PICTET WEALTH MANAGEMENT
ASSET ALLOCATION & MACRO RESEARCH
28 September 2021

GERMANY - UPDATE

GERMAN ELECTIONS AND THE BUND - WHAT'S NEXT?

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SUMMARY

- The results of the federal election in Germany on 26 September were very tight, with the Social Democratic Party (SPD) slightly ahead of the CDU/CSU. As a result, the Greens and the Free Democratic Party (FDP) are in effect the "kingmakers".
- Among the various coalition possibilities, our base case is still for a "Traffic Light" coalition (SPD, Greens and FDP) led by the SPD, with the party's Olaf Scholz as Chancellor. But it's a close call.
- At this stage, there is not much visibility about the future direction of policy in Germany. Decarbonisation of the economy will probably rank high on the incoming government's agenda, but this ambition will come at a cost. The Greens are likely to insist on public investment to meet Germany's net zero emissions target, whereas the FDP wants to reduce the tax burden and is opposed to any reform of the debt brake. The gap between the two parties will need to be bridged.
- With a first ECB rate hike being priced in for the end of 2023 and limited risk of a major shift in Germany's fiscal policies in the aftermath of the election, we expect the 10-year German Bund yield to stabilise around its current level (-0.22% on 27 September) in our central scenario. Our forecast is for -0.25% by the end of the year.
- Although inflation expectations have already risen significantly, we cannot rule out that they will rise more in our alternative scenario. Should euro area price pressures prove persistent, market participants might expect inflation to average more than 2% over the next ten years, pushing the 10-year Bund yield up more.
- An increase in infrastructure spending at both the German and EU levels could boost GDP growth potential over the medium term. As such, we will closely monitor the coalition talks, the spending proposals that a new coalition comes up with and tweaks to the Stability and Growth Pact. If higher investments boost the euro area's potential economic growth, the ECB might hike more quickly, and by more. However, in our view the likeliest outcome is that policy rates will remain lower for some time, and that the rate-hiking cycle in the euro area will be shallower and start later than in the US or UK.

Very tight results

The results of Germany's federal election on 26 September were very tight, with the SPD slightly ahead of the CDU/CSU. The **SPD won the most votes** of any party (25.7%, 206 out of 735 seats), improving on its performance in the 2017 election. In contrast, the **CDU/CSU suffered its worst-ever election result** (24.1%, 196 seats), down from around 32% of the votes in 2017 (*see chart 1 & 2*).

The Greens took 14.8% of the national vote, winning 118 seats – much better than the 9% they won in 2017 but still a big disappointment given how well the party was polling earlier in the year. It was nonetheless the **Greens' best result since the party was founded**. The liberal FDP (11.5%, 92 seats) also improved on its 2017 performance.

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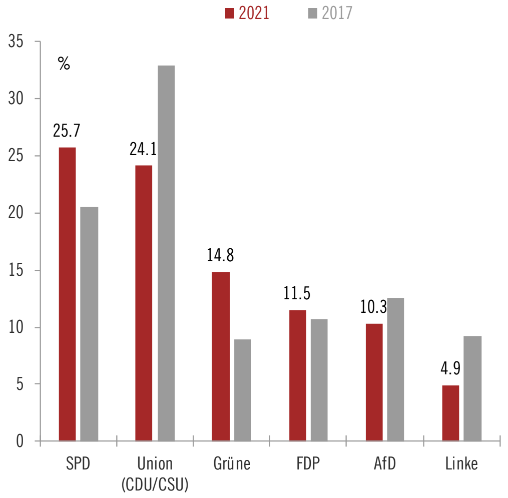
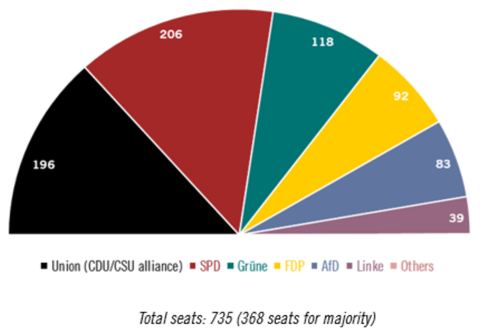
Finally, the far-right Alternative for Germany (AfD) and the Left Party both suffered significant losses.

CHART 1: GERMANY – ELECTION RESULTS (% VOTES)



Source: PWM - AA&MR, Bundeswahlleiter, 27 September 2021

CHART 2: GERMANY – ELECTION RESULTS (SEATS)

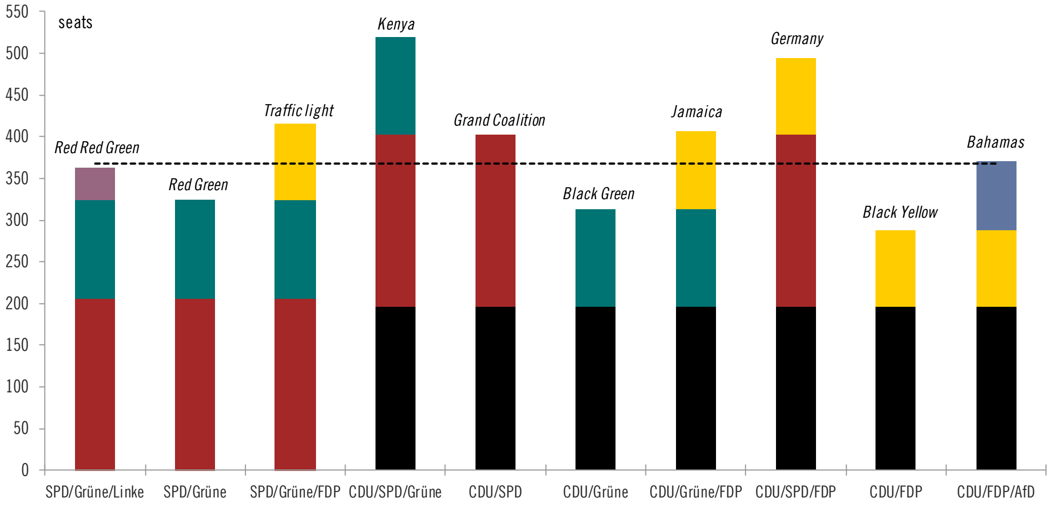


Source: PWM - AA&MR, Bundeswahlleiter, 27 September 2021

Negotiations will be tough

The close result means that lengthy coalition discussions will ensue. Several possible coalition combinations could lead to the formation of a government (*see chart 3*). Both the SPD and CDU/CSU have ruled out a repeat of the "grand coalition" that has been in place over the past four years, so a three-way coalition looks likely. The main focus is on a possible so-called 'Jamaica' coalition consisting of the CDU/CSU, Greens and FDP, or a 'Traffic Light' coalition between the SPD, Greens and FDP. In both cases, the Greens and FDP would be the kingmakers.

CHART 3: GERMANY – COALITION POSSIBILITIES



Source: PWM - AA&MR, 27 September 2021

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Of these two options, **the Traffic Light coalition seems more likely** because the SPD won the most seats and also because the centre-left grouping of the SPD and Greens has more seats than the centre-right grouping of the CDU/CSU and FDP.

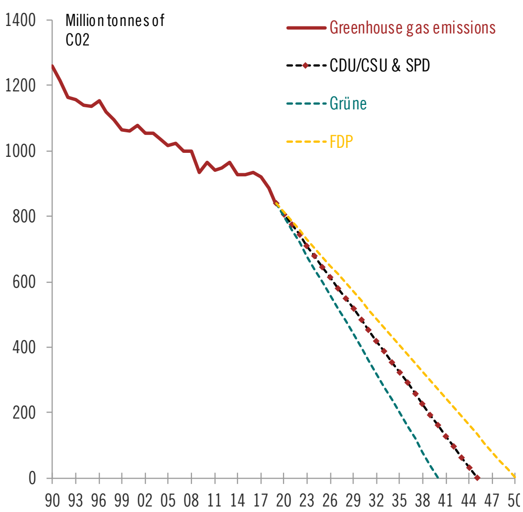
There is no legal deadline for the negotiations to end. However, everyone will want to avoid the kind of political crisis that followed the 2017 election (when it took 171 days to form a government) and to ensure that a Chancellor is sworn in by the Bundestag before the end of the year. A caretaker government under Angela Merkel will remain in place for as long as the coalition negotiations continue.

No paradigm shift on fiscal policy

The uncertain outcome of the election means there is **not much visibility about the future direction of policy in Germany**. Decarbonisation of the economy will probably rank high on the incoming government's agenda: Germany intends to reduce its greenhouse gas emissions by 65% by 2030 and to be net-zero by 2045, five years ahead of the EU's deadline (*see chart 4*). Such ambitions will come at a cost, however, with the need to increase spending in infrastructure and deal with complex fiscal rules.

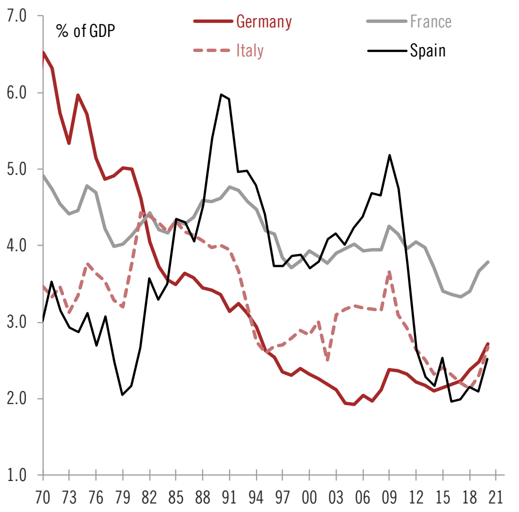
Since the global financial crisis, **public investment in Germany has lagged and only caught up with levels in other large EU countries in 2020** (see *chart 5*). Reforming Germany's debt brake, which was written into the country's constitution in 2009 to limit structural fiscal deficits, seems unlikely as doing so would require a two-thirds majority in the Bundestag and only the Greens are pushing for such a move. But there are other ways to increase public spending, such as through off-balance-sheet vehicles. **The Greens are likely to insist on public investment to meet Germany's net zero emissions target**, whereas the FDP wants to reduce the tax burden and is opposed to higher public deficits. The gap between the two parties will need to be bridged.

CHART 4: GERMANY – EMISSIONS REDUCTION TARGETS



Source: PWM - AA&MR, Eurostat, 27 September 2021

CHART 5: EURO AREA – PUBLIC INVESTMENT



Source: PWM - AA&MR, European Commission, 27 September 2021

Who becomes the next German finance minister is the key concern for Europe. Complicated negotiations about the reform of EU fiscal rules lie ahead, with the various

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political parties in Germany holding very different opinions on this important matter. With the Greens and the FDP – which have opposing views on this subject – both likely to be members of any new coalition government, changes to European policy will probably be limited.

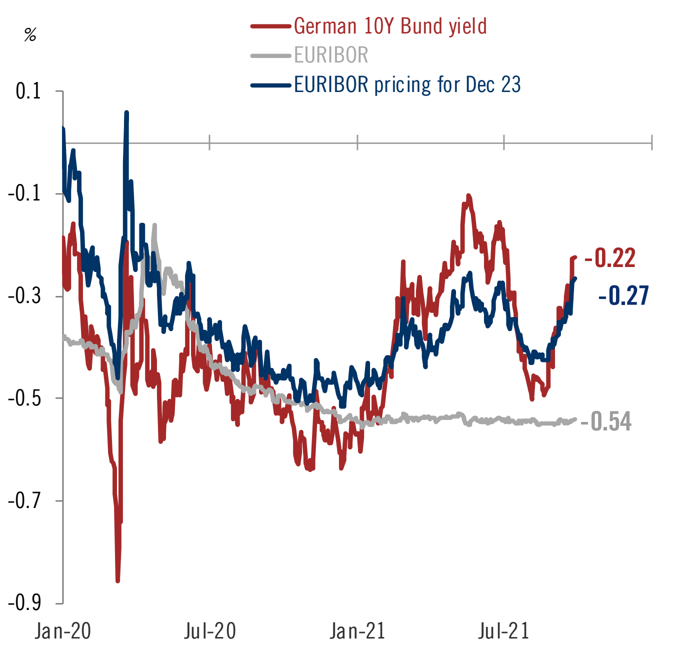
Inflation and ECB policy the most important factors for Bund yields

In our view, the major driver of **Bund yields will be the inflation outlook in the euro area and the ECB's monetary policy rather than German fiscal policy.**

With this in mind, the recent rise in the 10-year Bund yield (+28 bps from 20 August to 27 September) is unsurprising given expectations that **higher and more persistent euro area inflation** (due to supply bottlenecks and rising energy prices) **could give ammunition to the hawks within the ECB and lead to faster tightening of monetary policy**. Since 20 August, the Euribor future contract for December 2023 has risen by 16 bps to -0.27%, signalling that market participants are now fully pricing in a deposit rate hike of 25 bps by the end of 2023 (as of 27 September, *see chart 6*).

Even though the ECB has failed to achieve its "close to but below 2%" inflation target over the past decade, increasing underlying price momentum and the bank's latest strategy review (which saw it adopt a more dovish stance) have revived expectations of stronger inflation and growth in the coming years. In fact, **long-term inflation expectations in the euro area** (as represented by the 10-year German inflation breakeven and the euro five-year five-year inflation swap forward) **have moved up sharply recently**. Although at 1.78% (as of 27 September, *see chart 7*) they remain below the ECB's medium-term target of 2%, it seems that market participants now see this target as more achievable.

CHART 6: GERMAN 10-YEAR BUND YIELD AND EURIBOR FUTURES



Source: PWM - AA&MR Bloomberg, 27.09.2021

CHART 7: EURO AREA LONG-TERM INFLATION EXPECTATIONS

Source: PWM - AA&MR Bloomberg, 27.09.2021

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Ongoing (albeit lower) bond purchases in 2022 mean that the share of government bonds outstanding that the ECB holds is likely to increase further (see the Flash Note Tailwinds for euro periphery bonds for more details). The ECB holds 36% of outstanding German government bonds – a higher proportion than for the three other biggest countries in the euro area as German net issuance was negative in the years prior to the pandemic.

A coalition involving the SPD and the Greens could lead to positive net issuance in the coming years as both parties will insist on increased public investment (especially to foster the green transition). However, as stated, regardless of the exact make-up of any coalition we expect the debt brake to remain in place in its current form. As such, **Germany looks likely to remain fiscally conservative and retain its AAA credit rating.**

Bund yields could stabilize unless potential GDP growth is boosted

Discussions within the EU about the Stability and Growth Pact will be key for euro peripheral spreads, and Germany will hold the deciding vote in this debate. With the various German political parties holding opposing views on this matter, any changes to European policy are likely to be limited. Nevertheless, should the EU's fiscal rules be relaxed, in part to accommodate public investments to foster the green transition, **peripheral euro area countries should be the main beneficiaries, with spreads on their bonds versus Bunds remaining at low levels**.

If higher investments boost the euro area's potential economic growth, the ECB might hike more quickly, and by more. However, in our view the likeliest outcome is that **policy rates will remain lower for some time, and that the rate-hiking cycle in the euro area will be shallower and start later than in the US or UK**.

As well as being a major owner and buyer of government bonds, the **ECB's central role in the euro area bond market owes much to the attention it pays to financial conditions**. Although the ECB looks at a broad set of indicators when judging financial conditions, two particularly important gauges are nominal and real yields on 10-year euro GDP-weighted government bonds (*see chart 8*). While the ECB has avoided explicit yield curve control, **it remains alert to wide dispersions in government bond yields and to sharp increases in yields caused by shifts in market expectations**.

The ECB's focus on financial conditions and the remoteness of rate tightening lead us to expect yield dispersion within the euro area to remain low (in other words, sovereign bond spreads against the Bund should remain relatively tight). Likewise, **the 10-year GDP-weighted nominal yield should remain close to zero and the real yield well entrenched in negative territory over the coming months.** With a first ECB rate hike being priced in for the end of 2023 and limited risk of a major shift in Germany's fiscal policies after the federal election, **our central forecast is that the 10-year German Bund yield will be around its current level (-0.22% on 27 September) at the end of the year**.

Although inflation expectations have already risen significantly, we can imagine an alternative scenario where they rise even more. **Should inflation prove persistent in the euro area,** market participants might expect inflation to average more than 2% over the coming 10 years, **pushing the 10-year Bund yield higher than we expect in our central scenario**. In fact, **an increase in infrastructure spending at both the German and EU levels could boost GDP growth potential over the medium term**. As such, we will

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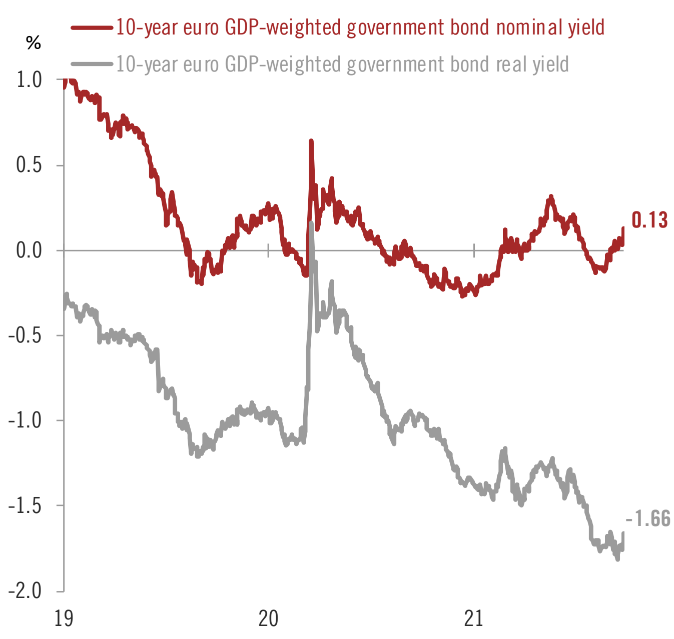
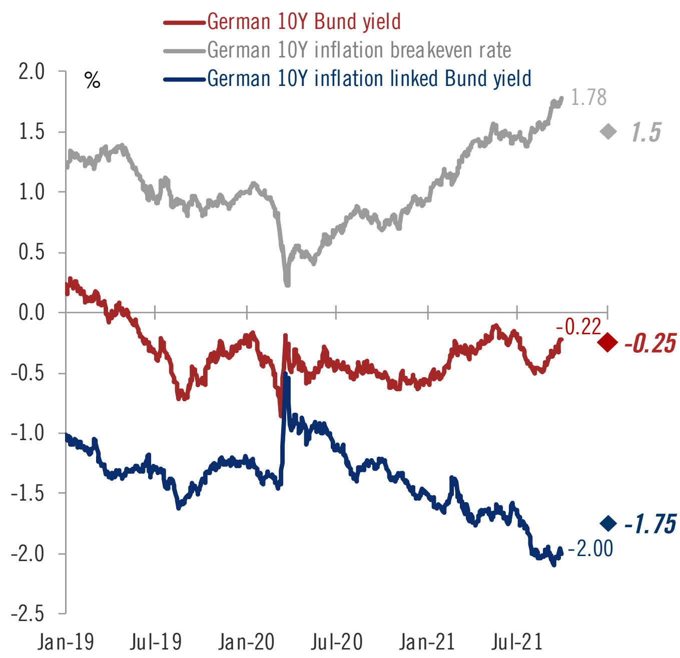
closely monitor the coalition talks and the spending proposals a new coalition government comes up with as well as possible tweaks to the EU's Stability and Growth Pact.

CHART 8: 10-YEAR EURO GDP-WEIGHTED GOVERNMENT BOND YIELDS



Source: PWM - AA&MR, own calculations, Bloomberg, 24.09.2021

CHART 9: GERMAN 10-YEAR BUND YIELD BREAKDOWN AND FORECASTS



Source: PWM - AA&MR, Bloomberg, 27.09.2021

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