Global Equity Outlook 2Q2015:
Preparing for the New Market Leaders

As the equity bull market enters its seventh year, the global economy nears several inflection points and new equity market leaders will likely emerge. In our view, macroeconomic themes, such as diverging monetary policies, the strong US dollar, low oil prices and structural reforms, affect every company’s earnings and stock price in a unique way. Therefore, we continue to differentiate between equities and economies and buy stocks, not stock markets. As the second quarter begins, we have increased our conviction in many of the views we presented at the beginning of the year and are preparing our portfolios for the new market leaders.

Summary of Our Key Views

- We are less bullish on US equities relative to other regions, even as we remain enthusiastic about the US economy, because we think stocks are fairly valued, on average.
- Although Europe’s economic recovery is still fragile, corporate earnings are on the upswing and we think European equities could be too.
- Japan’s economy is showing signs of improvement and stocks of companies that are embracing reform efforts could significantly outperform those that resist change.
- In China, expectations for growth are coming down and so have some valuations, but we think it is too early to get bullish on equities as long as the financial system remains under pressure.
- We continue to be excited about equities in India, even after strong recent performance and ahead of reforms, because we believe a new multi-year earnings cycle is just beginning.
- We remain positive on the Consumer Discretionary sector as we believe consumption has many drivers across regions, especially improving employment, rising wages and lower gasoline prices.
- We have increased our exposure to Financials, which we believe have relatively attractive valuations and could benefit from rising interest rates in the US and renewed loan growth in Europe.
- While the Energy sector has declined sharply, we believe it is still too early to invest broadly. We maintain limited exposure through higher quality companies and could turn more positive later in the year.
- Fundamentals in IT and Healthcare remain strong and M&A activity is likely to continue to be robust, but many stocks are fairly valued or getting expensive, in our opinion.
- We are increasingly cautious on several defensive, higher income sectors, particularly Utilities and REITs, where valuations look vulnerable in light of forthcoming rate hikes.

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As the equity bull market enters its seventh year, the global economy nears several inflection points and new equity market leaders will likely emerge. The US economy has strengthened to the point where the Federal Reserve (Fed) is preparing to raise interest rates for the first time since June 2006. The euro has depreciated to match the European Central Bank’s (ECB) near-zero interest rate and banks are lending again after years of deleveraging. In Japan, inflation is taking hold, wages are rising and consumption may be about to pick up. India’s re-accelerating GDP growth will likely eclipse China’s slowing growth rate this year. In our view, the macroeconomic themes behind many of these changes—diverging monetary policies and currencies, low oil prices and structural reforms—affect every company’s earnings and stock price in a unique way.

A Strong Dollar, Cheap Oil Kind of World

The effect of diverging monetary policy on currencies is becoming more pronounced and we are increasingly focused on the impacts of a strong US dollar. With the Fed on the cusp of raising rates and the Bank of Japan (BoJ) and ECB still in easing mode, the US dollar has continued to strengthen against the yen and especially the euro, where the exchange rate is approaching parity. The weak currencies are a boon to Europe and Japan, both of which have many export-oriented companies which are beginning to report the positive effect on their earnings. In the US, the strong dollar is likely to be good for consumption, which is critical for the US economy because it accounts for roughly 70% of GDP.1 However, corporate earnings are increasingly likely to reflect the negative effects of a strong currency. While the immediate effect of currency translation may be a near-term hit to earnings, we are more concerned about competitive disadvantage, which can have longer-term consequences.

1 World Bank data, 2010-2014

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Even when a portfolio’s sector or country weightings are similar to the broader market, a closer look may reveal differentiation through concentration, market-cap, quality or many other characteristics.

Just as the dollar looks likely to stay strong, we believe oil prices are unlikely to rise soon because even the substantial capital spending (capex) cuts already announced will have a limited effect on supply in the next few quarters. Like the strong dollar, low oil prices can have a mixed effect on economies. Generally, consumers and manufacturers will benefit from cheaper fuel and energy costs, but the US also has a large energy industry and many companies with energy-related businesses have been reducing earnings estimates. Big oil importers like Europe, Japan, China and India are benefitting from lower energy prices. However, while the deflationary impact is a potential risk for Europe and Japan, it is a blessing for India. Oil exporters like Russia and Brazil may continue to be negatively impacted.

**Structural Reforms: The Road Sometimes Taken**

Structural reforms—or the lack thereof—continue to impact equity markets and influence our views. Much of our bullish outlook on India stems from the belief that important changes are coming, whereas our caution on China reflects concerns about the lack of transparency and speed at which some reforms are moving. Brazil missed a chance to make bigger reforms during the commodity price boom, which is hindering its economic recovery in the aftermath. Skepticism about the abilities of Europe and Japan to execute on necessary reforms has held back both their economies and equity markets. Europe still has big issues to tackle, but has made important progress with its banking system. Japan is making a renewed effort at reform with Abenomics.

Industries also face periods of structural change. The banking system reforms in the US and Europe strengthened banks’ balance sheets and instilled confidence again, which contribute to our more positive view on financial stocks. Now, the energy industry is seeking ways to reduce a structural oversupply of oil. Capex and production cuts are a start and many companies may further restructure themselves to be profitable in a world with lower oil prices. These changes will take time, hence our continued cautious approach to investing in energy stocks.

**Differentiating Equities From Economies; Selecting Stocks, Not Stock Markets**

Naturally, we believe new equity market leaders are likely to emerge from the changing macroeconomic landscape. But the best performing stocks and stock markets may not necessarily be in the countries or industries with the highest growth, and yesterday’s laggards are not always ready to be tomorrow’s leaders. Furthermore, earnings multiples have crept up, leaving few bargains. We think global equity returns for the year will be slightly below their 8-10% long-term average,² which we once again believe will compare favorably with other asset classes.

We believe earnings growth will become an increasingly important driver of stock performance because multiples have already expanded. In addition, the sometimes offsetting or contradicting effects of macroeconomic conditions will make top-down calls more difficult, but we believe the true impact will be revealed in corporate earnings.

In our view, more expensive equities, lower return expectations and offsetting macro influences create a stock-picker’s market and one in which portfolios that outperform may look very different from the broader market. Even when sector and country weightings are similar, a closer look may reveal differentiation through concentration, market-cap, quality or many other characteristics. Last year was once again challenging for most active managers, especially in the US, but we think that is about to change.

² Source: MSCI data from Datastream based on total return for MSCI ACWI from 1988 and MSCI World from 1970

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Active managers have historically outperformed in lower return environments

% of US Large Cap Core managers outperforming the S&P 500 Index in different return environments (Rolling 3-year annualized returns, measured quarterly over the last 25 years)

Source: eVestment, as of December 31, 2014. The chart reflects 89 total observations of 3 year annual returns of the S&P 500 measured quarterly against the US Large Cap Core Universe.

Key Regional Views

US: Not So Easy Anymore

We are still enthusiastic about the prospects for US economic growth but we are now the least bullish on US equities that we have been in several years. The economy picked up through 2014, posting GDP growth of 2.4%, well ahead of most developed market economies, while unemployment fell to 5.5%, the lowest since 2008. US equities also outperformed in 2014 and the S&P 500 Index continues to mark new highs. Currently, the index is trading at the higher end of its historical multiple range, with some parts of the market outright overvalued, in our opinion. At the same time, earnings estimates for the US market in aggregate have come down due to the negative effects of a strong dollar on global businesses and lower oil prices on the energy industry.

The S&P 500 is trading at the high end of its historical price-to-earnings (P/E) multiple range

Source: Factset, as of March 31, 2015

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3 Consensus estimate from Bloomberg, as of March 15, 2015
4 US Department of Labor, Bureau of Labor Statistics, as of February 2015

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While we still believe that fundamentals are strong and that equities have a number of drivers, it is time to become increasingly selective. We are focusing our portfolios around stocks with earnings growth, as we do not expect further multiple expansion. We are also investing in companies that could benefit from (or not be adversely impacted by) rising interest rates, a strong dollar and low oil prices. Easy monetary policy has not been so easy for bank stocks, which tend to make money as interest rates and net interest margins (NIM) rise. However, with the Fed signaling that it is likely to raise rates in June or September, we believe large banks, which look attractively valued in a relatively full-priced market, will benefit.

Yet many stocks that offer investors high income could be negatively impacted by a rising rate environment. Low interest rates and low bond yields in the last several years have sent investors looking to equities for income and pushed up valuations. REITs and Utilities have been among the best performing sectors of the market and are now trading at much higher valuations than we think they deserve as highly regulated businesses. Many stocks in the Consumer Staples sector and pharmaceutical industry have also appreciated due to their relatively high yields. Our approach focuses on companies that have the ability to increase their dividends because they have lower payout ratios and growing businesses. We are cautious on those companies with already high payout ratios and limited growth prospects, which now look expensive.

Equity yields have come down with higher stock prices, but they are still greater than bond yields

If investors have not been chasing yield, they were likely chasing growth. As a result, we believe some fast-growing internet and biotech stocks are forming pockets of excess in the US market and are highly selective in our investments in these areas.

We are increasingly concerned about the effect of the dollar’s strength on US company earnings. While translation effects may present a near-term headwind, we are more concerned about longer-term competitive impacts. We are actively looking for ways to mitigate currency risk and think strategically about what a strong dollar and weak euro/yen mean for companies in the longer term. This includes looking at companies with very US-centric businesses, which are often small- or mid-cap companies, carefully analyzing a company’s immediate and longer-term impacts from currency, including its hedging strategy, and in some cases increasing the use of American Depository Receipts (ADRs), which enable US-based investors to more easily hold shares in non-US companies.
Europe: Exceeding Expectations
We are now increasingly bullish on European equities in light of several positive developments and building momentum. Europe’s economy is expected to grow 1.1% this year, an improvement from roughly 0.8% in 2014 and contraction in 2013. This modest growth could have an outsized impact on corporate earnings growth, given the potential for operating leverage with increasing revenues.

We believe the ECB’s easy monetary policies should encourage growth, inflation and a weak euro, all of which Europe needs to recover. The central bank’s most recent announcement of quantitative easing (QE) in January managed to exceed high consensus expectations and has been particularly helpful for the peripheral countries. So far, the ECB’s policies to repair the banking system appear to have been effective. Following the extensive Asset Quality Review (AQR) stress tests and targeted long-term refinancing operation (TLTRO), Europe’s banks are adequately capitalized and loan books grew for the first time in 4Q2014 after years of deleveraging. Banks’ willingness to lend and companies’ desire to borrow is important for growth.

Importantly for equities, earnings growth is already gaining momentum. For 4Q2014, companies (excluding Financials) reported an 11% increase in earnings from a year ago (earnings were up 32% including Financials). In addition, for the second quarter in a row, more companies beat earnings and revenue estimates than missed them. Part of the reason is that earnings are coming off of a low base and low expectations. However, year-over-year earnings comparisons are now hugely benefitting from the more than 20% drop in the euro versus the dollar since early 2014.

European earnings are gaining momentum
US and Eurozone upward to downward earnings revisions

But the European story is not without risks. Politics are becoming more populist as voters are frustrated with the slow pace of economic recovery and veer toward both the left and the right. The opposition party’s election in Greece has already re-opened debate about the fate of the European Union (EU). The UK and Spain also go to the polls this year, which may create noise around elections and likely keep markets more volatile. In addition, longer-term structural issues loom for Europe regarding the state of the EU, economic growth and expensive social systems.
Japan: Higher ROEs Could Drive Equity Returns Higher

Japan’s economy appears to be stabilizing and could improve further with the BoJ’s continued easy monetary policy, the weak yen and low oil prices. However, we are even more excited about the prospects for Japanese equities, which have drivers beyond macroeconomic improvement.

Boosting growth and inflation are among the key initiatives of Abenomics, and both the government and BoJ have provided substantial economic stimulus. As a result, the yen has depreciated against the dollar and other regional currencies such as the Korean won and Chinese renminbi, and is helping Japan’s many export-oriented companies become more competitive. In addition, the increase in exports combined with low oil prices is beginning to have a strong positive impact on Japan’s trade deficit. And while inflation looks like it will fall short of the central bank’s 2% target, largely due to low oil prices, real wages are starting to rise and we believe continued increases could drive more consumption. Last April’s consumption tax hike dampened spending in the second half of the year so much that a second hike planned for this year has already been postponed. We believe a number of favorable comparisons in spending and corporate earnings will emerge after April.

But the real boost to equities may come from corporate profitability, which has significantly improved, and from earnings growth of potentially 20% this year.8 The increasing profitability of Japanese companies has several drivers. The weak yen is making Japanese exports more competitive, while at the same time, sales in foreign currencies translate to higher revenues in yen for many companies. But Japanese corporations have also been cutting their cost structures for years, making them well-positioned to reap the benefits of increasing sales.

Importantly, profitability is also increasing because of corporate reforms proposed by Abenomics. Specifically, the reforms are intended to increase management and shareholder focus on return on equity (ROE), a measure of corporate profitability on which Japan has historically lagged its developed market peers. The Abenomics reforms also seek to improve corporate governance and shareholder value, areas where Japanese companies have earned a poor reputation. Now, as companies shift to a growth mentality with a focus on profits and shareholders, they are more willing to spend some of the high levels of cash on their balance sheets. Already last year, shareholders benefitted from a 33% increase in positive dividend revisions and a 93% increase in the value of share buybacks.9 However, our meetings with company managements reveal that not all companies are embracing the new mind-set, making it even more important to differentiate on a company-by-company basis.

Japanese corporate profitability is rising, relative to the rest of the world

Japanese ROE vs. World ROE

Source: Thomson Reuters, Credit Suisse Research, as of March 27, 2015. World ROE based on Datastream World Markets Index.

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8 Goldman Sachs Global Investment Research, Japan Weekly Kickstart, March 27, 2015

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Lastly, increasing allocations to Japanese equities could have a meaningful impact on the stock market. Years of economic disappointment and deflation have made equities unpopular with retail investors. However, if an inflationary mind-set and corporate reforms take hold, investors may begin to shift assets into equities. Furthermore, Japan’s Government Pension Investment Fund (GPIF), which is the largest pension fund in the world, announced last year that it would increase its domestic equity weighting to 25% from roughly 17%, and we believe many other funds could follow suit.

And yet equity valuations are still inexpensive relative to their own history and other markets. Japan’s spotty track record on making reforms and revitalizing its economy are partly to blame. The country also has longer-term structural issues to deal with such as an aging population and high levels of debt. In the near term, however, we are biased toward increasing our exposure to Japan through companies that are shareholder oriented and will run their businesses profitably.

**Australia: Concentrating on Stocks and Sectors We Like**

The economic environment in Australia continues to be challenging, with unemployment still rising while industrial profits and consumer spending are stagnating. The good news is that the central bank is responding and cut rates earlier this year to 2.25%, a low level for Australia. We also believe that the depreciating Australian dollar should help tourism, exports and domestic companies with foreign competition.

Currently, our portfolio is the most concentrated it has ever been because we are quite cautious on a number of areas of the Australian equity market. We are as underweight as possible in the resources sectors because we believe there is a structural oversupply. We are also significantly underweight REITs, Utilities, Telecommunications and Consumer Staples due to their valuations and limited growth prospects.

### Valuations for the developed markets in aggregate are now higher than average

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<tr>
<th></th>
<th>CAPE level</th>
<th>% time cheaper</th>
<th>One Year Forward PE level</th>
<th>% time cheaper</th>
<th>Price/Book level</th>
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Source: GSAM, Datastream, as of March 31, 2015. Cyclically adjusted price-to-earnings ratio (CAPE) calculated using US inflation and a five-year rolling window to smooth earnings. All based on MSCI country indices. Totals calculated using MSCI World Index (for Total Developed Markets) and MSCI Emerging Markets Index (for Total Emerging Markets). All “% time cheaper” data is based on full sample history for each country. Start dates vary.

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10 Government Pension Investment Fund (GPIF), October 30, 2014

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EM: Neutrally Weighted But Still Opinionated

We maintain a neutral stance on emerging markets (EM) versus developed markets. Within EM, we express most of our views at the stock level, where we believe we have an edge in alpha generation. As a result, sometimes our country weightings are in line with our view on economies, sometimes they are not.

In most regions, we continue to have less exposure to state-owned enterprises (SOEs) because we are concerned about government influence, inefficiency and a generally poor allocation of capital.

SOE profitability is lower than non-SOE profitability and is getting worse

Our unfavorable view on SOEs, which account for 29% of the MSCI Global Emerging Markets Index, spares us more capital to add names outside of the benchmark, further differentiating our portfolios from standard indices and amongst the peer group.

An industry we do like is stock exchanges, and we own shares in a number of countries. These capital-light companies have virtually 100% conversion of earnings to cashflow, and attractive valuations with 4-7% cashflow yields. They also tend to be monopolies and largely insulated from competitive pressures. By contrast, we struggle to find attractive opportunities in telecommunications because we believe the industry is very competitive and has high capital needs yet does not generate adequate returns on that capital.

We continue to see challenges for the many commodity-exporting EM countries, yet we still look for attractive investments in them. For example, we believe Russia’s economic outlook is poor and that the equity and currency markets will continue to be volatile in light of low oil prices, politics and the continuing conflict with Ukraine. In addition, Russian companies face very high refinancing costs in the domestic market because sanctions have blocked access to the cheaper financing available in international markets. The Russian companies we own either generate cash or have strong balance sheets that do not require additional capital.

Overall, we believe that the commodity-importing countries will continue to benefit from commodity price weakness and maintain positive views on Indonesia and the Philippines, where the economies and governments are working well, particularly compared with many other EMs.

Since our last outlook, we are more bullish on Indian equities and more cautious on Chinese equities, which present interesting contrasts between two of the largest EM economies and markets.

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India: More Good Times May Be Coming for Equities
A year ago, India’s now-ruling BJP party campaigned with the slogan, “Good times are coming.” Just the idea of a new reform-minded government that might be able to jumpstart India’s economy sent the equity market soaring. Almost a year later, the government appears committed to reforms and we believe the new budget presented at the end of February is the most progressive since 1991, when sweeping changes were proposed. Importantly, India is placing a big focus on reforms to improve the ease of doing business, which is a structural necessity for accelerating the economy and corporate capital spending, in our view. Other initiatives emphasize investment in infrastructure and industrial projects, which should also help kickstart the capital spending cycle from the low point reached last year.

India’s GDP is expected to grow roughly 8-9% in 2015 and 2016, which is one of the highest growth rates worldwide. As the fourth-largest user and importer of oil in the world, India is a huge beneficiary of lower oil prices, which are also helping tame the country’s high inflation rate. Lower inflation has already allowed the central bank to begin cutting rates, in an effort to support economic growth. In this improving economic environment, we believe businesses exposed to the domestic economy, such as industrial, consumer discretionary and financial companies have stronger prospects.

After a sharp rally last year, the equity market is trading slightly above its historical average. However, we believe that earnings growth in India could accelerate to around 20% in the next few years, which is one of the fastest rates of any market and well above India’s long-term average of 14%. In this context, current valuations look reasonably attractive and we maintain our bullish outlook for Indian equities.

China: Increasingly Cautious as Challenges Continue
China’s economic growth continues to slow and the official GDP target is now below 7%. While we do not believe that the economy is on the verge of a crisis, several recent events are making us more cautious. First, bottom-up signals such as power consumption, diesel consumption and the property market suggest lower growth than the official numbers. In addition, our conversations with banks suggest that the government’s efforts to stimulate lending may not be working, as they seem willing to lend only to state-owned enterprises (SOEs). Lastly, the property market is still oversupplied and falling prices are dampening the urgency to buy.

Given our concerns about the economy and especially the financial system, we are increasingly cautious on the Chinese equity market and very selective in our positioning. We have limited exposure to banks and to SOEs in general, where we are skeptical of the profitability and the fundamentals are weak. As a result, we also have less exposure to the industrial economy.

However, we are well-exposed to consumer-oriented stocks in the Staples, Healthcare, IT and Discretionary sectors. We also like stocks outside of China that benefit from Chinese consumption, such as personal care and travel-related companies in countries including Korea, Taiwan and Thailand.

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11 Indian government estimate in February 28, 2015 budget
12 US Energy Information Administration, data as of end 2013 (latest available)
13 GSAM estimates, as of March 2015

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Key Sector Views

Few sectors look cheap, relative to their histories

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<thead>
<tr>
<th>CAPE level</th>
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<td>15.5</td>
<td>27%</td>
<td>16.3</td>
<td>73%</td>
<td>2.0</td>
</tr>
<tr>
<td>Telecoms</td>
<td>15.9</td>
<td>39%</td>
<td>16.5</td>
<td>61%</td>
<td>2.4</td>
</tr>
<tr>
<td>Utilities</td>
<td>17.0</td>
<td>61%</td>
<td>15.7</td>
<td>75%</td>
<td>1.6</td>
</tr>
</tbody>
</table>

Source: GSAM, Datastream, as of March 31, 2015. Cyclically adjusted price-to-earnings ratio (CAPE) calculated using US inflation and a five-year rolling window to smooth earnings. Based on MSCI sector indices. All "% time cheaper" data is based on a sample history that starts in 1994.

Consumer Discretionary: Starting to Spend

Consumption still has not picked up to the level we would have expected by now, but conditions for the consumer continue to improve across many regions. We maintain our positive view on the consumer and our exposure to the Consumer Discretionary sector, with a bias toward retail, e-commerce and luxury goods. Lower gasoline prices, a much healthier labor market in the US and rising wages in Japan bode well for consumers in both countries. Although credit card companies are reporting that consumers are still paying down some debt, we are seeing some evidence of increased spending in the US, particularly from lower end consumers, and in restaurants and auto sales. Consumption in Japan has remained weak but we believe spending trends will look healthier than a year ago as the anniversary of last year’s consumption tax hike passes in April.

Currency movement is also affecting consumer behavior. Already, US and Chinese consumers are traveling and spending in regions with weaker currencies, such as Europe and Japan. For example, spending by Chinese consumers was up 50% globally, with sales to Chinese citizens in Europe up 22% in January.14 Consumption by tourists in Japan has also been increasing, particularly for cosmetics, pharmaceuticals, restaurants and hotels. Therefore, even without strong domestic demand, European and Japanese companies may still increase revenues.

We are generally more cautious on the EM consumer, given the impact of fluctuating currencies and commodities, and are positioned more toward consumer staples rather than discretionary spending. However, there are a few exceptions. Indonesia, which is already benefitting from lower oil prices, is about to hit an inflection point in discretionary spending as GDP per capita approaches the level where consumption typically takes off.15

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14 Global blue tax rebate data, January 2015
15 World Bank, GSAM, The Rise of the BRICs and N-11 Consumer, December 3, 2010

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Financials: They’re Back

After years of deleveraging, low interest rates and a lot of new regulation, banks’ balance sheets, net interest margins (NIM) and valuations have shrunk. Now, we believe they may be set to increase again, which makes us even more positive on banks. US banks have been in better shape than their European counterparts, but shares prices have been held back by both regulatory uncertainty and low interest rates. We expect about 10% earnings upside for banks with the first 100 bps increase in the Fed funds rate. Furthermore, we believe they will increasingly be allowed to return more capital to shareholders. In a relatively full-priced market like the US, banks and other financial stocks are among the more attractively valued.

European banks hit a milestone in 4Q2014, when loan books grew for the first time since the financial crisis. We have been tilted toward the peripheral banks, which are benefitting from low funding costs associated with QE. We also prefer smaller banks with simpler business models, which have fewer additional costs associated with cross-border regulation and complexities.

In the last quarter, corporate lending in Europe turned positive for the first time since the financial crisis

While Japanese bank stocks have done well by increasing dividends and share buybacks, we are cautious on many other Asian financials. We are underweight banks in Korea, China and Taiwan, where we have concerns about pressure from their governments. We also find many Chinese financial stocks to be fairly valued after a sharp rally following an interest rate cut late last year and have decreased our exposure. Indonesia is one exception, as we believe banks have growth opportunities as credit penetration increases from low levels. In addition, Indonesian banks are involved in infrastructure development by financing many public-private partnerships.

Energy: Still Digging Out

Energy stocks look cheap on many metrics but we believe it is still too early to invest broadly across the sector and are sticking with limited investments in higher quality companies. While US companies have announced a 25% cut in capex, there is a relatively long lag before oil production actually slows. European companies have less ability to cut capex this year due to projects already underway but will likely be announcing more cuts in 2016. In addition, our recent conversations with several Middle Eastern institutions suggest that they are not feeling pressured by current prices and that countries in the region are continuing to increase capacity and production. As a result, oil prices could stay lower for longer. We estimate that global oil production will peak around the second or third quarter of this year and that prices will average around $50-60 through next year.

16 GSAM estimate

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Despite big capex cuts announced late in 2014, production is still increasing and should peak before the end of 2015

Incremental Global Oil Supply Capacity & Demand (mn bpd) – Q/Q & Y/Y

Despite big capex cuts announced late in 2014, production is still increasing and should peak before the end of 2015. We could become more positive on energy stocks after production peaks later this year and when the market has had a chance to digest secondary equity issuance. We acknowledge that energy stock valuations have come way down but there are still some near-term risks. First, exploration and production (E&P) stock prices have not come down as much as the commodity price, which typically happens during the cycle. Second, many companies are issuing more equity to reduce high levels of leverage, which is likely to pressure stock prices in the near term. Stocks of oil services companies have fallen more than E&P companies and may be close to a bottom. They could have good operating leverage when production starts to grow again, with the best opportunities likely in companies involved in simpler projects rather than deep water, where we are skeptical that margins will ever get back to previous heights. However, in the near term, we prefer to wait until we believe oil production and prices are closer to stabilizing, if not recovering.

Healthcare/IT: Growth at a High Price

Many Healthcare and IT stocks are fairly valued or getting expensive, in our opinion. However, unlike some of the other expensive sectors, we acknowledge that fundamentals are still strong and we believe more M&A activity could be coming, particularly in Healthcare as companies seek to extend their pipelines and have a lot of cash to spend. We are avoiding some of the extremely high-priced internet and biotech companies, which we believe may have priced in growth expectations that might never be achieved. Biotech stocks also face the looming threat of biosimilars, which are essentially the generic versions of biotech drugs. While there are numerous hurdles for biosimilars to clear before hitting the market, they could alter the competitive landscape by the end of the decade.

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Utilities & REITs: Wrong End of Rising Rates
We are cautious on Utilities and REITs, particularly in the US, as valuations look extremely vulnerable in light of forthcoming rate hikes. While this view proved premature last year, we believe the case for limiting exposure is even stronger now. In the case of Utilities, we have concerns about the structural issues such as high regulation and low growth prospects for the sector, in addition to the current valuation. REITs face a cyclical challenge from the rising interest rate environment. As such, we attempt to manage this risk through security selection in our income-oriented portfolios, where REITs are still relatively attractive versus other assets. We prefer hotel or apartment REITs, which tend to have shorter lease terms and less sensitivity to rising rates rather than mortgage or healthcare REITs, which generally have longer lease terms and are very sensitive to interest rate changes. While these high yielding sectors may underperform broader equity markets, we believe they may still be attractive for income-oriented investors because they are likely to outperform bonds.

Conclusion
Some current macroeconomic conditions have been a long time in the making, such as the imminent interest rate hike by the Fed and Europe’s economic recovery. Others events, such as the sharp drop in oil prices, caught most investors by surprise. Expected or not, any of these and other macroeconomic factors could have a completely different effect on companies, even within the same sector or region. Therefore, we continually evaluate each company’s earnings potential and share price in light of changing near- and long-term conditions.

We constantly challenge ourselves to select individual stocks, regardless of our view on an entire stock market, and to be objective about a country’s equity market prospects versus its economic ones.

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