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Fixed Income Special

NORD/LB Floor Research

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Marketing communication (see disclaimer on the last pages)

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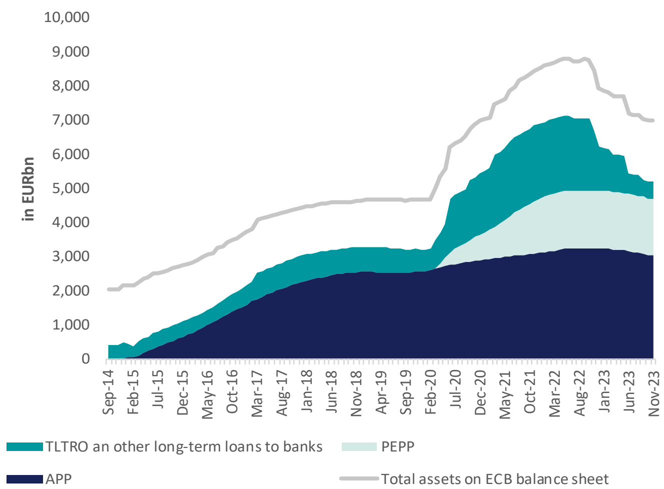
ECB preview: A silent, but holy summit meeting?

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

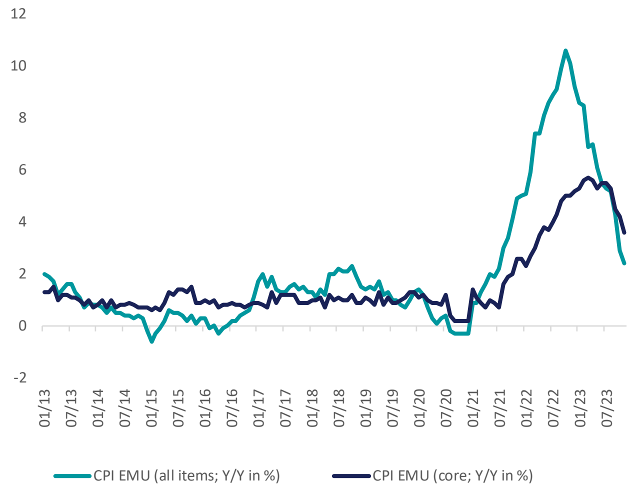
Key interest rate decision on 14 December: A silent, but holy summit meeting?

The environment in which the ECB Governing Council must hold its next key interest rate meeting is once again characterised by an increased level of geopolitical uncertainty. Experts see a difficult course of the war in Ukraine and tensions in politics because, for example, support from the West is waning. Ukraine lacks weapons, ammunition, money and, in the foreseeable future, soldiers. A harsh winter is therefore looming – and not just in terms of severe weather conditions. It is therefore undoubtedly clear that this issue, which has brought us not only massive suffering and refugee movements, but also high energy costs coupled with other inflationary drivers and additional expenditure on accommodation, supplies and the military, will also be with us in 2024. According to experts, there is now talk of a stalemate in a trench war, similar to the First World War. The situation in and around Israel is no less confusing for fixed income analysts and harbours plenty of potential for escalation. These geopolitical concerns, which are accompanied by sometimes dramatic developments, are overshadowing the usual monetary policy parameters and we are taking them with us into the new year. Meanwhile, both the relevant oil prices – Brent and WTI – are now back below USD 80 after reaching interim highs of over USD 90 per barrel, and yields on German government bonds are falling, too. The almost 3% at the long end (10y) are now "only" 2.3%. With regard to the direct economic impact, the focus is always on the price of crude oil and interest rates – in particular the conditions for bank refinancing from the ECB's perspective. A rise in prices at the beginning of 2024 and/or base effects coming to an end would not only jeopardise the upcoming ECB projections, but would also weigh on economic momentum in the Eurozone. For the upcoming ECB Governing Council meeting, all parameters underpin the fact that key interest rates will remain unchanged. This means that there are currently three relevant topics for us: What will happen with the PEPP ("first line of defence")? Will the balance sheet reduction (QT) be accelerated by an earlier end to full PEPP reinvestments? How and when does the ECB Governing Council dare to approach the minimum reserve requirement?

ECB balance sheet

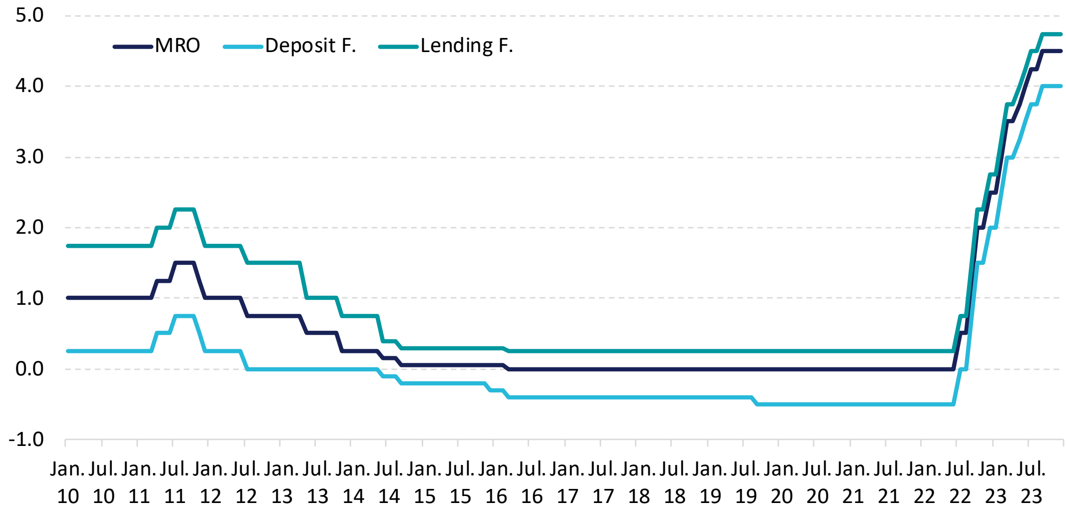


Inflation development (in %)



Source: ECB, Bloomberg, NORD/LB Floor Research

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



Source: ECB, Bloomberg, NORD/LB Floor Research

Opinions from the inner ECB circle: A dove that didn't want to be one?

Before focussing on the three questions stated above, it seems appropriate to assess the recent mood in the ECB Governing Council. In the current trading week, the words of Executive Board member Isabel Schnabel have certainly struck a chord. After all, in her statements, the monetary policymaker not only verbally rejected a further rise in interest rates, but also spoke in favour of earlier interest rate cuts – even if this was not really the intention. According to Schnabel, the remarkable decline in inflation rates makes a further interest rate hike rather unlikely and the flash estimate of EMU price inflation in November should also be seen as a pleasant surprise. A surprise with consequences? For Isabel Schnabel, a further interest rate hike in October could at least not have been ruled out. However, she did not mention a rate cut now either and did not want to venture an outlook for the first half of 2024. Instead, this was taken over by market participants, who were clearly increasingly positioning themselves in favour of the first interest rate cuts in the first half of 2024. However, this contrasts with the latest speeches by other central bankers. Pierre Wunsch's admonitions, which referred to the interest rate bets of some market participants and painted a further interest rate hike – at least in theory – on the wall, have all but faded away. However, we do remember the comments made by Bundesbank President Joachim Nagel in his keynote speech at the vdp annual reception, according to which the ECB's inflation target is not expected to be approached until 2025. Accordingly, it is also clearly too early to think about a "possible reduction in key interest rates", although a further interest rate hike "cannot yet be ruled out". With regard to other monetary policy control parameters, Nagel made it clear, for example, that the credit institutions were in a position to cope with an increase in the minimum reserve from 1% to 2%. Regarding PEPP reinvestments, Isabel Schnabel stated for the record that any decision in this regard would not be a "big deal" – also because the reinvestments would not have to be so large and because the market would expect them. However, not all Council members were likely to fully agree with this opinion. For the Council member from Italy, Fabio Panetta, the situation is different with regard to the key interest rate. For him, monetary policy tightening is "more effective than expected", so it is now also a matter of avoiding unnecessary damage. Will 2024 be another year of doves? It cannot be ruled out.

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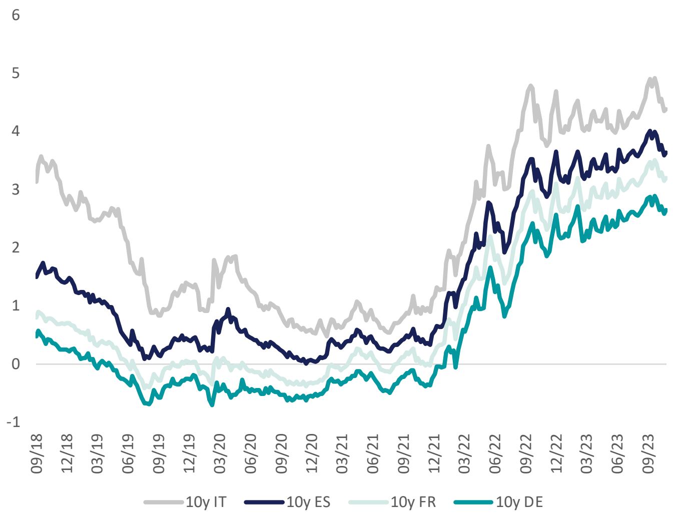
Yield development in the euro area (in %)



Spread development: Italy vs. Germany (in bp)

Source: Bloomberg, NORD/LB Floor Research

Minutes of the October meeting: Risks for economic growth!

On 23 November, the ECB made the minutes of last October's meeting available to the public. Based on our previous comments alone, the period of time between the last meeting and the minutes is sufficient to indicate that the wind is changing significantly. Just think of Schnabel's statements. Nevertheless, the "ECB Minutes" remain an important source of information for market participants. We would also like to keep this in mind for the meeting of the ECB Governing Council in October. After all, the minutes provide us with a comprehensive picture of the discussion situation at the time. In October, monetary policy makers were particularly concerned with the downside risks to economic activity. The minutes state unequivocally: “The risks to economic growth remained tilted to the downside. Growth could be lower if the effects of monetary policy turned out stronger than expected.” Following this line of reasoning, we come to the second key insight from the minutes, which should, however, take some of the wind out of the sails of those hawks who are still propagating the possibility of a further rate hike. Even if there are dissenters, the ECB has probably reached the end of the rate hike cycle. In particular, the establishment of this market expectation is likely to have "pleased" the central bankers in October. “Members generally agreed that the rise in longer-term interest rates in the euro area had tightened financing conditions by more than anticipated. It was argued that this made it more likely that the Governing Council’s monetary policy stance was restrictive enough, although there were still uncertainties around this assessment.” In our view, the fact that the debate has already turned in favour of interest rate cuts in the near future just a few weeks later is unlikely to be welcomed by the ECB Governing Council. Nevertheless, we also see some arguments in favour of these "interest rate bets" initially being of an episodic nature. However, we would see a change of heart at the current juncture with regard to the PEPP. While discussions about bringing forward the end of full reinvestment were still considered "premature", the December meeting should perhaps offer at least a little more room for manoeuvre here.

Our expectations for 14 December: End of the rate hike fantasies

For the upcoming interest rate decision, we assume that the ECB Governing Council will extend the pause that has already been painted on the wall. Against the backdrop of increased uncertainty due to recent geopolitical developments and falling oil prices and yields, we believe there will be no further hike. The meetings will therefore remain data-based, so as not to be "data-driven". After all, the past interest rate hikes are still having an effect. We therefore see no danger of the interest rate screw being turned too far. This would also have resulted in a hard landing for economic activity in the entire single currency area or in individual economies. We are looking forward to the new staff projections on 14 December, which will contain the figures for 2026 for the first time. For 2025 and 2026, we expect the harmonised index of consumer prices (HICP) to be close to 2%. Much more important, however, will be whether there will still be a "3" in front of the decimal point for 2024. If this were the case, we believe that this would clearly put an end to interest rate cut fantasies as early as Q1/2024. We are sticking to our forecast that there is unlikely to be an interest rate cut in H1/2024. All the more reason to focus on three issues: PEPP, QT and minimum reserve. We expect that there will be a stronger focus on the PEPP and the constantly postulated "first line of defence" both in internal discussions and at the press conference. In our opinion, however, the probability that a decision will be made in December that provides for a shortening of the phase of full reinvestment until (still) the end of 2024 is likely to be low. In our view, it would be questionable to allow the "first line of defence" to crumble now. The Governing Council of the ECB cannot want the TPI to be activated at some point. So, in our opinion, the PEPP needs a few more months before we can see more clearly, instead of an accelerated balance sheet reduction (QT). All in all, everything continues to speak in favour of a meeting-by-meeting approach instead of forward guidance on the interest rate side. This also applies to the minimum reserve. We agree with Bundesbank President Joachim Nagel: We believe that a heated debate is out of place. If there is, then we will see an increase from 1% to 2% in 2024 (or later). To put it polemically: a doubling. Rates of 5-10%, which are demanded by some, are the other utopian extreme.

Conclusion and outlook

What is exciting is that some financial market participants had clearly not quite finished with the interest rate hike cycle in October. Now, at the beginning of December, a majority of market participants are already in favour of an interest rate cut in the near future. Everyone is in agreement for December: a pause is now clearly to be expected. The central bankers' wait-and-see attitude actually has some advantages. Certainly, a wait-and-see attitude should not be confused with the ability to sit back and relax. There are enough topics for discussion. More hawkish central bankers would certainly like to see the PEPP or other monetary policy instruments such as minimum reserve requirements more prominently on the agenda. Discussions on the economic situation are likely to be just as vigorous. After all, against the backdrop of current developments, many outcomes are conceivable. In the coming week, there will probably "only" be discussion, not action. Discussion is the most effective means against the backdrop of a meeting-by-meeting approach. After all, ECB decision-makers are already likely to be thinking about how the latest staff projections will be received by the market. Consequently, this means debating PEPP, QT and minimum reserves and preparing the market for 2024 without misdirecting it.

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 Q3/2023 (quarterly update)

Covered bonds as eligible collateral for central banks

SSA/Public Issuers:

Issuer Guide – German Laender 2023

Issuer Guide – German Agencies 2023

Issuer Guide – European Supranationals 2023

Issuer Guide – French Agencies 2023

Issuer Guide – Dutch Agencies 2023

Beyond Bundeslaender: Belgium

Beyond Bundeslaender: Greater Paris (IDF/VDP)

Beyond Bundeslaender: Spanish regions

Fixed Income Specials:

ESG-Update 2023

ECB: Now is not the time for forward guidance!

ECB preview: Wait and see without calling it a pause

ECB: This rate terminates here – 99.9% sure

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