Weak German Ifo reading reminds us that stagflation is the base case

A weak Ifo reading in June should remind everyone that the German economy is feeling the full economic impact of the war in Ukraine, broader supply chain frictions, and higher inflation

Consumer confidence in Germany is already in clear recession territory

Short-lived optimism

After two months of improving business sentiment, Germany's most prominent leading indicator, the Ifo index, just delivered a reality check and dented any premature optimism. The Ifo index dropped to 92.3 in June, from 93.0 in May. In March, the Ifo stood at 90.8. Both the current assessment and the expectations component weakened in June, with expectations almost back down to the March levels. The reasons for dampened optimism are clear: the war in Ukraine, lockdowns in China and the consequent supply chain frictions, higher costs and prices, and weakening demand. It is actually not the first time German business sentiment seems to have had a delayed reaction to global events.

Stagflation remains our base case scenario for the German economy

Yesterday, the German PMI fell for the fourth consecutive month, to the lowest level since the fourth wave of the Covid-19 pandemic. The PMI details showed another sharp inventory build-up and a cooling in the services sector, a combination that definitely doesn't bode well for future economic activity.

In fact, supportive factors for the economy such as post-lockdown reopenings and filled order books have been losing momentum rapidly. Weaker global demand, supply chain frictions, and high inflation denting consumption are hitting the German economy. Supply chains continue to be disrupted due to the Shanghai lockdown and the war in Ukraine. Some might be disrupted for good. Elevated uncertainty and fear will weigh on both supply and demand in the coming months. Real disposable incomes of households will suffer, and companies will have increasing difficulties dealing with the costs of higher energy and commodity prices, putting corporate profit margins under pressure. Not a happy-go-lucky story.

The German economy will definitely not plunge as it did during the 2020 lockdowns. However, consumer confidence is already in clear recession territory and today's Ifo reading, as well as yesterday's PMI reading, both suggest that the manufacturing sector is quickly following suit. Stagflation for the rest of the year remains our base case scenario for the German economy, and an outright recession is our risk scenario.

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