

# GERMANY'S ELECTION SHOULD BE SUPPORTIVE

On the 24th of September, Germany will hold its general election to pick the members for the 19th Bundestag (lower house). Currently the centre-right Christian Democratic Union/Christian Social Union (CDU/CSU) party, headed by Angela Merkel is leading comfortably in the polls.

As it looks obvious who will win the election, the more interesting question is who will be the next coalition partner for Chancellor Merkel. The current government is made of CDU/CSU and centre-left Social Democrats (SPD). This so called "Grand Coalition" has never been the most desired option for anyone, as the partnership of the two main political blocks precluded the formation of a real opposition. Nevertheless, the combination had become necessary after the last election, as the CDU/CSU's first partner of choice, the business friendly Free Democratic Party (FDP) was not able to clear the 5% vote-hurdle. Most recent polls indicate that the FDP might make a comeback in the next election. However, just one coalition partner might not suffice and a combination of CDU/CSU, FDP and the Green Party, the alternative party focused on ecological issues, might become necessary. The latter has been recently implemented in Schleswig-Holstein, one of Germany's states.

The formation of coalitions has become difficult in Germany in recent years, as the party system became increasingly fragmented. In the next election, the far-right party Alternative for Germany (AfD) will most likely enter the parliament and worsen the situation. It will also be the first time that a far-right party enters the Bundestag. Nevertheless, populist parties haven't seen the same traction in Germany as they have in other European countries and recent polls indicate that AfD is losing its momentum.

Regardless of what combination Merkel chooses when she starts her fourth term, no one should expect significant changes to the current "status quo". A combination with one of the centre-left parties will probably reduce some of the recent economic dynamics, as seen during the current parliamentary term, i.e. introduction of a minimum wage. A partnership with the FDP could at least bring some modest business friendly changes to taxes. However, the FDP might be less comfortable with French president Emmanuel Macron's European agenda, as it recently criticized his desire for Euro bonds and a eurozone-specific budget, managed by an eurozone finance minister. More clear is the picture with regards to Brexit. All four major centre parties support Merkel's stance, where no "cherry picking" will be allowed.

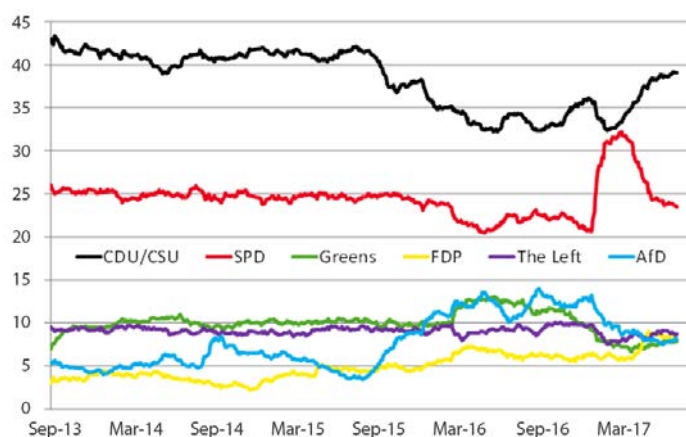
In the post-war era in Germany, coalitions have always reigned and politicians are used to developing a consensus. Currently, even if a law passes the Bundestag, it still has to pass the Bundesrat (upper house), where three political parties (CDU, SPD & Green) are in the position to block any law. Therefore, even with a clear win in the general election, Chancellor Merkel will have to strike deals continuously with the Bundesrat, which consists of the head of states and has to approve all laws affecting state competency and constitutional changes.

The biggest changes after the election will most likely be seen on the spending side. Germany might increase its infrastructure and defence investments, as well as expenditures for the integration of refugees. However, additional spending will potentially disappoint some of Germany's critics that demand a reduction of austerity measures and a significant increase in spending. Berenberg's economists assessed in a recent publication ("The German problem? It's complacency, not the current account" by Holger Schmieding) that the surplus of Germany's federal budget is a result of economic strength rather than austerity measures. Furthermore, the economists pointed out that Germany's competitive advantage, represented by a solid current account surplus, could shrink in the next few years. Labour costs in Germany have increased by 15% between 2010 and 2016 and none of the main political parties plan major structural reforms, so the current account should decline via lower exports. This partly explains why only a modest rise in investments and expenditures should be expected and some prudence will be required in the years to come.

Besides Germany's economic strength and its need to form coalitions, another factor differentiating the country from the rest of Europe is its complicated voting system. Half of the members of the parliament (299) are directly elected in their districts. The rest of the seats get allocated based on the percentage of the votes received in the election. Every voter gets two votes, one to pick the candidate in its district and the second to support a party. The second vote is all-important, as it determines the ultimate percentage of allocated seats. If a party gains more seats directly than its percentage weight is suggesting, the number of members of parliament ("Ausgleichsmandate") will be increased to bring the percentage weights back in line with the percentage share of the second vote. The system was design to combine elements of a parliamentary democracy and the desire to enable voters to choose a local candidate.

The peculiarities of the voting system gain particular importance in close elections. However, current polls are suggesting that this won't be the case this time. Chancellor Merkel's CDU/CSU leads by 15% (Figure 1) which suggest that there seems no other party currently able to stop her from winning a fourth term. But is there any tail risk for a surprise on Election Day? It doesn't look so. A recent article (<http://www.zeit.de/gesellschaft/zeitgeschehen/2017-07/wahlkampf-merkel-schulz-wohlstand>) in ZEIT ONLINE, the online version of one of Germany's main political newspapers, described Germans as complacent and focused on their private life, i.e. the next holiday, rather than overly politically inspired. Most of this seems driven by Germany's economic success and a desire to keep their wealth. Germans obviously recognize the threads coming from the outside world, i.e. Brexit, Trump, terrorism, etc., but Merkel is seen as a guarantor to tackle these problems and keep them away from home. Martin Schulz, party leader of the SPD, and its chancellor candidate, tried to score by pointing out some of the outside world's problems, like the still ongoing refugee crisis; however, beside a positive blip in the opinion polls at the beginning of the year, his strategy hasn't succeeded so far.

Figure 1 — Advantage Merkel: German opinion polls



Centre-right CDU-CSU, centre-left SPD, centre-left Greens, liberal FDP, ultra-left The Left and radical right AfD, average of 7 latest available polls.  
Source: National opinion polls, Berenberg calculation

## Conclusion

As the outcome seems obvious, it remains unclear who will be Merkel's coalition partner and how the election will impact financial markets. It doesn't look like much will happen, and most market participants are pricing in Merkel's victory and a continuation of current policies. Nevertheless, one coalition model might be better than the other. If the business friendly FDP joins, that will possibly be seen as more positive for the future of the German economy than any combination with centre-left parties. On a long-term basis, the latter would likely negatively impact equity valuations, as the above-mentioned higher labour costs would probably continue to reduce the country's competitiveness. Furthermore, it is unlikely that any government coalition will launch major structural reforms.

However, for investors with a mid-term time horizon, bonds from German "Mittelstand" companies, particular in the health care and auto parts sector, look attractive, as their credit profiles have benefited from the strong economy and their yields are still relatively appealing.

In sum, it looks that Election Day in September will be quite uneventful, although a government including the FDP should be more business minded. This presents a sharp contrast to the French and Dutch elections earlier in the year, where the market feared victories for populist parties that didn't materialise. Nonetheless, some stability and continuation might be welcome during turbulent times and present some investment opportunities in select German corporate bonds.

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