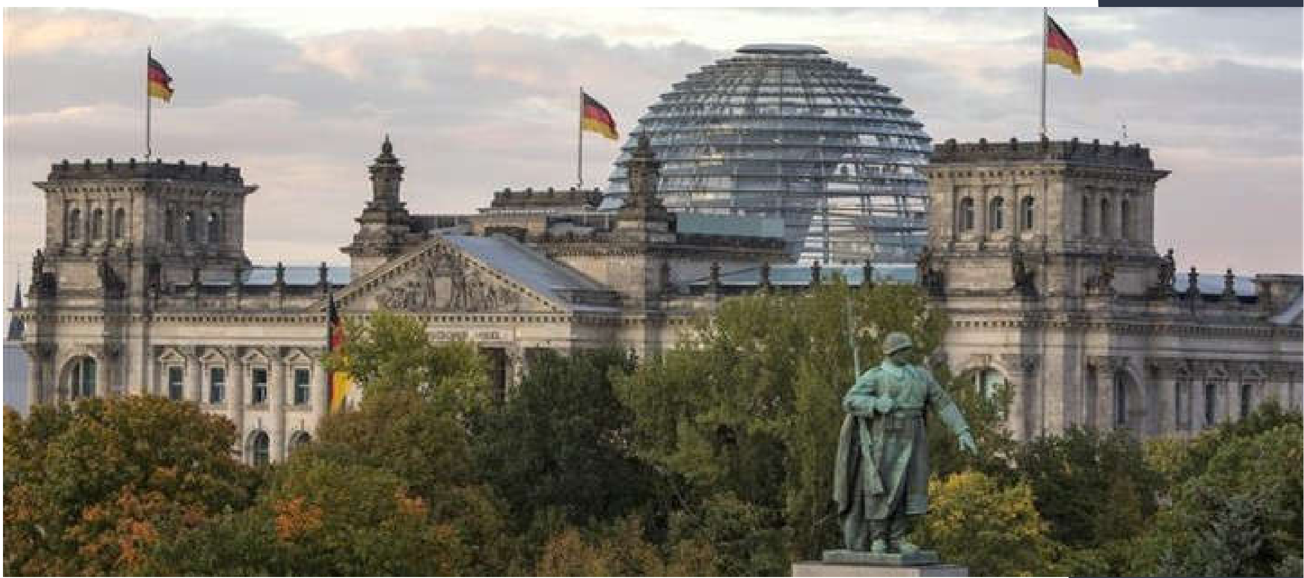
RATHBONES | Incorporating Investec Wealth & Investment (UK)

WEEKLY DIGEST | 25 February 2025

Merz, Schmerz



John Wyn-Evans
Head of Investment Strategy

One of the features of politics at the moment is that however bad things seem to be domestically in the UK, it's not as though everything is coming up roses elsewhere. In the last twelve months we have seen plenty of contentious elections, and, in many respects, the UK's was not one of them. For example, France's Parliament exists in an extremely fragile equilibrium and some of the antics in the United States leave one speechless – more on which anon.

The spotlight currently falls on Germany, which held Federal elections over the weekend. These elections to decide upon the composition of the Bundestag and a new Chancellor were called prematurely last year when the ruling coalition between the Social Democrats (SPD), the Greens and the Free Democrats (FDP) collapsed. As often seems to be the case these days, the exiting rulers were punished at the polls, with the SDP gathering the lowest percentage of votes in its history (16.4%) and the FDP failing to meet the 5% threshold required to have any seats at all in the new Parliament.

The leading party (28.5%) was the Christian Democratic Union (CDU) in combination with its sister party, the Christian Social Union (which operates solely in Bavaria). And, yes, it is all a bit reminiscent of the famous scene from Monty Python's Life of Brian. In second place was Alternative für Deutschland (Alternative for Germany or AfD) with its best ever share of 20.8%. This party is recognised as being the most right-wing of Germany's parties and generates unwelcome comparisons with the National Socialists of history. The only other party to collect enough votes for parliamentary representation was Die Linke (The Left), which pretty much represents the views you would expect on the label.

And so, what happens next? Nothing is straightforward. As the leader of the party with the greatest share of votes, Friedrich Merz is given the opportunity to form a coalition government (as no party has a majority of seats). He is viewed as business-friendly and so encouraging for investors, largely owing to the fact that he took time out of his political career to practise as a corporate lawyer, during which period he accumulated a decent amount of wealth. He has certainly been making all the right noises. Both the CDU and the SPD, which are effectively "centrist" parties, have ruled out forming any sort of coalition with the AfD, and so they are most likely to form a marriage of convenience between themselves, but that is bound to lead to policy compromise. For example, whereas the CDU would like to offer tax cuts to businesses and wealthier households, the SPD is more in favour of wealth redistribution. And when it comes to making radical decisions on the fiscal deficit, such as releasing the constitutional "debt brake", a two-thirds majority is required, which would mean bringing both the Greens and Die Linke into the fold. And despite the "encouragement" from the United States to increase defence expenditure, neither does there seems to be a consensus on that subject. And so, despite the widely expressed belief that Germany is well positioned for a growth-oriented political reset, there are plenty of hoops left to jump through.

Talking of defence spending, the UK government, keen to keep on the right side of President Trump, is floating the idea of increasing the annual budget from 2.3% to 2.5% of GDP. That's a laudable aim in these times of geopolitical uncertainty and almost certainly reflects the general direction of travel globally, but still has to deal with inconvenient issue of how it gets paid for. A faltering economy, lacklustre tax revenues and an uncooperative bond market have conspired to gnaw away at the Chancellor's already minimal fiscal headroom, calculated to be just £9.9bn at the time of last October's Budget. All will be revealed on March 26th when Rachel Reeves unveils her Spring Statement alongside the Office of Budget Responsibility's headroom calculation update. Somewhat dispiritingly, there is already talk of spending cuts and possibly even more tax increases. It's hard to see animal spirits reviving in the UK this side of that event.

I mentioned US political "antics" at the beginning. One can't help feeling that the mind-boggling volume of comments and policies emanating from the White House is leaving investors somewhat disoriented. After a week during which we saw one of the Musk juniors excavating his nasal cavities in the Oval Office, his father wielding a chainsaw handed to him by the President of Argentina – not even AI could have imagined that scenario! - and the President suggesting that sharks will not be inconvenienced by plastic straws as they munch their way through the oceans, one can be forgiven for wondering if this is all some kind of high-stakes magic or confidence trick, with the main performers distracting the audience with banter and crazy gestures while picking their pockets and stealing their watches and jewellery. It hardly feels like a time to be taking on excess risk in portfolios.

I must admit I'm struggling to see the "endgame" here. The bizarre (lack of) negotiating tactics with President Putin was extraordinary, as was President Trump's attitude towards Ukraine's Zelenskyy. The transactional nature of the demand for mineral rights in Ukraine doesn't surprise me so much, but the threatening nature of the demands to comply with US policy are more in keeping with how one would treat an enemy as opposed to a supposed ally. Much the same goes for the belligerent attitude towards the rest of Europe.

Or maybe this is just today's version of "Realpolitik" and is the only way to get things done and to dial down geopolitical tension. The concept of the world splitting into three primary "spheres of influence" is being discussed. In my lifetime we have had a bi-polar world (US/NATO vs the Soviet Union) and a unipolar world (US pre-eminence following the end to the Cold War). Now Russia is reasserting itself and China is a much more influential force, suggesting a possible "multi-polar" world, which already sounds more complicated even before adding in the likes of India and various Middle Eastern powers. All of this plays into our opinion that the (investment) world will provide even greater challenges in the years ahead than we have been used to.

One phrase I keep coming back to when commenting on policy shifts is that "if it was easy, someone would have done it already". For example, there was no difficulty in slashing tax rates or increasing government expenditure when deficits and interest rates were much lower. That was the easy part. It's much more difficult with higher deficits and a rising interest bill. Entitlements? Endowment Theory claims that it is far harder to reduce them than to create them. The danger is that nobody can actually fix anything because the electorate won't let them (largely because it will involve some sort of sacrifice). Incumbent governments fail either because they make the tough decisions and become unpopular (see Emmanuel Macron for details) or because they don't take the tough decisions and allow the problems to fester and are seen as incompetent. That could lead to more radical policies being favoured and more radical parties being elected. We are sort of there in the United States and would you really dare to bet heavily against the AfD, National Rally (France) or Reform (UK) having a bigger say in the future?

A wag observing Germany's travails once commented that it was a shame they didn't have a world for Schadenfreude. The German word for pain is Schmerz, which rhymes all too readily with Merz. It's a gift for sub-editors. Let's hope it's one they can keep wrapped for a while.

Economic Commentary

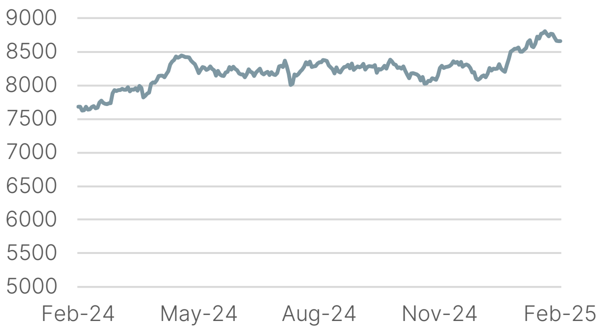
FTSE 100 weekly winners

NatWest Group Plc	5.5%
Standard Chartered PLC	5.3%
Lloyds Banking Group plc	4.7%
Coca-Cola HBC AG	3.7%
Schroders PLC	3.3%
Barclays PLC	3.1%
BAE Systems plc	2.2%

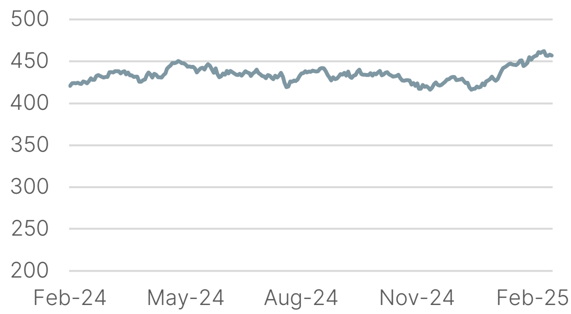
FTSE 100 weekly losers

Burberry Group plc	-10.6%
Glencore plc	-8.3%
B&M European Value Retail SA	-7.7%
Mondi plc	-6.6%
Barratt Redrow plc	-6.1%
InterContinental Hotels Group PLC	-5.8%
Tesco PLC	-5.7%

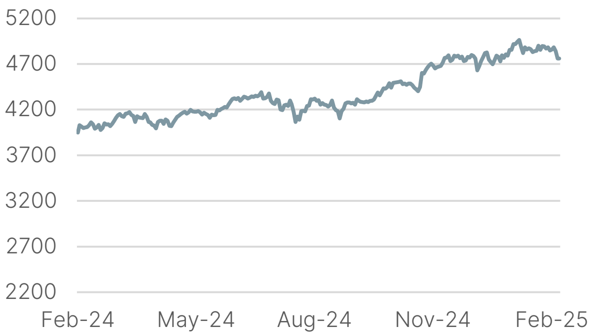
FTSE 100 index, past 12 months



EuroStoxx 600 index, past 12 months



S&P 500 index, past 12 months



All data shown in GBP.

investecwin.co.uk