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MACRO MORNING BRIEFING

June 19, 2024

Hawkish Doves Fly In Europe

SNB also a candidate for 'hawkish cut'

- Situation in France will play into CHF valuations calculation
- Clear upside risk to conditional inflation forecasts
- BoE to stay on the sidelines ahead of election

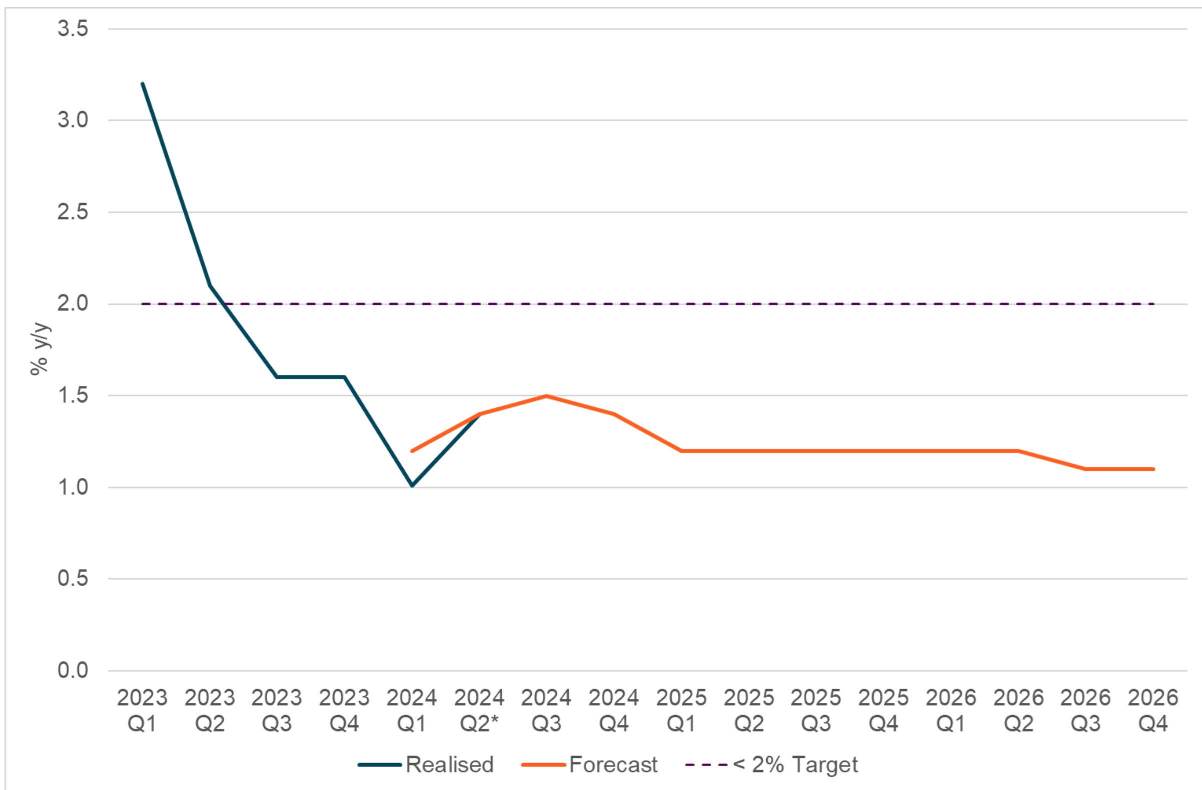
Policy and politics to mix again in Europe

This week's global policy calendar is fully focused on Western Europe with the Swiss National Bank, Bank of England and Norges Bank all due to deliver policy decisions.

Of the three, we think a rate cut is only possible from the SNB – but a toss-up at best. We held strong reservations about the surprise cut in March given the scale of the reductions in conditional inflation forecasts; we felt the downward revision for the entire forecast horizon was too aggressive. Standard errors increase further out into the forecast horizon relative to more immediate forecasts, and there is also a mismatch with the timeframe of monetary policy transmission. Consequently, the risk of policy error appears relatively high – and recent Swiss inflation numbers do not give the SNB grounds for comfort.

Be it a 'hawkish hold' or a 'hawkish cut' a la the European Central Bank, the SNB will likely need to raise inflation forecasts for its latest conditional inflation outlook (exhibit #1). Although it is unlikely that 2% is achievable through the forecast horizon, at least it would point to slightly higher (i.e., non-zero) terminal rates, and also be consistent with SNB President Jordan's recent comments suggesting the risk of higher equilibrium rates.

Exhibit #1: SNB Conditional Inflation Forecasts

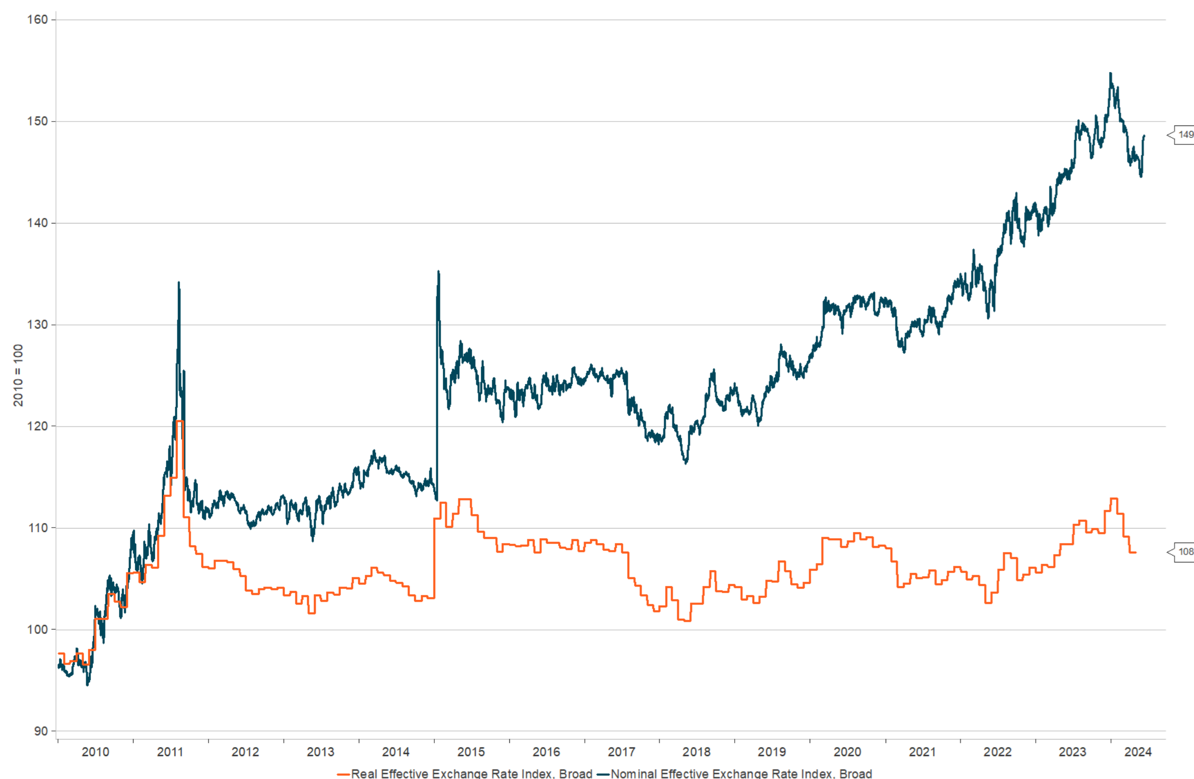


Source: Swiss National Bank, BNY Mellon

What may help tip the SNB into a cut despite more robust domestic conditions is the sudden re-emergence of sovereign risk premia, this time centred on France ahead of its elections. For the SNB's Governing Board, domestic inflation drivers remain the focus of policy direction – the thrust of the Q1 decision – so to suddenly pivot to external factors could complicate communication. Reports suggest that even the ECB is relatively comfortable with current developments with respect to monetary policy. We believe the only reason for a more assertive response is if external developments generate sharp CHF appreciation and contribute to any reinforcement or deterioration in the Q1 conditional inflation forecast.

There has been a clear reaction of late in the CHF nominal effective exchange rate (NEER) and we do not doubt that in the event of Eurozone sovereign risk, CHF will perform strongly as a safety valve. However, compared to the 2010-2011 run, the CHF real effective exchange rate (REER) remains well off the highs due to higher external inflation – including in the Eurozone. On the other hand, pace matters as much as levels. In hindsight, sharp CHF appreciation against all currencies towards the end of 2023 contributed significantly to the surprisingly downbeat inflation assessment in March, even if that round of currency strength was relatively short-lived and fully reversed in REER terms in subsequent weeks.

Exhibit #2: CHF Effective Exchange Rates (BIS)

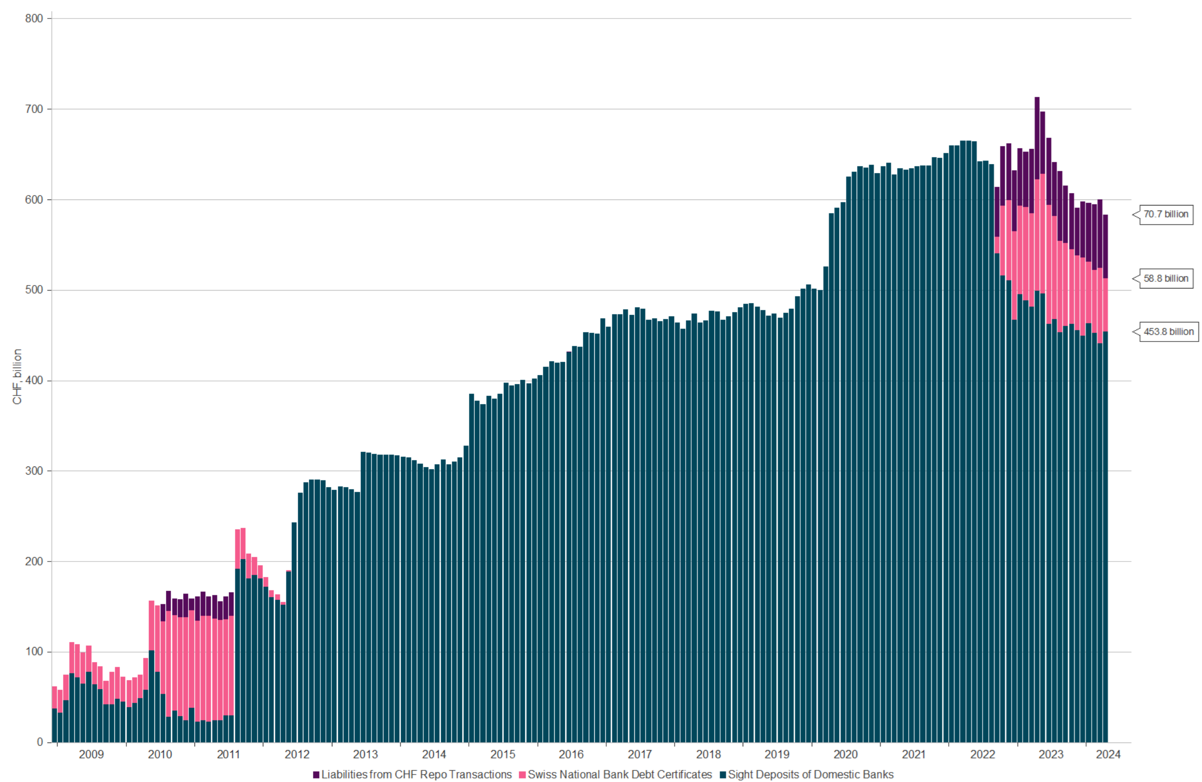


Source: Macrobond, BIS, BNY Mellon

Even if the SNB refrains from action on rates, it has other policy options through balance sheet activities, especially to increase the opportunity cost of holding francs. The number may be subjective but suffice it to say that at above CHF450bn or over 50% of nominal GDP, the level of sight deposits comfortably fits with the Fed's notion of “lowest comfortable level of reserves”. These levels would have exerted downside pressure on money-market rates in any case, but there is an additional CHF150bn to ‘liquefy’ back into sight deposits via liability management (exhibit #3). Repo transactions and SNB bills can roll off naturally, and in extremes bills can be bought back by the SNB, which it did actively in 2011. However, these would be reactive decisions and be highly contingent on CHF movement as specified above.

We retain our view that outright intervention will not take place until rates are cut to zero. Furthermore, we think the SNB will need to be particularly sensitive to the notion of intervention in reaction to stress in Eurozone sovereign debt. A dozen years ago, the SNB’s FX purchases were subsequently invested in Investment Grade Eurozone debt – leading to the perception that the SNB was inadvertently helping the ECB and Eurozone to ‘close spreads’. It would be easy to again draw parallels given current developments in OATs.

Exhibit #3: SNB Balance Sheet, Liabilities



Source: Macrobond, BNY Mellon

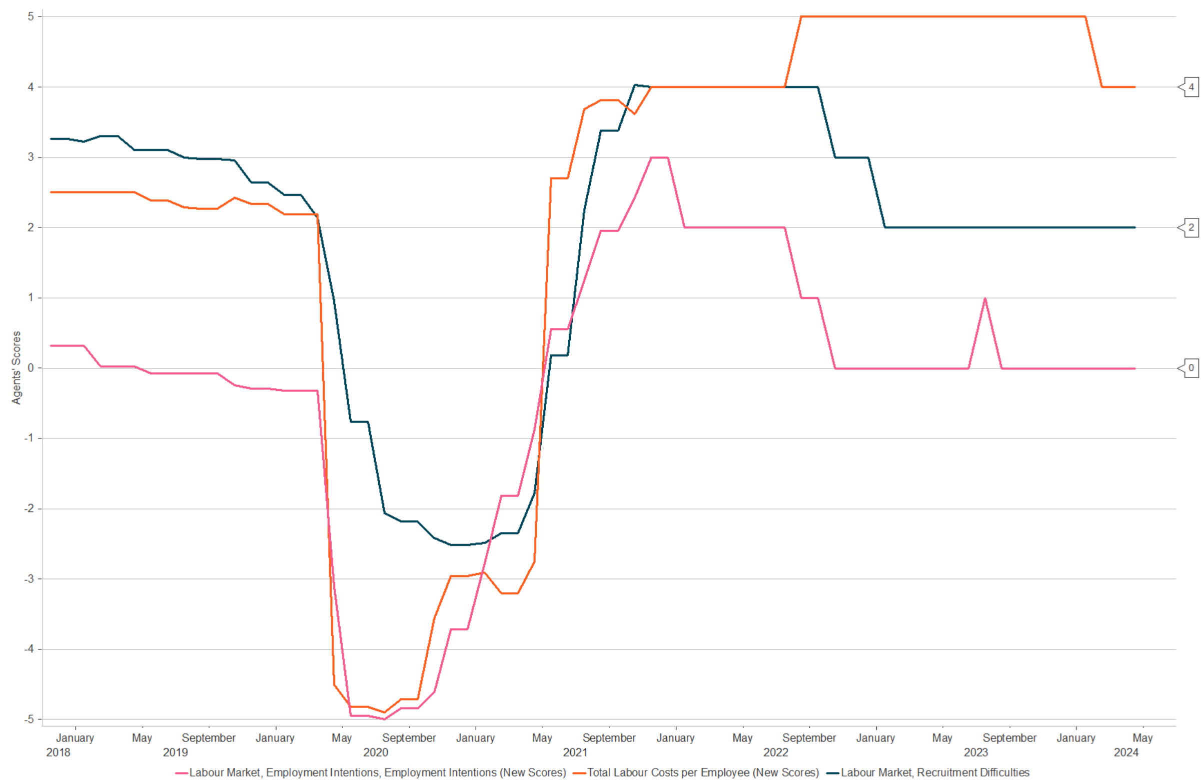
Moving to the UK, normally the BoE's MPC vote would be a highlight of any monetary policy week. Official commentary in the immediate aftermath of the last meeting pointed to a very close result for the June decision: at various points markets were willing to expect the first cut this year being brought forward to this month. However, the surprise decision by Prime Minister Rishi Sunak to call a general election for July 4th has complicated matters. Without the election, we believe that a majority for a cut would have remained lacking. But considering the political sensitivities just two weeks before the election, we expect MPC members will retain their votes from May. The cost-of-living crisis is at the forefront of campaigning. A rate cut would evidently support improvement in cashflow for households with mortgages and affect the immediate narrative of the election, even though we believe it wouldn't materially affect the vote given the wider issues affecting opinion polls. Nonetheless, the BoE – like all independent central banks – would be highly averse to any political narrative being injected into its decision-making. As soon as the election was called, BoE communication was largely reduced to statutory requirements.

Although the MPC decision on Thursday does not require the publication of a Monetary Policy Report, the statement will contain the BoE's latest assessment on price pressures and the important topic of wage persistence – the main factor inhibiting the BoE from decisively moving towards a dovish stance. Unlike the ECB and SNB, there isn't really an option of a 'hawkish hold' (assuming a cut is off the table) because the market sees far less scope for downward revisions to inflation. Governor Bailey has stressed in the past that inflation need not reach the policy target before the MPC opts to cut rates, and this is reflected in the votes of some members. However, some basic 'dissolution' (the opposite of crystallisation in physics) of "more persistent inflationary pressures" is still lacking. For example, the latest

BoE agents' survey still does not contain a single labour market factor in negative territory (exhibit #4), and the only 'improvement' has been total labour costs for new employees falling from the highest score. The clear disconnect between wage growth and employment levels – mostly due to participation distortions – continues to frustrate the MPC.

We retain our view that the BoE will only be ready to move in August, though there is even a case for a later shift as the MPC can assess the first fiscal event after the election.

Exhibit #4: Bank Of England Agents' Survey



Source: Macrobond, BNY Mellon

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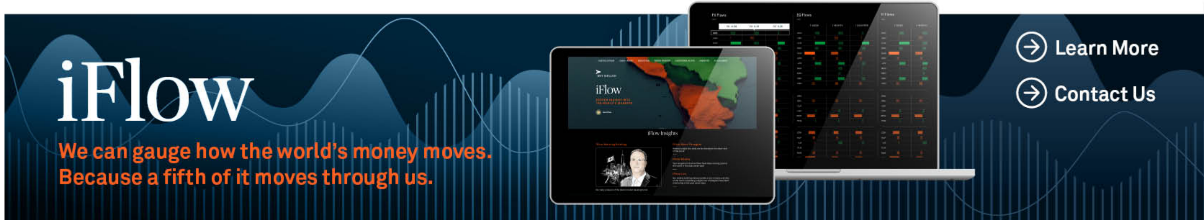

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