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German election: Merkel in a bind

Key views

Merkel wins a fourth term but faces tricky coalition talks after mainstream parties posted their worst results since the 1940s

We see the outcome slowing momentum behind a Franco-German drive to promote deeper eurozone integration

The powerful position of German finance minister could be key in coalition talks and the future of the eurozone

German Chancellor Angela Merkel has won a fourth term but now faces drawn-out coalition negotiations and a splintered parliament, likely slowing down a Franco-German drive to promote deeper eurozone integration.

We expect the outcome to have limited impact on financial markets but see it slowing momentum behind efforts to strengthen the eurozone. The election result also showed euroskeptic sentiments still run high in the bloc, as evidenced by the larger-than-expected 13 % share for the right-wing Alternative for Germany party.

Merkel's Christian Democratic Union (CDU) and its CSU sister party gained about a third of the vote, the lowest share since 1949. Merkel's junior coalition partner, the Social Democratic Party (SPD), indicated it would go into opposition after also receiving its worst result since the 1940s with about a fifth of the vote. This for now leaves Merkel to negotiate a tricky three-party coalition with the pro-business Free Democratic Party (FDP) and ecologist Greens – parties that appear diametrically opposed on key issues such as climate change, migration and eurozone integration.

A coalition involving the FDP may limit any plans for deeper eurozone integration. The FDP would likely be reluctant to sign up to a eurozone finance minister and would want a stronger focus on enforcing fiscal rules limiting budget deficits. Yet Merkel as the senior partner in this coalition may still have wiggle room to push for greater integration. The FDP likely will champion for tax cuts and deregulation, a potential positive for German equities, and advocate stricter controls on immigration.

A big question is whether the head of Germany's finance ministry might switch. Would Merkel's offering this powerful position to the SPD bring the Social Democrats back to the negotiating table? Such an outcome could soften Germany's stance toward peripheral eurozone countries and cause an uptick in government spending. The European Commission has already called for greater public investment to boost Germany's potential growth and spur economic activity elsewhere.

Franco-German cooperation had been seeing a revival with new French President Emmanuel Macron. Berlin flagged cautious openness to Macron's push for a centralised eurozone finance ministry and backed the idea of turning the crisis-fighting European Stability Mechanism into a European Monetary Fund to pool fiscal resources. Germany has ruled out the eurozone's issuing jointly guaranteed debt.

Germany's splintered parliament could make Merkel more cautious in supporting pan-European initiatives. In addition, the eurozone's solid economic expansion could dull the appetite for major reforms. Italy's election next spring is likely to result in a hung parliament, further limiting the scope for reforms.

We prefer European equities over government bonds and credit amid a sustained, above-trend economic expansion and a steady earnings outlook. Companies with much of their cost base overseas should have some cover against a strong euro in the short term, we believe. We see scope for the U.S. dollar to regain some ground against the euro as the Fed presses ahead with policy normalization and U.S. inflation looks ripe for a rebound. We believe core inflation in the eurozone is likely to stay muted, keeping the European Central Bank accommodative.

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