



2019 Investment Outlook



MACRO & MARKET VIEWS

2-5

A Better Deal: We remain pro-risk heading into 2019 with a preference for equities, especially in EM where the period of growth moderation is likely behind us. Asset prices and market expectations have adjusted significantly lower versus a year ago, offering a better deal and creating the potential for positive surprises. We expect to see more signs of an aging cycle in 2019, which may be challenging to navigate. Yet without clearer signs of deteriorating fundamentals, we think it is too early to position for a downturn in global growth or corporate earnings.

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A Better Deal

We think investors will face more signs in 2019 that the long cycle is becoming stretched after a challenging 2018. These challenges have been accompanied by a significant shift in valuations and sentiment that we think is overdone, lowering the bar for positive surprises.

A better deal: Markets are pricing in an overly downbeat 2019

We believe 2019 offers some important advantages relative to 2018. Valuations look more attractive after a challenging year for assets (**Exhibit 1**). And unlike today's starting point, conditions coming into last year were hard to beat: global growth was strong and synchronized, while market volatility and longer-term bond yields were still low. Against that backdrop, many of the surprises in 2018 were negative. And we believe markets have overreacted to the downside relative to the still growing—but slowing—global economy.

Outside of the US, we think the period of growth moderation is now behind us. Instead, we believe it will be the US's turn to see moderating growth over the next year, and our core expectation is that upward pressure on interest rates will continue. We expect these challenges will stoke fears about the end of the economic cycle and a peak in corporate earnings, but we believe these concerns are premature (**page 6**). The temptation to take down risk will rise as the cycle ages, but the signs of deterioration required to do so are absent. Corporate earnings are likely to grow in 2019, not contract. And we do not expect to see excessive central bank tightening or systemic financial imbalances in 2019 that would warrant end-of-cycle fears. The recession signal from a flat or inverted yield curve is also weaker as QE depressed term premium.

The growth outlook: Converging towards trend growth

We expect convergence towards trend growth to be a key theme in 2019. The pace of US growth is likely to moderate, particularly in the second half of the year, as the impact of fiscal stimulus gradually fades (**Exhibit 2**). Outside of the US, we have already seen a substantial moderation in growth. In Europe, growth has reached a more sustainable level, and we expect it to stabilize as monetary and fiscal policy remain supportive, while further declines in unemployment should help consumption. In EM, China's growth has slowed and a full-blown trade war is a potential risk, though not our

base case expectation. We think markets have gone too far in pricing these risks in EM assets, and the continued stream of policy support measures in China may generate a period of positive surprises. Outside of China, we think many EM economies such as Brazil, South Africa and Russia remain in the early stages of recovery.

Rising rates

With the US labor market tightening and inflationary pressures gradually building, our base case is that the Federal Reserve Bank (Fed) hikes in December and three times in 2019. The risks to our Fed view are balanced for 2019, with the potential for either a pause or a continuation of quarterly hikes (**page 7**). But the market is now pricing barely one hike in 2019. We think markets continue to underprice the most likely path of hikes, and we expect a continuation of what we have seen this year: rapid rises in interest rates interrupted by periods of consolidation, where upward pressures rebuild. In our view, upward pressure is likely to be greater in short-term rates as long-term bonds benefit from demand from investors seeking long-duration assets to offset long-term liabilities.

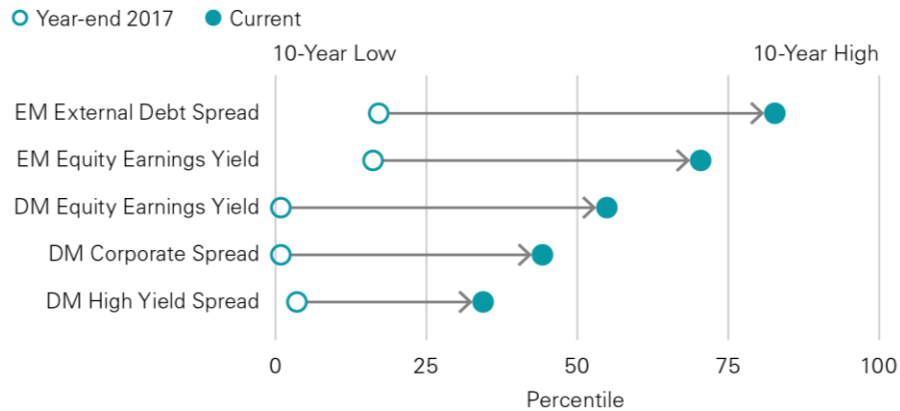
Investment implications: Equities over credit, credit over rates, EM over DM

We believe the continued economic expansion will drive equities higher. Within equities, we expect pricing power to become an increasingly important element of security selection (**page 10**). Converging growth is likely to reverse some of the major 2018 trends in asset markets. In particular, we think the moderation in US growth will overpower higher rates as a driver of the US dollar and expect renewed softness for the currency. We think the “[EM Comeback](#)” we called for in our September update has much more room to run in 2019 (**page 8**), supported by improving growth prospects and attractive valuations of EM currencies in particular (**Exhibit 3**). In fixed income, we think the environment will be supportive for corporate credit over government bonds, with a preference for high-quality, short-duration corporate bonds (**page 11**).

While our overall outlook for 2019 is optimistic, the potential risks are also substantial and likely to rise toward the end of the year. These include geopolitics, budget negotiations in Italy, escalating trade tensions, the potential for abrupt increases in interest rates driven by wage inflation (**Exhibit 4**) and looming concerns about the end of the cycle. Until we see clearer signs of deterioration in the macro environment, we think episodic drawdowns can provide dynamic buying opportunities.

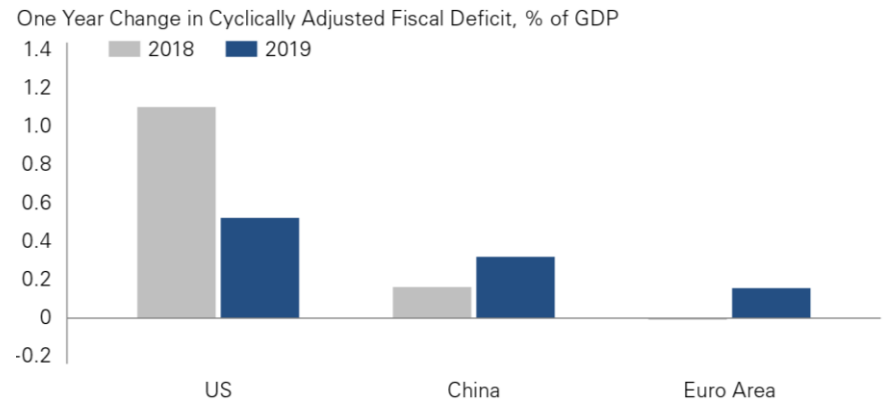
Charts that Matter

Exhibit 1: Valuations are more attractive after broad weakness in 2018



Source: Haver Analytics, Datastream, Bloomberg, I/B/E/S, GSAM. As of November 2018.

Exhibit 2: Fiscal support declining in the US, increasing in Europe and China



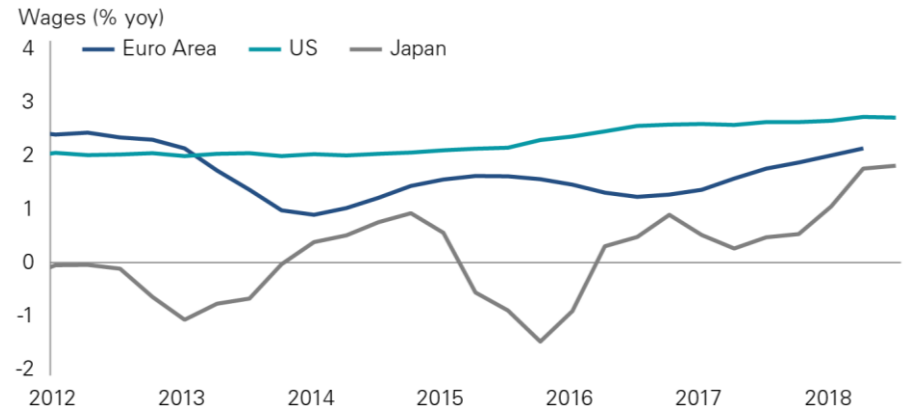
Source: IMF as of October 2018. Cyclically adjusted deficit reflects government spending in excess of revenues adjusted for the impacts of real GDP changes.

Exhibit 3: EM currencies are undervalued relative to fundamentals



Source: GSAM, Bloomberg. As of September 2018.

Exhibit 4: Faster wage growth is a risk for the policy outlook



Source: Haver Analytics, Datastream, GSAM. As of November 2018.

Past performance does not guarantee future results, which may vary. It is not possible to invest directly in an unmanaged index.

Market Views

We prefer equity over credit, and credit over rates, and regionally, EM to DM. These preferences are based on attractive valuations relative to macro and corporate fundamentals.

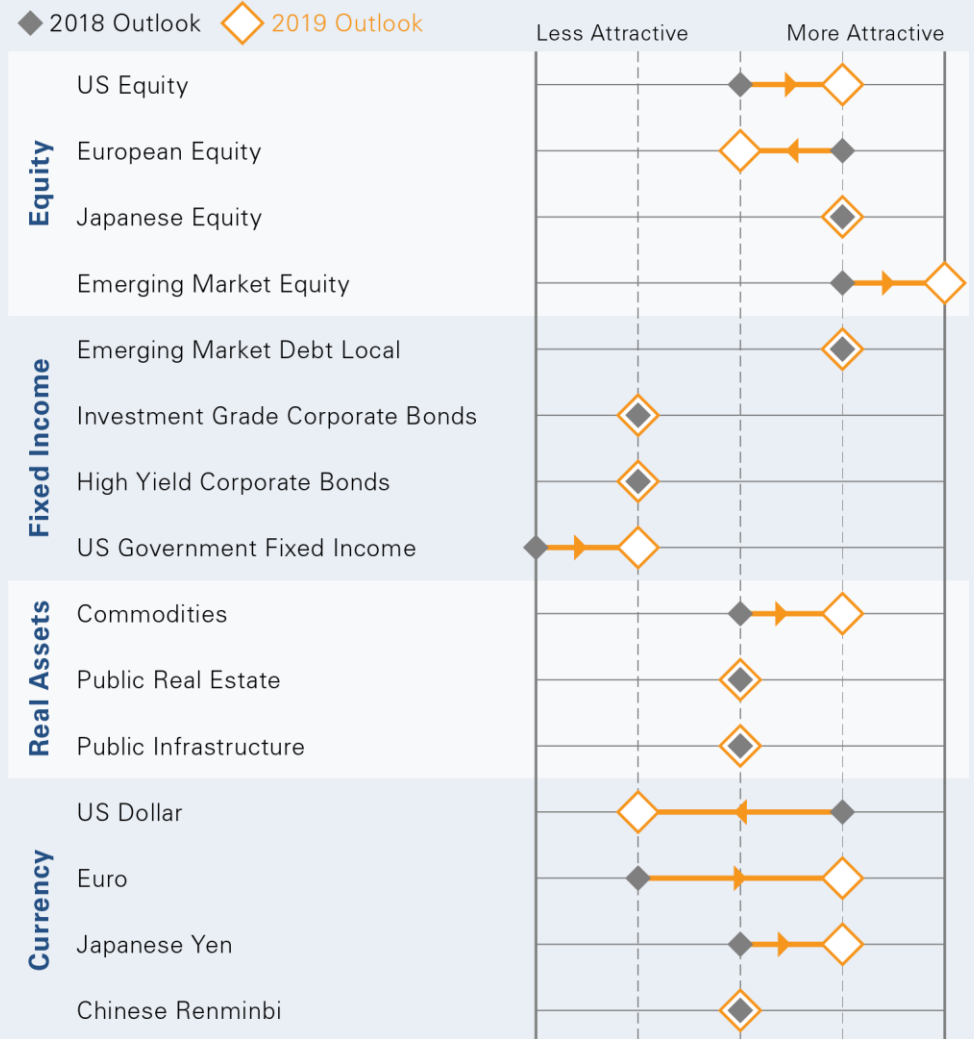
Equities are our preferred asset class. We expect the continued expansion to underpin corporate earnings and in turn equity performance. We think the 2019 risk-reward for equities has improved relative to 2018 after the de-rating in valuation multiples. Regionally, we prefer EM over DM (page 8). Among DM equities, we think the US and Japan markets are better positioned compared with Europe, where political uncertainties and euro appreciation may serve as headwinds.

Tactically constructive, structurally cautious on credit. Ongoing macro growth will elongate the healthy corporate environment of strong earnings and benign downgrade and default activity, making it too early to position for significant widening in credit spreads. Recent weakness provides an attractive opening to add tactical exposure in light of strong fundamentals. We recognize that we are approaching a point in the cycle when credit spreads have historically reached a low-point and we expect this to occur at some point during 2019.

Bearish front-end rates. We believe the market is underpricing the pace of near-term Fed hikes. We therefore remain bearish front-end US rates, and we expect to observe rate volatility as market pricing adjusts. Beyond this core scenario, we see a tail risk around the market requiring a higher risk premium to reflect the large US fiscal deficit, potential for a higher Fed inflation target or the global QE unwind.

Oil prices bounded by OPEC cuts and consumer nation pressures. We expect oil prices to be range-bound with West Texas Intermediate trading between \$50-70 per barrel. Demand and OPEC supply cuts will likely provide support to the range from the downside, while political pressure from consumer nations may limit the upside.

Soft US dollar and stronger EM currencies. As the global growth landscape rebalances away from US exceptionalism, we expect a softening of the dollar and some of the valuation potential in EM currencies to be released. Fed hikes should be supportive for the dollar, but we do not think they will be sufficient to offset the pressures from the changes in growth.



Source: GSAM as of December 2018 and are subject to change. Chart reflects GSAM relative asset allocation views and may not be representative of each GSAM portfolio team's view on opportunities within individual markets.

Macro Outlook Summary

Growth

We expect the global expansion to continue. However, we think the environment is shifting from one of divergence, with US growth strongly outperforming, to an environment of convergence as US fiscal stimulus fades and growth moderates. Outside of the US, we see DM growth stabilizing and EM growth surprising to the upside. In EM, growth outside of China is below our estimates of potential and in China we think the continued policy support will lead to a period of positive surprises.

Inflation

We expect tighter labor markets to underpin wage growth and gradual firming in core inflation. Our base case is that US core inflation remains close to 2% or slightly above throughout 2019, with the potential for upside surprises from tariffs or late-cycle wage dynamics. In the Euro Area, we think inflation will remain subdued. With expectations for Euro Area inflation already very low despite an acceleration in wage growth, we think an upside surprise would have the biggest impact in markets. In the UK, assuming currency stability on a status-quo Brexit outcome, we expect inflation to moderate toward target.

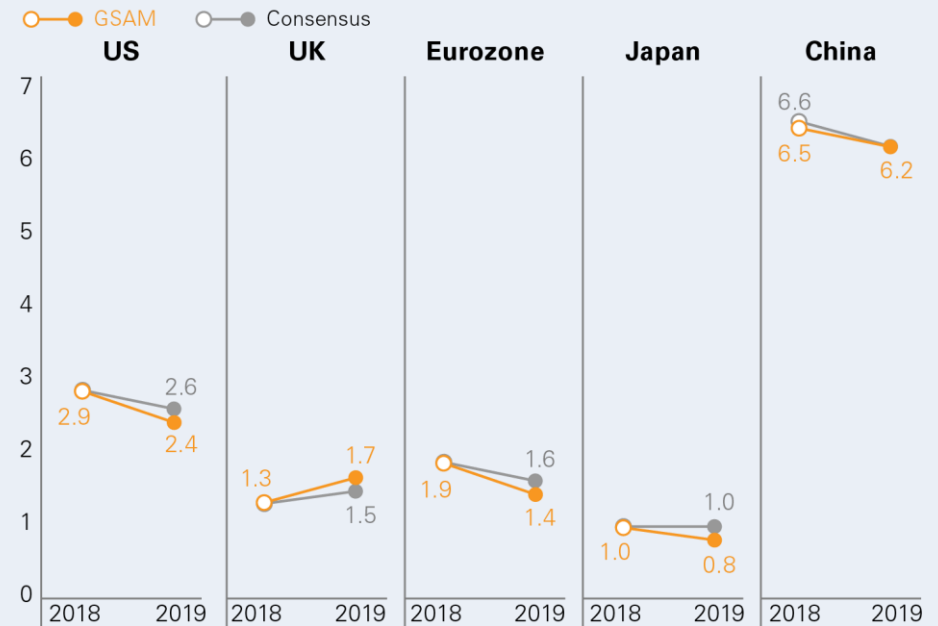
Monetary Policy

We expect the Fed to hike rates three times in 2019, well above what the market is currently pricing, but the risks to our view are more balanced than in previous years. The Fed could pause to see how growth is developing, or continue to raise rates every quarter if wage growth accelerates (page 7). We expect central banks in the UK and Europe to raise rates in 2019, leaving the Bank of Japan (BoJ) as the most dovish major central bank. We expect the global QE unwind to proceed in the background, with rate decisions being the responsive policy tool to incoming data.

Politics

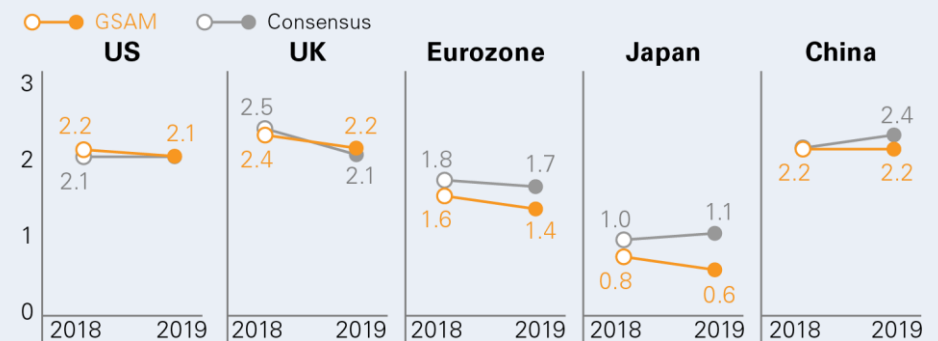
Political risks are elevated and a core source of episodic drawdowns in markets. We think this will remain the case in 2019. Market concerns about trade are likely to prove overdone, but we acknowledge a meaningful chance that the damage becomes more significant. The Italian budget negotiations are another potential source of volatility. We expect the impact of Brexit to be limited outside of the UK, with the British pound serving as the key shock absorber in negative scenarios.

Growth Forecast (%)



Source: GSAM, Bloomberg. As of December 2018.

Inflation Forecast (%)



Source: GSAM, Bloomberg. As of December 4, 2018. US is personal consumption expenditures (PCE) index. All others are consumer price index (CPI).

INVESTMENT THEMES

Navigating the cycle

2019 is likely to see an increased focus on the end of the cycle with the temptation to take down risk. We believe clearer signs of deterioration are required to do so. We do not expect to see those signs in the first half of 2019, though risks may rise as the year passes.

Late-cycle characteristics...

In 2019 we expect the US expansion to become the longest on record. This comes with increased signs that the economy is in the late-stage of the cycle, ranging from the tight labor market and slowly firming inflation to the pick-up in market volatility and a flattening yield curve. In addition, the combination of fading fiscal support and continued Fed hikes comes with the risk that the likely moderation in growth becomes more abrupt. Despite these signs, we expect the cycle to continue through 2019.

...likely to be reflected in markets

We expect the late cycle environment to shape markets. Typically equity volatility picks up towards the end of the cycle. We think we saw the trough in equity volatility in late 2017, and our call for episodic drawdowns is very much informed by this historical pattern. The next major market event on the historical template is the trough in credit spreads. We think it is too early to position for this but will be watching credit markets closely in 2019. Finally, the late cycle environment may come with discussions around peak earnings. We believe those discussion are premature. Historically, margins have continued to expand until very close to the beginning of recessions (Exhibit 5).

Too early to take down risk...

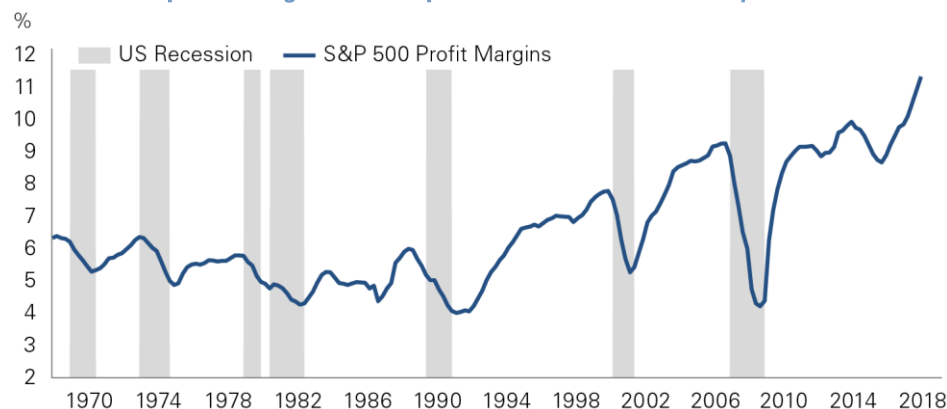
The long cycle with strong returns that we have enjoyed, together with the late cycle environment, makes it tempting to take down risk to prepare for the eventual end of the cycle. In our view that is too early. There will be significant uncertainty around any

call on the end of the cycle given the limited number of historical cycles to look back at. Given this uncertainty, we think any longer term view on timing of the end of the cycle should be supplemented with clearer confirmation from the data that the economy is headed in the wrong direction before risk is taken down. So far these signs—including contracting corporate profit margins, excessive central bank tightening and systemic financial imbalances—are not evident and we think we are unlikely to see them through 2019, though the risks will rise towards the end of the year.

...but not to work on improving the trade-off around the risk take-down

We do not think it is too early to consider ways to improve the trade-off between late-cycle risks and continued expansion. At the micro level, we think this includes exposure to companies with strong pricing power. On the macro front we favor early-cycle economies. Many EM economies are earlier in their cycle than DM economies and therefore EM assets can shift exposure earlier in the cycle. EM local debt offers a higher yield than high yield credit and managed to outperform substantially when the last DM cycle deteriorated.

Exhibit 5: US profit margins tend to peak late in the economic cycle



Source: Haver, NBER, GSAM. As of November 2018.



End-of-cycle signs—including contracting corporate profit margins, excessive central bank tightening and systemic financial imbalances—are not evident and we think we are unlikely to see them in 2019, though the risks will rise in the second half of the year.

INVESTMENT THEMES

How far will the Fed go?

The Fed has been steadily tightening monetary policy for two years, raising rates every quarter except for September 2017, when the central bank announced it would begin reducing the size of its balance sheet. One of the key questions for the 2019 outlook is whether that gradual tightening continues.

We had high conviction that the Fed would not pause its tightening campaign in 2018. Changes in Fed policy are transmitted to the economy through financial conditions, which include long-term bond yields, equities, credit spreads and foreign exchange rates. Until recently, there was little evidence that tighter Fed policy was causing overall financial conditions to tighten, and therefore no reason to expect the Fed to pause.

With the re-emergence of market volatility, financial conditions are beginning to tighten meaningfully for the first time since the Fed began raising interest rates at a regular pace (Exhibit 6). While we expect the Fed to continue tightening monetary policy in 2019, we have less conviction that the central bank will continue raising interest rates at the same steady pace.

Prioritizing the balance sheet

The Fed is both creating and responding to changes in financial conditions. If financial conditions continue to tighten, and declining support from fiscal policy leads to slower US growth, we think the Fed will respond by pausing to assess the medium- to longer-term outlook. In that scenario, we think the Fed will prioritize continued balance sheet reduction over continued rate hikes. The Fed has gradually ramped up balance sheet reduction to its targeted maximum of \$50 billion per month. We think policymakers will be reluctant to change that plan unless the economy slows drastically, suggesting that a pause in the tightening campaign is more likely to come via slower rate hikes rather than adjustments to the pace of balance sheet reduction.



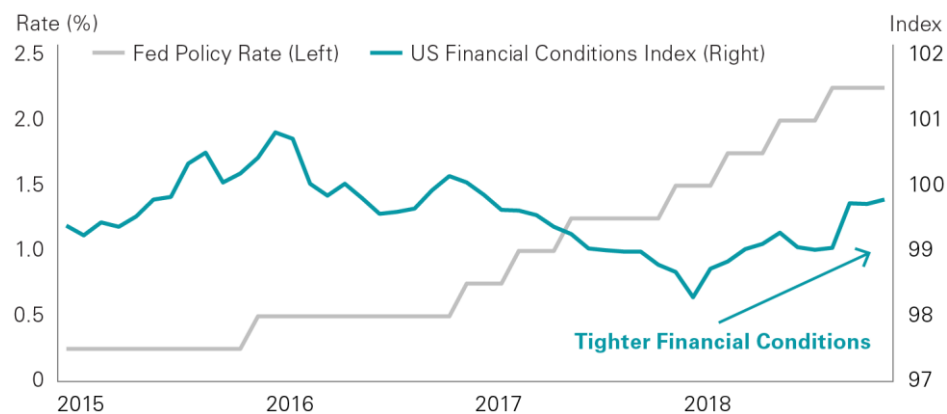
Our central expectation is for the Fed to deliver three hikes in 2019, but given this year's tightening in financial conditions, we expect next year's rate path to be more dependent on incoming data than it was in 2017-2018.

Dissecting financial conditions

The Fed targets overall financial conditions but it does not control the mechanism—interest rates, credit conditions, equities or exchange rates—through which tighter central bank policy is transmitted from financial markets to the real economy. For investors, we think some mechanisms matter more than others.

In our view, if financial conditions are tightening due to a cheapening in equities, that alone is not a compelling reason to de-risk, and could present opportunities. We are alert to other drivers of tighter financial conditions, including higher rates or wider credit spreads. But we expect some of this pressure to be offset by a softer US dollar as US growth converges toward the rest of the world. Wider corporate credit spreads have also contributed to the recent tightening in financial conditions, but we expect improved performance in 2019 amid continued strength in corporate fundamentals. As a result, we think one of the key risk scenarios for financial markets is that inflation accelerates despite moderating growth, leading the central bank to continue tightening.

Exhibit 6: Financial conditions are responding to Fed hikes



Source: Macrobond, GSAM. As of November 12, 2018.

INVESTMENT THEMES

EM: A drawdown, not a turning point

We expect renewed outperformance of EM assets relative to DM as global growth rebalances. But it is important to recognize that volatility and drawdowns in EM assets are not uncommon, and more importantly, do not preclude positive performance over the longer-term.

Drawdowns in EM bull markets are not unusual

2018 saw a substantial drawdown in EM assets, against our expectations. The explanation for this has been an evolving story, focusing at various points on rising rates, current account imbalances, trade tensions and slowing growth in China.

We think the main driver of EM asset underperformance in 2018 has been lower-than-expected growth in EM economies. However, growth remains better than in 2016 when EM concerns were previously elevated and we believe many economies are still the early stages of longer-term expansions. As a result, we see potential for EM growth and EM asset returns to improve. We also note that there is nothing unusual about substantial EM drawdowns in the middle of longer-term outperformance versus DM assets. Exhibit 7 shows that the current drawdown is well within the norms of past EM bull markets.

Attractive valuations

We see attractive return potential for EM assets in 2019, particularly in currencies and equities, which we expect to be unleashed by improving growth. Based on our estimates of fair value, EM currencies appear undervalued by 12% and 23%, when aggregated using the MSCI EM and GBI indexes, respectively (Exhibit 3). The magnitude of this undervaluation is similar to what we observed in early 2016 and in

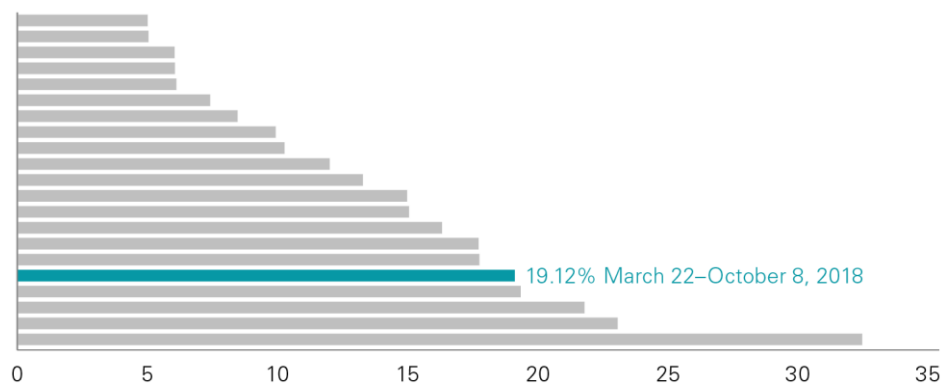
the early 2000s; both periods were followed by good returns for EM currencies. EM equities are trading at an attractive 25% discount to DM equities, while offering potentially higher expected earnings growth.

The challenge from China

The biggest risk to our view in both 2019 and over the medium- to long-term is China. In the near-term, we see broad-based policy support as a sign that policymakers are dissatisfied with current economic performance. We therefore expect support to continue until the growth environment improves. Nonetheless, our 2019 forecast for 6.2% growth would mark the slowest pace of Chinese growth since the early 1990s. Vast credit creation in recent years will present medium- to long-term risks as growth transitions to a lower trend level and rotates from investment- to consumption-led. However, we think the period of the highest intensity of growth deceleration is behind us, meaning there is less near-term pressure for the rest of the EM countries to offset.

Exhibit 7: EM drawdowns are not unusual, even in longer-term bull markets

5%+ Drawdowns in 1988–94 and 2001–10 EM vs DM Bull Markets



Source: Datastream as of October 2018.



EM asset drawdowns—particularly in currencies and equities—have surpassed what is implied by underlying fundamentals. In 2019, we expect EM asset performance to be unleashed by improving growth in EM ex-China and policy support in China.

INVESTMENT STRATEGY

Equities

Equities remain our favored asset class, but selectivity is increasingly important amid higher volatility, elevated political and trade risks, as well as slowing revenue growth and margin pressures.

Fundamentals remain solid, but volatility increases need for selectivity

We expect positive returns for equities in 2019. This view is underpinned by the continued economic expansion and earnings growth (Exhibit 9), albeit at a slower pace, as well as attractive valuations relative to macro fundamentals, particularly after the latest sell-off. The bouts of equity volatility, which we expect to continue amid ongoing uncertainty, have highlighted the importance of active management.

We continue to prefer EM equities to DM equities, as EM growth recovers from an unexpected moderation this year while EM valuations remain attractive relative to DM (page 8). While we acknowledge the near-term slowdown of growth in China, we believe that domestic Chinese equities will be supported by strong medium-term fundamentals from a combination of a secular transition to consumption and innovation-driven growth, ongoing reforms, and accommodative policy. We also remain positive on Indian equities on tailwinds from strong economic growth, ongoing structural reform and favorable demographics.

Within DM, we remain constructive on Japanese equities given continued reforms and believe valuations for US equities are more attractive following the drawdown. We are positive on smaller cap equities in the US. Smaller cap equities have benefited from higher domestic revenue exposure relative to large-cap equities (79% for Russell 2000 index vs. 63% for S&P 500 index) and are therefore more insulated from trade tensions. We expect 2019 earnings growth for small cap equities will be slightly faster than large cap equities, while valuations have fallen following outsized declines in the recent sell-off, with the Russell 2000 index now trading at a third lower than the historical 10-year valuation premium to the S&P 500 index.

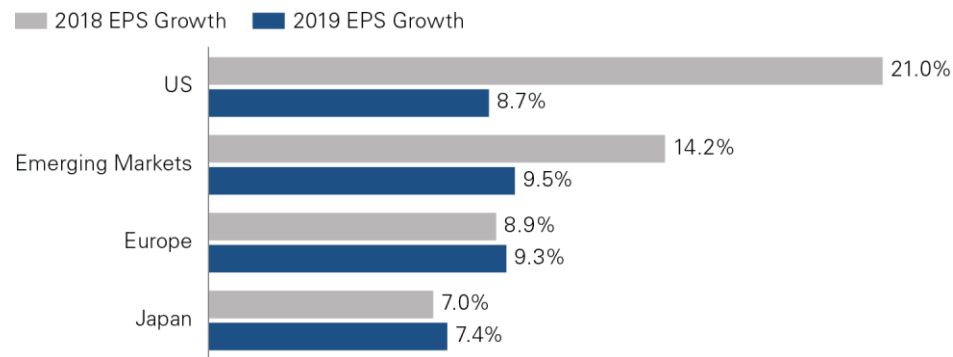


Equity valuations have fallen meaningfully, with the forward Price/Earnings ratio for the S&P 500 falling to February 2016 levels. While we remain pro-risk and take stock of the more attractive valuations, we are more alert to short-term uncertainty and emphasize dynamism and selectivity in equity investing.

Pricing power is key as companies face slowing sales and margin pressure

US corporate earnings and margins have not yet peaked in our view (page 6), although their growth will likely moderate going forward due to a combination of slowing sales growth and margin headwinds. Sales results have been mixed in the third quarter, and we believe sales growth, which is highly geared toward economic expansion, will decelerate as tailwinds from fiscal stimulus and tax reform dissipate. We are also alert to increasing margin headwinds, arising largely from tariffs, labor cost inflation as well as higher freight and input costs. Tariffs are our biggest concern for margins, since their potential impact is greater and reverberates across the entire supply chain. In addition, tariffs do not offer benefits to the consumer, in contrast to labor cost inflation which should boost consumption. We expect pricing power to become increasingly important in an environment of slowing sales and margin compression, reinforcing the importance of active management and stock selection. Pricing power fluctuates over time with demand and varies across sectors – Consumer sectors, Energy, Materials tend to have the least pricing power, while Utilities, Health Care, Technology and Real Estate have historically demonstrated greater ability to pass on their costs.

Exhibit 9: Equities are supported by continued earnings growth



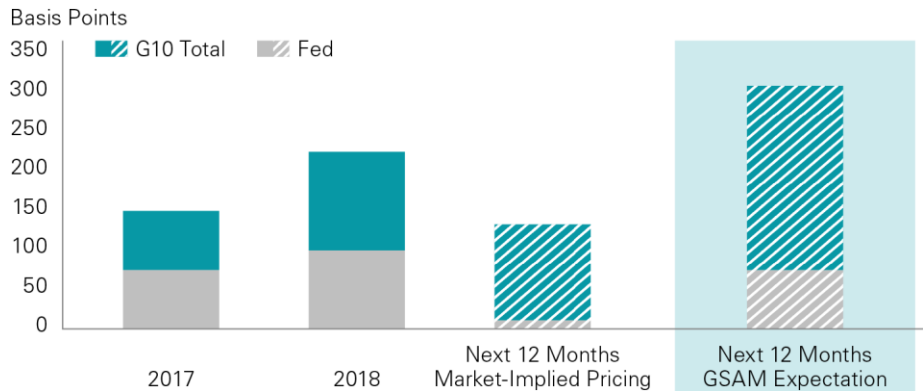
Source: Factset. As of November 24, 2018. Calculated using S&P 500 index for US, MSCI EM index for Emerging Markets, MSCI Europe index for Europe and TOPIX index for Japan.

INVESTMENT STRATEGY

Fixed Income

We expect more G10 central bank tightening in 2019 in aggregate relative to market implied-pricing. Our forecasts for the distribution and timing of rate hikes also differ, thereby informing our directional and relative value rate and currency views. Among credit markets, it is too early to position for a turn in the cycle and a wave of downgrades, but it is not too early to focus on high-quality, short-duration sources of carry.

Exhibit 10: We expect rate hikes to broaden out beyond the Fed in 2019



Source: GSAM, Bloomberg. As of November 23, 2018. 2018 values assumes a 25bps Fed rate hike in December.

Relative value macro views and modestly overweight spread risk.

Rates and currencies: Market-implied pricing of Fed rate hikes through end of 2019 remain well below our expectations. This mispricing drives our bearish view on front-end US rates, on both a directional and relative value basis. We are overweight core European rates and underweight the euro as slowing growth momentum alongside soft inflation supports our call for prolonged monetary accommodation in the region. Among other DMs, we favor underweight rate and overweight currency exposure in markets where central banks are nearing normalization (such as Sweden and Norway) relative to economies where central banks are wary of household rate sensitivity (such as Canada and Australia).

Corporate credit: At this late stage of the cycle, we sympathize with concerns around a trough in spreads and a wave of high yield downgrades among BBB-rated issuers. However, we think it is too early to position for either of these. Continued economic and corporate earnings growth may help to keep downgrade and default activity in check, while also affording over-levered issuers time to improve credit quality. Although contraction is not our base case, a deceleration in both macro and earnings growth in 2019 is. This necessitates exposure to issuers with strong or improving balance sheets, high interest coverage ratios and pricing power (given rising input and wage costs).

Securitized Credit: A key feature of this cycle has been a marked improvement in household balance sheets. Thus, we remain constructive on consumer credit as well as residential mortgage credit, despite emerging signs of a slowing US housing market. In our view, the US housing sector will remain supported by continued economic growth, credit availability, low inventory levels relative to history and rising demand as millennials – who are set to surpass baby-boomers as the US’ largest generation next year – move into their peak home-buying years.

EMD: We see investment potential in early cycle and rebounding EMs following this year’s corrections. We are neutral to slightly overweight external EMD and continue to identify idiosyncratic opportunities across local currency and EM corporate debt.



We are bearish front-end US rates and bullish core European rates. Among spread sectors, we are constructive on short-duration securitized credit and leveraged loans (as we proceed through a rising rate environment) and tactically upbeat on US corporate credit (due to attractive valuations and healthy fundamentals). Elsewhere, we continue to see medium- to long-term investment potential in EMD.

Disclosures

The views expressed herein are as December 2018 and subject to change in the future. Individual portfolio management teams for GSAM may have views and opinions and/or make investment decisions that, in certain instances, may not always be consistent with the views and opinions expressed herein.

Glossary of terms

Volatility is the manner in which the price of an investment moves up and down. If prices fluctuate dramatically over a short period of time, a market is said to be highly volatile. **Price/earnings (PE) ratio** is a gauge of how expensive a stock is. The higher the P/E ratio, the more the market is willing to pay for each pound of annual earnings. A bond with a credit rating of **BBB** or above from an independent rating service such as Standard and Poor's. **Drawdown** is the peak-to-trough decline during a specific recorded period of an investment security. **Tail risk** arises when the possibility that an investment will move more than three standard deviations from the mean is greater than what is shown by a normal distribution. **Bull market** is a term used to describe a market in which prices are rising or expected to rise. **G10**, or Group of Ten, is a group of eleven industrial countries which co-operate on economic matters. **Over-levered** is a term used to describe a company which has taken on too much debt.

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