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Overheating risks are looming

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The German economy is likely to have maintained its rapid growth rate in the second quarter. Consumer spending, in particular, has been stronger than expected thanks to the recent fall in oil prices and the continuing significant rise in employment levels. We have revised our GDP forecast for the whole year upwards to 1.6% (1.3%) which is equivalent to a calendar-adjusted rate of 2%. With an expected increase of 1.7% in 2018, German GDP is again likely to exceed the trend growth rate of around 1.25% – for the fifth successive year – and the positive output gap should widen to over two percentage points. The tight labour market could lead to increases in pay settlements of more than 3% during the round of collective pay bargaining (public sector, construction and metals) set to take place in early 2018, especially as these deals that are due to expire were originally negotiated some time ago, which signals some catch-up potential. Against the backdrop of additional fiscal stimuli after the Bundestag election, and monetary policy remaining extremely relaxed, the risk of overheating, at least in parts of the German economy, is increasing. However, the rate of (consumer price) inflation over the coming two years should remain below 2%, especially as we are not anticipating a depreciation of the euro against the US dollar.

Considerable house price increases in 2017 and 2018 – and more significant wealth effects? In the next few years, the persistent real-estate boom and high real-estate inheritances might result in wealth effects which may affect households' purchasing behaviour and consumption even in conservative Germany. As a debate about a potential overheating in Germany is about to begin, it might make sense to include house prices in economic forecasts. We have steadily extended the range of our forecasts for the real-estate sector in the last few years and are now projecting house and apartment price developments, rent developments and mortgage rates. While our price forecasts have been consistently in line with the trend, we have systematically underestimated the momentum. And our apartment price forecasts for 2017 and 2018 (increase of c. 7% per year) might turn out to be too conservative as well.

The view from Berlin. Summertime and election campaigns. While the economy is in excellent shape, the next government will have to address a number of challenges, among them globalisation, the future of Europe and the changes in the geopolitical situation as well as the demographic change. However, Germans do not take such a medium-term view but judge the economy on the basis of the current (good) performance. According to the polls the CDU/CSU is the strongest party again with a clear 15pps lead over the SPD – larger than it used to be before Mr. Schulz' nomination as SPD frontrunner. If elections were held today, a CDU/CSU-FDP (conservative-liberal) coalition would be able to achieve a majority of seats in the Bundestag, albeit a tight one.

Overheating risks are looming

Economic forecasts

	Real GDP (% growth)			Consumer Prices* (% growth)			Current Account (% of GDP)			Fiscal Balance (% of GDP)		
	2016	2017F	2018F	2016	2017F	2018F	2016	2017F	2018F	2016	2017F	2018F
Euroland	1.7	1.9	1.6	0.2	1.6	1.5	3.3	3.1	2.9	-1.5	-1.4	-1.3
Germany	1.9	1.6	1.7	0.5	1.6	1.6	8.4	8.0	7.8	0.8	0.5	0.2
France	1.1	1.4	1.6	0.3	1.3	1.3	-0.9	-0.6	-0.5	-3.4	-3.1	-2.8
Italy	0.9	1.0	1.0	-0.1	1.4	1.3	2.6	2.7	2.3	-2.4	-2.3	-2.3
Spain	3.2	2.7	2.1	-0.3	2.0	1.8	1.9	1.9	1.8	-4.5	-3.3	-2.8
Netherlands	2.2	2.1	1.5	0.1	1.1	1.4	8.5	10.2	10.2	0.4	0.6	0.0
Belgium	1.2	1.6	1.6	1.8	2.3	1.9	-0.4	1.0	1.0	-2.6	-2.1	-2.1
Austria	1.6	1.8	1.6	1.0	1.9	1.6	1.7	2.8	3.1	-1.6	-0.9	-0.8
Finland	1.5	1.2	1.5	0.4	1.0	1.4	-1.1	-1.0	-0.7	-1.9	-2.1	-1.6
Greece	0.0	0.9	2.0	0.0	1.1	1.0	-0.6	1.0	1.0	0.7	-1.3	0.6
Portugal	1.4	2.5	1.4	0.6	1.2	1.5	1.0	0.7	0.7	-2.0	-1.8	-1.7
Ireland	5.2	4.0	3.2	-0.2	0.2	1.3	4.7	10.0	8.0	-0.6	-0.7	-0.5
UK	1.8	1.6	1.2	0.6	2.7	2.8	-4.4	-4.0	-4.0	-2.9	-2.9	-2.5
Denmark	1.7	1.7	1.8	0.3	1.1	1.4	6.5	6.5	6.5	-2.1	-2.5	-1.9
Norway	0.7	1.6	1.8	3.6	2.7	2.5	4.4	6.2	7.0	3.7	3.9	4.2
Sweden	2.9	3.0	2.4	1.0	1.5	1.5	4.7	4.9	5.1	2.0	0.0	0.3
Switzerland	1.3	1.5	1.7	-0.3	0.5	0.7	9.5	9.3	9.0	-0.1	-0.1	-0.1
Czech Republic	2.3	2.8	2.1	0.7	2.3	2.0	1.1	1.1	1.0	0.6	-0.6	-0.6
Hungary	2.0	3.5	3.3	0.4	2.5	2.9	4.9	3.2	2.8	-1.9	-2.5	-2.3
Poland	2.7	3.4	3.2	-0.6	1.9	2.1	-0.3	-1.1	-1.2	-2.5	-3.0	-2.9
United States	1.6	2.4	2.6	1.3	2.3	2.1	-2.6	-2.9	-3.2	-3.1	-2.9	-2.9
Japan	1.0	1.2	0.7	-0.1	0.4	0.5	3.7	3.9	4.0	-3.5	-3.4	-3.0
China	6.7	6.7	6.3	2.0	1.7	2.7	1.6	1.3	1.1	-3.8	-4.0	-4.0
World	3.1	3.6	3.7	4.3	5.3	4.5						

*Consumer price data for European countries based on harmonized price indices except for Germany. This can lead to discrepancies compared to other DB publications.
Sources: National Authorities, Deutsche Bank

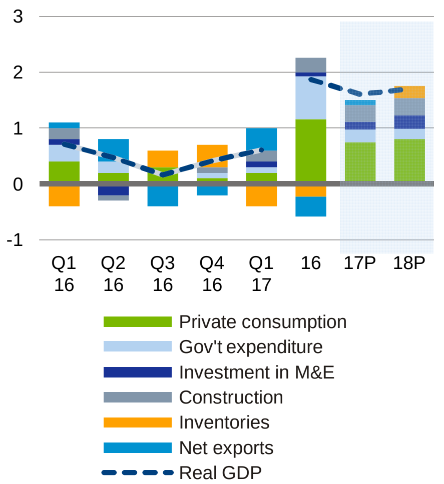
Forecasts: German GDP growth by components, % qoq, annual data % yoy

						2017				2018			
	2014	2015	2016	2017F	2018F	Q1	Q2F	Q3F	Q4F	Q1F	Q2F	Q3F	Q4F
Real GDP	1.6	1.7	1.9	1.6	1.7	0.6	0.6	0.5	0.5	0.4	0.3	0.3	0.3
Private consumption	0.9	2.0	2.1	1.2	1.5	0.3	0.5	0.4	0.4	0.3	0.3	0.3	0.3
Gov't expenditure	1.2	2.8	4.0	1.2	1.0	0.4	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Fixed investment	3.4	1.7	2.2	2.1	3.0	1.7	0.7	0.9	1.0	0.7	0.7	0.7	0.6
Investment in M&E	5.5	3.7	1.1	1.1	3.5	1.2	1.0	1.0	1.0	1.0	0.8	0.8	0.5
Construction	1.9	0.3	2.8	3.1	3.3	2.3	0.5	1.0	1.2	0.7	0.7	0.7	0.7
Inventories, pp	-0.3	-0.5	-0.2	0.2	0.0	-0.4	0.2	0.0	0.0	0.0	0.0	0.0	0.0
Exports	4.1	5.2	2.7	3.7	3.9	1.3	1.0	1.2	1.0	1.0	1.0	1.0	1.0
Imports	4.0	5.5	3.8	4.0	4.5	0.4	1.1	1.2	1.1	1.0	1.2	1.2	1.2
Net exports, pp	0.4	0.3	-0.4	0.1	0.0	0.5	0.0	0.1	0.0	0.1	0.0	0.0	0.0
Consumer prices*	0.9	0.2	0.5	1.6	1.6	1.9	1.7	1.4	1.3	1.3	1.6	1.8	1.8
Unemployment rate, %	6.7	6.4	6.1	5.7	5.5	5.9	5.8	5.7	5.6	5.6	5.5	5.4	5.4
Industrial production**	1.5	1.1	1.4	1.5	1.0								
Budget balance, % GDP	0.3	0.7	0.8	0.5	0.2								
Public debt, % GDP	74.9	71.2	68.3	65.9	63.4								
Balance on current account, % GDP	7.3	8.3	8.4	8.0	7.8								
Balance on current account, EUR bn	213	253	263	259	260								

*Inflation data for Germany based on national definition. This can lead to discrepancies to other DB publications. **Manufacturing (NACE C)
Sources: Federal Statistical Office, German Bundesbank, Federal Employment Agency, Deutsche Bank Research

Real GDP components
Key growth drivers 1

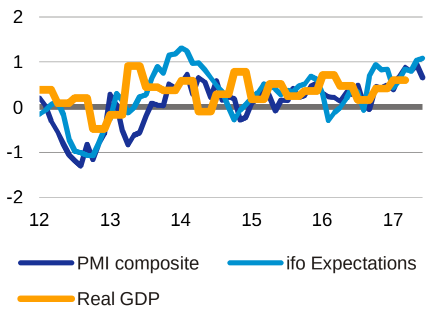
growth contributions to real GDP growth, %-points



Sources: National Statistical Office, Deutsche Bank Research

GDP Growth & Leading indicators 2

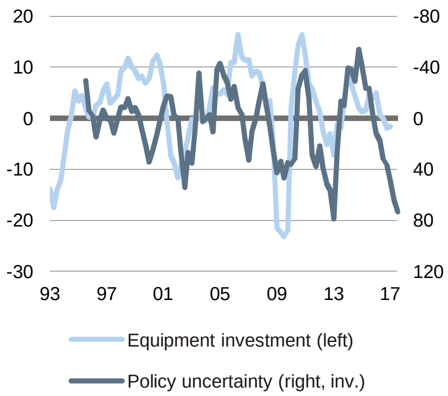
standardized values



Sources: Markit, ifo , National Statistical Office Deutsche Bank Research

Uncertainty weighs on investment 3

Change yoy, index points, 4Q avg., 3Q lead (left); % yoy, real (right)



Sources: Federal Statistical Office, Haver

2017 GDP forecast of +1.6% again above trend growth rate, increased risk of overheating in 2018

— The German economy is likely to have maintained its rapid growth rate in the second quarter. Consumer spending, in particular, has been stronger than expected thanks to the recent fall in oil prices and the continuing significant rise in employment levels. We have revised our GDP forecast for the whole year upwards to 1.6% (1.3%) which is equivalent to a calendar-adjusted rate of 2%.

— The strong economic situation is also reflected in leading indicators. The PMI composite, for example, remained high during the second quarter, while the ifo Index reached an all-time high. Following the victory of Macron's La République en Marche party in the French parliamentary elections, the political uncertainties in the eurozone have been pushed into the background, for the time being at least. This more growth-friendly environment is likely to soften the wait-and-see stance that had been adopted by investors last year.

— With an expected increase of 1.7% in 2018, German GDP is again likely to exceed the trend growth rate of around 1.25% – for the fifth successive year – and the positive output gap should widen to over two percentage points. The tight labour market could lead to increases in pay settlements of more than 3% during the round of collective pay bargaining (public sector, construction and metals) set to take place in early 2018, especially as these deals that are due to expire were originally negotiated some time ago, which is likely to result in demands to catch up on pay. Against the backdrop of additional fiscal stimuli after the Bundestag election, and monetary policy remaining extremely relaxed, the risk of overheating, at least in parts of the German economy, is increasing. However, the rate of (consumer price) inflation over the coming two years should remain below 2%, especially as we are not anticipating a depreciation of the euro against the US dollar.

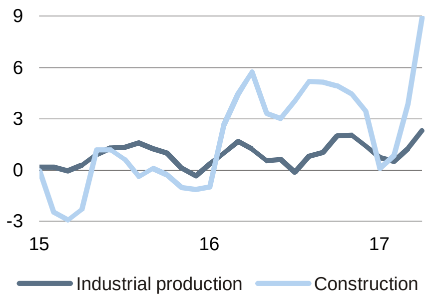
Upward trend in consumer spending is likely to increase in 2017

Consumer spending increased in Q1 for the 13th successive quarter (up 0.3% compared with the previous quarter and up 1.6% compared to the prior-year quarter), the longest uninterrupted rise since reunification. Employment growth has remained strong at 1.5% so far in 2017 (the considerable slowdown initially reported by the Federal Employment Agency was due to a statistical error). At the same time, nominal wage growth, which has been sluggish so far, has gained momentum. In the period January to April, wages saw year-on-year growth of around 2.4% according to the Bundesbank, and more than 3.3% according to the Federal Statistical Office; in any case a little more strongly than in the previous two years. Although real wage growth came under pressure temporarily from rising oil prices, the recent fall in oil prices should provide a fresh boost to consumer spending. Oil prices are likely to remain low for the foreseeable future due to excess supply on the world market and increased output in the US. And following the appreciation of the euro in the second quarter, the oil price (on the euro basis) is actually slightly below last year's figure.[1] The buoyant economic situation in the eurozone – we are anticipating GDP growth of 1.8% in 2017 – is more likely to increase, rather than decrease, the value of the euro (current official DB forecast for the end of 2017 is an exchange rate of 1.16). Higher wages, lower oil prices and a stronger euro

[1] The strong supply-side pressure is reflected in our official crude oil price forecast. We are anticipating only minor price increases until the end of the decade, and a crude oil price (WTI) of USD 55/bbl.

Construction and industrial production 4

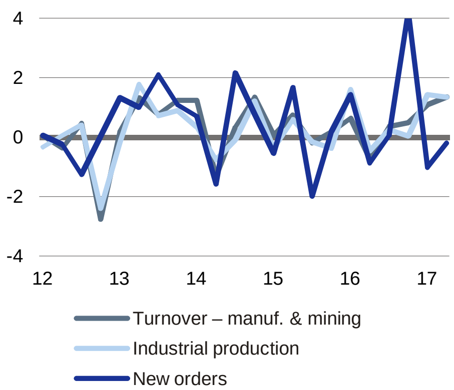
2010 = 100



Source: National statistical office

Turnover, Production and Orders 5

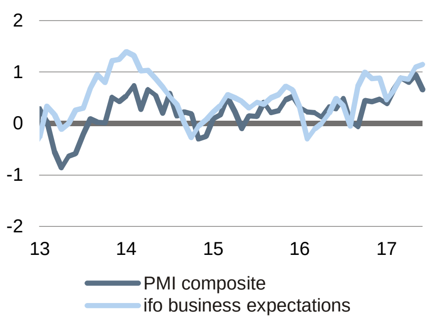
% qoq



Source: National Statistical Office

PMI composite and ifo expectations 6

standardised values



Sources: ifo, Markit

should lead to growth in real income, and we therefore anticipate a strong increase in consumer spending for the rest of 2017 (Q2-Q4 2017: approx. 0.45% per quarter compared with the preceding quarter). Growth in public spending has been back to normal following the positive growth shock that accompanied the wave of immigration, and now stands at only 0.4%. Accordingly, growth in 2017 is likely to decrease to 1.2% (4% in 2016).

Strong recovery in investment activity in 2017

Capital expenditure in construction increased by 2.3% in Q1 compared with the preceding quarter, which is a clear acceleration of growth and the biggest increase for twelve quarters, even if it was partly weather-related. However, there are currently three factors contributing to the uncertainty of forecasts. Firstly, the correlation between capital expenditure in construction and both soft and hard leading indicators in the construction sector was already weak in the last years. Secondly, the Federal Statistical Office has increased the sample size of construction companies surveyed, rendering any comparison with previous periods almost meaningless. It is also unclear whether this statistical change will merely impact on the statistical base level or if it will influence the (measured) rate of growth in the construction sector in future. Thirdly, the trend reversal in commercial construction increases the forecast uncertainty. Capital investment in this sector could rise for the first time in many years following a significant reduction in vacancy rates in the office market. It is therefore possible that capital expenditure in construction could vary considerably from our forecast of a little over +3% for 2017. It is clear, however, that the scarcity of residential construction is more likely to increase than decrease, and that the familiar arguments – capacity bottlenecks, regulatory obstacles and a lack of suitable land, skilled workers and political incentives – will continue to be limiting factors for investment.

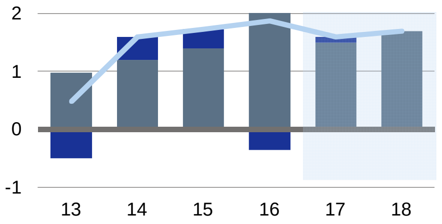
Capital expenditure on equipment also grew strongly, up 1.2% in the first quarter, making up in part for the decline seen in 2016. The drop in demand for German products in the global market caused by the falling price of crude oil was undoubtedly part of the reason for the previous dip in capital expenditure. The subsequent recovery of crude oil prices has revitalised global trade and capital spending. Of greater significance is the strain the many negative surprises in politics in 2016 (Brexit, US presidential elections, Italian referendum) have had on the investment climate. The European electoral calendar in 2017 was also studded with a variety of substantial risks. So far, the elections – especially Macron's victory in the French presidential and parliamentary elections – have led to more pro-business results, and the upcoming elections in Austria and Germany, and the referendum in Catalonia, should have less of an adverse effect on the investment climate.

The improved risk outlook is also likely to have contributed to the significant improvement of the leading indicators (ifo, PMI). The PMI for the manufacturing industry, for example, reached high levels in the second quarter, and the ifo Index for the whole of Germany even achieved an all-time high. At the same time, a discrepancy remains between the survey data (ifo, PMI) and the volume of new orders and industrial output, as seen over the last twelve months. In the second quarter, production increased by a mere 1.3% quarter-over-quarter, and the volume of new orders was slightly down. The more or less stagnant level of German orders for capital goods over the last six months also points to subdued growth. We therefore expect moderate growth of 1.0% per quarter (Q2-Q4) for the rest of the year, but no strong acceleration in investment growth. The annual growth rate in 2017 is likely to only just pass 1% due to the negative growth overhang. At the same time, this implies a high growth overhang towards the

Overheating risks are looming

GDP Growth 7

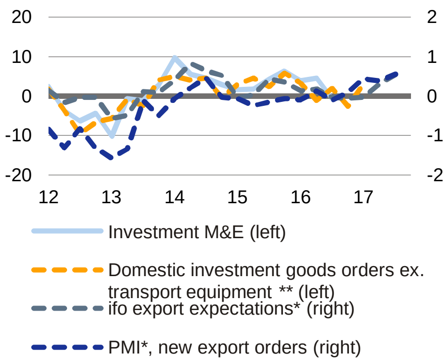
%yoy, %-points



Sources: National Statistical Office, Deutsche Bank

Equipment investment & indices 8

% yoy (left), standardised values (right)



*Lead structure * 2Q * *1Q

Sources: ifo, Markit, Federal Statistical Office, Deutsche Bank Research

end of 2017, which should contribute to an increase in capital expenditure of more than 3% in 2018.

Net exports drive strong GDP growth in Q1 2017

Global trade expanded by almost 4% in real terms in the first quarter of 2017 compared with the prior-year period. The partial stagnation over the course of 2016 also dampened the growth of German exports (up 2.7% in 2016, compared with 5.2% in 2015 and 4.1% in 2014). This slowdown, caused by fluctuations in the price of crude oil, has been overcome, and German exports have increased more strongly in the first quarter (up 1.3% compared with the preceding quarter). Considering the improved global investment climate, Germany's exports in real terms should continue to grow at roughly the same pace throughout the year. With growth of around 1% per quarter (Q2-Q4), the annual growth rate in 2017 will rise to almost 4%, although the impact of the latest appreciation of the euro could eventually weigh on exports by the end of the year. In view of the robust domestic economy, real import growth for the year as a whole should reach similarly high levels, and net exports should make only a marginal contribution to GDP growth. In the first quarter, however, import growth was weak (up 0.4% compared with the preceding quarter), which meant that net exports made a considerable contribution of 0.5 percentage points to GDP growth. The slow import growth reflects the temporary weakness in demand in real terms caused by the high crude oil prices in the first quarter. The strong increase in net exports in the first quarter can also be interpreted as a reaction to weak net exports in the second half of 2016 (down 0.2 percentage points in Q4 and 0.4 percentage points in Q3).

GDP forecast for 2017: up 1.6%, above trend growth rate once again

The main driver of GDP growth in the first quarter (up 0.6% compared with the preceding quarter) was net exports, which increased by 0.5 percentage points. In view of the buoyant labour market and the strength of the leading indicators, we expect to see further GDP growth of 0.6% in the second quarter compared with the preceding quarter. As the European electoral calendar harbours only minor risks for the second half of 2017 (parliamentary elections in Austria and Germany, referendum in Catalonia), growth should remain high and GDP should rise by 1.6% for the year as a whole. Taking into account the lower number of working days in 2017 compared with 2016, the GDP forecast – based on seasonal and calendar-adjusted data – increases to 2%. Despite the buoyant economy, inflation remains subdued. Overall inflation is currently 1.6% and should remain below 2% right into 2018, especially as oil prices are likely to fall, rather than go up.

Germany economy at growing risk of overheating in 2018

For 2018, we are forecasting GDP growth of 1.7% (1.6% in 2017). With the economy expected to grow above its trend rate (around 1.2%) in both years, the output gap in Germany should widen to more than +2 percentage points. The basis for this high growth rate is a strong labour market, which is still experiencing a surge in employment and a drop in the number of unemployed. In addition to that a structural lack of skilled workers and the continually rising number of job vacancies could put upward pressure on wage growth in 2018. Long-term collective pay agreements in three core areas of the German economy will come to an end in the first quarter of 2018: in electrical engineering and metals, in construction and in the public sector. When the contracts were agreed in early 2016, the economic outlook was subdued, and in retrospect the agreed wage increases were very modest. Potential demands to make up for this shortfall and the current situation in the job market could lead to noticeable wage increases of more than 3% in some cases. At the same time, house prices are likely to continue to rise, which for the first time in recent German history could have a tangible impact on wealth and, hence, consumer spending. Furthermore, the savings ratio could drop from its current high level of 9.8% and boost consumer spending.

Fiscal and monetary policy should also provide additional growth stimulus for 2018. During the election campaign, the parties have been discussing tax cuts and increased public spending of at least 0.5% of GDP. This fiscal stimulus is likely to be self-financing to a large degree, considering the bottlenecks in the labour market and high capacity utilisation in certain industry sectors, and should do little to erode the high fiscal surpluses of recent years. Monetary policy is likely to remain very loose for the foreseeable future, and we are not anticipating a rise in the base rate until at least the end of 2018. Any subsequent tightening of monetary policy, even if it marks the start of a cycle of interest rate hikes, is likely to remain accommodative. We expect the main refinancing rate to stay for many more years several percentage points below what could be considered a neutral interest rate level for the German economy. There is therefore a risk that a more restrictive monetary policy will be unable to prevent an increase in house prices and wages, in which case we consider it possible that the 2% inflation target will be temporarily exceeded at the end of the decade.

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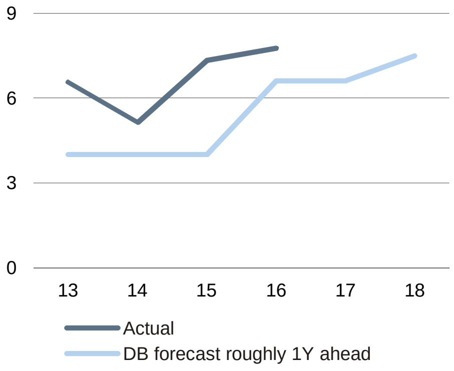
Germany: Comparison of DB forecast and actual prices, existing apartments **1**

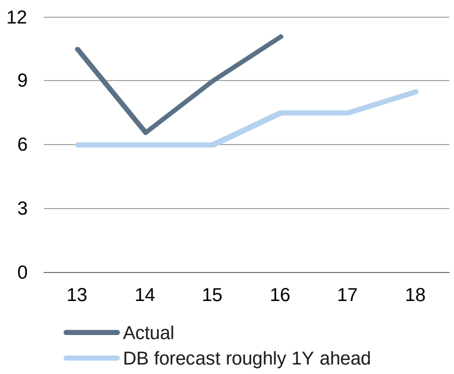
% yoy



Sources: Riwis, Deutsche Bank Research

Comparison of DB forecast and actual prices in A cities, existing apartments **2**

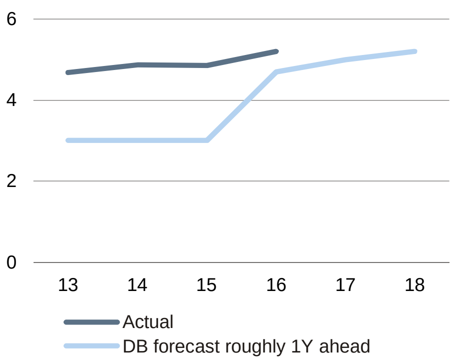
% yoy



Sources: Riwis, Deutsche Bank Research

Germany: Comparison of DB forecast and prices of single-family houses **3**

% yoy



Sources: Riwis, Deutsche Bank Research

Considerable house price increases in 2017 and 2018 – and more significant wealth effects?

— The number of available real-estate data series has increased considerably, and the general understanding of the relationship between the real-estate sector and the rest of the economy has improved. But even though the real-estate crises of the past decade have painfully shown that house prices may be at the root of major overall economic imbalances, house prices, apartment prices and rents still do not play a role in the economic forecasts of the IMF, the OECD, the EU or national institutions such as the German Council of Economic Experts, the Bundesbank or the Joint Economic Forecast.

— In the next few years, the persistent real-estate boom and high real-estate inheritances might result in wealth effects – even in conservative Germany – which may affect households' purchasing behaviour and consumption. As a debate about a potential overheating in Germany is about to begin, it might make sense to include house prices in the economic forecasts.

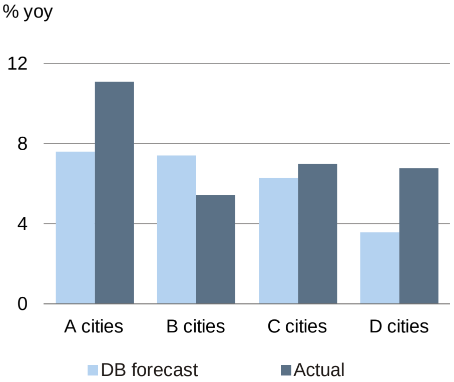
— We have steadily extended the range of our forecasts for the real-estate sector in the last few years and are now projecting house and apartment price developments, rent developments and mortgage rates. While our price forecasts have been consistently in line with the trend, we have systematically underestimated the momentum. And our apartment price forecasts for 2017 and 2018 (increase of c. 7% per year) might turn out to be too conservative as well. In fact, the price momentum seen between January and May 2017 suggests that prices might even grow at a two-digit rate in some market segments.

— In addition to our forecasts for 2017 and 2018, we also project the ratio between house prices and disposable income up to 2021, based on the OECD affordability index. We assume similar price and income developments as in the last few years. According to our model, the price-income ratio will exceed its former highs since the German unification by 2019.

Lack of forecasts for the real-estate sector

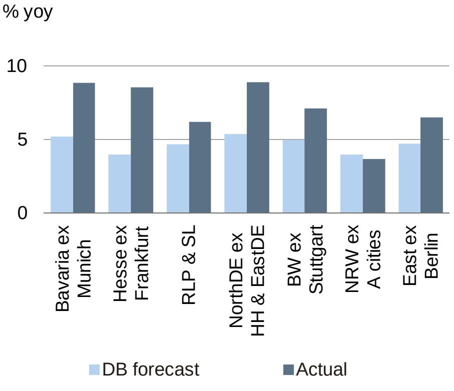
One of the lessons of the subprime crisis was that it makes sense to develop a better understanding of the real-estate markets and their impact on the economy as a whole. Today, the Financial Stability Reports regularly analyse the real-estate markets and discuss potential mispricings. Stress tests are used to calculate the potential effect of price declines on financial institutions and the financial markets. At the same time the number of real-estate price indices has increased and their quality has improved considerably. Today, house price indices are available not only at the national level and for large countries, but also for many smaller countries and even for individual cities or quarters within a city. Nevertheless, the analysis resembles a view in the rear mirror, as neither the large public-sector institutions nor the central banks (e.g. the ECB or the Bundesbank) publish regular forecasts for the real-estate sector. And the well-known economic analyses for Germany do not include sections on rents or home prices either. Surprisingly, the real-estate sector itself publishes only a relatively small number of forecasts, too.

2016: Comparison of DB forecasts and prices of existing homes 4



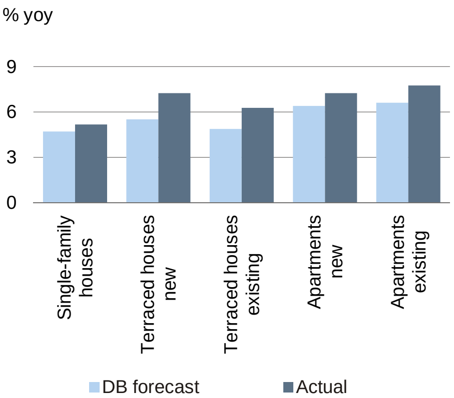
Sources: Riwis, Deutsche Bank Research

2016: Comparison of DB forecasts and regional prices, existing apartments 5



Sources: Riwis, Deutsche Bank Research

2016 DB forecast vs. actual prices in key residential asset classes 6



Sources: Riwis, Deutsche Bank Research

Real estate is an important sector for the overall economy

In fact, however, the real-estate sector is deeply integrated in the overall economy and has a major impact on macroeconomic developments. Construction investment accounts for almost 10% of GDP, and rents make up the largest share of the basket used to calculate consumer prices (20%). Real estate property even accounts for about 50% of the aggregate wealth in Germany. During the 1990s and 2000s, wealth effects on the consumption of German households were small or non-existent, as real estate prices rose very moderately. However, wealth effects might become more pronounced due to the current real-estate boom and against the background of the nascent discussion about potential overheating. The more dynamic price momentum has lifted the annual growth rate in real-estate wealth considerably, to c. EUR 250 bn (see chart). In view of the persistent public debate, households might respond more sensitively to price increases than before, i.e. the coefficient might rise. This and the very favourable cyclical development might cause the savings ratio to decline from 9.7% in 2016 by about ¼ of a percentage point by 2018. In addition, high real estate inheritances might cause wealth effects on consumption; according to Deutsches Institut für Altersvorsorge, properties worth more than EUR 100 bn are inherited every year[2]. If we assume that 5% of the annual wealth increase (EUR 12.5 bn) and 5% of the inherited wealth (EUR 5 bn) are used for consumption purposes, the total boost to consumption is equivalent to the tax relief proposed currently during the election campaign and would lift household consumption by about ½ of a percentage point.

Table 1: Nominal household wealth gains

EUR bn per year	2011-15	2006-10	2001-05
Real estate assets	254.3	167.7	94.0
Financial assets	191.4	74.9	131.9
Net wealth (= equity)	428.1	251.7	213.8

Sources: Federal Statistical office, Deutsche Bank Research

Actual price momentum systematically underestimated

As the real-estate sector plays a major role for the overall economy, we have started to forecast not only interest rates, wages, commodity and consumer prices, but also real-estate data in the last few years. We expected house prices and rents to rise across the cycle for both fundamental and cyclical reasons. While we believed our forecasts to be optimistic, they actually lagged behind the developments. We made detailed forecasts for individual regions and price segments for 2016. The charts on the margin compare our forecasts and the actual figures.

2017 and 2018: Condominium prices to rise considerably further

The table below gives an overview of our real-estate forecasts for 2017 and 2018. We expect nominal price increases to continue at the rate seen in the last few years. According to our forecasts, prices of existing condominium units will rise by 6.6% and 7.5% in 2017 and 2018, respectively, or even 7.5% and 8.5%, respectively, in A cities. For several reasons, the price momentum might even accelerate further in 2018. Even if the ECB reduces its monthly bond purchases

[2] "Erben In Deutschland 2015 – 24": Volumen, Verteilung und Verwendung, by Dr. Reiner Braun, empirica ag.

in 2018, capital market rates may remain low. Wage growth may pick up on the back of low unemployment and a lack of qualified labour and consumer price inflation is likely to remain clearly below the 2% target, which means that real wages will grow more strongly in 2018 than in 2017. Moreover, the Bundesbank expects the workforce to increase by an additional 400,000 due to immigration. This favourable labour-market development should fuel demand for new homes. With construction activity slow to pick up, we expect the demand overhang and, in turn, price pressure to increase.

Table 2: Deutsche Bank Research real-estate forecasts, % yoy

	Apartment units			House prices		
	Germany	A cities	Rents	Single-family homes	Construction investment	5-10Y mortgage rate, % eop
2017	6.6	7.5	4.0	5.0	3.1	1.7
2018	7.5	8.5	4.5	5.2	3.3	1.9

GE = Germany, A cities = Berlin, Dusseldorf, Frankfurt, Hamburg, Cologne, Munich, Stuttgart, eop= end of period (here: end of the year)

Source: Deutsche Bank Research

Projection of the price-income ratio up to end-2021

In view of the rising demand overhang, we have pointed out in the last few years that the real-estate cycle might continue until the end of the decade or even beyond. In addition to forecasts for 2017 and 2018, we also project the ratio between house prices and disposable income, based on the OECD affordability index. The historical median of this index is normed to 100, and any deviations from this median measure potential overvaluations (above 100) or undervaluations. Our projection for the years up to 2021 assumes that the price and income momentum continues for the remainder of the current house price cycle, which started in 2009. For the years after 2018, we assume price increases of 7.5% and household disposable income growth of 2.5% per year. Under these assumptions, the price-income ratio will successively rise until 2021 and reach new highs since the German unification from 2019. The forecast intervals of our projections are based on past forecast errors for condominium prices (root mean square error, RMSE, of 2.3% per year).

Overvaluations will not necessarily reverse abruptly

While a house price-income ratio above the historical median clearly points to potential future price declines, the price development will not automatically reverse; in fact, the affordability gap may widen for several years. Numerous countries, for example France, have already experienced long-term overvaluations. Moreover, observers should differentiate between overvaluations and price bubbles. Affordability indices beyond 130 are quite common within the OECD database, and in Spain and Ireland, the indices have even risen to more than 160. This means that our projection, which rises to a mean of 120 by 2021, does not necessarily suggest that we will see an abrupt price correction (see also our analysis of the euro-area housing markets).

We believe that house prices will not begin to decline until at least one of the following three conditions is met:

1. Monetary policy becomes considerably more restrictive
2. Consumers re-evaluate their decision to rent or buy their homes
3. New construction exceeds demand and vacancy ratios rise

In view of the very gradual exit from the ultra-loose monetary policy – we expect the first hike of the main refinancing rate in 2019 – mortgage financing should remain cheap. Even in the “best” case, we expect mortgage rates to rise only marginally after 2018. That means that mortgage payments may be below rent expenses for households in many large cities and metropolises. And finally, construction activity looks set to remain slow. As construction activity is only picking up gradually, the available supply of residential space will probably not substantially reduce the high demand overhang in the foreseeable future. Our three conditions will probably not be met for a long time to come – which means that our projection is likely to fit the future development.

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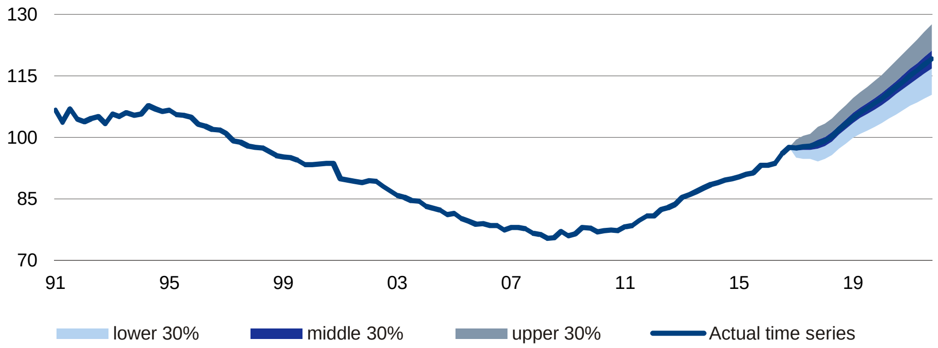
Price-Income-Ratio 7

Historical average = 100



Sources: OECD, Deutsche Bank Research

The view from Berlin

Summertime and election campaigns

Shortly before the summer break, the campaign for the German federal election (on Sept. 24) has entered a new stage. Over the weekend the CDU/CSU has finalized its election platform. Now all relevant parties have presented their manifestos. So the Germans have it in writing how the parties intend to tackle the country's major challenges. While the economy is in excellent shape, the next government will have to address globalisation, digitalisation, the future of Europe and the changes in the geopolitical situation, the climate change and last but not least the demographic change – leaving it with a full policy agenda for the next term.

In line with their traditional stance the parties advocate different ideas. Those on the (more) leftish spectre tend to relay on the state. Increased public spending e.g. on infrastructure investment, further labour market regulation and intensified transfers to low income earners and families are amongst their proposals. In contrast, the conservatives and the Liberals in particular tend to give market forces more leeway incl. broad income tax relief. All parties think that action is primarily needed in the fields of education, public infrastructure, innovative capacity, house building and family policy. Deutsche Bank Research will present more detailed analyses of the manifestos in the new series 'Election Notes'. The forthcoming first report will deal with necessary measures to strengthen the growth potential in Germany.

However, Germans do not take such a medium-term view but judge the economy and the labour market on the basis of the current (good) performance. In a recent survey (Forschungsgruppe Wahlen) only 2% and 7% regard the economic situation and unemployment, respectively, as Germany's most important problems. Instead, people still see the refugees' immigration and integration as the most important issue (46%), though it has significantly lost relevance compared to autumn 2016 and 2015 (68% and 87%, respectively). Social inequality, the SPD's major campaign topic, ranks second in overall terms but only 16% really bother about it.

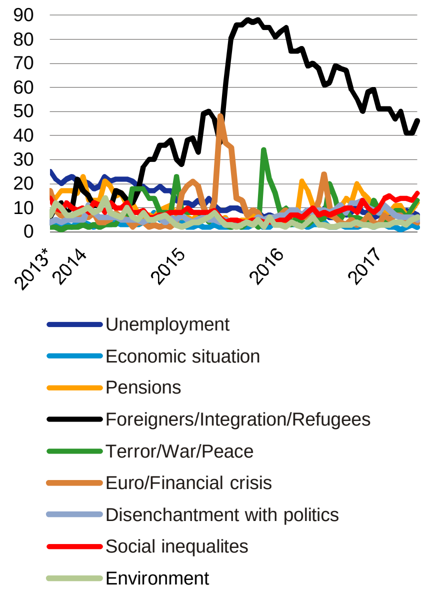
European politics which will remain very high on any future German government's agenda is a less visible topic in the campaign. Due to the good economic situation and the British experience with the Brexit vote, the public sentiment about the EU has improved markedly in the past year. More than two thirds of the Germans have a favourable view of the EU at present (Pew Research Center, FAZ). In addition, the two big parties, the CDU/CSU and the SPD, share a strong overall commitment to the euro area and the EU more generally. Thus, both parties find it difficult to initiate a controversial debate over the topic.

Given the lack of an outstanding issue attracting a broader electorate, the contest Merkel vs. Schulz is likely to remain in the limelight. According to recent polls (Forschungsgruppe Wahlen) 78% of the German's are satisfied with Merkel's performance and only 14% think that the SDP's frontrunner would be able to outperform her if he became chancellor. Consequently, a clear majority (58%, Schulz 31%) prefer her as the next chancellor indicating no mood for a change of political leadership.

Parallel to Merkel's popularity rating that of her party has markedly gone up in the past few months. The Conservatives are the strongest party by far again. As an average of the major polls their lead over the SPD is 15.2pps. Thus, the gap is even larger than it used to be before Schulz' nomination. From this point of view Schulz' endeavours to set the campaign's agenda did not yield sustainable success.

Most important problems in Germany 1

Max. 2 answers, percentage of those asked, %

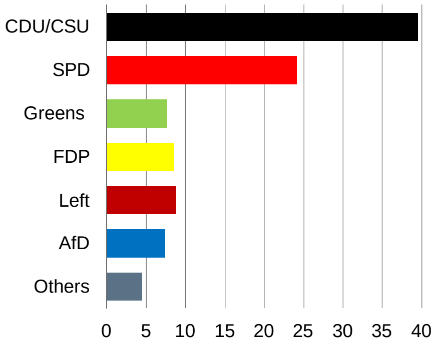


* From the federal election (September 22) onwards

Source: Forschungsgruppe Wahlen: ZDF Politbarometer (June 23,.2017)

Major political parties' popularity on the federal level* 2

Surveys published from mid-June to July 1, 2017, %

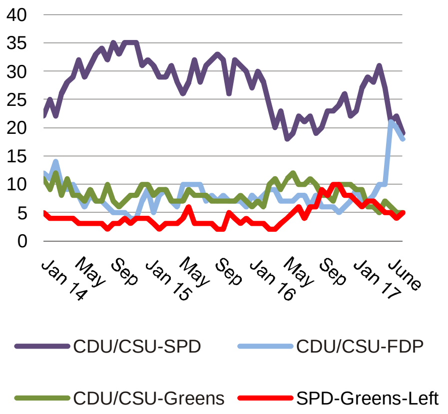


* Average of major surveys (Allensbach, Infratest Dimap, Forsa, Forschungsgruppe Wahlen, TNS Emnid)

Source: Wahlrecht.de

The Germans favourite government coalitions 3

Percentage of those asked, %



Source: Forschungsgruppe Wahlen: ZDF Politbarometer

In the past few months not only the Germans' voting intentions have changed but also their attitude towards the preferred government coalition. For most of the time since the 2013 election the present CDU/CSU-SPD coalition has clearly been regarded as the favourite alliance. In the first months 2017 still 28% favoured such a grand coalition. However, the acceptance has shrunk to 19% only, recently. In contrast, a liberal-conservative alliance between the CDU/CSU and the FDP has strongly gained in popularity, from 8% in Q1 2017 to 18% at present. According to the polls, such a coalition would also be able to achieve a majority of seats in the Bundestag, however a very small one. The recent developments highlight that only small changes in voter preferences are needed to change the overall picture again.

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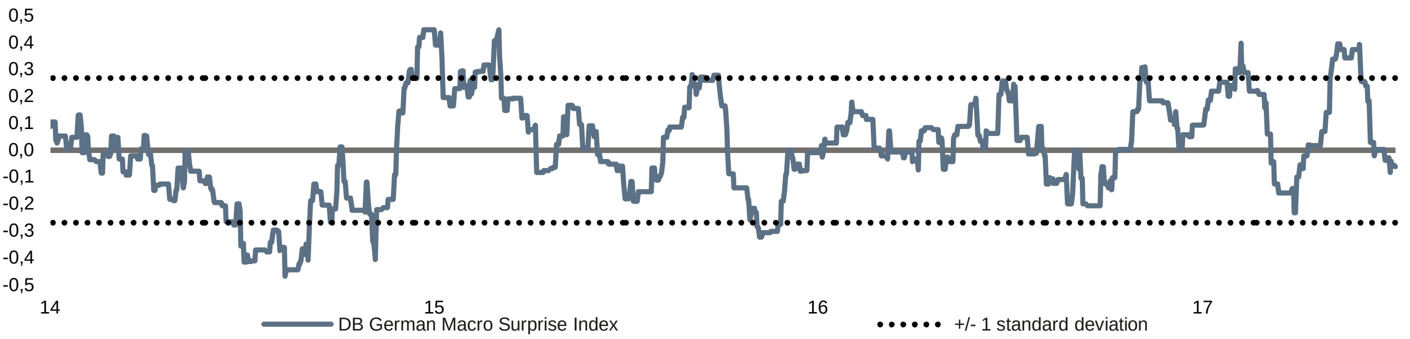
DB German Macro Surprise Index

The DB German Macro Surprise Index compares published economic data with market forecasts and thus provides clues as to the direction of future forecast revisions.

DB German Macro Surprise Index

Average of last 20 z-scores of data surprises



Values above (below) 0 indicate the data came in better (worse) than expected

Sources: Bloomberg Finance LP, Deutsche Bank Research

Last 20 published economic data for Germany

Bloomberg Tickers	Indicator	Reporting month	Publication date	Current value	Bloomberg consensus	Surprise	Standardised surprise	Quantile rank
GRIFPBUS Index	IFO Business Climate	5 2017	23/05/2017	114.6	113.1	1.5	1.0	0.9
GRGDPPGQ Index	GDP (% qoq)	3 2017	23/05/2017	0.6	0.6	0.0	-0.1	0.3
GRIMP95Y Index	Import Price Index (% yoy)	4 2017	30/05/2017	6.1	6.3	-0.2	0.2	0.5
GRFRIAMM Index	Retail Sales (% mom)	4 2017	31/05/2017	-0.2	0.3	-0.5	-0.1	0.4
GRUECHNG Index	Unemployment Change (000's mom)	5 2017	31/05/2017	-8.0	-15.0	-7.0	-0.5	0.3
MPMIDEMA Index	Markit Manufacturing PMI	5 2017	01/06/2017	59.5	59.4	0.1	0.1	0.5
MPMIDESA Index	Markit Services PMI	5 2017	05/06/2017	55.4	55.2	0.2	0.2	0.7
GRIORTMM Index	Factory Orders (% mom)	4 2017	07/06/2017	-2.1	-0.3	-1.8	-0.9	0.2
GRIPIMOM Index	Industrial production (% mom)	4 2017	08/06/2017	0.8	0.5	0.3	0.3	0.6
GRCAEU Index	Current Account Balance (EUR bn)	4 2017	09/06/2017	15.1	24.5	-9.4	-3.1	0.0
GRZEWI Index	ZEW Survey Expectations	6 2017	13/06/2017	18.6	21.7	-3.1	-0.4	0.3
GRZECURR Index	ZEW Survey Current Situation	6 2017	13/06/2017	88.0	85.0	3.0	0.3	0.7
GRCP20YY Index	CPI (% yoy)	5 2017	14/06/2017	1.5	1.5	0.0	0.2	0.3
MPMIDESA Index	Markit Services PMI	6 2017	23/06/2017	53.7	53.7	0.0	0.0	0.5
GRIFPBUS Index	IFO Business Climate	6 2017	26/06/2017	115.1	114.5	0.6	0.3	0.6
GRIMP95Y Index	Import Price Index (% yoy)	5 2017	28/06/2017	4.1	4.6	-0.5	-0.1	0.4
GRCP20YY Index	CPI (% yoy)	6 2017	29/06/2017	1.6	1.4	0.2	1.4	0.9
GRFRIAMM Index	Retail Sales (% mom)	5 2017	30/06/2017	0.5	0.3	0.2	0.4	0.7
GRUECHNG Index	Unemployment Change (000's mom)	6 2017	30/06/2017	7.0	-10.0	-17.0	-0.9	0.1
MPMIDEMA Index	Markit Manufacturing PMI	6 2017	03/07/2017	59.6	59.3	0.3	0.3	0.7

Sources: Bloomberg Finance LP, Deutsche Bank Research

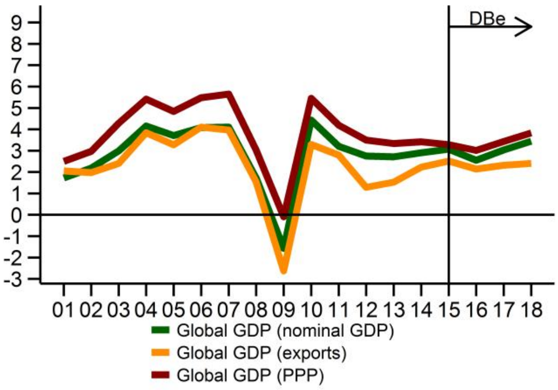
Updated by Marc Schattenberg and Jochen Möbert (+49 69 910-31727, jochen.moebert@db.com)
Source: Heiko Peters (2014). DB German Macro Surprise Index. Focus Germany, 4 August 2014.

German Export Indicator

The Export Indicator identifies the effects on German exports of changes in global demand on the one hand, and currency movements on the other (price impact).[3]

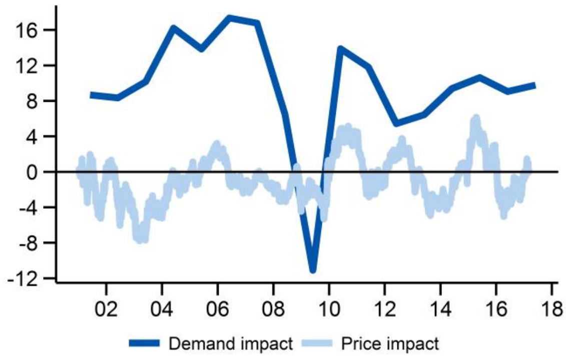
Global growth expected to accelerate

% yoy, weighting factor in brackets



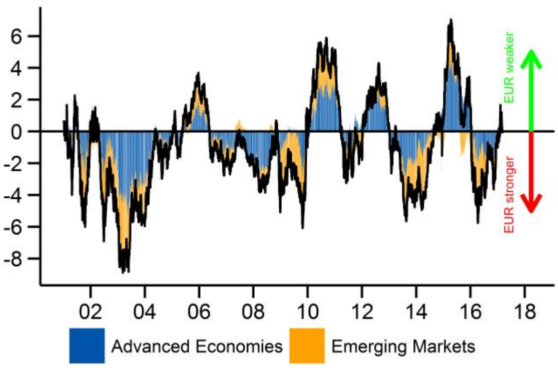
Demand and price impact for German exports

% yoy



Price impact about neutral so far in 2017

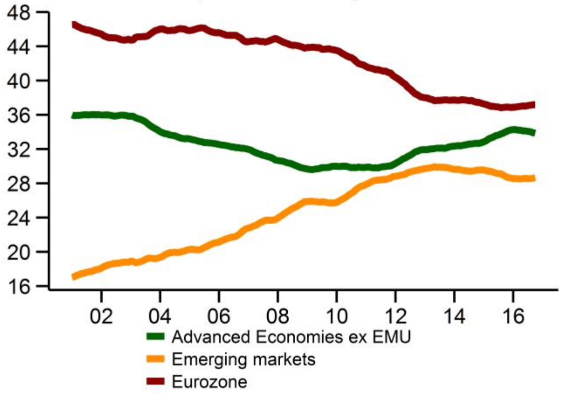
% yoy



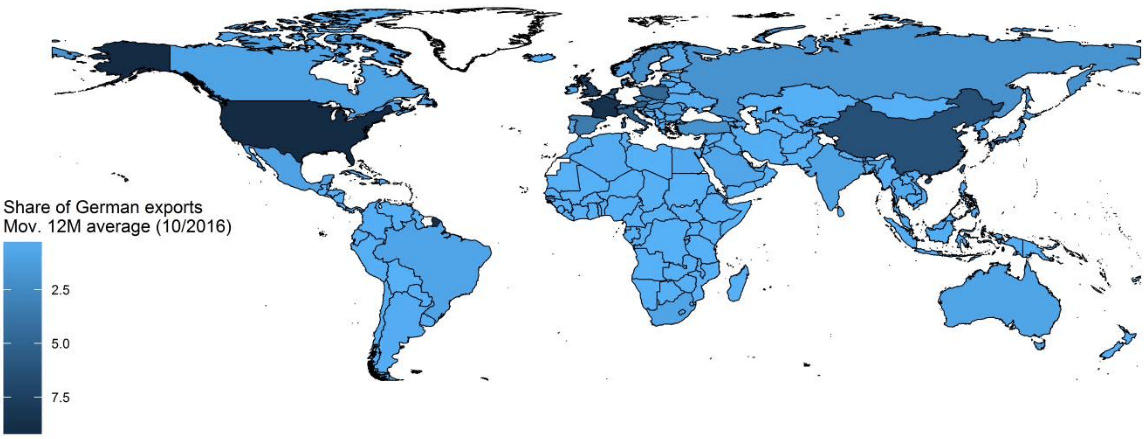
Weighed EUR yoy change using German export destination shares

Importance of EMU increased again recently

% of total German exports, 12M mov. avg.



German exports focus on Europe, the USA and China



Sources: Eurostat - Comext, Deutsche Bank Research

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[3] See for details Focus Germany, March 3, 2016.

Overheating risks are looming

Germany: Events of economic-, fiscal- and euro-politics

Date	Event	Remarks
7-8 July	G20 Summit, Hamburg	Debates on international economic, fiscal policy, trade and climate policy issues, among others. The G20 summit will attract special attention as it is the first such event that US President Trump will visit.
10-11 July	Eurogroup and ECOFIN, Brussels	Debates on deepening of the EMU, (poss.) Stability & Growth Pact implementation for euro area countries; (poss.) Follow-up on DBP and euro area fiscal stance; thematic discussion on growth and jobs: insolvency frameworks; Ireland – Post-Programme Surveillance - 7th review
20 July	ECB Governing Council meeting, press conference	Our baseline is a 'slow and extend' decision on QE in September. However, until the economy tells the ECB it is more compelling, tighter financial conditions mean risk of a 'stop/start' exit.
1 July to 4 Sep	Bundestag (German lower house), Berlin	Summer recess.
7 Sep	ECB Governing Council meeting, press conference	We expect tapering to be pre-announced (see July 20).
15-16 Sep	Eurogroup and ECOFIN, Tallinn	Thematic discussion on growth and jobs: economic resilience in EMU; (poss.) Greece – state of play.
24 Sep	Federal election	According to recent polls the CDU/CSU will come in as the strongest party by far. However, it is still open which parties will build the next coalition government.
4 Oct	ECB Governing Council meeting, press conference	Review of monetary policy stance.
9-10 Oct	Eurogroup and ECOFIN, Luxembourg	Debates on exchange rate developments, thematic discussion on growth and jobs – financing of labour tax cuts, (poss.) Portugal - Post Programme Surveillance – 6th review, Greece – state of play.
19-20 Oct	European Council, Brussels	(Poss.) Debates on the future of the EU and (poss.) on the Brexit negotiations.

Source: Deutsche Bank Research

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Germany: Data calendar

Date	Time	Data	Reporting period	DB forecast	Last value
6 Jul 2017	8:00	New orders manufacturing (% mom, sa)	May	1.0	-2.1
7 Jul 2017	8:00	Industrial production (% mom, sa)	May	0.5	0.8
10 Jul 2017	8:00	Trade balance (EUR bn, sa)	May	20.0	19.8
10 Jul 2017	8:00	Merchandise exports (% mom, sa)	May	0.2	0.9
10 Jul 2017	8:00	Merchandise imports (% mom, sa)	May	0.5	1.2
24 Jul 2017	9:30	Manufacturing PMI (Flash)	July	59.8	59.6
24 Jul 2017	9:30	Services PMI (Flash)	July	54.2	53.7
25 Jul 2017	10:30	ifo business climate (Index, sa)	July	115.0	115.1
28 Jul 2017	14:00	Consumer prices preliminary (% yoy, nsa)	July	1.6	1.6
31 Jul 2017	8:00	Retail sales (% mom, sa)*	June	-0.1	0.5
31 Jul 2017	09:55	Unemployment rate (%, sa)	July	5.7	5.7

*An earlier data release may be possible due to the Federal Statistical Office.
Sources: Deutsche Bank Research, Federal Statistical Office, Federal Employment Agency, ifo, Markit

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Overheating risks are looming

Financial Forecasts

	US	JP	EMU	GB	CH	SE	DK	NO	PL	HU	CZ
Key interest rate, %											
Current	1.125	-0.10	0.00	0.25	-0.75	-0.50	0.05	0.50	1.50	0.90	0.05
Sep 17	1.125	-0.10	0.00	0.25	-0.75	-0.50	0.05	0.50	1.50	0.90	0.15
Dec 17	1.375	-0.10	0.00	0.25	-0.75	-0.50	0.05	0.50	1.50	0.90	0.25
Mar 18	1.625	-0.10	0.00	0.25	-0.75	-0.50		0.50	1.50	0.90	0.75
3M interest rates, %											
Current	1.30	0.06	-0.34	0.31							
Sep 17	1.38	0.05	-0.30	0.40							
Dec 17	1.63	0.05	-0.30	0.40							
Mar 18	1.88	0.05	-0.30	0.40							
10J government bonds yields, %											
Current	2.29	0.09	0.46	1.25							
Sep 17	2.50	0.03	0.50	1.10							
Dec 17	2.75	0.00	0.65	1.40							
Mar 18		0.00	0.75	1.65							

Exchange rates

	EUR/USD	USD/JPY	EUR/GBP	GBP/USD	EUR/CHF	EUR/SEK	EUR/DKK	EUR/NOK	EUR/PLN	EUR/HUF	EUR/CZK
Current	1.14	112.53	0.88	1.30	1.09	9.66	7.44	9.57	4.23	308.97	26.19
Sep 17		116.00	0.88	1.32	1.05	9.43	7.46	9.25	4.13	310.19	26.30
Dec 17	1.16	118.00	0.91	1.29	1.00	9.25	7.46	9.00	4.10	312.00	26.00
Mar 18		119.00		1.28	1.01	9.13		8.88	4.20	313.50	25.93

Sources: Bloomberg Finance LP, Deutsche Bank Research

Overheating risks are looming

German data monitor

	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Feb 2017	Mar 2017	Apr 2017	May 2017	Jun 2017	Jul 2017
Business surveys and output											
Aggregate											
Ifo business climate	108.3	110.7	111.1	114.2		111.1	112.2	113.0	114.6	115.1	
Ifo business expectations	102.4	105.6	104.2	106.2		104.0	105.4	105.2	106.5	106.8	
Industry											
Ifo manufacturing	102.8	105.3	106.0	109.5		105.8	107.7	107.9	110.3	110.4	
Headline IP (% pop)	0.2	0.0	1.4			1.8	-0.1	0.8			
Orders (% pop)	0.1	4.2	-1.0			3.5	1.1	-2.1			
Capacity Utilisation	84.8	85.7	86.0	86.0							
Construction											
Output (% pop)	1.7	-1.4	4.7			17.0	2.7	-1.7			
Orders (% pop)	-4.3	7.9	0.7			1.8	-0.7	0.9			
Ifo construction	126.9	129.6	128.3	130.2		127.4	128.5	129.8	130.5	130.3	
Consumer demand											
EC consumer survey	-2.5	-1.5	-0.6	3.6		-2.1	0.2	2.8	3.1	5.0	
Retail sales (% pop)	0.5	0.8	0.2			1.0	0.7	-0.2	0.5		
New car reg. (% yoy)	4.2	-0.3	6.7	0.0		-2.7	11.4	-8.0	12.9	-3.5	
Foreign sector											
Foreign orders (% pop)	1.8	3.1	-0.4			0.4	4.6	-3.4			
Exports (% pop)	-0.2	2.4	2.8			1.0	0.4	0.9			
Imports (% pop)	1.7	3.5	3.6			-1.5	2.1	1.2			
Net trade (sa EUR bn)	61.2	60.1	59.9			21.2	19.8	19.8			
Labour market											
Unemployment rate (%)	6.1	6.0	5.9	5.7		5.9	5.8	5.8	5.7	5.7	
Change in unemployment (k)	-30.3	-32.0	-58.7	-40.0		-15.0	-27.0	-14.0	-8.0	7.0	
Employment (% yoy)	1.2	1.3	1.5			1.5	1.5	1.5	1.5		
Ifo employment barometer	109.0	111.1	110.3	111.1		110.7	109.4	111.4	110.8	110.9	
Prices, wages and costs											
Prices											
Harmonised CPI (% yoy)	0.4	1.0	1.9	1.6		2.2	1.5	2.0	1.4	1.5	
Core HICP (% yoy)	1.1	1.2	1.0			1.1	0.9	1.6	1.1		
Harmonised PPI (% yoy)	-1.7	0.2	2.8			3.1	3.1	3.4	2.8		
Commodities, ex. Energy (% yoy)	2.9	19.2	32.7	8.9		37.7	26.3	16.5	8.3	2.0	
Crude oil, Brent (USD/bbl)	46.6	51.1	54.5	50.8		56.0	52.6	53.8	51.4	47.6	49.7
Inflation expectations											
EC household survey	6.2	10.0	18.9	17.6		18.9	20.6	17.4	17.5	17.9	
EC industrial survey	3.0	6.2	13.0	12.2		13.8	13.8	11.7	13.4	11.4	
Unit labour cost (% yoy)											
Unit labour cost	1.8	2.3	1.1								
Compensation	2.3	2.3	2.3								
Hourly labour costs	2.4	3.4	0.8								
Money (% yoy)											
M3	6.6	5.7	6.0			5.6	6.0	5.1	4.9		
M3 trend (3m cma)	7.0	5.4	5.7			5.6	5.7	5.5	5.3		
Credit - private	2.6	2.9	3.3			3.0	3.3	3.1	3.2		
Credit - public	-0.1	8.9	21.0			18.4	21.0	11.5			

% pop = % change this period over previous period.
Sources: Deutsche Bundesbank, European Commission, Eurostat, Federal Employment Agency, German Federal Statistical Office, HWWI, ifo, Markit

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