



Germany Unconstrained A Guide for Investors

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GERMANY IN THE EUROPEAN CONTEXT

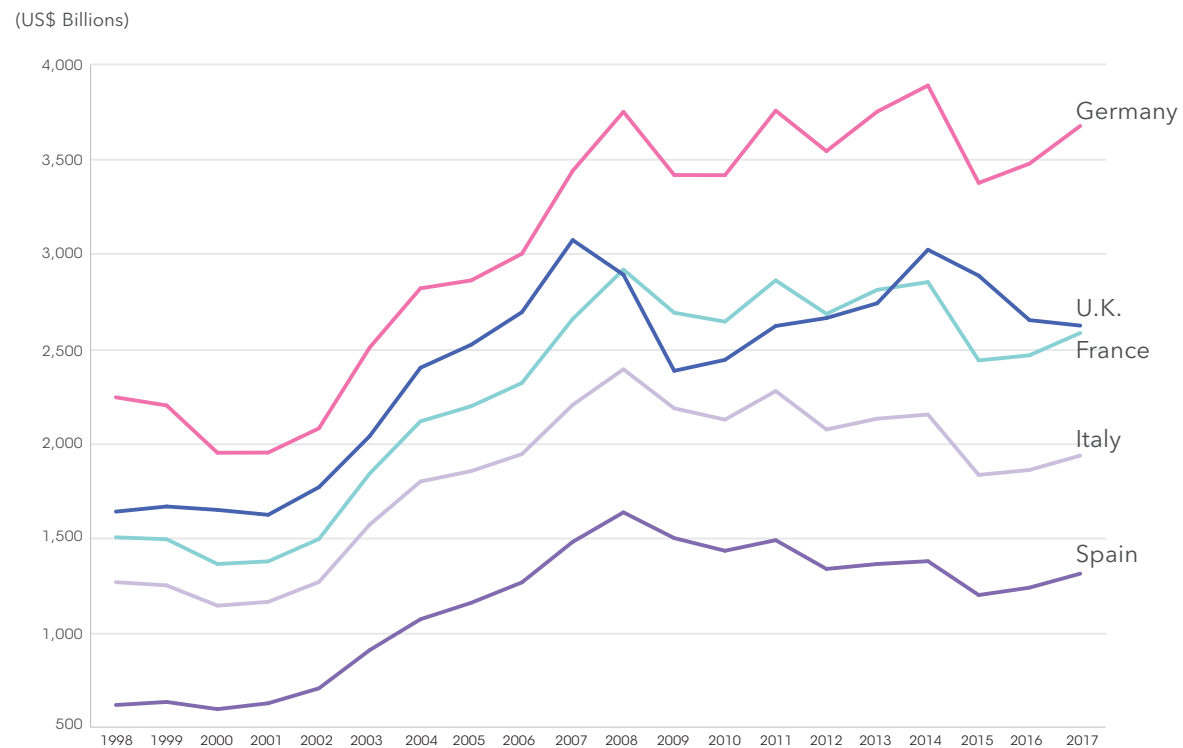
As the world's fourth-largest economy and the largest in the European Union, Germany has always commanded a leading role in the economic saga of Europe. With a GDP of \$3,677 billion in 2017 (according to the World Bank), Germany accounts for over 20 percent of the EU's total GDP. Germany's economic heft within the EU has only increased over the last decade, as certain members of the union, particularly Italy, Spain, Portugal and Greece, have undergone wrenching economic dislocations triggered by the Global Financial Crisis (GFC) of 2008-2009.

According to Eurostat, the official statistics keeper of the EU, unemployment in the EU rose from 7 percent in 2008 to 11 percent in 2013. GDP fell from \$19,137 billion in 2008 to a low of \$16,417 billion in 2015 (according to the World Bank, measured in current U.S. dollars). Other economic metrics, such as labor income and home prices, similarly followed suit downwards in much of the peripheral EU following the GFC.

Germany, however, during all the tumult of the GFC and in the subsequent years, has hardly missed a beat. Germany indeed experienced a recession just like the rest of the EU, but the German unemployment rate ticked up only slightly, from 7.5 percent in 2008 to 8.5 percent in 2009, and has since been on a steady march to a historic low of 5 percent, hitting 5.2 percent in August (according to Deutsche Bundesbank).

German inflation-adjusted home prices have risen steadily since 2008 and have now reclaimed their high of 1995. And on many other significant metrics, Germany's economic trajectory has been largely unmarred by the travails experienced by the rest of the Continent.

GDP of Major EU Countries, 1998-2017, Inflation Adjusted



SOURCE: World Bank - World Development Indicators

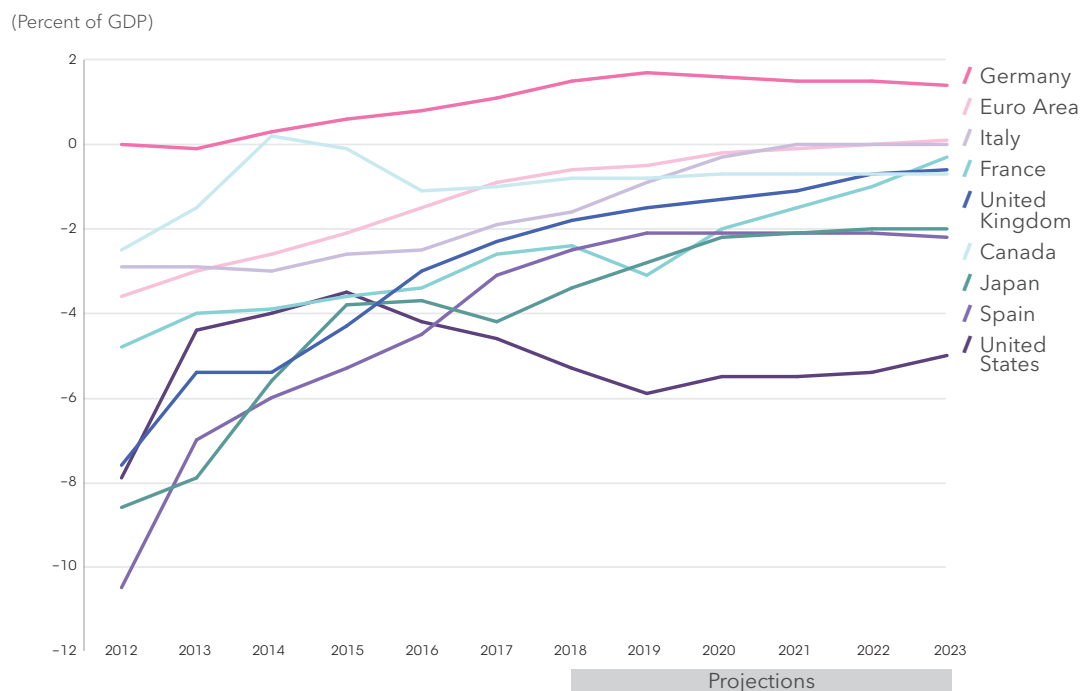
A TALE OF TWO SURPLUSES

One major reason for Germany's relative resilience during the GFC is the country's sensible fiscal framework. The German government's fiscal balance stood at a surplus of 1.1 percent in 2017 (according to the IMF), significantly better than the advanced-economy average of a deficit of 2.6 percent. Further, Germany's gross government debt-to-GDP ratio stood at 64 percent in 2017, also much better than the 105 percent registered by advanced economies in aggregate.

Perhaps most importantly, Germany's great strength lies in its trade with the rest of the world. In 2017, Germany's current account balance stood at almost \$300 billion (World Bank), making Germany the world's strongest export powerhouse. As a percentage of GDP, Germany's current account surplus has risen steadily during the past two decades to 8 percent in 2017. Major destinations for German goods and services include the United States, United Kingdom, France, Austria and China.



General Government Fiscal Balance, 2012–2023

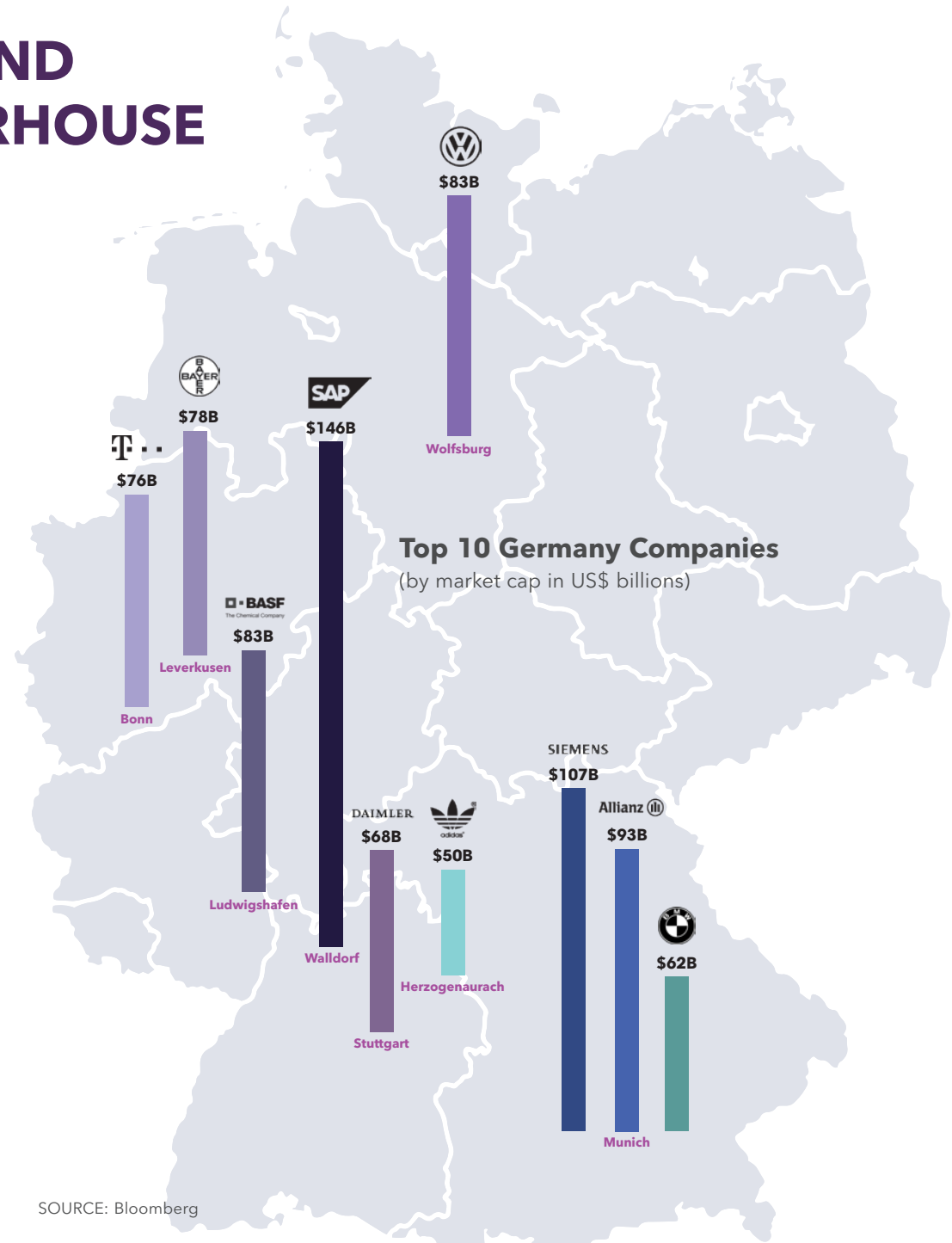


A GLOBAL INDUSTRIAL AND TECHNOLOGICAL POWERHOUSE

Germany's economic and export strength is predicated on a high degree of innovation, valuable intellectual property and scale. Germany spends almost 3 percent of its GDP on research and development, ranking ahead of the United States in this metric (World Bank). The country's major industries are automotive, machinery, chemicals, electronics, electrical equipment and pharmaceuticals.

Germany is home to a long list of world-leading companies, including, in order of market capitalization, SAP, Siemens, Allianz, BASF, Volkswagen, Bayer, Deutsche Telekom, Daimler, BMW and Adidas. Legendary German automotive manufacturers such as Mercedes-Benz, BMW, Audi and Porsche have long dominated the global luxury car market. Similar positions of strength can be found in industrial automation with Siemens and KUKA, in industrial gases with Linde, in global insurance with Allianz and Munich Re, in technology with SAP and Infineon, and in consumer goods with Adidas and Henkel.

In addition to its major global behemoths, Germany also prides itself on its corps of small and midsized businesses—the *Mittelstand*. Usually family-owned, these companies specialize in particular market niches, often competing at the global level. Typically defined as those with less than 500 employees or €50 million in annual revenue, the *Mittelstand* form the bedrock of the German economy, employing more than half of the German workforce.



SOURCE: Bloomberg

GERMAN CORPORATE CHAMPIONS ON THE WORLD STAGE

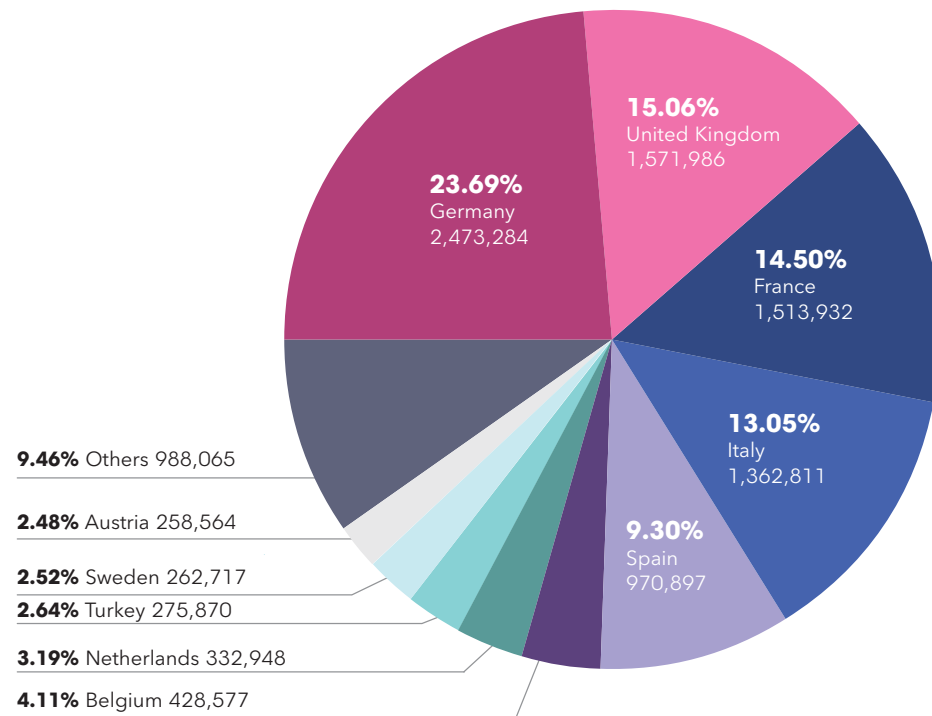
One area where Germany's economic dominance is readily apparent is the global automotive industry: The German auto manufacturers, principally BMW, Audi and Mercedes-Benz, now command a 70 percent share of the global luxury car market. What is most remarkable about this is that Germany has achieved such dominance not because of labor-cost advantages (which some Asian manufacturers enjoy) or because of strong home-market demand (which the American OEMs benefit from), but rather because of Germany's compelling products driven by quality, innovation and heritage.

And the German luxury carmakers produce profitably, commanding some of the highest margins in the industry. Operating margins for the super-luxury OEMs, such as Porsche, can reach almost 20 percent, while the more mainstream luxury brands such as BMW can also achieve margins in the double digits. By contrast, most global automotive manufacturers struggle to reach 5 percent operating margins on a consistent basis.

As the industry evolves, the German OEMs are evolving with it, often as leaders of change. For instance, in November 2017, the CEO of Volkswagen stated that the company was "laying the foundation for making Volkswagen the world's number-one player in electric mobility by 2025." BMW was the best-selling plug-in hybrid electric car brand worldwide in 2017. And Mercedes-Benz is investing over €10 billion in the electrification of its entire fleet.

In this way, German industry has a clear eye toward the future, investing in and defining the trends of tomorrow. Factory automation is another area of great economic promise. Here Germany commands a 25 percent share globally through Siemens and KUKA. In renewable energy, four of the world's top 10 wind-turbine manufacturers are German (Siemens Gamesa, Enercon, Nordex and Senvion). Siemens, arguably Germany's premier industrial conglomerate, has defined its focus as "electrification, automation and digitization," all areas of global demand growth, and the company spent over €5 billion on R&D in 2017.

Global Vehicle Sales—Western Europe

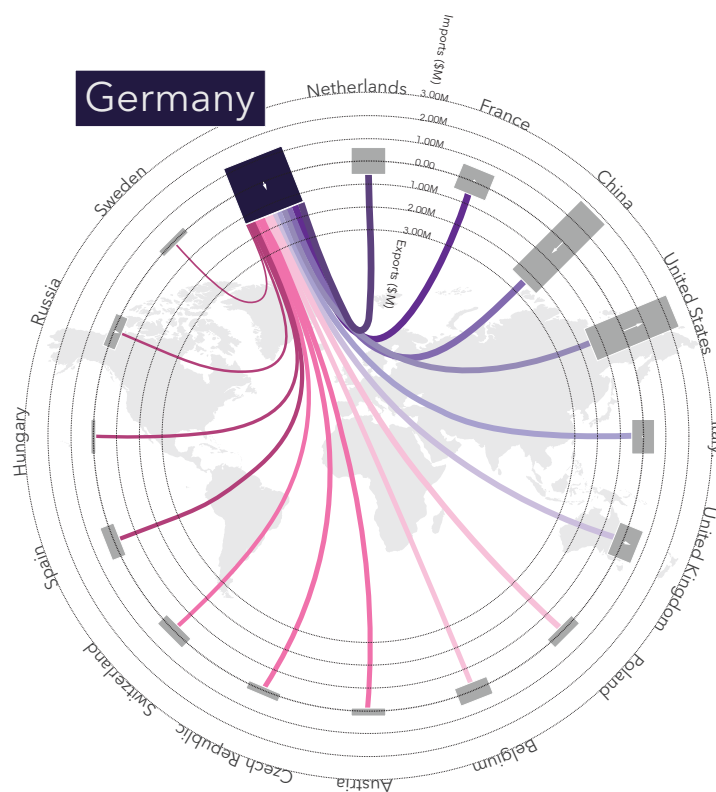


ATTRACTIVE VALUATION LEVELS FOR LISTED EQUITIES

As it maintains a substantial export surplus position, Germany benefits from growth globally as a supplier of goods and services to both developed and emerging markets. For instance, the U.S. and China are both major German trade partners. This export orientation is complemented by Germany's healthy and growing domestic economy, as evidenced by the country's record-low unemployment rate. Germany thus displays elements of both developed-market stability and emerging-market growth. Further, as described above, in many industries Germany leads globally, with few rivals in quality and innovation.

One would therefore expect the German equity market to command high valuation multiples. In fact, the German market trades at a significant discount compared to the American market. As captured in forward-looking 2018 price/earnings multiples, the MSCI Germany Index trades at 14x P/E, in contrast to the MSCI USA Index, which trades at over 18x P/E. This makes the German equity market an attractive investment relative to the equity markets of the U.S. and other countries.

Bloomberg World Trade Flow:



GEOPOLITICS IN THE AGE OF MERKEL AND TRUMP

Under the leadership of Chancellor Angela Merkel since 2005, Germany has enjoyed an extended period of relative political stability. Merkel has overseen an era of steadily increasing economic prosperity, low unemployment, fiscal and trade surpluses and rising labor income. Merkel and her party, the Christian Democratic Union, have held onto power through a coalition government formed in September 2017, following the most recent German federal election. In her position as head of the EU's largest economy, Merkel is considered the de facto leader of the EU, and she provided strong stewardship for the Continent during the Global Financial Crisis. While her party ceded some seats in the Bundestag to opposing parties in the last election, Merkel's control of Germany's political calculus remains firm.

Germany's global role has also evolved with Donald Trump's presidency in the United States. As America curtails its historical engagement on the world stage, Germany and Merkel have stepped into the void to provide leadership for the global economy. Germany's role in the EU has been further cemented with the U.K.'s abrogation of its leadership position post-Brexit. In addition to its industrial and technological prowess.

In addition to its industrial and technological prowess, Germany is now a prime contender to be the next financial hub of Europe. It is not an exaggeration to say that the economic trajectory of the European Union and, to a notable extent, the rest of the world, depends on Germany's continued geopolitical leadership and economic success.

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