GLOBAL ECONOMIC RESEARCH

EUROPEAN ECONOMIC PERSPECTIVES

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European Economic Perspectives

Why Have German Equities Done So Well?

In the first half of 2005, German nominal GDP rose by 1.2% year over year. This is not much better than Japan and compares with a 6.3% rise in the US. In spite of this, the German equity market has been one of this year's best performers, rising 15% compared with a broadly flat US market.

Several factors help explain this strong performance. A more supportive exchange rate and hopes that this week's federal election will deliver a more business-friendly government have played an important role. However, in this article we will focus on two other key factors. First, profit growth has been buoyant even though nominal GDP growth has been weak. Second, the performance of the domestic economy has become much less relevant for major German companies.

Although German nominal GDP grew modestly in the first half of 2005, national accounts data show that profits[1] were up 6.8% year over year. This has been achieved by exerting huge downward pressure on labour costs, thus boosting margins (**Display 1**). Downward pressure on labour costs has been evident for several years but has intensified recently due to the strong euro, declining union power and the threat from low-cost foreign producers. The impact of the latter has clearly been exacerbated by last year's enlargement of the European Union.

This squeeze on labour costs also helps explain the weakness of German consumption. Wage and salary income accounts for just over half of household income in Germany. In the first half of 2005, it fell by 0.3% year over year in nominal terms and by 1.4% in real terms. German companies are boosting profits but at the expense of consumer spending.

Another important factor in the strong performance of German equities is that German companies have become much less dependent on the performance of the domestic economy. Earlier this year, we showed how a number of German companies have reduced their reliance on high-cost domestic labour. Siemens, which has the biggest workforce of any German company, has cut the share of German workers in its global labour force from 62% in 1990 to 37% today.

According to our estimates, domestic employees now account for just under 50% of the workforce of the average DAX nonfinancial company (**Display 2**). Moreover, it is possible that this overstates the amount of actual production located in Germany. The latest annual report from Adidas-Salomon shows that 94% of its footwear and 77% of its clothing is now produced in Asia.

Reliance on German revenue has also been reduced. Again, Siemens is a good example. Over the last 10 years, Siemens' domestic sales have actually fallen slightly, whereas revenue from abroad has grown by 9% per annum. As a result, just 22% of Siemens' revenue is generated in Germany. For the average DAX nonfinancial company, we estimate that just 30% of sales are currently generated in Germany (**Display 3**).

Overseas revenue is very important in explaining the strong performance of German companies so far this year. Our estimates show that sales growth for the nonfinancial DAX companies reached 7% year over year in the first half of 2005. Some companies, such as BASF and Bayer, reported strong domestic and overseas demand. However, for most of the firms that reported geographical breakdowns, the picture was one of overseas strength offsetting domestic weakness (**Display 4**). At Siemens, for example, domestic revenue was down 4%, but foreign revenue was up 8%.

Conclusions

The strong performance of German equities so far this year reflects a number of factors, not least being the corporate sector's ability to raise profits by slashing domestic labour costs. However, it is not clear how long this can continue. By contrast, it is

[1] We are using entrepreneurial and property income as a proxy for profits. This is a wider measure than profits for nonfinancial companies, which are only available on an annual basis.

very clear that German companies will continue to reduce their dependence on their domestic economy, both as a production location and as a source of revenue.[2] This means that a challenging outlook for the German economy may not be reflected in the performance of German equities.

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[2] German companies still have a long way to go to match companies like Switzerland's Nestlé. Nestlé employs just 3% of its workforce and generates less than 2% of its revenue in Switzerland.

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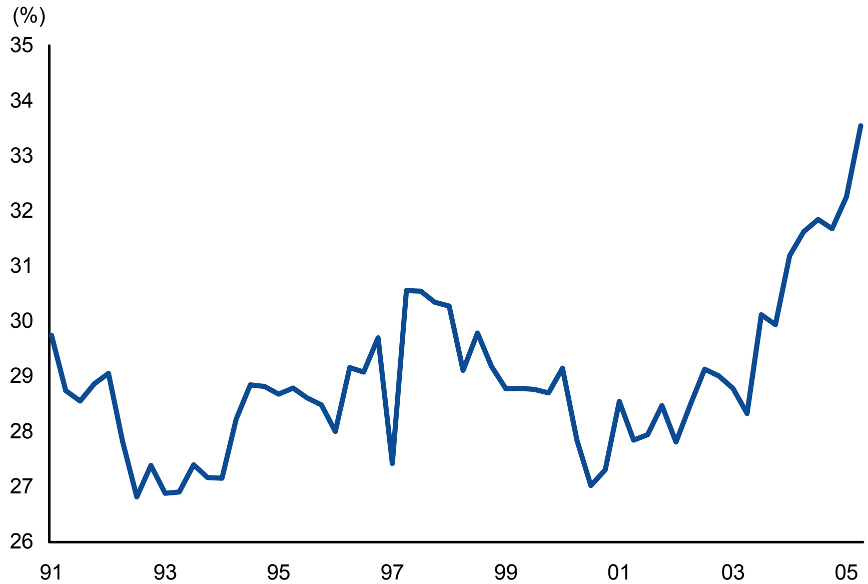
Display 1: German Profit Margins Have Risen to Record Levels
Share of Entrepreneurial and Property Income in National Income

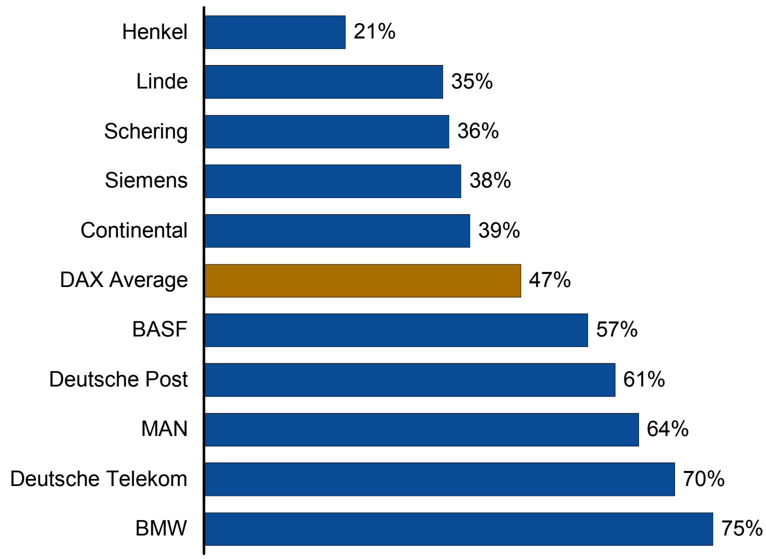


Source: Haver Analytics and Alliance Capital; September 16, 2005

Despite weak nominal GDP growth, German profits have risen strongly in recent quarters. This has been possible because German companies have put enormous downward pressure on domestic labour costs. As a result, profit margins have risen sharply and are now at their highest level in at least 35 years.

Display 2: German Companies Have Become Less Dependent on Domestic Labour…

Share of German Employees in Global Workforce in 2004



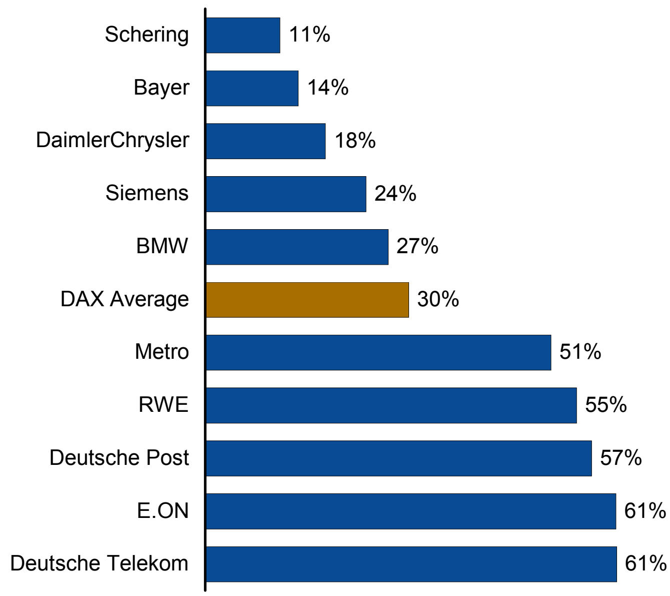
Note: DAX average refers to nonfinancial companies only.

Source: Company reports and Alliance Capital;September 16, 2005

German companies have reduced their reliance on domestic labour. Among the major manufacturing companies, the share of domestic workers in total employment ranges from 21% at Henkel to 75% at BMW. BMW's positioning as a prestige brand may necessitate its reliance on a high-cost domestic workforce. But for most companies, the shift to lower-cost production locations is likely to continue.

Display 3: …and Even Less Reliant on German Revenue

Share of German Revenue in Global Revenue in 2004



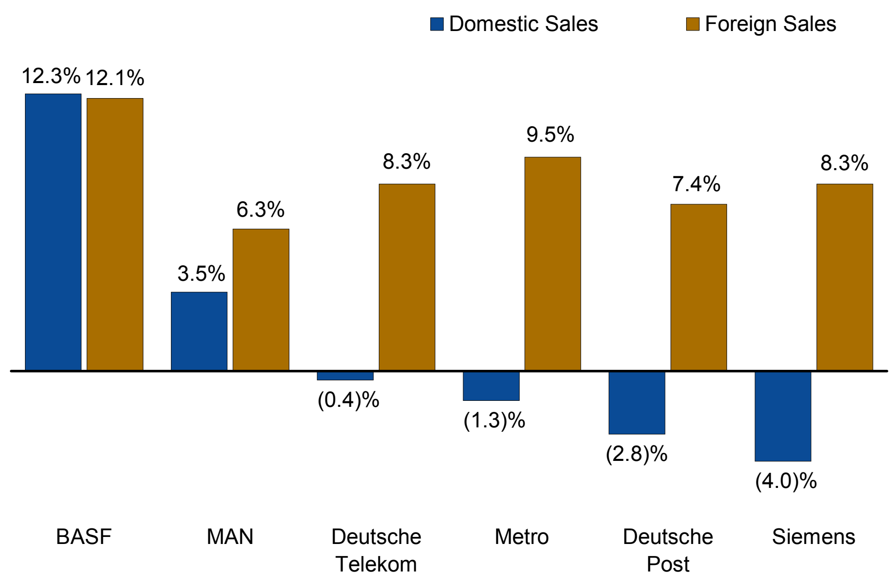
Note: DAX average refers to nonfinancial companies only.

Source: Company reports and Alliance Capital; September 16, 2005

With the exception of the major utility and communications companies, most major German companies now generate more than half of their revenue overseas.

Display 4: Overseas Revenue Has Offset Weak Domestic Sales for Many German Companies

Year-over-Year Sales Growth at Selected German Companies in the First Half of 2005



Source: Company reports and Alliance Capital; September 16, 2005

Some German companies, like BASF, are generating strong domestic and overseas revenue growth. But for most companies, the picture is one of overseas strength offsetting domestic weakness. This is not surprising given the squeeze being exerted on the German consumer.