Why global investors' eyes are on Germany as Angela Merkel steps down

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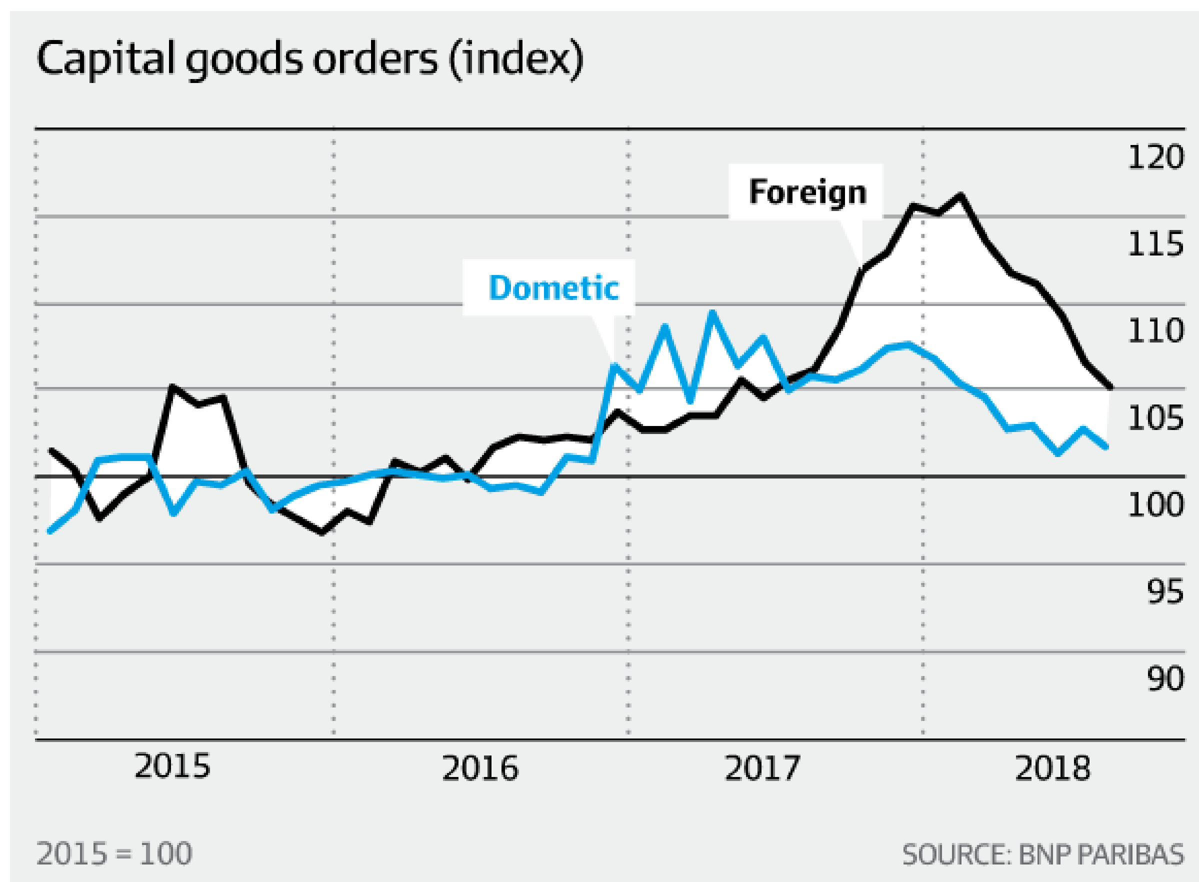
by **Stirling Larkin**

Angela Merkel has been an impressive national leader, but her imminent departure has not only left an indelible mark on German "ordoliberal" politics and the European experiment at large, it has rattled global investment markets, with German bunds sitting at the centre of all fixed-income market investment conversations this month.

Global institutional investors are looking beyond Merkel's term and extrapolating whether her successors will destabilise the stability German bunds provide, as they have anchored the transatlantic fixed-income market recovery since the Grexit crisis of 2012.

Among both Eurosceptics and EU proponents, these concerns are increasingly being conflated with those of the euro, which has created massively distorted prices across European asset classes since its inception in 1999.

The recent Bavarian state election loss for Merkel's grand coalition – which led to her resignation – has caused atypical volatility within German domestic politics. The anti-immigrant rise of the populist far-right Alternative for Germany (AfD) party has steadily taken votes from the Christian Democrats. The biggest winner, the Green Party, began in the 1970s on the far-left of the West German spectrum but has since moved substantially toward the centre to a position not far from the Social Democrats, Merkel's coalition partners.



Bearing in mind that Germans have an uncanny recurring ability to find a strong, stable middle ground during times of flux, the questions global institutional investors are asking are: who will step up, or step in, to bring a functional government to Germany; and what influence will they have on the presidency of the Deutsche Bundesbank, which oversees the all-important bund issuance market?

Australian ultra high net worth global investors find this particular relationship of interest as it was the 1987 destabilisation by the West German Bundesbank that triggered the 1987 stock market crash, which shook Japan and traumatised the Australian economy more than arguably any other.

In the early 1980s, foreign exchange volatility played havoc with businesses' spending plans and countries' ability to repay their foreign currency debts.

To remedy this situation, the world's leading financial policymakers got together – first in September 1985 at New York's Plaza Hotel and then in February 1987 at the Louvre in Paris – to agree on a plan to coordinate monetary policy.

Currency volatility

The idea was to reduce currency volatility, thereby steadying global economic growth – businesspeople would no longer have to worry about foreign exchange volatility wiping out their margins – and limiting the scope for financial shocks.

Unsurprisingly, global investors loved the idea that they would no longer get waylaid by big currency swings and as a result almost all risk-assets ripped higher.

After watching a rise in bond yields through the summer of 1987, the Bundesbank, which back then was a genuine inflation hawk, panicked and in October 1987 it raised short rates.

US Treasury Secretary James Baker responded angrily on October 18: "We will not sit back in this country and watch surplus countries jack up their interest rates and squeeze growth worldwide on the expectation that the United States... somehow will follow by raising its interest rates".

By Monday morning, it was clear to all that the Plaza and Louvre Accords were dead and in response the Dow Jones Industrials opened down -27 per cent, triggering the 1987 Black Monday crash, which ultimately led to the recession Australia had to have.

Fast forward to today, wealthy Australian investors fear that a destabilising of German bunds will affect ECB short rates, the euro and both short and long rates globally after the global financial crisis.

Global spikes

The contemporary scenario where US Treasury Secretary Steven Mnuchin's enthusiasm for a weaker US dollar already threatens the cozy "Shanghai agreement" of February 2016 – guaranteeing the markets that forex volatility will be constrained, repressing the Australian dollar to close to 72¢ – appears to be one major catalyst of the late January-early February and July spikes in volatility globally.

If German politics contaminates bund fixed income and Euro stability, along with an uneasy Shanghai Accord led by the capricious Trump administration, global markets – but specifically Australian UHNW investors – could be bushwhacked harder and faster than in 1987.

If these political conditions do improve, then markets that have fallen by more than 20 per cent since May, and are now trading on attractive multiples relative to prospective earnings and bond yields, should soon enjoy big rallies.

Even if conditions don't improve but merely stabilise, most of the bad news seems already to be discounted in market prices, with the upsurge in oil prices caused by the re-imposition of sanctions on Iran, the US-China trade confrontation and Italy's coalition government funding issues all being absorbed into today's price levels.

Until Europe finds a single market for services, banking and capital markets unions, which appears to be decades away, Germany and German political leadership matters greatly not only to Europe but the entire world.

Stirling Larkin is chief investment officer of Australian Standfirst (www.australianstandfirst.com).

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