August 12, 2011

Goldman Sachs

# GOAL: Global Opportunity Asset Locator

Portfolio Strategy Research

## Growth is lower, risks are higher

We now expect 4.0% global growth in 2011 and 4.4% in 2012 (PPP basis), with resilient growth in EM being a key contributor to overall growth. This is down from 4.8% and 4.9%, respectively, when we last published GOAL. Risks arise from: (1) a one-in-three chance of a US recession, (2) the possibility that the European sovereign situation could escalate further, (3) the limited room for policy, and (4) the unbalanced nature of the recovery, with significant slack in some areas combined with tight capacity in others. Further, the impact of current high market volatility on sentiment increases the already elevated risk of more severe and hard to quantify tail events.

## But much is priced and we still expect a good level of growth

In our view, markets have moved to discount a scenario which is significantly worse than our central scenario. Relative to our fundamental models, US 10 year Treasuries are about 1.6 standard deviations rich and oil and copper are trading cheaper. At the same time, the risk premium in US and European equities is near 20 year highs.

## Leaving us overweight of risky assets

Though volatility is likely to remain high and we probably need to see more signs of growth stabilization for markets to turn decisively, exact turning points are impossible to pin-point and the risk-reward in our view favors risky assets on both a 3 and a 12 month horizon at the current juncture. We would overweight equities and commodities on both a 3 and a 12 month view. We prefer equities to commodities on a 3 month basis and would reverse that ranking on a 12 month basis. Within equities we would overweight Asia ex. Japan and underweight Europe. On both horizons, we would neutral weight corporate credit and cash and underweight government bonds. Within our neutrals, we prefer cash to corporate credit, due to the large levels of current uncertainty.

**Expected returns and recommended allocation**

| New Recommendation | | | | | | |
|---|---|---|---|---|---|---|
| 3-Months Horizon | | | | 12-Months Horizon | | |
| Asset Class | Return* | Weight | | Asset Class | Return* | Weight |
| Equities | 17 % | OW | | Commodities | 25 % | OW |
| Commodities | 7 | OW | | Equities | 31 | OW |
| Cash | 0 | N | | Cash | 1 | N |
| 5 yr. Corporate Bonds | -1 | N | | 5 yr. Corporate Bonds | 1 | N |
| 10 yr. Gov. Bonds | -3 | UW | | 10 yr. Gov. Bonds | -5 | UW |

* Return forecasts assume full currency hedging

*Source: Goldman Sachs Global ECS Research.*

**Peter Oppenheimer**
+44(20)7552-5782 peter.oppenheimer@gs.com
Goldman Sachs International

**Anders Nielsen**
+44(20)7552-3000 anders.e.nielsen@gs.com
Goldman Sachs International

**Jeffrey Currie**
+44(20)7774-6112 jeffrey.currie@gs.com
Goldman Sachs International

**Christopher Eoyang**
+81(3)6437-9888 christopher.eoyang@gs.com
Goldman Sachs Japan Co., Ltd.

**Francesco Garzarelli**
+44(20)7774-5078 francesco.garzarelli@gs.com
Goldman Sachs International

**Charles P. Himmelberg**
(917) 343-3218 charles.himmelberg@gs.com
Goldman Sachs & Co.

**David J. Kostin**
(212) 902-6781 david.kostin@gs.com
Goldman Sachs & Co.

**Kathy Matsui**
+81(3)6437-9950 kathy.matsui@gs.com
Goldman Sachs Japan Co., Ltd.

**Timothy Moe, CFA**
+852-2978-1328 timothy.moe@gs.com
Goldman Sachs (Asia) L.L.C.

**Thomas Stolper**
+44(20)7774-5183 thomas.stolper@gs.com
Goldman Sachs International

**Aleksandar Timcenko**
(212) 357-7628 aleksandar.timcenko@gs.com
Goldman Sachs & Co.

**Dominic Wilson**
(212) 902-5924 dominic.wilson@gs.com
Goldman Sachs & Co.

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# Lower growth, more uncertainty and cheaper risky assets

**Our GOAL product highlights key forecast and investment opportunities across the asset classes and regions that we cover. The GS GOAL – Global Opportunity Asset Locator draws on research from across ECS (Economics Commodities and Strategy research) to focus on key drivers, themes, investable recommendations and how to implement them.**

## A poor four months for our asset allocation

In our last GOAL (published on April 15, 2011) we maintained our overweight in equities and underweights in cash and government bonds. We upgraded corporate credit to neutral and with the largest conviction we downgraded commodities to underweight. Our expectation of a fall in oil prices driven by a decline in the large risk premium built into prices on the back of the supply disruptions from Libya was our strongest held view, in what we otherwise acknowledged to be a lower conviction allocation.

Since April, risky assets have been volatile, and in the last few weeks they have sold off very sharply on a combination of renewed recession fears, concerns about sovereign risks in Europe, the US debt ceiling debate and the downgrade of the US credit rating. This week the intervention by the ECB in bond markets has pushed Italian and Spanish bond spreads back closer to fundamental levels, and the easing of policy by the FED has helped to partly reverse the recent tightening of broad US financial conditions. Both of these developments are very positive, but not a panacea for the current economic risks.

Taking the four months as a whole, the performance of our allocation has been poor. We were overweight equities, which returned -15%, and underweight government bonds which returned +9%. Our underweight in Commodities on the other hand was well-timed before the sell-off in early May. The -15% return of the asset class was not enough to compensate for the performance of our equity and government bond allocations, however.

## Lower growth, more uncertainty and cheaper risky assets

Last Friday we revised down our global growth outlook and adjusted our return forecasts across asset classes. Our new forecasts reflect rising challenges for growth on four fronts: (1) a softer private demand trend than we expected in the US; (2) the broadening and persistency of the European sovereign issues; (3) the ability of policy to respond to this being more restricted than last year, with the debt ceiling debate in the US and the consolidation in European government budgets limiting room for fiscal stimulus, and higher inflation leaving less room for monetary policy; and (4) the energy constraint on growth having proved in the first half of 2011 to be more binding than we thought.

Despite these challenges, our central outlook is still for 4.0% global growth in 2011 and 4.4% in 2012 as we expect EM growth to remain resilient. Many EMs are currently tightening and we believe the weaker external environment will to a large extent be offset by less policy tightening than would otherwise have been the case.

The risks around our central forecast have risen substantially since our last GOAL: (1) we now see a one in three chance of a recession in the US; (2) the sovereign situation in Europe could escalate further; (3) the necessary fiscal adjustments are a challenging balancing act between tightening too slowly and tightening too quickly; and (4) additional risks are also introduced by the lack of balance in the recovery. The output gaps in EM economies are largely closed, at the same time as large output gaps remain in most DM economies. The divergence of growth rates and policy needs within the Euro-zone is large

as well. Further, the impact of current high market volatility on sentiment increases the already elevated risk of more severe and hard to quantify tail events.

While risks have risen, the price adjustment for risky assets has also been very substantial, leaving valuations at levels that are discounting significantly worse outcomes than our central scenario. Over the next few months, our central scenario is for growth to pick up somewhat in the US, inflationary pressures in EM economies to moderate and the latest European package to be approved by parliaments. Admittedly, we forecast growth momentum to slow in the Euro-zone in the third quarter, but we then expect it to reaccelerate in the fourth quarter and into 2012. At the micro level we expect earnings to remain healthy with earnings growth next year ranging between 6% in the US and 18% in Japan. These expected developments combined with current valuations give very high expected returns for risky assets in our central scenario.

On a slightly longer horizon, the risk-reward is being further supported by the greater-than-even chance we now see for the FED to resume quantitative easing later this year or in the beginning of next year.

## Our current view: On balance we favor risky assets

The uncertain outlook, with a large probability of both outcomes with very high and with quite poor returns for risky assets, makes asset allocation unusually challenging. On balance, we have decided to overweight equities and commodities, neutral weight cash and corporate credit and underweight government bonds on both a 3 and a 12 month horizon. Within our overweights, we prefer equities over commodities on a 3 month horizon and commodities over equities on a 12 month horizon, as we see less risks to our commodity forecast than to our equity forecast over 12 months. On both horizons we prefer cash to corporate credit due to the large levels of current uncertainty.

Our conviction in this allocation is lower than usual given the uncertainty, especially on the 3 month horizon. Given that volatility is likely to remain high in the near term, and that valuation is a better predictor of returns over longer horizons, we believe the asset allocation decision at this juncture should be even more dependent upon investors' time horizon and ability to carry temporary mark to market losses than what is normally the case. For investors who are more constrained on these fronts, weightings very close to benchmark, with a high weighting in cash in the near term to capture opportunities as they emerge would make sense.

**Equities** have sold off sharply in recent weeks, and even with our revised targets we have very strong upside to targets on both a 3 and a 12 month horizon. There would still be further downside in a US recession scenario, but we feel that enough is priced to make the risk-reward justify an overweight. Within equities we prefer Asia ex. Japan followed by the US, Japan and finally Europe on both a 3 and a 12 month horizon.

**Exhibit 1: Performance since last GOAL and our new recommended allocation**

| Performance since last GOAL** | | |
|---|---|---|
| Asset Class | 3-Months Rec. In last Goal | Performance |
| Equities | OW | -14.7 % |
| 5 yr. Corporate Bonds | N | 3.7 |
| 10 yr. Gov. Bonds | UW | 8.6 |
| Cash | UW | 0.2 |
| Commodities | UW | -15.2 |

| New Recommendation | | | | | |
|---|---|---|---|---|---|
| 3-Months Horizon | | | 12-Months Horizon | | |
| Asset Class | Return* | Weight | Asset Class | Return* | Weight |
| Equities | 17 % | OW | Commodities | 25 % | OW |
| Commodities | 7 | OW | Equities | 31 | OW |
| Cash | 0 | N | Cash | 1 | N |
| 5 yr. Corporate Bonds | -1 | N | 5 yr. Corporate Bonds | 1 | N |
| 10 yr. Gov. Bonds | -3 | UW | 10 yr. Gov. Bonds | -5 | UW |

* Return forecasts assume full currency hedging
**Performance since last GOAL assuming full currency hedging

*Source: Goldman Sachs Global ECS Research.*

We have not changed our price forecasts for **commodities** on the back of our weaker growth outlook, with the exception of gold where we have revised our target from 1730 to 1860 on a 12 month horizon, reflecting our expectation that real yields will remain lower for longer. However, with our new economic forecasts the uncertainty around our commodity forecasts is now larger and the risks more symmetric, instead of being skewed to the upside. Our central scenario of 4% global growth with a heavy EM tilt will be sufficient to tighten key commodity markets in our view, and while demand has disappointed in the first half of 2011, supply has disappointed at least as much, leading to resilient commodity balances so far. One example is Non-OPEC oil production which declined by 200 thousand b/d yoy in 2Q2011 versus consensus expectations for growth. Since our return forecasts are driven by the expectation of substantially lower inventories and lack of spare production capacity in 2012 as a result of tightening balances, we have more confidence in them on a 12 than on a 3 month basis, and hence switch the order of preference within our overweights to favor commodities over equities on a 12 month horizon.

Historically, **corporate credit** has done well in the slow but positive growth environment we are forecasting in the US, and in a downside scenario a widening of spreads would likely be offset to some extent by declining bond yields. That said, the current sell-off in credit has been less extreme than in more risky assets creating less upside going forward. The asset class also has significant tail exposure in financials, which would be costly if we get further pressures in the financial system. Overall, our return forecasts are around zero for the asset class on both horizons.

**Government bond** yields are now very close to the lows of the financial crisis in the US, Germany and Japan. For the US, 10 year yields are now about 1.6 standard deviations below where our Sudoku model would suggest that they should be. This leaves negative return forecasts on both a 3 and a 12 months horizon in our central scenario. While bonds would still pay off in a recession scenario and are likely to be supported if further quantitative easing in the US materializes, the risk-reward of the asset class is now such that we would rather use cash than government bonds to protect the portfolio from poor outcomes. We neutral weight **cash** on both horizons, reflecting the uncertainty of the current environment.

**Exhibit 2: Goldman Sachs 3 and 12 month return forecasts by asset class**

| Asset Class | Weight | 3-month Total Return | | 12-month Total Return | |
|---|---|---|---|---|---|
| | | Local currency | In USD | Local currency | In USD |
| **Equities** | | **17.2** | **17.9** | **31.2** | **35.2** |
| S&P 500 | 40 | 21.0 | 21.0 | 31.5 | 31.5 |
| Stoxx | 30 | 14.9 | 17.2 | 28.5 | 40.1 |
| MXAPJ (in USD) | 20 | 16.7 | 16.7 | 38.1 | 38.1 |
| Topix | 10 | 10.1 | 9.9 | 24.8 | 29.6 |
| **10 yr. Government Bonds** | | **-2.6** | **-2.1** | **-4.8** | **-1.0** |
| US | 40 | -4.8 | -4.8 | -7.4 | -7.4 |
| Germany | 30 | -2.1 | -0.1 | -4.6 | 4.0 |
| Japan | 30 | -0.4 | -0.5 | -1.4 | 2.4 |
| **5 yr. Corporate Bonds** | | **-1.4** | **-0.4** | **0.8** | **5.3** |
| US: iBoxx USD Dom. Corporates | 50 | -1.4 | -1.4 | 0.4 | 0.4 |
| Europe: iBoxx EUR Corporates | 50 | -1.4 | 0.5 | 1.1 | 10.2 |
| **Commodities (GSCI Enhanced)** | | **7.0** | **7.0** | **24.9** | **24.9** |
| **Cash** | | **0.2** | **0.7** | **0.7** | **4.6** |
| US | 40 | 0.1 | 0.1 | 0.3 | 0.3 |
| Germany | 30 | 0.4 | 2.4 | 1.7 | 10.8 |
| Japan | 30 | 0.1 | -0.1 | 0.3 | 4.2 |
| **FX** | | 3 month target | Return vs USD | 12 month target | Return vs USD |
| EUR/$ | | 1.45 | 2.0 | 1.55 | 9.0 |
| $/YEN | | 77 | -0.2 | 74 | 3.9 |

*Source: Goldman Sachs Global ECS Research.*

# Equities: Overweight on attractive risk-reward

**We maintain our overweight in equities on both a 3 and a 12 month horizon. The overweight is driven by our assessment that the potential reward for holding equities under our central economic forecast is large enough to provide an attractive compensation for the increased levels of risk, which are clearly present. The returns in our central scenario are driven by 4% global growth combined with low interest rates, reasonable profit growth, and valuations that are now clearly stretched to the downside relative to what would be justified in this scenario. On both a 3 and a 12 month horizon we prefer Asia Pacific ex Japan, followed by the US, Japan and finally Europe.**

Equity performance since our last GOAL report has been first volatile and then simply terrible. The asset class is down 14% as the market has moved to price a weaker growth outlook, more policy uncertainty and a renewed chance of a recession in the US. The decline in double dip fears was probably the main driver of the equity rally late last year, and with those fears coming back markets are re-pricing lower. While our new global growth forecast at 4.0% for 2011 and 4.4% for 2012 is still healthy, a one in three chance of a double dip recession in the US, the possibility of renewed escalation of European sovereign issues and a less benign scenario for EM economies than our forecasts, are all risks which could cause a continued fall in equities.

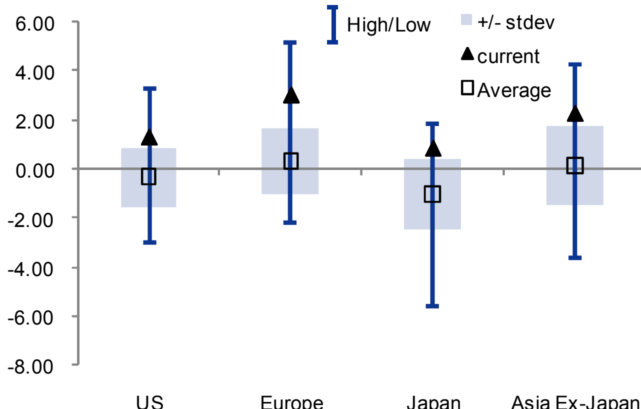
In our view, equity markets have already moved to partly price these risks. Given this and the very significant upside potential for equities if our central scenario materializes we believe the risk-reward looks attractive on both a 3 and a 12 month horizon.

Valuation is a necessary but not sufficient condition for a turnaround in markets. The policy actions from the ECB and the FED are important, but in order to give the all clear further stabilization in economic data is probably needed as well. It is impossible to pin-point exactly when markets turn; taking this into consideration we would also be overweight equities on a 3 month view. This overweight requires significant tolerance for potential interim mark-to-market losses, and for some investors a more neutral stance might therefore be better.

Our return forecasts in the central scenario, has four broad pillars of support: (1) a still strong level of global growth combined with low interest rates, (2) strong earnings growth, (3) an attractive valuation starting point on an absolute basis as well as (4) relative to other asset classes.

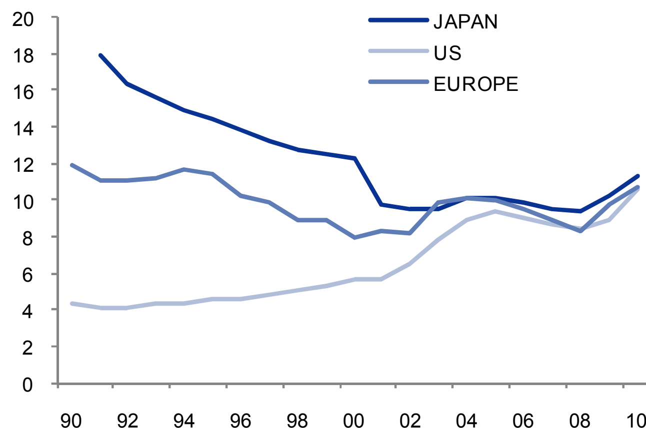
In terms of relative valuation, Exhibit 3 shows the difference between the dividend yield and the real 10 year government bond yield (we use five year historical average inflation as a crude measure of inflation expectations) for the four regions we consider. In all four regions this difference is now significantly more than one standard deviation above the average since 1990 (1995 for Asia ex Japan). Similarly, our regional estimates of the equity risk premium in Exhibit 4 range between 6.5% for the US and 8.0% for Europe. The European ERP is now higher than the 7.5% it reached in the end of February 2009, and is clearly in the extreme end of the distribution over the last 20 years.

**Exhibit 3: Dividend yields are high vs. real bond yields**
Dividend yields minus 10-year real government bond yields. We use five-year avg. inflation as a proxy for inflation expectations. The distribution uses data from 1990 except for Asia ex-Japan where it is from 1995.




*Source: Datastream, Haver Analytics, Goldman Sachs Global ECS Research.*

**Exhibit 4: Cash/Asset above peak from the last cycle**




*Source: Compustat, Worldscope, Goldman Sachs Global ECS Research.*

On an absolute basis, the NTM P/E ranges between 8.4 for Europe and 13.1 for Japan. Exhibit 8 gives a historical perspective.

Across all regions, the P/E is now at or close to the lowest levels we have seen since 2001 (on monthly data), reflecting that earnings have held up well, while prices have collapsed. It is our view that earnings will continue to hold up well, and this is a cornerstone of our positive view on equities. On a P/B basis, markets are slightly more expensive, but still at least one standard deviation below average. In the case of Europe, the market is close to its historical low even on a P/B basis.

Historically, valuation has been a key determinant of 5 year returns, so despite the near-term risks, long-term prospects for equities look great. The risks are high but so is the compensation investors are paid for taking those risks.

Earnings have held up well so far, and after our latest round of revisions we now expect earnings growth ranging from 6% for the US to 13% for Japan in 2012. In 2011 our forecasts range from 7% growth in Japan to 15% in the US.

Exhibit 6 shows that the negative impact on earnings from the earthquake now seems to be factored in as Japanese earnings revisions are now back in positive territory. Elsewhere, the US earnings season has been good and revisions are now solidly positive. In Europe, the earnings season has been disappointing and has led to acceleration in downward revisions. The stronger presence of tech companies in the US market and currency impacts on earnings, especially of Swedish industrials, have been important drivers of this divergence.

**Exhibit 5: Global indices price targets and earnings growth**

All data is in local currency except data for the MSCI Asia Pacific ex-Japan index which is in US$

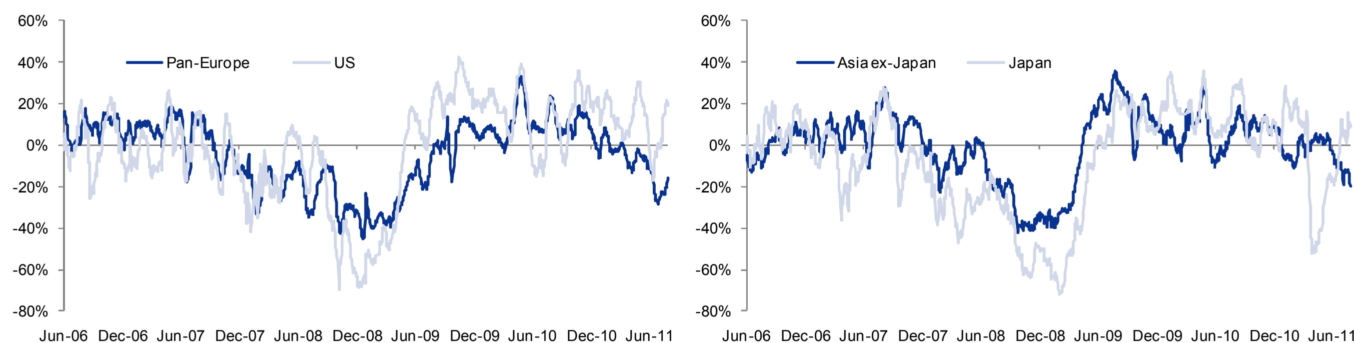
| Index | Current Price 10-Aug-2011 | GS Target 3-months | GS Target 6-months | GS Target 12-months | Upside to target (%) 3-months | Upside to target (%) 6-months | Upside to target (%) 12-months | Earnings Growth GS top-down 2011 | Earnings Growth GS top-down 2012 | Earnings Growth Consensus bottom-up 2011 | Earnings Growth Consensus bottom-up 2012 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| MXAPJ | 423 | 490 | 515 | 570 | 15.9 | 22 | 35 | 13 | 11 | 13 | 13 |
| Stoxx Europe 600 | 224 | 255 | 265 | 280 | 14.1 | 19 | 25 | 9 | 12 | 8 | 13 |
| S&P 500 | 1,121 | 1,350 | 1,400 | 1,450 | 20.5 | 25 | 29 | 15 | 6 | 18 | 14 |
| TOPIX | 777 | 850 | 900 | 950 | 9.4 | 16 | 22 | 7 | 18 | 22 | 18 |

*Note : TOPIX EPS is based on fiscal, not calendar, years*

*Source: Goldman Sachs Global ECS Research.*

**Exhibit 6: Earnings sentiment by region**

Upgrades less downgrades, as percentage of changes in estimates (last four weeks)




*Source: FactSet, I/B/E/S, Goldman Sachs Global ECS Research.*

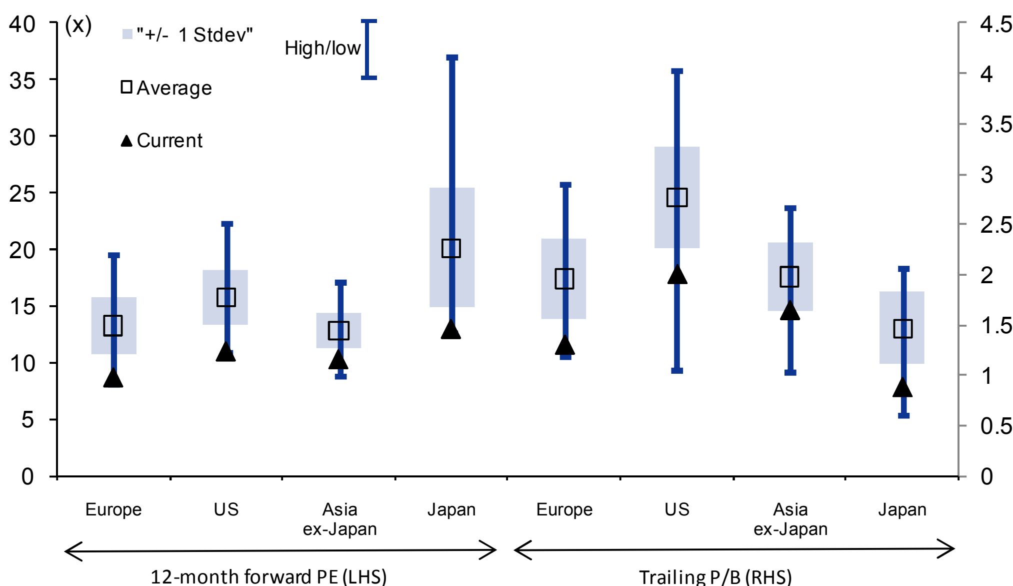
**Exhibit 7: Global valuation metrics**

P/E is NTM, all other data is 2010 or last twelve months

| | P/E | EV / EBITDA | FCF Yield | Div Yield | P/B | Operating Margin | ROE | Implied ERP |
|---|---|---|---|---|---|---|---|---|
| S&P 500 | 11.0 | 7.0 | 6.6 | 2.3 | 2.0 | 9.1 | 14.6 | 6.5 |
| Stoxx Europe 600 | 8.4 | 5.9 | 8.0 | 4.4 | 1.3 | 10.5 | 12.3 | 8.0 |
| Topix | 13.1 | 5.8 | 5.3 | 2.2 | 0.9 | 5.8 | 5.4 | 6.9 |
| MSCI Asia Pacific ex-Japan | 10.3 | 7.9 | 11.0 | 3.0 | 1.7 | 10.8 | 14.5 | 8.5 |

*Source: Worldscope, I/B/E/S, Datastream, FactSet, Goldman Sachs Global ECS Research.*

**Exhibit 8: Regional valuation relative to historical distribution (using data from 2001)**




*Source: Worldscope, I/B/E/S, Goldman Sachs Global ECS Research.*

Within equities we maintain our preference for Asia ex. Japan on both a 3 and a 12 month horizon. With the divergence in our growth outlook between EM and DM now being larger, and the point of deceleration in EM inflation being closer, we have more conviction on this view than in our last GOAL.

We have downgraded Europe to our largest underweight on both a 3 and a 12 months horizon. Our assessment of the fiscal situation has deteriorated significantly since our last GOAL as the crisis has spread to Italian bonds. While the ECB intervention is helpful, the fiscal contraction in the periphery is now being accelerated and our growth forecasts have been lowered. At the same time it now looks as if a reasonable degree of normalization will take longer to achieve. Earnings in Europe have been disappointing, and overall our return potential in local currency is both more uncertain and in the low end compared to other regions.

In the middle of our rankings, we prefer the US to Japan. This is at odds with the risk of recession in the US, but US earnings have proved resilient in the face of relatively low growth in 1H2011 and we now forecast a pick-up in growth going forward.

At the same time, the S&P 500 has corrected more sharply than the Topix in the last few weeks despite the Topix being more cyclical. In that sense, some of the positive impact from the recovery from the earthquake has probably been priced in by now. Japanese companies are also likely to see some impact from the high levels of the Japanese yen and we now expect the yen to strengthen further versus the dollar over the next 12 months. That said, the risks to our forecasts are higher for the US (with the risk of recession) than for Japan (which is still benefiting from the recovery from the earthquake), and we have therefore ranked both markets as neutral despite the difference in return forecasts.

**Exhibit 9: Our recommended weighting within equities**

The table shows our total return forecasts for each region (in local currency and in USD) and the allocation we would currently make relative to benchmark on both a 3- and 12-month horizon.

| Index | 3-Months | | |
|---|---|---|---|
| | Return Forecasts | | Recommended |
| | Local Cur. | In USD | Allocation |
| MXAPJ | 17 | 17 | Overweight |
| S&P 500 | 21 | 21 | Neutral |
| Topix | 10 | 10 | Neutral |
| Stoxx Europe 600 | 15 | 17 | Underweight |

| Index | 12-Months | | |
|---|---|---|---|
| | Return Forecasts | | Recommended |
| | Local Cur. | In USD | Allocation |
| MXAPJ | 38 | 38 | Overweight |
| S&P 500 | 31 | 31 | Neutral |
| Topix | 25 | 30 | Neutral |
| Stoxx Europe 600 | 28 | 40 | Underweight |

*Source: Goldman Sachs Global ECS Research.*

# Themes and basket implementations

## US

**Dividend growth (GSTHDIVG):** A sector-neutral basket of the 50 stocks with the strongest 2012 dividend growth and yield. We believe these will outperform as investors search for yield.

**ROE growth (GSTHGROE):** Firms that generate superior growth in return on equity have consistently outperformed the S&P 500. Our sector-neutral basket of 50 stocks comprises firms with the highest forecast ROE growth over the next twelve months.

**BRICs exposure (GSTHBRIC):** A sector neutral basket of companies with the highest sales exposure to the BRIC regions. We expect these companies to grow sales and EPS faster than the index due to their exposure to stronger economic growth.

**High Sharpe ratio stocks (GSTHSHRP):** Market volatility over the past several years has elevated the importance of risk analysis for all investors. We recommend a sector-neutral basket of 50 stocks with the highest risk-adjusted returns relative to the S&P 500.

## Europe

**Sales exposure to economic growth differentials. We have 2 implementations:** 1: (GSSTBRIC vs. GSSTDOME): BRICs sales exposure vs. European domestic sales exposure. 2: (GSSTUKIE vs. GSSTUKDE): UK exporters vs. UK domestically oriented firms.

**Rising energy prices (GSSTENGY):** Our energy hedge basket consists of companies which our analysts expect to perform well in a rising oil price environment.

**Pressure on European consumers:** We recommend investors to go long the index against an equal weighted short position in Retail, Travel & Leisure and Food & Beverages sectors to position for European consumer weakness.

## Japan

**Japan stable growth basket (GSSZSTGR):** Japanese firms that exhibited high and stable growth in sales and operating profits as well as ROE.

**China and Chindonesia related stocks (GSSZJPCN, GSSZCIND):** GSSZJPCN and GSSZCIND consists of Japanese stocks with high exposure to China and Chindonesia (China, India and Indonesia), respectively. We expect these stocks to outperform as the policy tightening intensity in China is reduced.

**Japan energy saving basket (GSSZJPES):** Japanese firms that are well-positioned to benefit from increased demand for energy conservation, alternative energy, and resource development technologies.

## Asia ex-Japan

**Domestic Cyclical Alpha vs. Global Cyclical (GSSZDOMA vs. GSSZMSGC):** This trade is designed to capture the divergence we expect between Asia domestic demand growth and broad DM growth.

**Taiwan tourism (GSSZTWTO):** Captures the tourism-related growth opportunities, and growing domestic demand momentum more broadly in Taiwan.

**Macau gaming (GSSZMACG):** Captures the growth potential of Macau's gaming industry and its tourism-related business.

**Apple supply chain 2 (GSSZAPP2):** Contains a list of stocks whose revenue exposure is meaningfully linked to Apple products.

## Cross-regional

**BRICs exposure (GSSTDM50, GSSTEM50):** GSSTDM50 comprises 50 DM companies with high BRICs sales exposure. GSSTEM50 comprises 50 structurally well positioned EM companies.

# Our sector views

**Energy and Materials:** We continue to have a positive view on commodity-related sectors. We have an overweight in Oil & Gas and Basic Resources in Europe and an overweight in Energy and a neutral in Materials in the US. Our Energy overweight is motivated by our constructive forecast on oil prices. The overweight in Basic Resources reflects our wish to maintain exposure to BRICs growth and to benefit from a catch-up between the sector performance and copper prices. In Asia ex-Japan, we are overweight Regional Energy and neutral on Metals & Mining. In Japan, we are overweight on Energy/Chemicals and continue to be neutral on Steel/Non-ferrous metals.

**Information Technology:** We have generally become more negative on the Technology sector across the regions reflecting lower global growth and the semiconductor industry moving towards excess supply in 2012. In the US we are now neutral on the sector while we have moved it to underweight in Europe. In Asia ex-Japan we downgraded the semis but continue to like the Apple supply chain theme. In Japan we have not reversed the downgrades to Electronic Components and Industrial Electronics that we made after the March earthquake.

**Financials:** Our view on Financials has on balance become more negative since April. In Europe we downgraded Banks to neutral following the short term bounce on the back of the second rescue package for Greece. We think the fears around the sovereign crisis will persist and loan growth will remain constrained by the ongoing deleveraging and weak domestic demand throughout much of the European periphery. Within the sector we like banks with international exposure and would recommend them relative to European banks with domestic exposure. In Asia we downgraded China Banks and Korea Financials to neutral. We, however, continue to recommend an overweight in Hong Kong banks which are likely to benefit from renminbi internationalization. We also upgraded ASEAN Banks to overweight reflecting our overall more positive stance on ASEAN demand. We remain underweight Australian Property, Australian Banks and India Financials. In Japan we continue to be overweight Banks and Insurance as "reflation" trades, given our expectation that deflation pressures will dissipate and core CPI will turn positive by 2012.

**Industrials:** We are now less positive on the industrial complex. In Europe we downgraded Industrial Goods & Services to neutral reflecting rich valuations relative to the market and slowing global industrial production. We still believe that the sector is a structural winner and would be looking to re-establish an overweight position later, but think the near-term macro headwinds could put the sector under pressure. Outside of Europe, our stance on industrials remained unchanged. We continue to be neutral on Industrials in the US and overweight Regional Capital Goods in Asia ex-Japan. In Japan we also maintained our overweight on Machinery.

**Defensives:** We have become marginally more constructive on defensive sectors reflecting increasing headwinds to economic growth. In both the US and Europe, we raised Health Care to neutral as we think the long-term issues for the sector (health care reform and patent cliff) are well understood by investors and incorporated in current valuation. We continue to be underweight on Health Care in Japan and on Regional Health Care in Asia ex-Japan. In Europe we downgraded Telecommunications to underweight as we feel valuations are not as attractive given expected earnings growth. Additionally, we think the growth opportunity from increased smartphone penetration will be offset by regulatory and competitive headwinds. We continue to be underweight on Utilities across all regions.

**Construction:** We continue to be underweight Construction & Materials in Europe, where government contracts are at risk considering the fiscal adjustment in most European countries. Additionally, with energy costs representing c.30% of costs for cement companies we expect further pressure on that part of the sector. We remain overweight in Japan, where potential reconstruction demand has improved the outlook for the Infrastructure sector.

**Consumption:** Although our overall stance on consumer facing sectors remained broadly stable, we have made significant shifts towards the more defensive part of the consumer complex. In the US, we have upgraded Consumer Staples to overweight (from underweight) and lowered Consumer Discretionary to underweight. We expect Consumer Staples to generate superior sales and earnings growth vs. Consumer Discretionary as input cost inflation begins to decline in 2H2011 and pricing starts to catch up. In Europe, we have upgraded Personal & Household Goods to overweight as we think the luxury goods and tobacco will benefit from strong pricing power and EM exposure. We have downgraded Travel & Leisure to underweight reflecting the impact of higher expected oil prices and US dollar weakness. In Asia ex-Japan we favor EM demand and have upgraded Food, Beverage & Tobacco to overweight. In Japan we remain underweight Consumer Staples, Entertainment/IT Services and Services.

**Exhibit 10: Recommended sector weightings by region**

| Overweight | Neutral | Underweight |
|---|---|---|
| **US** | **US** | **US** |
| Energy | Healthcare | Utilities |
| Consumer Staples | Industrials | Consumer Discretionary |
| | Financials | |
| | Telecom Services | |
| | Materials | |
| | Information Technology | |
| **Europe** | **Europe** | **Europe** |
| Automobiles & parts | Chemicals | Construction & Materials |
| Personal & Household Goods | Financial services | Food & beverage |
| Basic resources | Insurance | Utilities |
| Oil & Gas | Media | Telecommunications |
| | Banks | Retail |
| | Real Estate | Technology |
| | Health Care | Travel & Leisure |
| | Industrial Goods & Services | |
| **Europe Subsectors** | **Europe Subsectors** | **Europe Subsectors** |
| Beverages* | | Food Producers* |
| Luxury Goods* | | General Retail* |
| Oil Services | | Defense |
| Tobacco | | |
| **Japan** | **Japan** | **Japan** |
| Banks | Automobiles | Consumer Staples |
| Consumer Electronics | Communications | Entertainment/IT Services |
| Infrastructure | Electronic Components | Healthcare |
| Insurance | Transportation | Services |
| Machinery | Industrial Electronics | Utilities |
| Precisions | Retail | |
| Trading Companies | Securities | |
| Energy/Chemicals | Specialty Finance | |
| | Steel/Nonferrous metals | |
| **Asia ex-Japan** | **Asia ex-Japan** | **Asia ex-Japan** |
| Regional Retailing | China Property | Regional Health Care |
| Tech Hardware & Equipment | China Banks | Regional Transportation |
| Regional Capital Goods | China Insurance | Australia Property |
| Regional Energy | Metals & Mining | India Financials |
| Hong Kong Banks | India IT Services | Australia Banks |
| Food Beverage & Tobacco | Korea Financials | Regional Utilities |
| Consumer Durables & Apparel | Regional Chemicals | |
| ASEAN Banks | Telecommunication Services | |
| | Hotel Restaurants & Leisure | |
| | Automobiles & Components | |
| | Household & Personal Products | |
| | Hong Kong Property | |
| | Singapore Property | |
| | Taiwan Financials | |
| | Construction Materials | |
| | Semiconductors | |

*Denotes trades recommended as Long/Short

*Source: Goldman Sachs Global ECS Research.*

**Analyst Contributors**

**Peter Oppenheimer**
+44(20)7552-5782
peter.oppenheimer@gs.com
Goldman Sachs International

**Christopher Eoyang**
+81(3)6437-9888
christopher.eoyang@gs.com
Goldman Sachs Japan Co., Ltd.

**David J. Kostin**
(212) 902-6781
david.kostin@gs.com
Goldman, Sachs & Co.

**Kathy Matsui**
+81(3)6437-9950
kathy.matsui@gs.com
Goldman Sachs Japan Co., Ltd.

**Timothy Moe, CFA**
+852-2978-1328
timothy.moe@gs.com
Goldman Sachs (Asia) L.L.C.

**Anders Nielsen**
+44(20)7552-3000
anders.e.nielsen@gs.com
Goldman Sachs International

# Commodities: Maintaining our constructive outlook, but risks have increased

**Although risk to our constructive commodity views has risen, we maintain our overweight recommendation on commodities and prefer commodities over all assets on a 12-month horizon.**

Recent unexpected deterioration in macro indicators that has motivated Goldman Sachs economists to lower global GDP growth forecasts for this year and next – on top of the unsettling debt issues in Europe and the US and the ongoing tension between the inflation/growth tradeoff in the Emerging Markets (EM) – have slashed commodity prices and returns over the past week and have heightened uncertainty around the commodity outlook. However, several factors are leading us to keep our relatively constructive commodity views over the next year intact:

- Global growth expectations remain at 4.4% for 2012 even after GS economic downgrades – sufficiently high to tighten key commodity markets, in our view.
- Recent weakness and economic downgrades have been centered in Developed Markets (DM) and particularly in the US, with growth in EM – which comprise the vast majority of commodity demand growth – expected to remain robust, especially given the tightening policy path within key EM economies over the past year that could be reversed or eased to buoy growth. China growth forecasts in particular remain unchanged at 9.2% for 2012.
- Economic growth is still expected to improve in 2H2011 and 2012 – albeit from a weaker path in 2011 than originally reported.
- Commodity balances have generally been resilient during 1H2011 despite what we now know to have been a much weaker DM macro backdrop than we had thought.
- Supply disappointments have been substantially offsetting if not dominating demand disappointments in key commodity markets.
- Several physical commodity indicators have shown signs of strength.

On net, commodity fundamentals are thus far proving relatively resilient on the combination of still-strong EM demand growth and supply disappointments. We expect commodity markets to continue to tighten as long as global economic growth remains broadly positive and the EM economies in particular continue to perform, which remains the mainline view of Goldman Sachs economists. Accordingly, we maintain our recommended long positions in key cyclical commodities, including Brent crude oil, copper and soybeans and our Overweight recommendation for commodities relative to other asset classes within the portfolio context.

However, while the recent apparent macro deterioration and economic downgrades are not sufficient to alter our mainline commodity views, they do suggest that the prior upside risk skew to our price forecasts has been slightly reduced – all else equal – with key supply-constrained markets effectively hitting the wall of supply constraints potentially less hard than we had previously expected.

Further, a global recessionary and/or negative financial event would clearly be negative for all cyclical assets. As a result, the rising risk of a US recession – which Goldman Sachs economists now place at a 1 in 3 chance – as well as escalating pressure on peripheral Eurozone sovereigns as policymakers have yet to agree on a convincing solution to the European debt issues, has generally increased the risk of a global downturn and/or financial event that would at least temporarily derail our constructive commodity views. Thus, the risk around these views has generally risen. The heightened macro and market risks have reinforced our conviction in our recommended long gold position despite its recent outperformance.

**Although risks have increased, current expectations of global growth continue to suggest tightening balances and rising prices for key commodities over the next year including oil, copper, and soybeans. We also believe that gold should continue to move higher despite its recent outperformance. Accordingly, we maintain our overweight recommendation to commodities and believe that commodities should be especially well-positioned to outperform other asset classes on a 12-month horizon.**

## Energy

*We expect 32% returns on the Enhanced Energy index on a 12-month horizon.*

### Economic growth and supply disappointments continue to suggest tightening balances

Familiar concerns about slowing growth and sovereign debt issues have taken on a new urgency for the markets, culminating in a sharp sell-off across asset markets, with Brent crude oil prices plunging over 12% since August 1. Despite the clear shift in market sentiment, we maintain our view that Brent crude prices will rise to average $130/bbl in 2012 for the following three key reasons:

- US recession risk has risen, but the economic data and our revised US economic outlook remain consistent with a continued recovery, albeit at a slower pace, which is typical following a housing bust.
- Non-OPEC oil supply growth remains challenged, with Non-OPEC supply growth disappointing more than oil demand growth so far this year, suggesting that the pace of world economic growth will be sufficient to continue to tighten the world oil market into 2012.
- While the risk of a US recession has increased, the outlook for economic growth in China and the emerging markets remains constructive, and the scope for a policy response in the EM remains wide, should conditions there deteriorate.

However, while we continue to see an increase in the pace of economic growth in 2H2011, it will be a slower one than we previously expected. This suggests that the risk to our Brent crude oil prices forecast has become more balanced. Further, a global recessionary or negative financial event would clearly be very damaging for oil demand and prices, which is highly leveraged to economic growth. Accordingly, rising risk of these events presents downside risks to our constructive views.

### Natural gas: Hot weather not enough to tighten US balances, but global market has tightened

The US natural gas market remains in a deep surplus, created by continuing increases in shale gas production and a weak economic recovery. Even exceptionally hot weather that has generated record-high air-conditioning loads this summer has not been sufficient to meaningfully tighten the North American natural gas market. We maintain that US natural gas prices will remain under pressure in the near-to-medium term in order to curb natural gas production growth, and more importantly, to incentivize further fuel substitution in the power generation sector to rebalance the market. However, we also maintain that coal plant retirements motivated by stricter environmental regulations will be a key driver of rising natural gas demand beyond 2015 that will help to absorb the current surplus. In contrast to the over-supplied North American market, the global natural gas market has tightened substantially in the recent period as the wave of new liquefaction capacity has wound down at the same time that new non-OECD entrants into the LNG market and greater needs from Japan to compensate for nuclear outages have boosted demand for global natural gas supplies. We believe that the divergence between North American and global natural gas prices will remain a key feature of the markets over the next year.

## Industrial metals

*We expect 28% returns on the Enhanced Industrial Metals index on a 12-month horizon.*

### EM growth and rising costs expected to lend support

Base metals prices and returns have also been hard hit by mounting concerns about macroeconomic deterioration and broadening Eurozone sovereign pressure. Base metal demand is highly leveraged to the industrial cycle and would be substantially damaged by a shift into a global recessionary environment or a negative global financial event. However, metals demand growth is centered in the Emerging Markets (EM), where growth has held up well and is expected to remain robust, especially given the tightening policy path within key EM economies over the past year that could be eased or reversed to buoy growth. As long as global economic growth continues, we expect the balances of more supply-constrained metals such as copper and ultimately zinc, to tighten further. We continue to favor long positions in these metals. Although we are less constructive on aluminum and nickel fundamentals based on expectations that supply growth will be able to keep up with demand growth, we continue to believe that higher input costs and energy in particular will continue to underpin these markets.

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## Precious metals

*We expect 5% returns on the Enhanced Precious Metals index on a 12-month horizon.*

### Raising gold forecasts as US real rates fall and debt concerns rise

Gold prices have rallied strongly since the beginning of July with prices surging over the past week to well above previous record highs. We had expected gold prices would continue to rise through the middle of 2012, when we expected rising US economic growth would push real rates higher and gold prices lower. However, with our US economics team lowering their outlook for US economic growth to 1.7% in 2011 and 2.1% in 2012, we now expect US real interest rates will remain lower for longer, and as a result we recently raised our COMEX gold price forecasts to $1,645/toz, $1,730/toz, and $1,860/toz on a 3, 6, and 12-month horizon, up from our previous forecasts of $1,565/toz, $1,635/toz, and $1,730/toz, respectively (for further details see our August 7, 2011, *Precious Metals: Raising gold forecasts as US real rates fall and debt concerns rise*).

On net, this revision in effect pulls forward the higher gold prices we expected on a 6 and 12-month horizon – as US economic growth has been slower, and real rates lower, than previously anticipated – and extends the expected rise in gold prices through 2012 – where we had previously expected gold prices to peak in 2012. Further, the recent escalation in sovereign debt concerns suggests that the risk to our new gold price forecast is skewed to the upside.

## Agriculture

*We expect 6% returns on the Enhanced Agricultural index on a 12-month horizon, and 5% returns in the Enhanced Livestock index.*

### Poor US growing weather suggests higher prices across the complex

Agricultural prices and returns have held up relatively well amid the recent broader sell-off in cyclical assets given that agricultural demand is less leveraged to economic growth. We have revised our US corn production estimate sharply lower owing to sub-optimal weather during the US growing season and expect that the US corn balance will remain in deficit in 2011/12. As a result, we forecast that corn prices will need to rally further to achieve demand destruction. We also forecast strong corn-to-wheat feed substitution and as a result a larger 2011/12 US wheat deficit. This concurrent tightening of the corn and wheat balances will keep wheat and corn prices closely correlated. While we also forecast a US soybean market in deficit, as weak old-crop demand will help limit the new-crop inventory drawdown. As a result, we expect that corn prices will outperform soybean prices in coming months.

Amid concerns about macro deterioration and Eurozone debt, we also note that our generally low supply forecasts, the more defensive nature of agriculture demand, and the higher leverage of agricultural growth to EM income and population growth rather than to DM all suggest agricultural prices will likely hold up relatively well in a slowing economic environment. However, a global downturn and/or negative financial event would likely push crop prices lower, driven by both lower oil prices (a key driver to our corn price forecasts) and a likely decline in US domestic ethanol consumption along with US gasoline demand.

### Export demand likely to lend support; expect cattle to outperform lean hogs

Livestock performance has also held up well amid the recent sell-off of cyclical assets. We continue to expect that demand for meat will continue to improve in 2011 driven by strong EM income growth and import needs by both Japan and South Korea, on local production disruption. On the supply side, we expect lower placements of cattle on feed in coming months given weak margins and tight feeder cattle availability. Feeder cattle supply has declined as a result of both strong placements earlier this year on elevated deferred margins as well as the persistent US drought. In contrast, we expect a stable to slightly larger hog herd. As a result, we expect live cattle prices to continue to outperform lean hog prices. We note, however, that a sustained slowdown in US GDP growth would put our expectation for cattle over hog outperformance at risk as it would likely support domestic demand of lower-cost pork to the detriment of higher-cost beef.

## Performance and Forecasts of S&P GSCI Enhanced Commodity Index and Strategies

**Exhibit 11: S&P GSCI Enhanced Commodity Index and strategies' total returns forecasts**

| | Current Weight (%) | 2009 | 2010 | 2011 YTD | 12-Month Forward 12-mo Forecast |
|---|---|---|---|---|---|
| S&P GSCI Enhanced Commodity Index | 100.0 | 21.6 | 12.2 | -4.3 | 24.9 |
| Energy | 66.2 | 23.8 | 5.9 | -5.2 | 32.0 |
| Industrial Metals | 8.0 | 82.7 | 16.5 | -9.4 | 28.0 |
| Precious Metals | 4.2 | 25.2 | 34.5 | 22.1 | 5.0 |
| Agriculture | 16.7 | 3.6 | 33.7 | -4.5 | 6.0 |
| Livestock | 4.9 | -11.3 | 18.5 | 0.4 | 5.0 |

*Source: Goldman Sachs Global ECS Research.*

### Recent Commodity Research

Commodity Watch: *Maintaining our constructive outlook, but risks have increased,* August 8, 2011

**Analyst Contributors**

**Jeffrey Currie**
+44(20)7774-6112
jeffrey.currie@gs.com
Goldman Sachs International

**Allison Nathan**
(212) 357-7504
allison.nathan@gs.com
Goldman Sachs & Co.

**David Greely**
(212) 902-2850
david.greely@gs.com
Goldman Sachs & Co.

**Damien Courvalin**
(212)902-3307
damien.courvalin@gs.com
Goldman Sachs & Co.

# Corporate Credit: Solid fundamentals, but sizable tail risks

**On a long-term basis, we are cautiously constructive on investment grade corporate credit. But the near-term environment will be treacherous due to tail risks, which in our view are sizable, quite elevated, and still not well-compensated by spread levels (despite the spread widening of the past few months). On the other hand, current spread levels reflect these tails risks better today than they did back in June when we first changed our view to cautious. And if spreads fail to rally on a 12-month basis (our baseline forecast), then we can expect some offset in total returns from carry and rates exposure. We therefore think the risk premium in credit is high enough to justify neutral weighting in our asset allocation decision.**

**We are cautiously constructive on corporate credit.** We attribute most of the spread widening over the past few months to weaker macro data and the escalation of the European sovereign crisis. If macro data stabilizes, which is our baseline economic scenario, the credit market should regain its appetite for risk, pushing spreads sideways to tighter. Our view is underpinned by three fundamental reasons: (1) the corporate sector has been outperforming its beta to the domestic economy; (2) corporate managements, having lived through the funding shocks of 2008, will maintain conservative balance sheets; and (3) weak growth, low inflation, and hence low yields will support "search for yield" dynamics, and thus enhance the appetite for spread product.

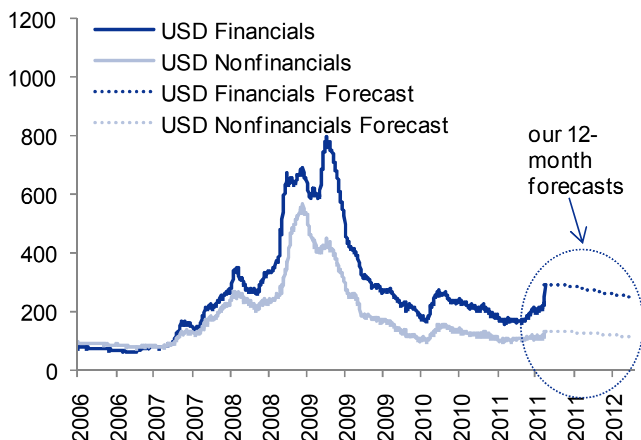
**The risk premium is enough to compensate the risks from a slow-growth economy (but not the tail risk of a renewed financial crisis).** Five-year spreads for the broad bond indices in US and Europe are wider by 60 and 80 bp, respectively, compared to the tights reached in mid-May. Our 3-month forecasts suggest elevated spreads amid more near-term uncertainties. Although we consider high volatility to be a given, we expect 5-year IG spreads between now and November to trade roughly sideways in the US, while pushing wider in Europe. But looking further out over the year ahead, our baseline scenario expects the crisis to ease, leading to better risk appetite, stable bottom-up fundamentals, and thus spread tightening.

We also expect a tailwind from rates over the past quarter will shift to a headwind that will more than offset the gains from carry and spread compression. In local currency, we expect total returns over the next three months of around -1.4%, for both the iBoxx IG USD and EUR indices. Over a 12-month horizon, we expect respective returns of +0.4% and 1.1%.

**Near-term tail risks remain elevated.** Despite our view that credit fundamentals remain solid, our concern for tail risks has risen significantly, for the following reasons.

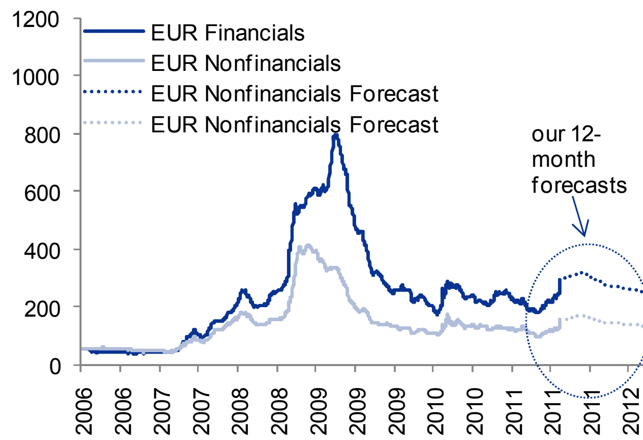
**1) Recession risk has increased.** The growth slowdown in the US has been more persistent than we expected, thus eroding our conviction that this is merely a soft patch. Last week, our US economics team lowered its 2H GDP growth forecasts to 2% and lowered the 2012 forecast to 2.1% from

**Exhibit 12: We expect IG spreads to grind tighter in the next 12 months in the US**
Chart shows the average of 3-5y and 5-7y IG spreads for the USD financial and nonfinancial indices.




Source: Goldman Sachs Global ECS Research.

**Exhibit 13: While there might be more pressures in the next 3 months in Europe**
Chart shows the average of 3-5y and 5-7y IG spreads for the EUR financial and nonfinancial indices.




Source: Goldman Sachs Global ECS Research.

3.3% previously, yet the risks to our forecasts are still skewed to the downside. Our economists now see a one-in-three risk of renewed recession, mostly concentrated in the next 6-9 months.

**2) "Lizard risk" in Europe is likely to persist.** The market continues to wait for a convincing policy solution to the European sovereign crisis, including a quicker setup of the ESFSF's new capacity and increase in the facility's resources to address the relevant tensions. We think the current environment, "lizard risk" – that is, tail risk that keeps growing back despite repeated clippings by policymakers – will likely be with us for the foreseeable future.

**The environment is challenging because growth risk and sovereign risks are multiplicative.** Both are vulnerable to negative sentiment that can feed back onto the other, thus fueling a self-fulfilling downward spiral. Indeed, we think the weaker macro data of the past several months are an under-appreciated reason why European sovereign risks have elevated and proven so resistant to policy response. Falling growth expectations lower the market's expectation that highly indebted economies can, with the help of external assistance, grow out from under their high debt-to-GDP ratios. Slow growth shifts the burden of fiscal stabilization onto austerity, external assistance, and debt write-downs, which are all less ideal than simply growing out. This is the sense in which growth risks and sovereign risks are multiplicative and thus mutually reinforcing.

**These concerns will likely continue to weigh on the confidence and risk sentiment of investors, households, and businesses,** increasing the risk of a sustained drop in confidence. Aggressive policy intervention is needed to break this feedback loop, but the scope for fiscal policy is greatly diminished and monetary policy (in the US) is already highly accommodative. Tail risks are high.

### Where are the pockets of attractive premia?

Within investment credit, we continue to see higher relative value in the following areas:

- For non-financials, we are comfortable remaining "down in quality" and favor BBB-rated names. We are comfortable with the fundamental risk in wider spread names since corporate balance sheets are in good condition and corporate profit growth in both the US and Europe has been outperforming GDP growth.
- In financials, however, we would move up in quality. Financials are clearly a high-beta sector in this recession and recovery, and they have the most exposure to the tail risk of an escalation of the crisis in Europe. But longer term we still maintain our longstanding view that spread levels for high-quality financials are generous relative to their long-run credit risks. But if market concerns over the above risks persist, financials could continue to face elevated market volatility.

**Analyst Contributors**

**Charles Himmelberg**
(917) 343-3218
charles.himmelberg@gs.com
Goldman Sachs & Co.

**Lotfi Karoui**
(917) 343-1548
lotfi.karoui@gs.com
Goldman Sachs & Co.

**Annie Chu**
(212) 357-5522
annie.chu@gs.com
Goldman Sachs & Co.

**Kenneth Ho**
852-2978-7468
kenneth.ho@gs.com
Goldman Sachs (Asia) L.L.C.

**Anthony Ip**
852-2978-2676
anthony.ip@gs.com
Goldman Sachs (Asia) L.L.C.

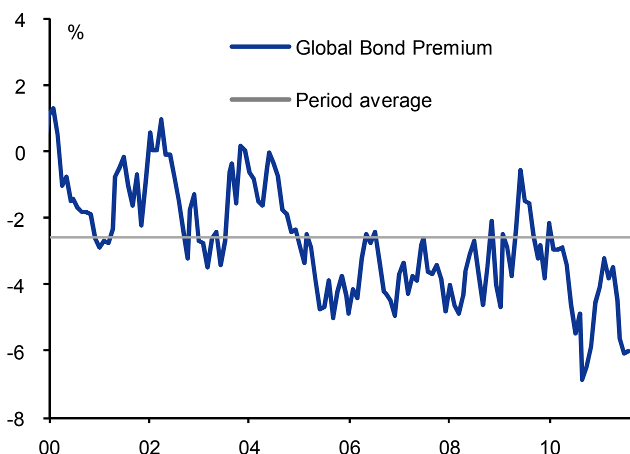
# Government Bonds: The price of slower growth

**On the back of the downgrade to our growth forecasts, published last Friday, we have revised lower our 10-yr bond yield projections across the board. Still, we find that intermediate yields are very depressed, particularly in the US, in relation to our modal expectations on the macro outlook. This indicates that there is now a substantial "tail risk" discounted in high-quality sovereign bonds. Developments in Euro-zone bond markets have been momentous over the past month. In line with our expectation, bond prices in Greece, Ireland and Portugal have increased from distressed levels following substantial modification to official loans. Italian and Spanish bond yields remain elevated in relation to Germany's and France's, even after ECB open market purchases. The introduction of domestic fiscal and structural policies and the steps towards ex ante risk sharing among EMU members should in our view underpin already attractive valuations of BTPs and Bonos.**

### A precipitous rally

After a relatively lackluster first half of the year, returns on intermediate maturity government bonds in the advanced economies have risen since the start of the third quarter, and particularly into the month of August. The "winners" have been those markets most sensitive to cyclical swings (7-10-yr US Treasuries have returned almost 7% non-annualized since the end of June, as yields dropped 80bp (!) since the start of this month; returns in the UK and Australia have been commensurately high). Returns on traditional "safe havens" have been mixed, with Swiss bonds up strongly, but Japan's moving sideways in local currency terms. In addition, there has been a large segmentation in the performance of bonds issued by EMU States, partly reversed by the ECB's open market interventions.

**Exhibit 14: Global bond premium remains depressed**

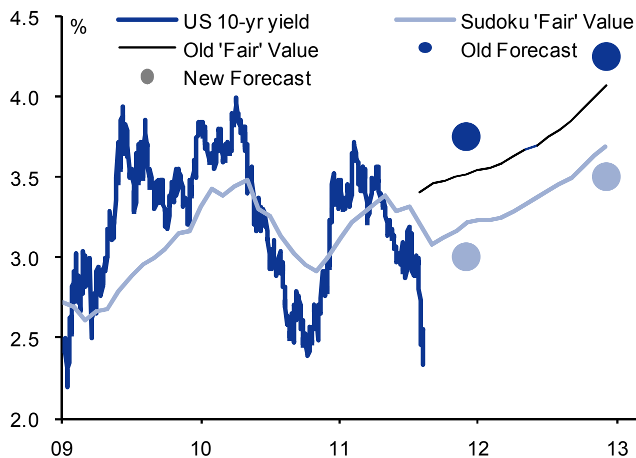



*Source: Goldman Sachs Global ECS Research.*

Driving the rally have been an unusual combination of factors, some of which are exceptional:

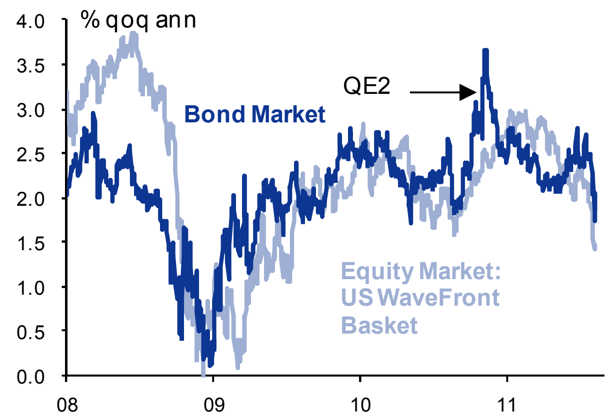
- First and foremost, these moves have come against a backdrop of a substantial decline in growth expectations, following a disappointing set of data, particularly in the US since April. To be fair, the growth data have been less uniformly bad over the past two weeks, and indeed our Wavefront US Growth basket (which pits cyclicals against defensives in the S&P 500) has outperformed the index in August. Thus, the recent sharp price action in equities and bonds has probably more to do with a focus on "tail risks" in an anaemic US growth environment, worries about a broader global growth slowdown (as reflected in the sharp moves in global indices) and positioning considerations, rather than outright weakness in the incoming data.
- Second, the macro backdrop and the tightening in US financial conditions that it caused precipitated a further round of policy easing by the Fed earlier this week. The central bank has indicated that its current economic forecasts warrant policy rates floored for at least another two years and stands ready to expand its balance sheet further if needed.
- Third, "safe-haven" flows originating from tensions in Eurozone sovereign markets have increased in the wake of a restructuring of Greek sovereign debt, spreading to Spain and Italy, jointly representing 40% of the area's aggregate government bond market.
- Finally, the downgrade of the US sovereign debt from AAA to AA+ (negative outlook) by S&P has added to the anxiety surrounding sovereign and financial risk globally and supported the idea that a further relaxation of fiscal policy to support demand is less likely.

**Exhibit 15: Our new bond yield forecasts are below the model projected "fair value"**




Source: Goldman Sachs Global ECS Research.

**Exhibit 16: US GDP growth has been repriced aggressively across markets**
Market implied forecasts of US GDP growth




Source: Goldman Sachs Global ECS Research.

In reaction to the precipitous change in the investment landscape, we have revised down our bond forecasts across the board, as articulated below. But our return expectations remain moderately negative, particularly beyond the next three months. This is primarily for two reasons:

- First, our measure of the global bond risk premium – which controls for contemporaneous macroeconomic conditions such as industrial production, CPI inflation, and short rates – is now at the lowest level since the start of the credit crisis in 2007 (Exhibit 14). Barring a US recession – which is not our baseline forecast, and if it does materialize is likely to be mild either way – the insurance premium embedded in highly rated government securities appears over-rated.
- Second, a meaningful hit to growth has now been incorporated into cyclical assets, according to our metrics. Our *Bond Sudoku* model indicates that the US market is now very overvalued (approx. a 1.6 std. dev. event, see Exhibit 15) in relation to our downwardly revised macro forecasts.

To gauge the extent of the downgrade in bond markets, we estimate one-year ahead US GDP growth expectation using the 10-yr yield level, the 10yr-3mth slope and the 20y-10yr-3mth curvature. The expected growth rate from this method can be compared to the growth rate implied by the equity market, which we track using the US Wavefront Growth Basket. As Exhibit 16 shows, both the bond market and the equity market have priced in around 75bp of lower growth over the past two to three weeks.

That said, current levels are still consistent with the expected growth rates seen last summer.

Also of note, 5-yr US nominal rates deflated by actual core inflation are below zero (and deeply negative when deflated by expected inflation), and on this measure have been below Japan's for several months. At around 3.75%, nominal 5-yr/5-yr forward rates are below the rate of nominal GDP growth (which consensus puts at 4.5%). Based on these considerations, we do not see much scope for 10-yr US bond yields to stay below 2.00-2.25% over the coming month, and project them to increase beyond that short horizon. Bond yields in other countries should follow suit, but the starting level is somewhat less stretched.

## Growth argues for lower bond yields

Last Friday we lowered our global growth forecasts to 4.0% for 2011 and 4.4% for 2012, from 4.1% and 4.6% respectively. The relatively modest downgrade to the aggregate GDP growth forecast masks a growing divergence between emerging economies, where economic activity remains relatively healthy, and the advanced economies, particularly the US where we now expect calendar 2012 real growth to be below trend and 90bp lower than our previous estimates. Accordingly, we have also cut our policy rate forecasts across developed markets, most notably in the UK, Switzerland and Australia, the latter for which we are now forecasting rate cuts (Exhibit 17).

**Exhibit 17: Lowering our growth forecasts**

| | Real Gross Domestic Product [%yoy] | | | | Policy Rates [% p.a. eop] | | | |
|---|---|---|---|---|---|---|---|---|
| | 2011 | | 2012 | | 2011 | | 2012 | |
| | Old | New | Old | New | Old | New | Old | New |
| **US** | 1.80 | 1.70 | 3.00 | 2.10 | 0.10 | 0.10 | 0.10 | 0.10 |
| **Germany** | 3.30 | 3.30 | 1.90 | 1.80 | 1.75 | 1.50 | 2.50 | 2.00 |
| **Japan** | -0.80 | -0.80 | 3.00 | 2.70 | 0.10 | 0.10 | 0.10 | 0.10 |
| **UK** | 1.90 | 1.50 | 2.60 | 2.50 | 0.75 | 0.50 | 2.00 | 0.75 |
| **Canada** | 2.90 | 2.70 | 3.20 | 2.50 | 1.25 | 1.25 | 2.50 | 2.00 |
| **Australia** | 2.00 | 1.50 | 4.00 | 3.80 | 4.75 | 4.25 | 5.00 | 4.25 |
| **Switzerland** | 2.10 | 1.90 | 2.00 | 0.60 | 0.75 | 0.00 | 2.75 | 0.25 |
| **Sweden** | 4.60 | 4.50 | 3.10 | 2.70 | 2.75 | 2.50 | 3.75 | 3.25 |
| **New Zealand** | 2.50 | 2.40 | 3.90 | 3.40 | 2.50 | 3.00 | 3.75 | 4.00 |

*Source: Goldman Sachs Global ECS Research.*

On the back of these revisions to projected macro factors, we have also pushed our 10-yr bond yield forecasts lower (see Exhibit 18). The biggest changes are in Australia and Switzerland where we now see 2012 year-end rates on 10 year government paper at 5.25% and 2.25%, respectively, from 6.25% and 3.25% previously.

For the US, we now forecast 10 year rates at 3.00% by the end of this year and 3.50% by end 2012. In Germany, we similarly cut our end-2011 forecast by 75bp to 2.75%, and end-2012 to 3.25%. Finally, in Japan rates are now seen at 1.25% and 1.40% on those two horizons.

**Exhibit 18: New and old 10-year forecasts**

| %p.a. eop. | 2011 | | 2012 | |
|---|---|---|---|---|
| | Old | New | Old | New |
| **US** | 3.75 | 3.00 | 4.25 | 3.50 |
| **Germany** | 3.50 | 2.75 | 4.00 | 3.25 |
| **Japan** | 1.60 | 1.25 | 1.90 | 1.40 |
| **UK** | 4.00 | 3.00 | 4.75 | 4.25 |
| **Canada** | 3.75 | 3.25 | 4.50 | 4.00 |
| **Australia** | 5.75 | 5.25 | 6.25 | 5.25 |
| **Switzerland** | 2.25 | 1.50 | 3.25 | 2.25 |
| **Sweden** | 3.75 | 3.00 | 4.25 | 3.50 |
| **New Zealand** | 5.75 | 5.00 | 6.50 | 5.75 |

*Source: Goldman Sachs Global ECS Research.*

## US Treasury valuations particularly stretched

From a valuation perspective, our Bond Sudoku model indicates that the US market is now very overvalued (close to a 2 std. dev. event) relative to consensus macro projections. Admittedly, these forecasts may not have fully reflected the loss of momentum in demand and the decline in stock markets. But even on our own forecasts, the long-end of the yield curve appears stretched.

Consider that, based on the downwardly revised set of macro forecasts we published last Friday, the model would place 10-yr US Treasuries and German Bunds at around 3% by the end of this year, or 60bp above current forward rates on that horizon. On past norms this degree of overshooting has represented a sufficiently strong signal to fade the rally.

Compared to the US, European markets are less stretched, while the cheapest markets include Japan and Sweden.

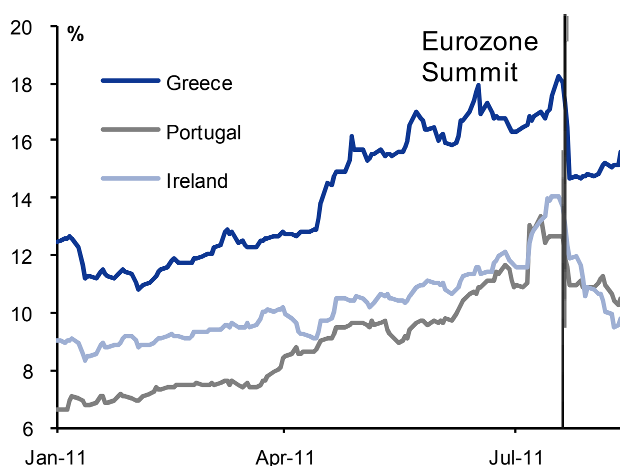
## Sunspots over Eurozone skies

Developments in Eurozone bonds have been momentous since the start of July. Official sector loans to Greece, Ireland and Portugal have been substantially modified, implying a large wealth transfer from the Eurozone's taxpayers to these three program countries. On the back of these events, yields in the three program countries have declined (Exhibit 19). In exchange, the Euro-area has limited the "collateral damage" from a sovereign default as well as attaining larger control over peripheral public sector cash flows. This broadly fits into our theme of a "managed deleveraging."

The involvement of the private sector in a second rescue package to Greece (through debt exchanges, maturity extensions or buybacks), which will be finalized in the first weeks of September, has however triggered a chain of unintended events. Credit rating agencies (CRAs) have questioned whether the same treatment will be applied to Ireland and Portugal and have downgraded these issuers. Moreover, CRAs have questioned whether Italy and Spain would have continuous "market access" as a motivation for downgrading these large and systemic issuers, leading to a sharp and self-reinforcing increase in their yields.

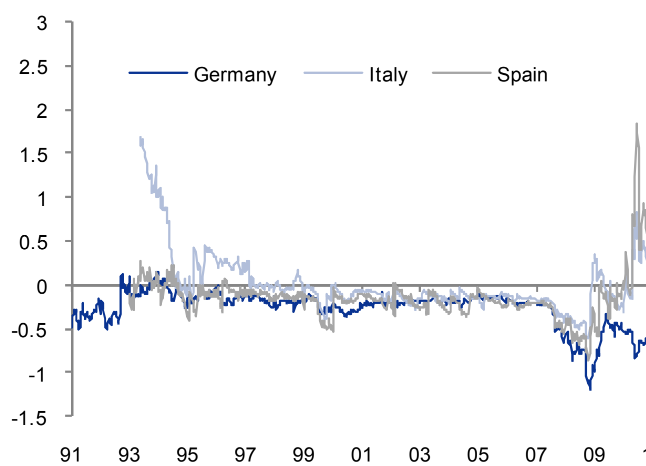
There have been three connected policy responses. On the domestic fiscal front, both Italy and Spain have pledged to take additional budgetary tightening measures, balancing their budget deficits over the next two years. Reforms in the labour and product markets should be also forthcoming and, in the case of Italy, a constitutional amendment to balance the budget through the cycle. At the Euro-area level, the EFSF has been given authority to intervene in secondary bond markets, and in the recapitalization of banks. These measures are "unconditional", implying a higher degree of ex ante "risk sharing" among EMU members. Finally, upon reaching guarantees that the abovementioned fiscal policies will be carried out speedily, the ECB has extended its Securities Market Program to Italy and Spain, purchasing government bonds of these two sovereigns in the open markets.

**Exhibit 19: Yields in the three program countries have declined after the summit**
10-year maturity




*Source: Bloomberg, Goldman Sachs Global ECS Research.*

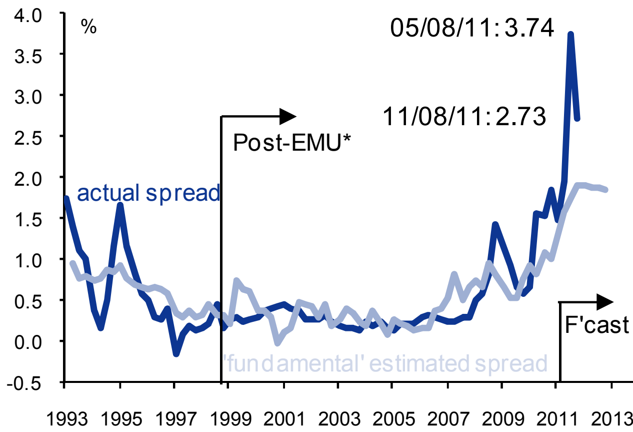
**Exhibit 20: Italian bonds at record wide levels to LIBOR and Germany**
2-yr Government Bonds less 2-yr Interest Swaps




*Source: Bloomberg, Goldman Sachs Global ECS Research.*

**Exhibit 21: 10-year BTP-bunds spread has overshoot relative fundamentals**

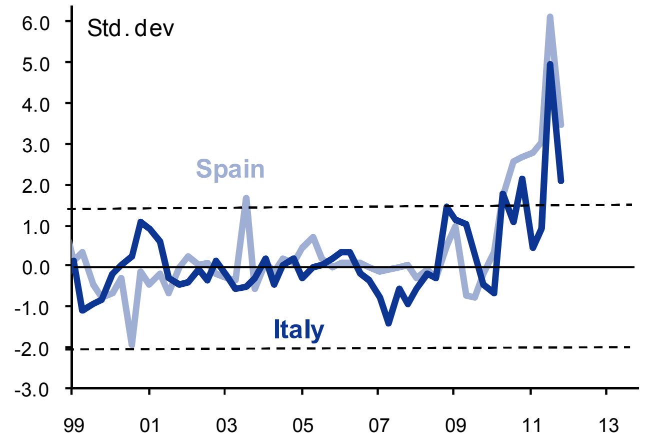
10-year asset swap spread between Italy and Germany




*Source: Goldman Sachs Global ECS Research.*

**Exhibit 22: A multiple standard deviation event relative to the past 20 year history**

Standardized residuals from "fair value" models




*Source: Goldman Sachs Global ECS Research.*

There are certainly implementation risks related to all these policy initiatives, and this will leave markets vulnerable as we head into September when the Greek debt exchange will be carried out and the package agreed at the Eurozone Summit of July 21 will be brought before national Parliaments for approval.

But the deviation from fundamentals – even after the ECB's open market purchases – which we document in accompanying Exhibits 21 and 22 alongside the stronger underpinning of these fundamentals, continues to leave us thinking that in relation to German Bunds, and French OATs, Italian BTPs and Spanish Bonos still offer value.

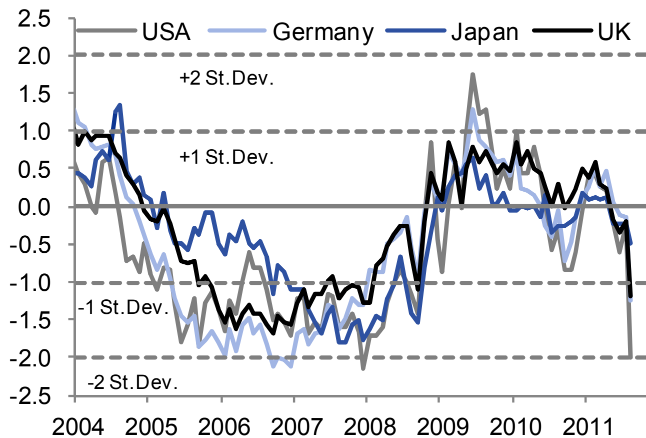
**Exhibit 23: Interest rate forecasts: Policy, interbank, 10-year government and 10-year swap rates (%)**

| | Date | Policy rate | 3-mth rates | | 10-yr rates | | | | Date | Policy rate | 3-mth rates | | 10-yr rates | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | Forecasts | Forward | Gov't Rate | Swap Rate | Swap rate (Forward) | | | | Forecasts | Forward | Gov't Rate | Swap Rate | Swap rate (Forward) |
| USA | **11-Aug-11** | **0.3** | **0.3** | **-** | **2.2** | **2.4** | **-** | Japan | 11-Aug-11 | 0.1 | 0.2 | - | 1.0 | 1.1 | - |
| | Sep-11 | 0.1 | 0.3 | 0.4 | 2.8 | 3.0 | 2.5 | | Sep-11 | 0.1 | 0.4 | 0.3 | 1.1 | 1.2 | 1.1 |
| | Dec-11 | 0.1 | 0.3 | 0.5 | 3.0 | 3.2 | 2.6 | | Dec-11 | 0.1 | 0.4 | 0.3 | 1.3 | 1.5 | 1.1 |
| | Mar-12 | 0.1 | 0.3 | 0.5 | 3.0 | 3.2 | 2.6 | | Mar-12 | 0.1 | 0.4 | 0.3 | 1.3 | 1.5 | 1.2 |
| | Jun-12 | 0.1 | 0.3 | 0.4 | 3.3 | 3.5 | 2.7 | | Jun-12 | 0.1 | 0.4 | 0.3 | 1.3 | 1.5 | 1.2 |
| | Sep-12 | 0.1 | 0.3 | 0.4 | 3.3 | 3.5 | 3.0 | | Sep-12 | 0.1 | 0.4 | 0.3 | 1.4 | 1.6 | 1.3 |
| | Dec-12 | 0.1 | 0.5 | 0.5 | 3.5 | 3.7 | 3.1 | | Dec-12 | 0.1 | 0.4 | 0.3 | 1.4 | 1.6 | 1.4 |
| Euro-zone* | Aug-11 | 1.5 | 1.5 | - | 2.3 | 2.9 | - | UK | 11-Aug-11 | 0.5 | 0.8 | - | 2.5 | 2.9 | - |
| | Sep-11 | 1.5 | 1.7 | 1.4 | 2.5 | 2.8 | 2.9 | | Sep-11 | 0.5 | 0.8 | 0.9 | 3.0 | 3.2 | 2.9 |
| | Dec-11 | 1.5 | 1.7 | 1.1 | 2.8 | 3.0 | 3.0 | | Dec-11 | 0.5 | 0.8 | 0.8 | 3.0 | 3.2 | 3.0 |
| | Mar-12 | 1.5 | 1.7 | 1.1 | 2.8 | 3.0 | 3.1 | | Mar-12 | 0.5 | 0.8 | 0.8 | 3.3 | 3.5 | 3.1 |
| | Jun-12 | 1.5 | 1.7 | 1.0 | 3.0 | 3.3 | 3.1 | | Jun-12 | 0.5 | 0.8 | 0.8 | 3.5 | 3.7 | 3.2 |
| | Sep-12 | 1.8 | 2.0 | 1.1 | 3.0 | 3.3 | 3.3 | | Sep-12 | 0.5 | 0.8 | 0.8 | 4.0 | 4.3 | 3.4 |
| | Dec-12 | 2.0 | 2.2 | 1.2 | 3.3 | 3.5 | 3.4 | | Dec-12 | 0.8 | 1.1 | 0.9 | 4.3 | 4.5 | 3.5 |

* 10-year government rate is for 10-year German Bund

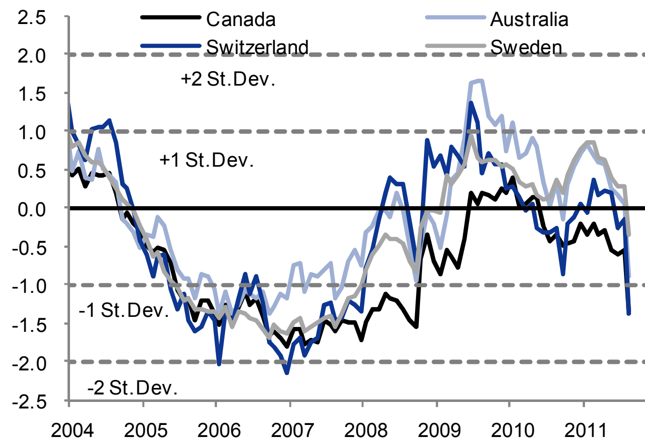
*Source: Goldman Sachs Global ECS Research.*

**Exhibit 24: Degree of 10-year bond mispricing according to Sudoku**




*Source: Goldman Sachs Global ECS Research.*

**Exhibit 25: Degree of 10-year bond mispricing according to Sudoku**




*Source: Goldman Sachs Global ECS Research.*

**Analyst Contributors**

**Francesco U. Garzarelli**
+44(20)7774-5078
francesco.garzarellli@gs.com
Goldman Sachs International

**Constantin Burgi**
+44(20)7051-4009
constantin.burgi@gs.com
Goldman Sachs International

# FX: Dollar weakness and fiscal policy to drive FX markets

Though we have been in a dollar bearish camp for some time now, it is still surprising to see just how weak the USD is, even in the face of the broader risk aversion seen in recent weeks. Compared to the post-Lehman period in 2008 the steep fall in risky assets should have caused the broad trade-weighted dollar to strengthen by about 8%-9% instead of the 2% observed in reality (see Exhibit 26). This increasingly suggests the USD is losing its safe haven status.

We continue to believe that structural US imbalances are the main reason. These lead to weak capital inflows, a continued large current account deficit and easier monetary policy than elsewhere. Specifically on the last point the Fed has just announced a stronger commitment to keep rates at exceptionally low levels until mid-2013 and we think QE3 is now the most likely scenario for the next policy step. It will take a while until these structural factors change and the dollar downtrend slows. This weak dollar theme also remains dominant across our tactical and Top Trade recommendations for currency markets.

In the latest round of forecast revisions, we have reflected the weak USD theme in particular in the JPY and CHF. These are the two other traditional funding and safe haven currencies. But with the dollar now losing this role, they may experience more appreciation than expected previously.

One important factor that remains critical for currency markets is fiscal policy. To analyse the transmission from fiscal policy factors into FX, an important distinction should be made between the stock of existing government debt and the flow of government debt in the form of the budget balance, in particular the primary balance.

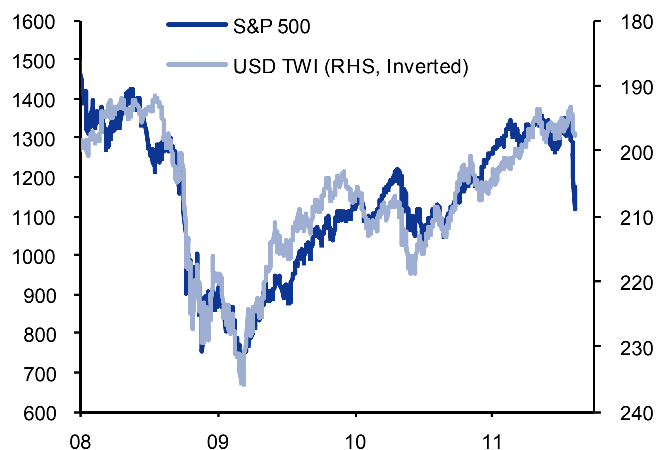
Budget deficits or surpluses directly affect the business cycle. For example, expansionary fiscal policy typically leads to stronger demand growth and real appreciation pressure. The way that the cyclical impact of fiscal policy is transmitted into FX markets is typically through capital flows and interest rate differentials. The levels of the debt stock and risk premia are the second key variable in assessing how fiscal parameters can affect FX. The key to understanding this factor is its forward-looking nature, as high debt levels can force a currency negative fiscal contraction in the future or even direct default.

As we discussed in more detail in the latest *FX Monthly*, the cyclical forces linked to the expected fiscal contraction in the US will likely prolong the underlying broad USD downtrend. The combination of weak capital inflows and a still large current account deficit has the same dollar-weakening impact as the expected widening in interest rate differentials, as the Fed remains on hold for longer.

Using the same framework on the other side of the Atlantic, there is still only relatively muted fiscal contraction in the euro area as a whole, given the small size of peripheral countries. However, the fiscal risk premium has been a dominating negative influence for the EUR.

Going forward, fiscal policy therefore will remain a key driving force pulling FX markets into opposite directions, though we continue to believe the size of likely fiscal contraction in the US will remain the dominating fiscal force, which likely adds to the dollar negative forces described earlier.

**Exhibit 26: S&P 500 and USD TWI**



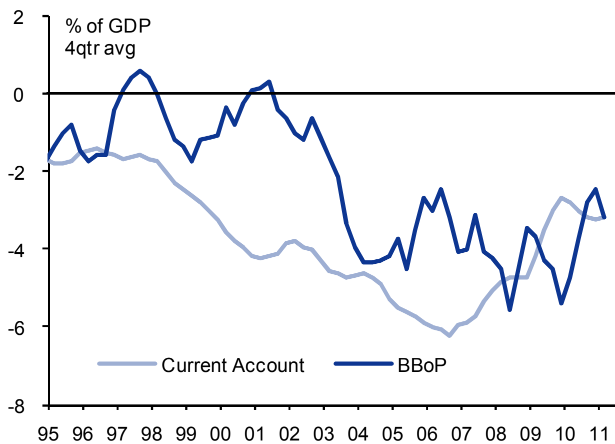

*Source: Goldman Sachs Global ECS Research.*

## **€/$**

Broad dollar weakness remains our core view. Underpinning our dollar-bearish views are the structural, large twin deficits that will likely persist. The overall monetary stance of the US supports this view, as our base case is now QE3 and the Fed announcement to maintain low rates until mid 2013. In the near term, unsettled risk sentiment could still lead to bouts of dollar strength, given risk correlations. But the overall backdrop of continued global recovery and accommodative policy in the majors should eventually prove supportive for risky assets

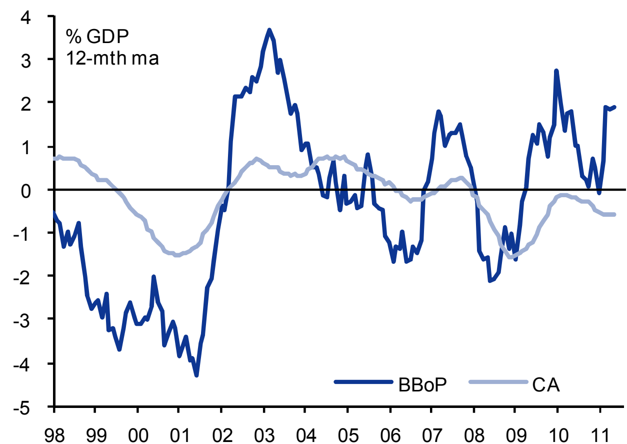
We maintain our €/$ forecast at 1.45, 1.50 and 1.55 over 3, 6 and 12 months. Current GSDEER fair value for €/$ is 1.19.

**Exhibit 27: US BBoP vs. Current Account**



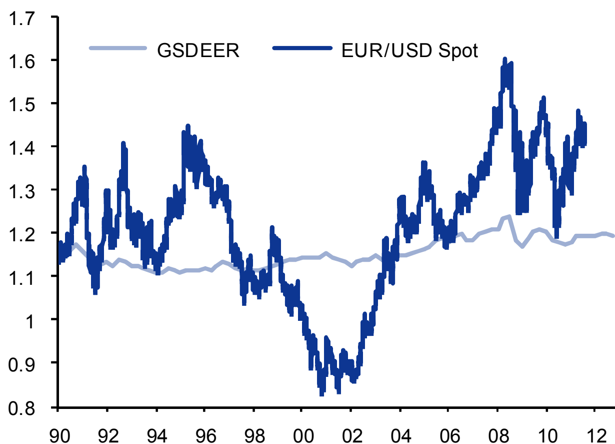

*Source: National Sources, Goldman Sachs Global ECS Research.*

**Exhibit 28: Euroland BBoP vs. Current Account**



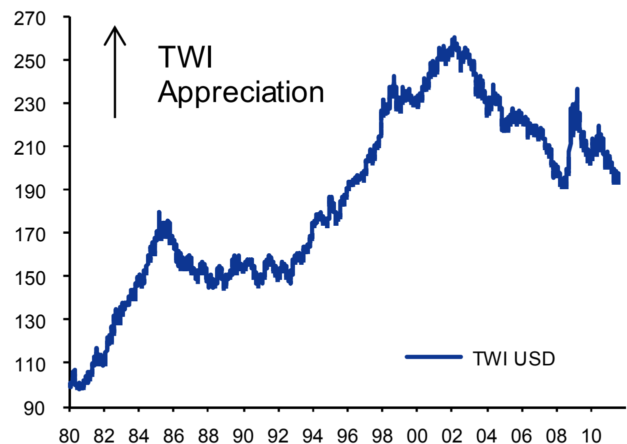

*Source: National Sources, Goldman Sachs Global ECS Research.*

**Exhibit 29: €/$ spot vs. GSDEER**




*Source: Goldman Sachs Global ECS Research.*

**Exhibit 30: US trade weighted index**




*Source: Goldman Sachs Global ECS Research.*

## Sterling

Sterling is trading at a discount to "fair value" vs. the EUR. However, persistently higher inflation prints have started to erode GBP valuation. Cyclically, the consolidation in fiscal policy combined with an accommodative monetary policy stance is typically negative for FX. Thus, our near-term forecast reflects GBP softness from current levels. Most recently PMI and IP data came in below expectations, while inflation softened unexpectedly in June. Recent EUR weakness has driven EUR/GBP lower but our forecasts point to a near-term rebound. Broader USD weakness should lead to considerable strength in Cable.

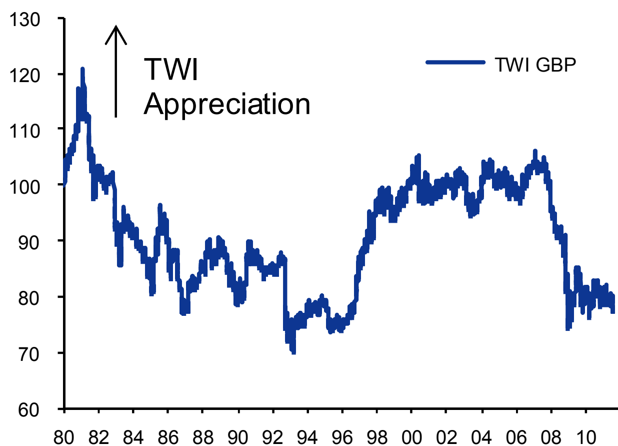
We maintain our EUR/£ forecast of 0.90 in 3 and 6 months and 0.84 in 12 months. This translates into £/$ of 1.61, 1.67 and 1.85 in 3, 6 and 12 months. Current GSDEER for €/£ is 0.78 and for £/$ 1.52.

## $/JPY

We revise our forecast on the back of a weaker picture of the global economy and the resulting portfolio flows. Also, we expect the trade balance to improve further as the supply chain disruptions continue to fade. We have already seen some intervention due to the rapid appreciation and we would not be surprised to see further intervention to prevent excessive JPY strength. In the US, we now see QE3 as the most likely scenario and thus the relative policy stance is JPY supportive.

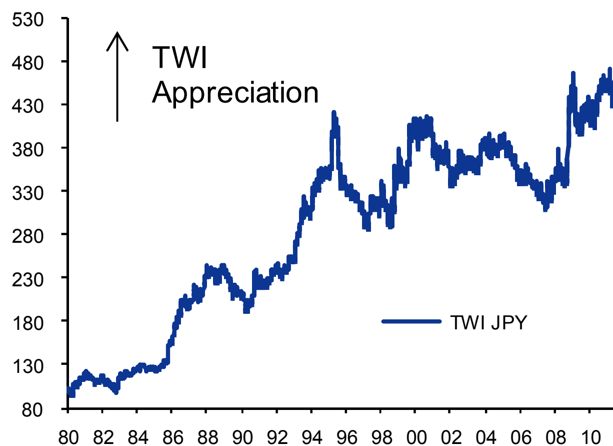
We have recently changed our $/JPY forecast to 77, 76 and 74 in 3, 6 and 12 months. This translates into €/JPY of 111.7, 114.0 and 114.7. Current GSDEER for $/JPY is 109.7 and for €/JPY 131.

**Exhibit 31: £ trade weighted index**




*Source: Goldman Sachs Global ECS Research.*

**Exhibit 32: JPY trade weighted index**




*Source: Goldman Sachs Global ECS Research.*

**Exhibit 33: Major FX Forecasts**

| | | 3-Month Horizon | | 6-Month Horizon | | 12-Month Horizon | |
|---|---|---|---|---|---|---|---|
| | **Current*** | Forward | **Forecast** | Forward | **Forecast** | Forward | **Forecast** |
| **EUR/$** | **1.42** | 1.42 | **1.45** | 1.42 | **1.50** | 1.42 | **1.55** |
| **$/¥** | **77.1** | 77.0 | **77.0** | 76.9 | **76.0** | 76.6 | **74.0** |
| **EUR/¥** | **109.6** | 109.3 | **111.7** | 109.0 | **114.0** | 108.4 | **114.7** |
| **EUR/CHF** | **1.02** | 1.01 | **1.05** | 1.01 | **1.15** | 1.00 | **1.20** |
| **CHF/¥** | **107.8** | 107.9 | **106.3** | 108.0 | **99.1** | 107.9 | **95.6** |
| **$/CHF** | **0.72** | 0.71 | **0.72** | 0.71 | **0.77** | 0.71 | **0.77** |
| **EUR/£** | **0.88** | 0.88 | **0.90** | 0.88 | **0.90** | 0.88 | **0.84** |
| **£/$** | **1.62** | 1.62 | **1.61** | 1.62 | **1.67** | 1.62 | **1.85** |
| **£/¥** | **125.0** | 124.7 | **124.1** | 124.4 | **126.7** | 123.8 | **136.5** |
| **£/CHF** | **1.16** | 1.16 | **1.17** | 1.15 | **1.28** | 1.15 | **1.43** |
| **EUR/NOK** | **7.88** | 7.91 | **7.70** | 7.94 | **7.70** | 8.01 | **7.60** |
| **EUR/SEK** | **9.33** | 9.36 | **9.00** | 9.39 | **8.90** | 9.44 | **8.80** |
| **A$/$** | **1.01** | 1.00 | **1.08** | 0.99 | **1.10** | 0.97 | **1.10** |
| **NZ$/$** | **0.81** | 0.80 | **0.85** | 0.80 | **0.87** | 0.79 | **0.90** |
| **$/C$** | **0.99** | 1.00 | **0.96** | 1.00 | **0.94** | 1.00 | **0.92** |
| **$/CNY** | **6.43** | 6.42 | **6.37** | 6.41 | **6.28** | 6.39 | **6.10** |

* Close 09 August 11

*Source: Goldman Sachs Global ECS Research.*


**Analyst Contributors**

**Thomas Stolper**
+44(20)7774-5183
thomas.stolper@gs.com
Goldman Sachs International

**Robin Brooks**
(212) 902-8763
robin.brooks@gs.com
Goldman Sachs & Co

**Themistoklis M. Fiotakis**
+44(20)7552-2901
themistoklis.fiotakis@gs.com
Goldman Sachs International

**Fiona Lake**
+852 2978-6088
fiona.lake@gs.com
Goldman Sachs (Asia) L.L.C.

**Constantin Burgi**
+44(20)7051-4009
constantin.burgi@gs.com
Goldman Sachs International


# Equity Basket Disclosure

The Equities Division of the firm has previously introduced the basket of securities discussed in this report. The Equity Analyst may have been consulted as to the composition of the basket prior to its launch. However, the views expressed in this research and its timing were not shared with the Equities Division. Note: The ability to trade this basket will depend upon market conditions, including liquidity and borrow constraints at the time of trade.

# Alt AC

We, Thomas Stolper, Allison Nathan and Francesco Garzarelli, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

# Reg AC

We, Peter Oppenheimer, Anders Nielsen and Charles P. Himmelberg, hereby certify that all of the views expressed in this report accurately reflect our personal views about the subject company or companies and its or their securities. We also certify that no part of our compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

# Investment Profile

The Goldman Sachs Investment Profile provides investment context for a security by comparing key attributes of that security to its peer group and market. The four key attributes depicted are: growth, returns, multiple and volatility. Growth, returns and multiple are indexed based on composites of several methodologies to determine the stocks percentile ranking within the region's coverage universe.

The precise calculation of each metric may vary depending on the fiscal year, industry and region but the standard approach is as follows:

**Growth** is a composite of next year's estimate over current year's estimate, e.g. EPS, EBITDA, Revenue. **Return** is a year one prospective aggregate of various return on capital measures, e.g. CROCI, ROACE, and ROE. **Multiple** is a composite of one-year forward valuation ratios, e.g. P/E, dividend yield, EV/FCF, EV/EBITDA, EV/DACF, Price/Book. **Volatility** is measured as trailing twelve-month volatility adjusted for dividends.

# Quantum

Quantum is Goldman Sachs' proprietary database providing access to detailed financial statement histories, forecasts and ratios. It can be used for in-depth analysis of a single company, or to make comparisons between companies in different sectors and markets.

# GS SUSTAIN

GS SUSTAIN is a global investment strategy aimed at long-term, long-only performance with a low turnover of ideas. The GS SUSTAIN focus list includes leaders our analysis shows to be well positioned to deliver long term outperformance through sustained competitive advantage and superior returns on capital relative to their global industry peers. Leaders are identified based on quantifiable analysis of three aspects of corporate performance: cash return on cash invested, industry positioning and management quality (the effectiveness of companies' management of the environmental, social and governance issues facing their industry).

# Disclosure Appendix

## Coverage group(s) of stocks by primary analyst(s)

Compendium report: please see disclosures at http://www.gs.com/research/hedge.html. Disclosures applicable to the companies included in this compendium can be found in the latest relevant published research.

## Option Specific Disclosures

**Price target methodology:** Please refer to the analyst's previously published research for methodology and risks associated with equity price targets.

**Pricing Disclosure:** Option prices and volatility levels in this note are indicative only, and are based on our estimates of recent mid-market levels. All prices and levels exclude transaction costs unless otherwise stated.

**Buying Options** - Investors who buy call (put) options risk loss of the entire premium paid if the underlying security finishes below (above) the strike price at expiration. Investors who buy call or put spreads also risk a maximum loss of the premium paid. The maximum gain on a long call or put spread is the difference between the strike prices, less the premium paid.

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| | Rating Distribution | | | Investment Banking Relationships | | |
|---|---|---|---|---|---|---|
| | Buy | Hold | Sell | Buy | Hold | Sell |
| Global | 32% | 54% | 14% | 52% | 41% | 37% |

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