June 23, 2014

GOAL: Asset Allocation Update

Portfolio Strategy Research

Sustained growth and policy easing: OW equities and UW bonds

Our macro scenario: Sustained growth and policy easing

We expect US and European economic growth to sustain recent strength and improve slightly through the rest of the year. We forecast a more substantial improvement in Chinese growth where risks have diminished but remain moderately to the downside. We believe recent ECB policy action is likely to strengthen the search for yield environment.

Our views across asset classes and our investment themes

Equities: We remain overweight over both 3 and 12 month horizons. Our conviction over 12 months is strong, but similar to last month our conviction over 3 months is lower.

Commodities: We see significant downside for agriculture and precious metals. For energy we forecast a -5% return over the coming year, but risks are skewed to the upside in an environment of heightened geopolitical risks and very limited OPEC spare capacity. Despite the negative return we forecast after the recent rally driven by events in Iraq, we stay neutral commodities due to the hedging benefits they offer against these risks.

Corporate credit: We expect the search-for-yield environment to remain strong and push spreads a bit tighter over 12 months. This is balanced by rising underlying government bond yields and we stay neutral.

Government bonds: We stay underweight as we expect yields to rise driven by a higher front end risk premium in the US and a decline in deflationary concerns in Europe. Our preferred implementation of our bearish view is to be long inflation in the Euro area and Japan and short 3-year Treasuries.

Investment themes: We seek exposure to the cyclical recovery and companies returning cash to shareholders. See page 6.

Expected returns and recommended allocation

New Recommendation						
3-Month Horizon				12-Month Horizon		
Asset Class	Return*	Weight		Asset Class	Return*	Weight
Equities	0.4 %	OW		Equities	9.4 %	OW
Cash	0.1	N		Cash	0.5	N
5 yr. Corporate Bonds	-1.8	N		5 yr. Corporate Bonds	-1.7	N
Commodities	-4.0	N		Commodities	-5.5	N
10 yr. Gov. Bonds	-5.1	UW		10 yr. Gov. Bonds	-7.6	UW

* Return forecasts assume full currency hedging

Source: Goldman Sachs Global Investment Research.

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

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

Jeffrey Currie
(212) 357-6801 jeffrey.currie@gs.com
Goldman, Sachs & Co.

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.

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

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.

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

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

What's New?

In summary

Since our last GOAL report, growth in the US and Europe has been sustained, while growth in China has improved in line with our expectations. The most significant event has been ECB easing, which we expect to support further search for yield. We maintain our existing allocation with an overweight in equities and underweight in bonds

Sustained growth...

Recent data has been consistent with our view of sustained growth in the US and Europe. In the US our current activity indicator (CAI) for May sits at 3.2%, inside the range observed in March and April. Our MAP index for data surprises has remained in positive territory though it has moderated a bit (Exhibit 1). In Europe our MAP index is now back close to neutral and the CAI has moderated marginally, but it remains in the range we have seen so far this year. Over the coming months we expect growth to improve slightly.

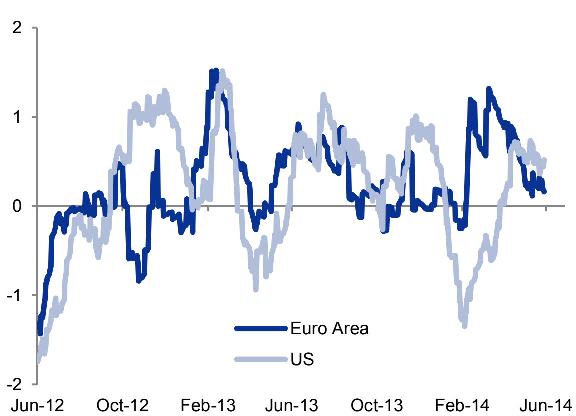
..and China improving

Whereas growth in Europe and the US has been broadly sustained, growth in China has clearly improved. A string of better data and policy announcements supporting growth has limited the downside risks to our growth forecast for this year, and we think GDP is now tracking just slightly below our 2Q target of 6.9% annualized growth. We forecast further improvement to 8.4% in 3Q, but risks, though smaller than a month ago, remain to the downside of these targets.

ECB easing

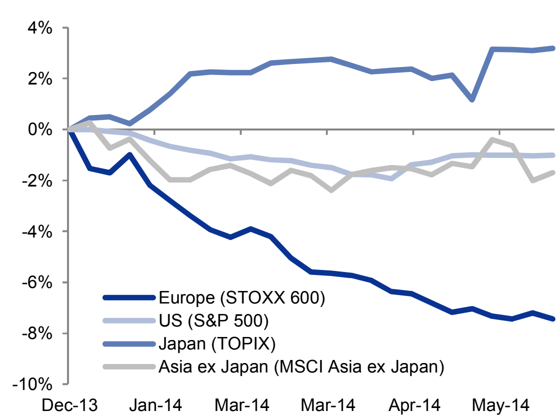
The biggest macro event since our last GOAL report has been the easing of ECB policy. Apart from a more general dovish message we see two channels of potential impact of the measures. First, there is a clear impact on liquidity. We estimate that the cancellation of the sterilization part of the SMP program alone will add €120 bn, and a usage of the full capacity of initial funding from the first set of TLTROs in September/December 2014 would add another €400 bn. However the actual uptake is likely to be smaller and substitution between new and existing LTRO operations as well as further improvements in the functioning of money markets is likely to limit the liquidity increase. Though still very uncertain we expect excess liquidity to increase from around €100 bn before the ECB announcement to somewhere in the range of €150 bn to €350 bn in the coming two years with a skew towards the lower end of the range. Second, there is the potential for credit easing. Here the eventual impact is even more uncertain and heavily dependent upon how the benchmark for loan growth in the TLTRO program is constructed as well as the subsidy for credit creation that could arise if the ECB was willing to take on credit risk at an attractive price.

Exhibit 1: US and European data surprises moderated
3-month linearly weighted data surprises vs. consensus for the US and Euro area, as measured by our MAP indexes



Source: Haver Analytics, Goldman Sachs Global Investment Research.

Exhibit 2: Earnings revisions have stabilized outside of Europe



Source: I/B/E/S via Datastream, Goldman Sachs Global Investment Research.

Search for yield

The liquidity channel and associated incentive to undertake carry trades is likely to support further search for yield, leading to further compression of spreads in the periphery as well as corporate bond spreads. We believe the impact of the liquidity channel on economic growth and inflation is likely to be more muted; the policies are likely to support a continuation of the existing trend towards a compression of risk premia which have already compressed significantly. Given this, the marginal return in terms of support to economic growth is likely to diminish. Similarly, we see the measures as supportive for our general positive view on equities but not game changing. The impact of significant credit easing on the economy and equity markets could be larger, but here the uncertainty remains too large for us to factor it into our forecasts.[1]

Long inflation

We maintain our underweight in government bonds. The ECB actions have increased support for the front end in Europe, but we continue to expect higher 10-year yields in the major markets for two main reasons: 1) we expect a higher term premium in the front end of the US curve driven by more volatility due to the data dependency of the hiking profile, and 2) a stabilisation of inflation in the Euro area around current levels followed by an increase as we move into 2015 should ease deflationary concerns. In line with the drivers we expect for higher yields, we recommend a short on 3-year Treasuries and a long on Euro and Japanese inflation.

Overweight equities

We have rolled a number of our equity forecasts forward to higher levels. The combination of policy easing, better growth in China and slightly better growth in the US and Europe is clearly supportive for equities. However, equities have risen 4% since our last GOAL report, geopolitical risks have increased and the potential for a rapid sell-off in bonds to impact equities negatively remains. The impact from a bond sell-off would likely be temporary and the timing is uncertain. So even though we are bearish on bonds, we do not see this risk as large enough to justify a downgrade of equities in the short term in what is otherwise a supportive environment for the asset class. We stay overweight with strong conviction over 12 months and lower conviction over 3 months, unchanged from our last GOAL report.

Earnings & valuation

Earnings expectations, which have long been a concern, have stabilised in all regions with the exception of Europe (Exhibit 2). In Europe we have downgraded our earnings growth forecast for 2014 to 6% reflecting the weak economic growth at the beginning of the year. Consensus is now in line with our top-down forecasts for all regions except Japan, where we expect substantially stronger profit growth from continued reform momentum. Valuation is increasingly a concern for investors. We think current levels are sustainable in our central macro scenario. But, the increase in valuations means that the buffer from low valuations has disappeared and we therefore see markets as more vulnerable if the macro environment was to disappoint. This is particularly a concern in the US.

An update on risks

The downside risks to Chinese growth have declined since our last GOAL but are still a source of uncertainty. Geopolitical risks on the other hand have increased with the conflict in Iraq. Here we expect the short-term impact on oil supplies to be limited as the conflict is far from the southern oil fields and export terminals from where nearly all oil exports originate. However, the situation remains highly volatile and while a low probability event, a disruption to these exports would likely have a large impact on global supplies in an environment with significant geopolitical interruptions elsewhere and the associated low OPEC spare capacity. We continue to worry about a temporary impact on other assets from a sell-off in rates along the lines of the experience of last summer. That said, the bond premium is now higher and better aligned with the macro economy and therefore any sell-off is likely to be more muted than what we saw then. Still, a shift in expectations on timing of Fed policy tightening would have ramifications on broad asset markets.[2]

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[1] See our June 18, 2014 European Economics Daily: ECB announcements, excess liquidity and Eonia for a further discussion of the liquidity outlook.

[2] See our June 13, 2014 Energy Weekly: No disruptions to Iraqi exports so far.

Detailed macro outlook, performance and forecasts

Macro outlook

We expect US and Euro area growth to improve slightly through the rest of the year. In China we expect further improvement from current levels. We remain concerned about the need for structural adjustments in some EM economies.

In the US we see support for our view of continued strong growth for the rest of the year. Personal consumption grew 3% in 1Q and looks set for an even stronger number in 2Q due to support from both healthcare spending and cyclical elements such as Auto sales. On the investment side, the outlook for capital spending is improving. We also expect the housing market to improve. The impact of the rise in mortgage rates last summer should now be behind us, and we would expect to see some support to housing data from the decline in rates this year in coming quarters. Longer term household formation should be supportive of this segment of the economy.

While Euro area GDP disappointed in the first quarter, the broader set of macro indicators reflected in our CAI has been in line with our forecasts. In line with this we expect GDP growth to pick up in coming quarters to levels slightly above what is currently indicated by the CAI. We see improving domestic demand in Germany, lower fiscal drag in the periphery and better exports as global growth improves as the main drivers of Euro area growth.

In China, uncertainty around the growth path has declined, but risks remain moderately to the downside of our forecasts. For the remainder of the year, we expect growth to be supported by an improving external environment, a normalization of consumption growth following the latest round of anti-corruption measures, the significant easing in financial conditions we have seen, and targeted policy support. We expect a decline in the growth contribution from fixed asset investment which is likely to be held back to some degree by concerns about credit growth. We expect fiscal policy to remain supportive of growth but in light of structural concerns, monetary policy is likely to stay more neutral. Looking out further, we expect the Chinese economy to continue to be characterized by an ongoing balancing process between reforms to support sustainable growth in the long term and the need to limit the near-term impact on growth of these reforms.

Performance

In our last GOAL report, we maintained our equity overweight matched by an underweight in government bonds over both 3 and 12 months. Since then equities have returned 4.0%, outperforming the -0.2% return on government bonds.

Exhibit 3: Performance since last GOAL and our new recommended allocations

Performance since last GOAL**		
Asset Class	3-Month Rec. in last Goal	Performance
Equities	OW	4.0 %
Commodities	N	3.5
5 yr. Corporate Bonds	N	0.1
Cash	N	0.0
10 yr. Gov. Bonds	UW	-0.2

New Recommendation					
3-Month Horizon			12-Month Horizon		
Asset Class	Return*	Weight	Asset Class	Return*	Weight
Equities	0.4 %	OW	Equities	9.4 %	OW
Cash	0.1	N	Cash	0.5	N
5 yr. Corporate Bonds	-1.8	N	5 yr. Corporate Bonds	-1.7	N
Commodities	-4.0	N	Commodities	-5.5	N
10 yr. Gov. Bonds	-5.1	UW	10 yr. Gov. Bonds	-7.6	UW

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

Source: Goldman Sachs Global Investment Research.

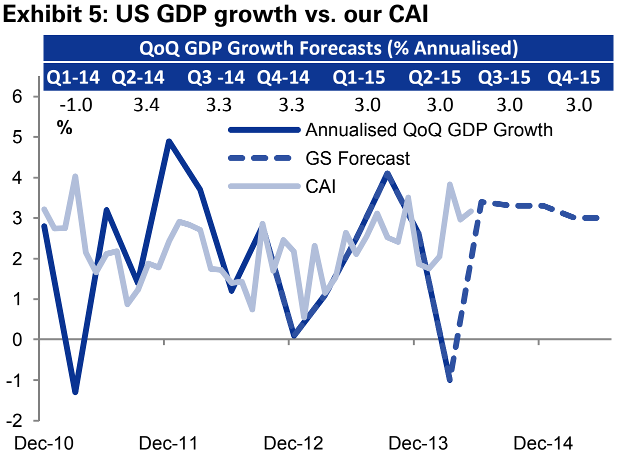
Exhibit 4: Our forecasts across asset classes

	Return in % over last 12 m	Return in % over last 3 m	Return in % over last 1 m	Current Level	Forecasts 3 m	Forecasts 6 m	Forecasts 12 m	Unit
Equities								
S&P 500 ($)	25.9	5.7	3.9	1963	1925	1900	2000	Index
Stoxx Europe 600 (€)	28.3	8.0	2.3	348	360	370	385	Index
MSCI Asia-Pacific Ex-Japan ($)	19.7	8.8	0.6	488	480	490	520	Index
Topix (¥)	17.7	11.9	8.6	1269	1250	1300	1450	Index
10 Year Government Bond Yields								
US	2.7	1.8	-0.3	2.61	3.15	3.25	3.50	%
Germany	5.9	2.9	0.6	1.34	2.15	2.25	2.60	%
UK	0.7	0.3	-0.6	2.69	3.15	3.25	3.40	%
Japan	4.0	0.5	0.4	0.59	0.95	1.00	1.15	%
5 year credit spreads*								
iBoxx USD	7.3	2.4	0.1	77	75	73	70	Bp
BAML HY Master Index II	11.6	2.8	1.1	339	339	332	320	Bp
iBoxx EUR	7.0	2.6	0.6	106	102	99	97	Bp
Commodities								
WTI	19.2	9.7	3.7	107	96.00	95.00	90.00	$/bbl
Brent	20.8	8.5	4.9	115	105.00	105.00	100.00	$/bbl
Nymex Nat. Gas	7.3	2.1	4.1	4.53	4.50	4.25	4.25	$/mmBtu
Copper	0.8	5.6	-0.9	6820	6600	6600	6600	$/mt
Aluminium	-4.1	7.9	5.1	1886	1700	1700	1900	$/mt
Gold	1.6	-1.5	1.7	1316	1195	1135	1050	$/troy oz
Wheat	-20.3	-15.5	-11.5	593	610	560	575	Cent/bu
Soybeans	21.4	7.3	-1.9	1416	1400	1050	1050	Cent/bu
Corn	-19.9	-4.1	-3.9	453	450	400	400	Cent/bu
FX								
EUR/USD	3.6	-1.4	-0.5	1.36	1.38	1.34	1.30	
USD/JPY	4.8	-0.2	0.4	102	103	107	110	

* We show performance for credit in total return terms, but current level and forecasts are for spreads

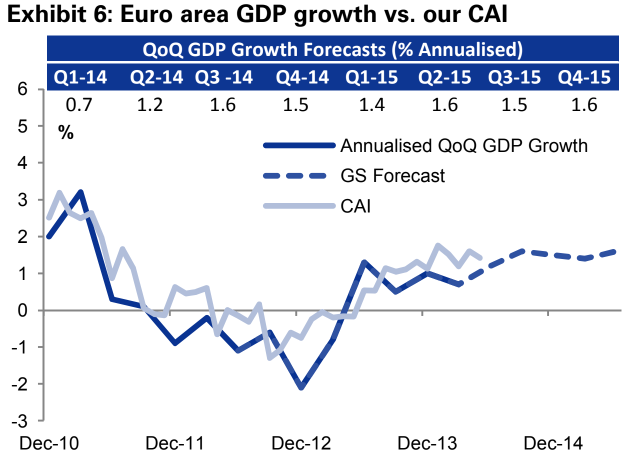
Source: Goldman Sachs Global Investment Research.

Exhibit 5: US GDP growth vs. our CAI



Source: Goldman Sachs Global Investment Research.

Exhibit 6: Euro area GDP growth vs. our CAI



Source: Goldman Sachs Global Investment Research.

Exhibit 7: Our forecasts for global economic growth vs. consensus

% yoy	2012	2013	2014E GS	2014E Consensus*	2015E GS	2016E GS	2017E GS
USA	2.8	1.9	2.1	2.2	3.1	3.0	3.0
Japan	1.4	1.5	1.5	1.5	1.2	1.6	1.5
Euro Area	-0.6	-0.4	1.0	1.1	1.5	1.7	1.6
China	7.7	7.7	7.3	7.3	7.6	7.6	7.4
BRICs	5.9	5.9	5.5	5.6	6.3	6.6	6.7
Advanced Economies	1.4	1.3	2.0	2.0	2.5	2.5	2.5
World	3.1	2.9	3.2	3.2	3.8	4.1	4.2

* Consensus Economics June 2014

Source: Consensus Economics, Goldman Sachs Global Investment Research.

Investing in our themes

Cyclical recovery

To benefit from the recovery in DM growth, we would position in stocks with high operational gearing, exposure to developed markets or both. We have active recommendations to leverage this view across the four regions that we look at. We see the reflation story in Japan as another angle on this theme. In government bond markets we remain long Japanese break-even inflation and are now also long Euro area inflation and short 3 year US Treasuries.

Exhibit 8: Our recommendations position for a DM driven cyclical recovery…

	Cyclical recovery
Equity	US companies with high operational leverage (GSTHOPHI) vs. US companies with low operational leverage (GSTHO
	US stocks we expect to benefit from higher rates (GSTHUSTY) vs. S&P 500
	Russell 1000 Growth vs. Russell 1000 Value
	Long DAX vs. Stoxx 600
	Operationally geared DM exposed European companies (GSSTDMGR) vs. Stoxx 600
	Long European financially levered companies (GSSTFNLV) vs. Stoxx 600
	Asian global cyclicals (GSSZMSGC) vs. Asian asset sensitive financials (GSSZMSFA)
	Asia ex-Japan stocks with high sales exposure to Europe
	China cyclical recovery basket
	Japanese capex growth beneficiaries (GSJPCPEX)
	Japanese domestic reflation basket (GSJPREFL)
	Wavefront US Consumer Growth basket (GSWBCOGA)
	Large cap banks in the US, Europe and Japan, with Equal weights in BKX, SX7E and TPNBNK
Gov Bonds	10y Japanese break-even inflation (long 10y JGBis vs. 10y JGBs).
	Long Euro area 3 year inflation swap rates 2-year forward
	Short 3 year US Treasuries

Source: Goldman Sachs Global Investment Research.

Shareholder return

As risk aversion moderates we expect companies to put cash to work. Given regional differences in return policies, we have developed different strategies for the different regions to capture this, but we like the theme in both the US, Europe and Japan.

Exhibit 9: …and companies using cash for shareholder returns

	Shareholder return
Equity	US companies with high trailing buy-back yield relative to their sector (GSTHREPO) vs. S&P 500.
	European companies with high dividend yields and growth (GSSTHIDY) vs. Stoxx Europe 600
	Japanese total shareholder yield stocks

Source: Goldman Sachs Global Investment Research.

Other strategies

We are long the US dollar vs. the Canadian dollar and in the equity space we recommend trades to benefit from the womenomics theme in Japan and from post-election policy reforms in India.

Exhibit 10: Other trade recommendations

	Other trades
X-asset	S&P 500 Dec 14 Future funded out of short AUD/USD Dec 14 future
Equity	Japanese womenomics winner basket (GSJPWMN2)
	Asia ex-Japan 'Streak winners' and 'Turnaround laggards' (See April 25 "Asia winnners/laggards (Part 2)")
	"Reform-beneficiaries" in India
FX	Long USDCAD

Source: Goldman Sachs Global Investment Research.

Equities: We stay overweight

Over 12 months we still see a solid case for our equity overweight, though return potential is lower following the rally. We expect returns to be supported by earnings growth, driven by the stronger economic growth environment. We see absolute valuations as relatively neutral for returns going forward given the state of the cycle. However relative valuations, reflected in large risk premia (Exhibit 13) remain a key argument for holding equities. There is upside risk that the high risk premia eventually translates into higher absolute valuations than we forecast. As discussed above we also stay overweight over 3 months. The conviction in this view is similar to when we last published, but remains significantly lower than our conviction over 12 months.

Our regional allocation is unchanged. We overweight **Europe** over both 3 and 12 months. While earnings have disappointed so far this year, we expect growth to pick up and that the weakness in earnings will be counterbalanced by more support from monetary policy than we anticipated leaving the overall outlook positive. We overweight **Japan** over 12 months and expect further BOJ easing, nuclear restarts and continued structural reforms and profit growth to support returns. We are neutral on **Asia ex-Japan** reflecting high uncertainty. We expect the region to benefit from acceleration in Chinese growth in line with our forecasts, but some uncertainty remains. At the same time we continue to expect EM concerns to reassert themselves later this year and even though the direct problems in Asia are limited the region is likely to suffer from spillover effects in that scenario. We underweight the **US**. We believe the return potential for the US market is dampened by limited room for valuation and margin expansion given the strong recovery we have seen already. It is also the market for which we have the lowest expectations for 2014-15 compound earnings growth.

Exhibit 11: Our recommended weightings within equities

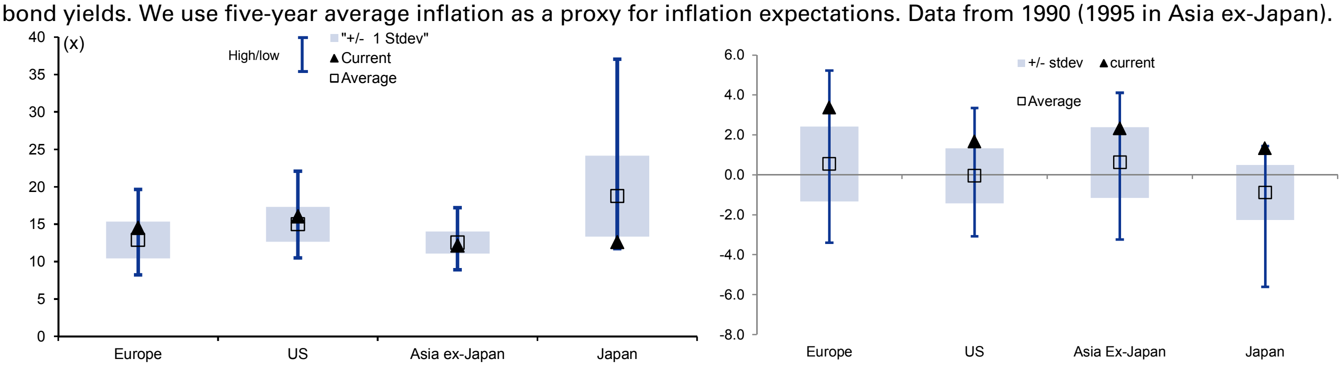
Index	3-Months		
	Return Forecasts		Recommended
	Local Cur.	In USD	Allocation
Stoxx Europe 600	4	6	Overweight
Topix	-1	-2	Neutral
MXAPJ	-1	-1	Neutral
S&P 500	-1	-1	Underweight

Index	12-Months		
	Return Forecasts		Recommended
	Local Cur.	In USD	Allocation
Topix	16	8	Overweight
Stoxx Europe 600	14	9	Overweight
MXAPJ	10	10	Neutral
S&P 500	4	4	Underweight

Source: Goldman Sachs Global Investment Research.

Exhibit 12: Current valuation vs. history

Left: NTM P/E relative to historical distribution (using data since 2001). Right: Dividend yields minus 10-year real government bond yields. We use five-year average inflation as a proxy for inflation expectations. Data from 1990 (1995 in Asia ex-Japan).



Source: Datastream, Haver Analytics, Goldman Sachs Global Investment Research.

Exhibit 13: Valuation data across the regions and our forecasts for earnings growth

P/E is NTM on consensus earnings; net income margin is consensus for 2013; all other valuation data is 2013 or last 12 months

	P/E (X)	EV / EBITDA (X)	FCF Yield (%)	Div Yield (%)	P/B (X)	Net Income Margin (%)	ROE (%)	Implied ERP (%)	Earnings Growth: GS top-down 2014E	GS top-down 2015E	Consensus bottom-up 2014E	Consensus bottom-up 2015E
S&P 500	16.0	9.6	4.6	2.0	2.8	8.9	14.7	5.0	8	8	9	11
Stoxx Europe 600	14.5	8.3	3.9	3.1	1.8	6.4	9.3	6.9	6	12	6	13
MSCI Asia Pacific ex-Japan	12.1	8.5	2.3	3.0	1.6	8.7	12.0	8.6	10	14	11	10
Topix	12.6	7.6	5.2	1.9	1.3	7.2	8.2	6.3	16	14	6	11

Note : TOPIX EPS is based on fiscal, not calendar, years (i.e 2013 represents the fiscal year ending in March 2014)

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

Government bonds: Yields to rise with better data

We remain underweight over both 3 and 12 months. We expect yields to rise as: 1) we expect a higher term premium in the front end of the US curve driven by more volatility due to the data dependency of the hiking profile stressed by Chair Yellen at last week's press conference, and 2) a stabilisation of inflation in the Euro area around current levels followed by an increase as we move into 2015 easing deflationary concerns.

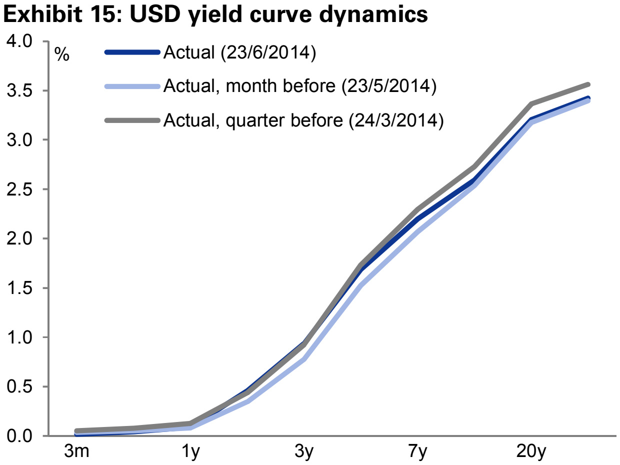
Exhibit 14: 10-year bond yields: Market vs. GS Sudoku Model*, spot and 3 months into the future

	Actual** (%)	Misvaluation against fair value***, standard deviations		Fair value***, %		Fair value change (due to change in fundamentals), t + 3mth
		CE	GS	CE	GS	GS
USA	2.61	0.0	0.0	2.62	2.62	0.02
Germany	1.34	-0.8	-0.7	1.84	1.74	0.01
Japan	0.59	-0.8	-0.9	0.91	0.97	-0.01
UK	2.69	0.0	0.1	2.68	2.60	0.00
Canada	2.29	-0.4	-0.7	2.60	2.81	0.02
Australia	3.69	-0.6	-0.3	4.16	3.95	-0.15
Switzerland	0.71	-0.9	-0.8	1.17	1.10	0.00
Sweden	1.81	-0.2	-0.1	2.02	1.97	-0.01

* Details in Chapter 12 of *The Foreign Exchange Market* (2006), *Global Viewpoint* 07/24 and *Global Viewpoint* 08/04. **Last close. ***CE stands for Consensus Economics inputs of macroeconomic fundamentals (latest available month), GS stands for GS Economic Research inputs (current month).

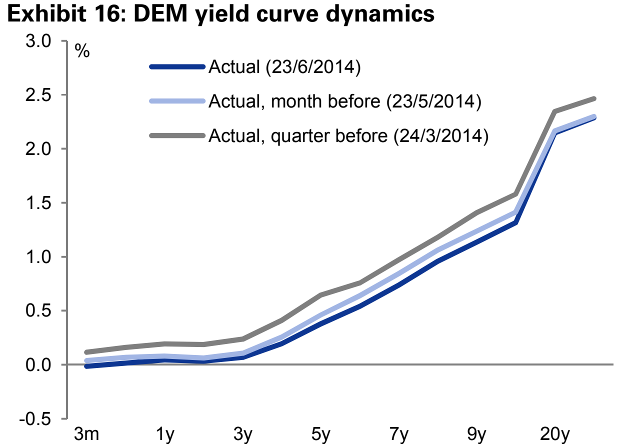
Source: Consensus Economics, Goldman Sachs Global Investment Research.

Exhibit 15: USD yield curve dynamics



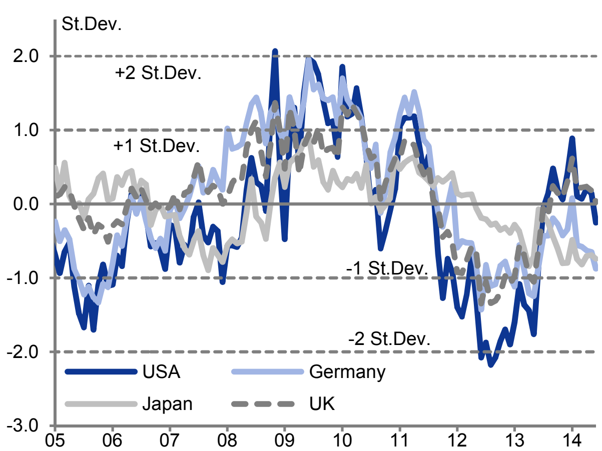
Source: Goldman Sachs Global Investment Research.

Exhibit 16: DEM yield curve dynamics



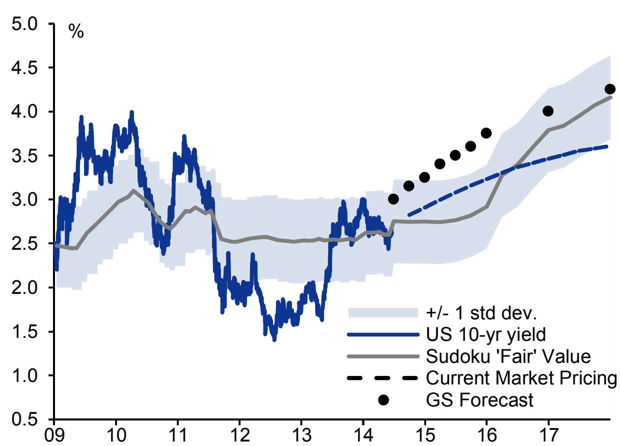
Source: Goldman Sachs Global Investment Research.

Exhibit 17: Degree of 10-year bond mispricing according to Sudoku



Source: Goldman Sachs Global Investment Research.

Exhibit 18: 10-year US yields vs. Sudoku fair value



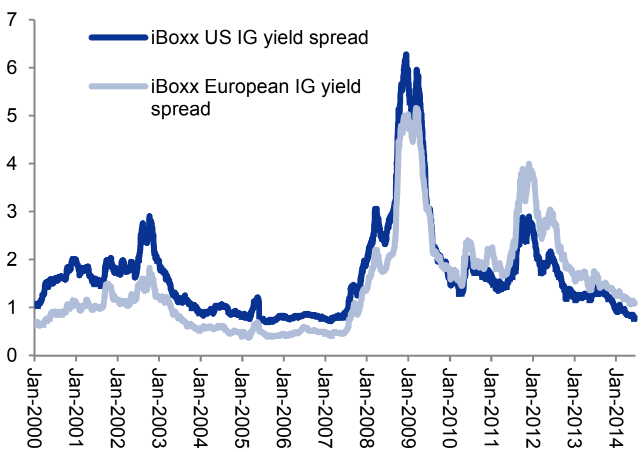
Source: Bloomberg, Goldman Sachs Global Investment Research.

Corporate credit: Search for yield strengthened further in Europe

Credit spreads have continued to narrow since our last report. We believe the search for yield will remain strong as monetary policy remains very accommodative, the stronger growth environment is sustained, inflation stays low and macro risks remain lower than in the last couple of years. This view has been strengthened by the ECB actions. We expect spreads to narrow marginally further from here. This leaves spread returns attractive, in our view, but from a total return perspective, the rise in the underlying government bond yield we expect leaves us neutral over both horizons. We still see corporate re-leveraging as the largest risk to credit quality.

Within credit, we prefer Europe over the US in the near term on technical demand related to the ECB policies, but over a longer horizon we think US credit looks better on a fundamental basis as the compensation investors receive for the structural risks related to the Euro area is small. We prefer financials over non-financials in both regions. We expect financial spreads to reach the level of non-financials this year in the US, while this process is likely to be slower in Europe. The re-leveraging risk is concentrated in the non-financial segment and regulatory changes should lower risk in financials. At the margin, we still prefer IG over HY spreads on a risk-adjusted basis. Thematically, we expect cyclical sectors to outperform and still think liquidity premia are worth pursuing. Specifically we recommend seeking extra spread in off-the-run bonds, small issues and bonds in smaller capital structures.

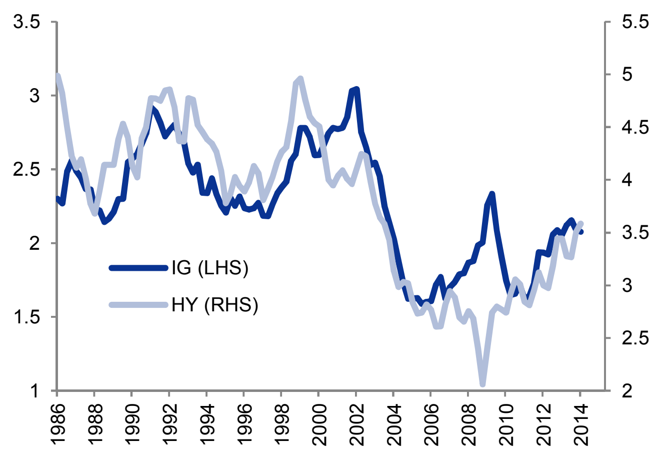
Exhibit 19: US and European 5-year IG spreads



Source: iBoxx, Goldman Sachs Global Investment Research.

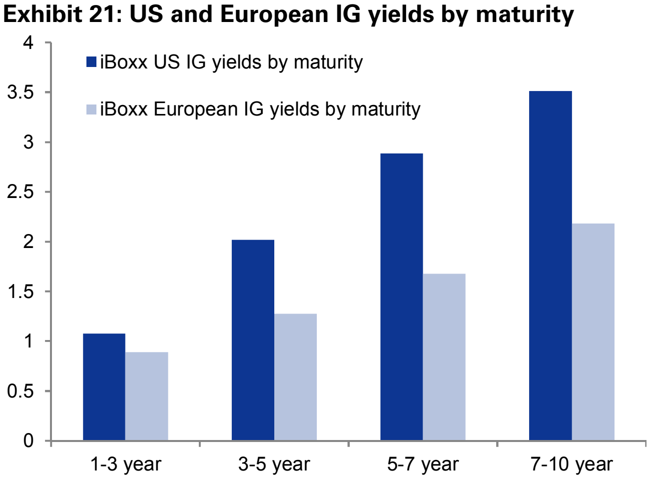
Exhibit 20: Debt/EBITDA ratio has risen

Median ratio of debt (net of cash) to EBITDA for IG and BB/B debt issuers



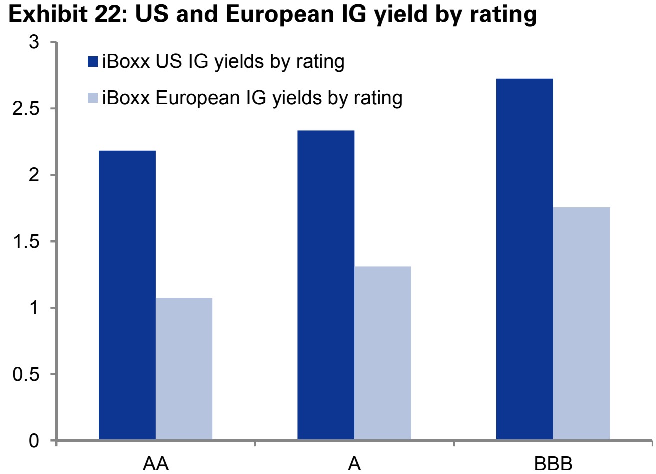
Source: Compustat, Goldman Sachs Global Investment Research.

Exhibit 21: US and European IG yields by maturity



Source: iBoxx, Goldman Sachs Global Investment Research.

Exhibit 22: US and European IG yield by rating



Source: iBoxx, Goldman Sachs Global Investment Research.

Commodities: Neutral as a hedge against geopolitical risks

We forecast a negative 5.5% return for the S&P GSCI® Enhanced Commodity Index over 12 months following the recent rally caused by the events in Iraq. We see the short term impact on oil supplies as limited and our central scenario is therefore for falling prices and a -5.0% return for energy over the coming year. However, the situation is volatile and OPEC spare capacity is still very limited, so despite the negative return forecast for commodities overall, we stay neutral for the hedging benefits that the asset class offers against a further deterioration of the situation and the likely negative spillovers of this scenario on our overweight in equities. We see significant downside for precious metals and agriculture on the back of higher real interest rates and increasing inventories under normal weather conditions respectively.

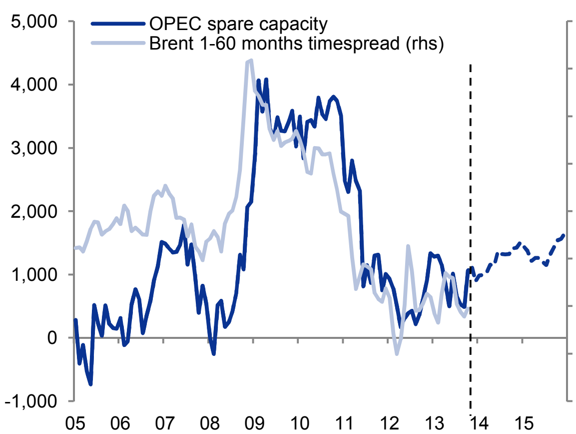
Exhibit 23: S&P GSCI® Enhanced Commodity Index and strategies' total returns forecasts

	Current Weight (%)	2012	2013	2014 YTD[1]	12-Month Forward 12-mo Forecast
S&P GSCI Enhanced Commodity Index	100.0	-0.1	-0.8	7.6	-5.5
Energy	72.6	-1.5	5.6	7.1	-5.0
Industrial Metals	6.3	1.3	-13.0	-0.6	-1.0
Precious Metals	2.6	6.2	-29.7	9.2	-15.0
Agriculture	12.3	5.4	-18.0	7.4	-10.0
Livestock	6.2	-2.8	-2.8	23.8	-3.0

[1] YTD returns through June 20, 2014

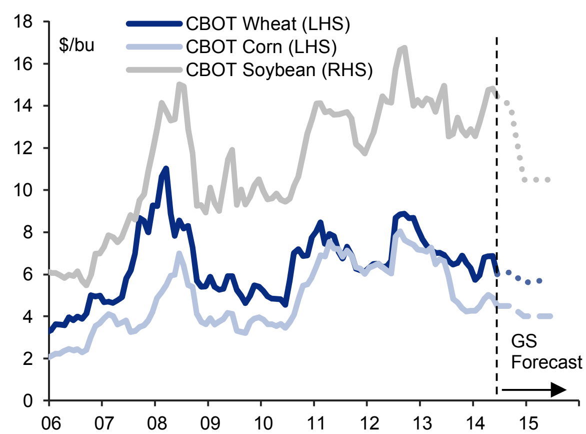
Source: Goldman Sachs Global Investment Research.

Exhibit 24: OPEC spare capacity is low



Source: IEA, Goldman Sachs Global Investment Research.

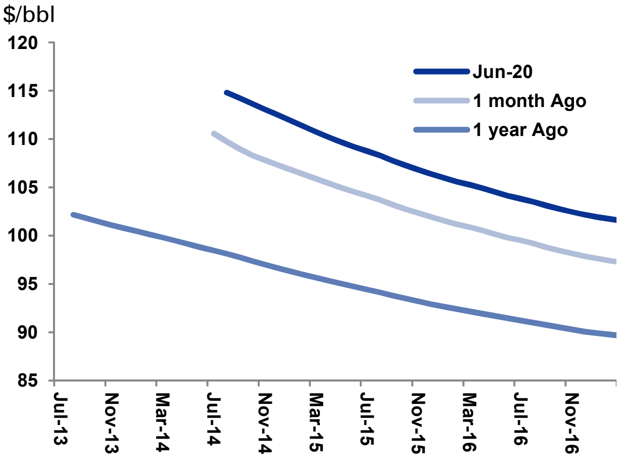
Exhibit 25: We forecast further downside for agriculture



Source: CBOT, Goldman Sachs Global Investment Research.

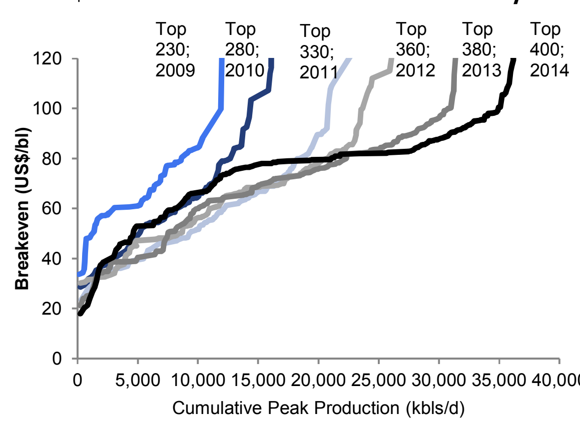
Exhibit 26: IPE Brent forward curves

$/bbl



Source: Goldman Sachs Global Investment Research.

Exhibit 27: The amount of crude oil that can be brought on at $80-100/bbl has increased substantially



Source: Goldman Sachs Global Investment Research.

FX: We expect the euro to weaken vs. the dollar

EUR/USD

We have maintained our EUR/USD forecast at 1.38, 1.34 and 1.30 in 3, 6 and 12 months. Our shift to a more bearish view of the Euro was motivated by ECB commentary which telegraphed that easing was possible given persistently low inflation prints. Easing was subsequently delivered at the June meeting which included a deposit rate cut, fixed-rate TLTRO operations and ending the SMP drain. In addition, the inflation forecast for 2016 was revised down from 1.5% to 1.4%. The combination of expectations of easing and its subsequent delivery has caused EUR/USD to fall by around 4 big figures and we believe further downside in EUR/$ should be sustained by the divergence in monetary policy. One push back we get to our EUR bearish view is the Euro area's strong external balance – namely its large current account surplus and strong portfolio inflows. We do not expect the current account surplus to get much larger and foreign demand for Euro area assets has been very strong since Mr. Draghi's 'Do what it takes speech', therefore it is difficult to envisage an acceleration of foreign demand from here. As a result our thinking remains that ECB easing is EUR negative.

USD/JPY

We expect USD/JPY to trade at 103, 107 and 110 in 3, 6 and 12 months. We expect inflation to soften in coming months likely causing the BoJ to be clearer that QQE will be extended into 2015 and until the 2% price stability target is reached. The prospect of an announcement of extended easing by the BoJ in October would mark a crossover with the end of QE by the Fed and therefore is likely to be an important driver for USD/JPY higher.

EUR/GBP

We expect EUR/GBP to trade at 0.82, 0.79 and 0.79 in 3, 6 and 12 months. Sterling has appreciated notably in recent months on the back of a substantial improvement in activity indicators. This economic strength will likely support capital inflows, which would offset some of the external vulnerability linked to the relatively large current account deficit. Moreover, the market now discounts a notable degree of monetary tightening after BOE governor Carney signalled a shift toward sooner monetary policy tightening last week.

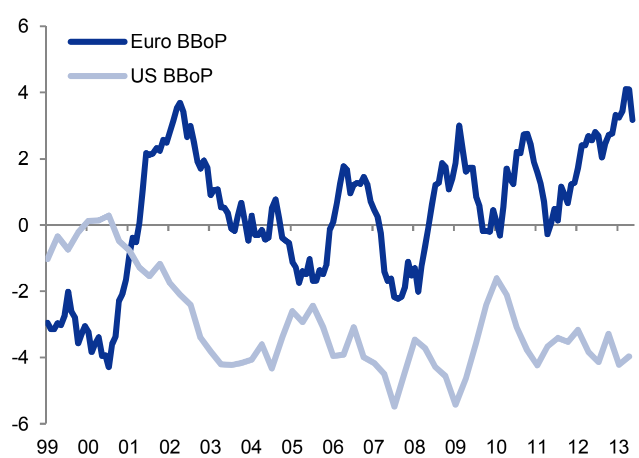
Exhibit 28: Our FX forecasts

		Forecasts		
	Current	3 months	6 months	12 months
EUR/$	1.36	1.38	1.34	1.30
$/JPY	101.93	103.00	107.00	110.00
£/$	1.70	1.68	1.69	1.65
EUR/£	0.80	0.82	0.79	0.79
EUR/CHF	1.22	1.25	1.28	1.28

		Forecasts		
	Current	3 months	6 months	12 months
A$/$	0.94	0.85	0.82	0.80
$/C$	1.08	1.10	1.12	1.14
$/KRW	1020	1010	1050	1070
$/BRL	2.23	2.30	2.40	2.55
$/MXN	13.01	13.00	13.00	13.00

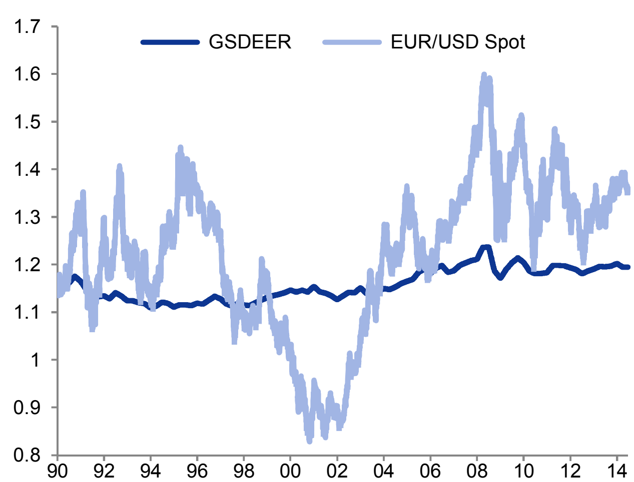
Source: Goldman Sachs Global Investment Research.

Exhibit 29: Euro area BBoP is stronger than the US BBoP



Source: National Sources, Goldman Sachs Global Investment Research.

Exhibit 30: €/$ spot vs. GSDEER



Source: Goldman Sachs Global Investment Research.

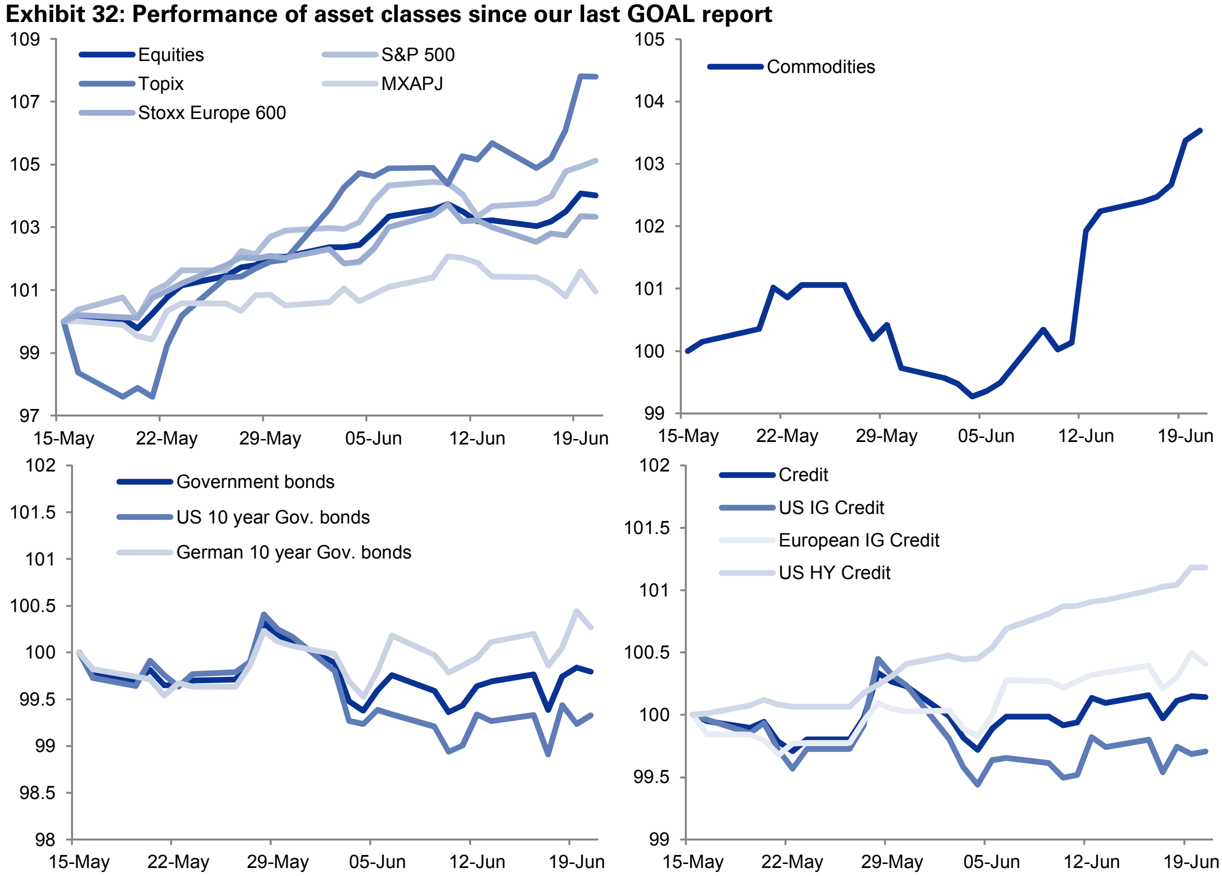
How we construct our asset classes

Exhibit 31: Goldman Sachs 3- and 12-month return forecasts by asset class

Asset Class	Benchmark Weight	3-month Total Return: Local currency	3-month Total Return: In USD	12-month Total Return: Local currency	12-month Total Return: In USD
Equities		**0.4**	**0.8**	**9.4**	**7.0**
S&P 500	40	-1.4	-1.4	3.9	3.9
Stoxx	30	4.3	5.8	14.1	9.0
MXAPJ (in USD)	20	-0.9	-0.9	9.8	9.8
Topix	10	-1.0	-2.0	16.3	7.7
10 yr. Government Bonds		**-5.1**	**-4.4**	**-7.6**	**-9.6**
US	50	-3.6	-3.6	-5.2	-5.2
Germany	50	-6.6	-5.2	-10.1	-14.1
5 yr. Corporate Bonds		**-1.8**	**-1.5**	**-1.7**	**-2.5**
US: iBoxx USD Dom. Corporates	60	-1.7	-1.7	-1.8	-1.8
BAML HY Master Index II	20	-1.6	-1.6	-0.4	-0.4
Europe: iBoxx EUR Corporates	20	-2.2	-0.8	-2.6	-6.9
Commodities (GSCI Enhanced)		**-4.0**	**-4.0**	**-5.5**	**-5.5**
Cash		**0.1**	**0.8**	**0.5**	**-1.7**
US	50	0.1	0.1	0.5	0.5
Germany	50	0.1	1.5	0.5	-4.0
FX		3 month target	Return vs USD	12 month target	Return vs USD
EUR/$		1.38	1.4	1.30	-4.5
$/YEN		103	-1.0	110	-7.3

Source: Goldman Sachs Global Investment Research.

Exhibit 32: Performance of asset classes since our last GOAL report



Source: Datastream, Bloomberg, Goldman Sachs Global Investment Research.

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