BearBull
Global Investments Group

28 November 2019

Switzerland's GDP strengthens in Q3, surprising forecasters

Nominal GDP has passed the CHF 700 billion per year mark. Equity valuations above their historical average. Clear overvaluation of the Swiss franc in terms of PPP.

Key points

- Swiss GDP's +0.4% growth rate in Q3 comes as a favourable surprise to forecasters
- Switzerland's GDP exceeds CHF 700 billion per year for the first time
- Growth is still driven by private and government consumption
- The sky is clearing a little for leading indicators
- Quiet end to the year for the Swiss franc
- The Swiss franc is clearly overvalued in terms of the OECD's purchasing power parities (PPPs)
- The Swiss National Bank (BNS) will stay on course
- Slow rebound of long-term rates
- Equity markets benefit from the absence of alternatives despite high valuations

Growth rate of +0.4% for Switzerland's GDP in Q3 a favourable surprise for forecasters

The State Secretariat for Economic Affairs (SECO) has published our country's growth figures for Q3 of this year, which highlight unexpectedly stronger growth. Indeed, the +0.4% quarterly growth rate surprised forecasters, who expected a limited increase of +0.2%. This result actually corresponds to the high side of estimates, which ranged from -0.1% to +0.4%. In unadjusted annual comparison, Switzerland's GDP rose by +1.1%, significantly more than the average consensus forecast of +0.8%.

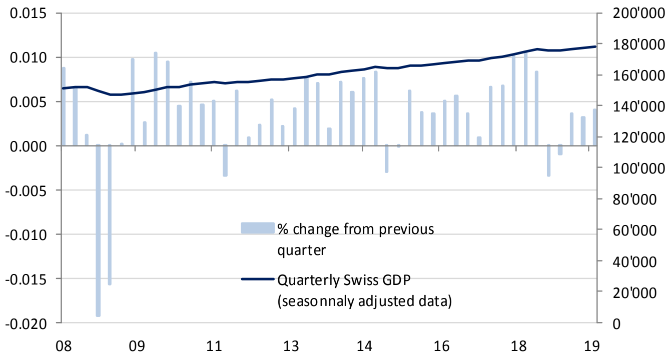
Nevertheless, our economy's performance is rather satisfactory in this context, even if risks of a more abrupt slowdown in the next few months still remain. This +0.4% increase in real GDP in Q3 is rather welcome given the particularly bleak context that impacted financial markets over the summer. Fears of a recession and the collapse in interest rates following growing uncertainty about prospects for economic growth turned out to be particularly excessive given our economy's actual results.

Switzerland's nominal GDP in Q3 thus increased from CHF 174.5 billion to 175.04 billion.

Year-on-year, Switzerland's GDP thus passed the historic threshold of CHF 700 billion Swiss francs for the first time.

Switzerland's economy benefitted from somewhat improving trends in Europe and a +0.3% growth rate in the EU in Q3, which was slightly better than in the previous quarter (+0.2%).

Performance of the Swiss economy (GDP in M CHF)



Sources: SECO, BearBull

The situation in Germany obviously influenced economic developments in Switzerland and did not have a significant positive impact this quarter. The lessening of tensions between the US and China helped reduce the uncertainty that weighed on Germany's economy and its industrial sector, but this was not enough to have a real impact on the latter.

The economic situation in Germany remains weak (+0.1%), but the country avoided recession after a negative Q2.

In this context, economic growth in Switzerland will likely be close to +1.1% for 2019 and +1.5% for 2020.

Growth still driven by private and government consumption

In the last quarters, consumption has established itself as an essential long-term driver for our economy. Nevertheless, its contribution was slightly less significant this quarter. Indeed, domestic demand posted a +0.2% increase in private consumption, slightly lower than in the previous quarter (+0.3%), thus proving a little more subdued. Contrariwise, in comparison with the previous quarter, government consumption recovered strongly, returning to the +0.5% rate it had previously achieved in Q1 after a slump in Q2 (+0.1%). Overall, domestic demand thus drove GDP growth throughout the quarter.

Capital goods investments on the other hand were particularly robust with a +0.7% upswing that almost completely offset the -1% drop in the previous quarter. In the building sector, the trend remains weak, as evidenced by the +0.2% increase in investments and the +0.1% in added value in the sector. The Swiss manufacturing sector is doing rather well in these circumstances and has surprisingly not really been affected as much as feared by the drop in global demand and the rise of the Swiss franc. Our country's industry has done well, unlike other European countries', contributing positively to GDP growth. The manufacturing sector grew further still at a steady pace of +1.2%, similarly to Q2 (+1.3%). Most of all though, it is the strength of the chemical and pharmaceutical industry, whose added value and exports increased significantly, that supported this positive trend.

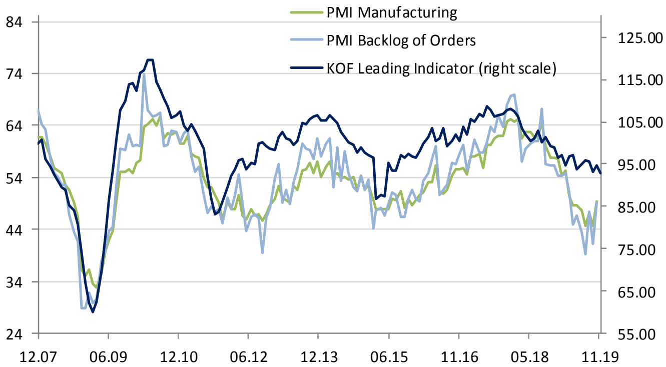
Industrial segments such as machinery and metals declined in a difficult international context for manufacturing. The energy sector posted its strongest growth rate ever, benefitting from favourable meteorological conditions that resulted in a +8.2% rise and a sharp increase in energy exports. Merchandise exports rose by +0.7%, a little less than imports however, which rose by +1.1%. In services, exports grew by +1.1%, while imports increased by +0.9%.

Switzerland's economy is gradually strengthening in an international context that is still relatively complicated in Q3.

Sky clearing a little for leading indicators

The manufacturing PMI finally rebounded strongly in October to 49.4, nearing the threshold of 50, after dropping to its lowest point (44.6) in September, i.e. its worst result in close to ten years. Yet, the indicator's downward trend and its fall below the theoretical growth threshold of 50 was not followed by a breakdown in real industrial production. For more than a year now, Switzerland's manufacturing PMI has been signalling a drop in production, which still has not materialised and which, on the contrary, seems to have strengthened in September. The +6.3% increase in Q3 might thus trigger a change in purchasing managers' perceptions and in the trend for this PMI. The KOF economic barometer also rebounded from 93.07 in September to 94.66 in October, without actually clearly pointing to any trend reversal. However, business conditions deteriorated in October in most sectors. Only the financial sector seems to be heading for a recovery.

PMI – KOF



Sources: Bloomberg, BearBull

Retail sales posted a +0.9% increase in September after a -1% drop in August, but consumer confidence still appears weak in an uncertain international context. The CS indicator on expected economic conditions increased significantly in November, climbing from -30.5 to -3.9, which represents its best result since July 2018. It follows a similar trend observed in the Eurozone and the US over the same period which shows a sharp improvement of confidence in terms of economic prospects for 2020.

Consumer confidence figures published by the State Secretariat for Economic Affairs for Q4 remain uncertain (-10.4) and fell a little further in comparison with the previous quarter (-8).

Let us also mention that the decline in leading indicators, which has now been going on for close to two years, still has not been followed by a marked weakening of Switzerland's GDP.

The economy is even holding up a little better in Q4 than predicted by leading indicators' negative forecasts with a +0.4% increase.

Although they have not clearly turned positive, leading indicators have stabilised and show a few more optimistic signs of future recovery.

Quiet end to the year for the Swiss franc

Following the Swiss franc's appreciation of approximately 2% against various currencies (EUR +2.05%, USD +2.2%, CNY +2.06%) in Q3, our currency stabilised during the quarter. The uncertainty which has affected financial markets in 2018 and 2019, essentially focused on risks of a recession relating to the absence of any clear progress on the trade issues between the US and China, has faded somewhat. Nevertheless, it has remained present enough to maintain strong international demand for safe bets, especially in Q3 when fears of a recession once again became more insistent.

However, Q4 will likely see a sharper reduction in recession prospects and an improvement in confidence for 2020. Demand for Swiss francs will likely go down, thereby helping our currency stabilise at the end of the year.

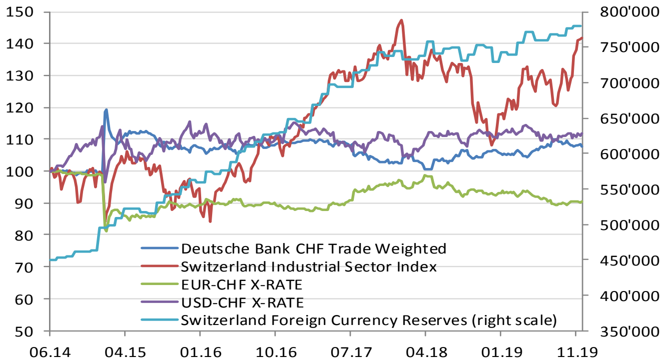
Nevertheless, in the longer term, we maintain our analysis and vision of a further weakening of the Swiss franc against the major currencies and against the euro in particular.

Let us mention that in terms of purchasing power parity (PPP), the Swiss franc may well be significantly overvalued in early 2020. A rise to 1.20 against the euro, which would represent a +10% increase, would help correct this excessive valuation and reduce pressure on our exports. According to the OECD, PPPs indeed suggest that the Swiss franc is overvalued in comparison with its "theoretical" value of 1.19 against the US dollar, 1.63 against the euro and 109 against the yen. According to the Big Mac PPP indicator, the franc's overvaluation is also particularly significant given its "theoretical" values of 1.18 against the US dollar, 1.56 against the euro and 109.6 against the yen.

The Swiss National Bank (SNB) to stay on course

The SNB has once again recently announced that it had sufficient leeway to lower its key rates further still if necessary. The bank is thus clearly and unsurprisingly staying the course of its monetary policy which aims to curb the appreciation of the franc against the euro. Recent developments in US key and long-term rates have certainly reduced the yield spread which the SNB relied upon in its strategy to depreciate the franc and may have disrupted its policy. However, let us highlight that the 75 basis point compression of the yield spread on long-term rates has had no real significant impact on the exchange rate and has not triggered any reaction from the SNB. The rise of the franc has indeed proven to be relatively moderate, as we mentioned in the previous paragraph, such that the SNB did not have to act during this period of adjustment of US monetary policy. Let us also mention that in the Eurozone, the drop in key rates is still very limited (-0.1%), meaning that no reaction from our national bank is required.

<u>**SNB exchange rates and reserves**</u>



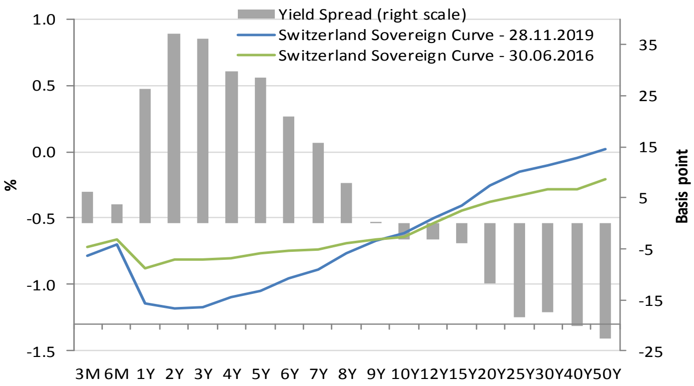
Sources: Bloomberg, BearBull

However, we believe that the next few months will likely be characterised by a new episode of widening yield spreads on long-term rates in particular, which will likely reinforce the dollar's appeal and drive the exchange rate above parity. The issue is different with regards to the euro, especially since the yield spread between rates in euros and in Swiss francs are not that significant and as the trend in the last few months does not augur the same type of development. The yield spread which the SNB had hoped to create and maintain on three-month rates to weaken the franc has come increasingly under attack because of the ECB's rate cut. It has thus gone from -0.99% in January 2015 to -0.28% in late November 2019. Despite a PPP favourable to an appreciation of the euro, for such an appreciation to happen, a serious and lasting European economic recovery will have to occur or at the very least be anticipated with enough credibility Nevertheless, in the medium term, we believe that probabilities of a moderate weakening of the franc are increasing.

Slow rebound of long-term rates

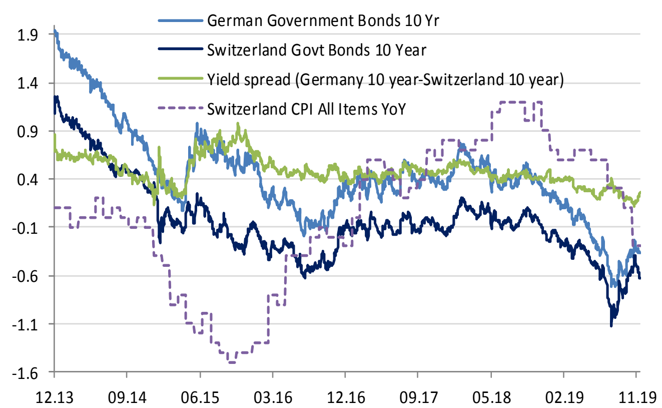
In September, we mentioned the irrational character of the collapse in ten-year yields from -0.5% to -1.12% in August, announcing a likely strong rebound as soon as risks of a recession are finally assessed rationally. The last few months of 2019 have thus been marked by a gradual increase of long-term rates from -1.12% to -0.4% in early November, which is likely to continue in the next few quarters. Prospects for bond markets in Swiss francs are negative in this environment, although the latest statistics published point to a possible return of deflationary risks in Switzerland. The CPI index for October shows a -0.2% drop in inflation for the month and -0.3% for the year. The real yield thus went from -0.85% to -0.75% in October.

Confederation rate curve 15/8 – 28/11



Sources: Bloomberg, BearBull

EUR-CHF 10-year interest rates

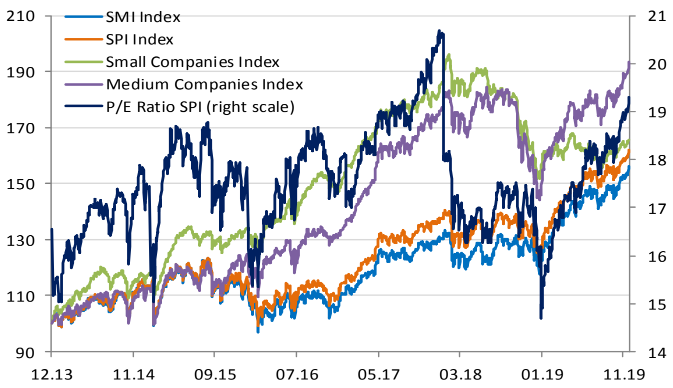


Sources: Bloomberg, BearBull

Equity markets benefit from the absence of alternatives

Consensus earnings growth estimates are above +10% for 2020, which we believe is a little high in a clearly weaker global economic growth context. A weak Swiss franc would be a favourable factor, however. The price/earnings ratio of the Swiss market is rather generous in this context, and at 18x expected earnings for 2020, these valuation levels lie between 15% and 20% above the historical average. In the absence of any investment alternative, the dividend yield may still be a driving factor for equities. Nevertheless, we recommend a more defensive strategy due especially to the high valuation levels.

Swiss equities



Sources: Bloomberg, BearBull

BearBull Group
Gate Village 3, Level 1
Dubai International Financial Centre
PO. Box. 127676, Dubai
United Arab Emirates
T +971 4 4019160
F +971 4 4019992
M info@bearbull.ae

www.bearbull.ae