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German industry

Output growth to remain shy of 1% in 2015

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Following weak performance in winter half-year 2014/15 industrial production in Germany is likely to return to a moderate uptrend in the course of 2015, resulting in expansion of roughly 1.5% in real terms in 2014 and about ¾% in 2015. This means the generally muted dynamics of industrial performance in evidence since 2011 would continue in 2015. Industry's share in total German gross value added (2013: 21.8%) will probably decline again, as in 2012 and 2013.

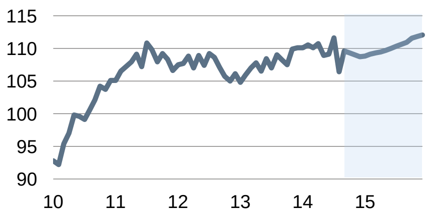
We expect both the automotive industry and mechanical engineering to increase their output by roughly 1% in 2015. While mechanical engineering should thus slightly improve its performance over 2014 (stagnation), the auto industry should see its growth cool noticeably (2014: +4%). Electrical engineering is poised for a round of stagnation in 2015 – following a 1.5% increase in 2014. Chemicals production is likely to add 2.5% in 2015; however, this would "only" neutralise the setbacks in 2014.

The only moderate growth of industry is primarily attributable to the currently subdued level of business activity and external shocks. Nonetheless, structural factors are going to regain importance. The ball is now in the politicians' court. Many of their recently adopted measures give rise to fears that Germany's international competitiveness as an industrial location is likely to decline.

To ensure profitable production in Germany in the long run against the backdrop of globalisation the country needs to offer a coherent policy environment. When Germany was the "sick man of Europe" roughly ten years ago, this also applied to some segments of German industry. Today, thanks to the policies of the Agenda 2010 and various entrepreneurial measures, German industry is in excellent shape compared with its counterparts in the EU. However, many of Germany's old and new competitors are located outside of Europe. Globalisation is a demanding taskmaster, but German industrialists and Germany as an industrial location have the potential to cope with the challenges in the long term.

Moderate uptrend following dip in 2015

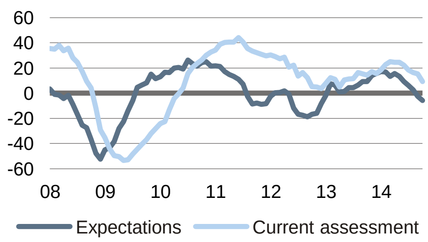
Manufacturing, real production index, 2010=100, seasonally adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

Current assessment still good, expectations clouded

Manufacturing, balance of positive and negative company reports

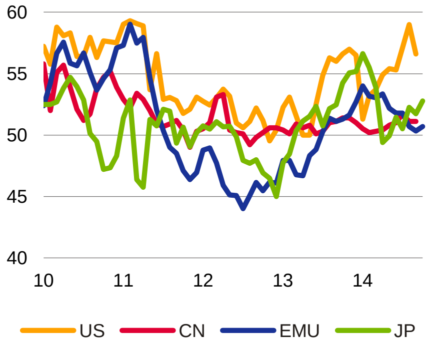


Source: ifo Institute

German industry: Output growth to remain shy of 1% in 2015

Subdued sentiment recently in the eurozone in particular 1

Purchasing Managers' Index, seasonally adjusted



Sources: ISM, Markit, National Bureau of Statistics of China

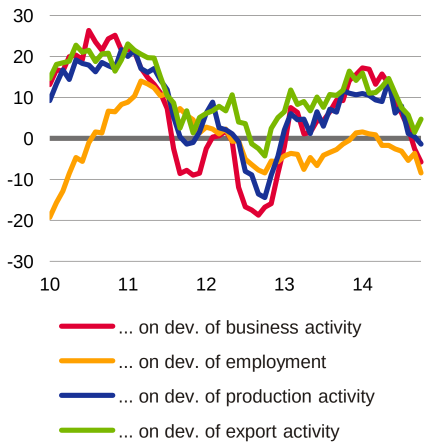
Forecasts for Germany: GDP growth by component (% yoy) 2

	2013	2014P	2015P
GDP	0.1	1.5	1.5
Private consumption	0.8	1.0	1.5
Public expenditure	0.7	0.8	0.5
Capital expenditure	-0,7	3.5	2.4
Machinery & equipment	-2,7	3.9	3.1
Construction	-0,1	3.6	2.8
Inventories (pp)	0.2	0.3	0.2
Exports	1.6	3.6	6.0
Imports	3.1	4.7	7.1
Net exports (pp)	-0,5	-0,2	-0.1
Consumer prices	1.5	0.8	1.4
Unemployment rate (%)	6.9	6.7	6.8

Sources: Federal Statistical Office, Bundesbank, Federal Employment Agency, Deutsche Bank Research

German industry: Decline in sentiment indicators 3

Company expectations, balance of positive and negative company reports



Source: ifo Institute

Macroeconomic environment: Risks to growth on the rise

The German economy has faced considerable headwinds over the past few months. The higher geopolitical risks – the conflict in eastern Ukraine in particular – are weighing on sentiment in Germany and the rest of Europe and have already led to poorer economic figures in real terms. The Purchasing Managers' Index has shown a sharp downtrend in the eurozone of late. All in all, the risks are reinforcing companies' reluctance to invest. This means that the economic recovery in the eurozone is making only slow progress and is continually being impacted by negative news from individual countries. True, the United States and China are reporting significantly stronger GDP growth than Europe, and the US growth rate is in fact expected to accelerate in 2015. Nonetheless, the two countries have recently been sending mixed signals that warrant caution. Taken together, the factors discussed are already reflected in a slight decline of German GDP in Q2 2014, although statistical effects did also play a role.

Our outlook for 2015 is influenced by the factors cited above. We generally expect Germany to return to a path of expansion over the next few quarters. However, this expansion is likely to be moderate and remain vulnerable to external shocks. Private consumption should be a pillar of growth in 2015, with an increase here of 1.5% in real terms benefiting consumption-related sectors. The main driver of the increase is likely to be wage settlements, which according to our forecast will (again) outstrip the long-term average in 2015. The labour market should also remain relatively robust, even though we look for a slight uptick in the unemployment rate. Furthermore, the build-up in employment of the past few years is likely to come to a standstill – at a high level. The first negative consequences of the German government's legislation on minimum wages and pension levels are starting to materialise. Finally, the continuing inflows of immigrants to Germany are a stimulus for domestic demand.

On the investment side, we expect to see further growth of capital spending in 2015. We currently forecast an increase in investment in machinery and equipment of just over 3% in 2015, though with still weak performance in winter 2014/15. The growth we predict from Q2 2015 is predicated on the global economy staging a strong recovery, more reforms being addressed in the eurozone and the geopolitical risks starting to ease. Higher investment in machinery and equipment is likely to lend impetus to Germany's capital goods sector during 2015. Investment in construction is set to increase by close to 3% in real terms. Here, (private) residential construction remains the most important pillar. Recently, the number of building permits has trended up steadily. Extreme weather conditions could boost the volatility of investment in construction.

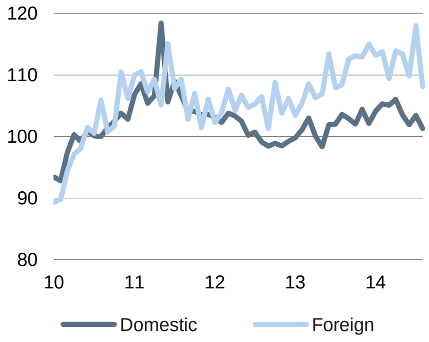
We believe that German exports are poised to jump by 6% in real terms. This ought to support key branches of German industry in 2015. The prospect of noticeably higher export growth than in 2014 hinges heavily on the forecast of a US recovery. At the same time, though, German imports are likely to surge by around 7%, so the contribution of net exports to GDP growth could in fact be marginally negative in 2015.

The interest rate environment remains favourable for the business sector. True, we expect inflation to accelerate in Germany in the coming year, to 1.4% (2014: 0.8%). However, since the economic recovery in the eurozone remains feeble and the EMU inflation rate will probably only barely top the 1% mark, the ECB is set to maintain its expansionary policy. Moreover, export-oriented sectors should benefit from the euro's potential (further) slide vis-à-vis the US dollar in 2015. The recent fall in commodity prices also brings relief on the cost side, even though this effect is slightly offset by the weaker euro in the case of imported commodities and those invoiced in US dollars (e.g. petroleum).

German industry: Output growth to remain shy of 1% in 2015

Orders: High volatility 4

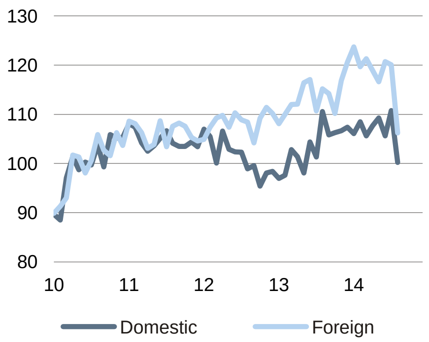
Manufacturing, real order intake, 2010=100, seasonally adjusted



Source: Federal Statistical Office

Recent drop in orders distorted by statistical effect 5

Automotive industry, real order intake, 2010=100, seasonally adjusted



Source: Federal Statistical Office

Growth of manufacturing output to slip below 1% in 2015

Manufacturing performance is naturally driven in part by the macroeconomic environment. At the latest reading, order intake and production were very volatile, though this is mainly attributable to one-off effects in the automotive industry (shift in the holiday-related factory shutdown period). All in all we reckon that industrial production will fall slightly in Q4 2014 versus Q3 in seasonally adjusted terms, and roughly flatline in Q1 2015 versus Q4. The expectations component of business sentiment has declined recently, pointing to subdued performance. Domestic industrial output should start to pick up again from roughly the second quarter of 2015, with stimuli likely coming both from abroad and from the home market.

The production scenario outlined above will probably lead to a roughly 1.5% (real) increase in manufacturing output in Germany for 2014 as a whole. Considering that industry had started 2014 with a statistical overhang and the growth expectations at the time were still mostly positive, in the end this could almost be classed as a disappointment. The year 2014 provides another example of how largely unpredictable external shocks (Ukraine crisis) can impact actual economic performance and make it difficult to forecast.

Germany's manufacturing industry is set to start 2015 with a slight statistical underhang. As a result, domestic output is likely to grow by "only" about ¾% in real terms for the year as a whole, even though we still expect an upswing to kick in from about Q2. This means the generally very muted dynamics of industrial activity in evidence since 2011 would continue in 2015. In such a growth environment it would already be an achievement if the currently high employment level in German industry could be maintained. The share of industry in total gross value added in Germany is probably going to continue to decline for the years 2014 and 2015 (as already in 2012 and 2013), even though German industry is in a much better position than the rest of Europe.

Auto industry: Substantially less drive in 2015

Auto industry output in Germany increased by 1.2% in real terms in 2013. Given the weak demand for cars in Germany and elsewhere in Europe this was a respectable result. The commercial vehicle segment helped prop up activity.

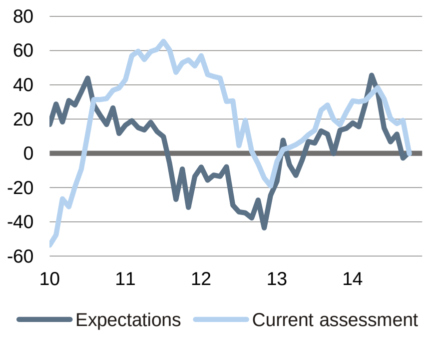
So far, 2014 has been a much better year for the industry. There are many reasons for this: by end-2013, demand for passenger cars had started to show signs of a turnaround in western Europe after a multi-year slump. This uptrend continued in the first few months of 2014. For the year as a whole, new car registrations in the EU look set to pick up by about 4%, albeit from a very low level. Since German brands claim a market share of 50% or so in the EU and many of the vehicles sold in the EU are manufactured in German factories, domestic production stands to benefit. Demand from Spain and the UK has proved particularly dynamic in 2014. In the first eight months of 2014, the value of auto industry exports (including suppliers) to these two countries exceeded the year-earlier level by 23% and close to 16%, respectively. In Germany, too, new car registrations will probably climb by about 3% in 2014.

The sector will be boosted by non-European demand as well. The main markets in this context are China and the US, where car demand continues to boom. The value of exports from Germany to these two countries has risen by 24% and 4% yoy, respectively, so far this year, even though German manufacturers continue to expand their local production. All in all, the higher exports to the markets mentioned may be able to compensate for the huge slump in exports to Russia (Jan-Aug 2014: -27% yoy).

German industry: Output growth to remain shy of 1% in 2015

Current situation better than sentiment 6

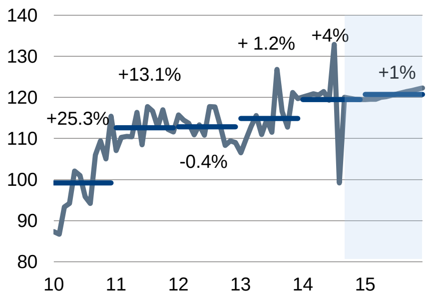
Automotive industry, balance of positive and negative company reports



Source: ifo Institute

Growth slowing noticeably 7

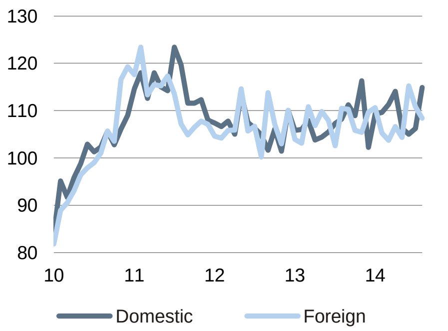
Automotive industry, real production index, 2010=100, seasonally adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

Orders: Differing directions 8

Mechanical engineering, real order intake, 2010=100, seasonally adjusted



Source: Federal Statistical Office

On balance, especially foreign demand is the main factor underpinning the German auto industry's good performance. In the first eight months of this year, domestic production was up by a real 5.7% on the corresponding level of the previous year. By contrast, our forecast looks for an "only" 4% or so increase for 2014 as a whole, since the demand stimuli from abroad will probably lose some of their intensity as the year progresses. For example, the Ukraine crisis is having a negative impact on sentiment among commercial and private car buyers alike in Europe, putting a damper on the general recovery process. Moreover, unit sales in the UK are now at such a high level that demand is increasingly likely to start cooling for basis reasons. The booming growth of car demand in the US and China during the first half of 2014 is also unlikely to continue, meaning that the average rates cannot be upheld during the second half.

The geopolitical risks and their spillover effects on overall sentiment in Europe in particular are reflected in the automakers' business expectations, which have declined more or less steadily during the last few months. Capacity utilisation was down in the fourth quarter of 2014.

The demand impetus for the German automotive industry from abroad is likely to fall again in 2015. The geopolitical risks and domestic policy issues are already severely testing the tentative recovery of car sales in the euro area again. While we do not expect car demand in the eurozone to shift back into reverse, an increase of more than roughly 2% is not very probable as things stand today. In Germany, new car registrations are scarcely likely to climb faster. In the UK, the US and China, the growth of car demand is poised to slow noticeably in the coming year versus 2014. Moreover, the US and China are increasingly being supplied from local production. And, in the extreme, exports to Russia could collapse in 2015 owing to potential economic sanctions. This is not our baseline scenario, though. At the end of the day, the German auto industry will probably only manage to boost output by about 1% in real terms on average in 2015. A statistical effect will play a part here, too, since the industry is likely to head into 2015 with a small statistical underhang.

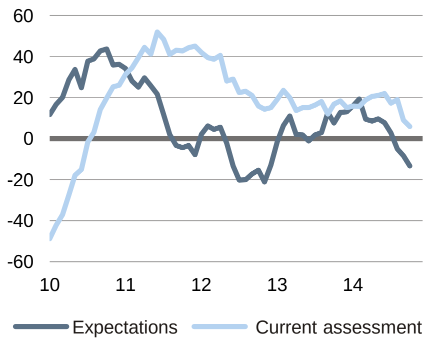
Mechanical engineering feeling the reluctance to invest

Germany's mechanical engineering industry staged a swift recovery after the worst of the 2008/09 global economic crisis. In the following two years (i.e. 2010 and 2011), it posted double-digit output growth but was subsequently unable to maintain a similar pace. Quite the contrary, in fact: after only slight higher real output in 2012 (+1.2%) and a roughly identical decline in 2013 (-1.6%), 2014 has been the third year of unassuming growth since domestic production will probably do little better than stagnate. Three consecutive years of a – more or less – sideways trend are anything but normal for a sector such as mechanical engineering in Germany. Especially the mechanical engineering sector is typically subject to, and follows, the fluctuations in the investment behaviour of its customer groups – from the auto industry to construction.

The sideways movement of the otherwise cyclically very vulnerable mechanical engineering industry right up to the current year ultimately results from several factors acting in different directions. On the cost side, falling commodity prices have (had) a positive impact on engineering, for example in the case of non-ferrous metals, which play a key part in production. On top of this, market interest rates have continued to drift downwards until recently, so funding costs for mechanical engineering investments have been favourable in comparison with other growth phases and also earlier business cycles. Of course, the above is set against risks that are clouding investor sentiment in general. Currently, a major concern has been the uncertainty surrounding the Russia/Ukraine conflict. This is undermining the increased propensity to invest in Russia seen over the

Expectations have been falling since the year started 9

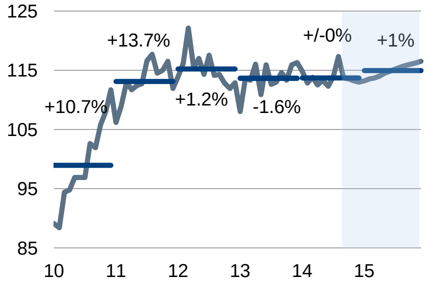
Mechanical engineering, balance of positive and negative company reports



Source: ifo Institute

Still low momentum 10

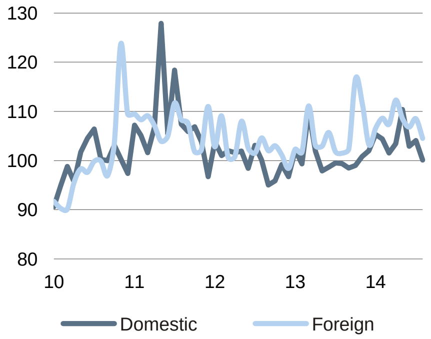
Mechanical engineering, real production index, 2010=100, seasonally adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

Picture darkening again 11

Electrical engineering, real order intake, 2010=100, seasonally adjusted



Source: Federal Statistical Office

past few years among Western European and German investors in particular – from the auto industry and energy companies right through to small and medium-sized mechanical engineering firms. In fact, the uncertainty is reversing the trend. Therefore, the currently very negative experience will probably linger in people's minds long after the conflict and make investors more cautious about business commitments in the East.

Of course, not all of the over 30 segments of the German mechanical engineering sector will perform as well as the average in 2014. Makers of mining machinery are feeling the pinch of the internationally weak price trends for mining products and thus also of the reduced global investment activity in this sector. Moreover, the producers of printing and paper equipment will probably have a below-average year. By contrast, the robotics and automation, fluid technology and power systems (turbines) segments are likely to outperform the mechanical engineering sector as a whole.

For 2015, assuming an easing of the current regional conflicts, not least in Eastern Europe, and thus a return to a more stable global economy, we expect the mechanical engineering sector to pick up again gradually in the course of the year. Mechanical engineers, who rely on investment activity in the constituent segments of their own sector and in other branches of industry including mining and construction, will probably start into 2015 without a statistical overhang. However, in the absence of political irritations in particular, there are good chances of order intake developing more favourably. An improving propensity to invest would play to German mechanical engineers' advantage, as this could help them to achieve a net increase in domestic output of 1%. One advantage for the domestic sector is that it could probably operate in a still favourable interest environment again in 2015. Furthermore, the cheaper euro in relation to the US dollar will stimulate the again better prospects for US sales. And China business, which has risen in importance over the past few years, will probably lend further impetus, albeit no longer with the booming growth of earlier years given the change of industrial policy there.

Electrical engineering: Still on a rocky road

The electrical engineering industry covers a broad range of consumer goods, capital goods and intermediate goods. With its products the industry is particularly well focused on international markets in the face of still burgeoning world trade. Much of this growth is due to the rapid developments in the Far East.

Electrical engineering performance has always been marked by pronounced volatility. For instance, order intake declined by 5.9% in 2012, only to increase by 1.5% in 2013. Since order intake started 2014 with a statistical overhang of 2.6% thanks to tailwinds from abroad, the order books have meanwhile filled up more quickly again. Domestic orders have risen 2.8% yoy so far in 2014, and foreign orders by no less than 3.9%. This currently puts total order intake 3.4% higher than in the year-earlier period.

In a very similar vein, the business climate indicators have also always fluctuated very strongly. For example, business expectations fell by 8.9 index points in 2012 on average vis-à-vis 2011, only to leap by 18.1 points in 2013 and thus surge back into positive territory. The indicator for the assessment of the current business situation dropped by no less than 26.5 points on average versus the previous year in 2012, and then 7.5 points in 2013. Currently, business expectations and the assessment of the current situation have deteriorated again following a spike in the first quarter.

Somewhat contrary to incoming orders and the business climate as outlined above, the amplitude of production growth has been exceptionally small most

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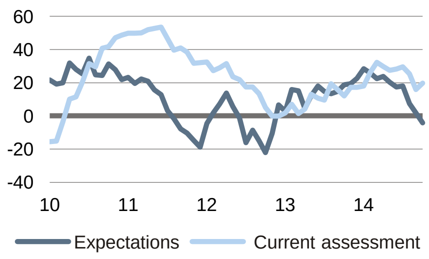
Recovery of business climate indicators is over | 12

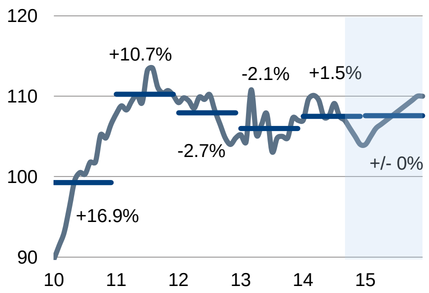
Electrical engineering, balance of positive and negative company reports



Source: ifo Institute

Return to uptrend during 2015 | 13

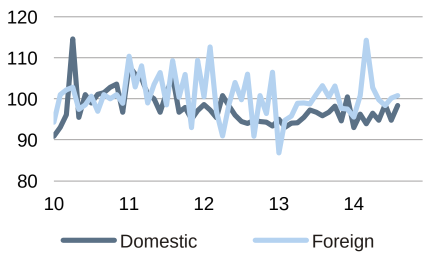
Electrical engineering, real production index, 2010=100, seasonally adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

Domestic orders starting to trend up | 14

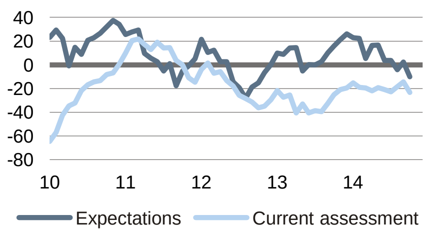
Metals production and processing, real order intake, 2010=100, seasonally adjusted



Source: Federal Statistical Office

Negative assessment of current situation for over two years | 15

Metals production and processing, balance of positive and negative company reports



Source: ifo Institute

recently following years of major fluctuations. The significant declines in the telecommunications technology and consumer electronics segments contrasted with good performance in the measuring and monitoring equipment segment, with industry output thus shrinking by 2.1% in real terms in 2012 and 1.8% in 2013. Sector production began the year 2014 with a statistical overhang of 1%, but this has meanwhile flattened out, partly because of the downturn in the electro-medical equipment segment. Thanks to the currently favourable trends for consumer electronics, but especially for electronic components, the production level in the electrical engineering industry is still up 2.4% on the year-earlier period.

Owing to the currently very uncertain geopolitical and economic situation and the "modest" developments in customer industries, we expect that the sector's prospects could gradually brighten again during 2015 following a weak phase over the next few months. With an easing of the geopolitical uncertainties, not only Industry 4.0, energy efficiency and the digital agenda but also the exchange rate could give this growth a fillip. All in all, we look for sector output to grow by 1.5% in real terms in 2014 and 0% in 2015; this will be partly due to the continuation of the growth pattern and the resulting statistical underhang at the upcoming turn of the year. In the medium term the growth potential of the electrical engineering industry will increasingly be driven by international competition. In this context, wage costs and productivity are the main factors which will play an even greater role.

Slowing user-industry dynamics feeding through to metals industry

Metals production losing considerable momentum

Germany's metals industry headed into 2014 with considerable hopes pinned on favourable developments in the economy as a whole and hence among its chief user industries. During the year to date, the metal producers' expectations have weakened substantially, though. One of the main reasons for this has been easing momentum in industrial sectors that are ultimately key customers of the metals industry. For instance – as discussed – Germany's mechanical engineering sector has also lost noticeable momentum since the year began.

Also a negative factor for the metals industry at present is its main geographical sales area. Given the relevance of transport costs the industry's focus is squarely on Europe. And the Old Continent has been labouring particularly – for years now – under the burden of structural problems (excess capacities), which have led to the fact that industrial production in many European user countries is currently in much worse shape than in Germany. What this boils down to is that the metal producers will not be able to boost output in 2014 to the degree expected back at the turn of the year. While 4% output growth still seemed feasible in the first months of the year, now the annual average will probably work out to only about 1%.

The outlook for 2015 is by no means better at this juncture. Indeed, we expect the metal producers' output to start to pick up in the course of the coming year. However, since the sector will have a statistical underhang at the outset, the outcome will probably show little more than stagnation. This is also suggested by the equally subdued performance of major user industries (mechanical engineering, automotive, electrical engineering). On the cost side, the German metals industry benefits from the fact that, thanks to recycling, a sizeable quantity of its inputs are now sourced in the home market. Note that we expect non-ferrous metals such as nickel and lead to command higher prices in 2015 than in 2014 – moreover on a higher valuation of the invoicing currency (i.e. USD) versus the euro, which additionally boosts the cost of importing ores and metals.

German industry: Output growth to remain shy of 1% in 2015

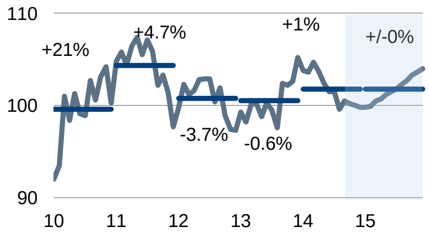
Prices of intermediates falling 16

Prices of iron ore and scrap steel in Germany, EUR basis, 2010=100

Source: HWWI

Trending up in 2015, stagnation on average 17

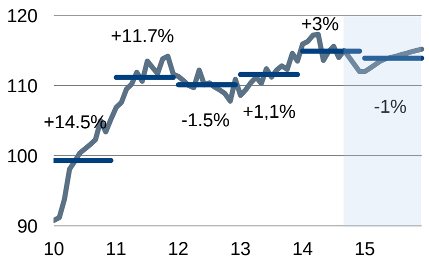
Metals production and processing, real production index, 2010=100, seasonally adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

2015: Production down slightly 18

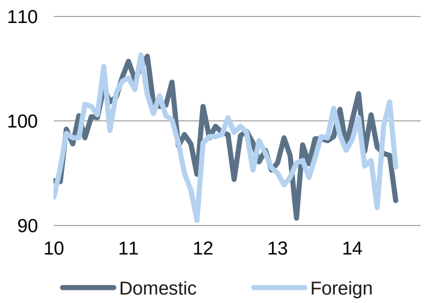
Metal products, real production index, 2010=100, seasonally adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

Domestic orders trending weaker 19

Chemicals industry, real order intake, 2010=100, seasonally adjusted



Source: Federal Statistical Office

Metals processing facing dip in production

The business expectations of makers of metal products have fallen somewhat versus their outlook at the start of 2014, and have slid into negative territory of late. This as well as the gradually darkening overall growth picture in Europe are strong signals of slowing order activity for metal products in the coming months. However, the metalworkers did start into 2014 with a production overhang and therefore they are likely to end the year with real output growth of roughly 3%.

The recent improvement in real incomes should benefit consumption-related metal products such as tools and household goods in 2015. The other metals segments are also expected to enjoy better prospects again in the course of 2015 once the many regional conflicts, also in Europe of late, start to abate. If the reluctance to invest gradually wears off in 2015 there should be a resurgence of demand for industrial and construction-related metal products – ranging from lightweight components for the auto industry right though to radiators for the building industry. All things considered, we expect the sector to see an improvement in order volumes and production in 2015. Nonetheless, the fact that metals processing could post a slight decline (1%) in real output is linked with the prospect of year-end 2014 seeing a production underhang that will weigh on the year-on-year comparison in 2015.

Chemicals industry set for noticeable recovery in 2015

2013 was a pretty stable year for the chemicals industry – production increased by 0.5% in real terms. By contrast, the first eight months of the current year saw a real downturn of 1.9% yoy. The decline was surprisingly pronounced in H1 2014 in particular. Recently, however, business has started to trend upwards again.

On the other hand, order intake fell by 1.1% in real terms in the chemicals industry in 2013 vis-à-vis 2012. This was primarily driven by lower foreign orders (-1.4%; domestic: -0.7%), which account for around 50% of total demand. In the year to date, production and incoming orders have moved in differing directions. During the first eight months of the year output – as mentioned – fell short of the year-earlier figure by 1.9%, while in the same period orders were up 1.6% in real terms on the year. Interestingly, real turnover and real output always used to run more or less in parallel – despite the recent upward revision to the production data – yet since the beginning of 2014 the two have largely decoupled. In plain English: sector turnover has developed better than domestic output. This performance was driven particularly by the basic chemicals segment.

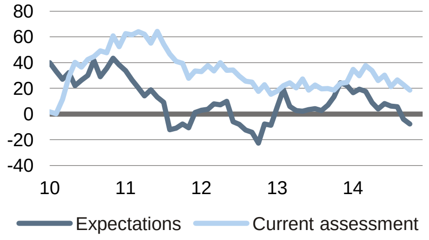
Following a fairly long sideways trend for chemicals in both components of the ifo business climate index in 2013, both expectations and the assessment of the current situation surged at year-end. However, both indicators have been on the decline again in the current year. The indicator of the current business situation has remained positive, though, while the expectations component has fallen into negative territory.

Capacity utilisation again proved to be pretty volatile in 2013 and climbed towards year-end. In 2014, the volatility has continued with a decline in Q3 and Q4. For full-year 2014 we expect output to continue on its recent uptrend, albeit at a low level. One indicator for the anticipated improvement is the development of producer prices, which have edged up slightly of late. The already emerging uptrend in production distinguishes the chemicals industry – traditionally a cyclical leader – from the other major branches of industry, which have had a much better start into 2014 though. In this respect the chemicals industry can regain some lost ground, but for the full year we nonetheless look for output to fall by about 2.5%.

German industry: Output growth to remain shy of 1% in 2015

Expectations have turned negative 20

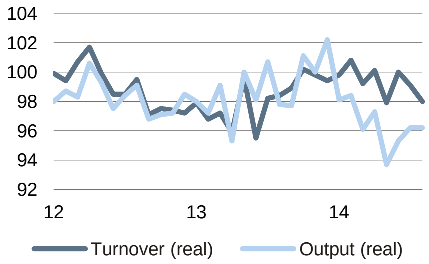
Chemicals industry, balance of positive and negative company reports



Source: ifo Institute

Chemicals: Turnover and output trends decoupled 21

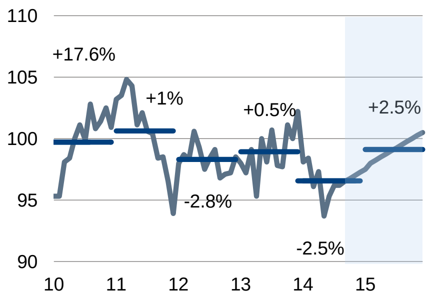
2010=100, seasonally adjusted



Source: Federal Statistical Office

No recovery until 2015 22

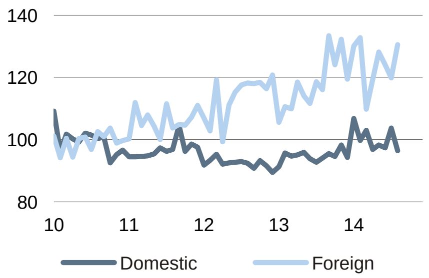
Chemicals industry, real production index, 2010=100, seasonally adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

Foreign orders very volatile 23

Pharmaceuticals industry, real order intake, 2010=100, seasonally adjusted



Source: Federal Statistical Office

For 2015, we also forecast that output will head north, but on a moderate path. In this context, there should be a bit of impetus from both domestic demand and from selected foreign markets (e.g. the UK, the Netherlands and Poland in Europe as well as the US and China outside Europe). Risks to growth lie in continued geopolitical crises and their impact on key sales markets and user industries. The growth of private consumption will probably boost sales of consumption-related chemicals. Overall, we expect chemicals production to grow by about 2.5% in 2015, which could neutralise the setbacks in 2014. Essentially, the growth will represent a catch-up effect following poor performance in 2014.

Pharmaceuticals industry: Booming growth mainly in 2014

Pharmaceutical products showed strong performance in 2013 with output growth of 5.3% in real terms. In the current year, output jumped again in the first eight months with a real increase of 6.8% on the pre-year reading. After a 1.3 percentage point rise in capacity utilisation in 2013 the positive trend has continued unbroken in 2014. In Q4, capacity utilisation hit 86.4%, noticeably outstripping the long-term average.

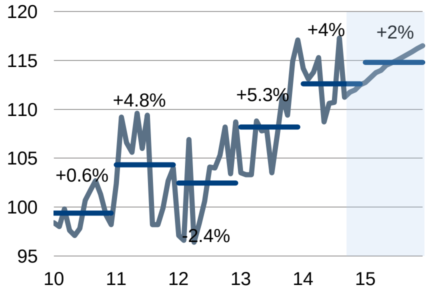
Unlike in the prior years, incoming domestic and foreign orders moved in the same direction in 2013. Nonetheless, the growth of the pharmaceuticals industry continues to be driven by exports (export ratio in 2013: 69%). Total order intake was up 3% in 2013, with domestic orders rising by 2.2% and foreign orders by 3.4%. The positive climate has resulted in very robust order growth again so far in 2014 (foreign: +9.6% yoy; domestic: +6.6%). For 2014 as a whole and for the coming year we look for positive impulses from the home market and from abroad. The foreign growth in particular results from strong demand from non-EMU countries. The improvement in the economy there, in the US in particular, is likely to support the growth of Germany's pharmaceuticals industry. Increasing demand for healthcare in Asia and Latin America could generate additional orders for the industry.

Nonetheless, the domestic market remains confronted with a challenging regulatory environment. This is evidenced above all by this year's decision to extend the price moratorium for pharmaceuticals until 2017, which is aimed at preventing an increase in the cost of supplying drugs and medications. Producer prices in the sector have thus been trending down for years.

All in all, real pharmaceutical output should grow by at least 4% this year. What argues against higher growth, which might have been the logical conclusion following the 8M results, are the increases in macroeconomic risks and the shape of the ifo business expectations, which have trended downwards during the last few months and were very volatile of late. Further existing burdens are the regulations governing new product launches and the benefit assessment of drugs on the basis of the Act for the Restructuring of the Pharmaceutical Market (AMNOG). For the coming year we forecast a lower rate of output growth (+2%) than in 2014, and a continuation of the positive fundamental trends (demographics, greater health consciousness). The lower growth will be partly attributable to a statistical underhang.

Production continuing to grow, albeit at subdued pace 24

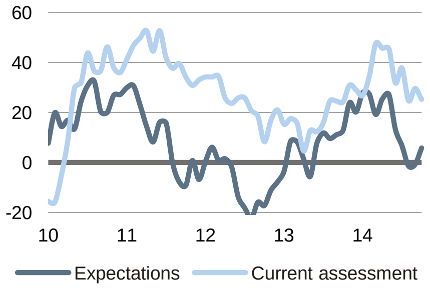
Pharmaceuticals industry, real production index, 2010=100, seasonally adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

Business climate indicators falling since recovery 25

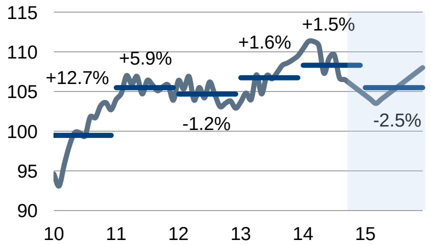
Plastics industry, balance of positive and negative company reports



Source: ifo Institute

Lower production in 2015 26

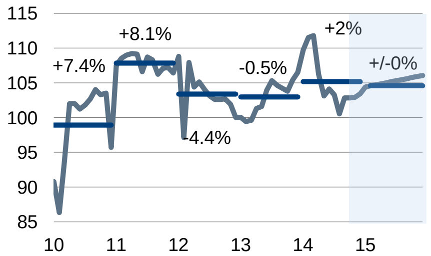
Plastics industry, real production index, 2010=100, seasonally adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

Roughly stagnating production in 2015 27

Building materials industry, real production index, 2010=100, seasonally adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

Plastics industry: Rollercoaster ride continues

Plastics production covers a broad spectrum of consumer and intermediate goods, ranging from films, hoses and profiles right through to packaging and builders' ware. This sector is typically among the leaders in the cycle and noted for a relatively low dependence on foreign orders in comparison with other sectors (export ratio: 37.5%) as well as for above-average dependence on business activity in its user industries. The sector's products, as intermediates, mainly flow to the automotive, mechanical engineering, electrical engineering and construction industries.

In the fairly recent past, the plastics industry has weathered very changeable conditions. For instance, domestic plastics production shrank by 1.2% in 2012, only to expand again slightly by 1.6% in 2013. Since sector output started the year 2014 with a statistical overhang of 2.6%, it had in fact already picked up further by April, yet has slipped slightly according to the latest figures. This means that the production level of the plastics industry is currently no less than 3.7% higher than in the year-earlier period.

Matching the production trend, the business climate indicators have also fluctuated strongly. For example, business expectations plunged by 18.8 index points in 2012 on average vis-à-vis 2011. However, they regained 17.1 points in 2013 and thus roared back into positive territory. The indicator for the assessment of the current situation dropped by no less than 18 index points versus the previous year in 2012, and then 5.2 points in 2013. As things stand today, business expectations and the assessment of current business have worsened again rapidly following an interim peak in the first half.

Owing to the currently fragile geopolitical and economic situation, the prospect of further commodity price increases and the modest trends in user industries, the sector's rollercoaster ride is set to continue. If the geopolitical situation eases, the sector's economic outlook should gradually brighten again in the course of 2015. All in all, we look for sector output to grow by 1.5% in real terms in 2014 and decline by 2.5% in 2015, with the projected downturn in 2015 partly attributable to the resultant statistical underhang at the upcoming turn of the year.

Building materials industry: Zero growth in 2015 despite robust building activity

Germany's building materials industry started 2014 with a bang. One key driver of this performance was the favourable weather conditions in Q1 which enabled a sharp rise in construction output and triggered higher demand for building materials. In the following months sector activity cooled noticeably, though – measured against the high starting level. For the full year, the building materials industry will probably now achieve a real increase in growth of "only" about 2% (2013: -0.5%). Considering that output was still growing at double-digit rates at the start of the year (in a year-on-year comparison), this outcome has to be regarded more or less as a disappointment.

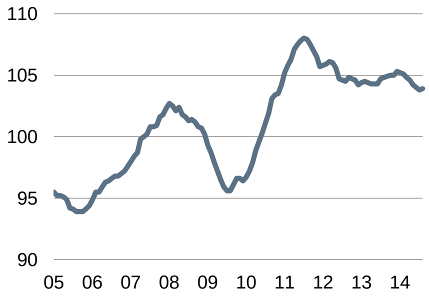
The macroeconomic environment for the construction industry, the most important customer of the building materials industry, should remain relatively favourable in 2015. Construction investment is likely to grow nearly 3% in real terms (2014: roughly 3.5%), with stimuli coming mainly from residential construction (rising number of building permits). Public-sector construction could benefit from higher federal spending on infrastructure. By contrast, investment in commercial construction will probably not develop as well because companies are likely to proceed cautiously with capital spending in view of economic uncertainties, geopolitical risks and a deterioration in the policy environment.

All things considered, we assume that domestic output in the building materials industry will trend slightly northward in 2015 thanks to the increase in construction output. But since the sector is poised to start the new year with a significant statistical underhang, real building materials output in Germany will probably show nothing more than stagnation for the year as a whole.

Paper industry: Marginal production increase possible again in 2015

Producer prices trending down of late 28

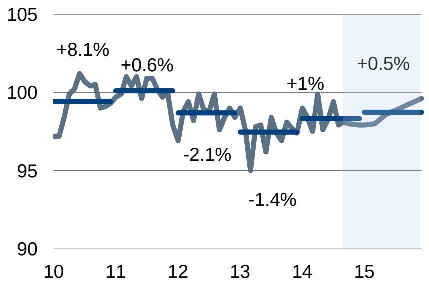
Paper industry, producer prices, 2010=100



Source: Federal Statistical Office

Slight growth in 2015 29

Paper industry, real production index, 2010=100, seasonally adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

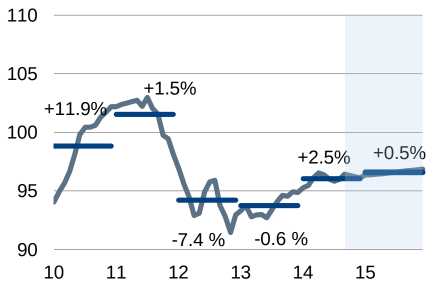
German paper industry production was trending slightly upwards at last reading, even though the sector registered lots of ups and downs at the monthly level. On average, production ought to pick up by about 1% in real terms in 2014, with paper making, which currently generates nearly 46% of total sector revenues, set to perform somewhat better than paper processing (54% of revenues). Within the paper processing segment, household goods and hygiene articles are benefiting from the robust consumer climate and reporting above-average growth for 2014. The production of corrugated paperboard and paper, the biggest segment in paper processing by far, has been hit over the past few months by the noticeable weakening of industrial activity; output here could fall slightly in 2014. Corrugated paperboard is the most important material for transport packaging in industry.

Paper industry orders have (still) not shown any visible downtrend over the past few months. However, the industry's business expectations have recently fallen into negative territory. This is likely attributable not only to the higher geopolitical risks but also to the darkened prospects for many user industries. Producer prices in the sector have also been trending more to the downside for several months – a sign of lacking business stimuli. In this respect, we now forecast domestic production to trend sideways at best over the next two quarters. From Q2 2015, production could start to pick up again. In sum, however, the full year 2015 will probably only see production increase by about 0.5%. Household-related segments could again score somewhat better than industry-related segments considering the satisfactory development of private consumption. Corrugated paperboard production is likely to begin 2015 with a statistical underhang which will weigh on the full-year result – despite our assumption of a recovery during the year.

Textile industry: Higher output, with 2014 outstripping 2015

Look for uptick in growth 30

Textile industry, real production index, 2010=100, seasonally adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

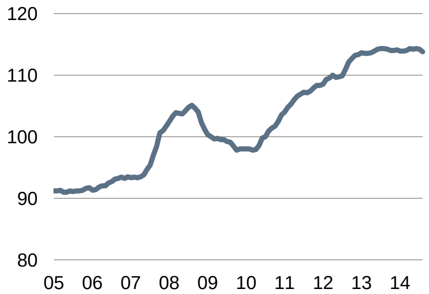
So far in 2014, Germany's textile industry has not shown any sign of being impacted by the overall weakening of growth and will probably post a respectable average annual increase in production of about 2.5% in real terms (2013: -0.6%). The key driver of this performance is the "Other textiles" segment. It encompasses high-quality, research-intensive technical textiles as well as fleece fabrics which combined now generate roughly 37% of total revenues in the textile industry. Manufacturers of technical textiles in particular are benefiting from the increasing use of their products in new fields of application (e.g. vehicle construction, building industry, energy sector, medical technology and functional clothing). The other textiles segment includes made-up textile articles, which are also contributing significantly to the sector's overall growth in 2014. By contrast – as has happened often in the past – the traditional segments (e.g. spinning mills or carpet production) have performed poorly.

While textile orders have been climbing slightly over the past few months, the business expectations in the sector have fallen considerably of late. In the remaining months of 2014 and in Q1 2015 the cooling economy is likely to impact negatively on demand for textiles and thus on domestic production. This also holds for technical textiles, the bulk of which are sold to industry including construction. Thanks to the prospective recovery from Q2, domestic production is set to rise by 0.5% in real terms for 2015 as a whole.

Food industry marking time

Prices holding steady at high level of late 31

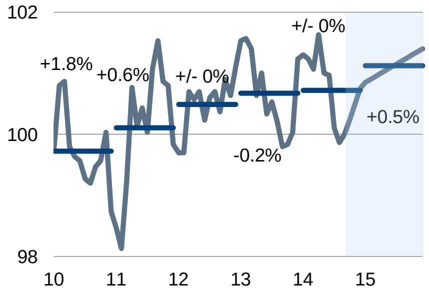
Food and animal feed, producer prices, 2010=100



Source: Federal Statistical Office

Moderate growth in 2015 32

Food and animal feed, real production index, 2010=100, seasonally adjusted



Sources: Federal Statistical Office, Deutsche Bank Research

In the food industry, real domestic output will probably more or less stagnate in 2014. This means the sector will mark time once again, as no growth was posted in either 2013 (-0.2%) or 2012 (+/-0%). Considering the generally pretty favourable environment for the sector, such performance comes as a surprise. Private consumption has picked up a tad more in the current year than it had in recent years. Germany's population is set to grow again in 2014, which points to higher demand for food. The labour market is showing relatively positive development. And the sector's nominal foreign turnover has been up moderately in 2014 – despite the slump in Russia business.

One reason for the sideways movement in 2014 (and the two prior years) could be the development of producer prices in the sector. While these will scarcely climb in 2014 compared to 2013, they are set to exceed the 2010 level by 14%. This could have triggered more conscious food buying behaviour among commercial and private consumers (focus on cheaper food, less waste). At the same time, more consumers are tending to buy fresh foods in certain product groups more often than processed foods; only the latter are included in the food industry statistics. This applies, for instance, to fruit and vegetables processing, where domestic production has fallen relatively sharply on average over the past few years.

For 2015 we look for the food industry to increase output by about 0.5%. The still pretty stable consumer climate and the increasing population will act to support the trend again in 2015. However, foreign demand could be hit if the economic recovery process in Western Europe continues to stall intermittently. Generally, we forecast that qualitative growth (higher qualities of food, innovative products) will continue to lend impetus to the sector on a medium-term horizon. However, above-average growth rates are just as unlikely to be observed as pronounced slumps in domestic output or demand.

Outlook: Structural aspects causing concern

The only moderate growth rates forecast for industrial output in Germany for 2014 and 2015 are mainly due to the currently subdued state of the economy in many sales markets as well as to external shocks. In the medium term, however, structural factors will play a more important role for Germany as a location for industry. These factors can be largely influenced by government policy makers. Nonetheless, many of the policies adopted and/or implemented recently give rise to fears that the competitiveness of the location – and thus also of German companies – will decline by international standards over the next few years.

Some cases in point are the decisions on pension policy (retirement at 63, higher pensions for mothers whose children were born before 1992) and labour measures that have already been implemented or are under discussion (minimum wage, restrictions on temporary work and service contracts). Such policies will lead to higher labour costs in industry and business-related services. Moreover, they will exacerbate the shortage of skilled labour that is increasingly manifesting itself regionally and in certain sectors at precisely the time when the baby-boom generations are starting to reach retirement age. Furthermore, they send a completely false signal to Germany's partners in the EU at a time when Europe needs structural reforms. Still another issue is

Germany's energy policy, which does pursue worthwhile objectives yet often banks on the wrong instruments, takes too little heed of reciprocal effects in the European energy market and ultimately leads to unilaterally higher energy prices in Germany. Considerable uncertainty continues to hang over the future shape of energy policy in spite of the latest reforms in this sector. In addition, there are cases of massive and acute worsening of the transport infrastructure and inordinately slow expansion of the broadband networks. Both infrastructure segments are essential for high-wage Germany to be able to achieve steady productivity gains. Not enough is being invested in the education sector either to further support Germany's most important resource, its human capital.

Considering, too, that growth potential in many emerging markets is much higher than in Germany or other European countries, it is to be feared that investments by German companies in these growth markets – which from their standpoint are understandable and necessary – will in future more often be made at the expense of local production in Germany. There is no mistaking that Germany will remain attractive as an investment location. However, from a political standpoint it would be disastrous to thoughtlessly squander the achievements of the past ten years. Companies should also bear a share of the responsibility; this applies with respect to further training of staff and the development of innovative products and services that have to be geared to the digital age. However, to ensure that people continue to conduct research, invest and ultimately also produce in Germany in the long run against the backdrop of globalisation, the country needs to offer a coherent policy environment. When Germany was the "sick man of Europe" roughly ten years ago, this also applied to some industrial sectors. Today, German industry is in excellent shape compared with its counterparts in the EU – thanks to the policies of the Agenda 2010 and various entrepreneurial measures. However, many of Germany's old and new competitors are based in the US, Japan, Korea, China and, increasingly, other emerging markets. Globalisation is a demanding taskmaster, but German industrialists and Germany as an industrial location have the potential to cope with the challenges. The ball is now in the politicians' court.

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German industry: Output growth to remain shy of 1% in 2015

Forecast for the main industrial sectors 33

Industry	NACE	Gross value added	Export ratio	Business climate*	Capacity utilisation*	Producer prices	Production 2012	2013	2014	2015
		EUR bn, 2012	%, 2013	Diff. yoy, Net points	Diff. yoy pp	Last 12M, % yoy	% yoy	% yoy	% yoy	% yoy
Food	10	26.3	21.9	-17.4	-0.7	0.2	0.0	-0.2	0.0	0.5
Textiles	13	3.2	47.7	-17.6	-12.1	0.6	-7.4	-0.6	2.5	0.5
Paper	17	9.5	40.6	-10.9	-0.8	0.1	-2.1	-1.4	1.0	0.5
Chemicals	20	34.7	56.4	-10.9	-0.8	-2.2	-2.8	0.5	-2.5	2.5
Pharmaceuticals	21	16.6	68.6	-29.3	4.1	0.2	-2.4	5.3	4.0	2.0
Plastics	22.2	16.9	38.3	-5.8	-2.4	0.8	-1.2	1.6	1.5	-2.5
Building materials	23	12.6	29.9	-13.8	-1.2	0.7	-4.4	-0.5	2.0	0.0
Metals production	24	18.7	38.8	-11.0	-2.5	-4.1	-3.7	-0.6	1.0	0.0
Metal products	25	37.8	33.2	-5.7	1.7	-0.4	-1.5	1.1	3.0	-1.0
Electrical engineering	26+27	57.5	54.4	-7.6	1.5	0.0	-2.7	-2.1	1.5	0.0
Mechanical engineering	28	75.6	62.6	-16.2	-0.1	1.2	1.2	-1.6	0.0	1.0
Automotive	29	78.2	64.9	-9.3	3.3	0.1	-0.4	1.2	4.0	1.0
Manufacturing	10-33	499.6	48.2	-10.2	0.4	-0.1	-1.1	-0.1	1.5	3/4

*Latest figure available
Sources: Federal Statistical Office, Deutsche Bank Research

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