

Market Update: 21st January 2021

German Policy to Change Direction

Back in 2018, Angela Merkel, the federal chairperson for the Christian Democratic Union Party (CDU) since 2000, announced that she would step down from party leadership and would not run for a fifth consecutive term as German Chancellor. Having provided certainty and stability for Germany since 2005, this is providing a source of uncertainty over the German outlook moving forward. This month, the CDU party announced its new chairperson in Armin Laschet. Consequently, with the upcoming federal election in 2021, the direction of both German and European policy is expected to change, which will have key implications for Europe, Germany's relationship with other nations, and financial markets. Acknowledgements that the CDU's success over the last 15 years has largely been due to specific votes for Angela Merkel have been made from political officials, and further uncertainty should be uncovered in the lead up to the federal election in the second half of 2021. As a result, despite the handling of the global pandemic being the key focus over the next six months, questions will soon be asked over the implications of the change in Germany and Europe in the years to come.

Germany's Current Positioning

As with many developed nations, Coronavirus has weighed heavily on Germany's economy, causing a contraction of 5% in 2020. As the world's third largest importer and exporter, the national shutdown and subsequent drop in trade as its borders closed and demand dropped have worsened Germany's debt-to-GDP ratio. Finance Minister Olaf Scholz expects more than 300 billion euros in new debt to be issued in 2020 and 2021, which has so far helped drive the debt-to-GDP ratio to 73.3%, having previously fallen to 60% in 2019. Although higher in relative terms to Germany's past debt ratios, the country has fared considerably better than the majority of Europe, partly supported by its two targeted fiscal packages:

- The first package amounted to 4.5% of GDP, focusing on health, jobs and firms through cash payments, social benefits, and tax deferrals
- The second package amounted to 1.8% of GDP, deployed to boost consumption through a reduction in VAT, with investment in digitisation and green energy

Germany's debt levels are considerably lower than the UK's debt-to-GDP ratio of 99.5%, yet fiscal consolidation is expected going forward as the nation aims to return back to the 60% Maastricht criteria. This will begin with the expiration in the temporary VAT cut, which will add 19% back onto prices at a time when unemployment remains elevated.

The subsequent changes to the nation's fiscal policy in the next 8 months will be largely dependent on the distribution of coronavirus vaccines. Daily cases remain heightened in Germany with the most recent figure reaching 29,000 new cases, however the number of cases appears to be on a downward trend which implies the nation's prolonged lockdowns are having a desired effect. In terms of vaccines secured, Germany has ordered 64 million doses from the EU, 30 million from a separate bilateral deal,

and are currently in the process of purchasing between 50-160 million Moderna doses that other countries decided not to buy. With a population of 83 million, Germany appears to have secured vaccines for its entire population, meaning it is one of the best positioned European nations as inoculation gets underway and activity picks up, which will help to reduce the fiscal burden and relieve the state from additional borrowing, despite any short-term uncertainty caused by the latest Pfizer vaccine delivery delay. That being said, the nation would be expected to be cautious of withdrawing fiscal support too fast, which could limit Germany's ability to drive its recovery through 2021 and beyond.

Incoming Chancellor to Stimulate Change

Although Germany's near-term strategy appears to be set, Europe's largest economy is expecting medium to long-term change upon the election of the nation's new Chancellor, creating uncertainty around its future policy strategy.

Armin Laschet has recently been announced as the newly elected chairperson of the CDU party, partly chosen due to his proven experience in government as the leader of Germany's most populous state. Unlike in the UK, the leader of the party does not automatically become the party's candidate to run for office, meaning his candidacy will be dependent on how the CDU perform in two regional election polls to be held in March. That being said, he is the party's likely candidate, which puts him in a relatively strong position to become Germany's Chancellor from September 2021. An election victory would be expected to be achieved through a coalition with the CSU (the CDU's sister party) as well as with support from the Greens, yet Chancellor Laschet would be expected to drive some policies aligned to his personal stance despite having been regarded as a Merkel loyalist.

In his policy proposals, Laschet aspires to make the incoming decade one of modernisation for Germany, with new economic dynamism, enhanced national security and improved educational opportunities for all. Alongside this, Laschet has highlighted enhancing digitalisation as a key driver to help modernise the nation, which could be achieved through increased funding and digital-specific policies. In terms of foreign policy, Laschet has emphasised a clear focus on the European Union, as he seeks greater cooperation having previously criticised Angela Merkel for lacking ambition on European Union actions. He is also expected to further strengthen Germany's relationship with France and the US, pushing for greater cooperation on climate and trade policy. Although many of these policies appear as a continuation of Merkel's policies, it can be expected that Laschet will aspire to leave his mark by utilising new resources and trying different strategies to reach his policy end goals.

Many are aligned with the policies outlined above, but questions remain over some of Laschet's personal views. When considering climate policy, nations around the globe have all set ambitious climate targets over the next decade or two as countries react to the urgent climate crisis, and political leaders have sought to establish green policy as a driver in their economic recoveries. Having been minister-president of the industrial hub North Rhine-Westphalia, Laschet is known for his industry friendly views, and has so far hinted he will seek to balance the nation's industry needs against ambitious climate targets. Additionally, on contrarian foreign affairs, Laschet has been regarded as someone who takes a soft stance on Putin's Russia as well as China, with personal ties to the former and strong export demand from the latter. As a result, Germany could be seen to be more collaborative with China and Russia, who are two nations that are facing calls from other political leaders to change their behaviour which has been deemed to be unacceptable over recent years.

What This Means For Europe and Financial Markets

With Merkel's departure from the European political stage, the union will in any case lose its most experienced and powerful compromise-broker. That could tilt power in Europe towards Paris, or Germany's elected Chancellor could continue to be the key driver in European policy. If Armin Laschet were to drive Europe's policy agenda, his personal desire to formulate more visionary EU policy could be implemented. In this, we could see further European integration and collaboration over the next decade, at a time when populism remains a key concern for many who see international collaboration as being key to success. However, his ability to further unify Europe will be dependent on how well he can unify the CDU party in the short-term.

A concern for financial markets could be Laschet's pro-Russia and pro-China stance. At a time when the WHO continues to investigate the source of the coronavirus from China with much struggle, the US is expected to continue its tough stance on China through Biden, who is seeking to work with allies such as Europe to help align Chinese behaviour to global interests. With Laschet's desire to improve cooperation with the US but also his desire to remain on good terms with China for trade purposes, Laschet could find himself in a difficult trade off. Additionally, his personal ties to Putin could unsettle many native German's who are firm believers that Putin's administration were behind the poisoning of Alexei Navalny on German soil in September 2020. Although Laschet will need to work cooperatively through a coalition in Germany and with other member nations on the international stage, financial markets could be discouraged by any uncertainty fielded by Laschet and his foreign ties. If Russian and Chinese behaviour remains unpredictable and uncooperative, financial markets could witness slightly higher volatility than what is typically experienced in normal economic conditions, however much lower volatility than what we are currently experiencing.

Additionally, although financial markets have factored in the latest sustainability and clean energy targets from national governments in the past 12 months, climate target expectations could be adjusted for Germany going forward if Laschet does not continue to accelerate Germany's approach to sustainability.

Our View

Although it is impossible to say who will be elected as Germany's Chancellor at this point in the year, it is widely agreed that change is expected for both Europe and the regions largest economy, even if the candidate aims for a continuation of Angela Merkel's policies. New challenges will arise which will demand unique policy action, and every leader will have a slightly different solution even if they are trying to solve the same problem. Economically, Germany is best positioned as we expect nations to exit out of the current pandemic conditions in the next six months, despite near-term volatility expected as vaccine and pandemic news flows alter financial market expectations. The key takeaway from this analysis is that the newly elected leader will not only alter Germany's policy direction, but they will also have a significant influence on European policy, which could lead to further integration and cooperation, or it could fractionate member states in their views on policy and foreign affairs to some extent. That being said, no matter who is elected, all European member states will be expected to experience an accelerating recovery over the next 12-24 months as nation's enforce a firm grip on the pandemic and relaunch their economies. We continue to expect the medium to long-term outlook for financial markets to remain positive, yet we will continue to monitor key political developments to gain a better understanding of expected changes in policy actions.

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