ERSTE Asset Management

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https://blog.en.erste-am.com/germany-economy-face-hot-summer/

Germany: is the economy about to face a hot summer?

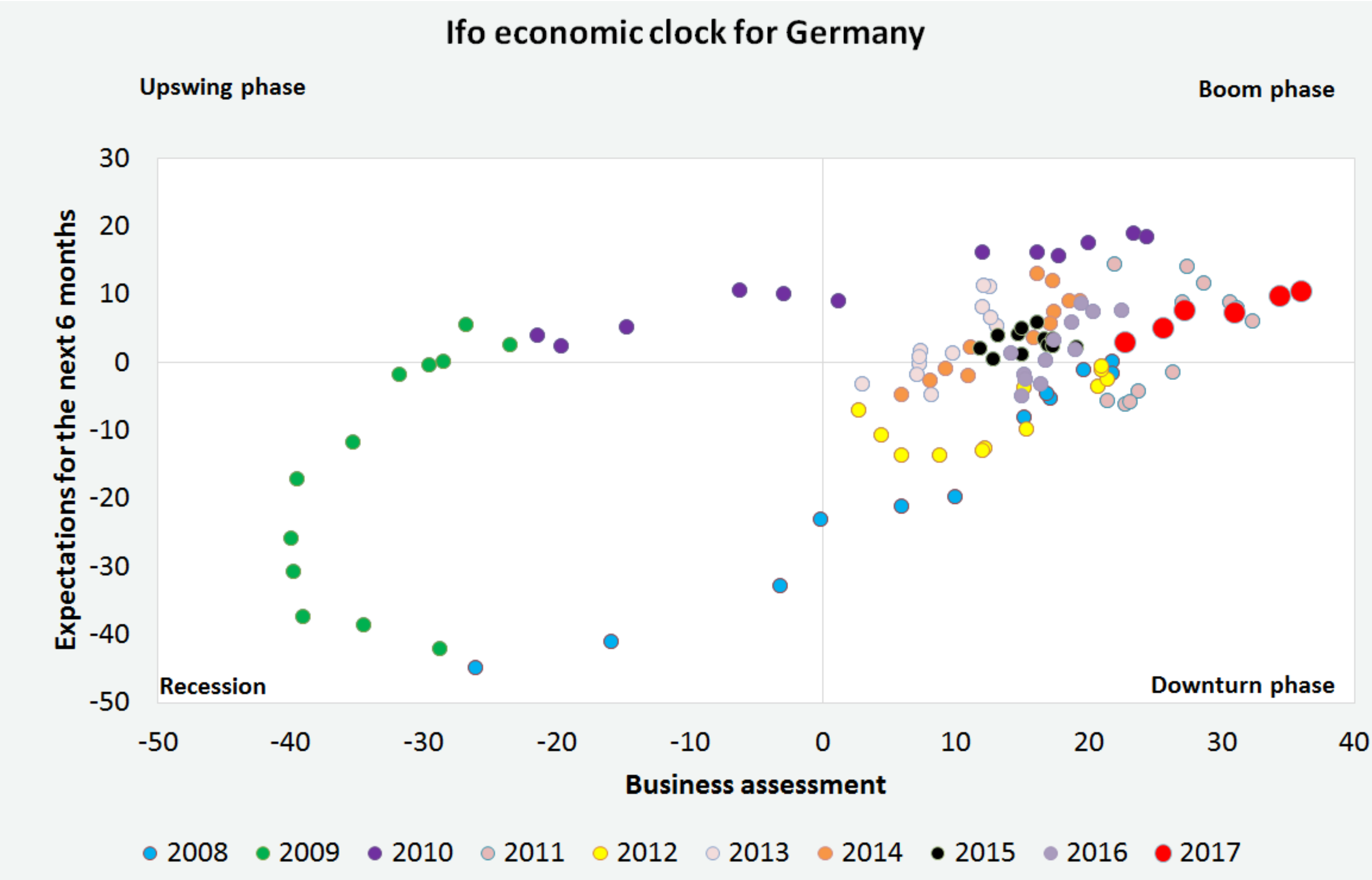
Gerold Permoser

The IFO business climate index calculated by the Munich-based IFO Institute is regarded as the most important German economic indicator. At 115.1, the value released for June last week was the highest since the launch in January 1991. It was also clearly above the value that had been expected by the financial analysts on average. The signs for substantial economic growth in Germany seem favourable.

From my point of view, this leads me to two questions: “What does that mean for the markets?” and “What is the outlook for the economy?” In order to answer these two questions, I would like to use a very simple illustration of the two components of the IFO index, i.e. the current assessment of the business environment and the expectations for the coming six months. The illustration is also known as IFO business-cycle clock. It simply derives the current position in the economic cycle from the relative position of the two components.

- If both the current business climate and outlook are clearly positive, the German economy is in a **boom phase**.
- If the current assessment and the outlook are negative, the economy is in a **recession**.
- In the **downturn phase**, the current assessment is positive, whereas expectations are starting to decline.
- The upturn phase looks exactly the opposite. While the current assessment is still negative, expectations are decidedly more optimistic.

As the chart below suggests, the German economy is currently in a boom phase.



Sources: EAM, Datastream

What does that mean for the markets?

The table in the following shows the**average** return of shares (MSCI Germany) and of 10Y German government bonds (Datastream Benchmark 10Y Total Return index) from January 1992 to June 2017, broken down by phase. In a boom phase as described above, shares would yield and average return of 14.6% per year, while government bonds would only yield 2.5% per year.

More interesting than the absolute figures is the ratio of return and risk indicators throughout the various phases. We can see clearly that shares have very low risk/return ratios during downturn and recessionary phases. These, in turn, are the phases when government bonds would show particularly attractive **return/risk ratios**.

Performance of the German equity market (MSCI Germany Total Return) and the 10-year-German-Government Bond market (Total Return Index) – 06/2012 – 06/2017

Source: Thomson Reuters Datastream; 3.7.2017
Please note that past performance is not a reliable indicator for future developments.

Performance and risk (i.e. standard deviation) for the German equity and bond market (1992-2017)

Equities	**Recession**	**Expansion**	**Boom**	**Downturn**
Monthly performance	0.1%	2.0%	1.2%	-0.6%
Monthly risk (std. deviation)	7.0%	6.0%	4.2%	6.4%
Annualisierte Performance	1.6%	23.8%	14.6%	-7.2%
Annual risk (std. deviation)	24.3%	20.7%	14.4%	22.2%
Return/Risk-Ratio	0.07	1.15	1.01	-0.33
Bonds	**Recession**	**Expansion**	**Boom**	**Downturn**
Monthly performance	0.8%	0.4%	0.2%	1.0%
Monthly risk (std. deviation)	1.6%	1.5%	1.5%	1.8%
Annualised performance	9.1%	4.4%	2.5%	12.0%
Annual risk (std.deviation)	5.7%	5.2%	5.3%	6.4%

Return/Risk-Ratio	1.60	0.85	0.47	1.89

Sources: Erste AM, Datastream; calculation based on monthly data

Please note that past performance is not a reliable indicator for future developments.

As pointed out earlier, the business-cycle clock currently shows a clear boom phase. Therefore, you would want to invest in shares rather than bonds. This is one of the reasons why the weighting of shares is currently high while bonds command a very low weighting in the asset allocation of our mixed funds.

What is the outlook for the economy?

The image of the clock implies an ongoing nature – clocks keep turning. Booms are followed by downturns. However, there are no signs for that in Germany at this point in time. In view of the extremely loose interest rate policy in the Eurozone, where the ECB has to keep in mind the average parameters of the euro area countries, nothing suggests that the ECB would want to rain on the German economic parade. From my point of view, Germany is therefore likely in for a hot summer –not only literally, but also in terms of economic performance.

Gerold Permoser

Gerold Permoser has been Chief Investment Officer at Erste Asset Management since early April 2013. He is responsible for all asset management activities and investment strategies for all investment funds held by the Erste Asset Management Group in Austria, Germany, Croatia, Romania, Slovakia, the Czech Republic, and Hungary. Before joining the company, he served this function at Macquarie Investment Management Austria KAG. Permoser has gathered experience in investments since 1997.

He began his career as a fixed-income analyst at the Creditanstalt in Vienna. He moved to asset management at Innovest KAG in 2000. He made significant contributions in the investment field there and advanced to CIO (director of asset allocation and research). Gerold Permoser studied at the University of Innsbruck and is a CFA charter holder. He offers training at the University of Vienna and at various post-graduate institutions for analysts and portfolio managers (i.e., at VÖIG, the Association of Austrian Investment Fund Companies).