6th June 2018

Swiss GDP grows +2.2% but the equity market is wavering

Sustained economic growth. 10-year high on inflation. Long rates look set to recover. Renewed weakness for the Swiss franc. Swiss equities are depressed but wavering.

Key Points

- The +0.6% rise in GDP in the 1st quarter confirms the trend from the end of 2017
- A buoyant 2018 for the Swiss economy
- GDP growth could exceed +2.2%
- Leading indicators point to a loss in momentum
- Climate still positive for private spending
- Boost expected for foreign trade
- New period of weakness for the Swiss franc
- Inflation once again hit 1% in May
- Is this the end of micro-movements on long rates?
- Interest rate differential likely to rise
- Attractive valuations for Swiss equities
- Opportunities to reposition in a temporarily depressed market

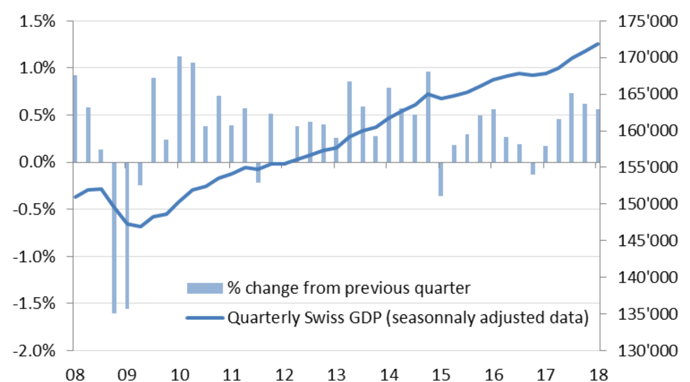
1st quarter GDP heralds a buoyant 2018 for the Swiss economy

Last Thursday, the State Secretariat for Economic Affairs (SECO) published the latest Swiss growth figures. Real terms Swiss GDP once again showed excellent +0.6% growth in the 1st quarter 2018 (+2.2% year on year). As such, it has kept up a sustained growth rate, bearing out our forecast which we had left unchanged at +2.2% for 2018. The Swiss economy is backing up its good results over the past few quarters, though proving a slight negative surprise for analysts who were expecting +2.3% year on year growth.

As such, the trend seems to have established itself well enough at the beginning of the year for the Swiss economy to post one of its best results of the past ten years in 2018. It has only twice hit the growth rate seen over the 1st quarter since 2011- in the first (+2.6%) and last (+2.9%) quarters 2014.

The good performance of European economies and of the economies of Switzerland's main trading partners, along with the weakness of the Swiss franc, should continue to support Swiss economic growth over the coming months. We had forecast better prospects for 2018, thanks in particular to the improvement in the international economic situation mentioned above, as well as positive exchange rate conditions. We are therefore pleased to note that Switzerland is now making a greater contribution to the international trend, which we believe to be more in line with its growth capacity in a more robust global context in 2018.

Swiss Economic Performance (GDP in millions CHF)



Sources: SECO, BearBull Group

This pleasing GDP performance was propped up by quite a few sectors, especially services and private spending. The leisure sector did particularly well, posting +7.3% growth thanks to large international sporting events. It seems worth underscoring this point, as it made a very clear contribution to the quarter's performance, which the SECO believes would only have stood at +0.4% otherwise. Final domestic demand made a positive contribution to GDP thanks to private spending. It rose +0.4% and was still a key growth driver over the quarter. Growth was also boosted by investment spending in research and development, which enabled investment in

capital goods to post solid +3.6% growth. Although in the previous quarter domestic demand had enjoyed the advantage of a positive combination of private and public spending, as well as investment in construction, the start of the year was more of a mixed bag. The latter two segments each made a negative contribution (-0.3% and -0.4% respectively). Most branches of the services sector posted a rise in their added value; the financial sector continued on its trajectory with a +1% rise, and transport and communication (+1.3%) and health (+1.2%) also posted satisfactory growth. After a few quarters of strong growth, the manufacturing sector has trodden water, with a modest +0.2% rise. In terms of foreign trade, merchandise imports grew +2.9%, backed up by +0.8% growth in services imports after two weak quarters. Services exports (+2.9%) posted higher-than-average performance, as did merchandise (+2%).

After a very favourable second half of 2017 for currencies, the 1st quarter 2018 was more stable for the Swiss franc, approaching the sensitive 1.18-1.20 zone against the euro, and 0.98-1.00 against the US dollar. The correction to the exchange rate, which we had been predicting ever since the Swiss franc-euro floor was dropped, is now materialising and propping up growth. The revaluation of the euro from 1.06 to 1.20 has greatly helped to improve economic conditions. After having stood strong in the face of the appreciation of the Swiss franc, the Swiss economy is now benefiting from exchange rate normalisation. This situation should continue in 2018.

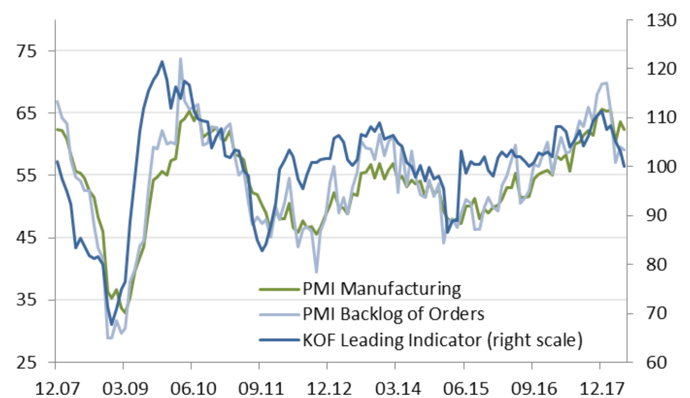
Swiss GDP growth could exceed +2.2% in 2018

At the end of the 2nd quarter, we believe that the current economic trend will continue, propped up in part by further adjustments to the value of the Swiss franc. This should enable the Swiss economy to post robust growth in past comparison, and perhaps even head above +2.2% growth by the end of the year. In 2018, the Swiss economy will benefit from the general improvement in the economic climate and consumer confidence to an even greater degree than in the second half of 2017. Specifically, domestic demand should be boosted by the lowest unemployment rate in ten years, high savings rates, and an investment recovery within an improved international economic context. The increasingly robust economic conditions which Switzerland's main economic partners should enjoy in 2018 should also drive the trend. The weakness of the Swiss franc against most currencies should make Swiss-made products more attractive. In this context, we are maintaining our Swiss growth forecasts at +2.2% in 2018.

The dip in some leading indicators suggests a loss of momentum

The latest leading indicators remain temporarily affected by renewed uncertainty on financial markets from the 1st quarter and by political events in Italy, but they are still pointing toward sustained economic activity for the coming months, despite a loss of momentum. The KOF index has continued to slide away since its peak in November (110.3), which marked the highest levels of optimism since 2010. In May it stood at 100.

PMI - KOF



Sources: Bloomberg, BearBull Group

The manufacturing PMI indicator, which hit its highest level (65.5) since July 2010 (65.6) in February, has been showing signs of weakness for a few months. The trend seems to be rather running out of steam according to the latest figures published for May (62.4), although it remains very much positive. Three years after the SNB dropped the euro-Swiss franc floor, the manufacturing sector is once again in good shape. That said, although for the time being the purchase managers index is not indicating any particular risk, some caution would seem reasonable given the recent bright spell on the index. Leading indicators are suggesting that the current trend will continue, but also seem unsure as to whether the Swiss economy can keep up its current pace.

Climate still positive for private spending

The latest drop in the unemployment rate to 2.4% in May demonstrates the strength of the Swiss economy in the 2nd quarter and suggests that there will likely soon be tensions on the job market. Indeed, over just a few months, the unemployment rate has fallen significantly, and is approaching a 10-year low (2.3%) last seen in 2008. This should continue to have a very positive effect on household confidence, and especially on spending, in Switzerland.

Household confidence has remained high after having regularly improved since 2015. The rise in the euro and the stabilisation of its exchange rate with the Swiss franc at around 1.20 should have an even starker effect on the Swiss economic climate over the coming months. As such, private spending should stick to its positive trend, propping up GDP. Public administration consumption spending will remain volatile in 2018, but federal and cantonal accounts are in rather good shape and the debt to GDP ratio (34%) remains low when compared to other countries, which could give some room for manoeuvre for public spending to make a positive contribution to GDP.

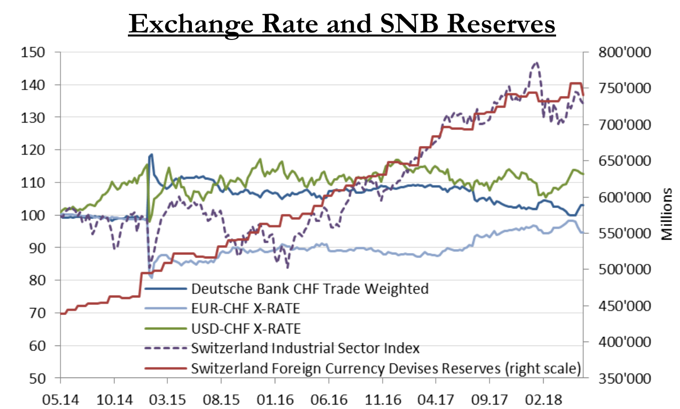
Boost expected for foreign trade

Since its peak in January 2017, the monthly foreign trade balance has stabilised at between 2 and 3 billion Swiss francs, with no clear signs of recovery for the time being. However, we believe that the improvement in international economic conditions and the weakness of the Swiss franc should finally work together to boost exports. The recovery of the watchmaking sector, which started in 2016, is on the right track. Sales in the watchmaking sector have increased +13.8% year on year according to the latest estimates in April. Exports of machines, manufacturing products, and services should also benefit from a more positive context.

New period of weakness for the Swiss franc

Since January 2015, in our analyses we have regularly upheld that the SNB's monetary policy would be a success, frequently mentioning that the EUR/CHF exchange rate would return to 1.20. Recently, the improvement in the European economic situation and the prospect of the end of ECB liquidity injections in 2018 have led to rise in the euro. However, we had indicated that in the short-term the euro would likely hit the 1.20 mark, but that it would be unsustainable in the immediate future. After the noticeable appreciation in the euro, we were expecting a phase of consolidation before an upward movement of the exchange rate against the Swiss franc could take place. As such, the correction in May came as no surprise amidst the uncertain political context in Italy. We probably need growth to pick up the pace in the Eurozone and the interest rate differential to widen in order to push the Euro to continue to appreciate beyond the 1.20 threshold against the Swiss franc. However, we believe that the weakness seen over the past few weeks (-4.5%) provides a new opportunity to reposition on the euro. As regards the US dollar, the consolidation has been modest (-2%) and we maintain our upward forecasts. The SNB should be pleased to note the effect of its policy, which is proving a major monetary strategy success, as demonstrated by the record 54.5 billion Swiss francs in profit for the bank in 2017. SNB currency reserves are still high, but have stabilised at around 740 billion Swiss francs. The market effects over the last few weeks certainly explain this drop in currency reserves, so one should not read into this a change in SNB monetary policy.

Exchange Rate and SNB Reserves

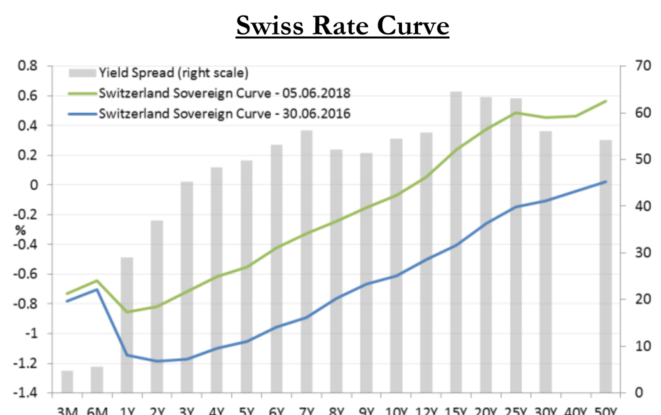


Sources: Bloomberg, BearBull Group

Is this the end of micro-movements on long rates?

Swiss long rates did indeed start to normalise in summer 2016 in the wake of the change of trend in the United States. However, after a first adjustment to ten-year Swiss rates from -0.6% to 0% in the 4th quarter 2016, we then saw a long period of stabilisation at around 0%. A few months ago, we announced that this situation would certainly not last in 2018, which has partly been proven right with an increase in volatility in the 1st quarter. In just a few weeks, long rates leapt 40 basis points, and then stabilised. This rise likely heralds the end of "micro-movements" on long rates, and the arrival of a faster pace of rate normalisation. SNB monetary policy is still influencing the very short end of the Swiss rate curve, and is holding back any increase in yield on this end of the curve. Short-term maturities have of course hardly reacted, whereas longer maturities have risen.

Swiss Rate Curve

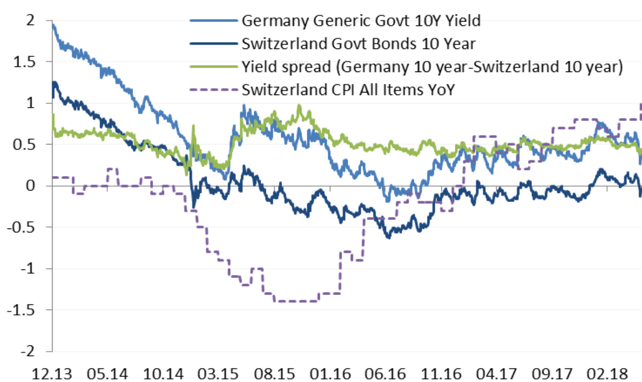


Sources: Bloomberg, BearBull Group

As such, the rate curve has steepened, as we had mentioned in previous analyses, and this should continue at a faster pace in 2018. A rise in inflation could be the next trigger for further long rate rises in the Eurozone and Switzerland.

Although it remains modest, the 1% rise in the CPI (YOY) is still the greatest rise of the last ten years, if we exclude the tensions in March (1.4%) and April (1.4%) 2010. In this context, the long rate differential between the German Bund and Swiss bonds has not really changed, and remains close to 0.5%.

EUR-CHF 10-Year Interest Rates



Sources: Bloomberg, BearBull Group

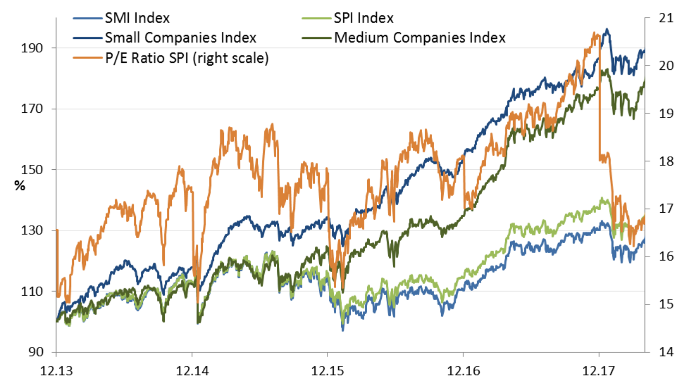
However, we believe this differential should grow, due to the improvement in the European trend and the end of the ECB bond purchasing programme.

Swiss equities are depressed and wavering

The correction to Swiss equities in February and the recent weakness at the end of May have significantly reduced market risk, particularly with the correction to valuation levels. Indeed, Swiss PE now stands at 16x forecast profits for 2018, and 15x 2019 profits.

The SPI is now trading at around 10,300 points, after having corrected 1,000 points from its peak in January (11,000) and recovered to levels seen at the end of April 2017. However, the weakness of the Swiss franc is propping up company profit growth. Companies are already benefiting from favourable international and domestic environments, as well as sustained organic growth in their sales and results. In 2018, Swiss company profits should hit new records, while average dividend yield remains high (3.4%), both in past comparison and when compared to bond yields.

Swiss Equities



Sources: Bloomberg, BearBull Group

In April, we underscored that the correction to Swiss equities provided a new opportunity to reposition for long-term investors, whilst not excluding the possibility that the market could remain volatile for a while, with this volatility offering better opportunities.

Today, we believe that Swiss equities have been temporarily indirectly affected by the correction to the euro and by European political risks in a context that favours a price recovery.

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