Investment Insight

September 2019

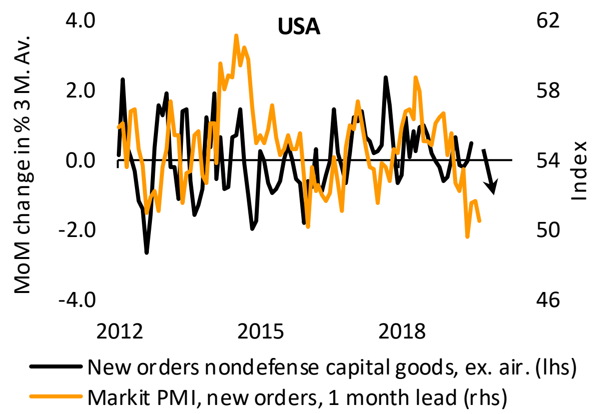
Consumption remains stable

The United States is facing a recession. Stable consumption offers Germany hope, in contrast. When exports pick up again, new growth is in sight.

US consumers have scarcely allowed the escalating trade dispute with China to unsettle them – at least that is what the most recent data on private consumption indicates. At +0.4% (inflation-adjusted over the previous month), private household spending in July increased soundly for the fifth consecutive month. Moreover, the Bureau of Economic Analysis (BEA) undertook an upward revision of the previous three months' figures. Altogether, this gives the current quarter an extremely positive start. Second quarter consumer spending had already posted the highest increase in more than four years, namely +4.7%. At present, third quarter growth again appears robust at around 3.5%.

However, dark clouds loom on the horizon. Individual consumer confidence and labour market indicators point to a downturn, which could be a harbinger of weaker consumption growth ahead. Corporate investment spending has also been under pressure for some time now. Shipments of civilian capital goods were down 0.7% in July over the previous month and thus reflect a further slowdown in investment momentum. The most recent increase in incoming orders is no consolation, with leading business surveys indicating these orders will decrease again in the months to come. The new orders sub-index of Markit's Manufacturing Purchasing Managers' Index dropped to 50.5 points in August and thus to its lowest level in ten years (see figure below).

USA: Corporate investments under pressure



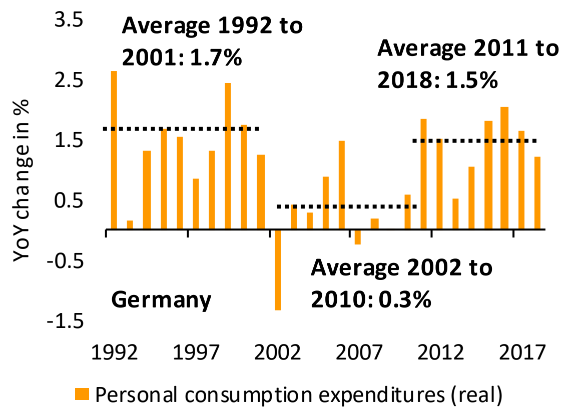
Sources: Census Bureau, Markit, BANTLEON

Current quarterly GDP growth of around 2% in the USA is likely to remain near the previous quarter's level, although we expect that pace to slow in the fourth quarter. For one thing, consumer demand will likely weaken as employment growth declines. Also, our in-house early leading indicators suggest that business investments will continue to wane, meaning a greater slowdown effect from this economic driver. GDP is predicted to grow at a slower rate of 1.0% to 1.5%.

Second quarter GDP in Germany fell by 0.1%. Published data on GDP components was a near-perfect match to expectations. Private consumer and government spending thus provided a positive impetus – as did spending in machinery and equipment, up for the tenth consecutive quarter (+0.6% over the previous quarter). In addition to the decline in construction investments, foreign trade in particular negatively affected economic output by 0.5% percentage points. But more important than looking into the economic rear view mirror is looking ahead. The ifo Business Climate Index does not bode very well in this regard, having slid down another 1.5 points in August, hitting 94.3. This is the lowest level since 2012, at the height of the Eurozone debt crisis. Expectations even fell to the lowest level since June 2009.

If we were to take the ifo index at face value, we would have to anticipate a decline in economic output for the current and the fourth quarter. But we do not expect to see things go that far. Private consumption is the main argument against a recession scenario. There are signs another sound increase is in store for the current quarter, after the weak increase posted in the second quarter (+0.1% over the previous quarter). A considerable rise is expected for August retail sales. Moreover, new car registrations in July rose considerably, by around 9% from their second-quarter level. Relatively high collectively agreed pay increases continue to mean we will see rises in real wages.

Germany: Consumption stabilises the economy



Sources: Destatis, BANTLEON

Government – as well as consumer –spending can be expected to play a role in stabilising the economy. Public coffers are full to the brim. The German government recorded a surprisingly high budget surplus of €45.3 billion in the first half of 2019, of which €17.7 billion was attributed to the federal government. Even if the »grand coalition« cannot warm to the idea of a stimulus package in the style of that adopted in 2008 and 2009, government spending can still be expected to increase by at least 1.5% given the current negative interest rate environment. And exports should also continue to increase over the medium term supported by the global economic development we expect to see.

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We therefore consider GDP growth in Germany of 0.2% to 0.4% over the previous quarter as realistic. Also in the following quarters, economic output is likely to increase at a moderate pace. Stabilisation of the German economy together with the sound growth forecast for France, Spain and the Netherlands will lead to an increase in economic growth of the entire Eurozone as well. Assuming compromise can be reached in the trade dispute between the USA and China and between the USA and the EU, we maintain our forecast of an average economic output increase of 0.4% over the previous quarter for both the third and fourth quarters.

The financial markets saw not the trade war but Brexit uncertainty trigger another flight to safe havens in recent days. The apparent end of Italy's government crisis acted as a counterweight to escalation in the debate over Brexit. The former foes (Italy's Five Star Movement and its Democratic Party) are in the process of forming a new coalition government, which would checkmate *Matteo*

Salvini at the same time. The prospective new government is likely to be more pro-European than its predecessors and adopt a budget in line with EU rules. These prospects have triggered a run on Italian government bonds, whose ten-year yields have fallen below 1.00% for the first time.

Equity markets are expected to continue their recent positive trend

The persistent downward trend in economic sentiment indicators had recently driven yields on high-quality government bonds lower and lower. Conversely, however, this also means that as soon as sentiment has reached its lowest level, yields will rise again. In our opinion, the foundation for this has been laid. We only need a few weeks of *Donald Trump* not squeezing in one of his offensive tweets to pass. Sentiment can also be expected to brighten given the extremely favourable Eurozone financing conditions, among other things. Initial signs that this will have a positive impact on the real economy are already emerging.

We thus continue to assume an imminent turnaround in leading economic indicators. However, as soon as the economic situation brightens, the fantasies of lower key rates will fade at the same time, with yields rising as a result. Ten-year Bund yields can be expected to gradually increase over the next few months and again trade above 0.0% by mid-year 2020. We see equity markets, meanwhile, benefiting from the increasingly positive economic data and continuing their recent positive trend.

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