Daily Note

GERMAN REBOUND ONLY TEMPORARY

Davide Oneglia

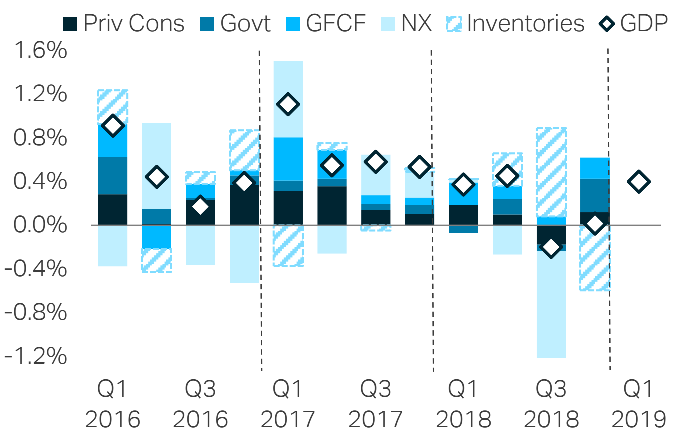
- **German preliminary Q1 GDP is softer than the headline suggests**
- **Soaring inventory and falling orders could weaken M&E capex**
- **Resurgent trade wars and weaker EM FX threaten the recovery**

The German economy accelerated by 0.4% QoQ in Q1 after flatlining in 2018Q4, according to preliminary GDP data published yesterday. The devil, as they say, is in the details. The GDP breakdown by spending, however, is released with a week's delay, so we won't know the details until May 23. So, for now, we should content ourselves with the few comments provided by Destatis in its press release. But should we?

The statistics agency highlights domestic demand as the key driver of growth, despite a negative contribution from government expenditure. Compared to Q4, *"fixed capital formation in construction and in machinery and equipment increased considerably … Household final consumption, too, increased substantially…"* Foreign trade is said to be sending *"mixed signals"*. As usual, Destatis makes no mention of the extent to which inventory has contributed to domestic demand. We address each of these points below.

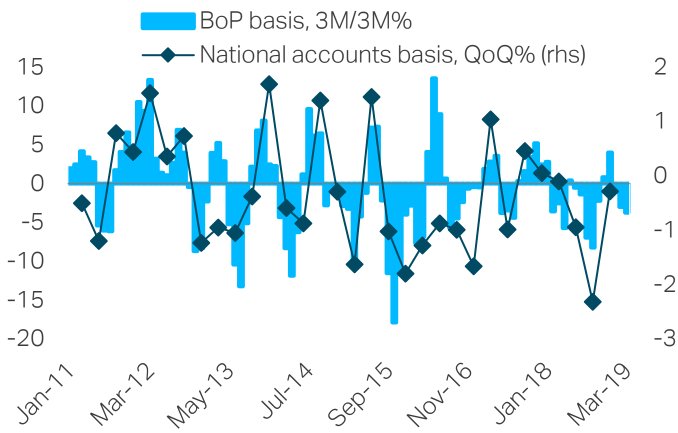
A negative contribution from net exports is already baked in the data. Monthly trade figures from the balance of payments report published last Friday signalled a pick-up in exports during Q1, but also a corresponding revival of import growth such to cause a contraction in net exports. The right-hand chart below shows that QoQ real net export growth as computed in the national accounts tends to be consistent with 3M/3M changes in real net exports derived from monthly balance-of-payments data. If anything, the national accounts seem to track declines better than increases.

Germany: the devil is in the details
Real GDP QoQ growth and pp. contributions



Source: Destatis, Datastream, TS Lombard

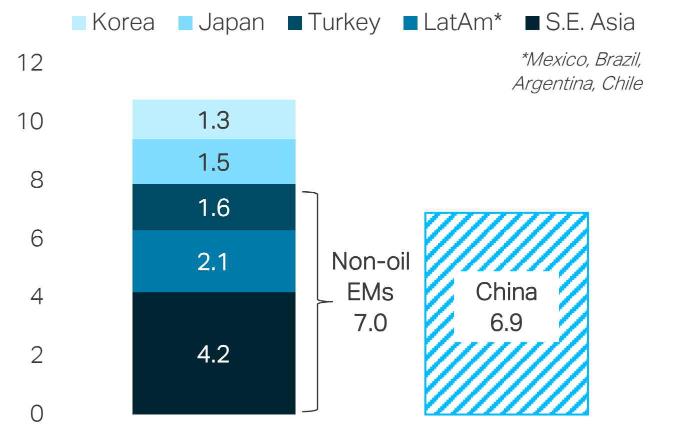
Exports recover but only marginally
Germany: real, SA net exports by data source



Source: Destatis, Bundesbank, Datastream, TS Lombard

Chinese stimulus vs. trade war damage

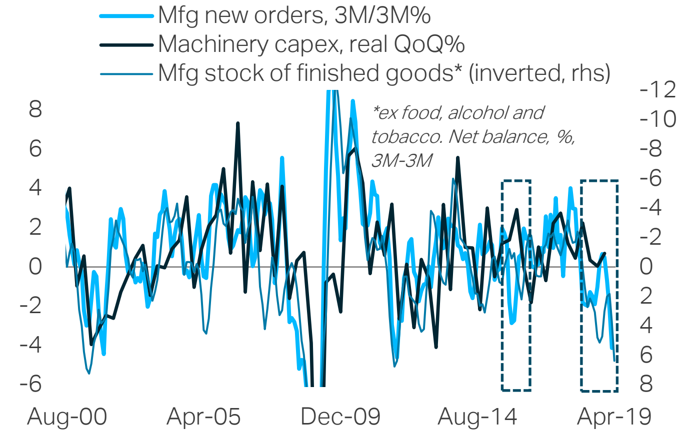
German exports by destination, nom. %tot (2017-18 avg.)



Source: Destatis, Bundesbank, Datastream, TS Lombard

Manufacturing capex lags orders & inventory

Orders and stocks: monthly. Real GFCF: quarterly



Source: IFO, Destatis, Datastream, TS Lombard

Inventory is likely to have boosted domestic demand substantially. A mix of prolonged, unforeseen weakness in foreign demand and pre-Brexit stockpiling (perhaps also related to the acceleration of imports mentioned above) caused a build-up of inventory in Q1. Besides Brexit distortions, we've shown repeatedly (e.g. here and here) that the surge in stocks of finished manufacturing goods has been broad-based across industries and across the euro area. Sector-specific factors (e.g. in the car industry) can explain only part of the rise in inventories. Bottom line: as manufacturers constrain production and run down stocks of finished products in the coming quarter(s), a partial reversal of Germany's current growth is on the cards.

Non-construction investment lags new orders and inventory. What's more, however, the dearth of new orders (both foreign and domestic) bodes ill for manufacturing capex. Despite the emphasis in the Destatis press release (see above), we're not impressed by the prospects of machinery and equipment fixed capital formation. In fact, we expect any acceleration in Q1 will not be sustained. The right-hand chart above shows that real manufacturing capex growth lags changes in manufacturing new orders and inventory levels. Since 2000, the only time capex has persistently diverged from orders was in 2015H2 (see first dotted box in the chart). Only a few months later, though, capex crashed in the midst of the global slowdown. Even allowing for brisk growth in construction output, thanks to relatively mild weather this winter, we think capex growth this year will remain subdued.

Slow trade and modest investment growth imply that household consumption is still effectively the most powerful engine of German growth. This is consistent with the rapid acceleration in real retail sales and with strength in services in Q1.

More generally, however, the global macroeconomic outlook has deteriorated markedly since President Trump imposed a new round of tariffs on China last Friday. A further ratcheting up of the US-China trade war is no longer a tail event. If Trump carries out his threat to levy duties on all Chinese imports, Beijing will have an incentive to double down on its credit stimulus, increasing the chances of a global rebound in 2019H2. However, non-oil emerging markets in S.E. Asia and Latin America are already suffering from a stronger dollar. The left-hand chart above shows that S.E. Asia, LatAm and Turkey combined account for the same share of German exports as China. Adding Korea and Japan, which are not faring well either due to falling world trade, we get to 10% of total German exports – or about 4% of nominal annual GDP. In other words, the positive spillover effect of Chinese stimulus on export-dependent economies such as Germany and the rest of the EA could now be offset by further demand contraction in other major export markets. German growth seems poised to remain slow for longer and the balance of risks is now tilted to the downside.