Europe: Portfolio Strategy

# Strategy Matters

## 10x 2010; attractive valuation supports higher prices

Many investors believe the 38% rise in the markets since the low is incompatible with the prospects of weak economic growth. We believe that valuation already reflects these fears. On our top down estimates, DJ Stoxx 600 trades at 10.4x 2010 earnings. The market appears to be implying a 2.6% 5-year annualised earnings decline on normalized ERP.

### Valuation based on earnings and dividends is attractive

On most measures we look at, valuations appear to be very attractive. On our top down earnings growth forecasts for 2010 (+34%), the market trades at little more than 10x earnings. Based on real trend earnings since 1973, the market trades on 9.5x or 11x ex-financials. On a cyclically adjusted Shiller multiple, the market is on 11.8x 2010E compared with a long run average of 15x. Adjusting for inflation, the current multiple is the lowest since the 1970s.

### Relative valuations remain compelling

Valuations relative to competing asset classes are also compelling. Even taking into account further sharp falls in dividends implied by the dividend swap market, the yield ratio is close to the lowest level in the UK since the 1950s. Meanwhile asset and enterprise based measures remain at the low end of their long run ranges – the P/B is 1.5x, EV/sales is 1x and EV/GCI is 0.8 on our 12-month forward estimates.

### GS DDM and implied growth rates point to further upside

On GS DDM, the implied ERP has fallen to 5.7% and there is 91% potential upside to our estimate of equilibrium valuation assuming a normalized real bond yield and ERP – consistent with our view that the market could double by 2014. Using a 3% ERP implies the market is discounting -2.6% annualized earnings growth over the next five years. Meanwhile the dividend swap market still implies a 45% fall in dividends from the 2007 peak with 2010 forecast dividend yield at 3.5%.

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# Valuation becomes important again

**Despite the sharp rise in equity prices since March, on our estimates equities remain attractively valued on most measures. This suggests to us that the market is already factoring in the slow recovery in economic activity that most investors fear. We believe this valuation base provides an attractive platform for further gains in the equity market.**

While valuations in the equity market had reached very attractive levels back in February of this year, with a backdrop of rising risk premium and deteriorating economic fundamentals, we did not believe that this was a sufficient condition to drive a sustained recovery in equity prices.

When the market started to recover sharply in March, however, valuations continued to be largely ignored. As investors started to place more confidence in the improving macro survey data, the focus shifted to macro sensitivity and leverage as key drivers of performance. In common with most recoveries, there was a strong tendency for stocks that were hit most in the downturn to outperform as many of these were effectively priced as options. Indeed, as a result of valuations being largely ignored in the initial rebound from March through to June, valuation dispersion across the market, across sectors and even within sectors collapsed (see our report of June 25, 2009, *Strategy Matters: Reversion of dispersion – more alpha opportunity*).

Now that we have seen a sharp rise from the trough, valuation is once again regaining its focus. Many investors fear that the market is expensive and that, in particular, the most cyclical parts of the market that have led the recovery are trading at extended multiples.

Measuring valuation at any point is fraught with difficulties, but never more so than into an inflection point. No valuation measure is perfect, but many investors worry that earnings based measures are expensive since they expect further deep declines in profits to emerge. So in addition, we also look at asset and enterprise-based measures, as well as relative valuation compared to other asset classes.

## Earnings based measures

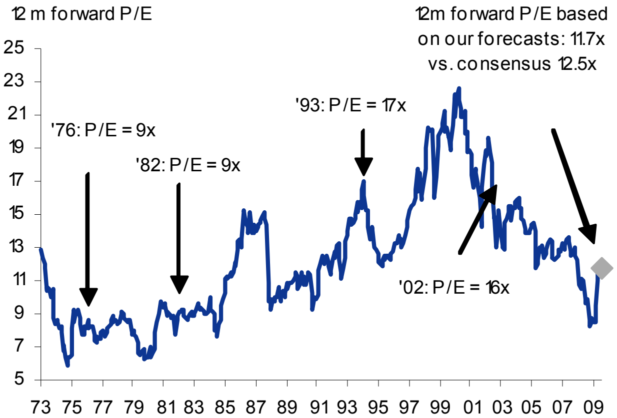
While we agree that we have not yet seen the low in annual reported EPS, we believe that, in aggregate, investors may be underestimating the strength of the likely profit recovery and are focusing more on the probable slow economic recovery. Last week we updated our top down profit model for Europe and revised our forecasts for DJ Stoxx 600 net income pre exceptionals to -19% for 2009 (from -38%) and +34% for 2010 (+19%). Ex financials we expect a 24% decline for 2009 and +28% for 2010. Current bottom up consensus is -21% for 2009 and +23% for 2010 for the total market, making us well above consensus for next year. Our year-end target of 235 on DJ Stoxx is unchanged, since we had expected investors to 'pre-pay' for a large part of the early recovery of which we now see more evidence in earnings; we expect a 17% return (to 260) over the next 12 months.

Three key factors account for our earnings revisions:

- Better financial numbers than we previously expected – our banks analysts forecast banks pre provision earnings to rise 13.7% in 2009 and 65.3% in 2010 (previously they expected -8% for 2009 and 53% for 2010);
- Increased operational leverage as corporate costs had been cut dramatically; and
- Higher emerging market forecasts to which Europe is increasingly exposed – Euroland exports to EM now account for 48% of total non-euro area exports.

On our new top down forecasts, the market trades at a 2010 P/E of 10.4x and a 12-month forward of 11.7x, back to the levels we were seeing in the 1980s and 1990s when inflation was also low – although, of course, interest rates are far lower today. The numbers ex-financials are very similar.

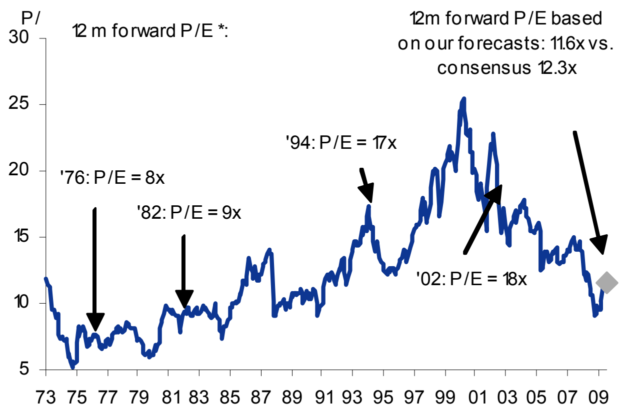
**Exhibit 1: Europe 12-month forward P/E with our earnings forecasts for the last data point**




NB Prior to 1988 we use perfect foresight for 12-month forward earnings; post 1988 we use consensus.

*Source: Worldscope, Datastream, Goldman Sachs Global ECS Research.*

**Exhibit 2: Europe ex-financials 12-month forward P/E with our earnings forecasts for the last data point**



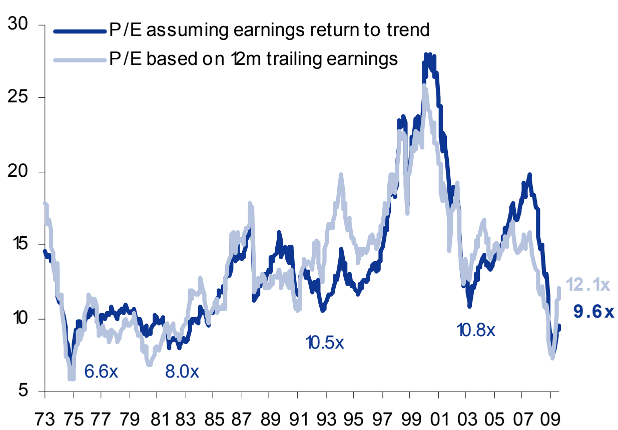

NB Prior to 1988 we use perfect foresight for 12-month forward earnings; post 1988 we use consensus.

*Source: Worldscope, Datastream, Goldman Sachs Global ECS Research.*

## Adjusting for trend earnings

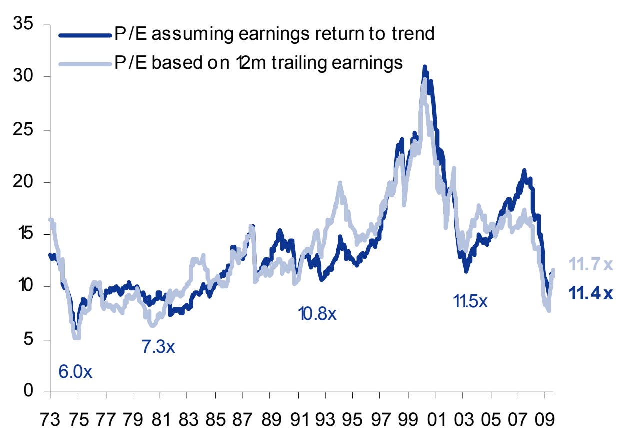
Using the long run trend in earnings since 1973 (in real terms) the multiple is just 9.6x – we think this is a useful indicator because it gives us a feel for what the market trades on mid-cycle or normalized earnings.

**Exhibit 3: Europe P/E based on trend earnings**




*Source: Worldscope, Datastream, Goldman Sachs Global ECS Research.*

**Exhibit 4: Europe ex-financials P/E based on trend earnings**




*Source: Worldscope, Datastream, Goldman Sachs Global ECS Research.*

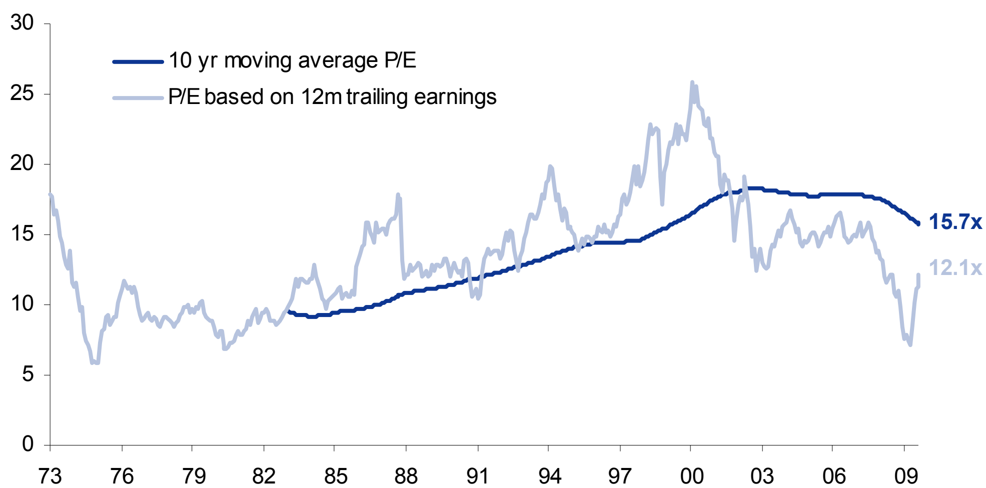
This puts the market below the trough multiples of the early 2000s and 1990s but above those of the early 1980s and 1970s – although, of course, the market has already rallied sharply from its low point, and at the trough, valuations were more comparable with the all time lows in those earlier decades.

The current P/E ex financials for the market based on the long run real trend in earnings is 11x – very similar to the lows seen in the last three downturns. However, once again it is difficult to compare this number today with previous trough levels because: 1) the market has already rallied by 38% from its low; and 2) inflation and interest rates are much lower today than in the past.

### Adjusting for 10-year average earnings

An alternative version of the trend adjusted P/E is the Shiller method of comparing current prices to the 10-year moving average of earnings. This is a similar approach to the trend multiple that we tend to use, but puts more emphasis on the more recent environment. As Exhibit 5 shows for Europe, this currently stands at 12.1x on a trailing basis compared with the average of 15.7x. In our report of June 19, 2009, *Europe: Portfolio Strategy: The next leg: The path to mid-cycle valuation*, we argued that an appropriate mid-cycle multiple by the end of 2013E would be 15x (using a 5% bond yield and 3% ERP). **Assuming, as we do, that ROE mean reverts to long run averages by then, we estimate the broader European market to double (420 on the DJ Stoxx 600).**

**Exhibit 5: P/E based on 12-month trailing earnings and its 10-year moving average**

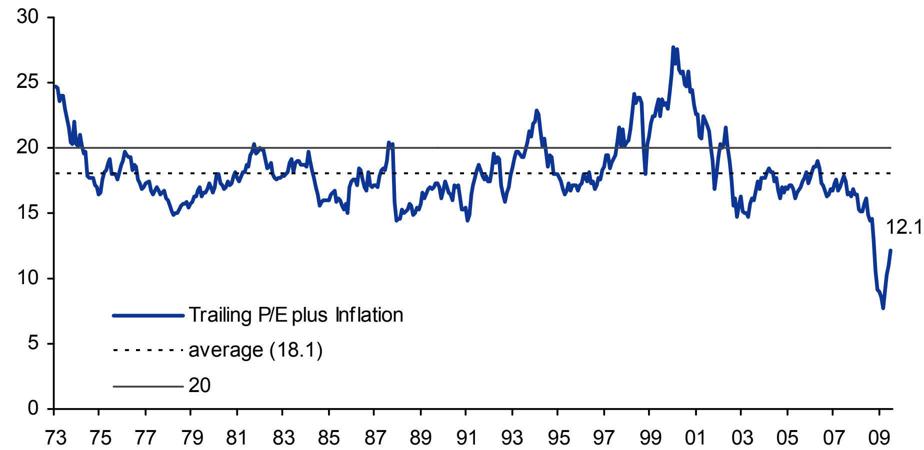



*Source: Datastream, Goldman Sachs Global ECS Research.*

### Adjusting earnings for inflation

One way to adjust for the issue of lower inflation is to add it to the current multiple. Traditionally this was referred to as 'the rule of 20' – suggesting that a higher inflation rate typically implied a lower P/E and vice versa. According to the 'rule', adding the two gives a number that should not exceed 20x. The average in Europe has been 18.1x since 1973 but fell to an all time low of 7.8x earlier this year and is currently 12.1x.

**Exhibit 6: P/E plus inflation**
'The rule of 20' (x)




*Source: Datastream, Goldman Sachs Global ECS Research.*

### Is the value a reflection of sector weights?

Some investors have argued that the market only looks cheap because the sector weights have shifted in a way that pushes the aggregate multiple down; expensive defensives have a smaller weight than typically lower multiple resource stocks or banks. However, the evidence does not support this case. As Exhibit 7 shows, the sector weightings in the index have remained surprisingly stable over recent years. Even banks have budged very little having peaked at 20% of the market in 2006 compared with 16% currently.

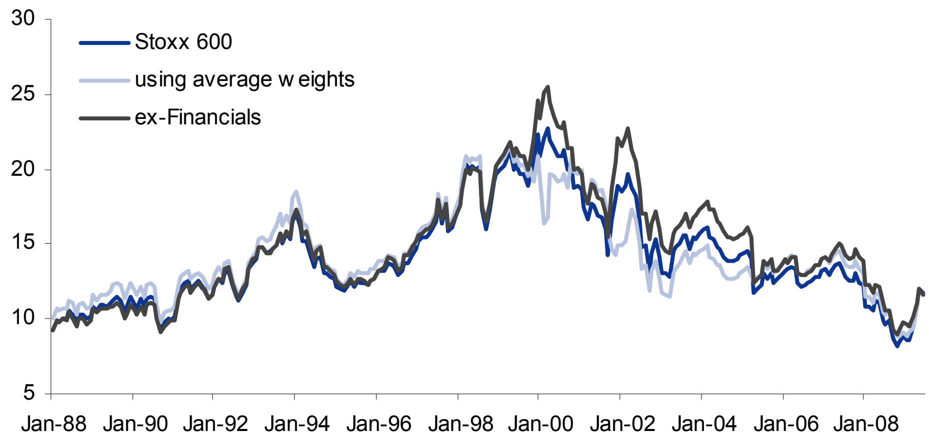
**Exhibit 7: Stoxx 600 sector weights compared with history**

| | Weight | | | Low | | High | |
|---|---|---|---|---|---|---|---|
| | Current | Average | Difference | Date | % | Date | % |
| Oil & Gas | 11% | 11% | 0 pp | 31-Jan-93 | 8% | 30-Sep-97 | 14% |
| Utilities | 6% | 6% | 1 pp | 30-Nov-88 | 3% | 31-Dec-08 | 11% |
| Chemicals | 4% | 3% | 0 pp | 31-May-00 | 1% | 31-Jul-90 | 6% |
| Basic Resources | 5% | 3% | 2 pp | 31-Dec-98 | 1% | 30-Jun-08 | 8% |
| Construction & Materials | 3% | 3% | 0 pp | 31-Mar-00 | 1% | 30-Jun-89 | 6% |
| Industrial Goods & Services | 8% | 8% | -1 pp | 30-Sep-01 | 5% | 28-Feb-89 | 13% |
| Media | 2% | 3% | -1 pp | 30-Jun-08 | 2% | 29-Feb-00 | 6% |
| Technology | 3% | 4% | -1 pp | 31-Oct-93 | 3% | 29-Feb-00 | 15% |
| Telecommunications | 7% | 7% | 0 pp | 30-Apr-90 | 3% | 31-Mar-00 | 18% |
| Automobiles & Parts | 2% | 3% | -1 pp | 30-Jun-00 | 2% | 31-Oct-08 | 5% |
| Travel & Leisure | 1% | 2% | -1 pp | 30-Sep-00 | 1% | 28-Feb-90 | 3% |
| Real Estate | 1% | 0% | 1 pp | 31-Mar-00 | 0% | 27-Jul-09 | 1% |
| Retail | 3% | 4% | -1 pp | 31-Jul-08 | 3% | 31-Aug-92 | 6% |
| Personal & Household Goods | 4% | 4% | 1 pp | 28-Feb-99 | 2% | 31-Mar-93 | 5% |
| Food & Beverage | 7% | 6% | 1 pp | 29-Feb-00 | 3% | 30-Sep-92 | 10% |
| Health Care | 10% | 8% | 2 pp | 31-Oct-89 | 4% | 30-Sep-01 | 12% |
| Financial Services | 2% | 3% | -1 pp | 27-Jul-09 | 2% | 31-Dec-89 | 4% |
| Insurance | 6% | 8% | -2 pp | 28-Feb-09 | 5% | 31-Dec-98 | 10% |
| Banks | 16% | 15% | 2 pp | 28-Feb-09 | 10% | 31-Oct-06 | 20% |

*Source: Worldscope, I/B/E/S, Goldman Sachs Strategy Research*

Adjusting the multiple for average weights over the past decade will have made very little difference to valuation.

**Exhibit 8: Stoxx 600 P/E reconstructed with average weights**
(x)

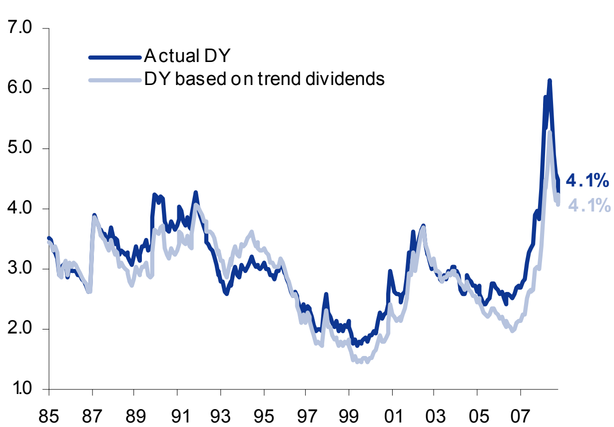



*Source: Worldscope, I/B/E/S, Goldman Sachs Strategy Research.*

## Valuation based on dividends

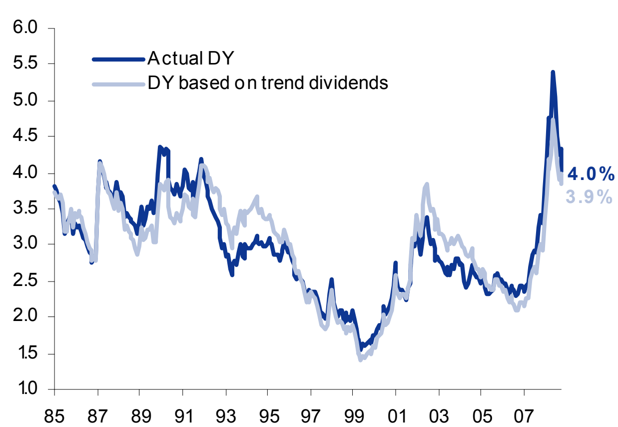
Looking at dividend yields shows a relatively similar story. While dividend yields have fallen from their all time highs, they remain at the high end of their long run range and this is true whether one looks at the market including or excluding financials. Some investors argue that, like earnings based measures, these are unreliable as dividends are set to fall. But it is important to note that dividend yields have already fallen 2.1% from their peak, driven primarily by the move up in equity prices.

**Exhibit 9: European market trend dividend yield**
Based on trailing dividends LTM




*Source: Worldscope, Datastream, Goldman Sachs Global ECS Research.*

**Exhibit 10: European ex-financials market trend dividend yield**
Based on trailing dividends LTM




*Source: Worldscope, Datastream, Goldman Sachs Global ECS Research.*

### Dividend swap valuations

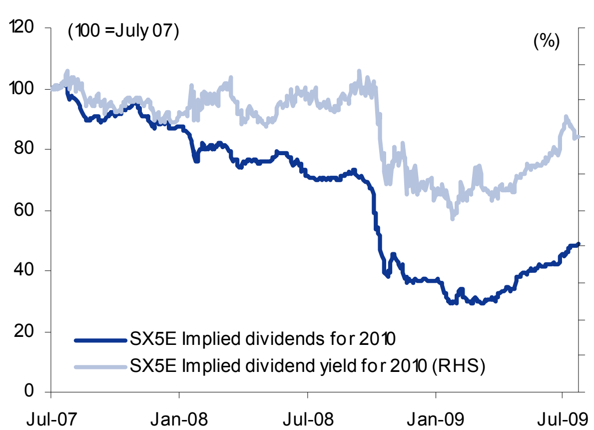
Furthermore, short-term dividend expectations as implied in the dividend swap market have started to increase materially since end of February following a decrease of 70% for the EURO STOXX 50 and 65% for the FTSE 100 implied dividends (along the term structure) since the beginning of the credit crisis. The recent stabilisation is a result of both an improved supply-demand balance for dividend risks and improved visibility and company guidance for dividends.

Implied dividend levels are still in the process of normalising, in our view, and are pricing a risk premium that dilutes the "real" dividend expectations. We expect peak-to-trough drops in dividends of 30% for the EURO STOXX 50 and 20% for the FTSE 100. At the low, the dividend market implied a peak-to-trough dividend drop of 65% for EURO STOXX 50 dividends – this has now decreased to a drop of some 45%.

Implied dividend yields for 2010 are now around 3.5% for both indices compared with peak dividend yields of 4.5%-6.0% in previous equity market corrections. This is equivalent to forecast dividend yields of 4.3% for the EURO STOXX 50 and 4.1% for the FTSE 100. A major swing factor could be financials, which we currently expect to pay low dividends. For further details please see *Global: Dividend Swap Monitor (June 2009): Dividend optionality in the financials sector,* June 30, 2009).

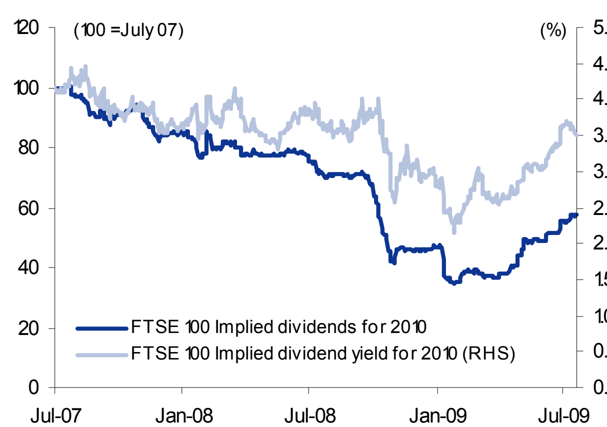
Exhibits 11 and 12 show the implied dividends for the EURO STOXX 50 and the FTSE 100 for 2010 (paid out of 2009 earnings) and the corresponding implied dividend yield (implied dividend level/equity spot price).

**Exhibit 11: EURO STOXX 50 implied dividends indexed and implied yield (using current EuroStoxx50 level)**




*Source: Goldman Sachs Global ECS Research.*

**Exhibit 12: FTSE 100 implied dividends indexed and implied yield (using FTSE 100 level)**




*Source: Goldman Sachs Global ECS Research.*

## Relative equity valuations

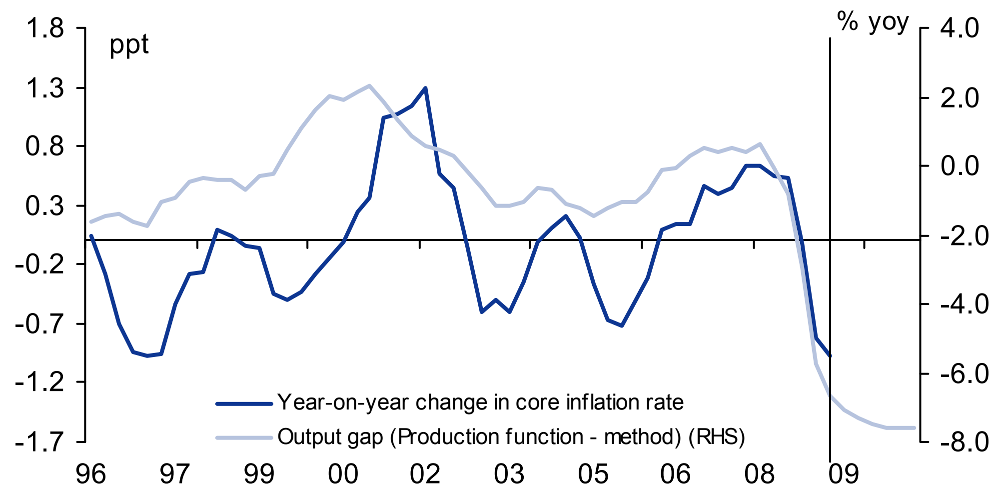
Measuring equities on a relative basis against a 'risk free rate' makes them even more attractive. Of course, there are two arguments that are often put forward which undermine these comparisons.

- Bond yields are artificially low and therefore do not provide a reliable basis for comparison with equities.
- There is no use looking at current dividends or earnings since they have yet to trough.

We do not believe either of these is a legitimate reason to ignore such comparisons.

On the first point, our bond strategists believe that bond yields will remain at low levels for some time given that inflation pressures are likely to remain very subdued. Given the size of the current output gap, we believe inflation will keep bond yields at low levels as Exhibit 13 suggests.

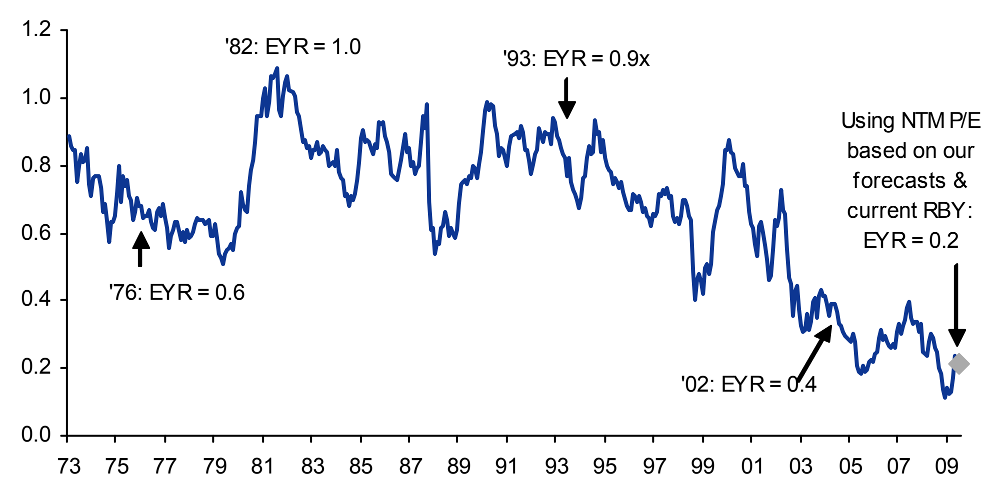
**Exhibit 13: Our forecast for the Eurozone output gap suggests inflationary risks are low**




*Source: Eurostat, OECD, Goldman Sachs Research estimates.*

On the issue of earnings and dividends having further to fall, we do not disagree. However, even on our forward estimates, there appears to be good value as the yield ratio (real bond yield divided by earnings yield) is near historical lows.

**Exhibit 14: European Real earnings yield ratio (EY is based on 12-month forward earnings***

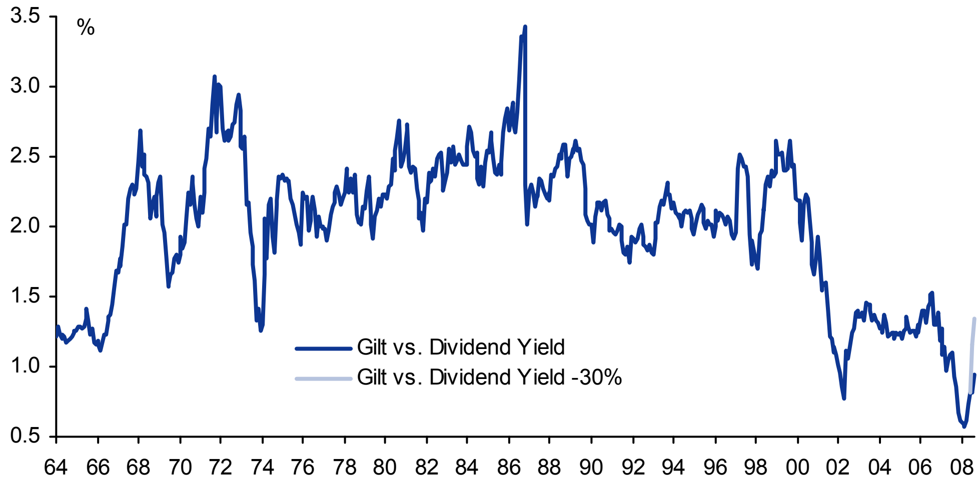



*Prior to 1988 we use perfect foresight for 12-month forward earnings; post 1988 we use consensus.

*Source: Worldscope, Datastream, Goldman Sachs Global ECS Research.*

Indeed, in the case of the dividend yield ratio, dividends have already fallen close to 30% from their peak; even if we assume that they fall a further 30% (which we think unlikely) the yield ratio would be close to the low levels seen over the past several decades. Exhibit 15 shows this for the UK, where we have a longer data series.

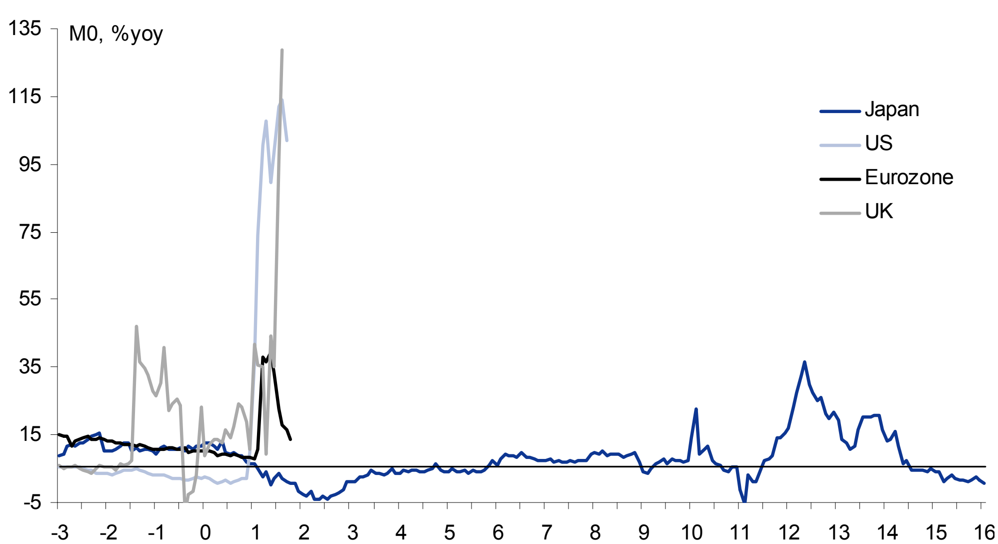
**Exhibit 15: UK Gilt vs. dividend yield**




*Source: Datastream, Goldman Sachs Global ECS Research.*

Overall these relative valuation measures seem to suggest either that the equity market is too low – and consequently investors should be well rewarded for risk – or, alternatively, the market is pricing a sustained deflation environment such as Japan experienced through much of the 1990s. If this scenario unfolded, then equities would be seen to offer no real future growth and would consequently need to yield more than bonds to compensate for the higher risk. We do not see this as likely given the very aggressive backdrop of policy easing. Exhibit 16 shows the current experience of quantitative easing by the main central banks relative to the experience of Japan in the 1990s. The horizontal axis shows the number of months around the peak of the equity market in the current cycle (and for Japan, it refers to the peak in Japanese equities in the late 1980s).

**Exhibit 16: Quantitative support in this cycle more aggressive than in Japan in 1990s**



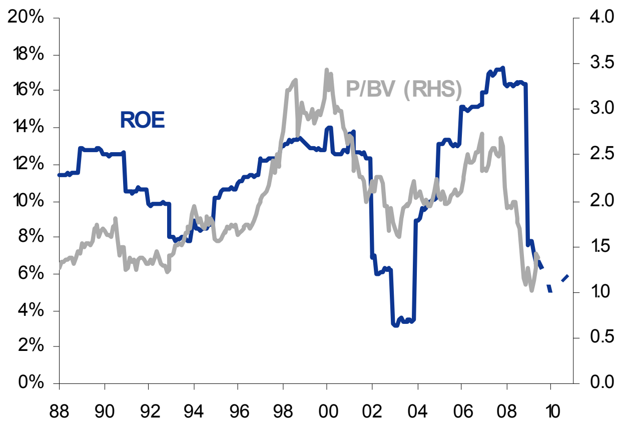

*Source: Goldman Sachs Global ECS Research.*

## Asset priced valuations

Some investors do not like to use earnings based measures since they argue that earnings are too difficult to measure at turning points, so using asset based measures gives a more reliable picture.

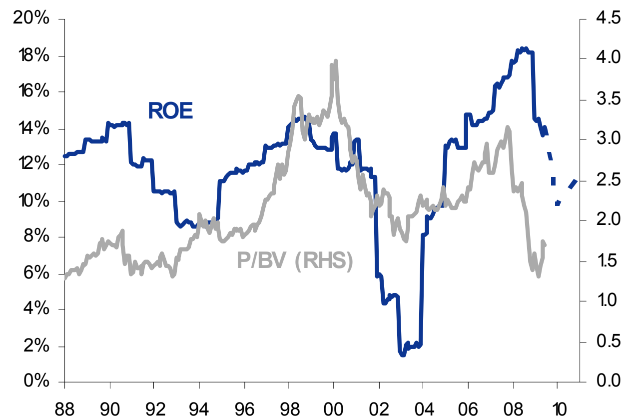
Using P/B as a guide, the broader market currently trades at 1.5x, at the low end of the range over the past 20 years (we do not have data beyond this). Although there is no stable relationship with ROE, this seems to be consistent with an ROE of around 6% for the whole market, although ROE reached much lower levels in the aftermath of the technology collapse without P/B falling so far. Of course, P/B has been particularly influenced by the bank sector. If we exclude banks, the P/B is 1.8x, still fairly close to the low end of the range since the late 1980s.

**Exhibit 17: P/BV and ROE including our top down forecasts**




*Source: Worldscope, Goldman Sachs Global ECS Research.*

**Exhibit 18: Europe ex financials – P/BV and ROE including our top down forecasts**

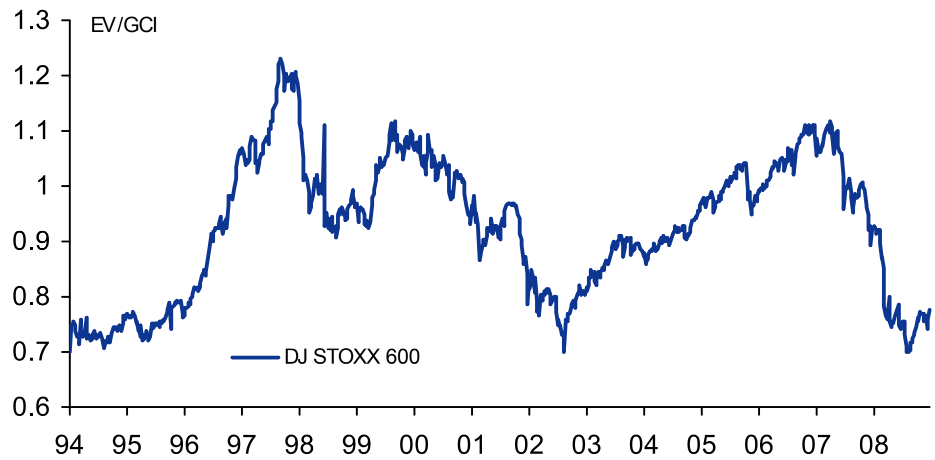



*Source: Worldscope, Goldman Sachs Global ECS Research.*

## Enterprise value multiples

Another valuation metric favoured by our research analysts is Enterprise Value to Gross Cash Invested (EV/GCI). For the aggregate market, we only have data going back to 1994 using our GS analysts' forecasts on a 12-month forward basis for our coverage universe. At the recent trough, the market appeared to trade on a similar EV/GCI to the trough levels of 2003 and 1994. Despite the recent sharp rally, EV/GCI is still very close to the bottom of the long run range for the market as a whole.

**Exhibit 19: Goldman Sachs EV/GCI estimates for the DJ Stoxx 600**

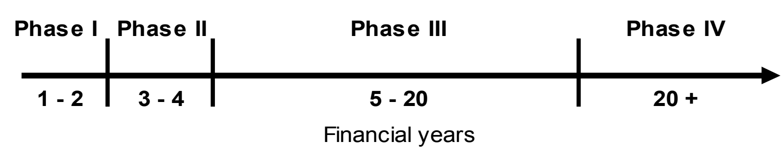



*Source: Goldman Sachs Research estimates.*

## GS DDM

Another approach to valuation is to use some kind of discount model. Our own GS DDM is based on four 'phases' and assumes that a proportion of earnings are paid out each year as dividends.

**Exhibit 20: Model time line**




*Source: Goldman Sachs Global ECS Research.*

We use our top down estimates for operating earnings growth for Years 1 and 2. For each year, we adjust the previous year's payout ratio by a factor that relates to the forecast growth rate (for example, if we expect earnings to rise rapidly, we assume last year's payout ratio falls moderately as dividends are more stable than earnings). In Phase II, Years 3 and 4, we assume the market gets back to trend ROE and that the earnings change to achieve this occurs equally over the two years. In Phase III we assume profits grow at their trend rate of growth (equal to the long-term real economic growth rate plus inflation) but assume that the proportion paid out by companies over this period equals the average of the past five years. In the final phase we assume that any profit growth in perpetuity is offset by a commensurate change in the payout ratio; this way we ensure that the return on equity is equal to the cost of equity and profits grow in line with trend real GDP.

The model currently suggests that the market is actually slightly above fair value by 9%, but this changes to an undervaluation of 18% if we plug in our bond strategists' fair value bond yield assumption using the Sudoku model. Perhaps more interesting is that, assuming a mean reversion of ERP and real interest rates, the model suggests that the market still could close to double. Approached from a different way, this is also the conclusion we came to in *Portfolio Strategy: The next leg: The path to mid-cycle valuation* (June 19, 2009), suggesting that the DJ Stoxx600 could reach 420 by the end of 2013.

**Exhibit 21: Fair value based on three scenarios**

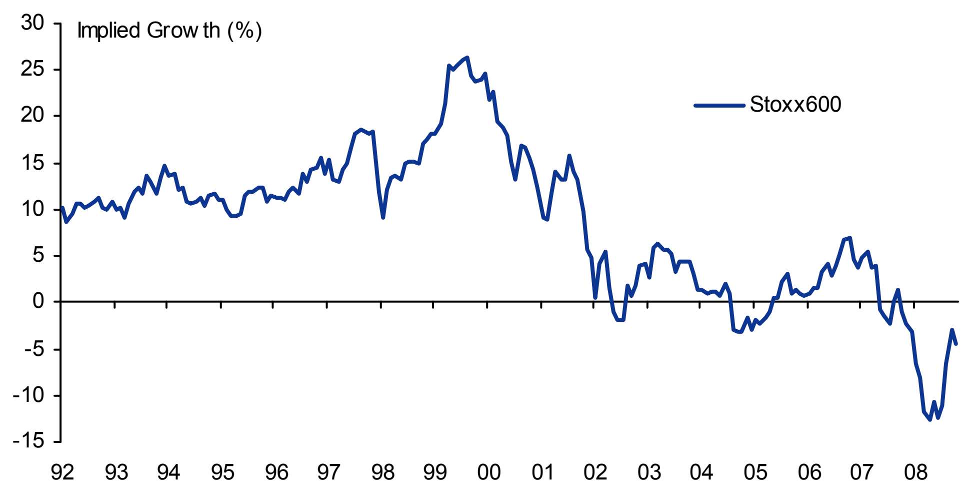
| | | Central Scenario | | Using Sudoku Fair Value Bond model | | Using equilibrium ERP* and 2% real interest rate | |
|---|---|---|---|---|---|---|---|
| | Current Level | Fair Value Level | Fair Value Upside / (Downside) | Fair Value Level | Fair Value Upside / (Downside) | Fair Value Level | Fair Value Upside / (Downside) |
| US (S&P 500) | 975 | 734 | (25%) | 925 | (5%) | 1437 | 47% |
| Europe (Stoxx 600) | 220 | 202 | (9%) | 261 | 18% | 420 | 91% |
| Japan (TOPIX) | 930 | 1313 | 41% | 1487 | 60% | 2241 | 141% |
| Asia (MSCI APxJ) | 378 | 255 | (32%) | 1196 | 2 | 405 | 7% |

*Source: Goldman Sachs Global ECS Research.*

## Implied growth

In trying to back out the implied growth rate of the market we need to make assumptions. In this particular case, we fix the ERP to back out the earnings growth the market implies for the next five years. To be consistent with GS DDM, we assume a long run equilibrium ERP of 3%. Unfortunately, for data reasons, our model only goes back to 1992, nevertheless, it provides a fairly good picture of how expectations have changed over more than 15 years. At the peak of the technology bubble in 2000 it appears that investors expected 25% cumulative growth in earnings each year for the next five years. At the worst point in the credit crunch this had fallen to an expected 10% decline each year. While expectations have rebounded somewhat, implied growth remains very subdued.

**Exhibit 22: DJ Stoxx 600 implied growth rate**
Earnings growth 5-year forward




*Source: I/B/E/S, Worldscope, Goldman Sachs Global ECS Research.*

Of course, backing out implied growth is dependent on the assumptions we use. Exhibit 23 summarises our key assumptions and the sensitivity to changes in some of the key inputs.

**Exhibit 23: Sensitivity of implied growth calculation around base case assumptions**

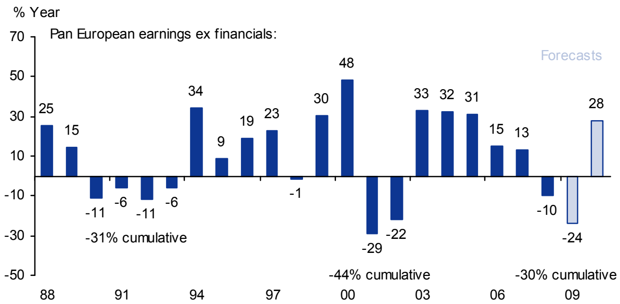
| **Assumptions (Bottom-up):** | | |
|---|---|---|
| Earnings for the first period | | I/B/E/S estimates |
| Equity Risk Premium (ERP) | | 3.0% |
| Perpetuity Growth Rate | | 4.5% |
| Perpetuity Payout Ratio | | calculated |
| Current Risk Free Rate (10 Yr) | | 3.5% |
| Beta, Cost of Equity & Payout Ratio | | Varies by Company |
| **5 Yr Implied Growth Rate** | | **(2.6)%** |
| **Implied Growth Sensitivity** | | **Implied 5-Year EPS Growth** |
| **Equity Risk Premium (ERP)** | | |
| | 6.0% | 9.6% |
| | 5.0% | 5.8% |
| | 4.0% | 1.7% |
| Base Case: | 3.0% | (2.6) |
| | 2.0% | (7.3) |
| **Perpetuity EPS Growth** | | |
| | 3.5% | (2.5)% |
| | 4.0% | (2.5) |
| Base Case: | 4.5% | (2.6) |
| | 5.0% | (2.8) |
| | 5.5% | (2.9) |
| **Perpetuity Payout Ratio** | | |
| | 30% | (1.8) |
| Base Case: | 31.2% (calculated) | (2.6)% |
| | 40% | (7.9) |
| | 50% | (12.6) |
| **Risk Free Rate** | | |
| | 2.0% | (10.1)% |
| | 3.0% | (5.1) |
| Base Case: | 3.5% | (2.6) |
| | 4.0% | (0.6) |

*Source: I/B/E/S, Worldscope, Goldman Sachs Global ECS Research.*

As with all models, changes in the ERP are particularly important. With the ERP at a particularly high level of, say 6%, close to our current assumed rate, the market would be implying nearly 10% growth pa – at a more 'normalised' level of 3% ERP, the market actually implies annual declines in earnings of around 2.5%. Even if the ERP were to stay very elevated levels, which we doubt, the 10% annual implied growth could be conservative.

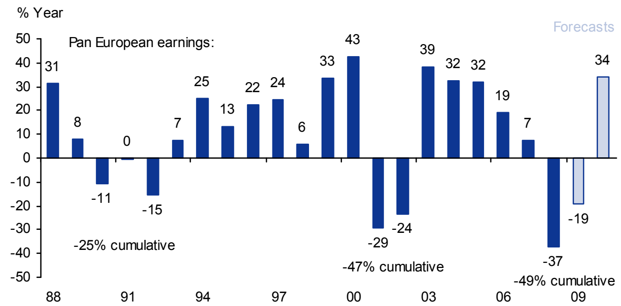
The initial recoveries in profits after economic downturns tend to be very strong. As Exhibits 24 and 25 show, the first five years of profit recovery from the downturns were 127% in the early 1990s and 210% in the mid-2000s. For non-Financials it was 110% and 202%, respectively.

**Exhibit 24: Ex-financials, we expect 2009 profits to be among the worst in the last twenty years**
Historical data based on DJ STOXX 600 ex Financials (all data is pre-exceptionals and pre-GW writedowns)




*Source: Worldscope, Goldman Sachs ECS Research.*

**Exhibit 25: Including financials, 2009 and 2010 earnings figures are higher**
Historical data based on DJ STOXX 600 (all data is pre-exceptionals and pre-GW writedowns)



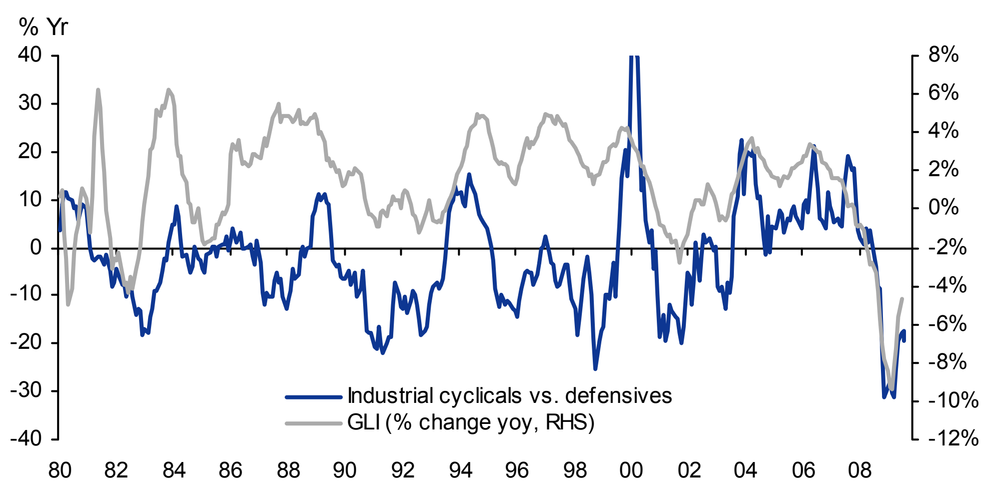

*Source: Worldscope, Goldman Sachs ECS Research.*

# What about cyclicals?

One view we often hear is that cyclicals are now expensive and the best place to buy the market, if at all, is in defensives. We do not share this view.

1) The outperformance of cyclical sectors seems to be simply moving with the macro data. As Exhibit 25 shows, the relative performance of cyclicals versus defensives maps fairly closely with our own global leading indicator (GLI).

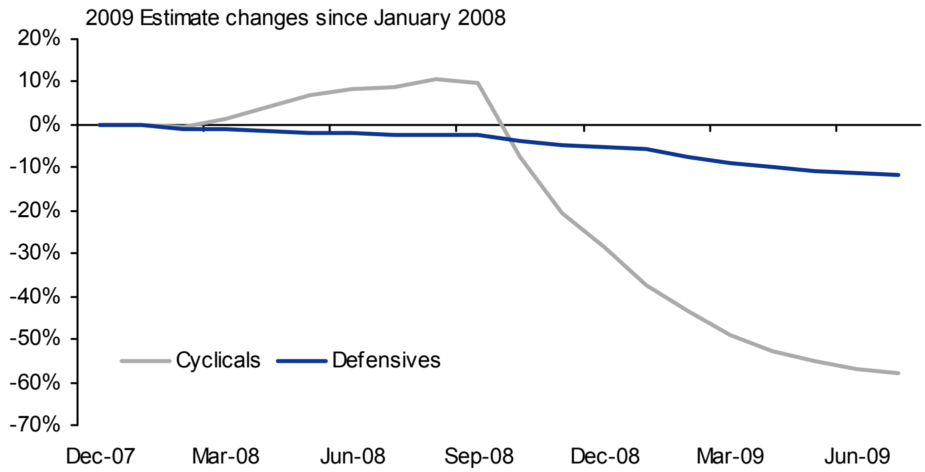
**Exhibit 26: Industrial cyclicals vs. defensives, vs. GLI**




*Source: Datastream, Goldman Sachs Global ECS Research.*

2) The reason cyclicals look expensive is because this is where most of the earnings downgrades have been so far (Exhibit 27).

**Exhibit 27: Earnings revisions: cyclicals vs. defensives**
Cumulative change to 2009 earnings estimates since January 2008

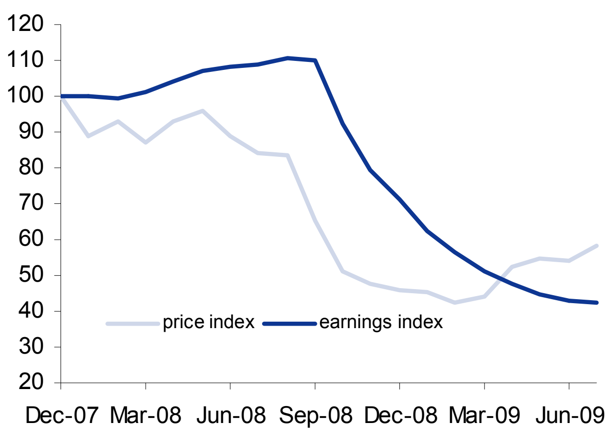



Note: Cyclicals includes Chemicals, Basic Resources, Construction & Materials, Industrial Goods & Services, Automobiles & Parts, Travel & Leisure, Leisure Goods, General Retail and Technology. Defensives includes Food & Beverage, Household Goods, Pharmaceuticals & Biotechnology, Food & Drug Retailers, Telecommunications and Utilities. These definitions are used throughout the report unless otherwise noted.

*Source: I/B/E/S, Worldscope, Goldman Sachs Global ECS Research.*

This pattern is very typical at the inflection point in the market when the economy is still contracting (albeit at a slower rate). As Exhibit 29 shows, the forward multiple based on consensus expectations of the cyclicals troughed in November at about 8x.

**Exhibit 28: Both prices and earnings for cyclicals have fallen dramatically**



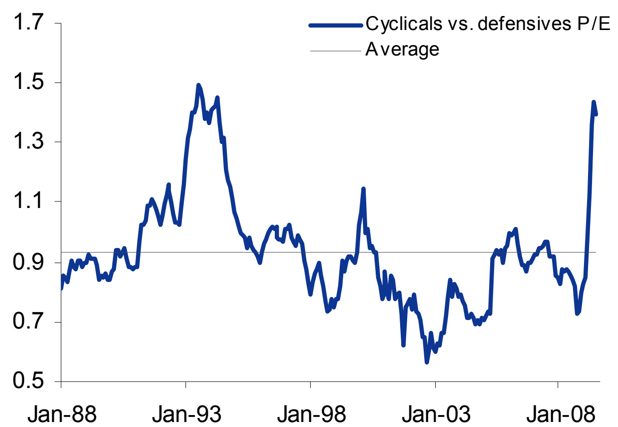

*Source: I/B/E/S, Worldscope, Goldman Sachs Global ECS Research.*

**Exhibit 29: Forward P/E for cyclicals – at first, price declines led to multiple declines; this reversed in October 2008**


*Source: I/B/E/S, Worldscope, Goldman Sachs Global ECS Research.*

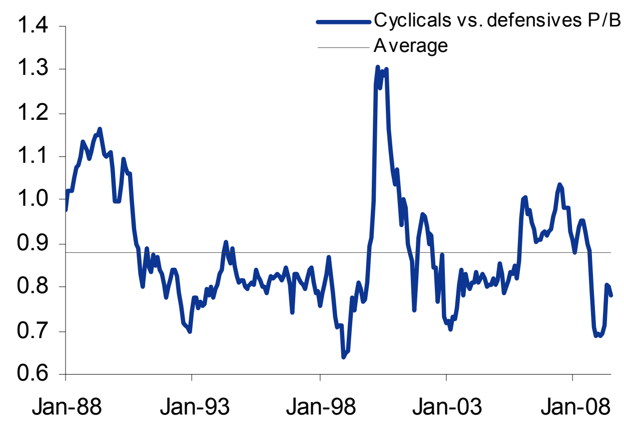
Of course this makes cyclicals look relatively expensive on an earnings based measure (Exhibit 30) but not so on a P/B basis (Exhibit 31).

**Exhibit 30: Cyclicals look expensive vs. defensives on a P/E basis**




*Source: I/B/E/S, Worldscope, Goldman Sachs Global ECS Research.*

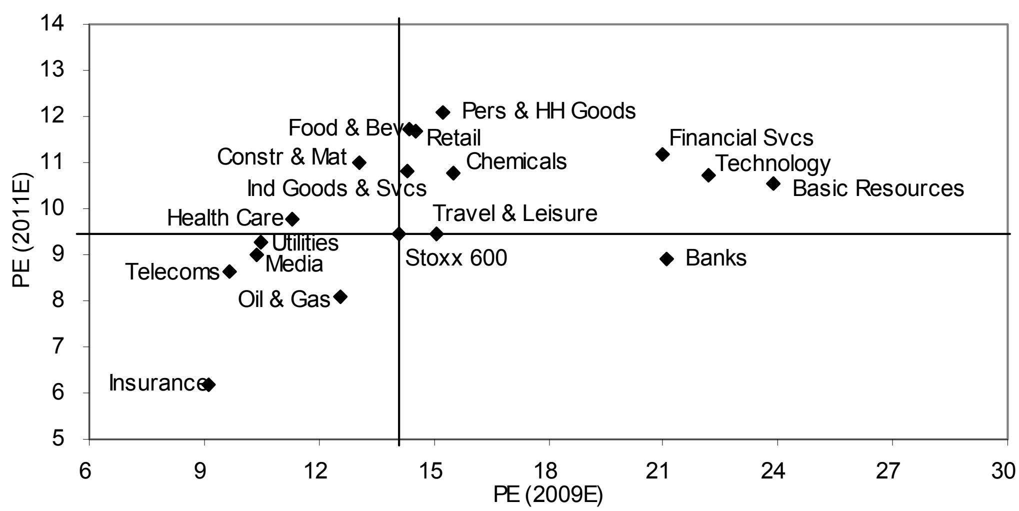
**Exhibit 31: Although it is a different story on an asset based metric such as price/book**




*Source: Worldscope, Goldman Sachs Global ECS Research.*

Generally, while cyclicals look expensive on a current year basis, there is much less differentiation between cyclical and defensive sectors on 2011 estimates based on consensus.

**Exhibit 32: P/E multiples based on 2009 and 2011 estimates give different stories**




Note: P/E based on I/B/E/S consensus estimates

*Source: Worldscope, I/B/E/S, Goldman Sachs Global ECS Research.*

# Reg AC

We, Peter Oppenheimer, Jessica Binder, CFA, Gerald Moser and Anders Nielsen, hereby certify that all of the views expressed in this report accurately reflect our personal views about the subject company or companies and its or their securities. We also certify that no part of our compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

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|---|---|---|---|---|---|---|
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