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Political “noise” does not impress companies

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Contribution
Tomasz Limberger

Editorial

Dear readers

Anyone observing the performance of the equity markets over the past year could easily draw the conclusion that political uncertainty is irrelevant for investors and therefore also for the companies listed on the stock market, i.e. the real economy: Despite seemingly dramatic political 'upheavals' with what one would expect to be extremely uncertain consequences (the outcome of the Brexit referendum and the election of Donald Trump as US President spring particularly to mind), share prices in the second half of the year hastened undeterred from one record to the next. In this issue of *Monitor Switzerland*, we do not analyze the impact of uncertainty on the financial markets but the direct impact on the decisions of Swiss companies. Here too, it would appear at first glance, political uncertainty has little relevance: While the growth of investments of Swiss companies has certainly shown signs of weakness in recent years, these are negligible when compared with the dramatic rise in the political uncertainty index calculated by us.

However, the theory of the irrelevance of political decisions for the behavior of companies does not hold out when subjected to closer scrutiny: Our analysis shows that the core factor is whether the political decisions actually change the fundamental environment for companies or not. For example, the acceptance at the ballot box of the mass immigration initiative made great waves in political circles and the media but was ultimately implemented in a 'soft' manner and therefore did not fundamentally restrict the access of companies to foreign labor. The lack of a(n) (over)reaction to the decision on the part of companies suggests that they assumed that politicians would not at the end of the day implement any measures that were clearly harmful to the economy despite all the 'commotion'.

On the other hand, companies did display clear reactions in the case of the dramatic change of course of the Swiss National Bank in January 2015 and the acceptance of the second home initiative which entailed specific and direct changes to the economic parameters. However, the abandonment of the EUR/CHF minimum exchange rate in particular has caused less damage than might have been expected based on the media response. The flexibility of companies also to cope with very severe disturbances was underestimated in many places. Nevertheless, we cannot rely on the Swiss economy automatically always being sufficiently competitive and politicians ultimately always doing what is 'right' for the economy as a whole. It is clearly also not right to conclude that the media always 'get it wrong' when assessing the consequences of political events. In today's world we must also take into account the fact that the age of the digital information overload is making it considerably more difficult for media to attract attention. The temptation to engage in sensationalist journalism therefore indeed have increased. Viewed over the long term, however, this hardly poses a sustainable strategy as at the end of the day the kind of reporting will also triumph among the media that creates greater intellectual and economic added value.

We wish you an interesting read.

Thomas Gottstein
CEO Credit Suisse (Schweiz) AG

Oliver Adler
CIO Office Switzerland

Contents

Global environment

Robust growth outlook with lower inflation again

While the global growth prospects remain good, a further significant acceleration is unlikely. Inflation will have reached its interim peak in many countries in the first quarter of 2017.

US economy should accelerate again and the Fed hike interest rates further

The official growth statement in the US was considerably weaker in the first quarter of this year than the sentiment indicators of consumers and businesses had led us to expect. However, this will only be a temporary phenomenon. We already expect a sharp acceleration in growth for the second quarter – thanks to robust private consumption and rising investments. The US central bank (Fed) is set to continue the normalization of its monetary policy in the next few months and hike interest rates further despite the fact that inflation has recently been somewhat lower.

Growth in the Eurozone consolidating and the ECB is likely to introduce a cautious tightening of its monetary policy

The economy in the Eurozone displayed an impressive performance in the last few months, especially in view of the many political risks entailed by important elections and referendums. The upturn should consolidate further in the months to come, thanks also to falling unemployment rates and a consequent boosting of private consumption. The election of a pro-European government in France should also inject new impetus into the reform efforts in the European Union (EU) and the Eurozone and nourish hopes that the EU will after all emerge stronger from the years of crisis. Because inflation remains a long way off the target of the European Central Bank (ECB), we only expect a slow tightening of the extremely loose monetary policy. However, the ECB should in September announce a gradual ending of its bond purchase program from January 2018.

Good growth outlook also for emerging markets but momentum largely restrained

The economic picture in the main emerging markets is generally still positive although the momentum remains restrained. After growth in China surprised on the positive side in the first quarter of 2017, we expect a somewhat slower pace again for the rest of the year. Russia has emerged from recession and Brazil should also manage this despite the recent political uncertainties. However, only a modest recovery is to be expected in both countries. On the other hand, the high growth in India should accelerate even further.

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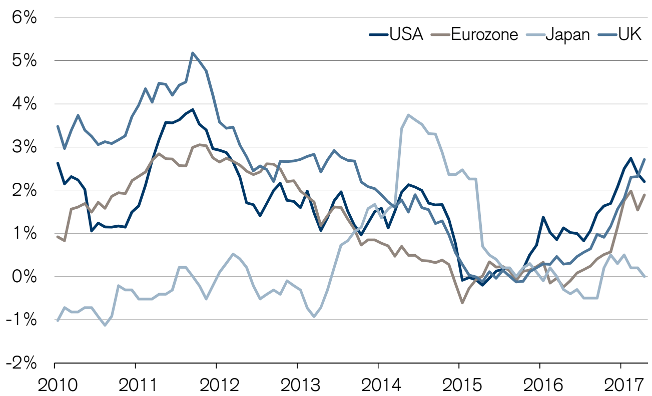
Inflation generally closer to central bank target

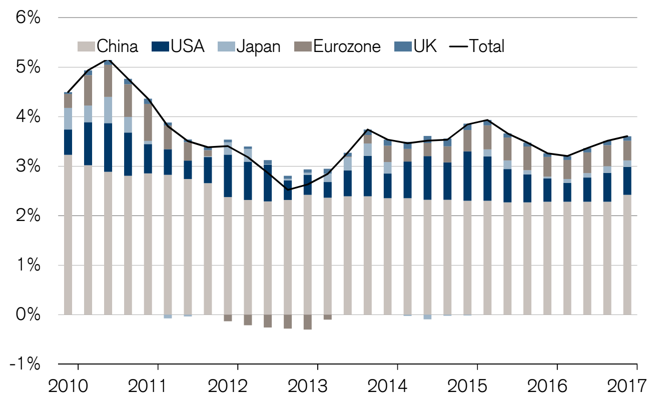
YoY consumer price index



Source: Datastream, Credit Suisse

Moderate global growth acceleration

YoY growth in %, growth contributions in percentage points



Source: Datastream, Credit Suisse

Swiss Economy

Slow acceleration

Economic growth is not impressive at present. However, it is gaining momentum and becoming more broadly based. We forecast growth of 1.5% for 2017 and 1.7% for 2018.

Quarterly results are better than they look ...

The word "disappointment" is making the rounds: According to the State Secretariat for Economic Affairs (SECO), economic output in the first quarter of 2017 increased by just 0.3% on the previous quarter. However, the state of the Swiss economy is better than it appears at first glance: First of all, investments and consumption rose again and exports were up. Secondly, prices went up again for the first time in three years, which points toward increasing pricing power. And thirdly, a negative contribution of the "stocks and statistical deviations" component placed a massive burden on the quarterly results (–1.7 percentage points). This component is strongly shaped by the trade of gold and commodities and therefore barely permits any conclusions about the momentum of the Swiss economy (see Figure below on the left).

... and the recovery of exports should continue ...

The prerequisites for a further recovery of the export economy are good. For one thing, the positive economic trend in the purchasing countries is providing tailwind. Our Export Barometer that measures this trend lies well above the growth threshold (see Figure below on the right). Furthermore, less and less headwind is coming from the overvaluation of the franc against the euro. The hope that the depreciation of the euro has been stopped appears to us to be realistic. Nevertheless, the Swiss National Bank (SNB) is generally refraining from currency market interventions whenever the franc appreciates as a result of better Swiss growth expectations. It primarily combats appreciation pressure whenever this is a consequence of political uncertainties (see page 15). However, the latter should decrease further in the Eurozone, the economic recovery of which is continuing to advance.

... while the domestic economy slowly picks up

Although the domestic economy remains sound, its growth is only accelerating slowly. Consumer sentiment is only brightening hesitantly due to the sluggish improvement of the labor market situation which is the most important determinant of sentiment. Furthermore, the times of increasing purchasing power thanks to falling prices are over. Immigration is continuing to support consumption growth but the growth contribution is getting smaller. Little acceleration is also to be expected in corporate investments: While the favorable financing conditions and constant urge to rationalize speak in favor of a sharper increase, the ongoing difficult revenue situation is limiting potential. The net operating surplus – an approximation of profits – still lies at the low level of 2009.

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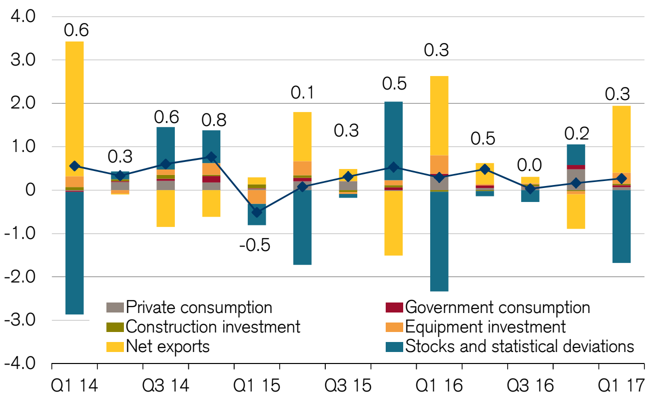
Volatile stock components

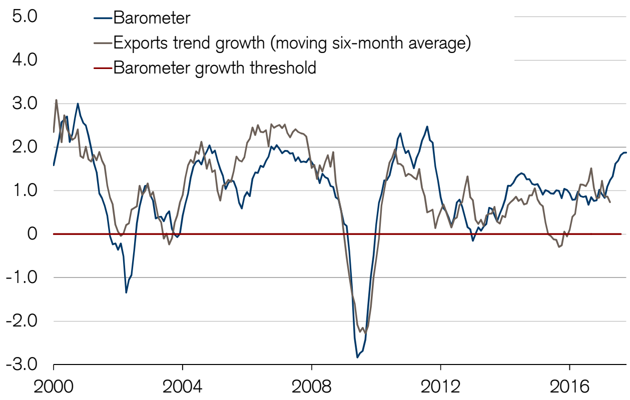
Real QoQ gross domestic product in %, seasonally adjusted



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

Export Barometer pointing to growth

In standard deviations



Source: Bloomberg, Datastream, PMIPremium, Credit Suisse

Swiss Economy I Monitor

Inflation

According to the household survey conducted on a quarterly basis by the State Secretariat for Economic Affairs (SECO), there has barely been any change in inflation expectations between January and April 2017. They remain close to their ten-year average. However, the inflation expectations canvassed monthly by financial analysts in the survey conducted by Credit Suisse and CFA Society Switzerland have recently risen and are now well above their ten-year average. We also expect a slight, although only temporary, increase in the inflation rate by the end of the year. Average annual inflation should amount to 0.5% in both 2017 and 2018.

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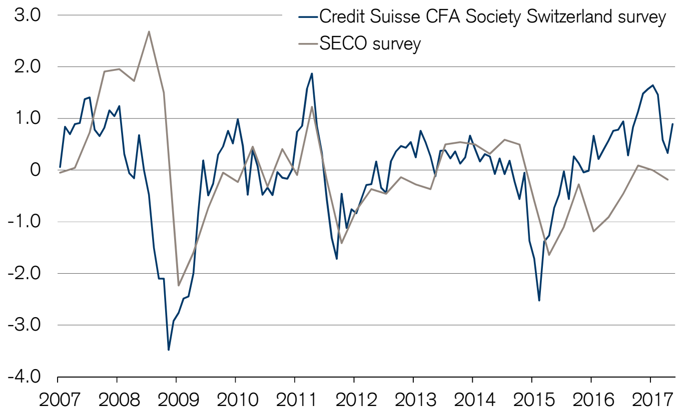
Diverging inflation expectations

Index, standardized



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

Labor market

The unemployment rate has been falling since peaking above 3.3% in the summer of 2016. However, it is decreasing considerably less strongly than it increased after the abandonment of the EUR/CHF minimum exchange rate. Moreover, the downturn lost momentum for the first time in April. The level prior to the franc shock (around 3%) is therefore not set to be reached again quite so soon. However, our surveys among industrial enterprises conducted for the purchasing managers' index and the currency situation suggest that unemployment will decrease further in the next few months.

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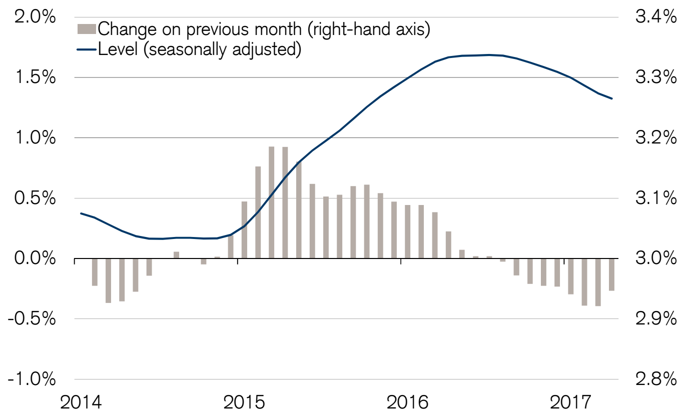
Fall in unemployment flattening somewhat

Seasonally adjusted unemployment rate and MoM change, in %



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

Immigration

The full free movement of persons with Romania and Bulgaria (EU-2) was introduced in June 2016. The rise in immigrants from these countries has now prompted the Federal Government to activate the safety valve. This means that residence permits for Romanians and Bulgarians will be restricted to 996 persons for the next twelve months (around 3,600 immigrants in net terms came from these countries between June 2016 and March 2017). However, it is to be expected that the restriction of B permits will lead to an increase in short-term residents as was already observed in 2013/14 in the case of the other Eastern European countries (EU-8).

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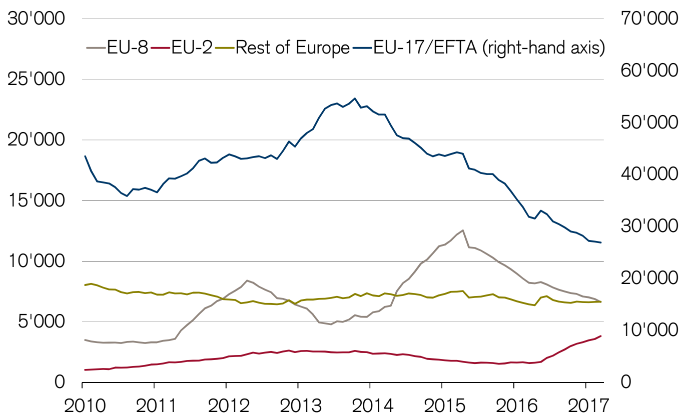
Safety valve for Romania and Bulgaria

Balance of migration of usual foreign resident population, 12-month total



Source: State Secretariat for Migration, Credit Suisse

Focus: politics and economy

Political "noise" does not impress companies

Vague political uncertainty of the sort that can be measured by media reports is not a good forecasting tool for the economy as companies weigh up the likelihood of implementation of political decisions extremely carefully.

Forecasts were often too pessimistic

"The economy will significantly lose momentum or even slide into recession owing to the increased uncertainty" – these and similar forecasts are often to be heard after political or monetary decisions catching the attention of the media. This was also the case, for instance, following the acceptance of the mass immigration initiative (MII), the abandonment of the EUR/CHF minimum exchange rate by the Swiss National Bank (SNB) in January 2015 and even after the geographically more distant Brexit vote in the UK. What all these events have in common is that the forecasts associated with them generally proved too pessimistic. With the exception of the abandonment of the minimum exchange rate, hardly any real economic reactions were actually measurable.

Uncertainty index quantifies degree of political uncertainty

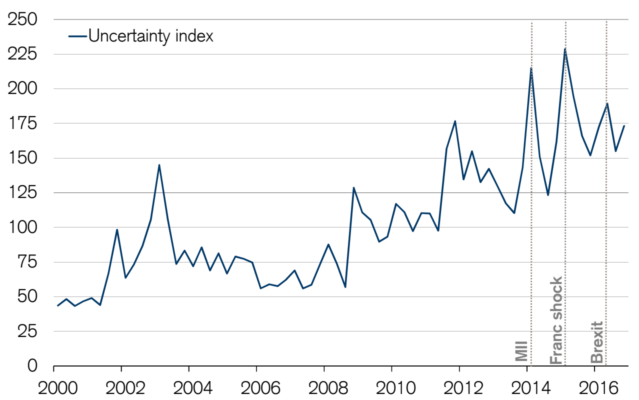
To measure the political uncertainty ported by the media, we make use of the "uncertainty index" compiled by us for Switzerland and modelled on the work of policyuncertainty.com (see Figure on the left). This searches the media landscape for various key words associated with political instability. Two observations come to light: Firstly, the monthly number of reports on economic policy uncertainties has tended to rise since the financial crisis, and secondly this increase has been pronounced since 2011. Events such as the acceptance of the MII, the abandonment of the minimum exchange rate and the Brexit vote triggered a veritable flood of articles focusing on uncertainties for the Swiss economy. As illustrated by the diagram below on the right, the political uncertainty conveyed by the media and the growth of investment correlated very strongly between 2000 and 2013. However, the time series have been drifting apart since 2011. A rising uncertainty index is no longer accompanied by falling investments, i.e. the previously statistically significant correlation no longer exists.

Political events do indeed affect sentiment ...

In order to understand the reasons for this break in trend, each link in the chain of effects of political uncertainty on the economy needs to be analyzed. Uncertainty initially impacts the sentiment of economic players. This can indeed be clearly illustrated by means of sentiment indicators (see diagram below on the left, next page). For example, the acceptance of the MII led to a significant downturn in the sentiment of financial analysts.

Politics leads to increased media uncertainty …

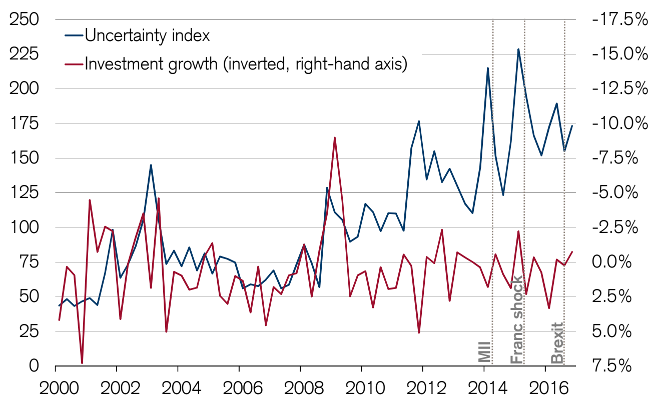
Number of newspaper articles on economic policy uncertainty



Source: policyuncertainty.com, Factiva, Credit Suisse

…but investments only respond marginally meanwhile

Number of newspaper articles on economic policy uncertainty;
QoQ growth of real investments in equipment, seasonally adjusted



Source: SECO, policyuncertainty.com, Factiva, Credit Suisse

The corresponding indicator recently calculated by us in collaboration with CFA Society Switzerland visibly lost ground back then. The sentiment of companies is also clearly influenced by political events, as exemplified by the fall in the business climate indicator of the KOF Swiss Economic Institute after the Brexit vote. The reactions to the abandonment of the EUR/CHF minimum exchange rate by the SNB were also particularly striking. Across the board, the sentiment fluctuations of private households were lower. One reason for this will be the fact that they are only measured quarterly in a survey carried out by the Swiss Secretariat for Economic Affairs (SECO).

... but companies postpone any concrete measures as long as the consequences are not yet predictable ...

Sentiment on the management floors of companies, among financial analysts as well as – to a lesser extent – among households is therefore very much shaped by the uncertainty in the economic environment conveyed in the media. So why does the investment restraint to be expected not set in after each of these events? The key to solving this apparent contradiction lies in the fact that companies weigh up extremely carefully how great the likelihood is of a political decision being implemented and how this will specifically impact their daily business. As long as no concrete and direct changes to the underlying economic conditions are imminent, many companies will therefore prefer to wait and see rather than making any hasty decisions.

..., as can be impressively deduced from surveys

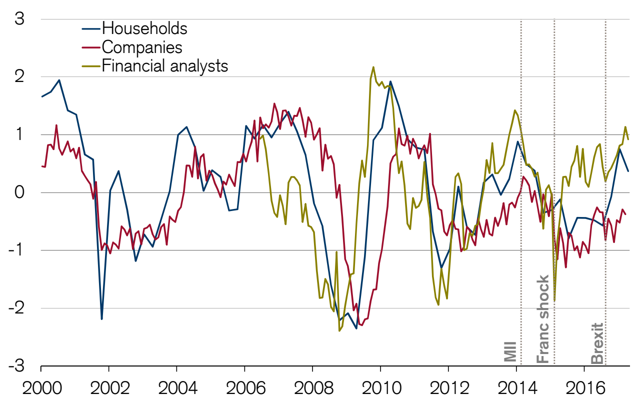
Business surveys serve to substantiate this hypothesis. Only a few months after the acceptance of the MII, more than 75% of the participants canvassed by us in the purchasing managers' survey in collaboration with procure.ch rated the likelihood as "high to very high" that the bilateral agreements would still be in force after 9 February 2017 (see diagram below on the right). In other words, the majority of entrepreneurs assumed from the outset that the MII would not be implemented in full. This confidence can also be gleaned from another survey: The umbrella association economiesuisse canvassed its member companies and associations in early 2015 about the MII and came to the conclusion that 57% of companies drew up contingency planning but decided to wait and see for the time being. Another 42% saw no need to take action. At the same time the survey data showed that around a quarter of companies responding were confident that the politicians would find a solution. The reality was to prove them right. Companies therefore clearly assessed the effects of the acceptance of the MII more realistically than many experts – ourselves included – and did not allow themselves to be misled by the predominantly negative picture in the media.

Rapid response of companies to what is seen as the persistent strength of the franc ...

A different situation held following the abandonment of the minimum exchange rate by the SNB: Immediately after the event almost exactly half of the companies canvassed in the purchasing managers' survey expected no further weakening of the franc within the next year. In May 2015 this had risen to more than two thirds that did not anticipate any depreciation of the franc.

Sentiment responds directly to events

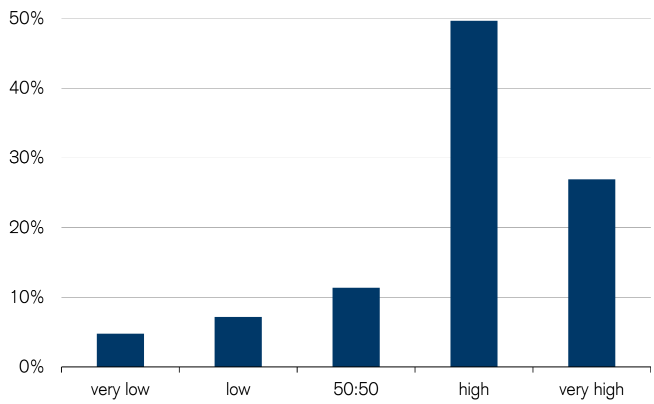
Sentiment indicators, standardized values



Source: KOF, CFA Society Switzerland, SECO, Credit Suisse

Companies expect bilateral agreements to be upheld

Purchasing managers' survey of July 2014: likelihood that Bilateral Agreements I are still in force after 9 February 2017



Source: procure.ch, Credit Suisse

Because companies anticipated hardly any easing in the currency situation in the near future, they responded: Four months after the franc appreciation, almost two thirds of the survey participants were purchasing more in euros than before and nearly three quarters had already introduced other adjustments. Almost three quarters were still not expecting any depreciation in May 2016. The range of measures adopted was correspondingly diverse. It ranged from the enhancement of procurement and price adjustments through to outsourcing abroad and job cuts. The diagram below on the left illustrates clearly how the employment subindex of the Swiss Purchasing Managers' Index (PMI) slid well below the growth threshold of 50 immediately after the abandonment of the minimum exchange rate and thereby pointed toward a reduction of employment in industry – in contrast to the German PMI and the period after the acceptance of the MII.

... through to a reduction of workforces

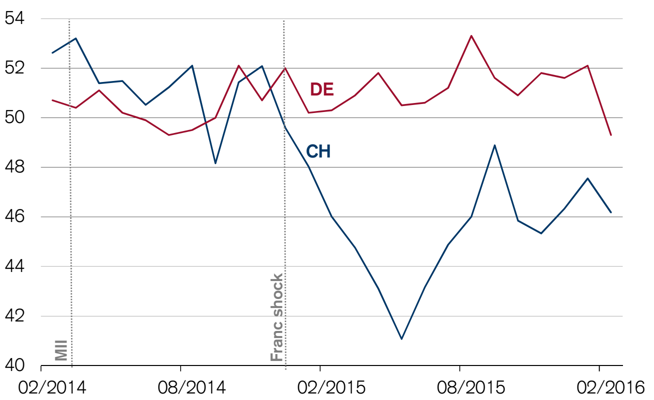
Companies thus only reduce their workforces if they consider an event to be irrevocable and persistent. The change of course by the SNB is likely to have been correctly interpreted as a change in the underlying conditions. Economic growth did indeed thereafter temporarily come to a halt but a recession was prevented thanks to the strong market position of large parts of the export economy, the subsequent stabilization of the exchange rate by the SNB and the domestic economy supported by immigration and the low interest environment (see page 12: The franc shock was particularly severe for SMEs). According to our calculations, the abandonment of the EUR/CHF minimum exchange rate cost around CHF 10 billion in terms of economic output and approximately 10,000 jobs were lost.

Many political decisions with strong impacts

Other political decisions in recent years also had a marked influence on the real economy. Following the entry into force of the Agreement on the Free Movement of Persons with the EU, a paradigm shift in immigration could be identified. Among other things, for instance, the level of education of immigrants rose. The acceptance by the electorate of the second home initiative in 2012 was initially followed by a mini construction boom in the municipalities affected due to a short-term doubling of planning applications for second homes. However, new construction activity subsequently more or less collapsed. The number of newly planned homes in 2015 was even around a third lower than before the referendum and the prices of existing homes have since been falling (see diagram below on the right). The introduction of the debt cap at federal level back in 2003 also triggered an immediate reaction, although not from companies but from the Federal Administration. Since then the debt level in Switzerland has fallen – in sharp contrast to many other countries (see diagram on the left, next page). The positive impact of the conclusion of free trade agreements (FTAs) on export revenues is illustrated by the diagram below on the right on the next page. One pattern emerges from all these examples: The more concrete the political decision and the more clearly it changes the underlying conditions, the stronger its impact. This additionally underpins the aforementioned hypothesis according to which companies wait before implementing specific measures until any effects on their business activities become foreseeable.

Swiss employment situation deteriorated immediately after the franc shock

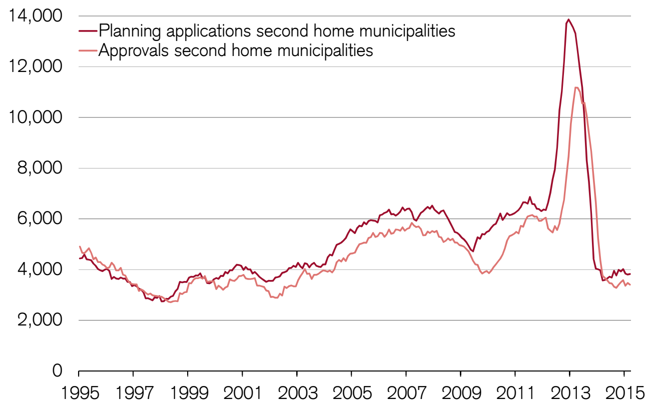
"Employment" subindex of the PMI survey. Values > 50 = growth



Source: procure.ch, Markit, Credit Suisse

Decline in second home municipalities

Number of residential units, moving 12-month total



Source: Baublatt, Credit Suisse

"Populist potpourri" does not unsettle companies in the long term

It is thus important for the quality of forecasts after political decisions to be aware of their assessment by the economic players. Relying solely on sentiment indicators falls short of the mark. In other words, data-based surveys such as the PMI index and specific special surveys are more helpful for forecasts than sentiment indicators or the uncertainty index presented here. Moreover, if a political decision is difficult to comprehend or implement and comes with an unclear time horizon – which is frequently the case particularly with populist demands – its impact on the real economy is likely to be low even if it dominates the media, at least as long as it remains unimplemented. There will also be no shortage in the future of events capable of causing a big stir in the media but which require a precise analysis: The Brexit process has only just begun, and not all uncertainties pertaining to the bilateral path have been resolved in Switzerland. Furthermore, a new version of Corporate Tax Reform III is imminent and what US President Donald Trump means for the economy also remains unclear. Nevertheless, almost 100% of the companies canvassed by us stated their intention after Trump's election first of all to keep an eye on things and wait and see. Having said this, the contingency plans will also be prepared in this case in order to be able to respond if the news turns out not to be 'fake' after all.

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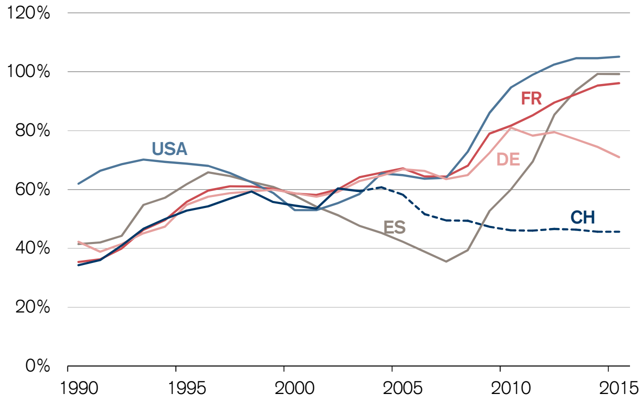
Switzerland with stable debt development

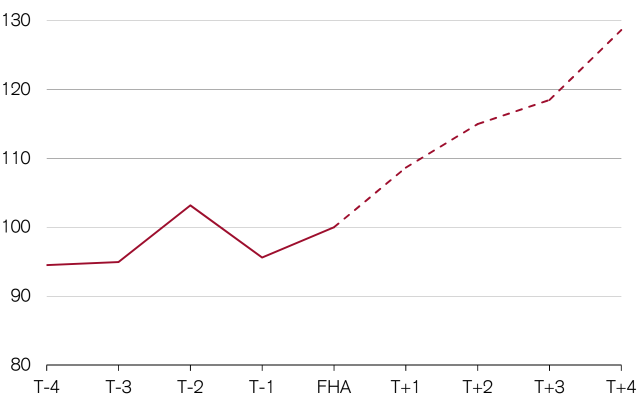
Public debt as % of GDP, dotted line = debt cap in force



Source: International Monetary Fund, Credit Suisse

Strong export growth thanks to free trade agreements

Nominal exports from Switzerland to FTA partner countries* excluding EU/EFTA; Index: time of FTA = 100, dotted line = FTA in force



Source: Swiss Customs Administration, Credit Suisse; *FTAs that entered into force before 2013

Sectors

The franc shock was particularly severe for SMEs

Political decisions hardly exert any direct influence on the assessment of the business situation by small and medium-sized Swiss industrial enterprises. However, the latter recovered less quickly from the franc shock back in 2015 than large industrial enterprises.

Political events barely affect sentiment at smaller industrial enterprises

The business situation of Swiss industrial enterprises as measured by the indicator of the KOF Swiss Economic Institute (KOF) is influenced by political and monetary policy decisions (see Figure left). The assessment of the business situation fluctuates considerably more sharply due to cyclical and exchange rate-related disturbances than due to political decisions. Only large enterprises display a reaction following political events: Their assessment clouded over following the acceptance of the mass immigration initiative (MII), the rejection of Corporate Tax Reform III (CTR III) and the acceptance of the Brexit referendum. However, these downturns were not especially marked and could well also be attributable to other factors. Furthermore, there was practically no change in the assessment of small and medium-sized enterprises (SMEs).

Franc shock of 2015 hit small players more than large ones – but recovery now also setting in among SMEs

A completely different situation holds in particular regarding a specific monetary policy decision: The business situation indicator has rarely responded as clearly as it did in February 2015 after the Swiss National Bank had abandoned its EUR/CHF minimum exchange rate. The collapse in the assessment of the business situation was similarly strong in all size categories (see Figure right). However, considerable differences can be observed in the recovery from the franc shock. Large industrial enterprises were already assessing their business situation almost as positively as before the franc shock again by mid-2016. Small enterprises experienced difficulties for considerably longer. The reasons for this diverging development are obvious: Larger enterprises more often have production locations abroad and will therefore have been able to cushion the currency shock via outsourcing more easily than smaller ones. On top of this, many small industrial enterprises are suppliers of larger companies and one of the measures adopted by the latter against the franc shock was also to outsource their supplier relationships. However, the situation has also brightened significantly for small industrial enterprises since March 2017. The general upturn in the global economy appears increasingly also to be arriving at Swiss industrial SMEs.

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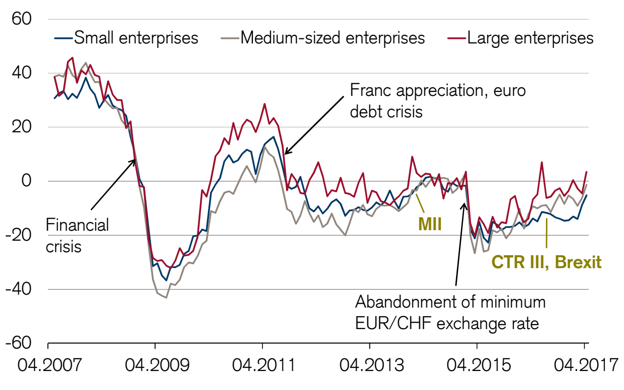
Political decisions barely influence sentiment

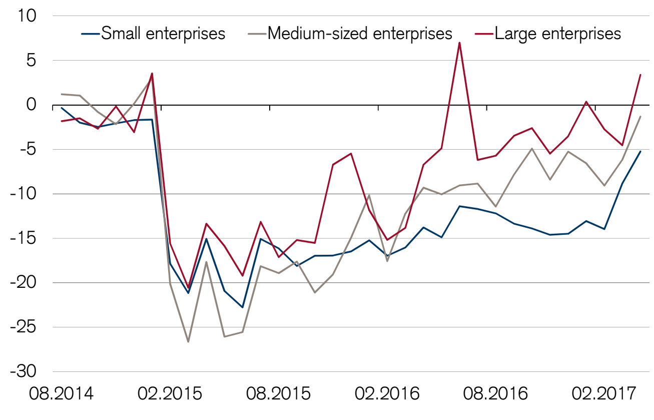
KOF business situation indicator (industry): Balances in percentage points



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

Recovery from the CHF shock lasted longer at SMEs

KOF business situation indicator (industry): Balances in percentage points



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

Sectors I Monitor

Chemical and pharmaceutical industry

Although year-on-year exports of the chemical and pharmaceutical industry rose sharply in the first four months of 2017 (pharmaceuticals: +7.9%; chemicals: +1.7%), a large share of this growth will be attributable to a base effect. The trend for exports moved sideways. However, the business situation continues to be assessed more positively by pharmaceutical and chemical companies than by other industrial sectors. We therefore still expect the sector to be able to increase its sales once again in the current year.

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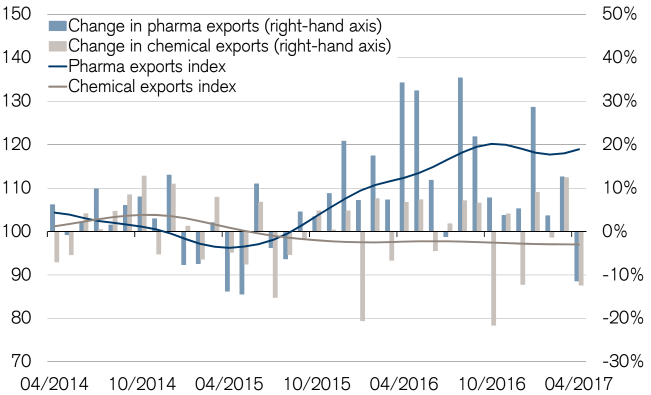
Export momentum stabilized again at the start of 2017

Exports: trend, index January 2014 = 100; YoY change in %



Source: Swiss Customs Administration, Credit Suisse

Engineering, electrical and metal industry (MEM)

Engineering is the segment of the MEM industry that has so far recovered best from the franc shock. Although sales are still well below the level of 2014, they have been growing again since the second half of 2016, not least thanks to demand from abroad. In the first quarter of 2017, sales in engineering recorded a year-on-year increase of 5.5%, while in the metal industry and electrical engineering they continued to decline (-3.9% and -3.1% respectively). In view of the positive economic outlook for the key sales markets, we expect the sales growth in engineering to continue as the year progresses.

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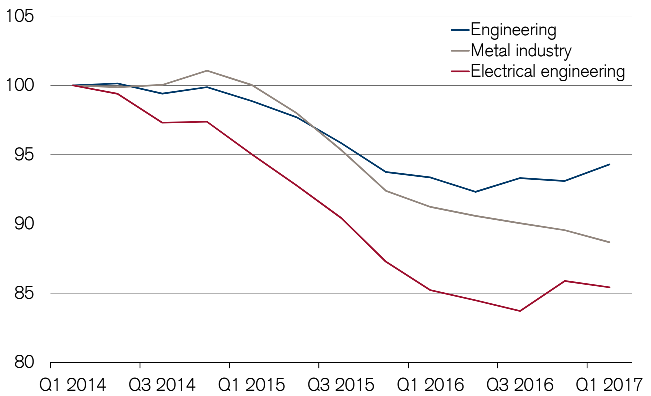
Sales recovering primarily in engineering

Sales, four-quarter average, index: Q1 2014 = 100



Source: Swiss Federal Statistical Office, Credit Suisse

Watch industry

Following the slump in 2016 (-9.9% year on year), working day-adjusted watch exports in the first four months of 2017 were 2.5% below the prior-year level. The development of capacity utilization and unemployment also points toward a stabilization, although watchmaking companies are still largely assessing the current business situation negatively. The turnaround on the Chinese market particularly helped to ease the situation and exports to the United Kingdom have also risen sharply so far this year. However, the situation remains tense in most other markets and we therefore do not expect any substantial growth in watch exports for 2017 as a whole.

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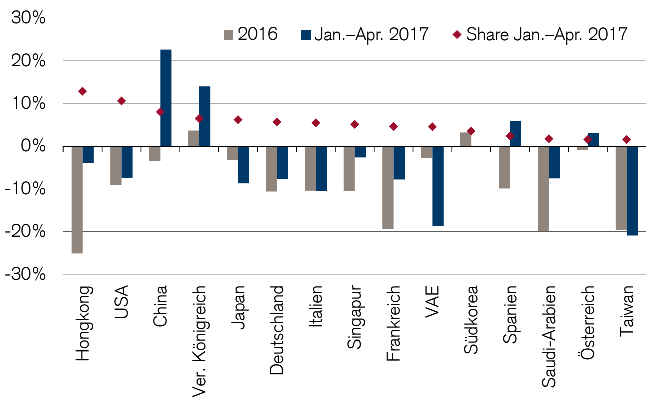
Watch exports to China increasing again

Nominal exports, working day-adjusted, YoY change in %; share in %



Source: Swiss Customs Administration, Credit Suisse

Retail trade

Thanks to the very mild weather in February and March 2017, the sluggish recovery so far in the retail trade picked up briefly in the first quarter. The do-it-yourself and clothing/shoes segments benefited most from the favorable weather, although the latter segment continued to sustain a nominal fall in sales (-2.1% in Q1 2017 compared with the previous year). Meanwhile, the food segment stagnated, although it is expected to grow moderately again in the course of the year. Despite the robust economy, the situation in the non-food segment remains tense owing to the structural shift to (partially) foreign online trade.

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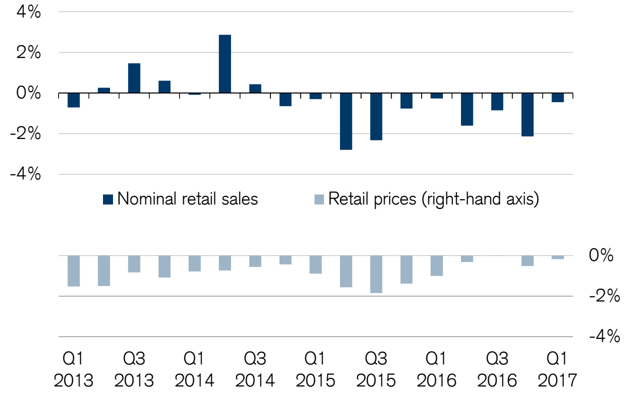
Sluggish recovery in the retail trade

Retail price index, 12-month average;
Nominal sales, YoY change in %



Source: GfK, Swiss Federal Statistical Office, Credit Suisse

Tourism

A winter season largely lacking in snow has delayed the recovery of the Swiss hotel and catering industry that set in in mid-2016. Following a positive fall (+1.9%, Sept. – Oct. 2016, YoY), the number of overnight stays between November 2016 and February 2017 remained at their prior-year level. Despite the recovery trend, the majority of hoteliers continues to assess the business situation negatively, with the assessment of small establishments, where sentiment has been deteriorating constantly for three years, particularly catching the eye. Based on the economy and the improved currency situation, we expect a slight increase in the number of overnight stays for 2017.

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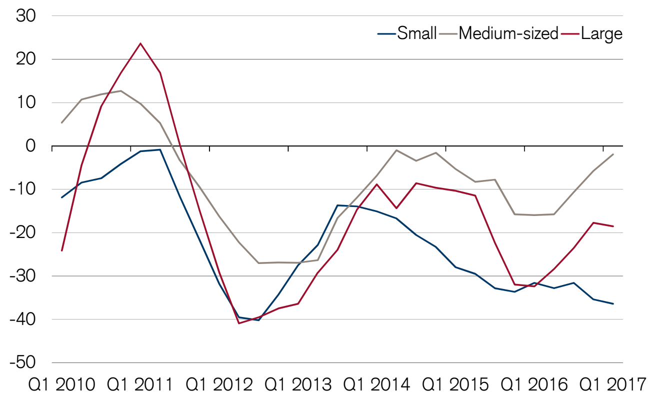
Small hotels becoming increasingly pessimistic

Hotel sector: assessment of current business situation by size of business, "good"/"poor" balance in percentage points*



Source: KOF Swiss Economic Institute, Credit Suisse, *four-quarter average

Energy supply

Although Swiss demand for electricity remained practically stable, domestic production fell by over 6% in 2016. This gave rise to the first electricity import surplus since 2011. The decline in production resulted among other things from extraordinary nuclear power plant shutdowns (Beznau I, Leibstadt) as well as below-average water levels at times. Energy wholesale prices that reached record low levels in 2016 also exerted a negative impact. However, wholesale prices have been rising again since the fall of 2016, not least due to stoppages at Swiss and French nuclear power plants.

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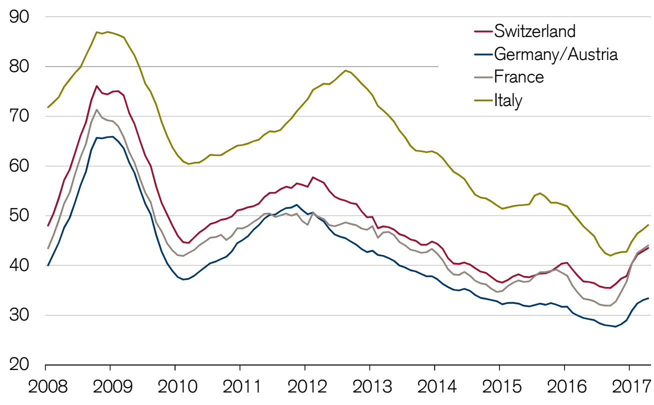
Turnaround in energy wholesale prices

Spot market prices of base load electricity in EUR/MWh, 12-month average



Source: European Energy Exchange, Gestore Mercati Energetici, Credit Suisse

Monetary Policy

Back to fundamentals

Monetary policy in Switzerland has recently been driven by global politics. Political stabilization should in our view help to refocus on inflation and economic growth.

Higher political uncertainty increased the need for foreign currency purchases

Since February 2015, we estimate that the Swiss National Bank (SNB) has spent CHF 143 bn (22% of 2016 GDP) on foreign exchange interventions. As shown in the figure below, the SNB interventions were concentrated in periods that saw a sharp rise in political uncertainty. The figure illustrates examples of the events that led to the uncertainty including: 1) the Greek referendum on an EU credit line, 2) the sharp drop in the equity and commodity markets, 3) the Brexit vote, 4) the US presidential election, and 5) the campaign for the French presidential election. These examples show that the SNB's tolerance of a lower EUR/CHF exchange rate is reduced whenever there is a rise in political risks or general uncertainty and also that the SNB stands ready to buy large volumes of foreign currencies in the event of a rapid build-up of CHF appreciation pressure.

SNB's inflation forecast does not yet indicate monetary policy tightening

Since the election victory of Mr. Macron in France, political uncertainty in Europe has abated, and with it CHF appreciation pressure. While we believe that the SNB will not halt its foreign currency purchases, we expect purchase volumes to decline significantly as long as the process of political stabilization continues in Europe. This also suggests that if CHF appreciation pressure were to emerge in response to improving Swiss growth and rising inflation rather than due to political risks, the SNB would be more likely to tolerate a moderate EUR/CHF decline. Having said this, the economic fundamentals suggest that it is too early to tighten monetary policy. Economic activity has certainly rebounded, but subdued inflationary pressure still warrants a loose monetary policy. In an earlier edition of this publication (December 2013), we showed that until 2009 the SNB raised its policy rate whenever the Purchasing Managers' Index (PMI) stood at or above 55.9 points and the most forward-looking point of the SNB's inflation forecast was at or above 1.75%. This simple rule does not take into account the exchange rate, however, and hence failed to predict the interest rate decisions after 2010. Nevertheless, we believe that the inflation forecast published by the SNB is a helpful indicator of future monetary policy. As the most forward-looking point of the SNB's inflation forecast currently stands at 1.4% (for Q4 2019), we think that the chances of monetary policy tightening are very limited over the short to medium term. If, however, the inflation forecast were gradually to be raised, monetary policy would probably turn less and less supportive.

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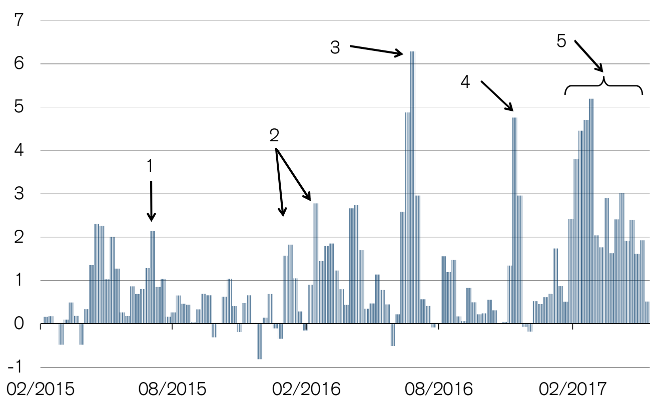
Foreign currency purchases in relation to political events

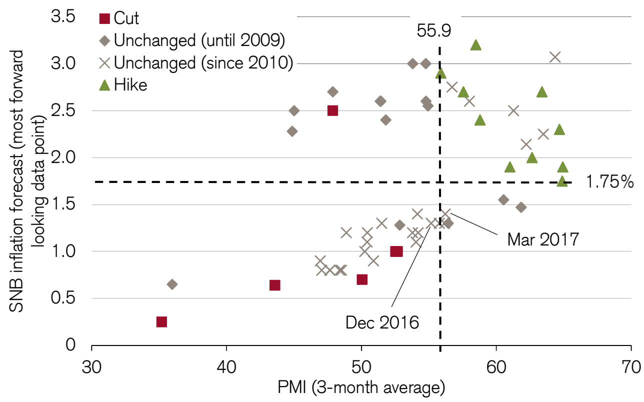
Estimated weekly foreign exchange interventions by the SNB, in CHF (bn)



Source: Swiss National Bank, Credit Suisse

SNB interest rate decisions

Interest rate decisions relative to the PMI and SNB inflation forecasts



Source: Datastream, Swiss National Bank, Credit Suisse

Monetary policy I Monitor

Real effective exchange rate

The real effective exchange rate of the CHF (i.e. a trade-weighted exchange rate index adjusted for inflation) has fallen back to the average level observed during the period between September 2011 and January 2015 when the SNB enforced the minimum EUR/CHF exchange rate. Viewed in this context, it will become more and more difficult for the SNB to credibly assess the current level of the CHF as being "significantly overvalued" as it presently does. Under the exchange rate floor regime it labeled the CHF "highly valued", which in our view is a weaker assessment.

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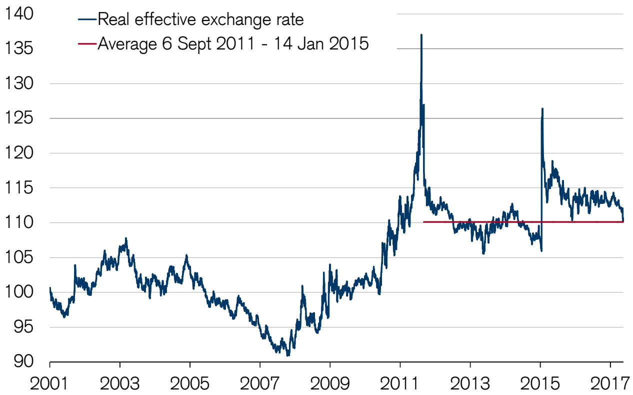
Less expensive CHF

Index (1 Jan 2001 = 100)



Source: Swiss National Bank, Credit Suisse

Foreign exchange reserves

In Q1 2017, the Swiss National Bank (SNB) reduced the EUR allocation of its foreign currency reserves to 40.3% (incl. derivatives), down from 42.3% in Q4 2016. This is the lowest EUR allocation since 1999. Conversely, the USD allocation was raised to 35.0% (up from 33.4% in Q4 2016), the highest allocation since 2003. The allocation to other currencies was not adjusted substantially, with 7.9% allocated to JPY, 6.7% to GBP, 2.8% to CAD and 7.3% to other currencies (primarily AUD, CNY, HKD, DKK, KRW, SEK and SGD).

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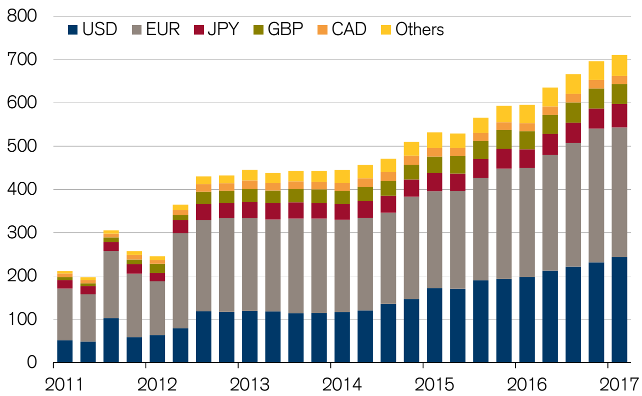
Fewer EUR, more USD

In CHF (bn)



Source: Swiss National Bank, Credit Suisse

Negative deposit rate

The SNB charges the negative deposit rate of –0.75% only on commercial banks' reserves (held at the SNB) in excess of 20 times the minimum required reserves. As minimum required reserves depend on selected bank liabilities, notably customer deposits, banks with a large retail customer business will be required to hold more minimum reserves and will therefore have a higher exemption threshold on their deposits at the SNB. Conversely, banks with a small retail customer business are required to hold fewer minimum reserves and have a proportionaly lower threshold. Their excess reserves subject to the negative rate are therefore proportionaly larger.

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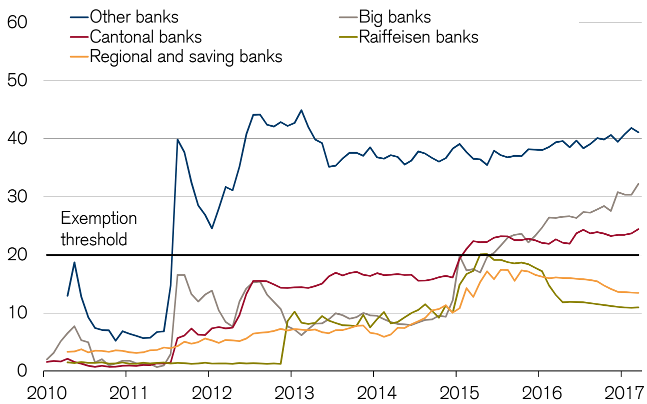
Not all bank groups are equally affected

Ratio of banks' deposits and minimum required reserves



Source: Swiss National Bank, Credit Suisse; Estimates are based on our own calculation of minimum required reserves and particularly uncertain for selected bank groups.

Economic Policy

Popular initiatives as election tools

Since 2010 we have voted on more than five popular initiatives each year. The success of a motion can now not only be measured in terms of the result of the referendum itself.

Popular initiatives often serve as a means of exerting pressure, food for thought or campaign resources

The popular initiative provides the Swiss electorate with a tool for amending the Federal Constitution. However, the uses of the popular initiative by far transcend this function. For example, initiatives are also launched with the intention of prompting the Federal Council and parliament to make a counterproposal. Furthermore, initiatives function as food for thought with regard to social and political discussions or are used by parties as campaign resources.

The number of popular motions has been growing strongly for decades

The number of popular initiatives put to the vote has risen sharply in the past few decades (see Figure). In the 1970s and 1980s, an average of two and a half popular initiatives per year reached the ballot box. This figure rose in the 1990s and in particular after the turn of the millennium. Between 2000 and 2009 there were already more than four and since 2010 the electorate has been voting on more than five popular motions each year.

Not only the referendum result determines the success of an initiative

The fact that more use is made today than ever before of this instrument of direct democracy could be interpreted as a sign that the population wishes increasingly to be involved in important political issues. Instead, however, parties appear have to discovered popular initiatives as a means to promote themselves and their party agendas particularly in the run-up to election years. Significantly more initiatives are therefore launched in the year preceding and during federal elections than in the interim periods. The fact that popular initiatives are originating more frequently from the parties has consequences for their enforceability, as for a party the political success of an initiative is not necessarily linked to its acceptance. There is therefore an incentive to draft the text of the initiative in a more extreme manner than would be the case if, for instance, an association were to launch an initiative for a vested interest and only to emerge victorious in the event of acceptance. However, the acceptance of an initiative originally launched for promotional purposes can place the economy and society before major challenges.

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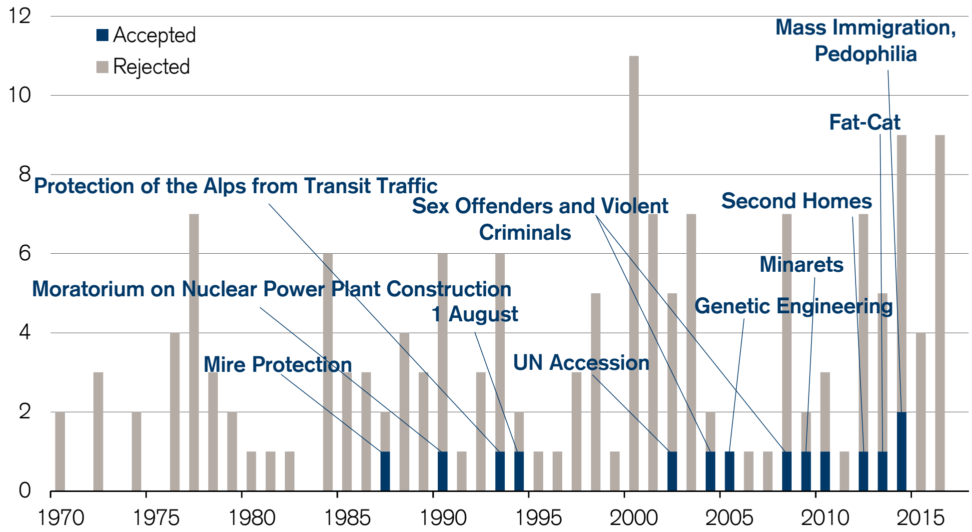
The number of popular motions has been increasing strongly for decades

Number of popular initiatives put to the vote, 1970 – 2016



Source: Swiss Federal Statistical Office, Credit Suisse

Investments

"Angry Societies" – Supertrend with investment opportunities

The five Credit Suisse Supertrends are long-term themes that offer attractive investment opportunities. One of these is the growing dissatisfaction of western societies and the trend toward a multipolar world resulting from this.

The western middle class feels disadvantaged ...

The western middle class is disillusioned. This has given rise to a social disenchantment that is driving the current political change in the developed countries. The majority of the electorate in the United Kingdom voted to leave the European Union. A political outsider wishing to break with political traditions has been elected President in the US. And in the Eurozone there is a high degree of support for politicians questioning the single currency and partly representing extremely nationalist sentiments.

... among other things due to a loss of economic significance

The dissatisfaction is also based on economic factors: Although the years of globalization have reduced the inequalities between countries, they have increased those within them. Many middle class households in Europe and the US have seen their lot deteriorate since the financial crisis in 2009. The persistently high unemployment rates and stagnating wages over a long period have taken their greatest toll on such households. At the same time, increasing frustration has been expressed about the alleged inability of the political elite to address the key problems. The seemingly uncontrolled flow of immigration and increase in terrorism have been a cause of concern, for example.

Focus on domestic market leaders and brands

The effects of the political change that has been triggered are set to become increasingly visible in the years to come. Governments will aim more and more to appease the middle classes by creating more jobs, bringing about wage increases and more strongly regulating and taxing sectors that are made responsible for job cuts. Sectors with a large amount of domestic labor should benefit from this accordingly. At the same time, more is likely to be invested in national security and defense – likewise topics that the middle class takes seriously. This should steer the attention of investors toward domestic market leaders (so-called "national champions", largely companies from the manufacturing sector, IT production, construction and telecommunications equipment suppliers) and companies from the "defense and security" sector. We anticipate investment opportunities here for several years.

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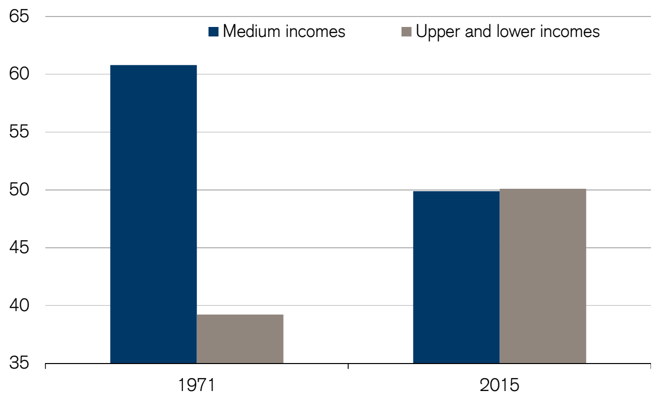
The five Credit Suisse Supertrends

Source: Credit Suisse

Middle class in the US no longer represents a majority

Share of adult population in %



Source: PEW Research, Credit Suisse

Real Estate | Monitor

Mortgage volumes of private households

Despite continued very low mortgage interest rates, households are increasingly unable to afford home ownership due to the high price level and the high financial requirements placed on mortgage lending. This is resulting in a persistent dampening of additional demand for owner-occupied housing that is reflected in the development of the volume of mortgages. The current growth of the volume of mortgages of private households compared with the previous year is 2.6%. However, the fall in growth has increasingly slowed down in the past few months.

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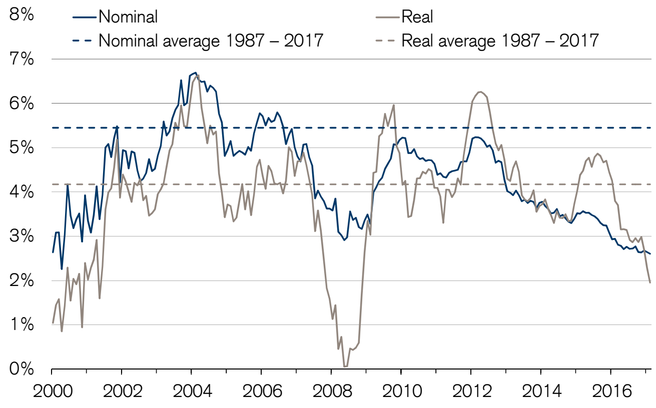
Little growth momentum in the volume of mortgages

Growth in the volume of mortgages compared to the prior-year month in %



Source: Swiss National Bank, Credit Suisse

Planning of owner-occupied housing

Construction activity for owner-occupied housing is slowing down further. Over the past 12 months, building permits were granted for just under 14,000 condominiums and 7,700 single-family dwellings. Compared with the previous year this represents a decline of 15.5% (condominiums) and 1.9% (single-family dwellings). The slowdown is most marked in the urban centers, while a downturn can also be observed in many places outside the high-price regions. Despite this decline, however, the expansion of residential property remains at an average level when viewed historically. We should therefore be talking about a normalization rather than a collapse of construction activity.

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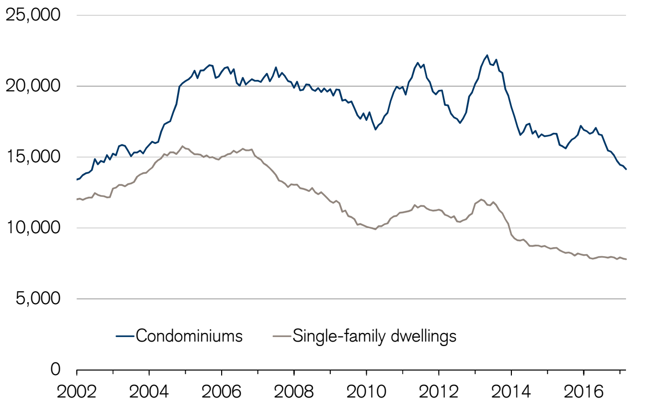
Normalization of construction activity

Building permits, moving 12-month total



Source: Baublatt, Credit Suisse

Rental apartments

The phase of rising rents prevailing for several years came to an end last year. The decline in immigration and the high construction activity have caused tenants to gain market power. This is most vividly reflected in advertised rents which were 0.7% below the level of the prior-year quarter in the first quarter of 2017. Following the reduction of the base rate from 1.75% to 1.50% communicated on 1 June, the rise in existing rents should also decrease again toward the end of the year at the latest.

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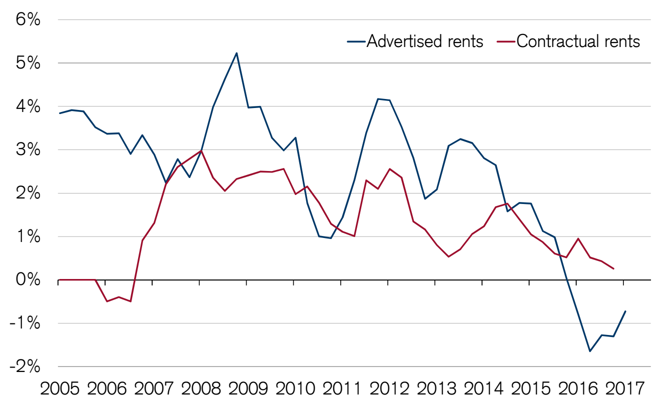
Era of rising rents over

Annual growth (nominal)



Source: Wüest & Partner, Credit Suisse

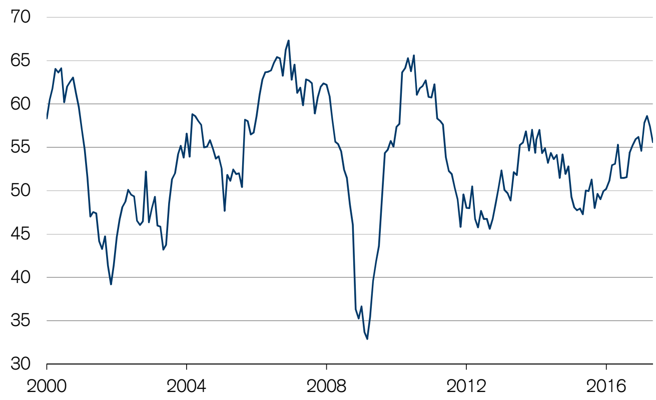
Credit Suisse Leading Indicators

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.

Industrial Activity

PMI index > 50 = growth



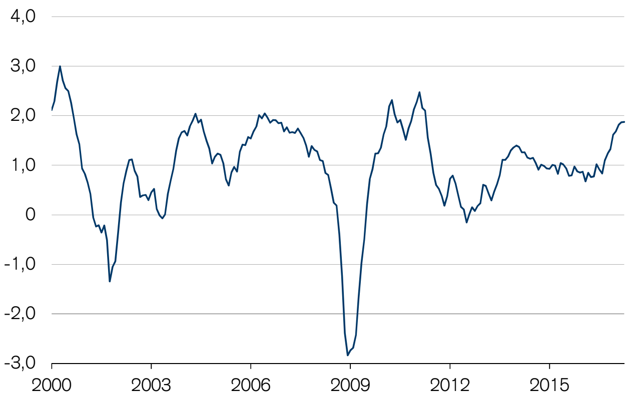
Source: procure.ch, Credit Suisse

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.

Exports

In standard deviation, values > 0 = growth



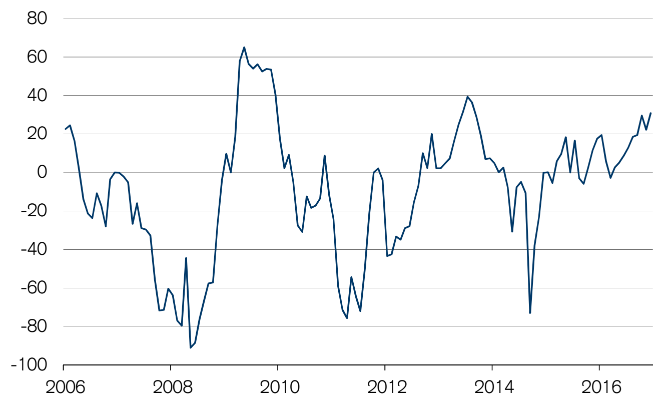
Source: PMIPremium, Credit Suisse

CS CFA Society Switzerland Index

Financial analysts have their finger on the pulse of the economy. Since 2017, we have been conducting a monthly survey of financial analysts jointly with CFA Society Switzerland under the heading Financial Market Test Switzerland[1]. 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 CS CFA Society Switzerland Index represents the balance of expectations regarding the development of Swiss economic activity over the coming six months.

Economic Activity

Balance of expectations, values > 0 = growth



Source: CFA Society Switzerland, Credit Suisse

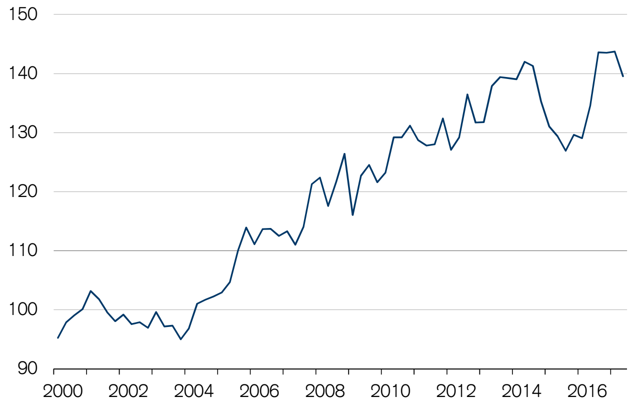
[1] Published as the Credit Suisse ZEW Index from 2006 until 2016

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 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



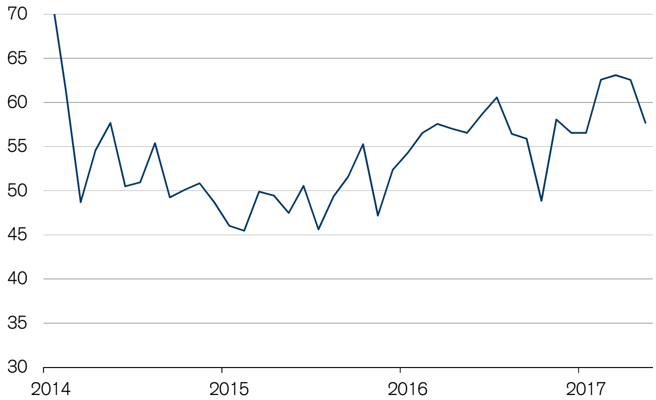
Source: Swiss Contractor's Association, Credit Suisse

PMI Services

Procure.ch, the professional association for purchasing and supply management and Credit Suisse are launching a PMI for the services sector. The Services PMI is structured in exactly the same way as its industry counterpart. Values over 50.0 points mean expansion. It is based on a survey of purchasing managers from Swiss service providers. There are six subcomponents: type of business, new orders, order book, purchasing prices, sales prices and number of employees.

Activity in the services sector

PMI Services index > 50 = growth



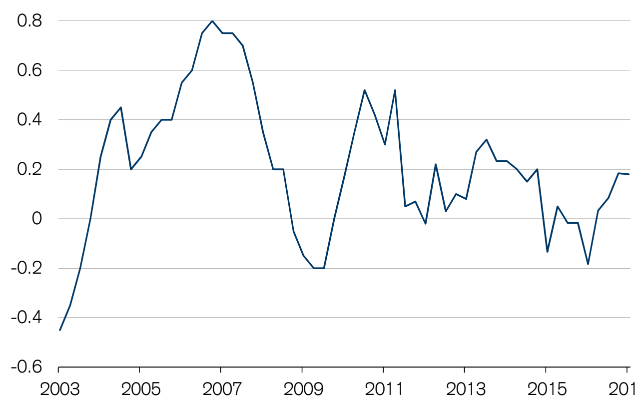
Source: procure.ch, Credit Suisse

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

	2017P Q1	2017P Q2	2017P Q3	2017P Q4	2018P Q1	2018P Q2	2018 Q3	2018P Q4	2017P	2018P
GDP (YoY, in %)	1.1	1.1	1.6	2.0	2.2	2.0	1.5	1.1	1.5	1.7
Consumer spending	1.4	1.5	1.6	0.8	1.5	1.5	1.5	1.5	1.3	1.5
Government expenditure	1.9	1.5	2.0	1.7	1.8	1.8	1.8	1.8	1.8	1.8
Gross capital investment	1.2	1.6	1.6	3.2	2.5	2.3	2.3	2.3	1.9	2.4
Construction investment	-0.1	1.0	1.1	1.8	1.5	1.5	1.5	1.5	1.0	1.5
Investment in plant and equipment	2.0	2.0	2.0	4.0	2.8	2.8	2.8	2.8	2.5	2.8
Exports (goods and services)	6.1	3.0	4.0	5.0	4.0	4.0	4.0	4.0	4.5	4.0
Imports (goods and services)	1.0	1.6	2.2	5.0	3.5	3.5	3.5	3.5	2.5	3.5
Inflation (in %)	0.5	0.3	0.4	0.8	0.6	0.5	0.4	0.3	0.5	0.5
Unemployment (in %)	3.3	3.3	3.3	3.2	3.2	3.1	3.1	3.1	3.3	3.1
Employment growth FTEs (YoY, in %)	0.2	0.3	0.3	0.3	0.5	0.5	0.5	0.5	0.3	0.5
Net immigration (in thousands)									60	
Nominal wage growth (YoY, in %)									0.5	
Current account balance (in % of GDP)									9.8	
General Government budget surplus (in % of GDP)									0.0	
Public debt (in % of GDP)									45.0	

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

Forecasts for the World Economy

	Forecasts				Structure		Significance for Switzerland	
Forecasts	**GDP** YoY, in %		**Inflation** YoY, in %		**Population** In million	**GDP** In USD billion	**Share of exports** In %	**Share of imports** In %
	2017	2018	2017	2018	2015	2015	2016	2016
World	3.5	3.6	3.0	2.8	7,222	73,171	100	100
US	2.0	2.3	2.3	2.3	322	17,947	14.9	8.0
Euro zone	1.7	1.5	1.6	1.6	333	11,540	44.4	63.5
Germany	1.6	1.6	1.7	1.7	82	3,358	18.8	27.8
France	1.4	1.6	1.4	1.5	64	2,421	6.6	7.8
Italy	0.8	0.8	1.4	1.4	61	1,815	6.0	9.6
UK	1.7	1.5	2.5	2.3	65	2,848	5.4	3.7
Japan	1.2	1.0	0.6	0.6	127	4,123	3.5	1.7
China	6.7	6.4	2.0	2.2	1,375	10,982	4.7	7.1

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)	555.8	547.9	495.5
SNB target range (in %)	-1.25 to -0.25	-1.25 to -0.25	-1.25 to -0.25	M1 money supply (%, YoY)	5.3	5.3	1.0
10-year government bond yields (in %)	-0.17	-0.1 to 0.1	0.1 to 0.3	M2 money supply (%, YoY)	3.5	3.3	2.7
				M3 money supply (%, YoY)	3.0	3.0	2.3
				Foreign currency reserves (CHF bn)	730.1	710.5	616.1

Source: Datastream, Bloomberg, Credit Suisse

Risk warning

Every investment involves risk, especially with regard to fluctuations in value and return. If an investment is denominated in a currency other than your base currency, changes in the rate of exchange may have an adverse effect on value, price or income.

For a discussion of the risks of investing in the securities mentioned in this report, please refer to the following Internet link:
https://research.credit-suisse.com/riskdisclosure

This report may include information on investments that involve special risks. You should seek the advice of your independent financial advisor prior to taking any investment decisions based on this report or for any necessary explanation of its contents. Further information is also available in the information brochure "Special Risks in Securities Trading" available from the Swiss Bankers Association.

Past performance is not an indicator of future performance. Performance can be affected by commissions, fees or other charges as well as exchange rate fluctuations.

Financial market risks

Historical returns and financial market scenarios are no guarantee of future performance. The price and value of investments mentioned and any income that might accrue could fall or rise or fluctuate. Past performance is not a guide to future performance. If an investment is denominated in a currency other than your base currency, changes in the rate of exchange may have an adverse effect on value, price or income. You should consult with such advisor(s) as you consider necessary to assist you in making these determinations.

Investments may have no public market or only a restricted secondary market. Where a secondary market exists, it is not possible to predict the price at which investments will trade in the market or whether such market will be liquid or illiquid.

Emerging markets

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