GLOBAL FIXED INCOME & CURRENCY STRATEGY

August 30, 2024

How Low Can The SNB Go?

- The SNB led the G10 central banks in easing policy as Swiss inflation was relatively quick to return to target.
- The risk is that Swiss inflation continues to fall to levels that the SNB considers to be much too low.
- Falling inflation, sluggish growth, and rising unemployment could force the SNB to cut its policy rate to zero.
- Downside inflation surprises could also be in store for other developed economies.
- As the U.S. labor market falls short of maximum employment, inflation could drop to below the Fed's 2% target.
- The Fed will have to cut rates more than what is discounted if the dual mandate is in jeopardy.
- Use a back-up in Treasury yields to 4% to increase duration.

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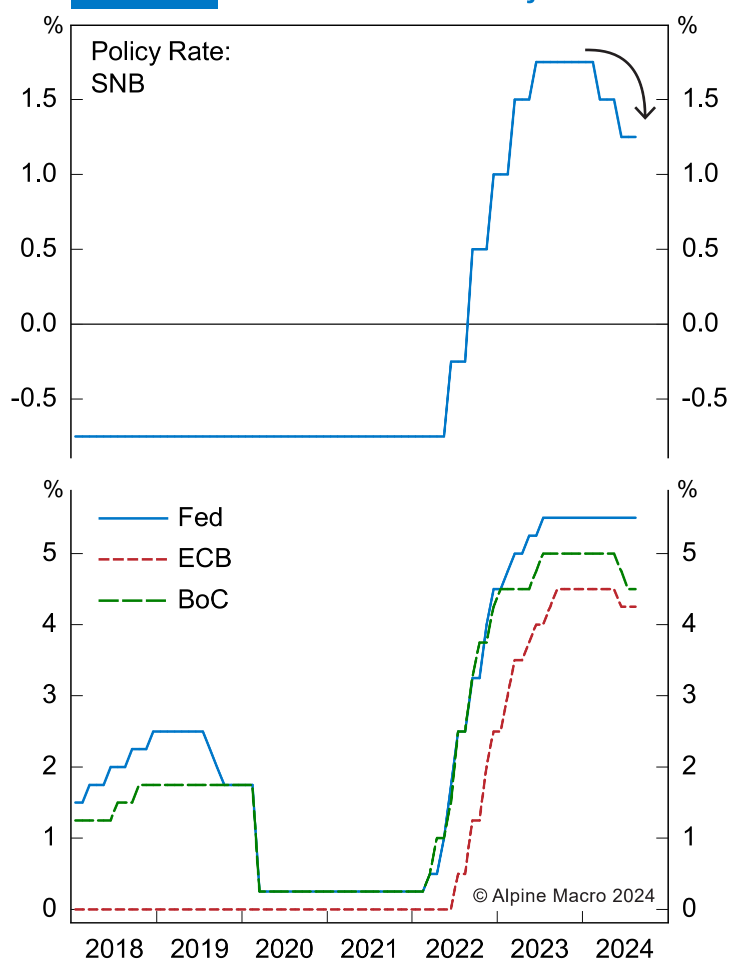
In March of this year, the Swiss National Bank (SNB) became the first G10 central bank to cut interest rates in the current cycle (**Chart 1**). While inflation did rise to above the SNB's target of "less than 2%", Switzerland did not experience as sharp of an increase as most other major economies. Consequently, inflation was relatively swift to return to the SNB's target.

Chart 1 The SNB Leads The Way



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Tipping Point In Financial Markets: A Melt-up or Meltdown?

Global financial markets are facing increasing challenges: the risk of recession is rising as tight monetary policy has entered its 28th month, while the bull market in big tech has turned parabolic and is due for a shakeout. However, inflation has fallen sharply, and the Fed is poised to ease at a time when political and geopolitical risks have greatly escalated.

At this critical juncture, Alpine Macro's strategists are joined by a group of highly respected outside experts to discuss the pressing issues facing investors, including:

- Are we at the tail-end of the bull market in equities, or does the bull have further to run? Which sectors should investors allocate their capital to, and what will be the new leaders in the marketplace?
- How should investors hedge against the rising risk of wars and conflicts?
- Harris vs. Trump: How will the election result change U.S. economic policies and affect financial markets?
- What's next for commodities and energy? Are we heading for a new super-cycle bull market, and is ESG dead?

Come and join us for a day of debate, discussion, and brainstorming on the big macro themes and how to capitalize on them in this highly uncertain environment.

This is an in-person only event, and seats are already 70% sold out. If you are interested in this event, please register now.

Click here for a detailed conference agenda.

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Guest Speakers + Alpine Macro Strategists

Ruchir Sharma

Greg Valliere

Mike Dooley

Gareth Shepherd

Francois Trahan

Tavi Costa

Jim Paulsen

Lenka Martinek

Gina Martin Adams

Adam Rozencwajg

Chart 2 Swiss Inflation Is Propped Up By Rents

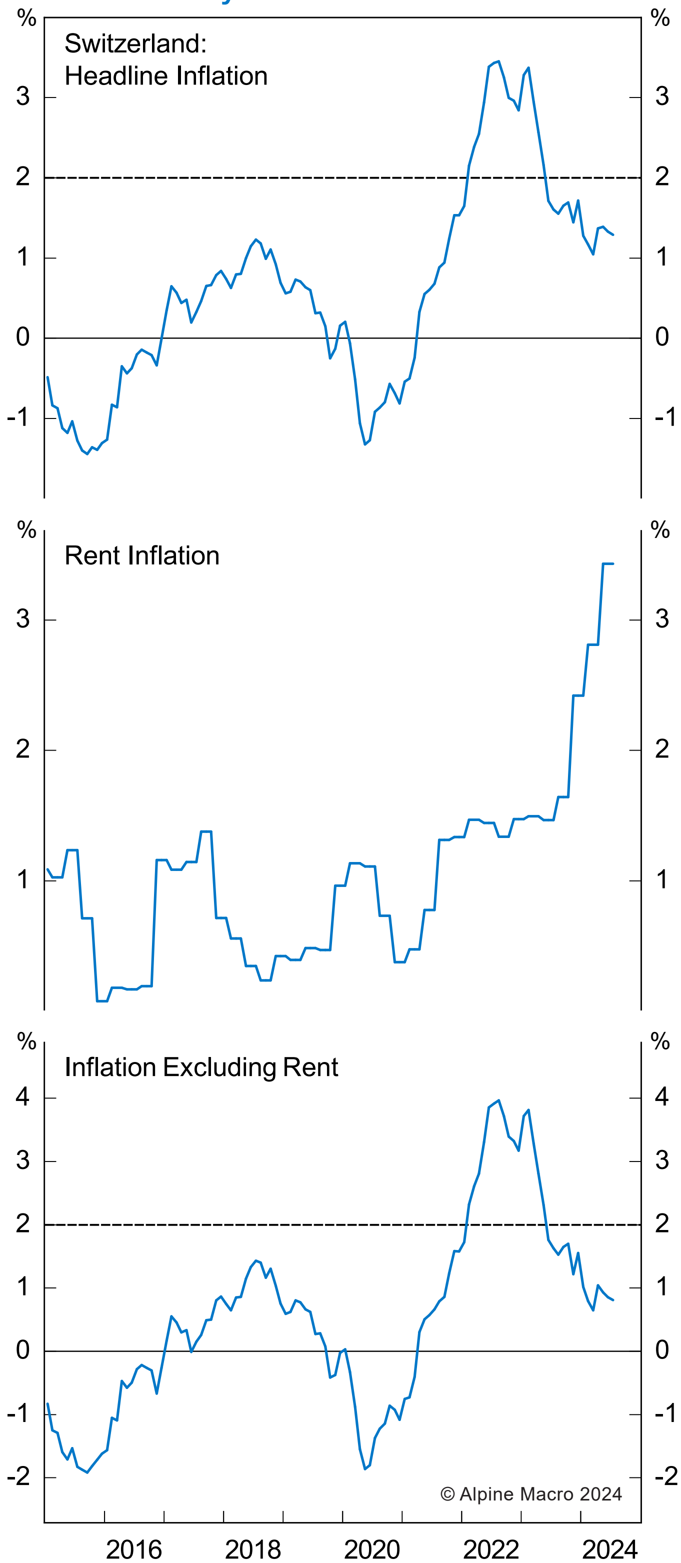
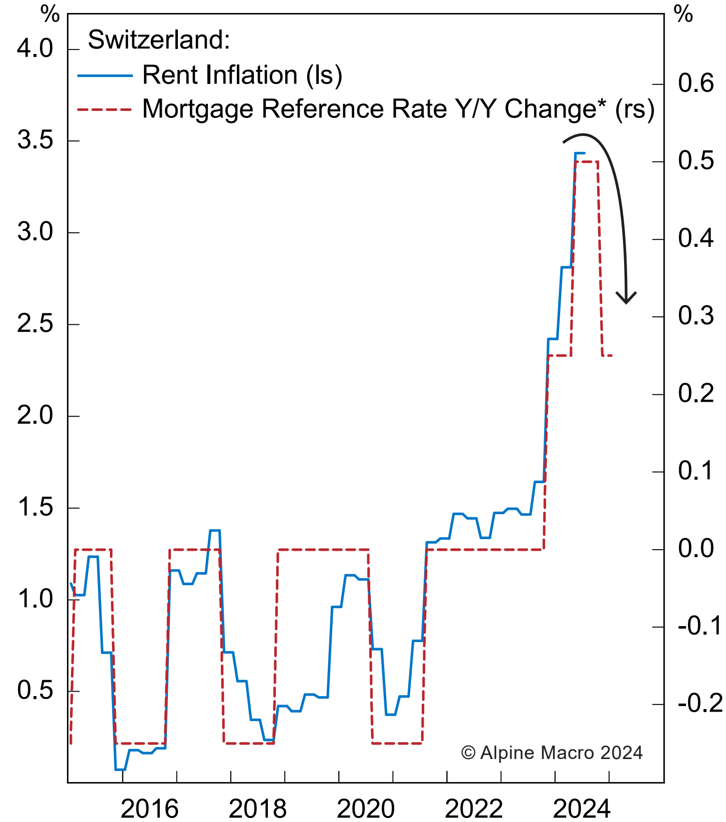


Chart 3 Rental Inflation Should Slow



*Advanced by 7 months

Looking forward, the risk is that Swiss inflation continues to fall to levels that the SNB considers to be much too low. **Chart 2** provides a breakdown of the inflation data. Total inflation is running at just 1.3%, which is being boosted by strong gains in rents. Excluding rents, Swiss inflation is down to only 0.8%.

The healthy gains in rents have been driven by the SNB's rate hikes that pushed up the mortgage reference rate. **Chart 3** shows that the annual change in the mortgage reference rate leads rental inflation by about seven months. With the SNB now cutting interest rates, the mortgage reference rate should head lower and pull rental inflation down. As this happens, the overall inflation rate could fall to below 1%.

Chart 4 Swiss Producer Prices Are Deflating

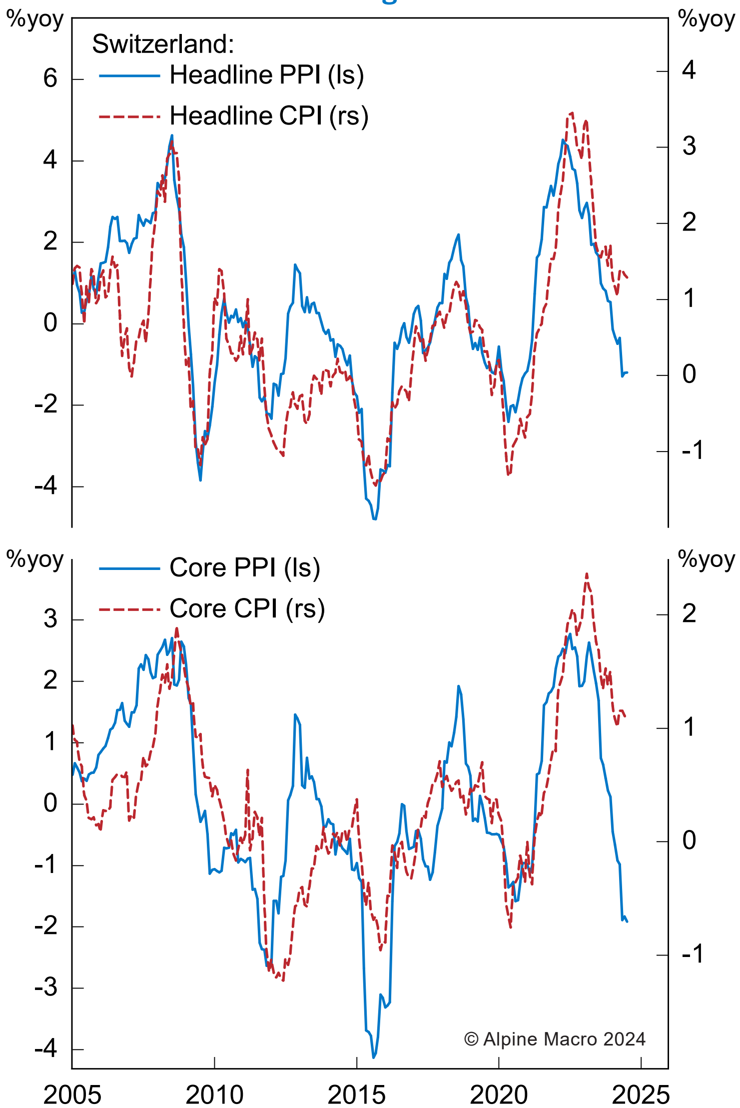
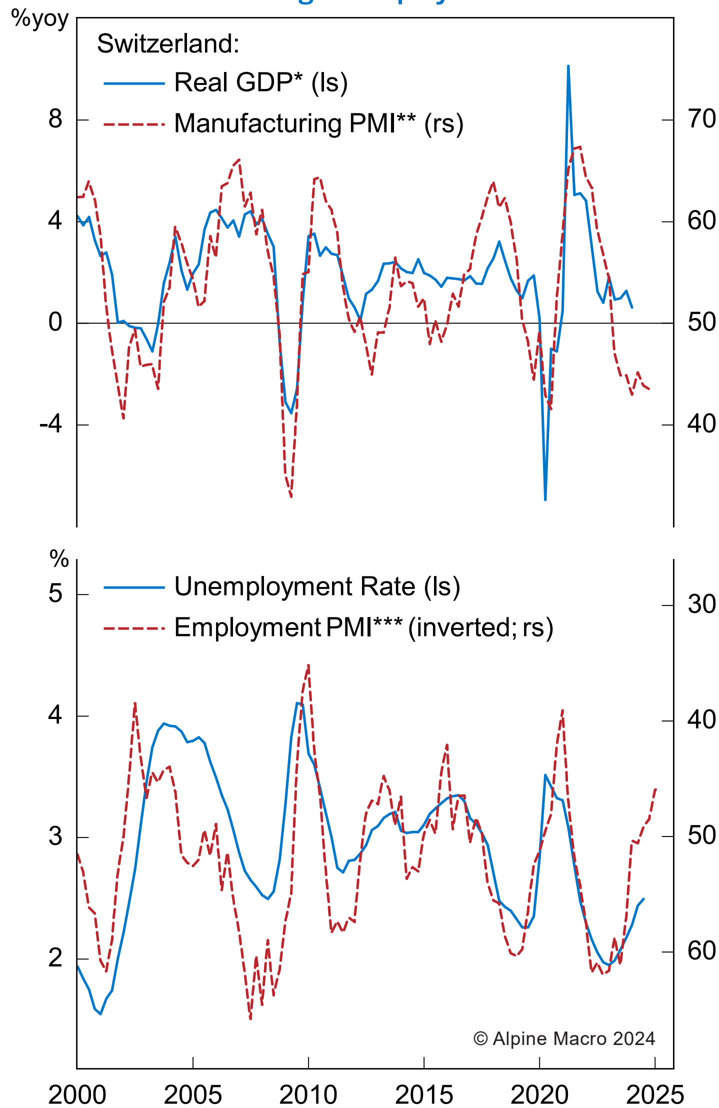


Chart 5 Sluggish Growth & Rising Unemployment



*Sport Event Adjusted
**Advanced by 1 quarter
***Advanced by 3 quarters

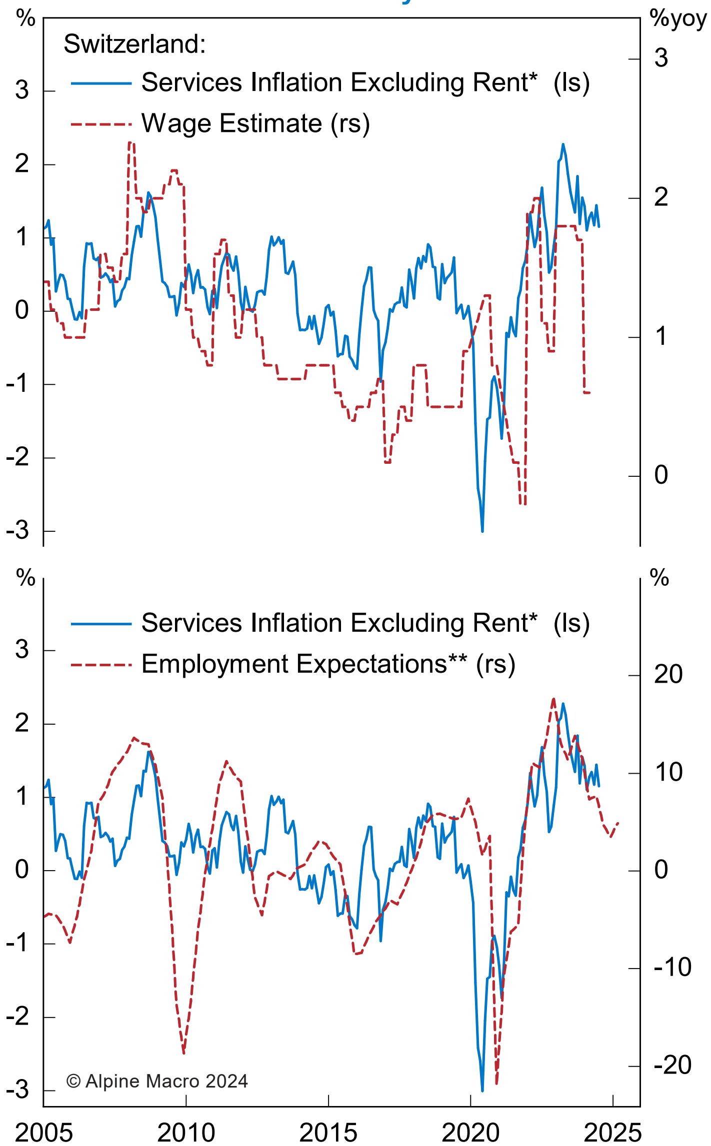
Aside from rents, producer prices are also flagging much lower inflation ahead. Both headline and core PPI are deflating on an annual basis. CPI inflation rates have been closely correlated with PPI (**Chart 4**). The historical relationship suggests that headline inflation could fall close to zero and core inflation could even turn negative.

Moreover, Switzerland's economy is experiencing weak growth and slack is building in the labor market.

The PMI remains below the critical 50 level, indicating that sluggish growth should persist. Meanwhile, the PMI's employment index is warning that the jobless rate should continue to head higher (**Chart 5**).

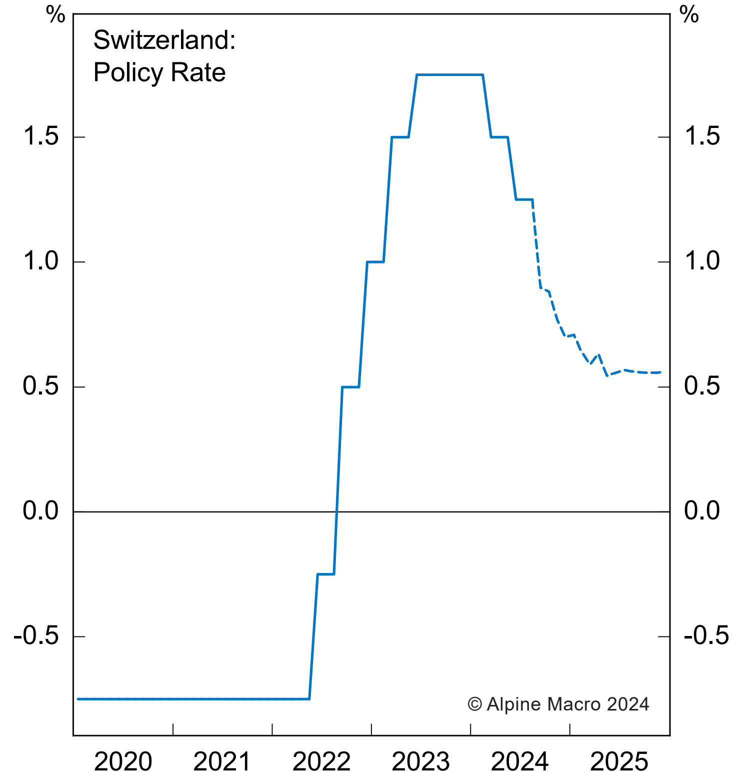
Swiss wage pressures are already receding rapidly as labor conditions soften. The latest estimate for wages and salaries shows growth of only 0.6% y/y.

Chart 6 The Swiss Labor Market Is Disinflationary



*Alpine Macro calculation
**Advanced by 6 months

Chart 7 The Market's Outlook For The SNB Is Too Cautious



Note: Dotted line denotes market expectations from OIS curve

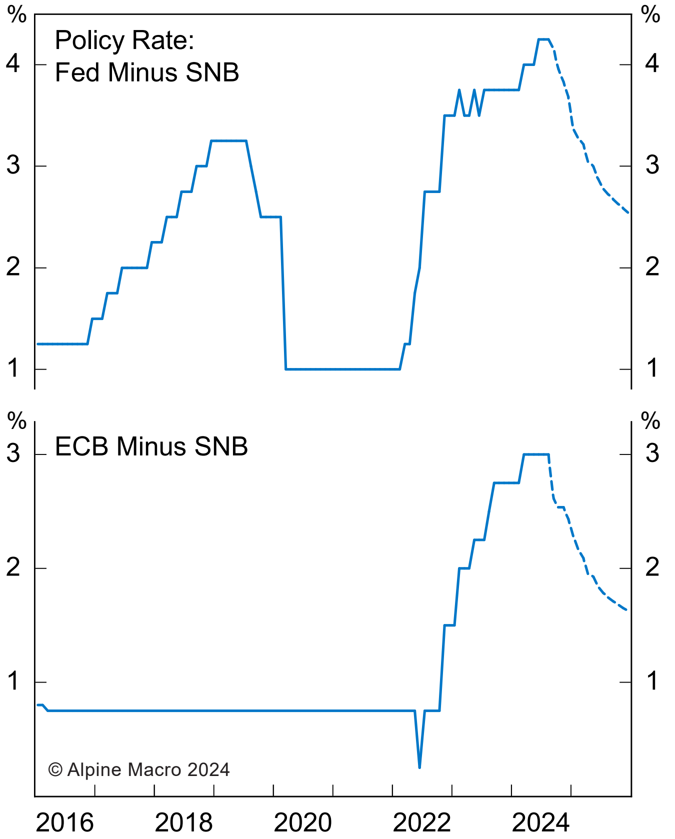
The sharp slowdown in wage gains and the weakness in hiring intentions should lead to lower inflation in the service sector (Chart 6). Non-rental services account for 42% of CPI and softness will be a significant drag on overall inflation.

If Swiss inflation surprises to the downside, then the SNB is likely to cut rates more than what is discounted in the market. The OIS curve indicates that the SNB will lower interest rates to near 0.5% by mid-2025 (Chart 7).

Former SNB President Thomas Jordan has said that the neutral real policy interest rate is near zero. If Swiss inflation conservatively falls to 0.5%, the market's pricing would leave the real policy rate at precisely neutral. However, the SNB may need to cut rates to below neutral.

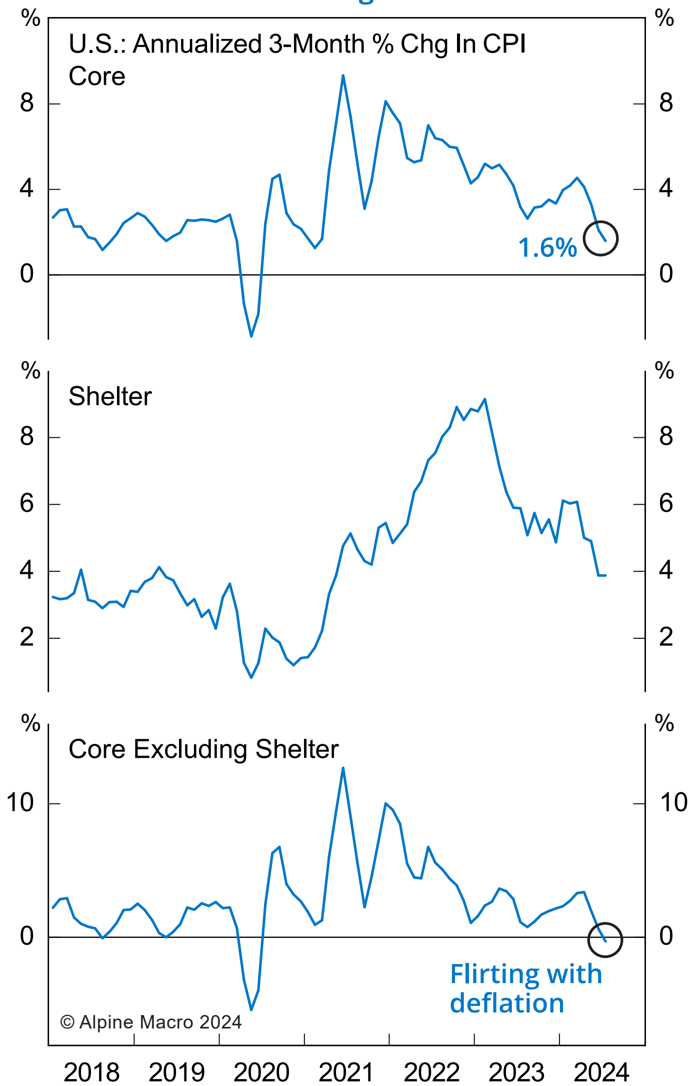
If inflation is too low to be consistent with the SNB's target, then the policy rate should be cut to a stimulative level (i.e. below neutral). It is very possible that the SNB may need to cut the nominal interest rate all the way to zero. A zero policy rate and 0.5% inflation would result in a real interest rate of -0.5%.

Chart 8 The Fed & ECB Have More Room To Cut Than The SNB



Note: Dotted lines denote market expectations from OIS curves

Chart 9 Downside Risks To The Fed's 2% Inflation Target



In terms of investment implications:

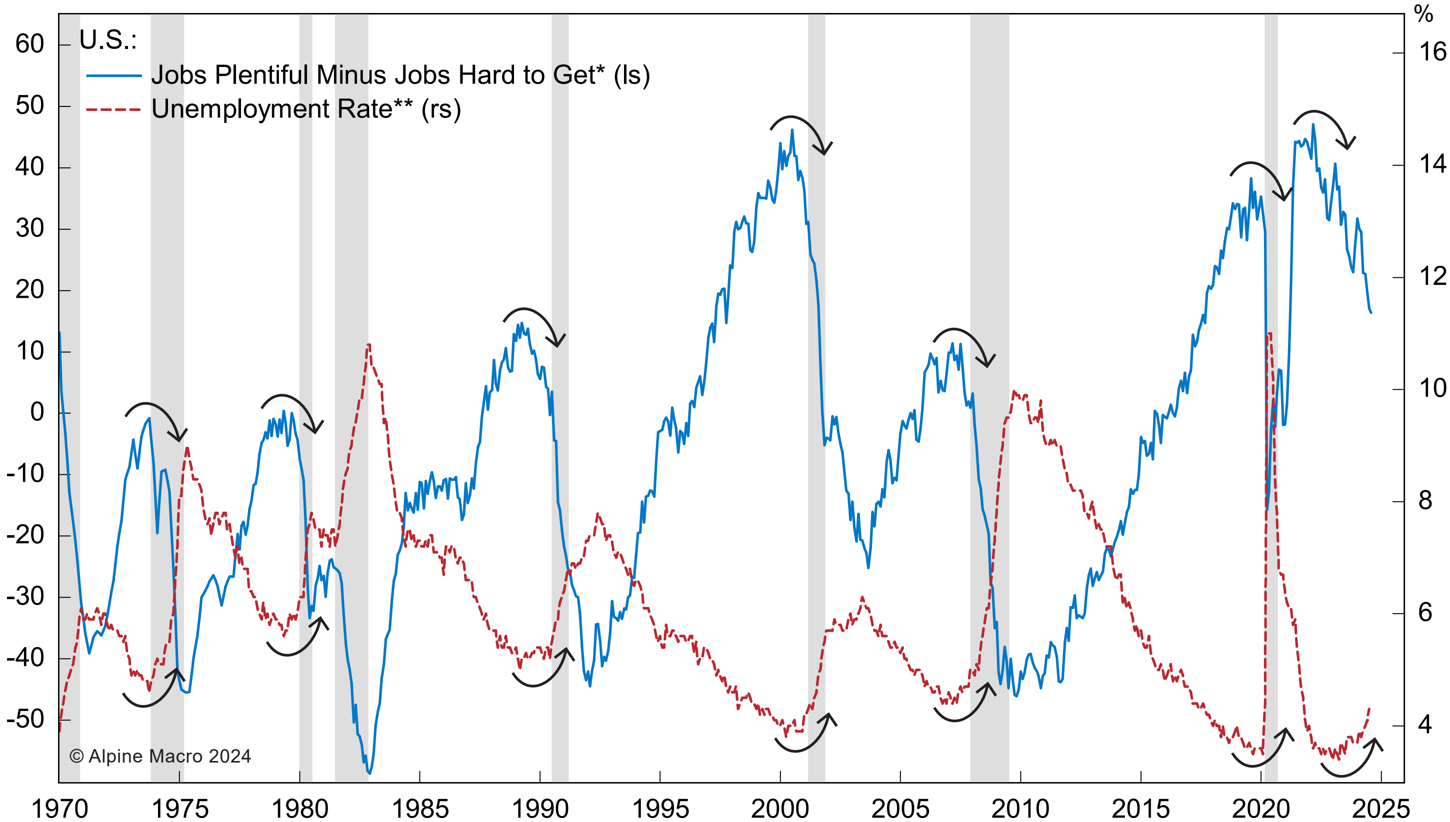
- Dedicated investors in Swiss bonds should maintain an above-benchmark duration.
- In global fixed income portfolios, we recommend a slight underweight position in Swiss bonds. The SNB has less room to cut rates in comparison to the other major central banks. Consequently, there is less upside potential in Swiss bonds in relative terms.
- With the SNB having relatively less scope to ease policy, interest rate differentials will be narrowing in favor of the Swiss franc (Chart 8). Global bond investors should refrain from hedging FX exposure to the franc.

Follow The Leader?

Switzerland could provide hints to what could happen in other G10 economies. Just as the SNB led the way in easing policy, downside inflation surprises could also be in store for other developed economies.

In fact, there are already signs that U.S. inflation risks undershooting the Fed's 2% target. On a 3-month annualized basis, core CPI inflation has fallen to just 1.6% (Chart 9). Even this low rate is

Chart 10 U.S. Unemployment Should Rise Further



*Source: Conference Board
**Truncated at 11%
Note: Shading denotes U.S. recessions

being propped up by stickiness in shelter inflation. Excluding shelter, core CPI has been flirting with deflation over the past three months.

Fed Chairman Powell used his speech at the Jackson Hole symposium to elevate the importance of the labor market for the direction of monetary policy. He noted that the upside risks to inflation have diminished, while the downside risks to employment have increased. Powell clearly stated that FOMC members *"do not seek or welcome further cooling in labor market conditions."*

If the U.S. labor market weakens further, not only would the Fed miss its mandate of "maximum employment", but it also would increase the odds of inflation falling below the 2% target. In last week's speech, Powell noted that labor market conditions are now softer than they were prior to the pandemic in 2019. This is noteworthy as U.S. inflation was running below 2% in 2019 and the Fed was in the process of cutting interest rates (from a much lower level) and re-starting QE.

Incoming data suggest that the labor market is continuing to soften. The latest consumer confidence survey showed a further decline in the difference between "jobs are plentiful" and "jobs are hard to get". For more than fifty years, this has signaled a rising unemployment rate (**Chart 10**). The U.S. jobless rate looks to be heading to 5%, if not higher.

This would put it above the FOMC's 3.5-4.5% range for the unemployment rate's long-term steady state.

Greater slack in the labor market will mean softer wage gains, which would exert downward pressure on inflation. Adjusted for the composition of jobs, the growth in average hourly earnings has already slowed from a peak of 6.1% to 3.6% (Chart 11). If labor productivity grows at 1.5%, then the current pace of wage gains is largely consistent with 2% inflation. A further deceleration in wages would imply an undershoot of the Fed's inflation target.

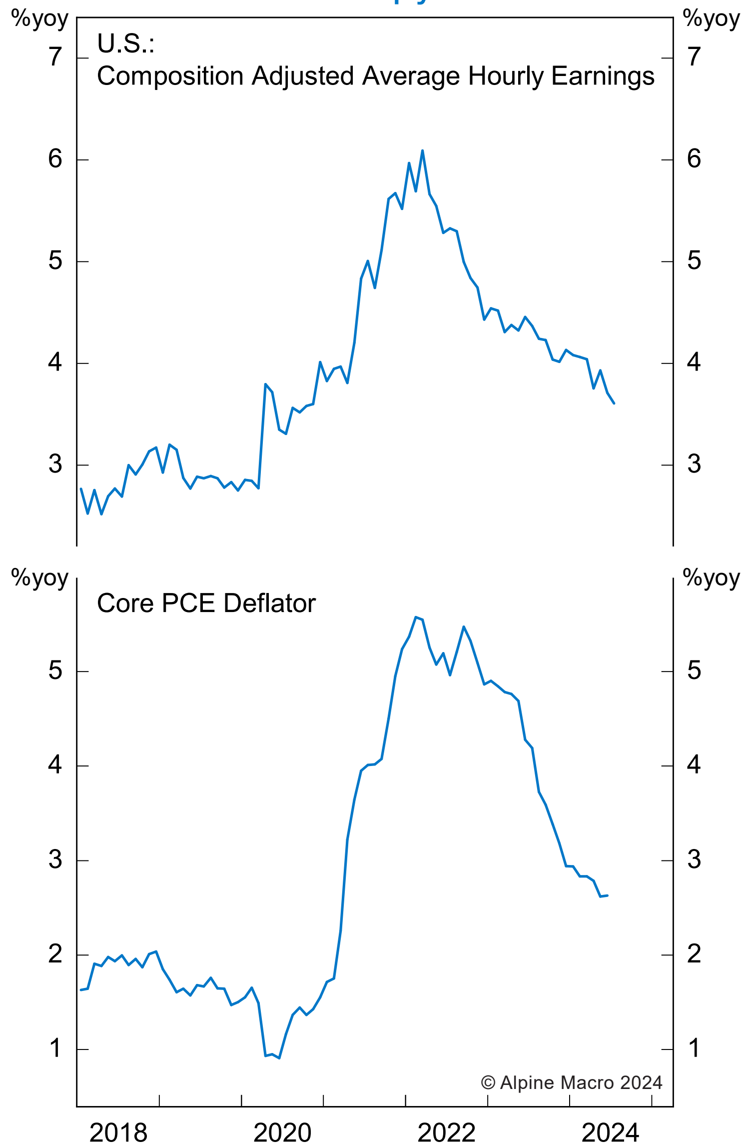
As we discussed in last week's report, the Fed runs the risk of missing both parts of its dual mandate.[1] That is, the labor market falls short of maximum employment and inflation drops to below 2%. Needless to say, this would have profound consequences for monetary policy.

To understand the potential implications for Fed policy, start with the neutral rate, or R-star. This is the interest rate that is neither restrictive nor stimulative. Unfortunately, R-star is not observable and can only be estimated. At the moment, the median estimate of FOMC participants puts R-star at 2.75%.

When the Fed is hitting its dual mandate (i.e. the economy is at full employment and inflation is at 2%), then the policy rate should be at R-star. If inflation is too high and the labor market is too tight, the policy rate should be above R-star. This was the environment that the Fed faced for the last few years. Consequently, policy was tightened aggressively to a restrictive level.

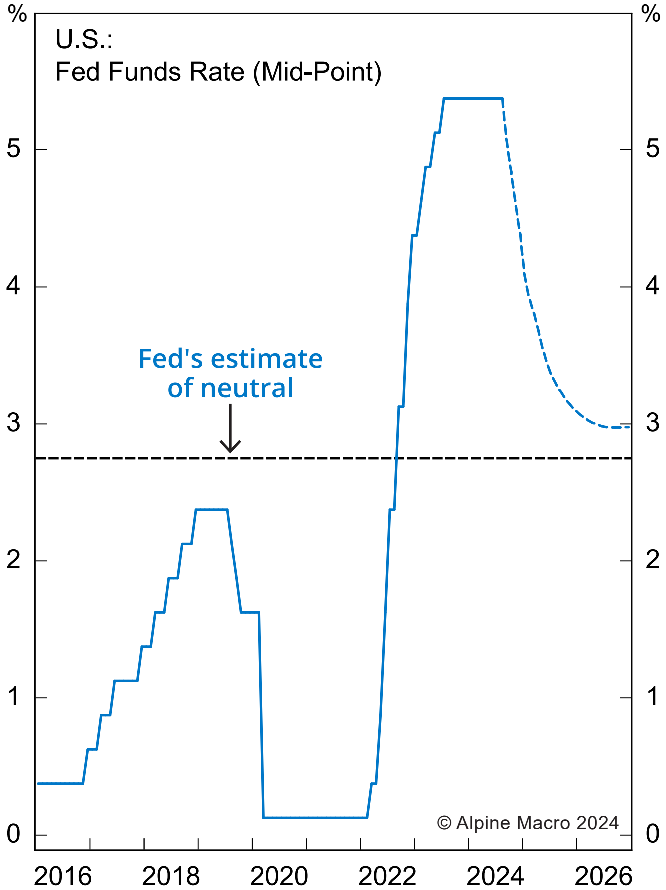
1 Alpine Macro *Global Fixed Income & FX Strategy* "Dual Mandate At Risk" (August 23, 2024).

Chart 11 U.S. Wage Gains Have Slowed Sharply



It follows that if the Fed misses its dual mandate on the downside, then it should lower interest rates to below neutral. Chart 12 shows the Fed's policy rate and the path priced into the OIS curve. Although rate cuts are discounted, the market expects the Fed funds rate to remain above R-star through the end of 2026. This would mean continued downward pressure on inflation and upward pressure on unemployment.

Chart 12 If The Dual Mandate Is At Risk, The Fed Will Drop Rates To Below Neutral



Note: Dotted blue line denotes market expectations from OIS curve

Admittedly, there is a lot of uncertainty over R-star. It could be higher than the Fed's estimate, but it could also be lower. Only the passage of time and an ex-post examination of the economy's performance will give a clear view on where R-star stood today.

Nevertheless, policy must be made in real-time and not with the benefit of hindsight. We believe that an undershoot of both sides of the dual mandate should force the Fed to err on the side of accommodation.

Bottom Line: The Fed will have to cut rates more than what is discounted if the dual mandate is in jeopardy. Investors should use a back-up in Treasury yields to 4% to increase duration.

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Currency Outlook

Vs THE DOLLAR		
	1-3 Months	9-12 Months
EUR	UP	UP
JPY	UP	UP
GBP	UP	UP
CHF	UP	UP
CAD	FLAT	UP
AUD	FLAT	UP
NZD	FLAT	UP

Vs THE EURO		
	1-3 Months	9-12 Months
JPY	UP	UP
GBP	UP	UP
CHF	~~FLAT~~ UP	~~FLAT~~ UP
SEK	FLAT	UP
NOK	FLAT	UP

Fixed-Income Outlook

OVERALL PORTFOLIO DURATION

AT BENCHMARK

COUNTRY ALLOCATION*	
U.S.	4
Japan	1
Eurozone	3
Core	4
Periphery	2
U.K.	3
Switzerland	2
Norway	2
Sweden	3
Canada	4
Australia	4

* Numbers denote allocation where 1 = maximum underweight and 5 = maximum overweight

Currency Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L		
					Spot	Carry	Total
Long AUD/NZD	2019-04-29	1.0574	1.2000	-	2.69%	-3.98%	-1.29%
Long Gold	2022-03-04	1,928	-	-	30.94%	-	30.94%
Short USD/JPY	2024-08-23	146.23	-	-	0.97%	-0.10%	0.87%
Long GBP/USD	2024-08-23	1.3094	-	-	0.63%	0.00%	0.63%

Fixed Income Positions

Recommendations	Open Date	Open Level	Target	Stop	P&L
Long 2-Year/Short 10-Year U.S. Treasuries	2022-12-02	4.24%/3.51%	-	-	69.71 bps

A Unique Mind On The Markets

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