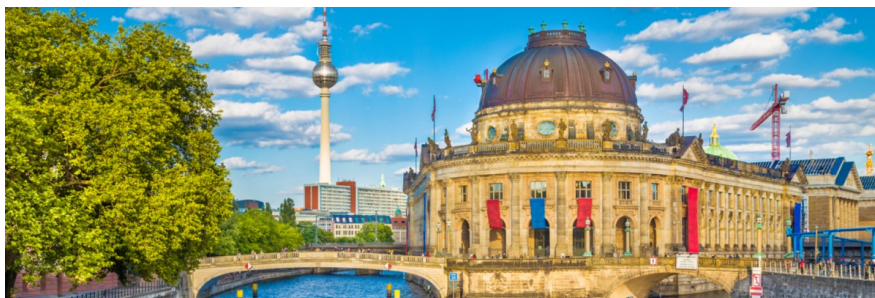


Germany: Stuck at the bottom

The latest Ifo index reading shows that a bottoming out does not automatically lead to a rebound. The economy will continue moving sideways



A cold shower for all the optimists. Germany's most prominent leading indicator, the Ifo index, just started the new year with a disappointment, dropping for the first time since August last year. In January, the Ifo index decreased to 95.9, from 96.3 in December. While the current assessment component strengthened somewhat, the expectations component fell after three consecutive increases.

The long process of finding a bottom

Today's Ifo index illustrates that the German economy, particularly the manufacturing sector, is still searching for a bottom. Also, it is plateauing at low levels, still masking significant differences across sectors. While the service sector has already gone through a real rebound since the summer, the manufacturing sector still looks paralysed, suffering from trade conflicts and the global manufacturing downturn. In Germany, the manufacturing slump goes beyond the automotive sector as all sectors, except for food and tobacco, are still in recessionary territory.

More promising PMI readings from last week and an Ifo index still searching for a lower bound suggest that the economy is currently bottoming out. However, this will not necessarily be followed by a strong rebound. In fact, at the current juncture, it is not at all clear what form the recovery will take from the alphabet soup of options. Will it be a 'V' for a strong rebound, a 'U' for a longer bottom followed by a strong rebound, a 'J' for a longer period of stagnation followed by a weak rebound, an 'L' for a long period of stagnation or even a 'W' for a double dip recession? Given the current split of the German economy, with a strong service and weak manufacturing sector, the shape of the recovery is key. In this regard, ongoing trade uncertainty, disruption in the automotive sector and a structural shift of the global economy away from manufacturing towards services are all potential obstacles on the road to recovery. Add to this still thin order books and

high inventories and the recovery in the manufacturing sector will, in our view, follow a J-shape.

All in all, today's Ifo index is a painful warning against premature optimism. The German economy is in a phase of bottoming out, which could come just in time to avoid more negative spillover effects from the manufacturing weakness to the labour market. However, for the time being, the economy remains stuck at the bottom.

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