PICTET WEALTH MANAGEMENT

Switzerland: What about a return to negative interest rates?

Finding positive income in Swiss corporate bonds and high dividend equities

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SUMMARY

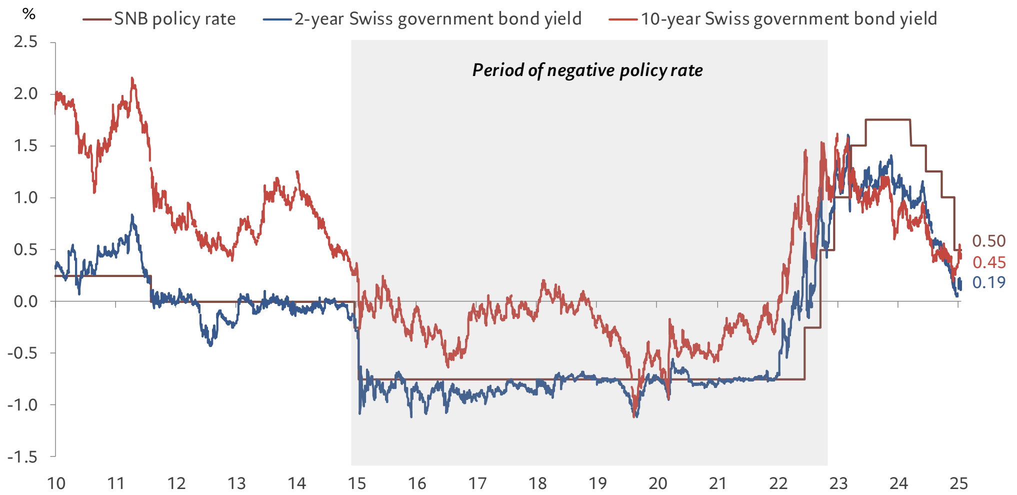
- The Swiss National Bank (SNB) recently cut its policy rate by 50 basis points to 0.5%, with expectations for two more cuts this year, potentially lowering the rate to 0.0%. There is a chance of further reductions, including negative rates, especially if the Swiss franc strengthens. The SNB previously had negative rates from 2014 to 2022 to manage currency pressures.
- Swiss government bonds performed well at the start of the negative rate period, but returns were mediocre afterwards. In 2025, we foresee a slight decrease in the 10-year yield to 0.25%, but a return to negative policy rates could push it back into negative territory. While this could enhance returns for both Swiss government and corporate bonds, only the latter would likely continue to offer positive yields.
- We see limited impact on CHF if Swiss policy rates do turn negative as we believe macro growth conditions and global risk appetite are more relevant tactical drivers of the currency.
- A return to negative Swiss rates and/or bond yields is unlikely to have a significant impact on the performance or valuation of the Swiss equity market. However, such an outcome would increase the attraction of Swiss companies that offer a high and secure dividend yield as domestic investors look for alternative sources of income.

ALL ROADS LEAD TO ZERO (AND BEYOND)

The Swiss National Bank (SNB) lowered its policy rate by 50bp to 0.5% at its last monetary policy meeting in December, citing a further decline in inflationary forces. As we expect inflationary pressures to remain low in Switzerland this year, **we see two more 25bp rate cuts, one in March and one in June. This would bring the SNB's policy rate down to 0.0%**. But there is a chance rates could be lowered further. In other words, a negative policy rate cannot be ruled out, especially if the Swiss franc strengthen.

Negative rates would not be new in Switzerland as the SNB's policy rate was in negative territory between 2014 and 2022. **On 18 December 2014, the SNB decreased its policy rate to -0.25%**. The rate was lowered further, to -0.75%, in January 2015 when the SNB also discontinued the minimum exchange rate of CHF1.20 per euro it had put in place between September 2011 to January 2015 (supported by FX intervention). The aim of introducing negative interest rates was to restore the interest rate differential against other currencies and lower the pressure on the CHF. Following the surge in inflation post pandemic, the SNB decided to allow the Swiss franc to appreciate (in nominal terms) with the aim of reducing inflationary pressure emanating from abroad. Additionally, the SNB started to tighten its monetary policy by raising its policy rate by 50bp to -0.25% in June 2022. **On September 2022, the SNB raised the policy rate further, this time by 75bps, bringing it back into positive territory, to 0.5%**. The SNB continued to hike rates until June 2023 reaching 1.75%. However, due to reduced inflationary pressure, weaker economic activity, and the appreciation of the Swiss franc in real terms, the SNB eased its monetary policy by lowering its policy rate by 0.25bps to 1.5% in March 2024. Since then, the SNB has cut its policy rate at each meeting, reviving the debate about negative interest rates.

Chart 1: a negative policy rate meant government bond yields close to zero or below



Source: Pictet Wealth Management, Bloomberg Finance L.P., 22 January 2025

To be sure, a negative interest rate is not our baseline scenario, but rather a risk scenario. The key questions that arise are under what conditions the SNB might lower rates below 0%, how far can they go and what could the other options be?

First, price pressures are low in Switzerland, and we believe the SNB might tolerate some negative prints in inflation without overreacting. To see the SNB pushing rates much lower, we will need to see a worsening in economic activity, inflation falling well below the target for some months and a renewed strengthening in the Swiss Franc (in real terms).

Second, there is a limit to how much a central bank can cut interest rates into negative territory before they start harming the economy. The interest rate limit at

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which accommodative policy becomes contractionary is known as the reversal rate, as described by Brunnermeier and Koby (2018)[1]. We do not know what the level of the reversal rate is in Switzerland. In the euro area, it is estimated at -1.0%[2]. **In Switzerland, past experience has shown that -0.75% was not the reversal rate, so interest rates could go lower in a negative scenario**. It is worth mentioning that at the time of negative interest rates, the SNB introduced a reserve tiering system to limit the financial burden on banks (see appendix for further details). We believe the SNB is likely to reintroduce a tiering system should they lower rates below 0%.

Third, the SNB has two main policy tools: interest rates and FX interventions. The SNB could intervene substantially in the FX market to limit persistent appreciation pressure on the CHF. Intervening in the FX market has also its downsides. The SNB's balance sheet is already large and, as seen in recent years, the larger it becomes, the more volatile are the SNB's profits. The SNB has signalled its willingness to intervene in FX markets, if necessary. So far, interventions have been limited and the policy rate has been the main policy tool. **We believe the SNB is likely to rely more on FX interventions for active easing as the policy rate approaches to zero**.

NEGATIVE POLICY RATES LIKELY TO MEAN LOW YIELDS ON SWISS BONDS

Looking back at the introduction of the negative policy rate in 2014, the impact on Swiss government bond yields was massive, as both short-term and long-term yields fell below zero (*see chart 1*). While the two-year yield remained close to the policy rate until 2022, when market participants started anticipating the SNB's rate hiking cycle, the 10-year yield was more volatile. It oscillated between negative territory and zero, reaching a low point of -1.12% in August 2019 due to global recession fears.

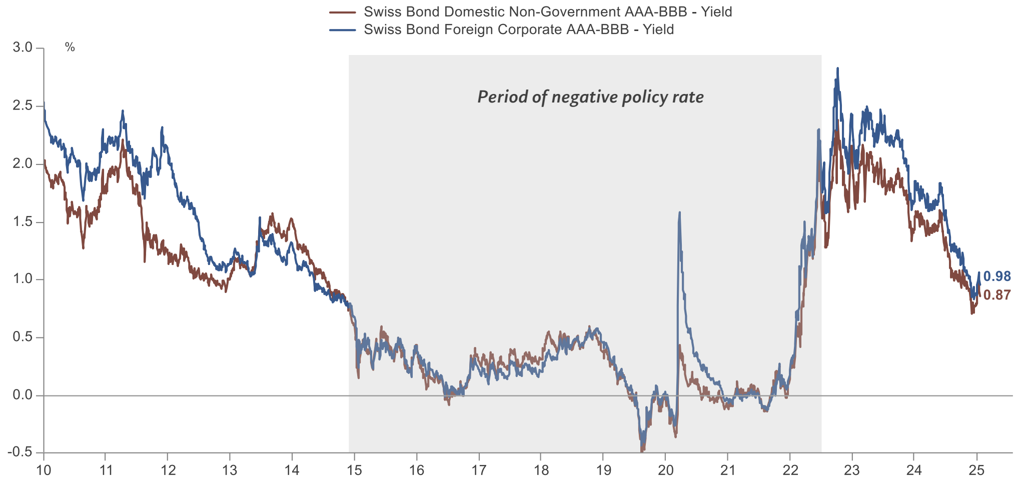
While the Swiss investment grade (IG) corporate bond market in aggregate did not experience such a long period of negative yields thanks to the additional yield pick-up it offers over sovereign bonds (i.e. the credit spread), yields did fall below zero for brief periods (*see chart 2*). Nevertheless, by historical comparison**, IG corporate bond yields were low, hovering between 0% and 0.5%**, except during the 2020 Covid-crisis when credit spreads shot up, leading yields to spike.

Given the elevated sensitivity of 10-year Swiss government bonds to yields movements (due to a duration around 10 years), **they performed very well at the start of the negative policy rate period**, but very poorly when the SNB started its rate hiking cycle in 2022 (*see chart 3*). The same observation holds for corporate bonds, even though a shorter duration limits the rate sensitivity. Baring this starting point however, **the total return performance of Swiss bonds is mediocre in a negative rate environment because of the low (or even negative) yield they offer.**

[1] Brunnermeier M.K., Koby Y. (2018), "The Reversal Interest Rate", NBER Working Paper 25406.

[2] Darracq-Pariès, Matthieu, Christoffer Kok, and Matthias Rottner. (2020), "Reversal interest rate and macroprudential policy" ECB working paper 2487.

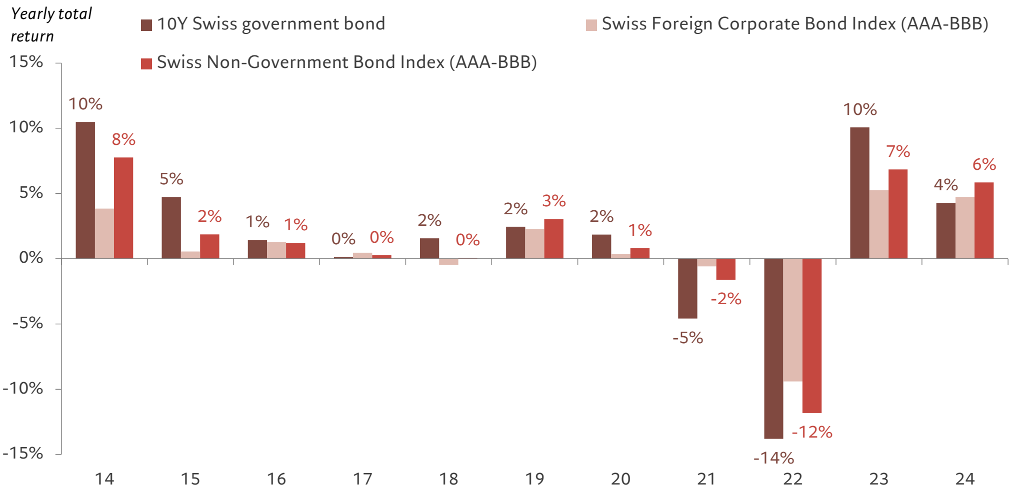
Chart 2: A negative policy rate meant low yields on Swiss corporate bonds



Source: Pictet Wealth Management, FactSet, 22 January 2025

In our central scenario for 2025, we expect the 10-year Swiss government bond yield to fall slightly from 0.45% (on 22 January) towards 0.25%, which is consistent with an SNB terminal rate at zero and subdued inflationary pressures. This would translate **into a low single digit return for the 10-year Swiss bond, making Swiss corporate bonds more attractive thanks to the higher yield they offer** (*see chart 2*). We remain neutral on Swiss government bonds and have a preference for Swiss credits.

Chart 3: Swiss bonds perform well at the start of the negative rate environment



Source: Pictet Wealth Management, Bloomberg Finance, L.P., FactSet, 31 December 2024

Nevertheless, we see clear downside risks on our 10-year yield forecast should the SNB's policy rate go negative again. In that case, **we would expect the 10-year yield to also dip into negative territory, most likely ending the year close to -0.2%.** In that alternative scenario, **10-year Swiss government bonds and Swiss corporate bonds would likely post a high single digit total return in 2025.**

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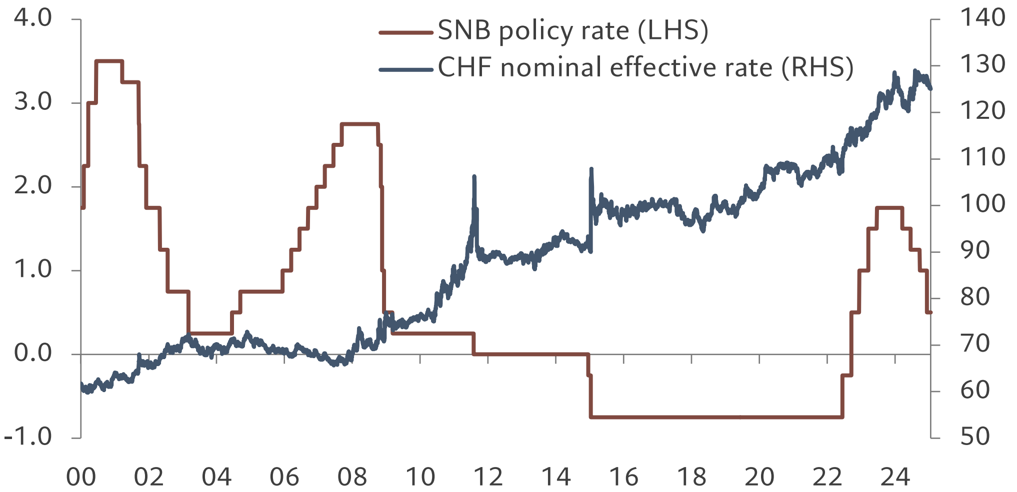
THE FRANC NEED NOT FEAR NEGATIVE INTEREST RATES

Given the strong macroeconomic fundamentals of the Swiss economy, **the franc has been on a multi-decade long appreciation trend**. This has persisted during periods of global crises, such as the Great Financial Crisis (GFC) or Covid, as well as the previous recent period of negative interest rates from December 2014 to September 2022. When the SNB abandoned the floor in January 2015, and lowered the policy rate to -0.75%, it nevertheless prompted an immediate further appreciation of the CHF.

As a result, **negative interest rates are not an impediment to franc appreciation** and indeed, they are most likely to be introduced in an effort to combat excessively rapid franc appreciation. Ultimately, the franc is likely to be driven by both Swiss economic conditions (such as domestic growth, the size of the current account surplus and the momentum of capital flows), as well as global attitudes towards risk (eg a rise in geopolitical tensions). If competitor economies such as the eurozone witness economic and/or political instability, the Swiss economy is set to stand out and its exchange rate to benefit. However, CHF could come under depreciation pressure if Switzerland became a target of President Trump's tariff policies.

Chart 4: The Swiss franc appreciated through various policy regimes



Source: Pictet Wealth Management, SNB, 22.01.2025

NEGATIVE RATES WOULD SUPPORT SWISS STOCKS PAYING GOOD DIVIDENDS

The start of 2015 was a very turbulent time for Swiss equities with the SMI index registering its biggest daily drop in 30 years (excluding one day during the covid pandemic in March 2020) of almost 9% on January 15th. While this coincided with the SNB's 50bps cut to take the policy rate further into negative territory we believe it was the concurrent change in the currency regime (discontinuing the minimum exchange rate) that was both the bigger surprise and hence also the bigger driver of the fall in equity markets.

Looking forward, the lack of any similar FX shock this time suggests that **Swiss equities would be less vulnerable if the SNB policy rate and/or Swiss bond yields**

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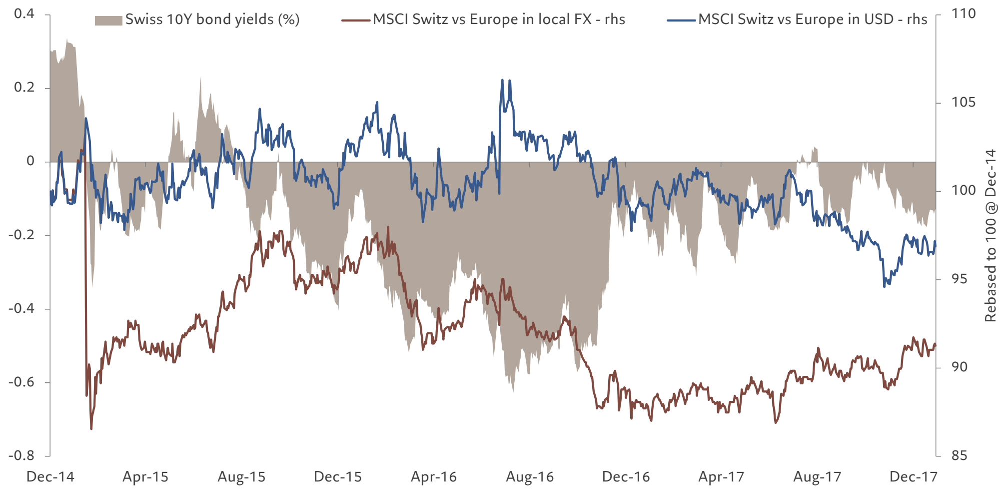
returned to negative territory again. Excluding this initial 'shock' period at the start of 2015, our analysis suggests that the impact on Swiss equities from the previous episode of negative Swiss rates and yields is moderate. For example, over the period from December 2014 to December 2017, the SMI index rose by 2.6% but underperformed MSCI Europe by 9% in local FX terms and lagged by 3% in USD terms (*see chart* 5). Even on a more tactical basis, there seems to be little link between short-term changes in Swiss bond yields and the relative performance of Swiss stocks.

Chart 5: Negative bond yields provided little support to Swiss stocks between 2015-2017



Source: Pictet Wealth Management, LSEG, MSCI, 20.01.2025

Given how different the macro and market environment is today (versus the mid-2010s), it is important to look at more recent correlations between Swiss equities, bonds and the CHF when we think forward to potential changes in Swiss monetary policy. As per *chart 6*, moves in Swiss bond yields (absolute or relative to Bunds) have had very little impact on Swiss equities over the last 12 months. However, there is more of a link to the CHF, where Swiss stocks have tended to outperform their peers during periods of currency strength and vice versa. This analysis suggests any CHF weakness associated with a move into negative rates is unlikely to drive any material outperformance from Swiss equities.

Looking back over the last decade we can find no link between the yield on Swiss bonds and the PE ratio on Swiss stocks. That is to say, lower yields do not seem to push equity valuations higher. However, **for income-oriented Swiss investors the low level of bond yields should increase the attraction of Swiss stocks given their increasingly superior yield** as shown in *chart* 7. In addition, the higher dividend paying stocks within Switzerland tend to be concentrated in the more defensively oriented sectors, suggesting a **high level of dividend resilience**.

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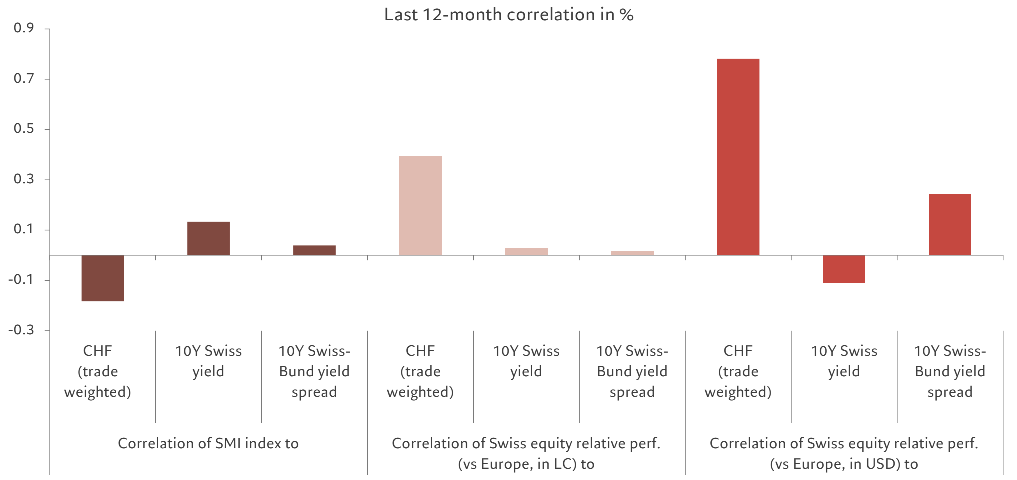
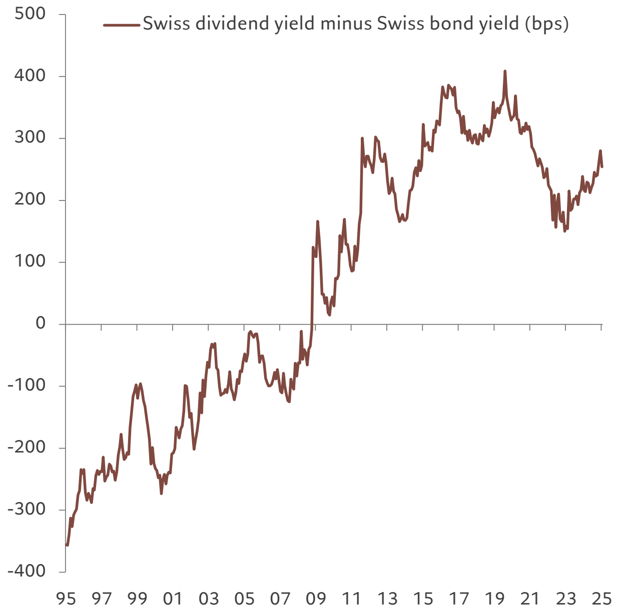
Chart 6: Strong Swiss franc supports Swiss equities relative performance to Europe



Source: Pictet Wealth Management, Bloomberg Finance L.P., 20.01.2025

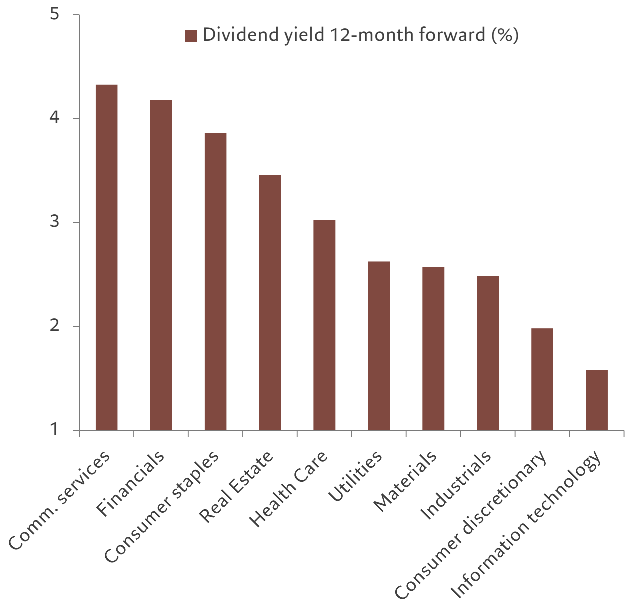
To conclude, we don't believe that a return to negative Swiss rates and/or bond yields would cause a significant change in the direction of the Swiss equity market, either on an absolute basis or relative to regional peers. However, we do think that such an outcome would increase the attraction of Swiss companies that offer a high and secure dividend yield as investors look for alternative sources of income.

Chart 7: Swiss stocks already offer a dividend yield 250bps higher than that on offer from Swiss bonds



Source: Pictet Wealth Management, LSEG, 20.01.2025

Chart 8: High dividend yields come from defensive sectors where dividend security should be good



Source: Pictet Wealth Management, Bloomberg Finance L.P., 20.01.2025

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APPENDIX: SNB TIERING SYSTEM

To limit the financial burden on banks, the SNB introduced a reserve tiering system. Under such a system, negative interest rates were applied only to sight deposits above a certain pre-defined threshold (see appendix for further details). In case of negative rates, we believe the SNB is likely to reintroduce a reserve tiering system to limit the burden on banks.

When introduced in December 2014, the exemption threshold was set at the bank-specific minimum reserve requirement[3] for the period of 20 October 2014 to 19 November 2014 times 20 (the threshold factor) (see SNB press release, 18 December 2014 here).

The exemption threshold was adjusted on 1 November 2019 (see SNB press release, 19 September 2019 here). Under the new method, the minimum reserves taken into account were a moving average over the preceding 36 reference periods multiplied by the threshold factor (instead of a fixed level of minimum reserves). The threshold factor was also increased from 20 to 25. The new method led to a large increase in overall exemptions, but with variations across banks[4]. In April 2020, the threshold factor rose to 30.

[3] In Switzerland, reserve requirements are determined by the short-term liability structure of a bank's balance sheet. Specifically, the reserve requirement equalled 2.5% of relevant short-term liabilities until 30 June 2024. The SNB rose the minimum reserve requirement to 4%, effective in July 2024

[4] Andreas Fuster, Tan Schelling, Pascal Towbin: "Tiers of joy? Reserve tiering and bank behavior in a negative-rate environment", SNB working paper, April 2021

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