Thoughts on the German Election

German Chancellor Angela Merkel won a fourth term in office on Sunday 24 September but will have to build a coalition to form a government. This follows a surge by the populist and anti-immigration Alternative for Germany (AfD) which won 13.5% of votes. This is the first time the AfD has had any seats in the Bundestag and is an indication of lingering political uncertainties on the continent. It remains to be seen how much policy influence the AfD will achieve.

Stock market reaction has been muted and the DAX index has been flat over the last month. The Euro has weakened 5% against Sterling in the last month and faced heavy selling against the Pound in the immediate aftermath of the election. This will compress gains in European equities and bonds for unhedged Sterling based investors; but with currencies moving quite unpredictably this may prove short term, especially as Brexit plays out. To give some context, the Euro has strengthened 2.6% against Sterling in the year to 27 September.

On the positive side economic recovery has gained traction across Europe this year and corporate earnings have begun to recover. Unemployment across the Eurozone is at eight-year lows, while manufacturing leading indicators are at six-year highs. Inflation and interest rates remain low with the ECB continuing to purchase government and corporate debt.

The upcoming Italian election has the potential to create short term “noise” in European equity markets. The main threat to the more traditional ruling parties has been the Five Star Movement, which wants to hold a referendum on the Euro and NATO membership. It remains to be seen whether the Italian electorate will embrace such radical changes.

Our portfolios include some exposure to German and Italian equities through global funds and more specialised European funds. The European exposure of our four preferred global funds (excluding the UK) ranges between 14% and 43%, interspersed with 17% and 25% as at August 2017, but their German holdings are limited. Three have no exposure to German or Italian listed companies and one has 4% in German companies and 5% in Italian companies comprising six holdings.

Our preferred European equity fund choices are well diversified in both geographical and sector exposures. The 3 funds on our panel have higher levels of exposure to Germany, ranging from 8.3% to 23%. Two have no exposure to Italy at all, whilst the other has a 9% allocation to Italian stocks. The funds all have a focus on quality companies with strong balance sheets. Whilst the Italian stocks are more domestic in focus, many of the German companies dominate a certain niche globally, so their fortunes are not tied to Germany alone. This may assist their relative performance should European stock markets prove volatile in the coming months.

The equity portion of our client portfolios are well diversified geographically. At this time we do not consider it necessary to make any changes in reaction to the German election and we are reassured by recent economic and corporate earnings data for Europe. Political events rarely have any significant long term effects on equity markets. Good stock picking drives the long term performance of actively managed funds and we therefore continue to focus our research on an in-depth understanding of the positioning and holdings of our carefully selected panel of funds.

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