Goldman Sachs Asset Management

Fundamental Equity Team
3rd Quarter 2014

Global Equity Outlook

The Slow, Steady Climb to Normal

Executive Summary

We believe equity returns for 2014 are likely to be in line with historical averages.

- Equity performance has been strong in many markets nudging valuations higher to near historical average levels.
- However, the global economic recovery is broadening and equity risk premiums are still above average, suggesting that equities may look attractive to other assets.

Not "missing the micro for the macro" will be critical for generating alpha.

- Average valuations for many markets will likely reduce the upside potential and make stock-picking more critical for generating returns.
- More importantly, we believe investors may overlook good companies by picking stocks based solely on a region's macroeconomic environment.

We have moved to a neutral view on developed vs. emerging markets.

- Valuations have moved higher for most developed markets while economic and earnings growth have progressed more slowly than consensus expectations.
- Improving prospects for some emerging markets, combined with lower valuations, suggest that the risk/reward trade-off has become more equal since our 2Q14 outlook.
- We think Europe could offer the most upside amongst the developed markets.
- In the growth and emerging markets, we are bullish on India, near-term cautious on China and watching Brazil closely.

We continue to favor companies and industries exposed to growth spending.

- Healthcare and information technology stocks have already been benefitting from increased M&A activity. We continue to believe technology stocks will be further helped by delayed capital expenditure (capex).
- We continue to have a cautious view on state-owned-enterprises (SOEs) because they often serve purposes other than maximizing and returning profits to shareholders.
- Despite recent outperformance, we remain underweight utilities and telecommunications companies in most regions, due to high regulation and low growth prospects.

OVERVIEW

It's been a long time since we have experienced a "normal" investing environment, but we might be close to one. Almost six years since the onset of the global financial crisis, which was quickly followed by the euro zone crisis, the global economy continues to improve, if slowly. Companies are starting to invest for growth, notably through mergers and acquisitions (M&A) and corporate earnings are increasing, even if not as fast as expected. Furthermore, correlations and volatility have fallen from elevated levels during the crises.

We believe equity returns in 2014 could be close to the historical average of 8-10%.

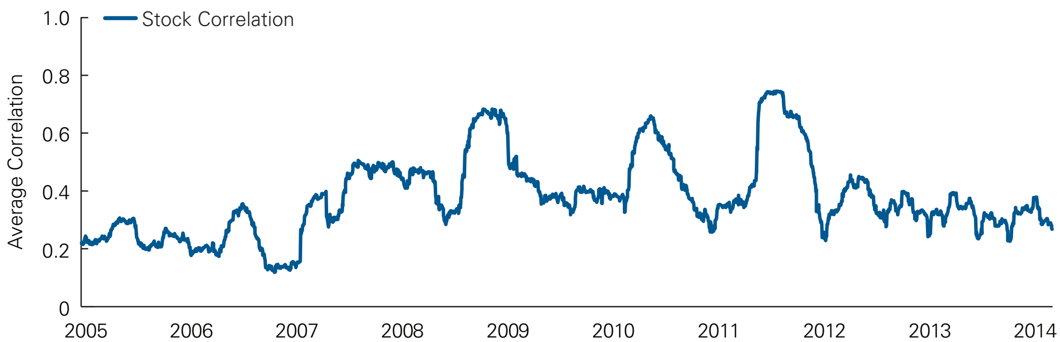
The Slow, Steady Climb to Normal

We believe equity returns for 2014 are likely to be in line with historical averages. In fact, with global equity returns of 6.18% (in USD) for the MSCI All Country World Index (ACWI) as of June 30th, they are more than half way to the historical averages for the MSCI ACWI (8%) and MSCI World Index (9.8%)[1]. Compared to the last couple of years, the slow, steady climb to normal, average returns may feel like it takes a lot of patience and effort. We agree. Following recent strong equity performance in many markets, valuations are close to historical averages, which means investors must look harder for individual stock opportunities and will have less downside protection. However, the global economic recovery is broadening and consensus expectations are for an 8.7% increase in earnings in 2014,[2] which should support roughly 8-10% equity returns. Furthermore, equity risk premiums are still above average, suggesting that equities may look attractive to other assets.

Don't Miss the Micro for the Macro

Active management and stock selection will be more critical for generating alpha, in our view. Several benchmarks, particularly in the US, have notably outperformed many active managers this year. We think this phenomenon is unlikely to persist. Correlations between stocks have fallen from elevated levels during the financial crisis, which creates more potential for stock level differentiation.

Correlations between stocks have fallen to more normal levels



Source: GS Global Investment Research, as of June 2014[3]

Furthermore, in the developed markets, valuations are largely at historical averages, which will likely lessen the upside potential for a broad index and will make stock picking more critical to generating returns. For example, while the US market is currently trading at about 15.5x forward earnings,[4] we see many interesting companies trading at around 10-12x forward earnings. Similarly, while we are bullish on the Information Technology (IT) sector globally, we are underweight Japanese technology stocks because most of them are hardware companies and we generally prefer software, IT services or companies related to secular trends like mobility and the cloud. We believe these companies are more likely to benefit from increased spending.

[1] Source: MSCI data from Datastream. Data based on total return for MSCI ACWI from 1988 and MSCI World from 1970.

[2] Source: GS Global Weekly Kickstart, June 23, 2014.

[3] The GS GIR data above have been prepared by Goldman Sachs Global Investment Research and is not a product of GSAM. It is financial research prepared in compliance with applicable provisions of law designed to promote the independence of financial analysis and is subject to a prohibition on trading following the distribution of financial research.

[4] Source: Datastream and GSAM calculations, as of May 2014

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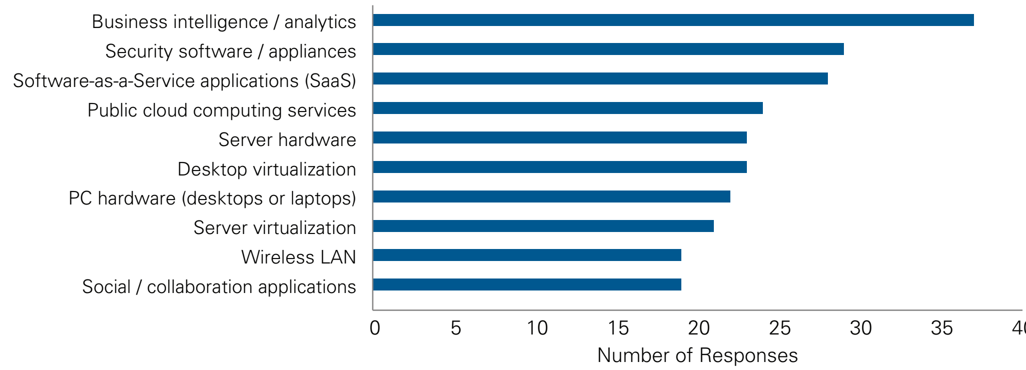
Technology Spending is Likely to be Focused on Software, Mobility and the Cloud

Survey results showing the top ten areas companies plan to accelerate IT spending in 2014



Source: GS Global Investment Research Global Technology Spending Survey, data as of December 2013.[5]

More importantly, we believe investors may overlook good companies by picking stocks based solely on a region's macroeconomic environment. In Europe, for example, where over 50% of revenues from European companies come from outside of the region,[6] investors need to look closely at the actual business model and end-markets of any given company, regardless of its domicile. In the growth and emerging markets, we would rather attempt to appropriately discount the macroeconomic risk in the price we are willing to pay for an otherwise good investment opportunity. For example, we like bank stocks in some smaller, less-covered markets like Colombia and Peru. These banks have massive market share and significant pricing power, which means they do not have to take nearly as much risk to earn the same return on equity (ROE) as a developed market bank that faces heavy competition.

Back to Neutral

We have moved to a neutral view on developed vs. emerging markets. While our portfolios reflect a wide variety of views within these markets, we have made this subtle shift based on our assessment that the risk/reward trade-off has become more equal since our 2Q14 outlook. Valuations have moved higher for most developed markets, while economic and earnings growth is coming more slowly than consensus expectations. Meanwhile, prospects for some emerging markets have improved and many of their valuations remain slightly below those of developed markets.

Developed Markets: Europe's Potential

Within the developed markets, we continue to see three distinct opportunities in each of the major regions. We continue to view the US as the highest quality story that comes at a higher price and we think Japan has great potential dependent on huge change. We believe that Europe, despite its risks, could offer the most upside when earnings start to come through.

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[6] Source: Global Exposure Guide 2013, Morgan Stanley European Equity Strategy Team

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Many developed country markets are trading at higher valuations, relative to their own histories, than growth and emerging markets

	CAPE		FY1 PE		Price/Book	
	level	% time better	level	% time cheaper	level	% time cheaper
US	22.7	72%	15.7	69%	2.7	69%
UK	14.3	55%	13.7	66%	2.0	60%
France	16.9	54%	14.2	60%	1.5	51%
Germany	17.2	59%	13.2	43%	1.8	57%
Italy	14.4	36%	13.8	45%	1.1	37%
Spain	12.7	33%	15.4	82%	1.6	64%
Japan	30.8	47%	13.2	8%	1.2	11%
Brazil	9.3	21%	10.0	76%	1.3	48%
China	11.7	24%	8.0	5%	1.4	26%
India	18.4	49%	15.8	74%	3.0	57%
Russia	5.5	5%	4.6	12%	0.7	10%
Mexico	22.9	78%	18.1	100%	2.8	78%
Korea	13.4	26%	9.3	34%	1.1	27%
Indonesia	16.0	38%	14.4	75%	3.5	72%
EM	13.0	20%	10.5	27%	1.5	22%
DM	20.6	57%	15.0	44%	2.1	55%
World	19.4	50%	14.3	36%	2.1	32%

Source: GSAM, Datastream, as of June 2014. Cyclically adjusted price-to-earnings ratio (CAPE) calculated using US inflation and a five-year rolling window to smooth earnings. All based on MSCI country indices. Totals calculated using MSCI World Index (for Total Developed Markets) and MSCI Emerging Markets Index (for Total Emerging Markets). All "% time cheaper" data is based on full sample history for each country. Start dates vary. Value rank is calculated as the rank of the average value score for each country market. A value score is given to each market and is a function of the percent of time it has been cheaper than historical observations.

US: Growth, at a Price

In our view, US equities could benefit from the strongest macroeconomic outlook amongst the developed markets, as well as exposure to growth spending. Consensus estimates for US GDP growth are 2.5% for 2014 and 3.3% for 2015, which are over one percentage point higher than estimates for the Euro area and Japan in both years.[7] The US equity market is well-positioned to potentially benefit from the current strong M&A activity in the Information Technology and Healthcare sectors, which account for 30% of the S&P 500 Index, as well as our expectation of forthcoming capital expenditure (capex). We also continue to have a favorable view on companies and industries that are positively impacted by US shale development. Currently, we like US energy companies with predominantly domestic assets, which we believe could have an advantage over

The US equity risk premium is still well above pre-crisis levels

Source: GSAM calculations as of June 2014

[7] Source: Bloomberg, as of May 2014

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In Japan, wage growth is taking hold and setting expectations for future wage growth and inflation, which is an important shift in the Japanese mindset after years of deflation.

the more internationally-focused companies. We also favor companies that could benefit from the cheaper US feedstock, such as refiners and petrochemical producers.

US equity valuations are beginning to reflect strong economic and corporate growth prospects for the US. The S&P 500 continued to make fresh highs into June and valuations for the overall market are generally in line with historical averages. While we believe that this could mute upside potential for the US compared to other markets, we note that the equity risk premium is still well above pre-crisis levels,[8] suggesting that US equities are attractive versus bonds.

Japan: Catalysts May be Coming

Encouragingly, Japan appears to have come through the April consumption tax hike with better than expected growth. In our view, the ultimate driver of higher equity returns in Japan will have to come from successful structural reforms in terms of labor, inflation and corporate culture, which may take time. However, Japan could have a series of near- and medium-term catalysts that may boost investor sentiment and equity prices. First, we believe that the Japanese government is particularly incented to show strong economic growth in the second half of the year, in part because it could help justify a further increase in the consumption tax next year. We think this increases the likelihood that the Bank of Japan will take further steps to stimulate the economy in the coming months, particularly as it did not act earlier in the year. Second, wage growth is taking hold and setting expectations for future wage growth and inflation, which is an important shift in the Japanese mindset after years of deflation. Lastly, Japan is the developed market country most exposed to global growth, given its export-driven economy. Despite these prospects, Japan's equity market has lagged other developed market regions this year, leaving it a valuation advantage versus some other markets.

Europe: Widest Range of Outcomes

We believe that the potential for upside, balanced against a number of risks, leads to a wider range of outcomes for Europe than other developed markets. The consensus expectation for Euro area economic growth in 2014 is a modest 1.1%, but it marks an important swing back into positive growth, following contractions of 0.4% and 0.7% in 2013 and 2012, respectively. Meanwhile, the UK is expected to grow 3.0% this year, the strongest of all the developed markets, which is also a healthy increase over 1.7% GDP growth in 2013.[9] If macroeconomic growth can support revenue growth, we believe that European companies have meaningful margin leverage to drive earnings higher, particularly with earnings still 35% below peak levels.[10] Furthermore, European companies—which collectively get 52% of their revenues from outside of Europe—could also benefit from accelerating growth in other regions. In our view, if Europe can outperform, it will outperform by a lot.

In order to maximize the potentially strong tailwinds of economic and earnings recovery, we believe that Europe needs to tackle some near-term economic conditions and longer-term structural reforms. First, despite the imminent threat of deflation, the euro has stayed surprisingly strong, which has been a headwind for European businesses and a key source of earnings downgrades this year. The good news is that the European Central Bank has earned credibility for its "whatever it takes" support of the European economy. The recent June 5th rate cut could help to both stem deflationary pressure and depreciate the euro.

Europe is also addressing critical structural reforms. The Asset Quality Review (AQR) is an important step toward renewing confidence in Europe's banks and we believe it is progressing well, with 30 billion EUR of equity raised so far this year. We do not expect any surprises when the findings are released in October. Other structural reforms, such as competitiveness and productivity, are being executed at the country level, but there are notable differences. For example, Spain, which

[8] Source: GSAM calculations as of May 2014

[9] Source: Bloomberg, as of May 2014

[10] Source: JP Morgan Casanove European Equity Research

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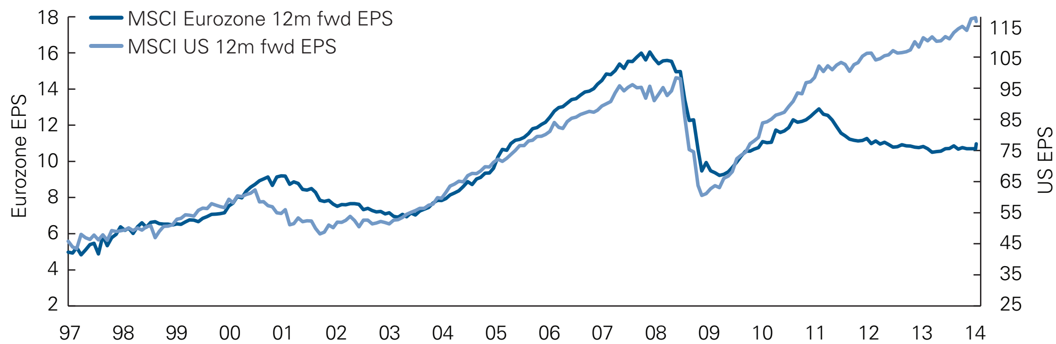
Improvements to competitiveness and productivity within every European country will be important to the whole of Europe as it continues to compete with the rest of the world. Successfully executing on these structural reforms will add to upside potential for European companies.

was brought to the brink during the euro crisis, has made critical labor reforms that reduced costs to the point that some companies are now repatriating jobs from Latin America. Italy's reform stalled but new labor reforms have recently been proposed with muted opposition. France, by contrast, has been slow to initiate reforms, which could put its economy at risk. Improvements to competitiveness and productivity within every European country will be important to the whole of Europe as it continues to compete with the rest of the world. Successfully executing on these structural reforms will add to upside potential for European companies.

European corporate earnings are still well below peak levels



Source: JP Morgan Equity Strategy, June Chartbook, June 2014

Growth and Emerging Markets: Watching the Tiger, the Dragon and the Football

In the growth and emerging markets, we are bullish on India, given the increased likelihood of structural reforms, and near-term cautious on China due to some excesses in the financial system and the resulting drag on growth. We are watching Brazil closely—and not just for the World Cup.

India: "Good Days are Coming"

Good days may indeed be coming to India, as promoted by the winning BJP party's tagline. In our view, the landslide election of Narendra Modi's BJP party could be the important catalyst that the Indian equity market—which is up 21.86% year-to-date (MSCI India in USD)—expects it to be. The Indian electorate handed a majority victory to the BJP party which enables them to act on many needed structural reforms. But to fully understand the potential for the next five years requires a quick look back at the last five. The Congress party's sweeping election victory in 2009 was expected to usher in an era of reform. However, changes did not come and after a series of reputation-damaging corruption scandals, the government waxed increasingly populist. Policy initiatives that increased both taxes and entitlement-based subsidies replaced plans to invest in infrastructure and structural reforms that would have spurred growth and allowed more foreign direct investment. Economic growth deteriorated, inflation barrelled higher and business confidence sank.

Now, we believe the Modi government is likely to propose a business-friendly agenda with greater clarity in regulation and a renewed emphasis on reforms, all of which could lead to a pick-up in investment in the coming months. This outcome could have an outsized effect on the Indian economy, as business confidence improves from recent very low levels, and companies restart stalled or postponed projects. As a result, we are positioned in areas well-exposed to capex, such as commodity-related industries, industrial companies and the financials sector. Many stocks in these sectors have not performed well over the past five years and therefore have room for upside as fundamentals improve. India is also the one region where we think SOEs could outperform in the near-term.

Although Indian equities ran up into the election, valuations are still around the historical average, which we believe looks attractive in light of the potential for India to be in the early stages of a multi-year earnings cycle. With sentiment and expectations so high for India, the biggest risk is disappointment if the Modi government cannot execute the needed reforms. In addition, while India's economy is more domestically-focused than many others, it is not immune from global shocks.

While India seizes an opportunity for structural change, China is beginning to deal with excesses and unsustainable financial trends, though the process is likely to be slow.

China: The Growing Shadow of Local Finances

While India's political bureaucracy spent much of the last decade unable to build enough infrastructure and struggling to accelerate economic growth, China's tightly controlled one-party system continued to steadily grow its economy and overbuilt infrastructure and housing. As India seizes an opportunity for structural change, China is beginning to deal with excesses and unsustainable financial trends. The process is likely to be slow, and there is a risk that it could be painful.

Land and property are at the core of many of China's current issues. Chinese local governments drive most of the fixed asset investment in the country. To raise capital, the local governments have long engaged in the practice of creating opaque, lightly regulated companies for borrowing purposes, which they finance through debt and land sales. Thousands of these companies now exist with a collective 3.6 trillion RMB in debt coming due this year.[11] 60% of the local government financing comes from land sales, which has been easy money in a booming property market.[12] But China's property market is now cooling, as developers are no longer as keen to buy land due to an oversupply of housing inventory. Making matters worse for the local governments, other sources of financing are also being tightened—the central government is cracking down on shadow financing and banks are becoming more cautious given the slowdown in the property market.

The local government financing situation is already a drag on fixed investment growth, which has slowed to 16.8% yoy through April[13] and could likely be the start of a multi-year deleveraging process. There is also a growing risk that some of the financing vehicles may default. While we believe the central government will likely find a way to manage the situation, we view the combination of financial risk and policy uncertainty as an investment risk. Therefore, we remain cautious on the macroeconomic environment in China until we have a better sense of policy and structural reforms the government might employ to diffuse the situation. We believe the mid-sized banks, which have relatively less liquid balance sheets, could be negatively impacted and we also have a cautious view on metals, mining and cement, which all suffer from overcapacity and are likely to be further hurt by reduced fixed asset investment.

Chinese consumption, however, is still growing strongly, though it is not enough to make up for the deceleration in other areas of the economy. Nevertheless, we have a positive view on the Chinese consumer and are positioned in the consumer-related sectors as well as the healthcare, technology and digital industries.

Brazil: What Will Kick Off Growth?

All eyes are currently on Brazil for the World Cup. However, we will continue to watch for hints that the seventh largest economy in the world is ready to make the necessary structural changes to kick-start its growth. Unlike China and India, the end of the commodity boom has been a major contributor to Brazil's recent economic woes, particularly for the equity markets, where energy and other commodity-oriented companies comprise over 25% of the market. But this is only part of the story. Like China, Brazil is also wrestling with some financial excesses, primarily an overlevered consumer. Similar to India, Brazil has seen its economic growth drop off sharply and has struggled to reignite it, in part due to high inflation which has forced the central bank to raise interest rates nine consecutive times. Brazil also has an important election in October, which could bring much needed

[11] Source: James Kynge, China Confidential

[12] Source: James Kynge, China Confidential

[13] JP Morgan Asia Pacific Equity Research

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structural reforms. Equity markets are already rising in response to increasing talk of change and we believe the election could become an important catalyst for Brazilian equities.

Exposure to Growth Spending

We have a positive view on the Chinese consumer and are positioned in the consumer-related sectors as well as the healthcare, technology and digital industries.

We continue to favor companies and industries exposed to growth spending. Global M&A has already surpassed $1.75tn this year, the strongest start to the year since 2007.[14] Healthcare and information technology stocks have already been amongst the biggest beneficiaries of this trend, which we expect to continue. Furthermore, we believe M&A, which is a lower-risk pro-cyclical action, is a likely precursor to capex. When capex comes, we continue to expect that information technology stocks will benefit.

We continue to have a cautious view on SOEs because they often serve multiple purposes in an economy and therefore may not always be run to maximize and return profits to shareholders. These companies comprise large parts of many growth and emerging market indexes. As a result, our portfolios tend to own more small- and mid-cap stocks, which we think can better capture the growth and profitability in these regions.

Despite recent outperformance, we remain underweight utilities and telecom in most regions. The low interest rate environment has sent investors searching for yield, including bond-like stocks, which offer relatively high dividends but little growth. We do not believe this trend will persist as economies are already recovering and interest rates are on the cusp of rising. Therefore, we remain cautious on these sectors due to their high regulation and low growth prospects.

Conclusion

The third quarter begins with the majority of economies once again growing and many stock markets on the rise. The macroeconomic environment is showing signs of getting back to normal—companies are beginning to invest for growth and some central banks are beginning to signal that they will soon increase interest rates after years at exceptionally low levels. In the equity markets, correlations and volatility have fallen from elevated levels during the crises and valuations for many markets near historical average levels. All of these factors mean that stock performance is more likely to be driven by fundamentals such as earnings growth. As we continue to believe total equity market returns for the year will be close to the historical average of around 8-10%, we believe stock selection will be critical to generating excess returns.

Against this backdrop, we have also taken a more neutral view on developed versus emerging market equities as we feel the risks and rewards are more equal than they were three months ago. We believe the US, Japan and Europe offer three different opportunities for investors, with Europe offering the greatest upside potential, despite its numerous risks. In the growth and emerging markets, we believe India's election outcome could usher in an era of reform and a new earnings cycle. We believe Brazil has a similar opportunity for change with its election later this year. We are cautious on China in the near-term as the government slowly works through some excesses in its financial system. We continue to favor companies and industries exposed to growth spending, like healthcare and information technology and retain our cautious view on SOEs, underweight utilities and telecommunications companies in most regions.

We start the second half of the year slowly and steadily climbing to normal and looking carefully for the best opportunities we can find in every market around the world.

[14] Source: Financial Times, June 24, 2014, data from Dealogic

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