Markets won’t regret change of German government

Even if the global economic cycle and new U.S. policies might dominate markets in the short term, a change of government could provide new impetus for German equities.

IN A NUTSHELL

- With the dismissal of his finance minister, German Chancellor Scholz has signaled the end of the coalition government.
- Before the vote of confidence in the next few weeks and possibly new elections in March, a minority government could still pass some laws.
- A reform of the debt brake and the prospect of a more business-friendly government could give the Dax new impetus in the medium term.

The traffic light turned red

On Wednesday evening, November 6, German Chancellor Olaf Scholz dismissed Finance Minister Christian Lindner, thus heralding the end of the ‘traffic light’[1] coalition. The main point of contention between Lindner's Free Democratic Party (FDP) and the two other parties in the three-way coalition was the debt brake ("Schuldenbremse"). While the FDP wanted to stick to a strict austerity policy, the other parties saw a higher need for financing in some areas. In particular, the development of defense capabilities is seen as urgent following Donald Trump's election victory. Lindner was unwilling to grant the debt brake override resolution demanded by Scholz.

In the coming weeks, Scholz intends to table a vote of confidence, paving the way for new elections. One possible election date would be in March 2025. With immediate effect, the red-green coalition will now continue to govern as a minority government after the FDP formally terminated the coalition. The appointment of the successors is to take place this Thursday. Jörg Kukies, a former investment banker who has served as a state secretary in Berlin since 2018, is to become the new finance minister. We expect that the reduced coalition could still try to push the following laws through before the last Bundesrat session on 20 December: Compensating for cold progression; Pension Package II; Tightening migration rules / rules of the Common European Asylum System; new emergency measures for industry and a possible reform or suspension of the debt brake to finance Ukraine, growth and defense. The minority coalition can count on support from the Christian Democratic Union (CDU) for projects in defense and economic stimulus. For other projects, it could try to rely on changing majorities (e.g. with Die Linke, Bündnis Sarah Wagenknecht (BSW) or FDP defectors). However, it is doubtful whether, for example, the freezing of the pension level will still pass.

[1] Based on the colors of the coalition partners: Social Democratic Party of Germany (red), Free Democratic Party (yellow), Green Party (green)

Market and policy implications

Although it is still very early to make predictions, the most likely scenario after the new elections seems to be a "grand" coalition between the CDU / Christian Social Union (CSU) and the Social Democratic Party (SPD), presumably led by the CDU. Another possibility is a black-green coalition under Robert Habeck, but this is less likely. This might be a positive development for Germany's economic future. Both parties largely agree on supporting Ukraine. As the ruling party, the CDU/CSU would also have little reason to stick to the debt brake. A reliable policy towards Ukraine, higher government spending, especially on external security, but also on investment, could help the German economy get back on its feet. In such a constellation, it would be quite conceivable to implement urgently needed structural measures, such as a fundamental reform of the pension system, stronger incentives for transfer recipients to take up work, and a generally more business-friendly policy - especially for German industry - even though there are still many hurdles to overcome.

Asset-class implications

Overall, we expect the market reaction to be limited, although it could provide some tailwind for equities and a slight headwind for bonds.

Fixed Income & Currencies:

German Bund yields have been on a downward trend since the beginning of the summer, influenced by falling inflation figures and weaker economic data. Since the beginning of October, however, they have been unable to escape the rise in U.S. Treasury yields. Even the U.S. election could not change this, although the tariffs planned by the new U.S. administration could weigh on German economic growth. The main drivers of German bond yields are likely to remain the economic outlook, inflation developments and, at the short end, the pace of interest rate cuts by the European Central Bank (ECB). We believe that the prospect of a change of government is unlikely to drive yields higher, as additional spending could be expected. Over the next 12 months, we continue to expect German government bond yields to decline and the yield curve to steepen slightly.

Equities:

For the time being, the German stock market will also be influenced more by U.S. policy than German policy. The looming tariffs and the global growth picture, particularly in the manufacturing sector, could be shaping the Dax. However, if more business-friendly policies are adopted after the election, we believe that valuations in Germany might be likely to rise over the next twelve months, even if there is a significant lag before earnings estimates are raised. However, we do not rule out the possibility that some investors will become more positive on the German market in anticipation of a new coalition, even if the effects of a change in government might not be felt until the end of 2025 at the earliest. Given the Dax's global bias, small caps might be more likely to benefit.

Glossary

The debt brake limits the German federal government to new borrowing of no more than 0.35% of gross domestic product.

The European Central Bank (ECB) is the central bank for the Eurozone.

Small cap firms generally have a market capitalization of less than $2 billion.

A yield curve shows the annualized yields of fixed-income securities across different contract periods as a curve. When it is inverted, bonds with longer maturities have lower yields than those with shorter maturities.

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