

SAL. OPPENHEIM

Strategy Weekly

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## German election: Uncertainty has risen – but CDU/FDP still remains our base scenario

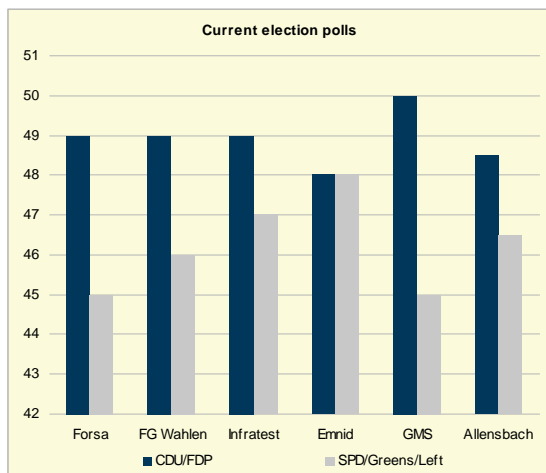
Polls still more in favor of CDU/FDP, however election exchanges bet on grand coalition

Five polls have been published this week after Sunday's TV debate between chancellor Merkel and SPD's frontrunner Steinmeier: four are still showing the CDU/FDP has a 2-4 pp lead on the SPD/Greens/Left. Yesterday's Emnid poll showed both blocs on par at 48% for the first time. However a major shift took place in the electronic election exchange ("pro:kons Wahlfieber" at <http://www.prokons.de/prognose>): Right now investors on this trading platform regard a continuation of the grand coalition between CDU and SPD as more likely than a CDU/FDP coalition. In late August there had been a significant majority expecting CDU/FDP. After the regional elections in three federal states, which showed a surprisingly strong Left party in all three regions, the likelihood of a CDU/FDP government dropped sharply. After the boring TV debate with a very cautious Ms Merkel, who did not push aggressively for a change of government, the grand coalition had been regarded as the most likely outcome.

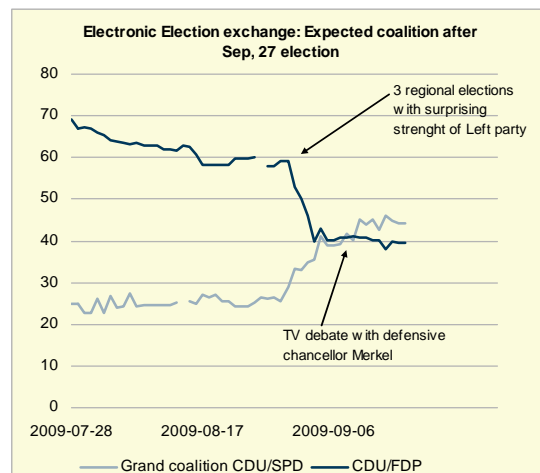
Utilities underperformed as investors increasingly expect no change in government

This shift in perception had been played as well by investors. The prime candidates to look at are German utilities, as they are ready to gain most from a CDU/FDP government due to the extension of the nuclear power plants' lifetime. Both RWE and E.ON basically started to underperform not only versus stock markets but peers as well, after the regional elections in late August. (The charts show some gaps as the time series is based on calendar days, not trading days.)

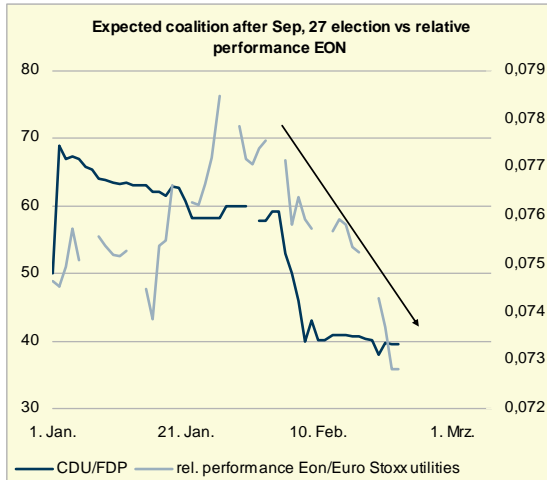
It is certainly possible that the upcoming polls may add to the uncertainty; thus investors may not change their perception in the very short term – and German utilities may continue to underperform in that time. However, we regard this as a trading opportunity as we still expect a CDU/FDP government in the end.



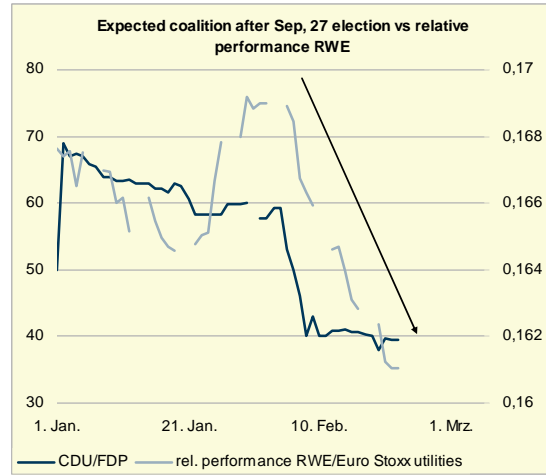
Source: Thomson Financial Datastream



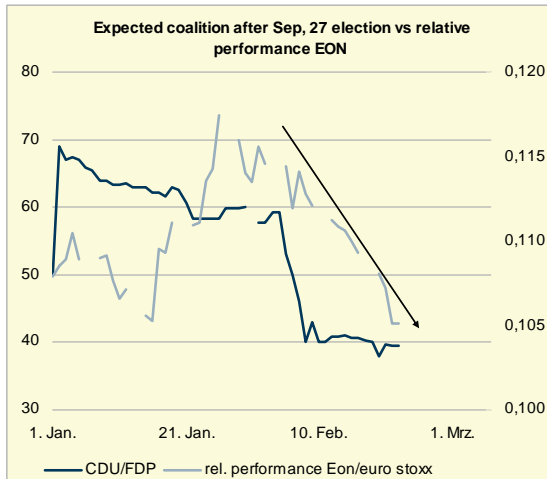
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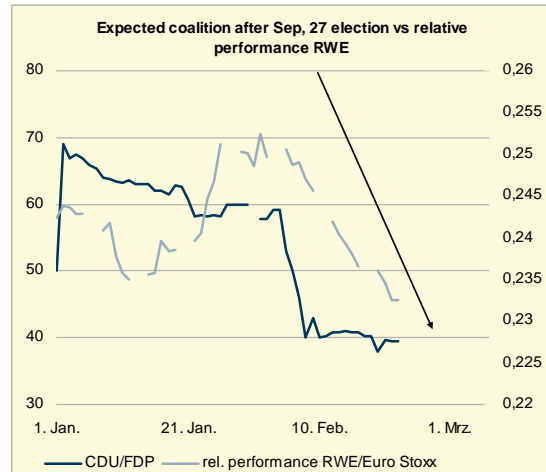
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Overhang mandates in favor of CDU are the key

One has to dig a little bit under the surface of the German election law to understand our view. The key points are the so-called overhang mandates, which are deeply rooted in the specifics of the German election law and which should guarantee a majority of CDU and SPD in the end under current circumstances. German voters have two votes. The first vote decides which politician gains the constituency. Half of seats in the lower house stem from the direct wins due to the first vote. However, the second vote is the key vote on the party list and decides – in principle – how many seats a party has in the lower house (Bundestag). The polls in Germany, which are shown in the chart, only ask about the second vote.

In general, the seats in the lower houses are distributed according to the share in the second vote. At the federal election, however, there is an important exception: so called overhang mandates, which occur when a party wins more seats directly (first vote) in a federal state than it should have according to its share in the second vote. And this is exactly what will most likely happen, particularly in CDU/CSU strongholds Baden-Wuerttemberg, Bavaria and Saxony. In these states it is possible that CDU and its sister party CSU in Bavaria wins all constituencies. According to German election law, a seat which is won directly by a politician remains in his or her party (if the party exceeds the 5% threshold in the second vote). This is the case even if , let's

say, a 50% share in the second vote would require a lower number of overall mandates which a party would get. These are the so called overhang mandates.

10 overhang mandates in favor of CDU possible

According to *election.de* – a small political think tank which makes a specific forecast for all German constituencies – the CDU/CSU would get 16 overhang mandates, the SPD would get 3 overhang mandates, i.e. CDU/CSU would gain a net 13 additional mandates, which might equal 2 percentage points in the national election. Basically they stem from the huge lead of the CDU/CSU to the SPD in the key southern states of Bavaria and Baden-Wuerttemberg (plus Saxony). This means that, even if the CDU and FDP on the one side, and the SPD, Greens and the Left on the other side both have an aggregated share of 48% - like in the recent Emnid poll – the CDU and FDP should still have a majority of some 10 seats. And it could lead to the paradoxical situation that a lower share of the CDU and FDP compared to the left-of-center parties (let's say 47.8% vs. 48.5%) could still transform into a majority of seats. Over the weekend *election.de* will publish a new forecast for all constituencies; it should offer fresh clues about the likely outcome of the election.

CDU/FDP government still likely

Admittedly, with the soft showing of Ms Merkel in the TV debate, uncertainty has risen whether she will really go for a CDU/FDP government in case of a tiny majority purely based on overhang mandates. One has to keep in mind that overhang mandates are exclusively related to the politician. If he dies, there will be no successor. Thus, the stability might be somewhat lower. But as net overhang mandates of 10 are not unrealistic, it should finally lead to a small, but still sufficient majority of seats. Even if Ms Merkel personally might favor a grand coalition, she would face significant pressure within her own party if she did not go for the CDU/FDP in case of reliable majority. In contrast to 2005, the "threat" for the CDU should stem less from the SPD, which remains in low ratings as Mr. Steinmeier is far less charismatic than former SPD chancellor Schroeder. The Lefts have been the rising star recently; however this should be a bigger concern for the SPD than for CDU.

Buy utilities ahead of the election

What does it mean? As the fresh concerns on a CDU/FDP government led to an underperformance of German utilities in the last two weeks, we would buy ahead of the election on September 27. If CDU and FDP form the new government as we expect, this prior underperformance will be reversed, and additionally investors will start to price in the beneficial extension of the lifetime of nuclear power plants. One has to keep in mind that, in the next legislation period, any new German government will face the fact that 7 nuclear power plants with a capacity of 6.2GW are stopping electricity production – if the extension of the lifetime doesn't happen. This equals 10% of the German electricity consumption; alternatives cannot substitute for the shortfall. It means that even a grand coalition will be confronted with tough questions and pressure to extend the lifetime.

Retailers face problems – VAT increase likely

Besides utilities, a CDU/FDP coalition could be a problem for German retailers and consumers. We expect that, given the fiscal needs to consolidate the budget, a higher VAT is quite likely. There have already been soft hints in the election campaign, most recently by SPD finance minister Peer Steinbrueck. The CDU/FDP will most likely go for a (marginal) reduction of the income taxes and an increase of the indirect taxes direct via elimination of exemptions. This would be negative for German retailers in net terms. Anyway, historic election pattern indicates that a shift towards an SPD government is positive for retailers while a shift towards a CDU/FDP government is negative for retailers.