Populism. Alive and Kicking?
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The German Election

Last June, after the "Brexit" referendum—the U.K.'s unexpected vote to leave the European Union (EU)—market participants began to worry that Brexit signaled the beginning of the end of the great EU integration project. However, consecutive election failures by the anti-EU parties in the Netherlands and France led to a sharp reversal of EU break-up fears; instead, the market narrative turned to one of reinvigorated European cohesion and solidarity, led by Emmanuel Macron and Angela Merkel at its core.

That narrative was arguably intact until the September 25 German election, which once again reignited concerns that populism remains a potent influencing force in global politics. While polls forecasted a range of potential outcomes, the broad consensus was for a comfortable win from Merkel's center-right Christian Democratic Union (CDU) along with its sister party the Christian Social Union (CSU), allowing her to continue her coalition government with the Social Democratic Party (SPD). Polls were mixed on the potential for a strong showing for the right-wing, nationalist Alternative fur Deutschland (AfD) party. The outcome was a modest surprise, Merkel's CDU/CSU winning 33% of the vote (down 8% from 2013), the SPD suffering its worst result since World War II with 20% (down 5%) and the AfD winning almost 13% of the vote (up 8%).

Since the election result, the SPD has said it will no longer participate in a coalition government, leaving Merkel with the less desirable option of forming a coalition with the Green party and the liberal Free Democratic Party (FPD). Amusingly this is termed the Jamaica coalition, the party colors of black, green and yellow being those of the Jamaican flag! This coalition may not even be successful given the parties' differing views on further EU integration, immigration, energy and defense spending, amongst other topics. Notably we would expect the FDP to continue their strong opposition to EU fiscal integration.

Why the Populism?

The more troubling aspect of the election outcome is with regard to the AfD. The AfD platform was clearly anti-immigration and focused on domestic security, but manifested itself in a controversial campaign where the AfD seemingly targeted topics that garnered media attention, and then claimed that it was the victim of a manipulative mainstream media which it termed Lügenpresse, the "lying press." Sound familiar?

We have been thinking about the underlying cause of this resurgence in populism. Is this a one-off? One conclusion we have reached is that many voters who cast their ballots for the AfD did so because they simply didn't see their views reflected in the platforms of the mainstream parties. Crime and terrorism, immigration, and pensions were some of the issues that deeply mattered to AfD supporters.

These reasons seem to rhyme with Brexit and Trump's victory. The lesson learned is that if mainstream parties can't somehow broaden the appeal of their core messages, they are likely to disenfranchise more of the support from their base constituents. It seems once again that the political establishment has underappreciated the degree of discontent within the voter base. A look at where AfD voters in the 2013 election previously affiliated tells this story—almost a quarter of support came from voters who previously cast ballots for the CDU and CSU parties, and another 14% had
supported the SPD and Left Party.

Implications for Asset Markets

Meanwhile, our job is to think about the implications for asset prices. At the margin, the German election seems to weaken the case for continued appreciation in the euro. We might look for President Mario Draghi and the European Central Bank (ECB) to take a slightly more cautious view on its announcements regarding quantitative easing (QE) tapering given the new information. Up until the German elections, we—along with most of the market—expected Draghi to address the future of QE at the ECB’s October meeting.

Conversely, this event probably helps the U.K., albeit slightly, in its Brexit negotiation as the election’s outcome modestly softens the case for a galvanized core Europe. We would therefore expect the British pound to outperform the euro. So far, eurozone bond markets appear to have shrugged off the news, and we would expect core yields in Europe to remain caught in a tug-of-war between the ECB’s QE program—which continues to keep yields lower and highly overvalued—and the continued pickup and broadening out in eurozone economic activity, which should push yields higher. Longer term, we see the potential for yields to move higher.

What’s Next in European Politics

We are sorting through the results of Catalonia’s independence referendum, as the wealthiest region in Spain voted for its independence on October 1. Although nearly 90% of ballots cast were in favor of independence, less than half of eligible voters took to the polls, while the Spanish high court preemptively declared the referendum illegal. This is yet another highly complex political event that could take months—if not years—to unfold. The euro and safe-have Bund yields did not significantly move in response to this referendum; the spread between Bunds and Spanish bonds remained below average and Spanish equities were down 1.8% the day after the vote. What makes the Catalan referendum different than say Brexit or Germany? We believe this particular issue in Spain is more about national identity than populism—the struggle between Catalonia and Madrid has spanned centuries.

The next major national election takes place in Italy in the first half of 2018; the latest date would be May 20. Given the success enjoyed by AfD, we expect the markets to begin to climb a wall of worry about the risk of Italy’s populist euroskeptic Five Star Movement (M5S) enjoying a stronger-than-expected showing. The most recent polls show M5S polling at around 25%, just behind the incumbent Democratic Party and comfortably ahead of other challengers. We will be watching with interest.

In summary, we see the result of the recent German election as a continuation of a broad global repudiation of politics as usual. The real question is what catalyzes such resentment for the political establishment, particularly as voters from more and more countries believe their traditional political parties no longer represent their interests. The answers to this question are complex and varied, but it is likely the root of discontent lies partly in income inequality. This year, our view has been that the global economy is in a phase of modest, low-inflationary synchronized growth. This environment has been constructive for labor hiring, as measured by declines in unemployment rates globally, yet wages are still not picking up even as economies operate at or near full employment. Consequently, many labor market participants feel left out of the post-crisis economic recovery. Furthermore, many of them have not seen any meaningful increase in household wealth, either through appreciation in property values or financial assets. Perhaps the chasm in income equality has been driven by 25 years of policymaking in favor of economic liberalization, and we are finally starting to see an opposing reaction as a countermovement crystallizes. The genesis and persistence of income inequality is certainly complex, but the fact that the resurgence in populism occurred in Germany—a paragon for economic strength—should put policymakers on notice.

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