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MONETARY POLICY OUTLOOK

December 2024

Switzerland

Martin Schlegel surprises in his first monetary policy assessment as SNB Chairman: the key interest rate is lowered by 50 bps, accompanied by a lower conditional inflation forecast. Schlegel had already signalled that negative interest rates could not be ruled out in the future - now comes the first major step in this direction.

In its new conditional inflation forecast, the SNB expects the inflation rate to fall to 0.20% in the coming year despite a key interest rate of 0.50% (Figure 1). Although the SNB does not yet officially anticipate negative inflation, further interest rate cuts seem likely next year in view of the low inflation expectations.

Today's interest rate cut has weakened the Swiss franc against the euro and should give export-oriented companies a boost. Despite what at first glance appears to be solid and growing foreign trade, Swiss exports are under pressure, primarily due to weakening sales markets in neighbouring countries. While chemical and pharmaceutical products, which account for more than half of exports, are largely independent of economic cycles and their demand reacts inelastically to the appreciation of the Swiss franc, other industries are struggling with weaker demand and the burdens of a strong domestic currency (Figure 2).

However, the Swiss franc is unlikely to depreciate significantly as a result of the interest rate cut alone. The SNB had already started to cut key interest rates in March and widened the gap to euro interest rates. Nevertheless, the Swiss franc continued to appreciate (Figure 3). This suggests that other factors, such as the franc's function as a safe haven, are overshadowing the effect of the higher interest rate differential. In the current global macroeconomic environment, the interest rate differential alone therefore only appears to reduce the attractiveness of the Swiss franc to a limited extent.

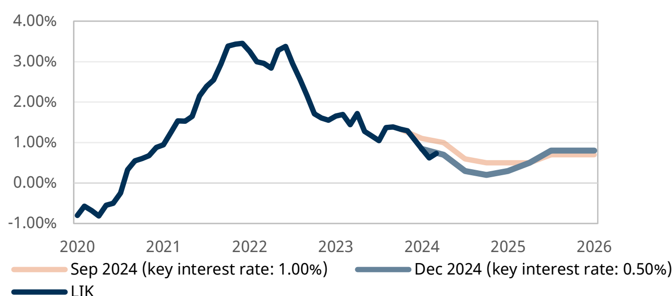
Based on this observation, systematic foreign exchange interventions through the sale of the domestic currency could be an effective instrument. However, they are most effective when the room for manoeuvre for interest rate cuts has been exhausted and the key interest rate is at the effective lower limit. Based on current practice, this is technically -0.75% (Figure 4). However, it is conceivable that the SNB will begin targeted interventions before this limit is reached.

Swiss monetary policy in the coming year will mainly be determined by inflation and the development of the Swiss franc. If the upward pressure on the Swiss franc persists and the deflationary trend continues, further cuts in the SNB's key interest rate may become unavoidable. At the same time, monetary policy discussions are likely to focus more on currency interventions.

Our expectation

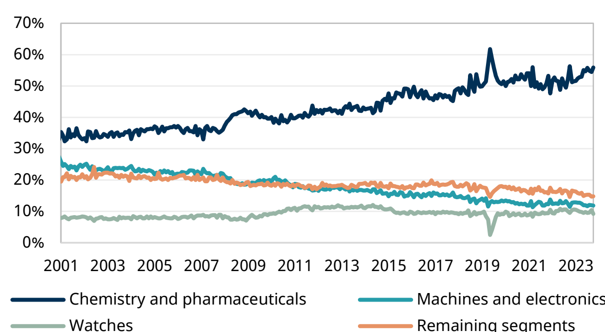
In our base scenario, we expect two further interest rate cuts of 25 bps each in the March and June meetings, which would lead to a key interest rate of 0% as early as June. However, we do not rule out another sharp cut of 50 bps in March.

Figure 1: New SNB inflation forecast



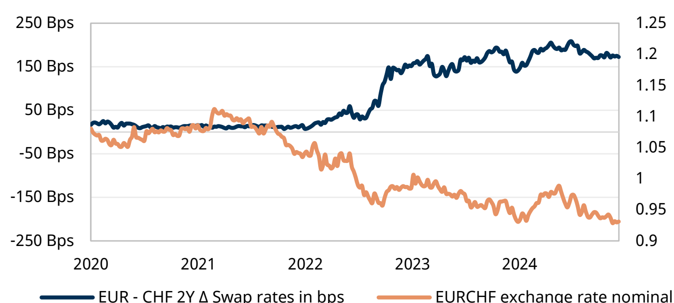
Note: The chart shows the current development of inflation and at the same time depicts the SNB's inflation forecasts as they were made at the time of the last monetary policy assessment. These forecasts are based, among other things, on the assumption that the key interest rate will remain unchanged over the entire forecast period of three years.
Source: Data from SNB, BfS, 12.12.2024

Figure 2: Swiss foreign trade by goods



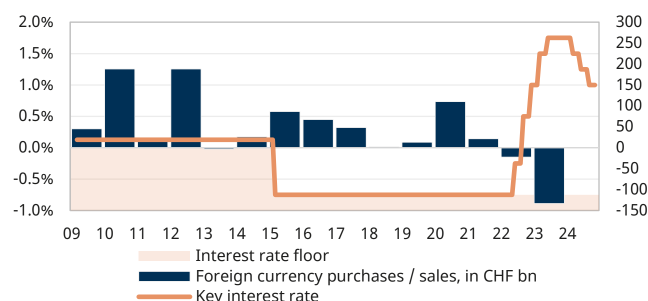
Note: The chart shows the historical development of the percentage share of the respective product group in total exports in nominal CHF amounts. The remaining product group includes precision instruments, metals, vehicles and textiles, clothing and shoes.
Source: Data from SNB, as at 12.12.2024

Figure 3: Nominal EURCHF exchange rate and 2Y swap difference



Note: The chart shows the historical development of the nominal CHF/EUR exchange rate and the difference in 2-year swap rates between ESTR and SARON in basis points.
Source: Data from Refinitiv Eikon, 12/12/2024

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.
Source: Data from SNB, as at 12.12.2024

International

The ECB has cut the deposit rate again by 25 bps for the fourth time, bringing it to 3.00%. Swap rates pricing in an interest rate of 1.60% for the end of 2025 show that we are less than halfway there. In view of current developments, the ECB is likely to maintain its pace for the time being and possibly even increase it.

The problems for the European Union are piling up. Events in the political landscape, particularly in France, are making themselves felt on the financial markets. For example, long-term French bonds have been trading at the same price as Spanish bonds for several months and even more favourably than Spanish bonds for several weeks (Figure 5).

Many European member states, above all France, have not yet been able to reduce the considerable budget deficits caused by the expansive fiscal policy during the pandemic (Figure 6). The EU's 3% deficit limit, which was suspended during the pandemic, has applied again since 2024. In addition to Romania, which has been under an excessive deficit procedure since 2019, an excessive deficit procedure was initiated against seven other member states, including Italy and France, in the summer. The consolidation plans include tax increases and extensive spending cuts. While Italy is already aiming to significantly reduce its deficit this year and could be back below the 3% limit by 2026, France is unlikely to reach this target before 2029.

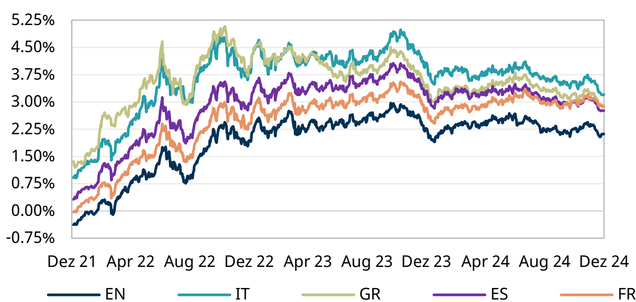
Although a more restrictive fiscal policy is necessary in the countries affected in order to ensure sustainable budget management in the long term, it is putting additional pressure on the economy - and at a time when the European economy urgently needs growth stimuli. Although economic growth in the eurozone rose slightly in the third quarter of this year to an annualised rate of 1.64% for the first time since the third quarter of 2022 (Figure 7), the outlook remains subdued and growth forecasts were revised downwards at the December meeting. Greater monetary easing could provide important stimulus, which is why the ECB is likely to stick to its course in the coming year and even increase the pace if the inflation situation allows.

The inflation figures in the US have turned out as expected and almost certainly confirm a third rate cut of 25 bps at next week's Fed meeting. However, the disinflationary process is slowing, while some components, notably housing costs, remain stubbornly high (Figure 8). This poses a substantial upside risk to inflation and could prompt the Fed to slow the pace of further rate cuts in the coming year.

Our expectation

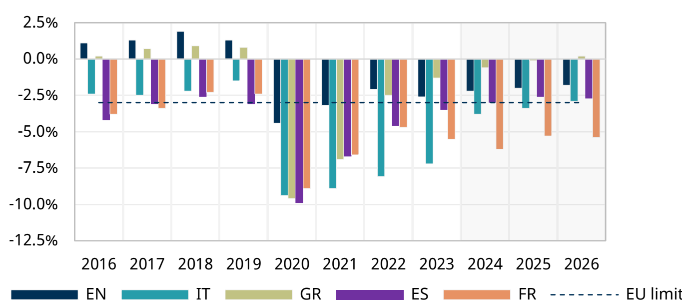
We expect the Fed to cut the key interest rate by 25 bps next week. For the ECB, we expect at least three further rate cuts of 25 bps each in the coming year.

Figure 5: 10-year bond yields of EU member state bonds



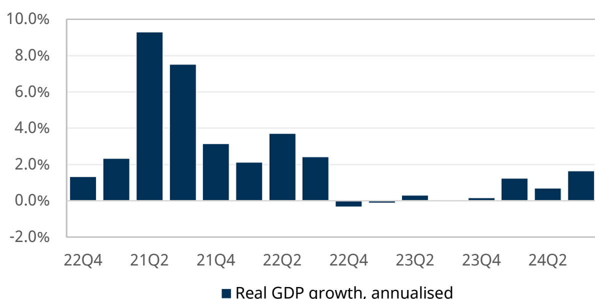
Note: The chart shows the bond yields of 10-year government bonds of European member states.
Source: Data from Refinitiv Eikon, as at 12.12.2024

Figure 6: Budget balance of the EU member states in % of GDP



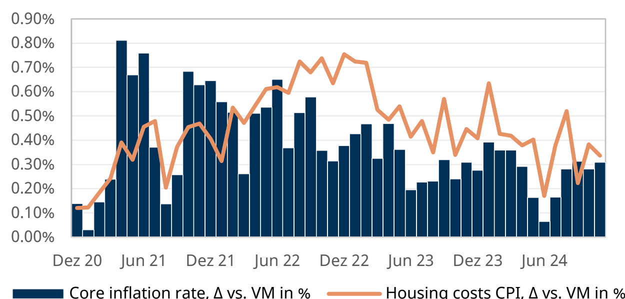
Note: The chart shows the percentage share of the government budget balance in relation to the GDP of the European member states. The values from 2024 onwards are based on the forecasts of the European Commission.
Source: Data from Eurostat, European Commission, as at 12/12/2024

Figure 7: Economic growth in the eurozone



Note: The chart shows real GDP growth on a quarterly basis with annualised growth rates.
Source: Data from Fred, as at 12/12/2024

Figure 8: US core inflation rate and housing costs



Note: The chart shows the monthly rate of change in core inflation and the housing cost component.
Source: Data from Fred, as at 12/12/2024

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Status: 12 December 2024

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