

WEEKLY ANALYSIS

Alain Freymond – Partner – CIO

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Has the year-end panic already given way to euphoria?

GDP growth resumes at modest pace in Q4 (+0.2%). Interest rate trends once again atypical. New records for Swiss equities and securitised real estate.

Key points

- Growth resumes in Q4 2018
- Swiss GDP expansion of +0.2% and +2.5% (yoy)
- The SECO reduced its forecast for 2019 to +1.1%
- The manufacturing sector is the main driver of growth
- Improved outlook for Q2 2019
- Leading indicators remain uncertain
- Consumption will likely also bolster GDP
- Stabilisation of the Swiss franc favourable to Switzerland's foreign trade
- Long-term interest rate trends once again atypical
- Panic gives way to euphoria
- New record for Swiss equities
- New record for securitised real estate
- We recommend reducing risk

Growth resumes in Q4 2018

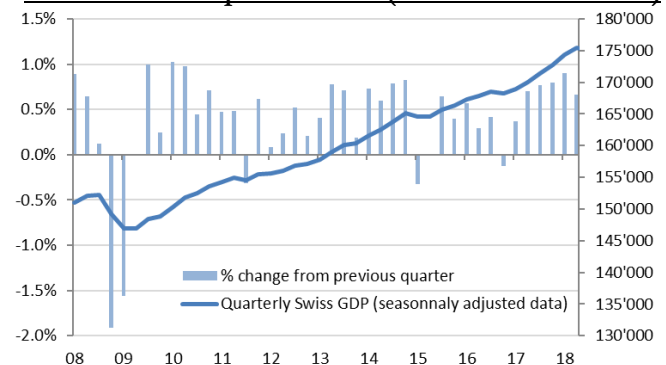
After the surprise contraction in Q3, the State Secretariat for Economic Affairs (SECO) released reassuring growth figures for our country showing a resumption of growth in Q4 2018. Indeed, Swiss GDP expanded by a welcome +0.2% on an actual basis adjusted for seasonal and calendar effects. After the -0.2% contraction in the previous quarter, the Swiss economy was able to avoid a second negative quarter and closed out 2018 on real GDP growth of +2.5% as estimated by the SECO. While this is a far cry from the exceptional results of June 2018 (+3.4%), it is still a satisfactory outcome given the slowdown in the European economy, a key economic partner for Switzerland.

Growth was well above average during the first half of 2018 but slowed down considerably during the second half. The Swiss economy was thus not able to dodge the global downturn.

Switzerland's nominal GDP grew from 172.7 to 173.3 billion Swiss francs in Q4. For the full year, it came in at CHF 689.9 billion compared to 668.6 billion for 2017.

The Swiss economy thus returned to a growth rate comparable to that of 2014. Its growth path seems moderate, but given the difficult economic climate in Europe in the last quarter, Switzerland stayed remarkably resilient, while Germany just barely avoided a recession in Q4, posting growth of 0%, well below the country's average.

Swiss economic performance (GDP in CHF million)



Sources: SECO, BBGI Group SA

The economic forecast of the Federal Government's Expert Group was revised downward, as the context remains rather uncertain thus far in 2019. The 1.5% GDP growth forecast was reduced to +1.1% due to the slowdown in global economic activity and the latter's expected impact on Swiss exports.

The manufacturing sector is the main driver of growth

Switzerland's real GDP reverted to positive growth in Q4 with a modest expansion rate of +0.2%. As domestic demand stayed relatively stable over the period, the increase in GDP was thus essentially caused by merchandise export growth and by the positive contribution of the manufacturing sector. While the latter had declined by -0.6% in the previous quarter, it recovered sharply in Q4, posting growth of +1.5%, thus contributing positively to GDP growth. The chemical and pharmaceutical segments performed particularly well. Other industrial sectors, such as watch-making and precision tools, as well as food, also posted higher revenues. Overall, the manufacturing sector benefited from improving global demand for Swiss products. This trend was highlighted by the sharp +5.6% increase in merchandise exports.

The consumption climate remained relatively glum with consumer confidence failing to show any real improvement. While private households did increase spending by +0.3%, which is significantly higher than in Q3 (+0.1%), this increase was mainly related to healthcare spending. A healthy job market and an unemployment rate at a 10-year low undoubtedly contributed to the positive trend in consumption, whose growth was nevertheless slightly below average.

The services sector produced uneven results in Q4. While value added further increased in healthcare (+0.9%) and business services (+0.4%), it decreased for the third consecutive quarter in trade (-0.6%), as the slight improvement seen in retail was not able to offset the decrease in wholesale. The financial sector also continued to trend downward (-0.8%). Hampered by a decline in services exports (-2.6%) and still sluggish final domestic demand (0.0%), the services sector overall continued to perform below its historic average.

Investment in the construction sector dipped slightly (-0.4%) due in particular to the decline in building activity. The decrease in investment in equipment was significantly steeper (-1.1%), mostly due to the volatile R&D component, although investment was limited in other categories as well. Weak domestic demand translated into a slight decrease in goods and services imports (-0.5%).

For FY2018, the preliminary GDP growth estimate indicates a real GDP growth rate of +2.5%. The manufacturing industry was the main driver of growth. The sector benefited from strong global demand for Swiss industrial goods. Most other segments also displayed positive trends, with one significant exception: for the first time since 2011, trade posted a decrease in value added. On the demand side, foreign trade

provided the main impetus for growth. In contrast, trends in domestic demand were less dynamic. Growth in private consumption in particular remained below average, hampered by weak improvement in real purchasing power. Similarly, investment in construction and equipment lost momentum compared to 2017.

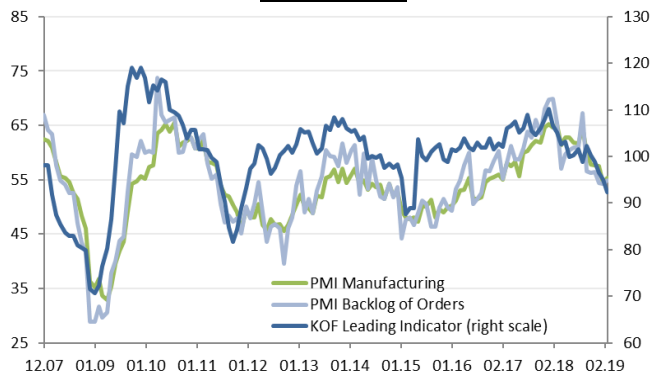
Improved outlook for Q2 2019

Our baseline scenario for the Swiss economy remains reasonably optimistic following the economic upturn – however modest – of Q4 2018. Global economic conditions were clearly less favourable over the past few months, in particular in the euro area and in Germany more specifically. Our economy thus relied on stronger foreign demand from other economic regions and on resilient domestic activity. The economic downturn in Germany continues to be a factor of uncertainty in Q1 2019 that could negatively impact our foreign trade over the next several months. However, we think that the outlook for Q2 2019 should improve and bolster demand for Swiss goods and services. Uncertainty remains high in the absence of a trade agreement between China and the US. Nevertheless, we believe that it is in the two parties' best interest to reach an agreement that would dispel this uncertainty and boost confidence, consumption, and investment. The stabilisation of the Swiss franc against the dollar close to parity and against the euro above 1.13 will also benefit Swiss foreign trade. Aside from exports, domestic demand will likely also continue to strengthen with slightly more robust growth in consumption in 2019. In this context, Swiss GDP is expected to grow by +1.5% in 2019.

Leading indicators remain uncertain

The KOF leading indicator has continued to fall in the first months of 2019 – rather sharply, as the index dropped -16% from its December 2017 high (110.1), which marked the highest level of optimism since 2010, to its February 2019 level of only 92.4. The manufacturing PMI posted a slight uptick in February (55.4) over January (54.3), though it remains well below the 64.6 it reached in August 2018. Growth in the Swiss industrial sector should stay robust, however, as order books seem relatively full, indicating strong results with regard to production. In spite of these declines, the indicators remain in the growth range and continue to indicate Swiss GDP growth in the order of 1.5%. The likely slowdown in economic activity and results implied by weaker leading indicators suggests that economic performance will be slacker than expected several months ago.

PMI – KOF



Sources: Bloomberg, BBGI Group S.A

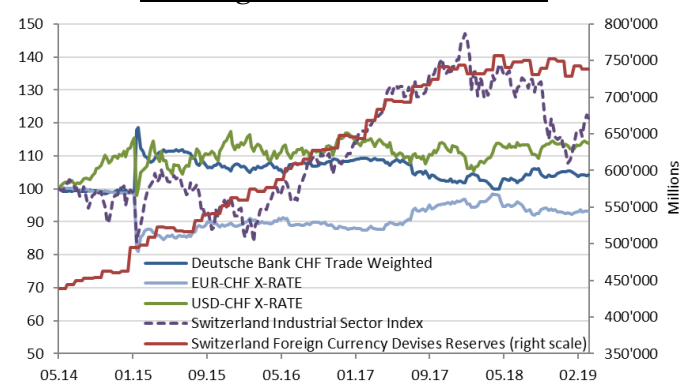
Consumption will likely also bolster GDP

Consumption strengthened slightly in Q4 but has yet to benefit from the unemployment rate, which has been at a historic low (2.4%) for several months, likely because nominal wages have increased only slightly. Disposable income did rise, however, as did household debt, which increased by +1.63% in 2018. Consumer confidence did not change much but we expect private consumption to continue on a positive trend, bolstering GDP.

Stabilisation of the Swiss franc favourable to foreign trade

The Swiss economy grew at a pace comparable to that of the Eurozone in Q4, although it expanded significantly faster over the year as a whole. The growth differential was thus not an adjustment factor for the exchange rate, and in the absence of pronounced trends on the interest rate front, the franc continued to stabilise. We still believe that further depreciation of the franc will depend on the relative economic performance and interest rate spread between the franc and the euro. We do not expect the SNB to raise rates as rapidly as the ECB, which now seems unlikely in 2019. In the meantime, the exchange rate will likely stabilise between 1.12 and 1.17 against the euro. With regard to the US dollar, the rate spread and growth differential remain positive factors for the dollar. While this state of affairs is not new, it could be sufficient to further bolster trends favourable to the dollar.

Exchange rate and SNB reserves

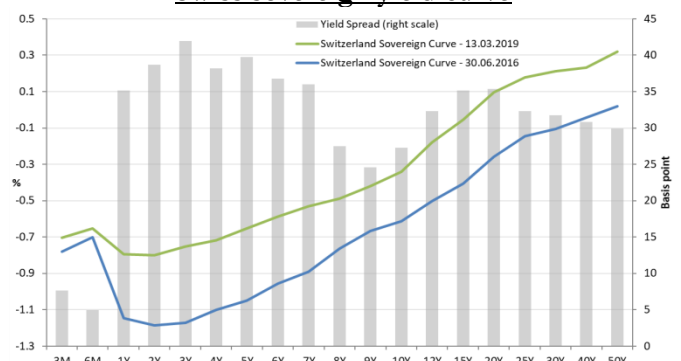


Sources: Bloomberg, BBGI Group S.A

Long-term interest rate trends once again atypical

While the normalisation of long-term interest rates in Switzerland started in the summer of 2016, the initial phase of adjustment rapidly stabilised at the 0% level for 10-year government rates before undergoing a significant further adjustment over the past five months. The surprise slowdown of growth in the Eurozone and in Switzerland along with the decline in inflation seen in our country from +1.2% in August to only +0.6% in February 2019 pushed 10-year government bond yields back into negative territory.

Swiss sovereign yield curve



Sources: Bloomberg, BBGI Group S.A

10-yr EUR-CHF interest rates



Sources: Bloomberg, BBGI Group S.A

The selloff in financial markets obviously benefited fixed income investments as volatility increased. What is more surprising so far this year is that interest rate markets have not yet reacted to the improvement in the stock market climate and investors' return into risky assets. Indeed, long-term interest rates are even slightly lower in February than they had been in December, which seems totally abnormal given the current context. Acceleration of the normalisation process will thus likely have to wait for an improvement in economic figures in Switzerland as well as in the euro area. In that respect, we expect Swiss long-term rates to climb back up over the next few months to their levels from the beginning of 2018. The performance of Swiss franc bond markets will thus likely be negative over the next several months.

New record for Swiss equities

At the end of the year, following the sharp correction in the Swiss equity market, we noted that, barring a marked slowdown in global growth in 2019, the outlook for Swiss equities was favourable, in particular with regard to SPI stocks and to small and mid caps, which had been particularly impacted by the recent increase in volatility. The beginning of 2019 will have been as extraordinary as the end of 2018 for equity markets overall and for the Swiss market in particular.

The correction of close to -10% of the SPI, reduced to -6.7% as of 31 December, rapidly gave way to a spectacular rally of +6.9% in January followed by a further increase of +4.28% in February and a promising start to the month of March, up +2.36% to date. Panic gave way surprisingly quickly to a certain euphoria, which nevertheless has no solid economic basis. The SPI index has thus exceeded the level it had reached prior to the sharp correction in December and is furthermore achieving new records in March, topping its January 2018 highs. Share prices have now risen +17% since the low of 27 December 2018.

We now recommend a less exposed and somewhat more defensive strategy following the uninterrupted growth in share prices over the past ten weeks.

Swiss equities



Sources: Bloomberg, BBGI Group S.A

New record for securitised real estate

Swiss securitised real estate paints a similar picture, with the SIX Real Estate Funds TR and the SXI Swiss Real Estate Shares TR (real estate companies) indices posting new records of 390 and 2783, respectively. Securitised real estate remains an excellent alternative to Swiss franc fixed income investments, although recent momentum will likely decelerate in the short term. Prices are likely to consolidate temporarily in these two market segments after the 10% increases posted since the beginning of the year.

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BBGI Group SA
Rue Sigismond Thalberg no 2
1201 Geneva – Switzerland
T: +41225959611 F: +41225959612
info@bbgi.ch - www.bbgi.ch