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German electorate sceptical about further European integration

The German election results will act as a brake on moves for deeper European integration and on any plans to work towards an all-powerful, European super-state. Beware of credit risk. The risk/return ratio for taking on credit risk looks ever less attractive.

Possible impact of the German Federal elections on financial markets

The German Federal elections have produced the most fragmented representation in the Bundestag since the founding of the Federal Republic. Germany's centrist parties risk losing more voters to radical parties (on the right and the left) if they don't respond to the fears and demands of those already voting for the radical alternative. In this context, the radical parties are already marking out their "red lines", the crossing of which could cause the established parties to lose further support.

A high-profile example: No official debt relief for Greece

Debt relief for Greece has been pushed into the long grass. The FDP won't accept it and chances of its implementation by a yet to be formed coalition government are much reduced. Greek debt relief, just like a CDU or SPD financed campaign, merely sends voters into the arms of the AfD.

No let-up in pressure on the ECB

A damper has been put on the Paris-Berlin/Merkel-Macron axis. With this, the creation of a European Finance Ministry and Budgetary authority has become less likely. Moreover, were the new German government to decide to go down this route (which would be unwelcome to the majority of Germans), all parties opposed to it, and not just the AfD, would reap an electoral bonus. The upcoming Italian elections are likely to result in a "hung parliament", which will also put sand in the works so far as further European integration is concerned. Thus those seeking a European super state steered by the bureaucratic elites are likely to face a setback, near-term. In this context, the main bulwark against the forces of disintegration within the Eurozone will remain the ECB. There won't be a Eurozone Finance Ministry to provide fiscal support. The implication is that ECB monetary policy will probably remain "looser for longer", with further near-term appreciation of the euro now less likely.

Green politics, if implemented, are unlikely to hurt the auto industry very much

As the experience in Baden-Württemberg shows, the Green party when in government tends to be less hostile to the auto industry than many assume. We expect the same will be the case in any coalition German Federal government. There are simply too many jobs at stake.

The number of zombie firms – i.e. firms whose "earnings before interest and tax"– do not, despite record low interest rates, cover debt servicing costs – has risen in the US from around 2% to around 12%; a sextupling!...**reflecting the politics of „cheap money"**

This large number of zombie firms reflects the destructive impact of very expansionary monetary policy on market competition. The politics of "cheap money" and the tendency after Lehman Bros. for governments, unwilling to tolerate bankruptcies, to stuff the monetary system with cheap credit is the main reason for low productivity growth since the Global Financial Crisis.

In this situation the natural renewal process, whereby new firms rise up to replace tired and less competitive older ones, is disrupted. And today's low credit spreads indicate that investors are still assuming that zombies will continue to be kept alive on cheap credit. Artificially sustained, these "half dead" suck the life out of otherwise viable companies. The effect is that economic resources are not put to their most effective use.

Without higher credit spreads and significantly more restrictive monetary policies, the fight against zombie firms cannot be won. 10 years after the onset of the Global Financial Crisis it is time to re-turn to properly functioning markets, i.e. to markets which are able to determine the appropriate credit spreads for specific firms and countries.

If central banks were to move in this direction the productivity problem would be improved, but at the probable cost of a lower economic growth rate over the medium term. But if policies stay the same the number of zombie firms will continue to increase, further undermining the competitive process, distorting politics and ultimately posing a threat to freedom.

The misallocation of resources and the zombie firm problem are blamed on a failure of the market, whereas it is policies which distort the market's allocation mechanism which are the true source of these problems. Those wanting more intervention and who seek to manipulate market indicators of scarcity are still gaining the upper hand. Owners, creditors and zombie firms all cry loudly to be rescued, while the zombie-enabling central banks seek to justify themselves by claiming to have rescued the whole world. And so it goes on.

The Fed will start to reduce its balance sheet, albeit at a snail's pace, from this October and has forecast one more rate rise this year. In 2018, three further US rate rises are likely.

The German Federal election result will probably lead to a more critical discussion of ECB policies as it will give the ECB's critics more of a platform. Their complaints will circulate more widely, at least in Germany.

At the very latest after the Italian parliamentary elections the ECB will (have to) make a start on tapering its balance sheet expansion program.

Thus monetary policy will move in a direction which tends to slow the creation of zombies, and to lessen their power to influence policy and events.

The central banks will remain "zombie-friendly" but there is a difference between monetary accommodation and extreme monetary accommodation. This difference should be enough to push credit spreads and default rates up and recovery values down.

Investors should take care not to confuse their goals with those of the central banks. In fixed income, moves towards conservativism and more concern for credit analysis are called for.

In the past, a shift to a more restrictive monetary policy has taken between 6 and 24 months to achieve its effects. This means investors still have time to make appropriate portfolio adjustments while markets are relatively calm.

Given current very low credit spreads, it makes less and less sense to expose portfolios to significant credit risk for the sake of a few extra basis points. Therefore Aquila is now starting to slowly reduce credit risk in portfolios.

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