FEBRUARY 2015

Debating the state of... ...Germany

BNY MELLON INVESTMENT MANAGEMENT

Contents

Can Germany boost its growth and drive European recovery?

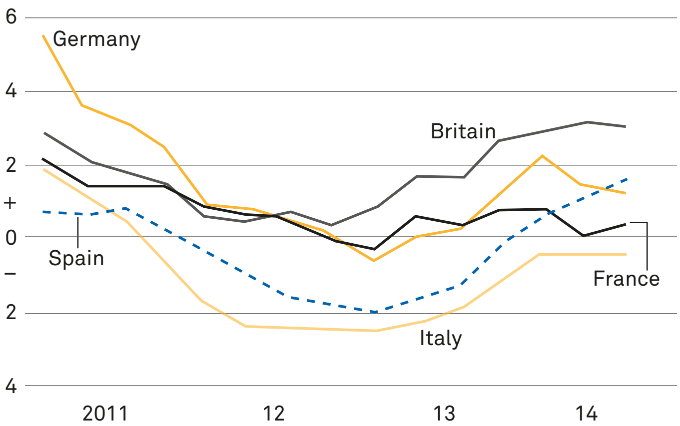
In 2015, 25 years on from the fall of the Berlin Wall, Germany is struggling with weak economic growth and gloomy business forecasts. In December last year the German central bank, the Bundesbank, halved its 2015 growth forecast to 1%[1] dashing hopes that one of Europe's strongest economies could help act as a catalyst for growth across the wider eurozone. Here, BNY Mellon assesses some of the recent developments – both positive and negative – in the German market with accompanying comments and opinions from our range of investment boutiques.

As Europe continues to grapple with the aftermath of the eurozone debt crisis, many economists have looked to the German economy as a possible engine for growth across the region. Unfortunately its erratic GDP growth rates have disappointed on the downside, with persistently low inflation proving more of a curse than a blessing. Germany's unfavourable demographic outlook is also expected to weigh on the country's economy in the medium term, while policy measures such as early retirement at 63 on a full pension are already constraining the labour supply, according to Bundesbank's December economic report.

Germany has maintained its current account surplus in the 6-7% range for the better part of the last eight years. Unfortunately, Europe's hope that German demand will turn "inward" via consumption and investment is lost to a very slow structural shift that will take years, not quarters, of easy monetary policy and explicit structural reform.

Rebecca Braeu, director of sovereign research, Standish

DOWN, UP, DOWN AGAIN
GDP, % change on a year earlier



Sources: Eurostat; Haver Analytics. As at 31.12.14.

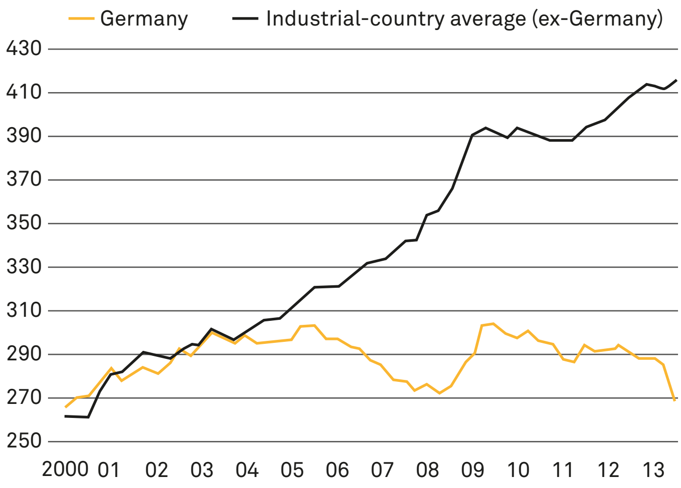
Germany has struggled with its role as the key economy in the eurozone. Domestic reflation would help its neighbours but goes against the grain of German policymaking.

Raj Shant, portfolio manager, global equity team, Newton

1 FT: Bundesbank *slashes German growth forecast for next year*. 05 December 2014

TOTAL NATIONAL DEBT

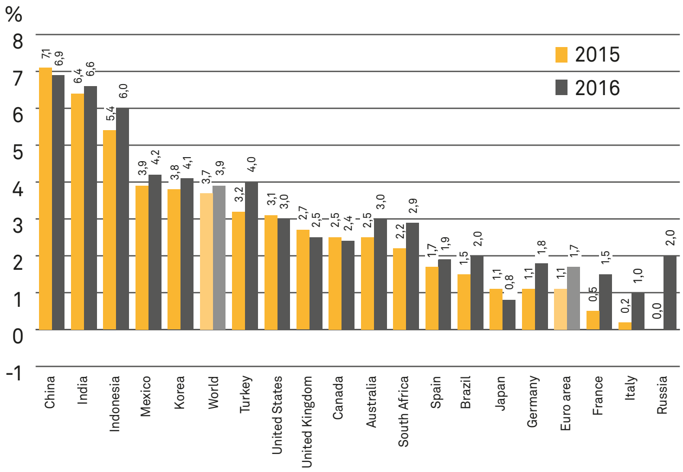
Total national debt: household, government, nonfinancial corporate and financial sector. As a percentage of GDP.



Source: McKinsey Global Institute. WSJ.com. As at 31.12.14.

GROWTH PROJECTIONS FOR 2015-16

GDP growth per cent



Source: Preliminary November 2014 OECD Economic Outlook database. As at 31.12.14.

Key economic data for Germany, 2012 – 2016				
	2013	**2014**	**2015**	**2016**
Gross domestic product (GDP), price-adjusted	0.1	1.5	1.7	1.9
Gross domestic product, deflator	2.1	1.9	2.0	2.3
Consumer prices	1.5	1.0	0.8	1.9
Labour productivity (per hour worked)	0.4	0.1	0.8	1.2
Employment (1000 persons)	42 281	42 651	42 916	43 236
Unemployment rate (percent) in relation to nominal GDP	6.9	6.7	6.6	6.4
Public sector net lending	0.1	0.5	0.2	0.3
Gross public debt	76.4	73.3	70.0	66.6
Current account balance	6.8	7.5	7.6	7.4

GDP, consumer prices, labour productivity: percentage change on previous year; Unemployment rate: As defined by the Bundesagentur für Arbeit.
Source: Statistiches Bundesamt, Fachserie 18, Reihe 1.2; Deutsche Bundesbank, Monatsbericht; Bundesagentur für Arbeit, Monatsbericht; shaded area: 1fW forecast. As at 18.12.14.

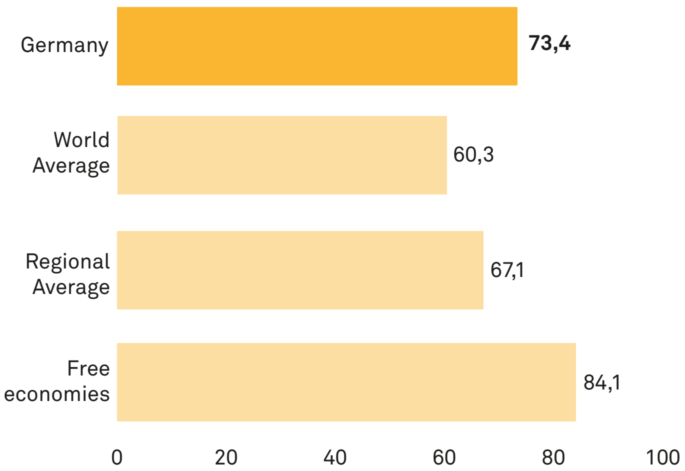
In December, against a mixed backdrop for equity markets the bellwether 10-year German Bund yield hit an all-time low of 0.682%, its fifth consecutive decline, as nervous investors sold out of peripheral European debt and moved to the apparently safe haven of German bonds.[2] Outside Germany, the shift raised wider questions about the effectiveness of European Central Bank (ECB) market intervention launched earlier in 2014 to boost growth and counter deflation, pointing to a need for further stimulus.[3]

The perception of Germany's economic performance has been on a roller-coaster – from 'sick man of Europe' some 10 years ago, to 'economic power-house' in the crisis rebound from 2010/2011. Indeed, Germany's economy is today in much better shape than in the first half of the noughties, but expectations regarding its contribution to euro area, or even global economic health, are potentially exaggerated.

Holger Fahrinkrug, chief economist, Meriten

2 Dow Jones MarketWatch: *The 10-year German bund yield just hit another all-time low*. 10 December 2014
3 Bloomberg: *German Bund Record Shows All Is Not Right in Euro Area*. 29 July 2014

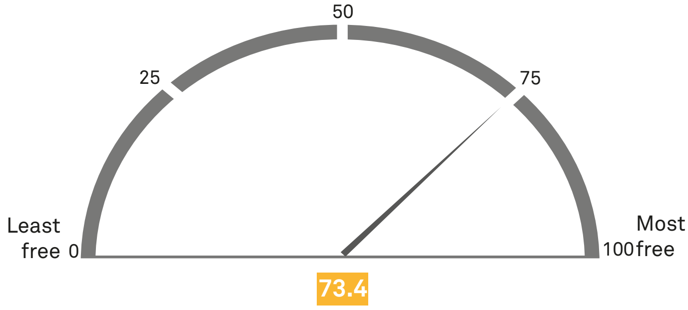
INDEX OF ECONOMIC FREEDOM COUNTRY COMPARISONS



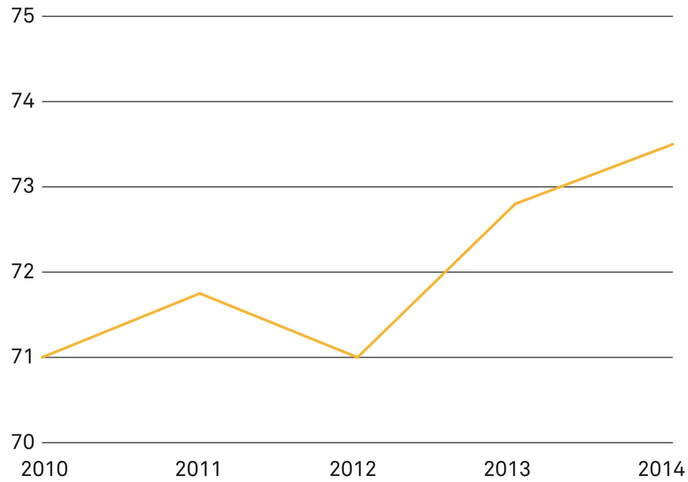
QUICK FACTS	
Population:	81.9 million
GDP (PPP):	$3.2 trillion $39,028 per capita
Unemployment:	5.5%
Inflation (CPI):	2.1%
FDI Inflow:	$6.6 billion

Source: Heritage.org as at 15 January 2015.

GERMANY'S ECONOMIC FREEDOM SCORE



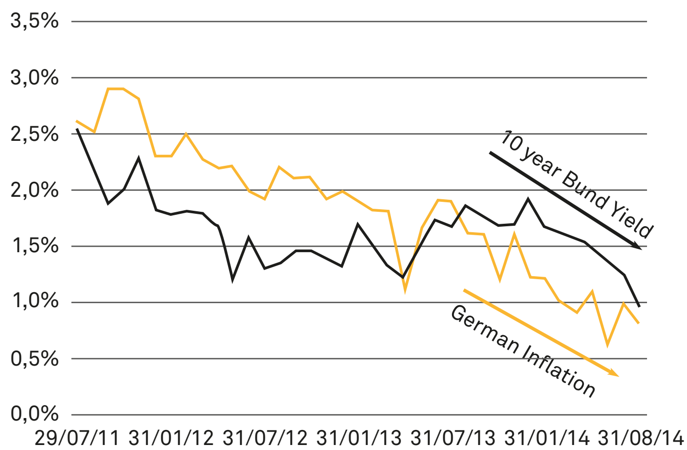
FREEDOM TREND



Still, the economy considered to be Europe's engine of growth is not without positives. According to the 2014 index of economic freedom, Germany is ranked 16th in the world (out of 186 countries) and seventh out of 43 European countries (as of January 2015). The index, published by the Wall Street Journal and US think tank Heritage Foundation, is based on 10 quantitative and qualitative factors, grouped into four broad categories, or pillars, of economic freedom: Rule of Law (property rights, freedom from corruption); limited government (fiscal freedom, government spending); regulatory efficiency (business, labour and monetary freedom); and open markets (trade, investment and financial freedom). The producers of the index state: "*In an economically free society, individuals are free to work, produce, consume, and invest in any way they please*. *In economically free societies, governments allow labour, capital and goods to move freely, and refrain from coercion or constraint of liberty beyond the extent necessary to protect and maintain liberty itself.*"

With respect to Germany, the index producers report it hit an all-time high last year with respect to its economic freedom ranking. The Heritage Foundation states: "*High levels of trade freedom and investment freedom continue to underpin Germany's competitiveness in global commerce and ensure dynamic economic growth.*" The index creators comment Germany has advanced in its rankings since 2006.

GERMAN 10 YEAR BUND YIELDS 0.9% vs. INFLATION 0.8%



Source: Bloomberg, AlianzGI, as at 31.08.2014.

Employment and wage growth

Towards the end of 2014 German unemployment fell, surprising many; November saw the unemployment rate hit 6.6% (adjusted for seasonal variation)[4]. While a decline in unemployment in November is considered normal, according to the German Federal Employment Agency, this year the fall was more than it had been in the past few years. Analysts in a November BBC report said record employment, rising wages and low interest rates were helping to prop up domestic demand in Germany.

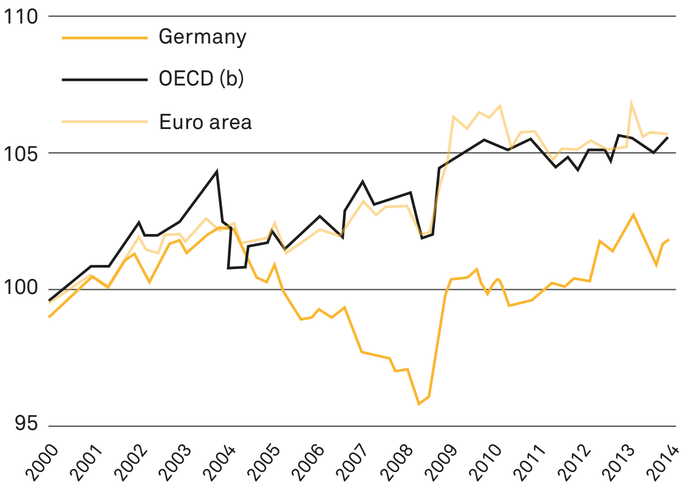
- The number of unemployed fell by 52,000 over the course of 2014, with fewer than three million people unemployed, the Federal Employment Agency (BA) reported in early January 2015. As such 2014, as in 2012, marked the lowest level of unemployment since 1991, the agency noted.
- Underemployment, which also covers persons participating in employment and training measures and those suffering from short-term incapacity for work, also fell over the course of the year. At 3.8 million in 2014, 98,000 less than a year ago, it was the lowest level since the Reunification, the BA said.
- According to the Organisation for Economic Co-operation and Development's (OECD) 2014 Employment Outlook, Germany's employment rate was among the highest of its peers. The report says: *"The unemployment rate will decline further in 2015 and Germany looks set to join the small group of OECD countries (26) with unemployment rates below 5%."*

In its employment report the OECD states Germany tends to have higher than average wages and lower inequality in comparison to other OECD nations. However, the country is marked below average with respect to quality of workplace, with many individual's reporting difficult and stressful conditions.[5]

The start of 2015 saw the implementation of Germany's first minimum wage – set at €8.50 an hour.[6] The OECD report says this may help to boost the wages of low-paid workers and reduce the number of working poor but at €8.50, it amounts to about half of the median full-time wage, similar to the ratio in Belgium, the Netherlands and the UK, but below the ratio in France.

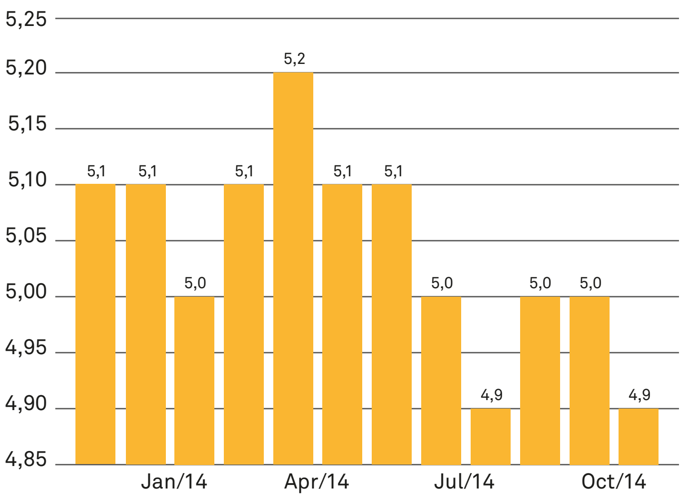
Economists at Germany's central bank, the Bundesbank, believe wages will rise through 2015 thanks to the buoyant German labour market but also as a result of the new minimum wage. Given wage costs will rise fairly noticeably in some cases, Bundesbank economists consider employment prospects for the low-skilled are likely to worsen, which could in turn raise structural unemployment in the medium term.

WAGE DEVELOPMENTS IN GERMANY
Real hourly wage,[a] base 100 in 2000



a) Total compensation of employees divided by total hours worked by employees in real terms.
b) OECD is the weighted average of 26 OECD countries.
Source: OECD calculations based on quarterly national accounts. As at 31.12.14.

GERMANY UNEMPLOYMENT RATE
Percentage of the labour force



Source: www.tradingeconomics.com. Federal Statistics Office. As at 31.10.14.

> *Germany's growth and employment trajectory have been strong in recent years and near-term more strength is likely as the economy is boosted by record-low interest rates, a softer currency, lower energy prices and the absence of fiscal stress.*
>
> *Holger Fahrinkrug, Meriten*

4 BBC: *German unemployment rate falls to a record low*. 27 November, 2014
5 OECD.org
6 BBC January 2015

Demographics and work

Last year saw the country lower its retirement age, allowing workers to drawdown from their pensions from age 63. The move, along with other pension reforms, is expected to cost around €60bn over the next five years.[7] Bundesbank economists say the new pension age – in combination with the new minimum wage – will result in a loss in the level of potential output of just over 0.5% up to 2016. *"This takes into consideration the fact that the shortage of experienced workers and increases in labour costs can have repercussions for investment plans and decisions on production locations."*

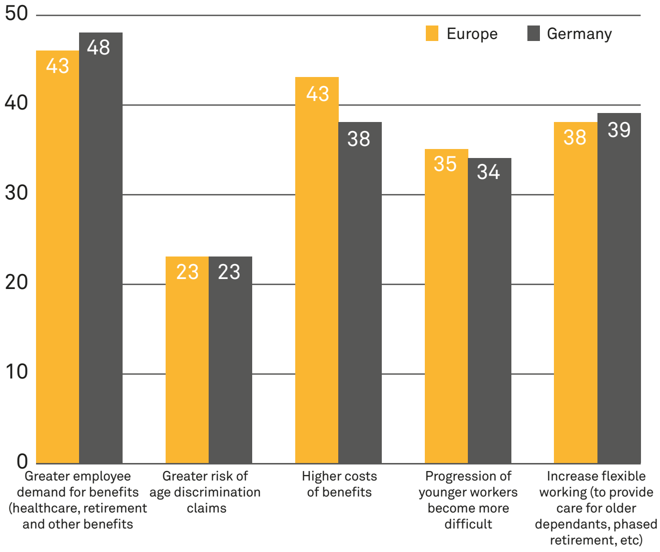
- Already, in the decade to 2012 the German ratio of dependent people (those aged under 15 and over 65) to the working-age population has increased from 45.6% to 51.2% – the biggest rise in Europe over that period.[8]
- The decline of the working-age population in Germany has been under way for a number of years, according to the European Commission (EC), which predicts the country could experience labour bottlenecks within the next two years.
- To achieve annual GDP growth of just 2%, some estimate productivity growth levels will have to climb by about 3% annually – three times the level achieved before the 2008 financial crisis.[9]

The *Economist* has reported the European Commission as stating: *"Over the next decade Germany will find it difficult to sustain employment and its GDP growth path without recourse to much higher inflows of foreign workers and a substantial increase in its annual productivity growth."* Some of this has been seen already. At an estimated 560,000 persons, net immigration for 2014 is expected to considerably outstrip earlier expectations for the full year. Asylum seekers and civil-war refugees, who are not immediately available to the labour market, account for a larger share of total immigration than in previous years.[10]

The German economy has grown just 1.3% annually, on average, over the past 10 years. Going forward the German economy will require robust structural reform in order to battle the adverse impact of an ageing society on aggregate productivity and growth.

Rebecca Braeu, Standish

WHICH OF THE FOLLOWING DO YOU THINK IS MOST LIKELY TO HAPPEN AS A RESULT OF AN AGEING WORKFORCE? (% of respondents)



Source: The Economist Intelligence Unit. As at 31.12.14.

Germans have traditionally been savers rather than spenders, which has not helped to drive regional growth.

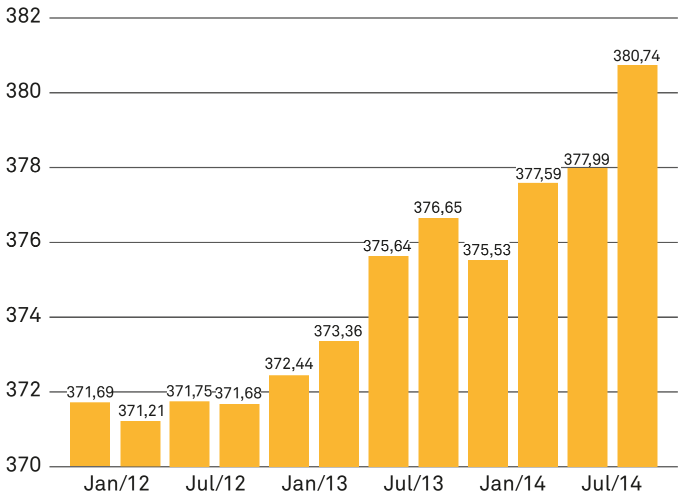
Raj Shant, Newton

7 TheLocal.de: *Ageing Germany lowers retirement age*. 23 May 2014
8 The Economist Intelligence Unit 2014: *Confidence or complacency? The implications of an ageing workforce in Germany*
9 Ibid
10 Deutsche Bundesbank Monthly Report December 2014

Consumers

Consumer prices rose last year but the amount by which they increased was the smallest in some time. The Federal Statistical Office has said prices were 0.9% higher in 2014 than in 2013, the lowest percentage increase since 2009.

GERMANY CONSUMER SPENDING



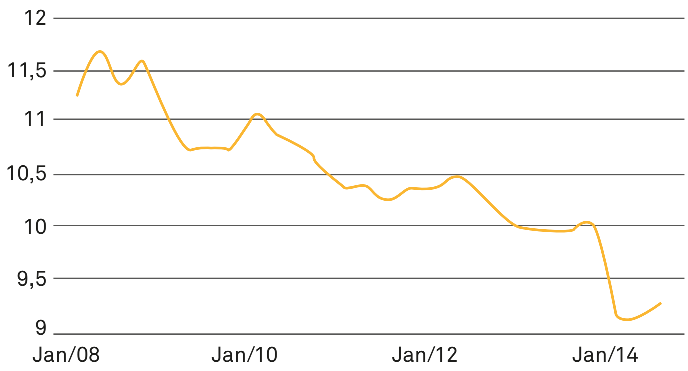
Source: www.tradingeconomics.com. Federal Statistics Office. As at 31.12.14.

– Consumer spending in Germany increased to €380.7bn in the third quarter of 2014, up from €378bn in the second quarter; it has averaged €325.2bn since 1991 so the third quarter figure marked an all-time high.[11]

– Private consumption rose in the second and third quarters on the back of wage growth and a subdued inflation rate, leading to a distinct rise in real disposable income, according to economists at the Bundesbank. They also noted the saving ratio in Germany was virtually unchanged through the year.[12]

Disposable personal incomes in the country increased to €445.4bn in the third quarter of last year, well up on their average of €204.5bn from 1960 until 2014. Meanwhile personal savings (the ratio of personal income saved to personal net disposable income) increased to 9.3% heading in to final quarter of 2014 but this was still down from the long-term average of 12.2% from 1960- 2014 (the all-time high of 17.3% was in 1975).[13]

GERMANY PERSONAL SAVINGS



Source: www.tradingeconomics.com. Federal Statistics Office. As at 31.12.14.

Private consumption represents just 56% of GDP at this time, which is below the longer term average of 57%. True, disposable incomes are likely to rise looking one to two years out but the German psyche is to save, as demonstrated by the rising personal saving rate and elevated current account surpluses. It will take years of the ECB pushing on a string and structural reform to raise the consumption share above 60%.

Rebecca Braeu, Standish

11 Tradingeconomics.com
12 Deutsche Bundesbank Monthly Report December 2014
13 Tradingeconomics.com

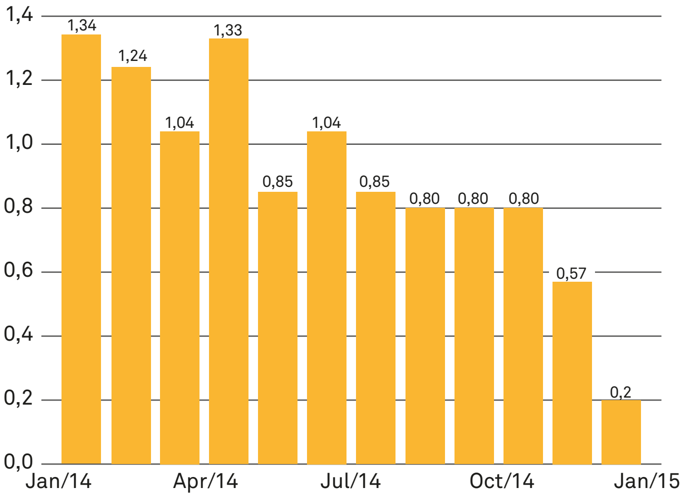
Inflation

In December 2014 German inflation fell to its lowest level in five years (0.2% down from 0.6% a month earlier), according to data supplied by the German federal statistics office Destatis. The statistics office stated average inflation for the full year was 0.9%[14]. The stats were said to reflect the negative inflation environment as 2014 drew to a close and as wider fears of deflation across European became a reality.

According to the Bundesbank: *"Inflation, as measured by the Harmonised Index of Consumer Prices (HICP), could rise to 1.1% in 2015 and to 1.8% in 2016. Excluding energy, the rate of inflation is likely to increase to 2% in 2016 in the wake of the marked rise in wages."*

However, the central bank's forecasts for inflation – *including energy* – was lowered on the back of the falls in crude oil prices. *"A fall in the price of crude oil on this scale has the effect of a small stimulus package in that it reduces both households' cost of living and companies' production costs,"* Jens Weidmann, Bundesbank president, said in early December. He believes if crude oil prices remain at this subdued level for an extended period of time, economic growth in 2015 and 2016 could be boosted. Bundesbank experts calculate that the HICP inflation rate would probably then, however, be 0.5% lower in 2015. *"At the beginning of 2015, the inflation rate in individual months could also be close to zero. There would also be slightly lower inflation rates in 2016."*

GERMANY INFLATION RATE
Annual Change on Consumer Price Index



Source: www.tradingeconomics.com. Federal Statistics Office. As at 31.12.14.

With low unemployment, a weak euro driving exports, a new minimum wage, interest rates ultra-low and going lower, rising property prices...could German inflation be a problem in a few years' time?

Raj Shant, Newton

14 The Wall Street Journal: *German Inflation Weakens Sharply in December, Hitting Five-Year Low*. 5 January, 2015

Industrial output

Germany remains one of the world's largest exporters and many commentators point to the broad weakness in the global economy as a factor in the current weak numbers than any domestic woes. Mixed data shows both good and bad news on the manufacturing side of Germany's economy.

German industrial production rose for a second consecutive month in October 2014 but fell back in November, considered to be a sign that the economic recovery in Europe's largest economy was uncertain.[15]

The numbers underscore the lack of momentum since last summer when August recorded industrial production shrank 4%, the largest contraction since early 2009[16], and when the full force of the global financial crisis first hit Europe's factories. Weak demand for goods in both the eurozone and China, and disruption to trade with important trading partner Russia, were among factors holding back orders.

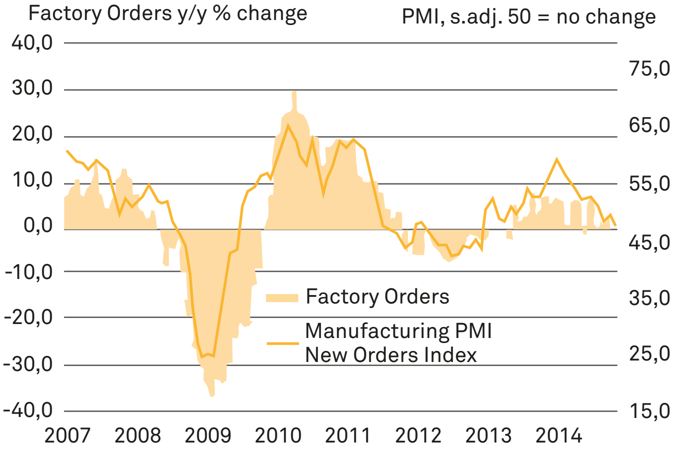
- Factory orders and the Manufacturing Purchasing Managers' Index (PMI) painted a fairly bleak picture towards the end of last year and pointed to an industrial sector light on growth and momentum, although December numbers showed some improvement.
- Manufacturing PMI fell to a 17-month low in November[17] but recovered some ground in December to indicate a return to moderate expansion.
- In the service sector, PMI data showed growth ahead of expectations in November but new work fell for the first time since June 2013, causing firms to work through backlogs of orders instead.[18]

German competitiveness gains are based on tempered relative wage growth, thereby raising labour productivity. Going forward, the risk to the German inflation rate is that wage negotiations stall amid lower energy prices and falling inflation expectations, thereby perpetuating the disinflationary trend. Core prices should remain relatively resilient with the domestic economy but the outlook for inflation – even in an economy with a tight labour market – is still quite subdued.

Rebecca Braeu, Standish

15 Bloomberg Business: *German Industrial Production Falls Amid Plunge in Energy Output*, 9 January, 2015
16 Bloomberg: *German Industrial Output Drops Most Since 2009* in August, 7 Oct 2015
17 International Business Times: *Euro plunges to nine-year low*, 5 January 2015
18 Reuters: *German private sector grows in December* – PMI, 6 January 2015

FACTORY ORDERS AND THE PMI



Sources: Statistisiches Bundesamt, Markt. As at 31.12.14.

In December Bundesbank economists noted a key prerequisite for German GDP growth is the acceleration of the country's export growth. *"For the moment, however, survey results from Ifo (an institute for economic research in Munich) and the Association of German Chambers of Commerce and Industry (DIHK) are pointing to a deceleration."* The central bank report cites the influence of the EU's sanctions against Russia and its countermeasures as playing a subduing role in export growth. However, economists at the central bank also note it is likely disappointment at the muted cyclical momentum in the euro area is a more significant factor.

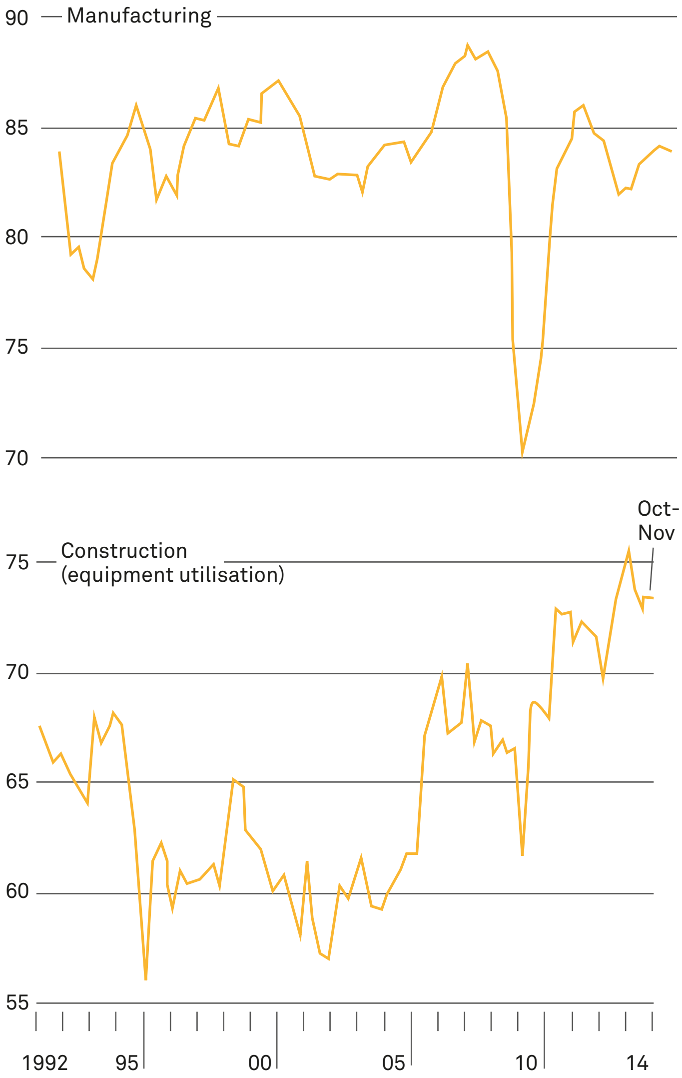
In view of what will probably turn out to be a weak fourth quarter of 2014 and first quarter of 2015, Bundesbank forecasts export growth (as defined in the national accounts) may decrease from 3.75% in the current year to 3% in 2015, before rising markedly to 4.5% in 2016.

While the near-term cyclical outlook is turning more favourable due to escalating policy stimulus, there are concerns that recent legislation, higher wage settlements and adverse demographics might contribute to a loss of competitiveness in the medium to longer term. In addition, Germany's export orientation can be a blessing or a curse. While there should be a significant boost from currency depreciation, in times of geopolitical crisis, the country's industrial sector tends to suffer more than others. And finally, the dramatic yield decline associated with the ECB's monetary easing policy will lower the returns of conservative German savers' financial assets. This in turn constitutes pressure to increase the savings ratio to the detriment of consumption.

Holger Fahrinkrug, Meriten

CAPACITY UTILISATION

Quarterly, seasonally adjusted, as a percentage of firms' customary full capacity utilisation



Source: Ifo business survey. Deutsche Bundesbank. As at 31.12.14.

The momentum of the German industrial production cycle should pick up amid the depreciation of the currency – the euro is down 17% against the dollar since the middle of 2014 (as of January 2015). The latest Ifo index – a survey of over 7000 domestic producers in Germany – points to a pickup in growth this year.

Rebecca Braeu, Standish

Corporate Germany

German companies are predominantly well positioned, with low debt and balanced price-cost ratios, the December Bundesbank report states. They are also present in all key markets with attractive product offerings so should be able to take advantage of opportunities that may arise.[19] While the country may be known for its auto industry the largest companies in Germany offer a broad sectoral mix with strong showings from the insurance and financial sectors.

Germany is among the top five countries in terms of the number of companies in PwC's Global Top 100, a list of the largest companies in the world based on market cap; in 2010 Germany had just two companies in the list. The 2014 PwC report highlights that Germany has experienced a rise of 135% in the size of its largest companies since 2009 – with their combined market cap amounting to US$660bn, up from US$281bn.

– Consultants Ernst & Young expect 2015 will see China overtake western Europe as the German auto industry's biggest market. From 2009 to 2013, German automobile sales in China more than doubled, from 1.6 to 3.7 million units and German carmakers now enjoy a record 23% market share in China, according to a study released by Ernst & Young.

– 15 of Germany's largest venture capital-backed tech companies in 2014 cumulatively raised just under US$982m, more than all of Berlin tech start-ups raised in 2013.[20]

– This year Germany's biggest utility E.ON intends to split in two – spinning off its nuclear, oil, coal, and gas to focus on renewables as well as energy efficiency.[21]

Global Top 100 companies per country – absolute market capitalisation change

Country	Market cap Change $bn 2009-2014	2014 Rank	2014 Market cap ($bn)	2014 No	2009 Rank	2009 Market cap ($bn)	2009 No.	Market cap ($bn) of current top 100 in 2009
United States	4,423	1	8,052	47	1	3,805	42	3,629
United Kingdom	517	2	1,147	8	3	715	9	630
China	244	3	1,082	7	2	1,061	9	838
Switzerland	386	4	733	3	6	347	3	347
Germany	379	5	660	6	7	299	5	281
France	291	6	591	5	4	481	7	300
Australia	247	7	464	4	12	118	1	216
Japan	165	8	287	2	5	366	6	122
South Korea	148	9	209	1	14	61	1	61
Brazil	51	10	201	2	8	234	3	150

Source: Bloomberg and PwC. As at 31.12.14.

19 Deutsche Bundesbank Monthly Report December 2014

20 CBInsights.com: *Germany's 15 Largest VC-Backed Tech Financings of 2014*, 6 January 2015
21 thinkprogress.org, 1 December 2014

Equity performance – German Dax

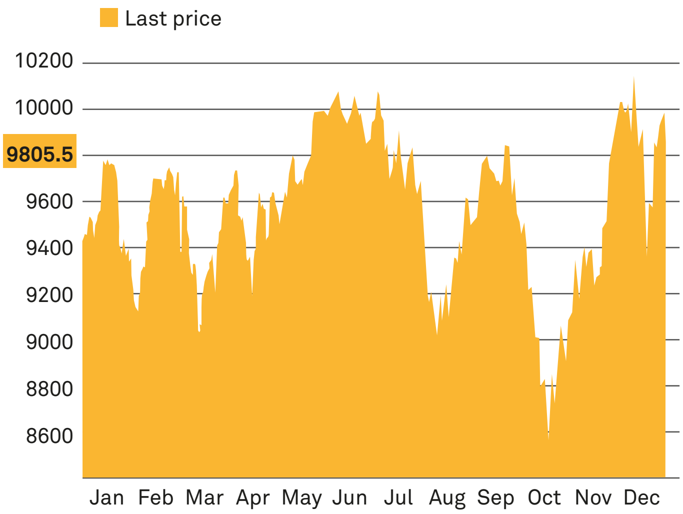
The DAX index, which consists of 30 blue chip stocks, has regained the losses it suffered in 2008 when it fell by more than 40% in euro terms; from the start of 2008 to end of 2014 the DAX returned 21.4%.[22]

The past year, though ultimately positive, saw some volatility as the index vacillated between positive and negative monthly returns. Having seen six negative months, the strong returns of November when the index rose 7% saw 2014 close out with a gain of 2.65% in euro terms. The strong November was attributed to a significant increase in investor optimism as measured by the ZEW, a monthly economic, six-month future, sentiment survey based on the amalgamated views of c350 economists and analysts. In October the ZEW was -3.6 and analysts had expected November's numbers to come it around 0.8 points, however, it was reported at 11.5, leading the DAX to rise sharply.[23] The ZEW Indicator made gains again in December, ending the year at 34.9 points – its long-term average is 24.4 points.[24]

The German stock market benefited strongly from the ECB's announcement to introduce large-scale quantitative easing and is expected to continue to do so. Yields of German sovereign bonds were also compressed further and now stand at levels that almost signal deflation. However, if growth accelerates as we expect, and inflation expectations start to normalise, we believe German yields might start to rise, albeit gradually as long as the ECB is active in the market.

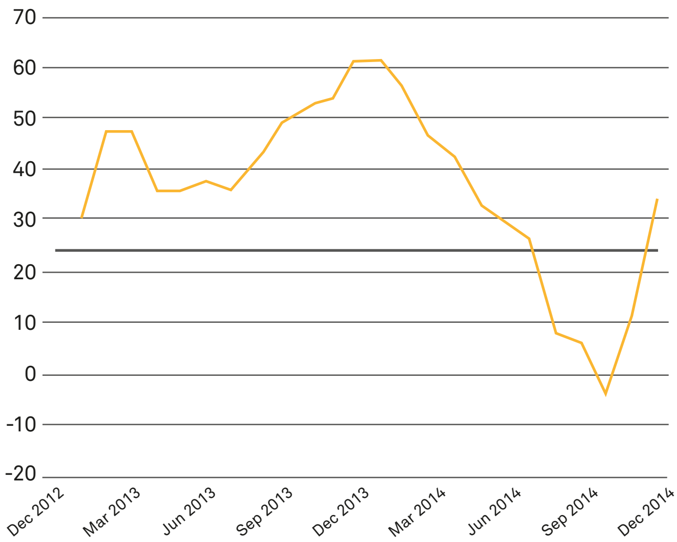
Holger Fahrinkrug, Meriten

EQUITY PERFORMANCE



Source: Bloomberg. As at 31.12.14.

ZEW INDICATOR OF ECONOMIC SENTIMENT (GERMANY)



Source: Zew.de. As at 31.12.14.

Boosting the German domestic index the most over the course of the past year was the conglomerate ThyssenKrupp, up 19.3% over the year, followed by healthcare companies Merck (19.2%) and Fresenius Medical Care (17.4%). At the opposite end of the scale in terms of performance was Adidas, falling 35.9% over 2014, Deutsche Bank (-23.2%) and chemicals company Lanxess, down 21.3%.[25]

Stocks on the DAX were trading on lower valuations in 2014 in comparison to 2013 but at a P/E 17.2x it was not the lowest level the index has traded at over the past 10 years. In 2004 the index was on a P/E of 15.6x, increasing to 21x in 2009 before dropping to 10.9x in 2011.[26] According to Bloomberg data the 2015 estimated P/E of the index is set at 12.5x before dropping further to 11.3x in 2016.

The DAX is full of companies that should benefit from the weaker euro. The biggest threat is slower demand from some of its key emerging markets.

Raj Shant, Newton

22 Bloomberg as of 2 January 2015
23 World Business Press Online: *Dax ends with strong gains on improved sentiment*
24 Zew.de
25 Bloomberg 1 January 2014 – 2 January 2015
26 Bloomberg DAX index Financial analysis

Date	Price/Earnings		
CY2016E	11.3805	CY2010	12.6457
CY2015E	12.5155	CY2009	21.037
Current	17.0738	CY2008	20.0008
CY2014	17.221	CY2007	13.7814
CY2013	18.2413	CY2006	13.9204
CY2012	15.3788	CY2005	14.6418
CY2011	10.9332	CY2004	15.6576

Source: Bloomberg, as at 2 January

From a sector point of view, in the FTSE Germany index healthcare subsector was the best performer for 2014, up 19.7% in euro terms. Non-life insurance (19.3%) and telecoms (10.3%) rounded out the top three best performing sectors in the market last year. Meanwhile, at the bottom of the list in 2014 was the personal goods sector (-25.2%), banks (-18.7%) and software and computer services, down 3.5%.[27]

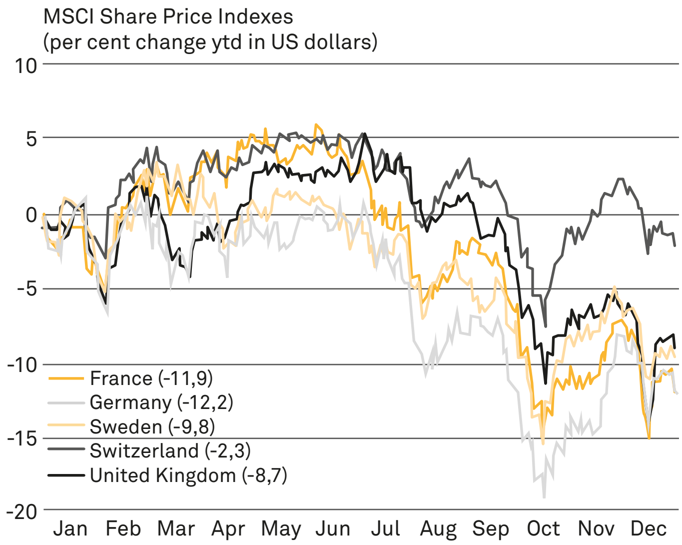
Mario Draghi might not be popular in the Bundesbank, but for the time being, markets are responding very positively. What is really smart is that QE is not just about short-term tactics. This is also a long-term strategic gambit. We expect QE, bank lending, cheaper energy, a lower euro, and a lack of further fiscal tightening will be the catalysts that enable the eurozone economy to stage a recovery this year, with GDP growth likely to reach 2.1%. If the ECB can take credit for this recovery it will burnish its reputation. For a central bank the most valuable currency of all is credibility – that is something even the Bundesbank would agree with.

Gareth Colesmith, senior portfolio manager, Insight

The euro, QE and the ECB

While the DAX did achieve a positive outcome over the past year, it was a gain only in euro terms – the DAX fell in US dollar terms, according to Bloomberg figures. Over the 12 months to 31 December the German stock market fell more than 9.5% in US dollar terms, highlighting just how big the fall was in the euro over the course of the past year.

PERFORMANCE 2014: EUROPE



Source: Morgan Stanley Capital International. As at 31.12.14.

In what was considered a result of speculation concerning the implementation of ECB quantitative easing (QE), the start of 2015 saw the euro fall below US$1.18 for the first time in more than nine years; by 21 January it had fallen further to near lows it had previously reached in late 2003.[28] On 22 January the ECB then announced its €1.1 trillion QE plans – effectively buying some €60bn worth of bonds from March 2015 to end of September 2016. The move, seen by many as late given the US Federal Reserve ended its programme in October 2014, was originally strenuously objected to by Germany.

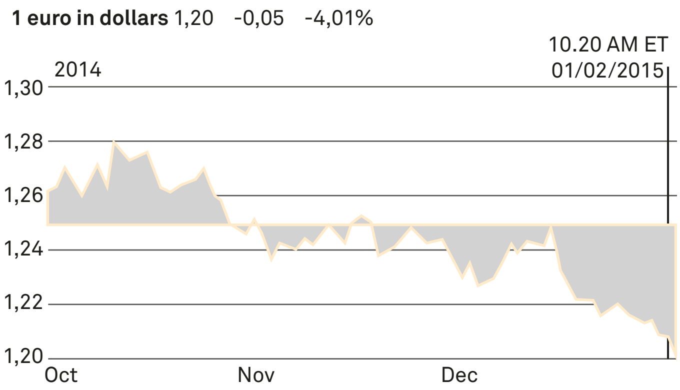
The view in Germany has been that QE was "akin to a bailout for free-spending governments such as Greece," Bloomberg reported ahead of the ECB's January move. "QE [in the eurozone] has been long in the making. The ECB took a first step in that direction in 2010 when it bought bonds of debt-strapped countries such as Greece. That was opposed by then-Bundesbank President Axel Weber within hours of its announcement, opening a rift between the ECB and the German central bank whose uncompromising stance on inflation inspired its design.

27 Lipper. FTSE Germany TR index in euros

28 FT: *Euro nears 11-year low as ECB acts*, 22 January 2015

"The rift [then] became a schism. In recent weeks, Jens Weidmann, the Bundesbank's current president, and his former deputy Sabine Lautenschlaeger, now on the ECB's executive board, have been the loudest voices against more stimulus."

As such in announcing the QE programme, ECB president Mario Draghi made what some called "concessions" to Germany's stance. *"Draghi said that 20% of the bond-purchases would be undertaken by national central banks, which would have to share the risk of their governments defaulting."*[29]



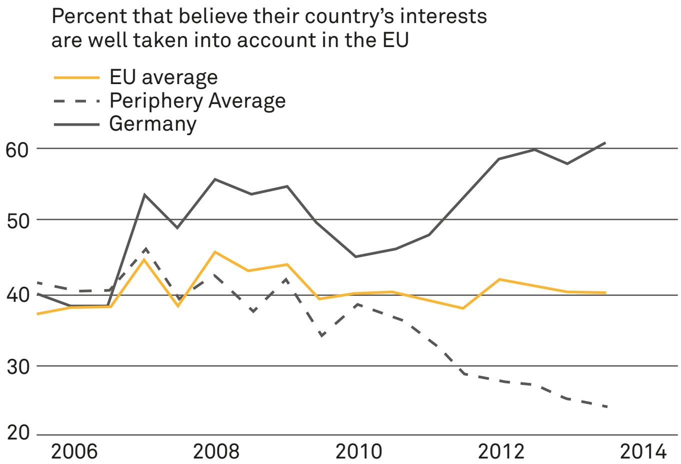
Source: Reuters. As at 31.12.14. The New York Times.

Germany's initial reluctance with respect to QE was likely due to its own fiscal prudence. Unlike other industrialised nations where debt has ballooned, Germany's national debt as a proportion of GDP is roughly where it was in 2000.

– Between 2000 and 2013, according to a report by consultants McKinsey, average total debt for industrial countries excluding Germany rose from slightly below German debt levels to 140 percentage points more, an increase by more than half.

– Across a range of measures – household debt, nonfinancial corporate debt, financial sector debt – the same holds true: Germany remains significantly less indebted than its industrialised peers.

GERMANS THINK THEY ARE IN CHARGE



*Includes Greece, Spain and Italy.
Source: EU Commission.
Source: BCA Eesearch, FTalphaville, 20 October 2014.

Angela Merkel's Christian Democratic Union has become more cautious toward euro integration since the rise of right-wing parties such as Alternative für Deutschland.

Gareth Colesmith, Insight

There is very little evidence Germans are leveraging up their balance sheets, which would be a sign of more inward fuelled growth. Given the structural deleveraging cycle across Europe that will contribute to slow growth for some time, one could "hope" for a bit of German private sector leverage to offset the deleterious deleveraging cycle in the rest of Europe. Unfortunately, that hope is misplaced.

Rebecca Braeu, Standish

29 Bloomberg: *Draghi reaches rubicon for euro region with QE decision imminent*, 22 January 2015

Political landscape

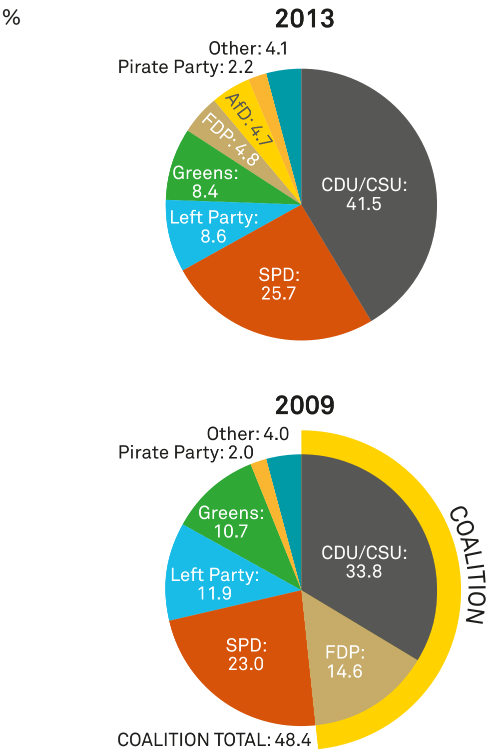
In September 2013 German chancellor Angela Merkel's Christian Democratic Union/Christian Social Union (CDU/CSU) saw their best election result since 1990, with nearly 42% of the vote and almost 50% of the seats.[30]

Since then, the situation has changed. State elections in May and in September 2014 saw a surge in support for eurosceptic parties, especially in the East of the country where Alternative für Deutschland (AfD) won more than 10% of the vote in Brandenburg and Thuringia.[31] The party campaigned on a platform including demands to expel weak southern European countries from the eurozone, end bailouts and return powers from Brussels to the national level.

In the months since, and mirroring a similar trend across Europe, fringe anti-immigration parties have also been gaining ground in Germany. While it is considered unlikely right wing eurosceptic parties will sweep into power, there is concern about the influence they could have on other mainstream parties, especially if they adopt a harder stance on fiscal consolidation. The next Federal election is slated for 2017.

> *The rise of populist parties of the left and right in Europe is emerging as a threat to the eurozone that is potentially just as profound as the sovereign bond crisis of 2011.*
>
> *Gareth Colesmith, Insight*

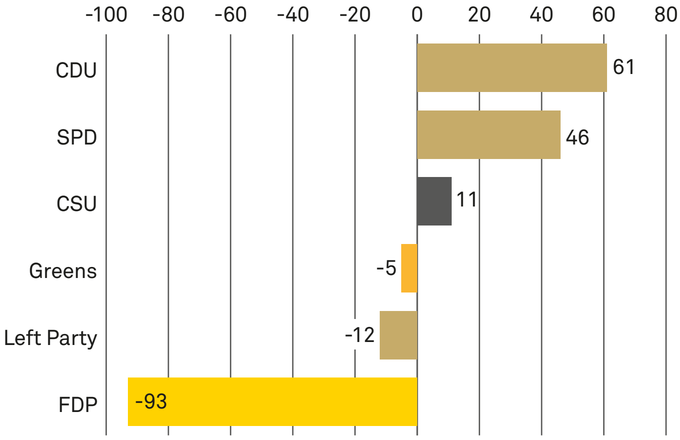
ELECTION RESULTS



Source: The Economist: *Who's in the Haus?* 23 September 2013.

GAINS AND LOSSES

Change in number of seats, 2013 election



What next?

Bundesbank economists believe economic growth in Germany will strengthen again, albeit slowly, but note as of early December there was still no indication of a radical cyclical improvement for the fourth quarter of 2014 and first quarter of 2015. *"However, there is no evidence of recessionary tendencies either."*

Given normal weather conditions, the central bank is forecasting GDP growth rates of 0.1% and 0.2% for Q4 2014 and Q1 2015. *"Whether the German economy can grow more dynamically over the course of 2015 primarily depends on the international setting."*

> *A sharply lower euro and substantially lower oil price should boost German growth and earnings in 2015. The key risk is the demand from emerging markets like China, Russia & Brazil.*
>
> *Raj Shant, Newton*

30 Der Spiegel: *Election Triumph: Merkel Victorious But Faces Tough Talks*, 22 Sept 2013
31 Reuters: *Merkel won't shift further right despite Eurosceptic's gains*, 15 Sep, 2014

About BNY Mellon

BNY Mellon's multi-boutique model encompasses the skills of 15 specialised investment managers. Each is solely focused on investment management, and each has its own unique investment philosophy and process. This publication features the expert views of four BNY Mellon boutiques who have extensive knowledge and experience in fixed income and equities. Our thanks to Meriten, Insight, Newton, and Standish for their valuable contributions.

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