May 31, 2018

Economics Group

Special Commentary

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Swiss Economy Continues Upward Momentum in Q1

Executive Summary

The Swiss economy strengthened further in Q1, with real GDP growing 2.2 percent year over year to surpass 2 percent for the first time since Q2-2016. Accommodative financial conditions likely propelled investment to surge in Q1, and along with a slow upward trend in consumer spending and tightening labor market, provide a solid base for the economy to expand further in coming quarters. The Swiss economy is also heavily dependent on trade relationships across the Eurozone, which look to have largely remained intact in Q1. But, the Swiss franc remains strong in a historical context, and further appreciation against the euro could restrain export growth going forward.

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A slowdown in export growth would also provide a roadblock to higher inflation, and, as inflation has remained under 1 percent over the past year, the Swiss National Bank (SNB) will likely continue to take a restrained approach to removing policy accommodation. The SNB probably does not want to get materially ahead of the European Central Bank's (ECB) monetary policy, and we look for the ECB to tighten at a gradual pace. In sum, this means that the SNB will likely remain on hold through the end of the year in light of only slowly rising inflation and a gradual pickup in consumer spending.

Q1 GDP Growth Remains Solid, Driven by Investment Rebound

Data released today showed that real GDP in Switzerland grew at an annualized rate of 2.3 percent in Q1-2018 relative to the previous quarter (Figure 1), largely in line with consensus expectations. Although today's print represents a slight slowdown on an annualized basis, real GDP is up 2.2 percent from a year ago, surpassing the 2 percent mark for the first time since Q2-2016 and putting the Swiss economy firmly in expansionary territory. Q1 GDP growth was led by a 3.6 percent (not annualized) rebound in equipment and software investment in the quarter, more than reversing the 1.3 percent decline registered in Q4.

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Stronger investment spending bodes well for the Swiss economic outlook, and has likely been supported by low interest rates. Consumer spending also continued its upward trend in Q1, growing 0.4 percent in the quarter after several quarters of nearly flat growth. Consumers have also enjoyed a falling unemployment rate, which should help to support income growth. While real retail sales declined in every month of Q1 on a year-over-year basis, they have since recovered in Q2 so far, rising 2.2 percent year over year in April and are a positive sign for further growth in overall personal consumption expenditures.

As we discuss in more detail below, the Swiss franc has remained at a historically high level, and presents a risk to Swiss export growth should it appreciate against the euro. This does not look to be an issue in the near term, as international trade remained solid in Q1. Goods exports rose 2.0 percent in the quarter, reversing the 1.2 percent decline seen in Q4. Switzerland's export momentum also looks likely to remain in place in Q2. Export volumes rose almost 3 percent in April (Figure 2), and strength in the manufacturing sector, as reflected by stronger investment spending in Q1, looks poised to continue in Q2. The Swiss manufacturing PMI rose more than 3 points in April and has remained well above the 50 demarcation line that signals expansion over the past three years.

Figure 1

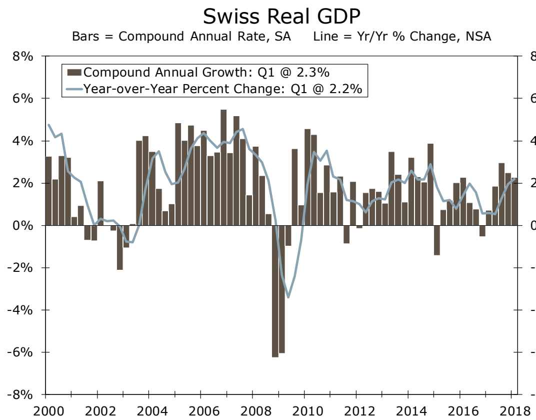
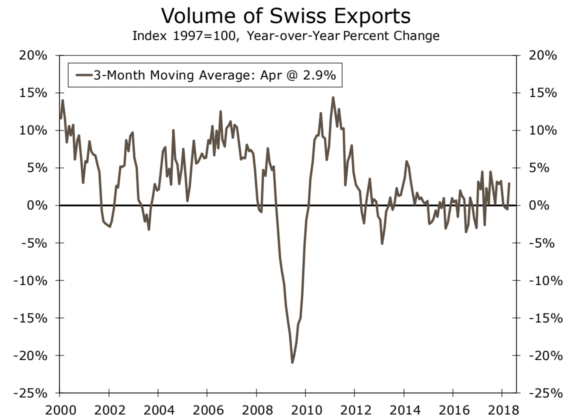


Figure 2



Source: IHS Markit and Wells Fargo Securities

When Will the SNB Begin to "Normalize" Monetary Policy?

Available monthly indicators suggest that growth has remained resilient in Q2.

In January 2015, the SNB slashed its target for three-month Swiss LIBOR to the midpoint of a -0.25 percent to -1.25 percent range, where it has subsequently been maintained (Figure 3). But by many measures the Swiss economy is firing on all cylinders at present. As noted above, real GDP growth has been solid in recent quarters, and available monthly indicators suggest that growth has remained resilient in Q2. The unemployment rate has declined sharply in recent months, and currently stands below 3 percent (Figure 4). Although we do not have a good indicator of wage inflation on a high frequency basis (e.g., monthly data), wages will presumably accelerate sooner or later if the labor market continues to tighten. Shouldn't the SNB be thinking about the "normalization" of monetary policy?

Figure 3

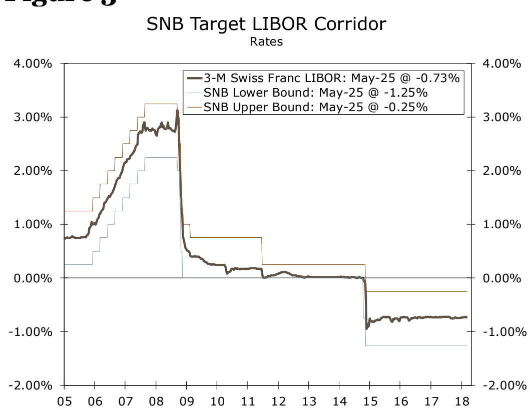
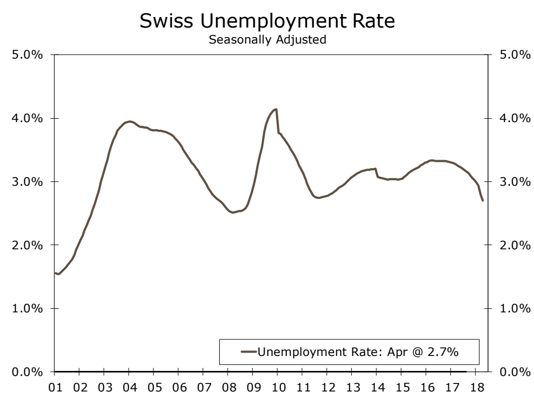


Figure 4



Source: Bloomberg LP, IHS Markit and Wells Fargo Securities

Until inflation shows signs of moving even higher, the SNB probably would be reluctant to start removing policy accommodation.

There are two issues that may keep the SNB on hold, at least for the foreseeable future. First, the SNB's sole policy objective is "price stability," which it defines as "a rise in the national consumer price index (CPI) of less than 2 percent per annum." Following a few years of mild deflation, consumer prices are rising again in Switzerland (Figure 5). But inflation rates remain below 1 percent, so the SNB's definition of "price stability" arguably has not been met yet. Until inflation shows signs of moving even higher, the SNB probably would be reluctant to start removing policy accommodation.

The second issue is related to the first. That is, Switzerland is a small open economy, and foreign influences have a large effect on Swiss price developments. Nominal exports are equivalent to about 65 percent of Swiss GDP, and Switzerland sends nearly 40 percent of its exports to the Eurozone.

On the other side of the ledger, about one-half of Switzerland's imports come from the euro area. The Swiss franc has depreciated vis-à-vis the euro over the past year or so, but it remains at a high level in a historic context (Figure 6). Given the intensive trade linkages that Switzerland has with the Eurozone, appreciation of the Swiss franc versus the euro, should that occur, could weaken export growth and impart a negative impulse to inflation in Switzerland. Consequently, the SNB probably does not want to get materially ahead of the ECB in tightening policy. Otherwise, the SNB risks a significant rise in the value of the Swiss franc.

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Figure 5

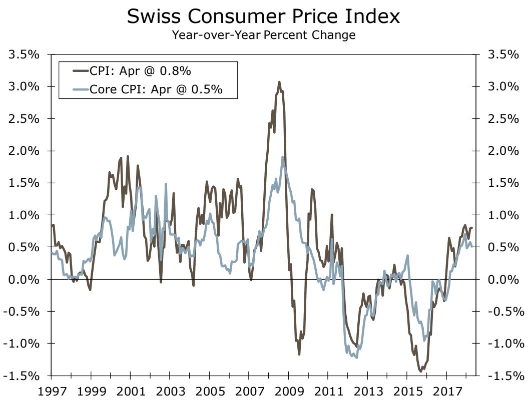
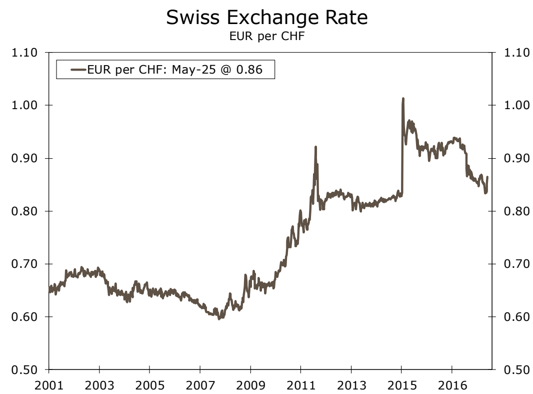


Figure 6



Source: IHS Markit and Wells Fargo Securities

So where does this leave the SNB? As we have written in previous reports, we think that the ECB will completely wind down its asset purchase program at the end of this year, provided that the current political uncertainty in Italy does not lead to another episode of the European sovereign debt crisis.[1] We then look for the ECB to raise its discount rate, which has been maintained at -0.40 percent since March 2016, to roughly -0.20 percent about a year from now. We forecast that it will then raise the discount rate to 0.00 percent while taking its main refinancing rate, which currently sits at 0.00 percent to 0.10 percent or 0.15 percent sometime during the summer of 2019. If, as we believe, the SNB will be hesitant to move quicker than the ECB, then the SNB likely will maintain its target for three-month Swiss LIBOR to the midpoint of a -0.25 percent to -1.25 percent range for another year or so. This view is more or less consistent with the consensus forecast, which looks for the SNB to remain on hold through at least the end of this year.

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Furthermore, we believe that the SNB will move at a gradual pace once it does begin to normalize policy. As discussed above, we do not believe that the SNB will want to get materially ahead of the ECB, and we forecast that the ECB will tighten at a gradual pace. And as we have noted in a previous report,[2] the household debt-to-income ratio in Switzerland has risen markedly over the past decade as home prices have soared. A rapid pace of monetary tightening could potentially lead to a retrenchment in consumer spending if debt servicing costs were to rise quickly.

Conclusion

Switzerland enjoyed broad-based growth in Q1, with real GDP rising 2.2 percent year over year. A pickup in investment spending, steady growth in consumer spending and solid momentum in Q2 so far position the Swiss economy to expand further in coming quarters. Heavy dependence on international trade also supported the Swiss economy in Q1, with exports and imports growing solidly.

Only slowly rising inflation along with the risk of a stronger Swiss franc against the euro have led the SNB to remain on hold.

However, only slowly rising inflation and the risk of a stronger Swiss franc against the euro have led the SNB to remain on hold. The slow removal of accommodation on the part of the ECB has also

[1] For example, see "Eurozone GDP Moderates in Q1, While Inflation Remains Low" (May 2, 2018). All Wells Fargo reports referenced herein are available upon request.
[2] "Swiss Economy Remains on Solid Footing in Q3" (November 30, 2017).

likely restrained the SNB, as it probably does not want to get too far ahead of the ECB or risk further appreciation of the Swiss franc. Although economic growth has remained solid, still-low inflation and the need to remain in line with ECB policy will likely lead the SNB to remain on hold through the end of the year.

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