PICTET WEALTH MANAGEMENT

Switzerland: 2024 macro and government bond outlook

Not all smooth sailing

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FLASH NOTE

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SUMMARY

- Economic activity in Switzerland is expected to remain sluggish in the first part of 2024 amid euro area weakness, but it is expected to pick up gradually from Q2 onwards. Stripping out the impact of major sporting events, we project annual GDP growth of 0.9% in 2024, after an estimated 1.2% in 2023. These figures are below the potential growth rate of 1.7-1.9%.
- Inflation has fallen rapidly from its peak of 3.5% in August 2022, helped by the Swiss franc's strength and base effects from energy. But domestic price pressures are expected to increase due to higher rents, electricity prices and VAT hikes. We expect headline inflation to average 1.7% in 2024, which is still above the pre-pandemic long-term average. Worth noting that the impact of rents introduces uncertainty to the outlook.
- The Swiss National Bank (SNB) is probably done with rate hikes. Domestic price pressures will keep the SNB on hold in 2024 in our view. The balance of risk is tilted towards a rate cut in H2 2024, depending on what other central banks do. Given reduced imported price pressures, we expect the SNB to be less active in the FX market.
- Swiss 10-year government bonds have outperformed those from the US and Germany year-to-date, rising in value by 6.7% (as of 24 November). We expect the 10-year Swiss bond yield to fall from 0.97% on 27 November to 0.90% by the end of 2024 due to weaker economic growth. Given Swiss government bond yields are relatively low and we only expect limited additional yield compression next year, we forecast a low-single-digit return for Swiss government bonds in 2024. For this reason, we remain underweight in Swiss government bonds, even though we are overweight in US Treasuries and core euro government bonds.

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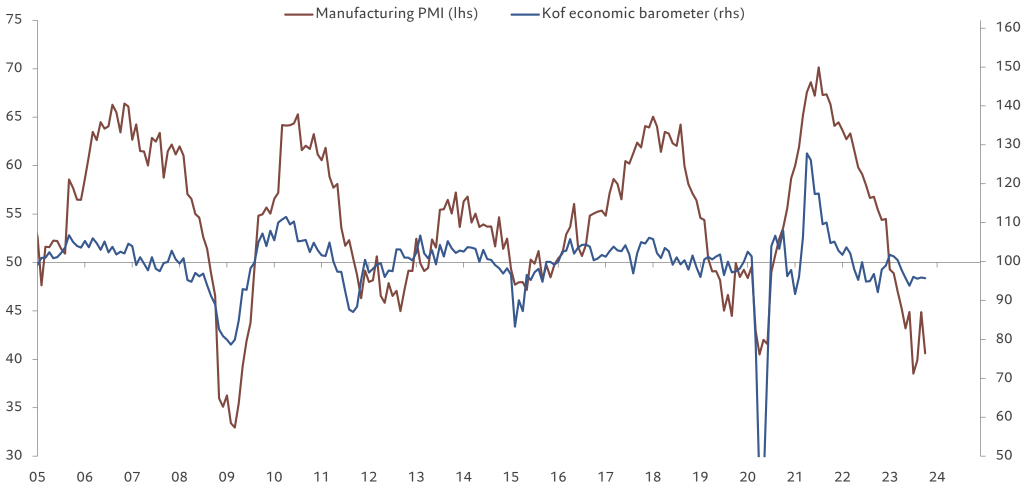
GROWTH: STILL BELOW POTENTIAL IN 2024

The Swiss economy has demonstrated its resilience in the face of many previous economic shocks, but it currently faces a number of challenges. In 2022, Switzerland's economy grew by 2.4%, a figure adjusted to exclude the impact of sporting events. However, its growth has slowed this year, with investment particularly weak. This downturn is largely due to reduced global demand, particularly from key trading partners like Germany, which has adversely affected the manufacturing sector. The strong Swiss franc is also having a negative impact on industries such as machinery and equipment. In contrast, domestic demand remains strong, supported by a robust labour market and – so far – minimal spillover from the manufacturing sector's struggles.

Chart 1: Switzerland – manufacturing PMI and KOF economic barometer



Source: Pictet Wealth Management, Procure.ch, KOF Institute, as of 27 November 2023

We expect economic activity, especially manufacturing, to be sluggish early next year due to subdued external demand, but it should begin to recover from Q2 onwards. Excluding the influence of sporting events, we forecast annual GDP growth of 1.2% in 2023 and 0.9% in 2024, figures that are below Switzerland's potential growth rate of 1.7-1.9%. Risks to this outlook hinge on global demand, especially from Germany and China, which could have a significant impact on Switzerland's growth.

We exclude sporting events from our analysis because even though they significantly affect GDP figures they do not reflect the business cycle or impact the labour market or consumption. The Euro 2024 football championships and the Olympic Games in Paris are likely to have a sizeable positive impact on the Swiss economy in 2024 as UEFA and the International Olympic Committee, the two bodies organising these events, are headquartered in Switzerland and they will receive considerable revenue from television and branding rights. We believe this will result in the Swiss economy growing by 1.2-1.3% in 2024, compared with just 0.9% if we exclude the effects of these events.

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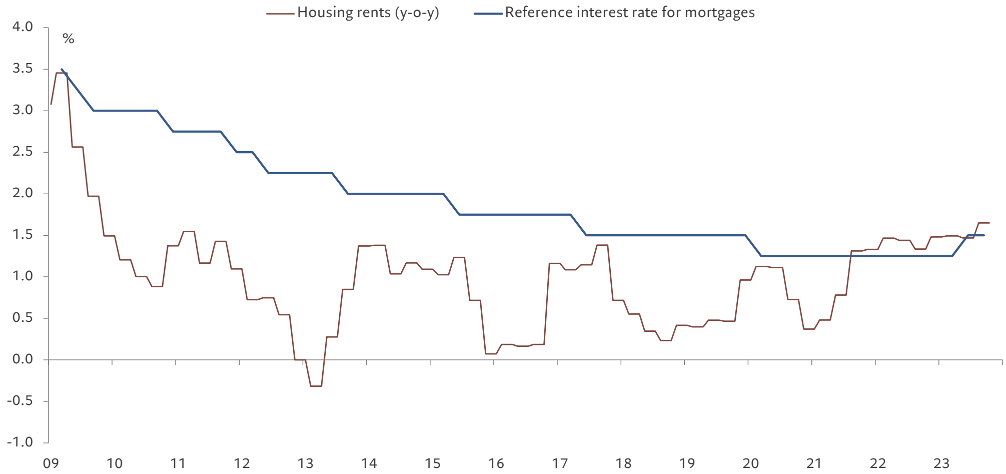
INFLATION: RENTS INTRODUCE UNCERTAINTY TO THE OUTLOOK

Inflation in Switzerland has fallen significantly, down from a high of 3.5% in August 2022 to below 2% by June. This fall has been helped by the strong Swiss franc and base effects from energy prices. Inflation is currently primarily influenced by domestic factors, and we anticipate an increase in domestic price pressures in the coming months for several reasons.

First, housing rents, which make up 18.6% of the Consumer Price Index basket, are likely to rise due to an increase in the reference rate. Predicting the full impact of this increase is challenging as the reference interest rate was only introduced in 2008, and we have no prior experience of it being increased. Its first hike, from 1.25% to 1.50%, occurred this June in response to higher rates of outstanding mortgages. However, rent increases are not automatic and are at the discretion of each individual landlord. It is uncertain how many lenders will pass on the interest rate hikes and how many rental contracts will be affected. Rent increases can only take effect when the current lease expires, and are only possible if the current rate is higher than the rate at the time the lease was signed. This condition applies to contracts signed after March 2020, when the reference rate was 1.25%.

Chart 2: Switzerland – housing rents and reference interest rate



Source: Pictet Wealth Management, Federal Office for Housing, FSO, as of 27 November 2023

Second, regulated electricity prices, which increase annually, are expected to rise by 18% in 2024, following their 24% increase this year. The direct impact will be most noticeable early next year, and it could also have an indirect impact on other goods.

Third, VAT rates are expected to increase in 2024.

We predict that headline inflation will hover around 2%, averaging 2.2% in 2023 and 1.7% in 2024. Before the pandemic, the long-term annual average for Swiss inflation was 1%.

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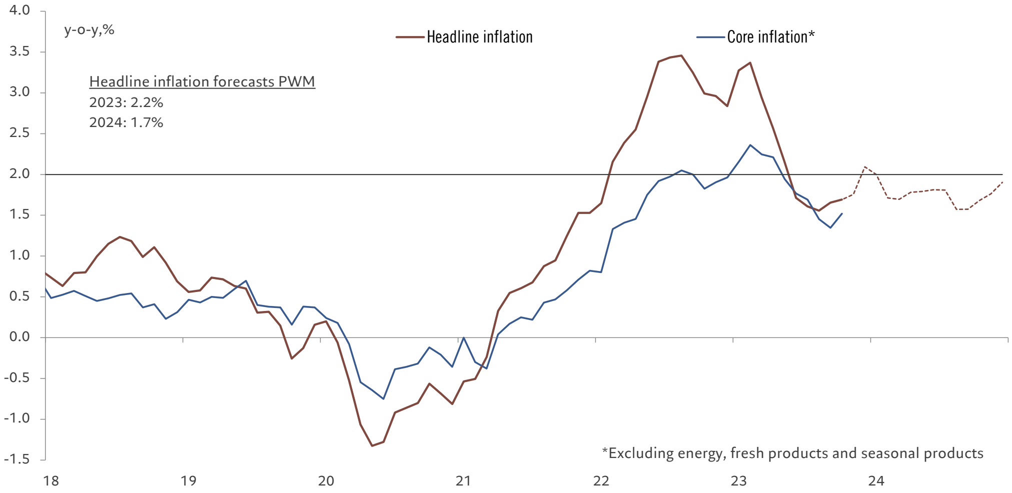
Chart 3: Headline and core inflation in Switzerland since 2018

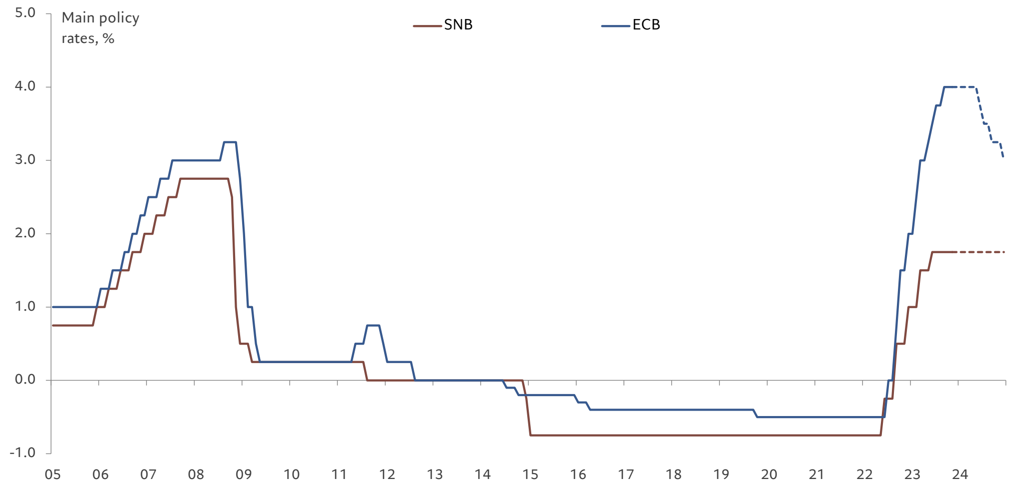


Source: Pictet Wealth Management, Federal Statistical Office, as of 27 November 2023

SNB: FURTHER HIKES LOOK UNLIKELY

Between June 2022 and June 2023, the SNB raised its policy rate by 250 basis points to their current level of 1.75%. Although it was a close call, the SNB decided to keep rates at 1.75% at its September meeting rather than increase them again. We believe that the SNB is unlikely to hike again for the foreseeable future. An additional hike in December seems unlikely for mitigating domestic pressures stemming from increasing rents and electricity prices. With inflation projected to stabilise within the SNB's acceptable range, along with domestic inflationary pressures, we expect the central bank to remain on hold in 2024. The balance of risks leans more towards a potential rate cut in the second half of 2024, contingent primarily on the monetary policies of other central banks.

Chart 4: ECB and SNB historic and expected policy rates



Source: Pictet Wealth Management, ECB and SNB, as of 27 November 2023

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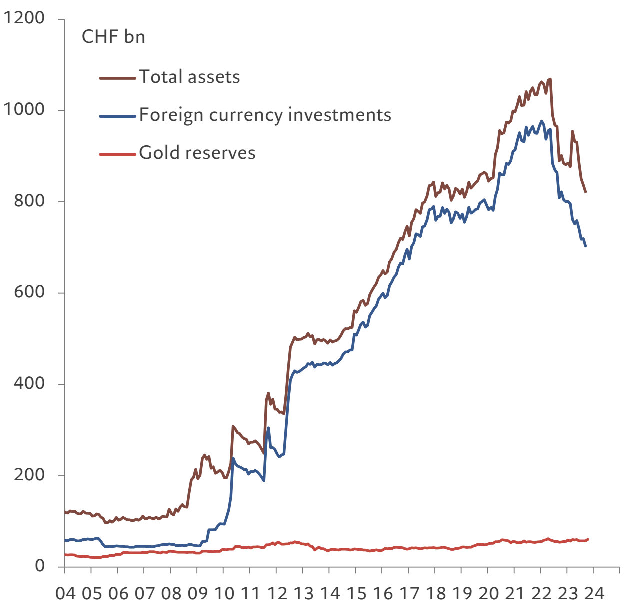
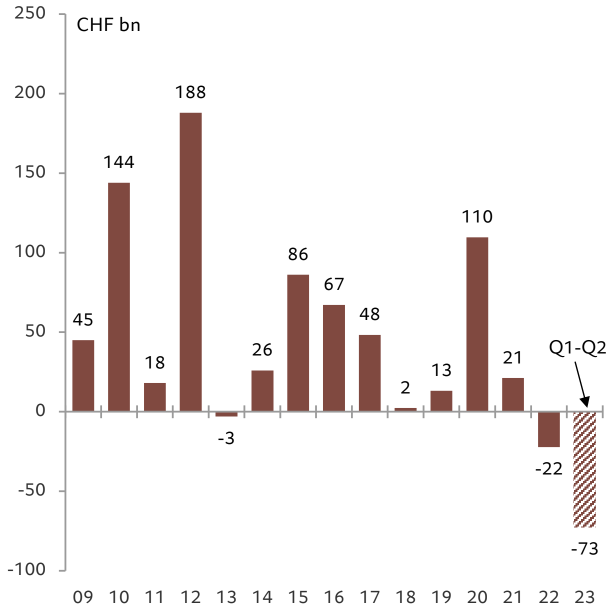
The SNB reiterated its commitment to FX market interventions in September, and is currently selling foreign currencies to maintain a strong Swiss franc. There was significant intervention by the SNB in the forex market in Q2, when it sold CHF 32 billion of foreign currencies (CHF 73bn in total in Q1 and Q2), and the sales appear to have persisted into Q3. Given reduced imported price pressures, we expect a gradual reduction in the SNB's foreign currency sales.

Chart 5: SNB balance sheet items



Source: PWM, SNB, as of 27 November 2023

Chart 6: SNB currency interventions



Source: PWM, SNB, as of 27 November 2023

BONDS: LOW YIELDS PROBABLY MEAN LOW RETURNS NEXT YEAR

Swiss 10-year government bonds have outperformed those from the US and Germany year-to-date, rising by 6.7% (as of 27 November) thanks to the 10-year yield falling from 1.62% at the start of the year to 0.97%. US and German 10-year government bonds have fallen in value over the same period.

Swiss bonds' strong performance is linked to the fact that Swiss inflation is already within the SNB's target range of between 1–2%, making it the first major central bank to have achieved its price stability objective in the wake of the post-pandemic surge in inflation. The speed with which Swiss inflation has returned to target and the SNB's resolve in this regard (as can be seen in its aggressive rate hikes and its sales of foreign currency reserves to strengthen the Swiss franc and dampen imported inflation) have reinforced the SNB's credibility. As such, bond investors are unlikely to require a higher inflation risk premium on long-dated Swiss bonds, as is likely to be the case for other core sovereign bonds.

The 10-year Swiss government bond yield at 0.97% remains well below short-term rates (the policy rate stands at 1.75% while the two-year bond yield is 1.35% on 27 November, *see chart 6*). One of the factors contributing to this is that market

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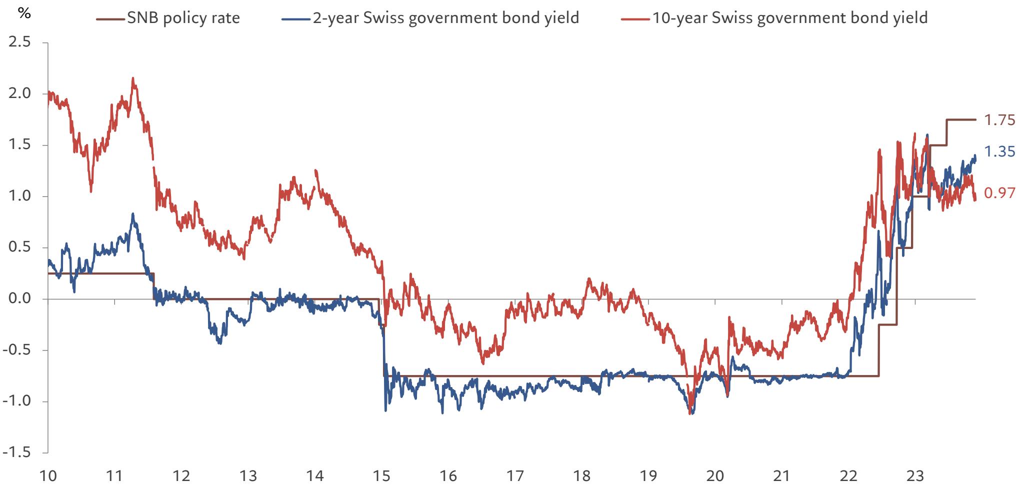
participants believe that the SNB has not only finished hiking rates, but that it could actually start cutting them in 2024. SNB rate cuts are not part of our central scenario for 2024, so we believe that the 10-year Swiss government bond yield has less scope to fall than its German counterpart.

We expect the 10-year Swiss bond yield to fall from 0.97% on 27 November to 0.90% by the end of 2024 due to weaker economic growth. That said, yields could fall more should market participants price in more aggressive rate cuts by major central banks due to a very weak economic backdrop. The comparatively low level of Swiss government bond yields and our forecast of limited additional yield compression mean we only expect a low-single-digit return for Swiss government bonds in 2024. For this reason, we remain underweight in Swiss government bonds, even though we are overweight in US Treasuries and core euro government bonds.

Chart 6: Swiss policy rates and government bond yields



Source: Pictet Wealth Management, Bloomberg Finance, L.P., as of 27 November 2023

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