SPECIAL REPORT

December 2, 2024

A Word From Chen Zhao

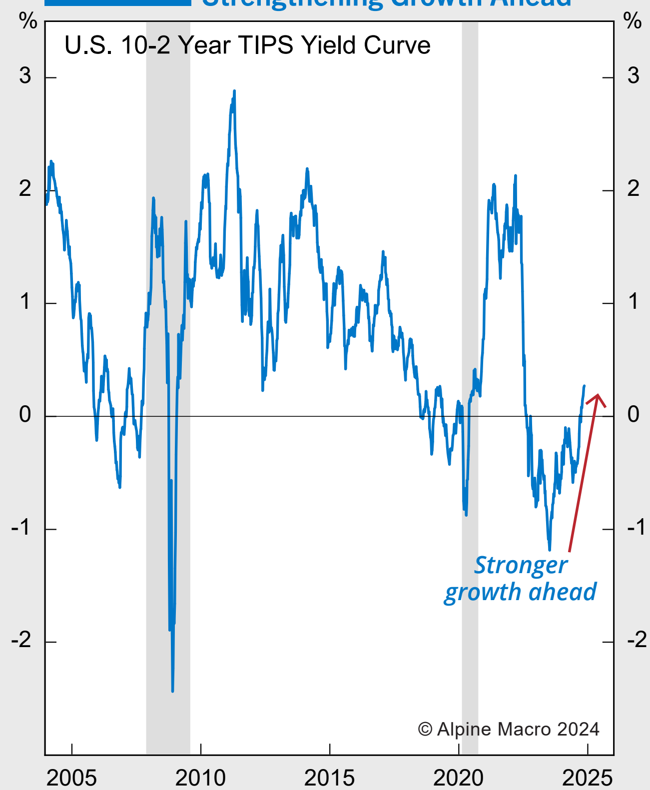
This week's *Special Report* is written by my colleague and our *Chief Asset Allocation Strategist,* Bassam Nawfal. Bassam takes a comprehensive look into the German economy and argues that Germany is still being squeezed by a lingering energy crunch, weak Chinese demand but intense competition, and fiscal austerity.

Having a fiscal straitjacket is a big problem for European economic growth. Endless fiscal austerity has been compounding Europe's over-saving problem, adding to its economic plight ever since the end of the pandemic crisis. This has made any significant economic recovery in Germany very hard to come by. Bassam does not believe that economic conditions will get much better next year, suggesting that German bunds are a better bet than the DAX. I trust you will find Bassam's piece lucid, convincing and insightful.

On financial markets, it strikes me that the so-called "Trump Trade" should take a breather soon. Stocks, bonds and the dollar have all made large moves to front-run Trump's economic policies, and a lot of positive changes are being discounted. The next stage for the Trump trade will need validation of actual policy shifts. In other words, financial markets need a "show me the money" moment to confirm what has been priced in.

Financial markets are very excited about Trump's supply-side policies, because they are genuinely pro-growth and pro-business. But there are also many nuances and even inconsistencies in these policy initiatives, including corporate tax cuts but tariff hikes, or boosting GDP growth but restricting labor supply. How these inconsistencies play out next year matters for markets.

Chart 1 TIPS Yield Curve: Strengthening Growth Ahead



Note: Shading denotes U.S. recessions

The good news is that Trump has assembled a good economic team and sent a signal that he cares about how his policy is perceived by financial markets. This has reduced the odds of Trump taking erratic and reckless actions once in power.

On investment strategy, we reiterate our bullish stance towards equities, even though stocks have risen a lot. Trump is charging ahead with once-in-a-generation changes in economic policy, and these changes are very positive for EPS growth, productivity, and therefore, disinflation over time.

The recent backup in bond yields does not indicate a rising fiscal risk premium. Rather, higher yields are reflective of rising growth expectations. This is evidenced by the fact that rising bond yields have been predominantly led by TIPS yields, and the real yield curve continues to steepen (**Chart 1**), projecting better growth ahead.

Chart 2 **Dollar Has Soared On Trump Victory**

Source: Federal Reserve

We are doubtful that the Federal Reserve will drop rates much below 4%, unless inflation plunges. If the Fed holds the policy rate at 4% for much of 2025, long bond yields should hover around 4.0-4.5%. This automatically means that, should 10-year Treasury yield retest 5%, investors should go long duration. By the same token, if bond yields fall towards 4% or lower, cut duration. We are currently at the benchmark weight.

Finally, the dollar will stay strong. Although Trump does not like a strong dollar, his tariff policy will drive up the greenback. Don't forget that the dollar is a reserve currency, and at times of trade wars, the natural defensive response from any nation under the threat of rising tariffs is to drop its local currency.

Trump has already fired the first salvo against Canada, Mexico and China, causing their currencies to tumble. He will make similar threats to Europe. **Chart 2** shows that the trade-weighted dollar has surged nearly 6% since October. We suspect that there is more dollar strength to come as trade tensions rise and interest rates in the rest of the world fall faster than the U.S.

Best Regards,
Chen Zhao

ALPINEMACRO
A Unique Mind On The Markets

SPECIAL REPORT

December 2, 2024

Germany: No Early Discharge For The Patient

In This Report

It is now widely recognized that Germany's economic performance is languishing. Commentators have become fond of pointing out that real output remains where it was on the eve of the pandemic. Yet, the benefit of hindsight suggests that Germany's afflictions began to manifest at least a couple of years prior to that, when its absolute and relative industrial production peaked (Chart 3).

De-industrialization has firmly taken root since then, leading to stagnant real profits and poor equity returns. The vital question for investors is whether or not the process is close to bottoming out. This report aims to answer this by evaluating the three pillars of Germany's growth model, as well as considering how cyclical factors come into play.

Germany Is Coping With A Lingering Energy Crunch...

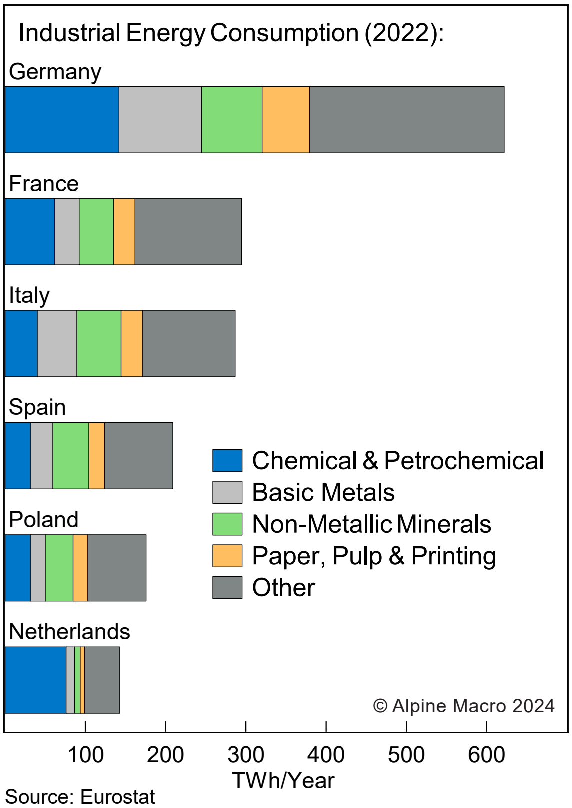
Germany's industrial sector is an energy behemoth, consuming nearly twice as much as any other European country due to its sizable industrial base (Chart 4). Naturally, Russia's invasion of Ukraine abruptly cut off Germany's access to cheap Russian gas, leading to a severe energy crunch.

Three years on, the gas price shock still reverberates throughout the economy. Wholesale electricity prices, closely linked to continental natural gas prices, remain nearly three times higher than the pre-2021 level (Chart 5). While electricity consumption as a share of GDP has normalized to 0.50-0.75% from a crisis peak of 4%, this is partly the result of drastic rationalization in usage, especially by industrial consumers.

Chart 3 Germany's Illness: There Were Signs

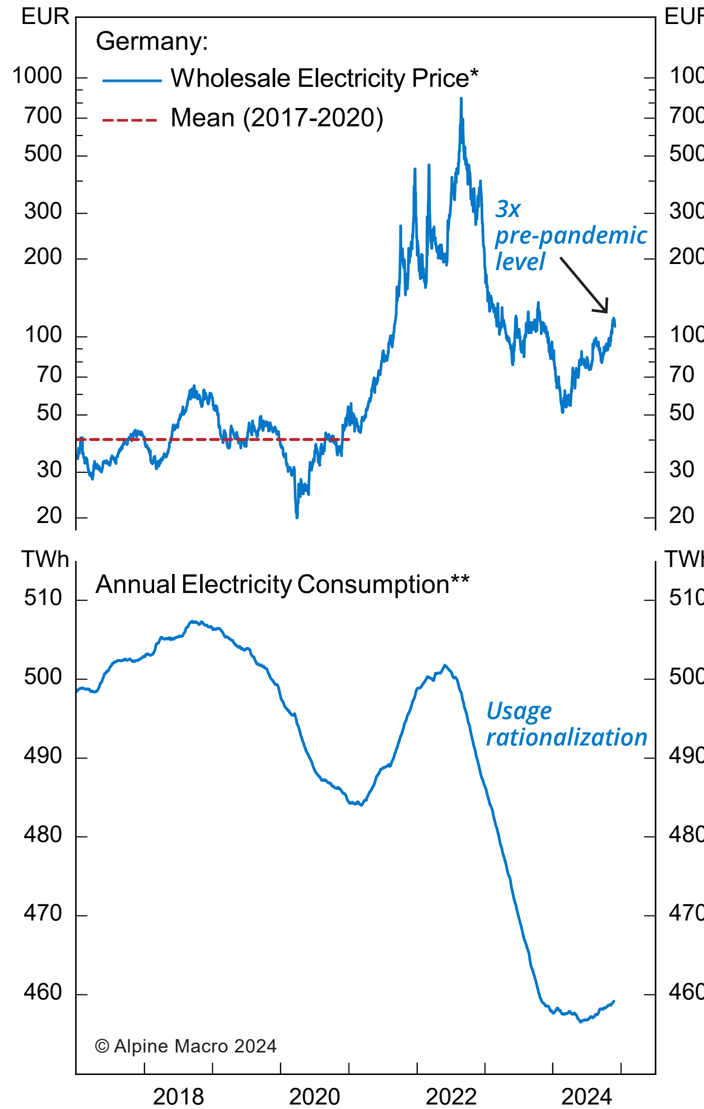
*Excluding construction; shown as 3-month moving average and rebased to Jan 2018=100; source: Netherlands Bureau for Economic Policy Analysis

Chart 4 **A Voracious Energy Appetite**



Source: Eurostat

Chart 5 **Gas Price Shock Still Reverberating**



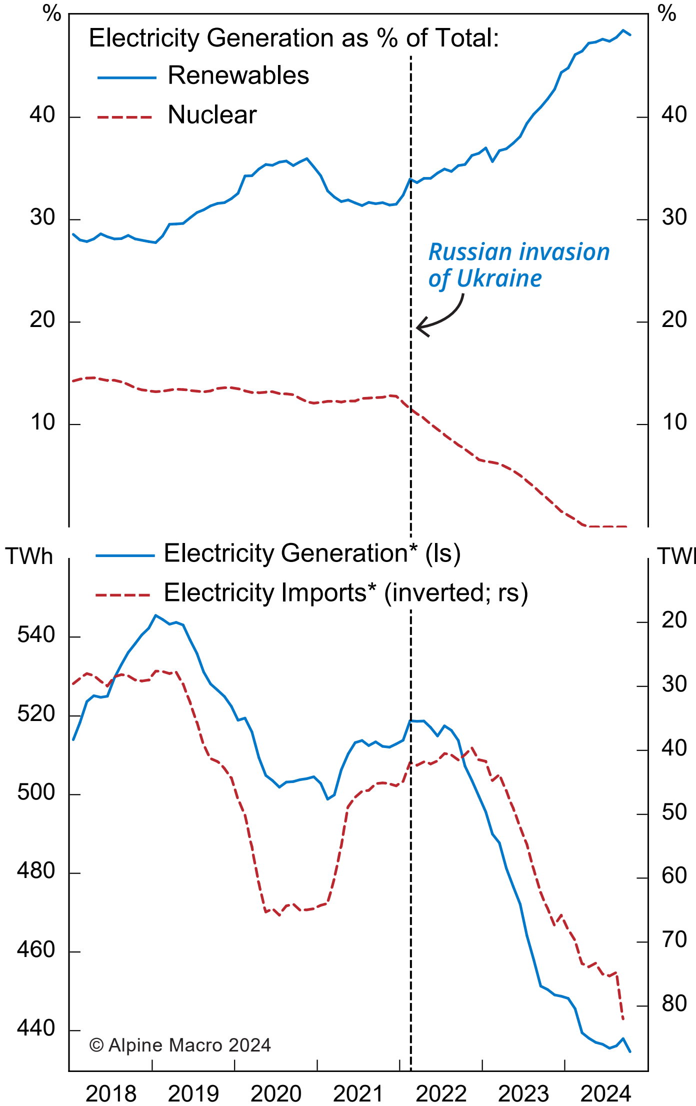
*Average of front three futures contracts; shown on a log scale; source: The Iberian Energy Derivatives Exchange
**Source: Bundesbank

Key missteps are prolonging Germany's adjustment. Notably, the government inexplicably decommissioned its last three nuclear reactors amid the crisis. While the phase-out aimed to promote renewables, investment in them has lagged. Local governments have also delayed permits for solar and wind projects and blocked transmission lines needed to connect the windy north with the sunny south. The result is a toxic mix of persistently high electricity prices, declining domestic generation, and rising imports, despite lower consumption (**Chart 6**).

The lingering effects of the energy crunch are driving broad de-industrialization. **Chart 7** compares overall industrial production with a median measure across all industries. Since the Russia-Ukraine conflict began, the industry median has been in free-fall, plunging to Great Financial Crisis (GFC) and pandemic lows. The economic pain clearly extends beyond energy-intensive sectors, a point overlooked by many observers who have focused narrowly on those industries.

Some energy cost relief may come as expanding LNG capacity in Europe and the U.S. enhances

Chart 6 Profound Energy Policy Failure...

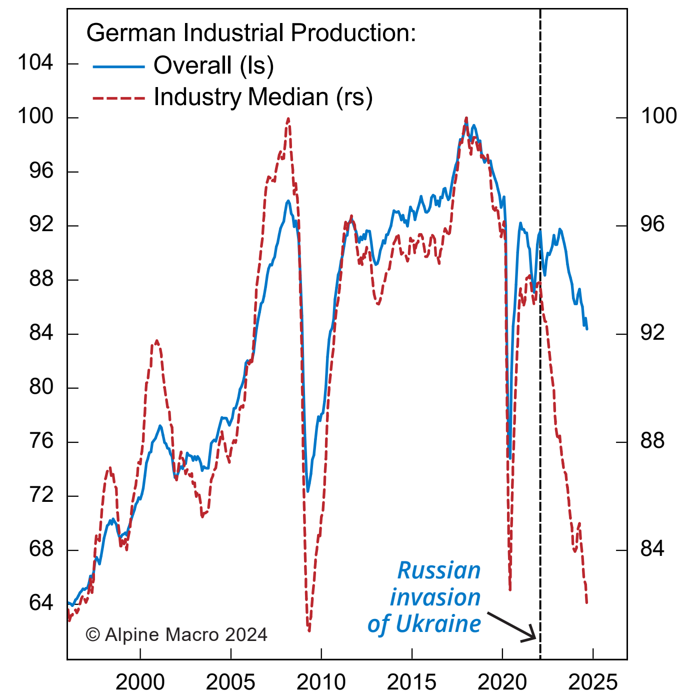


*Shown as 12-month moving sum
Source: Bundesnetzagentur, The Iberian Energy Derivatives Exchange, Alpine Macro calculations

market integration and encourages price convergence. However, this will likely unfold gradually over several years.

Bottom Line: Profits across much of German manufacturing remain under pressure as the aftershocks of the war-driven energy crunch persist. Some relief may come from rising U.S. LNG imports, but a meaningful impact is unlikely in the next 6-12 months.

Chart 7 ...Leading To Pervasive De-Industrialization



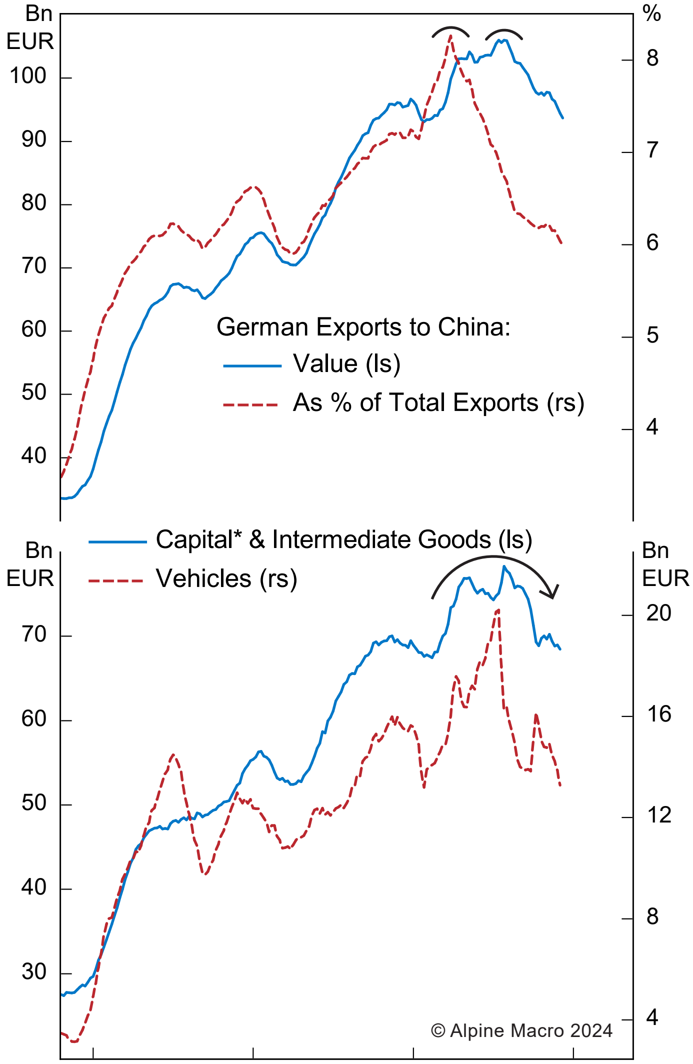
Note: Both series are shown as 3-month moving average and rebased to Jan 2018=100

...Fierce Market Competition With China...

Another key plank of Germany's economic prosperity has been its heavy reliance on exports to China. For years, Germany capitalized on booming Chinese demand for its goods, offsetting sluggish growth in Western markets following the GFC. However, this dynamic is facing mounting pressures, with German exports to China steadily declining by 12% since topping out in early 2023 (Chart 8, top panel).

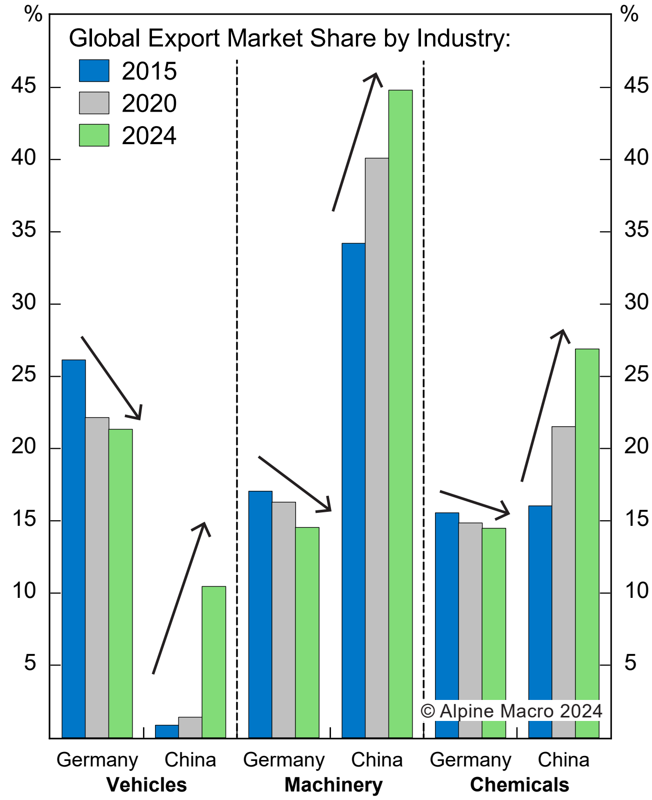
China's growth slowdown may have been the trigger for this sharp decline. However, the real culprit is China's rapid ascent up the value chain, enabling it to produce what it once imported from Germany, such as cars and capital/intermediate goods (Chart 8, bottom panel).

Chart 8 **China To Germany: It's Not You, It's Me**



*Excludes vehicles, which are defined as capital goods
Source: UN Comtrade, Alpine Macro calculations

Chart 9 ***Exportweltmeister* No More?**



Note: Based on U.S. dollar share; 2015 and 2020 figures are for January, while 2024 figure is for June; source: UN Comtrade, Alpine Macro calculations

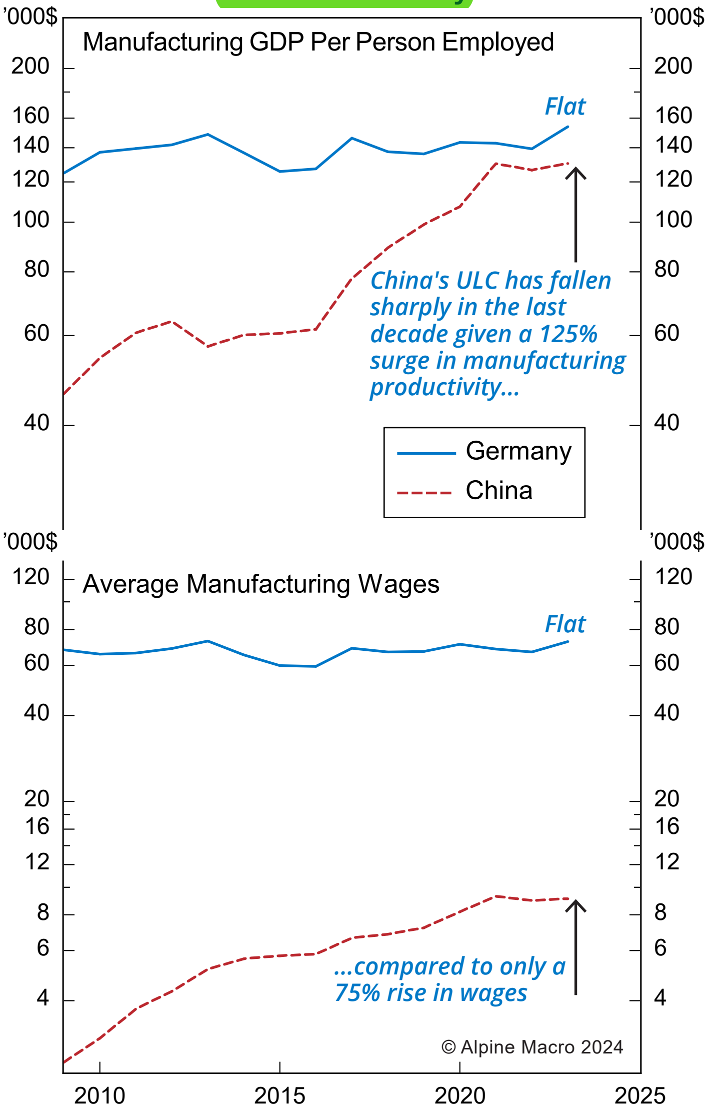
Even more concerning is China's emergence as a fierce global competitor in these sectors (Chart 9). While the dramatic rise of its auto and EV industry is widely acknowledged, China has also steadily captured global export market share in machinery and chemicals, often at Germany's expense.

Germany has worsened its position by failing to modernize its industrial base, which is hindered by bureaucratic inefficiencies and a digital deficit. While strong branding and EU tariffs could allow it to retain dominance in Europe, its competitive edge is clearly eroding.

In fact, we estimate that labor productivity in Germany's manufacturing sector stalled a decade ago (Chart 10). Meanwhile, China has achieved over 125% productivity growth, far outpacing its 75% wage increase. Like the U.S. and Japan, German industry has struggled to cope with the rapid decline in Chinese unit labor costs.

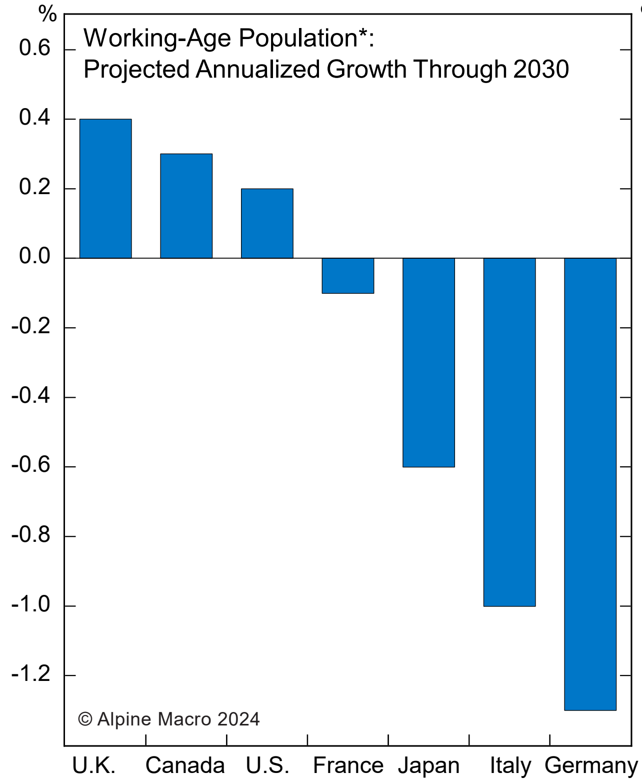
German firms are working to diversify away from China. However, progress is bound to be slow due to the complexity of shifting supply chains and the

Chart 10 China's Ultra-Competitiveness Pressures Germany



Note: Both series are shown on a log scale; source: Alpine Macro calculations

Chart 11 From Powerhouse To Pensionhouse



*Ages 20-64; source: UN

limited availability of alternative markets that match China's scale and demand.

Bottom Line: Germany's economic reliance on exports to China is unraveling as China aggressively expands into higher-value sectors like autos, machinery, and chemicals. With stagnant manufacturing productivity and slow diversification efforts, Germany risks further erosion of its export market share.

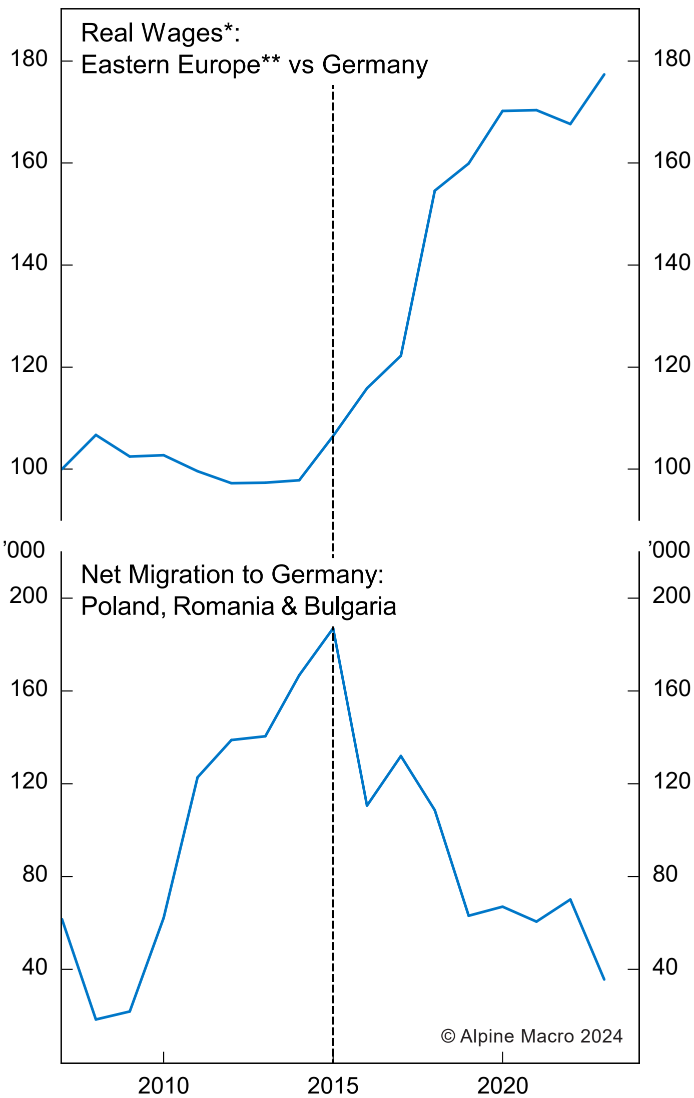
...And A Sclerotic Labor Market

The final pillar of Germany's growth model has been a flexible labor market. The Hartz reforms of the early 2000s strengthened this flexibility by expanding part-time and temporary work options, which reduced unemployment. Additionally, access to cheap, semi-skilled, and unskilled labor from Eastern Europe helped control costs in key sectors like manufacturing and construction.

Yet, Germany is grappling with daunting challenges on this front as well.

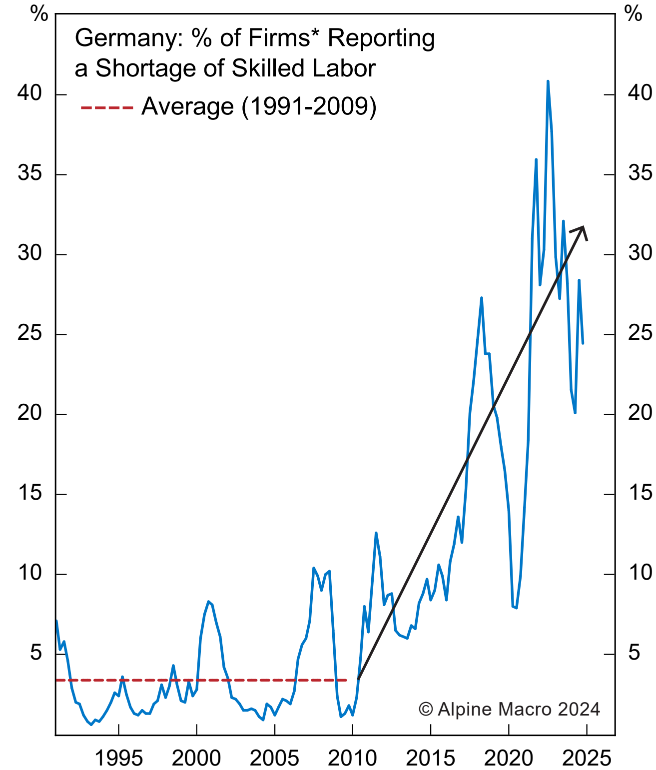
While aging demographics challenge many advanced economies, Germany's outlook is particularly grim. Its working-age population is set to decline by 1.3% annually through the rest of the decade, a dismal

Chart 12 Migrant Labor Drying Up As Eastern European Wages Surge



*Rebased to Jan 2007=100
**Median of Poland, Romania, and Bulgaria

Chart 13 Skills Shortage Squeezes German Firms



*For manufacturing prior to 2021, and an average of manufacturing and construction thereafter; source: Ifo Institute

figure surpassing even those of increasingly geriatric societies like Italy and Japan (**Chart 11**). The labor pool could be replenished by increasing migration, but the growing influence of the far-right has firmly shifted the political discourse against such policies.

Even if immigration policies were relaxed, it is debatable whether this would materially boost foreign labor availability. Real wages in Poland, Romania, and Bulgaria – once key sources of lower-skilled labor – have soared since the mid-2010s (**Chart 12**). These countries have seen annualized wage growth of 9%, vastly outpacing Germany's 1.8%. Unsurprisingly, net migration from the region continues to recede alongside rising relative wages.

A structural shortage of skilled workers adds to these pressures. A quarter of firms now report such bottlenecks, a far cry from the 3.5% average of the 1990s and 2000s (**Chart 13**). This has likely encouraged labor hoarding, which may explain why overall employment has remained steady despite Germany's flirtation with technical recession since 2022.

Bottom Line: Bargaining power will continue to swing away from the corporate sector and towards labor, fueled by particularly dire demographic trends, surging real wages for lower-skilled migrants, and an escalating shortage of skilled workers.

Stuck Between A Strong Euro And Austerity

By definition, structural challenges like those outlined above are unlikely to have simple or swift solutions. Unfortunately for Germany, its cyclical prospects offer little reassurance as they remain stifled by implicit and explicit policy straitjackets.

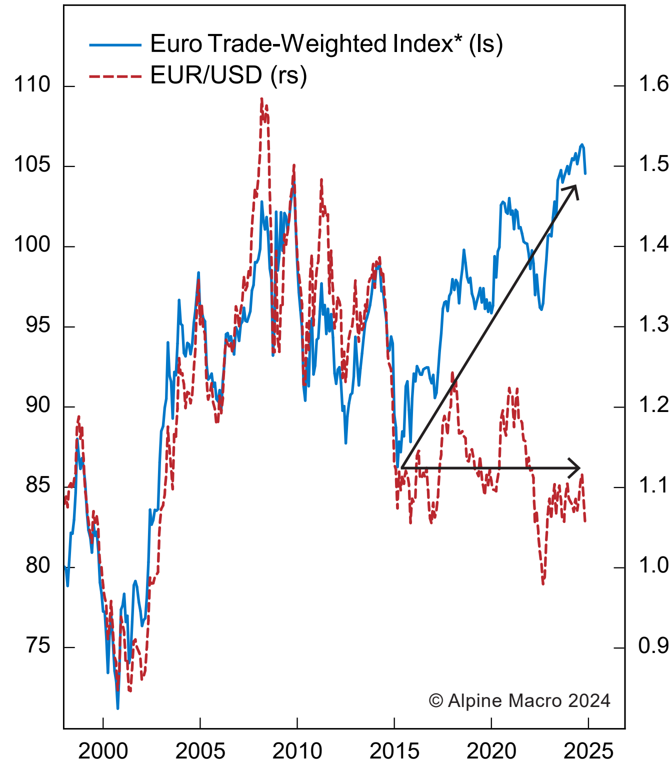
The implicit straitjacket is the euro, whose broad rise compounds the loss of export competitiveness. Chart 14 highlights the stark divergence between EUR/USD and the trade-weighted index since 2015. While the former has traded sideways, the latter has climbed nearly 25%, surpassing its post-GFC highs.

Little could have been done to curb this rise. Slowing trend growth in China weighed on Asian currencies, and ECB policy was already tethered to the zero bound until mid-2022. Nevertheless, the central bank is committing a policy error today by haltingly cutting rates despite muddled growth and fading inflationary pressures. The likely result of limited euro downside is minimal relief for German exporters.

Of course, Germany's so-called "debt brake" serves as the explicit straitjacket, capping the structural budget deficit at no more than 0.35% of GDP. From its introduction in 2009 until its suspension in 2020,[1]

1 Germany reinstated the debt brake in 2024 after having exceptionally suspending it for four years due to the pandemic and the war-induced energy crisis.

Chart 14 Cyclical Prospects Dampened By Overvalued Currency...



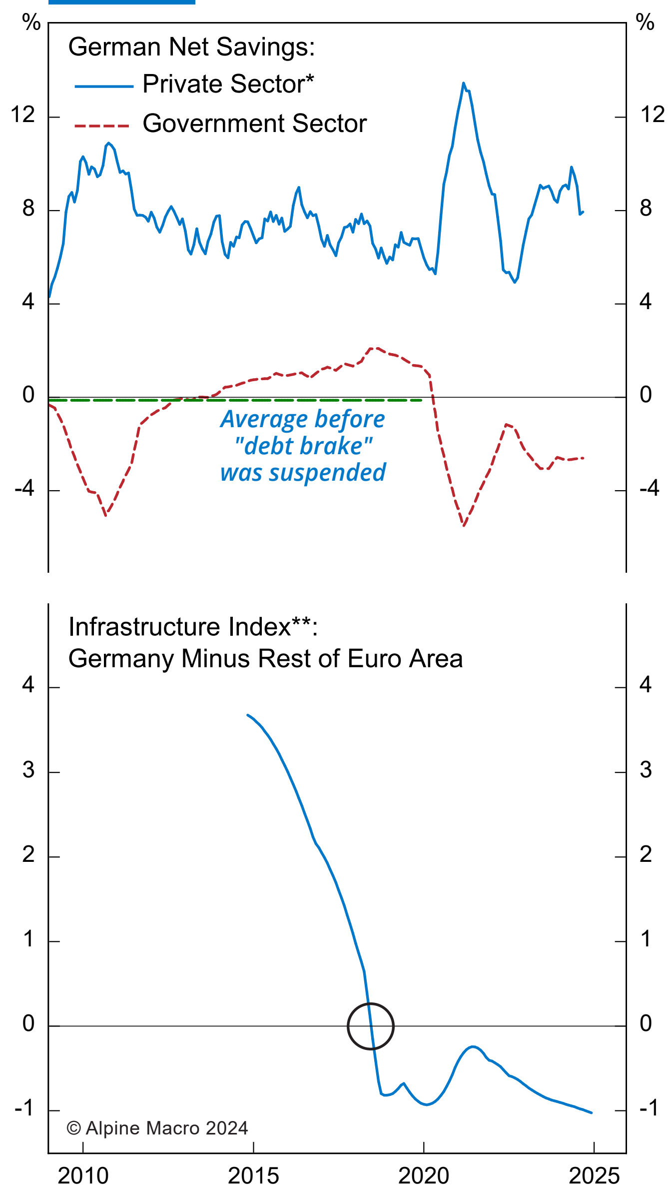
*Broad index; source: BIS

Germany's average fiscal deficit came even lower, at just 0.13%. Now that export growth is threatened, such fiscal restraint risks leaving aggregate demand insufficient to sustain growth given persistent private sector savings of 5-10% of GDP (Chart 15, top panel).

Moreover, this fetish with balanced budget rules has often led to too little public investment. Infrastructure has suffered in particular, which is now assessed to be worse on balance compared to the rest of the euro area (Chart 15, bottom panel). The crumbling of essential public goods is throttling economic efficiency, thereby preventing Germany from modernizing its economy and jumpstarting growth.

Hopes for reforming the debt brake, which would require a constitutional amendment, have recently

Chart 15 ...And Harsh Fiscal Restraint



*Inferred by current account balance minus fiscal balance
**Shown as 3-year moving average; rest of euro area is the median of 9 countries; source: Global Innovation Index

surged. The collapse of the "traffic light" governing coalition has prompted snap elections in February, with the center-right CDU/CSU widely expected to win. Friedrich Merz, the likely incoming chancellor, has signaled openness to reforming the rule, provided it prioritizes investment over expanded social spending.

We are skeptical that such change will materialize quickly:

- There are high odds that the hard-right AfD and the "left-conservative" BSW, both staunchly opposed to relaxing fiscal rules, could form a blocking minority. More broadly, Germany's political fragmentation makes it difficult to forge the stable coalition necessary to amend the debt brake.
- Constitutional amendments in Germany have historically been slow-moving due to legal hurdles and procedural delays. This suggests that reforming the debt brake would likely take considerable time, even in the best-case scenario.
- Even if reform is achieved, fully dismantling the debt brake may prove too radical for the electorate. The public debate on this issue has largely focused on "tweaking" the rule, rather than a wholesale abandonment. This is hardly suggestive of a wide opening of the fiscal taps.

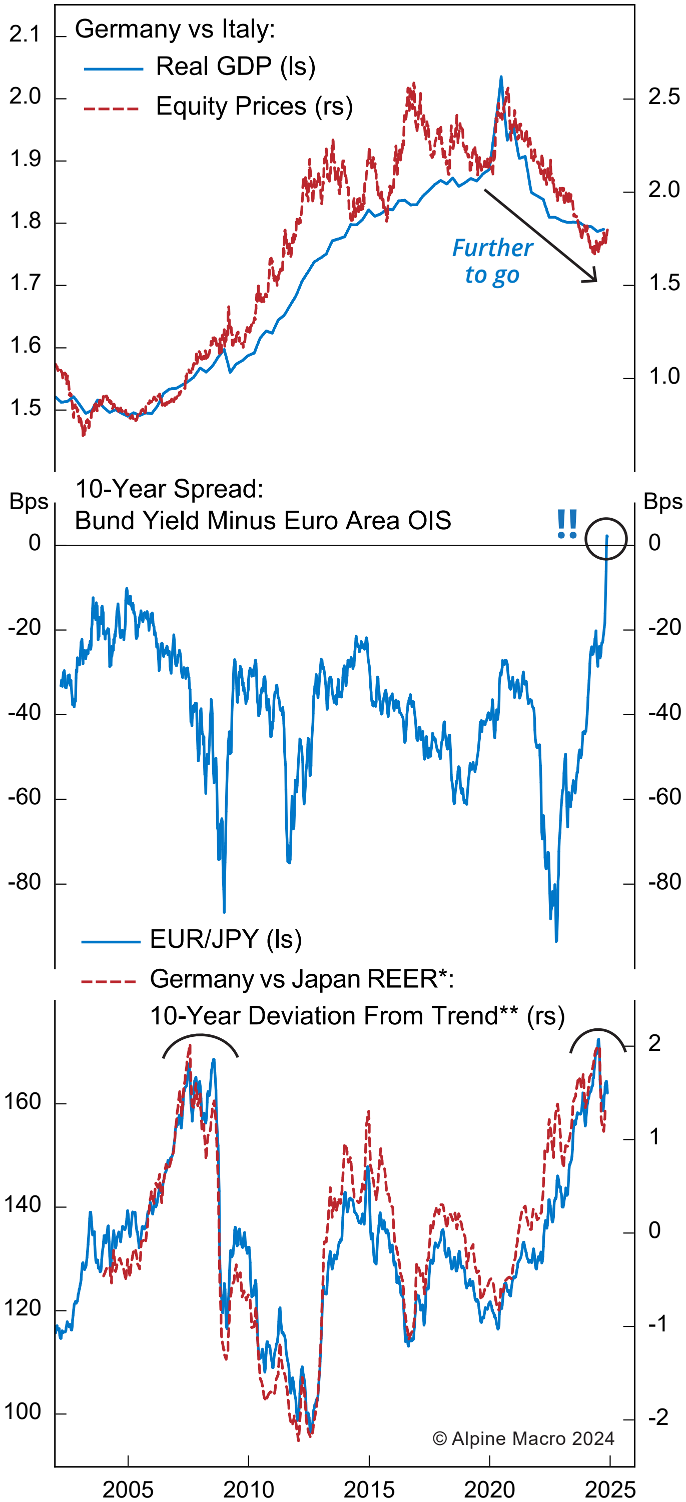
Bottom Line: In addition to pressing structural issues, Germany's cyclical prospects are dampened by a strong euro and self-imposed fiscal restraint. Political changes are unlikely to result in meaningful debt reform.

Investment Implications

This report argued that Germany's economic malaise is deepening as its growth model unravels and policy constraints hinder cyclical relief. For investors, this opens up profitable trading opportunities across several asset classes (Chart 16):

- Go short German stocks relative to Italian stocks. Although the German bourse has staged a

Chart 16 Three Investment Ideas



*Real effective exchange rate
**Shown standardized
Source: IMF, MSCI, Bloomberg Finance L.P., BIS

relative recovery of late, a resumption of growth underperformance will reinforce the attractiveness of this trade.

- Go long 10-year bunds while shorting the equivalent-maturity eurozone OIS contract. The spread between the two recently turned positive for the first time, signaling a growing belief that Germany's debt issuance is set to rise substantially. As discussed above, those expectations should be faded.

- Go short the euro versus the yen. Germany's real effective exchange rate has become unsustainably stretched relative to Japan, raising the likelihood that any euro weakness may initially emerge through a falling EUR/JPY. A mean reversion could accelerate once the ECB is forced to turn dovish, setting up a clear policy divergence with the BoJ.

Bassam Nawfal
Chief Asset Allocation Strategist

Investment Recommendations						
Tactical Investment Positions (3 - 6 months)						
Recommendations	**Open Date**	**Open Levels**	**Stop**	**Closing Date**	**Closing Levels**	**P&L Since Inception**
Long U.S. Regional Banks (ETF: KRE)	12/04/2023	48.12	Rolling -8%	-	-	45.2%
Long U.S. Financials (ETF: IYF)	08/19/2024	101.30	-	-	-	17.9%
Long Russell 2000 (ETF: IWM)	08/19/2024	215.20	-	-	-	12.8%
Long 10-Year German Bunds/ Short 10-Year JGBs	10/07/2024	2.3%/0.93%	-	-	-	2.6%
Short Brent Oil	10/22/2024	76.00	-	-	-	4.0%
Stop-Buy Gold (ETF: GLD)	-	-	225	-	-	-

Note: P&L is calculated using daily closing prices.

A Unique Mind On The Markets