WE NEED TO TALK ABOUT GERMANY

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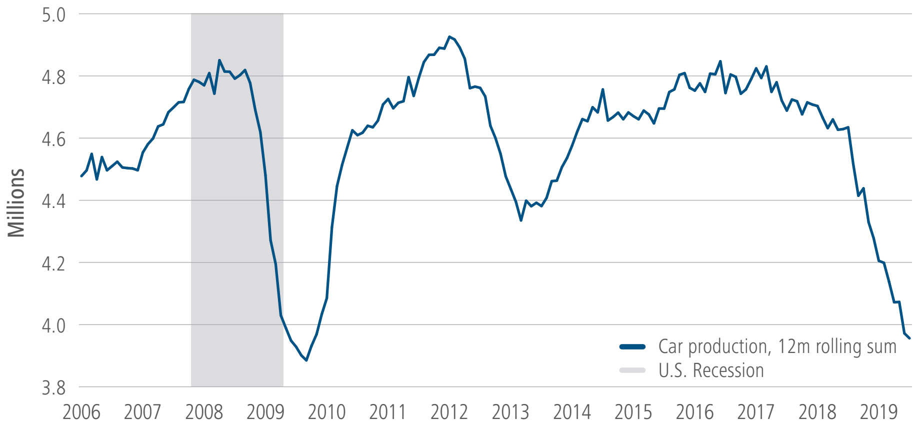
The last few weeks have seen a considerable increase in talk about a potential U.S. recession, largely as a result of the inversion in the yield curve. As we have written in previous notes, we are generally not ready to forecast a U.S. recession, believing instead that headwinds in the manufacturing sector will be matched by improvements in personal consumption and housing as well as Fed easing.

There is, however, one economy where we have witnessed more concerning trends: Germany. In the current economic cycle, Germany has been an outperformer in Europe, both in macroeconomic and market terms. The country's economic outperformance was largely attributable to the economic reforms that were carried out in the early 2000s, leading to a more competitive export sector better able to benefit from the global recovery. However, in recent months, the country's export-focused nature has proven to be more of a curse than a blessing, given trade tensions and the resulting slowdown in global trade.

There is also something more idiosyncratic which took place and hurt German industry considerably. Tighter emissions standards for motor vehicles were implemented in China in July. This led to a drop in Chinese car sales, as consumers waited for the new emissions rules to take hold before purchasing new vehicles. The trade war between China and the U.S. also dented consumer confidence in China, leading households to delay car purchases.

This had significant impacts on Germany. Roughly 25% of all cars sold in China in 2018 were German and China represents over a third of total car sales for German car manufacturers[1]. As a result, German car production fell the most since the 2008 global recession. German industrial production and manufacturing indicators are now in contraction territory, lagging other Eurozone countries such as France.

German Passenger Car Production



Mackenzie Investments (Verband der Automobilindustrie data via Bloomberg)

[1] Source: ING.

How will policy makers react and what are the investment implications? While we expect these negative trends to bottom out gradually in the coming months, we also think stimulus will be applied in Europe, both on the monetary and fiscal fronts. On the fiscal side, Finance Minister Olaf Scholz announced a stimulus package of EUR 50 billion (1.3% of GDP). However, we believe the most significant changes will come from the European Central Bank (ECB), which will have to get creative to respond to the weaker growth trends. On top of this German problem, the ECB is grappling with persistently low expected and realized inflation in the currency union. In our view, this means that the central bank will consider one or many of the following policy measures: 1) cutting rates to an even more negative level, with a "tiering" system for deposits to limit the negative impacts on banks; 2) restarting Quantitative Easing (QE) by purchasing more government bonds; 3) purchasing packages of loans from banks; or, more drastically, 4) purchasing equities.

We think these stimulus measures will be negative for the euro and positive for European equities. We are positioning ourselves for these measures by remaining underweight the euro against the U.S. and Canadian dollars and by owning European equities.

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