

# TOP *of* MIND

## EU ELECTIONS: WHAT'S AT STAKE?



Elections for the European Parliament (EP) taking place May 23-26 are setting up to be exceptionally important given the rise of populist forces that threaten Europe's long-standing centrist status quo. We sit down with José Manuel Barroso, fmr. President of the European Commission (EC), to get firsthand insight on the relevance of the EP in European governance (large and growing). We then ask Mark Leonard, Director of the European Council on Foreign Relations, as well as our own European Political Economist, Roxane van Cleef, what's at stake. Their answer: a potential realignment in power at both the European and national levels that could disrupt everything from EU leadership appointments, to trade deals, to the EU's budget—

not to mention implications for fiscal policy in member countries, among other policy areas. We also address the potential impact to monetary policy given this year's ECB leadership transition (a material shift in policy is unlikely), as well as which assets we view as most vulnerable to moves after the election (Italian and UK bonds, and the GBP).



The European Parliament has been ...playing an increasingly relevant role in the European Union. Let's not forget that the European Parliament is the only institution that can bring down the European Commission... and the Lisbon Treaty (2009) substantially expanded the purview of the Parliament.

- José Manuel Barroso

The European Parliament is not a traditional legislator, which generally has the power to set the agenda, such as the UK Parliament or the US Congress. Instead, the main power of the European Parliament is to say "no"... For that reason, it's not difficult to see how many of these different groups can come together to oppose, slow, or block initiatives.

- Mark Leonard



### WHAT'S INSIDE

#### INTERVIEWS WITH:

**José Manuel Barroso**, fmr. President, European Commission; Chairman, Goldman Sachs International

**Mark Leonard**, Director and Co-founder, European Council on Foreign Relations

**WHY THIS EUROPEAN PARLIAMENT ELECTION MATTERS**  
Roxane van Cleef, GS Europe Economics Research

**EU POLITICS: CHRONIC RISK FOR SOVEREIGNS**  
George Cole, GS Europe Markets Research

**WHAT TO EXPECT FROM A NEW-LOOK ECB**  
Alain Durré, GS Europe Economics Research

**POPULISTS: DISRUPTORS, NOT AGENDA-SETTERS**  
Roxane van Cleef and Pierre Vernet, GS Europe Economics Research

**BRACING FOR THE BREXIT EFFECT**  
Adrian Paul, GS Europe Economics Research

...AND MORE

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# Macro news and views

We provide a brief snapshot on the most important economies for the global markets

## US

### Latest GS proprietary datapoints/major changes in views

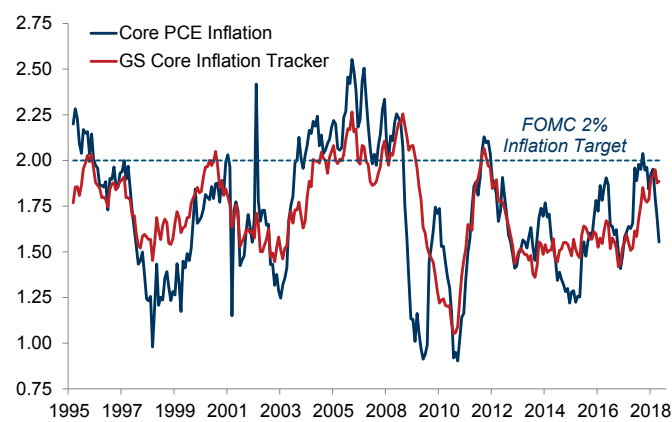
- We pushed back our forecast for the next Fed rate hike to 4Q2020 (from 1Q2020), and see an additional hike in 2021.

### Datapoints/trends we're focused on

- Stronger-than-expected Q1 GDP at 3.2% qoq ann., though most of the boost owed to noisy contributors.
- Softness in inflation; we think core PCE bottomed out in March, leaving 2019 Fed cuts relatively unlikely.
- A likely near-term increase in tariff rates on Chinese goods; we think the risk of further trade escalation remains fairly low.

### Trending up, not down

US Core PCE inflation and GS Core Inflation Tracker, % yoy



Source: Department of Commerce, Goldman Sachs Global Investment Research.

## Japan

### Latest GS proprietary datapoints/major changes in views

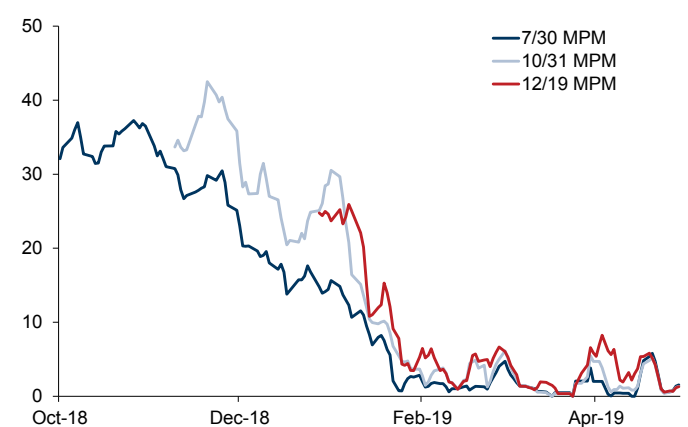
- We lowered our Q1 real GDP growth tracking estimate by 0.2pp to 0.0% qoq ann., given weak March data.

### Datapoints/trends we're focused on

- The BOJ's slight extension of forward guidance, which we think might be intended to head off rate hike expectations should the government postpone its planned VAT hike.
- The unexpected decline in March IP, on large declines in capital, construction, and durable consumer goods.
- The seventh straight monthly decline in consumer confidence.

### Heading off

Probability of a BOJ rate hike (short-rate target), % 5-day average



Source: Bloomberg, Goldman Sachs Global Investment Research.

## Europe

### Latest GS proprietary datapoints/major changes in views

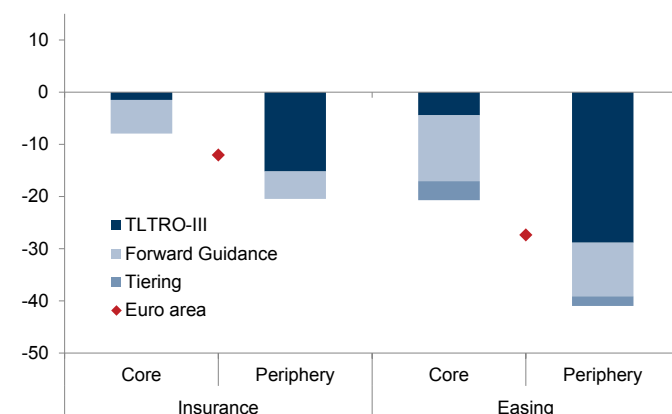
- We now expect the ECB to extend forward guidance by three months and discount TLTRO pricing in June.

### Datapoints/trends we're focused on

- Stronger-than-expected Q1 GDP growth in the Euro area (1.5% qoq ann.), though the composition was generally soft.
- Dim prospects of additional fiscal expansion in the Euro area, as countries most in need of a boost have little to no fiscal space.
- The UK's cross-party talks on Brexit; we expect an orderly exit, though risks have shifted towards reaching a resolution in H2.

### Insurance package

Impact of ECB policy packages on Financial Conditions Index, bp



Source: Goldman Sachs Global Investment Research.

## Emerging Markets (EM)

### Latest GS proprietary datapoints/major changes in views

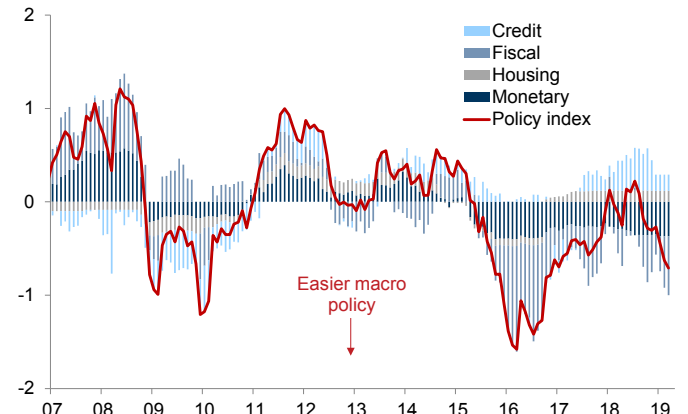
- No major changes in views.

### Datapoints/trends we're focused on

- China's quicker-than-expected growth this year, which we expect to moderate as Beijing slows easing while staying attuned to macro risks.
- Rising odds of EM rate cuts given the Fed's dovish shift and the accompanied easing in global financial conditions.
- Renewed contagion concerns given market volatility and rising inflation expectations in Argentina and Turkey.

### Off the accelerator, not on the brakes

China domestic macro policy proxy, z-score



Source: Goldman Sachs Global Investment Research.

# EU Elections: What's at stake?

The elections for European Parliament (EP) that occur every five years are typically a non-event. But in the context of growing populist, nationalist, and Eurosceptic forces that threaten the EP's long-standing centrist status quo, the elections taking place May 23-26 are setting up to be anything but. With top leadership positions in nearly every major European Union (EU) institution set to turn over following the elections, the new EP could set in motion a shift in the balance of power at the European and national levels, and the direction of the EU more broadly. In short, what the EP elections could mean for the European political landscape, markets tied to it, and, ultimately, the future of Europe, is Top of Mind.

We start with José Manuel Barroso, former President of the European Commission (EC), for a firsthand perspective on the role and importance of the EP in European governance. In his experience, although the EC (not the EP) technically initiates EU legislation, the EP's power to bring down the EC with a no confidence motion gives it substantial leverage—both over the EC itself and the broader policy-making process. And Barroso lived through the EP's other key channel of influence: its duty to elect the EC's President and approve all EC commissioners, who these days are grilled on policy positions before receiving the EP's blessing. Barroso therefore views this process as one of the most important ways the EP shapes EU policy. (Note: see pg. 10 for a lay-of-the-land on EU institutions.)

Mark Leonard, co-founder and director of the European Council on Foreign Relations (ECFR), and our own European Political Economist, Roxane van Cleef, then lay out why—given the long history of populist ups and downs in Europe—this time is different, and these elections are so critical. Leonard explains that efforts by populist groups (and their supporters—think Steve Bannon) to mobilize voters, let alone on EU-wide issues like migration, just didn't happen in past elections, which were typically fought on national issues.

And the stakes are much higher, Leonard says, not only because these groups have more support, but also because they are attempting for one of the first times to form alliances in the campaign and potentially beyond. This combination suggests a high likelihood that the entrenched ruling coalition between the center-right Christian Democrats (EPP) and the center-left Social Democrats (S&D) will lose their majority, and even some likelihood that populist groups could together secure over 1/3 of the seats in Parliament—a significant procedural threshold, according to Leonard. What would this increased influence mean in practice? Leonard and van Cleef's answer: a greater ability to disrupt, slow, or block everything from the crucial leadership appointments that Barroso described, to trade deals, to the EU budget.

That said, van Cleef and GS Senior European Economist Pierre Vernet make the case that with support for populist groups still likely to fall well short of a majority—and large ideological differences between them—such forces will most likely be disruptors rather than agenda-setters of European policy. And Barroso agrees that pro-European forces will probably maintain sufficient support to remain the primary drivers of EU policy.

But with the UK now almost certain to take part in EP elections, we ask how that could impact the EP, as well as the Brexit endgame. GS Senior European Economist Adrian Paul

argues that a likely poor showing by UK Prime Minister Theresa May's Tories in the EP election—as was the case in recent UK local elections—probably won't prompt a general UK election or alter the outcome of Brexit. But he does see potential for the UK's participation to increase the number of Eurosceptics in the EP, further complicating EU governance. (Note: Leonard argues that the UK's participation may actually do the reverse, i.e., reinforce the status quo).

## FAST FACTS ABOUT THE EUROPEAN PARLIAMENT (EP)

### What is it?

- The EP is the only directly-elected governing body in the EU, and represents the interests of citizens in EU lawmaking. Today, there are 751 seats in the EP; more populous countries have more seats (e.g., Germany has 96 seats while Malta has just 6).
- EU citizens elect representatives to the EP—aka as Members of European Parliament or "MEPs"—every five years. MEPs are elected at the national level, and electoral systems differ among EU member states.
- Once MEPs are elected, they form "groups," which mirror traditional political parties; these groups align by political ideology rather than by nationality. Groups then band together to form a governing coalition. Currently, the EU's "mainstream" center-right (EPP) and center-left (S&D) groups govern together.

### What power does it have?

- The EP does not set the agenda for European policy nor propose legislation (that's largely up to the European Council and Commission). But it must approve most EU laws, international treaties/trade deals, and the EU's annual budget. It also elects the European Commission President and consults on the selection of leadership for other EU institutions, like ECB executive board members.

Finally, we focus on key developments around the EP elections that could impact markets. Perhaps the most pressing question on investors' minds is what turnover at the ECB's highest levels will mean for monetary policy. GS Senior European Economist Alain Durré concludes that while the ECB leadership transition—both for the Presidency as well as two other ECB Executive Board (EB) seats—will no doubt be more politicized than usual, a material shift in policy direction is unlikely, with the economic and inflation backdrop leaving the ECB little choice but to maintain its accommodative stance for now.

GS Senior European Markets Economist, George Cole, also sees little immediate market impact from the elections, with potential populist endeavors such as the relaxation of fiscal rules likely taking time to implement, if they even happen at all. What is worth watching, according to Cole as well as our other contributors? What the elections reveal about national political sentiment, with Italian and UK sovereign bonds—as well as Sterling—likely most vulnerable to market moves should certain populist forces (namely, Lega in Italy and the newly formed Brexit Party in the UK) have a strong showing. (Note: see pg. 13 for more details on national implications.)

## Allison Nathan, Editor

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# Interview with Mark Leonard

Mark Leonard is co-founder and director of the European Council on Foreign Relations. Previously, he was director of foreign policy at the Center for European Reform and director of the Foreign Policy Center. Below, he argues that populist forces may capture a critical share of seats in the European Parliament, giving them real power to disrupt EU processes, and influence the direction of the EU.

*The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.*



**Allison Nathan: In the past, European elections have largely gone unnoticed. Why are they so important this time around?**

**Mark Leonard:** It's true that past elections to the European Parliament (EP) have tended to be low stakes, low turnout affairs. That's because, in spite of their name, European

elections have largely been about national politics, have never been fought on European issues, and have had almost no impact on the way that the European Union (EU) was run because cooperation between the main center-right and center-left blocks resulted in a high level of governance continuity.

But all of that has changed this time around. First, it's not simply a national election. Viktor Orbán in Hungary, Matteo Salvini in Italy, and a group of others helped by Steve Bannon are attempting to use the elections to reset the direction of the European project away from a mentality of openness and towards one of closed borders in terms of trade and especially migration. Indeed, they see the elections as a referendum on the latter. In that pursuit, they're trying to mobilize voters, and have been inspired by the lessons of Brexit where the "Leave" campaign found 3 million voters who don't normally vote. So election turnout could be much larger than in the past.

The stakes are also much higher because the elections could very well result in a shift in the balance of power away from the centrist groups that have typically dominated the European Parliament. Traditionally, parties on the more extreme ends of the political spectrum have not had enough support in the EU to have much of an impact on decision-making processes, and have also been very split, with left- and right-wing populists generally staying in their own lanes. As a result, these groups often didn't even bother showing up in Brussels.

But this time around, we are seeing an attempt to create an alliance between right-wing, anti-immigration, anti-Islam nationalists parties and left-wing anti-austerity parties that would enable them to work together during the campaign and maybe beyond. That suggests the deal struck after the last election between the two biggest centrist groups—the Social Democrats (S&D) and the Christian Democrats (EPP)—to shut these parties out of the system will be much more unlikely this time around. And if these parties do achieve greater influence, they could hold up EU processes in many ways.

**Allison Nathan: But given disparate ideologies across these right- and left-wing groups, is it realistic that they can form an effective alliance to have more sway in Parliament?**

**Mark Leonard:** The European Parliament is not a traditional legislator, which generally has the power to set the agenda,

such as the UK Parliament or the US Congress. Instead, the main power of the European Parliament is to say "no", as anything the EU aims to do by qualified majority voting rather than by a unanimous vote must be passed by the Parliament. For that reason, it's not difficult to see how many of these different groups can come together to oppose, slow, or block initiatives. The Brexit situation is a good example; it was very easy for disparate forces to form an alliance in favor of leaving the EU, even if it's been much more difficult for them to agree on what should come next.

**Allison Nathan: What are these groups trying to achieve by saying "no"?**

**Mark Leonard:** Most of these groups are trying to regain sovereignty at a national level; stopping the EU from adopting area-wide rules and strategies creates policy space for national governments. For example, we've seen the damage Viktor Orbán and Poland's Jarosław Kaczyński have been able to inflict on the EU's ability to embrace a common policy on refugees. That model could be used in other policy areas such as anti-austerity measures, the EU's budget or, perhaps most importantly, in trade and associations with third countries.

**Allison Nathan: What is the critical threshold of seats these groups need to secure in order to have real influence and what could they achieve if they do?**

**Mark Leonard:** There tends to be a focus on the majority threshold, but these groups only need to secure [1/3 of the seats in European Parliament](#) in order to disrupt many processes. Specifically, they would be able to disrupt the selection of the new leadership of the European Commission—the President and other commissioners. They could refuse to ratify the EU's budget. They could effectively stop the EU from pursuing rule of law proceedings against countries like Hungary and Poland. They could block free trade deals with third countries like Canada or the US. And they could stand in the way of the future enlargement of the EU.

Perhaps even more importantly, these developments would likely also play into national politics across the EU, where we are seeing traditionally-dominant centrist parties on the back foot, and new parties emerging; European Parliament elections are often a good launching pad for new political movements that could be quite disruptive to national politics.

All told, this suggests the European Parliament would likely become a much more contested place at the same time that the European Commission and the Council of the EU—composed of ministers of EU member governments—would likely become less pro-European and less pro-free market. So you could see a degree of fragmentation, divisiveness and paralysis across the three main institutions of the EU.

### Allison Nathan: What's the likelihood of these groups exceeding the 1/3 threshold today?

**Mark Leonard:** Although turnout will heavily influence the final election outcomes and we still have several weeks to go, the most recent poll that we conducted at the European Council on Foreign Relations suggests these groups would secure 35% of the seats. And I would note that polls often underestimate the success of these groups because it's typically more difficult for governing parties to motivate their supporters to vote. For example, in the last European elections in the UK, even though Nigel Farage's right-wing, Eurosceptic UK Independence Party (UKIP) was not winning the national polls, they won the European elections because it was more obvious to their supporters why they should vote. So many of these groups are hoping they can actually outperform their polling figures.

All that said, the level of volatility in voter preferences is remarkable. In our polling, we've found that about half of voters across the EU say they're not going to vote at all. But of the other half that say they will vote, 30% have not yet made up their mind on who they'll vote for. Even more surprising is that of the voters that claim they have decided on who to vote for, 70% are tempted by other parties, and that is prevalent even in the largest, most well-established parties, such as Sweden's Social Democrats. This is shocking and suggests that the European elections are very much up for grabs.

### Allison Nathan: How do potential Brexit developments impact all of the above?

**Mark Leonard:** The increasing likelihood that the UK takes part in European elections won't have a revolutionary impact on their outcome. Either way, it's pretty clear that the center-right Christian Democrats (EPP) and the center-left Social Democrats (S&D) will lose the majority they've had since the European Parliament was created as a directly-elected body in 1979, and a new battle for influence will ensue. But, on the margin, the UK's inclusion would most likely reinforce the status quo. That's because French President Emmanuel Macron was likely hoping that in the absence of the UK, he could orchestrate the emergence of a new center block as at least the second biggest force in the European Parliament behind the EPP, which would allow him to play a bigger role as a king-maker in Europe. But that seems much less likely if the UK participates; sending a large number of Labour MEPs to the Parliament would likely solidify S&D's position behind the EPP once again. Beyond that, if UK MEPs end up participating in the Parliament until October and beyond, I think they'll most likely continue to play a constructive role, as they have in the past.

Of course, there's also the worry that if Nigel Farage's newly formed Eurosceptic Brexit Party does well, they could strengthen anti-Europe forces. But I'd note that while Farage has been brilliantly effective at shaping British politics, he has not been particularly interested in the European Parliament and his party has historically punched well below his weight, with very low attendance and little impact on events in Brussels. Based on that, I'm not sure that Brexit Party MEPs would have a big impact on future dynamics in the European Parliament.

### Allison Nathan: To what extent does the rise in more extreme parties pose a threat to the European project?

**Mark Leonard:** Although many people seem to be framing the elections as a face-off between Eurosceptics and Europhiles, one of the most striking things about public opinion since the UK's Brexit referendum is that there's been a surge in support for the EU; in fact, our polling shows that four-out-of-five people support continued membership of the EU. Most people also feel a strong European identity; when asked "is your European identity as important as your national identity?" large majorities in almost every country agreed. Many of the populist parties have taken this on board; whereas three or four years ago they were advocating leaving the Euro area or the EU, they are now desperately trying to reposition themselves as parties that are pro-European but just want a different kind of Europe. So the goal is to reframe the European project from the inside.

We've also found in our polling that [most European citizens don't see opposition between Brussels and their national governments](#); they see them both as elements of their system of government—and what is most important to them is how they feel about that system. When we ask the question: "Do you think that your political system is broken or works well at a national and European level?" four groups emerge. One group, which comprises roughly 25% of the EU population, thinks the national and the European system work well. A second group, which makes up just under 40% of the electorate, thinks everything is broken both at a national and at a European level. A third group that represents about 25% of the population thinks their national system is broken, and looks to Brussels for salvation from their national diseases. And a fourth group are nationalist Eurosceptics that think their national system works well but that the EU is broken. But that's the smallest group in the EU, comprising only 14% of the population.

These numbers suggest that the anger people feel is largely directed at the system, rather than at Brussels, which goes a long way in explaining—and predicting—how people vote. Take the recent Spanish parliamentary elections, for example. Many observers predicted that the far-right would do very well. But our numbers suggest that the nationalist, Eurosceptic group in Spain makes up only 2% of the population while 17% of the population thinks everything works and 40% think that their country is broken but that Europe works. So there is a pro-European majority in Spain. And that largely explains why the more pro-European factions did relatively well at the polls.

### Allison Nathan: Is it possible that populist groups gaining more traction produces favorable changes for Europe?

**Mark Leonard:** Absolutely. Brussels has arguably been in a bubble, insulated from national politics in a way that is often not helpful for its own legitimacy. Many important decisions have been made without being properly debated. So shaking up the system, breaking the complacency of the cartel parties, and forcing them to become more engaged with the issues on voters' minds would all be positive developments. But, at the same time, if the net result is paralysis of the system and an inability to deal with the big global challenges that are coming up from China, Trump, new technology, and trade wars, that will ultimately just make all Europeans poorer and weaker.

# Why this EP election matters

## Roxane van Cleef explains why this year's European Parliament elections could shape EU politics—and policy—for years to come

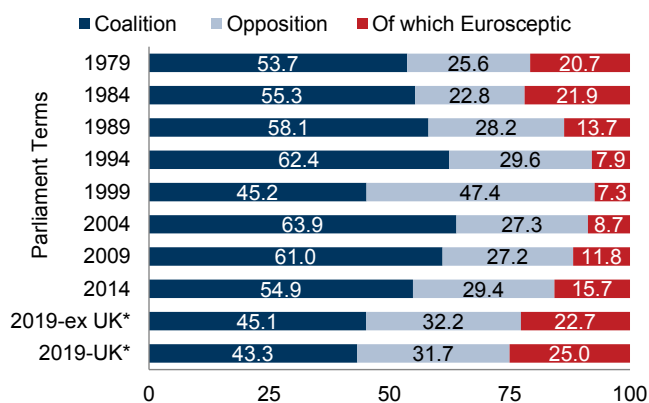
Between May 23 and 26, European citizens will go to the ballot box to elect a new European Parliament (EP). Historically, they have done so with little enthusiasm—turnout was just 42.5% in 2014—despite the fact that the EP plays an important role in EU decision-making. But with the rise of left- and right-wing populist parties across Europe, which aim to disrupt the long-running and centrist-dominated status quo, this election is setting up to be especially important.

### So long status quo?

Since the establishment of the EP as a directly-elected body in 1979, the two largest parties, the center-right European People's Party (EPP) and the center-left Social Democrats (S&D), have maintained a majority of seats in all but one EP term. As a result, following the implementation of the Lisbon Treaty in 2009 that gave expanded powers to the EP, these dominant parties—together with the Council of the EU—have had substantial say on almost all European legislation.

### The end of two-party rule?

European Parliament seat shares, %



\*2019 based on monthly opinion polls.

Source: European opinion polls, Goldman Sachs Global Investment Research.

But the rise of populist parties across Europe in recent years is set to disrupt the status quo. At the moment, populist parties are either a part of, or support, the governing coalition in no fewer than 11 EU Member states, resulting in important influence over government policy. The populist agenda for Europe no longer advocates an outright exit from the EU. But populist groups, while seemingly very disparate, generally share scepticism of the EU, and are determined to become a driving force in European politics. Their aim is generally to transform the EU into a less "European" EU, now giving voters a more credible alternative to the mainstream pro-European agenda in a European election.

### EU policy and process impacts

By increasing their representation in the EP, populist parties would have greater ability to affect European policy, particularly in a more-fragmented Parliament. This is especially crucial, as the next five years will likely see the EP make important

decisions on single market regulation, climate change, energy security, trade, immigration and rule of law issues. For example any EU-US trade deal would have to be agreed by the European Parliament, as would a Brexit deal. Recently, the EP failed to support the EU-US trade negotiating mandate, indicating how much more controversial free trade has become across the EU. We also expect the increased populist support to put a damper on EMU reforms in the short- and medium-term.

In addition to legislation, the new EP will also have a say on who runs the European Commission, the powerful body that both initiates and ensures the implementation of EU laws. The new MEPs will approve the nationally-proposed members of the new European Commission before they begin their mandate on November 1. The appointment of the Commission President will in turn influence other key appointments, such as the ECB presidency and the European Council Presidency (see pg. 19 for more detail).

### Not just EU, but also national implications

Besides EU-level considerations, the European election results will have meaningful implications for national politics. Broadly speaking, the rise of populist parties and political fragmentation has increased political uncertainty and shortened election cycles across Europe. And, as such, these elections will provide a critical sentiment update, and will potentially serve as a precursor to national elections to be held later in the year in countries including Poland, Portugal and Greece.

In other places, the results will inform the probability of snap elections or ability to implement reforms by national governments. For example, in Germany, the elections will be a test for the leadership transition that has been ongoing since October last year, with both the CDU and SPD struggling in the polls; a bad result would clearly put pressure on party leaders. In France, we believe a win for President Macron's LREM would support his reform agenda. Marine Le Pen's *Rassemblement National* could also give populist forces a boost by winning at the polls—just as it did in the 2014 elections—though we see limited downside risks on such an outcome, given the relative stability of the French political system. In Spain, while its general election is behind us, we only foresee government formation talks taking off after the European elections take place (see pg. 13 for more detail).

### What to expect? Unpredictability

Our poll of polls indicates that populists are poised to increase their vote share from 15% currently to around 20-25%. If we include populist parties that form part of the mainstream European groups, new populist parties and non-registered, the number rises to 30-35%. This is not necessarily enough to win the election but sufficient for the EPP and S&D to lose their traditional majority that historically approved about 95% of EU Commission proposals. This suggests that the political groups will need a broader coalition after the election, making the parliament less predictable and therefore more relevant for the future of the EU, as well as for financial markets.

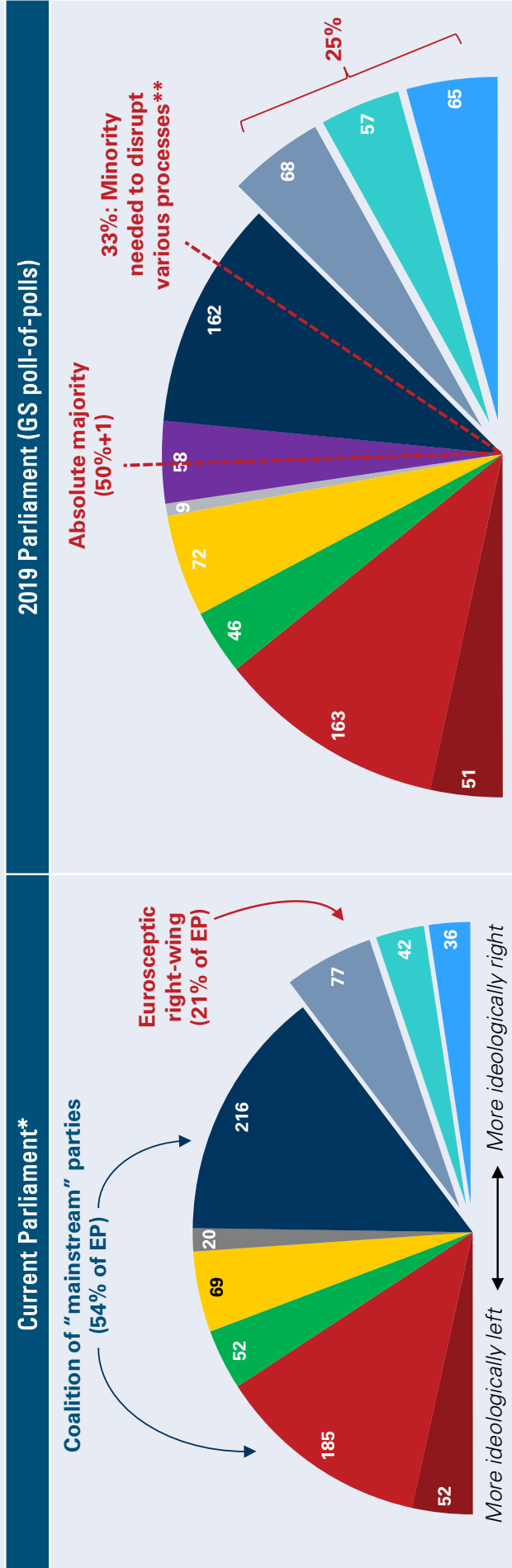
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# European Parliament breakdown

**There are 751 Members of European Parliament (MEPs). Once elected, MEPs form parliamentary groups—similar to traditional political parties—which are based on ideology rather than on nationality.**



Current share of EP	Projected share of 2019 EP	Groups
<b>EPP</b> 29% (22%)	<b>European People's Party:</b> Center-right, generally pro-European, composed primarily of Christian Democrats. Members currently come from Germany's CDU/CSU and Spain's PP, among others, though Hungary's Eurosceptic Fidesz (led by Victor Orbán) is also a member.	<b>Greens/EFA</b> 7% (6%)
<b>S&amp;D</b> 25% (22%)	<b>Progressive Alliance of Socialists &amp; Democrats:</b> Center-left, pro-European, composed primarily of Social Democrats. Members currently come from Germany's SPD, Italy's Democratic Party (PD), and France's Socialist Party (PS), among others.	<b>EFDD</b> 6% (8%)
<b>ECR</b> 10% (9%)	<b>European Conservatives and Reformists:</b> Right-wing, generally Eurosceptic. Members currently come from the UK's Conservative Party, Poland's Law and Justice, and Germany's Alternative für Deutschland (though AfD members may join a re-worked ENF group in 2019).	<b>ENF</b> 5% (9%)
<b>ALDE</b> 9% (10%)	<b>Alliance of Liberals and Democrats for Europe:</b> Centrist, pro-European. Members currently come from the Netherlands' VVD and Germany's FDP. The group will likely ally with French President Emmanuel Macron's La République en Marche in 2019.	<b>NI</b> 3% (1%)
<b>GUE/NGL</b> 7% (7%)	<b>European United Left/Nordic Green Left:</b> Far-left with some Eurosceptic leanings, composed primarily of Socialists and Communists. Members currently come from Germany's Die Linke, Greece's SYRIZA, and Spain's Podemos, among others.	<b>New</b> 0% (8%)

\*As of May 9, 2019; \*\* See interview with Mark Leonard on p. 4-5. Source: European Parliament, various news sources, Goldman Sachs Global Investment Research.

# Interview with José Manuel Barroso

José Manuel Barroso formerly served as president of the European Commission (2004-2014) and prime minister of Portugal (2002-2004). He is a chairman at Goldman Sachs International. Below, he describes the increasingly influential role of the European Parliament, and the ways in which populist forces are likely to shape the decision-making processes and political landscape in the EU.

*The views stated herein are those of the interviewee and do not necessarily reflect those of Goldman Sachs.*



**Allison Nathan: In your seat as President of the European Commission, what did you observe as the role of the European Parliament and how much influence it wields?**

**José Manuel Barroso:** In my observation, the European Parliament has been gaining influence and playing an increasingly relevant role in the

European Union (EU). Let's not forget that the European Parliament is the only institution that can bring down the European Commission by presenting a motion of no confidence. In fact, a past Commission led by former Prime Minister of Luxembourg Jacques Santer resigned because they understood they were going to be defeated by such a motion.

But even beyond this power, the Lisbon Treaty (2009) substantially expanded the purview of the Parliament. This has provided the Parliament leverage over the Commission to the degree that the Commission has become relatively defensive; although it has a so-called monopoly over proposing legislative initiatives, it must always consider the potential response from the Parliament when preparing its proposals. To that end, the Commission services and relevant parliamentary committees for specific policy areas are in constant contact. At times, this close relationship even raises concern among some national governments about complicity between the institutions. So it's fair to say that Parliament, beyond its formal competences in the legislative process, tries to gain political influence over the bureaucracy that prepares European legislation.

“The European Parliament has been ...playing an increasingly relevant role in the European Union. Let's not forget that the European Parliament is the only institution that can bring down the European Commission... and the Lisbon Treaty (2009) substantially expanded the purview of the Parliament.”

It's also important to emphasize that a constellation of organizations—from NGOs to interest groups—surrounds the Parliament, all trying to push their agendas. This prevalence of voices around the Parliament makes it a critical part of the decision-making process. But I think it also leaves in question whether the Parliament today is truly a responsible, integral part of the European system of governance—or is instead a body that conveys more narrow interests. That balance is not yet clear. And the latter role, which tends to support policies that only appeal to a small slice of European citizens, reinforces

a sense that the Parliament is very often out of touch with the public—what is sometimes referred to as the “Brussels Bubble”. So while the Parliament's influence today is undoubtedly substantial, I think its role is still evolving.

**Allison Nathan: Based on your experience, how important will the European Parliament be in shaping the next European Commission?**

**José Manuel Barroso:** The European Parliament will be critical to this process. In fact, one of the most important moments of influence for the European Parliament is the forming of a new European Commission because the Parliament must elect the President of the Commission and approve all of the commissioners. And in this process, it holds a series of hearings in the style of the American Congress, which puts pressure on the candidates to commit to certain policy lines in order to receive support from Parliament. I was in that hot seat twice in 2004 and 2009, as were my commissioners. So, in fact, the forming of a new Commission is not only an opportunity for the Parliament to wield influence over who holds the leadership positions, but also one of their best opportunities to shape the agenda of the EU.

“The forming of a new Commission is not only an opportunity for the Parliament to wield influence over who holds the leadership positions, but also one of their best opportunities to shape the agenda of the EU.”

**Allison Nathan: The upcoming elections are being billed as exceptionally important because of rising support for populist/Eurosceptic forces. Do you agree with this characterization?**

**José Manuel Barroso:** I agree that these elections are especially important and different from previous elections because the rise of populism—and even nationalism in some cases—is offering more dramatic choices today in some of our countries. And forces that are dangerous at the national level tend to be even more dangerous at the European level because, of course, the EU is by definition a union based on transnational principles. So if the leaders of the EU are against the very concept of transnational governance, then we have a problem.

There is also no doubt that these populist and Eurosceptic forces are more acute and pervasive today, perhaps owing to globalization or lingering effects from the financial and sovereign debt crises. We see this in national elections; parties against the so-called European consensus on both the left and the right have proliferated and gained support in most major countries. And we have every reason to expect the same will



occur in European elections. In fact, the proportional voting system used in most countries for European elections makes it much easier for these parties to gain visibility relative to national elections.

History also shows that voters tend to be more inclined to support a protest party in European elections because they feel there is less at stake than doing so in national elections. Some observers call these “less responsible” votes. I don’t agree with that characterization because it’s still a democratic decision. But the reality is that some voters are more hesitant to vote for a protest party at the national level because they want a “useful” vote—one that can help form a government—and they don’t feel the same onus in European elections.

**Allison Nathan: Do these forces present a real risk to the pro-European status quo in the European Parliament?**

**José Manuel Barroso:** I expect groups that are critical of the EU to have better results in these European Parliament elections than in the past. And I think the two mainstream blocs—the center-right European People’s Party (EPP) and the center-left Social Democrats (S&D) will probably lose their majority. But I think pro-European forces will remain the majority—although by a smaller margin—and will continue to shape European policy.

That said, we are also likely to see parties evolve as a consequence of these trends. In fact, we are already seeing mainstream parties integrate some of the concerns put forward by the more extreme parts of the political spectrum. I don’t necessarily view that as a negative. To me, that’s democracy at work. That’s not to say that I agree with the views being put forward, some of which are being supported by demagogic and completely false arguments. But in our democratic system, it’s important that people feel they can express their views, and that the system somehow takes those views into consideration. So to the extent that parties are responding to the changing political environment and needs of voters, I believe these developments are generally constructive.

But we are also seeing the reverse—parties that start out on the extreme end of the spectrum and end up moving towards the center. For example, the SYRIZA party in Greece was elected to the government on an anti-Europe platform. But over time, they have adopted more centrist views and today are

basically not too far away from mainstream consensus in many policy areas. This all says to me that the EU has an extraordinary capacity to integrate and to adapt. So while a slimmer pro-European majority in Parliament will likely leave the system more fragmented and decision-making more difficult, I take comfort in the remarkable resilience Europe has shown so far.

**Allison Nathan: Are there other silver linings from the rise of populist groups?**

**José Manuel Barroso:** Yes. In my experience in the EU, the main problem was not the criticism we received from those who opposed the EU, but the lack of ownership by pro-Europeans, who, by-and-large tend to take the EU for granted. I’ve always said that’s a mistake; if you support the EU, you should actively defend it. So I hope the rise of stronger opponents will be a wake-up call for pro-Europeans to step out of their comfort zones and be more strident proponents for and defenders of the European project.

“ In my experience in the EU, the main problem was not the criticism we received from those who opposed the EU, but the lack of ownership by pro-Europeans, who, by-and-large tend to take the EU for granted.”

**Allison Nathan: Given all of the above, is the European project at risk today?**

**José Manuel Barroso:** The reality is that the EU is a challenging project. But even today the forces of integration are stronger than the emboldened forces of disintegration. We can see this in public opinion polls that show a rising commitment to the EU in recent years, especially after the referendum on Brexit. And while the EU is perhaps an exceptional case, all democratic systems tend to be challenged over the course of their evolution. But they are still likely more stable than the alternatives. I strongly believe that the alternative to the EU—28 neighboring countries pursuing separate national agendas—would be much more unpredictable and difficult to manage than what we have today.

# Where does the Parliament fit in?

## AGENDA-SETTING

### European Council (EUCO) – European heads of state

Composition	Appointment	Function
European Council President + <b>28</b> Heads of state/government + European Commission President	Members directly elected at the national level; Council President selected by Council members	<ul style="list-style-type: none"> <li>▪ Determines EU’s general direction and priorities</li> <li>▪ Technically does not pass laws</li> <li>▪ Meets at least twice every six months at “EU summits”</li> </ul>

The EUCO often guides EU-level priorities and legislation

## LAWMAKING

### European Commission (EC) – The EU’s executive body

Composition	Appointment	Function
<b>28</b> Commissioners, including the President	Council of the EU Nominates President; adopts list of Commissioners European Parliament votes to approve President and Commissioners	<ul style="list-style-type: none"> <li>▪ Represents EU-wide interests</li> <li>▪ Initiates legislation</li> <li>▪ Ensures that laws are properly implemented among member states</li> </ul>

### Council of the European Union Group of government ministers

Composition	Appointment	Function
Varying number of government ministers, based on policy area	Parts of member state governments	<ul style="list-style-type: none"> <li>▪ Represents interests of national governments</li> <li>▪ Reviews and adopts EU laws and international treaties/deals</li> <li>▪ Approves the EU budget</li> <li>▪ Coordinates policies between member states</li> </ul>

### European Parliament (EP) The EU’s directly-elected body

Composition	Appointment	Function
<b>751</b> Members of European Parliament (MEPs)	Directly elected by EU citizens	<ul style="list-style-type: none"> <li>▪ Represents the interests of EU citizens</li> <li>▪ Reviews and adopts EU laws and international treaties/deals</li> <li>▪ Approves the EU budget</li> </ul>

## How European laws are (usually) made...



## OTHER

### European Central Bank (ECB)

Administers monetary policy of Euro area members; primary objective is price stability

**Appointment:** The European Council officially appoints members of the ECB’s Executive Board (Note: the Parliament is consulted, but does not have formal say in the choice.)

### European Court of Justice (ECJ)

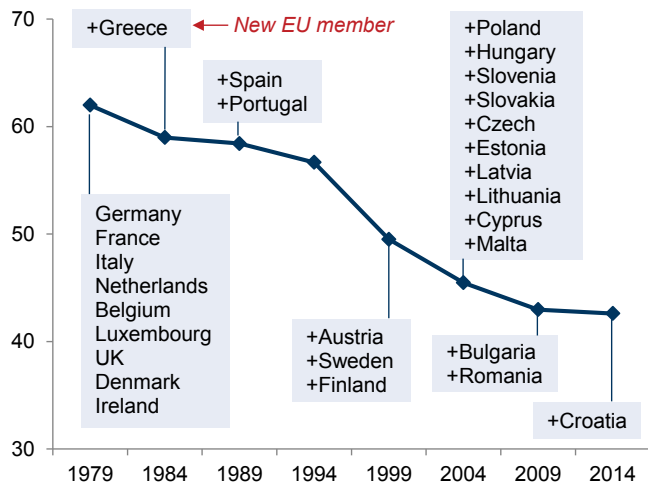
Interprets EU law and ensures that it is equally applied throughout the bloc

Source: European Union, Goldman Sachs Global Investment Research.

# Framing the elections

## Voter turnout in European elections has been waning...

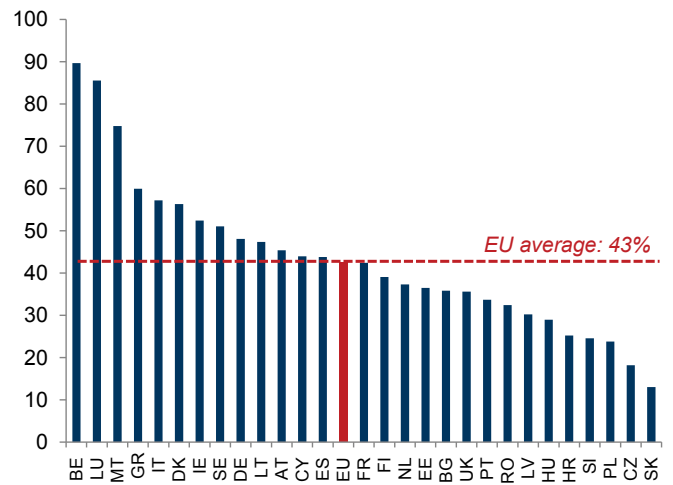
European Parliament election turnout (EU average), %



Source: European Parliament, Goldman Sachs Global Investment Research.

## ...and differs widely between member states

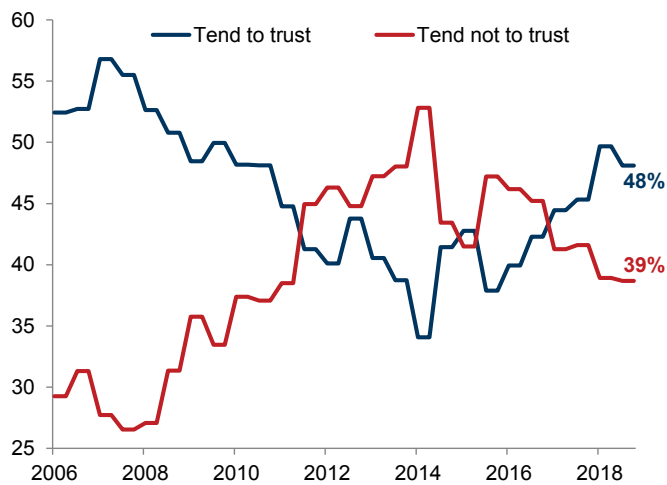
2014 European Parliament election turnout by EU member, %



Source: European Parliament, Goldman Sachs Global Investment Research.

## Europeans have mixed views on the EU Parliament...

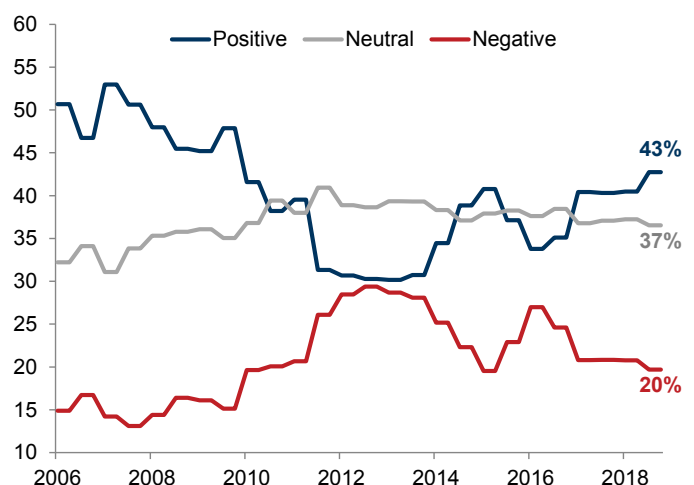
Trust in the European Parliament, %



Note: Excludes "don't know" responses.  
Source: European Commission, Goldman Sachs Global Investment Research.

## ...though the public's view of the EU has improved of late

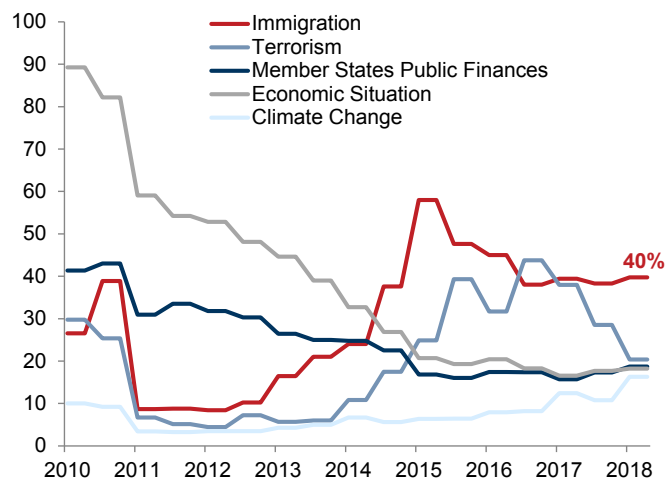
Perceived image of the European Union, %



Note: Excludes "don't know" responses.  
Source: European Commission, Goldman Sachs Global Investment Research.

## Immigration now outweighs the economy in voters' minds

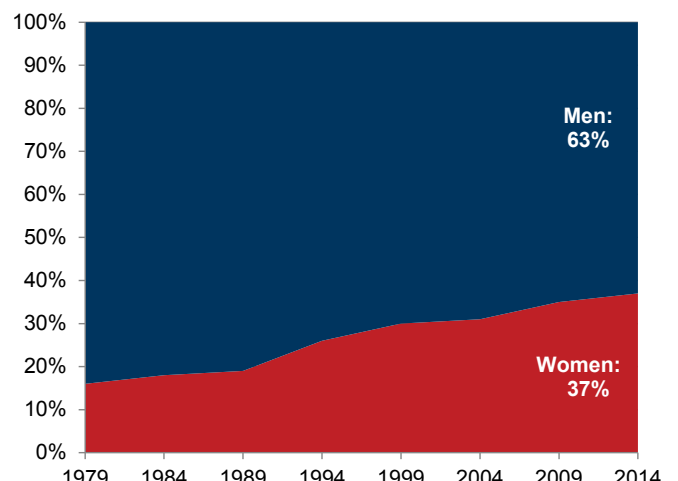
Most important issue facing the EU, %



Source: European Commission, Goldman Sachs Global Investment Research.

## The gender balance of the European Parliament is changing

Gender balance of MEPs, %



Source: European Parliament, Goldman Sachs Global Investment Research.

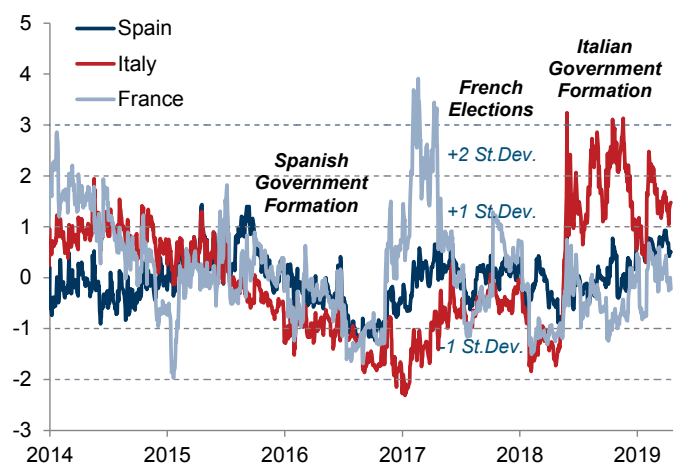
# EU Politics: chronic risk for sovereigns

## George Cole argues that European elections could reinforce a longer-term trend towards a politics-induced volatility in Euro area assets

European politics have vaulted to one of the top concerns for investors, as political volatility is having a tangible impact on European sovereign markets. In 2018, yields on Italian debt jumped as a populist coalition embraced a looser fiscal stance. And while the market impact has been less spectacular, populist opposition in France is putting President Macron's reform agenda under pressure. This upheaval is occurring as growth has slowed and ECB sovereign debt purchases have ended, creating a less-friendly backdrop for European sovereign spreads. At the upcoming EU elections populists look set to increase their vote share. But what are the direct implications for markets?

### European politics: bond markets' enduring worry

Mis-valuation of 10-year BTP, Bonos, and OAT spreads, st. dev.



Source: Goldman Sachs, Goldman Sachs Global Investment Research.

### European level: a slow-burn

The most market relevant part of the populist pitch is to relax the EU's approach to fiscal rules. The kneejerk reaction to an EU-wide relaxation in fiscal rules could see Euro area risk premiums compress initially, resulting in tighter bond spreads and a stronger euro. The longer term reaction is much less clear, given that the fiscal rules have also [been an important driver](#) of lower borrowing costs for Euro area sovereigns. In any case, the hurdle for a change to fiscal rules is high and we see little likelihood of a major shift in that direction. Populist parties are unlikely to achieve the numbers necessary to effect treaty change or legislation on fiscal rules such as the Stability and Growth Pact. Over time, populists may influence the political agenda towards a gradual relaxation in approach towards enforcement of fiscal rules. But change on this dimension is likely to occur slowly, if at all.

Populists can also impact policy at the European level by degrading the functioning of EU institutions. One possibility is "slow-walking" and disrupting parliamentary procedures, which could delay appointments to EU institutions such as the Governing Council of the ECB.

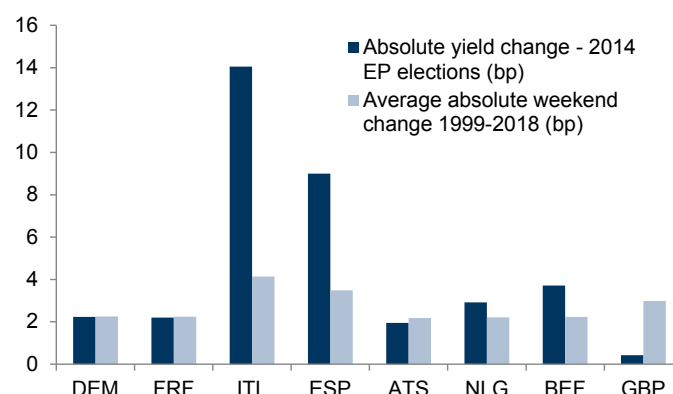
Neither of these channels is likely to have immediate impact following the EU elections. This means that the event itself should have a relatively muted overall impact on Euro area assets, including the EUR. Instead, an increase in populist representation in the European parliament will likely contribute to the higher volatility regime for European government bond spreads as populism becomes a chronic influence on the European political landscape.

### National level: watch Italy and the UK

Historically, EU elections have had the biggest market impact when they provide a temperature check on national politics. The elections are taking place at a delicate time for most major economies. Spain is in the hung-parliament aftermath of its April general election; Germany is in the midst of a prolonged leadership transition, and France is living through a political battle over President Macron's reform agenda. But market impact is likely to be biggest in Italy and the UK.

### EU elections: relevant for domestic outlook and assets

Absolute yield change, bp



Source: Goldman Sachs Global Investment Research.

In Italy, the performance of the current populist government will be benchmarked by its performance in the EU elections. Something similar occurred in 2014, when the newly-elected PM Renzi's PD party outperformed in the EU elections, boosting the case for reform and causing a significant rally in Italian debt. Current polling suggests a strong showing for Lega, which will likely entrench the status quo fiscal policy into the second half of the year. Without any change in the fiscal stance, the risks will rise for Italian debt as the deterioration of fiscal variables may put public debt sustainability in question. As such, we expect Italian government debt to continue to underperform Spanish and Portuguese bonds.

Finally, the UK is likely to hold EU elections in unique circumstances. The election results will have no formal bearing on the Brexit process. But with domestic politics hard to predict, it is possible that the fortunes of the Conservative Party in the EU elections could have a bearing on the viability of the current government. And a strong showing of the newly-formed Brexit party could lead to a perceived hardening of the UK electorate's position on Brexit, implying downside risks for Sterling.

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Goldman Sachs International

# EU elections, national implications

## Germany

**What do the polls show?** The center-right CDU remains the largest party, though a brief boost in popularity that followed last year's leadership election seems to be receding. The center-left SPD, which currently governs with CDU, trails not only the CDU, but also the Greens—and have polled at about 16% on average year-to-date (compared with 24% during the last legislature).

**What are the implications for the European Parliament?** Expected losses for the CDU and SPD will likely contribute to the diminution of mainstream centrist parties in the European Parliament (EP). Moreover, German candidates have generally favored a status-quo policy platform—in contrast to French President Macron's integrationist goals. Therefore, a lack of German-French coordination—as well as a shared political vision—may hinder the pace of the European reforms, while simultaneously impacting key EU appointments, such as European Commission President.

**What are the implications for domestic politics and policy?** The CDU party membership will decide on Angela Merkel's successor at December's CDU party congress. Annegret Kramp-Karrenbauer—who took over for Merkel as CDU party leader in late 2018, but not as Chancellor—remains the frontrunner, in our view. But EP election results—as well as those from regional elections set to take place in the fall—will be key factors informing the leadership decision. As for the SPD, continued weakness in the polls could increase the odds that the party exits the current governing coalition, though such a scenario remains unlikely in our view.

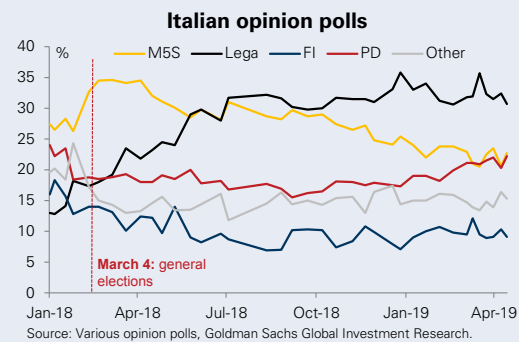


## Italy

**What do the polls show?** Far-right Lega is consolidating its popularity at the expense of its coalition partner, the Five Star Movement (M5S); Lega is currently polling at 34% (up from 17% in the March 2018 general election), while M5S is polling at 22% (down from 33%)—just about neck-and-neck with the center-left PD. The traditional center-right party, Forza Italia (FI), has continued to lag behind.

**What are the implications for the European Parliament?** Given Italy's sizeable number of seats in the EP, the continued popularity of Lega/M5S will likely contribute to the general rise of populist forces at the European level. Lega's leader, Matteo Salvini, has also sought to unite various groups of populist and Eurosceptic MEPs, which have historically failed to ally under a single leader or policy platform. We continue to think that a united populist front is unlikely to emerge, but a stronger showing for populist parties, including Lega in particular, would give more impetus to this process.

**What are the implications for domestic politics and policy?** Should Lega outperform M5S in the EP election, the party may attempt to crystallize its popularity through a general election at home. Importantly, a new election would likely yield a more traditional center-right or center-left government; and [we believe](#) such a government would find it easier to pass a budget law in line with EU rules (as they could prioritize either M5S' government spending increases or Lega's tax cuts, instead of implementing both). However, we believe new general elections remain unlikely, at least until 4Q2019, given various domestic constraints.

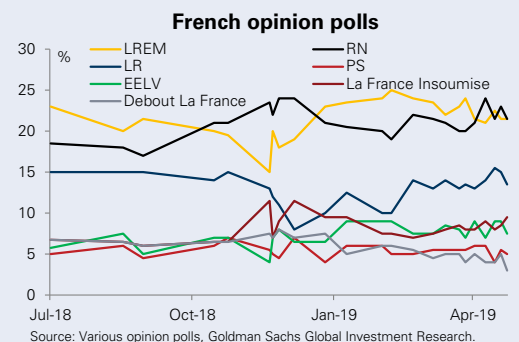


## France

**What do the polls show?** President Macron's centrist La Republique En Marche (LREM) and Marine Le Pen's far-right National Rally (NR) are in a two-way contest, with both parties currently garnering about 22% in the polls. Traditional center-left (PS) and center-right (LR) parties trail by a relatively wide margin.

**What are the implications for the European Parliament?** President Macron has pitted his reformist and pro-European agenda against the populist anti-politics forces, both domestically and in Europe. LREM MEPs are expected to obtain around 22 seats, out of around 60 MEPs from new parties. Even though President Macron has not yet committed to an EP group, we expect him to play an important role in forming a new majority in the parliament, having indicated his support for a centrist and green coalition.

**What are the implications for domestic politics and policy?** The election will give further indications of the success of President Macron's attempt to quell political tensions spurred on by "yellow vest" protests. The president's approval ratings have recently ticked up from early-year lows, but continue to hover around 30%. A major victory by LREM could also support Macron's reform agenda (which has continued, but slowed of late). Another risk to watch is that Marine Le Pen's NR becomes France's largest party at the European level, just as it did in 2014; however, we would expect the domestic political fallout to be limited, given the stability of France's political system.



- Roxane van Cleef and David Groman

# What to expect from a new-look ECB

Alain Durré argues that the ECB leadership transition following European elections is likely to be more politicized than usual, but a material shift in policy direction is unlikely

The ECB Presidency is part of a broad set of key appointments at other EU institutions, such as the European Commission, that will follow European elections this year. Given this timing, the selection of the new President—as well as two other ECB Executive Board seats that will need to be filled following a series of retirements<sup>1</sup>—will be more politicized than usual.

The significant amount of turnover in the context of broader political and economic uncertainty has heightened market concerns around Euro area monetary policy. And it has left investors wondering whether the next generation of ECB policymakers—and the new President, in particular—will be willing to play as active an intermediation role in euro financial markets as their predecessors.

## The process

The official [ECB succession process](#) is set out in the EU treaties, which states that the European Council appoints all members of the Executive Board, including the President<sup>2</sup>. In practice, this means Euro area member states propose candidates to the European Council (EUCO) which then makes an official recommendation of possible candidate(s). The European Parliament and the ECB Governing Council are then formally consulted, after which the EUCO ultimately decides who to appoint. The EUCO usually decides by consensus but can use a qualified majority vote if necessary, requiring 55% of member states and 65% of the Euro area population, when necessary.

## Pointing to July

Appointment process for ECB Executive Board members



Source: European Council.

## Presidential politics

Based on past experience, key ECB appointments tend to alternate between candidates from the Euro area's northern "core" and its southern "periphery." The most recent Executive Board appointee was Vice President Luis de Guindos—a Spanish national, while the Irish Governor Philip Lane will replace Peter Praet next June. Therefore, the presidency is now likely to rotate into the hands of a citizen hailing from Europe's core, especially given that the role was previously held by an Italian. Because of this, Germany and France are expected to play a key role in the choice of Draghi's successor. However, the choice will also depend on the

appointment of other high-level EU positions, particularly Commission President.

Given current polling, the German center-right candidate, Manfred Weber, is the frontrunner for Commission President under the controversial "Spitzenkandidat" system<sup>3</sup>. If this process—not enshrined in the treaties and disliked by certain leaders and European groups—is respected, then this would make a French or French-aligned candidate more likely for the ECB Presidency. But this is far from certain. For one, it supposes that the European People's Party (EPP) group led by Mr. Weber wins the upcoming EU elections. And, beyond that, both Germany and France have said they would prefer to hold the Commission presidency rather than lead the ECB. Therefore, all scenarios remain possible at this stage.

## The timeline

The official deadline for the ECB presidency appointment by the Council is the last EUCO meeting prior to the new term, which would mean a tentative deadline of October 17-18, 2019. Only President Draghi has been appointed after a complete term of a predecessor, setting very little precedent for an average timeline for the succession process. Using an equivalent timeline would imply an official candidature to be announced in mid-May with an appointment at end of June.

More recent Executive Board appointments have seen a shorter succession process, with the different steps more clearly communicated by the EUCO. This average timeline would indicate a late June call for candidates, a mid-July nomination and an end of August appointment. This timeline would dovetail nicely with the European election timeline which sees elections held on May 23-26 with a first session of the newly elected European Parliament to tentatively discuss appointments on July 4. Our base case is therefore for candidatures to be announced after the European elections and before July 4. The official appointment would likely come after July 4 as the European Parliament doesn't sit between the elections in May and July 4 and thus couldn't be officially consulted.

The fragmentation we expect in the European Parliament after the election could lead to a more difficult and lengthy process of appointments in the Commission and the Council. We therefore see risks of a further delay in the ECB presidency appointment until after July 4. Also, a more fragmented European Parliament could be unpredictable in its hearings of the ECB president nominee. But precedent suggests that while the European Parliament can delay the appointment significantly, the European Council can overrule its objections and appoint its nominee.

## Many possible candidates, few major differences

The six potential candidates – regularly mentioned in media and wire services – are Benoît Cœuré (ECB Executive Board member), Klaas Knot (President of the Dutch central bank), Erkki

<sup>1</sup> Three ECB Executive Board members will leave the bank this year: Peter Praet on May 31, Mario Draghi on October 31, and Benoît Cœuré on December 31.

<sup>2</sup> Article 11.2 of the European (TFEU) Treaty.

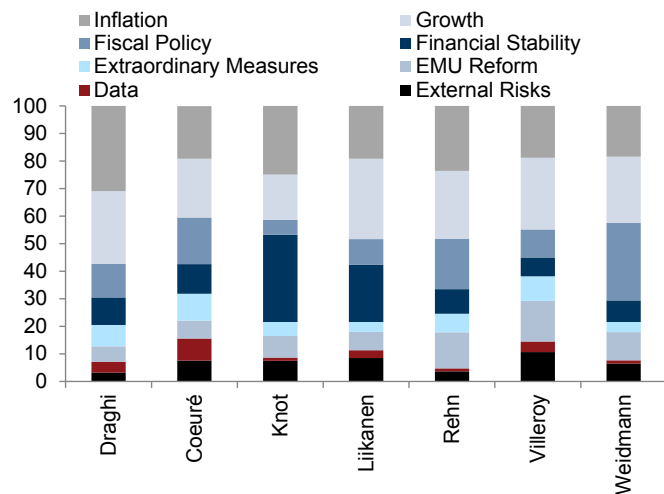
<sup>3</sup> Under the current "Spitzenkandidat" system, European Parliamentary Groups present their candidate for Commission President ahead of the European elections. The European Group that wins the most seats in Parliament will see their candidate become the next European Commission President.

Liikanen (former Governor of the Bank of Finland), Olli Rehn (current Governor of the Bank of Finland), François Villeroy de Galhau (Governor of the Bank of France) and Jens Weidmann (President of the Bundesbank). At this time, there appears to be no consensus on a favorite ECB President candidate either among member states or commentators, making for an unprecedentedly wide field of candidates. The key question at this stage is whether and how the conduct of monetary policy would change under any of these potential successors to Draghi.

One way to assess this is to identify areas of interest among them. By [investigating in detail the key words and topics](#) in each candidate's public speeches, we found relatively marginal differences, mostly explained by the different roles and responsibilities of the candidates within the ECB Governing Council. Although growth and inflation are the main focus for all potential candidates, financial stability also seems to be an issue for the Dutch and Finnish candidates compared with fiscal policy for the German candidate.

**Parsing words**

Relative occurrence of key topics in official speeches



Source: BIS, Goldman Sachs Global Investment Research.

**The next president will be shaped by responsibility...**

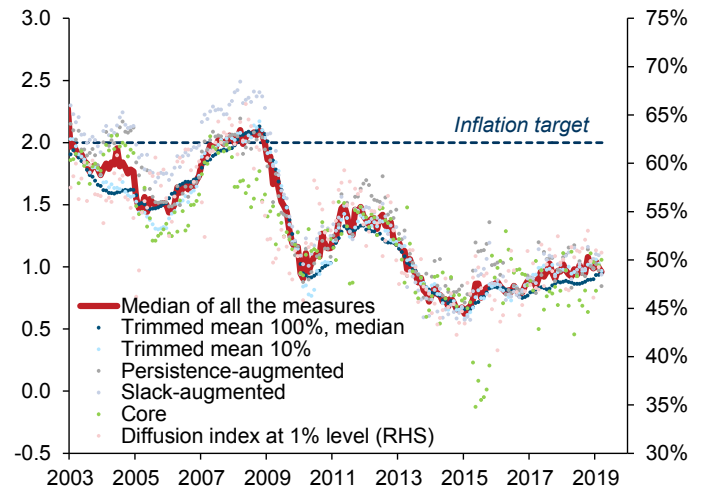
Regardless of who becomes the next ECB president, they will all face the same institutional constraints. In contrast to other central banks, the ECB has a strict mandate with a unique and precise policy objective: price stability defined as headline inflation close to but below 2% in the medium term. This limits the scope for interpretation, as well as the scope for a change in monetary policy. And it also explains why words such as "growth," "inflation," and "EMU reform" are commonly mentioned by all possible candidates (and by President Draghi).

The ECB president has no right of veto when it comes to decision-making; but, instead, his or her main task is to build consensus, while maintaining sufficient authority to find compromise between opposing views and deliver decisions in a timely manner. We think that the consensus-driven culture and the size of the Governing Council limit the scope for radical

change, particularly with forward guidance steering monetary policy toward normalization.

**Target practice**

Euro area underlying measures of inflation, % yoy (lhs), % (rhs)



Source: Eurostat, Goldman Sachs Global Investment Research.

**...and by circumstance**

Despite all this, the ECB president exerts significant influence over the Governing Council by guiding internal debate. For example, Mario Draghi played a key role in expanding the intermediation role of the ECB, largely via asset purchase programmes; since President Draghi took office in late 2011, the size of the [ECB's balance sheet](#) has more than doubled to roughly 40% of Euro area GDP. Mario Draghi has also contributed to the Governing Council's shift towards [a more forward-looking interpretation](#) of price stability definition. This has allowed for a more gradual return of inflation towards the ECB's 2% target, while limiting the scope for a target overshoot. But even in both of these extraordinary cases, policy decisions were still more likely dictated by the exceptional circumstances (i.e., the unique economic and market backdrop faced by President Draghi), and the need to act to reach price stability for the ECB to remain credible.

**Subdued inflation to dominate the policy outlook**

All things considered, we believe that ECB policy is unlikely to shift abruptly under new ECB leadership. This is because economic and [market conditions](#)—rather than personal profile—will continue to determine the evolution of ECB monetary policy. As long as Euro area inflation remains subdued, the ECB will need to [maintain accommodative monetary conditions](#) to return inflation towards its medium-term aim. So, while the style of communication may change, the broad direction of monetary policy under the new ECB President is unlikely to change much.

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Goldman Sachs International

# Populists: disruptors, not agenda-setters

Roxane van Cleef and Pierre Vernet explain why populists are more likely to disrupt—rather than shape—European policy, despite strengthening support

Support for anti-establishment populist parties has increased significantly across Europe, and their representation in European Parliament (EP) will likely rise markedly (see pgs. 6-7 for details). However, even with this larger representation, we see several reasons why populists will probably remain an obstructionist force at the EU-wide level, rather than a meaningful driver of European policy.

## Still short on numbers

First, populists are unlikely to garner enough support; currently, polls suggest that populist/ Eurosceptic parties will fall short of being able to form a populist majority in the EP, as occurred, for example, in national parliaments in Italy and Greece. This implies that in order for populist MEPs to leverage their election success, they would need to form a coalition with a mainstream party. The center-right European People's Party (EPP) would be the group most likely to do so, but numbers would still likely be insufficient for a majority. In addition, we think the EPP would have very limited appetite for such a coalition, preferring to remain close to its traditional liberal and pro-European partners.

## Differences of opinion

Populists will also likely struggle to exploit their gains given large ideological differences between the parties. Despite a shared aversion to "elites" and European integration, these parties currently sit in five of the eight European groups and have vastly different issue-specific political beliefs<sup>4</sup>. For example, populists' economic views span the spectrum from far-left to far-right, with the European United Left/Nordic Green members, Podemos (Spain) and Syriza (Greece) on the far-left, and Alternative für Deutschland (Germany) and Forum for Democracy (Netherlands) on the far-right. In addition to divergence in economic views, there are also significant differences in the importance these parties attach to economic policy; left-wing populist parties tend to focus more on economic policy than the European average and right-wing populists.

Although some parties have been able to overcome these differences on a national level, such as the Five Star Movement (M5S) and Lega in Italy, we think comparable cross-country coordination will likely prove more difficult. In addition to differences due to geographical or regional interests, the frictions caused by ideological differences in national populist coalitions would likely be amplified by the large number of participants on the EU-wide level.

## Compromising issue

This divergence in views is important in assessing a willingness to compromise in order to set a policy agenda. For example, left-wing populist parties such as Syriza and Podemos have moved closer to the political mainstream in order to influence economic agendas. Right-wing populists have attached significantly more value to cultural views than economic convictions, which makes their participation in government less dominant in the area of economic issues and more dominant on social ones.

And even though right-wing populist parties share an aversion to immigration and have similar sovereigntist and cultural agendas, their economic views make cooperation difficult. Some right-wing parties, such as the Polish Law and Justice party (PiS) and the Finns party in Finland, identify more closely with left-wing protectionists rather than with their right-wing allies in Parliament. We therefore think ideological differences between groups set a high bar for populists to form a cohesive group that could prove effective in driving policy.

## Likely disruption

That said, a sharp rise in Eurosceptic MEPs, combined with increasingly fragmented European and national parliaments, could create more scope for populists to obstruct and influence political agendas. Looking at past voting patterns in the EP, some particular areas of influence could be trade policy and economic integration (see pg. 17). Immigration is another policy area where populists may attempt to influence the debate. However, it's important to note that national differences on the topic may hinder this influence. For example, Italy's coalition parties favor a form of redistribution of immigrants to various EU member states. Conversely, Eastern European populist parties, while sharing an anti-immigration stance, do not favor redistribution. These disagreements can also be seen in parliamentary votes, with limited coordination between groups.

Taken together, we believe ideological differences between the Eurosceptic parties will prevent them from setting the European agenda, at least for now. But we think populism will remain a feature of the European political landscape, likely limiting the scope for EMU reform or broader European integration in the short-to-medium-term. That said, the immediate risk of a populist-driven repatriation of EU powers seems limited.

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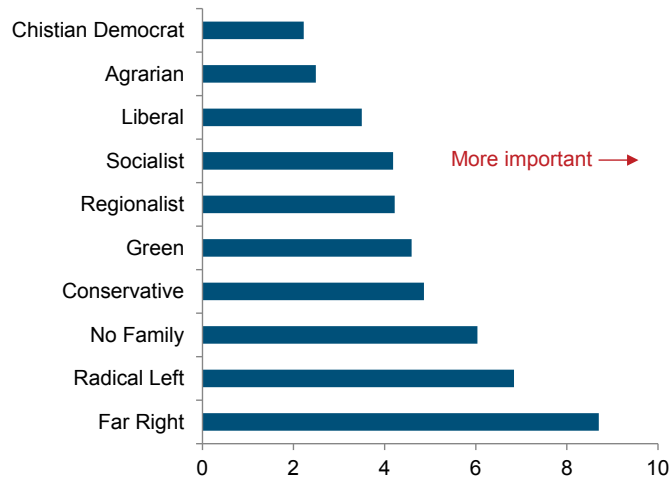
<sup>4</sup> We looked at the Chapel-Hill (2017) dataset—the longest-running survey assessing political parties in Europe—which asked 228 experts to estimate the ideological positioning of 132 political parties in 14 EU Member States.



# Populist disruptors in pics

## Anti-establishment views congregate on the extremes...

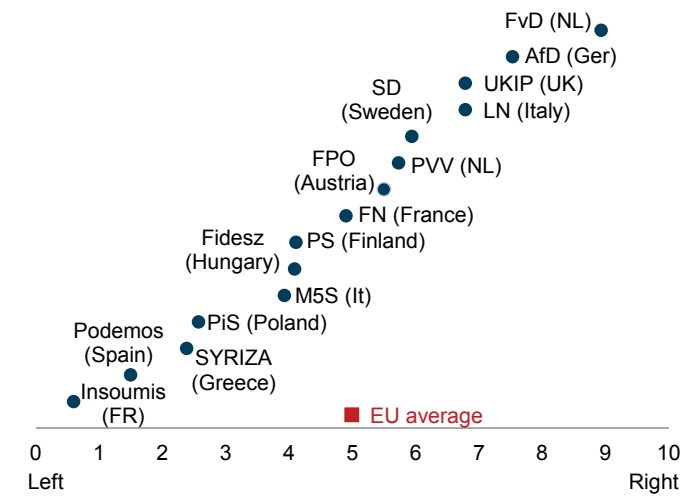
Party's importance of anti-establishment views



Source: Chapel-Hill (2017), Goldman Sachs Global Investment Research.

## ...and economic views differ meaningfully between populists

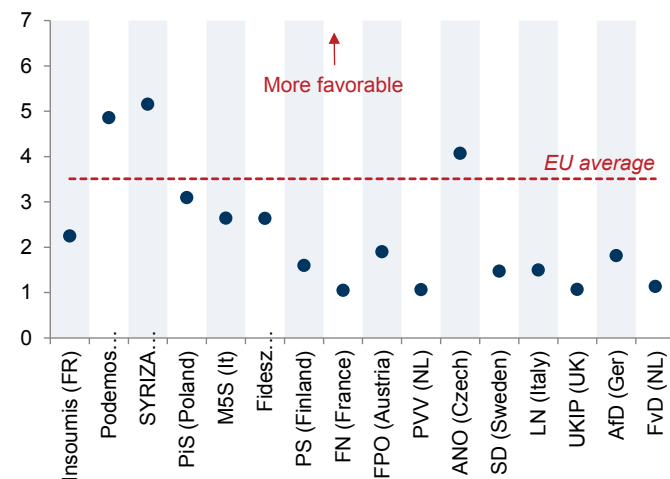
Economic positions of European political parties



Source: Chapel-Hill (2017), Goldman Sachs Global Investment Research.

## Populists generally oppose EU integration...

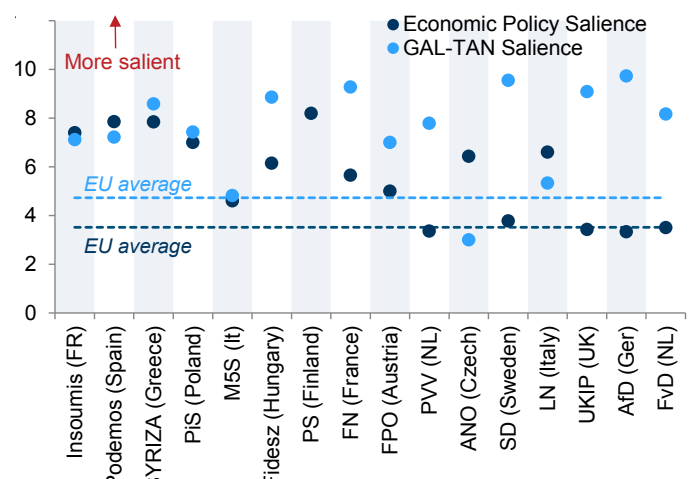
Position of populist parties towards EU integration



Source: Chapel-Hill (2017), Goldman Sachs Global Investment Research.

## ...but differ on their stance toward economic/cultural issues

Importance of cultural vs. economic views to populist parties



Note: GAL/TAN rates parties on a cultural dimension with Green / Alternative / Libertarian (GAL) at one end (0) and Traditionalist / Nationalist / Authoritarian (TAN) at the other (10); Source: Chapel-Hill (2017), Goldman Sachs Global Investment Research.

## Populists could influence the debate on trade, economics, and immigration—though national differences remain

Populist parties' voting record in the European Parliament on key trade, economic policy, and immigration measures

Vote	Outcome	Success Rate	GUE-NGL		ECR			EFDD			ENF				
			Pod	Syriza	AfD	NVA	PiS	DPP	M5S	SD	UKIP	FN	FPO	LN	PVV
US Trade Mandate Motion	Failed with	43%*	Against	Against	Against	Against	Against	Against	Against	Against	Against	Against	Against	Against	Against
EU-Singapore Free trade Agreement	Passed with	59%	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor
CETA	Passed with	59%	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor
EU-Japan	Passed with	71%	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor
TTIP	Passed with	62%	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor
Eurozone budget capacity	Passed with	48%	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor
Common Consolidated Corporate Tax Base**	Passed with	67%	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor
European Defence Fund	Passed with	54%	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor
European Border and Coast Guard	Passed with	66%	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor
Asylum and Migration Fund	Passed with	55%	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor	In favor

\*After successful opposition amendments passed, the ruling EPP and S&D voted against the mandate.  
\*\*Consultation.

Against In favor Abstained Did not vote

Note: Pod - Podemos (Spain); AfD - Alternative fur Deutschland (Germany); NVA - Nieuwe Vlaamse Alliantie (Belgium); PiS - Law and Justice (Poland); SD - Swedish Democrats (Sweden); FN - Front National (France); FPO - The Freedom Party of Austria (Austria); LN - Lega Nord (Italy); PVV - Freedom Party (Netherlands).

Source: European Parliament, Goldman Sachs Global Investment Research.

# Bracing for the Brexit effect

Adrian Paul argues that EU elections are unlikely to impact the Brexit endgame, but UK MEPs could further complicate EU governance (albeit temporarily)

It now looks likely that the UK will participate in elections to the European Parliament (EP). In our view, the extent to which these elections influence the trajectory of Brexit negotiations will hinge on two aspects of their impact at Westminster. First, will a strong indictment of the Conservative Party’s Brexit strategy catalyse the departure of Prime Minister May, and raise the likelihood of a general election before the next Article 50 deadline? Second, will the results of the European elections crystallise a shift in the UK electorate’s Brexit preferences, and compel MPs in the House of Commons to change their voting behavior? On both accounts, we think the risks are real, but we would discount their potency over the path to Brexit resolution.

As for the impact of UK participation on the European agenda, we expect UK MEPs to increase the share of Eurosceptics in the European Parliament. This increase will probably be small and temporary, but it has the potential to shift the balance of power between mainstream and populist parties, while possibly complicating key EU-level appointments.

## Eurosceptics emboldened (for now)

Vote share for UK parties in the European Parliament, %

United Kingdom party	2014	2019*	European Parliament group	2014 Seats/751	2019* Seats/751	2019* ex UK Seats/705
Conservatives	19	13	European Conservatives and Reformists	70	68	52
UUP	1	0				
Labour	20	24	Progressive Alliance of Socialists and Democrats	191	163	137
Liberal Democrats	1	5	Alliance of Liberals and Democrats for Europe	67	72	73
UKIP	24	4	Europe of Freedom and Democracy	48	57	44
Brexit party						
Greens	3	3	The Greens–European Free Alliance	50	46	42
Scottish National	2	2				
Plaid Cymru	1	1				
Sinn Féin	1	1				
DUP	1	1	European United Left–Nordic Green Left	52	51	56
			Non-Inscrits	52	9	9
			European Peoples party	221	162	173
			ENF		65	66
Change UK		3	New		58	53
Total UK Seats	73	73		751	751	705

Source: Various opinion polls, Goldman Sachs Global Investment Research.

## Toppling the government?

May is likely to be a difficult month for the UK Prime Minister. In local elections on May 2, the Conservative Party lost more than 1000 council seats, in its poorest performance for more than 20 years. The latest polling ahead of the EP elections suggests that Conservatives may lose a third of their seats in the EP. In normal times, defeats of this magnitude would threaten the PM’s position. But these are not normal times. Despite repeated attempts to oust her from the backbenches, PM May looks immune to another leadership challenge until December, at least for now. Even if the PM were to resign after consecutive Tory defeats in May, her internally appointed successor would face the uphill challenge of whipping MPs in favor of a general election at a time when the opposition Labour Party may well be 5-10pp ahead in the polls.

## Emboldening the Tails?

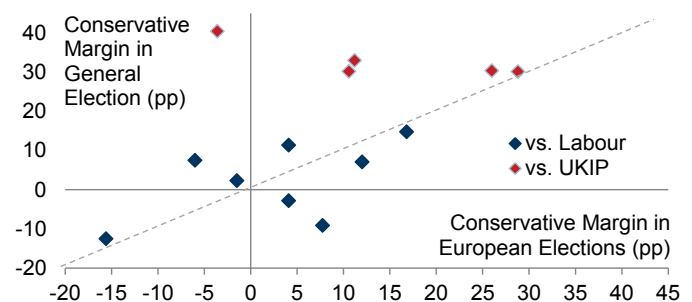
With the UK electorate clearly viewing the European elections as an opportunity to protest over the government’s handling of Brexit—and given that the proportional system adopted in

European elections favors smaller parties—there is a growing sense that advocates of “Remain” and advocates of “no deal” will be emboldened in Westminster if they win seats in the EP. After all, on the latest polls, the Brexit Party and UKIP look likely to attract around 30% of the vote (20 EP seats). The former is a newly formed offshoot of the latter, and both are advocates of immediate UK withdrawal from the EU, irrespective of a deal. Meanwhile, small parties in the “Remain” camp—including the Liberal Democrats, Change UK, the Green Party, the Scottish National Party, and Plaid Cymru—are likely to attract 29% of the vote (18 EP seats).

By comparison, the Labour Party is polling at 23% (20 seats) and the Conservative Party is polling at 14% (12 seats). These numbers certainly suggest dissatisfaction with the government’s Brexit strategy. But for that protest to affect policy, it must express itself in the parliamentary arithmetic in the House of Commons. We see good reasons to be sceptical of the view that the results of the European elections will map directly into the pattern of voting at the next general election in the UK. We also think it is a stretch to envisage the success of the Brexit Party on May 23 giving rise to a newfound majority in the current House of Commons in favour of a “no deal” Brexit on October 31. Indeed, while we find that the difference between the Conservative-Labour vote share in elections to the European Parliament is a good predictor of the difference between the Conservative-Labour vote share in the general election that follows, that mapping breaks down when it comes to the relative fortunes of smaller parties such as UKIP.

## Pro-Brexit EP vote ≠ pursuit of “no deal”

Differences in vote share in UK elections since 1979, pp



Source: European Parliament, Parliament UK, Goldman Sachs GIR.

## Tilting the balance?

We think the most likely outcome of Brexit negotiations is the ratification of a Withdrawal Agreement and a smooth UK departure from the EU. On timing, we look for a deal in Q2, but we see a significant chance that Brexit negotiations spill over into the second half of 2019. On this path, the UK would elect MEPs to their seats in the European Parliament, but the tenure of those MEPs would ultimately prove temporary. On our calculations, the UK’s presence would increase the incidence of Eurosceptics in the European Parliament by around 30 MEPs (that is, 4% of total EP seats). However short-lived, this boost has the potential to shift the balance of power between the Socialists (S&D) and the European People’s Party (EPP), possibly complicating key EU-level appointments due to be announced over the summer.

## Adrian Paul, Senior Europe Economist

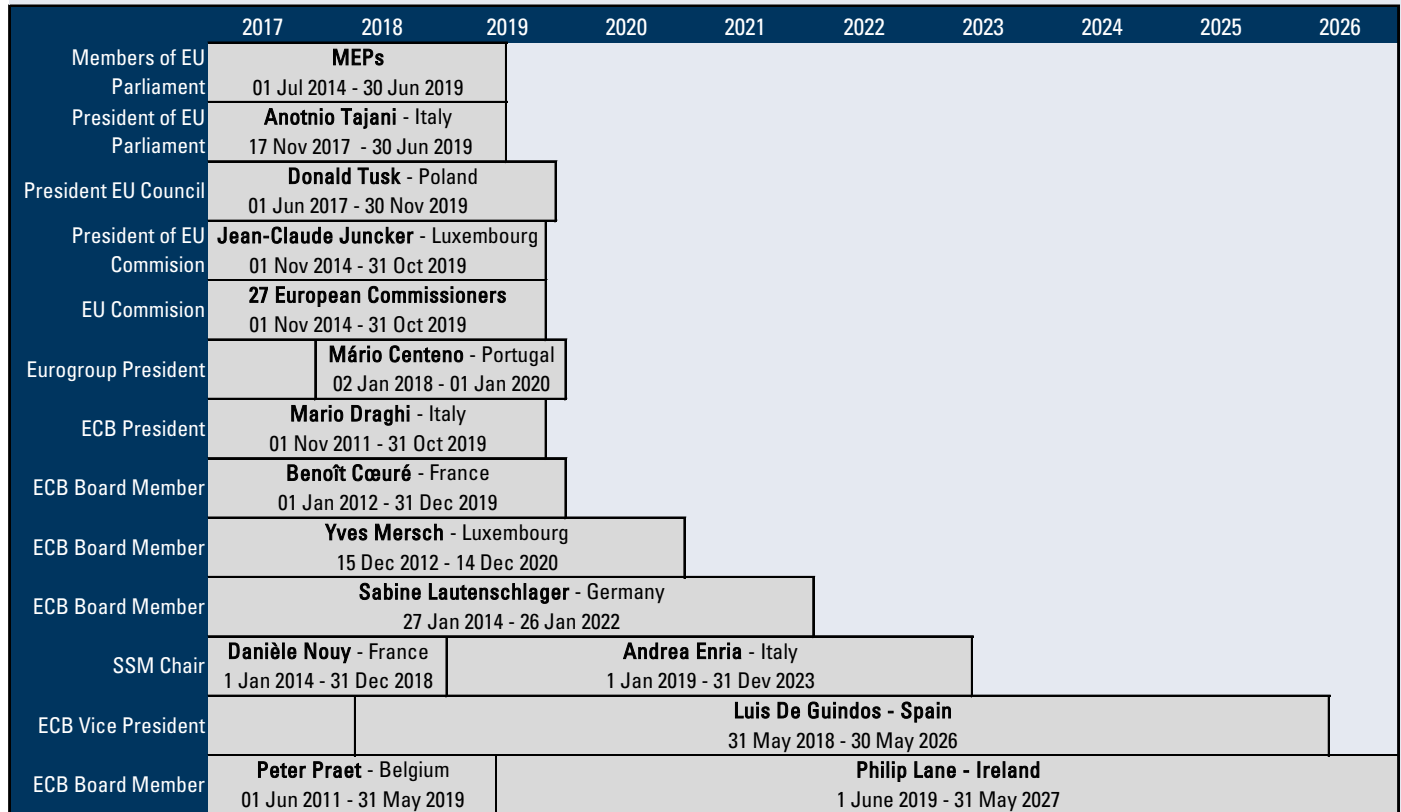
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# Key questions around EP elections

## How and when will European elections affect key EU-level appointments?

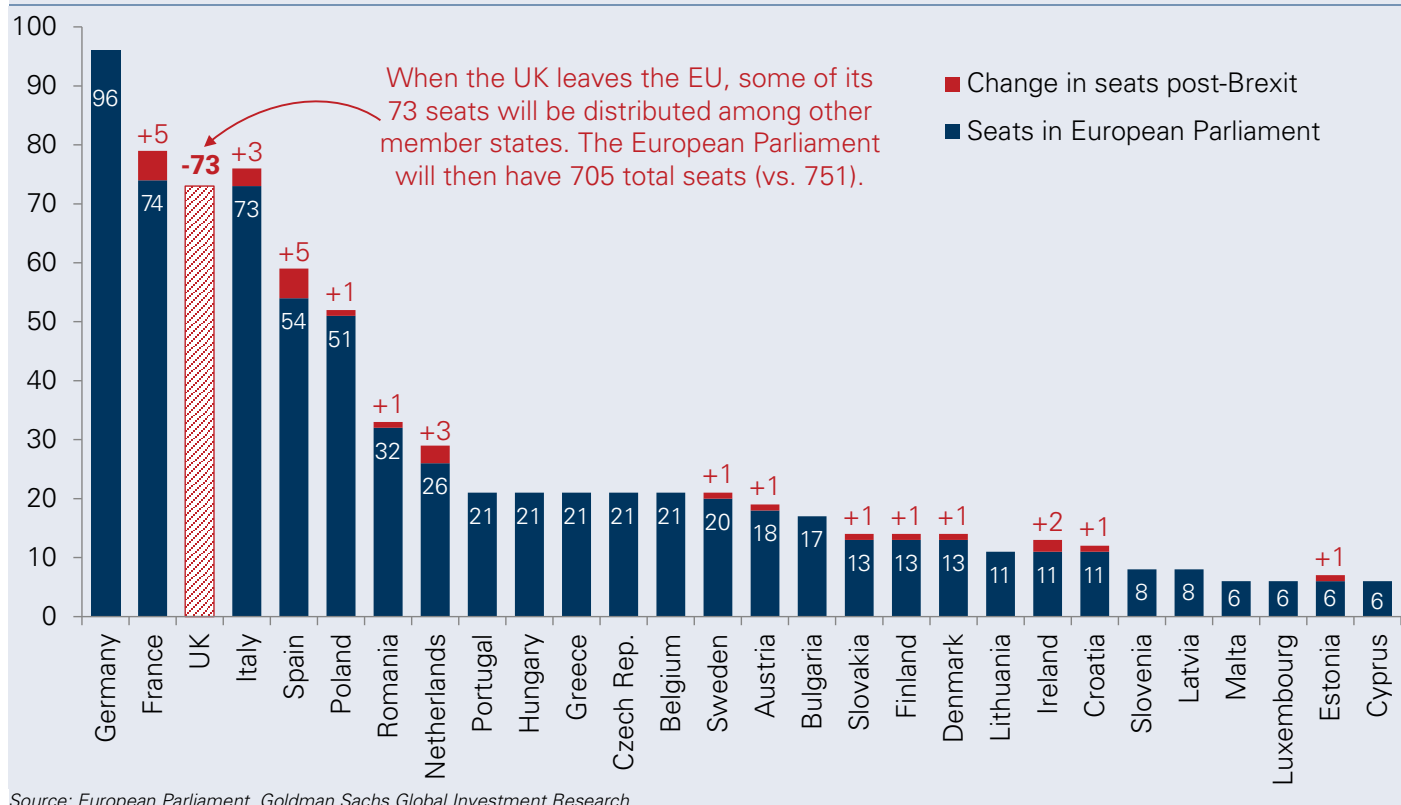
Flow of key European appointments



Source: ECB, European Council, Goldman Sachs Global Investment Research.

## How will Brexit affect the balance of power in Europe?

European Parliament seats by country pre- and post-Brexit



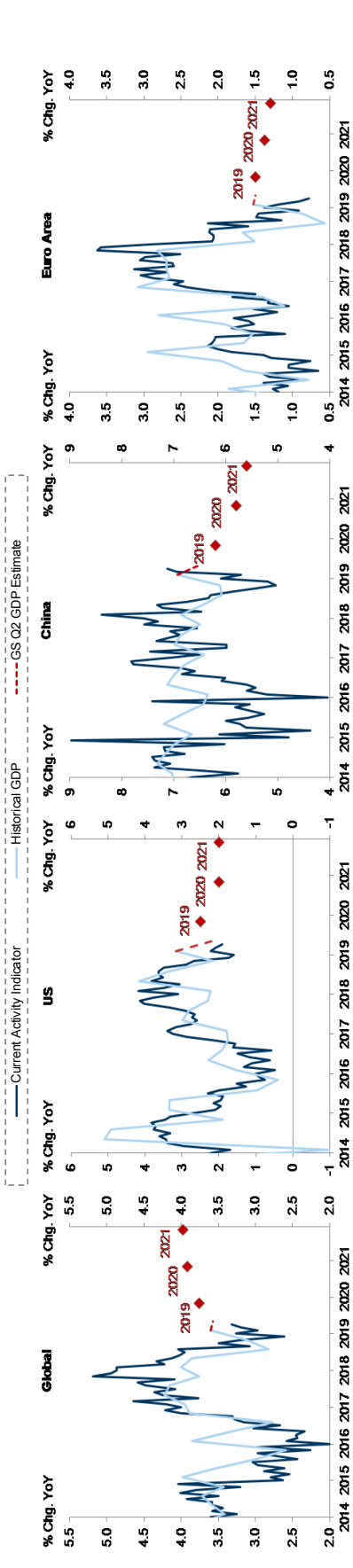
Source: European Parliament, Goldman Sachs Global Investment Research.

# Summary of our key forecasts

## Macro at a glance

- **Global growth is tracking at a solid pace**, recently boosted by a rebound in China. We expect 2019 growth of 3.4% (vs. 3.3% consensus).
- **In the US, we expect growth to slow temporarily** to a sub-2% pace in Q2 on short-lived inventory adjustments, but then expect a pick-up to an above-consensus 2.5% pace in 2H2019 as the drag from tighter financial conditions wanes.
- **We expect the Fed to remain firmly on hold this year**, but think the next move is more likely a hike than a cut—most likely after the US presidential election in 2020—given further tightening in an already-tight labor market and our view that US inflation has likely bottomed.
- **In the Euro area, we also expect a H2 bounce in growth** to an above-consensus 1.5% pace boosted by a friendlier external environment and easier financial conditions. Brexit developments will be key to watch; we still expect an orderly Brexit this year, though risks have shifted towards reaching a resolution in 2H2019.
- **We expect the ECB to further pursue a dovish tilt** by easing slightly in June (via unconventional means) to lean against still-slightish growth and inflation; we forecast the ECB's first hike in 2Q2020—earlier than markets expect.
- **In Emerging Markets (EM), we believe activity probably bottomed out in Q1**, and we expect a modest reacceleration in the remainder of 2019 on better Chinese growth and easier DM monetary policy.
- **In China, government stimulus and trade will be key to watch**; we expect a less-dovish policy stance will modestly temper recent stronger-than-expected growth; on trade, we now think a near-term step-up in US tariff rates on Chinese goods is more likely than not, though further escalation looks unlikely.

## Watching



Note: GS CAI is a measure of current growth. For more information on the methodology of the CAI please see "Peeking Around the Corner: Our New Leading CAI", Global Economics Analyst, May 8, 2018.

GDP growth (%)	2019		2020		2021		Equities				
	GS	Cons.	GS	Cons.	GS	Cons.	S&P500	GS Portfolio Strategy	Price	Consensus	
Global	3.4	3.3	3.8	3.3	3.8	3.3	\$173	6%	3,000	\$168	3%
US	2.8	2.4	2.3	1.9	2.3	1.9	\$181	4%	--	\$188	12%
China	6.5	6.3	6.1	6.0	6.1	6.0	--	--	--	--	--
Euro area	1.4	1.1	1.4	1.4	1.4	1.4	--	--	--	--	--

Policy rates (%)	2019		2020		2021		Equities				
	Market Implied	GS	Market Implied	GS	Market Implied	GS	Equity Returns (%)	YTD	P/E		
US	2.38	2.10	2.63	1.96	2.63	1.96	S&P500	-6.0	3.0	17.7	17.7x
Euro area	0.00	0.00	0.25	0.05	0.25	0.05	MXAPJ	3.0	6.0	11.8	14.1x
China	2.75	3.06	2.50	3.19	2.50	3.19	Topix	2.0	4.0	8.3	13.8x
Japan	-0.05	-0.09	-0.05	-0.11	-0.05	-0.11	STOXX Europe 600	2.0	5.0	14.1	14.4x

Interest rates, 10Yr (%)	2019		2020		2021		Equities			
	Last	3m	Last	3m	Last	3m	12m	E2020	E2019	12m
US	2.45	2.80	3.00	3.00	3.00	3.00	1.20	1.20	1.10	1.20
Germany	-0.04	0.35	0.75	0.75	0.75	0.75	105	105	110	105
Japan	0.10	0.25	0.25	0.25	0.25	0.25	6.6	6.6	6.7	6.6
UK	1.16	1.85	2.00	2.00	2.00	2.00	3.6	3.6	3.97	3.8

Commodities	2019		2020		2021		Equities			
	Last	3m	Last	3m	Last	3m	12m	E2020	E2019	12m
Nat Gas (\$/mBtu)	3.97	2.8	2.8	2.8	2.8	2.8	125	125	118	125
Crude Oil, Brent (\$/bbl)	69.9	72.5	60	60	60	60	405	405	383	405
Copper (\$/mt)	6,400	6,400	7,000	7,000	7,000	7,000	147	147	149	147
Gold (\$/troy oz)	1,300	1,300	1,375	1,375	1,375	1,375	412	412	386	417

Source: Bloomberg, Goldman Sachs Global Investment Research.

# Glossary of GS proprietary indices

## Current Activity Indicator (CAI)

GS CAIs measure the growth signal in a broad range of weekly and monthly indicators, offering an alternative to Gross Domestic Product (GDP). GDP is an imperfect guide to current activity: In most countries, it is only available quarterly and is released with a substantial delay, and its initial estimates are often heavily revised. GDP also ignores important measures of real activity, such as employment and the purchasing managers' indexes (PMIs). All of these problems reduce the effectiveness of GDP for investment and policy decisions. Our CAIs aim to address GDP's shortcomings and provide a timelier read on the pace of growth.

For more, see our [CAI page](#) and [Global Economics Analyst: Trackin' All Over the World – Our New Global CAI, 25 February 2017](#).

## Dynamic Equilibrium Exchange Rates (DEER)

The GSDEER framework establishes an equilibrium (or "fair") value of the real exchange rate based on relative productivity and terms-of-trade differentials.

For more, see our [GSDEER page](#), [Global Economics Paper No. 227: Finding Fair Value in EM FX, 26 January 2016](#), and [Global Markets Analyst: A Look at Valuation Across G10 FX, 29 June 2017](#).

## Financial Conditions Index (FCI)

GS FCIs gauge the "looseness" or "tightness" of financial conditions across the world's major economies, incorporating variables that directly affect spending on domestically produced goods and services. FCIs can provide valuable information about the economic growth outlook and the direct and indirect effects of monetary policy on real economic activity.

FCIs for the G10 economies are calculated as a weighted average of a policy rate, a long-term risk-free bond yield, a corporate credit spread, an equity price variable, and a trade-weighted exchange rate; the Euro area FCI also includes a sovereign credit spread. The weights mirror the effects of the financial variables on real GDP growth in our models over a one-year horizon. FCIs for emerging markets are calculated as a weighted average of a short-term interest rate, a long-term swap rate, a CDS spread, an equity price variable, a trade-weighted exchange rate, and—in economies with large foreign-currency-denominated debt stocks—a debt-weighted exchange rate index.

For more, see our [FCI page](#), [Global Economics Analyst: Our New G10 Financial Conditions Indices, 20 April 2017](#), and [Global Economics Analyst: Tracking EM Financial Conditions – Our New FCIs, 6 October 2017](#).

## Global Leading Indicator (GLI)

The GS GLI was designed to provide a timelier reading on the state of the global industrial cycle than existing alternatives did, and in a way that is largely independent of market variables. The GLI has historically provided early signals on global cyclical swings that matter to a wide range of asset classes. The GLI currently includes the following components: a consumer confidence aggregate, the Japan IP inventory/sales ratio, Korean exports, the S&P GS Industrial Metals Index, US initial jobless claims, Belgian and Netherlands manufacturing surveys, the Global PMI, the GS AUD and CAD trade-weighted index aggregate, global new orders less inventories, and the Baltic Dry Index.

For more, see our [GLI page](#) and [Global Economics Paper No. 199: An Even More Global GLI, 29 June 2010](#).

## Goldman Sachs Analyst Index (GSAI)

The US GSAI is based on a monthly survey of GS equity analysts to obtain their assessments of business conditions in the industries they follow. The results provide timely "bottom-up" information about US economic activity to supplement and cross-check our analysis of "top-down" data. Based on analysts' responses, we create a diffusion index for economic activity comparable to the ISM's indexes for activity in the manufacturing and nonmanufacturing sectors.

## Macro-Data Assessment Platform (MAP)

GS MAP scores facilitate rapid interpretation of new data releases for economic indicators worldwide. MAP summarizes the importance of a specific data release (i.e., its historical correlation with GDP) and the degree of surprise relative to the consensus forecast. The sign on the degree of surprise characterizes underperformance with a negative number and outperformance with a positive number. Each of these two components is ranked on a scale from 0 to 5, with the MAP score being the product of the two, i.e., from -25 to +25. For example, a MAP score of +20 (5;+4) would indicate that the data has a very high correlation to GDP (5) and that it came out well above consensus expectations (+4), for a total MAP value of +20.

## Real-Time Indicator of Activity (RETINA)

GS RETINA uses a comprehensive econometric methodology to filter incoming information from the most up-to-date high-frequency variables in order to track real GDP growth in the Euro area and the UK.

For more, see [European Economics Analyst: RETINA Redux, 14 July 2016](#) and [European Economics Analyst: Introducing RETINA-UK, 2 August 2017](#).

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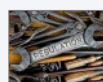
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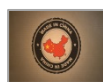
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We, Allison Nathan, David Groman, George Cole, Alain Durré, Adrian Paul, Roxane van Cleef, and Pierre Vernet hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

Unless otherwise stated, the individuals listed on the cover page of this report are analysts in Goldman Sachs' Global Investment Research division.

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