

Weekly Analysis

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MONETARY EASING AND A 12% RISE IN SWISS COMPANY PROFITS BY 2024

Economic slowdown in Q4. Inflation close to zero. Easing in Q2 2024. Historical yield differentials unfavourable to the franc. Bond yields below 1%. Sharp rise in corporate profits in 2024.

Key points



- Q3 better, but questionable
- Slowdown expected in Q4
- Fragile resilience in household consumption
- Leading indicators still uninspiring
- Further decline in foreign trade
- No inflation in Switzerland for nine months
- SNB monetary easing expected in Q2 2024
- Historical yield differentials unfavourable to the franc
- Bond yields falling below 1%
- Profit growth in excess of +10% in 2024

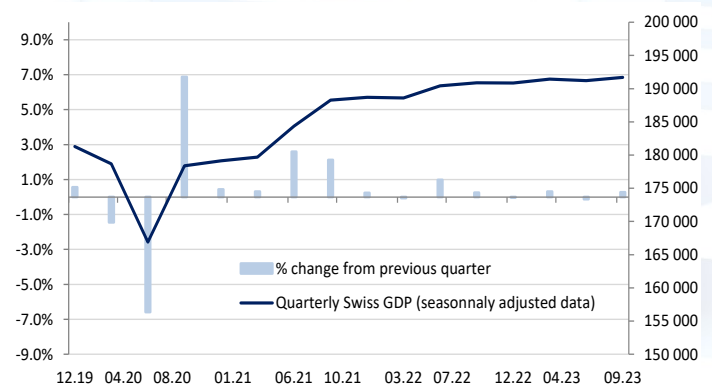
Q3 better but questionable after Q2 revision finally shows contraction in Swiss GDP

The GDP growth announced by SECO for the 3rd quarter of 2023 points to a rebound in economic activity of +0.3% in our country. This result remains below the historical average, and in our view is open to question following the revision of the growth rate for the 2nd quarter, which now indicates a contraction of -0.1% in the Swiss economy. For several quarters now, it has seemed increasingly clear that Switzerland's economic momentum has stalled, both because of the difficulties encountered by our main economic partners in Europe and because of the SNB's restrictive monetary policy. Rising interest rates and financing costs are now having a greater impact on households and businesses, which remain cautious about the outlook for 2024 and are translating their uncertainty and lack of confidence into more controlled spending. After the -0.1% fall in GDP at the end of June, the +0.3% growth in Q3 is a positive surprise for most economists, who were expecting only a slight increase of +0.1%. On a year-on-year basis, however, Swiss GDP growth was only 0.3%, below expectations (+0.5%).

In our view, the Swiss economy continues to be severely affected by a sluggish international environment and by the rise in the Swiss franc, which continues to affect the outlook for the manufacturing sector. In the absence of a clearer picture of future interest rates and inflation, Swiss economic agents remain cautious. As a result, value creation stagnated in industry, while the services sector remained more buoyant. The chemicals and pharmaceuticals industry, which is less exposed to international fluctuations, nevertheless advanced by 1.2%, thanks to positive sales trends and rising exports. Industrial sectors that are sensitive to the international economy, such as machinery and metals, made very little headway. Exports, which rose by a substantial +6.2%, benefited from transit trade, while imports grew by just +0.7%, owing to rather weak domestic demand.

In the services segment, it was above all the health (+0.7%) and trade (+1.1%) sectors that boosted domestic demand. Among the negative contributors were business services and the hotel and catering sector (-3.7%), which saw a marked slowdown in activity. Overall, services are struggling to drive final domestic demand, which therefore failed to grow (+0.0%) in what is also a very anaemic international environment. On the private consumption front, despite continuing mixed sentiment among households, there was still a very slight increase of 0.2%, which remains extremely weak. At the same time, public spending rose by an appreciable 0.5%, but still below its historical average.

Performance of the Swiss economy (GDP) in millions of CHF



Sources: Bloomberg, BBGI Group SA

Finally, investment in construction has not yet been greatly affected by the rise in interest rates, and has even managed to advance by +0.2%, while investment in capital goods has contracted by -1.1%.

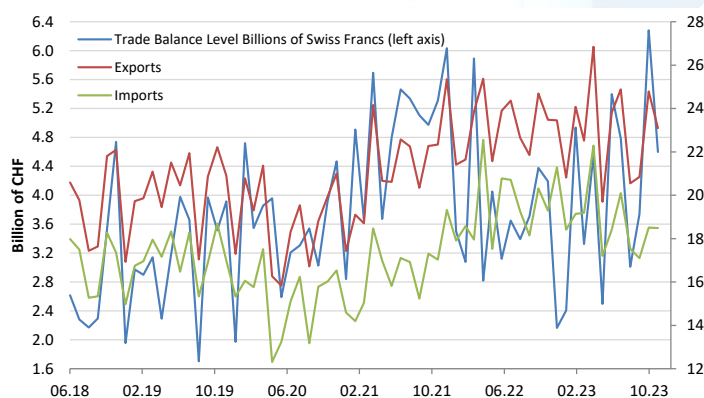
On the face of it, the Swiss economy appears to be in a position to withstand the weakness in the global economy, which has already led to a contraction in the eurozone. However, we believe that its momentum is being undermined by the strength of the Swiss franc and by the growing risks of a downturn in exports. Against this backdrop, which is not as positive as it might seem, the consensus forecasters still believe that GDP growth will be 0.8% in 2023, thanks in particular to a 0.2% rise still expected in the 4th quarter of the year.

Fragile resilience in household consumption

Household consumption held up well, with a very slight increase of 0.2%, lower than the previous quarter's +0.4%. It still seems relatively resilient despite a less favourable interest rate environment. 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 towards the end of the year. Against this backdrop, the rise in private consumption was satisfactory, although partly underpinned by the increase in spending on housing and services, particularly health care. Public spending once again underpinned GDP, with an increase of 0.5%, which remains substantial and welcome in the current environment. All in all, foreign trade made a positive contribution to GDP growth in the 3rd quarter. The level of merchandise exports does not seem to have been overly affected during the period by the rise in the Swiss franc. Indeed, the +6.2% rise in foreign sales was a welcome surprise, while imports of goods and services rose only slightly (+0.7%). The civil engineering sector contracted slightly (-0.3%), while construction advanced overall by +0.2%.

However, the foreign trade situation deteriorated significantly at the start of the 4th quarter. The value of Swiss exports fell by -7.2% in October, completely reversing the positive trend of the previous month (+3.6%). The decline in imports (-3.1%) in October follows on from the -1% fall already recorded in September. The Swiss economy is thus well on the way to a more difficult trend for the export sector, even if we can nonetheless be pleased to see a recovery in sales of Swiss watches of +5.1% over a year, thanks in particular to increased demand in China (+24.3%) and Hong Kong (+17.4%).

Trade balance, Swiss imports and exports

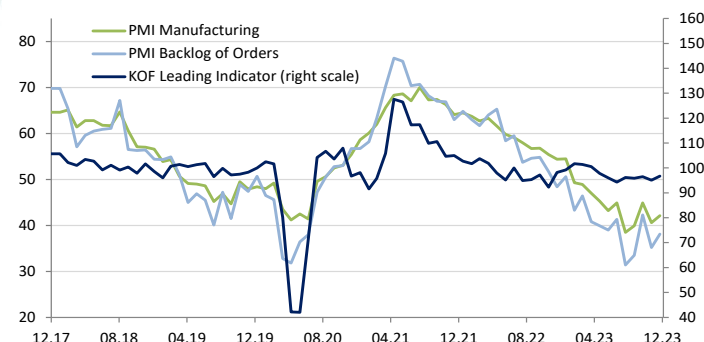


Sources: Bloomberg, BBGI Group SA

Leading indicators still uninspiring

The 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 recovered slightly, rising to 99 in March, but then deteriorated again and has since stabilised above 95. The timid recovery in November does not yet seem to be a sign of a trend reversal.

PMI and KOF indicators



Sources: Bloomberg, BBGI Group SA

As for the leading PMI indicators, the situation has also stabilised somewhat in recent months. The manufacturing PMI seems to have halted the long decline that began in July 2021, when it peaked at a high of 70. The fall during the summer to an all-time low of 38.5 reflected the already difficult economic conditions at the time, when the strength of the Swiss franc added further pressure on the competitiveness of Swiss manufacturing companies as international demand weakened. The new orders indicator is also rather worrying, suggesting little likelihood of improvement over the coming months.

After a period of stabilisation, the consumer confidence figures published by SECO once again suggest a very marked deterioration in household sentiment for the final quarter of the year. The fall in confidence is sharp and deep, with the indicator plunging from -27.1 to -40, suggesting a significant risk of a collapse in consumption. After having been fairly resilient, household demand looks set to weaken, with the CS/UBS survey also suggesting difficult economic conditions (-29.6).

Industrial production

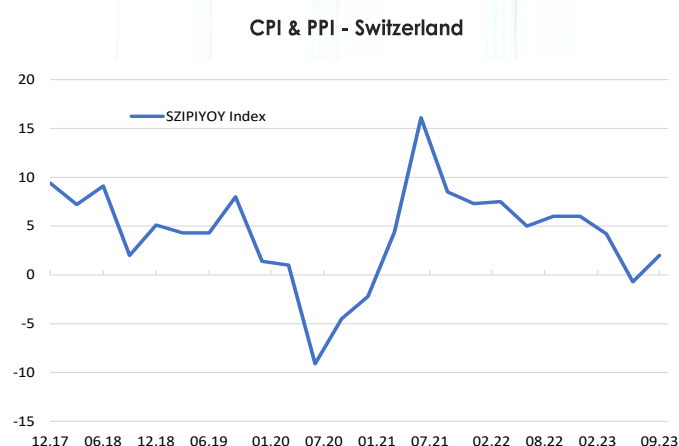


Sources: Bloomberg, BBGI Group SA

No inflation in Switzerland for nine months

The inflation figures published in Switzerland for November confirm the trend towards a clear improvement in price trends in our country. With a fall of -0.2%, the Swiss CPI index continues to confirm the trend announced back in July 2022 of the emergence of a new, much more moderate inflation regime, which would probably see a return to a reasonable level of inflation in our country by the summer of 2023. At the time, we were suggesting that a new inflation regime would be put in place from the 2nd half of 2022, which would be much lower than the one that had prevailed over the first six months. We suggested that price rises could be limited to +2.2%/year from June 2023 if our expectations of an average decline of around +0.2%/month were maintained for long enough. The inflation trend in Switzerland has come as a pleasant surprise to many, but this new, slower pace only confirms our analysis and augurs well for the months ahead. The CPI annual rate is barely +1.4%, which is already below the SNB's target. The consumer price index excluding energy and food (+1.4%) 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 the rise in prices in our country.

Although the monetary authorities are still cautious, regularly stressing that the rate hike cycle could continue with further increases, they can nonetheless see that average monthly inflation has been close to zero for nine months now. This should motivate the SNB to keep rates unchanged in December. We expect Swiss inflation to remain on this trend for a few more months, which could quickly translate into a fall in year-on-year inflation to well below +1%. The fall in the euro and the dollar against the Swiss franc has undoubtedly helped to reduce the risk of imported inflation. Import and producer prices are also now under control. Since peaking in June 2022 at +6.9%, the index has declined steadily, falling into negative territory in May. October's result of -0.9% is already the sixth decline in prices on record.



Sources: Bloomberg, BBGI Group SA

We believe that this trend should help companies to control their costs and margins. The stabilisation of producer prices means that we can also project a more positive outlook for consumer prices in the near future. Swiss inflation is showing a downward trend that is clearly superior to that of the eurozone and the United States. We believe that the expected global economic slowdown will ease price pressures as the effects of the fall in agricultural commodity prices, in particular, begin to

be passed on to consumer prices. This will help to bring inflation down further in Switzerland, against a backdrop of stable wages and unemployment at 2.1% in November.

SNB monetary easing expected in Q2 2024

Despite the very sharp decline in price indices, which saw the annual CPI fall from +3.5% in August 2022 to just +1.4% in November 2023, the SNB still seems concerned about the level of inflation. Although inflation is now well below its target of +2%, the SNB is persisting with its cautious stance and is not yet ruling out the idea of further hikes to ensure that the price level in our country remains under control. Against the backdrop of a fairly tight labour market and unemployment of just under 2%, 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 is also continuing to keep a lid on import prices, which are down by 0.9% year-on-year, favouring a fall in the CPI.

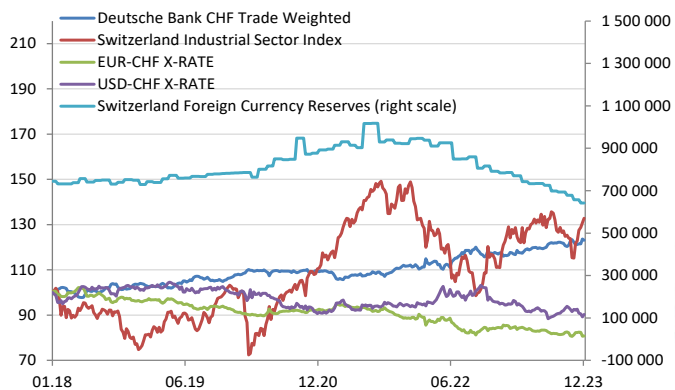
The SNB is therefore maintaining its restrictive bias, even though it now appears to be much more pessimistic about future inflation than Swiss economists as a whole. With a forecast lowered from +2.2% to +1.9% for 2024, inflation remains above the new consensus estimate of +1.6%. With key rates at 1.75%, above the published inflation figure for November of +1.4%, the SNB could already consider that its action has been crowned with success without envisaging any further hikes in the immediate future. All the more so since, in fifteen months 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 32% in twenty-two months to CHF 641 bn, through sales of between CHF 10 bn and CHF 20 bn per month. The SNB's monetary policy is thus more restrictive than it appears in absolute terms, but also in comparison with that of the Federal Reserve, which has only reduced the size of its balance sheet by -14% in the meantime.

In this restrictive environment, the resilience of the Swiss economy has been remarkable to date, but the free-falling 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 the SNB is currently planning, and anticipate a first cut of 25 bps at the end of the 2nd quarter of 2024.

Historical yield differentials unfavourable to the franc

In view of the marked deterioration in the economic situation and the quite spectacular improvement in inflation, 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 differential between 10-year Swiss government yields (0.75%) and German Bund yields (2.19%) has stabilised somewhat in recent weeks, but remains at a historically high level of 143 bps, its highest level since 2003. This observation is similar at the various points of the relative yield curve. Nominal spreads with US Treasuries have also stabilised at 340 bps, after hitting an all-time high of 380 bps at the end of October. Such spreads would weigh on the Swiss franc if the SNB did not take action.

Exchange rates and SNB reserves

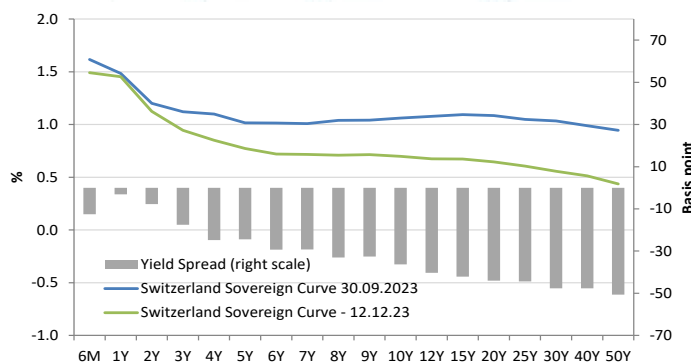


Sources: Bloomberg, BBGI Group SA

Bond yields falling below 1%

Ten-year Swiss government yields adjusted in November to the change in expectations for inflation and economic growth in Switzerland. After the already sharp decline from 1.6% to 1% seen in Q1, which had been followed by a long period of stabilisation around 1%, the nine-month sequence of price stability (CPI) finally brought market rates down to 0.75%. The yield differential between ten-year yields and short-term rates is now more than 100 bps, which is the sharpest inversion of the curve recorded in Switzerland for a long time. 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 regime of lower inflation. We felt that the yield curves presented opportunities for returns and capital gains for Swiss investors who had been deprived of returns since 2014. We now expect yield curves to stabilise, with little likelihood of further capital gains.

Confederation rate curve



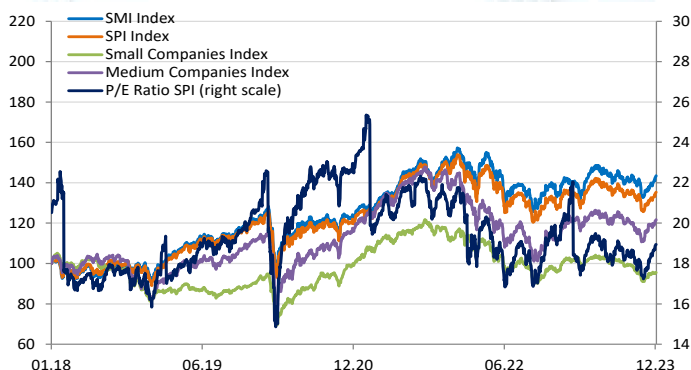
Sources: Bloomberg, BBGI Group SA

Profit growth in excess of +10% in 2024

After a few months of consolidation, a sharp decline in prices up to October and now more attractive valuations, we announced a probable resumption of the uptrend for the end of the current year, which began in November. The rise of almost 6% has already wiped out the decline in indices seen in October and should continue over the coming months. The Swiss equity market remained highly indecisive over the summer, penalised 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 in other European economic partner countries. As the rise in the Swiss franc affected the competitiveness of certain exported products and services, sales by Swiss exporting companies were often maintained at the expense of company margins. As a result, the strength of the franc weighed heavily on profit estimates expressed in Swiss francs.

The more favourable outlook for falling inflation and an end to the cycle of key rate rises will help to weaken the franc. The latter should support the resumption of November's uptrend. Overall earnings expectations for 2024 for the SMI are +12.5% and +12.4% respectively for the SPI. We believe that companies will be able to maintain their margins and deliver better-than-expected results. In terms of valuation, the price/earnings ratios for 2024 are 15.2x for the SMI and 15.7x for the SPI. The outlook for the Swiss market is positive for 2024, particularly for secondary stocks (mid caps and smaller companies), which should outperform the blue chips.

Swiss equity indices



Sources: Bloomberg, BBGI Group SA

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