Economic Research

WEEKLY ANALYSIS

29 July 2022

WINDOW OF OPPORTUNITY FOR SWISS EQUITIES?

Domestic demand is supporting growth. Strong franc dampens inflationary momentum. Unexpected change in monetary policy by the SNB. Extreme volatility in the capital market. A window of opportunity opens for Swiss stocks.

Key Points

- Swiss economy resists headwinds
- Public and private consumption remain the main drivers of the Swiss economy
- Leading indicators continue to plummet
- Swiss inflation at 30-year high
- Surprise and radical change in SNB policy
- The franc benefits from the Swiss central bank's monetary tightening
- Extreme volatility in the Swiss capital market
- A window of opportunity opens for Swiss equities

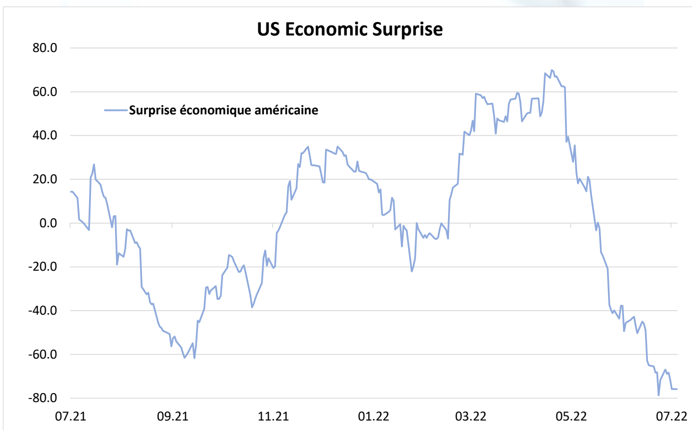
Swiss economy resists headwinds

The Swiss economy had already shown a rather solid resistance in the first quarter by recording a GDP growth of +0.5% in real terms, significantly higher than expected (+0.3%) and than the result of the previous quarter (+0.2%). This dynamic should continue in the quarter ending June 30. It brought its performance to +4.4% on year-on-year comparison. Swiss GDP was in line with the European trend of a rather strong first quarter after a revised +0.5% growth for the eurozone. In our country, this result was also particularly favourable in the difficult context of the first quarter marked by the outbreak of war in Ukraine and the strong increase in uncertainties resulting from this conflict in Europe. We will see below what were the main components that supported this growth and what the detailed outlook is for the coming quarters. With only a few weeks to go before the publication of the second quarter's performance, growth expectations seem to indicate a likely continuation of the resilience already observed at the beginning of the year in Switzerland. The Swiss economy is expected to have added +0.4% in real terms, in an increasingly difficult environment, characterized by a weakening international economy, rising inflation, a stronger Swiss franc and higher interest rates.

The Swiss economy is also facing undeniable contradictory forces. In particular, the crisis in Ukraine and the difficulties in obtaining raw materials and other products essential to Swiss industrial production are still having an impact on prices and supply levels. The end of the restrictions linked to Covid constitutes a more positive environment supporting the economic dynamic and the evolution of services in particular, but its positive effects come up against the increase in uncertainties directly linked to the war in Ukraine and which do not show any signs of easing to date.

The geopolitical context is likely to persist and remain tense for probably longer than most observers initially expected. The rise in energy and commodity prices in general is also affecting household purchasing power in Switzerland and potentially the level of consumption. However, we believe that Swiss consumers will be able to get through this period of inflationary pressure with only marginal changes in their consumption. We believe that for the year as a whole, Swiss GDP should not undergo a major revision and should grow by 2.5%.

Performance of the Swiss economy (GDP) in million CHF



Source: Bloomberg, BearBull Global Investments Group

Public and private consumption remain the main drivers of Swiss growth

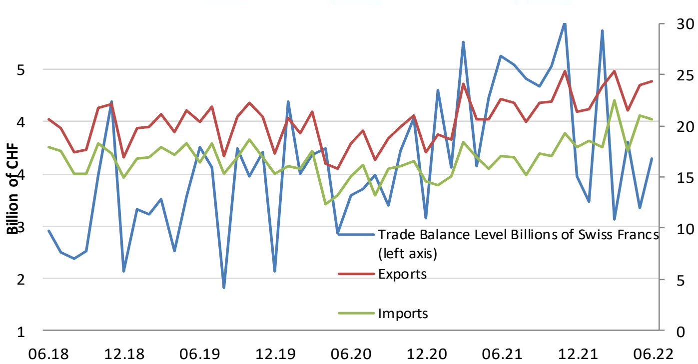
The industrial sector made significant progress at the beginning of the year (+1.7%), while growth stalled in the chemical and pharmaceutical industries. Exports of goods improved (+1.4%), outperforming the historical average. Imports of goods rose by +6.1% and were supported by demand from the chemical and pharmaceutical industries. Retail trade remained relatively stable (-0.1%) despite the removal of health restrictions. The hotel and restaurant industry remained depressed (-2.2%) and failed to record an increase in turnover. Private consumption supported the GDP with a +0.4% increase due to the good performance of the food sector. Once again, public spending, which recovered by 1.4%, supported GDP in connection with spending to combat the pandemic. On the capital goods investment side, the trend weakened (-3.1%) after a strong last quarter of 2021. A decline was also observed in construction (-0.7%) due to supply difficulties and raw material costs.

Government spending had thus already risen significantly at the beginning of the year, and we estimate that it was still strong in the second quarter. The initial pandemic-related spending was certainly replaced later by spendings related to the war in Ukraine. The refugee movement that has started is expected to last and impact the second half of 2022 as well.

Construction investment is expected to show a fifth consecutive quarterly decline and will continue to suffer in the coming months from difficulties in the supply of intermediate goods. In Switzerland, too, labour shortages are affecting the construction sector, which is likely to continue to suffer from high capacity utilization. However, demand remains solid in the construction sector, pushing up prices in the face of a supply level that is struggling to adjust. We believe that conditions remain favourable for the sector despite the rise in mortgage rates because of financing conditions that remain favourable overall by historical standards.

Investment in capital goods should be able to pick up again under the more sustained impetus of investment in the electrical and IT services segments. Foreign trade made a slightly negative contribution due to higher import costs, as exports had already risen by +2.1% to 16% above the pre-pandemic level.

Swiss trade balance, imports and exports

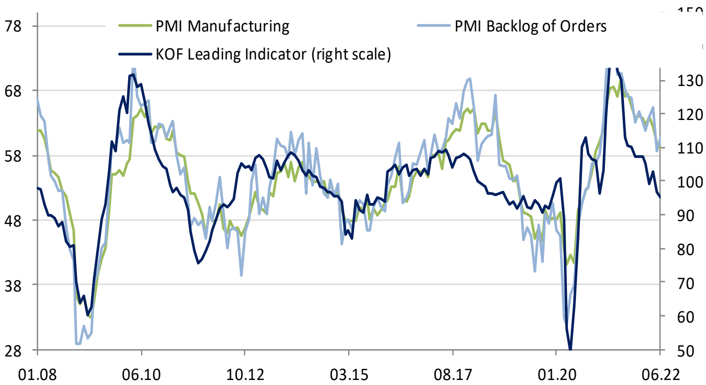


Source: Bloomberg, BearBull Global Investments Group

The collapse of the leading indicators continues

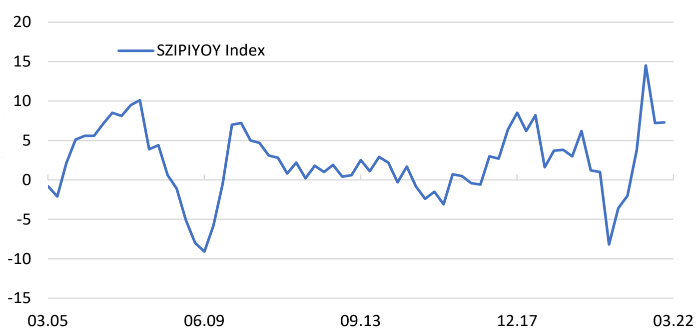
In July, the KOF Economic Barometer (-5.1 points) continued the long decline that began in the spring of 2021 and surprised observers by registering a more significant decline than expected. The decline of the KOF leading indicator has accelerated, suggesting that the situation is not yet improving despite the good results recorded in the first quarter of 2022. By slipping to 90.1 points, the index is now well below the 100 level and suggests that the Swiss economy is likely to weaken during the fall. Manufacturing is expected to suffer from the global economic downturn and supply difficulties, but the outlook is equally mixed for financial services, restaurants and hotels. Consumption seems to be holding up better, but production is largely affected, with order books in the machinery and pharmaceutical sectors showing more worrying trends. The manufacturing PMI also shows a similar downturn, with the latest publication for June dropping from 60 to 59.1. The indicator has been slipping since July and is now at its lowest level in a year. Overall, the leading indicators continue to point to a weakening of the economy in our country in the wake of that seen in most developed countries.

PMI and KOF indicators



Source: BearBull Global Investments Group

Industrial production



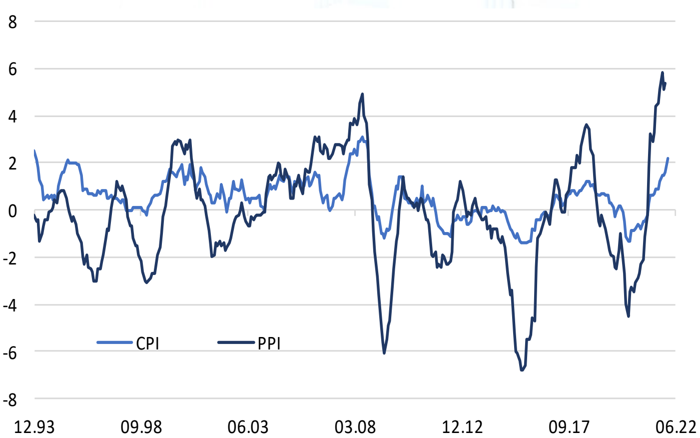
Source: Bloomberg, Bearbull Global Investments Group

Swiss industrial production is also being impacted by rising material costs and supply difficulties. Import and producer prices rose sharply in Switzerland in June (+0.6% and +0.2%), and the strength of the Swiss franc has certainly helped to slow down the strong upward movement in costs for the Swiss economy, despite the fact that it has been widely observed among our direct economic partners. In the eurozone, import prices and producer prices have indeed jumped by around 36% over the past year.

Swiss inflation at a 30-year high

The strength of the Swiss franc has certainly been a favourable factor in containing price developments in our country and slowing down the developments observed in most industrialized countries. Nevertheless, price indices have risen sharply in recent months. The CPI index rose by a further +0.5% in June, bringing its year-on-year increase to +3.4%, the highest level of inflation achieved in Switzerland in the last 30 years. While this result remains worrying in historical analysis for our country, in historical comparison, Swiss inflation remains well below the European figure of +8.6%. Excluding food and energy (+1.9%), Swiss inflation remains below the SNB target of 2%. The international tensions observed in the production chains have not eased and therefore represent a very important risk factor for Switzerland, which could support a further rise in prices. Rising transport costs, logistical problems and persistent tensions in the labour market remain serious. With the unemployment rate now at a decade-low of 2%, the Swiss economy may also have to adjust to the risks of wage increases. However, the upward momentum of energy and commodity costs is likely to slow significantly in the coming weeks and contribute to the loss of inflation momentum in Switzerland. On the other hand, the strength of the Swiss franc, which has strengthened in recent weeks, will also contribute to a likely improvement in inflation in the near future. The global economic downturn that has taken hold should also have an overall impact on prices by supporting an upcoming easing.

CPI & PPI -Suisse



Source: Bloomberg, BearBull Global Investments Group

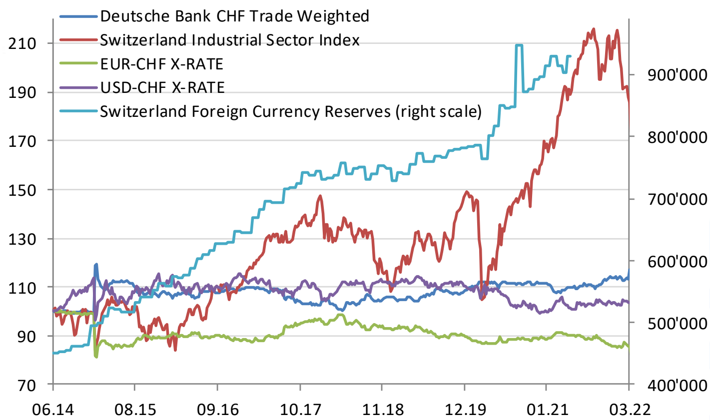
Surprise and radical change of policy by the SNB

The SNB surprised all observers by raising its key interest rates by 0.5% on June 15, the day after the Federal Reserve raised rates and well before the ECB could adjust its own policy. While all observers expected a status quo in June and probably a measured policy decision some time after the ECB's first rate hike, the action of our national bank was clearly not anticipated. The SNB, therefore, considered that the Swiss economy was no longer as likely to be penalized by a strong franc and that it would ultimately benefit more from a stronger franc in the global inflationary context. The strength of the franc against the euro was clearly seen as a positive factor in containing imported inflation in our country and as a monetary policy tool by the central bank, which is now more concerned about rising prices than about economic risks. The return of the risk of inflation slippage has thus pushed the SNB to refocus its policy on its assigned objective of controlling inflation. The SNB decided to act in June to avoid the risk of being perceived as lax if it waited until its next monetary policy committee meeting in September. This first significant step in policy normalization may be premature if Swiss inflation starts to fall during the summer.

Franc benefits from SNB monetary tightening

The SNB had changed its stance on the value of the franc by changing its assessment of its relative overvaluation in recent months. The widening inflation differential between the Swiss and foreign CPI and PPI indices, particularly in Europe and the US, led the SNB to conclude that the franc was no longer overvalued in the current context. The evolution of the euro/franc exchange rate towards parity materialized in an environment of stable key rates before central banks decided to adopt monetary policies adapted to the acceleration of global inflationary dynamics. The franc's rapid rise towards parity was then to be contained by a probable more rapid action by the ECB, which was to reinforce the yield differential in favour of the European currency. It was in this anticipation that the exchange rate was able to stabilize and rebound by +4% above parity. The SNB's surprise decision on June 16 totally contradicted this outlook and allowed the Swiss franc to appreciate rapidly against the euro by nearly 6%, reviving investor interest in the Swiss currency. The ECB's subsequent decision to raise its key interest rates by only 0.25% was therefore not enough to change the trend. The war in Ukraine and its geopolitical, economic and social consequences have not finished affecting Europe and Switzerland. Uncertainty remains high and also favours the short-term appeal of the franc as a safe haven currency. However, it should be remembered that the euro/CHF yield curve differentials have moved in favour of the euro on most maturities in recent weeks to the point of returning to levels similar to those of 2015, which allowed the European currency to rise. In this context, a stabilization of exchange rates seems more likely in the coming months.

Exchange rates and SNB reserves

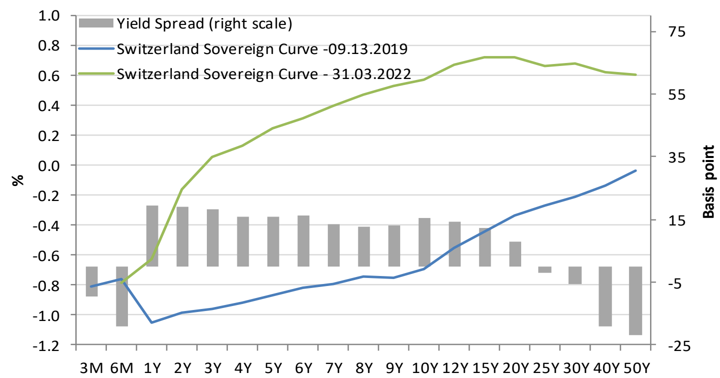


Source: Bloomberg, BearBull Global Investments Group

Extreme volatility in the Swiss capital market

The Swiss economy may well record near-zero growth in the second quarter, but it may show greater resilience due to lower inflation than its main economic partners and more resilient domestic demand. The international context will remain a key factor for its exports, which will certainly weaken with the decline in global dynamics. The risks of stagflation are thus still high in our country as well. However, the end of the quarter proved to be a very tense one for the capital market, which was unable to escape the global trend, which was largely affected by rising inflationary risks. Yields in Swiss francs were affected by the same fears and therefore suffered the same fluctuations as those observed on markets that were more affected by the slippage of inflation. The month of June will therefore be remembered for the extreme adjustment of long-term rates to the +8.6% inflation figure published in the United States, which did not fail to push the Swiss Confederation's 10-year rates above 1.54% despite much lower inflation. This movement observed in Switzerland already seemed to us to be clearly an exaggeration driven by an extreme and unjustified rise in uncertainties. This sudden rise in the Swiss yield curve in June thus appeared to have no real justification in the context of the probable economic slowdown also expected in our country.

The Confederation's rate curve



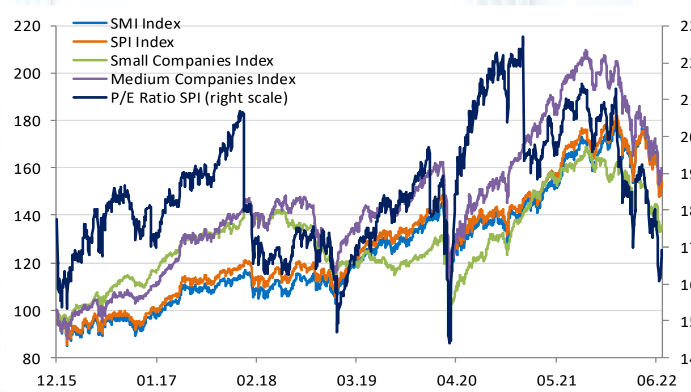
Source: Bloomberg, BearBull Global Investments Group

Confederation and investment grade bond yields therefore offered unique repositioning opportunities in our view, almost similar to those observed in March 2020, which were quickly followed by a downward adjustment in yields. We anticipated a rapid reversal of the trend, which would then be reinforced by a loss of inflation momentum. In a few weeks, the capital market did indeed adjust very sharply, lowering 10-year yields by more than 100 basis points. With a yield of 0.44%, they seem to us to be correctly priced to take into account the current context of slowing growth.

A window of opportunity opens for Swiss equities

After several months of believing that the risks of a consolidation in Swiss equity prices were significant and suggesting an underweight exposure to equities, the developments of the last few weeks now seem to us to point to a stabilization and a likely recovery of the markets. The main risk factor for Swiss equities at the time was that of a significant adjustment in interest rates and a contraction in price/earnings ratios, which has since largely materialized with the rise in ten-year rates above 1.5% and a drop in the market PE to around 15x. The change in risk perception that developed in June caused investors to re-evaluate their equity exposure, which did not fail to have the same effect on Swiss listed companies. The almost instantaneous -10% price correction in June in Switzerland brought the year-to-date price adjustment to -20% and therefore offered new repositioning opportunities in our view. Swiss equities should benefit in the coming months from lower inflationary expectations and the subsequent decline in yields. A sustained recession should be avoided and major corporate earnings revisions should be averted. We now recommend a neutral to overweight allocation to Swiss stocks.

Swiss Equity Indices



Source: Bloomberg, BearBull Global Investments Group

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