Goldman Sachs

Outlook

Investment Management Division

Within Sight of the Summit

We have had a great climb.

Sharmin Mossavar-Rahmani
Chief Investment Officer
Investment Strategy Group
Goldman Sachs

Brett Nelson
Managing Director
Investment Strategy Group
Goldman Sachs

Additional Contributors
from the Investment
Strategy Group:

Matthew Weir
Managing Director

Maziar Minovi
Managing Director

Benoit Mercereau
Managing Director

Farshid Asl
Managing Director

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Overview

US EQUITIES' EXCEPTIONAL PERFORMANCE IN 2013 has many investors wondering how to position equity allocations for the coming year. An improving economy and the market's initial positive reaction to the Federal Reserve's tapering of asset purchases might argue for holding firm or even increasing allocations to equities. Yet, the S&P 500's robust 32% total return last year has fanned fears of a growing stock bubble, arguing for reduced allocations. Given the far-reaching impact that US equities have on global financial markets and the US economy has on global growth, the most pressing question facing investors today is: Do current high equity valuations signify the summit?

We believe it is important to approach this question with a long-term investment horizon clearly in mind. Viewed solely from the standpoint of current valuations, US equities now comprise the most expensive major equity market in the world.

However, as we make the case in this year's *Outlook*, valuation alone is not an effective tool for underweighting equities. In fact, our analysis shows that both the odds and the penalty of being wrong when underweighting equities are very high if valuation signals are the only guide. Moreover, equity returns have historically been positive over the subsequent five years when starting from current valuations.

This analysis, combined with a favorable economic backdrop and higher margins sustained by structural shifts in the US economy, supports the current high valuations and leads us to recommend clients stay fully invested at their strategic allocation to US equities at this time. Since non-US equities are less expensive than US equities and will benefit from an improving global growth backdrop, we recommend clients stay fully invested in non-US equities as well.

In this report, we review the outlook for global equities for the coming year, along with our views on global currencies, fixed income and commodities. Following last year's debut, we once again include our return expectations for all major asset classes for the next one and five years.

Of course, considering the number of possible risks that could trigger equity downdrafts this year, we must remain vigilant as our outlook is far from certain. Still, we don't see any evidence at the present of the typical triggers that have ended past bull markets in the US.

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Within Sight of the Summit

"One sees great things from the valley;
only small things from the peak."
– G. K. CHESTERTON

US EQUITY AND EQUITY-RELATED ASSETS had an incredible run in 2013. The S&P 500 closed the year with a total return of 32%, topping off a cumulative return of over 200% since the trough of the market in March 2009. High-yield corporate bonds outperformed US Treasuries of similar duration by 9.9%, with a total return of 7.4%, bringing their cumulative return since 2009 to 141%. Small capitalization stocks provided even more spectacular gains with a return of 37% in 2013 and a cumulative return of 239%. US banks, one of the Investment Strategy Group's (ISG's) tactical overweight recommendations since the end of 2010, did especially well with a total return of 38% and a cumulative total return of 282%. US equities' total return over the 58 months since the trough was so strong that it has only been exceeded 7% of the time over the last 100 years.

With such exceptional performance and, consequently, high equity valuations, the most important question facing our clients pertains to their equity allocations: Should they add to equities given an improving economy, rebalance their portfolios and remain fully invested at their strategic allocation, or heed the warnings of a "bubble" in equities and reduce their allocation?

We recommend clients stay fully invested at their strategic allocation to US equities. Clients who read our *Sunday Night*

Insights and annual *Outlooks* or who participate in our client calls might interpret this as a common refrain since we have recommended clients be fully invested at their strategic allocation since late 2008, adjusting for some overweight allocations to various US sectors and US high-yield bonds. For example, in our December 2008 *Sunday Night Insight, I Was Seldom Able to See an Opportunity Until It Had Ceased to Be One,* we suggested that clients incrementally add to equities if they could withstand the volatility.

Similarly, in our April 2012 report *US Equities: The Long and Short of It*, we recommended our clients "stay long" but tolerate expected downdrafts. More recently, in an April 2013 client call and subsequent *Sunday Night Insight, To Invest or Not to Invest—That Is the Question*, we again recommended that "clients be at their full strategic allocation to US equities."

While our current recommendation to remain fully invested may appear to be the same as these past recommendations, the view is more nuanced. In late 2008, we specifically stated that "in a few years, today's prices would be considered a bargain." In April 2013, we wrote that current "US equity valuations have historically resulted in positive returns" and suggested staying invested. Now, in sharp contrast, valuations are no longer the tailwind that they have been over the last several years and the margin of safety has eroded. We therefore proceed with much greater caution and a heightened degree of vigilance.

We believe that having a long-term investment horizon is particularly important at this time because it gives our clients a comparative advantage over other investors whose investment horizons are hampered by institutional constraints such as quarterly reporting periods or public finance considerations. In addition, the current monetary policy environment of zero interest rates makes cash and high-quality fixed income assets much less attractive over the next one and five years, which, in turn, increases the attractiveness of equities.

As usual, our *Outlook* is comprised of three sections. In the first section, we will address the specific question of how to evaluate US equities. We will begin with the question of whether US equities are in a bubble by examining a series of valuation metrics. We will show why underweighting equities is not optimal at this time, despite somewhat expensive valuations. This will be followed by a detailed rationale for our recommendation to be fully invested in equities. It is also imperative that we review the risks to our equity view given the erosion in the margin of safety at these valuation levels. This section concludes by providing our expected returns across a range of asset classes over the next one and five years.

In the second section, we will provide a review of our economic outlook across the US, other developed economies and emerging market countries.

In the third section, we will provide our financial market outlook across global equities, fixed income, currencies and commodities. We also review our tactical tilt recommendations. For those particularly interested in emerging markets, we bring our December 2013 *Insight* report, titled *Emerging Markets: As the Tide Goes Out*, to your attention.

US Equities: Bubble Trouble or Just Expensive?

Our Focus on the US

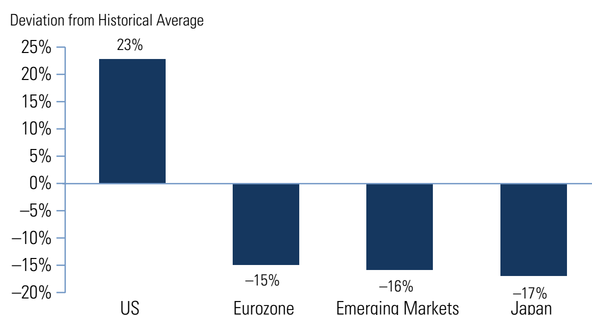
Since some of our readers have asked if we are US-centric or maybe even America boosters, we think it is important to clarify why we have focused on US equities as the key driver of our recommendation to stay fully invested in equities. There are three primary reasons: size, valuation and global financial market impact.

Size: With a GDP of more than $16 trillion, the US is the largest economy in the world, accounting for 23% of world GDP. With an equity market capitalization of $17 trillion, it is also the largest equity market in the world, accounting for 49% of the MSCI All Country World Index (ACWI).

Furthermore, macroeconomic and financial shocks that emanate from the US have far greater impact on the rest of the world than

Exhibit 1: Global Equity Valuations

Whereas US equity valuations stand above their historical average levels, other regions' valuations stand below.



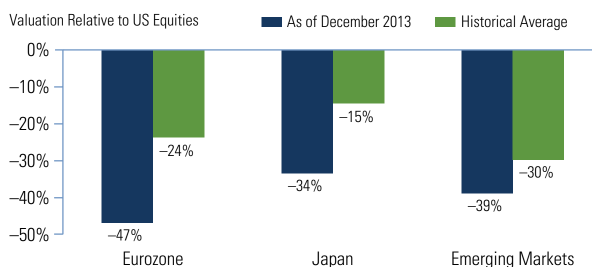
Data as of December 2013.

Note: Historical valuations are calculated beginning in: US: 1980, Eurozone: 1980, Emerging Markets: 1995, Japan: 1999 (beginning of deflationary period). Valuations are calculated across the following metrics: price/peak cash flow, price/peak earnings, price/book, price/10-yr average earnings (DM only), price/10-yr average cash flow (DM only), price/12-month trailing earnings (EM only), price/12-month trailing cash flow (EM only).

Source: Investment Strategy Group, MSCI.

Exhibit 2: Global Equity Valuations Relative to the US

Eurozone, Japanese and emerging market equities trade at a larger discount to the US than they have historically.



Data as of December 2013.

Note: Historical valuations are calculated beginning in: Eurozone: 1980, Emerging Markets: 1995, Japan: 1999 (beginning of deflationary period), using US valuation history according to the corresponding region's history. Valuations are calculated across the following metrics: price/peak cash flow, price/peak earnings, price/book, price/10-yr average earnings (DM only), price/10-yr average cash flow (DM only), price/12-month trailing earnings (EM only), price/12-month trailing cash flow (EM only).

Source: Investment Strategy Group, MSCI.

shocks stemming from other countries and regions, including the Eurozone. According to the Organisation for Economic Co-operation and Development (OECD), a 1% increase in short-term interest rates in the US would lower world GDP growth rates by 0.5%, while an increase in such rates in the Eurozone and Japan would reduce world GDP growth by 0.2% and 0.1%, respectively.[1] Similarly, according to the International Monetary Fund (IMF), a 1% negative surprise in US growth would lower other countries' GDP growth by 0.2%—double the impact of similar growth surprises in Japan and China.[2] While there is a regional component to some macroeconomic shocks—such as a disproportionate impact of Japanese shocks on China—"only the United States seems to matter profoundly to everyone."[3]

Valuation: After their strong outperformance over the last several years, US equities now comprise the most expensive major equity market in the world. US equities are expensive relative to their own long-term history, as well as that of other developed and emerging markets. As shown in Exhibit 1, US equities are expensive compared to their long-term average, while Eurozone, Japanese and emerging market equities are moderately inexpensive relative to their own long-term history. Furthermore, as shown in Exhibit 2, Eurozone, Japanese and emerging market equities are trading at greater discounts relative to US equities than they have historically.

Therefore, we are focusing on the US because if we ascertain that our clients should stay fully invested in US equities—which are expensive—then it follows that our recommendation would be to also stay invested in non-US equities, barring any country-specific or region-specific considerations. In some cases, such as with European stocks and Spanish stocks, we actually recommend a tactical overweight that will be discussed in greater detail in Section III.

Global Financial Market Impact: Finally, we have also focused on US equities because current evidence suggests that other markets will not be immune to any meaningful rise or fall in US equities. The IMF has noted that spillover effects of financial shocks are "uniquely strong from the United States, reflecting the depth of its money, bond and stock markets,"[4] the dominance of the US financial sector and the dollar's role as the world's reserve currency.[5]

We can see this impact when we attribute the returns of the MSCI ACWI to US and non-US equities. US equities account for 71% of the returns—well above their 49% weight (see Exhibit 3). When we perform the same analysis on the MSCI ACWI excluding US equities (in other words, taking the US weight in the index to zero) and attribute the remaining returns to US and non-US equities, US equities still indirectly account for a notable 59% of the returns.

We can also examine historical correlations. As shown in Exhibit 4, developed and emerging market equities are highly correlated with US equities. In fact, at 0.88 and 0.77, respectively, rolling three-year correlations are close to historical highs. While high correlations do not imply any causality, we can conclude that developed and emerging market equities will likely not decouple from US equities when it comes to any meaningful increase or decrease in prices.

No Bubble Trouble Yet

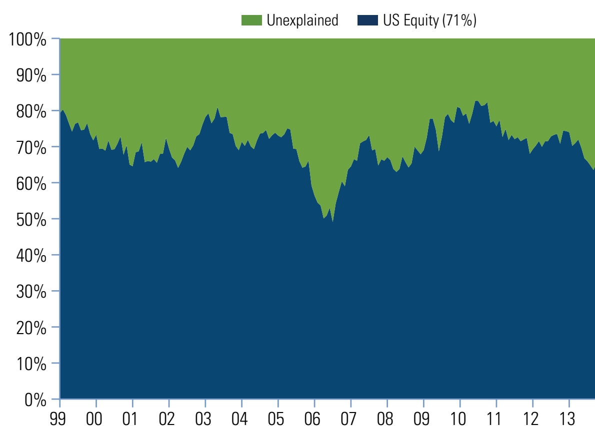
If Google searches and media headlines are any indication, fears of an existing or pending stock market bubble have risen substantially in the last two months. Based on data from Google Trends, searches for the term "stock bubble" reached the fourth-highest level since the company began gathering such data.[6] The presence of asset bubbles was the subject of US Senate confirmation hearings, has been opined upon by current and former government officials, and was referred to in the Nobel Prize lectures of two recent Nobel laureates in economics, Eugene Fama of the University of Chicago[7] and Robert Shiller of Yale University,[8] in December 2013.

While the use of the term has become pervasive, it is not obvious that all users of the term are referring to the same thing. Professor Fama pointed out the potential for confusion in his Nobel Prize lecture, saying, "When people use the word 'bubble,' they never tell you what they mean."[9]

So we should first define what we mean by a "bubble." *The Princeton Encyclopedia of the World Economy* defines a "bubble" as a situation in which "asset prices persistently deviate from their fundamental values—that is, the prices warranted by the true earning potential of firms."[10] The late Charles Kindleberger, professor of economics at the Massachusetts Institute of Technology and author of *Manias, Panics, and Crashes: A History of Financial Crises*, stated that, "a bubble involves a non-sustainable pattern of

Exhibit 3: MSCI ACWI Return Attribution

The share of MSCI ACWI returns attributable to US equities exceeds their 49% weight in the index.



Data as of December 2013.
Source: Investment Strategy Group, MSCI.

Exhibit 4: 3-Year Rolling Correlations of Developed and Emerging Market Equities to US Equities

DM and EM equity correlations with US equities have historically been positive and are close to their highs.

Data as of December 2013.
Source: Investment Strategy Group, Ibbotson, Datastream.

"… it is only rational to recognize that low interest rates raise asset values and drive investors to take greater risks, making bubbles more likely."[11]

– Larry Summers, Harvard Professor and Former US Secretary of the Treasury

"What am I missing here? I see asset bubbles."[12]

– Sen. Mike Johanns, R-NE

"Bubbles look like this. And the world is still very vulnerable to a bubble."[13]

"Stocks won't be in bubble territory until the [CAPE] metric climbs to 28.8."[14]

– Robert Shiller, Nobel Laureate in Economics

"We have to watch this very carefully, but I don't see this as an asset bubble."[15]

– Janet Yellen, Federal Reserve Chair Nominee

"This is another huge bubble driven by the Fed."[17]

– David Stockman, Former Director of the Office of Management and Budget

"We are again in a massive financial bubble in bonds, in equities, a bubble in asset prices."[16]

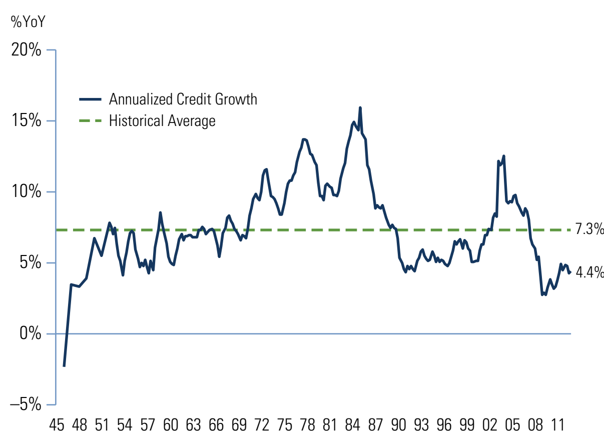
– Marc Faber, Publisher, The Gloom Boom & Doom Report

There are four reasons we do not believe that we are in bubble territory with respect to US equities at this time.

price changes or cash flows," and by definition, bubbles always implode.[18]

In our view, "bubble-like" conditions are created when the price of an asset deviates significantly from the underlying value of that asset based on a reasonable set of assumptions about the future drivers of fundamental value, such as growth, inflation and policy. We also believe that it is important to distinguish between bubbles and overvalued markets. While bubbles implode, overvalued assets can take one of three paths: stay overvalued and simply provide lower returns for the foreseeable future, become more overvalued over time until they reach bubble levels, or simply decline.

Exhibit 5: US Credit Growth
Credit growth is not excessive.



Data as of Q3 2013.
Source: Investment Strategy Group, US Flow of Funds: Domestic Nonfinancial Debt, National Bureau of Economic Research.

As pointed out by Kindleberger, bubbles occur after an extended period of time and are generally attributable to an exogenous positive shock. Examples he cites include a revolution in information technology, the end of a war, a bumper harvest, the widespread adoption of an invention and an unanticipated change in monetary policy. We were struck by the parallels to the current environment in the US. One can readily posit that conditions for a bubble are ripe in the US, with positive exogenous shocks coming from the continued revolution in information technology, the end of the Iraq and Afghanistan wars, the shale oil and gas revolutions, the widespread adoption of smartphones and quantitative easing on a massive scale.

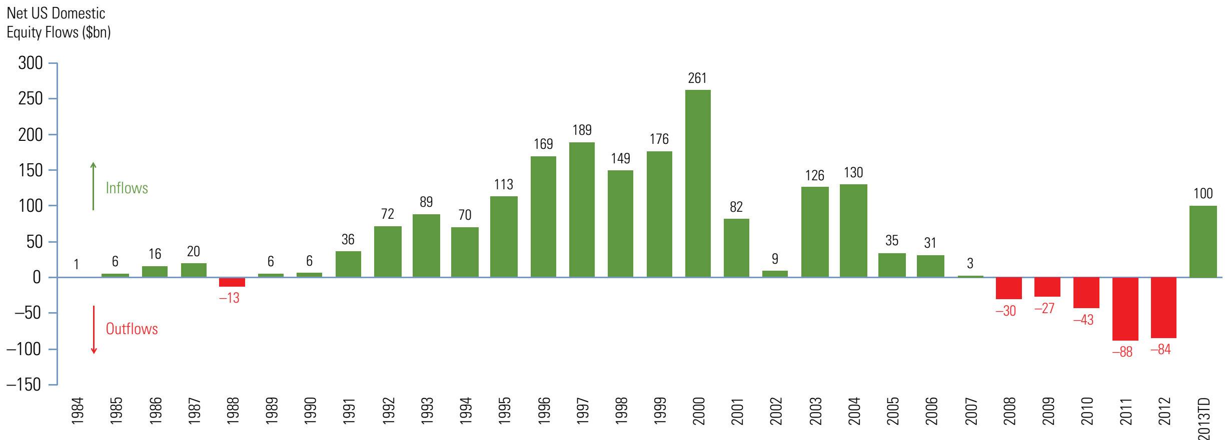
Still, while the parallels are striking, there are four reasons we do not believe that we are in bubble territory with respect to US equities at this time:

1. Credit growth, a key feature of financial asset bubbles,[19] is not excessive. On the contrary, as shown in Exhibit 5, the latest year-over-year (YoY) credit growth came in at 4.4%, well below the average of 7.3% since 1947 and near the lowest in more than 60 years. Credit growth over the last five years stands at the 2nd percentile, meaning that five-year credit growth rates have been higher 98% of the time. Furthermore, the velocity of money—a measure of how quickly money supply turns over to generate a given level of GDP—is at historical lows. We believe we need to see faster credit growth and, at least, an increase in the velocity of money for some extended period of time before we become concerned about bubble conditions.

2. Investor flows into US equities have not been excessive either; in fact, they only turned positive in the first quarter of 2013 after five years of outflows, as shown in Exhibit 6. It is

Exhibit 6: Annual US Net Equity Flows

Investor flows into US equities have not been excessive.



Data as of Q3 2013.

Note: Includes exchange-traded funds and mutual funds.

Source: Investment Strategy Group, Goldman Sachs Global Investment Research, ICI.

hard to imagine that such limited and recent flows equate to a bubble.

3. While sentiment toward the US has improved, we believe it still has further to go before matching our view of US preeminence expressed in our 2010–13 *Outlooks*, which outline the nation's unique combination of economic, institutional, human capital and geopolitical strengths. This lagging sentiment implies that we have not yet reached bubble territory.

4. While valuations are quite expensive and certainly imply lower returns over the next five years, normalization of valuations over time does not imply "implosion" or even negative annual returns. Furthermore, our economic outlook supports our moderate earnings-per-share growth expectation of approximately 6% for 2014. Therefore, based on our view of a reasonable set of assumptions, equity valuations have not deviated from intrinsic value significantly enough to be in bubble territory.

US Equities: Expensive at Lofty Valuations

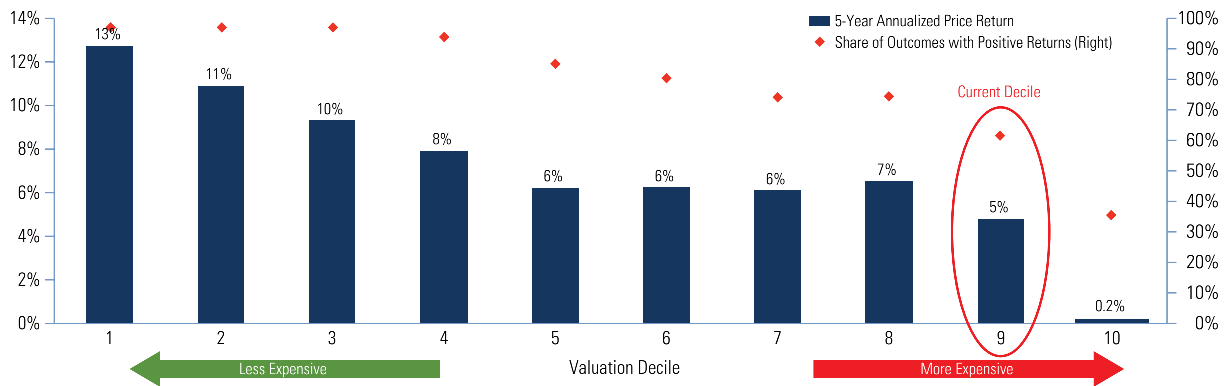
We will now examine US equity valuations in greater detail. We will first show the extent of US equity overvaluation based on a range of metrics and time periods. Most importantly, and surprisingly, we will show why underweighting equities based on current valuations alone is not optimal at this time. Furthermore, we will show that, historically, a tactical asset allocation strategy between stocks and bonds (or stocks and cash) based on valuation signals alone is more effective for overweighting stocks than for underweighting stocks—even at extreme valuation signals.

Such a discussion is particularly timely given the recent extensive coverage in investment research and the media about the Shiller Cyclically Adjusted Price-to-Earnings (CAPE) ratio as a signal of an overvalued market.

We use a broad range of metrics to evaluate equities in different countries and sectors. We recognize that no single metric can consistently provide a reliable valuation signal. We are also limited by the fact that not all valuation metrics go back as far as we would like. For example, while the Shiller CAPE ratio goes back as far as 1881, the price-to-free-cash-flow metric only has data going back to 1970.

Exhibit 7: US Equity Price Returns from Each Valuation Decile

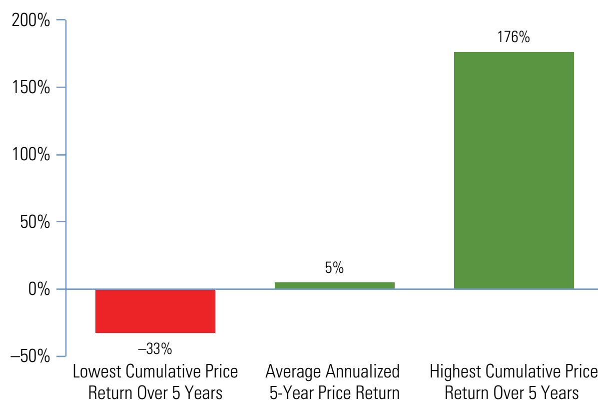
From the 9th decile, in which valuations currently stand, five-year annualized price returns have historically been 5% and price returns have been positive 63% of the time.



Data as of December 2013.
Note: Each decile contains five valuation metrics, beginning in September 1945. The current decile is based on an average difference from each decile's threshold across the following five valuation metrics: price/trend earnings, price/peak earnings, price/trailing 12m earnings, Shiller CAPE, and price/10-yr average earnings.
Source: Investment Strategy Group, Datastream, Robert Shiller.

Exhibit 8: Dispersion of US Equity Returns in the 9th Valuation Decile

The average returns in the 9th decile belie great dispersion.



Data as of December 2013.
Note: Deciling methodology is based on the same valuation metrics and history as Exhibit 7.
Source: Investment Strategy Group, Datastream, Robert Shiller.

For aggregate equity market valuations, we prefer a composite of five valuation metrics since 1945: price-to-trend-earnings, price-to-peak-earnings, price-to-trailing-12-month-earnings, Shiller CAPE, and price-to-10-year-average-earnings. We believe that the post-WWII valuation history is the most reflective of the range of outcomes we may experience in the next five years.

Based on this composite measure, we believe that US equities are quite expensive. As shown in Exhibit 7, equities rank in the 9th decile of valuations, meaning equities have been more expensive based on this aggregate measure only 10% of the time in the post-WWII period.

While one's initial reaction might be to underweight equities, further examination suggests that returns going forward are likely to be positive and higher than fixed income or cash returns over the next five years. From this decile, annualized price returns over the next five years have averaged 5% and price returns have been positive 63% of the time. More remarkably, about a quarter of the time, the annualized returns were 10% or higher over the subsequent five years. Of course, these averages belie great dispersion, as shown in Exhibit 8.

The oft-quoted Shiller CAPE, which currently stands at about 25x, is also in the 9th decile, based

on post-WWII data. However, we are cognizant of the fact that if we consider the entire dataset for the Shiller CAPE, this metric stands at its 10th decile, from which the average annualized return over the following five years has been –1%.

Of course, we need to be vigilant. At these valuation levels the margin of safety has eroded. We also recognize that if equity prices continue at this pace and the S&P 500 exceeds 2000 in short order—implying roughly 8% further price appreciation—we cross into the 10th decile of our own preferred measure.

So let's first show why valuation alone, including Shiller CAPE analysis, is not an effective signal for underweighting the equity market. We will then review the factors that have led us to stay invested in equities.

Valuation Alone Is Not an Effective Tool for Underweighting Equities

As many of our clients know, valuation and diversification are two key pillars of our investment philosophy (see Exhibit 9). With respect to market timing, diversification means diversification of entry and exit into any tactical tilt—in other words, the averaging in and averaging out of tactical recommendations. However, using valuation alone to tactically underweight equities has not been an effective strategy historically.

We performed a series of back tests to address three questions pertaining to valuation measures:[20]

- Is there any particular standard measure that is superior to other measures as a signal of overvaluation?
- Can one use valuation alone as a signal for tactical asset allocation?
- Can one use valuation to successfully underweight equities relative to a buy-and-hold strategy?

We examined three valuation measures: Shiller CAPE, the Jeremy Siegel CAPE (CAPE based on operating earnings and excluding write-downs), and ISG's composite of the five metrics discussed on page 14. We designed a strategy in which, assuming a 50/50 equity and bond portfolio, we would overweight US stocks when they were very inexpensive and underweight them when they were very expensive. As stocks reached the 3rd decile, we initiated a 5% overweight; we added 5% to the position at the 2nd decile and added another 10% at the 1st decile for a maximum overweight of 20%. The overweight was removed when valuations reached the 50th percentile, which represents average valuation levels.

Exhibit 9: Pillars of the Investment Strategy Group's Investment Philosophy

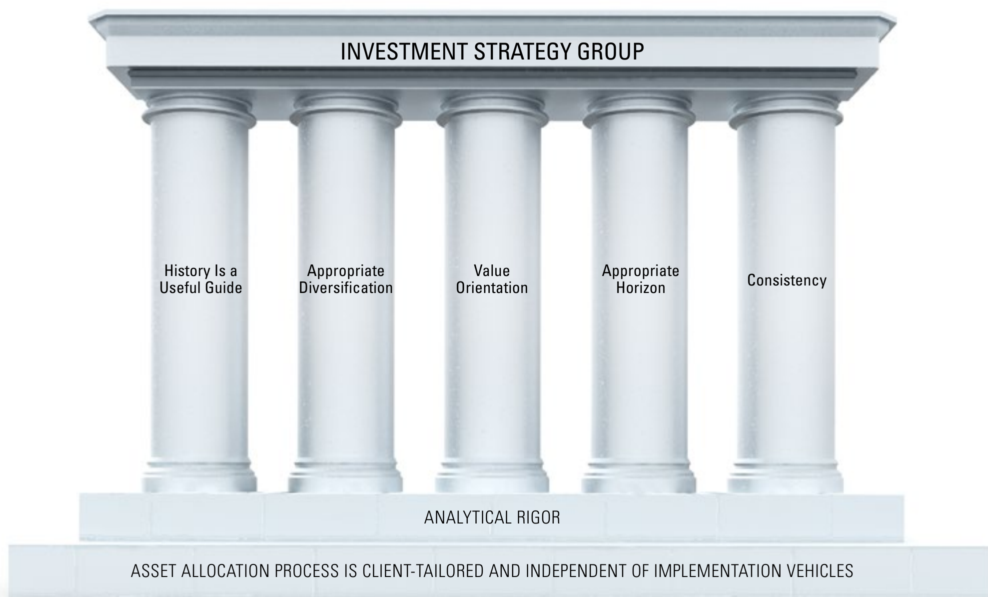


Exhibit 10: S&P 500 Price Level in Logarithmic Scale

Equities are clearly an appreciating asset class, as the magnitude of price increases has historically been greater than the magnitude of price decreases.

10,000
1,000
100
10
1
45 49 53 57 61 65 69 73 77 81 85 89 93 97 01 05 09 13

Data as of December 31, 2013.
Source: Investment Strategy Group, Bloomberg.

We were slower to underweight stocks given that even at the 9th decile, average returns have been positive historically. We reduced our equity exposure by 10% only when stocks crossed over from the 9th to the 10th decile. While there may be more optimal trading strategies, we wanted to more closely replicate the strategies of value-oriented investors who change equity allocations based on valuation alone. To be analytically rigorous, we back-tested the strategy based only on data available at each point in time (i.e., out-of-sample back tests).

We reached three straightforward conclusions. First, no metric is perfect, but the Siegel adjustments to the Shiller CAPE improve the effectiveness of the valuation signal for the purpose of tactical asset allocation. Our composite of five metrics was also more effective than the Shiller CAPE.

Second, on its own, valuation is a useful tactical allocation signal only at the extreme levels of low valuations. We believe one should begin to overweight when valuations are closer to the 3rd decile because being too early can be quite painful in big downdrafts, as we experienced from our overweight recommendations in late 2008. Furthermore, to have any meaningful impact on a portfolio, the overweight allocation has to be significant. For example, a back test of overweighting equities in the strategy discussed above (where the maximum overweight was 20%) resulted in an excess return of only 0.49% per year since 1945. Further, a 20% overweight is a significant tactical tilt in a well-diversified, moderate-risk portfolio and one very few investors might tolerate at times of great distress in the financial markets.

Third, and most importantly at this time of increased concern about high equity valuations, our back tests show that valuations alone are not an effective signal for underweighting equities in order to avoid, or even minimize, the impact of big downdrafts. In our back tests, a strategy of using low valuation signals to overweight equities outperformed, albeit by small amounts, a dual strategy of overweighting equities when valuations were low and underweighting them when valuations were expensive using the weights discussed above. For example, using the Shiller CAPE as our signal, the out-of-sample strategy of only overweighting equities outperformed a dual strategy of overweighting and underweighting equities by 0.2% per year over the post-WWII period. The same overweight-only strategy outperformed the dual strategy of overweighting and underweighting equities by 0.13% per year since 1926. While the differences are small, they are negative nonetheless. We found similar results using the Siegel and ISG metrics over the post-WWII period.

Furthermore, the probability of underperforming a moderate-risk portfolio that remains fully invested (buy and hold) increases when one uses a valuation signal—even a high one—to underweight equities. Using the Shiller CAPE as the signal to underweight equities when it crossed from the 9th decile to the 10th decile, the strategy underperformed the fully-invested portfolio 58% of the time in the post-WWII period (and 58% since 1926); using the ISG metric, the strategy underperformed 54% of the time.

Intuitively, we can better understand the high probability of being wrong when underweighting equities by examining a graph of the S&P 500 in logarithmic scale, as shown in Exhibit 10. Most importantly, we note that equities are clearly an

appreciating asset class that captures the profits of an economy that grows over the long term. In addition, the magnitude of the price increases (height of the green lines) is greater than the magnitude of the decreases (height of the red lines); by definition, that would be true of an appreciating asset class. And, finally, the appreciating periods last much longer than the depreciating periods (the width of the green lines is longer than the width of the red lines). More specifically, the duration from an S&P 500 trough to the next peak has averaged 58 months. However, the duration from an S&P 500 peak to the next trough is much shorter, at an average of 14 months (see Exhibit 11). This helps explain the commonly used expression that the stock market "rides an escalator on the way up but an elevator on the way down." Interestingly, the shortest bull market was five months shorter than the longest bear market.

Our key takeaway is that both the odds and the penalty of being wrong when underweighting US equities are very high.

This was the same conclusion reached by Elroy Dimson, Paul Marsh and Mike Staunton of the London Business School, who conducted an extensive study across 20 countries and 3 country aggregates between 1900 and 2012.[21] They performed a back test in which they would sell out of a region's equities when real returns were forecasted to be negative over the next five years based on expensive valuations. They then invested the proceeds in Treasury bills. In every single country, the strategy of underweighting equities based on a high valuation signal that implied negative real returns underperformed a strategy of remaining in equities all the time (see Exhibit 12 on the next page).

We acknowledge that current valuations are expensive; in fact, by definition, at the 9th decile they are quite expensive. However, underweighting equities solely based on expensive valuations has been a losing strategy even when valuations have crossed into the 10th decile. The hurdle for underweighting equities is even higher when one incorporates the impact of transaction costs and taxes. For example, equities would have to drop by more than 20% for investors in a high tax bracket to overcome the drag of federal, state and local tax payments if they had invested during the trough of the market in 2009. More realistically, equities would have to drop by more than 15% for such taxpayers if they had invested continuously from 1994 through 2007.

We do not rely on valuation as the sole driver of our tactical

Exhibit 11: Length of Previous US Equity Bull and Bear Markets

Bull markets tend to last much longer than bear markets.

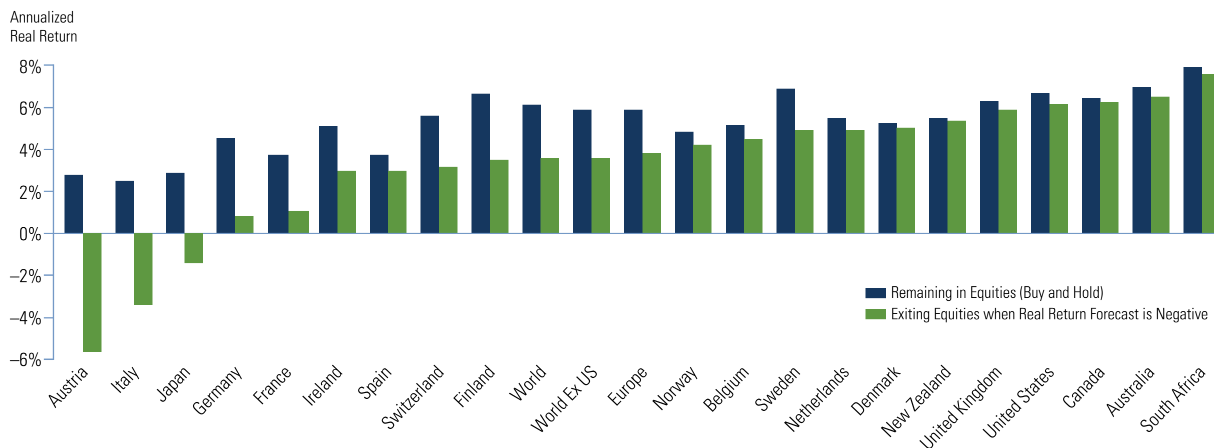
Market Trough	Market Peak	# of Months From Prior Peak to Trough	# of Months From Trough to Next Peak
Jun 1949	Aug 1956		86
Oct 1957	Dec 1961	15	50
Jun 1962	Feb 1966	6	44
Oct 1966	Nov 1968	8	26
May 1970	Jan 1973	18	32
Oct 1974	Nov 1980	21	74
Aug 1982	Aug 1987	20	60
Dec 1987	Jul 1990	3	31
Oct 1990	Mar 2000	3	113
Oct 2002	Oct 2007	31	60
Average		**14**	**58**
Median		**15**	**55**

Data as of December 2013.
Source: Investment Strategy Group, Bloomberg.

Our key takeaway is that both the odds and the penalty of being wrong when underweighting US equities are very high.

Exhibit 12: Real Returns of Portfolios Based on Mean Reversion (1900–2012)

A strategy of underweighting equities based on a high valuation signal has uniformly underperformed a strategy of remaining in equities.



Data as of February 2013.

Source: Elroy Dimson, Paul Marsh and Mike Staunton, *Triumph of the Optimists: 101 Years of Global Investment Returns*, Princeton University Press, 2002.

© 2013 Elroy Dimson, Paul Marsh and Mike Staunton. As published in "Credit Suisse Global Investment Returns Yearbook 2013," February 2013.

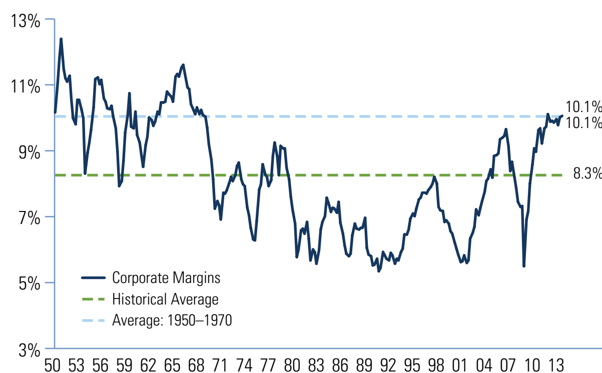
asset allocation recommendations. Other factors such as the policy environment, the macroeconomic backdrop, regulatory concerns, historical precedents, market technicals and investor sentiment are inputs in our decisions.

Our current recommendation to stay fully invested in equities is driven by three key factors:

- Structural shifts that have sustained high margins
- Historical precedents that show bull markets can last for a long time under conditions like today's, of subdued inflation and high unemployment
- A macroeconomic backdrop that favors a modest pickup in global growth

Exhibit 13: US Profit Margins Adjusted for Taxes and Overseas Sales

Many believe that profit margins will revert from current levels to their long-term average of 8.3%.



Data as of Q3 2013.

Note: Adjusted topline pre-tax profit as a percent of US GDP and overseas gross value added.

Source: Investment Strategy Group, Bureau of Economic Analysis.

Structural Shifts Will Support High Margins

One of the underpinnings of our view on equities over the last several years has been that the current level of margins is sustainable and likely to stay well above the levels seen in the 1970s through the 1980s.

Many market participants and academic commentators have asserted that profit margins will revert from current levels to their long-term average of 8.3%, as shown in Exhibit 13. When margins decline, they contend, earnings will fall. In turn, stocks will decline as result of both lower earnings and multiple compression.

We disagree. First, the statistical evidence on margin reversion to the mean is mixed. Contrary to conventional wisdom, S&P 500 operating

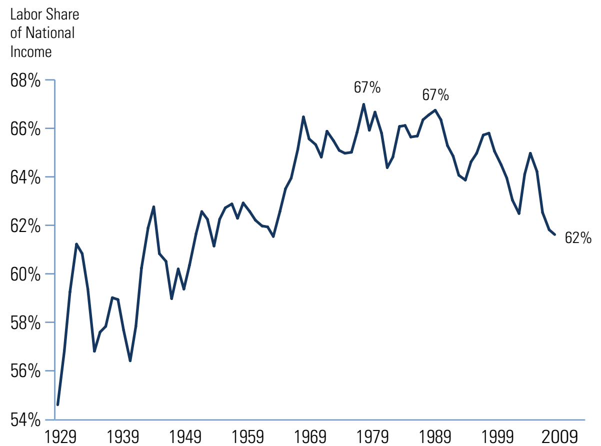
margins and net profit margins are not mean-reverting. Other broader profit measures, such as corporate profits as a percentage of GDP (based on the National Income and Product Accounts), have shown some mean reversion over the entire period. However, the statistical significance of that mean reversion has decreased in recent years. Further, there is no evidence of mean reversion over shorter windows. Therefore, mean reversion is not an independent force that will lower margins.

Second, there are structural reasons to believe that margins are more likely to match the levels reached during the decades following WWII, when margins averaged 10.1%, notably higher than the long-term average of 8.3%. Coincidentally, the current level of margins is exactly at the average of the 1950–70 period.

The most important structural reason for the increase in margins is the fact that the share of corporate revenues that accrues to labor has been steadily declining since 1990. As shown in Exhibit 14, labor's share of national income was on an upward trajectory until about 1970. It then stabilized for two decades with twin peaks in 1980 and 1992. Since then, labor's share has been on a downward trend. While some of the recent decline may be cyclical due to the financial and economic crisis of 2008–09, we believe that most of the shift is structural.

Exhibit 14: US Labor's Share of National Income

Labor's share has been on a downward trend since 1990.



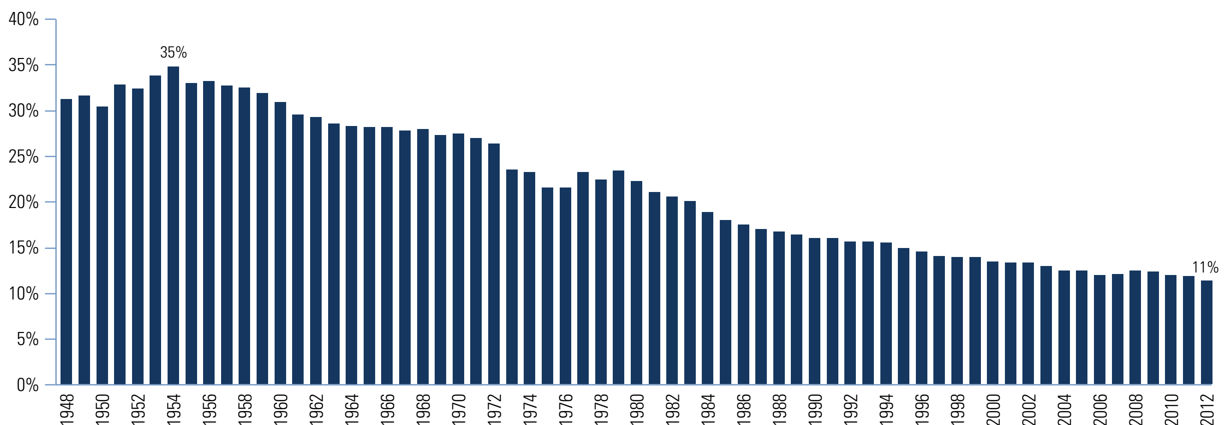
Data as of December 2013.

Source: Investment Strategy Group, Datastream, Bureau of Economic Analysis.

As shown in Exhibit 15, union workers have accounted for a declining share of US wage and salary workers. The share of union workers peaked at 35% in 1954 and has declined fairly steadily to a post-WWII low of 11%. The

Exhibit 15: Percentage of US Wage and Salary Workers Who Are Union Members

The share of workers who belong to unions has declined steadily since peaking in 1954.



Data as of January 2013.

Note: The Bureau of Labor Statistics did not publish union membership data in 1982. 1982 data displayed in exhibit represents an average of 1981 and 1983 data.

Source: Investment Strategy Group, US Census, Bureau of Labor Statistics, "Union Membership Trends in the United States" (2004).

shrinking role of unions in the workforce may well have been the initial impetus behind labor's declining share of national income, but other forces have contributed. China's entry into the World Trade Organization (WTO) clearly squeezed US manufacturing workers, who were, in effect, displaced by cheap labor. And, finally, globalization and outsourcing beyond China put some additional downward pressure on wages. These trends will not be reversed any time soon, as discussed in greater detail by our colleague, Jan Hatzius, chief economist at Goldman Sachs, in a 2012 report *Corporate Profits—A Bigger Slice of the Pie*.

Another structural contributor to higher margins has been an increase in foreign sales. As explained in greater detail in our 2013 *Outlook*, US firms' foreign profits as a percentage of total profits almost doubled over the last 20 years as companies aggressively pursued new markets and leveraged the global supply chain to reduce costs. These profits are taxed at nearly half the rate of profits earned at home.[22] Hence, US firms' growing foreign profits have driven their tax bills lower over time, causing after-tax profits as a percentage of US GDP to rise commensurately.

Finally, we should add that lower leverage among S&P 500 companies and lower interest rates have reduced interest expenses, thereby contributing to higher margins. Given our view of a gradual normalization of interest rates and the fact that many corporations have locked in low borrowing rates by issuing long-maturity debt, we do not believe the end of quantitative easing will pressure margins any time soon.

As an aside, we think the 1950s and 1960s might be instructive beyond the margin story. After WWII, US economic hegemony relative to Europe and Japan was unquestioned. In the 1970s and 1980s, the Arab oil embargo and competitive pressures from Japan were very disruptive to the US economy, and the world view of the US declined as a result. Similarly, in the 2000s, the bursting of the dot-com bubble and the 2008–09 financial and economic crisis were equally—if not more—disruptive to the US economy, causing the world view of the US to decline once again. Now, with the worst of the crisis behind us, along with some notable progress on the fiscal profile of the US and a less favorable view of emerging market economies, the world view of US preeminence is on the rise.

Historical Precedents: Bull Markets Do Not Die of Old Age

Another factor in our recommendation to clients to stay fully invested at their strategic allocation to equities is the precedent set by past bull markets. First, the duration and magnitude of this bull market is not a new phenomenon. Second, bull markets do not die of old age; they end when an exogenous shock triggers the next bear market, and no obvious triggers are in sight at this time. Third, when we compare this bull market with others that have lasted longer and/or had higher cumulative returns, we find that this version has much in common with the bull market of October 1990 to March 2000.

Let's review some basic facts. As mentioned earlier, bull markets have lasted an average of 58 months in the post-WWII era. Of course, we realize that everyone does not use the same definition of a bull market. In some studies, the period of October 1990 to March 2000 would be considered one continuous bull market. Others might argue that the Asian crisis and the corresponding equity market decline of about 20% between July and August 1998 brought that bull market to a close. At the extreme, some have

> "The farther backward you can look, the farther forward you are likely to see."[23]
>
> – Winston Churchill

defined the entire December 1987 through March 2000 period as one long bull market. Such different views have little bearing on the general conclusion that both the average and the median duration of bull markets are between four and five years. The shortest one lasted just over two years in 1966, and the longest one that was uninterrupted by a recession lasted 9.4 years. The total returns of bull markets have averaged 211%, with the weakest returning 58% and the strongest returning 545%.

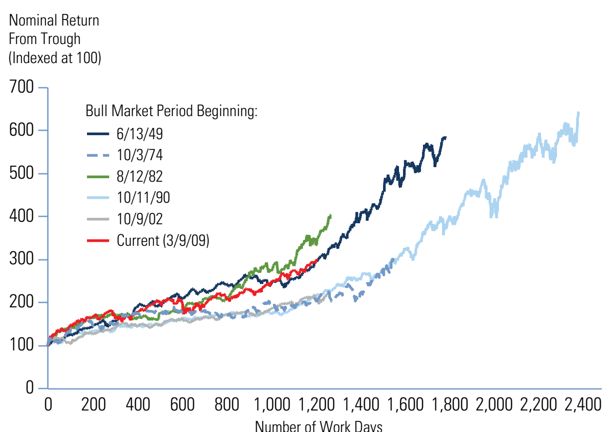
The current bull market has lasted 4.8 years and produced cumulative returns totaling over 200%. Five bull markets have lasted longer; of those five, three have exceeded the total return of this bull market (see Exhibit 16). Therefore this bull market may not necessarily end at any particular time or level.

We also do not see any evidence of the typical triggers that have ended past bull markets. All five of the bull markets that exceeded the duration of the current one ended as a result of tighter monetary policy or external shocks meant to correct extreme imbalances such as the dot-com and housing bubbles. Interest rates were higher at the peaks of all past bull markets, inflation was higher and the unemployment rate was much lower, with the exception of the November 1980 peak when unemployment was 7.5% compared with 7% today (see Exhibit 17). Note, however, that the early 1980s was a period of both double-digit inflation and double-digit 10-year Treasury yields. While no one has perfect foresight, we do not see any signs of such triggers on the horizon.

Finally, when we examine some of the underlying fundamentals, we believe this bull market has much in common with the bull market of October 1990. Both followed a financial crisis that was triggered by a housing imbalance and excessive leverage. Both crises resulted in severe market disruptions to specific sectors of the fixed income market: the dislocation of the mortgage-backed securities market and the related fall of Lehman Brothers Holdings Inc. was similar to the dislocation of the high-yield market in the early 1990s and the subsequent fall of Drexel Burnham Lambert. Both crises brought attention to an Asian country deemed to be superior to

Exhibit 16: US Equity Bull Market Returns

Five bull markets have lasted longer than the current one and three have exceeded its total return.



Data as of December 31, 2013.
Source: Investment Strategy Group, Bloomberg.

Exhibit 17: Characteristics of Historical US Equity Market Peaks

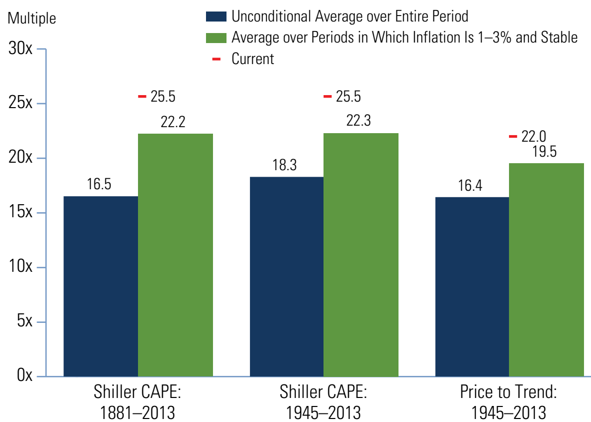
The end to nearly every past bull market since 1950 has been marked by higher interest rates and inflation and lower unemployment than present.

Market Peak	Unemployment Rate (%)	Yield of 10-Year Treasury (%)	Inflation (% YoY)
Aug 1956	4.4	3.3	1.8
Dec 1961	6.1	4.1	0.7
Feb 1966	4.0	4.7	2.5
Nov 1968	3.4	5.6	4.6
Jan 1973	5.2	6.4	3.6
Nov 1980	7.5	12.5	11.9
Aug 1987	6.1	8.7	4.2
Jul 1990	5.2	8.4	4.7
Mar 2000	4.1	6.4	3.7
Oct 2007	4.7	4.6	3.5
Median	**5.0**	**6.0**	**3.6**
Current	**7.0**	**3.0**	**1.2**

Data as of December 31, 2013.
Source: Investment Strategy Group.

Exhibit 18: Historical Average US Equity Multiples

US equities have generally traded at higher multiples when inflation is low and stable, which we expect in 2014.



Data as of December 2013.
Source: Investment Strategy Group, Robert Shiller.

the US in terms of management: Japan in private sector management and China in government effectiveness. Coincidentally, both bull markets started at a price-to-book valuation of 1.8 and they started at a similar price-to-trailing-earnings ratio (13.1 and 14.5, respectively).

If we are right with respect to the parallels between this bull market and that of the 1990s, then this bull market may have further to run. The biggest difference is that we do not expect to see the same type of excessive valuations that prevailed toward the end of the 1990s. Instead, we expect much more modest mid-single-digit returns over the next several years.

The favorable macroeconomic backdrop encompasses faster global economic growth, low and stable inflation in the US, and continued easy monetary policy by the Federal Reserve for the balance of 2014.

The Macroeconomic Backdrop

Another important factor underpinning our equity view is the favorable macroeconomic backdrop. It encompasses faster global economic growth, low and stable inflation in the US, and continued easy monetary policy by the Federal Reserve for the balance of 2014.

With respect to economic growth, we expect the US recovery to pick up some momentum compared with 2013 and grow about 0.9 percentage points faster. We expect Eurozone growth to improve by 1.1 percentage points. And we expect emerging markets to also grow at a slightly faster pace than in 2013. In aggregate, we expect the global growth rate to be about 0.6 percentage points faster. This moderate increase supports our view of mid-single-digit earnings growth for the S&P 500. For further details, please see a discussion of our economic views in Section II.

We also expect low and stable inflation in the US, with headline inflation of 1.5%, and core inflation of 2.0%. Such low and stable inflation bodes well for above-average multiples since US equities have generally traded at much higher multiples when inflation is low (between 1% and 3%) and stable (volatility of inflation at 1% or lower), as shown in Exhibit 18.

Finally, given that the Federal Reserve started to taper the pace of its purchases of Treasury and mortgage-backed securities in December, we expect purchases to now end by the close of 2014. Goldman Sachs Global Investment Research and Macroeconomic Advisers both share this view.[24, 25] However, as pointed out by Federal Reserve officials, “tapering” is not the same as tightening; albeit at a slower pace, tapering is continued easing. We believe that equity markets will remain well supported during an easy monetary policy environment.

The Risks of Staying Fully Invested

The Probabilities and Magnitude of Downdrafts

While equities are an appreciating asset class and we have shown that remaining fully invested in them is an effective investment strategy in the long run, equities are also quite volatile. As shown in Exhibit 19, volatility reached 81% in November 2008 in the midst of the 2008–09 financial crisis. This peak was nearly 14 times as high as the prior trough of 6% in early 2007. Such volatility implies that during the course of investing in equities, clients will experience frequent downdrafts, some of which will be quite severe.

It is very important to frame this topic precisely in order to correctly convey the probabilities of downdrafts. In other words, we have to be clear about what values are being compared and the period over which the downdraft is measured.

Over any period, one can define downdrafts in one of three ways. First, one can define a downdraft as the percentage change between an equity portfolio's beginning value and its ending value over a chosen time period, ignoring any volatility in between. For example, in a year like 2011, this first definition would not result in a downdraft because the year finished about where it started, as shown in Exhibit 20. For the long-term-oriented, patient investor, this would be the preferred definition.

Alternatively, one can define a downdraft as the percentage change from the beginning of the period to the low point or trough value reached during that period. Looking back to 2011 again, using this second definition would yield a downdraft of 13%. Even though the market recovered from the trough by the end of year, clients who adhered to this definition might have become unnerved enough to question their allocations.

A third definition measures a downdraft by comparing the peak value of an equity portfolio achieved at any point during a given period with the subsequent trough value. In 2011, the downdraft under this definition was just under 20%. This definition is likely what most investors think of when they experience a downdraft, but it is probably the least helpful for guiding investment decisions.

Exhibit 19: S&P 500 Historical Volatility

Historical equity volatility implies that equity investors will experience frequent downdrafts, some of which will be quite severe.

Data as of December 31, 2013.
Source: Investment Strategy Group, Datastream.

Exhibit 20: S&P 500 Downdrafts in 2011

The severity of downdrafts depends heavily on the definition used.

Source: Investment Strategy Group, Datastream.

Looking to 2014, the probability of a downdraft depends on which definition we use. As can be seen from the historical analysis in Exhibit 21 (see next page), the probability of a 10%, 15% or 20% downdraft is lowest if we use the first definition and highest if we use the third definition. Therefore, for clients who have staying power and can withstand

Exhibit 21: Probability of Loss in the S&P 500 (1945–2013)

Clients who take the long view face less risk of realizing substantial downdrafts.

Loss defined as…	Return from Beginning to End of Year	Return from Beginning of Year to Trough	Return from Peak to Trough within a Year
–10%	14%	32%	57%
–15%	8%	19%	30%
–20%	5%	12%	16%

Data as of December 2013.
Note: Based on price returns.
Source: Investment Strategy Group, Bloomberg.

Exhibit 22: Probability of Loss in S&P 500 When Valuations Are High (1945–2013)

The probability of loss is greater at higher valuations.

	Conditional on Being in the 9th or 10th Aggregate Valuation Decile at the Beginning of the Year		
Loss defined as…	Return from Beginning to End of Year	Return from Beginning of Year to Trough	Return from Peak to Trough within a Year
–10%	24%	37%	63%
–15%	19%	28%	40%
–20%	13%	23%	26%

Data as of December 2013.
Note: Based on price returns.
Source: Investment Strategy Group, Bloomberg.

interim volatility, the probability of experiencing a 20% downdraft, for example, that persists through year-end is a modest 5% based on data in the post-WWII period. On the other hand, clients who mark their assets to market on an ongoing basis as equities appreciate will experience 20% downdrafts much more frequently. Said differently, while the frequency of mark-to-market drawdowns within a year is greater, the likelihood that those losses will *persist* through the end of a one-year holding period is lower.

The period over which one measures the downdraft is also very important. The more patient investor is less troubled by the interim downdrafts because the probability of downdrafts decreases the longer the time horizon. For example, the probability of a 10% loss over a full year is 14%, but it drops to only 9% for the exceptionally patient investor who is viewing a downdraft over the span of five years.

Unfortunately, data are limited when we look at probabilities of loss at very high valuation levels. Nevertheless, we thought it would be helpful to show how the probability of downdrafts increases when one started in the 9th and 10th valuation deciles historically. While we are currently in the 9th valuation decile, we included both the 9th and 10th deciles to increase the number of historical observations. As shown in Exhibit 22, the probabilities of downdrafts when starting from higher valuations vary significantly depending on the definition used, as they did with our unconditional probabilities. Using our preferred longer-term orientation, the probability of a downdraft of 10% or more is 24%. Using the third definition, where the market can drop 10% but only after it has appreciated to higher levels, this probability increases to 63%. To put these losses in context, it would take a 25% drop in the S&P 500 to bring the ISG metric back to its long-term post-WWII average.

> "It is far better to foresee even without certainty than not to foresee at all."[26]
>
> – Henri Poincaré

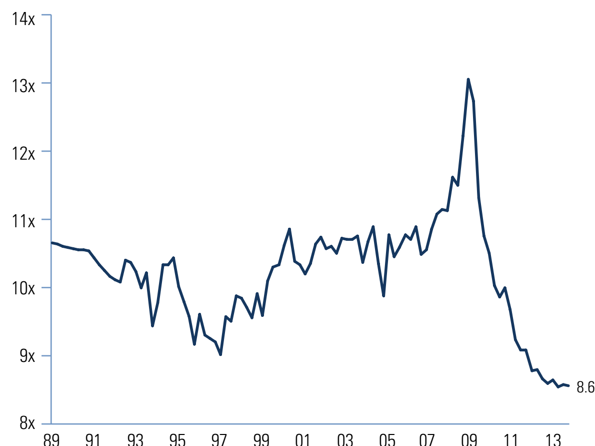
As mentioned earlier, we need to be vigilant. While we have assigned a 60% probability to our base-case total return of about 3% for the S&P 500 in 2014, we

also acknowledge a 25% probability that the S&P 500 will rally another 8%. We also assigned a 15% probability that the S&P 500 will decline by 22% by the end of 2014, which is not insignificant.

Our outlook is far from certain. Pliny the Elder, the 1st-century Roman author and philosopher, famously said, "The only certainty is that nothing is certain."[27] This insight notwithstanding, we are also mindful of the advice of Henri Poincaré, the French polymath who argued that "it is far better to foresee even without certainty than not to foresee at all."[26]

Exhibit 23: US Financial Sector Leverage Ratio

The financial sector has deleveraged extensively.



Data as of December 2013.
Source: Investment Strategy Group, Intrinsic.

Exhibit 24: US Household Sector Financial Obligations Ratio

Households have deleveraged.

Data as of Q3 2013.
Source: Investment Strategy Group, Federal Reserve Bank of St. Louis.

Possible Triggers of Equity Market Downdrafts

We have considered six possible triggers of downdrafts over the next year. All are low-probability risks; in fact, some are highly unlikely. However, in aggregate, the risk of some disruptive event is much higher. The possible triggers in order of importance to US equities are:

- The US stalls into a recession.
- The complete exit from quantitative easing by the Federal Reserve is more disruptive than expected.
- The Eurozone sovereign debt crisis bubbles over.
- Confidence in the impact of Japan's "Three Arrows" dissipates.
- One or more emerging market countries experience a hard landing.
- Geopolitical hot spots result in military engagement, temporary or otherwise.

Let's evaluate each of these risks.

US Recession: We believe the probability of a recession in the US is at the historical norm of 20%. When we examine past recoveries since WWII, we note that they have fallen into a recession because of one or more of the following factors: tightening of monetary policy; tightening of fiscal policy; oil shocks; or extreme imbalances that are no longer sustainable, such as the bubbles in the housing or dot-com sectors. As we look over the horizon, we do not foresee any of these factors pushing this recovery into a recession in 2014.

It is our view that monetary policy will remain accommodative through most of 2014. Fiscal policy will likely remain a drag but at half the rate of

Continued Federal Reserve tapering of asset purchases is a potential risk.

2013. We expect oil prices to remain flat with some downward drift, and we do not see any extreme imbalances in the private sector. Furthermore, the financial sector and the household sector both have clean balance sheets after four years of extensive deleveraging, as shown in Exhibits 23 and 24 on the previous page.

Some have suggested that economic recoveries eventually lose steam and expire. There are two reasons why this contention has no bearing on the current recovery. First, nearly half of the 11 recoveries since WWII have lasted longer than the current expansion (4.5 years) and more than a third have lasted more than six years. So, in the absence of a negative trigger, this recovery can easily last through the end of 2014. Second, there has been extensive academic research showing that US recoveries in the post-WWII period have not demonstrated what is referred to as "duration dependence," in which the length of the recovery impacts the probability of a recession. Given this, the fact that this recovery is 4.5 years old is irrelevant regarding whether it will last another one, two or more years. Finally, our recession index—a composite of several economic indicators—is quite low and well below the threshold for indicating a recession is imminent.

Of course, any unforeseeable exogenous shock, such as some geopolitical eruption that engages the US in another war, could derail this recovery. Such a situation would create a significant downdraft in the US since policymakers have less fiscal and monetary flexibility at this time.

Exiting Quantitative Easing: Continued Federal Reserve tapering of asset purchases is another potential risk that could end this equity rally. However, we think it is unlikely. If the market reaction to the Federal Reserve's tapering announcement in December is any indication, a slow but steady reduction in asset purchases that is fueled by an improving economic backdrop may actually support equity markets. Furthermore, Federal Reserve officials' assurances that short-term interest rates will be kept low for some time after the unemployment rate reaches 6.5% also bode well for the sustainability of this economic recovery.

Nevertheless, there are three key concerns regarding quantitative easing. One concern is that continued purchases, even at a slower pace, could push the Federal Reserve's accommodative monetary policy past some invisible tipping point where it would become destabilizing rather than beneficial to the economy. Richard Fisher, president of the Federal Reserve Bank of Dallas and a voting member of the Federal Open Market Committee (FOMC) this year, recently stated that he is concerned that the continued purchase of assets risks becoming "an agent of financial recklessness."[28] He also stated that the FOMC has to be extremely careful not to cross a tipping point that no one "can identify ex ante." We cannot quibble with the point that continued accommodation could result in financial

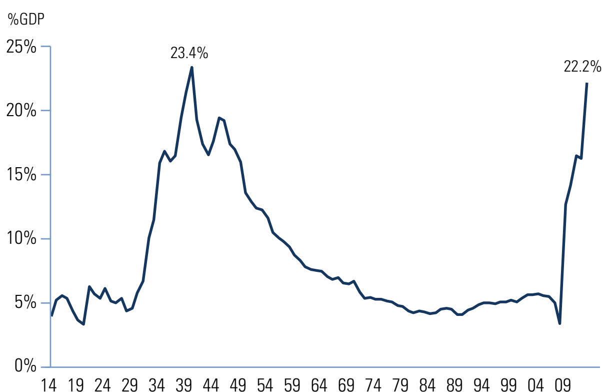
recklessness. However, with inflation expectations hovering around 2% and credit growth at modest levels (as shown earlier in Exhibit 5, page 12), it is hard to say that we face an immediate risk of crossing such a tipping point.

The second concern is that equity markets may drop with the anticipation that future Federal Reserve tightening will lead to a recession. History is a particularly useful guide in addressing this concern. Equity markets have historically peaked an average of 10 months before a recession that was triggered by Federal Reserve tightening. Not every tightening cycle, however, has led to a recession. Most importantly, six of the 14 tightening cycles have not led to recessions. Examples include the most recent cycle of tightening between June 2004 and June 2006, when the Federal Reserve raised the federal funds rate by 4.25 percentage points. Therefore tightening, by definition, does not have to result in recession and an equity market decline. Other factors such as inflation, financial conditions and exogenous shocks matter as well.

The third concern revolves around the size of the Federal Reserve's balance sheet and its impact on the exit from quantitative easing. Some market observers believe we are in uncharted territory in this respect. Actually, measured as a percentage of GDP, the Federal Reserve's balance sheet has been higher than it is today. As shown in Exhibit 25, its balance sheet peaked at 23.4% of GDP in 1940 after nearly eight years of quantitative easing. Moreover, the balance sheet did not return back to pre-1932 levels until the early 1970s.

Exhibit 25: Federal Reserve Holdings as a Share of GDP

The Federal Reserve's balance sheet has actually been higher as a share of GDP than it is today.



Data as of December 2013.
Source: Investment Strategy Group, Federal Reserve, Global Financial Data.

We recognize that the circumstances are not identical. In the early years, gold was the largest component of the balance sheet; large-scale purchases of Treasury securities started only in 1939 to support debt issuance during WWII, and the Federal Reserve did not reach the level of independence it enjoys today until 1951.

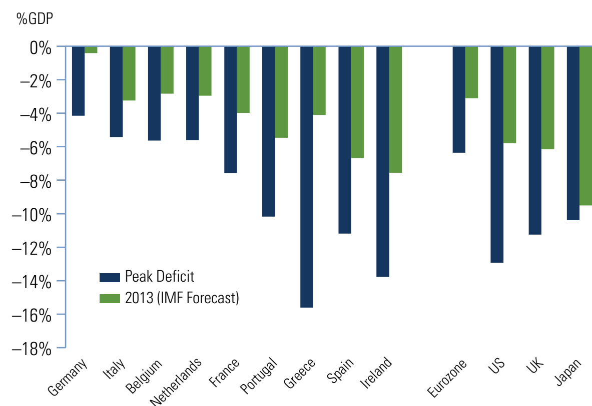
However, some factors are quite similar. The level of the balance sheet as a percentage of GDP is quite high. Treasury bills then were pegged at 0.375%, which is somewhat similar to the federal funds rate being held at 0–0.25%. Longer rates were held stable at 2.5% or lower, similar to the Federal Reserve's use of asset purchases to keep longer rates lower today.

Similarly, members of the Federal Reserve expressed concern about quantitative easing. Much like Richard Fisher today, the president of the Federal Reserve Bank of New York at the time, George L. Harrison, stated that quantitative easing "would not only do no good, but it might do some harm; it would be only another factor of uncertainty, tending toward inflation."[29] After

Some market observers believe the Federal Reserve is in uncharted territory. Actually, measured as a percentage of GDP, the Federal Reserve's balance sheet has been higher than it is today.

Exhibit 26: Eurozone Budget Deficits

Considerable progress has been made in reducing budget deficits.



Data as of 2013.

Note: The budget deficit peaked in 2010 for Germany, and in 2009 for the other countries included in the chart.

Source: Investment Strategy Group, Datastream, IMF.

the balance sheet peaked in 1940, real GDP grew at an annualized average of 5.6% and the S&P 500 returned an annualized 12.8% over the subsequent 10 years. The initial five-year period was even better, but we do not think it is as relevant a period since it spans WWII.

We highlight this past history to make the point that quantitative easing is not as unprecedented as it seems and an eventual exit does not have to be as treacherous as some fear. The Federal Reserve has stated that it may not sell assets to normalize its balance sheet but instead may use maturities and prepayments to reduce its holdings. It has also introduced a number of other monetary policy tools since October 2008, the most recent being the Overnight Fixed-Rate Full-Allotment Reverse Repo Facility,[30] that it can use to manage short-term rates. Finally, Federal Reserve policymakers are not expected to stop reinvesting maturities and mortgage-backed securities' principal payments until mid-2015 unless the economy improves far beyond their expectations. So the risks tied to a Federal Reserve exit are low and probably more of a 2015 issue.

Nevertheless, there is always a chance of a policy mistake or a communication mishap between now and then. We are reminded of the market's reaction in May 2013 after Federal Reserve Chairman Ben Bernanke's congressional testimony and the release of the minutes from the April/May FOMC meeting. We believe that Federal Reserve communications and tapering of Treasury and mortgage-backed securities will be a continued source of market volatility but will not threaten to derail the economy or unravel the equity markets.

All Is Not Quiet on the Eurozone Front: Among the potential threats to US equity markets, we think the Eurozone poses the greatest risk. While considerable progress has been made in reducing budget deficits, as shown in Exhibit 26, Eurozone countries have not reformed enough to ensure fiscal sustainability and political stability.

Italy is probably the country most likely to reignite the Eurozone sovereign debt crisis. The coalition government is not stable or strong enough to push through any meaningful reform in an expeditious manner, despite the fact that it is likely to achieve its intended fiscal targets. The coalition might be weakened even further if the European parliamentary elections in May strengthen the opposition and thereby encourage the People of Freedom Party and the Five Star Movement Party to call for early Italian elections.

In Spain, Catalonia's push for independence will create political noise and contribute to overall instability. While Prime Minister Mariano Rajoy's position is probably secure,

We are concerned that Eurozone leaders have become complacent given the current absence of market pressure.

far-reaching tax and labor reform are unlikely before the 2015 elections.

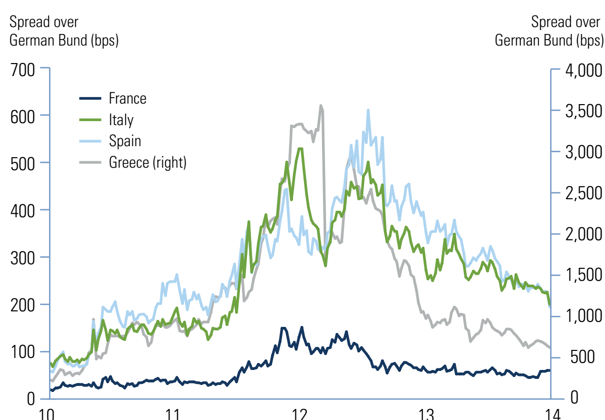
Greece has endured six years of recession and still requires further debt relief from the Troika of the European Central Bank (ECB), the IMF and the European Commission. It also must continue to implement structural reforms that risk undermining the current government's simple majority. Greece's negotiations with the Troika will be another source of volatility.

In France, President François Hollande's position seems secure through the end of his term in 2017, but he is unlikely to embark upon an ambitious program of further labor market and private sector reform to strengthen the country's competitiveness. The key question here is whether the markets will bring any pressure to bear on France; throughout this crisis, France has escaped somewhat unscathed.

We are concerned that Eurozone leaders have become complacent given the current absence of market pressure, as evidenced by the substantially lower levels of incremental yields of sovereign bonds over German bunds (see Exhibit 27). From the beginning of the European sovereign debt crisis in 2010, we have characterized European policymakers' approach as incremental, reactive and inconsistent. Whatever the issue was—the Greek debt restructuring, the Spanish bank recapitalization, or Italy's interim technocratic government of former Prime Minister Mario Monti between 2011 and 2013—policymakers and the electorate reacted to the crisis at hand by taking only incremental steps that did not fully resolve the underlying fundamental problem. They were also, at times, inconsistent in their words and actions. *Financial Times* columnist Wolfgang Münchau perhaps put it best when he said, "Each time the crisis subsides, the EU's leaders become complacent" until the next crisis.[31] Since market pressures have subsided, progress has been very limited and we are concerned that European leaders have not been sufficiently proactive in preparing themselves for the inevitable next crisis.

Exhibit 27: Incremental Spreads on Peripheral 10-Year Sovereign Bonds

Market pressure has receded.



Data as of December 31, 2013.
Source: Investment Strategy Group, Bloomberg.

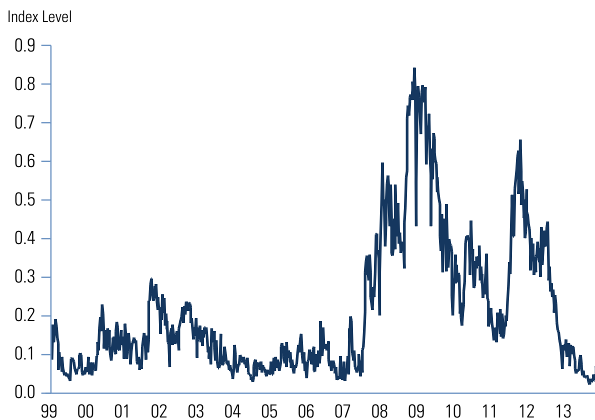
The late 2013 agreement on a Single Resolution Mechanism (SRM) illustrates the extent of the incremental, reactive and inconsistent approach adopted by Eurozone policymakers. In a nutshell, the SRM—expected to be operational by 2015—provides a framework by which banks will be recapitalized or closed down. It establishes the order in which losses will be absorbed, specifies how funds will be raised to recapitalize banks in the near term as well as after 10 years, and outlines the governance process to determine whether a bank will be recapitalized or unwound.

> "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."[34]
>
> – Mario Draghi, President of the European Central Bank

While the SRM amounts to progress toward greater banking

Exhibit 28: Euro Area Systemic Stress Indicator Composite Index

Risk premiums across asset classes in Europe have steadily declined.



Data as of December 31, 2013.
Source: Investment Strategy Group, Bloomberg.

union, it is only an incremental and limited step. One of its shortcomings is that a single Europe-wide fund will not be in effect for 10 years and, even then, the available funds will likely be limited to €55 billion. It is also reactive in that the SRM, along with a Single Supervisory Mechanism (SSM), was only set up after market concerns arose about the vulnerability of the Spanish banking system in April 2012, contributing to the underperformance of peripheral sovereign bonds and a sharp drop in European stocks. Most surprisingly, the SRM is also inconsistent with the June 29, 2012, Eurozone summit statement, in which policymakers affirmed "it is imperative to break the vicious circle between banks and sovereigns."[32]

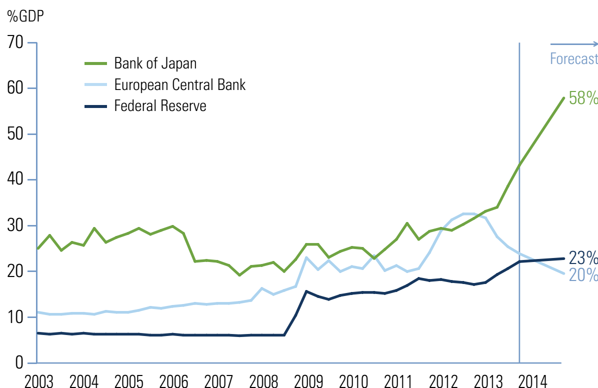
In the absence of sufficient funds, especially in the early years, sovereign governments will have to seek assistance from the European Stability Mechanism as Spain was forced to do in 2012. This means that the vicious circle between banks and sovereigns has not yet been completely broken. As they say in Europe, *"plus ça change, plus c'est la même chose"* ("the more it changes, the more it is the same").[33]

While we think that the Eurozone will be a source of volatility in the financial markets, we do not think that it is at risk of unraveling. Progress on fiscal deficits, new tools such as Outright Monetary Transactions (OMTs), and incremental steps toward banking union have substantially reduced the tail risk. In addition, we have to keep in mind ECB President Mario Draghi's 2012 pledge: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough."[34] Since this commitment was voiced, risk premiums across asset classes in Europe have steadily declined. As shown in Exhibit 28, the ECB's Composite Indicator of Systemic Stress has dropped to historical lows and even below pre-crisis levels.

Japan's "Three Arrows" Could Miss the Target: As discussed earlier, the US' impact on the world is substantially greater than Japan's, both from an economic perspective and from the perspective of financial shocks. Nevertheless, should Prime Minister Shinzo Abe's three-pronged strategy of quantitative easing, fiscal reform and structural pro-growth reform stall, Japan will fall back into deflation and put marginal downward pressure on US equities. We are particularly concerned about the negative impact of the expected hike in the consumption tax from 5% to 8% that will go into effect in April 2014. While our base case—discussed in greater detail in the next section of this *Outlook*—calls for continued growth of just under 2%, it is

Should the "Three Arrows" fail to have the desired impact, we think the Bank of Japan will undertake further quantitative easing.

Exhibit 29: Global Central Bank Balance Sheets
The BOJ's balance sheet as a percentage of GDP is expected to grow to more than double that of the Federal Reserve or the ECB by the end of 2014.



Data as of December 2013.
Source: Investment Strategy Group, Datastream.

possible that the latest stimulus package and recent depreciation of the yen will not offset the impact of the tax hike and growth that slows unexpectedly.

Should the "Three Arrows" fail to have the desired impact, we think the Bank of Japan (BOJ) will undertake further quantitative easing. As shown in Exhibit 29, the BOJ is already pursuing a particularly aggressive monetary policy in which its balance sheet as a percentage of GDP is expected to grow to more than double that of the Federal Reserve or the ECB by the end of 2014. Monetary policy is considered the most effective arrow for having an immediate impact on Japanese growth, and we think Prime Minister Abe will not hesitate to encourage further quantitative easing. Therefore, we believe that the risks emanating from Japan will be contained.

Hard Landing in Emerging Markets: We do not expect a hard landing in China or any other major emerging market country in 2014. China has the resources to address any immediate slowdown or unanticipated credit crisis. However, as discussed in great detail in our latest *Insight* report, *Emerging Markets: As the Tide Goes Out*, we believe that emerging market countries will be a source of significant volatility over the next several years. Their structural fault lines are deep and they have not taken advantage of periods of strong economic growth to address them in any meaningful way. Furthermore, some of them, such as India, Indonesia, Brazil, South Africa and Turkey, have elections in 2014 that could lead to increased volatility in emerging markets. As investors take note of these structural fault lines, we think capital will flow out of emerging market assets to US assets, providing some incremental support for US equities.

Exhibit 30: East China Sea Air Defense Identification Zones

China's ADIZ overlaps with one established by Japan, as well as with those maintained by South Korea and Taiwan.

Source: Investment Strategy Group, *New York Times.*

Military Conflagration: One of the risks to our equity view is the risk of a military conflagration in one of the key geopolitical hot spots in the world. They are, in order of global impact:

- East China Sea
- Iran
- South China Sea
- North Korea

East China Sea: China's announcement of the East China Sea Air Defense Identification Zone (ADIZ) in late November 2013 has increased tensions in the region. China's ADIZ overlaps with one established by Japan, as well as with those maintained by South Korea and Taiwan, as shown in Exhibit 30. The US promptly sent two B-52 bombers to fly through the ADIZ without registering their flight plans, while simultaneously reaffirming its security treaty obligations with Japan. While neither China nor Japan desires any military conflict, tensions between the two Asian powers will likely continue to rise over the East China Sea. Leaders from both nations like to use nationalist rhetoric for domestic purposes, and we do not believe the dispute over the affected Senkaku/Diaoyu Islands will abate any time soon. As such, the risk of a miscalculation or a military accident is high.

Iran: While the odds of a comprehensive nuclear deal with Iran are higher than they have been in years, the risk of a military attack will also be more pronounced should the negotiations fail. On average, policy experts assign a 40–60% probability of a comprehensive nuclear deal sometime in the second half of 2014. However, with the recent increase in rhetoric from Washington about further sanctions, and signs of internal strife among various constituents in Iran, the outcome of nuclear negotiations is highly uncertain. While the US may be reluctant to engage in another war in the region as it extricates itself from Iraq and Afghanistan, experts believe that Israel is more likely to initiate a military strike, in the absence of a nuclear deal. In such a case, oil prices would clearly rise and equity markets would fall.

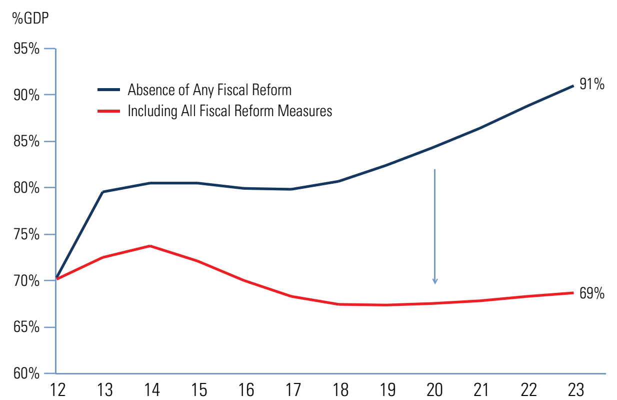
South China Sea: China has also declared that it will establish another ADIZ, and the South China Sea region is the likely target. As China and the 10 Southeast Asian countries already have 47 territorial disputes, geopolitical tensions in the region will likely continue to be volatile. However, trade between these countries has grown significantly over the last several years. Exports to China have grown annually by double digits since 1995, compared with 6–8% growth rates in exports to the rest of the world. As such, the Chinese will probably be more cautious toward these neighbors, especially since they do not want the countries in the Association of Southeast Asian Nations (ASEAN) to strengthen their ties with the US through trade partnerships and an even greater military presence.

North Korea: North Korea will remain an unpredictable country, especially under the

Japan Coast Guard's patrol boats surround a boat carrying Chinese activists in the East China Sea in August 2012.

Exhibit 31: US Federal Debt Held by the Public

Projections of federal debt held by the public as a percentage of GDP have fallen from 91% to 69% in 2023.



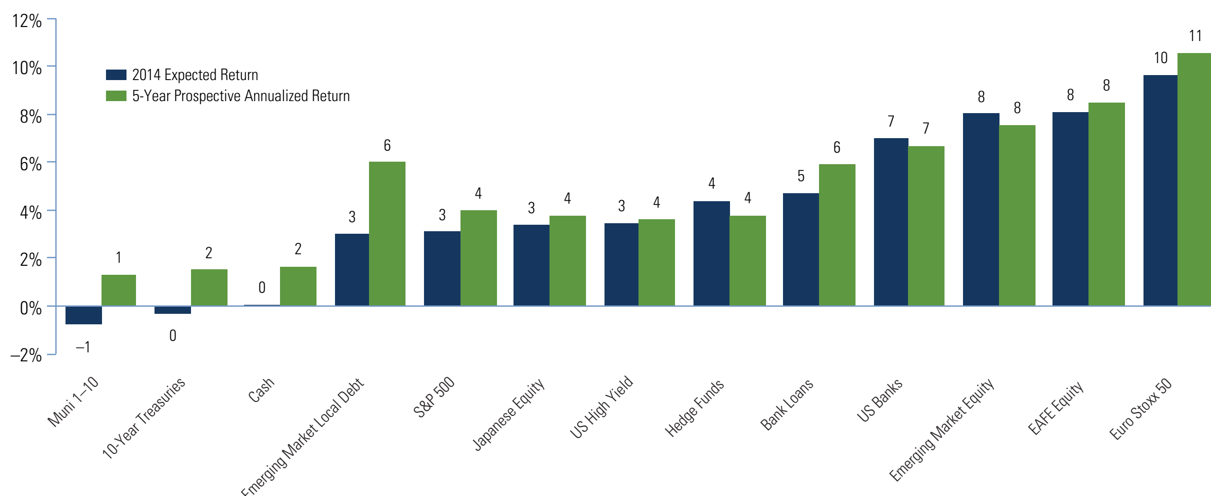
Data as of December 31, 2013.
Source: Investment Strategy Group, Congressional Budget Office, Committee for a Responsible Federal Budget.

leadership of Kim Jong Un. The execution of his uncle illustrates the extent of this regime's unpredictability. Given its history over the last few years, the possibility remains that North Korea may conduct nuclear weapons tests or sink other nations' naval vessels at any time. However, China's influence over North Korea should contain the impact of any such skirmishes. North Korea's provocations may not have disrupted US equity markets to date, but we should keep in mind that such an unpredictable regime is more likely to surprise to the downside.

US Debt Ceiling and Government Shutdown Are Not Real Risks

It is worth noting that we do not believe that the ongoing budget and debt ceiling discussions represent real risks to our outlook for US equities at this time. While those negotiations and the most recent government shutdown have contributed to market volatility over the last several years, Democratic and Republican leaders recognize that the political fallout for their respective parties was greater than they had anticipated. Furthermore, considerable progress has been made toward deficit reduction with the Budget Control Act of 2011, the American Taxpayer Relief Act of January 2013 and sequestration in March 2013. These developments have bought Washington some time before it has to address the US government's long-term debt profile again. The extent of this progress is most evident in the reduction of projections of federal debt held by the public as a percentage of GDP from 91% to 69% in 2023, as shown in Exhibit 31. Some political rhetoric will likely occur in the first half of 2014 with respect to a spending authorization bill and the extension of the debt ceiling, but we do not expect it to have any meaningful or sustained impact on equity markets.

Exhibit 32: ISG Prospective Returns



Data as of December 2013.
Source: Investment Strategy Group.

Investment Implications

At the beginning of this 2014 *Outlook*, we suggested that our clients might interpret our recommendation to stay fully invested at their strategic allocation to US equities as a common refrain from prior years. We then proceeded to explain that while this recommendation may appear to be the same as past recommendations, the view is more nuanced given the current higher valuations of US equities. However, when it comes to specific portfolio recommendations across asset classes, they are, in fact, very similar to last year's recommendations. Our one- and five-year expected returns are also somewhat similar to those we presented last year.

Our key 2014 investment themes, as summarized in Exhibit 32, are based on our view that:

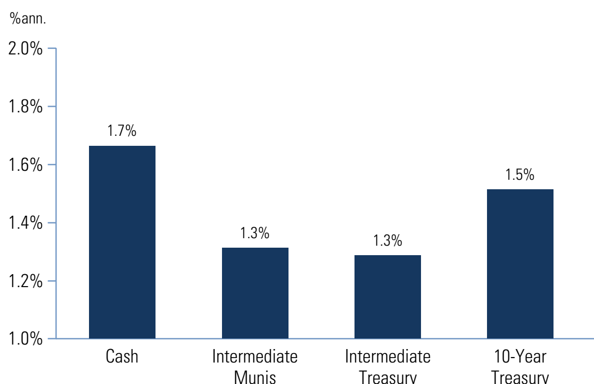
- High-quality bonds, including intermediate municipal bonds and 10-year Treasuries, will have slightly negative total returns for 2014 and modestly positive returns over the next five years.
- High-yield bonds, including bank loans, provide attractive nominal returns for 2014 and for the next five years.
- Hedge funds will have mid-single-digit returns.
- US equities will have modest single-digit returns in 2014 and slightly higher returns over the next five years.
- Euro Stoxx 50 will continue to have some of the most attractive near-term and long-term returns.
- US banks will have more subdued returns than last year but will still be quite attractive in absolute terms.
- The strategic allocation to emerging market assets should be reassessed.

Underweight Investment-Grade Bonds: We recommend clients underweight investment-grade bonds given the slightly negative total returns for 2014 and the very modest positive returns for the next five years. We have a greater underweight recommendation this year than last year because we are one year closer to the time of the first rate hike. While the start date of the first interest rate increase and the pace at which the Federal Reserve raises rates are uncertain, we believe the first hike is likely to occur in the third quarter of 2015. We assume that short-term rates will rise to 4% over the subsequent three years.

Our underweight recommendation can be achieved by either owning fewer bonds or owning substantially shorter-maturity bonds. Investors may debate the merits of either strategy but under most scenarios the difference in returns between the two strategies and the overall impact on a portfolio will be negligible. As shown in Exhibit 33, in our baseline scenario, the difference in returns between the various bonds is 0.2%.

The difference between cash and various high-quality bonds is slightly higher at 0.40%. However, while the higher returns of cash might be more appealing, especially to our more conservative investors who have a significant allocation to fixed income, we do not recommend a complete allocation away from high-quality bonds. Such bonds are the only reliable deflation hedge in a portfolio and, given the risks discussed above, it is prudent to maintain such a hedge in the portfolio.

Exhibit 33: 5-Year Annualized Fixed Income Return Projections



Data as of December 2013.
Notes: (1) Assumes a terminal short rate of 4% and term premiums normalize over a period of 4 to 5 years. (2) The intermediate Treasury strategy has an approximate duration of 4.6 initially. 10-Year Treasury has a duration of 9 currently.
Source: Investment Strategy Group, Datastream, Barclays.

Overweight High-Yield Bonds and Bank Loans: We recommend an overweight to high-yield bonds and bank loans. We expect both sectors to outperform investment-grade bonds and cash in the near term and over the next five years. While our recommendation at the beginning of last year was to exclusively own high-yield bonds, our recommendation today includes bank loans as well as high-yield bonds. A more detailed discussion is provided in our investment outlook.

Maintain Exposure to Hedge Funds: In this environment of low but rising interest rates, we expect modest single-digit returns in hedge funds. However, we expect them to outperform bonds. We therefore reiterate our recommendation that clients who are eligible to invest in hedge funds maintain their exposure to hedge funds at their strategic allocation. We note that hedge funds substantially outperformed our mid-single-digit return expectations in 2013 as a result of the exceptionally strong returns of US equities. Given our muted return expectation for US equities, we do not expect hedge funds to provide the same double-digit returns in 2014.

We recommend clients underweight investment-grade bonds given the slightly negative total returns for 2014 and the very modest positive returns for the next five years.

We expect mid-single-digit returns for a moderate-risk portfolio over the next one and five years.

Stay Fully Invested in US Equities and Maintain the Overweight to US Banks: As discussed at length above, we recommend staying fully invested in equities despite high valuations, an eroded margin of safety and a modest 3% expected return. First, we expect equities to outperform bonds and cash. Second, we think there is a higher probability that equities will outperform our expectations than underperform. Third, the penalty of underweighting equities, as shown by our research and that of Dimson, Marsh and Staunton,[35] is quite high. And, finally, for clients with taxable accounts who have significant gains in their equity holdings, we prefer deferring taxes until we have greater conviction that this bull market has reached its peak or is about to peak.

We also recommend maintaining a tactical tilt to US banks. This tilt has been in place since December 2010 and has returned about 48% since then, or 14% on an annualized basis (as measured by the S&P Banks Select Industry Index). While we have reduced the size of this tilt, we expect US banks to outperform bonds and US equities not only on an absolute basis, as shown in Exhibit 32 on page 34, but also on a risk-adjusted basis. Furthermore, while bank valuations have moved closer to normal levels, they still provide scope for upside, having been higher than today's level about 57% of the time over the last 25 years. Of equal importance, bank earnings will continue to benefit from falling credit costs, rising rates and improving loan demand.

Maintain an Overweight to Euro Stoxx 50 and Spanish Equities: As can be seen in Exhibit 32, we expect Eurozone stocks to be the best-performing broad asset class in 2014 and over the next five years. We recommend maintaining our tactical tilt toward large multinational Eurozone companies through Euro Stoxx 50. While this tilt was introduced in late 2011, we believe that it still has significant upside.

We also recommend expressing our positive view of Eurozone equities partly through Spanish stocks. Spanish stocks have lagged European stocks since the European sovereign debt crisis, and their current valuation discount to their Eurozone counterparts is nearly twice as large as it has historically been. Given greater domestic political stability than in some of the other Eurozone countries and greater progress in recapitalizing their banks, we believe that Spanish equities will provide very attractive returns.

Reassess the Strategic Allocation to Emerging Markets: Emerging market equities are likely to provide higher returns than investment-grade bonds and US equities, but we expect emerging market bonds to lag US high-yield bonds and bank loans. With respect to equities, we have three concerns. The volatility associated with these returns is very high at 24%, substantially higher than that of the US or developed market equities. Therefore, in a generally low-return environment, emerging market assets will have a materially greater and, at times, random effect on a client's overall portfolio. Second, as interest rates rise in the US and the Federal Reserve exits quantitative easing, emerging market countries with unsustainable current account deficits may face further market downdrafts. Finally, as discussed at length in our latest *Insight* report on emerging markets, we believe that the fault lines in many of these countries have deepened further since the end of their 2003–07 "Goldilocks" period, creating even greater uncertainty and contributing to unforeseeable bouts of volatility. We therefore recommend clients reassess their strategic allocation to emerging market assets.

Our Key Investment Takeaway

Our main investment theme since late 2008 has been to stay fully invested in US equities, overweight specific equity sectors and regions, and overweight high-yield bonds. However, after such strong returns—certainly well beyond our expectations—we are now more cautious.

Based on our asset class views, we expect mid-single-digit returns for a moderate-risk portfolio over the next one and five years. Equities are much more expensive and the margin of safety has eroded. As markets have rallied, we have steadily reduced our overall risk. Even though we have maintained many of the same tactical tilts, we have reduced the size of the tilts. We now have a modest allocation to cash and the overall beta (or equity-like risk) of the tactical tilts in a moderate-risk portfolio is about 20% lower than a year ago and about 80% lower than our peak level in April 2009.

We proceed with extra vigilance, knowing that the summit is in sight.

The Baton Pass

THE FATE OF A RELAY RACE ultimately rests on successfully passing the baton from one runner to the next. Yet the importance of a fluid handoff is not limited to the track. As we survey the global economic landscape, we see a number of such critical transitions afoot. In the developed world, whether countries can transition from a post-crisis malaise dominated by fiscal and monetary policy to a self-sustaining recovery has critical implications for global growth. So does the emerging world's ability to shift from commodity- and investment-dependent economies to more balanced, consumer-led ones.

While we are skeptical about a smooth transition in emerging markets—as discussed in our recent *Insight* report, *Emerging Markets: As the Tide Goes Out*—several factors make a bungled handoff less likely for developed countries. First, deleveraging is well advanced in both the private and public sectors, as budget deficits have halved from peak levels in the US and the Eurozone. At the same time, private sector balance sheets have improved on the back of rising asset values, refinancing and debt write-downs. Second, waning fiscal restraint is set to provide a meaningful boost to GDP growth. Specifically, the OECD projects that the GDP of its member nations will benefit from 0.6 percentage points less fiscal drag this year. Third, financial conditions remain

highly accommodative, even with the onset of tapering in the US. Fourth, today's improving global energy supplies make it less likely that oil prices will spiral higher and sabotage global growth, as they have in recent years. More stable energy prices should also temper inflation. Finally, the fog of uncertainty around the three key sources of systemic risk—a near-term hard landing in China, a breakup of the Eurozone and a fiscal crisis in the US—is clearing, which should bolster private sector confidence. In short, the impediments that stifled growth in recent years are abating, setting the stage for a globally synchronized expansion in 2014.

Although a pickup in growth would typically be a harbinger of inflation, the economic slack in many developed nations should temper price increases while also providing cover for accommodative policy and a measured withdrawal of liquidity in the US. That said, rising inflation could be more of an issue for some emerging markets. Meanwhile, global interest rates are likely to extend last year's move higher, a function of their still-depressed levels and improving global growth.

A summary of our GDP, inflation and interest rate forecasts for the developed economies is presented in Exhibit 34.

United States: Escape Velocity?

While last year's approximately 2.0% real GDP growth may seem uninspiring by historical standards, consider the gale-force headwinds the US economy has successfully weathered. All told, the drag from higher taxes, discretionary spending cuts and sequester-related reductions was nearly as large as GDP growth itself. In fact, 2013 marked the second consecutive year that total nominal federal outlays actually contracted, a pace of fiscal restraint not seen since the Korean War demobilization in the mid-1950s and one that many prognosticators thought made recession inevitable.

This tug-of-war between public restraint and private sector expansion has been a recurring theme in recent years. As shown in Exhibit 35, headline GDP would be notably higher in the absence of fiscal retrenchment, highlighting that the private sector has been more resilient than commonly thought. Indeed, private sector real GDP has been growing at a relatively steady 3–3.5% pace since the economy bottomed in 2009.

This last point is important, as headline GDP should accelerate toward the pace of underlying private sector growth as the fiscal burden ebbs this year. Specifically, growth should benefit from about 0.7 percentage points less drag this year

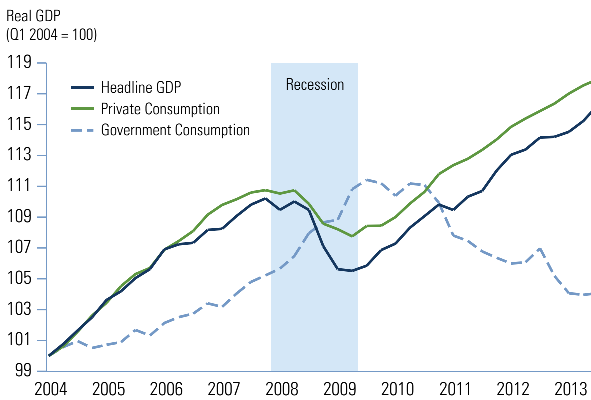
Exhibit 34: ISG Outlook for Developed Economies

Our forecast features accelerating growth, still-accommodative monetary policy, modest inflation and higher interest rates.

		UNITED STATES		EUROZONE		UNITED KINGDOM		JAPAN	
		2013	2014 Forecast	2013	2014 Forecast	2013	2014 Forecast	2013	2014 Forecast
Real GDP Growth*	YoY%	1.8%	2.25–3.25%	–0.4%	0.25–1.25%	1.9%	1.25–2.25%	1.7%	1.0–2.0%
Policy Rate	End of Year	0.25%	0.0–0.25%	0.25%	0.25–0.75%	0.5%	0.5%	0.1%	0.1%
10-Year Bond Yield**	End of Year	3.0%	3.0–3.75%	2.0%	2.0–2.75%	3.1%	2.75–3.5%	0.7%	0.5–1.0%
Headline Inflation***	Average	1.2%	1.0–2.0%	0.9%	0.75–1.75%	2.1%	1.5–2.5%	1.5%	1.75–2.75%
Core Inflation***	Average	1.7%	1.75–2.5%	0.9%	0.75–1.5%	1.8%	1.75–2.5%	0.6%	–

Data as of December 31, 2013.
*2013 real GDP is based on GS Global Investment Research estimates of year-over-year growth for the full year.
**For Eurozone bond yield, we show the 10-Year German Bund.
***For current CPI readings we show the year-over-year inflation rate for the most recent month available.
Source: Investment Strategy Group, Datastream, GS GIR.

Exhibit 35: Private vs. Public Sector GDP Growth
Headline GDP would be notably higher in the absence of fiscal retrenchment.



Data as of Q3 2013.
Source: Investment Strategy Group, Bureau of Economic Analysis, Datastream, National Bureau of Economic Research.

Exhibit 36: The Components of US Fiscal Restraint
Waning fiscal drag should provide a boost to growth in 2014.

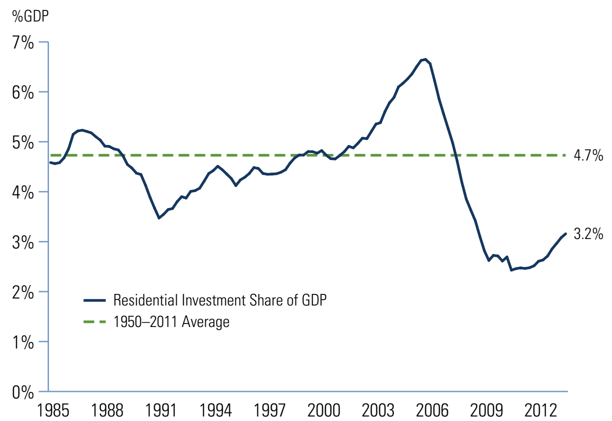
YoY	2013	2014
	Percentage Points	
Sequester	–0.4	–0.1
Spending (ex. Sequester)	–0.3	–0.3
Taxes	–0.5	–0.2
Total	–1.3	–0.6

Data as of December 2013.
Note: Impact on real GDP growth relative to a baseline forecast excluding the effects of fiscal consolidation. Average of Goldman Sachs GIR and Macroeconomic Advisers assumptions.
Source: Investment Strategy Group, GS Global Investment Research, Macroeconomic Advisers.

(see Exhibit 36). Moreover, fewer sequestration cuts under the budget deal recently brokered by Rep. Paul Ryan (R-Wis.) and Sen. Patty Murray (D-Wash.) could add 20–30 basis points. As a result, the private sector should gain an upper hand in this ongoing tug-of-war over the course of 2014.

Importantly, waning fiscal drag will not be the lone support for US growth this year; an ongoing housing recovery, stronger consumer spending and resilient business investment should also contribute. We discuss each of these key drivers below.

Exhibit 37: Residential Investment as a Share of GDP
The housing recovery still has ample scope for upside.



Data as of Q3 2013.
Source: Investment Strategy Group, Bureau of Economic Analysis, Datastream.

Housing

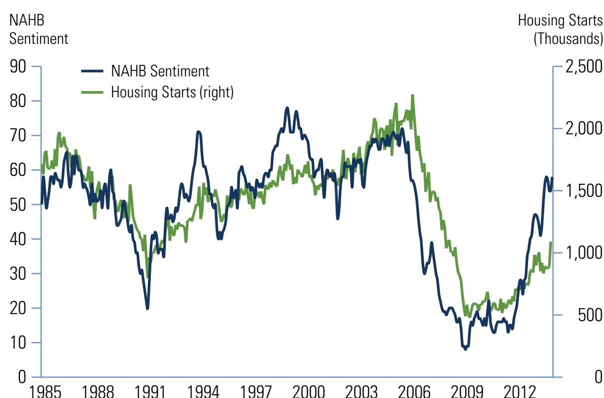
After 12 consecutive quarters of residential investment growth, there is considerable concern that rising interest rates will undermine the housing recovery. Others worry that recent double-digit home price gains imply another housing bubble is forming. Our view is more sanguine on both counts.

As shown in Exhibit 37, today's level of residential investment provides ample scope for further upside, as does the fact that vacancy rates are falling and long-term estimates of annual housing demand—measured by factors such as population growth and the scrappage of old homes—stand approximately 600,000 homes above the current level of housing starts. In addition, leading indicators of housing activity remain supportive. For example, the National Association of Home Builders (NAHB) Index, which has accurately anticipated the swings in housing starts over time, has been rising rapidly and now stands at levels last seen in 2006 (see Exhibit 38).

It is also noteworthy that recent price appreciation has merely brought the value of

Exhibit 38: Housing Starts vs. Homebuilder Sentiment

Leading indicators suggest the housing recovery will continue.

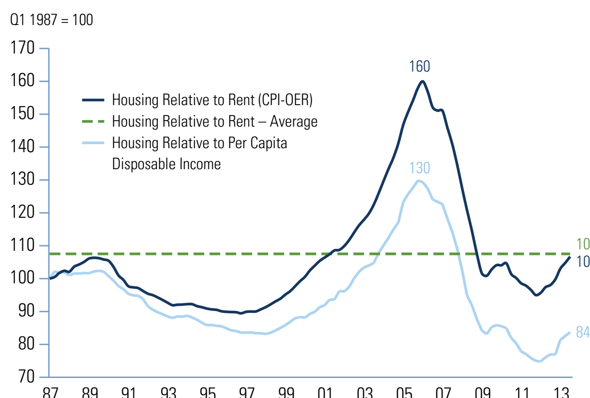


Data as of December 2013.

Source: Investment Strategy Group, Datastream, National Association of Home Builders, US Department of Commerce.

Exhibit 39: US Housing Values Relative to Rent and Income

Housing valuations stand considerably below their prior peaks.

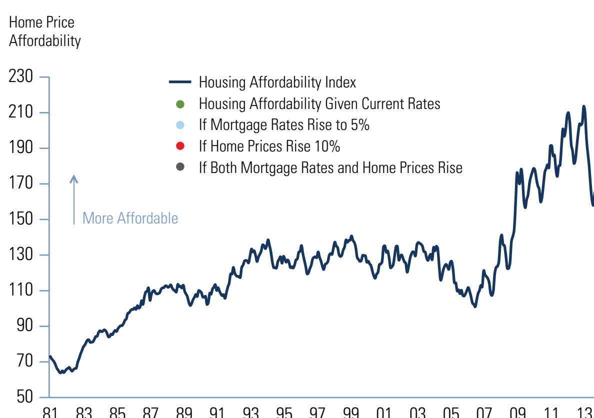


Data as of Q3 2013.

Source: Investment Strategy Group, Bureau of Economic Analysis, Bureau of Labor Statistics, Datastream, S&P/Case-Shiller.

Exhibit 40: Home Price Affordability

It would take a meaningful rise in both rates and home prices to eliminate today's high affordability.



Data as of December 2013.

Source: Investment Strategy Group, Datastream, Federal Reserve Bank of St. Louis.

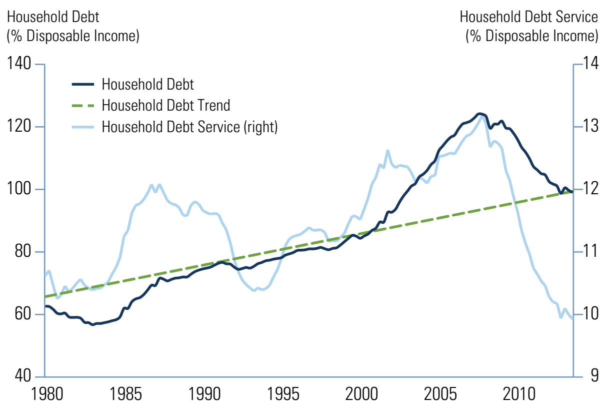
housing, relative to rent, back in line with its historical average (see Exhibit 39). Meanwhile, home prices relative to per capita disposable income remain deeply depressed. In either case, valuations stand considerably below their peak levels, a fact that runs counter to the notion of another housing bubble.

Of equal importance, neither the strength of housing prices nor the increase in mortgage rates has undermined the appeal of buying a home. As shown in Exhibit 40, housing affordability is near record levels, having been better only 12% of the time since 1981. In fact, it would take a meaningful rise in both rates and home prices to eliminate today's record affordability, suggesting that fears about rising rates may be premature.

On this point, the recent recovery in housing starts, new home sales and the NAHB index to post-crisis highs, despite a similar recovery in interest rates, suggests that the soft patch of housing data late last year could have had more to do with uncertainty surrounding the government shutdown than it did with mortgage rates. If so, housing should benefit further from the fading political uncertainty and still-low interest rates we expect this year.

Exhibit 41: Measures of US Households' Debt Burden

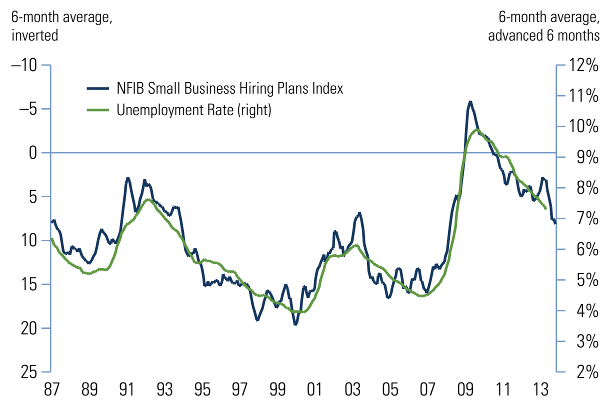
Consumer deleveraging is well advanced, removing a key headwind to growth.



Data as of Q3 2013.
Source: Investment Strategy Group, Datastream, Federal Reserve Board, US Department of Commerce.

Exhibit 42: Small Business Hiring Plans vs. US Unemployment Rate

Leading indicators suggest lower unemployment levels ahead.



Data as of November 2013.
Source: Investment Strategy Group, Bureau of Labor Statistics, Datastream, National Federation of Independent Business.

Consumption

Several factors point to a pickup in consumer spending this year, a notable development in an economy where consumption represents about 70% of GDP. First, household net worth reached an all-time high in 2013, bolstered by strong housing and equity gains. In fact, last year's estimated $9 trillion increase was the single largest on record. The spirited home price gains that contributed to this improvement also strengthened home equity; just 13% of homeowners remained underwater on their mortgages at the end of last year, a significant improvement from 25% in 2011.

Second, and partly as a consequence of the first point, the drag from consumer deleveraging is dissipating. As shown in Exhibit 41, the household debt-to-income ratio has retreated significantly, while the debt service ratio has collapsed to historic lows. In turn, rising net worth and lower debt service costs should decrease consumers' need for precautionary savings, providing a tailwind to spending.

Third, gasoline prices dropped about 40 cents per gallon in the last five months of 2013 and are now declining on a year-over-year basis. In turn, lower energy costs should provide a boost to consumer spending and reduce business transportation costs, aiding corporate profitability.

Finally, leading indicators of employment and recent business surveys suggest that the US labor market is healing (see Exhibit 42). While the bulk of this improvement is rooted in the private sector, it is noteworthy that state and local payroll growth has also turned positive, removing a persistent drag. Taken together, we expect these factors to support non-farm payroll growth of around 190,000 jobs per month, with unemployment falling to just above 6.5% in late 2014.

Several factors point to a pickup in consumer spending this year, a notable development in an economy where consumption represents about 70% of GDP.

Business Investment

The improvement in consumer demand discussed above has positive implications for capital expenditures, as does reducing the uncertainty that has discouraged investment in recent years. On this point, the recently passed budget agreement greatly lowers the risk of a government shutdown this year, removing one source of corporate angst. Similarly, broader economic clarity is emerging, as evidenced by fewer negative newspaper articles, a reduction in temporary tax measures and less dispersion in economic forecasts (see Exhibit 43). Moreover, economically significant regulatory changes declined by 40% last year, while the expiration of various tax breaks, such as the Bush tax cuts, has reduced uncertainty about the contours of future tax policy. In fact, the dollar value of tax provisions that expire in the next 10 years has plunged by 80% since 2012.[36]

With the fog of uncertainty clearing, corporate spending should increase, especially given a legitimate need to upgrade aging equipment (see Exhibit 44). Investment should also benefit from a handful of additional catalysts, including economy-wide profits that stand 18% above their 2006 peak; easing bank-lending standards; still-low borrowing rates; more than $1 trillion of cash on S&P 500 balance sheets; and recent strength in leading indicators, such as semiconductor industrial production and regional capital expenditure surveys.

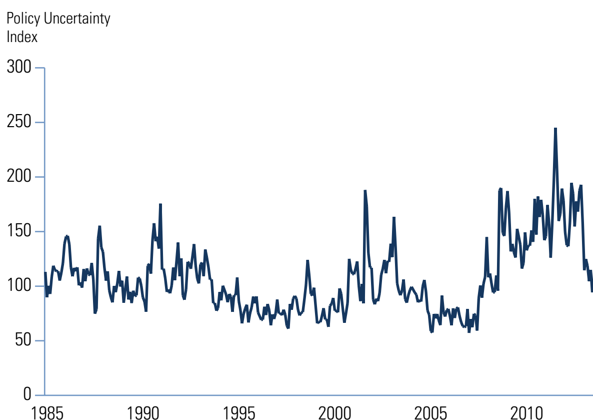
Taken together, these developments support our expectation for mid-single-digit growth in business investment in 2014.

Our View on US Growth

While the 2.8% real GDP growth we expect this year may not seem like escape velocity, its drivers—a pickup in consumption, further investment growth, a resilient housing market and abating uncertainty, both political and economic—has all the requisite ingredients. Of equal importance, we reach this inflection point with still-sizable slack in the economy, suggesting tepid inflationary pressures and hence less urgency for the Federal Reserve to hike interest rates despite improving growth. Far from contradicting the last point, the Federal Reserve's recent tapering decision represents a vote of confidence that the US recovery is resilient enough to prosper with fewer bond purchases. We agree.

Exhibit 43: Economic Uncertainty Index

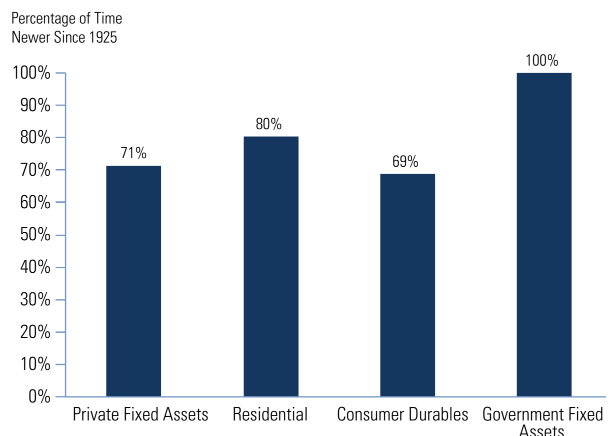
Falling uncertainty should remove a key headwind to private sector spending.



Data as of November 2013.
Source: Investment Strategy Group, www.policyuncertainty.com.

Exhibit 44: Percentage of Time Durables Have Been Newer Than Today

There is a legitimate need to upgrade aging equipment.



Data as of 2012.
Source: Investment Strategy Group, Bureau of Economic Analysis.

Eurozone: A Sluggish Recovery

After six quarters in recession, the Eurozone returned to positive growth in the second quarter of 2013. Yet this headline expansion belies a significant dispersion among the monetary union's member states. Whereas core countries, such as Germany, are growing again, many of their peripheral brethren, such as Italy, remain mired in recession. Partly as a consequence, the recovery thus far has been tepid by historical standards, with GDP increasing just 0.1% sequentially in last year's third quarter.

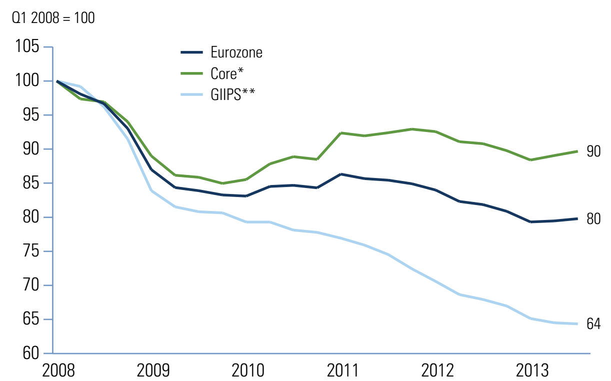
Despite its humble beginning, the region's recovery will likely continue in 2014 for several reasons. As in the US, the drag on growth from fiscal austerity will diminish significantly this year, falling from around 0.7 percentage points of GDP in 2013 to just 0.2 in 2014.[37] In fact, EU authorities explicitly reduced fiscal deficit targets last year to give states more latitude in pursuing structural reforms. Additionally, the stronger global growth we expect should directly benefit Eurozone exports, with net trade likely contributing almost half of Eurozone GDP growth this year.

Accommodative monetary policy should also support the recovery. With inflation set to remain under the ECB's comfort zone of below but close to 2%, the Eurozone's official policy rate should remain well below average, with additional cuts possible. At the same time, the ECB's pledge to provide unlimited liquidity to banks until at least 2015 should temper interbank borrowing costs and reduce fears of another bank-funding crisis. Not coincidentally, Bloomberg's Eurozone Financial Conditions Index suggests the level of financial stress in Eurozone money, bond and equity markets is now almost one standard deviation below normal. This greater accommodation should be supportive of investment, both in physical assets, given currently depressed capital stocks (see Exhibit 45), and in financial assets, already evidenced by last year's 23% rally in the Euro Stoxx 50 and 11% gain in peripheral bonds.[38]

Nevertheless, we should not mistake expansion for robust growth. Several headwinds will likely

Exhibit 45: Fixed Investment in the Eurozone

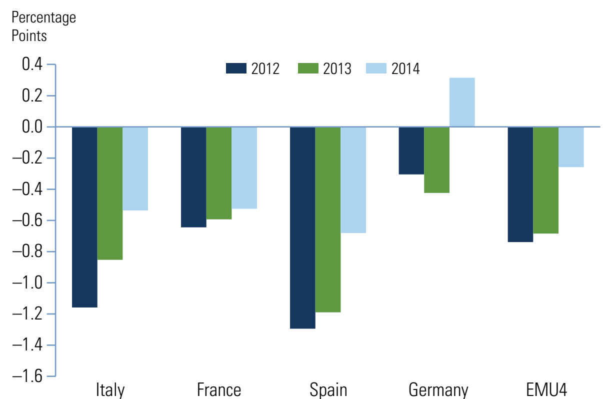
Currently depressed investment levels in the Eurozone provide scope for upside.



Data as of Q3 2013.
*Core = Eurozone ex-GIIPS.
**GIIPS = Greece, Ireland, Italy, Portugal and Spain.
Source: Investment Strategy Group, Datastream, Eurostat.

Exhibit 46: Impact of Fiscal Policy on GDP Growth

Fiscal policy will still weigh on growth in most of the Eurozone, despite being less of a drag than it was last year.

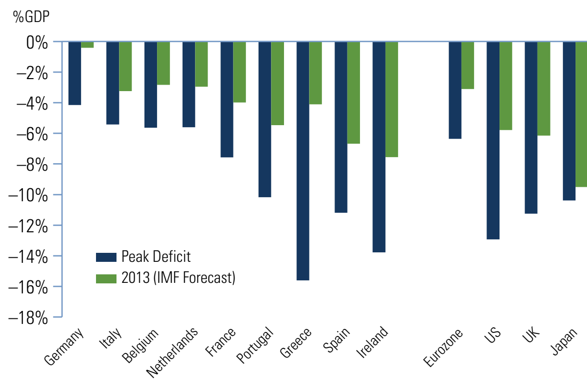


Data as of December 2013.
Note: Based on announced fiscal plans and GS GIR fiscal multiplier estimates.
Source: Investment Strategy Group, Datastream, GS Global Investment Research, national sources.

restrain GDP growth to a range of 0.25–1.25% in 2014, well short of the approximately 2% growth typically realized in the first year of Eurozone recoveries since 1970. First, fiscal policy will still weigh on growth, despite being less of a drag than it was last year (see Exhibit 46). The typical

Exhibit 47: Eurozone Budget Deficits

The Eurozone has made significant progress in reducing its budget deficits.



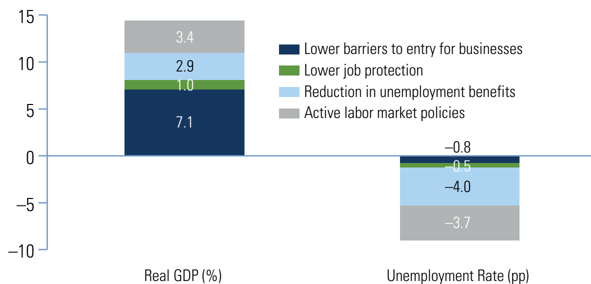
Data as of 2013.

Note: The budget deficit peaked in 2010 for Germany, and in 2009 for the other countries included in the chart.

Source: Investment Strategy Group, Datastream, IMF.

Exhibit 48: Impact of Structural Reforms on the Eurozone

Structural reforms could provide a sizable boost to growth and employment in the long run.



Data as of 2013.

Note: Based on OECD simulations that assume that the reforms close the gap between the Eurozone and OECD "benchmark countries": US, UK, Canada, Australia, New Zealand, Denmark and Sweden. Lower job protection is a reduction in firing costs and/or workers' bargaining power (e.g., via less centralized wage setting). Lower unemployment benefits is a lower wage replacement rate. Active labor market policies are measures increasing efficiency in job search and matching.

Source: Investment Strategy Group, OECD.

Eurozone recovery, by contrast, benefited from expansionary fiscal policy that added about 0.15 percentage points to growth on average.

Second, continued political volatility makes household and business confidence unlikely to rebound as strongly as it would in a normal recovery. Mario Monti's reformist Italian government collapsed after a single year, only to be followed by a hung parliament and policy inaction. Meanwhile, Portugal's finance minister resigned after he was unable to implement measures required by that country's international lenders. These examples, in addition to the about-face by Eurozone policymakers on the fate of Cypriot depositors, serve as poignant reminders that decisions within the EU will likely remain incremental, reactive and, at times, inconsistent. In this environment, policy uncertainty is likely to persist.

Third, while ECB measures have reduced policy rates and broadly lowered borrowing costs, access to credit remains tight for small and medium-sized enterprises (SMEs) in the peripheral countries. The percentage of SMEs reporting that access to finance is their most pressing problem has remained elevated throughout the last several years, despite the extraordinary measures of the ECB. That said, this drag should not be overemphasized, as historical experience suggests that GDP can recover despite subdued credit.[39]

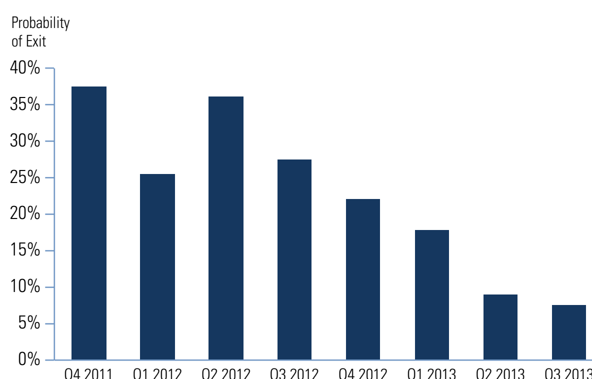
In short, we expect a lethargic recovery, and hence one more susceptible to shocks, both homegrown and foreign (see Section I of the *Outlook* for a more detailed discussion of Eurozone risks). Even so, we should not lose sight of the significant strides the Eurozone has taken to reach this point. As shown in Exhibit 47, country-level fiscal reforms are bearing fruit, reducing budget deficits across the Eurozone by more than half. And while undertaking further structural reforms will remain a politically unsavory and challenging process, the long-term upside to Eurozone growth from reducing inefficiencies and improving competitiveness is sizable (see Exhibit 48).

At the same time, institutional tools such as the European Stability Mechanism (ESM) and the ECB's Outright Monetary Transactions (OMT) facility

have greatly reduced the risks of global contagion (see Exhibit 49), an important driver of last year's robust market gains. Similarly, with the ECB slated to begin credible stress tests of the region's banks this year, important steps toward breaking "the vicious link between sovereigns and their banks"[40] are being taken, even if true banking union with deposit guarantees and a common fully funded backstop for failed banks remains years away.

Exhibit 49: Eurozone Member Exit Probability

Perceived probability of a member exiting the monetary union has decreased significantly.



Data as of November 2013.
Note: Average probability assigned by UK chief financial officers to the likelihood of any exiting euro-area member.
Source: Investment Strategy Group, Bank of England.

United Kingdom: An Unexpected Growth Revival

After lagging the recovery of most developed economies in the post-crisis period, UK growth accelerated strongly last year thanks to a confluence of positive developments. In particular, receding Eurozone tail risks boosted confidence, while the Bank of England's (BOE's) Funding for Lending Scheme and government mortgage guarantees helped credit growth and the housing market rebound. These same factors should enable growth to continue at a robust pace.

Overall, the UK should remain a direct beneficiary of improving growth in the Eurozone, considering the region accounts for half of the UK's exports. Of equal importance, the ECB's administration of credible bank stress tests this year should provide a further boost to business and consumer confidence across the European Union, as should the implementation of further structural reforms. Consequently, private demand in the UK should continue to recover. While growth in consumption, which accounts for almost 70% of UK GDP, will likely be the primary driver, we expect business investment to contribute to growth as well. Already, investment intentions based on CFO surveys have picked up sharply in recent months, a welcome development considering capital expenditures remain approximately 25% below their prior peak.

Although this growth revival is encouraging news for an economy seemingly mired in stagnation just a year ago, it is not without risks. Inflation remains problematic, particularly because headline inflation has been in excess of the BOE's 2% target for several years. At the same time, the Monetary Policy Committee has affirmed guidance that it will keep rates low until the unemployment rate declines another 0.4 percentage points. Meanwhile, uncertainty around a potential referendum on the UK's membership in the European Union could weigh on private sector confidence later this year.

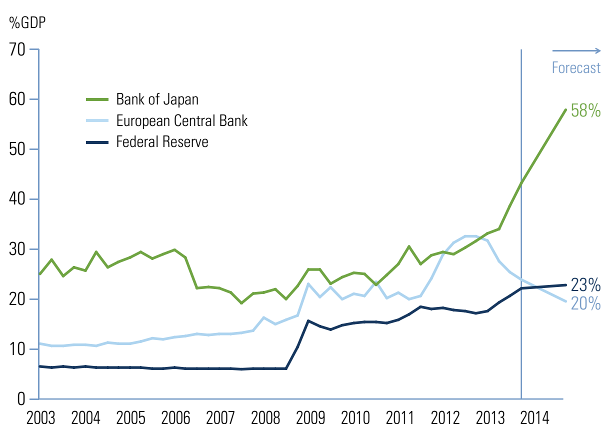
The ECB's administration of credible stress tests this year should provide a further boost to business and consumer confidence across the European Union.

Japan: Three Arrows but Only One Bullseye

There is little doubt that Prime Minister Shinzo Abe hit a bullseye with the first of his "Three Arrows" to reform the Japanese economy. After all, the first arrow envisioned bold monetary policy, and the Bank of Japan (BOJ) certainly obliged, committing to double the monetary base by the end of 2014. As shown in Exhibit 50, the resulting monetary expansion is the largest among major developed central banks, a notable distinction in a world awash in quantitative easing. Not surprisingly, the yen depreciated about 17% on a trade-weighted basis last year in response, contributing to soaring corporate profits, a 54% gain in the Topix index and an upturn in inflation expectations after decades of deflation.

Exhibit 50: Central Bank Balance Sheets

The Bank of Japan's monetary expansion is unmatched among central banks.



Data as of December 2013.
Source: Investment Strategy Group, Datastream.

In comparison, progress on the other aspects of "Abenomics" has been more elusive. Cutting the budget deficit without hobbling growth, the objective of Abe's second arrow, will be highly challenging given Japan's fiscal profile: the country runs a chronic 10% of GDP budget deficit and its debt represents 240% of GDP, the highest of all 175 countries tracked by the IMF. Highlighting this tension, the government had to soften the impact of this year's consumption tax hike by providing another round of fiscal stimulus.

Achieving faster growth through structural reforms, the intent of Abe's third arrow, has been equally challenging. In one telling example, an agreement on the Trans-Pacific Partnership—a key component of structural reform—was delayed from the end of 2013 to 2014. Needless to say, overcoming Japan's deeply entrenched special interests and broader cultural norms in pursuit of labor and immigration law reform will prove daunting.

Therefore, it would be premature to declare Abenomics a success. Wages have failed to keep pace with the increase in inflation, further eroding the purchasing power of Japanese households and highlighting the difficulty of implementing labor reforms. Meanwhile, job applicants still outnumber open positions and sequential employment gains have been modest, although both measures are improving. These already weak consumer fundamentals will face an additional headwind from the consumption tax hike planned for April.

Based on the foregoing, we expect Japan's headline GDP growth to weaken this year and keep inflation below the BOJ's 2% target, necessitating another round of quantitative easing.

There is little doubt that Prime Minister Shinzo Abe hit a bullseye with the first of his "Three Arrows" to reform the Japanese economy.

Emerging Markets: Structural Fault Lines vs. Cyclical Tailwinds

Growth in emerging economies fell well short of expectations in 2013, marking the second consecutive year of below-trend expansion. Although part of this underperformance was cyclical in nature, structural shortcomings were also in play (see Exhibit 51). As we argued in our recent *Insight* piece, *Emerging Markets: As the Tide Goes Out*, the failure of emerging countries to implement meaningful structural reforms is holding back their growth potential. For the year ahead, we fear this trend will continue, as looming elections will again delay needed reform measures. After all, countries holding elections in 2014 account for almost a quarter of emerging market GDP.

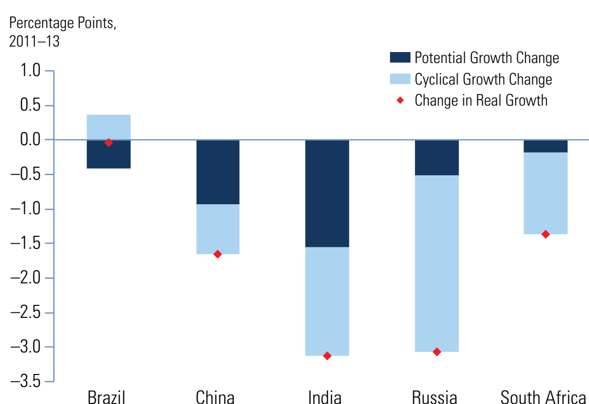
Despite these structural challenges, the cyclical backdrop for emerging economies is arguably improving. The stronger global growth we expect should increase external demand, boosting emerging market exports. However, tighter financial conditions arising as the Federal Reserve tapers its bond purchases will likely temper this improvement.

The interplay between these structural and cyclical dynamics will not be uniformly felt. Those countries with twin fiscal and current account deficits, such as Turkey, South Africa and India, will have to curtail domestic demand growth and raise rates as the Federal Reserve tightens monetary policy, or else risk even larger deficits and destabilizing capital outflows. By contrast, countries with stronger balance sheets, such as South Korea and Mexico, will have more freedom to pursue pro-growth policies and let their exchange rates absorb external shocks.

With structural and cyclical forces pulling in opposite directions, we project only a moderate rise in GDP growth in emerging economies, from 4.9% in 2013 to 5.2% in 2014.

Exhibit 51: Composition of GDP Growth Changes

Slowing emerging market growth reflects both cyclical and structural elements.



Data as of 2013.
Note: Estimates of cyclical and potential growth are based on a multivariate filter.
Source: Investment Strategy Group, IMF.

Emerging Asia

When its two largest economies sneeze, emerging Asia catches a cold. Such was the case last year, as disappointing export growth and slowing activity in China and India weighed on the region's performance. While better growth in the US and Europe should help fuel export demand in 2014, that benefit will likely be offset by the need for tighter policy: in China, to slow down credit and investment growth; in India and Indonesia, to avoid a further widening in fiscal and current account deficits. On balance, we expect emerging Asia GDP growth to increase only modestly this year.

China: The economy slowed last year, reflecting both weaker global demand and initiatives by the newly installed leadership to curtail credit expansion. A deceleration in second-quarter GDP growth to the new leaders' 7.5% year-over-year target quickly tested their tolerance for slower growth and serious reform. The leadership blinked in response, introducing a mini-fiscal stimulus that inoculated the economy against a further slide and set the stage for improving growth in the second half of 2013. It also served as a reminder of the challenges facing reform efforts in China.

On this point, the government unveiled a detailed reform plan for the coming years following the Third Plenary Session of the 18th Party Congress. As we discussed in our recent *Insight* piece on emerging markets, China faces a catch-22

in pursuing needed reforms. If reforms are too slow, China risks even greater imbalances, and a commensurately larger crisis somewhere down the line. Yet if reforms are too rapid, the potential for an immediate crisis becomes more acute.

How China balances these competing tensions will shape its growth trajectory for years to come. Chinese leaders seem aware that any serious reform effort will entail slower growth. To quote President Xi Jinping: "China has realized that it has to advance structural reforms in order to solve the problems hindering its long-term economic development, even though it will mean slower growth."[41] At present, the nation's leadership appears reluctant to engineer an abrupt slowdown. As a result, it is likely to pursue reforms that are least harmful to GDP, easier to implement and enacted incrementally over time to assess their evolving impact, as opposed to those most needed to rebalance the economy in the near term.

Against this backdrop, we expect a modest deceleration in GDP growth to 6.8–7.8% and stable inflation in 2014, with stronger external demand only partially offsetting weaker domestic demand. This slower growth also reflects less accommodative fiscal policy resulting from the lessening effects of last year's mini-stimulus, as well as tighter financial conditions arising from the leadership's continued efforts to curb excessive credit growth.

India: The Indian economy continues to suffer from dysfunctional politics in Delhi and a largely stalled structural reform agenda. Even prospects of a ratings downgrade and the pressure brought on by the onset of tapering in the US have not spurred India's leaders to act with sufficient decisiveness. For example, a cabinet committee was set up in 2013 to fast-track infrastructure projects held up by bureaucratic delays, but it has thus far moved slowly and has failed to kick-start a new and much-needed investment cycle.

Given these challenges, we expect only a modest improvement in GDP growth to 4.5–5.5% in 2014, still well below the pre-crisis rate of 9.1% a year. As in other emerging markets, an improving external environment should support stronger exports, as should the recent 11% depreciation of the rupee on a trade-weighted basis. Nevertheless, the relatively small size of India's export sector will limit its contribution to headline GDP growth, particularly in the face of supply-side bottlenecks and a lack of progress on structural reforms. Moreover, with virtually no room in the budget, the likelihood for meaningful fiscal stimulus ahead of upcoming elections seems remote. Similarly, persistent inflationary pressures will constrain the central bank's maneuvering room, despite the credibility it gained by nominating an internationally respected governor.

Latin America

Economic growth in Latin America was lackluster in 2013 under the weight of weak external demand, lower commodity prices and tightening financial conditions. Here again, the improving fortunes of the advanced countries should help in 2014. Even so, growth is likely to remain weak and uneven by historical standards given still-lingering headwinds.

Within Latin America, Mexico stands out as the biggest beneficiary of stronger external demand, given its close trade links with the US and recent gains in competitiveness versus China. Ongoing structural reforms and a strong macroeconomic policy framework should shield Mexico from the decline in global liquidity arising from the start of the Federal Reserve's tapering.

With structural and cyclical forces pulling in opposite directions, we project only a moderate rise in GDP growth in emerging economies in 2014.

The Brazilian government undermined its credibility last year through an activist industrial policy, fiscal slippage and exchange rate intervention.

Brazil: GDP growth accelerated in 2013, led by robust consumption and strong investment spending in the first half of the year. However, the revival in investment proved short-lived, as a combination of a 275-basis-point hike in interest rates, weak commodity prices and "interventionist haphazard cyclical management of the economy"[42] weighed on growth in the second half.

To be sure, ebbing confidence in government policy could haunt growth in 2014. The Brazilian government undermined its credibility last year through an activist industrial policy, fiscal slippage and exchange rate intervention. Meanwhile, the central bank suffered the same fate by allowing inflation to exceed its already wide 2.5–6.5% target band before tightening. With general elections coming up in October 2014, a major policy reversal seems unlikely in the near term.

Based on the foregoing, we expect stable but below-trend GDP growth of 1.8–2.8% in 2014. Fiscal policy will likely slip further in the run-up to elections, but tight monetary policy should keep inflation in check.

Europe, Middle East and Africa (EMEA)

The economic performance of countries in the EMEA region was mixed in 2013. Turkey and Hungary experienced stronger growth, while Russia, Poland and South Africa endured a slowdown in activity. As the countries in this grouping have considerable export exposure to the Eurozone, we expect them to see a modest acceleration in GDP growth in 2014. However, with fiscal and monetary policy already loose across the region, the room for further stimulus is limited, especially in Turkey and South Africa, two of the economies most vulnerable to tighter global liquidity.

Russia: The Russian economy has been slowing amid weak investment and range-bound energy prices. While some of this deceleration reflects cyclical factors, deep structural reforms are necessary to remedy the persistently difficult business climate that has hobbled investment. Meanwhile, consumption is also faltering given slowing wage growth and a clampdown on unsecured consumer loans.

As a result, we believe Russia is trapped in a low-growth state and expect only a modest cyclical uptick to 2–3% GDP growth in 2014. Two additional factors underpin this view. First, there will be little monetary stimulus, as the central bank will likely have to wait until inflation is firmly on a downward path in the latter half of the year before cutting rates to support growth. Second, Russia could face even more capital outflows, despite its low external financing needs and moderate debt levels, if investors continue to withdraw from emerging markets. In such an environment, domestic investors are likely to move assets to safe havens abroad given concerns about the fragile elements of Russia's banking system.

A Narrower Margin of Safety

"The margin of safety is always dependent on the price paid. It will be large at one price, small at some higher price, [and] nonexistent at some still higher price."

– BENJAMIN GRAHAM

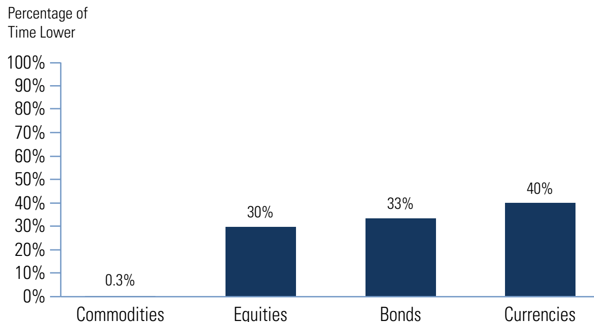
AT THE DEPTHS OF THE FINANCIAL CRISIS of 2008–09, deeply depressed asset valuations provided investors with a large margin of safety, even against the highly uncertain political and economic crosscurrents of the time. Put simply, if the world avoided a second Great Depression, assets priced for that outcome were set to deliver exceptional returns as fundamentals normalized. Today, with the price of the S&P 500 index 173% above its crisis lows, that margin of safety has clearly eroded.

As a result, we start the year with less of a buffer to absorb adverse developments and miscalculations in our forecasts. This observation is not limited to US equities. Across financial markets, the strong recovery in asset values since the crisis trough has compressed the once-large risk premiums available to investors. Even investment-grade bond purchasers face a narrower margin for error today, as still historically low interest rates adjust to an improving global economy. Consider that 10-year government bond yields in all G-7 countries have been higher at least 90% of the time since 1958. Less visibly, more than $1.3 trillion flowed into bond mutual funds while 10-year Treasury yields were below 3%, creating a large pool of investments that are now susceptible to losses from rising interest rates.

This backdrop has several important implications for financial

Exhibit 52: Percentage of Time that Volatility Has Been Lower by Asset Class

Volatility is low across asset classes, in part reflecting global central bank liquidity.



Data as of December 31, 2013.
Note: Using 252-day realized volatility and based on data since March 2001. Indexes used: Commodities: S&P GSCI; Equities: S&P 500, MSCI Europe, DAX, Topix and Hang Seng; Bonds: Barclays US Aggregate and JPM EMU Government 1–10 Years; Currencies: USD vs. EUR, GBP and JPY.
Source: Investment Strategy Group, Bloomberg, Datastream.

markets. First, investors should expect more modest returns, as strong erstwhile performance has borrowed from future years' gains. Second, the volatility of those returns is likely to be higher. With risky assets now priced for a more benign state of the world, they are more vulnerable to disappointment. Similarly, the eventual withdrawal of extraordinary central bank liquidity is likely to increase volatility, just as their purchases of financial assets over the past four years—approximately $7.5 trillion in total—reduced it (see Exhibit 52). Finally, the penalty for being wrong is now greater, as we begin from higher valuations.

That said, we need to differentiate a slimmer margin of safety from certainty of loss. As we detailed in Section I of this year's *Outlook*, US equities still offer positive expected returns (see Exhibit 53), making them particularly attractive relative to most fixed income investments. In the same way, US high-yield corporate credit, US banks, US technology stocks, European equities and hedged positions in Japanese equities also offer investors an attractive alternative to high-quality bonds. Moreover, today's unusual combination of highly accommodative monetary policy and improving economic momentum represents a potent elixir for risky assets.

In brief, there is still a bridge to higher risk-asset values, but it is a narrower and shorter walkway than before.

Exhibit 53: ISG Global Equity Forecasts: Year-End 2014

We expect positive total returns across equity markets this year.

	2013 YE	End 2014 Central Case Target Range	Implied Upside from Current Levels	Current Dividend Yield	Implied Total Return
S&P 500 (US)	1,848	1,825–1,900	–1%–3%	2%	1%–5%
Euro Stoxx 50 (Eurozone)	3,109	3,200–3,400	3%–9%	4%	6%–13%
FTSE 100 (UK)	6,749	7,050–7,350	4%–9%	4%	8%–13%
Topix (Japan)	1,302	1,275–1,350	–1%–5%	2%	0%–6%
MSCI EM (Emerging Markets)	1,003	1,010–1,090	1%–9%	3%	4%–12%

Data as of December 31, 2013.
Source: Investment Strategy Group, Datastream.

EAFE Equities: Patience Is a Virtue

There has been no shortage of concerns about the major EAFE (Europe, Australasia, Far East) economies in recent years. While the systemic risk of Eurozone dissolution remains chief among them, the prospect of a Eurozone banking crisis or economic stagnation also figures prominently, as do the potentially harmful effects of Japan's recent monetary expansion. Market returns have no doubt reflected this angst. In five of the last six years, EAFE equities have underperformed US equities. Moreover, they remain 21% below their 2007 peak, even as the S&P 500 has reached new all-time highs.

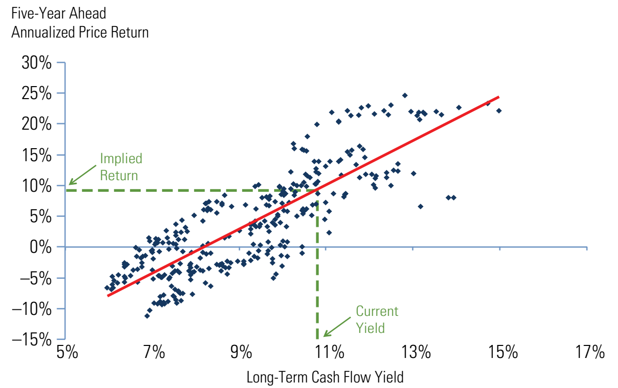
As a result, clients are increasingly questioning their allocation to EAFE equities. While the allure of selling now is understandable, we believe the market will ultimately reward their patience. Current EAFE valuations are very attractive, having been lower 33% of the time since 1969. As such, they provide an ample margin of safety against the oft-cited concerns discussed above.

As shown in Exhibit 54, valuation has been a key determinant of subsequent EAFE equity returns and today's message is bullish. Even when we include a broader range of measures, valuations comparable to today's levels generated positive returns 92% of the time over the subsequent five years, with an average price gain of 14% (see Exhibit 55).

These valuations, coupled with an expected

Exhibit 54: Long-Term Cash Flow Yield vs. Subsequent Five-Year Returns

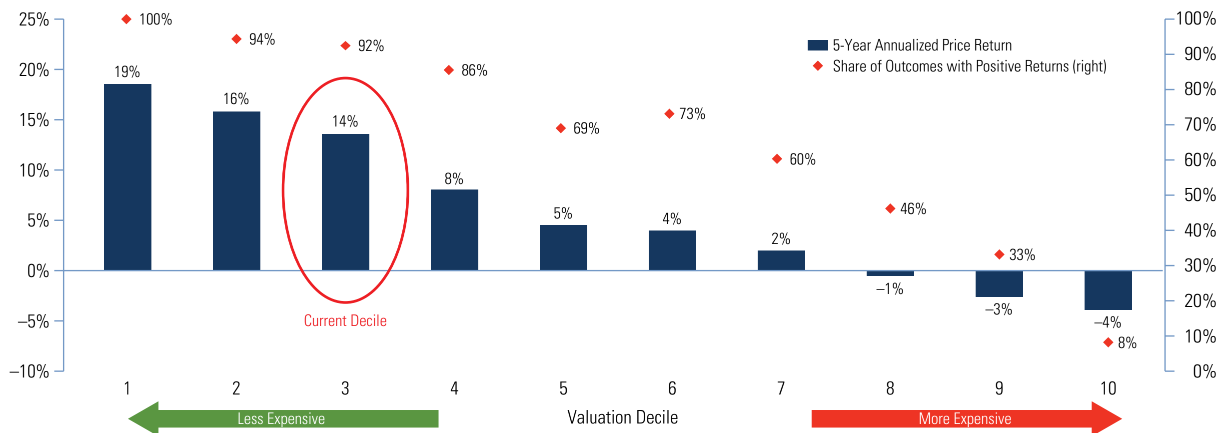
Today's valuations have led to attractive EAFE equity returns historically.



Data as of December 2013.
Source: Investment Strategy Group, Datastream, MSCI.

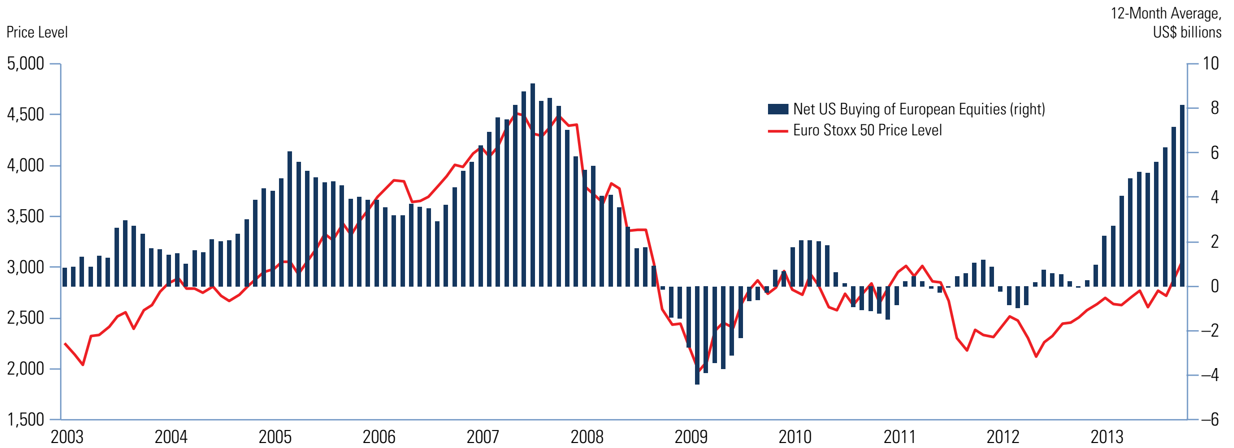
Exhibit 55: Historical Valuation Deciles and Subsequent EAFE Equity Returns

Valuations comparable to today have generated attractive returns historically.



Data as of December 2013.
Note: Each decile reflects an average of five valuation measures: price to book, price to 10-year average cash flow, price to peak cash flow, price to 10-year average earnings and price to peak earnings.
Source: Investment Strategy Group, Datastream, MSCI.

Exhibit 56: Net US Purchases of European Equities
Buying by US investors has historically underpinned equity gains.



Data as of October 2013.
Source: Investment Strategy Group, Datastream, Haver Analytics, US Treasury.

dividend yield of 3% and an improving global growth backdrop that should foster a pickup in earnings growth, position EAFE equities to deliver double-digit total returns over the next five years. This return is attractive not only in absolute terms, but also compared to other asset classes, including both investment grade fixed income and US equities. Thus, we recommend that clients remain fully invested in EAFE equities on a strategic basis and tactically overweight certain countries.

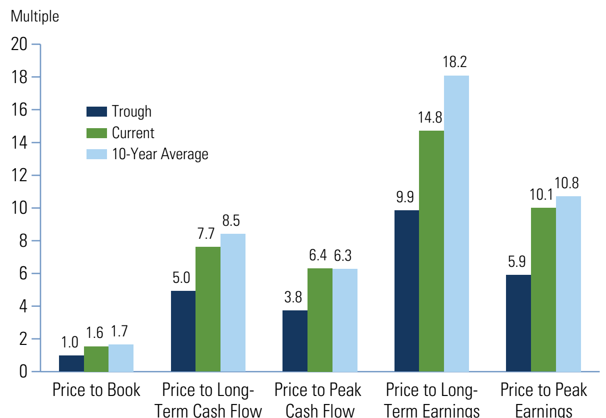
We discuss our view on select EAFE countries and regions next.

Eurozone Equities: On the Path to Normalization

Despite two years of double-digit returns and a marked uptick in investor sentiment, Eurozone equities remain attractive. In fact, the Eurozone contains the best tactical opportunities within EAFE, based on its still-depressed valuations, below-trend profit margins, high dividend yield and scope for additional investor inflows. In the year ahead, we expect receding Eurozone tail risks, incremental progress on needed structural reforms and strengthening global growth to move Eurozone equities closer to pre-crisis norms.

To be sure, Eurozone equities have already embarked on this path. After several years of apathy, US investors are purchasing Eurozone equities again. As seen in Exhibit 56, US

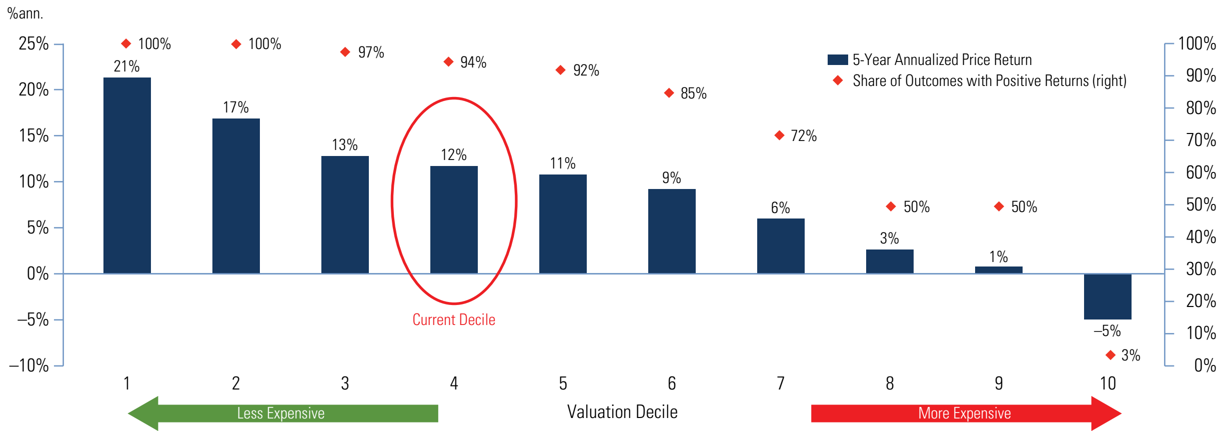
Exhibit 57: MSCI EMU Valuation Multiples
Eurozone valuations have recovered from trough levels but still offer ample upside.



Data as of December 2013.
Source: Investment Strategy Group, Datastream, MSCI.

Exhibit 58: Eurozone Equity Returns Arising from Each Valuation Decile

Current valuations have preceded positive price returns over the subsequent five years 94% of the time historically.



Data as of December 2013.

Note: Each decile reflects an average of five valuation measures: price to book, price to 10-year average cash flow, price to peak cash flow, price to 10-year average earnings and price to peak earnings.

Source: Investment Strategy Group, Datastream, MSCI.

buying has closely aligned with the direction of Eurozone equities historically. Of equal importance, recent purchases have only offset the redemptions that occurred during the crisis and represent just one-third of the heady inflows seen during the previous bull market, suggesting scope for upside. In turn, a further normalization in inflows should represent an important catalyst for Eurozone equities.

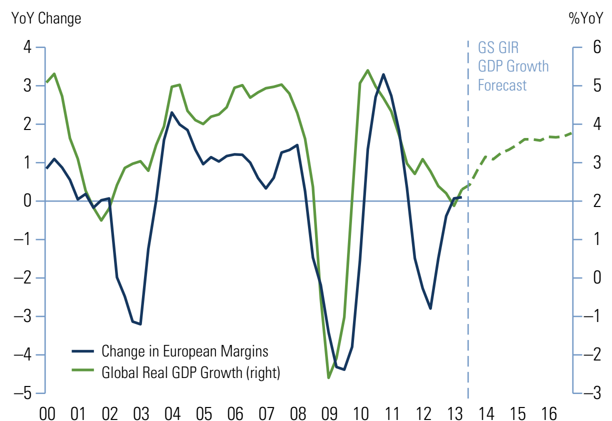
Similarly, Exhibit 57 (see previous page) highlights that while Eurozone valuations have recovered from trough levels, they remain below historical averages and still imply an attractive upside for investors. Indeed, current valuations have preceded positive price returns over the subsequent five years 94% of the time historically, with an average price return of 12% (see Exhibit 58).

At the same time, Eurozone margins stand to benefit from improving global growth. Exhibit 59 shows the tight correlation between the two historically. This relationship highlights the operating leverage of Eurozone companies; an increase in sales results in a larger increase in earnings because of more fixed costs than variable costs in their businesses. The synchronized worldwide expansion we expect this year should drive both faster sales growth and higher profit margins in the Eurozone, resulting in earnings growth of around 6%.

In short, we expect all three drivers of equity returns—earnings growth, multiple expansion and dividend yield (estimated at 3.5%)—to support a total return of 6–13% in 2014. Therefore, we

Exhibit 59: Global Real GDP Growth vs. Change in European Profit Margins

Eurozone margins stand to benefit from improving global growth.



Data as of December 2013.

Source: Investment Strategy Group, Datastream, Goldman Sachs Global Investment Research.

recommend investors remain overweight the Euro Stoxx 50.

Other countries and sectors within the Eurozone also present attractive tactical investment opportunities. Specifically, we recommend an overweight to Spanish equities, where still-depressed valuations do not yet reflect the country's considerable progress on structural reforms, including the stabilization of the banking system. Meanwhile, we are keeping a watchful eye on Italian equities and Eurozone banks for a tactical entry point, as both offer compelling valuations.

UK Equities: Good Returns but Less Upside

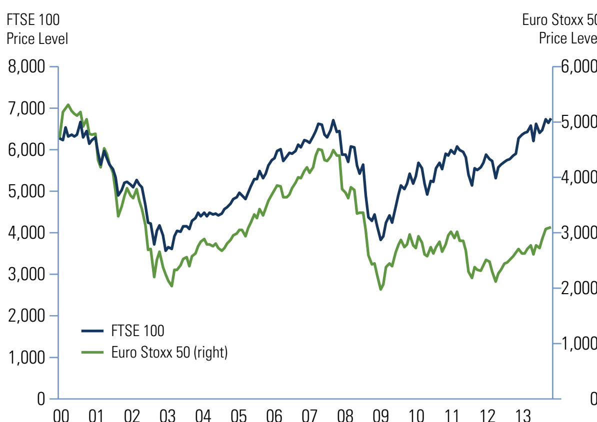
UK equities have substantially outpaced those in the Eurozone since 2009, as seen in Exhibit 60. In fact, while most EAFE equity markets remain well below pre-crisis levels, UK equities are trading higher than their 2007 peak. In light of this outperformance, we find the FTSE 100 relatively less attractive for a few reasons.

First, UK valuations stand closer to their historical median than those of the Eurozone. UK valuations have been higher 53% of the time since 1969 based on a blend of measures, compared with 62% for the Eurozone. Second, the UK dividend yield has been the most predictive metric of subsequent equity returns historically, and it currently implies just 3% annualized price returns over the next five years (see Exhibit 61). Finally, the fundamental prospects of the undervalued sectors of the UK market—energy, materials and healthcare—are particularly unfavorable, yet they account for nearly half of the FTSE 100's market cap.

While we are not recommending investors overweight the FTSE 100, we expect it to generate positive returns. Our base case is that earnings growth of 7%, combined with a slightly higher PE multiple and 3.5% dividend yield, should produce a total return of around 11%. That said, we see significantly less upside to our base-case equity returns in the UK than we do in the Eurozone given the valuation differentials discussed above. Moreover, investors in search of markets that have lagged and offer upside to pre-crisis levels are more likely to favor the Eurozone over the UK given the latter's outperformance in recent years. Thus, we do not include the FTSE 100 in our Eurozone overweight.

Exhibit 60: FTSE 100 vs. Euro Stoxx 50

UK equities have substantially outperformed Eurozone equities since 2009.



Data as of December 2013.
Source: Investment Strategy Group, Datastream.

Exhibit 61: Dividend Yield vs. Subsequent Price Returns for MSCI UK

Today's valuation implies just 3% annualized price returns for the next five years.

Data as of December 2013.
Note: Using data since 1969.
Source: Investment Strategy Group, Datastream, MSCI.

Japanese Equities: Déjà Vu All Over Again?

After several years of chronic underperformance, Japan was the best-performing major equity market in the world in 2013. All told, the Topix registered an impressive 54% total return in local currency terms, exceeding the second-best performing major equity market (US) by more than 20 percentage points. As a result, the Topix finished 2013 at a five-year high.

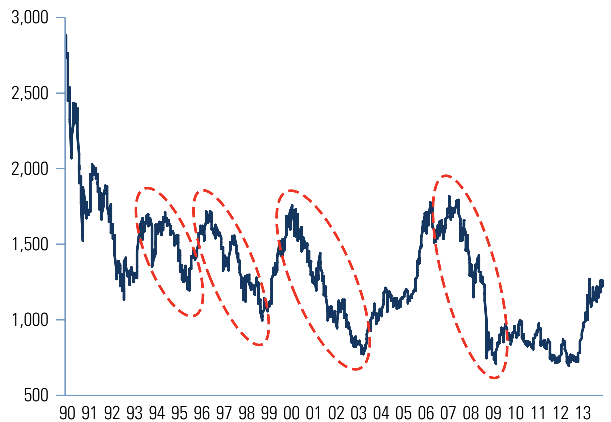
Of course, investors have seen this happen before. Over the last two decades, Japanese equities have posted four rallies exceeding 40%, only to see those gains erased within the subsequent one-to-two years (see Exhibit 62). Moreover, investors in Japan always have to be mindful of the country's formidable structural challenges. As we discussed in our 2013 *Outlook: Over the Horizon*, these include Japan's shrinking labor force, heavy debt burdens and almost annual turnover of prime ministers. No doubt the directionless pattern of trading that emerged in the second half of last year, after strong early gains, reflected investors' indecision about whether it is really different this time around in Japan.

While the ultimate fate of Japan under Abenomics remains unclear, some encouraging signs are emerging. Prime Minister Abe's approval rating remains above those of his predecessors at equivalent times in their tenure, and his first "arrow" of bold monetary policy has hit the bullseye, as was evident in the yen's 17% depreciation last year. The BOJ seems committed to use all tools at its disposal to end deflation. Meanwhile, several large companies have announced wage increases that, if followed by small and medium-sized enterprises, could help Japan reverse its deflationary spiral. These inflationary impulses are also benefiting from rising real estate and equity prices that together are boosting household net worth. Finally, Prime Minister Abe's government is attempting to encourage domestic households and institutions to invest more of their sizable savings in equities. If effective, this push could support further equity gains and simultaneously improve household balance sheets.

It is also worth noting that despite its strong advance last year, the Topix still has significant upside. When valuations have been comparable to today's levels in the past, subsequent returns were positive 88% of the time, with an average price gain of 12%. Successful reforms could boost these returns even more. The election in 2005, which handed Prime Minister Koizumi's party a supermajority and enabled him to pursue structural reforms, also helped spur a rally of over 50% in the Topix over the ensuing eight months. Of course, if policymakers fall short of

Exhibit 62: Topix Price Level Since 1990

The four biggest price rallies of the past 20 years were quickly erased.

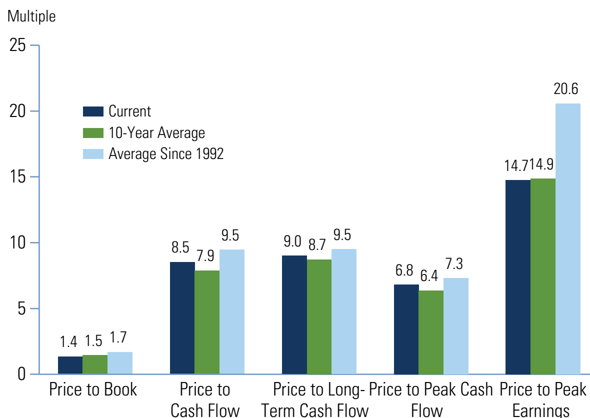


Data as of December 2013.
Source: Investment Strategy Group, Datastream.

It is also worth noting that despite its strong advance last year, the Topix still has significant upside.

Exhibit 63: MSCI Japan Valuations

Japanese valuations, across measures, still have upside to long-term averages.



Data as of December 2013.
Source: Investment Strategy Group, Datastream, MSCI.

their goals, the Topix could see its erstwhile gains evaporate quickly, as we have witnessed on several occasions in the past.

Thus, investors in Japan face a difficult trade-off. If sufficient political will materializes, there is sizable upside to equity prices as valuations return to their long-term averages (see Exhibit 63). If not, remaining invested in the market could be quite costly. While our central case puts more weight on a benign outcome, we nonetheless think that limiting risk makes sense given the penalty for being wrong. Therefore, we recommend that investors gain exposure to the Topix, but ensure that they implement it in a way that limits their downside exposure.

Emerging Market Equities: Less Than Meets the Eye

Emerging market equities faced a challenging year in 2013. Their 2% loss in dollar terms stood in stark contrast to the robust 30% gain of the MSCI World Index and extended a streak of underperformance relative to the S&P 500 that has widened to more than 60 percentage points since 2010. Negative fund flows no doubt contributed to this growing relative performance deficit, as last year's sizable $28 billion of withdrawals also marked the third year in the last six with net redemptions.

While a combination of price underperformance, deteriorating sentiment and seemingly attractive valuations would typically pique our interest, we remain tactically neutral on emerging markets at the moment. Absolute valuations are middling at best, standing just 0.3 standard deviations below their long-term average (see Exhibit 64), while the current discount to US equities is equally uninspiring (see Exhibit 65). The pockets of undervaluation that do exist are concentrated in countries (China and Russia) and sectors (banks, energy, materials and real estate) that we find less appealing. At the same time, the areas of greater appeal, such as Mexico, South Asia and the emerging market consumer and healthcare sectors, are more fully valued; they also represent crowded trades given their popularity with active managers over the last three years.

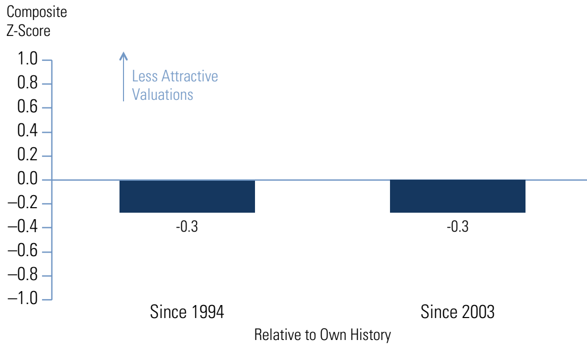
Perhaps most importantly, today's lower valuations are fundamentally justified by the decline in profitability we have seen since 2011, a trend we do not expect to reverse in the year ahead (see Exhibit 66). Until this measure stabilizes and begins to rise, the prospect of sustained multiple expansion is unlikely.

Today's lower emerging market valuations are fundamentally justified by the decline in profitability we have seen since 2011.

We see risks stemming from other areas as well. Our forecast for 6.5% earnings growth is almost half the rate of consensus forecasts for 2014.

Exhibit 64: Normalized Emerging Market Equity Valuations

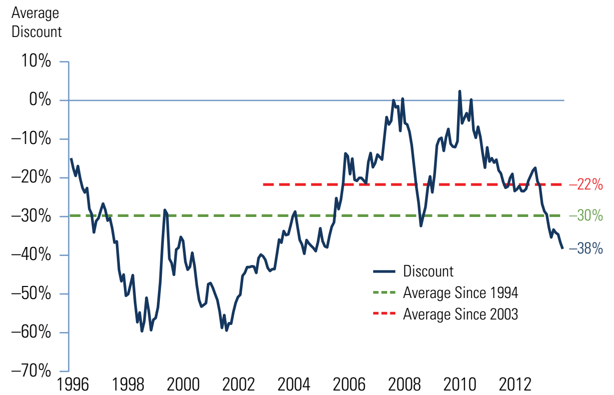
Current valuations are not compelling enough to justify an overweight.



Data as of December 31, 2013.
Note: Based on monthly data for Price/Forward Earnings, Price/Book Value, Price/Cash Flow, Price/Sales, Price/Earnings-to-Growth Ratio, Dividend Yield and Return on Equity.
Source: Investment Strategy Group, Datastream, I/B/E/S, MSCI.

Exhibit 65: EM Equities' Valuation Relative to the US

The current discount relative to the US does not offer a sufficient margin of safety.



Data as of December 31, 2013.
Note: Based on monthly data for MSCI EM, using Price/Earnings, Price/Book Value and Price/Cash Flow.
Source: Investment Strategy Group, Datastream, I/B/E/S, MSCI.

Moreover, the declining commodity prices we expect will exert a notable drag on basic resource firms, which account for approximately 50% of nonfinancial emerging market earnings. Finally, tapering in the US and the uncertainty brought on by national elections in Brazil, India, Indonesia, South Africa and Turkey increase the potential for higher domestic interest rates, which could further pressure emerging market fundamentals. Based on the foregoing, there is a much greater risk of downside in emerging market equities than our 8% return expectation for 2014 suggests.

While the current opportunity in emerging markets is less than meets the eye, we are mindful of the potential for upside surprises as well. A pickup in global growth that benefits emerging market exports, coupled with investors' current flat-to-underweight positioning, could quickly lead to higher emerging market equity prices. Weighing this likelihood against the aforementioned concerns suggests a roughly balanced risk and reward trade-off. Therefore, we retain our neutral weighting, but continue to seek out relative value opportunities within emerging markets.

Exhibit 66: Return on Equity of EM Equities Excluding Financials

Today's lower valuations are justified by a decline in profitability since 2011.

Data as of Q3 2013.
Source: Investment Strategy Group, Datastream.

2014 Global Currency Outlook

Last year was one of diverging fortunes for global currencies (see Exhibit 67). Whereas the US dollar strengthened against countries representing half of US trade in reaction to improving GDP growth and the onset of tapering by the Federal Reserve, fears of capital outflows and slower growth fostered marked declines in emerging market currencies like the Brazilian real and Indian rupee relative to the greenback. Meanwhile, the trade-weighted yen's dramatic 17% depreciation at the hands of the BOJ's bold monetary policy stood in stark contrast to the trade-weighted appreciation of the euro and pound on the back of their improving economic fundamentals.

These different axes of growth and policy prescriptions will continue to shape the currency landscape this year. The ultimate normalization of Federal Reserve policy, for example, will likely lead to further medium-term appreciation of the dollar, as will the US dollar's steady share of world reserves (at around 61%) and dominant share of foreign exchange market turnover (about 87% in 2013). At the same time, the onset of tapering will quell concerns that loose US policy was a de facto form of protectionism that could foster "Currency Wars." As we wrote in last year's *Outlook*, an eruption of currency wars is unlikely, despite further policy easing in Japan.

We discuss our specific views for the major developed and emerging market currencies next.

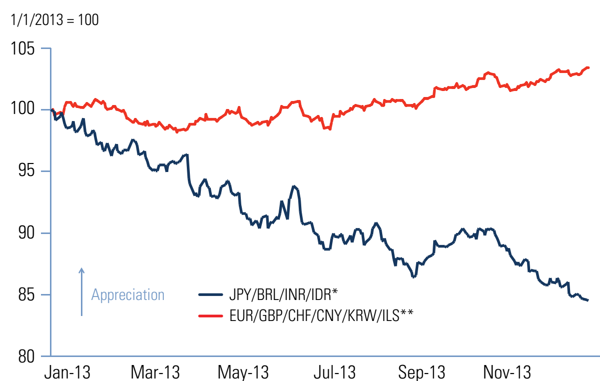
US Dollar

Despite appreciating 2% on a trade-weighted basis last year, the US dollar remains attractive relative to most G10 currencies. As shown in Exhibit 68, the dollar is about 1.2 standard deviations, or 12%, below its historical valuation relative to the currencies of America's trade partners, after adjusting for inflation. Notably, the dollar is 10% undervalued relative to the euro and 8% compared with the pound.

We believe this attractive valuation provides room for appreciation, with several factors likely to support the dollar over coming years. Chief among these is the measured withdrawal of the Federal Reserve's bond purchases, followed by actual increases in the federal funds rate from today's historic lows. A strengthening US economy should also help, as should falling fiscal uncertainty.

Exhibit 67: Trade-Weighted Currency Performance vs. US Dollar

Last year was one of diverging fortunes for global currencies.



Data as December 31, 2013.
*Japanese yen, Brazilian real, Indian rupee and Indonesian rupiah.
**Euro, British pound, Swiss franc, Chinese renminbi, Korean won and Israeli shekel.
Source: Investment Strategy Group, Bloomberg, Federal Reserve.

Exhibit 68: The US Dollar's Valuation: Deviation from Average

The dollar is undervalued against the currencies of major US trading partners.

Data as of December 2013.
Source: Investment Strategy Group, Datastream.

An eruption of currency wars is unlikely, despite further policy easing in Japan.

Because currency movements are always relative, the comparatively easier monetary policies of both the ECB and BOJ should also prove dollar-positive.

Of course, investor sentiment is already quite bullish on the greenback, making a sharp rise unlikely this year. Even so, we expect the dollar to continue to appreciate over the medium term.

Euro

The euro was the best performing G10 currency last year, appreciating 7.5% on a trade-weighted basis and 4.5% and 2.6% against the US dollar and the pound, respectively. This strength no doubt reflected the end of the Eurozone's almost two-year-long recession, receding fears about its sovereign crisis and the Eurozone's sizable, and growing, current account surplus.

With those tailwinds largely discounted, however, we are more guarded about the euro's prospects for the coming year. First, valuation has become less attractive, particularly relative to the currencies of key trading partners. For example, the euro is approximately 10% overvalued against the US dollar, and 20% against the yen. Second, the ECB's monetary stance is likely to be more accommodative than that of the US, particularly now that tapering is underway. Finally, while tail risks have receded in the Eurozone, sovereign tensions persist, particularly as the pace of reforms remains slow and incremental, and more often than not, in response to market pressure.

Based on the foregoing, we remain neutral on the euro for 2014, although we believe the probability of depreciation outweighs that of further upside.

British Pound

Last year was a rollercoaster ride for the pound, which ended the year close to where it began despite marked volatility in between. After depreciating 7% early in the year on a trade-weighted basis, the pound managed to recoup all its losses on the back of the UK's improving economic data and dovish policy announcements from both the ECB and the Federal Reserve.

While we expect UK growth to remain resilient in 2014, several factors will likely limit further pound appreciation, especially against the US dollar. First, valuation is no longer a tailwind, as the pound is only 3% less expensive than the currencies of the UK's trade partners, after adjusting for inflation. In fact, it is already 8% more expensive than the US dollar, although it is approximately fairly valued against the euro. Second, fundamentals remain challenging, given the UK's high current account and budget deficits. Finally, uncertainties around a potential referendum on EU membership may also weigh on the pound, particularly during the campaign period leading into the 2015 election.

Overall, we are neutral on the pound versus the euro and the US dollar, but we would note that risks are tilted to the downside against the greenback.

Yen

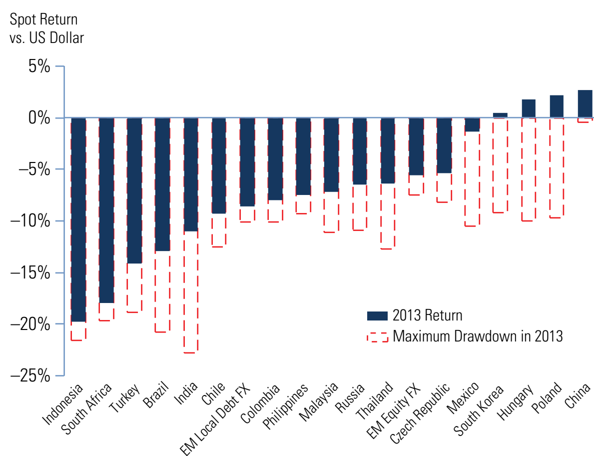
Prime Minister Abe's prescription for bold monetary policy as part of his "Three Arrows" strategy certainly found its mark as far as the yen was concerned, as the currency depreciated approximately 17% last year on a trade-weighted basis. While the yen will likely remain under pressure as the BOJ continues easing in 2014, we do not expect this new round of easing to have as potent an impact for several reasons.

First, the yen is no longer expensive. By contrast, last year's depreciation has left the yen undervalued relative to all other G10 currencies and on a trade-weighted basis. In fact, it is now

13% less expensive than the US dollar. Second, investors are already betting on further yen depreciation. Short positioning has reached its highest level since 2007, a clear positive from a contrarian perspective.

Exhibit 69: EM Currency Returns in 2013

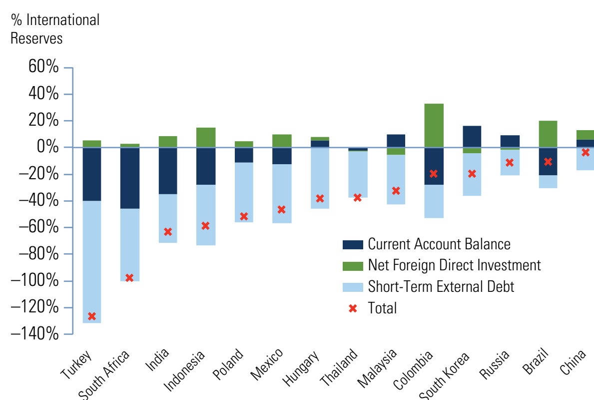
Most EM currencies lagged the dollar by 6–8% last year.



Data as of December 31, 2013.
Source: Investment Strategy Group, Bloomberg, Datastream.

Exhibit 70: External Funding Needs of Key Emerging Markets

Large current account deficits make Turkey, South Africa, India and Indonesia vulnerable.



Data are latest available.
Source: Investment Strategy Group, Datastream, IMF, World Bank.

Overall, we have a neutral view on the yen, but note the likelihood of further depreciation exceeds that of appreciation for 2014.

Emerging Market Currencies

Most emerging market currencies lagged the US dollar by 6–8% in 2013 and are at their weakest level since 2009 (see Exhibit 69). Some currencies, such as the Indian rupee and Brazilian real, dropped more than 20% from peak to trough, while others, such as the Russian ruble and Mexican peso, fell more than 10%.

We remain cautious on emerging market currencies, notwithstanding our broadly constructive view on risk assets and expectation for accelerating growth in the advanced economies. As described in our *Insight* report, *Emerging Markets: As the Tide Goes Out*, the current account balances of many emerging market countries have been deteriorating for a number of years. Four countries stand out in this respect: Turkey, South Africa, India and Indonesia (see Exhibit 70). They have had, in aggregate, negative current account balances since 2004. Their accumulating debt leaves them significantly more vulnerable to shifting sentiment in emerging markets or deterioration in global liquidity. Brazil is similarly vulnerable due to a rapid deterioration in its current account balance and uncertainty over the future of its massive currency intervention program. Taken together, these "Fragile Five"[43] countries also face elections in 2014, which introduces greater uncertainty and generally higher volatility. Meanwhile, there is little to entice investors back into these markets; despite their recent weakness, emerging market currencies are only slightly undervalued, making their near-term potential for appreciation less compelling.

While these concerns would typically justify an underweight position, we are mindful that the more fragile emerging market currencies could rally sharply if feared capital outflows do not materialize due to a slower rise in US rates or faster growth in emerging markets. Thus, we remain neutral on emerging market currencies overall, and we believe differentiation among them will provide tactical trading opportunities over the course of the year.

2014 Global Fixed Income Outlook

Last year witnessed a notable about-face for interest rates. After nearly reaching all-time lows early in the year, global yields jolted higher in response to fading sovereign fears, improving economic growth and expectations for eventual Federal Reserve policy tightening. The result was one of the worst performances on record for fixed income. The US aggregate bond index's 2% loss marked only the third negative return in the index's history. Meanwhile, high-quality government bonds in the US, Germany and the UK also registered losses. In fact, US high-yield corporate credit was one of only a few asset classes to be spared from 2013's fixed income rout (see Exhibit 71).

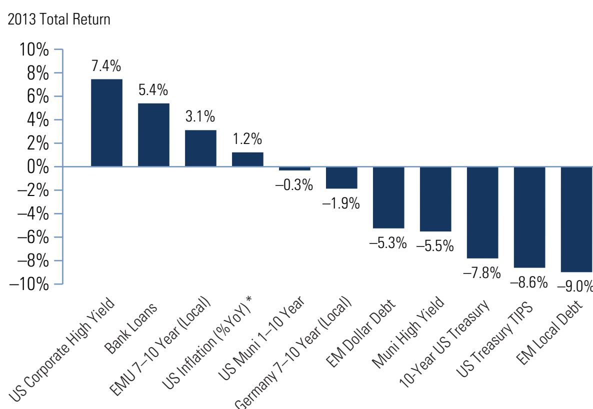
While some might consider last year's performance a mere setback in the longstanding bond bull market, we are more skeptical. Despite the dramatic rise in rates in 2013, yields remain incredibly low by historical standards. Consider that 10-year government bond yields in all G-7 countries have been higher at least 90% of the time since 1958. Of equal importance, we expect the factors that arrested the slide in yields to persist, with the onset of tapering likely marking the start of the Federal Reserve's withdrawal of extremely accommodative monetary policy. Thus, we believe the progression toward more normal interest rates remains in its infancy.

This view has important investment implications. Gradually rising interest rates imply further negative returns for US investment-grade fixed income and global 10-year government bonds, as today's scant coupon yields are not sufficient to offset falling prices. While high-yield municipal bonds offer more hearty incremental yields, these are likely to be at least partially offset by their longer duration. And these unattractive returns are expected to come with higher volatility, as the Federal Reserve's waning bond purchases withdraw liquidity from a market that is already holding significantly lower bond inventory (see Exhibit 72).

Against this backdrop, we recommend investors favor credit over duration risk by remaining

Exhibit 71: Fixed Income Returns by Asset Class

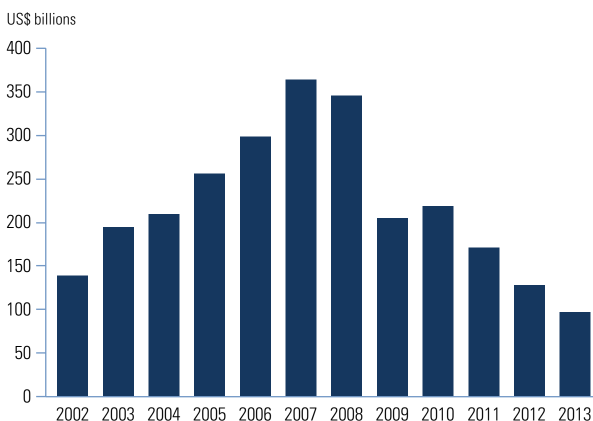
The positive returns in US high-yield corporate credit were one of few exceptions last year.



Data as of December 31, 2013, except where indicated.
*US inflation data is through November 2013.
Source: Investment Strategy Group, Datastream.

Exhibit 72: Nongovernment Bond Inventories

Today's lower broker-dealer bond inventory reduces liquidity and thus increases trading volatility.



Data as of 2013.
Source: Investment Strategy Group, IMF.

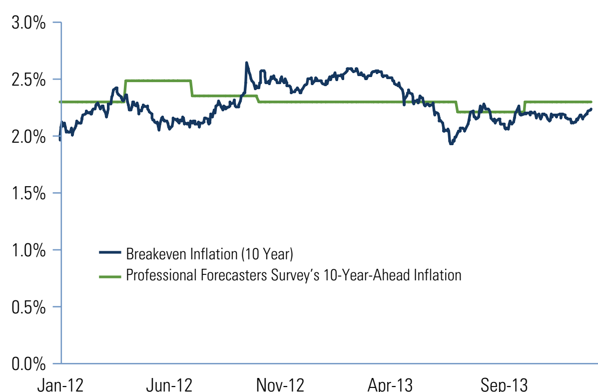
Consider that 10-year government bond yields in all G-7 countries have been higher at least 90% of the time since 1958.

overweight US corporate high-yield credit and underweight investment-grade fixed income. We also emphasize that while most investment grade bonds have unattractive tactical prospects, they nonetheless serve a vital strategic role in portfolios by providing a hedge against deflation and generating income. Therefore, investors should not completely abandon their bond allocation in search of higher returns.

In the sections that follow, we review the specifics of each market.

Exhibit 73: 10-Year TIPS-Implied Breakeven Inflation Rate

TIPS' breakeven inflation rate is around expectations for inflation over the next decade, providing little valuation support.



Data as of December 31, 2013.
Source: Investment Strategy Group, Datastream.

US Treasuries

US Treasuries were not immune to last year's fixed income tumult, with the 10-year bond suffering a 7.8% decline. In fact, there have been only 10 times in the last 100 years that 10-year yields increased 126 basis points or more in a single year, as they did in 2013. Returns are likely to remain unattractive in 2014, given our expectation for higher real rates on the back of improving growth and a higher term premium arising from the ongoing withdrawal of Federal Reserve liquidity. Keep in mind that it only takes a small, 36-basis-point increase in 10-year Treasury yields today to generate a capital loss sufficient to offset an entire year's worth of interest income.

Although we expect 10-year Treasury yields to increase again this year to a range of 3–3.75%, the midpoint of our forecast implies a much more measured pace of ascent. There are two reasons for this. First, there are practical limits to the steepness of the yield curve, especially with the Federal Reserve unlikely to raise short-term policy rates until 2015. Already, the spread between the 2- and 10-year Treasury is 262 basis points, a level that has been exceeded only 3% of the time since 1976. Second, the subdued wage growth and tame energy costs we expect should temper inflationary pressures.

This last point is important for Treasury Inflation-Protected Securities (TIPS). Last year's tepid inflation and rising rates conspired to drive TIPS 8.6% lower, their worst return on record. Because we expect both of these forces to persist, TIPS remain unattractive. TIPS' relative valuation to nominal Treasuries is not compelling either, as their breakeven inflation rate is already around consensus expectations for inflation over the next decade (see Exhibit 73). With inflation likely to remain well below 2% in the near term, the increase in TIPS coupon payments and principal could remain subdued.

Based on the foregoing, we recommend investors underweight intermediate-dated Treasuries by converting a portion of them to

cash, using them to fund tactical tilts with more attractive prospects or by reducing the portfolio's target duration, as we recommended earlier in 2013. Similarly, given TIPS' unfavorable tax treatment (discussed at length in our 2011 *Outlook*) and currently unattractive valuations, we suggest clients with taxable accounts avoid TIPS altogether. Meanwhile, tax-exempt investors should underweight TIPS, despite the hedge they provide to real purchasing power.

That said, we should not confuse being underweight with having a zero weight. As the last few years remind us, Treasuries are one of the few asset classes to effectively hedge against flaring sovereign concerns, deflation, recessions and unforeseen geopolitical risks. Thus, clients should maintain a sufficient allocation to bonds in the "sleep well" portion of their portfolios.

US Municipal Bond Market

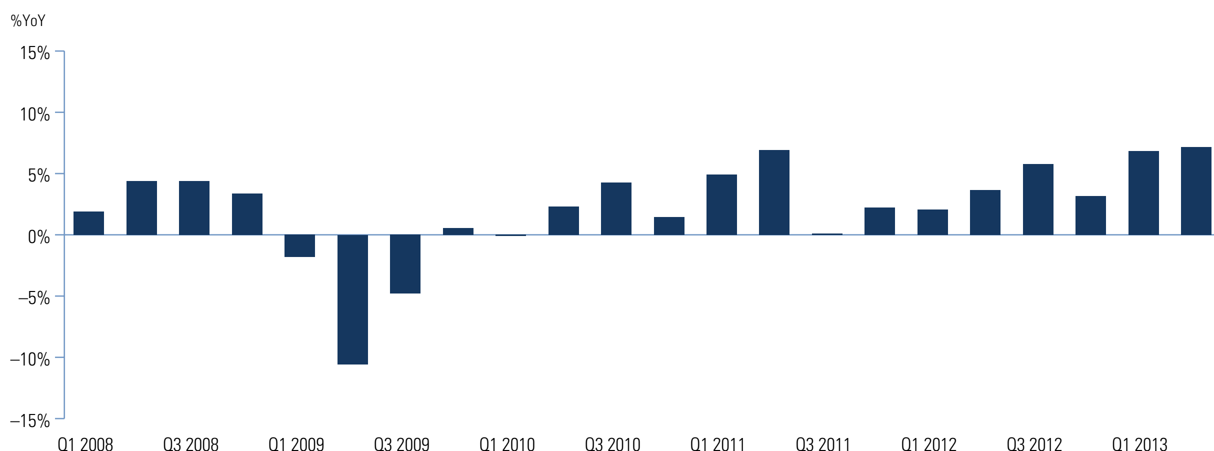
Few would fault municipal investors for wanting to forget 2013. Detroit's landmark $18 billion bankruptcy in the summer, the largest Chapter 9 filing on record, came after the market had already been rattled by the mere intimation that the Federal Reserve might begin tapering. The 20% selloff in Puerto Rican bonds, combined with negative ratings news, did little to assuage the market's angst, nor did the staggering $67 billion of outflows from municipal bond funds. Weathered by this perfect storm, intermediate high-quality bonds registered their first annual loss since 1994.

Yet last year's disappointing returns belie otherwise improving municipal fortunes. Keep in mind that state and local government revenues are on track to extend 15 quarters of consecutive growth, with both property taxes and other tax revenue now contributing positively (see Exhibit 74). At the same time, spending increases remain modest and states have been able to set aside money for budget reserve funds. In turn, total state budget gaps have collapsed from $110 billion to just $7 billion over the last two fiscal years. It is also noteworthy that the supply and demand backdrop will support municipal bonds. Indeed, the volume of redeemed bonds continues to outpace the amount of new issuance, making 2013 the third consecutive year of net contraction.

Of course, underfunded long-term pension liabilities remain a source of concern. Even so, we do not think this will be an issue for 2014, particularly given last year's rise in stock prices. While there are obviously significant differences between the two, the experience of corporate plans

Exhibit 74: Growth in State and Local Government Revenues

Tax receipts are on track to extend 15 quarters of consecutive growth.



Data as of Q2 2013.
Source: Investment Strategy Group, US Census Bureau.

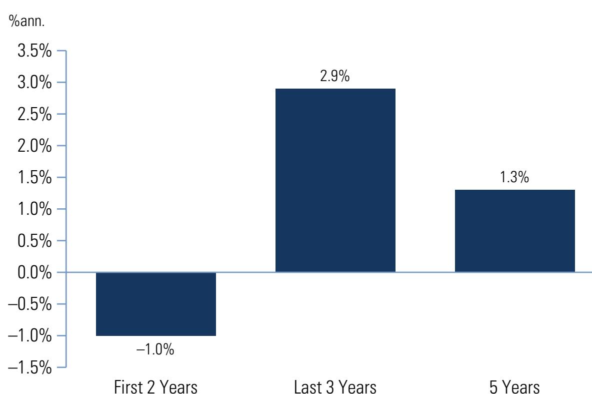
may be instructive on this last point. Consulting firm Mercer estimated that financial market gains have enabled S&P 500 companies to slash their combined pension deficits by a staggering 80% since the end of 2012.[44] While rising asset values will do little to remedy municipals' inadequate funding contributions, they will help increase the value of pension assets.

Nor do we think that municipal defaults will spike in the wake of Detroit's headline-grabbing bankruptcy. After all, Detroit's high debt level and fundamental problems are relatively unique, especially the 25% decline in its population between 2000 and 2010. Moreover, the eligibility criteria for municipal bankruptcy remain restrictive, while the legal and reputational costs are still punitive. Tellingly, overall defaults through November 2013 totaled just $3 billion, a mere 0.09% of the total outstanding market value of municipal debt. We expect the lack of any meaningful defaults or bankruptcies among higher quality municipal bonds to continue, with those that do occur likely concentrated in the unrated or below investment grade market.

Despite this supportive backdrop and last year's underperformance, municipal valuations are not particularly compelling relative to Treasuries. Currently, investors can pick up an additional 27 basis points of after-tax yield by owning five-year AAA-rated municipal bonds instead of Treasuries, which is less than the 56-basis-point average since 2000. With these spreads offering little buffer to absorb the backup in Treasury yields we expect this year, municipal bonds are likely to suffer further losses over the next two years. The silver lining to the dark cloud of rising interest rates is that bond investors will ultimately benefit from better reinvestment opportunities (see Exhibit 75).

Exhibit 75: Intermediate Municipal Bond Return Projections

Rising Treasury yields are likely to drive municipal bond losses over the next two years.



Data as of December 31, 2013.
Source: Investment Strategy Group.

In summary, we think that clients should moderately underweight their high-quality municipal bonds by converting a portion of them to cash or using them to fund various tactical tilts. We would not recommend a zero weighting for the same reasons we mentioned for US Treasuries. By contrast, clients should remain fully invested in high-yield municipal bonds at their customized strategic allocation. Here, we expect the drag from their 10.6-year duration in a rising rate environment to be offset by today's attractive 245-basis-point spread to investment grade municipal bonds, resulting in low-single-digit positive returns in the year ahead.

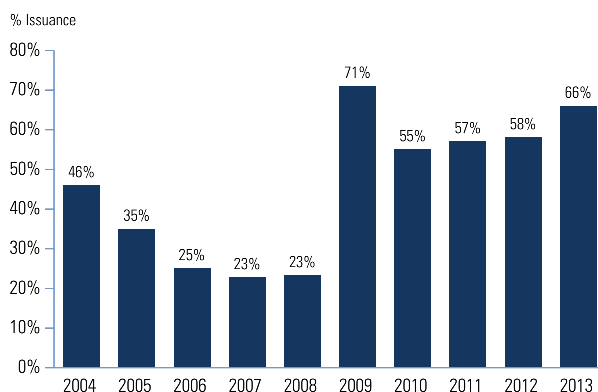
The silver lining to the dark cloud of rising interest rates is that bond investors will ultimately benefit from better reinvestment opportunities.

While the prospect of a high-yield credit bubble makes for provocative headlines, there are several reasons for a less alarmist view.

US Corporate High-Yield Credit
With 2013 marking the fifth straight year of positive high-yield returns combined with abnormally low volatility, perhaps it is not surprising that fears of a high-yield credit bubble grew even more pervasive. Last year's staggering $1 trillion of combined issuance, coupled with a doubling of assets in bank loan funds, seems to corroborate these concerns, as does the growing prevalence of lax covenants (i.e., "cov-lite" loans) that provide investors with less protection in the case of declining operating performance. Emblematic of this angst, Moody's issued a special comment last year highlighting the emerging "covenant bubble" in corporate credit.[45]

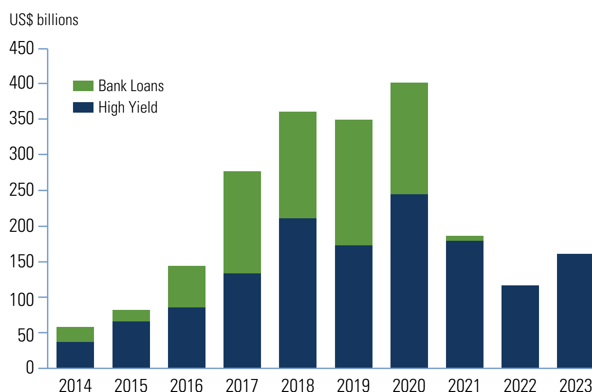
While the prospect of an asset bubble makes for provocative headlines, there are several reasons for a less alarmist view. First, the majority of the record issuance in recent years went toward refinancing existing debt at more attractive rates, not increasing overall debt levels (see Exhibit 76). As a result, interest expense for these firms has dropped from 7.5% to 6.4% over the last nine quarters, saving roughly $10 billion in annual interest payments.[46] This dynamic stands in sharp contrast to the years preceding the financial crisis, when companies issued debt primarily to finance acquisitions and leveraged buyouts, with refinancing constituting a mere 23% of issuance. Second, today's interest savings are likely to be long-lasting, as just 3% of outstanding high-yield credit matures this year and only 5% matures in 2015. With less than 10% of existing debt maturing in the next two years, there is also little refinancing-related default risk (see Exhibit 77). Third, high-yield firms stand to benefit directly

Exhibit 76: Refinancing's Share of Total High-Yield Corporate Credit Issuance
The majority of issuance went toward refinancing existing debt at more attractive rates.



Data as of November 27, 2013.
Source: Investment Strategy Group, JP Morgan.

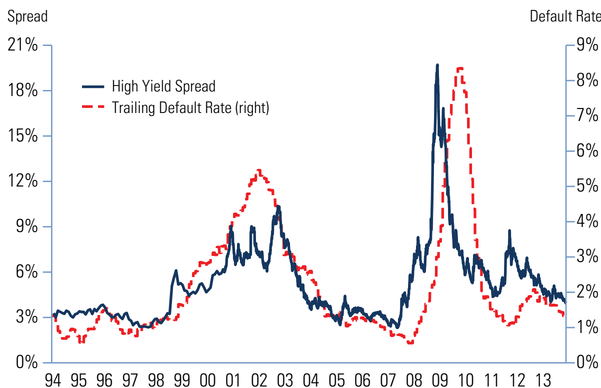
Exhibit 77: High-Yield Corporate Debt Maturity Profile
Less than 10% of existing debt matures in the next two years, posing little refinancing-related default risk.



Data as of December 2013.
Source: Investment Strategy Group, JP Morgan.

Exhibit 78: High-Yield Bond Spreads and Trailing Default Rates

Spreads remain above their previous trough and are consistent with today's low defaults.

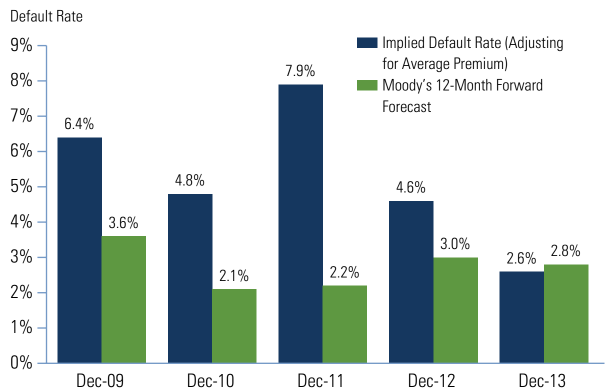


Data as of December 2013.

Source: Investment Strategy Group, Barclays, Moody's.

Exhibit 79: High-Yield Bond Implied and Forecast Default Rates

Today's spreads already imply low defaults, offering a narrower margin of safety than in recent years.



Data as of December 2013.

Source: Investment Strategy Group, Barclays, Moody's.

from the stronger US economic growth we expect this year, considering almost three-fourths of their sales originate domestically. Fourth, today's all-time-low absolute yields—often cited as a sign of investor exuberance—mainly reflect low risk-free Treasury rates. By contrast, high-yield spreads—which represent investors' compensation for assuming credit risk—remain more than 100 basis points above their previous trough and are consistent with other periods of low defaults historically (see Exhibit 78). Finally, leading indicators of defaults, such as Moody's liquidity and covenant stress indexes, suggest few speculative-grade companies are experiencing liquidity problems or are at risk of breaching financial covenants. Notably, both of these indexes began to deteriorate in advance of previous default cycles.

Of equal importance, the growing popularity of cov-lite issuance does not imply that companies are free from all covenants. It is true that a typical cov-lite bank loan eliminates maintenance covenants, which require the company to maintain certain debt and interest coverage ratios even in the face of declining profitability. Regardless, these firms are still subject to incurrence covenants, which restrain the level of debt they can incur without triggering default. In addition, nearly all the cov-lite loans sampled by Moody's were still technically subject to maintenance covenants through revolving credit agreements in their capital structure. While revolver lenders have sole discretion in enforcing these covenants, deteriorating company performance is likely to align their interests with those of other creditors quickly.

Corporate high-yield credit remains the best house in a bad fixed income neighborhood, supporting our continued overweight recommendation.

Of course, a more sanguine view of fundamentals does not necessarily suggest robust returns. In high-yield bonds, today's below-average spreads

already reflect our subdued default expectations, implying a narrower margin of safety than in recent years (see Exhibit 79). With spreads only partially able to absorb a further increase in rates, we expect returns of around 3–4% in the year ahead. Bank loans should perform marginally better at around 4–5% given their limited 0.25-year duration and continued investor demand for floating-rate products. That said, there is virtually no price upside in loans: 84% of the index constituents already trade above $99 and aggressive refinancing continues to erode coupon levels. In fact, repricings reduced the average coupon rate by 93 basis points last year, shaving about 40 basis points off bank loan spreads.[47]

In comparison, high-yield bond prices could increase further, despite concerns about the bonds being called away at a fixed premium to par. After all, about a third of the constituents of the Barclays High Yield Index are not even callable and only 41% of those that are trade above their call price now. Equally important, about two-thirds of these bonds cannot be called before 2016. Thus, bonds offer more potential upside than loans, although their return in 2014 is likely to be lower in our central case.

In short, while the above returns may pale in comparison to those we have seen over the last several years, they remain attractive relative to investment-grade fixed income, where we expect rising rates to generate negative returns. Thus, corporate high-yield credit remains the best house in a bad fixed income neighborhood, supporting our continued overweight recommendation.

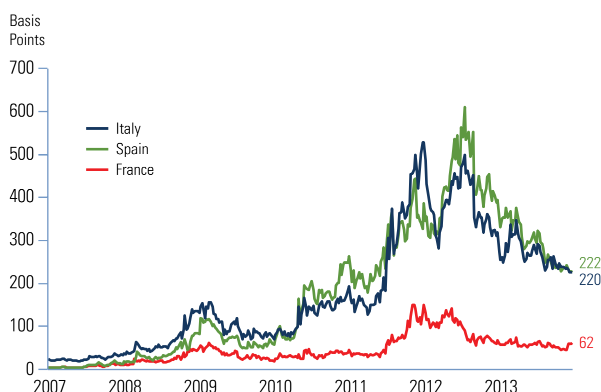
European Bonds

There was much to like about Eurozone peripheral bonds in 2013. A combination of receding Eurozone breakup fears, the end of a nearly two-year recession, falling budget deficits and better institutional firewalls tightened Eurozone bond spreads across the rating spectrum. Italian and Spanish 10-year bond spreads, for example, tightened by 100 and 140 basis points, respectively. The result was solid returns for both countries.

The core of the Eurozone was less fortunate, with higher rates generating losses in both German

Exhibit 80: Eurozone Countries' 10-Year Government Bond Spreads over German Bunds

Eurozone bond spreads have fallen well below peak levels, leaving less scope for spread compression.



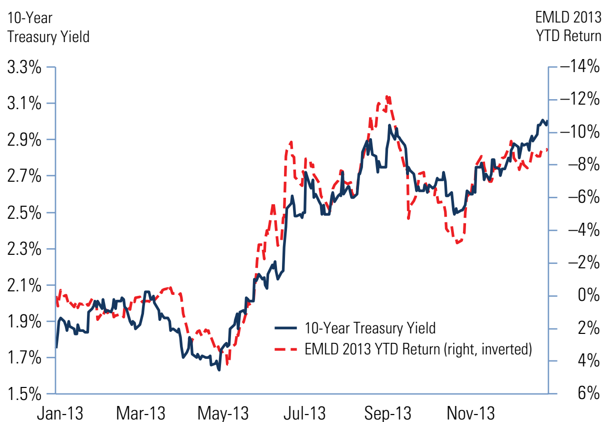
Data as of December 31, 2013.
Source: Investment Strategy Group, Bloomberg.

and French 10-year government bonds last year. We expect rates to move higher still in 2014, as demand for "safe-haven" German bunds recedes along with sovereign crisis and recession fears. The rise in US government bond yields we expect will also put upward pressure on core Eurozone rates.

Although we expect Eurozone rates to increase, their pace of ascent should slow for three reasons. First, the ECB is likely to maintain accommodative policy in the face of the Eurozone's weak recovery and deflationary risks. In turn, loose policy and the potential for further ECB action should prevent a sharp backup in yields. Second, today's low inflation and risk of outright deflation should support demand for nominal bonds. Finally, periodic bouts of political volatility should support ongoing demand for bunds, even while the magnitude of those "safe haven" flows is likely less than in recent years.

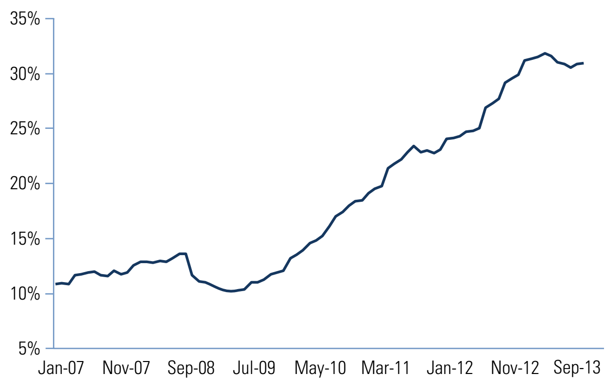
In short, German interest rates are likely to rise to 2–2.75% by year-end, generating another loss for bunds in 2014. Elsewhere, we see limited potential for further spread compression. As shown in Exhibit 80, spreads have fallen well below peak levels, as the systemic risk of a Eurozone breakup diminished. With this risk premium largely priced out of the market and spreads more closely aligned

Exhibit 81: 10-Year Treasury Yield vs. EMLD Return
Emerging market local debt returns rapidly deteriorated last year in response to Federal Reserve tapering fears.



Data as of December 31, 2013.
Source: Investment Strategy Group, Datastream.

Exhibit 82: Nonresident Ownership of EMLD Markets
Foreign ownership now accounts for more than 30% of EMLD, making it vulnerable to large outflows.



Data as of October 2013.
Note: Weighted average of Brazil, Hungary, Indonesia, Malaysia, Mexico, Peru, Poland, Russia, South Africa, Thailand and Turkey.
Source: Investment Strategy Group, national sources.

with underlying fundamentals, the margin of safety has narrowed.

Similarly, UK gilts have moved closer to normalized valuations after last year's 100-basis-point expansion in 10-year yields. Going forward, we expect gilt yields to mirror those of US Treasuries, a reflection of their similar policy stance, notwithstanding slightly higher UK inflation. Under our forecast, gilts should finish 2014 at 2.75–3.5%.

In summary, we remain underweight UK gilts and Eurozone government bonds more broadly. That said, clients should retain some exposure to German bunds and other high-quality bonds in the "sleep well" portion of their portfolios. Similarly, a limited exposure to peripheral debt remains appropriate for those clients who can tolerate the volatility.

Emerging Market Local Currency Debt

Emerging market local currency debt (EMLD) has seen a dramatic reversal of fortune in the last two years, from ranking among the best performing fixed income sectors in 2012 with a 17% gain, to standing among the worst with a 9% loss last year. This change of fate reflected both currency and bond price weakness, as capital flowed out of emerging markets in response to the sooner-than-expected prospect of tapering (see Exhibit 81). As discussed in our *Insight* report, *Emerging Markets: As the Tide Goes Out*, while there is still a place for EMLD in a client's strategic portfolio, there are several reasons we do not recommend a tactical tilt at this time.

First, the Federal Reserve's decision to taper its bond purchases directly threatens the large inflows of foreign capital into EMLD. As shown in Exhibit 82, foreign ownership now accounts for more than 30% of local government debt, up from about 11% in 2007. Should these flows reverse or be disrupted, EMLD would be particularly vulnerable.

Second, emerging market currencies are only slightly undervalued and, hence, do not offer a compelling margin of safety.

Third, emerging markets face even higher volatility due to today's uncertainties. For example,

countries accounting for 55% of the EMLD index are slated to hold elections in 2014. In addition, the need for external financing by many emerging countries makes them vulnerable to a shift in global investor sentiment, especially with four of the "Fragile Five" countries in the EMLD index (see our EM currency discussion).

Fourth, with a duration of 4.6 years, EMLD is likely to remain vulnerable to the increase in global rates we expect, even if tapering does not disrupt capital flows.

Finally, EMLD's 5–5.5% incremental yield over Treasury securities is not sufficient to compensate for the above mentioned risks, in our view.

Based on the foregoing, we expect a low-single-digit return for EMLD over the course of 2014, with about 10% volatility. While emerging market dollar debt (EMD) offers similarly uninspiring returns, it is unattractive for other reasons as well. Not only does its 6.7-year duration make it even more vulnerable to rising rates than EMLD, but also its incremental yield stands well below its long-term average. Moreover, the spread at the index level masks great dispersion among its countries, with Mexico's well-below-average spreads juxtaposed against Venezuela's 8% incremental yields, for example. Therefore, we remain tactically neutral both EMLD and EMD.

2014 Global Commodity Outlook

Last year extended the streak of lackluster commodity returns. Not only did the S&P GSCI Total Return Index finish roughly unchanged for its third consecutive year, but the bulk of its subcomponents also declined (see Exhibit 83). In turn, commodities continued to underperform other risk assets. As shown in Exhibit 84, the S&P GSCI index has now lagged US equity returns for four straight years, a stark departure from its outperformance during the 2002–07 commodities boom.

While some have ascribed this underperformance to purely cyclical factors, we are skeptical. In our view, it is no coincidence that commodities' relative performance peaked in 2007, around the time the "Goldilocks" growth period in emerging markets also culminated. After all, the higher resource intensity of emerging countries makes changes in their growth more influential on commodity prices. With a long list of structural challenges likely to temper the pace of emerging market growth in the years ahead, commodity demand is likely to suffer by extension. Thus, we are concerned that the commodity "supercycle" has run its course, suggesting the recent string of disappointing performance might continue.

Oil: The Supercycle Flatlines

Contracting volatility in financial markets often signals investor indecision. That arguably is the case today with oil, as Brent prices have stagnated

Exhibit 83: Commodity Returns in 2013

Last year extended the streak of lackluster commodity returns, with four out of five subcomponents declining.

	S&P GSCI	Energy	Agriculture	Industrial Metals	Precious Metals	Livestock
2013 Average Spot Price vs. 2012 Average	–2%	1%	–12%	–7%	–17%	3%
2013 Spot Return	–2%	4%	–22%	–9%	–29%	2%
2013 Excess Return*	–1%	5%	–18%	–13%	–30%	–4%

Data as of December 31, 2013.
*Excess return corresponds to the actual return from being invested in the front-month contract and differs from spot price return depending on the shape of the forward curve. An upward-sloping curve (contango) is negative for returns while a downward-sloping curve (backwardation) is positive.
Source: Investment Strategy Group, Bloomberg.

The high oil prices of recent years have arguably sown the seeds of their own demise by encouraging significant exploration and production investments.

since late 2010. Indeed, oil price volatility fell to 18% last year, the lowest level in 20 years and about half the long-term average. Similarly, the difference between the volatility of oil and the S&P 500 stands 11 percentage points below its historical average.

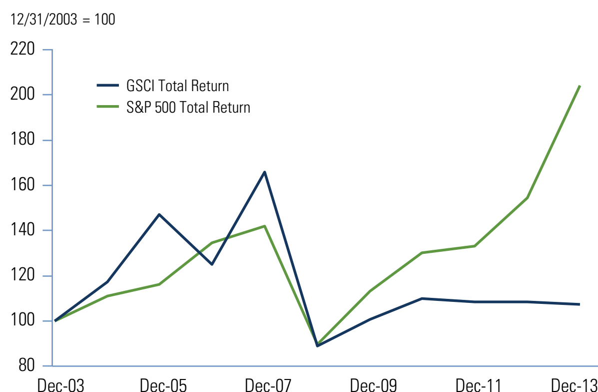
A host of crosscurrents belies this indecision. Chief among them is the tectonic shift underway in the global supply of oil (see Exhibit 85). The high oil prices of recent years have arguably sown the seeds of their own demise by encouraging significant exploration and production investments. As shown in Exhibit 86, US energy companies' ratio of capital spending to depreciation expense almost doubled since the early 2000s to slightly above 2-to-1 today. Similarly, the International Energy Agency estimates that the $710 billion of global upstream investment in 2013 was almost three times greater than similar investments in 2000 on a cost-inflation adjusted basis.[48]

These investments clearly have borne fruit. In 2013, non-OPEC crude oil production increased the most in 28 years, driven by North America and the United States in particular. Total US production reached an all-time high, with crude production up 15% and total liquids (including natural gas liquids, biofuels and liquefied petroleum gas) production surpassing its 1970 peak. While such rapid growth might prove difficult to sustain in the long term, we expect the ongoing "shale revolution" to provide a tailwind to US production for years to come.

Notably, this strong production in non-OPEC countries means that OPEC's "swing producers" will likely need to show production restraint or risk hurting oil prices. Indeed, most forecasters expect demand for OPEC supplies to fall next

Exhibit 84: Commodity vs. US Equity Indexed Returns

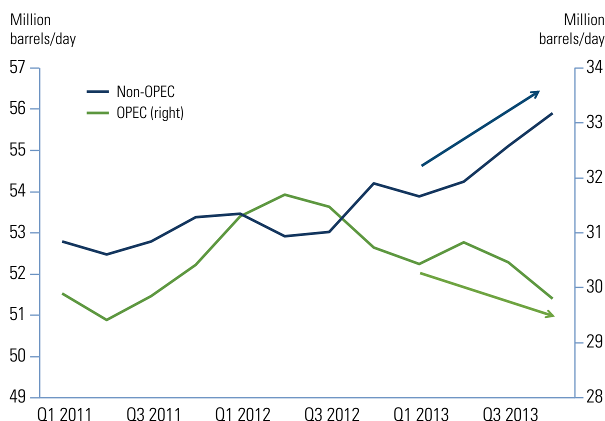
Commodities continue to lag equity returns, a stark departure from their outperformance during the 2002–07 commodities boom.



Data as of December 31, 2013.
Source: Investment Strategy Group, Bloomberg.

Exhibit 85: Sources of Crude Oil Production

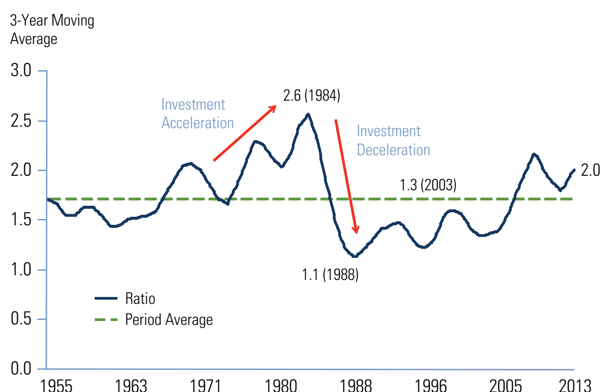
A production renaissance in non-OPEC countries, especially the US, is leading to a tectonic shift in the global supply of oil.



Data as of Q4 2013.
Source: Investment Strategy Group, International Energy Agency.

Exhibit 86: US Energy Companies' Capital Spending to Depreciation Expense Ratio

Energy firms are investing twice as fast as their assets are depreciating.



Data as of Q3 2013.
Source: Investment Strategy Group, Empirical Research Partners, LLC.

year, meaning OPEC would need to produce less oil to balance the market compared with the 2013 average. Tellingly, Saudi Arabia has already trimmed production in the past few months.

The fact that oil demand has not outpaced this wave of supply explains part of oil's stagnation. It is true that the acceleration we expect in US growth will likely result in a small uptick in US oil demand. Even so, sluggish growth in the Eurozone and the prospect of nuclear reactors coming back online in Japan largely offset this. Moreover, about 30% of emerging market demand growth comes from China, where growth is slowing, as we detail at length in our *Insight* report, *Emerging Markets: As the Tide Goes Out*. Consider that Chinese GDP growth has fallen from 14.2% in 2007 to around 7.6% now. If history is any guide, Chinese oil demand growth could further decelerate as the leadership attempts to rebalance China's economy away from investment-led growth. Oil demand growth in Indonesia, Malaysia, Thailand and South Korea collectively was as high as 9% in the years preceding the 1997 Asian crisis, but fell below 3% thereafter.

All that said, we do not expect a material collapse in oil prices. Despite the encouraging shifts in supply discussed above, there are practical limits to the downside of oil prices. Extracting US oil shale on a profitable basis requires Brent oil prices of approximately $80 per barrel, while less developed international projects can require prices exceeding $90 per barrel. What is more, Saudi Arabia has already stated a preference for prices of around $100 per barrel and is in a position to cut production to support those prices.

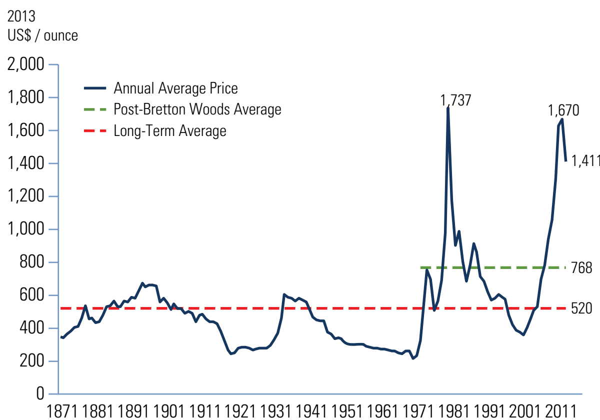
Thus, while we do expect the price of Brent oil to decline from current levels, it should ultimately settle in the range of $90–$110 per barrel in 2014. Relative to Brent, US-based WTI oil is likely to trade at a volatile $5–$15 discount, as North American refineries struggle to process the abundance of domestic crude. While prices are likely to remain volatile within these ranges, particularly given unpredictable geopolitical developments, we do not see a compelling tactical opportunity in oil at this time.

Gold: A Burst Bubble?

While the debate rages on about how to define an asset bubble, gold arguably exhibits all the properties of one that has already burst. Since its September 2011 peak of $1,900 per ounce, gold prices have collapsed 37%, placing the commodity among last year's worst performing asset classes. Over the same period, US equities appreciated 66%. Meanwhile, investors' fervent accumulation of gold exchange-traded funds (ETFs) has suffered an about-face: about 850 tonnes, or one-third of the gold held by such ETFs, was sold in 2013. This dramatic reversal of fortune is well documented in the media, with headlines such as "It's Official, Gold Was a Bubble" typical of recent coverage.[49]

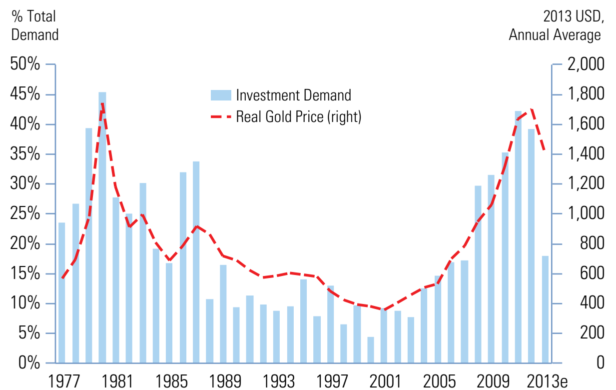
The swiftness of gold's descent prompted us to remove the bearish bet we initiated in March of last year, but gold's medium-term prospects remain unattractive today. It is true that today's lower prices are likely to stimulate demand and discourage supply in certain areas of the market. Global jewelry demand, for example, was up 14% year-over-year through 2013's third quarter, while demand for coins and bars increased 33%. Furthermore, gold recycling fell 14% over the same period, and miners are now cutting capital expenditures.

Exhibit 87: Real Average Annual Gold Price
Gold prices remain far higher than their inflation-adjusted, post-Bretton Woods average.



Data as of December 31, 2013.
Source: Investment Strategy Group, Bloomberg.

Exhibit 88: Investment Demand as a Share of Total Gold Demand
Collapsing investor demand from elevated levels has presaged gold weakness historically.



Data as of December 31, 2013.
Source: Investment Strategy Group, Bloomberg, CPM Group, World Gold Council.

Even so, today's gold prices still have significant downside to their long-term averages, despite their considerable decline thus far. As shown in Exhibit 87, gold prices remain far higher than their inflation-adjusted, post-Bretton Woods average of $768/ounce. Notably, real prices have reverted towards their mean over the long run. Similarly, gold still trades well above its marginal production cash cost of around $950 per ounce.

Additionally, while negative real interest rates have made the opportunity cost of holding gold negligible in recent years, the opposite is true in a rising rate environment such as we expect. Moreover, many of the fears that drove investors toward gold as a store of value—including US dollar debasement and high inflation—have failed to materialize and should continue to recede. Finally, gold's poor price performance and increased volatility have tarnished its "safe haven" status, leading to lower investment demand. As seen in Exhibit 88, collapsing investor demand from elevated levels has presaged gold weakness historically.

Based on the foregoing, we do not think gold is an appropriate substitute for the "sleep well" portion of a client's portfolio. Furthermore, gold remains vulnerable over the medium term, as a combination of a rising US dollar, improving US economy, moderate inflation and slowly rising real interest rates makes holding gold unattractive.

Thus, we continue to advise against holding gold and remain on the lookout for price rallies that would enable us to reestablish a bearish position.

Today's gold prices still have significant downside to their long-term averages, despite their considerable decline thus far.

In Closing

FOR FIVE YEARS NOW, we have recommended that clients stay fully invested at their strategic allocation to US equities. After a year in which US equities posted such exceptional performance, some might have expected us to dial back this recommendation. At this point in time, though, we believe underweighting equities would merely expose clients to greater risk of underperformance.

Our view continues to be informed by our longstanding premise of US preeminence relative to major economies and emerging markets. This view is also supported by positive cyclical and structural factors that should help sustain the bull market's run.

Even so, as we stated throughout this year's *Outlook*, it is a time to be extra vigilant for changing conditions that might alter this view. As we scan the globe, there are key risks worth monitoring as the year unfolds. If these risks evolve into genuine threats, we will be certain to revisit our investment recommendations.

We believe the summit is in sight, but the distance from here to there remains uncertain.

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Description of Methodologies Used

Additional contributors from the Investment Strategy Group include:

Thomas Devos
Vice President

Andrew Dubinsky
Vice President

Oussama Fatri
Vice President

Gregory Mariasch
Vice President

Paul Swartz
Vice President

Giuseppe Vera
Vice President

Harm Zebregs
Vice President

Matheus Dibo
Associate

Mary Craig
Senior Analyst

Travis Pfander
Senior Analyst

Lili Zhu
Senior Analyst

Back tests of valuation-only-based strategies (page 15): Methodology based on value-oriented investor strategy, allocation changes based on equity valuation alone, no other factors were considered. We started with a 50% equities/50% bonds portfolio represented by S&P 500 / Barclays Aggregate-Ibbotson. As the considered valuation measure changed through the time period, we took the following actions when the trigger level was reached:

I. Overweighting:

- At the valuation's 3rd decile we overweighted equities by 5%. The resulting portfolio was 55% equities/45% bonds.
- At the 2nd decile we overweighted equities by another 5%. The resulting portfolio was 60% equities/40% bonds.
- At the 1st decile we overweighted equities by another 10% for a maximum cumulative overweight of 20%. The resulting portfolio was 70% equities/30% bonds.
- When valuation crossed from the 4th to the 5th decile, the equity overweight was reduced to 10%. The resulting portfolio was 60% equities/40% bonds.
- When valuation crossed from the 5th to the 6th decile, the equity overweight was removed. The resulting portfolio was 50% equities/50% bonds.

II. Underweighting:

- At the 10th decile, we underweighted equities by 10%. The resulting portfolio was 40% equities/60% bonds.
- When valuation crossed from the 9th to the 8th decile, the equity underweight was removed. The resulting portfolio was 50% equities/50% bonds.

Calculation of expected returns for hedge funds (page 34): To estimate the prospective one- and five-year total returns for hedge funds, we used our factor-based approach and the HFRI Fund of Fund Composite Index as a representative index of the hedge fund universe. The estimated total return over a given horizon is the sum of two components: (1) the rate of return on a riskless investment, or the "Risk-Free Rate," and (2) the estimated return on an annual basis in excess of the Risk-Free Rate, or the "Risk Premium." In our one-year estimate, the Risk-Free Rate was assumed to be 0.25%. In our five-year estimate, the Risk-Free Rate was assumed to be 0.25% for the first 1.5 years and then assumed to gradually converge toward its long-term average of 4%. The Risk Premia corresponding to each of the horizons were estimated using our multi-factor model based on six factors: Equity, Term, Funding, Liquidity, Exchange Rate and Emerging Markets (a description of the factors is provided in the table below).

Factor Risk Premium	Rewards investors for bearing the risk associated with:
Equity	Fluctuations in the present value of future corporate earnings
Term	Fluctuations in inflation expectations and real interest rates
Funding	Fluctuations in the ease and cost of short-term borrowing
Liquidity	Marketwide fluctuations in the ease and cost of transacting
Exchange Rate	Systematic currency fluctuations
Emerging Markets	Economic, political and institutional uncertainties in emerging markets

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Description of Factor Model and Robust Optimization. We use our proprietary factor model and robust optimization process to construct a long-term asset allocation that has the potential to provide clients with the greatest long-term expected return given their investment goals and risk tolerance.

Our approach begins by establishing the risk and return characteristics for each asset class that could potentially be included in a client's portfolio. We use representative indices for asset classes to arrive at all estimates. We have identified several factors that we believe drive long-term risk and return, including systematic equity risk, inflation and interest rate risk, and market-wide liquidity risk. By estimating each factor's contribution to the risk and return of each asset class, we establish three key attributes:

Estimated Mean Return is our estimate of the average annual return of the asset class over long periods of time. Each asset class' Estimated Mean Return is the sum of two components: (1) the theoretical rate of return on a riskless investment, or the "Risk-Free Rate," and (2) the estimated long-term return on an annual basis in excess of the Risk-Free Rate, or the "Risk Premium"

Estimated Ranges of Risk Premia. We express the Risk Premium of each asset class as a specified percentage plus or minus an estimated range. For example, the Investment Grade Bonds of a given country may have a Risk Premium of 1.7% +/- 0.8%. The estimated range for each asset class reflects the level of certainty we have regarding our Risk Premium estimate. A larger range reflects a lower level of certainty.

Long-term Risk. We use two primary measures to quantify the risk of each asset class: volatility and correlation. Volatility measures the possible fluctuation in the return of each asset class. Correlations measure the linear relationships of each asset class' return with the returns of other asset classes. Volatilities of, and correlations across, asset classes included in a portfolio are used together to determine the overall risk of a portfolio.

We run our robust optimization process using the investment goals and risk tolerance clients share with their Private Wealth Management team and the asset class attributes described above. The process considers all potential asset allocation alternatives before arriving at the allocation that offers the greatest expected return with the greatest level of certainty given a client's investment goals and risk tolerance. The output of the optimization process is the target strategic asset allocation that we share with you. The results shown reflect the reinvestment of dividends and other earnings but do not reflect advisory fees, transaction costs, and other expenses a client would have paid, which would reduce return.

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