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How the German Election Could Dictate Europe's Future Direction

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As Germany prepares to go to the polls in its general election, David Zahn, Franklin Templeton Fixed Income Group's head of European fixed income, considers what the result could mean for Europe, the European Union and the eurozone. He also reviews the recent State of the Union address from European Commission President Jean-Claude Juncker for clues as to what the future might hold for investors—even for those outside of Europe.

European Commission President Jean-Claude Juncker's State of the Union address last week was notably more forthright and aggressive than we've come to expect from him. But I think the timing was significant.

These are optimistic times in Europe, in general. In contrast to what many observers might have expected nine months ago, we believe the political structure in Europe is probably the most stable it's been in 10 years.

Stability Reigns in Europe

Indeed, we'd argue that today Europe is more stable politically than some other parts of the world, such as the United States, where we'd usually expect stability.

From an investment perspective, that stability has been reflected in how investors have been recently allocating their investment dollars. Growing appetite for European assets has corresponded with the perceived improvement in the political outlook.

And while that stability will be tested again later this week as Germany goes to the polls in its general election, a cautious self-confidence was apparent in Juncker's State of the Union address.

The European Commission president re-emphasized his federalist agenda, outlining a number of approaches designed to bring the region closer together politically and economically. These include a closer banking union, a closer fiscal union, a single European Union (EU) foreign policy and complete adoption of the euro across the EU.

In our view, an obvious potential outcome of this push for integration and fiscal union is the emergence of a European bond.

We see this as a long-term issue, but if Europe starts heading down this road we'd expect to see bond and currency markets in the region become more homogenous. That of course also implies there could be less opportunity between the national governments because spreads would likely compress.

Biggest Obstacle to Integration Removed

The reason Juncker's reignited this debate now, in our opinion, is because the biggest obstacle to increased federalization—the United Kingdom—is gearing up to leave the club.

While Juncker's approach calls for greater centralization of powers, the United Kingdom has argued forcefully against giving away complete authority.

So we think Juncker's timing is significant, as we expect Brexit to magnify the divisions in Europe between those that want to go for a tighter federal union and those that are more skeptical.

In our view, this week's general election in Germany could play a significant role in how those arguments play out.

Merkel on Course for Success

At the moment, opinion polls are suggesting that the incumbent Chancellor Angela Merkel should perform well enough in the election to hold on to power. And the market seems to agree.

Once again, she's likely to have to pull together a coalition government and the interesting calculation will be who her coalition partners are.

We'll also want to monitor the success of the right-wing populist Alternative for Germany (AfD) party. It's currently polling upwards of 10%, so although it's not likely to be part of the government, it could do well enough to win seats in the Bundestag.

A strong performance from AfD and other populist parties would reflect a protest vote from people unhappy with the direction things are going in Germany.

And that, in turn, should serve as a signal to mainstream parties that they need to make adjustment to the economy. Otherwise, the chances are greater that more extremist parties could get a larger vote next time.

Despite the indications of the prior elections in France and The Netherlands, we believe populism isn't dead in Europe. It's just taking a back seat.

Europe's economy has generally been doing better, and we are seeing job growth. Against that backdrop, populism tends to slide back. It tends to re-emerge when discontent sets in. That's something we think politicians need to remember.

No Difference in Approach to Europe

In terms of attitude toward Europe and the EU in particular, we feel there's not a big difference between Merkel and her main rival, Social Democrat (SPD) Martin Schultz.

Indeed, having spent time working in Brussels, Schultz is possibly more pro-EU than Merkel.

Although we're convinced the overall integration of Europe will continue, the outcome of this week's German election could dictate the speed at which that process takes place.

In particular, the polling of Germany's more extreme parties could have an impact on how much Germany is willing to pay for further EU integration.

If the extremist parties do well by their own standards, Germany's political leaders may have to start reconsidering how they appease those voters. Integrating further into Europe might not accomplish that.

Who Dominates the Franco-German Axis

In our view, the outcome of the German election could also have implications for the balance of power in the EU, especially in the Franco-German relationship.

France's newly elected president Emmanuel Macron has already indicated his support for a more integrated Europe.

If Merkel doesn't perform as well in the election as she has in the past and has to form a larger coalition, that could dent her reputation as the default leader of Europe. She could become marginally weaker on the global stage.

The question then becomes: Who is the lead in the Franco-German axis? And Macron appears keen to take a larger role in European and global affairs than France has traditionally had.

We could find ourselves in a situation in which two leaders are vying for the leadership of Europe.

Macron has made it clear that he supports greater European integration, whereas Merkel has traditionally been more cautious about the speed of integration.

So if the French president were to gain the upper hand, we could expect to see more support for adopting Juncker's roadmap more quickly.

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