



German industry

Tangible production growth in 2014

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DB Research Management

Ralf Hoffmann

German industry shows first signs of recovery. Industrial production passed the trough at the turn of the year 2012/13 and has risen slightly since then. Since February, the expectations component of the ifo Business Climate Index has been in positive territory again. With regard to orders, demand from non-European countries has been better since the turn of the year than that from the euro area. In view of the large statistical underhang of 1.6% from the year 2012, we expect, however, that industrial production will only stagnate in the current year.

In 2014, industrial activity will increase again (+4%). The upswing will go hand in hand with stronger growth in the US and – to a lower extent – in China. The EMU countries will also register positive GDP growth again, so exports will give a boost to the economy. This supports e.g. the automotive industry, electrical engineering and mechanical engineering.

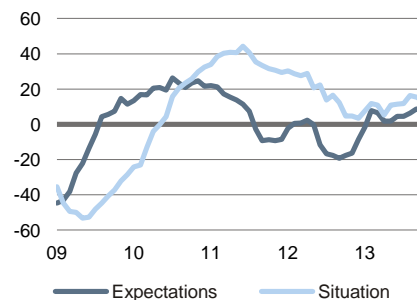
Automotive industry strongest sector in 2014. We expect real domestic automotive production to increase by 5% in 2014. West European car demand provides support due to the replacement needs built up in the meantime.

Mechanical engineering will record 4% growth in 2014. Besides the improvement in export business, mechanical engineering will benefit from stronger domestic demand next year. Rising investment in machinery and equipment (+4% in real terms) is conducive to the demand for machinery.

Electrical engineering should record an increase of 3.5% – last but not least favoured by the current megatrends, such as the "energy turnaround", the expansion of Germany's broadband network and cloud.

Business expectations positive again

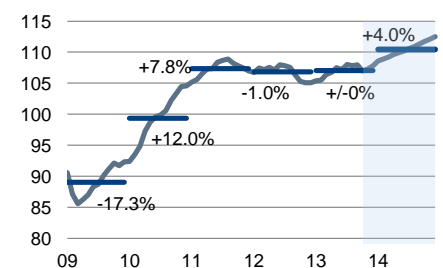
Manufacturing, balance of positive and negative company responses



Source: ifo Institute

Industrial production on a recovery path

Production, manufacturing, 2005=100 seasonally adjusted, moving average



Sources: Federal Statistical Office, DB Research



German industry: Tangible production growth in 2014



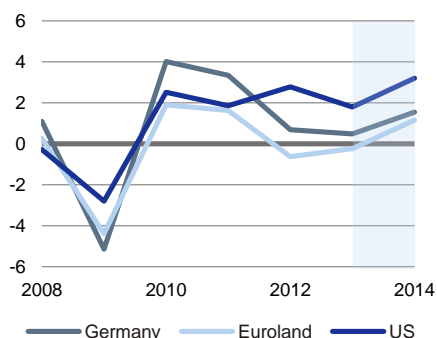
German industry: Tangible production growth in 2014

Overall economic environment gives impetus again

Eurozone: Growth recovering

1

Real GDP, % yoy



Source: DB Research

Germany: Forecasts at a glance

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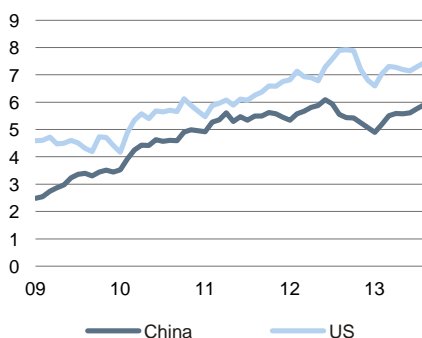
Change (% yoy)	2012	2013F	2014F
Real GDP	0.7	0.5	1.5
Private consumption	0.8	0.9	1.0
Government expenditure	1.0	0.8	0.7
Capital investment	-2.1	-1.2	3.4
Equipment	-4.0	-2.5	4.1
Construction	-1.4	-1.1	2.2
Inventories, pp	-0.5	0.2	0.0
Exports	3.2	1.7	6.5
Imports	1.4	2.5	6.7
Net exports, pp	0.9	-0.2	0.3
Consumer prices	2.0	1.5	1.5
Budget balance, % of GDP	0.1	0.0	0.2
Unemployment rate, %	6.8	6.9	6.7
Current account balance, % of GDP	7.0	7.1	7.0

Sources: Federal Statistical Office, DB Research

German exports increased of late

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German goods exports, bn EUR, moving average



Source: Federal Statistical Office

After a weak second half of 2012/13, the outlook for GDP growth in the remainder of 2013 and 2014 is more favourable. This also applies to Germany's industrial production which still declined by 1% in real terms last year. Industrial production passed its trough at the turn of the year 2012/13 and has risen slightly since then. The improved outlook has already been reflected in the expectations component of the ifo Index for some months. Since February, the balance of positive and negative assessments has been in positive territory. Recently, it recorded +8.3 in October. Capacity utilisation as well passed its trough in Q4 2012 already and recently widened to 83%. Against the backdrop of the large statistical underhang of 1.6% from the year 2012, we expect, however, that industrial production will only stagnate in the current year. At 0.5%, GDP growth remains moderate all in all due to the weak starting basis for 2013. However, growing by 0.7% qoq in Q2 2013 and by 0.3% in Q3 the German economy returned to a decent growth path.

The economic upswing in 2013 goes hand in hand with a pick-up in growth in the industrial countries. This is of major importance to the exporting nation Germany which often receives economic impetus via exports. In the eurozone countries, which, at an export share of 37.5% (2012), are Germany's most important export region, structural reform and the consolidation of budgets should dampen the economy less strongly than in the years before. For 2014, we thus expect GDP growth in major German export markets to be positive again (NL: +0.4%; FR: +1.3%; IT: +0.6%). Foreign orders of German industry which come from the EMU countries have already risen again slightly since the turn of the year (Q1: +0.2% qoq; Q2: +2.6% qoq; Q3: +0.1% qoq). This should support the flagships of German industry, such as the automotive industry and mechanical engineering.

In non-European countries as well, the economic situation will improve next year. Despite an initially very weak start of the year, impetus from countries outside EMU (orders Q2: +3.9% qoq; Q3: +1.5% qoq) has recently been stronger again than from EMU. The development of 2012 thus continues. Exports to China and the US picked up somewhat again of late. All in all, exports of German mechanical engineering companies to these markets have benefited. Automotive and electrical engineering exports to China and the US have also risen during the last few months. For the remainder of the year and for 2014 we anticipate a pick-up in growth in China and the US, which should be accompanied by increasing demand for manufacturing products in Germany. In the US, GDP is likely to expand by 3.2% in the coming year (2013: +1.8%). GDP growth in China will presumably accelerate from +7.7% in 2013 to +8.6% next year. True, this does not catch up with the double-digit growth rates before the economic crisis but signals a stable growth trend. The recovering global economy is reflected in sharply growing German exports, which should expand by 6 1/2% real in 2014.

The domestic economic situation is also improving. As in 2012 and 2013 already, German private consumption, at a growth rate of roughly 1%, will remain a stable growth pillar for the domestic economy in 2014. This will benefit the consumption-related sectors, such as consumer electronics and healthcare products. Further impetus comes from investment in machinery and equipment which will grow by around 4% in real terms in 2014. This mainly benefits mechanical engineering. From the construction sector, we expect a moderate increase of close above 2% on balance next year. The driving factor there is the continually dynamic housing sector, which is benefiting from the low level of interest rates. By contrast, hardly any significant stimulus comes from commercial and public construction.



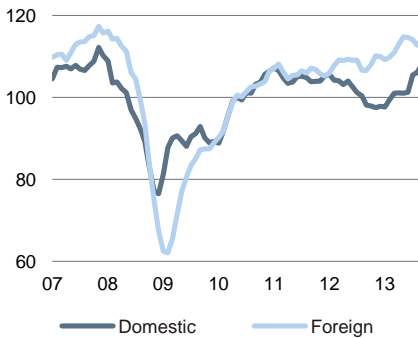
German industry: Tangible production growth in 2014

Overall, we expect GDP to grow by 1.5% in 2014. Industrial production should increase by 4% (real). Our forecast is mainly based on a general upswing of the world economy and assumes that there will be no large turmoil in the eurozone or the emerging markets.

Stimuli mainly from abroad

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Auto industry, order intake, 2010=100, moving average

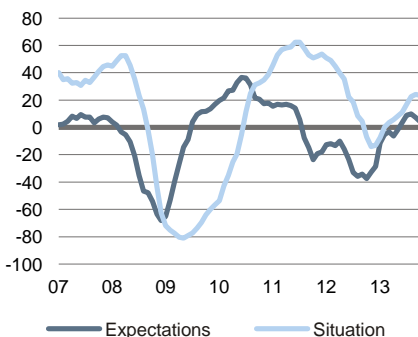


Source: Federal Statistical Office

Business expectations positive again

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Auto industry, balance of positive and negative company responses

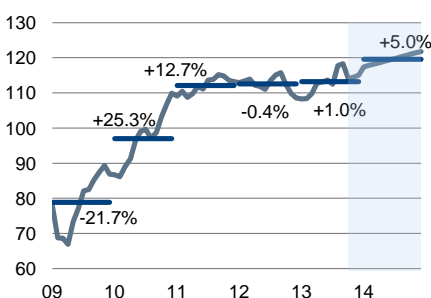


Source: ifo Institute

Significant growth in 2014

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Auto industry, real production index, 2010=100, moving average



Sources: Federal Statistical Office, DB Research

Automotive industry: Strong growth in 2014

The automotive industry strongly curbed its production in Q4 2012, thus reacting inter alia to the continuing weakness in demand in Western Europe. In total 2012, domestic real production fell by 0.4% in terms of the production index. The sector took a breather following the two strong years 2010 and 2011 when double-digit production growth was reached.

Owing to the production decline at the end of 2012, the automotive industry started with a statistical underhang of roughly 3.5% into the year 2013. Although production tended to rise in the first nine months of 2013 (e.g. Q3 2013: +4% qoq), only a marginal increase has therefore been registered in a year-on-year comparison: from January to September 2013, production was 0.3% up on the corresponding pre-year level.

For the further course of the year, we expect the upward trend in the domestic automotive production to continue, so that on an annual average production is likely to increase by 1%. In terms of value, exports of the sector provide differing impetus. While exports to the US and Britain will increase in 2013 and support domestic production, German exports to Continental Europe will initially only gradually reach the trough. Exports to China have recently recovered but will decline in full year 2013 although the Chinese car market continues to grow. This reflects the fact that Chinese car demand is to an increasing extent served from local production sites of German companies. After a weak start into 2013, the domestic market for passenger cars should recover in the coming months. In addition, the demand for commercial vehicles is developing positively; unit output will increase in 2013.

For next year, our forecast for the German automotive industry is considerably more optimistic. We expect real domestic automotive production to increase by 5% in 2014. Support is expected to come from west European car demand, which is likely to recover next year, for the first time since 2009. This is due not least to the replacement need: in 2013, the new car registrations in the EU-15 have for the sixth consecutive year been below the average level of the past 15 years. However, the prerequisite for the recovery of the west European car market is that there will be no further setbacks in overcoming the debt crisis. In the US and China, car demand is also likely to grow further, with growth dynamics probably slowing down above all in the US. Finally, new registrations of passenger cars are also likely to recover in Germany in 2014 (+3%), thus supporting domestic production. Business expectations have again been in the positive range for some time despite a setback at the latest reading; this also suggests an uptick in production in the coming months. Capacity utilisation declined in Q4 2013, however, on a quite high level.

In the long term, growth potential of domestic production is limited by the fact that by far the major part of expansion investments of German automotive producers is not carried out in Germany but in foreign countries. However, the location has outstanding prospects for the future i.e. due to the excellent cooperation and networking between car producers, suppliers, equipment companies and research institutes. It is undisputed that further innovations and productivity gains are required to survive in the global competition of car production locations. In addition, a stronger liberalisation of trade with the growing car markets of the future (such as India and ASEAN) would be helpful for domestic production locations.



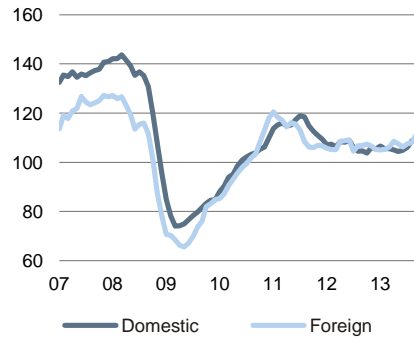
German industry: Tangible production growth in 2014

Mechanical engineering will overcome growth dip in 2014

Orders stagnating

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Mechanical engineering, order intake, 2010=100, moving average

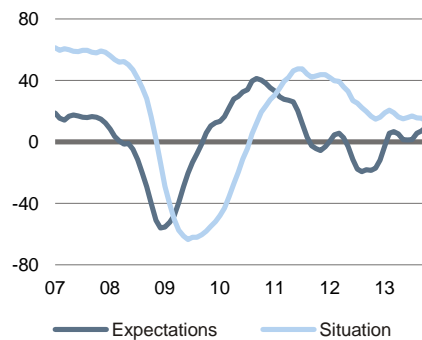


Source: Federal Statistical Office

Business expectations up recently

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Mechanical engineering, balance of positive and negative company responses

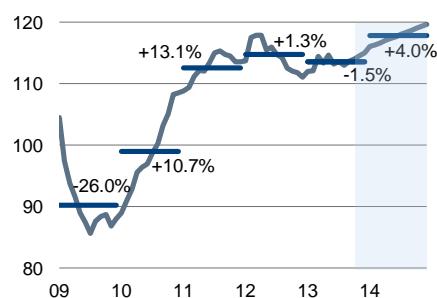


Source: ifo Institute

Production with dent

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Mechanical engineering, real production index, 2010=100, moving average



Sources: Federal Statistical Office, DB Research

The production curve of the German mechanical engineering companies, which rose strongly after the slump in 2009, has been hovering at a relatively high level for two years already. Small and medium-sized operators are benefiting from their high flexibility – not only in production but also in international marketing. Thus, the weakness in US business which lasted several years was offset by strategies of moving forward on the Asian growth markets as well as in Russia. In 2012, China became the principal sales market and overtook the US. In the last few months, the main drivers changed pace again. The new Asian growth countries shifted into lower gear; as a consequence, German machinery exports to China declined by 10% in 2012. At the same time, however, deliveries of machinery to the US expanded by 13%.

German mechanical engineering started the year 2013 with a production loss of 2.1% yoy in the first nine months. The development of incoming orders is still moderate. Business expectations are "slightly positive". Although we expect a 1.5% downturn in machine production in total 2013, this assumption is based on several positive assessments: first, there are increasing indications of China's sustained return to a higher growth path (2014: +8.6%). This suggests higher order and supply volumes to China. However, the export dynamics of previous years are unlikely to return for some time to come. On the one hand, China's demand for machinery will be covered much more by Chinese producers, whose product range is becoming ever broader and technologically more modern. On the other, some German mechanical engineering companies are currently also producing in China, e.g. to supply the local German car producers even more effectively. Second, German mechanical engineering companies probably obtain further demand impetus as a result of the economic stabilisation in the US and the US efforts to "reindustrialise" the country. Third, prospects have recently brightened in Europe, which absorbs 53% and thus the lion's share of German machinery exports. Fourth, the pick-up in industrial activity in the coming months is likely to entail an increase in demand for machinery in Germany. All this suggests a sustained pick-up in the mechanical engineering segment and higher production growth in 2014 (+4%). For mechanical engineering companies – and their customers – the currently low interest rates are interesting. Furthermore, the prices for input materials are attractive: iron and non-ferrous metal prices have in some cases corrected considerably. Locking in prices for an extended period may be rewarding in the future.

In the medium term, domestic mechanical engineering will be faced with major challenges. With growing concerns about the future availability of sufficiently qualified personnel in Germany the sector is not alone, though. But especially for mechanical engineering, know-how and superior competence lead have been competitive edges so far. A further advance of Chinese mechanical engineering companies into the medium-tech product segment is likely. The future rise in Chinese labour costs and an expected gradual appreciation of the Chinese currency versus the euro may alleviate the competitive pressure, though.

However, many interesting chances are ahead for mechanical engineering as well. For instance, some weeks ago the world's leading metal processing fair (EMO) dedicated itself to a future subject for all segments of industrial production, i.e. "Producing more intelligently". Key parameters are excellence, efficiency and intelligence whereby information technology has a key function for the better interaction of conventional production processes. Here, the German mechanical engineering companies could make the most of their comparative advantages, inter alia initially identify, simplify and master complex challenges and then design effective machinery solutions and thus tap into new markets.

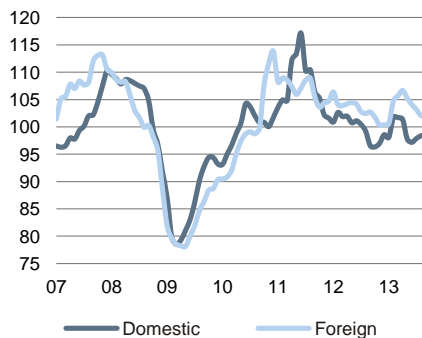


German industry: Tangible production growth in 2014

Significant recovery of foreign orders not yet in sight

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Electrical industry, order intake, 2010=100, moving average

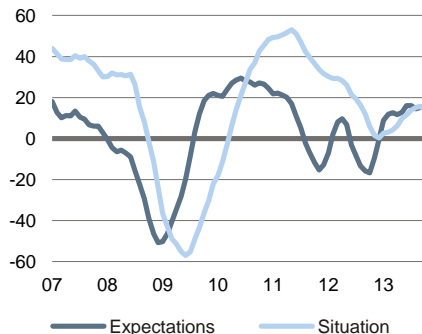


Source: Federal Statistical Office

Business expectations: Recovery after the low

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Electrical industry, balance of positive and negative company responses

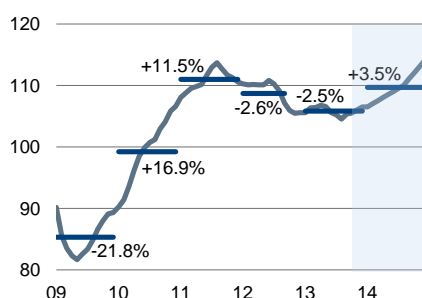


Source: ifo Institute

Finally in for a recovery

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Electrical industry, real production index, 2010=100, moving average



Sources: Federal Statistical Office, DB Research

Electrical industry: Difficult times drawing to a close

The electrical industry has a very international orientation already and is developing very quickly. For instance, global trade with electrical products was up another 9% in 2012. In the meantime, China has taken over the pole position among the leading producing countries from the US, followed by Japan, South Korea and Germany. These internationally leading countries gear their production mainly to electronic components, information and communication technology as well as automation.

In Germany alone, the electrical industry makes up one-eighth of total industrial output or just under 3% of domestic GDP. Since the low of 2010, 45,000 new jobs have been created in Germany so far, so that the electrical industry currently has 841,000 employees. Germany's electrical engineering industry is known for its broadly-based portfolio of innovative products. Capital goods (e.g. automation and energy technology) account for four-fifths of output, intermediate goods (e.g. electronic components, semiconductors) for one-eighth and consumer durables (e.g. household appliances, consumer electronics) for one-tenth. With its product portfolio, German electrical industry is benefiting from the currently much observed megatrends, cyber-physical systems (i.e. the consistent automation of production), cloud computing, electromobility, "energy turnaround" and broadband expansion.

In the current debate about the relocation of production sites several arguments clearly speak in favour of Germany as a business location. Besides the regulatory framework, the main arguments in favour of Germany are related to staff and cooperation across sectors. Currently, there are many well-trained workers, up to highly specialised engineers – even if not in every specialisation, all over the country and in sufficient numbers at all times. Furthermore, in the product life cycle, the proximity to related highly performing sectors – e.g. to the world market leaders in mechanical engineering – proves very stimulating for the development of German electrical industry.

Given the recurrent economic and debt crisis, the German electrical industry has been in difficult times for some years now. As a consequence, assessments on the situation and expectations dimmed accordingly. For example, the assessment of the business situation slumped in the 2011 to 2012 period. At the same time, business expectations, coming from a very high level, underwent a very volatile period with a double dip. Since the turn of the year 2012/13, both indices have been trending up – even if the expectations curve is currently flattening.

The economic challenges of the eurozone and the concomitant uncertainty in the main recipient countries currently still reduce the sales opportunities abroad. In addition, however, these turbulences have negative repercussions on German key customer industries (especially the building sector, the automotive industry and mechanical engineering), which in second-round effects have an impact on electrical engineering.

The difficult situation of the electrical industry so far can be easily shown in order intake. Incoming orders have declined by 0.3% year-on-year so far this year. In this period, foreign order intake grew by 0.5% yoy, while domestic order intake weakened by 1.4%, whereby large orders positively distort this observation.

The tense situation of the domestic key customer industries and the economic challenges in key foreign markets currently reduce the propensity to invest and, on top of this, the growth of electrical industry in the current year. However, in the coming year we expect a noticeable improvement of the macroeconomic environment for the foreign and domestic customers – last but not least because of the megatrends mentioned above. On this basis, the production of the



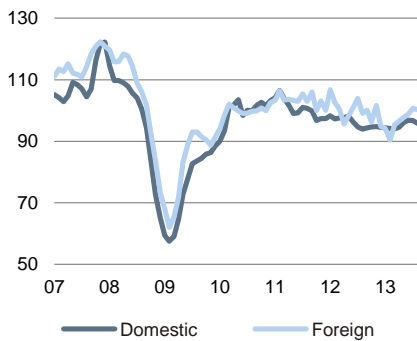
German industry: Tangible production growth in 2014

German electrical industry should decline by 2.5% this year but rise by 3.5% in 2014.

Domestic and foreign orders lack momentum

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Metal production and metalworking,
Order intake, 2010=100, moving average



Source: Federal Statistical Office

Metal industry gradually regaining traction

Metal production starts cyclical upswing

The iron and non-ferrous metal industries are known for their cyclical movements, depending on the overall economic situation. Here, the actual performance and the expectations play a large part each. The German metal producers usually buy their primary raw materials – e.g. iron ore – abroad. Furthermore, thanks to the substantial rise in recycling quotas over the years, a large part of input raw materials stems from "domestic sources".

In reaction to the only stuttering global economy in the last two years, especially the correction in the leading customer country for metals, i.e. China, prices of iron ore and important non-ferrous metals such as aluminium and copper fell strongly. For metal producers, the correction of input prices was only weak consolation, though, for the 3.8% fall in production was not the only decline. Selling prices were under pressure as well: on the one hand, customers insisted on price concessions, while on the other, competitors from the neighbouring EU countries, who suffered from sales declines even more, were in the German market with aggressive price positioning. From the point of metal producers, this reflected the negative impact of global overcapacities.

Currently, there are glimmers of hope, however: iron ore prices are likely to have passed the trough in mid-2012 already. Furthermore, non-ferrous metal prices are rising slightly. The metal customers who are of major importance in Germany, such as the automotive industry, mechanical engineering and residential construction, expect growth to pick up perceptibly in 2014. Thus it is no wonder that metal producers' business expectations are already much better than their assessment of the business situation.

In anticipation of a better order situation, metal producers should be able to raise their production slightly and thus end the year as a whole reporting stagnation on balance. The metal industry is in for a recovery in 2014. The better prospects of domestic major customers and the uptick of the world economy are supportive. What is more, we expect an improved environment in European business. Thanks to a slight production overhang, metal production should rise by 4% in 2014. Furthermore, some metal producers – in anticipation of the upswing – should increasingly be confronted with the question of hedging on the procurement side.

Prices of iron ore* on the move

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EUR/dmt



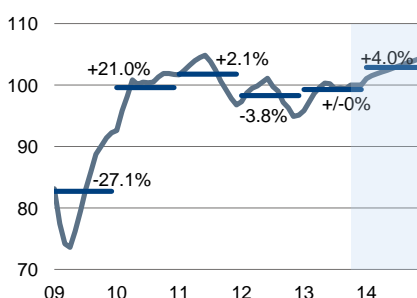
*Iron ore with 62% iron content

Source: The Steel Index

Output stagnates in 2013

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Metal production and metalworking,
real production index, 2010=100, moving average



Sources: Federal Statistical Office, DB Research

Metal products in for additional demand from industry and the construction sector

In the current year, the industry-related producers of metal products suffer from the weakness of industry, while construction-related producers suffer from the all in all weak construction business. By contrast, the improvement in the employment situation in the last couple of years and the – in relation to GDP – above-average growth in private consumption support the consumption-related metal segments such as household appliances and tools. Thanks to the brightening industry and construction sector, we expect growing demand for industry- and construction-related metal products, such as steel and aluminium products, radiators and metal containers. The sector is benefiting from industrial trends such as the trend towards light construction in car manufacturing. The economic stabilisation in Europe is also positive, though, for the area accounts



German industry: Tangible production growth in 2014

for three quarters of foreign sales. For this sector that mainly consists of small and medium-sized businesses we expect production growth in line with the industry average of +4% in 2014.

Chemical industry without momentum

The year 2012 was a weak year for the chemical industry – production declined by 2.6% in real terms. Clearly positive signals for the chemical business have been missing so far, although the chemical sector is considered an early-cycle sector and thus should already send recovery signals for industry as a whole. In the first nine months, production was only 0.6% higher than in the same period of the previous year. In Q3 2013, production was 0.6% up qoq (Q2: +0.3% qoq), albeit with considerable fluctuations during the last few months.

Nevertheless, the early indicators in the chemical industry gradually suggest increased dynamics for the remainder of 2014. Orders and production largely move in parallel in the chemical industry. Q3 2013 orders were up 2.2% qoq. Positive impetus came from abroad (Q3: +1.9% qoq) and from domestic orders (+2.5%). The ifo Business Climate Index has largely moved sideways in both components for some months. The expectations component, which consists of the balance of positive and negative assessments, has moved upwards recently. The business situation is rated better by companies and reached a level of 17.6 in October. Since early 2012, capacity utilisation as well has been moving without a clear direction in a range between 82% and 84%. At 84% in Q4, it was back to the upper end of the range. All in all, real production in the chemical industry will grow moderately by 1% this year.

In 2014, the pick-up of German industry and the upswing of foreign markets are likely to benefit the chemical industry, too. For the sector, especially the economic recovery in Europe is of major importance as it delivers half of its exports into the EU. Here, the slight recovery should help which we forecast for EMU GDP in the coming year. In major European neighbouring countries outside EMU as well which are important for the chemical sector the economic situation will improve next year (UK: 2.5%, Poland: 2.5%). Initial positive indications are visible from the growth situation in non-European foreign countries. In Q3, non-EMU orders rose by 2.1% qoq. Here, especially the US and China as the two major export markets are in focus as we expect stronger growth from them.

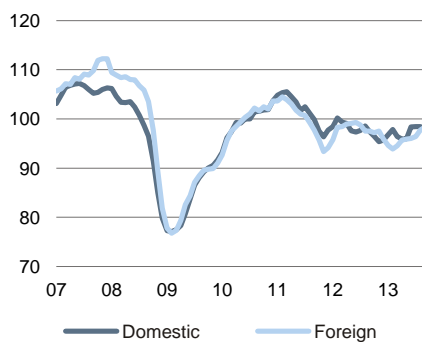
Next year, domestic demand for chemical products will be fuelled by impetus from other sectors of manufacturing. For instance, we expect dynamic growth of automotive production (5%) in 2014 which should support chemical production as well. Consumption-related chemical sales are likely to benefit from the favourable development of private consumption in Germany. This will benefit e.g. the (relatively small) segment of detergents and personal hygiene. Here, production has performed better in the first nine months of 2013 compared to basic chemicals. We expect chemical production to grow by 3.5% in the coming year.

Currently, sector sales suffer from the weak development of producer prices. While they still rose by 2.9% in 2012, the index has been down on the pre-level since April. Prices of naphtha, the most important raw material of the chemical industry, recently declined even faster, so that the margins of companies could even have expanded. Crude oil prices have decreased by tendency since early September. If oil prices were to stay on a quite low level, recovery of producer prices in the chemical industry could be delayed.

Order intake not yet dynamic

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Chemicals industry, order intake, 2010=100, moving average

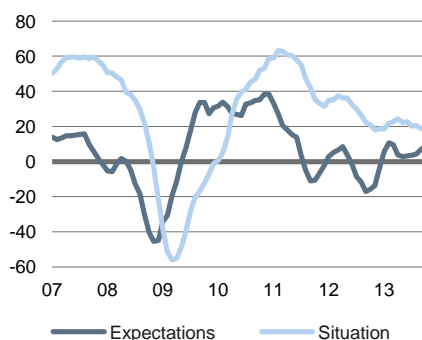


Source: Federal Statistical Office

Business expectations up again

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Chemicals industry, balance of positive and negative company responses



Source: ifo Institute

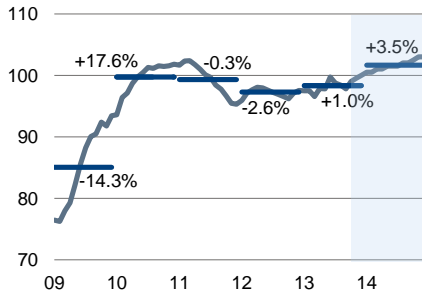


German industry: Tangible production growth in 2014

Chemicals: Recovery in 2014

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Chemical industry, real production index, 2010=100, moving average

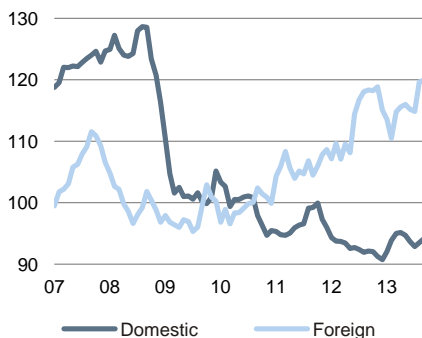


Sources: Federal Statistical Office, DB Research

Stimuli from abroad

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Pharmaceutical industry, order intake, 2010=100, moving average

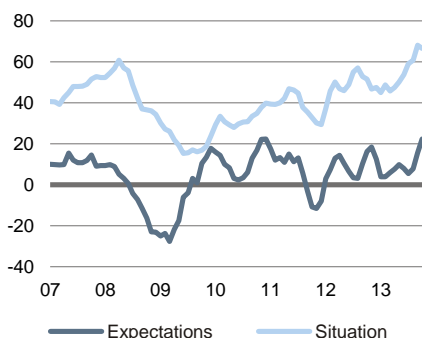


Sources: Federal Statistical Office, DB Research

Positive business expectations

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Pharmaceutical industry, balance of positive and negative company responses



Source: ifo Institut

Pharmaceutical industry: Export markets will continue to gain importance

2012 was a weak year for the production of pharmaceuticals: the decline of pharmaceutical production by 2.4% was even stronger than that of industrial production as a whole (-1%). Since the middle of last year, the outlook has improved somewhat, however. In the period April-September 2013, the production of pharmaceuticals was 2.5% up on the level of the preceding six months; and domestic production even accelerated at the latest reading. Capacity utilisation rose in the first three quarters of 2013 but receded a decline in Q4.

Domestic and foreign order intakes continue to see a contrasting development. The dynamics of the pharmaceutical industry is mainly due to exports; in 2012, the pharmaceutical sector registered an export ratio of 68%. In 2012, foreign order intake recorded a 6.8% increase (domestic orders: -4.9%). This positive trend in foreign orders continued in the first nine months of 2013 (+2.9% yoy). For the remainder of 2013 and the coming year as well, we expect positive impetus from foreign markets. This forecast can mainly be attributed to – despite the economic crisis in the euro area – growing order intake from the eurozone, the most important export region for German pharmaceutical companies. But the growth pick-up in the US, which, at a share of close to 15% of 2012 total pharmaceutical exports, is the largest individual market of German producers, should also help the pharmaceutical industry. Only a small fraction of exports so far goes to the more dynamic emerging markets. However, exports to China have surged in 2012 (+38%), so that the share in total German exports grew from 1.7% in 2011 to 2.2% in 2012. The continuing high demand for healthcare in the markets of Asia and Latin America will probably continue to support the pharmaceutical sector although the shares of the individual markets are mostly rather low.

In the domestic market, however, pharmaceutical companies are still in the throes of a difficult regulatory environment. This is reflected inter alia in the continuing fall in producer prices (2012: -0.7%; Jan.-Sept. 2013: -0.7% yoy). Like its predecessor, the new Federal government is likely to pursue a policy targeting cost curtailment in healthcare. Thus – despite the expiry of the price moratorium at the end of 2013 – a considerable improvement in the environment is unlikely.

Nevertheless, domestic business went up slightly at the start of the year. For instance, domestic orders in the first nine months of 2013 were 1.3% higher than the comparable figure for 2012 and domestic orders have tended upwards since the summer months. Our assessment for 2013 and the coming year is currently quite optimistic. The solid growth of private consumption in Germany this year and next (DBR forecast 2013: +0.9%; 2014: +1%) should continue to boost the market for non-prescription drugs slightly. This should benefit more expensive lifestyle products. For pharmaceutical companies this also offers an opportunity to offset fiercer yield regulation in the statutory health insurance market.

All in all, real pharmaceutical production should grow by 3% this year. This is also suggested by business expectations which continue to be positive and increased significantly of late. However, the continuing weakness of the sector with a view to the launch of new products as well as the benefit assessment of drugs on the basis of the Act for the Restructuring of the Pharmaceutical Market (AMNOG) are burdening factors. Next year as well, against the background of the contrasting development between the domestic and foreign market, production growth is expected to be 3% in real terms. However, production is very volatile in the course of the year, so positive and negative surprises are possible.

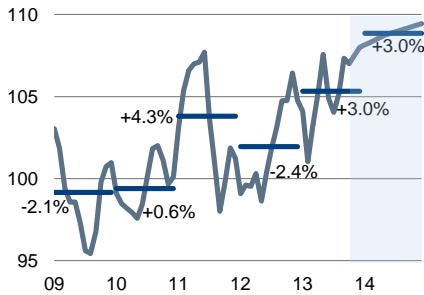


German industry: Tangible production growth in 2014

Pharmaceutical production to grow in 2013 and 2014

21

Pharmaceutical industry, real production index, 2010=100, moving average



Sources: Federal Statistical Office, DB Research

Plastic products: Out of the trough

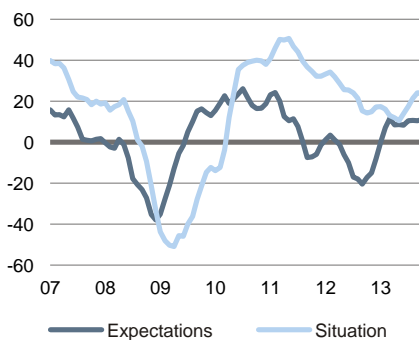
The plastics processing industry is an early-cyclical sector. Like chemicals companies, plastics producers also mainly cater to other industrial customers such as vehicle and machinery manufacturers as well as electrical engineering firms. Moreover, the construction industry and the consumer goods industry are major customers.

In the plastics manufacturing sector, the recovery of German industry is reflected most strongly. After production still declined by 1.1% last year, it emerged from the trough at the turn of the year. In Q3 2013 it rose by 0.8% qoq (Q2: +3.6% qoq). Since February, business expectations have been in positive territory again, but lately trended sideways in a band between +9 und +12.5. The sector is very optimistic with regard to the assessment of the business situation. Capacity utilisation has most recently stabilised at 79% but is still clearly below the peak of 85% seen in spring 2011. Against the backdrop of the 2012 underhang of 1.5%, we expect an increase in real production of 2% for the current year.

Expectations signal recovery

22

Plastics industry, balance of positive and negative company responses



Source: ifo Institute

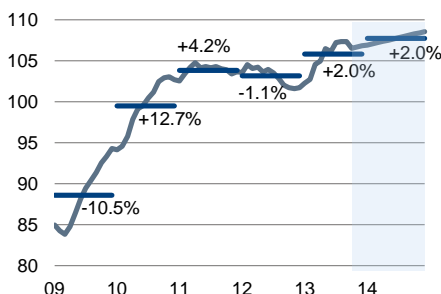
In the coming year, a real expansion of production of another 2% should be possible. The dynamic development in major customer industries such as the automotive industry (2014: +5%) and the electrical industry (2014: +3.5%) is likely to give impetus to the production of the plastics manufacturing sector. Given the low export ratio of the sector of only 38%, the domestic economic situation is of major importance. Investment in construction which, according to our estimates, will grow by 2.2% real in 2014 will have positive effects on the sector. Makers of packaging materials for the consumer goods industry will probably benefit from the continuing robust private consumption in Germany, which is set to increase by 1% in 2014 as in the previous years.

At an increase of 1.6%, the price development in the sector was moderate last year. In the current year as well, prices rose by only 1% yoy in the first nine months. This also reflects the largely sideways development of oil prices since mid-2012. Oil prices have tended downwards somewhat since early September which is expected to dampen the development of producer prices.

Plastics: Moderate growth rates

23

Plastic products, real production index, 2010=100, moving average



Sources: Federal Statistical Office, DB Research

Construction materials industry to benefit from upswing in construction industry

In 2012, the production of construction materials was down 4.3% after it had expanded by an average of 8% in 2010 and 2011. Last year's decline was mainly due to lower construction activity: real construction investments were down 1.4% in 2012 (2011: +7.8%). Residential construction performed better than commercial construction and civil engineering; in the latter sector, the expiry of economic stimulus programmes had a burdening effect. Furthermore, adverse weather conditions led to a decline in construction activity in 2012.

The construction materials industry started into 2013 with moderate momentum. In the first nine months of this year, production was down by a real 2.1% on the corresponding level of the previous year. Currently, however, there are indications of a slight recovery which in our view should continue up to the end of 2013. Nevertheless, according to our forecast, the production of construction materials will decline by 2% in total 2013. Demand from the construction sector will turn out weak again: investment in construction should fall by roughly 1% in the current year, with residential construction again performing better than other construction segments.

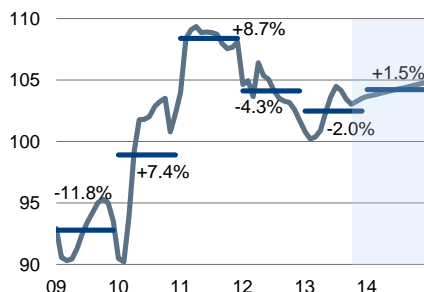


German industry: Tangible production growth in 2014

Stronger growth in 2014

24

Construction materials industry, real production index, 2010=100, moving average



Sources: Federal Statistical Office, DB Research

For 2014 we expect the production of construction materials in Germany to increase by around 1.5% price-adjusted. The main driver for this development is the economic pick-up in the construction sector. For 2014 we anticipate a real pick-up of investment in construction of more than 2%. Here, major impetus will again come from residential construction, while civil engineering – despite the high investment requirements e.g. in transport infrastructure – will move up only slightly. Our forecast for 2014 is supported by business expectations in the construction materials industry which are clearly in the positive range.

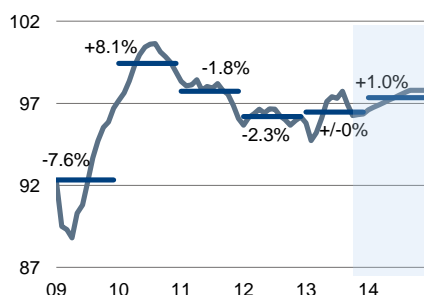
Paper industry 2014: First growth possible since 2010

In the German paper industry, 2012 production fell by 2.3% price-adjusted. Thus, the decline was in a similar range as in 2011 (-1.8%). This development was mainly attributable to the all in all weaker economic situation in Germany which was accompanied by subdued paper demand from both commercial and private customers.

Paper production to rise moderately in 2014

25

Paper industry, real production index, 2010=100, moving average



Sources: Federal Statistical Office, DB Research

So far this year, there are no indications of a substantial recovery of paper production yet. For the first nine months of 2013 domestic output was up 0.3% yoy. However, order intake declined again recently, whereby domestic orders performed better than foreign demand. Business expectations are currently back in positive territory. But capacity utilisation has fallen in four consecutive quarters, albeit at a relatively high level. All in all, paper production is likely to stagnate in total 2013.

In 2014 the sector could grow again. Due to the more favourable industrial activity and the increase in private consumption, domestic demand should provide stimulus to the paper industry. What is more, the economic environment in western Europe, the largest foreign sales market by far, is gradually improving, so exports should support domestic production. On an annual average, paper production is likely to increase by 1% next year in our view.

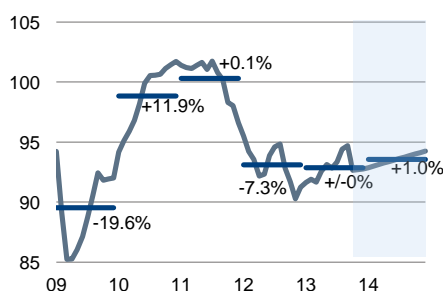
Due to lacking economic stimulus, producer prices moved more or less sideways in the last few months. If demand for paper picks up in the coming months, producer prices should also rise.

Textile and clothing industry: Change in the trend in 2014

Production stagnates in 2013

26

Textile industry, real production index, 2010=100, moving average



Sources: Federal Statistical Office, DB Research

Both in the textile as well as in the clothing industry, domestic production declined strongly in 2012 (-7.3% real and -9.3%, respectively). In the textile industry, this was due inter alia to the fall in demand from commercial customers for technical textiles. In this sector, which developed positively in the previous years, production declined by over 10% in 2012. In the clothing industry, the decline in production is still due to structural factors (relocation or closure of production capacities). Here, the domestic production basis is so low, however, that the time series concerned are susceptible to statistical outliers; this reduces their meaning and has a negative effect on the forecast quality.

Production in the textile and clothing industry trended slightly upwards in the first nine months of 2013. However, this was insufficient to reach positive territory in comparison to the level of the previous year. In the textile sector, production in the first nine months of 2013 was 0.4% down on the level of the previous year; in the clothing industry, production was 1.1% lower than in the pre-year period. For total 2013 we expect a stagnation of production in the textiles sector and a decline by 1.5% in the clothing industry. In the textile industry, technical textiles are again outperforming other segments.

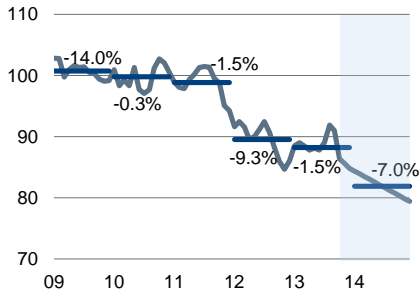


German industry: Tangible production growth in 2014

Downward trend continues

27

Clothing industry, real production index, 2010=100, moving average



Sources: Federal Statistical Office, DB Research

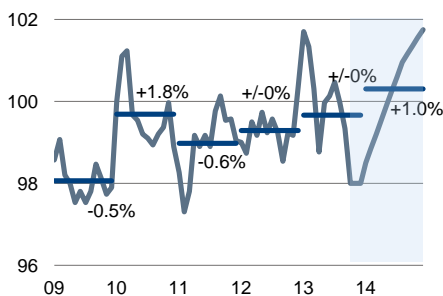
For 2014 change is on the cards for both sectors. For the textile industry we expect an about 1% increase in domestic production – above all due to renewed stronger demand for technical textiles from industry. In the clothing sector, by contrast, the downward trend is likely to continue; here, a decline of 7% is likely in our view. Especially in the clothing sector, however, the development of domestic production is no good economic indicator because of the cited structural effects. In the past, sector sales developed better on average than domestic production. In addition, many German clothing companies have for years successfully benefited from the possibilities of the international division of labour which result from the liberalisation of the international clothing market.

Food industry 2014: Moderate increase in production

Haven of stability

28

Food and animal feed, real production index, 2010=100, moving average



Sources: Federal Statistical Office, DB Research

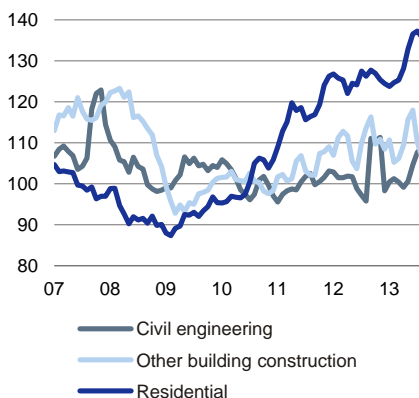
Production in the German food industry should stagnate (price-adjusted) in 2013. This would be the third consecutive year without growth (2012: +/-0%; 2011: -0.6%). Such a long lean spell is not typical for the sector, which in the past was characterised by a moderate but relatively constant upward production development which was mainly due to qualitative growth (higher quality, innovative products). However, this trend seems to be broken of late. One reason could be that producer prices in the food industry rose relatively strongly in the last few years: currently, they are 14% higher than the average level of 2010. This price increase could have triggered a certain reluctance to buy on the part of consumers at home and abroad especially for more expensive food.

In principle, we expect the food industry to return to a moderate growth path in the next months and years. Beside the qualitative growth mentioned, the increasing export market development plays a major role here. Given the gradual recovery of the important west European sales markets, impetus from foreign demand is likely to pick up again in 2014; the export ratio in the sector was just below 22% in 2012. All in all, we expect a 1% increase in production for the coming year.

Stimuli in almost all sectors

29

Construction, order intake, 2010=100, moving average



Source: Federal Statistical Office

Construction: Friendly outlook

Contrary to expectations, 2012 construction activity weakened by 1.4% year-on-year. Especially non-residential construction declined strongly (-4.6%); this was also the case for public-sector investment (-10.5%). By contrast, residential construction was able to increase slightly (+1.1%).

The leading indicators – building permits and new order intake – have been trending positive in 2012. Currently, 2013 building permits are roughly 9% higher than in the same period of the previous year. Building permits have risen in both residential (+11.7%) and non-residential construction (+6%). Due to an improved environment on the financing side in commercial construction, the divergence between residential construction and commercial construction could turn out to be lower in the future. The picture is similar for orders. Order backlog rose significantly in 2013, and order intake continued to increase as well.

There is a complex relationship between leading indicators and investment forecasts, for construction investment grew very erratically after the Great Recession of 2008/09 as illustrated by the following figures: from Q3 2009 to Q2 2013 quarterly growth averaged 0.7% qoq. However, this result was strongly driven by the two high growth readings of 6.6% in Q2 2010 and 9.5% in Q1 2011. Without these two high positive growth rates, investment in construction contracted by 0.4% qoq on average in the same period. These data make it particularly difficult to forecast investment in construction.

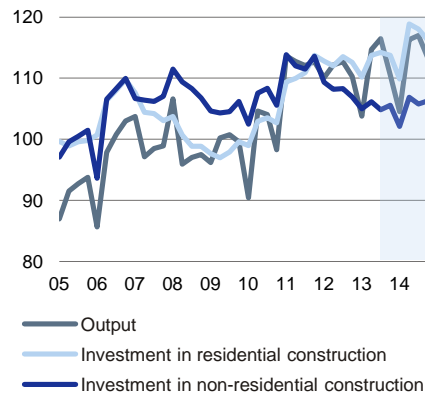


German industry: Tangible production growth in 2014

Construction: Output & investment

30

Construction sector, production and investment, 2010=100



Source: Federal Statistical Office

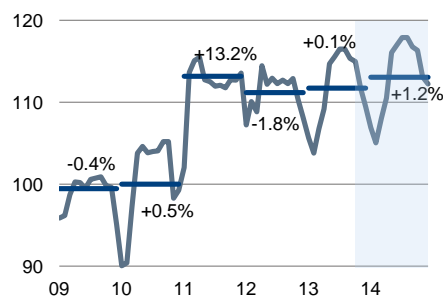
In the first half of 2013, total investment in construction fell by roughly 2% compared to the first half of 2012. Investment in the non-residential construction segment fell much more strongly (-4.8%) than investment in residential construction (-1.7%). Despite low investment in the last few quarters, leading indicators and the improved outlook in commercial construction suggest a continuation of the positive overall situation for the German real estate market. In addition, the decline in investment contributes to a further increase in residential property prices due to the tight housing market. Rising prices, however, encourage investment and should sooner or later also be reflected in investment activity.

Thus, investment in construction is likely to pick up in H2 2013. Nevertheless, for 2013 as a whole we expect a 1.1% decline in construction investment. Given a positive growth overhang, construction investment should expand by over 2% in 2014 as a result. As in the previous years, growth of building construction and housing will remain stronger than that of commercial construction and civil engineering. For total 2013, we expect a stagnation of building construction and residential construction. In 2014 building construction is likely to grow by over 2%, while civil engineering is likely to grow only slightly. In line with our investment forecast we expect to see stagnating construction output in the current year. In 2014, construction output is likely to increase by 1.2%.

Construction: Stronger growth in 2014

31

Construction, real production index, 2010=100, moving average



Sources: Federal Statistical Office, DB Research

Outlook: Further recovery in the coming year

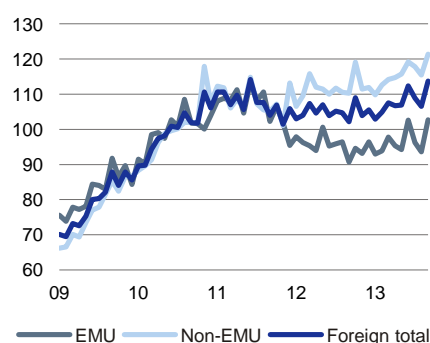
German industry is showing first signs of recovery. Industrial production passed the trough at the turn of the year 2012/13 and has risen slightly since then. Since February, the expectations component of the Ifo Business Climate Index has been in positive territory again. With regard to orders, demand from non-European countries since the turn of the year has been better than that from the euro area. In view of the large statistical underhang of 1.6% from the year 2012, we expect, however, that industrial production will only stagnate in the current year.

In 2014, industrial activity will continue to increase (+4%). The upswing is associated with stronger growth in important foreign markets of German industrial companies, especially in the US and – to a lower extent – in China. The EMU countries will also register positive GDP growth again, so exports will give a boost to the economy. This supports e.g. the automotive industry, electrical engineering and mechanical engineering.

Order intake from EMU somewhat stronger again

32

Manufacturing, index, 2010=100, seasonally adjusted



Source: Federal Statistical Office

The automotive industry will be the strongest sector in 2014. We expect real domestic automotive production to increase by 5% in 2014. Here, west European car demand – boosted by the accumulated need for replacements – will have a supportive effect. Electrical engineering should record an increase of 3.5% – favoured by the current megatrends, such as the "energy turnaround", the expansion of Germany's broadband network and cloud computing. With an increase of 4%, mechanical engineering will also record a significant growth rate in 2014. Besides the improvement in export business, mechanical engineering will benefit from stronger domestic demand next year. Rising investment in machinery and equipment (+4% in real terms) is conducive to the demand for machinery.

Our forecast is mainly based on a general upswing of the world economy and assumes that there will be no large turmoil in the eurozone or the emerging markets. If there were a renewed crisis in the eurozone or if growth in the US or China were to turn out much weaker than predicted, our forecast would be subject to downward risks.



German industry: Tangible production growth in 2014

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Forecast for the major industrial sectors

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Sector	NACE	Gross value added	Export ratio	Business climate	Capacity utilisation	Producer prices	Production			
							2011	2012	2013	2014
		EUR bn, 2011	%, 2012	Diff. yoy balance values	Diff. yoy pp	Last 12 months, % yoy	% yoy	% yoy	% yoy	% yoy
Food	10	25.8	21.8	4.0	1.5	3.8	-0.6	0.0	0.0	1.0
Beverages	11	6.5	10.8	-5.0	-0.5	1.9	3.1	-0.5	1.0	0.5
Textiles	13	3.4	46.5	6.0	4.8	0.4	0.1	-7.3	0.0	1.0
Clothing	14	2.2	39.1	12.5	3.8	2.2	-1.5	-9.3	-1.5	-7.0
Paper	17	9.3	39.9	19.5	1.4	-1.3	-1.8	-2.3	0.0	1.0
Chemicals	20	37.1	56.6	19.5	1.4	0.4	-0.3	-2.6	1.0	3.5
Pharmaceuticals	21	16.4	67.7	15.4	-0.1	-0.7	4.3	-2.4	3.0	3.0
Plastics	22.2	17.0	37.9	25.0	2.7	1.2	4.2	-1.1	2.0	2.0
Building material	23	12.5	30.3	27.1	2.2	1.5	8.7	-4.3	-2.0	1.5
Metal production	24	19.6	38.5	20.2	5.2	-3.5	2.1	-3.8	0.0	4.0
Metal products	25	37.7	32.2	22.9	2.4	-0.1	10.9	-1.4	1.0	4.0
Electrical engineering	26+27	60.4	53.1	24.3	1.6	-0.4	11.5	-2.6	-2.5	3.5
Mechanical engineering	28	75.1	62.4	12.6	0.2	1.5	13.1	1.3	-1.5	4.0
Automotive	29	78.6	64.0	26.6	2.8	0.4	12.7	-0.4	1.0	5.0
Manufacturing	10-33	504.2	47.5	17.8	1.8	0.7	7.8	-1.0	0.0	4.0
Constructions	41+42	107.5**	-	4.1	0.4	1.0	13.5	-1.3	0.1	1.2

* According to cost structure statistics (Gross value added in accordance with the national accounts not available for all sectors)

** Latest available reading

*** Total construction industry

Sources: Federal Statistical Office, DB Research



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