German Election Watch

Europe after the German elections

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- Outlook: Recent opinion polls suggest an 85% chance for Merkel to retain the chancellery. Multiple coalition scenarios imply different economic consequences for Germany as well as partly opposing consequences for European integration, which is expected to accelerate in the coming years. That said, potential coalition partners may seek the finance minister's post, which could affect the stance on the Eurozone periphery as well as the choice of the ECB president in 2019.
- Markets: The short-term market impact is expected to be muted as a populist is unlikely to assume the chancellor's post. However, in the medium to long term, the CDU/CSU's future coalition partner(s) may influence the euro, equities and Eurozone bond yields given the implications for the speed of European integration, the stance to the Eurozone periphery and the nominations for European institutions.
- What we're watching: Polls, comments from politicians and the fragile EU-Turkey deal on refugees. The ECB's QE program and the economic outlook may also influence polls.

Source: Dreamstime

CIO German election coverage

- Volatility of polls set to increase, 4 September
- The German election and Greece, 28 August
- The election and its implications for Europe, 19 July
- Merkel in pole position after regional elections, 14 May
- Introducing the Q&A, 27 March
- The race is on, 30 January
- Schulz to run against Merkel, 25 January

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Our view

We assign a 85% probability of Angela Merkel retaining the chancellery. Our base case remains a grand coalition, but it is no longer as clear cut as it once was. The rise of the FDP and the Greens in the spring has moved potential two-way coalitions close to the 50% mark. Economic plans are supportive overall for growth, despite the balanced budget, while any taxation plans may be watered down given the necessary approval of the highly-fragmented upper chamber. We therefore don't expect a wealth tax anytime soon. Improved Franco-German relations raise the prospect of a future Eurozone finance minister post (with a small budget), a European defense union and a European Monetary Fund. We believe European integration will deepen in the next legislative period, as support for the euro hits record highs, despite the UK's exit from the EU. Nonetheless, we don't foresee debt mutualisation under any coalition scenario. Indeed, a coalition with the FDP may imply a tougher European policy and a slower integration process.

Potential coalition partners may claim the German finance ministry. Given fiscal bailout mechanisms and a potential future Eurozone budget, the finance ministry post has become very high profile. Should Wolfgang Schäuble leave the finance ministry, a harder (FDP) or softer tone (SPD or Greens) may be struck with the periphery.

It is conceivable, that Wolfgang Schäuble may seek one of the myriad of presidencies that will become vacant in the coming two years, should he leave. In such an event, we think the chances for a German ECB president in 2019 would decline to safeguard a balanced representation of member states at European institutions. This may imply a slower policy rate normalization path and lower euro and Eurozone bond yields than with a German ECB president.

German election preview

Germany: A shift toward the right

Comparing current polling with the results of previous elections indicates a marked shift to the right. Two parties are polling significantly better than in 2013. The Alternative for Germany (AfD) is set to become the first right-wing party to enter the Bundestag. It is currently polling almost five percentage points higher than it did in the last Bundestag election. The conservatives from the FDP are also eyeing an increase over 2013 (more than four percentage points). The CDU, CSU, SPD have all lost ground, with the Left and the Greens stable (see Fig. 1).

German election backdrop/polls

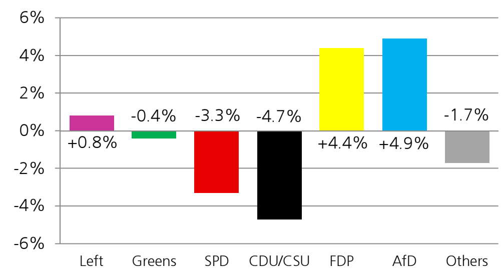
We allocate an 85% probability of Merkel retaining the chancellery (up from 75% last week). Recent polls have not only cemented the CDU/CSU's lead of over 14 percentage points over the Social Democratic Party (SPD), but also the rise of the Greens and the FDP. Although we still see a 60% chance of a grand coalition, political uncertainty has increased markedly. Indeed, potential coalition options other than a grand coalition are now more numerous, bringing possible two-way coalitions with either the FDP or the Greens relatively close to the 50% mark (see Fig. 2 and 3). Although the CDU/CSU/FDP/Greens coalition is polling above 50%, we think this combination of parties is unlikely given the significant policy differences between the three. Finding compromise agreements between the three would also be far more difficult than between two parties.

The SPD and the finance ministry

The SPD has stabilized since early June. Nonetheless, with approx. 23%, the SPD is still well below its high of over 32% in March (see Fig. 2). That said, the SPD may have reached the limits of what it can achieve in a CDU/CSU-led grand coalition after exhausting low hanging fruits, and it therefore may require a high price for staying on board. It is therefore quite conceivable that it may request the finance ministry. Of course, its negotiating position will be driven by its election result and that of the FDP

Fig. 1: Current polls vs. last election

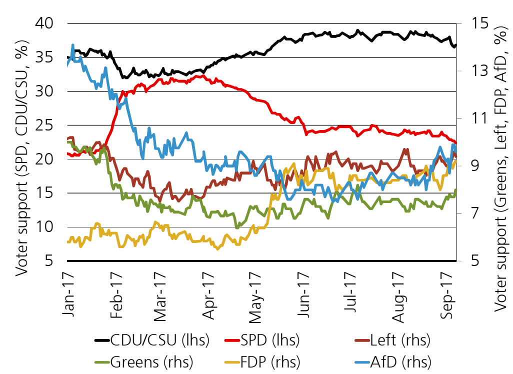
The last four years have seen a shift to the right



Note: Based on the 5-poll average of various pollsters
Source: INSA, Emnid, Forsa, Forschungsgruppe Wahlen, GMS, Infratest dimap, Ipsos, Civey, Allensbach, Trend Research, UBS, as of 7 September 2017.

Fig. 2: Political polls

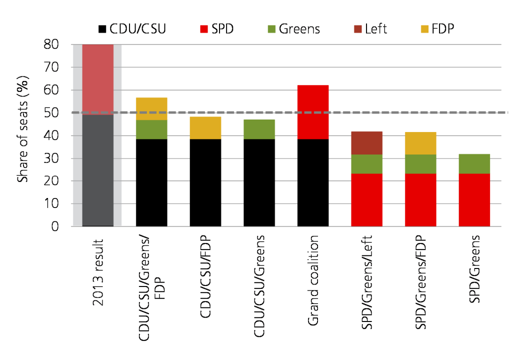
CDU-led government most likely



Note: Based on the five-poll average of various pollsters
Source: INSA, Emnid, Forsa, Forschungsgruppe Wahlen, GMS, Infratest dimap, Ipsos, Civey, Allensbach, Trend Research, UBS, as of 7 September 2017.

Fig. 3: Support for political parties

Merkel-led grand coalition as base case



Note: Based on the 5-poll moving average of various pollsters.
Source: INSA, Emnid, Forsa, Forschungsgruppe Wahlen, GMS, Infratest dimap, Ipsos, Civey, Allensbach, Trend Research, UBS, as of 7 September 2017.

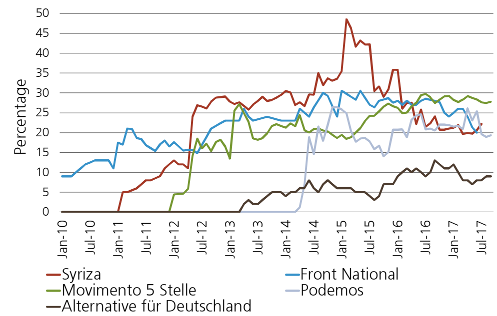
and the Greens. To claim the most prestigious ministry – the finance ministry – and to retain Sigmar Gabriel's foreign ministry (reportedly a priority), it will probably have to get back to approximately 30%. In that event, the CDU/CSU would probably move back below 35%, giving the SPD a large relative weight and cutting down the CDU/CSU's large lead of over 14ppt currently.

A more conservative German government within reach
The FDP would likely punch beyond its weight (it currently polls approximately 9%) in a conservative government with the CDU/CSU. The SPD would be leaving the coalition in this scenario, so the relative importance of the FDP and the CSU would increase accordingly, and together they would make up over one-third of the coalition's seats in parliament. What's more, the CDU itself boasts conservatives in its own ranks. Almost one-quarter of the CDU/CSU voted against the third Greek bailout package in the summer of 2015, counter to Merkel's clear recommendation. Adding these parliamentarians to the mix, the conservatives could easily make up half or more of the future German government. Given the FDP's tough stance on Europe, a CDU/CSU/FDP coalition may make it more difficult for Merkel to continue with her current European plans. Given the political damage the FDP suffered in the 2013 election after running the foreign ministry, this time it may claim the finance ministry.

Europe after the German election

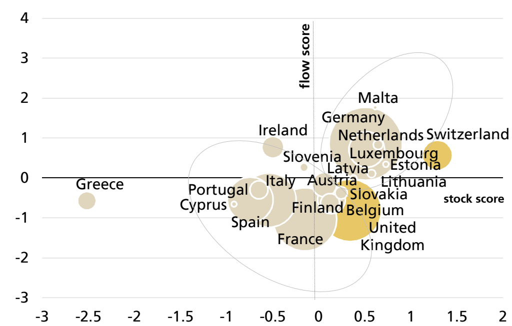
Populists' victory averted, but still on the rise
The German election will likely conclude the 2017 election marathon in major European countries. The recent elections in Europe have so far resulted in two main developments. Firstly, populists recorded successes in several nations although the market was clearly relieved as they didn't form governments and performed somewhat worse than polls suggested. That said, they expanded their share of seats in the Dutch parliament, the Front National recorded its best results ever in a French presidential election and the German right wing party AfD is set to enter the Bundestag for the first time since World War II. Nonetheless, populists didn't manage a much-feared breakthrough in the Netherlands and France, leading to a subsequent decline in market volatility. Despite market perception that populism was defeated, we argue that the long term uptrend in European populism remains on track (see Fig. 4), having led to widespread fragmentation in numerous parliaments and making governance much more difficult in many instances. The Spanish minority government and the hyper-fragmented Dutch parliament are examples. Plus, Marine Le Pen's chances may increase substantially

Fig. 4: Support for populist parties
Populism close to critical mass



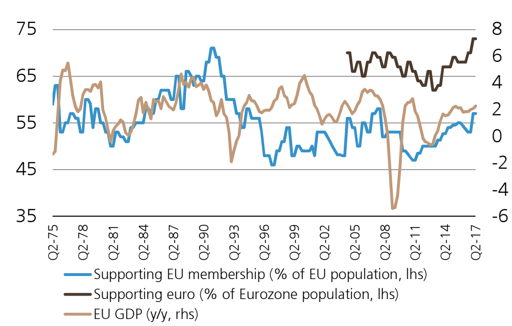
Source: UBS, as of September 2017.

Fig. 5: Imbalances in Europe
Greek imbalances no longer deteriorating



Note: Non-Eurozone members are in yellow. The stock dimension is based on the debt-to-GDP ratio, the net international investment position (i.e. net foreign financial position of all residents in a country) and excess unemployment. The flow dimension is based on the government deficit, the current account balance and the nominal GDP growth. The upper right quadrant reflects relative strength.
Source: UBS, Haver Analytics, as of 2016.

Fig. 6: Support for the Euro and the EU
Euro support at historical high



Source: European Commission, UBS CIO WM, as of May 2017.

in France's next presidential election in 2022 if Macron doesn't perform well. Should the economy go into a recession at some point, populist forces would get a boost.

Europe and the renaissance of the Franco-German axis

Secondly, the CDU/CSU is now working with a centrist rather than a socialist-led France, rekindling the relationship between the two nations. Macron and Merkel holding an unusual joint press conference after the June European Council is a case in point. Also, Merkel has suddenly opened up the possibility for a European treaty change, raising the specter of significantly more European integration (including establishing a Eurozone finance minister post, together with a small budget).

The timing couldn't be better as almost all countries are now complying with the Maastricht 3% deficit criterion and the economy is doing well. Even France and Spain are about to comply and the European Commission has recommended releasing Greece from the Excessive Deficit Procedure (even before France and Spain). Figure 5 shows how Greece has improved a lot, and its aggregate imbalances are no longer deteriorating (even if they are still big).

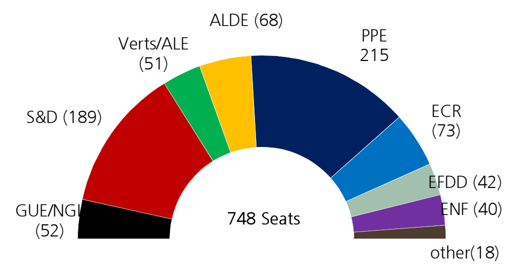
Since the euro crisis, Germany has been adamant about demanding Eurozone governments to bring their fiscal houses in order before talking about fiscal integration measures. With Eurozone fiscal deficits set to average only 1.4% in 2018 according to the European Commission, the backdrop for European (fiscal) integration measures has changed considerably. In addition, the economic upswing has driven up popular support for the Eurozone to historical highs (see Fig. 6), with a recent survey conducted in Germany suggesting that 79% of citizens want the government to increase cooperation within Europe. As such, talk has started for example about a European finance minister with a small Eurozone budget, which would complement national budgets. Regarding a Eurozone finance minister and budget, Merkel said at a recent joint cabinet meeting with the French administration that "we can talk about it" and "we will surprise you in that respect." Accordingly, we expect European integration to accelerate in the years ahead.

Back from the national to the European stage

The focus will likely move back to the European stage following the Dutch, French, UK and German elections (assuming there are no snap elections). As such, Brexit is expected in March 2019 (with negotiations set to conclude in 2H18), just in time for the European parliament election in May/June 2019. The timing ensures that the UK will not participate in the European

Fig. 7: European Parliament

British members leaving before European election



Source: European Parliament, UBS CIO WM. Note: European parliament elections are scheduled for May/June 2019.

parliament election in 2019 (see Fig. 7). More importantly, almost all key posts in Europe are due for changes in the coming two years (see Fig. 8), including the presidencies of the ECB, the Eurogroup, the European Commission and the European Council. Furthermore, the potential creation of a Eurozone finance minister post could be an additional high profile role. These appointments will be key bargaining chips in negotiating further European integration.

European policy-making to reset: Watch the ECB

As a consequence, European policy-making may change not only because of the renewed Franco-German axis, but also due to new policy-makers in Europe's most powerful institutions. Therefore, European politicians are set for a period of bargaining to place their candidates. Germany appears keen to claim the presidency of the ECB. This position has been held so far by a Dutchman (Wim Duisenberg), a Frenchman (Jean-Claude Trichet) and an Italian (Mario Draghi). Coincidentally, Jens Weidmann's mandate at the Bundesbank ends in April 2019 (see Fig. 8), six months before the new ECB president is set to take office (October 2019). We believe a German ECB president could lead to a hawkish shift in ECB policy-making, with the hurdles for monetary easing becoming higher in the future. This would also mean that any future ECB interest rate normalization would likely proceed faster once it starts (CIO expectation: 2019 at the earliest). Altogether, this may prove supportive for the euro and Eurozone yields.

However, the decision has yet to be made (appointments are done by the European Council, where Germany has an important weight), and other candidates may also have good chances. The governor of the Banque de France, François Villeroy de Galhau, may also be a candidate, despite it being potentially the second time the job goes to a Frenchman (after Trichet). Furthermore, he may also be acceptable to Germany, given his family's strong German roots (he also speaks German well).

The German election and European nominations

The CDU/CSU may have to give up the finance ministry to build a coalition. This would allow Wolfgang Schäuble to then potentially claim one of the numerous key European posts, such as, for example, the expected new Eurozone finance minister post or the presidency of the European Commission. The latter option would probably mean that the institution would become more restrictive when it reviews national budgets, leading to more fiscal discipline in the periphery. The current European Commission president – Jean-Claude Juncker – has already announced that he will not run again in 2019.

Furthermore, Schäuble may potentially also orchestrate a transfer of the European Commission's fiscal watchdog function to the European Stability Mechanism or Eurogroup (given Germany's disappointment with the European Commission's stance on fiscal matters). With Schäuble potentially running the European Commission (or becoming the first Eurozone finance minister), the ECB presidency would probably go to a non-German as Germany already holds the presidencies of the European Stability Mechanism and the European Investment Bank. Given that the latter two institutions have direct fiscal implications for Germany, we expect the German government to want to keep these positions.

Thus, adding both the ECB and the European Commission on top of these posts may be too much for the other 26 member states, which are also trying to push through their own candidates. That said, Germany would probably have to pay a high price for getting these two posts, such as offering significantly more fiscal integration against the will of its own population. As a consequence, we think that the likelihood of a German running the ECB would decline if Schäuble leaves the finance ministry after the German election (with him possibly taking on a European institution). A German running the European Commission or a future Eurozone finance minister post rather than the ECB may be more investor-friendly as it would likely imply a still investor-friendly ECB. Implementing a Eurozone finance ministry post may take some time, even though we don't think it would require a cumbersome European treaty change. Indeed, Schäuble may bridge that gap by taking over the Eurogroup presidency (which could be turned into a permanent capacity), as Jeroen Dijsselbloem is set to leave the Eurogroup by the end of the year.

Fig. 8: European political calendar

European politics to take center stage again after national election marathon

	Country/area	Event/institution	Officeholder
Sep 2017		German Bundestag election	–
2H 2017		Eurogroup President	Jeroen Dijsselbloem (NL)
Jan 2018		European Investment Bank President	Werner Hoyer (DE)
1H 2018		Italian parliamentary election	–
May 2018		ECB Vice President	Vítor Constâncio (PT)
Dec 2018		ECB Banking supervision (SSM)	Danièle Nouy (FR)
Mar 2019		Brexit	–
Apr 2019		ECB Council/Bundesbank President	Jens Weidmann (DE)
May/Jun 2019		European parliamentary election	–
Oct 2019		ECB President	Mario Draghi (IT)
Oct 2019		Greek parliamentary election	–
Oct 2019		European Commission President	Jean-Claude Juncker (LU)
Nov 2019		European Council President	Donald Tusk (PL)

Source: UBS CIO WM, as of September 2017. Note: Dates for officeholders refer to end date of respective mandate.

Investment implications

Equities

In the medium to long term, the German election and its implications for the future ECB policy, as well as the future German stance on European integration and the periphery (for example, if the FDP joined the government), will be a driver for German/Eurozone equities. But the market impact is unlikely to be significant in the short term, whichever coalition forms the next government as the implications of the German election may be felt only over the medium to long term. As such, in the short term, other factors may impact the market, such as Eurozone and German equities' international exposure and sensitivities to global growth, interest rates and currency movements. Also, German domestic revenues account for less than 30% of MSCI Germany's total revenues, among the lowest of the main Eurozone country indices. Currently, Eurozone equities are supported by solid economic growth and strong earnings momentum, which should translate into low double-digit EPS growth this year. The negative currency effect on corporate earnings from a stronger euro will be mostly felt in 2H17, but the impact should be modest, unless the euro rises further.

The prospect of the ECB tapering its QE program should continue to provide support to Bund yields, which is a positive for EMU financials. In our EMU country allocation, we are overweight on Germany, whose above-average cyclicality should benefit from solid, synchronized global growth.

Author: Bert Jansen

Eurozone government bonds

Elections have been moving bond markets in the cases of the French elections and the Italian referendum, but we think the immediate effects will be much more modest in the case of the German elections. While the ECB policy outlook will remain the dominant driver of EUR bond yields into 2018, we think the most imminent effect on yields from the German elections should result from different expected new issuance volumes for Bunds under the government scenarios and the different stance of potential junior coalition partners vis a vis the Eurozone periphery. We believe under our base case, with Angela Merkel leading a new government, either in a grand coalition or with the Greens, issuance of Bunds would be similar to 2017 (around EUR 160bn). We would expect market reaction to be minimal in such scenario, both in Bunds and peripheral government bonds. A coalition with the FDP may benefit Bunds moderately versus peripheral bonds, which may suffer from the FDP's tougher stance on Greece and other economically weaker countries. A Schulz chancellery would surprise bond markets as much as pollsters and has the largest potential implications for yields and spreads. In particular a left wing coalition would justify higher EUR bond yields, due to likely fiscal expansion and higher bond issuance. At the same time, the left wing case would much ease the German stance towards support for peripheral countries and result in tightening peripheral risk premiums.

Depending on the precise outcome of the German elections, opinion leaders like Wolfgang Schäuble and/or Jens Weidmann may advance to leading roles within the EU and ECB. Either of the two obtaining such a role would likely weigh on peripheral risk premiums initially, while their stricter stance on fiscal consolidation may, over time, be beneficial for peripheral countries' credit quality and bond yields. The prospect of a German leader at the ECB would support the euro, while the impact on bond yields is more ambiguous. While a lower inclination to conduct government bond purchases would speak for higher EUR bond yields, tighter monetary policy may also result in lower inflation expectations and therefore lower long-term bond yields.

Author: Thomas Wacker

The euro

The German election poses little short term risk to the euro, in our view. It might support the currency slightly if it leads to a more hawkish ECB and more European integration. The recent advance of EURUSD limit, however, the upside. We expect EURUSD to remain in a broad 1.15-1.20 range. A pronounced rise of EURUSD above 1.20 would seriously challenge the ECB's inflation target, in which case one has to expect the central bank to act.

Germany has always been the key stabilizing factor for the common currency and that will hardly change with this election. The key issues affecting the euro in the coming months are the ECB's QE and its potential, Macron's policy changes, Brexit and at some stage next year's Italian election. That said, we think a change from a grand coalition to one including the FDP may shift the government's stance towards a more stringent European policy, slightly increasing the support for the euro. A red-red-green coalition, which is a very low probability event, may cause some volatility in the short term. In the longer term, the growth impulse and ensuing higher employment (due to the bigger fiscal stimulus) could be positive for the euro. Potential compromises in the budget and the question whether red-red-green would maintain the debt-break that was introduced 2009 under Merkel and Schäuble would be negative. As long as this foundation stays in place, we would not expect any negative impact on the euro.

The other big question, which is discussed in this paper, concerns Draghi's successor in 2019. The outlook for the euro may improve should Germany win the presidency. Investors are therefore well advised to monitor the future of the German finance ministry and the implications for European positions such as the ECB presidency.

Author: Thomas Flury

Appendix: Electoral programs

	CDU/CSU	SPD	FDP	Greens	Left Party	AfD
Taxes and fiscal	• Income tax: Raise the 42% upper tax rate threshold from €56k to €60k (€15bn per year). • Solidarity tax: Abolish in steps from 2020 (€4bn per year from 2020). • No tax hikes, no wealth tax, no inheritance tax change. • Fiscal rules: Commitment to balanced budget and constitutional debt brake. • Support Financial Transactions Tax (FTT).	• Income tax: Raise the 42% upper tax rate threshold from €56k to €60k (€15bn per year). • Income tax: New 45% tax rate will kick in at €76.2k with a 3% surcharge for incomes above €250k (€10bn per year). • Solidarity tax: Abolish for lower incomes from 2020 (€10bn per year from 2020). • Close loopholes in inheritance tax and VAT. • Support FTT.	• Income tax: Unspecified income tax cuts and indexation of thresholds. • Solidarity tax: Completely abolish from 2020. • No tax hikes, no wealth tax, no inheritance tax change. • Fiscal rules: Balanced budget insufficient, actual debt reduction targeted. • Debt: Insolvency law for federal states and municipalities. • Lower energy tax.	• Income tax: Increase in the tax free allowance, higher tax rate for >€100k incomes. • Wealth tax. • Corporate tax: salaries >€500k not tax deductible. Fighting corporate tax evasion or avoidance. • Support FTT.	• Income tax: Raise tax free threshold to €12,600 per year. Raise income tax for incomes above €7,100 per month. • Introduce wealth tax from €1 million.	• Income tax: Tax-bands instead of tax rate progression and indexation of thresholds to avoid "cold progression". • Income tax: Increase the tax-free minimum income. • VAT cut by 7ppt. • Reduce tax quota in the medium-term to 40%, from nearly 50% in 2016. • Abolition of inheritance tax and no introduction of wealth tax. • Country-of-origin principle for corporate taxation.
Welfare and pensions	• Increase in child benefits (€300 per child per year). • Childcare: Right to full-time primary schools. • Pensions: No change. Commission to make proposals for post-2030 pensions by 2019.	• Social security subsidies for low-income households. • Equal employers/ employees social sec. contr. (€5bn/year). • Social security: Same healthcare insurance for all. • Childcare: Abolishing nursery fees. Full-time primary schools. • Families: €300 p.m. for parents if both are working part-time. • Pensions: Replacement ratio of 48%, maximum contributions of 22%; "Solidarity pension"; keep pension age unchanged.	• Flexible pension age (60-70) with adjusted pension payments. Improve possibilities to earn on top of pension. • Social security exemption of second-pillar pensions and less regulation of investment spectrum of third-pillar pensions. • Education: Introduce university tuition fees (paid after graduating).	• Pensions: New minimum pension. Stabilise replacement ratio. Retirement age stays at 67, but early retirement from 60 possible. Improve possibilities to earn on top of pension. All companies have to offer second pillar pensions. • Social security: Same health and care insurance for all. • Social subsistence: increase in allowances.	• Raise replacement ratio from 48% to 53%. • Minimum pension of €1,050 per month. • Equal pensions in East and West Germany. • Minimum welfare payment of €1,050 per month. • Same health insurance for all.	• Full pension after 45 years of contributions. • Pensioners can earn additional income without reductions of their pensions. • Harmonization of employer and employee social security contributions.
Public investment and spending	• Raise investment in R&D from 3.0% of GDP to 3.5%. • More investment in digital infrastructure (no amounts). • 15k new police officers. • Raise military spending to 2% of GDP by 2024.	• "Investment offensive": Raise public investment by €30bn over 4 years. • Raising investment in R&D from 3.0% of GDP to 3.5%. • 15k new police officers. • Rejection of 2% of GDP military spending.	• Raise education expenditure as share of GDP to Top 5 of OECD (from 3.7% of GDP to 5.6% of GDP according to the OECD 2013). • €2bn per year extra for roadbuilding (for 20 years). • More investment in digital infrastructure (no amounts).	• Major investment in renewable energy. Aim 100% renewables by 2030 (no amounts). • Additional investment in education (no amounts). • More investment in digital infrastructure (no amounts).	• Additional public investment in healthcare, transport, housing construction, energy, digital infrastructure (no amounts). • Expansion of public sector employment (no amounts). • Ending privatizations.	• Additional investment in transport infrastructure and education (no amounts).
Immigration and refugees	• New skilled immigration law. • No cap on refugee intake.	• New skilled immigration law. • No cap on refugee intake.	• New immigration law. • Dual citizenship.	• New immigration law. • Citizenship: by place of birth, no restriction on dual citizenship.	• No limits to asylum. • Major investments and legislative action to improve integration of immigrants.	• Immediate closure of borders for immigration. • Outlawing some symbols of Muslim faith in public.

	CDU/CSU	SPD	FDP	Greens	Left Party	AfD
Housing	• 1.5 million new flats 2017-2021: streamlining planning permissions, introducing regressive depreciation. • New home buyer subsidy (€1,200/year per child)	• Better enforcement of the rent brake. • Indexation of rent subsidies. • More flats in public or company ownership.	• Increase annual depreciation from 2 to 3% to promote housebuilding.	• 1 million new flats with low rents. • Better enforcement of the rent brake.	• 250k new flats per year with regulated rents.	• Reduction of house purchase taxation. • Streamlining of planning permissions.
Labour Market	• Flexibility in weekly working hours. • Halving unemployment to 1.25 million by 2025.	• Longer unemployment benefits and wider eligibility. • Temporary work: Equal pay from day 1; new restrictions. • Wages: fewer minimum wage exceptions; strengthened collective bargaining. • Worker board representation threshold lowered to 1,000 employees.	• Deregulation of temporary jobs. • Increased working time flexibility	• Wages: fewer exceptions from minimum wage. • Temporary work: new restrictions to avoid abuse. Equal pay from day 1. • Sabbatical: new time-out for social care with government bursary.	• Raise minimum wage from €8.50 per hour to €12. • Abolition of temporary work contracts. • Reduction of working hours. • Raise wages in social sector. • Equal pay of men and women. • Longer unemployment benefits.	• Supports minimum wage. • Use of temporary work limited to 15% of the workforce per company. • New citizens' work service for the long-term unemployed. • Reform of labor statistics to reflect full extent of unemployment.
Eurozone and EU	• European Monetary Fund (EMF) to aid Eurozone countries in trouble. • Debt mutualization ruled out. • Focus on EU defense union. • Corporate tax harmonization with France. • No Turkish EU accession.	• European infrastructure investment program. • More flexible Eurozone fiscal rules. • European social union (common welfare standards and employee representation). • Coordinated Eurozone economic policy. • EZ budget, funded by FTT. • Convert ESM into EMF. • No country should be forced to exit the euro. • EU tax harmonization. • European defense union. • Replacement of UK MEPs with transnational lists. • New attempt at EU constitution.	• "Europe of different speeds". • European Army. • Phasing out of the ESM. • ECB should not complement ESM programs (OMT). • Insolvency law for Eurozone member states. • New possibility for orderly exit from Eurozone. • Banking: Risk weights for sovereign bonds, strict bail-in enforcement. • Automatic sanctions in stability and growth pact. • End to low ECB interest rates. • Turkey: end of EU accession negotiations.	• European refugee policy. • Free Interrail-Ticket for 18-year-olds. • Europe of different speeds must be exception. • Debt relief for Greece. • "New Green Deal" for Europe. New investment fund. • Minimum standards for welfare and labor law. • Stronger EU parliament. • EU defense union. • Turkey should keep EU accession option.	• End of austerity and no threat against EZ countries pursuing alternative economic policies. • Referendums on treaty changes. • Repeal of CETA et al. • Investment program • Direct ECB government funding. End independence. • Restructuring of "illegitimate" public debt, including Greek debt restructuring, with Germany unilaterally paying war reparations to Greece. • Rejection of capital markets union. • European minimum wage at 60% of the national average wage.	• Conversion of EU into looser grouping of states by abolishing the Maastricht and Lisbon treaties. • Germany to exit EU if other member states disagree. • Outlawing ECB asset purchases and zero or negative interest rates. • No bail-outs for states and banks, no banking union. • Even before "D-Exit" from euro, end Target 2 imbalances. • Preparation of return to Deutsche Mark. • No European army. • Ending bilateral free trade deals like Ceta.
Brexit	• Limit damage of Brexit for people and the economy. • Countries leaving EU no longer benefit from its advantages.	• No cherry-picking, no division of the EU. • Principles of single market are non-negotiable.	• No cherry-picking • Principles of single market are non-negotiable. • No extension of Article 50. • Open EU door for Scotland.	• Priority for unity and integrity of the EU, no cherry-picking. • Help for Northern Irish and Scottish "Remainers" • Principles of single market are non-negotiable. • UK citizens in Germany should have easy way to German citizenship.	• Maintaining mutual free mobility of labor and expats rights.	• Brexit as a role model: use threat to leave the EU and Eurozone to reform the EU.

Other	• Outlawing online pharmacies.	• More financial regulation, including support for bank leverage ratio and separation of retail and wholesale banking.	• Venture-Capital-Law to end tax preference of debt over equity. • Liberalization of transport (Uber) and hospitality (AirBnB). • Privatization of rail operator. • Flexibility in opening hours, including Sunday.	• More financial regulation, including support for bank leverage ratio and separation of retail and wholesale banking.	• Foreign policy: Abolition of NATO, better relations with Russia.	• Direct democracy: Introduction of referendums; direct election of federal president. • Social: End of antidiscrimination law, opposition to same-sex marriage. • Foreign policy: Improved relations with Russia; exiting Paris climate agreement. • Energy: Continued use of nuclear energy.

Source: UBS CIO WM, Citi Research, as of July 2017.

Glossary

Bank Recovery and Resolution Directive (BRRD)
The Bank Recovery and Resolution Directive (BRRD) harmonizes the tools used in the recovery and resolution of credit institutions in the EU. The BRRD stipulates that should a bank fail, its shareholders and creditors should normally be first in line to absorb any risks and losses. Only then should a resolution fund financed by the entire banking industry (Single Bank Resolution Fund, or SBRF) step in. In extreme cases, government institutions can still be financially involved in the recovery or resolution of an institution ("bail-out").

Current account
The current account measures the cross border flow of goods, services, net investment income and cash transfers in a given period. Usually, the trade balance is the largest component of the current account. A current account surplus (normally associated with a trade surplus) means that the respective country has increased its net foreign assets, or in the case of net liabilities, reduced it in a specific period.

Deposit Guarantee Schemes Directive (DGSD)
The new European Directive on Deposit Guarantee Schemes entered into force on 2 July 2014. It replaced the previous Deposit Guarantee Scheme Directive from 1994. Its main elements include: simplification and harmonization, in particular relating to coverage and payout arrangements; further reduction, to one week, of the time limit for paying out depositors, and better access for DGSs to information about their members (i.e. banks); harmonization of minimum ex ante financing requirements for DGSs; mutual borrowing between DGSs, i.e. a borrowing facility in certain circumstances.

ECB Deposit Facility
A standing facility of the Eurosystem which counterparties may use to make overnight deposits at a national central bank. Such deposits are remunerated at a pre-specified interest rate ("deposit rate").

ECB Executive Board
One of the decision-making bodies of the ECB. It comprises the President and the Vice-President of the ECB and four other members, all of whom are appointed by common accord by the Heads of State or Government of the EU Member States whose currency is the euro.

ECB Governing Council
The supreme decision-making body of the ECB. It comprises the President and the Vice-President of the ECB plus the other members of the Executive Board and the governors of the national central banks of those EU Member States whose currency is the euro.

ECB longer-term refinancing operation (LTRO)
A regular open market operation executed by the Eurosystem in the form of a reverse transaction. Longer-term refinancing operations are carried out through monthly standard tenders and normally have a maturity of three months.

European Fund for Strategic Investments (EFSI)
An investment plan from the European Commission aimed at relaunching public and private investment in the real economy over 2015–2017. The fund is operated by the European Investment Bank.

European Semester
A six-month period each year when member states' budgetary, macro-economic and structural policies are coordinated so as to allow member states to take EU considerations into account at an early stage of their national budgetary processes and in other aspects of their economic policymaking.

European Stability Mechanism (ESM)
The European Stability Mechanism is an intergovernmental institution based in Luxembourg, set up to provide financial assistance to Eurozone member states experiencing, or being threatened by, severe financing problems, if this is indispensable for safeguarding financial stability in the Eurozone as a whole. The maximum lending capacity of the ESM is set at EUR 500 billion. This is achieved with a subscribed capital of EUR 700 billion (EUR 80 billion paid-in capital, the rest callable). The ESM entered into force on 27 September 2012. It took over the tasks fulfilled by the European Financial Stability Facility (EFSF).

European System of Financial Supervision (ESFS)
The group of institutions in charge of ensuring the supervision of the EU's financial system. It comprises the European Systemic Risk Board, the three European Supervisory Authorities (the European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority), the Joint Committee of the European Supervisory Authorities, and the national supervisory authorities of the EU Member States.

European Systemic Risk Board (ESRB)
An independent EU body responsible for the macro-prudential oversight of the financial system within the EU. It contributes to the prevention or mitigation of systemic risks to financial stability that arise from developments within the financial system, taking into account macroeconomic developments, so as to avoid periods of widespread financial distress.

Eurosystem
The central banking system of the euro area. It comprises the ECB and the national central banks of those EU Member States whose currency is the euro.

Excessive Deficit Procedure (EDP)
The corrective arm of the Stability and Growth Pact (SGP) ensures that Member States adopt appropriate policy responses to correct excessive deficits by implementing the Excessive Deficit Procedure (EDP). The EDP operationalizes the limits on the budget deficit and public debt given by the thresholds of 3% of deficit to GDP and 60% of debt to GDP not diminishing at a satisfactory pace.

Full allotment policy
This policy provides banks with access to unlimited ECB liquidity, as long as eligible collateral is delivered to the ECB. The MRO interest rate applies to the liquidity lent out under fixed allotment policy.

HICP Inflation
Consumer price inflation in the euro area is measured by the Harmonized Index of Consumer Prices (HICP). The HICP is compiled by Eurostat and the national statistical institutes in accordance with harmonized statistical methods. The headline inflation refers to the inflation rate including core and non-core inflation.

Main refinancing operation (MRO)
A regular open market operation executed by the Eurosystem (in the form of a reverse transaction) for the purpose of providing the banking system with the amount of liquidity that the former deems to be appropriate. The interest rate on MROs represents the key policy rate for the ECB to implement its monetary policy stance.

Marginal lending rate
The interest rate on the Eurosystem's marginal lending facility which banks may use for overnight credit from a national central bank that is part of the Eurosystem.

Monetary aggregate
Currency in circulation plus outstanding amounts of certain liabilities of monetary financial institutions (MFIs) that have a relatively high degree of liquidity and are held by non-MFI euro area residents outside the central government sector. The Governing Council has announced a reference value for the growth of M3.

Outright monetary transactions (OMT)
A program under which the ECB makes purchases ("outright transactions") in secondary, sovereign bond markets, under certain conditions, of bonds issued by Eurozone member states. Conditions for eligibility are that the government has asked for financial assistance through the ESM or EFSF and that it agrees to implement certain domestic economic measures.

Purchasing Manager Index (PMI)
The Markit PMI™ series are monthly economic surveys of carefully selected companies compiled by Markit. They provide advance insight into the private sector economy by tracking variables such as output, new orders, employment and prices across key sectors.

Securities Markets Programme (SMP)
Interventions by the Eurosystem in public and private debt securities markets in the Eurozone to ensure depth and liquidity in those market segments that are dysfunctional. The objective is to restore an appropriate monetary policy transmission mechanism, and thus the effective conduct of monetary policy oriented toward price stability in the medium term.

Single Resolution Mechanism (SRM)
The Single Resolution Mechanism complements the Single Supervisory Mechanism. It is set to centralize key competences and resources for managing the failure of any bank in the Eurozone and in other Member States participating in the Banking Union.

Single Supervisory Mechanism (SSM)
The Single Supervisory Mechanism (SSM) is a new system of banking supervision for Europe. It comprises the ECB and the national supervisory authorities of the participating countries. Its main aims are to ensure the safety and soundness of the European banking system, increase financial integration and stability, and ensure consistent supervision. The SSM is one of the two pillars of the EU banking union, along with the Single Resolution Mechanism.

Six-pack
A set of six legal acts adopted in 2011, strengthening procedures for the surveillance of the member states' fiscal policies (the "Stability and Growth Pact") and introducing new ones for their macroeconomic policies. The aim is to better control public deficits and national debt and to better address macroeconomic imbalances.

Stability and Growth Pact
The Stability and Growth Pact (SGP) is a rule-based framework for the coordination of national fiscal policies in the European Union. It was established to safeguard sound public finances, based on the principle that economic policies are a matter of shared concern for all Member States.

TARGET2
The second-generation TARGET system. It settles payments in euro in central bank money and functions on the basis of a single IT platform, to which all payment orders are submitted for processing. This means that all payments are received in the same technical form.

Targeted Long-Term Refinancing Operations (TLTRO)
A new LTRO (see above) announced on June 2014 targeted at business loans, consisting of eight LTROs. Its aim is to improve bank lending to the Eurozone non-financial private sector in order to ensure that the supply of credit will not endanger the recovery of the real economy. TLTROs should also improve the distortions in the monetary transmission channel. TLTROs have been accessible on a quarterly basis from September 2014.

Treaty on stability, coordination and governance (fiscal compact)
The fiscal compact is an intergovernmental treaty signed by euro area members and other EU member states at the European Council meeting on 2 March 2012. The treaty requires structural government deficits not to exceed 0.5% of GDP and the budget to be in balance or surplus. In addition, debt to GDP ratios above 60% of GDP must be reduced over a 20- year period (subject to a three-year grace period following compliance with the deficit objective).

Two-pack
The second package of proposals on economic governance was presented by the Commission in November 2011 and builds on the so-called "six-pack" of economic governance proposals. Once adopted, the two draft regulations will introduce provisions for enhanced monitoring of Eurozone countries' budgetary policies.

Unit labor costs
Unit labor costs (ULC) measure the average cost of labor per unit of output and are calculated as the ratio of total labor costs to real output. A rise in an economy's unit labor costs represents an increased reward for labor's contribution to output.

Source: BaFin, Bundesbank, ECB, European Union, Markit, OECD.

Appendix

Terms and Abbreviations

Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
A	actual i.e. 2010A	COM	Common shares
E	expected i.e. 2011E	Shares o/s	Shares outstanding
UP	Underperform: The stock is expected to underperform the sector benchmark	CIO	UBS WM Chief Investment Office