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SWITZERLAND: ECONOMIC ACTIVITY

LOWER GROWTH, LOWER INFLATION

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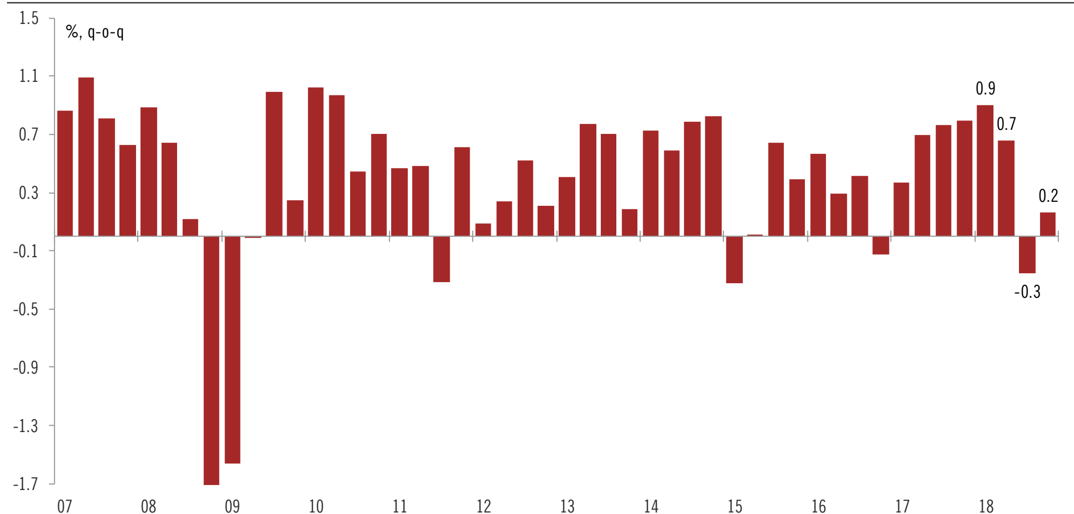
SUMMARY

- The Swiss economy posted impressive GDP growth in 2018, although there was significant divergence between the first and the second halves of the year.
- Looking ahead, we expect the Swiss economy to slow. Fundamentals supporting domestic demand remain solid, but the challenging global environment and the difficulties encountered by some key trading partners are weighing on Swiss exports.
- Consumer price inflation should remain moderate in 2019.
- We expect the Swiss National Bank (SNB) to maintain its accommodative monetary policy throughout 2019, with the first policy rate hike coming in H1 2020.

Growth: back to moderation in 2019

Swiss GDP grew by 2.5% in 2018, the strongest rate in eight years and higher than the +2.4% growth rate recorded in 2014, just before the Swiss National Bank (SNB) scrapped the minimum EUR/CHF exchange rate. However, there was a marked split between a dynamic first half (0.8% q-o-q average growth in H1 2018) and the stagnation of the second half (see *Chart 1*).

CHART 1: SWISS QUARTERLY GDP GROWTH



Source: PWM - AA&MR SECO, April 2019

In H1 2018, growth was lifted by one-off items such as licensing fees for international sport events, while in H2 2018, fading stimulus from abroad caused a slowdown. Within Europe, the German and Italian economies (Switzerland's two key trading partners) shrunk slightly in 2H. **The details of the Swiss GDP report showed that the 2H stagnation was not just about external demand pressures**. Some one-offs were at play too, notably weak energy production and the exceptionally low level of the Rhine, which disrupted the transport of (mainly chemical) goods from Switzerland. A drop in R&D spending exaggerated the 2H weakness. Furthermore, investment contracted in each of

PICTET 1805

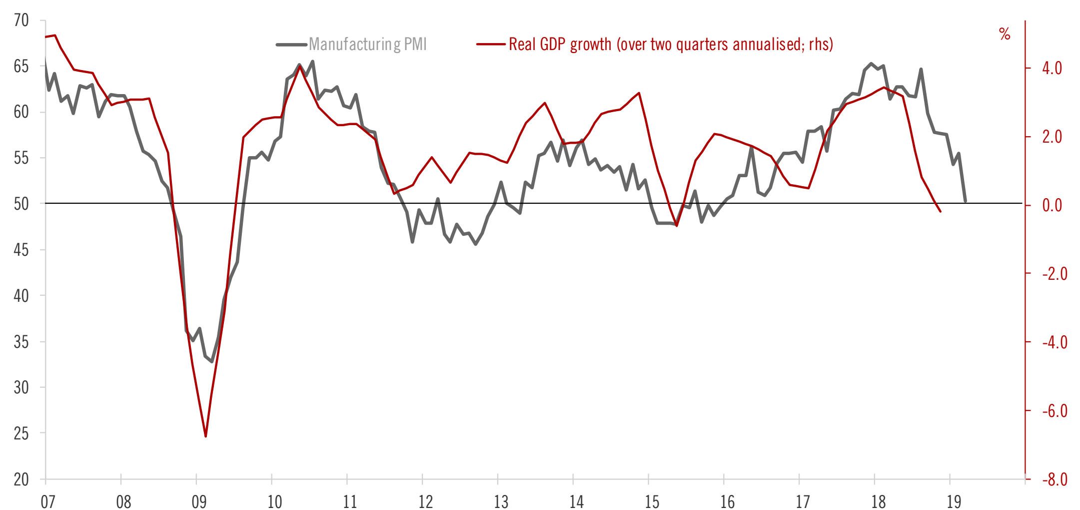
SWITZERLAND: ECONOMIC ACTIVITY
LOWER GROWTH, LOWER INFLATION

the last two quarters of 2018 for the first time since 2012. The decline in capex spending may reflect uncertainties about prospects for global trade, but doubts about Switzerland's future trading relationship with the EU may also be having an impact. Finally, consumer spending remained sluggish in 2H 2018.

Looking ahead, **the deceleration in global growth is likely to weigh on Swiss exporters for some time**. Recent sentiment indicators (KOF survey, Markit purchasing manager indexes (PMI)) for the manufacturing sector, which is the most exposed to external demand, confirm the loss of momentum in industrial activity (see *Chart 2*).

However, **not all industries will be impacted the same way**. Pharmaceutical exports are less sensitive to exchange rate movements and the economic cycle than others. In contrast, exports from the Swiss engineering, electrical and metal industries will likely be lower this year. Furthermore, the weakness in parts of the German economy, notably the car industry, will be a drag as Swiss companies are important suppliers of car parts to Germany.

CHART 2: SWISS REAL GDP GROWTH AND MANUFACTURING PMI



Source: PWM - AA&MR, Markit, SECO, April 2019

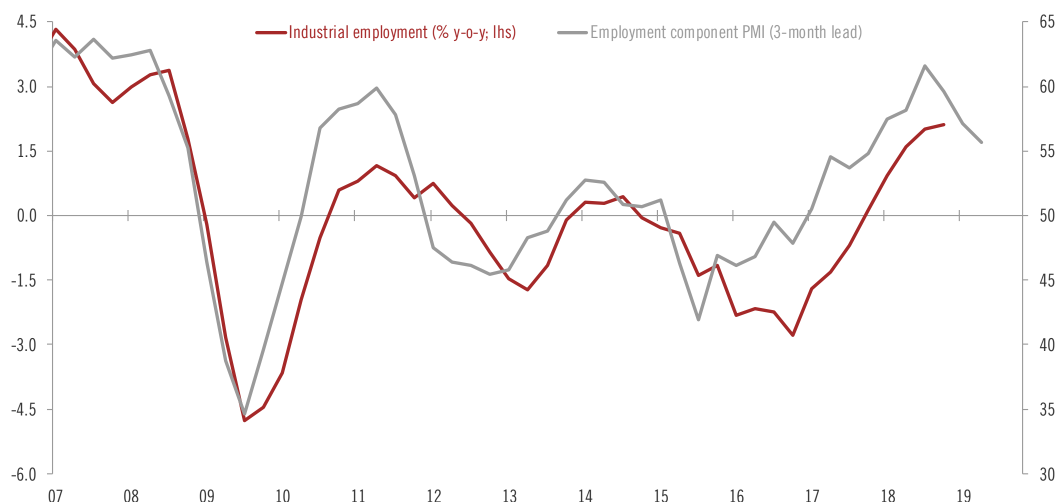
Modest export demand should coincide with subdued investment in machinery and equipment. By contrast, investment in construction is likely to be an important growth support in 2019.

Household consumption is likely to remain resilient, underpinned by a healthy labour market and upbeat consumer sentiment. The unemployment rate is at a 17-year low (even though the recent decrease in unemployment is skewed by changes in methodology). Employment growth in industry was particularly vibrant in 2018, increasing 1.7%, a figure not exceeded since 2008. Leading indicators such as the PMI suggest that jobs will continue to be created in industry, albeit at a slower pace than before *(see Chart 3)*. Overall, **we expect Swiss GDP to expand by 1.3% in 2019, down substantially from 2.5% in 2018**.

SWITZERLAND: ECONOMIC ACTIVITY

LOWER GROWTH, LOWER INFLATION

CHART 3: SWISS INDUSTRIAL EMPLOYMENT GROWTH AND EMPLOYMENT COMPONENT OF PMI



Source: PWM - AA&MR, Markit, SECO, April 2019

Risks to our growth outlook: tilted to the downside

Risks to our growth outlook are tilted to the downside. An intensification of trade disputes and a rise in political uncertainties in Europe (Italy, Brexit) could lead to an appreciation of the Swiss currency and thus prove to be a drag on Swiss foreign trade and investment. Uncertainty regarding the finalisation of a framework agreement with the EU could also weigh on sentiment. Domestic considerations, such as uncertainty over the reform of corporate taxation and the Swiss pension system (AVS) (to be voted on May 19 (see here for further details)), could increase uncertainty for businesses as well.

Inflation: subdued

Consumer price inflation should remain moderate in 2019. The looming oversupply of rental apartments, seen in record number of empty dwellings on the market, is dampening inflationary pressures in housing rent (accounts for 18% of the Swiss consumer price index (CPI), *see Chart 4*). Moreover, political pressure to reduce healthcare costs suggest that the downward trend in healthcare inflation (15% of CPI) will likely persist. In addition, upward pressure on wage growth remains limited. Many Swiss exporters did not change their prices in euro after the Swiss franc shock at the beginning of 2015, resulting in a squeeze in margins. With many firms preferring to invest before granting higher wages, few employees received any wage increase in 2017 and 2018 and the leeway to grant wage rises remains limited.

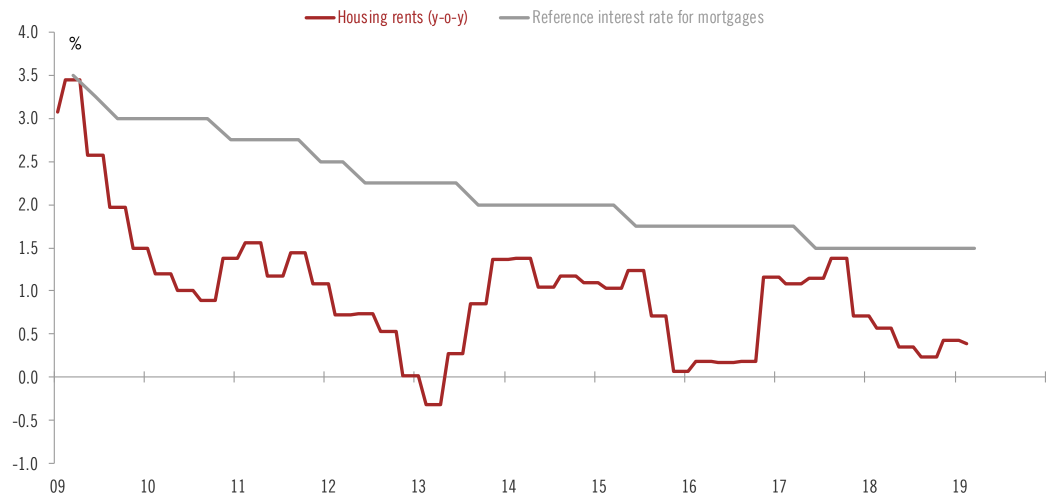
In the absence of any marked appreciation of the CHF, **we forecast Swiss headline inflation to average 0.6% in 2019, down from 1.0% in 2018.** Our foreign exchange strategist expects a CHF/EUR of CHF 1.14 in three months' time, compared with CHF1.13 on 11 April. Political uncertainty in Europe and the lingering threat of trade tariffs may mean the euro has limited room to appreciate against the franc (see our Flash Note here).

PICTET 1805

SWITZERLAND: ECONOMIC ACTIVITY

LOWER GROWTH, LOWER INFLATION

CHART 4: SWISS CPI IN HOUSING RENTAL AND REFERENCE MORTGAGE RATE



Source: PWM - AA&MR, Federal Office for Housing, SFSO, April 2019

Monetary policy: no rate hike before 2020

As expected, at its last monetary policy meeting in March, the Swiss National Bank (SNB) left its monetary policy unchanged. The interest on sight deposits at the SNB was left at –0.75% and the target range for the three-month Libor was left at between –1.25% and –0.25%. The central bank's assessment of the Swiss franc also remained unchanged from its previous meeting in December, with the SNB stating that it continued to see the currency as "highly valued" and the situation on foreign exchange markets as "fragile". Meanwhile, the SNB revised down its inflation forecast for 2019 (from 0.5% to 0.3%) and 2020 (from 1.0% to 0.6%). One explanation for this downward revision could be delayed market expectations for US Federal Reserve (Fed) and European Central Bank (ECB) rate hikes, which, in the SNB's model (conditional on SNB policy rates remaining unchanged), points to less depreciation of the Swiss franc than before.

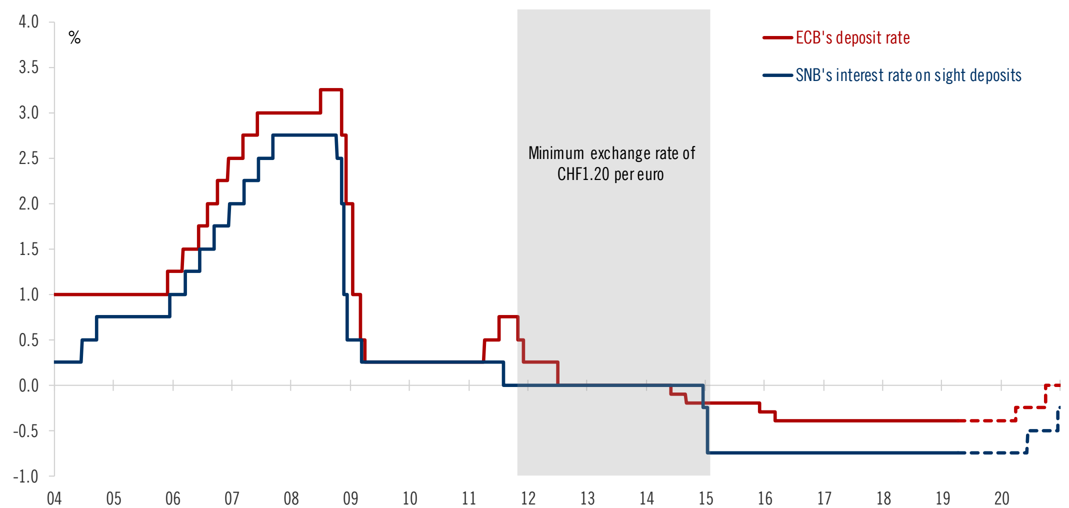
The persistence of adverse risks (trade disputes, EU-Swiss trading relations, Brexit…), as well as the dovish tones adopted by other central banks like the Fed and the ECB, gives the SNB further room to remain cautious.

We expect the **SNB to maintain its accommodative monetary policy throughout 2019, with the first policy rate hike not coming until H1 2020**. The exact timing of any move is difficult to assess, but we expect the ECB to raise its deposit rate first in March 2020, and a second time in September 2020. Thus, June seems the most favourable timing for an SNB rate hike. To avoid piling upward pressure on the CHF, we believe that the SNB will proceed gradually with rate hikes. We therefore expect only two rate hikes in 2020, the second in December 2020.

SWITZERLAND: ECONOMIC ACTIVITY

LOWER GROWTH, LOWER INFLATION

CHART 5: SNB AND ECB DEPOSIT RATES



Source: PWM - AA&MR, Swiss National Bank, European Central Bank, April 2019.

We believe it is unlikely that the SNB will hike rates before the ECB. SNB's members of the Governing board have many times referred to the importance of the interest rate differential for the exchange rate. A policy rate increase before the ECB would likely lead to an appreciation of the franc, which would weigh on the inflation outlook. The only way we see the SNB hiking rates before the ECB is if there is a surge in inflation, which we believe is improbable.

Criticism of central banks' negative interest rates has become louder in the euro area and Switzerland. Yet rates are expected to remain low for longer than previously expected. While in our baseline scenario we see both the SNB and the ECB hiking rates in 2020, **there is a risk that neither manage to normalise policy at all during this economic cycle.**

The SNB's members of the Governing board have said many times that there is still some room to cut rates further should the need arise. While we do not know exactly what the "lower bound" might be, negative rates are certainly weighing on the banking sector. Should the SNB need to loosen monetary policy further, it could increase the exemption threshold (see Appendix for explanation of see how negative interest rates work in Switzerland). However, this would not solve the side effects linked to negative interest rates on the mortgage sector.

PICTET 1805

SWITZERLAND: ECONOMIC ACTIVITY

LOWER GROWTH, LOWER INFLATION

Appendix: how negative interest rate work on Switzerland?

In response to pressure on the EUR/CHF minimum exchange rate floor it had established (CHF1.20), the Swiss National Bank (SNB) announced the introduction of negative interest rates (-0.25%) in December 2014. With the pressure on the franc continuing unabated, the SNB then discontinued the minimum exchange rate in January 2015 (triggering the so-called 'Frankenshock') and lowered the interest rate further, to -0.75%. Negative interest rates were accompanied by SNB's announcement that it stood to intervene further in the foreign exchange market as needed.

From the start, negative rates on deposits with the SNB have been tiered. Negative interest is only charged on the portion of sight deposits that exceeds s thresholds defined by the SNB. The SNB has two exemption thresholds. The first threshold applies to all banks that have to fulfil minimum reserve requirements (e.g for domestic banks or bank-like domestic institutions). This exemption currently corresponds to 20 times the minimum reserve requirement. A second exemption threshold exists for institutions' not subject to the capital reserves requirements (e.g. foreign banks, securities dealers, cash processing facilities, clearing and settlement organisations, mortgage bond institutions, insurance companies, international organisations, central banks and decentralised units of the Swiss Federal Administration). The minimum fixed threshold is CHF10 million. At the end of December 2018, total sight deposits held at the SNB subject to negative interest came to CHF269bn. Income accruing to the SNB from negative interest amounted to CHF2.0bn in 2018.

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