CIO | VIEW
Macro Perspectives
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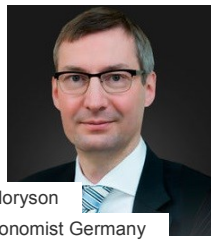
DWS

GERMAN ECONOMY: CONSUMPTION HAS TO FIX IT

German industry remains weak but domestic consumers are propping up the economy – and Asia offers hope.



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IN A NUTHSELL

- Manufacturing is currently weakening worldwide, not least because of trade disputes. That's bad news for export-oriented countries like Germany.
- The good mood in the service sector and among consumers is partially offsetting the industrial weakness, especially in Germany.
- Together with increasingly positive data from Asia, this strengthens our confidence in the German economy. But the Dax has anticipated the good news.

RECESSION IN GERMAN AND EUROPEAN INDUSTRY?

Karl Valentin, a German comedian at the time of the Weimar Republic, famously said that "the future used to be better." His witty remark might be applied now to the German economy. The forward-looking, soft (survey-based) indicators paint a much darker picture than the hard data of the past. So is German industry on the brink of recession, or even in the middle of it? Is European industry in the same boat? And what may that mean for the economy as a whole? We want to answer these questions here.

A lot is currently being written about the danger of a recession: technically, a decline in economic output over two consecutive quarters is called a recession. The popular concept of a recession, however, is probably something worse: prolonged contraction, rising unemployment, significant hardship[1]. Germany, and the Eurozone as a whole, show signs of being a long way from that. Employment is rising, unemployment is falling, real wages are rising and capacity utilization is particularly high outside of industry. This applies to Germany, many other European countries, and thus also to the Eurozone as a whole.

WEAKNESS IN GERMAN INDUSTRY

The outlook for German industry has clouded. At the end of last year it was expected to weaken briefly. The picture now is that the slowdown is likely to drag on for longer and - most importantly - that growth may not be able to return to the old level afterwards.

This industrial weakness is part of a phenomenon that we can observe worldwide. At present, economic growth is being driven by domestic demand, especially by the services sector. Investment and export - and thus also industry - are currently having a hard time everywhere. European industry – as measured in terms of industrial production - also remains under a strain. Since the beginning of last year, it has lacked dynamism. Industrial orders data in Germany once again showed a clear downward trend in February, and actual industrial production has also continued its downward trend since May last year.

WHERE DOES THIS WEAKNESS COME FROM?

There are a whole range of reasons for the weakness. First of all, the industrial expansion that began in spring 2017 could not continue forever. To a degree the slowdown in gross-domestic-product (GDP) growth that began in the summer of 2018 represented normalization. In addition, there were some temporary reasons for industrial weakness. In the autumn of 2018, for example, low water levels in the Rhine meant that large petrochemical plants could not be supplied - with corresponding effects on the entire value chain. A further problem was difficulty introducing standards for exhaust emission testing for new cars; this led to a slump in German car sales. Meanwhile it has become apparent that German car registrations have again picked up somewhat, though production remains sluggish. Foreign demand in particular is lacking.

Weak foreign automotive demand is clear, but the negative mood is by no means limited to this sector alone. There is a broad global slowdown in production. It is attributable in part to the numerous trade conflicts between the United States and the rest of the world. Goods account for the lion's share of trade, while services are only affected to a minor extent by trade conflicts. In addition, both the United States and the

[1] Economists define a recession as a (significant) decline in capacity utilization, which leads to a (significant) underutilization of production capacities, or exacerbates an already existing underutilization.

countries imposing countermeasures are trying to protect their own consumers. The punitive tariffs therefore tend to be at the expense of export-oriented industry. Although the actual level of the tariffs imposed so far appears to have been manageable and the direct effects likely to be minor, free trade as a whole has been under considerable pressure for some time now. Not only have there been punitive tariffs so far imposed in the United States and China but there have also been discussions about further tariffs (on cars or against Mexico, etc.) which continue to be negative for trade. So too has Brexit, whose uncertain fate has been discussed in the news every evening. The doubts created about free trade are affecting entrepreneurs and leading to a certain inertia in investment. Finally, the current German ifo data also show that industrial companies are more skeptical about the future and expect fewer orders, especially from abroad.

MIXED SIGNALS FROM GERMAN MANUFACTURING DATA

Sources: Haver Analytics Inc., DWS Investment GmbH as of 4/8/19

SO IS GERMANY FACING A RECESSION?

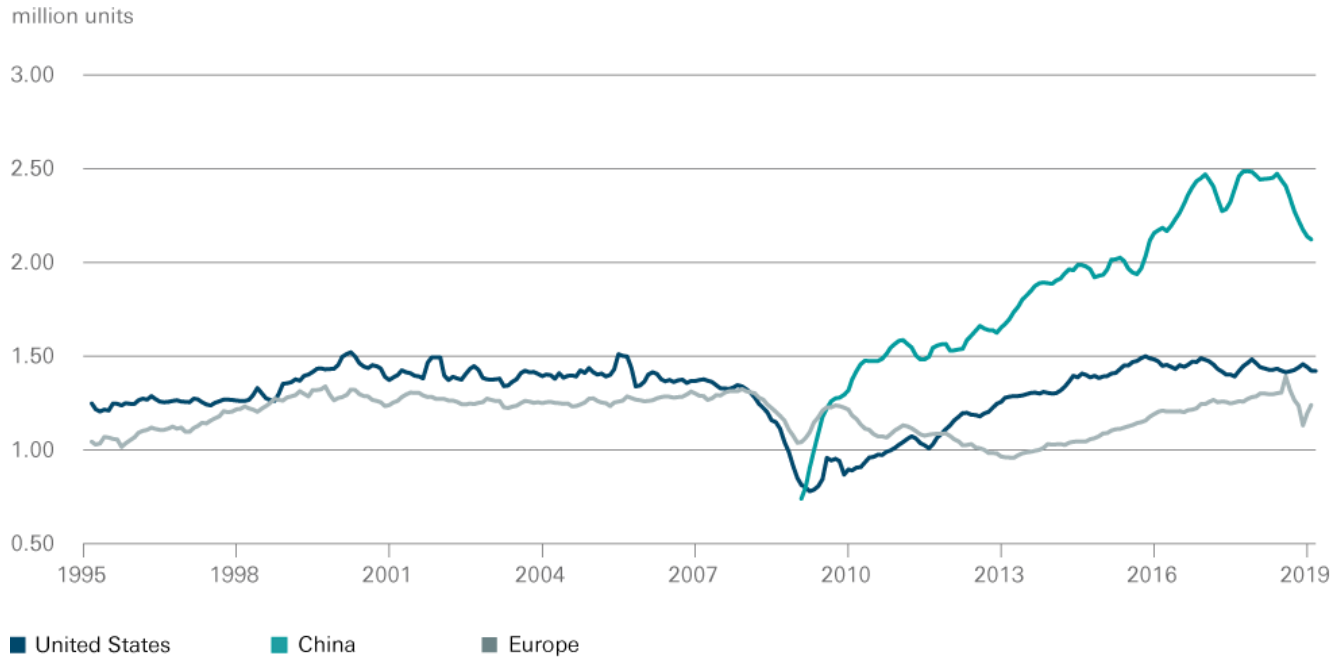
And yet we do not expect Germany to slide into recession. This is primarily due to robust domestic demand. Germany has the highest level of employment since reunification, the unemployment rate is at a record low, and wages are rising at a respectable pace. All this has ensured that the mood in the service sector has so far held up extremely well. This raises the question of whether the problems in industry will sooner or later drive down consumer sentiment and the services sector too, or, conversely, whether the global consumer will brighten up (German) industry. Econometric studies suggest that the industrial sector's mood is more likely to influence the service sector's mood than the other way around. And so the crucial question is: can consumer confidence remain high until industry recovers? It could – or, certainly, there are good arguments to suggest it could. In addition to the robust employment situation mentioned above, construction is booming as there are housing shortages, rents are rising and interest rates are extremely low. We are also seeing the first buds of an economic recovery in Asia, which should sooner or later also become visible in German export figures. And even if it is too early to make a final judgment, the signs are currently pointing to a relatively business-friendly end to the Brexit discussions.

However, the automotive industry remains a problem child, in both the short and long term. In the short term, punitive tariffs might still be imposed by the United States. Now that the U.S. authorities have established that importing European cars poses a risk to the U.S. national security, the U.S. President has until May 18 to announce appropriate countermeasures and restore national security. So far nothing has been announced, but the threat of 25% punitive tariffs is still pending. Rough calculations show that the direct effect on German GDP would be of the order of 0.1 percentage points. But the signal that the world's most important economy and Europe's closest ally is imposing punitive tariffs on Germany's core product for reasons of national security would certainly be harmful. It would hurt German industry and consumer sentiment and could therefore call into question the recovery of the German economy.

ROBUST LABOR MARKET SUPPORTS DOMESTIC CONSUMPTION

Sources: Haver Analytics Inc., DWS Investment GmbH as of 4/8/19

GERMAN CAR SALES - THE PENDULUM SWINGS IN CHINA



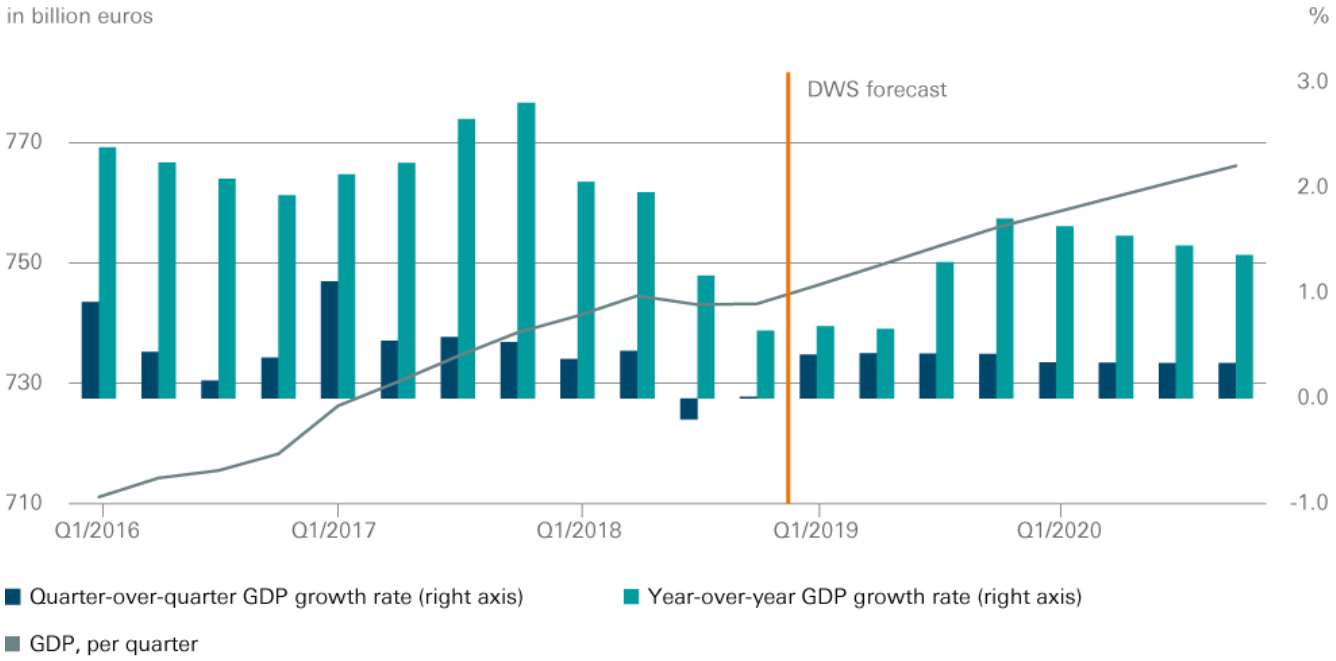
Sources: Haver Analytics Inc., DWS Investment GmbH as of 4/8/19

The automotive industry could also prove to be a negative factor for the German economy in the long term. The boom in the sector, which coincided with the recovery from the financial crisis, is over. In the most important sales markets, demand for passenger cars has stabilized and is no longer growing as rapidly as in the past. In China, there has been a marked decline for some time now. In addition, environmental concerns about petrol and, even more so, diesel vehicles, and the emergence of electric and even autonomous vehicles is bringing technological uncertainty to the sector.

IMPLICATIONS FOR EQUITIES AND BONDS

We do not see a German recession but do expect a phase of pronounced weakness, the main causes of which lie in the global economy. A healthy level of consumption and the booming construction industry should be able to keep the German economy going until industry has recovered. However, the former good German rate of growth is unlikely to be reached, especially if the engine of German industry - car construction - continues to stutter. How this translates into GDP growth figures both from a year-over-year and quarter-over-quarter perspective, can be seen in the graph below.

WE BELIEVE THAT THE FOURTH QUARTER OF 2018 MARKED THE LOW IN GERMAN GDP GROWTH RATES



Sources: Statistisches Bundesamt, DWS Investment GmbH as of 4/16/19

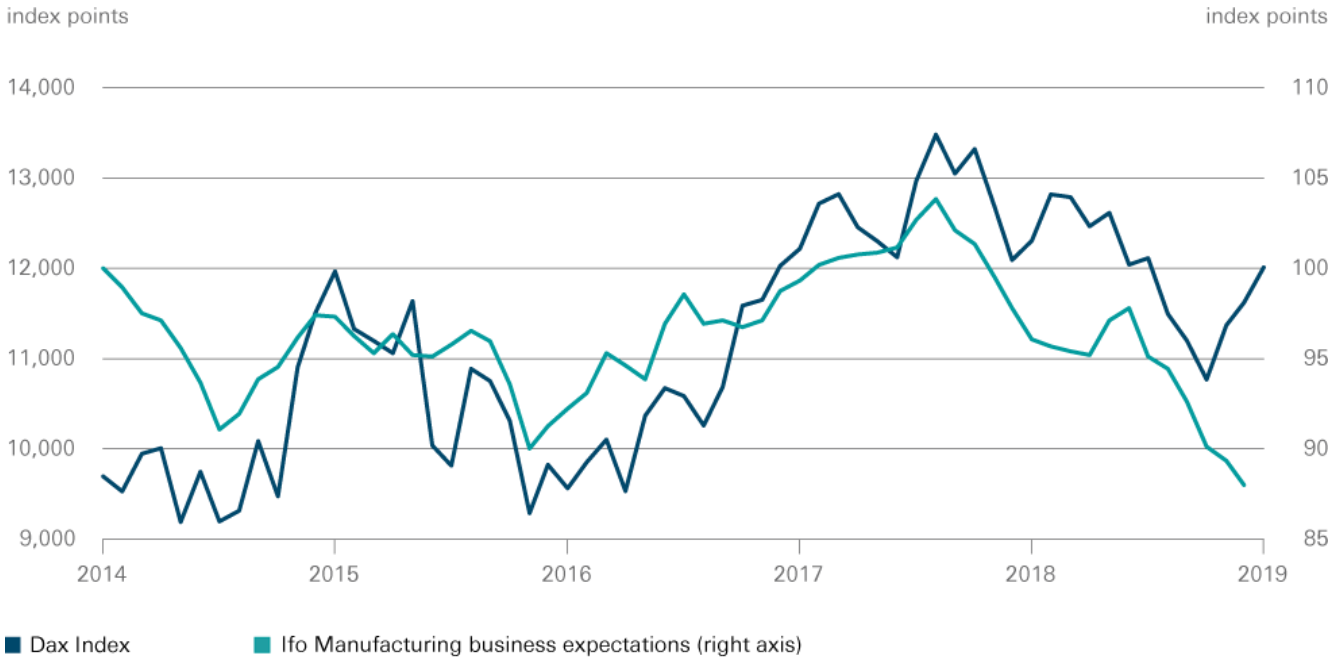
EQUITIES - DAX WITH CURRENTLY UNFAVORABLE SECTOR MIX BUT RELATIVELY FAVORABLE VALUATION

Germany's leading index, the Dax, has been lagging behind both the European and U.S. leading indices (Stoxx 600 and S&P 500) since the end of 2017. With a benevolent eye it might be possible to speak of a bottom formation visible since mid-February of this year. This relatively weak phase is also one reason why German equities, measured by their price-earnings ratio, for example, have a relatively large valuation gap compared to U.S. equities from a historical perspective.

We believe German equities would indeed be well positioned if the global economy were to pick up speed again in late summer or autumn and China in particular were once again more willing to spend on foreign goods. The latest positive developments in the Chinese Purchasing Managers Index, the housing market and credit volume growth, confirm our view that green shoots are starting to show in emerging markets (see "Emerging turnaround?"). On the other hand, German equities are still under pressure from various sides. Be it the weak phase of the global economy - however temporary it may be - or the planning uncertainty caused by Brexit, or home-grown challenges: in the automotive sector, banks and a chemicals sector that is once again suffering from unfortunate overseas takeovers.

On the other hand, German equities continue to benefit from the ongoing low interest-rate environment and the soft euro, which is still not strengthening against the dollar. In the short term, the reporting season continues to be an important driver. Analysts' earnings revisions, particularly negative at the beginning of the year, have already stabilized for several weeks. It is now up to companies to confirm this trend with their quarterly figures or even produce a positive surprise with optimistic forecasts. On the basis of current data and our forecasts, we consider the Dax to be fairly valued overall and maintain our March 2020 price target of 11,800. But of course the index can always overshoot our target, as Tim Albrecht, Head of German Equities at DWS, admits: "The easing of the situation in the trade war between the United States and China is a major reason for the impressive comeback of German stocks since the beginning of the year. A further improvement in the geopolitical situation would also make higher Dax levels possible - which is why we are keeping a close eye on current developments and not taking profits yet."

EQUITY INVESTORS ARE ALREADY BETTING ON IMPROVED IFO FIGURES



Sources: Thomson Reuters Datastream, DWS Investment GmbH as of 4/15/19

BONDS - NO ROOM FOR BIG INTEREST-RATE JUMPS

Our cautious but at the same time not overly pessimistic view is also reflected in our forecasts for Bund yields. Until March 2020, we expect only moderate interest-rate hikes across the entire yield curve. We expect yields on 10-year German government bonds, for example, to rise to only 0.3% by then. The yield curve is also likely to become only slightly steeper. Besides the currently soft economy, European-Central-Bank (ECB) policy should also tend to back our interest-rate forecasts, especially the intensifying discussions about a tax-free allowance for banks' negative interest-bearing surplus reserves (see "An ECB gift with strings"). Oliver Eichmann, DWS Co-Head Rates EMEA, commented: "The introduction of a tax-free allowance should be seen by market participants as a signal that the ECB will keep key interest rates at the current level for some time, and that there may even be scope for further reductions in deposit rates. Expectations of interest rate hikes seem thus dispelled for the foreseeable future, and German government bonds should benefit."

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.

Capacity utilization
Capacity utilization refers to the share of an economy's productive capacity that is in use.

Dax
The **Dax** is a blue-chip stock-market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

Emerging markets (EM)
Emerging markets (EM) are economies not yet fully developed in terms of, amongst others, market efficiency and liquidity.

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.

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, particulary known for its sentiment indicator "ifo Business Climate Index".

Price-to-earnings (P/E) ratio or multiple
The **price-to-earnings (P/E) ratio** compares a company's current share price to its earnings per share.

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.

S&P 500
The **S&P 500** is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Stoxx Europe 600
The **Stoxx Europe 600** is an index representing the performance of 600 listed companies across 18 European countries.

Valuation
Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

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.

Yield curve
A **yield curve** shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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