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EU domestic market would not sink the Swiss island of high prices

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Contribution

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Éditorial

Dear Readers

The American comedian Groucho Marx (1890 – 1977) famously quipped that he would refuse to join any club that would have him as a member. With a view to the chaotic Brexit process, but also to Switzerland's ongoing squabbles over the framework agreement with the European Union (EU), the quote should perhaps be inverted to say, "I never want to leave this club, although I reject the membership." Or, more directly formulated: both the UK and Switzerland have a sharply polarized – one might even say schizophrenic – relationship with the EU.

In both nations, there are loud voices fulminating against the EU for its "nannying" or even "subjugation", and these factions occasionally score political successes such as the "yes" vote on the Swiss anti-immigration initiative or, indeed, Brexit. Certain unnecessary and objectively unreasonable threatening gestures by the EU, such as its failure to recognize the Swiss stock market, are justifiably met with incomprehension. Nonetheless, in both countries, ultimately the conviction prevails that it would be better – somehow – to remain in the detested "club". We therefore expect that the UK will opt for a "soft" Brexit and that a majority can be found in Switzerland to support the framework agreement with the EU.

The explanation for this apparent paradox is evident: overarching economic interests outweigh the various fears, in the long run. Simple and legally secured access to the large, integrated EU domestic market is worth a great deal. However – and we examine this in detail in our Focus article – there are considerable open questions as to how far this market is actually already integrated. An analysis of detailed price data in the individual EU countries reveals that there are still major flaws in the domestic market. These are partly due to regulatory measures that protect national or regional special interests.

In return for membership, members must obviously relinquish control and submit to the rules of the club. The most important rule of the EU, and the one that provokes the most spirited debate, is the free movement of workers from EU countries. This concept is key to maintaining the political union. However, with reasonable limitations for extreme situations, and for immigrants from non-EU countries, it should not pose too great a problem to Switzerland and the UK, countries that have long traditions of reliance on guest workers. This realization appears to have taken hold, at least here in Switzerland, although it will be tested once again in a referendum.

Perhaps by then the misgivings about our (de facto) club membership will also have receded. In general, we hope that the coming year in Europe, but also elsewhere, will see a return to reasonable discourse rather than pure polemics.

With our best wishes for the New Year,

Thomas Gottstein
CEO Swiss Universal Bank

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CIO Office Schweiz

Contents Page

Global environment

Europe

The situation on the European labor market recently improved further, which should continue to support private consumption next year. The solid consumption forecast for 2019 should in turn help to limit the decline in growth in the euro zone, despite the fact that external trading activity will probably be lower in 2019. Since the European Central Bank (ECB) is not expected to raise interest rates before the second half of 2019, the euro should appreciate only moderately, if at all. Extreme risks include a "hard" Brexit and a debt crisis in Italy – both of which we consider very unlikely.

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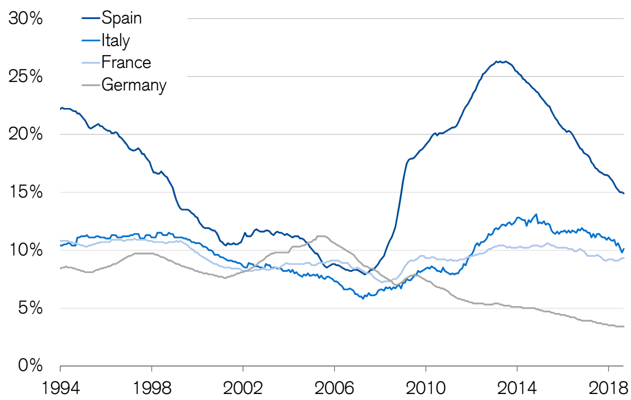
Continuous improvement in labor market conditions

Unemployment in %, seasonally adjusted



Source: Eurostat, Credit Suisse

USA

The ongoing trade spat between the world's two largest economies does not seem to be dimming US corporate sentiment. The business indicator for small and medium-sized enterprises (SMEs) in the USA has climbed to a level not seen since 2005. Corporate investment in the USA is likely to continue to surge in 2019 thanks to upbeat sentiment. However, construction investment will probably be lower because building and financing costs are rising as a result of increasing wage costs and successive interest rate hikes by the US Federal Reserve.

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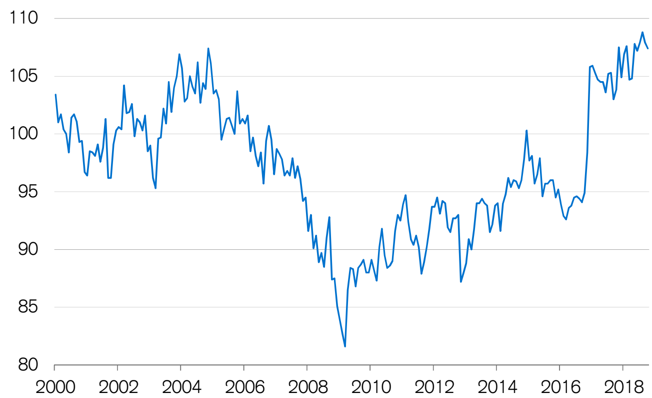
Ongoing optimism among US SMEs

Business indicator for SMEs in the USA, index



Source: Datastream, Credit Suisse

China

In China too, economic growth is likely to dip slightly in 2019. High debt in connection with real estate, and the associated debt servicing costs, will probably weigh on consumer spending, and the increase in investment spending is likely to remain modest. Nonetheless, the central bank is prepared to use credit stimulus and "artificial" currency depreciation to compensate for negative effects from US tariffs. China's contribution to global growth should remain high in the near future.

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China still makes a large contribution to growth

Real GDP growth in China in % and China's contribution to global GDP growth in percentage points, adjusted for purchasing power

Source: World Bank, Credit Suisse; 2018: Credit Suisse estimate

Growth deceleration

The Swiss economy is set to grow by 1.7% in 2019, a rate significantly weaker than in 2018. The main driver will be private consumption, while the contributions from foreign trade and investment growth are likely to decline.

Weakness of GDP growth in Q3 seems exaggerated

Switzerland's gross domestic product (GDP) contracted by 0.2% in the third quarter of 2018, after expanding vigorously for the previous six quarters. However, the correction is largely attributable to temporary factors: unseasonably warm weather, for example, resulted in lower revenues in the retail trade (see chart) and less power generation in hydroelectric plants. Moreover, Switzerland was not left unscathed by the weakness in the German auto industry – most of which is probably also temporary. Recall that exports to the “car-heavy” German states of Bavaria and Baden-Württemberg are about twice as high as exports to China. Accordingly, our forecast for GDP growth of 2.7% in 2018 remains unchanged.

Less growth impetus from abroad

The growth contribution from external trade will probably decrease further in 2019. The chart below right illustrates that export growth has already decelerated in the cyclical sectors, while pharmaceutical exports (once again) provided support. However, according to the Swiss Purchasing Managers Index, weaker export momentum should have only limited consequences for industry. This leading indicator recently stabilized at a level that is above the average. In consequence, growth in capital expenditure should remain intact, but similarly decelerate. As for construction investment, we also foresee lower growth here because the oversupply on the market for rental apartments is rising and the order books are gradually thinning out.

Stronger growth in consumption in Switzerland

In contrast, growth in private consumption is poised to accelerate in the coming year. Immigration has now stabilized at a low level, which is why no additional stimulus can be expected from this previously significant growth driver. However, the improved labor market conditions in general, and the falling unemployment rate in particular, should have a benign effect on consumer sentiment and thus contribute to robust growth in private consumption. Rising expenditure on healthcare and the uptick in housing spending (mainly rent and mortgage interest payments) should also boost consumption in the year ahead. The acceleration in private consumption is unlikely to offset the deceleration in other demand components, though. On balance, we therefore forecast lower GDP growth of 1.7% in 2019.

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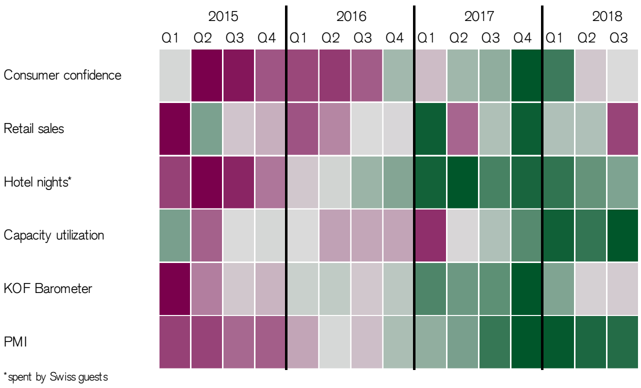
Retail trade suffers heatstroke in Q3 2018

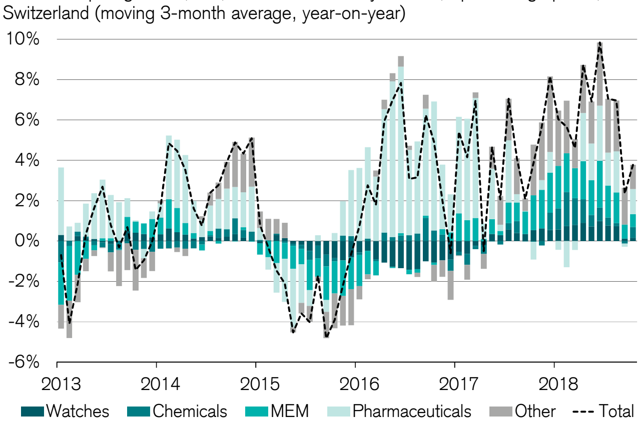
Heat map: green = above average, red = below average



Source: Datastream, FSO, GfK, Credit Suisse

Cyclical sectors contribute less to export growth

Nominal export growth (in %) and contribution by sector (in percentage points) in Switzerland (moving 3-month average, year-on-year)



Source: Federal Customs Administration, Credit Suisse

Inflation

The Swiss price level should rise moderately in 2019, with domestic-oriented services particularly likely to become more expensive. In contrast, rent prices for housing should rise only moderately, especially since higher vacancies weigh on prices. Global crude oil prices are currently lower, but we expect them to rebound soon. Moreover, the water level of the Rhine – the delivery route for nearly one third of crude oil – is so low that transportation costs have risen sharply. On balance, we forecast an inflation rate of 0.7% in 2019.

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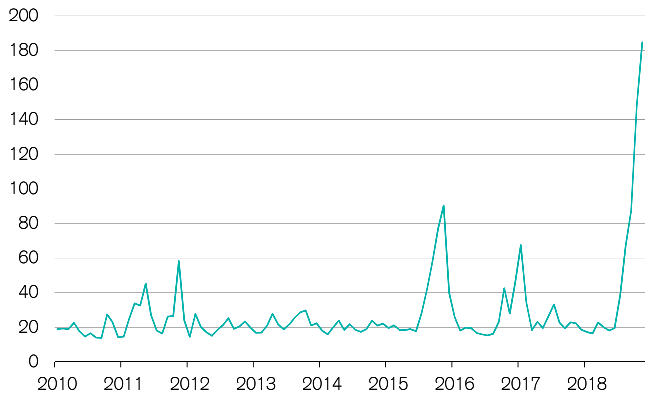
Transport costs for petroleum products have risen sharply

Rhine freight costs in CHF per ton (monthly average)



Source: Bloomberg, Credit Suisse

Labor market

The situation on the Swiss labor market recently brightened further. Although jobs growth slowed slightly in the third quarter of 2018, the deceleration was largely concentrated in healthcare and social services, a segment with close ties to the state, thus attributable to the public sector. In the industrial sector, on the other hand, job creation picked up further. Our survey of Swiss purchasing managers indicates that industrial companies will continue to increase staffing in the months to come.

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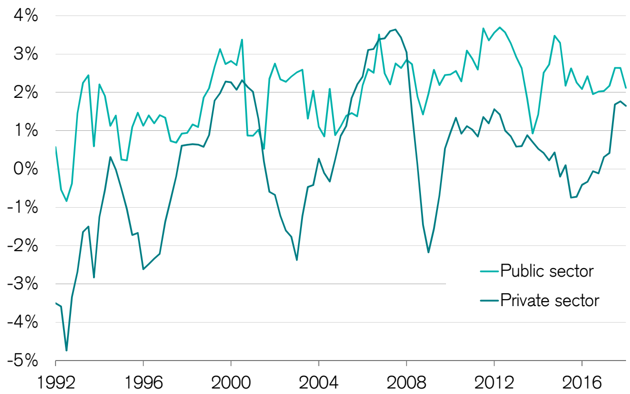
Job creation increasingly evident in the private sector

Employment growth year-on-year



Source: FSO, Credit Suisse

Immigration

The migration data by nationality reveal a reversal in the trend among German and Italian immigrants. In the first nine months of the current year, net immigration of German citizens was up 18%, that of Italian citizens 10%. However, net immigration from both of these countries is still well below the records set in 2008 and 2015. Net immigration from Germany today is a mere one sixth of the 2008 high, and the figure for Italy is about 60% of the 2015 level.

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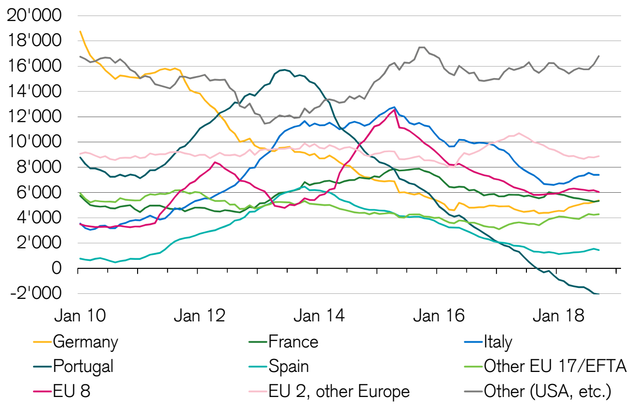
Numbers of Germans and Italians rising again

Net immigration of resident foreigners, 12-month total



Source: State Secretariat for Migration, Credit Suisse

Chemical and pharmaceutical industry

Exports in the chemical industry climbed 7.3% from July to October 2018, while those from the pharmaceutical industry increased 4.0% (year-on-year in both cases). For the chemical industry, this is primarily due to another very positive assessment of business conditions in October. We expect this sector to register renewed growth in 2019, albeit at a slower pace due to a slight deceleration in the global economy. The pharmaceutical industry continues to profit from demographically driven growth in demand, but patent expirations and price pressure are likely to weigh on revenue growth in the years ahead.

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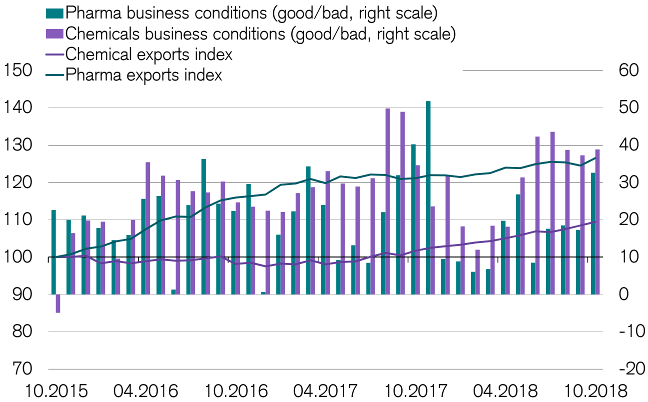
Chemical industry growing further

Exports: moving 12-month average, index: October 2015 = 100;



Source: Swiss Customs Administration, KOF Economic Institute at ETH Zurich, Credit Suisse

Engineering, electrical and metal industry (MEM)

The MEM industry continues to enjoy a good to very good state of business. Although the high rate of export growth in the first half of 2018 (+9.9% year-on-year) was not sustained in recent months, the 4.3% increase from July to October 2018 is still a respectable performance. With the exception of South Korea, all key foreign sales markets generated healthy demand in 2018 to date. However, foreign demand is likely to be tempered in 2019 given the deceleration of the global economy, which would further ease growth in the MEM industry.

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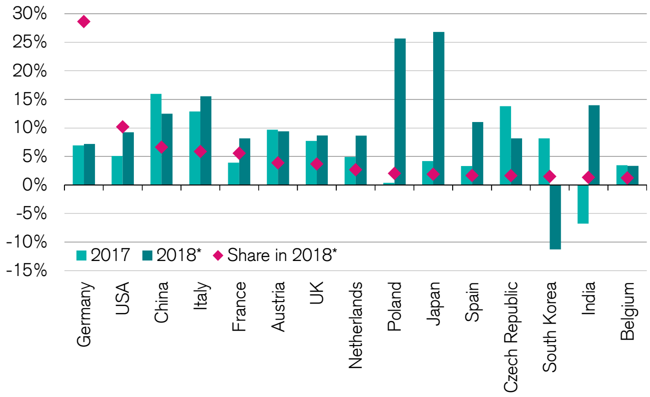
Export growth has broad geographical support

Exports: YoY change and share of total MEM exports in %



Source: Swiss Customs Administration, Credit Suisse; *January - October

Watch industry

From July to October 2018, watch exports climbed further (+3.1% year-on-year), albeit much less sharply than in the first half (+10.6%). Production has been running at full throttle in recent months, with capacity utilization in the third quarter reaching a level not witnessed since the end of 2014. Hence the outlook for the sector in the coming year remains bright, even though growth rates are likely to be lower than in 2018. One particular uncertainty is the economic deceleration in the key Chinese sales market.

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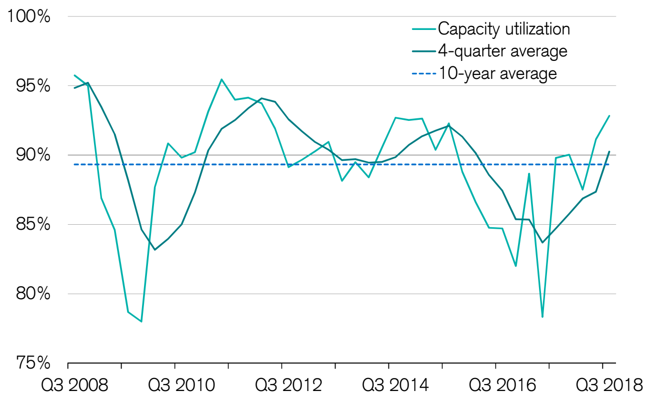
Full steam ahead for production capacity

Average degree of technical capacity utilization in %



Source: KOF Economic Institute at ETH Zurich, Credit Suisse

Retail trade

Revenues in the retail trade stagnated in the third quarter of 2018 (+0.1% year-on-year). The relatively warm weather supported sales growth in the food segment (+1.7%). However, in non-food, clothing retailers, for example, found that the warm autumn meant much of their winter collections could only be sold at a discount. On balance, non-food sales fell 1.6% in the third quarter. For the full year, non-food sales will probably be down around 0.8%, while food sales will likely be up 1.5%.

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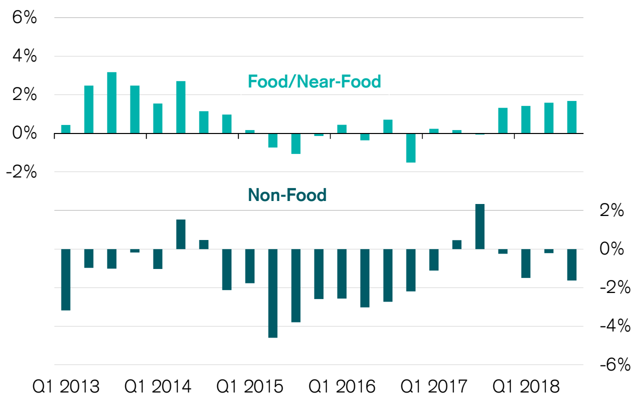
Good weather is bad news for the non-food segment

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



Source: GfK, Credit Suisse

Tourism

Hotels and catering in the alpine regions had one of the best summer seasons of the last decade, with overnight stays up 3.2% between May and October. The macro-economic outlook for the winter season now underway remains good. Growth in employment and incomes, for example, should persist into 2019. This will particularly stimulate demand from domestic tourists. Nonetheless, the high increase in overnight stays in the 2017/2018 winter season (+4.3%), which was partly due to good snowfall, will be hard to beat.

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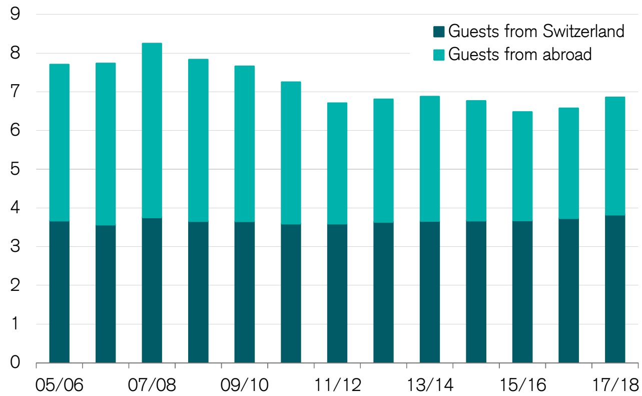
Good economic signs for the winter season

Overnight stays in hotels, spa resorts and youth hostels in alpine areas during the winter season (November to April), in millions



Source: FSO, Credit Suisse

Information technology (IT)

Business in the IT sector is still good, although several indicators in the third quarter of 2018 suggest that growth has again slowed somewhat compared to preceding quarters. Demand for IT services is likely to remain solid in 2019 thanks to the ongoing trend towards digitalization. However, for many IT companies, the difficulty of finding enough specialist staff is a serious hindrance. The percentage of open positions in the IT sector has increased sharply in recent quarters and is currently some three times higher than in the services sector as a whole.

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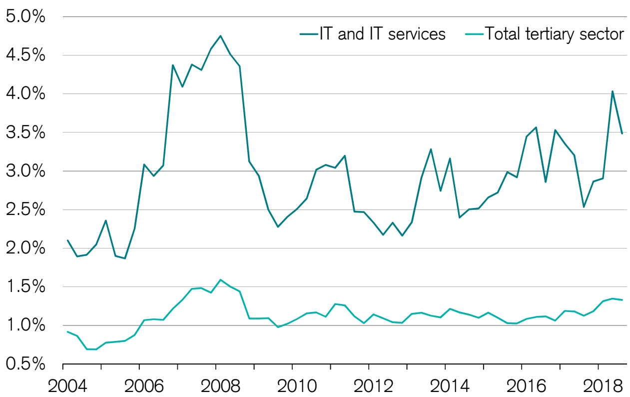
The IT sector struggles to fill available jobs

Ratio of open positions in %



Source: FSO, Credit Suisse

Joining the domestic EU market would not end Switzerland’s status as a high-price island

The high level of prices in Switzerland reflects our prosperity, but it is also a result of market protection. Cases in the domestic EU market, however, suggest that even an open market would not trigger a widespread collapse in price levels here.

Switzerland is Europe's second most expensive country

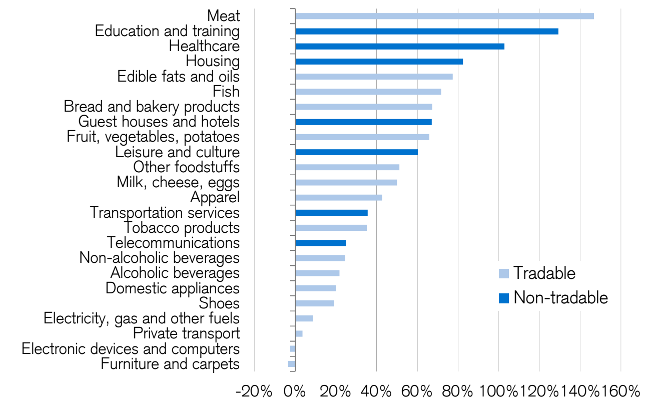
Switzerland has the second-highest price level in Europe – only the remote island nation of Iceland is even more expensive. Norway follows in third place. The three most expensive countries are thus all outside the European Union (EU). Fourth and fifth place go to Denmark and Sweden, countries that are EU members but do not use the common currency. In particular, prices for services that are anchored in a certain location and not easily tradable are higher in Switzerland than in neighboring countries (e.g. in the areas of education and training, healthcare, and housing), as are goods that have political protection from competition (e.g. meat or other food, see figure). Swiss prices are only lower on easily tradable and non-protected electronic devices and home furnishings, which are generally not manufactured in Switzerland.

High price level is also the flip side of affluence

Part of Switzerland's high price level is obviously the reverse side of a high standard of living, since there is a significant connection between a country's economic output as measured by gross domestic product (GDP) per capita, and its price level (see figure). This theoretically logical connection – in rich, high-wage countries, local service providers such as physicians or teachers must still receive a competitive wage, which results in a generally higher price level – accounts for much of the difference in price levels across Europe. However, an increasing share of the difference in price levels remains unexplained, and especially in more affluent countries such as Switzerland, the connection between economic output and price level appears weaker. For example, the price level in similarly affluent countries such as Luxembourg, Ireland, Germany or the Netherlands is considerably lower than here.

Tradable goods are also more expensive here

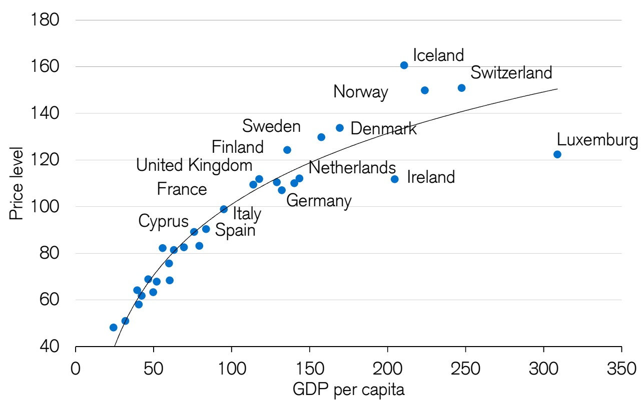
Switzerland’s deviation from EU 28 price level, 2016



Source: FSO, Credit Suisse

Clear link between price level and economic output

Price level (EU 28 = 100) and real GDP per capita (in EUR), 2017



Source: Eurostat, Credit Suisse

EU counters elevated prices with open markets

Given the higher Swiss prices for products that have political protection from competition, and the predominance of non-EU members in the ranking of price levels, a hypothesis emerges that protectionism and/or only partial participation in the domestic EU market is partly responsible for the higher price level. Indeed, competition promotes market efficiency and generally results in lower prices. The declared goal of the EU is to release the positive forces of competition in the domestic EU market through the free circulation of goods, people, services, and capital.

Price convergence is occurring, but for many reasons

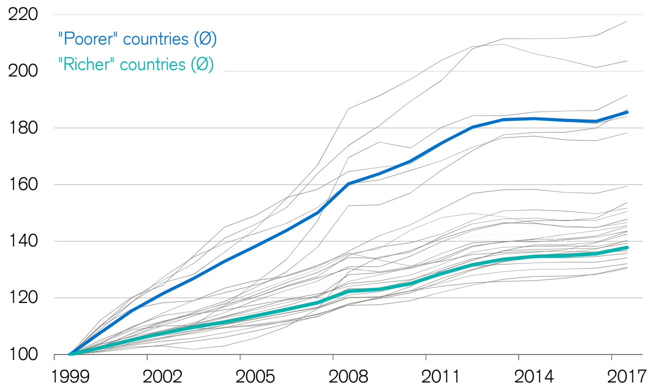
Measured by the development of price levels over the last two decades, the liberalization of the domestic EU market appears at first glance to have been a success. As would be expected in a domestic market, price levels among the individual countries of the EU have drawn closer together since 1999, when the euro was introduced, as is evident in the nearly 10-percentage-point total decline in the variation coefficient. In addition to the market opening, however, the general economic homogenization of the countries has also contributed to price level convergence. In the economically weaker countries of the EU, GDP per capita has increased disproportionately since 1999 (see figure), and, as would be expected, prices have also risen (see figure). This is a clear indication that economic convergence played an important role in smoothing out price levels. The fact that prices for non-tradable services have also converged (see figure on following page) similarly suggests that price convergence is not solely due to the mechanisms of market liberalization. Moreover, the exchange rate trends within Europe since 1999 have also moved closer, and among the 19 countries that have now adopted the euro, there is no longer any possibility of exchange rate movements.

More than half attributable to growth and exchange rate

The impact of economic growth and exchange rate trends on changes in price levels between 1999 and 2017 cannot be estimated for each country individually given the brevity of the data series. Thanks to a method of estimation that simultaneously considers the development of all nine non-euro countries of the EU, however, the average influence of these factors can at least be quantified. As it happens, the two factors of economic growth and exchange rate trends have a combined and nearly equal influence that accounts for somewhat more than half of the differences in price levels. This finding also applies when only easily tradable consumer goods are considered. But the logical conclusion, that the unexplained approximately 45% is due solely to market liberalization, does not hold true; there are numerous other factors affecting the price trend that are unobserved and thus not considered in the estimate. These include local preferences, transportation costs, weather factors, and tax adjustments.

The steeper rise in prices in poorer countries...

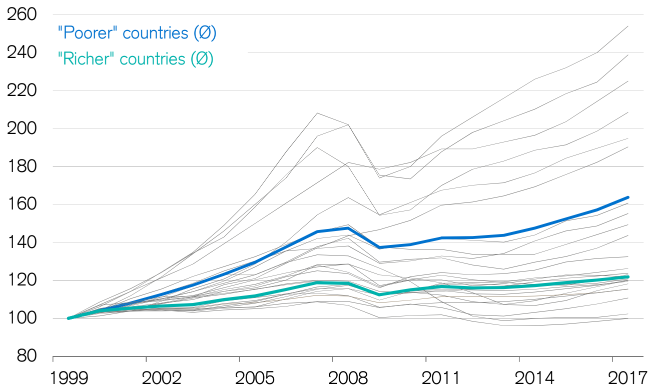
Development of price level, index 1999 = 100 (excluding Romania)



Source: Eurostat, Credit Suisse

...is also a result of more dynamic economic growth

Development of real GDP per capita, index 1999 = 100 (excluding Ireland)



Source: Eurostat, Credit Suisse

Price convergence is lower among founding euro countries...

In fact, exchange rates and economic growth are likely to have a more direct effect on changes in price levels than the domestic EU market does. One of the facts supporting this position is that price convergence has been greatest among the EU countries that joined the market as part of the eastern EU expansion – precisely the countries in which exchange rate convergence and economic alignment were most pronounced, starting from a typically lower level of both affluence and prices. On the other hand, alignment of price levels has largely ceased between the 11 countries that first adopted the euro in 1999 (EU 11). Even before the common currency, these countries were generally more economically homogeneous than the EU as a whole, and the exchange rate effect was completely wiped out by the launch of the euro. The figure at right illustrates that prices for approximately half of goods and services have aligned, but the difference between prices for the other half has actually become greater over time. The gap also widened between prices for some tradable goods, in contrast to the expected development of a fully integrated domestic market. Price levels diverged the most in service areas such as education and training, healthcare, and tobacco products (which are heavily influenced by taxes) – thus in locally anchored services that have very little exposure to international competition.

...and lower between Germany, Austria, and the Netherlands

To gain an impression of the possible effects of an open market on the price level in Switzerland, it is useful to compare the price development here with those in the geographically and economically similar euro countries of Germany, Austria, and the Netherlands. Price level convergence was marginal in this comparison group and was also limited to around half of all goods and services. There was no collapse in prices caused by the EU domestic market. Nonetheless, price levels in all three comparison markets rose less sharply than in Switzerland, for a majority of products and services. Such a simple comparison of Switzerland with foreign countries on the basis of the euro naturally overlooks the exchange rate effect, since some of the price growth in Switzerland can be attributed to the franc's nearly 30% appreciation since 1999. While prices in CHF for imported goods fell by nearly 5% during this period, prices for domestic goods in CHF climbed by nearly 15%.

No sweeping price collapse expected in Switzerland

Even after adjusting for the exchange rate effect and considering different economic developments, our estimates indicate that compared to Switzerland, the rise in the price level was 9 percentage points lower in Germany and 3 percentage points lower in Austria. This suggests a certain deceleration in the price trend thanks to the EU domestic market. The fact that the similarly adjusted price level in the Netherlands rose 1.5 percentage points more than in Switzerland appears to contradict this hypothesis. However, it does not negate the conclusion that a broader opening of the Swiss market to the EU domestic market would not set off a massive and widespread price slide.

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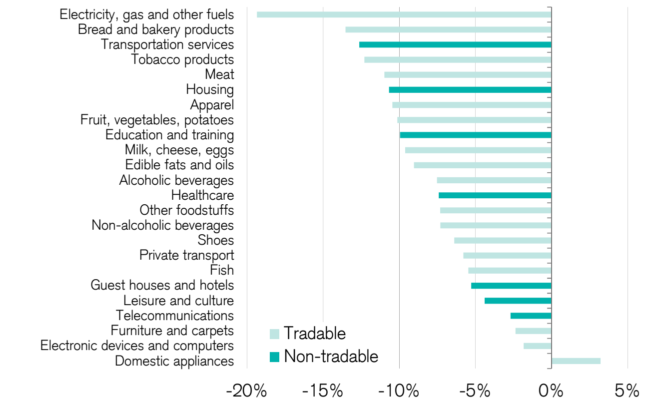
Price levels in the EU 28 have aligned on nearly all products...

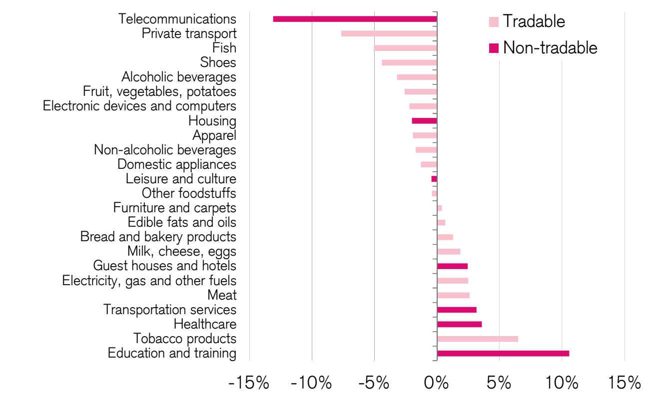
Change in the variation coefficient of the price level between 1999 and 2016, in percentage points



Source: FSO, Credit Suisse

...but convergence in the EU 11 is limited to a few products

Change in the variation coefficient of the price level between 1999 and 2016, in percentage points



Source: FSO, Credit Suisse

SNB set to distribute CHF 2 billion in 2019

Despite a loss in the first three quarters of 2018, we believe that the Swiss National Bank (SNB) will have sufficient reserves by the end of the year to distribute CHF 2 billion to the cantons and the Confederation in 2019.

SNB's distribution reserve is plentiful

On October 31, the SNB reported a loss of CHF 7.8 billion for the first three quarters of 2018. Nevertheless, we believe that the SNB will be able to distribute the maximal amount of CHF 2 billion to the cantons and the Confederation in 2019. According to the current agreement between the Federal Finance Department and the SNB, which governs the annual profit distribution to the cantons and the Confederation, the SNB distributes a maximal amount of CHF 2 billion if its distribution reserves do not fall below CHF 20 billion after the distribution. Taking into account the mandatory annual increase of the provisions for currency reserves (we assume the SNB will propose to increase them by 8% or CHF 5.4 billion), reserves available for distribution amounted to CHF 54 billion at the end of the third quarter of 2018. Hence, even a loss of CHF 32 billion in the fourth quarter of 2018 would leave enough reserves to allow a distribution of CHF 2 billion in 2019.

Large losses on substantial CHF appreciation are unlikely

Only a loss of at least CHF 54 billion in the fourth quarter would prevent a profit distribution. While not impossible, such a loss appears unlikely, in our view. For each decline of 1 centime of either EUR/CHF or USD/CHF (i.e. whenever the CHF appreciates by that amount against either the EUR or the USD), the SNB loses approximately CHF 2.7 billion. For example, EUR/CHF would need to fall below 1.04 and USD/CHF below 0.88 to put the profit distribution at risk. Such a rapid and large appreciation of the CHF (around 10%) would most likely be countered by foreign currency purchases by the SNB, making it highly unlikely. Moreover, the SNB can count on a relatively stable source of income stemming first from the negative interest rate charged on commercial banks' sight deposits and second from dividends and coupons it earns on its foreign exchange reserves. The SNB should generate approximately CHF 3.5 billion to CHF 4 billion on these sources of income in the fourth quarter of 2018, on our estimates, providing an additional buffer.

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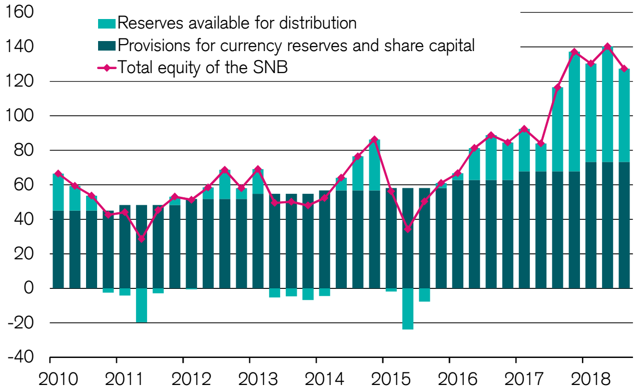
Large reserves available for distribution

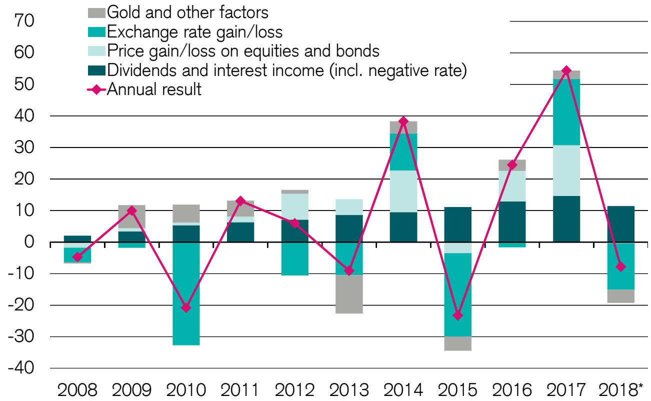
In CHF billion



Source: SNB, Credit Suisse

SNB annual result by source of income

In CHF billion



Source: SNB, Credit Suisse. *Q1 to Q3 2018.

Banknotes

Banknote demand follows a clear seasonal pattern: at the end of the year, banknotes in circulation increase significantly, reflecting substantially higher retail sales and, in some instances, SMEs paying year-end awards in cash to their employees. At the beginning of the (following) year, the public returns banknotes to commercial banks, which bring them back to the SNB. As a result, banknotes in circulation drop. After the introduction of the negative interest rate by the SNB, the demand for banknotes rose strongly (particularly for the CHF 1000 notes). It has since then slowed down, and 2018 should record only a moderate increase in banknotes in circulation. In parallel, the on-going shift to electronic payments is in play as well.

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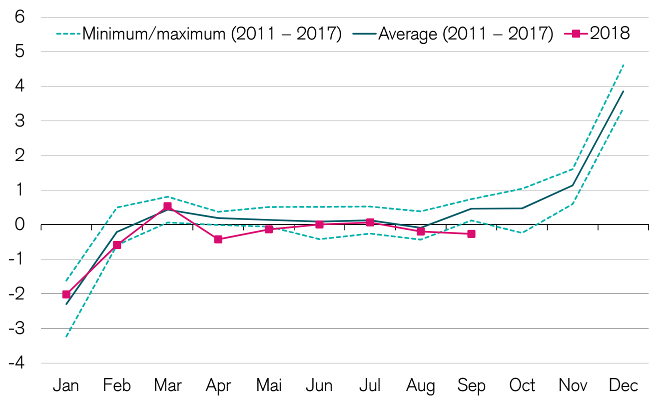
Unusual drop in banknote demand in September 2018

Monthly changes in banknotes in circulation, in CHF billion



Source: SNB, Credit Suisse

Capital flows

In September 2018, CHF deposits of foreign banks with banks in Switzerland and at the SNB jumped to CHF 149 billion, an increase of almost CHF 19 billion in comparison to August. Foreign banks had reduced their CHF holdings over the course of the summer. But the latest increase in CHF holdings by foreign banks shows that there is still a strong demand for CHF from foreign investors, possibly due to renewed fears of financial market turbulence.

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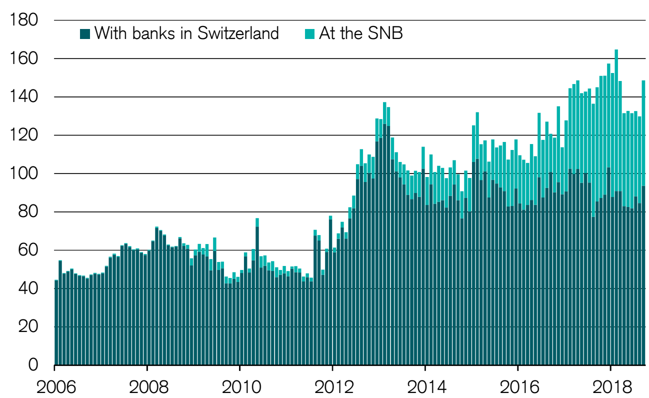
Foreign banks again hold more CHF in Switzerland

CHF deposits of foreign banks, in CHF billion



Source: SNB, Credit Suisse

EUR/CHF fair value

Our currency valuation model estimates the current "fair value" of EUR/CHF at 1.24. Given the uncertainty around the model estimates, we would consider the CHF as "fairly" valued against the EUR for any value between EUR/CHF 1.14 and 1.35. Lately, EUR/CHF has traded close to the lower bound of the fair value band, indicating that the CHF has remained expensive. Yet, the overvaluation is not as pronounced as it was between 2015 and mid-2017.

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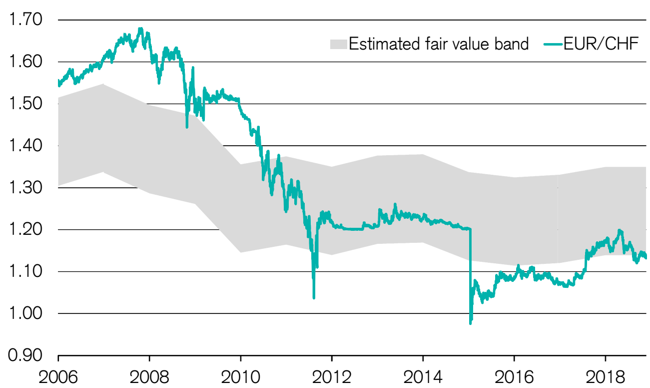
The CHF remains expensive against the EUR

EUR/CHF



Source: Bloomberg, Credit Suisse

Populism heightens risk of inflation

Each autumn, Credit Suisse identifies three key investment themes that have the potential to affect the financial markets in the following year. For 2019, one of these themes is the rise of populist governments and their influence on inflation.

The last 40 years have seen the spread of globalization and free trade around the world. This constellation allowed for decades of strong global economic growth that was accompanied by moderate inflation and an increasing worldwide integration of the financial markets. Despite all the advantages, however, there were also negative consequences. For example, in some Western countries, including the USA, there was a surge in income inequality. Moreover, shocks such as the US subprime mortgage crisis quickly contaminated the entire global economy, pulling nearly all asset classes worldwide into the red.

One of the factors spurring the inequality was a stagnation in real wages for workers who found themselves competing with cheaper production locations in low-wage countries. The stalled standard of living reinforced the sense of being left behind – fertile ground for populism to take root. Themes such as immigration offer disillusioned voters a place to project their anger and serve as a target for opportunistic politicians and ideologues. But the very concept of globalization itself is also viewed with increasing suspicion, particularly since the global financial crisis.

What impact does this have on the financial markets? The greatest risk is that populism will translate into heightened inflation, for the following reasons. First, populists seldom pursue a sustainable financial policy, despite high levels of debt. On the contrary, they could exert greater pressure on central banks to finance their spending plans by printing money. A loss of central banks' independence to set monetary policy would lead to higher risk premiums on stocks and bonds. Second, the imposition of tariffs – another populist measure – tends to spur inflation while simultaneously hemming growth. Since investors currently appear convinced that inflation is unlikely to rise, their portfolios are particularly exposed to higher inflation. This danger seems limited for the time being. However, it would certainly make sense to begin building some inflation hedging into investment portfolios.

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Residential property

At the last measurement, 73'000 housing units (1.62% of the inventory) in Switzerland were vacant – the highest number ever. This trend is primarily a result of overproduc-tion in the rental apartment segment. The vacancy rate for rental apartments rose from 2.24% to 2.51% within the span of a year. Vacancies are highest in rural areas, and in small and mid-sized centers. There is no sign yet that the trend may reverse to lower housing vacancies. The project pipeline remains well filled, and negative interest rates will continue to support demand for real estate investments.

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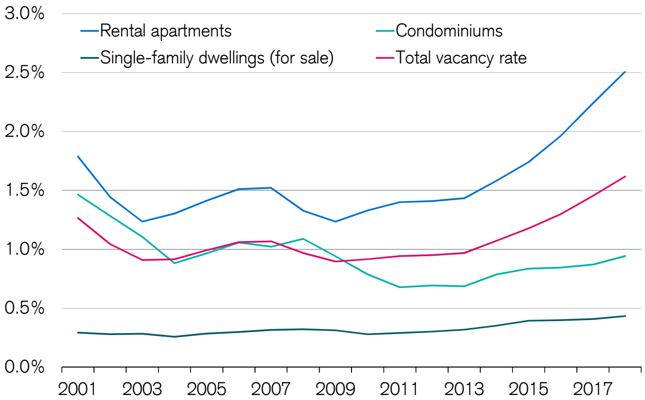
Sharp rise in housing vacancy rate

Housing vacancy rate by segment, as % of the relevant housing inventory, as at June 1



Source: FSO, Credit Suisse

Owner-occupied housing

Prices for owner-occupied housing continue to rise, but as expected, the trend recently lost some momentum. On balance, prices rose 3.0% year-on-year in the third quarter of 2018 (condominiums: +2.4%, single-family dwellings. +3.3%). There are significant differences among the regions. The strongest price growth is currently reported in Central Switzerland and many areas of Western Switzerland. Prices in Valais and Ticino, in contrast, are in a decline. Thanks to the healthy economic development, mortgage rates that have fallen even lower, and decreasing residential construction, we expect prices to rise further in the coming quarters.

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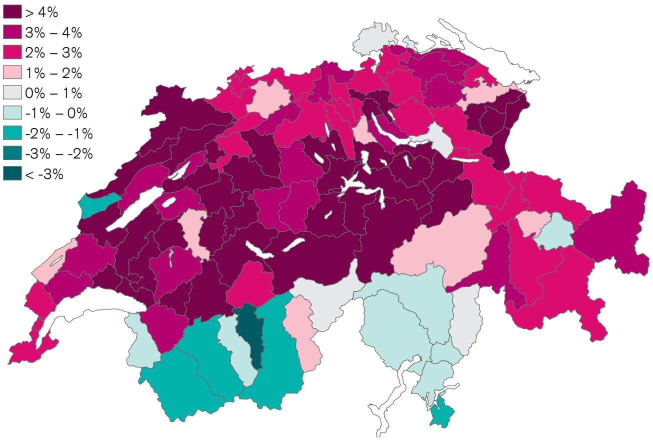
Most housing prices are rising

Annual growth rates for owner-occupied housing, Q3 2018



Source: Wüest Partner, Credit Suisse, Geostat

Office property

The economic upturn gave a significant boost to employment growth and thus stimulated demand for office space. The main contributors to growth are business services, IT, the public sector, and the reinvigorated industrial sector. As a result, there has been an observable recovery in the office markets of the major centers. In peripheral areas, however, there are few signs of a revival, except for the region around Lausanne.

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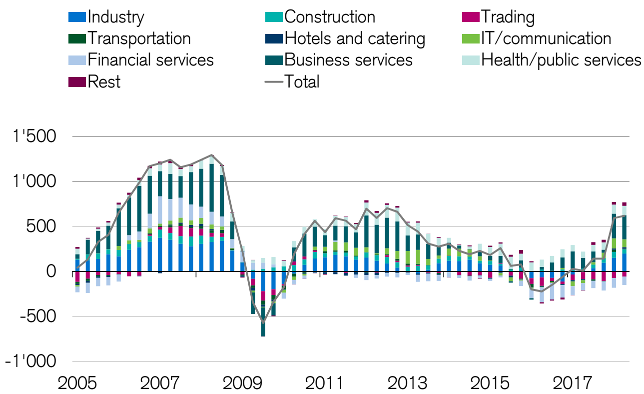
Rising demand for office space

Estimated additional demand compared to the previous year's quarter in 1000 m2



Source: Credit Suisse, FSO

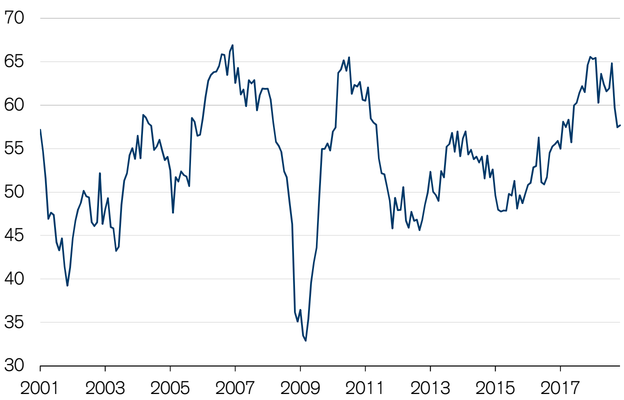
Credit Suisse Leading Indicators

Purchasing Managers' Index (PMI)

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

Industrial Activity

PMI index > 50 = growth



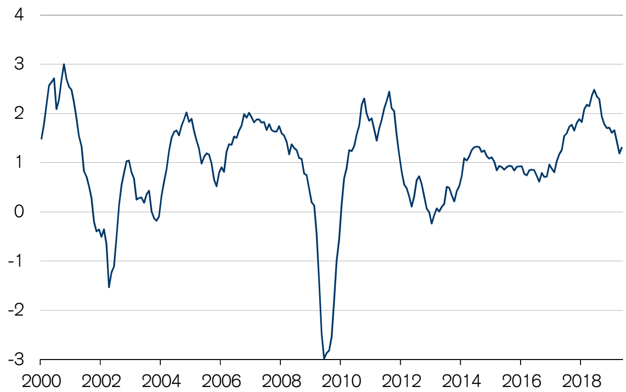
Source: procure.ch, Credit Suisse

Credit Suisse Export Barometer

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

Exports

In standard deviation, values > 0 = growth



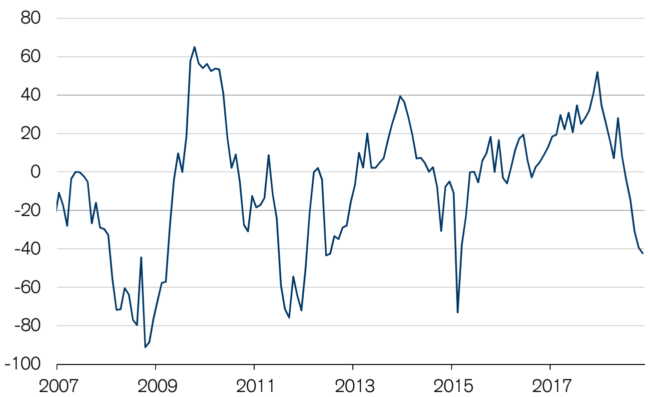
Source: PMIPremium, Credit Suisse

CS CFA Society Switzerland Index

Financial analysts have their finger on the pulse of the economy. Since 2017, we have been conducting a monthly survey of financial analysts jointly with CFA Society Switzerland under the heading Financial Market Test Switzerland[1]. Analysts are questioned not only about their assessment of the current and future economic situation as well as the rate of inflation but also about financial market issues such as equity market performance and interest rate forecasts. The CS CFA Society Switzerland Index represents the balance of expectations regarding the development of Swiss economic activity over the coming six months.

Economic Activity

Balance of expectations, values > 0 = growth



Source: CFA Society Switzerland, Credit Suisse

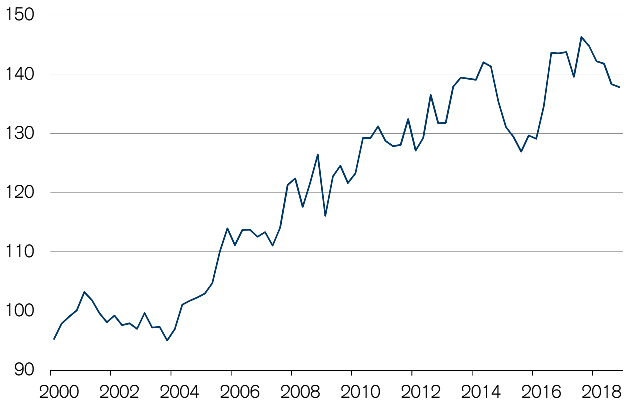
[1] Published as the Credit Suisse ZEW Index from 2006 until 2016

Swiss Construction Index

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

Construction Industry Climate

1st quarter 1996 = 100



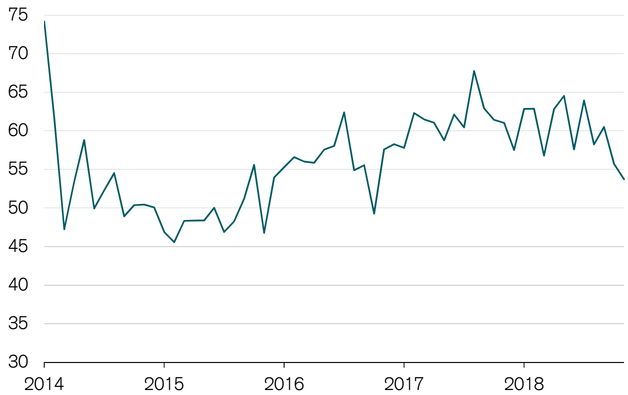
Source: Swiss Contractor's Association, Credit Suisse

PMI Services

Procure.ch, the professional association for purchasing and supply management and Credit Suisse 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

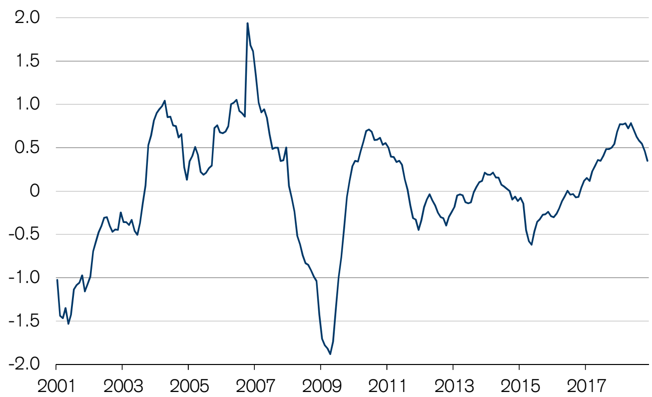


Source: procure.ch, Credit Suisse

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	2018 Q3	2018P Q4	2019P Q1	2019P Q2	2019P Q3	2019P Q4	2018P	2019P
GDP (YoY, in %)	2.9	3.5	2.4	1.9	1.5	1.3	2.0	2.0	2.7	1.7
Consumer spending	1.1	1.2	0.7	0.9	0.9	1.2	1.6	1.7	1.0	1.4
Government expenditure	1.4	1.4	0.8	0.6	0.9	0.9	0.9	0.9	1.1	0.9
Gross capital investment	3.4	3.8	1.0	1.9	2.5	2.2	2.2	2.1	2.5	2.2
Construction investment	0.9	2.2	0.7	1.3	0.5	0.5	0.5	0.5	1.3	0.5
Investment in plant and equipment	4.8	4.8	1.1	2.1	3.0	3.0	3.0	3.0	3.2	3.0
Exports (goods and services)	3.8	5.7	-1.0	5.0	2.8	3.0	3.0	3.0	3.4	3.0
Imports (goods and services)	5.0	3.2	1.2	0.7	3.0	3.0	3.0	3.0	2.5	3.0
Inflation (in %)	0.7	1.0	1.1	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	1.8	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)									7.1	6.5
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				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 %
	2018	2019	2018	2019	2017	2017	2017	2017
World	3.2	3.0	2.7	2.7	7'530	80'051	100	100
US	2.9	2.7	2.5	2.0	326	19'485	15.3	6.8
Euro zone	2.0	1.8	1.8	1.4	341	12'633	44.1	63.4
Germany	1.7	2.0	1.9	1.8	83	3'701	18.9	28.2
France	1.6	1.6	2.1	1.3	65	2'588	6.4	7.9
Italy	1.0	0.9	1.3	1.2	61	1'939	6.2	9.7
UK	1.2	1.5	2.5	2.2	66	2'628	5.2	3.3
Japan	1.1	1.2	0.8	0.8	127	4'873	3.3	1.9
China	6.6	6.2	2.1	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 %)	-0.74	-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 %)	-0.16	0.0-0.2	0.4-0.6	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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