

**FIXED INCOME**

# How Angela Merkel's Future Could Influence European Markets

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Markets have largely brushed off speculation about the future of German Chancellor Angela Merkel as she stood down as leader of the Christian Democratic Union party. However, Franklin Templeton's Head of European Fixed Income David Zahn believes her decision could have ramifications, both politically and economically, in the not-so-distant future.

We've long argued that politics and European Central Bank (ECB) monetary policy are the most influential factors governing the direction of European fixed income markets.

Recent events in Europe have done little to dissuade us from that belief.

The decision of German Chancellor Angela Merkel to step down as leader of the Christian Democratic Union (CDU) has potentially significant implications for both the political and monetary policy scenes in Europe, in our view.

## A New Direction for Germany?

Market response to the news has so far been muted. Mrs Merkel's current term as chancellor runs until 2021 and she has said she intends to see that out. But many observers, including us, doubt whether that is feasible. We believe the fallout from this development could soon be apparent.

Attention has quickly shifted to who the new leader of the CDU will be, and how he or she might change the political direction in Germany.

The election to replace Mrs Merkel as CDU leader will take place in December, but already a number of figures—some well-known, others less so—have indicated their intention to stand.

We wonder how long a newly elected CDU leader would be prepared to support Mrs Merkel continuing as chancellor. So, we would not be surprised to see her step down from the role before 2021.

In Germany—as with a number of other countries—we're seeing a political bifurcation. Voters are abandoning the parties of the traditional centre ground in favour of the extremes of the right and left. That's likely to affect the direction taken by Mrs Merkel's successor.

## Changing Attitudes Towards the EU

Two of Mrs Merkel's defining ideas have been her support for immigration and for integration in Europe. But opinion polls and recent regional election results suggest those views are not resonating with German voters.

So, we suspect any successor could be less enthusiastic about further European integration than Merkel has been. That doesn't mean we expect any new leader in Germany to be anti-Europe, but they may not be quite as pro-Europe as German administrations have been in the recent past. That possible change in attitude has implications most noticeably for the possibility of a trading deal between the European Union (EU) and a post-Brexit United Kingdom.

Because of its strong exporting position, Germany is one of the countries likely to be hardest hit by Brexit. So one would expect Germany to be pushing for a deal between the United Kingdom and the EU.

However, Germany's ability to influence other countries could be weakened by Mrs Merkel's diminished role.

For many years, Mrs Merkel has been seen as the de facto leader in Europe, offering clear direction. With her position weakened and no one figurehead leader offering clear leadership, it might become harder to achieve agreement across the bloc. France's President Emmanuel Macron is working on establishing himself in a pan-European leadership role, but he's not there yet.

We still expect there will be a post-Brexit deal between the United Kingdom and the EU, but we recognise the chances of a no deal scenario are significantly higher than they were before Merkel's announcement.

## **Possible Impact on Monetary Policy**

Meanwhile, Mrs Merkel's political fortunes could also have an indirect effect on the direction of monetary policy in the eurozone.

The current president of the European Central Bank (ECB), Mario Draghi is due to step down later next year and already speculation is mounting as to who might replace him.

One of the leading contenders had been Bundesbank Chair Jens Weidmann. But his chances of landing the top job took a knock amid reports that Mrs Merkel would not support his candidacy. A change in leadership in Berlin could push Weidmann back into contention.

We don't foresee a dramatic change of direction for the ECB regardless of who its new president is, but we would expect the new incumbent to want to stamp their mark on the role.

We'd expect eurozone monetary policy to remain accommodative in the face of reasonable growth and low inflation across the region. However, the degree of accommodation may alter.

## **Wait-and-See Mode**

Recent regional election results for parties making up the coalition government in Germany have made it clear that some kind of political change in direction was required in Berlin. That's why we think Mrs Merkel's announcement didn't create larger waves for markets.

However, as the situation plays out in the coming months, we foresee much greater ramifications. Whether those ramifications are good or bad will depend on the view of the new administration.

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