Global Equity Outlook

Passing The Baton to the Global Consumer

Executive Summary

Five and a half years into the bull market for equities we continue to believe that equities look attractive in light of the potential for accelerating revenue and earnings growth and their return potential versus other asset classes. Valuations in many markets are trading close to their historical averages, which we view as fair in light of improving global economic growth, low inflation in many regions, mostly accommodative central bank policies and above-average equity risk premiums. We maintain a neutral view on developed versus emerging markets but continue to see diverging fundamentals across regions.

Consumers in the developed markets have been conspicuously quiet during the recovery from the 2008 financial crisis. In contrast, central banks acted swiftly at the onset and have kept monetary policy loose in an effort to stabilize financial systems and stimulate growth. More recently, a number of governments have delivered or proposed structural changes to strengthen their economies, while many companies are once again beginning to invest for growth.

Yet in the last couple of years, consumers in both developed and emerging markets have been relatively subdued. That may change as soon as consumer confidence and disposable incomes increase in many regions and near-term cyclical pressures, including inflation and currency, subside. A recovery in consumption in developed markets could extend the current economic cycle, while increasing consumption in emerging markets could be a powerful long-term secular trend, in our view. Central banks, governments and corporations are ready to pass the baton to global consumers—will they take it and run?

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The slow macroeconomic recovery is still on the upswing in many regions, which we believe will drive revenue growth and further earnings growth.

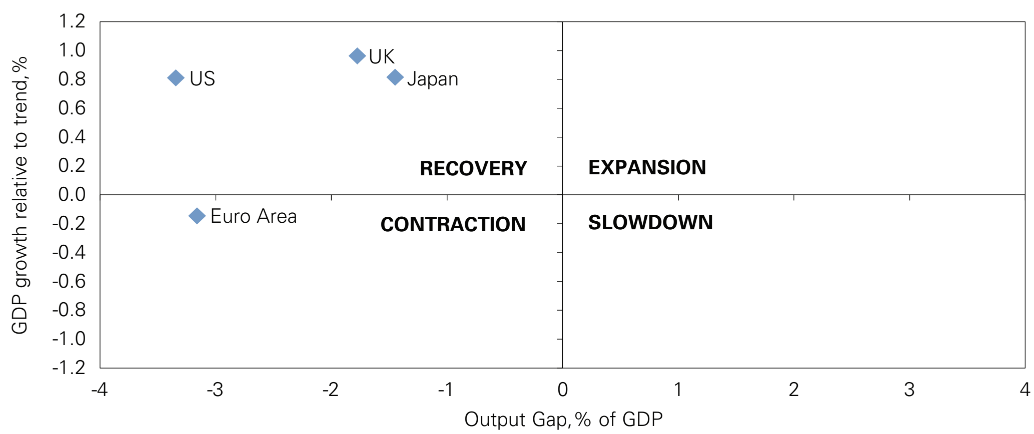
A Slower-Paced Bull Market

Five and a half years into the bull market for equities that began in March 2009, many stock markets are making record highs while volatility is hovering around the lowest levels in years. Have market participants become complacent? We don't think so. In fact, we believe these impressive milestones are actually making many investors nervous. In our view, equities continue to look attractive in light of the potential for accelerating revenue and earnings growth and their return potential versus other asset classes. We continue to believe that global equity returns this year will be similar to average historical returns of about 8-10%.[1] While we expect near-term returns to be lower than in recent years, they may compare favorably with returns from other asset classes.

Macroeconomic Improvement Could be a Tailwind

Six years on from the financial crisis, the slow macroeconomic recovery is still on the upswing in many regions, which we believe will drive revenue growth and further earnings growth. We continue to expect global economic growth of 3.2% this year, which is an improvement over 3% last year, and we expect further acceleration to 3.8% in 2015.[2] Analysis of past recoveries also suggests that we are likely still in the early to middle stage of an economic cycle. Recoveries that follow housing busts and deep recessions, like the current one, are typically longer than shallower or non-bust recessions. Another way to gauge the point in an economic cycle is to look at a country's growth relative to its trend versus the output gap. For example, the US economy is producing above-trend GDP growth while the output gap is still negative, suggesting that it is still in the early to middle stages of an economic cycle. Given that the US economy is currently among the strongest in the world, this analysis would suggest that many other economies are at even earlier stages, with plenty of potential for improvement.[3]

Most developed market economies appear to be in earlier stages of the economic cycle



Source: Goldman Sachs Global Economics Weekly Issue No: 14/28, September 3, 2014

[1] MSCI data from Datastream based on total return for MSCI ACWI from 1988 and MSCI World from 1970.

[2] GSAM estimates as of September 2014

[3] GS Global Investment Research, Global Economics Weekly Issue No: 14/28, September 3, 2014

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Our conversations with many US industrial companies, which tend to be economically sensitive, also support the idea that the US economic recovery is only mid-cycle.

Our conversations with many US industrial companies, which tend to be economically sensitive, also support the idea that the US economic recovery is only mid-cycle. Volumes in some key subsectors and geographies are still below cyclical norms and margins incrementally increased this past quarter. We believe margins are sustainable and have room for expansion if revenue growth can accelerate from this year's 2-4% organic growth, which reflects European weakness. A number of US-based companies have also expressed surprise about the relative strength in Chinese demand in light of softening economic indicators, and are expecting India to pick up from the depressed levels of the last few years. We believe continued improvements in the macroeconomic environment could fuel increases in revenue growth across many industries and engage the virtuous cycle of earnings growth.

Importantly, many of the conditions that normally precede economic downturns are not yet present. Continuing with the example of the US, previous expansions have ended either because overheating in the economy led to inflation and central bank tightening or because sharp asset price increases led to private-sector financial imbalances which turned to busts. While there may be some isolated pockets of excess, which we will discuss later, none of these conditions appear currently, further supporting the idea that the US economic recovery has a way to go.[4]

Valuations are Not Yet a Headwind

While broad market valuations are not cheap, we believe most markets are reasonably priced, given underlying strong or improving fundamentals. Valuations in many markets are trading close to their historical averages, which we view as fair in light of improving global economic growth, low inflation in many regions, mostly accommodative central bank policies and above-average equity risk premiums. Only China and Russia stand out as inexpensive on the surface, but this is largely due to geopolitical or economic uncertainty, as well as large weightings to state-owned-enterprises in their benchmarks, which generally trade at lower valuations.

Valuations for most markets look reasonable, though few look inexpensive

	CAPE		FY1 PE		Price/Book	
	level	% time cheaper	level	% time cheaper	level	% time cheaper
US	22.3	70%	15.8	70%	2.7	68%
UK	14.0	52%	13.2	59%	1.9	51%
France	16.7	53%	13.5	54%	1.5	46%
Germany	15.9	56%	12.5	33%	1.7	51%
Italy	15.3	38%	12.7	37%	1.1	32%
Spain	13.5	39%	14.6	77%	1.5	62%
Japan	29.8	45%	14.2	16%	1.3	16%
Australia	17.8	60%	14.1	52%	1.9	64%
Brazil	9.1	19%	10.9	88%	1.4	52%
China	11.5	23%	8.8	14%	1.4	25%
India	19.2	53%	16.4	80%	3.0	54%
Russia	4.7	2%	4.4	9%	0.7	7%
Mexico	23.6	79%	19.2	99%	3.0	82%
Korea	11.9	9%	9.6	39%	1.0	20%
Indonesia	16.1	38%	14.7	80%	3.6	73%
Turkey	9.2	20%	9.5	60%	1.5	8%
EM	12.5	11%	10.9	34%	1.5	22%
DM	19.8	53%	15.0	44%	2.2	55%
World	15.6	34%	14.4	36%	2.1	32%

Source: GSAM, Datastream, as of September 30, 2014. 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.

[4] GS Global Investment Research, Global Economics Weekly Issue No: 14/28, September 3, 2014

Importantly, overall stock market valuations hide pockets of value and excess, particularly in more expensive markets like the US. Our bottom-up fundamental analysis approaches a "market of stocks," and helps us avoid stocks and areas of the market that we believe have fully priced-in expectations, while seeking those which might have further upside.

Equity investors have continued to reward the shares of acquiring companies (typically shares of target companies rise and those of acquirers fall), signalling their willingness to see companies invest for growth after years of cost-cutting and dividend increases.

Passing the Baton to the Global Consumer

In addition to the improving macroeconomic environment, we see three key drivers for equities: growth spending, structural reforms and consumer spending patterns.

Growth Spending

We expect continued corporate and investor appetite for M&A, which has reached almost $600bn in the last four quarters, and is approaching the last peak of $700bn in 2007.[5] M&A has had a significant impact on stock prices, particularly in the Information Technology (IT), Healthcare and Consumer Staples sectors. Equity investors have continued to reward the shares of acquiring companies (typically shares of target companies rise and those of acquirers fall), signalling their willingness to see companies invest for growth after years of cost-cutting and dividend increases. We continue to believe that the robust M&A market is a precursor to capital expenditure (capex) increases. And while capex has been slower to materialize than we expected, we still believe that pent-up demand exists, particularly for technological upgrades.

Structural Reforms

Countries that have or have not made structural reforms are seeing an impact in their economies and equity markets. Equity markets in Japan, India and Mexico all rose ahead of elections that ushered in reform-minded governments within the last two years. We maintain a positive view on each market because they have succeeded, or we believe will succeed, in passing reforms that have potential to improve their economies, drive consumer spending and create sustainable growth.

Brazil could take a similar path. Currently, Brazil's economic growth has been crippled by high inflation, rising interest rates and increasing consumer debt. Many of the companies we speak with also frequently cite poor infrastructure and labor costs as critical issues that are hampering business activity. For example, only a small percentage of highways are paved, and many of those have just one lane. Labor is expensive in Brazil, where the social costs of an employee can be as much as salary; in Mexico the ratio is closer to half. Brazil's presidential election in October is bringing discussion of needed economic reforms to the top of the agenda. We believe getting past the election uncertainty, which is stalling economic activity, will be helpful. More importantly, if market participants believe that the existing or a new government is committed to reviving growth, bringing down inflation and making structural reforms, it could be a huge catalyst for Brazil's equity market. Given our favorable view on Mexico and the potential to become more positive on Brazil, we believe Latin American equities are starting to look more interesting.

Europe and China are also in the midst of structural reforms, but the measured pace is weighing on their economies and equity markets. The European Central Bank (ECB) has taken action, reducing interest rates to virtually 0% and setting up an expectation for some form of quantitative easing. Some countries, such as Spain and Ireland, which have been more aggressive with structural reforms, albeit out of necessity, have been rewarded with economic improvement and equity market performance. We believe that other European countries that take steps toward stimulating growth and making their economies more competitive could be similarly rewarded.

China is approaching reform through important steps such as targeted easing and loosening property restrictions. However, uncertainty about further steps the government will take and growing concern that these efforts might not be enough is dampening investor sentiment. In our

[5] Barclays US Equity Strategy, M&A – this cycle is different, September 18, 2014

view, Chinese equities are likely to respond positively to increasing transparency from the Chinese government and policy details.

While there are a number of factors contributing to near-term cyclical weakness, when they subside the consumer has the potential to be a powerful force.

Consumer Behavior and Spending Patterns: Cyclical vs. Secular

While central banks and many governments have implemented a number of policies and reforms since the financial crisis and corporate activity has picked up, consumers in most regions have been relatively subdued. While there are a number of factors contributing to near-term cyclical weakness, when they subside the consumer has the potential to be a powerful force. If the global consumer takes the baton and runs with it, developed markets like the US and Japan could extend their economic recoveries, while in Asia and other emerging markets, we believe increased consumption will be an important long-term secular trend. In addition, changes in spending patterns will have an impact on company fundamentals and equity markets.

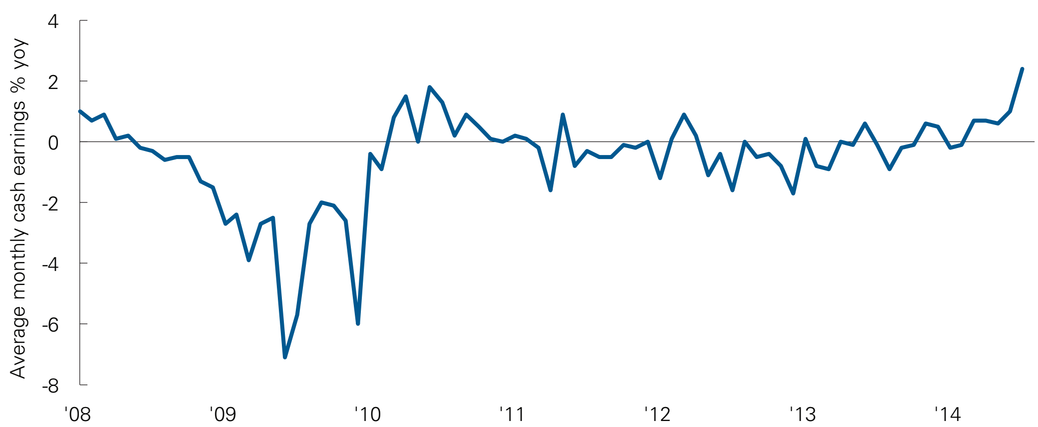
Cyclical Softness: Why Isn't Anyone Spending?

Several factors are contributing to the near-term softness in consumption. First, the low-end consumer is still weak, particularly in the US where the middle class is stagnating and the income gap is as wide as it has ever been. We believe that continued improvements in employment and the housing market should increase consumer confidence and, ultimately, spending. Interestingly, consumption in India is displaying a similar pattern, where those who can are spending as sentiment has significantly improved since the election, but inflation is still hurting the poor.

Wages in the US and Europe have not been growing. In the US, household disposable income has not yet improved, despite falling unemployment, however credit has become more widely available and the consumer culture has a high propensity to spend. European consumer sentiment has weakened as economic growth stalls and there is less access to credit, dampening the prospects of a pick-up from European consumers.

In Japan, wages have been increasing but consumers may still be exercising restraint following heavy spending early in the year ahead of the consumption tax increase in April. Poor weather in the summer and a weak yen may also be temporarily depressing consumption. However, rising wages are contributing to increasing disposable income which we believe will ultimately spur consumption.

Rising wages in Japan could lead to increasing disposable income and consumer spending



Source: Bloomberg, as of August 31, 2014

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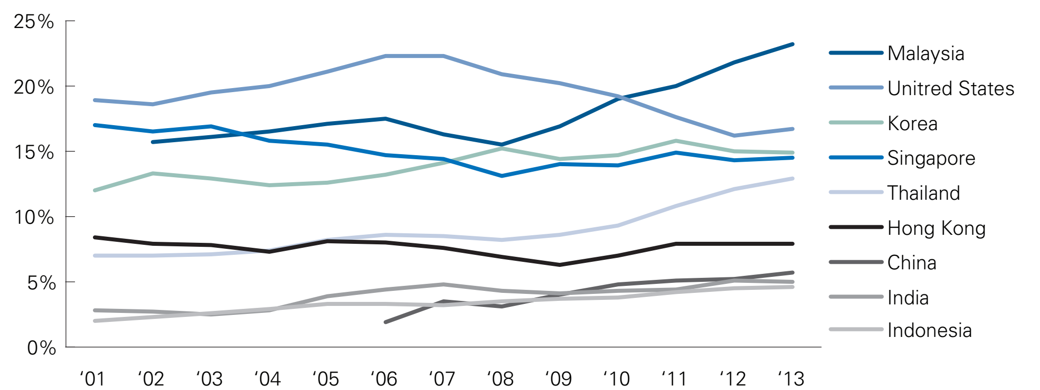
In many growth and emerging markets, such as Russia, Brazil, Turkey and South Africa, consumer weakness is largely due to geopolitical uncertainty, inflation and weak currencies. While we have become slightly more cautious on Russia since our last outlook due to increasing geopolitical risk, employment and disposable income in Russia are still strong, meaning the Russian consumer has the potential to bounce back more quickly.

In many growth and emerging markets, such as Russia, Brazil, Turkey and South Africa, consumer weakness is largely due to geopolitical uncertainty, inflation and weak currencies.

Consumer spending is slowing in a number of Asian markets due to a combination of slower growth from China, inflation, weakening currencies and consumer leverage. In Korea, the strong won and slowing growth in China have weighed on the economy, while a national tragedy further hurt consumer sentiment earlier in the year. However, sales are starting to recover and we note that Korea's new finance minister is particularly focused on domestic consumption. We are cautious on countries where consumer leverage is higher, like Malaysia and Thailand.

Household debt has been rising in Malaysia and Thailand while the US consumer has been deleveraging

Household debt service ratios



Source: Standard Chartered research, Asia – Leverage Uncovered: an update, June 17, 2014, data from BIS, IMF, Standard Chartered

Lastly, China's anti-corruption measures are continuing to have a greater-than-expected impact on general consumption. Over a year since the measures began, many consumers and corporations still appear to be adjusting their behavior as it becomes apparent that the crackdown is not temporary and the days of excessive gift-giving are over. Furthermore, there appears to be a trickle-down effect to general consumption. As a result, spending is not only softer, but the patterns are changing. Overall consumption will be more price-sensitive because it comes from consumers and corporations (which will be more sensitive to cyclical trends), rather than price-insensitive gift-giving. We also continue to expect less spending on luxury items until at least the middle of next year. In addition, items like gift card sales are down, as they were often used as a tax-free way to give bonuses to employees.

Secular Strength: Changing Spending Patterns

We emphasize the cyclical factors behind the current softness in Asian and emerging market consumption because we actually expect that increasing consumer spending has the potential to be an enormous secular driver of growth in these regions. The middle class in Asia and many emerging markets is rapidly expanding as disposable incomes increase. Already, we notice that middle class spending has recently accelerated versus high income spending. Furthermore, people are becoming wealthier at younger ages in Asia. One luxury goods company notes that its Chinese consumer is about 20-25 years younger than its European and US customer base.[6]

[6] Burberry FQ32014 Sales and Revenue Call – Trading Update, January 15, 2014

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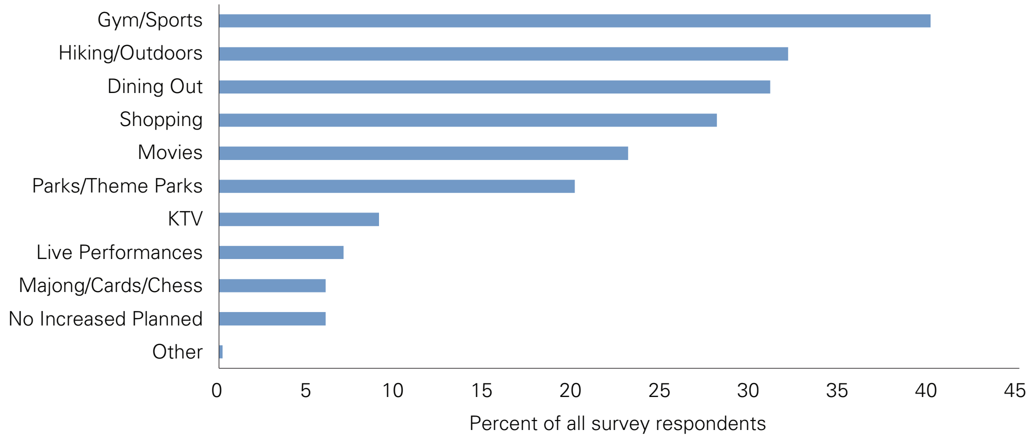
Within these regions, there are varying preferences for global versus local brands. Global brands have had more success in China and India but ASEAN[7] consumers tend to prefer local brands. Currently, we have a favorable view on Indonesia, where the consumer class is growing by 5 million per year, roughly the size of Singapore's population.[8] We are focused on companies with strong local brands in Indonesia, which is important in this brand-loyal market.

Consumers all over the world are spending more on services and experiences, such as travel, rather than goods, housing and autos. Technological innovation and access are also changing spending patterns.

Consumers all over the world are spending more on services and experiences rather than goods, housing and autos. High house prices in the US, UK and China are part of the issue, making it difficult for young people to move into their own homes, particularly when unemployment has been relatively high, such as in the US and UK. As a result, they are choosing to spend on experiences rather than saving for a home.

Chinese consumers expect to increase spending on many activities, particularly more health-related ones



Source: Survey of Chinese consumers, CLSA China Reality Research, Mr. & Mrs. China Dare to Dream, September 2013

Travel is benefitting significantly from the trend toward spending on experiences from both younger people as well as those with new disposable income. Interestingly, airline and hotel prices in the US have been going up despite lacklustre retail data in other areas. 100 million Chinese travelled outside of China last year and some analysts expect it could be 200 million by the end of the decade.[9]

Many Asian consumers will also be spending more on healthcare. Middle class families in China are buying more private health insurance. In addition, women in Asia make many of the household spending decisions and are more likely to spend on healthcare. Even elective services like plastic surgery are also likely to increase according to surveys.[10]

Lastly, technological innovation and access is changing spending patterns. E-commerce continues to gain market share in Asia, driven by rapid technological advances and the advantage of price transparency. E-commerce is now taking off in Brazil, where companies are investing heavily as they vie to become the Amazon.com of Brazil. Even in the US, e-commerce still only accounts for 6.4% of total retail sales and is continuing to gain market share. In 2Q14, e-commerce sales rose 15.7% yoy, while total retail sales increased 4.4% yoy.[11]

[7] The Association of Southeast Asian Nations includes Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam.

[8] McKinsey & Co., Understanding ASEAN: Seven things you need to know, November 2013

[9] CLSA research, Mr. & Mrs. China Dare to Dream, September 2013

[10] CLSA research

[11] US Census Bureau news release August 15, 2014

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The strengthening economy and rising interest rates could put upward pressure on the US dollar, which could turn into a headwind for US companies, though it may help consumption.

Mobile commerce is growing even faster, particularly in many Asian and emerging markets given the high level of smartphone penetration. For example, nearly 100% of young, single, urban Chinese women—one of the most active consumer demographics—have a smartphone and they spend roughly 3.5 hours a day on it outside of conversation. Moreover, 65% of factory workers in China have a smartphone.12 In India, consumers bought 18 million smartphones in just the first quarter of this year, a 186% increase from the year before. By the end of this year, total handsets sold could reach 80 million,13 which is contributing to a rapid uptake in internet usage, including mobile commerce.

Regional view

We maintain a neutral view on developed versus emerging markets but continue to see diverging fundamentals across regional markets.

US

The US has the best macroeconomic outlook of the developed markets, which could ultimately benefit other markets. We are expecting approximately 3% GDP growth[14] and our conversations with companies confirm they have similar expectations. We continue to believe a macroeconomic tailwind will fuel revenue growth and further boost earnings. We also continue to believe that capex will increase, particularly for the IT sector. Corporate appetite for M&A remains strong, though the window for inversions—cross-border transactions in which companies relocate for tax purposes—may be closing soon.

Housing has been slower to recover than we expected, but home improvement spending has been increasing. Overall consumer spending is still muted, particularly at the low end, likely due to the slow recoveries in the housing and labor markets. Consumer spending accounts for 70% of US GDP so increased consumer spending can have a big impact on the US and global economies.

Interest rates have stayed lower for longer than we expected and our underweight to interest-rate sensitive areas of the market, such as REITs and utilities, proved to be early. However, the Fed continues to signal that it will act soon. The strengthening economy and rising interest rates could put upward pressure on the US dollar, which could turn into a headwind for US companies, though it may help consumption. In our view, valuations are fair considering the positive macro environment and continued room for improvement in revenues and earnings.

Japan

In our view, economic and structural reforms from Abenomics are working and could ultimately drive consumption. Inflation has been steadily rising and has led to increasing wages and household disposable income. Consumption, however, has disappointed, even adjusting for the demand pull-through earlier in the year ahead of the consumption tax increase. Some of the softness may be due to the weak yen and poor weather but we will be watching closely for signs of improvement.

The third stage of Abenomics involves corporate reforms that are putting a new emphasis on profitability and corporate governance. Free cash flow continues to improve and corporate profitability has been better than expected. Importantly, companies have been increasing capex more than in most other regions. Consumer companies, in particular, have been spending to increase their footprint in Asia, given the strong secular trends in the region. We also expect many companies to use their increased profitability to increase dividends and share buybacks, as well as make acquisitions, though we would look carefully at acquisitive companies as some Japanese companies have overpaid in the past, especially in foreign transactions.

[12] CSLA research

[13] IDC research as reported in ETCIO.com, June 4, 2013

[14] GSAM estimates

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While we continue to expect the Bank of Japan to ease next year, many market participants are starting to believe that there could be announcements of easing and fiscal stimulus before the end of the year. Japanese equities look cheap relative to their long-term average, but that is because the long-term includes some very expensive periods. We think current valuations are fair for earnings growth of about 10% and ROE of 8-9%.[15]

In Europe, the risk of deflation and "Japanization"—the scenario where there is no growth, interest rates remain at 0% and balance sheets are shrinking—is real.

Europe

Europe's macroeconomic picture has weakened in the last several months, though ECB action, a weakening currency and structural reforms such as the Asset Quality Review could improve prospects for the region. While we had expected only modest improvements in growth, Europe's economy was flat which meant that companies were not able to realize the operating leverage we had thought possible. As a result, we have become slightly less optimistic about Europe, but if growth improves European companies could significantly exceed expectations. The weakening euro could be helpful, with the effects likely coming over the next 6-12 months. Consumer spending is stabilizing with GDP improvement but we believe it will take real GDP growth to fully engage the consumer.

In the meantime, the risk of deflation and "Japanization"—the scenario where there is no growth, interest rates remain at 0% and balance sheets are shrinking—is real. We are currently overweight financials due to the expectation of some form of quantitative easing and stress test results, which are due in October and that we expect will be positive. However, we are still cautious in the long term on European financials and the region, unless additional structural reforms are implemented to improve productivity and competitiveness. In our view, valuations are fair in light of real risks.

China

The government is taking small steps toward structural reforms but the weak property market and anti-corruption campaign make for a bumpier transition to a consumer-led economy at the same time that evidence of a cyclical recovery is fading. As a result, we have become slightly more cautious on China. Recent economic data also indicates that what looked like a positive turn for the economy may have been short-lived. Many market participants are debating how China will achieve its target 7% growth, though we expect the government will manage the economy and post a number not far below target.

We remain cautious on China's property market and financials. The property market is still under significant pressure due to oversupply and the perception that prices are not rising further, which is turning away buyers. The Chinese government has pressured banks to lower mortgage rates but it remains to be seen if banks will really lend. Another growing concern is that there have not been enough bankruptcies and that the government will let some small local property developers default.

In addition, the crackdown on shadow banking is further tightening conditions and triggering a downward spiral of property prices. We expect the Chinese government to avoid a crash but banks' profitability will remain under pressure and some will need to raise equity.

These issues create uncertainty for both investors and Chinese consumers. At the same time, the anti-corruption campaign is further weighing on consumer spending. While the Chinese equity market looks cheaper than many other regions, much of this is due to the big discount in property and financial stocks, which trade around 4-5x earnings and 0.8x book value. Ex-financials, the Chinese equity market trades closer to 10x (A-shares) or 13x (H-shares) earnings.[16] In light of slower growth expectations, we are focused on companies that can grow faster than the broader economy and that have new products and pricing power. We have also been focused on other pockets of strength, including e-commerce and railroads.

[15]GSAM estimates

[16]Morgan Stanley research as of September 30, 2014

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With growth in many markets still slow, we are focused on companies with the potential to grow faster than GDP with strong brands and pricing power.

India

Proposed structural reforms post the election have continued to drive equity market returns and are beginning to fuel consumer spending. We believe GDP growth can accelerate from 4% to 8%, with earnings growth increasing from 10% to 20% in the next few years.[17] At the same time, the Reserve Bank of India is expecting inflation to decline to 8% by January 2015 and further to 6% the following year.[18] Business and consumer confidence have increased following the election and those with disposable income are spending again, though the lower-income consumers are still stifled by high inflation. We believe that current valuations, which are in line with historical averages, are reasonable in light of India's strong fundamentals.[19]

Australia

Australia's economy is closely linked to structural change in China. As such, we expect a low growth environment and that monetary policy will remain accommodative to offset the significant weakness in mining-related sectors. We are very underweight resource stocks, with a negative view on coal due to steel oversupply, though we are neutral on energy. However, in the long term, Australia may benefit as China's economy changes via inbound property investment, tourism and education. We believe current valuations are fair, with real estate the only sector looking slightly rich.

Sector Implications

Growth spending, structural reforms and consumer behavior are impacting the consumer, healthcare and information technology/telecom sectors.

Consumer

We are focused on companies that capture changes in spending patterns such as travel, services and the shift to e-commerce, though we are mindful of valuations in some internet-related companies. We continue to expect weakness in luxury goods companies in the near term, due to China's anti-corruption campaign, cyclical slowing in consumer spending across much of Asia and weakening currencies in many emerging markets.

With growth in many markets still slow, we are focused on companies with the potential to grow faster than GDP with strong brands and pricing power. In China, we are looking for companies with new products, or new drugs, in the case of healthcare companies. Products related to electric vehicles, like charging stations and batteries, are also a big theme.

While we were more enthusiastic on the auto industry earlier in the year given strong credit-fueled sales in the US and reports that Japanese companies were not aggressively discounting, we have become more cautious. US sales may now be peaking, while sales in Europe have tapered off and look weaker into next year amidst the softening macroeconomic environment. In China, auto sales may be negatively impacted by the issues in the housing market, as well as the anti-corruption campaign, which are weighing on consumer sentiment. Furthermore, the Chinese government is pressuring global auto parts companies to lower prices in China to conform to global pricing. Auto makers could face similar pressures.

Lastly, the rapid growth of e-commerce in Asia continues to be one of the biggest themes in the Consumer sector with implications for several industries. The uptake has been much faster than in the US and Europe a decade ago and is displacing bricks and mortar players in China who have had less time to adapt. In addition, while logistics and infrastructure related to e-commerce has not yet become an issue in China, they are a gating factor to expansion in some smaller Asian markets.

[17] GSAM estimates

[18] Reserve Bank of India forecast as of April 2014

[19] Reuters, using one year forward P/E of Sensex since 1990.

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We are mindful that biotech indices are back to their March highs. Valuations are neither a bargain nor excessively expensive, but prices now reflect the expectation of some success in company pipelines.

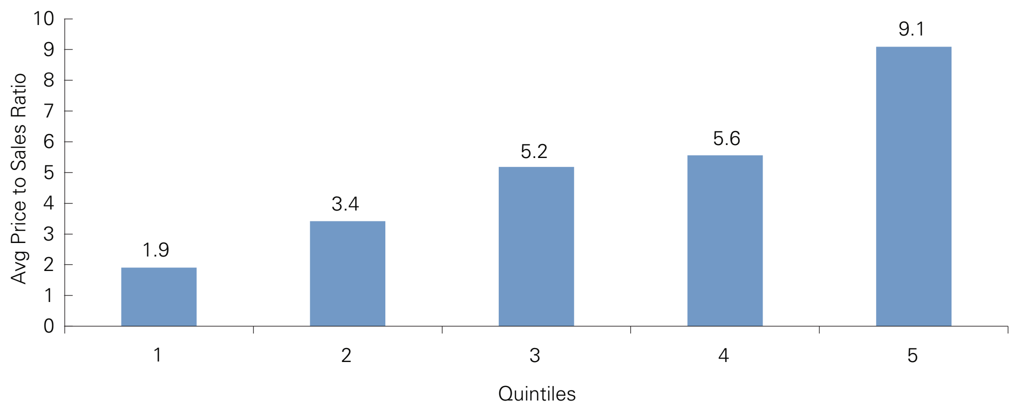
Healthcare
We are neutral to underweight the Healthcare sector across our regional portfolios, mostly due to very strong recent performance. M&A and inversions remain a strong theme in the US and Europe. In Japan, we are cautious on pharmaceutical companies because we expect government pressure to reduce medical costs to improve the fiscal deficit.

In the US, the improving economy and expanded coverage as a result of healthcare reform is increasing hospital volumes but also profitability, which may lead to the first increase in hospital capex in several years. Generic drug pricing remains very strong due to global supply consolidation and higher safety/manufacturing quality standards being enforced by the FDA. As a result, profitability for generic drug manufacturers and distributors is improving. We are mindful that biotech indices are back to their March highs. Valuations are neither a bargain nor excessively expensive, but prices now reflect the expectation of some success in company pipelines.

Companies with a presence in China are very bullish, claiming the market is growing rapidly. Diabetes and healthcare services related to pollution are likely to be big areas of growth in China. Currently, we prefer companies that interact directly with the consumer, as when the government is the end-buyer there can be more pricing pressure and unpredictability. China is also still a big end-market for med tech companies because Chinese companies have not yet fully developed their capabilities. We continue to expect many healthcare companies to benefit long term from increasing disposable income in emerging markets, better access to healthcare and demands for better care.

Technology/Telecom
We continue to think there is pent up demand in enterprise spending, particularly in the US. Some of the biggest end markets, notably the federal government, are in much better shape than last year. Companies may also be delaying spending as they assess the development of cloud computing and how best to integrate related services. A number of the companies that could benefit from the pick-up in enterprise spending are more mature companies with growth rates more in line with the broader economy. However, we find them attractively valued for their level of growth.

Companies in the IT sector are trading at vastly different valuations
Price to sales ratio for IT companies in the Russell 1000 Index



Source: Factset and GSAM calculations, as of September 26, 2014

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We believe some increase in equity market volatility creates more opportunity for active managers.

The pace of the 4G rollout in China is accelerating, according to vendors, and Chinese companies are reporting relatively good margins from this project. In addition, Chinese telecom operators are looking more robust than we would have thought, leading us to believe that smartphone volumes may increase, which bodes well for further mobile commerce growth.

While we are enthusiastic about the prospects for e-commerce as well as other disruptive and fast-growing internet-related industries, we are conscious that valuations for many companies are now discounting enormous expectations for future growth. Although we own some of these companies, we generally own less than the broader market.

The Healthcare and IT sectors trade at average or below-average multiples relative to their own histories, masking higher valuations for some sub-sectors

	CAPE		FY1 PE		Price/Book	
	level	% time cheaper	level	% time cheaper	level	% time cheaper
Cons Disc	26.5	58%	15.7	29%	2.9	84%
Cons Staples	21.7	50%	17.8	67%	3.7	41%
Energy	15.7	40%	13.2	46%	1.7	16%
Financials	20.3	70%	12.9	54%	1.2	27%
Health Care	24.4	49%	17.4	51%	4.0	49%
Industrials	21.7	50%	15.1	30%	2.5	48%
IT	23.8	39%	16.1	29%	3.6	57%
Materials	17.7	40%	14.5	56%	1.9	37%
Telecoms	16.7	47%	15.4	55%	2.3	69%
Utilities	17.3	62%	15.5	75%	1.6	33%

Source: GSAM, Datastream, as of September 30, 2014. 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.

What Could Trip up Equity Markets?

While we generally believe that the current direction of the macroeconomic environment should allow the bull market to continue, we are monitoring a number of factors that could cause it to trip and stumble. First, we are watching for signs of market excess, such as ballooning market capitalizations, the number and quality of IPOs and valuations that are no longer connected to fundamentals.

We also acknowledge that while many central banks still have a bias toward easing, the Fed is clearly moving in the opposite direction and equity markets may not be anticipating how quickly or aggressively the Fed could act.

Many markets, including equities, have displayed surprisingly low volatility despite geopolitical risks, the potential for interest rate increases and generally fair or slightly above average valuations. If we believed this was reflective of investor complacency, we would be more concerned, but this is not currently our view. Furthermore, we believe some increase equity market volatility creates more opportunity for active managers.

Lastly, currency is increasingly becoming an issue for companies, economies and equity markets. The strengthening US dollar could be a headwind for the US economy and companies with foreign sales, such as many tech companies. Notably, a large percent of internet transactions are global, which could negatively impact these companies when foreign revenues look weaker expressed in dollars. In contrast, Europe and Japan could benefit significantly from currency weakness.

Our local research teams are well-positioned to spot subtle trends and inflection points in their regional markets, while our investment process channels these insights, allowing us to make connections between supply chains, industries and markets.

Conclusion

As we enter the final quarter of 2014, we believe the slow, steady climb to normal that we discussed in our last outlook is still on track. The overall global economy continues to improve, though with growing regional variations, and we expect a stronger macroeconomic environment to drive revenue and earnings growth. As equities reach new heights in many markets, the pace of their ascent is likely to slow, but we continue to believe that equity returns may look attractive versus other asset classes, given the still above-average equity risk premium and valuations that are reasonable, in light of growth prospects.

We see several main drivers of equity markets, including growth spending and structural reforms, which we have been discussing for some time. In addition, we believe that global consumption has the potential to be a significant driver of economies and equity markets, both in the near- and longer-term. We believe a number of factors which have depressed consumer sentiment and spending in many regions could be reversing soon. But we also continue to believe that the growth of the middle class and consumption in Asia and the emerging markets will be an important secular theme for many years.

Consumer behavior will not only affect the consumer sectors, but will also likely have a strong impact on the Healthcare and Technology sectors, among others. Similarly, increasing consumer spending in Asia and the emerging markets could have a significant impact on US, European and Japanese companies, as well as local ones. Our local research teams are well-positioned to spot subtle trends and inflection points in their regional markets, while our investment process channels these insights, allowing us to make connections between supply chains, industries and markets. When global consumers are ready to take the baton, we will be watching closely to see if anyone fumbles the handoff and who takes the lead.

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