Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist

MACROCOSM

Germany Votes

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Lorcan Roche Kelly

Euro-skeptics wrong again. In September's election, there's no alternative for Deutschland.

Throughout the five years of the euro-crisis, one iron rule has held -- in a general election, the incumbent loses. September 22 seems likely to break that rule, as Germans will vote while happier than ever with their current government, according to polls.

- Before we get into the analysis of what the likely outcomes from September's election will mean, it is worth pausing to note that the current political reality in Germany is very much at variance with what many commentators has been predicting throughout the euro debt crisis. The conventional wisdom has been that the German electorate would get "bail-out fatigue." Every regional election defeat for Chancellor Angela Merkel's CDU/CSU party was accompanied with political epitaphs for her government, while the launch of the anti-euro Alternative für Deutschland (AfD) party was hailed as the game changer it has resoundingly failed to become.
- "Bailout fatigue" has not materialized, despite repeated rescues of struggling peripheral euro area economies and banking systems. This is due in no small part to the fact that Germany has actually had to pay very little for the euro crisis. Most of what it has contributed has been in the form of guarantees, rather than funds from the German exchequer.

Most important for Merkel's re-election chances, Germany has had a pretty good euro crisis. The supply-side reforms introduced by Gerhard Schroder's government in 2003 (see "Europe's Supply-Side Revolution" February 17, 2012) meant that the German economy was in a good position to weather the crisis when it hit. That strength paid further dividends when Germany became the euro area's safe haven, with 10-year bund yields falling as low as 1.13% and 1.16% in 2012 and 2013, respectively.

- For the ordinary German, the euro crisis is hard to spot, with unemployment low, real wages rising and even property prices going up. This is reflected in polling in which last week 76% of respondents said that their personal economic situation was either good or very good. We have to go back to 1998 to find a reading as high from that survey.

Update to strategic view

EUROPE MACRO, EUROPE BONDS: Don't believe the hype -- the German election is not a euro area risk event. There's no sign of "bail-out fatigue." The anti-euro Alternative für Deutschland party is making no progress in polls against Merkel's government, which is more popular than ever. If Merkel's current coalition partner, the FDP, manages to get past the critical 5% vote threshold, as now seems likely, there will be little change in government. With a recovering euro area, and a low-risk German election, the euro area's main safe haven asset -- the German bund -- will continue to come under pressure, catching up to normalizing values for similar assets worldwide.

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Merkel's government is composed of the CDU/CSU union in coalition with the Free Democratic Party (FDP). Recent polls show that the most likely post-election government will be a continuation of this arrangement.

- Critically, under German electoral law, a party has to achieve more than 5% of the votes in the election to be eligible for any seats at all.
- The FDP -- which got over 14% of the vote in the 2009 election -- is currently polling in the 5-6% range. If the FDP fails to get over the critical 5% threshold, new configurations for a government emerge.
- The most likely alternate scenario is a so-called "grand coalition," in which Merkel's CDU/CSU forms a government with the main opposition party -- the Social Democratic Party (SPD).
- Merkel's first term as Chancellor -- from 2005-2009 -- was as head of a grand coalition.
- Another possible government is an alliance of the current opposition parties -- the SPD, the Left and the Greens. But this is highly unlikely, because the SPD has actively avoided in the past -- as in 2005 -- going into government with the Left.
- To handicap the three possible scenarios: the present CDU/CSU-FDP coalition is by far the most likely, with a grand coalition the only viable alternative. A coalition of all the opposition parties is very unlikely to get past the negotiating table.

A few other things to note.

- Generally the parties in Germany are referred to by colors rather than their actual names. The CDU/CSU is black, the FDP is yellow, the SPD is red, the Greens are green and the Left is also red.
- German commentators will often talk about coalitions by referring to this color code -- the current government is black/yellow, a grand coalition is black/red and an alliance of all the opposition parties is called a "traffic light" government.
- The German electoral system works on both a direct vote and a list system. Each voter has two votes -- one for a member of parliament for their constituency, and one for a party.
- This system can produce what is described as "overhang seats," when a party wins more seats in a constituency (direct vote) than it is entitled to according to the party vote. Under agreement reached by the parties in late 2012, the number of "overhang seats" will be allocated to allow no change in party proportions in the Bundestag.
- This means that, if there are "overhang seats," the number of seats in the Bundestag could exceed the current 598.

From an investment perspective there are a few things to watch, and a few opportunities.

- There will be some noise ahead of the election as politicking starts in earnest.
- We already saw a slightly ham-fisted example of this over the weekend, with the German magazine *Der Spiegel* publishing

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Donald Luskin
Chicago IL
312 273 6766
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
617 600 6969
lorcan@trendmacro.com

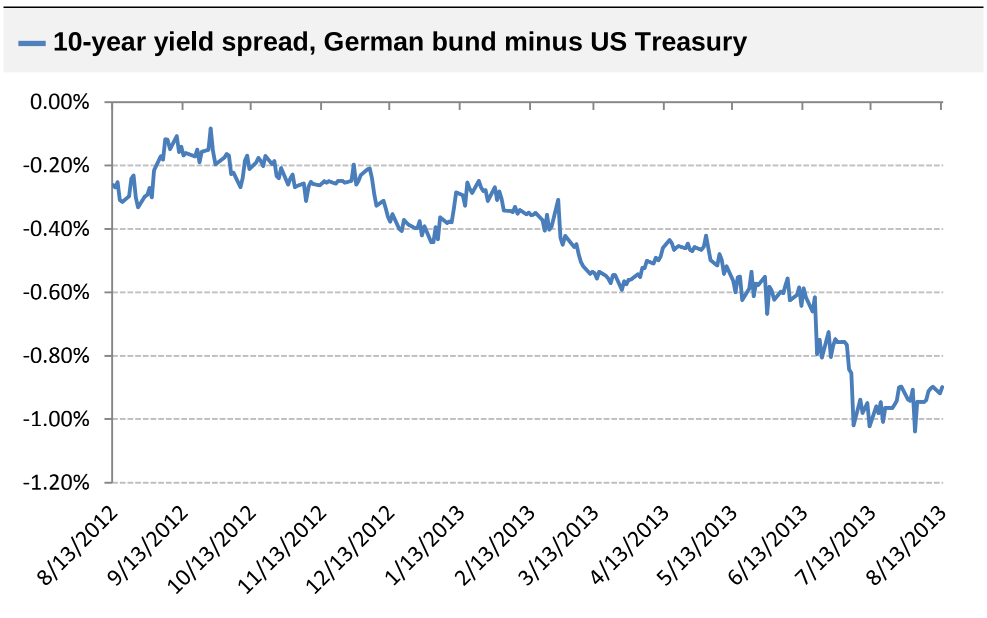
[About us]

leaked comments from the Bundesbank saying that Greece will need a new bailout after the election. This Bundesbank intervention in German politics -- perhaps it is disappointed with the AfD's dismal performance -- has created few waves, but it is the kind of thing that is likely to continue until the election. Investors should ignore it.

- *Do not* ignore the continued robust performance of the German economy, and the ongoing emergence of recovery in the rest of the euro area.

The German election is not a risk event. So we reiterate our current asset allocations, particularly long German stocks and long Spanish sovereign bonds (see "SpanDax" July 12, 2013).

- As the market comes to realize that there is little risk from the German election, there should be a further improvement in investor sentiment towards the euro area as a whole, and therefore a reduction in demand for the euro area's main safe haven asset -- the German bund.
- As global systemic risk has been reduced all year, safe haven assets of all types have become less valuable (see, among many, "US Fixed Income Strategy: The Fed Irrelevancy Hypothesis" July 2, 2013). So has the bund, the 10-year yield of which has backed up about 65 bp from the lows. But the bund has been a laggard -- the 10-year US Treasury yield has backed up far more (please see the chart below).



Source: Bloomberg, TrendMacro calculations

- We expect the values of safe haven assets world-wide to continue to normalize, as 2013 continues to be the first year in six free of global systemic risk. The laggard bund still has some catching up to do.

Bottom line

Don't believe the hype -- the German election is not a euro area risk event. There's no sign of "bail-out fatigue." The anti-euro Alternative für Deutschland party is making no progress in polls against Merkel's government, which is more popular than ever. If Merkel's current coalition partner, the FDP, manages to get past the critical 5% vote threshold, as now seems likely, there will be little change in government. With a recovering euro area, and a low-risk German election, the euro area's main safe haven asset -- the German bund -- will continue to come under pressure, catching up to normalizing values for similar assets worldwide.