

Growth remains robust despite uncertainties

Monitor Switzerland | September 2018

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Publisher, Credit Suisse AG, Investment Solutions & Products

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Editorial deadline

10 September 2018

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Dear Reader

It is now ten years since the collapse of the American investment bank Lehman Brothers, the ultimate combustible agent of the global financial crisis. Although the crisis also severely affected the Swiss financial center, we appear in the meantime almost to have forgotten it. This is not least due to the fact – barely conceivable back then – that the Swiss economy has since experienced an almost continuous upturn.

Who do we have to thank for this “miracle”? There can be no doubt that structural strengths of the Swiss economy have made a contribution: We not only have strong major corporations but also small and medium-sized enterprises (SMEs) many of which perform excellently in the global competition as illustrated by a study published recently by us. Furthermore, Switzerland stands out due to the pronounced flexibility of its labor market. Our tradition of a cooperative social partnership and the frequently observed “non-utilization of the wage policy scope for distribution” (see focal article on page 10) makes it easier for companies to maintain relatively high employment even in the face of major economic setbacks.

However, economic policy measures and special factors are likely to have been more decisive: These include first of all the firm action taken by the authorities to stabilize the banks in the midst of the first crisis; secondly the renewed firm actions of the Swiss National Bank (SNB) to prevent a further appreciation of the franc in the wake of the euro crisis; thirdly the stimulation of the domestic economy and above all construction activity with extremely low interest rates; and fourthly the extremely strong migration of foreign labor force.

As long as our economic forecasts prove at least partially correct, the global upturn will continue in the coming year despite the smoldering trade conflicts, the fragility of some emerging markets and political uncertainties in Europe. This will also support the Swiss economy. At the same time we expect inflation gradually to pick up as capacities slowly run short. Inflation in the US has now reached the central bank’s target and in Switzerland as well it is almost back where it was in the decade preceding the financial crisis. (Nominal) wages should therefore also rise more sharply in the medium term.

The bottom line is that ten years after the financial crisis the greater bulk of economic performance appears to be coming to rest at a more or less normal level. However, there is one major exception – interest rates. Not just nominal but also real interest rates both in Switzerland and elsewhere are in strongly negative territory and therefore well below the historic norm. If and when a marked rise in interest rates sets in is the subject of heated debate shaped by a high degree of forecasting uncertainty. We expect another year to pass before the SNB carries out an initial interest rate hike. This “soft” interest rate scenario is another reason for our forecast of a sustained upturn. However, this is also increasing the risk of growing imbalances in the economy and on the financial markets, not least on the real estate market.



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Growth remains robust despite uncertainties

The Swiss economy is undergoing a ‘mini-boom’. However, this is attributable to a perfect interplay of several factors that is very unlikely to be repeated in 2019. Economic growth is therefore set to slow down to below 2%.

Swiss economy currently booming

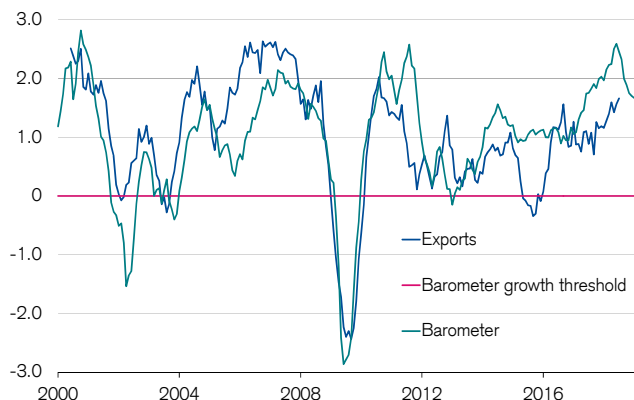
The Swiss economy once again recorded booming growth in the second quarter of 2018. Real gross domestic product (GDP) increased by 0.7% on the previous quarter after the economy had even expanded by 1% in the first quarter. This is the highest growth since the recovery boom back in 2010 after the financial crisis. However, it is estimated that almost a quarter of the growth recorded in the last two quarters is attributable to a temporary boost due to international sporting events such as the Winter Olympics. A large number of international sports federations such as the International Olympic Committee (IOC) and the Fédération Internationale de Football Association (FIFA) are headquartered in Switzerland and their revenues are allocated to Swiss GDP despite the fact that their activities take place outside the country. At the same time, statistical revisions of the previous years have increased the growth path. We are accordingly revising our forecasts of GDP growth in 2018 from 2.2% to 2.7%.

Absence of special effects and less tailwind in 2019

In comparison with this, the 1.7% growth forecast by us for 2019 at first glance appears meager. However, some of the slowdown is attributable to the fact that there are no international sports galas taking place in the coming year. Meanwhile, the underlying situation for the export sector is no longer quite as positive as in the two preceding years. The Export Barometer that measures the demand potential for Swiss goods abroad at any rate recently fell sharply (see Figure). At the same time the underlying situation of the exchange rate is different from that of 2017 and 2018. According to our client survey at the time, companies in 2017 budgeted a EUR/CHF exchange rate of 1.08. The following depreciation of the CHF accordingly came as a positive surprise. The rate budgeted for 2018 was 1.17 and companies were once again positively surprised during the first five months (see Figure). Positive surprises awaken the infamous “animal spirits”, i.e. what is often the decisive courage to risk investments. Furthermore, CHF depreciations increase the margins and profits of exporting companies and therefore the scope for the financing of investments. This was one of the reasons for the above-average investment activity seen so far.

Export Barometer dips from peak

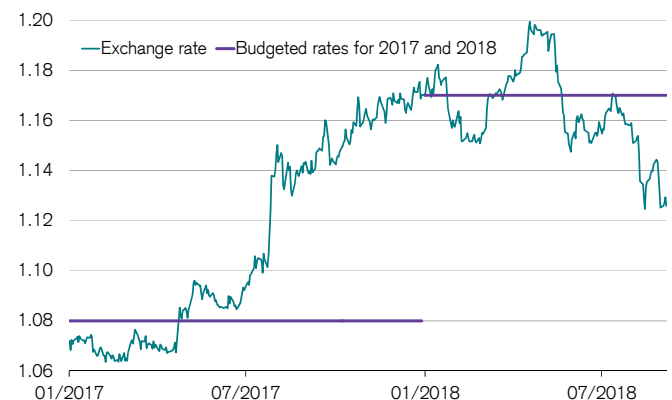
In standard deviations, nominal exports, moving six-month average



Source: PMIPremium, Datastream, Credit Suisse

Positive exchange rate surprises are over

EUR/CHF, budgeted rates from foreign exchange rate market surveys of Credit Suisse



Source: Datastream, Credit Suisse FX surveys for 2017 and 2018

Exports and investments losing momentum

Meanwhile, the CHF has several appreciation surges behind it so that the welcome surprise has changed into an unpleasant one. This is set to dampen investment sentiment. At the same time, the excessive capacity utilization prevailing until recently in industry appears to be decreasing. This at least is suggested by the ratio of the two subindices “suppliers’ delivery times” and “output” of the purchasing managers’ survey (PMI) (see Figure). According to this, companies have recently increased their output so sharply that suppliers’ delivery times – an indicator of bottlenecks – contracted again from their record levels at the start of the year. The incentives for further capacity expansions have therefore got smaller. Altogether both exports and investments in machines and equipment should remain lively in 2019 but be weaker than in the present year. While both expanded by 4.0% each in 2018, the increase in 2019 is set to amount to just 3.5% (exports) and 3.0% (investments in equipment). We also expect a contraction in the growth of construction investments from 1.6% to 0.5%. The decisive factors here are the growing oversupply on the housing market and the order books in structural and civil engineering that are becoming gradually thinner.

Labor market recovery offers solid foundation for economic growth

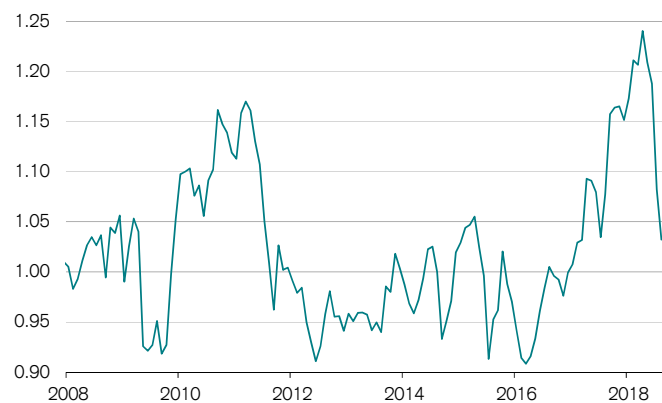
Private consumption should remain solid in 2019, although it will continue to increase relatively modestly. We anticipate unchanged growth momentum in comparison to 2018 (+1.3% in each case). Four components were the key drivers of private consumption: the rise in population and therefore above all immigration, the labor market situation and the sentiment and purchasing power of consumers. Immigration has now stabilized at a lower level; additional growth momentum of what has so far been the key growth driver is therefore not to be expected (see page 7). The labor market situation has recently improved rapidly and this improvement is now broadly based. Employment should also increase in 2019 and unemployment fall further, thereby creating a solid foundation for robust economic performance. However, subjectively perceived job security is only improving slowly as this normally lags behind the overall economy (see Figure). Furthermore, the constant flow of crisis reports from abroad will be depressing households and thereby limiting the scope for an improvement in consumer sentiment. At the same time, real wages are again only rising at a subdued rate, as we explain in our focal article on page 10.

Rather positive than negative surprises

The broad base is to a certain extent making Swiss GDP growth resistant to the global political disturbing factors. However, Switzerland’s open economy would also not be immune toward a possible collapse in the global economy. Having said this, the likelihood of negative surprises is at present altogether probably lower than that of positive ones. We nevertheless expect the growth level seen in this year’s “mini-boom” no longer to be achieved in 2019. The perfect interplay of extremely dynamic global economic growth, a surprising depreciation of the CHF, low interest rates, the recovery of the labor market and special effects due to the sports galas as witnessed at the end of 2017 and start of 2018 is likely to remain a unique constellation for the time being.

Fewer bottlenecks thanks to increase in capacity

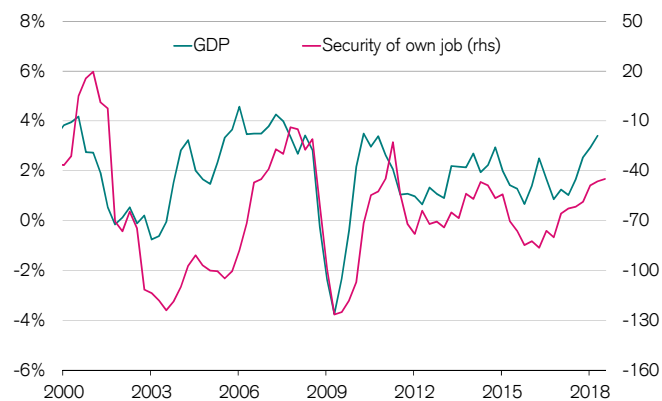
Ratio of “suppliers’ delivery times” and “output” PMI subindices



Source: procure.ch, Credit Suisse

No euphoria regarding labor market

Gross domestic product YoY, real. Survey-based assessment of consumers, index



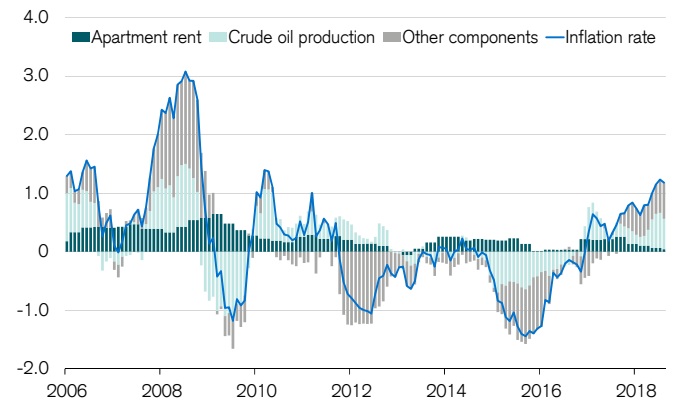
Source: State Secretariat for Economic Affairs (SECO), Credit Suisse

Inflation

Inflation has risen to over 1% in the last few months. Almost half of this increase is attributable to higher oil prices. However, the rise in prices has now also accelerated in other areas, thereby marking the end of the period of falling prices. For example, the price level of communications services has stabilized following several years of falling prices. A similar trend is emerging in the furniture and household goods sector. In view of these developments, we are revising our inflation forecast for 2018 upwards from 0.8% to 1.0% but leaving the forecast for 2019 unchanged at 0.7%.

Rise in inflation strongly driven by oil prices

YoY change in %



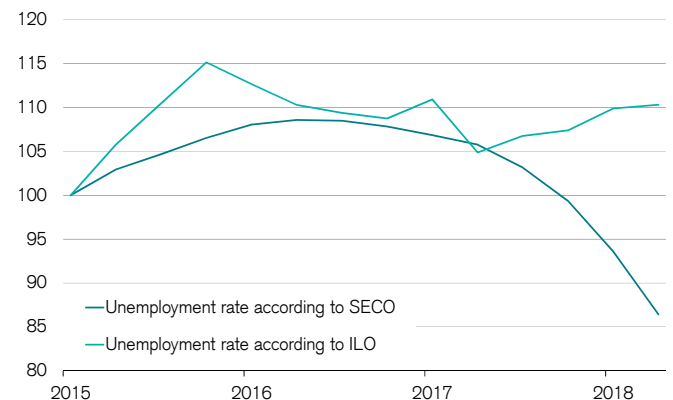
Source: Datastream, Credit Suisse

Labor market

The decline in the number of unemployed registered with the regional employment centers (RECs) is continuing so that the State Secretariat for Economic Affairs (SECO) has now been reporting a positive trend for two years. However, according to the definition of the International Labour Organization (ILO) that also includes persons not registered with the RECs and therefore particularly captures the long-term unemployed better, the unemployment rate has been falling significantly less sharply and has even risen slightly in the last four quarters. This at least raises the question of whether residual unemployment, which barely decreases even when the economy is booming, has risen due to the currency shock of 2015.

Higher residual unemployment than before 2015?

Indexed Swiss unemployment rates, Q1 2015 = 100



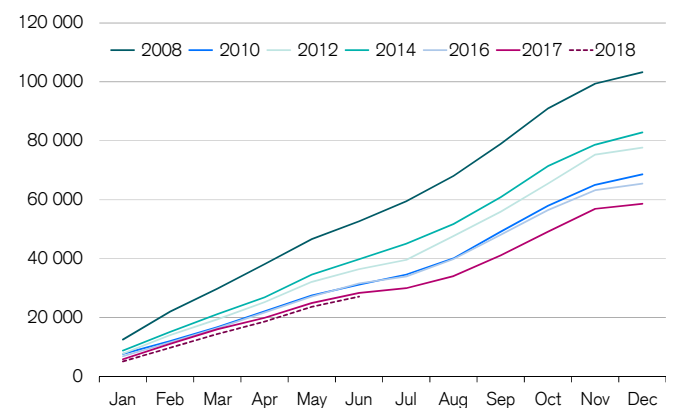
Source: State Secretariat for Economic Affairs (SECO), Swiss Federal Statistical Office, Credit Suisse

Immigration

Immigration to Switzerland appears gradually to be bottoming out after reaching its lowest level since 2007 in the summer of 2017. While in the first quarter of 2018 net migration was still around 10% down on the prior-year quarter, it increased by 3.3% in the second quarter. The balance of migration of the Portuguese remains negative, while Germans and Italians have recently been coming to Switzerland more frequently again. We expect a balance of migration for the current year (Swiss and foreigners) of around 50,000 persons overall.

Immigration stabilizing

Balance of migration of usual foreign resident population, cumulative since start of year



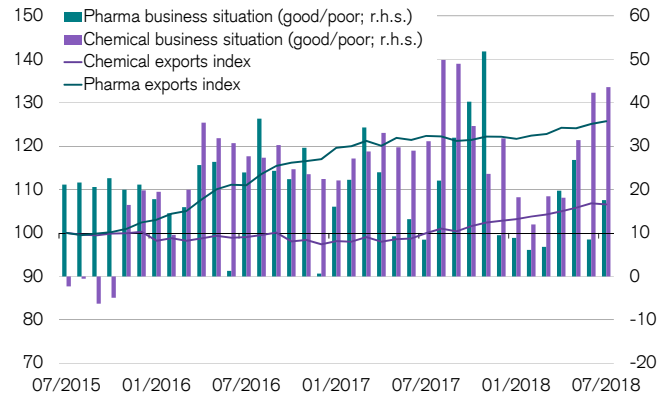
Source: State Secretariat for Migration, Credit Suisse

Chemical and pharmaceutical industry

The year-on-year exports of the chemical industry increased by 10% in the second quarter of 2018 and those of the pharmaceutical industry by almost 8%. Above all in the chemical industry this is accompanied by a very positive assessment of the business situation. Although we expect renewed growth for this sector in the months to come and in 2019, this is set to slow down due to a slightly weaker global economy. While the pharmaceutical industry is continuing to benefit from the demographically induced growth of demand, patent expiries and price pressure are likely to have a curbing effect in the coming year.

Dynamic growth in the second quarter of 2018

Exports: moving 12-month average, index: July 2015 = 100;
business situation: share of companies surveyed, balances in percentage points



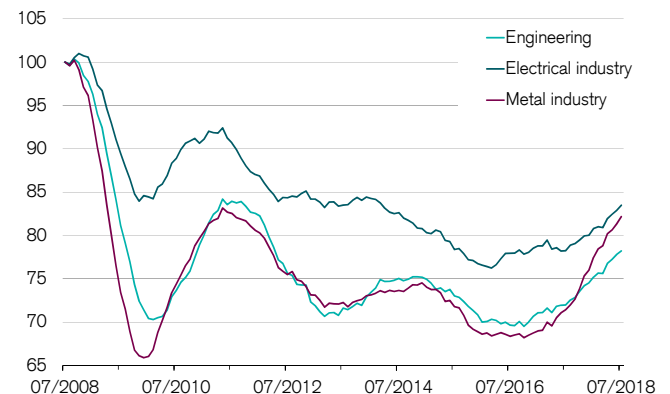
Source: Swiss Customs Administration, KOF Swiss Economic Institute, Credit Suisse

Engineering, electrical and metal industry (MEM)

The MEM industry also upheld the momentum at the turn of the year in the second quarter of 2018, with year-on-year exports rising by almost 12%. The majority of companies thus continue to assess their business situation as good or satisfactory. We expect the business situation of the MEM industry also to remain attractive in the months to come and in 2019. However, the growth is likely to be lower than in the previous months owing to the slightly weaker global economic momentum and the political uncertainties.

MEM exports continuing to peak

Exports: moving 12-month average, index: July 2008 = 100



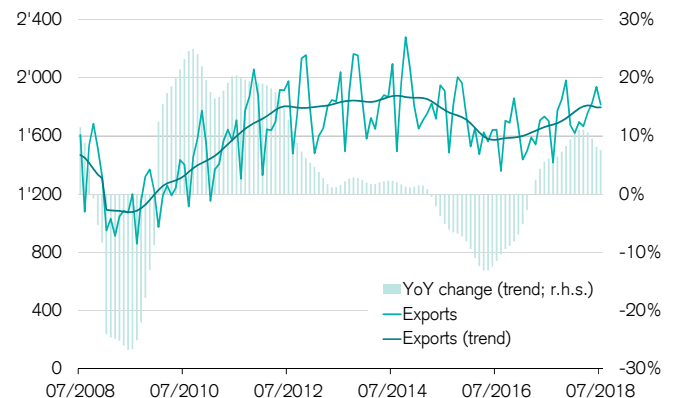
Source: Swiss Customs Administration, Credit Suisse

Watch industry

The watch industry also significantly increased its exports in the second quarter of 2018 (+10% YoY). A majority of the companies canvassed by the KOF Swiss Economic Institute accordingly rate their current business situation to be good or at least satisfactory. However, the export momentum decreased in June and July and we expect this development to continue in the months to come and in 2019. In particular slightly lower economic growth in the key sales markets of Hong Kong, China and the USA could exert a negative impact on the sector's sales growth next year.

Strong first half of 2018 but momentum decreasing

Exports (monthly figures) in CHF mn., YoY change, in % (trend)



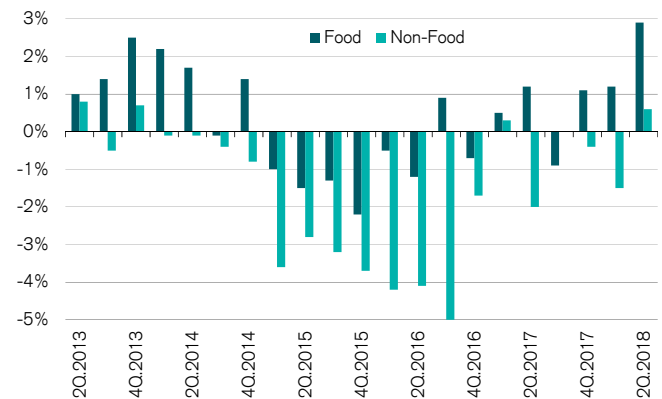
Source: Swiss Customs Administration, Credit Suisse

Retail trade

Sales in the retail trade rose by 2% year on year in the second quarter of 2018. As well as strong growth of 2.9% in food retail, the non-food segment also recorded growth of 0.6% despite the fact that sales in the clothing retail segment were once again down. However, the altogether robust growth (last achieved on this scale in 2012) was also attributable to certain positive special effects for the retail trade such as the Football World Cup and the hot and fine weather. Sales performance is therefore likely to lose some momentum again in the months to come, particularly since consumer sentiment is also set to deteriorate slightly.

Growth boosted by special effects

Nominal retail sales, YoY growth in %



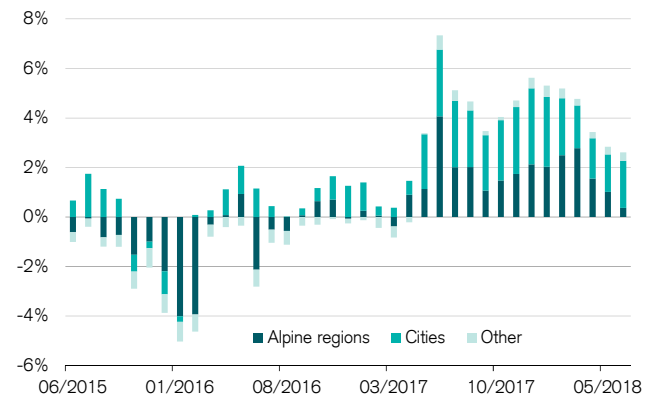
Source: Swiss Federal Statistical Office, Credit Suisse

Tourism

The dynamic growth in overnight stays since mid-2017 continued in the early summer of 2018. The Alpine regions in particular benefited from the hot and sunny summer, with the mountain railways increasing their year-on-year sales by almost 10% in the period from May to July. Sentiment in the sector is accordingly better than it has been for years. However, it is unlikely that this strong growth will be repeated in 2019 as this would require another very snowy winter and hot summer. Moreover, while economic momentum is expected to remain sound in 2019, it is likely to slow down somewhat.

Tourism benefiting from the hot summer

Overnight stays, moving three-month average, YoY growth in %



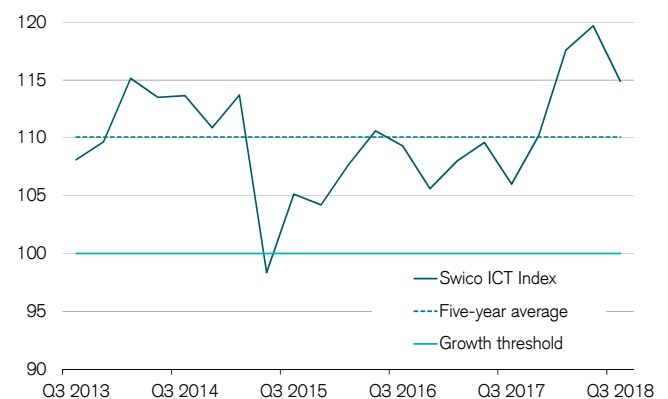
Source: Swiss Federal Statistical Office, Credit Suisse

Information technology (IT)

The business situation in the IT sector has deteriorated somewhat at a high level. The Swico ICT Index that summarizes the current quarter expectations of Swiss IT companies regarding the development of sales, order intake and margins fell somewhat in the third quarter of 2018 but remains at a high level. The sector is currently benefiting from the good business situation of important customer segments and the prevailing trend toward digitalization should also generate strong demand for IT services in 2019. However, the shortage of skilled labor is continuing to have a curbing effect.

Sentiment somewhat worse at a high level

Sentiment index: > 100 = improvement, < 100 = deterioration on previous quarter



Source: Swico, Credit Suisse

Restrained pay rises

Somewhat stronger wage growth is to be expected from an economic perspective. However, the Swiss labor market is shaped by wage restraint. It is precisely for this reason that the workforce receives a high share of gross domestic product.

Wage growth was nominally low after the financial crisis but high in real terms

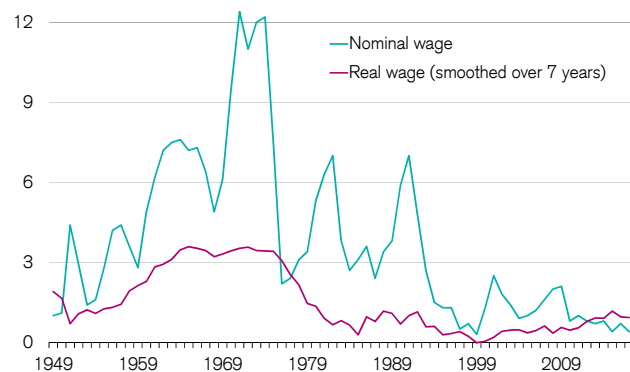
Wallets have recently only been filling up slowly: Nominal wages in Switzerland have on average risen by less than 1% per year since the financial crisis and in 2017 only went up by 0.4%, the second lowest increase after 1999 since the earnings survey was launched back in 1943 (see figure below on left). Nominal wages have also risen extremely modestly in the European Union and the US since the financial crisis, with wage growth on both sides of the Atlantic virtually halving. However, a different picture emerges if the purchasing power of the wages is considered: Particularly in Switzerland, this until recently rose more sharply than in the preceding 30 or so years in which it had tended to lose momentum in a similar way to economic growth. Real wages (adjusted for inflation) rose more sharply in Switzerland from 2009 to 2016 than at any time since the end of the 1970s – thanks to the falling price level after the global financial and euro crisis. However, the price level has been increasing again since 2017 and average real wages therefore actually fell slightly last year (-0.1%). Accelerated nominal wage growth will therefore be required for higher real wages – a development that has recently been observed in the US and Europe, although only to a subdued extent.

Falling unemployment is no guarantee of faster wage increases

In order to enrich the wage discussion that is undoubtedly also springing up in Switzerland, we take a look beyond short-term pay negotiations at factors that could shape future wage growth in the long term. A tool often used to conduct a medium-term cyclical analysis is the so-called Phillips curve (see figure below on right) that places wage adjustments in relation to labor market shortages. This curve has since the mid-1990s been gradually approaching its origin and has significantly bottomed out recently. This suggests that nominal wages are today reacting less strongly to falling unemployment rates than in earlier periods. Two key hypotheses are put forward to explain this phenomenon that can also be observed in other countries: According to the first one, employees have greater trust in the ability of monetary policy to keep inflation low and have now actually become “accustomed” to a stagnating or even falling price level, while according to the second, employees are failing to assert higher wage demands despite increasing “shortages” because their negotiating power has declined. The trend toward falling trade union membership numbers as well as factors such as automation, offshoring and easier migration are frequently cited as reasons for this.

Nominal wage growth has lost further momentum

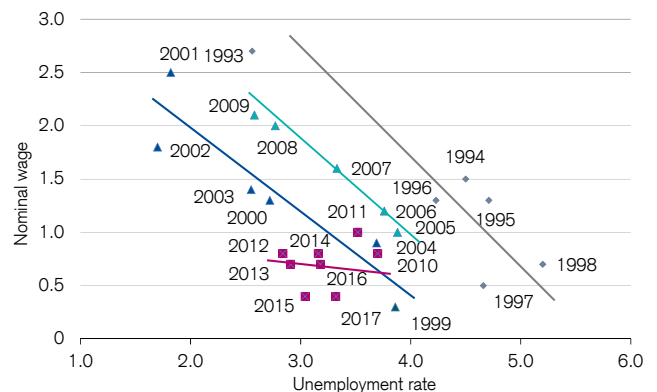
Nominal wage growth in %



Source: Swiss Federal Statistical Office, Credit Suisse

Phillips curve has become flatter

Change in nominal wages in relation to unemployment rate in %. Phillips curves: 1993 to 1998 gray, 1999 to 2004 blue, 2005 to 2009 turquoise, 2010 to 2017 magenta



Source: Swiss Federal Statistical Office, State Secretariat for Economic Affairs (SECO), Credit Suisse

Whether structural changes such as automation, digitalization ...

It is very difficult to say to what extent such structural changes actually do influence cyclical wage behavior over the long term. Among other things, the theory that automation and digitalization are resulting in persistent downward pressure on wages needs to be questioned. Although by adapting a study of the German Institute for Employment Research to Switzerland we have calculated that the current automation potential is theoretically “medium” for around 50% of the workforce and actually “high” for 6%, this does not in any way mean that a large share of these jobs is at risk of immediate rationalization as this would barely be feasible from a business perspective – not least because it would entail high capital expenditure on the part of companies. Furthermore, the theory fails to take account of the fact that technical advances are actually creating new job profiles in high wage segments. Thus while digitalization is indeed set to increase the pressure on certain jobs, in sum it is likely to raise the wage level.

... or offshoring influence the cyclical behavior of wages is unclear

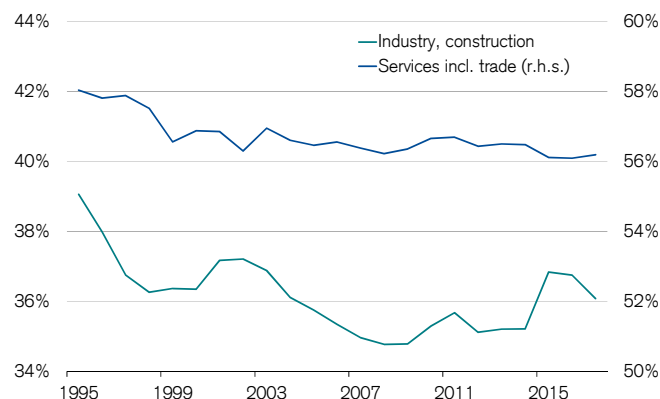
It is likewise unclear whether offshoring structurally increases the downward pressure on wages. One measure of the degree of offshoring of activities abroad is the gross value creation rate, defined as the ratio between value creation and gross production value (see figure below on left). A falling rate points toward an increase in advance deliveries and therefore a greater division of labor that is accompanied by the offshoring of activities (although an abrupt appreciation of the CHF can increase the rate in the short term in purely mathematical terms). However, the wages in many target countries (e.g. in Eastern Europe) have risen sharply in recent years, thereby reducing the attraction of offshoring. Moreover, the rise in automation is to some extent actually facilitating a “re-shoring” of production. What is much more crucial, however, is the fact that offshoring typically affects jobs with lower wages. This by implication means that the jobs with high wages are more likely to stay in Switzerland.

The free movement of persons also appears only to exert a limited impact on wage growth

The impact of easier migration on the Swiss wage level has for years also been the subject of controversial discussion. While an observatory report of the Federal Government on the Agreement on the Free Movement of Persons between Switzerland and the EU does not find any general and direct wage pressure due to migration, this factor has allegedly countered steeper wage growth in the upper segment of the pay scale. Finally, the role of the trade unions in Switzerland has also not changed much in recent decades unlike in other countries where their influence has tended to decline. Altogether the relations between employer and employee organizations in Switzerland remain characterized by much willingness to compromise. We therefore consider the main reason for the recent flattening of the Phillips curve not to lie in such structural changes but in the inflation expectations that have fallen further since the financial crisis and become anchored at a low level. Both the surveys (see figure below on right) and the extremely low interest rates suggest that this will remain virtually unchanged in the immediate future.

Division of labor also increasing among service providers

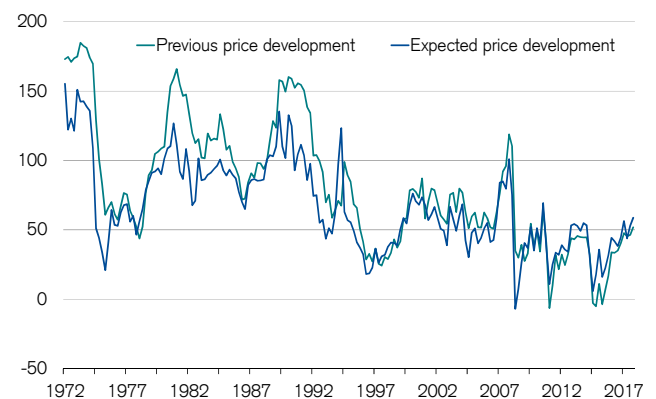
Gross value creation rates



Source: Swiss Federal Statistical Office, Credit Suisse

Inflation expectations are well anchored

Survey-based assessment of consumers, index



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

The wage policy scope for distribution tends not to be fully utilized in Switzerland

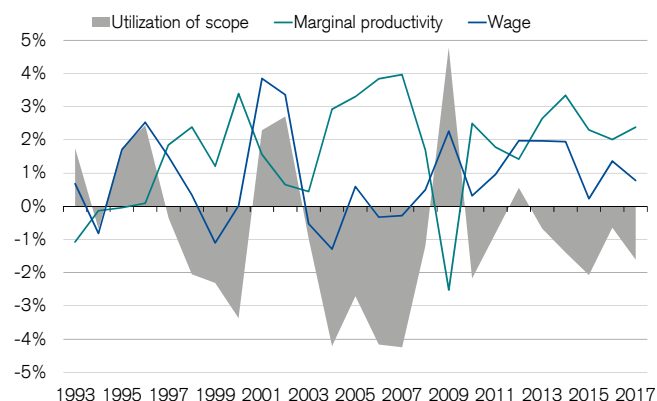
However, the Phillips curve has merely got flatter but is not running horizontally. This suggests that wages will gradually rise in view of the continuation of the economic upturn expected by us and the further shortages on the labor market entailed by this. However, we continue to expect a very subdued development. An important reason for this appears to be a systematic wage restraint that is anchored in the long term in Switzerland – or to put it another way a systematic non-utilization of the wage policy scope for distribution. A comparison of wage rises with the increase in the marginal productivity of labor serves to illustrate this theory. In a model economic world these two variables ought to correlate as long as the productivity factors labor and capital are optimally deployed. The figure below on the left illustrates our assessments of the extent to which wages have in fact reflected this (marginal) productivity since the 1993 wage negotiations. Positive values indicate an overdrawn scope and negative values a scope for distribution that has not been fully exploited. The latter clearly applies in the majority of cases. However, we are unable to prove entirely that this actually represents a long-term feature of the Swiss labor market. It should be interpreted as suggesting that employees in Switzerland are generally prepared to forgo maximum wage increases in the short term in order to reduce the risk of unemployment and thereby contribute to safeguarding long-term prosperity.

Workforce altogether receives a record share of GDP

This wage restraint – be it intentional or not – has at any rate triggered positive employment momentum. An employment-impeding “overdrawing” of the scope for distribution only arose during the recessions at the start of the 1990s, after the turn of the millennium and after the financial crisis, i.e. wages at those times did not fall quickly enough to maintain full employment. Apart from this, the underlying tariff rate and the good availability of skilled labor together with the cyclically high supply of foreign labor will have been the main reasons why the workforce in Switzerland has also continued to grow significantly since the financial crisis and despite the recession and franc appreciation shock. Employment growth was not only the key driver here for the above-average economic growth but is also one of the factors responsible for the share of overall economic output paid out as wages and social benefits climbing to new record levels. The figure below on the right illustrates the distribution side of gross domestic product (GDP). It is clear that the total wage bill (as measured by employee compensation) has in recent years risen much more sharply than corporate profits (as measured by net operating surpluses). On a long-term average, the share of GDP paid out in the form of wages and social benefits amounted to around 57%. This share rose from early 2011 to reach a record level of almost 60% in the fourth quarter of 2016 and has only fallen marginally since.

Wage policy scope for distribution rarely utilized

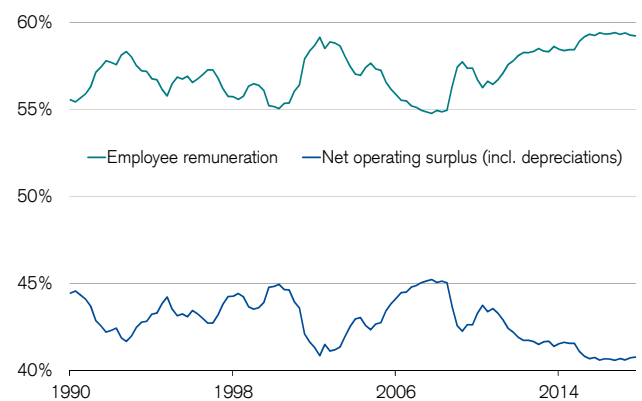
Marginal productivity of labor and wage index per hour, change in % (real)



Source: Swiss Federal Statistical Office, Credit Suisse

Workforce share of GDP at record levels

Share in gross domestic product (GDP)



Source: Swiss Federal Statistical Office, Credit Suisse

Switzerland incidentally almost stands out on a limb when compared internationally with this positive picture for the sum of all employees: Only Iceland boasts an employee compensation rate around the same level as in Switzerland and Norway is the only country in which it has risen more sharply than in Switzerland since the financial crisis. In the US, for instance, it has actually fallen significantly over the same period.

**Flattening of
employment growth
and higher wage
growth to be expected
...**

Looking ahead, it seems likely for several reasons that employment growth in Switzerland is set to bottom out. First of all, like other highly developed countries, Switzerland is approaching a wave of retirements among the baby boomers. Secondly, the employment rate in Switzerland is already very high: Around 80% of the working population is currently – at least partially – employed. And thirdly, the migration of labor from abroad is likely not to accelerate markedly any more due to the improvement in the labor market situation in Europe. The supply of labor should therefore decrease in future not just due to the aforementioned expectations of solid economic activity. However, in view of the expected contraction of the workforce, economic growth will have to be generated through productivity increases. Should this succeed, real wages would begin to rise again in a sustained and significant manner. However, in view of the substantial obstacles to faster productivity growth in Switzerland (the reduction of which would require liberalizations in the domestic sector, for instance), we anticipate only a slight acceleration of productivity growth in the next few years despite the shortage of labor. Real wage increases of just over 1% seem realistic to us, although wage growth in years in which inflation once again proves surprisingly low could well be significantly higher. It is also difficult to predict whether the systematic wage restraint will also prevail in the event of a larger-scale shortage of labor.

**... but real wage
growth should remain
subdued in 2019**

The development for the coming year appears easier to forecast in view of the wage-curbing factors identified above. Although nominal wage growth should be somewhat greater than in 2018, the positive inflation (forecast: 0.7%) will limit real growth. Altogether we expect a nominal wage increase of 1% for 2019 and a real wage increase of 0.3%.

Defining "fragile"

The "fragile" situation of the exchange rate situation has kept the Swiss National Bank (SNB) alert, but indicators suggest that this potential "fragility" is not CHF-specific.

The SNB is focusing on the "fragility" of the exchange rate situation

Since September 2017, the SNB has argued that the exchange rate situation has remained "fragile". Coupled with the "high valuation" of the CHF, the SNB has argued that this "fragility" has warranted the negative rate policy and its willingness to intervene in the foreign exchange market. However, the SNB has never officially defined what it means by a "fragile" exchange rate situation. We looked at two indicators which indeed show that the situation has changed on the foreign exchange market. However, these indicators also suggest that the changes are not limited to the CHF.

Turnover on the exchange rate market has dropped

Firstly, bid-ask spreads, i.e. the difference between the highest price a buyer is willing to pay and the lowest price at which a seller is willing to sell, have widened. This is true not only for EUR/CHF, but also for the G-10 currencies¹ in general. Although the foreign exchange market is highly liquid, this may nevertheless reflect a decline in liquidity. The triennial survey of the Bank for International Settlements (BIS) indeed reported a decline in the turnover of spot transactions in the foreign exchange market of almost 20% between the 2013 survey and that of 2016.

The option market indicates that the CHF is more likely to appreciate than to depreciate

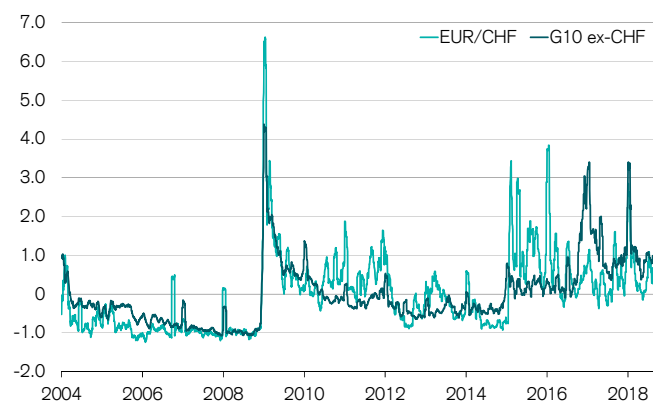
Secondly, so-called risk reversals have been negative for EUR/CHF since January 2015 (and were negative most of the time until the end of 2012). Risk reversals are derived from the option market, and a negative value indicates that a put option is more expensive than a similar call option or, to put it simply, that the probability of a drop in the exchange rate is higher than a rise of similar magnitude. From the perspective of the SNB, a negative risk reversal for EUR/CHF or USD/CHF would probably describe a "fragile" situation, as it would indicate a larger probability of an appreciation than a depreciation of the CHF against either the EUR or USD. But risk reversals have rarely been close to 0 since the financial crisis, not only for EUR/CHF and USD/CHF, but also for EUR/USD.

How much did the SNB contribute to the "fragility" of the exchange rate situation?

Identifying the causes of these changes would go beyond the scope of this article. However, the BIS mentioned the removal of the exchange rate floor for EUR/CHF by the SNB in January 2015 as an event that led to more risk aversion in the foreign exchange market and may have given rise to the trends described above. Ironically, the SNB may itself have contributed to the "fragility" of the exchange rate situation – which has since kept it alert...

Wider bid-ask spread in the foreign exchange market

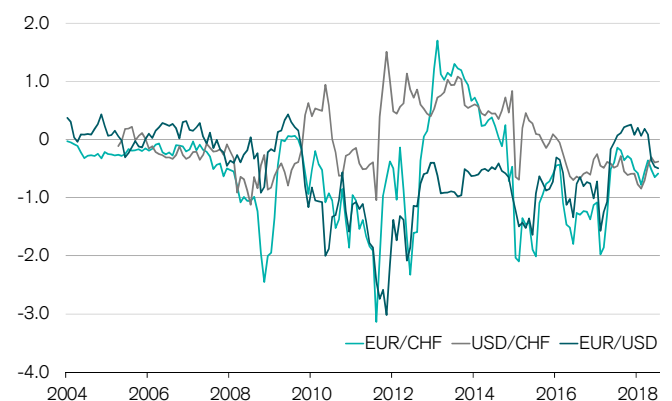
Z-scores of the 10-day moving averages of the bid-ask spreads



Source: Bloomberg, Credit Suisse

Risk reversals currently negative for EUR/CHF

3-month risk reversal (25 delta) volatility



Source: Bloomberg, Credit Suisse

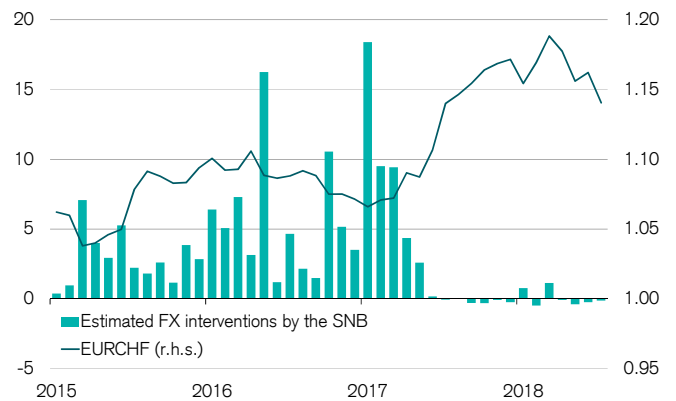
¹ EUR, JPY, GBP, AUD, CAD, CHF, NZD, NOK, SEK, all versus the USD.

Currency interventions

We have not detected any indication of meaningful foreign currency purchases by the SNB since July 2017. This could have political implications: Switzerland could be dropped from the US Treasury monitoring list of potential exchange rate "manipulators". Switzerland was added to this list in October 2016, having fulfilled two of the three US criteria, namely a current account surplus of more than 3% of GDP and foreign exchange interventions in excess of 2% of GDP over 12 months. However, apart from drawing less international attention to Swiss monetary policy, being dropped from the monitoring list should not have any concrete implications.

No more foreign currency purchases

In CHF (bn); EUR/CHF (r.h.s.)



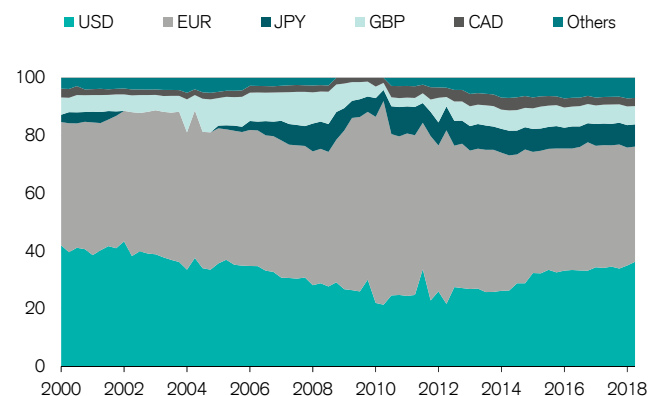
Source: Datastream, SNB, Credit Suisse

Allocation of foreign currency reserves

The SNB reduced the allocation of its foreign currency reserves in EUR from 40.9% in Q1 2018 to 39.9% (excluding derivatives) in Q2 2018. This is the lowest level since Q4 1999. In parallel, the USD allocation has been raised from 35.0% to 36.3% (excluding derivatives), which is the largest USD allocation since Q2 2005. The rest of the reserves were allocated in JPY (7.7%), GBP (6.3%), CAD (2.9%) and other currencies (6.9%).

Fewer EUR, more USD

Allocation of foreign currency reserves, in %



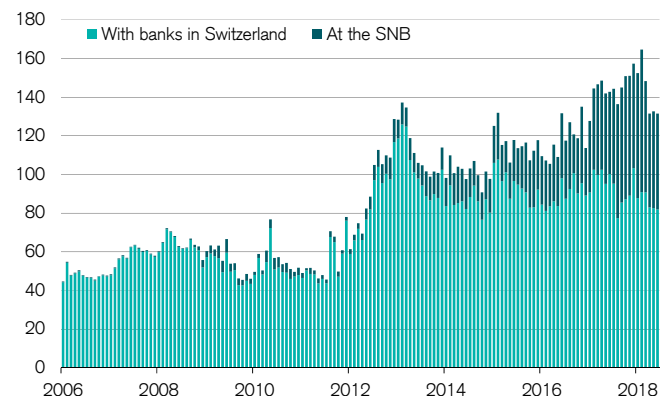
Source: SNB, Credit Suisse

CHF holdings of foreign banks

Foreign banks reduced their CHF deposits with banks in Switzerland and the SNB in March and April 2018, a period when the CHF weakened against the EUR. On the other hand, the appreciation of the CHF in May 2018 does not seem to have been the result of "safe haven" flows into Switzerland, as foreign banks did not step up their CHF holdings that month. Nevertheless, foreign banks hold vast amounts of CHF in Switzerland, which suggests that the international demand for CHF remains high.

Foreign banks hold fewer CHF in Switzerland

CHF deposits of foreign banks, in CHF (bn)



Source: SNB, Credit Suisse

Values of the millennials – a supertrend with potential

Over the coming decades, the babyboomer cohorts will pass on trillions of financial assets to their descendants, the millennials. Their values are therefore also gaining significance from an investor perspective.

Younger ones taking over

Fifty percent of the world's population is less than 34 years old. The values of this generation – we refer to them as millennials – are set increasingly to become the norm. We have therefore defined the values of the millennials as one of five supertrends. We expect these supertrend issues to play a dominant role in the years to come and to offer attractive investment opportunities.

High weighting of emerging markets

The millennials are among other things a digital, global, environmentally friendly and social generation. Brands geared to the values of the millennials outperformed their corresponding overall markets in 2017. We expect this trend to continue. A particular feature of the millennials is that most of them come from the emerging markets due to the global demographic trend. A particularly large number of millennials live in China. A survey of consumers from emerging markets carried out by the Credit Suisse Research Institute has recently confirmed that they value special experiences and a lifestyle centered around enjoyment, health and leisure.

Millennials shaping online consumption

Millennials are assuming a leading role throughout the world as online consumers. Millennials also tend to be more environmentally conscious. It will not least be thanks to this generation that electric vehicles, clean energy and ecological and social investments increasingly gain ground. Sustainability is an important value for millennials. Companies are increasingly having to prove that they make a positive contribution to society if they wish to persuade millennials to buy their products.

True digital natives

Millennials are also changing the way business is done. As true “digital natives”, millennials have grown up with direct access to information and also expect this for the goods and services they buy. There therefore remains much scope for increased use of digitalization in advertising, the retail trade and the media.

Own work-life balance

Millennials not only have their own concept of the work-life balance and self-fulfillment, but also pursue their own ideas regarding their housing situation. They show little interest in the suburban houses of their parents. Their priorities include access to public transportation, shopping facilities accessible on foot and proximity to the workplace. Millennials therefore prefer an urban life.

Residential construction activity

Construction activity on the Swiss housing market remains at a very high level thanks to the unbroken strong demand for investment properties. The construction of 29,000 rental apartments was approved in the past 12 months alone. An exceptionally large number of new rental apartments will therefore continue to come onto the market in 2019 and 2020. By contrast, the number of residential units approved for owner-occupied housing is continuing to decline. Permits for 13,600 condominiums and 7,200 single-family dwellings were granted over the last 12 months so that the expansion of residential property remains below its current potential demand.

Owner-occupied housing

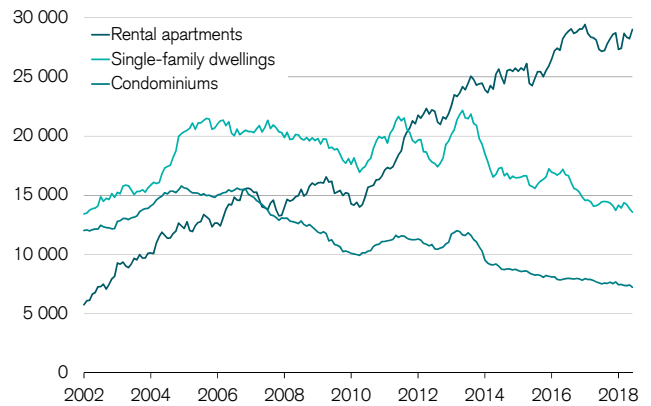
While the price growth of owner-occupied housing is continuing to prevail, it has recently lost some momentum again. Compared with the prior-year quarter, the prices of condominiums went up by 3.0% and those of single-family dwellings grew only marginally less at 2.6%. Thanks to the very good economic situation, the prevailing low interest rates and a decline in new construction activity, we also expect price growth in the coming quarters. However, this is likely to be somewhat down on the recently recorded percentages.

Rental apartments

Falling rents have already been observed in online housing advertisements for around three years, which is attributable to the fall in immigration with a simultaneous increase in construction activity. The rental contracts actually agreed are now also pointing toward falling rents. Year-on-year contractual rents fell for the first time in almost 12 years in the second quarter of 2018 and were down 1.2%. However, anyone concluding a rental contract today in Switzerland can nevertheless expect an average rent increase of around 17% compared with 2005, and as much as 23% in the major centers.

Rental apartment construction continuing to peak

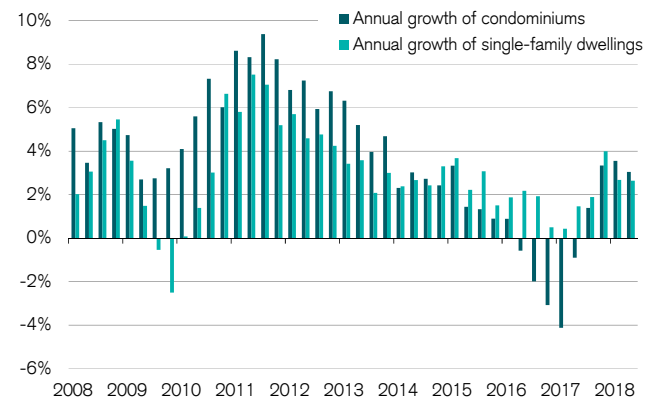
Building permits in number of residential units, moving 12-month total



Source: Baublatt, Credit Suisse

Prices for owner-occupied housing continuing to grow

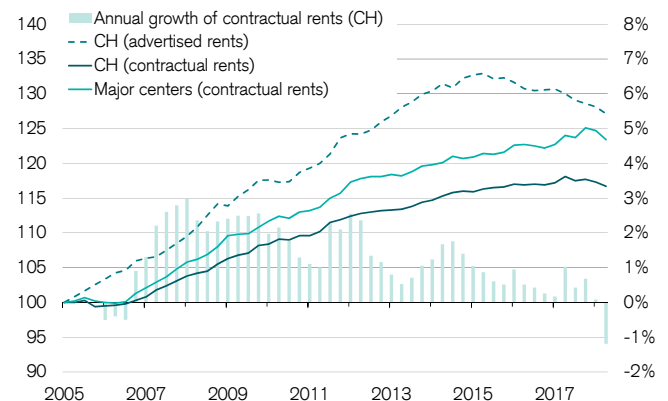
Annual growth rates in %



Source: Wüest Partner, Credit Suisse

Downward pressure on rents increasing

Index of advertised and contractual rents (l.h.s.), annual growth rate of contractual rents (r.h.s.)



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.

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.

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 Switzerland¹. 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.

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

Industrial Activity

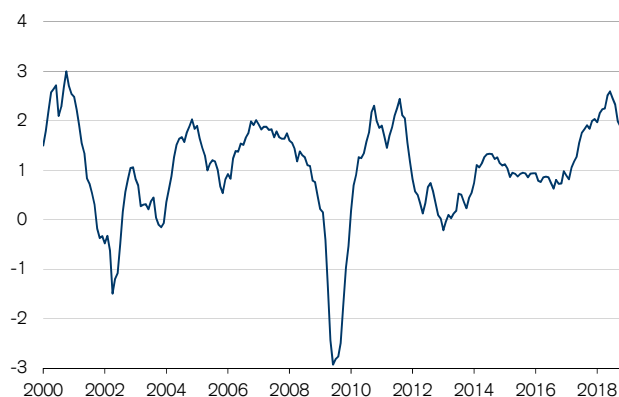
PMI index > 50 = growth



Source: procure.ch, Credit Suisse

Exports

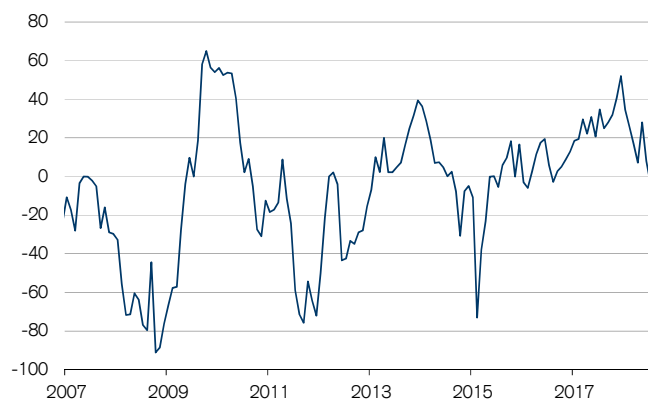
In standard deviation, values > 0 = growth



Source: PMI Premium, Credit Suisse

Economic Activity

Balance of expectations, values > 0 = growth



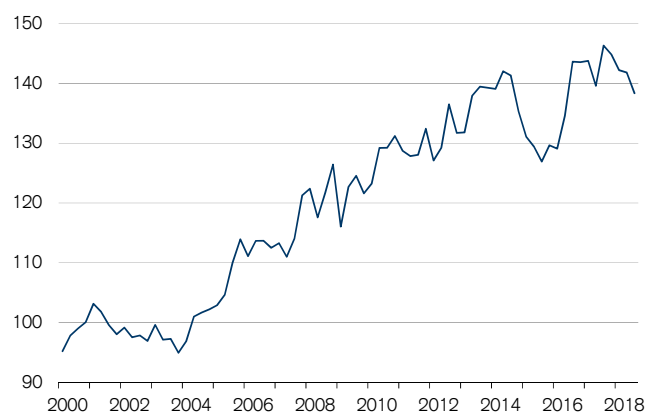
Source: CFA Society Switzerland, Credit Suisse

Swiss Construction Index

The Swiss Construction Index is published once a quarter jointly by Credit Suisse and the Swiss Contractors' Association (SCA). It serves as a leading indicator for the state of Switzerland's construction sector by forecasting the volume of work in the core construction business in the coming quarter. The indicator is calculated by Credit Suisse 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



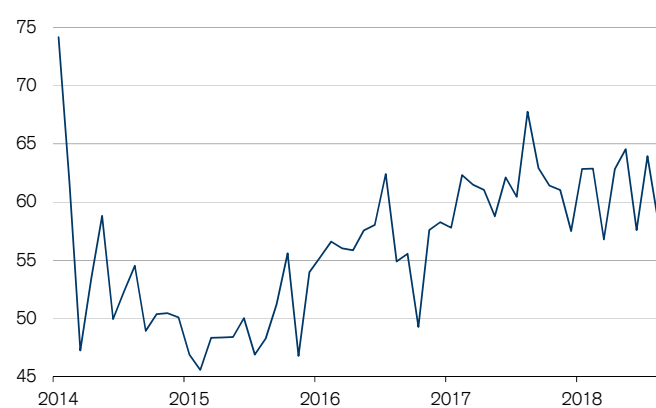
Source: Swiss Contractor's Association, Credit Suisse

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

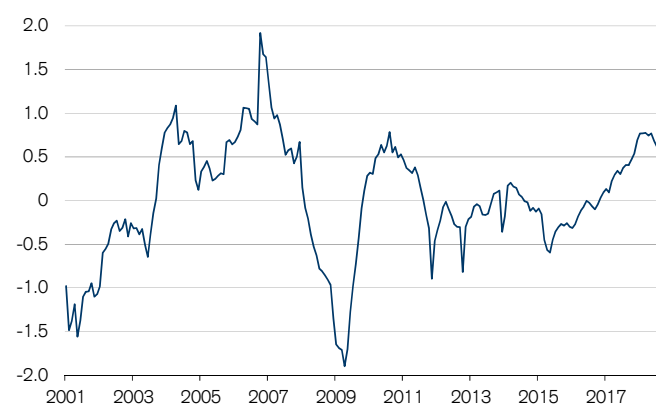


Source: procure.ch, Credit Suisse

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

	2018 Q1	2018 Q2	2018P Q3	2018P Q4	2019P Q1	2019P Q2	2019P Q3	2019P Q4	2018P	2019P
GDP (YoY, in %)	2.9	3.4	2.6	1.9	1.5	1.3	1.8	2.1	2.7	1.7
Consumer spending	1.2	1.3	1.4	1.7	1.5	1.5	1.2	1.3	1.4	1.4
Government expenditure	1.3	1.2	1.0	0.6	0.9	0.9	0.9	0.9	1.0	0.9
Gross capital investment	3.4	3.3	2.6	3.2	2.5	2.2	2.1	2.1	3.1	2.2
Construction investment	0.9	2.6	1.8	1.0	0.5	0.5	0.5	0.5	1.6	0.5
Investment in plant and equipment	4.8	3.7	3.0	4.3	3.0	3.0	3.0	3.0	4.0	3.0
Exports (goods and services)	2.3	5.3	4.0	4.6	3.5	3.5	3.5	3.5	4.0	3.5
Imports (goods and services)	4.9	3.3	3.3	2.5	3.0	3.0	3.0	3.0	3.5	3.0
Inflation (in %)	0.7	1.0	1.2	0.9	0.9	0.7	0.5	0.5	1.0	0.7
Unemployment (in %)	2.9	2.6	2.4	2.3	2.3	2.3	2.2	2.2	2.6	2.3
Employment growth FTEs (YoY, in %)	1.9	2.0	2.0	1.8	1.3	1.2	1.2	1.2	1.9	1.2
Net immigration (in thousands)									50	50
Nominal wage growth (YoY, in %)									0.7	1.0
Current account balance (in % of GDP)									6.8	7.2
General Government budget surplus (in % of GDP)									0.0	
Public debt (in % of GDP)									40.9	.

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

Forecasts for the World Economy

Forecasts	Forecasts				Structure		Significance for Switzerland	
	GDP YoY, in %		Inflation YoY, in %		Population In million	GDP In USD billion	Share of exports In %	Share of imports In %
	2018	2019	2018	2019	2016	2017	2017	2017
World	3.3	3.1	2.6	2.4	7 530	79 865	100	100
US	2.9	2.5	2.4	2.0	326	19 391	15.3	6.8
Euro zone	2.1	2.0	1.8	1.7	341	12 607	44.1	63.4
Germany	2.1	2.0	1.8	1.9	83	3 685	18.9	28.2
France	1.7	1.7	2.1	1.5	65	2 584	6.4	7.9
Italy	1.2	1.2	1.4	1.6	61	1 938	6.2	9.7
UK	1.3	1.5	2.5	2.2	66	2 625	5.2	3.3
Japan	1.3	1.0	0.7	0.8	127	4 872	3.3	1.9
China	6.5	6.2	1.9	2.0	1 390	12 015	5.2	7.0

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	-0.8 to -0.6	-0.6 to -0.4	M0 money supply (CHF bn)	552.1	544.6	557.0
SNB target range (in %)	-1.25 to -0.25	-1.25 to -0.25	-1.00 to -0.00	M1 money supply (% YoY)	5.1	5.0	6.2
10-year government bond yields (in %)	-0.06	0.1-0.3	0.3-0.5	M2 money supply (% YoY)	2.7	2.7	4.2
				M3 money supply (% YoY)	2.4	2.3	3.9
				Foreign currency reserves (CHF bn)	776.9	783.8	745.3

Source: Datastream, Bloomberg, Credit Suisse

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