Switzerland

The Swiss interest rate swap curve has recorded a surprising decline across all maturities in recent weeks (Figure 1). This can primarily be explained by the fact that a greater easing of monetary policy is now being priced in than was the case until the previous month. A SARON rate of 0.78% is currently being priced in after the March meeting next year, which is in stark contrast to the forecasts of economists, the majority of whom expect a key interest rate of 1.0% until next year according to Bloomberg surveys (Figure 2).

The argument in favour of a key interest rate of 1.0% is based on the concept of the neutral interest rate, which is regarded as an important reference point for the formulation of monetary policy. Many economists share the view that the neutral interest rate is 0.0%. With a longer-term inflation expectation of 1.0%, this results in a nominal neutral interest rate of 1.0%. At this level, saving and investment would be in equilibrium, meaning that the economy would neither overheat nor slow down.

Structural factors have pointed to a downward trend in the neutral interest rate for decades. However, given the current macroeconomic environment, the question arises as to whether this interest rate could now be higher. This question is complex and not easy to answer, especially as the neutral rate is not directly observable. Due to its theoretical nature, there should be a constant interplay between the SNB and the market, in which the SNB continuously evaluates the impact of its interest rate adjustments and gradually moves closer to the actual neutral interest rate rather than locking in a fixed value. A constant cost-benefit analysis is crucial.

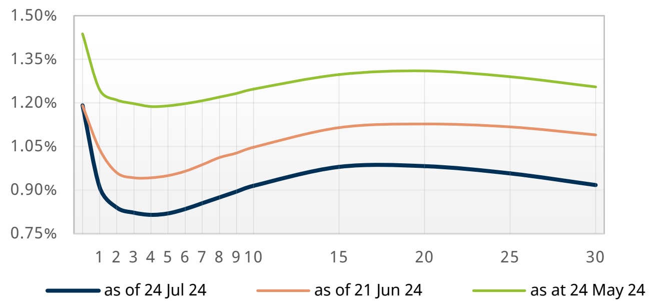
If the SNB overestimates the neutral interest rate and remains too restrictive, deflation, a strong franc and a dampening of economic activity will occur as side effects. The appropriate response to this would be to cut interest rates. If, on the other hand, the SNB cuts interest rates too sharply and underestimates the neutral interest rate, this would be accompanied by higher inflation, a weakening of the Swiss franc and overstimulation of the economy. In view of the prevailing economic weakness, the costs in the first scenario are greater than in the second, which is why the SNB may be inclined to cut rates further below 1.0%.

In the second quarter of this year, Swiss foreign trade performed extremely well, underlining Switzerland's global competitiveness (Figure 3). However, this success is under pressure from an appreciating Swiss franc. This pressure could increase again with the forthcoming easing of interest rate policy by the Fed and the ECB. As a countermeasure, the SNB could consider pre-emptive interest rate cuts. Should the franc depreciate too much as a result, a reaction with foreign currency sales would be conceivable. These measures would also enable the SNB to further reduce its balance sheet, which has grown as a result of extensive foreign exchange interventions in recent years, or to stop building it up further in order to ensure greater flexibility for future interventions (Figure 4).

Our expectation

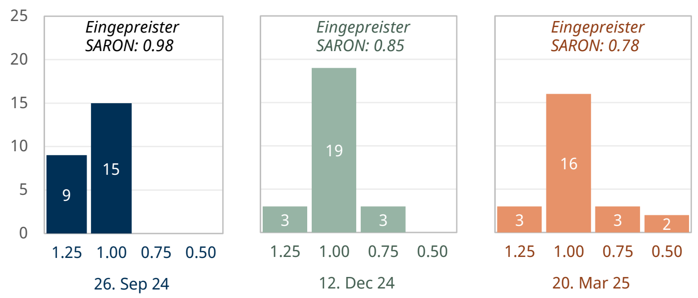
We expect a further reduction in the key interest rate in September. We do not rule out an additional cut in December. We expect a key interest rate of 0.75% after the March 2025 meeting at the latest.

Figure 1: Swap curve



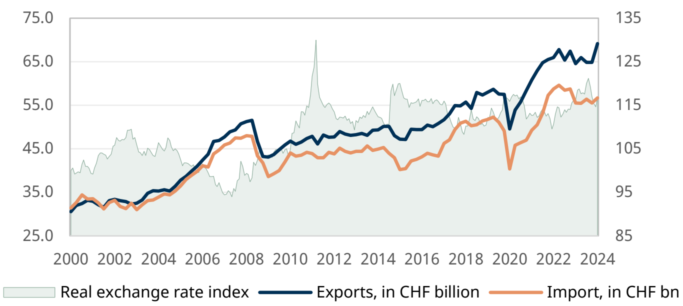
Note: The swap curves serve as a graphical representation of the underlying interest rate structure on the Swiss swap market. The respective swap rates as at the reporting date for the different maturities (in years) together form the swap curve.
Source: Data from Refinitiv Eikon, as of 24.07.2024

Figure 2: Economist surveys vs. market-implied SARON



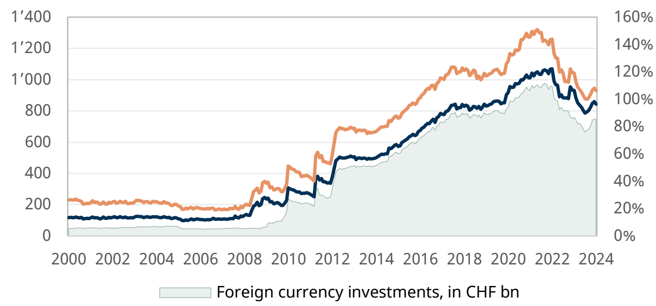
Note: The chart shows the results of Bloomberg's regular economist surveys, which capture the expected development of the key interest rate for the upcoming monetary policy assessments. For comparison, the SARON rate derived from the swap rates, which is priced in after the respective meeting, is shown above.
Source: Data from Bloomberg, Refinitiv Eikon, as of 24.07.2024

Figure 3: Swiss foreign trade and real exchange rate



Note: The chart shows the historical development of Swiss foreign trade (nominal, quarterly) and the real exchange rate index. This index shows the exchange rate development of the Swiss franc compared to the currencies of Switzerland's most important trading partners, adjusted for inflation and consumer price developments.
Source: Data from SNB, BAZG, as of 24.07.2024

Figure 4: SNB balance sheet



Note: The chart shows the size of the SNB's balance sheet and the foreign currency investments asset item. Foreign currency investments are the SNB's investments in foreign currencies in the form of foreign bonds, shares and balances with other central banks.
Source: Data from SNB, BfS, as of 24.07.2024

International

The interest rate markets are confident: they expect the Fed to start cutting key interest rates in September. This expectation is based less on the current inflation trend and more on concerns about the economic situation. The ECB, which took a break at its July meeting, is also likely to ease its interest rate policy in September.

In the USA, inflation is moving in the desired direction, but only very slowly (Figure 5). A positive trend was recently observed in housing costs, which recorded a lower price increase. Nevertheless, there is still pressure on prices in the service sector, which is also linked to the high wage growth rates that are moving slowly but steadily in the right direction. Overall, there is a marginal increase in confidence regarding the development of inflation in the desired direction, even if caution is still required.

Nevertheless, a full interest rate hike is being priced in for September (Figure 6). This move is motivated, among other things, by the ongoing slowdown in the labour market, which is characterised by an increase in the unemployment rate, fewer job vacancies and a slowdown in employment growth (Figure 7). While the first two indicators signal a return to pre-pandemic levels, employment growth remains stronger than before the pandemic crisis period.

A weaker labour market leads to lower consumer spending and ultimately to a slowdown in economic momentum. The economic data to be released over the rest of the week will shed light on how much the economy has actually cooled. Weak data could be seen as good news in this context, as it indicates that the Fed's monetary policy measures are having an effect.

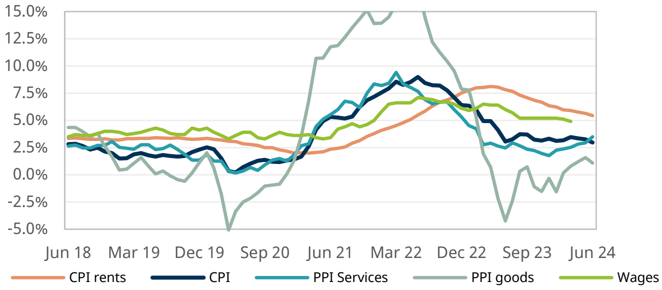
Just as interest rate hikes have a delayed effect on the economy, the same applies to interest rate cuts. Therefore, now is the right time for the Fed to start cutting rates despite the persistence of stubborn inflation. September could prove to be the right time, and the July meeting should set the tone in this respect.

Wage trends are a critical factor for the ECB's future monetary policy (Figure 8). Although the current data speaks against an easing of monetary policy, survey results point to a possible slowdown in the current and coming year. The ECB needs more data points to gain clarity on the future course of wage development. For this reason, the ECB refrained from clearly steering interest rate expectations at its July meeting and instead emphasised once again the data dependency of its decisions. In contrast, the interest rate market is already assuming a full interest rate hike (Figure 6).

Our expectation

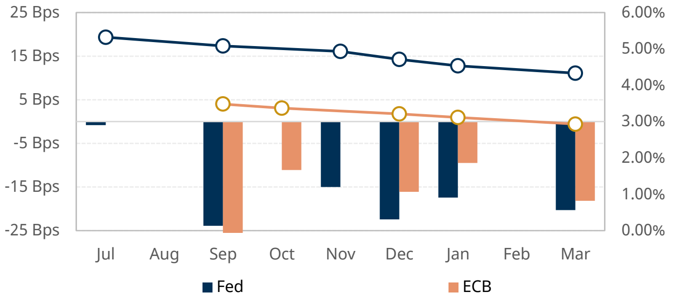
We expect both the Fed and the ECB to cut their interest rates by 25 basis points in September and each to take a further step by the end of the year.

Figure 5: Inflation trend in the USA



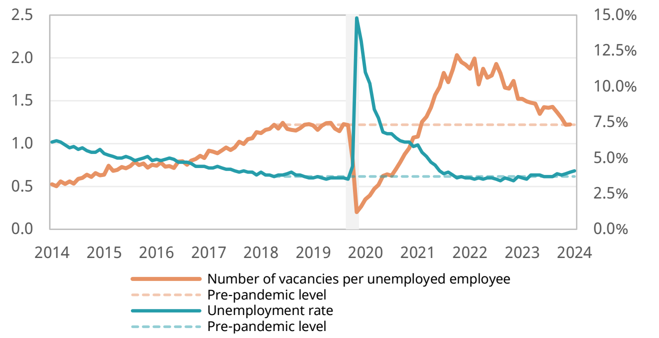
Note: The chart shows the historical development of the annual rates of change of various US consumer and producer price indices. The CPI rent price index is based on owner-equivalent rents. The wage price development shown corresponds to the 3-month moving average of the weighted median hourly wage.
Source: Data from Fred, as of 24.07.2024

Figure 6: Market-implied key interest rate developments



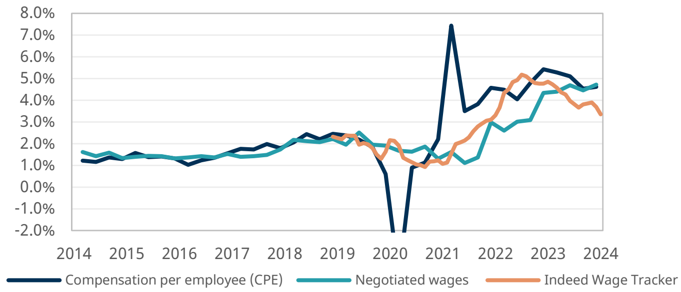
Note: The chart shows the market-implied development for the key interest rates of the Fed and the ECB (right axis). These are derived from Fed funds futures and overnight index swaps. The left axis shows the implied interest rate adjustments (in basis points) in the respective month in which a monetary policy meeting is scheduled.
Source: Data from Refinitiv Eikon, as of 24.07.2024

Figure 7: US labour market



Note: The chart illustrates the development of the US labour market. The shaded area marks the recession phase during the pandemic.
Source: Data from Fred, as of 24.07.2024

Figure 8: Wage growth trend in the eurozone



Note: The chart shows the development of various indicators for monitoring wage trends in the eurozone.
Source: Data from ECB Data Portal, GitHub, as of 24.07.2024

CONTACT

Burak Er, CFA
Head Research

Avobis Group AG
Brandschenkestrasse 38
8001 Zurich

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

Status: 24 July 2024