GOAL: Global Opportunity Asset Locator

Portfolio Strategy Research

Conviction themes for a 'fat and flat' market; equities to N over 12m

Sticking with 'fat and flat'; downgrade equities to N for 12m

We downgrade equities to Neutral over 12 months on growth and valuation concerns. Until we see sustained earnings growth, equities do not look attractive, especially on a risk-adjusted basis. We expect particularly poor returns in dollar terms, with our forecast of a stronger dollar and the prospect of less negative equity/FX correlations.

Remain OW cash, but upgrade commodities to N over 3m

We remain Overweight cash on a 3-month basis, as we see potential for higher cross-asset volatility. Key risks include less China growth, a general pick-up of European political risk, a repricing of the Fed rate hike cycle, and commodity price declines (in particular for metals). But we now expect less downside to oil over 3 months, given supply disruptions, and upgrade commodities to Neutral. Our key Overweight remains credit, where valuations and fundamentals appear supportive. We remain Underweight bonds and would hedge duration more actively, in particular in the US.

Conviction cross-asset themes in a trendless market

We highlight five conviction cross-asset themes for a volatile but trendless market: (1) prefer credit to equity, (2) focus on cross-asset carry opportunities, in particular EM, (3) position for pick-up in US inflation, which should drive rotation within equities, (4) oil to outperform metals and drive divergence in equities and credit, and (5) resurgence of divergence, with a focus on FX, which seems best positioned to benefit.

Our asset allocation, return forecast and preferences with asset classes

3-Month Horizon		
Asset Class	**Return***	**Weight****
5 yr. Corp. Bonds	**-0.4 %**	**OW**
USD HY	*0.4*	↑
EUR IG	*0.2*	↑
USD IG	*-0.8*	↓
Cash	**0.0**	**OW**
Equities	**2.1**	**N**
TOPIX	*6.5*	→
MSCI Asia Pac ex Japan	*5.9*	→
STOXX Europe 600	*1.1*	→
S&P 500	*-0.2*	→
Commodities	**-5.6**	**N**
10 yr. Gov. Bonds	**-1.7**	**UW**
Germany	*-1.3*	↑
US	*-2.1*	↓

12-Month Horizon		
Asset Class	**Return***	**Weight****
5 yr. Corp. Bonds	**0.3 %**	**OW**
USD HY	*4.2*	↑
EUR IG	*0.7*	↑
USD IG	*-1.1*	↓
Equities	**8.0**	**N**
TOPIX	*19.7*	→
MSCI Asia Pac ex Japan	*9.8*	→
STOXX Europe 600	*7.0*	→
S&P 500	*5.1*	→
Cash	**0.2**	**N**
Commodities	**-2.2**	**N**
10 yr. Gov. Bonds	**-5.1**	**UW**
Germany	*-4.8*	↑
US	*-5.4*	↓

** Total return forecasts in local currency, MXAPJ in USD. ** Arrows denote preferences within asset classes.*

Source: Goldman Sachs Global Investment Research.

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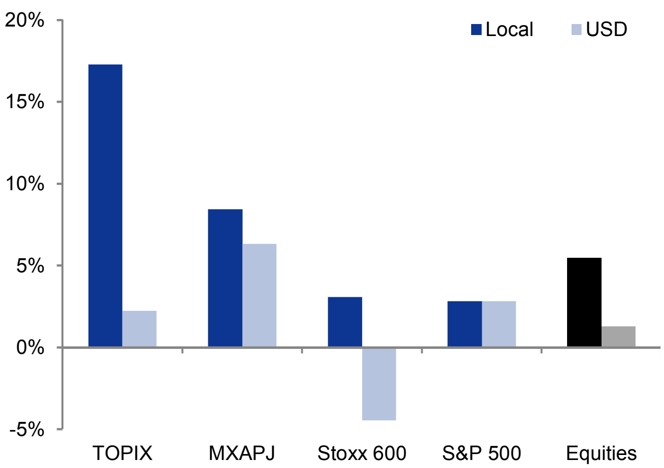
Asset allocation: Sticking with 'fat and flat'; equities to N over 12m

Markets have been calmer and cross-asset correlations with oil have fallen since our last *GOAL* on March 21. Declines in bond yields, owing to a continued dovish Fed, a weaker dollar and stronger commodity prices, have been the key cross-asset moves. This has lifted bond and credit returns, but equities have not benefited much. Global earnings growth revisions have been negative and equity valuations remain high, with the equity risk premium a less useful predictor of returns owing to uncertainty over trend growth and normalisation of bond yields (see *GOAL – Global Strategy Paper No. 18: Valuation investigation: Varying signals for the ERP*, May 3, 2016).

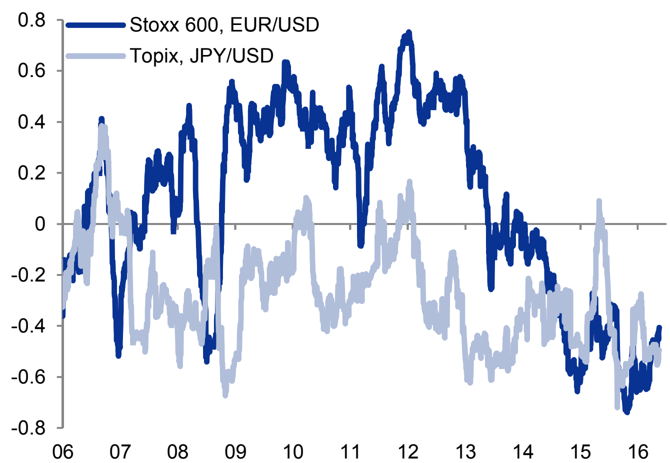
We stick with our 'fat and flat' view for equities. After the rebound from the trough on February 11, and with the S&P 500 at the upper end of its recent range, **we downgrade equities to Neutral over a 12-month horizon, in line with our 3-month view. Until we see sustained signals of growth recovery, we do not feel comfortable taking equity risk,** particularly as valuations are near peak levels. **Our equity strategists have become more defensive, owing to heightened drawdown risk and growth scarcity** (see *US Weekly Kickstart*, May 13, 2016 and *Strategy Expresso*, May 16, 2016). While we see some upside to equities in local currency (particularly Japan), we expect the dollar to strengthen (see *FX Views,* May 13, 2016), resulting in **poor USD returns over the next 12 months** (Exhibit 1). **We prefer to implement the divergence theme via FX rather than equities**; equities are generally more volatile than FX and, while the equity/FX correlation for Europe and Japan remains negative, it has increased recently (Exhibit 2) (see *GOAL: Lost in translation*, October 2, 2015). For Europe, equity/FX correlations could become even less negative as political risks in Europe intensify. **We also move to Neutral across equity regions on a 12-month basis (in line with our 3-month basis)** alongside these effects.

Exhibit 1: Forecast returns are poor in USD terms
12m local currency and USD price return forecasts



Source: Datastream, Goldman Sachs Global Investment Research.

Exhibit 2: Equity/FX correlations have turned from lows
3m rolling correlations of daily returns



Source: Goldman Sachs Global Investment Research.

Commodities have rallied on the back of the dovish Fed, China data and supply disruptions. **We upgrade commodities to Neutral over 3 months, given supply disruptions should support oil spot prices and less negative roll yields near term.** But **the physical rebalancing is incomplete, in our view** (see *Oil: Fundamental volatility creates uncertain path for oil rebalancing*, May 15, 2016). As a result, **we remain Neutral over 12 months,** given roll yields and spot prices should weaken as oil inventories start to build once again in 1Q2017. We think continued fundamental adjustments in both the physical and capital markets are needed, and now see oil prices reaching $60/bl in 4Q2017 vs. mid-2017 previously. We remain bearish on metals (see *Metal Detector*, May 6, 2016, and May 10, 2016).

We stay Overweight credit over both 3- and 12-month horizons. Our constructive view on credit is increasingly one on spreads rather than total returns; post the recent bond rally, we would start hedging duration risk more actively. **We prefer US HY within the asset class over 3 months (in line with 12 months), while we would avoid US IG owing to limited total return potential.** We believe US HY credit still offers high potential carry and wide spreads provide a buffer for higher rates. A stabilisation of commodity prices coupled with falling correlation with oil also make US HY credit attractive on a risk-adjusted basis, in our view (see *Global Markets Daily*, May 16, 2016). **We stay Overweight EUR IG** in advance of ECB credit easing beginning next month. While not in our benchmark, we also prefer EUR HY to IG as investors move up the risk curve in their search for yield (see also *The Credit Trader*).

We remain Underweight bonds but have lowered our bond yield forecasts in the major advanced economies by an average 30-40 bp (see *Macro Rates Views*, May 10, 2016). This reflects a downgrade in expected Fed Funds rates hikes from our US economists after weaker-than-expected labour market data. They **now expect two hikes this year (next one most likely in September) followed by a further three hikes next year**, compared with three and four previously. We continue to expect absorption of duration risk by the ECB and particularly by the BoJ, delivered in conjunction with negative rates.

Risks abound, OW cash allocation still appears sound

Given we do not see much value across asset classes and we see a variety of cross-asset risks, **we remain Overweight cash near term.** We believe the market's dovish pricing of the Fed increases rate shock risk, in which case both equity and bonds could sell off. We are also not convinced the EM rally is sustainable (see *EM Spotlight: EM v. DM: A low hurdle, but outperformance requires EM growth*, May 6, 2016), which could weigh on commodities, in particular metals. China growth concerns could also come back into focus, as we think the support from policy will fade during 2H2016. Finally, we continue to see elevated European political risk with uncertainty around the UK's upcoming EU referendum.

Lost and found: Five conviction themes for a 'fat and flat' market

We highlight five conviction cross-asset themes for this volatile but trendless market. Generally, our focus is shifting to carry strategies across assets and relative value opportunities. We continue to **prefer credit to equity**, despite the strong rally in credit, with the potential for further spread compression high, in our view. We **see some attractive carry opportunities in EM FX, credit and dividends**. The main remaining directional conviction view we have is **a continued upward trend in US inflation;** once this trend becomes more established, we think there is potential for sector and style rotation within equities. On the relative value side, we continue to **favour oil vs. metals in equity and credit.**

Exhibit 3: Our asset allocation, return forecasts and preferences within asset classes

3-Month Horizon		
Asset Class	**Return***	**Weight****
5 yr. Corp. Bonds	**-0.4 %**	**OW**
USD HY	*0.4*	↑
EUR IG	*0.2*	↑
USD IG	*-0.8*	↓
Cash	**0.0**	**OW**
Equities	**2.1**	**N**
TOPIX	*6.5*	→
MSCI Asia Pac ex Japan	*5.9*	→
STOXX Europe 600	*1.1*	→
S&P 500	*-0.2*	→
Commodities	**-5.6**	**N**
10 yr. Gov. Bonds	**-1.7**	**UW**
Germany	*-1.3*	↑
US	*-2.1*	↓

6-Month Horizon	
Asset Class	**Return***
5 yr. Corp. Bonds	**-0.6 %**
USD HY	*0.9*
EUR IG	*0.4*
USD IG	*-1.4*
Cash	**0.1**
Equities	**4.5**
TOPIX	*14.7*
MSCI Asia Pac ex Japan	*6.8*
STOXX Europe 600	*3.5*
S&P 500	*1.5*
Commodities	**-5.9**
10 yr. Gov. Bonds	**-3.3**
Germany	*-2.7*
US	*-3.9*

12-Month Horizon		
Asset Class	**Return***	**Weight****
5 yr. Corp. Bonds	**0.3 %**	**OW**
USD HY	*4.2*	↑
EUR IG	*0.7*	↑
USD IG	*-1.1*	↓
Equities	**8.0**	**N**
TOPIX	*19.7*	→
MSCI Asia Pac ex Japan	*9.8*	→
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Cash	**0.2**	**N**
Commodities	**-2.2**	**N**
10 yr. Gov. Bonds	**-5.1**	**UW**
Germany	*-4.8*	↑
US	*-5.4*	↓

** Total return forecasts in local currency, MXAPJ in USD. ** Arrows denote preferences within asset classes.*

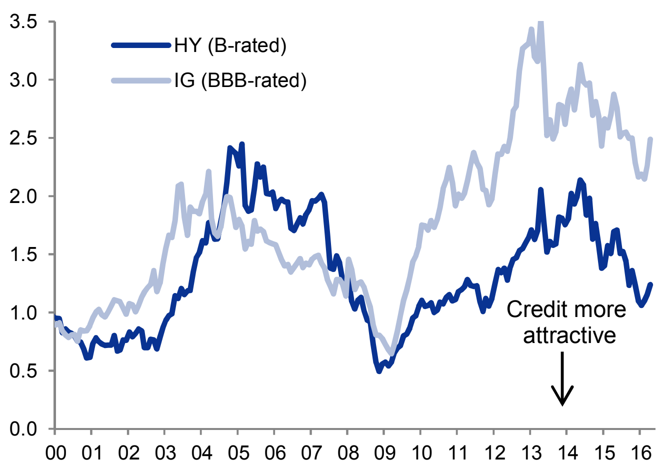
Source: Goldman Sachs Global Investment Research.

(1) Don't give any credit to equity; prefer credit to equity

Fundamentals: Equity valuations look stretched (NTM P/E for S&P 500 = 16.6x, as at close on May 16), while **credit valuations are less so**, particularly in HY (US HY spreads are at their 72^{nd} percentile since 1985). ECB credit easing and improving oil prices should be supportive to credit. Historically, **US HY has outperformed US equity following peaks in HY credit spreads** (Exhibit 5), and **risk-adjusted outperformance has been even stronger. Since 2009, US HY credit has had a Sharpe ratio of 2 compared to 0.58** for the S&P 500, and the outperformance resumed more recently (Exhibit 6). This mostly reflects lower volatility of US HY total returns relative to equity, as it benefits from risk-on scenarios (spreads compress) and risk-off scenarios (bond yields decline).

Implementation: We prefer **long US HY credit to S&P 500**. While CDX HY has outperformed a comparable equity basket (see *Credit is Moving: Should Equity be Worried?,* May 9, 2016), **HY cash spreads still seem high relative to equity implied vol** (Exhibit 7). We also like long EUR HY v. IG (see *Credit Notes: Reiterating our compression view with a recommendation to go long iBoxx EUR HY v. IG*, April 19, 2016).

Exhibit 4: US HY credit looks particularly attractive
Equity to credit expected return ratio (S&P 500 for equity)



Source: BAML, Datastream, Goldman Sachs Global Investment Research.

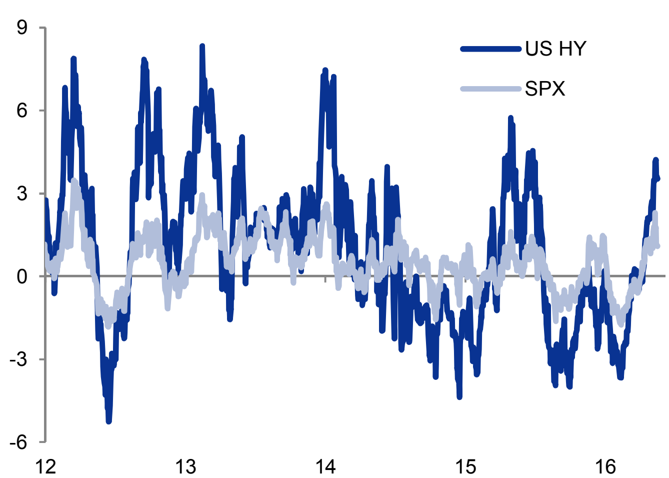
Exhibit 5: US HY outperforms following HY spread peaks
BAML US HY Master II and S&P 500 after US HY spread peak

HY peak date	HY spread at peak	HY returns +3m	HY returns +6m	S&P 500 returns +3m	S&P 500 returns +6m
31-Oct-1987	538	7%	10%	2%	6%
31-Jul-1989	598	-3%	-6%	-1%	-3%
31-Jan-1991	1014	18%	24%	12%	15%
16-Oct-1998	678	7%	10%	18%	26%
7-Dec-2000	913	10%	8%	-6%	-4%
30-Oct-2001	973	4%	6%	5%	3%
10-Oct-2002	1120	14%	20%	16%	9%
17-May-2005	457	6%	5%	4%	7%
17-Mar-2008	862	6%	-1%	6%	-8%
15-Dec-2008	2182	11%	44%	-12%	8%
8-Jun-2010	727	6%	11%	4%	17%
4-Oct-2011	910	9%	14%	14%	26%
16-Dec-2014	571	5%	6%	6%	7%
11-Feb-2016	887	13%	13%*	13%	14%*
Average	**888**	**8%**	**12%**	**6%**	**9%**
Median	**875**	**7%**	**10%**	**6%**	**8%**

**Values based on 16-May-2016 close. Shading indicates positive returns.*

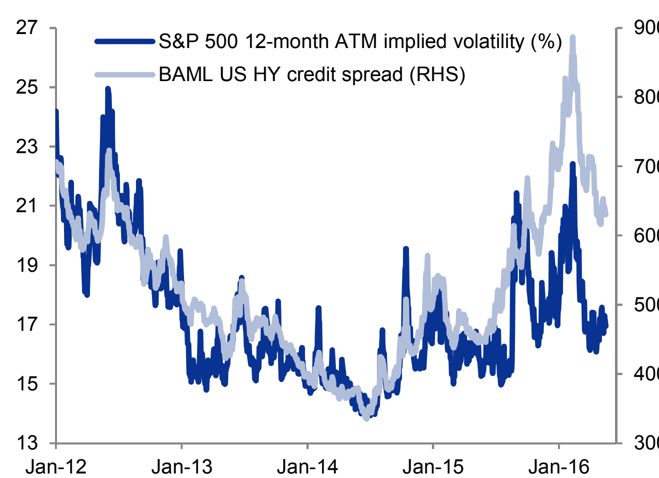
Source: BAML, Datastream, Goldman Sachs Global Investment Research.

Exhibit 6: HY credit Sharpe ratios have been picking up
Rolling 3m Sharpe ratios for US HY credit and S&P 500



Source: BAML, Datastream, Goldman Sachs Global Investment Research.

Exhibit 7: HY spreads still seem high relative to equity vol
12m ATM SPX implied vol, US HY credit spread



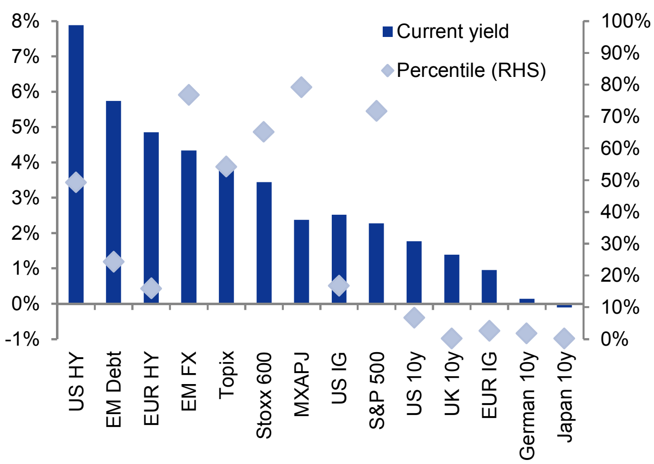
Source: BAML, Goldman Sachs Global Investment Research.

(2) Carry on – the next phase of the search for yield

Fundamentals: The search for yield has driven up equity and bond valuations, and investors have a preference for income-bearing assets in the current market environment. Although dividend yields are elevated (Exhibit 8), the risk of capital loss makes us selective towards equities as a carry story. In our view, other carry opportunities are more attractive.

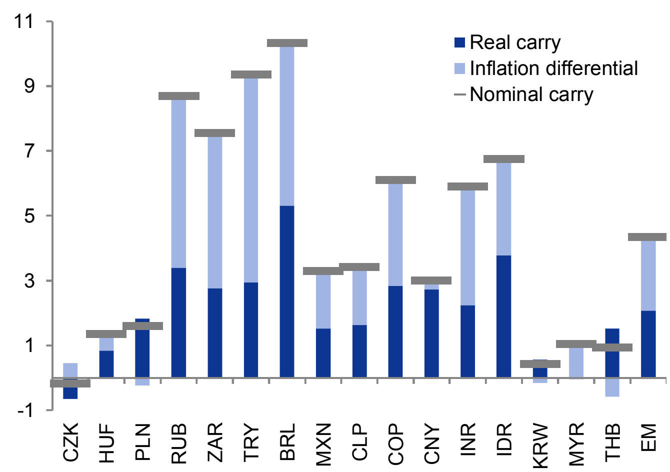
Implementation: In addition to US HY credit, we like selective EM FX carry trades where imbalances have adjusted and valuations are supportive, including RUB, INR and MXN (Exhibits 9) (see *EM FX Views: Good carry, bad carry*, March 21, 2016). Both real and nominal EM FX carry have remained elevated in the recent macro environment (Exhibit 10). **We also like writing OTM puts on EURO STOXX 50 longer-dated dividends** as the implied dividend vol term structure remains very steep (Exhibit 11) and dividend risks are well discounted, in our view (n.b. put writers' maximum loss is the strike minus the premium received) (see *Dividend Swap Monitor,* April 13, 2016). **Stable, more defensive high dividend yield baskets in Europe (GSSTDIVY) and the US (GSTHDIVG) also appear attractive to generate carry** (see *Strategy Matters: Searching for yield in a 'Fat and Flat' market*, May 10, 2016, and *US Weekly Kickstart*, April 22, 2016).

Exhibit 8: Equity carry high, but risky; gov bonds low
Yield/ carry across assets (percentile over last 10 years)



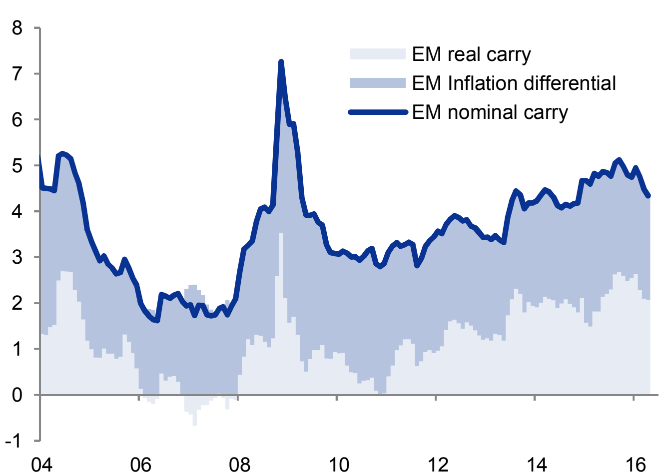
Source: Datastream, iBoxx, JP, Goldman Sachs Global Investment Research

Exhibit 9: INR and RUB real carry looks attractive
Real and nominal carry across EM FX



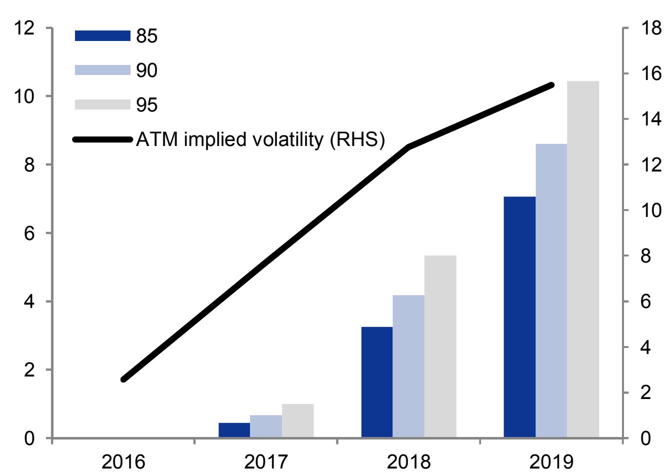
Source: Goldman Sachs Global Investment Research.

Exhibit 10: EM FX carry good in the macro environment
EM carry broken into nominal and real contribution, ann.



Source: Goldman Sachs Global Investment Research.

Exhibit 11: Implied dividend term structure is steep
EURO STOXX 50 dividend put premia and vol term structure



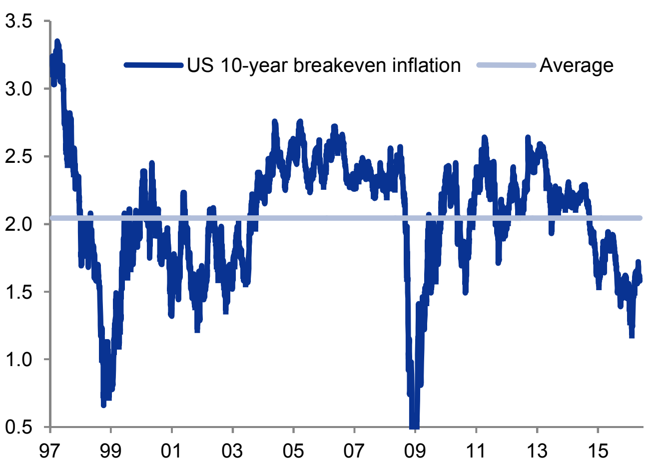
Source: Bloomberg, Goldman Sachs Global Investment Research.

(3) Reflation flirtation continuation; positive inflation momentum

Fundamentals: While inflation expectations inflected in February (Exhibit 12), **breakeven inflation remains underpriced,** in our view, particularly in the US (see *Macro Rates Views: Lower Rate Forecasts, But Reflation Theme Intact*, May 10, 2016). We expect inflation to continue to rise as the US labour market moves to full employment – pushing wage inflation higher – and the drag from healthcare and energy prices gradually drops out (Exhibit 13) (see *US Views: Stepping Back*, May 8, 2016). However, **inflation swap pricing is actually low enough that it implies the WTI oil price will be around $30/bl in 2018** (Exhibit 14). In our view, nominal bonds are expensive, reflecting this mispricing.

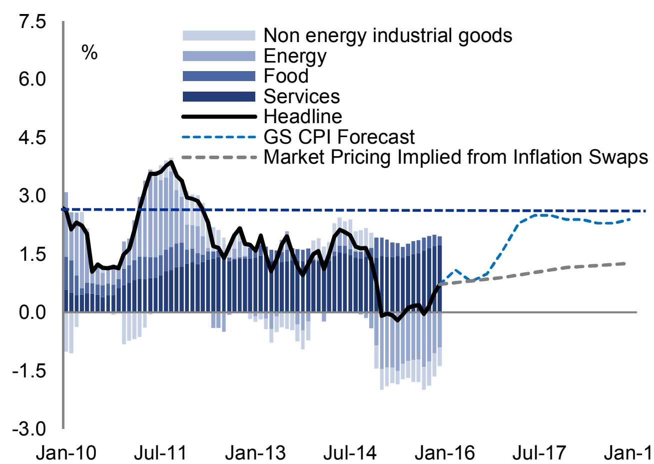
Implementation: **Long US breakeven inflation via long US 10Y TIPs vs. US 10Y nominal bonds**. As US inflation picks up, we would **gradually roll exposure from stable growth, defensive and lower volatility to more cyclical sectors** that have historically benefited from such a shift (see *GOAL: Reflation Flirtation: Near-term risks to relief rally, upgrade cash*, March 21, 2016). We expect bond proxy sectors to suffer, in particular (Exhibit 15). The Fed raising interest rates would only contribute further to this repricing, in our view. **In Europe and Japan, however, with inflation momentum less strong, this rotation might take longer.**

Exhibit 12: US breakeven inflation has troughed
US 10-year breakeven inflation



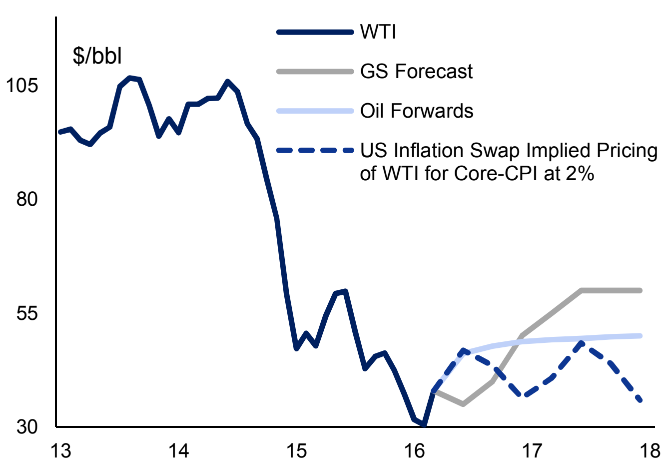
Source: Datastream, Goldman Sachs Global Investment Research.

Exhibit 13: We expect a continued pick-up in US CPI
Contribution of major constituents to headline US inflation



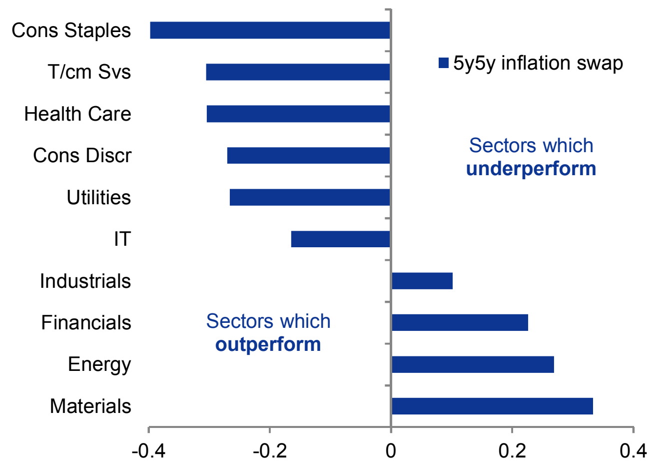
Source: Federal Reserve, Haver, Goldman Sachs Global Investment Research.

Exhibit 14: US inflation market is saying oil stays low
WTI, GS forecasts, WTI forwards and implied WTI pricing



Source: Goldman Sachs Global Investment Research. As of Feb 2016.

Exhibit 15: Cyclicals should pick up while defensives lag
MSCI World sector correlations with US inflation since 2008



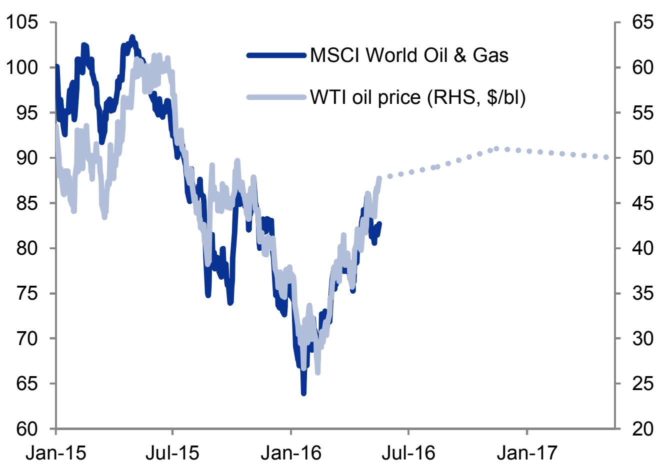
Source: Datastream, Goldman Sachs Global Investment Research.

(4) Heavy metal, oil floats; pick-up of commodities dispersion

<u>**Fundamentals:**</u> In our view, **the outlook for metals continues to be bearish as supply curtailments come off in China and elsewhere** (see *Metal Detector*, May 6, 2016). In contrast, **our commodities team sees oil moving to $60/bl in 4Q2017**, albeit with mid-term downside risks (see *Oil: Fundamental volatility creates uncertain path for oil rebalancing*, May 15, 2016). As performance of the Oil & Gas and Metals & Mining/Basic Resources sectors have closely tracked these prices (Exhibits 16 and 17), **we like going long oil & gas vs. metals in both equities and credit.**

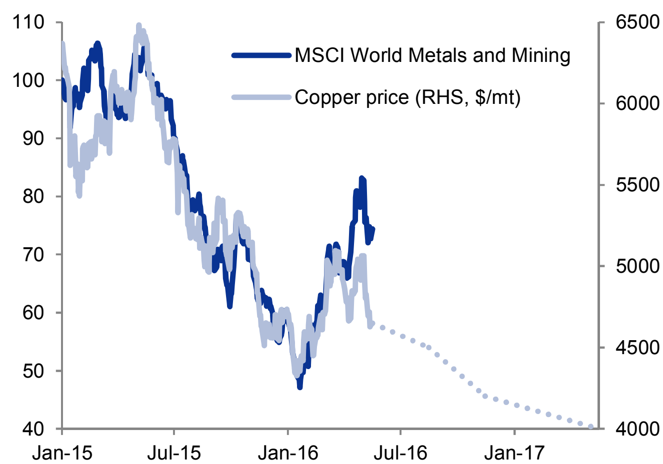
<u>**Implementation:**</u> **This appears best done in equity**, given lower transaction costs and lack of indices in credit. Valuation and implied vol of the Stoxx Europe 600 Oil & Gas sector (SXEP) is low relative to the Basic Resources sector (SXPP) (Exhibits 18 and 19). **We think it attractive to write SXPP calls to finance SXEP calls** (maximum potential loss is unlimited). Alternatively, as WTI implied vol is at the upper end of its range, while copper implied vol is at the bottom end of its range, **selling WTI puts could finance copper puts** (maximum potential loss is the WTI put strike minus premium plus the copper put premium).

Exhibit 16: We expect oil prices to continue to rebound…
MSCI World Oil & Gas; WTI oil price, forecast in dotted line



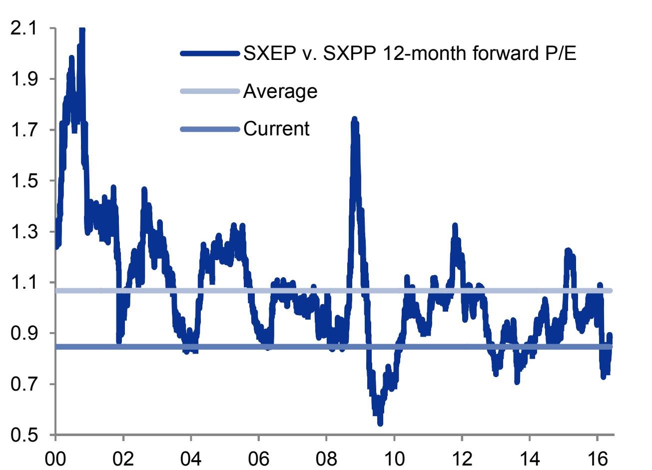
Source: Datastream, Goldman Sachs Global Investment Research.

Exhibit 17: …while metals prices continue to decline
MSCI World Met. & Min.; Copper price, forecast in dotted line



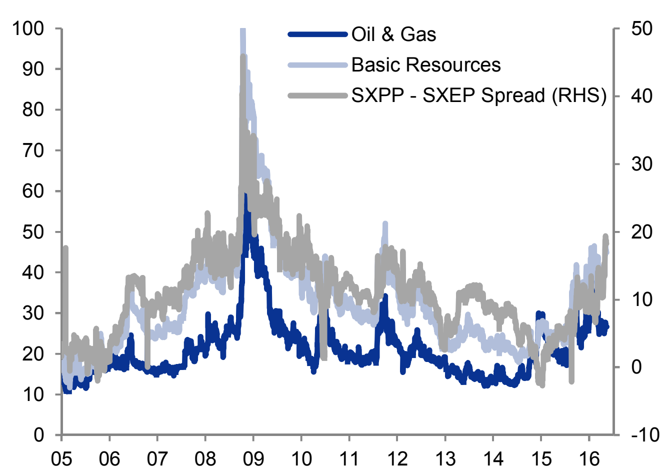
Source: Datastream, Goldman Sachs Global Investment Research.

Exhibit 18: Relative valuation is attractive in Europe…
Stoxx 600 Oil & Gas v. Basic Resources NTM P/E



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

Exhibit 19: …and implied vol spread is attractively wide
Stoxx 600 sector 3-month ATM implied volatility



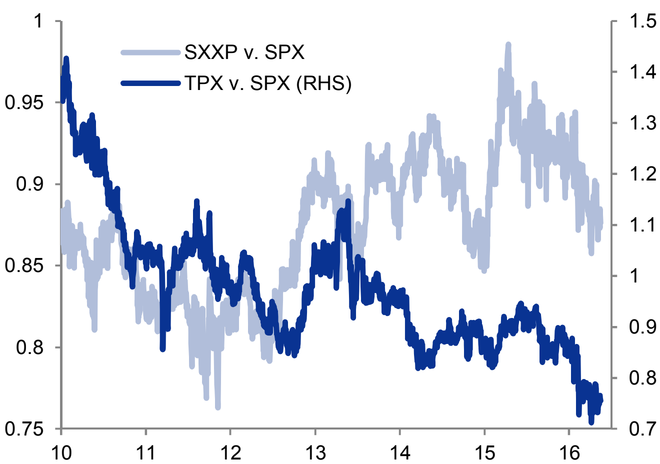
Source: Goldman Sachs Global Investment Research.

(5) Resurgence of divergence; FX best placed

Fundamentals: We expect two Fed rate hikes this year and three in 2017, while policy easing continues in Japan and Europe. **With Japanese and European areas facing questions about the efficacy of policy and concerns about growth and inflation, equity valuations relative to the US have come down** (Exhibit 20). Speculative dollar positioning has come down even more sharply (Exhibit 21), leading our FX team to argue the dollar is near a bottom (see *Global Markets Daily: The Dollar Bottom*, May 10, 2016).

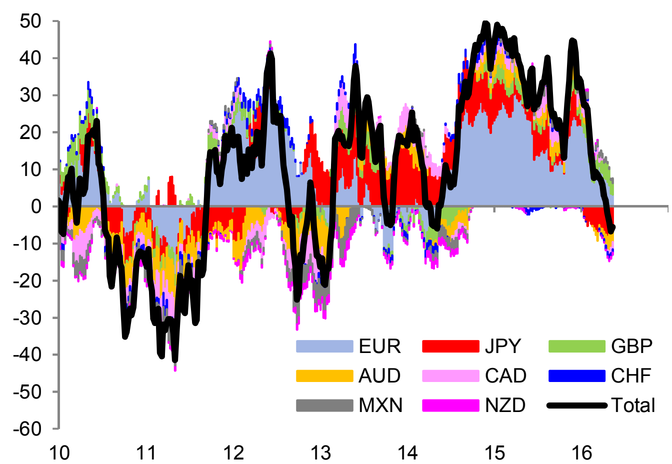
Implementation: Europe and Japan equity/FX correlations have risen from their all-time lows (Exhibit 2) (see *GOAL: Lost in translation; Equity/FX correlations back to extremes*, October 2, 2015), and could become less negative as political risks in Europe play out and growth concerns in both regions remain. This could result in currencies weakening without equity outperforming. **We think currencies are better positioned than equity to benefit from policy divergence**, and we think JPY/USD will in particular weaken in the coming months (Exhibit 22). Historically, Japanese and European **FX has been less volatile and less prone to large, fast drawdowns than equity**. Range-bound 10y bond yield differentials make us less comfortable positioning for a divergence in rates (Exhibit 23).

Exhibit 20: QE premium has been entirely undone
Stoxx 600 and Topix NTM P/E relative to S&P 500 NTM P/E



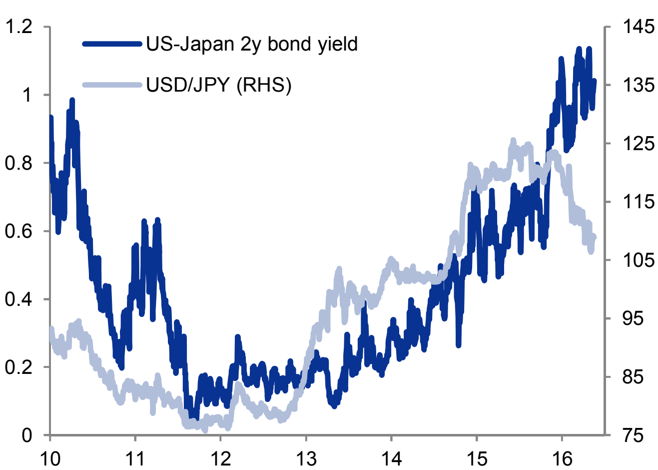
Source: Datastream, I/B/E/S, Goldman Sachs Global Investment Research.

Exhibit 21: Dollar positioning has come down a lot
Speculative USD longs (+) against currencies in CFTC CoT



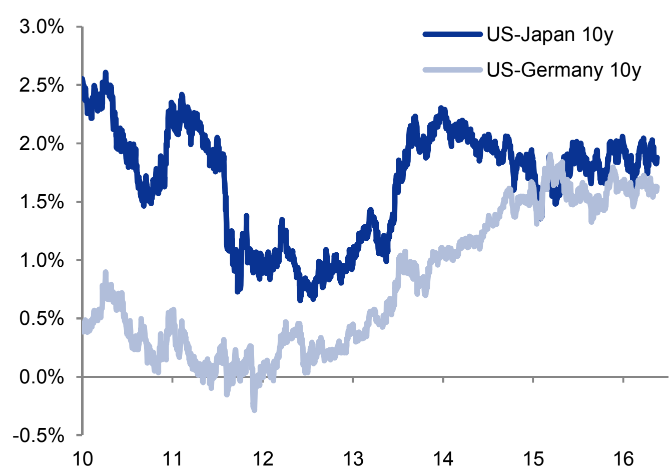
Source: CFTC, Bloomberg, Goldman Sachs Global Investment Research.

Exhibit 22: Yen has strengthened despite IR differentials
US/Japan 2y interest rate differentials, USD/JPY (RHS)



Source: Goldman Sachs Global Investment Research.

Exhibit 23: Yield differentials have been range bound
US/Japan, US/Germany 10y interest rate differentials



Source: Datastream, Goldman Sachs Global Investment Research.

Views on asset classes

Equities (3m and 12m Neutral): Downgrade to Neutral long term on growth and valuation concerns

We downgrade equities to Neutral over 12m and remain Neutral over 3m. We continue to see valuations as expensive, particularly in Europe and the US and ex-financials (ex-financials NTM P/E is 17.6x in the US, 16.5x in Europe). However, not only are valuations high, but growth prospects look poor. Earnings have been consistently revised down across regions, with recent positive earnings surprises coming primarily because of a low bar. **Until we see consistent signs of better earnings growth and higher inflation expectations, we believe equities will remain on a 'fat and flat' trajectory. Within the asset class, we remain Neutral across regions near-term and downgrade Europe and Japan to Neutral over 12m, while upgrading the US to Neutral over 12m.** The Fed has been more dovish than we initially expected, and market impact and realisation of policy divergence has slowed, creating a boost to the US relative to Europe and Japan. A strong yen and euro are weighing on European and Japanese earnings, while negative rates weigh on their financials. **We are Neutral Asia ex Japan**, as China data has been better than expected at the start of the year, but we believe risks remain. **We continue to prefer alpha to beta opportunities** within equities. We like **Oil & Gas vs. Metals & Mining** across regions, **shareholder return strategies (US, Japan), stable growth (Europe) and dividend yield baskets (US, Europe).**

Government bonds (3m & 12m Underweight): More reflation pressure, still expect two Fed rate hikes

We remain Underweight bonds over both 3 and 12 months. We downgraded our expectation for Fed hikes from three to two in 2016 (Sept, Dec) and four to three in 2017, but are still hawkish given the market's pricing (0.5 in 2016, less than 1 in 2017). As temporary factors such as energy drop out of inflation, we expect it to continue to rise, particularly in the US where the labour market is later cycle and should drive wage inflation. **We continue to recommend being long US breakeven inflation. We retain our preference for German bunds relative to US treasuries, amid continuing policy support from the ECB, and have a relative preference more broadly for European core and periphery bonds given this.**

Credit (3m and 12m Overweight): Valuations and carry attractive and risks lower; upgrade US HY 3m

We continue to be Overweight credit on both a 3- and 12-month horizon, given valuations appear cheaper than in equity and the carry looks attractive. Spreads have narrowed substantially in recent weeks – particularly in EUR IG and US HY – but remain at levels consistent with recessions (US HY spreads are at their 72nd percentile since 1985) while we forecast defaults in US HY well below recession levels, at only 4.5%-5% in 2016. While we forecast continued distress in Energy and Metals & Mining, we see little spillover to broader HY. **We upgrade US HY to OW over 3m and downgrade US IG to Underweight over 3m (both matching our 12m allocation) given recent commodity price improvement, higher carry in HY relative to IG, and our view that spread decompression between HY and IG spreads has likely run its course for now.** Additionally, Fed hikes should be a headwind for US IG total returns, with less spread buffer for rate increases than exists in US HY. **ECB credit easing in the coming months and less re-leveraging in Europe relative to the US cause us to remain Overweight EUR IG both near and long term, while our credit strategists have also initiated a trade going long EUR HY v. EUR IG.** They also expect the search for yield to cause compression within the quality spectrum.

Commodities (3m and 12m Neutral): Disruptions at play, adjustments under way, not complete

We upgrade commodities to Neutral over 3 months, as we expect supply disruptions to drive higher spot oil prices and less negative roll yields in the near term. But we expect this to delay fundamental oil adjustments to the later part of 2017 and so any near-term backwardation will likely be temporary, in our view. **Until the oil forward curve enters into sustained backwardation, as a result of fundamental adjustments, we refrain from being outright bullish as negative roll yield will likely continue to weigh on index investor returns. Consequently, we remain Neutral over 12 months.** We expect the WTI oil spot price to be at $51/bl in 4Q2016, $50/bl in 2Q2017 and $60/bl in 4Q2017. **We continue to expect industrial metals price weakness, owing to a combination of excess supply and weak demand, and have the view that the support from China will be temporary. We remain directionally bearish on gold, but we recently revised up our price targets** on the back of our Fed hike forecast being revised down to two hikes this year. We have 3/6/12m gold targets of $1,200/1,180/1,150/oz.

FX: Near-term risks to long-term expectation of dollar strength, selective EM FX value

We see near-term risks alongside a more dovish Fed than we had expected, but we continue to believe the USD will strengthen against the broader G10 currency complex over 12m, and be most pronounced against the euro and yen, given policy divergence between the Fed and the ECB/BoJ. In 12 months, we forecast EUR/USD at 1.05 and JPY/USD at 125. We scaled back our USD/CNY 12m forecast to 6.80, given the Fed and better China data than expected. **We see good carry opportunities in EM FX, but choose selectively** based on where imbalances have corrected more: **we like being long MXN, INR and RUB.**

Asset class forecast returns and performance

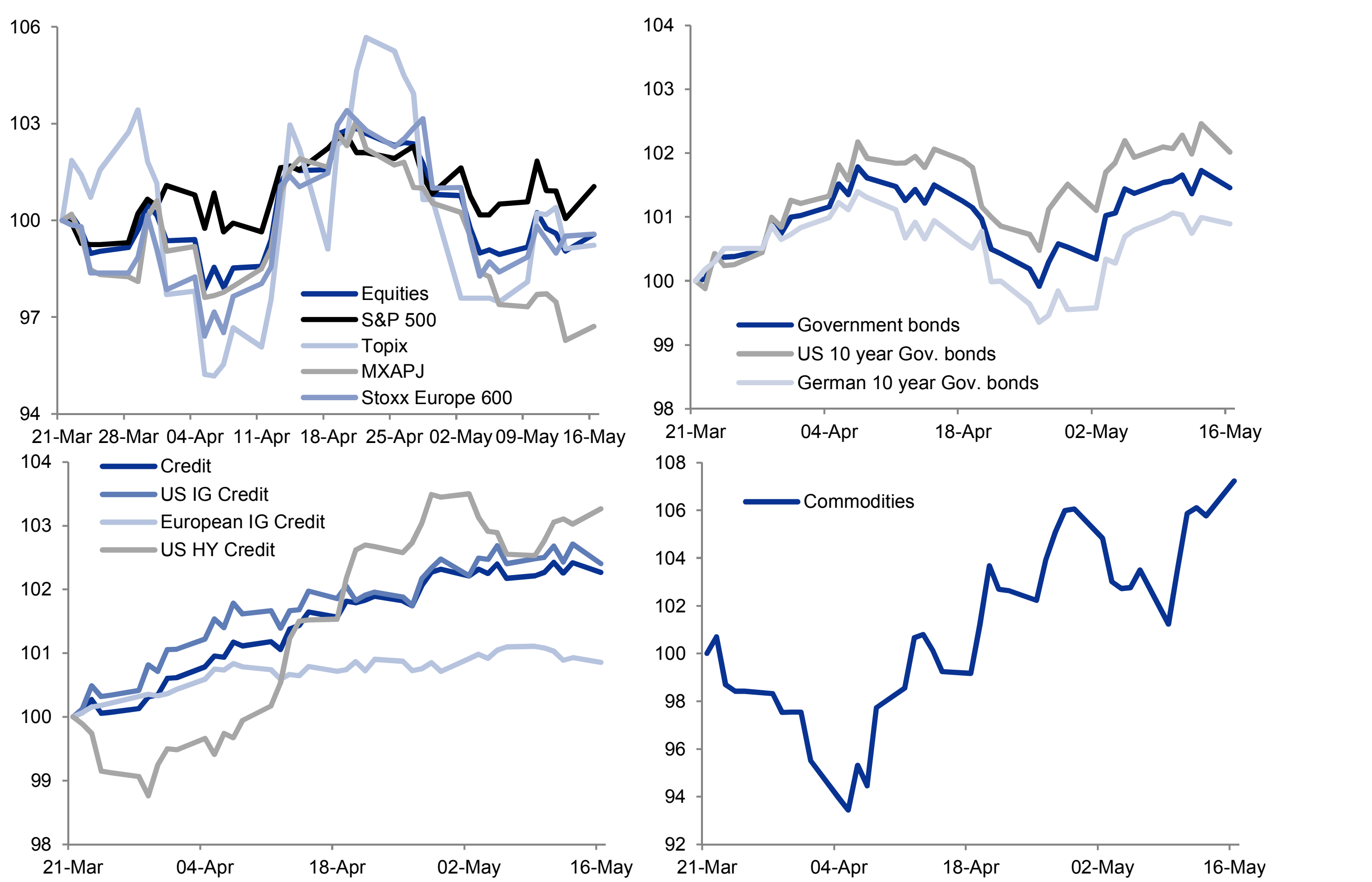
Forecasts and views on specific asset classes are attributed as follows:
Equities: *Peter Oppenheimer, Kathy Matsui, Tim Moe, David Kostin*; **Credit:** *Charlie Himmelberg*;
Bonds: *Francesco Garzarelli*; **FX:** *Robin Brooks, Sylvia Ardagna*; **Commodities**: *Jeff Currie*.

Exhibit 24: Goldman Sachs' 3-, 6- and 12-month return forecasts by asset class

Asset Class	Benchmark Weight	3-month Total Return		6-month Total Return		12-month Total Return	
		Local currency	In USD	Local currency	In USD	Local currency	In USD
Equities	**35**	**2.2**	**1.2**	**4.8**	**2.5**	**8.5**	**4.2**
S&P 500	40	-0.2	-0.2	1.5	1.5	5.1	5.1
STOXX Europe 600	30	1.1	-0.1	3.5	0.5	7.0	-0.9
MSCI Asia Pac ex Japan	20	6.7	5.9	8.4	6.8	11.9	9.8
TOPIX	10	6.5	0.9	14.7	4.1	19.7	4.3
10 yr. Government Bonds	**45**	**-1.7**	**-2.2**	**-3.3**	**-3.6**	**-5.1**	**-8.6**
US	50	-2.1	-2.1	-3.9	-3.9	-5.4	-5.4
Germany	50	-1.3	-2.4	-2.7	-3.4	-4.8	-11.7
5 yr. Corporate Bonds	**10**	**-0.4**	**-0.6**	**-0.6**	**-1.1**	**0.3**	**-1.2**
US: iBoxx USD Dom. Corporates	60	-0.8	-0.8	-1.4	-1.4	-1.1	-1.1
BAML HY Master Index II	20	0.4	0.4	0.9	0.9	4.2	4.2
Europe: iBoxx EUR Corporates	20	0.2	-0.9	0.4	-2.5	0.7	-6.7
Commodities (GSCI Enhanced)	**5**	**-5.6**	**-5.6**	**-5.9**	**-5.9**	**-2.2**	**-2.2**
Cash	**5**	**0.0**	**-0.5**	**0.1**	**-1.4**	**0.2**	**-3.5**
US	50	0.2	0.2	0.3	0.3	0.6	0.6
Germany	50	-0.1	-1.2	-0.1	-3.0	-0.3	-7.6
FX		**3 month target**	**Return**	**6 month target**	**Return**	**12 month target**	**Return**
EUR/$		1.12	-1.1	1.10	-2.9	1.05	-7.3
$/YEN		115	5.5	120	10.1	125	14.7

Source: Goldman Sachs Global Investment Research.

Exhibit 25: Performance of asset classes since our last *GOAL* report



Source: Datastream, Goldman Sachs Global Investment Research.

Key macro forecasts

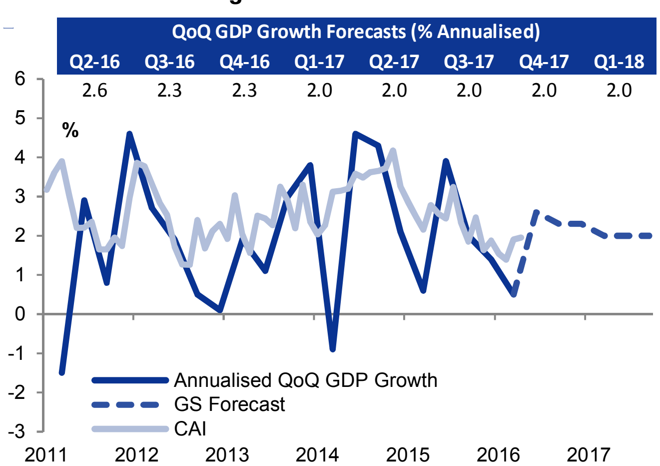
Exhibit 26: Our key forecasts across asset classes

	Return in % over last				Current	Forecasts				Up/ (downside) in %		
	12 m	3 m	1 m	YTD	Level	3m	6m	12 m	Unit	3m	6m	12 m
Equities												
S&P 500 ($)	-0.5	9.6	-0.5	2.0	2067	2050	2075	2125	Index	-0.8	0.4	2.8
Stoxx Europe 600 (€)	-12.7	6.5	-1.4	-6.6	335	335	340	345	Index	0.1	1.6	3.1
MSCI Asia-Pacific Ex-Japan ($)	-19.0	7.7	-5.1	-2.0	400	420	420	425	Index	5.1	5.1	6.3
Topix (¥)	-16.0	2.9	-2.9	-13.7	1322	1400	1500	1550	Index	5.9	13.5	17.3
10 Year Government Bond Yields												
US	5.7	0.9	0.0	5.6	1.77	2.03	2.28	2.55	%	26 bps	51 bps	78 bps
Germany	6.3	1.2	0.0	5.5	0.14	0.28	0.43	0.65	%	14 bps	29 bps	51 bps
Japan	7.4	0.6	0.4	5.6	-0.11	-0.05	0.05	0.20	%	6 bps	16 bps	31 bps
UK	6.0	1.6	0.0	3.9	1.39	1.65	1.75	1.95	%	26 bps	36 bps	56 bps
5 year credit spreads*												
iBoxx USD	3.6	5.6	0.4	5.3	124	122	119	109	Bps	-2 bps	-5 bps	-16 bps
BAML HY Master Index II	-1.7	11.7	1.7	7.2	630	620	610	564	Bps	-10 bps	-20 bps	-66 bps
iBoxx EUR	2.1	2.9	0.1	2.9	133	124	115	105	Bps	-9 bps	-19 bps	-29 bps
Commodities												
WTI	-30.2	35.5	13.2	14.0	48	49	51	50	$/bbl	2.7	6.9	4.8
Copper	-27.1	2.2	-3.4	-1.0	4645	4500	4200	4000	$/mt	-3.1	-9.6	-13.9
Aluminium	-19.7	1.0	-0.9	1.6	1548	1450	1400	1350	$/mt	-6.3	-9.6	-12.8
Gold	3.6	5.5	3.2	20.2	1276	1200	1180	1150	$/troy oz	-5.9	-7.5	-9.8
Wheat	-9.8	0.2	1.5	-1.6	475	490	490	490	Cent/bu	3.2	3.2	3.2
Soybeans	12.5	19.7	10.4	21.8	1065	875	875	875	Cent/bu	-17.8	-17.8	-17.8
Corn	-4.1	4.7	2.0	5.3	394	375	375	375	Cent/bu	-4.8	-4.8	-4.8
FX												
EUR/USD	-0.9	1.7	0.3	4.3	1.13	1.12	1.10	1.05		-1.1	-2.9	-7.3
USD/JPY	-8.8	-4.4	0.1	-9.5	109	115	120	125		5.5	10.1	14.7

** We show performance for credit and gov. bonds in total return terms, but current level and forecasts are for spreads and rates, respectively.*

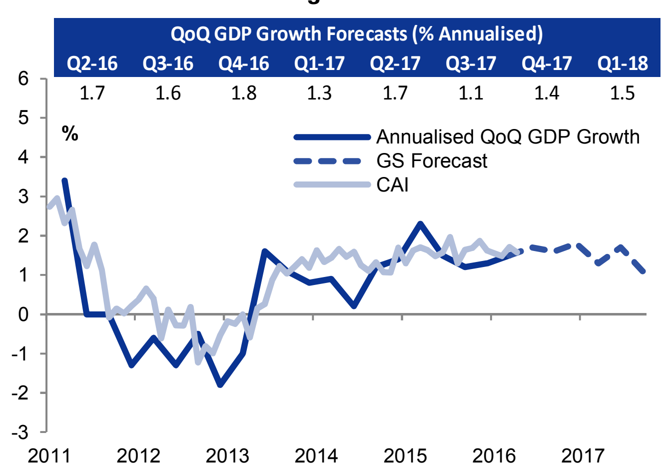
Source: Datastream, iBoxx, S&P, Goldman Sachs Global Investment Research.

Exhibit 27: US GDP growth vs. our CAI



Source: Goldman Sachs Global Investment Research.

Exhibit 28: Euro area GDP growth vs. our CAI



Source: Goldman Sachs Global Investment Research.

Exhibit 29: Our forecasts for economic growth (real GDP) vs. consensus

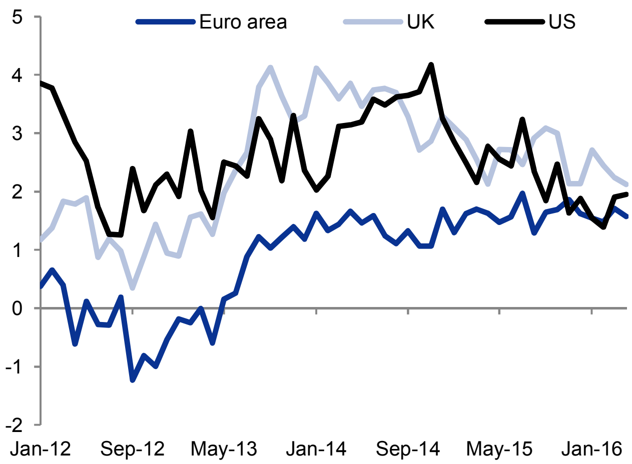
% yoy	2014	2015E	2016E		2017E	2018E
	GS	GS	GS	Consensus*	GS	GS
USA	2.4	2.4	1.8	2.0	2.1	2.0
Japan	0.0	0.5	0.5	0.6	0.7	0.7
Euro Area	0.9	1.5	1.4	1.5	1.5	1.6
UK	2.9	2.3	2.1	2.0	2.1	2.3
BRICs	5.8	4.7	5.2	5.0**	5.9	5.9
Advanced Economies	1.9	1.9	1.7	1.8	1.9	1.9
World	3.4	3.1	3.2	3.0	3.6	3.7

** Consensus Economics April 2016. **Consensus Economics March 2016.*

Source: Consensus Economics, Goldman Sachs Global Investment Research.

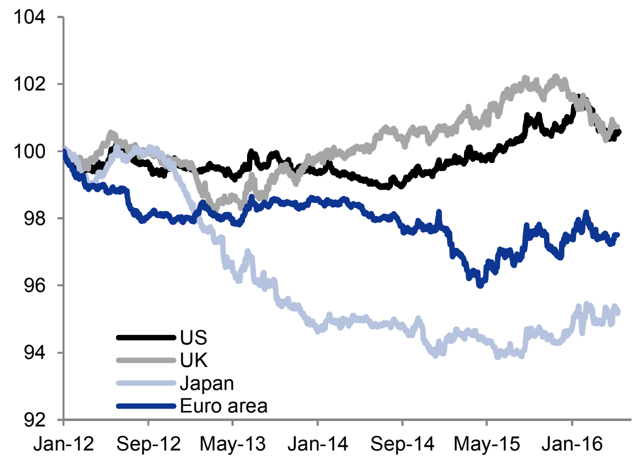
Macro monitor: EM/Japan macro surprises positive, from a low bar

Exhibit 30: Current activity indicator (CAI)



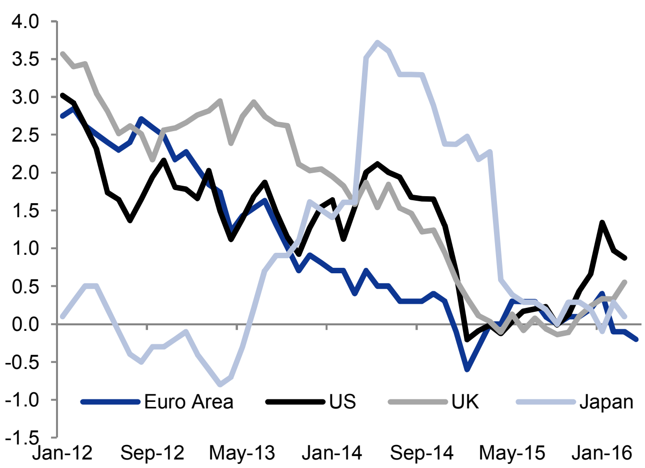
Source: Goldman Sachs Global Investment Research.

Exhibit 31: Financial condition indices (FCI)



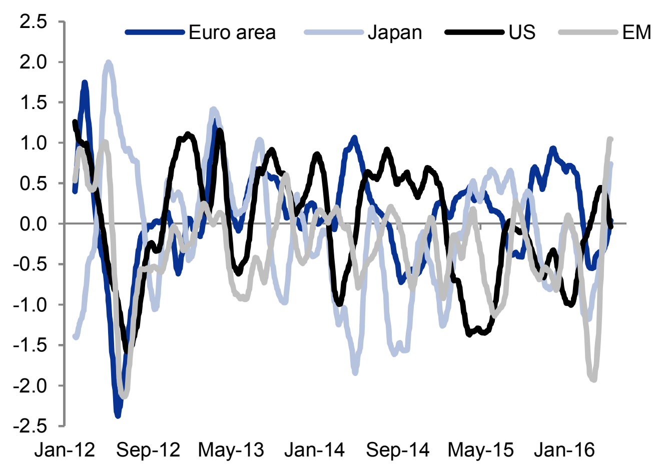
Source: Goldman Sachs Global Investment Research.

Exhibit 32: Inflation (CPI, yoy)



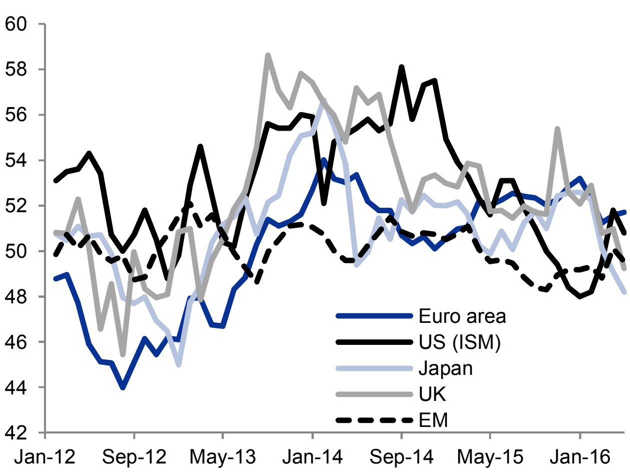
Source: Goldman Sachs Global Investment Research.

Exhibit 33: Macro surprise indices (MAP, 1-week avg)



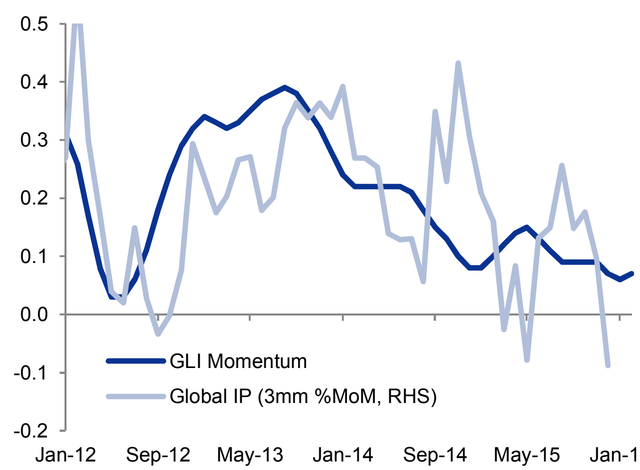
Source: Goldman Sachs Global Investment Research.

Exhibit 34: Manufacturing PMIs



Source: Markit via Haver. Goldman Sachs Global Investment Research.

Exhibit 35: GLI momentum and global IP



Source: Goldman Sachs Global Investment Research.

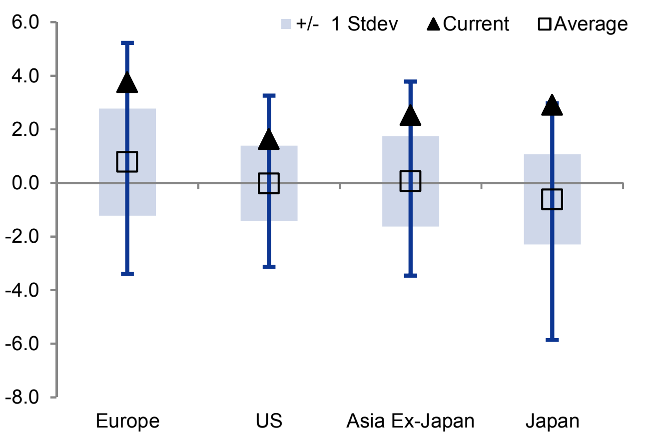
Equities (3- and 12-month Neutral)

Exhibit 36: Forecast returns and our recommended regional weightings within equities
Total return forecasts (in local currency and in USD) and the allocation relative to benchmark on 3- and 12-month horizons

		3-month				12-month						Long-term forecast		
				Price Return				Price Return		Total return		Level		CAGR to
	Current	Level	Wgt	Local	USD	Level	Wgt	Local	USD	Local	USD	2017	2018	2018 (local)
TOPIX	1322	1400	**N**	**6 %**	0 %	1550	**N**	**17 %**	2 %	**20 %**	4 %	1700	1800	**12 %**
MSCI Asia Pac ex Japan	400	420	**N**	**6 %**	5 %	425	**N**	**8 %**	6 %	**12 %**	10 %	450	480	**7 %**
STOXX Europe 600	335	335	**N**	**0 %**	(1)%	345	**N**	**3 %**	(4)%	**7 %**	(1)%	350	360	**3 %**
S&P 500	2067	2050	**N**	**(1)%**	(1)%	2125	**N**	**3 %**	3 %	**5 %**	5 %	2200	2300	**4 %**

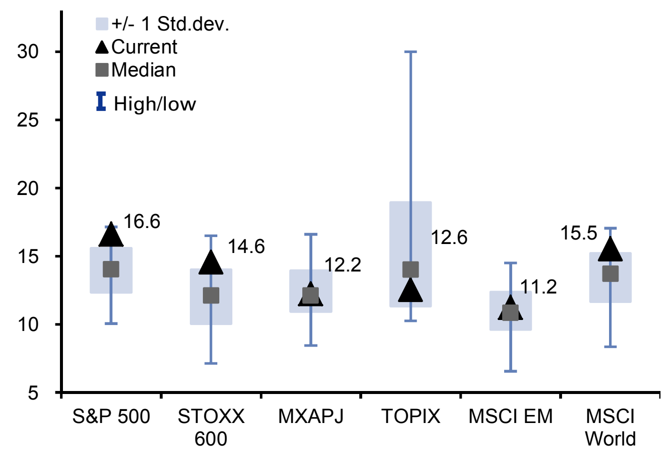
Source: Bloomberg, Datastream, Goldman Sachs Global Investment Research.

Exhibit 37: Dividend yields are high vs. real bond yields
Dividend yields minus 10-year real government bond yields. We use five-year average inflation as a proxy for inflation expectations. The distribution uses data from 1990, Asia ex-Japan from 1995



Source: Datastream, Haver, Goldman Sachs Global Investment Research

Exhibit 38: Valuation ranges of major market indices
12-month forward P/E over the past 10 years



Source: MSCI, I/B/E/S, Datastream, Goldman Sachs GIR.

Exhibit 39: Global valuation metrics and earnings growth
P/E is NTM on consensus estimates, all other data is for 2015 or last twelve months.

	P/E (X)	EV / EBITDA (X)	FCF Yield (%)	Div Yield (%)	P/B (X)	Net Income Margin (%)	ROE (%)	Implied ERP (%)
S&P 500	16.8	10.9	4.5	2.2	2.7	8.9	14.2	5.8
STOXX 600	14.5	9.6	4.8	3.6	1.6	6.6	7.9	8.5
MSCI Asia Pacific ex-Japan	12.3	6.6	7.8	3.3	1.4	8.6	10.4	9.4
Topix	12.7	4.2	3.8	2.3	1.1	4.3	7.5	7.3

Note: TOPIX EPS is based on fiscal, not calendar, years (i.e 2015 represents the fiscal year ending in March 2016). As of May 13, 2016.

	Earnings growth forecast (%)			
	GS top-down		Consensus bottom-up	
	2016E	2017E	2016E	2017E
S&P 500	9	12	1	12
Stoxx Europe 600	-2	15	1	13
MSCI Asia Pacific ex-Japan	2	7	1	11
Topix	11	7	15	NA

** TOPIX data based on March-ending fiscal year (the year after). The rest based on December-ending fiscal year.*
** Growth rates are based off local currency. US Consensus Bottom-Up reflects adjusted EPS. As of May 13, 2016.*

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

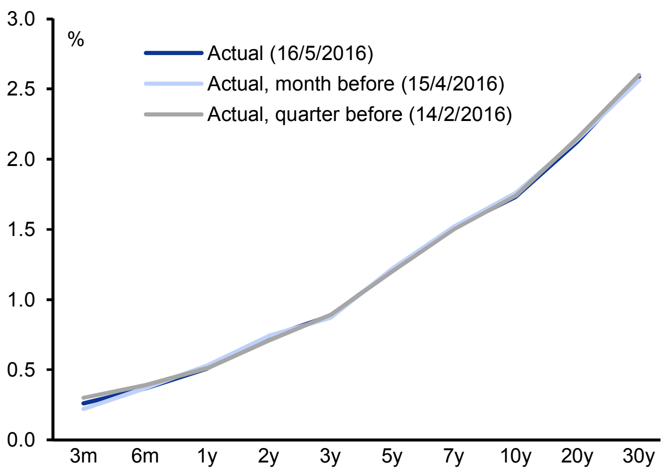
Government bonds (3- and 12-month Underweight)

Exhibit 40: 10-year bond yields: Market vs. GS Sudoku Model*, spot and 3 months into the future

	Actual* (%)	Misvaluation against fair value**, standard deviations		Fair value**, %		Fair value change (due to change in fundamentals), t + 3mth
		CE	GS	CE	GS	GS
USA	1.76	-1.62	-2.12	2.57	2.82	0.31
Germany	0.16	-1.48	-1.68	1.33	1.49	0.18
Japan	-0.10	-1.53	-1.44	0.58	0.54	-0.03
UK	1.41	-1.25	-1.44	2.48	2.64	0.20
Canada	1.31	-1.31	-1.99	2.27	2.77	0.56
Australia	2.30	-1.14	-1.50	3.40	3.74	0.34
Switzerland	-0.29	-1.51	-1.82	0.68	0.87	0.21
Sweden	0.53	-0.90	-1.02	1.62	1.77	0.17

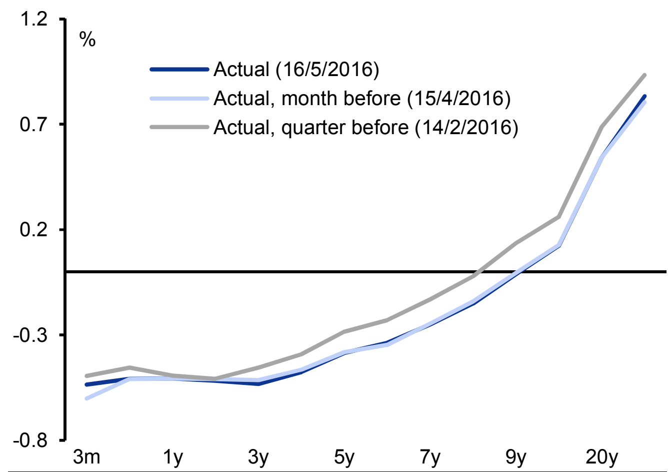
*Source: Goldman Sachs Global Investment Research; *Close May 16, 2016. **CE stands for Consensus Economics inputs of macroeconomic fundamentals (latest available month), GS stands for GS Economic Research inputs (current month).*

Exhibit 41: USD yield curve dynamics



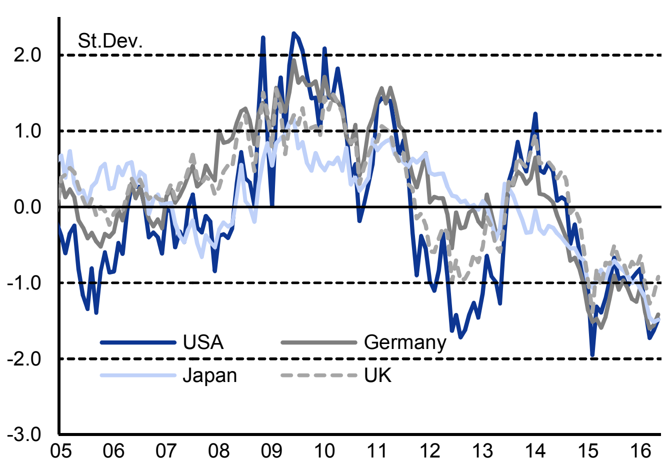
Source: Bloomberg, Goldman Sachs Global Investment Research.

Exhibit 42: DEM yield curve dynamics



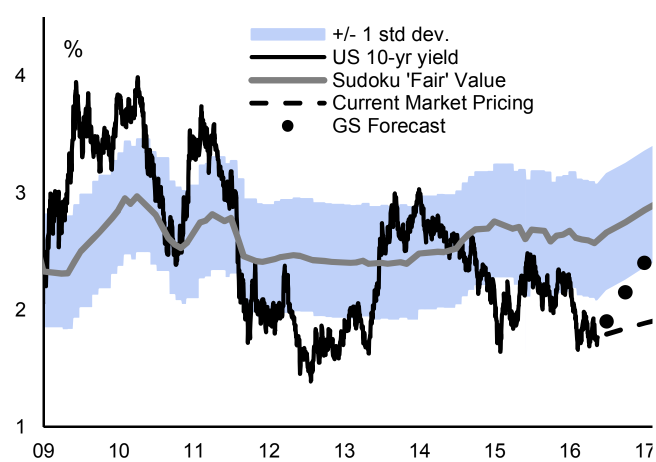
Source: Bloomberg, Goldman Sachs Global Investment Research.

Exhibit 43: Degree of 10-year bond mispricing according to GS Sudoku



Source: Goldman Sachs Global Investment Research.

Exhibit 44: 10-year US yields vs. GS Sudoku fair value



Source: Bloomberg, Goldman Sachs Global Investment Research.

Credit (3- and 12-month Overweight)

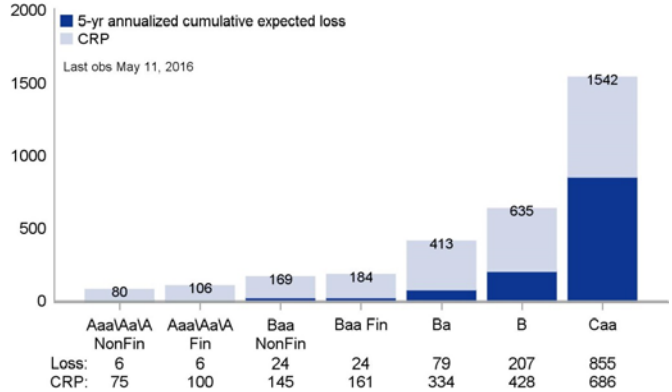
Exhibit 45: From current spread levels, we expect another 5bp of spread tightening in US IG and 35bp in US HY by year-end, and 21bps in EUR IG

Sector	2015YE	Current	2016Q2	2016Q4	2017Q2	2018Q4
	Period (Updated May 11, 2016)					
USD						
IG 5y	141	123	134	118	106	88
IG Fin 5y	116	126	109	96	89	76
IG Non-Fin 5y	154	122	147	130	115	95
High Yield	695	640	686	605	551	455
BB Rated	424	399	429	377	342	280
B Rated	715	628	670	585	529	428
CCC Rated	1653	1549	1521	1365	1265	1078
EUR						
IG 5y	140	131	129	110	103	87
IG Fin 5y	136	143	122	103	96	81
IG Non-Fin 5y	144	124	133	114	107	90

Source: iBoxx, BAML, Haver Analytics, Goldman Sachs Global Investment Research.

Exhibit 46: CRP indicates best opportunity in B and BB rated bonds

5-year spread decomposition into our estimates of expected losses and CRP (bp)



Source: Moody's, iBoxx, BAML, Haver Analytics, Goldman Sachs Global Investment Research.

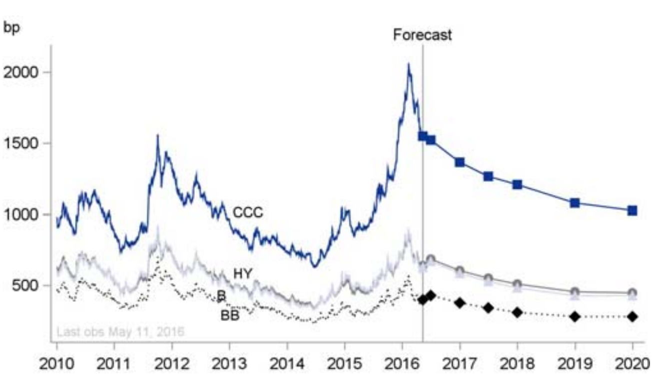
Exhibit 47: USD spread forecast for IG 5y Fin vs Non-Fin

Source: BAML, Haver Analytics, iBoxx, Goldman Sachs Global Investment Research.

Exhibit 48: EUR spread forecast for IG 5y Fin vs Non-Fin

Source: BAML, Haver Analytics, iBoxx, Goldman Sachs Global Investment Research.

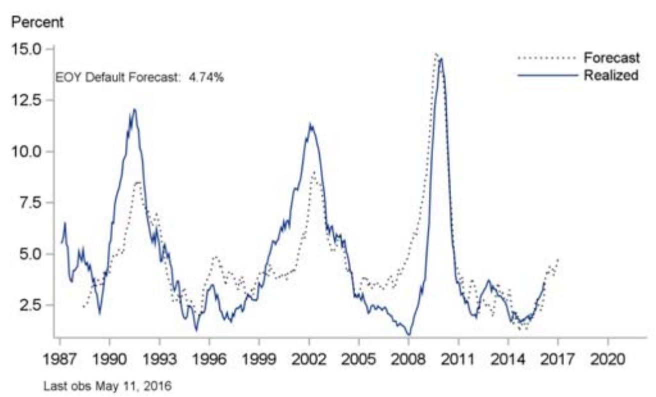
Exhibit 49: Long term, we expect a rally from current US HY levels



Source: BAML, Haver Analytics, iBoxx, Goldman Sachs Global Investment Research.

Exhibit 50: We expect the current benign default environment to persist

Our HY default rate forecasts vs. actual default rate



Source: Moody's, Goldman Sachs Global Investment Research.

Commodities (3- and 12-month Neutral)

Exhibit 51: S&P GSCI ® Enhanced Commodity Index total return forecasts

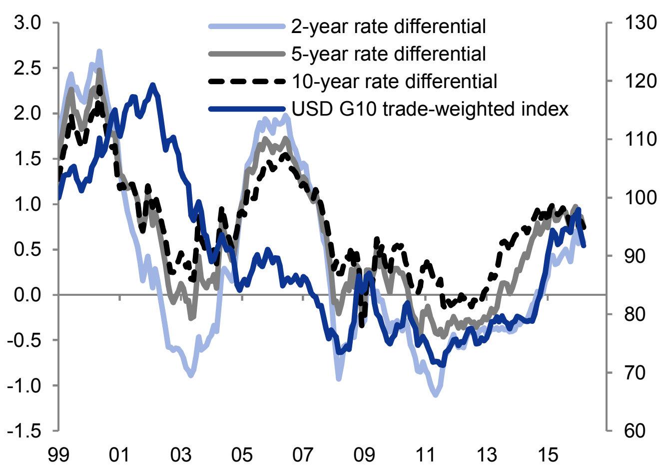
	Current Weight (%)	Returns (%)			Return forecasts (%)		
		2014	2015	2016 YTD[1]	3-months	6-months	12-months
S&P GSCI Enhanced Commodity Index	100.0	**-31.1**	**-29.9**	**9.3**	**-5.6**	**-5.9**	**-2.2**
Energy	58.9	-42.2	-36.8	12.5	-5.5	-4.4	4.0
Industrial Metals	8.6	-7.3	-24.3	1.4	-4.2	-9.4	-13.2
Precious Metals	4.7	-4.1	-11.1	20.6	-5.6	-7.2	-9.5
Agriculture	19.2	-9.3	-17.1	5.2	-7.6	-9.7	-12.2
Livestock	8.6	27.0	-19.1	-0.5	-2.8	-3.4	-6.7

[1] YTD returns through May 16, 2016 close.

Source: S&P, Goldman Sachs Global Investment Research.

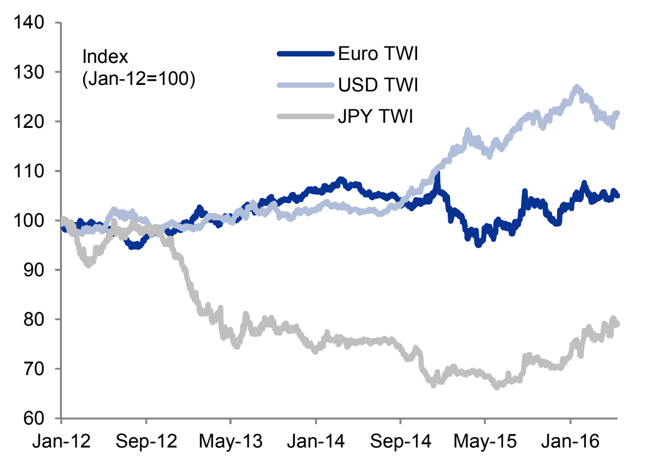
FX (USD strength to resume)

Exhibit 52: We expect the US dollar TWI to resume strengthening against the G10 through the end of 2017



Source: Bloomberg, Goldman Sachs Global Investment Research.

Exhibit 53: EUR, USD and JPY trade-weighted index (TWI)



Source: Goldman Sachs Global Investment Research.

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Disclosure Appendix

Reg AC

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