Switzerland

The SNB's first monetary policy assessment of the year is approaching and another surprise decision cannot be ruled out. Since the December meeting, expectations on the interest rate market for further interest rate cuts have eased somewhat, while negative interest rates are no longer an issue for the time being. A further interest rate cut is obvious, but the SNB could still act cautiously and pause.

Overall inflation in Switzerland fell to 0.40% in January, reaching a new low (Figure 1). This development was largely in line with expectations and is in line with the SNB's forecast. Despite a supposed rise in the core inflation rate, price pressure remains low: month-on-month, core inflation is slightly negative and the increase is primarily due to base effects (Figure 2). There are therefore no signs of a turnaround in inflation - on the contrary, inflation is continuing to move towards zero. Inflation could already be at 0% or even in negative territory in the February data.

Against this backdrop, there are many arguments in favour of a further interest rate cut. Nevertheless, the SNB could tolerate temporarily low inflation as long as it remains within the target range in the medium term. In this case, a wait-and-see approach would be conceivable in order to preserve monetary policy room for manoeuvre for later interventions. Recent statements by SNB representatives at least indicate that such a strategy is not out of the question. This caution is also reflected in market expectations: forecasts for monetary easing have been scaled back for this year (Figure 3), while the interest rate swap curve has steepened significantly compared to previous months (Figure 4).

The current yield curve allows for various interpretations. However, the most plausible assumption seems to be that market participants are anticipating an economic upturn in Switzerland and a possible increase in inflation. This would reduce the pressure on the SNB to respond with further interest rate cuts, which explains the recently subdued expectations of monetary easing.

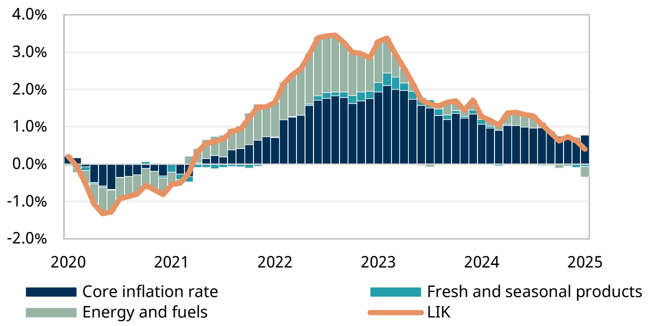
According to rapid estimates, the Swiss economy grew by 0.80% in 2024, falling short of the previous year. However, it is resilient compared to the rest of Europe. A moderate recovery is expected for 2025, driven by solid consumption and growing pharmaceutical exports. At the same time, the MEM industries remain under pressure, not least due to US tariffs under Trump, which are already indirectly impacting Swiss exports. The pharmaceutical industry could also come under pressure from potential trade barriers, as the US is a key sales market.

Despite these risks, the economy should remain stable overall, albeit with limited growth. Innovation, structural adjustments and the expansion of trade relations are essential in order to remain competitive. Further monetary easing could also provide additional economic stimulus.

Our expectation

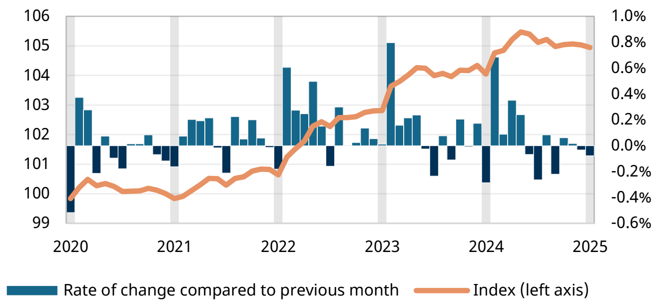
We expect a further significant fall in inflation in February and consider a key interest rate cut of 25 bps to be the most likely scenario. However, a decision by the SNB to pause for the time being would not be surprising either.

Figure 1: The national consumer price index (CPI)



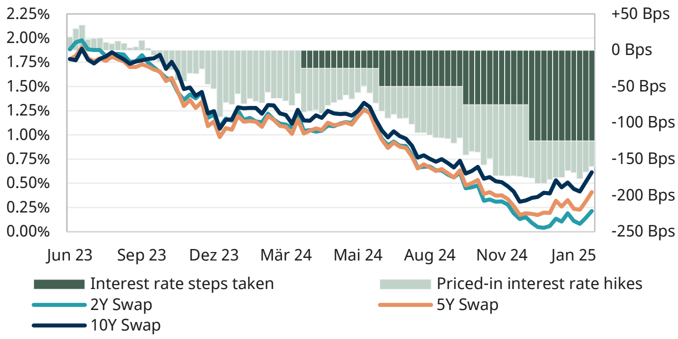
Note: The chart shows the development of the national consumer price index (CPI) as well as the contributions of the core inflation rate and the volatile components to the year-on-year change.
Source: Data from BfS

Figure 2: Core inflation rate



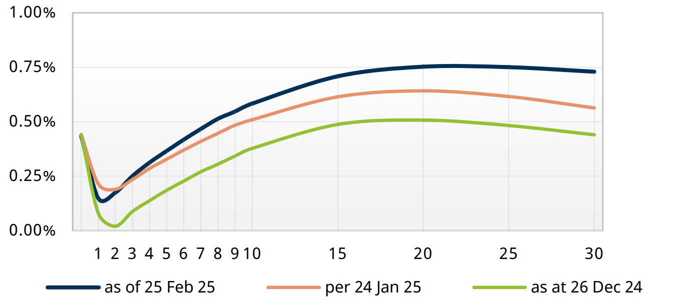
Note: The chart shows the core inflation rate, indexed to 100 in January 2020, as well as the percentage change compared to the previous month. The respective months of the previous year are marked in grey.
Source: Data from BfS

Figure 3: Long-term swap interest rates and priced-in interest rate steps 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

Figure 4: Swap curves vs. SARON



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

International

As we expected, the Fed is adopting a wait-and-see approach and is postponing further interest rate cuts for the time being in view of ongoing inflation concerns. The ECB, on the other hand, lowered the deposit rate by 25 bps to 2.75% at its January meeting. While the anchoring of long-term inflation expectations could become a challenge in the USA under the economic policy of the new Trump administration, a pause in monetary easing is also likely to be increasingly discussed within the ECB.

For monetary policy to be effective, it is crucial that market participants' inflation expectations remain stable at the desired level. If they deviate from this, the credibility of the central bank suffers, which could raise doubts about its ability to control inflation in the medium and long term. In extreme cases, this could necessitate more restrictive measures. In addition, rising inflation expectations harbour the risk of a self-fulfilling prophecy, which further increases price pressure if companies adjust their prices pre-emptively and consumers accelerate their spending in order to avoid future losses in purchasing power.

Certain indicators suggest that the Trump administration's economic policy, in particular tax cuts and tariffs, has already led to an increase in inflation expectations. The inflation expectations surveyed by the University of Michigan for one and five years show a significant increase (Figure 5). Market-implicit inflation expectations, on the other hand, have risen only slightly but remain at a high level (Figure 6), which indicates a tense but not out-of-control monetary policy situation. The Fed can and should therefore hold off on further easing, especially as the labour market remains solid.

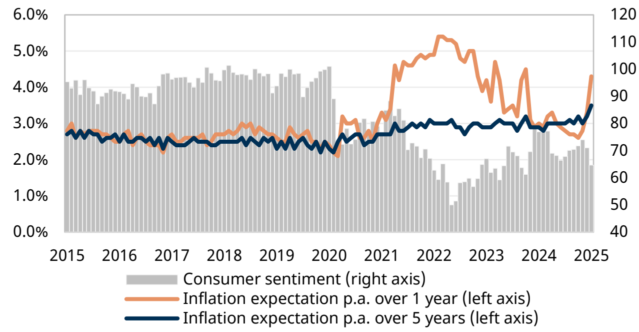
An ECB wage indicator, which measures negotiated wages, recorded a smaller increase in the fourth quarter of last year compared to the previous quarter (Figure 7). The disinflation process in the eurozone is thus continuing - albeit slowly - and should enable the ECB to cut financing costs by a further 25 bps in the coming week, which is already fully priced into the interest rate market (Figure 8).

Nevertheless, wage increases remain high enough to provide strong arguments in favour of further monetary easing not being a matter of course. This is increasingly focussing the discussion on the timing of a possible interest rate pause. Currently, key interest rate cuts of around 80 bps are being priced in until the end of the year.

Our expectation

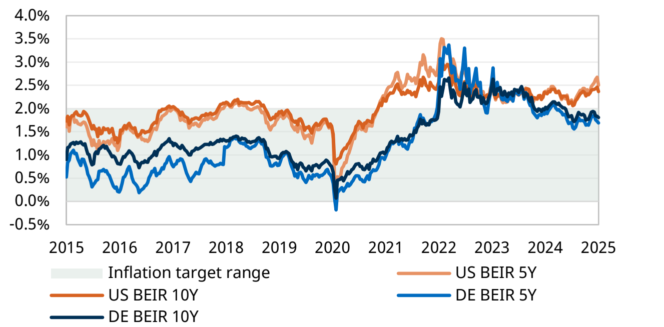
We expect the ECB to cut the key interest rate by 25 bps at its meeting next week, followed by a further rate cut before taking a pause in view of increased inflation risks. If the indicators for wage growth in the coming months do not impair the disinflation process, we believe a further interest rate cut is possible. We continue to expect the Fed to pause interest rates until the summer.

Figure 5: Inflation expectations based on survey data



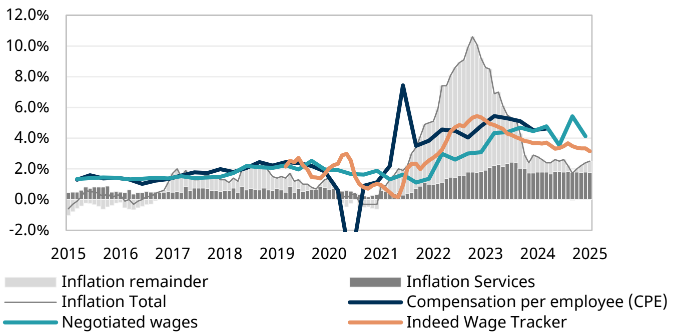
Note: The chart shows the results of the University of Michigan's monthly surveys on inflation expectations and consumer sentiment.
Source: Data from University of Michigan, Refinitiv Eikon

Figure 6: Market-implied inflation expectations



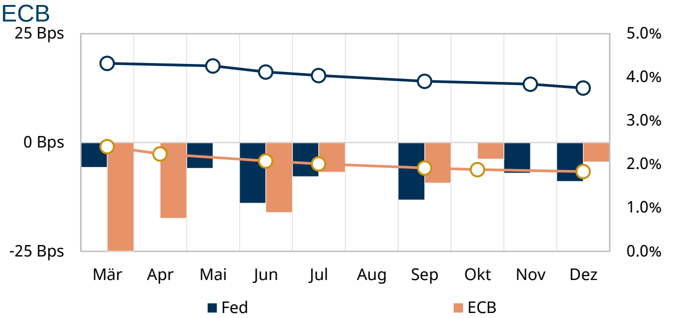
Note: The chart includes the historical development of the break-even inflation rate (BEIR) for the USA and Germany. The BEIR is defined as the yield differential between government bonds and inflation-linked bonds (ILB) with the same maturities. The BEIR can be interpreted as a market-implied inflation expectation.

Figure 7: Wage growth rates vs. inflation



Note: The chart shows the inflation rate, broken down into services and the rest, and the development of various indicators for monitoring wage trends in the eurozone.
Source: ECB Data Portal, GitHub

Figure 8: Market-implied key interest rate developments Fed & ECB



Note: The chart shows the market-implied development for the key interest rates of the Fed and ECB (right axis). These are derived from Fed Funds futures and overnight index swaps. The left axis shows the implied interest rate adjustments (in basis points) in the respective month in which a monetary policy meeting is scheduled.
Source: Refinitiv Eikon

CONTACT

Burak Er, CFA
Head Research

Avobis Advisory AG
Brandschenkestrasse 38
8001 Zurich

T: +41 58 255 49 09
burak.er@avobis.ch