WEEKLY ANALYSIS

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Swiss GDP weakens in the wake of German decline

GDP contracts by -0.2% in Q3. Swiss growth remains dependent on German economy. Normal yield curve. Stabilisation of the franc. Positive outlook on equities.

Key points

- Euphoria gives way to bewilderment
- Downward revision of the growth outlook for Swiss GDP
- Surprise collapse of economic momentum in Q3
- Swiss economy impacted by trade tensions between Beijing and Washington
- Leading indicators still uncertain
- Consumption will likely bolster GDP
- Trade surplus increase in October
- Stabilisation of the Swiss franc
- Yield curve remains normal
- Performance of Swiss equities still lacking?

Euphoria gives way to bewilderment

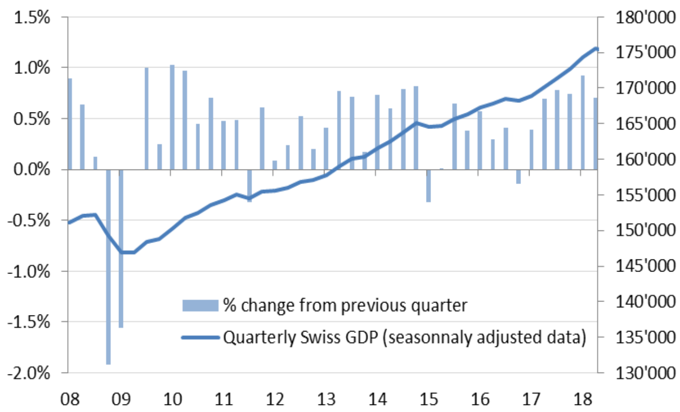
The State Secretariat for Economic Affairs (SECO) released Swiss growth figures, which shocked everyone and highlighted the collapse of the incredible economic momentum of Q2 2018. Indeed, Switzerland's real GDP contracted by -0.2% in Q3, despite growing by an extraordinary and promising +0.7% in the previous quarter. Swiss GDP growth thus decreased from +3.4% to only +2.4% yoy, effectively putting an end to six consecutive quarters of economic expansion.

The strong growth phase was thus interrupted in real terms even though Switzerland's quarterly nominal GDP grew very slightly from CHF 172.8 to 173 billion in September.

These surprising results are concerning for several reasons, and in particular because they indicate, for this quarter at least, a stronger dependence on the German economy than was previously thought to exist. Switzerland thus followed in the wake of the pronounced economic slowdown in Germany (-0.2%) and other European countries in the same period.

The Swiss economy, which posted a growth rate well above both historical trends and the growth rate of the Eurozone in Q2, was ultimately significantly impacted by developments in the Eurozone. This episode is thus a reminder, if we needed it, of the country's special situation with regard to its regional partners.

Swiss economic performance (GDP in CHF mn)



Sources: SECO, BBGI Group SA

Downward revision of the growth outlook for Swiss GDP

The economic shock of Q3 is calling into question expectations for 2018 and 2019. SECO experts displayed notable optimism when they revised their outlook for 2018 and 2019 significantly upward to +2.9% and +2.4%, respectively. At the time it was not unreasonable to anticipate that economic trends prevailing just before the summer, sustained by strong global economic conditions, would persist, enabling the Swiss economy to achieve growth of up to +3% over the year. As for us, we noted that this exceptional momentum would likely slacken over the next several quarters, without fundamentally calling into question the year-end trend driven by a combination of positive dynamics in industry, consumption, investment and exports.

Q3 results obviously challenge these expectations. In our main scenario, we now expect that less favourable global economic conditions, in particular the economic slowdown in Germany, could have a negative impact on Switzerland's foreign trade over the next few months. The recent stabilisation of the Swiss franc against the euro at 1.13 since mid-August as well as the relative stability of the dollar, unchanged over the past seven months and close to parity, are unlikely to penalise the competitiveness of Swiss exports and consequently of the country's foreign trade.

In this context, we are revising our outlook for Swiss GDP, which is unlikely to progress by more than +2.5% in 2018 and +2% in 2019.

Surprise collapse of economic momentum in Q3

To everyone's surprise, Switzerland's real GDP unexpectedly contracted by -0.2% in Q3, bringing GDP growth to +2.4% yoy. This slump occurred following excellent results in Q2 (+0.7%) and is surprising in terms of its relative magnitude, as economists' consensus anticipated growth of +0.4% over the quarter and +2.9% yoy. This is the first contraction since the -0.1% drop in Q4 2016. Thus, it interrupts six consecutive quarters of growth exceeding +0.4%. These developments are synchronous with the sharp slowdown in Europe and in Germany in particular.

The manufacturing industry declined by -0.6% after increasing by +1.5% in the previous quarter, which could be considered a stabilisation at a relatively high level, given the strong momentum seen previously. A particularly dry summer weighed on hydroelectric power plant output, and the energy sector thus posted a drop of -2.2%.

Total merchandise exports fell by -4.2%, also contributing overall to poor GDP performance. With regard to services, retail and wholesale trade value added fell by -1%, as did that of the financial sector (-1.1%). Only the corporate services (+0.7%) and healthcare (+0.5%) sectors contributed positively. The consump- tion climate remained relatively gloomy; indeed, households increased spending only very marginally (+0.1%).

The public sector was not much more active, with public spending sliding back -0.1%. Capex also decreased by -2.2%. With regard to foreign trade, weak domestic demand naturally weighed on imports of goods and services (-1.6%). A healthy job market and an employment rate at a 10-year low certainly contributed to the positive trend in consumption, whose +0.3% growth rate was nevertheless slightly below average. In sum, final domestic demand was slightly less robust, and capex was down slightly (-0.3%) following several quarters of sustained growth.

Swiss economy impacted by trade tensions between Beijing and Washington

We had been mentioning for several months that an intensification of global trade tensions was the main source of risk for the Swiss economy, even though order books seemed full, boosting the outlook for the manufacturing sector.

The uncertainty affecting the German auto sector over the past several months, in particular due to the introduction by the US of import taxes on vehicles made in Germany, ended up indirectly impacting Switzerland's industrial sector. The truce agreed upon by China and the US on 30 November came about at the right time, in our view, to avoid –if the two parties manage to come to an agreement– a negative impact on global growth prospects for 2019 and a particularly damaging intensification of uncertainty for financial markets at this point in the cycle.

Switzerland is not itself a target, but it is clearly feeling the indirect effects of the impact on other economies and its partners such as Germany. The German slowdown thus rather swiftly spread to Switzerland.

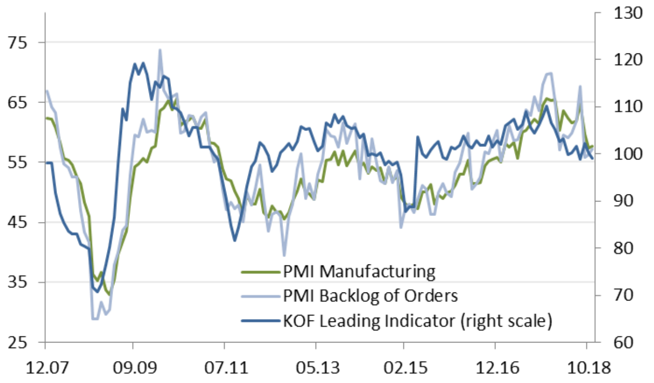
Leading indicators still uncertain

The KOF index continued to fall from its November 2017 high (110.3), which marked the highest degree of optimism since 2010, coming in at 99.1 in November, below the 100-point level. The trend does not seem to be reversing, just a few weeks shy of the end of the year. As for the manufacturing PMI, which still indicated a healthy level of optimism in August, it also tumbled suddenly, dropping from 64.8, close to its 10-year high (65.6), to a mere 57.7 in November, a slight uptick from its October number.

The services PMI also fell from 55.7 in October to 53.7 in November. In spite of these declines, the PMI indicators remain within the growth zone and continue to point to GDP growth in the +1.5% to +2% range in Switzerland.

The likely slowdown in economic activity and performance, indicated by slackening leading indicators, points to economic results inferior to those expected just a few months ago.

PMI – KOF



Sources: Bloomberg, BBGI Group SA

Consumption will likely bolster GDP

Growth in consumption was weak in Q3, failing to benefit from the record low unemployment rate (2.4%) over the past few months, probably due to the uninspiring increase in nominal wages. There was no major change in household confidence, but we think private consumption will likely continue to trend upward, bolstering GDP.

Public consumption expenditure will remain volatile in 2018, but the federal government's and cantons' budgets are rather solid, and the debt-to-GDP ratio (34%) is low by international standards, which gives the government some leeway to boost GDP through public spending, after the slight decrease noted.

Trade surplus increase in October

Since its January 2017 high, the monthly trade balance (2.13 in August) stabilised between CHF 2 and 3 billion, without showing any clear sign of resuming its upward trend. We were expecting that the improvement in global economic conditions and a weaker franc would finally lead to a boost in exports and an improvement in the trade balance.

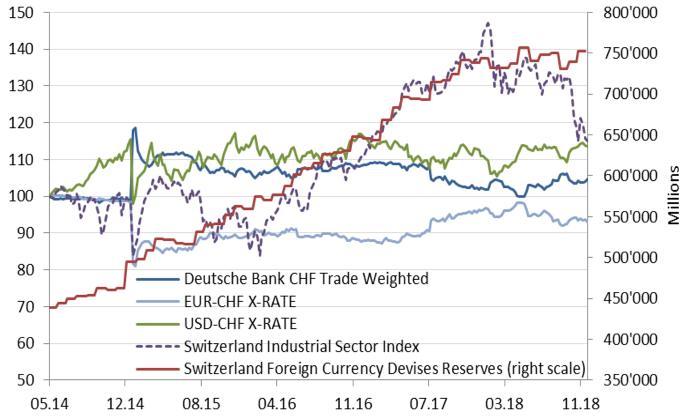
The October results seem to point to such a trend, given the 3.75 billion surplus posted. In parallel, the performance of the watchmaking sector continued to improve with a nominal increase of +7.2% yoy in October.

Stabilisation of the Swiss franc

After the significant appreciation of the European currency to 1.20 in April, we were expecting a phase of consolidation of the exchange rate, which occurred amidst an uncertain political context in the Eurozone. The Swiss economy, which appeared stronger several months ago, fell into line with the Eurozone's. The economic growth differential, which at the time clearly favoured the Swiss franc, is no longer significant. Any future phase of weakness of the franc will depend on the relative economic performance of and on the interest rate spread between the franc and the euro.

We continue to expect that the SNB will not raise rates as fast as the ECB. In the meantime, the exchange rate will likely stabilise between 1.12 and 1.17 against the euro.

Exchange rate and SNB reserves



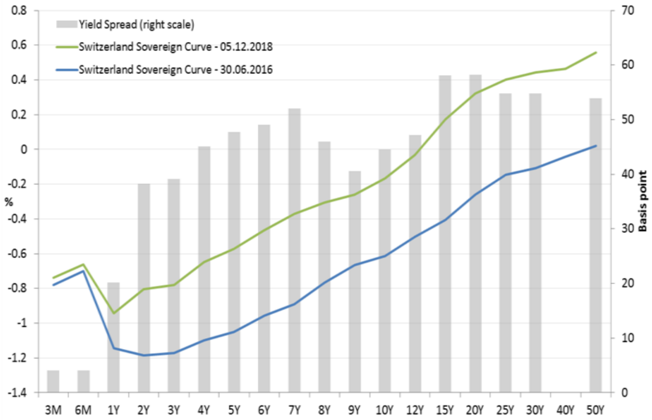
Sources: Bloomberg, BBGI Group SA

Yield curve remains normal

The normalisation of long-term interest rates in Switzerland started in summer 2016, but this initial adjustment phase rapidly stabilised at 0% with regard to 10-year Swiss government bond yields. The surprise slowdown of growth in the Eurozone and in Switzerland as well as the stabilisation of inflation in the latter at around 1% somewhat slowed the gradual upward trend in long-term rates. In order for the normalisation process to accelerate, economic statistics will have to improve in Switzerland as well as in the Eurozone.

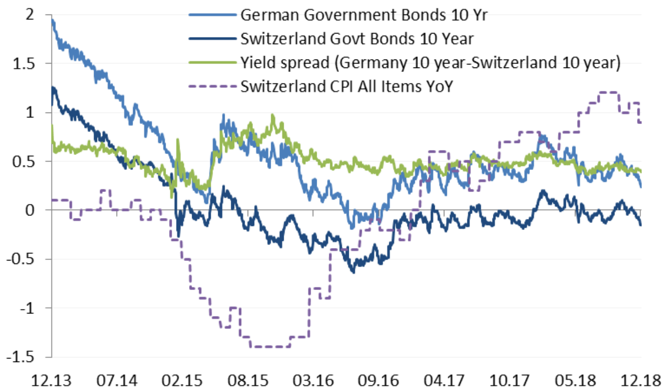
The yield curve continues to steepen in a context where the SNB's monetary policy will likely remain stable in 2019. In this view, we believe that the upward trend of long-term rates in Switzerland will likely strengthen somewhat in 2019, if economic growth resumes in Europe. The planned termination of the ECB's bond purchasing programme could cause a few unpleasant surprises with regard to sovereign bond yields and increase the risk premium in relation to Swiss government bonds.

Government yield curve



Sources: Bloomberg, BBGI Group SA

10-yr EUR-CHF interest rates



Sources: Bloomberg, BBGI Group SA

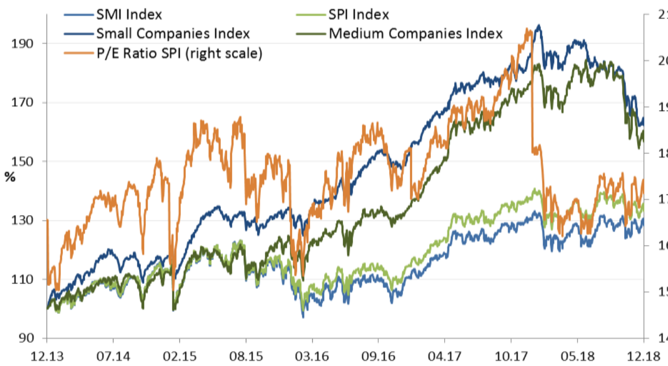
Performance of Swiss equities still lacking?

2018 seems to be ending with an increase in volatility in financial markets, to which unfortunately the Swiss market has not been immune. The latter could thus, absent a year-end rally, close on overall negative results. The performance of Swiss equities since the beginning of the year is indeed still negative, as is the case moreover for almost all international stock markets. In Swiss francs, only the US and Japanese markets posted slightly better results.

While one could still recently talk about a bull market in the US, the situation in other markets and in Switzerland in particular is somewhat different. Since December 2014, the SMI index has not in fact really progressed, since it is still trading at around 9,000 points, its closing level in 2014. After the fall in equity markets in Q1, we noted that Swiss equities provided an opportunity for long-term investors to buy, without excluding that volatility may persist for some time.

The Swiss market's current PE ratio of 15x expected 2019 earnings does not seem excessive, but calm has not yet returned, in spite of the truce agreed upon in the trade negotiations between China and the US. Barring a sharp slowdown in global growth in 2019, our outlook for Swiss equities is favourable, in particular with regard to SPI stocks and small and mid caps, which were especially impacted by the recent increase in volatility.

Swiss equities



Sources: Bloomberg, BBGI Group SA

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