UOB

Investment Insights

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German Election – Bittersweet Victory

Inside

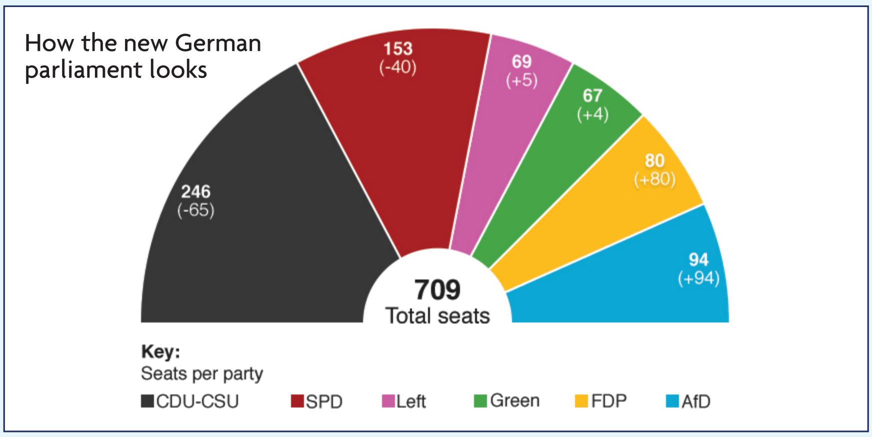
Election Results

Unlike last year's Brexit and the US Presidential election, the German election lacked the dramatic excitement of previous events.

As widely anticipated, Angela Merkel, Germany's first female chancellor, is on track for her fourth term. Though she won the election, the victory was bittersweet as her party suffered significant loss of votes compared to the last election. In contrast, the anti-European Union (EU) and far-right party, Alternative for Germany (AfD), gained the most votes, as people expressed their unhappiness about Merkel's immigration policy.

Post-election, Merkel will have the daunting task of forming a coalition government. She will need at least half the support from the parliament, yet her previous coalition partner and the second largest party in the parliament, Social Democratic Party (SPD), has rejected the offer of coalition. A partnership with AfD is also improbable. This leaves Merkel with the so-called "Jamaica coalition", comprising of four parties, namely Merkel's Christian Democratic Union (CDU), its sister-party Christian Social Union (CSU), the pro-business Free Democrats party (FDP) and the Greens. Given the vast differences in political stances between the parties, talks could be complex and prolonged.

Fig. 1: The number of seats for different parties in the new German parliament



Source: German federal returning officer, BBC, 25 September 2017

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What does Merkel's victory and new government mean for Germany and EU?

Overall, Merkel's victory is positive for Germany and EU economies.

Merkel has a proven track record of providing a pragmatic and steady leadership. Her win signals continuity in government policies and provides an anchor for the EU. Admittedly, AfD could complicate the dynamics of the German parliament. However, the party is expected to play a very limited role in the new government. On a more positive note, pro-business FDP is likely to have a bigger role in the government and could help push for domestic reforms. The German economy is likely to stay robust and continue to be the growth engine for Europe's economic recovery.

A potential tricky issue will be the Franco-German relation. French President Macron is pushing for deeper fiscal integration, which FDP is strongly against. As such, while the new German government continues to strengthen its cooperation with France, the stance may moderate.

Implications for investors ▶▶

With the German elections behind us, political uncertainties were further reduced for European equities. Meanwhile, economic activities continue to remain strong and valuations remain attractive relative to US equities. Although there are still impending risks, such as political concerns in Spain and Italy, we believe European equities could outperform going forward. Some key factors are highlighted in the discussion below.

Valuations

In 2016, weak earnings were the key factors behind the underperformance of European equities versus their US counterparts. However, since the beginning of 2017, earnings of European equities have been on an upward trajectory. (Fig. 2).

Despite the recovery in earnings since the start of 2017, European equities continued to lag the US counterparts, mainly due to rapidly appreciation in Euro. Year-to-date performance of European equities was at +10.5% while US equities recorded a +14.2% gain (Source: Bloomberg, 29 September 2017).

With the ratio of European equities P/E to US equities near a 5-year low (Fig. 3), valuations of European equities remain relatively attractive.

The combination of earnings recovery and relatively underpriced stocks prices should continue to support the performance of European equities.

Fig. 2: Earnings for European equities continue to be well supported this year, recovering from underperformance in 2016.

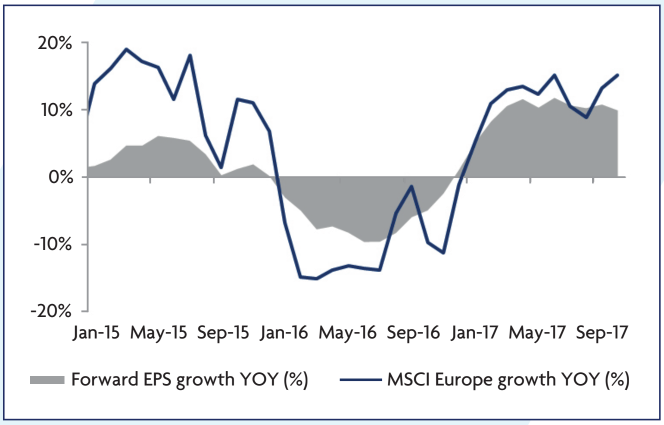
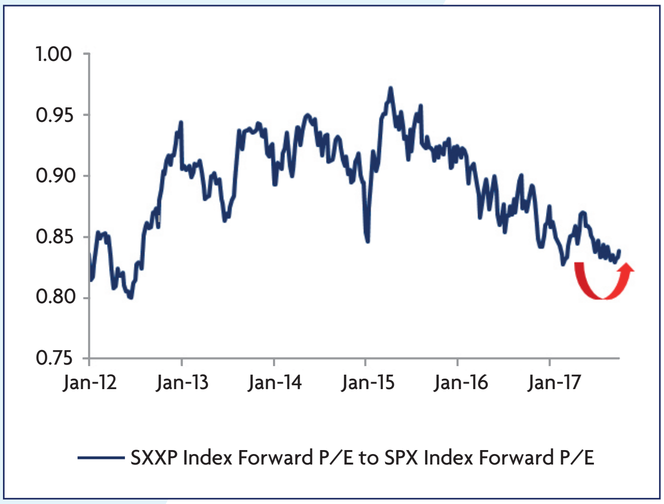


Fig. 3: Relative valuation of European equities to US equities is near the bottom range for a 5 year period.



Source: Bloomberg, 29 September 2017

Technicals

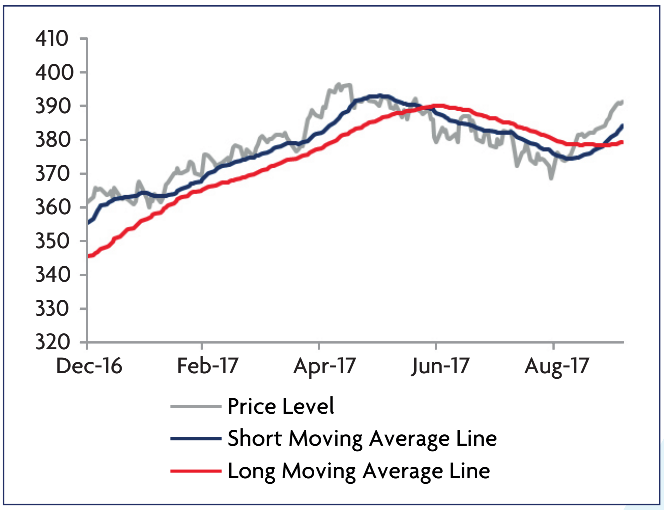
Since the start of the year, fund outflows from European equities have been reversing as confidence in the markets returned. Although the market entered a consolidation phase in the third quarter of the year, momentum has returned as political risks fade and economy continues to improve (Fig. 4).

Activities

Momentum in European economic activities have been picking up since the beginning of the year. In September, Eurozone manufacturing PMI rose to 58.1, a six-and-a-half year high and services PMI registered 55.8 to signal the 50th successive month of expansion (Source: HIS Markit, October 2017). Both numbers are well above the threshold of 50 (PMI above 50 indicates that activities are expanding, while a reading below 50 indicates contraction).

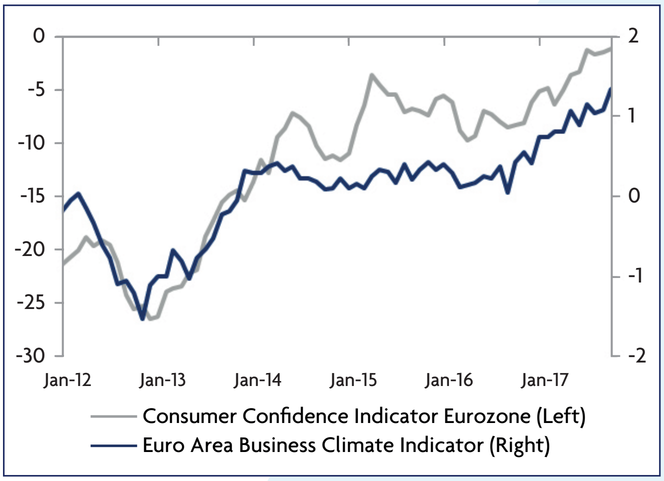
Similar positive sentiments in the economy are also reflected in the Consumer Confidence indicator and Business Climate indicator where both indicators hit multi-year high (Fig. 5). Consumer and corporate spending is expected to pick up and that will further boost the economy.

Fig.4: Crossover of short moving average line over long moving average line signals a return of positive momentum. Price levels have rebounded after a consolidation phase.



Source: Bloomberg, 29 September 2017

Fig.5: Consumer confidence and business climate also hit multi-year high.



Source: Bloomberg, 29 September 2017

Key risks

The conclusion of the French elections and German elections removed the major part of the political concerns for 2017. The foreseeable risks ahead would include:

a) Italian elections next year (deadline in May 2018)
Although the dominant political party in Italy, Partito Democratico (PD), is euro-friendly, the populist party, Five Star Movement (M5S), has been running neck to neck with PD according to recent polls. However, stance of M5S has recently moderated, with its new leader, Luigi Di Maio, recently stating that the party does not want to leave the EU but instead wants to renegotiate certain treaties (Source: CNBC, 24 September 2017). Market chatter about the event is likely to increase closer to the date, but at the moment, we see low likelihood of an Italian exit from the EU.

b) The recent Catalonia referendum in Spain contributed to uncertainties in the region, but the issue is largely localized.

c) A stronger Euro could cause translation loss in earnings for European companies and affect price competitiveness of European exports. In the last few months, EUR has rallied strongly, causing concerns about European equities. While markets have rushed to price in the potential effects of ECB's tapering on Euro strength, the impact of Fed's rate hike and potential USD strength have largely been underpriced. This may result in a pause in Euro strength which could become a tailwind for European companies.

Market Outlook and Strategies ▶▶

Macro	
Global Growth	**The medium term US economic outlook has been downgraded** as many of Trump's pro-growth policies are likely to be delayed. However, other regions like Europe and China picked up the slack.
Monetary Normalisation	Following Fed's monetary policy path, **ECB may just turn the corner and gradually move towards normalisation**. BOJ is likely to continue their asset purchase programs.
Inflation & Rates	**Inflationary pressure stay subdued**, partly due to tepid wage growth. **The Fed announced Balance Sheet Reduction (BSR) in September and is expected to raise rates 3 times in 2017**, with the last one likely to be in December.

Risks	
Trump Disappoints	**Trump's tax proposal lacks details and could face challenges ahead**. As markets have priced in the positives, the failure of implementing such policies is likely to unsettle investors.
China Policy Missteps	After the 19th Party Congress in October, China government may focus more on structural reforms. **Overly aggressive policies may cause increase in default rates and hard landing risks**.
North Korea Tension	**Tension between the US and North Korea continued**. Further provocative moves from North Korea may trigger military intervention. If that happens, risk assets could be sold off.

Strategies

Tactical Strategy		Key Proposition	Key Risks
Position for higher rates.	**Short duration high yield bonds**	• Lower sensitivity to interest rates and offers attractive yields versus longer-dated Treasuries.	• Default risks could rise if economic conditions worsen. However, economic outlook remains constructive.
	Subordinated bonds	• Higher yields versus senior bonds while enjoying the same credit risks.	• Recovery is lower than senior bonds in the event of default. However, the default rates for IG issuers are very low.
Participate in Asian growth story.	**Asian equities**	• Attractive valuations over DM equities, with improving fundamentals over the year.	• China slowdown could pose risks but we expect the process to be controlled.
Recovery and policy shifts in DM offers opportunities.	**European equities**	• Attractive discount versus US and tailwinds from improving economic activities.	• Strong Euro could negatively impact the exporters. We expect Euro to stabilise as ECB could respond by being more cautious to taper.
	Quality equities	• Tend to experience less drawdowns during sell-offs and outperform broad equity markets over longer investment cycles.	• Hefty valuations could increase probability of short-term corrections. However, global recession risks remain low.
Healthcare sector shows potential for long-term growth.	**Global healthcare equities**	• Attractive valuations and recent outperformance is likely to be sustained due to better-than-expected earnings.	• Repeal and replacement of Affordable Care Act (ACA) could affect outlook for industry, but we expect most provisions to remain intact.

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