Deutsche Qualität

The German economic cycle in question

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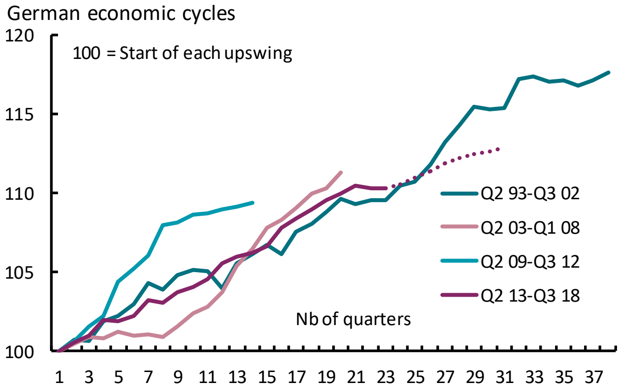
Key points

- The German economy has slowed significantly in 2018, dampened by weak trade and poor private consumption.
- Supply side issues related to one-offs, such as a slump in auto and chemical production have exacerbated the weakening in external demand, explaining the sharp slowdown in exports growth in the second half of 2018.
- But we believe the external environment will prove more supportive in the second half of 2019, with Chinese stimulus taking effect by mid-year. Hopefully Brexit related uncertainty will abate (possibly with a delay).
- On the domestic side, we expect further weakness in business investment as higher labour costs and demand concerns weigh on corporate profits and the investment outlook. Private consumption should come to the rescue, benefitting from fiscal stimulus, solid wage growth, lower inflation and a normalisation of the auto sector.
- Overall, we see German GDP growing by 0.9% in 2019.
- Risks are skewed to the downside and are primarily external. Lack of stabilisation in China, a disorderly Brexit and the US imposing auto tariffs are the main threats to the German economy.

Where does Germany stand in the cycle?

Since the second quarter of 2013 (Q2 13), the German economy has been recovering at a moderate pace. Compared to the three previous upswings[1], the current pace of economic activity growth is largely similar (an average quarterly gain of 0.45%) to that seen in the first and longest expansion which lasted from Q2 93 to Q3 02 (Exhibit 1). The current cycle is also already longer than the second and third upswings, which were interrupted by unique events, both in terms of scale and origin: the global financial crisis in 2008 and the euro are sovereign debt crisis in 2012. Barring events of similar magnitude, our forecasts suggest the ongoing German economic cycle could continue for a few quarters (more on that below).

Exhibit 1: German current economic cycle: long and moderate



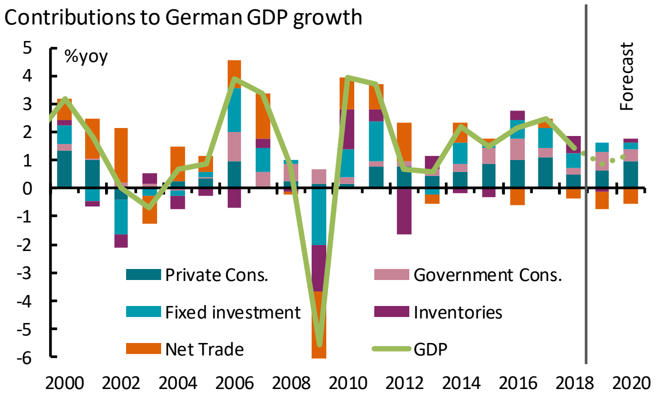
Source: Datastream and AXA IM Research

German activity disappointed in 2018, slowing to 1.4% in 2018 from 2.5% in 2017, one of the weakest annual growth rates in the past five years. The deceleration was primarily driven by weaker export growth amid a global trade slowdown and elevated uncertainty (Brexit, Italian politics, US- China trade war). Simultaneously, a moderation in domestic demand was also at play, with higher oil prices

[1] Upswings start with the first positive quarterly growth after a recession and end when growth peaks, before two consecutive negative quarters.

dampening household purchasing power and idiosyncratic factors such as regulatory changes in the auto industry and adverse weather conditions (harsh winter in Q1 and drought in the Summer/Autumn) took their toll on economic activity (Exhibit 2). Overall, of the 1 percentage point (pp) GDP deceleration in 2018, 0.6pp came from private consumption, 0.7pp from net trade, 0.2pp from investment, while a build-up in inventories offset some of this weakness (adding 0.6pp to growth). In this report, we dig into the drivers of 2018 GDP component weakness and see the implications for 2019.

Exhibit 2: Weaker trade and consumption behind 2018 growth deceleration



Source: Datastream and AXA IM Research

2018 trade slowdown: Not just China, not just one-offs

German exports slowed to 2.2% in 2018 after growing by 5.3% in 2017, while imports fared a bit better (3.4% in 2018 and 5.3% in 2017). The deceleration intensified in the second half of the year, with exports shifting gear from 3.6% year-on-year (yoy) on average in H1 to 0.8%yoy in H2 18.

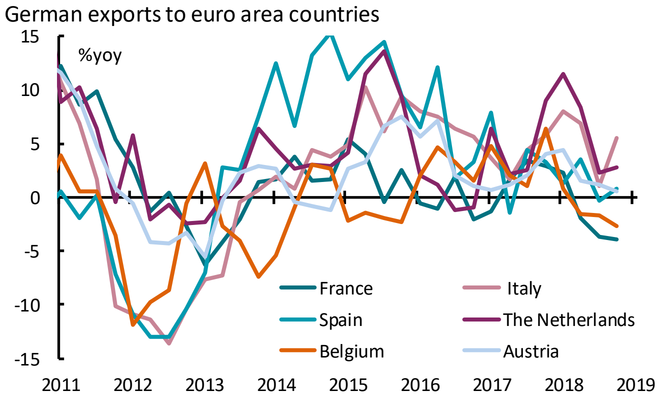
Exhibit 3: In H2 18, a broad-based weakness across trading partners

Source: Datastream and AXA IM Research

Exhibit 3 s**hows that the slowdown was broad-based across key trading partners.** China's contribution to German growth fell to close to zero, explaining a non-negligible part of the deceleration in Q3 18 (one third). The contribution of German exports to US to German GDP growth moved into negative territory in Q4 18. Exports to the UK have continued to lose ground since the Brexit vote, with their contribution to German growth dropping from +20 basis points (bps) on average in the period Q2 13-Q2 16 to -12bps since Q3 16.

More importantly, contribution from exports to the euro area – Germany's main trading partner gathering (close to 37% of total German exports in 2018), shrank significantly from 100bps end 2017-early 2018 to zero in Q4 18. The deceleration was once again broad based by countries. But exports to France and the Netherlands, which represents around 8% and 7% of total German exports, respectively, slowed more markedly (Exhibit 4).

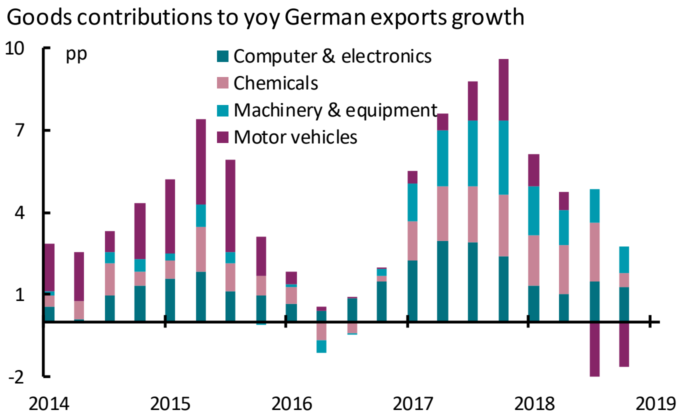
Exhibit 4: Exports to France and the Netherlands- accounting 15% of German exports- slowed the most



Source: Datastream and AXA IM Research

Overall export weakness was widespread by destinations, with China not the only culprit behind poor export performance. The story is broadly similar when we look at exports by products. **Weakness was broad based although two categories stood out: motor vehicles, primarily in Q3 18 and chemicals in Q4 18** (Exhibit 5).

Exhibit 5: The culprits: primarily autos and chemicals



Source: Datastream and AXA IM Research

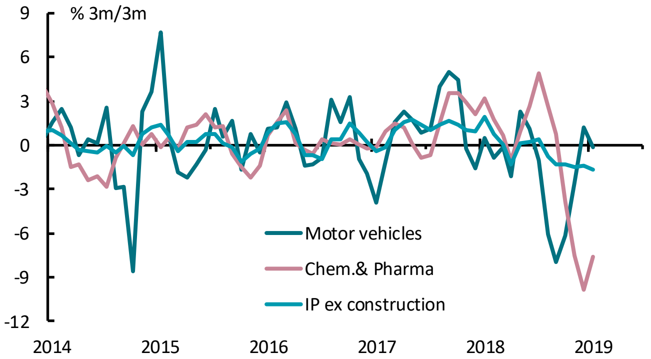
As widely reported, the German car industry has struggled to adapt to the new emission certification system – the Worldwide harmonized Light vehicles Test Procedures (WLTP) – that has applied to all new car registrations since

September 2018. This had led to a significant contraction of motor vehicles production in Q3 18, by 8% quarter-on-quarter (qoq), followed by a mild rebound of 1.2%qoq in Q4 18.

The automotive sector is the backbone of German industry: its share in manufacturing production stood at 22.6% in 2016, well above the EU average (10.6%). Motor vehicles and vehicle parts are Germany's most important export, accounting for 18.4 % of German exports in 2017 (Exhibit **17**). That's why the slump in car production in Q3 18 led to a sharp decline in auto exports (Exhibit 5). Overall, given the auto industry amounts for 7.7% of German GDP, we estimate the car sector made a significant -50bp contribution to Q3 GDP growth (which shrank by -0.2%qoq).

Exhibit 6: Weak exports reflect poor production

German industrial production

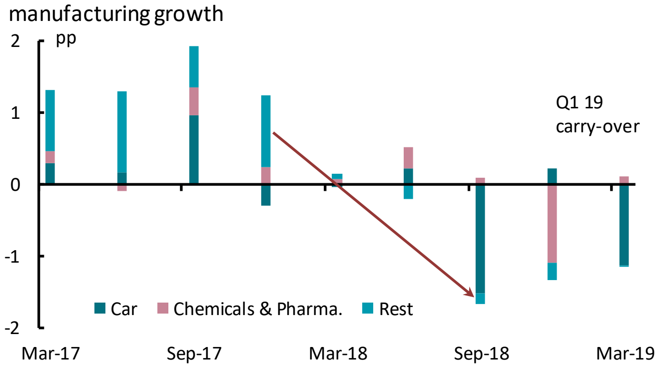


Source: Datastream and AXA IM Research

In Q4 18, auto exports remained depressed (-5.3%yoy) and continued to weigh on total export growth. This was followed by a slowdown in chemical exports, which slowed to 2.1%yoy from an average of 7.9%yoy in the first three quarters of the year. Once again this reflected poor output: chemicals and pharmaceuticals production plunged due to the Rhine drought (Exhibit 6).

Exhibit 7: Not just one-offs: weakening underlying momentum

Germany - one-off factors' contributions to quarterly manufacturing growth



Source: Datastream and AXA IM Research

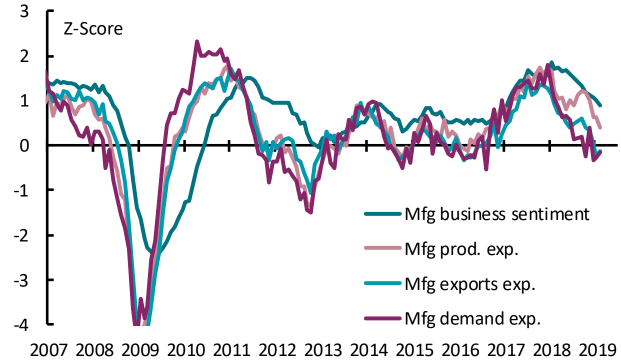
Yet, Exhibit 7 shows that although one-offs in the auto and chemicals/pharma sectors explain a large chunk of the manufacturing sector contraction in the second half of 2018 (H2 18), the rest of the manufacturing sector has slowed too. Contribution from other categories (e.g. computers and electronics, machinery and equipment) to manufacturing growth has dropped from 0.9pp on average in 2017 to -0.1pp in 2018, highlighting the weakening of underlying momentum. Overall, **in 2018 supply side factors (autos and chemicals) have exacerbated the softening in global demand, explaining Germany's poor trade performance.**

2019 trade: Supply to normalize and demand to pick up in H2

Latest activity indicators point to further weakness in the industrial sector. February manufacturing Purchasing Managers Indices (PMIs) and the IFO headline index stood at their lowest since December 2012 and December 2014, respectively (Exhibit 8). Worryingly, forward looking components continued to decline on global uncertainty (trade wars, Brexit) and softer demand, especially from exports markets. Problems related to the car industry also seem far from solved. PMI panellists mentioned it as a key concern and details of IFO components show that auto sector orders and sentiment is heading further South. Yet, we believe that the poor reading of January car factory orders (-6.1%mom) might have been distorted by the Chinese Lunar year, while a strike at a major car maker might partially explain the sharp drop in January motor vehicles production (-9.2%mom). Cars should continue to weigh on manufacturing production in Q1 19 – but less so than suggested by the Q1 carry-over[2] – chemicals should rebound, and machinery and equipment should remain subdued in line with the latest surveys, bringing Q1 industrial production growth to around -0.5%qoq. This would still represent a 1pp improvement from Q4 and thus a +0.2pp boost to GDP compared to the previous quarter.

Exhibit 8: Manufacturing forward looking components remain depressed

German IFO business confidence



Source: Datastream and AXA IM Research

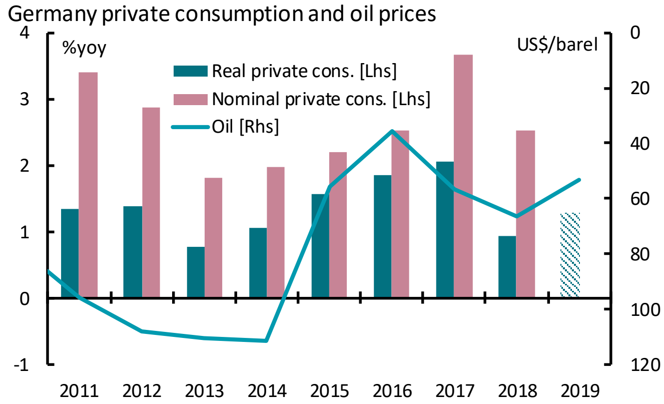
[2] Industrial production Q1 carry-over assumes that growth will be flat in February and March, and shows the impulse at the beginning of the quarter.

On the external front, we expect weakness to persist in H1 19, but look for some slight sequential acceleration in H2 19. Intra-EU exports should gradually normalise, with key trade partners' growth outlook improving (Italy exiting recession in Q2 19 and French growth continuing on at cruise pace). We also believe exports to extra-EU partners will benefit from a stabilisation in China. The Chinese economy had a difficult start to the year and we expect some more poor economic data before the policy stimulus filters through the economy. We expect a mild recovery in H2, as opposed to a "V-shaped" rebound, given Beijing's more cautious stimulus this time around. Chinese demand for German exports should recover to 4%yoy and given exports to China account for close to 3% of German GDP, this could boost economic activity by 0.12pp in H2 19.

Private consumption: when headwinds become tailwinds

Although the decline in German private consumption was less severe than that in exports, the importance of household demand (54% of GDP in 2018, vs. 50% of GDP for exports) warrants close scrutiny. After two years of growth at around 2%, private consumption moderated to 0.9%.

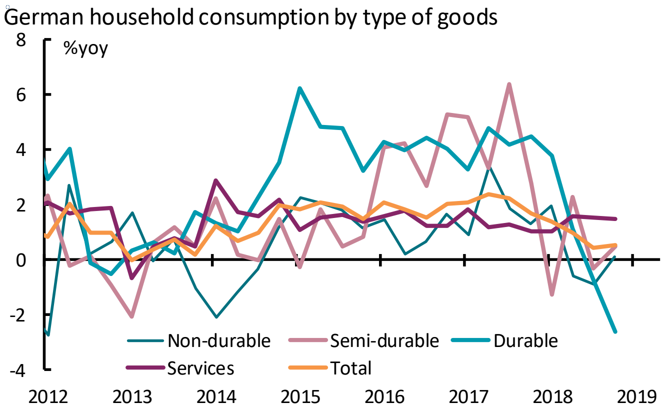
Exhibit 9: Higher oil prices affected 2018 consumption



Source: Datastream and AXA IM Research

Several factors, that should reverse in 2019 in our view, explained the weakening of household spending in 2018. Higher oil prices pushed inflation to 1.9% on average (up from 1.7% in 2017), reducing household purchasing power (Exhibit 9). Real household disposable income growth was down to 1.6%, the lowest since 2013. Cars also played a significant role. Private consumption shrank by 0.3%qoq in Q3 18, and as shown in Exhibit 10, most of the weakness was driven by a plunge in durable goods. We believe the drop in durable goods spending is also a factor contributing to the sharp increase in household savings rates in H2 18. As consumers could not buy cars - no production, lots of delay discouraged spending - they saved money, pushing their savings rate to 10.9% of disposable income, the highest since the global financial crisis (Exhibit 21).

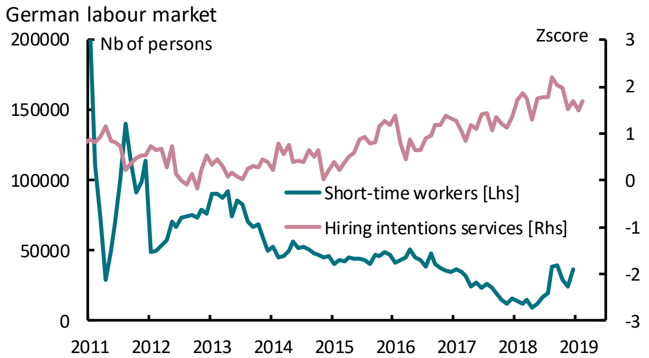
Exhibit 10: Durable goods explaining most of the weakness in H2 18 household spending



Source: Datatream and AXA IM Research

Looking ahead, things should get better, we look for private consumption to grow by 1.3% in 2019. **First, one-offs related to the car sector should gradually fade**. New car registrations rose markedly in January and February and are now back to H1 18 levels of around 300 thousands units per month (Exhibit 22). As cars become available again, it is fair to assume that household spending on them should resume.

Exhibit 11: Labour market outlook remains favourable



Source: Datastream and AXA IM Research

Second, we expect real wages to strengthen further. Negotiated earnings rose firmly by 2.8% in January and February, and we believe dynamism should continue in 2019, on the back of labour market tightness. More fundamentally we believe the employment outlook is key for the health of private consumption. Latest activity indicators suggest resilience ahead, with hiring intentions in the services sector (more labour intensive than manufacturing) holding up well, while the rise in short-term work schemes[3] has been relatively limited (Exhibit 11). Favourable labour market developments should support real wages growth; we see it hovering around 3% in 2019, up from 2.6% in 2018. The minimum wage also

[3] Short-term work schemes, *Kurzarbeit*, play the role of automatic stabilisers; in case of economic slowdowns, working hours can be temporarily reduced, while the employee remains employed.

increased by 3.9%yoy in January 2019 and given the higher marginal propensity to consume of low-income earners, this should further support household spending. Lastly, negative base effects from energy prices should push the headline inflation down to 1.2%, from 1.9% in 2018, a significant gain in purchasing power for households.

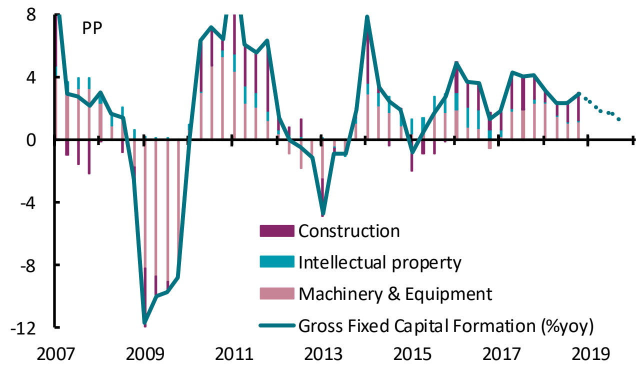
Third, fiscal policy should provide a boost to household disposable income. The budgetary easing is significant in 2019, amounting 1% of GDP, and households are key recipients, via tax bracket adjustments, higher pensions and social transfers, and lower social security contributions. Given still elevated consumer confidence, we believe these gains will be largely spent. Indeed, as mentioned above we associate the surge in savings rates in late 2018 to the distortion in the car sector and unlikely to repeat this year. Overall, we think 2018 headwinds (high oil prices and inflation, drag from cars) will turn into tailwinds in 2019, while fiscal stimulus and solid wage growth will provide another boost to consumer spending.

Investment to suffer again from the external environment

Investment growth slowed in 2018 to 2.7%, down from 3.5% on average in 2016 and 2017. The deceleration was primarily driven by a decline in machinery and equipment investment while construction held firm (Exhibit 12). The later was supported by very easy financial conditions, robust households demand and confidence at historical high. We expect these factors to remain at play in 2019, leading to another year of solid construction investment.

Exhibit 12: Business investment slowing

Germany - Contribution to investment growth

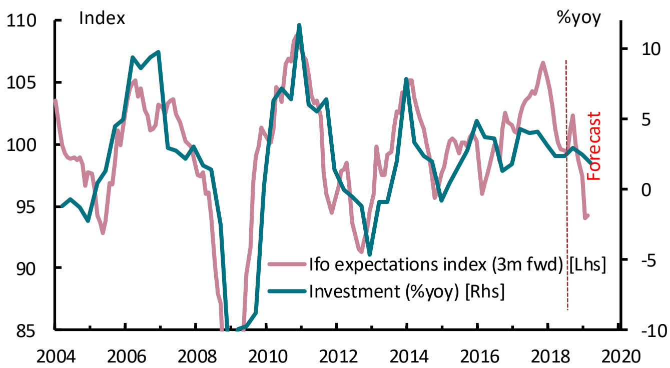


Source: Datastream and AXA IM Research

The picture is different for **business investment. In 2018 it suffered from global uncertainty, softer demand and industry weakness.** Its contribution to total investment growth roughly halved. The latest survey from the German Chambers of Commerce and Industry (DIHK) signals that things are unlikely to get any better soon. Industrial companies are significantly reducing their investment intentions due to growing demand concerns and labour cost developments. Indeed, the flipside of strong wage growth is higher labour costs (which rose by 2.8%yoy in Q4 18). This translates into lower corporate profits (as firms reduce their margins rather than increase their prices) thus limiting investment prospects.

Exhibit 13: Ifo expectations signalling further weakness ahead

German Ifo expectations and investment

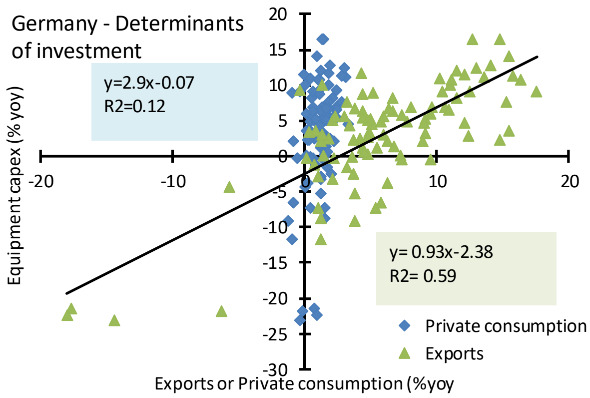


Source: Datastream and AXA IM Research

Other forward-looking components paint a similar picture. The Ifo expectations component, which tracks business investment relatively well, stood close to a seven year low in February (Exhibit 13). Although the sharp decline is coming after the excessive optimism of 2017, so it might be an overreaction.

The last argument underpinning our forecast of slower business investment is that it is more sensitive to exports than private consumption. Exhibit 14 shows linear regressions of equipment capex on exports and private consumption, highlighting that exports matter much more than consumption for business investment. Given our expectations of subdued exports growth in 2019 (2.2%), we expect business investment to continue to decelerate.

Exhibit 14: Exports, not consumption, matter for fixed investment



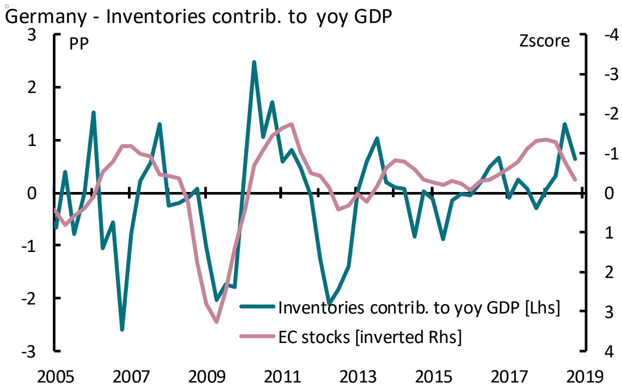
Source: Datastream and AXA IM Research

Overall the robustness of construction investment will not be enough to offset the deterioration in business investment. We expect total investment growth to moderate to 1.7% in 2019, from 2.7% in 2018.

Inventories: Non-negligible residuals

Inventories played a non-negligible role in Germany's 2018 GDP profile, adding 0.6pp to GDP growth. It is usually difficult to comment on inventory data from national accounts, as the series is quite volatile and includes several residual components. In theory, inventories are usually a means to smooth output against temporary demand swings, but in practice they tend to be pro-cyclical: stocks of finished goods decline when demand weakens.

Exhibit 15: Large stock accumulation in 2017 and destocking in 2018

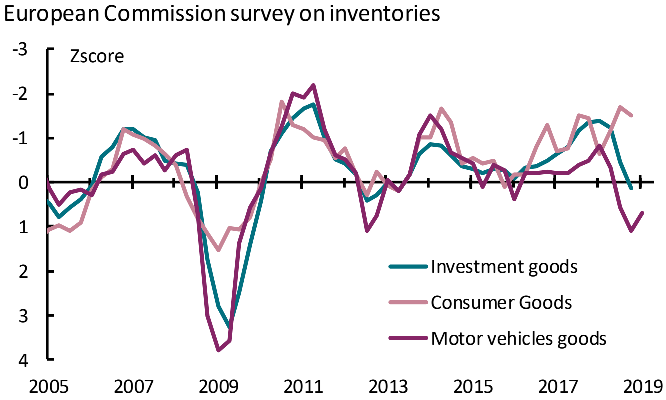


Source: Datastream and AXA IM Research

In 2017, the European Commission survey (which shows firms' assessment of their stock levels) signalled a large accumulation of stocks, but it appeared in GDP data only with a lag in 2018 (Exhibit 15). The build-up in inventories added 0.3pp and 0.9pp to Q218 and Q3 18 GDP, respectively.

The European Commission survey suggests that inventories have been above their desired levels since Spring 2018 for car producers (Exhibit 16). There is an easy explanation for that – due to problems implementing the new emission system, WLTP, German car companies imported more cars than usual, and consumers bought fewer in Q2 and Q3 18 (Exhibit 10) leading to higher inventories.

Exhibit 16: Destocking more pronounced for investment goods and vehicles



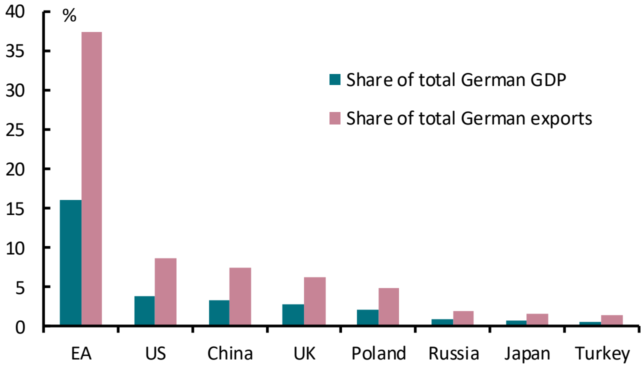
Source: Datastream and AXA IM Research

The problem is that now, destocking has started, withdrawing 0.6pp from GDP growth in Q4 18. We expect the depletion of the stock of finished goods to be a drag on GDP growth again, as firms will likely prefer to correct their above-desired level of inventories. More precisely we expect a negative contribution of 0.3pp to Q1 19 GDP growth.

To sum up, the German economic cycle should continue for a few more quarters and we expect GDP to rise by 0.9% in 2019. The fading one-off effects should help growth to renew with better numbers, although we do not expect significant improvement in underlying momentum. On the domestic front, higher labour costs and concerns on demand should weigh on corporate profits and the investment outlook. Private consumption should come to the rescue, benefitting from fiscal stimulus, solid wage growth, lower inflation and normalisation of the car sector. On the external front, we see some sequential improvement in the second half of the year, as Chinese policy stimulus filters through the economy and helps stabilise foreign demand for German exports. In our opinion, the risks are skewed to the downside: the absence of a stabilisation in China, a disorderly Brexit, and more importantly, the US imposing auto tariffs in May could push the German economy into recession.

Exhibit 17: Germany main trading partners, 2018

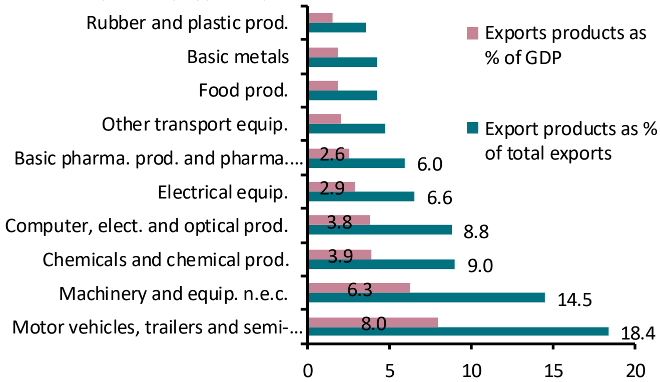
German exports by partners



Source: Datastream and AXA IM Research

Exhibit 18: Vehicles dominate German exports

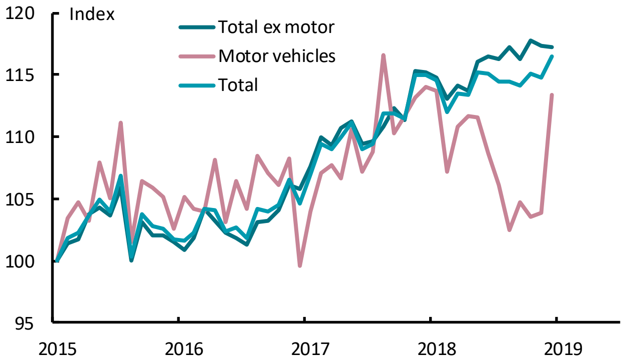
German exports by type of products, 2017



Source: Datastream and AXA IM Research

Exhibit 19: German exports: the role of autos

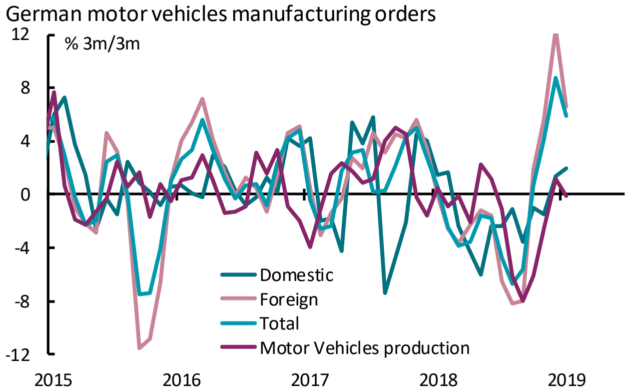
German exports



Source: Datastream and AXA IM Research

Exhibit 20: Expect some gradual normalisation of the auto sector

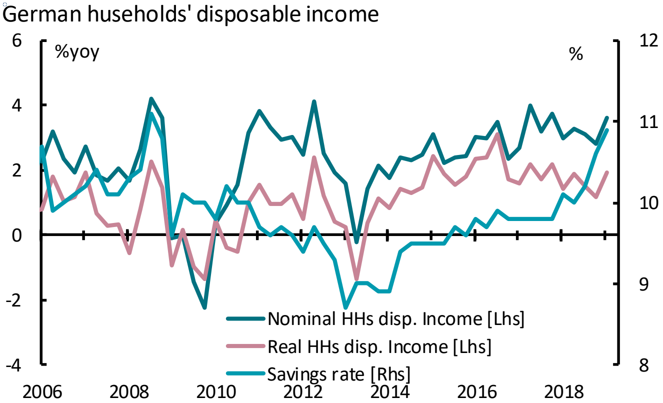
German motor vehicles manufacturing orders



Source: Datastream and AXA IM Research

Exhibit 21: Autos: behind the sharp rise in households' savings rate

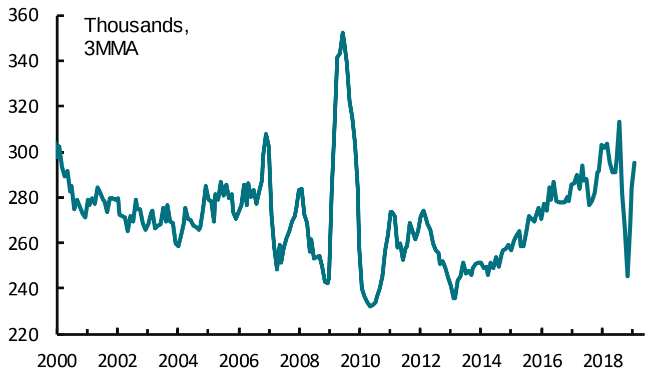
German households' disposable income



Source: Datastream and AXA IM Research

Exhibit 22: Car registrations recovery suggest the drag on consumption should fade

Germany new car registrations



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