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MONETARY POLICY OUTLOOK

August 2024

Switzerland

Following the surprises of the last two meetings, the monetary policy assessment in September could also bring unexpected developments, as a rate cut of 50 bps is on the cards. The decisive factor will be whether the monetary policy framework justifies such a move and whether Thomas Jordan will support this striking decision shortly before his resignation.

The interest rate swap curve has fallen further this month, with rates for maturities of one year or more shifting almost in parallel by around 15 bps (Figure 1). This means that a normalisation of the yield curve is moving further into the distance.

This downward movement in swap rates is clearly due to growing expectations of potential interest rate cuts (Figure 2). These expectations have not only led to a decline in interest rates for short-term maturities, such as two-year maturities, for around a year, but have also spread to longer maturities of up to ten years. There is therefore only further scope for lower long-term interest rates if the SNB eases more than the market currently expects.

It can be deduced from the intra-year swap rates that cumulative interest rate cuts of around 65 bps have already been priced in for the next twelve months, or over the next four meetings, with 30 bps being attributed to the next meeting. Some market participants are therefore hedging against a possible interest rate cut of half a percentage point in September and are not ruling out a more aggressive approach by the SNB.

The SNB began cutting interest rates at an early stage and acted pre-emptively. In view of its monetary policy orientation to date, such a move would be justified in September if the Swiss franc continues to appreciate and disinflation in Switzerland is unexpectedly stronger.

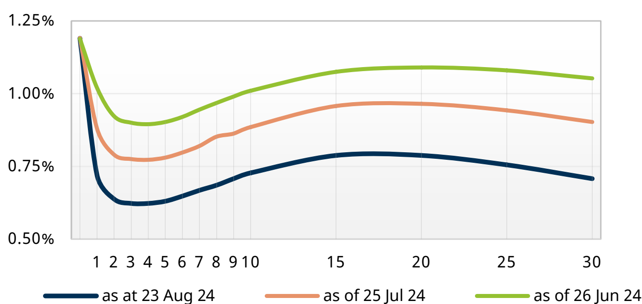
The SNB's latest inflation forecasts indicate that an inflation path close to 1.0% is considered sufficient (Figure 3). The inflation data for July already support the case for a rate cut. If disinflation increases further in the coming data, particularly in August, a rate cut of 50 bps could become likely.

The forthcoming interest rate cuts by the Fed and fears of recession in the US are likely to put further pressure on the Swiss franc. The SNB will probably continue to intervene in the event of short-term exchange rate fluctuations but will not make any large-scale foreign currency purchases in the current interest rate environment, as it has done since the financial crisis (Figure 4). As the key interest rate has not yet reached the lower limit, the SNB will continue to use the interest rate instrument and widen the interest rate differential in order to counteract the upward pressure. In this context, an interest rate hike of 50 bps may become necessary under certain circumstances.

Our expectation

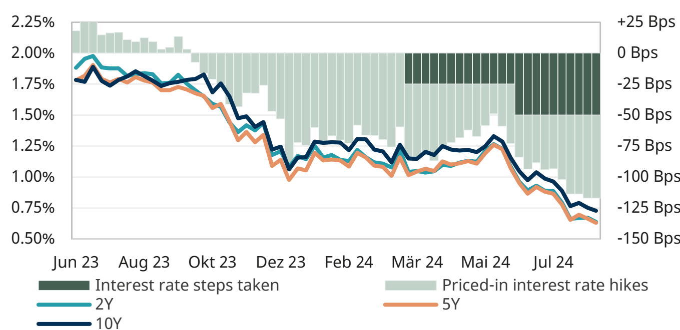
We now expect a rate cut of 25 bps in each of the next three meetings as a base scenario. If the Swiss franc continues to strengthen and the inflation data for August is clearly positive, this could pave the way for a rate cut of 50 bps in September. In this scenario, lower long-term interest rates are to be expected.

Figure 1: Swap curve



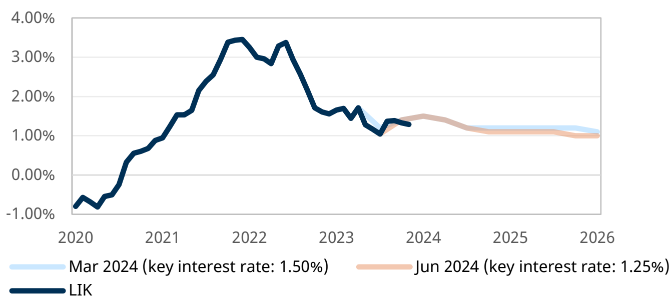
Note: The swap curves serve as a graphical representation of the underlying interest rate structure on the Swiss swap market. The respective swap rates as at the reporting date for the different maturities (in years) together form the swap curve.
Source: Data from Refinitiv Eikon, 26/08/2024

Figure 2: Long-term market interest rates and priced-in interest rate hikes for the next four meetings



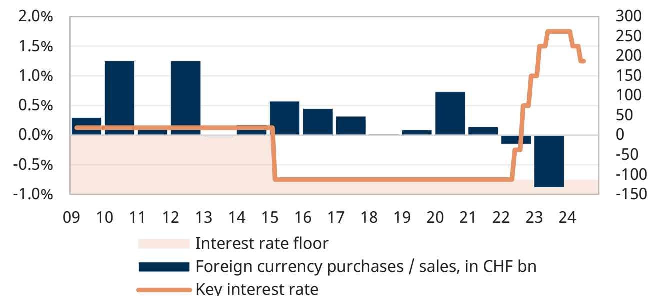
Note: The chart shows the historical development of swap interest rates for maturities of 2, 5 and 10 years as well as the interest rate moves that have already taken place and those priced in for the next four meetings from the monetary policy assessment of 22 June 2023, when the SNB policy rate was last raised from 1.50% to 1.75%.
Source: Data from Refinitiv Eikon, 26/08/2024

Figure 3: SNB inflation forecast



Note: The chart shows the current development of inflation and at the same time depicts the SNB's inflation forecasts as they were at the time of the last monetary policy assessment. These forecasts are based, among other things, on the assumption that the key interest rate will remain unchanged over the entire forecast period of three years.
Source: Data from SNB, BfS, as at 26/08/2024

Figure 4: SNB foreign exchange market interventions



Note: The chart shows the SNB's net foreign exchange purchases and sales in CHF bn carried out in the respective year, as well as the development of the key interest rate and the interest rate floor. The interest rate floor marks the level below which the SNB cannot lower the key interest rate any further, as this would jeopardise the efficiency of monetary policy. Data up to the end of Q1 2024.
Source: Data from SNB, 26/08/2024

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International

Jerome Powell announced at the economic symposium in Jackson Hole that the time has come for interest rate cuts. While the upside risk of inflation has decreased, the downside risk in the labour market has increased. A further weakening of the labour market will not be tolerated by the Fed, and it appears that the US economy has already approached this critical threshold.

The monetary policy of central banks worldwide, now including the Fed, is now largely coordinated and the phase of disinflation favours a further easing of interest rate policy (Figure 5).

Another instrument, quantitative tightening (QT), which has been used by several central banks in parallel with interest rate hikes since around mid-2022, has so far brought additional restrictiveness to the financial system without disrupting the money markets and remains in force (Figure 6). Although QT and interest rate cuts work through different channels, in principle they have opposing effects. With the Fed's transition to a phase of interest rate cuts, the QT programme is also likely to come to an end in an orderly process in the foreseeable future, with the meeting in September possibly providing the first indications of this.

Despite the latest revision, the development of employment on the US labour market over the last twelve months can be classified as robust. The official estimate for total employment in the period from April 2023 to March 2024 was revised downwards by 818,000. This adjustment represents a downward revision of around 0.50% and means that monthly employment gains averaged around 174,000 compared to the previously reported 242,000. Despite this significant revision, employment growth remains stronger than before the pandemic. However, an adjustment of this magnitude was more or less expected, as the underlying model tends to either underestimate or overestimate the situation in volatile economic cycles (Figure 7).

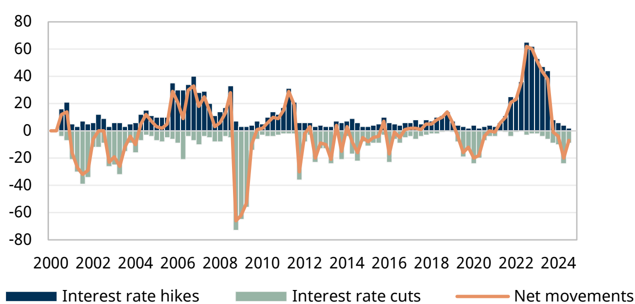
Nevertheless, there are many signs that the labour market is cooling and there are increasing signs of weakness. Negative data could prompt the Fed to act more quickly and decisively. Inflationary pressure, which has eased significantly according to the latest data and estimates from the Fed minutes of the July meeting, is now likely to play only a minor role.

It will be interesting to see whether the Fed can actually achieve an economic soft landing and avoid a recession. A strong sign of an impending recession is the inverted yield curve. This indicator has been a reliable harbinger of recession in nine out of ten cases in the last 70 years (Figure 8).

Our expectation

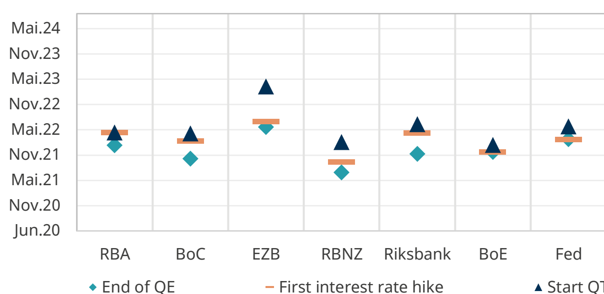
Interest rate cuts of between 25 and 50 bps are on the cards for the Fed. Jerome Powell's announcement in Jackson Hole served as forward guidance, which would otherwise have been necessary in September in order to avoid surprises. However, given the current level of interest rates, the effect of a rate cut of 25 bps will be small, which is why we believe a more decisive approach by the Fed with a rate cut of 50 bps is more likely.

Figure 5: Global interest rate policy



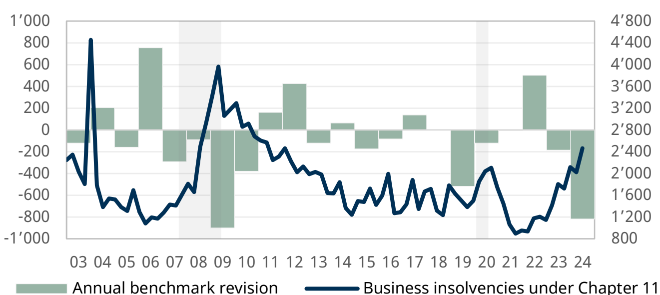
Note: The chart shows the number of key interest rate changes - both increases and decreases - made by the central banks of OECD member states on a quarterly basis.
Source: Data from Refinitiv Eikon, as at 26/08/2024

Figure 6: Global quantitative tightening (QT)



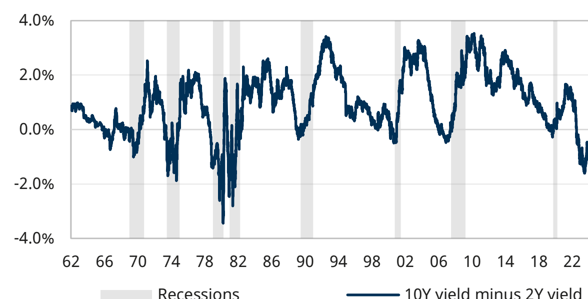
Note: The chart shows the dates on which the central banks shown ended their QE programme, initiated the first interest rate hike and started to reduce their balance sheet as part of QT. RBA (Central Bank of Australia), BoC (Central Bank of Canada), RBNZ (Central Bank of New Zealand), Riksbank (Swedish Riksbank), BoE (Bank of England).
Source: Data from the respective official websites, as at 26/08/2024

Figure 7: Revision of US employment figures



Note: The Bureau of Labor Statistics model shows strong deviations in volatile economic phases, but provides accurate estimates during quiet periods. The right axis shows the extent of the revision. The left axis shows the number of insolvencies. The grey areas indicate recessions.
Source: Data from Bureau of Labor Statistics, Refinitiv Eikon, as at 26/08/2024

Figure 8: Inverse US yield curve as an indicator of an impending recession



Note: An inverted US yield curve is seen as a harbinger of an impending recession.
Source: Data from Fred, as at 26/08/2024

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