Germany: Cold shower

After some encouraging signals from confidence indicators earlier this week, the Ifo index just poured cold water on them

Still falling. Germany's most prominent leading indicator, the Ifo index, dropped for a sixth consecutive month and came in at 98.5 in February, from 99.3 in January. The drop was driven by both weaker current assessments and expectations, even though the current assessment lost more momentum than the expectations component. Today's Ifo index somewhat undermines the tentative signs of stabilisation we saw earlier this week in the ZEW index and PMIs. The still-high uncertainties, mainly stemming from trade, China and Brexit are denting German business sentiment.

As suggested by yesterday's strong PMI services and this morning's GDP data, the domestic side of the German economy remains strong. However, the increasing dichotomy between domestic strength and external uncertainties or domestic strength and faltering manufacturing is both remarkable and worrying. It raises the question of who is leading whom? Will domestic demand follow weaker external activities, eventually bringing the entire economy down to its knees or will manufacturing rebound?

Previous episodes suggest that manufacturing and service activities in Germany have moved in tandem. It is only since the start of 2015 that a structural break between the two has occurred, with services (as a proxy for domestic demand) flourishing, while the manufacturing sector went through significant fluctuations. Only time will tell whether this decoupling will last or whether the domestic side of the German economy will also show cracks in the course of the year.

For the time being, the two tales of the German economy will continue. The first is one of a strong and solid domestic economy with consumption and investments supporting growth. The second is one of an export-oriented economy which suffers from too many conflicts, problems and slowdown in the rest of the world. Of these two, the biggest risk is that the external risks, which up until now have hardly materialised, could become self-fulfilling prophecies, pushing the entire economy into a negative sentiment loop. Happy end or rude awakening? Right now, both endings are still possible.

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