Switzerland

The interest rate market is currently lively and optimistic - a counterbalance to the globally rising interest rates. Before the interest rate decision in September, a key interest rate of 2.0% seemed unalterable with the expectation that interest rates would remain at this level for some time. Currently, however, there are signs of a change in expectations: A series of interest rate cuts is expected from 2024 onwards. This is reflected in an inverted interest rate structure, in which swap rates for medium maturities are partly below 1.30%.

The latest inflation data, released on Thursday 2 November, show only a modest year-on-year increase in prices for both the total basket and core inflation (Figure 1). An increase in inflation towards 2.0% by the end of the year has long been expected, but now seems less likely, which is why swap rates have fallen further in response to the new data.

The interest rate structure has now inverted to such an extent that the SARON interest rate is currently above the swap rates for maturities up to 30 years (Figure 2). Swap rates are particularly low for the medium maturities between two and five years. The current curve structure suggests a considerable probability of a first rate cut in March 2024, with the prospect of further possible cuts in subsequent meetings (Figure 3).

The SNB is sticking to its strategy of using the Swiss franc as a monetary policy instrument to control inflation by continuing to intervene actively in the foreign exchange market (Figure 4). This measure has proven effective so far and will probably remain a central aspect of current monetary policy.

Against the backdrop of the Swiss franc's effectiveness as a monetary policy measure and the trend towards lower fixed interest rates, the appropriateness of a high policy rate in fighting inflation is legitimately questioned. In this light, it might seem appropriate for the SNB to lower the SARON rate in line with fixed market rates, thereby modifying the yield curve structure.

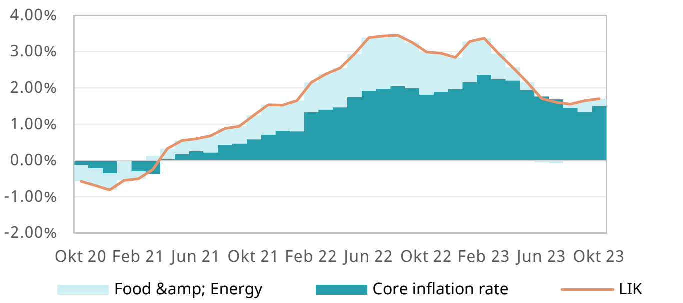
However, in view of the higher interest rate differential with foreign currencies, drastic cuts in the key interest rate could lead to a devaluation of the Swiss franc. This would run counter to the SNB's strategy of actively appreciating the franc.

However, it can be stated that the peak of the interest rate development seems to have been reached.

Our forecast

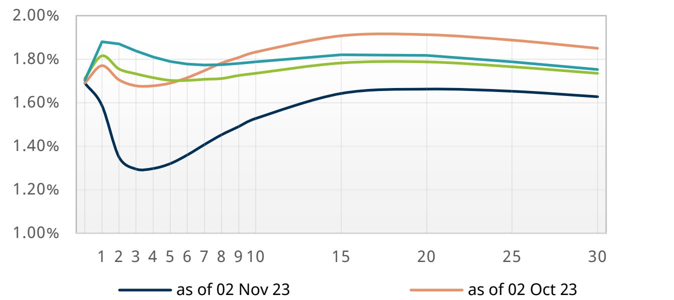
Our expectations are focused on the next SNB meeting in December, for which we forecast an interest rate pause. We consider a first rate cut of 25 bps in spring 2024 possible but see the current market forecasts as overly confident. However, changes in the SNB's foreign exchange policy could pave the way for further rate cuts.

Figure 1: The national consumer price index (CPI)



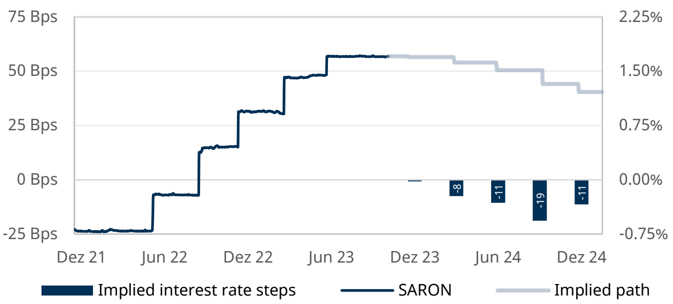
Note: Contributions to the previous year's change in consumer prices in Switzerland; the core inflation rate includes all components except food, energy, tobacco and seasonal products (food and energy).
Source: Data from Refinitiv Eikon, as of 02.11.2023

Figure 2: Swap curves vs. SARON



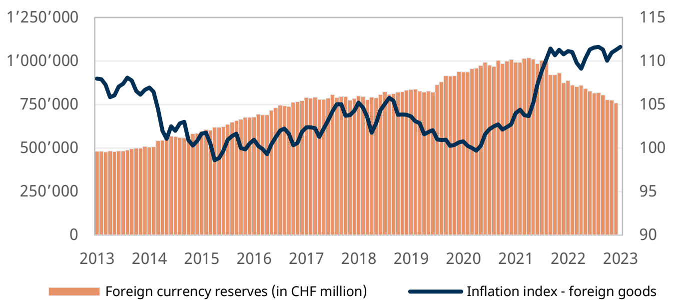
Note: The swap curves serve as a graphical representation of the underlying interest rate structure on the Swiss swap market. The respective swap rates as of the reporting date for the different maturities (in years) together form the swap curve.
Source: Data from Refinitiv Eikon, as of 02.11.2023

Figure 3: Market-implied development SARON



Note: The graph depicts the market-implied development for the SARON rate (right axis). These are derived from the interest rate swaps. The left axis plots 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 02.11.2023

Figure 4: SNB foreign exchange reserves and imported inflation



Note: The chart shows the SNB's foreign currency reserves in CHF million (left axis) and the inflation index for foreign goods.
Source: Data from SNB, BfS, as of 02.11.2023

International

During October, a geopolitical flashpoint ignited in the Middle East, posing a potential inflation risk from a monetary policy perspective. Although the impact on oil prices and global markets so far has been minor, there is a risk of disruptions in the energy sector if the conflict intensifies. Currently, inflation is on the retreat despite high initial values, which has led the central banks of the Fed and ECB to announce a pause in interest rate hikes in their latest decisions.

The ECB kept the key interest rate constant on 26 October after it had risen to 4% in ten successive steps. This decision can be attributed primarily to the decline in inflation and the weakening economic momentum. The sharp decline in the consumer price index in the euro area from 4.3% to 2.9% in October and the confirmation of the downward trend in the core rate illustrate the cooling economic demand and the associated easing of price pressures (Figure 5).

This slowdown is also reflected in the subdued growth figures for the third quarter (Figure 6). Forward-looking economic indicators also point to reduced growth momentum, which forecasts more moderate growth rates for the current and coming years. In view of these developments, further interest rate hikes seem to be off the table at present.

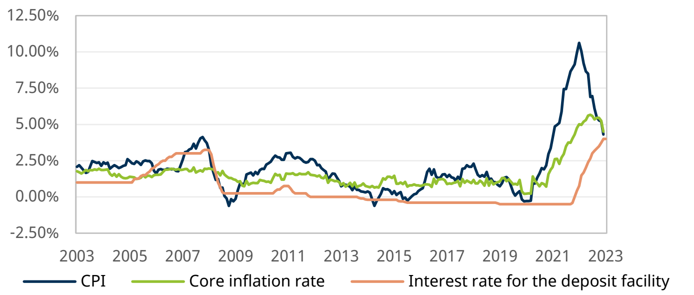
In contrast, the US economy shows considerable growth in the third quarter of the year and demonstrates considerable robustness (Figure 6). A positive consumer spending climate and optimistic sentiment are strengthening economic demand. The labour market in the US also continues to be characterised by an imbalance between supply and demand, despite some cooling, which further fuels economic activity (Figure 7). The economic slowdown hoped for by the Fed has therefore not yet materialised, which underlines its openness to further interest rate hikes - should they be deemed necessary.

Nevertheless, the significant increase in long-term interest rates has led to tighter financing conditions (Figure 8). The nominal 10-year bond yield reached 5.0% in October. In particular, the rise in real interest rates is likely to have a restrictive effect on the economy. This will have been one of the motivations for the Fed to refrain from further rate hikes for the time being.

Our forecast

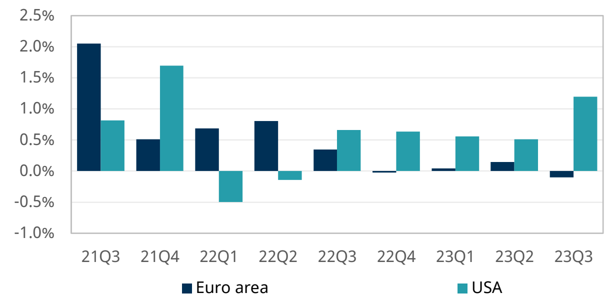
We do not forecast any further interest rate adjustments by the central banks but expect discussions on possible interest rate reductions in the coming year. In the US, the strong economic momentum currently still stands in the way of discussions on possible interest rate cuts, which makes the "higher for longer" assumption appear to remain true. In contrast, economic performance in the euro area is less dynamic, which could prompt the ECB to take initial interest rate reduction measures from spring 2024 to support the economy.

Figure 5: Inflation and interest rate developments in the euro area



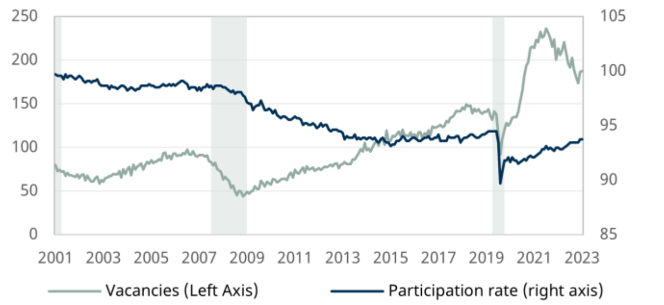
Note: The chart shows the historical development of the ECB's deposit facility rate, the consumer price index (CPI) and the core inflation rate.
Source: Data from Refinitiv Eikon, as of 02.11.2023

Figure 6: Economic growth in the euro area & USA



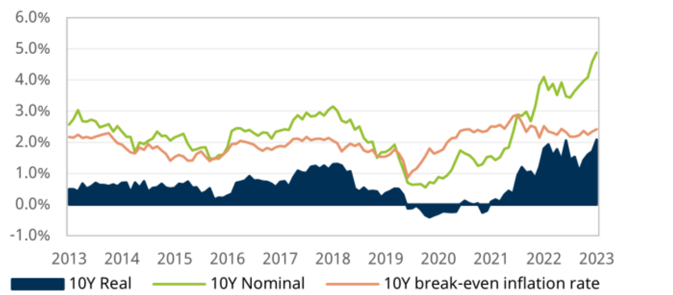
Note: The chart shows the real GDP growth rates compared to the previous quarter.
Source: Data from FRED, Eurostat, as of 02.11.2023

Figure 7: Robust US labour market



Note: The figure shows the labour market situation in the USA (index 01.12.2000 = 100). The shaded areas indicate recessions in the USA.
Source: Data from FRED, as of 02.11.2023

Figure 8: Development of 10-year US bond yields



Note: The chart shows the development of the 10-year US bond yield in nominal and real terms as well as the 10-year break-even inflation rate, which can be interpreted as market-implied long-term inflation expectations.
Source: Data from Refinitiv Eikon, as of 02.11.2023

CONTACT

Burak Er, CFA
Head Research

Avobis Group AG
Brandschenkestrasse 38
8001 Zurich

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

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