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Outlook Monetary Policy

smzh UPDATE
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SNB

Negative interest rates require clear-cut deflation or a clear weakening of the economy, neither of which is currently evident. The SNB is holding monetary policy steady, and the Swiss franc is appreciating, particularly against the US dollar.

Current signals

- The SNB has left the key interest rate at 0% and adjusted its inflation forecast up slightly
- In August inflation was at 0.2% y/y and -0.8% m/m
- Real GDP grew at 1.4% in 2024

The SNB refrains from negative interest rates, for now

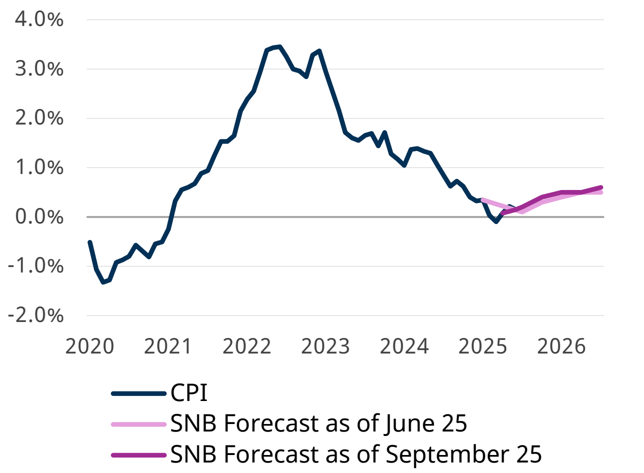
In September, the Swiss National Bank (SNB) chose not to move into negative interest rate territory, instead slightly raising its short-term inflation forecast. While the SNB acknowledges existing economic risks, it sees no need to deploy its interest rate tool to support specific sectors affected by tariffs and the strong Swiss franc. Furthermore, as the inflation outlook has changed very little, the SNB currently does not see any deflationary risks.

Negative interest rates remain an option

Negative interest rates remain part of the SNB's toolkit, but their introduction appears unlikely given current conditions. The decisive factor for negative interest rates would be a sustained return of domestic inflation into negative territory, for which there is no evidence at the moment. However, imported inflation is expected to ease further due to falling producer prices and a stronger franc. In addition, the recent reduction of the reference mortgage rate to 1.25% has reduced housing costs and may further dampen the consumer price index. Excluding the rental component, inflation has been negative since February.

High US tariffs have also left their mark on the Swiss export sector, despite anticipated adjustments. Even if a favorable trade agreement seems realistic, risks remain – not least because an economic slowdown abroad could quickly spill over to the global economy, which is a critical factor for a small, open economy like Switzerland. Nevertheless, Switzerland is well positioned thanks to the diversification of its trade relationships and retains some flexibility to mitigate negative effects.

SNB adjusts its inflation forecast up slightly
Current inflation rate vs. SNB inflation forecast



Source: Federal Statistical Office, SNB, smzh ag.

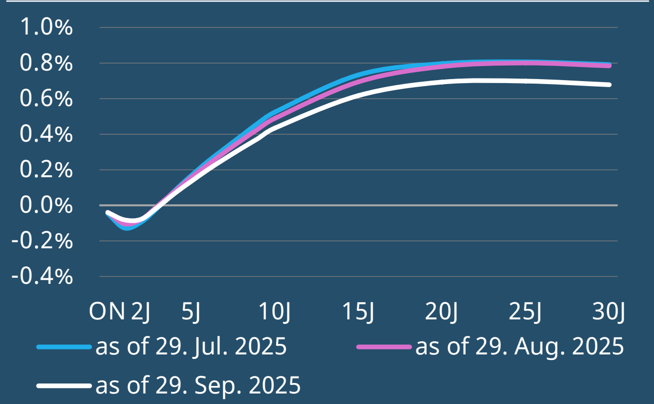
Next step by the SNB: further pause or cut to -0.50%

The SNB currently faces a significant challenge, yet a more forceful intervention would be premature at this stage. The Swiss franc continues to appreciate despite interest rate differentials, while interventions are only marginally effective as long as the US dollar is weak. As negative interest rates have limited impact, the SNB is likely to wait for clear signals and, if necessary, respond with a substantial and decisive move.

Implications for financial markets

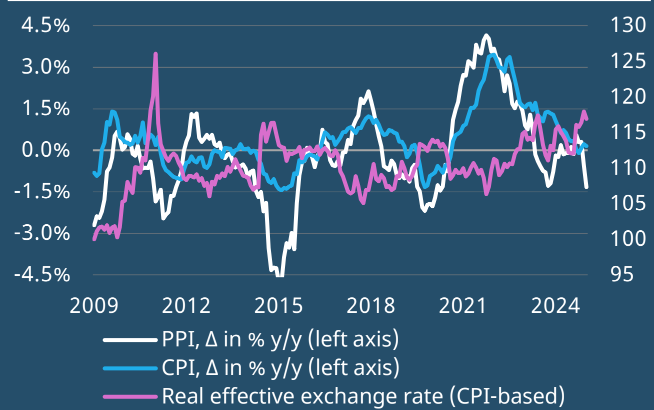
- The swap curve is likely to remain largely stable.
- A combination of investment-grade bonds, high-quality high-yield bonds, and selected emerging market bonds is still attractive.
- Swiss equities provide stability but could lag their global peers. Dividend strategies as well as small and mid-caps look attractive.
- The Swiss franc is trending upward against the US dollar but is stable against the euro.

CHF swap curve remains stable
Swap curve compared with prior months



Source: Bloomberg, smzh ag.

Strong Swiss franc bears deflation risks
CHF real effective exchange rate, inflation and import prices



Note: PPI = producer price index, LIK = Swiss consumer price index, KPI = consumer price index. Real exchange rate is trade-weighted.
Source: Federal Statistical Office, SNB, smzh ag.

ECB

The ECB's rate cut cycle is over for now. Only unequivocal signs of deflation could justify further cuts, though some fine-tuning until year-end is possible.

Current signals

- The ECB is keeping the deposit rate at 2.0%
- Inflation was at 2.1% y/y and 0.2% m/m in August
- Spreads of French government bonds versus German Bunds have widened to over 0.75%

France's budget problems spur spread widening

France's persistently high deficit – most recently at over 5% of GDP – and stalemate in structural reforms have significantly increased the risk premiums on French government bonds. For the first time since the introduction of the euro, the OAT-Bund spread has exceeded that of Italy – a break in market logic that has already prompted Fitch to downgrade France's credit rating.

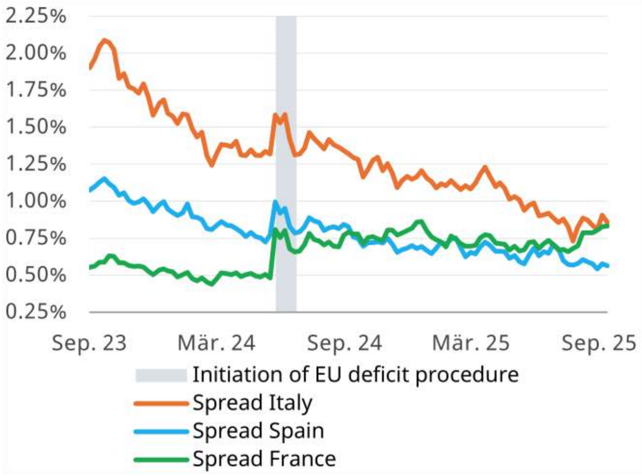
For the ECB, however, this is not a reason to intervene: the Transmission Protection Instrument (TPI) is only triggered in case of disorderly market movements and requires compliance with fiscal rules – criteria that France does not currently meet. As a result, the budgetary issue remains a matter of monetary policy transmission rather than of the key interest rate.

The ECB pauses interest rate cuts for now

After eight cuts of 0.25% each, the ECB halved its deposit rate by June 2025. It held rates steady in the September meeting, a pause that market participants interpreted as the end of the rate cutting cycle. The ECB's decision is understandable: The disinflationary impulses of weakening energy and goods prices have largely run their course, while wages and services have moved to the center of attention. Though inflation risks do exist in these areas, momentum is moving in the right direction of late.

On the demand side, the impact of US tariffs has been weaker than feared thanks in part to the EU's trade deal with the US. Eurozone growth remains modestly positive, though with significant regional differences: While parts of the periphery are showing a slight recovery, the German economy remains in stagnation.

French spreads on a par with Italy's
Credit spreads versus 10-year German Bunds



Source: Bloomberg, smzh ag.

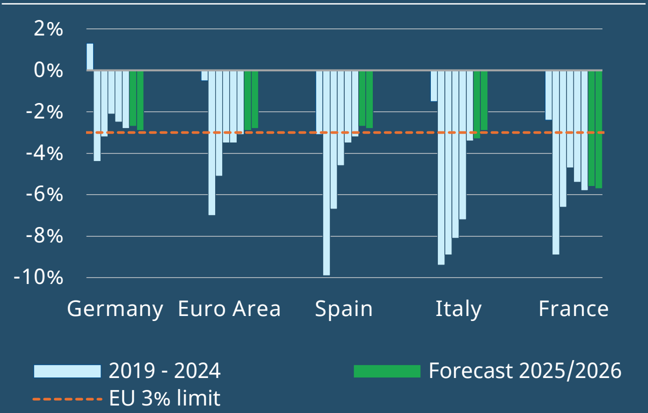
The ECB is headed for stable monetary policy

The ECB is clearly headed for a phase of stable monetary policy. New developments on the inflation front would be needed to trigger further interest rate cuts. While some fine-tuning until year-end remains possible, the cycle is over for now. The French budget crisis is increasing political risks, which the ECB is tolerating, however. The motto for the upcoming ECB meetings therefore is to observe rather than act.

Implications for financial markets

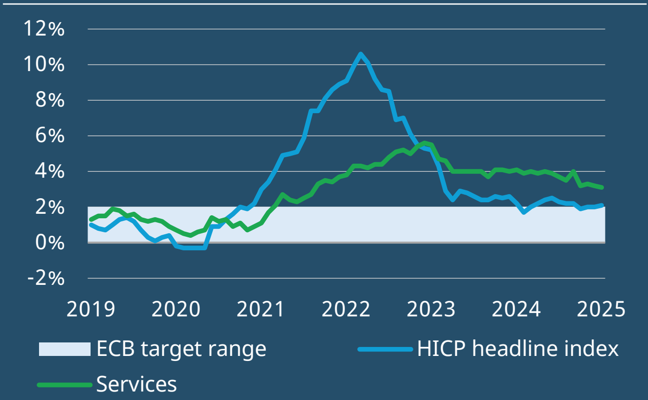
- Economic stimulus measures in Europe are partly offsetting the weakening economy.
- Eurozone equities continue to benefit from tailwinds despite the challenging US trade policy.
- The euro is still well supported and should remain steady particularly against the Swiss franc.

No fiscal relief in sight for France
Budget deficits 2019 - 2026 compared to EU limit of 3%



Source: ECB Data Portal, smzh ag.

Inflation rate at the upper limit of the target band
Inflation in the Eurozone, change vs. prior-year month



Source: ECB Data Portal, smzh ag.

Fed

The Fed is loosening monetary policy cautiously, as inflation and fiscal headwinds are preventing a rapid reduction of interest rates.

Current signals:

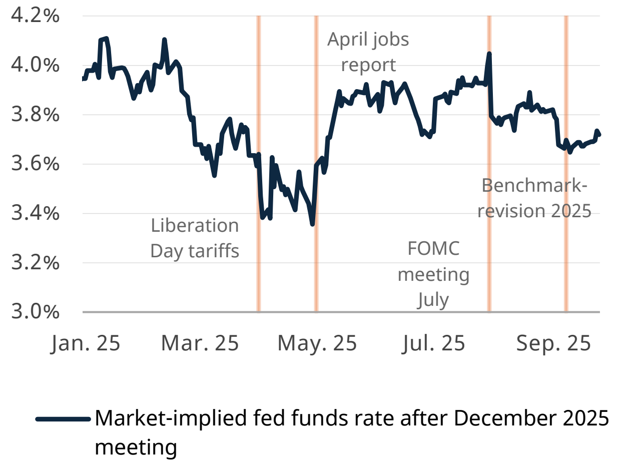
- Fed cuts federal funds rate by 0.25% to 4.00% – 4.25%
- Core inflation (PCE) at 2.9% y/y and 0.2% m/m in August
- Second-quarter GDP growth revised from 3.3% to 3.8%
- The Atlanta Fed's GDP tracker suggests third-quarter growth of 3.9% (up from 3.3%)

Persistent inflation, weakening labor market
In cutting interest rates by 0.25% in September, the Fed kicked off its rate-cutting cycle, in line with expectations. Monetary policy remains challenging, however. While inflation risks are growing, labor market momentum is losing steam. This asymmetrical risk situation is forcing the Fed to manage a narrow window. It will be decisive for the Fed to guard the credibility of its monetary policy path and convince markets of a controlled sequence of further steps.

Fiscal risks are limiting the long end
Last year's experience demonstrates that interest rate cuts do not automatically translate into lower long-term yields. Despite monetary policy easing, yields actually increased – a pattern likely to recur given high government debt and persistent deficits. As a result, a more cautious pace of rate cuts than markets currently expect appears probable. Fiscal headwinds at the long end are limiting the transmission of monetary policy impulses and reducing the potential for significantly lower yields.

Soft landing remains baseline scenario
Although inflation remains above the Fed's target and labor-market risks are growing, the US economy is more robust than the restrictive financing conditions would suggest. Consumption remains strong, investment activity stable, and growth solid overall. Weaker labor market data therefore do not necessarily point to a recession but rather suggest a gradual cooling. This environment is increasing the likelihood of a soft landing, strengthening the Fed's credibility.

Interest rate path remains carefully priced
Market-implied fed funds rate until year-end



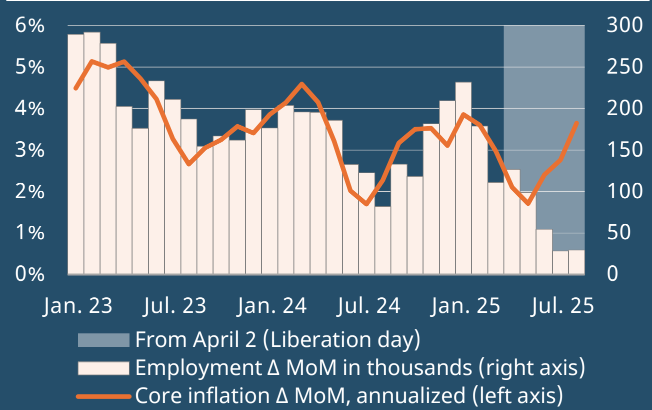
Source: CME Group, smzh ag.

Next rate cut in October
The Fed is likely to calibrate upcoming rate cuts carefully and keep a close eye on incoming data. A further rate cut of 0.25% in October is considered the baseline scenario, even though the pace of the cycle is likely to lag current market expectations.

Implications for financial markets

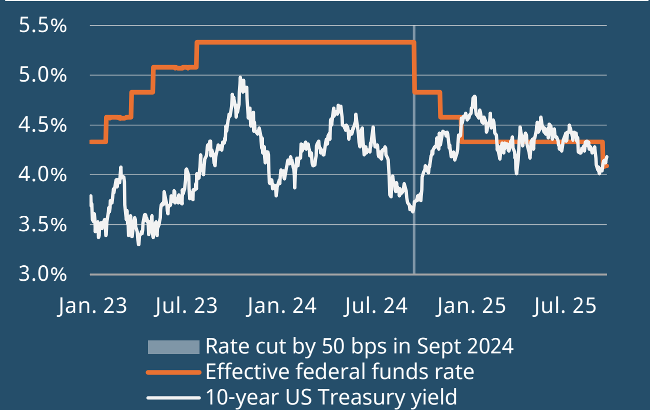
- The US dollar remains vulnerable. For investors who are overweight USD, it may be sensible to reduce or hedge their exposure.
- Rate cuts outside of a recession traditionally have a positive impact on financial markets even though equity market valuations are already pricing in numerous positives.
- Based on persistent risks of a yield curve steepening, short to medium-term duration looks more attractive.

Labor market is cooling, inflation remains elevated
Employment vs. core inflation (three-month average)



Source: FRED, smzh ag.

Can the Fed steer the long end more successfully this time?
Effective federal funds rate vs. 10-year Treasury yield



Source: FRED, smzh ag.

Do you have any questions regarding investments? Contact our experts

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