Weekly Analysis

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MORE FAVORABLE OUTLOOK AFTER ONE LAST BNS RATE HIKE IN 2023

GDP growth slowed. Inflation stabilizes below 2%. End of key rate hike cycle imminent. Potential weakness of the Swiss franc. Stabilization of yields. Bullish recovery for equities.

Key points

- Swiss economy slows sharply in Q2, with seasonally adjusted real GDP stagnating
- Private consumption and service exports on the rise
- Leading indicators still not very encouraging
- Inflation stabilizes below the SNB's +2% target
- SNB policy more restrictive than it seems
- Yield differentials unfavorable to the franc
- Stabilizing rates and low capital gains potential
- Renewed uptrend in equities

Swiss economy slows sharply in Q2, with seasonally adjusted real GDP stagnating

The Swiss economy got off to a rather surprising start in 2023, finally recovering quite markedly after a last quarter of 2022 in which GDP stagnated (0%). GDP for the 1st quarter of 2023 initially showed growth of +0.5%, corrected to just +0.3% later, after adjustment for sporting events, which nevertheless exceeded economists' forecast of very slight growth of +0.1% at the start of the year.

After a rather surprising start to the year, Switzerland's Q2 GDP slowed sharply, posting no growth over three months to the end of June. On a year-on-year basis, the Swiss economy remained positive, but declined to a moderate +0.5%. The Swiss economy thus turned out to be significantly weaker than expected, with limited overall support from the services sector, and most other components making a rather negative contribution.

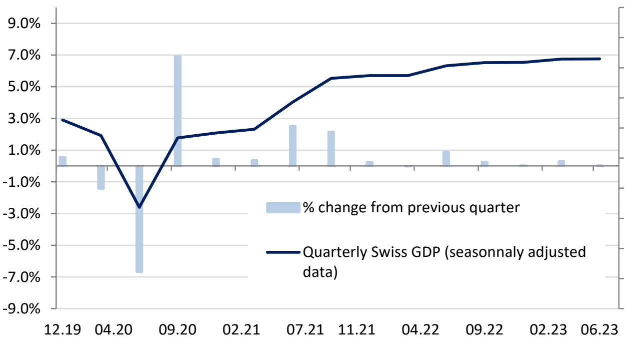
Value creation in industry was significantly reduced, while activity in services recorded above-average growth. The favorable start to the year in industry was largely reversed in Q2, with a -2.9% fall in activity. The chemical-pharmaceutical sector was also down by -2.3%.

Rising final domestic demand underpinned GDP, thanks in particular to strong private consumption, up +0.4%. A slowdown in growth in 2023 was widely expected, and is now materializing as some of Switzerland's major European economic partners are experiencing persistent difficulties that are also affecting Swiss momentum. The Swiss economy weakened slightly more than the eurozone as a whole in Q2 (+0.1%) after revision of initial data, and performed identically to the German economy (+0%) over the period under review.

The quarterly evolution of our GDP is in line with quarterly sequences of gross domestic product development still close to zero, and therefore still insufficient to maintain annual growth close to the historical average. The outlook for the coming months will continue to be affected by a persistently uncertain international economic environment, although the risks associated with inflation and monetary policy are diminishing.

At the start of the year and at the end of Q2, our forecasts for annual Swiss GDP growth were +0.7% in 2023, but the results of Q2 call into question this expected performance for the year. The current quarter and the following one should be slightly positive (+0.2%), which may not be enough to enable GDP growth of around +0.7% for 2023 as a whole.

Swiss economic performance (GDP) in million CHF



Source: Bloomberg, BBGI Group SA

Private consumption and service exports on the rise

Household consumption proved relatively resilient despite a less favorable interest rate environment than in previous years. The SNB's monetary policy has increased pressure on interest rates in recent months, with significant effects on the cost of financing for households and businesses. The impact on rents is still limited, but could increase at the end of the year.

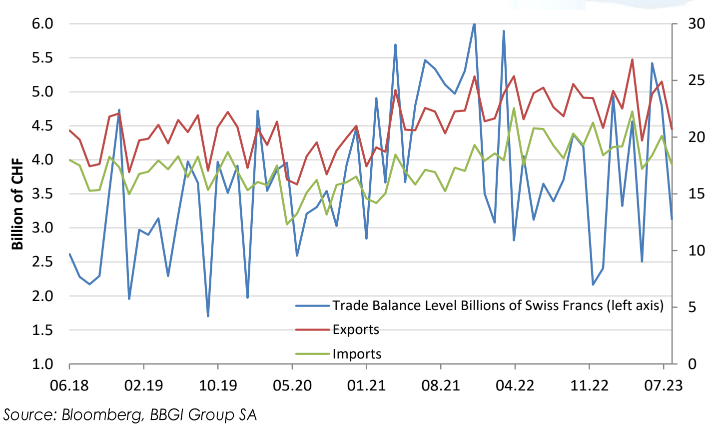
Against this backdrop, the +0.4% rise in private consumption was satisfactory, although partly underpinned by higher spending on housing and services, particularly in the health sector. The increase in the number of tourists led to a very significant rise in value added in the hotel and catering sector (+5.2%).

This trend is likely to continue in Q3, thanks to a particularly sunny summer and an increase in foreign tourist numbers. Most other service sectors also recorded increases in Q2. Value creation climbed in health and social services (+0.8%), business services (+0.7%) and recreational activities (+0.7%). In contrast, value creation stagnated in the transport and communications sector; while passenger transport increased, freight transport declined. In financial services (+0.0%), value creation stabilized after several consecutive quarters of decline. In particular, fee and commission business showed signs of recovery in the wake of increased exports of financial services.

Retail trade, meanwhile, posted a slight decline (-0.4%). Thanks to the wholesale and automotive trades, trade nevertheless ended the quarter with an above-average result (+2.1%). All in all, foreign trade made a positive contribution to GDP growth in Q2. The fall in goods exports was offset by an increase in services exports (+2.6%) and a decline in imports of goods and services (-3.7%). The construction sector suffered a sharp downturn, with a decline of -0.7% due to lower sales in all building and civil engineering segments.

Construction investment was also negatively impacted by higher financing costs, contracting by -0.8%. Investment in capital goods also saw an overall decline of -3.7%, partly due to weakness in the IT sector. The manufacturing industry (-2.9%) also suffered from the effects of the strong franc, in a negative international environment for economically sensitive branches such as the machinery industry. As a result, exports of goods also fell (-1.2%).

Trade balance, Swiss imports and exports

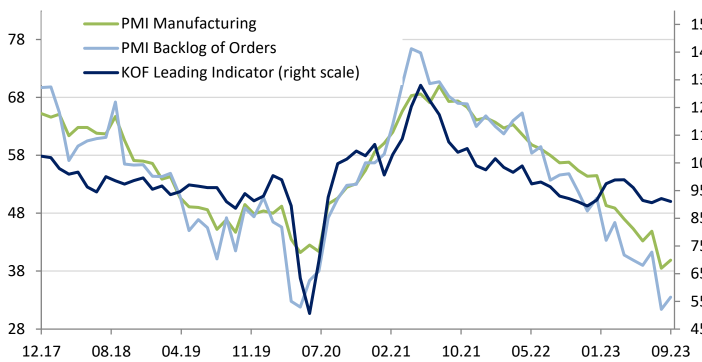


Source: Bloomberg, BBGI Group SA

Leading indicators still not very encouraging

Leading indicators had initially risen in the first few months of the year, but then tended to fall back in the 2nd quarter and during the summer. The KOF economic barometer had recovered somewhat, rising to 99 in March, but then deteriorated again and remained very uninspiring at the end of August, with a value of 91.1, practically the lowest since July 2020.

PMI and KOF indicators

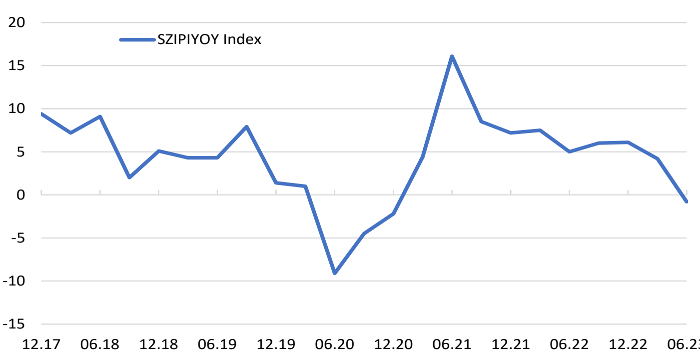


Sources: Bloomberg, BBGI Group SA

The worsening economic conditions in Switzerland seem to be affecting the industrial sector even more strongly, as illustrated by the manufacturing PMI indicator, which fell further over the summer to 39.9 at the end of August, its lowest level ever and well below its previous low point of April 2020 at 41.2. The leading indicator for the manufacturing sector has now been in decline since July 2021, as the strength of the Swiss franc adds further pressure and penalizes the competitiveness of Swiss industrial companies. The new orders indicator is also rather worrying, suggesting little likelihood of improvement over the coming months.

SECO's consumer confidence survey, meanwhile, suggests an improvement in household sentiment, but this is far from positive and remains very negative (-29.7) for Q3. The picture is similar in the CS survey, which shows a relapse in confidence and perception of the economic outlook (-38.6). Overall, leading indicators remain highly uncertain and do not yet point to a clear economic recovery in our country, while retail sales slipped by -2.2% in July year-on-year and industrial production was again negative in Q2 (-0.8%) year-on-year.

Industrial production



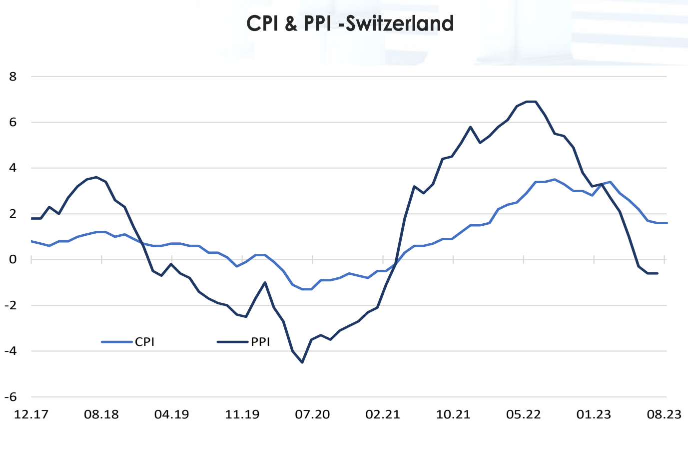
Sources: Bloomberg, BBGI Group SA

Inflation stabilizes below the SNB's +2% target

Swiss inflation figures for August confirm the trend towards a clear improvement in price trends in our country. With a moderate rise of just +0.2%, the Swiss CPI index is in line with our forecast made in July 2022 of a probable return to a reasonable level of inflation in our country by summer 2023. In fact, at that time, we suggested 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 during the first six months. We also suggested that price rises could be limited to +2.2%/year by June 2023, if our expectations of an average decline of around +0.2%/month were maintained for long enough.

The inflation trend in Switzerland came as a pleasant surprise to many, but this new, slower momentum only confirms our analysis and augurs well for the months ahead. The CPI annualized rate is barely +1.6% and is already below the SNB's target. The consumer price index excluding energy and food is also below the SNB's target of +2%, which is an excellent result for our central bank, which can pride itself on having controlled price rises in our country. These developments could motivate the SNB to hold back its next rate hike on September 21, but it may decide on one last turn of the screw before taking a break from its cycle of key rate hikes. We expect Swiss inflation to remain subdued towards the end 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% rise 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 euro's -2% fall against the Swiss franc and the dollar's stability had no impact on prices during the quarter. The currency factor has therefore not made a major contribution to containing price trends in our country in recent months. In terms of import and producer prices, the situation quickly turned out to be favorable, as since the June 2022 peak of +6.9%, the PIP index has steadily declined into negative territory, indicating that prices have already been falling for three months.



Sources: Bloomberg, BBGI Group SA

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 begin to be passed on to consumer prices. This will contribute to a further decline in inflation in Switzerland, in a national context marked by wage stability and a very slight rise in unemployment from 1.9% to 2%.

SNB policy more restrictive than it seems

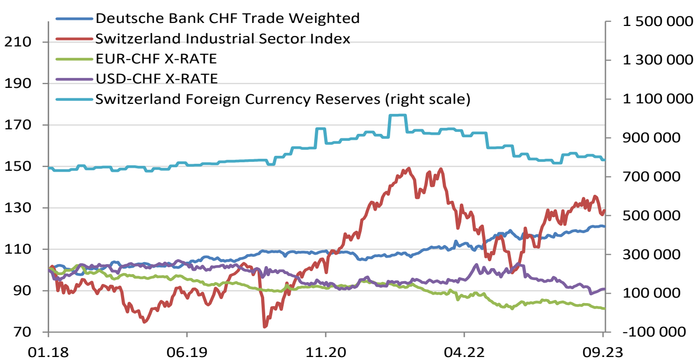
The SNB still seems concerned about the level of inflation, despite the sharp decline in price indices which pushed the annual CPI (+1.6%) below its target (+2%). It is still considering further hikes to ensure that the price level remains below 2%. However, wage increases over the next twelve months should remain contained at around 2%, according to the latest KOF estimates. The recent rise in the value of the Swiss franc also continues to keep a lid on imported prices, which are down -0.6% year-on-year. The SNB is maintaining its bullish bias, even though it now appears much more pessimistic about future inflation than Swiss economists as a whole. With a forecast of +2.2% for 2024, this is well above the consensus estimate of just +1.5%.

With key rates (1.75%) above July's published inflation figure of +1.6%, the SNB could already consider its action to have been a success, without envisaging any further hikes in the immediate future. Indeed, consensus expects a further rise of 0.25% to 2% in September. All the more so since, in a year of monetary tightening, the SNB has also been very active in reducing the size of its balance sheet. Foreign exchange reserves, which had reached CHF 946 bn in January 2022, have been drastically reduced by -26% in eighteen months, to CHF 694 bn. Total sight deposits also fell by -40%, from 754 to 459 billion. The SNB's monetary policy is more restrictive than it appears, also in comparison with that of the Federal Reserve, which reduced the size of its balance sheet by only -8%. The resilience of the Swiss economy to date has been remarkable, but the plummeting manufacturing PMI suggests a return to difficulties that should not leave the SNB indifferent. We therefore believe that key rates should be cut well before the 4th quarter of 2024, as currently envisaged.

Yield differentials unfavorable to the franc

We believe that the SNB could now reduce its purchases of Swiss francs and let interest rate differentials act as the main vector for currency flows. Against this backdrop, the yield spread between the 10-year Swiss government bond and the German Bund of 95pdb is virtually at its highest level since 2012. This observation is similar at the various points of the relative yield curve. The evolution of nominal yield spreads with those of the US Treasury had already reached a 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 US inflation continues to fall.

Exchange rates and SNB reserves



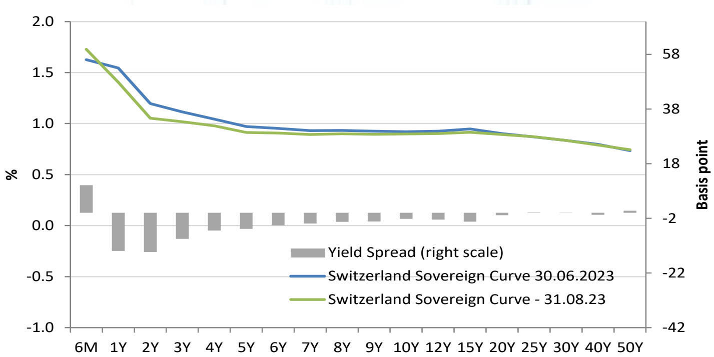
Sources: Bloomberg, BBGI Group SA

Stabilizing rates and low capital gains potential

The Swiss government's ten-year yield has been stabilizing at around 1% for several months now, significantly below the 1.6% rate in June 2022 at the peak of annual inflation. The decline in inflation has thus allowed yields to fall and stabilize. Ten-year Swiss government yields fell by 0.6% in 2023 as inflation declined, 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 a sharp rise in the Swiss yield curve at the end of 2022 seemed premature in view of the Swiss economic situation and the prospect of a new, lower inflation regime. We saw yield curves as presenting opportunities for returns and capital gains for Swiss investors who had been deprived of yield since 2014. We now expect yield curves to stabilize, with little likelihood of further capital gains.

Confederation rate curve



Sources: Bloomberg, BBGI Group SA

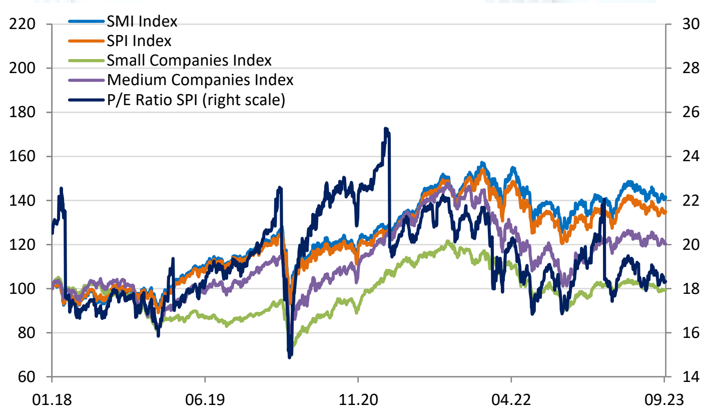
Renewed uptrend in equities

The Swiss equity market remained highly indecisive over the summer, penalized in particular by the strength of the Swiss franc and a still restrictive monetary policy. The macroeconomic data and statistics published did little to generate enthusiasm for Swiss equities, which were also affected by the economic slowdown in Switzerland and other European trading partners. Following a rise of almost +10% in stock market indices between mid-March and mid-May, consolidation materialized on both small & mid cap indices and those representing the largest market capitalizations, against a backdrop of growing uncertainty for the manufacturing sector and for Swiss exports.

The rise in the value of the Swiss franc has also affected the competitiveness of some exported products and services, but it is also contributing to the decline in earnings estimates expressed in Swiss francs. We believe that the prospect of declining inflation, the end of the interest-rate hike cycle and a weaker Swiss franc should be factors supporting a resumption of the uptrend in Swiss equities.

Earnings expectations for 2024 for the SMI are +13% and +12.8% respectively for the SPI, and we believe that companies will be able to maintain their margins and deliver better-than-expected results. In terms of valuation, price/earnings ratios for 2024 are 15.3x for the SMI and 15.9x for the SPI. The outlook for the Swiss market is positive for 2024, especially for secondary stocks (mid-caps and smaller), whose performance should outperform that of the blue chips.

Swiss equity indices



Sources: Bloomberg, BBGI Group SA

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