

Europe: Portfolio Strategy

Strategy Matters

Why the market has further to rise

With the market up 50% from lows, many question the potential from here. As we move from a 2nd derivative improvement in activity to a 1st, we expect slower returns. But based on recent GDP revisions and higher earnings forecasts, we upgrade our DJ Stoxx 600 year-end target to 260 (from 235) and maintain a cyclical bias.

Tracking previous recoveries

Following the 50% rebound since March, many argue that there is little upside for the market from here. While we agree that the market tends to make its strongest returns while the economy is still contracting, albeit at a slowing rate (an improving 2nd derivative), it tends to make further gains as the economy begins to expand (the 1st derivative). Furthermore, the sharp recovery is not unique given the depth of the declines over the past two years and the market remains 25% below the pre-Lehman levels while our financial stress index is back to pre-September 2008 levels.

Valuation and earnings upgrades support higher returns

We have upgraded our European and global GDP forecasts recently and now expect 4% global GDP growth in 2010, well above consensus. This, coupled with higher financial earnings, has resulted in a further rise in our top down profit forecasts. We now expect net income growth pre-exceptionals of -16% for 2009 (-23% ex financials) and +40% for 2010 (+37% ex financials). This puts the market on 10x 2010 earnings on our forecasts. We upgrade our year-end DJ Stoxx 600 target to 260 (from 235) and have a 12-month target of 275.

We retain a broadly cyclical bias

We have made a few sector changes but retain a broadly cyclical bias. We have upgraded Banks to a modest overweight from neutral, Construction & Materials and Food & Beverages to neutral from underweight. We have downgraded Utilities and Technology from overweight to neutral.

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Moving into the growth phase

The market rally over the past few weeks, on low volumes, had taken equities to new highs for the year but has failed, so far, to break important technical resistance levels and in recent days has weakened on good news. Ever since April we have taken a positive view on the markets as it became increasingly clear to us that through March and beyond, the pre-conditions for a sustained recovery in equities that we had been looking for were beginning to emerge. Cheap valuations, clear signs of a second derivative improvement in activity, improving credit markets and an ability to shrug off deteriorating earnings forecasts were central to our constructive view. We argued that the market would likely recover by 30%-50% over the first 6-12 months of the recovery. Given the 50% rebound from the low, we revisit our year-end forecast and our sector views.

From second to first derivative improvement

The DJ Stoxx 600 has now risen roughly 50% from its low and is close to our prior year-end target of 235 and 13% below our 12-month target of 260. While the market has rebounded sharply from early March levels, it has failed to break through the heavy resistance of more than a 50% rebound from the lows, and there has been a growing sense of fatigue in the market's reaction to generally better than expected macro data over the past couple of weeks. The US housing data have been one of the most important recent upside surprises. Existing and new home sales and Case-Shiller all showed further signs of stabilization. The latest ISM numbers were also encouraging with new orders rising at the fastest rate since December 2004 and inventories continue to be flat – that spread is the widest since 1975. Outside the US, we have seen better 2Q GDP prints in a number of places in Europe, with Germany, in particular on the services side, much stronger. Nonetheless, despite the evidence that we are transitioning from a second to a first derivative improvement, investors may now generally require new information for the market to move higher, but we think the better news will come. Our 2010 Global GDP forecast is 4%, above consensus, and our revised top down earnings forecast for DJ Stoxx600 for 2010 at 40% is higher than consensus.

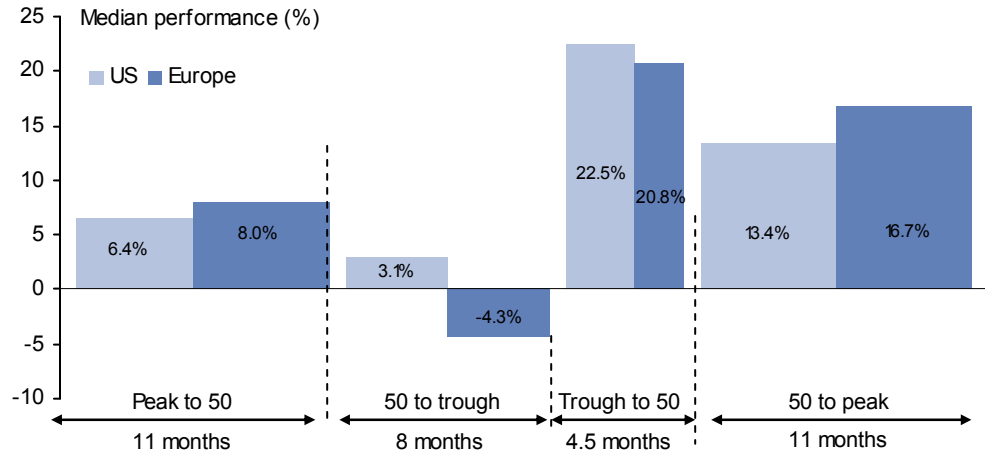
Raising our target for the end of the year

We often hear from investors that all the market gains in expectation of the recovery have already been made and that there is little more to drive it. We certainly agree that market recoveries tend to be 'front loaded' and we have long argued that the sharpest returns would come while the economy was still contracting and that the second derivative of growth (the rate of decline) would be slower. Indeed, this is why we argued that the initial market recovery would be 30%-50% over a 12-month period. It is in this phase, when valuations are cheap (reflecting a high risk of further economic and profit deterioration) that a stabilization of the macro data tends to lead to a fall in the equity risk premium. As we have shown recently, on our model, the ERP peaked at around 7% and has fallen to around 5.5% since March. But this does not mean that the market can make no further progress. That the ERP remains at such an elevated level relative to long run average (which we estimate to be about 3%) is testament to the attractive valuation that remains.

Furthermore, while we have shown that the market tends to have the strongest returns while the economy contracts, but at a slower rate (for example when the ISM moves from trough back to 50), we have also shown that, on average, the market continues to rise when the ISM goes from 50 to peak, albeit at a slower pace. This is demonstrated in Exhibit 1 which shows the average annualized returns in both the US equity market (from 1950) and Europe (from 1973) during different phases of the ISM. While the phase from

trough to 50 is the strongest on average – and also the shortest period – the market tends to make slower gains as the ISM makes further progress above 50.

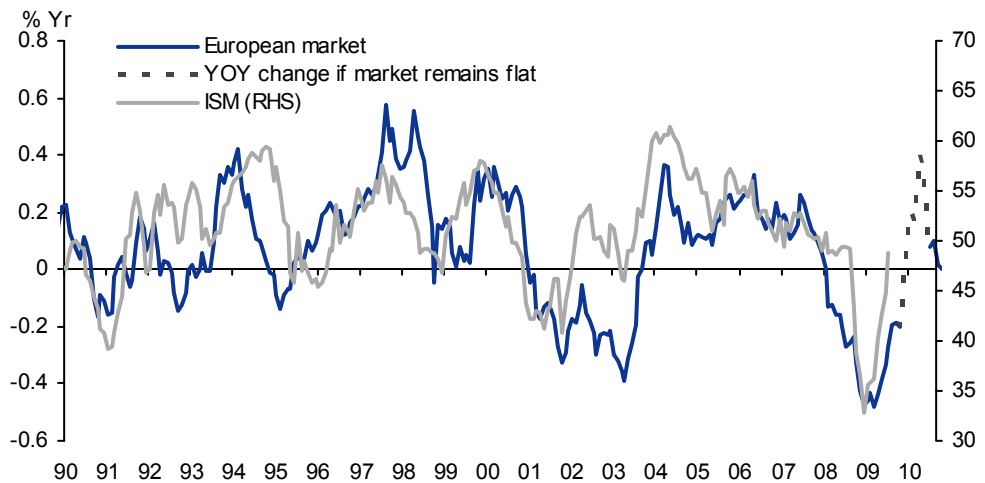
Exhibit 1: Equities typically enjoy strong returns as the ISM moves back towards 50
Annualized performance covering 16 ISM cycles for the US (1950) and ten for Europe (1973)



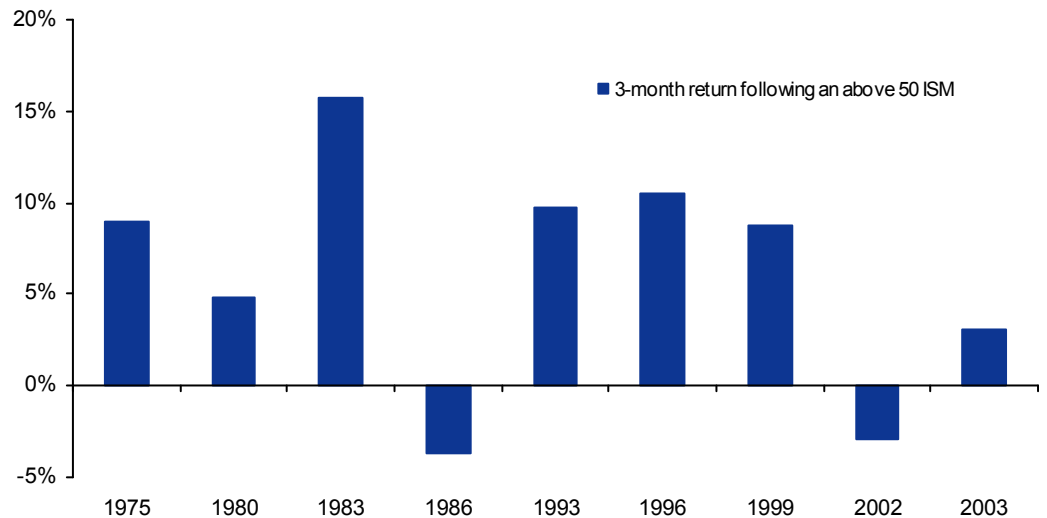
Source: Datastream, Goldman Sachs Global ECS Research.

The ISM manufacturing index returned above the 50 threshold on September 1, indicating that the US manufacturing sector has returned to expansion over the month. This is a key milestone in the economic recovery process. We studied the evolution of the European equity market following an ISM print above 50. Over nine past occurrences since 1975, European markets had a positive performance in the following three months in seven out of nine times. The 3-month performance following the ISM release has on average been 6.1% while the median performance is equal to 8.8%.

Exhibit 2: The ISM is still ahead of European equity market



Source: Datastream, Goldman Sachs Global ECS Research.

Exhibit 3: 3-month return after the ISM passes 50 points

Source: Datastream, Goldman Sachs Global ECS Research.

Raising our earnings estimates

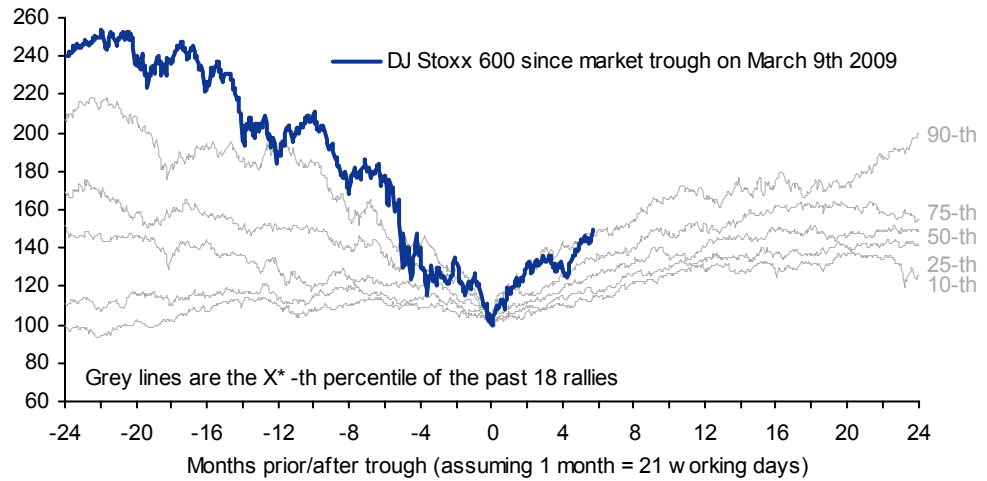
Given our recent economic upgrades, which keep us significantly above consensus for 2010, coupled with relatively attractive valuations and stronger recent earnings in the financials, we have again raised our earnings forecasts for this year and next. We now anticipate 40% total market net income growth (pre-exceptionals) for 2010, compared with 34% previously. Precise forecasts are currently even more difficult than normal given the huge potential swing factor in financials and the huge swings in percentage gains given the very weak base. Our banks team currently forecast 47% pre-exceptional profits growth (from 15%) for this year and 76% for next (from 65%). Adding the insurance sector to the broad financial picture, our analysts expect financials to grow earnings 34% this year and 55% in 2010. But there is clear upside to these estimates given the 2Q surprises, particularly for large global retail banks. Taking this and our economists recent GDP forecasts into account, we also raise our year-end target for the DJ Stoxx 600 to 260 and our 12-month target to 275.

Furthermore, the recovery in the market so far seems to be tracking the leading indicators quite closely. Exhibit 2, for example, shows the market returns on a yoy basis against the ISM. So far the market has not moved ahead of where the macro data has implied on past relationships. Of course this is showing a yoy change, so that if the market stays at this level it would progress as the dotted line suggests over the next year. But this path does not look unreasonable to us.

The market recovery is not yet exceptional

One comment we hear regularly in conversations with clients is that the pace of the recovery has been so violent that it does not leave any room for further upside. Is this forecast too high given the sharp rebound already? As Exhibit 4 illustrates, the recovery so far is tracking the 90th percentile of recoveries taking the average of the 18 worst bear markets over the post war period. But this should be seen against a backdrop of the last two year declines has been above the 90th percentile of post war market declines.

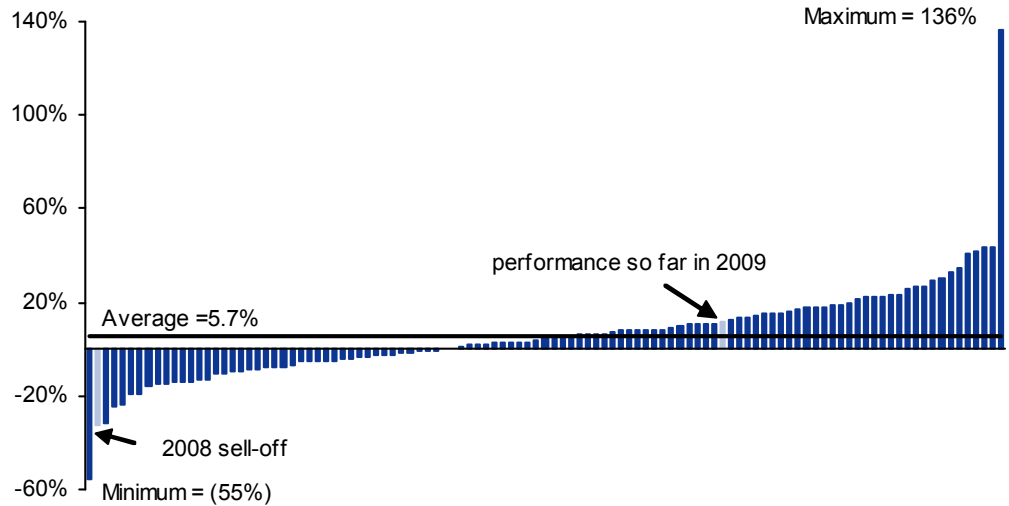
Exhibit 4: The depth of the bear market was more unusual than the strength of recovery



Source: Datastream, Goldman Sachs Global ECS Research.

As Exhibit 5 shows, taking data for the UK back to 1900, the decline in 2008 was the second worst on record, while the recovery this year is about average for annual returns over this period.

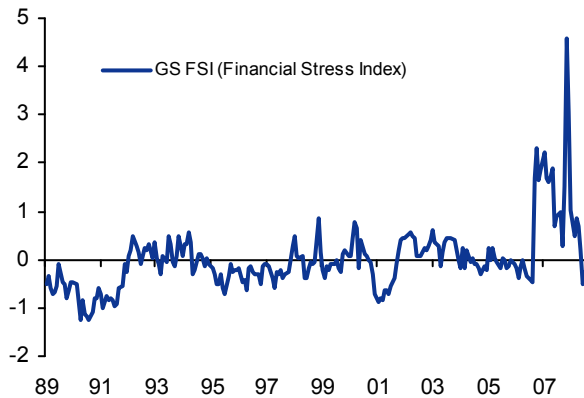
Exhibit 5: FTSE All-Share yearly return distribution



Source: Global Financial Data, Datastream, Goldman Sachs Global ECS Research

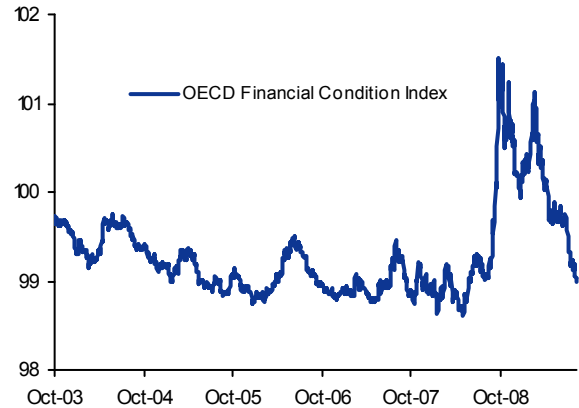
On a calendar year basis, the DJ Stoxx rise (so far about 16%) is actually pretty mild (given the 45% decline in 2008). Of course calendar year moves can be very misleading, bearing in mind that the market fell first before recovering strongly from March. But it is also worth recalling that the DJ Stoxx was at 291 just prior to the Lehman collapse, (25% higher than current levels) and the S&PComp at 1251 (23% above current levels). Meanwhile our financial stress index (together with several other macro indicators of health) is now back to pre-Lehman levels – Exhibit 6.

Exhibit 6: Financial Stress Index shows little stress



Source: Goldman Sachs Global ECS Research.

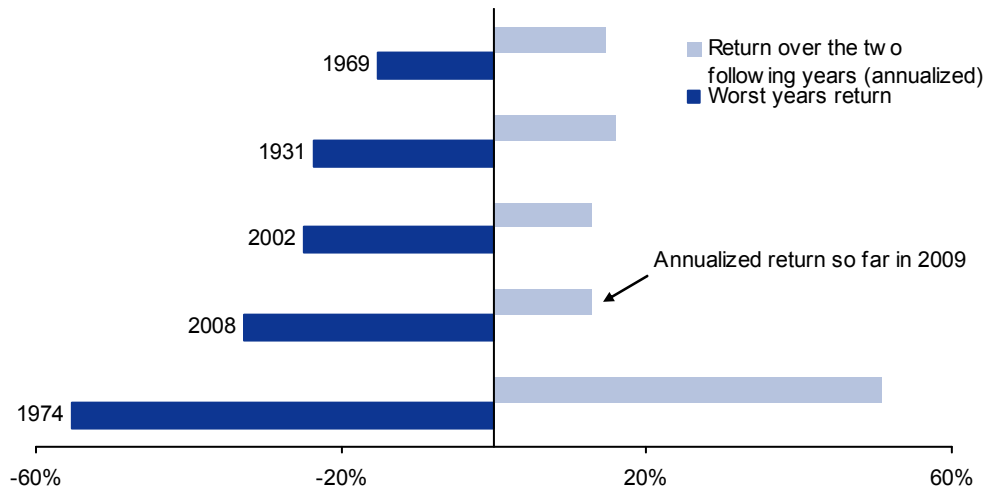
Exhibit 7: Financial condition in OECD countries



Source: Goldman Sachs Global ECS Research.

There is a strong tendency for the worst down years to have the strongest recoveries. Exhibit 8 shows the 2-year annualized return following the worst down years in history. While 2008 was the second worst year on record since 1900 for the FTSE All-Share, the annualized return so far in 2009 is only 13%.

Exhibit 8: FTSE All share returns after market falls
2-year annualized returns following a fall in the market



Source: Global Financial Data, Datastream, Goldman Sachs Global ECS Research.

Backdrop remains constructive

Our general view is that the market is heading higher supported by stronger earnings estimates for next year and by cheap valuations.

Overall we see several factors that together are likely to support further gains in equity prices.

- We expect global GDP growth of 4% for 2010; above consensus and in line with long run growth. The second derivative improvement in activity is turning into a first derivative improvement and, while we expect future gains in the market to be more modest than we have seen so far, prices should run further.
- We expect a stronger recovery in profits for next year than consensus; our top down forecast for net income growth pre-exceptionals for DJ Stoxx 600 is 40% for 2010, driven in particular by higher operational leverage and particularly strong growth from emerging economies, together with a sharp percentage rebound in financials and commodity related earnings.
- While growth is likely to be at trend by next year, valuations are still well below long run trend and the ERP remains unusually high. We estimate that the market will return to long run average ROE at 11.4% by end 2013 and deliver earnings per share of €28 (DJ Stoxx 600). We anticipate a mid cycle P/E of 15x, which would imply a Stoxx 600 target of 420 (compared with the current 230). In essence we think that the market is now at mid-cycle valuations (15x trailing earnings) but not at mid-cycle earnings.

Of course there are negatives too. In particular there are two factors on which we would focus.

- Increased supply. We anticipate a raft on new issues in 4Q as private equity firms and others use a more robust market environment to sell businesses. On top of this, it is possible that there could be other equity raising, with the insurance sector being a possible candidate.
- Fears of a double dip may well return to the forefront of investors' minds on any evidence that leading indicators roll over later in the year. Investors are likely to be particularly sensitive to any such prospects given the recovery expected in 3Q owes much to temporary fiscal initiatives coupled with strong restocking. Rising unemployment coupled with evidence that final demand is not coming through could again heighten concerns about deflation given the experience of Japan. While we do not expect this outcome, there is a risk that investors price it as an increasing risk on any evidence that the pace of recovery is slowing.

However, despite these risks, we think the balance of factors support further upward moves in the market. After all, the still elevated level of the ERP suggests that investors remain wary and vigilant to bad news.

The economy

Over the past month our economists have made a number of upgrades to their economic forecasts for this year and next. In the US these reflect mainly a faster recovery during the second half of this year with annualized growth of 3% (up from 1%) followed by a slowdown in momentum during 2010. The faster than expected pick up in the 2H reflects the bigger inventory liquidation in 2Q, a greater fiscal stimulus effect and a more significant near-term upturn in homebuilding. We expect things to level off again next year as the two first effects are clearly temporary and the homebuilding will be tempered by the still large amount of excess capacity. The story is similar in Europe, where we have also seen forecast upgrades. There is more and more evidence that the collapse in global trade

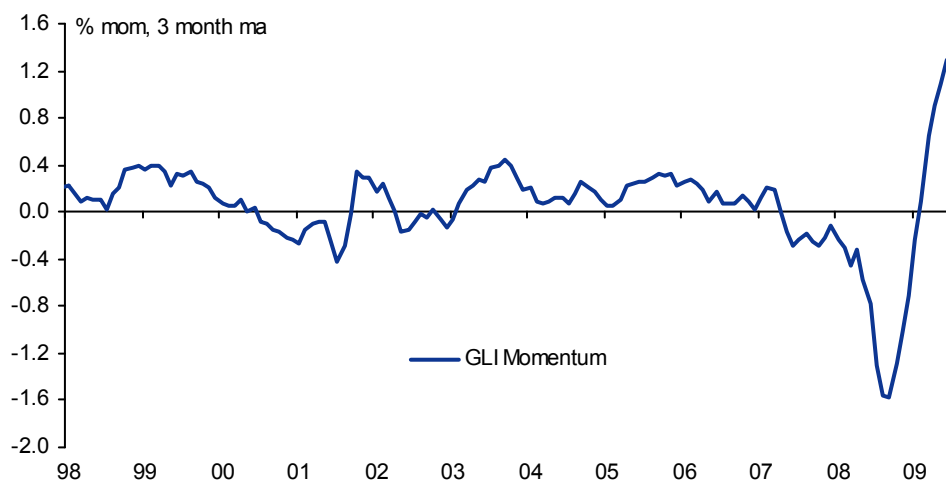
earlier this year is being re-invigorated; orders were put on hold owing to trade finance issues and general uncertainties, but with the systemic risk evaporating, orders are being restarted from the unnatural lows. We know from business surveys that the inventory cycle has now turned and the sharp destocking seen in 2Q bodes well for the short-run outlook as companies are restocking. This should help particularly Germany, which was hit the hardest, but it should be a stronger effect in 3Q than in later quarters; our economists forecast a rise of +1.0% qoq (4% annualized).

Exhibit 9: GDP growth: GS vs. consensus

%yoy	2007	2008	2009		2010	
			GS	Consensus	GS	Consensus
USA	2.1	0.4	-2.6	-2.6	2.0	2.3
Japan	2.3	-0.7	-5.2	-6.1	1.5	1.3
Euroland	2.7	0.6	-3.8	-4.3	1.2	0.6
UK	2.6	0.7	-4.2	-4.3	1.9	0.9
Europe	2.9	0.8	-3.6	-5.8	1.4	0.3
China	13.0	9.0	9.4	8.3	11.9	9.3
India	9.0	6.7	5.8	6.2	7.8	7.2
BRICs	10.4	7.5	5.3	5.1	8.7	7.2
Advanced Economies	2.8	0.6	-3.2	-3.5	1.9	1.7
World	5.0	2.8	-0.8	-1.0	4.0	3.4

Source: Consensus Economics August 2009, Goldman Sachs Global ECS Research.

Similar improvements are emerging across Asia and other parts of the World and in China our economists have revised up their growth rates for 2010 to 11.9%, well above consensus. We now expect global GDP growth of 4% for 2010, in line with long run trend, and the near term momentum looks particularly strong. Exhibit 10 shows our GLI momentum series. Our August Final GLI reading picked up to -3.7% yoy, from last month's -5.7%, while momentum posted yet another all-time high reading of 1.29% mom. After months of fears of no growth, or a 'U' shaped recovery, the pace of improvement is looking very much more 'V' shaped than investors have dared to hope and the market has priced in. Furthermore, and importantly, particularly owing to our optimism about China and India, we think the non-inflationary growth rate of the world is around 4%, somewhat higher than many others. If we are correct, then the 4% growth we forecast will not require aggressive early tightening of monetary policy around the world nor will it generate inflation.

Exhibit 10: Global Leading Indicator

Source: Goldman Sachs Global ECS Research.

Profits: Raising our earnings forecast again

In our report of July 23, 2009, *Strategy Matters: Why earnings are likely to surprise on the upside in 2010*, we raised our earnings forecasts above consensus for 2010 to a rise of 34%. Previously we had been below consensus with 19% earnings growth in 2010. For net income ex financials, we had been forecasting a 28% rise for 2010. Given our recent economic upgrades to above consensus for 2010, coupled with particularly strong recent earnings in the financials, we have again raised our earnings forecasts for this year and next. We now anticipate total market net income growth (pre-exceptionals) of 40% for 2010, compared with 34% previously.

Exhibit 11: Europe top-down profit growth forecasts for 2009 and 2010 (%)

2008 figures are a combination of published results and Goldman Sachs Research analysts' estimates

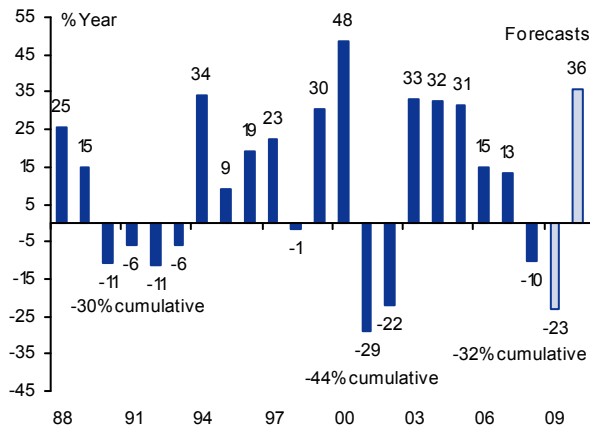
	Growth rates (%)			07-10E CAGR
	2008	2009E	2010E	
Actual/ Model results (all pre excep.):				
Sales	6.3	-5.7	8.7	2.9
EBIT	1.7	-17.0	29.1	2.9
Net income ex financials	-6	-23	37	0
Net income financials pre-exception.	-77.9	34.0	54.9	-22.9
Weight of financials pre-except.	38%	13%	20%	
Net income pre-exceptionals DJ STOXX	-33	-16	40	-8
Level of EPS for the DJSTOXX	19.3	16.2	22.7	

Source: Datastream, Goldman Sachs Global ECS Research.

These forecast profit increases for 2010 appear to be very strong but it is worth noting that this is not unusual in the first year of recovery (see Exhibits 12 and 13). Rises of 20%-30% are not uncommon. In terms of the market ex financials, the first year of profit recovery in the early 1990s was 34% while it was 33% in the first year of profit recovery in the early 2000s. Also bear in mind that these numbers imply a -8% earnings CAGR between 2007 and 2010. Our sales growth estimate of 8% for 2010 results in a 2.9% change between 2007 and 2010.

Exhibit 12: Europe ex financials earnings history and forecasts for 2009 and 2010

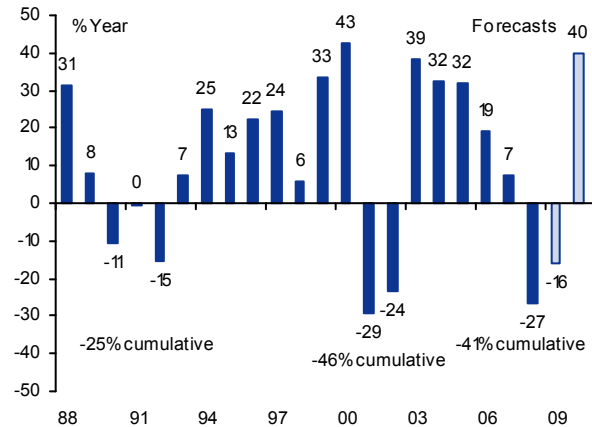
Historical data based on DJ STOXX 600 ex financials (all data are before exceptionals and GW writedowns)



Source: Worldscope, Goldman Sachs Global ECS Research.

Exhibit 13: Europe earnings history and forecasts for 2009 and 2010

Historical data based on DJ STOXX 600 (all data are before exceptionals and GW writedowns)



Source: Worldscope, Goldman Sachs Global ECS Research.

We note three key reasons for the upgrades, and we show further details about these in the accompanying Strategy Expresso of September 3, 2009, *Explaining our earnings forecasts*.

- Financials pre-exceptional earnings have been stronger than expected and commodity profits are likely to rise sharply.** Financials have generally surprised to the upside over the past two quarters as there have been fewer writedowns and capital markets and mortgage refinance activities have been strong. Banks results have also been boosted as a result of the steep yield curve. Higher commodity prices are a large driver for sales for the index, given the high weightings of Oil & Gas, Basic Resources, Chemicals and Utilities. Our Commodity Strategists expect the average oil price to increase by 41% in 2010 after falling 36% in 2009. We expect basic resources companies to see a jump of 70% in EPS in 2010.
- Increased operational leverage as a result of sharp cost cutting.** Companies have been quick to cut costs this cycle, which we believe will result in higher operating leverage and higher margins. We assume that fixed costs as a percentage of total costs will increase to 60% from 40% in 2009 before normalizing to a 50/50 split in 2010.
- Increased EM growth prospects.** We assume that emerging markets generate about 25% of European companies' sales for each of the next two years. Emerging market sales have increased from 17% in 2005 to 20% in 2008, a trend that will likely continue given the above-trend growth we expect for the region.

Some clients have said that our top-line growth forecast of 8.7% with a price increase of 5.2% is too high given the outlook for inflation. But our price forecasts are driven by three buckets: consumer prices (45%), producer prices (45%) and commodity prices (10%). For consumer prices and producer prices, we attribute the same proportion as we do for volumes. As the first few columns of Exhibit 14 show, we expect European prices to be up 0.8%, US prices to fall 1.3% and emerging prices to rise 3.8%. But our commodity analysts expect oil prices to rise 41.6% on average in 2010 compared with 2009. As the table shows, this has a meaningful impact on total prices.

Exhibit 14: Commodity price increases are the key driver of overall prices

2010E	Europe		US		Other		Commodity Prices	Total
	CPI	PPI	CPI	PPI	CPI	PPI		
	0.7%	0.9%	0.5%	-3.1%	4.5%	3.0%		
% Weight	50%	50%	50%	50%	50%	50%		
Selling Prices	0.8%		-1.3%		3.8%		41.6%	
% Weight	54%		14%		23%		10%	100%
Contribution	0.4%		-0.2%		0.8%		4.2%	5.3%

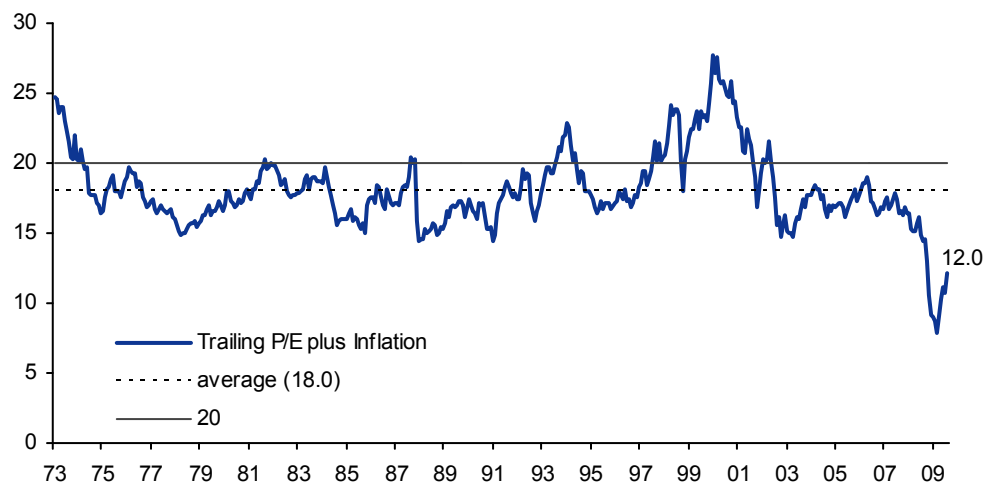
Source: Datastream, Goldman Sachs Global ECS Research.

If these numbers are correct, it suggests that equities remain cheap.

Valuation

In our report of July 30, 2009, *Strategy Matters: 10x 2010; attractive valuation supports higher prices*, we emphasised our view that despite sharp rises in the market from the lows, equities still looked attractive on a valuation basis. With the market now up 50% from the low, this remains the case. The current P/E for DJ Stoxx 600 is 15.1x, but on our top-down 2010 end year earnings forecast it is currently 10x. Bear in mind that this is against a backdrop of historically low interest rates and inflation. As we have pointed out before, adding the annual inflation rate to the P/E has traditionally been a way to assess a 'cyclically adjusted' multiple. When we do this (Exhibit 15), the market has only been really expensive twice in the past 35 years, in 1973, before the major bear market and in 2000 before the technology bubble burst. Traditionally the low end of the range has been about 15x. In this cycle it troughed at a historical low of about 7x before rising to 12x currently.

Exhibit 15: P/E plus inflation



Source: Datastream, Goldman Sachs Global ECS Research.

Our fair value GS DDM model suggests that the market is currently close to fair value, using the current implied ERP and bond yields. However, there is 15% upside if we input the lower bond yield that derives from our bond strategists Sudoku 'fair value' bond model. An assessment of 'equilibrium' valuation assumes full normalisation of the ERP and bond

yields back to long run averages; under these conditions we estimate the market has 80% upside. Of course, we don't expect this to happen immediately, but it is at least a guide to where the market might go over the course of the cycle, and is very close to the estimates we have made separately in *The next leg: The path to mid-cycle valuation* (published June 199, 2009) where we anticipate a value of 420 on the DJ Stoxx 600 by end 2013.

We have argued that the ERP remains very high. While it has fallen from the peaks of around 7%, it remains at 5.5% on our model, still well above the long run average of 3%.

Exhibit 16: Our DDM model points to more upside as normalization continues

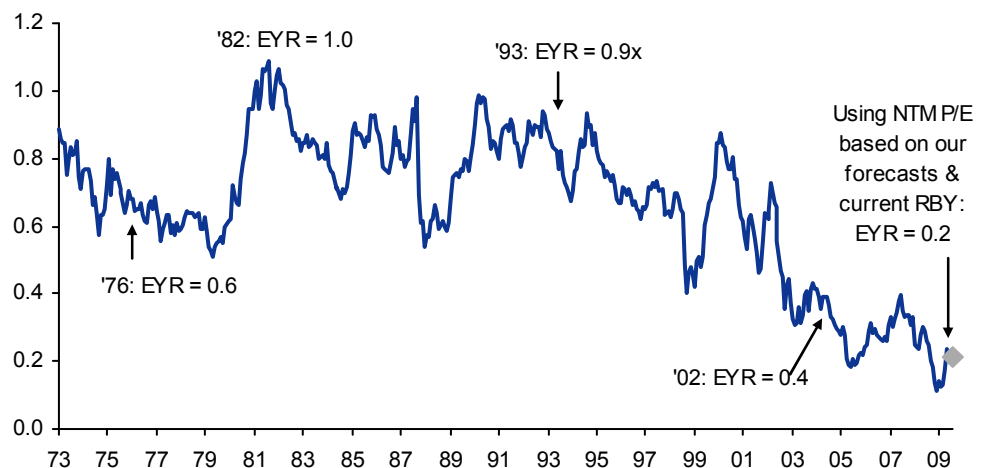
	Current Level	Central Scenario		Using Sudoku Fair Value Bond model		Using equilibrium ERP* and 2% real interest rate	
		Fair Value Level	Fair Value Upside / (Downside)	Fair Value Level	Fair Value Upside / (Downside)	Fair Value Level	Fair Value Upside / (Downside)
Europe (Stoxx 600)	231	230	(0%)	272	15%	423	80%

Source: Datastream, Goldman Sachs Global ECS Research.

Another way of looking at this is the relative value between bonds and equities. This ratio has been on a clear downward trend since 2000 (Exhibit 17) and, of course, is influenced by depressed earnings currently. But even if we 'normalise' earnings so that they are back to long term trend (as shown in the light blue line at the end) the ratio is still at the low of its long run range or, put another way, the ERP is unusually high. This is also true when we compare dividend yields to bond yields.

Exhibit 17: European real earnings yield ratio

EY is based on 12-month forward earnings



Source: Datastream, Goldman Sachs Global ECS Research.

Sector positioning – still pro-cyclical

We have been moving towards cyclicals and away from defensives since last December. Since the March low, the rotation towards Financials and Cyclicals continues. Basic Resources, Construction & Materials and Industrial Goods & Services have all outperformed the market since the trough on March 9. Financials have performed strongly – Banks have rebounded 147% followed by Insurance with 90%. Real estate and Financial Services have also outperformed the STOXX 600. Defensives such as Telecoms, Health Care, Utilities and Oil & Gas have all dramatically underperformed although, notably, the pattern has changed more recently when many of the defensive sectors have outperformed the market since June (as shown in the penultimate column).

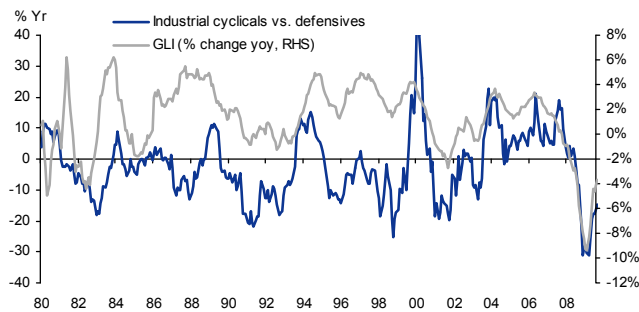
Exhibit 18: Rotation into Financials and Cyclicals continues

Sector		1-Jun-07 to 9-Mar-09	9-Mar-09 to 2-Sep-09	1-Jun-07 to 2-Sep-09	Since 5-Jun-09	YTD
Banks	SX7P	-83%	147%	-58%	22%	43%
Insurance	SXIP	-75%	90%	-52%	11%	4%
Real Estate	SX86P	-78%	71%	-62%	23%	12%
Basic Resources	SXPP	-68%	73%	-44%	2%	40%
Financial Services	SXFP	-74%	69%	-56%	3%	18%
Construction & Materials	SXOP	-68%	62%	-49%	11%	17%
Industrial Goods & Services	SXNP	-60%	48%	-41%	11%	19%
STOXX 600	SXXP	-61%	47%	-42%	10%	13%
Technology	SX8P	-60%	39%	-45%	6%	15%
Automobiles & Parts	SXAP	-61%	38%	-45%	-7%	2%
Personal & Household Goods	SXQP	-50%	35%	-33%	13%	16%
Retail	SXRP	-56%	34%	-41%	6%	18%
Chemicals	SX4P	-42%	33%	-23%	4%	13%
Food & Beverage	SX3P	-39%	30%	-20%	12%	10%
Travel & Leisure	SXTP	-66%	27%	-57%	0%	2%
Utilities	SX6P	-50%	24%	-38%	7%	-6%
Health Care	SXDP	-39%	21%	-26%	11%	1%
Oil & Gas	SXEP	-44%	24%	-30%	-2%	6%
Media	SXMP	-55%	20%	-46%	9%	3%
Telecommunications	SXKP	-42%	19%	-31%	16%	0%

Source: Bloomberg, Goldman Sachs Global ECS Research.

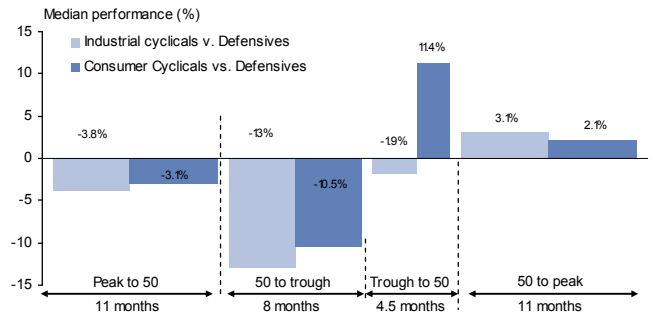
While we acknowledge that a clear beta split may be less appropriate going forward, we continue to have a pro-cyclical bias reflecting our recent economic upgrades to above consensus for 2010 and the historical performance of cyclicals vs. defensives at economic inflection points. Exhibit 19 shows that the industrial cyclicals are tracking the GLI well on the recovery and appear to have further to catch-up relative to defensive sectors. We often get asked whether cyclicals continue to outperform in the phase of early economic expansion when the ISM, for example, rises above 50. As Exhibit 20 shows, if we take the median annualized returns of industrial cyclicals relative to defensives, and the same for consumer cyclicals, the answer is generally yes. Consumer cyclicals tend to do rather better than industrials when compared with defensives in the phase of second derivative improvements in the economy – when the ISM goes from trough to 50. But industrial cyclicals typically do slightly better when the ISM goes above 50 on its way to its peak. In both cases though, on average, industrial and consumer cyclicals tend to outperform defensives in the expansion phase.

Exhibit 19: Industrial Cyclicals vs. Defensives, vs. GLI



Source: Datastream, Goldman Sachs Global Research estimates

Exhibit 20: Cyclicals vs. Defensives around the ISM Since 1973



Source: Datastream, Goldman Sachs Global ECS Research

A detailed peak-to-trough analysis of price performance of individual sectors in Exhibit 21 also shows that cyclical sectors tend to perform best relative to the whole market after the ISM has moved above 50. Especially commodity-driven sectors such as Oil & Gas and Basic Resources have historically performed strongly.

Exhibit 21: Cyclicals continued to outperform above an ISM of 50 – commodity-driven sectors have had the strongest performance historically

Sector price performance relative to market since 1973

	Down cycle		Up cycle	
	Peak to 50	50 to Trough	Trough to 50	50 to Peak
Oil & Gas	2.2%	2.5%	0.0%	12.4%
Basic Resources	-1.5%	-14.9%	1.6%	7.4%
Autos & Parts	-9.7%	-3.8%	9.1%	5.2%
Media	-5.5%	5.1%	0.0%	4.6%
Chemicals	-4.7%	3.9%	-4.7%	4.3%
Travel & Leisure	4.8%	-8.2%	0.0%	3.3%
Utilities	-2.6%	4.0%	-9.4%	1.9%
Constr & Mat	-3.4%	-3.8%	6.5%	1.1%
Tech	19.7%	-4.0%	10.4%	1.0%
Ind Goods & Svcs	1.1%	-4.4%	-1.9%	0.7%
Real Estate	-2.0%	-14.3%	-11.1%	0.6%
Food & Bev	-0.2%	8.8%	-1.3%	0.0%
Retail	-2.5%	7.3%	12.3%	-0.2%
Health Care	0.2%	14.2%	1.8%	-1.6%
Financial Svcs	3.7%	-10.4%	-5.3%	-1.7%
Banks	-2.5%	1.8%	0.0%	-3.0%
Pers & HH Goods	1.4%	2.7%	6.8%	-4.0%
Insurance	4.3%	7.4%	-1.4%	-4.6%
Telecom	-2.5%	1.7%	-9.8%	-4.9%
STOXX 600	-23.8%	-15.9%	22.5%	13.8%

Source: Datastream, Goldman Sachs Global ECS Research.

To refine the analysis, we focus on the relative sectors' performance in the first three months after the ISM moved above 50 from the trough. As Exhibit 22 shows, cyclical sectors tend to benefit most from this economic improvement with oil & gas, chemicals, and travel & leisure recording the biggest gain relative to the market. Defensives sectors such as healthcare, utilities or telecoms, are among the worst relative performers.

Exhibit 22: Relative sector performance in the three months following an ISM manufacturing index above 50

The median and average performance has been calculated for Europe ex-Emerging markets over nine occurrences

Sector	Average	Median	Number of periods during which it has outperformed the market
Oil & Gas	6.1%	2.1%	6
Chemicals	2.4%	2.6%	6
Travel & Leisure	1.8%	1.2%	6
Banks	1.8%	1.9%	5
Ind Goods & Svcs	1.6%	1.8%	5
Construction materials	1.0%	0.6%	6
Real Estate	0.8%	0.3%	7
Basic Resources	0.7%	-0.7%	5
PHHG	0.0%	-0.1%	5
Media	-0.1%	-0.3%	5
Financial Svcs	-0.2%	-0.3%	4
Retail	-0.6%	0.1%	3
Technology	-0.7%	4.4%	3
Food & Beverages	-0.8%	-2.0%	4
Autos & Parts	-1.3%	-2.5%	2
Health Care	-1.7%	-1.0%	2
Insurance	-2.0%	-1.2%	4
Utilities	-2.8%	2.0%	2
Telecom	-4.1%	-3.9%	4

Source: Datastream, Goldman Sachs Global ECS Research.

Recommended STOXX 600 Supersector weightings

We have been moving towards cyclicals and away from defensives since last December. However, we remained neutral on Banks, Insurance and Financial Services and were underweight Real Estate. Financials have been the best performing sectors ytd. We have made the following changes to our recommendations.

Exhibit 23: We retain a cyclical stance – downgrade Utilities, upgrade Food & Beverage and Real Estate

STOXX 600 Supersector Recommendations		
Overweight	Neutral	Underweight
Automobiles & parts	Construction & materials ↑	Chemicals
Banks ↑	Financial services	Health Care
Basic Resources	Food & Beverage ↑	Real Estate
Industrial goods & Svcs	Insurance	Retail
Oil & gas	Media	
	Personal & Household Goods	
	Technology ↓	
	Telecommunications	
	Travel & Leisure	
	Utilities ↓	

Source: Goldman Sachs Global ECS Research.

Banks (upgrading to overweight from neutral): Banks have been the best performing sector since March, ytd and since our last sector update in June. 1H results have shown that credit quality deterioration and NPL formation was less than expected by our analysts – this is in part driven by more willingness to restructure loans. This is an important difference compared to previous credit cycles and in part the result of very low short rates in Europe, which has allowed banks to move the loans to interest only. This technically prevents the loan from being in default and reduces the need to raise provisions as much as would otherwise be necessary. In addition, revenues have also surprised to the upside and there have been the first writebacks on levered loans. Several banks are generating regulatory capital now, often through capital market earnings, so many of the recent capital raisings were mainly opportunistic to strengthen the capital position whilst funds were available.

Still, our analysts expect limited loan growth as there is limited funding (partly as a function of the ongoing restructuring of existing loans) and the demand for loans remains low (down 50%-60%). But at the same time they do not think current valuations reflect that banks are growth businesses. Using normalised earnings, for example, (i.e. normalised credit costs) and 10-year average P/Es would still result in significant upside to current valuations.

Our analysts are most positive on large cap banks such as HSBC, Standard Chartered, BBVA and Santander owing to predictable forecast dividend yields, BRICs exposure, the ability to absorb credit losses and proven business models – those four companies alone account for some 37% of the index. Meanwhile, current valuations of the large cap, global retail banks are in-line with the domestic focused banks. The SX7P has tracked the Global Retail Banks very closely since the trough in March. We think risks in the sector are skewed to the upside on a market cap weighted basis despite the recent strong gains, and we upgrade the sector to a small overweight (25bp).

Utilities (downgrading to neutral from overweight): We upgraded Utilities in June believing the sector should benefit from higher oil prices. However, the correlation with the oil price has suffered because coal & gas prices, which are more relevant for Utilities, have decorrelated from the oil price. As a result, SX6P remains the worst performing sector ytd (although the second best over the past month). We think the risk of capital raisings or dividend cuts has decreased as companies have chosen to restructure balance sheets through disposals and capex cuts. Still we prefer the direct exposure through the oil & gas sector, which looks more attractive on valuation and has similar dividend yields.

In addition, our analysts see potential short-term downside to German utilities E.ON and RWE (roughly 28% of the SX6P) from the German elections on September 27 (see *Germany: Utilities: German election positives priced in*, August 31, 2009). They think the uplift from potential nuclear life extensions under a new conservative-liberal government is mostly priced in and there is downside risk in case of a continuation of the grand coalition and significant uncertainties on the actual “government deal”. This includes the closure of specific stations and a potential profit-sharing scheme. Thus we downgrade the sector to neutral.

Food & Beverage (upgrading to neutral from underweight): We are upgrading food & beverage from underweight to neutral. We think the current valuation premium to the market is not too high and the recent outperformance, in part driven by beverages, is unlikely to reverse. The average sales exposure to emerging markets and the BRICs is one of the highest on average across sectors. Our economists have increased their economics growth forecasts for BRICs and selective emerging markets further.

In addition, while 1H results have shown a slowdown in top-down growth, margins have risen materially as companies have been more aggressive in cost-cutting. And although input costs have come down, several consumer goods companies have been able to keep

pricing. As a result our analysts expect margins in 2009 to exceed those in 2007 in several cases.

Construction & Materials (upgrading to neutral from underweight): The construction sector has performed better than we expected since the market trough in March, in part driven by the strong performance of the building materials sub-sector.

Our analysts now forecast 2010 European construction spend to stabilise (-0.2% yoy) following a forecast contraction of 12% in 2009. This forecast stabilisation is driven by: (a) an expected improvement in residential spend in line with the GDP recovery in 2010; and (b) strength in Civil Engineering (including infrastructure) spend in 2010 driven by government stimulus packages. Our analysts forecast Civil spend to grow 3.5% in 2010 vs. an expected decline of 4% in 2009. They expect non-residential (commercial) construction to remain weak in Europe in both 2009 and 2010 given the historical 6-12 month lag between residential and non-residential trends.

The improving trend in construction spend is also reflected in GS cement volume forecasts, which should benefit the building materials sub-sector. We now expect western European volumes to improve to -0.5% in 2010 from a 20% fall in 2009. Our analysts also expects cement volume growth in 2010 in North America, Asia and the Middle East. 1H results reveal that consolidated end markets may have helped pricing. Based on the latest country cement capacity data in the 2009 Global Cement Report, the five largest producers supply 83% of the market (excluding China owing to its size). Despite Western European volumes falling c.30% in 1H2009, prices increased 4.3%. With the three largest producers supplying 83% of the market in Europe, on average, we believe there is less scope for price erosion in 2010. We have put the building materials sub sector (Bloomberg ticker GSSBBUIL) on our tactical buy.

Technology (downgrading to neutral from overweight): Historically, Technology has shown a high correlation with economic indicators. Recent IT spending surveys point to an upturn and the semiconductor cycle has gained positive momentum. However, the sector is very concentrated on a few stocks – Nokia, SAP and Ericsson are 60% of the index. The semiconductors, IT services and software sub-sectors have a relatively low weight.

All of the major large cap stocks in the index are rated Neutral by our analysts. They recently downgraded Nokia (€9.35), the largest stock in the index, from Conviction Buy to Neutral. Their analysis of handset market value suggests Nokia's problems are mostly company-specific rather than cyclical. Rising competition threatens Nokia's c.55% mid-end smartphone share, while a high-end recovery is unlikely in the next 12 months. These risks offset Nokia's discounted valuation/high BRICs exposure (see *Nokia (NOK1V.HE): Mid-end share at risk, execution uncertain; downgrade to Neutral*, August 13, 2009). Ericsson (Skr68.20) is also currently rated Neutral.

Our analysts continue to rate SAP (€34.22) Neutral as they believe upside surprises in licenses are required for the stock to outperform the sector (see *SAP (SAPG.DE): Neutral, Sharp license recovery required for outperformance; still Neutral*, July 29, 2009). While they remain generally constructive around the beginning of a recovery in IT spending in 2H2009 for software more broadly, we believe a recovery for SAP licenses will likely be later cycle given the more discretionary nature of applications purchases.

Exhibit 24 lists our current recommended sector weightings.

Exhibit 24: Goldman Sachs recommended sector weightings relative to the benchmark

	Sector	Ticker	Market weight	Deviation from Benchmark (bp)
Overweight	Industrial goods & services	SXNP	7.84%	75 bp
	Oil & gas	SXEP	10.01%	75
	Automobiles & parts	SXAE	1.82%	50
	Basic resources	SXPP	4.39%	50
	Banks	SX7P	17.49%	25
Neutral	Construction & materials	SXOP	2.63%	0 bp
	Financial services	SXFP	1.57%	0
	Food & beverage	SX3P	6.84%	0
	Insurance	SXIP	5.82%	0
	Media	SXMP	2.12%	0
	Personal & household goods	SXQP	4.46%	0
	Technology	SX8P	3.15%	0
	Telecommunications	SXKP	6.77%	0
	Travel & leisure	SXTP	1.16%	0
	Utilities	SX6P	6.54%	0
Underweight	Chemicals	SX4P	3.52%	-50 bp
	Real Estate	SX86P	1.08%	-50
	Retail	SXRP	3.26%	-75
	Health care	SXDP	9.52%	-100

Source: Goldman Sachs Global ECS Research.

Tactical trade ideas with our Goldman Sachs sub-sector baskets

To fill the gap in the European market for sector products, we have created tradable equally-weighted sub-sector baskets around narrowly defined industries that aim to decrease intra-sector dispersion and increase inter-sector dispersion. We allow overlaps between the sub-sectors if companies have exposures to several industries, and aim to strike a balance between relevance and diversification with the number of companies included. See our Bloomberg page GSPM (type GSPM 5 <GO>) for details on price performance and constituents.

On July 16, 2009 we introduced a long/short trade to get exposure to rising oil prices. We recommended long Oil Services (Bloomberg ticker GSSBOILS), Mining (Bloomberg ticker GSSBMINE) and Fertilizers (Bloomberg ticker GSSBCHFE) – those sub-sectors are the most leveraged to commodities prices, in our view. Conversely, Airlines (Bloomberg ticker GSSBTRAA) and General Retail (Bloomberg ticker GSSBGERE) should be negatively affected by rising commodities prices, especially higher oil prices.

Exhibit 25: We continue to prefer sub-sectors exposed to commodity prices and BRICs – we would sell sub-sectors that could be negatively affected by rising oil prices

Sector		1-Jun-07 to 9-Mar-09	9-Mar-09 to 2-Sep-09	1-Jun-07 to 2-Sep-09	Since 16-Jul-09	YTD
Banks - Global Retail	GSSBBKGL	-71%	130%	-34%	26%	38%
Mining	GSSBMINE	-75%	117%	-47%	5%	108%
Building Materials	GSSBBUIL	-77%	99%	-55%	19%	30%
Luxury Goods	GSSBLUXG	-61%	68%	-34%	15%	39%
Oil Services	GSSBOILS	-61%	63%	-37%	4%	73%
General Retail	GSSBGERE	-64%	55%	-44%	16%	48%
Trucks	GSSBTRUC	-74%	51%	-60%	21%	11%
STOXX 600	SXXP	-61%	46%	-42%	9%	13%
Transportation - Airlines	GSSBTRAA	-68%	22%	-61%	4%	2%
Chemicals - Fertilizers	GSSBCHFE	15%	6%	22%	-21%	4%

Source: Goldman Sachs Global ECS Research.

Fertilizer stocks have underperformed the market strongly as demand has deteriorated severely and potash and nitrogen prices have fallen. While China, the world's largest potash buyer, could face a shortfall in supplies, potash prices could fall further. Fertilizer prices are highly correlated with agricultural commodity prices (e.g. corn, soy and wheat), which remain volatile and could come under more pressure. We remove our tactical long position. We also **remove our short position of the airlines sub-sector**. While our commodities team still expects rising oil prices, the better, consolidated industry structure coupled with ongoing cost-cutting and restructuring as well as the low valuation limits further downside to airline stocks. Finally, we **remove the short position in the general retail sub-sector** as high operating leverage and the rebound in consumer spending is likely to benefit several of the large companies. Our analyst team has recently upgraded Marks & Spencer (339.4p) to Conviction Buy.

In order to get more focused exposure to the improving trend in construction spend and the resulting upgrades to GS cement volume forecasts, we initiate a **long position on the Building Materials sub-sector** (Bloomberg ticker GSSBBUIL). 1H results reveal that consolidated end market may have helped pricing. For investors, who want to get more focused exposure to Global Retail banks, we recommend a **long position in our Banks – Global Retail sub-sector** (Bloomberg ticker GSSBBKGL). We also initiate a **long position on the Luxury goods sub-sector** (Bloomberg ticker GSSBLUXG). We think because of economic growth in the BRICs, continued destocking and market share gains by large brands the risks are skewed to the upside. Similarly, we recommend a **long position of our Trucks sub-sector**, which might have seen the cyclical trough and remains one of the worst performers since June 2007.

As we lack conviction on sub-sector shorts we suggest pairing our long sub-sector trades with the market.

Exhibit 26: We continue to prefer sub-sectors exposed to commodity prices and BRICs

Goldman Sachs Sub-Sector Baskets	
Long	Short
GSSBBKGL (Banks - Global Retail) GSSBBUIL (Building Materials) GSSBLUXG (Luxury Goods) GSSBMINE (Mining) GSSBOILS (Oil Services) GSSBTRUC (Trucks)	

Source: Goldman Sachs Global ECS Research.

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Reg AC

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