6 March 2020

Caution recommended as Swiss GDP threatened by Covid-19

Covid-19 will also affect Switzerland's GDP. As expected, the franc is in high demand in the short term. The growth outlook has deteriorated. Panic is finally impacting equities.

Key points

- +0.3% growth in Switzerland in Q4 raised hopes of a good start to 2020
- Growth was still driven by private and public consumption in Q4
- Following improvement in leading indicators, a major deterioration is now likely
- Emergence of an exogenous factor likely to significantly impact Switzerland's economy
- Covid-19 has changed the economic scenario and the stock market outlook for 2020
- Covid-19 strengthening the Swiss franc
- The SNB once again in the starting blocks?
- Covid-19 reversing the trend in rates
- Panic taking over in equity markets
- Precautionary principle takes priority

+0.3% growth in Switzerland in Q4 raised hopes of a good start to 2020

The State Secretariat for Economic Affairs (SECO) published our country's growth figures for Q4 2019, which point to slightly reduced activity in comparison with the previous quarter (+0.4%). Nonetheless, GDP growth of +0.3% is a little better than expected by forecasters, who expected growth to reach +0.2% at best.

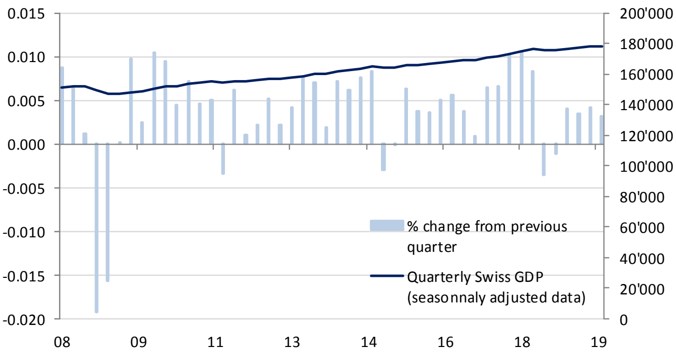
The initial estimate of real GDP for 2019 points to an annual growth rate of +0.9%. In unadjusted annual comparison, Switzerland's real GDP increased by +1.5% in 2019, significantly less than the +2.8% rate posted in 2018.

Ultimately, this is not so disappointing considering the particular context of 2019, which had a severe impact on our primary economic partner specifically. Germany ended the year with growth up a mere +0.3% yoy, among its worst performances since 2008, which has naturally affected our economy.

Fears of a recession and a collapse of interest rates following the growing uncertainties relating to economic growth prospects were ultimately excessive in 2019, since Switzerland's economy grew at a rate similar to that of the rest of the Eurozone (+0.9%).

Real adjusted GDP in Q4 in Switzerland thus increased from CHF 177.9 billion to 178.5 billion. On an annual basis, Switzerland's GDP has now exceeded 715 billion Swiss francs.

<u>Performance of Swiss economy (GDP in M CHF)</u>



Sources: SECO, BBGI Group SA

Global economic conditions in Q4 were not very favourable to Switzerland's economy, which saw its exports affected by a drop in demand. Domestic factors were a little more positive, as domestic demand helped drive growth at the end of the year.

Earlier in the year, we were forecasting that our economy's decent performance in Q4 would lead to a likely strengthening of activity in 2020. Indeed, we mentioned improved prospects due to the expected recovery of global growth resulting among other factors from the stimulus measures implemented by various central banks and governments in H2 2019, which were expected to have visible positive effects in Q1 2020 already. Our expectations can obviously not remain unaffected by the emergence of a significant new exogenous factor in the last few weeks, which will undoubtedly have a significant impact on international demand as well as on household behaviour.

The relatively positive Swiss and global economic scenario that prevailed at the beginning of the year cannot be maintained at this stage, and we have to consider the possible impact of the events in China in the last two months, which have unfortunately begun affecting other regions, including Switzerland.

Growth still driven by private and public consumption in Q4

Consumption has firmly established itself in the last few quarters as a major driver of economic growth in our country. Its contribution was once again significant this quarter. Indeed, domestic demand rose by +0.4% (+0.2% in Q3). In comparison with the previous quarter, government consumption remained robust, up by +0.5%. Domestic demand thus drove GDP growth overall during the quarter, and this trend is likely to continue in the beginning of the year. Most components of the services sector benefitted from this rise. Trade thus achieved strong growth (+1.2%), fuelled especially by motor vehicle sales. Similarly, after two negative quarters, the key segment of business services showed timid growth (+0.2%). Public administration (+0.5%) and the healthcare sector (+0.5%) also contributed positively. By contrast, the previous quarters' lacklustre trends persisted in the transport and communication sector (-0.3%) as well as in the financial sector (-0.4%), both of which were hampered among other things by their international business activities.

Altogether, exports of services experienced an average growth rate (+0.8%), while imports of services declined (-1.8%). The trend reversed with regards to investment in capital goods, heavily influenced by the uncertain international context. Investment in machinery and electric equipment dropped, while investment in capital goods increased by +2.4%. The construction sector increased slightly (+0.4%), as did added value in building and civil engineering (+0.9%). On the other hand, the Swiss manufacturing sector is once again slowing down. After four consecutive quarters of above-average growth, added value slowed in the manufacturing sector (0%). The unfavourable international situation continues to put a strain on industry segments that are sensitive to the economic situation, such as machines and metals, whose turnover dropped once again. Of course, the chemical and pharmaceutical industry shored up economic growth in Switzerland, but it was not able to maintain the momentum of previous quarters.

Switzerland's economy ended the year on a positive trend and could at that time anticipate improved prospects for 2020, driven by continued favourable domestic trends and stronger global growth. However, fears of a slowdown are now justified.

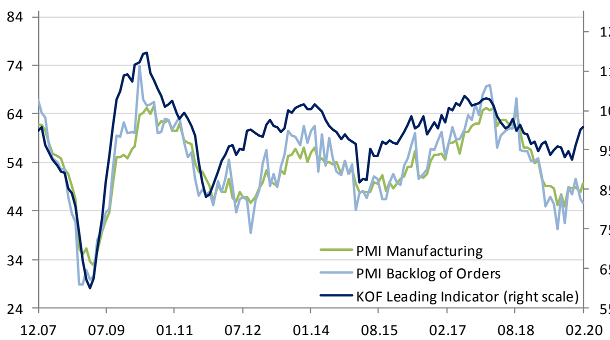
Following improvement in leading indicators, a major deterioration is now likely

The manufacturing PMI index for the month of February increased from 47.8 to 49.5. Although still shy of the threshold of 50, this indicator nevertheless posted its best result since the end of September 2019, pointing to an economic recovery for the beginning of the year in Switzerland. For more than a year, Switzerland's manufacturing PMI pointed to a decline in production, which never materialised, as production actually seemed to strengthen in September before dropping to only +1.3% yoy in Q4.

We now believe that risks in the Swiss manufacturing sector are once again significant due to the effects of Covid-19 on the global economy, which will not spare our country. The KOF's economic barometer offered a clearly optimistic sign in February when it climbed back over 100 for the first time since September 2018.

This improvement heralded better economic conditions for the beginning of 2020, but it will likely not withstand the ongoing changes in expectations as well as the gradual factoring in of the growing risks relating to the Covid-19 virus.

PMI – KOF



Sources: Bloomberg, BBGI Group SA

Retail sales began the year rather timidly with a -0.1% decline, maybe already due to the uncertainties that began to appear in January. Although leading indicators seemed to point to better prospects in January and February in a surprisingly serene atmosphere despite the situation in China, the growing awareness of the real importance of the new risks relating to Covid-19 in the last few weeks has now radically changed the situation and will have a major impact on everyone's expectations.

In this context, we expect significant changes in risk assessments, which will necessarily and quite quickly trigger visible adjustments in expectations with regard to leading indicators in the next few days.

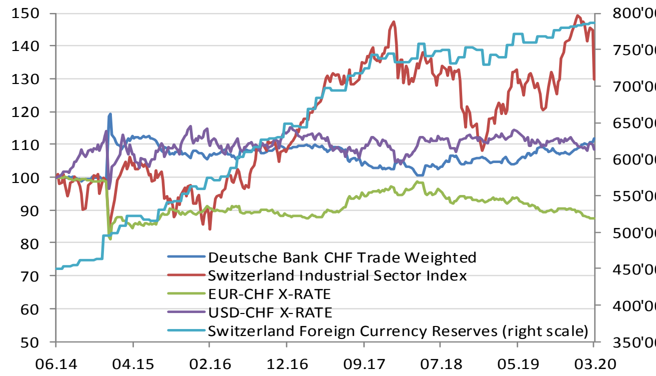
Covid-19 strengthening the Swiss franc

We expected a rather stable Q4 2019 for the Swiss franc and a start to the year marked by relative weakness, driven by higher levels of global economic activity and declining uncertainties. Indeed, the Swiss franc remained stable against the dollar in Q4 and until 21 February, fluctuating around an exchange rate of 0.98. The demand for Swiss francs, which was expected to contract given the more favourable global economic scenario, has actually increased in a matter of days with the growing risks relating to Covid-19. The decision by the US Fed to reduce interest rates by 50 basis points in prevision of new economic difficulties was enough for our currency to appreciate over seven days by almost +4%, significantly more than the increase observed against the euro (+2.4%) since the beginning of the year. Although the yield differential has decreased, we still believe that positive dollar rates as well as the clearly superior growth prospects in the US in comparison with other industrialised countries justify a higher demand for dollars and a rise of the US currency.

The SNB once again in the starting-blocks?

Recently, the SNB once again stated that it had sufficient leeway to lower its key rates if necessary. It has thus clearly and unsurprisingly decided to maintain the direction of its monetary policy to curb the appreciation of the franc against the euro. Recent developments in US key rates and long-term rates have reduced the yield differential on which the SNB based its strategy to weaken the franc and have potentially disrupted its policy. The rise of the franc is still moderate in the increasingly worrying context of the emergence of Covid-19 in Switzerland as well.

Exchange rates and SNB reserves



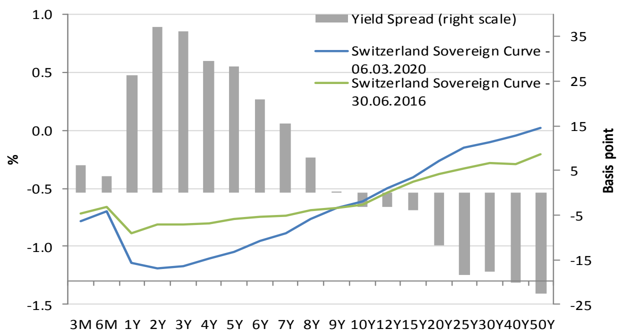
Sources: Bloomberg, BBGI Group SA

Covid-19 has clearly postponed the widening of yield spreads, which would have strengthened the appeal of the dollar and pushed the exchange rate above parity. With regards to the euro, the issue is different, especially since the yield spread between rates in euros and in Swiss francs is not that significant and the trend in the last few months does not point to similar developments. The yield spread that the SNB had hoped to create and maintain on three-month rates to weaken the franc is now increasingly under attack. The spread between ten-year German Bund and Confederation yields is down to only 0.18% in favour of euro rates. For the moment, the strength of the franc certainly remains acceptable to the SNB, which will undoubtedly wait a little longer before deciding whether to cut rates again.

Covid-19 reversing the trend in rates

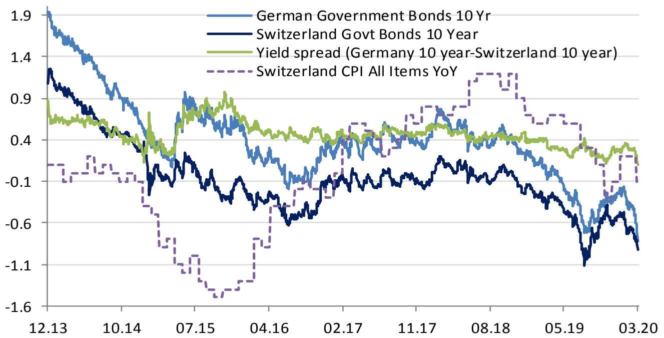
We noted in September the irrational nature of the collapse in ten-year yields from -0.5% to -1.12% in August, predicting a likely significant rebound as soon as risks of a recession were assessed rationally. The last few months of 2019 were thus marked by the gradual recovery of long-term rates from -1.12% to -0.4% at the beginning of November, which was expected to continue in the next few quarters. However, on 13 January 2020, the health crisis broke out in China, which completely upturned growth expectations in the country, raising new uncertainties about global growth.

Confederation's yield curve 30/6 – 6/3



Sources: Bloomberg, BBGI Group SA

Ten-year interest rates EUR-CHF



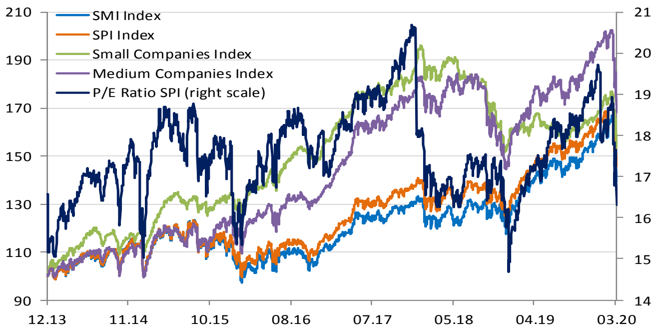
Sources: Bloomberg, BBGI Group SA

The Covid-19 epidemic in China was gradually factored into the risk modelling for 2020, including in the rate market in Swiss francs. Investor interest in our safe-haven currency undoubtedly pushed demand for governmental bonds more than the inclusion of risks of a recession in Switzerland, lowering the Confederation's nominal ten-year yields to -0.85%. If the pandemic ends up triggering a sharp global economic slowdown, let us also note that the impact on consumer prices may turn out to be more inflationary depending on changes in supply in particular. To date, inflation is once again negative year-on-year in Switzerland (-0.1%), and the real yield is thus at -0.5%.

Panic taking over in equity markets

At the beginning of the year, we recommended a more defensive strategy due especially to the already high valuation levels compared to the actual earnings growth outlook for 2020 and the extreme complacency that seemed to characterise the behaviour of investors in the face of a rational analysis of risks and opportunities. The rise in equity markets in the first six weeks had indeed further stretched already extremely high valuation and risk levels, which did not seem to worry the majority of participants in the market. Now we find that the emergence of the new factor of risk and uncertainty represented by Covid-19 has completely upturned perceptions and triggered a feeling of panic in stock markets. The -13.5% correction in the SMI since 19 February may tempt a few investors, but in the current context we believe that the precautionary principle must clearly prevail over the desire to take advantage of the corrections and to gamble on a rebound of indices. We do not believe the flow of bad news is likely to dry up in Europe. Hence, we recommend further caution in this particularly uncertain environment.

Swiss equities



Sources: Bloomberg, BBGI Group SA

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