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Oil price shocks, inflation concerns, and interest rate decisions

12 June 2026, 12:30 UTC, written by Michael Bolliger

The oil price shock is stoking inflation risks, putting central banks in a more challenging position. Yet, although the trigger is the same, monetary policy responses are likely to differ: The ECB has already hiked pre-emptively, while the Fed and SNB are expected to stick to their current course for now, each for different reasons. For markets, the key point is that expectations for US rate cuts may be pushed further back. This suggests continued volatility in the short term—but not necessarily a break in longer-term investment trends.

The European Central Bank (ECB) raised key interest rates by 25 basis points this week. The question is whether the Swiss National Bank (SNB) and the Federal Reserve will respond similarly to the oil price shock. Markets are now pricing in higher rates for these central banks as well, but although the trigger is the same, the monetary policy responses are likely to differ. This can have implications for investors.

The starting point is similar for many central banks: As long as there is no credible prospect of de-escalation in the Middle East, the path to lower energy prices remains blocked. While not every economy is equally sensitive to higher energy prices—for example, Switzerland's dependence is very low—the pressure on central banks to tighten monetary policy is likely to increase in many places. And although the inflation shock is not yet showing up in the data across the board, the risks have grown in recent weeks, especially in the minds of consumers, politicians, and investors.

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The ECB evidently felt compelled to increase rates, even though the Eurozone economy is struggling. It may want to prevent a price shock from turning into a credibility problem, especially since memories of the oil price shock in 2022 are still fresh. Against this backdrop, a precautionary rate hike seems quite reasonable to us. The ECB is responding to rising inflation risks, even if the growth environment remains fragile.

In the US, the situation is different. Inflation risks have also increased and the impact of higher energy prices is noticeable. Added to this are the political costs, especially around five months before the midterm elections. However, the Fed operates under a dual mandate, which requires a more balanced weighting between full employment and inflation. Despite strong labor market data, wage pressures are currently lower than in 2022, reducing the risk of second-round effects. Unlike the market, which is pricing in one rate hike by year-end, we do not expect an increase this year. That does not mean it will be smooth sailing from here. As recent weeks have shown, even a delay in expected rate cuts could lead to turbulence in equity markets, shift exchange rates, and move yields.

For the Swiss National Bank, we consider a change in key rates even less likely. This is mainly for two reasons. First, inflation in Switzerland is low and inflation expectations remain firmly anchored. Second, the strong franc continues to act as a buffer against imported price pressures. As a result, the monetary policy backdrop for the SNB is different from that of the ECB; slightly higher inflation expectations and some franc weakness would likely even be welcome here.

Our conclusion? Inflation risks have increased. And with each week that passes without a credible peace deal in the Middle East, central banks find themselves in a more difficult position. Nevertheless, we do not expect a monetary policy change from either the Fed or the SNB, and the ECB is also likely to fall short of the currently expected two rate hikes. Communication around these decisions will also be relevant: The Fed could initially argue that it will not loosen its monetary policy reins, supporting higher yields and further dollar appreciation at least in the short term. Conversely, we think the SNB is likely to welcome a weaker franc, as the currency is too expensive and inflation expectations too low. This could mean central banks will initially dampen the current equity market euphoria rather than support it. Given the looming economic risks in the event of a prolonged energy crisis, we consider a pronounced tightening of monetary policy unlikely. And if a peace deal is reached in the Middle East, expectations for further rate hikes are likely to be quickly unwound. We advise investors to respond calmly to periods of increased volatility and stick to their investment strategy. After all, we still see structural trends pointing toward higher equity prices, a stronger franc, and a renewed rise in the gold price.

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