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Strategy

Western Europe

European Equity Strategy

Swiss Shock Presents Opportunity

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Swiss Shock Presents Opportunity

The Swiss National Bank (SNB) announced that it is ending the CHF/€ exchange rate cap, which it introduced in late-2011. The SNB has also cut interest rates by 50bp. Swiss financial markets have reacted strongly to events with Swiss equities (SMI) trading c10% lower intra-day. Near-term volatility is likely across all Swiss assets as investors digest what has been a surprise move by the SNB. This note considers the investment case for Swiss equities over the coming 12-18 months in a post-cap environment and also suggests implications for equities elsewhere in Europe. We think the pull-back in Swiss equities presents an opportunity for investors to buy the dip and we think that the net impact is positive for the rest of European equities.

When they wake up tomorrow morning, and following today's moves, Swiss investors can choose between negative deposit rates (cash), 10-year bond yields currently trading below 0.1% or an equity market with a dividend yield of c3%. For equities to be the wrong asset allocation decision over the next 1-2 years we believe that investors need to believe in: 1) a prolonged Swiss earnings recession, 2) widespread Swiss dividend cuts, 3) global recession/deflation, 4) external systemic shock. None of these scenarios is our base case. While we would expect near-term moves to remain volatile, we, therefore, see today's market moves as presenting an opportunity for investors to re-load, buy the dip or add to existing positions.

A stronger CHF is going to present an immediate hit to Swiss corporate earnings, as suggested by our Banks, Capital Goods and Luxury Goods teams, amongst others, but we believe that share prices have quickly priced in a significant portion of this. We therefore see today's fall as an opportunity for fresh capital to raise exposure. Given the lack of yield/return opportunities in other asset classes, there is no need for investors to take on equity benchmark risk. This makes the ongoing case for secure income/high cash generating stock opportunities in the Swiss market.

For non-CHF based investors, today's sharp fall in the SMI has been more than covered by respective currency moves, e.g. US$ investors have made a good return today on the SMI, providing they were not hedged. How will the investment case for the Swiss equity market look tomorrow morning for them? We show that the SMI bears an uncanny likeness to the US equity market in terms of high price/book and equally high/impressive RoE. Before currency-induced EPS downgrades, Swiss equities also traded on the same 2016E P/E (14.5-15x) and had the same 2014-16E EPS growth profile as US equities, but with a >50% higher DY. We can also now add strong currency to that list of similarities. So, while near-term EPS downgrades present headwinds, if much of that has been priced in today's moves then we see Swiss equities as offering similar attractions to US equities from here.

Additionally, and more importantly, we don't think that today's moves detract from our overall barbell strategy across European equities. This barbell is exposed to stocks/sectors which offer a combination of attractive fundamentals with liquidity support through two main groups: 1) surplus FCF with strong balance sheets, where the potential for corporate re-leveraging (bottom up QE), especially with ECB QE in place, offers upside optionality to investors; 2) "reasonable and secure" yield stocks/ sectors which can see direct and indirect beneficiaries of ECB QE (top down QE) – this includes sectors with high DY and surplus FCF such as Insurance and Telecoms, as well as likely beneficiaries of further €/US$ weakness such as stocks with operating leverage or surplus FCF/strong balance sheets and high US exposure. Overall, we would prefer to own these two themes than Swiss equities since we want exposure to the liquidity "kicker" which we see from either corporate re-leveraging (bottom-up) or from QE (top-down).

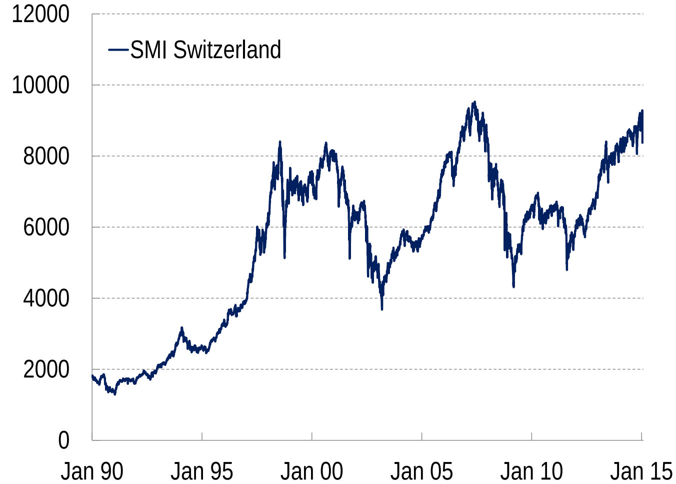
What happened?

The SNB announced the end of their CHF/€ exchange rate cap today, surprising many across financial markets. It also cut rates by 50bp. Swiss equities have sold off aggressively, currently down c10% intra-day. What do these moves mean for Swiss equities and also what are the broader implications for European equities?

Figure 1. CHF/USD

Source: Datastream, Citi Research

Figure 2. SMI in Local Currency



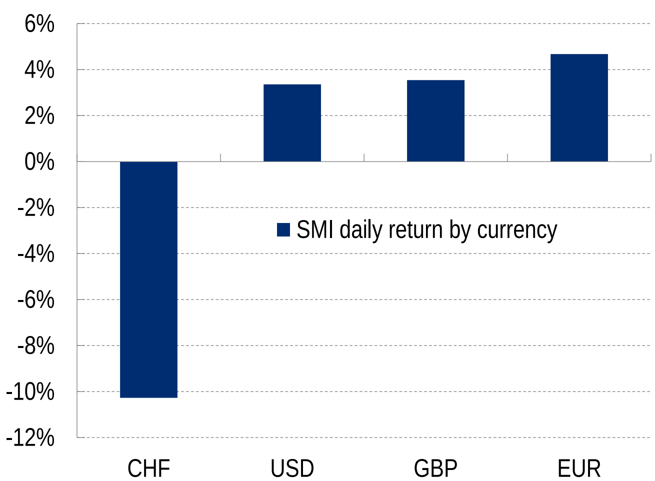
Source: Datastream, Citi Research

It has been a tough day for CHF owners of Swiss equities, but many (unhedged) international investors would have made more on today's currency moves than they would have lost on share price moves. That is today, what about tomorrow?

Relative attraction

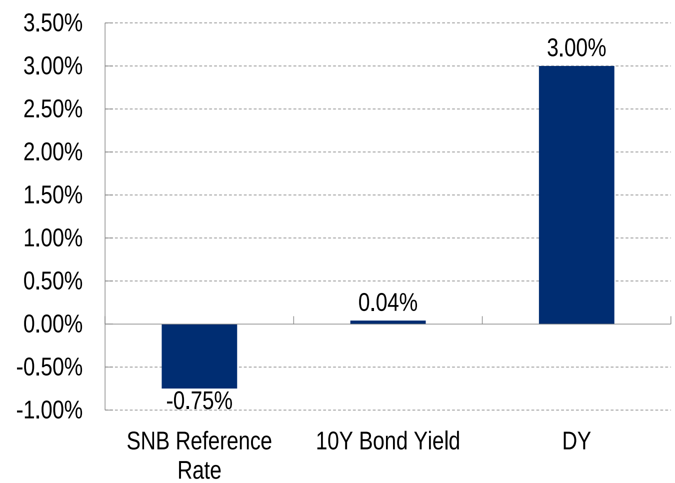
When dawn breaks, investors will have the choice, in Switzerland between allocating to a negative deposit rate (cash), buying 10-year government bonds with a yield of 0.04% (at time of writing) or an equity market with a c3% coupon.

Figure 3. 15th January Returns in SMI Index in main currencies



Source: Bloomberg, Citi Research

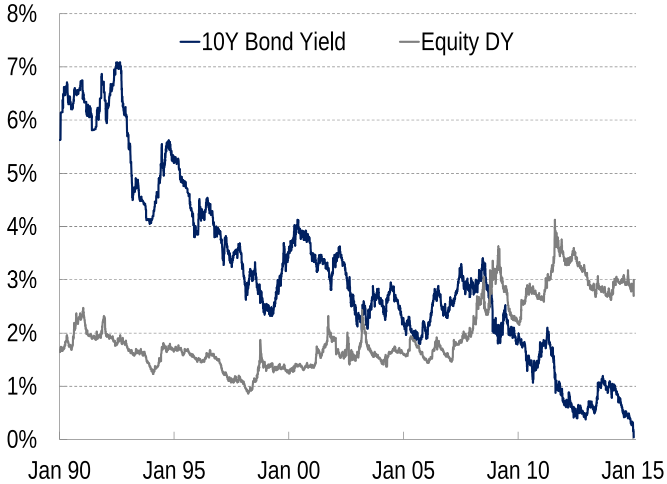
Figure 4. Yields Comparison



Source: Datastream, Bloomberg and Citi Research

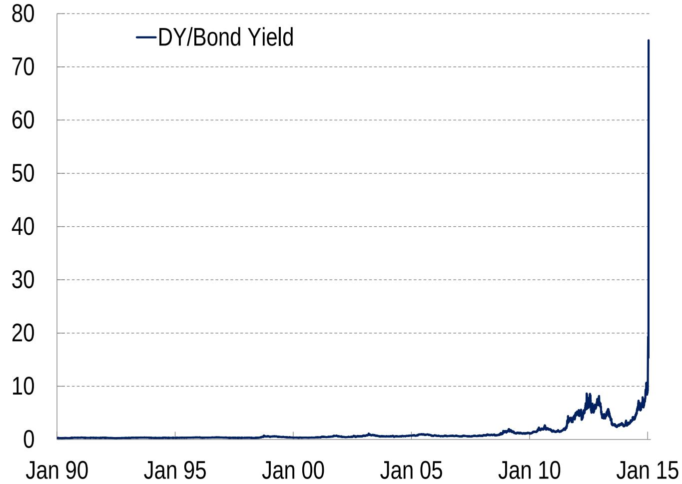
For equities to be the wrong asset allocation decision over the next 1-2 years we believe that investors need to believe in: 1) a prolonged Swiss earnings recession, 2) widespread Swiss dividend cuts, 3) global recession/deflation, 4) external systemic shock. None of these scenarios is our base case. While we would expect near-term moves to remain volatile, we, therefore, see today's market moves as presenting an opportunity for investors to re-load, buy the dip or add to existing positions.

Figure 5. Bond Yield vs Equity DY



Source: Datastream, Bloomberg and Citi Research

Figure 6. DY relative to Bond Yield



Source: Datastream, Bloomberg and Citi Research

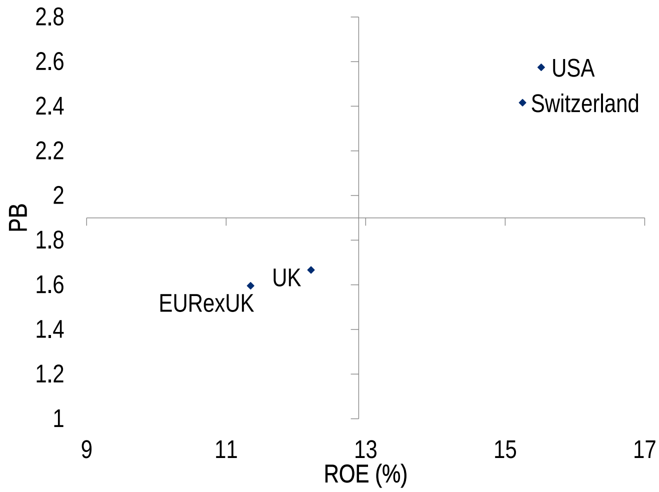
Recent market moves, especially the collapse in Swiss bond yields, have confirmed Switzerland as the major market with the widest gap between dividend yields and government bond yields. The crossover, i.e. bond yields falling below DYs, first occurred in March 2003. Since then, Swiss equities have returned over 230% (before today's move) vs a very respectable 60%+ from government bonds.

Now, consider for a moment who the marginal buyers of equity are in Switzerland, in Europe, and indeed globally. They are not traditional equity benchmarked investors. It is a combination of the following groups: 1) central banks, 2) income investors, 3) "low risk" quant style investors, 4) multi-asset investors, 5) the bond market via sponsoring corporates to use cheap debt funding and with credit investors moving to equity. All of these marginal buyers have one thing in common = no traditional equity benchmark. Instead, they seek risk-adjusted and/or real returns. Therefore, they are interested in the yield opportunity across different asset classes. This, we think will remain a key support for equities in Switzerland and across Europe in a world of QE-sponsored low interest rates.

Switzerland and US — not so different

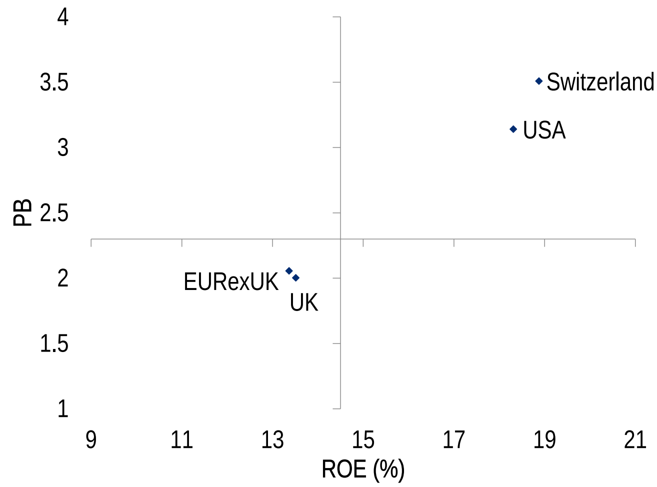
Taking a step back, we also highlight similarities between Swiss and US equity markets. In particular both have high price/book multiples, backed by impressive RoE for full market and ex-financials. While currency moves are going to impact near-term earnings in many Swiss stocks, if dividends can be defended or even continue to grow, then this provides a strong support in absolute and relative terms for Swiss equities. Post near-term earnings downgrades, both the Swiss and US equity markets should (generally) offer investors the combination of high quality, well-managed, high RoE, high FCF margin companies in a strong currency market.

Figure 7. ROE vs PB



Source: Citi Research

Figure 8. ROE vs PB (ex Financials)



Source: Citi Research

We think that both marginal and equity buyers will find attraction in this mix, although we continue to argue that we find the prospect of higher returns in markets or stocks where there is greater likelihood of top-down (QE) or bottom-up (use of corporate balance sheet) liquidity support.

Strategy outlook

Today's surprise move from the SNB has seen a strong reaction from financial markets. Non-CHF based investors will have had a good day despite a c10% fall in Swiss equities. The sharp drop in the SMI, we think, provides a buy the dip opportunity, especially with Swiss equities commanding such a big yield premium to other Swiss assets and despite the near-term EPS downgrades following today's SNB actions. To not buy Swiss equities here is to back a persistent period of aggressive CHF strengthening which Swiss companies cannot offset, widespread dividend cuts or global recession/deflation. None of these scenarios = base case.

Additionally, and more importantly, we don't think that today's moves detract from our overall barbell strategy across European equities. This barbell is exposed to stocks/sectors which offer a combination of attractive fundamentals with liquidity support through two main groups: 1) surplus FCF with strong balance sheets, where the potential for corporate re-leveraging (bottom up QE), especially with ECB QE in place, offers upside optionality to investors; 2) "reasonable and secure" yield stocks/sectors which can see direct and indirect beneficiaries of ECB QE (top down QE) – this includes sectors with high DY and surplus FCF such as Insurance and Telecoms, as well as likely beneficiaries of further €/US$ weakness such as stocks with operating leverage or surplus FCF/strong balance sheets and high US exposure. Overall, we would prefer to own these two themes than Swiss equities since we want exposure to the liquidity "kicker" which we see from either corporate re-leveraging (bottom-up) or from QE (top-down).

Appendix A-1

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Data current as of 31 Dec 2014	Buy	Hold	Sell	Buy	Hold	Sell
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