WEEKLY ANALYSIS

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END OF SWISS YIELD CURVE INVERSION IN 2025

Temporary acceleration in GDP. Leading indicators still uncertain. Fall in exports. Inflation below 1%. Key rates at 0.75%. Limited franc weakness. Long-term interest rate target reached. Positive outlook for Swiss equities.

Key points

- Swiss GDP growth accelerates significantly
- Swiss exports plummet since April
- Leading indicators still too uncertain
- Inflation will temporarily fall below 1%.
- SNB to cut rates by a further 0.25% in September
- Don't bet on a weak franc
- The decline in long-term interest rates is coming to an end
- Positive outlook for Swiss equities

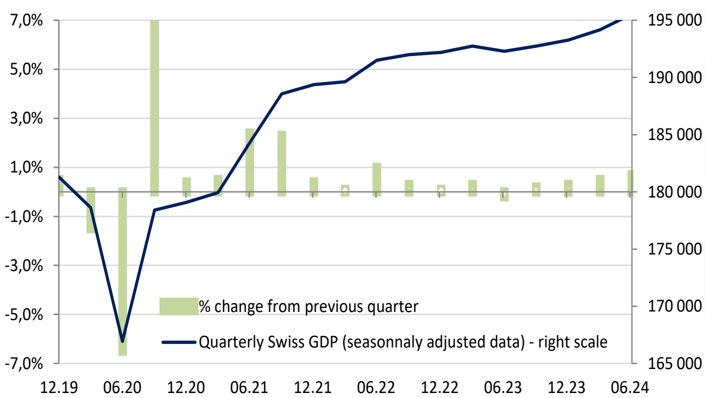
Swiss GDP growth accelerates significantly

Swiss GDP growth for the 2nd quarter has just been published, and this time it shows more than just a degree of resilience on the part of our national economy in an international and European context that is still very hesitant. The Swiss economy grew by a further +0.7% before the summer, and by +0.5% adjusted for sporting events in the 2nd quarter, bringing the year-on-year increase to +1.8%. This is the strongest Swiss quarterly growth since Q2 2022 (+1%), when annualized growth stood at +3.9%. The GDP growth announced by SECO was part of an accelerating trend, above the historical average. The Swiss economy was thus able to strengthen its pace of growth, while the manufacturing sector seemed to suffer a little less from the exchange rate, declining in the first six months of 2024 by around -7% against the dollar. The change in monetary policy decided by the SNB and implemented by a first rate cut in March 2024 helped to create the conditions for a weaker franc and to support the Swiss economic outlook.

It is particularly interesting to note that Switzerland's momentum was no longer affected to the same extent by declining global demand and the level of the exchange rate in the 2nd quarter. However, the manufacturing sector has not yet recovered, although the PMI indicator has been suggesting an improvement in the potential situation for some months now. At the same time, the trend reversal is spectacular for the services indicator, which rebounds from 44.7 to 52.9, offering a distinctly different and much more optimistic picture at the start of September.

An analysis of the situation at the end of June, based on data published by Seco, shows vigorous expansion in the chemical and pharmaceutical industries. Expansion in this segment was robust in Q2; the +8.4% rise was exceptional, and was largely underpinned by very dynamic exports. Value creation in the manufacturing segment proved rather surprising, with above-average growth of +2.6%. In the other branches of industry, value creation declined, reflecting difficult situations in Switzerland's European partner countries. Domestic demand proved relatively weak, with a notable -1.4% drop in investment in capital goods. Investment in construction remained subdued (+0.5%), while consumption rose only slightly. Private consumption grew by only +0.3%, a below average increase, while public consumption contributed only +0.2%.

Swiss GDP in million CHF (quarterly data)



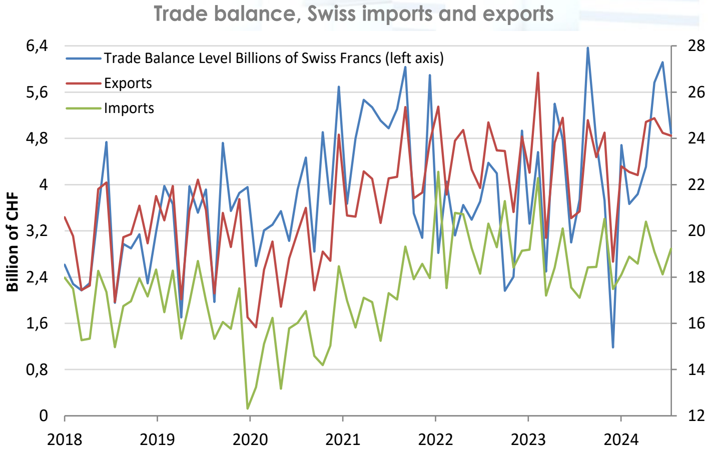
Sources: Bloomberg, BBGI Group SA

The stagnation of domestic demand is reflected in the sluggish growth of value creation in the service sector, characterized by great heterogeneity between industries. In the hotel and catering sector, value added increased thanks to a rise in the number of foreign and Swiss travelers (+2.7%). Value creation was also positive in health and social services (+1.1%), business services (+0.6%) and public administration (+0.3%). The transport and communications sector stagnated (0%). Finally, financial services (-0.2%), retail trade (-0.4%), and trade as a whole (-1.2%) recorded a moderate decline. Exports of goods as a whole enjoyed sustained growth (+6.9%), while exports of services rose slightly (+1.5%). All in all, foreign trade played a decisive role in supporting GDP growth in Q2, at a time when the weakness of the Swiss franc was undoubtedly providing Swiss products with some competitive edge and Swiss exporters with some room for man oeuvre. Unfortunately, this weakness was only temporary, and the reversal of the trend in April had a negative impact on the following months.

Swiss exports plummet since April

After a good April, with exports up +7.3%, the following three months were once again difficult for Swiss exporters, with three consecutive declines in sales. The end of April marked the lowest point for the CHF/USD exchange rate, with the franc declining by -9.2%. Despite the SNB's more flexible monetary policy since March, and a further cut in key rates in June, the Swiss franc has regained lost ground, particularly since the shock of the reversal of speculative carry trade positions on the yen in early August, which also had some impact on the franc. The return to CHF 0.84 to the dollar in the 3rd quarter is clearly not good news for Swiss exporters and the competitiveness of Swiss industry. The foreign trade situation is suffering as a result, and Swiss exports fell by -1.8% in July. The export sector is therefore struggling, as illustrated by international watch sales, which grew by +1.6% year-on-year in July, well below the average growth rate of close to +10% for 2022-2023. Imports, meanwhile, recorded no growth at all in July (0%). The balance of trade may well suffer from these trends, but at the end of June it still showed a positive result of $59.5 billion, significantly up on December 31, 2023 ($53.4).

Trade balance, Swiss imports and exports

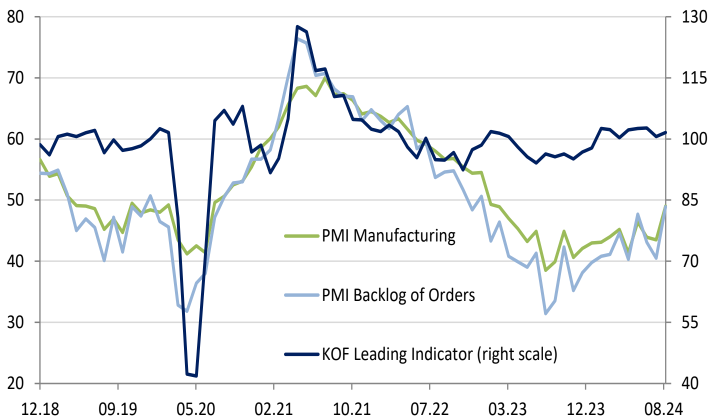


Sources: Bloomberg, BBGI Group SA

Leading indicators still too uncertain

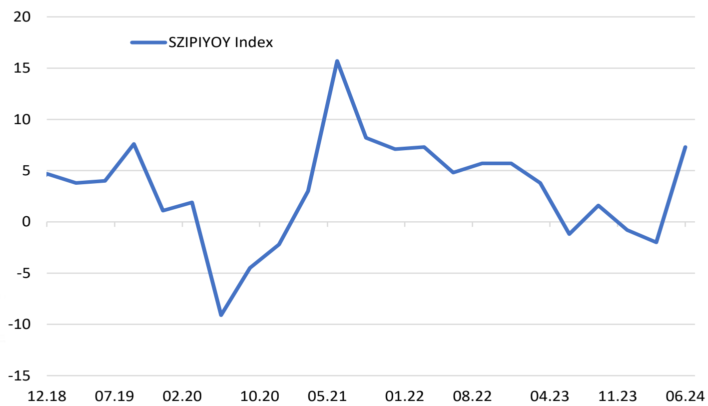
The latest leading indicators published for August remain particularly uncertain. Consumer confidence measured by the State Secretariat for Economic Affairs remained very low in August (-34.6) without showing any tangible signs of improvement. At the end of 2021, the measured level was still positive (3.5), before falling to -46 in 2022. The improvement in this indicator over the last two years still leaves it at an extremely worrying level. Despite falling inflation and the start of a more accommodating monetary policy, confidence remains at half-mast, jeopardizing the rather resilient level of household consumption again this past quarter.

PMI-KOF Indicators



Sources: Bloomberg, BBGI Group SA

Industrial production



Sources: Bloomberg, BBGI Group SA

The picture is slightly better, however, for the KOF outlook, whose index has risen to 101.6, corresponding to an overall stagnation since the start of the year with no real sign of recovery. Instead, we have to look to the PMI manufacturing index (49) and PMI services index (52.5) for further signs of a potential improvement in economic momentum. These two indicators have rebounded sharply from their lows, offering a brighter outlook. In the shorter term, retail sales also picked up in August, following the sharpest year-on-year fall in June (-2.6). On the industrial production front, the situation had in fact strengthened significantly in Q2, thanks to a rebound from -3.3% to +6.4% on an annual basis. Overall, the usual leading indicators remain uncertain, doubtless still affected by the still hesitant international economic environment and the further appreciation of the Swiss franc.

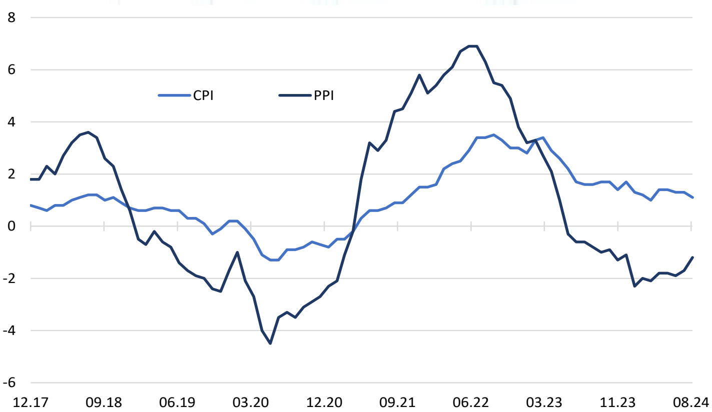
Inflation will temporarily fall below 1%.

The US Swiss inflation had reached its low point of 2024 in March, with an annual change of just +1%, before rebounding to +1.4% in April and May. At that point, the SNB decided that it was finally appropriate to reduce the cost of money by cutting its key rates by 0.25%, thus initiating a new cycle of policy normalization. We pointed out at the time that, in our view, the CPI rebound would not be sustainable, and that the downward trend in prices remained in place. The latest figure published for August proves the point, as the CPI is back close to its record low at just +1.1%/year, and stagnant on a monthly basis (0%). Since the start of the year, the CPI has recorded just four monthly increases, with the last three measures showing average inflation of just -0.066%. We believe that the overall index may end 2024 on a still low or even negative monthly pace, but that over the full year it will probably be difficult to bring the CPI level significantly below 1%.

As regards core inflation (excluding food and energy), the dynamic is identical, with the core index up +1.1% over eight months and +0.1% over the last month.

The situation is even more favorable for imported and producer price indices. The overall index was also flat in July, but year-on-year, prices were down -1.7%. This is the fifteenth successive negative reading since May 2023. In this respect, the Swiss economy has already been in deflation for over a year, which is also a positive factor for the CPI, but also for corporate margin management.

CPI & PPI - Switzerland



Sources: Bloomberg, BBGI Group SA

Inflation trends in Switzerland had clearly benefited from the franc's appreciation in 2023. Indeed, there is a correlation between a stronger franc and lower imported inflation. However, the Swiss currency's recent fluctuations against the dollar - first down, then up - no longer had the same impact in 2024. The SNB's change of policy following its success in controlling inflation indirectly implies a probable depreciation of the franc. The stabilization of producer prices means that the outlook for consumer prices is also more positive. Inflation should therefore temporarily fall below the 1% threshold.

SNB to cut rates by a further 0.25% in September

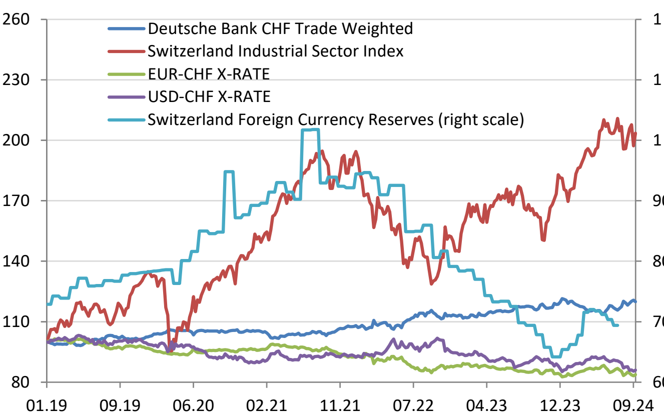
Inflation is well and truly under control in Switzerland, and recent statistics provide no cause for concern about a possible upturn in the near future. With only a few months to go before the end of the year, the SNB's inflation forecast of +1.4% may even be too conservative, given the current level of only +1%. Inflation is now within the desired fluctuation band and no longer requires strong corrective action by the SNB, which can of course live with inflation at this level. However, it is also possible that the SNB does not want this trend to continue too unabated, which could potentially create a deflationary situation in Switzerland. This risk is probably a long way off, unless the recent strength of the franc takes hold. In the run-up to its meeting on September 26, the Swiss central bank has considerable leeway to act on a number of factors. The first of these is certainly the evolution of the Swiss franc and its recent appreciation of around +9% against the dollar and +6% against the euro. The last three months of franc appreciation have certainly helped to keep inflation at zero in our country, and this factor could still influence indicators for a few months yet. It is not certain that the SNB would welcome an appreciation of the franc, which could lower inflation to the point of creating deflationary risks. Leading indicators are still very uncertain, raising doubts about the quality of the economic situation, particularly in the industrial sector and household consumption, which may be held back by confidence that is still at half-mast.

It may also have to consider the extent of the rate cut needed to halt the franc's appreciation, and the potential need to intervene in the market by selling francs and buying foreign currencies. It remains unlikely that the SNB will decide on a 0.5% rate cut in September, but given its success in fighting inflation, this probability remains and is estimated at 50%.

Don't bet on a weak franc

The franc's strength certainly peaked in late December 2023, and the expected phase of weakness materialized as the SNB announced its policy change. However, it is also likely that the Swiss rate cut will reach its nadir more quickly in a few months' time, when the ECB, Fed and BoE cycles will be longer. Yield differentials should logically contract, a positive factor for the franc.

Exchange rates and SNB reserves



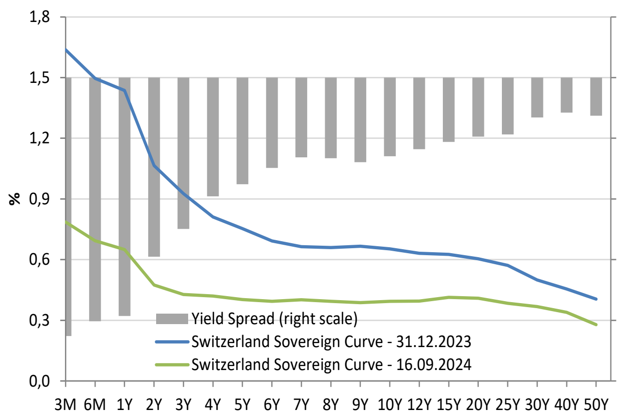
Sources: Bloomberg, BBGI Group SA

But having reduced the size of its balance sheet to what it was in 2017, the SNB now once again has the means to influence the level of the exchange rate. Against this backdrop, while it seems that franc weakness remains likely, we no longer anticipate a decline as significant as that envisaged at the start of the year. Nevertheless, we expect the franc to weaken by 5-7% against the dollar and the euro over the coming months.

The decline in long-term interest rates is coming to an end

For two years now, inflation has been back under control in our country, and monetary policy has adjusted to this new paradigm by cutting its key rates back in March. Our target rate is now 0.75%, which should mean two more rate cuts in September and December. During this phase of declining inflation, the downward trend predicted by BBGI for Confederation long-term rates has materialized, with a fall from 1.6% in March 2023 to 0.34% in August 2024. Our forecasts of declining inflation and a change in monetary policy have also materialized, leaving little room for further significant movements. We believe that if inflation slips below 1% over a year, the SNB's key rates could be lowered to 0.75% in a gradual flattening of the yield curve. In this context, the current level of Swiss government long-term interest rates could also be adjusted upwards this time, towards a target of 0.75%. Prospects for capital gains on Swiss franc bonds are therefore increasingly limited. Recent yield trends in Switzerland no longer offer much of interest.

Confederation rate curve



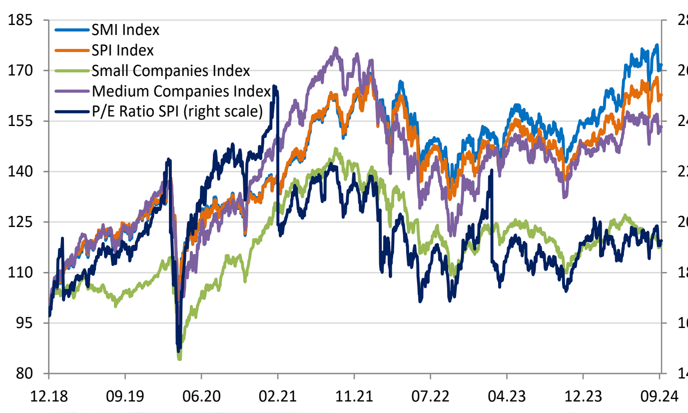
Sources: Bloomberg, BBGI Group SA

Positive outlook for Swiss equities

Swiss equities rose sharply in 2024, but despite an increase of +10.6%, they still lagged behind the performance of US equities (S&P500 +18% in dollars), but were on a par with European companies (+7.2% in euros). The weakness of the Swiss franc in the first half of the year supported the Swiss stock market, but the Swiss franc earnings of other stock markets benefited from the currency effect, boosting their Swiss franc earnings. Since the end of June, the franc's rebound has had no specific impact on our market, with Swiss stocks up +0.5% against an uncertain international backdrop and heightened volatility caused by the reversal of carry trade positions (SPX +3%, Stoxx50 -0.9%, FTSE100 +1.4%). As a result, the Swiss market will continue to underperform international equities in 2024, albeit to a lesser extent.

The decline in Swiss exports in recent months is further evidence of the difficulty posed by the relative strength of the franc for Swiss companies. The next key rate cuts and the end of SNB purchases of Swiss francs will help to weaken the franc. The latter should encourage a reassessment of earnings prospects and support the continuation of the current uptrend. The outlook for the Swiss market is therefore still positive for the remainder of 2024, particularly for the more interest- and exchange-rate-sensitive secondary stocks (mid caps and smaller companies), whose performance should outperform that of the blue chips. It should be noted, however, that the still high level of Swiss PEs (22x for the SMI) represents a potential brake on the appreciation of stock market indices, whose positive outlook seems to us to lag behind that of other developed markets.

Swiss equityy indices



Sources: Bloomberg, BBGI Group SA

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