GERMAN AND SWISS SOVEREIGN BONDS UPDATE

TORN BETWEEN INFLATION AND RECESSION

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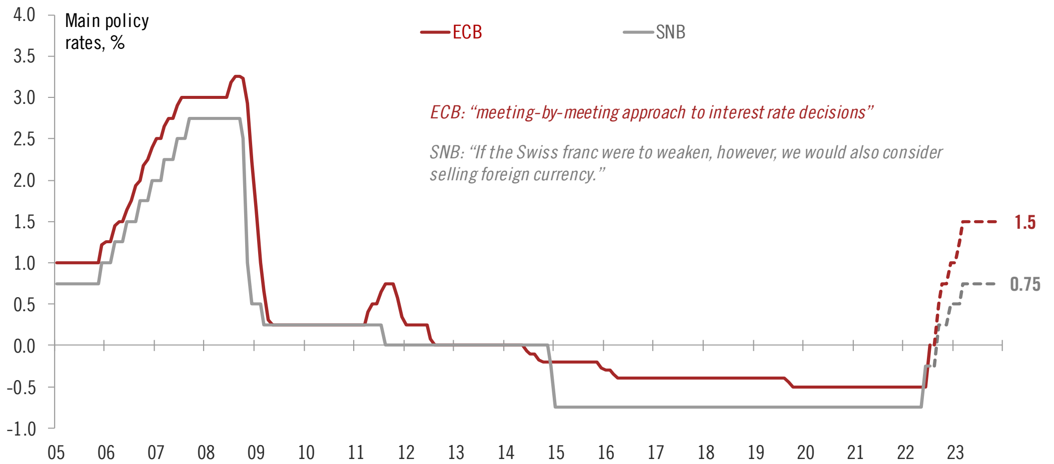
SUMMARY

- After peaking at 1.76% and 1.46% respectively on 21 June, the German and Swiss 10-year government bond yields have rallied sharply on the back of economic growth concerns to 0.93% and 0.55%, respectively – a fall of more than 80 bp (between 21 June and 27 July).
- Through their decisive anti-inflation actions, the European Central Bank (ECB) and the Swiss National Bank (SNB) have set market participants' expectations for this year's rises in policy rates, but recession concerns have led to a repricing of their terminal rates lower to 1.04% and 0.57% in 18-month, respectively.
- Even if we reckon that increasing downside risks to economic growth in Europe could lead German and Swiss 10-year government bond yields lower in the coming months, the ongoing supply side and gas shortages likely mean inflation will stay high with the ECB and SNB hiking their policy rates further.
- In our central scenario, we therefore expect the 10-year German and Swiss government bond yields to rise slightly into year-end to 1.3% and 0.9%, as market participants' concerns about a severe recession are assuaged.
- The positive inflation rate differential between the euro area and Switzerland that we project is likely to maintain the yield differential between the 10-year Bund and its Swiss counterpart in positive territory and close to 40 bps.
- We stay neutral on core sovereign bonds, expecting them to remain a safe-haven asset in case of recession or financial markets turmoil. Although elevated inflation could put a floor on yields due to further policy rate hikes, long-term yields could experience only a moderate rise into year-end due to lingering growth concerns.

CHART 1: EUROPEAN CENTRAL BANK AND SWISS NATIONAL BANK POLICY RATE AND OUR PROJECTIONS



Source: Pictet Wealth Management – CIO Office & Macro Research, Refinitiv, as of 27.07.2022

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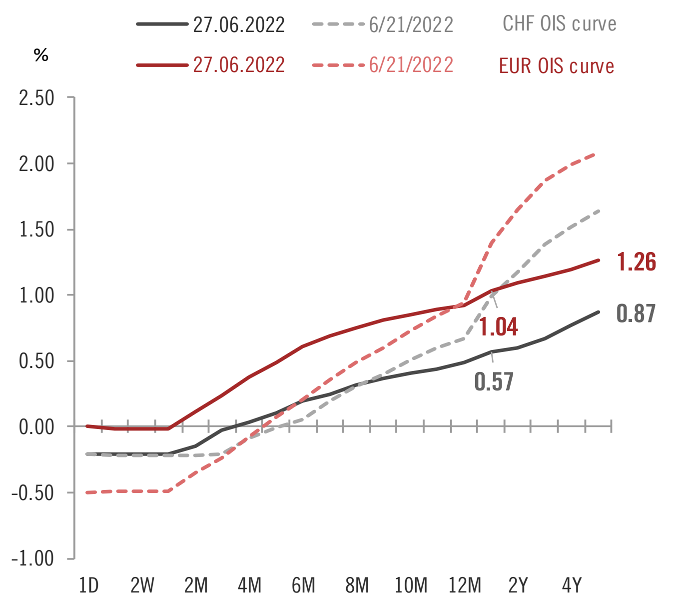
A fall in yields driven by recession worries

After peaking at 1.76% and 1.46% respectively on 21 June, the **German and Swiss 10-year government bond yields have rallied sharply on the back of economic growth concerns** (*see chart 3*). The surge in commodities prices, the fear of gas rationing and the central banks' hawkish rhetoric have all contributed to market participants increasingly pricing in a risk of recession in Europe, which has in turn led long-term government bond yields lower, and this despite still accelerating inflation.

Both the European Central Bank (ECB) and the Swiss National Bank (SNB) showed their resolve in their fight against above-target inflation by hiking their policy rates by a surprising 50 bp (on 21 July and 16 June, respectively). This brought the euro deposit rate back to zero, while the SNB policy rate remains negative at -0.25% (*see chart 1*). Through their decisive anti-inflation actions, both **central banks have set market participants' expectations for this year's rises in policy rates, but recession concerns have led them to reprice both the ECB and the SNB's terminal rate lower** (*see chart 2*), contributing to the 10-year German Bund yield falling to 0.93% and its Swiss counterpart to 0.55% a fall of more than 80 bp (between 21 June and 27 July).

Although in mid-June market participants' pricing of the ECB's and SNB's terminal rate looked aggressive, the recent fall to 1.04% and 0.57% in 18-month, respectively (on 27 July), means it is now below our economists' projections of 1.5% for the euro deposit rate and 0.75% for the SNB's policy rate by the end of 2023 (*see charts 1 & 3*).

CHART 2: ECB AND SNB FUTURE POLICY RATE PATH PRICING



Source: Pictet Wealth Management – CIO Office & Macro Research, Bloomberg Finance L.P., 27.07.2022

CHART 3: 10-YEAR GERMAN AND SWISS GOVERNMENT BOND YIELDS

Source: Pictet Wealth Management – CIO Office & Macro Research, Factset, 27.07.2022

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As such, even if we reckon that **increasing downside risks to economic growth in Europe could lead German and Swiss 10-year government bond yields lower in the coming months**, the ongoing supply side and gas shortages likely mean inflation will stay high. **As inflation is the only objective for both the ECB and the SNB they will probably need to hike their policy rate further until the end of the year**. Moreover, we believe the economic slowdown could be mild in part thanks to a robust labour market, savings accumulated during the pandemic lockdowns and government fiscal support to counter part of the rise in energy costs.

Elevated inflation likely to provide a floor to yields

In our central scenario, we therefore expect the German and Swiss 10-year government bond yields to rise slightly into year-end to 1.3% and 0.9% (an upward revision from our previous forecasts of 0.4% and 0.3%, respectively), as market participants' concerns about a severe recession are assuaged. Nevertheless, **uncertainty around the future path of inflation and policy rates is high, which is likely to translate into bond market volatility staying elevated** for some time.

On top of that the **ECB has effectively abandoned its forward guidance on policy rates** by stating in its 21 July monetary policy decision communiqué that it was shifting to a "meeting-by-meeting approach to interest rate decisions". While the SNB has never had a forward guidance policy, rather preferring to surprise market participants (as acutely reminded on 16 June), **it has significantly shifted its stance with regards to the Swiss Franc.** It now aims for **a strong Swiss Franc to dampen imported inflation**, being ready to use its balance sheet in this endeavour as stated in its 16 June communiqué: "If the Swiss franc were to weaken, however, we would also consider selling foreign currency".

The reaction of the Swiss Franc to this drastic change in rhetoric has been swift, as it has appreciated by 6.09% against the euro between 15 June and 27 July, and by a more moderate 3.61% against the US dollar. This **strengthening of the Swiss Franc** against the two main currencies used for Switzerland's imports **is likely to translate into the country's inflation rate remaining well below its European neighbours** even though it imports most of its energy (electricity and gas) from the region. This **positive inflation rate differential** between the euro area and Switzerland that we project **is likely to maintain the yield differential between the 10-year Bund and its Swiss counterpart in positive territory** and close to 40 bps. We had already signalled in our preceding note, that after turning negative since 2020, we were expecting the yield differential to become positive again.

In this environment **we stay neutral on core sovereign bonds as we expect them to remain a safe-haven asset in case of economic recession or financial markets turmoil**. Additionally, although elevated and still rising inflation rates could put a floor on yields as central banks keep hiking policy rates, **long-term yields could experience only a moderate rise into year-end if we enter a mild recession in Europe** as we expect in our central scenario. Alternatively, the risk is for a larger rise in German and Swiss 10-year yields if there is no economic recession and inflation stays elevated, while yields could fall again in a range between 0% and 0.5% if the recession is severe, potentially forcing both the ECB and the SNB to cut short their hiking cycle.

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