

Global Fixed Income Outlook

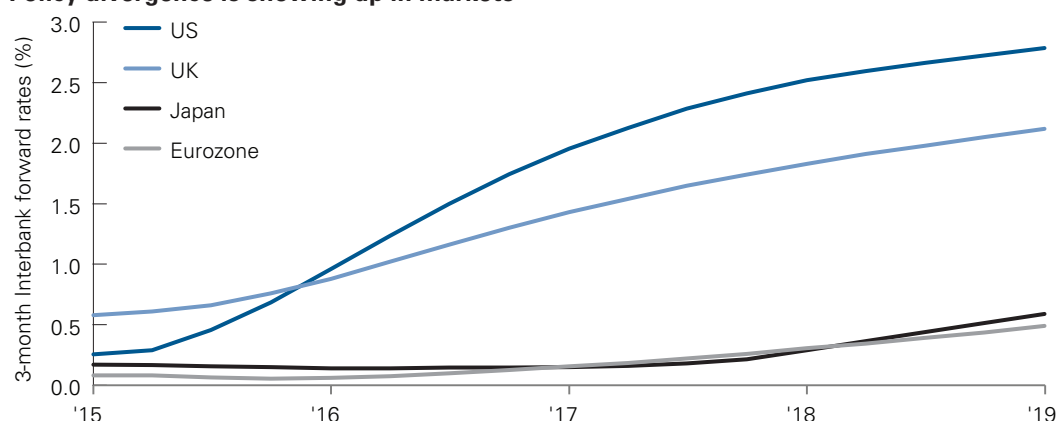
Divergence Plays out in Markets

Executive Summary

Our evolving theme of divergence reaches a pivotal point in 2015, as markets react to contrasting growth and policy drivers. We see strong US growth triggering the first rate hike since the crisis, while weakness in the next-largest economies leaves their central banks firmly in easing mode. Lower oil prices add to the cross currents. While we are cautious in volatile market conditions, we see more opportunities ahead.

- At the forefront of the global recovery, we see US growth accelerating in 2015. A modest pickup is likely in the Eurozone and Japan, despite persistent disinflationary pressures. In China, monetary and fiscal stimulus should keep growth close to 7%.
- Lower oil prices are a tailwind for global growth. The largest economies are net importers, and their savings should more than offset the negative effect on oil exporters. Declining prices have also pressured headline inflation lower, but the impact is likely temporary.
- In the US, we expect robust growth and labor market indicators will persuade the Fed to look through any short-term softness in inflation. We think a rate hike is likely in June, with risks tilted to September.
- Risk assets are still supported by low inflation, strong growth in the US and stimulus outside the US. We are monitoring the effect of the oil price drop on high yield assets, but we see value in some market dislocations, particularly in currencies and emerging markets (EM).

Policy divergence is showing up in markets



Source: Bloomberg, as of Dec. 26, 2014.

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OIL STRATEGY

In credit markets, we are cautious in volatile conditions, but we see potential value in some oversold sectors of EM and high yield.

While we are broadly underweight the energy sector in high yield, we think other sectors should benefit from low oil prices, including airlines, automakers and homebuilders.

Oil: Drivers and Impact of Weakness

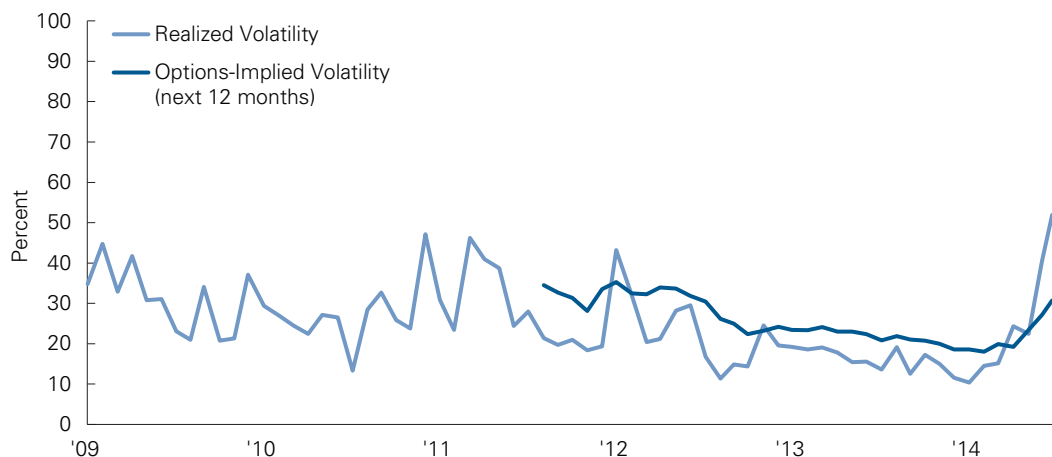
Oil prices have dropped nearly 50% over the past six months, to start the new year at 2009 crisis levels close to \$50/bl. We believe this is a transitional period as markets adjust to significant pressures on both the supply and the demand sides. While prices may decline further in the very near term, oil market fundamentals now seem supportive of higher prices. That said, we don't expect a return to prior levels anytime soon, and we think this is a structural shift to a more volatile environment.

In terms of the oil market outlook, we see supply and demand factors conspiring to reset equilibrium prices at \$60-\$80/bl, well below the highs around \$115 in June 2014. The demand-side pressures are both cyclical, given slowing economic growth in China and Europe, and structural, given the trends towards fuel-efficient vehicles and alternative energy.

Over the short term, we think the dominant market pressure is a supply surplus, which arose this year due to rapid growth in US output and the return of Libyan production. We believe that the surplus may correct in late 2015, as the recent declines in Libyan output are likely to continue, and as US shale producers adjust their output and capex plans to reflect reduced margins.

We see longer-term market implications from OPEC's decision not to intervene to support the market by cutting production, preferring instead to preserve market share. Looking ahead, a market more reliant on US adjustments may be more a volatile price environment, given the fragmentation of the US industry, in which individual producers are responding to different breakeven levels, with no central body to communicate these decisions to the market.

In terms of the global outlook, we think the overall economic impact of oil prices at these levels is positive. The largest economies—including the US, China, Japan and the Eurozone—are net oil importers and should benefit from lower costs, more than offsetting the negative impact from oil exporting nations. Consumption-driven economies such as the US and India stand to gain the most, as savings at the pump translate to more disposable income for households. Lower oil prices can also help global growth by keeping headline inflation down, which should in turn allow central banks in weaker economies to remain accommodative. We estimate that the oil price declines as of early January could add as much as 0.5% to global GDP over the next 18 months.

Markets are pricing in a higher volatility environment in crude

Source: Bloomberg, as of Dec. 19, 2014.

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The decline in oil prices is a negative development for oil exporters, many of which are in EM. The implications for global growth are modest given their combined contribution of around 11% to global GDP. We are monitoring the potential for a shock in EM, particularly against a backdrop of heightened political risks in Russia, but so far we see limited risk of contagion. We think many of these economies will be able to cushion the impact by allowing their currencies to weaken, making fiscal adjustments or simply accepting lower growth.

In terms of industrial impact, energy producers are taking the brunt of the current market weakness. In the US, one effect of the shale boom is that the proportion of energy companies in the high yield universe has grown, and some may be vulnerable to lower oil prices. As a result we have modestly increased our default expectations for 2015, though we believe defaults overall are likely to remain very low relative to history.

US: Strong Growth Paves Way for Hike

The US economy is accelerating into 2015 across a broad range of indicators, and unemployment is subsiding to pre-crisis levels. We expect the sharp drop in oil prices to provide additional support to growth over the next few quarters as the savings to consumers translate to more spending. Against this backdrop, we believe the Fed is on track to raise interest rates for first time since 2006, at either the June or September 2015 meeting.

Examples of the recent momentum in growth include:

- **GDP** growth for the third-quarter 2014 was revised up from 3.9% to 5%, the fastest rate in more than a decade, due mainly to stronger consumption.
- **Non-farm payrolls** rose by 321,000 in November, bringing the six-month average gain to more than 250,000 for the first time since 2006.
- **Retail sales** (excluding autos) increased 4.3% year-over-year in November, the biggest increase since 2012.
- **Auto sales** twice hit an annualized rate of more than 17 million in the second half of 2014, a level not seen since 2006.
- **Confidence** is at its highest level since 2007 among both consumers and small businesses, according the University of Michigan and National Federation of Independent Business surveys.

We think this momentum will persist in 2015 as the effects of a reinvigorated labor market and a likely rebound in consumption more than offset the effects of slower growth outside the US and a strong dollar. We see yields around the middle of the US curve rising as market participants reach the conviction that the current low interest rate settings are out of synch with the economy's strong fundamentals.

One possible setback in 2015 is that weakness in oil markets may check the recovery in capital expenditure. Lower and more volatile oil prices are likely to reduce investment in oil and gas production. However, while energy-related investment has become a large component of overall US business investment, it accounts for less than 1% of the overall US economy. In addition, lower gasoline prices should boost disposable income, which will benefit particularly lower- and middle-income households.

US STRATEGY

We think US interest rates are too low given the strength of the economy and the Fed's increasingly clear signaling of rate hikes in 2015. The main risk to this view is that global investors could continue to see value in Treasuries as the Bank of Japan (BoJ) and European Central Bank (ECB) focus on keeping their rates low.

However, since the Fed is no longer buying government bonds, we think the supply/demand backdrop for US Treasuries has deteriorated and could create more upward pressure on rates. Against this backdrop, we anticipate higher government rates, tighter corporate credit spreads and continued gains in the US dollar.

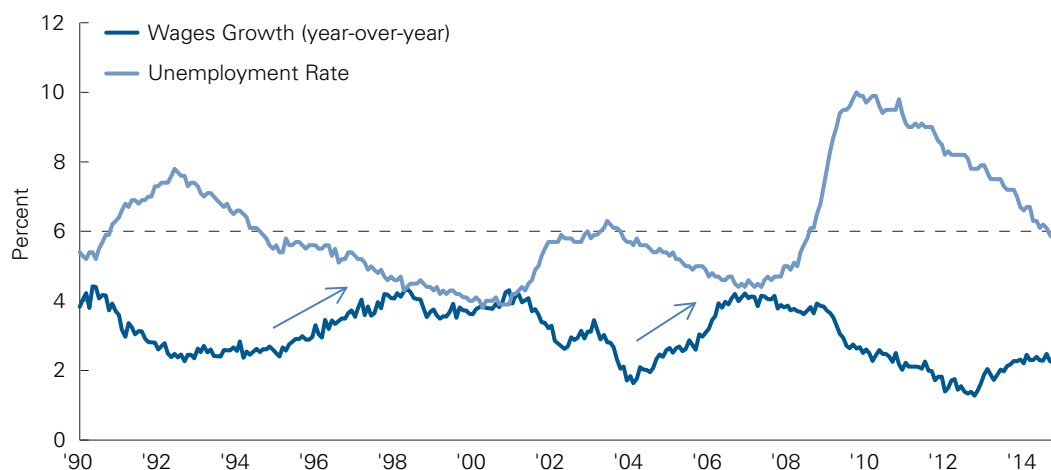
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The timing of the first rate hike depends in part on how the Fed balances the two components of its mandate—maximum employment and price stability—in the context of a strong labor market and an uncertain inflation outlook. At some point in 2015 we think the two will be mutually reinforcing in support of rate hikes, as declining unemployment leads to a tipping point for wage growth, which in turn boosts inflation. Moreover, we think that the Fed will be willing to look through moderately below-target inflation on the basis that the drivers—low input prices due to weakness in commodities—are likely temporary, and longer-term inflation expectations remain healthy.

We think the main risk to this view is if broader measures of unemployment remain elevated, which would suggest the economy still has some slack that could constrain wage growth. However, historically, the relationship between unemployment and wage inflation has not been a linear, one-for-one relationship, but a non-linear relationship in which wages tend to rise more quickly once unemployment falls below about 6%. With unemployment at 5.8% in November and wages already showing some modest gains, we think the upward pressure is likely to increase.

Wage growth could pick up with unemployment below 6%



Source: Bloomberg, Federal Reserve. As of Dec. 17, 2014.

Eurozone: Easing the Path to Growth

We have revised our forecast for Eurozone growth up slightly to 1.2% in 2015, in response to three supportive factors: declining oil prices, the prospect of further ECB stimulus and euro depreciation. Our modest upgrade does not extend to the inflation outlook, however. We think that even with a solid commitment to balance sheet expansion, the ECB will struggle to keep inflation in positive territory in the first quarter, let alone on a path to the target just below 2%.

This is not to downplay the significance of ECB action in the coming months. Heading into 2015 the central bank looks poised to deliver on market expectations for sovereign quantitative easing (QE)—a move unthinkable for its conservative base not so long ago. Policymakers are reaching a consensus that the focus on lending strategies has not delivered the anticipated benefit to the real economy by restoring the flow of credit. The disappointing takeup of the recent Targeted Long Term Refinancing Operations (TLTROs) suggests that the problem may be more demand- than supply-oriented. Indeed, capital expenditure has failed to rebound since the financial crisis, and the outlook remains weak. As a result, the effectiveness of liquidity injections may be limited.

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EUROZONE STRATEGY

Heading into the new year, the prospect of QE in the Eurozone leaves us negative on the euro and cautiously positive on Eurozone peripheral sovereign debt.

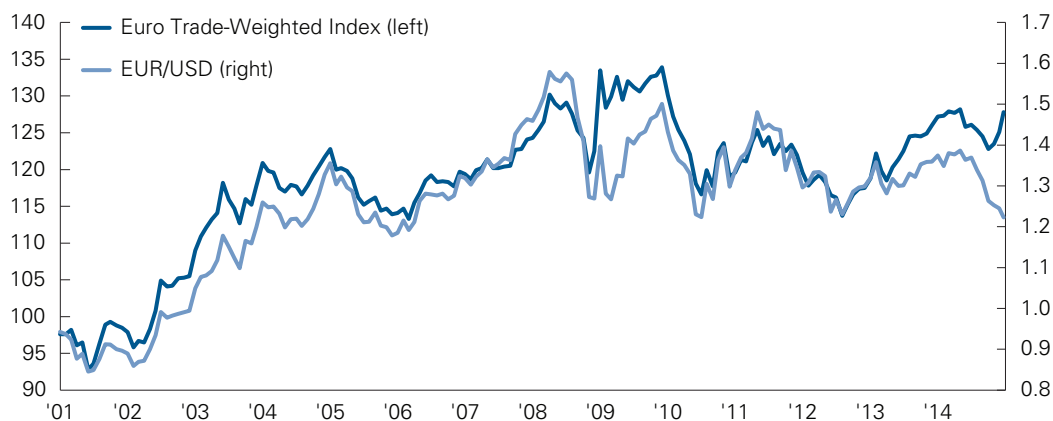
We believe further stimulus is already priced into core markets, and we are neutral German Bunds.

The effectiveness of further stimulus in a zero- to negative rates environment is also in question, but the exchange rate is still a viable avenue to the real economy. We believe QE can provoke a further decline in the currency, which should help Eurozone exports. Though the euro weakened substantially in 2014, the decline was sharpest versus the dollar at nearly 10%, as a result of Fed tightening expectations. On a trade-weighted basis—the measure most indicative of its competitiveness in the global marketplace—the euro has held relatively steady against the steep declines in the yen and EM currencies. The tailwind of euro weakness, combined with low energy costs, underpins our expectations for slightly stronger growth in 2015.

Alongside the advantages of a weaker euro, ECB President Mario Draghi has stressed the urgent need to boost inflation expectations. While we think QE can help the ECB achieve its stated commitment to expand its balance sheet to 2012 levels, which would add around €1 trillion, we are skeptical that it can counteract the disinflationary forces in the euro area. Aside from the temporary impact of lower oil prices, we see significant factors standing in the way, including poor wage growth in Germany—despite a relatively tight labor market—and persistently high unemployment elsewhere, weighing on consumer demand and services prices. Our 2015 inflation forecast is well below consensus, as we see the rate declining to 0.3%.

In our view, the biggest challenges for ECB policymakers this quarter will be to exceed market expectations. Markets are fully priced for more aggressive stimulus, and we see a risk of a sharp market correction if the ECB's actions disappoint. These market tensions will be playing out against rising political tensions in some regions, as 2015 brings some significant elections, including state polls in Germany and general elections in Portugal and Spain. In the near term, markets are particularly focused on Greece's Jan. 25 general election. We expect Eurozone tensions to rise because the leftist party Syriza, which leads in the opinion polls, is likely to take a much tougher line in talks with the troika (the European Commission, ECB and IMF) on the terms of Greece's debt. We expect that the troika and a Syriza-led government would eventually reach agreement, but in the meantime we see potential downward pressure on Greek and other Eurozone risk assets.

The euro's drop has been steeper versus the US dollar than in trade-weighted terms



Source: Bloomberg, Goldman Sachs. As of Dec. 22, 2014.

Japan: Abenomics 2.0

Two years after the election that launched his bold three-point economic plan, Prime Minister Shinzo Abe has secured another term and Abenomics is rebooting. The program stalled on corporate reforms, which we think are necessary to lock in sustainable growth and inflation over the long term. However, the outlook for 2015 is positive, due to low energy prices, record

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JAPAN STRATEGY

Yields have rallied to very low levels, but strengthening growth and the low likelihood of further BoJ action in the foreseeable future may persuade more domestic investors to rotate into higher-yielding offshore assets. The Government Pension Investment Fund (GPIF)—the world's second-largest pension fund—has already announced a reduction in domestic bond holdings in favor of equities.

As a result, we expect yields in the mid-section of the JGB curve to rise in 2015, and we are biased to underweight. In the near term we think BoJ buying will likely pressure JGB yields lower at the long end relative to UK yields. We are overweight long-dated JGBs versus the UK.

monetary stimulus, a new fiscal package and a revised tax plan. While low oil prices will probably dampen inflation early in the year, we expect the effects of a weaker yen and rising wages will help push CPI to 1.6% in 2015.

Growth has already recovered somewhat from the contraction that followed the April 2014 value-added tax (VAT) hike. Our proprietary current activity indicator (CAI), which draws on a range of data to render a picture of monthly economic activity, shows momentum rebounded in the fourth quarter. We see this continuing in 2015, driving growth to around 1.6%.

Monetary stimulus should help. In late October, the BoJ increased its already-massive asset purchase program, raising its target for Japanese government bond (JGB) purchases, and tripling its purchases of riskier assets such as exchange-traded funds (ETFs) and real estate investment trusts (REITs) to ¥3 trillion per year. The BoJ also scrapped the 2015 timing it had set for reaching its inflation target, leaving the 2% goal open-ended.

Fiscal stimulus is also ramping up, with a package of temporary subsidies for consumers, small- and medium enterprises (SMEs) and local governments with weak financial positions. The package is part of Abe's pledge to shore up the economy ahead of the second VAT hike, which would take the tax to 10% and has been delayed two years to 2017. Abe has said there will be no further postponement, suggesting that the target of reaching primary balance surplus by 2020 remains intact.

With all the action on the monetary and fiscal policy fronts, little progress has been made on structural reforms, the so-called "third arrow" of Abenomics. These are unpopular steps, such as restructuring in protected industries and labor market deregulation. However, the government's two-thirds majority—reconfirmed in December's elections—should facilitate such legislation.

Policy aside, Japan should benefit from several tailwinds in 2015. Japan is a net importer of oil, so lower prices should translate to savings in various industrial and consumer discretionary sectors. Consumer spending should also gain from an improved outlook for wages, amid mounting pressure on companies to spend some of their record cash holdings—in excess of \$2 trillion—on compensation. Trade unions are making bolder demands, and more advocates from SMEs are joining them, in the leadup to the Spring wage talks. Moreover, the government is planning incentives in the form of tax breaks for companies offering raises.

Our current activity indicator points to positive growth momentum in Japan



Source: GSAM, Bloomberg as of December 2014. GDP is quarter-over-quarter, seasonally-adjusted annualized rate.

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UK: Intermission

The UK faces an unusual degree of uncertainty in 2015, with a central bank cooling its heels on rate hikes, and the prospect of a very close election in the second quarter. As a backdrop to this lack of clarity on policy, economic momentum has slowed, weighed down to a certain extent by the Continent. However, domestic data from the housing and autos markets to the manufacturing sector suggest growth remains sustainable at close to 3% heading into the new year.

UK STRATEGY

Strong demand from pension funds has kept long-dated rates at very low levels in spite of the recovering macro environment and rising US yields. As a result, long-dated rates look expensive by historical standards, even when accounting for prior periods of intense liability-driven investment activity. We are biased to underweight UK long-end rates versus overweight the US, Japan and Australia.

One surprising development on the economic front is the sharp decline in inflation, to a 12-year low of 1% in November. The drop puts inflation at the lower bound of the Bank of England's (BoE) official target, and we think a further decline is likely in the coming months, prompting a letter of explanation from BoE governor Mark Carney to the Chancellor.

This disinflationary trend undermines the case for rate hikes, which until recently seemed possible in the first half of 2015, given the central bank's repeated aim to start normalizing rates early in order to ensure a gradual and limited tightening. We now think a rate hike is unlikely before the fourth quarter of 2015 and may not come until the following year.

One benefit of the drop in inflation is that average earnings are finally ahead of the cost of living. Though the gain of 1.4% including bonuses is still too modest to provide much fresh impetus for consumer spending, the direction is encouraging and consumer confidence has improved. The coinciding drop in unemployment to a six-year low of 6% raises hopes that a sustainable trend of wages pressure may be in the making.

We see other hurdles to policy normalization, including persistent weakness in exports, which would be unlikely to improve on a strengthening currency. The clouded political outlook may also weigh in favor of keeping rates on hold. The May elections look set for a four-way battle between the Conservatives, Labour, Scottish National Party and the right-wing party UKIP. A positive market outcome is difficult to project given the policy mix in play, with the Conservatives pledging a referendum on membership in the European Union, and given uncertainties over the opposition's commitment to fiscal reform. Moreover, the tightness of the race and the strong possibility of a coalition or an unstable minority government add to potential volatility in policy.

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