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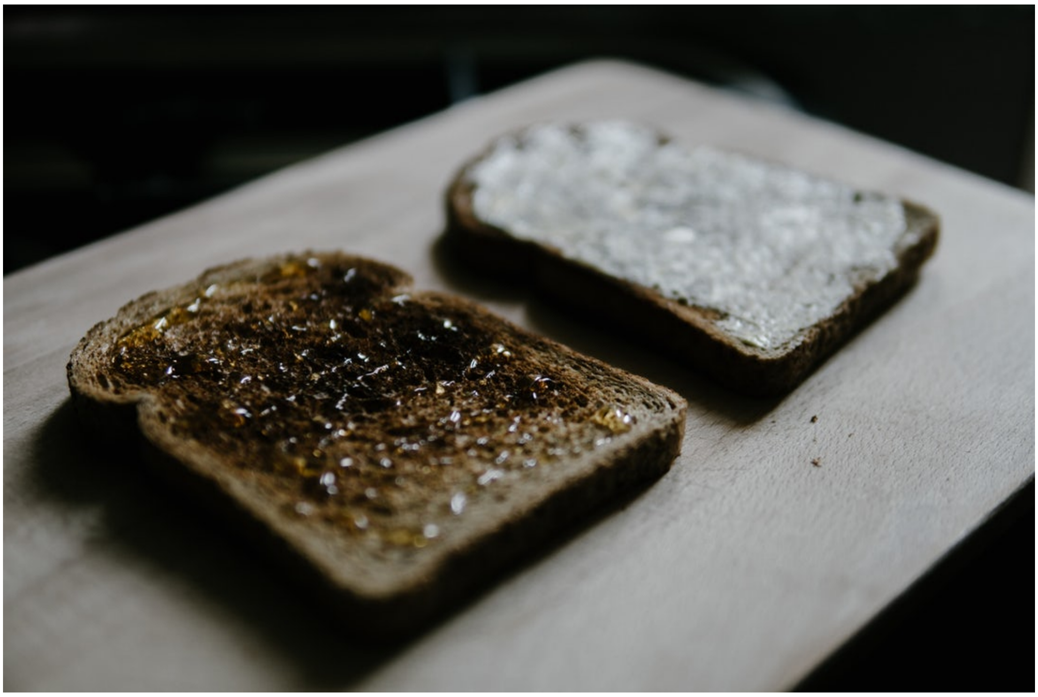
Disruption to Germany's bread-and-butter industries dents growth



Yesterday, a second release of Eurostat data confirmed that the 19-nation Eurozone grew at a pace of 0.2% in the third quarter - the weakest performance since 2013, when the bloc was in the midst of a government debt and banking crisis. Whilst Italy registered no growth at all, surprisingly, Europe's growth locomotive – Germany – was the main detractor. For the first time in three years, the German economy contracted, shrinking by 0.2% from July through September.

However, what is crucial to note, is that Germany's economy has not taken a U-turn - rather a temporary detour because of various idiosyncratic factors that are currently plaguing Germany's manufacturing industry.

First and foremost is the introduction of new EU emission tests on vehicles. This has overwhelmingly affected car production – often considered the jewel in the crown of the nation's manufacturing sector. In order to comply with the new guidelines (which were introduced following 'Dieselgate', the scandal over illegal levels of German vehicle emissions), carmakers have had to slow production until they clear a backlog of hundreds of thousands of new vehicles which must be tested against the new environmental criteria. As a result, these unsold vehicles have been placed in temporary car lots, resembling scenes from the US of 'unsold car graveyards'. According to the Financial Times, Volkswagen, the largest German carmaker, had a quarter of a million unsold vehicles parked all over Europe through summer.

But there is another factor affecting the German economy which has received less media coverage: the country is facing a severe drought which has left rivers such as the Rhine and the Elbe at record low levels. This has been described as a 'crisis unseen since the start of record keeping in 1881', with Germany's key waterways now too shallow to facilitate the transport of goods. The disruption of oil shipments to German cities along the Rhine has been so acute, that the government has released strategic fuel reserves, which, by law, may be tapped in order "to relieve a local crisis situation". Reserves of gasoline, diesel and jet fuel have all been unlocked. This has also obliged certain companies to scale back activities – for example, the industrial giant Thyssenkrupp has cut back production at its Duisburg plant because of a reduced supply of raw materials. Supply chains will remain disrupted until there is very heavy rainfall which restores water levels. Of course this will seep into near-term GDP readings.

However, analysts widely view these factors as temporary and expect industry output – and GDP – to bounce back. We believe that the German economy is robust enough to absorb the current blow to its bread-and-butter industries. As Tobias Buck aptly wrote a while back in the Financial Times, Germany 'is a country that takes pride in the solidity of its public finances, in balanced budgets and high savings rates, in the fact that society as a whole knows how to delay gratification, tighten its belt and wait for jam tomorrow.'

So whilst Germany waits for the jam, what will be crucial is the ECB's take on the situation and whether they will consider this blip when forming their 2019 strategy at their vote mid-December. We believe that the ECB will stick to its guns in that it will end its mass bond buying this year, but we could potentially see a more cautionary approach taken with regard to other elements of its QE exit, whilst the German economy remains stuck in a low gear.

The caveat to all this however, is that Germany is largely exposed to industrial exports. If Trump doubles down on his protectionist rhetoric and a global trade war materializes, Germany's path of future growth becomes a lot more uncertain.

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