BearBull Global Investments Group

Economic Research

WEEKLY ANALYSIS

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Sharp rebound in Swiss GDP already anticipated by equity markets

The economic recovery is underway. SNB staying on course. Swiss franc likely to weaken against the euro. New paradigm for interest rates. Risks return to equity markets.

Key points

- Swiss GDP falls by -8.2% in Q2, by -10.5% in H1
- Switzerland withstands the shock of Covid-19 better than its neighbours
- Solid growth prospects in H2 for Swiss GDP, expected to rise by 5.5%
- SNB maintains a policy distinct from that of the major central banks
- Swiss franc likely to weaken
- Temporary new paradigm in fixed income markets
- Risk-reward ratio again unfavourable to Swiss equities

Swiss GDP falls by -8.2% in Q2

The State Secretariat for Economic Affairs (SECO) has published the Q2 2020 growth figures for our country, which show that seasonally adjusted real GDP contracted by -8.2% after a -2.5% decline in the previous quarter.

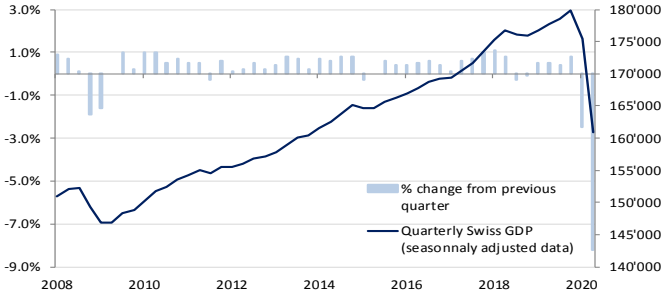
Unsurprisingly, Switzerland's economy is clearly feeling the effects of the global health crisis and the partial lockdown implemented during this period, with the largest quarterly decline since these statistics were first published in 1980.

However, the economic downturn is somewhat less severe than expected, with Switzerland performing better than most industrialised countries.

By international comparison, Switzerland appears to have been somewhat more resilient in the face of the crisis and the general recession caused by the protective measures taken by governments and health authorities. The cumulative fall in GDP of -10.5% over just two quarters in 2020 is therefore logically much more severe than that recorded during the last contraction observed (-3.5%) between Q4 2008 and Q1 2009.

The SECO logically notes that the coronavirus pandemic and the measures taken by our government to contain it severely limited domestic economic activity from March to June. Moreover, the international economy's plunge also contributed to the decline in GDP by penalising our export industries, with the exception of the understandably strong performance of the pharmaceutical sector.

Swiss economic performance (GDP in M CHF)



Sources: BearBull Global Investments Group Limited

The sectoral composition of the Swiss economy has made it possible for the overall economy to fare better in Switzerland, thanks in particular to the greater weight of the healthcare/pharmaceuticals segment.

The pharmaceutical sector, which managed to increase its sales given the health context, thus partially offset the shock suffered by the other manufacturing sectors, which declined by -9% overall.

During the quarter, most components of GDP posted negative contributions, with the exception of public services, up very slightly by +0.2%. Sectors sensitive to international economic conditions suffered considerably due to weak external demand.

Thus, sales in the machinery, precision instruments and watchmaking sectors in particular fell sharply in conjunction with the -9.4% drop in merchandise exports. The second quarter was even more difficult for the service sectors, which were more severely affected by the health measures, the lockdown and the closures of public establishments required by the pandemic.

The Swiss hotel and restaurant industry had already been hit hard at the end of Q1, recording a historic decline in turnover of -23.4%, but Q2 really called into question the very survival of an exponential number of establishments as value added for the sector dropped by a further -54.2%.

Transport and communications were also battered by the slowdown in activity, posting a second contraction of -21.7%. Trade was logically more resistant to the pandemic and saw its turnover decrease by -3.6%. The healthcare and business services sectors posted an overall decline of -8.6%. Investment in construction (-4%) and capital goods (-11.7%) also declined across the board. Services exports (-15.9%) fell de facto more sharply than goods exports (-9.4%), but the decline in final domestic demand (-7.4%) also led to a greater reduction in imports of goods (-14.3%) and services (-22.2%).

The relatively lower share of tourism-related services in Swiss GDP vs. French, Italian, and Spanish GDPs in particular ultimately had a smaller impact in our country.

Switzerland better withstands the shock of Covid-19

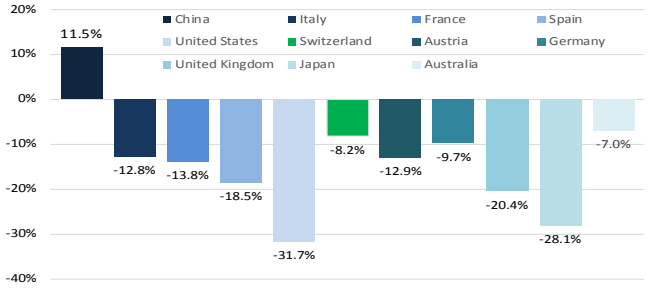
Switzerland's main economic partners have also experienced a sharp deterioration in their economic and health situations. Logically, sensitive economic sectors such as watchmaking or the machine or precision instruments industries were therefore affected by a decrease in international demand. The industrial sector thus recorded its strongest decline since the massive rise of the franc in 2015.

By international comparison, the -8.2% decline in the Swiss economy in Q2 can in fact be considered a real success in our view, given the performance of our main neighbours and of the major developed economies.

Indeed, the initial figures published for Italy (-12.8%), France (-13.8%), Spain (-18.5%) and the UK (-20.4%) show much more dismal performances. With regards to Germany (-10.1%) or Austria (-10.7%), for example, lockdowns similar to ours had similar effects. As for the US (-9.1%), the management of the health crisis, often considered catastrophic, did not, however, lead to any excessive economic slippage.

In Asia, India was hit hard with a -25.2% drop in GDP, while contractions in Japan (-7.9%) and Australia (-7.1%) were similar to that in Switzerland. China already seems to be in a completely different growth zone thanks to a rebound of +11.5% erasing the -9.8% fall of the previous quarter.

International comparison of Q2 GDPs



Sources: BearBull Global Investments Group Limited

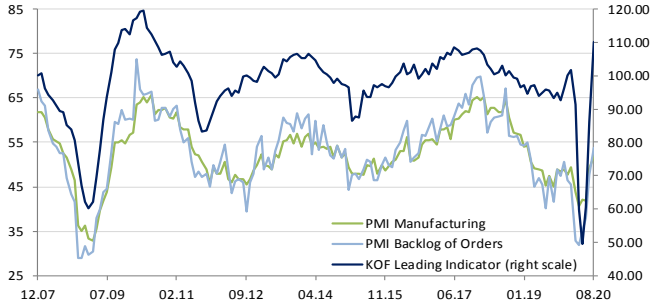
Solid growth prospects in H2 for Swiss GDP

After a -10.5% contraction in GDP in H1, a clear recovery from Q3 onwards is now probable. Most leading indicators now point to a significant recovery in GDP in Q3, which could approach +5.5% in that quarter and +1.5% in Q4 2020. The manufacturing PMI index for August (+51.8) is back above its theoretical growth threshold (50) after hitting a low point of 40.7 in April.

These results are also supported by the order book component, which proved to be even more solid (53.7). This trend was further confirmed by the rise in the services PMI, which stood at 51.7, a clear recovery from its April low of 21.4. As for the KOF leading indicator, which had collapsed from 101.7 in February to 49.5 in May, it rebounded in just three months to 110.2, its highest level since August 2010.

Consumer confidence is also back almost to its pre-Covid levels, jumping from -39.3 to -12, despite still hesitant retail sales.

PMI – KOF



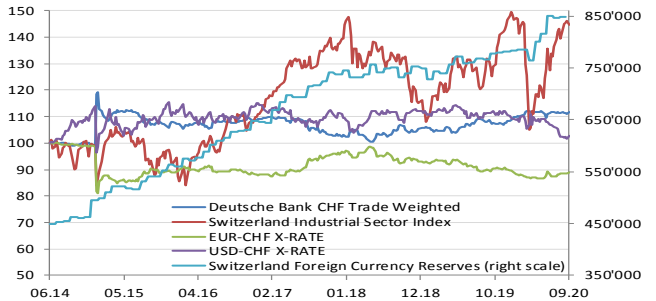
Sources: BearBull Global Investments Group Limited

The favourable outlook for H2 is essentially based on expectations of a global economic recovery following the gradual easing of lockdown measures in the main developed economies and the return of "normalised" activity with no new risk of widespread lockdowns, as many governments have already announced that further lockdowns are not an option. While a second wave still seems possible, it should not be of the same nature and is unlikely to have the same devastating effects.

The SNB maintains a policy distinct from that of the major central banks

The SNB has remained relatively discreet in recent months and has not changed its monetary policy, unlike other major central banks, which have been more active in supporting the economy in their respective countries.

Exchange rates and SNB reserves



Sources: BearBull Global Investments Group Limited

Key interest rates remained unchanged in Switzerland, and no asset purchase or further liquidity injection strategy was envisaged in Q3. The Swiss franc continued to appreciate somewhat against the dollar and the yen, as uncertainties diminished and financial markets resumed their upward trend, although it weakened against the euro. Sight deposits rose further to 635 billion as of mid-September, while foreign exchange reserves have remained stable at around 848 billion since June. The SNB has not changed its course and is still trying to curb any further appreciation of the Swiss franc against the euro. The downward trend in US policy rates and long-term interest rates has further narrowed the yield differential on which the SNB's strategy of weakening the Swiss franc is based and has somewhat disrupted its policy.

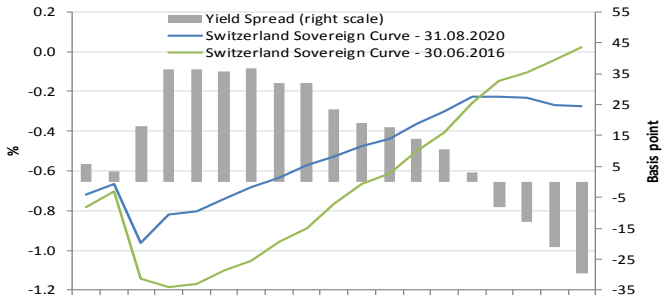
The end of the crisis should, however, be conducive to a further weakening of the Swiss franc already under way since mid-May against the European currency (-2.5%).

Temporary new paradigm in fixed income markets

Interest rate markets in Switzerland have partly followed trends in international markets in recent months. While the outbreak of the health crisis had initially significantly lowered government yield curves in most countries due to legitimate concerns about growth prospects, yields on various maturities rose relatively quickly in response to fears of rising debt in connection with the fiscal policy decisions of most governments in industrialised countries.

Swiss interest rate markets were also affected by this global trend in March and then in April, with 10-year yields recording an initial decline of around 25 basis points followed by a 60 basis point recovery, bringing them back close to 0%.

Swiss Confederation yield curve



Sources: BearBull Global Investments Group Limited

However, Swiss interest rate markets have not reacted as much to more recent trends in the US and the Eurozone in particular. While central banks in these two regions clearly maintained and reinforced the downward pressure on yields, the lack of SNB intervention in Switzerland left market forces free to find an equilibrium.

De facto, the Confederation's 10-year yields have remained rather stable in recent months and are still below zero at -0.45%. As for investment grade Swiss franc bonds, the same uncertainties had led to a rapid increase in yields of almost 150 basis points in March and a rise in risk premiums, which we described at the time as a fresh window of opportunity to take new positions in the corporate Swiss franc segment. The BBB-10-year Confederation risk premium had at the time jumped from 1% to 2.46% and was at a ten-year high.

A few months later, while the Confederation's yields remained relatively unchanged, the influx of capital into corporate bonds in particular has squeezed yields and the risk premium, which now stands at 1.1%. The new paradigm that emerged in Swiss interest rate markets in March has already changed significantly. We believe that while the risk premium could contract by a few more basis points in the coming months, repositioning opportunities are no longer attractive at current levels. With regards to government bonds, it is likely that the international environment, characterised by monetary policies involving massive asset purchases, will continue to keep interest rates low for some months to come, indirectly influencing the Swiss market.

We will probably have to wait for a real economic recovery and the beginning of 2021 before expectations become more negative for bond markets. Immediate risks of a rise in interest rates are relatively small in our country, but so are opportunities. The forthcoming economic environment is again likely to trigger changes in expectations and launch a new phase of rising long-term yields, since following current deflationary conditions, it is not impossible that in 2021 inflation may pick up and Switzerland's long-term interest rates rise once again above zero.

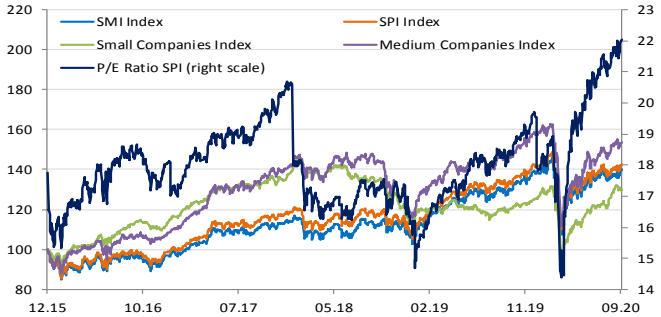
While at the end of March we noted the extreme pessimism of the investment climate by pointing out the opportunities for repositioning in Swiss equities at reasonable valuation levels, the current level of the Swiss stock market, on the other hand, prompts us to recommend caution once again.

The rise in share prices predicted in March has largely materialised, although price levels are once again similar to those prevailing in January when growth expectations for 2020 and 2021 were above +4%/year globally.

Today, it is clear that instead of cumulative growth of +8% over two years, world GDP will have to wait until 2022 to return to its pre-Covid levels. The SMI's PE is once again above 20x for the current year and 17x for 2021.

In a context characterised by abundant global liquidity, it is not impossible that the current trends will continue, but the risks of temporary consolidation now seem present once again and therefore suggest a return to prudence.

<u>Swiss equities</u>



Sources: BearBull Global Investments Group Limited

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