

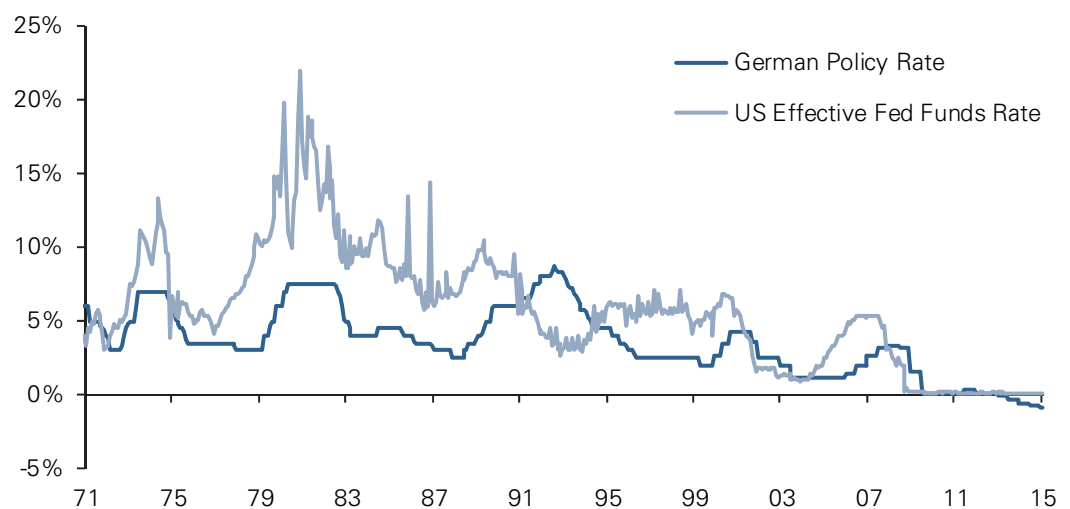
GSAM | Macro Insights

Transatlantic Cross Currents

In March, as the Federal Reserve officially lost 'patience' on its way to policy tightening, the European Central Bank (ECB) started the first round of sovereign bond purchases under its new quantitative easing (QE) program. With the central banks of the two largest developed economies headed in opposite directions, we consider the impact on their respective markets and prepare for more volatility in the coming months.

- History may not repeat, but it rhymes: our Focus Piece (p.4-5) looks at the market reaction to US hiking cycles dating back to the 1970s as a guide to the tightening ahead.
- Picking up from January's *Notes* on the Eurozone, we summarize views on the region's improved outlook from the quarterly meetings of our Fixed Income and Fundamental Equities strategy groups (p.6).
- Key takeaways are that the current macro backdrop is still conducive for corporate credit, and we prefer the look of valuations in the US. In Europe, equities seem more viable for trading the growth upswing in a stimulus-driven marketplace.

US and European policies are set to part ways again

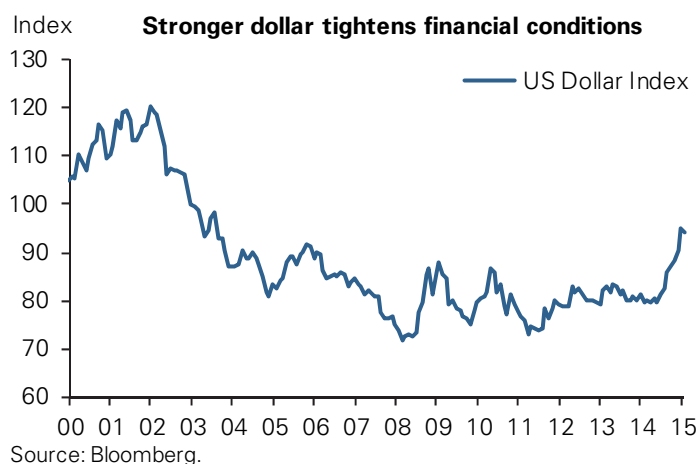


Source: Bloomberg.

Macro Trends and Views

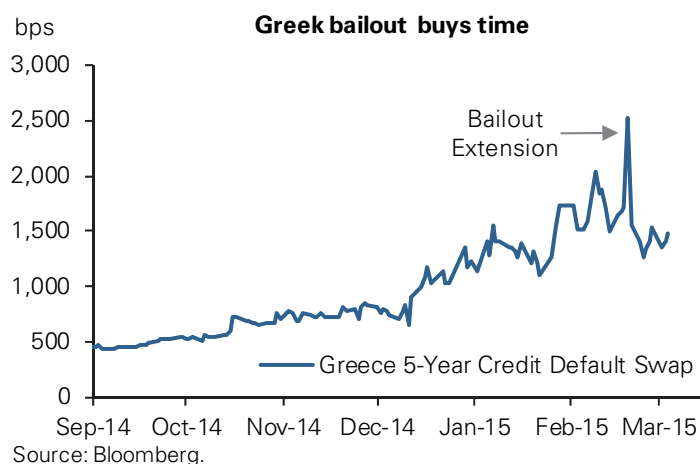
US

- The Fed left open the option to hike rates in June, omitting from its March statement the reference to remaining “patient” with respect to tightening.
- We think a move in September is more likely, given concerns about the role of the stronger dollar in tightening financial conditions.
- Policymakers may also want to delay to allow for a pickup in inflation. The US economy is still showing little sign of inflationary pressure, and the latest prices data showed a 0.5% monthly decline in final demand producer prices.



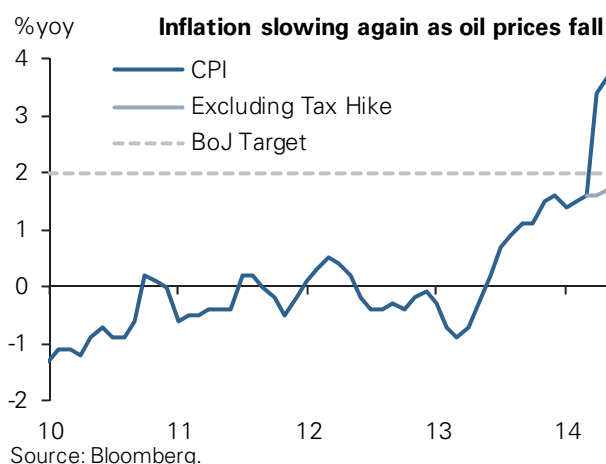
Europe

- The official launch of QE drove the euro to a 12-year low versus the dollar and yields on more than a quarter of euro government bonds into negative territory.
- Eurozone consumers are staging a comeback. Lower oil prices seem to be helping confidence and annual retail sales growth jumped to 3.7% in January. Moreover, German wage growth has picked up slightly.
- Greece reached agreement with Eurozone leaders to extend its bailout deal by four months. We anticipate further volatility as parties negotiate a new package to cover €7 bn of payments in July/August.



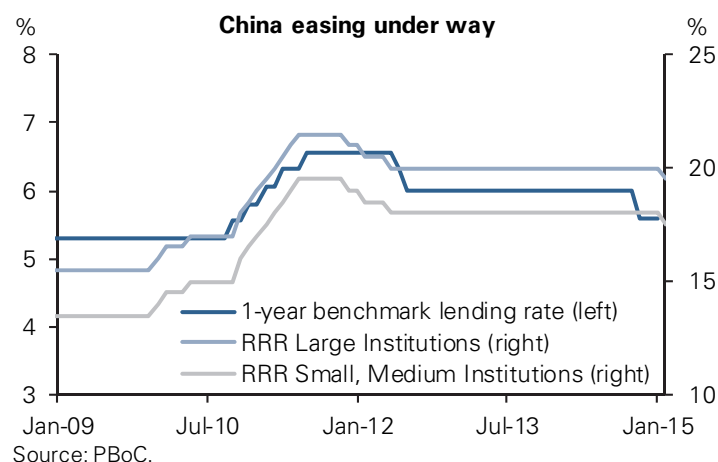
Japan

- Inflation has dropped off its improving trajectory, largely due to oil price declines. Core consumer prices rose just 0.2% on the year in January, far below the target of 2% in 2015.
- The Bank of Japan said inflation is likely to flatline for the time being, raising expectations for further stimulus.
- Nevertheless, sentiment on the economy is improving, with the Economic Watchers survey index rising to 50.1 from 45.6 in February. Driving factors are the decline in oil prices and expectations for wage hikes in April.



Emerging Markets

- Central banks in emerging markets (EM) are contributing to the trend of increased stimulus. India eased for the third time this year, dropping its repo rate 25bps to 7.5%. China also cut 25bps from its loan and deposit rates.
- Brazil is bucking the global trends of policy easing and low inflation. The central bank hiked its key rate 50bps to 12.75% to rein back its highest inflation in a decade.
- Brazil's government faces fresh turmoil as protesters took to the streets amid increasing allegations of corruption beyond the Petrobras scandal.



Asset Allocation Views: Post-rally positioning

We believe that global output will continue to reaccelerate in a low but ultimately benign inflation environment. So far in 2015 this scenario is playing out with a notable uptick in the global purchasing managers index (PMI), improving credit growth and modestly positive inflation expectations in Europe and Japan.

So far so good for our asset allocation views, which center on an overweight to developed market (DM) equities and the US dollar. With markets increasingly pricing the more positive economic backdrop, we have reviewed our positioning and conclude that we still prefer equities to credit and especially to rates. Commodities still look vulnerable and dollar strength has not yet peaked.

We rotated out of US equities into European bourses late last year in anticipation of ECB easing. In late February we reduced our Japanese and Indian overweights, given returns of 32% and 22% over the MSCI World, respectively, over the prior 12 months. Going forward, we favor equities exposed to the US consumer as personal real earnings grow, supported by the fall in oil prices and improving labor markets. We maintain our overweight to Europe as QE helps to further ease financial conditions and the feed through of lower oil prices. In particular, we like Spain, where we see considerable potential for recovery from recent underperformance. Among the key risks to our overweight equity positions are high valuations, possible volatility around the start of the Fed hiking cycle and any sharper escalation in geopolitical turmoil.

In risk markets, we are more cautious on credit, due mainly to its greater sensitivity to rising rates. We are constructive on bank loans as they pay a floating rate, and spreads currently imply a default rate of over 6% versus our estimate of 2.5% this year. We see value in specific energy names that can withstand a potential further decline in oil prices.

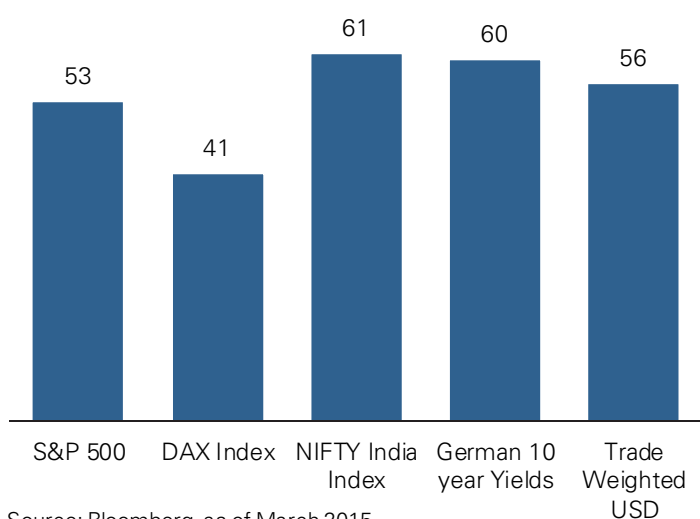
In bonds, divergent monetary policy between the US and the rest of the world is a key theme for this year. We are positioned for a US hike later in 2015 than current market pricing as the Fed faces weakening inflation and a recent moderation in growth. Nevertheless we expect longer-dated yields to rise as the Fed reaches lift-off in a robust growth environment and with valuations at stretched levels. In regions outside the US where bonds should benefit from central bank QE, we prefer allocating to equities, seeing greater potential for yields to rise than to compress. A world in which Ireland can borrow at a third of the United States' interest rate is unappealing from a valuation perspective.

Divergence also impacts currency markets and has made us strong dollar bulls. This view has paid off and we are growing wary of the consensus short euro trade. We dislike the British pound in the run up to an uncertain election, and among the commodities currencies we favor the Mexican peso over the Canadian dollar. Mexico stands to benefit from energy market reforms and exposure to US growth, whereas Canada's commodity exposure could be more problematic for the economy.

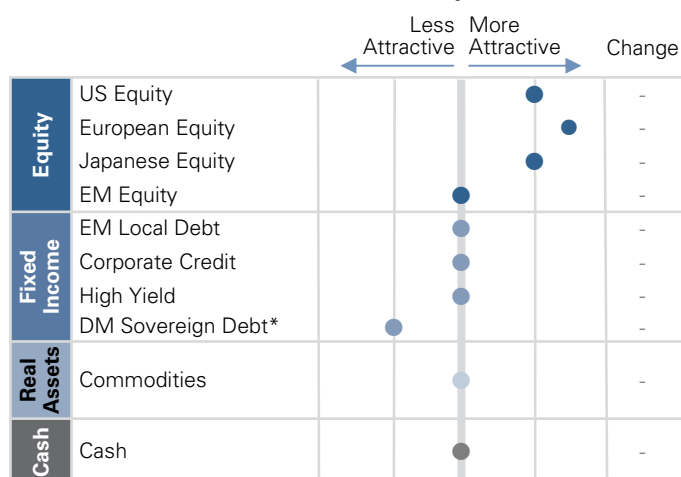
The oil price collapse was arguably the key event of last year, and we still see oversupply. Supply cuts could lead to equilibrium over the medium term, but we see vulnerability in the near term. Our preferred method of expressing this view is again in equity markets, via an underweight position in oil and gas producers.

Our positioning overall remains bullish, allowing for tactical shifts around strong price movements. Our inclination toward equities and the dollar is predicated on our ongoing positive outlook for growth, led by the US but recovering in other advanced economies.

Number of Highs in the Last 12 Months



Asset allocation views on a one-year horizon*



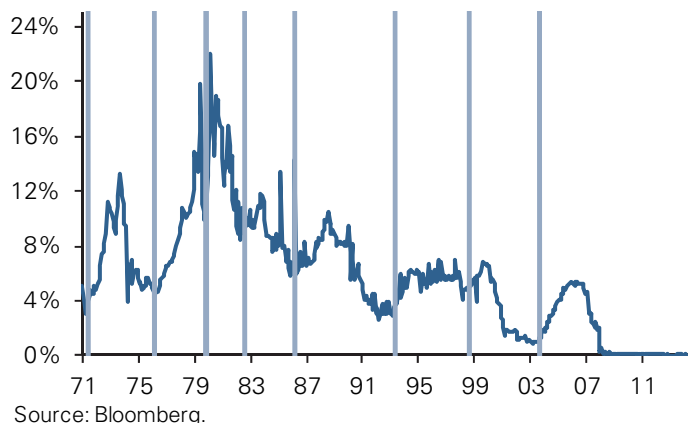
Source: GSAM Global Portfolio Solutions. As of March 2015.

* Note that this does not account for liability-driven investment.

Focus Piece: US hike—Is this time different?

The current monetary policy cycle is unique in terms of the degree and duration of easing and the policy tools used, which raises the question: Is this time different? We think this cycle has more similarities than differences with prior cycles, and so an historical analysis is a useful template.

Exhibit 1. Hiking in eight cycles

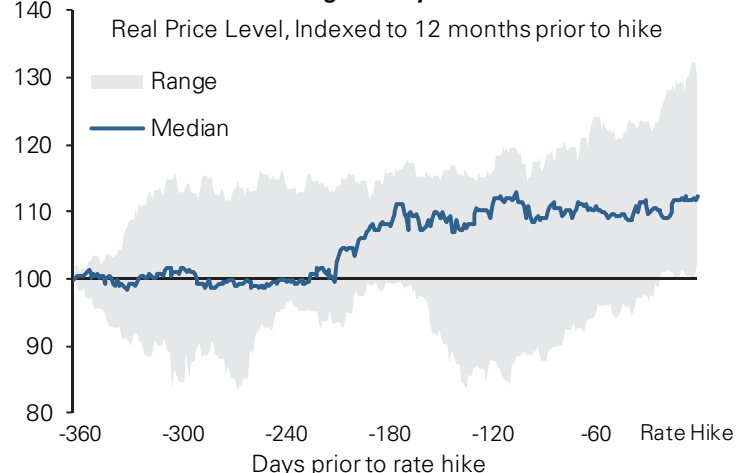


We think Fed tightening this year could drive volatility in asset prices, which otherwise benefit from the tailwinds of an increasingly healthy economic growth cycle. In this piece we examine historical market behavior around the start of Fed tightening cycles. The full table of findings, at the end of this piece, shows that:

- Treasuries generally weaken, as expected
- Equities tend to struggle immediately after a hike
- Credit spreads and gold typically outperform
- The hike doesn't much change the US dollar trend.

We look at eight distinct hiking periods going back to the 1970s. Two episodes stand out: The 1980 hike was during a double-dip recession and 1999 was late in the economic cycle. However, our findings hold irrespective of whether these episodes are included.

Exhibit 2. The S&P generally rallies into rate hikes



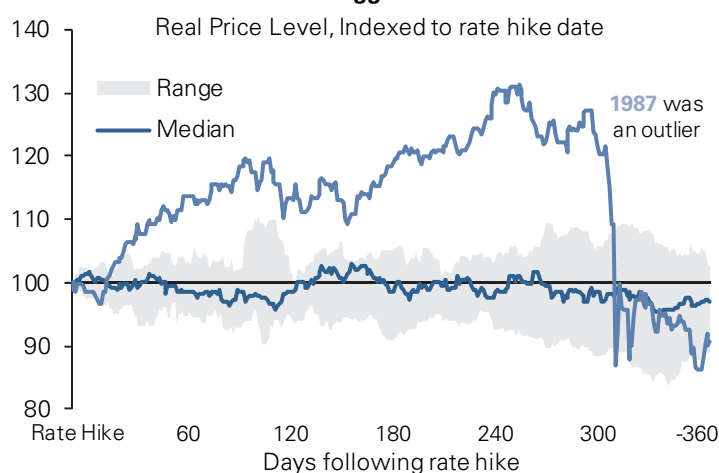
US Treasuries behaved almost exactly as one would expect. The 10-year yield tended to start rising around three months prior to the hike as markets priced the Fed move and/or rising inflation. Interest rate volatility generally peaked around six months prior to a hike. The most recent hikes in 1999 and 2004 are unusual in that rates rose for a year before the hikes, and 2004 is particularly unusual as yields actually fell after the hike and continued falling for a year. This earlier pricing of the move in recent times could be the result of a more communicative Fed stance. TIC data from 2004 show very strong foreign demand for US Treasuries, which could have driven yields lower despite rate hikes

Stocks struggle, credit spreads gain

Based on prior experience, the outlook for equities is also challenging. S&P500 real returns tended to rise in the year up to a hike, but they dipped into negative territory immediately after, and recovered six months later. The median real price return in the year following a hike was -4.1%. Importantly, this basic trend held for virtually all the cycles we examined, and despite some evidence that the market recovered more quickly in recent hiking cycles, the difference is marginal. In our sample, the highest real return in the year after a hike was just 2.7%.

While equities returns have generally been good leading up to a hike, volatility has tended to pick up three- to six-months ahead, and subside modestly afterwards. That volatility has manifested in some notable corrections in equity markets. In the six months prior to a hike, drawdowns ranged from 7%-11% in half our observations. Three hikes saw smaller drawdowns. The outlier was a sharp 17% drop in 1980, owing more to the double-dip recession than to Fed policy. There was no strong delineation between older and more recent hiking cycles. Comparing the 12 months before and after a hike, we saw a similar magnitude and frequency of drawdowns.

...but can struggle afterwards



Focus Piece: Cont'd

Corporate credit and equities tended to behave in almost exactly opposite ways. Spreads generally widened, reflecting poorer returns on credit investments, from 12- to six months prior to a hike. Spreads then rallied, continuing through the event and for 12 months after. This behavior was quite consistent across all episodes despite uncertainty surrounding some cycles.

Gold, dollar on separate paths

At first glance, Fed rate hikes appear to have benefitted gold and weighed on US dollar real returns, with the trade-weighted dollar losing an average of 6% in the year after a hike. However, in all but two episodes the dollar simply continued pre-existing trends. This is true both in recent cycles and in the 1970s, as the dollar steadily lost value. In the early 1980s, the currency's rally was well entrenched after years of high interest rates and budget deficits, and continued through the hiking cycle. The reverse was true after the 1985 Plaza Accord. The message—pertinent to today's strong-dollar environment—seems to be that dollar trends can be sustained even as the Fed shifts policy.

Gold, typically considered less desirable in a rising rate environment, actually outperformed the S&P500 by a median of 11.5% in the year after a hike. Some of this gain was probably a side-effect of US dollar weakening, the rest was attributable to inflows from equity sell-offs and gold's inflation-hedging properties.

Looking at the broader commodity complex—and referencing the GSCI due to its long history—we saw highly variable returns. The initiation of a hiking cycle does not appear to be a key driver of commodities performance.

Is this time different?

Monetary policy has been unusual in this cycle, both in terms of the extent of easing and the tools used. However,

these differences do not represent a fundamental change in the monetary policy framework, but rather a fortified response to an unusually large economic shock, in which standard policy tools have been exhausted by the zero lower bound. The broader aim of these unusually aggressive measures is the same as in prior cycles: to ease financial conditions and support the economy. The Fed's experimentation with new tools such as QE creates more uncertainty than usual about the impact of Fed policy, but given that the broader policy framework has not changed we think the historical template remains relevant.

We also argue that the economic backdrop of this hiking cycle is not materially different to those prior.

Unemployment, corporate profits and even credit spreads are all roughly in line with previous cycles. Even the cross currents of diverging global rates are not atypical, as German rates often moved independently from, or at a lag to, the US. (see Exhibit on p.1) That said, our Fixed Income team believes global macro and market drivers are most likely exerting a stronger influence on US assets today than in earlier cycles, and the full implications of policy divergence are yet to manifest.

Nevertheless, we believe the past is a reasonable guide to the future. We expect the Fed to lift off in the second half of this year, and some volatility due to market uncertainty in the meantime. We expect muted US large cap equity returns and we prefer domestically focused stocks, or international markets such as Europe and Japan. Our portfolios are overweight the US dollar, slightly overweight credit and underweight US government bonds. Ultimately, despite the associated uncertainty, an interest rate hike reflects the Fed's confidence in underlying economic momentum. And that should, on the whole, be positive for many asset classes.

Time around first hike	Over interval to hike date						On specific date relative to hike		
	Median Change		Median Real Price Return				Median 2-mo Volatility/ Correlation		
	10y Tsy Yield	A-Rated Credit Spread	S&P500	Trade-Weighted US Dollar	Gold	Commodities (GSCI)	S&P500	10y Tsy Total Return	Equity/Rate Correlation
12 mos prior	-0.25%	0.31%	12.8%	-5.8%	15.6%	-3.3%	10.2%	5.4%	-18.1%
6 mos prior	-0.14%	-0.02%	2.5%	-3.7%	-0.3%	7.6%	14.6%	8.5%	-23.1%
3 mos prior	0.14%	-0.02%	5.1%	-0.7%	-2.6%	3.6%	13.6%	7.9%	-21.2%
1 mo prior	-0.06%	0.04%	2.2%	-0.3%	0.6%	-0.4%	14.6%	6.5%	-18.0%
1 mo after	0.10%	-0.11%	-0.1%	-1.5%	-0.4%	3.7%	14.1%	6.4%	-37.5%
3 mos after	0.33%	-0.23%	-1.6%	-1.8%	1.7%	6.2%	12.3%	7.5%	-28.8%
6 mos after	0.91%	-0.31%	0.2%	-3.3%	8.3%	7.9%	11.5%	7.3%	-27.1%
12 mos after	1.17%	-0.64%	-3.8%	-5.8%	7.6%	16.5%	12.3%	6.8%	-21.6%

Source: S&P500 Index (equity); US 10-year yields (govt bond); S&P Industrials A Rated Bond Yield – US 5 Year Generic Yield (credit spreads); GSCI Enhanced Roll Total Return Index, GSCI Total Return Index before 1995 (commodities); DXY index (dollar); Gold price in USD.

Notes: Navigating Europe's Negative Rates and Improving Growth

The outlook for Europe was a key topic at our Fixed Income and Fundamental Equity teams' quarterly strategy discussions in March. Below, we highlight some of the key conclusions from those discussions.

Europe's growth outlook is improving

- We **revised up our 2015 Eurozone GDP forecast** to 1.6% from 1.2%. That puts us above the Bloomberg consensus of 1.3% (as of March 16).
- We see **four main reasons to expect stronger growth** in the Eurozone, at least in the near-term:
 1. Oil prices declines benefit consumers
 2. Weak euro helps exports and corporate earnings
 3. The banking system is in much better repair
 4. ECB policy has lowered rates significantly
- The **benefits are showing** in a range of indicators:
 1. Credit and lending growth is improving
 2. Consumer confidence is at post-crisis highs
 3. Retail sales have bounced, particularly in Germany
 4. Wage growth is picking up in Germany

Longer term challenges persist

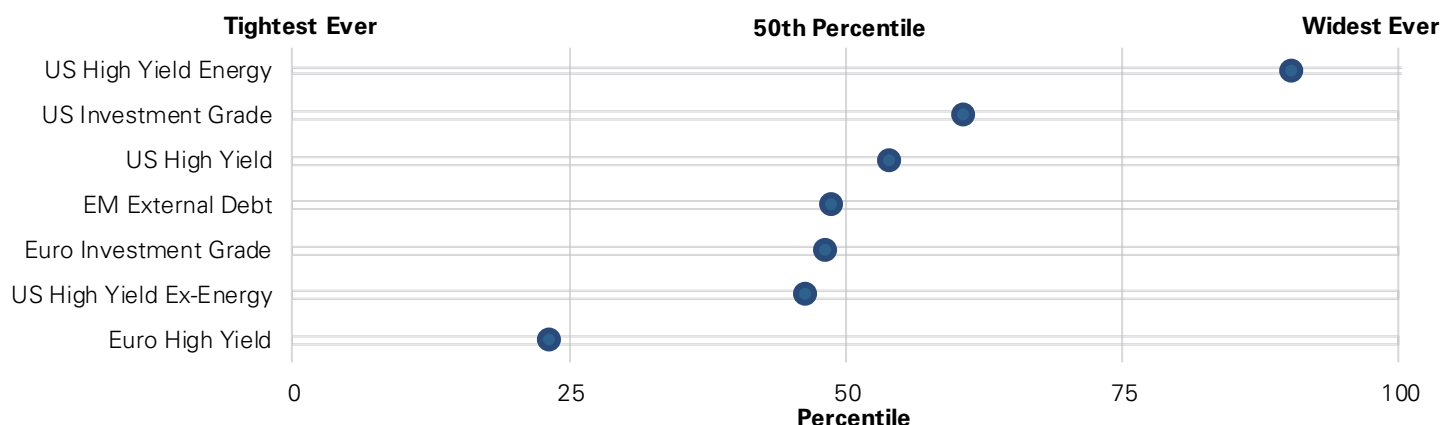
- **Looking beyond this year, however, we are still cautious** on the Eurozone economy. We think momentum may slow as the temporary effects of lower oil prices and euro declines subside. We see growth easing back to 1.2% in 2016.
- We think **weak inflation is a long-term challenge** due to poor demographics and weak wage growth. We think inflation will struggle to get to 1% next year, let alone the target of just below 2% before the QE program's review in September 2016.
- The risk of a Greek exit has risen, as the new Syriza government contests its reform agenda in negotiations the creditors. An exit is not our base case, but the tight schedule of repayments and antagonism between the parties has made a disorderly outcome less unlikely.

QE quandary

- **Prolonged QE poses a challenge for bond investors.** In its first week, the program drove yields in more than a quarter of euro government bonds below zero.
- **Eurozone rates are not very attractive as outright long or short positions.** Improving growth ordinarily drives rates higher, but QE is weighing heavily on the short end of the market. That said, we see potential for long-end rates to rise as governments take advantage of low rates to ramp up long-dated issuance.
- We think **European corporate bonds are expensive** relative to US corporates or emerging market debt. The chart of historical percentiles below shows European high yield spreads have traded tighter than current levels only about 20% of the time.

Positioning for the assisted recovery

- **We are cautious in peripheral sovereign debt markets**, and trading tactically with modest long relative value positions in Spain and Italy.
- **We think equities may offer more value than fixed income** as a way to position for the Eurozone recovery in an environment of heavy stimulus.
- **Corporate earnings are improving.** For the second quarter in a row, more companies are beating earnings expectations than missing them.
- **We have recently become more bullish on financials**, especially in the periphery where banks are benefitting from cheaper funding costs. We also like companies that are benefitting from euro weakness and the strong US end market.



Sources: Barclays US High Yield Index - 2% Issuer Constrained; Barclays US Corporate Index; Barclays US High Yield Energy Index; Barclays US High Yield ex-Energy Index; Barclays Pan-European High Yield Index; Barclays Euro Aggregate Corporate Index; JP Morgan Emerging Market Bond Index Global Diversified

Appendix: GSAM Growth Forecasts and Asset Valuation

GDP Growth Forecasts: GSAM vs Consensus

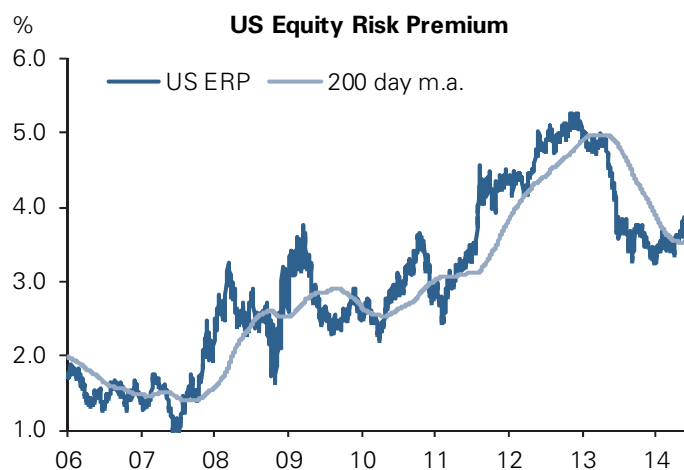
	2012	2013	2014	2015		2016	
				GSAM	Consensus*	GSAM	Consensus*
US	2.3	2.2	2.4	3.2	3.0	3.4	2.8
UK	0.7	1.7	2.6	3.0	2.6	3.0	2.4
Euro area	-0.8	-0.5	0.9	1.6	1.3	1.2	1.6
Japan	1.8	1.6	0.0	1.8	1.0	1.4	1.5
Brazil	1.0	2.5	0.1	-1.0	-0.5	2.0	1.3
China	7.7	7.7	7.4	7.0	7.0	6.8	6.7
India	4.8	4.7	5.4	7.0	7.4	7.2	7.7
Russia	3.4	1.3	0.6	-5.0	-4.0	1.0	0.5
Mexico	3.9	1.1	2.1	3.5	3.0	3.5	3.5
Korea	2.3	2.9	3.3	3.4	3.4	3.7	3.7
Indonesia	6.0	5.6	5.0	5.2	5.3	5.5	5.8
Turkey	2.1	3.8	3.8	2.4	3.5	3.8	3.8
Advanced	1.1	1.2	1.6	2.5	2.2	2.4	2.2
BRIC	6.0	5.9	5.5	4.9	5.2	5.6	5.7
Growth Markets	5.5	5.3	5.1	4.7	4.9	5.3	5.4
World	3.2	3.1	3.2	3.5	3.4	3.7	3.7

*As of March 2015. Source: GSAM and Bloomberg

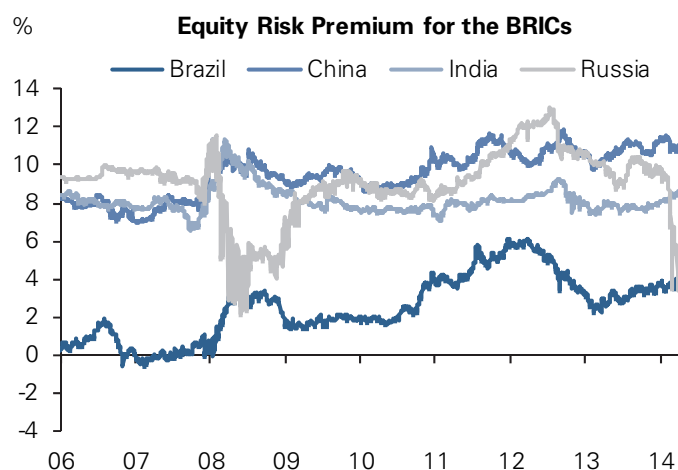
Equity Valuation Across Advanced and Growth Markets

	CAPE*		FY1 PE		Price/Book		Dividend Yield		Earnings Momentum**
	Level	% time cheaper***	Level	% time cheaper***	Level	% time cheaper***	Level	% time cheaper***	% change in 1y fwd EPS
Japan	28.7	42	19.6	51	1.3	47	1.7	42	2.59
US	22.8	73	19.2	64	2.7	58	1.9	74	-7.27
India	21.0	57	22.7	87	3.6	80	1.3	71	-5.02
Canada	20.7	62	24.7	79	2.6	86	2.8	58	-17.43
Australia	19.4	75	19.7	60	2.5	68	4.3	37	-7.79
France	19.1	61	23.1	77	1.6	49	2.8	76	-7.65
Germany	18.5	66	22.4	75	1.3	26	2.5	79	-1.25
Italy	17.4	46	36.8	89	1.2	44	2.8	56	-12.33
Europe	17.2	55	21.8	79	1.8	48	2.9	68	-5.46
Spain	15.0	47	23.2	82	2.3	54	4.9	36	-4.78
UK	14.7	60	17.6	82	2.4	63	3.6	68	-12.04
China	12.6	32	12.0	32	1.6	44	2.9	33	-4.13
Portugal	9.4	13	233.1	99	1.4	31	2.9	68	-3.75
Brazil	7.7	8	17.3	78	1.7	35	4.4	27	-10.05
Russia	3.8	2	5.8	32	0.8	50	4.2	4	-22.11

* Cyclically-adjusted PE ratio (5-yr rolling window). ** % change in 1-yr fwd EPS over last 3 months. *** Current percentile relative to full history
As of March 2015. All data based on MSCI country indices. Source: Datastream, GSAM calculations



Source: GSAM calculations.



Source: GSAM calculations.

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