on the further path of balance sheet reduction. We also admittedly would not have attributed the highest probability to the presumed decision to no longer endorse any reinvestments from July onward. Nonetheless, the surprise potential that was exploited was given: After all, the ECB's withdrawal from the order quota for covered bonds on the primary market was also faster than expected. And against the backdrop of the stronger accentuation of the "force" of the previous interest rate steps, according to which "plus 50 basis points" are off the table, the announced adjustment of the rate at the APP even seems more than understandable. A significantly reduced purchasing activity not only has an accommodative effect, but may ultimately also have the force of an interest rate hike in terms of gradually withdrawing liquidity or support from the market. At present, this explicitly applies only to the APP! With regard to the PEPP, we do not expect any surprises in the style of the APP at the upcoming meetings. In view of the first line of defense, we consider a deviation from the previous approach – to fully reinvest maturities until the end of 2024 – to be extremely unlikely and would also render the last still active forward guidance absurd. As long as PEPP can still defend spreads, there will also be no need for activating the emergency program à la TPI. Therefore, we are currently very happy that the spread of Italian ten-year bonds against German Bunds with identical maturities is settling at around +190bp. We have not overestimated smaller swings towards 170bp, nor do we think a return to above +200bp is too critical. At the peak last year, it was more than +250bp.

Expected monthly maturities in APP (in EURm) – equivalent to balance sheet total reduction as of July



	May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23	Nov-23	Dec-23	Jan-24	Feb-24	Mar-24	Apr-24	May-23 - Apr-24	2022	2023	Jan-24 - Apr-24
APP	35,838	22,893	30,972	17,880	21,245	52,491	17,537	8,579	33,502	25,995	31,021	34,264	332,217	299,142	331,128	124,782
PSPP	30,451	16,619	26,192	16,445	13,374	44,431	13,261	6,336	25,524	20,840	22,413	28,712	264,598	228,585	255,132	97,489
CSPP	2,579	2,557	3,038	986	3,377	2,589	2,393	1,336	3,363	2,325	2,177	3,315	30,035	17,670	30,429	11,180
CBPP3	1,874	3,112	1,170	0	3,346	4,467	1,351	408	4,109	2,449	4,434	1,814	28,534	41,244	35,147	12,806
ABSPP	934	605	572	449	1,148	1,004	532	499	506	381	1,997	423	9,050	11,643	10,420	3,307

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

Conclusion and comment

Before the meeting, we found that our classification placed us between the athletic-verbal balancing act and the anatomically almost impossible two hearts in one chest: Inflation targeting and/or financial stability. A "versus" would have put these two ECB target images in competition with each other too harshly. Moreover, an "and/or" last week was not meant to show our discord, but to reflect the current state of muddle in the Governing Council. The hawks clearly see the goal of fighting inflation at risk should the target rate for policy rates be reached soon. For the doves (and some banks), the interest rate journey so far may have been too fast. Financial market stability seems to be far less of a factor in the decision-making process than it was at the previous meeting. With today's meeting, we think the ECB has turned the interest rate screw enough in the first half of the year. But the wording in the press conference smells only minimally of an interest rate pause in June – but only because the announcements on the APP are restrictive in character. Moreover, in the view of the ECB's Governing Council, the interest rate hikes since July 2022 are increasingly materializing or the exact progress remains uncertain as of today. With regard to the impact delays, 12-18 months can also be considered "normal" in this context. The first rate hike was less than ten (!) months ago. It would have been charming and comfortable to take a deep breath in June and concentrate purely on the further course of action regarding the balance sheet reduction – Lagarde did not sound like this at all. Looking at the primary market activities, the flow on the secondary markets in general and the corresponding spread developments, the Governing Council is not causing any deep wrinkles of concern on our foreheads today. Both the Public Issuers/SSA submarket and the covered bond segment should hold their own in this environment. However, we see our expectations confirmed that the ECB's withdrawal will continue to confirm the spread differentiations across jurisdictions and issuers.

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Appendix
Publication overview

Covered Bonds:

Issuer Guide Covered Bonds 2022

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 Q4/2022 (quarterly update)

Covered bonds as eligible collateral for central banks

SSA/Public Issuers:

Issuer Guide – German Laender 2022

Issuer Guide – German Agencies 2022

Issuer Guide – Dutch Agencies 2022

Beyond Bundeslaender: Belgium

Beyond Bundeslaender: Greater Paris (IDF/VDP)

Spotlight on Spanish regions (Update planned in 2023)

Fixed Income Specials:

ESG-Update 2022

ECB interest rate decision: Backbone in times of turmoil?!

ECB interest rate decision: Roadmap to QT

ECB: The Wishing-Table, the Gold-Ass, and the Cudgel in the Sack

NORD/LB:	**NORD/LB:**	**NORD/LB:**	**Bloomberg:**
Markets Strategy & Floor Research	Covered Bond Research	SSA/Public Issuer Research	RESP NRDR <GO>

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Appendix
Contacts at NORD/LB

Markets Strategy & Floor Research

Dr Frederik Kunze
Covered Bonds/Banks

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

Melanie Kiene
Covered Bonds/Banks

+49 172 169 2633
melanie.kiene@nordlb.de

Stefan Rahaus
Covered Bonds/Banks

+49 172 6086 438
stefan.rahaus@nordlb.de

Dr Norman Rudschuck
SSA/Public Issuers

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

Valentin Jansen
SSA/Public Issuers

+49 157 8516 7232
valentin.jansen@nordlb.de

Sales

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

Trading

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Governments	+49 511 9818-9660
Länder/Regionen	+49 511 9818-9550
Frequent Issuers	+49 511 9818-9640

Origination & Syndicate

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

Sales Wholesale Customers

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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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