ATLANTIC
FINANCIAL GROUP

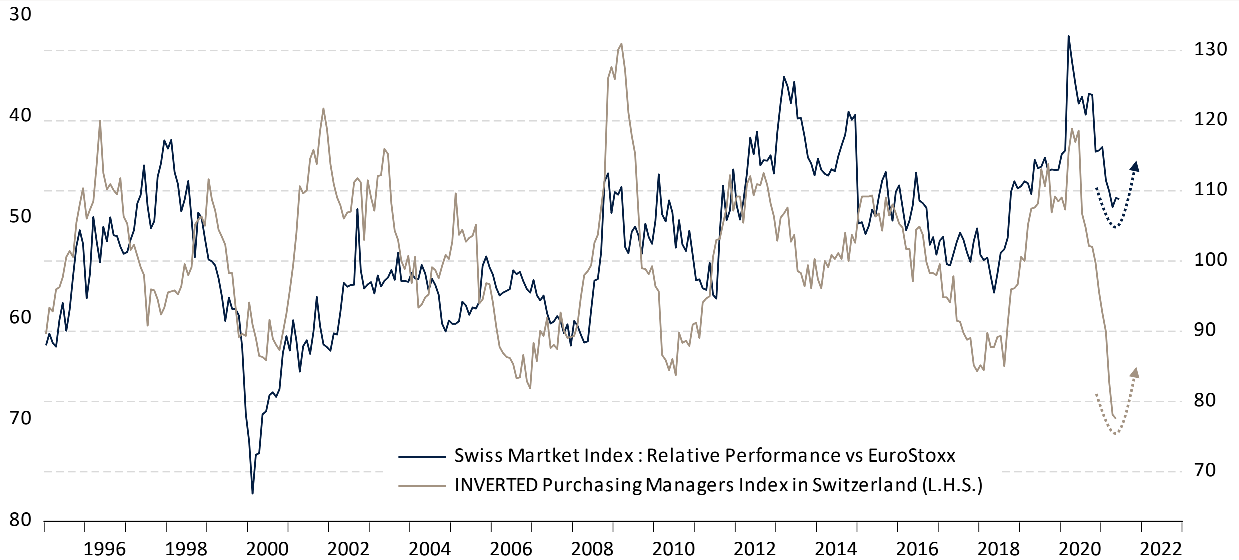
Weekly Investment Focus

14 June 2021

"SWISS EQUITIES, THE DEFENSIVE RISK-ASSET"

- After a poor first quarter, the Swiss economy is recovering strongly
- Everything is in place for Swiss companies to catch up and outperform
- The main risks are related to the real estate market and the negotiations with the EU
- The Swiss franc will continue to appreciate as the SNB curbs its interventions

CHART OF THE WEEK: "Swiss equities outperform when confidence weakens"



Source: Bloomberg, Atlantic Financial Group

FINANCIAL MARKETS ANALYSIS

In the first quarter, Switzerland's Gross Domestic Product (GDP) shrank again, by -0.5% compared to the previous quarter, keeping annual growth in negative territory (see Fig. 2). This negative result is mainly due to household consumption, which fell sharply in the second quarter. On the supply side, the restaurant and hotel sector showed the largest decline, falling by -30.4%. Next in order of difficulty were the leisure sector (-5.1%), trade (-4.8%) as well as transport and communication (-0.9%). In contrast, the recovery in industry (+4.9%) prevented a more pronounced decline in GDP between January and March.

After stalling in the first few months of 2021, **the Swiss economy is recovering strongly and the outlook is encouraging.** In May, leading indicators such as the one built by the economic research centre of the Swiss Federal Institute of Technology in Zurich or the one measuring purchasing managers' confidence (see Fig. 2) set new highs. They reached levels never recorded since their creation. In services, however, the increase was slower and below analysts' estimates.

Fig. 2 - Economic growth in Switzerland

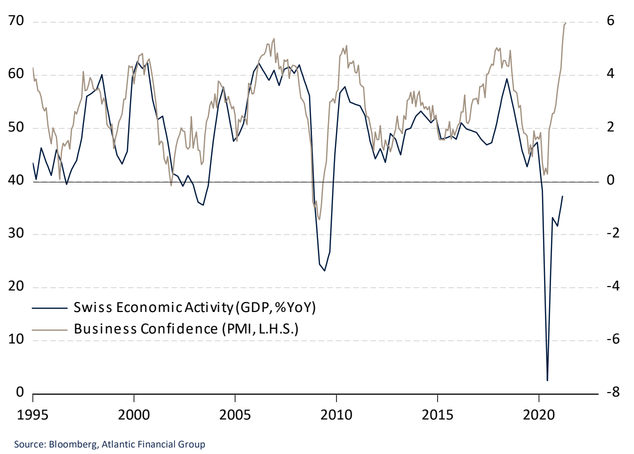
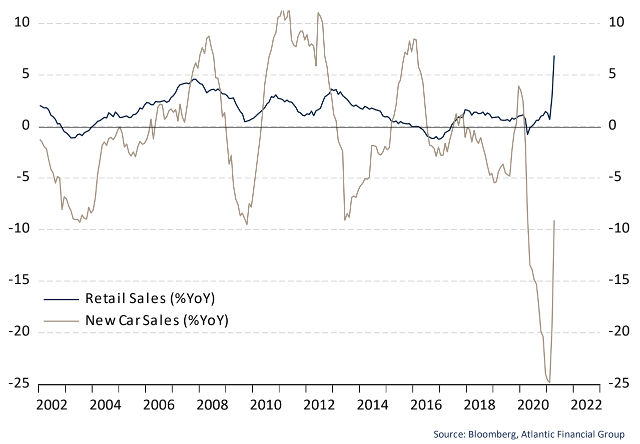


Fig. 3 - Household consumption



Our econometric models suggest GDP growth of +3.4% in 2021 and +2.7% in 2022. The improved outlook for the labour market and the gradual reduction in safety savings will allow a rebound in consumption in the heart of the Alps (see Fig. 3), while the decline in uncertainty on the health front will encourage capex to recover.

Within this optimistic scenario, there are two points to monitor. The first is the overheating of the real estate market. The second is the failure of negotiations with the European Union.

1. **The pandemic has pushed up property prices, particularly for houses,** accentuating a trend that had already been in place for several decades. Over the past 22 years, prices of single-family houses have increased by +79% (see Fig. 4). This has been made possible by good economic dynamics, rising wages and the historic fall in mortgage interest rates. Today, it is possible to finance a property with a fixed rate of 1.2% for 10 years, compared to 5.5% in 2000. The Swiss National Bank (SNB) speaks of "increased vulnerability", as households are too heavily dependent on low rates. It is concerned about their ability to afford the mortgage interest charges if rates were to rise. In addition, the number of vacant dwellings continues to grow. Unsurprisingly, the prices of rental apartments have accelerated their fall, which began in 2015. **The risk of a housing bubble deflating is therefore real** (see Fig. 5).

Fig. 4 - House and apartment prices

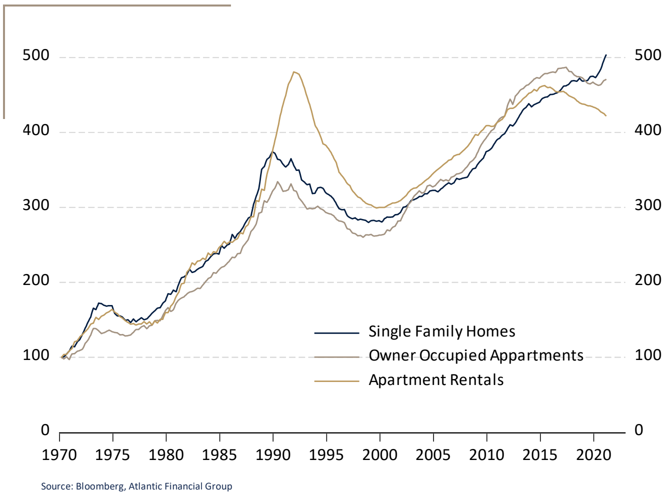
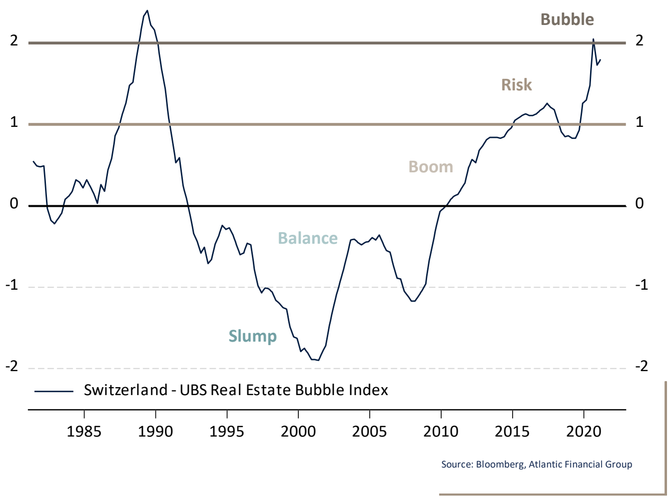


Fig. 5 – Real estate bubble index



2. On 26 May, after more than seven years of discussions, **the Federal Council unilaterally decided to break off the negotiations** on the framework agreement deal with the European Union (EU). The underlying idea of these negotiations was to make the relationship between Switzerland and the EU long-lasting **so that Switzerland would continue to have access to the European single market while remaining outside the Union.** Since 1992, Switzerland and the EU have been linked by more than a hundred bilateral agreements, negotiated over time: free movement of persons, exchange of goods, transport, agriculture, etc. These links are more than just free trade agreements, but less than membership of the European Union. Victims of their success, they have become too numerous and too complex. Some of them have expired and others need to be adapted to the evolution of Community legislation.

   There are many points of disagreement.

   - The search for consensus: while the Swiss Federal Council refers to the framework agreement as a "project", the EU Commission refers to a "necessary agreement".
   - Free movement of persons: while Switzerland agrees to allow free movement of employees and their families, the EU mentions the free movement of all its citizens.
   - Wage protection: Switzerland would like EU companies sending employees to work in Switzerland to continue to notify the authorities in advance in order to prevent wage dumping and thus protect Swiss wage levels.
   - Social assistance: Switzerland fears that the granting of this financial support could concern all EU citizens living in Switzerland, whether active or inactive, thus favouring an "immigration to social assistance".
   - The banking sector: Switzerland fears that its banks will no longer be allowed to operate with state guarantees, as the EU prohibits state support in this case.
   - Dispute resolution: Switzerland is concerned that it will have to adapt too much to EU legislation and that the European Court of Justice will lean in favour of the EU.

For all these reasons, Switzerland has wanted to break off the negotiations. **As the EU makes the signature of the framework deal a precondition for the conclusion of any new bilateral agreement on access to its market, the situation is not optimal.** In the near future, in sectors no longer covered by bilateral agreements, trade will become more complicated and costly. This is already the case for medical materials, for example, where the bilateral legal framework allowed for mutual recognition and removed technical barriers for their export... it has just expired. Other current agreements between Switzerland and Europe will gradually expire. In 2023, it will be the turn of standards for machinery. Other areas at risk include rail transport, research, electricity and e-commerce.

Following the failure of negotiations on a framework agreement between Switzerland and the EU, **the rating agency, Fitch, considers that Swiss economic growth will be penalised.** It takes into account the fact that trade between the two partners is an important issue: 48% of Swiss exports and 56% of imports are made with Europe (see Fig. 6).

Fig. 6 - Swiss trade balance

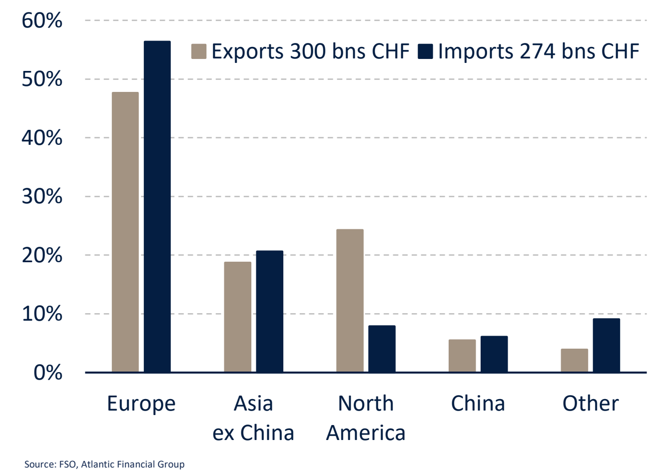
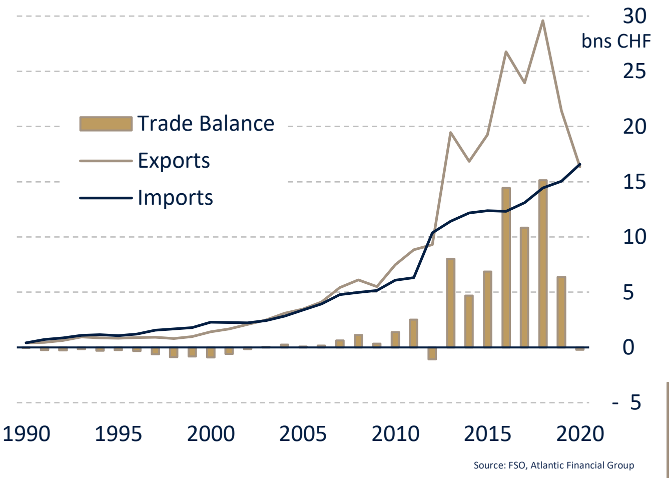


Fig. 7 - Trade balance with China



However, the Swiss economy is strong enough to withstand the time it takes for a political solution to be put in place. The federal government's wide financial leeway is an important element in cushioning this type of exogenous shock. In the past, Switzerland has regularly managed to overcome structural challenges. While the current situation complicates trade relations with its main partner, it does not bring them to a standstill. As proof of this, since mid-2019 the EU no longer recognises the equivalence of the Swiss legal and prudential framework for stock exchange transactions. This does not prevent the smooth functioning of financial markets and investments.

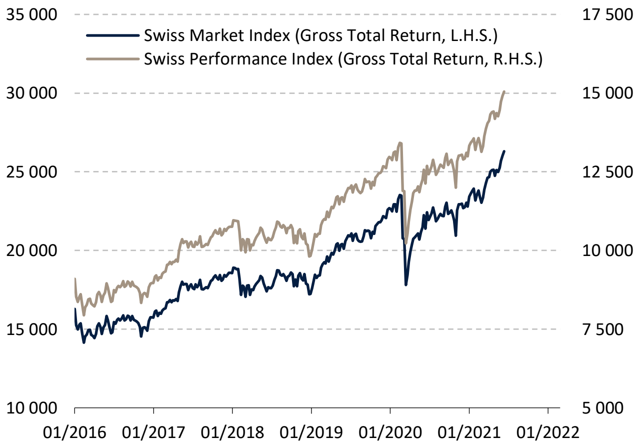
Overall, Swiss companies will remain strong thanks to their competitiveness and their exposure to non-European international markets. For the record, Switzerland is one of the very few developed countries with a positive trade balance with China (see Fig.7). Swiss multinationals could also choose to deploy more subsidiaries or to conduct part of their activities directly from Europe. **Thus, despite its concerns, Fitch has maintained its rare and valuable "AAA", a top rating that Switzerland shares with only eight countries** (see Fig. 8). The rating agency did not even want to change its outlook, keeping it at "stable".

Fig. 8 - The last nine AAA-rated countries

Country	S&P	Moody's	Fitch
1- Germany	AAA	Aaa	AAA
2- Australia	AAA	Aaa	AAA
3- Netherlands	AAA	Aaa	AAA
4- Singapore	AAA	Aaa	AAA
5- Sweden	AAA	Aaa	AAA
6- Denmark	AAA	Aaa	AAA
7- Switzerland	AAA	Aaa	AAA
8- Norway	AAA	Aaa	AAA
9- Luxembourg	AAA	Aaa	AAA

Source: Bloomberg, Atlantic Financial Group

Fig. 9 - Absolute performance of Swiss equities



Source: Bloomberg, Atlantic Financial Group

Investors are not worried either. The Swiss stock market is moving towards new highs. Its flagship index, the SMI, broke through the 11,500-point barrier for the first time and the 26,000-point total return mark (see Fig. 9). Since 1st January, some stocks have performed exceptionally well: Richemont (+44%), Swatch (+38%) and Partners Group (+33%) share the podium. At the other end of the ranking, Credit Suisse (-14%) and Novartis (-4%) are the only two with red figures. In the heavyweight category, Roche (+9%) and Nestlé (+4%) are in line with the index. In addition to the major stocks in the SMI, there are smaller companies in the broader SPI market that are very well positioned in their respective markets: AMS (-3%), Bucher (+18%), Bystronic (8%), EMS Chemie (-1%), Georg Fisher (+14%), Idorsia Pharmaceuticals (+4%), Logitech (-3%), Medartis (+92%), Schindler (-6%) or Sonova (+41%) for example.

Over the past 15 years, due to its sector composition, the SMI has performed significantly worse than its US counterpart, the S&P 500, but has grown much faster than the EuroStoxx (see Fig. 10). Recently, the pedestrian evolution of the SMI has been completely out of sync with earnings estimates, which have risen sharply. As a result, **relative valuation ratios appear to be very favourable for Swiss companies** (see Fig. 11), whether compared to their US or European counterparts. As good news never comes alone, it is **usually when leading indicators have peaked that the Swiss stock market outperforms** the other geographical indices (see Chart of the Week). Here we are!

Fig. 10 - Relative performance of Swiss shares

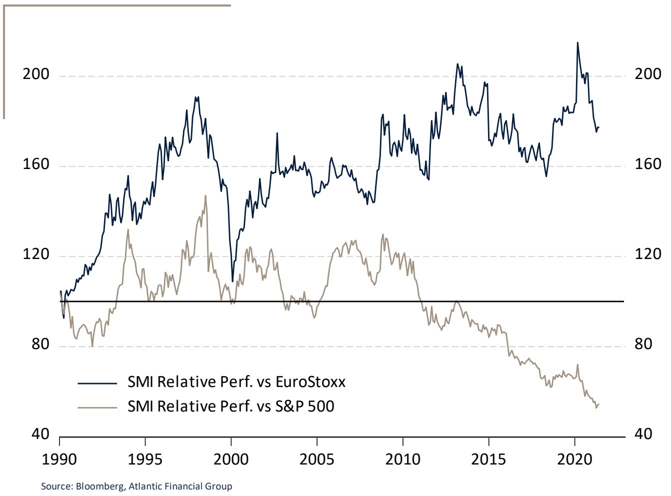
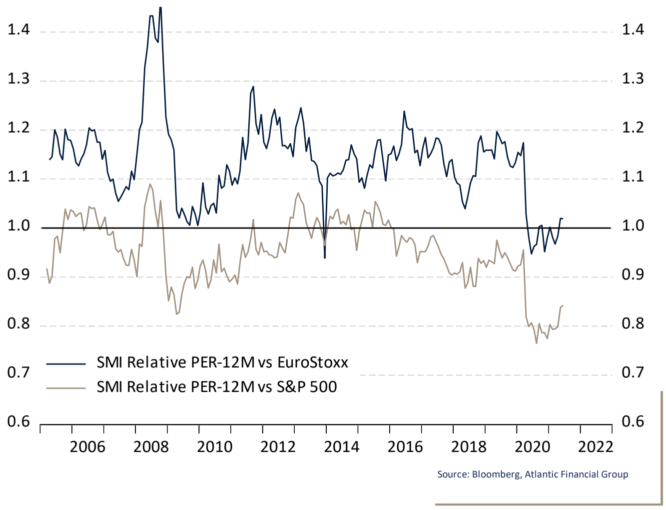
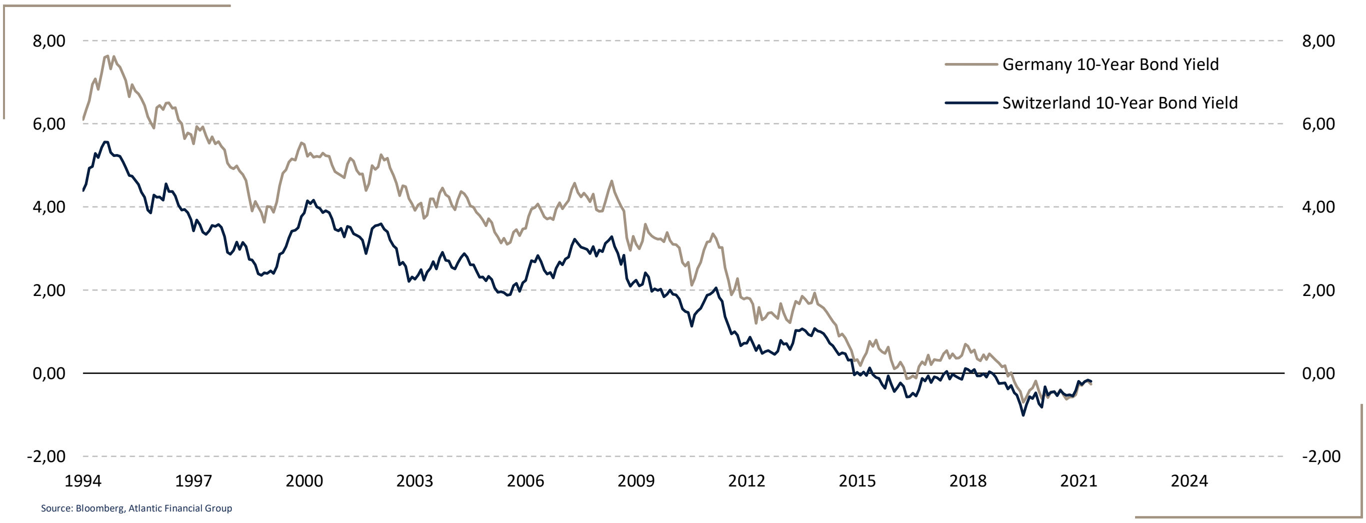


Fig. 11 - Relative valuation of Swiss shares



In the forex market, Swiss National Bank (SNB) officials believe that the high valuation of the franc still justifies an expansive monetary policy. Its vice-president, Fritz Zurbrügg, recently said that the easing of the Swiss currency since the end of last year was welcome, but that it was due to the improved global economic outlook, particularly the stimulus packages in the US and the Euro Area. This had led to a reduction in demand for safe havens such as the franc. The argument is commendable, but the central bank is trying to see the glass as half full, as it seeks to defend itself from manipulating its currency in the face of US criticism.

Fig. 12 - 10-year bond yields in Switzerland and Germany



According to our estimates, the depreciation of the Swiss franc is not the result of a natural balance between supply and demand. Excluding market effects, the SNB injected some CHF 116 billion into the market between February and October 2020 to weaken the Swiss currency. Since March, it has slowed down its interventions and, mechanically, the franc has tended to appreciate. This is the case not only against the US dollar and the Japanese yen, which are weak overall, but also against the main European currencies, which are rather strong at the moment. The Swiss franc has therefore risen against the vast majority of its counterparts over the past three months. Our analyses lead us to conclude that **this trend of the appreciation of the franc is not over, quite the contrary. For the first time in their history, the bond yields offered by the Confederation are not lower than those offered by Germany.** This situation, which removes one of the major disadvantages of investing in the franc rather than the euro, is a powerful support for the Swiss currency (see Fig. 12).

Conclusion:

Swiss companies are well positioned to benefit from the rebound in international economic growth, despite the failure of negotiations between the Swiss government and the European Union. They will benefit from the upturn in activity and also from the catching up in valuation with their American and European counterparts. As for the appreciation of the Swiss franc, it may constitute a headwind. However, previous episodes have shown that most Swiss companies are coping well with it. There are various reasons for this: they make a large proportion of their sales on the domestic market, they import their raw materials from abroad or they have significant pricing power. As the Swiss would say, "all good" for the next few months.

RETURN ON FINANCIAL ASSETS

Markets Performances (local currencies)	Last Price	Momentum Indicator (RSI)	1-Week (%)	1-Month (%)	2021 Year-to-Date (%)	2020 (%)	2019 (%)
Equities							
World (MSCI)	719.5	66.79	0.5%	3.2%	12.4%	16.9%	27.3%
USA (S&P 500)	4 247	62.49	0.4%	2.5%	13.8%	18.4%	31.5%
USA (Dow Jones)	34 480	54.46	-0.8%	0.9%	13.7%	9.7%	25.3%
USA (Nasdaq)	14 069	64.26	1.9%	5.2%	9.5%	45.1%	36.7%
Euro Area (DJ EuroStoxx)	457.6	68.29	0.9%	5.0%	17.1%	0.8%	27.3%
UK (FTSE 100)	7 134	62.36	0.9%	3.0%	12.3%	-11.4%	17.2%
Switzerland (SMI)	11 841	78.18	2.3%	7.8%	13.7%	4.3%	30.2%
Japan (Nikkei)	29 158	52.38	0.0%	1.2%	6.2%	18.3%	20.7%
Emerging (MSCI)	1 382	62.70	0.1%	4.2%	7.8%	18.8%	18.8%
Brasil (IBOVESPA)	129 441	68.19	-0.5%	5.3%	8.8%	2.9%	31.6%
Russia (MOEX)	3 842	70.31	0.9%	5.9%	19.2%	14.8%	38.4%
India (SENSEX)	52 206	68.16	0.9%	7.1%	10.5%	17.2%	15.7%
China (CSI)	5 225	50.81	-1.0%	4.3%	0.7%	29.9%	39.2%
Energy (MSCI World)	187.6	69.71	0.3%	6.5%	32.4%	-27.7%	13.9%
Com. Serv. (MSCI World)	114.43	61.30	0.8%	3.3%	14.2%	24.2%	25.1%
Materials (MSCI World)	379.7	52.53	-1.0%	-1.8%	17.4%	21.6%	20.8%
Info. Tech. (MSCI World)	492.0	65.27	1.6%	5.5%	8.7%	46.2%	47.5%
Utilities (MSCI World)	156.3	56.69	1.1%	1.2%	4.8%	4.8%	22.3%
Financials (MSCI World)	148.7	53.74	-1.6%	2.2%	21.8%	-3.1%	24.1%
Cons. Staples (MSCI World)	281.7	62.67	-0.2%	2.5%	6.4%	8.8%	22.4%
Health Care (MSCI World)	344.5	68.76	2.7%	4.0%	9.2%	15.4%	23.3%
Cons. Discret. (MSCI World)	402.9	58.79	0.7%	3.1%	6.7%	37.0%	28.2%
Industrials (MSCI World)	326.7	54.09	-1.0%	1.2%	13.8%	11.8%	27.2%
Bonds (FTSE)							
USA (7-10 Yr)	1.46%	67.68	0.7%	1.5%	-3.5%	9.3%	7.4%
Euro Area (7-10 Yr)	0.02%	67.86	0.6%	1.2%	-1.8%	4.5%	6.7%
Germany (7-10 Yr)	-0.27%	63.59	0.4%	0.8%	-2.7%	3.0%	3.0%
UK (7-10 Yr)	0.71%	61.53	0.6%	0.9%	-3.8%	5.4%	4.8%
Switzerland (7-10 Yr)	-0.24%	64.94	0.7%	0.6%	-1.1%	0.4%	2.0%
Japan (5-10 Yr)	0.04%	76.62	0.4%	0.3%	0.1%	-0.1%	0.0%
Emerging (5-10 Yr)	4.18%	79.13	1.1%	2.1%	-0.9%	5.2%	13.3%
USA (IG Corp.)	2.04%	70.53	1.0%	1.8%	-1.8%	9.9%	14.5%
Euro Area (IG Corp.)	0.30%	70.82	0.3%	0.7%	-0.3%	2.8%	6.2%
Emerging (IG Corp.)	3.80%	70.13	0.3%	0.7%	0.6%	8.1%	13.1%
USA (HY Corp.)	3.88%	84.65	0.4%	1.0%	3.0%	7.1%	14.3%
Euro Area (HY Corp.)	2.74%	87.19	0.3%	1.1%	3.2%	2.3%	11.3%
Emerging (HY Corp.)	5.95%	79.75	0.8%	1.8%	1.8%	4.3%	11.5%
World (Convertibles)	447.9	63.55	1.3%	3.5%	4.6%	38.8%	17.3%
USA (Convertibles)	599.5	61.50	1.5%	3.9%	4.2%	54.5%	22.8%
Euro Area (Convertibles)	4 176	65.51	0.7%	2.6%	1.5%	6.1%	7.6%
Switzerland (Convertibles)	186.8	68.67	0.2%	0.2%	0.0%	0.5%	2.4%
Japan (Convertibles)	198.9	52.66	0.1%	0.4%	2.3%	2.8%	2.6%
Hedge Funds (Crédit Suisse)							
Hedge Funds Indus.	708.5	71.12	n.a.	2.6%	5.5%	2.5%	9.3%
Distressed	928.5	70.79	n.a.	1.7%	8.0%	1.5%	1.4%
Event Driven	779.4	75.70	n.a.	1.9%	8.3%	3.1%	8.2%
Fixed Income	386.7	76.43	n.a.	1.2%	3.4%	2.2%	6.1%
Global Macro	1 169.8	77.47	n.a.	3.5%	6.4%	2.0%	10.4%
Long/Short	903.5	71.90	n.a.	3.1%	5.5%	3.6%	12.2%
CTA's	331.5	65.52	n.a.	2.7%	5.0%	-3.2%	9.0%
Market Neutral	282.3	64.06	n.a.	2.4%	3.3%	-0.1%	1.6%
Multi-Strategy	679.9	75.45	n.a.	2.2%	4.4%	1.4%	7.3%
Volatility							
VIX	15.65	41.52	-4.7%	-28.3%	-31.2%	65.1%	-45.8%
VSTOXX	15.15	37.22	-12.8%	-32.8%	-35.2%	67.5%	-41.5%
Commodities							
Commodities (CRB)	563.5	n.a.	2.2%	3.4%	27.0%	10.5%	-1.9%
Gold (Troy Ounce)	1 863	48.46	-1.9%	1.1%	-1.8%	24.9%	18.3%
Oil (WTI, Barrel)	70.91	69.09	2.4%	8.6%	46.2%	-20.5%	34.5%
Oil (Brent, Barrel)	72.36	67.33	1.6%	5.5%	41.3%	-23.0%	24.9%
Currencies (vs USD)							
USD (Dollar Index)	90.546	54.25	0.7%	0.2%	0.7%	-6.7%	0.2%
EUR	1.2101	44.31	-0.7%	-0.3%	-0.9%	9.7%	-2.2%
JPY	109.73	45.08	-0.4%	-0.3%	-5.9%	5.3%	0.9%
GBP	1.4107	50.06	-0.5%	0.1%	3.2%	2.8%	3.9%
AUD	0.7709	46.32	-0.6%	-0.8%	0.2%	9.5%	-0.4%
CAD	1.2153	48.40	-0.6%	-0.4%	4.7%	1.8%	5.0%
CHF	0.8988	53.54	-0.1%	0.3%	-1.5%	9.8%	1.4%
CNY	6.3987	57.62	-0.1%	0.5%	2.0%	6.7%	-1.2%
MXN	19.852	52.41	-0.2%	0.1%	0.3%	-4.9%	3.8%
EM (Emerging Index)	1 755.6	73.05	0.2%	1.0%	2.1%	3.3%	3.1%

Source: Bloomberg, Atlantic Financial Group

Total Return by asset class (Negative \ Positive Performance)

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