Holger Schmieding, Chief Economist | Holger.schmieding@berenberg.com | +44 20 3207 7889

GERMAN ECONOMY: HOW SERIOUS IS THE SLOWDOWN?

Berenberg Macro Flash

After a major growth spurt last year, the Eurozone economy lost momentum in the first half of 2018. But how serious is the slowdown? And could the worst be over soon? The data do not yet allow us to draw firm conclusions. So far, the evidence for the Eurozone's largest swing economy, highly cyclical and manufacturing-oriented Germany, largely supports our view: Eurozone growth remains close to the underlying trend rate of 1.5% for now. The correction in surveys of business confidence from cyclical peaks at the start of the year to less exuberant but still solid levels now has not derailed the economic upswing. If trade tensions do not escalate ever further, positive domestic fundamentals can raise Eurozone growth back to a rate around 2% in late 2018. Of course, the German data also highlight the risk: if trade tensions get worse and worse, mounting anxiety about the outlook for global trade could spill over more meaningfully and for longer into real economic activity than we currently project.

GERMANY: A MODEST REBOUND IN Q2 AFTER A WEAK Q1

A harsh winter and a flu epidemic conspired to dampen German GDP growth to a mere 0.3% qoq in Q1 after average quarterly gains of 0.7% throughout 2017. While the weather and the flu may well have kept some people away from the shops, the contrast between a 1.4% qoq surge in disposable income and a 0.6% drop in retail sales in Q1 still looks suspicious. Once again, retail sales and consumption data may well be revised up after a while, yielding a 0.4% qoq gain for Q1 GDP that would be more in line with underlying trends.

Taking the hard data for April and May as a proxy for Q2, we can hazard a first educated guess about the likely Q2 result. Except for the backward-looking labour market, most of the recent German data look a little stronger than they did in Q1:

- Helped by a spring rebound in construction, **industrial output** rose 0.4% in April/May versus Q1 after a flat qoq reading before.
- The often underreported **retail sales** advanced by 0.6% after an unlikely 0.6% qoq drop before.
- **Goods exports** advanced 0.8% in April/May vs. Q1 after falling 0.6% qoq before.
- **Employment growth** slowed to 0.25% qoq after a 0.4% qoq gain in Q1, though.

Monthly data are volatile and the June results could well change the picture. Still, the available hard data suggest that the German economy fared a little better in Q2 that in Q1 with a qoq gain of at least 0.4% instead of 0.3% before. Whether net exports contributed to growth in Q2 after subtracting 0.05% in Q1 remains unclear. While goods imports (+2.2% in April/May vs. Q1 rose much faster than exports (+0.8%), this probably reflects higher oil prices rather than a gain in import volumes that would subtract from real GDP. German Q2 GDP data are due on 14 August; Eurostat will publish a first flash estimate for the Eurozone on 31 July.

A GLIMPSE INTO THE FUTURE

Hiring intentions and trends in the inflow of new orders offer a better glimpse into the immediate future than backward-looking data on production and employment. Abstracting from two obvious outliers, a surge in bulk orders from other Eurozone countries last December and a one-off dearth in domestic orders in April 2018, German factory orders have fallen slightly on trend since reaching a peak late last year. While the May 2018 reading came in 0.7% below the September-to-November 2017 average, it remains 3.8% above the Q2 2017 level. At the same time, the index for the backlog of orders has continued to rise. Even with a slight dent in the inflow of new orders, demand continues to outpace the growth of supply.

The ongoing rise in German job vacancies to a record 797k in June points in the same direction: aggregate demand remains fairly solid. In reaction to Trump's trade war threats, German companies may well delay decisions about their future cross-border supply chains. We thus look for some slowdown in investment growth. However, with full order books, we do not project a major weakness in overall output yet.

Interestingly, the slight decline in the inflow of new orders since late 2017 is due solely to fewer orders from Germany and other countries of the Eurozone (see Chart 1). Despite global trade tensions and the lagged impact of last year's euro strength, new orders from outside the Eurozone in April and May 2018 exceeded their September-to-November 2017 average by 0.4%. As usual, we should not read too much into the drop in orders from within the Eurozone which seems to largely reflect a weaker-than-usual intake of highly volatile bulk orders. All in all, the data suit the view that Germany is not yet facing an actual fall in demand from overseas. Instead, uncertainty about the outlook for future trade makes companies more reluctant to order capital goods and intermediate goods from all sources, be they domestic or foreign. Capital and intermediate goods are needed at the early stages of the production cycle. Demand for them thus reflects concerns about the future more than orders for consumer goods.

POSITIVE DOMESTIC FUNDAMENTALS

The outlook for domestic consumption remains encouraging. After a 4.4% gain in 2017, German gross wages and salaries rose by 4.6% yoy in Q1 on the back of solid gains in employment (see Chart 2). Stronger wage increases kicking in from Q2 onwards and a 3.25% rise in German pensions as of July 2018 will raise disposable incomes. While inflation will probably edge up slightly to 2.3% yoy in July after 2.2% in June due to higher oil prices, headline inflation looks set to ease again later this year unless oil prices were to rise much further. A likely fall in inflation to 1.9% or less by Q4 2018 will leave more room for a rise in real consumer spending, which we expect to accelerate from a projected 1.2% yoy increase in 1H 2018 to roughly 2% annual gains from late 2018 onwards.

THE "TRADE ANGST" FACTOR

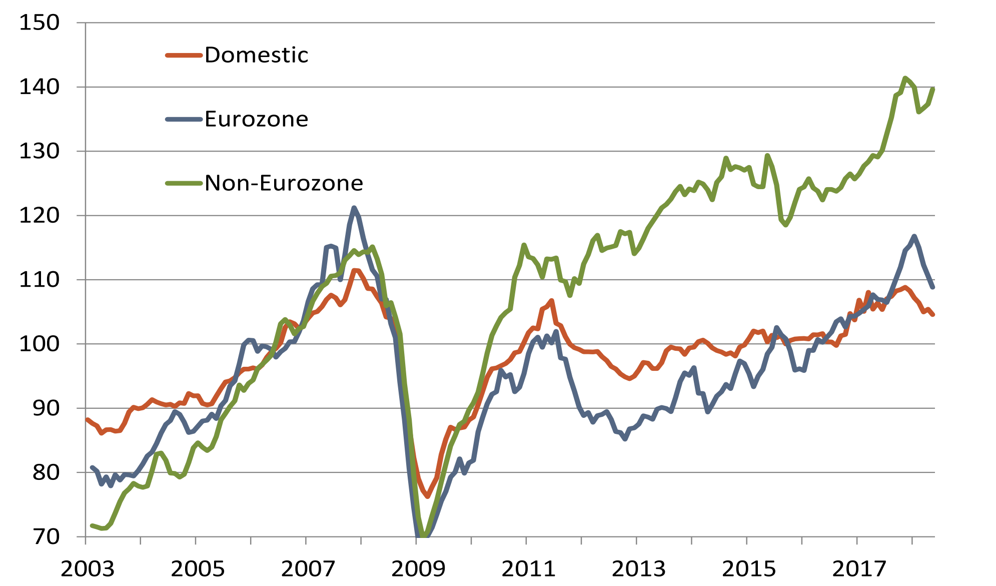
Some indicators such as the slight rise in Germany's composite PMI to a 3-month high in June suggest that the downturn in sentiment surveys may have started to peter out as the service sector benefits from solid domestic fundamentals. In a similar vein, German Ifo business confidence fell only modestly in June after significant expectations-driven declines in the first four months of the year (see Chart 3). The stage could thus be set for a rebound in confidence soon.

Unfortunately, we are not quite there yet. The imposition of US tariffs on $34bn of imports from China and the immediate Chinese tit-for-tat response on 6 July and today's publication of a list of $200bn of further US imports from China that may be subject to a 10% tariff has shone a harsh spotlight on the trade war risks again. The drop in ZEW investor expectations in July to the worst levels since August 2012 probably overstates the downside risks significantly. Financial markets tend to be more nervous than business investors. Still, we probably have to brace ourselves for another fall in key sentiment surveys in July. The US Commerce Department hearing on 19-20 July about a potential 20% US tariff on car imports from the EU could potentially add to the tensions.

So far, the tangible damage from new trade barriers remains minor. Instead, a fear factor – or "trade angst" – seems to be holding back corporate investment spending while overall demand from domestic and foreign markets continues to hold up. Looking ahead, an easing of trade tensions and a decline in inflation should pave the way for a modest re-acceleration of German – and Eurozone – growth from rates around 0.4% in Q2 and Q3 2018 to 0.5% qoq from Q4 2018 onwards. That remains our main scenario. It does not necessarily require that trade disputes are settled with a "deal". It would suffice if, after a period of escalating threats now, the US engages in more serious negotiations with China and the EU and slows down the pace of new tit-for-tat tariff announcements in the process. If so, sentiment in Germany and the Eurozone could stabilise from September onwards, helped by ongoing gains in exports to China and the US. As long as the facts do not fully corroborate the worst "trade angst" fears, businesses and consumers can get used to quite some noise over time.

Of course, if Trump goes on and on, perhaps wanting to impress his base with a tougher and tougher stance rather than with an ability to strike deals ahead of the US midterm elections in November, mounting concerns about trade could weigh more heavily and for longer on the global, Eurozone and German economy than we currently project. To gauge the outlook for the Eurozone, we unfortunately have to watch US politics at least as much as economic fundamentals at home. To put a less negative spin on it, one consolation in these turbulent times is that Trump's trade war threats are coming at a time when the domestic economic situation in the Eurozone looks better than it has been for 10 years.

Chart 1: German factory orders

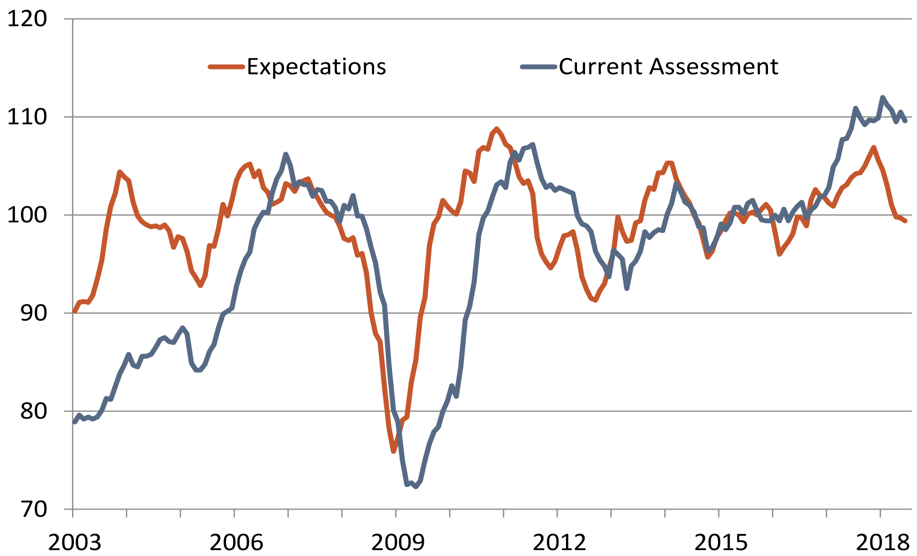


3-month moving averages, rebased to 1Q 2006=100, not adjusted for December 2017 one-off spike. Source: Bundesbank

Chart 2: German gross wages and salaries

Yoy change in %. Source: Bundesbank

Chart 3: German Ifo: is the slide in expenditure petering out?



Expectations for the next six months and assessment of the current situation, industry and trade only. Source: Ifo, Haver Analytics

Joh. Berenberg, Gossler & Co. KG
60 Threadneedle Street
London EC2R 8HP
Phone +44 20 3207 7878
www.berenberg.com
holger.schmieding@berenberg.com