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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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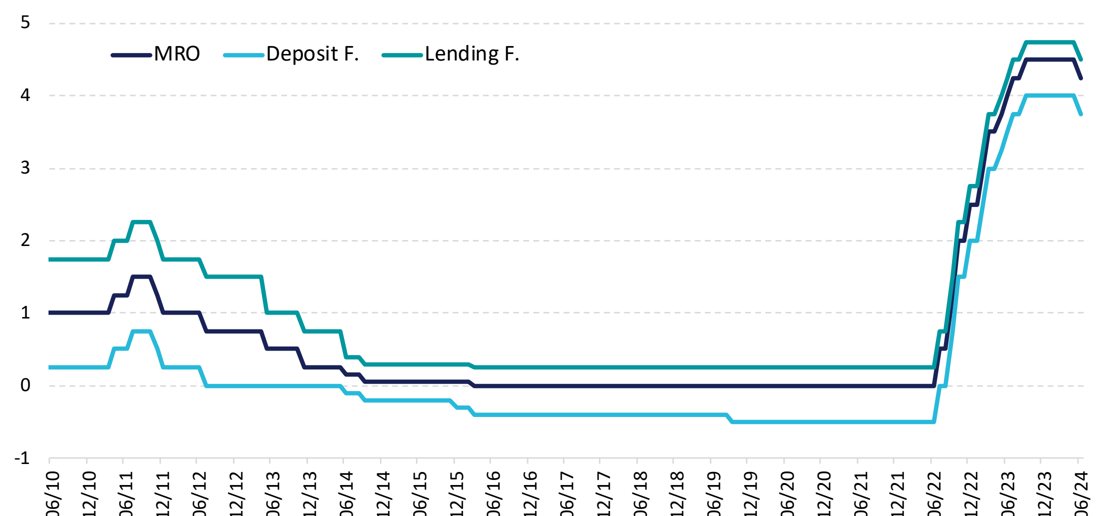
Decision day: One swallow does not make an ECB summer!

Authors: Dr Norman Rudschuck, CIIA // Christian Ilchmann // Lukas-Finn Frese

ECB key interest rate decision: About the summer of interest rate cuts that shouldn't be

In the past few days, the current key interest rate decision has been talked about from various directions. Despite all the (media-evoked) forward guidance, the decision-makers at the European Central Bank (ECB) probably did not have much room for maneuver this Thursday without building up a credibility mortgage: all three key interest rates were fine-tuned downwards. The interest rate for the main refinancing operations was reduced to 4.25%, and the interest rates for the marginal lending facility (4.50%) and the deposit facility (3.75%) were each reduced by 25bp to the same extent. The associated press release points out that, in the Council's opinion, the key interest rates were at a level for a sufficiently long time that made a significant contribution to stabilizing the price level. The highest escalation level of restrictiveness to date can now be abandoned. For the historiographers it should also be noted: Today it became historic. Never in its almost 26-year history has the ECB cut interest rates before the Federal Reserve. Going forward, we see the Governing Council continuing to be faced with a dilemma: inflation vs. interest rate cuts. As in the fable alluded to in the title from around 500 BC., today's decision should not be understood as a sign of an (expansive) summer of key interest rate cuts. As a reminder: Because signs of the times were misinterpreted, Aesop's swallow fell dead from the sky and the young man froze without his protective cloak.

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



Source: ECB, Bloomberg, NORD/LB Floor Research

ECB statement: Well-known official haze

Updated assessment of the inflation outlook, dynamics of underlying inflation, strength of monetary policy transmission and the usual abundance of well-known ECB official haze. It is now appropriate to reduce the degree of monetary policy tightening, the ECB said in its press release. What makes you sit up and take notice, however, is the phrase separated in the latest version: “The Governing Council is not pre-committing to a particular rate path” or clearly spoken: No more (self-)enforced forward guidance!

ECB projections: Inflation data rises, interest rates fall, reporters and analysts jam

The adjusted ECB staff projections leave us slightly speechless. For the current year, the central bank's experts now expect an average inflation rate of 2.5% (previously: 2.3%). The figure for 2025 is now 2.2% after previously 2.0%. 2026 is sufficiently far away in the future and is still valued at 1.9%. However, the ECB sees inflation excluding energy and food at 2.8% in 2024 (previously: 2.6%), before declining to 2.2% in 2025 (previously: 2.1%) and to 2.0% in 2026 (previously: 2.0%). Disinflationary tendencies, as we were used to from past staff projections, are therefore – as of today – off the table for the first time. With regard to economic activity, we believe that the basic scenario is “soft landing”. The ECB experts adjusted their projection for 2024 slightly upwards to 0.9% (previously: 0.6%). For the following years 2025 and 2026, the central bank communicated a growth rate in economic output in the common currency area of 1.4% and 1.6% respectively (2025 so far: 1.5%; 2026 so far: 1.6%). After the ECB again adjusted the forecast for short-term economic performance slightly upwards for the current year and gently downwards for the coming year, we see the “soft landing” scenario confirmed.

Latest ECB projections for euro area growth and inflation (in %)*

	June 2024 projections		
	2024	**2025**	**2026**
Real GDP	0.9	1.4	1.6
HICP inflation	2.5	2.2	1.9

* Change versus previous year in %
Source: ECB, NORD/LB Floor Research

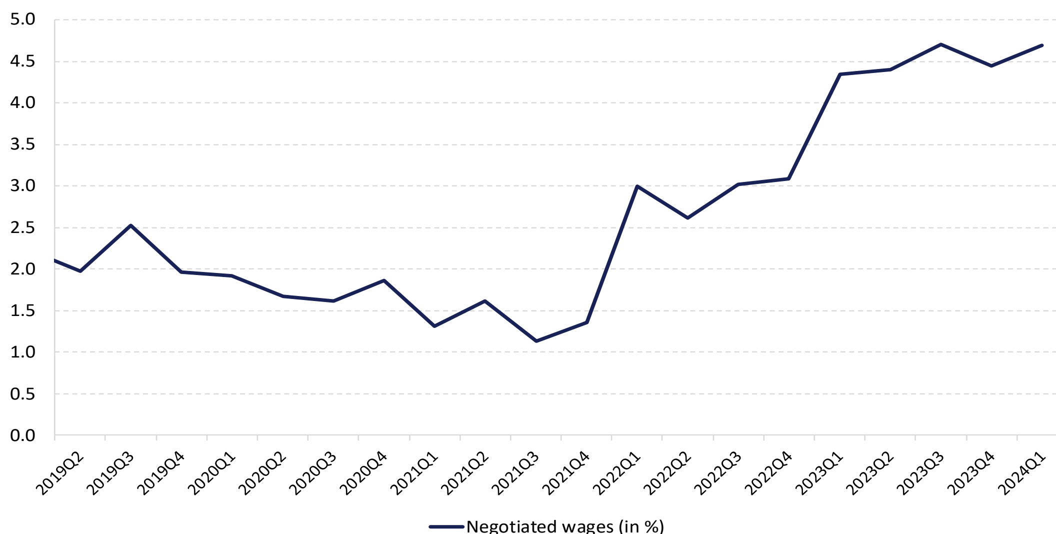
Press conference: Teflon-coated versus „I’m in charge“

As usual, “the markets” already had 30 minutes to digest the press release before President Lagarde appeared in front of the journalists. In initial reactions, the current key interest rate decision was classified as a “hawkish cut”. Afterwards, Lagarde was not tired of emphasizing that the ECB Council was not committing to a specific interest rate path for the future. The result: The market is no longer fully pricing in a further interest rate cut by the October meeting. Traders have an 84% chance of the ECB easing at that meeting, while the probability of a third rate cut by the end of the year is 44%. After the usual confident teleprompter presentation of Lagarde's press statement, the most obvious questions immediately followed: Why is the ECB cutting key interest rates when inflation projections have been raised? How does this fit with the data-based approach? The Teflon-coated ECB President then remained as vague as possible with an almost endless non-answer: Since the change in monetary policy in 2022, inflation rates have been halved. This was followed by the repeated, usual invocation of the ECB’s “data dependence” – a circular argument? However, Lagarde nuanced this by saying that the way in which the decision-makers analysed the data was particularly important. What the interest rate cut shows in any case is a change within the ECB itself: it has regained confidence in its own forecasting abilities. We also find it remarkable: today's key interest rate decision was made unanimously – with one exception. And in case there was still any confusion: Lagarde wore a necklace with the inscription “In Charge” when things were not going well with rhetorical clarity recently.

Negotiated wages development calls data-based approaches into question

An important indicator of the growth of wages and salaries in the Eurozone has not slowed down at the beginning of 2024. As can be seen from the data on the development of negotiated wages in the common currency area published on 23 May, they increased by +4.7% in the first quarter of the current year compared to the same period in the previous one. Growth was last this high in Q1/2023 (+4.5%) and a gradually weakening trend initially became apparent. However. there have recently been indications of an ongoing upward pressure from the German Bundesbank, which stated in its Monthly Report - May 2024 that wages in Europe's largest economy rose by +6.2% between January and March, primarily due to tax-free one-off payments. Nevertheless, ECB economists expect wage pressure in the euro area to decrease significantly over the year, as can be seen from a recent blog post: “Overall, negotiated wage growth is expected to remain elevated in 2024, which is in line with the persistence that has been factored into Eurosystem staff forecasts. [...] However, wage pressures look set to decelerate in 2024. ECB wage tracker data for the first few months of the year, when most agreements take place, indicate that negotiated wage pressures are moderating.” This assessment was also shared by François Villeroy de Galhau, who pointed out that nominal wages in all other major economies in the Eurozone declined. In this regard, the current data situation is not alarming for him. In our opinion, the available figures on the development of negotiated wages in the Eurozone presented the ECB with a dilemma today: in the context of a data-based approach, interest rate cuts seemed rather implausible in view of these data, as President Lagarde has referred too often in the past to the need for a weakening wage growth as a prerequisite for interest rate cuts. On the other hand, the opinions from the ECB environment in the past few weeks and months simply pointed too strongly towards a guaranteed cut today for this to happen. In our opinion, the ECB has therefore moved away from its data-based approach to some extent with today's decision. To what degree and how significantly their credibility could suffer in the future remains to be seen.

Development of negotiated wages in the Eurozone (in %)



Source: ECB, NORD/LB Floor Research

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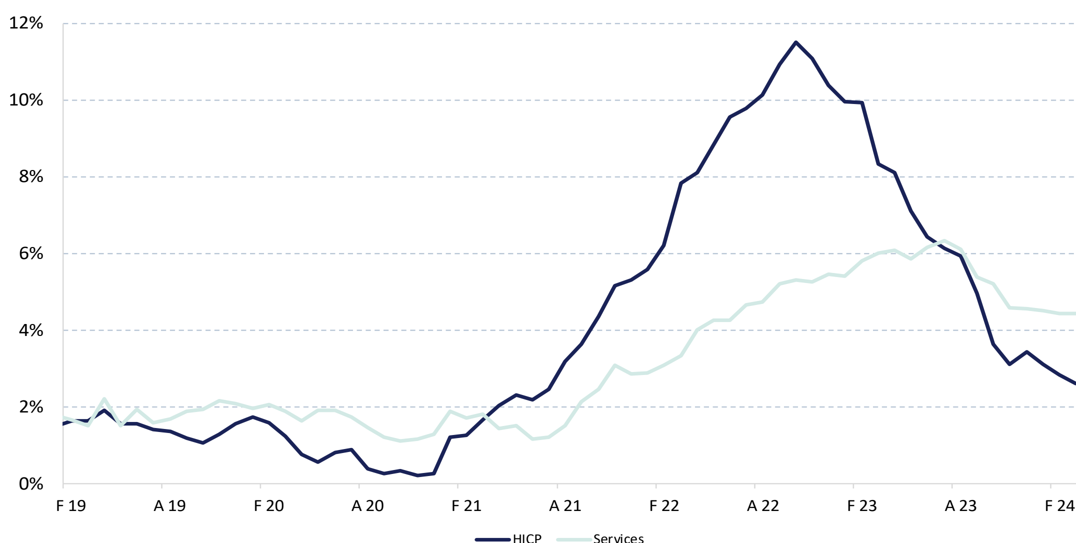
Is the ECB itself acting as an inflation driver?

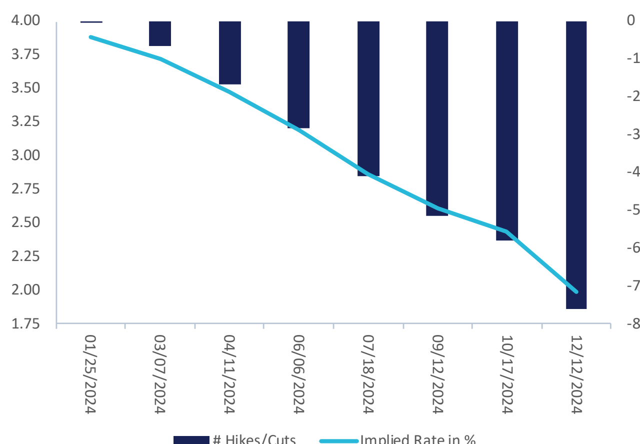
The development of inflation will obviously be of crucial importance as to whether or how many interest rate hikes we will see in the further course of the year. As has often been the case in the past, Christine Lagarde once again tried to distinguish between “HICP inflation” and “core inflation”, i.e. excluding prices for energy and food – which we believe is only partially appropriate. Now that energy prices have now somewhat returned to normal, there is a threat of trouble from another direction and so cannot necessarily have been an argument in favour of cutting interest rates if the ECB were to pay attention to the change in service prices. While HICP inflation has fallen steadily from its peak (11.5% Y/Y) in October 2022 and was just shy of the magic ECB inflation target of 2% in March, the price index for services continued to rise until August 2023 (6.4% Y/Y). Since then, the growth rate of the latter has been consistently above that of the consumer price index and has (comparatively) fallen significantly more slowly. When the ECB reached interest rate peaks last year, it also caused a significant deterioration in financing conditions, both for (commercial) investments and for real estate. With the key interest rates, loan interest rates also rose, which increased the costs of financing your own home by an average of around 40%. This resulted in a decline in demand on the real estate market, which in turn initially led to falling prices. According to market studies, these fell by an average of around 10% nationwide last year alone. In the meantime, a trend reversal is becoming apparent: in the first quarter of this year, house prices rose in 14 of the 15 largest cities in the Federal Republic. The reason for the price increase is once again the ECB's interest rate policy. While rising interest rates were responsible for falling prices, it is now the prospect of (further) falling interest rates. These are also passed on to the loan market for real estate financing. When financing becomes cheaper again, demand increases and so do prices. Mutatis mutandis, the above also applies to commercial investments. If financing costs rise there, either investment demand falls and/or higher investment costs are passed on to consumers in the form of higher end-user prices. In both cases the following applies: the inflation screw continues to turn.

Growth rates of HICP versus Services Price Index

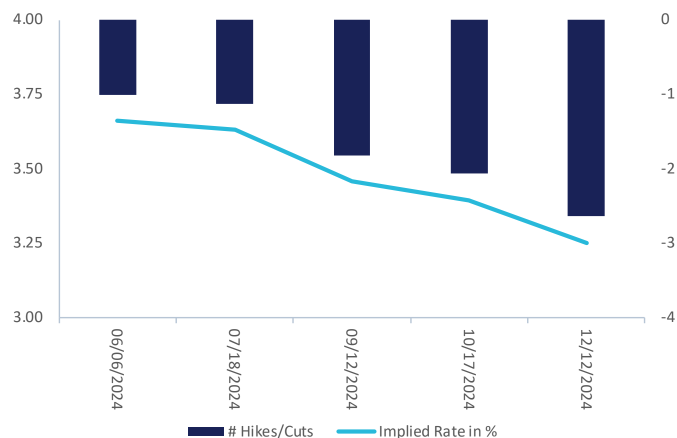


Source: Eurostat, NORD/LB Floor Research

Implied Overnight Rate 12/27/2023



Implied Overnight Rate 06/06/2024



Source: Bloomberg, NORD/LB Floor Research

Conclusion and outlook

Something historic had been in the offing beforehand and that is what ultimately happened: with the first interest rate cut in the Eurozone since 2019 and at the same time the very first before the Fed, the ECB has demonstrated the courage we invoked in our preview of today's meeting. But courage could also have unwanted side effects. The data-based meeting-by-meeting approach, which has been preached with great credibility for a long time, is a thing of the past for now, as the latest data indicates anything but an easing of monetary policy, as the ECB heralded with its decision today. As we have been predicting for some time now, our eyes are inevitably turning to the second half of the year. While at the beginning of the year the majority of market participants expected a veritable avalanche of interest rate cuts, given the current situation, a maximum of two further easing steps seems likely. However, we expect restraint at the next meeting on 18 July. The next interest rate cut in September appears much more realistic, when new staff projections will again be available to the ECB. As we all know, one swallow does not make a summer... The phrase has its origins in the fable "The Wasteful Youth and the Swallow" by the ancient Greek poet Aesop and therefore in the animal kingdom in the broadest sense. As we know, the swallow is a migratory bird. This means that it lives in different places depending on the season. Swallows overwinter in Africa or other warm areas of the world and return to us in spring. However, if a single swallow returns, this does not mean anything about the change of seasons. So it happened that the spendthrift youth also sold his coat when he saw the first swallow return home. But then it froze again, so that the swallow froze to death and the freezing spendthrift angrily complained about the swallow. In this respect, all market participants should act prudently and from today assume that nothing will happen in July and that September has at most a high probability that a second step will follow.

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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 2024

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

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

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Origination Corporates	+49 511 361-2911

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Asset Finance	+49 511 361-8150

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