Goldman Sachs

Investment Management Division

2013 Outlook: Over the Horizon

In search of investment peaks in a low-return environment.

Investment Strategy Group – January 16, 2013

Today's Discussion

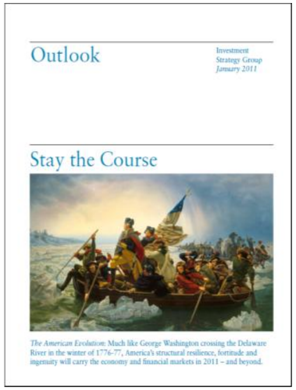
- Three Key Takeaways
- 2013 Economic and Financial Markets Outlook
- Some Key Risks
- Recommendations

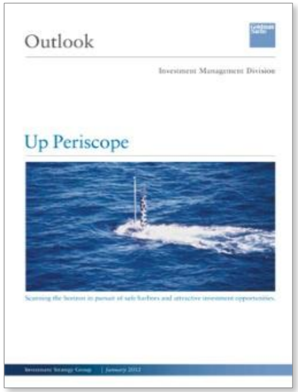
Three Key Takeaways

1. Interest Rates are Likely to Remain Low for a Few Years and We Encourage Investors to Lower Their Return Expectations

2. "Policy" Will Remain Incremental in Key Developed and Emerging Market Economies

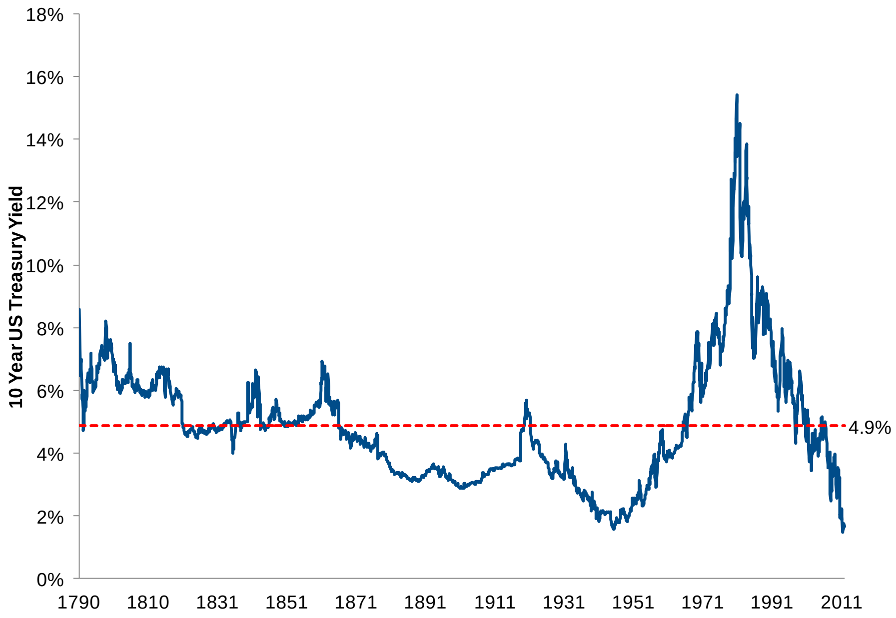
3. We Reaffirm that US Preeminence is Intact and Sustainable





Interest Rates are Likely to Remain Low for a Few Years

U.S. 10 Year Treasury Yield Since 1790

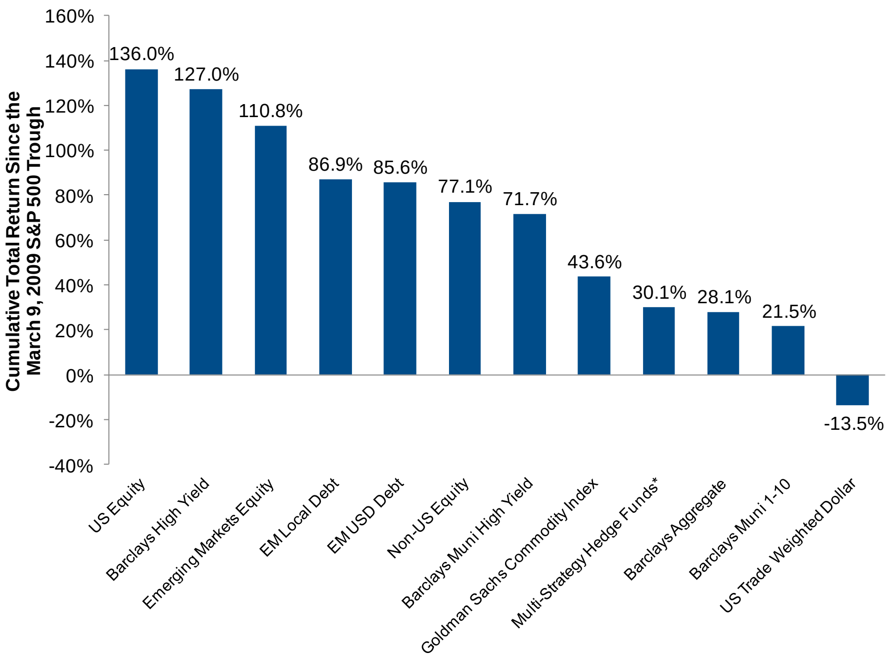


- Interest rates are at historical lows in many regions of the world and are expected to remain low.
- Historically, rates have exhibited extended periods of rising and falling rates without any evidence of mean reversion.
- The 10-year Treasury rate was on a downward trend from 1790 through the lows in 1941. And then from 1941 to 1980, rates were on an upward trend. In fact, interest rates stayed below 2.5% for 11.5 years, between 1939 and 1951.

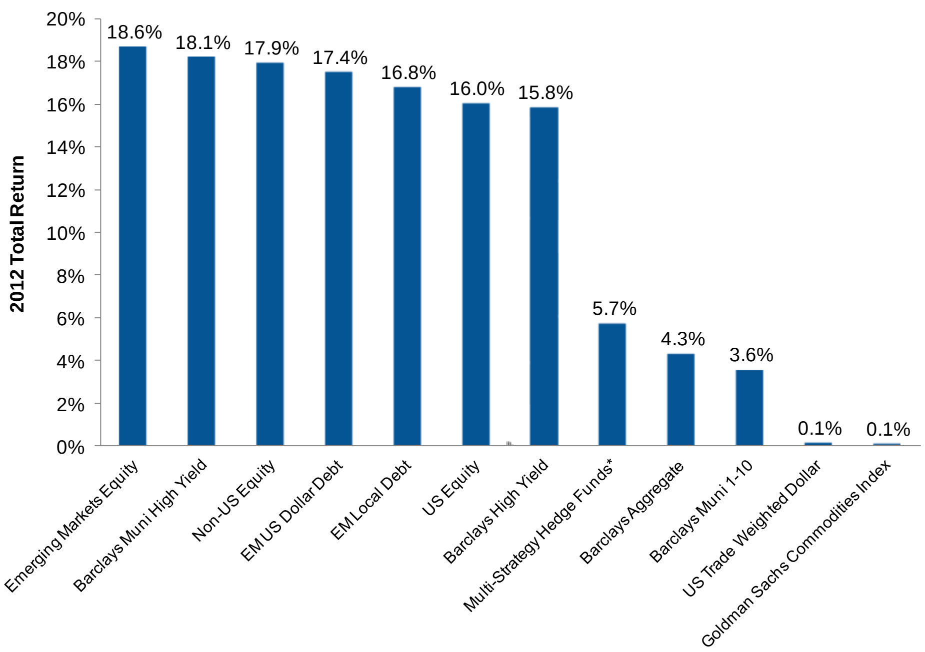
Source: Investment Strategy Group, Global Financial Data

Returns Have Been Strong Since Early 2009

1. Cumulative Total Returns Since the 2009 S&P 500 Trough



2. 2012 Asset Class Total Returns



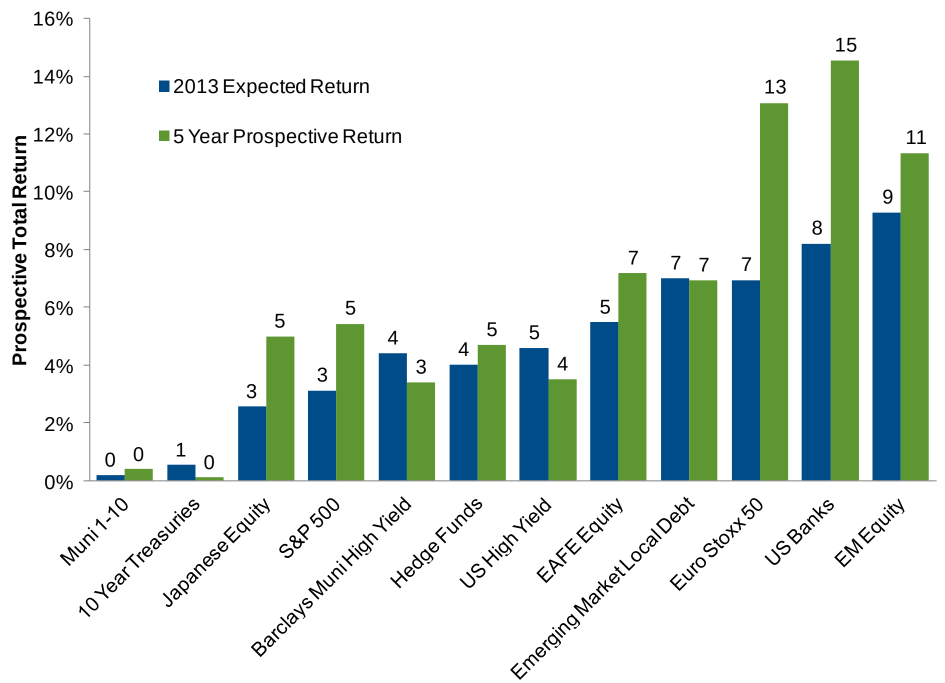
- Returns across most asset classes have been very strong since the trough of the S&P 500 in March 2009 (Exhibit 1), and 2012 was no exception (Exhibit 2).

* Hedge fund data is through November 2012

Source: Investment Strategy Group, Bloomberg, Datastream, Barclays

Low Interest Rates and Strong Returns Since Early 2009 Have Lowered Prospective Returns Across Asset Classes

2013 and 5-Year Prospective Annualized Returns (As of January 14, 2013)



- Bonds will have virtually no nominal returns for the foreseeable future.
- High yield and emerging market local debt provide attractive absolute and volatility-adjusted returns.
- Hedge funds will have mid single-digit returns.
- US equities have both near-term and long-term attractive returns, especially relative to bonds.
- Euro Stoxx 50 and US banks have the most attractive near-term and long-term returns.
- Emerging market equities provide reasonable but not exceptional returns given the various risks.

Source: Investment Strategy Group, Datastream, Bloomberg

“Policy” Will Remain Incremental

- **United States:** Policymakers are likely to tackle the fiscal problem in an incremental fashion – the pattern they have already established. We will discuss this further on an upcoming client call in February.

- **Eurozone:** Measures will continue to be introduced incrementally given the need to build consensus among the policymakers and electorates of 17 different countries. Given this, resistance to structural reform and a weak economic backdrop are both likely.

- **Emerging Markets:** Structural reform to address the fault lines in emerging markets will be incremental at best.

2013 Outlook for Growth and Inflation

		2013 ISG Central Case Range			
	2012 Real GDP Growth[1]	Real GDP Growth			2013 Inflation (ISG Midpoint)
US	2.3%	1.5	-	2.5%	2.0%
Eurozone	-0.4%	-0.8	-	0.3%	2.0%
UK	0.1%	0.0	-	1.0%	2.3%
Japan	2.0%	0.0	-	1.0%	0.0%
China	7.7%	7.5	-	8.5%	3.0%
Brazil	1.0%	2.8	-	3.8%	5.8%
India	5.4%	5.5	-	6.5%	7.3%
Russia	3.7%	3.3	-	4.3%	6.3%
Major Developed Economies[2]	**1.2%**	**0.4**	**-**	**1.4%**	**1.7%**
BRICs	**5.7%**	**6.1**	**-**	**7.1%**	**4.5%**
World	**2.7%**	**2.3**	**-**	**3.3%**	**3.2%**

- We expect a slight acceleration in world GDP growth in 2013, driven by emerging market countries.

(1) 2012 end-of-year numbers are based on GS Global Investment Research's estimate

(2) Includes the US, UK, Eurozone, and Japan.

Source: Investment Strategy Group, GS Global Investment Research

Outlook for Global Equities

2013 ISG Equity Scenarios (As of January 14, 2013)

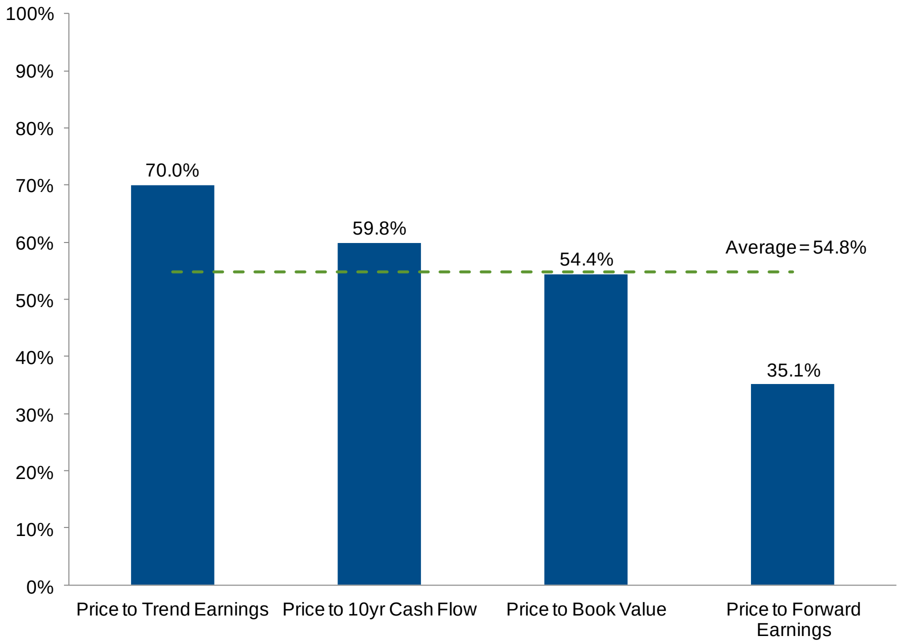
	Current	End 2013 Central Case Target Range[1]			Implied Upside from Current Levels			Current Div. Yld.	Implied Total Return		
S&P 500 (US)	1,471	1,450	-	1,525	-1%	-	4%	2%	1%	-	6%
Euro Stoxx 50 (Eurozone)	2,715	2,700	-	2,900	-1%	-	7%	4%	3%	-	11%
FTSE 100 (UK)	6,108	6,100	-	6,400	0%	-	5%	4%	4%	-	9%
Topix (Japan)	899	850	-	950	-5%	-	6%	3%	-3%	-	8%
MSCI EM (Emerging Markets)	47,632	49,500	-	52,000	4%	-	9%	3%	7%	-	12%

- Ongoing global growth should support earnings, providing a rising fundamental floor for global equities.
- Some moderation in the pace of returns is likely in 2013 after last year's strong equity gains.
- Even so, these returns remain attractive relative to bonds, particularly considering the implied gains to the upper-end of our fair value ranges.

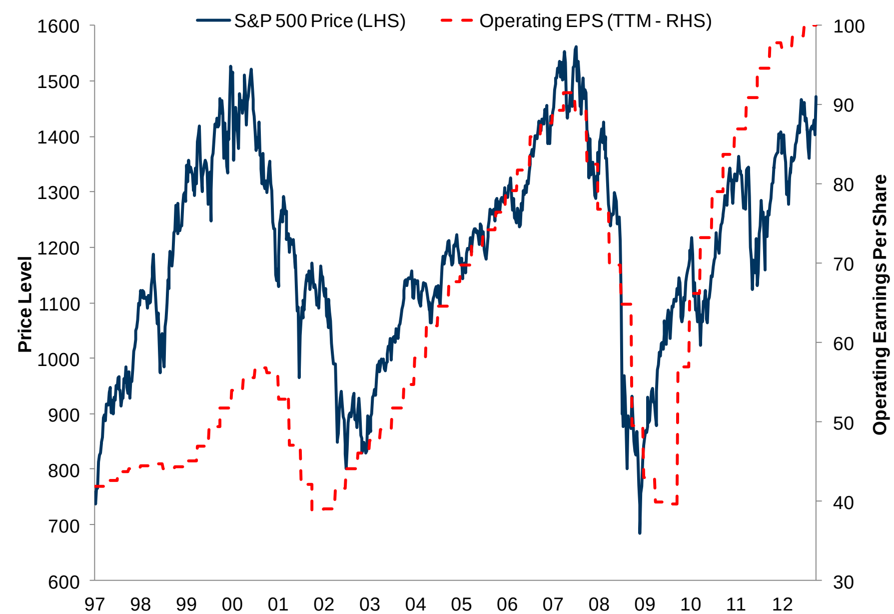
Source: Investment Strategy Group, Datastream.

Outlook for US Equities

1. Percent of Time US Equity Valuations Have Been More Attractive than Current – January 14, 2013



2. S&P 500: Operating Earnings (Trailing 12 Months-4Q 2012E) vs. Index Price (1997 – January 14, 2013)

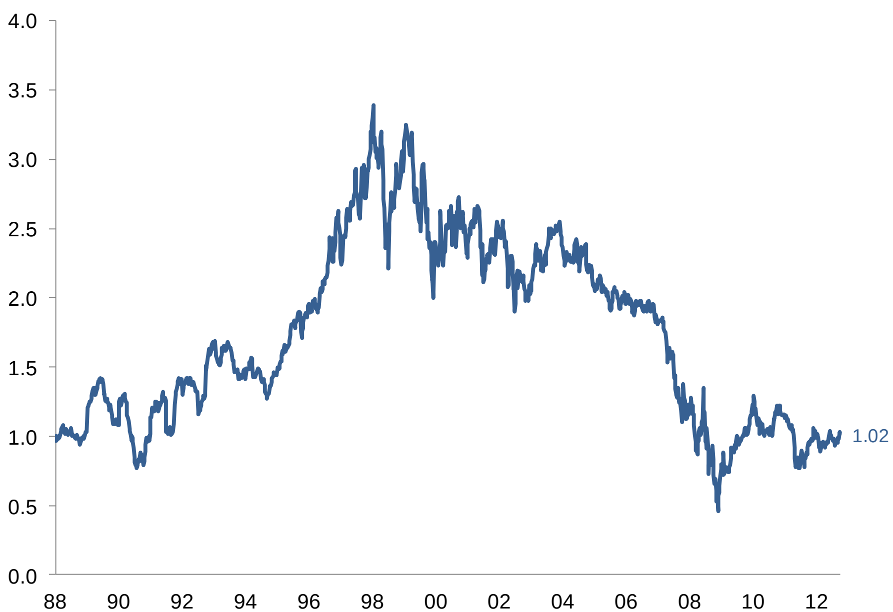


- Key valuation measures, on average, reside around the middle of their post-war ranges, underscoring that US equities are not overvalued (Exhibit 1).
- In fact, the S&P 500 would need to rally above 1,600 to reach top-quartile valuations, the zone in which the vast majority of historical bull markets have topped.
- If anything, today's valuations remain understated, as the S&P 500 continues to lag the ascent of operating earnings. Restoring this relationship would imply an S&P 500 value around 1,600 (Exhibit 2).

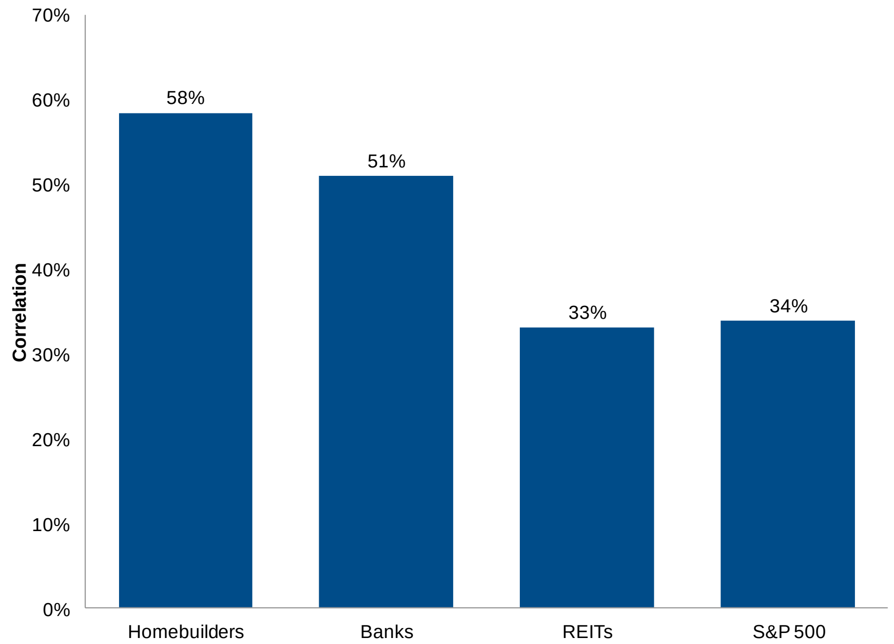
Source: Investment Strategy Group, Datastream, Robert Shiller, Bureau of Economic Analysis

Outlook for US Banks

1. US Banks Price to Book Ratio – Through January 14, 2013



2. Correlation of Equities and Housing Fundamentals

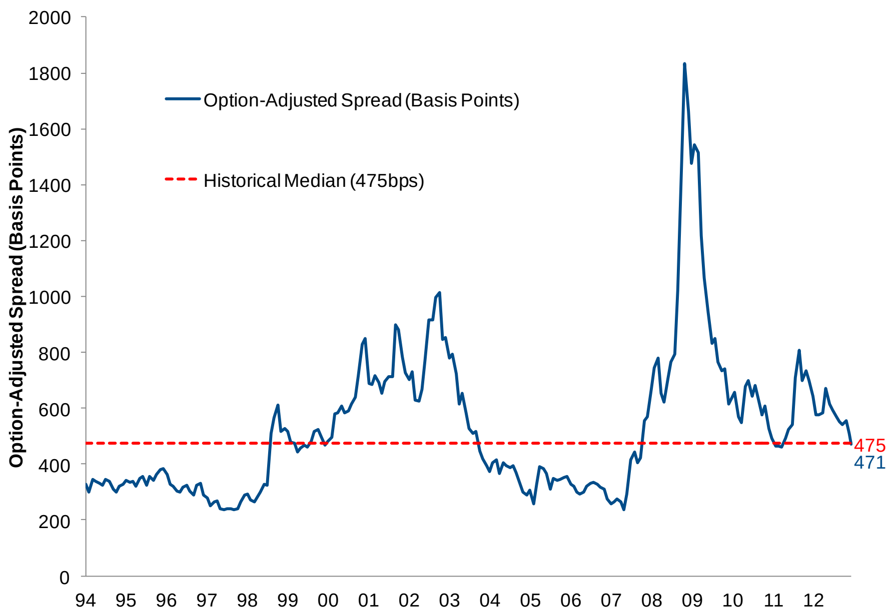


- **Attractive valuations:** US Banks currently trade around book value, a valuation level that has been higher 84% of the time historically (Exhibit 1).
- **Strong linkage to housing recovery:** While US homebuilders have historically had the highest leverage to housing fundamentals, US banks are a close second, as the majority of their balance sheet is backed by US real estate.
- **Increasing capital return:** High capital levels coupled with below-average payout ratios should allow banks to increase dividend payments and buybacks this year. Thus, banks will offer both dividend growth and dividend yield that is likely to surpass that of the S&P 500.

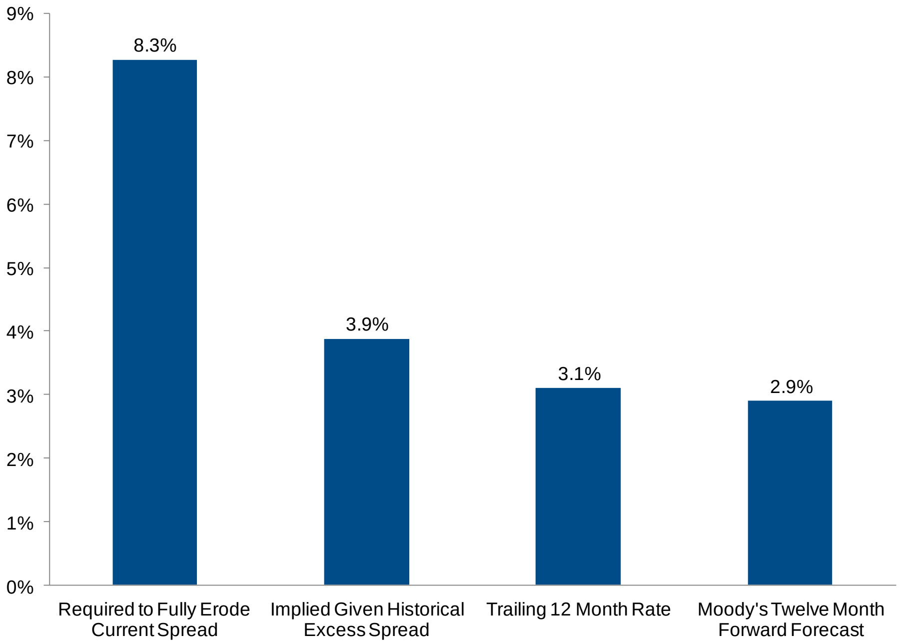
Source: Investment Strategy Group, GS Global Investment Research, MSCI.

Outlook for US High Yield Corporate Bonds

1. US High Yield Corporate Bond Spreads – Through January 14, 2013



2. US High Yield Corporate Bond Default Rates – Through January 14, 2013

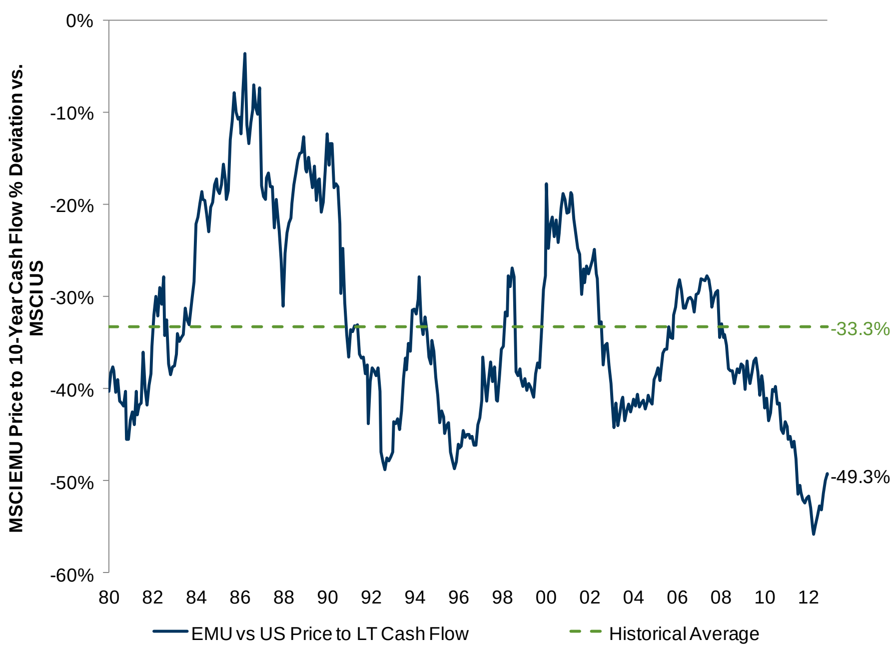


- High yield spreads currently stand at their historical median level, suggesting valuations do not yet reflect investor exuberance (Exhibit 1).
- In fact, the last two credit cycles saw spreads consolidate for several years below 400 bps (1994-1998, 2004-2007).
- Today's spreads still look attractive relative to expected defaults (Exhibit 2).
- In addition, high yield may be a better interest rate hedge than expected. When rates rose quickly historically, HY returns were positive 73% of the time and exceeded those of investment grade fixed income 82% of the time.

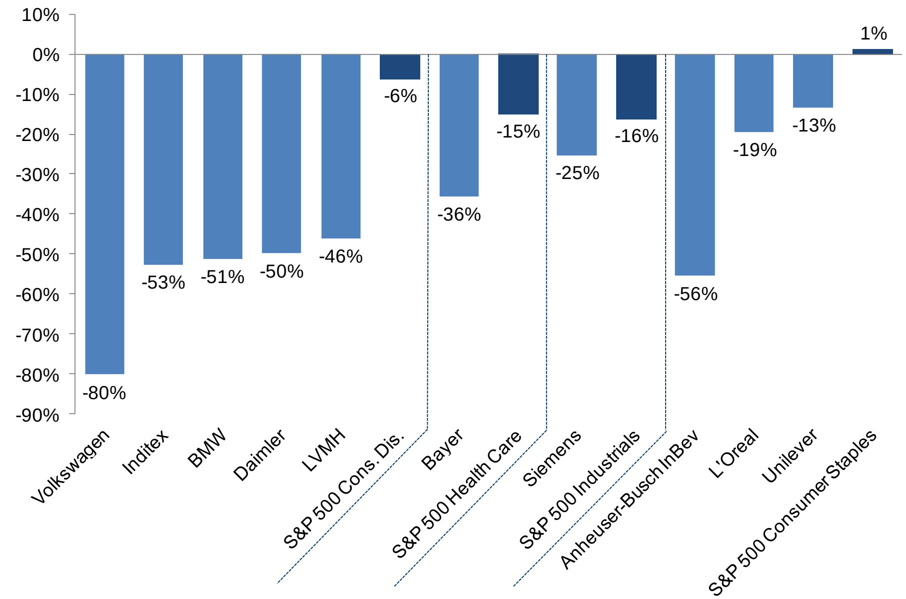
Source: Investment Strategy Group, Datastream, Barclays

Outlook for Eurozone Equities

1. MSCI EMU Price to 10-Year Cash Flow % Deviation vs. MSCI US



2. Percent Deviation of Current PE Multiple from 10-Year Average

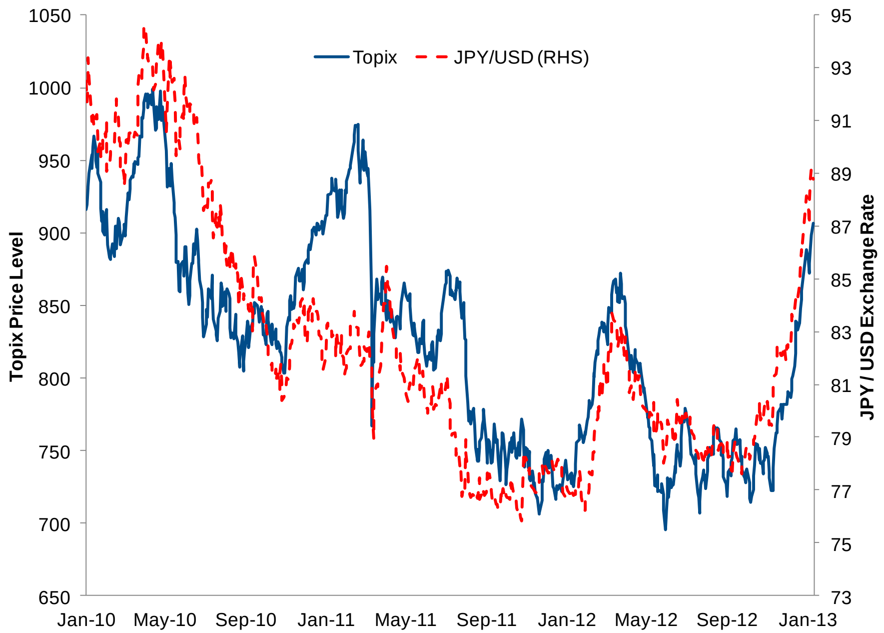


- Eurozone valuations remain extremely attractive (Exhibits 1 and 2), standing in the lowest historical quartile compared to their own history, with nearly every sector and country currently below its historical average.
- In fact, prices would have to rise another 31% just for valuations to reach average levels.
- Multiple expansion from these depressed levels, along with a resumption of earnings growth and a dividend yield of 4% point to an attractive potential return in 2013.
- The Euro Stoxx 50 is comprised of mega cap multi-national brand names who derive nearly half of their sales from outside Europe.

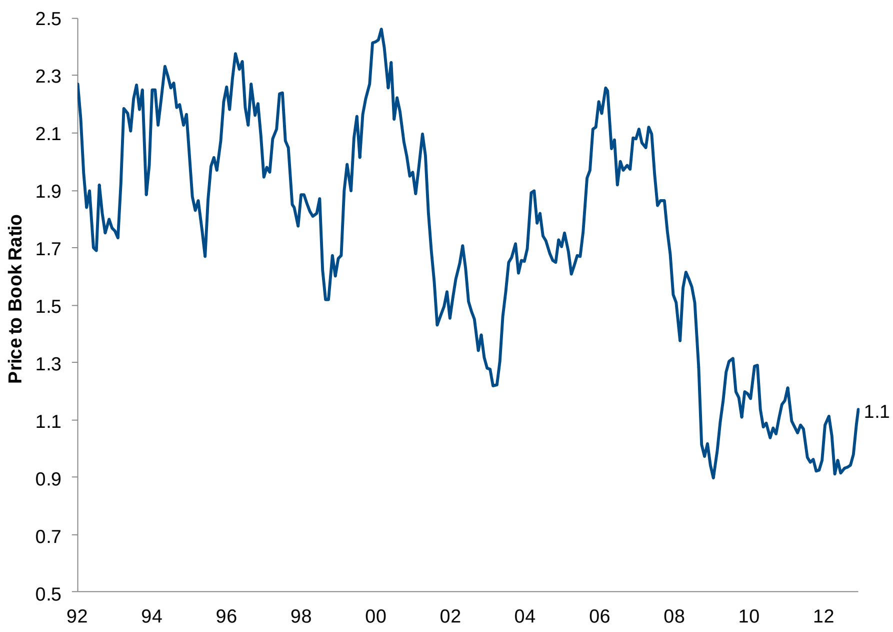
Source: Investment Strategy Group, Datastream, Bloomberg, Intrinsic, Empirical Research Partners

Outlook for Japanese Equities

1. Topix Performance vs. the Yen – Through January 14, 2013



2. Japanese Equities Price to Book Ratio – Through January 14, 2013

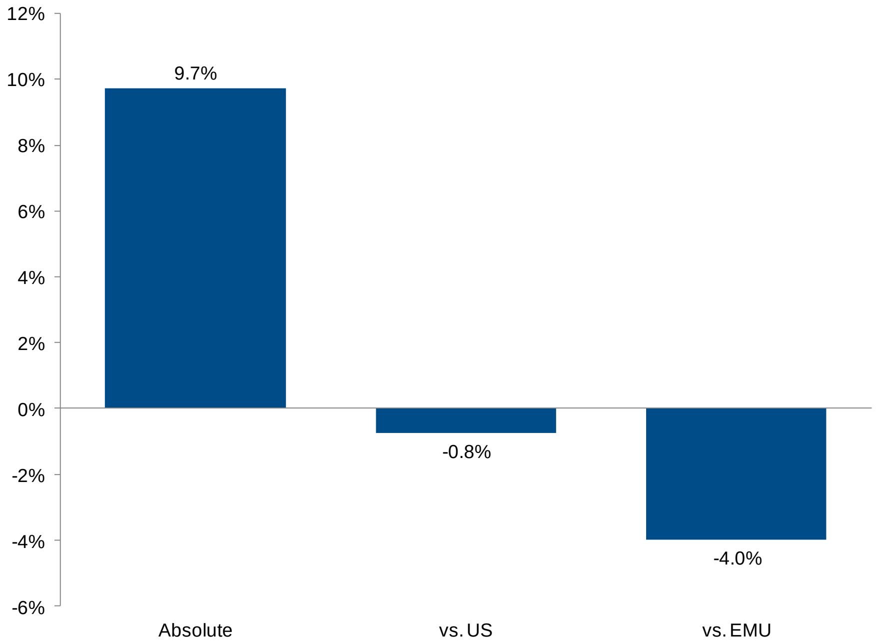


- The repeated pledge of Prime Minister Abe to weaken the yen has been a positive catalyst for Japanese equities in recent weeks, given the close correlation between the two assets (Exhibit 1).
- The structural fault lines of Japan do not obviate the tactical case for its equities in 2013, particularly in the first half of the year:
  – Prime Minister Abe will likely implement favorable economic policies ahead of the summer elections.
  – Furthermore, Japan's aggregate price-to-book ratio remains near the low established during the financial crisis, despite the significant reduction in global tail risks since then (Exhibit 2).

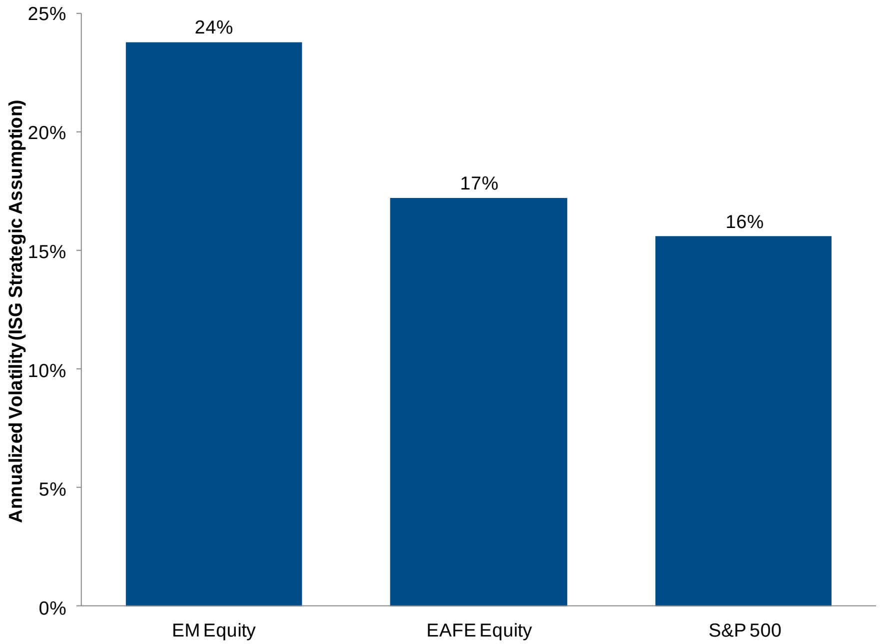
Source: Investment Strategy Group, Datastream.

Outlook for Emerging Market Equities

1. Implied Upside/Downside to 10-Year Average Valuations



2. Annualized Volatility of Global Equities

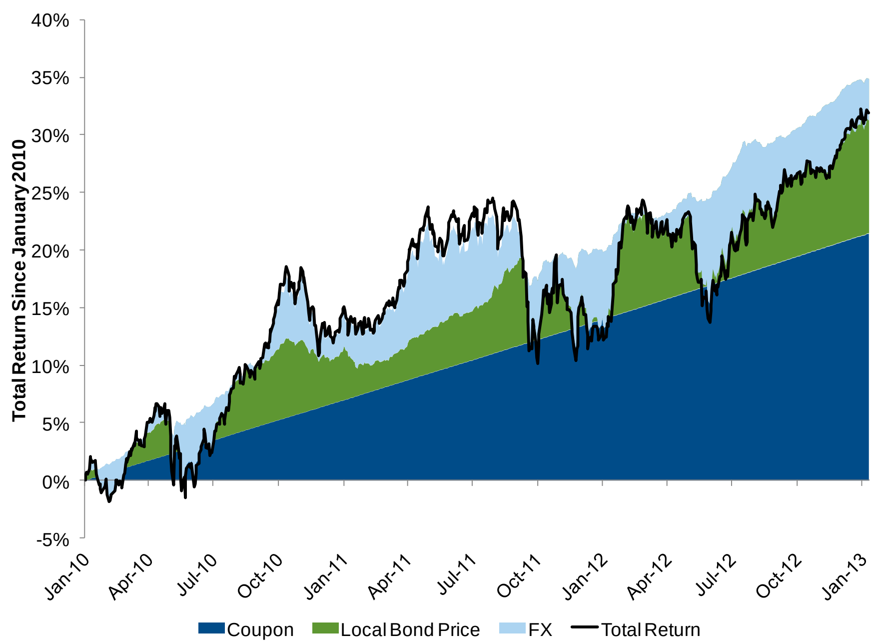


- Emerging market equity valuations are less attractive than other markets: while emerging market equities appear attractive compared to their 10-year average valuation level, the same mean reversion analysis implies negative returns relative to other markets. (Exhibit 1)
- Moreover, emerging market equity volatility is about 50% higher than US volatility and 40% higher than EAFE volatility. (Exhibit 2)
- As such, we do not think emerging market equities offer a compelling tactical opportunity at this time, particularly in light of their significant structural fault lines.

Source: Investment Strategy Group, Datastream.

Outlook for Emerging Market Local Debt

EMLD: Breakdown of Returns by Component



- We expect mid- to high-single-digit returns in EMLD in 2013. Drivers include a positive beta to S&P, coupon income and modest emerging market currency appreciation.

Source: Investment Strategy Group, JP Morgan.

Emerging Market Local Debt Provides Exposure to a Broad Set of Risk Factors

1. Global Risk Premium Exposure: EM Local Debt vs. EM Dollar Debt[1]

2. Emerging Market USD-Denominated Debt (EMD) Spread (%)

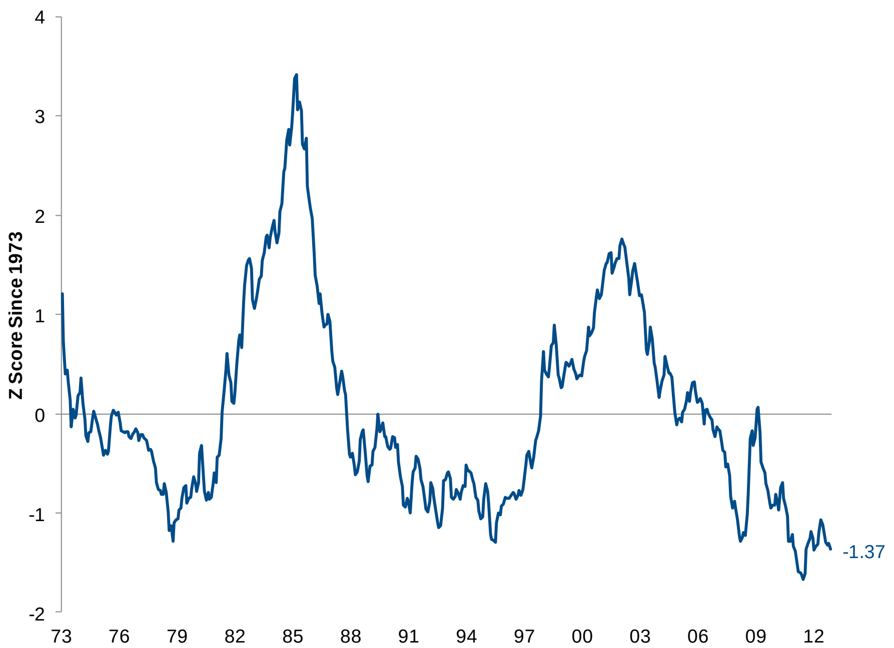
- Emerging market local debt provides better diversification benefits than emerging market US dollar-denominated debt because it offers exposure to a broader set of global systematic risk factors (Exhibit 1).
- Emerging market local debt has less exposure to the “term” risk premium as its duration is 4.9 years, meaningfully lower than the 7.5-year duration of emerging market US dollar-denominated debt.
- Emerging market local debt is also more attractive on a tactical basis. The spread of emerging market US dollar-denominated debt is only 1% above its all-time low while emerging market local debt spreads are slightly above their 10-year average (Exhibit 2).

(1) Please see “Strategic Asset Allocation in a Multi-Factor World,” in the November 2012 *Journal of Portfolio Management* by Farshid Asl and Erkko Etula for additional details.

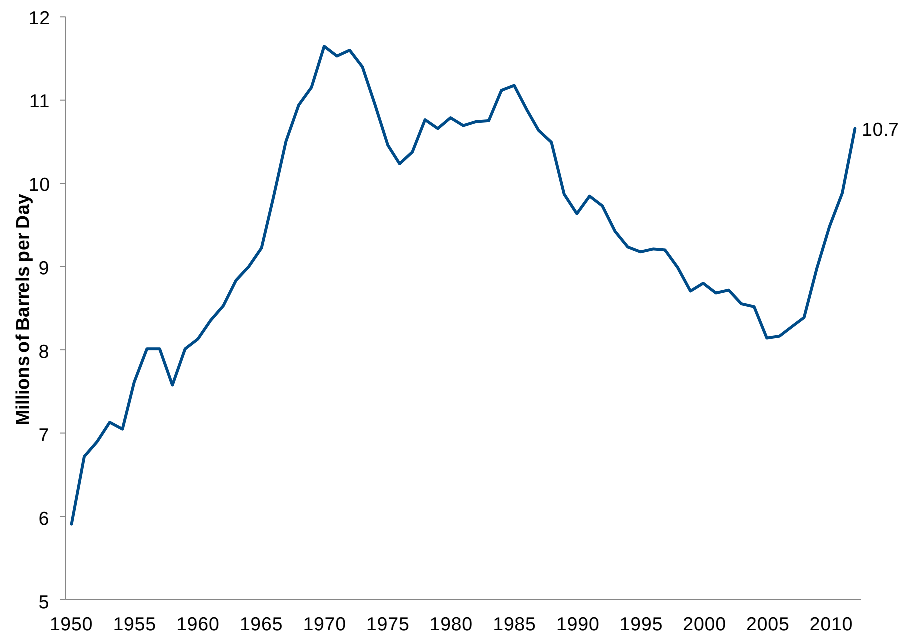
Source: Investment Strategy Group, EMBI Global Diversified Index.

Outlook for Currencies and Commodities

1. US Dollar Real Effective Exchange Rate – Through December 2012



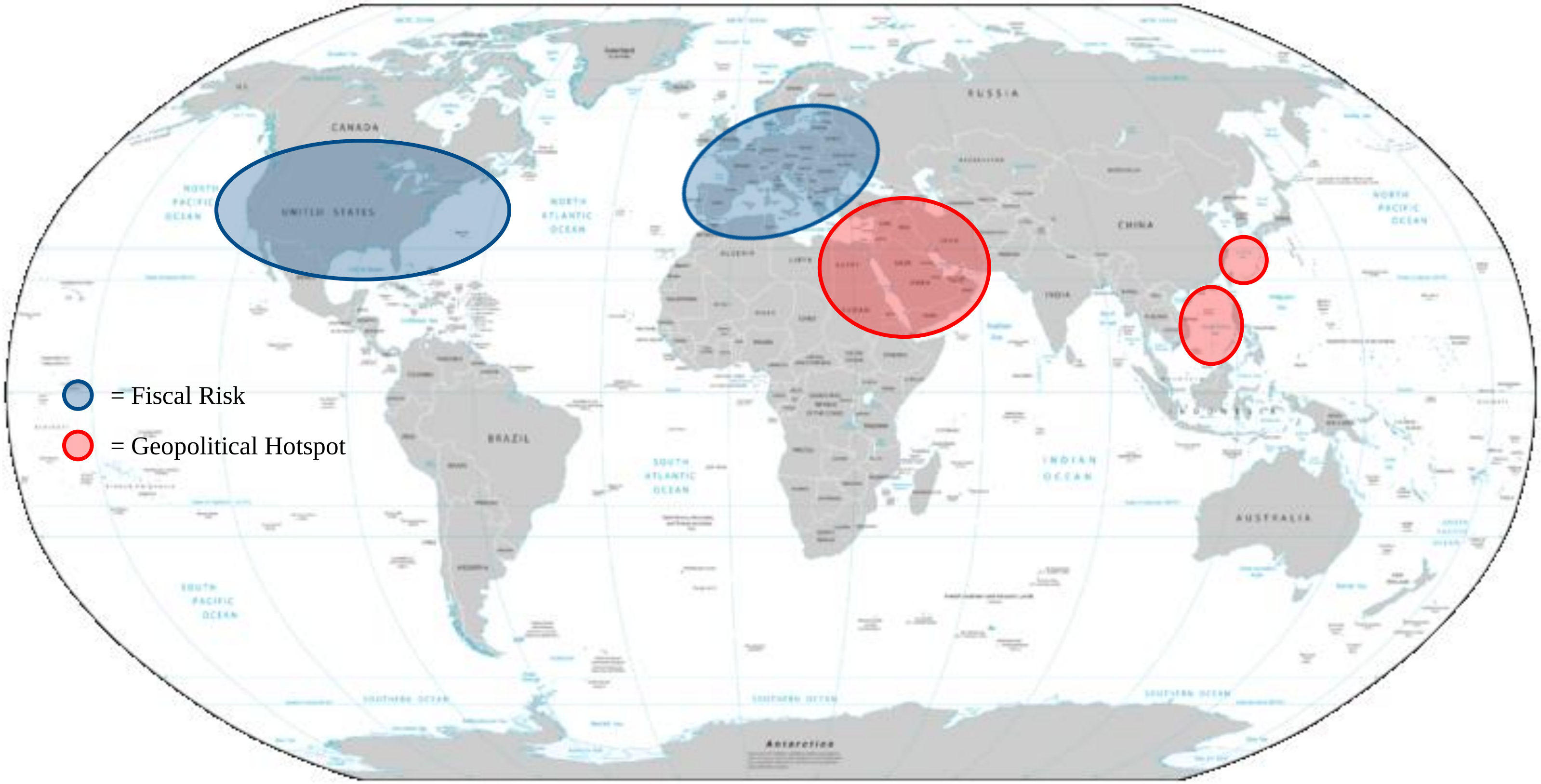
2. US Production of Petroleum Products - Crude and Other Liquids



- Our outlook for the USD and oil has not changed meaningfully:
  - While the USD is attractively valued, we expect the US Dollar to remain relatively range-bound in 2013. The Fed is likely to remain very accommodative and the current account deficit will remain a drag.
  - We expect Brent oil prices to stay between $85 and $110 this year, implying a slightly lower average price than in 2012. Meanwhile, West Texas Intermediate (WTI) should remain at a $5–15 discount to Brent.

Source: Investment Strategy Group, Datastream.

Key Global Risks Over the Horizon That Could Lead to Market Volatility



1. Contentious debate over the US debt ceiling and expenditure cuts
2. Escalation of the Eurozone Crisis
3. Major geopolitical crisis in the Middle East
4. Heightened tensions between China and Asian neighbors over maritime boundaries

Recommendations

- Expect lower prospective returns across asset classes.
- Hold core assets in US equities and high yield.
- Consider attractive opportunities in US banks, the Euro Stoxx 50 and emerging market local debt.
- Anticipate that fiscal issues in the US and the Eurozone sovereign crisis will lead to market downdrafts.

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