October 2018

Bavarian elections: European political landscape continues to evolve

Didier BOROWSKI
Head of Macroeconomic Research

Thomas KRUSE
CIO Germany,
Co-Head of Income & Risk Overlay

- ***The outcome:*** *The election result in Bavaria marked the defeat of the conservative CSU, which lost its absolute majority, and of its junior ally, the SPD. An increase in political fragmentation emerged from the election, with the Greens and the AfD as the main beneficiaries. This election may be seen as an early signal of a political reshuffling at the federal level which we need to watch closely in the coming weeks.*
- ***Impact on Europe****: This election confirms the breakthrough of some form of populism in Europe and shows that the migrant crisis does not only affect the countries with high unemployment rates. The political fragmentation is a broad based phenomenon that is clearly not (or not only) related to economic factors. The strong showing by the Greens, supporters of some European reforms and fiscal integration, could become a tailwind for the European project in this evolving political landscape.*
- ***Market implications****: Market implications are negligible on European assets as a consequence of this local election. However, this is part of a complex European political framework and electoral calendar, with the Italian budget law process, Brexit and next year's EU parliamentary elections next year representing three important milestones. Political issues, we believe, could limit the appeal of European assets for the time being. Opportunities may open up again in Europe if further risk asset repricing occurs, and Europe could return to focus with attractive valuations. Currently, however, in a context of risk neutrality, with a multi-asset perspective, we prefer US equities in our regional selection; we look for relative value opportunities in Europe at the sector level.*

Could you comment on the results of the Bavarian state elections?

DB: This election was a key test for the current government coalition for at least two reasons. Firstly, with almost 13 million people, Bavaria represents around 16% of the total population and accounts for more than 18% of German GDP: it is the second largest state in Germany. Secondly, Horst Seehofer - Interior Minister and strong opponent of Angela Merkel in the coalition - is a member of the CSU (the Bavarian sister party of CDU), the leading party in Bavaria. Historically, the conservatives have always maintained a comfortable majority in this wealthy state but this is no longer the case. In line with the most other recent polls, the results show **increasing political fragmentation**, with the traditional parties (CDU and SPD) falling more than expected.

"The poor performances from the traditional parties in the Bavarian elections represent early signs of a political reshuffle at the federal level".

While it is quite usual with federal elections to observe some weakening of the government parties, these results reflect a more structural change in the German political landscape; and this election may be seen as an early signal of a political reshuffling at the federal level. Note that the increasing support for the Greens does not only come from the left. The environment has become a key concern for the whole population and the fact that the Greens have moved closer to the center should give them more traction at the federal level.

The refugee policy of the current coalition has clearly increased support for the far right (in Bavaria and elsewhere). The CSU and CDU have clashed several times over the past three months. Horst Seehofer has even twice been close to leaving the Grand Coalition due to diverging views with Angela Merkel with regard to asylum seekers. Regarding the AfD, it is clear that its arrival in the Bavarian parliament will have a strong emotional impact in the country as well as in Europe. But it does not come as a real surprise and we don't believe that this party has the means to affect the policies carried out at the federal level, as all the other parties clearly want to keep the AfD out of power.

With the contribution of:
Tristan Perrier
Economist

Giuseppina Marinotti,
Investment Insights Unit

"There might be a strong incentive for Angela Merkel to reconsider a coalition with the Greens that could be formed ahead the 2021 elections".

Could these results change the situation for the current Government?

DB: The impact on the coalition is unclear currently. On one hand, the CSU defeat is a stern warning to Horst Seehofer and it will take time to digest the defeat, giving more room for manoeuver to Angela Merkel. At the same time, Horst Seehofer could potentially lose the leadership of the CSU and his position as interior minister. But on the other hand, the CSU defeat and the rise of the AfD is also a warning signal to Angela Merkel. It is indeed the traditional conservative camp that has been weakened. And, as a result, the question of her leadership may be more in focus earlier than expected (with the CDU convention in Hamburg on 7-8 December).

Despite its defeat, the CSU will probably continue to lead the next Bavarian government with coalition parties. It is too early to assess the political consequences at the federal level; we will need to watch in particular how the SPD reacts in the coming days and weeks. **Against this backdrop, the next state elections in Hessen on 28 October will be crucial**. This state has 6 million inhabitants (7.5% of the German population) and accounts for to 9% of its total GDP. Thus after this second election, more than a quarter of the German electorate will have been consulted. Recent polls tend to point to the same situation as in Bavaria (i.e. fewer votes for the CDU and a breakthrough by the AfD, with the *SPD* losing ground to Greens). **Looking ahead, there might be a strong incentive for Angela Merkel to reconsider a coalition with the Greens, possibly a "Jamaica coalition"** (CDU, CSU, Greens and FDP) that could be formed ahead the 2021 elections. Furthermore, **SPD leaders may soon wish to reconsider their membership to the Grand coalition in Berlin** as this membership seems to pose an existential threat for their party.

"The results from the election clearly do no relate to a weakening of the economy. What is at stake in Germany, as in many other European countries, is more deeply rooted".

"Their rising importance of the Greens could encourage Germany to find a compromise with France on some Eurozone reforms ahead of the EU parliamentary elections".

What are the main challenges the German economy is facing in this phase of the cycle?

DB and TP: From an economic standpoint, the backdrop is still positive. Real GDP growth is expected to remain slightly above potential in 2019 at 1.8%, thus picking up slightly after weakness in 2018, and then gradually decelerating as the cycle matures. At this stage, we see few signs of overheating. However external uncertainties (trade war, rising oil prices) have increased and may weaken more than expected the manufacturing sector. In addition, the car industry has been negatively affected since the start of the year by Dieselgate. From a cyclical standpoint, exports are the Achilles' heel of the economy.

The labour market should however remain very strong, with job creation continuing and the very low unemployment rate (3.4%) further supporting wage growth.

Twin surpluses will persist:

- On the one hand the current-account surplus remains very high (still close to 8% of GDP in 2018), albeit slightly declining. The trade surplus should however decline in the coming years with the rise in internal demand and the improvement in the competitiveness of other Eurozone economies. Risks to exports are on the downside, given the protectionist rhetoric and the slowdown observed in some key emerging economies.
- On the other hand, the fiscal surplus should remain above 1% of GDP, which looks moderately expansionist, as the government intends to support investment, extend housing policies, expand child care facilities and increase military spending. The budget surplus will persist. The debt-to-GDP ratio should move well below the Maastricht threshold of 60% next year for the first time since 2002.

Thus the results from the elections in Bavaria, clearly do not come from the weakening of the economy. What is at stake in Germany, as in many other European countries, is more deeply rooted. In addition, we must keep in mind that 28 years after the reunification, there are still large economic divergences between Eastern and Western Germany (higher unemployment and lower wages in particular at the East). So that many young eastern Germans, who still lack prospects, are thinking moving to stronger areas. It explains why the breakthrough of the AfD is much more pronounced at the East than at the West of Germany.

How might this election affect Europe?

DB: On the one hand, this election confirms the breakthrough of populists in Europe and shows in addition that the migrant crisis has not only affected the countries that have high unemployment rates (the average unemployment rate in Bavaria is hardly above 2%, 1% lower than the national average). The political fragmentation is a broad based phenomenon that is clearly not (or not only) related to economic factors. But, **this election also confirms the rising "Green power" in the German political landscape. Looking ahead, there is a distinct possibility that at some point, the Greens will be part of a coalition at the federal level**. Bear in mind that the Greens support Emmanuel Macron's reform agenda for Europe. The rise of the party's importance in state elections should thus encourage Germany to find a compromise with France on some Eurozone reforms ahead of EU parliamentary elections (May 2019).

What are the implications for financial markets?

"Political uncertainty is expected to continue to weigh on the appeal of European assets for the time being".

TK: We don't expect to see significant short-term consequences of the election results due to their local nature. European assets are moving in line with the global risk sentiment which drove last week's correction (see our recent paper: *Late cycle features at play: more pain, but not the end of the game*). The long-term implications of the declines experienced by the mainstream parties could be more significant, as this could impact the overall political risk scenario in Europe. What we see now is that the fragile and weakened German coalition unfolds in the current phase of political uncertainty in Europe. If we also consider the Italian budget issues, the *Brexit* at a standstill, the European elections in spring, we see some limit in the short term regarding the appeal of European assets for international investors as volatility may remain high. Further price dislocation on European assets, which could emerge in the coming months, could be seen as a new opportunity to re-enter the market with more appealing valuation levels. This thinking is based on the overall economic picture remaining sound despite decelerations and barring any further escalation in the Italian situation (regarding which we believe a compromise solution will be found). In the current phase, based on a multi-asset perspective, we slightly prefer US equity on a regional basis and we see some relative value opportunities at the sector level in Europe (for example, in basic materials).

APPENDIX: Results Recap

The CSU (Bavarian branch of conservatives, sister party of the CDU) has lost its absolute majority in seats only for the second time since 1962. With 37.2% of votes (vs. 47.7% at the previous election in 2013), this is much more than a political setback. It represents its worst result since 1954. The CSU won 85 seats (103 seats needed for a majority).

The SPD (Social Democratic Party, left) also suffered a very significant defeat, with its votes falling to 9.7% (from 20.6% in 2013), thus, only winning 22 seats.

The centre-left Greens were the big winners in this election, having more than doubled their votes to 17.5% (vs 8.6% in 2013) and winning 38 seats.

The AfD (Alternative for Deutschland, far right) was also a winner, with around 10.2% of votes (22 seats). This party, created in April 2013, did not participate in the 2013 election. However, we would note that the AfD's percentage remained well below the levels seen in eastern Germany (often more than 20%).

Finally, **the Free voters** (regionalists, lean right) obtain 11.6% of votes (vs. 9.0% in 2013) and 27 seats. **The FDP** (liberal, centre right) obtain 5.1% of votes (vs. 3.3% in 2013) and will thus enter in parliament with 11 seats.

Important Information

AMUNDI INVESTMENT INSIGHTS UNIT

The Amundi Investment Insights Unit (AIIU) aims to transform our CIO expertise, and Amundi's overall investment knowledge, into actionable insights and tools tailored around investor needs. In a world where investors are exposed to information from multiple sources we aim to become the partner of choice for the provision of regular, clear, timely, engaging and relevant insights that can help our clients make informed investment decisions.

Discover Amundi investment insights at our Research Center

http://research-center.amundi.com/

Visit us on:

www.amundi.com