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CIO Viewpoint

Switzerland's economic recovery: Digging for yield in bonds and real estate

Investment Solutions

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In common with every other advanced nation, Switzerland is coping with a pandemic-induced collapse in economic growth with record unemployment. But unlike others, its export-oriented economy faces the challenges of a persistently strong currency and negative interest rates that make investing portfolios in Swiss-francs particularly testing.

At the start of 2020, the Swiss economy already faced slowing growth and stagnating inflation. In addition, Switzerland's exports were suffering from the tensions around international trade. Last week, the Swiss National Bank (SNB) said that GDP is likely to contract by around 6% this year, the fastest fall since the oil crisis of the 1970s, and that the country's economy won't recover before 2021.

The Swiss economy is going through "a sharp recession" SNB President Thomas Jordan said last week. GDP was 2.6% lower in the first three months of the year, which excluded the worst of the confinement period, compared with the last quarter of 2019. Unemployment reached 3.4% in May, a relatively low rate, but the country's highest in more than three years. The central bank has kept its benchmark policy interest rate at -0.75% and forecasts inflation at -0.7% for 2020. It has also stepped up its credit lines to commercial banks, in an effort to offer businesses lending.

In early March, we wrote that the SNB's decisions were not getting simpler. Its policy tools of currency intervention and lower interest rates are weakening with no signs of inflation on the horizon.

Mr Jordan last week reinforced the central bank's messaging around its currency intervention policy. "We remain willing to intervene more strongly in the foreign exchange market," he said. The franc's strength is largely driven by the global economy, as it continues to act as a haven currency. As the SNB has intervened to contain the rising franc through the crisis, the national bank's balance sheet hit a record 903.5 billion francs at the end of April, shattering the previous end-November 2019 peak.

While the SNB has had to intervene less in recent weeks, as long as haven buying continues the franc is likely to remain strong. And as long as the SNB's intervention on currency markets does not trigger instability in the economy, there is no reason for the central bank to halt.

The SNB also plays an important function in stimulating the Swiss economy with liquidity to commercial banks. However, it seems unlikely that the huge amounts of liquidity injected into the economy will have an inflationary impact, at least in the mid-term.

Key takeaways

- The Swiss National Bank expects the country's economy to contract by 6% in 2020 due to Covid-19; the central bank has its negative interest rates on hold
- Considering the low yields in Swiss fixed income, real estate offers an interesting alternative
- The Swiss real estate fund market has rebounded thanks to more attractive valuations
- We have built a Swiss real estate position since November 2018 and expect the asset class to continue to provide an attractive risk/return profile.

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Credit, with the support of the SNB, will play an important role in Switzerland's recovery process. The number of corporate bond issues in recent months has spiked, although much of the Swiss fixed income market remains priced to reflect a lack of liquidity rather than the borrower's fundamentals (see chart 1).

There are also wide differences between sectors, with essential goods and services such as telecommunications, retail food, pharmaceuticals and construction less affected in recent months than travel, transport and non-food retailers. We continue to monitor credit risks closely and evaluate credit ratings, sectoral variations and metrics such as loan-to-value to favour quality issues in our portfolios to identify the most resilient businesses. This is especially important where traditional income and cash-flow metrics prove less reliable in the current context.

The quoted Swiss fixed income market was worth around 500 billion Swiss francs last year, more than three-quarters of which is domestic issuance. More than 20% of the market by volume has a duration of 10 years or longer, which, over the past decade, has increased (see chart 2). The Swiss bond market is geared to 'risk-free,' high-quality issuers including sovereign debt, which tends to reduce yields. To improve returns, we can also work with higher-yielding issuers or lengthen the duration exposure in portfolios. This is why active management in this fixed income segment is key to creating the best risk-return balance between duration and yield in the credit components of a portfolio.

In the current negative-rate environment, which the central bank expects to persist for another two years, Swiss-franc denominated investors need additional sources of income.

As a complement to credit exposure, we have built a position in Swiss real estate since November 2018. This asset class has proven that it can offer an interesting risk-return profile. In January 2020, following an exceptional performance of 20% in 2019, we shifted some of this exposure into European real estate to improve geographical and sectorial diversification.

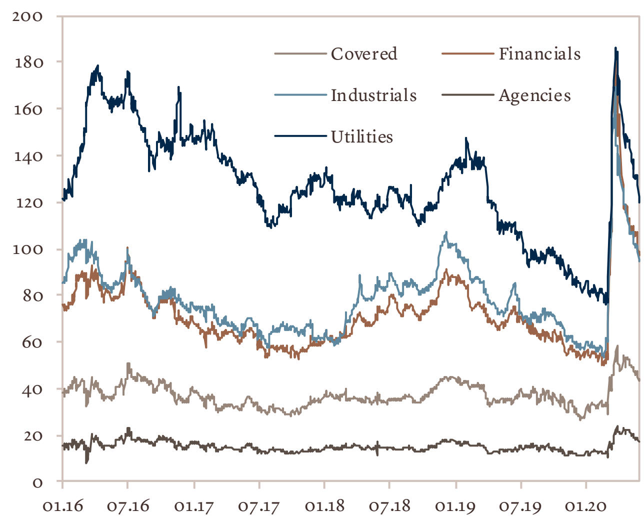
The real estate market, in common with most other markets, will undoubtedly evolve following the experience of the Covid-19 pandemic. Many owners and tenants, both residential and commercial, may rethink their living and working environments. Vacancies may rise, rents fall and demand change with greater call for outside spaces as long as fears of further lockdowns continue.

From a sector point of view, the pandemic intensified existing trends. In line with the impact on the wider travel sector, hotels saw foreign visitor numbers halve in the first three months of the year, adding to the pressures from the strong franc that undermined tourism in recent years.

Secondly, commercial retail premises have suffered. The asking price for retail shopping rents fell 2.1% in the first quarter, compared with a 2.8% year-on-year rise in 2019. The exception is food retailers who remained open through the pandemic. Thirdly, changes to longer-term demand for office space after the crisis is not yet clear as businesses adapt to more employees working from home. Logistics, thanks to consistently rising demand for e-commerce deliveries in recent years, has proven one of the least affected sectors over the pandemic.

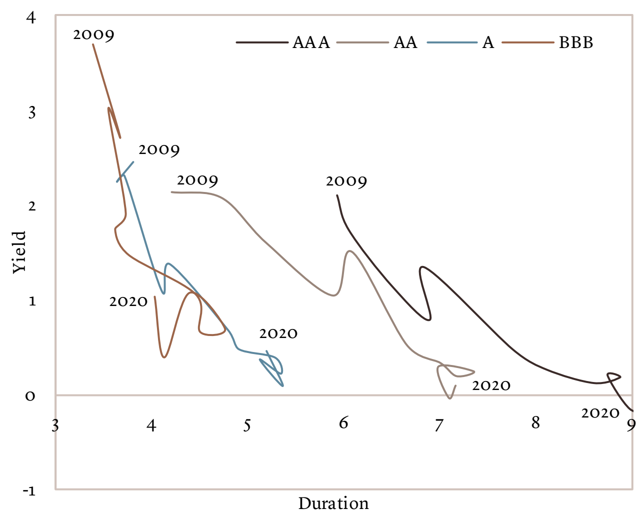
Finally, the residential market is clearly proving to be the most resilient real estate sector in the post-pandemic era. However, the Swiss market continues to out-build demand. That imbalance may not filter through to valuations as demand

Chart 1: Swiss investment grade credit spreads by sector



Sources: Credit Suisse, Bloomberg and Lombard Odier calcualtions

Chart 2: Swiss bond durations have lengthened since 2009



Sources: LOIM, SIX, Bloomberg

in the most dynamic markets continues to rise, especially for buildings and markets with features such as gardens or large living rooms, for example, that people missed or appreciated through weeks of lockdown. This would of course support prices of family homes compared with apartments.

The pandemic created historic levels of volatility on the Swiss real estate funds market, which in December was 53.7% exposed to the residential sector. The SXI Real Estate Index, which measures total returns on the asset class, fell a record 19.92% between 24 February and 17 March. In the short run, we saw a few real estate funds suspend or postpone rents in the interests of helping tenants to survive the pandemic and maintain their existing premises. Recently, the market has rebounded thanks to more attractive valuations.

We expect Swiss real estate funds, as an asset class, to continue to generate attractive yields in comparison with other Swiss-franc denominated investments. Dividend yields for such funds are around 2.7%, and so offer a spread of more than 300 basis points compared with the Swiss benchmark 10-year government bond. As higher share price volatility continues, the role of active managers remains clear. They must continue to add value by seizing opportunities to invest as well as to take profit, at the right time.

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