MORNING BRIEFING
November 7, 2018

Europe Splintering

See the collection of the individual charts linked below.

(1) The party is over for Merkel. (2) Immigration is a top issue in Germany. (3) Chancellor through 2021? Unlikely. (4) Three contenders. (5) Macron alone trying to keep EU from disintegrating? (6) Germany's economic indicators rapidly losing their oomph. (7) German stocks may stay weak as long as political uncertainty remains a problem.

Germany I: *Auf Wiedersehen*, Madam Chancellor. Embattled German Chancellor Angela Merkel stunned the world by announcing she would relinquish her role as leader of the ruling Christian Democratic Union (CDU) in December. She dropped her bombshell on October 29, the day after the party she has led for 18 years suffered its worst showing ever in the Hesse regional election. Germans had dubbed the Hesse vote a "*schicksalswahl*," or vote of destiny, according to a 10/28 BBC News article. It certainly sealed the fate of the party's 64-year-old leader.

The end of the Merkel era has been unfolding for the past year. A general election in September 2017 resulted in no clear majority for any party, and it took six months for Merkel to form the most tenuous of coalitions. She has been battling competing forces and opposition within her own cabinet and had to make major concessions to persuade the SPD to form a coalition government, as we pointed out in the 3/7 and 6/25 *Morning Briefings*.

While it was a surprise that she conceded defeat, it is hardly surprising that her time is up. Her biggest political mistake was allowing more than a million asylum seekers, mostly Syrian refugees escaping civil war, into Germany in 2015. The move created a huge backlash, rending a rift within the ranks of her conservative party. Moreover, it provoked President Trump to lob an unprecedented personal attack on an ally by a US President when he taunted her in a tweet over her immigration policy.

The backdrop for the shifting and uncertain German political scene includes a sputtering economy, a Eurozone that's splintering over immigration and fiscal responsibility, and the effects of a global trade war. The German stock market has been steadily declining since May and is now off 14.7% y/y and down 11.0% ytd, making it the worst performing of the core European financial markets (*Fig. 1*). The euro weakened in the wake of the news and recently traded at €1.14 per US dollar (*Fig. 2*).

I asked Sandra Ward, our contributing editor, to take a closer look at the ramifications of Merkel's decision and what it means for Germany and the EU:

(1) *A miracle.* In giving up her party's leadership, Merkel also said she hoped to remain chancellor until 2021. The chances of that happening are considered slim: It's highly unusual in German politics to split the roles, noted an 11/4 *WSJ* article. It explained that in the rare cases in which the roles have been split, the chancellor's power has been undercut by power battles. Merkel herself, who has been chancellor since 2005, has long made the case for linking the positions. Former Defense Minister Karl-Theodor zu Guttenberg told the *WSJ* that he thought it would be "a miracle" if Merkel were to stay on as

chancellor. He also thought it unlikely that the fragile governing coalition with the Social Democrats (SPD) would survive.

(2) *Collateral damage.* The SPD took a beating in the Hesse election along with its coalition partner CDU as gains by the Greens and the far-right Alternative for Germany (AfD) eroded support for the governing parties. Hesse was a replay of elections in Bavaria a few weeks earlier when the Christian Social Union, a conservative sister party to Merkel's CDU, and the SPD saw their support dwindle in favor of the Greens and AfD. Many in the SPD blame their party's woes on the alliance with Merkel's conservative CDU, observed a 10/28 BBC article. The threat is the SPD could withdraw from the coalition and bring down the government.

Commenting on the outcome of the Hesse vote, SPD leader Andrea Nahles said the state of the government was "unacceptable," according to the report, and cautioned that it would be reviewing whether the coalition with the CDU "is still the right place for us."

(3) *Three candidates.* Immediately following Merkel's announcement, three contenders surfaced to succeed her at the CDU annual convention on December 7 and 8. Friedrich Merz, a 62-year-old lawyer who is supervisory board chairman of Blackrock's German asset management unit, is a longtime adversary of Merkel's since she emerged victorious in a leadership power struggle against him 16 years ago, according to a 10/30 Bloomberg story. The pro-business Merz has declared himself a "convinced European and trans-Atlanticist" and aims to return the CDU to its social conservative roots.

Another candidate, Health Minister Jens Spahn, 38, is known for his criticism of Merkel's open-border migration policy, his advocacy of banning burkas, and his emphasis on law and order.

Lastly, 56-year-old Annegret Kramp-Karrenbauer, a Merkel protégé handpicked to serve as secretary-general of the CDU, is making a bid. Known as "AKK" and nicknamed "mini-Merkel" by the press, she was the chief minister of Saarland from 2011 to 2018, the first woman to hold the post and the fourth to lead a state government. A win by AKK in December is seen as Merkel's best chance at remaining chancellor, according to the 11/4 *WSJ* article. Polls by *Handelsblatt Daily* and Spiegel Online put Merz as the frontrunner, with AKK coming in second and Spahn a distant third, according to a 10/31 piece in the *Guardian.*

(4) *EU reform. Kanzlerin dämmerung,* the twilight of Chancellor Merkel, the EU's longest-serving leader, leaves French President Emmanuel Macron as the lone champion of reform and greater integration amid a sea of populism across the Eurozone, explains an 11/3 report in the *Daily Express*. His divisive style may make it difficult for Macron to achieve his goals. He is the last pro-EU leader standing at a time when his approval ratings are ebbing, his labor reforms have proved unpopular, unemployment is rising, and economic growth is slowing, according to a 10/28 piece in the *Guardian*.

The EU's Parliamentary elections in May should prove pivotal in determining who will lead Europe, especially as Italy's Matteo Salvini and France's Marine Le Pen have said they will fight against the EU in its current form and campaign for a "Europe of nations, a 10/16 story in Spiegel Online reported. The UK can be counted on to continue to dither over its Brexit strategy.

Germany II: *Achtung*, Baby. The changing of the guard is coming amid a slowdown in German economic growth and more pessimistic business expectations (*Fig. 3*). Consider some recent data:

(1) *Manufacturing PMI.* Growth in the manufacturing sector was the weakest in two and a half years in October, according to an 11/2 release of an IHS Markit/BME Germany Manufacturing survey. Order books fell for the first time since late 2014. Auto industry emission-standards issues and a drop-off in

demand from international clients were blamed for the poor showing. Worse, production is expected to fall over the next 12 months, the first negative outlook among manufacturers in four years.

The headline IHS Markit/BME Germany Manufacturing PMI fell in October for the third straight month, to 52.2 from 53.7 in September. Export sales fell for the second straight month. Facing the sharpest drop in new export business in five years, manufacturers curtailed their purchasing activity for the first time since early 2015.

(2) *Business sentiment.* Confidence among business owners weakened in October, to a reading of 102.8 on the ifo Business Climate Index, down from 103.7 in September. Manufacturers' business outlook sank to its lowest level since March 2017 (*Fig. 4*). A bright spot: Optimism in the construction industry hit another record high (*Fig. 5*).

(3) *Inflation.* Consumer prices spiked in October at the fastest rate in six years, rising 2.4% y/y on soaring energy prices, according to data released by Germany's national statistics agency, Destatis (*Fig. 6*).

(4) *Consumer confidence.* Consumer confidence remained steady in November, with GfK's latest Consumer Climate Indicator unchanged at 10.6. Consumers' willingness to make purchases increased to 55.9 from 52.9, buoyed by strong labor markets and a sense of job security. However, economic and income expectations weakened slightly on ongoing global trade uncertainty, but remain at relatively high levels (*Fig. 7*).

(5) *Valuation.* The MSCI Germany share price index has fallen 12.1% ytd (in euros), compared with a drop of 7.8% in the MSCI EMU index and a gain of 2.4% in the US, through Monday (*Fig. 8*). MSCI Germany's forward P/E of 11.4 is near the lowest levels of the past five years, but that's not surprising with NERI (our Net Earnings Revisions Index) solidly negative since mid-2017 and down to a 29-month low in October (*Fig. 9* and *Fig. 10*).

The end of the Merkel era brings a new era of uncertainty to Germany, and markets hate uncertainty.

CALENDARS

US. Wed: Consumer Credit $16.5b, MBA Mortgage Applications, EIA Petroleum Status Report, FOMC Meeting Begins. **Thurs:** Jobless Claims 213k, EIA Natural Gas Report, FOMC Announcement 2.125% (2.00% to 2.25%). (Econoday estimates)

Global. Wed: Eurozone Retail Sales 0.1%m/m/0.8%y/y, Germany Industrial Production -0.1%m/m/0.2%y/y, Japan Leading & Coincident Indexes 103.8/114.6, Japan Machine. **Thurs:** Germany Trade Balance €20b, China Trade Balance, China Foreign Direct Investment, Mexico CPI 0.5%m/m/4.9%y/y, ECB Published Economic Bulletin. (DailyFX estimates)

STRATEGY INDICATORS

S&P 500 Q3 Earnings Season Monitor (*link*): With over 80% of S&P 500 companies finished reporting earnings and revenues for Q3-2018, the earnings surprise beat and y/y earnings growth are stronger compared to the same time period in Q2, but the revenue surprise and y/y revenue growth metrics have eased somewhat from Q2's stellar results. Of the 403 companies in the S&P 500 that have reported through mid-day Tuesday, 78% exceeded industry analysts' earnings estimates by an average of 6.9%; they have averaged a y/y earnings gain of 28.9%. On the revenue side, 61% of companies beat their Q3 sales estimates so far, with results coming in 1.5% above forecast and 9.4%

higher than a year earlier. At the same point during the Q2-2018 reporting period, a slightly higher percentage of companies (80%) in the S&P 500 had beaten consensus earnings estimates by a lower 5.2%, and earnings were up a lower 26.0% y/y. With respect to revenues, a sharply higher 73% had exceeded revenue forecasts at this point in the Q2 season by a slightly higher 1.7%, and sales rose a higher 10.2% y/y. Q3 earnings results are higher y/y for 88% of companies, vs 84% at the same point in Q2, and Q3 revenues are higher y/y for 83% vs 87% a quarter ago. While these figures will change as more Q3-2018 results are reported, it's safe to say that Q3-2018 will mark the ninth straight quarter of positive y/y earnings growth and among the highest-growth quarters since Q4-2010. Its y/y revenue growth will be positive for a tenth straight quarter, with its pace slowing somewhat but remaining well above the historical trend. The strong results are mostly due to lower tax rates and improved business conditions, but headwinds are coming in the form of increasing cost pressures and global growth concerns. One harbinger of the slowdown ahead is the fact that fewer companies have been reporting positive y/y revenue growth and surprises during the Q3 reporting season.

US ECONOMIC INDICATORS

JOLTS (*link*): Job openings in September took a step back after reaching a new record high in August. Openings dropped 284,000 to 7.009 million after a three-month surge of 634,000 to a record high 7.293 million in August; openings are up 1.3 million ytd. Meanwhile, hirings fell 162,000 to 5.744 million after climbing four of the previous five months, by 430,000, to a record-high 5.906 million. Total separations sank 112,000 to 5.667 million after a three-month spurt of 360,000 to 5.779 million—which was the highest since January 2001. The latest hiring and separations data yielded an employment advance of only 77,000 for September, 41,000 below September's payroll increase of 118,000—understating the increase in five of the last six months. Those quitting their jobs dipped 47,000 to 3.601 in September after climbing 171,000 during the two months through August to a record-high 3.648 million. September's private industry job-opening rate (4.8%) was little changed from August's record high of 4.9%, while the quit rate (2.7) was unchanged at its highest percentage since spring 2001; the total hire rate (4.2) is in a volatile flat trend around its cyclical high. August's ratio of unemployed workers per job opening was below 1.00 for the seventh month, sinking to a new record low of 0.85 in September.

GLOBAL ECONOMIC INDICATORS

Global Composite PMIs (*link*): Global economic activity accelerated slightly in October after slowing to a two-year low in September. The JP Morgan Global Composite Output Index (C-PMI) ticked up to 53.0 after falling from 54.2 to 52.8 the prior three months; it was at a 3.5-year high of 54.8 in February. The NM-PMI (to 53.4 from 52.9) improved last month after slipping to a 24-month low in September. Meanwhile, the M-PMI fell for the ninth time this year, sinking from 54.5 in December to a 23-month low of 52.1 last month. The C-PMI for the US (54.9 from 53.9) showed that it once again replaced the Eurozone (53.1 from 54.1) as the main driver of the global economic expansion, with the former rising to a two-month high and the latter falling to a 25-month low. However, within the Eurozone, Ireland's C-PMI (56.1, 7-month low) was at the top of both the global and Eurozone leader boards, though its growth did slow during the month. France's C-PMI (54.1, 2-month high) moved up to the number-two spot on the Eurozone's board, followed by those of Spain (53.7, 4-month high), Germany (53.4, 5-month low), and Italy (49.3, 59-month low)—with the latter contracting for the first time since December 2014. Russia (55.8 from 53.5) joined the US, Germany, Ireland, France, and Spain among the nations registering a rate of expansion above the global average. Economic activity rose at the fastest rates in six and three months, respectively, in Japan (52.5 from 50.7) and India (53.0 from 51.6), while China (50.5 from 52.1), the UK (52.1 from 54.1), and Australia (52.0 from 52.5) all saw slower growth; Brazil (50.5 from 47.3) returned to expansion.

Global Non-Manufacturing PMIs (*link*): October saw the rate of expansion in the global services economy accelerate for the first time in four months. JP Morgan's NM-PMI rose to 53.4 last month after falling from 54.6 in June to 52.9 in September; it was at a three-year high of 54.8 in February. The pickup was widespread as activity expanded across the business, consumer, and financial sectors—with the rate of expansion picking up in the first two, and slowing to a five-month low for the latter. A country comparison shows the best growth was recorded in Ireland (57.2, 7-month low) and Russia (56.9, 11-month high), though growth was slower than September's for the former. Meanwhile, NM-PMIs show growth in the US (54.8, 2-month high), Japan (52.4, 6-month high), and India (52.2, 11-month high) accelerated, while those for the Eurozone (53.7, 21-month low), China (50.8, 13-month low), and the UK (52.2, 7-month low) decelerated. Italy's service sector (49.2) contracted for the first time since May 2016, while Brazil's (50.5) returned to expansion.

Germany Manufacturing Orders (*link*): Orders in September unexpectedly rose as domestic orders jumped along with demand from other Eurozone economies; billings from outside the Eurozone slumped following August's double-digit surge. Factory orders rose 0.3% following an upwardly revised 2.5% (from 2.0%) increase in August; billings are down -5.5% since reaching a new record high at the end of last year. Foreign orders fell -1.4% during September as a -3.7% loss in orders from outside the Eurozone more than offset a 2.4% gain from within the Eurozone; domestic orders rebounded 2.8% after a -2.7% drop in August. Year to date, orders are falling across the board. Here's the breakdown by domestic/foreign and inside/outside the Eurozone: domestic orders (-2.7 ytd), total foreign orders (-7.5), inside (-10.7), and outside (-5.4). By industrial groupings, only consumer goods orders are showing a ytd gain, up 3.1%, led by foreign orders from within (11.4) the Eurozone, while foreign billings from outside (2.5) the Eurozone expanded at a slower pace and domestic (-1.6) orders contracted slightly. Meanwhile, the biggest loser was capital goods—with total billings down -6.5% ytd, led by a sharp decline in foreign (-9.1) billings, particularly from within (-16.1) the Eurozone.

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