Germany: Last stronghold weakens as Ifo drops

The first drop in the Ifo business sentiment index since the lifting of lockdown measures adds to growth concerns for the last few months of the year

A sign reading 'We're closing' at a Karstadt Sport store in Berlin

After several leading indicators pointing to a weakening of the economy, Germany's most prominent leading indicator, the Ifo index, has finally joined the crowd. Until September, the Ifo index seemed to be defying growing pessimism but after five consecutive increases, it dropped in October for the first time since April. The headline number came in at 92.7, from 93.2 in September. While the current assessment component improved for the fifth month in a row to 90.3, from 89.2, the expectations component weakened for the first time since April. The current assessment component is still almost 10% below its pre-crisis level.

The new divergence continues. Last week's PMIs illustrated the two-speed German economy. While the weakening of the service sector has continued under new social distancing restrictions, the manufacturing sector continued its upward trend. In our view, there are three main reasons for this new divergence:

- First of all, the latest tightening of social distancing restrictions mainly affects parts of the service sector such as leisure, hotels, restaurants, sports and culture. This 'smart lockdown'

currently still spares most areas of the industry.
- Secondly, the strong and continuing rebound of the Chinese economy has helped German exports to recover.
- Finally, the rebound in manufacturing started later than the rebound in services.

The current divergence could simply be a delayed reaction. In any case, don't forget that the manufacturing sector entered the crisis on a much weaker footing than the service sector, putting any temporary divergences clearly into perspective.

Looking ahead, as painful as the 'smart' lockdowns are for the already hard-hit sectors, the impact on the total economy will be much less accentuated than at the start of the crisis. However, with even more social distancing restrictions on the horizon, there is a significant risk that 'smart' lockdowns across Europe turn into more severe ones, which in turn would bring the third quarter rebound to an abrupt halt in the last few months of the year.

At face value, today's Ifo index is not weak enough to fear another collapse of the economy but as all of Europe is in the second wave of the virus, today's Ifo index definitely marks the end of the rebound and the start of double-dip fears.

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