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R&R Weekly Column
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The Failure Of Germany's Grand Coalition

In the inaugural column of this Viewsletter, we asked: *Is a German "Grand Coalition" Necessarily Good News?.* Even though the creation of such a coalition had resolved the uncertainty related to the German government's formation (a process that lasted more than six months), nevertheless we highlighted the presence of a series of downside risks resulting from it. We wrote: "if the grand coalition fails, there is a risk of making euro-skeptic AfD and FDP stronger…This means that, at the end of this experience (in 3-4 years), Germany runs the risk of finding itself with an even more fragmented political spectrum, unable to form a governing coalition, and express a government strong enough to complete the European integration process, when centrifugal forces could be even stronger."

The results of state elections in Bavaria and Hesse, which saw the collapse of the SPD and the CDU/CSU and the rise of the AfD and the Greens, leading to Chancellor Merkel's decision not to run again for her party's leadership in December, showed that those concerns were well placed. The risk is that Germany will soon experience a government crisis in which (among other things) Merkel could be forced to step down from her Chancellor's position much earlier than has initially been anticipated. In fact, of the various contenders now being considered for the future leadership of the CDU, a possible "co-habitation" between Merkel as Chancellor and someone else as CDU leader could be envisioned only with Merkel's chosen successor, Annegret Kramp-Karrenbauer, while a diarchy with either Friedrich Merz or Jens Spahn is difficult to imagine. The fourth potential candidate, Armin Laschet may therefore eventually emerge as a good compromise candidate able to reunite the party (as we discussed already in our recent trip report).

As we will discuss in detail in forthcoming research, Merkel's eventual departure has a number of consequences at the domestic as well as international level. Domestically, her departure means that the CDU will have to move more towards the right. This will also occur because of the parallel rise of the Greens, a party that has occupied a strategic position within Germany's political spectrum, being more conservative than the SPD on fiscal issues yet more progressive on migration, social rights and technological evolution. The Greens now occupy that centrist political space that the CDU wanted to cover within this "GroKo". So the CDU will instead have to try to re-absorb the moderate/conservative votes that have abandoned it, votes that are temporarily "parked" with the AfD.

From an international perspective, as we discussed in a recent trip report, there are a number of implications as well, especially at the European level. First of all, Merkel's departure would make the window of opportunity in which to promote EU and EZ reform in the next few years even smaller than it was already (or even make it virtually non-existent). Secondly, if Merkel were to eventually decide to run for a top European job (something she is currently denying thinking about), it would fundamentally change the ongoing European musical chairs game, as – at the very least – France would demand to be fully "compensated" with adequately powerful appointments, such as the head of the European Central Bank, in response. Finally, after Merkel's departure, the possibility of an agreement to rule the EU between the European People's Party and the populist front, emerging after the May 2019 EU election, becomes more likely.

Meanwhile, European tensions related to Brexit and budget negotiations will continue to see German bunds in high demand, implying long-term yields being lower than what economic fundamentals (growth, employment, inflation, etc.) would typically justify, with well-known consequences even for long-dated US Treasury yields.

Our Recent Publications

- *MARKET VIEWS: Hedging The Risk of A Potential Emerging Markets Crisis, by Alessandro Magnoli Bocchi, Pablo Gallego Cuervo, Francisco Quintana, 2 November 2018*
- ***AHEAD OF TUESDAY'S US MID-TERM ELECTIONS READ AGAIN*** *Verdict on the Trump Revolution, by John C. Hulsman, 17 October 2018*

The Week Ahead

In the US, mid-term elections will take place on Tuesday November 6. The latest opinion polls are indicating that the Democrats will take control of the House of Representatives—where all 435 seats are up for election—while the Republicans will retain a narrow majority in the Senate—and possibly even expand it.

The Quarter Ahead

In the US, the labour data remain consistent with further tightening. The likelihood of a hike in December rose to 79.2% (pw: 70.3%), and that of "at least 3 additional hikes by December 2019" to 59.7% (pw: 47.7%).

In the EU growth stagnates and political risks increase. In the EZ, unemployment is stable (September, a: 8.1%; c: 8.1%; p: 8.1%) and inflation lingers around the ECB target of 2% (September, a: 2.2%; c: 2.2%; p: 2.1%). However, the ECB policy normalization strategy is being clouded by growth and political risks: a) last week, the EZ posted its weakest economic performance in four years (Q3 GDP y-o-y, a: 1.7%; c: 1.8% y-o-y; p: 2.2%), with Italy lagging (Q3 GDP q-o-q, a: 0.0%; c: 0.1% y-o-y; p: 0.2%); b) in Germany, Chancellor Merkel announced that she will step down as CDU head, increasing the risk that the CDU/SPD coalition could collapse before the end of its term; c) in the UK, a Brexit agreement remains unlikely, although the GBP rallied (+1.1% w-o-w to GBP/USD 1.297) on rumours that British banks may have continued access to EU markets after Brexit.

In China, the government will keep providing support. China's growth continues to show signs of deceleration (Manufacturing PMI October, a: 50.2; c: 50.6; p: 50.8); however, stocks (Shanghai Comp, +3.0%) and CNY (+0.8% to USD/CNY 6.889) improved w-o-w following conciliatory remarks from US president Trump.

In Turkey, the lifting of US sanctions will contribute to policy normalization. The US officially lifted sanctions on Turkey following the release of pastor Brunson; as a result, the TRY appreciated (+3.0% w-o-w to USD/TRY 5.592) and 10y bond yields declined (-57bps to 17.09%).

Globally, populist parties will continue to gather support. Last week, in Brazil, Mr. Jair Bolsonaro, won the presidential election, triggering a rise on stocks (IBOVESPA, +3.1%).

In the GCC financial regulation will continue to tighten. Last week, the UAE approved a law to combat money laundering and terrorism financing to bring its rules into line with international standards.

Brent prices will suffer downward pressure but will remain close to 80 USD/b. Last week, the US announced exceptions from Iran sanctions for eight countries, reducing fears about a shortage of supplies and sending crude prices to their lowest levels in three months. However, upcoming sanctions on Iran and a limited spare capacity will contribute to maintain prices near USD80/b.

Last Week's Review

Positive economic data and declining trade risks lifted stocks. Global stocks rebounded (MSCI ACWI, +3.1%) driven by: a) optimism over the US October jobs report, as: i) wage growth rose at the fastest pace since 2009 (average hourly earnings October, c: 3.1% y-o-y; c: 3.1%; p: 2.8%); ii) the number of new jobs beat expectations (non-farm payrolls September, a: +250k m-o-m; c: +190k; p: 118k); and iii) the unemployment rate remained at a 49-year low (October, c: 3.7%; p: 3.7%); b) solid US corporate earnings; and c) conciliatory comments of US president Trump on trade talks with China. Stocks rose in most markets (S&P 500, +2.4%; Eurostoxx50, +2.5%) but particularly in EMs (MSCI EMs, +6.1%).

Volatility fell towards its 10y average (VIX, -4.7 points to 19.5; 52w avg.: 14.7; 10y avg.: 19.0). Bonds registered marginal losses (BAML Global bond index -0.3% w-o-w) as rising expectations of higher interest rates increased 10y bond yields in most DM markets (UST, +14bps w-o-w to 3.21%; Germany, +9bps to 0.44%).

The USD strengthened w-o-w against: 1) a currency basket (DXY, +0.2%); and 2) the EUR (EUR/USD -0.1%, to 1.140), but weakened against EMs (MSCI EM Currency index, +0.9%).

As expected, policy rates remained unchanged in Japan, China and the UK. Central banks kept policy rates on hold in Japan (BoJ, a: -0.1%; c: -0.1%; p: -0.1%), the UK (BoE, a: 0.75%; c: 0.75%; p: 0.75%), and China (PBoC, a: 4.35%; c: 4.35%; p: 4.35%).

__Pablo Gallego Cuervo__ contributed to this Viewsletter.

The picture in the front page comes from this website

Abbreviations, Acronyms and Definitions

a	*Actual*	*LN*	*Northern League, Italy*
AKP	*Justice and Development Party, Turkey*	*M5S*	*Five Star Movement, Italy*
ann.	*annualized*	*m-o-m*	*Month-on-month*
ARS	*Argentinian Peso*	*mb*	*Million barrels*
avg.	*Average*	*mb/d*	*Million barrels per day*
bn	*Billion*	*MENA*	*Middle East and North Africa*
BoC	*Bank of Canada*	*MHP*	*Nationalist Movement Party, Turkey*
BoE	*Bank of England*	*mn*	*Million*
BoJ	*Bank of Japan*	*NAFTA*	*North-American Free Trade Agr.*
bpd	*Barrels per day*	*NATO*	*North Atlantic Treaty Organizat.*
bps	*Basis points*	*OECD*	*Organization for Economic Cooperation and Development*
BS	*Balance sheet*	*Opec*	*Organization of Petroleum Exporting Countries*
c	*Consensus*	*p*	*Previous*
C/A	*Current account*	*P2P*	*Peer-to-peer*
CB	*Central bank*	*PBoC*	*People's Bank of China*
CBB	*Central Bank of Bahrain*	*PCE*	*Personal Consumption Expenditures*
CBK	*Central Bank of Kuwait*	*PE*	*Price to earnings ratio*
CBT	*Central Bank of Turkey*	*PM*	*Prime minister*
CDU	*Christian Democratic Union, Germany*	*PMI*	*Purchasing managers' index*
CNY	*Chinese Yuan*	*pps*	*Percentage points*
CPI	*Consumer Price Index*	*pw*	*Previous week*
DJIA	*Dow Jones Industrial Average Index*	*QCB*	*Qatar Central Bank*
DJEM	*Dow Jones Emerging Markets Index*	*QAR*	*Qatari Riyal*
d-o-d	*Day-on-day*	*QE*	*Quantitative easing*
DXY	*US Dollar Index*	*q-o-q*	*Quarter-on-quarter*
EC	*European Commission*	*RE*	*Real estate*
ECB	*European Central Bank*	*RBA*	*Reserve Bank of Australia*
ECJ	*European Court of Justice*	*RRR*	*Reserve Requirement Ratio*
EIA	*US Energy Information Agency*	*RUB*	*Russian Rouble*
EM	*Emerging Markets*	*SWF*	*Sovereign Wealth Fund*
EP	*European Parliament*	*tn*	*Trillion*
EPS	*Earnings per share*	*TRY*	*Turkish Lira*
EU	*European Union*	*UAE*	*United Arab Emirates*
EUR	*Euro*	*UK*	*United Kingdom*
EZ	*Eurozone*	*US*	*United States*
Fed	*US Federal Reserve*	*USD*	*United States Dollar*
FOMC	*US Federal Open Market Committee*	*USD/b*	*USD per barrel*
FRB	*US Federal Reserve Board*	*UST*	*US Treasury bills/bonds*
FX	*Foreign exchange*	*VAT*	*Value added tax*
FY	*Fiscal Year*	*VIX*	*Chicago Board Options Exchange Volatility Index*
GCC	*Gulf Cooperation Council*	*WTI*	*West Texas Intermediate*
GBP	*British pound*	*WTO*	*World Trade Organisation*
GDP	*Gross domestic product*	*w*	*Week*
IMF	*International Monetary Fund*	*w-o-w*	*Week-on-week*
INR	*Indian Rupee*	*y*	*Year*
IPO	*Initial public offering*	*y-o-y*	*Year-on-year*
IRR	*Iranian Rial*	*y-t-d*	*Year-to-date*
JPY	*Japanese yen*	*ZAR*	*South African Rand*
k	thousand	*2y; 10y*	*2-year; 10-year*
KSA	*Kingdom of Saudi Arabia*		