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TRENDMACRO LIVE!

On the German Election

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Lorcan Roche Kelly

So much for "bailout fatigue." The German electorate vindicates Merkel's euro strategy.

As we expected (see "Germany Votes" August 13, 2013), with the results of the German election now in, incumbent chancellor Angela Merkel's CDU/CSU is the clear winner, coming within 5 seats of an overall majority. This means that we now face some weeks of negotiations over the form of the next coalition government -- but it is certain that Merkel will continue as chancellor.

For the global economy, the most noteworthy thing about this election is how popular Merkel's handling of the euro crisis has been in Germany. That means no internal political resistance to fiscally strong Germany continuing its essential role as rescuer and unifier of its weaker European neighbors.

- As we have been telling clients for years, Germans want to be in the common currency, and in a more unified Europe, as leaders -- and they are willing to pay for it (see, among many, "Two-Tier Europe is Born" August 17, 2011). Though some opposition to this view always exists within Germany itself -- as nationalist parties like the AfD show -- it has never been an investable thesis to bet on Germany experiencing "bail-out fatigue," or leading a break-up of the euro.
- Merkel's pragmatic leadership has always protected German interests throughout the crisis. But she has shown -- and strongly believes -- that the continued existence of the euro, and Germany's place in it, is very much in Germany's interest.
- It is clear that Germans agree with her. The only party offering an alternative view -- the AfD -- failed to make the 5% vote threshold required to earn any seats in the parliament.

The forming of a new government will not be a rapid process -- it generally takes weeks rather than days for the parties to come to an agreement. But with the broad structure of the next government already inevitable -- CDU/CSU and SPD -- there is no immediate market risk from this election.

- Merkel's previous coalition partner, the FDP, failed to get past the 5% threshold mark that it needed to secure parliamentary representation. So Merkel will have to find a new coalition partner among the three parties that did manage to get past the 5% cut-off.

Update to strategic view

EUROPE MACRO, ECB, EUROPE BONDS, EUROPE STOCKS: As expected, Germany voted for more of the same -- once again confounding those who believed the electorate's bailout fatigue would drive Merkel from office. We will now have weeks of negotiation over the formation of the nearly inevitable "grand coalition" between the CDU/CSU and SPD. This frees the ECB from political constraints against further easing. It is yet another potential risk event that has lifted. With Europe a safer place, the bund should continue to shed its excessive safe-haven premium, with value flowing to German equities -- closing up the widest equity risk premium in the developed world.

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- By far the most likely outcome is a so-called "grand coalition" between Merkel's CDU/CSU and Peer Steinbrück's SPD -- a repeat of the Merkel-led 2005-2009 government.
- *Such an alliance poses no threat to Germany's continued fidelity to the euro and to European unification. The SPD is even more pro-Europe than the CDU/CSU.*
- Merkel will sound out the possibility of a coalition with the Greens, but their high tax agenda means any agreement is unlikely.
- The only other party to make it to parliament is neo-communist Left. Both Merkel and Steinbrück have already ruled out forming a government with them -- which also rules out a coalition of the SPD/Greens/Left, which could have been an alternate majority without Merkel's party.

Continuing a theme we have been highlighting all year (see "The Crisis Score is Four for Four" March 4, 2013), this election stands as yet another potential risk event that has failed to materialize.

- But in this case, even better than being the removal of a possible negative, the passing of the event itself should be a positive for the euro area. It has been a roadblock to pro-growth policy that will now become unstuck (see "Bundesblock" June 19, 2013).
- Indeed, as we write these words, ECB President Mario Draghi is addressing the European Parliament, suggesting ways the central bank might be able to be more accommodative.
- We again repeat our call that German debt's safe haven premium is becoming increasingly less valuable (again, see "Germany Votes"), and that value will transfer to German equities (see "SpanDax" July 12, 2013). This will represent the overdue normalization of Germany's equity risk premium, which has been the highest in the developed world.

Bottom line

As expected, Germany voted for more of the same -- once again confounding those who believed the electorate's bailout fatigue would drive Merkel from office. We will now have weeks of negotiation over the formation of the nearly inevitable "grand coalition" between the CDU/CSU and SPD. This frees the ECB from political constraints against further easing. It is yet another potential risk event that has lifted. With Europe a safer place, the bund should continue to shed its excessive safe-haven premium, with value flowing to German equities -- closing up the widest equity risk premium in the developed world.

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