Global - 2019 Outlook

Riding the cycle...uphill

- **We expect low equity returns across all regions for 2019.** Total returns (including dividends) are expected to be high-single to low-double digits, even post the recent sharp sell-off. With an expected weaker dollar, return forecasts in Europe and Japan are boosted when converted into dollar-terms.
- **Underlying this view is a slowdown in earnings growth** in every region. In all cases, we forecast EPS to grow between 4% and 6% in 2019, a slowdown compared with 2018, particularly in the US. Our forecasts for all regions are below the bottom-up consensus.
- **With slow profit growth, investors are likely to focus on a deterioration in the growth and inflation mix.** The combination of strong growth and loose financial conditions was highly supportive for equities in 2017. This year we have seen a tightening of financial conditions alongside a divergence of global growth, with the US outperforming. In 2019, we see renewed economic convergence driven mainly by the US economy slowing at a time when inflation pressures and interest rates are increasing.
- **That said, there is support for equity markets.** Benchmarking equity returns to growth expectations suggests that there may have already been an overshoot on the downside. Valuations have also now de-rated to more manageable levels.
- **We do not see a recession in 2019 or 2020.** Without a recession, it is unlikely that profits fall. Without profits falling, it is unlikely that we see a sustained bear market.
- **A period of low returns in a 'Skinny & Flat' range** implies low aggregate returns, but swings in the market of +/-10% (as opposed to a 'Fat & Flat' market of low returns but much wider swings).
- **We see a less binary, factor-driven market environment with a greater emphasis on searching for alpha.** Generally, we look for companies with strong balance sheets and a 'quality' bias. But we like companies that are reinvesting for growth while not trading at big valuation premiums as well as areas of the markets where there is a transition away from being a value trap to a value creator.

Peter Oppenheimer
+44(20)7552-5782 |
peter.oppenheimer@gs.com
Goldman Sachs International

Sharon Bell, CFA
+44(20)7552-1341 | sharon.bell@gs.com
Goldman Sachs International

Lilia Peytavin
+44(20)7774-8340 |
lilia.peytavin@gs.com
Goldman Sachs International

Guillaume Jaisson
+44(20)7552-3000 |
guillaume.jaisson@gs.com
Goldman Sachs International

Global - 2019 Outlook

1. 2019 is likely to be a year of relatively low stock market returns across the world with equities stuck in a 'Skinny & Flat market'; by this we mean low returns with a relatively narrow range (i.e., no wild swings from bull and bear market).

A key feature of our forecasts is that all main regions experience relatively similar price returns (based on a similar outlook for EPS growth) for 2019 both in price and total return terms. Although when we look at these forecasts in US $, the returns are higher in Japan and Europe; we get a range of c.10% total returns for a US investor in both the US and Asia and 12% to 16% in Japan and Europe, respectively. The returns in Exhibit 1 are from current levels to the end of 2019 and assume an expected bounce from the recent sharp sell-off.

A further consideration for investors is risk. Based on historical betas, the risk adjusted total returns in dollars are shown in Exhibit 2 below. We see a modest improvement in risk adjusted returns compared with the recent past but below average relative to longer term comparisons (from the early 1970s for example).

Exhibit 1: Our forecasts for 2019
Price target end 2019, returns from current levels to end 2019

	Index Level		Price Return		Total Return**	
	Current	2019	Local	USD*	Local	USD*
S&P 500	2736	3000	10%	10%	12%	12%
STOXX Europe 600	358	375	5%	11%	9%	16%
TOPIX	1629	1725	6%	10%	8%	12%
MSCI Asia-Pacific ex Jp ($)	487	520	7%	7%	10%	10%

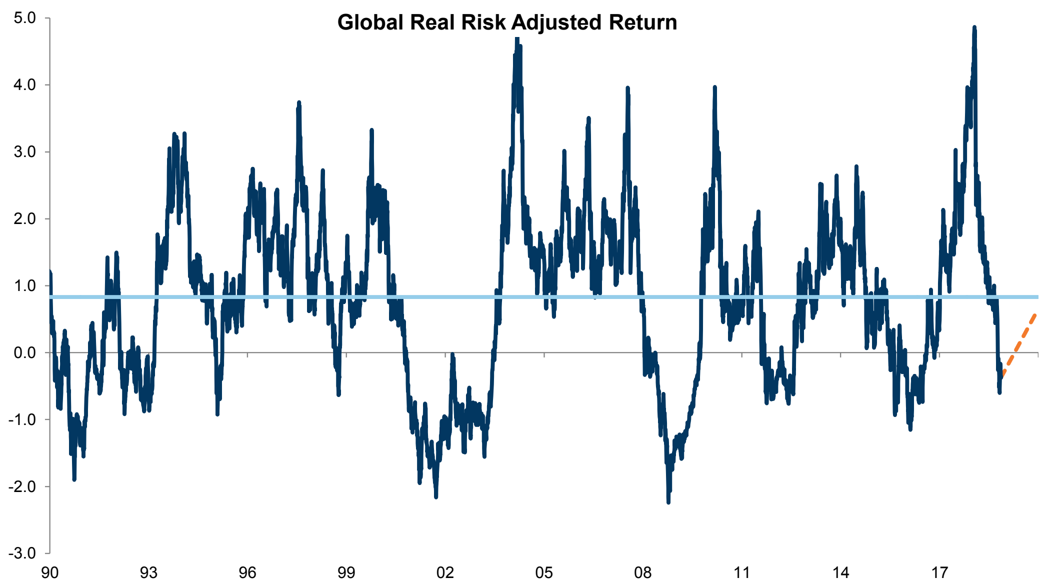
** Using GS FX Strategy forecast*

*** Using Consensus 12m fwd Dividend Yield*

Source: Datastream, FactSet, Goldman Sachs Global Investment Research

Interestingly, the global risk adjusted return has already experienced a very steep drawdown after an exceptional period of returns as the global economy enjoyed a strong and synchronised rebound in 2017.

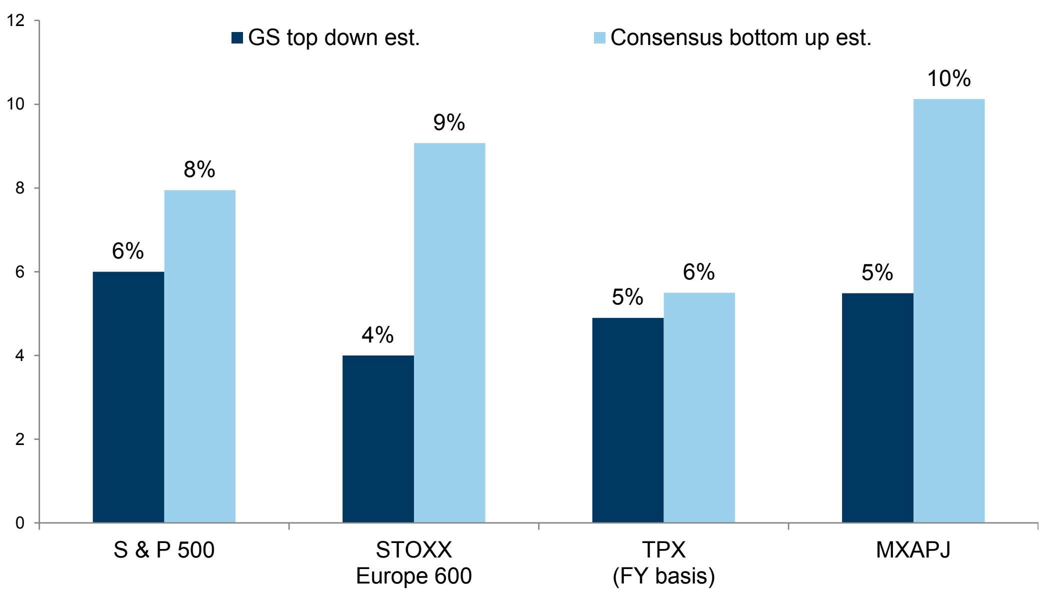
Exhibit 2: We forecast low risk adjusted returns... but not as low as the last year
yoy real total return to vol, forecast calculated using historical realised volatility



Source: Worldscope, Datastream, Goldman Sachs Global Investment Research

2. Underlying our expectations of slow returns for equities is a view that earnings growth forecasts across the main regions come down materially. As Exhibit 3 shows, in all regions we have a reasonably sharp slowdown in profit growth forecast for 2019; our expectations are below consensus in all regions.

Exhibit 3: GS top-down vs. consensus bottom-up estimates of 2019 EPS growth



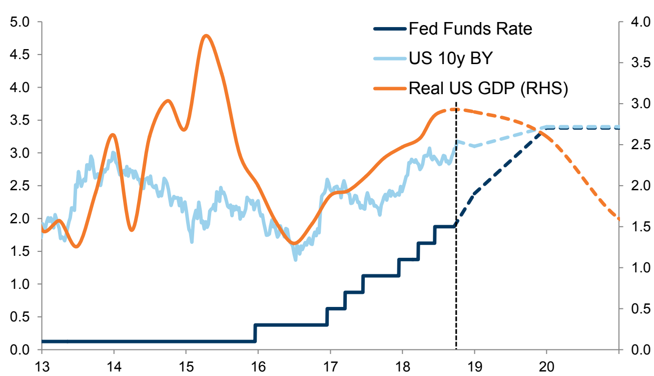
Source: I/B/E/S, MSCI, Goldman Sachs Global Investment Research

For the S&P 500, the growth in 2018 has been boosted by fiscal policy and financial conditions that are now fading. Rising margins in many markets have been an important contributor as has the impact of rising oil prices. But in all markets, **economic growth is the most important macro driver of profits and our economists' forecasts imply positive but decelerating growth through 2020. The slowdown in economic growth that we expect in 2019 is most prominent in the US,** where real average annual US GDP growth will gradually decelerate from 2.9% in 2018 to 1.6% in 2020. For the US equity market our top-down model shows that every 100 bp change in US economic growth results in a $5 change to S&P 500 EPS. Other factors, such as the roll off of the impact of tax cuts in the US and lower oil prices will also slow earnings growth.

We also expect margins in most regions to plateau or even contract moderately in 2019 and beyond. As with GDP growth, the slowdown is most marked in the US where we expect S&P500 earnings to slow from 23% in 2018 to 6% in 2019 and 4% in 2020. But interestingly, **the growth forecasts for all markets in 2019 are very similar with mid - single digit rates of growth and in all cases our forecasts are below the bottom up consensus.**

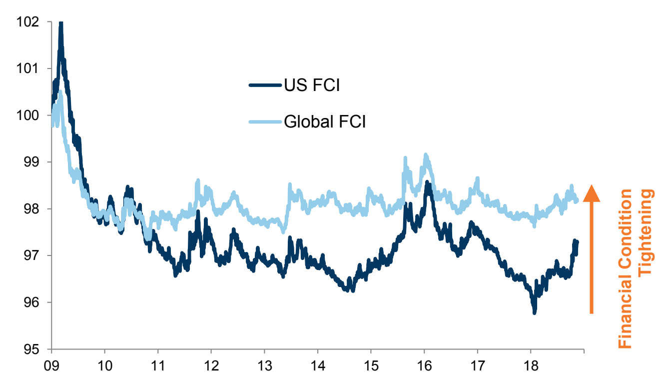
3. With only moderate profit growth to support returns, investors are likely to focus on the deterioration in the 'growth/rate' mix as the backdrop for 2019. With the fading of the US fiscal boost and a further tightening of US financial conditions **investors will likely be sensitive to the risks of a US recession in 2020.**

Exhibit 4: Strong growth, but poised to slow, meets rising yields and inflation



Source: Haver, Datastream, Goldman Sachs Global Investment Research

Exhibit 5: Financial conditions tighten as markets pullback
FCI - GS Financials Condition Index



Source: Goldman Sachs Global Investment Research

But a long economic cycle, like the current one, does not necessarily mean that it is close to an end; this been an unusual cycle in many respects. As we discussed in *Making cents, the cycle & the return of low returns, Global Strategy Paper 30, September 4th 2018,* we have seen the weakest economic recovery in the post-war period, particularly in nominal terms. A continuation of low inflation, and therefore relatively moderate rises in interest rates by historical standards, limits the risks of recession. If, as we expect, the US economy continues to grow past summer 2019 it will have been the longest US cycle in history.

Consequently, recent **fears about the end of the US economic cycle may be overdone.** Even though our economists expect US policy rates to rise four times in 2019, well above the current expectation of two hikes priced by the market, this would still leave rates reaching a peak of between 3 1/4 and 3 1/2%, well below that of other cycles. The market has already priced 11 of the 13 hikes we expect for this cycle, so most of the adjustment to more normal US interest rates is probably behind us. This, coupled with the absence of major private sector imbalances, should help propel growth for some time to come.

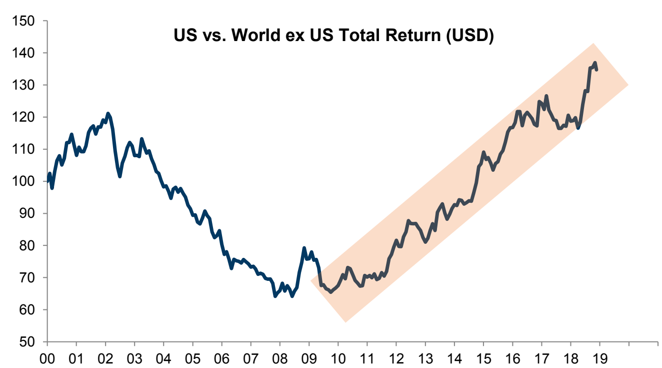
Even in the US, where corporate debt levels have increased, **the private sector balance is 4.5% of GDP, nearly two percentage points above the 30-year average.** Overall healthy household balance sheets, a relatively high personal saving rate, strong labour market momentum, and high business confidence all remain important supports, and we would need to see a significant further tightening of financial conditions to trigger a recession (see *European Economics Analyst - European Outlook: Recovery fatigue*, 15 November 2018).

4. While our economists anticipate a slowing of US growth they continue to expect global GDP in 2019 to be above trend at 3.5% and resulting in some re convergence of global growth. This backdrop is likely to be supportive of a hiatus in the long period of US equity market outperformance, particularly when measured in dollar terms (Exhibit 7).

Exhibit 6: Slowing US growth...

Source: Goldman Sachs Global Investment Research

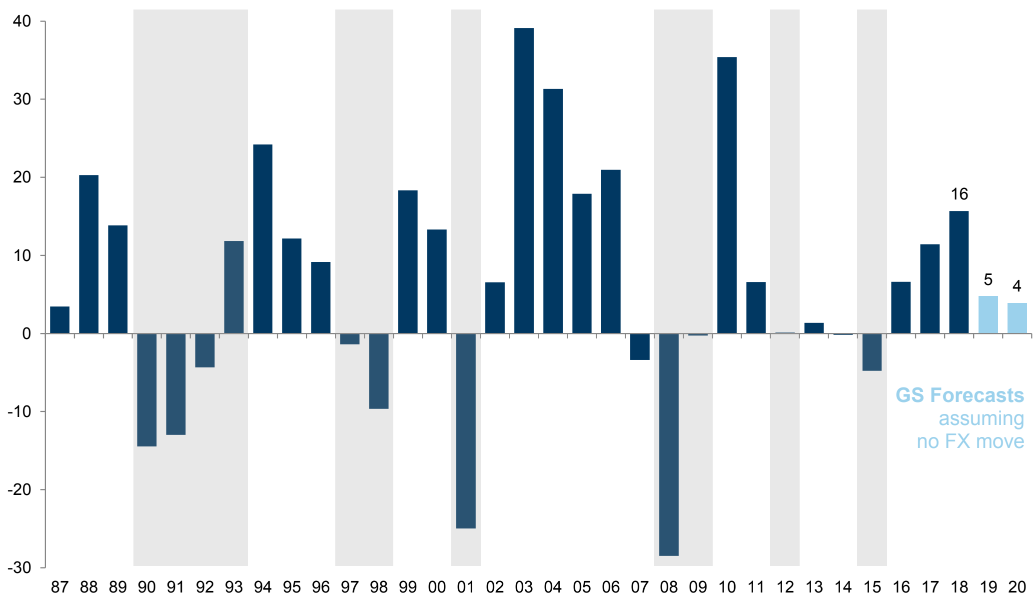
Exhibit 7: ... will hurt US outperformance
USD



Source: Worldscope, Datastream, Goldman Sachs Global Investment Research

5. In this context of continued, albeit weaker economic growth, a sustained bear market is unlikely, in our view. **While we expect low returns, backed by weak profit growth, it is unlikely that profits would fall without a recession and, consequently it is also unlikely that equities sustain a bear market (see *Bear Necessities; an update, 9 November 2018*).** As Exhibit 8 shows, all previous periods of falling profits globally have coincided with US recessions.

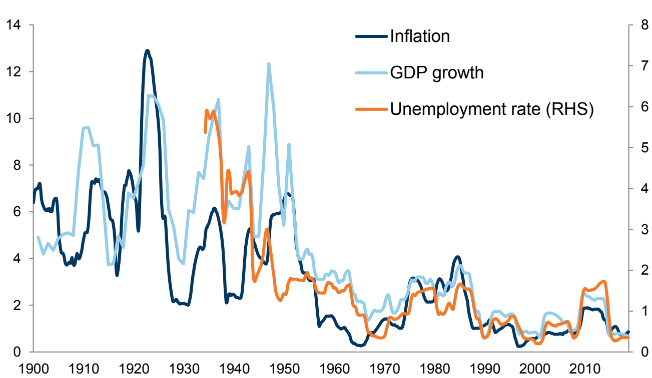
Exhibit 8: EPS rarely falls outside of recessions
MSCI AC World annual realised earnings growth, grey shading indicates recessions (US, Europe, Japan, or EM)



Source: IBES, Datastream, Haver Analytics, Goldman Sachs Global Investment Research

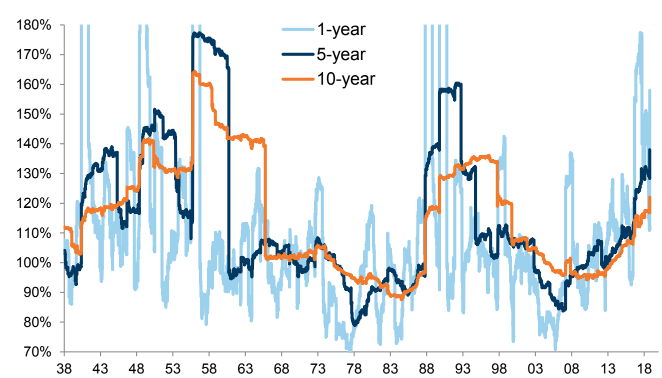
6. Low returns are not unusual but it is worth noting that such periods are very rarely 'flat' for very long. We describe two types of 'flat returns'; those that are **'Fat & Flat' - low returns but very wide swings in both directions (with falls and rallies of 20% or more, and those that are 'Skinny & Flat' - with a narrower range (+/- 10%). In our view the latter is much more likely** as we do not see sufficiently big swings in bond yields, inflation or macro variables to justify large market moves. But while macro volatility has fallen over time (see Exhibit 9), we are seeing an increase in the vol of vol.

Exhibit 9: Volatility of US GDP growth, inflation and unemployment rates has declined, especially since the 1980s
5-year rolling volatility



Source: GFD, Jorda-Schularick-Taylor Macrohistory Database, Goldman Sachs Global Investment Research

Exhibit 10: Vol of vol has trended up since the GFC
Volatility of S&P 500 1-month volatility (daily)



Source: Bloomberg, Goldman Sachs Global Investment Research

Some of this is down to market microstructure:

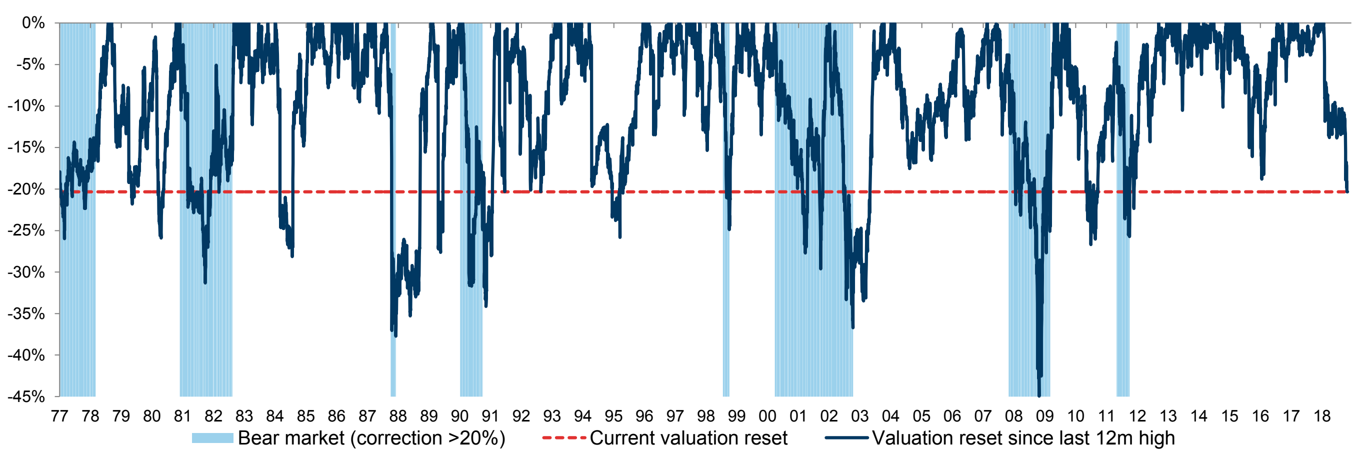
- Changes in bank regulation have reduced liquidity across assets.

- The rise of systematic investing, e.g., passive/smart beta strategies that reduce liquidity, can drive crowding.
- CTAs, risk parity and volatility target funds, which often invest very pro-cyclical.
- Levered or liquidity-constrained exchange-traded products, e.g, on high yield credit or commodities.
- Short vol carry strategies, e.g., short VIX ETPs.

These factors could contribute to more short-lived corrections and volatility in 2019, but are unlikely to change the fundamental drivers to low returns.

7. On a more positive note, and offsetting the slowdown in global profit growth, we see valuation as less of a risk moving forward relative to the start of 2018. **PEs have now fallen across equity markets broadly.** This is not unusual in a period of rising Fed funds rates but would appear to have already achieved the scale of de-rating that would be typical before an economic downturn.

Exhibit 11: Valuation de-rating in equities is one of the largest outside of a bear market
MSCI World NTM P/E change since last 12-month peak in valuation

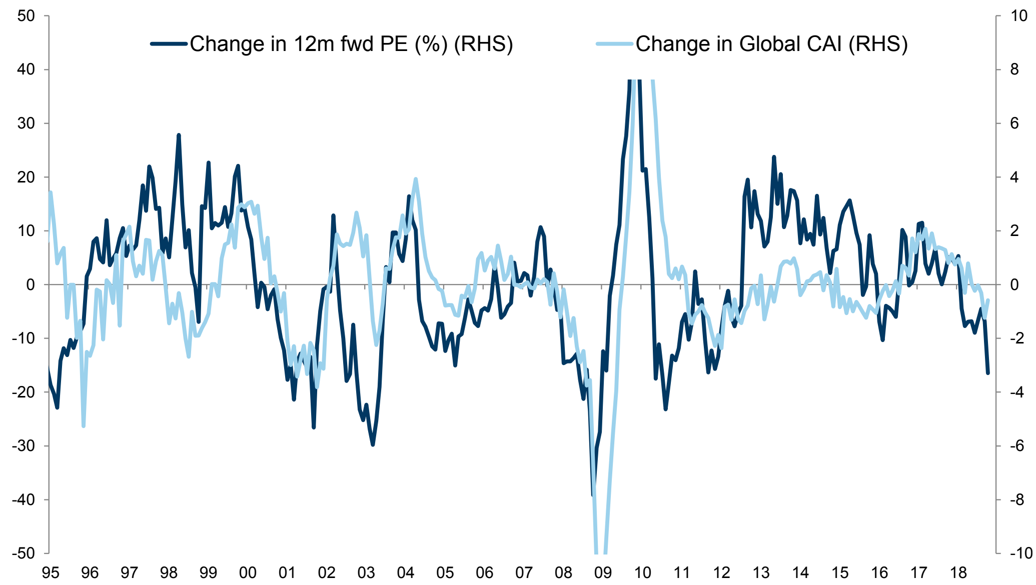


Note: NTM P/E based on S&P 500 data before 1988

Source: I/B/E/S, Datastream, Goldman Sachs Global Investment Research

Exhibit 12 shows the change in 12 month forward PE of the MSCI World against the change in our Global CAI (Current Activity Indicator). There is a reasonable relationship between the two but typically such an aggressive fall in multiples would be associated with a sharper slowdown in global growth than we forecast.

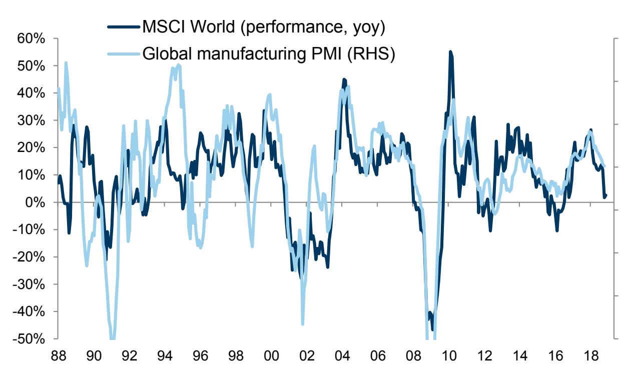
Exhibit 12: Valuations have fallen already discounting a fall in growth
Yoy change in 12m fwd of MSCI AC World PE with yoy change in Global CAI (Current activity indicator)



Source: Datastream, IBES, Goldman Sachs Global Investment Research

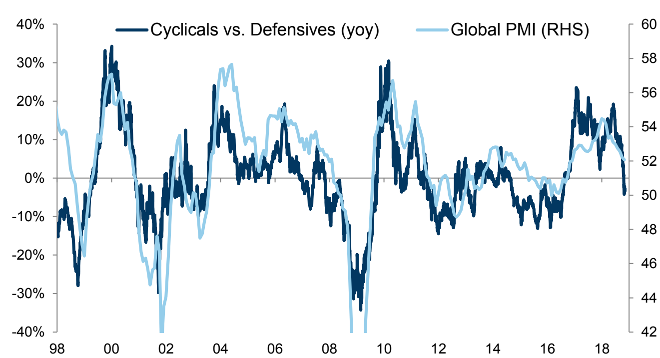
8. We have also seen an overshoot of growth expectations relative to our forecasts. Per Exhibit 13 and 14, the falls in equities on a year over year basis, and particularly in the most cyclical sectors relative to defensive ones, suggest that the market has overshot the fundamentals or is implying a bigger future slowdown in growth.

Exhibit 13: Growth slows, market follows
MSCI World (performance, yoy) vs. Global manufacturing PMI



Source: Datastream, Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 14: Cyclicals vs. Defensives performance points to a lower level for the Global PMI
World Cyclicals vs. Defensives relative to global manufacturing PMI

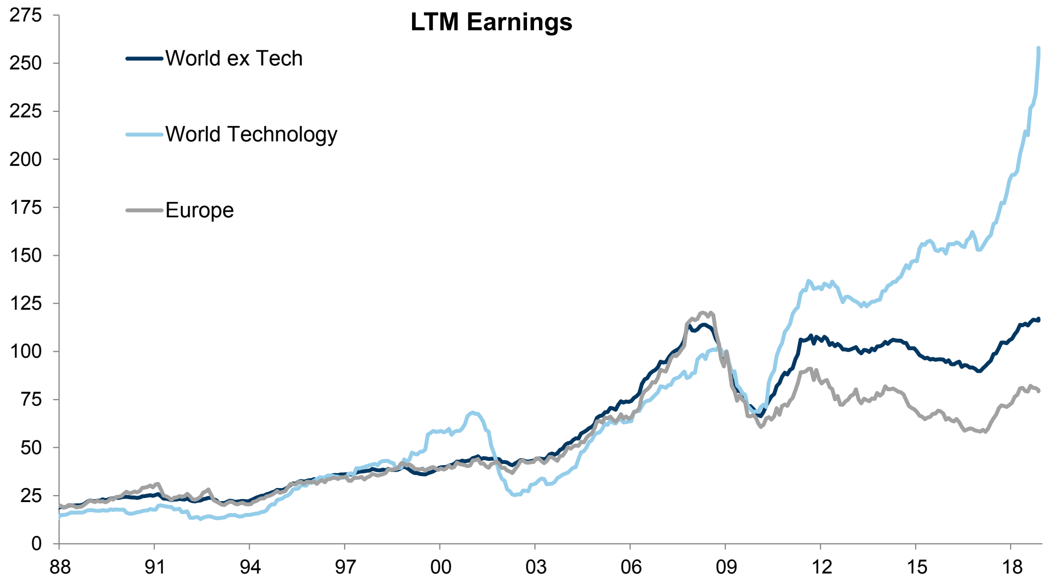


Source: Datastream, Haver Analytics, Goldman Sachs Global Investment Research

9: Since the financial crisis there has been an almost binary outcome in terms of market leadership beneath the market surface. In particular across the world there has been a very significant and persistent underperformance of value versus growth. This has reflected a combination of factors.

1) The staggering outperformance of technology (a key part of 'growth') is shown in Exhibit 15. This contrasts sharply with the global progression of earnings ex-tech which are only now back to pre crisis levels.

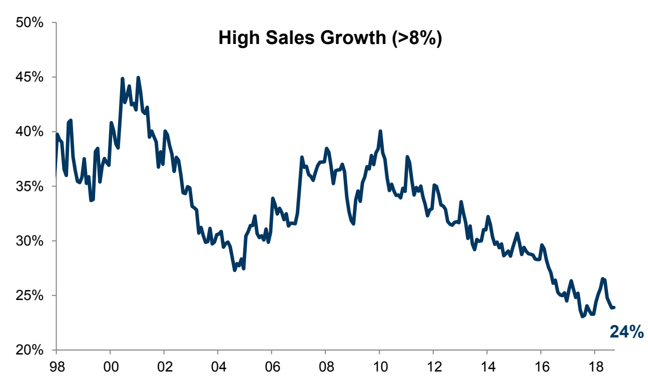
Exhibit 15: Tech earnings outstripped those of the market
LTM earnings (01/01/2009 = 100)



Source: Worldscope, Datastream, Goldman Sachs Global Investment Research

2) The scarcity of growth. As Exhibit 16 shows the proportion of companies globally that are achieving expected forward top line growth of 8% or more has nearly halved since 2000.

Exhibit 16: Few companies generate high top-line growth
% of MSCI AC World companies with high expected Sales growth in FY3



Source: Datastream, IBES, Goldman Sachs Global Investment Research

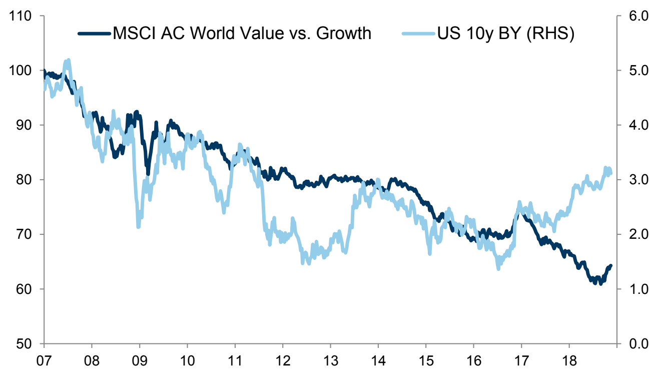
Exhibit 17: Few companies generate high bottom-line growth
% of MSCI AC World companies with high expected EPS growth in FY3

Source: Datastream, IBES, Goldman Sachs Global Investment Research

3) The relentless decline in bond yields which has supported longer duration assets, both in terms of growth versus value and also Cyclicals versus Defensives (Exhibit 18 & 19).

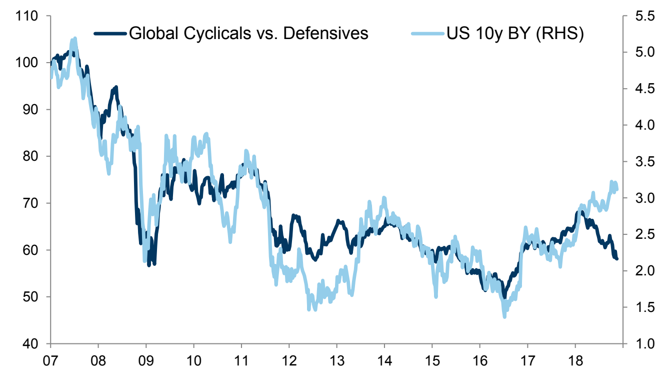
4) The impact of the crisis hit sectors such as banks which were at the epicentre of the financial crisis, and have been a drag on returns in more cyclcial and value based parts of the markets.

Exhibit 18: MSCI AC World Value vs. Growth with US 10-year BY - parts of value should be supported by rising yields



Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 19: Cyclicals vs. Defensives with US 10-year Bond Yield - cyclicals benefit from rising yields
Cyclicals: Autos, Banks, Basic Resources, Chemicals, Financial Svs, Industrials, Cons & Mat, Technology, Travel and Leisure. Defensives: Food & Bev, Healthcare, PHHG, Retail, Telcos, Utilities.



Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

Several of these drivers are reversing or, at least, not persisting as before. This makes it harder to take strong thematic views based on style or factor. We would expect a shift from beta to alpha as the main driver of returns within equity markets but see more of the alpha coming from companies with specific micro rather than macro characteristics.

1) In most cases, we are looking for companies that offer quality and/ or strong balance sheets.

Definitions of quality can vary widely. Our approach emphasizes balance sheet strength and stable growth. In the US our strategists recommend their **High Quality basket (GSTHQUAL)** which combines five metrics: (1) strong balance sheets; (2) stable sales growth; (3) low EBIT deviation: (4) expanding ROE; and (5) low stock drawdown experience.

In Europe our strategists focus on a recommended pair being **long strong balance sheet companies vs. weak (GSSTSBAL vs. GSSTWBAL)** - we have a similar approach via two stock lists in Asia as well as in a list of companies offering high and secure dividend yields. In Japan, we highlight **stocks with significant potential to boost their shareholder returns**. Specifically, companies with current low total payout ratios (i.e. dividends + buybacks/net income) and positive consensus profit forecasts that have not recently announced buybacks or dividend hikes.

2) From a growth perspective we are trying to identify the nexus of companies that are growing but are not too expensive - especially stable GARP and margin winners/losers) in Asia and a VARG screen in Japan (value with reasonable growth). Other approaches to finding growth include identifying companies that are reinvesting for growth; the basket of companies growing capex in Japan fits with this approach

(GSJPCPEX) and the **High Growth Investment Ratio basket in Europe made up of companies within each sector that are reinvesting the most (capex &/or R&D) but with rising cash returns (GSSTHGIR)** is also in this mode. There are growth sectors where we are still overweight such as Information Technology and Communication Services in the US and Europe (as well as software in Asia) given their low macro sensitivity and idiosyncratic growth profiles, high profit margins, and reasonable valuations relative to history.

3) From a value perspective, we identify oil majors in Europe as an ongoing opportunity as they transition from being a value trap to being a value creator and are very cash generative. Our US strategists have also upgraded utilities to overweight given the sector's track record of notable outperformance during decelerating GDP growth environments and a low historical beta to S&P 500. Our strategists are also overweight utilities in Asia and Hybrid utilities in Europe.

4) China recovery prospects - In Asia our strategists see value in China equities and are long China A shares (rising index inclusion) and recommend HSCEI 3m 105 calls to play a potential moderation in US/China trade friction (see here). Alongside this, our strategists like commodity cyclicals in Europe and Asia. In Japan, our strategists highlight a list of **China-exposed industrial stocks**.

In Japan our strategists have the scenario of a 1H rebound and recommend VARG (Value at Reasonable Growth) stocks and capex beneficiaries (e.g. GSJPCPEX) but shift the focus to a more defensive posture focused on shareholder return/high dividend payout stocks and select SMID-caps (e.g. womenomics: GSJPWMN2) for the latter half of the year.

Exhibit 20: What we like

Quality	Selected Growth
US: High Quality (GSTHQUAL)	US: IT and Communication Services
Europe/Asia: Strong vs. Weak Balance Sheet	Europe: Tech
Japan: Potential to boost their shareholder returns	Europe: High Growth Investment Ratio (GSSTHGIR)
Japan: Value with reasonable growth	Asia: stable GARP and margin winners/losers
	Asia: Software
	Japan: Growing capex (GSJPCPEX)

Selected Value	China recovery
US/Asia: Utilities	Europe/Asia: Commodities
Europe: Hybrid Utilities	Asia: China A shares
Europe: Oil	Japan: industrial stocks exposed to China
Asia: Secure & High DYs	

Source: Goldman Sachs Global Investment Research

10. There is no shortage of known risks for 2019. In Europe, we expect risk appetite to remain constrained until the Italian budget crisis is resolved, which may be deep into next year. Our economists believe that market pressure is the more likely catalyst for a return to fiscal discipline so from a market perspective, things may need to get worse before they get better. In Europe, our Strategists have downgraded banks to neutral given these risks.

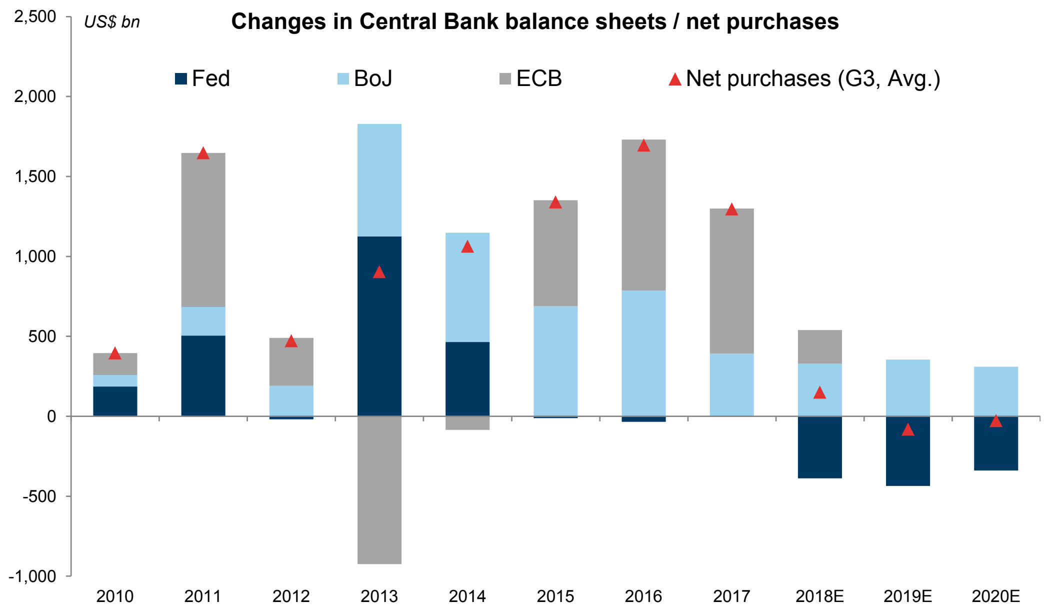
This seems to be a similar narrative in terms of the Brexit negotiations as well. The Prime Minister recently explained that the UK has three options – to leave the EU with "no deal", to risk "no Brexit at all", or "to unite and support the best deal that could be negotiated". Depending on the domestic course of politics in the UK and, in the event that Parliament fails to ratify the Brexit deal there could be either (i) a subsequent, successful attempt to pass an amended Withdrawal Agreement; (ii) a second referendum; or (iii) a "no deal" cliff-edge departure. Some of those paths raise the prospect of a general election so uncertainty is likely to remain high in 1H 2019.

For China with monetary and fiscal policy now being eased, our economists expect only a modest further deceleration. While the trade issues are still likely to dominate headlines, they think the macro impact of increasing tariffs is also likely to remain manageable, even if, as they expect, there is further escalation in early 2019. Also, Chinese stocks and corporate credits now embody decent value. If Chinese growth stabilizes in line with policymakers' aim, on the back of a renewed focus on infrastructure investment, there is likely to be upside here. That said, a further depreciation of the Renminbi is also a risk for international investors, in our view.

Fundamentally, and aside from political events, we see the biggest macro risk to markets coming from rising inflation and the exit from QE. Our economists stress that wage growth across most DM economies has started to pick up even across the broader Euro area and many other smaller G10 economies, in addition to places like the US and Germany where unemployment is low. For the US in particular, wage growth is now up to about 3% year-on-year, with wage survey indicators pointing toward further gains. With core inflation at 2.0% at a time when the tariff impact is probably just about to show up in higher goods pricing, our economists expect a gradual move to about 2¼% by the end of 2019.

All this is happening at a time when we are transitioning from aggressive QE to QT (see Exhibit 21). While the direct relationship between quarterly net asset purchases by central banks and financial conditions or equity market returns is less clear, the impact of QT is likely to be felt through higher rates which would feed into tighter financial conditions with a lag. We view the transition from QE to QT as akin to a 'tidal' shift that is likely to cap the magnitude of any potential valuation recovery in 2019.

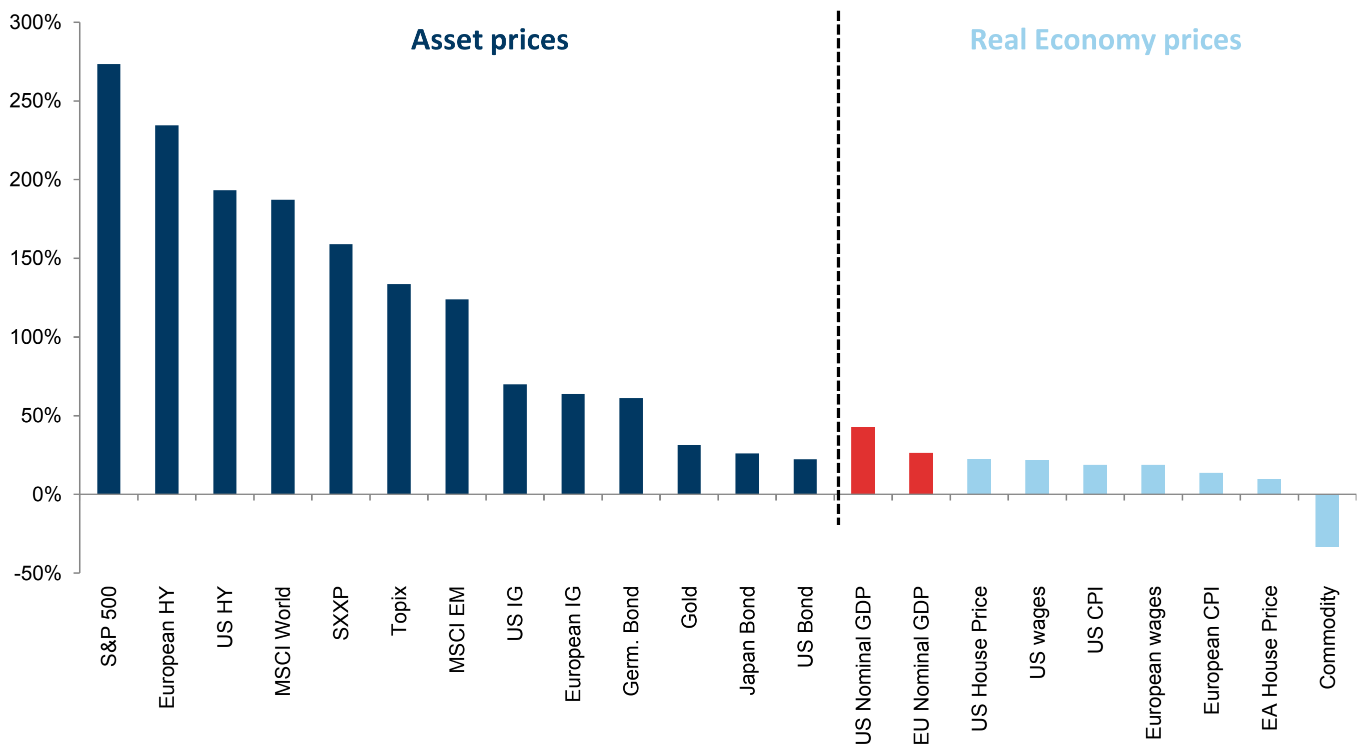
Exhibit 21: Aggregate central bank balance sheets are likely to contract further next year, after prolonged net purchases since 2009



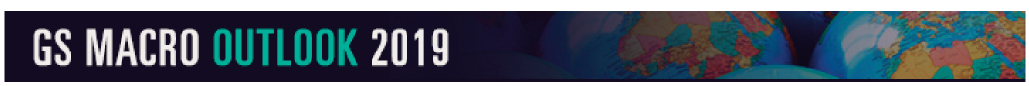
Source: Goldman Sachs Global Investment Research

If the economy doesn't slow and bond yields rise meaningfully we would likely see a further de-rating across most financial assets. As Exhibit 22 shows, since the start of QE in 2009, there has been a wide gap between measures of inflation in the real economies (consumer prices, wages and so on) where inflation pressures have been very modest up until now, and financial asset price inflation (on the left of this chart) where price increases have been very significant. If inflation expectations in the real economies rise, forcing bond yields higher, we are likely to see a 'Balanced Bear' (a bear market across financial assets), see *GOAL — Global Strategy Paper: The Balanced Bear — Part 2: Chasing your tail risk and balancing the bear*, 2 October 2018.

Exhibit 22: Wide dispersion between asset price inflation and 'real economy' inflation
Total return performance in local currency since January 2009



Source: Goldman Sachs Global Investment Research



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Reg AC

We, Peter Oppenheimer, Sharon Bell, CFA, Lilia Peytavin and Guillaume Jaisson, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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