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A grim outlook for the German economy



The fact that the eurozone's economic powerhouse is tiptoeing around the 'R' word, does not bode well for the bloc at large. Its trajectory is starting to look like a cautionary tale straight off the pages of the Brothers Grimm with the ECB's quantitative easing having served as the cake, confectionary and candy that was so irresistible to Hansel and Gretel. The eurozone lapped it up, but now it is leaning over the oven, facing another downturn. But this time around, the ECB will have to be imaginative about what it pulls out of its cookie jar to save the day...

On Tuesday, market fears about Germany's slowdown were amplified by data confirming that its economy contracted 0.1% in the second quarter of 2019, in

line with first estimates. The GDP breakdown revealed that the downturn is driven by a slump in exports.

Personal

consumption rose by a mere 0.1% quarter-on-quarter, down from Q1's 0.8% increase, while capital investment fell by 0.1%, after increasing by +1.6% the previous quarter. Net trade was a major detractor, shaving 0.5% from quarterly growth. This emphasizes our previous assertion that Germany is falling victim to a 'butterfly effect', whereby its export-dependent economy is wide open to collateral damage from the US-China trade dispute. A key export category for Germany is industrial equipment, which is sensitive to the economic cycle. Already the trade spat is weighing on global growth and on Chinese demand (with less growth comes less demand for such machinery), and there is the real danger Trump will continue to push his protectionist rhetoric, or even shift his gaze to European goods.

Already

the White House has threatened to slap import duties on European cars – another of Germany's major export categories. The auto industry delivers a €90.3 billion trade surplus for the continent with the main destination for European cars being North America, which represents 22.5% of total sales. With the European car industry already knee-deep in a quagmire [of its own issues](#), this could come as a *coup de grace*.

All

this considered, it's no surprise that the IFO confidence index fell for a fifth consecutive month to a 7-year low of 94.3 in August - the commentary said that "not a single ray of light was to be seen in any Germany's key industries" and there is fear the malaise could spread to services.

A lot of Europe's hopes are pinned on an ECB easing package. However, looking at the crumbs of information supplied thus far with regard to what this could entail, it is questionable how much this can benefit Germany. Demand for German bonds is already high and liquidity is ample, meaning that a rate cut won't have a huge impact.

Thus,

calls are growing for the German government to abandon its *Schwarze Null* principle (which has seen

the country run a budget surplus for year) in order to provide fiscal stimulus.

Already, Germany seems willing to invest EUR 50bn – but only if a recession materializes. Will this be too little, too late?

Beside

economic woes, Germany may soon have to grapple with political turbulence too.

Sunday will play host to two regional elections which threaten to pull the rug from under Angela Merkel's CDU-SPD coalition. According to recent polls, the AfD (a far-right, nationalist party) is neck-to-neck with the CDU to become the biggest party in Saxony, with both parties currently sitting with around 25% of votes. In Brandenburg, the AfD, SPD, CDU, the Greens and the Left Party each command around 18% of votes. As more Germans in the East feel they are being left behind economically and socially, affiliation to the AfD is increasing.

It is unlikely that AfD will take power, as

most major parties have ruled out the formation of a coalition with them.

However, if the SPD loses Brandenburg (which it has governed since reunification in 1990), calls would grow louder for the SPD to exit Merkel's coalition. A defeat for Merkel's CDU party in Saxony, where it has ruled the roost for 30 years, would call to question the party's position in Berlin.

Germany's

'happily ever after' is largely dependent upon trade policies emanating from the US – and the 'Big Bad Wolf' in this story is rather unpredictable. At the same time, we have yet to see a fiscal package leave the realms of fiction and become a fact. In light of the ominous outlook and ongoing uncertainty, we further trimmed our European equity exposure at our August allocation.

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