8 June 2020

Swiss GDP down -2.6% with a more brutal shock in store for Q2

-10% contraction expected in Q2. Economic recovery will take place in H2. SNB will not change course. Weakening of the franc. Gradual rebound of long-term rates. Reduce equity risk.

Key points

- Switzerland's GDP contracts more sharply in Q1 than experts expected
- The drop in GDP in Q1 is actually due to only two weeks of confinement
- Switzerland withstands Covid-19 shock more successfully
- Further -10% shock to GDP in Q2?
- What prospects for H2?
- SNB remains discrete but active
- Shift in outlook for rates
- Beware, euphoria already replacing panic
- Valuations once again high for Swiss equities

Switzerland's GDP contracts more sharply in Q1 than experts expected

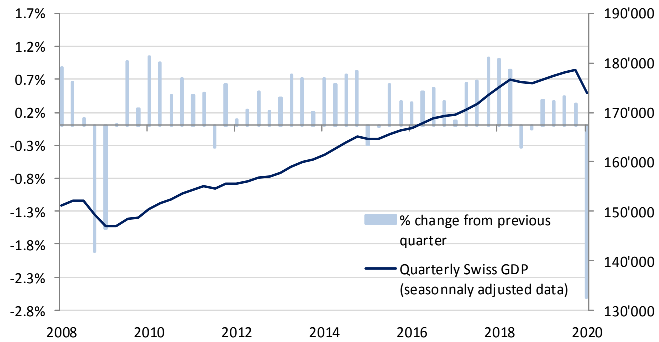
The State Secretariat for Economic Affairs (SECO) published our country's growth figures for Q1 2020, showing a -2.6% contraction in seasonally-adjusted GDP. Switzerland's economy also suffered the effects of the global health crisis, with a drop in activity far more significant than the declines observed in the financial crises of the last 40 years.

In 2008-2009, the recession that hit our country resulted in negative growth of -1.9% in Q4 2008 and -1.6% in Q1 2009.

The current situation is thus clearly worse than the recession that followed the financial crisis in 2008. While experts' estimates had gradually drawn a more positive potential trajectory in the last few months, estimating the impact of the Covid-19 crisis on GDP in Q1 at between -1.5% and -2.1%, the results published by the SECO seem more dismal than expected. However, it should be noted that it was particularly difficult to derive a precise estimate given the highly unusual situation.

The SECO logically notes that the coronavirus pandemic and the measures taken by our government to contain it severely limited economic activity in March. Moreover, the collapse in international economic activity also contributed to the drop in GDP by hampering our export industries.

Performance of the Swiss economy (GDP in M CHF)



Sources: SECO, BearBull Global Investments Group Limited

Most GDP components thus posted negative contributions except for public services and finance. The services sector was heavily hit by confinement measures and the closing of public facilities. The Swiss hotel and restaurant industry already suffered a heavy blow, posting a record drop in revenues of -23.4%, primarily due to the "disappearance" of foreign tourists. Transport and communications posted their worse results of the last 40 years with a -5.5% contraction, while retail (-4.4%) was also affected by the reduction in demand. The usually stable healthcare sector (-3.9%) was hampered by the fight against the pandemic and the mobilisation of teams and means to the detriment of the usual activities and procedures, which were postponed due to the extraordinary mobilisation.

Theoretically, international economic conditions were not favourable to Switzerland's economy. However, the latter nevertheless benefited from a +3.4% increase in merchandise exports, while imports decreased by -1.1%. The picture is less positive for services, as exports dropped by -4.4% and imports by -1.2%.

Drop in GDP in Q1 is actually due to only two weeks of confinement

The economic and health situation was relatively normal for 10 weeks before the introduction of measures to contain the pandemic. In only two weeks between 17 and 31 March, the measures taken by the Federal Council massively affected private consumption, which dropped by -3.5% over the quarter, which gives an idea of the major impact recorded over just two weeks. The impact on investment was also radical with a -4% contraction in demand for capital goods. Government consumption, up 0.7%, was a rare positive domestic component. Overall, final domestic demand recorded its sharpest decline in 40 years (-2.6%) in the wake of a confinement that was rather light in comparison with the strict lockdowns in Italy, Spain and France.

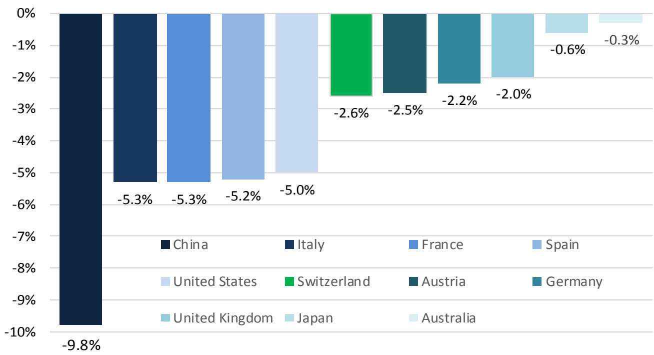
The impact is thus particularly stunning, considering the limited number of days involved during the period under review.

Switzerland withstands Covid-19 shock more successfully

Switzerland's main economic partners also suffered a sharp deterioration of their economic and health situations. Logically, sensitive economic sectors such as watchmaking and the machine and precision instrument industry were also affected by a reduction in international demand. The industrial sector thus posted its sharpest decline since the massive rise of the franc in 2015.

By international comparison, we believe the -2.6% drop of Switzerland's economy in Q1 can actually be considered as a major success with regards to the performances of our largest neighbours and of major developed economies. Indeed, the initial figures published for Italy (-5.3%), France (-5.3%) and Spain (-5.2%) point to much more dire performances. With regards to the UK (-2%), Germany (-2.2%) and Austria (-2.5%), for example, confinement measures similar to ours had similar effects. As for the US (-5% annualised), which had barely begun putting in place limited confinement measures in certain states, the impact seems particularly severe. In Asia, Japan (-0.6%) and Australia (-0.3%) do not seem too badly affected, while China posted a logically expected impact of -9.8% over the quarter.

International GDPs in Q1



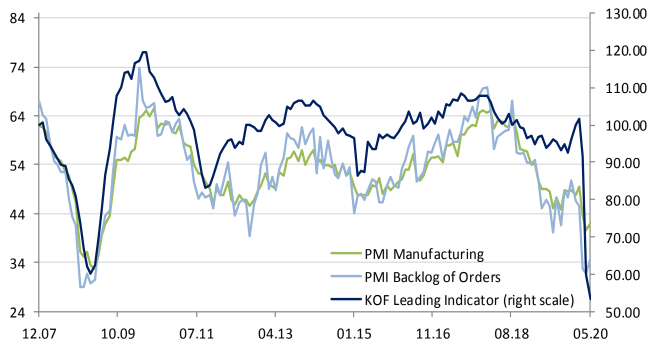
Sources: BearBull Global Investments Group Limited

Further -10% shock to GDP in Q2?

By the end of Q2, Switzerland's economy will thus have suffered almost two months and a half of confinement in a regional economic context heavily affected by the safety measures implemented by the various European governments to fight the pandemic. In view of the contraction posted in Q1, a -10.3% contraction in Switzerland's GDP in Q2 is rather likely, even if the confinement measures start being lifted in June. Most leading indicators logically point in the direction of a severe recession in Q2 without being able to predict a subsequent recovery in activity for the moment. The estimated growth shock at this time certainly exceeds the more optimistic initial estimations. However, this shock has broadly been taken into account since March and will thus not be considered as a surprise during the next reporting period in the summer. The risks we predicted of a rapid deterioration of leading indicators throughout Q1 materialised and are now likely to stabilise. The manufacturing PMI index dropped from 49.5 in February to 40.7 in April before stabilising in

May at 42.1. For the KOF, the leading indicator collapsed from 101.7 to 53.2 in May and shows no sign of recovery yet. In the current context, it is not surprising that consumer confidence, which was already at risk in March (-10), is in freefall in Q2 (-40). Logically, retail sales also posted a 19.9% yoy drop.

PMI – KOF



Sources: BearBull Global Investments Group Limited

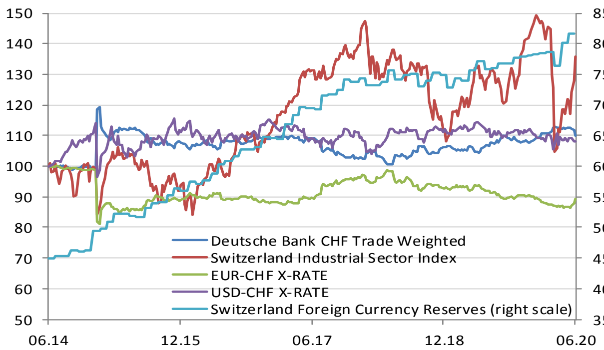
What prospects for H2?

The magnitude of the economic contraction in Q2 will certainly have to be analysed, but the main issue now pertains to recovery prospects in the second part of the year. The gradual deconfinement will undoubtedly be well under way at the start of the summer in Switzerland. Nevertheless, it is hard to imagine a return to normal in Q3 already. Regarding private consumption, although consumers are expected to return, we doubt that consumption will return to a pre-crisis level. Businesses will not be able to make up H1 revenue losses. While the unemployment rate has remained relatively stable in our country (3.4%) during the crisis due to work-time reduction implemented by the authorities, the risks of seeing another trend develop in September are substantial. Indeed, an economic recovery that could be significant and close to +5% in Q3 may also be insufficient to ensure the viability of certain companies and SMEs just barely being kept afloat by government aid. Risks are thus high of seeing a rise in bankruptcies and unemployment at the end of Q3. These prospects will certainly put somewhat of a damper on the pick-up in consumption and investment. We remain confident about the capacity of Switzerland's economy to bounce back in H2.

SNB remains discrete but active

Unlike other central banks, the SNB kept a relatively low profile during the Covid-19 crisis. The Swiss franc only marginally appreciated against the dollar and the euro. However, it is mainly thanks to the stability of its monetary policy and its discretion that the SNB set itself apart from other central banks. While the ECB, the Fed and the BOJ flooded financial markets with fresh money and a string of shock announcements, the SNB increased its overnight domestic deposits from 500 to 594 billion without any spectacular announcement and increased its currency reserves from 763 to 816 billion. The SNB did not change key rates during the crisis, and there was no new monetary strategy inspired by the asset purchase programmes initiated by the other central banks.

Exchange rates & SNB reserves



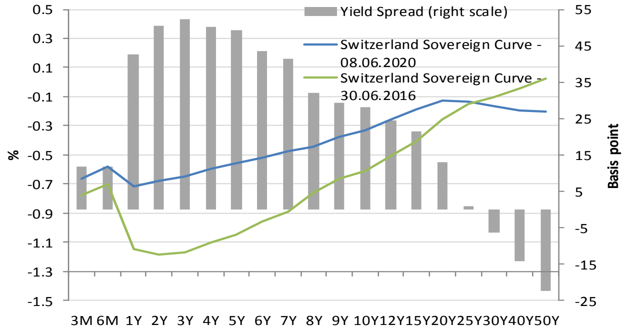
Sources: BearBull Global Investments Group Limited

Clearly and unsurprisingly, the SNB's monetary policy, which aims to hinder any appreciation of the franc against the euro, has thus not changed. Shifts in US key and long-term rates have reduced further still the yield spread on which the SNB has based its weakening strategy for the franc and slightly disrupted its policy. The end of the crisis is likely to be conducive to a weakening of the franc.

Shift in outlook for rates

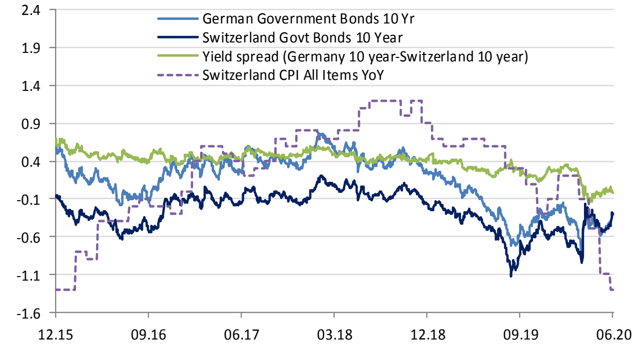
The first half of the year will have been characterised by a complete change in growth expectations and outlook for long-term rates. The development of the health crisis in China into a global pandemic triggered a drop in government yields and a rise in risk premiums for other issuers during the financial panic in March, a trend that has nevertheless weakened significantly since then.

Swiss sovereign rate curve 06/2016 – 06/2020



Sources: BearBull Global Investments Group Limited

EUR-CHF 10-year interest rates



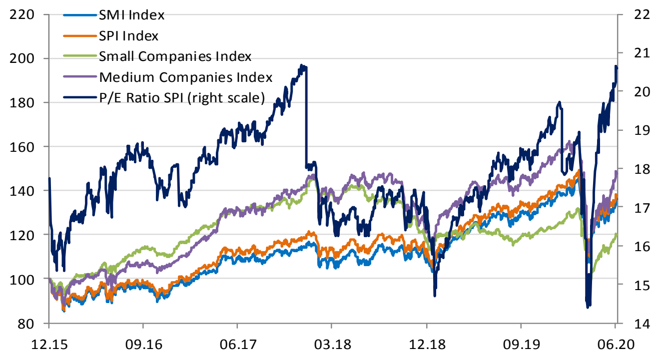
Sources: BearBull Global Investments Group Limited

The economic context going forward is likely to once again trigger changes in expectations and drive new increases in long-term yields. Long-term rates in Switzerland do not have the benefit of a central bank asset purchase programme. Prices will thus not be driven by central bank demand and will be determined only by economic prospects and institutional and private investment demand. After an initial deflationary phase, we cannot exclude a rise in inflation and in the Swiss government's long-term rates above zero in the medium term.

Beware, euphoria already replacing panic

Although we recommended caution in January, Swiss equities benefitted from the general euphoria before succumbing to complete panic in March. In late March, we took note of the extreme pessimism by highlighting repositioning opportunities at reasonable valuation levels. A few weeks of gradually regained enthusiasm will have been enough for Swiss equities to return to their pre-crisis levels. Euphoria is thus once again present, driven by prospects of a quick return to normal and the promise of abundant liquidity. Profit growth will nevertheless not resume so quickly, and at 20.6x expected earnings, valuations once again appear high and justify profit-taking.

Swiss equities



Sources: BearBull Global Investments Group Limited

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