

# Macro-Strategy Key Issue

## Switzerland: What next for the SNB?

### Economics

Europe including UK

#### Growth has been weaker and inflation stronger recently

Since the last SNB meeting in March, GDP growth has surprised on the downside and inflation has come in stronger. Real [GDP growth](#) in Q1 was 0.1% q/q (0.7% y/y), slightly below our and consensus expectations (0.2% q/q) and lower than the 0.4% q/q growth rate in Q4. This came against the backdrop of fairly strong growth in the Euro Area in Q1 (0.6% q/q) and strong readings in the Swiss Manufacturing PMI. We continue to project a gradual pick-up of growth in Q2 and through the year, helped by a weaker CHF relative to last year and robust growth in the Euro Area. Overall, we maintain our GDP growth projection of 1% for this year and 1.5% for 2017. The SNB's forecast for this year as published in March is 1-1.5%.

Headline inflation has increased from -1.3% in January to -0.4% in May, driven primarily by a substantial rise in core inflation and less drag from energy prices. We have increased our forecast and now expect inflation to average -0.3%y/y this year (up from -0.7%) and 0.4% in 2017 (up from 0.2%). Hence, inflation should gradually increase going forward, supported by the envisaged rise in energy prices and a weaker CHF, but damped by an increasing output gap as GDP growth remains below its potential. We expect inflation rates to turn positive at the turn of the year and to reach 0.6% in Q4 2017.

#### We continue to expect the SNB to keep rates on hold until at least Q2 2017

Against this background, we continue to expect the SNB to keep rates on hold until at least Q2 2017. FX intervention is projected to be the policy tool of choice to guard against an appreciating CHF, as frequently noted by the SNB. A further cut in the interest rate on sight deposits would only be an [option](#), in our view, if substantial intervention is required by the SNB to keep EURCHF above 1.05-07. While, in principle, the SNB could lean against massive appreciation pressures, the willingness of doing so seems limited as the result would be a significant increase in its balance sheet; the SNB already has one of the largest balance sheets among advanced economies, and SNB board members have in the past argued against an 'uncontrollable expansion'.

#### First rate increase a function of ECB QE

Our baseline is for rates on sight deposits to remain at -0.75% until the end of the ECB's QE programme, when the appreciation pressures on the CHF are assumed to fade. We think the ECB will give guidance at either its September or December meeting on the duration of QE beyond March 2017, i.e., whether it will prolong purchases, taper them or stop them altogether. [After last week's ECB meeting](#), we think the chances of ending QE in March 2017 have declined further. This implies that the probability of the SNB keeping rates at their current level has increased. We will re-assess our SNB rate call once more guidance is obtained from the ECB.

#### Market views: FX and rates

The Swiss franc is virtually unchanged vs. the euro since the 17 March meeting and we look for EURCHF to [rise to](#) 1.15 by early 2017. If the outcome of the UK vote on EU membership on 23 June results in a marked appreciation of the Swiss franc, we believe the SNB is [likely](#) to step up FX interventions before considering rate cuts. The recent increase in Swiss inflation and improvement in Euro Area growth have not resulted in higher 10y Swiss yields yet even as market-based expectations of further easing by the SNB in the next 12 months have fallen since March (Figure 4:). We see the drag on 10y Swiss yields as a result of the recent fall in 10y German yields, which we [expect to reverse](#) in the medium term, resulting in 10y Swiss yields rising gradually. We expect a wider [10y EUR-CHF](#) yield spread and 10y Swiss yields to [rise more than](#) those in Japan.

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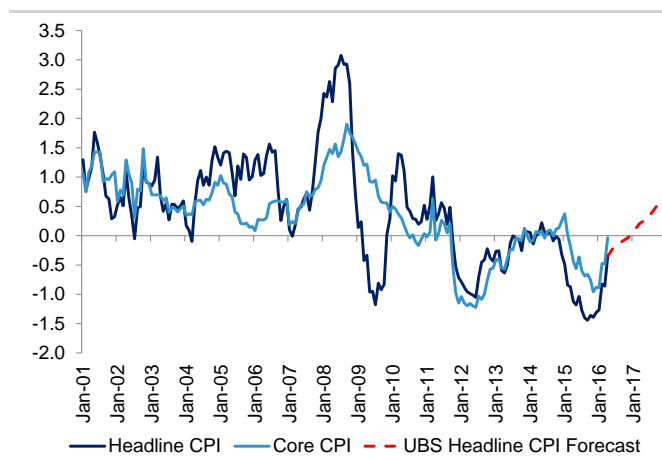
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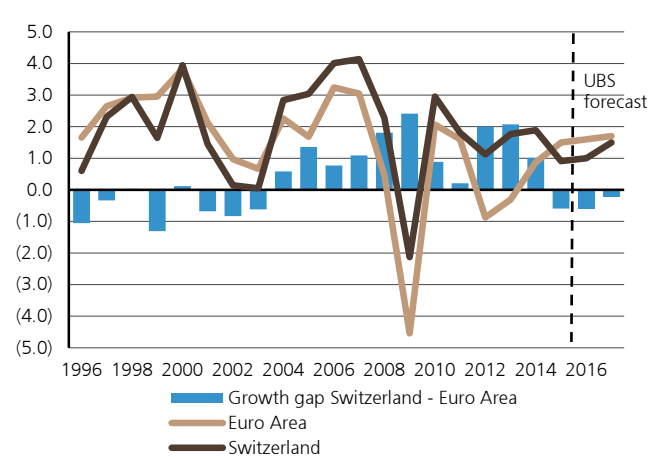
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**Figure 1: Swiss inflation: Core and headline (YoY change %)**



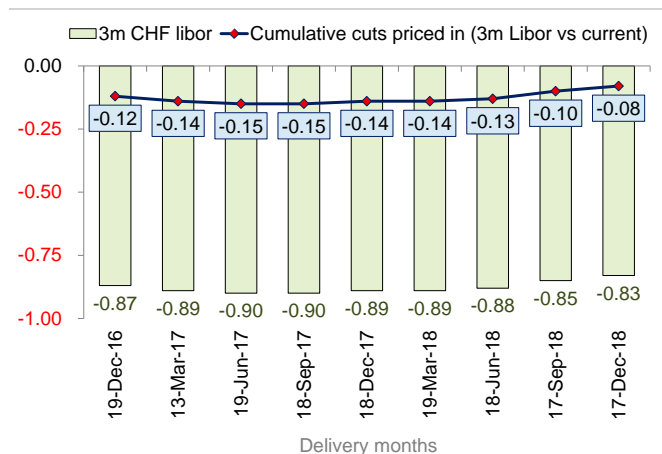
Source: Haver, UBS

**Figure 2: GDP growth Switzerland and Euro Area (%)**



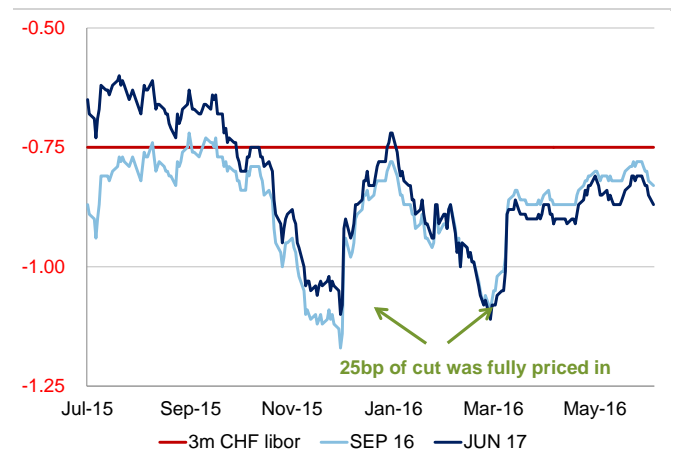
Source: Haver, UBS

**Figure 3: Cumulative cuts priced in by the market (dates correspond to the expiry date of 3m CHF Libor contracts); a 50% chance of a 25bp rate cut in the next 3 months (%)**



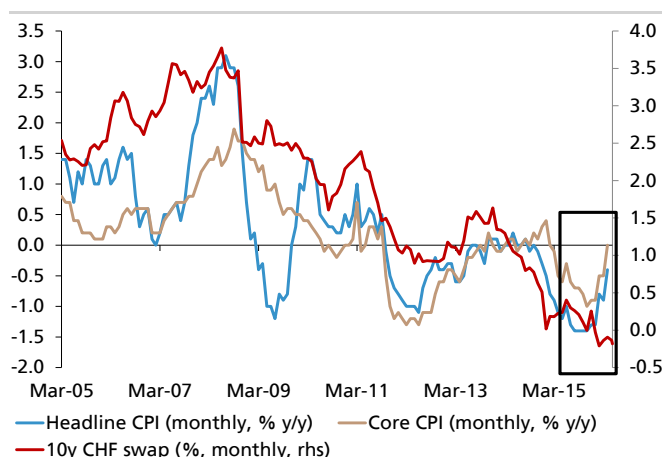
Source: SNB, Bloomberg, UBS

**Figure 4: Market expectations of a rate cut by September 2016 and to June 2017 have reduced dramatically since March 2016 but have increased in the past few days (%)**



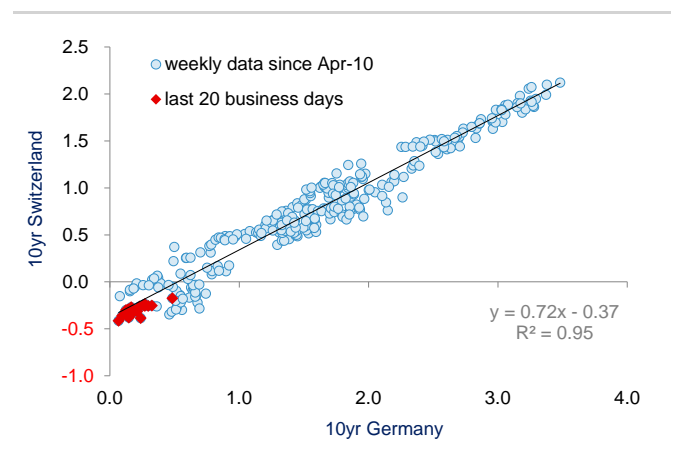
Source: Bloomberg, UBS

**Figure 5: 10yr CHF swap yields have decoupled from Swiss CPI in the past few months**



Source: Bloomberg, UBS

**Figure 6: 10-year Swiss yields continue to remain highly correlated with German yields; yields in both markets are currently at historical lows (%)**



Source: Bloomberg, UBS

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