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TOP of MIND

HOW INVESTABLE IS EUROPE?

Just as Europe emerged from two years of stagnation, weak survey data, increased political risk, and structural issues have put the region's outlook back in question. So, how significant are these challenges, and how investable is Europe? GS GIR's Jari Stehn sees a dimmer cyclical outlook, which could become even more so if Trump is reelected and implements his proposed tariffs. Bruegel's Jean Pisani-Ferry is slightly less concerned about potential Trump tariffs in the short term, but worries about the lack of cyclical momentum and risk of a more isolationist US. Politically, former EC President José Manuel Barroso argues that despite the rise of nationalism, the trend in Europe remains toward more integration, but Ferry and Stehn worry that Europe's politics may impede its ability to address its structural issues. In all, BlackRock's Helen Jewell believes Europe is quite investable and expects European equity outperformance vs. the US, while GS GIR's Sharon Bell sees a trickier investing landscape. But both see compelling opportunities in Europe and highlight one particular area: the UK.

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The European growth outlook has certainly dimmed.

- Jari Stehn

Europe's longer-term outlook is... concerning, as the region is facing several structural challenges that I am worried it lacks the political capacity to tackle.

- Jean Pisani-Ferry

Despite worries about the rise of political nationalism and extremism in Europe, external factors… are likely to continue pushing the Union toward more—not less—integration over the medium term.

- José Manuel Barroso

Whether the deep valuation gap between Europe and the US marks a temporary or more structural shift is a valid question. But the risks facing the region look fully priced in given the magnitude of the European equity risk premium today.

- Helen Jewell

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Jari Stehn, Chief European Economist at Goldman Sachs

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...AND MORE

Allison Nathan | allison.nathan@gs.com
Jenny Grimberg | jenny.grimberg@gs.com
Ashley Rhodes | ashley.rhodes@gs.com

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

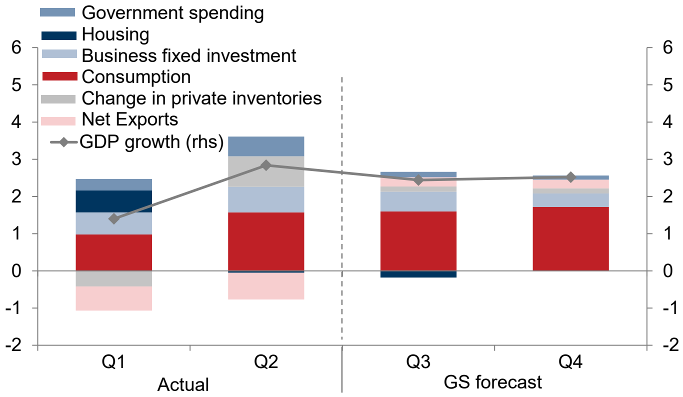
- No major changes in views.

Datapoints/trends we're focused on

- US growth; we expect a modest growth pickup in H2 from H1 for real GDP growth of 2.3% in 2024 (Q4/Q4), reflecting robust consumer spending growth, easing financial conditions, and a pick-up in equipment and AI investment.
- Fed policy; we expect quarterly Fed cuts starting in September to a terminal rate range of 3.25-3.5%.
- US election; a potential rise in tariffs under a Trump presidency could significantly boost US inflation and weigh modestly on US growth.

US economy: consuming its way to growth

Contributions to 2024 US GDP growth (lhs, pp), real GDP growth (rhs, % chg, at annual rate)



Source: Department of Commerce, Goldman Sachs GIR.

Japan

Latest GS proprietary datapoints/major changes in views

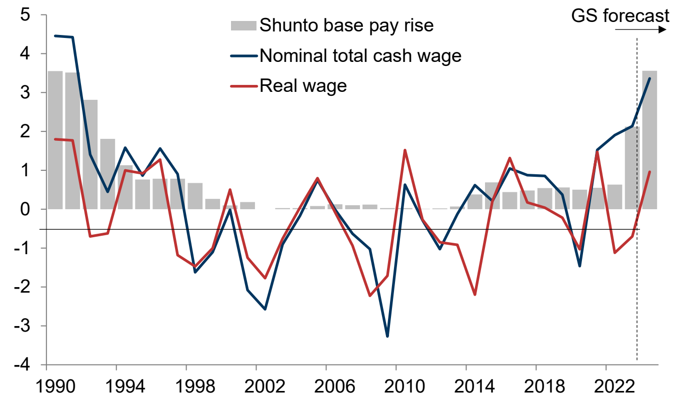
- No major changes in views.

Datapoints/trends we're focused on

- BoJ policy; we expect the BoJ to deliver 25bp rate hikes at a semiannual pace until the policy rate range reaches 1.25-1.5% in 2027.
- Japanese growth; while consumption, capex, and exports all declined in Q1, we expect each to turn to growth in Q2 for 2Q24 growth of 2.4% (qoq ann.) (vs. -2.9% in Q1).
- Japanese real wage growth, which we estimate will turn positive in 2024 for the first time in four years following the highest *shunto* base pay rise since 1990 of 3.56%.

Japan: negotiating power

Shunto base pay rise and macro wage growth, % chg, yoy



Source: Ministry of Health, Labour and Welfare, Ministry of Internal Affairs and Communications, JTUC-RENGO, Goldman Sachs GIR.

Europe

Latest GS proprietary datapoints/major changes in views

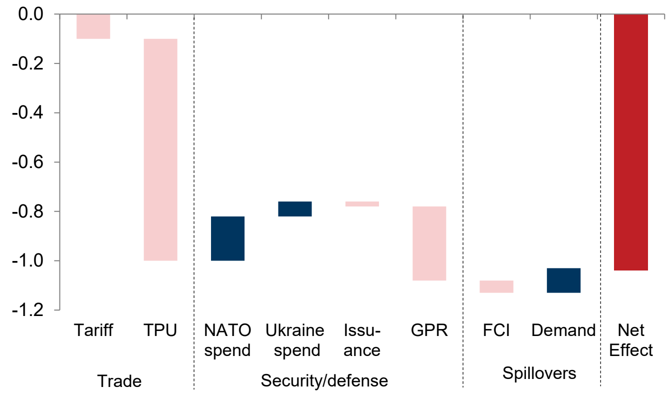
- We recently lowered our Q2/Q3/Q4 2024 Euro area GDP growth forecasts to 0.2%/0.3%/0.3% (from 0.3%/0.4%/ 0.4%, non-ann.), which has lowered our full-year forecast to 0.7% (from 0.8%), given weaker survey data, French policy gridlock, and rising risks from international trade.

Datapoints/trends we're focused on

- ECB policy; we expect the ECB to deliver another 25bp cut in Sept, followed by quarterly cuts to a 2.25% terminal rate.
- UK growth; we expect 2024/25 GDP growth of 1.2%/1.6% given rising real incomes, easing financial conditions, and a more growth-friendly fiscal policy mix under a Labour gov't.

Growth risks from a potential Trump presidency

Estimated effect of a Trump presidency on Euro area GDP*, %



*Red/pink bars represent negative effect, blue bars represent positive effect.

Source: Haver Analytics, Goldman Sachs GIR.

Emerging Markets (EM)

Latest GS proprietary datapoints/major changes in views

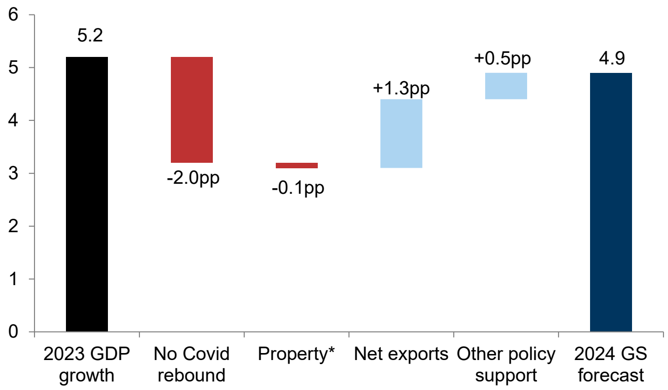
- We lowered our 2024 China GDP forecast to 4.9% yoy (from 5.0%) following a large downside surprise in Q2 GDP data.
- We lowered our 2024/2025 China policy rate forecasts to 1.6%/1.4% (from 1.7%/1.7%) following the PBOC's unexpected July policy rate cuts.

Datapoints/trends we're focused on

- China exports; while strength in exports has buoyed growth this year, we see several structural headwinds to China's export outlook in 2025 and beyond.
- EM macro outlook, which remains encouraging, but external political risks, including a global trade war, cast a shadow.

China: export and policy easing boosts, for now

Contribution to change in China real GDP growth, % chg, yoy



*Includes investment in social housing and urban village renovation programs.

Source: Haver Analytics, Goldman Sachs GIR.

How investable is Europe?

Recent weak European survey data has raised the question of whether Europe's nascent cyclical recovery may be failing. Alongside these cyclical worries, Europe is grappling with increased political risks in light of the recent European Parliament and French election outcomes and, more crucially, the prospect of heightened trade and security risks depending on the US election outcome—all of which could spell bad news for Europe's economy. And these risks are coming atop daunting structural problems that continue to plague the region. Just how significant Europe's cyclical, political, and structural challenges are—and what that means for Europe's investability—is Top of Mind.

We first speak with Jean Pisani-Ferry, Senior Fellow at Bruegel, and Jari Stehn, GS Chief European Economist, about Europe's cyclical outlook. Stehn argues that while the pickup in growth in 1H24 suggests that Europe has emerged from two years of stagnation, the cyclical outlook has dimmed owing to the recent weaker survey data and rising growth risks from trade amid a slowdown in China and proposed Trump policies should he win the US presidency. Stehn now expects 0.7% and 1.3% GDP growth in the Euro area this year and next, respectively, and downside risks to even this relatively weak baseline loom large. He estimates that Trump's proposed 10% across-the-board tariff on all US imports would lower Euro area growth by 1%. And even if such tariffs aren't implemented, he argues that a sharp rise in trade policy uncertainty—which has already begun to manifest---would prove damaging for growth.

Ferry also worries that Europe's economy lacks sufficient momentum to withstand the cyclical headwinds it faces. While he is slightly less concerned than Stehn about Trump's proposed tariffs in the short term—noting that the more immediate concern for Europe is potential US foreign policy shifts vis-à-vis Ukraine—he cautions that a more isolationist US would ultimately prove extremely costly for Europe.

Beyond the Trump policy risks, Europe is also grappling with domestic political challenges following the EU and French elections. Although the outcome of both elections ultimately left centrists in the driver's seat, the far-right gained a significant number of seats in the European Parliament, and the hung parliament resulting from the French election portends policy gridlock.

To assess the significance of these shifts, we speak with José Manuel Barroso, former European Commission President, who says that any surge in nationalism across Europe poses a threat to the European Union, as it has the potential to throw its very existence into question. But he thinks that the deep—and too often underappreciated—economic linkages between EU countries provide strong incentive for the EU to remain united, and that external challenges in the form of a more aggressive Russia, assertive China, and unpredictable US argue in favor of more—not less—European integration over the medium term.

Ferry and Stehn, however, are concerned that Europe's political landscape may impede its ability to address its structural challenges. Ferry argues that while the EU and French election outcomes may have proved less extreme than many feared, the underlying sentiments that led to the rise of the far-right remain. This, Ferry says, together with a lack of fiscal space, makes it difficult for Europe to address the three major structural challenges it faces: dismal productivity, economic security vulnerabilities, and climate competitiveness problems, which, left unresolved, could threaten the European project.

Stehn and GS senior European economists Filippo Taddei and Alex Stott also see political headwinds to another structural issue: Europe's fiscal position. They argue that French policy gridlock could complicate much-needed fiscal consolidation efforts there as well as in Italy while also slowing further progress on fiscal and broader economic integration, including the Capital Markets Union. Beyond its fiscal challenges, Stehn is also concerned about Europe's deteriorating demographics and trade risks, which he warns could weigh on productivity, with these structural challenges leading him to expect only ~1% potential growth for the Euro area, well below the US.

So, what does this all mean for European assets? GS senior rates strategists George Cole and Simon Freycenet argue that European front-end yields will likely continue to decline owing to the weak economic data and US trade risks, with French sovereign spreads also likely to widen. And GS senior FX strategist Michael Cahill sees further Euro underperformance ahead unless Europe's outlook improves significantly.

But the key question amid all these challenges is: how investable is Europe? When it comes to credit, GS Chief Credit Strategist Lotfi Karoui expects the recent resilience in EUR IG and HY corporate bonds to extend. Helen Jewell, CIO of Fundamental Equities at BlackRock, is similarly optimistic about the outlook for European equities and expects European outperformance vs. the US owing to four factors: cyclical and earnings uplifts, Europe's deep valuation gap with the US—which suggests that the risks facing Europe are fully priced in—and the European market's breadth of quality. Jewell also argues that the market's large international exposure should mitigate the impact of a weaker domestic cyclical backdrop. However, she says the prospect of more restrictive US trade policies is worrying and is "the one risk that would clearly make it very difficult for Europe to outperform".

GS senior European equity strategist Sharon Bell, for her part, sees a "trickier" European equity landscape ahead. While she agrees with the market positives that Jewell highlights and forecasts low single-digit returns for European equities that suggest slight outperformance vs. US equities, the increasingly challenging cyclical case—on top of an already tough structural case—for investing in Europe, as well as downside tail risks vis-a-vis trade, leaves Bell and team recommending a neutral equity allocation across regions.

So, how should European equity investors position? Jewell sees the most compelling opportunities in construction, semis, and utilities, with selective pockets of value in banks and SMIDs. And Bell recommends focusing on the GRANOLAS and Value stocks active in the "buyback bonanza". One area both Jewell and Bell highlight: the UK, which Stehn and GS UK economist James Moberly see as a bright spot in Europe, owing in part to the new Labour government's policies.

Allison Nathan, Editor

Email: allison.nathan@gs.com
Tel: 212-357-7504
Goldman Sachs & Co. LLC

Interview with Jari Stehn

Jari Stehn is Chief European Economist at Goldman Sachs. Below, he argues that Europe's outlook has dimmed amid weaker survey data, French policy gridlock, and rising trade risks.

Jenny Grimberg: Are recent disappointments in European economic data a sign that Europe's economic recovery may be failing?

Jari Stehn: The European growth outlook has certainly dimmed. The pickup in real GDP growth in H1 suggests that Europe has emerged from the stagnation of the last two years. But the latest surveys, including the flash PMIs, point to soft momentum into H2. As a result, our Current Activity Indicator (CAI) has returned to negative territory. The brightening of forward-looking indicators has also stalled, with softer PMI new orders/inventory gap and expectations surveys. This all suggests less growth momentum heading into 2H24 than we had expected.

Further clouding Europe's economic outlook is the emergence of policy gridlock in France following their recent elections and rising growth risks from international trade amid slowing China growth and the potential for more restrictive US trade policies should Trump win the US presidential election. These factors led us to recently lower our 2024 Euro area GDP growth forecast to 0.7%, only marginally above last year's pace. That said, the two key pillars of Europe's economy recovery—strong real disposable income growth and a fading credit drag as the ECB continues easing policy—remain intact. So, we continue to expect growth to improve over the next year, at a 1.3% pace in 2025. But the new growth headwinds we've discussed have narrowed Europe's path to above-trend growth and have tilted the risks to the 2025 outlook to the downside.

Jenny Grimberg: Germany seems to be in the crosshairs of many of the challenges facing Europe. How concerned are you about its economic outlook?

Jari Stehn: Germany contracted in Q2 and its outlook is concerning. China is a very important German export market, but with China's economy slowing and tensions between the West and China rising, German exports to China have slowed. China is also a rising competitor to Germany and gaining market share at its expense. So, Germany, and Europe more broadly, need to diversify away from China, but this will likely be a slow process given the difficult balance between diversification aims and negative economic spillbacks. Germany is also very reliant on global trade more broadly, so a Trump trade war could affect it more than other European countries, as we saw in 2018/19.

That said, reasons exist to believe that Germany will return to growth over the medium term. The country's industrial sector should benefit as energy prices and interest rates continue to decline, and Germany has by far the strongest public balance sheet across advanced economies, which gives it significant scope to expand investment. So, the German economic story isn't all negative. But the recent data disappointments and looming trade risks certainly make it more concerning.

Jenny Grimberg: What potential repercussions could the policies that Trump has signaled he would pursue if he wins the US presidential election have for the Euro area?

Jari Stehn: Proposed Trump policies could have profound implications for Europe's economy along two main dimensions: renewed trade tensions and security pressures. Trump has pledged to impose a 10% across-the-board tariff on all US imports, but even if such tariffs aren't ultimately implemented, the sharp increase in trade policy uncertainty would weigh on European growth. Europe's economy slowed sharply during the 2018/19 Trump trade war, which owed more to the threat of tariffs and uncertainty around their size and scope than to the tariffs themselves. We've found that this uncertainty was very damaging for European activity and investment. So, even in the event of smaller tariffs, Europe's economy could still incur substantial damage. We estimate that Trump's proposed tariffs would lower Euro area GDP growth by 1% and boost inflation by a relatively modest 0.1pp. Given the uncertainty around the US election outcome, we're currently treating the potential growth hit from a renewed trade war as a risk rather than as our baseline. But trade policy uncertainty has already begun to rise, which could start to dampen confidence in Europe even before the election outcome is known.

On the security front, Trump expects European countries to spend at least 2% of GDP on defense, as required of NATO members. And should Trump end US military aid to Ukraine, we estimate that Europe would need to spend an additional 0.5% of GDP on defense annually. This increased spending should boost growth. But modest military spending multipliers in Europe and upward pressure on long-term yields from the resulting higher deficits would likely limit this boost.

Jenny Grimberg: Could the dimmer growth outlook and other looming risks lead the ECB to cut more/faster?

Jari Stehn: It's possible. The ECB has not provided specific guidance on the next rate cut, likely reflecting continued stickiness in underlying inflation. But early wage indicators for Q2 have weakened, with recent ECB surveys pointing to additional cooling into next year. That, along with our lower growth forecasts, leaves us more confident that the ECB will cut again in September and December. However, renewed growth risks also raise the likelihood of sequential cuts, especially in 1H25. Taylor rules point to additional cuts worth 30-40bp if Trump is reelected and implements his proposed tariffs, reflecting the large hit to growth that more than outweighs the modest increase in inflation. So, we now see a 30% chance of faster ECB cuts, which puts our probability-weighted path for the policy rate well below market pricing.

At the same time, US tariffs would likely *weaken* the case for Fed cuts given the relatively smaller US growth hit and larger US inflation boost we anticipate, so trade tensions could lead to greater monetary policy divergence between the US and Europe. While such divergence isn't concerning in and of itself, the bigger growth hit in Europe vs. the US that it reflects is worrying. After the last two years of stagnation, Europe needs a growth pick-up to have any hope of closing its output gap with other countries, or else risks falling further behind.

Jenny Grimberg: What is the market missing that is leading it to underprice ECB cuts?

Jari Stehn: Many investors are skeptical that further progress on disinflation will occur. While we similarly don't expect much progress in the near term, we remain fairly confident that inflation will return toward target next year, and believe the ECB is more inclined to be forward-looking on that front than many appreciate. Investors are also interpreting the ECB's lack of forward guidance as an unwillingness to cut further, but this is likely more a function of their communication strategy than of a belief that inflation progress has stalled. Indeed, recent comments from ECB officials indicate growing confidence that wage growth will decline significantly next year. And, with respect to growth, investors seem to be underestimating the downside risk of a renewed trade war, which we believe is the key risk that could motivate the ECB to deliver sequential cuts.

Jenny Grimberg: Beyond the cyclical challenges, Europe also appears to be grappling with several structural issues. How concerned are you about Europe's structural outlook?

Jari Stehn: Europe is indeed facing a battery of structural challenges. It has made good progress on addressing some of these, such as short-term energy shortages, but several others will increasingly weigh on Europe's economy over the longer term. Europe's population is aging even more so than many other developed countries. Strong immigration—largely from Ukraine—has mitigated these demographic issues, but with that now near its peak, Europe's demographic situation is set to deteriorate rapidly, which will undoubtedly weigh on growth.

Europe is also in a difficult fiscal position. EU fiscal rules put pressure on countries to pursue fiscal consolidation. But Europe will also need to make significant investments in defense, the climate transition, etc. ahead, though the EU's fiscal goals may constrain such efforts. And, of course, the trade risks we've discussed will also matter structurally, as they would weigh further on productivity in Europe if they impede Europe from importing productivity-enhancing technology and innovation from the US and beyond. These structural challenges lead us to expect only ~1% potential growth for the Euro area, well below the close to 2% we estimate for the US.

Jenny Grimberg: How could the outcomes of the recent European Parliament and French elections affect fiscal consolidation efforts?

Jari Stehn: While the far-right gained seats in the European Parliament following the June elections, the center-left to center-right coalition retained its majority, which suggests relatively limited implications for the EU fiscal outlook. The outcome of the French snap elections, however, is more concerning. While the election did not bring about a far-left or far-right majority that could have led to a significant shift in fiscal policy, it did result in a hung parliament that entrenches France in policy gridlock. As a result, in France we now expect a slower pace of fiscal consolidation and continued rise in the debt-to-GDP ratio, which flies in the face of EU fiscal rules. Fiscal slippage in France could also act as a catalyst for slower consolidation in other EU countries, most notably Italy, which the European Commission has also reprimanded for its excessive deficit.

Jenny Grimberg: What could the recent elections portend for further progress on fiscal/economic integration?

Jari Stehn: Further steps toward integration will likely proceed only gradually. France has traditionally forcefully pushed for greater European integration, but its policy gridlock will likely limit these efforts. And with a similarly fragmented political landscape in Germany—the other strong voice for European integration—the EU lacks a strong pro-Europe force to push for further integration, at least until more political clarity emerges in these countries. This will be consequential for several initiatives long in the works, including the Capital Markets Union (CMU), joint defense financing, and potential successors to the EU Recovery Fund, which could all see progress stall.

Jenny Grimberg: What could the recent return to a Labour Party-ruled government in the UK for the first time in over a decade mean for the UK's policy and growth outlook?

Jari Stehn: Labour will be constrained by the same fiscal rule as the previous government that targets a reduction in the debt-to-GDP ratio in the fifth year of the Office for Budget Responsibility's forecast, which limits fiscal space but does allow for a different composition of fiscal policy. We expect more spending and somewhat higher taxes than current government plans, which, on net, should provide a modest boost to near-term demand growth. So, we recently raised our 2025/2026 UK growth forecasts by 0.1pp to 1.6%/1.5%, which puts us significantly above consensus. Firmer demand will also likely result in marginally higher wage growth and inflation, though the magnitudes are small enough that the implications for the BoE will likely be limited. Several other Labour policies may also help boost longer-term growth, including planning reforms—which could support productivity—higher public sector investment, and closer trade ties with the EU. Given all that, we are constructive on UK growth and assets.

Jenny Grimberg: Given everything we've discussed, will Europe be in a better or worse place in the coming years?

Jari Stehn: All things considered, it's hard to be confident that the European economy will be in a better place in the years ahead. Reasons for optimism do exist, including a fading growth drag as the energy situation continues to improve and a further cooling of inflation. We also expect a small improvement in productivity over the near term as the labor hoarding that occurred post-Covid unwinds. The green sector will also likely be a source of growth, as it is well-positioned to benefit from the ongoing energy transition. And Europe's institutional setup is now more robust owing to the ECB backstop and the EU Recovery Fund.

However, as we've discussed, cyclical and structural challenges abound, and I am especially concerned about the possibility of a US-EU trade war, which would have a profoundly negative impact on Europe's economy, likely stifling growth for years to come. Even if such risks don't materialize, European growth likely still won't be outstanding given its structural issues and weak productivity growth. So, Europe will probably continue underperforming regions like the US in the years to come.

Interview with Jean Pisani-Ferry

Jean Pisani-Ferry is Senior Fellow at Bruegel and the Peterson Institute for International Economics. He previously served as Commissioner-General of France Stratégie, the ideas lab of the French government (2013-16), and Founding Director of Bruegel (2005-13). Below, he argues that Europe's longer-term success will depend on its ability to address several structural challenges, which it may lack the political capacity and fiscal space to do.

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

Jenny Grimberg: How would you characterize Europe's economic and political picture, and what challenges is the region facing on each of these fronts?

Jean Pisani-Ferry: The latest economic surveys indicate that European growth still lacks momentum. Things had improved over the past year, but monetary policy is still too cautious, especially as fiscal policy has turned restrictive. In an uncertain economic and geoeconomic environment, the economy may lack the momentum needed to face its headwinds. It is time for the ECB to bring some more clarity about the pace of interest rate declines. While concerns about the last mile are valid, I view the recent stickiness in services inflation and wages as cause for vigilance rather than worry. There is no need to question the data-driven approach that the ECB has followed.

Turning to politics, the situation has fortunately remained stable at the European level. While the far-right gained power in the European Parliament following the June elections, the center-right alliance remains the largest parliamentary group, and Ursula von der Leyen has been reappointed as EU Commission President with the support of the center-right, the center-left, the liberals, and the Greens. So, the political dynamics provide some short-term relief, and the prevailing coalition is likely to prove strong enough to face economic and geopolitical challenges. Europe's longer-term outlook is more concerning, as the region is facing several structural challenges that I am worried it lacks the political capacity to tackle.

Jenny Grimberg: Risks for Europe could grow should Trump win the US election and implement the tariffs and foreign policy shifts he's signaled. Does that worry you?

Jean Pisani-Ferry: The 10% across-the-board tariff Trump has proposed is concerning, but more so for the US than the EU. It probably wouldn't have major negative implications for Europe over the short term. The US accounts for around 20% of EU exports, so the tariff would apply to only a fraction of Europe's foreign trade. And while an across-the-board tariff would be novel, Europe has already lived through a Trump Administration with all its bluster vis-à-vis external trade. The medium-term implications could be more severe, as a US turn toward isolationism would destroy what remains of the rules-based global order and would prove extremely costly for Europe.

But the potential foreign policy shifts under a Trump presidency are the more immediate worry. Ukraine's ability to prevail in its war against Russia will partly depend on domestic factors such as army fatigue levels, but also crucially on the amount of external support Ukraine receives, which may significantly decline if Trump is elected. And Europe isn't yet prepared to step in and fill the gap that the US would leave.

Jenny Grimberg: What structural issues leave you concerned about Europe's longer-term outlook?

Jean Pisani-Ferry: Enrico Letta's Single Market report and what we know of the key points of the competitiveness report that Mario Draghi will soon present to the EU Commission have illuminated three major challenges facing Europe: productivity, economic security, and the climate transition.

The productivity challenge has been well-documented: Europe's productivity growth is dismal compared to the US', partly owing to Europe's failure to develop innovative small companies into large firms, especially in the high-growth tech sector that drive aggregate productivity gains. The pandemic, Russia-Ukraine war, and increased tensions between the West and China have also shed light on Europe's economic vulnerabilities and underscored the need for the region to rethink its economic security strategy. And the EU faces climate competitiveness problems on several fronts, including high energy prices, an uneven playing field between it and countries whose decarbonization efforts are based on different instruments, such as the Inflation Reduction Act (IRA) in the US, and little progress on building a green industrial base, all of which complicate Europe's path toward achieving carbon neutrality. And my greatest concern is that Europe lacks the proper political conditions to effectively tackle these challenges.

Jenny Grimberg: But, as you said, the centrist alliance retained its majority in the European Parliament and the far-right won only third place in the French elections. Do you take any comfort from those outcomes?

Jean Pisani-Ferry: A few weeks ago, the baseline scenario was that the far-right would gain a blocking minority in Europe and would be put in charge of governing France. Neither of these fears have materialized. But the underlying factors behind the rise of the far-right remain. A significant share of EU voters feels unsettled and disoriented. Left-out citizens want their leaders to listen to them and address their day-to-day problems, not tackle longer-term issues that they may perceive as more aspirational, which makes it difficult to make progress on some of Europe's structural challenges. The problem is that the agenda for economic action has largely taken shape but that political conditions are not auspicious to action.

Jenny Grimberg: So, what actions should European leaders take now to improve the region's economic prospects?

Jean Pisani-Ferry: Europe's leaders should forget about the "nice to have" and focus on initiatives that can quickly unleash investment and deliver concrete gains. The priority should be decarbonizing the energy system. Energy is hard because it is a national prerogative at its core, but it must be addressed because it is a key component of Europe's lost competitiveness. More progress on decarbonization would not only help improve its competitiveness but also improve weakened household budgets by allowing Europe to move beyond the expensive LNG it has substituted for cheap Russian gas toward renewables that will eventually be less costly.

Leaders should also pursue further economic and financial integration through the Capital Markets Union, now known as the Savings and Investment Union. Such integration would enable innovative companies to develop and obtain the funding necessary to achieve scale. And leaders should remain attuned to their population and act to remove well-identified irritants such as poorly functioning public services or the sense of unease associated with uncontrolled immigration. In other words, they should aim to improve economic performance without alienating citizens. In practice, that likely means more integration when it matters, and less when it doesn't. It's all about balance.

Jenny Grimberg: Even with these steps, how vulnerable would the European economy remain to external risks?

Jean Pisani-Ferry: Risks would remain, which requires a reassessment of Europe's economic security strategy. Such a strategy should aim to prevent and mitigate disruptions to critical imports, economic coercion through export restrictions, and broad disruptions to global trade that have significant macroeconomic impacts. The first step toward achieving this security is identifying critical import dependencies, which is no easy task. However, substantial progress has been made on this front in recent years, with Mejean and Rousseaux finding that the EU is import-dependent on 49 products across the energy and mining, construction, textile, and health sectors, with these products accounting for 0.5% of the total value of the EU's aggregate imports.

However, the diagnosis of risks remains incomplete, with export and financial vulnerabilities not yet well understood. And policy instruments put in place to reduce trade dependencies are imperfect. EU-level instruments are generally weak, EU-level funding for policies aimed at expanding domestic capacity is limited, and national policies come with coordination problems. So, much remains to be done to identify and reduce Europe's economic vulnerabilities. And threading the needle between strengthening economic security and remaining open to trade—which still provides an important hedge against domestic disruptions—will be difficult. Many countries have fallen into the trap of responding to trade risks by turning more inward, but leaders should again strive for a balance between openness and protection, and Europe's pivot toward economic security should not become an excuse for protectionism.

Jenny Grimberg: In this context, how should Europe's relationship with China evolve?

Jean Pisani-Ferry: The EU should seek to limit its overall trade dependency on China's market as part of its economic security objectives. However, this should not take the form of a hard decoupling, which would be very costly. Baqaee et al. recently estimated that, in a hard decoupling scenario, Germany's output could decline by 3-5% of GDP, and possibly more. While Germany would suffer the most due to its deep China ties, the hit to other EU economies would also be significant.

Fortunately, Europe intends to pursue a *de-risking* rather than *decoupling* strategy with respect to China. Unlike the US, which seeks to retain its status as the dominant global power, Europe is no longer in the game of global dominance. So, it doesn't view China as a rival, though it generally remains vigilant about any potential threats from China. The differences between the US and European strategies are visible in their respective approaches toward Chinese electric vehicles (EVs). While the Biden Administration has imposed prohibitive tariffs on Chinese EVs, essentially with the intention of decoupling the US' green sector from China, Europe has only levied tariffs equivalent to the unfair advantage resulting from China's domestic EV subsidies. Such a de-risking strategy will undoubtedly prove much less costly for Europe's economy than decoupling, especially if pursued gradually.

Jenny Grimberg: Does Europe have the fiscal space necessary to address its structural issues?

Jean Pisani-Ferry: Europe's fiscal framework unfortunately doesn't make allowances for the investments required to strengthen the region's security and defense and accelerate the green transition. The EU Treaty requires EU states to keep budget deficits below 3% of GDP, with the aspirational aim of bringing public debts below 60% of GDP. Consistent with this, a new framework to enforce fiscal responsibility was put in place at the beginning of the year. It assesses each country's debt sustainability based on various factors, including potential growth, and uses that to determine the necessary fiscal adjustments a country must make. The framework helpfully allows for a more gradual fiscal adjustment for countries who undertake reforms and investments that structurally improve their growth outlook. Despite numerical safeguards introduced at Germany's request, this is a positive development.

But some priorities, such as improving energy competitiveness and strengthening defense, have little to do with growth, and policymakers missed an opportunity to strike a better balance between fiscal discipline and these priorities in crafting the new framework. I am not advocating for an open door on spending painted green or khaki. But these priorities deserved special treatment in the fiscal rules given their importance. Without it, solving Europe's structural problems becomes even harder.

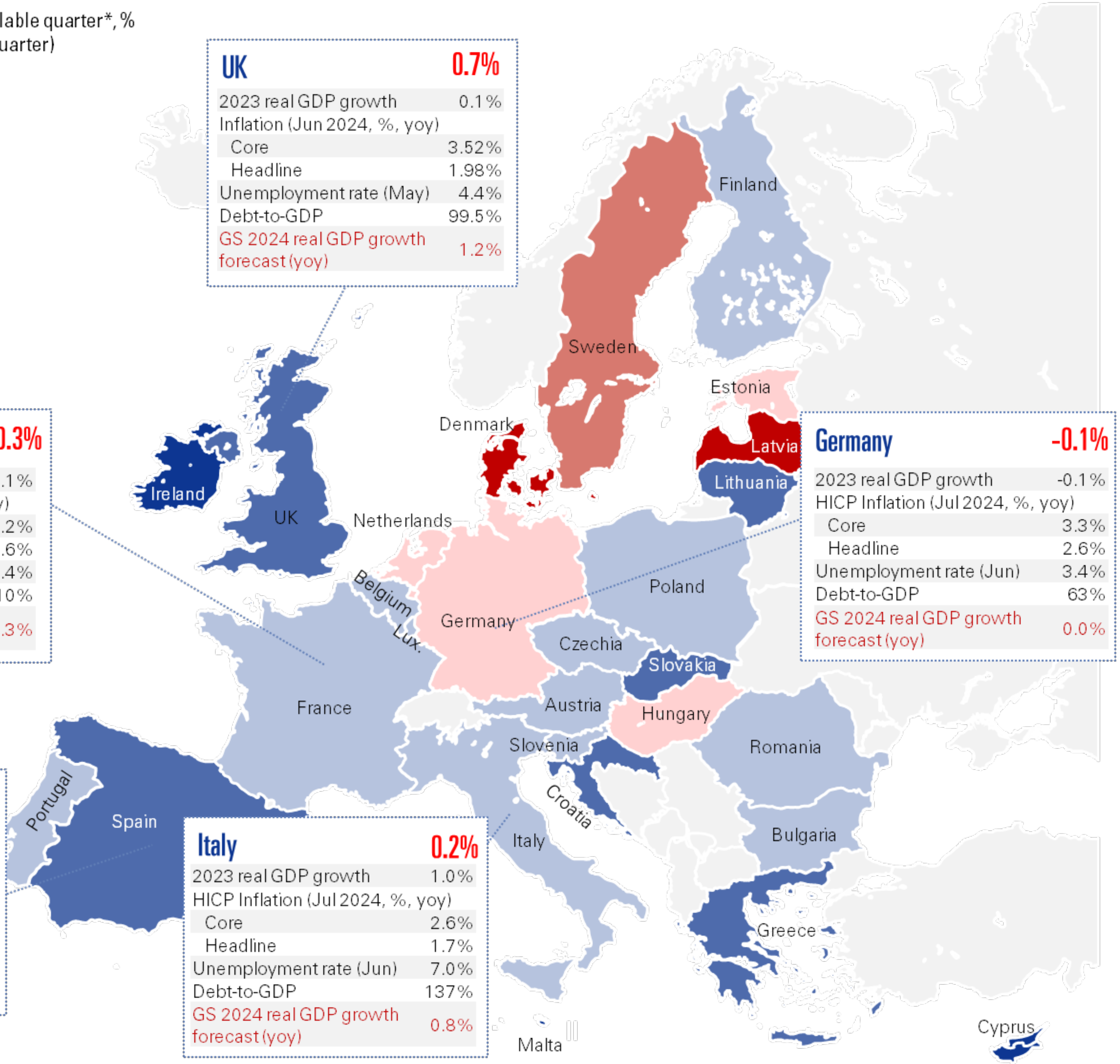
Jenny Grimberg: Given everything we've discussed, how worried are you about the future of the European project?

Jean Pisani-Ferry: Europe will be in serious trouble if it doesn't start addressing its structural challenges. The European project is ultimately unsustainable if it can't improve competitiveness and deliver growth. Leaders must focus on improving the region's productivity, strengthening its economic security, and moving ahead with the green transition, and the worst thing that could happen to Europe would be inertia on all fronts. Encouragingly, awareness of these challenges has grown substantially over the last several years. But awareness is only the first step. Europe must now muster the ability and willingness to solve its issues, which is far more challenging.

European growth, mapped out

Quarterly real GDP growth (latest available quarter*, % change compared with the previous quarter)

- >1.5%
- 1.1-1.5%
- 0.6-1.0%
- 0.0-0.5%
- -0.1% to -0.5%
- -0.6% to -1.0%
- <-1.0%



UK 0.7%

2023 real GDP growth	0.1%
Inflation (Jun 2024, %, yoy)	
Core	3.52%
Headline	1.98%
Unemployment rate (May)	4.4%
Debt-to-GDP	99.5%
GS 2024 real GDP growth forecast (yoy)	1.2%

France 0.3%

2023 real GDP growth	1.1%
HICP Inflation (Jul 2024, %, yoy)	
Core (% chg, yoy)	2.2%
Headline (% chg, yoy)	2.6%
Unemployment rate (Jun)	7.4%
Debt-to-GDP	110%
GS 2024 real GDP growth forecast (yoy)	1.3%

Germany -0.1%

2023 real GDP growth	-0.1%
HICP Inflation (Jul 2024, %, yoy)	
Core	3.3%
Headline	2.6%
Unemployment rate (Jun)	3.4%
Debt-to-GDP	63%
GS 2024 real GDP growth forecast (yoy)	0.0%

Spain 0.8%

2023 real GDP growth	2.5%
HICP Inflation (%, yoy)	
Core (Jun 2024)**	3.0%
Headline (Jul 2024)	2.9%
Unemployment rate (Jun)	11.5%
Debt-to-GDP	108%
GS 2024 real GDP growth forecast (yoy)	2.7%

Italy 0.2%

2023 real GDP growth	1.0%
HICP Inflation (Jul 2024, %, yoy)	
Core	2.6%
Headline	1.7%
Unemployment rate (Jun)	7.0%
Debt-to-GDP	137%
GS 2024 real GDP growth forecast (yoy)	0.8%

*Quarterly GDP figures for Belgium, Czechia, Germany, Ireland, Spain, France, Italy, Latvia, Lithuania, Hungary, Austria, Portugal, and Sweden are 2Q24, all other countries are 1Q24.
**July core inflation data not yet available.
Source: Eurostat, Haver Analytics, Goldman Sachs GIR.

Snapshot: European macro asset views

Given Europe's macroeconomic and political/geopolitical backdrop and the risks to it, what's the outlook for your asset class?

Rates—Core EUR and sovereign spreads

George Cole and Simon Freycenet

- **Core EUR rates.** Risks to core rates in Europe are skewed to the downside, especially in the front-end of the curve. European survey data has been weakening and our Current Activity Indicator is once again in negative territory. Meanwhile, the ECB remains focused on inflation risks and has been unwilling to commit to a full-throated easing bias. And while political uncertainty in France has receded as a Euro area-wide issue, it is likely to remain a modest drag on French growth. These factors, together with a possible deterioration of the trade environment under a Trump presidency, suggest that European front-end yields will likely continue to fall, and that the market is underpricing ECB cuts; we expect four cuts in 2025 vs. current market expectations of three cuts.
- **Sovereign spreads.** The results of the French election were modestly constructive relative to the significant risk premium priced into OAT-Bund spreads in the run-up to it, with the outperformance vs. polls of President Macron's allies suggesting any stable coalition will need to include the center. This outcome should limit the risks associated with expansionary fiscal policy and offer Macron more leeway to steer foreign policy. However, medium-term headwinds remain. A hung parliament leaves France little room to pursue debt consolidation, which, combined with uncertain international investor appetite, point to a de-rating of French credit against Euro area peers. Strong Spanish fundamentals suggest that Bonos stand to win the most from a reallocation away from French debt. That said, given that political risk will likely remain contained to France, we also see room for compression in other semi-core sovereign spreads, such as Belgium, Finland, and Ireland.

FX—Euro

Michael Cahill

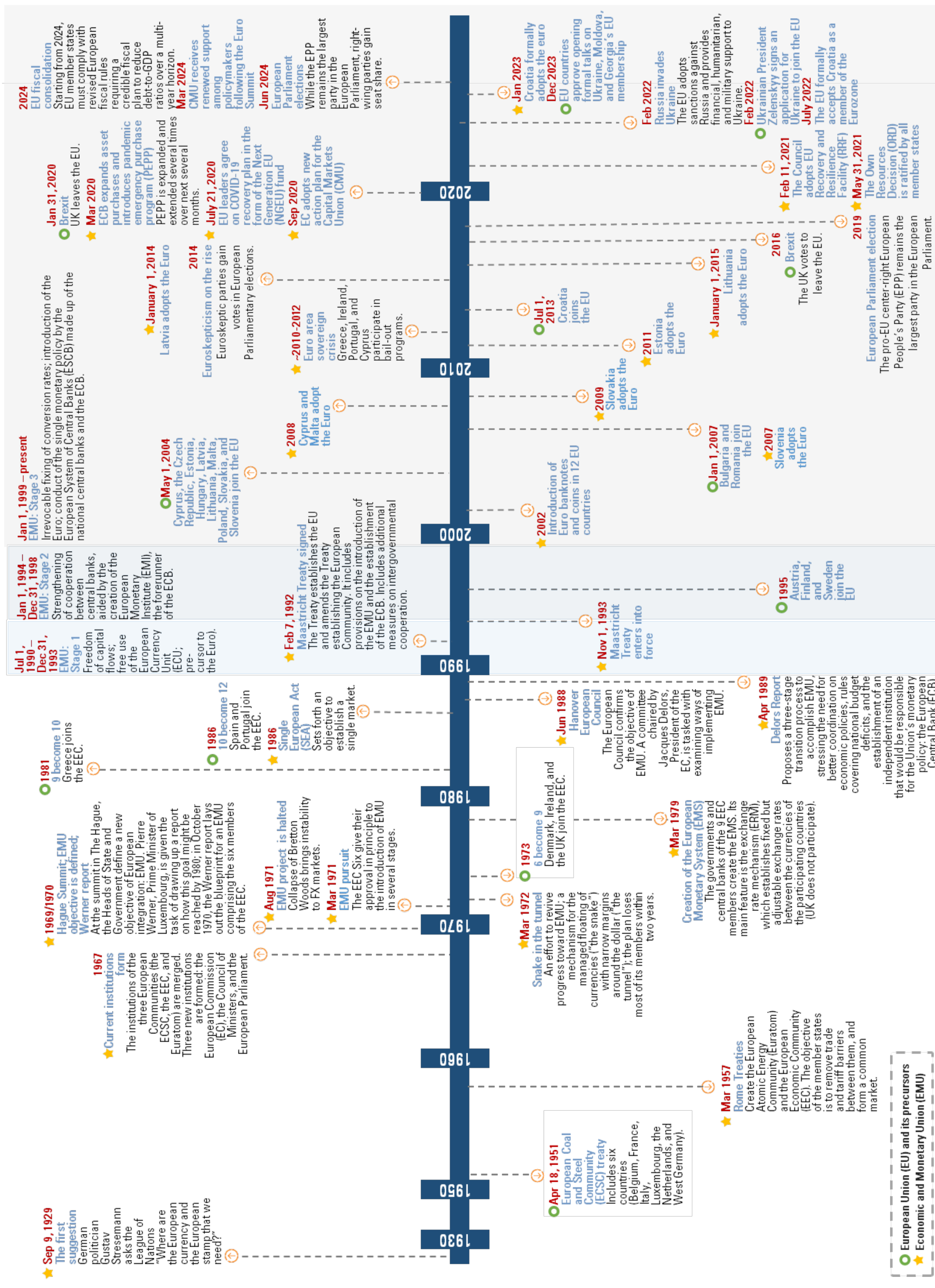
- The Euro has been undervalued against the Dollar for close to a decade as measured by economic differentials, the trade balance, and the long-run average of the exchange rate. We find that this undervaluation coincides with a material shift of portfolio flows out of the Euro area and into the US. In short, investors of all types—including central bank reserve managers, government pension funds, asset managers, and hedge funds—have sought higher and relatively more stable returns outside of Europe.
- During this period, the Euro rose closer to 'fair value' on two occasions: in 2017 and 2020. Both occasions were marked by rising global growth optimism following policy stimulus in Europe and China. The durability and extent of the Euro's climb in both episodes surprised us because it outpaced the relative shift in other asset classes like equities and rates. With hindsight, we find that large, unhedged cross-border flows back into European assets drove the currency's outperformance. Stronger global growth outturns help to bring currency markets back into balance.
- Looking ahead, a significant shift in the outlook will be required for the Euro to climb again as it did at the beginning and end of Trump's first term. The threat of tariffs under a potential second Trump term will create uncertainty and likely weigh on cross-border investment. This is what happened in 2016 and the 2018/19 trade war. The Euro could benefit from a strong fiscal policy response around the world to potential tariffs, which we think is the most plausible path to something resembling a "currency pact." But if Europe cannot find a way to kickstart its economy and more closely match US investment returns, then the Euro will continue to underperform, which we think is the more likely outcome.

Credit—EUR IG and HY

Lotfi Karoui

- As optimism over the European growth outlook has faded in recent weeks, several headwinds have resurfaced, including the ongoing growth slowdown in China, potential tariff risks under a Trump Administration, and a hung parliament in France that bodes poorly for the pace of fiscal consolidation and the country's relationship with European institutions. But more than halfway through the year, the EUR corporate bond market has remained unfazed by these macro headwinds. In fact, excluding the contribution of rates, both the EUR IG and HY markets have outperformed their USD peers year-to-date.
- Two factors have fueled this resilience in the face of rising macro uncertainty. First is the strength of investor demand and the asset class' attractive value proposition from an "all-in yield" standpoint. Second is the benign backdrop for corporate financial distress. Indeed, the iTraxx Crossover index—a widely followed EUR index of mostly high yield-rated firms—has yet to experience one default in this cycle. Given the lower sensitivity of credit to fluctuations in domestic and global growth—certainly relative to the equity market—we think this resilience can extend. Barring a full-blown Euro area recession, which is not our economists' baseline view, we expect spreads to remain within their recent range.

A history of European integration

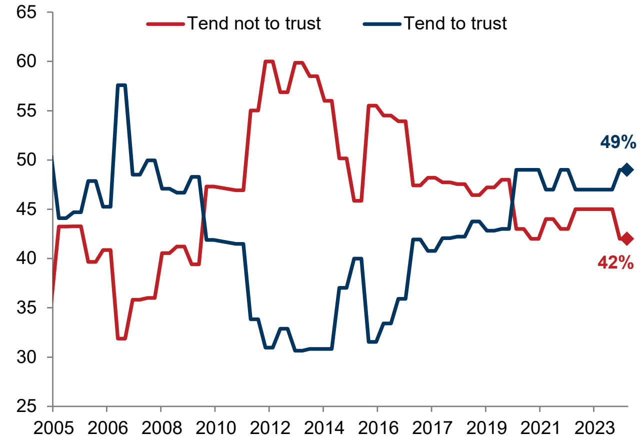


Source: ECB, European Commission, Europa, European Council, European Union, Goldman Sachs GIR.

The state of EU public opinion

Trust in the European Union (EU) has risen in the decade since the European sovereign debt crisis…

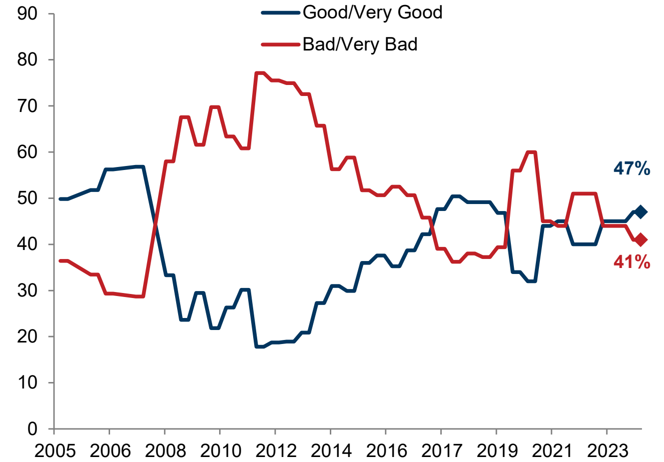
Trust in the EU, % of respondents



Note: Question asks respondents if they tend to trust or tend not to trust the European Union.

…and relative to both the debt crisis and Covid-19 pandemic, EU citizens feel like the European economy is in a better place

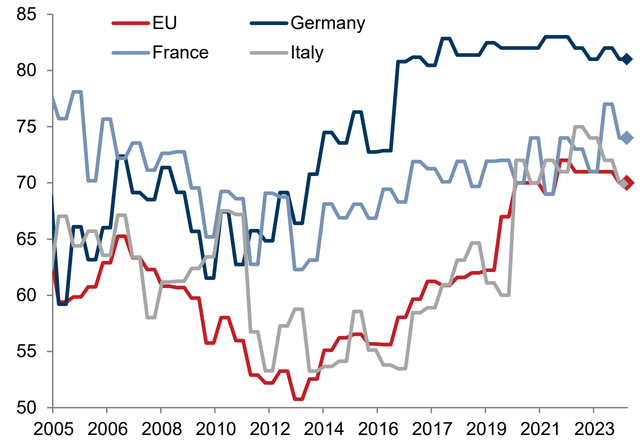
Perception of the European economy, % of respondents



Note: Question asks respondents how they would judge the current situation of the European economy.

Support for the Euro has also grown substantially over the last decade, stabilizing at relatively high levels

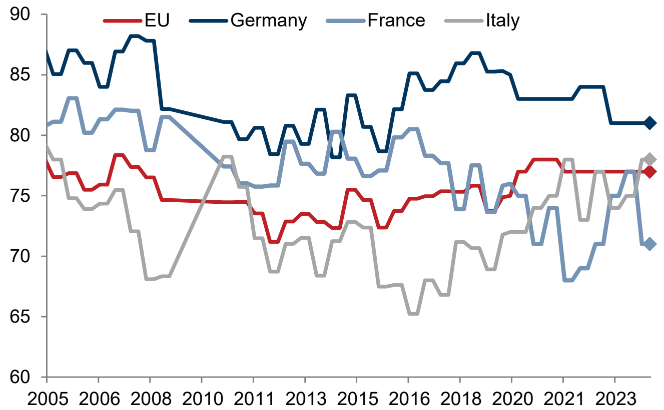
Support for Euro, % of respondents



Note: Question asks whether respondents are for or against a European economic and monetary union with one single currency, the Euro.

And citizens generally support a common defense and security policy among all EU member states, though the support from larger countries in the EU has declined recently

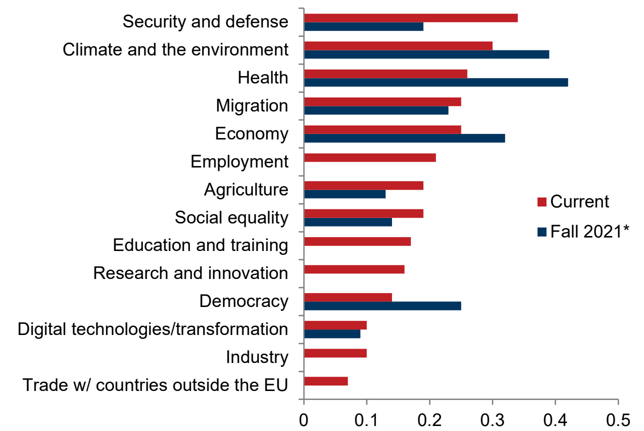
Support for common EU defense and security policy, % of respondents



Note: Question asks whether respondents are for or against a common defense and security policy among EU Member States.

Defense and security are at the top of citizens' priority lists for the EU, rising in importance since before Russia's invasion of Ukraine

Most important issue for the EU, % of respondents

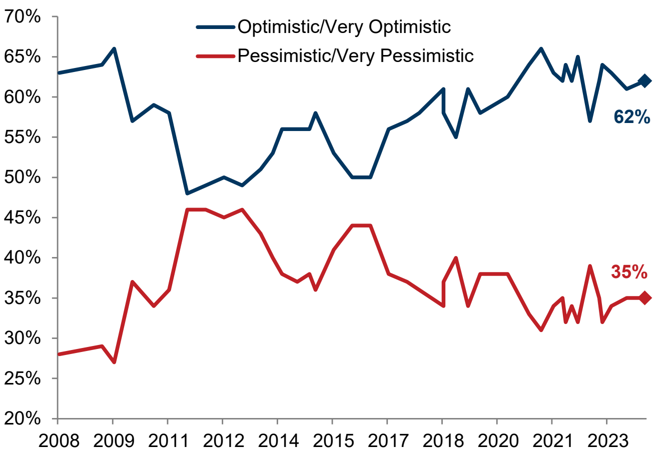


**Not all categories were included in the Fall 2021 survey.*

Note: Question asks which of the above areas should the EU take measures on in the medium term, i.e. in the next five years. Doesn't sum to 100 because respondents asked to pick multiple issues.

Citizens generally feel optimistic about the future of the EU, with optimism gradually rising since the Euro area sovereign debt crisis

Optimism/pessimism about the future of the EU, % of respondents



Note: Question asks respondents if they are very optimistic, fairly optimistic, fairly pessimistic, or very pessimistic about the future of the EU.

Source for all exhibits: European Commission (Eurobarometer), compiled by Goldman Sachs GIR.

Interview with José Manuel Barroso

José Manuel formerly served as President of the European Commission (2004-14) and Prime Minister of Portugal (2002-04). He is Chairman of International Advisors at Goldman Sachs. Below, he argues that, despite the rise of nationalism in many European countries, the overarching trend in Europe remains toward more integration, especially on defense.

The interviewee is an employee of the Goldman Sachs Executive Office Division, not Goldman Sachs Research, and the views stated herein reflect those of the interviewee, not Goldman Sachs Research.

Allison Nathan: How concerning is the shift in Europe's political landscape following the recent European Parliament elections for the future of Europe?

José Manuel Barroso: The outcome was not as extreme as many people predicted. Pro-European forces retained a clear majority, with the center-right European People's Party (EPP) increasing its number of seats. But the far-right parties, including France's National Rally, gained enough seats to become the third largest group in the Parliament. In France, the rise of the far-right subsequently faltered, with Marine Le Pen's National Rally coming in only third in the snap legislative elections that soon followed the European Parliament elections, which underscores the complexity of the situation. But, even so, the rise of political extremism no doubt presents a challenge for Europe. That owes less to the actual degree of extremism—European politics are arguably less polarized than US politics as the recent shocking events and rhetoric in the run-up to this year's US presidential election demonstrate—and more to the nature of the EU as a supranational institution. This leaves the EU particularly vulnerable to surges in nationalism because each surge has the potential to put in question the very existence of the European Union, whereas even the most nationalistic elements in the US don't seem to threaten its existence.

That said, even in the EU context, more nationalism, while representing a real challenge and danger for the EU, does not necessarily conflict with a further strengthening of the Union. This is counterintuitive but has been the reality; even with nationalism on the rise in many EU countries, European integration has moved forward in spectacular ways in recent years. For example, Europe's pandemic response included—for the first time ever—debt mutualization. The European Commission established an €800bn recovery fund package, known as NextGenerationEU, to help member states recover from the pandemic, with the package financed through the joint issuance of common debt bonds. When I was attempting to address the Global Financial Crisis and the Euro area sovereign crisis during my tenure as European Commission President, Germany and others refused to undertake such debt mutualization, so this was remarkable progress.

And, in response to Russia's invasion of Ukraine in 2022, the Commission established a peace facility that buys weapons for Ukraine, with further defense integration no doubt lying ahead, both in terms of common capabilities and common procurement. Even some of the most nationalistic parties and governments, like the right-wing populist Law and Justice (PiS) party that was, until recently, in power in Poland, or the current ruling Brothers of Italy party led by Prime Minister Giorgia Meloni in Italy, are champions of a common defense for Europe given concerns about Russian aggression. So, the issue of European integration in the context of evolving national political landscapes is complex and should not be oversimplified.

The reality is that despite worries about the rise of political nationalism and extremism in Europe, external factors—namely, a much more aggressive Russia, a more assertive China, and a more unpredictable US—are likely to continue pushing the Union toward more—not less—integration over the medium term. And that applies not only to the European Union, but also to the United Kingdom, which is also increasingly grappling with the prospect of less US support and protection and, in turn, the need to bolster European defense. This is truly a major development; I've worked with NATO since the 1980s as Deputy Foreign Minister and Foreign Minister of my country, and this is the first time in my lifetime that Europeans are thinking seriously about their common defense.

Allison Nathan: Does the less extreme outcome of the French election compared to the EU elections signal that the European Parliament just doesn't matter that much?

José Manuel Barroso: The European Parliament is important, as it is a directly-elected body, which provides legitimacy. But it is a distant entity. Among the 27 EU member countries that have nearly as many official languages, most European voters are unaware of the European Parliament's work, so it does not wield the same influence as, say, national parliaments or the US Congress that are closer to voters, and does not play a critical role in driving the EU's policy direction. Rather, the power in Europe's institutions lies with the European Council, which is comprised of the heads of governments of all EU member countries and decides the overarching strategy for the direction of the EU, and with the Commission, which is the executive body. Case in point: when the European Commission proposes legislation, if the national governments accept it, the European Parliament almost always does too after some negotiation and possible amendments. So, the Parliament plays an important but not really decisive role.

Allison Nathan: With that in mind, do the political and economic challenges facing the largest EU countries with the most influence over the European Council and the direction of EU policy—France and Germany—worry you?

José Manuel Barroso: Of course, the weakening of these important countries also weakens the Union. But we must put these countries' challenges into perspective. As discussed, the far-right party in France that is critical of the pro-European consensus came in third in the recent legislative elections, and President Macron, who represents France in the European Council, will retain his status until the next presidential election in May 2027. Nobody knows what will happen at that point. If a country like France elects a leader that clearly opposes the European Union, that would certainly be a decisive moment and potentially lead to a meaningful shift in the EU's policy direction, but that's not the situation today. As for Germany, the current ruling coalition, while contending with daunting economic challenges, low popularity, and internal disagreements, remains strongly pro-European and Germany will, with this and the next government, no doubt maintain a European orientation.

All told, of the 27 countries in the EU today, only two governments can be classified as "Euroskeptics": Hungary and Slovakia. But with all due respect to those countries, they don't have the weight to seriously challenge the European Union's path toward integration, as clearly demonstrated by, for example, the EU's unwavering support for Ukraine despite Hungarian Prime Minister Viktor Orban's constant objections. So, yes, challenges exist, but the European Union is more resilient than most people usually acknowledge. Remember that the conventional wisdom during the sovereign debt crisis was that Greece would leave the Euro. Even Nobel Prize-winning economists expected this. But they were wrong. The EU was able to resist those threats to its dissolution and the Euro remains the second most important global currency after the Dollar. All in all, the overarching trend in Europe remains toward integration rather than disintegration.

Allison Nathan: What are people missing that leads them to underestimate Europe's resiliency?

José Manuel Barroso: People tend to underestimate the depth of the economic linkages between EU countries. Even though a far-left Euroskeptic government came to power in an EU member country—Greece—for the first time in the mid-2000s, the country found that it had no alternative but to support the European Union, and European countries had no alternative but to support Greece, given the degree of economic integration. For example, a car made in Germany may use components from 14 European countries, so they are really "European" cars rather than "German" cars. And the supply chains of many companies based in northern Italy are more closely integrated with companies in Germany than with companies in southern Italy, while companies in western Germany are more integrated with companies in northern Italy than in eastern Germany. So, Germany quickly came to the aid of northern Italy when the pandemic began there, because not doing so would have spelled economic disaster for Germany. This economic integration is precisely the point of—and largely explains the success of—the EU to date, but is often underappreciated by observers both inside and outside the EU. The interests and incentives for the Union to remain united are very strong, which leaves me confident that it will remain so.

Allison Nathan: But wasn't that also true for the UK? So, does Brexit give you cause for concern?

José Manuel Barroso: When David Cameron told me, as European Commission President, that he planned to hold a referendum on the UK's exit from the European Union, I told him that was a mistake if his end-goal was for the UK to remain part of the EU, because when you criticize the EU from Monday to Saturday, you can't expect people to vote to remain part of it on Sunday. But he disagreed, and Brexit was the outcome. So, Brexit was a lesson in how costly mistakes of political judgment can be. Of course, it's possible that something similar could happen with another European country. But at present it's unlikely. Public opinion polls in Europe show that support for the European Union is currently higher than before Brexit in all countries, even in countries where the government is critical of the EU. So, Brexit has proven more of a vaccine than a virus for the EU.

Allison Nathan: Is Labour's landslide victory in the recent UK election likely to alter the UK-EU relationship?

José Manuel Barroso: I was in touch with members of the "Shadow Cabinet" before this Government was formed and it seems committed to resetting the relationship. But this will likely be a pragmatic reset rather than the UK asking to rejoin the EU or even the customs union or the single market. The new Prime Minister Keir Starmer is broadly considered to be a credible leader with a real mandate and a reliable partner. So, I expect more and sincere cooperation in key areas where UK-EU incentives are aligned, such as defense. Of course, the degree and urgency of increased cooperation on defense will largely depend on the outcome of the US election. If Trump wins, the UK and EU will likely move closer on European defense and all areas related to national security.

Allison Nathan: Even if Europe has shown resiliency up to now, is it really up to the task of meeting the geopolitical, security, and economic challenges that may lie ahead?

José Manuel Barroso: Yes, because Europe has no choice but to meet these challenges. It's true that Europe currently lacks sufficient integration on defense to face Russia on its own, so NATO is essential to European security. But a total paradigm shift has been taking place whereby virtually all northern European countries and beyond are actively thinking about Europe's common defense against the threat of further Russian aggression. So, while Europe is not ready to face this threat alone today, and NATO is and will remain indispensable, Europe will grow in defense identity and capabilities. As demonstrated by the European energy crisis that followed Russia's invasion of Ukraine—which European leaders ultimately navigated better than expected—the EU tends to be more reactive than proactive. But it's able to make the tough decisions when necessary.

All that said, the core problem Europe faces remains an economic one. It continues to lack the growth mindset of the US and lags the US and China in investment in the critical areas of technology and science. For Europe to continue to thrive, it must become more serious about its own productivity and competitiveness and gain "scale" in its economy and businesses. In particular, Mario Draghi's upcoming competitiveness report will certainly identify areas, like the pandemic response and defense, where European integration has progressed, but also a key area where it has not—the internal market. The fact that Europe still lacks a capital markets union—which the European Commission first attempted to launch under my leadership over a decade ago—is inexcusable. More progress must be made in this area for the European project to reach its full potential, but I remain hopeful that it will be.

The role of the European Parliament

AGENDA-SETTING

European Council (EUCO) – European heads of state

Composition	Appointment	Function and Workings
President of the European Council + 27 Leaders from all the EU member states + President of the European Commission	Members directly elected at the national level; Council President elected by Council members through qualified majority (55% of member states and 65% of EU population)	▪ Determines the EU's political direction and priorities ▪ Sets the EU's policy agenda ▪ Does not negotiate or adopt EU laws ▪ Decisions are usually made by consensus. However, in certain cases provided for in the EU treaties (such as the adoption of legal acts), the Council decides by vote, which requires a quorum (presence of 2/3 members)

The EUCO often guides EU-level priorities and legislation

LAWMAKING

European Commission (EC) – The EU's executive body

Composition	Appointment	Function and Workings
27 Commissioners, led by the Commission President	The President is proposed by the European Council and elected by the European Parliament Commissioners are nominated by the Council of the European Union in agreement with the presidential candidate and then voted on by the European Parliament	▪ The EC has the sole power to propose laws ▪ Monitors the implementation of these laws ▪ Manages the EU budget ▪ Represents EU interests on the global stage ▪ Decisions are generally made by consensus, but votes can also take place, which require a simple majority

Council of the European Union
Group of government ministers

Composition	Appointment	Function and Workings
The Council meets in 10 different configurations of 27 national ministers depending on the policy area discussed. The Presidency rotates every 6 months	Different parts of member state governments	▪ Part of the EU's legislative branch ▪ Represents the interests of EU member governments ▪ Negotiates and adopts new EU legislation ▪ Coordinates EU policies ▪ Approves the EU budget ▪ Decisions in most areas are made by qualified majority, though unanimity and simple majority voting also occurs

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

Composition	Appointment	Function and Workings
720 Members of European Parliament (MEPs) (currently) + EP President	MEPs are directly elected by EU citizens every five years The EP President is voted on by the MEPs	▪ Part of the EU's legislative branch ▪ Decides on new legislation proposed by the Commission ▪ Votes on new trade agreements and scrutinizes EU institutions ▪ Approves the EU budget ▪ Decisions are usually made by absolute majority

How European laws are usually made...

1. The Commission proposes a new law
2. The Parliament and Council of the EU approve the new law in a process called "co-decision"
3. The Commission and EU member states then implement the new law

The EU's other institutions

European Central Bank (ECB)

Administers the Euro area's monetary policy; primary objective is price stability

Appointment: The European Council officially appoints members of the ECB's Executive Board. The Parliament is consulted, but does not have formal say in the decisions.

Court of Justice of the European Union (CJEU)

Ensures EU law is applied/interpreted uniformly across the EU and settles legal disputes between national governments and EU institutions

Appointment: Judges and advocate generals in each of the two courts (Court of Justice & General Court) are appointed by national governments.

European Court of Auditors (ECA)

Looks after EU taxpayers' interests by ensuring that EU funds are collected and used correctly

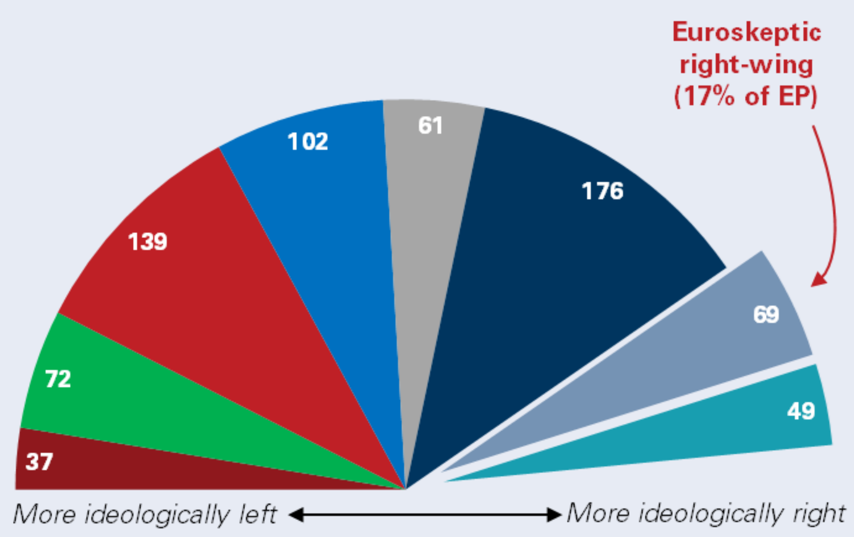
Appointment: Members are unanimously appointed by the Council of the European Union, with one member from each of the EU countries.

Source: European Union, Goldman Sachs GIR.

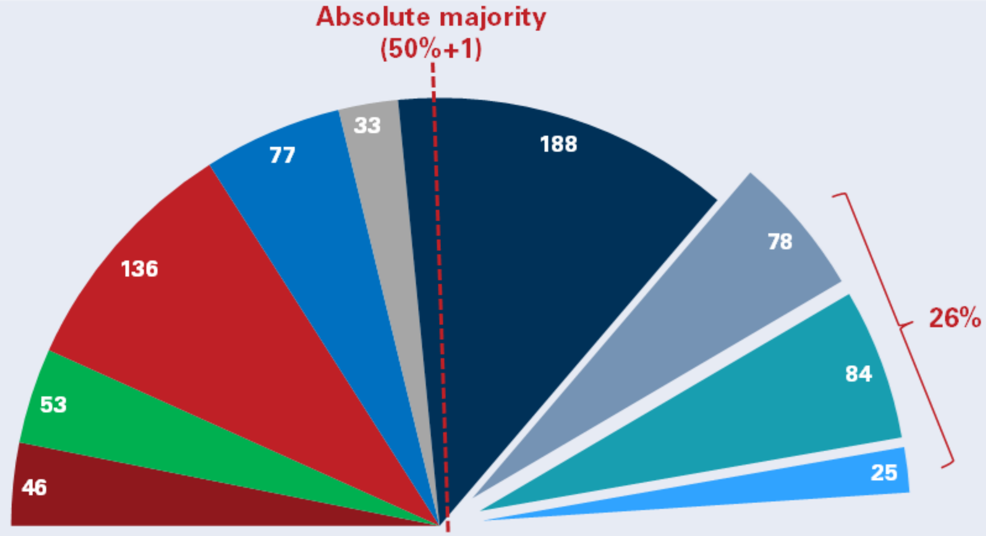
European Parliament breakdown

There are now 720 Members of European Parliament (MEPs), up from 705 MEPs in the outgoing Parliament*. Once elected, MEPs form parliamentary groups—similar to traditional political parties—based on ideology rather than on nationality.

Outgoing Parliament



New Parliament**



Groups

Share of New EP / Share of Outgoing EP

EPP 26% (25%) — **European People's Party:** Center-right, pro-European, comprised of Christian Democrats, Conservatives, and Liberal-Conservatives. Members currently come from Germany's Christian Democratic Union, Spain's People's Party, Poland's Civic Platform, and others.

S&D 19% (20%) — **Group of the Progressive Alliance of Socialists and Democrats:** Center-left, mostly comprised of Social Democrats. Members currently come from Spain's Socialist Workers' Party, Italy's Democratic Party, the Social Democratic Party of Germany, and others.

PfE 12% — **Patriots for Europe:** Right to far-right, sovereignist, Euroskeptic group formed ahead of the current (10th) European Parliament. The group includes mostly all the former members of the Identity and Democracy Party (which held 49, or 7%, of seats in the outgoing EP). Members come from France's National Rally, Hungary's Fidesz, Italy's League, and others.

ECR 11% (10%) — **European Conservatives and Reformists Group:** Right-wing, anti-federalist, and soft Euroskeptic. Members currently come from Brothers of Italy, Poland's Law and Justice, Romania's Alliance for the Union of Romanians, and others.

Renew Europe 11% (14%) — **Renew Europe Group:** Center to center-right, pro-European. The group succeeded the Alliance of Liberals and Democrats for Europe (ALDE), and is composed of the ALDE Party, the European Democratic Party, and L'Europe Ensemble.

Greens/EFA 7% (10%) — **Group of the Greens/European Free Alliance:** Center-left to left-wing, primarily composed of Green and Regionalist parties. The group currently consists of the European Green Party, Volt Europa, part of the European Free Alliance, and the European Pirate Party.

GUE/NGL 6% (5%) — **The Left in the European Parliament:** Far-left, composed mainly of Democratic Socialists, Communists, and parties with soft Euroskeptic orientations. Members currently come from France's La France Insoumise, Italy's Five Star Movement, Greece's Syriza, and others.

NI 5% (9%) — **Non-Inscrits:** MEPs who don't belong to any of the recognized political groups. Members currently come from Germany's left-wing Alliance Sahra Wagenknecht, Slovakia's fiscally center-left but socially right-wing Direction-Social Democracy, and others.

ESN 3% — **Europe of Sovereign Nations:** Far-right group formed after Germany's AfD MEPs were expelled from the Identity and Democracy Party shortly before the 2024 European Parliament elections. The AfD is the largest party within the group, which also includes Poland's New Hope, Bulgaria's Revival, and others.

**EU law allows for a maximum of 750 MEPs (not including the EP President). How many seats each EU Member State receives is decided before each election according to population and the need for a minimum level of representation. In Sept 2023, MEPs approved the European Council's decision to raise the number of seats in the Parliament by 15 for the 2024-29 term. **The new legislative term officially began on July 16, the first day of the new EP's first plenary session.*
Source: European Parliament, various news sources, Goldman Sachs GIR.

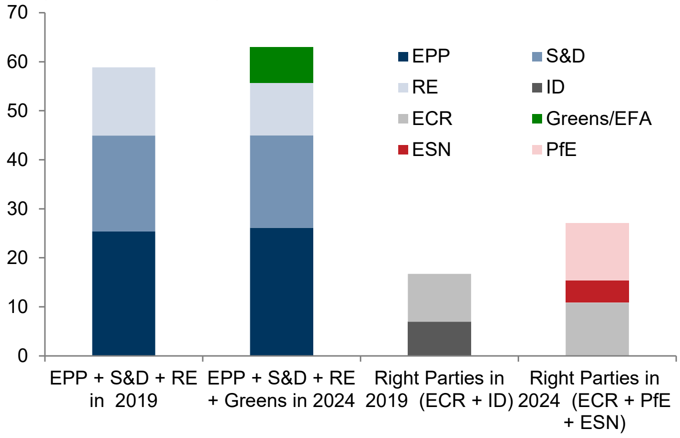
Brussels after Paris: EU policy shifts

Filippo Taddei and Alexandre Stott see limited policy impacts from the EU election, but more from France's hung parliament

With the European Parliament election outcome largely suggesting the status-quo for European Union (EU) policy ahead, markets remain focused on the hung parliament that resulted from the French snap elections and what this gridlock could mean for French and EU policy. We see two main implications of French policy gridlock for the EU. First, likely fiscal slippage in France could act as a catalyst for slower fiscal adjustment in other countries, most notably Italy. Second, France's traditional role of providing steady support for further European fiscal and economic integration could diminish, potentially stalling progress on these efforts, including around the creation of a single market for capital.

Modest shift to the right for the European Parliament…

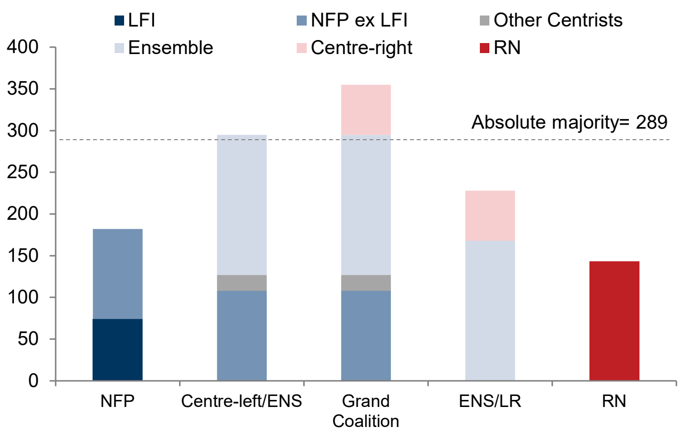
Composition of the European Parliament, % of total seats



Source: European Parliament, Goldman Sachs GIR.

...and a hung parliament for France, with a few coalition options

Coalition options in a hung parliament (National Assembly), number of seats



Source: French Parliament, Goldman Sachs GIR.

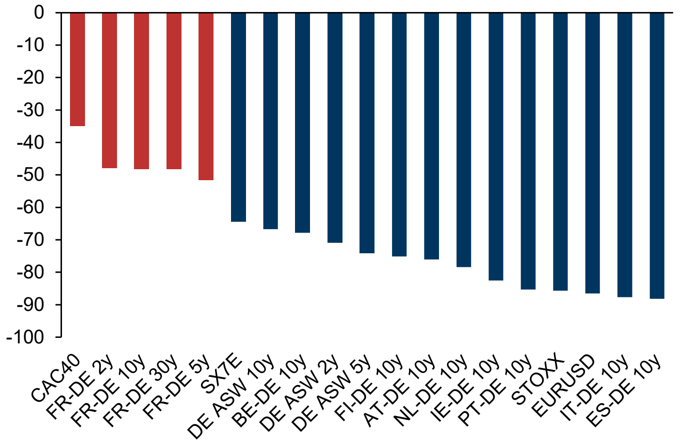
Two new parliaments, only one majority still intact

While parties most strongly opposed to European integration—Patriots for Europe (Pfe), European Conservatives and Reformists (ECR), and Europe of Sovereign Nations (ESN)—gained roughly 70 seats in the 720-seat European Parliament in June EU elections, the pro-European ruling coalition—European People's Party (EPP), the Progressive Alliance of Socialists and Democrats (S&D), and Renew Europe—secured a comfortable majority. And EU Commission President Ursula von der Leyen secured a second term. The European Council—the central forum directing European policy, comprised of the various heads of government—will also retain the same composition. As a result, we see limited implications of the recent political developments at the EU level for the EU policy agenda.

However, the snap elections in France that President Macron called following the convincing victory for the French far-right party, National Rally, in the EU Parliament elections has produced a hung parliament with no clear majority for any party/alliance, putting France firmly into policy gridlock. So far, the impact on EU policy has remained limited. And the initially broad increase in risk premia across Euro area assets in the run-up to the election has largely retraced, with markets now pricing the French election as only a domestic issue.

Lower risk premia across European assets, except in France

Risk premia across European assets, % recovery from max selloff after snap election announcement



Source: Bloomberg, Goldman Sachs GIR.

Fiscal slippage spillovers

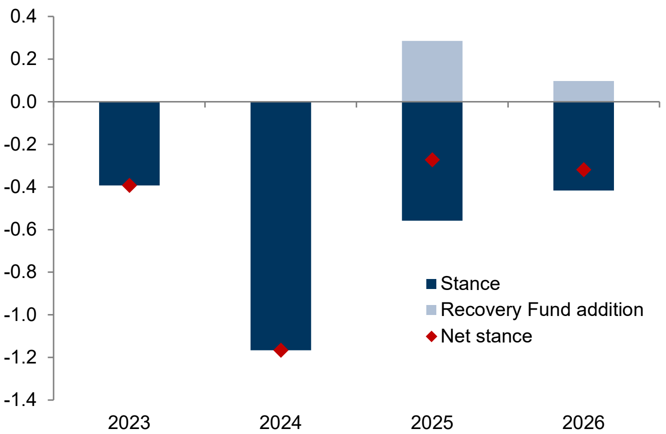
However, the French election outcome will likely have broader implications for the EU's fiscal goals. Beginning this year, EU member states must comply with revised European fiscal rules and deliver a credible fiscal plan to reduce their debt-to-GDP ratios. The European Commission has expressed its dissatisfaction with current fiscal plans in France and Italy, along with five other EU countries, and has proposed Excessive Deficit Procedures (EDP), which require countries to take additional steps toward fiscal consolidation. Prior to the French elections, President Macron had committed to a notable fiscal consolidation in 2025, but we now expect policy uncertainty to reduce the pace of this consolidation. This fiscal slippage could, in turn, prompt slower adjustment in other countries, including Italy, as the incentives to frontload one country's fiscal efforts are affected by the general commitment to fiscal consolidation within the broader European policy landscape.

Headwinds to European integration…

The French election outcome will also likely impact two major decisions that European policymakers face around fiscal/ economic centralization. First, they have the option to mobilize additional fiscal support—about €94bn (0.6% of EU GDP) is still available within the EU Recovery Fund—to address Europe's strategic priorities and scale up industrial investment within the next 18 months. Defense spending continues to be the most likely beneficiary of a potential increase in fiscal support. Second, EU policymakers must decide how to advance the commitment made by European Commission President von der Leyen in her July 18 statement to the EU Parliament to extend support for the Recovery Fund, which is due to expire in 2026, and activate a new *European Competitiveness Fund* to expand private investment capacity through public funding. Under President Macron's leadership, France has played a significant role in pushing for progress on all of these fronts, and the EU is unlikely to be able to adopt any of these measures without France's continued support. But, continued strong support looks unlikely amid French political gridlock/fragmentation. So, we expect any further progress to likely only be gradual.

EU policy is a question of willingness…

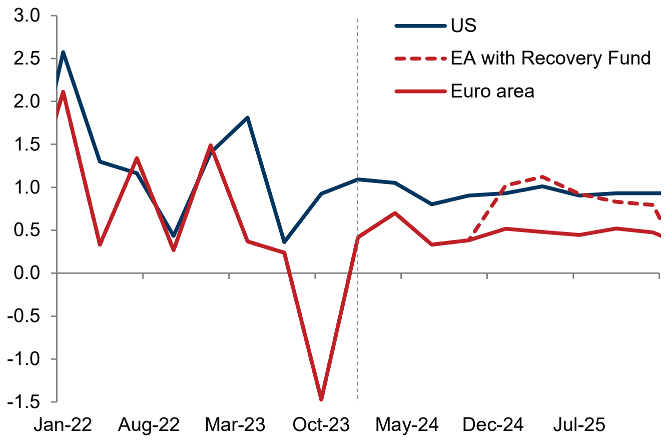
EMU-4 fiscal stance, % of GDP



Source: Haver Analytics, European Commission, Goldman Sachs GIR.

…not funding

Business investment, %, qoq



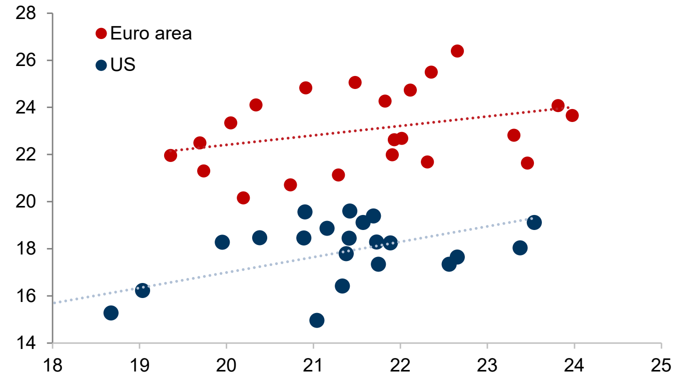
Source: Haver Analytics, Goldman Sachs GIR.

…including the Capital Markets Union

France's more limited role will also pose headwinds to the development of financial infrastructure that can help retain European savings in the domestic economy—a necessary feature to scale up European investment. One such program long in the works is the Capital Markets Union (CMU) that President von der Leyen recently revived by setting the objective of building an effective Savings and Investment Union in the EU. She has stressed that fragmentation of Europe's capital markets facilitates the outflow of ~€300bn in European savings each year. So, through the CMU, its proponents hope that the introduction of a "pan-European Personal Pension Product" to fund higher domestic private savings will unleash sizable long-term investment in the European economy. The CMU received renewed support after the recommendation of the European Council in March, with France again taking the lead in pushing for its advancement.

Lack of investment is also a saving intermediation issue

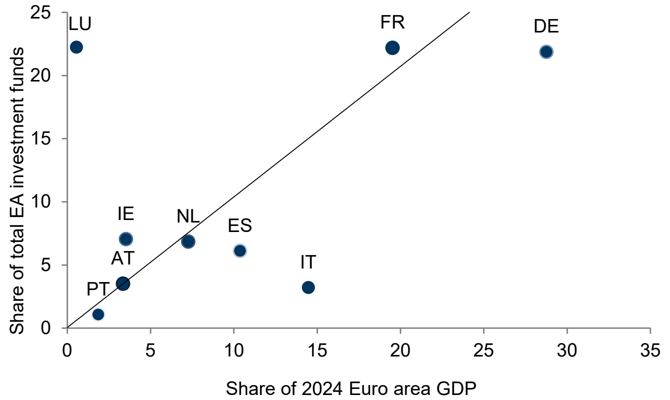
Savings vs. investment, % of GDP



Source: Haver Analytics, Goldman Sachs GIR.

And a larger than proportional share of investment funds are located in Ireland, Luxembourg, and the Netherlands

Share of investment funds vs. share of Euro area GDP, %



Source: Haver Analytics, ESMA, Goldman Sachs GIR.

However, the political headwinds to the CMU are immense given strong opposition from jurisdictions that have so far benefitted from capital markets segmentation. EU members such as Ireland, Luxembourg, and the Netherlands have received a much larger share of investment funds by providing regulatory arbitrage. And even if tax incentives for European saving products were deployed, the CMU is unlikely to make progress if the European Council does not act pragmatically and adopt a compensation scheme for the jurisdictions that would lose out by the shift toward regulatory harmonization. But this pragmatism is unlikely to emerge before France has a new government and Macron is able to resume supporting the CMU.

EU policy support increasingly critical, but elusive

With Europe's cyclical outlook dimming and Europe particularly exposed to the risk of a policy shift and rising tariffs following the US election (see pgs. 4-5), increased EU policy support is especially important to combat these headwinds. However, with France entrenched in policy gridlock, progress toward such support is likely to stall, at least until a new government is formed in France and more political clarity emerges.

Filippo Taddei, Senior European Economist

Email: filippo.taddei@gs.com *Goldman Sachs International*
Tel: 44-20-7774-5458

Alexandre Stott, Senior European Economist

Email: alexandre.stott@gs.com *Goldman Sachs International*
Tel: 33-1-4212-1108

What happened in the French elections?

MAJOR PARTIES/ALLIANCES

New Popular Front (NFP)	Ensemble	National Rally (RN)	The Republicans (LR)
Left-wing	**Center**	**Far-right**	**Center-right to right**
Won 26% of votes and secured 193 seats in the French National Assembly	**Won 25% of votes and secured 164 seats in the French National Assembly**	**Won 37% of votes and secured 142 seats in the French National Assembly***	**Won 6% of votes and secured 47 seats in the French National Assembly**
• The NFP was launched ahead of the 2024 legislative elections and is an alliance of France Unbowed (LFI), the Socialist Party, the Ecologists, and the French Communist Party, among other center-left and left-wing groups. • Promises to reverse President Macron's pension reforms and lower the retirement age back to 60 (from 64 currently). • In favor of raising public sector wages as well as the minimum wage. • Wants to introduce a wealth tax and lower income taxes for low earners. • Aims to cap the price of essentials such as food, gas, and electricity. • Agrees to support the freedom of the Ukrainian people.	• Created by President Macron, Ensemble is an alliance of Renaissance, Democratic Movement, Horizons, the Radical Party, and the Union of Democrats and Independents. • Renaissance has said that it has no plans to revive a debate around pensions, and Macron's initial 2017 comprehensive pension reform plan is no longer on the table. • Renaissance has no plans to raise taxes, as stated by current Finance Minister Le Maire in June. • Renaissance has promised to lower electricity prices by 2025. • Macron has confirmed France's lasting support for Ukraine.	• The RN is a party associated with Jean-Marie Le Pen and his daughter Marine Le Pen, now led by Jordan Bardella. RN allied with some candidates that were formerly part of Les Republicains, led by Eric Ciotti, in the second round of the elections. • The RN initially opposed raising the retirement age to 64, but Bardella has taken contradictory positions on pension reform, first stating that it would not be a priority and later that he would introduce a repeal if he came to power. • Proposes exempting wage increases from employer contributions, within limits. • Wants to replace the real estate wealth tax with a financial wealth tax. • Promises a drastic reduction in energy prices. • The RN has been vague, and somewhat contradictory, on its position on Ukraine.	• Formed in 2015 as the succeeding party of the Union for a Popular Movement (UMP) • The party has no plans to revive the debate around pension reform. • Proposes increasing French wages by lowering social security contributions for low-wage workers. • Wants to lower companies' production and payroll taxes. • Advocates for significantly more financial support for Ukraine, though opposes EU membership for Ukraine.

COALITION DEVELOPMENTS

How it started

- RN secured the largest share of votes in the first round of the elections on June 30.
- Following the results, the left-wing and centrist parties withdrew over 200 candidates to avoid splitting support and a far-right victory. The NFP prevailed in the second round of elections, though no single party or alliance managed to secure a majority.
- Immediately following the results, LFI Founder Jean-Luc Melenchon declared that his party was unwilling to negotiate to form a coalition government.

How it's going

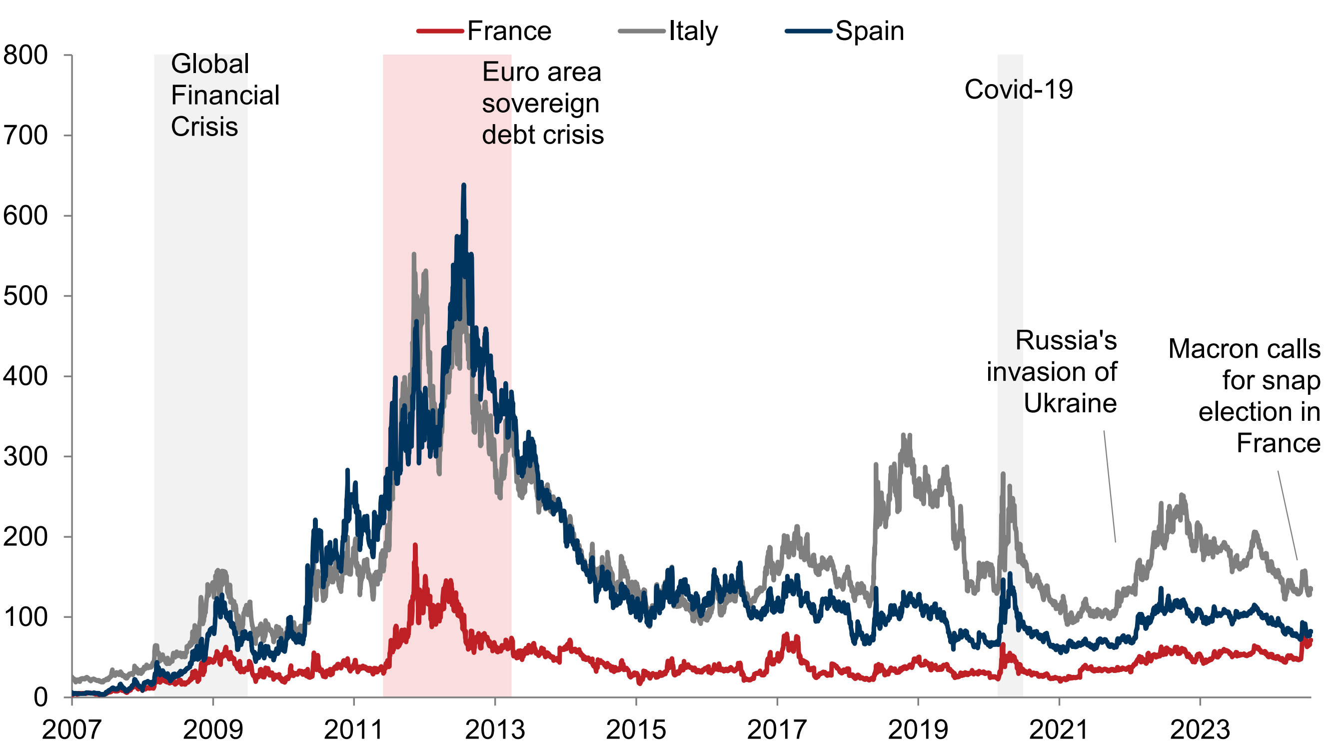
- After days of negotiations and failure to agree on a candidate for Prime Minister, NFP has announced that it will propose Lucie Castets, Finance Director for Paris City Hall, for the post.
- President Macron has stated his preference for mainstream parties (i.e. excluding the RN and LFI) to work together and put forward a PM candidate who can command a majority in parliament. He has also announced that he will not name a new government before the Olympic games end in mid-August. The current centrist caretaker government will remain in place until then.

**The discrepancy between vote share and seat tally owes to the structure of France's electoral system, in which legislators are elected by constituency. The number of voters per constituency differs across constituencies, in some cases significantly so, which makes it possible for a party/alliance with the highest vote-share to not secure the greatest number of seats.*
Note: Parties ranked by seats won in the National Assembly, most to least. Only top 4 vote-getters shown.
Source: French Ministry of the Interior, Le Monde, various news sources, Goldman Sachs GIR.

Europe: far from a crisis

Euro area countries' sovereign bond yield spreads to German Bund yields—a reflection of risk premium—rose following Macron's surprising call for snap elections in France, though they remain well below levels seen during past crisis periods

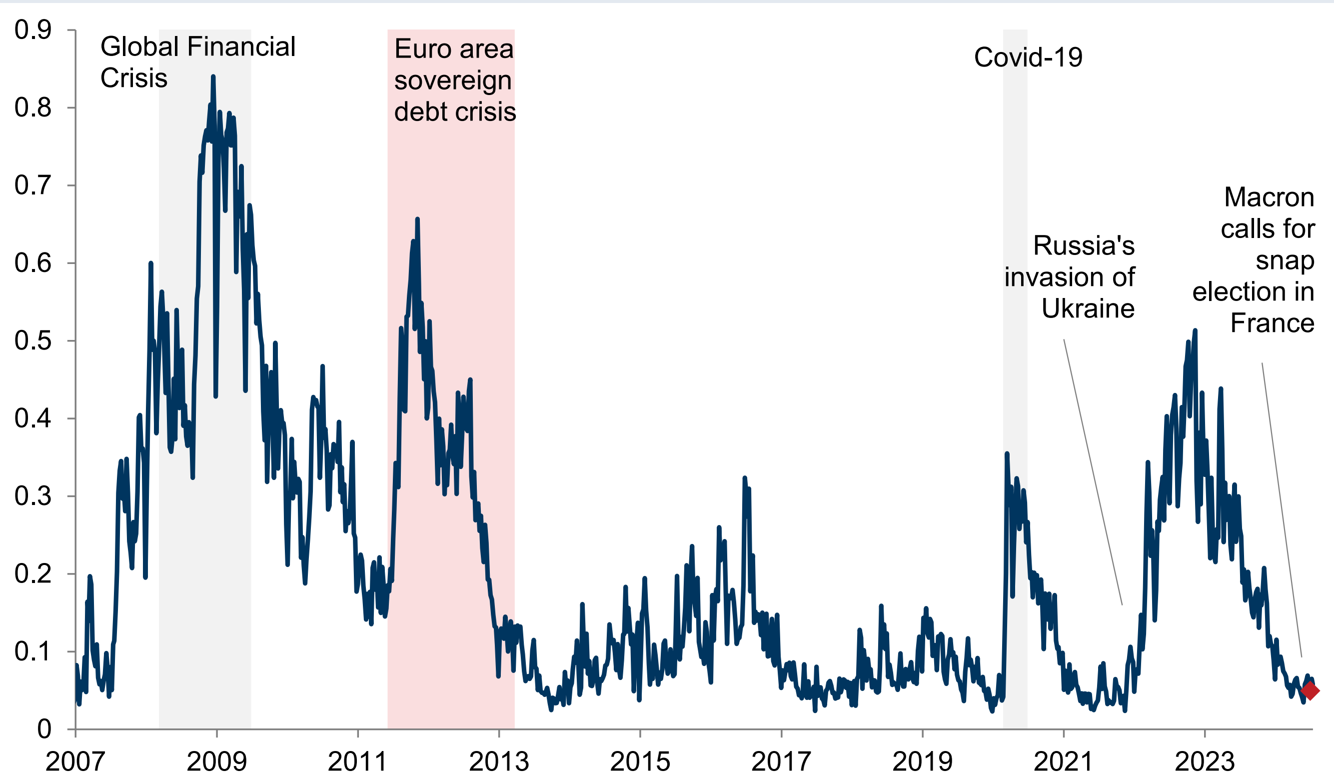
10y sovereign spreads to German Bund yield, bp



Source: Bloomberg, Goldman Sachs GIR.

The ECB's composite indicator of system stress also suggests that stress in Europe's financial markets remains relatively low

ECB Composite Indicator of Systemic Stress (CISS), index

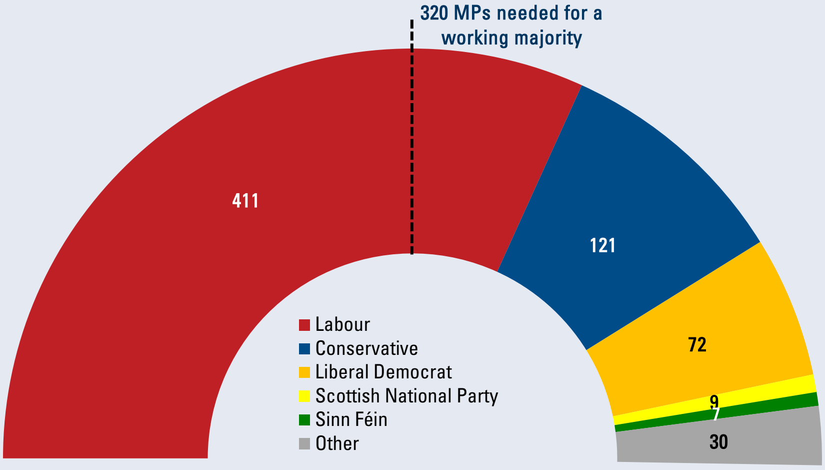


Note: The CISS includes 15 mainly market-based financial stress measures that are split into five categories: the financial intermediaries sector, money markets, equity markets, bond markets, and foreign exchange markets. For more information see here.

Source: ECB, Goldman Sachs GIR.

A UK Labour victory

There are 650 MPs in the UK House of Commons. The Labour Party, led by Keir Starmer, recently defeated the governing Conservative Party (the Tories) in a landslide election victory, ending 14 years of Conservative Party rule.



Parliamentary cheat sheet

The basic math: The government requires a simple majority (50% + 1) of voting Members of Parliament (MPs) to pass most legislation[1].

The winning formula:	MPs
There are 650 elected MPs	650
- The Speaker, an elected MP, typically does not vote	(1)
- Three Deputy Speakers, all elected MPs, typically do not vote	(3)
- Seven members of the Irish party Sinn Fein do not vote[2]	(7)
…Leaving 639 voting MPs	639
PM Starmer's magic number: Simple majority (50% + 1) of voting MPs	320

Labour's Policy Platform

Spending	• Aims to raise spending by around £9.5bn annually (0.3% of GDP). • Roughly half of this spend would go toward the Green Prosperity Plan, the Party's plan to make the UK a clean energy superpower by working with the private sector to double onshore wind, triple solar power, and quadruple offshore wind by 2030 while creating 650k new jobs. • The remainder would go toward funding other public service priorities, including adding more police community support officers (PCSOs) and investing in road maintenance.
Taxes	• Plans to fund the proposed spending increase through higher taxation, intending to raise £5.2bn annually by FY28 by reducing tax avoidance and reforming the non-domicile tax regime. • Additional reforms to windfall and carried interest taxes and the introduction of a VAT on private school fees would bring the total increase in taxes collected to around £8.6bn annually.
Wages	• Pledges to introduce a "genuine living wage" by changing the Low Pay Commission's current remit to keep the National Living Wage at two-thirds of median income to consider the cost of living as well.
Immigration	• Pledges to reduce net migration through reforms to the points-based immigration system, though no numerical targets have yet been set out.
UK-EU Relationship	• Pledges closer UK-EU trade and security ties. This would likely be done across two dimensions: (1) offering closer cooperation on defense and security issues and (2) seeking a veterinary agreement, which would harmonize standards related to animal health and welfare and thereby facilitate trade in food products. • However, Labour has drawn three red lines for its EU policy: no return to the single market, the customs union, or freedom of movement.
National Wealth Fund	• Plans to establish a National Wealth Fund capitalized with £7.3bn over the course of the next Parliament. These funds will be used to upgrade ports and build up domestic supply chains, create new gigafactories for the auto industry, rebuild the UK steel industry, accelerate the deployment of carbon capture, and support green hydrogen manufacturing. • The fund will target attracting £3 of private investment for every £1 of public investment.
Planning Reform	• Aims to boost homebuilding through reforms to the planning system, specifically by releasing certain areas of the green belts around major cities for homebuilding as well as reintroducing mandatory local housing targets.
National Health Service (NHS) Improvement	• Aims to cut NHS waiting times by offering 40k more appointments weekly. • Plans to double the number of cancer scanners, create a new Dentistry Rescue Plan, and add 8,500 new mental health staff.

[1] The Speaker is not included as part of the government or the opposition.
[2] Sinn Fein would be allowed to vote if they took the Oath of Allegiance to the King and took their seats, but they choose not to do so.

Note: Exhibit does not constitute an exhaustive list of Labour's proposed policies.
Sources: UK Parliament, Labour.org.uk, Goldman Sachs GIR.

The UK-EU relationship: a Labour reset

James Moberly argues that the UK-EU relationship reset Labour is pursuing should boost UK growth, but that the impact will likely be limited by Labour's stated red lines

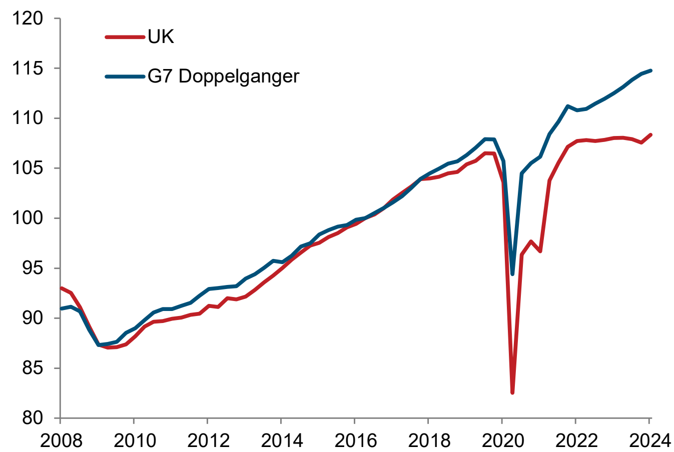
Following the Labour Party's decisive victory in the recent UK general elections, new Prime Minister Keir Starmer has stated that he wants to "reset" the UK's relationship with the EU. This reset has already begun, with the UK agreeing to a security pact with Germany and planning for greater UK-EU cooperation on illegal migration, while Chancellor of the Exchequer Rachel Reeves has said that Labour will seek to improve its trading relationship with the bloc. A reset is welcome news from a growth perspective given Brexit's negative impacts on the UK economy, though the growth benefits are likely to be limited by Labour's outlined "red lines" on the relationship.

A welcome reset...

The UK's departure from the EU has come at a significant economic price. Since 2016, UK growth has slowed relative to the economies that the UK performed most similarly to in the years before the Brexit referendum, with UK real GDP falling short by around 5%. While part of this relative slowdown likely reflects the effects of the pandemic and the energy crisis, weakness in goods trade volumes and stagnant business investment suggest that Brexit has also played an important role. As such, re-establishing closer trading links with the EU would likely boost UK growth.

We estimate that UK growth has fallen short by around 5% since the Brexit referendum

UK real GDP vs. G7 doppelganger*, index, 2Q16=100



**We use statistical techniques to find the best combination of other countries that match the path of UK real GDP before the referendum and use the same combination to project what may have happened thereafter.*

Source: Haver Analytics, Goldman Sachs GIR.

...but a relatively limited one

That said, Labour's room for maneuver is constrained by its commitment to not rejoin the EU single market or customs union or to allow freedom of movement. So, how much scope exists for Labour to reverse the costs of Brexit while remaining within these red lines?

Labour has indicated that it will pursue agreements on the mutual recognition of qualifications and visa arrangements for short-term business visitors. The government also intends to seek a veterinary agreement with the EU to reduce border checks on food products. While these measures would be helpful, they are unlikely to materially mitigate the economic costs of leaving the EU. The Centre for European Reform estimates that a deal to harmonize veterinary standards could boost British agrifood exports to Europe by around £2bn, equivalent to only 0.1% of GDP.

Beyond these initiatives, Labour faces an important decision on the extent of regulatory alignment to pursue in other sectors. On the one hand, aligning with EU regulations would leave the UK as a rule-taker, going against the spirit of Brexit. At the same time, regulatory alignment would likely reduce the costs to businesses from having to comply with multiple regulatory regimes. Without alignment, these costs could grow over time as UK-EU regulatory regimes diverge. And unilaterally aligning with EU regulations in certain sectors could prove useful in future negotiations around reducing trade barriers.

The Tony Blair Institute has argued that such a policy could serve as a stepping stone to an agreement on mutual recognition of conformity assessments—i.e. the verification that products and services fulfill specified requirements—which would further reduce regulatory barriers to trade. The Centre for European Reform has also suggested that the EU's negotiations with Switzerland and its Deep and Comprehensive Free Trade Agreements with Ukraine, Moldova, and Georgia show some willingness to agree to improvements in market access in return for regulatory harmonization, which could prove to be the case for the UK as well.

Early indications suggest that the Labour government is open to some degree of regulatory alignment beyond the agricultural sector. Reeves has indicated that regulatory harmonization could also take place in the chemicals industry. The Product Safety and Metrology Bill included in the King's Speech intends to ensure that "the law can be updated to recognize new or updated EU product regulations… where appropriate to prevent additional costs for businesses and provide regulatory stability". This appears to give the government the option to align with EU regulations where it views alignment as advantageous to the UK without the need to pass primary legislation.

That said, the EU will likely remain opposed to attempts to "cherry-pick" the benefits of bloc membership, which may complicate efforts to improve market access. And even if the EU proves willing to negotiate mutual recognition of conformity assessments, trade frictions will exist so long as the UK remains outside the customs union and the single market. Studies have estimated that rejoining the customs union or the single market could provide the UK a notable output boost, potentially increasing UK GDP by 1-2% relative to the current UK-EU trading arrangement. But the growth upside from a resetting of the relationship will likely be more limited so long as Labour sticks to its current red lines.

James Moberly, UK Economist

Email: james.r.moberly@gs.com *Goldman Sachs International*
Tel: 44-20-7774-9444

Interview with Helen Jewell

Helen Jewell is CIO of Fundamental Equities at BlackRock. Below, she argues that European equities will likely outperform US equities ahead—with the most compelling opportunities in construction, semiconductors, and utilities, as well as the SMID and UK markets.

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

Allison Nathan: European equities have lagged US equities year to date and the cyclical momentum appears to have slowed. So, is that underperformance likely to continue?

Helen Jewell: No. Four factors lead me to expect European outperformance ahead. First is cyclical uplift. Europe, which is by nature a more cyclical market than the US, is in a different and earlier part of the cycle, with ECB rate cuts already underway. Second is earnings uplift. Earnings for European companies, while only in low positive territory, have begun to accelerate, with more companies now being upgraded than downgraded. Third is compelling valuations. After narrowing earlier this year, the valuation gap between Europe and the US has widened again off the back of French political uncertainty, from around 25% historically to 40% today. While a re-rating of European equities amid the current uncertain political/geopolitical backdrop seems unlikely, so does a further de-rating of European equities.

And fourth is the breadth of quality in the European markets, which isn't necessarily new but is often underappreciated. When investors seek breadth, they often focus on equal-weighted indices. But indices that offer a broader composition of quality than the US S&P 500 is another way to achieve breadth, and European markets offer breadth across different high-performing sectors. In fact, the composition of the European market has shifted dramatically over the last decade, with the top 10 companies no longer comprised of lower-returning oil/natural resources, traditional healthcare, and consumer staples companies but rather high-growth, profitable, and stable margin companies in sectors ranging from semiconductors to innovative healthcare to luxury goods. So, the European market looks very different today.

Allison Nathan: But given the recent disappointments in the survey data, are you concerned that the cyclical—and ultimately earnings—story could be less supportive than you expect?

Helen Jewell: The recent PMI numbers were no doubt disappointing, and the potential for more macro weakness than we expect is certainly a risk to the equity story. But while European markets tend to be more cyclical markets, a large proportion—roughly 60%—of European earnings come from outside of Europe. Of course, the 40% of earnings more exposed to Europe's cyclical picture is not insignificant. But the market's large international exposure should mitigate the impact of a weaker European cyclical backdrop. So, while an economic slowdown in Europe wouldn't be great news for European equities, it likely wouldn't amount to a total car crash, either.

> "The [European] market's large international exposure should mitigate the impact of a weaker European cyclical backdrop."

Allison Nathan: You said you don't expect European equities to de-rate further. Does that mean you believe the risks facing Europe are fully priced in?

Helen Jewell: The uncertainty around the European parliamentary and French legislative elections not only sparked investor nervousness about the election outcomes themselves, but also reminded investors of long-held concerns about investing in the region given the many risks it faces. So, whether the deep valuation gap between Europe and the US marks a temporary or more structural shift is a valid question. But the risks facing the region look fully priced in given the magnitude of the European equity risk premium today.

And, to flip it around into a positive, the current large equity risk premium suggests the potential for upside should uncertainty dissipate, and conditions improve. That's precisely what's begun to occur in the UK market following Labour's recent landslide victory—more UK political stability has led to renewed investor interest in UK assets that is starting to close the large valuation gap between the UK and European/US markets.

> "Whether the deep valuation gap between Europe and the US marks a temporary or more structural shift is a valid question. But the risks facing the region look fully priced in given the magnitude of the European equity risk premium today."

Allison Nathan: That said, some risks facing Europe—like the structural slowdown in China and the potential for a more restrictive US tariff regime post the upcoming elections—look daunting. Are there risks that, if realized, could derail your relatively positive view?

Helen Jewell: Anything that could impact European earnings presents risk to our view. And, yes, a slowdown in China and, in particular, a weaker Chinese consumer, especially the top-end consumer, would pose a serious risk to the luxury goods companies that are a cornerstone of the European market. The Biden Administration also recently floated the possibility of imposing severe trade restrictions to prevent China from gaining access to advanced semiconductor technology, which would be detrimental to European semiconductor companies as well. But, again, given the breadth of the European market, other sectors like European banks, construction, and renewables could pick up some of the slack. Whether outperformance in those sectors would be enough to lead to overall outperformance is unclear, but it should at least soften the blow if any of these risks come to fruition. That said, the one risk that would clearly make it very difficult for Europe to outperform is the risk of substantially more restrictive US trade policies depending on the outcome of the US election.

> "The one risk that would clearly make it very difficult for Europe to outperform is the risk of substantially more restrictive US trade policies depending on the outcome of the US election."

Allison Nathan: Flows into European equities had begun to turn the corner after more than two years of net outflows following Russia's invasion of Ukraine. Can that positive momentum persist given the risks facing the region?

Helen Jewell: It's true that the start of a cyclical and earnings uplift in the region, combined with global investors' growing concern about the acute concentration of the US equity market, began to fuel inflows into European equities for the first time in a long time earlier this year. And we saw four consecutive months of European equity ETF buying by US investors through June, which is important to note. The numbers were still quite small, and it will be interesting to see whether the stalled path of ECB rate cuts that acted as a catalyst in June has dented that progress, but it's been progress, nonetheless. Whether that momentum continues remains to be seen, but I'm hopeful that the numbers will at least remain positive—if not large—given how underinvested investors have been in the region.

Allison Nathan: You mentioned the potentially positive implications of the UK election for UK assets. How much of that is already priced in?

Helen Jewell: Not enough. The UK still trades at a 15% discount to Europe. Some of that discount is structural because of the higher weighting to Value companies in the UK market. But cyclical factors suggest that discount should narrow. As we discussed, the resolution of political uncertainty following the election that delivered a clear government mandate should help. Consumer confidence is high in the UK versus its developed markets peers. The Pound has been one of the best performing developed market currencies. And these developments are beginning to attract flows into the country. UK midsized stocks, which are closely tied to the fortunes of the UK, have experienced three consecutive months of inflows. So, the stars are aligned for better performance, but the deep discounts remain.

So, I expect some re-rating of the UK market, likely supported by increased inflows, and further earnings uplift. And, on a sector level, the UK construction sector looks particularly compelling right now. The combination of a dearth of homebuilding, BoE rate cuts, and, more structurally, increased demand for data centers and building energy efficiency upgrades leaves the UK construction sector in the middle of a perfect Venn diagram between cyclical and structural factors that should drive returns.

Allison Nathan: More broadly, given everything we've discussed, how should investors be positioned today? Which sectors in Europe are most compelling, and which should investors avoid?

Helen Jewell: The most compelling sectors are semiconductors, which have suffered a pullback, but should continue to receive structural support owing to the AI theme that is far from over, construction, which is almost as compelling in Europe as it is in the UK for all of the same reasons, and utilities, which also sit in the sweet spot of a Venn diagram between cyclical and structural drivers. European utilities have lagged US utilities but benefit from many of the same drivers, so that is definitely a sector to watch.

The sector to avoid would be autos, which are highly exposed to China risks. But I would note that autos comprise a very small part of the European market today. German auto OEMs, which are often seen as the powerhouse of European OEMs, comprise just over 1% of the MSCI Europe. So, the idea that an underweight in autos by global portfolio managers is negative on Europe is just wrong. The other sector I'd mention is European banks, where views are mixed. Given their strong performance so far this year and expectations of continued central bank rate cuts, many of our investors are now reducing their exposure to the sector. But perhaps just as many of our other, active, investors believe European banks are better positioned than ever before given their paramount role in the economy that continues to generate substantial opportunities and robust regulation that has reduced risk. But investors need to be selective in the European bank space.

> "We're most focused on semiconductors, construction, and utilities, would be selective banks and SMIDs, and would avoid autos."

Lastly, the relative underperformance of small and mid-caps (SMID) versus large caps in Europe and their continued de-rating—with a rare P/E discount below 0.9 relative to large cap today—has been a key focus for our clients, with the question shifting from identifying value to catalyzing value. SMIDs had a brief false start earlier in the year, but interest rate shifts and relative earnings strength should help catalyze a comeback. That said, selectivity in SMIDs is key—the upside for SMID lies in the best SMIDs becoming large caps. So, all in all, we're most focused on semiconductors, construction, and utilities, would be selective banks and SMIDs, and would avoid auto.

Europe: be selective in a trickier market

Sharon Bell argues that the cyclical and structural case for European equities is trickier as downside risks loom large

Earlier this year, we argued that the case for investing in European equities was the cyclical one. Europe would benefit from a pick-up in global PMIs, and in particular an upswing in the manufacturing cycle, along with easier monetary policy as the ECB embarked on rate cuts. But, since then, Europe's much-anticipated cyclical recovery has been both dulled and pushed out, with our economists recently downgrading their Euro area GDP growth forecasts following weak survey data (see pgs. 4-5). Germany, Europe's largest economy, is currently contracting and will likey see near -zero growth again in 2024.

Potential trade and other policy shifts should Trump win the US presidency poses downside risk to this already-lackluster cyclical picture. Our economists estimate a 1pp growth hit from Trump's proposed 10% tariff on all US imports, which would translate into a 6-7pp hit to Europe EPS, sufficient to wipe out all EPS growth in 2025. Our base case forecasts low positive returns for European equities in 2024/25, driven by modest earnings growth, continued share buybacks, and dividend growth and policy support from declining interest rates, which may be sufficient to achieve very modest outperformance relative to the US market, which remains expensive, highly concentrated, and vulnerable to any rotations out of the AI theme. But the downside risks to the outlook for European equities have grown in light of the dimmer cyclical and more uncertain US policy outlooks.

A weak structural case, too

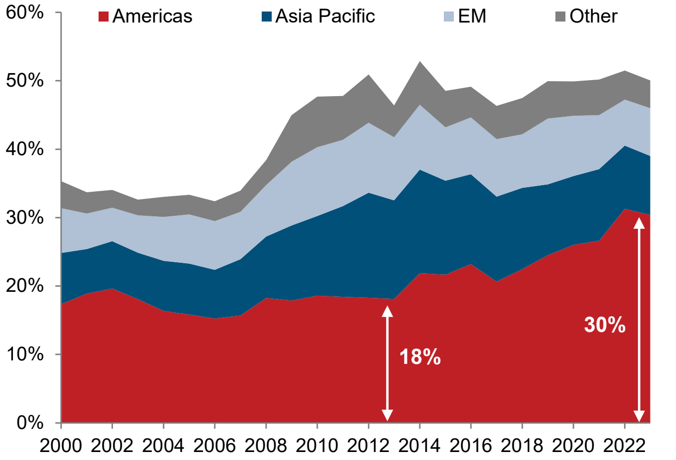
The structural trade to buy Europe is also unconvincing. The structural backdrop was always relatively weak owing to Europe's low underlying economic growth, aging populations, and government debt problems. European stock markets also have lower liquidity than US markets: trading volumes on the primary exchange are 14x higher in the US than in Europe, and 5x higher even after adjusting for market cap, which is a growing investor concern. Intense competition for investment owing to the CHIPS Act and Inflation Reduction Act (IRA) in the US combined with high regulation and taxation in Europe—which may worsen given Europe's current political dynamics—is also arguably damaging investment and productivity in Europe. Finally, Europe must contend with China's structural slowdown as well as the implications of increased trade tensions between the West and China.

Some rays of hope

While the cyclical and structural case to buy Europe is challenging, we see some positive features within the European market. One, European companies are global, with over half their sales coming from outside of Europe. European firms have significantly raised their exposure to India in recent years. And around a quarter of European companies' sales occur in the US, not through exports but through the ownership of US-based businesses, which leaves them relatively less exposed to tariff risks. So, both the European and global cyclical backdrops matter for European stocks.

European companies have raised their exposure to the US

Asset ownership for STOXX Europe 600, %

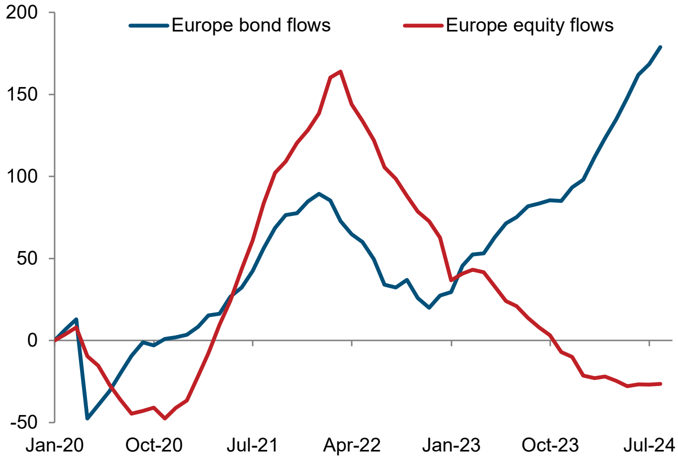


Source: Datastream, Goldman Sachs GIR.

Two, European corporates are becoming more efficient in their use of capital—buybacks have soared and dividends have grown in recent years. Three, positioning and valuation measures suggest that most investors are already cautious on Europe. Fund flows into European equities from global investors were consistently negative for two years following Russia's invasion of Ukraine in early 2022, and Europe trades at a significant discount to the US even when adjusting for sector differences. And four, Europe tends to perform well when investors rotate into Value, so any shift from Growth—which has been the only game in town since the Global Financial Crisis—into Value should benefit Europe. In all, we expect European equities to slightly outperform US equities over the next 12m, though we think strong outperformance is unlikely given the tepid European economic recovery we expect and Europe's vulnerability to political risks. So, we remain neutral across regions in both our 3m and 12m global asset allocations.

Flows into European equities were consistently negative for two years following the Russian invasion of Ukraine...

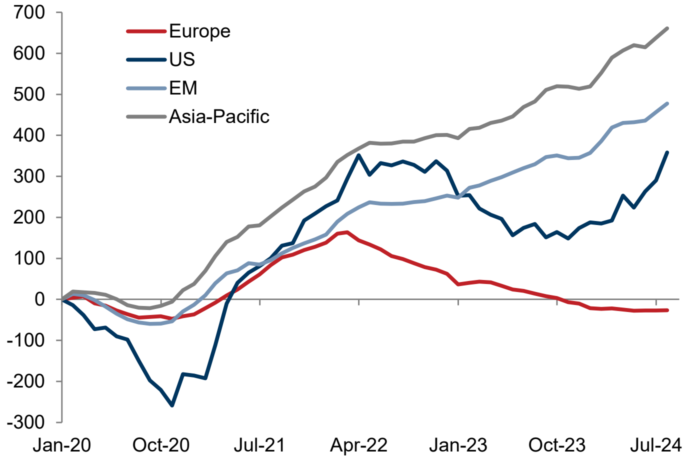
Cumulative monthly flows, weekly data for current month, $bn



Source: EPFR, Haver Analytics, Goldman Sachs GIR.

...and have been much weaker than for all other regions

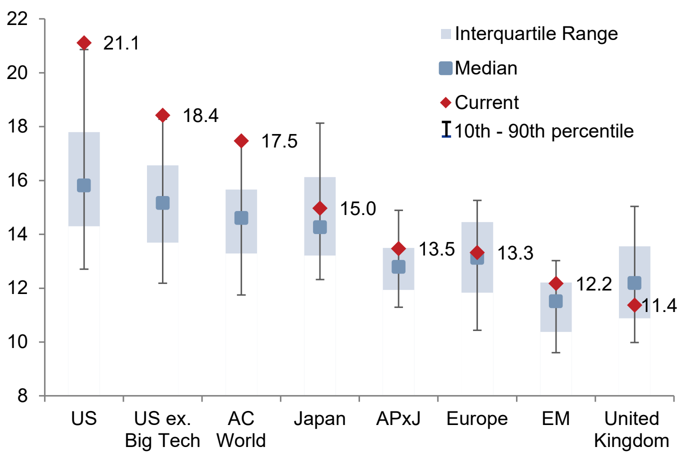
Cumulative monthly flows, weekly data for current month, $bn



Source: EPFR, Haver Analytics, Goldman Sachs GIR.

Europe trades at a significant discount to the US and Japan

12m fwd P/E multiple for MSCI regions (data for the last 20 years)



Source: FactSet, Goldman Sachs GIR.

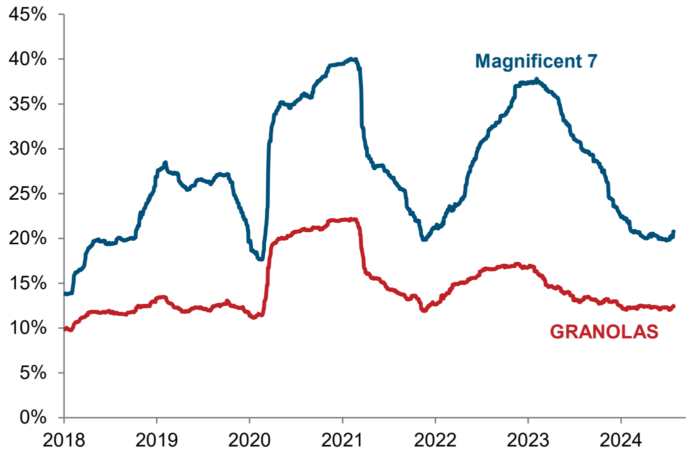
Look to the GRANOLAS, buybacks, and UK

Amid the challenging investing backdrop for European equities, we see three areas where opportunities remain compelling:

GRANOLAS: Europe's equity market is dominated by a small group of internationally exposed quality-growth compounders: the GRANOLAS. We created this grouping and acronym during the first European lockdown in 2020 for the largest European companies by market cap. The GRANOLAS account for roughly one-quarter of the STOXX 600's market cap, similar to the combined weight of Energy, Basic Resources, Financials, and Autos. The GRANOLAS exhibit qualities that we expect to perform well in this cycle: strong earnings growth, low volatility, high and stable margins, and strong balance sheets. They also stand to benefit from the structural shift towards passive investment. Returns for the GRANOLAS have risen over 80% in five years and with a volatility 2x lower than for the Magnificent 7. We also find that the GRANOLAS have a relatively low correlation with the Magnificent 7, and so should act as a fund diversifier.

The realized volatility of the GRANOLAS is on average 2x lower than for the Magnificent 7

1-year realized volatility of daily returns



Source: Datastream, Goldman Sachs GIR.

Buyback Bonanza in Value stocks: European companies used to eschew share buybacks as they chose to focus on dividends or investments/M&A, the latter often providing only low returns. With valuations in certain sectors low and profitability high, share repurchases have risen sharply. 60% of European companies are now buying back shares compared to around 20% historically. This buyback bonanza is concentrated in Financials and Energy, and in both cases the combination of dividends and buybacks mean investors in these sectors are seeing cash returned to them worth around 9-10% market cap per annum. We expect this trend to continue.

Return of the UK: Investors have been skeptical about the outlook for UK equities, as evidenced by low valuations and persistent fund outflows. Indeed, the UK currently trades at half the valuation of the US compared to a 30-year average discount of 22%. A combination of heightened political uncertainty since the Brexit Referendum, a weak macro backdrop (owing to the painful combination of high inflation and low growth), and a lack of listed technology companies has led global investors to shun the UK. But flows have started to turn up from low levels and investor interest has risen. The new center-left government with its large majority should bring stability along with potentially slightly more fiscal spend. It has also promised to raise homebuilding by relaxing planning restrictions (see pg. 20). And the cyclical data has been much more resilient in the UK than in the rest of Europe, with a pick-up in the most recent set of PMIs. The risk of tariffs is also less problematic for the UK given that it's a more service-centered economy. And the Value-oriented market with little or no tech weight makes the UK a good diversifier against US tech exuberance.

Sharon Bell, Senior European Portfolio Strategist

Email: sharon.bell@gs.com Goldman Sachs International
Tel: 44-20-7552-1341

Summary of our key forecasts

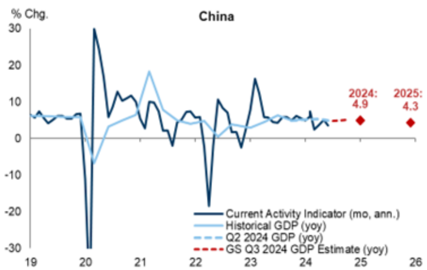
GS GIR: Macro at a glance

Watching

- **Globally,** we expect real GDP growth of 2.7% yoy in 2024, reflecting tailwinds from real household income growth, a gradual recovery in manufacturing activity, and broadening rate cuts. We expect global core inflation to fall below 3% by end-2024 and converge towards 2% by end-2025 as core goods inflation continues to decline, shelter inflation falls further, and both services inflation and wage growth continue to slow in response to the improved supply-demand balance across the global economy.
- **In the US,** we expect a modest growth pickup in 2H24 from 1H24 for real GDP growth of 2.3% in 2024 on a Q4/Q4 basis reflecting robust consumer spending growth, easing financial conditions, and rebound in inventory investment. We expect core PCE inflation to stand at 2.6% yoy by December 2024 before converging toward 2% next year, reflecting further rebalancing in the auto and housing rental markets. We expect the unemployment rate to end 2024 at 4.1% and decline gradually to 3.8% over the next two years.
- **We expect the Fed** to deliver the first 25bp cut in September, after which we expect rate cuts to proceed at a quarterly pace with the next 25bp cut in December until the terminal rate range reaches 3.25-3.5%.
- **In the Euro area,** we expect real GDP growth of 0.7% yoy in 2024 amid weakening survey data, policy gridlock in France, and rising growth risks from international trade, though we think the two main drivers of the recovery in Europe—continued real disposable income growth and a fading credit drag—remain intact. We expect core inflation to slow further to 2.7% yoy by December 2024, reflecting continued declines in services inflation, normalizing wage growth, and further scope for energy-related effects to fade.
- **We expect the ECB** to deliver a 25bp cut in September, after which we expect cuts to continue at a quarterly pace until the policy rate reaches 2.25% in 4Q25.
- **In China**, we expect real GDP growth of 4.9% yoy in 2024 as growth headwinds such as a prolonged property downturn and the lack of confidence among households and private businesses are offset by strong exports and manufacturing activity as well as continued policy easing. Looking further ahead, we expect China's growth to decline over subsequent years amid deteriorating demographics, the ongoing housing downturn, and global supply chain de-risking.
- **WATCH US ELECTION AND GEOPOLITICAL RISKS.** The November US election could have important macro and market implications, especially if it leads to a further rise in tariffs should Trump be reelected, which would weigh on growth in the US, with potentially larger growth impacts in Europe and China. Elevated geopolitical tensions as the situation in the Middle East remains highly uncertain, the Russia-Ukraine war drags on, and US-China relations continue to be fraught, could also have material market implications.

Goldman Sachs Global Investment Research.

Growth



Source: Haver Analytics, Goldman Sachs Global Investment Research.
Note: GS CAI is a measure of current growth. For more information on the methodology of the CAI please see "Improving Our Within-Month CAI Forecasts," Global Economics Comment, Mar. 06, 2023.

Forecasts

Economics

GDP growth (%)	2024 GS (Q4/Q4)	2024 Cons. (Q4/Q4)	2024 GS (CY)	2024 Cons. (CY)	2025 GS (CY)	2025 Cons. (CY)
Global	2.7	--	2.7	2.6	2.8	2.6
US	2.3	1.6	2.7	2.3	2.3	1.7
China	4.8	4.7	4.9	4.9	4.3	4.5
Euro area	1.1	1.2	0.7	0.7	1.3	1.4

Policy rates (%)	2024 GS	2024 Mkt.	2025 GS	2025 Mkt.
US	4.88	4.65	3.88	3.53
Euro area	3.25	3.10	2.25	2.21
China	1.60	1.60	1.40	--
Japan	0.25	0.31	0.75	0.60

Markets

Interest rates 10Yr (%)	Last	E2024	E2025
US	4.09	4.25	4.10
Germany	2.28	2.25	2.00
Japan	1.06	1.25	1.80
UK	3.93	3.75	3.75

Commodities	Last	3m	12m
Crude Oil, Brent ($/bbl)	81	86	81
Nat Gas, NYMEX ($/mmBtu)	2.04	2.80	4.00
Nat Gas, TTF (EUR/MWh)	35.04	30	33
Copper ($/mt)	9,102	10,500	13,000
Gold ($/troy oz)	2,426	2,600	2,700

FX	Last	3m	12m
EUR/$	1.08	1.05	1.08
GBP/$	1.28	1.27	1.32
$/JPY	150	155	150
$/CNY	7.20	7.35	7.40

Credit (bp)		Last	3Q24	4Q24
USD	IG	93	90	90
	HY	314	294	291
EUR	IG	125	120	120
	HY	356	339	336

Equities

S&P 500	E2024 GS	E2024 Cons.	E2025 GS	E2025 Cons.
Price	5,600	--	--	--
EPS	$241	$244	$256	$279
Growth	8%	9%	6%	14%

Returns (%)	12m	YTD	E2024 P/E
S&P 500	3	16	23.1x
MXAPJ	9	7	14.5x
Topix	4	18	16.4x
STOXX 600	4	8	14.3x

Consumer	2024 CPI (%, yoy)	2024 Unemp. Rate	2025 CPI (%, yoy)	2025 Unemp. Rate
US	3.0	4.1	2.5	3.8
Euro area	2.5	6.7	2.2	6.7
China	0.4	--	1.5	--

Wage Tracker 2024 (%)	Q1	Q2	Q3	Q4
US	4.1	4.0	--	--
Euro area	--	--	--	--
China	--	--	--	--

Source: Bloomberg, Goldman Sachs Global Investment Research. For important disclosures, see the Disclosure Appendix or go to www.gs.com/research/hedge.html.

Market pricing as of July 31, 2024

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.

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.

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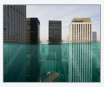

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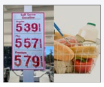

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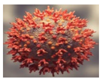

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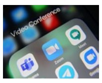

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Reg AC

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