German Election Watch

The election and its implications for Europe

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- **Outlook:** Recent opinion polls suggest increased uncertainty in the aftermath of the 24 September elections, as the CDU/CSU (expected to capture most votes) may be able to form a coalition with either the FDP or Greens given their rise in recent months. Multiple coalition scenarios imply different economic consequences for Germany as well as partly opposing consequences for European integration. What is more, 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

German Election Watch

- 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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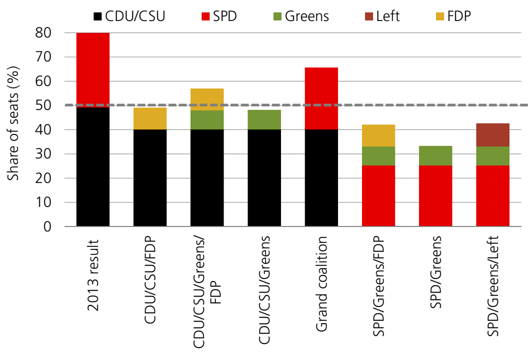
Our view

Based on polling as well as statistical models we assign a 75% probability of Angela Merkel retaining the chancellery. Our base case remains a grand coalition, but it is no longer as clear cut. The rise of the FDP and the Greens in recent months has moved potential two-way coalitions very close to the 50% mark. Economic plans are overall supportive 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. The improved France-German relations raise the prospect of a future small Eurozone budget/Eurozone finance minister, European defense union and a future European Monetary Fund. We don't foresee debt mutualisation in any coalition scenario. 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 up for appointment 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.

Fig. 1: Support for political parties
CDU/CSU gaining momentum



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 17 July 2017.

Polls and the fate of the finance ministry

Polls: Impact of electoral programs not fully reflected yet

Given the dominance of the CDU/CSU (see Fig. 2) and historical coalition experiences under Merkel, potential coalition partners may seek the highly prestigious and powerful finance ministry as a condition for joining any coalition with the CDU/CSU. That said, polling data has not yet seen much impact from the release of the various political parties' electoral programs. However, we believe that most people have yet to scrutinize all the manifestos, given the timing of the election on 24 September, the holiday season and that the manifestos were only published recently; for example, the CDU/CSU only published its manifesto on 3 July (see the appendix for a comparison of the manifestos).

The rise of the FDP: A tougher European stance?

The CDU/CSU has regained a substantial lead over the SPD (polling over 38% versus about 24%), while the FDP moved up sharply to 8-9% during April/May (well above the 5% hurdle to enter the Bundestag) and has been stable since then. Also, after bottoming in April, the Greens have been on an uptrend and their recovery continues. This has raised the specter of the FDP returning to the government either with the CDU/CSU or in a "Jamaica coalition" (i.e. CDU/CSU, FDP and Greens). The CDU/CSU and the FDP are currently polling 48-49% (see Fig. 1) and the Jamaica coalition 56-57% (see Fig. 3). Given the FDP's tough stance on Europe, this scenario may probably make it more difficult for Merkel to continue with her current European plans (see appendix) given that the more conservative forces in government would multiply (see Fig. 4). This would add to the conservative forces in the CDU/CSU (almost a quarter didn't vote for the Greek bailout in 2015). Given the hit the FDP took in the 2013 election after running the foreign ministry, it will probably want a higher price this time for joining the CDU as a junior partner – possibly the finance ministry (which has become key given Eurozone bailouts and financing mechanisms such as the ESM).

Are the Greens making a comeback?

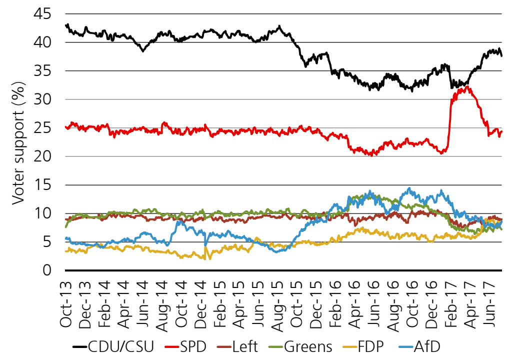
The turnaround of the Greens may also revive the specter of a CDU/CSU and Greens coalition (see Fig. 1 and Fig. 3). Currently, the CDU/CSU and the Greens are polling around 47-48%. Should their recovery since April continue, a black-green coalition may become a real possibility. The Greens might push less hard for the finance ministry than the SPD or even the FDP and their manifesto doesn't have such big issues regarding Europe as the CDU/CSU would have with the FDP.

The SPD and the finance ministry

The SPD has stabilized since early June, mostly at the expense of the CDU/CSU and the FDP. Nonetheless, with approx. 24%, the SPD is still well below its high of over 32% in March. 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 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 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.

Fig. 2: Polls since last election

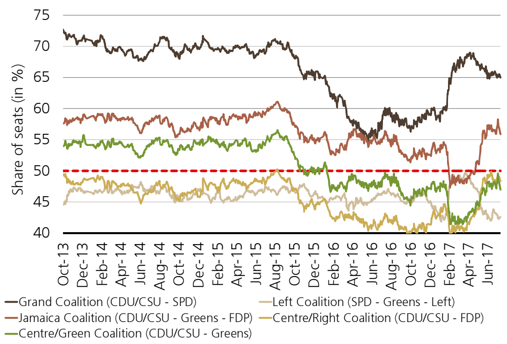
CDU/CSU back, Greens with catchup potential



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 17 July 2017.

Fig. 3: Polls and coalitions since last election

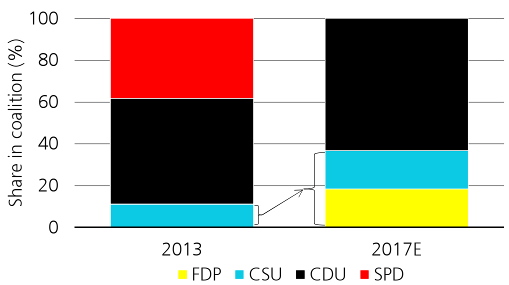
CDU-led government most likely



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 17 July 2017.

Fig. 4: Potential CDU/CSU/FDP coalition

CSU and FDP would control over a third



Note: Share of CDU, CSU, and FDP (in 2017) election of total votes received, based on 5-poll moving average. Expected CSU election result based on Bavarian polls. Source: Wahlrecht, UBS, as of 17 July 17.

Statistical forecasting models

Polls have been off the mark on several occasions lately, calling several key votes in the UK incorrectly as well as the electoral college in the last US presidential election. In the latter case, a tailor-made statistical model (from Nate Silver) gave Donald Trump a better chance than almost anyone else, even if it didn't call a Trump win. It appears there is value in complementing traditional polling data with statistical election models to broaden the basis, especially when the polls are very close. Moreover, modelling adds further value by measuring uncertainty and by accounting for risk. Accordingly, we have leveraged two tailor-made models for Germany.

The Chancellor model and the federal election

The Chancellor model (by Helmut Norpoth, Stony Brook University/Thomas Gschwend, University of Mannheim) makes predictions for voter shares for the German parliamentary election for the two top parties (see Fig. 6). It uses as predictors long-term partisanship (i.e. parties' historical average election results), short-term chancellor candidate approval ratings and the number of terms in office (as a proxy for government fatigue). These predictors have proven important and broadly reliable in German elections. Since 1953, the Chancellor model has predicted German election results in the vast majority of cases quite closely. Currently, the model sees the SPD getting 2-3ppt more than the polls suggest (see Fig. 7).

Forecasting the Bundestag election: INWT's model

Another model (by Marcus Gross, INWT statistics) scrutinizes the forecast accuracy and biases of each polling institute and constructs a trend for the voter shares. Also, it uses 100,000 simulations for election day, thereby adjusting for the intricacies of the German electoral system (such as the 5% hurdle for entering parliament). During the last five federal elections, it predicted the election outcome 11ppt more accurately than the last five polls before election day. Currently, it sees the SPD's result broadly in line with the polls, but sees downside for the FDP and upside for the Greens (see Fig. 7).

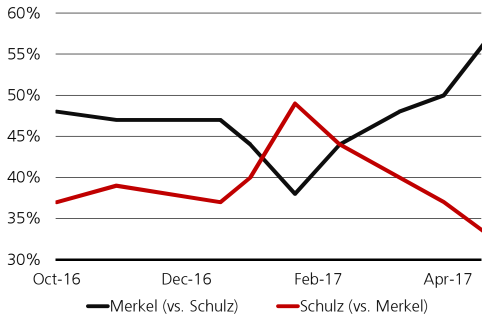
Conclusion

The consistent picture for the CDU/CSU's vote share (as well as those of the SPD) across polling institutes is confirmed by statistical models. The Chancellor model as well as INWT model point to the CDU/CSU capturing the highest share of the vote with a considerable lead. Accordingly, our baseline view is that the CDU/CSU will lead the next government.

For the smaller parties, polls as well as the INWT model suggest that the FDP, Greens, the Left and the AfD should comply with the 5% hurdle to enter the Bundestag. However, there are substantial discrepancies at the level of the FDP and the Greens, suggesting the potential for significant surprises here on election day in terms of their share of the vote. As a consequence, the uncertainty relating to the future of the finance ministry is significant.

Fig. 5: Chancellor approval ratings

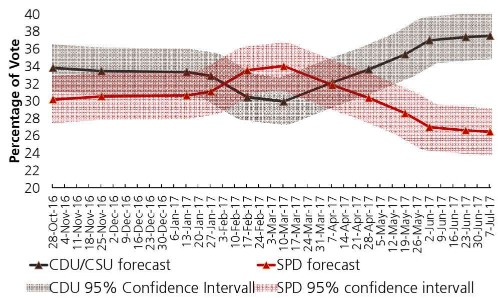
Merkel has a big lead



Note: The question posed was "who would you rather see as chancellor after the Bundestag elections…" when given the choice between Merkel and Schulz.
Source: ZDF Politbarometer, UBS, as of 7 July 2017.

Fig. 6: The chancellor model

SPD and CDU/CSU have stabilized



Note: Based on Norpoth and Gschwend (2010, The chancellor model: forecasting German elections)
Source: Norpoth & Gschwend (2010), wahlrecht.de, Forschungsgruppe Wahlen, UBS, as of 7 July 2017.

Fig. 7: Overview of election predictions

CDU/CSU leading clearly in all benchmarks

	Polls	INWT Model	Chancellor Model
CDU/CSU	37.6	37.5	37.5
SPD	24.4	24.5	26.5
FDP	8.5	6.9	-
Greens	7.2	9.2	-
Left	9	8.9	-
AfD	8.7	8.3	-

Note: Polls represent a 5-poll moving average of votes (rather than seats).
Source: wahlrecht.de, Chancellor Model (Norpoth & Gschwend), INWT, UBS, as of 17 July 2017.

Scenario 1 – Merkel: Impact and coalitions

The backdrop for the CDU/CSU is very favorable as illustrated by the polls. Its chancellor enjoys high popularity (see Fig. 6) and the economy is doing very well (favoring the CDU/CSU). In addition, the SPD has lost its initial momentum, as was the case in other elections. We therefore allocate a 75% probability of the CDU/CSU capturing the highest share of votes on 24 September (up from 70% in the last German Election Watch in May).

Favorable economic impact

The short-term impact on the economy will likely be favorable, given the planned stimulus package amounting to EUR 15bn or about 0.5% p.a. of GDP (mostly through tax measures) and additional infrastructure spending (R&D, digital and military spending). The CDU should be able to reduce taxes as long as the economy remains benign. Given the similarities to the SPD manifesto regarding tax cuts, it may be able to count on the SPD's support in the upper chamber (see Fig. 9 and box, changes to taxes require the Bundesrat's support). The residential housing sector will see additional support. Most of the planned funds are sourced from a strong economy and excess tax revenues, as a balanced budget remains a priority. No cap is expected on refugee intakes.

Franco-German axis to spearhead European integration

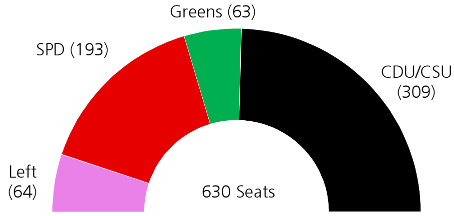
For European integration, it would broadly mean a continuation of the new spirit of cooperation between France and Germany, including the harmonization of corporate taxes with France (with Macron seeking to lower the tax rates). However, the manifesto still rules out measures such as debt mutualization, while foreseeing a European Monetary Fund (i.e. an enhanced ESM with greater powers) and focuses on an EU defense union. Geopolitically, the manifesto foresees no Turkish EU accession and on Brexit, it seeks to limit the damage to the German economy.

Coalition outlook: More options than in 2013

To govern, we believe the CDU/CSU would first try to form a government with either the FDP or the Greens (rather than with the SPD), and if that is not possible, with both together. This way, the CDU/CSU could maximize its power at the ministerial level (the SPD currently has 24%, the FDP/Greens 16%). However, given the potentially heavy compromises and how difficult it may be to form a Jamaica coalition (CDU/CSU, FDP, Greens), the CDU/CSU may not push too hard. Not only are there large differences on European policy between the CDU/CSU and the FDP, but also between the Greens and the FDP (for example, on climate change, immigration and Europe). Even the CDU/CSU agreeing on a coalition with its natural partner - the FDP - would have its challenges as the FDP's position on Europe is markedly different and tougher (phasing out of the ESM, allowing for Eurozone exit, no OMT for the ESM, automatic sanctions in the European Stability and Growth Pact, etc.). The Greens' recent rise may offer a way out for the CDU/CSU, but it is too early to tell.

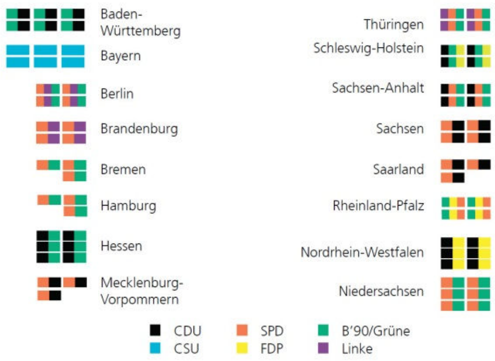
When balancing the incentives for working with smaller parties against forming a three-way coalition, we regard a grand coalition as slightly more likely (as long as a two-way coalition isn't feasible), at 55%, even if the SPD grabs the finance ministry (assuming a 30% result in the election). In the section "Europe after the elections," we explore the potential implications at the European level.

Fig. 8: Current seat distribution of Bundestag
Large majority of grand coalition



Source: Bundestag, UBS, as of July 2017.

Fig. 9: Structure of the Bundesrat
Difficult without the SPD



Source: Bundestag, UBS, as of July 2017.

Box: The Bundesrat

The Bundesrat is the upper chamber of the German parliament. It is designed to give the states a say at the federal level. Only members of a state government can have a seat in the Bundesrat. This also entails that all members of a state have to vote unanimously, otherwise their votes are invalid. Every state has a minimum of three votes. States with a population larger than two million get four, states with more than six million people five, and states with more than seven million people six votes – adding up to a total of currently 69 seats.

Through an absolute majority of 35 votes, the Bundesrat can reject laws (so-called Zustimmungsgesetze; about 40% of laws) that:

- have an effect on the finances of the states (Bundesländer),
- intervene in the states' organizational or administrative prerogative,
- change the constitution (two-third approval of Bundesrat is required).

Other laws (so-called Einspruchgesetze; about 60% of laws) can only be sent back to the Bundestag, where the Bundesrat can be overruled.

Source: UBS, Bundesrat.

Scenario 2 – Schulz: Impact and coalitions

Following the nomination of Martin Schulz and the initial boost in polls, news-flow on the SPD abated somewhat at the federal level. With the recent manifesto, the SPD is returning to the national stage, suggesting at least a stabilization, if not some potential recovery, ahead in the polls. The bottoming in SPD support in the polls in June is a case in point. However, in the absence of popular fatigue with Merkel ("Wechselstimmung"; see Fig. 5) and with a 14ppt gap versus the CDU/CSU, it will be an uphill battle to win the election. So we have reduced our probability assessment for the SPD obtaining the highest share of votes from 30% to 25%.

The SPD and the economy: More support at the margin
The SPD's plans are somewhat more conducive for economic growth at the margin than the CDU/CSU's, in our view. The main reason is that the SPD may exhibit less fiscal discipline, leading to a greater fiscal stimulus.

In terms of measures disclosed so far, the SPD's manifesto entails somewhat higher taxes for higher incomes (and closing loopholes in VAT and inheritance) to fund lower taxes for lower incomes, but also a more generous phasing out of the solidarity tax amounting to EUR 10bn p.a. (CDU/CSU: EUR 4bn p.a.) from 2020 onwards and more generous welfare and work benefits overall. However, the SPD would unlikely be able to raise taxes (certainly not a wealth tax), as it would need the approval of the highly-fragmented Bundesrat (see Fig. 9). That said, the SPD's housing plans entail a better enforcement of the rent brake and is overall less supportive for the housing industry than the CDU/CSU's. Both parties support the European Financial Transaction Tax (FTT) and reject a cap on refugee intakes.

Even more Europe with the SPD
The SPD's manifesto shares many similarities regarding Europe with that of the CDU/CSU. Not surprisingly, after four years in the grand coalition, positions have converged regarding many points. As such, the SPD manifesto also supports, for example, a conversion of the European Stability Mechanism into a European Monetary Fund, a European defense union and a new attempt at a EU constitution (as Merkel suggested at the last European Council). On the other hand, it foresees a European infrastructure investment program, no pressure on countries to exit the euro and more flexible Eurozone fiscal rules. An SPD-led government begs the question whether Schulz would be able to work as well with Macron as Merkel has done to date. Given that En Marche! is expected to position itself between the center-right and the socialists in Europe, the answer should be yes. Moreover, Schulz is also pro-European like Macron.

Coalition options limited - grand coalition most likely
Schulz would probably only have two options: either a grand coalition or teaming up with the Greens and the left. Like the CDU/CSU, the SPD would most likely also first reach out to the smaller parties, i.e. the Greens and the Left. Plans regarding taxes would probably be reconcilable, while compatibility is probably most difficult at the European level. In particular, the Left's position would probably be hard to reconcile. Objectives include direct ECB funding to governments, the end of ECB independence, war reparations to Greece, the rejection of the capital market union and the abolition of NATO. Accordingly, we would think the grand coalition option is more likely (65% probability).

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 there was market relief because they didn't form governments and performed somewhat worse than the polls suggested. They expanded their share of seats in the Dutch parliament, the Front National recorded its best results ever in a French presidential election and German right wing party AfD is set to enter the Bundestag for the first time since World War II. Next year, Italy's 5 Star Movement's expansion in the parliament may lead to a hung parliament, perhaps forcing at least another election in 2018.

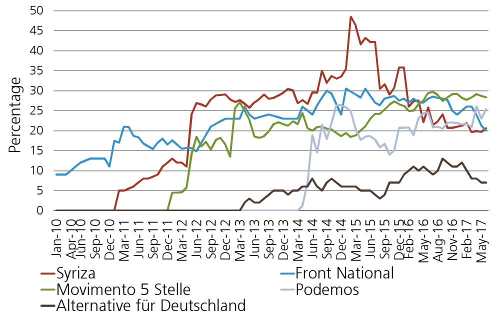
Populists didn't manage a much-feared breakthrough in the Netherlands and France, leading to a subsequent decline in market volatility. Despite market perception that populism was defeated, we argue that the European uptrend in populism remains on track (see Fig. 10), having led to widespread fragmentation in numerous parliaments and making governance more difficult in many instances. The Spanish minority government, the hyper-fragmented Dutch parliament and the lack of a majority in the Italian parliament are examples. Plus, Marine Le Pen's chances may increase substantially 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.

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 11 shows how Greece has improved a lot, and its aggregate imbalances are no longer deteriorating (even if they are still big).

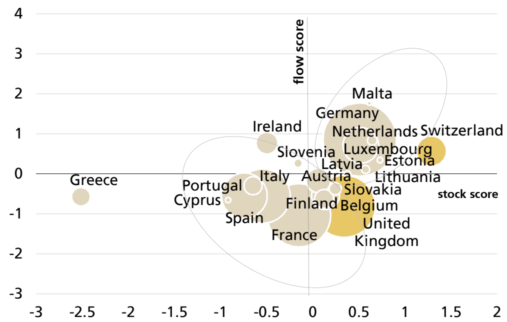
Since the euro crisis, Germany has been adamant about demanding Eurozone governments to bring their fiscal houses in order before talking about fiscal integration measures. With Eurozone fiscal deficits set to average only 1.4% in 2018 according to the European Commission, the backdrop for European fiscal integration measures has changed considerably. In addition, the economic upswing has pushed up popular support for the Eurozone (see Fig. 12). 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."

Fig. 10: Support for populist parties
Long-term trend in major countries still up



Source: UBS, as of June 2017.

Fig. 11: 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.

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 have to participate in the European parliament election in 2019 (see Fig. 13). More importantly, almost all key posts in Europe are due for changes in the coming two years (see Fig. 14), including the presidencies of the ECB, the Eurogroup, the European Commission and the European Council.

European policy-making to reset: Watch the ECB

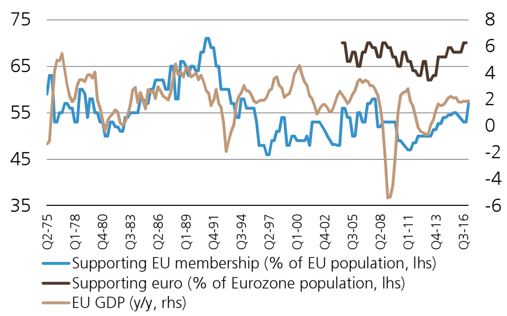
As a consequence, European policy-making may change not only because of the renewed Franco-German axis, but also due to new policy-makers in Europe's most powerful institutions. Therefore, European politicians are set for a period of bargaining to place their candidates. Germany appears keen to claim 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. 14), 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 (including other German ones). The governor of the Banque de France, François Villeroy de Galhau, may also be a candidate. Although it would be the second time the job goes to a Frenchman (after Trichet), it would comply with the historical compromise of having the ECB located on German soil but with a non-German president. 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. Becoming free after the German election, Wolfgang Schäuble would then potentially claim one of the numerous key European posts, such as, for example, the European Commission. This 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.

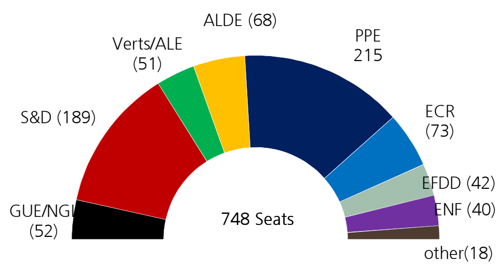
Furthermore, Schäuble may potentially also orchestrate a transfer of the European Commission's fiscal watchdog function to the European Stability Mechanism or Eurogroup (given Germany's disappointment with the European Commission's stance on fiscal matters). With Schäuble running the European Commission, the ECB 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.

Fig. 12: Support for the Euro and the EU
Solid support in line with GDP growth



Source: European Commission, UBS CIO WM, as of 2016.

Fig. 13: European Parliament
British members leaving before European election



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

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 like the European Commission). A German running the European Commission rather than the ECB may be more investor-friendly as Schäuble at the Commission may mean more fiscal discipline in the Eurozone, but also a still investor-friendly ECB.

Fig. 14: 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 June 2016. 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, excluding the strong base effects from the energy and financial sectors. The negative currency effect on corporate earnings from a stronger euro will be mostly felt in 2H17, but the impact should be modest.

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

The euro
The German election poses little risk to the euro, in our view; on the contrary, if it leads to a more hawkish ECB and more European integration, it may support the currency. 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: Tom 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.
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.

	CDU/CSU	SPD	FDP	Greens	Left Party	AfD
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. Note: Manifesto of Greens not final yet.

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

Appendix

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