SNB: Back in positive territory

Swiss economy

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- In its September monetary policy review, the SNB raised its policy rate by 0.75 percentage points to 0.5%. The policy rate is thus positive for the first time since the end of 2014. The SNB is likely to further increase its policy rate at the next two meetings. We expect an increase of 0.5 percentage points in December 2022 and 0.25 percentage points in March 2023, to reach a level of 1.25%.
- The recent rise in long-term rates, which already factor in a more restrictive monetary policy, is unlikely to continue, in our view. We therefore see only a slight upward movement in Swiss rates in the coming quarters, accompanied by high volatility.
- The Swiss franc is likely to strengthen against the euro in the short term and against the US dollar in the medium term. Switzerland's much lower inflation compared both with the Eurozone's and the US's points to the franc’s significant appreciation potential.

Source: UBS

In its monetary policy review in September, the Swiss National Bank (SNB) raised the policy rate by 0.75 percentage points (ppt) to 0.5% amid a renewed increase in inflationary pressures and in an attempt to prevent second-round effects.

In its assessment, the central bank hinted at further hikes in the coming quarters, and we expect them in its next two meetings: by 0.5ppt in December and 0.25ppt in March, reaching a level of 1.25%. SNB President Thomas Jordan also left open the possibility of making interest rate changes between ordinary assessments, if necessary. We think this would only be called for if inflation or the economic situation deteriorates significantly. Should inflation turn out stronger than expected, however, we would first expect an interest rate hike of 0.75ppt instead of 0.5ppt in December.

UBS rate forecast

	Mar-23	Sep-23
SNB policy rate	1.25%	1.25%
CHF 10y interest rates	1.25%	1.25%

Source: UBS

Unlike the SNB’s rate hike in June, its decision in September had been expected—two weeks ago, the European Central Bank (ECB) raised its policy rate by the same extent. The SNB continues to focus on inflation risks and forecasts higher inflation in 2023 than the level recorded in June (Fig. 1).

Inflation expectations for 2024 are at the same level as in June, and slightly lower for 2025 due to tighter monetary policy. The SNB expects inflation to fall back below the 2% mark by 2H23.

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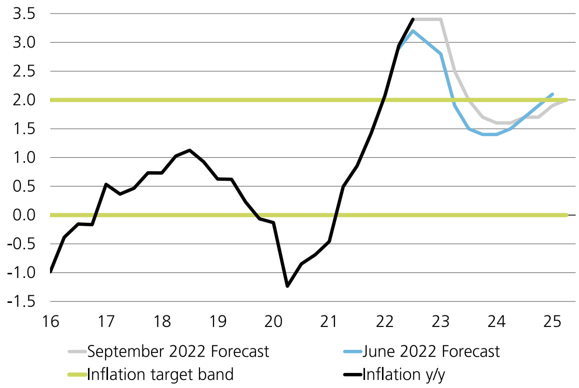
We expect an inflation rate of 3.1% for 2022, and 2.1% for 2023. Our 2023 forecasts are slightly lower than the SNB's inflation expectations (2022: 3%; 2023: 2.4%), which assumes, in its conditional forecast, that policy rates will remain at today's level. We, however, see further rate hikes in the coming quarters, which should slow growth and inflation.

Figure 1: SNB sees inflation below the 2% mark again from mid-2023

Conditional inflation forecast by the SNB (conditional on unchanged policy rates) in June and September with the SNB's target range for inflation, in %



Sources: SNB, UBS

Interest rate hike pause in 2023

The SNB's rate hike cycle is likely to be fierce, but relatively short-lived, in our view. We expect a pause in hikes as early as mid-2023, in step with the ECB. The economic slowdown in Europe, driven by a possible energy crisis, is likely to significantly worsen the cost-benefit ratio of a further hike. In addition, there is a possibility that this year's hikes will have already significantly calmed Swiss inflation until the middle of next year.

Whether rate cuts are already imminent in the second half of next year depends on how much the Swiss economy deteriorates and how significantly the local inflation trend has weakened by then. Our base case scenario does not assume a deep recession in Switzerland, and we therefore do not see any rate cuts in the second half of 2023.

Exemption limit remains, but different

The SNB wants to keep SARON, the overnight interest rate for secured loans, close to the policy rate in order to guarantee that a change in policy rates will also impact the money market and the entire yield curve. The challenge here is that the SNB has over CHF 700 billion in sight deposits on its balance sheet. If the SNB sets the interest rate for total sight deposits at 0.5%, no one except the SNB has an incentive to provide liquidity. If the SNB leaves interest rates for total sight deposits at 0%, the money market interest rate may threaten to settle at 0%.

The SNB has responded to these challenges with a system similar to what it applied to negative interest rates. Up to a certain limit (28 times the minimum reserve requirement over the last three years), banks can invest their excess liquidity with the SNB at an interest rate of 0.5%. This supports the money market interest rate. Above this exemption limit, the sight deposits bear interest at a rate of 0%, which gives commercial banks—whose sight deposits are above the limit—the incentive to offer liquidity on the money market. Commercial banks whose sight deposits are below the limit, on the other hand, have the incentive to demand liquidity on the money market. To ensure that SARON will settle close to the policy rate, the SNB will fine-tune the market rate with interventions in the money market (SNB bills and repo transactions).

10-year interest rates with little upside potential

Long-term (for example, 10-year) interest rates have had a rollercoaster ride. The expectation that the SNB will significantly raise its interest rates caused 10-year interest rates to rise to over 1.4% at the long end of the yield curve in June. In July, recession fears dominated the Swiss yield curve, with 10-year-olds falling back to a level of just over 0.4%. In recent weeks, fears of inflation have again come to the fore, which was associated with a sharp rise in interest rates, to 1.2%.

How the Swiss economy develops—a further acceleration in inflation, combined with even stronger interest rate hikes by the SNB or a recession and thus a rapid reversal in interest rate policy—will probably not be fully clarified in the coming months. We therefore expect capital market rates to continue to fluctuate strongly.

In the long term, the trend in rates will be determined by whether the policy currently priced in by the financial markets proves to be too restrictive, or not sufficiently restrictive. Markets today expect a sharp rise in policy rates over the next twelve months and a decline in the second half of 2023. The market therefore expects a more aggressive monetary policy than we predict. We therefore expect long-term rates to move only slightly higher in the coming quarters.

The short end of the yield curve has risen significantly due to the upcoming rate hikes, making the Swiss yield curve virtually flat today. This is unlikely to change in the coming quarters.

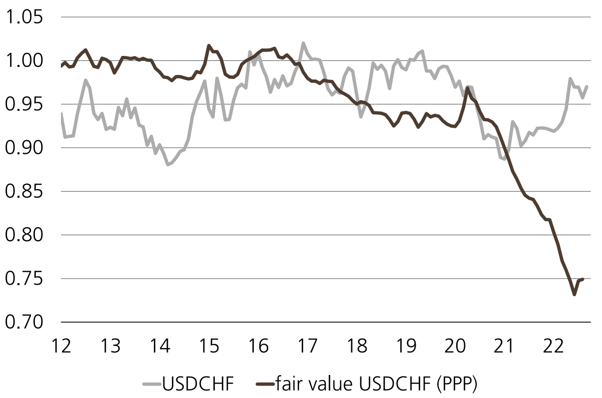
Swiss franc to gain against the US dollar in 2023

For the USDCHF exchange rate, the focus in recent months has been on the rate differential. The expectation that the US Federal Reserve will raise interest rates quickly and sharply this year has caused the expected interest rate differential to rise significantly, which has helped the US dollar against the Swiss franc.

The rate differential is likely to remain the determining factor in the short term, supporting the dollar against the Swiss franc. But if central banks take a break in 2023, the interest rate differential should lose influence and the strong overvaluation of the US dollar should become more important. Significantly higher inflation in the US has caused the fair value of the US dollar against the Swiss franc to fall below USDCHF 0.8 (Fig. 2). We therefore expect the Swiss franc to appreciate significantly against the US dollar in 2023.

Figure 2: Dollar significant depreciation potential in the medium term

USDCHF exchange rate with the corresponding purchasing power parity (PPP)



Sources: Macrobund, UBS

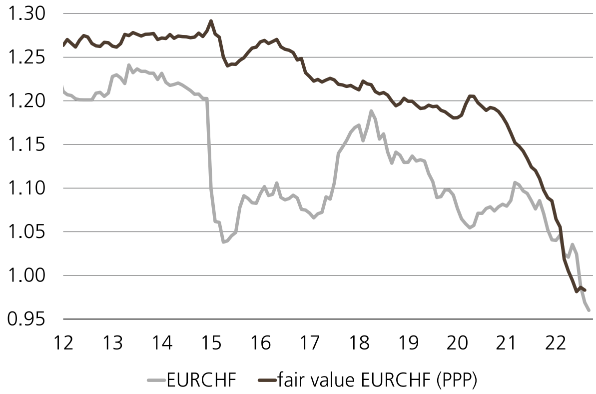
There is room for euro appreciation

Inflation differentials are also important for the EURCHF exchange rate. While the fair value was 1.20 two years ago, it has now fallen below parity (Fig. 3). Although the Swiss franc has gained significantly against the euro in recent months, it can hardly be described as overvalued today.

This also influences the SNB's monetary policy. We expect the Swiss franc to appreciate against the euro in the coming quarters. A recession in Europe—probably a mild one, but possibly also a deep one—supports the safe haven franc and punishes the cyclical currency euro. Because the franc is only slightly overvalued at the moment, the SNB is unlikely to intervene in the currency relations in a first phase and accept a lower EURCHF exchange rate. In addition, an appreciation also has an inflation-mitigating effect. Only when EURCHF falls to around 0.90 would we expect a foreign exchange market intervention by the SNB. The SNB's statement in its monetary policy assessment also goes in this direction.

Figure 3: Euro no longer undervalued

EURCHF exchange rate with the corresponding purchasing power parity (PPP)



Sources: Macrobond, UBS

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