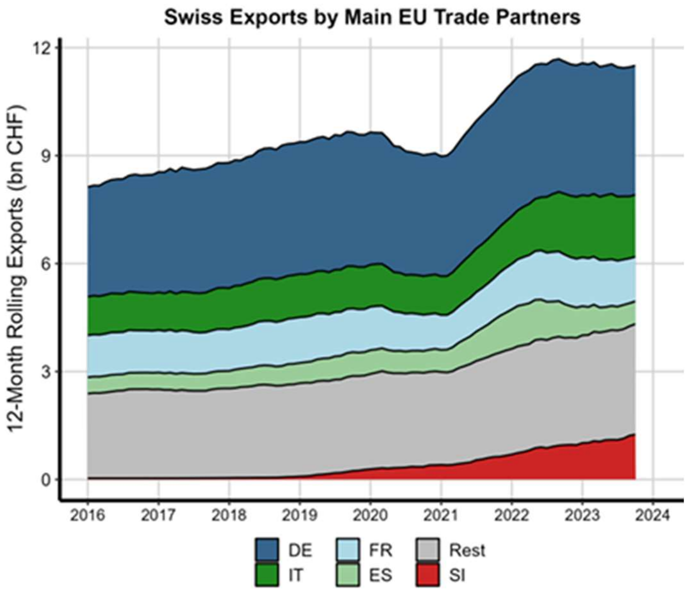
Germany makes life difficult for Europe, and industries emigrates to the USA

Europe's leading manufacturing nation is grappling with an economic contraction that is now pretty much widely defined as structural. The effects are also being felt in Switzerland, whose exports to the country to the north fell by 10% during fiscal year 2023.



The German automotive sector is increasingly relocating to Eastern Europe

There is less and less steam in the so-called locomotive (more resembling Stephenson's 1814 steam engine *"the Blucher"* rather than an *ICE*) of Europe. In addition to openly talking about recession for the largest economy of the Old Continent, some analysts are raising the bar and even venturing into the possibility of deindustrialization, probably due to the growing delocalization of production activities. According to Deloitte, two out of three German companies have relocated at least part of their operations, mainly citing high energy prices and inflation as reasons for the move. The sectors most affected are mechanical engineering, industrial goods and automotive. Basically, the *pièce de résistance* of German success and industrial might. The situation is such that in mid-March the German Parliament approved a growth package (*Wachstumspaket*), a tax relief worth 3.2 billion euros which also aims to alleviate the bureaucratic burden, a factor often cited by companies among the main reasons for delocalizing. Germany may be efficient, but when it comes to cumbersome bureaucracy it is second to none.

Destination USA

The US of A is increasingly benefiting from the German industrial move, at least on a geographical level, and is now overtaking China in terms of German investments. According to an analysis done by the Financial Times, in 2023 German companies announced record investments of 15.7 billion dollars in the United States, double that of the previous year and 5.9 billion higher than those announced for China. What attracts German investments in particular is the Biden Administration's *Inflation Reduction Act* economic development program which puts around 400 billion dollars in tax incentives on the table for innovative activities linked to the energy transition. Here's a positive side-effect (for the Germans) of the *New Green Deal* so trendy among the Democrats in America.

German companies, according to the Financial Times, have already announced close to 200 investment projects in the USA, of which almost half in the manufacturing sector. The largest project was a two-billion-dollar investment by Volkswagen's in collaboration with Scout Motors electric vehicle for a subsidiary in South Carolina.

Three structural characteristics

The process underway in Germany, whose economy represents over a quarter of the Eurozone's GDP, is not temporary. The difficulties arise from some structural and institutional characteristics of the functioning of the German system.

The first is linked to exports, the weight of which has doubled to almost 50% of GDP. With the growing regionalization of world trade (which began after 2008) and the new face of globalization, there is a tendency to manufacture in the main outlet markets, rather than export.

This is a textbook case for the automotive industry, which is increasingly looking to the central-eastern European area, for example Poland, the Czech Republic and Romania, for the transfer of the production lines of manufacturers such as VW, BMW and Mercedes. It is, as matter of fact, cheaper to produce where you sell, and do not even have to mention the much lower labor costs.

The automotive sector is the second structural characteristic that afflicts the German economy. The sector is particularly relevant for Germany, where it employs 2.1 million people and has a turnover of close to half a trillion euros. This sector received a very hard blow from the *dieselgate* that broke out in 2015 and is making a painful transition to electric. Car production in Germany has fallen significantly and is unlikely to return to the levels of its heyday, due to strong Chinese competition and the relocation strategy of large car manufacturers. Furthermore, an electric car has a much lower added value than an endothermic one and this leads to a reduction in the number of employees.

The third characteristic is the aversion to public deficit and debt. The ideological extremism of the *Nullkommanichts* (zero point zero) is costing the German economy dearly in the current juncture of the green and digital twin transition, experts say. In fact, the federal government had diverted 60 billion (1.5% of GDP) of funds not used during the pandemic to green incentives and the Constitutional Court rejected this diversion, forcing Berlin to cut those incentives and make other savings, with the result of freezing sales of electric cars and canceling orders already acquired by companies, with a chain crisis in the *Mittelstand* (the manufacturing backbone made up of medium-sized companies).

And in Switzerland? The KOF revises growth and inflation downwards

As it often happens, if Germany gets sick, its neighbors are no better off. As the country to our north is Switzerland's largest trading partner, the effects of the slowdown have been felt in the Confederation for some time already.

Growth and inflation forecasts have been revised downwards for the current year: the economists consulted by the Economic Research Center of the Federal Institute of Technology in Zurich (KOF) have adjusted them following those announced last week by the Swiss National Bank and by the State Secretariat for Economic Affairs (Seco).

According to the results of the consensus forecast survey, Swiss gross domestic product growth in 2024 will be 1.1%, compared to the 1.2% forecast in December. Initial estimates for next year are around 1.7%, as well as for the next five years. Inflation for the current year is expected to be 1.4%, down from 1.6%, and continue to fall to around 1.2% in 2025.

As for unemployment, the forecasts are the same as in December: the jobless rate will be 2.2% in 2024 and 2.3% in 2025, as well as for the next five years.

Furthermore, still according to the 12 economists questioned by the KOF in early March, the euro/franc rate will be at 0.96 in three months and 0.95 in twelve months, while for the dollar 0.87 and 0.86 respectively. At the same time, the rates on 10-year federal bonds will be at 0.90% and 1.00%. The Saron reference rate (Swiss Average Rate Overnight) is instead forecasted at 1.57% and 1.17% respectively.

The evolution of the stock market is still interpreted in the name of slight progression: for the next three months we are betting on an SPI index at slightly above 15’000 points and in a year the indicator should be closer to the 16’000 points mark.

Ultimately, how would the current German situation impact our future portfolio positioning? As we had already been eying a small reduction into European stocks, the German ones could be mostly concerned (notably industrials, machinery, electrical, engineering and automotives). Swiss companies -many of which are extremely dependent from Germany- could also be the object of a possible downsizing. There are however some sectors, Tech, Medtech, Pharma, Watches and Financials for example, that are less tied to the fortunes (or misfortunes) of our northern neighbor, and those are usually our main investment focus. We will in any case keep a vigilant stance.

Marcello Tedeschi, April 3, 2024

Sources: KOF, LSEG, The Financial Times, University of St. Gallen