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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: The early bird catches the worm?

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

The early bird catches the worm, but the second mouse snatches the cheese

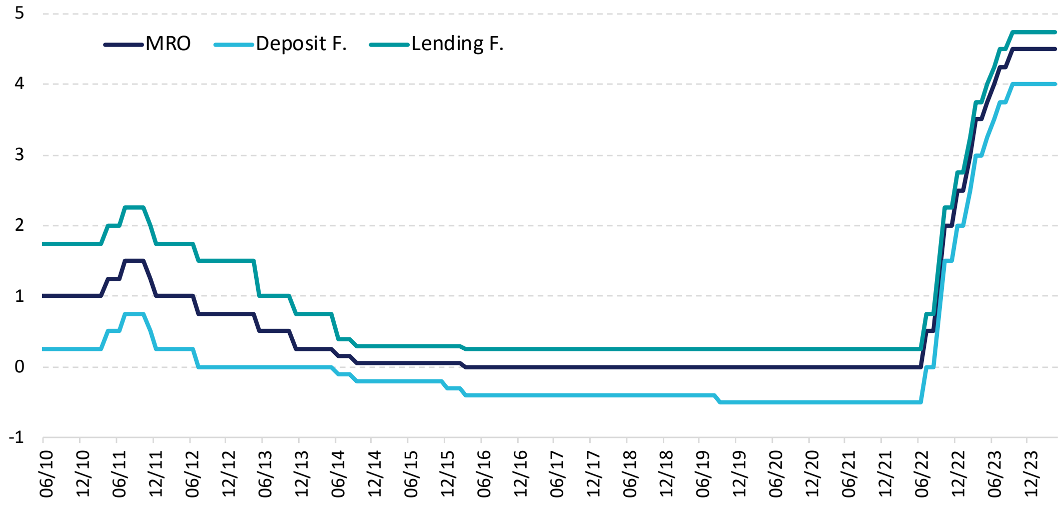
The latest data points on the development of inflation rates in the Eurozone have undoubtedly fueled interest rate cut fantasies among financial market participants. However, in our opinion, it would be more than premature to equate this with a rapid turnaround in interest rates. In our opinion, this applies not only against the background of the results of the ECB survey of private households presented on April 2, 2024. The survey determines consumers' inflation expectations for a forecast horizon of twelve months and refers to the data collection period of February 2024. This resulted in a value for consumer price inflation of 3.1%, which is still significantly higher than ECB's 2% target. It remains undisputed that the path of inflation has recently been downwards. This was confirmed this morning: Based on Eurostat's flash estimate, the inflation rate fell to 2.4% Y/Y in the reporting month of March. However, we would warn against perpetuating this development into the future. The risks of the ECB cutting interest rates too early are still too high in April. Though it would be too short-sighted to blame this solely on possible wage increases. Far more variables should be (additionally) included in the decision-making process or weighted more heavily. We are thinking of the interactions between the interest rate decisions of the ECB Governing Council and the FOMC. Ultimately, these two currency areas are in different economic conditions. However, for those ECB decision-makers who overweight the risk of a "hard landing" in the Eurozone, the long period between the April and June meetings could amount to a "fainting period". Despite May Day, Ascension Day and Pentecost, there are still more than 35 working days between these two meetings. According to the ECB, while financial markets, institutions and business partners adapt to the changes in the liquidity environment that accompanied the reduction of the Eurosystem's balance sheet, the Governing Council will closely monitor how excess liquidity develops and how it will be distributed. Furthermore, the formation of money market interest rates, the development of banks' demand for central bank reserves as well as the functioning of the money and financial markets in general within the recently announced parameters could be other important topics. Based on the experience gained, the Governing Council will review the key parameters of the operational framework again in 2026. It also stands ready to adjust the design and parameters of the operational framework at an earlier stage, if necessary, to ensure that monetary policy remains in line with the established principles.

The slightly longer timetable for 2024

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

- 11 April
- 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 pause expected by us)



Source: ECB, Bloomberg, NORD/LB Floor Research

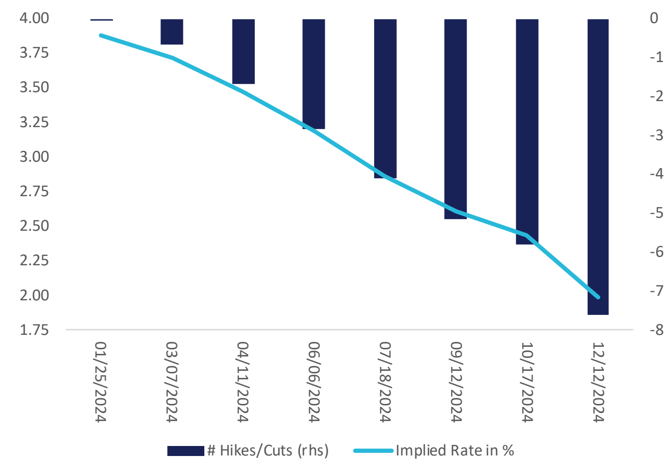
Opinions from the inner ECB circle: A rate cut in June remains the majority opinion

Month by month or preview by preview, we devote ourselves to the "public" discourse of the ECB decision-makers with regard to the appropriate timing and/or level of interest rate steps. In this context, we have not yet discussed the statements made by Italian newcomer Piero Cipollone, who was appointed as a member of the six-member ECB Executive Board with effect from November 1, 2023 and is therefore a voting member of the Council. The fact that Cipollone – like his compatriot Fabio Panetta – belongs to the camp of the monetary policy doves is evident from his recent statements. The central banker made it clear that if the March projections were confirmed, the ECB would have to be ready to "quickly" reduce the restrictive monetary policy stance. But "quickly" might be too hasty for some council members. Bundesbank President Joachim Nagel, for example, noted that there should be no automatism in the form of a "sequence of interest rate cuts". François Villeroy de Galhau spoke up from our neighbouring country. The President of the Banque de France recently stated that interest rate cuts should also be seen as an "insurance" against a too sharp slowdown in growth. Even for the hawk Robert Holzmann, an interest rate cut "before the Fed" is now entirely possible. Nevertheless, he still sees great risk potential and once again made it clear that a decision on interest rate cuts should not be made before the updated ECB projections in the context of the meeting in June are available. He also dealt (already for June) with the interdependencies of his own decisions with the actions of the US central bankers almost a week later. He expressed the hope that the Fed would immediately follow suit in June. If the FOMC does not follow the ECB's example, Holzmann believes this would reduce the economic effect of its own decision. However, there can hardly be clearer words from Holzmann regarding the meeting next week: "April is not on my radar." More than a week ago, it was ECB chief economist Philip R. Lane who, in our opinion, presented a more diverse perspective of monetary policy on wage development. It is "desirable and inevitable" that the currency area is characterized by wage increases above the "normal level".

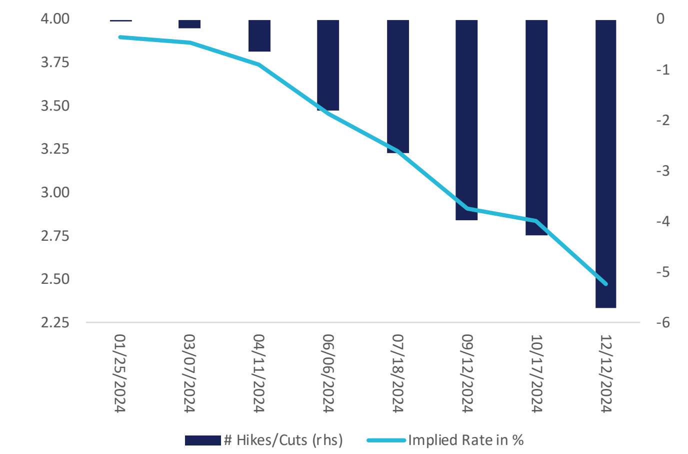
Minutes from the March meeting will be presented tomorrow (only)

The ECB has planned to publish the minutes of the March meeting on April 04. Even though we do not want to downplay the importance of the "Minutes" of the most recent meeting of the Council, the potential for surprises does not seem be very high for us. This applies not only because the "dovish undertone" that was already evident on the press conference. What we would like to highlight in the context of the ECB's publications (still in March) is the press release on the revision of its own monetary policy framework. The interest rate for the main refinancing operations (short-term) will be adjusted on September 18, so that the gap between the interest rate for the HRGs and the deposit rate will be reduced from the current 50 basis points to 15 basis points. According to the ECB, this narrower gap will provide an incentive to submit bids in the weekly tenders, which should keep short-term money market rates close to the deposit rate. It will also limit the extent of potential fluctuations in short-term money market rates. At the same time, it leaves room for money market activities and offers banks incentives for market-based refinancing solutions. The interest rate on the marginal lending facility will also be adjusted so that the spread between the interest rate on the marginal lending facility and the interest rate on the MROs remains unchanged at 25 basis points.

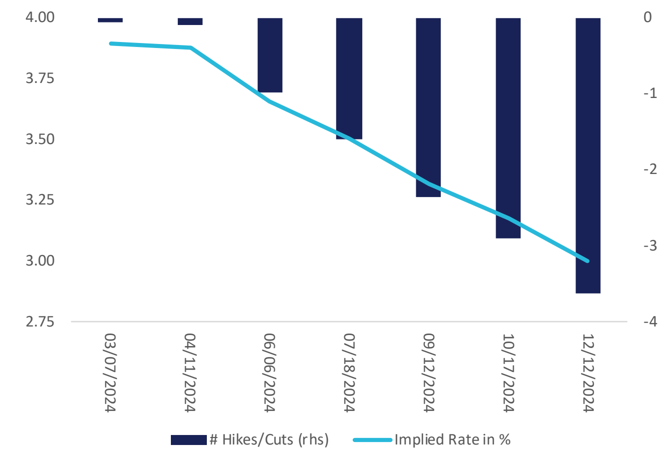
Implied Overnight Rate 27.12.2023



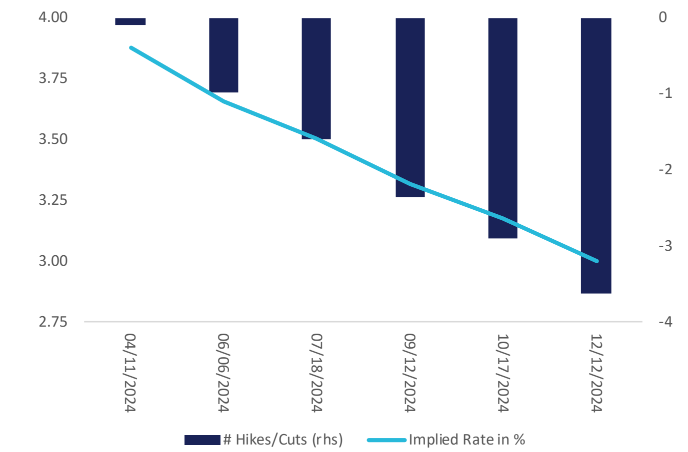
Implied Overnight Rate 24.01.2024



Implied Overnight Rate 26.02.2024



Implied Overnight Rate 03.04.2024



Source: Bloomberg, NORD/LB Floor Research

Our expectations for April 11: Preparation is half the battle

We assume that the ECB Council will extend the interest rate pause again. We also continue to see two relevant questions that, in our opinion, the ECB Council should discuss before June: Not whether interest rates will be cut in 2024, but a) when and b) how often? As we expected and as communicated by the ECB, the meetings remain data-dependent, to not use “data-driven” again. According to President Lagarde, the basis for discussion in April will contain less data than in June. This is undisputed in the case of monthly data. We are already looking forward to June with excitement, because that is when the new *staff projections* will be published. At the end of 2023, we forecasted very few interest rate cuts in 2024 (three or four) and also pointed out that cutting too early could be more damaging. APP and PEPP have been discussed thematically, QT is in full swing and will gain further momentum in the second half of the year. We continue to expect that there will be a greater focus on interest rate cuts both in the internal discussion and in terms of questions at the press conference. The question now arises as to whether the ECB would really act before the Fed. This would mean that the US currency area would become more attractive in terms of interest rates, which in turn would have a direct impact on the exchange rate.

Conclusion and outlook

A lot has happened since the last meeting of the ECB Council. The ECB decided on changes to the monetary policy framework on March 13. According to the ECB, these changes would impact how central bank liquidity is provided given that excess liquidity in the banking system remains significant but will be gradually declining in the coming years. The framework for action is intended to control short-term money market rates so that they are closely aligned with the monetary policy decisions of the ECB Council. The review of the framework for action was already announced in December 2022 to ensure that it continued to be appropriate in the context of the Eurosystem’s balance sheet normalization. We have tried to classify this for our readers in the appropriate sections above. Furthermore, at the moment we would like to shed more light on the implicit interest rate probabilities and their “alignment” with reality. We continue to believe that a first step in June (-25bp) would be the highest of emotions; the door is more than a little open for this. Everyone also agrees for the April meeting: Another pause in interest rates is clearly to be expected. The wait-and-see attitude of the central bankers actually brings a number of advantages. Against the background of a meeting-by-meeting approach, discourse is once again the most effective means. We are already looking forward to the meeting in June with great interest, as that is when the new *staff projections* will be announced, which always contains a certain “explosiveness”. These have gained even more weight, as everyone is now looking for the first data-dependent interest rate cut around the middle of the year. This would actually come before the Fed and would cause new implications – the US economic area would become (even) more attractive due to the increasing interest rate differential, which in turn would have new implications for the exchange rate due to capital flows. These would generally not be desirable as they could harm the local economy. This is not within the mandate of the ECB; who is solely committed to the inflation target. That is why we are asking ourselves the question of today: Does the early bird catch the worm? This does not always have to be the case with interest rate cuts. Does the second mouse always snatch the cheese? The second-round effects will show this as the economy, interest rate landscape, geopolitics, etc. gradually unfold.

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 Q4/2023] (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 – Canadian Provinces & Territories 2024]

[Issuer Guide – European Supranationals 2023]

[Issuer Guide – French Agencies 2023]

[Issuer Guide – Dutch Agencies 2023]

[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: The council thinks game-by-game]

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