SNB Watch: keep calm and carry on

November 5, 2025

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Neutrality works great until it suddenly doesn't

- **Just ask Belgium.** Up until now, Switzerland may be the prime example of the success of neutrality. But neutrality hasn't saved them from war in 2025: the great US trade war that is.
- **After the initial April tariff shock subsided, the Swiss woke up on August 1st, suddenly facing one of the highest US country-specific tariff rates in the world.** The US had raised the rate to 39 percent while the Swiss had expected a rate in the low tens. Apparently, Trump felt irked by the Swiss and he knows the market will let him get away with punishing tiny Switzerland.
- **The renewed bout of trade uncertainty dampens what had been an improving outlook for the Swiss National Bank**. In May, the economy faced deflation, but since then inflation has been back within the SNB's mandate. The return of inflationary pressure – as little as it may be – gives the SNB space and to hold rates steady at its December 11th meeting. However, Switzerland is still one shock away from deflation.
- **Deflation has been an exchange rate story, by and large determined by exogenous factors.** Be it geopolitics, monetary 'spillovers' from the ECB, or trade – including the whims of President Trump. Foreign events and developments determine SNB decisions, making forecasting very tricky indeed. We will discuss exogenous factors that could drive the rate decision in three scenarios: what could trigger an SNB cut; what could lead to rates being raised; and what could allow the status quo to continue. Before delving into these scenarios, we will first discuss the situation that the SNB faces for the meeting on December 11th.

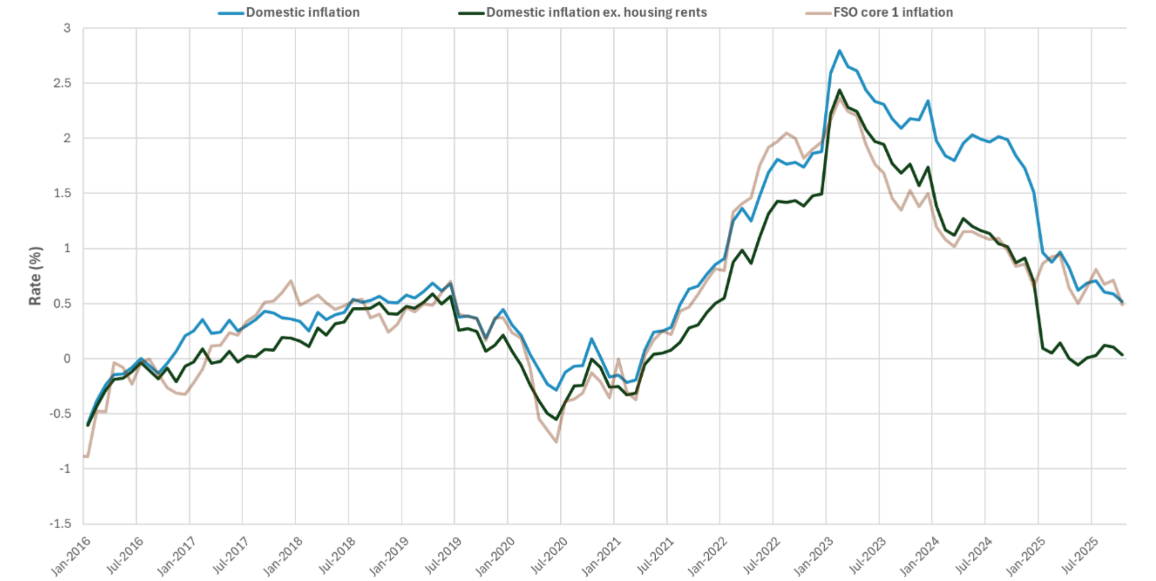
Just checking in

- **Leading up to the December meeting of the Swiss National Bank, modest inflationary pressures have provided some breathing space.** CPI returned to positive territory, coming in at 0.1 percent YoY in June and 0.2 percent in July, August, and September, before sliding back to 0.1 percent in October. Modest indeed, but back within the SNB's target range. The SNB can live with inflationary pressure just above zero, stressing time and again that the hurdle for further cuts into negative territory is far higher than for a 'standard' rate cut.
- **The return of inflationary pressure, much like the earlier decline, is by and large exchange rate driven.** The Swiss are literally a passenger along for the ride. The rise in headline inflation from May to September was due to imported deflation easing as the exchange rate stabilized after a period of strong

appreciation. The slowdown in October was, again, for the largest part driven by an increase in imported deflation following an appreciation of the franc. Domestic inflation has slowed marginally since May, though it has remained in positive territory.

- **Domestic inflation printed at 0.5 percent YoY in October.** But this strength is misleading. Strip out housing rents, and domestic inflation is essentially zero. Figure 1 below shows that domestic inflation excluding housing has inched up since May but remains close to zero. I included the so-called core-1 inflation measure, which excludes energy and seasonal products. Core-1 is the Federal Statistics Office benchmark for underlying inflation.

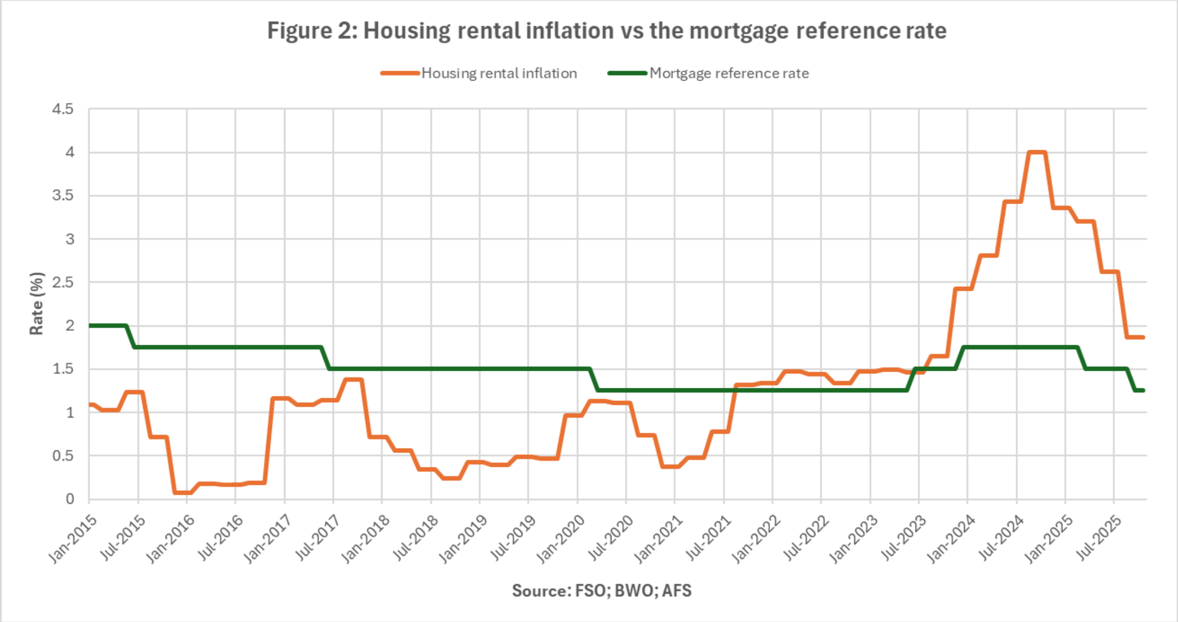
Figure 1: Domestic Inflation is driven by housing rents



Source: FSO; AFS

- **Clearly the exchange rate is not the only concern.** Housing rents are a lagging indicator, slowing in recent months and set to weaken further as mortgage rates fall[1]. Figure 2 shows that in the past, a 25bps decline in the mortgage rate was associated with a 0.5-1.0 percentage point decline in rental inflation in the nine months that followed.

[1] Changes in rents are linked to the Swiss mortgage reference interest rate, which was last lowered on September 2nd. When this falls, tenants can request rent reductions, while with a rise, landlords can request to raise rents.



- **Since February this year, the mortgage reference rate has already been cut twice.** Our expectation is that housing inflation will fall below 1.0 percent in 2026. Without other items picking up, domestic inflation risk sliding towards zero as rental inflation continues its downwards trajectory. At its current pace, underlying domestic inflation can't offset falling housing inflation. For underlying inflation to pick up over the coming months, stronger economic growth is required.
- **Much like inflation, the Swiss economy has faced headwinds without a doubt.** But unlike inflation, it has stayed remarkably resilient. The SNB's Business Cycle Index plunged after the US tariff announcements in April, yet by August it had returned to its long-term trend. Meanwhile, SECO's Weekly Economic Activity Index shows growth just above one percent, significantly below the estimated potential growth rate of one and a half percent. With growth below potential, an output gap with disinflationary effects has formed.
- **Despite below potential growth, the economy is holding up reasonably well on the back of relatively strong domestic demand offsetting weaker global demand.** The services sector – the key growth driver – remains resilient, with PMI data showing new orders picking up in September after a sluggish summer. Manufacturing, by contrast, continues to struggle. The export-reliant sector has seen purchasing activity decline for twelve straight months as weakening global demand and US tariffs weighs increasingly on the economy. The current balancing act between services strength and manufacturing weakness is a fragile state, but one the SNB is willing to live with for now.
- **The risks to growth remain tilted to the downside.** US tariffs haven't hit fully yet: businesses and their US consumers are still adjusting to the new normal, with the PMI showing a steady increase in the number of Swiss manufacturing firms impacted by protectionist measures, rising to 47 percent in September.
- **The Swiss National Bank has downplayed the threat, noting that only around 4 percent of exports are directly affected by the 39 percent tariff rate.** That conveniently ignores one crucial fact: pharmaceuticals – nearly half of Switzerland's goods exports to the US – still face the risk of heavy tariffs.

- **For now, pharma tariffs are on hold.** But if Washington pulls the trigger and implements tariffs, pressure on Switzerland's economy will intensify. While the demand elasticity for pharmaceutical exports is relatively low – volumes respond less to a change in price – the postponed tariff rate is much higher than the country-specific rate at 100 percent. A rate of 250 percent had even been threatened earlier this summer. Such measures, if implemented, would effectively force Switzerland's drug industry to relocate to the US.
- **Apart from trade, foreign demand also risks suppression from a cumulative weakening of the US labor market and stagnant growth rates of the Eurozone economy.** These factors will determine if Swiss growth hold on to its momentum or whether the economy will slow, potentially stalling.

If it ain't broke…

- **The picture for inflation and growth isn't rosy.** I'd call it a fragile 'it'll do', a status quo the SNB seems willing to accept. Normally, with inflation this close to zero, an insurance cut would be justified. But the SNB is wary of pushing rates deeper into negative territory. The bottom line: as long as the status quo lasts, rates are on hold.
- **Markets still doubt the status quo.** The SARON swap curve is inverted, signaling that rate cuts are more likely than hikes, though the market hasn't fully priced them in. For December, swaps imply under a 30 percent chance of a 25 bp cut. This rises to 50 percent for March 2026.
- **In the near term, I believe the status quo is likely to persist.** Trade risks are unlikely to fully materialize by year-end. So, the December interest rate decision will be a hold.
- **Looking at 2026, though, I can hear the theme song from the movie Jaws.** Beneath the surface, danger is lurking, dragging the economy and inflation downward while the SNB is powerless.
- **Rather than slapping arbitrary 60/40 odds to a future rate cut, we'll focus on how exogenous factors – such as US tariffs policy – need to develop for the SNB to move rates or continue the status quo.**
- **In this analysis we exclude two policy measures that counter strong and unwanted exchange rate appreciation:** large-scale FX interventions to control the franc, which are toxic under US political pressure, and politically contentious capital flow restrictions. Be aware that, based on past precedent, the SNB can resort to an emergency intermeeting rate cut.

Rate cut: It's all downhill from here

- **When the Swiss National Bank cuts rates, it won't be because of what's happening in Switzerland.** The drivers of easing will be foreign: from U.S. trade policy and a global slowdown to a balance-of-payments crisis in France and foreign monetary policy spillovers.
- **Top of the list is US trade policy: tariffs, to be precise.** If the Swiss do not reach agreement with the US to lower tariffs, the SNB could be forced to cut rates the first half of 2026. The trouble is, Switzerland is too small for markets to care much, so Trump can keep tariffs high without real blowback. Making a deal thus depends on the whims of one person, with Swiss President Karin Keller-Sutter admitting that any agreement "depends on whether the U.S. president gives the green light or not".
- **Although the very high 39 percent tariff rate has been in place for two months, its full impact hasn't been felt yet.** If it becomes clear that high tariffs

are here to stay, businesses and consumers will stop waiting for relief and start cutting back on spending, dragging the economy down. Things could get worse if 100 percent tariffs on pharmaceuticals – or, as once threatened, 250 percent – go through. The intent behind these tariffs is clear: to get Switzerland's pharmaceutical sector to relocate to the US. The pharmaceutical industry won't completely disappear, but with over 50 percent of pharmaceutical exports going to the US, the Swiss will feel the pain from the outflow of plant, capital, workers, and know-how.

- **Beyond tariffs, a global economic downturn would force the SNB to act.** The US labor market is steadily weakening and if the economy tips into a recession, the European economy, including that of Switzerland, will catch the cold as well. A global slump would hit Switzerland more gradually than targeted tariffs, allowing the SNB to hold off in March 2026. But once recession bites, easing becomes inevitable.
- **More acutely, France's budget deficit risks could trigger a balance-of-payments crisis.** Capital would predictably flee to Switzerland, strongly boosting the franc's exchange rate. The SNB would need to move fast by cutting rates first to ease pressure on the franc. Not only that, but the initial shock would also be followed by a financial crisis that would be felt in the real economy in both the Euro Area and Switzerland.
- **Besides this, there are many "known unknowns" – a phrase attributable to former US Defense Secretary Donald Rumsfeld – that can send the franc soaring.** And that will lead to the SNB taking their rates deeper into negative territory to slow the appreciation of the franc. The last time the Swiss took rates deep into negative territory – cutting rates by 50bps – was in January 2015, when the ECB announced QE, forcing the SNB to bow to the inevitable and scrap the exchange rate floor.
- **A 50bps jumbo cut remains in the toolkit.** Out of six interest rate cuts in the post-floor period since 2015, there has been one 50bps cut: in December 2024 because of a much stronger than expected decline in underlying inflation. SARON could fall by up to 70bps, depending on the interest rate on sight deposits above the remuneration threshold.

Rate hold: Steady as she goes

- **If Switzerland avoids a stalling economy and inflation stays in the low tenths of a percent, the SNB will accept the situation and hold rates.** To maintain the status quo of moderate and below potential growth and inflation barely above zero, Switzerland needs a trade deal with the US, with a tariff rate that matches its 'competitors'.
- **A good deal would bring the Swiss in line with advanced economies like the EU, Norway and Japan at 15 percent.** An agreement at – or below – this level would be a clear win, though it is a tough ask. The more realistic outcome is a deal at 20 percent. While that would constitute a mediocre deal, it will be one Bern would gladly take as it would allow the current economic status quo to continue. Switzerland would find itself aligned with Asian manufacturing hubs like Taiwan, Indonesia, and Vietnam, whose initial April 2nd tariff levels are similar.
- **A smaller reduction, to the mid-twenties, would leave Switzerland stuck in no man's land.** It's not disastrous, but still bad. Even so, if that's all Washington offers, the Swiss will swallow it. That is because anything above 30 percent is disastrous. At this level, Switzerland would be in the company of Syria,

Myanmar, Laos, Iraq, and Serbia, irrelevant trade partners, economically speaking. Only those nations that truly crossed Trump – Brazil, India and Canada – face worse tariff rates.

- **Besides a lower country-specific tariff, the threatened sectoral tariff of 100 percent on patented pharmaceutical must also remain just that: a threat.** A likely outcome, given that the White House will want to avoid a spike in drug prices. In practice, other sectoral tariffs are far lower. At 30 percent, Swiss drugmakers can absorb the tariff hit in their margins. Even at 50 percent[2], many high-end drugs can absorb the hit. Anything substantially higher, however, makes trade with the US unprofitable, especially since raising prices to offset tariffs risks Washington's ire. Even holding prices steady risks Washington's wrath, expecting lower drug prices as tribute for continued market access.
- **For now, the biggest players – Novartis, Roche, and Lonza – are expected to be exempt from the 100 percent tariff because of their investments in the US.** If that exemption holds, the fallout will be contained to smaller firms, keeping the broader economic impact limited. The goal is clear: Washington wants production to move stateside. For Novartis, Roche, and Lonza, the US accounted for 35–50 percent of sales. Either they shift production to the States – hurting Swiss manufacturing – or they stay put and eventually the tariff man will come a-knocking.
- **Finally, there is the dreaded appreciation of the franc.** While an even stronger franc would do more damage to the Swiss economy, an intervention by the SNB is not necessarily required. The SNB could be forced to act when appreciation comes as a large shock. Gradual gains, however, can be tolerated, especially if the franc holds relatively firm against one of its major pairs: the dollar or, more importantly, the euro. Sadly, for the Swiss, historically speaking gradual and ultimately relatively benign exchange rate appreciations are rare.

Rate hike: Never bet against TACO Trump

- **Switzerland's outlook is clouded, but stronger growth, inflationary pressure, and even positive interest rates aren't off the table.** As Rocky Balboa put it: "I didn't hear no bell." Weaknesses still outweigh the positives, but they haven't won the fight yet. The potential upside – however optimistic it sounds – is still there.
- **Yes, tariffs have hurt Switzerland.** But a better deal with the US is still likely, potentially by the end of the year. Why couldn't it be a good deal? Reportedly, top trade lieutenants Scott Bessent, Howard Lutnick and James Greer supported an agreement with a 10 percent country-specific tariff rate, before President Trump shot it down. The EU negotiated their tariff rate down to 15 percent from a threatened 50 percent. Why should the Swiss not get a good deal too? More importantly, other nations secured exemptions for their key industries, including pharmaceuticals. If the Swiss – or individual pharmaceutical companies – can do the same, the doom and gloom may prove to be overdone.

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[2] Roche reported a core operating profit margin of 50+ percent in 2024 and 2025. We assume that high-end drugs are sold with a larger margin, especially in the US where drugs are sold at relatively higher price. Sources: https://assets.roche.com/f/176343/x/2d95c66259/hy25e.pdf; https://www.nber.org/system/files/working_papers/w32606/w32606.pdf

- **A trade deal is not the only avenue of economic growth.** Planned fiscal expansion in the Eurozone – especially in Germany – could be able to spark growth as well. Stronger European demand would spill over into Switzerland, push up inflation, and eventually give the SNB room to lift rates above zero.
- **That said, Germany – and its notoriously slow bureaucracy – will find it hard to actually spend the proposed stimulus.** Even in the best-case scenario, it will take time to ramp up spending. Rate hikes will not come into play in the first half of 2026. But if growth accelerates, a return to positive interest rates – most importantly SARON – could be within reach.
- **The SNB could also be nudged into tightening if inflation picks up abroad.** It's not impossible: fiscal expansion or AI driven growth could reignite price pressures, just as in 2022. We are skeptical about this. A weaker franc would have a similar effect, though given its safe-haven status, that seems the longest shot of all.

Conclusion

- **Of all the 'what-ifs' on the table, the most likely outcome is that the status quo holds.** The SNB will keep rates steady over the next 12 months, avoiding a deeper dive into negative territory.
- **Growth will remain subdued through the first half of 2026, but headwinds won't be strong enough to knock the economy off course or force the SNB's hand.** Cuts further into negative territory will be reserved to counter sharp franc appreciation from safe-haven inflows. Even if growth picks up later in the year, which I doubt, it won't be enough to justify a hike. For now, Switzerland will ride the waves of the global economy. At the helm, the SNB can take comfort that these won't push the country far off course.