The German automotive industry is at the end of its run: this is how Germany weighs down the eurozone. ECB forced to rescue.

OSSERVATORIO

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AT A GLANCE

- At the autumn economic test the US passes with flying colours, China is delayed in launching its recovery plan and the Eurozone is almost in recession, pulled down by Germany and France.
- Germany's car production is still 30 per cent below its 2016 peak, just after "dieselgate" forced it to abandon the motorisation it was banking on, and has become fourth globally, overtaken by China, Japan and India.
- Its transition to the electric car, which entails the loss of 60 per cent of the value added, compared to the endothermic engine, appears to be stalled: monthly volumes are stuck above 100,000 units, about a third of the total, by the end of 2022.
- Italy faces additional challenges, in addition to the weakness of Franco-Germanic demand: reduction of the public deficit; falling investment in housing; lack of workers.
- In the US, the employment-consumption pair will not lose steam.
- Wage inflation will remain higher due to the strength of the labour market.
- The ECB and the Fed will continue to cut rates, pandering to falling inflation. The former will do more than the latter and the euro will suffer.
- In an environment of positive nominal and real rates, equity investment becomes selective.
- Views from the managers: a summary of the insights and observations that emerged in meetings with Ceresio Investors' managers following a recent trip to the United States.

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IN THE AUTUMN ECONOMIC SCENARIO, THE USA DISTANCES CHINA AND THE EUROZONE, IN THE MANNER OF COPPI...

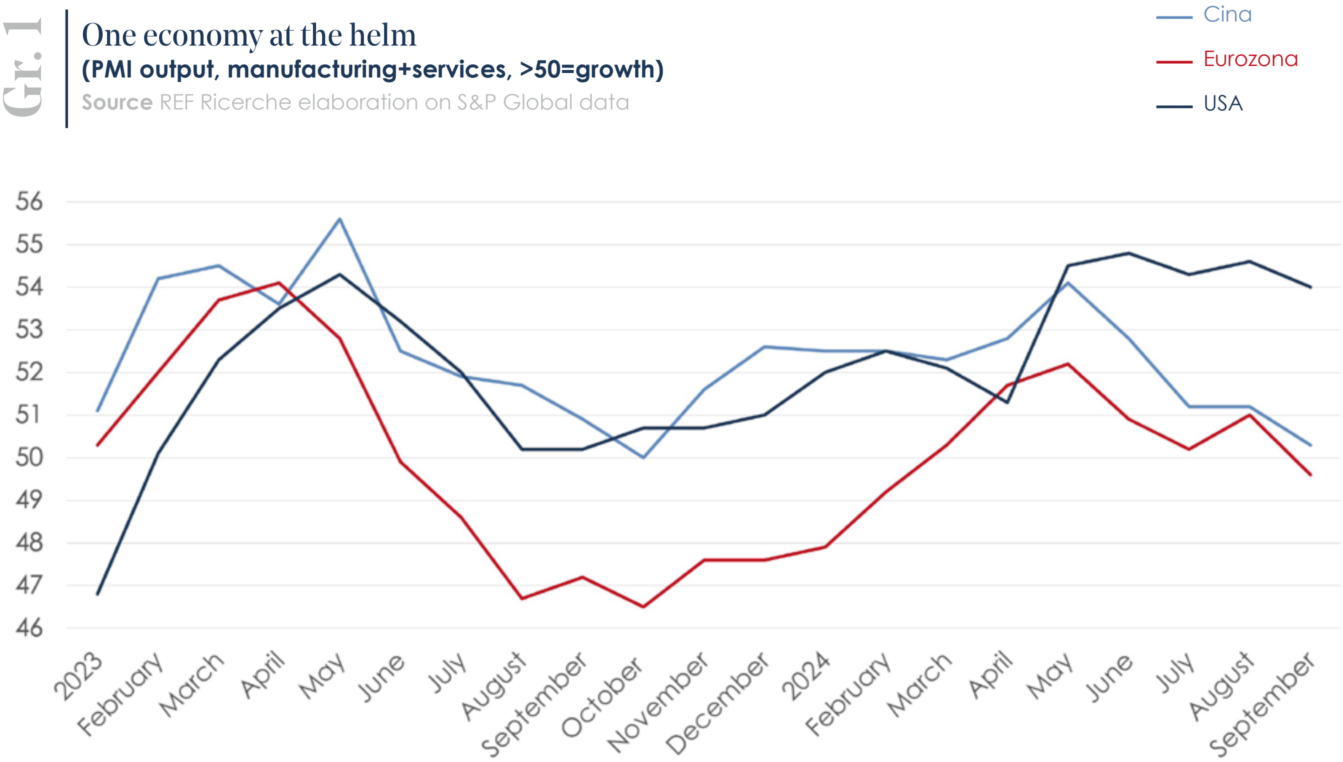
In the autumn world scenario there is one economy running on a twin engine, powerfully fuelled by fiscal policy, while monetary policy has started to let up. And another economy running with a big cylinder stuck, the fuel of the government budget being skimped and the monetary authorities having to run for cover. Finally, there is a third economy that always disappoints expectations, seems to be barely moving forward because it has been engulfed by a real estate crisis and disheartening political spin for businesses and consumers, but is now a global leader in many technologies, including the electric car, so economic policy is about to become expansionary with all the tools at its disposal.

Coppi during a stage of the 1952 Tour de France (AFP/Getty Images)

In this picture, there is no contest: the first economy, i.e. the United States, is clearly winning, doubling the second economy, which is the Eurozone, and leaving behind the third, i.e. China. And indeed, the most recent economic indicators confirm the cyclical performance gap: the composite manufacturing PMI sees the star-studded car grow robustly, the Chinese supercar stagnate again and the European star-blue car even lag behind (Chart 1).

Gr. 1

One economy at the helm
(PMI output, manufacturing+services, >50=growth)
Source REF Ricerche elaboration on S&P Global data



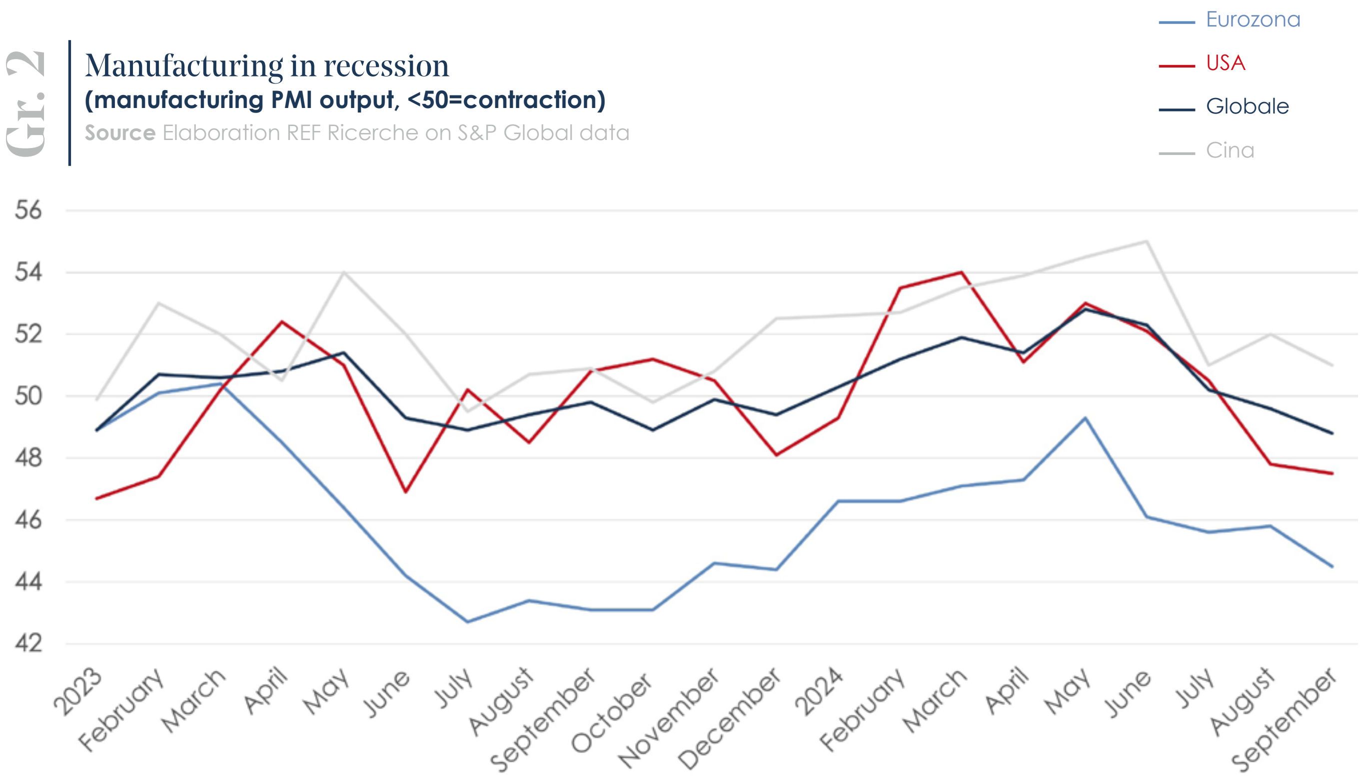
The world economy, in reality, is more a convoy than a car race, where if a few carriages go wrong, the whole system marches with more difficulty. Whereas if all advance fluidly, the dynamic impulses are transmitted (via foreign trade) to the whole and increase its speed without creating imbalances and stumbles, i.e. crises.

THE REASONS WHY MANUFACTURING IS IN RETREAT

This is true both when looking at different countries and when looking at sectors. And for some time now, services have been buoyant while manufacturing has been suffering just about everywhere (Chart 2). This is as a consequence of a number of adverse factors: the saturation of the manufactured goods markets with frenzied purchases in 2020- 2021; the increased upward sensitivity of the cost of money to the demand for financially more demanding manufactured goods; the unravelling of global supply chains due to protectionist measures of various kinds; the German automotive crisis. Monetary loosening will make the second factor disappear, while the reorganisation of supply chains will mitigate the second and the passage of time will heal the first. That leaves the automotive crisis at the epicentre of the European recession, though not the only headwind.

Gr. 2

Manufacturing in recession
(manufacturing PMI output, <50=contraction)
Source Elaboration REF Ricerche on S&P Global data



GERMANY IS NO LONGER *ÜBER ALLES*, NOT EVEN IN AUTOMOTIVE

Automotive=Germany? Das Auto snootily recites the ending of every advertisement for the Volkswagen brand, which heads the world's second largest automotive group, behind Toyota. However, Germany is only the fourth largest producing country (Table 1).

Tab. 1

The ten automotive giants
(2023, millions of units)
Source REF Ricerche on national data

COUNTRIES	TOTAL	X 1.000 AB.	HOUSES	
China	26.1	18.4	Toyota	11.1
Japan	7.8	62.9	Volkswagen	9.2
India	4.8	3.3	Hyundai-Kia	7.1
Germany	4.1	48.2	GM	6.2
South Korea	3.1	59.6	Renault-Nissan	5.7
Spain	1.9	39.6	Stellantis	5.6
Brazil	1.8	8.5	Ford	4.2
USA	1.8	5.2	Honda	3.9
Czechia	1.4	127.3	Suzuki	3.1
Indonesia	1.2	4.2	Byd	2.9

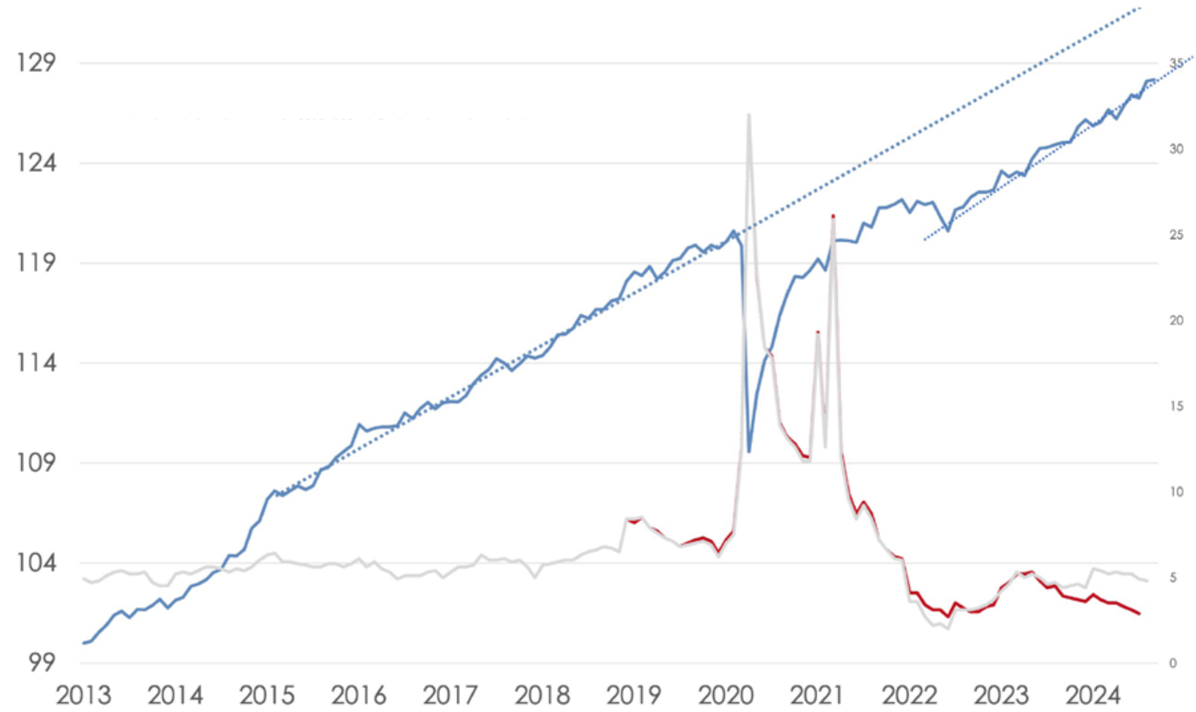
In the lead is China, whose brands are beginning to assert themselves and enter the top ten of the world rankings, followed by Japan and India. The German automotive vocation remains strong, as Germany is third in terms of cars produced per thousand inhabitants (if we exclude the outlier Czech Republic), and is preceded again by Japan and South Korea, while it is second in terms of brand size. However, domestic car production is almost 30 per cent lower than the peak reached in 2016, in the aftermath of dieselgate, and since then its share of total world production by German manufacturers has fallen from 36.2 per cent to 29.1 per cent. While the transition to electric is stuck at the end of 2022, in terms of volume and share of domestic production. These numbers serve to understand that a kind of de-automobilisation of the German economy is underway, which will be accentuated both by the closure of plants (for the first time VW is intending to do this) and by the transition to the electric car, the value added of which is 60 per cent lower than that of internal combustion engines. A long and burdensome process for the Eurozone's leading economy, and thus for the single currency area as a whole; remember that in Germany the car is a sort of totem, and the automotive sector accounts for a quarter of industrial added value and 5% of GDP.

THE DUAL ENGINE PROPELLING THE USA

On the other side of the Atlantic, on the other hand, the United States continues to rocket: +3.2% is the latest projection for GDP in the third quarter, following +3.0% in the second quarter and +1.6% in the first. The dual engine is the employment-consumption combination. The labour market exorcised midsummer fears of a sharp slowdown and re-accelerated its pace in both key components: salaried employment rose by 186,000 per month in the July-September period, up from +147,000 in the previous period and +267,000 in the first three months of 2024; hourly wages rose by an annualised quarterly 4.3%, after +2.8% in April. Given the simultaneous slowdown in inflation, real wages continue to rise along a very bright trend (+2.4% annualised in spring and summer) and provide spending power and consumer confidence (Chart 3). Not surprisingly, consumption is growing robustly, explaining almost 70% of total GDP growth alone. Nor is there any fear that consumers will slow down, because the revision of the national accounts has raised savings from mid-2023 onwards, so that American households appear decidedly less cyclical and therefore better prepared and able to cope with any cyclical downturns; the savings rate, in fact, is barely half a percentage point lower than the 2013-2016 average, when the process of adjustment from the debt overhang that triggered the Great Financial Crisis was not yet over. And past and coming rate cuts will ease borrowing costs (there has already been a surge in the renegotiation of mortgages) and entice some debt purchases, especially of consumer durables and investment goods, with a rapid response given the solid situation of household and corporate balance sheets. While we wait to see who will win the presidential election on 5 November, we can say without fear of contradiction that the economy's vote is for the status quo.

Gr. 3

US wages robust and savings OK
(Monthly data seasonally adjusted)
Source REF Ricerche elaborations on US BLS, US BEA data



A CHANGE OF COURSE FOR THE REVIVAL OF CHINA

Poised between the enviable position of the United States and the uncomfortable posture of the Eurozone is China, which thanks to the tonnage it has achieved (in PPP it outstrips the American giant by 20%) continues to provide a quarter of world growth (it used to contribute a third) although it is advancing at a much slower pace than it once did. Although physiological from the point of view of economic analysis, the Chinese slowdown is causing not inconsiderable social breakdowns, and rather than shared prosperity, the policy pursued so far has produced a common and widespread discontent that is reflected in the stuttering economic indications. Hence the change of course in monetary and budgetary policy, and also in those invisible but very material measures made up of sanctions and punishments for those who do not align themselves with the centre's directives. Such a change is welcome, because amidst wars, protectionism and assorted uncertainties, the world convoy can only benefit from the Chinese revival. Moving from giants to 'common' economies, Italy is called upon to overcome certain tests to secure that 1.2% growth to which the Meloni government is aiming in 2025. In fact, in addition to the lesser German and French drought (in fact, even France has abruptly slowed down after the Olympics) and the risk of Chinese consumers' disaffection for western brands, they will have to keep up with the recoil in investments in housing, whose superbonus increase explains two-thirds of the increase in GDP between 2020 and 2023; meanwhile the budget policy will be restrictive, albeit less than it would have been under current legislation, because it must guarantee a reduction of half a percentage point in the primary structural deficit (i.e. net of interest). Despite the boost to consumption from the return to positive changes in real wages, which will replenish households' purchasing power, Italy will have to cling to the full implementation of the NRP, so as not to end up like the castaways on Géricault's Raft of the Medusa.

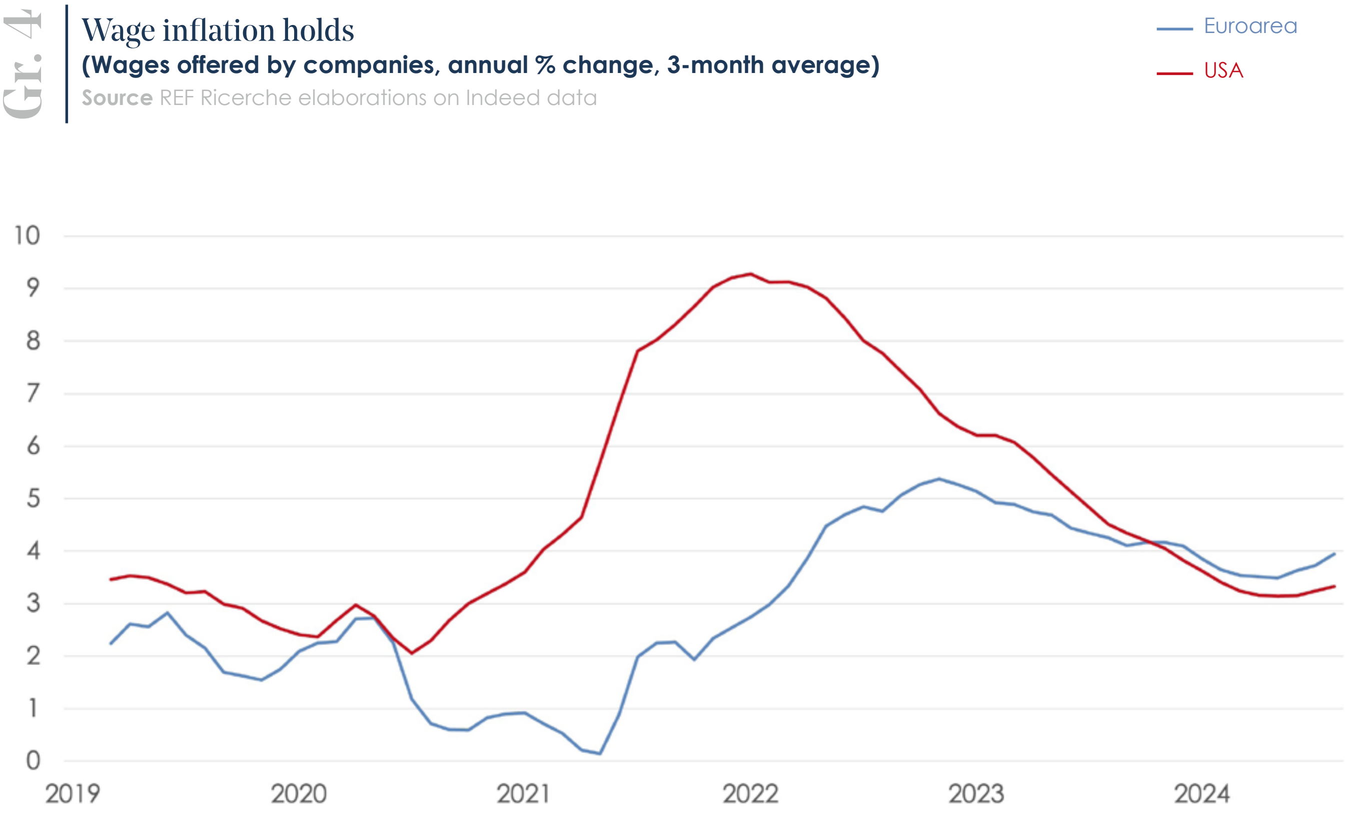
The Raft of the Medusa
Théodore Géricault
(Getty Images)

THE NEW PARADIGM OF WAGE INFLATION

An increasingly clear change between the period before and after the pandemic is the permanent and physiological wage inflation. In the monthly reading of the Purchasing Managers' Surveys (PMI, precisely) labour costs are almost always cited as a factor in input price increases. While the only comparable statistic between the US and the Eurozone, i.e. the annual change in pay offered by companies looking for workers, shows that the dynamics remain one or two percentage points above the 2019 level (Chart 4).

Gr. 4

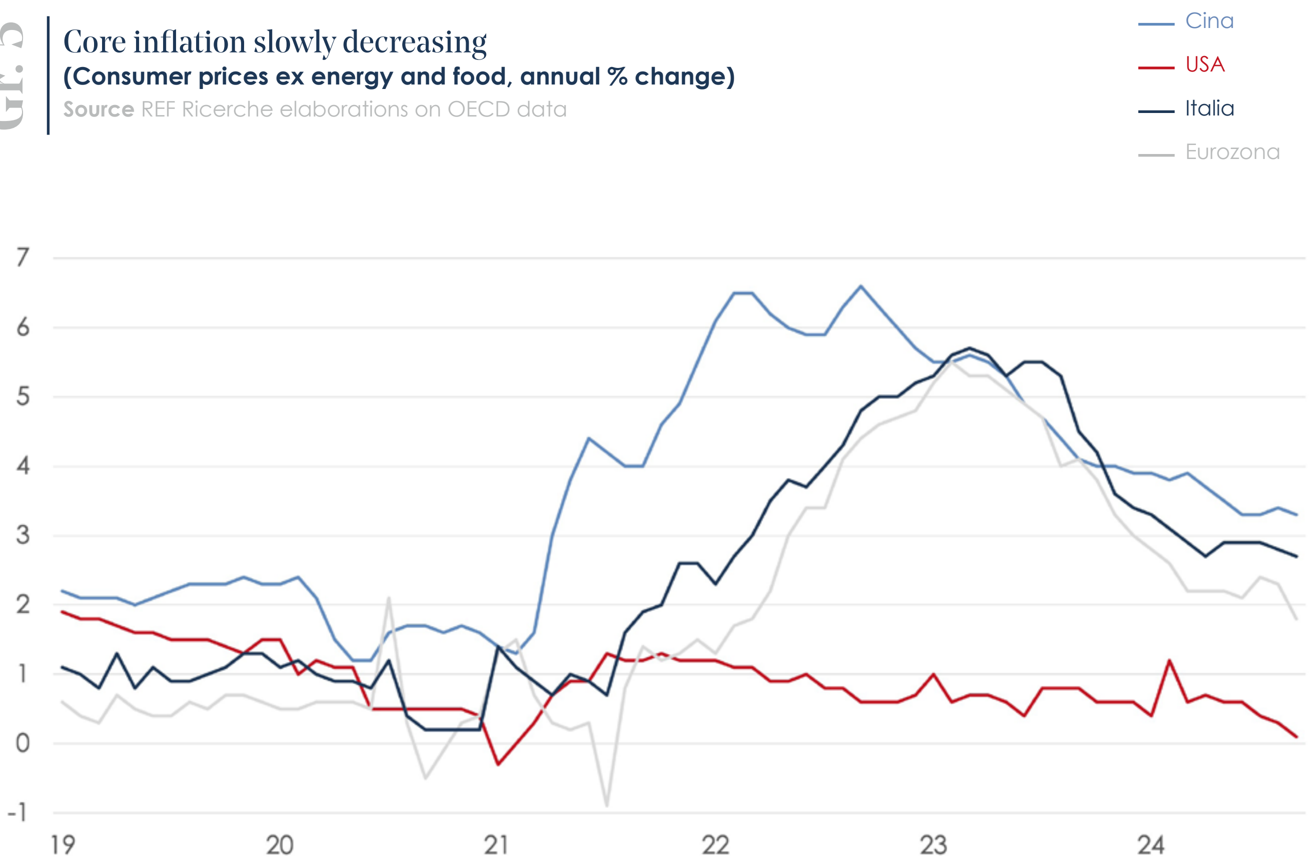
Wage inflation holds
(Wages offered by companies, annual % change, 3-month average)
Source REF Ricerche elaborations on Indeed data



There is a common structural reason, beyond the institutional differences of the two labour markets (decentralised and unorganised in the US, with centralised collective bargaining in continental Europe). The reason is the shift of the bargaining needle to the workers' side, as unemployment has fallen and the working-age population is shrinking. A shift that had started before the pandemic but was exacerbated by it, insofar as it caused many to withdraw prematurely from the labour market (the 'big resignations') or accentuated the gap between skills required and skills offered in the various geographical and sectoral parts of the economic system. Instead, the surge in inflation, on the one hand, was the litmus test of how tight the labour market was, with the prompt wage response to imported price increases (food and energy above all), and, on the other hand, attracted new labour supply into the market. However, the shortage of workers will be increasingly felt: in Italy alone there will be a shortage of 700,000 people to fill the jobs that will be created by the albeit modest growth in 2025-29. A backdrop of warmer wages and a slight and normal temperature of consumer prices, close to but above the central banks' 2% limit, will characterise the coming scenarios. And this is also why core inflation will take a while to come down and keep monetary policy on the sidelines (Chart 5).

Gr. 5

Core inflation slowly decreasing
(Consumer prices ex energy and food, annual % change)
Source REF Ricerche elaborations on OECD data



REAL RATES ARE STILL TOO HIGH

However careful they are not to let go of the reins too quickly, the ECB and the Fed will have to take note that the real interest rates they manoeuvre have become too high relative to the potential and actual growth of economies. Indeed, while the ten-year real rate may be in line with the GDP growth rate, the short rate cannot be much higher than zero, given the normal slope of the yield curve. In fact, the members of the Fed's rate-setting committee have in mind a median level of just under 3% in the long run, almost two percentage points below the current one. While the ECB itself considers the 3.50% rate set in September to be decidedly restrictive, and its forecast for growth to accelerate to 1.3% next year (from 0.8% in 2024) looks challenging in light of both recent sagging trends (see above) and the more restrictive tone of fiscal policies in many member states, which have to comply with new European rules, and, finally, global uncertainty fuelled by political tensions. Therefore, the ECB will also continue to cut rates, with effects on the euro exchange rate (which will become weaker). Given the prospect of falling rates, which play in advance of falling inflation and help to avoid recession, investors know that stocks benefit. No longer, however, will it be like in the era of zero nominal and negative real rates, when all stocks were, like cats in the night, churlish: stock-picking and active management are becoming rewarding again.

Views from the managers

We recently returned from a week of meetings with our US-based managers who as usual provided some interesting insights and observations.

When asked about the upcoming US Presidential election, most managers expressed dissatisfaction with both candidates. Trump is generally viewed as pro-business, but morally questionable, while Harris is seen as well-intentioned, but with a poor track record and influenced by the Democrats Party's progressive wing. It is a closely contested race between Trump and Harris, although Republicans are likely to regain control of the Senate, potentially leading to a split Congress. This would in any case limit drastic changes to domestic policies from either party. The economic implications of the election are a major concern, since both candidates may lead to a worsening of the budget deficit and potentially higher inflation. Trump's policies will prioritize economic growth possibly at the cost of fiscal stability, while Harris might take a more hawkish stance on taxes, limiting growth, but still face fiscal challenges. A Trump victory could benefit domestic mid-cap equities, reduce regulations and spur M&A activity, while a Harris win might bring policy continuity, but lower economic growth.

Several managers expect a Trump presidency to lead to fewer Fed rate cuts, higher long-term interest rates, a stronger dollar and positive outcomes for US equities, but negative for global equities. Conversely, a Harris presidency might result in Fed cuts and potentially lower long-term interest rates, a weaker dollar and positive outcomes for both US and global equities.

Looking beyond this election, there's a sentiment that whoever wins in 2024 will face significant challenges by 2028, with some managers hoping for a return to more centrist leadership in the future.

There is not a strong consensus on the overall market valuation or the US economy direction, but most managers expect short-term interest rates to decline over the next few months as the economy transitions to a soft landing. However, most managers also expect inflation to remain above the Fed's target of 2%. A hard landing scenario remains a low probability.

Rather than complaining about the index performance due to the concentration in the Magnificent 7 stocks, most managers are actively pursuing idiosyncratic bottom-up stock ideas and various macro themes (both long and short), some of which are present in most portfolios: AI beneficiaries, increasing electricity demand, winners and losers of GLP-1 adoption, normalisation of the US housing market, aerospace supply chain, aging demographics, the increasing relevance of private credit and challenged auto producers, among others.

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