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Swiss Economics

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The era of strong growth is over in Switzerland too

Monitor Switzerland | March 2019

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Editorial deadline
13 March 2019

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Éditorial

Dear Readers

Looking back over the last two decades, we identify two pivotal trends that have shaped the global economy: first, the seismic shifts in the technology field (note internet penetration, digitalization), and second, the equally dramatic ascent of China to the position of an economic powerhouse. Both trends raise hopes, but recently they have also given rise to fears.

Apprehensions about China tend to take two diametrically opposed directions. On the one hand are mounting concerns about a the possibility of a spreading weakness in the Chinese economy, and this since early 2018, long before retaliatory US tariffs were slapped onto Chinese imports. The onset of the US-China “trade war” exacerbated these worries. Our main scenario depicts the two partners hammering out a deal in the coming weeks or months, because the tariffs obviously harm both countries. However, even in this scenario there is no guarantee that the economic cooling in China will be quickly reversed, since growth in the Middle Kingdom in recent years has stemmed primarily from a massive and hardly sustainable accumulation of debt, particularly on the part of government enterprises. At the same time, the demographic situation is visibly deteriorating as a consequence of decades of a one-child policy. A scenario similar to Japan in the beginning of the 1990s, when a decade-long credit-driven growth boom suddenly collapsed, cannot be entirely ruled out. Nonetheless, we think a continuation of the gradual growth deceleration is significantly more realistic. Our Focus article describes what direct and indirect effects a growth slump in China could have on Switzerland. It seems clear that these effects are sharply underestimated if one only considers China's relatively modest share of direct Swiss exports.

In the opposite direction, there are fears that it is not China's weakness, but its increasing strength, that poses the real threat. The US tariffs on imports from China, as well as the stricter approval procedures for Chinese firms to acquire US companies, and other measures (note Huawei) reflect these fears and can be viewed as an attempt to hinder China’s ascent. The Swiss parliament, too, is regularly petitioned to prevent a “sell-off” of Swiss industry by imposing rigorous governmental approval procedures. This position is less concerned about valuable capital inflows being lost in the process. In our view, a central criterion in corporate takeovers, whether by domestic or foreign investors, should be to maintain the competitiveness of the market economy. However, it is admittedly a gray area when government-supported companies carry out this type of investment. Rather than acceding to the current demands of protectionist leanings, it would make more sense to insist on adherence to internationally recognized standards, as stipulated in the preamble to the Swiss-Chinese free trade agreement. This would certainly aid in calming the above-described fears.

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Global environment

Euro zone

The steep drop in growth in European industry – especially in Germany – has yet to hit bottom. The purchasing managers' index (PMI) for manufacturing slipped below the growth threshold of 50 points for the first time in more than five years. Meanwhile, the services sector is displaying preliminary signs of stabilization. European PMIs for this sector continue to indicate mild growth and actually rose slightly in the most recent survey. Nonetheless, economic growth in the euro zone is likely to be weak in 2019.

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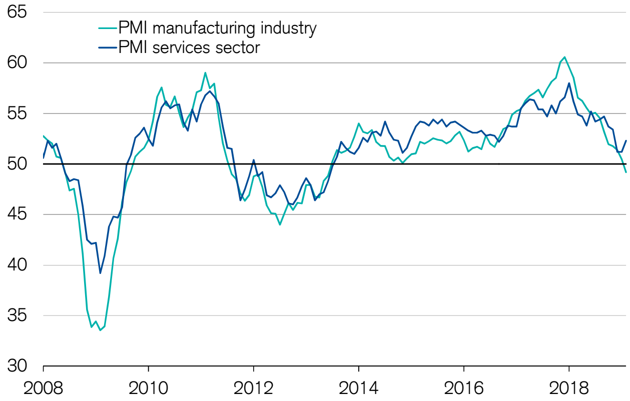
Signs of stabilization in services sector

Purchasing managers' indices (PMI) for the euro zone, growth threshold = 50



Source: PMIPremium, Credit Suisse

USA

In contrast to most other large economies, the US economy appears to be in relatively robust condition. Nonetheless, at its January meeting the US Federal Reserve adopted a more cautious tone for the first time in years, and let it be known that further interest rate hikes were on hold. This decision was based on the significantly higher risk of global economic cooling – especially in Europe and Asia. No inflationary risk is evident at the moment; the inflation rate of 1.6% in January again fell short of the targeted 2%.

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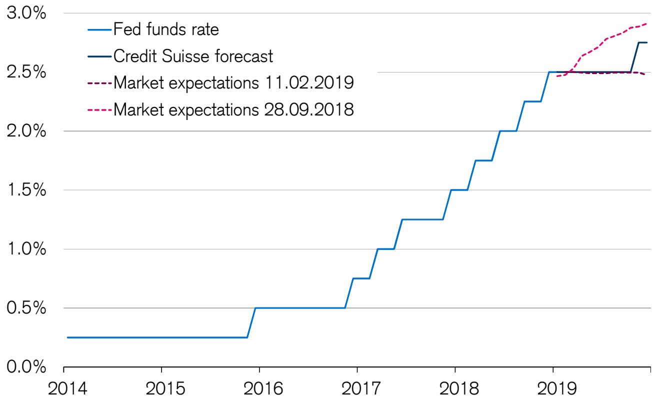
US Federal Reserve on hold

US Fed policy rates and forecasts



Source: Datastream, Credit Suisse

China

China's export and import growth dropped sharply at the turn of the year. Given the uncertainties surrounding the trade conflict, and business impacts related to the Chinese lunar New Year, export data should be interpreted with caution. Weak import figures also reflect dwindling domestic demand in China, which is likewise expressed in retail sales. On balance, China's economy should thus expand at a slower rate in 2019 than in 2018.

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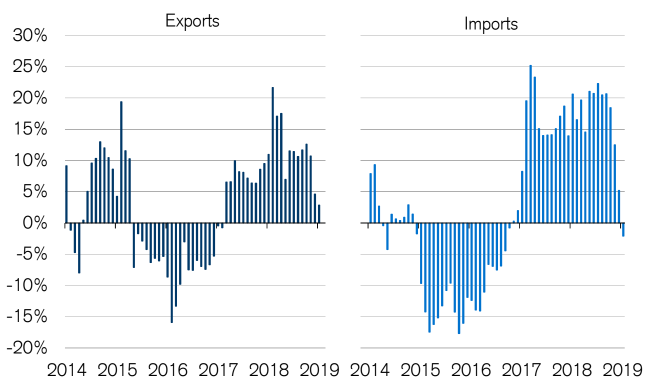
China's external trade is decelerating

China's exports and imports, year-on-year growth, 3-month average



Source: Datastream, Credit Suisse

An era of strong growth is over in Switzerland too

As global economic momentum decelerates, the era of strong growth for the Swiss export economy is also drawing to a close. Thanks to relatively solid domestic consumption, the Swiss economy should nonetheless expand by 1.5% in 2019.

The Swiss economy grew by 2.5% in 2018. This is the strongest rate in eight years, even inching above the high in 2014 (+2.4%), just before the Swiss National Bank (SNB) scrapped the minimum EUR/CHF exchange rate. However, there was a marked split last year, with an unusually dynamic first half followed by stagnation in the second half. This was firstly attributable to special effects such as licensing fees from international sporting events abroad and the summer heat wave. The subsequent slower pace was chiefly due to fading stimulus from abroad, although non-cyclical pharmaceutical exports managed to counteract the general export weakness somewhat (see chart).

The global growth deceleration is likely to weigh on the Swiss export industry for some time. Our export barometer, which measures economic conditions in foreign sales markets, recently plummeted and is now supported only by the USA (see chart below). The main culprit for the fall of the barometer is Europe, and the poor sentiment in China doesn't help. Accordingly, we expect export growth to weaken further in 2019. We forecast a rate of 2.5%, which would be the lowest figure since 2015. Modest export demand generally coincides with subdued investment activity, which is why we expect no further growth stimulus from investments in machinery and systems. As for construction investment, we forecast only a minimal pick-up in growth because the oversupply in the rental apartment market is still rising and order books are less well filled.

In contrast, the healthy labor market and correspondingly upbeat consumer sentiment, as well as a return to slightly increasing immigration, all underpin consumer demand. However, the 1.4% increase we forecast in consumption (2018: 1.0%) is not sufficient to offset declining momentum in the export industry, which is why Swiss economic growth on the whole will likely be lower this year than it was in 2018. We are therefore trimming our estimate for real GDP growth in 2019 from 1.7% to 1.5%.

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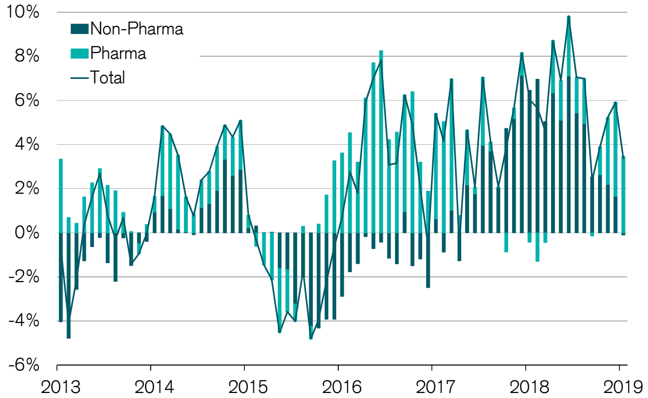
Pharma exports keep average growth high

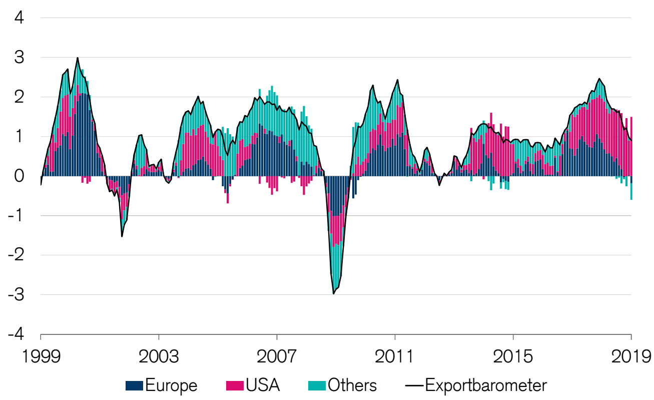
Year-on-year growth (3-month average)



Source: Federal Customs Administration, Credit Suisse

Only the USA bolsters the export barometer

In standard deviations or growth contributions



Source: PMIPremium, Swiss Federal Customs Administration, Credit Suisse

Inflation

Inflation in Switzerland has been negative for several months, which is partly attributable to oil prices being lower than they were a year earlier. But even aside from this factor, this is hardly any inflationary pressure. Only around 15% of the components of the national index of consumer prices are currently more than 2% higher than they were a year earlier. Against this backdrop, we are slightly lowering our inflation forecast for 2019 to 0.5% (previously 0.7%). We are leaving our 2020 estimate unchanged at 0.5%.

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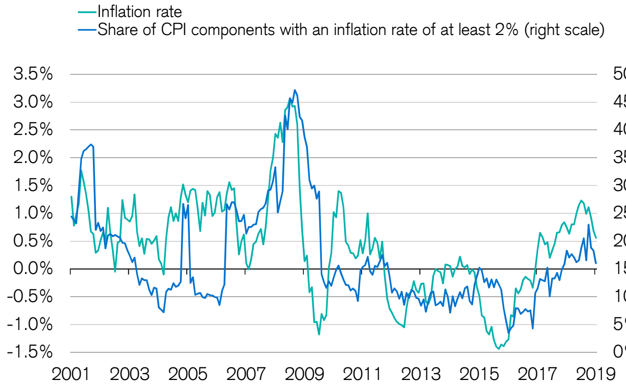
Virtually nothing in Switzerland is actually more expensive

Year-on-year change in %



Source: Datastream, Credit Suisse

Labor market

The Swiss labor market remains in good shape. Although employment growth slowed slightly further in the fourth quarter of 2018, there was a solid rise of 1.8% for the year as a whole (2017: 0.6%). Employment in industry was particularly vibrant, increasing by 1.7%, a figure not exceeded since 2008. Leading indicators such as the Purchasing Managers Index (PMI) suggest that jobs will continue to be created in industry, albeit at a slower pace. We expect overall employment to rise 1.2% in 2019.

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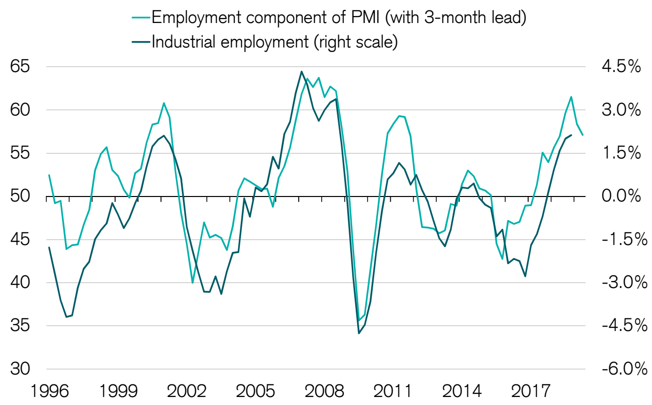
Dynamic employment growth in industry

Employment in full-time equivalents, YoY growth in %, PMI > 50 = growth



Source: SFSO, procure.ch, Credit Suisse

Immigration

A strong economy in 2018 put an end to the decline in immigration to Switzerland that has been observed since 2014. Including the migration of Swiss citizens, net immigration should be around 50,000 persons in 2018, roughly in line with the previous year's figure. This year, employment is likely to increase more strongly in Switzerland than in the euro zone. An increase in the allowed contingents for non-EU countries, and the expiration of the safeguard clause restricting immigration from Bulgaria and Romania, lend additional stimulus. We therefore expect net immigration to rise to around 55,000 persons.

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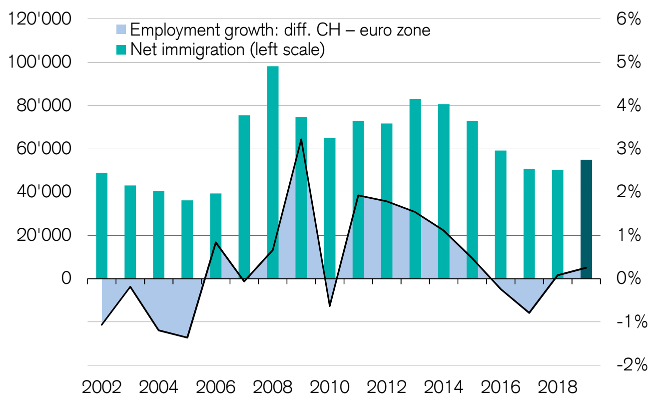
Migration on the rise

Net immigration of resident population (Swiss and foreigners, excluding registry corrections); 2018: extrapolation; 2019: forecast



Source: State Secretariat for Migration, OECD, Credit Suisse

Chemical and pharmaceutical industry

The strong export growth in the chemical industry came to an abrupt halt in the fourth quarter of 2018. A major factor here was the extremely low water level of the Rhine river, which disrupted goods transportation. Aside from this extraordinary effect, weaker industrial demand in Europe may depress the pace of export growth in future, especially in the cyclical chemical sector, or even temporarily reverse the trend to shrinking exports. Pharmaceutical exports are likely to continue rising, since they have little dependence on European industry.

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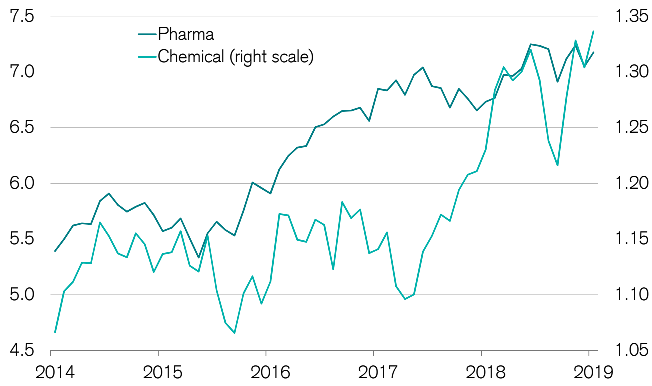
Growth deceleration in the chemical industry

Exports of goods in CHF bn, moving 6-month average



Source: Federal Customs Administration, Credit Suisse

Engineering, electrical and metal industry (MEM)

Exports in the MEM industry fell back sharply due to weak demand at the turn of the year from the German automobile industry. Among other things, a new inspection procedure for automobiles in the German auto industry led to production stoppages. Moreover, demand for German cars faltered in China. The extent of the decline appears somewhat overstated due to these special effects. However, weak global industrial output will probably further depress export growth in Swiss MEM products over the course of the year.

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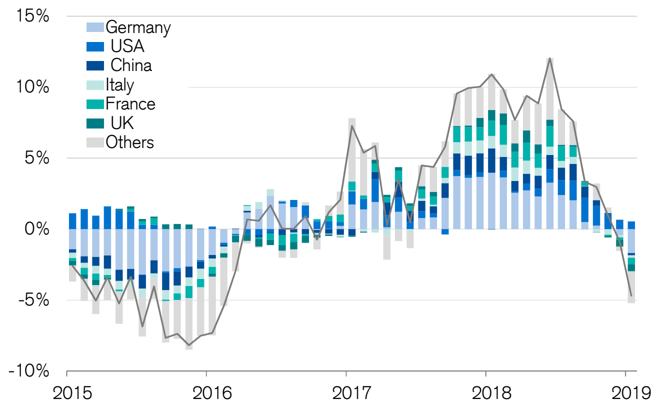
Drop in exports overstated by special effects

Exports: growth contribution by region, moving 3-month average



Source: Federal Customs Administration, Credit Suisse

Watch industry

Export growth in the watch industry had run out of steam in the third quarter of 2018 and practically came to a standstill around the turn of the year. Demand from Hong Kong, China, and Europe was significantly weaker. This lull depressed sentiment in the Swiss watch industry, where business conditions in January 2019 were rated "good" much less often than was the case for overall Swiss industry. While we do not foresee a decline in watch exports in 2019, it will probably be some months before the key export markets mentioned above have recovered.

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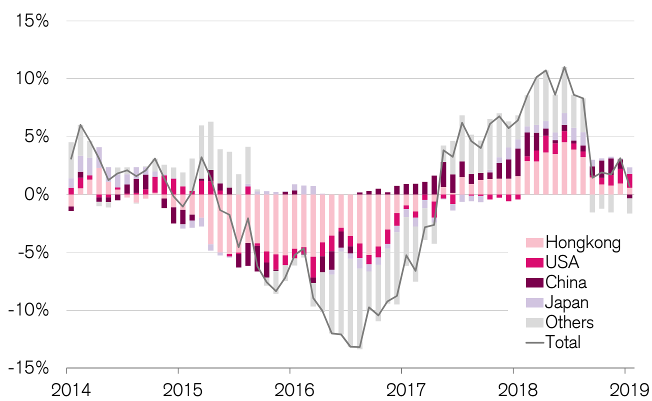
Growth stabilizing at a lower level

Exports: growth contribution by region, moving 3-month average



Source: Federal Customs Administration, Credit Suisse

Retail trade

Retail sales rose 1.0% in the fourth quarter of 2018 compared to the previous year's period, a rate somewhat stronger than in the preceding quarters. With the exception of apparel sales, all segments reported an increase in revenue – in some cases quite impressive. As a result, turnover was up 0.5% for the full year 2018. At the same time, the non-food segment contracted due to the increasing international competition from online vendors. For the current year, we expect sales growth to accelerate slightly given the robust labor maket and the mild pick-up in immigration.

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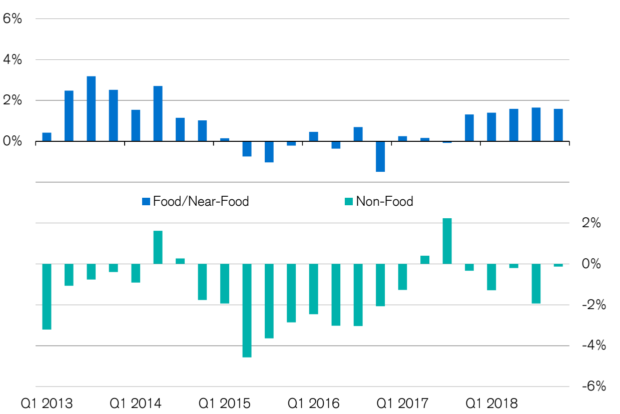
No growth acceleration so far

Nominal retail sales, change compared to previous year's quarter



Source: GfK, Credit Suisse

Tourism

The alpine destinations enjoyed a healthy start to the winter season. Mountain rail and cableways saw turnover increase by 3.4% from the beginning of the season to the end of January 2019, and hotel overnight stays in alpine regions were up 1.6%. The increase was less dependent on foreign guests than it was in 2017, when the franc depreciated significantly against the euro. The rise in demand from Swiss guests should remain intact thanks to the solid state of the labor market and the excellent weather and snow conditions during the February 2019 sport holidays.

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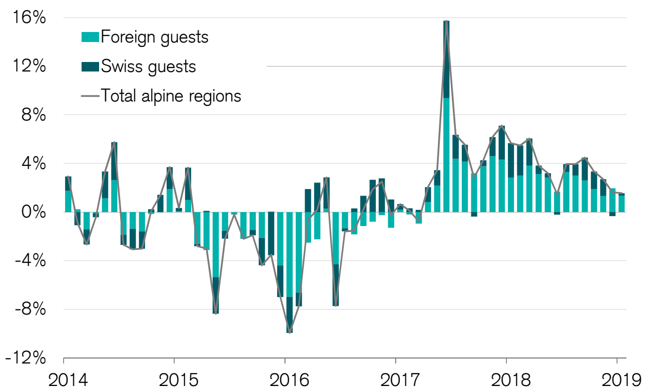
Steady overnight stays by Swiss guests

Alpine regions: Overnight stays in hotels, spa resorts, and youth hostels; growth contribution by guest origin; moving 3-month average



Source: SFSO, Credit Suisse

Information technology (IT)

Growth for IT service providers should persist this year, partly due to the ongoing digitalization trend. A majority of the IT service providers surveyed by the KOF economic research unit of the ETH Zurich assessed business conditions at the beginning of the year as "good" or at least "satisfactory", although the percentage was somewhat lower than it has been in earlier quarters. This can be attributed to both the ongoing shortage of specialist staff and the cooling global economy, which affects key customer sectors for the IT indiustry.

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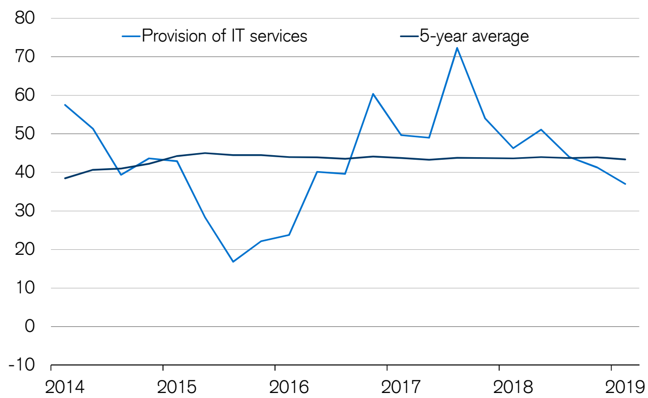
Sentiment cooling, but still good

Business conditions; share of surveyed IT service providers, balance in percentage points; quarterly



Source: Economic research unit of the ETH Zurich (KOF), Credit Suisse

Effects of a growth slump in China on Switzerland would be primarily indirect

The Swiss economy's exposure to China is greater than would appear at first glance. So it would be mistaken to expect the Swiss economy to be immune to a potential sharp slowdown in China's growth.

The world's second-largest economy is losing momentum

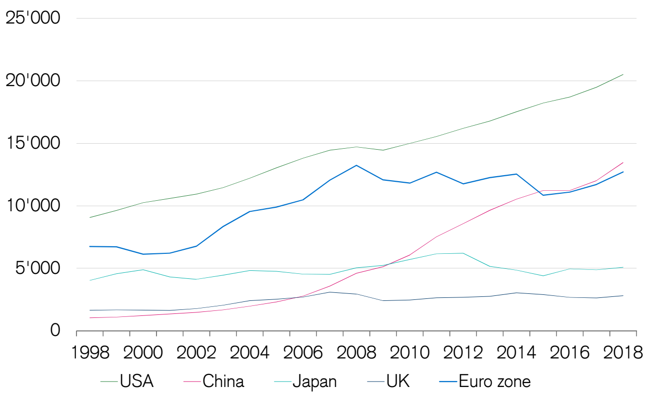
China's economy is decelerating. Beijing's days of reporting growth rates in excess of 10% are history. The International Monetary Fund currently estimates that China's economy will expand by only around 6% p.a. over the next three years, and our forecast is along the same lines. However, more pessimistic voices foresee an even sharper growth slump, and the trade spat between the USA and China, in particular, harbors potential for significant economic setbacks. Given the unfavorable demographic trends and staggering debt in China, a "Japan scenario" cannot be ruled out in the medium term: after decades of booming economic growth in Japan, an aging population and high debt levels set off a lengthy slump at the beginning of the 1990s. But what would be the consequences of a collapse in Chinese growth for the Swiss economy?

Relatively few exports to China

At first glance, Switzerland's export economy appears to have little exposure to China. However, thanks to its enormous growth over the last few decades, China has become the world's second-largest economy, overtaking the euro zone, Switzerland's biggest trade partner (see chart). Nonetheless, only some 5% of Swiss export goods were destined for China in 2018. This corresponds to a trading volume of around CHF 12 million. If the Hong Kong Special Administrative Region is included, the figure rises to nearly 8%. While this makes China the fifth-largest sales market for the Swiss export industry, the distance to leader Germany is still vast. Exports to Bavaria and Baden-Württemberg alone, the two German states bordering Switzerland, are nearly double Swiss exports to China, and the export volume to Germany as a whole is nearly four times more.

China sprints to second place in the world economy

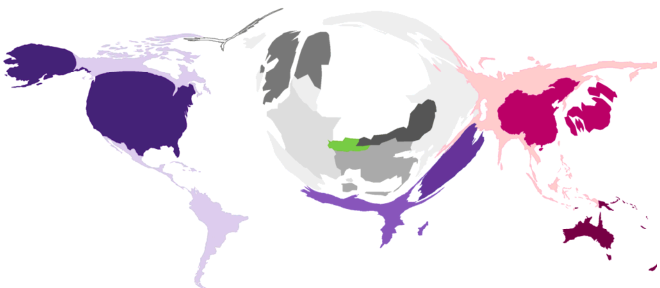
Gross domestic product in USD bn, nominal



Source: International Monetary Fund, Credit Suisse

The world from the view of the Swiss export industry

Areas correspond to export volumes



Source: Federal Customs Administration, Credit Suisse

Export elasticity Switzerland–China is insignificant...

This type of static observation is too limited in scope to quantify the effects of another, more severe growth slump in China on the Swiss export industry. To this end, export elasticity is a better tool. This indicates by how many percentage points export growth would increase or decrease if China's gross domestic product (GDP) were to change by 1 percentage point (at constant exchange rates). The chart below left shows that export elasticity between Switzerland and China is not statistically significant – in contrast to the elasticity between China and all other countries reviewed, with the exception of the UK. Consequently, exporters in the USA, Germany, Italy, and Japan would be much harder hit by a recession in China than Switzerland would be.

...but there are big differences depending on the sector

The Swiss average smoothes over major differences among the sectors. As is evident in the chart below right, in the past only exports from the chemical and pharmaceutical industries, and from the medical technology sector, trended independently of economic conditions in China, which is why their export elasticity is minor and insignificant, respectively. Since these three sectors account for nearly half of all goods exports to China, Swiss exports as a whole react very slowly to economic volatility in China. All other industries that we examined are, in contrast, very closely tied to business in the Middle Kingdom – especially the food and beverage sector. Over the observation period, a 1 percentage point decline in China's economic growth would translate into 2.6 percentage points less export growth to China for Swiss food manufacturers. The watch industry and the mechanical engineering sector – two heavyweights in exports to China – also display a measurable sensitivity. Moreover, China is already the main sales market for certain Swiss producers. For example, China is the destination for one third of global export volumes by Swiss producers of infant formula, and one fourth of structural ceramics and sanitary ware.

Chinese buy Swiss watches on their travels

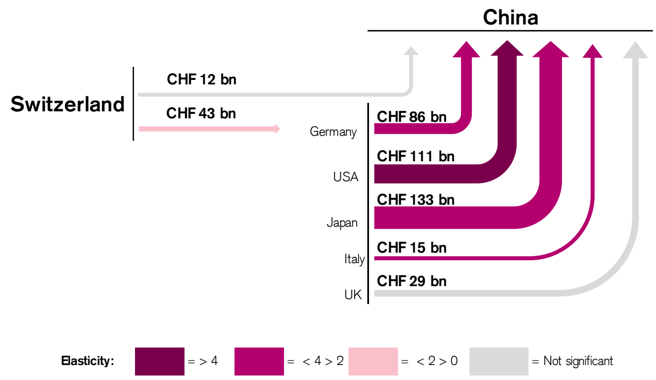
China's significance for the Swiss economy cannot be fully grasped solely from direct trade statistics and their derived elasticity. Consider the watch industry. In terms of value, not even one in ten exported watches ends up in China. However, Chinese travelers often purchase Swiss watches abroad, particularly in Hong Kong, the Swiss export market with the highest volumes. And Chinese tourists may also buy Swiss watches in Switzerland or other European countries (see box on trade in services, page 13). As a result, watch sales react sensitively to events that affect the behavior of Chinese tourists, such as the terrorist attacks in France or unrest in Hong Kong. Accordingly, as a result of the recent growth deceleration in China, exports of Swiss watches weakened not only to China itself, but also to Hong Kong and Europe (see Sector Monitor, page 8).

When growth engine China sputters, the global economy stalls

In order to more fully quantify China's significance for the Swiss economy, we must also consider its role as a key growth engine for the entire global economy. Around one fourth of global economic growth over the last 20 years can be attributed to expansion in China, and China is now an integral part of world trade. According to figures from investment bank JPMorgan, China was the largest sales market for nearly 16% of countries around the world in 2017 – the figure was just 3% in 2000.

Swiss export sales barely react to GDP growth in China...

Colors = GDP export elasticity (2000 – 2018); width = goods export sales 2018



Source: Datastream, Swiss Federal Customs Administration, Credit Suisse

...but this does not apply to most industrial sectors

GDP export elasticity between Switzerland and China by sector (1999 – 2018)

Switzerland → China

	Export weighting	Elasticity
Food and beverages	4%	2.6
Metals	4%	2.3
Watches	9%	2.2
Electrical engineering	4%	2.2
Precision instruments	2%	1.8
Plastics	2%	1.5
Mechanical engineering	10%	1.5
Pharmaceuticals	37%	-
Chemicals	7%	-
Medical technology	5%	-

Source: Datastream, Swiss Federal Customs Administration, Credit Suisse

The steep drop in Chinese imports in 2018 left clear traces in the global economy. The Chinese government intends to transform the economy from an investment- and export-driven to a consumption-driven model; this means that the global economy's sensitivity to fluctuations in China's domestic market will tend to increase, since the share of imports in China's GDP would increase from the very low 18% posted in 2017 (Switzerland: 54%).

Two thirds of all smart phones are made in China

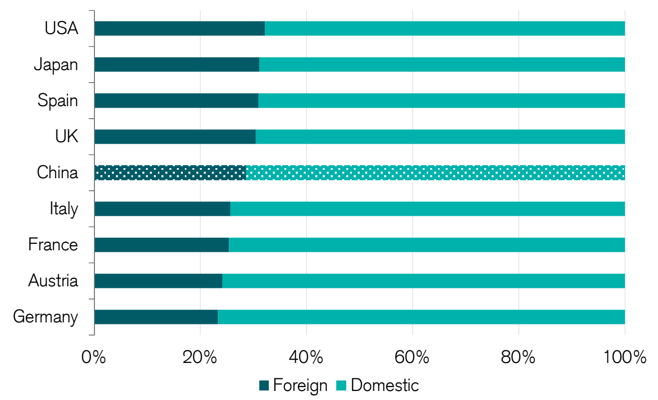
In the past decades, China's primarily image has been that of export champion. China was the largest supplier to 27% of countries in 2017 – the figure was just 2.3% in 2000. China is also a comparatively large source of imports into Switzerland. Each year, Switzerland imports Chinese goods for a value of CHF 13 billion, which represents around 7% of all imports. More is imported only from three neighboring countries – Germany, Italy, and France – and here too Germany's share is disproportionate (28%). Another impressive fact is that two thirds of all smart phones sold in Switzerland and one in four articles of clothing are made in China. Precisely in the case of complex electronic products, exports and imports are closely linked thanks to globally integrated production chains. Hence it is not particularly meaningful to observe the effects of changes on the export and import sides separately. An analysis of shocks that affect the overall economy is more helpful. Model calculations by the European Central Bank, for example, suggest that if China's GDP growth were to decline by a total of 3.3 percentage points over three years, it could lower GDP growth in the euro zone by up to 1.1 percentage points. Although the complexity of trading streams means that such simulations must be interpreted cautiously, one can nonetheless assume that the figure for Switzerland could be of a similar size.

Trade from a value creation viewpoint: China buys mostly finished products

Another approach is to identify the indirect and complex effects of a sharp growth slowdown in China on Swiss GDP by means of the World Input–Output Database (WIOD). Statistics on trade from a value creation viewpoint take into account the fact that a production process can extend across several countries. Swiss industrial exports to China comprise on average 29% foreign, i.e. imported, added value. Only in Swiss exports to the USA, Japan, Spain, and the UK is the share of foreign added value even higher (see chart). While the high values for these countries are primarily due to the major share of foreign added value in pharmaceutical exports (Switzerland is a global distributor for pharmaceutical products), exports to China include a great deal of foreign added value in nearly all product categories. This means, on the one hand, that a change in export sales to China, all other things being equal, would have less influence on Swiss GDP growth than a change in trading revenue with neighboring countries. On the other hand, it is evident that Switzerland exports mainly finished products to China, and these tend to contain elements that were manufactured abroad. Indeed, in trade with China, Swiss industry reports an above-average 40% share of value creation from the sale of finished products and practically none from the delivery of goods that Chinese companies use for their own exports (see chart). The high percentage of finished products in turn increases the significance of Chinese end-demand for Swiss exporters and GDP growth.

Swiss exports to China with imported added value

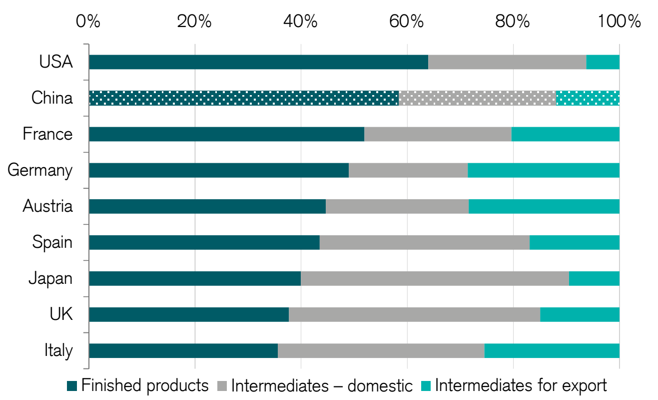
Origin of added value in Swiss industrial exports, 2014



Source: World Input-Output Database, Credit Suisse

High share of finished products in trade with China

Added value by application in Swiss industrial exports, 2014



Source: World Input-Output Database, Credit Suisse

Swiss exports to Germany also shaped by China

China's indirect impact on the Swiss export economy can be illustrated by the example of Germany. As mentioned previously, economic momentum in Germany, Switzerland's main export market, is affected by that in China – the corresponding export elasticity is positive and significant. At the same time, Swiss exports to Germany – with the exception of pharmaceutical exports – are highly sensitive to changes experienced by our northern neighbor. So it stands to reason that Swiss exports to Germany are affected to some extent by developments in China. In fact, around 20% of value adding Swiss exports to Germany are exported again, to destinations that include China. One prominent example of Swiss companies supplying a globally-oriented German manufacturing sector is the automotive industry. A study by the Swiss Center of Automotive Research (swiss Car) of Zurich University found that sales by Swiss automotive suppliers totaled around CHF 12.3 billion in 2018. Since most of this output is probably exported, it likely accounts for around 5% of all Swiss exports. Stocks of Swiss companies that are active in the automotive sector are among those whose share price development tends to align somewhat with China's economy and stock market. Evidently, the stock markets reflect a certain exposure of the Swiss economy to China, although the share of direct exports is small and Swiss companies invest relatively little in China. The level of Swiss direct investment (FDI) in China is just CHF 22 billion or 2% of all FDI – quite modest. Then there are issues such as inadequate patent protection and general legal recourse, geographical distance, and cultural differences. In the long term, however, integration is bound to increase simply because of the enormous size of the Chinese market.

Cause of a growth slowdown would be decisive

We conclude that the Swiss economy is probably more exposed to China than would appear at first glance. It is therefore mistaken to believe that the Swiss economy would be immune to a potential sharp slowdown in China's growth. In light of the above analysis, however, it is important to differentiate between two scenarios. If China's economy were to decelerate due to China-specific factors (debt, demographics, domestic politics – the "Japan scenario"), its impact on Switzerland would be limited. The sectors that engage in direct trade with China and whose demand is cyclically sensitive would suffer most – mainly the engineering, electrical, and metal industry, as well as the watch business and automotive suppliers that focus on Germany. If, on the other hand, the triggers of the deceleration were of a geopolitical nature, such as an escalation of trade conflict, this would have more serious, and significantly broader, consequences for Switzerland. Even economic sectors that do not deal directly with China would likely see a drop in demand due to the global effects of the trade conflict – not least via setbacks on the global financial markets. Finally, the sensitivity of various Swiss sectors to China is likely to shift as a result of structural changes in China's economy. For example, even the otherwise cyclically insensitive pharmaceutical industry could feel the effects of a collapse in China's progress towards prosperity.

China's significance for service providers limited to tourism sectors

According to the Swiss National Bank (SNB), just 2.7% of all revenues from services rendered abroad are generated in China – and of these, nearly one third from the unspecific category of "license fees". The SNB's statistics do not include tourism. Today, the Chinese are the fourth most important group of foreign guests for the Swiss hotel and catering industry. However, the needs of Chinese tourists are generally different from those of individual "western" tourists. Their budget for lodging, as well as the time they spend in Switzerland, generally tends to be more abbreviated. This is evident in the overnight lodging locations. Reasonably priced locations such as Erstfeld (UR) are enjoying a veritable explosion in overnight stays by Chinese guests. In 2010, only around 60 Chinese guests stayed in hotels in Erstfeld, but by 2016 the figure had climbed to 11,000. This is because the "Tour de Suisse" favored by Chinese tour groups, beginning in Zurich, Rome, or Paris, usually passes through Lucerne.

Rate hike not before 2020

A subdued inflation outlook, weaker economic growth in the Eurozone and a still expensive CHF have led us to revise our expectation for the Swiss National Bank's (SNB) rate path. We now expect the first rate hike in 2020.

The SNB is unlikely to raise its policy rate before June 2020

Inflation in Switzerland is likely to remain low over the course of the year, not least due to lower oil prices. Moreover, slower global growth has led to a shift in the rhetoric of the major central banks, particularly the US Federal Reserve (Fed), toward a more cautious tone. The European Central Bank (ECB) will also likely be patient before initiating a rate hike cycle. In such an environment, there is no leeway for the SNB to signal an imminent rate increase. Hence, our earlier forecast of an interest rate hike in September 2019 now seems quite unlikely. We have therefore revised our forecast and now expect the SNB to raise its policy rate by 0.25 percentage points in June 2020 and a second time in December 2020. However, a rapid resolution of the trade tensions between the USA and China as well as an agreement between the EU and the UK on Brexit could weaken the CHF and prompt us to shift our forecast toward an earlier interest rate hike. On the other hand, persistently weak economic growth, in particular in the Eurozone, could push any rate increase beyond 2020. The latter scenario, implying a negative policy rate for several more years, seems to be partially priced in by financial markets, as indicated by negative yields on long-term Swiss government bonds.

Sales of foreign currency reserves do not have priority

Meanwhile, the SNB has not intervened in the foreign exchange market since the summer of 2017, in our assessment. Yet, even if the SNB were to raise its policy rate as we expect, any reduction of the foreign exchange reserves through active sales of assets, and hence of the SNB balance sheet, is unlikely to come on the table anytime soon, in our view. We believe that the priority of the SNB will be to raise the policy rate to zero or into positive territory, before contemplating a reduction of its balance sheet.

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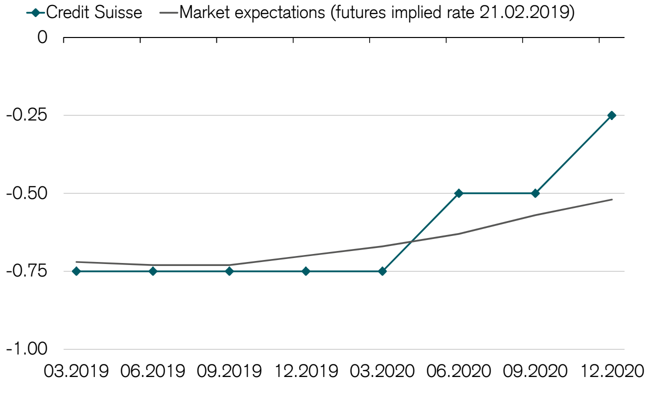
SNB policy rate forecast and market expectations

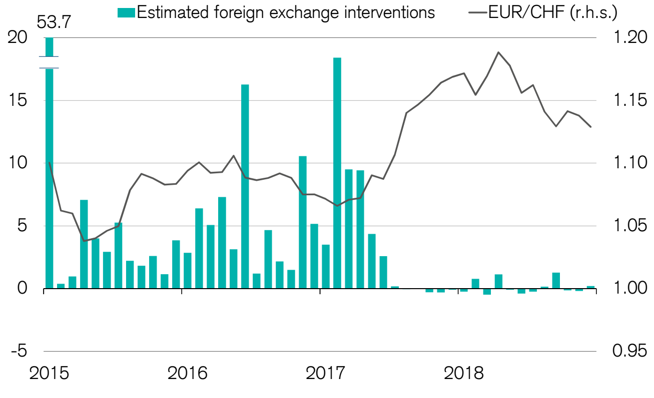
Policy rate, in %



Source: Bloomberg, Credit Suisse

No indication of foreign exchange purchases since mid-2017

In CHF billion; EUR/CHF (right-hand scale)



Source: Datastream, SNB, Credit Suisse

Foreign currency reserves

At the end of December 2018, the currency allocation was broadly unchanged in comparison to a year earlier: 40% of the foreign currency assets were allocated in EUR (43% in December 2017) and 34.4% in USD (34%). The rest were held in JPY (9.1%), GBP (6.9%), CAD (2.7%) and other undisclosed currencies (6.8%). Regarding the asset allocation, the equity allocation fell to 19% from 21% a year earlier, probably due to the drop in global equity prices in Q4 2018. The SNB held the equivalent of CHF 32.8 billion of its foreign currency reserves in cash, making up 4.5% of the total asset allocation. The remainder was allocated to bonds.

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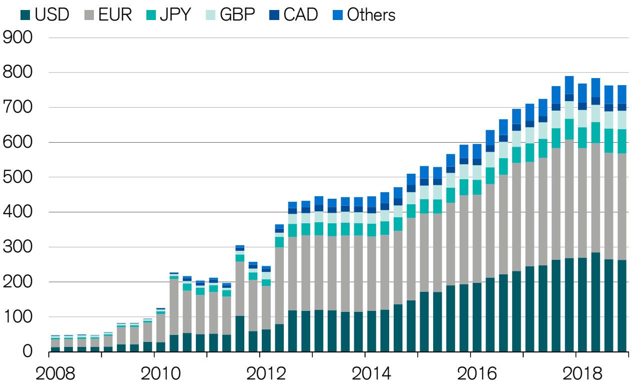
Stable EUR allocation

SNB foreign currency reserves, in CHF billion



Source: SNB, Credit Suisse

Credit to non-financial corporations

Credit to non-financial corporations rose rapidly for most of 2018. The sector that contributed the most to this growth is the trade sector, which includes commodity traders. The latter are probably the main driver of credit growth for non-financials, given the very large turnover generated by their business model. Credit growth in manufacturing increased solidly last year, in tandem with economic activity in this sector, as reflected by business survey. However, as activity slowed at the turn of the year, credit demand from this sector will also likely weaken.

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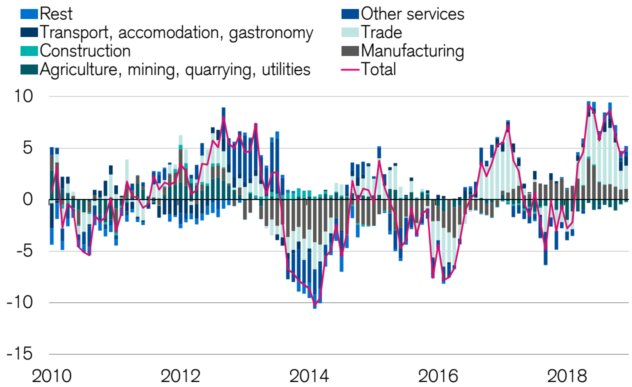
Solid credit growth

Credit growth to non-financial corporations, in % YoY (excl. mortgage credit)



Source: SNB, Credit Suisse

Cross-border capital flows

Swiss residents have failed to contribute to the "recycling" of Switzerland's current account surplus. With the exception of a few quarters, notably Q1 2015 when the CHF appreciated substantially following the removal of the exchange rate floor against the EUR by the SNB, thus making foreign assets particularly cheap, purchases of foreign equities, bonds, and fund shares by residents have been muted. On the other hand, non-resident investors have been net sellers of Swiss securities, in particular of Swiss equities, which has led to capital outflows.

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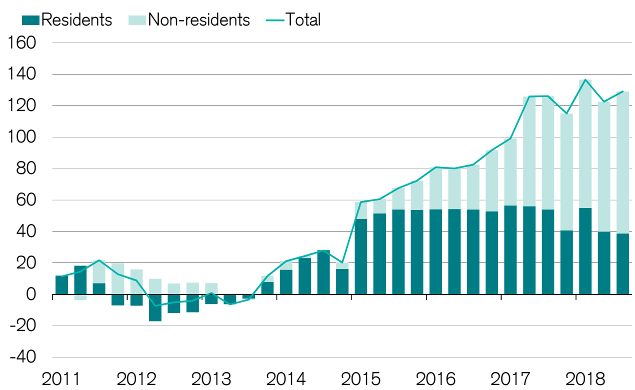
Foreign investors have sold Swiss equities

Cumulated portfolio investment outflows since Q1 2011, in CHF billion



Source: SNB, Credit Suisse

Rental apartments

In light of the record-high supply rate (5.3%) and vacancy rate (2.5%), a correction in prices on the market for rental apartments is inevitable. The same is suggested by advertised rents, which have been signaling decreasing market rents for two to three years already. Neither index has registered an acceleration in the price decline lately. However, there is a significant difference in the extent of the price erosion, depending on the index (last data point Wüest Partner index: –2.1% year-on-year; Homegate index –0.3%). With some delay, the rental agreements concluded since the second quarter of 2018 have also displayed a falling tendency (–0.2%).

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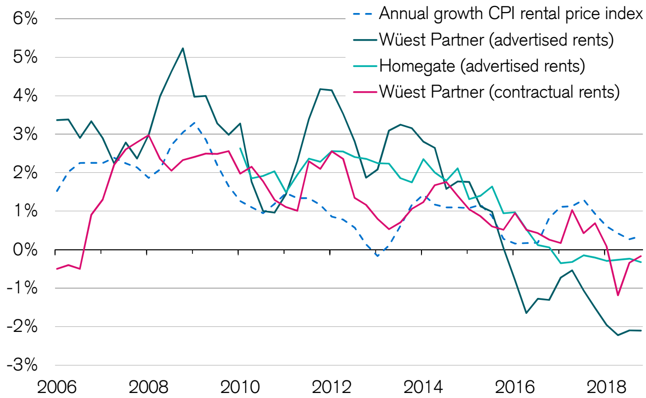
Contractual rents falling since early 2018

Rental price indexes in comparison, annual growth rates



Source: Wüest Partner, Homegate, SFSO

Owner-occupied housing

As we expected, price growth settled somewhat over the course of the year and is now largely homogeneous in the various price segments. Over the last 12 months, prices for mid-range condominiums rose by 1.7%, while prices for single-family dwellings rose by 3.4%. With the exception of the alpine areas and Canton Ticino, prices for owner-occupied housing rose in nearly all regions of Switzerland. Given the dwindling economic stimulus, we expect price momentum to decline slightly in 2019, with price increases of no more than 2% on average. Prices for single-family dwellings will probably rise more markedly than those for condominiums.

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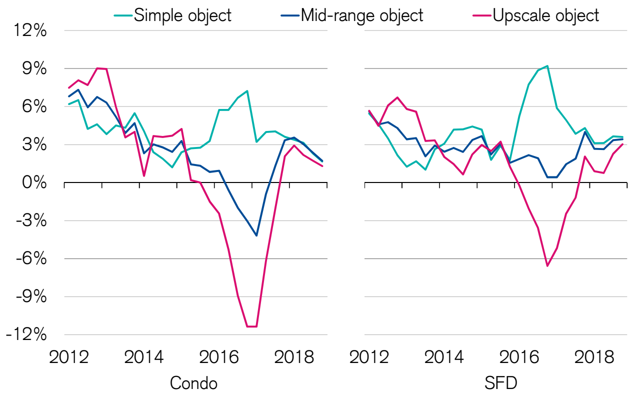
Prices rising in all price segments

Annual growth rates for owner-occupied housing by price segment



Source: Wüest Partner

Office property

The acceleration in economic growth boosted employment in 2018 and stimulated demand for office space, which had long been stagnant. One thing all major centers have in common is that the recovery spreads outward from the central districts. There, the amount of office space advertised for lease has declined by around one fifth. In Geneva and Zurich, the recovery has spread to include the middle business district. Nonetheless, overall supply rates have increased further, because the outer business districts – except for Lausanne's – display little evidence of a recovery yet. For a widespread recovery, the future trends in demand and employment growth will be decisive.

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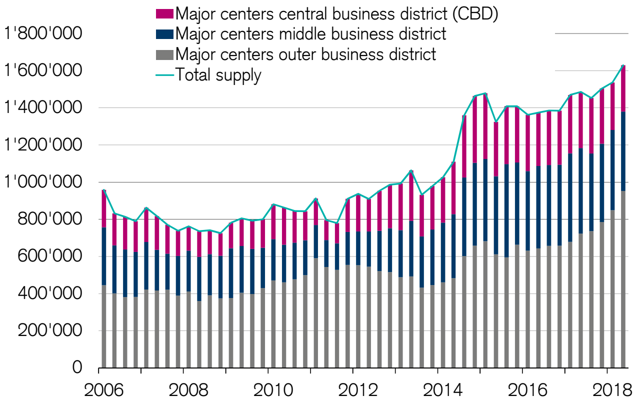
Supply of office space decreasing in central business districts

Total office space advertised for lease* each quarter (inventory and new buildings), in m^2



Source: Meta-Sys AG, Credit Suisse *space advertised on the internet

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

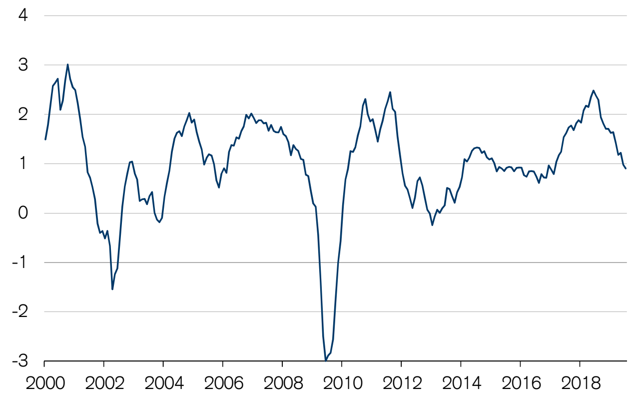
Source: procure.ch, Credit Suisse

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



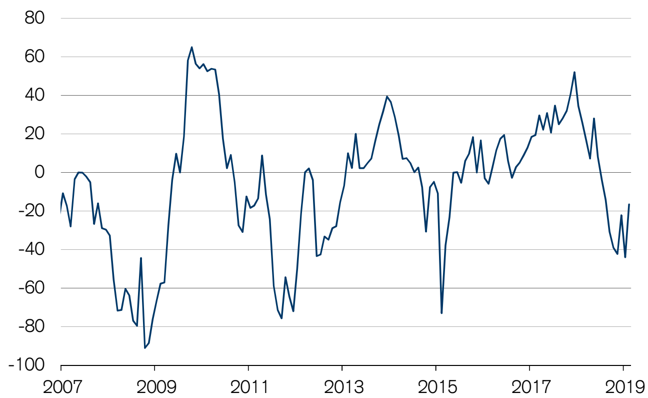
Source: PMIPremium, Credit Suisse

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

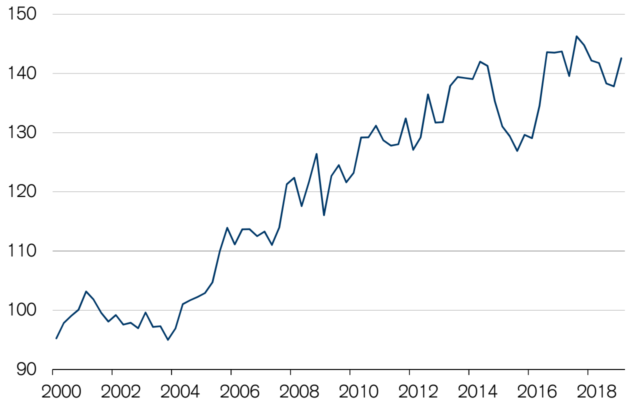
Credit Suisse Leading Indicators

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



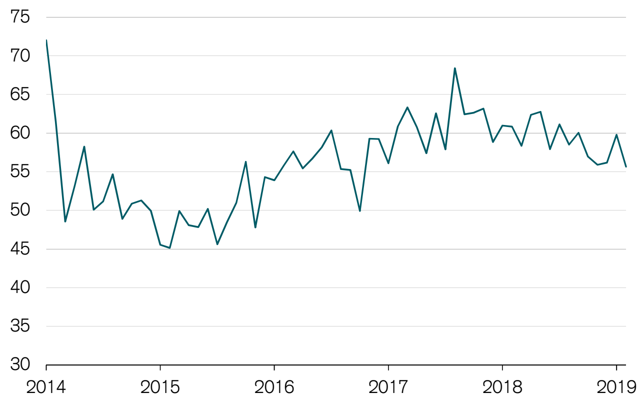
Source: Swiss Contractor's Association, Credit Suisse

PMI Services

Procure.ch, the professional association for purchasing and supply management and Credit Suisse launched a PMI for the services sector in 2014. 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

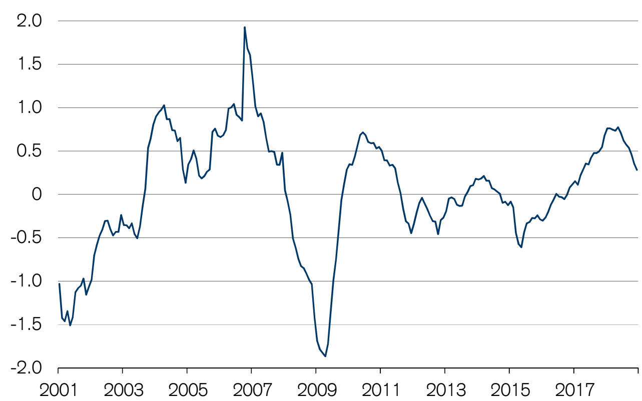


Source: procure.ch, Credit Suisse

Macro Momentum Indicator

The Credit Suisse Macro Momentum Indicator (MMI) condenses the current performance of key Swiss economic data to a single figure. Data from economic surveys, consumption, the labor market, lending and the export economy are used to calculate a standardized momentum that is then weighted with the applicable correlation to GDP development. Values above (below) zero point toward an acceleration (slowdown) of the Swiss economy in the last three months compared with the past six months.

Economic Activity



Source: Datastream, Credit Suisse

Forecasts and Indicators

Forecasts for the Swiss Economy

	2019P Q1	2019P Q2	2019P Q3	2019P Q4	2020P Q1	2020P Q2	2020P Q3	2020P Q4	2020P	2020P
GDP (YoY, in %)	0.9	0.8	1.8	2.4	2.3	2.1	1.6	1.3	1.5	1.8
Consumer spending	0.9	1.1	1.7	1.7	1.6	1.5	1.3	1.4	1.4	1.4
Government expenditure	0.9	0.9	0.9	0.9	1.0	1.0	1.0	1.0	0.9	1.0
Gross capital investment	2.3	2.1	2.0	2.0	2.0	2.0	2.0	2.0	2.1	2.0
Construction investment	0.9	0.9	0.9	0.9	1.1	1.1	1.1	1.1	0.9	1.1
Investment in plant and equipment	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Exports (goods and services)	2.5	2.5	2.5	2.5	3.0	3.0	3.0	3.0	2.5	3.0
Imports (goods and services)	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
Inflation (in %)	0.6	0.4	0.4	0.4	0.6	0.5	0.5	0.4	0.5	0.5
Unemployment (in %)	2.4	2.4	2.5	2.5	2.5	2.5	2.5	2.5	2.4	2.5
Employment growth FTEs (YoY, in %)	0.8	0.8	1.3	1.5	1.5	1.3	1.0	1.0	1.2	1.2
Net immigration (in thousands)									55	55
Nominal wage growth (YoY, in %)									1.0	1.0
Public debt (in % of GDP)									6.6	6.9

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 %
	2019	2020	2019	2020	2018	2018	2018	2018
World	2.8	2.9	2.5	2.5	7'530	84'835	100	100
US	2.3	2.1	1.5	2.2	328	20'513	16.3	6.2
Euro zone	1.2	1.6	1.3	1.5	341	13'738	44.3	61.7
Germany	0.9	1.5	1.6	1.6	83	4'029	18.5	27.1
France	1.0	1.4	1.4	1.7	65	2'795	6.3	8.0
Italy	0.1	0.9	0.9	1.4	61	2'087	6.0	9.3
UK	1.0	1.4	1.9	2.1	66	2'809	3.8	3.8
Japan	0.8	0.7	0.6	0.5	126	5'071	3.3	1.7
China	6.2	6.0	1.9	2.0	1'397	13'457	5.2	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 %)	-0.70	-0.8 to -0.6	-0.8 to -0.6	M0 money supply (CHF bn)	562.3	555.3	548.4
SNB target range (in %)	-1.25 to -0.25	-1.25 to -0.25	-1.25 to -0.25	M1 money supply (%, YoY)	5.1	5.5	7.5
10-year government bond yields (in %)	-0.24	-0.3--0.1	0.2-0.4	M2 money supply (%, YoY)	3.2	3.5	4.2
				M3 money supply (%, YoY)	3.4	3.1	3.9
				Foreign currency reserves (CHF bn)	773.1	763.7	759.7

Source: Datastream, Bloomberg, Credit Suisse

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For a discussion of the risks of investing in the securities mentioned in this document, please refer to the following Internet link:
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This document 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 document 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.

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Hedge funds are not subject to the numerous investor protection regulations that apply to regulated authorized collective investments and hedge fund managers are largely unregulated. Hedge funds are not limited to any particular investment discipline or trading strategy, and seek to profit in all kinds of markets by using leverage, derivatives, and complex speculative investment strategies that may increase the risk of investment loss.
Commodity transactions carry a high degree of risk and may not be suitable for many private investors. The extent of loss due to market movements can be substantial or even result in a total loss.

Investors in real estate are exposed to liquidity, foreign currency and other risks, including cyclical risk, rental and local market risk as well as environmental risk, and changes to the legal situation.

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The retention of value of a bond is dependent on the creditworthiness of the Issuer and/or Guarantor (as applicable), which may change over the term of the bond. In the event of default by the Issuer and/or Guarantor of the bond, the bond or any income derived from it is not guaranteed and you may get back none of, or less than, what was originally invested.

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