

COULD VALENTINE'S DAY BRING A BAD SURPRISE?

We will find out next week whether Germany has slipped into a technical recession, but the real reasons for concern are elsewhere.

When is the next recession coming? If you are in Germany, you might already have missed it. Numbers for Germany's gross domestic product (GDP) in the fourth quarter of 2018 are due to be published, on February 14, just in time for Valentine's Day. That's when we will know whether Germany has slipped into a "technical" recession in the second half of 2018. Such a recession is defined as two consecutive quarters of negative growth.

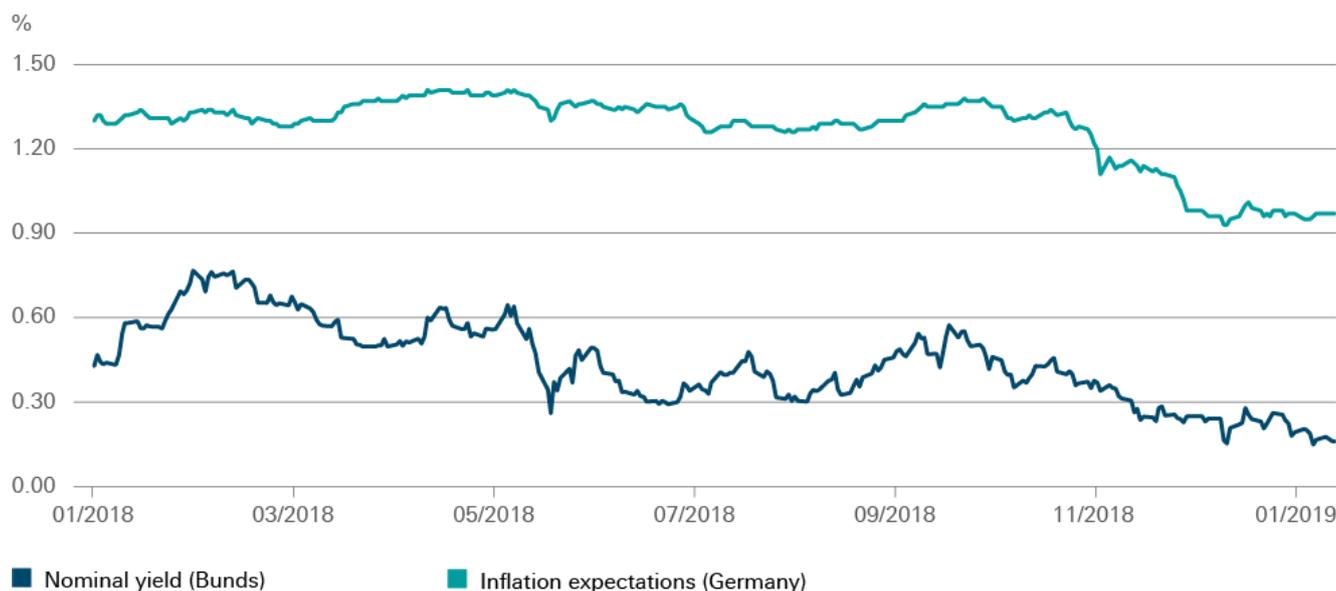
Above all, this shows how absurd the widespread definition of a recession is. According to this, a 0.1% drop in GDP in two quarters would be a recession, while a five times larger drop in economic output of 1% in one quarter, followed by zero growth the next, would not be a recession. That is why the economists tend to prefer a broader definition. Recessions simply mark periods when resources are underutilized.

That does not appear to be the case in Germany. In the third quarter, the automotive sector in particular suffered; since the beginning of the fourth quarter, orders have risen again, which suggests a recovery in production at the beginning of 2019. In December, construction output slumped by 4%, which could drag the fourth quarter into the red. But

even if we have a lot to worry about, we do not believe the German construction industry is one of them.

However, as far as 2019 is concerned, we should not become too calm. The falling yields on German government bonds are giving pause for thought. This applies both to the nominal yields on German government bonds and to the yields on inflation-indexed longer-dated German government bonds, as our Chart of the Week shows. The difference between real and nominal yields, the so-called inflation break-even rate and an indicator of inflation expectations, has also fallen – in the ten-year maturity range even to a new two-year low. All of these are hardly signs of economic dynamism. Since January of this year, the European Central Bank (ECB) has also stopped net new purchases of securities as part of its purchasing program. That should actually have pushed yields upwards.

However, signs of weakness in the Eurozone, from the falling Ifo index and significantly lower retail sales in Germany in December 2018 to weak purchasing managers' indices in France and Italy are now accumulating. Then, there are various political risks, from the Brexit chaos to trade conflicts. "Should the growth prospects actually deteriorate sig-



Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 2/7/19

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nificantly, it cannot be ruled out that the ECB will resume its bond-purchase program with net purchases. This would cause the prices of all bonds, including Bunds, to rise further and yields to fall further," explains Ulrich Willeitner, Senior Portfolio Manager of DWS for European bonds. This

shows that central banks and recessions might have something in common with more conventional Valentine's Day surprises. No matter how long you think ahead and how carefully you plan: something can always go wrong.

GLOSSARY

Brexit

Brexit is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom of the European Union.

Bunds

Bunds is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

Central bank

A **central bank** manages a state's currency, money supply and interest rates.

European Central Bank (ECB)

The **European Central Bank (ECB)** is the central bank for the Eurozone.

Eurozone

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

Government (sovereign) debt/bonds

Government (sovereign) debts/bonds are debt/bonds issued and owed by a central government

Gross domestic product (GDP)

The **gross domestic product (GDP)** is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

ifo Institute for Economic Research

The **ifo Institute for Economic Research**, based in Munich, is a leading European research institute, particularly known for its sentiment indicator "ifo Business Climate Index".

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Inflation-indexed Bond

An **inflation-indexed bond** is a bond where the principal and / or coupon is indexed to the consumer price index.

Nominal

In economics, a **nominal** value is not adjusted for inflation; a real value is.

Purchasing Managers Index (PMI)

The **Purchasing Managers Index (PMI)** is an indicator of the economic health of the manufacturing sector in a specific country or region.

Recession

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Technical analysis

Technical analysis is a tool used by capital market participants that want to forecast the development of security prices by detecting patterns in past market data such as prices and volumes.

Yield

Yield is the income return on an investment referring to the interest or dividends received from a security and is usually expressed annually as a percentage based on the investment's cost, its current market value or its face value.

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