BEAR STEARNS

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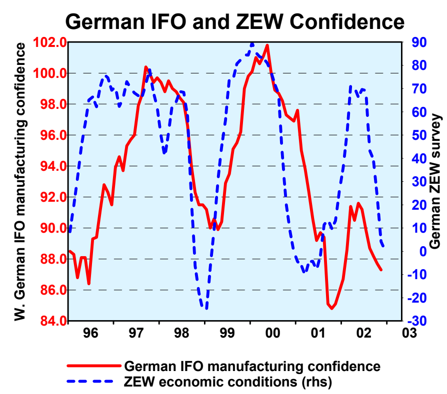
EconomyWatch: Germany

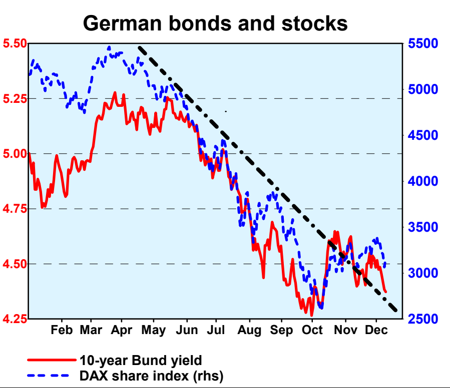
International Fixed Income / Currency Economics and Market Strategies

Bloomberg commentary on page BSI
Reuters commentary on BEARLON

Double dipping and in duress



Still waiting for the breakout



GERMANY THE WEAKEST LINK

- **Germany's economic woes remain at the epicentre of Eurozone concerns as the economy continues to slide down the slippery slope to deeper downturn. A snapshot of the German economy right now shows a sorry sight of more economic gloom, receding inflation risk, and more scope for ECB intercession on rates.**

- **Over the last few months, the Germany's ZEW business climate survey has fallen off a cliff in terms of expectations about the future outlook. There is still no end in sight. Business confidence dropped again in December, this time getting critically close to negative territory, a harbinger that the recession bell could toll more ominously in the next few months.**

- **Quite frankly, Germany looks like the weakest link in the Eurozone growth stakes right now. Growth is virtually at a standstill this year, with GDP up only 0.2% and recovery limited to no more than 0.7% next year. Germany could be stuck in the slow lane to recovery for years.**

- **Evidence that German domestic demand has hit a wall is also showing up in German consumer prices, which fell a further 0.5% over the last month. It is clear that deflation risks are on the rise, a trend that is not going unnoticed at the Bundesbank and ECB, and probably a contributing factor why the ECB cut rates so aggressively last week by a half percent.**

- **In terms of where we head to ultimately on the ECB repo rate, we are going down to 2.25%, at least, from 2.75% currently and we would not rule out a move down to 2.0% if the German economy really goes pear-shaped ahead.**

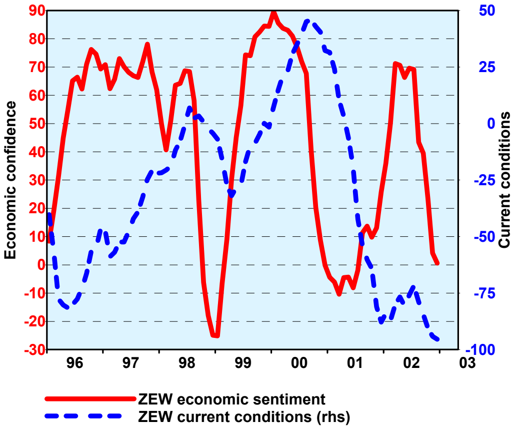
- **For structural players, we still tend to favour recovery trades over downturn plays, which means longer term flows will continue to steer their way into stronger stocks and weaker government debt markets over the longer term.**

- **Investors should stay overweight the US versus the Eurozone in stocks, but relative recovery dynamics suggest that it is best to remain overweight euro government debt relative to US Treasuries as yields continue to rise higher in the government debt markets.**

Germany the weakest link

Still no signs of a bottoming out

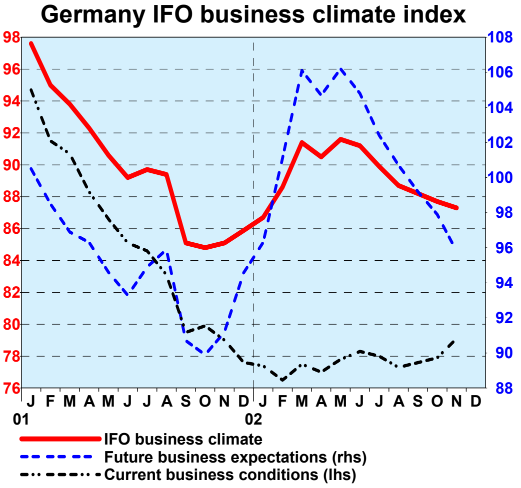
German ZEW Confidence



Germany's economic woes remain the epicentre of Eurozone concerns as the economy continues to slide down the slippery slope to deeper downturn. A snapshot of the German economy right now shows a sorry sight of more economic gloom, receding inflation risk, and more scope for ECB intercession on rates. Over the last few months, Germany's ZEW business climate survey has fallen off a cliff in terms of expectations about the future outlook. There is still no end in sight. Business confidence dropped again in December, this time getting critically close to negative territory, a harbinger that the recession bell could toll more ominously in the next few months. The ZEW index dropped 3.6 points to 0.6 in December from 4.2 in November, presaging further duress for other business sentiment surveys and bigger downturn risks for the German economy at large. This is no surprise since German domestic demand remains chronically weak, the spectre of rising unemployment is on the rise and consumer confidence is starting to show deeper cracks. The government's recent conversion to tougher fiscal austerity, to get its deficit reduction strategy back on track, is also simply making things a lot worse. At the moment, our German growth model is telling us that GDP will rise by 0.2% in Q4 and by 0.1% in Q1 next year. Given the way the latest contemporaneous data is slipping so fast, that model could easily be wrong on the signs. The chances are both quarters could easily show negative rather than positive signs in front of them. The first quarter next year definitely looks like it has entered the danger zone for negative growth, especially after the European Commission admitted that the range of its GDP forecasts for that period range from –0.2% to +0.2%. Quite frankly, Germany looks like the weakest link in the Eurozone growth stakes, with growth virtually at a standstill this year, with GDP up only 0.2% and recovery limited to no more than 0.7% next year. Germany could be stuck in the slow lane to recovery for years.

No signs of consolidation

Germany IFO business climate index

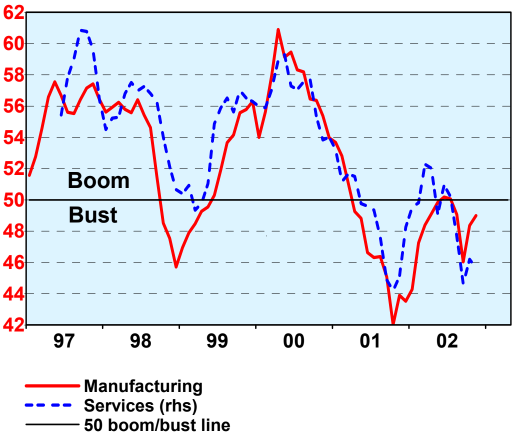


All pointing lower

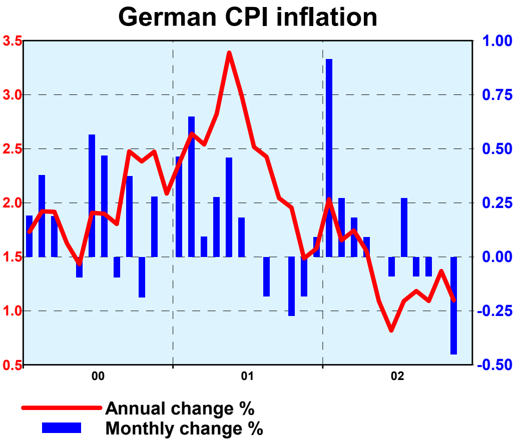
An important feature of the ZEW index is that it is a good leading indicator of other business confidence surveys, usually anticipating turning points in Germany's business cycle to the tune of three to four months. Without any concrete signs of Germany's ZEW expectations bottoming out just yet, it is clear we are still some months off any potential recovery in German business sentiment. The IFO index is still heading lower, while the German PMI surveys for manufacturing and services are still showing business sentiment steeped in negative territory, consistent with further business contraction ahead. This is an ominous sign for German recovery prospects. It will mean plans for increased industrial orders and output will be put on hold, new investment intentions will be put on the back burner and more German jobs will be axed while the German corporate sector continues to retrench and rationalise. The net effect will ratchet through into increased unemployment fears, with negative fall-out to consumer confidence and spending plans. The latest consumer trends in Germany have weakened sharply and suggest consumer confidence has fallen off a cliff in the last few months, with negative implications for any hopes of consumer led recovery. Unemployment remains resolutely on the rise and the consequence of that is consumer confidence, which has held up fairly well in the first half of the year, now seems intent on a deeper nose-dive. This is very apparent in recent retail sales data for Germany with shop sales down 1.1% over the last month and new passenger car registrations falling 6.0% from a year ago. Confidence has taken a hard knock in the last few months and consumers are going to ground and keeping their heads down until better times roll again. With overseas and domestic demand on a weak footing, unemployment fears on the rise and the government intending to take a big slice out of German purchasing power through higher taxes and spending cuts, it is no surprise German consumers feel down in the dumps. They seem especially reluctant to go out and spend on big-ticket items. This is quite clear from the latest German industrial production data, with output down 2.1% in October and consumer goods production down 3.1% over the latest month.

Still in negative territory

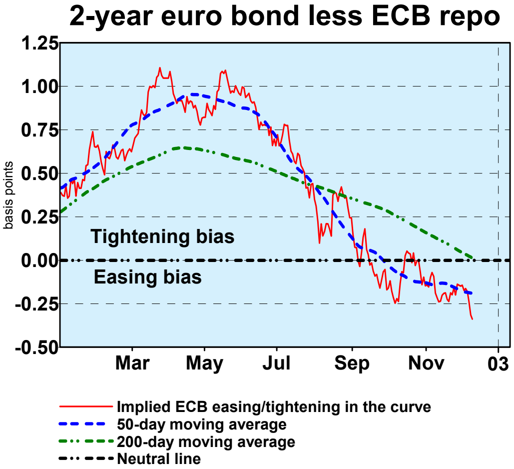
German PMI Business confidence



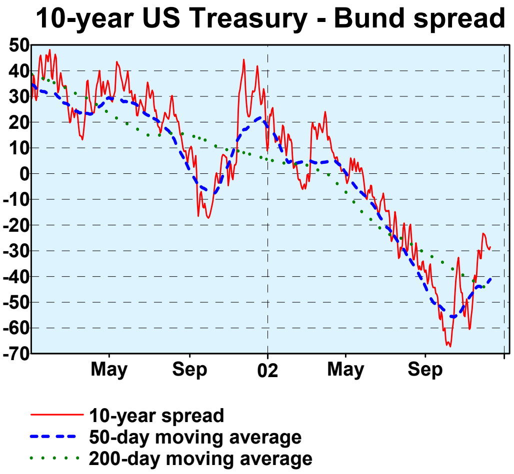
Inflation risks receding



Still another half point in ECB's pot



Spread heading back to par



Deflation spectre rising

Evidence that German domestic demand has hit a wall is also showing up in German consumer prices, which fell a further 0.5% over the last month. Out of the last six months, German consumer prices have fallen in four months, stayed flat in one and only risen in one. It is clear deflation risks are on the rise, a trend that is not going unnoticed at the Bundesbank and ECB, and probably a contributing factor why the ECB cut rates so aggressively by a half point last week. While recent rises in the ZEW and PMI Eurozone business conditions survey may show some tentative signs that Eurozone activity elsewhere in the EMU area may be coming off rock bottom, Germany still has a long way to go on that front before it moves off the path to perdition and rejoins the road to recovery. It is impossible to ring fence Germany's problems from the Eurozone. With Germany accounting for around 25% of the Eurozone population and 30% of EMU area GDP, if Germany goes down the growth plughole, then the Eurozone will not be too far behind.

Lower ECB rates the only alternative

It seems pretty obvious to us that another half point rate cut is on the agenda and this is likely to surface at the February ECB meeting after a month's policy rest in January. This tends to suggest there is better scope for the euribor futures strip to rally in the coming months, as it looks too cautious in its outlook on ECB rate policy prospects. Certainly, there is very little chance that faster growth will come back on its own accord based on domestic initiatives. The government looks as if it is up a creek without a paddle right now, with German economic policy looking stranded, high and dry on a mud bank. With Germany's budget deficit running close to 4.0% of GDP right now, the heat is on to raise German taxes and cut public spending to rein in the government shortfall. This means the government will be taking demand out of the economy rather than putting it back in over the next couple of years. This is a big issue for the government and is already sparking resignation rumours surrounding Chancellor Schroeder as he struggles to get tax raising legislation through his sceptical and tax resistant SPD party. In other words, it is all looking rather like a sorry mess, with political risks on the rise again. The only saving grace is likely to be lower rates from the ECB. In terms of where we head to ultimately on the ECB repo rate, we are going down to 2.25%, at least, from 2.75% currently and we would not rule out a move down to 2.0% if the German economy really does go pear-shaped ahead.

Asset allocation stakes rise

As far as the case for the bonds versus stocks trade-off right now, short-term factors will probably tend to favour government debt in the short term and weigh against a better stock market recovery. But as clear as day follows night, the fundamentals for US recovery are still locking into gear and it will be largely this factor that should pull Eurozone stocks up by the bootstraps in the coming months as the Eurozone will remain stuck on a weak wicket for quite a few more months yet. For structural players, we still tend to favour recovery trades over downturn plays, which means that longer term flows will continue to steer their way into stronger stocks and weaker government debt markets over the longer term. Longer term relative dynamics suggest that US recovery and stocks are going to lead the way to higher ground in the next six to 12 months, leaving the Eurozone economy and equities trailing in their wake. Investors should stay overweight the US versus the Eurozone in stocks, but relative recovery dynamics suggest that it is best to remain overweight euro government debt relative to US Treasuries as yields continue to rise higher in the government debt markets. Within the next few months as government debt markets take the strain within the Eurozone, we expect to see benchmark ten-year bund yields make the break above the 5.0% barrier again, with a trade test of 5.50%-5.75% later in 2003 once the stock market rally really begins to motor. The current 30-bps differential between US and German bonds should tend towards zero over the coming months as the US recovery eventually picks up and the US starts to accelerate away from Germany and the Eurozone.

	2001				2002				2003				Annual		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2001	2002	2003
	(% change, yoy)				(% change, yoy)				(% change, yoy)				(% change, yoy)		
Growth															
Real GDP (% change qoq)	0.6	0.0	-0.2	-0.3	0.3	0.2	0.3	0.2	0.1	0.1	0.3	0.4	-	-	-
Real GDP	1.8	0.7	0.4	0.1	-0.2	-0.1	0.4	0.9	0.7	0.7	0.7	0.9	0.7	0.2	0.7
Consumption	2.0	1.4	1.5	1.6	-0.5	-1.2	-0.5	-0.4	0.1	-0.1	-0.8	-0.5	1.6	-0.7	-0.3
Investment	-1.8	-4.2	-6.7	-7.0	-6.4	-7.8	-6.7	-6.9	-6.2	-3.9	-3.3	-1.5	-4.9	-6.9	-3.7
Government spending	0.9	1.1	1.3	-0.1	1.2	1.8	1.9	1.3	0.5	-0.2	-0.1	0.3	0.8	1.5	0.1
Stock changes (% of GDP)	-0.5	-0.5	-1.2	-0.9	-1.1	-0.5	-0.5	-0.4	-0.3	-0.1	0.0	0.0	-0.8	-0.6	-0.1
Exports	10.7	7.0	5.2	-0.5	0.0	1.6	3.3	4.3	4.7	4.5	2.9	4.2	5.4	2.3	4.1
Imports	7.5	4.5	-0.3	-5.6	-5.7	-4.2	0.5	-0.9	2.4	1.4	-0.8	2.0	1.3	-2.6	1.2
Domestic Demand	0.6	-0.2	-1.4	-1.6	-2.1	-2.0	-0.7	-1.0	-0.3	-0.5	-0.7	-0.1	-0.7	-1.5	-0.4
Total Final Expenditure	3.1	1.6	0.3	-1.3	-1.6	-1.1	0.4	0.4	1.1	0.8	0.3	1.1	0.9	-0.5	0.8
Nominal GDP	2.8	2.2	1.5	2.4	1.8	1.6	2.7	2.2	1.7	1.9	1.6	1.9	2.2	2.1	1.8
Inflation															
GDP Deflator	1.0	1.5	1.0	2.3	2.1	1.6	2.3	1.3	1.0	1.2	1.0	1.1	1.4	1.8	1.1
Consumer Price Index	2.5	3.1	2.5	1.9	1.8	1.2	1.0	1.1	0.6	0.5	0.7	0.8	2.5	1.3	0.6
CPI core	1.6	2.2	2.2	2.3	2.2	1.5	1.2	1.2	0.7	0.8	0.7	0.6	2.1	1.5	0.7
CPI - EU Harmonised	2.4	3.2	2.5	1.7	2.0	1.1	1.0	1.1	0.6	0.5	0.7	0.8	2.4	1.3	0.6
Producer Prices	4.7	4.6	2.6	0.3	-0.2	-0.9	-1.0	-0.2	-0.5	-0.2	0.2	0.6	3.0	-0.6	0.0
Average Earnings	2.3	1.8	1.5	1.7	0.5	1.2	1.5	1.8	1.8	1.5	1.2	1.2	1.8	1.3	1.4
Real Activity															
Industrial Production	4.4	0.4	-1.5	-3.7	-3.8	-2.1	-1.0	0.7	0.3	0.6	0.2	1.3	-0.1	-1.6	0.6
Real Disposable Income	1.5	1.7	1.5	1.5	-1.4	-1.8	-0.4	0.3	1.4	1.4	1.1	0.7	1.5	-0.8	1.2
Retail Sales	1.5	-0.2	0.5	0.8	-2.1	-3.0	-1.7	-1.9	0.3	1.8	1.3	2.1	0.7	-2.2	1.4
Money Supply	-0.3	2.1	5.5	6.9	4.5	4.3	4.2	4.8	7.0	6.1	5.0	5.0	3.5	4.5	5.7
	(%, quarterly average)				(%, quarterly average)				(%, quarterly average)				(%, yearly average)		
Capacity Utilization	86.5	85.1	84.5	82.3	82.8	83.6	83.8	86.3	86.4	86.6	86.5	86.5	84.6	84.1	86.5
Savings Ratio	10.1	10.2	10.3	10.1	8.8	8.6	8.8	9.4	9.9	10.0	10.5	10.6	10.2	8.9	10.3
Unemployment	9.2	9.3	9.3	9.5	9.4	9.9	9.8	10.3	10.4	10.4	10.4	10.3	9.3	9.9	10.4
Fiscal Fundamentals															
Budget Deficit (% of GDP)	0.2	-0.8	-1.7	-2.7	-2.8	-2.9	-3.1	-3.3	-3.5	-3.7	-3.6	-3.6	-2.7	-3.3	-3.6
Government Debt (% of GDP)	59.6	59.8	59.6	60.2	59.7	60.4	61.4	62.3	62.1	63.0	63.9	64.8	59.8	61.0	63.5
External Trade															
Trade Balance (% of GDP)	4.3	4.2	4.9	4.9	6.1	5.7	6.2	6.4	6.0	5.7	5.7	5.6	4.5	6.1	5.8
Current Account (% of GDP)	-0.2	-0.8	0.2	1.4	2.0	2.3	2.1	2.6	2.2	1.8	1.7	1.6	0.1	2.3	1.8
Demographic Trends															
Population (mns)	82.2	82.2	82.2	82.2	82.2	82.2	82.2	82.2	82.1	82.1	82.1	82.1	82.2	82.2	82.1
	(%, end-period)				(%, end-period)				(%, end-period)				(%, end-period)		
Financial Forecasts															
Repo rate	4.75	4.50	3.75	3.25	3.25	3.25	3.25	2.75	2.25	2.25	2.75	3.00	3.25	2.75	3.00
3-Month Libor	4.56	4.44	3.66	3.29	3.45	3.44	3.30	2.95	2.75	2.75	3.25	3.40	3.29	2.95	3.40
2-Year Bond Yield	4.13	4.29	3.48	3.64	4.30	3.91	3.08	3.15	3.40	3.75	4.40	4.55	3.64	3.15	4.55
5-Year Bond Yield	4.32	4.59	4.06	4.40	4.88	4.49	3.59	3.80	4.05	4.30	4.90	5.00	4.40	3.80	5.00
10-Year Bond Yield	4.70	5.10	4.79	5.00	5.22	4.94	4.27	4.50	4.60	4.75	5.25	5.35	5.00	4.50	5.35
10-2 Year Bond Spread (basis points)	58	82	131	136	92	103	119	135	120	100	85	80	136	135	80
Euro/Dollar Exchange Rate	0.88	0.85	0.91	0.89	0.87	0.99	0.99	0.93	0.91	1.00	1.10	1.12	0.89	0.93	1.12
Trade-Weighted Exchange Rate	87.2	84.5	88.2	87.2	86.7	92.3	91.6	89.0	88.0	92.0	97.0	100.0	87.2	89.0	100.0