

GIAM Macro & Market Research - Market Commentary

European Election outcome: A more fragmented Parliament with a still pro-European majority

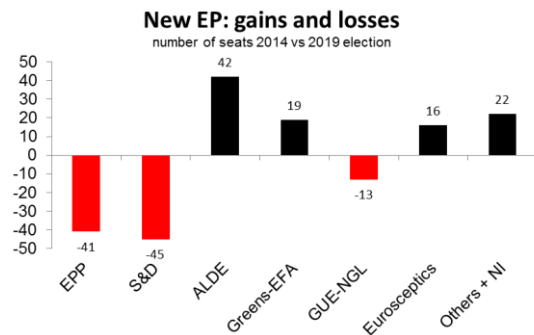
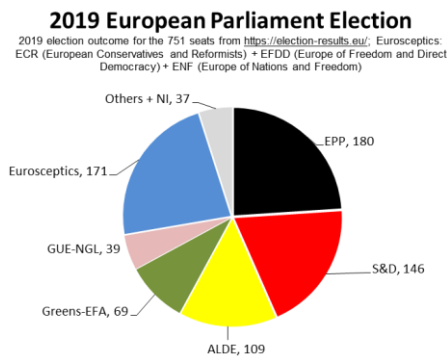
- Eurosceptics gained considerably in the European elections and the informal pro-European coalition of Conservatives and Socialists lost its majority. However, concerns about a landslide victory for the Eurosceptics did not materialize. A pro-European majority can still be engineered with help of either the Liberals or the Greens, who both emerged strengthened from the vote.
- Amid a more fragmented new European Parliament (EP), the process of agreeing on a new EC President could prove very protracted. The Conservatives (EPP) again became the strongest faction. But substantial losses will make it hard to gather sufficient support for its candidate Manfred Weber and for – more generally – the EPP to push through the lead candidate system.
- In Italy, the balance of powers within the government strongly shifted in favor of the Eurosceptic Lega which has become the de facto senior partner of the ruling coalition. This is likely to have positive effects on infrastructure programs, but the fiscal challenges for the government remain unchanged. A snap election remains a possibility, but is not our baseline.
- In the UK the landslide gains of the New Brexit Party and the defeat of Tories have added to concerns about a rising support for a hard Brexit.
- The European election outcome also has ramifications for other countries. In Germany, the poor results for the ruling parties are likely to intensify tensions in the government while in France President Macron fell short of the electoral support hoped for. In Greece snap elections are about to come in June.
- European equity markets opened on a stronger note on Monday morning, while bond and FX markets have barely moved over the weekend.

Dear Colleagues,

Europe has elected. From May 23 to 26, about 418 mn people from still 28 member states just elected the next European Parliament (EP). Unlike to previous years, this election received huge attention. The turnout ratio rose to 50.95%, the highest since 1994. As we have outlined in a recent [Focal Point](#), key points of concern have centered around the rise of Eurosceptics, the allocation of EU top jobs with the next EC President in the first place as well as on repercussions at national levels. Here, the stability of the Italian coalition and the further course of the Brexit process stand out.

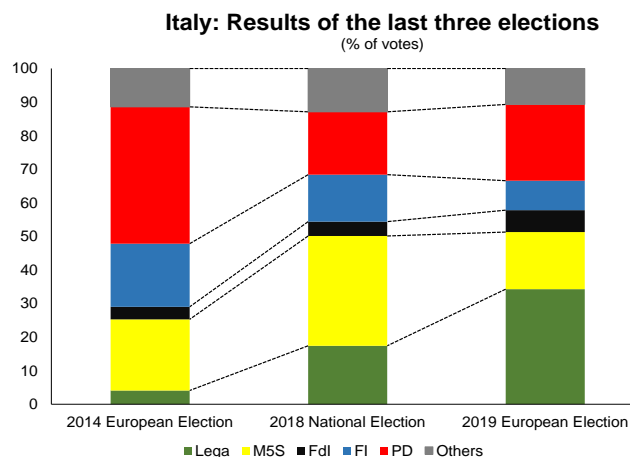
Eurosceptics gained and the traditional pro-European coalition lost its majority: As widely expected ahead of the election, Eurosceptic groups – which we consider the European Conservatives and Reformists (ECR), Europe of Freedom and direct Democracy (EFDD) and Europe of Nations and Freedom (ENF) - gained. According to preliminary results at noon, they increased the sum of their seats by 16 to 171. Thereby, Eurosceptics altogether have only 9 seats less than the still strongest group of Conservatives (EPP). The Conservatives and the Socialists (S&D) traditionally formed an informal pro-European majority in the EP and negotiated compromises on key issues. In the recent election both groups suffered considerable losses and lost their majority in the EP.

Greens and Liberals to become kingmakers: The winners in the new EP are the Liberals, mainly due to the fact that the newly founded French “En Marche” party of President Macron decided to join this group. More surprising were the huge gains of the Greens which are largely due to their good performance in Germany. Hence, while the new EP is more fragmented than the previous one, a pro-European coalition building is still feasible. The EPP and the S&D can form a majority with either the Liberals or the Greens, giving them the role of the new kingmakers. As a result, these groups have more power to push through their agenda. We conjecture that the next EP will put more emphasis on environmental issues. A wild card is fiscal policy. We could imagine that the huge losses of the Socialists could make them more lenient on fiscal topics.



Election of new EC President litmus test for new pro-European coalition forming: Following the 2014 EP elections the so called *Spitzenkandidaten* or lead candidate system had been applied for the first time, meaning that the candidate whose group got the highest share of votes in the new Parliament will be appointed as the next EC President. While the EP welcomes this approach, the Head of States are generally less enthusiastic as this limits their ability to push through their own candidate. Especially French President Macron was very explicit on this issue in recent comments. For the upcoming nomination of the new EC President it will be crucial that the EP candidate - Mr Weber from the EPP would be the natural choice – manages to get the backing from a parliamentary majority. The time frame is tight: There will be an EU Head of States summit on the next EC President and other top jobs (with the ECB President being the most important one) on May 28. Consultations with the EP will start right now and the Council is expected to propose a candidate for EC Presidency at the June 20-21 meeting, taking into account election results. With the times of the informal grand coalition now being over we see the process of the selection of the new EC President as a first litmus test whether pro-European forces (e.g. EPP, S&P, ALDE or Greens) will be able to compromise on crucial European issues. Looking further down the road, the negotiations about the new EU budget will be very challenging in our view.

The Lega's rise continued in Italy: The right wing Lega's result was outstanding. It took 34.4% of votes, at the upper end of the range shown by polls, doubling, the result made in last years' election. Conversely, the five Star Movement (M5S) dropped from 32% to 17%, virtually disappearing from the Northern and Central regions. The center Left Democratic Party (PD) improved from the 18% of the 2018 election to 22.7%. Far Right Fratelli d'Italia (Fdi) strengthened to 6.5% while Silvio Berlusconi's Forza Italia (FI) continued to shrink to 8.8%.



The combined share of votes of the ruling Lega-M5S barely changed, but the internal balance of power switched drastically, with Lega becoming by far the senior partner. In his first speech after the results Lega's leader (and vice Prime Minister) Matteo Salvini stated that the coalition continues as before the elections, but it is clear that, given the strong momentum shown by its party, the temptation of pulling out from the government and trigger a new election has increased markedly.

However, the combined score of Lega and Fratelli d'Italia (a far right party whose program almost perfectly overlaps with Lega's) is just above 40%, the threshold at which a coalition may hope to get a majority in both houses of the Parliament. A strong majority would require taking on board Forza Italia, which at the moment keeps its traditional pro-European stance.

Therefore it appears more likely that Lega will try to impose its agenda to the current government, knowing that M5S is basically cornered, as a new election, given yesterday's result, would probably result in the party halving its MPs.

This means that the completion of the high speed railway between Turin and Lyon (a taboo for M5S) will carry on and, above all, some of the economic measures advocated by Lega will be pushed more forcefully. During the last days of the campaign, Salvini called for a sharp reduction in income taxes, of an estimated costs of around €15bn, to be part of next year's budget. This would come on top of the other € 25 bn of extra expenditure on basic income, early retirement and of tax cuts on independent workers, already enacted this year.

New Brexit Party wins on failure of established parties to deliver orderly EU exit: Following the postponement of the Brexit date to October 31, the UK had to participate in the EU parliamentary election to fill its 73 seats. The new Brexit Party of Nigel Farage (previously head of Ukip) was the clear winner, garnering 31.7% of the votes (but less than latest polls had predicted). By contrast, the Tories dropped to 8.7% and Labour to 14.1%, being strongly defeated over the handling of the Brexit process. Liberal Democrats (18.6%) and Greens (11.1), both with a clear position on Brexit, could benefit.

UK's participation in the EU election was politically unwanted and showed its effects already ahead of the actual voting. The strong result of the Brexit party in the polls already prompted a hardening of political fronts, esp. in the Conservative party which is deeply divided between hard Brexiteers and more EU friendly MPs. To a lesser degree, this is also true for Labour. Talks of the two parties about a Brexit compromise broke down and PM Theresa May's proposal of a "new" Brexit deal was rejected from all sides. This eventually led PM May announcing to step down on June 7.

The resignation will be triggering a leadership contest in the Conservative Party from next week on. The procedure is that MP candidates put their own names forward. Then the 313 Tory MPs vote in a series of rounds to whittle down the candidates. In each round, the person with the fewest votes is removed. When the field is reduced to two candidates, the choice is put to the party membership. The FT recently reported that as many as 17 MPs could stand. Bookmakers see Boris Johnson and Dominik Raab in the lead. The

process does not have a definite timetable, but is said to last until mid-July. Given that the new leader will have a large impact on the Brexit process, the choice may be embattled strongly. A hard Brexiteer could well pursue a no deal Brexit. By contrast, a moderate candidate would likely continue to face a divided party and Parliament. Thus, any compromise could still be very hard to reach, independently of any fresh Prime Minister. In Brussels, the landslide gains of the New Brexit Party and the defeat of Tories have likely added to concerns about a rising support for a hard Brexit.

Moreover, the European election also has implications for other countries:

- In **Germany**, the governing coalition of Conservatives and Social Democrats experienced huge losses losing their majority while the Greens became second strongest after the Conservatives. The Social Democrats' ongoing decline in elections will increase the pressure on the party to change its course. Therefore, tensions within the German government are about to rise lifting the tail risk of a coalition breakdown.
- In **France**, President Macron's party did not manage to gather more votes than the right-wing party of Marine Le Pen thereby missing its objective. However, the traditional right (EPP) and left parties in France also lost leaving Macron as the only non-extreme alternative to Le Pen.
- In **Greece**, President Tsipras' party (Syriza) only became second after the Conservatives (Nea Demokratia) triggering him to announce elections already for late June or early July instead of the previously expected date in October.

Financial markets unimpressed: European equity markets opened on a stronger note on Monday morning, with the Eurostoxx50 stronger in early trading. Bond and FX markets, though, have been barely changed by the election results over the weekend. The yield of 10y Bunds traded around -0.12% on Monday morning, the one on Italian BTPs at 2.57%. The EUR/USD kept hovering around 1.12.

Authors:

Christoph Siepmann

christoph.siepmann@generali-invest.com

Martin Wolburg

martin.wolburg@generali-invest.com

Paolo Zanghieri

paolo.zanghieri@generali-invest.com