NORMALISED INTEREST RATES

Investment policy

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Benjamin Schoch
Head of Asset Management

André Kistler
Chief strategist at Albin Kistler AG

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June 2022, Benjamin Schoch and André Kistler

Economy

It is seven years since the Swiss National Bank implemented its negative interest rate policy in Switzerland. An end to the policy is now finally in sight. In the real economy, numerous factors have been pointing to more restrictive monetary policy since 2021[1].

In raising its negative interest rates as communicated on 16 June, the Swiss National Bank has demonstrated its independence from the euro area and shown that it takes its mandate to protect price stability in Switzerland seriously. We greatly welcome this.

In the aftermath of the pandemic, rising energy prices and the impact of goods and supply bottlenecks on prices in particular have proved more persistent than expected. “Normal” interest rates are called for again in order to combat inflation.

What are the implications of this for the financial markets and, after a delay, for the real economy? The financial markets are also starting to normalise. All asset classes, from bonds to equities and real estate, are undergoing a revaluation due to higher interest rates and have suffered corresponding losses.

It takes time for the impact of higher interest rates and inflation to filter through to the real economy: consumption tails off, credit-financed investments cost more, and higher prices curtail economic growth.

The massive temporary shock of the pandemic years has left the economy more cyclical again, leading economic growth, inflation, interest rates and the financial markets to normalise accordingly.

Outlook

The challenge for central banks is to find the right balance between taking consistent and credible anti-inflationary measures and maintaining the long view on economic performance.

While it is clear that the central banks in the US, the UK and Switzerland are well on the way to achieving this, the hesitant approach of the European Central Bank is concerning but not surprising. The debt burdens of many EU member states will be untenable if interest rates rise.

These debt problems had temporarily receded into the background as a result of the pandemic but will now have to be addressed again. There are strong signs that politicians will once again opt to simply muddle through rather than finding a way to reduce the debt mountains.

The corporate world also needs to adapt. The era of unlimited zero-cost debt capital is over. Stretched balance sheets must be painstakingly deleveraged, and unprofitable business models will not survive. Such periods of adjustment are necessary and prepare the ground for the next upswing.

Conclusion

From an investor perspective, this normalisation is to be welcomed. The associated price corrections on the financial markets are preferable to a loss of credibility for central banks and the fatal long-term consequences that this would entail.

Well-positioned companies with healthy balance sheets will still be able to grow even as interest rates move higher; the capital markets will then reward this in the long run with higher valuations. Falls in the share prices of high-quality companies reduce their valuations and present good purchase opportunities over the long term.

[1] See also our opinion piece “Everyone is talking about interest rates apart from the SNB” (available in German and French only), published on our website in March 2022.