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German corporate profits rise further, domestic capital spending shows signs of life

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1. While German GDP had been flat in the second quarter, compared with the first, and up only 0.6% from a year ago, **business has become more up-beat recently**. The main reason is that, in spite of the large increase of energy prices and weak domestic demand, **earnings continue to rise briskly**. In the second quarter, the share of non-labour income in national income has increased to 33.5%, from 32.5% in the first quarter and, incidentally, 29.2% in Q4 of 1998, after the present government had assumed power. Chancellor Gerhard Schröder has indeed been, as the German press likes to point out, a friend of the bosses. Not that this will help him much in winning the national election on September 18.

2. **Between Q4 2004 and Q2 2005 national income was up at an annualized rate of 6.5%, but the non-labour income component rose by 19.4%.** Year-on-year, its rate of growth was 8.8%. This follows two very good years, 2003 and 2004, when non-labour income increased by 3.6% and 11.7%. Note that non-labour income is a very mixed bag: it does not only contain income from entrepreneurial activity but also interest, dividends, the income of the self-employed and from renting which together account for more than 50% of the total. Since there has not been much momentum in these sub-components – rents for instance have increased in the order of only 1% for several years now – **corporate earnings as such have grown quite strongly. They will probably be up by 15 to 20% y/y in 2005. This is not quite as good last year but is certainly nothing to complain about.**

3. **Profits are not strong because productivity is booming. Just the opposite is the case.** For mainly cyclical reasons, ie the near-stagnation of output, productivity growth is unusually slow. By the most meaningful yardstick, real GDP per hour worked, it has been unchanged in the second quarter (from the first), and has been up a measly 0.5%y/y. No, the reason profits are doing so well is the fall in labour income.

4. In the August Monthly Report the Bundesbank states that it expects the trends toward moderate wage increases, reductions in fringe wage benefits and an extension of the working time to continue. They add that more and more wage settlements are outside national agreements which means that workers receive smaller raises than negotiated by trade unions. **In Q2, effective wages per hour declined at an annualized rate of 8.2% (!) from Q1, and were 0.6% lower than one year ago. Germany experiences wage deflation** which is the main reason why consumer prices ex energy and tobacco were just 0.8% y/y in July, and why

the GDP deflator, the broadest inflation gauge, has been unchanged in Q2 from Q1 (seas. adj.), exceeding its year-ago level by just 0.4%.

5. To be sure, firms are faced with steeply rising import prices (4.8% y/y and 8.1% 6-months annualized), but **the combination of falling wages and rising output prices (4.5% y/y and 5.1% 6-months annualized) means that earnings are doing very well,** thank you for asking. Labour costs account for about two thirds of total costs in the economy as a whole. So even though output volumes continue to disappoint, profits surprise on the upside. Another surprise is the return of pricing power. One can only speculate that this is due to the depreciation of the euro since the beginning of the year and an output mix that is well-adapted to the structure of world demand.

6. Firms must still have considerable spare capacities. Not only can their capital stock churn out considerably more than at present, the work force is probably willing to put in more hours as well whenever required, and without asking for overtime bonuses, simply because their income situation is so bad. **Whenever a genuine recovery comes, a productivity miracle will unfold – which will then give another boost to profits.**

7. It is still early in the game. **There are now some signs that spending on machinery and equipment is picking up, but the growth rate of 4.8% y/y in the first half of 2005 is still a disappointment considering how profitable firms have become.** It is also smaller than in earlier comparable cyclical situations. The emphasis remains on cost cutting, not on the expansion of capacities. As welcome as the growth of machinery and equipment may be, it remains smaller, in absolute terms, than the simultaneous decline in spending on construction. In its August report the Bundesbank admits that one cannot yet speak of a broad-based recovery of investment demand.

8. **Nevertheless, indicators of business sentiment, while still low, are now clearly on the way up. It would be strange if it were otherwise.** The environment could not be more benign: the exchange rate is competitive, pricing power and balance sheets have been restored, workers are intimidated and unusually cooperative, wages are falling, and the coming government is proposing further cuts of the corporate income tax. The problem is that consumer demand remains depressed, and that one cannot trust that the exchange rate will stay as low, nor that Germany's aggressive belt-tightening will not trigger competitive devaluations of the real exchange rates inside EMU, and thus a deflationary spiral.

9. **Germany certainly does not contribute to a reduction of the world's imbalances.** As the IMF keeps arguing, in order to defuse the growing risks to the stability of the world economy, the euro area should stimulate domestic demand, presumably through higher wage settlements, lower interest rates and more expansionary fiscal policies, while allowing the euro to appreciate. So far, neither the labour unions, nor business, nor the ECB, nor national governments show any inclination to move in that direction.

10. **For investors, the message can not be clearer: inflation is not a risk, bonds are therefore still a good buy, German equities are also cheap, given a trailing price-to-earnings ratio of 16 and the positive outlook for corporate earnings, and even real estate looks like a steal (if you don't mind that you cannot raise rents for years to come).**