



2018 Investment Outlook

MACRO & MARKET VIEWS

Weathering Heights: We expect the global expansion to continue in 2018 and to carry global equities to new highs. However, we anticipate more risks along the way as markets will need to navigate a deceleration in the pace of growth, central bank tightening and the potential for renewed China fears.

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A moderating expansion in 2018

We think the global expansion will continue, but at a more moderate pace in 2018.

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Valuations: Not a strong concern for now, except in government bonds

Relative to macro conditions, we think government bonds are the misvalued asset.

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Central bank tightening finally starts to matter in 2018

We think central bank tightening will be a catalyst for volatility.

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Navigating the forces of disruption

Consumer cyclicals look ripe for disruption in 2018, followed by autos.

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What's hidden in the big data?

The subtle and often overlooked connections between companies in today's world.

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Bottom Line

In equities, we are looking beyond benchmarks and beyond borders for value. In fixed income, we find opportunity in emerging markets and relative value.

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Weathering Heights

We expect the global expansion to continue through 2018 and to carry global equity markets to new highs. However, the macro environment is likely to create meaningful risks along the way. We expect more volatility and see enhanced value from a dynamic investment approach.

New highs as global expansion continues at a more moderate pace...

We expect the global expansion to continue through 2018 though at a moderating pace (Page 6). This would make the US expansion the second longest on record and closing in fast on the record-long expansion in the 1990s. We believe equities can climb to new highs in this environment, and we continue to prefer equities over credit and credit over rates (Page 5). This ranking reflects our view of the relative attractiveness of these asset classes from a valuation perspective, as well as our read of the economic data, which suggests that the economic and market cycle has yet to fully mature.

...but more risks to navigate along the way

2017 has been a remarkably benign environment for equities, with a broadening global recovery, interest rates remaining well-anchored and many of the political concerns at the beginning of the year gradually fading. As a result, we are now about a month away from the S&P 500 breaking a 66-year record of the longest stretch without a drawdown of at least 5% (Exhibit 4). The benign environment is reflected in prices, and even though we expect new peaks from here, the pace of return is likely to be much more moderate. We also expect meaningful drawdowns along the way as the economy and markets navigate an increasing number of potholes. In our view, the combination of lower returns and greater risks makes a dynamic approach more appropriate.

Risk 1: A moderation in the pace of global expansion

Global growth has reached a pace that, in our view, is unlikely to be sustainable. Risks are broadly skewed to the downside, though the reasons vary across regions—from the risk of overheating in the US, which could encourage more abrupt tightening, to less monetary and fiscal support in Europe and less growth-friendly policies in China

(Page 6). We would not position for this moderation before more tangible signs show up in high-frequency data, but we do anticipate that slower growth will be accompanied by higher volatility. Emerging Markets (EM), outside of China, are a bright spot and we expect EM economies to outperform in 2018, widening the gap between EM and Developed Market (DM) growth rates.

Risk 2: Central bank tightening starting to matter

2018 is likely to be the year where the shift towards less accommodative monetary policy starts to matter. In the US, financial conditions have eased and the decline in unemployment has accelerated (Exhibits 3-4). We believe the Federal Reserve (Fed) will need to continue to tighten policy to avoid more serious overheating. If growth does not slow, the path of tightening could be even steeper. In Europe, quantitative easing (QE) is likely to provide ongoing support for the economy, but we would expect the very long-end of the curve to continue to rise, reflecting the fact that the European Central Bank (ECB) is also on the path towards the exit. We are bearish on duration and see government bonds as the most misvalued asset (Page 7). A more abrupt shift in the market outlook for monetary policy also represents a high risk for equities in 2018. That said, our analysis suggests that equity markets should be able to withstand 10-year US yields rising to around 3%, without triggering a more sustained sell-off.

Risk 3: China fears

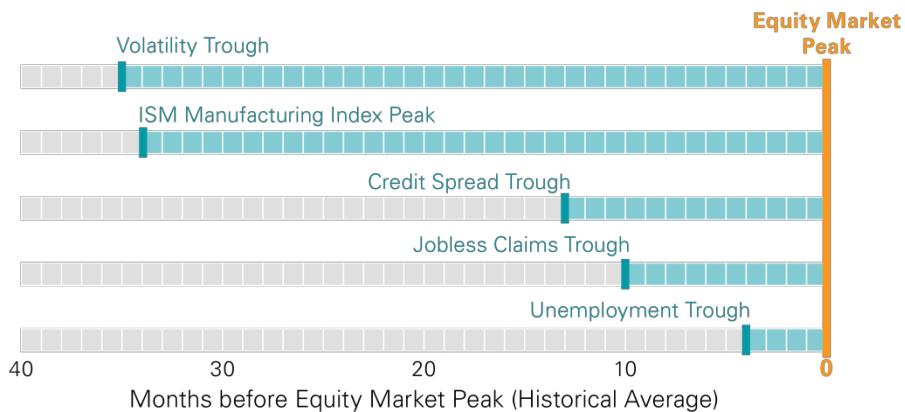
This year saw a remarkably swift change in the market's perception of China. We continue to believe that China can avoid a hard landing in the next few years, but a moderation in policy support following the recent Party Congress is more likely than not. If this or a less favorable external environment were to cause a moderation in growth, perception could quickly swing again, exposing still large debt levels and an expanding fiscal deficit. A shifting policy focus elevates the risk of a sell-off, although it would likely be temporary. We continue to strategically favor EM over DM.

Other risks: Geopolitics, Trump policies and upside surprises

On the downside, we worry about geopolitics, in particular North Korea, and US trade relations. On the upside, market expectations for growth-friendly policies from President Trump have now declined to an extent where we see room for an upside surprise. Global growth at the current pace could also prove to be more sustainable.

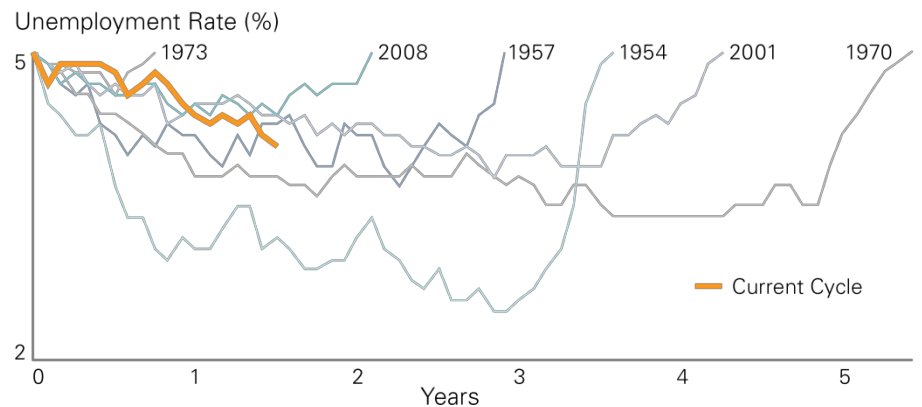
Charts that Matter

Exhibit 1: History suggests the US equity bull market still has time to run...



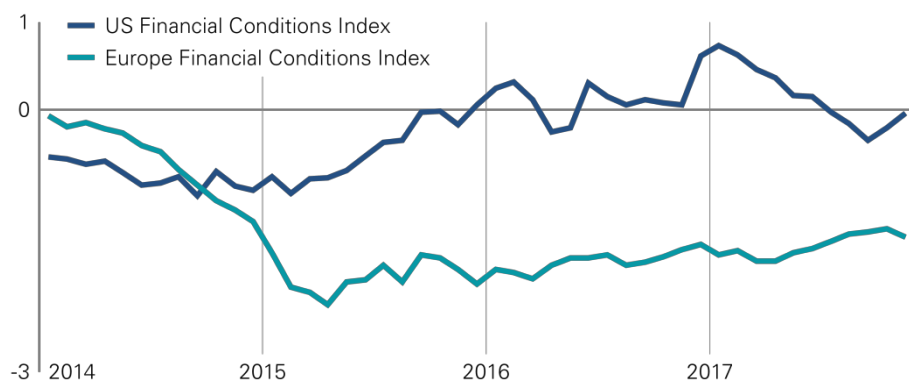
Source: GSAM. As of November 2017. Based on S&P 500 from January 1960 through December 2007.

Exhibit 2: ...but falling unemployment puts the US at risk of overheating



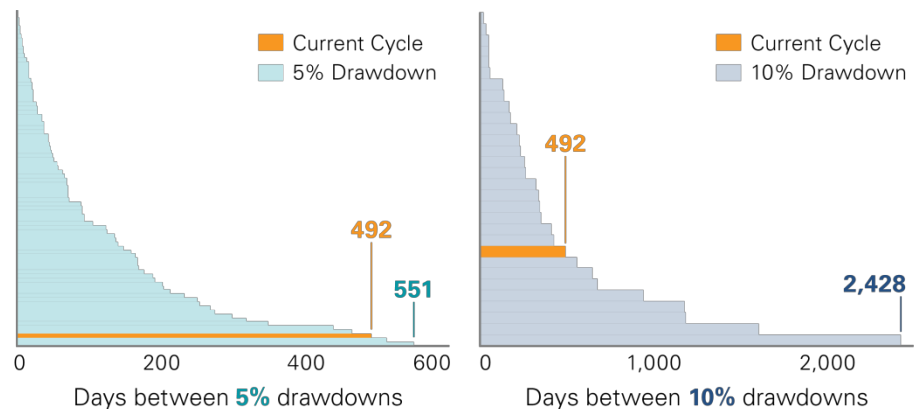
Source: Bloomberg, GSAM. As of November 2017.

Exhibit 3: Financial conditions may be too easy in the US, too tight in Europe



Source: GSAM. As of November 2017.

Exhibit 4: Policy tightening could drive temporary drawdowns in US equities



Source: Haver, GSAM. Based on S&P 500 daily data from January 2, 1952 through November 15, 2017.

Macro Outlook Summary

Growth

We expect the global expansion to continue but at a more moderate pace. In the US, this is due to a lack of spare capacity. In Europe, the monetary and fiscal factors supporting growth are becoming less powerful and, in China, policymakers might rebalance their focus somewhat away from growth and towards addressing imbalances after the 2017 party congress. EM economies, outside of China, are a bright spot and we expect the EM vs DM growth gap to continue to widen, supporting performance of EM assets (Page 5).

Inflation

We think the soft patch in US inflation this year will prove temporary. We do not expect a rapid acceleration in inflation in 2018. Importantly, we think the main impact of inflation on asset prices will run through monetary policy and given the tightness of the US labor market, we think the inflation bar is fairly low for policy tightening to continue. In Europe, we expect inflation to be more muted and for any surprises to have relatively little market impact given the still large undershoot relative to target.

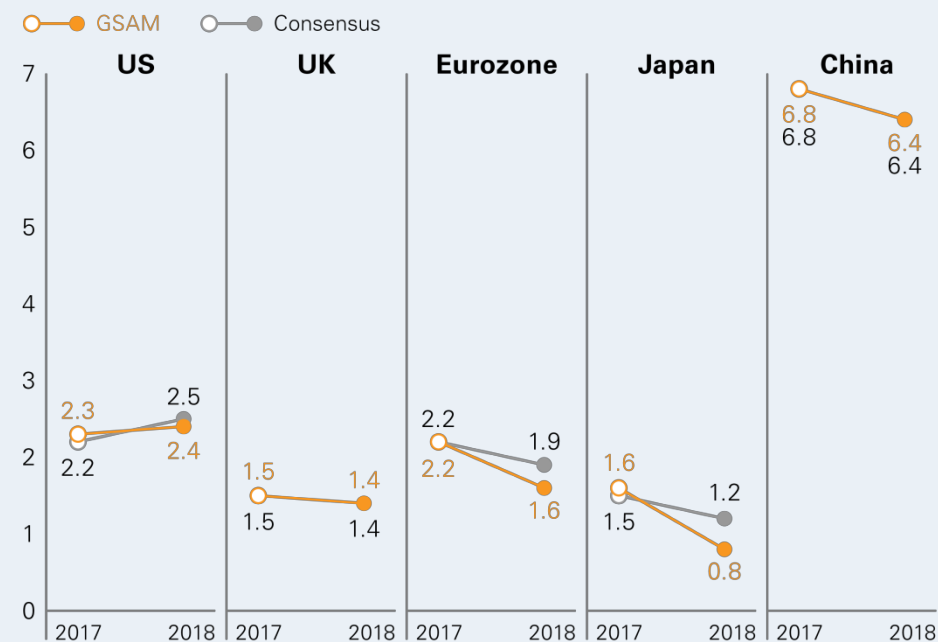
Monetary Policy

We expect the tightening of monetary policy to start to matter in 2018. The slow and well-advertised transition out of QE programs is likely to have a limited impact. We expect the main impact to come through a significantly faster pace of Fed hiking than the market is expecting. This will likely lead to pressures on bonds and there is a significant risk that it could be a source of temporary broader market volatility. Outside of bonds, we think the most persistent effect will be dollar strength (Page 8).

Politics

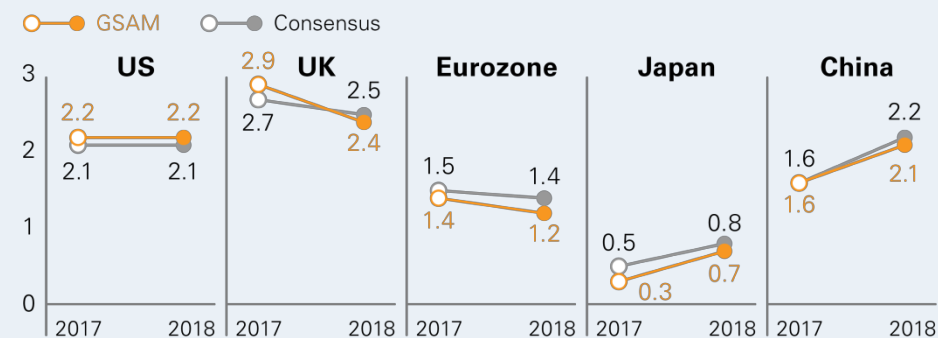
In the US, expectations for President Trump's ability to implement his policies are so low that we think there is room for surprises. We think markets have already adjusted to reflect the probability of tax reform but increased deregulation is a potential source of upside surprise. A deterioration in US trade policy is a risk. North Korea and geopolitical risks more broadly remain a factor, but are not something we would position for at this point. In Europe, we expect Brexit to mainly impact the UK economy, with only muted spillovers to the Eurozone.

Growth Forecast (%)



Source: GSAM, Bloomberg. As of November 2017.

Inflation Forecast (%)



Source: GSAM, Bloomberg. As of November 2017.

Market Views

We prefer equity over credit, and credit over rates as we think the expansion has yet to fully mature. We prefer EM relative to DM.

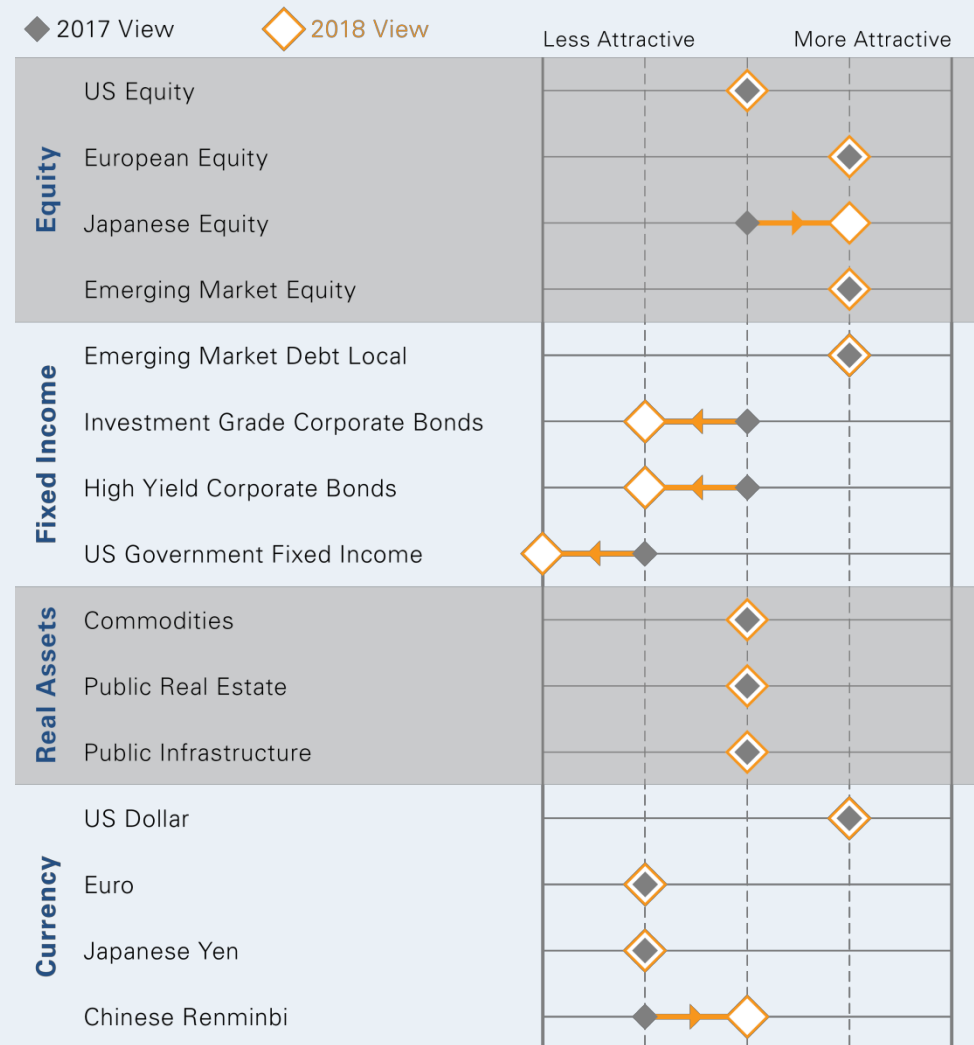
Moderate but positive returns in equities. Equities remain our preferred asset class. After the run-up this year and given the potholes that need to be navigated, we expect only moderate, but positive returns supported by the continuing expansion and earnings strength. Within DM, we prefer Europe and Japan, where relative valuations are supportive and leverage to the global cycle and the rebound in global investment spending is greater than in the US. Globally, we prefer EM equities relative to DM.

Bearish on government bonds. We believe the market is underpricing the pace of future Fed rate hikes and think the softness in US inflation data this year is temporary. More broadly, the risk of more US fiscal expansion, discussions about the potential for the Fed to adopt a higher inflation target in the future and the risks around the slowdown in global QE flows all suggest the need for a higher risk premium in government bonds.

Turning point in credit approaching. We think current levels of spreads are roughly justified by the macro environment and corporate fundamentals (Page 7). From here, we expect bouts of volatility and favor a dynamic approach to manage that. We think it is too early to position for the turn in spreads for the cycle, but we are approaching that point and are more likely than not to reach it in 2018.

Oil prices bounded by OPEC cuts and shale supply. We think the willingness of OPEC to cut supply will provide a floor for oil prices at around \$40/barrel and the ample supply of shale will provide a ceiling at around \$60/barrel. We also expect the broader commodity market to generally be range-bound. This makes commodities a key area for a more dynamic approach to allocation.

US dollar, EM currency to outperform. After underperforming in 2017, we expect the US dollar to outperform as interest rate differentials should increasingly favor the US. Should it occur, we would sell into such strength, since the power of rate differentials is likely to eventually fade as other central banks get closer to the exit. EM currencies should continue to benefit from the global growth backdrop and low inflation, though the path is likely to be more volatile.



Source: GSAM. As of November 2017.

INVESTMENT THEMES

A moderating expansion in 2018

We expect the expansion to continue, but the pace of growth will likely moderate. We see downside risks to the current pace for varying reasons across the US, Europe and China. EM, outside of China, is a bright spot and we expect the EM vs DM growth gap to widen.

The US is at risk of overheating from easy financial conditions...

Since 1970, US unemployment has only been below the current level of 4.1% for 11 months, or less than 2% of the time (Exhibit 2). Whereas the improvements in the labor market typically flatten out towards the end of the cycle, they have accelerated this year. This combination suggests a need for a slower pace of growth in the US to avoid a more dangerous level of overheating. Before positioning for slower growth, we would prefer to see more evidence in the data. So far, we see no signs of a slowdown but think that is very likely to happen in 2018 due to more forceful tightening by the Fed, external events or unpredictable shocks.

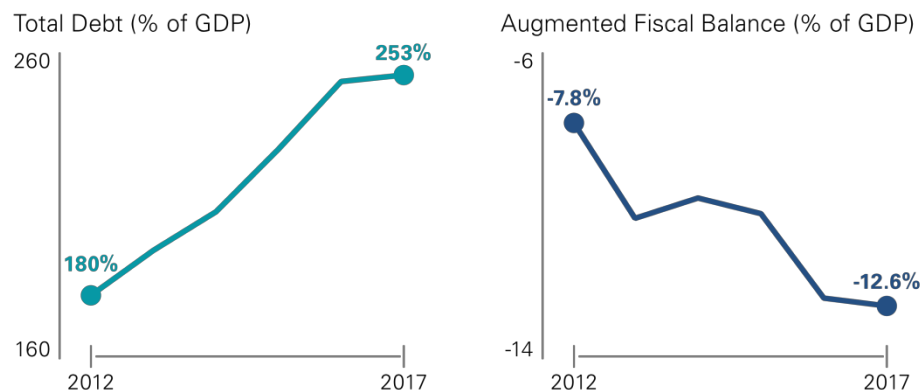
...whereas tighter financial conditions in Europe could slow growth...

European growth has been a strong surprise this year, driven by a combination of easy financial conditions, a positive fiscal backdrop and its exposure to the recovery in global trade and manufacturing. While the overall backdrop is likely to remain supportive, we think the growth impact from these factors is peaking out. Financial conditions, in particular, have tightened somewhat this year due to the appreciation in the euro and the rise in longer-term interest rates (Exhibit 3). We think these factors together will cause the pace of growth to moderate in 2018, although growth is likely to remain strong enough for unemployment to continue falling. Before positioning for slower growth, we would need to see more evidence in the data.

...and imbalances remain the main concern in China

We believe a hard landing is unlikely in China in the next few years. However, imbalances are large, and even though the build-up in debt (as a percent of GDP) has eased this year, the IMF's measure of the augmented fiscal deficit has continued to widen (Exhibit 5). In our view, China's economic policy needs to gradually shift its focus from growth to lowering imbalances. With the 2017 National Party Congress out of the way, we think this shift could occur to some degree in 2018, leading to a moderation in the pace of growth. Rebalancing would be good for the long term, but weaker data out of China is likely to be a source of market volatility in the near term. Outside of China, EM economies are a bright spot. Many of these economies are earlier in their cycle than DM. We expect the EM vs DM growth gap to widen and for that to support EM assets, even if there is likely to be more volatility along the path in 2018 than in 2017.

Exhibit 5: A slowdown in China's debt growth is offset by a large fiscal deficit



Source: IMF, CEIC. Annual data. Debt as of September 2017. Fiscal balance as of August 2017.



We expect the global expansion to continue but for the pace to moderate. In this environment, we still prefer equities over credit and credit over rates. EM, outside of China, is a bright spot and we continue to prefer EM over DM.

INVESTMENT THEMES

Valuations: Not a strong concern for now, except in government bonds

We think the signal from valuations should be judged in the context of the macro environment. As 2017 has shown yet again, valuations can be high for several years and associated with good returns if conditions are right. Relative to the macro environment, equities are on the cheap side, credit spreads are in line, and only bond yields look worrying.

Market participants have been concerned about elevated absolute valuations for years. For those who believe that valuations have largely been driven by QE, 2018 looks particularly concerning as peak QE either has passed or is coming up depending upon whether one takes the flow or the stock perspective. Given the limited historical experience with QE, uncertainty about the impact of withdrawal has to be acknowledged. However, we think the QE impact is more limited and draw comfort from the fact that US core asset valuations outside of bonds largely can be explained with models that relate valuations to the macro environment without QE effects.

Government bonds are the misvalued asset

Our models can explain the path of US government bonds, until late 2013. Since then, economic conditions have increasingly called for policy rates higher than what has materialized. Initially, there were good reasons: the strength of the dollar, the spare capacity in labor markets not captured by traditional measures and the asymmetry of risks when rates are near the zero lower bound. Since early 2016, these reasons have faded and we now see the Fed as being behind the curve. As a result, we are bearish on bonds and think a sell-off could arise as the Fed hikes faster than the market expects. Bonds could also come under pressure if the market starts to require an unusually large risk premium for longer maturities given the risk of inflation in an environment of unusually easy monetary policy and a tight labor market.



We see government bonds as the overvalued asset. Outside of bonds, we are not overly worried as valuations can be justified by current macro conditions. We believe valuations mainly will become a problem once the cycle turns, at which point we could see deeper losses.

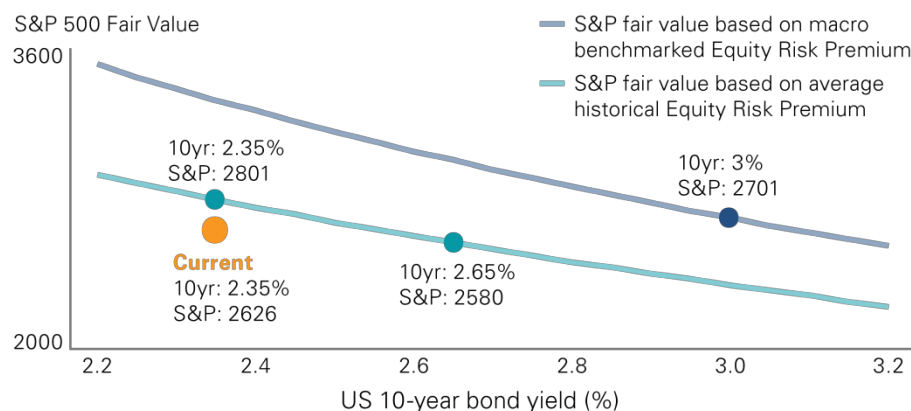
Credit spreads in line with the macro environment

Next on the risk spectrum, corporate credit spreads are low but broadly consistent with strong fundamentals. We therefore believe that a sell-off in government bonds due to a continued improvement of the US economy should at most lead to a temporary widening of spreads. The bigger risk is that we are approaching the point in the cycle when fundamental support for credit spreads have historically started to turn.

Equities on the cheap side

On an absolute basis, equity valuations are indisputably high, particularly in the US. However, we estimate that equities are on the cheap side relative to macro conditions. Exhibit 6 shows that current levels of the S&P 500 and 10-year yield imply a large equity risk premium (ERP) compared to the average level (teal line) and even larger compared to the ERP level justified by current macro conditions (blue line). We expect this gap to close mostly due to higher bond yields (moving to the right in the Exhibit), with room for 10-year yields to rise to around 3% without the need for a sustained equity sell-off.

Exhibit 6: Equities remain cheap relative to macro factors



Source: Haver Analytics, GSAM. As of November 2017.

INVESTMENT THEMES

The turn in central bank policy is starting to matter

So far, the consequences of moderation in central bank support have been very limited. Even as the Fed has started to increase rates more systematically, market conditions have remained benign and US financial conditions have eased. We expect a bigger impact in 2018, but primarily from rising policy rates rather than the wind down of QE.

Limited impact of the wind down in QE...

Central bank QE policy is gradually turning. The flow of central bank asset purchases has already peaked, and the stock of assets on central bank balance sheets will likely peak in 2018. In our judgment, the changes are slow and well telegraphed enough to limit the impact on asset prices and economies. Our main concern has been Italy, where a combination of 1) internal political challenges, 2) reduced ECB buying of Italian bonds and 3) questions around long-term debt sustainability could drive Italian bond yields higher. However, the ECB is now set to continue QE through at least September and Italy has decided on a new electoral law that should limit the impact of anti-establishment parties. As a result, we think the risks associated with slowing ECB purchases are much smaller. That said, we acknowledge uncertainty about the impact of the wind down of QE given the lack of historical precedence.

...with rate changes being the main story...

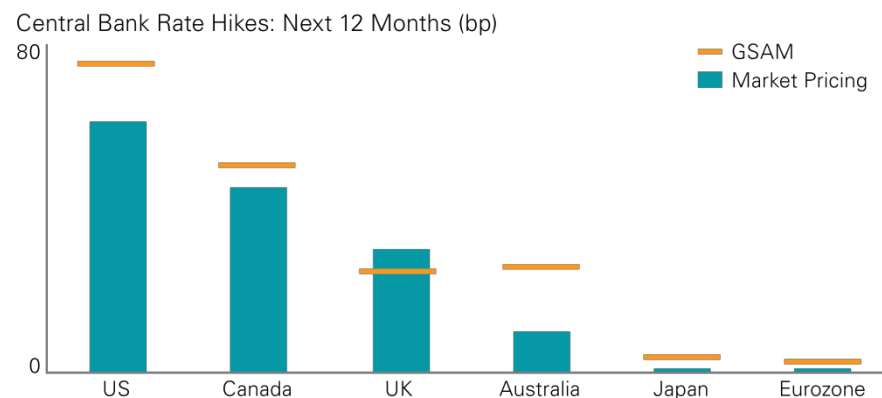
Even if the QE wind down has limited impact, in our view, the US needs tighter financial conditions to avoid a more dangerous level of overheating. We believe the Fed will eventually hike policy rates enough to generate that outcome. Market expectations for rate hikes are unrealistically low in our view (Exhibit 7) and we think the risk of broader market volatility due to a faster-than-expected pace of rate hikes is high. Outside of bonds, we think the impact of more tightening in the US than elsewhere is

most likely to be felt in currencies. Part of the weakening of the dollar this year has been a consequence of market skepticism about Fed rate hikes given the slowdown in US inflation, but with the US economy at or near full capacity, we expect inflation to resume its upward trend in 2018.

...and the market impact temporary outside of bonds

Over the longer term, we think the market impact of Fed rate hikes will be limited to higher bond yields. In past episodes when shifting Fed expectations drove sell-offs, both equities and EM currencies have quickly rebounded. Dollar strength versus other DM currencies could last longer, but even this should eventually mean-revert as the ECB moves towards the exit and the Bank of Japan eventually does the same.

Exhibit 7: We think market expectations for Fed rate hikes are unrealistically low



Source: GSAM, Bloomberg. As of November 2017.



We expect limited impact from the wind down of QE. We anticipate a faster pace of rate hikes in the US than the market, and we think that will be the core channel through which the gradual turn towards policy tightening by global central banks will impact asset prices.

INVESTMENT THEMES

Navigating the forces of disruption

In 2017, the disruption spotlight fell on the US retail sector, driving retail stocks and related real estate assets to sharply underperform. We think the consumer staples sector is ripe for disruption in 2018, but brace for disruption to cut across nearly every industry and market ahead.

Disrupting now: Retailers...how to survive in the Amazon

Traditional retail has been heavily disrupted by the rise of e-commerce, and will continue to face pressures to their top-line growth and margins. We believe retailers will need to focus on building omni-channels and in-store customer experiences as prerequisites for survival, while pursuing a differentiated supply chain and scaling advantages in order to thrive.

Next up in 2018: Consumer staples...the next shoe to drop

Consumer staples are likely to be the next target of e-commerce disintermediation. E-commerce has changed consumption patterns by creating an online “endless shelf” to foster niche brands, since off-line shelf spaces are dominated by larger brands. In addition, e-commerce is spawning growth in private labels through voice-assisted devices as well as mining proprietary data to draw traffic, removing the consumer data advantage of traditional players. The data revolution is moving into the Smart Home—the next frontier where an increasing share of consumer staples purchases is expected to be made, with voice-assisted devices acting as “gatekeepers” of household item purchases and enabling a frictionless shopping experience. The number of Smart Homes is expected to double in North America and triple in Europe between 2016 and 2019, helping to propel the velocity of digitalizing and collecting consumer information.

In the next decade: Autos....the next Retail?

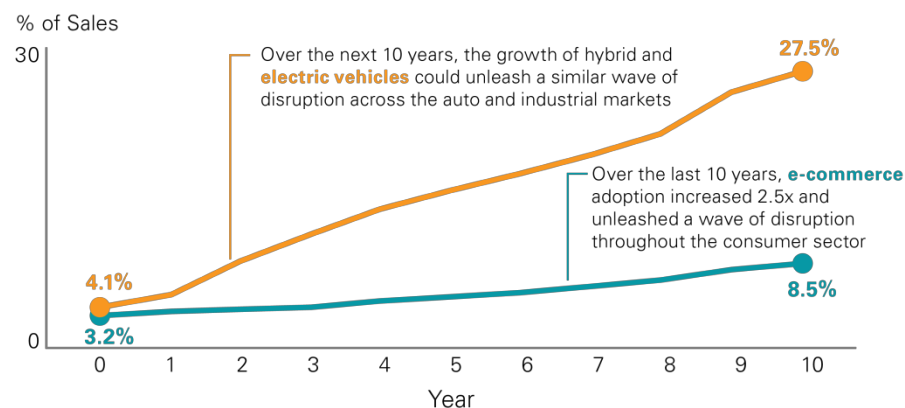
The 5% new sales penetration rate of electric vehicles matches that of Retail e-commerce in 2007, and IHS Markit forecasts it to increase to 35% by 2030 (Exhibit 8). Over the next 10 years, the growth of hybrid and electric vehicles could

unleash a wave of disruption across the auto and industrial markets, similar to what e-commerce did in the consumer sector in the last 10 years. While we believe in the theme of autonomous and electric vehicles, we think the “pure plays” are pricing in extremely high valuations even under a blue sky scenario. We see more value in downstream parts, such as semiconductors and automation components.

On the horizon: Emerging Technology in Emerging Markets

The lack of incumbent technology and infrastructure in many EM countries has reduced any barrier to disruption. Many innovative technologies are being rapidly adopted in emerging markets. With 86% of the world’s millennials residing in the EM world—the first generation of true “digital natives”—the subsequently higher e-commerce penetration rates in EM have created opportunities across the supply-chain. EM adoption of e-wallet and mobile payment platforms has outpaced that of the developed world, as traditional banks in EM underinvested in the retail market while focusing on the corporate sector, creating a vacuum for alternative providers to thrive.

Exhibit 8: Today’s electric vehicle market is similar to e-commerce 10 years ago



Source: IHS Markit as of May 2017, U.S. Census Bureau as of June 2017. % of total retail sales ex travel and % of new vehicles sales.



Disruption is an ongoing driver of risk and return globally. Over the longer term, innovation is likely to disrupt virtually every sector in which we invest. The disruptive impact of technology is likely to be even bigger in emerging markets, creating compelling opportunities.

INVESTMENT STRATEGY

Equities

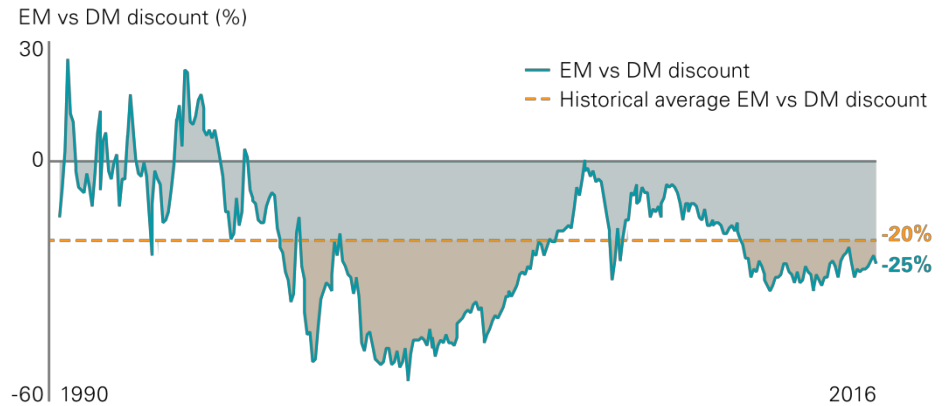
Looking to 2018 and beyond, we believe opportunities in equities exist beyond benchmarks and beyond borders.

We look “beyond benchmarks” for bottom-up opportunities. In the US, we believe **small cap** companies are well positioned to benefit from domestically-oriented and pro-growth policy, and could see a boost should there be further progress on tax reform given their higher effective corporate tax rates compared to larger cap companies. **Value-oriented sectors** have the potential to outperform in periods of economic recovery, like the one we are currently in, while trading at a significant discount to growth sectors. We also like **companies that invest in their future growth through capex and R&D**, rather than focusing on shareholder returns. While companies with high shareholder returns have historically outperformed, those focused on investing for the future have outperformed significantly since 2016. We anticipate this outperformance to continue with solid economic growth. Finally, we believe the focus on disruption in the retail sector (Page 9) has led the market to become overly pessimistic on **retail real estate**, whose performance has significantly lagged other REIT sectors in 2017 due to market discounting without regard for quality. However, shopping center occupancy is near record highs, while retail bankruptcies are at historically normal levels. We believe well-located assets with tenants focused on “necessity based” or “experiential based” retail will remain resilient, compared to poorly-located assets with “commodity” tenants.

We also believe US and European investors should look “beyond borders”. We are especially constructive on **EM equities**, where the macroeconomic fundamentals are supportive and valuations are attractive. The EM economic growth premium to DM continues to widen, and the recovery is broad-based across EM countries. Prior to their recent gains, EM equities had underperformed for five years and continue to trade at a roughly 25% discount to DM (Exhibit 10). We think EM equities can continue to recover, supported by consumer-driven economic growth.

We are also positive on **Japanese equities**, where corporate fundamentals have been recovering over the last 20 years, as evidenced by high cash levels, low debt levels, improving profit margins and a rising return on equity. Corporate governance reforms are also resulting in more shareholder friendly actions. Despite improving fundamentals, Japanese equity valuations remain attractive relative to other DM equities and their price-to-book ratio is cheapest relative to the US since the global financial crisis.

Exhibit 10: EM equities have continued to trade at an attractive discount to DM
EM vs DM 12-month forward P/E premium/discount



Source: IBES via Datastream, As of September 2017.



WHAT WE'RE WATCHING

Equity valuations remain high, particularly in the US, where the median stock trades in the 99th percentile on a forward P/E basis versus the last three decades. In our view, this makes it more important to pursue a selective and active approach to investing.

As fundamental investors, we look for companies with inflection points in their business models and compelling growth opportunities. With elevated valuations, especially in the US, our biggest conviction views exist “beyond benchmarks” and “beyond borders”.

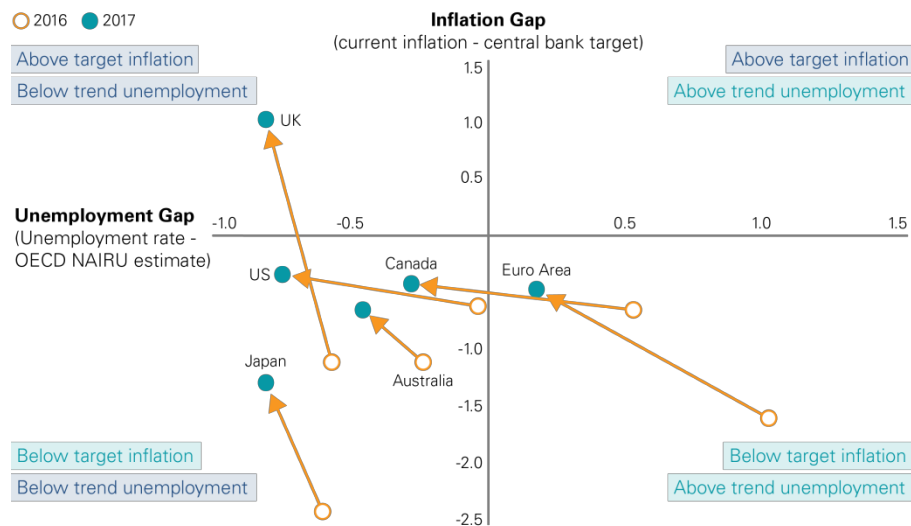
INVESTMENT STRATEGY

Fixed Income

Growth and corporate earnings have surprised to the upside and pulled forward expectations for monetary policy normalization while elongating the US credit cycle. In response, we have recalibrated central bank expectations but still think market pricing underestimates the pace of Fed tightening and undercompensates for credit risk.

Exhibit 11: Diminishing slack points to less monetary accommodation

Inflation relative to central bank targets and unemployment relative to trend estimates



Source: Macrobond, Organization for Economic Co-operation and Development (OECD). As of November 2017.

Neutral on spread risk, focused on relative value across rates and currencies.

Central bank policies: converging in direction, diverging in pace. Inflation remains low considering current unemployment and growth rates, although transitory factors have contributed to positive inflation surprises in Europe and negative surprises in US inflation. Despite these nuances in inflation, economic slack in developed economies is diminishing (Exhibit 11). In aggregate, the unemployment rate for developed market countries is nearing pre-crisis levels. We still expect the Fed to lead in its hiking cycle, but as more economies are faced with tight labor markets and risk of overheating we expect to see more central banks prepare for, kick-start or re-start (in the case of Canada) their rate hiking cycles. We think this creates relative value opportunities across developed government bond and currency markets.

Corporate credit: tighter spreads, less upside potential. A mix of healthy growth, low inflation, revived commodity prices and contained volatility has compressed corporate credit spreads to multi-year tights. In 2018, we think these supportive factors are likely to fade somewhat and give way to concerns around high levels of leverage, low levels of interest coverage and extended valuations. Tax reform remains a tentative tailwind but insufficient to sway our cautious view on credit at this stage of the cycle.

Exposure to assets geared to growth still makes sense. In our view, the global growth environment, real rate differentials and relative valuations continue to favor exposure to EM currencies versus the dollar. Fundamentals have improved in many EM countries, as reflected by a decline in current account deficits. And while we expect Chinese growth to moderate—a welcome development if driven by reforms—we expect some offset from improving growth in commodity-oriented EM countries.

**WHAT WE'RE WATCHING**

Several catalysts—including policy missteps or political upsets—could drive higher market volatility. This may catch markets off guard, raising the risk of a correction in risk assets. We're also alert to the risk of a material pick up in US inflation that could lead to a repricing of Fed policy and a sustained rally in the US dollar.

Across fixed income markets, our high-conviction views are based on market mispricing for central bank policies which creates relative value rate and currency opportunities, and ongoing strength in global economic growth, which favors exposure to EM currencies.

GSAM 2018 INVESTMENT OUTLOOK

Disclosures

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