



Outlook 2019

Slowing growth, but no hard landing

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About a year ago, German business sentiment enjoyed new record highs virtually every month. On January 23, the DAX marked its record high (13,599.5), after rising by over 10% since October 2017. Not even professional forecasters could escape the widespread euphoria. The consensus forecast for German GDP growth in 2018 surged from 1.9% (Oct. 2017) to over 2.4% in February 2018. Si tacuisses ...

The 0.2% qoq drop in Q3 GDP was, of course, largely due to the WLTP effect, but underlying growth has also clearly slowed in 2018. After mustering 1.6% in 2018, we expect German GDP to expand by 1.3% in 2019. Growth should be only marginally higher in 2020, despite a strong positive working day effect, as a further slowing of the global economy and EUR appreciation will provide considerable external headwinds.

In 2019 private consumption and booming construction will remain the mainstays of growth. Capex investment should expand at an only modest rate as weak external demand and geo-political uncertainties will curtail animal spirits.

Although the (positive) output gap will likely stand in a 1 to 2 percentage points range of GDP in 2019, core inflation should pick up only marginally to 1.6%, as corporate bottlenecks are easing. With the oil price increase tapering off headline inflation should remain below 2% in 2019.

With the election of AKK short term risks to the Groko's survival have receded. But if one or both of the Groko partners performs badly in next year's Länder elections, tensions are expected to increase again as conflicting policy priorities – with the CDU focusing more on tax cuts and the SPD pushing hard for its "Sozialstaat 2025" agenda – will come to the fore.

While we still expect Brexit to take place on the basis of the current exit agreement, a hard Brexit would probably knock off more than 0.5pp of 2019 growth. Similarly, 25% US tariffs on EU cars would not only cut the German car industry to the quick, but impact other areas of the economy. The conflict between Rome and Brussels about Italy's fiscal plan is not expected to have a direct substantial impact on German GDP but could together with strong populist gains at the EP elections in May erode Germany's confidence in a rule-based E(M)U policy setting further.



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Economic forecasts

	Real GDP (% growth)			Consumer Prices* (% growth)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2018F	2019F	2020F	2018F	2019F	2020F	2018F	2019F	2020F	2018F	2019F	2020F
Euroland	1.9	1.4	1.3	1.7	1.6	1.7	2.7	2.3	2.0	-0.8	-1.0	-1.0
Germany	1.6	1.3	1.4	1.9	1.7	1.4	7.1	6.4	6.0	1.3	0.9	0.9
France	1.6	1.4	1.3	2.1	1.4	1.6	-0.4	-0.3	-0.2	-2.5	-3.1	-2.0
Italy	0.9	0.7	0.9	1.3	1.3	1.6	2.5	2.2	2.2	-2.2	-2.8	-2.7
Spain	2.5	2.4	2.1	1.8	1.5	2.1	1.4	1.2	1.0	-2.7	-2.2	-1.8
Netherlands	2.5	1.9	1.8	1.5	2.2	1.8	10.2	9.9	9.7	0.8	0.6	0.4
Belgium	1.5	1.4	1.4	2.3	2.1	1.8	0.3	0.4	0.5	-1.1	-1.3	-1.4
Austria	2.6	1.9	1.8	2.1	1.8	1.8	2.2	2.3	2.5	-0.2	0.1	0.3
Finland	2.4	1.9	1.8	1.2	1.2	1.6	-0.5	0.0	0.5	-0.7	-0.7	-0.6
Greece	2.0	1.9	1.8	0.9	1.5	2.5	-1.0	-0.6	-0.3	0.6	1.1	1.3
Portugal	2.2	1.7	1.5	1.2	1.1	1.8	-0.1	0.0	0.0	-0.8	-0.7	-0.6
Ireland	6.4	3.4	3.3	0.7	0.9	1.2	11.0	10.0	9.0	0.0	0.0	0.3
UK	1.3	1.6	1.4	2.5	2.0	2.1	-3.5	-3.3	-3.0	-1.1	-1.4	-1.4
Denmark	1.5	1.9	1.7	1.0	1.5	1.8	6.1	6.2	6.1	0.1	-0.2	0.2
Norway	2.4	2.1	2.0	2.6	2.1	2.0	6.2	6.0	6.1	5.4	5.3	5.2
Sweden	2.4	2.0	1.9	2.0	1.9	1.9	2.8	3.1	3.1	1.1	0.9	0.6
Switzerland	2.6	1.4	1.6	1.0	0.8	1.1	10.3	10.3	10.7	0.7	0.5	0.4
Czech Republic	3.0	2.9	2.8	2.2	2.3	2.1	0.7	0.6	0.5	1.0	0.4	0.1
Hungary	4.7	3.6	3.1	3.0	3.4	3.2	1.9	1.5	1.2	-2.3	-2.0	-1.8
Poland	4.8	3.5	3.2	1.7	2.5	3.0	-0.6	-0.8	-0.9	-1.0	-1.8	-2.4
United States	2.9	2.7	2.1	2.4	1.5	2.2	-2.7	-3.5	-3.5	-3.9	-4.6	-4.5
Japan	0.8	0.6	0.2	0.9	0.3	0.7	3.5	3.6	4.2	-2.6	-2.2	-1.9
China	6.6	6.3	6.0	2.2	2.4	2.6	0.5	-0.2	-0.4	-3.5	-4.5	-4.0
World	3.8	3.6	3.5	3.3	3.1	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

	2017				2018F				2019F				2020F				2019				2020							
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1F	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Real GDP	2.2	1.6	1.3	1.4	0.6	0.3	0.4	0.3	0.3	0.2	0.3	0.2	0.3	0.2	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Private consumption	1.8	1.2	1.1	1.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Gov't expenditure	1.6	0.9	1.7	1.3	0.4	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Fixed investment	2.9	3.4	3.2	2.8	0.7	0.7	0.7	0.6	0.7	0.7	0.7	0.6	0.5	0.4	0.4	0.5	0.5	0.4	0.4	0.4	0.5	0.5	0.4	0.4	0.4	0.5	0.5	0.5
Investment in M&E	3.7	4.4	2.7	2.4	0.7	0.7	0.7	0.5	0.7	0.7	0.7	0.5	0.3	0.0	0.0	0.3	0.3	0.0	0.0	0.0	0.3	0.3	0.0	0.0	0.0	0.3	0.3	0.3
Construction	2.9	3.5	4.2	3.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Inventories, pp	0.1	0.5	0.3	-0.1	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exports	4.6	2.1	2.1	3.2	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Imports	4.8	3.4	3.7	3.9	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8	0.8
Net exports, pp	0.2	-0.4	-0.6	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
Consumer prices*	1.7	1.9	1.7	1.4																								
Unemployment rate, %	5.7	5.2	4.8	4.7																								
Industrial production**	2.9	1.5	0.5	1.0																								
Budget balance, % GDP	1.0	1.3	0.9	0.9																								
Public debt, % GDP	63.9	60.5	57.6	54.6																								
Balance on current account, % GDP	8.0	7.1	6.4	6.0																								
Balance on current account, EUR bn	261.2	241	226	220																								

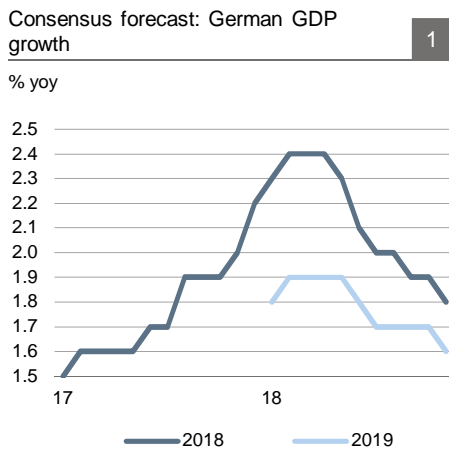
*Inflation data for Germany based on national definition. This can lead to discrepancies to other DB publications. **Manufacturing (NACE C)

Sources: Federal Statistical Office, German Bundesbank, Federal Employment Agency, Deutsche Bank Research



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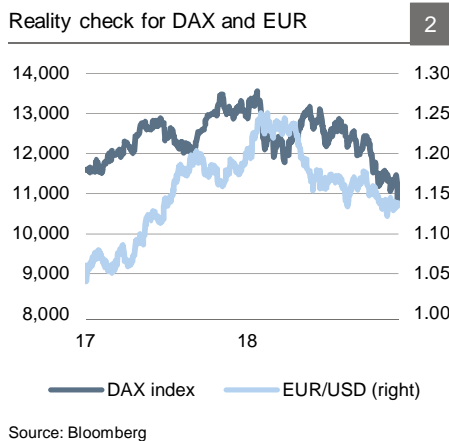
2018: Initial euphoria, special factors and external headwinds



About a year ago, German business sentiment enjoyed new record highs virtually every month, after GDP in the first three quarters of 2017 had expanded at average quarterly rates of 3.0% (annualised). Consumer confidence also rose steadily to 11.0 in February 2018, but remained well below its all-time high of January 1999 (26.2). Investors were in party mood, too. On January 23, the DAX marked its record high (13599.5), after rising by over 10% since October 2017. Not even professional forecasters could escape the widespread euphoria. The consensus forecast for German GDP growth in 2018 surged from 1.9% (Oct. 2017) to over 2.4% in February 2018. Si tacuisses ...

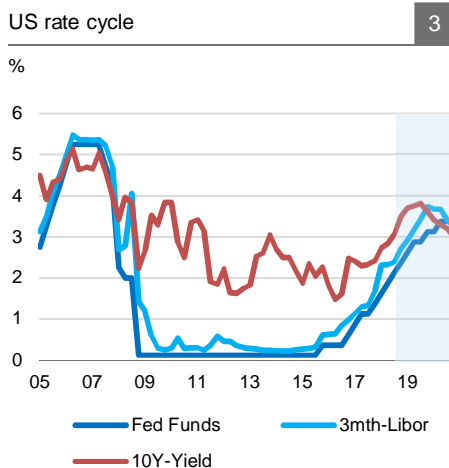
Disappointed expectations

The visible slowdown in first-quarter growth momentum (initially reported at 0.3%, later revised up to 0.4%) was still attributed to adverse special factors such as the extraordinarily severe flu season or disruptions stemming from the strikes in the metal sector. But when growth in the second quarter picked up only marginally and confidence indicators continued their downtrend following a temporary rebound in the summer months, it was evident that – even excluding the WLTP effect – the German economy had clearly lost steam. At an expected 1.6%, GDP growth in 2018 looks set to fall well behind the high-flying expectations of this spring.



Stabilisation after WLTP-related decline in third-quarter GDP growth

Current hard data (production, retail sales) and monthly business surveys (ifo, PMI) argue for stabilisation, at best, but no trend reversal. On the contrary, only sporadic signals so far suggest that the automotive sector will actually recover as expected. Further downside risks are self-evident: The possibility of a disorderly Brexit, the US-Chinese trade conflict, which could leave its distinct mark on German automotive manufacturers, in particular, or the Italian government's deviations from the fiscal path have been keeping markets on their toes over the past months. Furthermore, these risks are correlated. Italy's fiscal problems, for instance, would be aggravated, if the European economy were to deteriorate amid an escalating trade conflict. Not to mention the fact that there are other less obvious risks beyond those outlined above.



Activity levels still high

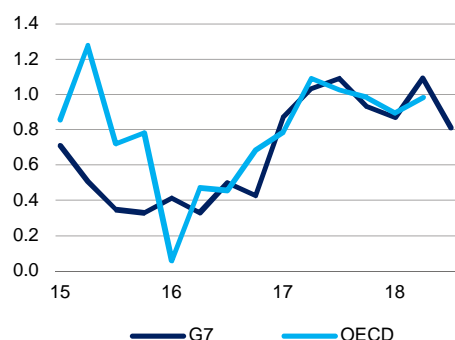
At the turn of 2018/19, it is precisely the above-mentioned partially self-reinforcing overreaction of the economic actors, however, that should serve as a warning against giving preference to the availability bias and carrying the current downtrend forward into 2019. Owing to evolution, we focus on changes and therefore tend to lose sight of the bigger – more stable – picture. At an estimated rate of 3.6%, global growth thus looks set to grow at an only marginally lower rate than in 2018. Against this backdrop, the current moderate lack of spare capacity in the major industrialised countries, where – according to the IMF – the output gap was already closed in 2017, can be expected to increase further. Key driver is the US economy, which looks set to grow by just 2.7% in 2019, courtesy of the tax reform and regulatory easing. Even in the euro area, growth is expected to reach 1.4% in 2019 after 1.9% in 2018, which would be well above its potential rate of around 1.0%. At the same time, inflation remains subdued. We have therefore adjusted our rate forecast for 2019 and now expect only three 25bp increases on the part of the Fed. We now also expect the ECB to wait with its first 15bp increase of the deposit rate (to -0.25%)



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Gross fixed capital formation 4

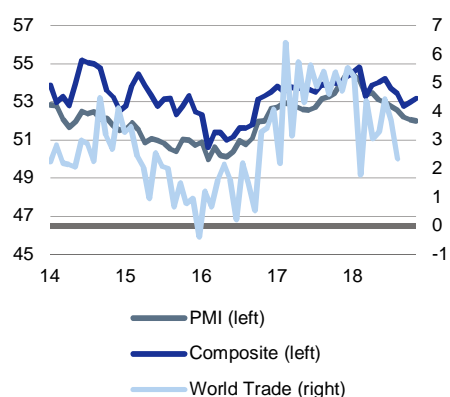
% qoq, 3q moving average (seasonally adjusted)



Source: OECD

Global growth indicators 5

Index (left), % yoy (right)



Sources: IHS Markit, CPB

Economic growth forecasts 6

% yoy

	2017	2018F	2019F	2020F
US	2.2	2.9	2.7	2.1
Japan	1.9	0.8	0.6	0.2
Euroland	2.5	1.9	1.4	1.3
Germany	2.2	1.6	1.3	1.4
France	2.3	1.6	1.4	1.3
Italy	1.6	0.9	0.7	0.9
Spain	3.0	2.5	2.4	2.1
Netherlands	2.9	2.5	1.9	1.8
Greece	1.4	2.0	1.9	1.8
Portugal	2.8	2.2	1.7	1.5
Ireland	7.2	6.4	3.4	3.3
UK	1.7	1.3	1.6	1.4
Asia (ex Japan)	6.1	6.2	5.9	5.8
China	6.9	6.6	6.3	6.0
India	6.2	7.5	7.0	7.6
Eastern Europe	2.7	2.7	2.6	2.8
Latin America	1.0	0.9	2.0	2.7
World	3.8	3.8	3.6	3.5

Sources: IMF, Deutsche Bank Research

until Q1 2020. The first refi rate hike might not materialize before H2 2020. The dampening effects from US monetary policy may hence be more moderate than previously feared, whilst the degree of monetary accommodation in Europe continues to be extremely ample even though the ECB will end QE at the end of 2018.

External headwinds are increasing

Based on our forecast of 1.3% GDP growth, German capacity utilisation ought to remain at elevated levels. Employment is likely to rise by around 1% and the unemployment rate will continue its secular decline which started in 2005 at 11.7%, which suggests that negotiated wages in 2019 will edge up at nearly the same rate as in 2018. Headwinds are primarily coming from external demand, which has prompted companies to sharply lower their expectations. Even if the trade conflict does not escalate further, global trade is likely to lose further momentum, slowing to just under 4% in 2019. As the global investment cycle, in particular, ought to fall behind previous expectations, German exports will be especially hard hit, due to their capital-goods-intensive structure. Here too, however, we should not exclusively focus on the deterioration, but also on the levels. As regards the purchasing managers' index, for example, the new export orders component has fallen below the boom/bust level of 50 since September (November 47.4). Companies surveyed hence expect order intake to decline compared with the previous month. When taking a glance at the export expectations component of the ifo index, however, the overall assessment is put into perspective. The latter also declined sharply in the course of the year (to 12.2 in November) but were still slightly above their long-term average of 10.

Construction boom continues

In Germany, weakening export expectations tend to weigh on corporate investment activity. But investment in machinery and equipment has been fairly subdued relative to capacity utilisation in this cycle and companies have to get ready for digitisation and Industry 4.0, which argues for stabilising investment. The construction sector, particularly residential construction, remains on track for strong expansion, which is however limited by substantial capacity bottlenecks, especially as regards labour.

2020: Working-day effect continues to counteract slowdown

On balance, the domestic drivers, supported by still-expansionary fiscal policy (we expect the general government's structural surplus to shrink by close to half a percentage point of GDP) suggests that growth in 2019 will be in line with the potential rate of 1.3%. Given the US economy's expected slowdown to 2.1% in 2020, impulses from this front are likely to become more subdued. As the moderation in growth will be accompanied by a sharp appreciation of the EUR versus the USD according to our FX strategists, up from 1.25 at year-end 2019 to 1.40 at year-end 2020, GDP in 2020 is likely to grow at an only marginally higher rate than in 2019, despite a positive working-day effect of around 0.4 percentage points.



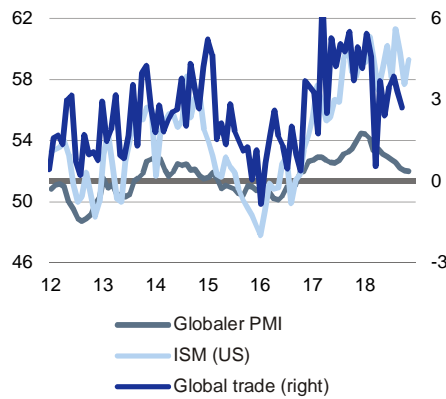
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Export growth remains lackluster

Global trade vs. globaler PMI and US-Purchasing manager index: ISM

7

left y-axis: Index < 50 contrac., > 50 expansion
right y-axis: % yoy



Sources: IHS Markit, ISM, CPB, Deutsche Bank Research

Led by restrictive US trade policy, global trade lost steam in the course of 2018. The progressive escalation of the trade conflict between the US and China, in particular, weighed on exports. At the same time, business sentiment worldwide blurred. German exports could not escape this trend and real exports slowed markedly in 2018. Following an increase of over 4% in 2017, export growth in 2018 looks set to have more than halved to around 2%. At the start of the year, external trade was dampened, as the euro appreciated by over 6% year-over-year in real terms. In the summer, the announcement of additional tariffs on US imports from China worth USD 200 billion per year caused another soft patch. Although the euro had to pare some of its gains in the further course of 2018, it appreciated by 3% in real terms compared with the previous year. Many export models assume long-term exchange rate elasticities of exports to be 0.6 to 0.7, which suggests that the euro exchange rate will shave around 2 percentage points off German export growth in 2019.

Rising by only around 2%, nominal exports to nearly all Asian countries slowed markedly in 2018. Exports to China, now the third-largest market, still edged up by as much as c. 7%, after 13% in 2017. Front-loading effects should have played a role, however, as exports were up during the course of the year, despite the escalating trade dispute and the slowdown of the Chinese economy. In light of the 90-day negotiation round reached between China and the US in early December 2018 and agreement to suspend plans to step up tariffs to 25% on 1 January 2019, further front-loading effects may be on the cards, followed by corresponding counter-movements in spring 2019. If tariffs are imposed on additional US imports, the negative impact on global trade should weigh on German exports to China which may decline temporarily.

Nominal exports vs. indices

8

% 3Mo3M



Sources: Federal Statistical Office, ifo, IHS Markit, Deutsche Bank Research

Exports to the US, which continue to be the key German export market with a share of just under 9%, were up by only c. 1%. Without the trade conflict, a stronger increase would have been on the cards, given the robust US economy. The further decline in auto exports, in particular, left its mark (2016 -13.5%, 2017 -2.9% and 2018 probably -8%), whereas all other sectors reported solid increases. Exports to France, the second-largest market, were flat in 2018. The slowdown was not limited to France, but left its traces in nearly all European countries.

Exports to the UK plunged for the third consecutive year, falling by a total of around 7% in the period from 2016 to 2018. On the back of recent developments, the UK has meanwhile dropped from rank 3 to rank 5 of the key export markets. In the face of the uncertainty surrounding future trade relations between the EU and the UK, the weakness looks set to continue in 2019. Another factor contributing to continued sluggish demand ought to be the fairly weak sterling. Exports to Turkey were also down for the third year in a row. After c. -2% p.a. in 2016 and 2017, they took another deep dive of around 5% p.a. in 2018. In line with this evolution, Turkey is playing a lesser role for German exporters and may even drop out of the list of the 20 key export markets, should the recent trend continue.

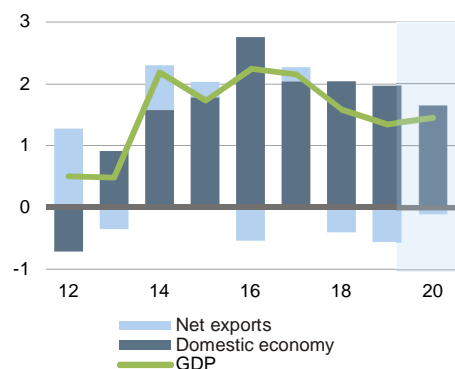
At roughly 7 ½%, the Netherlands, Germany's fourth-largest market, reported the strongest increase of the ten major export markets in 2018. On balance, exports to the neighbouring countries (with the exception of France), which absorb around one-third of German exports, continue to strongly support foreign trade. They rose by roughly 4 ½%. Surprisingly, demand from Italy also remained solid, despite the recent economic and news flow. For the fourth consecutive year, exports edged up by around 6%. To the euro area as a whole, exports rose by c. 5% in 2018, whereas those to the EU were nearly halved to only around 3%.



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GDP growth rate 9

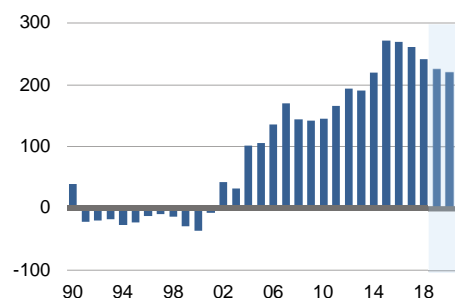
% yoy and pp



Sources: Federal Statistical Office, Deutsche Bank Research

Current account 10

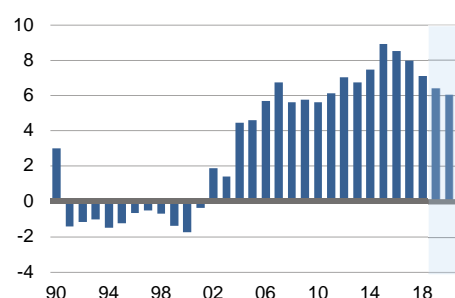
EUR bn



Source: Federal Statistical Office, Deutsche Bank Research

Current account 11

% GDP



Source: Federal Statistical Office, Deutsche Bank Research

Given potentially negative news, above all in the first half of 2019 (trade dispute, deficit procedure against Italy, Brexit, European Parliament elections), sentiment is likely to remain subdued, pointing to a further loss of trade momentum in the near term. This view is also corroborated by sentiment indicators, such as the ifo indicators, national and global purchasing managers' indices. In the second half of 2018, some of them declined sharply, to or even below their historical averages. Like in 2018, we therefore expect exports to expand only moderately by around 2% in real terms. As the recent decline in energy prices should also be reflected in export prices, at least in early 2019, the latter look set to stagnate, particularly at the beginning of the year. For the full year, we expect prices to rise by 1%, which would translate into nominal export growth of roughly 3%.

Again, the key risks ought to be further escalation of the trade dispute between the US and China and a hard Brexit. During their meeting at the G20 summit in Buenos Aires at the beginning of December 2018, President Trump and his Chinese counterpart Xi only agreed on a 90-day breather until February 2019. The counterparties hope to have reached a breakthrough by then. Even though the recent announcement to strengthen the WTO is a positive signal, uncertainty and risks of further escalation continue to be high, the more so as many observers have the impression that geopolitical considerations are taking a front seat. Although a hard Brexit is still unlikely from our perspective, the negative effects are likely to be very significant. In a hard Brexit scenario, the Bank of England recently assumed a house price crash and a very sharp decline in GDP. A no-deal Brexit would certainly take a severe toll on growth in EMU and, in particular, Germany.

The German current account surplus looks set to have shrunk to c. 7% of GDP or EUR 240 bn in 2018. This marks the third consecutive decline (2015: 8.9%, 2016: 8.5% and 2017: 7.9%) and reflects both the slowdown of global growth and still robust domestic demand. As these trends ought to remain intact in 2019, the surplus ratio is likely to decline to 6.4%, which would correspond to a decrease in the surplus to EUR 226 bn. Among the major countries contributing to global imbalances, Germany nonetheless continues to stand out and criticism of Germany's high export surpluses is hence unlikely to abate. Moreover, declining surpluses in 2018 were reflected in net exports. At -0.4pp, their growth contribution was clearly negative. For 2019, we again reckon with a negative growth contribution of -0.6pp. In the years ahead, German exports are likely to grow less dynamically than imports, which continue to benefit from strong domestic demand. Negative net exports may, as a consequence, become the rule. From 2013 to 2018, the growth contribution of net exports was already negative in three out of six years.

Private consumption to remain the most important pillar of growth

Private consumption is likely to grow 1.2% this year and just above 1% in 2019, thus contributing 0.7 pp and 0.6 pp to GDP, respectively. Together with investment spending (estimated contribution to GDP in 0.7pp in both years), household consumption will remain the most important pillar of German GDP growth. The small slowdown in consumption growth stems from a slight deterioration in consumer confidence against the background of global economic turmoil and political uncertainties in Europe. Household incomes should benefit from wage hikes negotiated in 2018 and entering into force in 2019. As employment growth looks set to weaken only slightly, wage negotiations in 2019 will probably result in wage increases of c. 3% for a total of 7.3 million employees subject to collective wage agreements. In addition, the statutory minimum wage will be lifted from EUR 8.84 to EUR 9.19 in January 2019. Disposable income should also benefit from shifts in social security

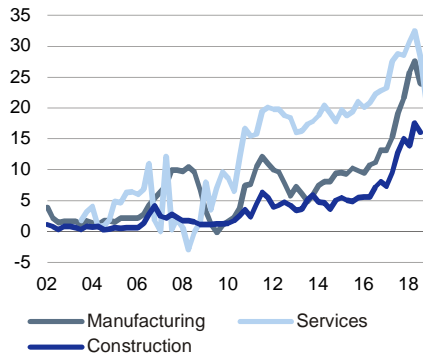


Outlook 2019: Slowing growth, but no hard landing

Labour shortages still pressing but easing

12

Labour shortage as limiting factor, share of companies, %

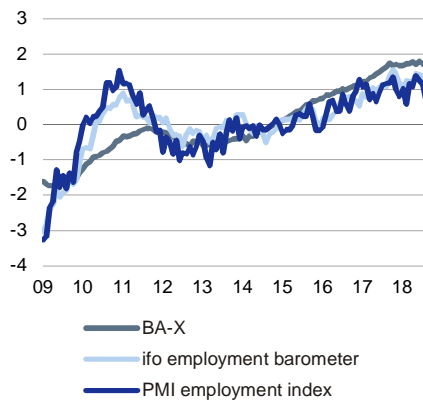


Source: EU Commission

... but companies show a more cautious attitude to hiring

13

Standardised values (since 2009)

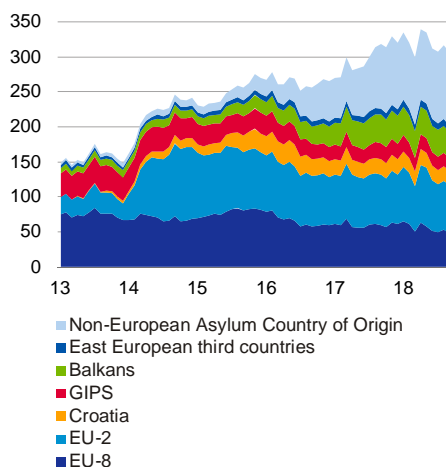


Sources: Federal Employment Agency, ifo, IHS Markit, Deutsche Bank Research

Employment driven by migration remains at a high level

14

Change yoy ('000 persons)



Sources: Federal Employment Agency, Deutsche Bank Research

contributions. While contributions to old-age care insurance will be hiked by 0.5 pp at the beginning of 2019, contributions to unemployment insurance will be reduced by the same amount. Contributions to statutory healthcare insurance will be borne equally by employers and employees again, and transfer payments, such as specific pensions for mothers (“Mütterrente II”), will be increased. Statutory pensions will be raised by 3.91% in the eastern and by 3.18% in the western German states by July 2019. This amounts to an average increase of 3.6% and 3.2%, respectively, for the year as a whole. In addition, favourable financing conditions should continue to support private consumption. Moreover, a slight deceleration in inflation, from 1.9% in 2018 to 1.7% in 2019, should support households’ purchasing power in real terms.

Full employment

The German labour market has done very well in 2018, and the favourable trend looks set to continue in 2019, albeit at a slower pace. The aggregate number of workers rose strongly during 2018 and should have reached a record level of just above 45.1 million by the end of the year. Overall, employment was up 1.3% yoy. Remarkably, most of the new jobs were subject to social security contributions. During the year, the unemployment rate dropped to 5% recently. On average, it will amount to 5.2% for the year as a whole and thus be below the consensus expectations published at the beginning of the year (5.5%).

Leading indicators such as the IAB labour market barometer suggest that demand for labour will remain robust. The ifo surveys and the employment component of the purchasing managers’ indices (PMIs) paint a similar picture, even though they recently pointed to a minor decline in momentum. However, this does not apply to construction, where employment went from peak to peak during the year, at least according to the ifo Employment Barometer. At the moment, roughly 807,000 job vacancies are registered with the Federal Employment Agency. According to a representative company survey by the Institute for Employment Research (IAB), as many as 1,237,000 jobs were vacant in Q3 2018. The average time until a vacancy is filled has risen to a new record of 152 days. According to several surveys, many companies regard the lack of well-qualified workers as one of the main obstacles for their business. 25% of all companies in the manufacturing sector and 18% of all construction companies recently said so. The lack of qualified labour will remain a bottleneck, impeding employment growth in the coming years.

Persistently high capacity utilisation (87.1%) supports our labour market forecast for the year as a whole. We expect 385,000 new jobs (+1%) to be created in 2019. The unemployment rate is likely to decline to 4.8%. In 2018, immigration, above all in the framework of the European freedom of movement for workers, made an important contribution to employment growth. The number of workers from the eastern European EU member states, Greece, Spain, Italy and Portugal, the Balkans and eastern European third countries had risen by 11% yoy (or 306,000) to 3 million (figures for September 2018). Many of these immigrants have suitable qualifications and were quickly integrated into the labour market.

Wage round 2019 – wage increases close to 2018’s

Wages rose strongly this year, and with demand for labour still high, the wage negotiations in 2019 will get much attention. The wage round will cover roughly 7.3 million employees, i.e. just above 20% of all employees in jobs that are subject to social security contributions (33 million).



Outlook 2019: Slowing growth, but no hard landing

At the beginning of 2019, the focus will be on negotiations for state civil service employees. It will then shift to retail trade in the second quarter. The trade union ver.di has already demanded wage hikes of at least 6% for 12 months on behalf of 935,700 state civil service employees. In the end, employers and trade unions will probably settle for similar increases as at the federal level (just above 3%). The agreements at the state level will also have an impact on the income of about 2.1 million civil servants and pensioners. In March and April 2019, wage agreements for about 1.9 million employees in retail trade will run out. While the trade union has not yet made any demands, the actual wage hikes will probably be below the average.

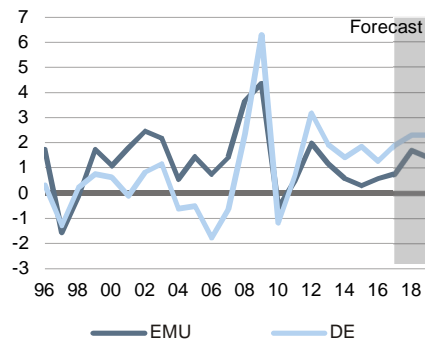
Together, these two groups make for a good 40% of all employees whose wage agreements run out in 2019. The remaining almost 60% will probably aim at wage hikes of c. 3% as well, but make much higher demands initially. However, there could also be a discussion about options between wage increases and working time flexibility. Since some of the sectors where negotiation will take place are facing cyclical and structural headwinds it might be more difficult to achieve strong wage increases. Overall, wages might rise by just below 3% next year on a monthly basis. The hike in the minimum wage to EUR 9.19 from January 2019 (which is not taken into account in the calculations based on wage negotiations) will result in a slightly positive wage drift. According to the Federal Statistical Office, this will affect roughly 2.2 million jobs.

Overall, the expected trend in wages and employment and the rise in monetary social security benefits (pensions) should lift households' nominal disposable income by a good 3% in 2019. Economic risk factors may continue to weigh on consumer sentiment in the coming year, which is why the savings rate is unlikely to decline much from its current level of 10.7%. We forecast an inflation rate of 1.7% for 2019 (2018: 1.9%), which means that real disposable income is likely to rise by around 1 1/2%. Wage increases and the return towards equal employer and employee contributions to healthcare insurance, which will drive up nominal unit labour costs, will slightly dampen Germany's international competitiveness.

Unit labour costs: Germany getting more expensive

15

Nominal unit labour costs, % yoy



Source: Eurostat, Deutsche Bank Research

Investment in machinery and equipment

Uptrend still intact, though less robust

Equipment investment vs. ifo business expectations

16



Sources: WEFA, Ifo, Eurostat, Deutsche Bank Research

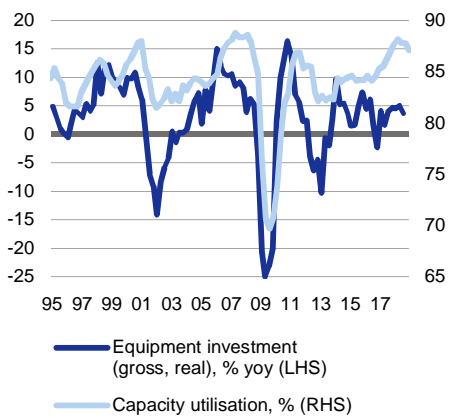
German investment in machinery and equipment (machines, equipment, vehicles) looks set to have again expanded at a fairly solid pace this year. Whilst German GDP was down in Q3 2018, investment in machinery and equipment rebounded following stagnation in the second quarter. As the weakness in Q3 ought to have been partially attributable to challenges the German auto industry faced amid the roll-out of the new WLTP test procedure, catch-up effects in this sector ought to support investment in machinery and equipment in the final quarter. On balance, we expect an increase of 4.4% in 2018 (in real terms), which would be well above the expansion rates reported for the preceding two years (3.7% in 2017 and 2.3% in 2016). Although investment activity looks set to remain tilted to the upside in the years ahead, dynamics will slow slightly. It seems as though German investment is already past its peak. According to our forecast, quarterly growth will moderate from on average 1.0% this year to just 0.7% in 2019. We therefore expect annual growth in 2019 and 2020 to decline to around 2.7% and 2.4%, respectively. Despite the slowdown, however, investment in machinery and equipment would continue to edge up at a much faster pace than German GDP.



Outlook 2019: Slowing growth, but no hard landing

Equipment investment vs. capacity utilisation (industry)

17



* of the manufacturing sector (EC survey) (seasonally adjusted)

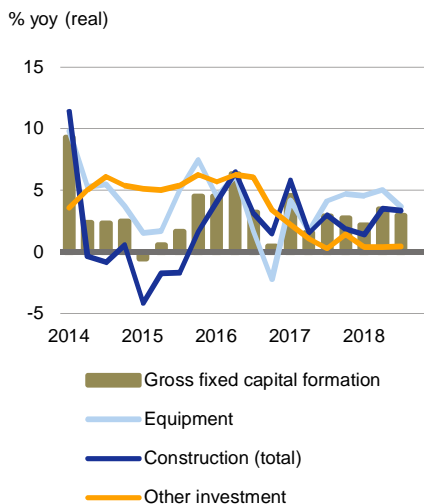
Sources: WEFA, Eurostat, EC, Deutsche Bank Research

Tailwind (still) coming from high capacity utilisation ...

Whilst extraordinarily high capacity utilisation in the manufacturing sector continues to provide positive impulses, the blurring global environment argues against more robust investment dynamics. Over the next two years, the key driver of investment in machinery and equipment will remain capacity-increasing investment, courtesy of the extremely high utilisation rates at many companies. According to the industry survey of the European Commission, annual capacity utilisation of German industrial companies continued to rise in 2018 (up to 87.6%; Q1-Q4 average), despite a visible drop in the fourth quarter (to 87.1% from 88.0% in Q3). This is well above the long-term average of 83.9% (1995-2017) and only slightly below the 2007 all-time high (88.3%). Further support is likely to come from financial conditions, which continue to be extremely easy. At roughly 5%, corporate loans are currently rising at the same rate as in 2000, though the high level is unlikely to be maintained for much longer (both as regards short- and long-term loans).

Gross fixed capital formation

18



Sources: Eurostat, Deutsche Bank Research

... but the blurring global environment and domestic labour market bottlenecks are thwarting a more robust expansion pace

A domestic factor that represents a major impediment to growth – and hence investment – from the perspective of many companies is the increasingly tight German labour market (shortage of skilled workers). Even though investment in machinery and equipment might benefit from automation and streamlining measures by companies (in order to mitigate the lack of skilled labour), the growth-dampening bottleneck on the labour market is likely to dominate in the short term. Further headwinds are coming from the broad-based slowdown of global growth (EU, key emerging markets such as China) or the looming tightening of financing conditions, as monetary policy in the USA and the euro area is normalised. Amid heightened geopolitical and economic uncertainties and risks (surrounding the trade conflict between the USA and China, the Brexit and the dispute over Italy's 2019 budget), domestic companies are also likely to turn more pessimistic and trim back their investment activities/ plans. Given the increasing trend towards protectionism, German companies may boost local investment, which would also come at the expense of investment in Germany.

Construction investments

19



Sources: Federal Statistical Office, Deutsche Bank Research

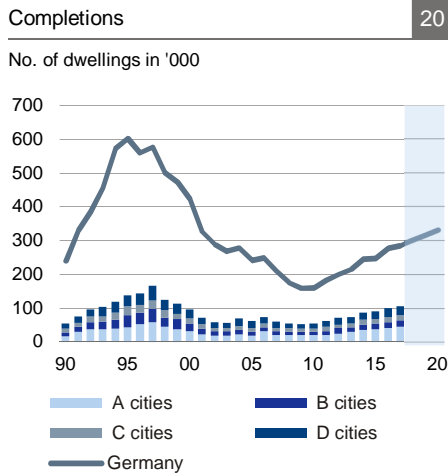
Construction and housing: Price boom to continue in 2019

Demand for residential and office space is likely to remain high, as the labour market situation is still very good and people continue to migrate to Germany, mostly from other European Union member states. The supply shortage has intensified for ten years in a row, i.e. since the beginning of the house price cycle in 2009. In total, considerably more than one million apartments are lacking, particularly in large cities and metropolises. Bottlenecks are increasing in the office segment as well. In many cities, vacancy ratios have dropped considerably below the base level of c. 5%; in fact, in some cities the ratio is even below 2%. Both residential and office space will probably be in even shorter supply in the coming years.

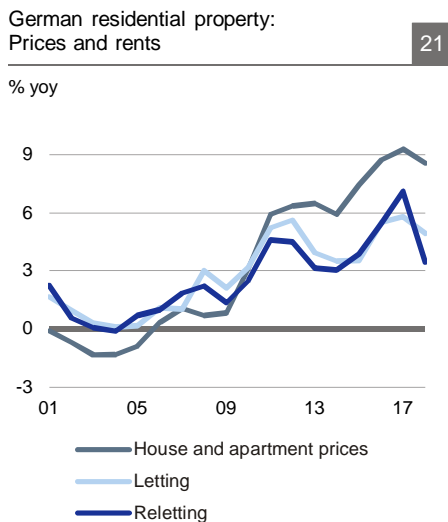
Nevertheless, we expect any increase in construction investment in 2019 to be subdued, as in the preceding years. A lack of available construction plots, long permission procedures and complex construction rules due to the energy transition are the main reasons for the shortages on the residential and office markets. The residential market is also suffering from more restrictive rental law provisions. These drags will remain in place in the coming years. We believe, however, that there is another problem which will pose the biggest difficulty in the future: the shortage of qualified construction workers. Current cyclical



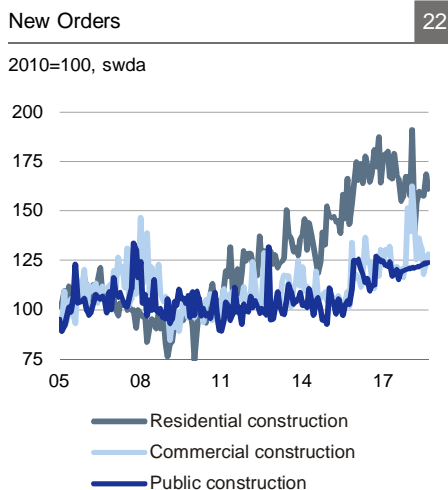
Outlook 2019: Slowing growth, but no hard landing



Sources: riwis, Federal Statistical Office, DB Research



Sources: riwis, Deutsche Bank Research



Sources: Federal Statistical Office, Deutsche Bank Research

shortages will be intensified by a structural, demographic bottleneck. With numerous qualified workers due to retire, apprentices and new staff cannot fully compensate for the loss, both in terms of quality and in terms of quantity. The construction sector is in for a major challenge. At the same time, construction workers and craftsmen will be able to push through additional significant wage increases; in 2018, their negotiated wages already rose by more than 5%.

Against this background, the newly planned immigration act for qualified labour might provide considerable stimulus for the construction sector. Numerous other political measures, particularly those adopted at the residential construction summit in 2018, will probably have only a minor effect. While several steps have been taken to support new construction, for example more favourable depreciation rules, their impact will be offset by more restrictive rental law provisions. This effort to hamper effective market mechanisms is likely to dampen construction activity, which means that investors rather than tenants will probably benefit in the medium to long term.

The shortage of qualified construction workers may be one reason why, according to the ifo institute, the order backlog reached an all-time high in 2018 while order books, capacity utilisation, order intake and the number of building permits increased only marginally. We therefore expect construction investment growth to pick up only a bit in 2019, from c. 3 1/2% in 2018 to c. 4 1/4%. Once again, the growth rate is likely to be strongest in residential construction, at 4 1/2%, with growth rates in residential and commercial construction steadily converging. Any increase in the number of completed apartments (only 5% p.a. between 2015 and 2017) will probably remain small in both 2018 and 2019 (the figures will be released in spring 2019 and 2020, respectively). Our forecast is for 300,000 completed apartments in 2018 and 315,000 in 2019. If this growth momentum remains unchanged, the cycle looks set to continue until 2022, at least. In that year, the additional annual supply might exceed the additional annual demand (more than 350,000 apartments) for the first time in the cycle.

With residential space remaining scarce, prices rose further in 2018. According to bulwiengesa (which covers 126 cities), house prices and apartment prices rose c. 8% on average. As in the preceding years, the strongest price increases were registered in metropolitan areas and large cities. However, many smaller cities also experienced significant price rises, and in none of the 126 cities did prices decline. The price boom has an impact on rents, too. In 2018, rents for newly completed and existing homes rose by c. 5% and 3 1/2%, respectively. After two years of very high rental growth, the momentum is declining sharply, especially in the case of re-letting rents. In view of the bottlenecks, however, this decline is likely to be no more than a breather.

In 2019, any slowdown in price and rent growth will be small at best. The supply shortage on the housing market and the excellent labour market will continue to be the dominant price drivers. In view of the favourable income and wage trends demand is unlikely to be dampened significantly by higher prices. The continued increase in 5-10-year mortgage rates will not be a major drag on demand either. We expect mortgage interest rates to come in at 2.3% by end-2019 (Oct 2018 1.7%) and rise further in 2020. With the end of the real estate cycle still some years away, the risk of a bubble has increased markedly.

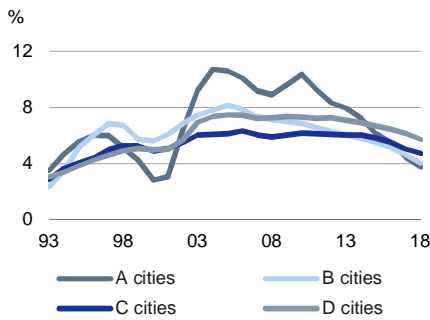
As expected, commercial construction turned the corner in 2017 and 2018. Investment increased by a total of 5% and thus offset the preceding decline by c. 5% between 2012 and 2016. Steady employment growth and strong overall domestic activity should continue to prop up demand for commercial properties. As mentioned above, the office market should benefit most. At the same time, healthy economic activity should support the hotel market, even though there is anecdotal evidence of a significant increase in supply in some cities, which might even result in oversupply. The uninterrupted boom in online retailing will



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Office: Vacancy rates

23

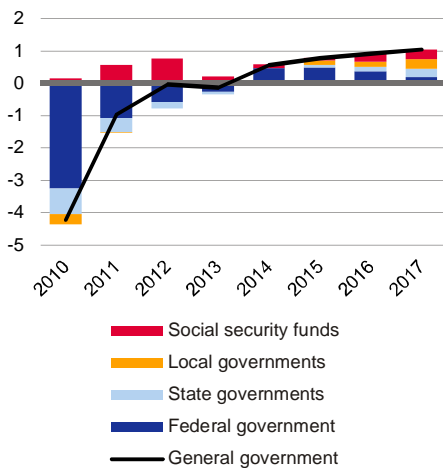


Sources: riwis, Deutsche Bank Research

General government balance in surplus for the fourth year in a row

24

General government balance (national accounts), % of GDP

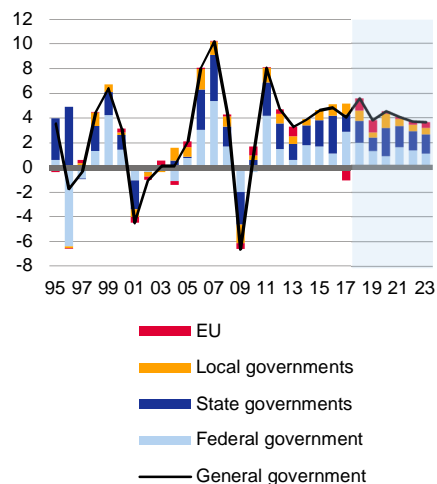


Sources: WEFA, Destatis, Deutsche Bank Research

Tax revenues of the general government

25

% yoy and growth contributions, (pp)



Forecast: Working Party on Tax Revenues

Sources: Deutsche Bundesbank, Working Party on Tax Revenues, Deutsche Bank Research

probably lead to higher demand for logistics properties. At the same time, this trend is weighing on traditional retailing, which is facing a structural crisis. With order intake continuing to increase in 2018 and the number of construction permits coming in near the all-time highs registered at the beginning of the 1990s, the overall trend in commercial construction is favourable. We therefore expect commercial construction investment to rise by c. 3% in 2018. As planning and construction takes considerable time, the recent slowdown of GDP growth will probably not be felt until after 2019.

With domestic activity remaining strong and tax revenues high, public-sector construction revived after roughly ten years of stagnation. During the past three years, public-sector construction investment rose by more than 3%. This increase was driven not only by numerous large-scale projects in the framework of the energy transition, investments in digital infrastructure and the planned restructuring of the defence expenditure, but also by smaller construction projects rendered possible by the good fiscal situation of many local authorities and federal states. In this segment, too, order intake and construction permits point to another healthy increase in investment in 2019, by 3 ½%.

Increasing headwinds, but fiscal surplus (still) rising

Surpluses thanks to full employment, tax boom and ultra-low interest rates

Public finances in Germany (federal government, federal states, local authorities and social security funds) continue to benefit from an environment that is still highly conducive from a budgetary point of view (at potential growth rate, full employment, tax boom, low interest rates, demographic respite until the mid-2020s). Against this backdrop, it does not come as a surprise that the general government budget (national accounts according to the Maastricht definition) ran a substantial surplus of around EUR 48 bn or 2.9% of GDP in the first half of the year (2017: EUR 34 bn or 1.0% of GDP). Whilst the preliminary results for H1 go only so far in providing reliable information about the full year, also in view of the positive effect of the government's interim budget management, there is little doubt that the general government surplus in 2018 will also stand out.

Budget surplus ought to have peaked ...

Over the next two years, the environment for public finances ought to remain favourable. Going by the general government surplus, however, German public finances ought to have passed the peak this year. This view is corroborated by several reasons. On the one hand, tax revenues are likely to rise at a somewhat less dynamic pace, led by the deterioration of the global environment and the associated slowdown of the German economy. On the other hand, the budgetary relief from declining interest payments (which were more than halved over the past ten years), is likely to fade over time.

Firstly, because the ECB is expected to start normalising monetary policy, which ought to lead to slightly higher interest rates and yields, and secondly, because a large share of German government debt has already been refinanced at extremely favourable interest terms. Apart from these two factors, higher primary spending (expenditures ex interest payments) is the key reason why budget surpluses are likely to melt away. Given the excellent starting point of public finances, we expect the general government surplus to rise further to 1.3% of GDP this year (up from 1.0% in 2017), before declining markedly in 2019 on the back of the new government's additional priority spending measures and slowing economic growth.

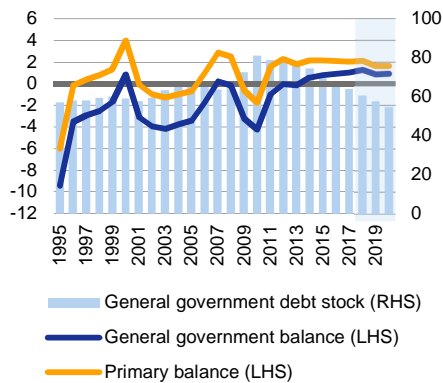


Outlook 2019: Slowing growth, but no hard landing

Fiscal outlook 2018/19: Falling debt ratio thanks to strong economy

26

% of GDP (general government level) (NA)



Sources: WEFA, Destatis, Eurostat, Deutsche Bank Research

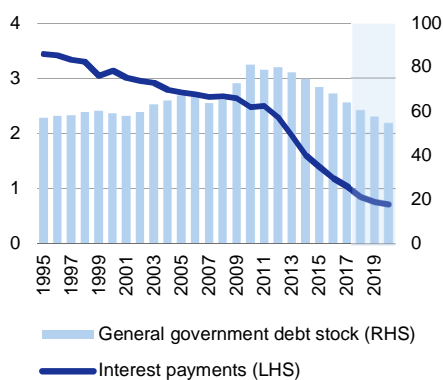
... and ought to shrink in the years ahead

Given higher spending for social and investment purposes (pensions for mothers II, children's allowance for parents who buy or build a home), moderate tax relief (e.g. cold progression allowances) and the economic slowdown, we expect the surplus to shrink to 0.9% of GDP in 2019/20. As the budget will remain in the black, the debt-to-GDP ratio of the general government (according to the Maastricht definition) looks set to decline further this year, to 60.5% by year-end (compared with around 64% in 2017). By 2019 it ought to finally undershoot the Maastricht threshold of 60% (at 57.6%), for the first time since 2002 (59.4% of GDP), and may fall below 55% by 2020, provided economic growth does not surprise to the downside and the government does not adopt further measures that weigh on the budget. In the years ahead, the "black zero" in the federal core budget, together with the constitutionally-anchored debt brake (maximum structural net borrowing of 0.35% of GDP), argues for some fiscal stability.

Government interest payments fell drastically

27

% of GDP (general government level) (NA)



Sources: WEFA, Destatis, Eurostat, Deutsche Bank Research

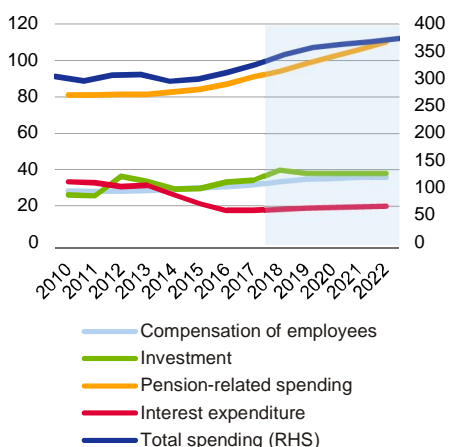
Fiscal policy turning more pro-cyclical despite "black zero" ...

On the face of it, fiscal policy appears very solid. Meanwhile, however, the government's structural position (adjusted for positive cyclical effects and the balance of financial transactions) is deteriorating visibly, which implies potential risks for the budget should growth falter or interest rates rise. At the federal level, the planning of the government (based on the 2019 draft budget and the 2020-22 fiscal plan), foresees fiscal deficits throughout the three-year period – despite the still favourable fiscal environment. By 2019, the federal structural deficit is likely to widen to EUR 15.6 bn compared with EUR 5.5 bn in 2018. At roughly 10.3 bn, structural (i.e. adjusted for cyclical and special effects) net borrowing of the federal government, the key parameter for compliance with the debt brake, would be very close to the statutory upper limit of around EUR 11.4 bn next year. At the general government level, the fiscal situation is also likely to take a turn for the worse in structural terms. In our opinion, the structural fiscal surplus looks set to shrink to 0.5% of GDP in 2019 (by comparison: 0.9% of GDP in 2018).

Selected expenditure items (from the 2018 federal budget, 2019 draft budget and financial plan until 2022)

28

EUR bn



Investment in 2018: including digitalisation fund.

Sources: Federal Ministry of Finance, Deutsche Bank Research

... and more vulnerable to economic slowdown

Despite these two budgetary guideposts ("black zero", debt brake), which limit the fiscal leeway of the federal government in times of solid growth and aim to thwart fiscal loosening, a pro-cyclical, non-sustainable shift seems on the cards. Courtesy of the financial reserves that were built up in the preceding years (such as the reserve fund for refugees, which amounted to EUR 24 bn at year-end 2017), the German government is in the comfortable position to loosen fiscal reins without taking on new debt. But a policy that completely leaves aside debt redemption and fully exploits current fiscal leeway is prone to setbacks if the economy falters.

Higher social spending weighs on sustainability

With regard to sustainability – and in view of the demographic challenge that will put a larger burden on German public finances from the mid-2020s – the substantial increase in statutory pension expenditures (pensions for mothers) and other pension promises beyond that are particularly problematic. Admittedly, the key promise of the federal government, the "double stop line" (contribution rate for the statutory pension system does not exceed 20%, pension benefit level is stabilised at 48%) will not yet weigh considerably on the

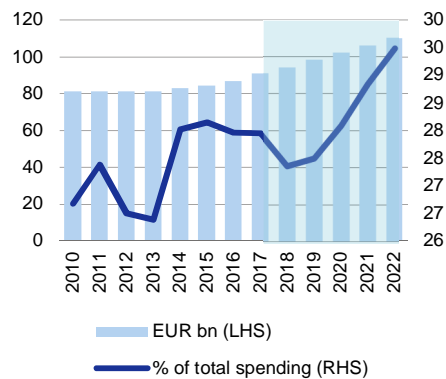


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Pension-related spending of the federal government

29

Federal subsidy to the statutory pension insurance system



Sources: Federal Ministry of Finance, Deutsche Bank Research

federal budget – at least in the current legislative period. But starting in 2025 (when the current pension programme of the government expires), considerable adjustments may be required (e.g. withdrawal of current promises, more rapidly rising federal transfer payments to the pension scheme and/or an increase in retirement age). In fiscal policy, not much will actually change in the years to come. Rather than using excellent public finances for meaningful tax cuts and/or reductions in high social security contributions, the lion's share is diverted to even higher social spending or new costly social goodies of partially disputable value (children's allowance for parents who buy or build a home). With respect to fiscal sustainability, this leaves much to be desired.

Economic slowdown and less pressure from energy prices dampen inflation

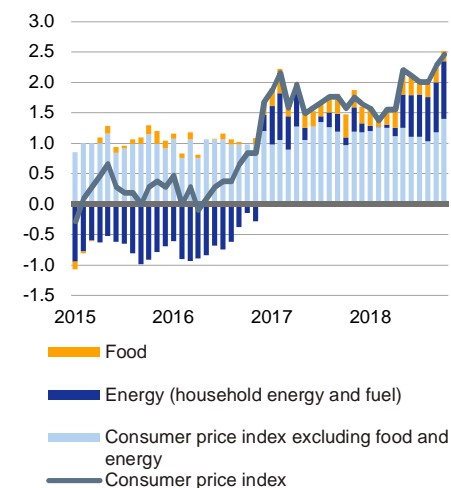
Pick-up in inflation largely due to higher energy prices

Most large developed economies have finally seen rising price pressures this year. However, much of this is due to the uptrend in energy prices. Core inflation rates (which exclude volatile energy and food prices) have remained moderate in numerous countries, despite the favourable cyclical and labour market situation. In fact, somewhat higher inflation would not have been unexpected, what with the economic cycle already at a mature stage and output gaps closed or positive. There is still no convincing explanation why core inflation remains moderate – the “inflation riddle” has not been solved yet.

Inflation rate is pushed upwards by higher energy prices

30

% yoy and growth contributions (pp)



Sources: Destatis, Deutsche Bank Research

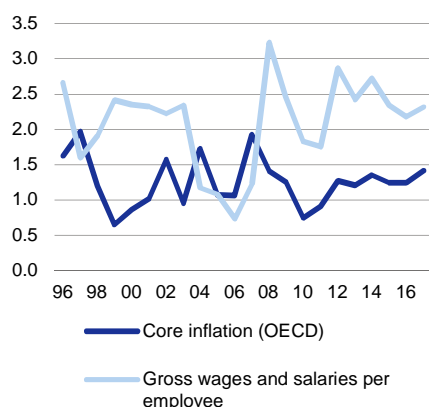
Inflation in Germany already past its peak?

With growth slowing and energy price pressures receding, the question arises whether not only growth, but also inflation are already past the peak. What are the arguments for and against a pick-up in inflation in the coming year? It is possible to make a convincing case both for and against an acceleration in core inflation in the coming year. On the one hand, the significant slowdown in growth should dampen (core) inflation with a certain time lag. On the other, high capacity utilisation in the industry points to somewhat stronger price pressures, even though it has considerably declined as growth has slowed and indicators for tensions, such as delivery times and order backlog (as measured by the PMI), have recently normalised. Moreover, labour market bottlenecks will put persistent upward pressure on the core rate, even though recent monthly figures suggest that wage pressures are declining a bit. All in all, the core rate looks set to be slightly above this year's figure in 2019. Monetary policy is unlikely to dampen (core) inflation in the foreseeable future. Despite the monetary normalisation in the US and the end of the ECB bond purchasing programme, (global) monetary conditions should remain accommodating.

Core inflation vs. compensation of employees

31

% yoy



Sources: OECD, Deutsche Bundesbank, Deutsche Bank Research

Headline inflation to decelerate slightly in 2019

In 2018, the significant rise in energy prices probably drove German inflation up by about half a percentage point. This effect will probably peter out during 2019, as energy price pressures abate and basis effects run out. As long as the strong increase in energy prices, in particular oil prices, is not repeated, the energy component will make a considerably smaller contribution to headline inflation in 2019. We believe that core inflation will peak in 2019. It looks set to rise slightly to c. 1.6% (up from an expected 1.5% for this year) and decline somewhat in 2020. That said, headline inflation looks set to decelerate somewhat in the coming two years, from 1.9% in 2018 to 1.7% in 2019 and 1.4% in 2020. Energy



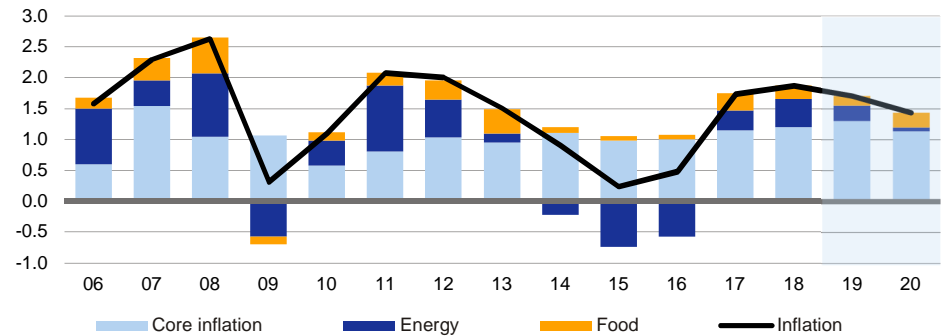
Outlook 2019: Slowing growth, but no hard landing

price pressures will probably be the most important factor for this downtrend. Apart from energy, the slowdown in core inflation will also play a role in 2020.

Consumer price inflation outlook for 2019/20

32

% yoy and contributions to annual (average) inflation rate, (percentage points)

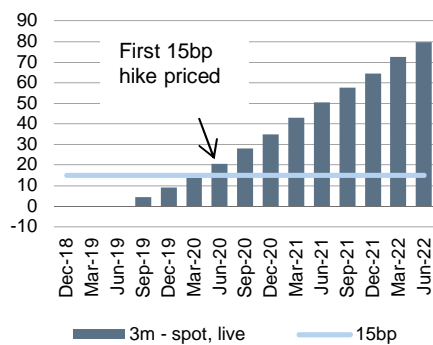


Sources: Destatis, Deutsche Bank Research

ECB: committed to ample accommodation, pushing rate hike to March 2020

Market pricing the first 15bp deposit rate hike only in mid-2020

33

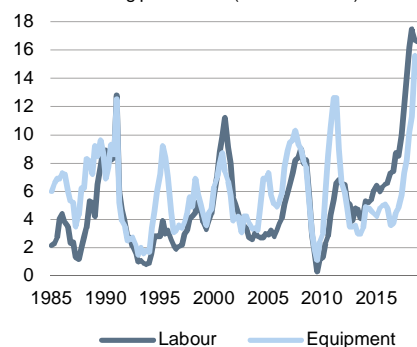


Sources: Deutsche Bank, Bloomberg Finance LP

Survey evidence of capacity constraints in labour markets and with equipment

34

Factors limiting production (net % of firms)



Sources: Deutsche Bank, European Commission, Haver Analytics LP

Recent commentary suggests the ECB is not losing confidence in domestic resilience or inflation. However, ECB confidence is conditional on ample monetary accommodation remaining in place.

We expect the ECB to end net asset purchases in December 2018. The ECB argues the benefits of QE are rotating from flow effects to stock effects and we expect net asset purchases to finish in December 2018. Ample accommodation requires the ECB to maintain its open-ended forward guidance on unchanged policy rates and full reinvestment. An automatic repricing of market expectations for the timing of the first hike is consistent with the open-ended guidance. This is what Mario Draghi meant recently when he said the ECB reaction function was "well-defined". We do not expect the ECB to fight the repricing.

We are pushing back our view on the timing of the first ECB hike from September 2019 to March 2020. This is consistent with the downwardly revised expectations for growth and inflation and the sensitivities in our modified Taylor Rule. It will only be in the final months of 2019 that core inflation rises to 1.5%. We believe this is the threshold level for the ECB and it will not be inclined to raise policy rates until it is convinced this level is sustainable; the Council will probably wait until March 2020.

After an initial rate hike in March 2020 (+15bp deposit rate hike, no change to the refi rate) we expect the tightening cycle to proceed at a rate of 25bp (deposit rate and refi rate) every six months. This means the first hike of the cycle would not come before the end of Mario Draghi's tenure. Draghi will be in no rush to exit by the end of his term in office in October – his legacy will be to give his successor the best chance of being able to normalize monetary policy. We think ECB succession is a red herring. We expect a largely continuous ECB reaction function.

We expect a new TLTRO in H1 2019 — this is required to avert the threat of disorderly deleveraging — and a further enhancement of forward guidance in H2 2019, for example, on the pace of policy rate tightening. This will be designed to minimize money market volatility and maintain a clear monetary policy signal as the turning point in the monetary policy cycle gets closer.

A first policy rate hike could occur earlier than March 2020 for cyclical or noncyclical reasons. Cyclically, if there was a re-upgrading of growth and/or

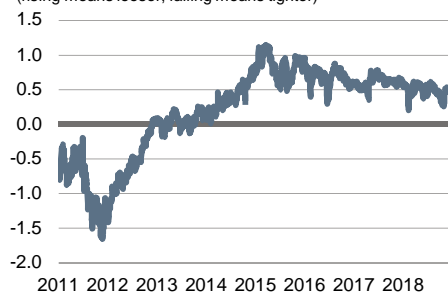


Outlook 2019: Slowing growth, but no hard landing

Financial conditions remain easy

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Financial Conditions Index (FCI)
of standard deviations from mean
(rising means looser, falling means tighter)



2011 2012 2013 2014 2015 2016 2017 2018

Sources: Bloomberg Finance LP, Deutsche Bank, Haver Analytics LP

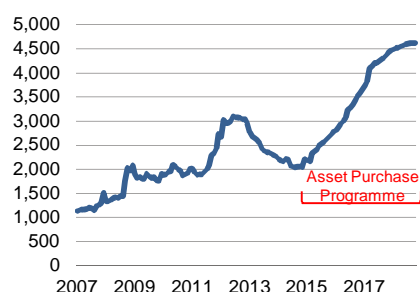
inflation forecasts, for example, if the weak manufacturing PMI converges back towards a more resilient services PMI and the pass through from wage inflation to consumer price inflation accelerates.

Non-cyclically, bank capital, the standing facilities corridor and a TLTRO2 replacement could each offer a rationale for a technical adjustment upwards in the deposit facility rate. Given the improvement in capital ratios and the potential political toxicity of supporting banks, the capital argument is not compelling. Hiking the deposit rate would narrow the corridor. This has benefits, for example, reducing short term rate volatility – useful ahead of a tightening cycle. It is also a de facto credit easing policy to counterbalance the end of net asset purchase. A TLTRO2 replacement may need compromise on the Council – for example, agreement conditional on the liquidity pricing off the refi rate. A technical deposit facility rate hike would reduce the opportunity cost to banks exposed to the liquidity rolling over.

ECB balance sheet reaching a peak

36

Eurosystem total assets, EUR bn



2007 2009 2011 2013 2015 2017

Sources: Deutsche Bank, ECB, Haver Analytics LP

The key to a technical adjustment occurring would be detaching it from a tightening cycle, that is, to prevent financial conditions from tightening. One way to do that would be to coordinate a technical deposit rate increase with a revision of the forward guidance, for example, an extension of the time commitment to an unchanged refi rate beyond summer 2019.

Industry: WLTP is not the only relevant factor

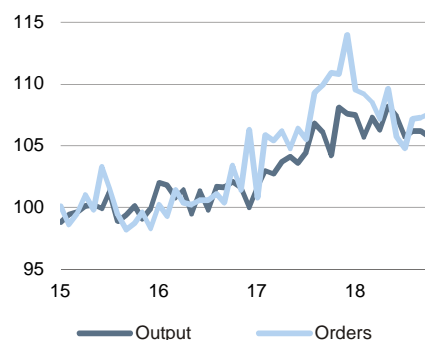
In real terms, German manufacturing output looks set to rise by c. 1.5% in 2018. The growth rate has roughly halved in comparison to 2017 (+2.9%). While monthly industrial output figures were highly volatile in 2018, they trended largely sideways during the year as a whole. A large share of the overall increase is due to a statistical overhang registered at the turn of the year 2017/18. Overall, industrial output rose for the fifth year in a row.

Manufacturing order intake, both from domestic and foreign customers, trended downwards in the course of 2018. Overall, the industry benefited from a relatively high order backlog.

German industry: Reduced momentum

37

Manufacturing industry in DE, output, 2015=100



15 16 17 18

— Output — Orders

Source: Federal Statistical Office

Once again, exports accounted for just above 50% of total industrial sales in 2018. Export-oriented German companies had to deal with major geopolitical and economic challenges this year, such as trade conflicts, Brexit-related uncertainties, the debate about the Italian budget or exchange-rate turmoil and political uncertainties in a number of emerging markets. In addition, the nominal trade-weighted euro exchange rate tended to appreciate in 2018, thus making German exports more expensive. Still, the euro depreciated versus the US dollar. On average, German nominal exports of goods look set to have declined only by a small amount in 2018. A significant increase in exports to China prevented more significant losses.

Geopolitical uncertainties and loss of economic momentum

Right now, it seems unlikely that geopolitical and economic policy risks will decline significantly in 2019. Rather, conflicts which already had receded into the background may suddenly flare up again; just think of the crisis in Ukraine. What with US trade and foreign policy being volatile and, to some extent, unpredictable, German industrial companies should prepare themselves for another year of geopolitical and economic turmoil. Persistent uncertainty is weighing on companies' willingness to invest, both in Germany and in important export markets. In any case, the global economic cycle has reached a mature stage. Moreover, rate hikes in the US will make financing more expensive for US companies.

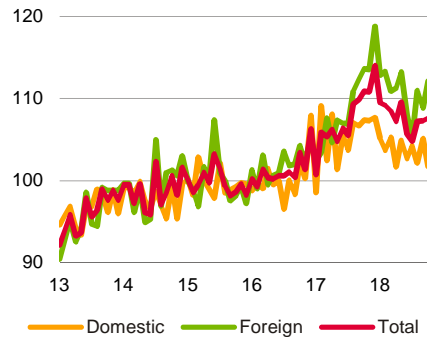


Outlook 2019: Slowing growth, but no hard landing

Weak order development

38

Manufacturing industry in DE, orders, 2015=100



Source: Federal Statistical Office

While we expect global GDP growth to remain healthy in 2019, many important markets for the German industry – not least the euro area and Germany itself – will probably see the momentum slow. If the euro appreciates in 2019 as expected (also versus the dollar), German industrial companies will have to bear an additional burden from the FX side. Nevertheless, we believe that neither the economy nor industrial production are likely to drop into a recession. Overall, we expect manufacturing output to grow more slowly in 2019 (+0.5%).

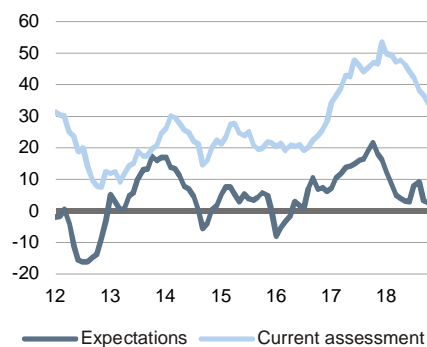
Sentiment deteriorates, but is still positive – capacity utilisation declines

The recent trend in the ifo expectations index is in line with our forecast: a slowdown in industrial activity, but no recession. At the moment, business expectations are still just about positive, despite the risks listed above and the lower growth momentum. In fact, industrial companies are more optimistic about the output and export outlook. The DIHK survey of autumn 2018 paints a similar picture: while the expectations are still positive, they are trending downwards. It is somewhat surprising that company managers persist in their optimism. Perhaps they believe that the risks are (largely) irrelevant for their business as long as order intake is still good. However, sentiment might quickly turn sour in the coming months if demand declines as the economic and political framework conditions deteriorate.

Manufacturing: Expectations less optimistic of late

39

Manufacturing industry in DE, balance of positive and negative company reports



Source: ifo

In addition, capacity utilisation in the German manufacturing sector points to slower growth in the coming months. After having steadily increased between Q2 2016 and Q1 2018, it has declined for three quarters in a row since. Nevertheless, it was still 3.5 pp above the long-term average at the beginning of Q4 2018. With capacity utilisation declining, incentives to invest in order to increase capacities will wane in during 2019.

Looking at the individual sectors: broad-based slowdown

Compared to 2017, output growth slowed in almost all major industrial sectors in 2018. In fact, automotive output was probably down by c. 1.5% in real terms (2017: +2.4%). Much of this decline was probably due to the shift to the new emissions test standard WLTP in autumn 2018. Several German carmakers interrupted production in a number of factories for some days because they had not yet obtained a WLTP certification for certain vehicles. While the WLTP effect is petering out, the cyclical framework conditions for the auto sector are still a challenge. The three largest markets (China, the US and the EU) will probably see a slowdown or even a decline in demand in 2018 and 2019. We therefore expect output in the automotive sector to rise only by 0.5% in 2019. Quite apart from cyclical developments, developing alternative propulsion technologies and smart driving technologies remain a major challenge for the sector.

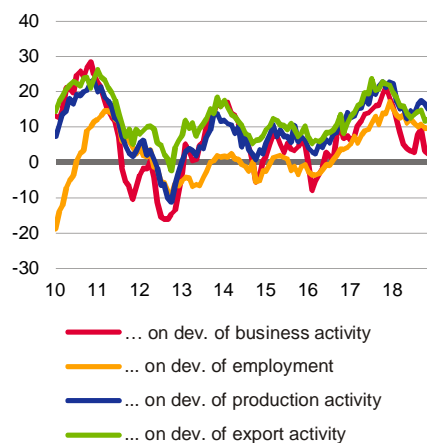
Mechanical and electrical engineering companies will feel the effects of the maturing national and international growth cycles, the relatively strong euro and lower demand from important customers such as the auto industry in 2018 and 2019. Mechanical engineering output looks set to have increased by 2.5% in 2018 (2017: +3.7%). We forecast a growth rate of 1% for 2019. Electrical engineering output is likely to expand more slowly in 2019, too, at 0.5% (2018: c. +2%; 2017: 5.2%).

Pharmaceutical output probably jumped by more than 20% in 2018 (2017: +5.2%). While momentum in the sector is quite dynamic anyway, this was by far the biggest increase since the German unification. Much of the rise is due to exports, which probably expanded at a two-digit rate (in nominal terms) in 2018. Nevertheless, the unusual momentum in the sector is difficult to explain. We expect pharmaceutical output to increase by c. 6% in 2019.

Export expectations in the German industry surprisingly positive

40

Company expectations, balance of positive and negative company reports



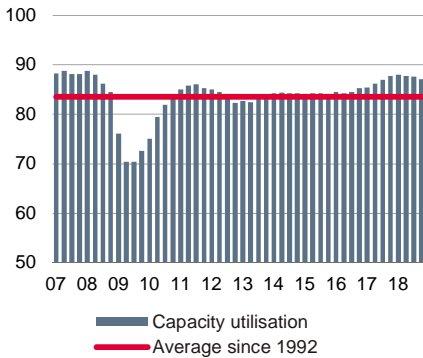
Source: ifo



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Capacity utilisation is falling slightly 41

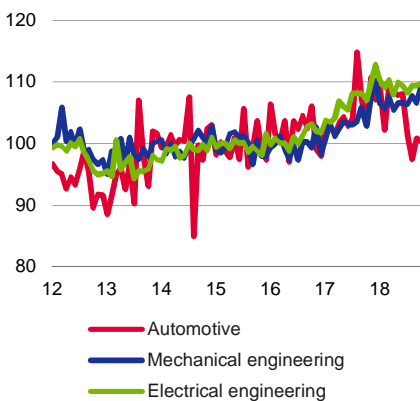
Capacity utilisation in the manufacturing industry in Germany, %



Source: ifo

Capital goods producers experience economic slow-down 42

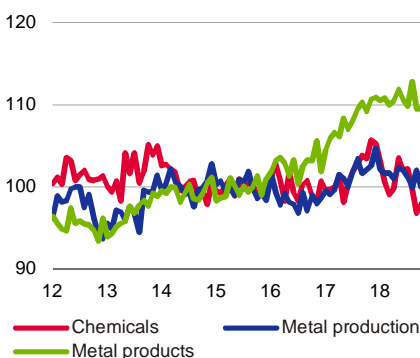
Output in selected sectors in DE, 2015=100



Source: Federal Statistical Office

Divergent development 43

Output in selected sectors in DE, 2015=100



Source: Federal Statistical Office

In contrast, chemical output probably shrank by 1% in 2018 (2017: +1.4%), and we expect a similar decline for 2019. In principle, the chemical industry is an early-cycle sector, which means that the impact of a cyclical slowdown is felt earlier and more strongly than in sectors which tend to lag behind. Structural trends play a role as well: the capital stock has been shrinking for years due to insufficient investment in domestic factories. From our vantage point, this reluctance to invest stems to some extent from uncertainties around German energy and climate policy. For example, chemical companies are unsure about how long they can continue to benefit from exemptions under the Renewable Energy Act or under the EU emissions trading scheme.

Output in the metals industry probably rose by just below 2% in 2018 (2017: +3.9%). As in the preceding years, metal product manufacturing did better than metals production and processing. Overall, the output of the metals sector might decline slightly in 2019. As a rule, metals production as such is faced with bigger structural challenges (such as global overcapacities) than metal product manufacturing, which is more closely linked to the capital goods sector.

We expect output in the food sector to increase by c. 1% in each of the years 2018 and 2019. The sector should benefit from population growth in Germany and its move towards additional export markets. While the export ratio is considerably below the average for the manufacturing sector as a whole, it has steadily increased during the last few years, to c. 24% in 2018.

Moderate producer price inflation

Manufacturing producer prices have continued to rise steadily in the last few months and were probably up by c. 2% on average in 2018 (2017: +2.6%). At first sight, it seems that the slowdown in the industrial sector has not yet fed through to prices. However, the rise in producer prices in the last few months is to some extent due to the temporary jump in oil prices. As economic momentum slows, producer price inflation is likely to decline as well in 2019.

Structural challenges remain

The structural challenges for the German industry have not changed much during the past year. Industry 4.0 is becoming an ever more important issue, even though the challenges differ from sector to sector and company to company. With digitalisation becoming an ever more common feature along the value chain, we believe that the German industry looks set to enjoy higher potential growth in the coming years. Moreover, digital technology might offset the negative impact of the demographic development (such as a shrinking pool of potential workers) at least to some extent.

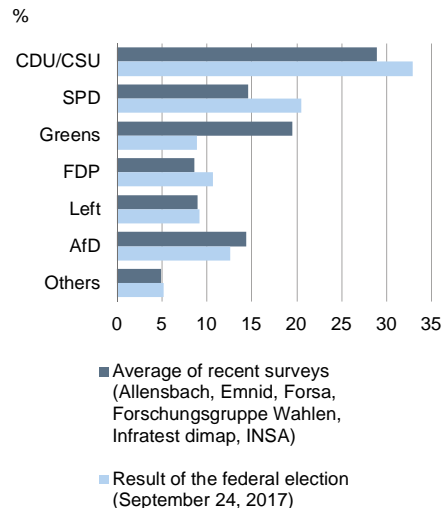
In the short run, the lack of qualified labour is the main limiting factor. Depending on the region and the individual sector, it becomes more and more obvious. According to the DIHK survey mentioned above, companies regard the lack of qualified labour as the most important risk for their business by far. If sufficient qualified labour had been available, industrial companies would certainly have been able to fulfill orders more quickly during the past year. This means that labour bottlenecks have a clear effect on the economic cycle. Energy and materials prices take second place on the list of most important business risks, followed by labour costs.



Outlook 2019: Slowing growth, but no hard landing

AKK's success saves Merkel's chancellorship – for now

Major political parties' popularity & result of the past federal election 44



Source: Wahlrecht.de (December, 10)

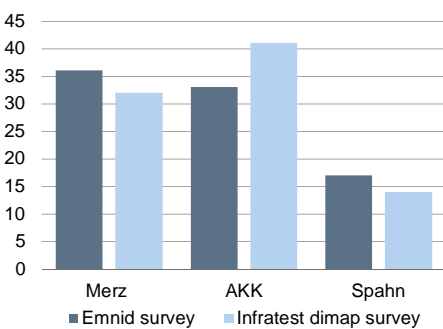
On December 7 at their party convention in Hamburg the CDU elected Annegret Kramp-Karrenbauer (AKK, 56), Merkel's desired successor, as the new party leader. The labels Merkel 2.0 or even "Mini-Merkel" (The Washington Post) are misleading. There is a risk of underestimating AKK. Her victory in the Saarland elections in March 2017 was a catalyst for the SPD's heavy defeat in the 2017 federal election by bringing the "Schulz hype" to a sudden stop. In the past she often proved tougher and more conservative than expected. AKK has repeatedly stated her willingness to become Chancellor, too. However, this is very unlikely in 2019 already. Furthermore, it cannot be ruled out that in the end AKK will decide not to take on this role, leaving it to someone else.

Merkel's power limited

AKK's victory has probably rescued Merkel's chancellorship, at least for the time being. Nevertheless, the Chancellor can hardly continue with business as usual. Substantial power will pass to AKK who is unlikely to just act on Merkel's orders. AKK also promised CDU party members to move away from the top-down approach that has generated discontent, especially during the Euro crisis, towards a more bottom-up approach. In this respect, the convention and the preceding contest might have marked a watershed. The party's new self-confidence might also impact the German government's work. In line with AKK's request, Merkel will probably have to pay more attention to the opinions and wishes of the party.

Germans' attitude on the CDU candidates' performance as chancellor: Pick your survey! 45

Q.: "Do you think the respective candidate would be a successful Chancellor?"
% of those asked



Sources: Kantor Emnid, Infratest dimap

Germany's EU policy stance only marginally tweaked

For German E(M)U policy "continuity" could be the header. Following the imminent summit on Brexit on December 13 to 14 the German government's respective policy agenda over the coming months is unlikely to go beyond what was agreed at the December 3 to 4 Eurogroup summit. AKK seems unlikely to interfere. So far, she refrained from taking controversial positions with regard to E(M)U issues. Having grown up in the Saarland and as former MP there she advocates close relations with France.

As the CDU's General Secretary, AKK endorsed the CDU's position regarding upgrade of the ESM with new instruments but with still conditionality of financial aid. In line with the German government's view, she sees risk reduction as a prerequisite for a European Deposit Insurance Scheme (EDIS) (Frauen Union Braunschweig, April 21).

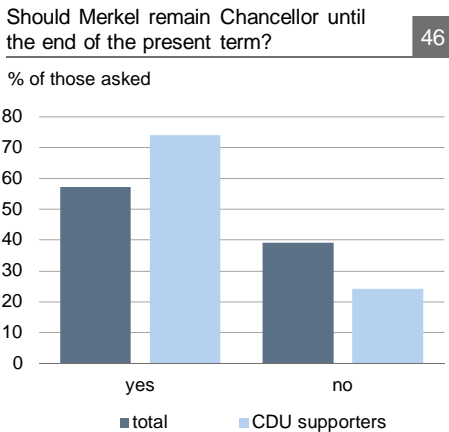
AKK calls for amendments of the Groko's tax and social policy ...

AKK seems likely to put more emphasis on (domestic) economic policy. As one of the architects of the coalition treaty she stated in February that the treaty was a solid base for the Groko's work. She has not distanced herself from any of the Groko's decisions including for example the employees' right to temporary part time work. This also reflects her political background. From 2012 to 2018 she headed her own Groko in the Saarland. She was also one of the first CDU grandees who advocated a statutory general minimum wage (which the Groko established in Jan. 2015).

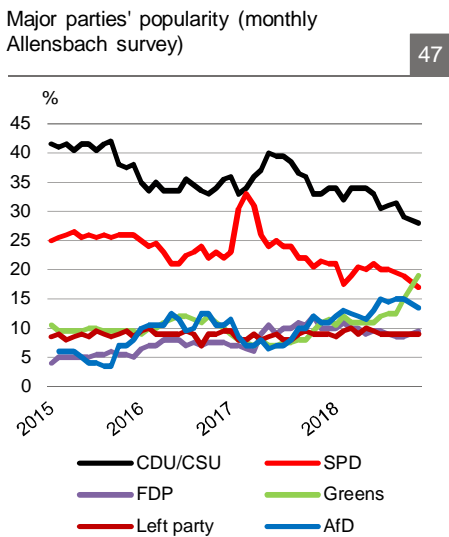
However, she says the coalition treaty is not sacrosanct and that some projects need an overhaul (Rheinische Post) such as the planned increase in pension benefits for low-wage earners and amendments to the Hartz IV legislation. She wants to ensure that those who have worked for years and paid contributions to



Outlook 2019: Slowing growth, but no hard landing



Source: Infratest dimap: ARD Deutschland-Trend (Dec. 6)



Source: IfD Allensbach

the social security schemes should be better off in the end. It contrast with the basic income concept from SPD left-wingers and the Greens, but has support from the CDU's employees association and traditionally orientated Social Democrats. This could become a major stumbling block for a possible coalition with the Greens, if the Groko fails. Furthermore, AKK has advocated a thorough tax reform including a complete abolition of the income tax solidarity surcharge. However, it seems less likely that AKK will urge Merkel to (fully) adopt this proposal and to call for such a tax reform anytime soon.

... however, AKK is unlikely to derail the Groko with reform requests

AKK's requests might trigger debates among the government parties but are unlikely to derail the Groko given the options for compromise on social policy issues. This prospect for ongoing political stability has its flip side, of course. Reforms to strengthen GDP growth will remain in short supply. This is all the more problematic, given the risk of a more severe slowdown of the German economy.

Poor election results could still produce strong headwinds in September

This benign political scenario for Merkel presupposes that the CDU will be able to leverage AKK and her ideas so that the party's popularity ratings will rise again. Heavy CDU defeats in the three state elections in East Germany in September 2019 could produce strong headwinds for Merkel and the Groko. In such a scenario Merkel could surprise again by stepping down as Chancellor too.

SPD's Groko policy midterm review likely to be crucial

According to recent polls the outcome of these elections could be even more disastrous for the SPD and have negative repercussions on the SPD's Groko midterm review in (late) autumn 2019. The SPD will assess the federal government's performance with regard to the party's pet projects, such as increase in pensions, intensified labour market regulation and enhanced social equality, i.e. income redistribution. It is not clear whether the SPD will stay or go. 61% of the SPD supporters think that the party should emphasise a more leftist policy stance (Forschungsgruppe Wahlen). Poor election results could fuel the anti-Groko sentiment within the SPD further. If the SPD decides to go, the formation of a new government could depend on the CDU's candidate for chancellor. A possible failure of the Bundestag to elect a new chancellor would result in snap elections

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- " Outlook 2019:
Slowing growth, but no hard landing December 14, 2018
- " 2019: Only 1.3% GDP growth,
snap elections a distinct possibility November 4, 2018
- " Increasing headwinds but fiscal surplus (still) rising ... October 4, 2018
- " Clouds on the horizon for Goldilocks September 4, 2018
- " On a bumpy road into summer break July 2, 2018
- " More signs of slowing (underlying) growth June 11, 2018
- " Growth rates have peaked – inflation should still recover.. May 8, 2018
- " Trade tensions challenge corporates and government .. April 10, 2018
- " Strong growth, limited inflation March 13, 2018

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