CIO View

CIO Special

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Marketing material

Germany – benefiting from low expectations

The economy of Europe's recent worst performer could catch up with the rest this year and support equities along the way.

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IN A NUTSHELL

- We have long been overweight European equities as a whole – and Germany could be the next candidate for an upgrade.
- The German economy has faced some big recent challenges and continues to wrestle with them, but overall it has been coping remarkably well.
- The worst for growth should now be behind us. Early indicators are pointing up and we expect some interest-rate help from the European Central Bank (ECB). All this should support German stocks and shrink the valuation gap with the U.S.

But can you really like the German economy again? In August 2023, The Economist magazine asked whether Germany was again the sick man of Europe.[1] The Germans themselves aren't too positive. No wonder – looking at how many German trains are running behind schedule. And the newspapers are full of stories about the nation's decline. Politically, meanwhile, the strong performance of radical parties in opinion polls suggests a high level of dissatisfaction. The malaise is also in black and white, in the growth figures. With estimated gross-domestic-product (GDP) growth of 0.2% for 2024, Germany is bottom of a developed-countries growth league in which 1.7% growth is needed just to be in mid-table.[2]

But not everyone is taking a pessimistic view on Germany. Some investors still trust it. In the Eurozone, yields on Germany's bonds are lower than for any other country, showing German creditworthiness remains strong. And two months after The Economist speculated about Germany's sickness, the Dax changed course. By May 14th this year, with a total return of 27%, it has slightly outperformed its European neighbors (the Stoxx 600 rose by 24%).[3]

[1] The Economist, "Is Germany once again the sick man of Europe?" as of 8/17/23; https://www.economist.com/leaders/2023/08/17/is-germany-once-again-the-sick-man-of-europe?
[2] Consensus estimates taken from Bloomberg Finance L.P.; as of 5/14/24
[3] Source: Bloomberg Finance L.P. as of 5/14/24

Dax versus Ifo business expectations

Source: Bloomberg Finance L.P.as of 5/14/24

It might seem that investors are closing their eyes to reality, but in fact there is a simple explanation: they are looking ahead. In the first quarter of this year the economy bounced back from the 0.5% contraction in the previous quarter and grew by 0.2%.[4] The early indicators (such as the ifo business expectations shown in the chart above) point to the upswing becoming more dynamic, with an encouraging pick up in exports. This is good for investor sentiment, especially as investors know that the fate of German companies, especially larger ones, listed on the stock exchange, depends heavily on the international market. But the main reason why, in our opinion, German stocks are increasingly interesting again is their relative valuation.

The Dax is trading at a record discount to the world's most important benchmark, the S&P 500 in the U.S. And this despite the fact that in our opinion the momentum in Germany and Europe is better than in the U.S. when it comes to central-bank policy, profit dynamics, expectations, election uncertainties and national debt. And where growth and image are concerned, the European Football Championship in Germany in the summer is a positive. The World Cup in 2006 contributed to a significant improvement in Germany's image abroad. Then again, the trains ran on time more back then.

1 / Economy: weak, but the weakness is weakening

1.1 Back to normal after a series of crises

Germany was especially vulnerable to war and Covid

The shortages of energy and other supplies, high migration flows and the weakening manufacturing sector globally caused by Covid and the Ukrainian war hit the particularly open and trade-oriented German economy especially hard. But the economy coped far better than expected. Germany and Europe have weathered the numerous crises with astonishing resilience – while creating significantly less new debt than the U.S. In the summer of 2022, the prospects looked bad: it was forecast that Germany's economy would shrink by over 9% in the second half of 2022 if Russian gas deliveries stopped. Instead, it contracted during 2023 by just 0.3%.[5]

[4] Source: Bloomberg Finance L.P. as of 5/14/24
[5] Source: Bloomberg Finance L.P. as of 05/14/24

In the eyes of many market participants and corporate leaders, however, there remains another crisis: the governing coalition and its ever-increasing regulatory requirements. These have affected economic sentiment quite substantially. But, after two years in government, at least in terms of sentiment, the bottom could be reached here, too, because at least the corporate world knows what to expect.

Long-term weaknesses exist…

What Germany does face, without doubt, is structural problems with which it will have to struggle for some time to come: an aging population; decades of underinvestment in infrastructure and education; increasing bureaucratization and high costs, not least due to high energy prices. There are also growing disincentives to take up employment or work longer hours. That might be changed with relatively little political effort. But the current unemployment rate of 5.9% is unlikely to be bad enough to prompt the supply-side reforms last seen in 2003-2005 (when unemployment topped 10%). Germany's potential growth rate will remain anemic therefore in our view. Dr. Martin Moryson, chief European economist at DWS, complains: "Germany lacks political answers to the question of how it can increase the total amount of hours worked by any German in their lifetime. This makes the aging society a major problem."

…but short-term developments are moderately encouraging

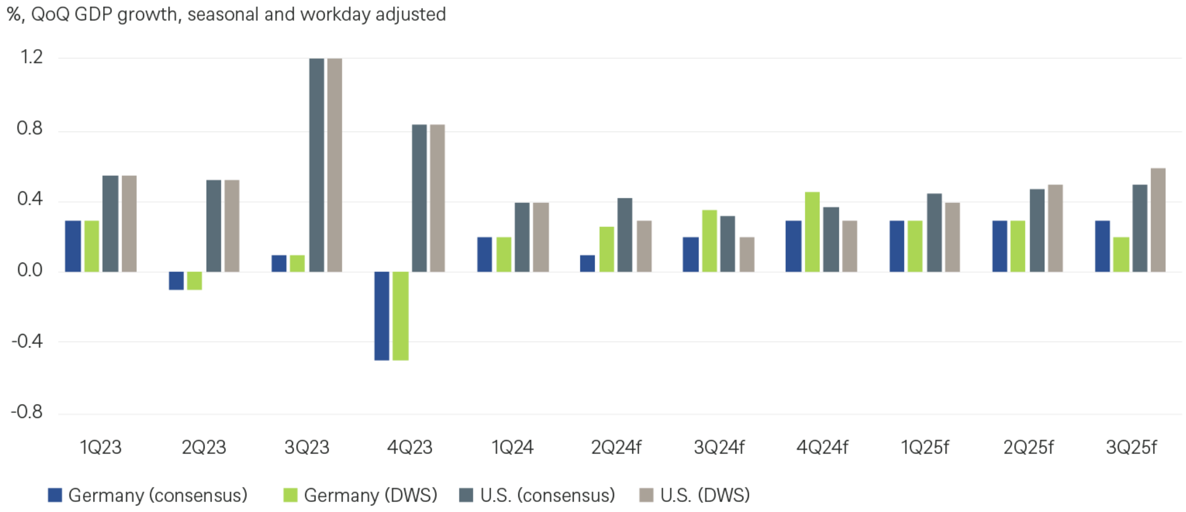
With the publication of the GDP figures for the first quarter, Germany's economic turnaround became more or less official. Not only did the economy grow better than expected, at 0.2% from the previous quarter, but the figures for the first three quarters of 2023 were revised upwards.[6] This means that, according to current estimates, the German economy did not shrink last year, but merely stagnated, which also corresponds to our initial forecast. Our estimates for 2024 are also above those of the consensus. For the full year we see average annual growth of 0.4%, above the consensus of 0.1%. We also expect growth to pick up during the year – in the fourth quarter of 2024 we see 1.3% year-on-year growth, double the consensus forecast of 0.6%.[7]

The latest ifo business climate figures were published a week before the quarterly GDP figures and also painted a positive picture. What was surprising was not so much the third increase in business prospects in a row, but the magnitude of the increase. The purchasing managers' indices, published almost at the same time, followed the same pattern, and in April the composite managed to exceed the expansion threshold of 50 points for the first time since June 2023.[8] The (preliminary) figures published for May confirm the positive trend: both manufacturing and services PMIs came in above expectations, pushing the Composite PMI from 50.6 to 52.2 points.[9]

For the capital markets, not just the absolute numbers, but also whether they underperform or exceed expectations, is important. This is reflected quite well by the Citi Economic Surprise Index[10], which has been pointing upwards for Europe for almost a year and Germany's pick up is reflecting in part that of Europe as a whole.[11] Last but not least, the German consumer is slowly recovering and, in our opinion, will increasingly contribute to growth. Wages are rising strongly, employment is currently increasing, and the inflation rate is falling, so that consumers have significantly more money in their pockets in both net and real terms. Consumer mood is still weak, but the latest GfK survey[12] measuring this shows that consumers are slowly becoming aware of their improving purchasing power. Martin Moryson believes that "the economy should develop quite well in the next few months, even if the structural problems remain unresolved for now."

[6] Source: Bloomberg Finance L.P. as of 5/14/24
[7] Consensus numbers from Bloomberg Finance L.P. as of 5/14/24
[8] Source: Bloomberg Finance L.P. as of 5/14/24
[9] Source: Bloomberg Finance L.P. as of 5/23/24
[10] It needs to be said, though, that in the past few quarters the CESI has shown a better correlation to the bond than to the equity market.
[11] Source: Bloomberg Finance L.P. as of 5/14/24
[12] Bloomberg Finance L.P. as of 5/18/24

Real GDP growth vs. previous quarter



* Last 12m earnings per share
** indexed: 5/15/14 = 100
Sources: Bloomberg Finance L.P.; Destatis; DWS Investment GmbH as of 5/13/24

The nice thing about low expectations is that they can more easily be exceeded. The U.S. is currently experiencing the opposite, at least if you look at Citi's Surprise Index, which has been falling for the U.S. since August last year[13], but with a sharp fall since mid-April of the current year. A further comparison with the U.S. is worthwhile. The often-celebrated economic growth in the U.S. has been accompanied by a significant increase in national debt, while Germany's debt has remained low – perhaps not entirely in the country's best interests. Measured against GDP, German debt only increased from 59.6% to 63.3% between 2019 and 2023, while in the U.S. it rose from 79% to 97.2%.[14] Planned budget deficits in the U.S. in the coming years suggest that the difference between the two countries will widen further.

2 / German stocks are relatively cheap

Stock investors quite understandably ask themselves whether they actually need to take a closer look at the German economy when the 40 Dax stocks generate an average of over 80% of their sales abroad. We would argue that this certainly reduces their dependence on the domestic market but in no way eliminates it. Think of production locations, regulation or taxes. It is also true that investor sentiment reflects the situation in the country and its external image. "The Dax is still an above average cyclical index, that's why it should profit from an improving European economy. We also believe that many of its constituents have structurally improved over the past couple of years. The valuation discount to U.S. equities seems way exaggerated in my opinion" says Marcus Poppe, Co-Head of European Equities at DWS.

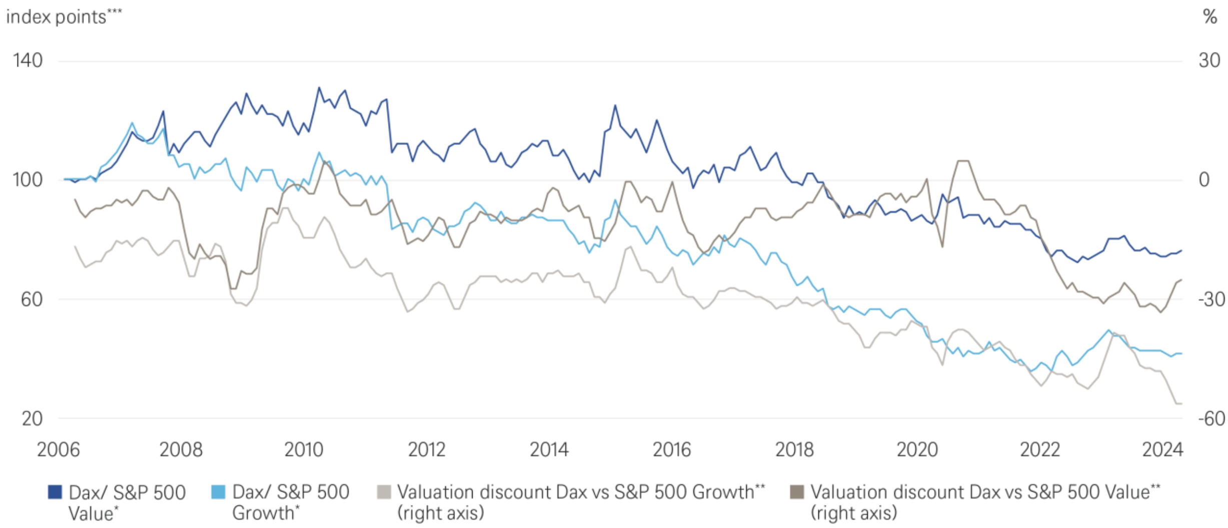
[13] Bloomberg Finance L.P. as of 5/18/24
[14] German data: Bundesbank; U.S. data from the White House; both taken from Bloomberg Finance L.P. as of 5/14/24.

2.1 German equities underperformed more than the earnings trend would suggest

Dax could not even keep up with S&P 500 Value Index

The U.S. market remains the benchmark for global stocks. In the recent past, however, it has largely owed its good fortunes to a handful of large technology companies, often referred to as the Magnificent 7[15], even if we would structurally limit this group to five dominant companies. Once again this year, these growth companies are dominating the quarterly reporting season and are almost single-handedly responsible for the profit growth of the S&P 500 – which, after all, comprises a full 500 companies. To examine the divide in the U.S. market, we look at the performance of growth versus value stocks. As the first chart shows, the Dax has performed around 20% worse than U.S. value stocks since 2006, and it has lost 60% compared to the growth stocks. However, over the past two years it has been able to keep up with both segments, as the interest-rate turnaround has had a harder impact on growth stocks.

Dax performance and valuation versus S&P 500 growth and S&P 500 value.



* All indices: total return incl. gross dividends
** based on 12m forward P/E ratio; 3-months moving average
*** indexed: 5/31/06 = 100
Sources: LSEG Data and Analytics, Bloomberg Finance L.P., DWS Investment GmbH as of 5/13/24

The discrepancy becomes even clearer when it comes to valuation. As the chart shows, the Dax traded at only a slight discount to the value segment of the S&P 500 for many years, while the growth segment has built up an increasingly high valuation premium for around ten years. After the interest-rate shock was digested, this expanded again but now also U.S. value stocks are trading at a 25% premium to the Dax.[16] This, we believe, will not be sustainable. Not least because the Dax not only consists of value stocks but also counts a couple of major growth stocks, albeit to a much smaller extent than the S&P 500. We also think that there is significantly more potential for improvement in German profit margins than in the U.S. As the chart below shows, there has been quite an earnings lag in the Dax compared to its European and U.S. competitors over the past four years alone.

Dax is trading at the average of its historical valuation - but the index is changing its character

With a price-to-earnings (P/E) ratio of 13, the Dax is currently trading exactly at its P/E average of the past 20 years. From this one might conclude that the price potential of the index stems primarily from earnings growth and not from expanding multiples. But one should not forget that the composition of the Dax is constantly changing. It is still one of the most cyclical

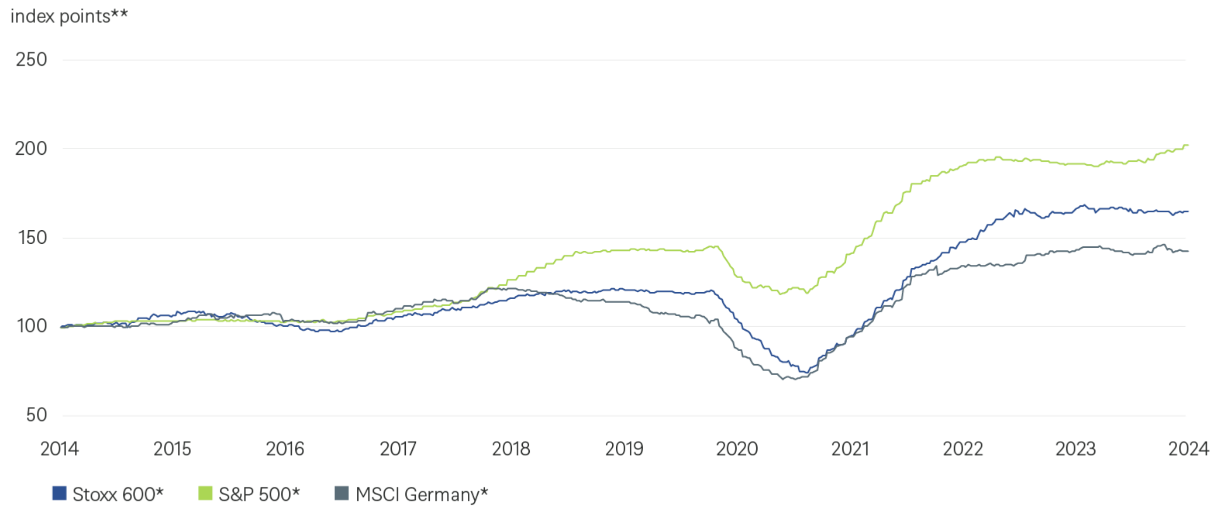
[15] Commonly used term for Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia and Tesla
[16] Based on next 12months earnings estimates. Source: Bloomberg Finance L.P. as of 5/14/24.

stock indices in the world, with a high weight of industrial stocks. The automotive sector alone contributes on average around a quarter of the index's profits. This sector's volatility was evident again this year: it performed significantly better than the overall index for almost three months before making a sharp turnaround in mid-April. But that shouldn't obscure the fact that while industrial stocks, including cars, still make up a third of market capitalization and financial stocks another fifth, technology, communication services, health care and consumer discretionary account for a third of the index. In addition, industrial stocks also have more solid balance sheets today than they did 20 years ago, which could indicate higher valuation multiples.

2.1 Quarterly results and outlook

The first quarter (Q1) was still negative in terms of corporate profits compared to the previous year, but on a sequential basis the Dax' (adjusted) earnings increased by low single digits.[17] The second-quarter profits should also show growth compared to a year earlier. Q1 saw a solid number of earnings beating estimates, and equally many companies increasing their profit guidance. We also expect that the gap with the U.S. should shrink over the course of the year – while profit estimates for the full year 2024 were revised upwards for the U.S. during the Q1 reporting season, they fell further for the Dax. We expect profit growth of 4-8% for the year as a whole for the Dax.

German corporate earnings growth lags peers



* Last 12m earnings per share
** indexed: 5/15/14 = 100
Sources: LSEG Data and Analytics, as of 5/16/24

Again, a comparison with the U.S. is revealing. Earnings estimates in the U.S. have been increased significantly over the past few months. The consensus now expects 10% earnings growth in the U.S. and a decline of 2% in Europe. Based on these metrics, which coincide with significantly higher GDP growth forecasts for the U.S., we see negative surprise potential in the U.S. and the potential for positive surprises in Europe and in Germany. For the latter two, we are above consensus for the following three reasons, among others: 1. a favorable base effect, as last year the final three quarters showed no or negative growth; 2. our more positive outlook vs. consensus for growth in China and Europe based on improving leading and sentiment indicators; 3. the European Central Bank's (ECB's) likely earlier interest-rate cut. In addition, we also notice from discussions with the boards of German companies that, though the mood is still not rosy, it is stabilizing or improving slightly.

[17] See Deutsche Bank Research, "Made in Germany – DAX Q1 Earnings Special" as of 5/17/24

3 / Bonds stable, real estate turning

3.1 Inflation, central-bank policy and bond outlook

The ECB's rate trajectory seems more certain than the Fed's

Until recently, some market participants seemed to think it was a kind of law of nature that the ECB could never raise or even cut interest rates before the U.S. Federal Reserve (the Fed). The market consensus now believes that it can do so. The derivatives markets show that the ECB is expected to cut interest rates three times this year, starting in June, and that the Fed may only start in September or November and not even make two cuts.[18] We agree. However, it is difficult to say whether this view has already penetrated all areas of the financial markets. In recent quarters, the central banks' self-proclaimed data dependence has led to both investors and central bankers being equally uncertain about the future rate path. This is unlikely to change in the next twelve months, especially since we continue to expect fluctuations in the inflation path - we are paying particular attention to wage developments. In our base case, we expect an inflation rate of 2.6% for the Eurozone by the end of the year.

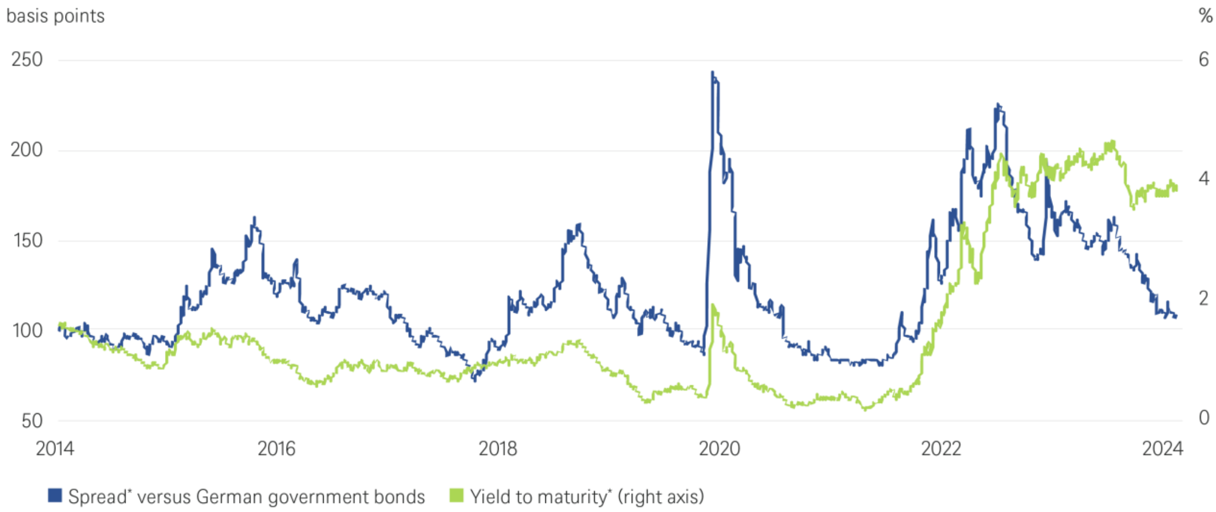
German government bonds are worth a look again

Based on our inflation and ECB interest-rate forecasts, we assume that the yields on 2-year government bonds will fall to 2.5% and those on 10-year bonds will fall to 2.6% by the end of March 2025. Accordingly, we position ourselves more at the shorter end of the yield curve, up to the 5-year range.

Corporate bonds offer only a small premium

Europe's corporate bonds have recently faced some big challenges: the ECB dropped out as a buyer; 2022 and 2023 were characterized by extreme interest-rate increases; geopolitical crises increased the idiosyncratic risks. But we still think these bonds are worth considering in the longer term due to their high initial yields. From a short-term perspective, we have become somewhat more cautious on the investment-grade (IG) segment, and even more so on the high-yield segment, due to the very low risk premiums (spreads) compared to government bonds. In our opinion, an ideal scenario is now being priced in, which could lead to major setbacks even in response to minor disappointments.

Yield of euro corporate bonds (IG) looks enticing, but valuation relative to government bonds is not cheap any more



*ICE BofA Euro Corporate Index; Source: Bloomberg Finance L.P., DWS Investment GmbH as of 5/17/24

[18] Source: Bloomberg Finance L.P. as of 5/16/24.

3.2 Real Estate

High hurdles for the supply side limit the downside - bottoming out likely to be complete soon

We assume that, depending on the segment, the biggest price corrections in the German real-estate market are either already behind us or immediately ahead of us. Our two preferred segments remain residential and logistics. The former is suffering particularly from a limited supply (in terms of costs and regulations) while demand remains almost constant. We particularly like functional residential properties such as higher-quality student or retirement homes.

The market for logistics real-estate providers is easing on both sides. Nationwide supply in the industry is weakening, and demand is also experiencing a weak phase. However, the long-term market trends and fundamentals remain healthy and are reflected in a very low vacancy rate of just over 2%. We expect particularly strong rental growth for urban logistics in the future. Combined with the previous price corrections, this should create an interesting mix.

The office market remains challenging, but less so in the premium segment. Here, price corrections have taken place, some of them significant, and demand in key markets such as Berlin and Munich is structurally strong. Short-term weak supply and increased construction costs support this trend. Older assets, on the other hand, offer potential for conversion, for example into residential use. Overall, we expect 2024 to be an exceptionally good year to start engaging in this segment.

4 / Conclusion

German equities have been doing quite well for a few months now, which is somewhat in contrast to the rather negative mood in the country. However, some economic indicators are now turning positive, and we expect economic growth to gain momentum. Here we see a difference compared to the U.S. in particular, which is why we e that German equities will outperform the U.S. and narrow their record high valuation gap to the U.S. in the next 12 months.

Glossary

The Dax is a blue-chip stock-market index consisting of the 40 major German companies trading on the Frankfurt Stock Exchange.

The European Central Bank (ECB) is the central bank for the Eurozone.

The Eurozone is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

The gross domestic product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

Growth stocks are stocks from companies that are expected to grow significantly above market average for a certain period of time.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

The Ifo Business Climate Index is a highly regarded indicator of economic sentiment in Germany.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

The price-to-earnings (P/E) ratio compares a company's current share price to its earnings per share.

The Purchasing Managers' Index (PMI) is an indicator of the economic health of the manufacturing sector in a specific country or region.

In economics, a real value is adjusted for inflation.

The risk premium is the expected return on an investment minus the return that would be earned on a risk-free investment.

The S&P 500 is an index that includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

The spread is the difference between the quoted rates of return on two different investments, usually of different credit quality.

The Stoxx Europe 600 is an index representing the performance of 600 listed companies across 18 European countries.

The U.S. Federal Reserve, often referred to as "the Fed," is the central bank of the United States.

Value stocks are stocks from companies that are trading at prices close to their book value and that are therefore cheaper than the market average on that metric.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

A yield curve shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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