September 12, 2014

GOAL: Asset Allocation Update

Portfolio Strategy Research

Outlook to year-end: OW equities, UW credit and gov. bonds

Macro outlook: Sustained growth and higher bond yields

We expect sustained strong growth in the US and a small acceleration from the current weak level for European growth. In China we see a moderation of growth into 4Q. These fluctuations are nuances around the view that global growth will be sustained at a stronger level than in the last couple of years, and that this will be a key driver of market performance.

Our recommended allocation

Equities: We are overweight over both 3 and 12 months. We expect earnings growth, dividends, and high risk premia to support returns.

Commodities: We are neutral over both 3 and 12 months but expect significant dispersion below the index level. On a 12-month horizon we are bullish on nickel, palladium, zinc and aluminium, but see downside for copper and gold. We expect roll carry to be a significant component of returns on long positions in the asset class.

Corporate credit: We remain underweight over both 3 and 12 months. We expect spreads to narrow, but given already tight levels, rising government bond yields are likely to dominate the returns, especially for US IG credit. The exception is US HY where the recent spread widening provides ample room for total returns to absorb the rates back-up that we expect. Within credit we recommend an overweight in HY relative to IG on a total return basis.

Government bonds: We stay underweight. We expect yields to rise due to: 1) sustained high US growth and accelerating inflation, 2) a decline in deflation concerns in Europe, and 3) support to inflation expectations from ECB policy action.

Expected returns and recommended asset allocation

New Recommendation						
3-Month Horizon				12-Month Horizon		
Asset Class	Return*	Weight		Asset Class	Return*	Weight
Equities	4.2 %	OW		Equities	13.0 %	OW
Commodities	2.0	N		Commodities	4.0	N
Cash	0.0	N	→	Cash	0.5	N
5 yr. Corporate Bonds	-0.4	UW		5 yr. Corporate Bonds	-0.1	UW
10 yr. Gov. Bonds	-2.7	UW		10 yr. Gov. Bonds	-4.6	UW

* Return forecasts assume full currency hedging

Source: Goldman Sachs Global Investment Research.

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What's new?

In Summary

In our GOAL Flash Update last week we upgraded equities to overweight over 3 months and we are now overweight equities and underweight corporate credit and government bonds over both 3 and 12 months. We think this positioning will be supported by sustained growth around current levels, as this drives earnings growth and leads to higher bond yields. The main risks are geopolitical and the possibility that a further rapid rise in yields lead to a temporary sell-off in equities.

GOAL: Flash Update

Last week we published our first GOAL Flash Update. This is a much shortened version of our regular GOAL report, which we intend to use when necessary to comment on events and adjust our allocation with a fast turnaround time. In the report we upgraded equities to overweight over 3 months. Here, we expand on the comments from the Flash Update providing our usual more comprehensive overview of the cross-asset outlook.

The pace of growth…

After continued positive data surprises in the US and negative surprises in Europe (Exhibit 1), our current activity indicator (CAI) at 3.8% is running somewhat ahead of the 3.3% pace of growth we are forecasting for the US in 4Q. For the Euro-area our CAI at 1.3% is running a bit behind the 1.6% growth rate we forecast in 4Q. We expect growth in Europe to rebound from the current weaker level, in line with our forecast. We think this will represent a meaningful surprise relative to current market concerns about the growth outlook in Europe as expressed in very low bond yields and the underperformance of cyclicals vs. defensives ytd. In China, data have recently weakened consistent with our view that growth will slow from 8.4% qoq annualized in 3Q to 8.0% in 4Q. Risks around these forecasts have also shifted from being on the upside to being in line on 3Q, and if anything mildly to the downside on 4Q.

…drivers from here

The short term movements in growth are nuances around our core view that data is consistent with sustained global growth that is substantially stronger in the next couple of years than what we have seen in the last couple of years. We expect US growth around 3% over the next few years supported by easy financial conditions. Substantial further acceleration is likely in residential investment growth. Capital spending has caught up and we now expect sustained annual growth in that segment at around 5%. In Europe, market participants have been particularly concerned about the weakening of the German growth outlook. Here we think that consumption will be supported by the strong labour market, investment spending will benefit from pent-up investment demand, easy financial conditions and rising profits, whereas exports should be supported by the stronger global outlook.

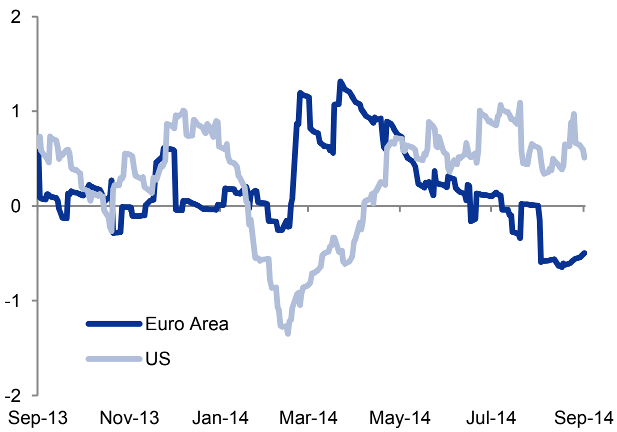
Strategic outlook

Strategically, the sustained improvement in growth is the key driver of our views. We expect it to support earnings growth as a driver of solid equity performance; to drive bond yields higher and to be supportive of our benign view on credit spreads. We have very high conviction that this environment will support our long-term overweight in equities vs. bonds. We think the growth differential between the US and Europe and the associated gap in monetary policy, will support a significant weakening of the euro vs. the US dollar. We have extended the fall we forecast and now see the cross at 1.20 in a years' time and parity in 2017.

Tactical thoughts

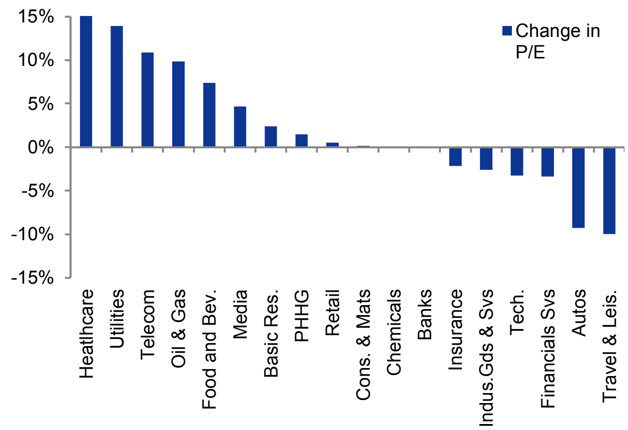
Tactically, we think the key risk to our strategic views is that a further shift higher in bond yields will lead to a temporary sell-off in equities in line with the experience during the summer last year. While qualitatively similar, we would expect the magnitude of the sell-off to be smaller than what we saw back then as less adjustment is needed for bond yields. We still see a high likelihood of this happening over the fall, but the timing is uncertain and the risk has to be balanced against the underlying return potential in equities. We still have high conviction that yields will increase into year-end but the ECB policy action has shifted risks in the direction of a slower rise relative to when we published GOAL in late July. We have also lowered our 10-year bund forecast to 1.30% at year-end from 1.60% previously.

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



Source: Haver Analytics, Goldman Sachs Global Investment Research.

Exhibit 2: In Europe defensive multiples have expanded
YTD change in 12-month forward P/E in Europe



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

Our equity upgrade

This shift in risks against a solid long-term return backdrop for equities was the motivation for the 3 months upgrade in our GOAL Flash Update last week. We expect solid returns for all the major regions, driven mainly by earnings growth and dividends. The ECB policy action reflects a weaker growth and inflation outlook for the Euro area, which is also a drag on equities. However, we think much of this is already reflected in the data and, on balance, we think the net effect of the policy action from here will be positive for equity markets. Geopolitical risks are likely to remain a significant driver of short-term volatility. The conflicts in both Iraq and Ukraine remain very volatile, but in both cases we see the likelihood of broader market impact over the longer term as low.

Still UW credit

In corporate credit, we are still constructive on spreads. We expect the search for yield environment to remain strong as monetary policy remains easy, growth is sustained at current higher levels and macro risks stay relatively low. However, this has to be held up against the losses we expect on the government bond component of the total return. Even with bond risks now being somewhat lower they still dominate the spread return for IG credit, and we remain underweight corporate credit. For high yield on the other hand, the spread return has the potential to offset any loss on the bond component of the total return. We therefore have a clear preference for HY over IG, on a total return basis.

Regional changes

Within equities we also shifted our regional allocation in our GOAL Flash Update. Over 12 months, we maintained our existing stance: overweight Europe and Japan; neutral Asia ex-Japan; and underweight the US. We have less conviction in our regional allocations over 3 months but, on balance, we downgraded Japan to underweight after a strong run in recent months and given current macro headwinds. Longer term, for Japan, we still believe in the ability of reforms to drive profit and performance and that, together with an attractive valuation, is reflected in our overweight stance over 12 months. We upgraded Asia ex-Japan to overweight over 3 months and expect support from the Shanghai-Hong Kong stock connect theme as well as our generally more positive view on EM assets (for details see *China Strategy report: SH-HK Connect: New regime, unprecedented opportunity*, September 1, 2014 and *Emerging Markets Weekly (14/28): Tactically positive EM risk*, September 4, 2014). We upgraded the US to neutral reflecting the current robust US growth environment. Finally, we maintained our overweight in Europe.

Performance

The performance of our allocation since our July GOAL report has been poor. Our underweights in corporate credit and government bonds returned 0.0% and 0.5% respectively while our overweight in cash returned 0.0% until we turned it into an equity overweight on September 5. Since then equities have returned -0.7%.

Our forecasts

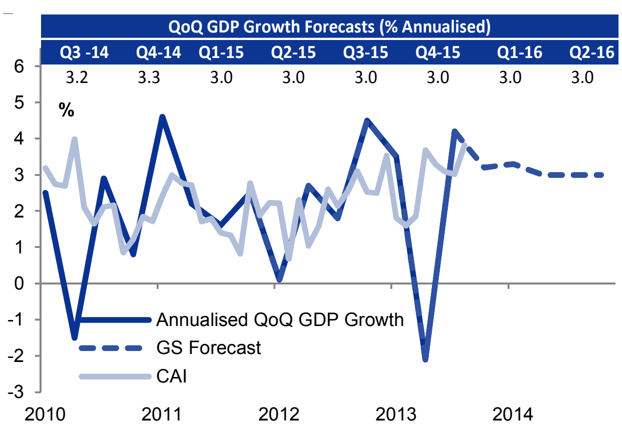
Exhibit 3: Our forecasts across asset classes

	Return in % over last			Current	Forecasts			
	12 m	3 m	1 m	Level	3 m	6 m	12 m	Unit
Equities								
S&P 500 ($)	20.7	3.3	3.4	1997	2050	2075	2150	Index
Stoxx Europe 600 (€)	14.4	-0.5	4.7	344	365	375	390	Index
MSCI Asia-Pacific Ex-Japan ($)	12.5	3.0	1.0	502	530	540	555	Index
Topix (¥)	12.4	5.9	4.7	1311	1250	1300	1450	Index
10 Year Government Bond Yields								
US	5.7	1.1	-0.7	2.55	3.00	3.13	3.38	%
Germany	10.6	3.2	0.7	1.04	1.30	1.40	1.65	%
UK	6.4	2.8	1.1	2.55	3.00	3.06	3.19	%
Japan	2.8	0.7	-0.1	0.57	0.75	0.82	0.94	%
5 year credit spreads*								
iBoxx USD	8.8	1.0	-0.2	83	73	71	70	Bp
BAML HY Master Index II	9.4	-0.3	0.4	401	332	325	320	Bp
iBoxx EUR	8.7	2.0	1.0	102	99	97	95	Bp
Commodities								
WTI	-9.4	-9.4	-4.8	93	90.00	90.00	90.00	$/bbl
Brent	-5.5	-8.4	-5.9	98	100.00	100.00	100.00	$/bbl
Nymex Nat. Gas	-2.6	-13.8	-4.2	3.82	4.00	4.10	4.00	$/mmBtu
Copper	-3.8	2.4	-2.1	6835	6600	6600	6200	$/mt
Aluminium	4.7	8.2	-0.2	2040	2000	2050	2100	$/mt
Gold	-9.3	-1.8	-5.5	1239	1195	1135	1050	$/troy oz
Wheat	-26.7	-18.1	-9.5	510	560	575	575	Cent/bu
Soybeans	-9.3	-19.6	-8.5	982	1050	1050	1050	Cent/bu
Corn	-27.8	-20.8	-6.8	332	400	400	400	Cent/bu
FX								
EUR/USD	-2.7	-4.4	-3.4	1.29	1.29	1.25	1.20	
USD/JPY	6.8	4.8	4.6	107	103	107	110	

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

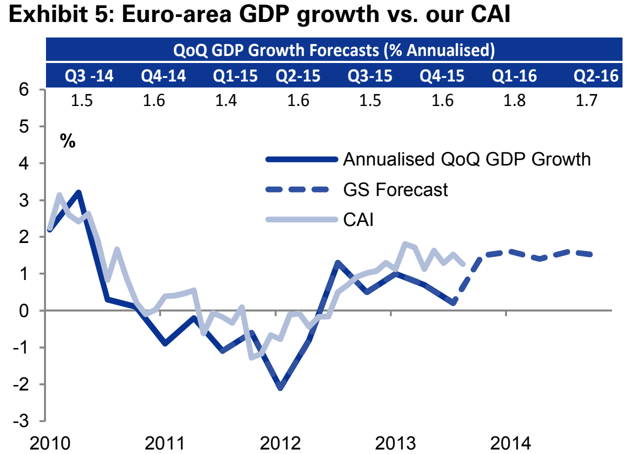
Source: Goldman Sachs Global Investment Research.

Exhibit 4: US GDP growth vs. our CAI



Source: Goldman Sachs Global Investment Research.

Exhibit 5: Euro-area GDP growth vs. our CAI



Source: Goldman Sachs Global Investment Research.

Exhibit 6: Our forecasts for economic growth vs. consensus

% yoy	2012	2013	2014E		2015E	2016E	2017E
			GS	Consensus*	GS	GS	GS
USA	2.3	2.2	2.2	2.1	3.1	3.0	3.0
Japan	1.5	1.5	1.0	1.5	1.2	1.5	1.5
Euro Area	-0.6	-0.4	0.8	1.0	1.4	1.7	1.6
China	7.7	7.7	7.3	7.4	7.6	7.6	7.4
BRICs	5.9	5.9	5.4	5.5	6.1	6.7	6.7
Advanced Economies	1.2	1.4	1.9	1.9	2.5	2.5	2.5
World	3.0	3.0	3.1	3.1	3.7	4.1	4.1

* Consensus Economics September 2014

Source: Consensus Economics, Goldman Sachs Global Investment Research.

Investing in our themes

Cyclical recovery

To benefit from the better sustained growth environment, we would position in stocks which are cyclically exposed from a variety of perspectives. In the US and Asia ex-Japan we shy away from companies with European sales exposure as the level of growth in Europe is weaker than in the US and we expect the Euro to weaken. In government bond markets we remain short 3 year US Treasuries.

Exhibit 7: Our recommendations position for a DM driven cyclical recovery…

	Cyclical recovery
Equity	US companies with high domestic sales (GSTHAINT) vs. US companies with European sales exposure (GSTHWEUR) US companies with highest combined beta to US economy and stock market (GSTHBETA) vs. S&P 500 US companies with weak balancesheets (GSTHWBAL) vs. US companies with strong balance sheets (GSTHSBAL) DAX vs. Stoxx 600 Operationally geared DM exposed European companies (GSSTDMGR) vs. Stoxx 600 European financially levered companies (GSSTFNLV) vs. Stoxx 600 FTSE 250 vs. FTSE 100 Asian global cyclicals (GSSZMSGC) vs. defensives (GSSZMSDF) Asia ex-Japan Stocks with US exposure (GSSZAPUS) vs. Asia ex-Japan stocks with European exposure (GSSZAPEU) Asia ex-Japan margin expanders vs. margin contractors (see June 30 3Q views: Harder-earned returns) Japanese capex growth beneficiaries (GSJPCPEX) Wavefront US Consumer Growth basket (GSWBCOGA) Large cap banks in the US, Europe and Japan, with Equal weights in BKX, SX7E and TPNBNK
Gov Bonds	Short 3 year US Treasuries

Source: Goldman Sachs Global Investment Research.

Shareholder return

As risk aversion moderates we expect companies to put cash to work. Given regional differences in return policies, we have developed different strategies for the different regions to capture this, but we like the theme in all four regions that we cover.

Exhibit 8: …and companies using cash for shareholder returns

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

Source: Goldman Sachs Global Investment Research.

Other strategies

We are long the US dollar vs. the Canadian dollar. In the equity space we recommend trades to benefit from the Womenomics theme in Japan and the Shanghai-Hong Kong stock connect theme in Asia ex-Japan.

Exhibit 9: Other trade recommendations

	Other trades
X-asset	S&P 500 Dec 14 Future funded out of short AUD/USD Dec 14 future
Equity	Japanese womenomics winner basket (GSJPWMN2) Shanghai-Hong Kong stock connect beneficiaries (see June 30 3Q views: Harder-earned returns)
FX	Long USDCAD

Source: Goldman Sachs Global Investment Research.

Equities: Overweight over both 3 and 12 months

Over 12 months we still see a solid case for our equity overweight, though the return potential is lower than what we have seen in the last couple of years. We expect returns to be supported by earnings growth, driven by the stronger economic growth environment. We see absolute valuations as relatively neutral for returns going forward given the state of the cycle. However relative valuations, reflected in large risk premia (Exhibit 12) remain a key argument for holding equities. There is upside risk that the high risk premia eventually translates into higher absolute valuations than we forecast. Over 3 months we have upgraded to overweight as described above but the risk of a sell-off from higher bond yields remains a significant concern.

Regionally, we overweight **Europe** over both 3 and 12 months. While earnings have disappointed so far this year, we expect growth to pick up and that the weakness in earnings will be counterbalanced by more support from monetary policy than we anticipated leaving the overall outlook positive. We underweight **Japan** over 3 months due to the strong recent performance despite disappointing Japanese macro data. However longer term we remain very constructive. We are overweight over 12 months and expect positive earnings surprises, potential further BOJ easing, and continued structural reforms to support returns. We are overweight **Asia ex-Japan** over 3 months and expect support from the Shanghai-Hong Kong stock connect theme as well as our more positive near-term view on EM more broadly. Over 12 months there is still significant uncertainty about the growth outlook for China and the adjustment process to remaining imbalances in EM more broadly, and we stay neutral. We are neutral the **US** over 3 months due to the current robust growth environment, but remain underweight over 12 months, as valuations are high and margins around peak levels.

Exhibit 10: Our recommended weightings within equities

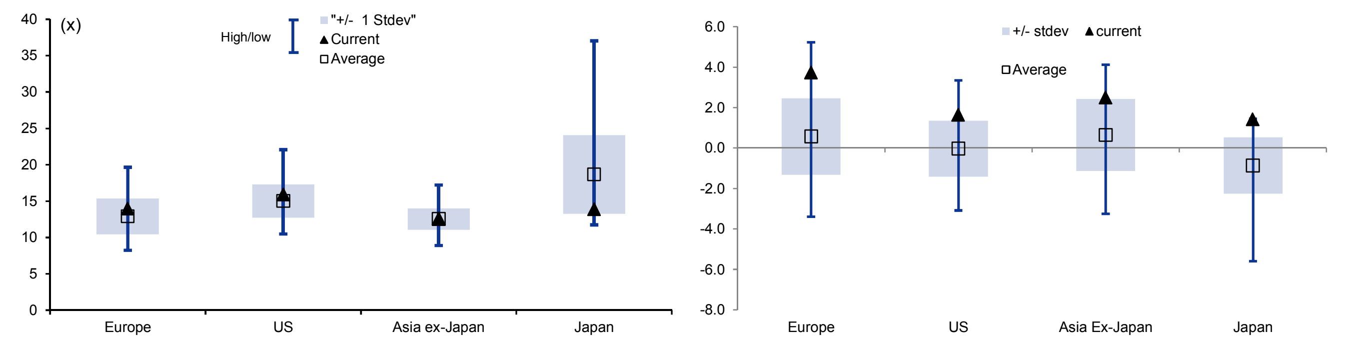
Index	3-Months		
	Return Forecasts		Recommended
	Local Cur.	In USD	Allocation
Stoxx Europe 600	7	7	Overweight
MXAPJ	6	6	Overweight
S&P 500	3	3	Neutral
Topix	-4	0	Underweight

Index	12-Months		
	Return Forecasts		Recommended
	Local Cur.	In USD	Allocation
Stoxx Europe 600	17	9	Overweight
Topix	13	10	Overweight
MXAPJ	14	14	Neutral
S&P 500	10	10	Underweight

Source: Goldman Sachs Global Investment Research.

Exhibit 11: Current valuation vs. history

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



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

Exhibit 12: Valuation data across the regions and our forecasts for earnings growth

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

	P/E	EV / EBITDA	FCF Yield	Div Yield	P/B	Net Income	ROE	Implied	Earnings Growth			
									GS top-down		Consensus bottom-up	
	(X)	(X)	(%)	(%)	(X)	Margin (%)	(%)	ERP (%)	2014E	2015E	2014E	2015E
S&P 500	15.9	9.7	4.6	2.0	2.8	8.9	14.7	5.1	8	8	9	12
Stoxx Europe 600	14.0	8.3	3.9	3.1	1.8	6.4	9.3	7.4	6	12	5	13
MSCI Asia Pacific ex-Japan	12.6	8.7	2.3	3.0	1.7	8.9	12.1	8.5	9	13	10	9
Topix	13.9	7.7	4.9	1.9	1.3	7.2	8.7	NA	16	14	8	10

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

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

Government bonds: Yields to rise with better data

We remain underweight over both 3 and 12 months. We expect yields to rise as: 1) we expect a higher term premium in the front end of the US curve driven by more volatility due to the data dependency of the hiking profile repeatedly emphasized by Chair Yellen, and 2) a stabilisation of inflation in the Euro area around current levels followed by an increase as we move into 2015 easing deflationary concerns and 3) the ECB policy action supports inflation expectations.

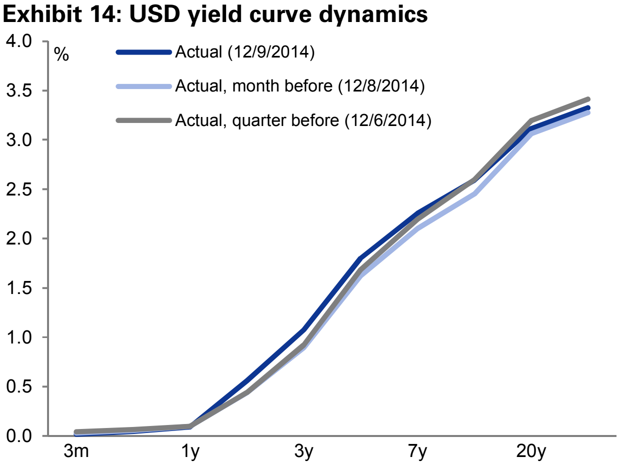
Exhibit 13: 10-year bond yields: Market vs. GS Sudoku Model*, spot and 3 months into the future

	Actual** (%)	Misvaluation against fair value***, standard deviations		Fair value***, %		Fair value change (due to change in fundamentals), t + 3mth
		CE	GS	CE	GS	GS
USA	2.58	-0.3	0.0	2.71	2.59	0.07
Germany	1.08	-1.0	-0.9	1.71	1.63	0.03
Japan	0.58	-0.7	-0.8	0.88	0.91	0.00
UK	2.53	-0.2	0.0	2.68	2.54	0.05
Canada	2.22	-0.5	-0.7	2.62	2.73	0.05
Australia	3.61	-0.5	0.1	4.01	3.56	0.09
Switzerland	0.54	-1.1	-1.1	1.10	1.07	0.05
Sweden	1.58	-0.3	-0.2	1.93	1.85	0.03

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

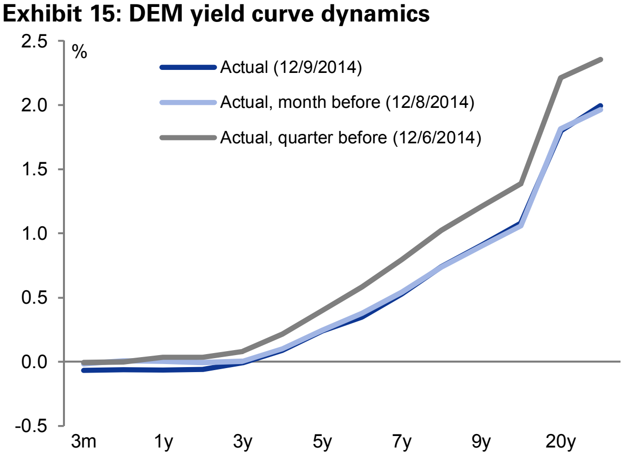
Source: Consensus Economics, Goldman Sachs Global Investment Research.

Exhibit 14: USD yield curve dynamics



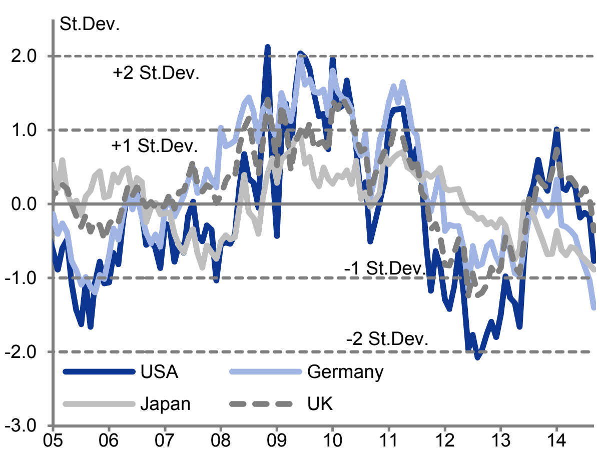
Source: Goldman Sachs Global Investment Research.

Exhibit 15: DEM yield curve dynamics



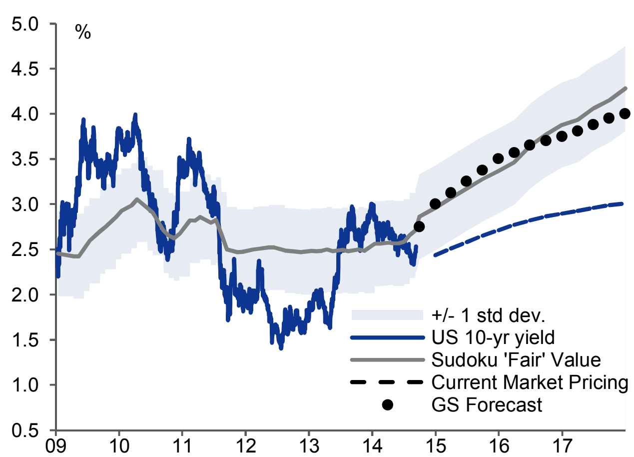
Source: Goldman Sachs Global Investment Research.

Exhibit 16: Degree of 10-year bond mispricing according to Sudoku



Source: Goldman Sachs Global Investment Research.

Exhibit 17: 10-year US yields vs. Sudoku fair value



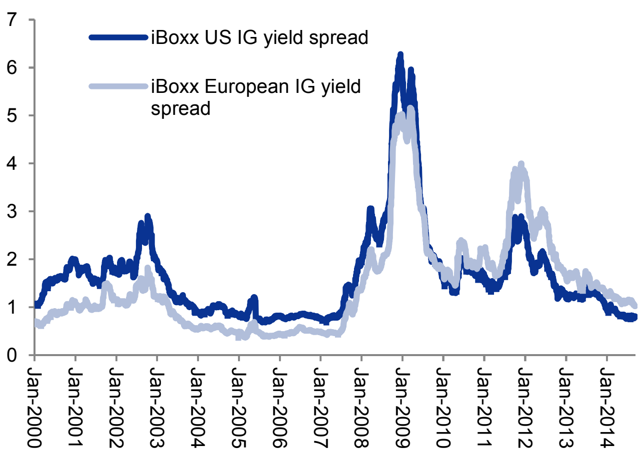
Source: Bloomberg, Goldman Sachs Global Investment Research.

Corporate credit: Search for yield to remain strong

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

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

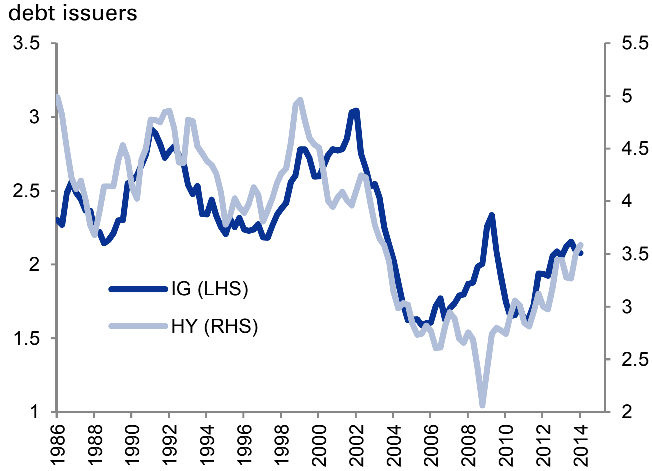
Exhibit 18: US and European 5-year IG spreads



Source: iBoxx, Goldman Sachs Global Investment Research.

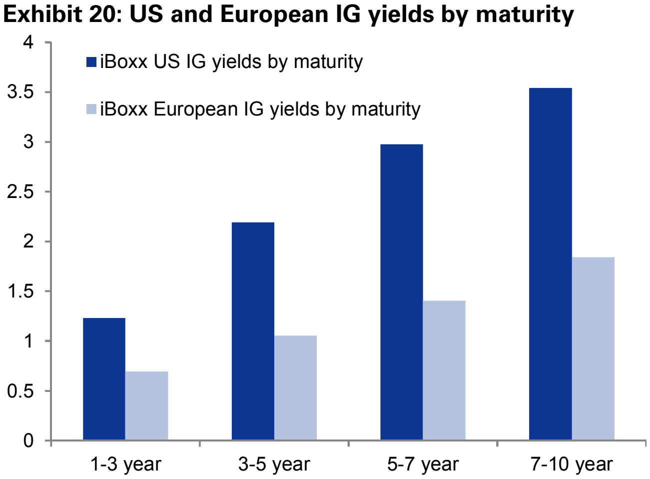
Exhibit 19: Debt/EBITDA ratio has risen

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



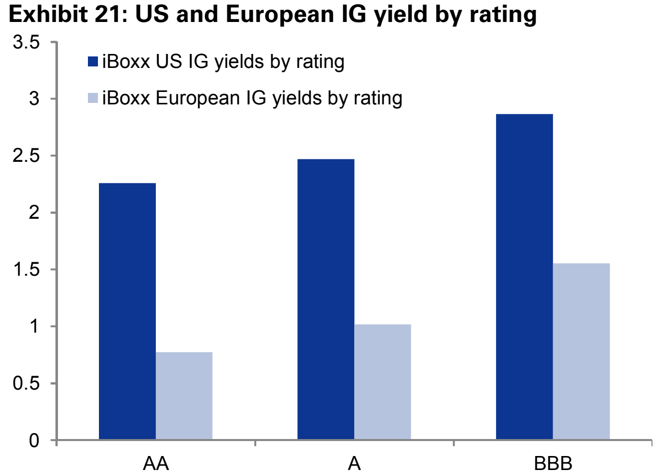
Source: Compustat, Goldman Sachs Global Investment Research.

Exhibit 20: US and European IG yields by maturity



Source: iBoxx, Goldman Sachs Global Investment Research.

Exhibit 21: US and European IG yield by rating



Source: iBoxx, Goldman Sachs Global Investment Research.

Commodities: Neutral over both 3 and 12 months

We see the recent sell-off in commodities as being driven by concerns about demand from both China and Europe. We remain neutral on the asset class over both 3 and 12 months, and continue to highlight two themes. 1) Dispersion: with commodity markets being more supply driven, we see large differences in outcomes between different commodities. On a 12-month horizon we are bullish on nickel, palladium, zinc and aluminum and see downside for copper (due to strong supply) and gold (due to higher real interest rates). 2) Roll yield as a driver of returns: while we do not see price increases in many commodities, we do expect roll yields to contribute meaningfully to returns, and support the long term attractiveness of commodities in an asset allocation context.

Exhibit 22: S&P GSCI® Enhanced Commodity Index and strategies' total returns forecasts

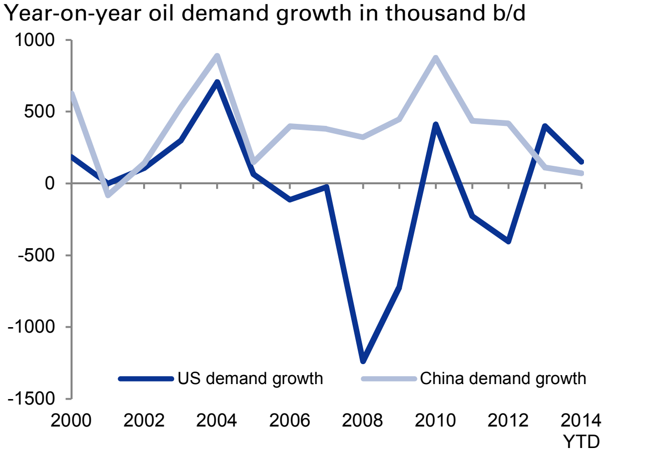
	Current Weight (%)	2012	2013	2014 YTD[1]	12-Month Forward 12-mo Forecast
S&P GSCI Enhanced Commodity Index	100.0	-0.1	-0.8	-4.3	4.0
Energy	72.4	-1.5	5.6	-6.1	6.0
Industrial Metals	7.0	1.3	-13.0	1.8	2.5
Precious Metals	2.8	6.2	-29.7	1.9	-13.9
Agriculture	11.3	5.4	-18.0	-11.7	2.0
Livestock	6.5	-2.8	-2.8	28.5	-4.3

[1] YTD returns through Sep 11, 2014

Source: Goldman Sachs Global Investment Research.

Exhibit 23: US oil demand growth outpaced that of China in 2013 but both have weakened in 2014

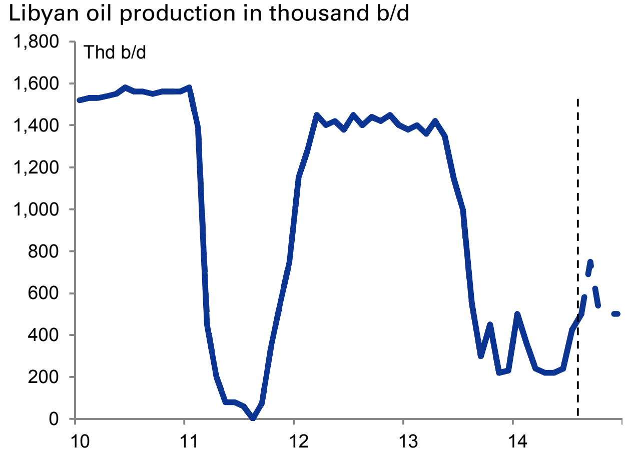
Year-on-year oil demand growth in thousand b/d



Source: EIA, CEIC, Goldman Sachs Global Investment Research.

Exhibit 24: Libyan oil production surging despite escalating civil war

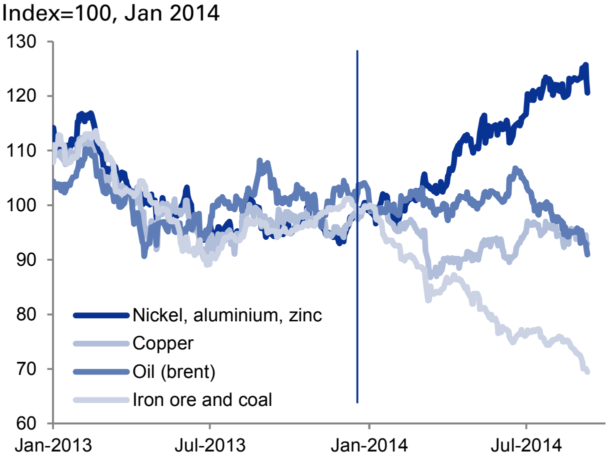
Libyan oil production in thousand b/d



Source: IEA, Goldman Sachs Global Investment Research.

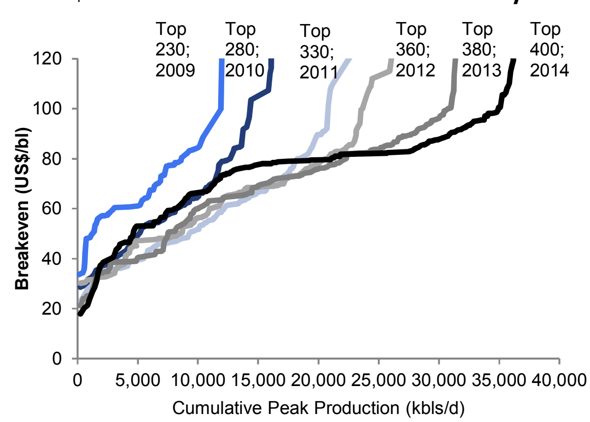
Exhibit 25: Major commodity price dispersion in 2014

Index=100, Jan 2014



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

Exhibit 26: The amount of crude oil that can be brought on at $80-100/bbl has increased substantially



Source: Goldman Sachs Global Investment Research.

FX: Dollar strength kicking in.

With the market's attention squarely on the start of the fed's tightening cycle as well as ongoing strong US growth, the dollar strength which we have been anticipating is kicking in across the board. The USD has appreciated by 4% against its major trading partner currencies and by 2% on a broader trade-weighted basis. Aside from US drivers of dollar strength, domestic considerations have also been a factor in driving the dollar higher, particularly against the euro.

EUR/USD

We revised down our EUR/$ forecast to 1.29, 1.25 and 1.20 in 3, 6 and 12 months (from 1.35, 1.34 and 1.30 previously). We also revised our longer-term forecasts lower, bringing the end-2015 number down to 1.15 (from 1.27), and that for end-2017 to 1.00 (from 1.20). We switched from forecasting euro strength to weakness in April, when we revised our 12-month forecast from 1.40 to 1.30, and the decline since then has been faster than we anticipated. Our latest forecast change aims to signal that the current move lower in EUR/$ has staying power and, in our view, is the beginning of a trend. We think the USD still has room to catch up with the 2-year rate differential, which is currently the most dollar-supportive since mid-2009. In addition, changes to the Fed's forward guidance in coming months have the potential to move the rate differential further in support of the dollar, especially if US data continue their cyclical outperformance versus the rest of the G10. We also believe that the dynamics of the euro have fundamentally changed. Prior to the ECB's latest round of easing in June, the foreign exchange market was very sceptical that additional monetary stimulus could be euro-negative, since it would attract foreign inflows that would buoy the single currency. That thinking has changed fundamentally, in our view, because domestics are increasingly sending portfolio flows out of the Euro area, as ongoing ECB easing encourages a hunt for yield elsewhere.

USD/JPY

We expect USD/JPY to move higher on the back of greater monetary policy differentiation between the US and Japan. Relative monetary policy dynamics are likely to change in October, when the Fed ends its tapering process and the BoJ eases, policy further as inflation softens into year end, thus providing a kicker for USD/JPY higher. We expect Japanese CPI to soften to 0.8% yoy (ex VAT) by year end, below the BoJ's forecast. BoJ easing is likely to take the form of doubling the annual purchase amount of ETFs to JPY2 tn on top of continuing QQE beyond the end of 2014. Our forecast is 110 in 12 months' time.

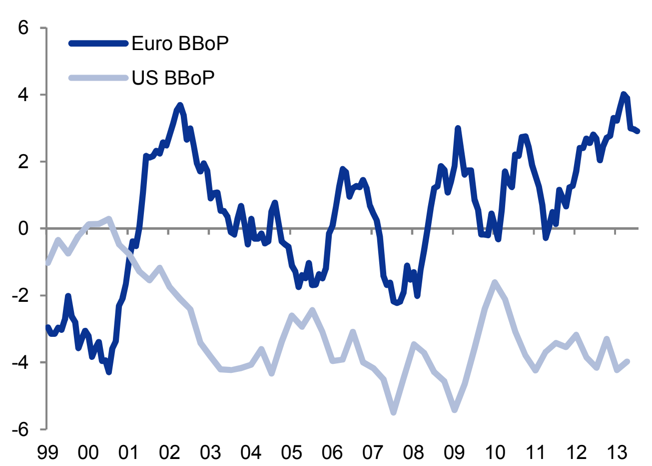
Exhibit 27: Our FX forecasts

		Forecasts		
	Current	3 months	6 months	12 months
EUR/$	1.29	1.29	1.25	1.20
$/JPY	107.07	103.00	107.00	110.00
£/$	1.62	1.65	1.62	1.60
EUR/£	0.80	0.78	0.77	0.75
EUR/CHF	1.21	1.25	1.28	1.28

		Forecasts		
	Current	3 months	6 months	12 months
A$/$	0.91	0.90	0.88	0.86
$/C$	1.11	1.10	1.12	1.14
$/KRW	1036	1030	1050	1070
$/BRL	2.29	2.30	2.40	2.55
$/MXN	13.22	13.10	13.20	13.35

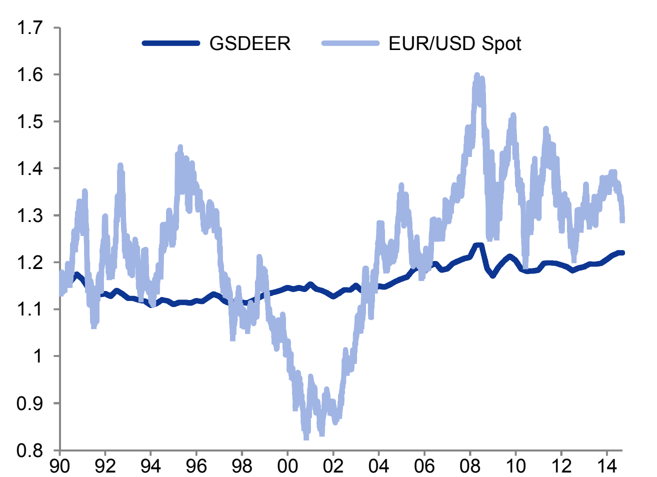
Source: Goldman Sachs Global Investment Research.

Exhibit 28: Euro area BBoP is stronger than the US BBoP



Source: National Sources, Goldman Sachs Global Investment Research.

Exhibit 29: €/$ spot vs. GSDEER



Source: Goldman Sachs Global Investment Research.

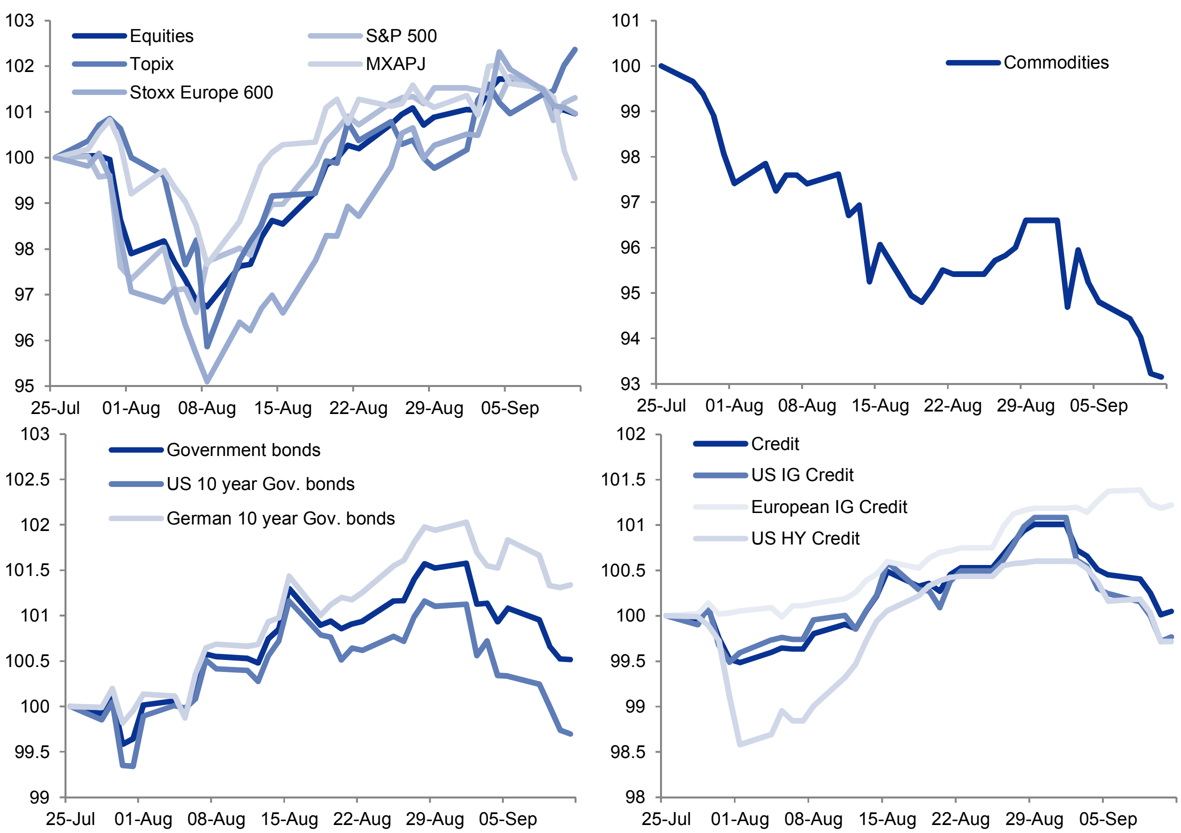
How we construct our asset classes

Exhibit 30: Goldman Sachs 3- and 12-month return forecasts by asset class

Asset Class	Benchmark Weight	3-month Total Return		12-month Total Return	
		Local currency	In USD	Local currency	In USD
Equities		**4.2**	**4.5**	**13.0**	**10.2**
S&P 500	40	3.2	3.2	9.7	9.7
Stoxx	30	6.9	6.7	16.9	8.5
MXAPJ (in USD)	20	6.3	6.3	13.8	13.8
Topix	10	-4.2	-0.4	12.6	9.6
10 yr. Government Bonds		**-2.7**	**-2.8**	**-4.6**	**-8.0**
US	50	-3.3	-3.3	-4.7	-4.7
Germany	50	-2.1	-2.3	-4.5	-11.3
5 yr. Corporate Bonds		**-0.4**	**-0.4**	**-0.1**	**-1.6**
US: iBoxx USD Dom. Corporates	60	-1.1	-1.1	-1.2	-1.2
BAML HY Master Index II	20	2.0	2.0	3.2	3.2
Europe: iBoxx EUR Corporates	20	-0.4	-0.6	-0.4	-7.6
Commodities (GSCI Enhanced)		**2.0**	**2.0**	**4.0**	**4.0**
Cash		**0.0**	**0.0**	**0.5**	**-3.1**
US	50	0.1	0.1	0.6	0.6
Germany	50	0.0	-0.2	0.3	-6.8
FX		3 month target	Return vs USD	12 month target	Return vs USD
EUR/$		1.29	-0.2	1.20	-7.1
$/YEN		103	4.0	110	-2.7

Source: Goldman Sachs Global Investment Research.

Exhibit 31: Performance of asset classes since our last GOAL report



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

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