Goldman Sachs Asset Management

A Better Balance of Risks: 2018 Mid-Year Outlook

MACRO & MARKET VIEWS 2-5

A better balance of risks: We think the outlook for risk asset returns has improved. Interest rates have risen, equities have sold off and the bar for growth is lower after the recent moderation. We are strategically pro-risk, but continue to emphasize a dynamic approach to investment as volatility re-emerges.

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A better balance of risks

The balance of risks for markets has improved. Economic data has softened this year, lowering the bar for positive news on growth going forward. Interest rates have increased, reducing the risk of a further rapid rise in rates. These developments, coupled with a sell-off in equities and emerging market assets, create more room for potential upside for risk asset returns.

Risks outlined at the start of the year have materialized...

We suggested in December that we were likely to see new highs in equities this year, but also that the market was overdue for a pick-up in volatility (Exhibit 1). Compared to the benign conditions in 2017, we expected a moderation in growth and a more substantial impact from central bank tightening. This is now well underway. Challenges for volatility-selling strategies, the risk of regulation in the technology sector and protectionist concerns have captured headlines, but we think the macro impact of these events will be contained. We suspect the slowdown in macro momentum—which now shows early signs of rebounding—and rising rates are largely responsible for the sell-off.

...leaving a better outlook for risk asset returns.

The result of these developments is a better balance of risks. The recent weaker momentum has set a lower bar to beat for growth. Rates have reset higher in Q1 and market expectations for the pace of central bank tightening have shifted in line with our views. Given the reset, we see fewer catalysts for a further rapid rise in rates compared to the start of the year, diminishing the risk of negative spill-overs to other asset classes in the near term. With lower near-term risks and lower asset prices after the sell-off, we now see markets as more attractive. Volatility is likely to moderate in the near term, but we do not expect to revisit the lows from last year. As the year progresses we are likely to see renewed temporary drawdowns where a more dynamic approach to managing exposures can add value.

Theme 1: Continued expansion

We see the risks to future growth as roughly balanced around current levels. The headwinds from tighter financial conditions have yet to materialize, despite central bank tightening. In the US, the February budget agreement significantly increased tailwinds to growth from what was already a positive fiscal impulse (Exhibit 3). We expect this positive impulse to start to show up in the data soon. With this backdrop, we think the risks are to the upside for US growth. This is also true for Japan, where recent data has been surprisingly weak given the exposure to the global expansion, making room for a rebound. However, for the global picture, these positives are balanced by risks that we see as somewhat to the downside for Europe and China (see Page 6).

Theme 2: A reset of rates risk

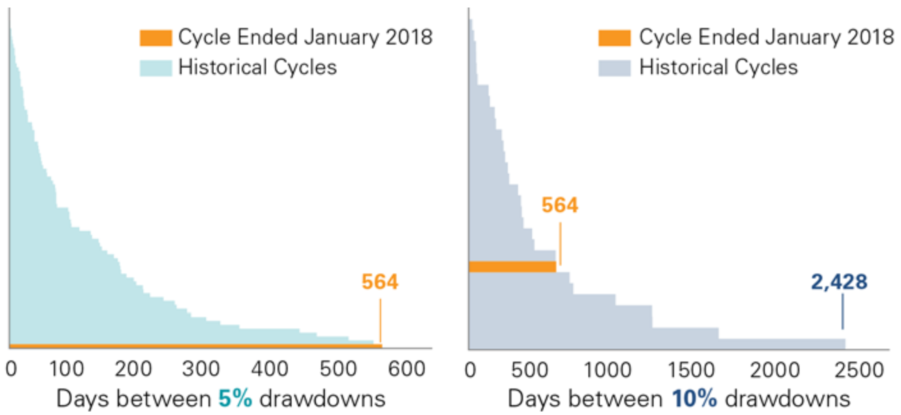
We expected 2018 to be the year when central bank tightening would start to matter more. It certainly has in terms of the rise in US interest rates. However, so far it has not generated the material tightening in financial conditions that we expected. We still expect this to happen, but near-term catalysts are hard to see; inflation has already risen substantially from the 2017 lows (Exhibit 6) and the market is now pricing close to a 100% chance of the Fed hiking in June. Interest rates are now more in line with what we think is appropriate for the current environment. In terms of the impact on other asset classes, we believe US 10-year rates could rise to around 3.5% before leading to a sustained sell-off for stocks (Exhibit 4). We think the risks from the theme of central bank tightening are likely to take a breather until later this year. At that point US tightening could coincide with discussions about the ECB's exit from its quantitative easing program heating up, with resulting volatility.

Theme 3: Be dynamic as volatility re-emerges

We believe that the current investment environment favors a dynamic approach, actively modulating asset class positioning as market and macro conditions change. We see markets as more attractive in the near term but see renewed bouts of volatility later this year. The balancing act between US fiscal and monetary policy, a significant upside surprise to inflation, and further geopolitical risks are all potential sources of volatility.

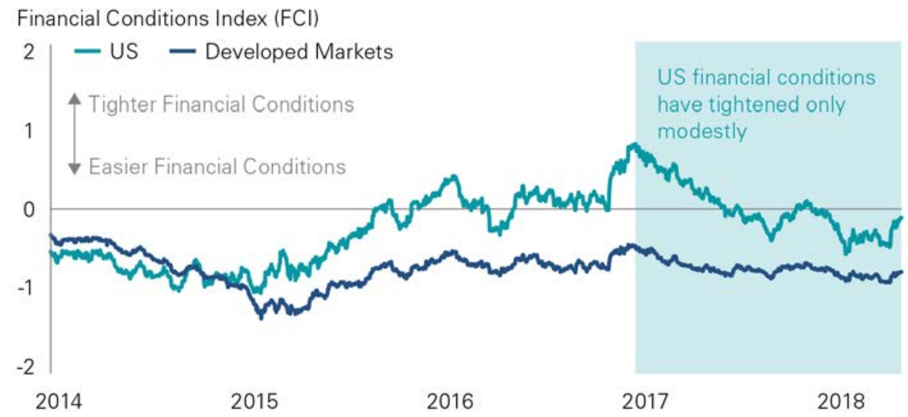
Charts that Matter

Exhibit 1: History suggests US equities were overdue for moderate volatility



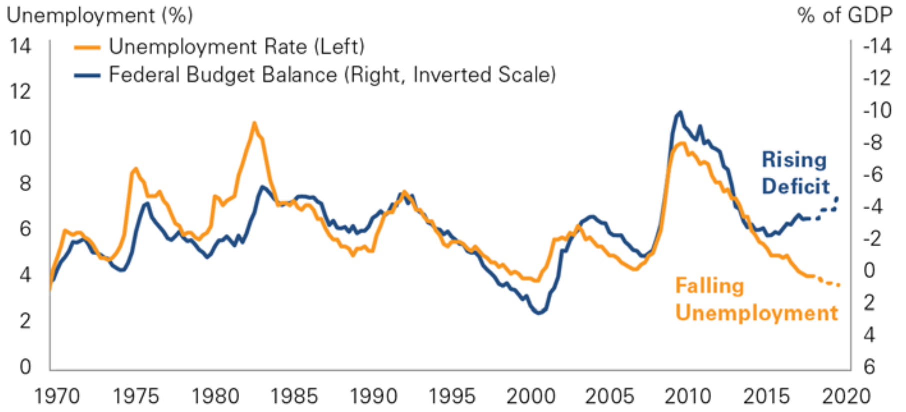
Source: Haver Analytics. Based on S&P 500. As of April 2018. Historical cycles since 1952.

Exhibit 2: Still-easy financial conditions create a positive growth impulse



Source: Macrobond, GSAM. As of May 9, 2018.

Exhibit 3: US fiscal stimulus amid low unemployment raises overheating risk



Source: Macrobond, GSAM. As of April 2018. Includes projections.

Exhibit 4: Rising rates alone are a poor indicator of subsequent equity returns

Source: FactSet, GSAM. As of March 2018. **Past performance does not guarantee future results, which may vary.** If any assumptions used do not prove to be true, results may vary substantially.

Macro Outlook Summary

Growth

We see the risks to global growth as roughly balanced after the recent moderation in data. We see risks to the upside in the US, where the fiscal boost is likely to pick up soon, and in Japan, where growth is slowing but likely to a rebound after surprisingly weak first-quarter data. This is balanced by risks that are somewhat to the downside for Europe and China. In Europe we worry about the headwinds from a stronger currency and higher rates as well as the eventual fading of the rebound of the global industrial cycle. In China, we think the focus on rebalancing of the economy is likely to provide some headwind.

Inflation

We are likely to see a gradual firming of inflation in the US given the tightness of the labor market. A faster rise has the potential to be disruptive, but it is not our core scenario. In Europe, we expect inflation to be more muted (Page 9) and for any surprises to have relatively little market impact given the still-large undershoot relative to the ECB's target.

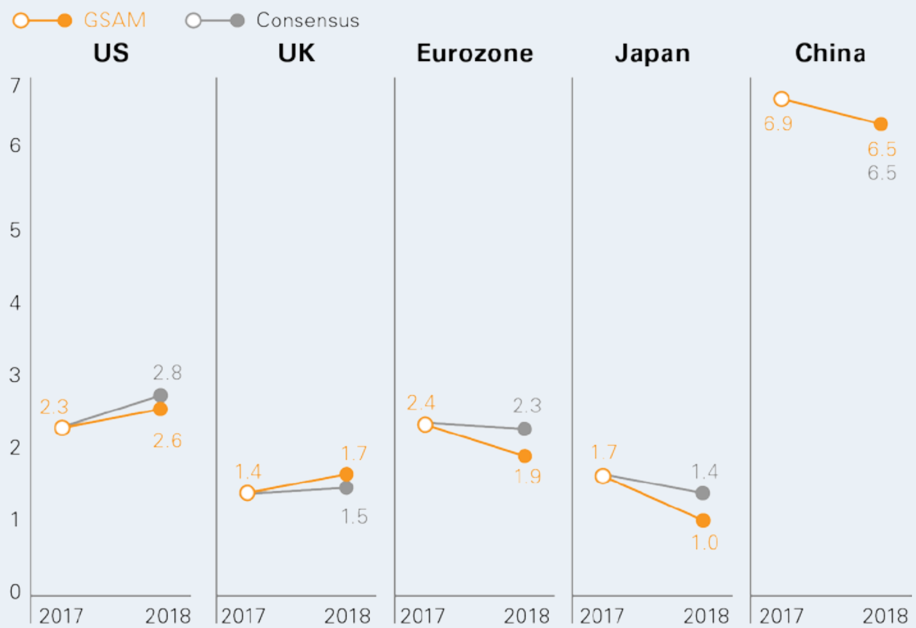
Monetary Policy

We expect three additional Fed hikes this year. We do not see clear near-term catalysts for the market to move to this view, given that inflation has now rebounded from last year's temporary weakness and the June hike is already close to 100% priced. In Europe we expect quantitative easing purchases to end this year, but do not see rate hikes until the latter part of 2019.

Politics

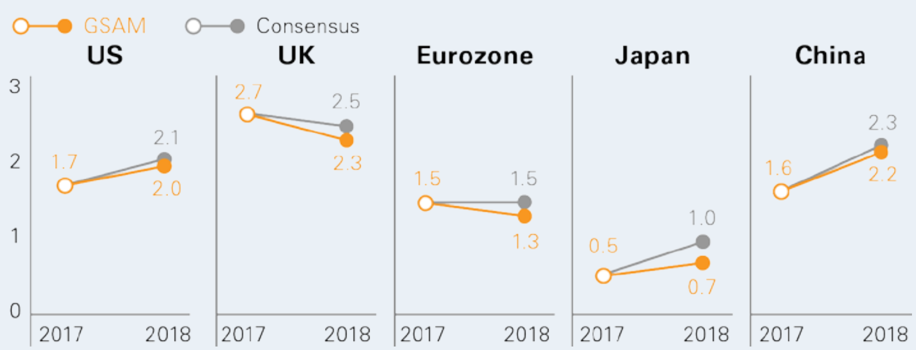
We now think the market is overpricing trade risks relative to what is likely to materialize. We still see upside risks from reform agendas globally, including de-regulation in the US, labor reforms in France, and corporate governance improvements in Japan. We continue to worry about geopolitical risks outside of trade.

Growth Forecast (%)



Source: GSAM, Bloomberg. As of April 2018.

Inflation Forecast (%)



Source: GSAM, Bloomberg. As of April 2018. US is personal consumption expenditures (PCE) index. All others are consumer price index (CPI).

Market Views

We prefer equity over credit, credit over rates and emerging markets (EM) relative to developed markets (DM).

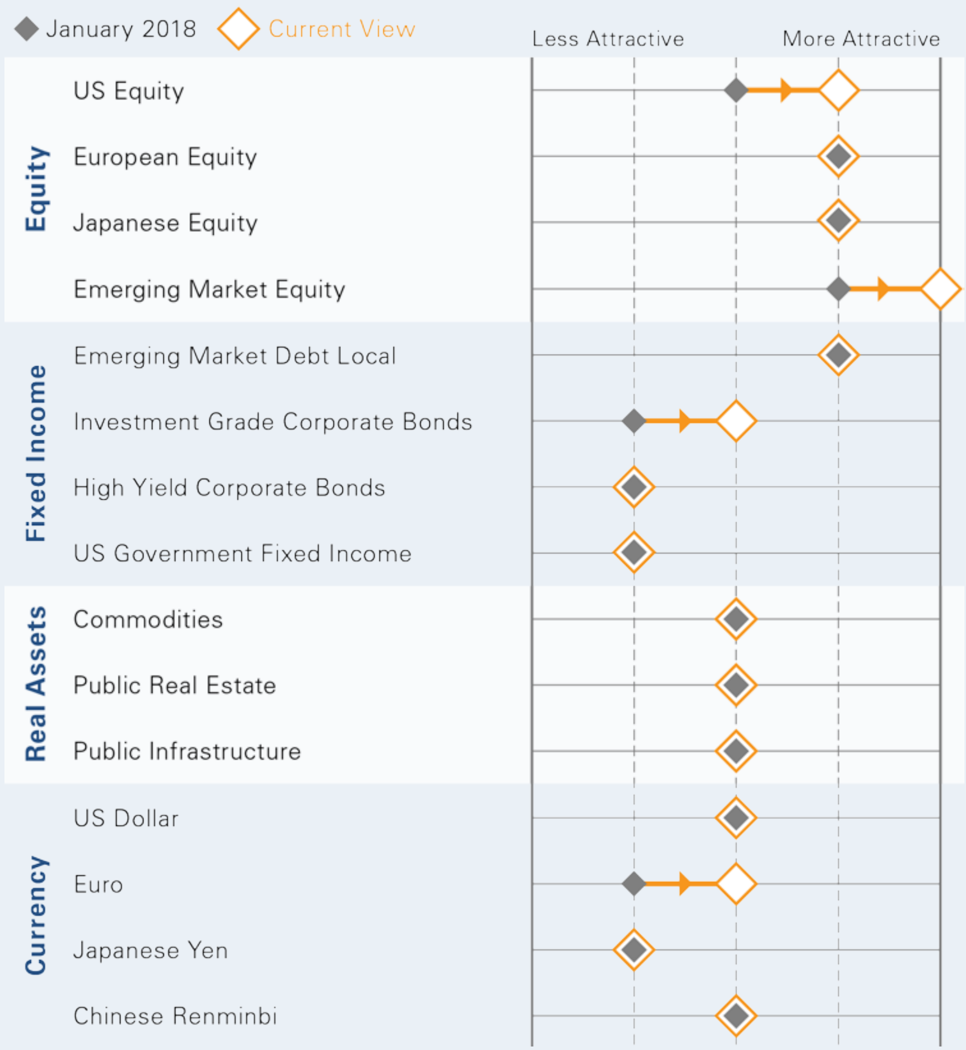
Moderate but positive returns in equities. Equities remain our preferred asset class for 2018, and after the sell-off the tactical outlook has improved. We expect moderate but positive returns for the year, as equities will likely need to digest higher bond yields as the year progresses.

Bearish on government bonds. We believe the market is underpricing the pace of future Fed rate hikes. More broadly, the risk of more fiscal expansion, discussions about the potential for the Fed to adopt a higher inflation target and the risks around the slowdown in global QE flows all suggest the need for a higher risk premium in government bonds. However, on a tactical basis we do not see clear catalysts for a material shift higher in yields in the near term.

Turning point in credit approaching. We think it is too early to position for a significant widening in spreads given the positive backdrop from corporate fundamentals and the macro environment. Instead, we think recent weakness presents an opening to add select exposure. That said, we are approaching the point in the economic cycle when credit spreads have historically started to widen and we think we are more likely than not to reach an inflection point in 2018.

Oil prices bounded by OPEC cuts and shale supply. We believe that WTI crude oil prices will trade in a $60-80/bbl range, as OPEC-induced market tightening keeps prices above their long-term equilibrium. In base metals, we are neutral over the medium term, as global cyclical tailwinds are partially offset by the potential for a moderate deceleration in Chinese demand growth. In precious metals, we expect real rates and the US dollar to be the main drivers in the medium term.

EM and cyclical European currencies to outperform. We have exposure to EM currencies with strong underlying macro and policy dynamics and where valuations are attractive. In Europe, we see value in being overweight the currencies of economies where inflation is closer to central bank targets than the Euro area. We are neutral the US dollar, as we see no clear fundamental catalyst for recent strength.



Source: GSAM. As of May 2018.

INVESTMENT THEMES

Continued expansion

After the softening of data in the beginning of this year, we think the bar has reset to a level where the risks around global growth are roughly balanced. This balance is an aggregate of regional differences, where we see risks to the upside for US and Japan and risks as somewhat to the downside for the Euro area and China.

In the US a stronger fiscal impulse is near…

The February US budget agreement has significantly increased the expected fiscal impulse to growth, while the potential headwind from a tightening of financial conditions has yet to show up. This together with the moderation we have seen in data means that risks are tilted to the upside from current growth rates.

While the growth picture is likely to be positive for risk assets in the near term, the longer-term impact of these policies is a source of concern. They add to already high levels of debt and deficits. Fiscal stimulus is also likely to boost the US growth rate, when the economy is already at risk of overheating.

The potential for overheating creates a need for more substantial monetary policy tightening that is likely to cause renewed volatility in markets later this year. However, for the time being we expect the positive growth impulse to dominate the market narrative. We also see risks skewed to the upside in Japan. Data has been surprisingly weak this year and we expect to see a rebound given the Japanese economy's exposure to the still-positive global environment.

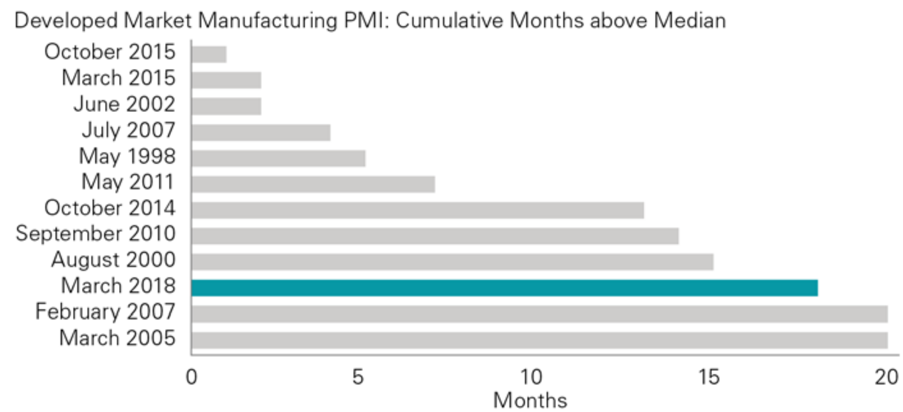
…but we see downside risks for the Euro area…

The Euro area has enjoyed very strong growth over the last year and a half, though very recently there have been clear signs of moderation in the high frequency data. From here, support is fading given the strengthening of the euro, rising interest rates and a likely moderation in global industrial activity (Exhibit 5). That said, the labor market remains strong and domestic drivers may take over as a source of support.

…and in China

We continue to see a hard landing in China as unlikely in the next few years, but incoming information continues to suggest some degree of shift in priorities toward reform after the leadership consolidation. This is likely to weigh on growth this year, and we expect a gentle downward pressure on Chinese growth. That said, we would also expect policy support to be quick to come back if we, against our expectations, were to see more significant signs of slowing growth.

Exhibit 5: Global manufacturing strength is likely to moderate



Source: Haver Analytics, GSAM. As of March 2018

We think that risks to global growth are roughly balanced following the reset to somewhat lower growth momentum. We see risks to the upside for the US and Japan, but risks as being somewhat to the downside for the Euro area and China.

INVESTMENT THEMES

A reset of rates risk

The rise in US rates this year has not translated into the tightening of broader financial conditions that we think is needed to bring US growth rates to a more sustainable level. We expect broader tightening to appear, but the catalysts are not on the immediate horizon, and the near-term risks to other assets from rising rates have declined.

We see a need for tighter financial conditions…

In our Outlook, we argued that central bank policy would need to start to have a bigger impact on the economy in order to slow US growth down to more sustainable levels, given that the labor market was already tight and continued to tighten at a rapid pace (Exhibit 3). There were also clear catalysts for this to happen. Markets priced in very little in terms of Fed rate hikes, there were still concerns in the marketplace that the period of weak inflation in 2017 reflected more than just noise in the data, and it was not clear that the rate path communicated by the Fed fully reflected the positive growth impulse from fiscal policy. We expected all of these aspects to be resolved in a way that would support higher rates. As this has happened, rates have risen. However, broader financial conditions have not tightened substantially and the shift in rates has now lost some momentum.

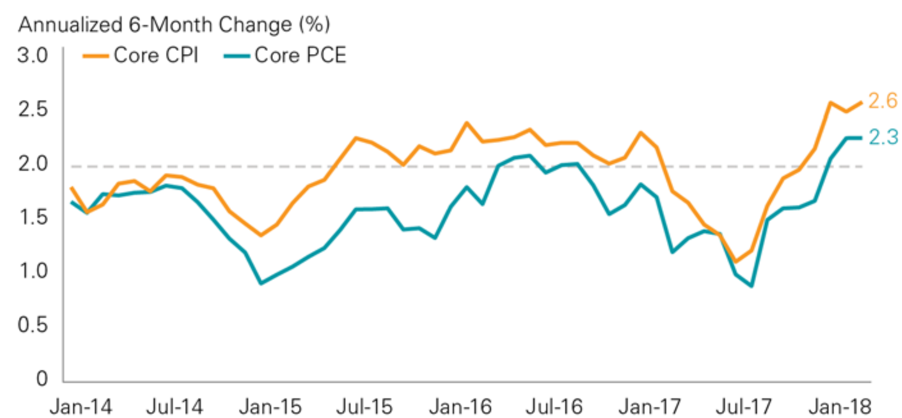
…but a lack of catalysts…

We see fewer near-term catalysts for a further shift in rates. We expect four rate hikes in total this year and still think the market is underpricing the pace of hikes, but the gap is much smaller than it used to be. Also with the market already pricing a roughly 100% chance of a rate hike in June, it is very possible that we need to wait until later this year before the path indicated by the market comes under clearer pressure from central bank communication. Similarly for inflation, the data now clearly suggests that the weakness last year was temporary (Exhibit 6). Consequently, something beyond normalization in inflation is likely to be required to bring rates higher as a consequence of inflation. We do think that inflation is firming due to the tightness of the labor market, but it is a gradual process that could take time before it starts to provide pressure on the market pricing of rate hikes. We are still bearish on US duration, but we think a period of consolidation is likely before yields continue their rise.

…makes us less worried about the risks to other assets

The recent sell-off in rates helped close the gap between market expectations and Fed guidance for tightening, while reducing potential catalysts for a rapid rise in rates ahead. We believe the risk to equities from higher rates has moderated and see opportunities in EM and US small caps. That said, the tightening mission is not accomplished and rate risk is likely to intensify again later this year.

Exhibit 6: US inflation moves beyond 2017 weakness



Source: Macrobond. As of March 2018.

We remain bearish on rates, but near-term catalysts for the view are limited and a period of consolidation is likely before the shift higher continues. We see the near-term risks to other assets from higher rates as diminished, which contributes to a better balance of risks.

INVESTMENT THEMES

Higher volatility, but not a high-volatility regime

We have seen a spike in equity volatility after an extraordinarily calm 2017. We expect more frequent drawdowns from here, requiring a dynamic approach to investing. However, we believe volatility will be episodic related to temporary drawdowns, rather than shifting to a persistently high-volatility regime at this point in the cycle.

1: Volatility in 2017 was abnormally subdued

The S&P 500 experienced a record stretch without at least a 5% drawdown until the equity sell-off hit in late January (Exhibit 1). The sell-off was in line with our view that we were likely to see more volatility in 2018, as markets would have to digest a moderation of growth momentum and higher interest rates. For the near term, the sell-off has brought us to a better balance of risks and hence a more positive outlook. Over the medium term, we do expect to see more frequent sell-offs giving rise to opportunities for active investment strategies, but not an outright shift to a high-volatility regime.

2: We are at a point in the cycle where volatility normally picks up

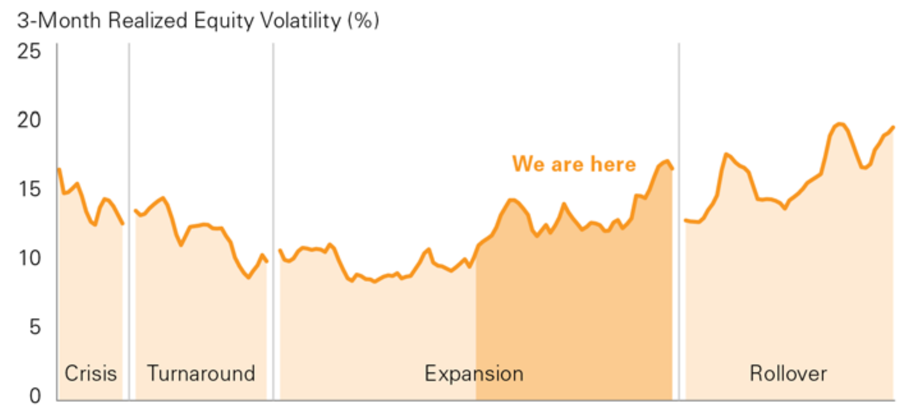
We divide the economic cycle into four phases, and the data generally suggests that we currently are a bit past the middle of the expansion phase. Exhibit 7 shows that equity volatility on a median basis troughs about one quarter into the expansion phase and then starts to gradually make its way higher. We expect episodic bouts of volatility, related to temporary drawdowns, rather than a persistently high-volatility regime, which normally occurs much later in the cycle.

3: The balance of risks is now better, but that is likely temporary

We expect it to be increasingly evident later this year that a firmer offset from monetary policy is needed to avoid more substantial overheating in the US economy given the size of the positive fiscal impulse. The balancing act between fiscal and monetary policy is a highly likely source of volatility. A continued gradual moderation in the pace of growth in Europe and China could also be a source of drawdowns, especially once the offset we expect from upside risks in the US due to fiscal policy becomes less pronounced later this year.

We also worry about a number of risks that are not part of the core scenario. Geopolitical risks remain high, a more significant upside surprise to inflation could be disruptive, and we think the market is at risk of end of cycle scares if we were to see an unexpected bout of data weakness. On the positive side the reform agenda remains alive across many countries, suggesting some room for upside surprises.

Exhibit 7: Volatility rises at mature stages of the cycle



Source: Bloomberg, GSAM. Median equity volatility at different stages of the economic cycle

We still think there are risks for further drawdowns, driving bouts of volatility. We think it is too early in the cycle to shift into a persistently high volatility regime.

INVESTMENT THEMES

Lowflation in the Euro area

The Euro area recovery is moderating but ongoing, and the output gap is expected to close this year. Despite expansionary activity, upward inflationary pressures remain scarce. In turn, our inflation and monetary policy outlook is more dovish than consensus and the ECB.

The Euro area recovery is cooling off after growth in 2017 hit its strongest level since before the European sovereign debt crisis. Unemployment declined by one percentage point to 8.6%—its lowest level since 2008—and the Euro area manufacturing purchasing managers index (PMI) reached an all-time high of 60.6 late last year. Firm activity has not boosted inflation, which remains sluggish. Annual headline and core inflation have averaged just 1.4% and 1.2%, respectively, over the past decade. We think this "lowflation" trend is likely to persist due to three main cyclical and structural factors, leading the ECB to move only gradually toward policy normalization.

1: Excess slack in the labor market

Several indicators point to slack in the labor market. Unemployment and hours worked are above and below pre-crisis levels, respectively. Youth unemployment exceeds 30% in several peripheral countries and the proportion of part-time workers is in excess of 22% in the Euro area. Taken together, these factors build a weak case for employers to raise wages. With respect to broader economic activity, we anticipated a decrease in momentum from firm levels. Nonetheless, recent moderation coupled with last year's currency strength presents dovish risks for already soft wage and price inflation.

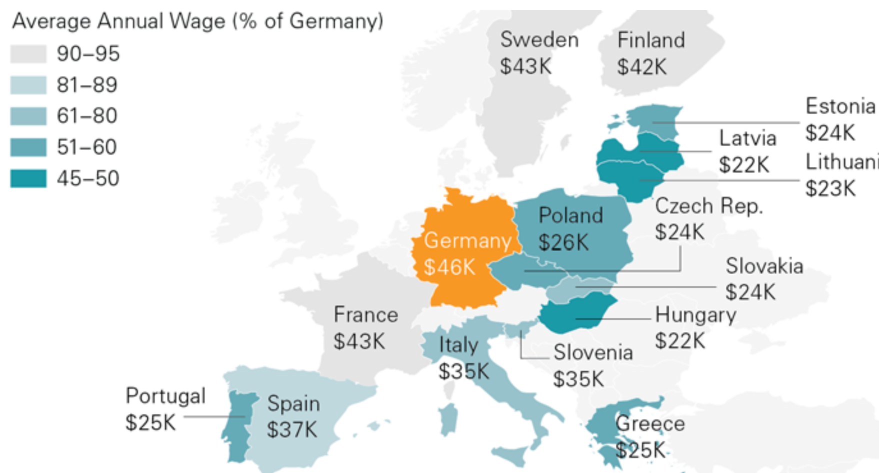
2: Increased labor migration

Even if unemployment declines, wage growth—which in turn spurs broader price pressures through higher domestic demand—is not guaranteed. Other than a brief five-month period during the global financial crisis, the German unemployment rate has been on a sustained downward trend since 2005, but wage growth remains lackluster. As discussed previously, this is due to migrant labor from surrounding countries where wages are lower than in Germany (see Exhibit 8). Employers can expand their workforce and output without raising wages by hiring workers from these countries, while employees tolerate modest wage growth for job security. With demographic challenges encouraging greater migration openness, this dynamic could persist for some time.

3: Technological disruption

The disinflationary impacts of technological advances are not unique to the Euro area but given the uptake of technology lags other markets, the inflation impact may still be in the pipeline. For example, e-commerce activity as a proportion of total retail sales is just 3.2% in Italy, compared to 9% in the US and 19% in the UK. Increased internet penetration and rising e-commerce activity will alter underlying inflation dynamics across sectors, while increased automation may pressure wages in certain sectors.

Exhibit 8: Germany is surrounded by disinflationary wage pressures



Source: OECD (Organisation for Economic Co-operation and Development), GSAM. Average annual wage in 2016 (USD PPP).

We are below consensus on Euro area inflation as we believe there is still pent-up capacity in the labor market, despite low unemployment and above-trend growth.

INVESTMENT THEMES

What Big Data is telling us about market themes

Companies are connected in ways that may impact their performance, but are often subtle and unnoticed. In our experience, analyzing unstructured "Big Data" can help bring these connections to light.

We believe the importance of thinking broadly about unexpected connections between companies will continue to grow as technological change morphs the definitions of economic sectors. Below, we describe three themes we are watching in 2018.

The internet of food

People are moving online for more of their entertainment. Big Data suggests the same is true of how they get their food. We have seen restaurants and internet software and services (ISS) companies connected through themes such as "website," "strategy" and "social," indicating a trend towards an integration of food preparation and delivery with internet platforms. Studies have shown that restaurants that employ a form of online delivery services have benefited from significantly stronger revenue growth relative to their non-internet connected peers. On the other hand, many ISS companies have incorporated online food delivery into their business models, utilizing their comparative advantage in logistics to supplement restaurant supply.

Greener, cleaner and cheaper

We see multiple seemingly unrelated industries benefitting as the cost of manufacturing semiconductors continues to fall. We identified linkages between semiconductor manufacturers, generators of renewable electricity and engineering firms through themes such as "solar", "electricity" and "installation." The same cost-saving techniques used in semiconductor manufacturing are now used in solar cell manufacturing, resulting in an overall cost reduction when manufacturing and installing solar power plants. This coincides with growing demand for solar energy, which grew by 26% in 2017 as more nations look toward clean, renewable energy.[1]

Legally bound

Another theme we see is the acceleration of companies facing future liabilities based on their past actions. For example, tobacco companies and oil producers are linked through litigation-based themes such as "appeals", "judgment", "trials" and "damages". More governments and tobacco users have been suing tobacco companies for damages, and governments and activists have filed lawsuits against oil companies for damages from climate change. For example, the states of Minnesota and Iowa sued multiple tobacco companies for hiding or downplaying risks of smoking, while New York City is suing the world's five largest publicly traded oil companies, seeking to hold them responsible for damage to the city from climate change.

Exhibit 9: Deep analysis of unstructured big data can reveal macro trends

Source: GSAM. For illustrative purposes only.

[1] Source: GSAM, International Energy Agency (IEA). As of March 2018.

We believe that investors can use big data to identify market themes and disruptive secular changes that connect otherwise disparate companies.

INVESTMENT STRATEGY

Equities

Within equity markets, US small caps and EM look attractive.

Can equities withstand higher rates?

We estimate that US equities can absorb a 10-year US Treasury yield of roughly 3.5% before a sustained sell-off, as implied by the equity risk premium (ERP). However, history has shown that rising rates alone are a poor indicator of subsequent equity returns. US equities were able to generate double-digit positive returns over the subsequent 12 months in all but one hiking cycle since 1988 (Exhibit 4). The driver of higher rates is important—equities may perform well to the extent that higher rates reflect strong economic growth prospects, as is the case in the current cycle.

Natural selection creates opportunities for stock selection

The normalization of rates and rising cost of capital reinforce a Darwinistic framework where strong companies thrive and the weak perish, increasing the dispersion among companies and sectors. For large cap equities, much of the earnings recovery since the financial crisis has been driven by cost-cutting and margins growth, rather than revenue growth. With rising cost pressures, pricing power will become an increasingly important differentiator of future success. The increased dispersion between winners and losers reinforces the importance of active management.

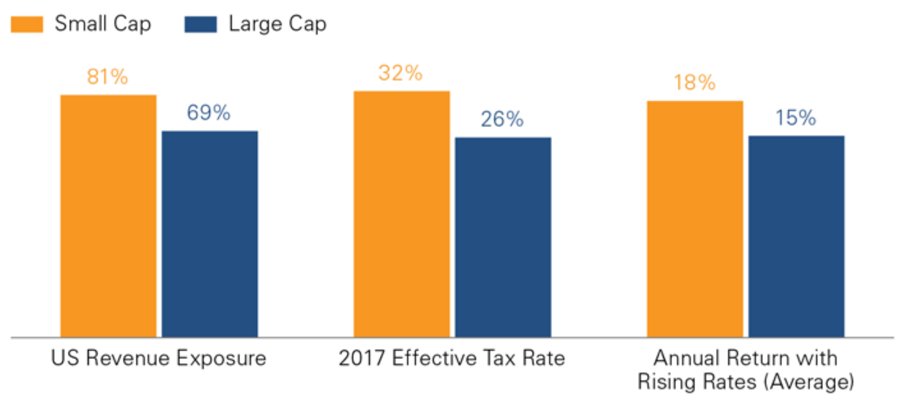
US small caps tend to outperform large caps in rising rate environments

US small cap equities look increasingly attractive. Small caps have performed well in rising rate regimes as they are more levered to better growth prospects and are less sensitive to interest rates due to smaller dividends on average. Higher domestic exposure also allows small caps to benefit more from tax cuts, while being relatively insulated from the negative impact of potential tariffs and trade tensions. Operating margins for small caps remain well below pre-crisis peaks in contrast to the new highs reached by large cap companies, providing room for improvement (Exhibit 10).

EM equities are another bright spot with strong earnings at a valuation discount

The accelerating EM economic growth is expected to exceed DM economies in the next few years. EM is expected to contribute over 70% of global GDP growth between 2015 and 2025, and we estimate that as 1.2 billion people in EM rise into middle- and high-income classes over this 10-year period, real consumption should more than double. This shift is evident in the changing composition of EM equity markets towards the information technology and consumer sectors. Supportive macro fundamentals have revived EM earnings growth, which has outpaced DM, while valuations are at a 20-25% discount.

Exhibit 10: US small caps are better positioned in the current environment
More boost from growth and tax cut; less exposed to rising rates and trade tensions



Source: BEA, BAML, Credit Suisse, Russell, S&P Capital IQ/ClariFi, Compustat as of Dec 2016, Factset, GSAM as of Mar 2018. Small caps calculated using Russell 2000 index, large caps calculated using S&P 500 index.

[1] GSAM, Goldman Sachs Global Investment Research, IMF, rebased to 2015 USD GDP, as of Dec-2016

We think equities have room to digest higher rates without a sustained sell-off, up until the 10y US Treasury reaches 3.5%.

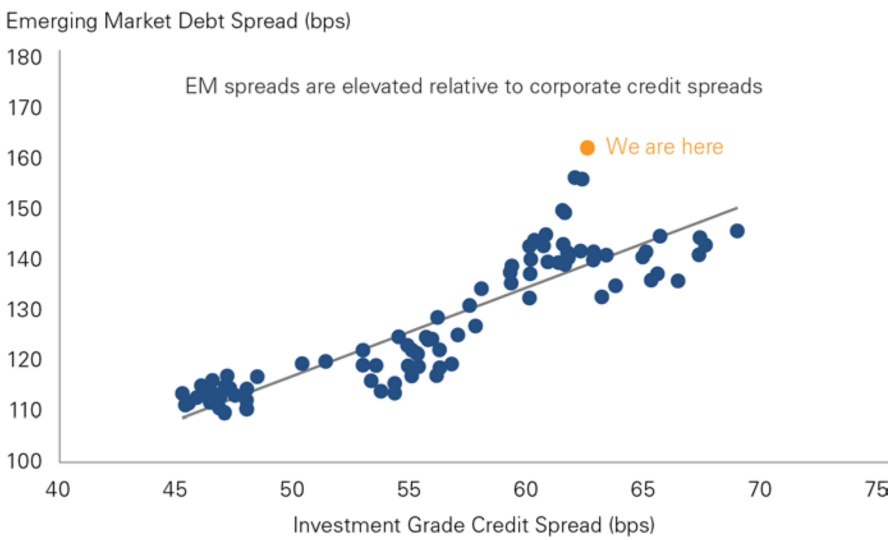
We think US small caps and EM equities are best positioned to outperform in the higher-rate, late cycle environment.

INVESTMENT STRATEGY

Fixed Income

Within fixed income markets, we remain bearish on US rates and see scope for gains in EM assets as the global economic expansion continues. That said, macro data has lost some momentum and we will likely see volatility return, especially if US inflation surprises to the upside and geopolitical tensions intensify.

Exhibit 11: EM debt appears undervalued compared to US corporate bonds
Year-to-date relationship between EM sovereign debt and US corporate spreads



Source: Bloomberg. EM debt spread based on EM CDX Index. US investment grade spread based on US Investment Grade CDX Index. Daily spreads from Jan. 2, 2018 through May 8, 2018.

Modestly overweight spread risk with a preference for securitized credit, and focused on relative value across rates and currencies.

Rates and currencies: We remain bearish US rates and overweight European rates on a relative value basis. We think US rates will struggle to move higher in the near term after a steady climb that pushed 10-year yields above 3% in April for the first time since 2014. Longer term, we expect the upward pressure on US rates to continue. Fiscal stimulus has reduced the downside risks for US growth while we think the upside risks for growth and interest rates have increased. We also think the Fed will continue to raise rates at a steadier pace than market pricing suggests, while the ECB is likely to move more slowly given the persistence of low inflation in the Euro area. In currencies, we are positive on EM currencies geared to global growth as we expect the global expansion to continue.

Spread sectors: We continue to see value in holding exposure to spread sectors given the relatively positive macro backdrop, with a preference for securitized credit and emerging market external debt over corporate credit. EM debt has significantly underperformed corporate credit in recent weeks and now trades at elevated spreads relative to comparable US corporate bonds (Exhibit 11). Against a backdrop of rising interest rates, we favor short-duration securitized credit which offers attractive carry for firm fundamentals. That said, we are cautious about volatility and late-cycle risks and our positioning is modest.

Be dynamic: An active and flexible investment approach is essential as we move beyond an era of pro-growth policies. The US dollar's disconnect from interest rate differentials earlier this year underscores the need to look beyond traditional market relationships and drivers. For example, we see value in strategies focused on capturing spreads in short-term credit, which have been pushed higher by supply pressures, including outflows driven by US multinational companies repatriating foreign profits.

We are bearish US rates, while bullish on EM currencies with strong underlying macro stories. Among spread sectors we see value in emerging market debt after recent underperformance in the sector, and in high quality, short-duration securitized and corporate credit.

Disclosures

The views expressed herein are as May 2018 and subject to change in the future. Individual portfolio management teams for GSAM may have views and opinions and/or make investment decisions that, in certain instances, may not always be consistent with the views and opinions expressed herein.

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