



Citi Global Wealth Investments |

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# Europe Strategy Bulletin

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## Rising German uncertainty ahead of 26<sup>th</sup> September Federal Election

### Summary

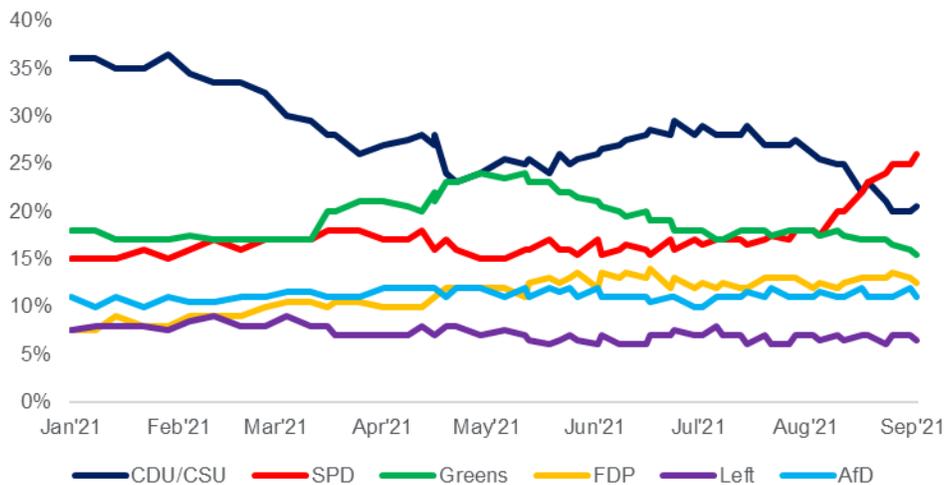
- The 26<sup>th</sup> September German federal election could lead to the defeat of the CDU/CSU coalition that has governed for the past 16 years. The centre-left Social Democrats (SPD) are 5 points ahead in the latest polling. Were the SPD to win, their eventual coalition partners would be very important in determining Germany's policies. The current finance minister Olaf Schulz (SPD party) is the leading candidate for chancellor, the position currently held by Angela Merkel.
- The stakes are high, given the wide range of key issues: economic and health recovery from Covid; climate change; immigration; pressures for more fiscal expansion to ease ageing infrastructure pressures; possible tax increases to fund the fiscal expansion; Europe's dependence on Russia for energy, on the US for defence, and on China for exports.
- Ahead of the election, we advise caution as the worst-case scenarios could impact all asset classes. A left-wing leaning coalition could hurt equities in the short-term through concerns about more regulation and higher corporate taxes, and higher outflows. The sovereign bond market is expensive, with almost all German bunds across the maturity spectrum offering negative yields, and could be pressured by moves to ease the German 'debt brake' and expand fiscally. Given the large range of possible outcomes, there could be a period of several weeks, perhaps even months, before the coalition is formalized, which could be reflected in Euro weakness during that period.

### Polls shifting sharply against the ruling conservative Christian Democrats

With just under a month before Germany's federal election, the polls are tight and the outcome is uncertain with several coalition permutations possible. After 16 years in power, there is a real and growing prospect of a government without Angela Merkel's conservative centre-right Christian Democrats (CDU) and its Bavarian sister party the CSU. The CDU has governed Germany for 50 of the last 70 years. Earlier this year, it was regarded as almost a foregone conclusion that the CDU/CSU coalition would win Germany's federal election and form a coalition with the Greens, which would be the first such "black-green" alliance in German history. However as polls have narrowed recently, an inconclusive election

result is increasingly likely, with a rising possibility of a left-leaning coalition emerging. The most recent polling data shows the SPD at 25%, while the CDU/CSU trails in second place with 20% - **Figure 1** below:

**Figure 1: German Election 2021 – Polling Data**



Source: INSA/YouGov as of September 6, 2021.

## The parties:

- **Christian Democrats:** The CDU slippage could be partly because of their long association with leader Angela Merkel and now they have not done a great job in clarifying policies that meaningfully differentiate on the key issues.
- **Social Democrats:** As the centre-left SPD rise in the polls, there is a rising chance of a so-called “traffic light coalition” comprising the SPD, Greens, and the liberal pro-business Free Democrats. The SDP manifesto seeks better regulation of digital platforms, more re-onshoring of pharmaceutical production, introduce a nationwide rent brake, expand EU-wide public investment initiatives, and have more dialogue with Russia.
- **Free Democrats:** The FDP are also known as the Liberals, and have often formed part of Conservative-led coalitions. They typically prefer lower taxes and less state involvement. In this election their manifesto stresses the need for better digital infrastructure, and better education for all with an extra Euro 2.5 billion per year extra in education. They would prefer defence spending to rise to 3% of GDP and a tougher approach with China and Russia.
- **Greens:** The party seeks German carbon neutrality within 20 years as their key policy. The party has also vowed to get tougher on China (with import duties on Chinese state-backed company imports) and Russia (applying sanctions on the property assets of individuals connected with the Russian president). They are also looking to reform Germany’s fiscal rules regarding maximum deficit and debt levels, to help support their proposed Euro 500 billion spending package over the next 10 years.
- **The Left:** Originally formed from the old East German Communist party and breakaway elements from the SPD’s Left, and their policies include higher taxes, a wider taxation base and more constraints on personal freedoms. Their manifesto includes Eur 10 billion per year for social housing with rent capping, Eur 38 billion per year for public transport, and a minimum wage of Eur 13 per hour. They would prefer to nationalize all healthcare providers, and legalize all illegal immigrants.

## The Chancellor candidates:

- **Armin Laschet** the CDU/CSU’s chancellor candidate has had a poor campaign so far. Surveys suggest the Bavarian premier Markus Soder would be preferred but postal ballots have already been sent out. Laschet has

not recovered in polling after appearing unsympathetic when recently visiting flooded areas, and is polling at only 10%.

- **Olaf Scholz:** The SPD surge is largely due to the popularity of their chancellor-candidate Olaf Scholz who is also Germany’s finance minister and is polling at 32%. Scholz is viewed as the continuity experienced candidate who is considered to be reliable and tested. Scholz has been a prolonged champion behind the recently agreed minimum corporate tax rate which has been well-received in Germany, and he is aligned with Merkel’s pro-EU integration views.
- **Annalena Baerbock:** The Green candidate Annalena Baerbock has been punished in polling after several mistakes on the campaign trail, however the Green party is consistently polling in third place and could still be a coalition partner, pushing to introduce a wealth tax and significantly increase state investment.

## Two potential coalition scenarios

After the election, there might be a prolonged period of coalition-building, particularly if the SPD win but cannot form a coalition with the FDP due to incompatibility between the SPD/Greens and the FDP on tax and public investment policy. In this scenario, the SPD/Greens could turn to the Left party (currently polling at 7%), or there could be an eventual SPD-less coalition might be formed between the CDU/CSU, Greens and FDP. At best financial markets could hold steady during the coalition-building period. While these are the main two possible scenarios, there are others – **Figure 2** below:

**Figure 2: Germany – Coalition Scenarios**

Coalition	Chancellor	Finance minister	Fiscal expansion (% of GDP)
“Germany” CDU/CSU-SPD-FDP	Laschet/ Scholz	Scholz/ Lindner	0.5%
“Jamaica” CDU/CSU-Greens-FDP	Laschet	Habeck/ Lindner	1.0%
“Traffic Light” Greens-SPD-FDP	Baerbock/ Scholz	Lindner/ Scholz	1.5%
“Kenya” CDU/CSU-Greens-SPD	Laschet/ Scholz	Scholz/ Habeck	1.5%
“R2G” Greens-SPD-Left	Baerbock/ Scholz	Scholz/Habeck	2.0%

Source: Citi Research *European Economics Weekly: Election Update – The Importance of the SPD’s Late Surge*, August 18, 2021. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events.

## Issues for new coalition and new leader

The race for chancellor has deflected the attentions of candidates and voters away from seriously debating the critical issues facing Germany: the export dependency on China, climate change, ageing infrastructure, security dependence on the US, and the Nord Stream 2 gas pipeline. Polls are showing that voters are most concerned about two issues - Covid and immigration. Party policies for containing Covid are broadly similar and focused on improving the vaccine rollout and acceptance, while the immigration issue following events in Afghanistan is likely to eventually have a European-wide

approach. Economic policy is the area of most differentiation between potential coalitions, at a time when the economy is reaching a crucial stage.

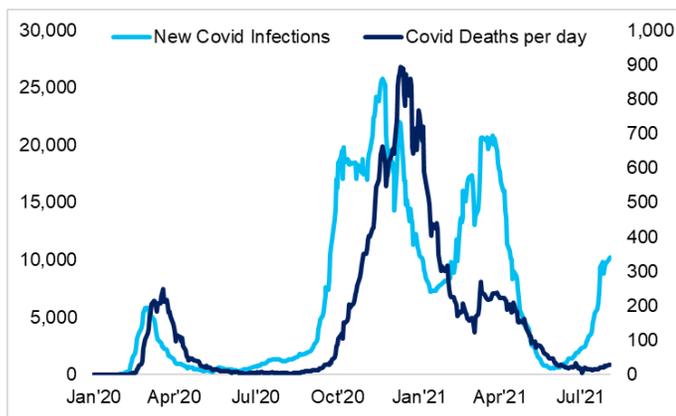
### 1. The German economic rebound is slowing as inflation surges

Germany's real GDP rose 1.6% quarter-on-quarter in the three months through June, following a 2% QQ drop in the first three months of this year. The main driver was household spending, which rose 3.2% QQ, along with strong fiscal support and rising capital investment. However August PMI numbers showed that private-sector activity in Germany slowed and manufacturing output fell amid supply shortages. Germany's ZEW Expectations index which measures investor confidence fell from 63.3 in July to 40.4 in August, a bigger fall than expected. GDP remains 3.3% below 4Q 2019 pre-pandemic levels. At the same time, inflation has risen to 3.4%, the highest level since 2008, due to rising energy prices and supply chain pressures. Our base case is that GDP growth will slow next year however remain positive, and inflation pressures are temporary, nevertheless the pressures on both will be high in the early days of the new coalition whose makeup and policies are not yet known.

### 2. Delta Covid still a challenge with vaccination level relatively low

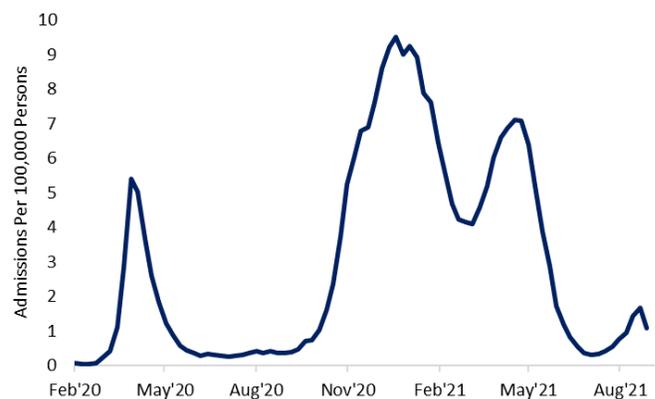
Rising Covid infections are raising concerns about more domestic lockdowns and more travel restrictions. Germany has done reasonably well in containing the Delta variant, however the level of vaccinations is one of the lowest in Western Europe (76% of adults have had at least one dose), and the pace of new first immunizations is slowing. (Figures 3 and 4).

Figure 3: Germany – New Covid Infections vs Deaths



Source: Oxford – Our World in Data, Haver Analytics as of September 3, 2021.

Figure 4: Germany – New Covid-19 Hospital Admissions, per 100,000 persons



Source: European Centre for Disease Prevention and Control, weekly data as of September 2, 2021.

### 3. Uncertainty surrounding Nord Stream 2 gas pipeline

The current German Chancellor Angela Merkel has vowed to push for more sanctions against Russia if the Kremlin uses the Nord Stream 2 gas pipeline linking Russia to Germany as a 'weapon'. The comments came after Russian President Vladimir Putin imposed conditions on any extension of a gas-transit agreement with Ukraine. Nord Stream 2 has been the target of criticism from the US and many EU member states, saying that the project gives Russia too much leverage and raises Europe's dependence on Russian energy. In July Merkel finalised a deal with US President Joe Biden to back away from threats of stricter Russian sanctions if Germany committed to act in the face of hostile Russian activity. President Putin recently stated that any extension to the project would depend on further demand from Europe.

### 4. No clear EU response yet to the upcoming Afghan refugee challenge

Since the Taliban takeover of Afghanistan, European leaders have stressed the moral responsibility to allow Afghan refugees that helped the EU and may want to leave the country. 400,000 Afghans have been internally displaced this year (source: UN). However at this stage there are different messages from different European countries, with many scarred by the memories of the 2015-16 Syrian refugee crisis. It is premature to assess the likely EU response, however there are signs that efforts are being made to agree principals for co-operation at the European level.

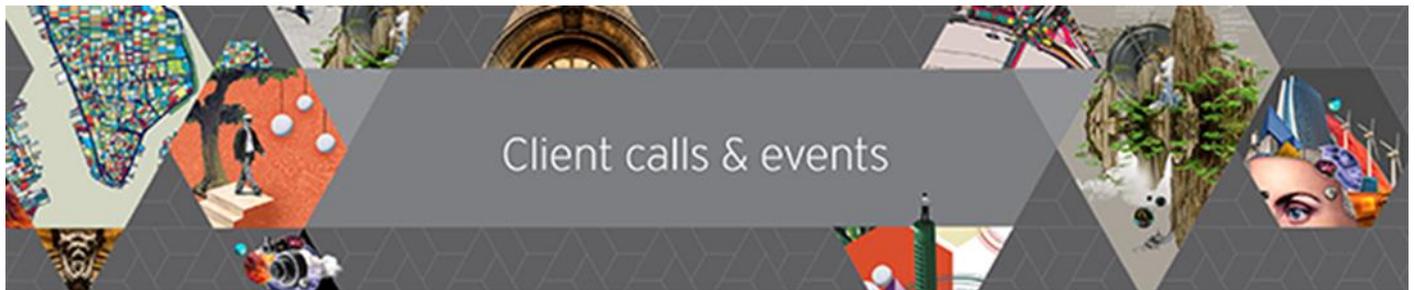
## Investment conclusions

**Equities:** We advise caution ahead of the election, patience during the coalition-building phase, then gradual accumulation. The critical factor to watch in the election is whether the result raises the prospects of corporate tax increases. Even if it does, this won't be agreed or implemented quickly, while exporter orderbooks and domestics with Green exposure should be very well supported. If there is a left-leaning coalition, there could be an initial sell-off as the market discounts higher taxes and more business regulation, which might give a good entry level for the long-term.

The German market is reasonably priced, on 13.9x prospective earnings, with 45% EPS growth this year and at least 11% next year. The multiple compares well with the prospective multiple of 16.7x for Europe ex-UK. The average German dividend yield of 2.7% is close to the regional average of 2.9%. The market offers good cyclical exposure as well as quality companies with tested management and strong balance sheets.

**Fixed income:** German bunds are already expensive and vulnerable to further cyclical economic strength and to more supply, with the added potential catalyst of much more aggressive fiscal expansion after the election. The Greens, with their aggressive public spending manifesto, are likely to be part of the coalition. What is unknown is the influence they will have, which of course depends on the final voter count.

**Euro:** The Euro is unlikely to sustainably rally during the post-election collation-building stage, and could be under downward pressure if the eventual German coalition is left-leaning. There could also be Euro impact if the fiscal direction puts pressure not only on the German debt brake but also on the broader Europe Maastricht criteria for maximum deficit and debt levels. If the CDU/CSU lead (increasingly less likely, but still possible), then the Euro would be well supported with the likely continuation of the Merkel domestic and foreign policies.



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