17 September 2018

Switzerland posts strong economic gains: GDP up +3% in 2018.

GDP up +3.4% in Q2. Inflation at 10-year high. Steepening yield curve. Temporarily strong Swiss franc. Bullish trend in Swiss equities.

Key points

- Exceptional and unexpected economic upturn in Switzerland in Q2
- GDP growth exceeds +3% in 2018
- Strong momentum in Q2: +0.7%
- Switzerland not immune to the risks of a trade war between Beijing and Washington
- Leading indicators pointing toward growth in the manufacturing sector
- Upswing in confidence to boost private consumption
- Foreign trade expected to expand
- Swiss franc temporarily stronger due to acceleration of growth
- Yield curve is steepening
- Bullish trend in Swiss equities continues

Exceptional and unexpected economic upturn in Switzerland in Q2

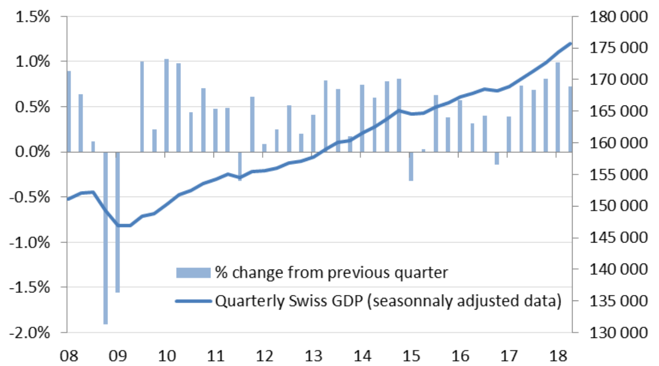
The State Secretariat for Economic Affairs (SECO) published domestic growth figures that surprised observers and highlighted the exceptional upturn in economic activity in Q2 2018. Indeed, real GDP posted a notable further increase of +0.7% in Q2 2018, bringing growth to +3.4% yoy. These results are quite remarkable and constitute the country's best economic performance since 2010 as well as the fifth consecutive above-average quarterly expansion.

Switzerland's nominal GDP clocked in at CHF 172.8 billion in Q2, namely almost CHF 6 billion more than for the same period in 2017 (CHF 166.3 billion).

The Swiss economy thus not only confirmed the strong results of the past several quarters but clearly surprised economists, who were expecting much lower growth of around +2.4%.

It was indeed quite the surprise, as our economy now appears to be growing at a pace both clearly superior to its long-term trend and faster than that of the Eurozone countries (+2.1%).

Swiss economic performance (GDP in CHF millions)



Sources: SECO, BBGI Group SA

GDP growth could exceed +3% in 2018

Even though this exceptional momentum will likely weaken in the next few quarters, the developments mentioned above are encouraging and will have a positive and significant impact on economic performance in 2018. In this context, SECO analysts have already revised 2018 expectations to +2.9%, a sharp increase from their previous forecast of +2.4%.

As Q3 comes to a close, we expect current economic trends to persist, bolstered by solid global economic conditions, leading to GDP growth of +3% for the year. Indeed, at the end of the year the Swiss economy will likely benefit from a combination of positive trends in industry, consumption, investment, and exports, which will help achieve these results.

We continue to anticipate, in our main scenario, that the favourable economic conditions currently in place will persist and boost foreign trade over the next few months. Moreover, in spite of the recent strength of the franc against the dollar and the euro in particular, we expect that the average exchange rate will not penalise the competitiveness of Swiss exports, which should benefit more broadly from the global upturn.

Swiss GDP could see growth of +3% in 2018 and +2.2% in 2019.

Strong momentum in Q2: +0.7%

Real GDP further expanded by a notable +0.7% in Q2. Three years after the change in the SNB's monetary policy and the shock of the dramatic appreciation of the Swiss franc, our country is experiencing a particularly prosperous period on the economic front, involving all business sectors. The manufacturing industry (+1.5%) was the strongest contributor to GDP growth, thanks to favourable trends in external demand. The energy sector had an exceptional quarter, and momentum in the construction sector (+0.8%) accelerated once again. A healthy job market and an unemployment rate at a 10-year low certainly contributed to the positive trend in consumption, whose +0.3% growth rate was nevertheless slightly below average. Final domestic demand ended up being somewhat less dynamic. Investment in capital goods declined slightly (-0.3%), admittedly following several quarters of sustained growth. With regard to services, the leisure sector surged up +10.1%, while hotels and restaurants (+1.4%) also posted positive results, besting the healthcare sector (+0.5%). Exports of goods contributed once again very positively to GDP growth, after two relatively lacklustre quarters, with an above average increase of +2.6%. Having withstood the appreciation of the franc, the Swiss economy is now benefitting from the normalisation of the exchange rate.

Switzerland not immune to the risks of a trade war between Beijing and Washington

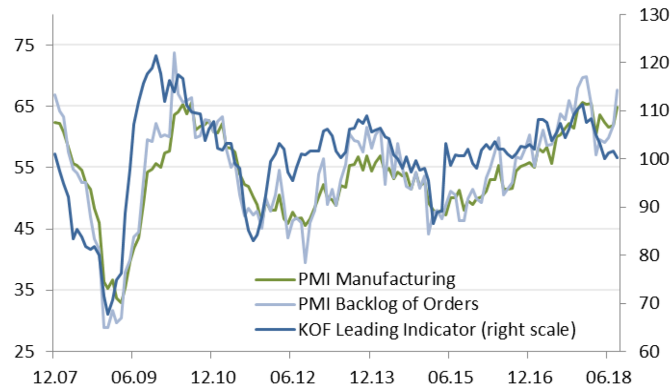
Rising tensions with regard to international trade are still the main risk for the Swiss economy. Order books are full, bolstering the outlook for the manufacturing sector. In parallel, the consumption climate is improving, which should also boost domestic demand. The risks that could threaten and call into question the positive outlook for the Swiss economy today are in our view primarily related to a significant change in the outlook for global growth resulting from an intensification of the risks of a protracted trade war. Switzerland is not a direct target of the actions of the US president, who is primarily going after China. However, a lasting crisis between Beijing and Washington would inevitably affect investors' perceptions and their outlook on global economic growth. An escalation of tariff hikes between the two powers would have repercussions on trade levels, inflation, and consumption. The risks of an economic slowdown at this point in the economic cycle could thus significantly affect the global outlook, and hence Swiss exports in particular. In the current context, even if it is certainly not clear that the worst will come to pass, it must be acknowledged that the crisis is more likely to intensify than to be resolved over the next few months.

The risks for the Swiss economy are thus above all tied to how the negotiations between the two partners progress. We believe that resolving the tensions is of course desirable and rational. However, at this stage we do not exclude the possibility that the situation will deteriorate prior to that, calling into question the outlook for Swiss GDP in 2019.

Leading indicators pointing toward growth in the manufacturing sector

The KOF index has continued to decline since its November 2017 high (110.3), which had marked the highest degree of optimism since 2010, coming in at 100.3 in August. The manufacturing PMI index confirms the significant upturn in the industry, nearly reaching (64.8) its 10-year high (65.6). The new orders index underscores the excellent outlook for the next few months, progressing from 61.9 to 67.6. With regard to services, the leading indicator decreased from 63.9 to 58.2, suggesting a loss of momentum in the sector, which seems to be affecting the level of activity as well as new orders, sales, and prices.

PMI – KOF



Sources: Bloomberg, BBGI Group SA

Three years after the SNB abandoned its exchange rate floor, the manufacturing sector is thus once again doing well, but given the risks mentioned above, caution is advised, and a decrease in the intensity of activity in the next several months is to be expected.

Upswing in confidence to boost private consumption

The unemployment rate in Switzerland has remained stable (2.4%) for several months, even as economic activity is intensifying and as Swiss businesses are announcing plans to hire more staff. Pressures are likely to materialise in the job market, which would perhaps finally result in an increase in nominal wages. These are positive factors in terms of household confidence in our country and especially with regard to consumption, which remains a significant component of GDP. The trend in private consumption will thus likely continue to be favourable, boosting GDP. Public consumption spending will remain volatile in 2018, but the federal government's and cantons' budgets are reasonably solid, and the debt-to-GDP ratio (34%) is low by international comparison, which provides some leeway for public spending to contribute positively to GDP.

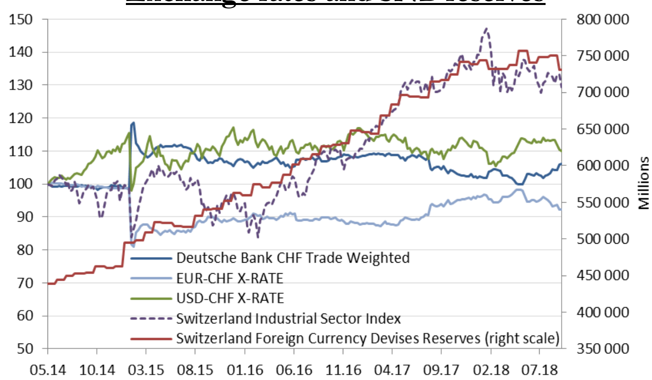
Foreign trade expected to expand

Since its January 2017 high, the monthly foreign trade surplus (2.13 in August) stabilised between CHF 2 and 3 billion, without showing clear signs of an increase for now. However, we expect that the improvement in global economic conditions and a weaker franc are likely to finally bring about an upswing in exports. The watchmaking sector, however, is growing at a somewhat slower pace, with exports up +5.5% yoy in August. Overall, after two rather more difficult quarters, exports of goods were back up by +2.6%. This trend will likely strengthen over the next few months, boosting GDP growth.

Swiss franc temporarily stronger due to acceleration of growth

Our long-term forecast in January 2015 for a return to a EUR/CHF exchange rate of 1.20 came true on 20 April 2018. We mentioned at the time that a push of the euro to 1.20 was likely in the long term, though certainly not tenable in the short term. Following the strong appreciation of the European currency, we were expecting a period of consolidation, before any upward trend in the exchange rate against the Swiss franc could materialise. The correction of the past few months occurred in an uncertain political context in the Eurozone, which led to an appreciation of the Swiss franc initially expected to be temporary. Given the particularly favourable economic conditions currently in place in our country, we consider that the GDP growth differential is for now favourable to the franc. It would thus now be imperative for economic growth in the Eurozone to be significantly higher than what it is currently to envisage a new phase of weakness of the franc. The interest rate spread between the franc and the euro has not changed significantly, and we continue to expect that the SNB will not increase its policy rates as fast as the ECB. In the meantime, the exchange rate will likely stabilise between 1.12 and 1.17 against the euro, as will the SNB's currency reserves, which decreased from 757 billion to 730.9 billion only because of the franc's appreciation.

Exchange rates and SNB reserves

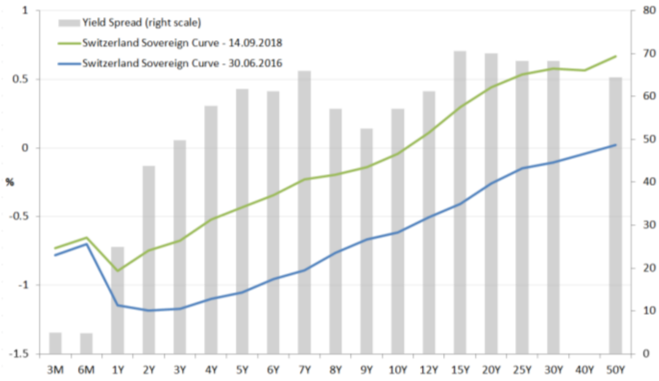


Sources: Bloomberg, BBGI Group SA

Yield curve is steepening

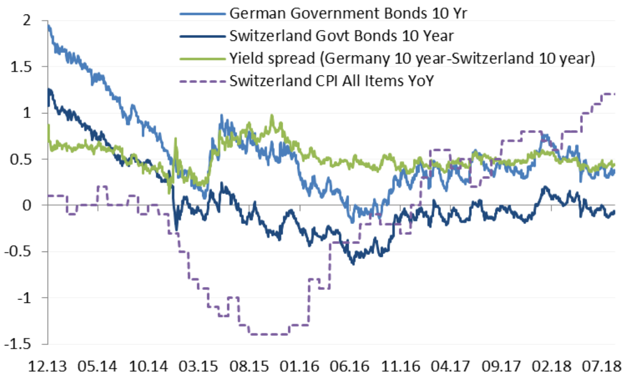
The normalisation of long-term rates in Switzerland started in summer 2016, but that first phase of adjustment rapidly stabilised at 0% for 10-year government bond rates. The acceleration of the pace of GDP growth and the increase in inflation in Switzerland to over 1.3% yoy now indicate a more sensible normalisation of long-term rates. Last quarter we predicted the end of micromovements in long-term rates and an acceleration of the interest rate normalisation process, which now seems to be under way. Consequently, the yield curve will likely steepen further in 2019, as the SNB's monetary policy will remain unchanged and will maintain higher yields on the short end.

Swiss sovereign yield curve



Sources: Bloomberg, BBGI Group SA

EUR-CHF 10-year interest rates



Sources: Bloomberg, BBGI Group SA

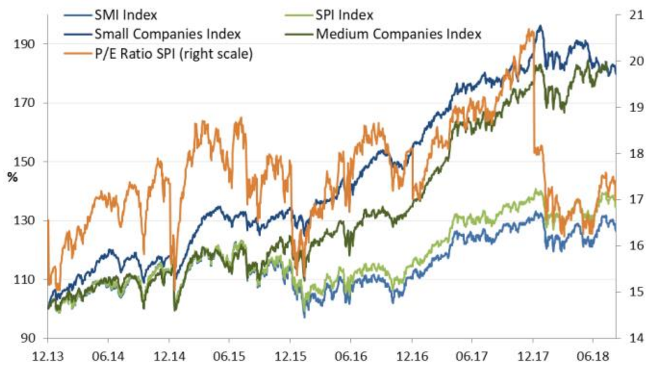
The upward trend in Swiss long-term rates will thus likely strengthen slightly, while the yield spread with regard to German long-term rates should increase, due in particular to stronger economic momentum in Europe and to the scheduled termination of the ECB's bond-buying programme.

Bullish trend in Swiss equities continues

Following the drop in the equity markets in Q1, we noted that Swiss equities offered buying opportunities to long-term investors, while not excluding the possibility that volatility could persist for a while longer. Indeed, the price drop had significantly reduced market risk by correcting valuation levels. Since then, Swiss equities have posted an increase of about +6%, climbing back up to the 11,000 level on the SPI.

The Swiss market's current PE of 15x expected 2019 earnings does not seem excessive. However, in the short term, the franc's appreciation is weighing on SPI share prices. Corporate earnings growth is unlikely to be affected by the recent exchange rate movements but should instead benefit from a favourable domestic and international environment. In 2018, Swiss corporate earnings are thus likely to reach new records, while average dividend yields remain high (3%), both by historical comparison and compared to bond yields.

Swiss equities



Sources: Bloomberg, BBGI Group SA

The bullish trend in Swiss equities will likely continue at a slower pace over the fourth quarter, unless the key risks mentioned above of an all-out trade war come to revive the threat of a recession, although the latter seems rather unlikely at this point.

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