Global Equity Outlook

Expectations Versus Reality

Halfway through the year is a natural time to reflect on how the expectations from our previous outlooks are playing out. In many cases, our views are proving correct. When the reality is different, we explore potential reasons and assess whether they change our long-term view and investment strategy. In this outlook we opine on three themes affecting equity markets and update our views on select regional markets and sectors.

- **Global equities are likely to return slightly below the historical average of 8-10%**[1], in our view. Many of the views we expressed in April are unchanged, though we note a few near-term updates in this outlook.
- **Long-term low rates may have some side effects**, from increasing the US savings rate—which may be dampening consumer spending—to encouraging higher valuations for equities.
- **Consumers are increasingly price-conscious, tech savvy and diverse**. US consumption is not as strong as expected, yet not as weak as many think; the mix of Chinese consumption is changing; and global spending patterns will continue to evolve with technology and demographics.
- **Economic growth forecasts are not a great predictor of equity market returns**. We correctly anticipated that US equity returns were unlikely to match the strong forecast for US economic growth. In contrast, China's local equity market has defied gravity—as well as its economy and our expectations.
- Low 2Q15 earnings expectations for many **US** companies may set up positive earnings surprises and a near-term rally.
- **Europe**'s recovery is on track and the weak euro is boosting corporate earnings, as expected. However, European stocks may be pressured in the near-term as optimistic earnings growth forecasts from the beginning of the year come down while the situation in Greece heats up.
- Bottom-up measures of **China**'s economy suggest real economic growth may be weaker than official numbers suggest. However, the domestic equity market reflects the reality of the local mindset.
- Market sentiment has turned more bullish in the **Energy** sector and many stocks are discounting a $70-75 oil price—we think the price will be closer to $60 (WTI)/$65 (Brent) at the end of this year, which makes it more challenging to find attractive investments.

[1] Source: MSCI data from Datastream based on total return for MSCI All Country World Index (ACWI) from 1988 and MSCI World Index from 1970

Overall, we continue to believe the US economy will lead other developed markets, but that easy monetary policy, weak currencies and the potential for higher corporate earnings growth give European and Japanese stocks better chances of outperforming.

Summary of our views

Halfway through 2015, the MSCI All Country World Index (ACWI) is up 4.3%, which is in line with our expectations that global equities would return slightly below the long-term average of 8-10% this year. Many of the views we expressed in April are generally unchanged, though we note a few near-term updates in this outlook. Overall, we continue to believe the US economy will lead other developed markets, but that easy monetary policy, weak currencies and the potential for higher corporate earnings growth give European and Japanese stocks better chances of outperforming. In the emerging markets, we are increasingly cautious on China, given weakening economic fundamentals coupled with a run up in the stock market. We remain most bullish on India and still believe that Russia and Brazil face a number of headwinds.

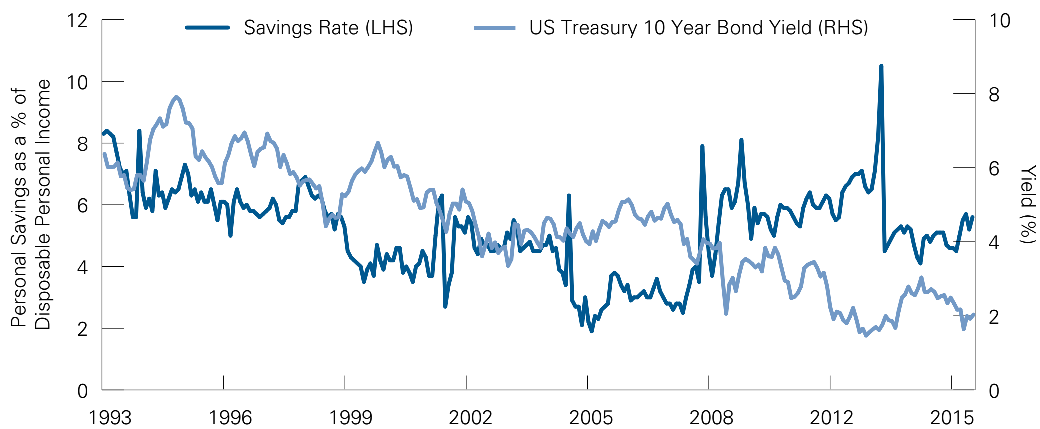
We remain enthusiastic about the consumer, which we discuss at length, and are relatively cautious on the Energy sector, where we think oil prices will hover around current levels. We maintain the more bullish stance we took on Financials last quarter and are still positive on the fundamentals in Technology and Healthcare, but are keeping an eye on valuations.

Long-term low interest rates may have side effects

The US has recovered faster than the rest of the developing world, in part thanks to the ultra-loose monetary policy of the US Federal Reserve (Fed), which helped to coax the animal spirits in the economy. Part of the slow, steady climb to normal we outlined a year ago was an eventual move away from the extraordinarily low interest rates in place since the 2008 financial crisis. While the Fed has signaled its intention to raise rates possibly as soon as September, in the meantime, we consider some potential side effects from seven years of near zero interest rates.

Although credit standards were aggressively tightened post the financial crisis, conventional wisdom suggested that consumers would begin to spend as the economy improved and borrowing costs remained low. Instead, personal savings has reached a recent high of over 5%.[2] One explanation could be that consumers may be forced to save more because deposit rates and bond yields are so low.

Low interest rates may be forcing consumers to save more



Source: Factset, data through April 30, 2015

[2] Source: Factset, US savings rate as of April 30, 2015.

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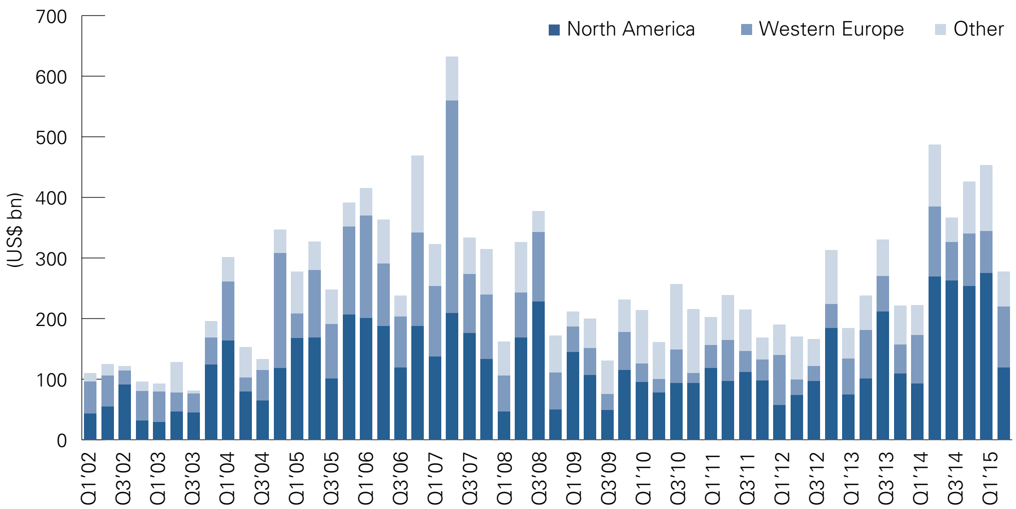
While corporate capital expenditure (capex) has been more muted than originally anticipated, companies have been shelling out to buy other companies. After a record-breaking 2014, merger and acquisition (M&A) activity has continued at a brisk pace in 2015. The long-term low rate environment appears to be encouraging a number of companies to justify lower return hurdles, even some companies that have traditionally been very disciplined. We note several recent examples in the Industrial and Healthcare sectors.

Low interest rates have spurred global M&A activity

Global M&A excluding Private Equity Buyers: Deals >$1b in Size by Volume/Target Region



Source: Bloomberg as of May 2015. Only pending and completed deals; excludes reported, withdrawn and terminated deals. Target region defined as country of risk, not incorporation.

While companies, investors and markets tend to discount short-term currency translation effects, a long-term trend may motivate companies to think about using currency advantage more strategically.

A long-term low rate environment may have a few other effects on corporate behavior. Low rates typically lead to currency depreciation. The Fed is likely to raise rates soon, while the central banks in Europe and Japan have pledged to keep rates low. As a result, the dollar has appreciated significantly against the yen and euro, and expectations are that it will stay strong for some time. While companies, investors and markets tend to discount short-term currency translation effects, a long-term trend may motivate companies to think about using currency advantage more strategically. US multinationals, in particular, could face eventual headwinds.

Another potential consequence of low rates is short-sighted, irrational corporate behavior that leads to excess competition and market distortions. For example, a US vulture fund which typically buys distressed assets, ordered ships because they were relatively inexpensive due to over-capacity and cheap financing. Now, the extra ships are driving charter rates lower and pressuring returns for all players in the industry.

Lastly, on a more positive note, several economists with whom we have recently spoken, proposed that equities may deserve to trade at higher multiples in a long-term, low rate environment.

Consumers are increasingly price-conscious, tech savvy and diverse

Expectations for increased consumption have been high as conditions for spending have been ripening since last year: unemployment is down in the US and at record low levels in Japan, gas prices have declined almost everywhere and hints of wage inflation are emerging in some regions.

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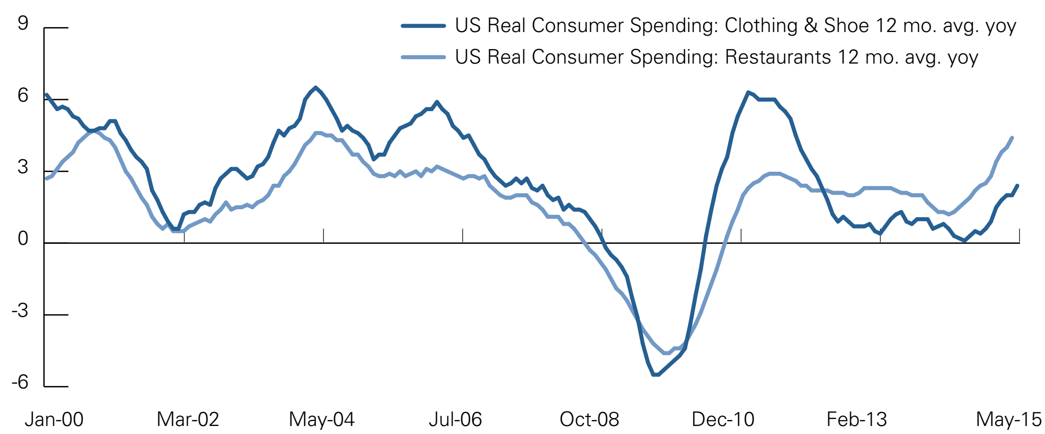
Yet there is an overall impression that consumption has been weak. We believe the reality is more complex. Diverging spending patterns and changing behavior are being driven by factors ranging from technological innovation to demographics.

US consumption is not quite as strong as expected, yet not as weak as many think. In fact, restaurant sales have been notably stronger, consistent with historical trends when gas prices decrease. Home-related spending has been strong, which is not surprising given the improvement in the housing market. Vehicle sales reached 17.2 million annualized in June[3], likely reflecting pent-up demand and widely available financing.

The weakness has been primarily in apparel retail, where many companies missed 1Q15 earnings estimates. However, a mix of temporary factors and longer-term trends may explain the disappointing results. Another rough winter on the east coast and the port disruption on the west coast potentially kept both consumers and goods from the stores. The port issue is now resolved and May retail sales growth of 1.2%, on top of upward revisions to the prior months, suggest that US consumers are shopping again. Longer term, however, traditional apparel retailers may continue to face price pressure from ultra-low cost retailers and online competition.

Restaurant sales have been strong, while apparel sales have been weak



Source: Cornerstone Macro, May 30, 2015

Lastly, the savings rate has increased about 1% over the last few quarters to a recent high of over 5%. In our view, a combination of drivers are likely responsible: older consumers need to save more because returns from cash and bonds are so low, while many lower and middle income Americans are still scarred from the financial crisis, housing bust and aftermath of a slow recovery. Whatever the combination of causes for increased savings, the near-term negative effect on spending is clear.

Importantly, the drivers for increased US consumption are still in place: a strengthening economy—especially jobs and housing, continued relatively low gas prices, more confidence to spend more and save less, and a continued strong dollar making many foreign goods less expensive.

[3] Source: GS Global Equity Research, July 1, 2015

The mix of Chinese consumption is changing. In contrast to the US, China has a number of near-term headwinds to increasing consumption. Weakening Gross Domestic Product (GDP) growth and the fragile property market are negatively impacting consumer confidence. And while the effects of the corruption crackdown are starting to fade, consumers are still keen not to appear ostentatious.

The wealth effect from the stock market might help mitigate GDP concerns but it is too small to offset weaker growth, assuming it is even a lasting effect. The Chinese currency is also relatively strong, particularly within Asia. Combined with an increasing desire and ability to travel, more consumption is focusing on leisure activities or buying goods abroad. Chinese tourist spending increased over 80% in May yoy in Europe and 122% in the rest of the world, most likely driven by many middle class Chinese spending in Japan and Korea.[4]

Other changes in consumer spending patterns will continue to affect many companies operating in the Chinese markets. Discretionary spending is growing, as evidenced by increased travel, box office revenues and sales of cosmetics and bottled water. Leisure spending may soon be branching out to sports-related spending, given a noticeable increase in sports participation. Recent auto sales were weak overall, but domestic Chinese brands gained at the expense of foreign brands, which may partially reflect the desire to avoid conspicuous consumption.

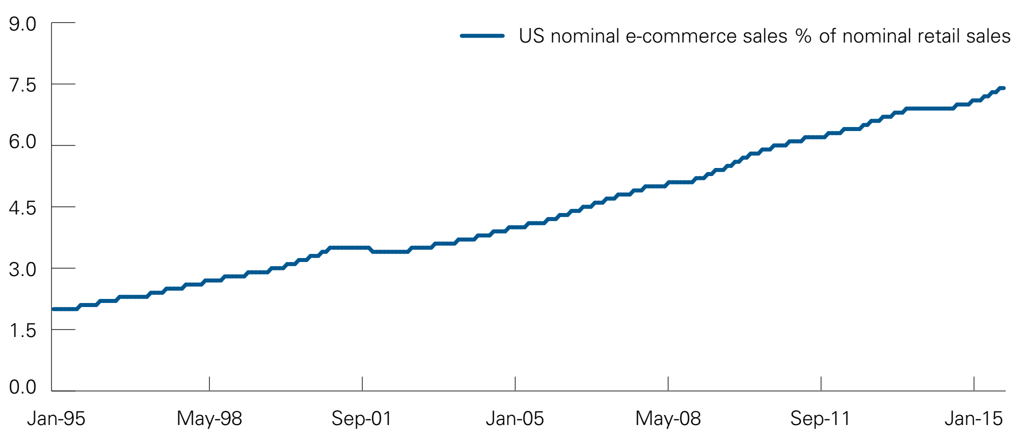
Lastly, online retail sales grew almost 50% yoy in 2014 and we expect continued growth of around 40% this year. E-commerce has grown to over 10% of retail sales and could reach 13% by the end of 2015.[5] We expect this trend to continue in light of the high rates of smart phone penetration. Furthermore, better transportation infrastructure is already leading to rising sales volumes.

Global consumption patterns will also continue to evolve, driven by disruptive business models, technology and evolving consumer preferences. Shifting demographics and cyclical factors such as interest rates, oil prices and currency movement, could also play a role.

Just as online spending disrupted traditional retailing, the next generation of disruptive business models is already having an impact on personal transportation and hotels.

Just as online spending disrupted traditional retailing, the next generation of disruptive business models is already having an impact on personal transportation and hotels. In our view, further advances in mobile technology and payment systems will only further the trends of online retailing and e-commerce. Technological innovation also continues to influence consumer spending. With increasing smartphone functionality and memory, consumers are ditching PCs, but becoming dependent on smartphones, internet access and apps.

E-commerce continues to take share from traditional retail business models



Source: Cornerstone Macro, as of May 30, 2015

[4] Source: Barclays European Luxury Goods Equity Research, June 18, 2015

[5] iResearh data and GSAM estimates, as of June 2015

In our view, demographics will also drive long-term spending patterns. Millennials already show different spending preferences than previous generations, with many shunning car and home ownership in favor of travel and other experiences. Millenials are also much more comfortable with using technology in daily life and tend to be early adopters of new technologies. A long-term trend of rising disposable income in many developing countries will fuel increased spending on discretionary items and open new markets.

Lastly, cyclical factors can also influence shorter-term consumption patterns. Currency differences are spurring or inhibiting tourism and tourist spending. For instance, while Chinese tourist spending on luxury goods is up 67% yoy for 1Q and is up 92% yoy for 2Q through May, Russian tourist spending on luxury goods was down almost 50% and 30%, respectively, for the same time periods.[6] In the US, lower gas prices have likely contributed to recent strong auto sales.

Economic growth is not a great predictor of equity market returns

Midway through 2015 there are many examples of the disconnect between economic growth and stock markets.

GDP forecasts and near-term stock market performance appear to have little correlation.

	GDP Growth Estimate	Stock Market Performance (local currency)	
	2015	2Q15	1H15
US	3.2%	0.13%	0.92%
Euro area	1.6%	-4.93%	12.82%
Japan	1.8%	5.19%	15.96%
China	7.0%	11.12%	27.42%
India	7.0%	-1.92%	2.49%
Brazil	-1.0%	3.96%	6.69%
Russia	-5.0%	3.99%	20.33%
DM	2.5%	0.69%	4.14%
EM*	4.7%	0.70%	5.63%

*EM GDP estimates are for the Growth Markets.
Source:GSAM GDP growth estimates. Market returns from Factset and MSCI, as of June 30, 2015. Stock markets returns in local currency for each region based on the following indicies: S&P 500, MSCI EMU, TOPIX, CSI 300, MSCI India, MSCI Brazil, MSCI Russia, MSCI World, MSCI EM.

In our last outlook, we stated that we are bullish on the US economy, but less so on the stock market. We also shared our view that European and Japanese equities appeared better positioned to outperform, based on slowly improving economies and other drivers including easy monetary policy, weak currencies and structural reforms.

China A-shares have defied gravity, as well as the Chinese economy and our expectations, while India's accelerating growth, which is projected to surpass China's this year, was not evident in its stock market performance. Meanwhille, Russian equities were bouyant despite a projected sharp economic contraction.

Clearly, markets can behave unpredictably and counterintuitively. We find that focusing on corporate fundamentals and stock selection, while being aware of various macroeconomic factors, is more in line with variables that we believe generate long-term returns, such as earnings growth and valuations. Therefore, particularly in emerging markets, we may very well own stocks in countries where we do not have a favorable macroeconomic view.

We find that focusing on corporate fundamentals and stock selection, while being aware of various macroeconomic factors, is more in line with variables that we believe generate long-term returns, such as earnings growth and valuation.

[6] Source: Barclays European Luxury Goods Equity Research, June 18, 2015.

Regional Views

Valuation differences between many markets have tightened

	CAPE		One Year Forward PE		Price/Book	
	level	% time cheaper	level	% time cheaper	level	% time cheaper
US	21.6	67%	17.3	79%	2.9	73%
Europe	16.4	50%	15.9	75%	1.8	61%
Japan	27.3	40%	15.7	25%	1.5	19%
Australia	17.2	56%	15.8	82%	1.9	60%
Brazil	7.4	8%	12.8	98%	1.4	49%
China	12.9	36%	11.1	47%	1.6	39%
India	19.1	50%	18.0	93%	3.3	68%
Russia	3.9	3%	5.0	27%	0.7	13%
Mexico	20.4	63%	18.6	97%	2.9	79%
Korea	10.2	6%	9.8	42%	1.0	16%
EM	11.7	6%	11.9	47%	1.6	29%
DM	19.0	49%	16.6	66%	2.2	61%
World	17.9	38%	16.0	61%	2.1	37%

Source: GSAM, Datastream, as of June 30, 2015. 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.

US: the bar is set low

Consistent with the view we presented in our last outlook, we maintain a positive outlook on the US economy. Unemployment is at 5.3%, the lowest level since the financial crisis, the housing market continues to recover and gas prices are likely to remain low, given our expectation that oil prices are unlikely to move much higher for some time. We believe these factors should support improving consumption. Furthermore, the savings rate is at recent high levels—some normalization could lead to increased consumption.

In the near-term, we believe 2Q earnings could positively surprise and move US stocks higher.

In the near-term, we believe 2Q earnings could positively surprise and move US stocks higher. Expectations for corporate earnings have been coming down since last year and bullish sentiment waned after mediocre 1Q results. Growth expectations for 2Q are now flat,[7] which we think might be low and give companies a chance to exceed expectations. Longer-term, we note that the US equity market is trading close to the high end of its historical multiple range, implying less upside than in recent years and potentially compared to other stock markets.

Europe: a marathon, not a sprint

The positive expectations for quantitative easing (QE), the monetary policy in which the European Central Bank (ECB) purchases bonds in the market in an effort to lower interest rates and increase money supply, are already having an effect on Europe's economic recovery and stock markets. The consensus GDP growth forecast for the Eurozone has risen to1.5%, largely due to better expectations for Spain.[8] Loan growth, which turned positive at the end of 2014, continues to increase and the euro remains weak, which is helping exports. Activity in the periphery has recently surprised the most.

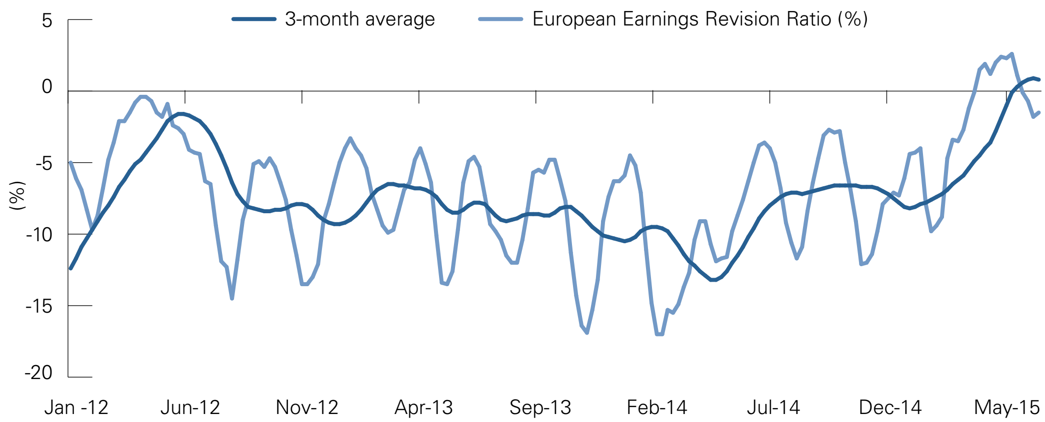
[7] Source: GS Global Investment Research, US Weekly Kickstart, June 26, 2015, consensus estimates from First Call, I/B/E/S and Factset.

[8] Bloomberg, June 2015

The outlook for corporate earnings is strong, but stocks may face some near-term headwinds. 1Q earnings benefitted from the weak euro and lower oil prices, prompting many companies to raise earnings guidance. However, consensus estimates were too optimistic at the beginning of the year (a typical phenomenon) and are coming down.

In addition, the intensity of the talks between Greece and the EU toward the end of June caught markets by surprise and weighed on sentiment. Given that European banks now have immaterial direct exposure to Greece, we believe the direct impact on European equities could be contained. However, fears of contagion to Europe's periphery are likely to keep markets nervous and more volatile. We expect the ECB will take action if bond yields in the periphery rise dramatically. As a result, we would not be surprised to see the stock market take a rest before moving higher again.

European companies' earnings revision ratio is near a three-year high



Source: Morgan Stanley Research, MSCI, IBES, Datastream. Earnings revision ratio = (#upgrades - #downgrades)/ # estimates, as of June 18, 2015.

We continue to believe European equities could outperform over the course of the year. Corporate earnings are still well below their 2007 peak and those of US companies.[9] Return on equity (ROE) of European companies also still significantly lags that of their US peers. Continued QE, the weak euro and low oil prices should continue to help and there is further potential upside from consumer spending, which remains lackluster due to relatively high unemployment in the region.

Currently, the main risks to Europe's recovery and equity market appear political. Greece remains a pressing and dynamic issue, meaning markets may be volatile for some time. Other EU countries have elections this year which may also contribute to market volatility, particularly given rising populist sentiment in many countries.

Japan: making reforms reality

Heavy stimulus and a weak yen appear to be helping Japan's economy to slowly recover, although inflation is proving harder than expected to stimulate and is likely to fall short of the 2% target in the immediate future. However, unemployment has hit an all-time low of 3.3% which is starting to put upward pressure on wages. In fact, real wage growth turned positive in April for the first time in two years and we expect that nominal wages are likely to increase by roughly 1% this year. With the anniversary of last year's April tax hike out of the way, we expect these trends to be positive for domestic consumption.

[9] JP Morgan, IBES, DataStream, Bloomberg, as of June 2015

While the economy is still on the path to recovery, corporate earnings are already near record highs,[10] due to a combination of the weak yen, reduced cost structures and an increased focus from companies on profitability and shareholder returns. In addition, the number of companies that announced share buybacks in the most recent earnings season increased by over 50%.[11] Adding to the pressure for CEOs to embrace reforms, the corporate governance code which became effective in June 2015 allows the proxy service Institutional Shareholder Services (ISS) to recommend voting against CEOs or chairmen who have generated less than a 5% ROE.

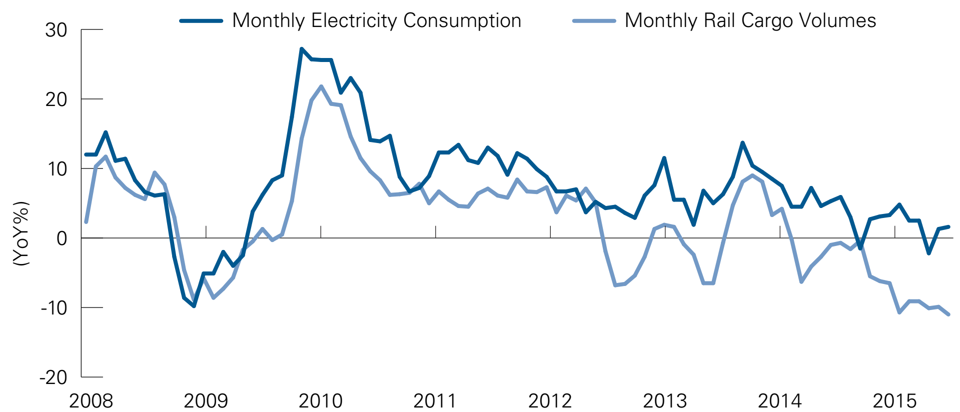
Japanese equities are indeed reflecting some of the good news. The TOPIX rose 17% in the first half of this year, which follows three years of double-digit gains. The reform story has attracted foreign investors and we continue to expect increasing domestic participation to rise from current low levels. Valuations remain below historical averages, which look reasonable in light of the strong earnings and increasing profitability. However, we continue to be selective in Japan, as not all companies are equally focused on ROE and shareholders, which we believe will ultimately be reflected in their stock prices.

China: reality, with Chinese characteristics

Economic growth is decelerating and may be weaker than the reported official numbers. GDP growth has slowed to 7% but a growing consensus believes the real number is lower, with some economists thinking it may be significantly so. The skepticism stems from mounting evidence that some of the key metrics of China's economic growth have virtually stalled. First, electricity consumption is now flat.[12] Second, rail cargo volumes have turned negative, which is a bigger decline than in the financial crisis.[13] Third, bank lending is not increasing, despite heavy stimulus.[14] In addition, cement demand has turned negative[15] and the largest steel producer recently told us they think they are currently at peak steel production, which is earlier than expected.

The skepticism stems from mounting evidence that some of the key metrics of China's economic growth have virtually stalled.

Growth in electricity consumption is roughly flat and rail cargo volumes are negative



Source: CLSA, as of May 2015

[10] Nomura, May 2015

[11] Nomura, May 2015

[12] CLSA as of May 2015

[13] CLSA as of May 2015

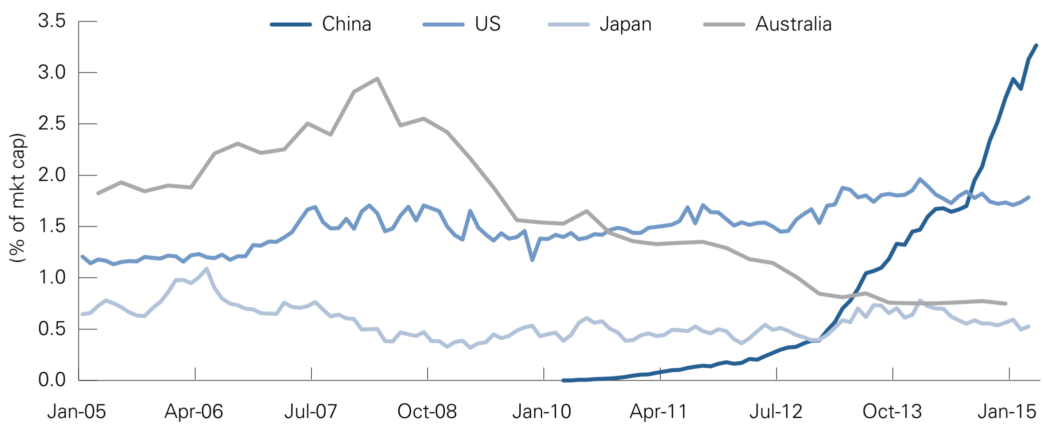
[14] Credit Suisse, CLSA, as of May 2015

[15] CLSA as of April 2015

Looking at all of these pieces together, we believe it is possible that the industrial part of the economy could be experiencing negative growth. Adding to the industrial woes, the property market continues to be oversupplied. While there has been some recovery in the Tier 1 cities, the real problem is in the more inland Tier 3-5 cities, which have seen no population growth in the last five years but hold most of the housing inventory.[16]

Despite these economic challenges, the offshore H-shares market has rallied and the domestic A-shares market has roughly doubled in the last 12 months. There are a number of reasons for this phenomenon, but they have little or nothing to do with company fundamentals, in our view. Part of the optimism comes from the Chinese population's unwavering faith that the government can and will fix the economy. This optimism is then being levered with rapidly rising margin financing, where investors buy securities with money borrowed from a broker. Roughly 3.3% of the total market capitalizaion and 7% of the free float market capitalization is now bought on margin, up from 0% less than a decade ago.[17] In fact, the percentage of the Chinese market bought on margin is now several times higher than in most other markets.

Margin financing in China has spiked to multiple times the levels in other major markets



Source: Credit Suisse China/HK Strategy Report May/June 2015, data as of March 2015

In addition to disconcerting signs like the margin activity, we note other bubble-like behavior, such as companies changing their names to match the hot sectors—even when the underlying business remains the same.

The government may be happy to promote the stock market to boost confidence and enable equity fund-raising to help mitigate the corporate leverage problem. In fact, the chairman of the People's Bank of China recently announced that the stock market is not a bubble. However, we see many symptoms that indicate a market bubble. In addition to disconcerting signs like the margin activity, we note other bubble-like behavior, such as companies changing their names to match the hot sectors—even when the underlying business remains the same. Yet, we are cognizant of the fact that bubbles can get bigger before they burst.

In light of the cooling economic data and hot stock market, we are very selective in our China equity investments. The H-shares are more reasonable, tempered by a much higher percentage of global companies and foreign investors. We find better opportunities in companies that will benefit from consumer spending. While valuations may be rising for some of these companies, we believe they are more attractive compared with industrial companies and are consistent with valuations for consumer-oriented companies across the emerging markets.

[16] National Bureau of Statistics (NBS), CLSA and China Reality Research, as of April 2015

[17] Bloomberg and GSAM calculations as of June 2015

We continue to have limited exposure to state-owned enterprises (SOEs), which comprise about 70% of the Chinese market,[18] because we believe they are less focused on profitability and shareholder returns. Our underweight in SOEs also makes our portfolios, by default, less exposed to the Industrial sector. With limited exposure to SOEs, we are using the extra capital in the portfolio to own a meaningful portion of small- and mid-cap stocks, as well as many that are not in the benchmark.

India: the bull rests

India is on track to grow faster than China this year, a milestone supported by generally improving macroeconomic data. India's economy continues to benefit from relatively low oil prices, which is rapidly reducing inflation and has allowed the central bank to begin lowering interest rates.

Despite this tangible economic improvement, why have Indian equities underperformed many equity markets so far this year? After an exceptional 2014, some of the optimism on the economy and reforms may have been priced into Indian equities. Furthermore, the pace of economic recovery and scope of reforms may not have met the very high expectations of investors. Lastly, earnings from earlier this year were disappointing.

Already, India has proposed a number of measures to cut red tape for businesses, a feat not to be underestimated given India's current rank of 142 out of 189 countries in the World Bank's *Ease of Doing Business* survey.

However, we remain bullish on the prospects for Indian equities. The macroeconomic environment should continue to improve as oil prices remain low and inflation trends even lower. With time, reforms currently in progress should start to yield results. Already, India has proposed a number of measures to cut red tape for businesses, a feat not to be underestimated given India's current rank of 142 out of 189 countries in the World Bank's *Ease of Doing Business* survey.[19] As we mentioned in our last outlook we believe that the combination of an improving macro economy and a better business climate means that India might be in the early stages of a strong earnings growth cycle. We believe earnings growth could accelerate to around 20% in the next few years, which is above the long-term average.

Australia and select EM: no easy choices

We remain selective in several other major markets including Australia, Brazil, Russia and Mexico, albeit for different reasons. Our Australian equity team continues to keep close tabs on China, given the importance of China's economy to Australia's. Their research contributes to our cautious view on China and has kept our positions in Australia very concentrated. In light of our expectations that commodity prices will remain tepid, we remain underweight resources stocks, which are roughly 15% of the Australian equity market.

Our commodity price outlook also factors into our cautious views on both Brazil and Russia. Brazil continues to wrestle with slow growth but rising inflation, as well as a corruption scandal at a large state-owned company. Russia's geopolitical issues remain at the forefront and its economic outlook remains depressed by sanctions and weak energy prices. In contrast, Mexico offers strong fundamentals but we are challenged to find opportunities due to relatively high valuations.

[18] MSCI

[19] Doing Business 2015, World Bank

Sector Views

Few sectors look cheap on price-to-earnings, relative to their histories

	CAPE		One Year Forward PE		Price/Book	
	level	% time cheaper	level	% time cheaper	level	% time cheaper
Cons Disc	23.9	44%	17.4	52%	3.2	94%
Cons Staples	21.1	42%	19.7	80%	4.1	67%
Energy	11.3	18%	21.6	93%	1.5	4%
Financials	16.5	38%	13.5	62%	1.3	31%
Health Care	27.8	82%	18.8	69%	4.2	55%
Industrials	19.3	37%	16.3	52%	2.7	69%
IT	22.7	28%	16.8	36%	3.6	58%
Materials	14.9	24%	16.6	78%	1.9	39%
Telecoms	16.3	43%	16.7	61%	2.5	70%
Utilities	16.6	56%	15.3	70%	1.5	29%

Source for table: GSAM, Datastream, as of June 30, 2015. Cyclically adjusted price-to-earnings ratio (CAPE) calculated using US inflation and a five-year rolling window to smooth earnings. Based on MSCI sector indices. All "% time cheaper" data is based on a sample history that starts in 1994.

Energy: shale shocked
A decade ago, concerns about peak oil production dominated the oil dialogue. We now find ourselves in a new era of energy investing, with plenty of oil and sluggish demand.

We expect oil prices of around $60 WTI/$65 Brent by the end of the year. Despite the rebound in oil prices from the bottom, our recent conversations with companies suggest they are cautious to add back rigs. Surplus capacity is at a historically low level, which could also support oil prices.

However, a number of factors may continue to keep oil prices down. Comments at the latest Organization of Petroleum Exporting Countries (OPEC) meeting suggested production could reach higher levels than expected, which in reality may lead to "phantom cuts." Improving technology will continue to increase efficiency and decrease production costs, likely resulting in more supply. Some larger companies will use their balance sheets to finish projects that are already underway, despite the current low prices, which could further contribute to supply.

We agree with the CEO of a major global energy company who stressed the importance of owning the "right rocks," given very big differences in asset quality. As investors, we seek stocks where these assets may be mispriced.

Market sentiment, however, is as bullish as we have ever seen on the turn in energy prices. Exploration and production (E&P) stocks are discounting $70-75 oil versus our estimate of around $60. In fact, while oil bottomed under $50, the stocks were discounting an oil price of $55-60, suggesting a tendency to be optimistic. We therefore remain underweight and selective in the sector because expectations may be too high. We agree with the CEO of a major global energy company who stressed the importance of owning the "right rocks," given very big differences in asset quality. As investors, we seek stocks where these assets may be mispriced.

Consumer Discretionary and Staples: pricing power plays
As we consider investments in consumer-related companies, we look at all of the factors affecting consumer behavior across the world that we discussed earlier. In addition, we combine those views with other influences on companies, such as pricing power, and other competitive dynamics, such as the growth of online retail.

Pricing power is a critical but seemingly scarce competitive advantage right now for many companies. We are seeing significant deflationary pressure for many apparel retailers coming from two sources: the growth in online retailing and fast-fashion brands. Online competitors are using technology, virtual stores and price transparency to lower prices for customers, while fast fashion focuses on lowering input and production costs to offer cheaper goods.

Currency can also affect pricing power. Currently, some global luxury goods companies which generally retain pricing power, are lowering prices in Asia in an effort to synchronize pricing across regions. We are also hearing from many European consumer staples companies that the pricing environment remains challenging because lower input costs make it difficult to raise prices and retailers have been engaging in price wars. However, some global European-based consumer staples companies are using the weak euro as a competitive advantage in the US.

Many of our portfolios are tilted toward the consumer. We look for well-managed companies with strong brands, because they are more likely to be able to maintain pricing power. We are also positioned to capture the growth in online retail, particularly in Asia, and the trend of spending more on experiences and services. In the US, we are overweight restaurants and online retailers, while in China we own travel and other entertainment companies. Lastly, we also look at special situations of change, such as the Russian food retail sector, which is highly fragmented but consolidating, and allowing strong companies to gain share and grow profitably.

Financials: banks and exchanges

In our last outlook we expressed our more positive view on financials stocks across the developed markets. In the US, we remain overweight bank stocks ahead of the expected rise in rates from the Fed, as we continue to believe that banks will benefit from increasing net interest margins. In addition, the trading business has picked up for many of the big banks. We continue to limit our exposure in Real Estate Investment Trusts (REITs), which we believe will be negatively impacted by rising interest rates.

In the US, we remain overweight bank stocks ahead of the expected rise in rates from the Fed, as we continue to believe that banks will benefit from increasing net interest margins.

In Europe, many investors chose to play the recovery through the banks, particularly in the periphery. We have trimmed some positions as the stocks appreciated, however, we are looking to add back on market pullbacks and we remain constructive as loan growth is now genuinely recovering. In Japan, the Financials sector has been the best-performing and we have recently added to positions in megabanks and insurance companies. Many banks have announced share buybacks or dividend increases and increased ROE targets. In addition, lending growth could be roughly 3-5%, helped by the weaker yen and the desire for companies to invest in Japan.

Our positioning in financials stocks across the emerging markets has centered around private sector banks and stock exchanges. In China, we think banks are likely to remain under pressure as continued easing dampens earnings growth through 2016 and interest rate liberalization pressures margins. In Colombia and Peru, we own bank stocks because we think the banks have very competitive positions in these relatively small and consolidated markets. We continue to own shares in stock exchanges across the emerging markets, including Mexico, Brazil, Poland, South Africa and Russia. These capital-light businesses have strong free cashflow and as near monopolies, are largely insulated from competitive pressures.

Healthcare: healthy companies

Healthcare stands out as a sector where most companies have been meeting or beating earnings expectations. Fundamentals remain strong, bolstered by good pricing power. Many stocks have appreciated and we have taken the opportunity to trim some positions. However, we remain slightly overweight in Europe and slightly underweight in the US.

One area we will be watching closely is M&A. Activity remains robust but there are signs that companies may be getting more aggressive in their assumptions. For example, investors are now assigning more value to the earlier stage products in company pipelines. While there are many mergers that will make strategic sense, we will be closely scrutinizing valuations.

We seek to balance our exposure to some faster growth internet and software companies with more mature franchises, which are generally trading at more reasonable valuations.

Information Technology: old vs. new
Disruption from innovation and change is often most obvious in the Information Technology sector. Currently, we are observing a growing gap between companies with older technologies and those with newer ones combined with a change in spending patterns as technologies evolve.

Enterprise spending has been more robust for faster growing areas like the internet and the cloud than older ones such as storage and servers. Internet-related companies continue to boast higher growth rates and are taking share from traditional media in advertising spending.

However, spending is also shifting increasingly toward software and services and away from hardware. Yet, some cyclical factors still affect spending. For instance, PC sales jumped last year as a result of an overdue upgrade cycle.

M&A activity has been extremely strong amongst semiconductor companies, which we see as a sign that the industry is maturing. However, we do not expect the same level of M&A to spread to other tech industries in the near future.

Unsurprisingly, valuations for the more growth-oriented technology names are high and as a result, we find it more challenging to find investment candidates with significant upside potential. Our portfolios are overweight internet, software and services companies versus hardware companies. However, we seek to balance our exposure to some faster growth internet and software companies with more mature franchises, which are generally trading at more reasonable valuations.

Conclusion

We look optimistically toward the second half of 2015. We believe loose monetary policy in Europe and Japan could revive their economies, while stable energy prices and other drivers remain in place to spur US consumption, all of which will be important for global economic growth.

We also believe we will begin to see evidence of structural reforms—from corporate governance changes in Japan to reforms in India—which could ultimately lead to stronger earnings growth and higher valuations in these regions.

Offsetting these positive factors is slowing Chinese growth, coupled with a frothy Chinese stock market and beleaguered property market. As a result, commodity prices are also likely to stay weak, which will pressure commodity exporters across both the developed and emerging markets. Political risks, particularly Greece, in the near-term could increase uncertainty and market volatility.

However, we continue to find opportunities across most regions and sectors, provided we ground our expectations in reality.

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The MSCI All Country World Index is a capitalisation weighted index comprised of 23 developed market countries and 23 emerging market countries.

The TOPIX Index is an equity index, gross of dividends, unhedged to JPY. The TOPIX Index covers a broad range of Japanese stocks and consists of over 1,500 Japanese companies which are listed on the Tokyo Stock Exchange, first section.

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The MSCI Brazil Index is designed to measure the performance of the large and mid-cap segments of the market, covering approximately 85% of the Brazilian equity universe.

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