No matter how Germany’s Sept. 26 election plays out, one thing is certain: Angela Merkel will step down as chancellor of Germany, having navigated the economy through the 2008 financial crisis and COVID-19 pandemic. The election offers voters an opportunity to weigh in on the many challenges facing the region’s economic powerhouse, and it seems like popular support for the old guard is slipping.

Although the election outcome is uncertain, the relatively small gaps between the three major parties increase the likelihood of a three-way coalition.

- We see positive tailwinds for German equities and prefer domestically focused mid-cap indexes that could benefit from higher consumption and investment activity given potentially lower corporate and personal income taxes.
- We are neutral on German 10-year government bond yields over the near term and see the 10-year rate rising over the medium term as demand for the country’s debt moderates.
- Germany’s commitment to green technologies should support funds tied to renewables. Recent flows into related equities demonstrate that the theme likely has more room to run.
After sixteen years at the helm of Europe’s largest economy, Angela Merkel—leader of the Christian Democratic Union (CDU) and its sister party, the Christian Social Union (CSU)—is stepping down as German chancellor. The Sept. 26 election offers voters an opportunity to weigh in on the many challenges facing the region’s economic powerhouse.

As we move closer to election day, it has become clear that the incumbent center-right party’s influence in German politics is waning, and it faces an uncertain future. Polls show that the party, which has led Germany for nearly five decades, is losing ground to the center-left Social Democratic Party (SPD) and the farther left of center Green Party (see Exhibit 1).

Exhibit 1: The SPD, the FDP and the Greens Have Made Gains Since the 2017 Elections

![Polling from Sept. 14, 2021 Share of Votes 2017](Image)

Note: Politico aggregates data from multiple sources. Christian Democratic Union (CDU), Christian Social Union (CSU), Alternative for Germany (AfD), Free Democratic Party (FDP)


Although the outcome is uncertain, the relatively small gaps between the three major parties increase the likelihood of a three-way coalition—a first for Germany. We see significant changes ahead given the low probability that we assign to any party emerging as the absolute winner.

Investors who are less familiar with German politics would be forgiven for asking why any of this matters. Well, in the German parliament, seats are allocated based on proportional representation. Since 1957, no party has won an outright majority, and, as a result, coalitions are often formed to ensure cohesion of thought and policy. For the purposes of our analysis, we treat the CDU and the CSU as a single entity.

With the two major parties polling below 50%, there is a real possibility that a three-way coalition could be formed. As it stands, polls predict that the CDU/CSU, the SPD and the Greens will take the top spots. That being said, MS & Co.’s strategists see a coalition between the CDU/CSU, the Free Democratic Party (FDP) and the Greens as a more likely outcome, especially if the CDU/CSU emerge as the largest party.

Investors will likely be sensitive to changes in pandemic-era policies, especially those with an intermediate investment horizon. Although support for the CDU/CSU has slipped, we think that the candidates’ election manifestos are broadly bullish for equities, neutral-to-bearish for bonds and generally supportive of a stable euro.

**Taxes.** With everything on the table, tax policies are of particular importance for voters. The parties broadly support the redistribution of income vis-a-vis lower taxes for low- and middle-income households and some increases for higher-income households. According to MS & Co. Research, the CDU/CSU, the SPD and the Greens have proposed tax plans that will boost annual disposable income for households earning below 300,000 euros. Only the CDU/CSU, among the leading parties, has proposed extending those same benefits to households earning above 300,000 euros.

All else equal, we think a meaningful tax decrease could support consumer spending over the intermediate term. After declining 4.3% year over year through June 2020, German household income rose 5.5% for the 12 months ending June 2021—albeit against a backdrop of COVID-19-related stimulus. That being said, dovish tax policies support consumption and could boost retail sales, benefitting the German DAX Mid-Cap Index (MDAX), which is more domestically oriented than the DAX (see Exhibit 2).

Exhibit 2: Proposed Changes in Tax Policy Could Support Domestically Oriented Companies

![DAX Index MDAX Index](Image)

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 10, 2021

Lower corporate taxes could also be in the cards. As it stands today, the CDU/CSU has proposed capping taxes on corporate profits at 25%. This compares to the current average marginal tax rate of around 30% according to data collected by KPMG that measures top rates (see Exhibit 3). Lowering corporate taxes could improve Germany’s competitiveness among Europe’s larger economies.
Exhibit 3: Lower Corporate Taxes Could Improve Germany’s Competitiveness

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Dec. 31, 2020

Fiscal Policy. In response to the global pandemic, Germany introduced Europe’s largest fiscal stimulus package to boost confidence and mitigate the economic fallout. In order to allow its deficit to grow, Germany’s policymakers suspended its “debt brake,” permitting the country to take on borrowing in excess of the constitutional limit of 0.35% of GDP that was put in place following the 2008 financial crisis. Over the past year, Germany’s spending has accelerated. According to Eurostat, Germany’s 4.2% year-end 2020 public sector deficit was its largest since at least 1995.

Although Germany is generally more fiscally conservative than other European nations, it is unlikely to tighten policy quickly. In fact, the leading parties have advocated for a more gradual return to compliance with the debt brake compared to the government’s current plan, which calls for a rapid reduction of the deficit from nearly 100 billion euros to just 5 billion euros, according to MS & Co. Research.

A gradual return to compliance with the debt brake should limit sharp moves in German rates. In fact, you can see the dynamics play out in real time with a near-term peak in German 10-year rates alongside a peak in support for the Greens, who have more ambitious spending plans. A coalition dominated by the Greens is not our base case, but the German rate market’s reaction to their strong poll numbers this past summer is noteworthy (see Exhibit 4).

Climate. Driven in part by July’s deadly floods, German policymakers are throwing their support behind initiatives to combat climate change. In fact, there is an emerging consensus to increase public investment to facilitate Germany’s transition to a greener economy. The CDU/CSU, the SPD and the Greens target climate neutrality by at least 2045 and have outlined a series of proposals around emissions reduction and renewable energy to achieve this goal.

Possible funding sources for Germany’s green transition will likely be a pain point for many politicians. The Green Party has proposed establishing a special purpose vehicle to issue debt that would circumvent the debt brake. Although there are a few issues that could get in the way of their proposal, it is clear that Germany is committed to green investment. We think this will benefit companies with exposure to clean energy. In fact, flows into environmental, social and governance (ESG) funds saw a noticeable uptick in recent months, suggesting that investors are anticipating there will be more public investment in green technology (see Exhibit 5).

Exhibit 4: 10-Year German Bond Yields Trade Higher with Greens Bounce in Polls

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Aug. 31, 2021

Exhibit 5: Investors Position for Germany’s Green Agenda

Note: Socially Responsible Investing (SRI), Environmental, Social and Governance (ESG)
Investment Implications

Although the election outcome is uncertain, the relatively small gaps between the three major parties increase the likelihood of a three-way coalition, and investors will be sensitive to changes in pandemic-era policies.

Although support for Germany’s two major parties has slipped, we think that the candidates’ election manifestos are broadly bullish for equities, neutral-to-bearish for bonds and generally supportive of a stable euro. Lower personal and corporate taxes should benefit consumption and investment activity. Domestically oriented companies might fare the best as consumer savings work their way through the economy.

Historically, the German bond market has behaved well around elections. We are neutral on German 10-year government bond yields over the near term and see the German 10-year going rate higher over the medium term as demand for the country’s debt moderates.

Lastly, German policymakers are committed to the country’s maintenance of a dominant share of various green technologies. Recent flows into equities tied to ESG and renewables are unlikely to abate, and we see opportunities for investors to benefit from intense public interest.
Charts You Can't Miss

Exhibit 6: COVID-19-Related Restrictions in Germany Are Elevated Versus Peers

Note: The COVID-19 Stringency Index records the strictness of "lockdown style" policies that generally restrict people's behavior. It encompasses containment and closure policy indicators as well as an indicator pertaining to public information campaigns. Source: Bloomberg, Our World Data, Morgan Stanley Wealth Management Global Investment Office as of Aug. 27, 2021

Exhibit 7: Germany Q2 2021 GDP Disappointed

Note: EA19 is Belgium, Germany, Estonia, Ireland, Greece, Spain, France, Italy, Cyprus, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Austria, Portugal, Slovenia, Slovakia, Finland. Source: MS & Co., Morgan Stanley Wealth Management Global Investment Office as of July 30, 2021

Exhibit 8: German Enthusiasm to Vote Could Surprise to the Upside

Note: From 1949 to 2017, voter turnout for German general elections has varied widely, peaking in 1953 at 94% and reaching a low of 72% in 2009. Source: German Federal Statistical Office, Morgan Stanley Wealth Management Global Investment Office as of Sept. 14, 2021

Exhibit 9: Currency Markets Not Pricing a Lot of Volatility Post-Election

Note: Deutsche Bank one-month implied volatility weights are EUR/USD 37.84%, USD/JPY 18.92%, GBP/USD 12.16%, AUD/USD 8.11%, USD/CAD 6.76%, USD/CHF 5.41%, EUR/JPY 4.05%, EUR/GBP 4.05%, EUR/CHF 2.70%. Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 3, 2021
**Current Readings From Our Quantitative Framework**

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**Ongoing Development Spotlight**

MS & Co.’s European fixed income strategy team expects the net issuance of German debt to remain negative next year. However, ECB quantitative easing (QE) could play a crucial role in German net supply beyond 2022. A pickup in euro area issuance could facilitate a rotation from German bonds to debt issued by other euro area economies that would likely offer more attractive yields. We see a number of catalysts for higher German yields, but demand for higher quality German government bonds could keep yields depressed, supporting higher levels of negative yielding global debt.

**Exhibit 10: Global Negative-Yielding Debt Could Remain Elevated**

![Dollar Value of Global Negative-Yielding Debt](source)

Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Sept. 6, 2021
Disclosure Section

Index Definitions

GERMAN DAX MID-CAP INDEX (MDAX) This is a total rate of return index of 60 mid-cap issues that rank below the DAX.

For other index, indicator and survey definitions referenced in this report please visit the following: https://www.morganstanley.com/wealthinvestmentsolutions/wmir-definitions

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Equity securities may fluctuate in response to news on companies, industries, market conditions and general economic environment.

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