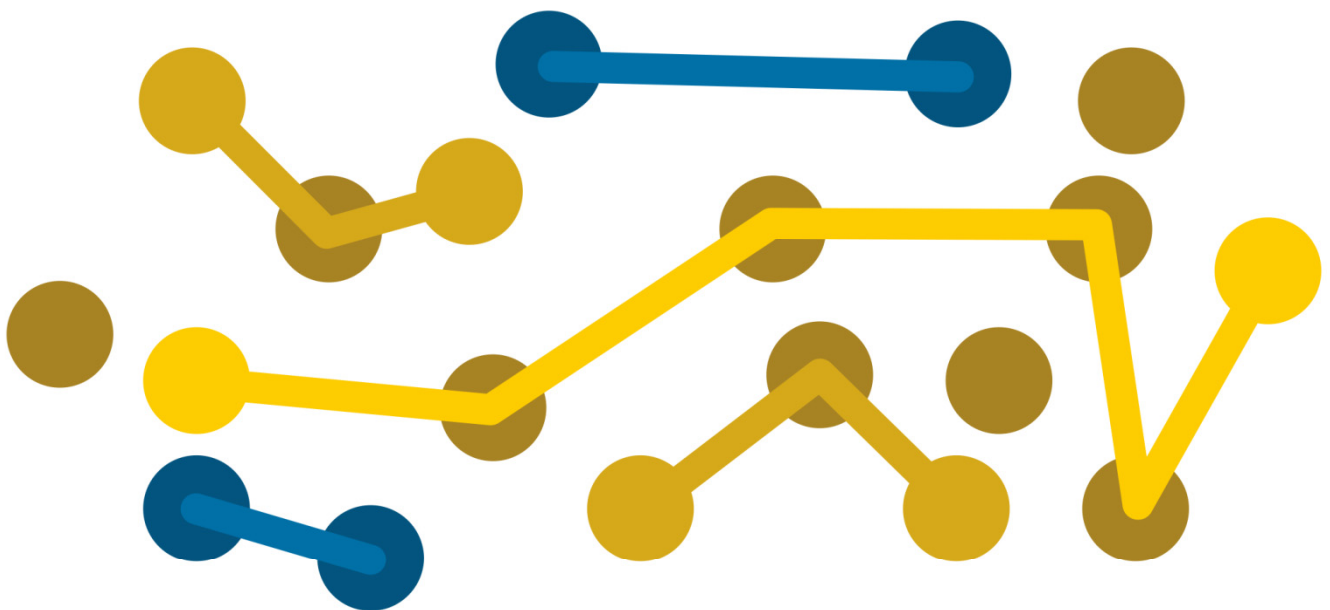


Monitor Switzerland

September 2016

On the way to a new normal?



Working Population
Demographic arithmetic
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Monetary Policy
SNB balance sheet and regulation
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Economic Policy Agenda
Brexit vote: glance into the unknown for Switzerland
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Imprint

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Contribution

Tomasz Limberger

Dear Reader

One of the most conspicuous forecasting errors committed by economists in recent years is the systematic overestimation of the global growth trend. The closely related error of financial analysts was to fail to recognize the sharp downward trend in interest rates. Interestingly, the economists of Credit Suisse overestimated the trend of Swiss gross domestic product much less than that of the USA and the Eurozone, for example. One possible explanation is that our economists simply perform better with their forecasts for Switzerland thanks to their proximity to the subject at issue. But why have forecasters, including the local experts, overestimated growth in places such as the USA and the Eurozone so much more?

A more convincing explanation seems to us to be that certain factors have supported growth in Switzerland more in the past few years than elsewhere and have therefore largely offset the very adverse shocks that have affected our economy (key word: CHF appreciation surge). We think that two factors were decisive: firstly the growth of employment and hence consumption driven by the strong immigration, and secondly the Swiss real estate boom. The extremely low interest rates and strong employment growth were the original drivers of this boom and the sharp credit growth to finance it. In most of the other developed countries at least one if not both of these factors has been missing. The recovery in the credit and construction cycle following the financial crisis was considerably more hesitant in the USA. On the other hand, starting from a low level, employment grew very sharply, although the labor participation rate until recently fell significantly and immigration stagnated. Both factors have been missing in many European countries. The delayed restructuring of banks was one of the core factors behind the sluggish lending and economy.

However, the central growth driver in other cycles, namely productivity growth, has performed extremely weakly both in Switzerland and elsewhere. Can we expect a clear trend reversal here? Several factors speak against a new, productivity-driven investment boom, not least that of aging that is curbing the long-term growth trend and thereby reducing the need for investment. Although the pace of technological progress remains swift, we therefore continue to expect below-average investment rates and hesitant productivity gains throughout the world. If in addition immigration tails off in Switzerland ([scenarios for this on page 14](#)), trend growth will also fall here. It is to be hoped that this will be a gradual process so that the real estate sector can also be positioned for a soft landing. This should be possible in our baseline scenario as we are not anticipating an interest rate shock. Finally, the demographics are not only pointing to a lack of investment but also to a prevailing high level of saving – and therefore low real interest rates.

We wish you an interesting read.



Thomas Gottstein
CEO Swiss Universal Bank



Oliver Adler
Head of Economic Research

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Global Economy

Growth low but quite stable

Global economic growth is not very impressive at present. However, it is displaying a certain degree of resilience that has enabled it to survive the past few quarters without suffering any serious damage despite various shocks.

Robust US growth should permit base rate hike by the end of the year

The solid position of the US economy has only changed marginally in the past few months. While gross domestic product (GDP) expanded very cautiously in the first half of 2016, as the growth rates were partially burdened by special effects, we expect a slight acceleration for the second half of the year. The pillars of US growth continue to be found in the domestic economy: robust private consumption, a sustained recovery of the construction sector and little headwind from fiscal policy. Manufacturing is the only sector to have been under considerable pressure for a prolonged period but is now at least appearing to stabilize. The labor market remains in very good shape, and wage growth is also continuing to increase, although very slowly. However, as there is a lack of clear inflation pressure, we only expect the US Fed to carry out further interest rate hikes very gradually. We expect the next interest hike before the end of the year, followed by two more in 2017.

Brexit so far less negative than expected; Eurozone should grow moderately

The immediate negative consequences of the British decision to leave the European Union (EU) have so far remained limited. There has been a recovery in business sentiment following an initial setback and the hard data has so far painted a relatively robust picture. The Bank of England has nevertheless eased its monetary policy and is likely to cut interest rates to around zero in the future. Fiscal stimulus should also follow by the end of 2016. There has therefore been little change so far in the Eurozone to the relatively robust although moderate growth outlook. However, as the inflation outlook remains subdued, the European Central Bank is likely to have to extend its bond purchase program once more.

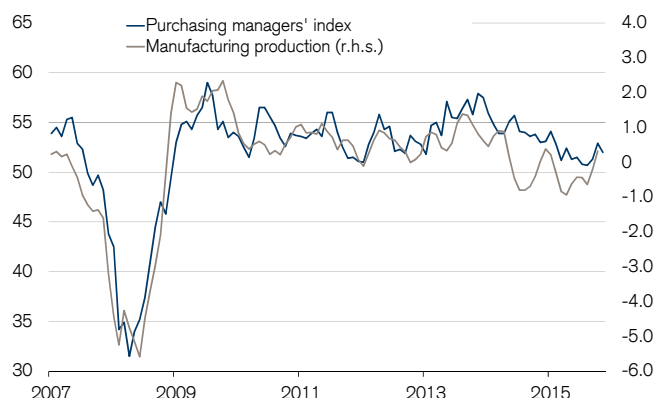
China's economy should grow more slowly again after stabilizing; Brazil and Russia have bottomed out

The picture in the major emerging markets is slightly better than a few months ago. The Chinese data displayed a pleasing stabilization in the first half of the year, although this was thanks to government stimulus. By contrast, momentum in the private sector remains weak. We therefore expect a renewed slowdown in Chinese growth for the second half of the year, but no collapse. India's economy remains sound and the positive growth outlook should also apply to the coming year. The Brazilian economy is only recovering very slowly from the deep recession. As inflation is gradually subsiding, the Brazilian Central Bank should also slowly be able to reduce its base rates again. Russia's economy also appears to have bottomed out although a rapid recovery is not to be expected in view of the continued low energy prices.

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Manufacturing sector in the USA moving toward recovery

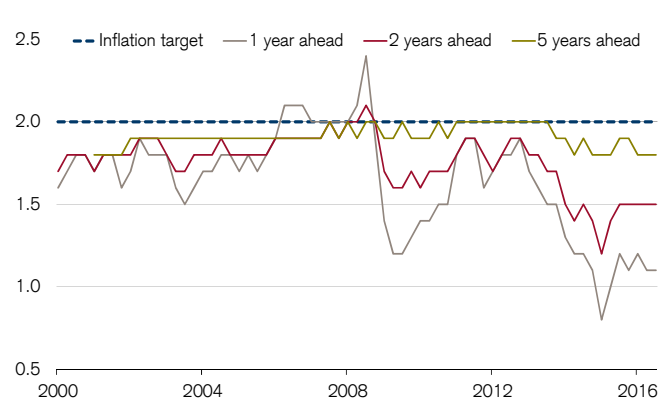
Index; QoQ growth in %



Source: Bloomberg, Datastream, Credit Suisse

Subdued inflation outlook in the Eurozone

ECB inflation target, inflation rate expected by professional forecasters in %



Source: Datastream, Credit Suisse

Global Economy I Monitor

United Kingdom

Major uncertainty continues to prevail regarding the consequences of the UK's departure from the EU ("Brexit") for the British economy. The latest economic data largely surprised on the positive side. However, we do not expect this development to hold up. Instead we continue to anticipate a marked slowdown in the economy. Companies will increasingly hesitate to make investments and hire staff. This in turn is likely to exert a negative impact on private consumption.

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USA

Despite all political differences, there is consensus between the US presidential candidates on the need to increase spending on infrastructure. However, due to delays in implementation, much of the growth momentum is only likely to take effect from 2018. The impact on the state budget could prove neutral if Hillary Clinton is elected as she is planning tax increases for high incomes. However, if Donald Trump were elected, government debt would probably rise further as he is simultaneously proposing massive tax cuts, particularly for companies.

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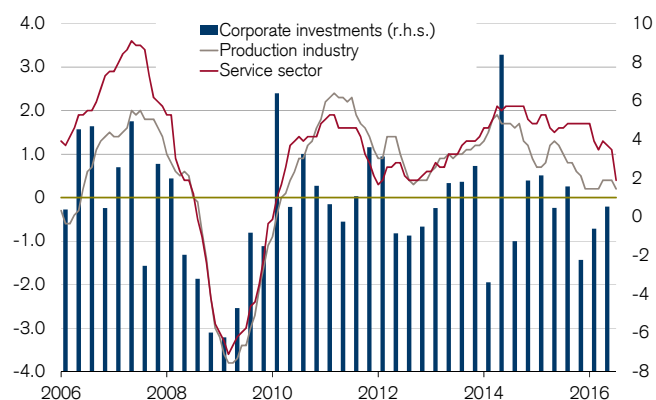
India

Unlike the continued weak growth in most of the other major emerging markets, India's economy is experiencing a boom phase. The country is already growing stronger than China for the second year in succession. For the 2017/18 financial year we expect a further acceleration of GDP growth to 8.0% year on year. The key driver is an extensive reform program intended to boost public and private investments.

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Collapse of investment intentions due to Brexit decision

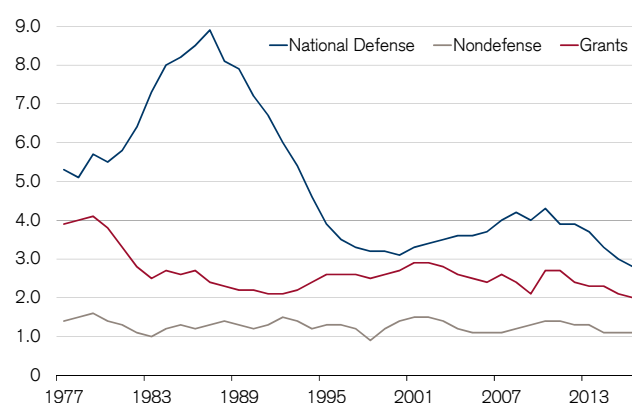
Investment intentions according to BoE Agents Survey, QoQ growth in %



Source: Datastream, Credit Suisse

Government investments declining for some time

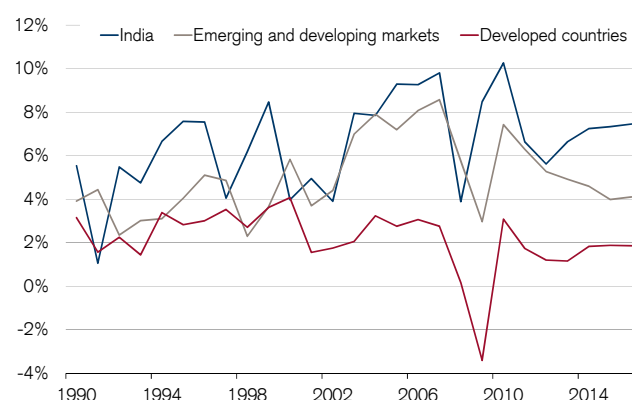
Investments in physical capital, as % of federal expenditure (2016 figure = estimate)



Source: US Office of Management and Budget, Credit Suisse

India's economic boom should continue further

Growth of gross domestic product, YoY in %



Source: International Monetary Fund, Credit Suisse

Swiss Economy

No call for euphoria

The Swiss economy is set to expand by 1.5% in 2017. Growth is therefore likely to remain weaker than before the appreciation of the franc. With the exception of exports, no acceleration is to be expected for any demand component.

Exploit in Q2 2016 statistically exaggerated

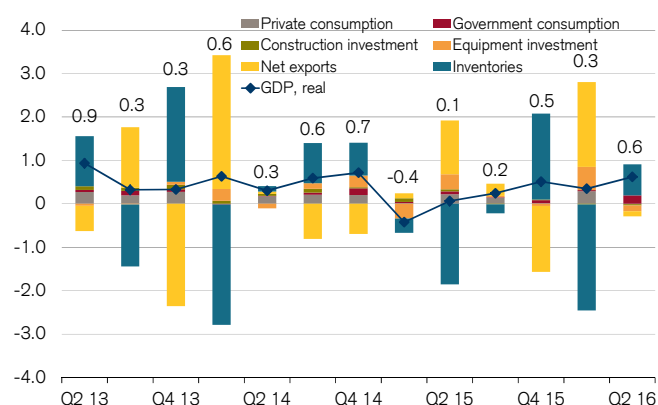
According to the State Secretariat for Economic Affairs, economic output in the second quarter of this year increased by 0.6% on the previous quarter. Altogether, gross domestic product (GDP) after the first half of the year was back 2% above its prior-year level. Is Switzerland therefore already embarking on another boom phase? Caution appears warranted: A large share of the growth was attributable to the "stocks" component (and the statistical deviations contained therein). Whether companies really have increased their stocks to this extent is questionable, as the monthly survey of purchase managers in industry conducted by procure.ch actually points toward a reduction in stocks. The development of government consumption, a contributory component that fluctuates strongly from quarter to quarter, was likewise positive. By contrast, private consumption stagnated and investments fell, with investments in equipment even declining more sharply than at any time since shortly after the abandonment of the EUR/CHF minimum exchange rate of 1.20. Exports increased but primarily thanks to the chemical and pharmaceutical industry (see [Sectors: Diverging export performance on page 12](#)). At the same time there was also a rise in the volume of imports. There can therefore be no talk of a broad-based upturn.

Margin declines curbed but not offset

Our three composite indicators that we use to measure the impact of the strength of the franc (see [Figure](#)) also paint a heterogeneous picture: The indicators from "Production" have indeed recovered again, with no sign of the broad dispersion within industry here. The available indicators concerning the labor market and consumption suggest that households are so far not affected significantly by the strength of the franc and until recently have even benefited from it thanks to the gain in purchasing power. However, the at times record price discounts and the associated significant margin losses reflected in our "financial environment" composite indicator have only partially been made good (see [Figure](#)). The weak profit situation of companies is likely also to shape cyclical performance in the coming year. We therefore continue to anticipate only subdued economic growth of 1.5% in 2017 (following revised growth of 1.5% this year based on the figures for the second quarter).

Major fluctuations of stock components

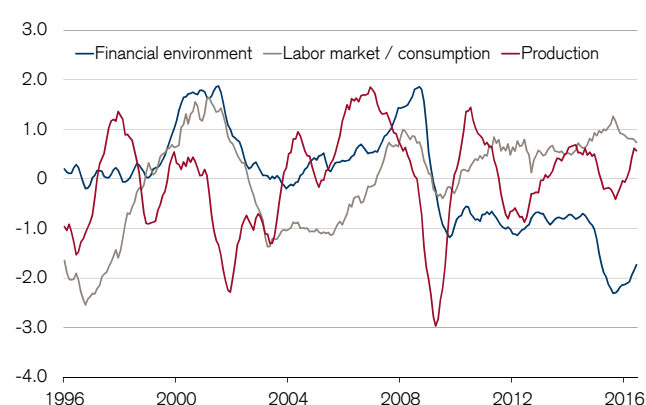
QoQ in %, seasonally-adjusted



Source: State Secretariat for Economic Affairs (SECO), Credit Suisse

Strong franc still weighing down on margins and profits

In standard deviations, moving three-month average



Source: Datastream, Swiss Customs Administration, Credit Suisse

Lower immigration curbing consumption growth

Private consumption, the most important demand component, is once again likely only to make a subdued contribution to economic growth in 2017. Two factors are preventing an acceleration. First of all immigration is set to slow down further ([see detailed discussion on page 11 -> Immigration](#)). According to our analysis, more than a quarter of consumer growth in the past seven years was based on immigration. Although increased demand due to immigration is once again expected in the coming year, this will amount to below CHF 1 bn again, almost a fifth less than in the previous year. Secondly, consumer sentiment is likely to remain gloomy. The unemployment rate is too high and there is too much bad news coming from Switzerland and abroad. The uncertainty index that records the frequency of the citing of "political uncertainty" in media reports accordingly reached a new peak at the time of the Brexit vote ([see Figure](#)). On the other hand, the low mortgage interest rates are continuing to relieve the budgets of homeowners and – thanks to the linking of rents to the interest environment – at least to some extent also those of tenants.

No increase in the unemployment rate but also no growth in real wages

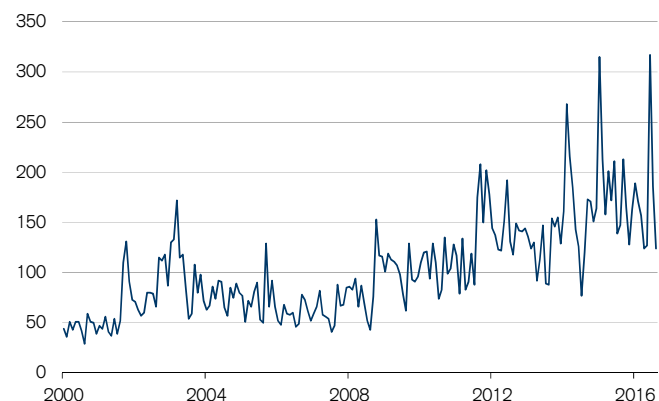
Consumption decisions are ultimately made on the basis of the labor market situation. On the positive side, the unemployment rate is no longer rising. We anticipate an unchanged unemployment rate of 3.3% in the coming year. The increase following the appreciation shock of January 2015 was therefore significantly lower than in previous crises ([see Figure](#)). In view of the comparatively sound capacity utilization, companies are as far as possible retaining their workforces. Furthermore, new jobs are still being created in sectors such as healthcare and social services as well as the public sector. However, due to the decreased margins and profits, companies are endeavoring to reduce their wage costs, be this by making more use of part-time work ([see Labor market on page 11](#)) or by limiting remuneration. This suggests that wages will only rise very modestly in 2017. We expect a nominal increase in wages of 0.5%. Because at the same time inflation is expected to be positive again for the first time in five years at 0.5% ([see Inflation on page 11](#)), there will be no real gain in purchasing power in the coming year. At 1%, consumption growth in 2017 is even set to be marginally weaker than in 2016 (1.1%).

Government consumption remains a pillar of growth

Government consumption is set to increase at a similarly strong rate in the coming year as in 2016. The slightly lower population growth and the planned austerity programs will be matched by low refinancing costs. The key driver of government consumption is personnel expenditure, more than half of which is attributable to the cantons. Particularly the workforces of the municipalities and cantons are set to grow further, and even the Federal Government is likely to create jobs again despite cost-cutting efforts. With growth of 1.8%, government consumption is likely also to rise more sharply in the coming year than GDP and the population.

Uncertainty index at a peak following Brexit

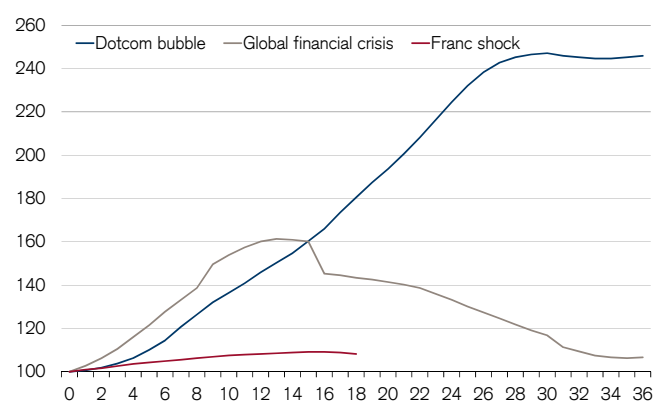
Number of articles on "political uncertainty"



Source: [policyuncertainty.com](#), Factiva, Credit Suisse

Labor market comparatively robust

Change in unemployment rate, index: 100 = start of respective crisis



Source: State Secretariat for Economic Affairs (SECO), Credit Suisse

Barely any changes in investment behavior

There is also no significant change in investment behavior anticipated in the foreseeable future. Particularly the gloomy revenue situation and ongoing major uncertainty are having a hampering effect on investments in equipment. By the same token, the urge to rationalize as well as low interest rates and high equity valuations speak in favor of investments in equipment. A good indicator of their future development is the purchasing managers' index (PMI) of Credit Suisse/procure.ch. The PMI has been above the growth threshold for nine months, although at times only just. Altogether we forecast unchanged growth in investments in equipment in the coming year. Meanwhile, the Construction Index based on the business figures of the member companies of the Swiss Contractors' Association and the published planning applications is a short-term indicator of construction investments (see Figure). It is presently at a new record high which suggests an acceleration of construction investments. The decisive factor for the current acceleration is primarily housing construction that is receiving tailwind from the negative interest environment (key word "investment crisis"). However, because demand for rental apartments and office buildings is set to decrease in future due to the lower population and employment growth and vacancies will rise, the growth of construction investments will be limited in the coming year. We forecast growth of 0.5% in 2017, the same as in 2016.

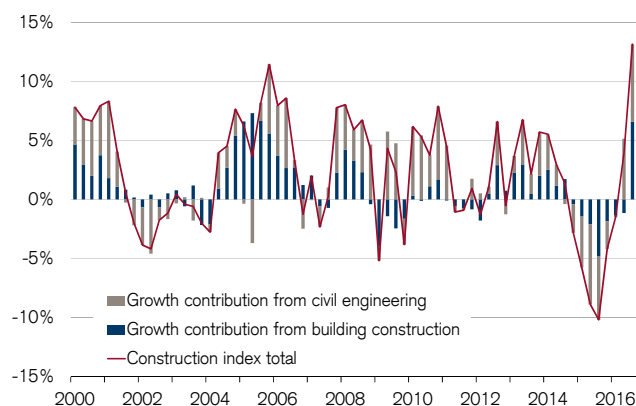
Real volume of exports should recover further in 2017

Meanwhile, the situation for exporters should ease further. Thanks to the combination of negative interest rates and foreign exchange purchases by the Swiss National Bank and assuming there are no major distortions on the international financial markets, the franc should devalue slightly in the course of the year. At the same time, the Credit Suisse Export Barometer that estimates foreign demand for Swiss goods suggests that export growth should continue in the months to come. With a value of 0.86, the barometer is almost at the level of its long-term average and well above the growth threshold of 0 (see Figure). Furthermore, the Swiss export economy is active in areas that are currently seeing global growth (see Export on page 10). We therefore anticipate an increase in real exports of 4.5% for 2017 despite the continued overvaluation of the franc that is exerting a negative impact on the price competitiveness of the Swiss export industry. Imports should rise by 3.5% over the same period.

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Construction Index: Construction is rearing up

YoY in %



Source: Swiss Contractors' Association, Credit Suisse

Export Barometer pointing to growth

In standard deviations



Source: Bloomberg, Datastream, PMI Premium, Credit Suisse

Swiss Economy I Monitor

Exports

Swiss exports grew between 2001 and 2015 by 7.6% per year, while global exports on average increased by 8.0% per year. The difference between Swiss and global export growth (net growth) can be split into a part that reflects the initial specialization and a part that reflects gains in market shares (competitiveness). This breakdown shows that the Swiss export industry was active in the 'right' sectors between 2008 and 2011 and above all between 2011 and 2015. However, viewed across all three periods examined, Switzerland has sustained slight losses in market shares.

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Consumption

According to the GfK, the retail trade in Switzerland generates sales of almost CHF 100 bn p.a. These contrast with annual household expenditure for final consumption of around CHF 340 bn as shown by figures of the Swiss Federal Statistical Office. With a share of less than a third, retail consumption accordingly only amounts to slightly more than an average household spends on the "housing and energy" expense item. This explains why private consumption can increase even if retail sales stagnate or even fall.

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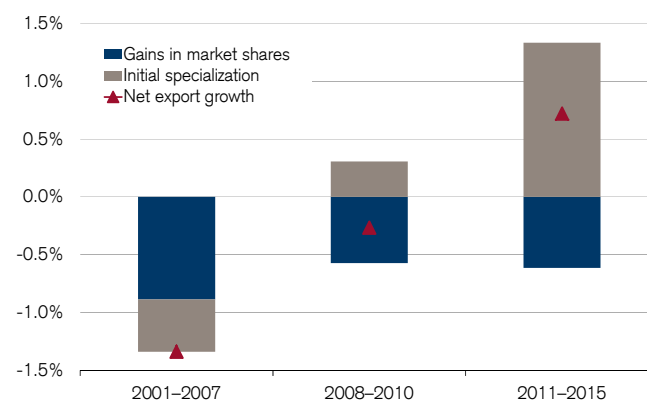
Investments

Almost half of the non-financial capital stock in Switzerland of around CHF 460 bn (excluding real estate) consists of "classical" machines (allocated to the "other equipment/military" aggregate). However, the share of this category has tended to decline since 2009 following a "breakout" of just five years in the course of "reindustrialization". By contrast, the bulk of the other categories has been gradually increasing for decades. Particularly investments in the areas of research and development and IT products are continuously gaining importance.

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Good sector choice is decisive

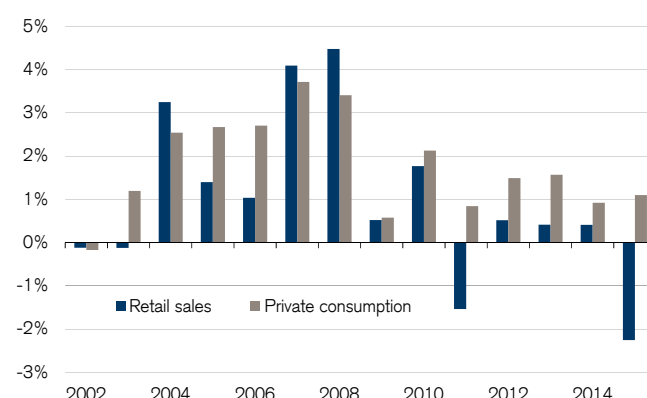
In % or percentage points



Source: Intracen, Credit Suisse

Retail trade a poor indicator of overall consumption

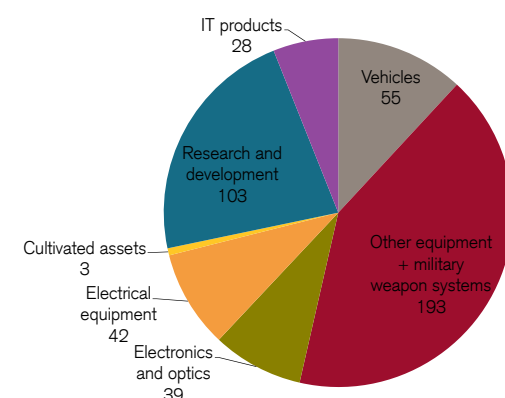
YoY in %



Source: Swiss Federal Statistical Office, GfK, Credit Suisse

Classical machines still prevailing in capital stock

In CHF bn, 2014



Source: Swiss Federal Statistical Office, Credit Suisse

Inflation

After having fallen for five years, consumer prices are set to rise again slightly in 2017. We expect an average inflation rate for 2017 of 0.5% (revised from 0.0%) following a likewise revised -0.3% in 2016. The main contributor to the increase is the energy component. The reason for this lies in the higher oil prices. By contrast, the other components of the consumer price index (CPI) are unlikely to increase. Above all rents (almost 20% of the CPI) are hardly likely to get any more expensive owing to the historically low mortgage interest rates.

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Immigration

Immigration to Switzerland has slowed down somewhat in the first two quarters of the current year. A comparison of the trend so far in 2016 with that of previous years shows that immigration is pretty much at the level of 2010. Back then there was a balance of migration of foreign resident population at the end of the year of just under 69,000 persons and following subtraction of the traditional emigration of Swiss nationals a balance of around 65,000 persons for the population as a whole. In view of these figures and taking into account the increase in transfers from the asylum sector expected by us in the second half of 2016, we are upholding our forecast of net migration of a total of 70,000 persons.

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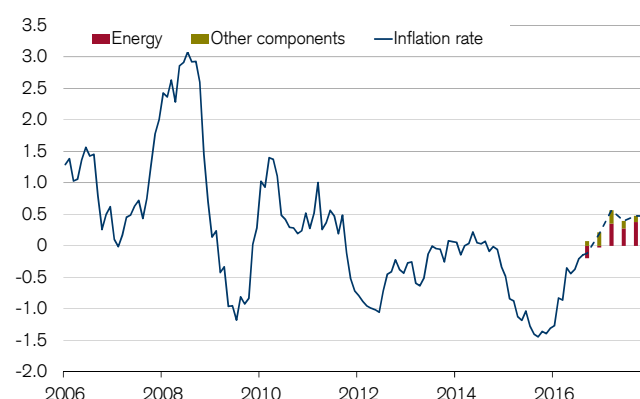
Labor market

The situation on the labor market remains tense. In order to curb the growth of wage costs, companies are making use of a recipe that has already proven its worth in past downturns: They are focusing more on part-time work. Part-time work has increased sharply since the franc shock, while full-time employment has decreased on a similar scale to during the global financial crisis. Most of this shift has taken place in the service sector that in any case has an affinity for part-time work, although the number of part-time jobs in industry has also risen sharply since the franc shock. This points toward conscious cost-saving strategies.

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Positive inflation rates again in 2017

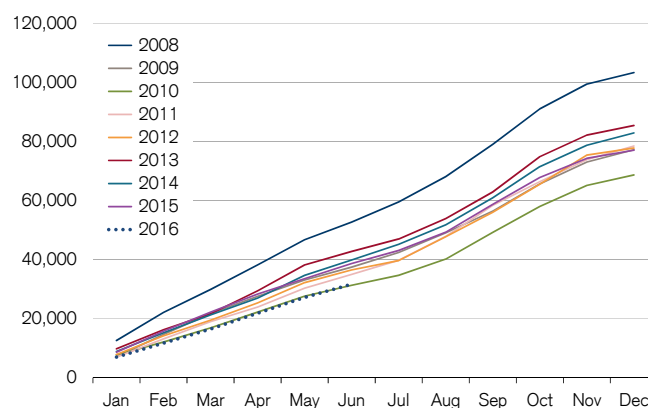
YoY in %



Source: Swiss Federal Statistical Office, Credit Suisse

Immigration at the level of 2010

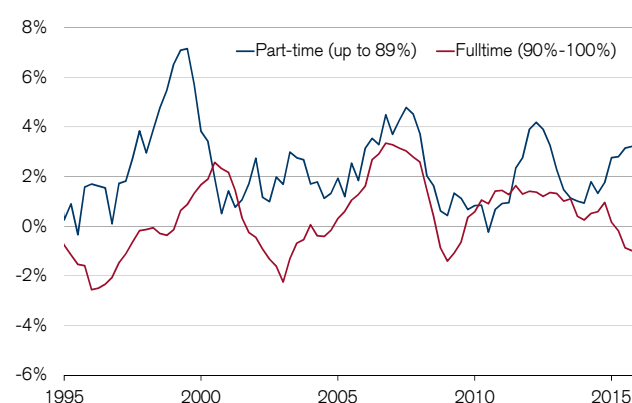
Balance of migration of foreign resident population, cumulative, in persons



Source: State Secretariat for Migration, Credit Suisse

Part-time rather than full-time jobs

Employment growth, YoY in %



Source: Swiss Federal Statistical Office, Credit Suisse

Sectors

Diverging export performance

Swiss goods exports are continuing to rise. However, growth has so far practically been attributable solely to the chemical and pharmaceutical industry. By contrast, current export momentum in the watch industry is extremely negative.

Chemicals/pharmaceuticals as the driving force, watch industry as the curbing factor

Having fallen by 2.6% in nominal terms in 2015 due to the franc shock, Swiss exports have this year returned to the growth path. Between January and July 2016 they recorded a year-on-year increase of 4.2%. However, there can be no talk of a broad-based upturn as the sector differences remain large (see Figure). By far the greatest growth contribution came from the chemical and pharmaceutical industry: Switzerland's most important export sector increased its exports by a high 12.9% compared with the previous year. Without this Swiss exports would have continued to decline in the current year. Although the engineering and electrical industry recovered somewhat from its slump in the previous year, its exports have so far remained negative in 2016 (-1.2% year on year). However, the greatest negative impact came from the sharp acceleration of the decline in exports in the watch industry (-11.1%).

Export momentum as a measure of short-term export dynamics

The picture of strongly diverging dynamics is confirmed by so-called export momentum that we are now also calculating at sector level (see Figure). This indicator compares the weighted average of (seasonally-adjusted) exports of the past three months with that of the past six months and in doing so enables a statement to be made about short-term export performance. A figure above zero signals an upward trend and vice versa. Of the largest export sectors, the chemical and pharmaceutical industry recovered quickest from the franc shock. Its export momentum has remained continuously in positive territory since the fall of 2015. The trend reversal in the engineering and electrical industry did not take place until early 2016. Meanwhile, the watch industry has been on a downward path since spring 2015.

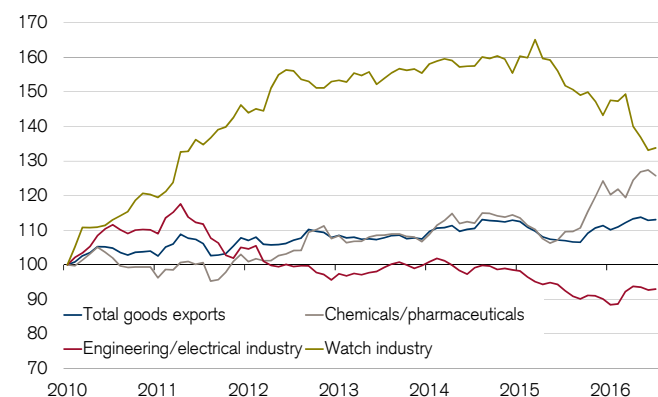
Swiss exports set to grow further

Altogether we expect a further growth of Swiss exports in the next few months. The chemical and pharmaceutical industry will remain the main driver thanks to strong demand for pharmaceuticals in particular from the USA. The decisive factor for the further course of business in the cyclical engineering and electrical industry will be the economy in its main sales markets. Moderately positive momentum is currently coming from the global environment. However, many uncertainties remain for the watch industry, among others with regard to the development of the economy in China and its influence on the travel and spending behavior of Chinese consumers.

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Pharmaceuticals driving Swiss export growth in 2016

Nominal exports, seasonally-adjusted, three-month average, index Jan. 2010 = 100



Source: Swiss Customs Administration, Credit Suisse

Watch industry under pressure since spring 2015

Nominal exports, seasonally-adjusted, export momentum*

Export momentum*	10/2014	11/2014	12/2014	01/2015	02/2015	03/2015	04/2015	05/2015	06/2015	07/2015	08/2015	09/2015	10/2015	11/2015	12/2015	01/2016	02/2016	03/2016	04/2016	05/2016	06/2016	07/2016
Chemicals/pharma	0.3	0.4	0.2	-0.3	1.1	0.8	2.0	1.9	0.1	0.3	0.8	1.1	3.2	2.2	3.6	0.7	1.1	1.2	2.0	2.2	1.1	0.3
Engineering/electrical	-0.1	-0.0	-0.5	-0.3	1.1	-1.5	-0.8	-0.5	1.3	-1.5	-1.4	-1.6	-0.3	0.6	1.6	-1.2	-0.2	1.5	0.9	0.0	0.7	0.6
Watch industry	0.4	0.2	-1.9	1.8	0.6	0.3	0.0	-0.4	-1.3	-2.1	-1.1	-1.6	-1.1	-1.4	-0.0	1.0	-0.2	-1.4	-2.4	-2.3	-3.1	-1.7
Precision instruments	0.9	1.1	0.7	0.3	-0.9	-0.3	-0.1	-0.5	-1.3	-0.8	0.1	-0.5	0.1	-0.0	-0.9	0.6	1.0	0.7	1.1	1.2	1.0	1.0
Metal industry	0.7	0.7	0.2	-0.4	-1.1	-1.3	-1.1	-0.7	-1.4	-1.4	-0.6	-1.0	-0.5	-0.5	-0.7	-0.2	0.4	0.7	0.7	0.7	0.2	0.9
Jewelry	0.3	1.9	3.6	0.1	3.2	-0.9	0.7	1.3	-0.4	-0.1	0.8	3.2	-0.9	-0.2	-0.2	3.1	1.7	1.1	-1.1	-0.2	3.5	6.4
Food industry	0.4	-0.2	-0.4	-0.8	-1.2	-1.1	-1.2	-0.8	-1.0	-0.9	0.5	0.8	1.1	1.1	-1.2	0.3	0.5	1.7	0.2	1.9	-0.6	0.6
Vehicle construction	6.6	4.7	4.2	2.5	-0.2	4.6	0.0	-0.7	-1.4	-7.5	-3.3	-3.0	1.5	1.3	-1.9	0.7	0.9	0.7	-0.5	-4.8	-6.8	-3.8
Plastics industry	-0.4	-0.0	0.1	-0.3	-1.6	-2.4	-2.0	-1.6	-1.8	-1.4	-1.2	-0.0	0.6	0.7	0.1	0.2	0.6	0.5	0.4	-0.1	-0.0	-0.1
Textiles/clothing	0.9	1.0	0.8	-1.0	-2.4	-1.3	-0.9	0.8	0.5	0.3	0.3	-0.3	0.4	1.2	0.7	0.7	0.2	0.4	0.8	1.2	0.4	-0.4
Paper/printing	-0.2	-0.5	-0.6	-1.8	-0.9	-3.1	-1.3	-1.5	-3.0	-1.5	-1.0	-1.3	-1.4	0.9	-0.3	-0.2	0.2	0.2	0.3	-0.4	-0.3	-0.2
Total goods exports	0.4	0.5	0.1	0.0	-0.7	-0.9	-1.1	-1.1	-0.7	-0.7	-0.9	-0.4	1.2	0.8	0.4	0.4	0.8	0.9	0.9	0.8	0.0	0.5

*Positive if exponential moving three-month average > exponential moving six-month average

Source: Swiss Customs Administration, Credit Suisse

Sectors I Monitor

Energy supply

Pressure on Swiss electricity producers is holding up. With energy wholesale prices already having dropped at the start of the year due to falling commodity prices, they declined further over the last three months (May to July 2016: -9.0% YoY) and in doing so reached new lows. The prices achieved on the wholesale market so far in 2016 are on average around 40% below the cost price of a medium-sized Swiss hydroelectric power station. The markets (measured in terms of the prices on the futures market) are currently not expecting a recovery of European energy wholesale prices in the next three years.

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Retail trade

After the situation in the retail trade had eased slightly in the first quarter of 2016, the second quarter proved sobering: Nominal sales were 1.7% below their prior-year level. Part of this downturn was caused by the cold and wet weather that above all afflicted the clothing (-8.3%), leisure (-5.8%) and do-it-yourself (-4.3%) segments. Altogether, non-food sales were 3.0% and food/near-food sales 0.5% down on their prior-year level. A positive signal comes from the fact that shopping tourism in the first half of 2016 stabilized at the level of 2015. We expect a slight easing in the retail trade in the next few months.

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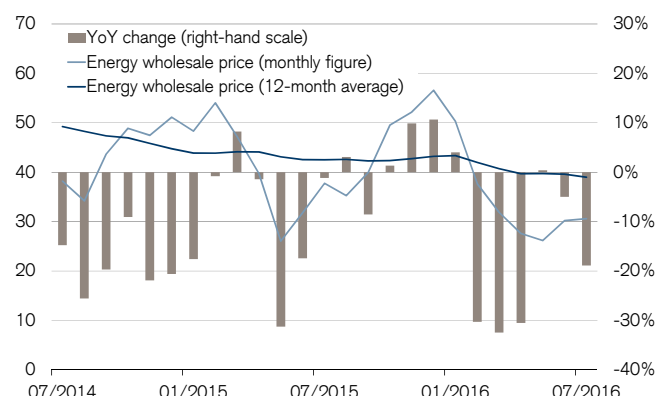
Tourism

The tourism industry has been struggling with falling numbers of overnight stays for over a year. Ongoing fears of terror attacks particularly kept tourists from Asia away (April to June 2016: -5.6% YoY). The strong franc remained responsible for declining hotel stays from Europe (-1.0%) and owing to the mixed weather in the early summer, Swiss guests also failed to deliver any growth momentum (-1.7%). The situation was further exacerbated by lower prices (January to July 2016: -2.4% YoY) that additionally reduced the sales of hoteliers. We expect the business situation in the hotel industry also to remain difficult in the months to come.

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Energy wholesale prices fall to all-time low in 2016

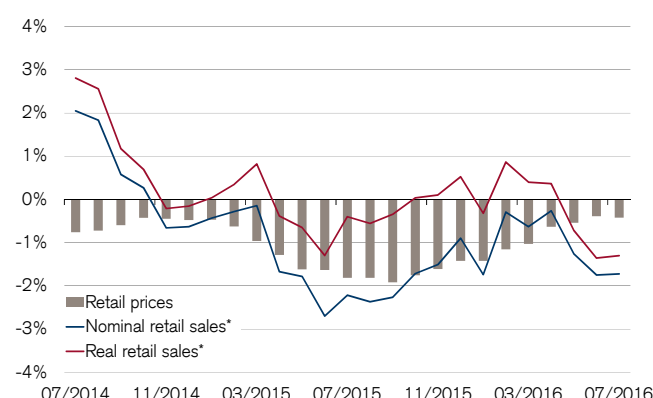
Average spot market price for base load electricity (SwissIX) in CHF/MWh



Source: European Energy Exchange, Credit Suisse

Downturn in Q2 2016 partially caused by the weather

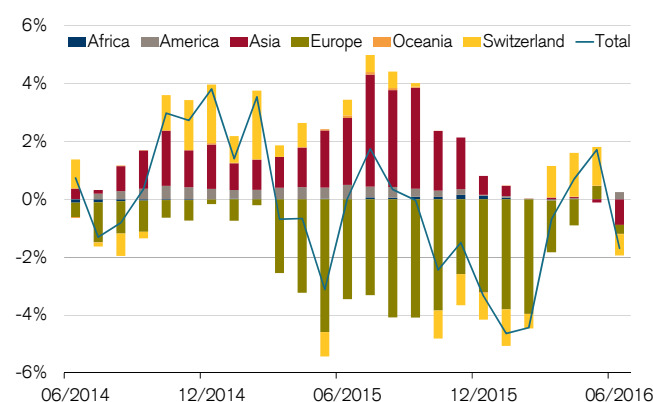
Moving three-month average, YoY change in %



Source: GfK, Swiss Federal Statistical Office, Credit Suisse; *calendar-adjusted

Still no light at the end of the tunnel

Overnight stays: Three-month average of growth contributions by continent



Source: Swiss Federal Statistical Office, Credit Suisse

Debate on migration and the working population

Demographic arithmetic

Implementation of the initiative against mass immigration will influence immigration to Switzerland. Our model calculations show how this will affect the working population.

Implementation of mass immigration initiative: Time is pressing

The debate about the implementation of the mass immigration initiative (MII) has entered crunch mode in recent weeks. According to the constitution, the initiative needs to be implemented by 9 February 2017 and in view of the late stage in the proceedings, there is astonishingly little of a tangible nature on the negotiating table. Having said this, the solution recently presented by the Political Institutions Committee of the National Council does offer a clear strategic direction. The draft bill favors upholding the Bilateral Agreements with the European Union (EU) over a literal and narrow interpretation of the constitution. The core of this proposal comprises a protective "light" clause based on improved exploitation of the domestic workforce potential and a compulsory job reporting requirement for employers when certain threshold values are exceeded. Should these two instruments fail to achieve the desired effect, the Federal Council can implement corrective measures but these must be unanimously agreed with the EU. In the next step, the National Council will discuss the bill in the forthcoming fall session and at the time of going to press the next important meeting of the President of the Constitution with EU Commission President Juncker was scheduled for 19 September.

Immigration to Switzerland affected

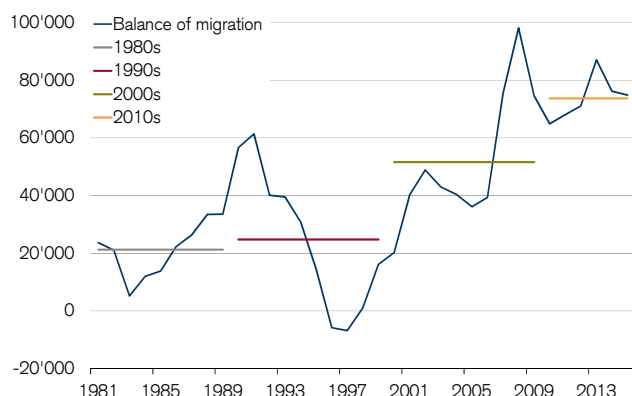
Whether annual quotas, priority for Swiss nationals or a protective clause in the event of serious economic or social problems is ultimately decided or whether the Bilateral Agreements are to be discontinued, one thing is certain: Implementation of this initiative will exert an influence on immigration to Switzerland. This in turn will affect the availability of labor and population growth in Switzerland. Migration is currently contributing more than 80% to population growth and making a decisive contribution to workforce potential, as half of the immigration flows comprise economic migration. There is much uncertainty about the future scale of immigration, not just due to the forthcoming implementation of the MII. Nevertheless, in order to gain an idea of how restrictions on immigration would affect Switzerland's working population, we have carried out model calculations based on different migration assumptions.

Five scenarios for the development of the working population

To highlight the migration effect, the individual scenarios differ exclusively in terms of their migration components (see box on next page). Age and gender-related labor participation is kept constant at its current level throughout the entire forecast period.

Net migration to Switzerland is slowing down

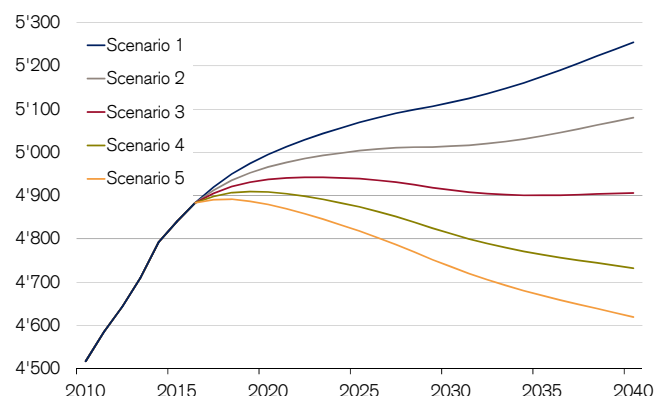
Balance of migration of usual resident population with multi-year averages



Source: State Secretariat for Migration, Swiss Federal Statistical Office, Credit Suisse

Five scenarios for the working population

Working population aged 15-74 in thousands



Source: Swiss Federal Statistical Office, Credit Suisse

Scenarios for the working population in Switzerland: Hypotheses

The working population of a country comprises the population of working age (15 to 74 years) as determined by demographic developments and its participation in the labor market as measured by the labor participation rate. Multiplying these two variables results in the number of persons participating in the labor market, i.e. the working population. A gradual reduction in net migration (in terms of the number of persons) is assumed for all scenarios, with the following annual benchmark figures applying:

Scenario	2017-2020 average	2030	2040
Scenario 1	60,000	50,000	50,000
Scenario 2	50,000	40,000	40,000
Scenario 3	40,000	30,000	30,000
Scenario 4	30,000	20,000	20,000
Scenario 5	20,000	15,000	15,000

It is also assumed for all scenarios that age and gender-related labor participation will remain constant at the level of 2015.

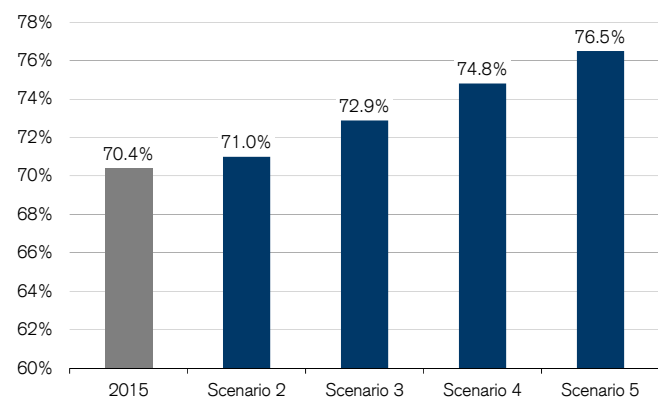
Scenarios 1 and 2 assume less restrictive implementation of the MII. Net migration only decreases gradually in these scenarios and in the years 2017 to 2020 reaches an average of 60,000 and 50,000 persons per year respectively. This development is in line with the slowdown in migration to Switzerland that has been observed for two years and that is explained on the one hand by the slower employment growth in Switzerland and on the other by the improved labor market situation in the countries of origin, above all Germany (see Figure). In scenario 3, net migration to Switzerland falls to an average of 40,000 persons between 2017 and 2020 and levels out at 30,000 persons per year by the year 2030. Strong restrictions on immigration can only be assumed for scenarios 4 and 5 where the balance of migration declines to an average of 30,000 and 20,000 persons respectively in the period from 2017 to 2020 before subsequently stabilizing at 20,000 and 15,000 persons respectively. This would see net migration to Switzerland falling to levels last seen in the 1980s and 90s.

Slowdown in growth of working population across all scenarios

Growth of the working population will slow down in all scenarios in the next few years and already grind to a halt in 2020 even based on the assumption of relatively modest restrictions on migration (scenario 3). Even if we assume that the balance of migration stabilizes at 40,000 persons per year from 2030 (scenario 2), which is equivalent to the long-term average of the past 35 years, the working population will cease to grow from this point at the latest.

Female labor participation almost at male level

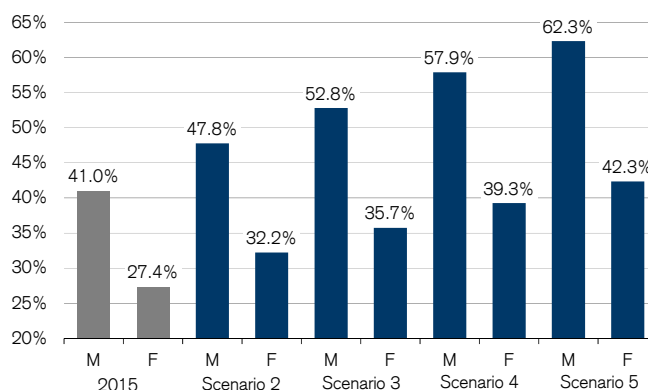
How much would the labor participation rate of women (15-74 years) have to rise to maintain the working population at the level according to scenario 1 by 2025?



Source: Credit Suisse

More than half of pensioners would have to work

How much would the labor participation rate of older people (60-74 years) have to rise to maintain the working population at the level according to scenario 1 by 2025?



Source: Credit Suisse

If net migration were only to average 20,000 persons per year in the next few years (scenario 5), the working population would already start to fall from 2019. Only if we assume a long-term balance of migration of 50,000 persons per year will the working population continue to record positive growth until 2040. However, even with this scenario the aging population takes its toll, with growth of the working population slowing from 1% at present to 0.3% in 2040. In other words, the rejuvenating effect of immigration is able to ease the impact of the aging population on workforce potential somewhat but not to offset it.

Relief by increasing labor participation...

One obvious recipe for averting a slowdown in growth or even a decline in the working population is to increase labor participation. There has been frequent talk in the discussions about implementing the MII of increased mobilization of the domestic workforce potential. The focus is placed here on the labor participation of women and extending working life beyond the currently prevailing retirement age. These two solutions face several obstacles. The labor participation of women cannot easily be increased in the long term without flexible working time models, affordable childcare provision and an alleviation of the negative tax incentives for second earners. Older employees are not infrequently discriminated by the ongoing youth-centric human resource policy of companies and today's pension system still takes too little account of the increase in life expectancy, particularly in the case of good health.

Age leading to a decline in the average labor participation rate

Because the labor participation rate of individual persons varies over their life cycle, the average labor participation rate of a population also tends to reflect demographic changes. The participation rate typically reaches its peak in the group of 25 to 54-year-olds and is lower for younger and older population groups. If a generation moves into the next age group with different labor participation, this demographically entails a change in the average labor participation rate. In this respect the movement of the baby boom generation along the age structure will result in a decline in the average participation rate in the next few years as long as the age-specific participation rates remain unchanged.

...but how much would the participation rates have to rise?

Regardless of the feasibility of such an increase in labor participation, it is interesting to know how much the participation rates of individual population groups would actually have to rise in order to keep the working population on course for growth. To this end we have simulated how high the participation rates of women and older employees aged between 60 and 74 would have to be in order to keep the working population at the level of scenario 1, the scenario with the strongest growth momentum, until the year 2025. The participation rates for 2015 serve as benchmarks.

According to our simulations, the labor participation of women would have to increase by between 0.6 and 6.1 percentage points depending on the scenario and in scenario 5 would almost reach the level of men (see Figure). If we apply this increase to the current population of women of working age, it would entail between around 20,000 and 195,000 women more on the labor market. If the offsetting burden were to lie entirely on the shoulders of older employees aged between 60 and 74, the participation rate of women would have to rise by between 4.9 and 14.9 percentage points and that of men by between 6.7 and 21.3 percentage points (see Figure). This means that in the year 2025 more than half of men aged 60 to 74 and a good third of women in the same age group would have still to be active in the labor market.

Work more or become more productive

It is difficult to say at present in what form the mass immigration initiative will be implemented and what implications this will have on immigration flows to Switzerland. However, whatever the outcome, there are only a few ways of averting a downturn in the country's workforce potential. We have attempted to show in this analysis what would be necessary in terms of labor participation. Another (additional) option would be to focus on increasing productivity. Appropriate measures can no longer be put off for long in either case.

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Monetary Policy

SNB balance sheet and regulation

New banking regulations will, in our view, indirectly force the SNB and other central banks to keep the size of their balance sheets much higher than before the global financial crisis.

Regulatory requirements may become a constraint on central banks' balance sheets

Within the so-called Basel III framework, banks are required to hold highly liquid assets in order to minimize the risks of illiquidity in the event of substantial withdrawals of selected customer deposits. To meet this requirement (referred to as the liquidity coverage ratio or LCR), regulators have essentially identified two types of asset (referred to as high-quality liquid assets or HQLA): banks' deposits with central banks (reserves) and debt instruments of high-quality issuers such as central banks, sovereigns or supranational organizations.

The SNB is the main provider of liquid assets in Switzerland

In Switzerland, where the LCR has been gradually implemented since 1 January 2015, our very rough estimate suggests that the Swiss banking system requires as much as CHF 250 bn of liquid assets. Currently, most banks meet their LCR requirements by holding reserves at the Swiss National Bank (SNB). Notwithstanding the banking regulation, the size of the SNB balance sheet and therefore the amount of banks' reserves held at the SNB has already increased substantially over the last few years due to the central bank's foreign currency purchases. There is therefore no risk of a supply shortage of CHF HQLA at present. However, excluding reserves held at the SNB, we believe that the market for CHF HQLA is too small in relation to the estimated needs to prevent market disruption. In fact, the current market value of debt instruments in CHF potentially recognized as HQLA is around CHF 360 bn. However, around half of this comprises a type of HQLA that can be used only up to a certain limit and on which a "haircut" is applied, i.e. they can only be recorded below their market price. Moreover, institutional investors, such as pension funds and insurance companies, also typically hold large amounts of these assets (although not for regulatory purposes), thereby further limiting their supply.

The SNB could at any time need at least CHF 400 bn on its balance sheet

At some (still distant) point in the future, monetary policy normalization through balance sheet reduction could conflict with the demand of banks for reserves at the SNB so that the supply of these reserves becomes a new constraint on the size of the SNB balance sheet. In order to ensure a sufficient supply, we believe that the size of the SNB balance sheet is likely to have to remain significantly larger than its pre-crisis level regardless of the course of monetary policy. Indeed, to avoid disruption of the CHF HQLA market in a situation in which demand in the market exceeds supply, we believe that it would be necessary for the SNB at any time to be able to step in as a supplier of the required quantity of liquid assets for the Swiss banking system, with the banks obviously left free to decide which assets they wish to use to meet their LCR requirements. Taking into account other SNB balance sheet items such as banknotes (currently around CHF 70 bn) and equity capital (CHF 80 bn), this means that the size of the SNB balance sheet should not be allowed to drop below CHF 400 bn or 60% of Swiss GDP. This suggests that the minimum SNB balance sheet would be around four times its pre-crisis level.

Foreign exchange reserves are set to remain substantial, even in the long term

This implies, firstly, that the SNB will have to maintain a large balance sheet regardless of its monetary policy stance. However, it could still tighten monetary policy if needed, for instance by issuing debt certificates (so-called SNB bills) which would reduce money supply; SNB bills would also qualify as liquid assets. Secondly, it puts the current size of the SNB balance sheet (around CHF 690 bn or 108% of GDP) into perspective. While still very large, it should be compared to the "new normal," i.e. CHF 400 bn, and not to its pre-crisis level. Thirdly, foreign exchange reserves, which are on the asset side of the SNB balance sheet, are set to remain substantial, even in the long-term. Finally, the SNB's earnings will remain volatile and dependent on the exchange rate, implying uncertain profit distribution for the cantons and the federal budget.

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Money, Credit and Markets I Monitor

SNB equity capital

After recording a loss of more than CHF 50 bn in January 2015 that wiped out 60% of its equity capital, accumulated profits since mid-2015 have allowed the SNB to replenish its reserves. We estimate that the SNB needs at least CHF 63 bn in equity capital to distribute CHF 1 bn to the cantons and the federal budget (assuming the conditions of distribution remain unchanged). At more than CHF 80 bn, the current chances of profit distribution are good. Nevertheless, the SNB's profit is dependent on financial market volatility and therefore remains difficult to predict accurately.

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Currency in circulation

As a negative interest rate cannot be introduced on banknotes and coins (at least not easily), a risk associated with the central bank's negative rate policy is the rise in demand for paper money in order to avoid the negative rate. In Switzerland, such an increase is clearly visible although it goes back to before the introduction of negative interest rates by the SNB. Nevertheless, demand for physical cash has increased further since the introduction of such rates. However, it is uncertain whether this trend is related to the negative rates. In Denmark and Sweden, where the respective central banks have also imposed negative interest rates, no such rise in currency in circulation is visible.

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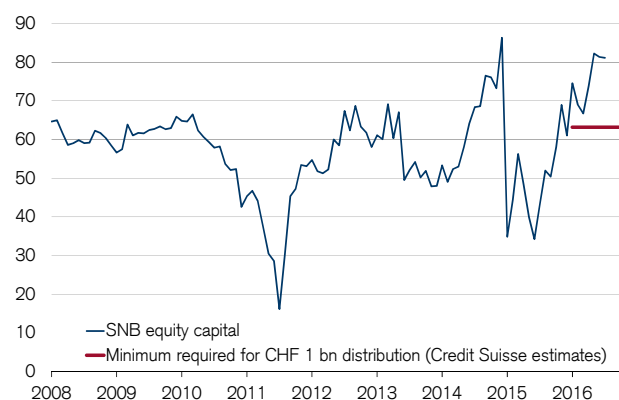
Payments with cards

One reason for the aforementioned diverging trend in currency in circulation despite negative interest rates is probably related to payment habits. In Switzerland, the use of cards for payments is lower than in the Eurozone, and even more so than in Sweden and Denmark. It is therefore not surprising that currency in circulation is higher in Switzerland. The preference for paper money in Switzerland is also reflected in the number of ATMs: While in Sweden and Denmark there are only 333 and 448 ATMs per million inhabitants respectively, Swiss payment service providers operate 827 ATMs per million inhabitants.

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SNB's loss of January 2015 almost regained

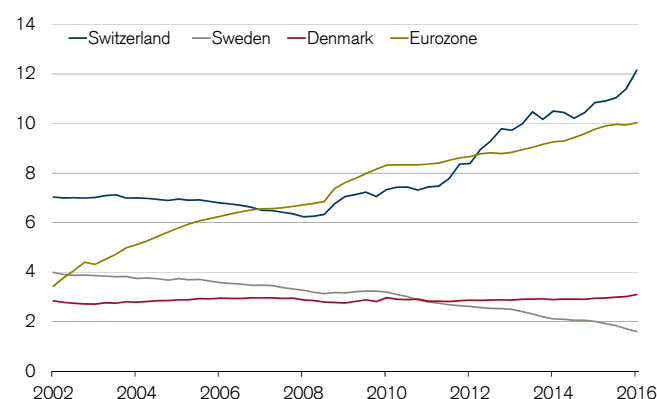
In CHF bn



Source: Swiss National Bank, Credit Suisse

Paper money is very popular in Switzerland...

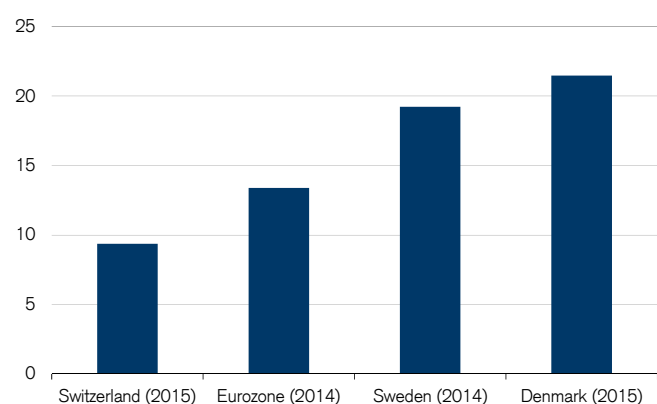
Currency in circulation, as % of GDP, seasonally adjusted



Source: Datastream, Credit Suisse

...but plastic money less so

Payments with cards, as % of GDP



Source: Central banks, Datastream, Credit Suisse

Bonds

Due to the ongoing loose monetary policy of the central banks we expect the low interest rate environment for government bonds to prevail. Corporate bonds are also receiving strong support, in EUR and GBP even in direct form from the European Central Bank (ECB) and the Bank of England (BoE). This additional demand is set to continue for some time. We see value potential in financial bonds and subordinated bonds denominated in euros and especially also for emerging market bonds, particularly since we are now assessing emerging market currencies more positively.

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Currencies

EUR/CHF traded in a narrow margin between 1.08 and 1.10 over the past month. Demand for secure investments has fallen significantly in the wake of the Brexit vote in the UK. Furthermore, the Federal Reserve is preparing the markets for an interest rate hike before the end of the year. All this is reducing the appreciation pressure on the Swiss franc. Should volatility remain low in the next few weeks, EUR/CHF should continue to trade at levels of around 1.09 even without any intervention by the SNB.

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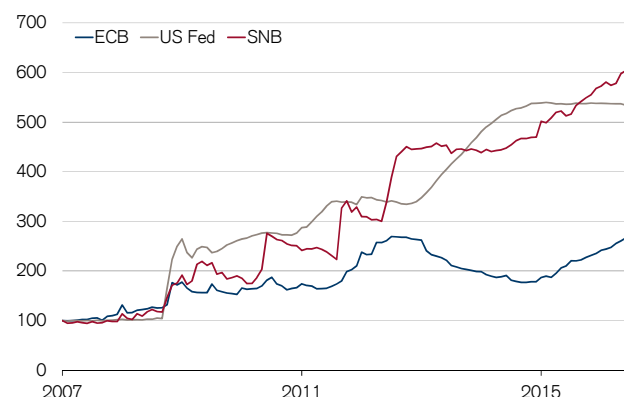
Equities

In the event of a correction on the equity markets, the Swiss market should prove relatively stable owing to its defensive characteristics. While global equities appear expensive compared to the last ten years, various key valuation figures for Switzerland are still relatively low. We also expect the relatively loose monetary policy of the SNB, a continuation of the recovery in the Eurozone on the back of domestic demand and the above-average dividend yields in the Swiss market to remain positive drivers.

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ECB expands its balance sheet further

ECB balance sheet, assets, in EUR trillions



Source: Datastream, Credit Suisse

Swiss franc stable in July

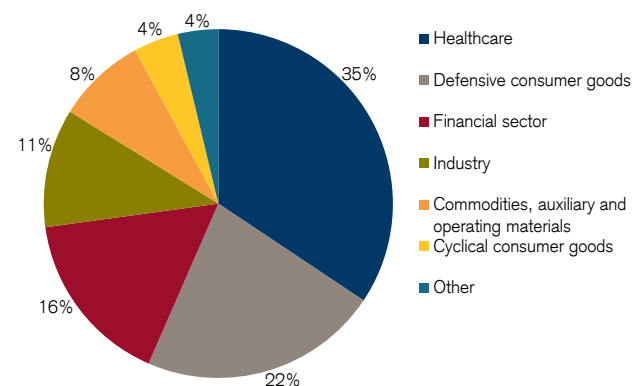
EUR/CHF exchange rate



Source: Bloomberg, Credit Suisse

Overweighting of defensive sectors

SPI sector composition, 6.9.2016



Source: FactSet, Credit Suisse

Regions

Locational quality: City of Basel set to overtake Canton Zurich

Corporate Tax Reform III will entail a restructuring of the Swiss tax system. The attractiveness of the individual cantons will in future increasingly be determined by their ordinary tax rates on profits. The City of Basel, Vaud and Geneva are rolling up the field from behind in terms of their attractiveness.

Corporate Tax Reform III (CTR III): the big changeover

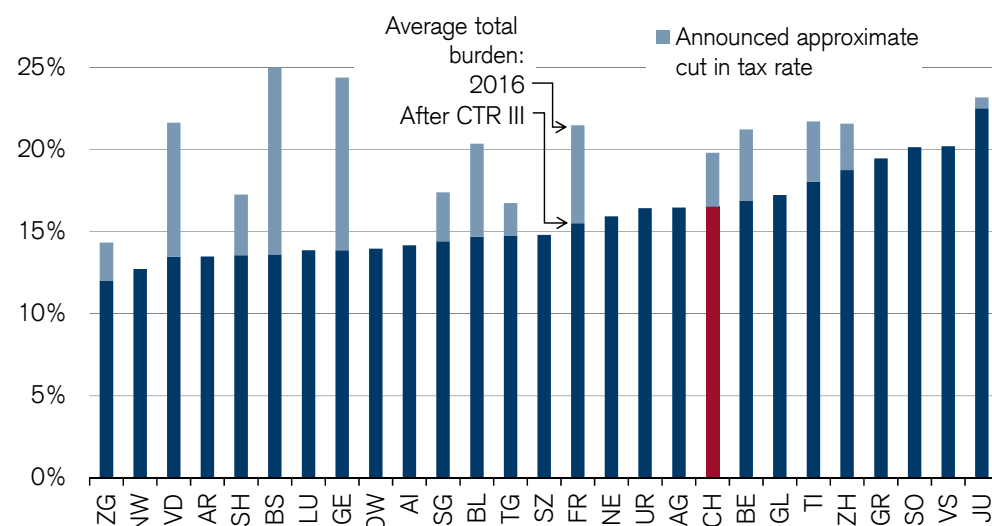
Parliament approved the bill for the third reform of corporate taxation (CTR III) in June 2016. The reform is intended to bring corporate taxation into line with the prevailing international standards. Holding and management companies (special status companies) whose revenues and costs are largely incurred abroad currently enjoy considerable tax relief or even tax exemption. This unequal taxation of earnings generated in Switzerland and abroad will no longer be permissible in the future. Instead, new privileges (in particular the patent box and the promotion of research and development) are to be introduced at cantonal level that are also recognized abroad. However, many companies are unlikely to be able to benefit from these new tax incentives. The cantons therefore increasingly need to safeguard their fiscal attractiveness via their ordinary tax rates on profits.

CTR III will bring movement to the cantonal ranking

The majority of cantons have meanwhile announced the scale of ordinary tax rates on profits envisaged in the future. Based on the adjustments to taxes on profit and capital announced by the beginning of September 2016, we have recalculated the tax burden of legal entities (see Figure). Various cantons are reviewing an adjustment of their tax rates but have not yet made any specific statements. Furthermore, tax cuts in most cantons have to be approved by the electorate. The positions of the cantons are therefore set to change.

CTR III: Zug heading for the top, Geneva and Vaud making major advances

Overall burden* of taxes on profit and capital, as % of net profit, 2016 and taking into account the adjustments to corporate taxation already communicated by the cantonal governments



Source: TaxWare, cantons, Credit Suisse

* Average costs before taxes for a joint-stock company with capital of CHF 2 million and net profit between CHF 80,000 and CHF 1,040,000

City of Basel, Vaud and Geneva climbing sharply up the rankings, Zug now also top in terms of corporate taxation

Zug intends to reduce its tax rate on profits to 12%, which would put it in top position also among legal entities, followed by Nidwalden which currently comes top. In Western Switzerland and the City of Basel – the location of a large number of companies enjoying privileged taxation – corporate taxes are to fall particularly sharply. The reduction of the tax rate on profits to 13.79% approved by the electorate of Vaud will catapult the canton to third position. The rate in Geneva is to fall to 13.49%, which in the ranking of the overall tax burden (including taxes on capital) puts it in eighth position. The City of Basel intends to reduce its profit tax rate to 13%. In addition, the relatively high current tax rate on capital of 5.25 per thousand is to be cut to 1 per thousand. All in all this will enable the currently bottom-placed canton to jump 20 places to sixth position.

Tax burden for companies in Berne and Zurich will remain above average

Zurich and Berne are among the cantons where a larger share of tax revenue is attributable to companies subject to ordinary taxation. A reduction of the ordinary tax rates to the level of the least expensive cantons would accordingly result in considerably larger revenue shortfalls from the ordinary tax payer. The Canton of Zurich therefore intends only to reduce the cantonal tax on profits from 8% to 6%. With a maximum profit tax burden of around 18.2%, this will also make it one of the less attractive cantons fiscally in the future. Meanwhile, the Canton of Berne is considering scenarios with profit tax burdens of 16.37% and 17.96% respectively.

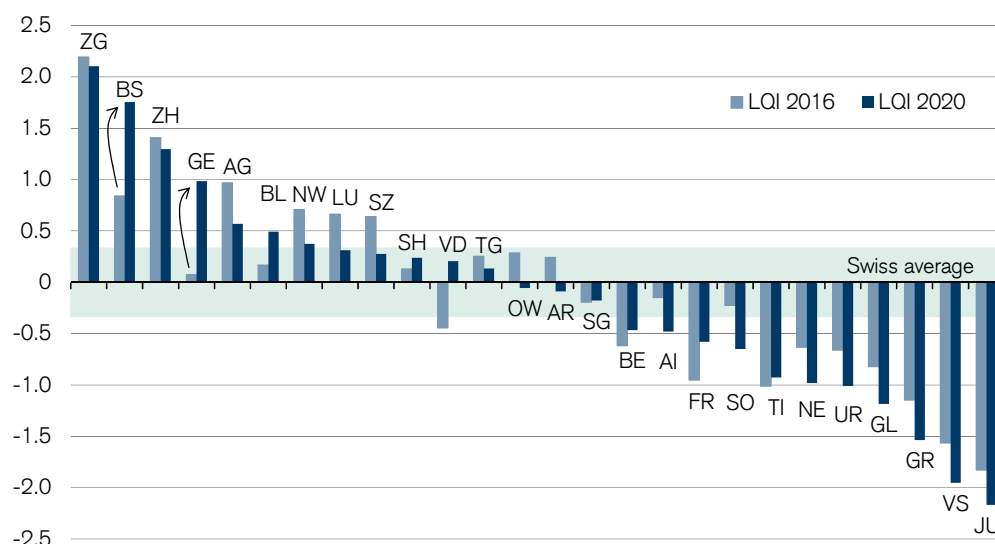
Locational quality outlook for 2020

Cuts in ordinary tax rates on profits increase locational quality. In addition, the complete opening of the New Transalpine Rail Link (NEAT) from 2020 will improve the reachability of Central and Southern Switzerland. Taking into account these substantial changes, we venture to cast an outlook on locational quality in the year 2020 (see [regional study 2016 Locational Quality, Credit Suisse, September 2016](#)). The greatest gains in ranking are recorded by the cantons of Geneva (+9 positions), Vaud (+6) and Basel-Landschaft (+5). These cantons are able to offset the current drawback of high corporate taxes and therefore advance forward in terms of locational quality. While the Canton of Zurich has ranked second since we started measuring locational quality, it is now overtaken by the City of Basel and pushed down to third position.

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Comparison of the locational quality of the Swiss cantons in 2016 and 2020

Locational Quality Indicator (LQI), synthetic index, Swiss average = 0, 2016 and following recalculation of partial indicators for reachability and the tax burden of legal entities



Source: Credit Suisse

Regions | Monitor

Gross domestic product by economic region

Gross domestic product (GDP) per employee enables a statement to be made about the productivity of persons employed in an economic region, i.e. the value creation intensity of companies based there. There are major productivity differences between the economic regions: The Zug region of Lorzenbene/Ennetsee, the City of Basel and Fricktal, the City of Zurich and its surrounding regions as well as Schaffhausen achieve the highest scores. Employees in these regions generate almost twice as much value creation intensity as those in the least productive regions of Entlebuch and Schanfigg.

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Commuter deductions

Some cantons are becoming more expensive for commuters. When approving the bill for the project to fund and expand the rail infrastructure (FERI), the electorate voted for a limit on the commuter deduction on direct federal tax of CHF 3,000. Now the cantons can decide for themselves also to introduce such an upper limit. Around half the cantons have already made use of this opportunity. Limiting the commuter deduction there is generally part of a broader cantonal package of savings measures. However, other cantons, above all rural ones, have deliberately rejected any limit.

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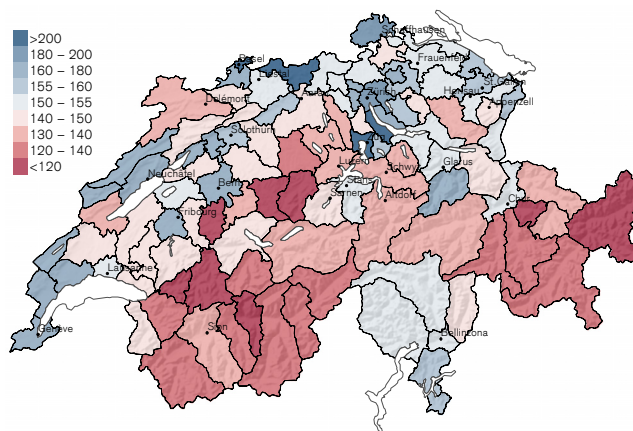
Congestion hours on main roads

The overburdening of the road network impairs reachability. The sharp population growth of recent years and rising mobility needs per inhabitant have caused the number of congestion hours to shoot up since 2008. The A1 is the most congested route. As well as technical measures and capacity expansions here and there, politicians need to review economic traffic management measures, with mobility pricing the key word here. This would enable more efficient capacity utilization of the existing infrastructure to be achieved.

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Zug, Zimmerberg and City of Basel at the top

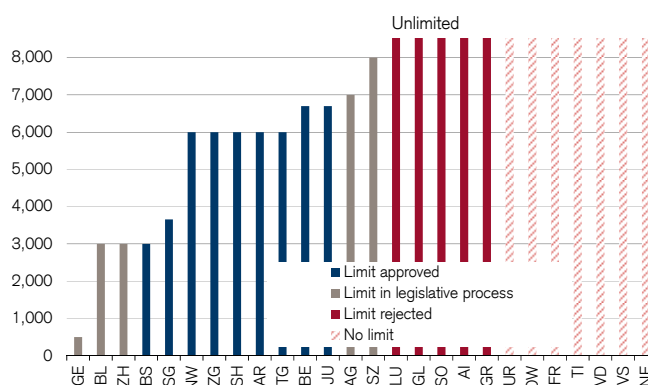
Gross domestic product per employee, in CHF 1,000, 2013



Source: Swiss Federal Statistical Office, Credit Suisse

Commuter deductions shaped by major cantonal differences

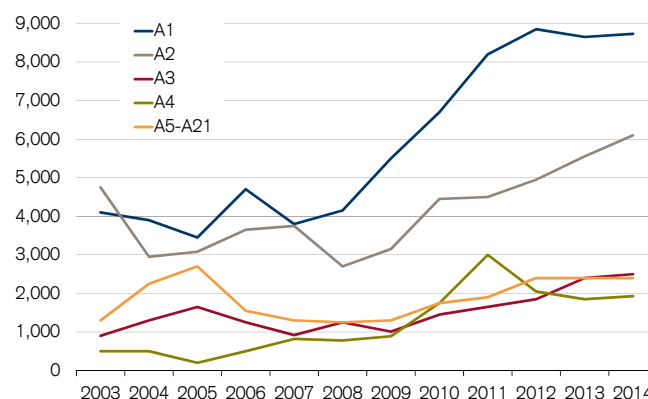
Commuter deductions in CHF, August 2016



Source: Cantons, Credit Suisse

Overburdened roads reduce locational quality

Development of annual congestion hours, by main road



Source: Viasuisse, Federal Roads Office, Credit Suisse

Economic Policy Agenda

Brexit vote: glance into the unknown for Switzerland

For Switzerland, the medium to long-term consequences of the Brexit vote remain uncertain. The negotiations with the EU are likely to prove even more difficult in the short term. The Swiss population generally sees benefits for the economy and politics.

Major uncertainty about long-term consequences

While the short-term turbulence following the Brexit vote has largely been overcome, the potential long-term – positive and negative – consequences are a matter of speculation. There is considerable uncertainty in view of the need to redefine the relationship between the European Union (EU) and the United Kingdom. However, negotiations are not likely to be formally opened until 2017 and could last for several years.

Limited direct impact on the Swiss economy

The direct impact of Brexit on the Swiss economy is likely to be limited as long as there is no marked slowdown in growth in the Eurozone. Swiss exports to the United Kingdom only account for around 6% of overall exports and half consist of pharmaceuticals that are less sensitive to economic and exchange rate developments. The Swiss population canvassed within the scope of the Credit Suisse Worry Barometer is optimistic and generally sees benefits for the Swiss economy.

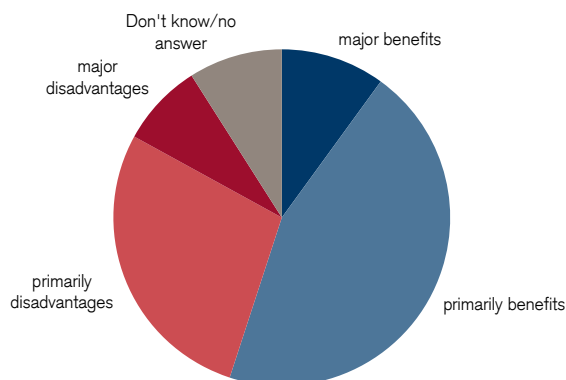
Limited strengthening of Swiss asset management as a 'safe haven'

Prolonged uncertainty in Europe and a strengthening of the Swiss franc brought about by this would strengthen Switzerland's position as a 'safe haven' in asset management although this is also likely to cause hopes of an imminent turnaround in the interest environment to disappear. However, such a scenario only appears realistic in the event of a further fragmentation of the EU or the European Economic Area (EEA) or in an extreme case of the euro itself. It is also highly questionable whether the Swiss financial center would be able to benefit on a large scale if financial institutions were to relocate their branch offices in order to retain access to the market. It is more likely that they would resettle in other financial centers within the Eurozone such as Frankfurt and Paris or Luxembourg and Dublin (for funds) and Berlin (Fintech). Many players already have branches there and above all the question of market access is settled, which is not the case in Switzerland.

Swiss largely see benefits for the economy due to the Brexit vote

"The UK has voted in the so-called Brexit referendum to leave the EU. Will this bring the Swiss economy ..."

% of voters

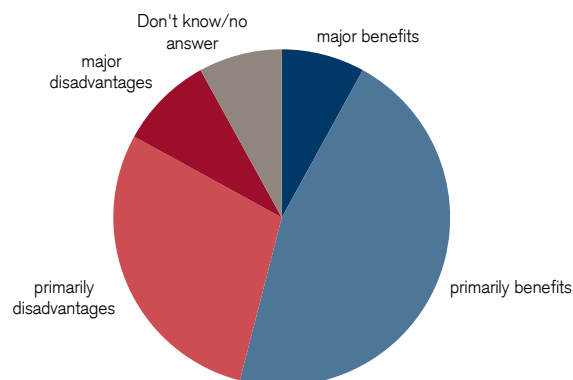


Source: Credit Suisse Worry Barometer

Voters expect improved Swiss negotiating position versus the EU

"And how will the UK's decision influence Switzerland's policy toward the EU? Will this bring Switzerland's negotiating position versus the EU ..."

% of voters



Source: Credit Suisse Worry Barometer

Future market access a key success factor for the UK's financial sector

Brexit essentially offers the UK the opportunity of greater differentiation potential for more business-friendly and above all bank-friendly regulation. Improvements are conceivable for making better use than today of the potential for business with third countries outside the EU. For instance, targeted measures around the renminbi hubs or the trust business would be very much possible. However, just like for Swiss banks, EU market access will also ultimately be a key requirement for British financial institutions. The decisive question here is whether or not the UK will become a normal third country. The answer depends on whether the country does indeed limit the free movement of persons with the EU. Full participation in the European Single Market seems barely conceivable without the free movement of persons. However, there are clear signs that the new government under Theresa May intends to respect the will of the people and impose restrictions on the free movement of persons. This is likely to turn the United Kingdom into a normal third country that would have to endeavor to achieve market access (in the area of financial services) by means of equivalence.

The UK as a standard for the recognition of equivalence

The recognition of equivalence is an instrument for granting international companies market access to the EU as long as they are subject to an equivalent foreign regulatory and supervisory framework. From the perspective of the EU this path also taken by Switzerland would in future assume a much more prominent role in such a scenario, with the UK likely to become a benchmark for further recognitions of equivalence in the field of financial services. London would have no problem in reaching third country agreements with the EU on an equivalent regulation as until the time of departure the country will not only have equivalent but EU-compliant regulations. The United Kingdom should also achieve equivalence on new regulations much more easily thanks to this 'super-equivalent' basis than other third countries such as Switzerland, particularly since the gaps to be overcome would be significantly smaller, at least in the initial years after Brexit. For this reason and owing to the increased significance of the equivalence issue for the EU, it is to be expected that its approach to third countries in this scenario will in future be handled more strictly.

Difficult Swiss negotiations with Brussels

This will not make the challenge for the Swiss negotiators any easier. It can instead be argued that Switzerland's negotiating position has been made worse by the Brexit vote. The EU is set to be preoccupied with withdrawal negotiations with the UK in the next few years. By contrast, resolving the mass immigration issue with Switzerland will not be a matter of priority for the EU. Moreover, every concession to Switzerland could be viewed as a precedent for the UK or at least be analyzed in terms of its implications for these negotiations. However, it can be argued in a more optimistic scenario that the Brexit vote has made clear that the principle of the uncompromised free movement of persons throughout Europe has come under pressure and a different solution is required. In the long term the British referendum vote could even open up new opportunities as the EU may be forced to seek new ways of collaborating with third countries with particularly close economic ties. The majority of the Swiss population appears to share this view.

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Real Estate

Slowdown of residential property market continuing

The price growth of residential property in Switzerland is continuing to diminish. Increasing differences are emerging between condominiums and single-family dwellings.

Major regional differences

Residential property prices in Switzerland increased by an average of 1.3% year-on-year in the second quarter of 2016. Growth thus remains as high as at the end of 2015 but significantly below the average growth since the year 2000 of 3.6%. On a regional basis, a growing gap between the linguistic regions is emerging. Having originally started in the Canton of Geneva, price declines for residential property are now being recorded in virtually all regions of Western Switzerland. Particularly along Lake Geneva the price level has no longer been sustainable for some time, which in recent quarters has led to corrections. Meanwhile, growth around Lake Zurich is also only marginal and the City of Zurich is currently even recording a slight fall in prices. However, a different situation is prevailing outside the high-price regions, where growth rates in some cases exceeding 5% continue to be achieved.

Prices of condominiums falling slightly

While with the exception of Western Switzerland and some tourist regions the prices of single-family dwellings continue to rise (Switzerland as a whole: +2.2%), the prices of condominiums have fallen for the first time since 2003. Almost half of all regions recorded negative growth, especially Western Switzerland and regions in the Cantons of Berne, Ticino and Zurich. On a national average this led to a price drop of 0.5% compared with the prior-year quarter for condominiums.

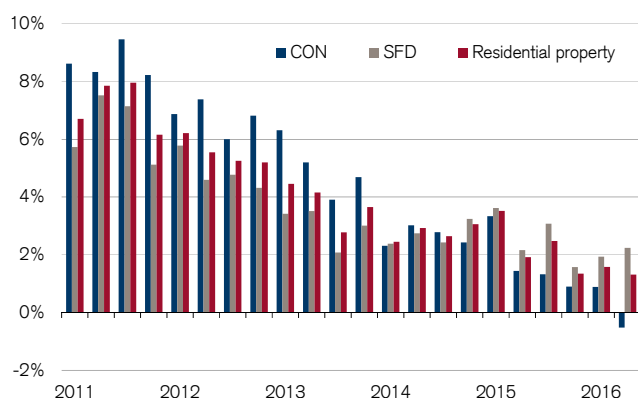
Growth slowdown set to continue

As in the preceding quarters, the price performance of residential property in the second half of 2016 is subject to opposing forces that largely balance each other out. Following the Brexit vote, mortgage interest rates have fallen to new lows in recent weeks. In terms of the financial outlay, ownership has thus become even more attractive compared to renting. The desire to live in one's own four walls remains correspondingly large. However, due to the price level that has been reached and the tightened regulatory measures, the financial requirements for buying residential property are now so high that an increasing number of households are no longer able to afford this despite record low mortgage interest rates. The slowdown in prices is thus set to continue. However, with the exception of Western Switzerland, price drops should remain a rare occurrence.

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Weaker trend in price growth momentum

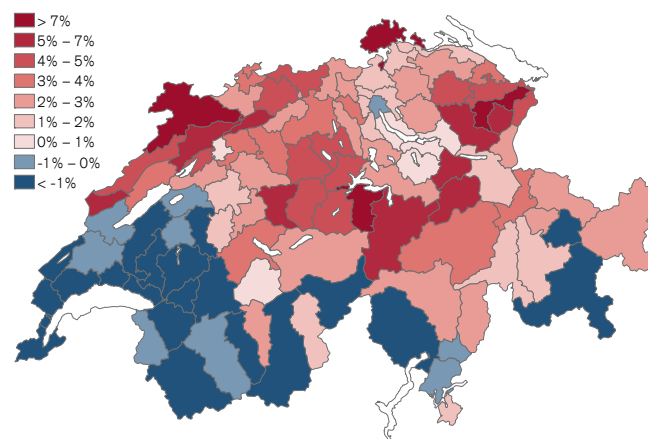
Annual growth rates; CON: condominiums, SFD: single-family dwellings



Source: Wüest & Partner, Credit Suisse

Major regional differences

Price growth of residential property, Q2 2015 to Q2 2016



Source: Wüest & Partner, Credit Suisse, Geostat

Real Estate I Monitor

Rental apartments

The planning of new rental apartments appears to know no limits. The reason for this is investment pressure. Because real estate remains attractive in comparison with most other forms of long-term investment, the planning of new rental apartment projects is flourishing. From July 2015 until June 2016, a new record of almost 28,000 residential units was approved – 14% more than in the previous year. The development of planning applications suggests that approvals are set to rise even further. The risks of an already emerging oversupply are increasing.

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Office property

Because demand for office space is stagnating due to the lack of employment growth and the increase in new office space is comparatively high, there are imbalances to be observed on the office property market. This is reflected not only in vacancies but also in office rents that have been in a phase of consolidation for over four years. At -9% since the peak at the end of 2012, the rent adjustment has been greatest in the Zurich market region. In view of the continued above-average planning of office space, the oversupply situation and pressure on rents are set to persist.

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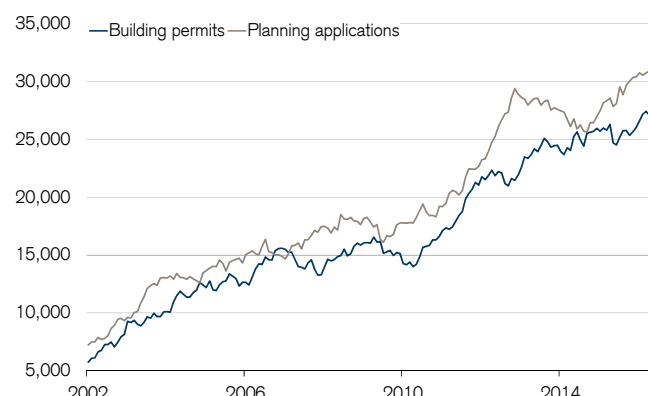
Retail property

The retail trade is unable to escape negative headlines at present. E-commerce and shopping tourism are afflicting the sector and leading to falling sales, shop closures and bankruptcies. The KOF survey illustrates how challenging the profitability situation of retailers is. Apart from one quarter, the majority of retailers have for five and a half years been reporting year-on-year deteriorations in their profitability situation. Demand for retail space is correspondingly weak and the marketing situation very challenging. There is no sign of any easing of the situation in the near future.

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Record planning of new rental apartments

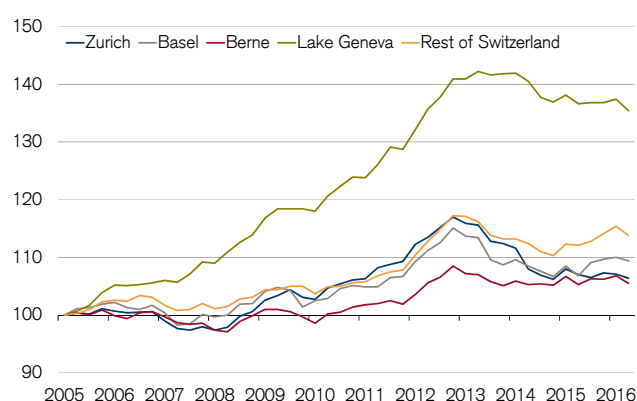
In number of residential units (12-month total)



Source: Baublatt, Credit Suisse

Ongoing pressure on office rents

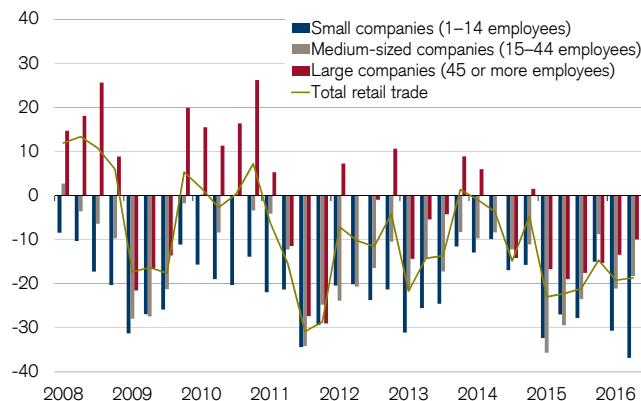
Hedonic rent index: Q1 2005 = 100



Source: Wüest & Partner, Credit Suisse

Challenging profitability situation curbing demand for retail space

Balance of share of positive (= improved) and negative (= deteriorated) responses regarding profitability situation (YoY)



Source: KOF Swiss Economic Institute (KOF), Credit Suisse

Leading Indicators

Purchasing Managers' Index (PMI)

Purchasing managers stand at the beginning of the production process. The PMI uses this forward-looking feature to forecast the level of economic activity. The index is based on a monthly survey conducted by procure.ch, the industry body for purchasing and supply management. Purchasing managers respond to eight questions on output, backlog of orders, purchasing volumes, purchase price, delivery times, stocks of purchases, stocks of finished goods, and employment. They indicate whether activity levels are higher, the same, or lower than in the preceding month. The percentage share of responses stating "higher" and "no change" are used to calculate the sub-indices, though only half of the "no change" share of responses is included. The PMI lies between 0 and 100, with a figure of more than 50 indicating an expansion of activity compared with the previous month.

Credit Suisse Export Barometer

The Credit Suisse Export Barometer takes as its basis the dependence of Swiss exports on foreign export markets. In constructing the export barometer, we have drawn together important leading industry indicators in Switzerland's 28 most important export markets. The values of these leading indicators are weighted on the basis of the share of exports that goes to each country. The export barometer consolidates this information to produce a single indicator. Since the values in question are standardized, the export barometer is calibrated in standard deviations. The zero line corresponds to the growth threshold. The long-term average growth of Swiss exports of approximately 5% is at 1.

Credit Suisse ZEW Index

Financial analysts have their finger on the pulse of the economy. Since June 2006, we have been conducting a monthly survey of financial analysts jointly with the Centre for European Economic Research (ZEW) in Mannheim under the heading Financial Market Test Switzerland. Analysts are questioned not only about their assessment of the current and future economic situation as well as the rate of inflation but also about financial market issues such as equity market performance and interest rate forecasts. The Credit Suisse ZEW Index represents the balance of expectations regarding the development of Swiss economic activity over the coming six months.

Industrial Activity

PMI index > 50 = growth



Source: procure.ch, Credit Suisse

Exports

In standard deviation, values > 0 = growth



Source: PMIPremium, Credit Suisse

Economic Activity

Balance of expectations, values > 0 = growth



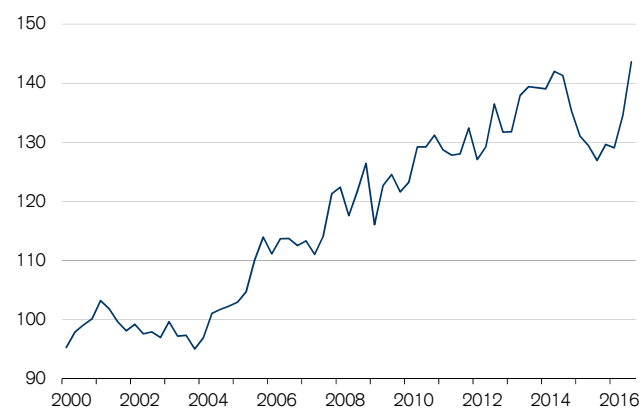
Source: Centre for European Economic Research, Credit Suisse

Swiss Construction Index

The Swiss Construction Index is published once a quarter jointly by Credit Suisse and the Swiss Contractors' Association (SCA). It serves as a leading indicator for the state of Switzerland's construction sector by forecasting the volume of work in the core construction business in the coming quarter. The indicator is calculated by Credit Suisse Economic Research and is based mainly on a quarterly survey conducted by the SCA among its members. Additional data is provided by the Swiss Federal Statistical Office and Baublatt. The Construction Index was launched in the first quarter of 1996.

Construction Industry Climate

1st quarter 1996 = 100



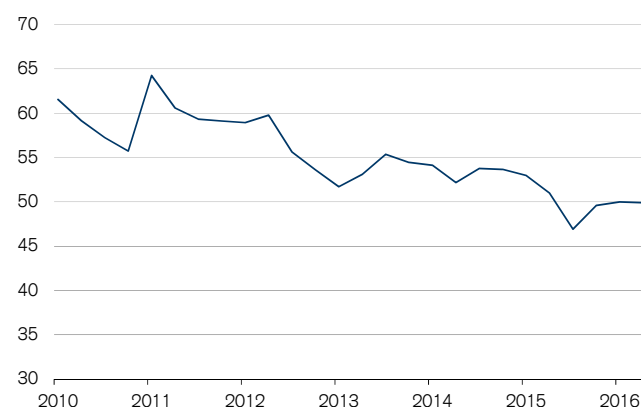
Source: Swiss Contractor's Association, Credit Suisse

Renewable Energy Index

The Renewable Energy Index Switzerland is published each quarter by Credit Suisse in cooperation with the Swiss Agency for Renewable Energy and Energy Efficiency (A EE). This indicator is based on a survey of companies in the sustainable energy solutions sector (renewable energies and energy efficiency). The data is collated and analyzed in accordance with the standards of the International Federation of Purchasing and Materials Management. The Renewable Energy Index directly reflects the course of business and performance in the sustainable energy solutions sector. Launched in the first quarter of 2010, the Renewable Energy Index survey is thus a valuable addition to the basic data sources for this sector.

Renewable Energy Sector

Index > 50 = growth



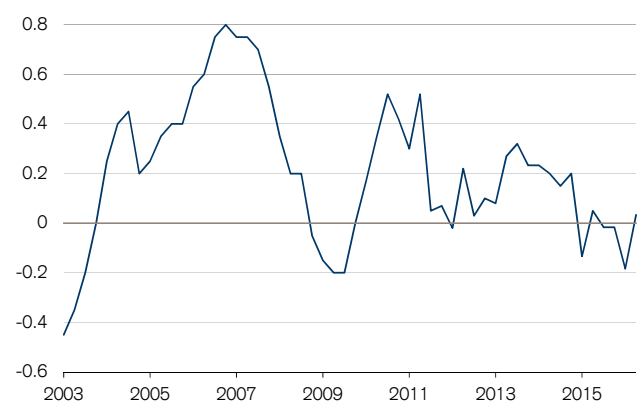
Source: Agency for Renewable Energy and Energy Efficiency, Credit Suisse

Blue Book Index

The Blue Book Index translates the qualitative information on economic activity published by the Swiss National Bank as part of its Quarterly Bulletin into a quantitative index. The Blue Book Index (so called because the cover of the SNB Quarterly Bulletin is blue) is an aggregate of five sub-indices that capture developments in four sectors of the economy (manufacturing, construction, non-financial services, and banking), as well as the labor market. The Blue Book Index is the arithmetical average of the five equally weighted sub-indices. Each sub-index can range between a value of -1 and +1, at intervals of 0.25 points. We define +0.25 as "normal conditions" or "moderate growth," while +1 and -1 constitute "boom" and "contraction" respectively.

Quantitative translation of SNB Quarterly Bulletin

Standardized index from -1 to +1



Source: Credit Suisse

Forecasts and Indicators

Forecasts for the Swiss Economy

	2016 Q1	2016 Q2	2016P Q3	2016P Q4	2017P Q1	2017P Q2	2017P Q3	2017P Q4	2016P	2017P
GDP (YoY, in %)	1.1	2.0	1.7	1.3	1.3	1.2	1.5	1.9	1.5	1.5
Consumer spending	1.2	1.0	1.0	1.0	0.8	1.1	1.1	1.1	1.1	1.0
Government expenditure	1.5	2.6	1.0	2.0	1.8	1.2	2.5	1.7	1.8	1.8
Gross capital investment	3.7	1.5	0.9	0.5	-0.4	1.4	2.2	3.9	1.6	1.8
Construction investment	0.8	-1.2	0.8	1.5	-1.5	-0.5	1.0	2.8	0.5	0.5
Investment in plant and equipment	5.5	3.4	1.1	0.0	0.0	2.5	3.0	4.5	2.5	2.5
Exports (goods and services)	6.0	7.4	1.0	0.0	3.0	4.0	6.0	5.0	3.5	4.5
Imports (goods and services)	3.3	5.4	3.5	0.0	3.5	3.5	3.5	3.5	3.0	3.5
Inflation (in %)	-1.0	-0.4	-0.1	0.2	0.6	0.4	0.5	0.5	-0.3	0.5
Unemployment (in %)	3.3	3.3	3.4	3.3	3.3	3.3	3.3	3.3	3.3	3.3
Employment growth FTEs (YoY, in %)	-0.2	-0.1	0.1	0.1	0.5	0.3	0.5	0.6	0.0	0.5
Net immigration (in thousands)									70	60
Nominal wage growth (YoY, in %)									0.5	0.5
Balance of payments (in % of GDP)									7.7	8.8
General Government budget surplus (in % of GDP)									0.1	-0.2
Public debt (in % of GDP)									45.7	45.1

Source: Federal Statistics Office, State Secretariat for Economic Affairs SECO, Credit Suisse

Forecasts for the World Economy

Forecasts	Forecasts				Structure		Significance for Switzerland	
	GDP YoY, in %		Inflation YoY, in %		Population In million	GDP In USD billion	Share of exports In %	Share of imports In %
	2016	2017	2016	2017	2015	2015	2015	2015
World	3.1	3.3	2.6	2.6	7,222	73,171	100	100
US	1.8	2.0	1.3	2.0	322	17,947	13.9	17.0
Euro zone	1.5	1.3	0.1	1.2	333	11,540	43.2	63.0
Germany	1.5	1.3	0.2	1.5	82	3,358	18.3	28.3
France	1.3	1.3	0.2	1.1	64	2,421	6.8	8.1
Italy	0.9	0.8	0.1	1.0	61	1,815	6.3	9.7
UK	1.5	0.2	0.7	2.0	65	2,848	5.7	3.1
Japan	0.6	0.9	-0.2	0.2	127	4,123	3.3	1.8
China	6.5	6.0	2.0	1.8	1,375	10,982	4.4	7.4

Source: Datastream, International Monetary Fund, Credit Suisse

Interest Rates and Monetary Policy Data

	Current	3-month	12-month		Current	Prev. mth.	Prev. year
3-month Libor (in %)	-0.73	-0.9 to -0.7	-0.9 to -0.7	M0 money supply (CHF bn)	506.4	493.1	464.0
SNB target range (in %)	-1.25 to -0.25	-1.25 to -0.25	-1.25 to -0.25	M1 money supply (% YoY)	2.3	1.4	0.7
10-year government bond yields (in %)	-0.51	-0.5 to -0.3	-0.3 to 0.1	M2 money supply (% YoY)	3.2	2.7	1.1
				M3 money supply (% YoY)	2.7	2.3	1.9
				Foreign currency reserves (CHF bn)	641.0	635.3	550.7

Source: Datastream, Bloomberg, Credit Suisse

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