German Election Watch

German election Q&A: All you need to know

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- Outlook: Opinion polls point firmly to Angela Merkel retaining the chancellery following Sunday's election. As the SPD continues to lack traction shortly before the election, we have raised our probability of Merkel retaining the chancellery from 85% to 90%. Although a grand coalition remains our base case (CIO estimate: 60%), uncertainty is much higher when it comes to the CDU/CSU's future coalition partner. In this note we have drawn up a set of questions and answers based around the different coalition scenarios and implications these political unions may have.
- Markets: The short-term market impact is expected to be muted as a populist is unlikely to assume the post of chancellor. 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 are watching: Polls, comments from politicians and the fragile EU-Turkey deal on refugees.

Our view

We assign a 90% probability that Angela Merkel retains 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 Brexit. Nonetheless, we don't foresee debt mutualization under any coalition scenario. Indeed, a coalition with the FDP may imply a tougher European policy and a slower integration process.

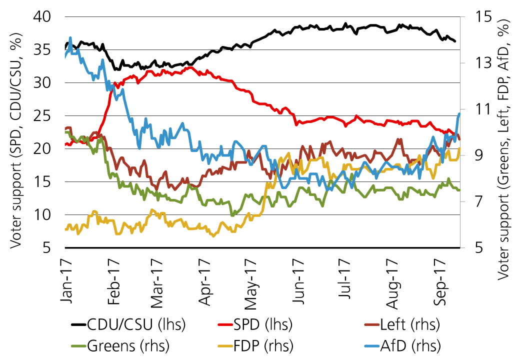
Potential coalition partners may claim the German finance ministry. Should Wolfgang Schäuble leave the finance ministry, a harder (FDP) or softer tone (SPD or Greens) may be struck with Europe's periphery. In contrast, if Schäuble remains, a German could take up the ECB presidency in 2019. This may imply a faster policy rate normalization path and higher euro and Eurozone bond yields than with a non-German ECB president.

Source: Dreamstime

CIO German election coverage

- Europe after the German elections, 12 September
- 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

Fig. 1: Support for political parties
AfD puts in strong performance in the final weeks



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 18 September 2017.

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CIO baseline views

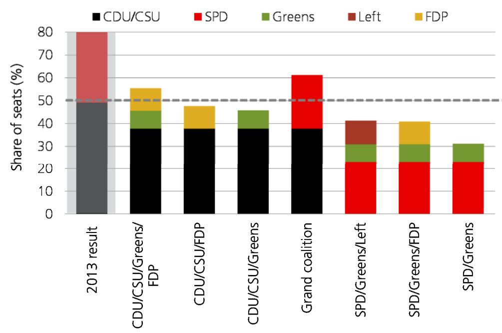
1. What is the CIO baseline scenario?

To govern, we believe the CDU/CSU would first try to form a government with either the Greens or in particular the FDP (i.e. if the respective combinations exceeded 50%). This way, the CDU/CSU could maximize its power at the ministerial level (the SPD currently has 22-23%, the Greens 7-8% and the FDP 9%). Should these two-way coalitions not be possible, we think the CDU/CSU will not push hard for a Jamaica coalition (CDU/CSU, FDP, Greens) but rather seek a grand coalition. 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.). In conclusion, as long as a Jamaica coalition and a grand coalition remain the only mathematical options, our base case is a grand coalition with a probability of 60% even if the SPD grabs the finance ministry (assuming a 30% result in the election). Furthermore, we expect Angela Merkel to remain chancellor with a probability of 90%.

Should a CDU/CSU/FDP coalition exceed 50% of seats on election day, such a combination would become our base case (even if it claimed only a slight majority). However, this is conditional on both Angela Merkel and Christian Lindner (party head of the FDP) confirming their willingness to engage in such a coalition, post the election. Should the CDU/CSU/Greens exceed 50% of seats, (while a combination of CDU/CSU/FDP falls short), it would become our base case provided the coalition exceeds the 50% mark by at least a few percentage points (given that the CDU/CSU are politically further removed from the Greens than it is from the FDP). This would require the CDU/CSU and the Greens to confirm its interest in such a coalition post the election.

Fig. 2: Projected coalition options

Merkel-led grand coalition as base case



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 18 September 2017

2. What would a grand coalition mean for Schäuble?

With approx. 22-23%, the SPD is still well below its high of over 32% in March (see Fig. 1). 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 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 14ppt currently. That said, with 22-23%, the SPD is currently polling close to its worst election result since WWII (23% in 2009), making a transfer of the finance ministry from the CDU/CSU to the SPD unlikely.

If Schäuble should leave the finance ministry in order to get the buy-in from another party to form a coalition with the CDU/CSU, he might take up one of the many European institutions up for appointment in the next two years (see question 7).

3. Why should the German economy benefit from the election?

The 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 (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. Should the CDU/CSU work with a coalition partner other than the SPD (such as the FDP), we would expect the economic and fiscal impact to be similar. Even if digitalization may be a key priority for Merkel, we don't expect deep reforms such as the Agenda 2010, given the lack of pressure in a very benign economic environment.

Growth is therefore set to be boosted by fiscal easing of approximately ½% in 2018 and 2019, leading to our GDP growth outlook of 2.1% in 2017 and 1.7% in 2018 (see fig. 3). Our 2018 forecast therefore includes the aforementioned fiscal easing.

Fig. 3: UBS German economic forecasts
Growth outlook unchanged

UBS German economic forecasts

% change yoy in real terms				Forecasts UBS[2]	
	Level[1]	2015	2016	2017F	2018F
Gross domes	3'144	1.5	1.9	2.1	1.7
Private consı	1'674	1.9	1.9	1.3	1.5
Government	615	2.8	3.7	1.4	1.1
Investments	630	1.1	2.9	2.8	2.7
Exports	1'450	4.6	2.4	4.2	2.6
Imports	1'199	5.0	3.8	3.7	2.7
Inflation		0.1	0.4	1.7	1.9
Unemployment rate		4.6	4.2	3.8	3.7

09/18/17

1 Year 2016 (in EUR (bn) at current prices, ESA 2010)
Source: UBS, Haver

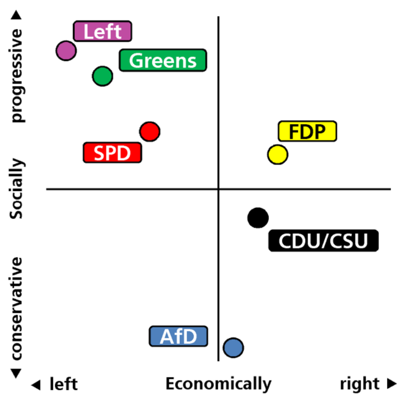
Source: UBS, Haver, as of 18 September 2017.

Key party positions

4. What are the key differences between the parties' policies?

The main point of agreement among the parties is the call for income tax cuts (from EUR 10-30bn), while large structural reforms remain absent (see appendix). That said, the SPD and the Greens focus on lower-income households and wish to increase taxes for high incomes, while the CDU/CSU and the FDP propose relief for all income ranges. The FDP calls for the highest income tax cuts, but only as long as the budget balance target is – at least – complied with and relies on the FDP's assumptions on the expected tax surpluses. We therefore think that any tax relief would be similar to the CDU/CSU's plans. Only the Greens and the Left carry a wealth tax in their manifestos, making the wealth tax unlikely in the next four years (also due to the highly fragmented upper chamber).

Fig. 4: Political landscape
Overview of ideological party positions



Note: Economically left implies favoring government planning and public control, economically right implies favoring a private sector economy and free competition.
Source: Wahl Navi, UBS, as of August 2017.

With regards to public spending, the SPD, the FDP and the Greens favor higher public investment, but only the Greens have an explicit financial target (EUR 10bn). Coupled with the difficulty for the federal government in sourcing sufficient investment projects, we don't expect an incremental and material investment boost after the elections. In any event, there are also differences with regards to increasing defense spending. The CDU/CSU and FDP all aim to increase defense spending in compliance with NATO's target of 2% of GDP (currently 1.2%), with the SPD and Greens being opposed to such an increase in spending.

On European policy, points of agreement include a hardline toward Brexit, a common defense policy and a European redistribution system for refugees. The SPD and Greens go further and propose a common European budget, a European investment program and, together with the CDU/CSU, aim to transform the ESM into a European Monetary Fund. On a different note, the FDP has a less positive stance toward Europe, proposing for example less burden sharing, a phasing out of the European Stability Mechanism and creating the option for countries to leave the EMU without leaving the EU (in particular Greece). The FDP's position could therefore complicate Angela Merkel's pursuit of increasing Eurozone integration at the intended speed.

Another area of conflict between the FDP and Greens that may hinder a possible Jamaica coalition with the CDU/CSU is that both parties (the FDP and the Greens) have contrasting positions on energy and climate policies. The Greens wish to introduce a carbon tax and increase existing measures, while the FDP hopes to lower the energy tax. This includes the car industry, where the Greens want to prohibit the registration of cars with combustion engines from 2030 onwards (and are the only party who wish to do so). On the other hand, the CDU/CSU wants to increase subsidies on electric cars, while the FDP opposes both further subsidies and the prohibition of combustion engines by 2030.

5. CDU/CSU and FDP coalition: what are the implications?

The CDU/CSU and the FDP are together polling approximately 47-49% of seats. 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). A Jamaica coalition is difficult in our view, given the discrepancies between the Greens and the FDP as well as more cumbersome negotiations (compared to a two-way coalition). 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 (see appendix) given that the more conservative forces in government would multiply (see Fig. 5). This would add to the conservative forces in the CDU/CSU (almost a quarter didn't vote for the Greek bailout in 2015). Nonetheless, we would still expect European integration to speed up in the coming years, even if under different and less progressive terms.

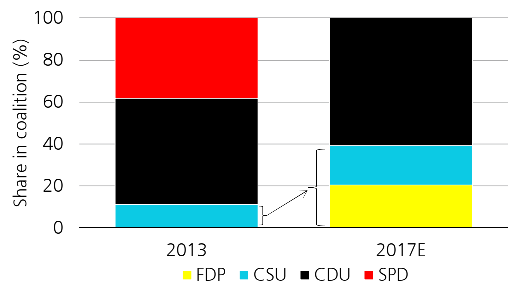
In addition, given the hit the FDP took in the 2013 election after running the foreign ministry, it will probably want a higher price this time for joining the CDU as a junior partner – possibly the finance ministry (which has become key given Eurozone bailouts and financing mechanisms such as the ESM). To this effect, FDP board member Alexander Hahn said that "the FDP should not join any government, if it does not hold the finance ministry." In addition, the FDP would (just as the SPD and the Greens) make any coalition agreement subject to a grassroots referendum. That said, we regard both the CDU/CSU's and FDP's economic and fiscal policy as similar (emphasizing tax cuts), leading to a similar bond issuance during the legislative period. This should also apply in our view, if the FDP would manage to obtain the finance ministry.

6. What does the AfD's entry into the Bundestag mean?

After entering 13 out of 16 state parliaments since 2014, the AfD is set to enter the Bundestag for the first time since its foundation in 2013. Current polls suggest that the populist party could become the third-largest force in parliament and probably the largest party in opposition. As the polling error in state elections since 2014 has been as much as 3%, the AfD could garner around 10–15% of the votes on 24 September. It is also the party that consistently attracts the most attention, with the highest share of Google searches among all parties.

Fig. 5: Potential CDU/CSU/FDP coalition

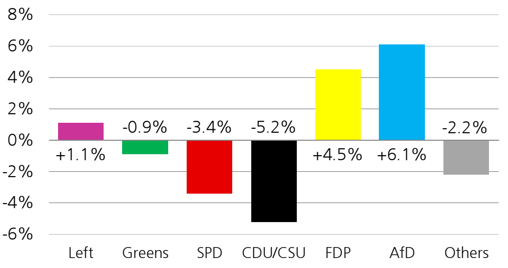
Conservatives with over a third of coalition's seats



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 18 September 2017.

Fig. 6: Current polls versus last election

Move away from the center in the last 4 years



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 18 September 2017.

The AfD's entry into and the FDP's possible return to the national parliament would increase political fragmentation in Germany. If the FDP enters parliament as well, the Bundestag would boast six parties – the highest number since 1953. If this becomes the new norm, coalitions of a large party and small party will be much rarer than in the past, given the reduced size of parties (i.e. more difficult to reach a majority). In contrast, grand coalitions would be more frequent in the long term compared to post-WWII history, in our view, given the complexities of a three-way coalition compared to a two-way coalition. A political gridlock similar to Spain in 2016 or a link-up of euro-sceptic movements such as the AfD and the Left are unlikely this year though. The grand coalition is still expected to obtain a comfortable majority of about 60%.

Still, the AfD's surge (see fig. 6) also means that work in parliamentary committees and on contentious European issues, such as future bailouts for Greece, may become more difficult (especially if dissenting voices in the ranks of other parties, notably the CDU/CSU and the FDP, rise too). FDP party head Christian Lindner, for example, made the cancellation of Greek debt contingent on Greece's exit from the Eurozone. Given Germany's central role to the integrity of the Eurozone, more fragmentation might increase political uncertainty further.

Europe after the German elections

7. What are the implications for Mario Draghi's successor?
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 anticipated Eurozone finance minister post or the European Commission (see fig. 7). The current European Commission president – Jean-Claude Juncker – has already announced that he will not run in 2019. To bridge the gap, Schäuble could take up the Eurogroup presidency, as Jeroen Dijsselbloem is set to leave the Eurogroup by the time the new Dutch government is formed (expected by the end of 2017).

With Schäuble running a European institution, the ECB would probably go to a non-German in 2019 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 wish to keep these positions. A German running the European Commission, Eurogroup or even the anticipated Eurozone finance minister post rather than the ECB may also be more investor-friendly as Schäuble at any of these institutions may mean more fiscal discipline in the Eurozone, but also an investor-friendly ECB.

8. Will the election drive the speed of European integration?
For European integration, another CDU-led government would broadly mean a continuation of the new spirit of cooperation between France and Germany. More specifically 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.

Fig. 7: European political calendar
European politics to take center stage again after national election marathon

	Country/area	Event/institution
Sep 2017		German Bundestag election
2H 2017		Eurogroup President
Jan 2018		European Investment Bank President
1H 2018		Italian parliamentary election
May 2018		ECB Vice President
Dec 2018		ECB Banking supervision (SSM)
Mar 2019		Brexit
Apr 2019		ECB Council/Bundesbank President
May/Jun 2019		European parliamentary election
Oct 2019		ECB President
Oct 2019		Greek parliamentary election
Oct 2019		European Commission President
Nov 2019		European Council President

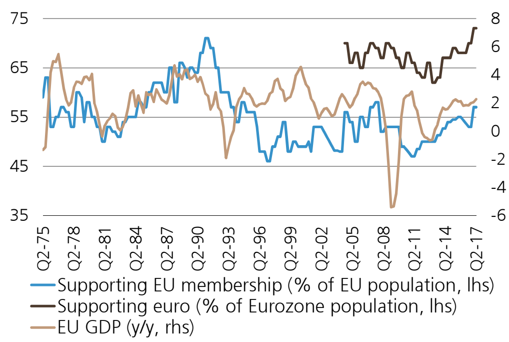
Source: UBS CIO WM, as of September 2017.

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). 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. 8) with a recent German survey found 79% of citizens calling now for more integration.

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." However, Merkel still rules out measures such as debt mutualization, while foreseeing a European Monetary Fund (i.e. an enhanced ESM with greater powers) and an EU defense union.

Geopolitically, the CDU/CSU manifesto foresees no Turkish EU accession and on Brexit, it seeks to limit the damage to the German economy.

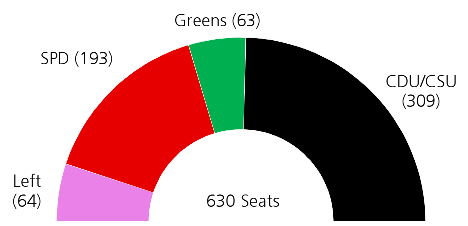
Fig. 8: Support for the Euro and the EU
Solid support in line with GDP growth



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

Election and government formation: The nuts and bolts

Fig. 9: Current seat distribution of Bundestag
Large majority of grand coalition



Source: Bundestag, UBS, as of July 2017.

9. How does the Bundestag election system work?

German voters have two independent votes: a first vote on a direct candidate and a second one on a party. The Bundestag has at least 598 seats, 299 being filled by the direct candidates of the first vote. These 299 seats are voted in each of Germany's 299 districts ("Wahlkreis," each one comprised of about 250,000 citizens). The winner is selected by relative majority (i.e., more "Yes" than "No" votes) in each district and automatically obtains a seat in the parliament (even if the party fails to clear the 5% hurdle in the second vote). In this way, every voting district has a representative in the Bundestag, no matter what. The first vote determines the size of parliament and the composition of each party's representatives (provided the party wins in at least 3 districts).

With their second vote ("Kanzlerstimme"), voters choose a party and its list in their respective state ("Landesliste"). This is the basis for filling up the remainder of the Bundestag seats (i.e. beyond the 299 elected by the first vote). To receive Bundestag seats in proportion to the second vote, a party has to win at least 5% of the second vote or win at least three districts in the first vote. The second vote is the key vote as it alone and independently determines the total size of each party in the Bundestag, providing the basis for coalition building. Consequently, investors need to focus on the second vote ("Kanzlerstimme").

Additional Bundestag seats (overhang mandates, "Ueberhangsmandate") are created (i.e. beyond the 598 seats), if a party wins more seats through the first vote at the district level than implied by the second vote

("Landesliste"). To ensure that the seat distribution in the Bundestag still reflects the second votes, the other parties are also apportioned additional seats until the shares of the second votes are complied with ("Ausgleichsmandate"). The final result is that the composition of the Bundestag equals the composition of the second vote ("Kanzlerstimme"). This led to the creation of 32 additional seats in the last election, increasing the Bundestag from 598 to 630 seats.

10. What is the schedule for election day?

Once the polling stations close at 6pm, forecasts based on exit polls for the day will be broadcast by the major news channels. These are usually a good guide as to the final result (estimated average deviation 0.5ppt according to German state TV), and should point to who will be Germany's next chancellor. The first election result estimate is published soon thereafter (see fig. 10), based on early ballot paper counts. Usually, no large deviations from this result are seen in later updates.

A round of interviews with the main candidates starts at 8:15pm during which they will be quizzed on first impressions and conclusions from the campaigns, as well as thoughts on coalition talks. If the result is close, especially between the smaller parties, potential coalition options will only be clear once the preliminary official result is published. This is expected between midnight and around 3am on the morning of 25th of September, although results from individual states may come in earlier than this. Since the CDU/CSU and the FDP (or the Greens) are polling close to 50%, the preliminary official result might be necessary to determine the feasibility of these coalition options. The final official result is usually accepted around two weeks following election day, but deviations from the preliminary official result are not usual.

Fig. 10: Indicative election day schedule
24/25 September events

Time	Event
6:00 pm	Polling stations close
~6:00 pm	First prognosis based on exit polls
~6:15 pm	First statistical estimation of voting results
8:15 pm	Interview round with main candidates
~12pm-3am	Preliminary official result
~2 weeks later	Final official result

Source: UBS, as of 18 September. All deadlines to be confirmed.

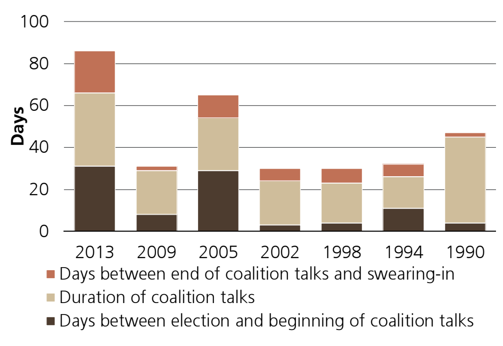
11. Coalition talks: Way forward after 24 September?

There is no formal coalition building mandate or law, rather an informal one for the party with the most votes. That said, parties (respectively their leadership committees) start exploratory coalition discussions immediately after the election (after the election in 2013, the CDU/CSU held talks with the Greens and the SPD).

These preliminary discussions are followed by formal coalition talks, which culminate in a coalition agreement. In 2013, the coalition agreement between the CDU/CSU and the SPD was signed almost three months after election day. The duration will, in our view, depend on the election result, as another grand coalition or a three-party "Jamaica coalition" may take longer to conclude than a natural alliance between the CDU/CSU and the FDP. However, it should become clear over the course of October who will take on the key posts in the forthcoming government. Furthermore, all the potential coalition partners (SPD, FDP and Greens) have stated that they would hold a grassroots referendum on any coalition agreement.

The first convention of the new Bundestag must then be held by 30 days after the election. One of its first remits is electing the next federal chancellor. However, before electing the chancellor, coalition discussions must be concluded. During this transitional period, the incumbent cabinet stays in office. In 2013, Merkel was re-elected chancellor one day after the coalition agreement was signed.

Fig. 11: Duration of coalition talks
Government formation to conclude by year end



Source: Bundestag, UBS, as of 2016.

12. How and when will the chancellor be elected?
There is no deadline to elect the chancellor. After consultative talks with party and floor leaders, the federal president (currently Frank-Walter Steinmeier from the SPD) formally nominates a candidate, who must then be elected with absolute majority by the Bundestag. Until now, the federal president has always nominated the chancellor candidate of the coalition which is set to govern. Moreover, every candidate proposed was elected at the first onset in the past. If a candidate reaches an absolute majority, the federal president must declare the person chancellor.

If no absolute majority is reached at the first attempt, the Bundestag can elect a chancellor without consulting the federal president during a 14-day period. An unlimited number of elections (or none at all) can be held in this time.

If still no absolute majority is reached after this second election period, another election in the Bundestag is held immediately, but by simple majority (i.e. more yes than no votes are enough). After this last election, the federal president is free to declare the candidate chancellor even if only a simple majority is reached. Alternatively, the president can dissolve the Bundestag.

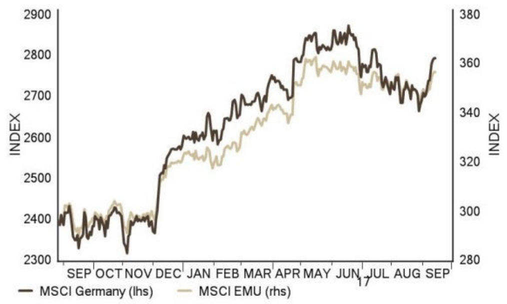
Given that coalition building is firmly part of the German political culture, snap elections or gridlocks like in Spain in 2016 are very unlikely. Accordingly, we expect the chancellor to be elected before year end. After being elected, the chancellor nominates the ministers, who are then confirmed by the federal president).

Investment implications

13. Will equity volatility increase after 24 September?
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

Fig. 12: Eurozone and German stock markets
Election's impact mainly medium to long term



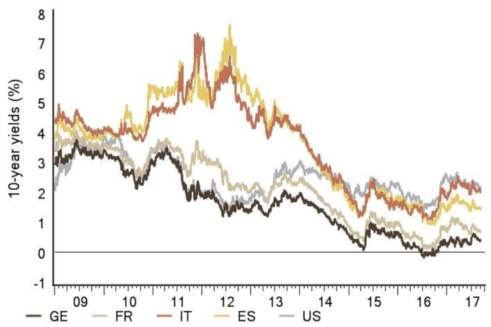
Source: Haver Analytics, UBS, as of 15 September 2017

14. SPD vs. FDP: What does it mean for 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

Fig. 13: 10-year bond yields
Taking a breather recently



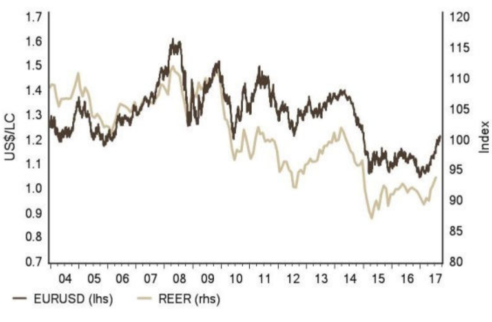
Source: Haver Analytics, UBS, as of 15 September 2017.

15. Will the election support the euro exchange rate?

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 limits, 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

Fig. 14: EURUSD and REER
EURUSD taking off in recent months



Note: REER = Real effective exchange rate.
Source: Haver Analytics, UBS, as of 15 September 2017.

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.
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.

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

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