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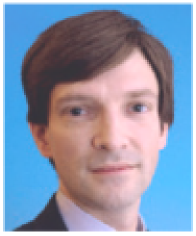
What is in store for investors after the German government talks collapse?



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The strength of the Eurozone economy will prevent the uncertainty in German politics from having a significant impact on the currency.

It seems that a new government coalition in Germany is now out of reach. What are the possible options for Germany at this stage?

TP: There is still a possibility that a coalition will be formed, although it will take time. A Jamaica (CDU/CSU, FDP and Greens) coalition, would require the FDP party to return to the talks, while another Grand coalition (CDU/CSU and SPD) would require the SPD to drop its current refusal. A combination of public opinion pressure, additional concessions from the CDU/CSU and the will to avoid repeat elections (or even, although unlikely at this stage, A. Merkel accepting to step down as Chancellor) may lead to such developments. A minority CDU/CSU government is also an option, unprecedented in modern German history, but its stability would be very uncertain. Finally, repeat elections (also unprecedented) cannot be ruled out. However, current polls indicate that they may not yield very different results from the September ones, while mainstream parties would probably be reluctant to let them happen, as they could lead to further gains by the far-right AfD party. In the meantime, the caretaker CDU/CSU-SPD government stays in place, with no given time limit.

What are the risks for Germany and the possible implications for Europe of this political stalemate?

TP: Against a backdrop of strong economic recovery (German Q3 GDP growth figures have surprised to the upside) we do not see the political gridlock as a major risk to the economic outlook. Remember that, recently, long periods without a government in Belgium and Spain did not lead to a slowdown. European day-to-day cooperation will also not be affected. The main issue is rather that, as long as it only has a caretaker government, Germany cannot proceed with major new steps in European construction (such as agreeing to some of the recent French proposals, or proposing alternatives). However, with no economic emergency at the moment, current delays can probably be made up later. Of course, repeat German elections (especially if taking place at a moment close to the Italian election) would add to the political noise and perception of risk by markets, although this would not be enough to undermine our positive view on the Eurozone for 2018-2019.

What could be the implications of German political instability on the euro currency?

BD: On Monday Nov 20th, the euro depreciated at market opening before paring losses. Our view is that the current stalemate should not destabilize the euro. So far this year, the EUR/USD parity has been driven by the evolution of the long-term interest rate differential between the US and Germany and we think that this will still be the case in the coming months. The strength of the Eurozone economy will prevent uncertainty in German politics from having a significant impact on the currency. This being said, it is true that a weaker position for Angela Merkel on the German political scene would slow the European reforms promoted by the French President Emmanuel Macron and would consequently slow down the process of euro appreciation.

From a Multi-Asset perspective, do you think that the collapse in German government talks can trigger a risk-off sentiment in equity markets?

FS: In Germany, the political parties have struggled to find common ground on major issues, such as climate change, with the Greens calling for a reduction in coal-generated power, and migration. Indeed, parties have a polarized view on migration. Migration emerged as a contentious political issue in Germany following the refugee crisis, when 1.2 million migrants entered the country in 2015-16. In this sense, we believe these conflicting views on migration seem to be priced in by financial markets. Sticking to such an immigration policy can impact long-term growth prospects for a country like Germany affected by challenging demographic trends, but it seems an unlikely risk factor for financial markets, that nowadays seem to respond more to monetary stimulus. We hence think that although volatility in European equity markets might be on the rise over the coming months because of progressive reduction of monetary stimulus globally, the actual political impasse will play a modest role as a risk-off catalyst for Europe.

We believe the current German political impasse can affect certainly some sectors such as Energy and Utilities.

How do you think investors should deal with this uncertainty?

FS: Foreign investors' appetite for Europe at present seems related to a recovery and normalization story. We believe the current German political impasse can certainly impact some sectors such as Energy and Utilities, which we both view cautiously, where long-term profitability can be somehow conditional to the final outcome of the coalition' negotiations. We maintain a cautiously positive stance towards Europe by acknowledging robust cyclical recovery, but we are aware of the dependency of a pro-Europe global positioning from rising rates, something that appears to be played down by Draghi's recent speech. The German coalition impasse can only modestly challenge the 2017 trend of decrease in geopolitical risk perception from global investors (after the Macron election), and it can't be seen alone as a risk-off catalyst. A perceived risk of global slowdown or lower than expected inflation could, instead, potentially trigger risk-off sentiment given the attention from investors on European financials.