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WEEKLY ANALYSIS

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SWISS INFLATION FALLS INTO LINE: A KEY FACTOR IN THE RISE OF FINANCIAL ASSETS

Good economic growth in Q1 (+0.5%). Inflation (+1.9%) in sharp decline and already below SNB target. End of rate hike cycle in sight. Opportunities in bond markets. Bullish revival for equities.

Key points

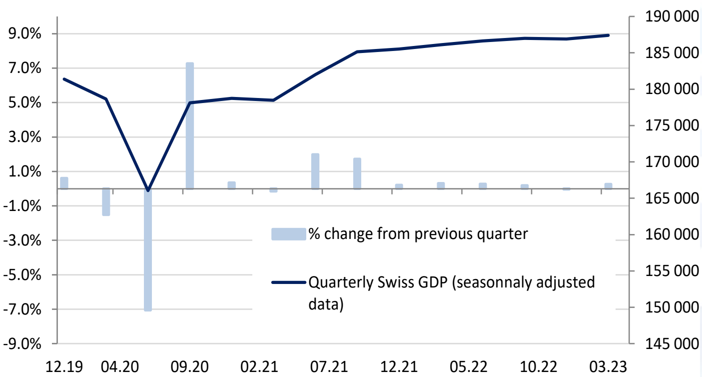
- Swiss economy surprises on the upside with +0.5% GDP growth in Q1
- Domestic demand and exports underpin GDP
- Leading indicators still very uncertain
- Inflation falls below SNB target
- Status quo now a possibility for the SNB
- Spread trends unfavorable to the franc
- New opportunities for the bond segment
- Renewed uptrend in equities

Swiss economy surprises on the upside with +0.5% GDP growth in Q1

The Swiss economy has got off to a rather surprising start in 2023, finally picking up fairly sharply after a last quarter of 2022 in which GDP stagnated (0%). The GDP for the 1st quarter of 2023 recently published by the *State Secretariat for Economic Affairs* showed growth of +0.5%, after adjustment for sporting events, which quite clearly exceeds the forecast of only +0.1% growth estimated by economists. The Swiss economy had been penalized by a fall in exports, and is already recovering in Q1 thanks to a return of exports at the start of the year, which contributed significantly to this good result. Final domestic demand, up +0.9%, underpinned GDP, thanks in particular to strong private consumption, up +0.6%. A slowdown in growth in 2023 was widely expected, but for the time being Switzerland still seems to be better able to withstand the effects of the more restrictive monetary policies pursued in most of its major economic partner countries. Taking into account the evolution of global inflation parameters, the development of restrictive monetary policies and the rise in financing costs in Switzerland and abroad, this GDP growth is still rather satisfactory. The Swiss economy is therefore still growing, and stands out from the more negative overall trend in Europe. In our country, the economy seems to be far more resilient to the turbulence of all kinds that began in 2022, and which has taken time to affect European economies more strongly. The European Union's GDP contraction of -0.1% in Q1 thus follows an identical drop at the end of 2022, suggesting that the EU has entered a recession over the past six months, in contrast to Switzerland's resilience.

The upturn at the start of the year in Switzerland was set against a backdrop of quarterly GDP growth sequences close to zero, but still insufficient to maintain annual growth close to the historical average. However, this performance exceeded economists' expectations. As far as we are concerned, our forecasts for annual Swiss GDP growth were +0.7% in 2023 at the start of the year, and the results of this 1st quarter confirm our estimates, which remain unchanged for the time being. We will look below at the main components influencing GDP growth in recent months, and at the detailed outlook for the coming quarters to 2023. We believe that, while the outlook for the year will continue to be affected by a still uncertain international economic environment, a more favourable environment in terms of inflation, interest rates and monetary policies should strengthen the likelihood of an economic recovery in the second half of the year.

Swiss economic performance (GDP) in million CHF



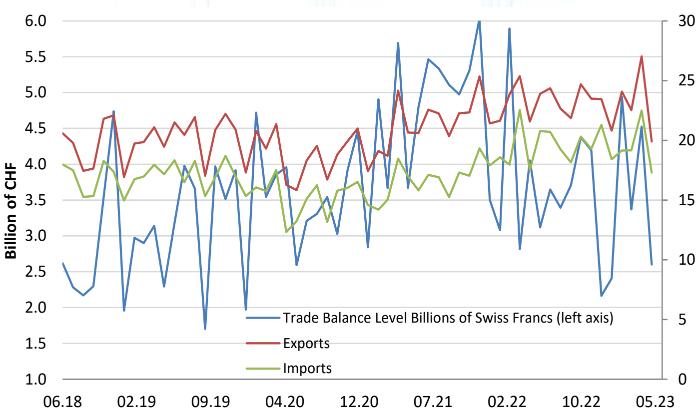
Sources: Bloomberg, BBGI Group SA

Domestic demand and exports underpin GDP

Despite the fact that interest rates in Switzerland are still significantly higher than the average for the last ten years, and that the SNB's more restrictive monetary policy is pushing up interest rates and financing costs, domestic demand has actually reacted rather well. Overall, it grew by +0.9%, well above its historical average. Domestic consumption has thus held up rather well against rising credit costs and the negative effects of inflation, continuing the solid trend of previous quarters. Domestic momentum is partly explained by a certain acceleration in capital goods investment, which jumped by +2.6% after an already solid +1.7% rise in the previous quarter. Research and development and vehicles, as well as other items, posted slight overall growth. Investment in construction (-0.1%) remained stable overall. After several quarters of weakness, value creation in construction rose again (+0.8%) on the back of higher sales in civil engineering and specialized construction. After three consecutive quarters of negative values, there was also a slight reversal in the trend for value creation in manufacturing (+0.3%). While value creation in the chemicals and pharmaceuticals industry, although high, is down (-0.6%), that of the other industrial branches is up.

Exports and sales rose, particularly in the machinery and vehicle sectors. vehicles. Overall, merchandise exports rose in a large majority of categories and countries (+4.0%). In April, however, exports declined again (-5.2%), while imports contracted less sharply (-3.3%). The Swiss trade balance still showed a surplus of CHF 2.6 billion.

Trade balance, Swiss imports and exports



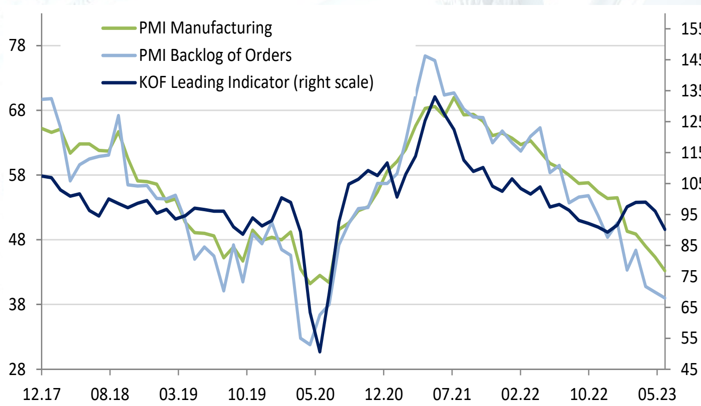
Sources: Bloomberg, BBGI Group SA

Household consumption remained relatively resilient, growing by +0.6%, again above average. Consumer spending on services, in particular, rose sharply, especially in the areas of mobility and tourism. Driven by the travel sector, which continues to reinvigorate, value creation recorded above-average growth in the transport and communications sector (+0.7%) and in the hotel and catering industry (+1%). Public consumption stagnated (0%). Consumer spending on goods was more moderate, resulting in a slight decline in value creation in retail trade (-0.4%), which had been at a high level. Thanks to wholesaling and motor vehicle sales, however, trade ended the quarter on a positive note (+2.1%). Most other tertiary sectors also recorded positive trends in the 1st quarter, including the important business services sector (+0.2%), healthcare (+0.7%) and recreation (+1.2%).

Leading indicators still very uncertain

Leading indicators had initially risen in the first few months of the year, but then tended to fall back in the 2nd quarter. The KOF economic barometer had recovered slightly to 99 in March, but sank again in May (90.2) to its lowest level in two years.

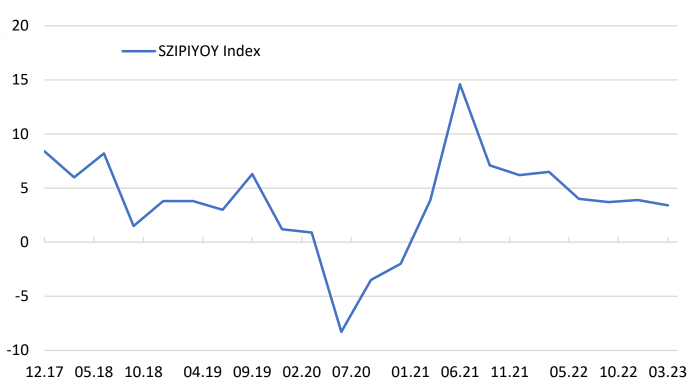
PMI and KOF indicators



Sources: Bloomberg, BBGI Group SA

Manufacturing PMI indicators are not yet improving, as suggested by the latest drop to 43.2 in May. The decline which began in August 2021 is continuing, and is approaching the milestone of two years of more or less regular falls. Although consumer confidence figures published by SECO suggested an improvement in sentiment in the 1st quarter, this has not really been confirmed since, and remains in negative territory (-30.2). The picture is similar in the CS survey, which shows a relapse in confidence and perception of the economic outlook (-32.2). Overall, the leading indicators remain highly uncertain and do not yet point to a clear economic recovery in our country, while retail sales slipped by -3.7% in April and industrial production is still growing, but slowed again from +4.1% in December to +2.9% in March.

Industrial production



Sources: Bloomberg, BBGI Group SA

Inflation falls below SNB target

The inflation figures published in Switzerland for May (+2.2%/year) come as a surprise to all observers, yet are in line with our forecast made a year ago of a probable return to a reasonable level of inflation in our country by 2023. Indeed, back in June 2022, we were already suggesting that a new inflation regime would be in place by the 2nd half of 2022, which would be significantly lower than the one that had prevailed over the first six months. At the time, we suggested that price rises could be limited to +2.2%/year as early as June 2023, if our expectations of an average decline of around +0.2%/month were maintained for long enough. While the publication of an unchanged CPI for May (0%) came as an excellent surprise to many people, this result confirms our analysis and augurs well for the months ahead. The consumer price index excluding energy and food even fell below the SNB's target of +2%. The SNB is due to meet on June 22 to decide on a further probable increase in key rates of 0.25%, according to consensus estimates. However, if inflation were to fall more rapidly than the central bank had expected, it might already decide to take a pause in its policy in order to assess whether further tightening is required before its next meeting in September. Swiss inflation should continue its downward trend in the second half of the year, reducing the risk of interest rate pressures. Nevertheless, the benchmark rental rate for lease contracts, which had remained unchanged at 1.25%, was finally adjusted by 0.25% for the first time in 15 years, and now stands at 1.5%. Officially, a 0.25% increase in the reference rate allows lessors to adjust rents by +3%. This adjustment will not affect all rents, but could logically have a long-term effect on inflation through higher rents, particularly if the rise in the reference rate continues in the next publications on September 1 and December 1. The evolution of the Swiss franc against the euro and the dollar has had no notable specific impact over the past two rather stable months, with the franc appreciating by +1.4% against the US dollar and +1.6% against the euro. The currency factor has thus not made a major contribution to containing price trends in our country in recent months. In terms of import and producer prices, the situation turned out to be more favourable more quickly, since the June 2022 peak of +6.9%, these have in fact slipped further in recent months, falling to just +1% at the end of April, and thus no longer represent the same threat to companies.

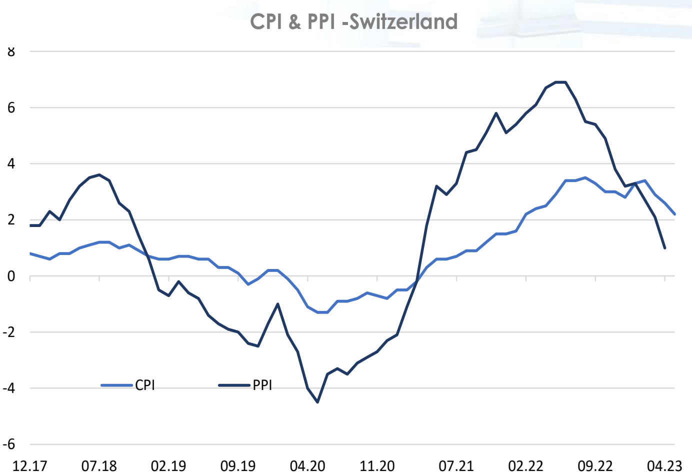
In our view, this trend should help companies to control their costs and margins. The stabilization of producer prices means that we can also project a more positive outlook for consumer prices. Swiss inflation is showing a downward trend well ahead of that of the eurozone and the United States. We believe that the expected global economic slowdown will ease price pressures as the effects of falling agricultural commodity prices in particular begin to be passed on to consumer prices, contributing to a further, more marked reduction in inflation in Switzerland in a national context marked by wage stability.

Status quo now a possibility for the SNB

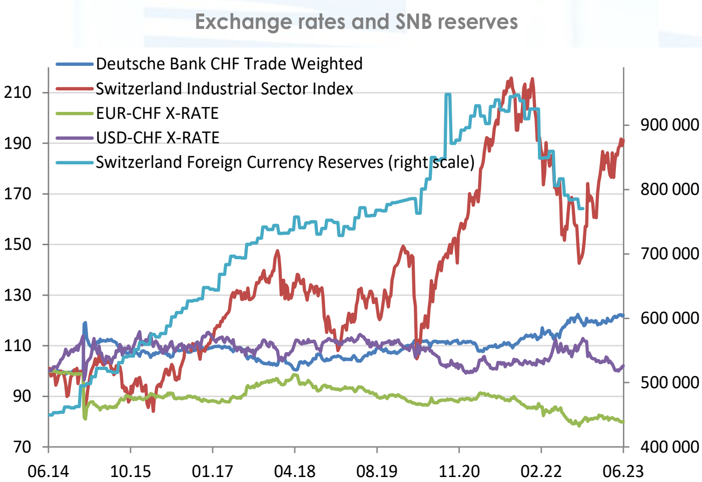
SNB President Thomas Jordan recently declared that the SNB's battle to control inflation was not over, and that we must remain vigilant until inflation truly and sustainably stabilizes below +2%. According to his comments, further rate hikes should not yet be ruled out, given that the overall environment for inflation remained too high and that price rises were still too widely visible and spread across the various sectors of the economy. After raising its key rates by 225 basis points over the past year, the SNB is likely to adjust interest rates once again on June 22, despite what we believe is an increasingly reassuring scenario for price trends in our country. The status quo could already be envisaged by the SNB, but it is likely that a final increase of 0.25% will be decided before a pause that could last until September. The SNB's inflation target of +2.2% for 2023 has in fact already been reached, so the SNB could pause for a moment while suggesting that further increases are still possible, pending confirmation of the current trend over the coming months.

Spread trends unfavorable to the franc

Switzerland's monetary policy is therefore nearing the end of its cycle, which is not the case in most other countries. In our view, policy rate differentials will not be favorable to the franc in an international context where tensions are tending to ease. To date, the yield differential between the 10-year Swiss government bond and the German Bund is 95bps, virtually its highest level since 2012. This observation is similar at the various points of the relative yield curve.



Sources: Bloomberg, BBGI Group SA



Sources: Bloomberg, BBGI Group SA

It should also be noted that, compared with the situation in 2015, the current level is higher than that which saw the euro rise from 0.97 to 1.20. The evolution of nominal yield spreads with US Treasury rates had reached their nadir in November 2022 at almost 300 bps and have gradually narrowed to 225 bps today. However, they remain sufficiently attractive to encourage a rise in Swiss investors' interest in US assets, which could support a rise in the exchange rate, especially if the decline in US inflation accelerates.

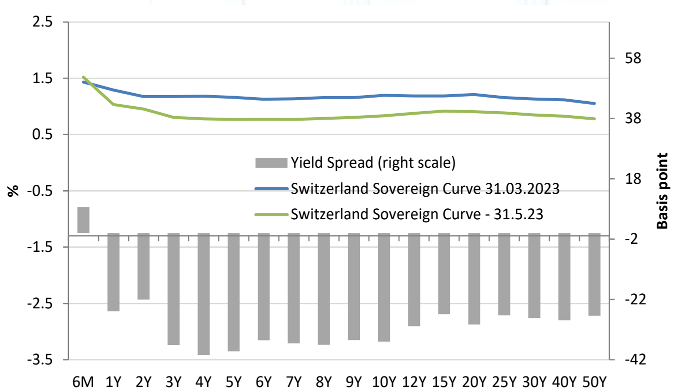
New opportunities for the Swiss bond segment

The decline in inflation in our country has largely contributed to the favorable trend in interest rates, which are now lower (0.96%) on the long end (10-year) of the yield curve than they were (1.6%) in June 2022, just after the SNB began implementing its monetary tightening cycle. Ten-year Swiss government yields fell by 0.6% in 2023 as inflation fell, implying an inverted yield curve of over 70 bps exclusively due to short-term rates (1.7% six months, 1.2% twelve months) linked to the SNB's high key rates. We had already announced that the sharp rise in the Swiss yield curve at the end of the year seemed premature in view of the Swiss economic situation and the prospect of reduced inflationary pressures in 2023. At the time, we saw these yield levels as opportunities for Swiss investors, who had been deprived of them since 2014 if inflation remained on a downward trend. A continuation of the downward trend in inflation and the approaching end of the cycle of monetary restraint will be conducive to an easing of the yield curve, underpinning attractive new prospects in the corporate investment grade segment.

Renewed uptrend in Swiss equities

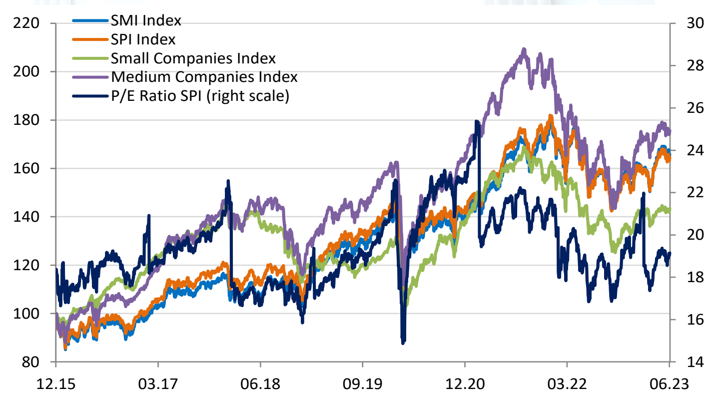
The uncertainties of March and the shock of the forced takeover of Credit Suisse by UBS, which had had damaging effects on the Swiss equity market, were fairly quickly wiped out by the favourable trend in interest rates, which enabled stock market indices to rise in April. After fears of a revival in inflation and key interest rates, the situation at the end of the 1st half of the year seems much calmer with regard to these two main factors. Declining inflation, prospects for the end of the interest-rate hike cycle, a possible weakening of the Swiss franc and resilient economic growth all appear to be sufficient factors to support a renewed uptrend in Swiss equities over the coming months. The SMI can now rely on these factors and its 100- and 200-day averages to get back on track. On a fundamental level, the prospect of a rising euro/CHF and USD/CHF exchange rate should boost Swiss companies' financial results in 2023, providing another positive factor to support their share prices. While twelve-month expectations for the SMI as a whole are -8% and +14% for 2024 (-4% and +13% respectively for the SPI), we believe that Swiss listed companies will be able to maintain their margins and deliver better-than-expected results. In terms of valuation, Swiss indices are in the relatively expensive group of markets based on price/earnings ratios for the year 2024. With a PE of 17.4x, the SMI is barely below the S&P500 (19.3x) and significantly above the CAC40 (12.5x), the Dax (11.3x) or the FTSE (10.5x). However, the Swiss market is still expected to perform positively over the coming months, especially secondary stocks (mid-caps and smaller), whose performance is likely to outperform blue chips.

Confederation rate curve



Sources: Bloomberg, BBGI Group SA

Swiss equity indices



Sources: Bloomberg, BBGI Group SA

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