Global Equity Outlook

From Low Growth to Pro-Growth

Rising populism and stagnant economic growth are creating a profound change in the macro landscape. We saw the initial tremors in 2016 with Brexit and the US election. In 2017, we expect the new US administration to drive seismic shifts, with many implications for equity investors.

- **We believe the macro environment is shifting from low growth to pro-growth.** We expect more aggressive fiscal and pro-business policy, which could lead to stronger US and global growth. Improved business sentiment could reignite corporate “animal spirits,” economist John Maynard Keynes’ term for the confidence and willingness to invest that are essential for economic growth.

- **Pro-growth policy could help extend the equity bull market.** Stronger economic growth could support revenue-driven earnings growth in the US. Higher interest rates and inflation are likely to follow. We think equities can continue to do well in that environment as long as the underlying driver is healthy economic growth.

- **We believe changing policy and recent equity market reaction could result in modestly positive equity returns in 2017, with higher dispersion.** Cyclical, value-oriented and small-cap stocks have outperformed following the election, reflecting investor anticipation of a more pro-growth environment. Further share price appreciation may be moderate because earnings growth is likely to materialize later in 2017 and 2018. As US policy details become clearer, we expect higher volatility and increased differentiation in individual equities as investors assess the impact on specific companies and industries.

- **This backdrop increases the potential for alpha and its importance to total returns.** We believe active managers have more opportunities to generate alpha through stock selection when the dispersion of returns is higher and correlations are lower. Alpha can contribute more meaningfully to portfolio performance when equity market returns are modest, as we are expecting for 2017.

- **The dynamic macro and policy environment affects our views across regions and sectors.** We are more positive on the outlook for US earnings, but acknowledge that US equity valuations are high. Our continued neutral view on Europe balances the potential benefits from stronger global growth with political risks in the region. We are more positive on Japan, in light of the potential for a weak yen and rising inflation. Emerging markets (EM) continue to offer alpha opportunities and portfolio diversification but we note the near-term macro risks from rising interest rates, increasing protectionism and a strong dollar. Bank stocks could be among the biggest winners as they benefit from rising interest rates, lower taxes and an abatement of regulatory headwinds. We remain positive on infrastructure assets, especially relative to bonds, but we think the “builders” of infrastructure, such as engineering, construction and basic material companies, are now fully priced.

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Pro-Growth Policies Could Ignite Animal Spirits

In our last quarterly outlook, we discussed our view that many governments seemed ready to turn to fiscal policy after years of ultra-loose monetary policy had failed to produce more than modest economic growth. Following the US election, markets have moved rapidly to price in not only fiscal easing but a broadly pro-growth US agenda. Directionally, we are expecting:

- **Lower taxes:** Trump is proposing cutting the corporate tax rate from 35% to 15-20% and reducing the cash repatriation tax from 35% to 10%.\(^1\) Businesses and industries with higher tax rates—often due to a more domestic focus (US corporate tax rates are higher than most other countries) and/or lack of deductions for items like research and development—could benefit the most. For example, banks and many industrial companies could see a meaningful improvement in margins while pharmaceutical companies may be less impacted.

- **Increased spending:** We believe Trump’s proposed $1 trillion spending on infrastructure over 10 years could be positive in the long term for infrastructure-related equities, as discussed in our 2017 Investment Outlook (A Global Fiscal Big Bang?) and later in this outlook.

- **Lighter regulation:** We believe a number of industries may see fewer new regulations and the potential for some existing ones to be enforced less aggressively or rolled back. We explore this topic in our 2017 Investment Outlook (Regulation to De-Regulation). Among those industries most likely to benefit are financial services, energy and manufacturing.

Anticipation of a more pro-growth environment appears to be improving business sentiment. We met with the CEOs of two of the largest US-based global banks in early December who offered their candid perspectives on the rapid change in sentiment and the new environment. One CEO shared his view that the massive liquidity pumped into the global financial system in recent years has been trapped by increasing regulation. With the floodgates open, this capital is freed up to invest in return-generating opportunities. The other CEO suggested that his small business clients seemed notably more optimistic in recent conversations. Actual policy changes will take time and may fall short of expectations in some areas, but we think the change in sentiment is notable and could contribute to a new environment of sustained economic growth as increasing animal spirits could drive higher corporate investment.

Policy Uncertainty and Protectionism are Risks

While stocks have surged on expectations of a pro-growth environment, we see important caveats in the macro backdrop as well. We are focused in particular on:

- **Changing Policy:** Critical details on trade, taxes and other regulation and legislation could emerge in the first quarter. Actual policy that differs from market expectations could impact business decisions and prompt stock price reactions. We identified several key transitions in our 2017 Investment Outlook and will provide updates of our views on the global policy and political environment as they evolve this year in Macro Insights and our regular quarterly Outlooks.

- **Protectionism:** We believe Trump is likely to pursue a trade agenda that will aim to support the US domestic economy, as we discussed in our 2017 Investment Outlook (Trade [Dis] agreements). In light of potential retaliation from trading partners, we believe domestically-oriented companies around the world may be better positioned in the near term, while multinationals or companies dependent on global supply chains may be negatively impacted.

- **Volatility:** In our view, policy uncertainty and Trump’s propensity to disregard protocol could increase financial market volatility. These factors also correlate with a higher dispersion of returns, which we discuss further in the section on active management.

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The Current Environment is Good for Equities...

On balance, we think a macro environment marked by stronger economic and revenue-driven earnings growth provides a positive backdrop for equity investing.

Recent years of low growth and low inflation have resulted in weak revenue growth that constrained earnings. If policy changes succeed in generating a stronger economy and corporate revenues, we think earnings growth is likely to follow because many businesses now have significant operating leverage. Some companies are also likely to get a boost to net margins from lower taxes. Consensus estimates for sales and earnings growth for the MSCI World in 2017 are 5.4% and 12.8%, respectively, following lackluster growth in 2016 of -0.1% and 0.9%, respectively.\(^2\) We believe pro-growth policy is likely to lead to rising inflation, higher interest rates and continued strength in the US dollar. Equities can also perform well when inflation and interest rates are rising at a measured pace and for the appropriate reason—stronger economic growth.

Equities have historically outperformed other asset classes in a rising rate environment

Average 3-month total return in a rising rate environment

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...and Better for Alpha Generation

While the pro-growth environment is positive for equities, we think global equity returns will likely be in the mid-single digits in 2017, slightly below the long-term historical average. Corporate and investor sentiment changed rapidly following the US election. Corporate investment now needs time to catch-up as management teams wait for policy details. We believe earnings growth is more likely to materialize later in 2017 and 2018, likely limiting dramatic share price appreciation in 2017.

We expect higher volatility and increased differentiation in individual equities as investors assess the impact of emerging US policy details on specific companies and industries. We think the opportunity for alpha generation through active stock selection will be greater than in recent years. In the previous environment of scarce growth and low yields, investors bid up valuations of high-growth and high-yield securities to extremes. More recently, in anticipation of a more

\(^2\) IBES via Datastream, as of January 11, 2017, calculated using fiscal years

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pro-growth environment, investors have rotated into more cyclical, value and small-cap stocks and out of EM, more defensive and higher-yielding securities. The performance differentiation between sectors and equity asset classes has been dramatic, but notably less so within them. In our view, investors will now have to consider how individual company fundamentals are impacted by the changing economic, policy and regulatory landscape.

**Broad macro themes have driven recent equity market performance but we believe stock specific factors could have a greater impact going forward**

Periods of uncertainty may contribute to increased dispersion in equity returns and lower correlation across sectors. We believe active fundamental investors, who can analyze how each company will be uniquely impacted by factors such as changing trade policy, tax policy, regulation and currency movement, may have an advantage in identifying long-term winners and losers. In the next section, we discuss our views on opportunities across regions and sectors.

**Active managers can benefit when the dispersion of returns is high and correlations are low**

Source: Datastream, calculated using data from December 31, 2015 to December 31, 2016.

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Our Regional and Sector Views

**US:** We are more positive on the outlook for economic and revenue-driven earnings growth but the equity market remains expensive. The median S&P 500 stock is trading in the 95th percentile relative to history, while the aggregate market 12-month forward price-to-earnings (P/E) ratio of 17.4x is the highest of the major regions. That said, we believe that the US equity market still offers significant opportunities at the stock level as more policy details become clear and investors begin to focus on company-specific impacts.

**Europe:** Our view on Europe remains neutral and unchanged from our last quarterly outlook. We believe earnings upside potential remains the main driver of European equities. The consensus forecast for European earnings growth in 2017 is 14%, above the 12% for the US, largely due to a lower starting point—European earnings are still roughly 50% below the 2008 peak, while US earnings are roughly 30% above. In our view, many European companies can benefit from US-driven stronger global growth. As discussed in our 2017 Investment Outlook (From Globalism to Populism), we believe Europe’s biggest risk remains political, with increasing populist sentiment challenging mainstream parties in national elections in the Netherlands, France and Germany in 2017.

**Japan:** We are more bullish on Japan since our last quarterly outlook. The increased potential for inflation and the strong US dollar/weak yen is particularly helpful for Japan. The Japanese equity market is export-oriented so a weaker yen tends to drive earnings growth. Consumption has yet to recover but total real wage has been growing consistently for over a year (versus declining 2% two years ago) due to the tight labor market. Corporate balance sheets remain strong and corporate governance continues to improve, both of which can boost returns for shareholders. Prime Minister Abe’s popularity is high, allowing him to continue to push through structural reforms.

**EM:** We believe the alpha generation opportunity in EM remains high but acknowledge that EM will face near-term macro headwinds from rising US interest rates, a stronger US dollar and increasing protectionism. Some of this is already reflected in EM underperformance since the election and valuations are attractive versus history and developed markets. From a longer-term perspective, we believe EM fundamentals are recovering: external imbalances have been reduced, Purchasing Managers Indices (PMIs) are rising and we expect corporate earnings will rebound. We believe there will be continued divergence in EM between state-owned and privately-owned companies and the companies and regions more or less affected by protectionist trade policy. For example, we are currently focusing on domestically-oriented companies in Mexico and countries such as India, which has many domestic drivers of growth and is more insulated from the global economy. We discuss our EM outlook in more detail in Staying the Course in EM.

### US fundamentals are strong but valuations remain high

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<th>12-month forward P/E (X)</th>
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Source: Goldman Sachs Global Investment Research, IBES via Datastream, as of January 12, 2017.

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3 Goldman Sachs Global Investment Research, as of January 6, 2017. Median stock valuation on a 12-month forward PE basis.

4 IBES via Datastream, as of January 12, 2017. Calculated using MSCI Europe for Europe and S&P 500 for US.

5 SMBC Nikko, as of December 2016.

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Financials

Banks have multiple tailwinds that could flow through to earnings almost immediately. Increasing interest rates will boost net interest margins while economic growth and lighter regulation could increase loan growth and trading activity, all of which would drive revenue growth. US banks also tend to have high tax rates because they are relatively domestically-focused and have few deductions, so they are likely to be big beneficiaries of a lower corporate tax rate.

We have been positive on bank stocks for several quarters, in anticipation of rising rates and the potential to return more capital to shareholders. US bank stocks have now rallied sharply. We believe much of the move is warranted but we are assessing how much of the future earnings potential is now priced in. European banks could also benefit from a stabilizing regulatory environment and stronger global growth and while their stocks have also rallied, they are still trading at almost a 30% discount to US banks.

Consumer

The backdrop for US consumers remains encouraging. Unemployment was 4.7% in December, almost in line with the 2007 average, and the labor market is now at full employment by the Fed’s estimate. Consumer confidence surged to 113.7 in December, from 109.4 in November and 100.8 in October; the latest reading exceeded the pre-Financial Crisis high in July 2007. The household debt burden fell to 10%, the lowest in four years, and the S&P Case-Shiller 20-city house price index grew at a robust pace of roughly 5% in 2016.

Looking forward, consumers may begin to face some headwinds including higher costs of goods from protectionist policy and/or inflation, rising mortgage rates, uncertainty regarding healthcare coverage and costs and rising gas prices.

Actual US consumer spending patterns remain mixed. Retail sales grew 3.7% YoY in November and 4.3% YoY in December but in the prior months, some previous areas of strength such as restaurant, auto and home-improvement spending had slowed.

If pro-growth policies and healthy consumer sentiment extend the economic cycle, consumer discretionary companies could benefit from increasing sales. However, these companies will require the pricing power, supply chain flexibility and cost structure to manage the expected inflation in wages and other input costs.

Consumer staples stocks have traded down in the rotation out of defensive stocks. The yield premium that many of these stocks commanded in the recent low-rate/low-yield environment has been reduced. Many companies will also face challenges from higher input costs, supply chain disruption due to new trade regulations and weak EM end markets.

In light of these many cross-currents, we have not made any significant changes to our investment strategy in the consumer sectors. We continue to favor businesses with strong e-commerce platforms, brands and pricing power. We remain most cautious on autos as we expect weakening sales globally.

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6 12-month trailing price-to-book ratio using Factset, as of January 12, 2017
7 Department of Labour, US Congressional Budget Office, Haver Analytics
8 Conference Board, Haver Analytics, Goldman Sachs Global Investment Research
9 Standard & Poor’s, Haver Analytics
10 Census Bureau, Haver Analytics

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Health Care

The weak performance of the health care sector in recent years reflects growing concerns that the pricing and volume trends that drove strong earnings growth across the industry are coming under pressure. The repeal of the Affordable Care Act could negatively impact volumes which were boosted throughout the health care system following enactment of the legislation.

Increasing pressure on drug pricing is likely to have a more significant effect on many health care stocks, particularly pharmaceutical and biotech companies. Competition from generics remains an issue for the pharmaceutical industry and is a growing threat for biotech given advances in biosimilars, generic equivalents for biopharmaceutical compounds. Populist pressure to reduce drug prices is likely to grow. We believe these challenges will create stock-picking opportunities and we continue to focus on companies with strong drug development pipelines. We also believe that merger and acquisition activity could increase as companies seek to buy pipelines in a more accommodative regulatory environment and before interest rates increase.

Infrastructure

We believe increased fiscal policy in many regions may take the form of spending on infrastructure. Stocks of the “builders” of infrastructure, such as engineering and construction companies, are generally perceived to be the most immediate beneficiaries of increased spending on infrastructure and have run up sharply since the election. We believe they may be pricing in earnings growth that is actually several years out, given the time it takes to approve and fund infrastructure projects.

Our outlook for the “owners” of infrastructure—securities relating to assets such as railroads, airports or mobile phone towers—is much more positive. While we believe more infrastructure assets will become available for public investment as governments increase public/private partnerships, our enthusiasm for the prospects of global infrastructure as an asset class long-term extends well beyond the likely increase in fiscal spending. Global infrastructure assets have historically offered attractive yields, long-term growth and resiliency in inflationary and rising interest rate environments, and we believe that investors will continue to seek to diversify their portfolios with assets that offer these attractive investment attributes. We explore these ideas further in Building a Case for Global Infrastructure.

Global infrastructure assets have offered attractive yields and growth

![Graph showing yields and growth of global bonds, equities, and infrastructure from January 2011 to January 2016.](image)

From Reactive to Active

Financial markets and investors have spent much of the last eight years since the financial crisis reacting to economic and central bank policy. Low economic growth hampered revenue and earnings growth for many companies while low interest rates and low returns artificially inflated some assets that offered growth and yield. The net result was an eight-year bull market for equities, meaning beta-driven returns were easy. Generating alpha was more challenging.

In our view, we have reached a turning point on many fronts. A growing populist trend is driving political and potentially economic change. Monetary and fiscal policy appear ready to break out of the post-crisis pattern. We believe the increased potential for economic and earnings growth, combined with many pending policy changes, could extend the bull market for equities. More critically, we believe some companies will emerge from the changes with much stronger growth profiles while others will be weakened, meaning that investors may once again be rewarded for being active, rather than reactive.
**Risk Considerations**

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Real estate investments will be highly illiquid and will not have market quotations. As a result, the valuation of real estate investments involves uncertainty and may be based on assumptions. Accordingly, there can be no assurance that the appraised value of a real estate investment will be accurate or further, that the appraised value would in fact be realized on the eventual disposition of such investment.

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A basis point is 1/100th of a percent.

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The “Standard & Poor’s S&P 500 Index” is an index based on the prices of the securities of 500 different companies, 400 of which are industrial, 40 of which are utility, 40 of which are financial and 20 of which are transportation companies.
The MSCI EM (emerging markets) Index is designed to measure the performance of the large and mid-cap segments of the market, covering approximately 85% of the EM equity universe.

The MSCI Europe Index captures large- and mid-cap representation across 15 developed markets in Europe. The index covers approximately 85% of the free float-adjusted market capitalization across the developed European equity universe.

The MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. With 318 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in Japan.

The STOXX Europe 600 Index is derived from the STOXX Europe Total Market Index (TMI) and is a subset of the STOXX Global 1800 Index. With a fixed number of 600 components, the STOXX Europe 600 Index represents large, mid and small capitalization companies across 18 countries of the European region: Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Norway, Portugal, Spain, Sweden, Switzerland and the United Kingdom.

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