

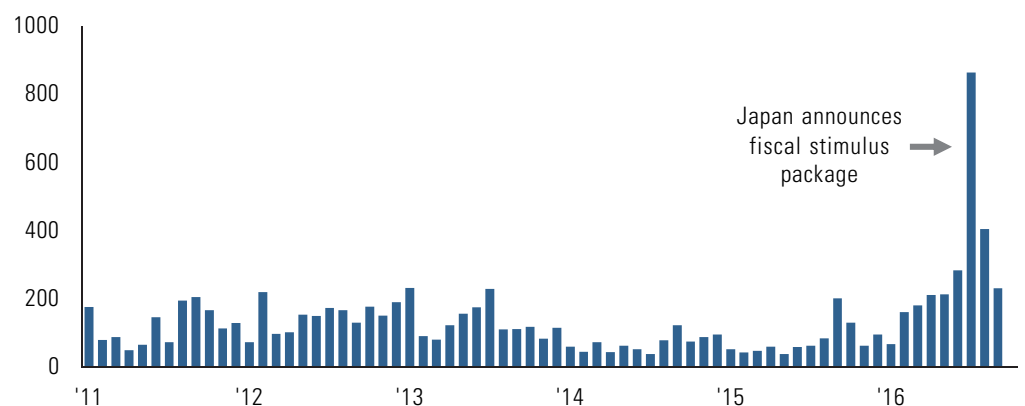
A Turning Point in Policy

The long recovery from the global financial crisis appears to have reached an important inflection point this year. Monetary policy, the main tool for combatting persistently low growth and inflation, appears close to its limits. As a result, the market's attention has turned to fiscal policy. In this edition, we attempt to answer some of the questions that arise from this shift.

- What are some of the main challenges facing policymakers? Continued low inflation expectations and growing damage to financial institutions and savers (see *Four Charts on Key Policy Challenges*, p.3).
- What is the outlook? We think monetary policy in Europe and Japan will primarily be about sustaining existing measures, and we see limits to the potential impact of fiscal policy. Our long-term scenarios range from pessimistic (a break-up of the Eurozone) to more optimistic (gradual healing), but we see few near-term catalysts for major market reversals (see *Focus*, p.4).
- Where do markets offer opportunity? We think investors can find selective opportunities in high-yielding stocks, emerging market stocks and fixed income spread sectors (see *Focus*, p.5).
- What are the asset allocation implications? We hold to our view that equities are more attractive than credit and credit is more attractive than interest rates (see *Interview*, p.6).
- What are the implications for divergence? Quantitative trend signals indicate growing divergence in currencies and short-term rates (see *Quant Call*, p.7).

With Monetary Policy at its Limits, Attention turns to Fiscal

Number of Bloomberg Stories per Month Containing the Phrase "Fiscal Stimulus"



Source: Bloomberg. Monthly data, through September 2016.

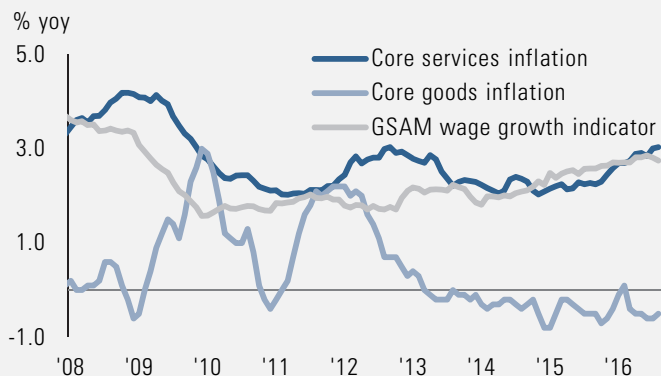
Macro Trends and Views: Four Charts on Key Policy Challenges

US

"The chart shows the uptrend in domestically driven US inflation measures, which include services and wages, versus core goods prices, which have been dragged lower by global factors. This divergence has kept the Federal Reserve on hold, but we think the markets are underestimating the risk of rising US inflation as the effect of global factors fade in the coming quarters."

Tom Teles
Global Fixed Income Team

US Inflation Measures



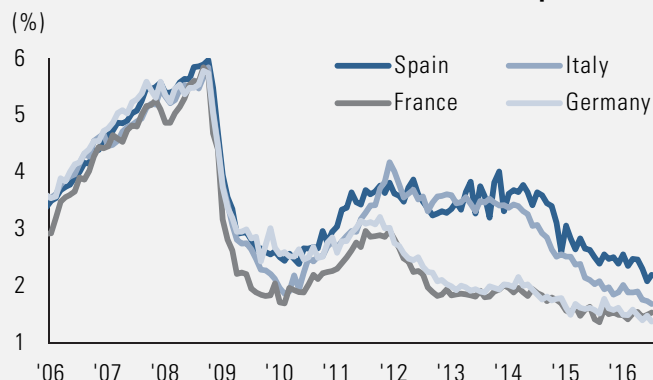
Source: Source: Haver Analytics, GSAM. As of August 2016.

Europe

"The European Central Bank has been effective at driving funding costs lower across Europe, both through the bank channel and the corporate bond channel. This is supportive for the economy but is hurting bank profitability. We think central banks are taking steps to reduce the impact, but in the near-term, bank revenues and profitability will remain under pressure."

Alexis Deladerrière
Fundamental Equity Team

Interest Rates on Loans to Non-Financial Companies



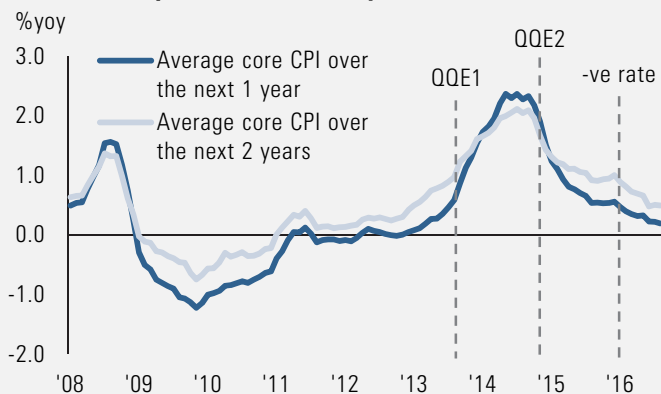
Source: Haver Analytics, ECB. As of July 2016.

Japan

"After the Bank of Japan began 'Quantitative and Qualitative Easing' (QQE) in 2013, inflation expectations surged, as yen depreciation caused import prices to rise. However, since 2015, the inflation outlook has deteriorated, partly due to energy prices. Now, despite negative interest rates, inflation expectations have declined further as the yen has appreciated against most major currencies due to risk-off sentiment. This is a key challenge for the central bank."

Ichiro Kosuge
Fundamental Equity Team

Inflation Expectations Survey



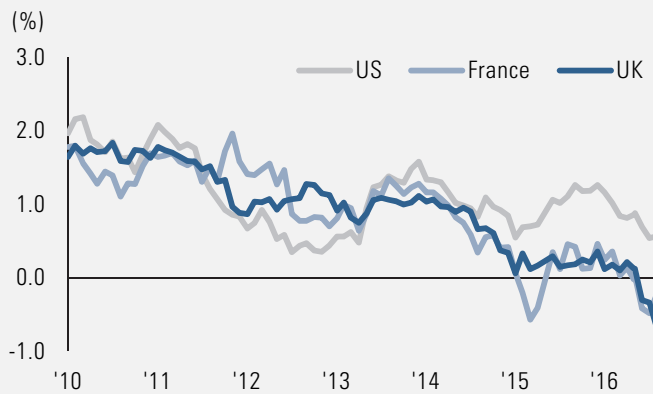
Source: Nikkei QUICK, GS Global Investment Research. As of August 2016.

UK

"UK long-term real interest rates have fallen to new all-time lows following the EU referendum and the Bank of England's rate cut. In other words, the market is pricing UK rates to remain low for a very long time. This is going to create significant challenges for many UK pensions that use inflation-linked securities to hedge against inflation-linked liabilities, as declining real rates have made this hedge a very expensive proposition."

Andrew Wilson
Global Fixed Income Team

30-Year Real Yields



Source: GSAM. As of September 2016. UK real rate adjusted to account for differences in inflation measures .

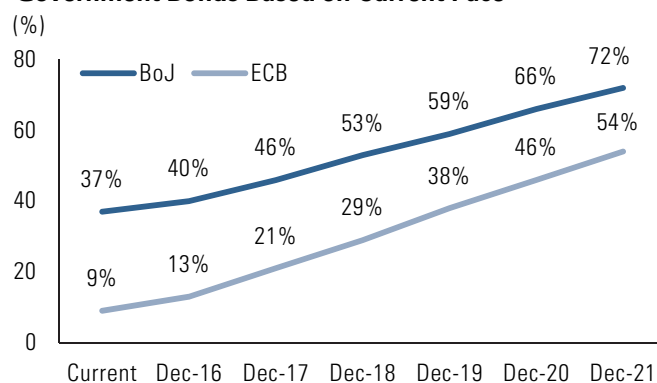
Focus: A Turning Point in Policy

Recent policy decisions by the European Central Bank (ECB) and Bank of Japan (BoJ) suggest policy may be at a turning point, with monetary policy at its practical limits and fiscal policy as the best option for further easing. In this edition, we attempt to answer some of the questions that arise from this apparent turn: Is monetary policy at its limits? Can fiscal policy have a meaningful impact? What might the end-game look like? And where might investors find value as policy turns and the hunt for return continues?

Has monetary policy reached its limit?

We expect the Federal Reserve to raise rates in December, which would provide some room for future easing if needed. In Japan and the Eurozone, we think monetary policy easing is effectively at its limits. Incremental rate cuts by the BoJ or ECB would likely have little effect and significant cuts would probably be counterproductive. Both banks are also already buying government bonds at a pace that will become increasingly difficult to maintain as their holdings grow as a percent of the total market (Exhibit 1).

Exhibit 1: Central Bank Holdings as % of Outstanding Government Bonds Based on Current Pace



Source: Autonomous Research, based on the current pace of government bond purchases by the ECB and BoJ

Negative rates and massive asset purchases were intended as stabilizing shocks to the system that would change the dynamic on inflation. But the sprint has become a marathon. The Eurozone has had negative rates for more than two years now, and Japan is more than a year past the BoJ's initial two-year target for inflation rising to 2%. As a result, we think the unintended consequences of extreme policy in Europe and Japan have grown, most notably on the financial system and savers.

Looking ahead, we think future changes are likely to focus on 1) avoiding the need to taper existing purchase programs due to limited availability of eligible bonds, 2) shielding the financial system from the effects of existing policy, and 3) encouraging fiscal policymakers to take advantage of this period of stability and low interest rates.

We think the BoJ's recent shift—from targeting a specific path for the supply of money to targeting a specific level for 10-year rates—is a significant step in this direction. If the government increases fiscal stimulus and issues more debt, the BoJ can now absorb those bonds without any explicit change in policy.

What is the outlook for fiscal policy?

We expect modest fiscal easing in the year ahead, but we do not see this as a panacea for growth, for several reasons.

First, except for tax cuts, fiscal policy tends to have a gradual impact. In the US, for example, both presidential candidates have suggested the need for increased spending on infrastructure. These projects take time to approve and can take many years to affect growth. Either US candidate might be able to pass a significant fiscal spending program, but the gradual nature of infrastructure projects means the boost to growth is likely to amount to a few tenths worth of GDP spread out over several years.

Second, fiscal stimulus increases government debt. More government borrowing might ease the scarcity constraints on ECB or BoJ bond purchases, but debt growth creates other issues. In China, for example, fiscal stimulus has helped to stabilize the economy, but investor concerns about China's growing debt burden have also contributed to de-stabilizing capital outflows.

Third, politics are likely to constrain fiscal easing. After years of austerity, Eurozone fiscal policy has loosened in 2016 due to spending related to refugees and security, and could loosen more ahead of upcoming elections. More overt stimulus, such as tax cuts, might provide a bigger, quicker boost. However, fiscal policy in several countries is already straining the flexibility of Eurozone rules and Germany appears to have little appetite for major stimulus. As a result, we think a crisis would probably be required to overcome the political barriers to significant stimulus in the Eurozone.

How does the policy experiment end?

We see three scenarios: growth, inflation or default. Default is not a very popular option, so we generally expect countries to fall along a spectrum: from growth that allows policy to gradually normalize to inflation that becomes difficult to control. Whatever the end-game might look like, we don't see any clear, near-term catalysts that lead to more pessimistic scenarios, so the environment of low growth, modest global inflation and investor demand for yield could remain in place for a long time.

What are we pessimistic about?

Japan, China and Europe appear to be on unsustainable paths and we see risks in combining fiscal and monetary policy.

In Japan, the BoJ is effectively monetizing government debt while committing to overshoot its inflation target. We would usually expect investors to sell government bonds in this situation, leading to higher borrowing costs and unsustainable government debt dynamics. However, Japan is unique: most government debt is held domestically, Japan has significant foreign assets and Japanese investors tend to bring their money home in times of crisis. This could allow an otherwise unsustainable situation to continue. Longer-term, controlling an overshoot on inflation may be a challenge for the BoJ.

Focus: A Turning Point in Policy (cont'd)

In China, policy has helped to stabilize growth but has also contributed to bubble-like conditions in one domestic market after another, including equities, wealth management products, commodities, corporate bonds and real estate. We expect this to eventually lead to a rise in defaults and a need for bank recapitalization. But again, we see no near-term catalyst for a debt crisis in an economy where the government has significant ability to socialize losses.

Europe bears watching. The Eurozone appears to be following Japan's path, but is less cohesive and more politically fractured. Modest fiscal loosening, enabled by ECB rate policy and bond purchases, may support growth in the near-term but is likely to create political challenges over the longer-term. Some of these challenges may be on the horizon with upcoming elections in Germany and France, and a constitutional referendum in Italy. When we look for potential catalysts that could lead to another crisis, a break-up of the Eurozone is probably the leading candidate.

What are we optimistic about?

With no obvious catalyst for the more pessimistic scenarios, we are optimistic that markets can navigate the turning point in policy for now, as central banks are likely to succeed in extending accommodative monetary policy and fiscal policy becomes somewhat more supportive. If slow growth reflects an extended recovery cycle, as Neill Nuttall discusses on page 4, accommodative policy might allow an economy like the US to grow its way out and avoid the most pessimistic scenarios.

Where are the opportunities in equities?

We see security selection opportunities across global equity markets, but in the context of the current policy environment, we focus here on two particular areas: emerging markets and bond-like equities.

Emerging market (EM) equities have attracted significant investor demand this year, helped by expectations that EM growth may have turned a corner and that monetary policy will remain accommodative in the developed world.

More recently, some of the biggest risks for EM equities, such as China's industrial slowdown and low oil prices, also appear to be stabilizing, while valuations remain attractive versus DM equities.

However, we believe investors should remain active and highly selective in EM: not only are EM economies at different stages of recovery, the MSCI EM Equity provides poor exposure to what we believe are some of the best opportunities.

While investors looking for growth are increasingly turning to EM, those searching for yield have flocked to high-dividend-yielding stocks, including real estate investment trusts (REITs). As a result, many of these "bond proxies" look richly valued by equity standards. However, we think they are relatively attractive compared to bonds.

Moving slightly lower along the yield spectrum in equities can also offer more value. For example, as shown in Exhibit 2, stocks with slightly lower yield potential may be more attractive on important metrics related to sustaining that yield, including lower debt, lower dividend payout ratios and stronger earnings growth potential.

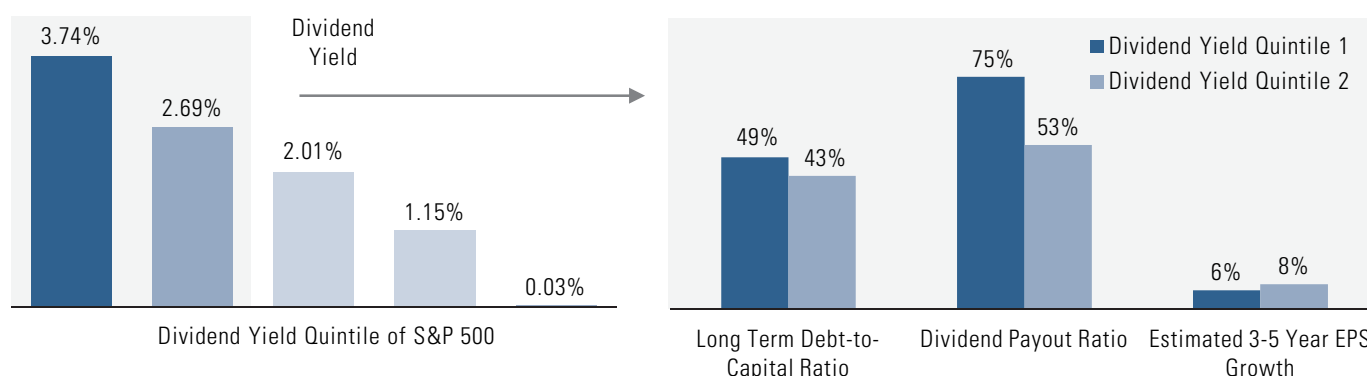
Where are the opportunities in fixed income?

With no clear catalyst for sharply higher interest rates, we think it makes sense to maintain exposure to fixed income sectors that offer a spread over government bonds.

Many investors are familiar with corporate bonds, and the sector has seen strong demand among those seeking higher-yielding alternatives to low or negative yields in the government bond market. This dynamic has contributed to rising corporate leverage and deteriorating balance sheets. We see more value in spread sectors that investors tend to be less familiar with, such as high-quality collateralized loan obligations (CLOs) and bonds secured by mortgage credit or government-backed student loans.

For more detail on our equity and fixed income market views, see our upcoming outlooks.

Exhibit 2: Within the Highest Yielding Segment of the S&P 500...the 2nd Quintile May Offer More Attractive Value



Source: FactSet, as of Q2 2016.

¹ S&P 500 quintiles subdivides dividend paying stocks within the S&P 500 index into fifths with the first quintile representing the 100 highest yielding stocks and quintile five, the 100 lowest. Dividend yield is calculated using annual dividends per share divided by the share price as of the report date. ² Long term debt-to-capital ratio is calculated as long term debt divided by total capital. Dividend payout ratio is calculated as annual dividends per share divided by annual earnings per share as of the most recent fiscal period. Estimated 3-5 year EPS growth rate is calculated as the mean of all 3-5 year EPS growth rate estimates provided to FactSet by individual brokers using their own individual methodologies. Shown for illustrative purposes. **Past performance does not guarantee future results, which may vary.**

Interview: Asset Allocation and the Turning Point in Policy

Neill Nuttall, Co-Chief Investment Officer for GSAM's multi-asset group, Global Portfolio Solutions (GPS), discusses the case for maintaining exposure to risk assets while global growth remains in the expansion phase of the cycle.

Do you think secular stagnation is taking over from the economic cycle as a key driver of markets?

No. We believe the current environment is best understood as a prolonged cyclical recovery from an unusually large economic shock. Despite all the talk about secular stagnation our analytical work suggests that asset performance can be explained well by cyclical dynamics. In particular we believe that current low bond yields are anchored by monetary policy which is likely to shift as US growth continues to bring down unemployment and increase inflation. Our view contrasts with the secular stagnation view that we have seen a structural shift to a low nominal growth environment where interest rates will stay very low for a very long time.

If secular stagnation is less of a concern, what other risks are you focused on?

We do worry that a shift in market perception of monetary policy could lead to a rapid shift higher in global bond yields causing volatility across assets. Right now, there seems to be a very high burden of expectation on policy makers, both monetary and fiscal, to stay behind the curve and keep conditions very easy. We saw the ECB recently disappoint such expectations and we think the change in focus of the Bank of Japan could also lead to disappointments.

On the fiscal side, we do not think the US political framework will permit sizeable fiscal easing, nor for that matter do we believe that the prevailing macro conditions there warrant such easy policy. Further disappointments of actual policy relative to elevated expectations are a likely catalyst for a sell-off at some point in coming months.

Beyond that, there appears to be a gap between recent economic data surprising to the downside while markets have been holding up, and we have trimmed equity risk tactically, to prepare for a potential short term drawdown. Later this year, we believe that we shall see some rise in market volatility around the US election, which is only now starting to get priced in markets. Finally, as the impetus from fiscal stimulus fades in China, the risks are to the downside in the short term there too.

If we are in a prolonged cyclical recovery, how are you managing client portfolios to navigate that?

We believe we can add significant value by adjusting the risk posture of portfolios to account for where we are in the economic cycle. In particular, we are aiming to avoid potential downsides: winning by not losing as it were. Beyond ascertaining where we think we are in the cycle, we look at the valuation of assets relative to economic conditions, we try and answer the question "why might this cycle be different" and we also look for specific latent risks in markets (for example credit growth in China) when we make these adjustments to the risk posture.



Neill Nuttall

Neill is Co-Chief Investment Officer for GSAM's Global Portfolio Solutions team.

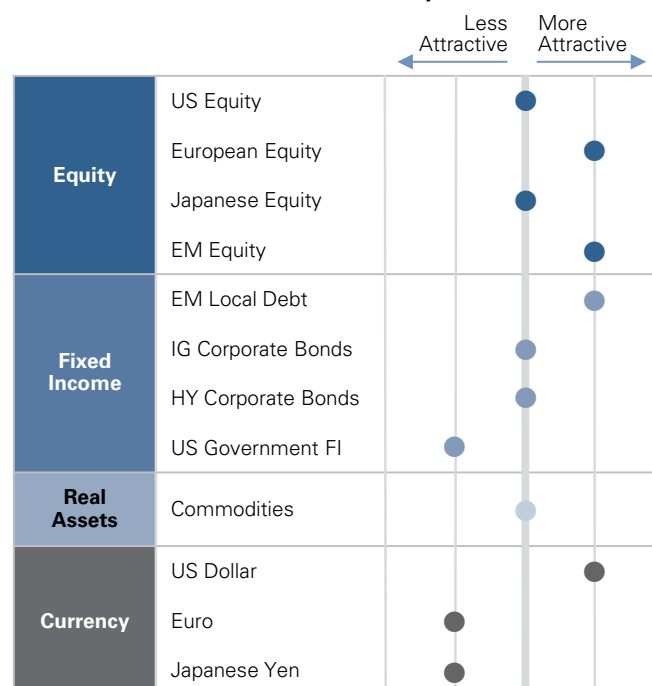
How are you positioned in your portfolios?

We believe we are still in an expansionary phase of the cycle and so remain overweight risk assets. That said, return potential is broadly more muted and therefore we are emphasizing a theme of dynamism in portfolios. While our positive growth outlook underpins our overweight to equities and some credit investments over the medium term, dynamism makes us focused on buying when the market dips and taking profit judiciously on fast rallies. We like EM over the medium term, though we have trimmed our tactical overweight recently after the rally. We think EM currencies are at attractive valuations and the economic outlook for the universe is reasonably strong. EM currencies and debt also offer attractive carry which is another theme we have been overweight for some time. Finally, we are underweight DM government rates and also bond surrogate equities such as utilities.

So it would be fair to say equities over credit over rates?

Yes, absolutely. And EM over DM for now.

GPS asset allocation views on a one-year horizon*



Source: GSAM Global Portfolio Solutions (GPS). As of September 2016.
* Note that this does not account for liability-driven investment.

Interpreting Divergence through Quantitative Trend Signals

Policy-related market divergence can also be examined by quantitatively analyzing price trends, writes **James Park**, senior portfolio manager for the Macro Alpha team within GSAM's Quantitative Investment Strategies platform.

Given the recent unconventional moves made by the ECB and BoJ, many sovereign debt markets have entered uncharted territory. At the same time, US Fed has been gearing up to raise its benchmark rate in response to stronger US economy. During this period of market speculation on the future of central bank policy and its scale of impact on economies and financial markets, we are observing some key turning points and divergence in many macro assets. Using quantitative methods, we have observed that since the beginning of 2016, many asset classes are exhibiting increased price divergence.

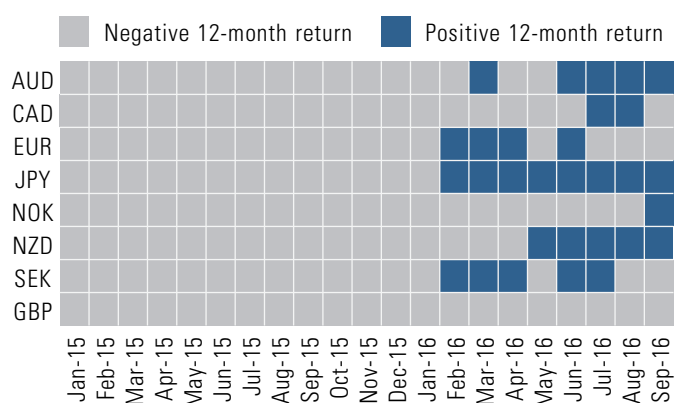
Below we focus on two notable episodes of price trend divergence within two major asset classes.

High and volatile divergence in global currencies

As markets moved away from the USD-driven environment in 2014 and further stabilized after the Chinese currency devaluation in August 2015, we now observe more pronounced diverging trends in global currencies. These trends are partly caused by differences in central bank moves among developed and emerging economies, and partly driven by other macroeconomic shocks (e.g. Brexit).

Exhibit 1 below illustrates that starting from 1Q 2016, the performance of global currencies versus the US dollar has become more dispersed.

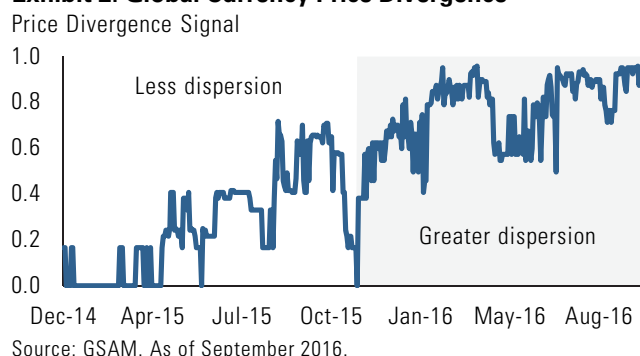
Exhibit 1: Dispersion in 12-month Return of Global Currencies vs USD



Source: GSAM. As of September 2016.

Exhibit 2 shows the divergence signal in global currencies, measured using simple trend signals defined over multiple return horizons.¹ This measure again confirms the diverging trend in this market and highlights the lack of US dollar dominance previously observed in this asset class.

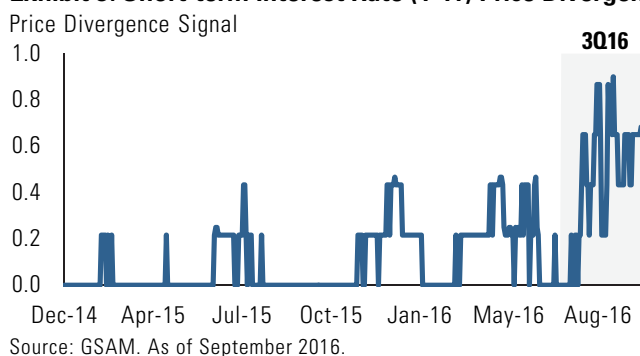
Exhibit 2: Global Currency Price Divergence



Divergence in short-term interest rates in Q3 2016

Starting in 2016, we have also seen divergence in the short-term interest rates market, which has previously moved largely in unison (divergence signal of less than 0.5). This dichotomy grew in 3Q 2016, as the expectation of a US rate hike intensified. Interestingly, this divergence is not happening in the longer tenor points. This suggests many investors may be skeptical about the prospect of a sustained rise in US interest rates in the near term.

Exhibit 3: Short-term Interest Rate (1-Yr) Price Divergence



Potential opportunities from greater dispersion

Some of the divergence within asset classes may offer more nuanced and potentially diversifying investment opportunities for trend-following investors.

In fixed income, for example, short-term US Treasuries look bearish while US 10-year Treasury notes appear attractive from a trend perspective. This suggests a yield curve flattening trade.

Despite broadly positive performance of risk-on assets, we also see some strong positive trends in risk-off assets – some of these include Japanese yen and precious metals. These types of risk-offsetting trend trades may be especially appealing to investors who utilize trend following approaches for its diversification benefits.

¹ Signal construction methodology: we first measure returns of individual assets at the 3-month, 6-month, 9-month and 12-month periods. Within each of the time periods, we take the price return sign as a binary signal (positive or negative), and calculate the standard deviation of this signal across assets. We then take an equal-weighted average of the standard deviation for each time periods to arrive at an overall signal for each asset class. This signal is between 0 and 1, where a larger value corresponds to higher price dispersion.

Appendix: GSAM Growth Forecasts and Asset Valuation

GDP Growth Forecasts: GSAM vs Consensus

	2013	2014	2015	2016		2017	
				GSAM	Consensus*	GSAM	Consensus*
US	1.5	2.4	2.4	1.6	1.5	2.2	2.2
UK	1.9	3.1	2.2	1.5	1.8	0.8	0.7
Euro area	-0.3	0.9	1.7	1.4	1.5	0.8	1.3
Japan	1.4	0.0	0.6	0.6	0.6	1.0	0.8
Brazil	3.0	0.1	-3.8	-3.0	-3.3	1.5	1.0
China	7.7	7.3	6.9	6.6	6.6	6.0	6.3
India	4.7	6.6	7.2	7.3	7.5	6.5	7.7
Russia	1.3	0.7	-3.7	-0.8	-0.6	1.5	1.3
Mexico	1.4	2.2	2.5	2.2	2.1	2.5	2.5
Korea	2.9	3.3	2.6	2.7	2.6	2.7	2.7
Indonesia	5.6	5.0	4.8	5.0	5.0	5.2	5.4
Turkey	4.2	3.0	4.0	3.0	3.2	3.3	3.0
Advanced	0.9	1.6	1.9	1.4	1.4	1.5	1.6
EM	5.5	5.3	4.6	4.8	4.8	4.9	5.2
World	3.3	3.6	3.3	3.2	3.2	3.3	3.5

* As of October 2016. Source: GSAM and Bloomberg.

Equity Valuation Across Advanced and Growth Markets

	CAPE*		FY1 PE		Price/Book		Dividend Yield		Earnings Momentum**
	Level	% time cheaper***	Level	% time cheaper***	Level	% time cheaper***	Level	% time cheaper***	% change in 1y fwd EPS
US	21.5	67	17.4	79	2.9	76	2.1	67	-0.83
India	19.6	56	17.9	91	3.2	63	1.3	70	-0.63
Canada	19.3	58	16.6	81	1.9	66	2.9	56	-0.01
Japan	19.1	27	13.4	13	1.2	13	2.3	19	-5.56
France	17.8	58	13.8	56	1.4	41	3.6	46	-0.21
Italy	16.9	44	12.2	29	0.9	20	4.3	8	-6.00
Australia	16.1	51	16.7	88	1.9	60	4.4	34	-0.69
Europe	16.0	50	14.7	66	1.7	53	3.4	51	-2.32
Germany	15.7	54	13.0	41	1.7	50	2.9	65	-1.84
Spain	14.7	46	12.6	50	1.2	39	4.9	38	-6.67
UK	14.3	57	16.1	74	1.8	43	3.9	54	1.01
Portugal	12.0	39	16.1	76	1.9	56	3.4	51	2.62
China	10.2	24	11.8	60	1.6	41	2.3	65	-1.13
Brazil	9.7	35	12.4	96	1.5	65	3.5	59	0.69
Russia	4.2	12	5.8	38	0.8	26	4.6	8	5.11

* Cyclically-adjusted PE ratio (5-yr rolling window). ** % change in 1-yr fwd EPS over last 3 months. *** Current percentile relative to full history

As of September 2016. All data based on MSCI country indices. Source: Datastream, GSAM calculations

US Equity Risk Premium



Equity Risk Premium for the BRICs



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