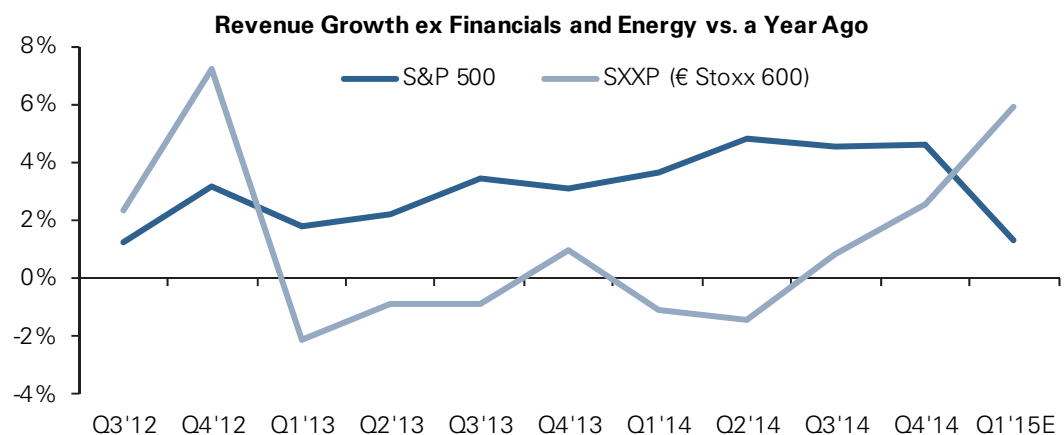


Macro Meets the Bottom Line

Our discussion last month about the impact of dollar strength on corporate profits tipped off a broader conversation about how other top-down themes may be impacting the bottom line. Earnings reports, interviews with executives and data on corporate behavior all provide insights into how boardrooms are responding to prevailing macro trends. While these themes are not the driving principles in our security selection, the challenges they pose and the varying success of corporate strategies to address them are relevant to our investment choices.

- We consider the implications of three macro themes that emerged as common refrains in first quarter earnings reports: oil price fluctuations, weak inflation and patchy global demand (see *Focus* p.4-5).
- Our high-level takeaways from the latest crop of earnings are 1) despite headwinds to revenue growth, companies have found ways to expand margins, and 2) opportunities in European equities may be increasing relative to the US. Executives paint the picture in the *Notes* on p.6.
- Our broadly positive outlook for the largest developed economies supports our selective overweights in Equities and Corporate Credit. Meanwhile, the big news in rates markets corresponds with our negative outlook for the sector globally (see *Asset Allocation*, p.3).

What a difference a quarter makes

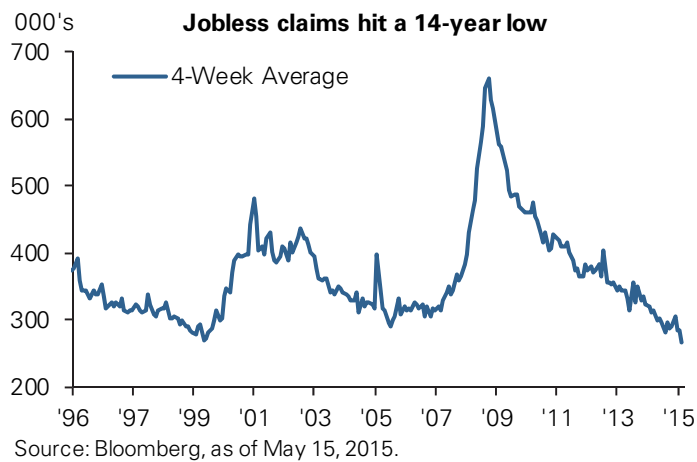


Source: Bloomberg, GSAM Estimates, as of Q1, 2015.

Macro Trends and Views

US

- Unemployment hit a seven-year low of 5.4% in April and payrolls recovered with 223K new jobs, though prior months were revised down 39K. Initial jobless claims fell to a 15-year low of 264K.
- The Employment Cost Index's (ECI) 2.6% rise in the first quarter beat consensus, though due partly to commission-based pay, and still below the Fed's preferred 3%-4%.
- The Fed's minutes noted signs of a pickup in inflation. Members considered the first quarter slowdown "largely transitory," but lacked data to warrant a June hike, raising expectations for a move in September.



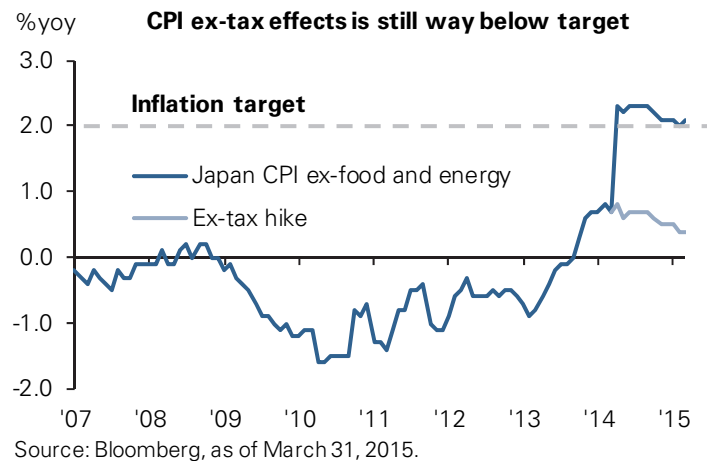
Europe

- Greece scraped together an arrangement with the IMF to borrow to meet its May payment, but steeper bills are due in the weeks ahead. The government's reshuffle of its negotiating team may signal a gentler approach.
- The Eurozone's financial system is showing encouraging signs of repair, as lending to business picked up in March. The 0.1% increase on the year was modest, but it was the first positive reading in three years.
- The UK Conservative Party gained a surprise majority in the May elections. Prime Minister David Cameron has pledged a referendum on European Union membership.



Japan

- The Bank of Japan (BoJ) revised its timeline for getting inflation up to the 2% target, from sometime in the next 10 months to around the end of September 2016.
- Consumer price inflation is still trending far below target, at 0.4% on the year in March, minus food and energy costs and accounting for last year's tax hike.
- First-quarter growth beat consensus at 2.4% annualized. The gain came mainly from high inventories, but capital expenditure was also up for the first time in a year.



Emerging Markets

- A couple of weeks after slashing the reserve requirement ratio, the People's Bank of China delivered its second rate cut this year, dropping the deposit and lending rates 25bps to 2.25% and 5.10%, respectively.
- Russia's central bank delivered an unexpectedly sharp cut, dropping its key rate by 150bps to 12.5%.
- Brazil recorded its 13th straight month of contraction in industrial output in March. The central bank reinforced its tightening bias to tame inflation despite sluggish growth.



Asset Allocation Views: Bonds Capitulated, We Stay the Course

Bond yields rose aggressively in late April and early May: 10-year German yields leapt 65bps, matching their feat in the “Taper Tantrum” of June 2013. Now the dust has settled we examine the move, and consider what the signal from bond markets is telling us and our portfolio allocations as a consequence.

Extreme valuations met improving fundamentals

Europe has been the primary driver of global rates this year. The European Central Bank’s (ECB) quantitative easing (QE) drove yields to record lows, and in many cases below zero, despite improving growth prospects since the turn of the year. The robust policy response, along with stabilization in oil prices, helped reduce the tail risk of longer-term deflation, as inflation expectations bottomed in January. Initially, the ECB purchased more bonds than governments issued, but after the first month this negative net issuance reversed, turning from -€45bn net issuance in April to +€45bn in May. The divergence between growth and inflation fundamentals and yields, catalysed by meeting that technical supply factor, was a big driver of the snap up in rates, in our view.

The jump was felt around the world. In the US, Treasuries were as overvalued relative to economic fundamentals as they were in 2012. The impulse from abroad, coupled with rising inflation expectations amid signs of tightening in the labor market, sparked a rapid rise in rates.

Consistent with our positive macro outlook

We see the move in bond yields as consistent with our macro outlook of reaccelerating global growth accompanied by low but positive inflation. We think the US recovery is well entrenched, and the weakness in the first quarter was temporary. Our indicators put current growth around 2.4% but we remain above consensus in our outlook for growth in

2015. Globally, monetary policy easing in Europe, Japan and China should continue to backstop growth.

Risks: Grexit, US growth and the Fed

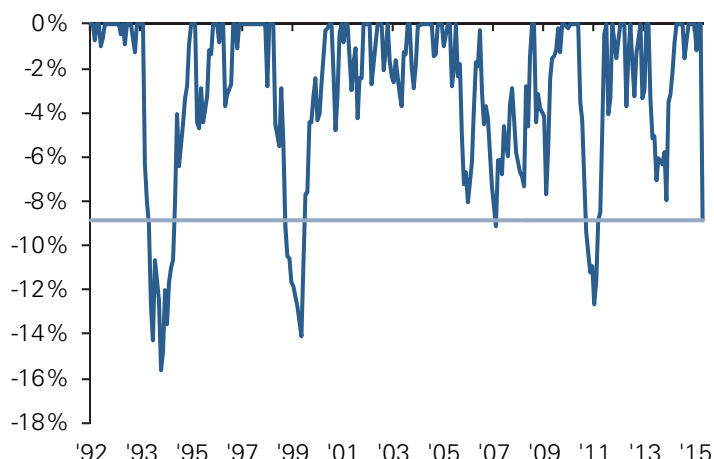
Though our base case is for Greece to stay in the Eurozone, the risk of an exit is material and could drive volatility across European assets. Another near-term risk is the potential for continued US growth disappointments. Dollar strength, port strikes, the weather and lower investment in the oil sector are all good reasons for weakness in the first quarter. However, only dollar strength is likely to be a longer-term factor, and we would therefore expect data to improve as temporary headwinds fade.

The slow start to second-quarter releases, such as soft retail trade, raises concerns that longer-term weakness may have been masked by these factors, and the rebound may be slower and shallower than we currently envisage. If growth recovers as expected, some volatility will likely arise from markets starting to re-price short-dated rates in the US in anticipation of a rate hike, though not until later in the year. As highlighted in our March Focus (*US hike—Is this time different?*), this disrupts both bond and equity markets.

Stay overweight equities, underweight bonds

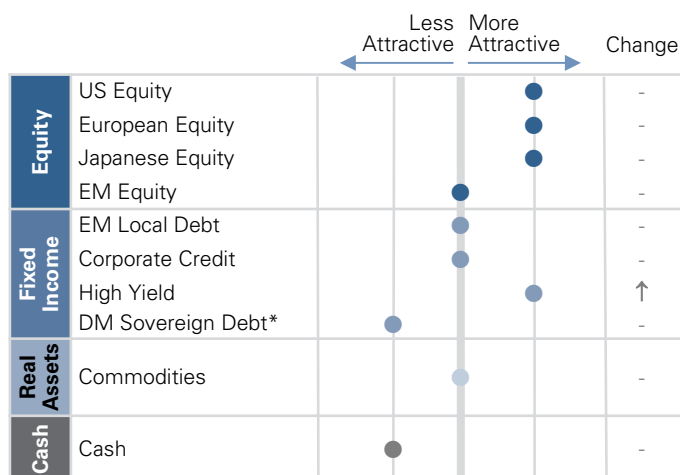
In the face of declining bond prices, we bought UK gilts to profit from some stabilization in yields. This reduces our UK underweight but we still believe government bonds are overvalued and we remain short overall in our portfolios. We also added to long US dollar positions in the recent pullback, for example against the euro and commodity-producing countries. In the equity space the latest earnings season has been decent, we see valuations as reasonable for the macro environment and we remain broadly overweight. That said, we use options to limit downside in European equities given the potential for a disorderly outcome in Greece.

Historical Drawdowns: German Govt Bond 10+ Year Total Return Index



Source: Bloomberg, as of May 31, 2015.

Asset allocation views on a one-year horizon*



Source: GSAM Global Portfolio Solutions. As of May 2015.

* Note that this does not account for liability-driven investment.

Focus Piece: View from the Boardroom

Last month we talked about how macro forces are inverting the normal relationship of fundamentals driving currencies, as currency shifts are starting to impact fundamentals. This dynamic stood out in the corporate sector, as dollar strength weighed on earnings in the US, while boosting them in Europe. This month, we look at the significance of other macro trends for companies' top and bottom lines, and implications for our strategies. We consider three common themes in the latest earnings reports: oil price fluctuations, inflation, and persistently soft global demand.

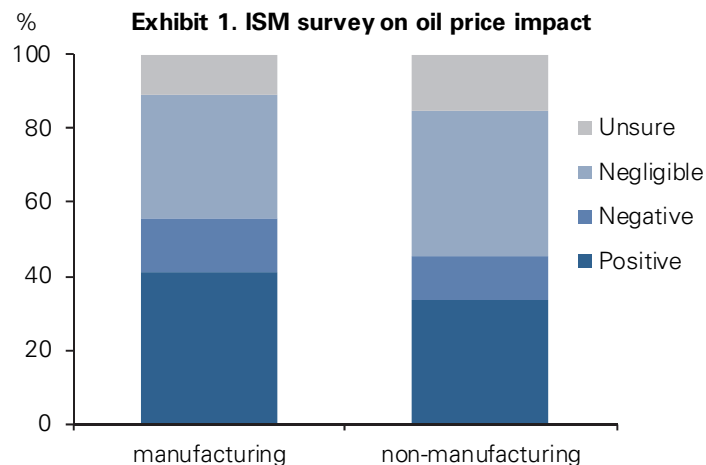
First to clarify: our experts on the corporate sector typically focus on bottom-up analysis rather than macro themes in their investment process. But while these themes are not themselves driving forces in our strategies, they can inform security selection via their impact on decision-making among corporations.

For instance, M&A activity has reached the highest levels in a decade, in part due to strong corporate balance sheets and high levels of cash, but macro conditions have also contributed to record-breaking deal-making. Slower global growth has driven industry consolidation, while low interest rates have made many acquisitions more attractive than holding cash and low volatility has contributed to confidence in the economics of transactions.

From a positioning standpoint, our investment grade corporate credit team has remained cautious around names and sectors that could be more prone to embarking on M&A as a growth strategy. We tend to favor deal-related issuance in order to capitalize on companies re-focusing on improving credit.

Oil prices: accentuating the negative

The dramatic decline in oil prices has made a somewhat less dramatic impression than expected in some sectors. While only about 10%-15% of US companies have reported a negative impact (see Exhibit 1), it has been conspicuous, with Energy earnings plummeting 57% in the first quarter. The positive impact has been more diffuse. Many



Source: Institute for Supply Management survey, April 2015.

companies have benefitted from lower input costs, which supported earnings growth despite lackluster demand.

Disappointing reports have received more attention. Specifically, retail sales data have been sluggish so far this year and many US apparel companies missed first-quarter earnings estimates. The results are surprising, given expectations of a boost from consumers spending the money they saved at the pump. A harsh winter is partly responsible, and strong earnings reports for cafes and restaurants support the view that US consumers have been redirecting their monthly savings on gas to low-ticket items in the meantime. Some has been stashed away, however, as implied in February's jump in the savings rate to its highest level in more than two years, at 5.7%. The more recent decline in the savings rate to 5.3%, along with improving confidence, could point to increased spending in the months ahead.

The recent 35% bounce in oil prices clouds the outlook somewhat, but while we think oil prices have likely bottomed, a sustained increase above \$60/bl is unlikely given persistent oversupply issues. Moreover, we don't think this recovery is likely to have much impact on earnings expectations for the coming quarter, for two reasons:

- The bounce came from \$47/bl for WTI and \$55 for Brent—lows that were never factored into consensus forecasts.
- Consensus forecasts for both WTI and Brent are above the forward curve, revealing a significant disconnect between what commodity markets anticipate for oil prices, and the more optimistic outlook baked into earnings expectations.

Strategy: Our credit and equity strategies focus on companies that can weather prices around current levels for a prolonged period. We have maintained limited exposure in Energy equities via higher-quality companies, and we think the exploration and production (E&P) industry—where we have been selectively adding high yield credit positions—looks more attractive than the services industry. In the private equity and hedge funds space, we have seen merger arbitrage and event equity opportunities arising from consolidation in the sector. Given the surprising shortage of distressed names, we are wary of trades getting crowded in certain sectors.

Inflation: will wage growth lead the way?

The global trend of low inflation is a mixed blessing: while lower input costs are a tailwind for many industries, pricing power is limited in an environment of fragile demand. So far companies have been resourceful in finding ways to improve margins, largely through cost initiatives such as leaner sourcing, strategic M&A and carefully targeted price increases.

Focus Piece: Cont'd

Cost containment may be getting tougher, however, given early signs of wage pressure. In the US, various indicators point to diminishing labor market slack as headline unemployment has sunk to a seven-year low of 5.4%. Wage indicators including the Employment Cost Index (ECI) are starting to pick up (see Exhibit 2). Furthermore, the largest retailer in the US is among companies that recently announced an increase in its minimum wage, along with the City of Los Angeles.



Source: US Bureau of Labor Statistics, as of May 25, 2015.

The gap between price inflation and unit labor cost (ULC) inflation is a dominant driver of profit margins at the aggregate level. When prices rise faster than ULCs, firms typically manage to increase profits. We don't think rising ULCs pose a significant threat to profit margins this year, particularly not in Europe, where unemployment remains above 11%. However, this is cold comfort for the major European industrial company that last quarter reported a pricing trend of zero, the lowest level in a decade.

Strategy: In the US, we believe EBITDA margin expansion has helped mitigate the impact of weak revenue growth. Moreover, improved margins have boosted earnings growth and stock prices, and helped drive equity valuation multiples higher. This latter phenomenon has allowed debt-to-market capitalization ratios to remain relatively constant even as management teams have added leverage.

This scenario supports our selectively overweight stance in corporate bonds in this late-expansion stage of the cycle, though we are cautious around sectors that we think may be more prone to relevering, such as Healthcare and Pharmaceuticals. While we are positive on the US growth outlook, we see fewer opportunities in US equities relative to other markets because valuations are at the higher end of the historic range.

Our credit and equity teams are watching for signs of inflationary pressure which, aside from having the potential to trigger swifter-than-anticipated hikes from the Fed, could

erode margins. Margin contraction, combined with weak top-line trends, could also hit earnings and share prices, which would diminish asset coverage for bonds and credit.

Global demand: still sluggish

Despite improving global economic growth, many companies are still reporting headwinds from weak global demand. In the world's largest economy, consumer demand has struggled recently, as discussed above. Europe is an example of an emerging two-speed scenario: while consumption is driving a surprising turnaround in the smaller peripheral economies of Spain and Italy, Germany faces headwinds from its exposure to China's slowdown. The chairman of a leading German auto manufacturer recapped first-quarter earnings with an early reference to slowing momentum, or "normalizing" in the world's largest car market. Weak Chinese auto sales in April reflected this dynamic, as imports—with the exception of Japanese brands—are losing market share to domestic brands, and face pressure to cut prices.

Japan's relative outperformance in this market owes in large part to currency weakness, as the yen leads the broadening global trend of policy-driven depreciation. Competitive currency devaluation is a function of the faltering recovery in much of the world, as aggressive policy easing in Japan and Europe has drawn other countries into the easing cycle to defend their share of a price-sensitive global exports market. The race to the bottom is leaving some sectors struggling to keep up: for instance, Hong Kong retail sales have rapidly deteriorated as the weak yen and euro lure Chinese consumers to Japan and Europe.

Among the more encouraging developments in Europe is the recent shift in the trend of loans to the private sector, which turned positive in March for the first time in three years. Provided that Greece's negotiations with creditors reach a resolution to alleviate the current risks to the region's recovery, we see room for growth and investment to continue to improve this year.

Strategy: The Eurozone recovery is still in its relatively early stages, but we feel that the combination of QE, euro weakness and repair in the financial sector are positive drivers for European equities. We see potential for earnings upgrades as the recovery gains traction later in the year. We consider Japanese equities attractive based on valuations, the increased focus among companies on shareholder returns, and solid fundamentals as corporate profits are around record highs. The weaker yen has had a positive impact on corporate earnings, while wage inflation is expected to drive domestic consumption.

Notes: Macro Themes from Q1 Earnings

Each quarter, our investment teams meet with corporate management teams and participate in quarterly earnings discussions. The following comments are from executives of large-cap corporations across a range of sectors on macro developments that emerged as common themes in the latest earnings season.

Weaker commodities

Impacts from lower crude prices have been largely confined to the Energy sector and industries exposed to related capital expenditure cutbacks. In the US, consumers have been pocketing savings from lower gasoline prices.

“We’re still not seeing any kind of significant impact that we could relate to the decrease in oil prices...”

— US multinational restaurateur

“Based on recent surveys, **we know that many of our US customers are using...the extra money from lower gas prices to pay down debt or put it into savings.** They’re also using these funds for everyday expenses like utilities and groceries.”

— US multinational retailer

“Consumers are only using a small portion of their savings from gas to buy new goods and services...**any additional consumer spend has not been enough to make up for the lower gas spending.**”

— US credit card company

Low inflation, weak pricing

Many companies reported limited pricing power in an environment of weak inflation. In the US, pricing and cost reductions have helped to offset incipient wage pressures.

“We are seeing signs of some slower growth [in China]...in some of the smaller segments, as it gets more competitive there. **Net pricing has been negative for a number of years in the marketplace.**”

— US automaker

“Southern Europe, let’s take the example of Spain, it seems that the market may now have bottomed out and is showing the first signs of growth. However, **there, the price pressures continue unabated.**”

— European industrial company

“In Europe we continue to see price deflation. Some, maybe even many of the economies, are now starting to pick up. But any improvement in demand for our categories is likely to be slow at best.”

— European consumer goods multinational

Soft demand

Demand in Europe is improving as economic growth recovers, though regional differences persist. China’s continued growth slowdown remains a challenge.

“In Europe, there are also some green shoots on the back of monetary easing, but it’s early days...Consumer spending in Europe is still sluggish as it will take time for monetary easing to flow to consumer pockets.”

— US soft drink retailer

“The Chinese car market is normalizing...In Japan the number of new car registrations is expected to decline again this year. The development in the emerging markets remains uneven...**Our strategy of balanced global sales continues to allow us to even out the disparities across the world.**”

— European automaker

“In China, headwinds related to the government’s anti-corruption initiatives and efforts to favor domestic innovation will continue to impact the Chinese healthcare market in 2015.”

— European technology company

Dollar strength

US multinationals are feeling an impact, but many have proven resourceful with strategies to expand margins further, which has been a source of upside surprise.

“Our US business is under pressure from increased, very aggressive competitive discounting, enabled by the dramatic shift in world currencies. Consequently, we believe it is prudent to adjust our shipment plan...”

— US motorcycle manufacturer

“We’re going to see currencies move up and...down. It takes quite a while to shift your manufacturing footprint.

The day you think you’ve got that right is the day a currency might turn against you and you end up in a very different place than you had hoped.”

— US industrial manufacturer

“In Q1 we began implementing targeted price increases, putting more focus on gaining concessions from our supplier base and controlling costs more tightly...Part of that is some very targeted price increases in those markets where foreign exchange has been a factor and where there’s not a lot of domestic competition, domestic meaning local competition in those markets.”

— US biotech multinational

Appendix: GSAM Growth Forecasts and Asset Valuation

GDP Growth Forecasts: GSAM vs Consensus

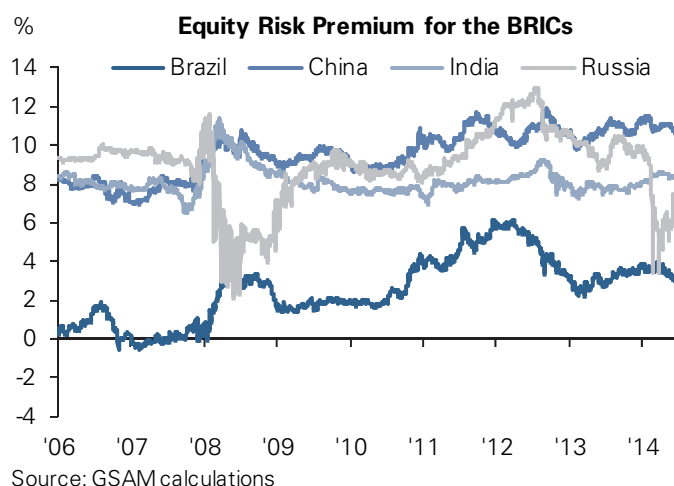
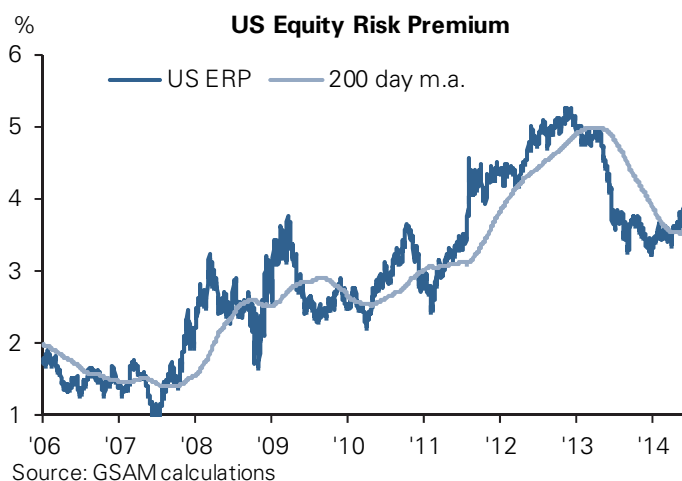
	2012	2013	2014	2015		2016	
				GSAM	Consensus*	GSAM	Consensus*
US	2.3	2.2	2.4	3.2	2.8	3.4	2.8
UK	0.7	1.7	2.6	3.0	2.6	3.0	2.4
Euro area	-0.8	-0.5	0.9	1.6	1.4	1.2	1.7
Japan	1.8	1.6	-0.3	1.8	0.9	1.4	1.4
Brazil	1.0	2.5	0.2	-1.0	-0.9	0.0	1.2
China	7.7	7.7	7.4	7.0	7.0	6.8	6.7
India	4.8	4.7	5.4	7.0	7.4	7.2	7.7
Russia	3.4	1.3	0.6	-5.0	-4.1	1.0	0.5
Mexico	3.9	1.1	2.1	3.5	2.8	3.5	3.5
Korea	2.3	2.9	3.3	3.4	3.2	3.7	3.6
Indonesia	6.0	5.6	5.0	5.2	5.3	5.5	5.8
Turkey	2.1	3.8	2.9	2.4	3.3	3.8	3.8
Advanced	1.1	1.2	1.6	2.5	2.1	2.4	2.2
BRIC	6.0	5.9	5.5	4.9	5.1	5.6	5.7
Growth Markets	5.5	5.3	5.1	4.7	4.8	5.3	5.4
World	3.2	3.1	3.2	3.5	3.3	3.7	3.7

*As of May 2015. Source: GSAM and Bloomberg.

Equity Valuation Across Advanced and Growth Markets

	CAPE*		FY1 PE		Price/Book		Dividend Yield		Earnings Momentum**
	Level	% time cheaper***	Level	% time cheaper***	Level	% time cheaper***	Level	% time cheaper***	% change in 1y fwd EPS
Japan	28.2	45	15.7	55	1.5	59	1.7	50	0.22
US	22.1	57	17.6	97	2.9	74	2.0	43	-3.23
Canada	20.4	51	17.5	99	2.0	51	2.8	31	-6.34
France	19.4	65	16.5	99	1.7	56	2.8	78	-1.43
India	18.6	36	16.9	78	3.1	42	1.4	35	-4.80
Australia	18.5	56	16.7	100	2.0	45	4.4	26	-4.33
Germany	18.1	64	14.9	93	2.0	91	2.5	61	0.51
Italy	18.1	67	15.8	91	1.2	54	2.7	99	-5.77
Europe	17.3	53	16.5	99	1.9	60	2.9	62	-1.29
Spain	15.6	61	15.7	99	1.5	45	4.8	47	-1.44
UK	14.7	64	16.1	82	2.0	54	3.7	33	-8.03
China	14.7	40	12.3	68	1.8	39	2.4	55	-4.05
Portugal	10.5	31	15.9	83	1.8	52	2.9	62	3.15
Brazil	8.0	5	13.0	98	1.4	26	4.0	41	-13.99
Russia	4.3	4	5.5	35	0.8	20	4.5	4	-10.03

* Cyclically-adjusted PE ratio (5-yr rolling window). ** % change in 1-yr fwd EPS over last 3 months. *** Current percentile relative to full history As of May 2015. All data based on MSCI country indices. Source: Datastream, GSAM calculations



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