



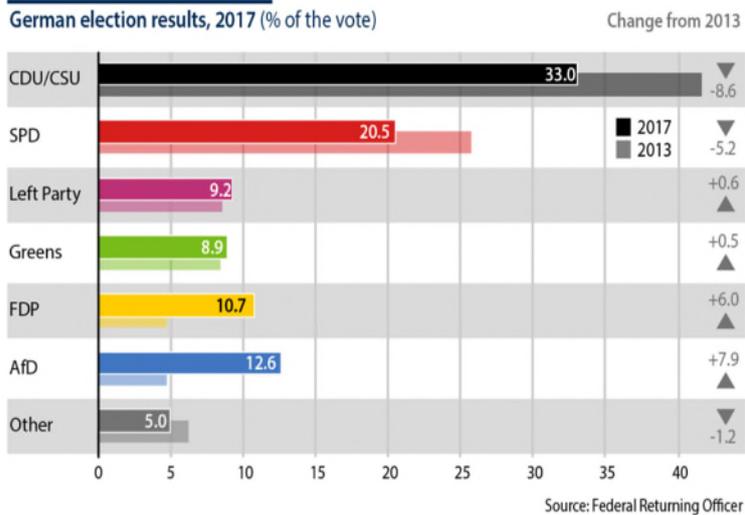
As widely anticipated, Angela Merkel secured a historic fourth term as German Chancellor in the election on 24th September. However, it was far from the emphatic victory that she would have wanted and certainly not worthy of celebration on a level seen after Germany's victory in the World Cup in 2014.



Why the disappointment?

Germany has been governed by a "conservative alliance" overseen by Angela Merkel for many years. No one party ever wins an absolute majority of the seats, given their system of proportional representation, and all German governments since 1949 have been coalitions.

It was expected that her party, the Christian Democratic Union (CDU) and its sister Bavarian party, the Christian Social Union (CSU) would win; however, the result was their worst in almost 70 years with only 33% of the popular vote compared with 41.5% in 2013. Despite this, they will form the next government as the alliance has the largest number of seats and the left-leaning parties together do not come remotely close to a parliamentary majority.



Over the past few years, with Angela Merkel's three previous coalitions, Germany has been the bastion of strong and stable government. In the meantime, we have seen political upheaval across much of the rest of the developed world, with the election of Donald Trump, Brexit and a party created barely a year before sweeping to power in France. Disenchanted voters, upset with the status quo of "old politics", have realised that they have a voice

and more significantly, a vote to force change. Now, it seems, that same feeling of discontent has started to influence German politics too.

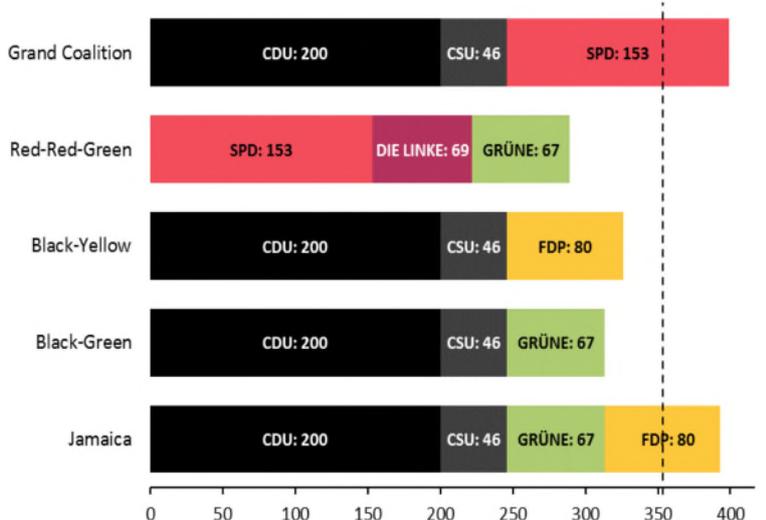
"Alternative for Germany" (AfD) was the surprising success of the German election. The populist far-right party started with an anti-euro bias but later turned its focus to immigration and Islam. AfD's election campaign capitalised on a backlash over Angela Merkel's decision to open Germany's borders to undocumented migrants and refugees in 2015, mainly from the Middle East. They managed to secure 12.6% of the vote (94 seats in the 709-seat federal parliament), a far greater proportion of the vote than most observers dared predict. The party performed particularly well in what was formerly East Germany, taking 21.5% of the vote as the second most popular party.

What are the possible coalitions?

It is unthinkable that any of the other parties will work in tandem with the AfD and so it looks like Angela Merkel will have to endure a few months of negotiations with other parties before forming a workable coalition that has the power to govern effectively.

Concerningly for her the SPD, who have been in a coalition with Merkel's party for the past four years and represent the second largest party in the Bundestag, have ruled out being part of a coalition for a second term. Perhaps aware of the Liberal Democrats' recent experience in the UK, the SPD feel that their poor performance in the election is as a direct result of their time in the coalition and they now wish to sit in opposition.

So, Angela Merkel is forced to try to form a working coalition through protracted negotiations with other parties. To describe complex ballot outcomes, political pundits in Germany use colourful symbolism, often alluding to the flags of other nations. Coalition short-hand includes 'Jamaica,' 'Kenya,' and 'traffic light' coalitions:



Coalition possibilities based on seats won by party



The scenario mooted as the most likely outcome at present is a 'Jamaica' coalition between Angela Merkel's CDU/CSU, the business-friendly Free Democrats FDP and the Greens, which has never been tried at the federal level.

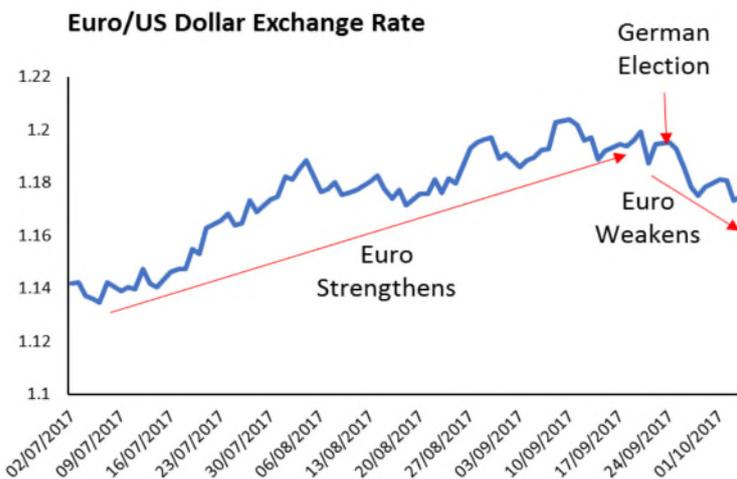
Is this likely to lead to unstable government?

Despite the disappointing result there are no murmurings for a change in leadership and indeed a leadership challenge would be almost unprecedented. Over the past six decades of the Bundestag, there have been only eight Chancellors and yet over the same period there have been 12 Prime Ministers in the UK and 40 in Italy! Whilst we can therefore expect that Angela Merkel will complete her fourth term, there is no doubting that her grip on power has been weakened.

Despite stable leadership, the potential three-party grouping under the 'Jamaica' coalition is likely to be loose at best due to deep divisions over fundamental issues, from the environment and Europe to tax and migration.

With the SPD in all likelihood back in opposition and the inclusion of the far right, German parliament will be far more fractious now. Indeed AfD leader Jörg Meuthen left us in no doubt about his plans, stating that confrontation and provocation were central to his party's strategy.

How have financial markets reacted to the results:



Euro weakens against the US dollar after German election

As we witnessed in the immediate aftermath of the Brexit referendum the most noticeable reaction to the result was seen in the currency markets. Whilst the euro has strengthened significantly year to date, up 12.3% against the US dollar and 3.45% against sterling, it was no surprise to see the euro weaken by just over 1% against both currencies in the immediate aftermath of the election.

The German stock-market was certainly not as euphoric as the French market in April after their surprise result, ending the first trading day post the election almost unchanged. This was, however, in contrast to the usual post-election falls, as the average return in the two days following an election has typically been around -0.97%.

Consequences for Wider Europe

Over the past eighteen months sentiment towards Europe has steadily improved, with a better economic backdrop and until recently a more stable political base (particularly relative to that in the UK). The recent German result, coupled with the Independence vote in Catalonia, could well undermine that positive sentiment.

It was only in April of this year that President Macron was swept to power in France on a pro-European agenda and he had hoped that a reinforced and reinvigorated Angela Merkel would enable him to press ahead with his wish for deeper euro integration. At the heart of Macron's plans for a "sovereign, democratic and unified Europe" is the concept of a euro area budget and a euro area finance minister, both of which he hopes will enable the economies within the single currency to better deal with any further economic crises.

Another grand coalition in Germany represented Macron's best chance for realising his vision and whilst he still exuded confidence in his speech at the Sorbonne the week after the election, it is widely believed that he will eventually have to dilute many of his ideas. Angela Merkel stated that she thought Macron had put in place "important building blocks" for EU negotiations but in a weakened position she is going to struggle to win over the sceptics in her own party and faces a brick wall in the form of the Liberal Democrats (FDP) who are fundamentally opposed to many of Macron's ideas. For his part Macron had invited the Chancellor to sign a new European treaty with him, on 22 January 2018 – the 55th anniversary of the Élysée treaty, signed by Charles de Gaulle and Konrad Adenauer in 1953. That seems ambitious now after a less than emphatic election victory in Germany.

The rise of the populist AfD party is also likely to bring about a change in stance within Germany towards foreign refugees, which is likely to cause outright confrontation with the likes of Poland and Hungary. In the view of many Christian Democrats, the AfD would have never gotten this far if other European countries had taken in their fair share of refugees instead of letting Germany bear the burden. The new Party Leader of the Christian Social Union has already stated that his party wish to put in place an annual limit of 200,000 migrants as part of the coalition agreement, something Angela Merkel and the Greens are vehemently opposed to.

In the end France and Germany may agree to establish some form of budget and an oversight position for a 'finance minister' for the eurozone. However, neither will have the scope that Macron had been hoping for.

So what other European surprises lie in store for us?

There has been a limited reaction thus far by EU leaders towards the unofficial independence vote in Catalonia, although the symbolic nature of the vote cannot be underestimated. Even if the end result is not independence, this could act as a catalyst for other ballots and certainly gives populist political movements justification to continue to bang the drum.

Perhaps the greatest concerns surround the Italian elections, which are due to be held prior to 20th May 2018. Italy has not recovered



economically from the recent economic crisis, in the same manner that Ireland and Spain have (GDP growth is half that of the wider euro area). Of greatest concern is the banking sector, as Italy's Non-

Performing Loans (NPLs) stood at 356 billion euros at the end of June last year, corresponding to 18% of total loans for Italian banks, a 12 % increase over the past ten years. This is equivalent to 20% of Italy's GDP and one-third of the euro area total for NPLs. Over the same ten-year period German Bank NPLs have remained relatively stable at approximately 2.5%.



German Non-Performing Loans tumble as Italy's soar

Many in Italy blame the single currency for their demise and support for the euro there has crashed to just 41% compared to a euro area average of 56%. Some 47% of Italians think that the euro is a bad thing for Italy. The self-proclaimed populist Five Star Movement, led by comedian Beppe Grillo, is not now (as once it was) considered a major threat come election time, but their rise cannot be discounted given goings-on elsewhere in Europe. After all, Five Star counts the mayors of both Rome and Turin amongst its party members.

On the surface of it, the recent election result does nothing to damage Europe's growth prospects in the short-term. We still expect corporate earnings to be robust and Mario Draghi's rhetoric suggests that there is no reason to expect a slow-down in growth in the months ahead. Whether the recent elections leave a lasting imprint on the economic prospects for the eurozone will partly depend on the Italian vote in 2018.

Of greater significance for us at home is the possibility that the changing political landscape influences the Brexit negotiations materially. We suspect that the Brexit waters are muddy enough at the moment and that no amount of European political stirring can make the outcome much murkier for the foreseeable future. In any case, we have Boris Johnson to do that job for us just fine, thank you.