MyStratWeekly
Market views and strategy

Ostrum ASSET MANAGEMENT

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N° 035 // **September 6, 2021**

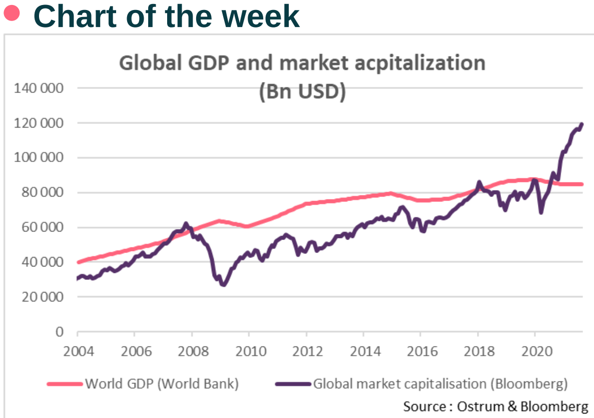
Topic of the week: German elections

- **The German elections were rarely an event likely to make the financial markets move a lot. The stability of German politics coupled with the fiscal orthodoxy widely shared by all parties reduce the potential for surprises.**
- **However, it is interesting to look at the upcoming elections, the outcome is particularly uncertain with at least three very different coalitions that may win.**
- **It would be wrong not to follow the outcome of the election. In the longer term, decisions on budgetary balances, the energy transition and Europe could be affected. Especially since potential coalitions have very different views on these issues.**

Market review: *Fed keeps markets guessing*

- **Timing of tapering uncertain after job data;**
- **The ECB meets this week as hawks take flight;**
- **Risk assets still upbeat;**
- **Quite modest steepening pressure as spreads trade sideways.**

Chart of the week



Global market capitalization has grown steadily since the turn of the century, but it has only rarely exceeded the level of global GDP until last year. It is currently 40% higher.

Warren Buffet's indicator for the United States looks at the ratio between the country's market capitalization and its GDP. This indicator is currently high and therefore signals very expensive equity markets. Warren Buffet believes this is a reason to remain cautious.

The ratio at the global level is even more extreme when compared to its history.

Figure of the week

3.0

Source : Ostrum AM

Euro area inflation hit 3.0% for the first time in 10 years with the core index also rising.
However, some of this increase is temporary.

Stéphane Déo
Head of markets strategy

Axel Botte
Global strategist

Zouhoure Bousbih
Emerging countries strategist

Aline Goupil- Raguénès
Developed countries strategist

Topic of the week

German elections

The German elections were rarely an event likely to make the financial markets move a lot. The stability of German politics coupled with the fiscal orthodoxy widely shared by all parties means that the result of the elections does not lead to very wide-ranging policy changes in contrast to other countries. However, it is interesting to watch the upcoming elections, the outcome is particularly uncertain with at least three very different coalitions that may prevail. This uncertainty is unusual and if markets should not, as usual, really react in the short term, heavy decisions on future trends could be affected: budgetary rules, energy transition, European budgetary aspect.

Rules of the game

It may be interesting to return quickly to the German electoral process, which has notable particularities.

The 598 MPs (in German «Mitglieder des Bundestages», or «MdB») are elected for four years by a mixed-member proportional representation system. There are, however, two particularities. On the one hand, voting takes place simultaneously at two levels, at the level of the 299 constituencies (Direktkandidaten im Wahlkreis) and at the level of the Lander (Landesliste). On election day, the elector therefore has two votes, one “first vote” (Erststimme) to vote for the candidate in the constituency and one “second vote” (Zweitstimme) to vote at the lander level.

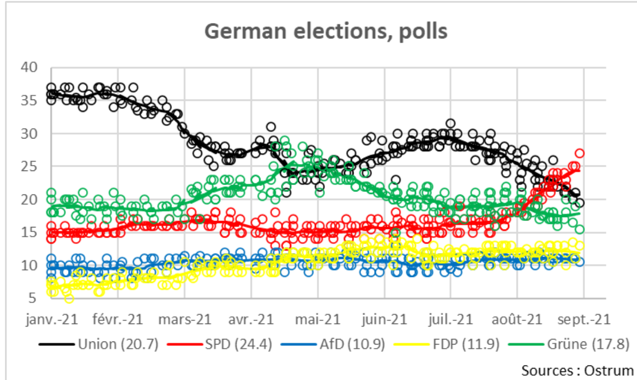
Seats are then allocated proportionally from the count of the “second votes”. Only political parties that have reached more than 5% of the votes cast or that have won in at least three constituencies are allocated seats. Seats are then filled from a complex mix of candidates from both levels of voting.

The elected Bundestag shall appoint the Chancellor. Recall that the last elections held on 24 September 2017 had not given a clear majority and that the formation of a government coalition between the CDU/CSU and the SPD had to wait until 7 February 2018 when a grand coalition agreement was eventually signed, then approved by SPD members.

These five and a half months of negotiations and power vacancy had only slightly affected the markets. In times of relative calm, the absence of government rarely results in an increase in the risk premium.

And the winner is…

If we use the surveys, whose reliability is of course indisputable, we obtain the following graph.

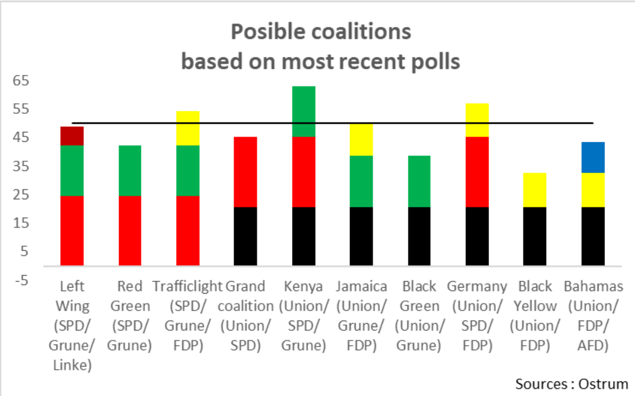


Three parties are in the lead. The Greens, who briefly passed in the lead in the spring, were overtaken by Union (aka CDU/CSU) and then the SPD. Union, which enjoyed a significant lead at the beginning of the summer, fell significantly and showed a gap of 3.1/2 points. The SPD of the current Finance Minister, Olaf Scholz, on the other hand, has made a superb comeback since the beginning of August by gaining 8 points over the month.

The personality of the head of the list seems to play an important role in this recent development. A poll shows that 44% of Germans want Scholz to be the next Chancellor against only 21% for Laschet (CSU/CDU) and 16% for Baerbock (Brune).

To put some downside to the proverbial reliability of electoral polls we must also point out that almost one in five voters is not yet sure of their vote, which is largely enough to tip the balance between the three main parties.

This gives many opportunities for coalitions after the elections. And that may be the main point. Still based on the polls, we can do a number of simulations on a possible government coalition. The, very colorful, result is presented on the following graph.



We included the Kenya coalition hypothesis with the three major parties together. It is by far the solution that provides the greatest majority, but this assumption is an unlikely one from a political point of view.

The other three majority coalitions include two of the three main parties with the participation of the FDP. These three coalitions ("Traffic light", "Jamaica" and "Germany") are the most likely. This leads to three observations:

1. Outside the «Kenya coalition», a majority cannot be found without the participation of the FDP, which thus becomes, despite its 12% voting intentions, the king maker.

2. The range of possibilities is very wide, unusually so for German elections. In the «traffic light» coalition, the left parties (SPD and Grune) would hold almost 80% of the seats gathered by the coalition. While the coalition «Germany» would very much resemble the «grand coalition» currently in power (Union/SPD) would also represent there about 80% of the seats.

3. The race is desperately close, and it is very difficult to know if the ballot boxes will give one option a decisive advantage over another.

As a result the race is unusually open with several possible coalitions. Special mention should also be made of the left wing coalition, which does not seem to be in a position to win at the moment but is an outsider to watch closely; in this case it would be an even more dramatic change after almost 16 years of Angela Merkel's reign.

The political line of the next government will certainly be decided by the photo finish … and after long negotiations between the parties.

Platforms

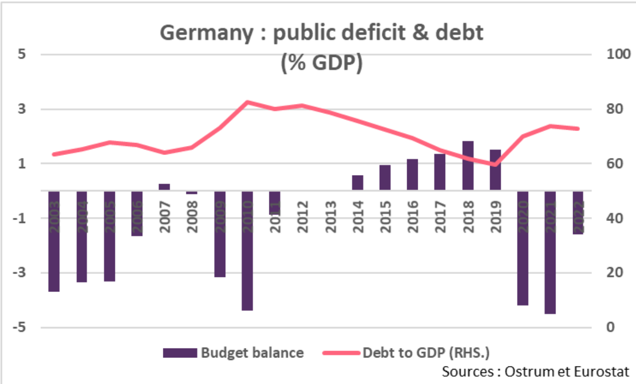
The part of the platforms which is most relevant to the markets is linked to the budgetary aspect, both at home and at European level.

		FDP	Union	SPD	Linke	Grune
Domestic	Reintroduction of the debt break (structural deficit below 0,35 %)	YES	YES	YES but with more room for manouevre		After reform (public investment allowed in certain cases)
	Return to a 60 % debt to GDP	YES	YES	-	-	-
	Use of SVP to boost public investment	-	YES	-	-	YES
	Increase in taxation	NO	NO	YES, for high income	YES, for high income	YES, for high income
Europe	Reform of the stability and growth pact (SPG)	YES, with higher penalties for offenders	YES, but no softening of constraints	YES	YES	YES
	NGEU to become a fiscal caapcity	NO, NextGen a one-off	NO, NextGen a one-off	YES NextGen is "a durable step forward"	YES	YES

Source : Ostrum

Budgetary trajectory, the domestic part

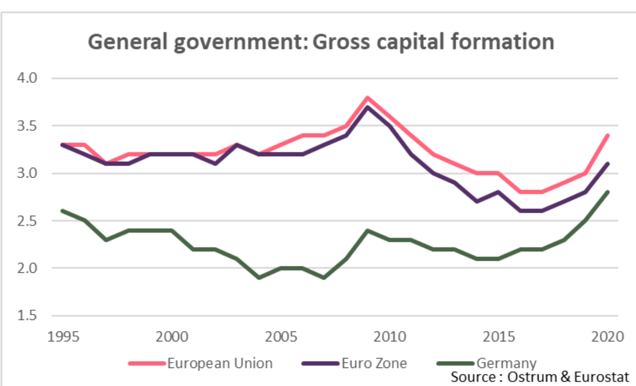
Germany had posted eight consecutive surplus budgets between 2012 and 2029, the famous "schwarze Null", literally the "zero black", that is to say a slightly positive budget, "zero plus" would be a more appropriate translation. Covid forced Germany to plunge back into deficit in a very marked way, -4.2% in 2020, even if this figure remains limited compared to the 7.2% deficit of the Eurozone or the 9.2% and 9.5% of the other two main countries, France and Italy.



What do the programs say about the future trajectory? If there are differences, the tax rules are not really in question. The SPD and the Grune are the only two parties that intend to give themselves leeway, but this remains limited and the experience in the landers which have been managed by both parties shows that fiscal orthodoxy is not in question. It should also be noted that the multi-annual plan of the Federal budget forecasts a return to a balanced budget, or almost balanced, in 2023.

The target of a debt-to-GDP target of 60% is even explicit for the two right-wing parties, FDP and Union, even if with zero or negative rates one may wonder what the purpose of this approach is.

The difference may be elsewhere, on public investment. Despite extremely favorable financing conditions over the past decade, Germany has always been extremely parsimonious on its public investment policy. Over the past decade, as shown in the graph below, German public investment as a percentage of GDP was 1/5 lower than the euro area average. While the cost of financing for the German State is negative, this lack of investment in the future is difficult to justify.



It is on this point that the electoral programs diverge the most with a much more proactive attitude of the Grune and the SPD who seek margins for maneuver. The consequence, beyond the purely budgetary aspect, is obviously the energy transition which remains in the background and which could have a much faster implementation in the case of a «Traffic light» coalition.

As an alternative to the reform of German tax rules - which seems politically difficult - Grune proposed to create SPV (Special Purpose Vehicle), an off-balance sheet investment fund that would be able to issue debt and invest in the green transition. The idea is to endow this SPV with a capacity of 50 billion euros per year, or about 1.5% of GDP from 2020, until 2030. This off-balance sheet commitment would not be accounted for in the budget and would therefore not be subject to the “debt restraint” rules. Laschet, the Union candidate also expressed his support in principle for a similar construction. Even if it is pure creative accounting, the proposal can indeed be an effective way of combining compliance with the current rules, at least formally, and meeting investment needs. An alternative option proposed by the SPD would be to expand the scope of KfW which would be a faster solution to be put in place.

Budgetary trajectory, Europe

Another area where differences are notable is Europe. The key issue is the future of the Next Generation EU program, the European Recovery Program to help countries recover from the Covid crisis. This programme has been launched, the table below lists the 18 countries which have received approval for their programme.

Date	Country	Scheme approved
19-Jul	Czech Rep.	Approved
16-Jul	Ireland	Approved
8-Jul	Chypreus	Approved
8-Jul	Croatia	Approved
2-Jul	Lituania	**Approved***
2-Jul	Slovenia	Approved
23-Jun	Belgium	**Approved***
23-Jun	France	**Approved***
22-Jun	Italy	**Approved***
22-Jun	Latvia	Approved
22-Jun	Germany	**Approved***
21-Jun	Austria	Approved
21-Jun	Slovakia	Approved
18-Jun	Luxembourg	**Approved***
17-Jun	Greece	**Approved***
17-Jun	Denmark	**Approved***
16-Jun	Portugal	**Approved***
16-Jun	Spain	**Approved***

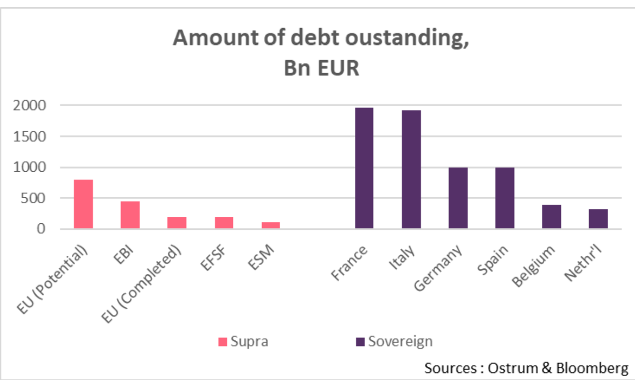
* First payment implemented

Note that 10 of these countries have already received a payment as shown in the table below.

Date	Country	Payment from EC / Next Generation EU
2-Sep	Denmark	0.201
26-Aug	Germany	2.250
19-Aug	France	5.100
17-Aug	Spain	9.000
17-Aug	Lituania	0.289
13-Aug	Italy	24.900
9-Aug	Greece	4.000
3-Aug	Belgium	0.770
3-Aug	Luxembourg	0.001
3-Aug	Portugal	2.200

Considered as a one-off programme that does not have to be renewed, it nevertheless constitutes an important precedent in particular in terms of the European Union's debt issuance capacity.

The graph below gives an order of magnitude. The total outstanding issued by the European Union is currently close to 200 billion euros, which already makes it a major supranational issuer, it surpasses both the EFSF and the MSE. In the long run, if the programmes are actually implemented, the stock of debt issued could reach 800 billion, which would make it a much larger issuer than the Netherlands or Belgium, which currently have 320 and 392 billion respectively. This would also place the European Union close to Spain with a little less than 1,000 billion debt outstanding.



The main question is whether this programme is in fact purely a one-off or whether it will lead to a permanent borrowing capacity of the European Union and own fiscal capacity.

There are clear differences between the parties' electoral platforms. Not surprisingly, FDP and Union are much more cautious than the other parties and want to leave it at that, while the other three parties wish to go further. Even if Germany, with a left-wing coalition, became more favorable to a major budgetary integration of Europe, the fact remains that these advances would most probably take place under yet another crisis and that many countries are not in favor. The marked difference in parties' electoral platforms in this direction should therefore not lead to spectacular progress. The time of Europe is not the time of the markets.

Conclusion: a question of which horizon

The result of the German elections should not make the markets move sharply. Even in difficult negotiations, which we had four years ago, markets remained calm. The current situation, with an economy recovering from its pre-crisis level, calls for no immediate major decisions. A power vacancy of a few months during negotiations would not be so difficult to get through.

However, it would be wrong not to follow the outcome of the election. In the longer term, decisions on budgetary balances, the energy transition and Europe could be affected. Especially since possible coalitions have very different views on the subject.

Stéphane Déo

Market review

Fed keeps markets guessing

Employment maintains uncertainty over the date of the tapering announcement.

The date of the Fed's tapering announcement is undoubtedly the focus of attention. At the Jackson Hole symposium, Powell confirmed that the reduction in asset purchases will begin this year. There are three FOMCs left this fall. The September 22nd FOMC will collide with a busy congressional agenda. The outcome of current negotiations on fiscal stimulus plans has grown more uncertain. The $ 500bn infrastructure spending plan enjoys bipartisan (and hence qualified majority) support, but so-called “human” infrastructure (social spending) planned for $ 3.5T now meets strong opposition from centrists affiliated to the Democratic Party. The reconciliation bill (simple majority) could thus fail. Senator Joe Manchin doubts the need for a far-reaching plan, given funding issues, the size of public debt as the debt ceiling was reinstated in August, and the risk of inflation. The Fed will have little additional information in November other than employment in September and the outcome of budget negotiations. The reappointment of Jerome Powell as President of the Fed is also an element of uncertainty, despite the support of Janet Yellen.

The issue of inflation is indeed central to the Fed’s decision. While two-thirds of FOMC members see risks of rising inflation, Jerome Powell links current inflation to transient spurts in consumer demand. However, it seems that supply constraints are predominant and persistent. The manufacturing ISM survey points to a reduction in employment despite the context of sustained activity. The resurgence of the epidemic partly explains the weakening of job creation in August to 235k. However, the rise in wages corroborates surveys of companies facing unprecedented difficulties to hire. Median wage growth is now 3.7%y, its pre-crisis level, according to Atlanta Fed estimates. Unit labor costs rose by a further 1.3% at annualized rate in the second quarter. In addition, the increase in consumer prices is weighing on household confidence.

In Europe, the news centers on the next ECB governing council meeting. Comments from Robert Holzmann or Klaas Knot calling for PEPP to be capped caused quite a stir in the Bund. Christine Lagarde also agrees on the need to further target the action of the Central Bank after the deluge of liquidity decided in spring 2020. The fight against climate change requires reorienting purchases by greening the ECB's interventions. The ECB President may hint at changes in asset purchase programs this week before making formal policy announcements next December.

Euro rates stabilized above -0.40%. The syndication of a new 30-year bond for € 5.5 billion revived the steepening trend somewhat. The 30-year Bund yield thus ended the week around 0.14%. Sovereign spreads are broadly unchanged from a week ago. The reduction in auction sizes in Spain and signs of improvement in public finances are supporting the Bonos (70bp spread). Italy's fiscal performance is also encouraging as the Italian BTP spread remains within its 100-110bp range. As for US Treasuries, the slightly bearish reaction to the employment statistics may be traceable to the improvement in wages. The US 10-year T-note is trading around 1.32% in narrow volumes ahead of Labor Day weekend. Volatility remains low overall on the fixed income markets. This is logically favorable to carry strategies, including exposure to emerging debt denominated in US dollars. Emerging bond spreads tightened below 350bp. Emerging bond issuance until year-end mainly pertains to investment grade rated borrowers, which keep attracting strong interest from institutional accounts seeking diversification opportunities.

European investment grade credit spreads have been inert for several months. The average investment grade spread stands at 85bp. The summer bond rally pushed more than 40% of the investment grade universe into negative yield territory. Corporate credit valuations therefore remain a drag on institutional investments, but the return to primary market activity in September nevertheless offers some investment opportunities. New issue premiums, however, are almost zero. The high yield market (294bp) still offers spreads close to 300bp. Record primary issuance in 2021 does not prevent further tightening of risk premiums, thanks to the appetite of institutional accounts looking for (still positive) yield. Credit indices are also showing a narrowing trend. The iTraxx Crossover is trading below 230bp, a tightening of 7bp over one month.

Equity markets hesitated all week as economic data hit the wires and still posted a weekly gain of 0.3% in Europe. The Nasdaq and the US indices set new annual records in session. The 2Q 2021 publications reassured market participants despite building inflationary pressures on corporate margins. Flows into European equity funds recovered after a period of profit-taking early on this summer. In turn non-resident investors keep adding to European stock positions.

On the foreign exchange market, US employment data may have been interpreted as signaling a building wage inflation issue. With the modest increase in rates came a weaker dollar. The Australian and New Zealand dollars are gaining ground as vaccination is expected to gather pace and the economic outlook improves again.

Axel Botte
Global strategist

Main market indicators

G4 Government Bonds	03-Sep-21	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	-0.71 %	+3	+6	-1
EUR Bunds 10y	-0.36%	+6	+12	+21
EUR Bunds 2s10s	35 bp	+3	+6	+22
USD Treasuries 2y	0.21 %	-1	+4	+9
USD Treasuries 10y	1.32 %	+2	+15	+41
USD Treasuries 2s10s	112 bp	+2	+11	+32
GBP Gilt 10y	0.72 %	+14	+20	+52
JPY JGB 10y	0.04 %	+2	+3	+2
€ Sovereign Spreads (10y)	**03-Sep-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
France	34 bp	-1	0	+11
Italy	107 bp	+1	+2	-5
Spain	70 bp	-2	-2	+8
Inflation Break-evens (10y)	**03-Sep-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR OATi (9y)	145 bp	+4	+4	-
USD TIPS	234 bp	-5	-3	+36
GBP Gilt Index-Linked	365 bp	+1	+8	+65
EUR Credit Indices	**03-Sep-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
EUR Corporate Credit OAS	85 bp	+0	+1	-7
EUR Agencies OAS	42 bp	-1	-2	+1
EUR Securitized - Covered OAS	36 bp	-1	-3	+4
EUR Pan-European High Yield OAS	292 bp	-5	-12	-66
EUR/USD CDS Indices 5y	**03-Sep-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
iTraxx IG	45 bp	0	-2	-3
iTraxx Crossover	228 bp	-2	-7	-13
CDX IG	47 bp	0	-3	-3
CDX High Yield	274 bp	-4	-19	-19
Emerging Markets	**03-Sep-21**	**-1wk (bp)**	**-1m (bp)**	**YTD (bp)**
JPM EMBI Global Div. Spread	340 bp	-7	-16	-11
Currencies	**03-Sep-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
EUR/USD	$1.188	+0.72	+0.1	-2.82
GBP/USD	$1.387	+0.78	-0.33	+1.61
USD/JPY	¥109.71	+0.12	-0.59	-5.84
Commodity Futures	**03-Sep-21**	**-1wk ($)**	**-1m ($)**	**YTD ($)**
Crude Brent	$72.4	$0.7	$0.6	$21.5
Gold	$1 827.7	$10.2	$16.9	-$66.6
Equity Market Indices	**03-Sep-21**	**-1wk (%)**	**-1m (%)**	**YTD (%)**
S&P 500	4 535	0.58	2.54	20.75
EuroStoxx 50	4 202	0.26	2.04	18.28
CAC 40	6 690	0.12	-0.50	20.51
Nikkei 225	29 128	5.38	4.70	6.14
Shanghai Composite	3 582	1.69	3.57	3.13
VIX - Implied Volatility Index	16.41	0.12	-9.04	-27.87

Source: Bloomberg, Ostrum Asset Management

Additional notes

Ostrum Asset Management

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