Goldman Sachs Asset Management

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FROM THE OFFICE OF THE CHAIRMAN

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Big Issues for Investors to Think About

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Introduction

Judging from the questions we are getting, many investors are already thinking about 2013 as we move into the fourth quarter. As such, in our remaining editions of *Monthly Insights* for this year, we will update our 2013 GDP growth forecasts, introduce our first look at 2014 and provide a summary of our new *Strategy Series* on Global Fixed Income Benchmarking to be published later in the year. Ahead of these plans and against the background of 2013, we provide some supplementary thoughts to our September *Monthly Insights*, in which we assessed our views about the main perceived and widely discussed 'risks' in the global markets and how investors should be thinking about them in terms of their approach to asset allocation.

In the context of all the perceived uncertainties about the current and future investment environment, we take a closer look at the Equity Risk Premium (ERP) as a tool for determining asset allocation views. We show that, despite the rally in equity markets through the summer, the ERP still seems to be rather high. While there are certainly a number of caveats to using this metric, including the issues related to the concept of the risk-free rate, we argue that for medium- to long-term investors, it remains a good time to be favouring equities over bonds in asset allocation decisions. This view is also generally supported by one of the most conservative equity valuation metrics.

We also touch on the popular topic of regulation, especially as it relates to its uncertain impact on the likelihood of future economic recovery and the attraction of equities relative to 'safe' assets. In addressing this, we highlight the key distinction between better regulation and more regulation. We also argue that concerns about the regulatory environment seem to be currently holding back the risk appetite of both corporates and financial investors, in spite of the lower rate environment driven by central banks.

Finally, once more, we briefly review the three big macro issues that are particularly important: the US economic outlook, the Euro area crisis and China's economic adjustment from 'quantity' to 'quality' of growth. In the US, the recent positive signs in the data are somewhat offset uncertainty about the fiscal cliff. In the Euro area, while tricky issues are again back to the fore, it seems to us that both the ECB and Europe's key policymakers continue to be committed to muddling through their considerable challenges. In China, the cyclical environment remains disappointing but scope for monetary easing and upside growth surprises remains wide. Even taking into account all the risks, China's equity market seems attractively valued.

Asset Allocation in an Uncertain World

A frequently repeated assertion from client meetings is that the current investing environment is highly uncertain and, as a result, it is an especially difficult time to assess asset allocation and styles of investing. While we believe part of this concern is warranted, we often wonder whether this is more a reflection of people's state of mind rather than anything that is truly different. At the core of this comment is the following question we encourage all investors to ask: Is the environment really so different now that everything is more uncertain, or is it simply that, as a result of events since 2008, we are now all aware that so many things are uncertain? And perhaps as a related point, in hindsight we now know that things were not as certain as we originally believed over the last decade or, more specifically, for much of the time from 2001 to 2007.

From an investment perspective, we relate the uncertainties about the future and investment alternatives directly to the concept of the ERP. The ERP is generally defined as the excess equity return being offered at any moment in time beyond that of the risk-free rate. *Table 1* shows our estimate of the latest ERP globally and in some key regions of the world. A positive ERP is generally offered to compensate investors for the risk of holding equities over the risk-free rate. A rising ERP, as has been observed over the last five years globally, can generally be regarded as a symptom of investors requiring a higher rate of return to compensate for the (perceived) growing risks. A high ERP, especially relative to some past norm, suggests that investors perceive the future to be riskier. So with respect to discussions with clients, the real question is: Is the ERP high (and attractive) enough to compensate for all these risks that we talk about? We believe that there is quite a lot of evidence that the ERP has some mean reverting tendencies, and when the ERP is relatively high compared to some period in the past, then in fact it is usually a good time to invest in riskier assets, especially equities.[1] In this context, at the end of the 1990s the US ERP was rather low as *Exhibit 1* shows. This coincided with a period where many people did not seem to be as aware that there was a lot of uncertainty lying ahead. Put another way, is it more comforting for an investor when all the trustees or advisors are worried about a lot, or worried about very little?

Exhibit 1 - The US ERP makes a strong case for holding equities in favour of bonds

Source: Datastream and GSAM calculations

Today, despite the rally in equity markets through the summer, the ERP still seems to be rather high as we discussed in the September *Monthly Insights*. Our starting position is that this suggests for medium- to long-term investors, now is a good time to be favouring equities over bonds in asset allocation decisions.

Table 1 - Equity risk premia are elevated across the world

%	Real GDP Growth	Real Earnings Growth	+	Dividend Yield	=	Expected Real Return	-	Real Bond Yield	=	Implied ERP
US	2.5	2.5		2.2		4.7		-0.8		**5.5**
UK	2.3	2.3		3.5		5.8		-1.2		**7.0**
Europe ex UK	2.0	2.0		3.7		5.7		0.0		**5.6**
Japan	1.5	1.5		2.6		4.1		0.5		**3.6**
Brazil	5.0	5.0		4.2		9.2		3.4		**5.8**
China	8.0	8.0		4.1		12.1		0.5		**11.6**
India	8.0	8.0		1.5		9.5		4.1		**5.3**
Russia	5.0	5.0		4.0		9.0		1.7		**7.4**
GDP-weighted										
Advanced	2.1	2.1		2.9		5.0		-0.3		**5.3**
BRICs	7.0	7.0		3.8		10.8		1.7		**9.1**
World	3.5	3.5		3.1		6.6		0.2		**6.4**
PPP-weighted										
Advanced	2.2	2.2		2.8		5.0		-0.4		**5.4**
BRICs	7.3	7.3		3.6		10.9		1.7		**9.1**
World	4.2	4.2		3.1		7.3		0.5		**6.9**

Source: Datastream and GSAM calculations. As of 10/10/12

[1] "Finding 'Fair Value' in Global Equities: Part I", GS G*lobal Economics Paper* No. 179, February 2009 .

Supplementary Issues to the ERP Conundrum: The Risk-free Rate

Amongst many issues there are two that we think are important to consider. Firstly, many people often argue that the main reason the ERP is so high is primarily due to the fact that the so-called risk-free rate is so low. Along with that observation comes the question of whether the US (or other government) 10-year bond yield can actually be considered a genuine risk-free rate at such low levels and also whether we can have confidence in identifying a risk-free rate anymore. While aspects of these questions are connected, there are separate issues to consider.

In terms of the perceived low-level of both nominal and real 10-year bond yields in the US and globally, it is the case that they are low compared to the past. In a more forward-looking context, it may be the case that these low yields reflect some kind of pessimism about the economic potential of the future. The case of Japan gives some support for such a pessimistic conclusion, and if all of the US, Europe, Growth Markets and other parts of the world faced a future similar to the one Japan experienced from 1989 to 2012, then it would be difficult to treat such views lightly. In such a world, while the ERP is high compared to its past, it could be set to rise further as the future earnings growth from the world 'disappoints' suggesting that to invest in equities would become even riskier.

The second issue we wish to raise is very close to the ERP concept, and it concerns the notion of cyclically-adjusted Price to Earnings ratios (CAPEs) for many regional stock markets. *Table 2* shows our latest estimates. In our view, the CAPE approach is a rather conservative method of assessing the value of equity markets. As can be seen, despite the erratic rally since 2008, and including the rally of the last four months, several markets appear to be 'cheap' relative to their own history and also relative to expectations of future earnings. In particular, both continental Europe and a number of Growth Markets seem quite attractive. While, of course, there are some valid caveats to using this metric (just as with any other valuation method), we find the strong complementary signals of CAPEs and the ERP to be especially compelling. Of course, it is true that the future may be so bleak in so many different parts of the world, that future earnings will never be able to match earnings of the past. But you would have to be quite confident about this, rather than just 'worried'.

So What is the Risk-free Rate?

While it may be the case that 10-year bond yields are not a true indicator of the risk-free rate, the question is, what other financial measure can one find? It is possible, in fact perhaps likely, that the 10-year bond yield is still a good indicator for this purpose. Certainly the fact that in 2012, a number of government bond yields have dropped and some others—primarily those of peripheral Europe—have risen, suggests that markets do have the ability to differentiate and apply suitable risk premia to different governments.

Table 2 - Equity Valuations

	Latest CAPE	Forward PE	Deviation from avg.	CAPE vs FY1 PE
USA	22.9	12.8	22%	78%
Mexico	22.0	16.5	13%	33%
Indonesia	19.5	13.4	-10%	45%
Japan	18.8	11.6	-59%	62%
India	17.5	13.7	-21%	28%
Canada	16.9	13.0	-12%	30%
Australia	15.8	12.4	0%	27%
Korea	13.9	8.8	-16%	58%
China	12.6	9.0	-27%	41%
Germany	12.4	10.5	-35%	18%
UK	11.2	10.6	-18%	6%
France	10.3	10.5	-48%	-2%
Brazil	10.1	10.1	-34%	0%
Turkey	9.9	10.1	-35%	-2%
Italy	6.9	9.0	-69%	-24%
Russia	6.9	5.1	-51%	37%
Spain	6.4	10.7	-64%	-40%

Source: Datastream and GSAM calculations

Of course, some observers would respond that the genuine risk inherent in many Western bond markets (the US, UK, Japan amongst others) is only being curtailed or disguised by the fact that the central banks of these countries have become such active buyers of their own bond markets. Therefore, the argument goes that they are not appropriate measures of a risk-free rate. While one can understand why this observation is offered, it is a fact that central banks frequently influence the relative attractiveness of their own bond markets by their decisions, rather than it being just a feature of life since unconventional monetary policy or quantitative easing. By definition, when central banks adjust their interest rates as part of the 'norm', they will have an impact on their own bond markets.

In any case, in terms of selecting different markets for asset allocation purposes, if it is true that the actions of the Federal Reserve, Bank of Japan, Bank of England, European Central Bank (ECB) et al are artificially inflating bond prices, then it simply adds to our view that equities are relatively more attractive than bonds.

In this context, as and when, Western central banks decide that they can start to 'exit' from their current unconventional monetary policies and/or choose to raise short-term interest

rates, it would seem quite likely that longer-term bond yields, including 10-year yields would rise. Some may argue that in terms of the currently high ERP, such an increase in bond yields would in fact reduce the ERP back to 'normal' levels without having any positive impact on equity markets, even if on a relative basis they perform better than bonds. We think that there is a danger of too much simplification in such an environment. Undoubtedly, on days when bond yields may rise significantly as part of some return to 'normality,' it would seem conceivable that equities may suffer. But presumably it would depend more specifically on why bond yields were rising and the valuation of specific equity markets at the time.

As we discussed in the September *Monthly Insights*, it is possible that if the US economy positively surprises in 2012, and survives the threat of the 'fiscal cliff' (more on this to follow), then the US ERP will return to normal, more by a rise in bond yields, than by a rally in equities. This is because US equities do not appear to be particularly cheap from a CAPE valuation perspective. But it is very questionable to apply the same thought process elsewhere. In the Euro area, for instance, one could easily imagine that a return to 'normality' in terms of German bond yields would probably be associated with a stabilisation of the Economic and Monetary Union (EMU) crisis, which would likely be rather positive for undervalued equities in the region. Similarly, Chinese equities that appear to be cheap would presumably cheer in light of clear evidence that Chinese GDP growth may achieve 7-8% in 2013 given all the current fears of a hard landing.

Regulatory Issues and Investing

One other issue that is frequently raised by investors is the broad topic of regulation, and whether increased regulation is both reducing the likelihood of future economic recovery and the attraction of equities relative to 'safe' assets. There are a number of aspects to the regulation debate, of which perhaps three seem especially critical. At the core of all the issues is the key distinction between better regulation and more regulation. We all would probably agree that better regulation would help sustainable growth but in the search for such, it is often tempting for policymakers to bias quantity over quality. More regulation can result in less economic growth if it stifles the risk-taking decision capability of corporate leaders and entrepreneurs.

In the post 2008 environment, the most vocal debate concerning regulatory issues obviously relates to banks, and the financial sector in general, in the US and Europe, with a myriad of implemented and planned changes. While critical aspects of various policies are quite different, the one common theme is essentially that financial intermediaries, especially banks that have a traditional role in lending money and accepting deposits, will be forced to hold more capital. As a result of this and some other changes, the return on capital for banks is widely expected to be less. Much—if not all—of finance theory would suggest that a lower return on capital is consistent with less economic growth. However, there are two pertinent arguments at this point in time that would challenge this common view. Firstly, if the regulatory changes contribute to a less volatile return on bank capital, even if it is perceived to be lower, might this not be helpful for the future of bank earnings or those that own their equity? And secondly, of course, markets have already taken onboard the anticipated path to a lower return on capital, or at least one would imagine judging from most bank equity valuation metrics as *Exhibit 2* shows. It is also probably worth adding that it is dangerous to generalise about all banks globally. The environment facing US-based banks is quite different from those in Europe (better capitalised perhaps), and the environment surrounding banks originating in Growth Markets is certainly different from that in the US and Europe.

A second regulatory concern relates to the broader behaviour of western corporate leaders in general and the current tendency of many to hold large amounts of cash, which one might imagine could be better deployed by investing, for acquisition or other uses. It often seems as though corporate leaders share the concerns of many financial investors. Frequently when quizzed, however, they seem eager to point out that their own company outlook is fine, but they worry about broad economic uncertainties, especially, in Europe an the US. Quite often, we discuss these issues at our regular internal CIO call and encourage our Fundamental Equity investment teams to ask their corporate contacts in a variety of industries: What would it take to make them want to spend and invest more? The answers invariably involve comments regarding uncertainty about the future, and as part of this, frequent reference to concerns about the regulatory environment both in terms of issues about taxation, disclosure and reporting standards. In our view, based on the frequency that we hear such comments, it indeed seems that this is one of the more legitimate concerns contributing to caution from corporate CEO's, especially in the US.

Exhibit 2 - Price-to-book ratios point to a structurally lower return on capital for banks

Source: Datastream

The third regulatory issue to consider is more specific to financial investors, and in particular, to pension funds and insurance companies post 2008. Aspects of this issue also relate to the previous two. The zest to impose the so-called mark-to-market accounting in recent years, while justifiable for the activities of financial institutions and in particular their trading books, seems much less rational when you ponder the purpose of pension funds and insurance companies, whose goals tend to include longer-term horizons and planning. Such institutions are natural holders of less liquid assets, which by definition are harder to value on any one day as there are no liquid markets for some of those assets. By introducing stricter regulatory guidelines to these investors, there appears to be some evidence that it discourages them from holding riskier assets than they otherwise might due to tougher capital requirements. In addition, as we learnt from our detailed survey of insurance companies globally, a notable minority are searching for higher-yielding investments to somehow help give them the returns necessary to satisfy their mandates in spite of the lower rates driven by central banks.

The Three Big Macro Issues

As we discussed in our September *Monthly Insights*, there are many macro issues that both warrant concern and of course get plenty of attention. Of them, we believe that there are three that are particularly important; the US economic outlook against the backdrop of the so-called fiscal cliff, the Euro area crisis and China's economic adjustment from 'quantity' to 'quality' of growth. Here is a brief summary of our latest thoughts on each.

The US Outlook

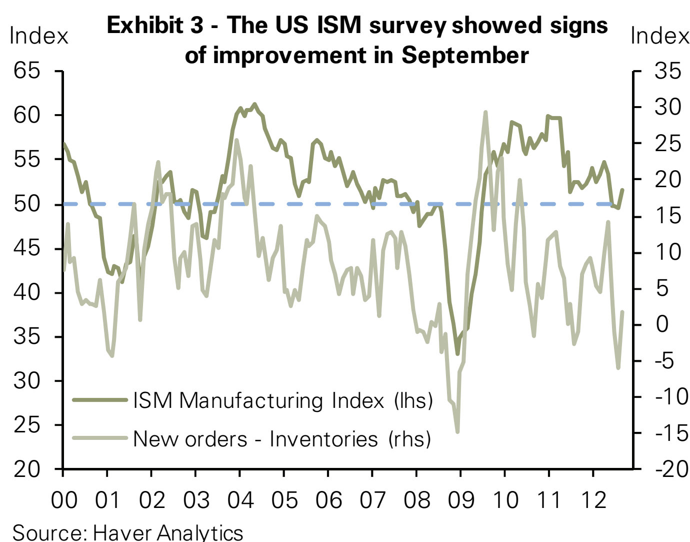
As we await the presidential election outcome in a few weeks with suddenly opinion polls looking rather tight and less certainty about the winner. What remains unclear, even if markets had confidence about the election outcome, is whether there will be a sizable and early compromise on fiscal policy in order to both reduce the risk of an undesirable significant fiscal tightening in 2013 and to have credible plans for medium- to longer-term fiscal consolidation. It is a very delicate balancing act, and it remains uncertain as to how policymakers will deal with both. We are assuming that some sort of compromise to avoid excessive 2013 tightening will be found, although it is not clear whether efforts to boost long-term fiscal credibility will be addressed.

In the meantime, as always, we are watching all the incoming data releases, and since our September *Monthly Insights*, the news flow has been better. In addition to the surprising drop in US unemployment rate to 7.8%, both the manufacturing and service sectors ISM surveys positively surprised. In particular, the key new order and inventory components of the manufacturing survey showed a notable improvement as can be seen in *Exhibit 3*. While there are downside risks to the US outlook, there is also upside potential.

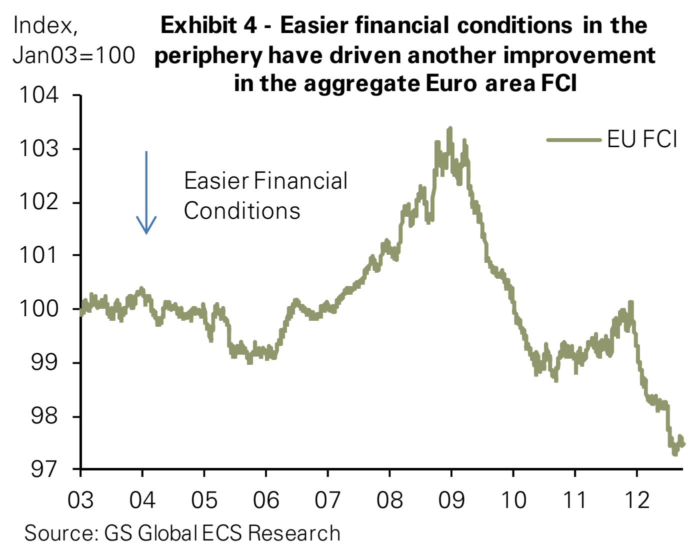
Euro Area Issues

Since the calm of August and early September, tricky issues are back to the fore in the Euro area. In particular, what to do about Greece and Spain in terms of their financing is at the top of the agenda, and the early signals about major agreed steps towards a banking union across the Euro area appear to be somewhat questionable. Each of those three topics, as well as other less predictable ones, could flare up further.

However, we believe that there are two key forces that investors need to remember when thinking about these (and other) tough challenges in the Euro area. Firstly, in announcing the Outright Monetary Transactions (OMT), the ECB made it quite clear that they intend to both offset any tendency of financial markets to impair the monetary mechanism of the ECB, and to reduce any implied Euro 'break-up' risk. Both of these concerns suggest that the ECB will fight more aggressively to avoid any fresh unwarranted tightening of the Euro area financial conditions. As can be seen in *Exhibit 4*, Euro area financial



Source: Haver Analytics



Source: GS Global ECS Research

conditions have eased considerably since the end of June. In this regard, it is interesting to see that the September Purchasing Managers' Index (PMI) surveys showed some signs of stabilisation of the Euro area recession, although given the scale of previous declines, one needs to be careful about giving too much attention to just one month. The detailed geographical breakdown did show some improvements in the so-called peripheral economies, notably Italy.

The second important issue is that the German Chancellor, Angela Merkel, despite considerable domestic opposition, has backed the ECB. We continue to interpret this decision as a 'more Europe' kind of judgement, which suggests that at a minimum, Europe's key policymakers will continue to try and muddle through their considerable challenges.

China

At the time of writing, we await the release of China's Q3 GDP estimate as well as all the September monthly economic data. Based on our favoured GS proprietary economic indicators, the GS China Activity Index (GSCA) and the China Financial Conditions Index (FCI), it seems as though the near-term economic data will surprise on the downside, as *Exhibit 5* illustrates. Our forecasts for Chinese GDP growth for both 2012 and 2013 are below the consensus.

Against this near-term headwind, there are three important forces that point in the opposite direction. Firstly, our long-term optimism towards China includes an assumption that China will 'only' grow by 7.1% this decade, and we have been assuming this for a few years. Once market participants get away from the expectation of 10%-type real GDP assumptions, this will make it easier for China to positively surprise. Secondly, in the context of expectations, financial conditions and leading indicators of cyclical growth, China's low inflation rate makes it quite likely that policymakers will be able to stimulate growth if necessary, consistent with their assumption of 7% GDP growth to deliver their 12th five-year plan. Thirdly, as shown earlier in the discussion of CAPE, China's equity market seems attractively valued, even taking into account all the risks.

Exhibit 5 - An easing in China financial conditions would provide support to economic activity

Source: GS Global ECS Research

Investing. Seeking Return and Minimising Risk

As we discussed in our September *Monthly Insights*, some investors have become so concerned with future economic and financial risks that they frequently think about so-called 'tail risks' and the notion of disaster hedging. We prefer to think about risk and return in the context of our ERP metric and more well-established valuation concept such as CAPE (although we would add that at current implied and actual volatilities, option-based strategies to protect downside risks are quite cheap).

In addition, against the background of a world economy increasingly being driven by economic activity in Growth Markets, our recommended approach to both global equity and fixed income investing is to seek equity and fixed income benchmarks with higher Growth Market allocations than in established market-cap based benchmarks. These alternative approaches offer more exposure to stronger growth and key fundamentals.

Appendix

GDP Growth Forecasts: GSAM vs Consensus

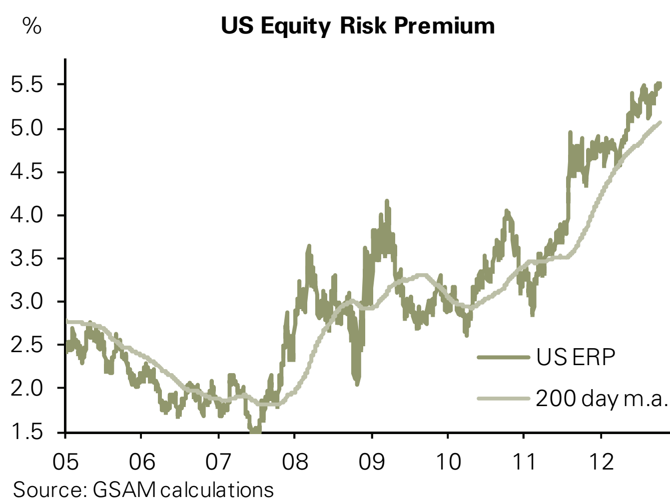
	Trend GSAM	2011	2012		2013	
			GSAM	Consensus*	GSAM	Consensus*
US	**2.5**	1.7	1.8	2.2	2.5	2.1
UK	**2.3**	0.7	-0.2	-0.3	1.8	1.3
Canada	**2.5**	2.5	2.2	2.0	2.5	2.0
Euroland	**2.0**	1.5	-0.4	-0.5	1.0	0.1
Japan	**1.5**	-0.7	1.9	2.4	1.3	1.3
Brazil	**5.0**	2.7	2.0	1.6	5.0	4.0
China	**8.0**	9.2	7.4	7.7	8.0	8.1
India	**8.0**	6.9	6.2	5.9	8.0	6.9
Russia	**5.0**	4.2	4.0	3.8	5.0	3.7
Mexico	**3.0**	3.9	3.6	3.9	3.8	3.5
Korea	**4.8**	3.6	2.5	2.6	4.8	3.5
Indonesia	**5.8**	6.5	6.0	6.1	6.1	6.1
Turkey	**5.0**	8.5	3.0	2.9	5.0	4.3
Advanced	**2.2**	1.3	1.0	1.2	1.8	1.3
BRICs	**7.3**	7.4	6.2	6.2	7.4	6.9
Growth Markets	**6.8**	7.0	5.7	5.7	6.9	6.4
World	**4.2**	3.8	3.0	3.2	4.1	3.6

*As of Sep 2012. Source: GSAM and Consensus Economics

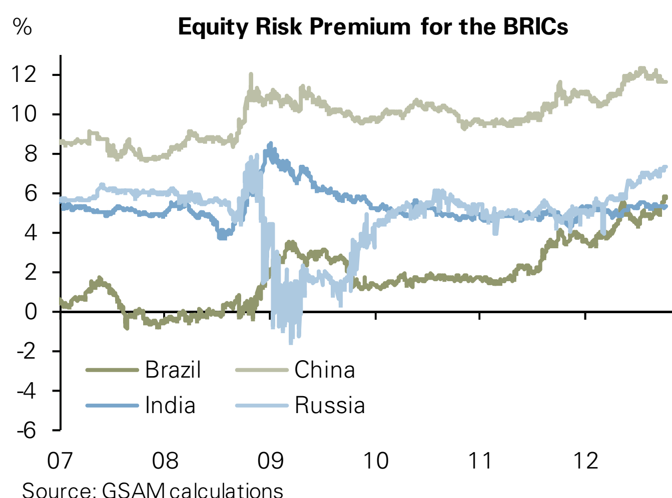
Global Equity Risk Premium*

	Real GDP Growth Trend	Real Earnings Growth	+	Dividend Yield	=	Expected Real Return	-	Real Bond Yield	=	Implied ERP	Expected Inflation	Expected Nominal Return
US	2.5	2.5		2.2		4.7		-0.8		**5.5**	2.0	6.7
UK	2.3	2.3		3.5		5.8		-1.2		**7.0**	2.0	7.8
Europe ex UK	2.0	2.0		3.7		5.7		0.0		**5.6**	2.0	7.7
Japan	1.5	1.5		2.6		4.1		0.5		**3.6**	1.0	5.1
Brazil	5.0	5.0		4.2		9.2		3.4		**5.8**	4.5	13.7
China	8.0	8.0		4.1		12.1		0.5		**11.6**	3.0	15.1
India	8.0	8.0		1.5		9.5		4.1		**5.3**	4.0	13.5
Russia	5.0	5.0		4.0		9.0		1.7		**7.4**	6.0	15.0
GDP-weighted												
Advanced	2.1	2.1		2.9		5.0		-0.3		**5.3**	1.8	6.8
BRICs	7.0	7.0		3.8		10.8		1.7		**9.1**	3.8	14.6
World	3.5	3.5		3.1		6.6		0.2		**6.4**	2.4	9.0
PPP-weighted												
Advanced	2.2	2.2		2.8		5.0		-0.4		**5.4**	1.9	6.9
BRICs	7.3	7.3		3.6		10.9		1.7		**9.1**	3.7	14.6
World	4.2	4.2		3.1		7.3		0.5		**6.9**	2.6	9.9

*As of 09 Oct 2012. Source: GSAM calculations



Source: GSAM calculations



Source: GSAM calculations

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The concept of the ERP stems from a risk-return tradeoff, in which a higher rate of return is required to entice investors to take on riskier investments. The risk-free rate in the market is often quoted as the rate on longer-term government bonds, which are considered risk free because of the generally accepted notion that there is a low chance that the government will default on its loans. On the other hand, an investment in equities is far less guaranteed, as companies may suffer downturns or go out of business. The size of the premium will vary as the risk in a particular stock, or in the stock market as a whole, changes. High-risk investments are typically compensated with a higher premium.

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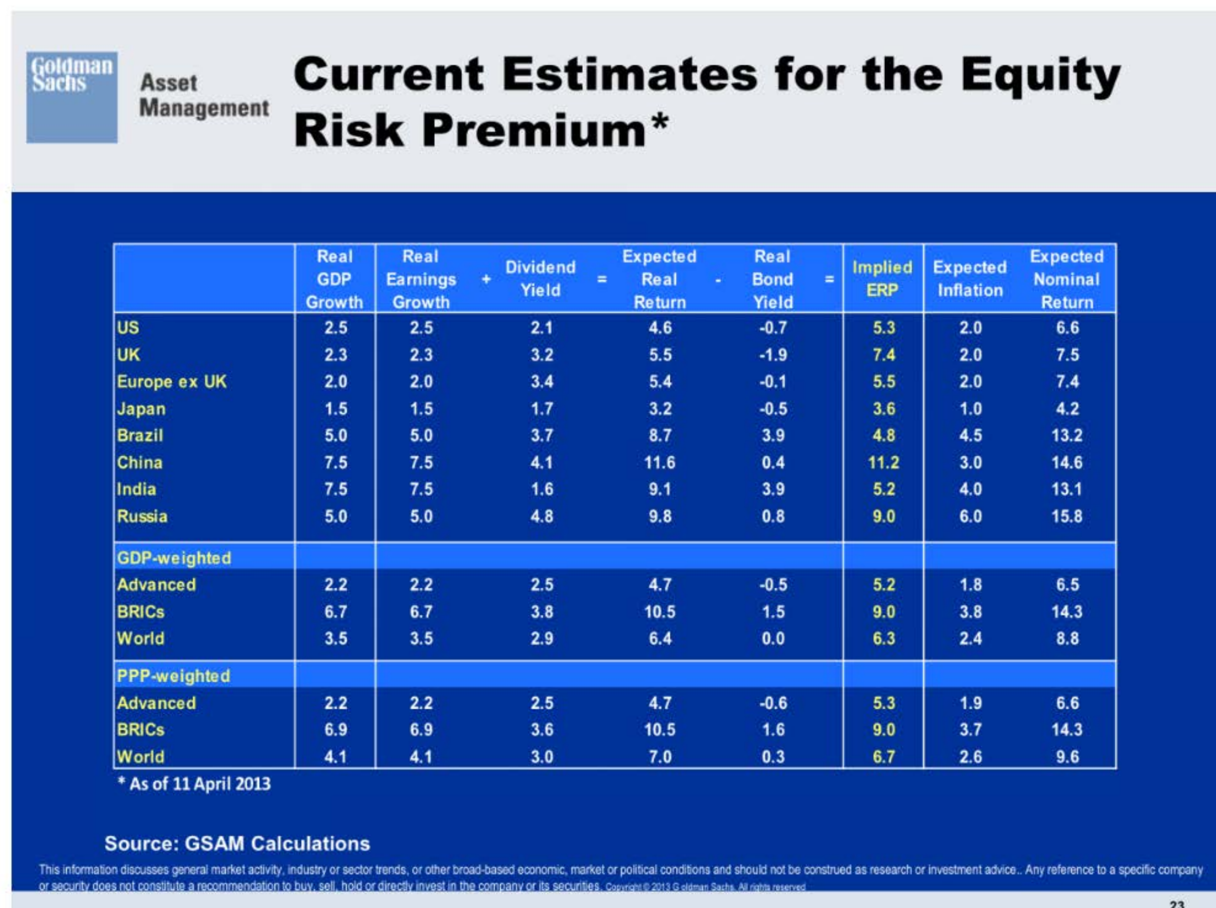

Current Estimates for the Equity Risk Premium*

	Real GDP Growth	Real Earnings Growth	+	Dividend Yield	=	Expected Real Return	-	Real Bond Yield	=	Implied ERP	Expected Inflation	Expected Nominal Return
US	2.5	2.5		2.1		4.6		-0.7		5.3	2.0	6.6
UK	2.3	2.3		3.2		5.5		-1.9		7.4	2.0	7.5
Europe ex UK	2.0	2.0		3.4		5.4		-0.1		5.5	2.0	7.4
Japan	1.5	1.5		1.7		3.2		-0.5		3.6	1.0	4.2
Brazil	5.0	5.0		3.7		8.7		3.9		4.8	4.5	13.2
China	7.5	7.5		4.1		11.6		0.4		11.2	3.0	14.6
India	7.5	7.5		1.6		9.1		3.9		5.2	4.0	13.1
Russia	5.0	5.0		4.8		9.8		0.8		9.0	6.0	15.8
GDP-weighted												
Advanced	2.2	2.2		2.5		4.7		-0.5		5.2	1.8	6.5
BRICs	6.7	6.7		3.8		10.5		1.5		9.0	3.8	14.3
World	3.5	3.5		2.9		6.4		0.0		6.3	2.4	8.8
PPP-weighted												
Advanced	2.2	2.2		2.5		4.7		-0.6		5.3	1.9	6.6
BRICs	6.9	6.9		3.6		10.5		1.6		9.0	3.7	14.3
World	4.1	4.1		3.0		7.0		0.3		6.7	2.6	9.6

* As of 11 April 2013

Source: GSAM Calculations

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