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More signs of slowing (underlying) growth

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German GDP growth slowed palpably in Q1 to 0.3% qoq, down from a robust +0.6% qoq in Q4 2017. The deterioration in sentiment had already become evident with declining ifo and PMI indices and weak industrial output. As industrial production remained sluggish and new orders heavily declined in Apr Q2 M&E investment growth could be restrained. No positive impulses are expected from net exports as long as international trade tensions continue. For these reasons, we have recently adjusted our annual growth forecast from 2.3% to 2%. Impulses for Q2 GDP growth should mainly come from the construction sector and consumption. Thanks to high wage settlements, private consumption should be the key growth driver. We also expect a rebound in government consumption after a weak Q1.

Lacklustre new construction – cycle unlikely to end soon. Given acute housing shortages, the Federal Statistical Office's new construction figures are taking a front seat in the media. In 2017 around 285,000 new residential units were completed (released May 2018). This is almost a stagnation compared to the previous year. The average annual growth rate of completions was 5% in the past three years. Against this backdrop, evidence is already mounting that the government's target of 1.5 million new dwellings in this legislative period can hardly be achieved. Assuming that completions continue to inch up by an annual 5% over the next years (DB forecast), less than 1.3 million new dwellings will be built. Consequently, price and rent growth looks set to remain dynamic and macroprudential risks are expected to increase.

Lending in Germany maintains momentum – companies stocking up on liquidity in Q1. In Q1, lending to non-financial companies and self-employed persons in Germany grew at the strongest clip since the financial crisis; the outstanding amount was up 4.3% year-on-year. The increase continues to be spread across all sectors, with growth rates of above 5% in both manufacturing and the services sector. Short-term loans grew particularly strongly due to companies stocking up on liquidity.

The view from Berlin: Transatlantic tensions to foster appetite for reforms in Europe? Against the background of the new US import tariffs on steel and aluminium and the developments in Italy Chancellor Merkel presented her views on EU and EA reforms signalling that Germany is prepared to move. This includes the preparedness to transform the ESM into a European Monetary Fund with the ability to evaluate EU countries' public finances and debt sustainability. She also mentioned short-term loans (up to 5y) to countries stressed by external circumstances. These loans will come under certain conditions, be limited and have to be repaid. Merkel also put forward her ideas for an EA "investment budget" for technology and competitiveness. With the volume being in the low double-digits of billions euro it is far behind President Macron's proposal for a stability and convergence budget of some points of the EU GDP but stretches out a hand to the southern neighbours.

More signs of slowing (underlying) growth

Economic forecasts

	Real GDP (% growth)			Consumer Prices* (% growth)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2017	2018F	2019F	2017	2018F	2019F	2017	2018F	2019F	2017	2018F	2019F
Euroland	2.6	2.1	1.7	1.5	1.6	1.5	3.5	3.3	2.7	-0.9	-0.6	-0.6
Germany	2.2	2.0	1.8	1.8	1.6	1.8	8.0	6.8	6.4	1.2	1.2	1.0
France	2.3	1.8	1.6	1.2	1.9	1.5	-0.6	-0.4	-0.4	-2.6	-2.1	-2.8
Italy	1.5	1.3	1.0	1.3	1.2	1.5	2.9	3.1	3.2	-2.3	-1.7	-1.2
Spain	3.0	2.8	2.5	2.0	1.5	1.7	1.9	1.6	1.4	-3.1	-2.1	-1.3
Netherlands	3.2	2.5	2.5	1.3	1.3	1.8	10.2	10.2	10.1	1.1	0.5	0.4
Belgium	1.7	1.9	1.8	2.2	1.9	1.7	-0.2	-0.7	-1.0	-1.0	-1.0	-1.0
Austria	3.1	3.0	2.3	2.2	2.1	1.8	1.9	2.4	2.7	-0.7	-0.6	-0.3
Finland	2.7	2.3	2.1	0.8	1.2	1.4	0.7	0.5	0.5	-0.6	-0.3	-0.3
Greece	1.3	2.3	2.2	1.1	0.6	1.0	-0.8	-0.5	0.0	0.8	1.5	2.0
Portugal	2.7	2.2	1.7	1.6	1.0	1.5	0.6	0.4	0.2	-3.0	-1.0	-1.0
Ireland	7.8	5.4	3.3	0.3	1.0	1.3	12.5	6.0	3.0	-0.3	0.1	-0.4
UK	1.8	1.3	1.6	2.7	2.4	2.1	-4.1	-3.8	-3.5	-1.5	-1.9	-1.4
Denmark	2.2	2.0	1.9	1.1	1.5	1.6	7.9	7.5	7.0	0.9	-0.5	-0.5
Norway	2.0	2.2	2.0	1.9	1.9	1.8	5.5	6.0	5.5	4.4	4.0	5.0
Sweden	2.5	2.7	2.4	1.8	1.9	2.0	3.3	4.0	4.0	1.3	1.0	0.5
Switzerland	1.1	2.2	1.8	0.5	0.5	0.6	9.8	11.2	11.4	0.6	0.2	0.2
Czech Republic	4.6	3.4	3.1	2.5	1.9	2.1	1.0	0.6	1.1	1.6	0.8	0.6
Hungary	4.0	3.8	3.2	2.3	2.7	3.2	2.9	1.9	1.5	-2.0	-2.2	-2.3
Poland	4.6	4.2	3.4	2.0	1.9	2.8	0.3	-0.8	-1.1	-1.6	-2.0	-2.3
United States	2.3	2.9	2.8	2.1	2.6	2.2	-2.9	-3.2	-3.5	-3.6	-3.7	-5.3
Japan	1.7	0.7	0.6	0.5	1.0	0.8	4.0	4.1	4.4	-2.7	-2.6	-2.4
China	6.9	6.6	6.3	1.6	2.7	2.4	1.3	0.6	0.3	-3.7	-3.5	-3.5
World	3.8	3.9	3.9	2.9	3.4	3.2						

*Consumer price data for European countries based on harmonized price indices except for Germany. This can lead to discrepancies compared to other DB publications.
Sources: National Authorities, Deutsche Bank

Forecasts: German GDP growth by components, % qoq, annual data % yoy

					2018				2019			
	2016	2017	2018F	2019F	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Real GDP	1.9	2.2	2.0	1.8	0.3	0.6	0.5	0.5	0.4	0.4	0.4	0.4
Private consumption	2.1	1.8	1.6	1.5	0.4	0.7	0.5	0.5	0.3	0.4	0.3	0.2
Gov't expenditure	3.7	1.5	0.6	1.0	-0.5	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Fixed investment	3.1	3.3	4.0	3.5	1.7	1.3	1.0	0.8	1.0	0.9	0.9	0.8
Investment in M&E	2.2	4.0	4.5	3.0	1.2	1.0	1.0	0.5	1.0	0.7	0.7	0.5
Construction	2.7	2.8	4.7	4.9	2.1	1.8	1.2	1.2	1.2	1.2	1.2	1.2
Inventories, pp	-0.2	0.2	-0.1	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exports	2.6	4.6	3.8	4.5	-1.0	1.2	1.2	1.2	1.1	1.0	1.0	1.2
Imports	3.9	5.2	3.4	5.1	-1.1	1.4	1.4	1.4	1.2	1.2	1.1	1.2
Net exports, pp	-0.3	0.1	0.4	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Consumer prices*	0.5	1.8	1.6	1.8								
Unemployment rate, %	6.1	5.7	5.3	4.8								
Industrial production	1.4	3.0	1.8	1.5								
Budget balance, % GDP	1.0	1.2	1.2	1.0								
Public debt, % GDP	68.2	64.1	60.3	57.0								
Balance on current account, % GDP	8.5	8.0	6.8	6.4								
Balance on current account, EUR bn	268.8	262.5	229	225								

*Inflation data for Germany based on national definition. This can lead to discrepancies to other DB publications.
Sources: Federal Statistical Office, German Bundesbank, Federal Employment Agency, Deutsche Bank Research

German GDP growth slowed palpably in Q1

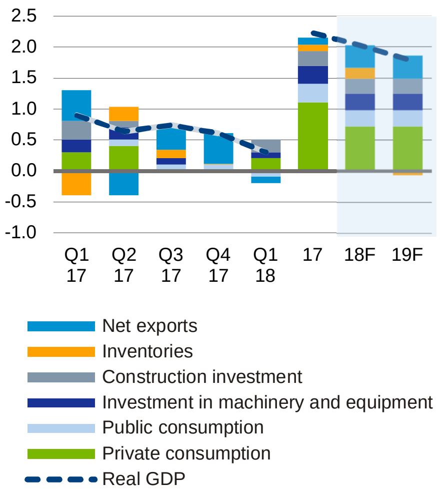
— Germany's GDP growth rate dropped to 0.3% qoq in Q1 2018. At the same time, sentiment indicators declined and industrial output was weak, not least due to heightened geopolitical uncertainties and an unusually severe flu season in Germany. Sentiment brightened somewhat at the beginning of Q2.

— We expect some revival in Q2, mainly driven by domestic demand. The favourable labour-market development and high wage agreements in Q1 (which even exceeded expectations) should continue to boost household consumption.

— With trade tensions continuing, the global economic environment is unlikely to become easier for German exporters. The effects of the recent euro depreciation will not be fully felt until H2; for now, the significant appreciation seen in the last few quarters should continue to predominate. External growth impulses in Q2 look set to be neutral at best.

Domestic economy the main growth driver 1

Contributions to real GDP growth, qoq, pp



Sources: Federal Statistical Office, Deutsche Bank Research

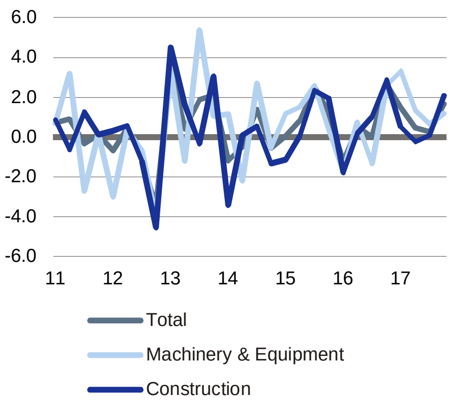
GDP details for Q1 2018: Investment as the main growth driver

German GDP growth slowed palpably in Q1, to 0.3% qoq, down from a robust +0.6% qoq in the final quarter of 2017. This confirms the deterioration in sentiment, which became evident when the ifo and PMI indices declined and industrial output was weak in spring. .

In Q1, any impulses for growth came from the domestic economy, with investment being the main driver. Investment in machinery and equipment contributed 0.1 of a pp and construction investment another 0.2 of a pp to quarter-on-quarter GDP growth. Following half a year of near stagnation, private consumption picked up in real terms and contributed 0.2 of a pp. However, the decline in government consumption and net exports each shaved off 0.1 of a pp from the quarter-on-quarter growth rate.

Investments 2

% qoq



Source: Federal Statistical Office

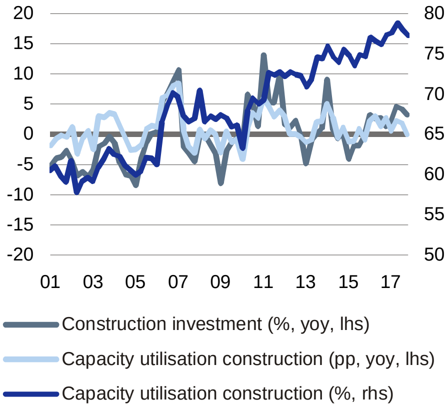
Significant pick-up in private-sector investment – environment mixed

During Q1, private-sector investment benefited both from very high industrial capacity utilisation (88%) and strong demand for construction work; in fact, capacities in the construction sector are fully booked for four months ahead. Private investment in machinery and equipment therefore accelerated, to 1.2% qoq in Q1 (Q4 2017: 0.7%). Corporate financing conditions are still favourable. Thanks to healthy profits, companies can also rely on sizeable amounts of own cash.

At the same time, recent geopolitical developments, in particular the intensifying trade conflict with the US, are weighing on sentiment and (what is even more important for investment activity) on expectations. The ifo business expectations component has steadily declined since the beginning of the year and dropped to 99.6 in May (H2 2017: 105.4). In particular, the balance of ifo export expectations was down to 13.6 – a level last seen in January 2017. This suggests that investment in machinery and equipment will not necessarily continue to grow, despite high capacity utilisation. Due to the lack of skilled labour, companies are increasingly investing in training their staff. However, training expenses are not included in the official statistics on investment.

Private-sector construction investment rose considerably, by 2.1% qoq (Q4 2017: 0.5%). In addition, the Federal Statistical Office revised its figure for construction investment growth in Q4 2017 up by 0.5 pp, to 0.1% qoq. Sentiment in the construction sector is still buoyant, and the ifo sentiment index for the construction sector climbed to a new record high in May, at 111.8. The small dent at the beginning of the year has been more than offset. With capacity utilisation near 80%, i.e. just below its all-time high, the lack of labour and delays along the supply chains are the main hurdles for the completion of construction projects.

Construction investments: Capacity bottlenecks 3



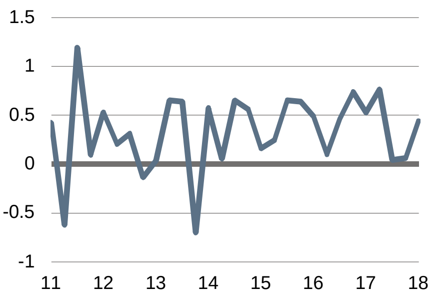
Sources: ifo, Federal Statistical Office, Deutsche Bank Research

Household consumption benefits from good labour market situation

Following half a year of near stagnation, private consumption picked up in real terms and rose by 0.4% qoq. This normalisation was supported by a strong increase in national income (+4% yoy). Wage income grew very dynamically in a year-on-year comparison (+4.6% yoy), and corporate and capital income also rose at a robust clip (+2.9% yoy). The very favourable labour market situation continues to support household consumption, too. The total number of workers was up 1.4% yoy, or 609,000, in Q1, and the unemployment rate declined to 5.4%. Against this background, wage negotiations in the public sector (2018: +3%), the metals and electronics industry (2018: +3.9%) and the construction sector (2018: +4.7%) resulted in very strong wage increases. The majority of these agreements will enter into force in Q2 and should boost household consumption further, even though oil prices have recently risen and the euro has depreciated since the beginning of Q2.

Revitalisation of real private consumption 4

Real, % qoq



Source: Federal Statistical Office

Government expenditure declines for the first time in almost 5 years

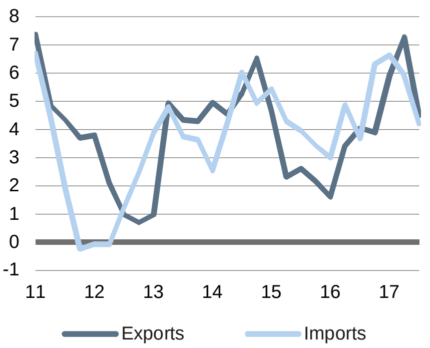
Government expenditure fell 0.5% qoq in Q1. This was the first decline in almost five years. In all probability, the drawn-out coalition negotiations played a role in this development. Until the establishment of the permanent committees of the Bundestag on January 31, 2018, a Main Committee dealt with regular administrative parliamentary issues. A look at the details shows that government spending was reduced across the board (administrative spending, security and defence, research and development, infrastructure and business support). Government expenditure is likely to normalise during the second quarter.

No positive contribution from net exports

Net exports dampened GDP growth in Q1. Exports shrank by 1% qoq, and imports fell by 1.1% qoq. Persistent trade tensions and geopolitical uncertainties in the Middle East caused the balance of the ifo export expectations to decline steadily, down to 13.6 in May. This level was last seen in January 2017. The new export order component of the PMI also dropped to a two-year low in May, at just above 52 points. Since it seems unlikely that a solution for the underlying causes for this development will be found in the near future, the contribution from net exports to GDP growth will be neutral in Q2.

Real imports and real exports decreased in Q1 5

Real, % qoq



Source: Federal Statistical Office

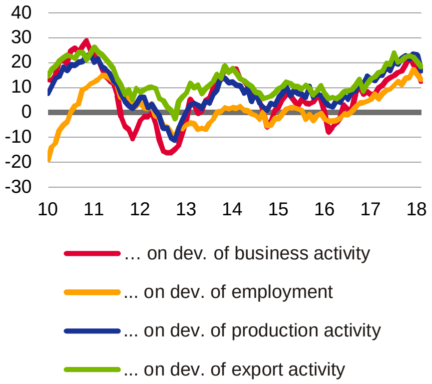
Outlook for Q2 – after the flu season is before the trade conflict

Now that the German economy has overcome the impact of the severe flu season in Q1, it is still faced with the persistent trade conflict. As long as the uncertainty about the future of international trade continues, we expect no growth impulses from net exports to GDP growth. In April exports dropped

More signs of slowing (underlying) growth

Sentiment indicators in the German industry still in positive territory 6

Company expectations, balance of positive and negative company reports



Source: ifo Institute

slightly (-0.3% mom), the third negative month in 2018, whereas imports grew strongly by 2.2%. As a result, net exports may dampen Q2 GDP growth. Industrial production and new orders also declined in April, which curbs our outlook on investments. For these domestic and external reasons, we have recently adjusted our annual growth forecast from 2.3% to 2%. That said, we remain positive on the development of household consumption as retail sales surprised to the upside. Thanks to high wage settlements and the good labour-market situation, the momentum should continue in Q2. Government consumption looks set to rise again, so, all in all, domestic demand should remain the key growth driver in Q2.

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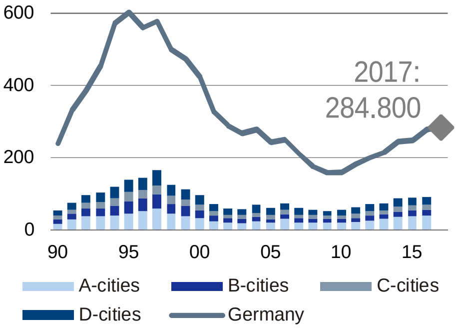
Completions 1

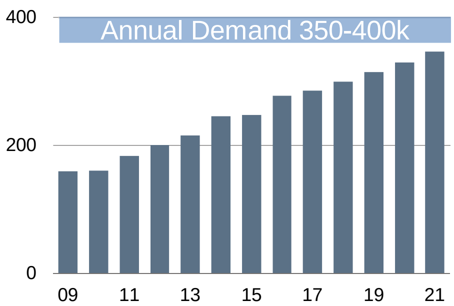
No. of dwellings in '000



Sources: riwis, Statistisches Bundesamt, Deutsche Bank Research

Completions vs. demand 2

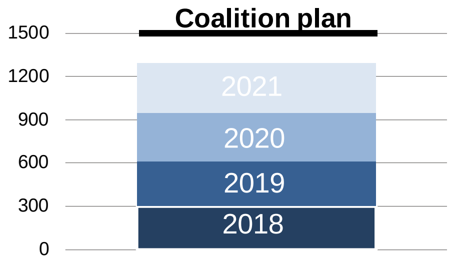
Number of dwellings '000



Sources: Deutsche Bank Research, Federal Statistical Office

Coalition plan in the legislative term vs. DB forecast 3

Number of dwellings '000



Sources: Deutsche Bank Research, Federal Statistical Office

4


Deutsche Bank Research

Germany Monitor

The German housing market in 2018

Price and rent outlook for Berlin, Düsseldorf, Frankfurt, Hamburg, Munich and Stuttgart

January 26, 2018

Lacklustre new construction – cycle unlikely to end soon

— Given acute housing shortages, the Federal Statistical Office's new construction figures are taking a front seat in the media. According to the data released on May 24, 2018, around 285,000 new residential units were completed in 2017, an increase of only 7,000 dwellings or 2% compared with the previous year.

— The average annual growth rate of completions was 5% in the past three years and only 7.5% since 2009. The reasons for the sluggishness are clear: lack of land for construction, strict regulatory conditions, rising building costs, skilled labour shortages and high capacity utilisation in the construction sector. These stumbling blocks for construction activity ought to slow new construction over the next few years.

— Against this backdrop, evidence is already mounting that the German government's target of 1.5 million new dwellings in this legislative period (2018-21) can hardly be achieved. Assuming that completions continue to inch up by an annual 5% over the next years (DB forecast), less than 1.3 new dwellings will be built.

— Demand for housing continues to be strong. Consequently, growth of prices and rents looks set to remain high. Moreover, private households are reducing their credit aversion. Recently, private household borrowing has picked up and, at the same time, the rate of redemption declined slightly. Looking forward, macroprudential risks are increasing.

Starting point for 2018 – moderate headwinds

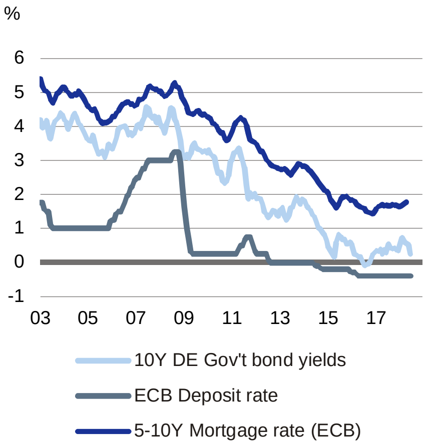
In our outlook for the German housing market, we discussed at the beginning of 2018 two new major developments in this cycle. Firstly, capital market rates and mortgage rates are likely to edge up slightly, given signals from the ECB that it could terminate its bond-buying programme by the year end. Secondly – as suggested by the coalition treaty – the federal government plans to strongly expand new construction for the first time in the current house price cycle. Given the ongoing supply shortage and our expectation of a shortfall of more than 1 million dwellings in Germany, we considered it highly unlikely that the house price boom is coming to an end and expected prices to rise further. Against this backdrop, we now analyse the effects of the political crisis in Italy on future mortgage rates as well as the Federal Statistical Office's recent data release on new construction in 2017.

Mortgage rates at 2% by year-end, despite Italy crisis

Led by the initial political muddle in Italy following the election in March, Italian sovereign bonds sold off. Yields temporarily soared, and spreads vis-à-vis Bunds widened even more sharply than yields due to the flight into safe havens. In view of the ECB's still-massive bond purchases of EUR 30 bn per month, these market reactions are an alarming signal. We nonetheless stick to our year-end forecast of 1.25% for 10-year Bund yields. With the ECB's exit from its bond-purchasing programme, the main buyer drops out of the euro area bond market in future and, as a result, Bund yields ought to rise, too. According to the ECB, 5-10-year mortgage rates are currently 1.77% (April 2018). We therefore maintain our forecast of 2% for this year. In the years ahead, capital market yields and, consequently, mortgage rates will continue to rise only moderately.

As a result, housing demand ought to come down only slightly from elevated levels.

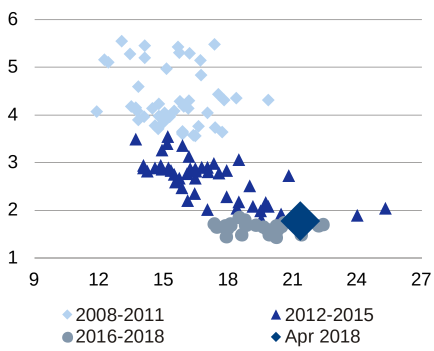
Mortgage rate, gov't bond yields vs. ECB deposit rate 5



Sources: Deutsche Bank Research, ECB

Dynamic mortgage credit growth 6

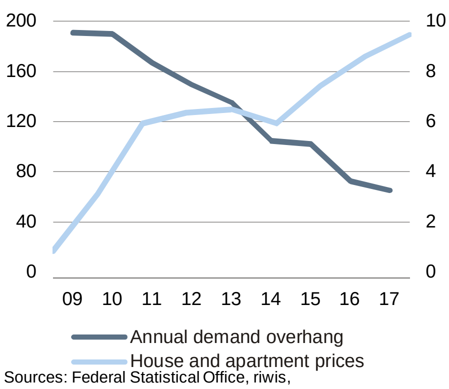
y-axis: Mortgage rate in %
x-axis: New mortgages in EUR bn per month



Sources: Bundesbank, Deutsche Bank Research

Additional annual demand overhang vs. prices 7

left y-axis: No. of dwellings in '000
right y-axis: Prices in % yoy



Sources: Federal Statistical Office, riwis, Deutsche Bank Research

When will we raise our forecast for mortgage rates?

Although real economic leading indicators in EMU have declined over the past months, they are still at levels pointing to above-potential growth, and the global economy continues to be robust after all, despite higher energy prices and several persisting economic and geopolitical risks.

From our perspective, economic risks include a potential acceleration of global inflation, above all in the United States, and, accordingly, higher money and capital market interest rates. European bond markets might not escape this trend, especially in view of the fact that the end of the ECB's bond purchases is drawing near. This scenario would point to an upward revision to our forecast for long-term mortgage rates.

When will we lower our forecast for mortgage rates?

A downward revision, however, is discussed more often. An adjustment to the downside may be on the cards, particularly if the political uncertainty in Italy and/or the trade conflict between the United States and China leave their mark on the economy in the course of the year. On top of that, growth could be slowed by a materialisation of further risks including the complete cancellation of the Iran nuclear deal, a disorderly Brexit or other geopolitical risks. Global central banks were likely to react, should these risks materialise. Money and capital market interest rates would decline resp. rates in the euro area would not rise as expected. In such a scenario, we could lower our forecast for long-term German mortgage rates.

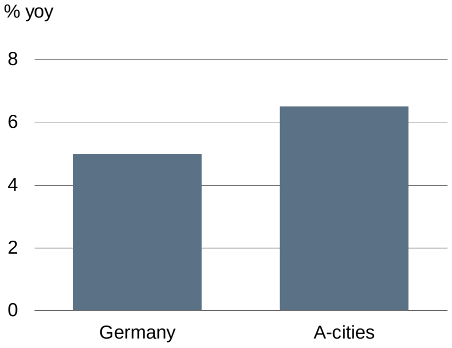
Further stagnation of residential construction is an alarming signal

Unlike the interest rate front, housing supply is much less uncertain. To date, the market trend is dominated by the shortfall of residential units. According to the Federal Statistical Office, 247,700 dwellings were completed in 2015, well below expectations and nearly flat on 2014. In 2016, completions rose sharply to almost 277,700. For 2017, however, the recent data release indicates an increase to just 284,800 (DB exp. 305,000), up by roughly 7,000 dwellings or slightly above 2% compared with the previous year. Hence, the average annual growth rate in the past three years was a meagre 5%. Given sluggish growth momentum, annual demand of at least 350,000 apartments looks set to exceed supply until 2022. This would result in a demand overhang of well above 1 million apartments, which ought to be reduced only slowly in the years beyond. As a consequence, upward price pressure is unlikely to meaningfully subside before 2022.

Structural reasons for sluggish construction activity

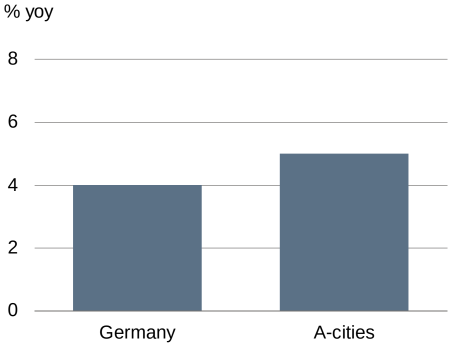
The reasons for low construction investment are clear: lack of land for construction, strict regulatory conditions, rising building costs, and skilled labour shortages. Removing these stumbling blocks is a mammoth task, the more so as politicians in densely populated areas have little incentive to present comprehensive solutions. The processes are complex, many building authorities are understaffed, civic participation is strong, furious citizens regularly come on the scene, and, as a result, the implementation of large building projects may

2018-2022 Forecast: Residential house prices 8



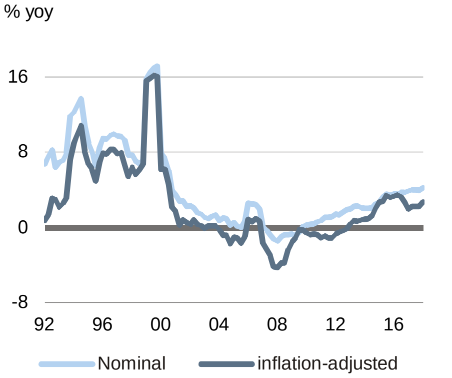
Source: Deutsche Bank Research

2018-2022 Forecast: Residential Rents 9



Source: Deutsche Bank Research

Mortgage credit 10



Sources: Bundesbank, Deutsche Bank Research

easily take longer than a decade. Proactive politicians are hence faced with the risk of losing political majorities for their initiative or generating no political capital from large building projects.

New coalition's policy is likely to fail

Achieving the federal government's targets should be no easy task, given regional and local political structures. Its plans to build 1.5 million new apartments in the 2017-2021 legislative period are beyond reach, due to sluggish construction activity. If – as in recent years – completions continue to rise at an annual rate of 5%, less than 1.3 million apartments will be completed in this legislative period. With capacity utilisation at an all-time high, many government measures from the introduction of child benefits for homes to tax reliefs to public-sector investment in social housing will primarily result in crowding-out effects and even higher prices. Against this backdrop, the impulses for new construction ought to be marginal, in our view. The government's failure to make housing policy an issue of national relevance between 2009 and 2017 is now taking its toll. Political inertness in the early years of the house price cycle is a key reason why strong price momentum is now also leaving its mark on rents. Every tenant who terminates a rental contract after several decades is confronted with massive rent increases. Against this backdrop, dissatisfaction is bound to rise among voters.

Medium-term outlook positive

Given these conditions, residential house price and rental inflation will remain high in the next years. According to our forecast, apartment prices in the biggest 126 towns and cities are likely to edge up by around 5% yoy between 2018 and 2022. For the metropolitan areas (A-cities), we expect price increases of 6 ½% in the same period. Like in recent years, rents will also rise at a much faster rate than consumer price than consumer price inflation. We reckon with rent increases of roughly 4% in the biggest 126 towns and cities, and around 5% in the metropolitan areas. In the following years, price momentum ought to remain at similar levels. Correspondingly, the risk of overvaluation increases. Based on the price to income ratio, prices for owner-occupied homes in Germany could exceed historically fair prices by on average 20% in 2022, as indicated by our calculations. If housing is still scarce by then, the German housing market might be in for a full-blown bubble – a scenario we have warned about for years.

Poor credit growth so far, but risks are increasing

Currently, year-over-year nominal credit growth in the German mortgage market is only 4%. In inflation-adjusted terms, volumes were up by 2.7% on the year. On a cumulative basis, nominal mortgage volumes have increased by 23% since Q1 2009. In real terms, they inched up by just 10%, and declined from 44% to 40% relative to GDP, which means that the house price cycle is almost creditless. But there are signs pointing to stronger credit growth in the future. Over the entire cycle, new lending activities, which are relatively sensitive to interest rates, was accompanied by high and rising rates of redemption. Recently, however, the repayment rate has dropped to below 3%, from its peak of 3.2% per year. In parallel, average lending of German households rose markedly over the past 12 months. The combination of these two factors ought to provide a slight lift to credit growth. In view of low supply and high prices for owner-occupied homes, many households might be increasingly forced to step up lending to get a chance on the German housing market. Looking forward, macroprudential risks are therefore increasing, especially if – as described above – the cycle continues well beyond 2022.

Summary

Provided the new Italian government pursues a less confrontational course, bond markets' uncertainty surrounding the recent Italy crisis could fade further in the near term, leaving German mortgage rates by year-end relatively unaffected. The moderate expansion of new construction in 2017 is a clear indication that the current house price cycle will continue. The federal government's target of 1.5 million new apartments in this legislative period is thus moving beyond reach. In the years ahead, new construction ought to be sluggish, and we do not expect the upward cycle to end before 2022. Given strong demand and limited supply, prices and rents are likely to rise further. By 2022, prices of owner-occupied homes could be overvalued by 20% based on historical price-to-income ratios. At the same time, there are first signs that the credit aversion of German consumers is declining somewhat, which means that macroprudential risks are increasing. If demand continues to exceed supply after 2022, the German housing market will be in for a full-blown bubble – a scenario we have warned about for years.

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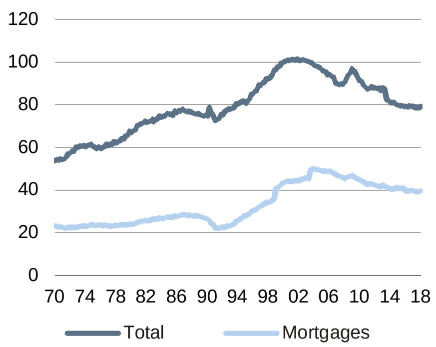
Germany: Credit volume 11

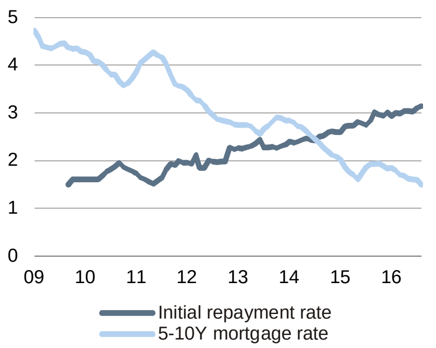
% of GDP



Sources: Bundesbank, Deutsche Bank Research

Repayment and mortgage rate 12

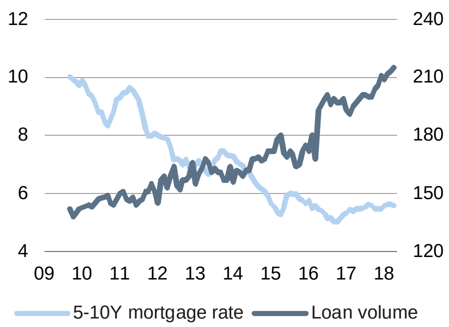
% per annum



Sources: ECB, Dr. Klein, Deutsche Bank Research

Repayment and loan volume 13

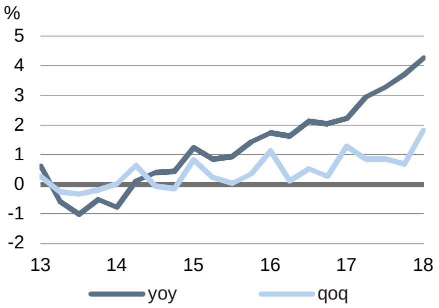
left y-axis: % per annum
right y-axis: EUR k



Sources: Dr. Klein, Deutsche Bank Research

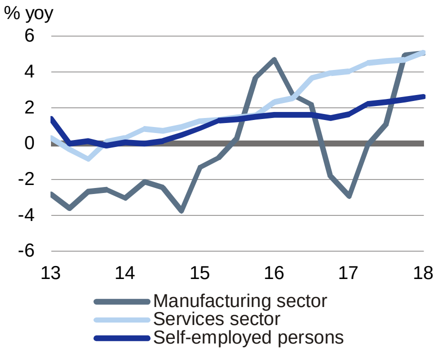
More signs of slowing (underlying) growth

Loans to domestic companies and self-employed persons* 1



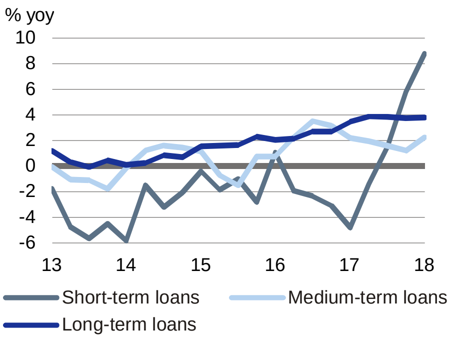
* excl. other financial institutions
Sources: Bundesbank, Deutsche Bank Research

... by industry 2



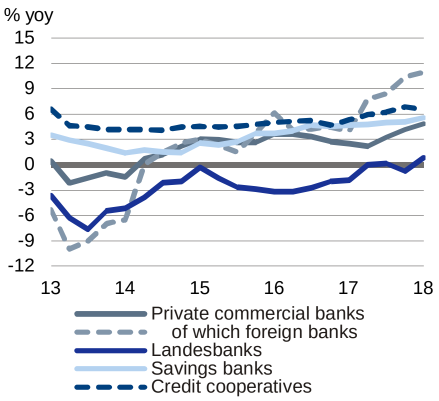
Sources: Bundesbank, Deutsche Bank Research

... by maturity* 3



* excl. other financial institutions
Sources: Bundesbank, Deutsche Bank Research

... by banking group* 4



* excl. other financial institutions
Sources: Bundesbank, Deutsche Bank Research

Lending in Germany maintains momentum – companies stocking up on liquidity in Q1

In Q1, lending to non-financial companies and self-employed persons in Germany grew at the strongest clip since the financial crisis; the outstanding amount was up 4.3% year-on-year. The increase continues to be spread across all sectors, with growth rates of above 5% (i.e. a post-crisis record level) in both manufacturing and the services sector. Lending to mechanical engineering/automotive industry (+10%), investment companies (14%), chemicals industry (8%) and utilities/mining (7%) is growing particularly strongly.

During Q1, which is traditionally their strongest quarter, the biggest increase was registered in short-term loans (maturity < 1 year); their volume was up 8.3% qoq, i.e. more strongly than in any other quarter since reunification. This might be due to the palpable slowdown in GDP growth and intensifying concerns about a trade war, which have caused companies to become more cautious. They have therefore stocked up on liquidity in a similar way to 2007/08. Excluding the exceptional increase in short-term loans, credit growth came in at 3.4% yoy.

All banking groups saw their lending volumes grow between December and March. As before, foreign banks are leading the pack (+11% yoy), followed by cooperative banks (+6½%) and savings banks (+5½%). Domestic commercial banks also experienced a good quarter after a relatively long dry spell and registered credit growth of almost 2% yoy. The Landesbanks achieved a meaningful increase (1%) for the first time since 2009. Nevertheless, the bifurcation of the market Nevertheless, the bifurcation of the market remains in place, and locally-focused banks and foreign banks continue to gain market share.

At the same time, deposits from enterprises and self-employed persons shrank more strongly in Q1 than in any other quarter since 2013. Even sight deposits declined by EUR 4 bn after a period of steady growth. Ultimately, after a long period of surprisingly healthy deposit growth, the extremely low – and therefore unattractive – interest rates seem to be taking their toll. This development had already been on the cards for some quarters. Rates on sight and term deposits are, in fact, in quite negative territory, at -3 and -6 bp, respectively. The increase in lending and the simultaneous decline in deposits are due to several factors: i) Companies have made relatively large investments in Q1. ii) They have reduced their capital market liabilities, i.e. redeemed corporate bonds. iii) Companies have probably invested part of the additional liquidity outside the banking sector.

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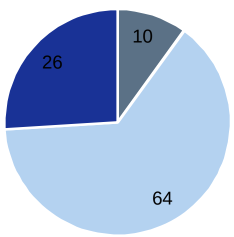
The view from Berlin. Transatlantic tensions to foster appetite for reforms in Europe?

The month of June started with the US following through with the 25% tariffs on steel and aluminium imports that the US administration announced back in March. At the recent G7 Finance Ministers meeting six of the ministers voiced their “unanimous concern and disappointment” regarding the US action against its allies and now all eyes will be on the G7 summit in this regard. The EU Commission in charge of trade policy confirms that its response would be above all drawing up a list with retaliatory tariffs (German Economics Minister Altmaier expects the agreement on that within the next two weeks) as well as taking the case against the US to the WTO’s dispute resolution mechanism as it believes that the new tariffs on the ground of national security are a breach of WTO rules. The EU’s move is joined by Canada, Mexico and China. But it seems unlikely that the EU’s initial reaction will follow the tit-for-tat principle, i.e. reach the same amount as the recent US measures, but be more moderate. There had been indications that the EU might consider taking a WTO case against China on the issue of intellectual property rights – not least to show the US that there would be a shared interest in keeping the world trade system as open and fair as possible. While an escalation of the situation should be in no one’s interest there is a non-negligible risk of derailing the global trade order with the respective negative repercussions on business confidence and growth.

German business leaders' view on the recent US trade policy's impact 1

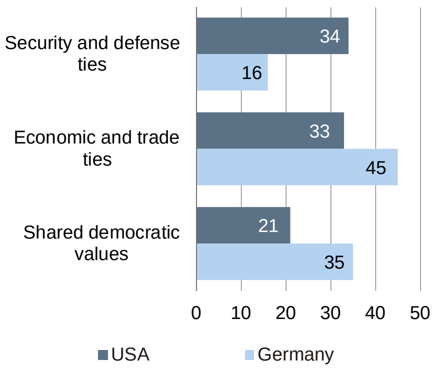
The risks for the German economy resulting from the US trade policy are ..., % of those asked



Sources: CAPITAL-FAZ-Elite-Panel, IfD Allensbach, May 2018

Which are the core elements of the U.S.-German relationship? 2

in %



Sources: Pew Research Center / Körber Stiftung, Oct. 2017

Growing alienation between Germany and the US

In Germany, political and business leaders are particularly alarmed. The concern is both more general – about compliance with WTO regulations and the future of a rule-based trade order – and more specific about an extension of tariffs to other sectors, above all cars as threatened by President Trump. While the impact of the steel and aluminium tariffs should be manageable, the prospect of a 25% tariff on cars on the grounds of “national security” could cost the German economy up to EUR 5bn. Thus 74% of the opinion leaders surveyed regard the negative impact of the US trade policy a (very) big risk for the German economy, and 55% of the business leaders expect their company to be affected directly (CAPITAL-FAZ-Elite Panel, May 2018). They support a strong positioning of the German government towards the US and back the EU Commission’s decision to implement retaliatory tariffs (62% of those surveyed).

In a wider sense, there seems to be an increasing alienation and a decrease in mutual understanding between the Germans and the Americans. While 68% of Americans believe that relations between the US and Germany are good, already back in Oct 2017 a 56% majority of Germans took the opposite view (Pew Research Center) and the recent developments have most probably driven up these numbers further. 70% of Germans think that Europe and the US are drifting apart, up from 32% in 2011 (IfD Allensbach, May 2018). Americans and Germans also have different perspectives on the core elements of the US-German relationship (see chart). Conversely to the decline of trust in transatlantic partnership and the perception of the US as a reliable partner, demands for Europe assuming more responsibility for its future meets broad public support.

Merkel details her views on EU reforms

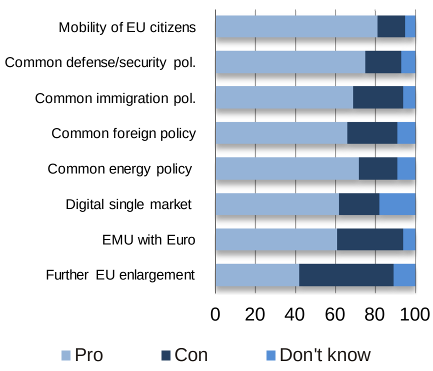
Given the increasing transatlantic tensions and Germany’s particular vulnerability to Trump’s policy as well as markets’ reactions to developments in Italy, it was not by chance that Chancellor Merkel gave one of her rare press interviews last weekend (FAS, June 3, 2018). In the long awaited response to President Macron's proposals for reforming the EA she offered some more clarity on a number of issues the coalition treaty from March had already included. She spent, however, more time talking about closer EU cooperation in defence security (now even backing Macron's idea of an intervention initiative) as well as a common asylum policy and external border control which she considers more important to counter the increasing eurosceptical populism in parts of the EU than the technicalities of EA reforms and budget lines. .

Merkel repeated her preparedness to transform the ESM into a European Monetary Fund with the ability to evaluate members' economies, public finances and debt sustainability (incl. appropriate instruments to restore debt sustainability if necessary). The existing option of long-term loans in case of the EA being at risk could be complemented with short-term loans (up to a five-year-maturity) to countries that experience stress due to external circumstances. These loans would come with certain obligations, too, would be limited and would have to be repaid. The possibility of a sovereign bond restructuring – as indicated by Merkel – is a red line for France (and Italy) as they are concerned that this might reduce the markets' trust in the creditworthiness of sovereign bonds while some other EA members such as the Netherlands are in favor of such a mechanism. As mentioned in the coalition treaty the EMF should remain an intergovernmental body under the control of national parliaments.

Merkel also put forward her ideas for an "investment budget" for the EA to improve the convergence in the EA with the focus on investment in technology and competitiveness. With the volume being in the low double-digits of billions of euro (introduced gradually) and left open if in- or outside the EU budget, it falls short of Macron's proposal for a stability and convergence budget of some percentage points of EU GDP but stretches out a hand to the southern neighbours. Merkel's idea shares some similarities with proposals put forward by the EU Commission in the context of the Multiannual Financial Framework, the next EU budget 2021-2027. They foresee a EUR 30 bn subsidized loan plan (outside the budget but guaranteed by it) for countries hit by external shocks to avoid cuts in investment as well as a budget line of EUR 25 bn within the cohesion fund for conditional incentives for members to undertake structural reforms. With these proposals and the loss of the British contributions to the budget post-Brexit German financial commitment to the EU is set to increase

What is your view on the following topic? 3

in % - EU 28



Source: Standard Eurobarometer, Autumn 2017

In terms of asylum policy Merkel calls for a common refugee authority to carry out all asylum procedures on the basis of a uniform European asylum law. While more than two thirds of the EU public (Eurobarometer, autumn 2017) supports a common asylum and migration policy, the political views of the member states are distances away from each other. The June deadline to compromise on the EU's proposals for a recast of asylum rules looks set to be missed again.

Merkel offered more (fiscal) solidarity than some had expected making full use of the domestic political leeway which the overall positive German public sentiment on Europe and the backing of senior people of her CDU/CSU party as well as the SPD party leader Andrea Nahles provided. But she was clear also on the conditions attached thus not fully closing the gap to France and downsizing Macron's ambitions. With this interview she signaled that European politics remains with the Chancellery while leaving the topic of banking and capital union to the finance minister. On June 19, the German Chancellor and the French President will convene with their top ministers near Berlin to hammer out a joint position to overhaul the E(M)U. This will be a necessary but by no means sufficient exercise to yield a deal at the EU summit on June 28-29 as the two need to get the other 17 euro states or, on issues such as banking union, defence or asylum policy, the other 25 EU members on board.

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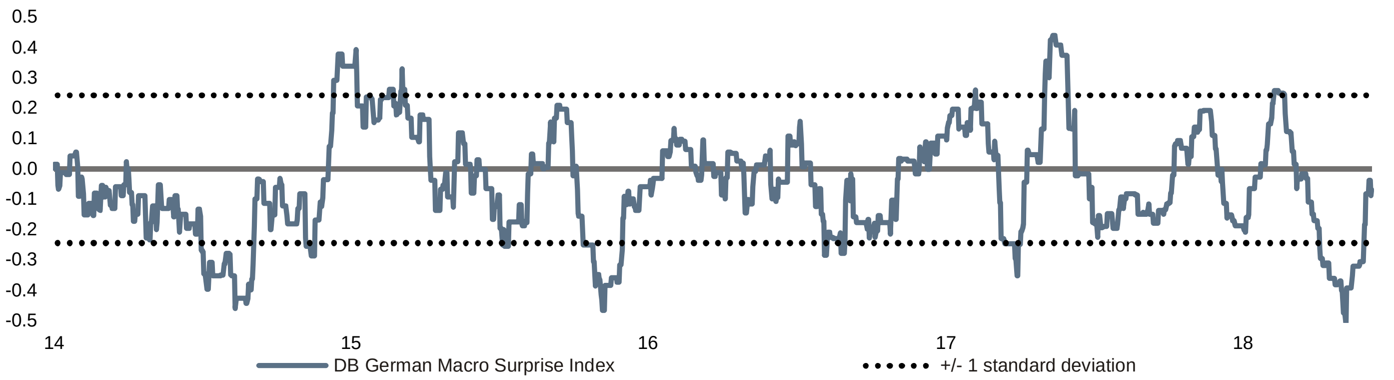
More signs of slowing (underlying) growth

DB German Macro Surprise Index

The DB German Macro Surprise Index compares published economic data with market forecasts and thus provides clues as to the direction of future forecast revisions.

DB German Macro Surprise Index

Average of last 20 z-scores of data surprises



Values above (below) 0 indicate the data came in better (worse) than expected

Sources: Bloomberg Finance LP, Deutsche Bank Research

Last 20 published economic data for Germany

Bloomberg Tickers	Indicator	Reporting month	Publication date	Current value	Bloomberg consensus	Surprise	Standardised surprise	Quantile rank
GRFRIAMM Index	Retail Sales (% mom)	3 2018	30/04/2018	-0.4	0.8	-1.2	-0.7	0.2
MPMIDEMA Index	Markit Manufacturing PMI	4 2018	02/05/2018	58.1	58.1	0.0	0.0	0.4
MPMIDESA Index	Markit Services PMI	4 2018	04/05/2018	53.0	54.1	-1.1	-1.2	0.1
GRIORTMM Index	Factory Orders (% mom)	3 2018	07/05/2018	-1.1	0.5	-1.6	-0.8	0.2
GRIPIMOM Index	Industrial production (% mom)	3 2018	08/05/2018	1.7	0.8	0.9	0.8	0.8
GRCAEU Index	Current Account Balance (EUR bn)	3 2018	08/05/2018	29.6	27.0	2.6	0.4	0.7
GRZEWI Index	ZEW Survey Expectations	5 2018	15/05/2018	-8.2	-8.2	0.0	0.0	0.6
GRZECURR Index	ZEW Survey Current Situation	5 2018	15/05/2018	87.4	85.5	1.9	0.2	0.6
GRCP20YY Index	CPI (% yoy)	4 2018	16/05/2018	1.6	1.6	0.0	0.2	0.3
GRGDPPGQ Index	GDP (% qoq)	3 2018	24/05/2018	0.3	0.3	0.0	-0.2	0.3
GRIFPBUS Index	IFO Business Climate	5 2018	25/05/2018	92.9	102.0	-9.1	-0.6	0.3
GRIMP95Y Index	Import Price Index (% yoy)	4 2018	30/05/2018	0.6	0.8	-0.2	0.2	0.5
GRUECHNG Index	Unemployment Change (000's mom)	5 2018	30/05/2018	-12.0	-10.0	2.0	-0.1	0.4
GRCP20YY Index	CPI (% yoy)	5 2018	30/05/2018	2.2	2.2	0.0	0.2	0.3
GRFRIAMM Index	Retail Sales (% mom)	4 2018	30/05/2018	2.3	0.5	1.8	1.7	0.9
MPMIDEMA Index	Markit Manufacturing PMI	5 2018	01/06/2018	56.9	56.8	0.1	0.1	0.5
MPMIDESA Index	Markit Services PMI	5 2018	05/06/2018	52.1	52.1	0.0	0.0	0.5
GRIORTMM Index	Factory Orders (% mom)	4 2018	07/06/2018	-2.5	0.8	-3.3	-1.6	0.0
GRCAEU Index	Current Account Balance (EUR bn)	4 2018	08/06/2018	22.7	20.0	2.7	0.5	0.7
GRIPIMOM Index	Industrial production (% mom)	4 2018	08/06/2018	-1.0	0.3	-1.3	-1.0	0.1

Sources: Bloomberg Finance LP, Deutsche Bank Research

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Source: Heiko Peters (2014). DB German Macro Surprise Index. Focus Germany, 4 August 2014.

More signs of slowing (underlying) growth

Germany: Events of economic-, fiscal- and euro-politics

Date	Event	Remarks
14 Jun	ECB Governing Council meeting, press conference, (external meeting in Riga, Latvia)	Our baseline view is that the QE exit announcement will be made in July. After Peter Praet's speech this week no one will be able to claim surprise if the ECB announces the end of QE at the Governing Council meeting on 14 June.
21-22 Jun	Eurogroup and ECOFIN meeting, Brussels	Debates on (poss.) implications of the spring forecast for excess deficit procedures (EDPs) and European Innovation Partnership (EIPs) for euro area countries, thematic discussions on growth and jobs: allocative efficiency in labour markets & pension sustainability, (poss.) IMF regional surveillance of the euro area, (poss.) IMF Financial Sector Assessment Programme – euro area aspects, Greece – state of play, among others.
28-29 Jun	European Council meeting, Brussels	Debates on the future of the EU, foreign affairs and international relations, esp. trade relations with the US and China, decision on the prolongation of sanctions against Russia, political exchange on the EU budget, (poss.) state of the Brexit negotiations; planned decision on the reform of the EU asylum policy likely to be postponed.
Mid-Jul - 7 Sep	Deutscher Bundestag Berlin	Parliamentary summer recess.
26 Jul	ECB Governing Council meeting, press conference	In the July council meeting the ECB may announce the QE exit. With the announcement the focus will directly shift to policy rates. We expect two 20bp deposit rate hikes and simultaneous 25bp refi hikes in Jun and Dec 2019. The soonest we could imagine a hike is June 2019.

Source: Deutsche Bank Research

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Germany: Data calendar

Date	Time	Data	Reporting period	DB forecast	Last value
22 Jun 2018	9:30	Manufacturing PMI (Flash)	June	56.2	56.9
22 Jun 2018	9:30	Services PMI (Flash)	June	52.5	52.1
25 Jun 2018	10:30	ifo business climate (Index, sa)	June	102.0	102.2
28 Jun 2018	14:00	Consumer prices preliminary (% yoy, nsa)	June	2.2	2.2
29 Jun 2018	9:55	Unemployment rate (%, sa)	June	5.3	5.2
29 Jun 2018	8:00	Retail sales (% mom, sa)*	May	1.0	2.3
5 Jul 2018	8:00	New orders manufacturing (% mom, sa)	May	2.7	-0.2
6 Jul 2018	8:00	Industrial production (% mom, sa)	May	1.1	-1.7
9 Jul 2018	8:00	Trade balance (EUR bn, sa)	May	20.3	19.2
9 Jul 2018	8:00	Merchandise exports (% mom, sa)	May	0.6	-3.1
9 Jul 2018	8:00	Merchandise imports (% mom, sa)	May	-0.3	-1.3

*An earlier data release may be possible due to the Federal Statistical Office.
Sources: Deutsche Bank Research, Federal Statistical Office, Federal Employment Agency, ifo, Markit

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More signs of slowing (underlying) growth

German data monitor

	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Jan 2018	Feb 2018	Mar 2018	Apr 2018	May 2018	Jun 2018
Business surveys and output											
Aggregate											
Ifo business climate	102.5	104.3	105.0	104.1		104.8	104.1	103.3	102.2	102.2	
Ifo business expectations	100.8	102.0	103.1	100.6		101.5	100.3	100.1	98.7	98.5	
Industry											
Ifo manufacturing	105.9	108.0	109.0	107.8		109.5	107.6	106.3	104.9	104.8	
Headline IP (% pop)	1.5	1.6	1.0	0.3		0.0	-1.7	1.6	-1.7		
Orders (% pop)	1.2	2.3	3.5	-2.2		-3.5	-0.2	-1.1	-2.5		
Capacity Utilisation	86.1	86.9	87.7	88.2	87.8						
Construction											
Output (% pop)	5.4	-0.4	-1.0			5.9	-7.2				
Orders (% pop)	-2.0	-1.7	10.2	-1.7		-12.8	9.9	-15.1			
Ifo construction	108.1	109.9	110.7	110.1		110.2	109.3	110.8	111.4	111.8	
Consumer demand											
EC consumer survey	3.6	4.1	5.5	6.7		7.4	6.5	6.1	6.1	5.9	
Retail sales (% pop)	0.5	0.5	0.8	-0.8		-0.6	-0.1	-0.4	2.3		
New car reg. (% yoy)	0.0	0.3	4.2	4.0		11.6	7.4	-3.4	8.0	-5.8	
Foreign sector											
Foreign orders (% pop)	1.5	3.5	4.9			-4.6					
Exports (% pop)	1.6	0.7	2.9	-0.6		-0.4	-3.1	1.8	-0.3		
Imports (% pop)	1.4	0.2	2.8	-0.1		-0.2	-1.5	-0.2	2.2		
Net trade (sa EUR bn)	60.5	62.0	64.3	62.6		21.5	19.4	21.6	19.4		
Labour market											
Unemployment rate (%)	5.7	5.7	5.5	5.4		5.4	5.4	5.3	5.3	5.2	
Change in unemployment (k)	-45.0	-25.7	-55.3	-69.0		-23.0	-21.0	-18.0	-7.0	-12.0	
Employment (% yoy)	1.4	1.5	1.4	1.4		1.4	1.4	1.4	1.4		
Ifo employment barometer	102.6	103.3	104.0	104.8		105.5	105.0	103.9	103.3	104.1	
Prices, wages and costs											
Prices											
Harmonised CPI (% yoy)	1.6	1.7	1.6	1.4		1.4	1.2	1.5	1.4	2.2	
Core HICP (% yoy)	1.4	1.5	1.3	1.3		1.3	1.4	1.3	1.0	1.5	
Harmonised PPI (% yoy)	2.8	2.7	2.5	2.0		2.1	1.8	1.9	2.0		
Commodities, ex. Energy (% yoy)	8.9	4.2	-5.6	-12.4		-11.1	-13.5	-12.6	-6.3	5.9	
Crude oil, Brent (USD/bbl)	50.8	52.2	61.5	66.9		69.1	65.3	66.0	72.0	76.9	75.2
Inflation expectations											
EC household survey	17.6	16.3	16.0	16.4		16.6	18.3	14.4	15.1	16.8	
EC industrial survey	11.4	10.2	14.2	15.0		16.3	14.5	14.2	14.6	12.1	
Unit labour cost (% yoy)											
Unit labour cost	2.4	1.8	1.0	2.2							
Compensation	2.6	2.6	2.4	2.8							
Hourly labour costs	3.9	2.6	2.6	3.7							
Money (% yoy)											
M3	5.6	4.7	4.3	3.3		3.6	3.2	3.3	3.5		
M3 trend (3m cma)						4.1	3.7	3.4	3.3		
Credit - private	3.8	3.9	4.2	4.3		4.3	4.3	4.3	4.3		
Credit - public	4.1	5.5	-2.9	-20.0		-5.4	-12.9	-20.0			

% pop = % change this period over previous period.
Sources: Deutsche Bundesbank, European Commission, Eurostat, Federal Employment Agency, German Federal Statistical Office, HWWI, ifo, IHS Markit

More signs of slowing (underlying) growth

Financial Forecasts

	US	JP	EMU	GB	CH	SE	DK	NO	PL	HU	CZ
Key interest rate, %											
Current	1.625	-0.10	0.00	0.50	-0.75	-0.50	0.05	0.50	1.50	0.12	0.75
Jun 18	1.875	-0.10	0.00	0.50	-0.75	-0.50	0.05	0.50	1.50	0.05	0.75
Sep 18	2.125	-0.10	0.00	0.75	-0.75	-0.50	0.05	0.75	1.50	0.05	0.75
Dec 18	2.375	-0.10	0.00	0.75	-0.75	-0.25	0.05	0.75	1.50	0.05	1.00
3M interest rates, %											
Current	2.32	0.08	-0.33	0.63							
Jun 18	2.23	0.05	-0.30	0.60							
Sep 18	2.48	0.05	-0.35	0.55							
Dec 18	2.73	0.05	-0.35	0.75							
10Y government bonds yields, %											
Current	2.98	0.06	0.48	1.47							
Jun 18	3.00	0.00	0.50	1.35							
Sep 18	2.95	0.00	0.85	1.55							
Dec 18	3.25	0.00	1.25	1.80							
Exchange rates											
	EUR/USD	USD/JPY	EUR/GBP	GBP/USD	EUR/CHF	EUR/SEK	EUR/DKK	EUR/NOK	EUR/PLN	EUR/HUF	EUR/CZK
Current	1.18	109.96	0.88	1.34	1.16	10.26	7.45	9.50	4.29	317.36	25.65
Jun 18	1.24	102.00	0.91	1.37	1.20	9.60		9.25	4.16	317.00	25.44
Sep 18	1.17	105.00	0.86	1.36	1.18	9.50		9.10	4.17	316.00	25.05
Dec 18	1.20	102.00	0.85	1.41	1.20	9.20	7.46	9.00	4.19	315.00	24.75

Sources: Bloomberg Finance LP, Deutsche Bank Research

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