Goldman Sachs | Economics Research

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Global Markets Analyst

Top Ten Market Themes For 2017: Higher growth, higher risk, slightly higher returns

Our Top Ten themes are:

1. Expected returns: Only slightly higher
2. US fiscal policy: A pro-growth agenda
3. US trade policy: Concerns are likely overdone
4. EM risk: 'Trump tantrum' is temporary
5. Trump and trade: Hedge with RMB
6. Monetary policy: Focusing the toolkit on credit creation
7. Corporate revenue growth recession: Signs of inflection
8. Inflation: Moving higher across DM
9. The next credit cycle: Kinder and gentler
10. The 'Yellen Call' 2.0: Now with 'contingent knock-in'

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Higher growth, higher risk, slightly higher returns

We expect a lack of investment opportunities to remain an enduring challenge for investors in 2017. We think this despite the fact that economic growth will likely pick up in 2017 vs the somewhat disappointing performance in 2016. Indeed, over the past several months, the growth rate of global GDP already appears to be realizing at the top of the 3%-3½% range that has prevailed throughout the past five years. The main reason is the swing in the financial conditions impulse from sharply negative to modestly positive, both in the US and in parts of the emerging world. And the fiscal stimulus that will likely be enacted by the new Trump administration, and in other advanced economies, will only reinforce the inflation pressures already in place. With output and employment already close to potential, the rising inflation pressure strengthens our conviction that the Federal Reserve will likely raise the funds rate in December and again three more times during 2017 ("A catalyst for tighter Fed policy", *Global Economics Analyst*, 16 Nov 2016).

Stronger cyclical growth in the US will probably not do much for asset markets except help shift the narrative from 'low-flation' and monetary accommodation to reflation and rising rates. But this will not change the fact that the trend growth rate of GDP appears to have fallen for both advanced and emerging economies during the post-crisis period. Meanwhile, valuation levels for equities and especially bonds remain highly elevated by historical standards, so expected returns appear to be low across most asset classes. In fixed income, yield is scarce, and in equities, growth is scarce. So investors have been pushed into less familiar strategies, such as equity investors reaching for yield in high-dividend, low-vol stocks, or bond investors lining up to own the growth risk inherent in the long-duration bonds of tech companies.

In our view, expected market returns are likely to remain low as long as investors remain convinced that the growth outlook is anaemic. But many of the fundamental drivers behind the declining trends in DM GDP growth are likely to stay weak for the foreseeable future. One of the sustained headwinds for GDP growth in recent years has been the declining growth rate of the working-age population (age 16-64). In the US, for example, this fell sharply from 1.52% in 1998 to just 0.32% in 2016, while in Europe it fell to a negative rate of -0.53% (from +0.24% in 1998). Productivity growth is low, too, so there has been little to offset the demographic drag on growth. The 5-year annualized growth rate of labor productivity in the OECD, for example, has fallen to 0.49% from 1.67% in 1998.

There are reasons to think the longer-term outlook *could* brighten next year – this is part of the higher volatility (to the upside) featured in our Outlook title. For one, in most countries, the falling growth rate of the working age population is forecast to decelerate over the next several years. Second, research by our economics team suggests that the pace of scientific discovery and technological change has not slowed nearly as much as measured productivity indices would suggest ("Doing the Sums on Productivity Paradox v2.0," *US Economics Analyst*, 24 July 2015). Finally,

there is the theoretical, but untested, possibility that untapped productivity growth lies hidden in the economy, and that all that is required is to let it 'run hot' for a while; perhaps the mix of Chair Yellen's Fed and President-elect Trump's spending will help growth surprise further to the upside than most assume possible. But we are skeptical. Until more clear evidence accumulates showing that the outlook for productivity and *trend* growth has improved, the opportunity set for investors is likely to remain low.

Exhibit 1: Our global market forecasts for 2017

	Current*	GIR 2017 Forecast				Forecasted Change	
		Q1	Q2	Q3	Q4	2017 Q4	Percentile
10Y Rate (%)						|0 ------------|----------100|	
US	2.22	2.30	2.40	2.60	2.75		79%
UK	1.28	1.30	1.40	1.50	1.65		73%
Germany	0.31	0.40	0.55	0.75	0.80		79%
Japan	0.02	0.05	0.05	0.10	0.15		80%
Currencies							
EURUSD	1.07	1.08	1.04	1.02	1.00		37%
GBPUSD	1.25	1.20	1.18	1.16	1.14		12%
USDJPY	109.17	108.00	110.00	112.50	115.00		65%
USDCNY	6.87	7.00	7.15	7.23	7.30		97%
USDRUB	64.70	64.00	63.00	62.50	62.00		14%
USDINR	68.10	67.50	68.00	68.25	68.50		54%
USDMXN	20.25	20.00	19.50	19.25	19.00		15%
USDKRW	1173.71	1180.00	1200.00	1225.00	1250.00		81%
USDBRL	3.42	3.20	3.30	3.35	3.40		47%
Credit							
US Investment Grade, 5y	105.37	98	91	90.5	90		35%
US High Yield	494.00	464	433	432	430		25%
EUR Investment Grade, 5y	119.36	106	93	92	91		26%
Equities							
S&P 500	2176.94	2125	2150	2175	2200		56%
STOXX Europe 600	338.47	350	355	360	360		87%
MSCI Asia-Pacific Ex-Japan	424.41	470	470	470	475		87%
Topix	1421.65	1350	1375	1400	1425		50%
Commodities							
WTI	45.57	45.00	50.00	55.00	60.00		87%
London Gold	1224.50	1280	1280	1265	1250		54%
LME Copper	5525.00	5000	4800	4800	4800		20%

*Current as of November 16, 2016.

Source: Goldman Sachs Global Investment Research

1. Expected returns: Only slightly higher

Our total return forecasts across a broad array of assets are summarized in Exhibit 2. For many assets, expected returns are actually slightly higher for 2017 than they were for 2016. Because the magnitude of forecast returns reflects the quality of the investment opportunity set, we find it instructive to compare our 2017 forecasts to our forecasts from last year. In particular, this gives a sense of the extent to which our perception of the opportunity set has changed.

Comparing this year's forecasts to last year's reveals that, despite a slighter stronger outlook for global growth, expected returns remain low. In US equities, for example,

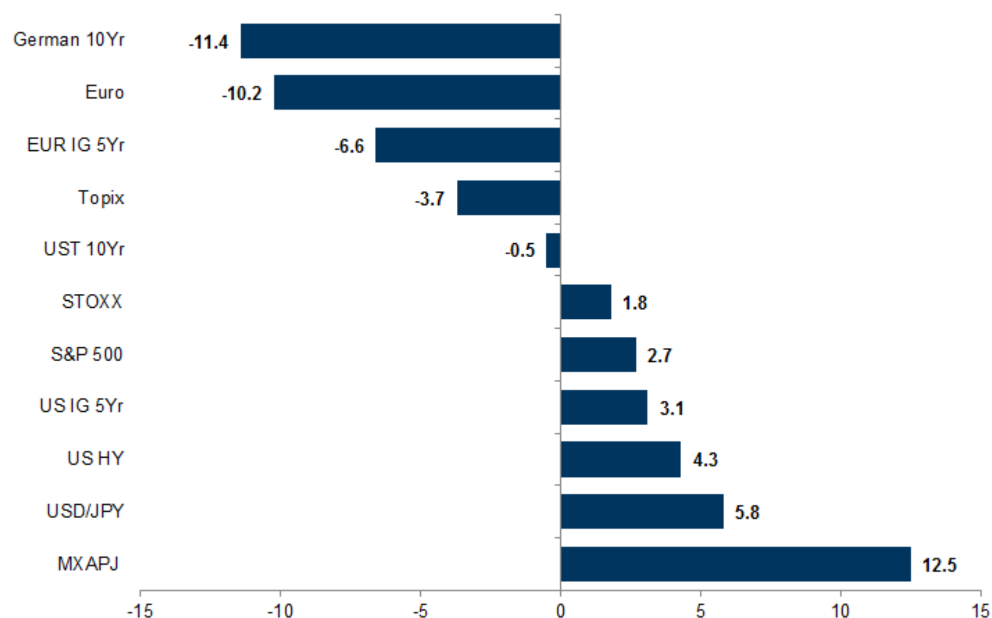
we have upgraded our expected return forecast, but only to a modest 2.7% for 2017 (vs last year's forecast of 1.5% for 2016). The best improvement in the opportunity in global equities is in Asia ex-Japan, where we forecast returns of 12.5% (vs 3.8% for 2016). At the other end of the equity spectrum, in Japan we are forecasting declines of -3.7% on the Topix (vs 5.2% for 2016).

In bond markets, the opportunity set for returns looks just about as bad for 2017 as it looked for 2016. For US 10-year Treasuries, for example, our 2017 total return expectation is around negative 50bp (we forecast yields to end 2017 at 2.75%). With an expected return of around -11%, German Bunds will remain among the most challenging bond markets for USD-based investors, mainly because of the roughly 10% depreciation of the Euro against the USD that we forecast.

Finally, expected credit returns do not look as attractive to us as they looked in 2016 but, given that spreads have not rallied much past their historical medians this year, they still look much better than pure rates duration and offer the best carry in the global fixed income landscape. A very similar picture holds in Emerging Markets, where valuations are perhaps less compelling than in early 2016, but the real carry on offer is still generous relative to DM fixed income. The highest credit return available remains in US HY, where we expect returns of 4.3% in 2017 (vs our expectation of 8.2% in 2016). The biggest difference between this year forecast and last year's is valuation — US HY has been among the best performing asset classes in 2016, with the BAML HY index returning over 14% year to date. US IG, however, looks slightly better next year (3.1% vs 0.3% last year), mostly due to the lower drag from rates.

Exhibit 2: Forecast returns are not much better for 2017

Forecasted 12-month Total Returns (USD)



Source: Goldman Sachs Global Investment Research

2. US fiscal policy: A pro-growth agenda

The balance of risks in 2017 is rapidly evolving. In addition to recent data showing stronger US and global growth, the election of Donald Trump as the 45th president of the US surprised markets and us. Before the election, many market participants, including ourselves, held the view that a win by Trump would come as a large shock to 'policy uncertainty'. And, on this basis, we expected that risk markets would sell off ("Better global growth data, but a binary outlook on risk post-election", *Global Markets Daily*, 8 Nov 2016).

We were wrong, as it turns out. While 'risk off' was the initial reaction on election night as exit polls began to suggest that Trump might win, this all changed during his early morning acceptance speech. By avoiding any mention of the controversial themes that characterized his campaign, and choosing instead to focus on infrastructure spending, Trump reversed the sell-off: "*We are going to fix our inner cities and rebuild our highways, bridges, tunnels, airports, schools, hospitals. We're going to rebuild our infrastructure — which will become, by the way, second to none*." The rally continued from that point on, and by week's end had become one of the largest one-week rallies in years.

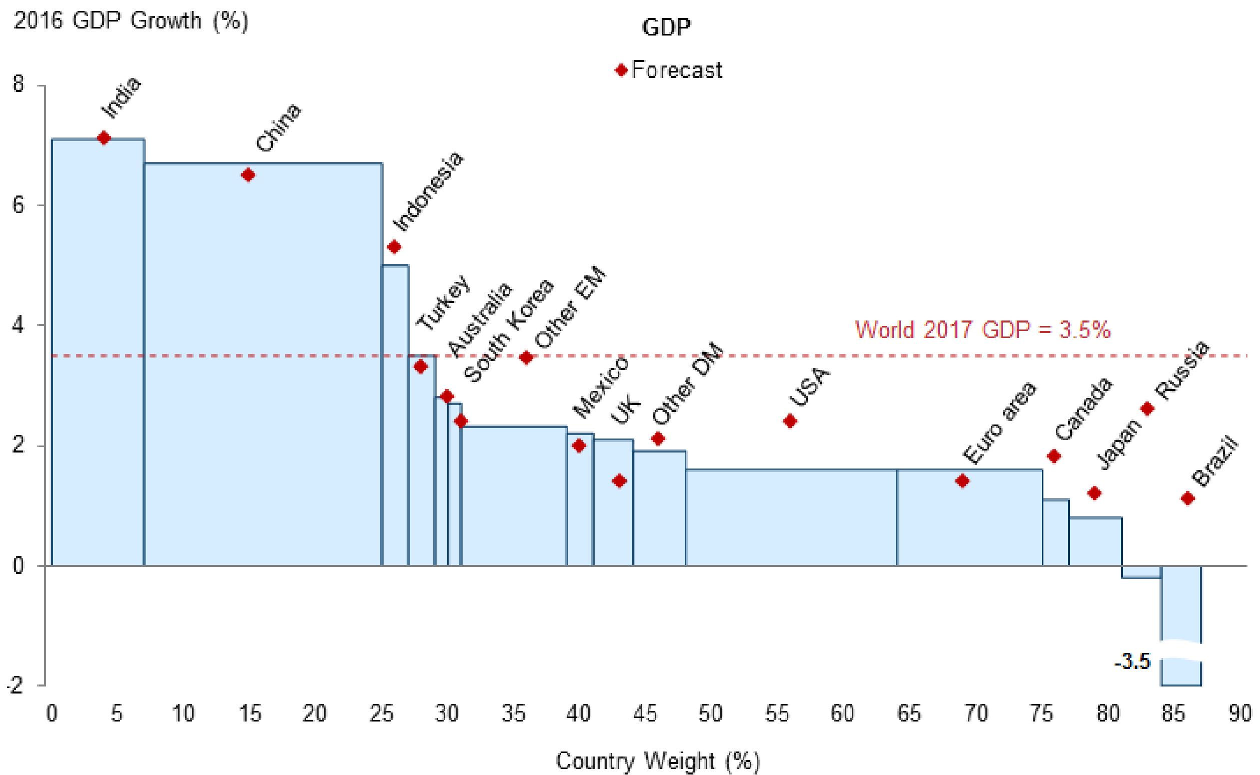
Markets are starved for growth. This is plainly visible in the eagerness with which markets seized on Trump's growth-focused message. It is also visible in the speed with which the market's narrative on the economic outlook under Trump has shifted from 'uncertainty' to 'growth'. We are mindful of how little has actually changed so far. Much of the optimism regarding the market's comfort with Trump's pro-growth views would likely have a different tone if the market's election night sell-off had not reversed itself. But it is also our sense that Trump does intend to prioritize an aggressively pro-growth fiscal agenda of tax cuts, deregulation, infrastructure spending and defense spending.

US fiscal stimulus is a welcome growth and reflationary impulse, especially in a weak global growth environment where the scope for lowering real policy rates remains constrained by low inflation and the zero lower bound on nominal rates. And Republican control of congress gives such an agenda a good chance of being enacted. The President-elect's proposals seek mutually incompatible goals — higher spending, lower taxes, and lower deficits. And with only a slim majority in the Senate, he will need to win over the most fiscally conservative members of his caucus, which will constrain the scope of deficit spending. Nevertheless, deficit spending is what we expect.

The new administration does, of course, bring the potential for significant downside risks. For one, Mr. Trump is a highly unconventional and unpredictable politician. His ability to lead and execute in government remains unknown. Second, his desire to aggressively renegotiate better trade deals poses the risk of retaliatory actions and breakdowns in trade. Third, he has also been critical of the Fed, and with at least two FOMC seats turning over this year, there is a risk of policy discontinuity. Finally, while Trump may have run as a Republican, his policy views do not fit cleanly into the party's traditional policy platform. His legislative agenda may prove harder to pass

than is commonly thought, and may cause him to shift from his pro-growth agenda to areas where he has more autonomy (such as trade). But, so far at least, the incoming administration has signaled a legislative agenda that is firmly pro-growth.

Exhibit 3: Our GDP forecasts for 2017



Source: Goldman Sachs Global Investment Research

3. US trade policy: Concerns are likely overdone

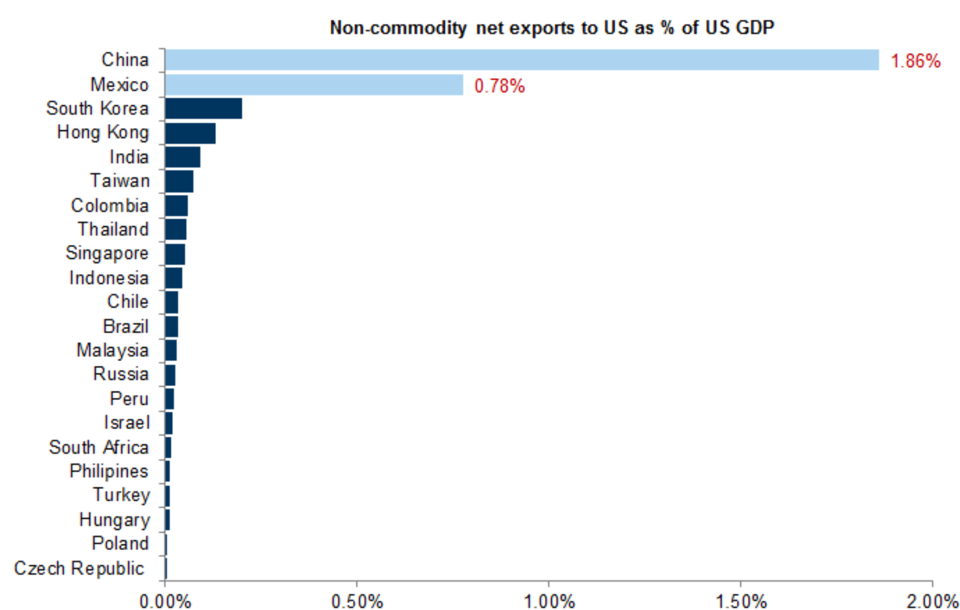
Offsetting the post-election optimism over President-elect Trump's increased emphasis on his pro-growth policies (and softening of more controversial issues), protectionist trade policy tops the list of policy priorities on which economists and global markets have been most focused. We share these concerns but, relative to market views, we think the popular media narrative on the downside risk of a trade war is overstated.

When asked for his philosophy on trade, President-elect Trump answers "I'm a free trader. I want free trade, but it's got to be fair trade." And on his transition website, his policy statement on trade begins "Free trade is good as long as it is fair trade." Considering that the Republicans in control of the House and Senate are committed free traders, we think that President-elect Trump will take a far more practical approach to US trade policy than his campaign rhetoric would suggest. Trump does not defend protectionism, but rather says he intends to push back on unfair trade practices.

Of course, US-China trade tensions are already elevated. In May 2016, for example, the Obama administration levied a 522% tariff on Chinese steel in response to

dumping charges. While the tit-for-tat strategies commonly deployed in trade negotiations can devolve into trade wars, this is not our baseline expectation. Our tentative view is that Trump's use of punitive tariffs will be just as pragmatic as President Obama's, albeit more vocal. This remains to be seen, of course, and we see a risk that Trump might be tempted to overplay his hand in trade negotiations. He has also threatened to "repeal NAFTA." But this would be a disaster for US growth, which Trump surely hopes to avoid. Instead, we think, his intent is to renegotiate it. Any trade agreement involves horse-trading over details, and we would expect the Trump administration to place more priority on provisions designed to benefit US manufacturing and other Trump constituencies. But, like most trade agreements, we expect the broad emphasis to remain on free trade.

Exhibit 4: Trade relations with China (and to a lesser degree Mexico) will receive heavy scrutiny under Trump



Source: UNCTAD, Goldman Sachs Global Investment Research

4. EM risk: 'Trump tantrum' is temporary

Since the US election on 8 November, EM asset markets have been roiled by a 'Trump tantrum', a mix of both higher DM yields and falling EM asset prices. At first glance, this price action in EM makes sense. Many of the policies advocated by President-elect Trump, particularly US trade policy, appear to pose large downside risks to EM economies. But the overall policy mix, if it results in stronger US growth and inflation alongside commodity price increases, may benefit parts of EM. We have consistently found that when stronger US growth accompanies higher US rates, EM assets can prosper, especially EM equities and spreads. Hence, while we expect a bumpier ride as EM markets adjust to higher US rates, we nonetheless see EM as a beneficiary of better US growth.

But EM markets are likely worried about more than just growth. In particular, it is possible that markets are also pricing the incremental risk of US protectionism. We think such concerns are overdone. While the rhetoric around trade negotiations seems certain to grow louder, we are tentatively of the view that Trump, and

especially the Republican Congress, are the free-traders they claim to be. We nonetheless see a real risk that aggressive public rhetoric around trade negotiations (which we find harder to judge at this point) could intermittently weigh on the sentiment towards EM.

On net, we think EM assets are poised to perform once the current move in core rate moves begins to stabilise. In support of this view, it is important to recognize the many differences (mostly positive) relative to the 'Taper tantrum' episode of 2013. EM economies today have stronger external balances, higher real carry, better valuations and more encouraging signs of an improving growth outlook. All these factors should help support the 'good carry' stories in EM (such as BRL, RUB and INR) that are less heavily positioned and less exposed to US trade and demand, and hence less exposed to the risk of a 'Trump trade tantrum'.

5. Trump and Trade: Hedge with RMB

In our view, positioning for a weaker RMB makes sense in 2017. Our forecasts ($/CNY at 7.30 in 12 months) call for a depreciation that is well beyond forward market pricing, thereby implying positive gains even accounting for the negative carry. And beyond the usual reasons for wanting to hedge exposure to 'China risk', we think it will also hedge the risk of a 'Trump trade tantrum'.

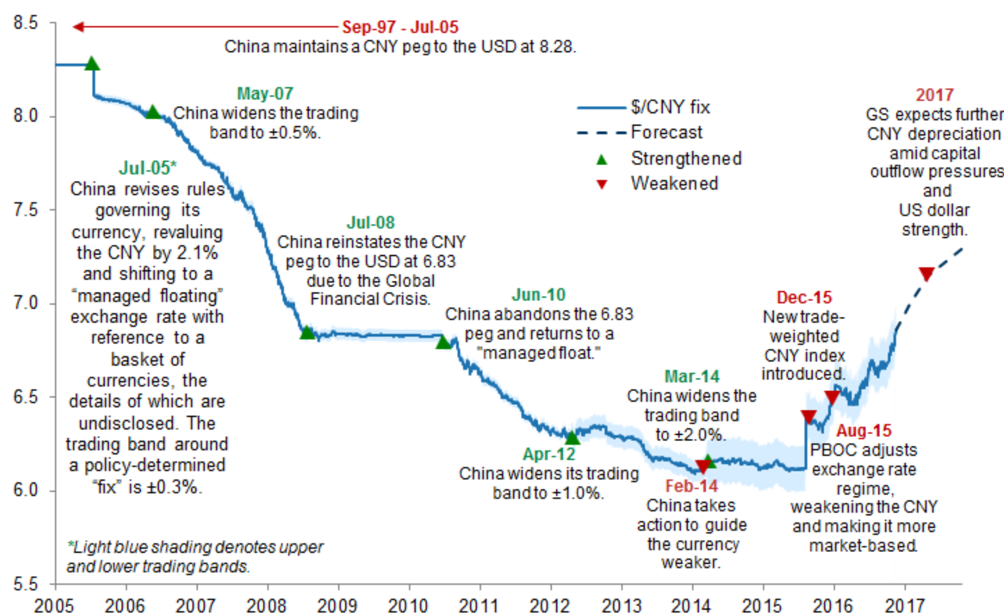
First, China's management of its currency remains vulnerable to the destabilizing effect of sharp devaluations against the Dollar ("No Easy Fix to the RMB Problem," *FX Views*, 2 June 2016). While the Chinese authorities have clearly communicated a shift in focus to a trade-weighted currency basket, thus de-emphasizing the signal, it is still the case that the only signal that matters is $/CNY. We think higher fixings still run the risk of encouraging capital outflows as households and firms anticipate a faster pace of depreciation. While the shift to a trade-weighted regime makes sense, China has historically had a bilateral exchange rate, which means that fixing $/CNY weaker is not as easy as it sounds.

Second, the RMB has a "*bias to depreciate*" ("Downside RMB Asymmetry," *FX Views*, 28 October 2016). Our research finds an asymmetry in the response of the $/CNY fix to the Dollar. Since March, we find that the $/CNY fix has risen 0.60% for every 1% rise in the Dollar, while the $/CNY fix has fallen only 0.38% for every 1% drop in the USD. There is therefore clear evidence of asymmetry in how the RMB responds to Dollar moves, which in our minds is evidence of an underlying bias to weaken the currency and supports our bearish view on the RMB.

Third, we think RMB could be an effective hedge against the key downside risk to the Trump Administration, namely, that an aggressive effort to renegotiate US tariff and trade agreements ends badly. While we think Trump will most likely pursue trade agreements that are less radical than his protectionist rhetoric, we nonetheless acknowledge that his negotiations could be more aggressive and hence more risky. China is likely to be a primary focus of these efforts ("The US election and its implications for Asian economies," *Asia Economics Analyst,* 14 November 2016). For one, levying tariffs on Mexico would require repealing NAFTA, which we see as unlikely (even if efforts to reform NAFTA are more likely). Moreover, in contrast to

the large bilateral trade deficit that the US runs with China, trade is nearly balanced with Mexico. We think tariffs on Chinese imports represent the clearest risk of Trump's trade policy, and we prefer to use the RMB to hedge this risk.

Exhibit 5: We forecast continued depreciation of RMB against USD



Source: Bloomberg, Various news sources; annotated by Goldman Sachs Global Investment Research.

6. Monetary policy: Focusing the toolkit on credit creation

This year the Bank of Japan introduced 'yield targeting' to its monetary policy toolkit. We think this is a harbinger of more changes to come in 2017, both for the BoJ and for central banks globally. In particular, we see a growing recognition of the collateral damage created by QE policies with a stated quantity target ("Central Bank Choices and Challenges", *Top of Mind*, 6 October 2016).

To us, one of the main merits of QE rests in the headroom it creates for the fiscal authorities to pursue more expansionary fiscal policies. This is achieved by removing an amount of bonds multiple times the net issuance (in Germany, where net issuance is around zero, the Bundesbank purchases 1.2 times the gross issuance of government bonds in a year), and by rolling over the securities that have been already purchased (in the US, for example, where QE has ended, the Fed is rolling over its huge portfolio of Treasuries and Agencies).

With policy rates across most advanced economies still hovering near zero, we think the year ahead will see the policy discussion begin to emphasize the desirability of policy tools that target the intermediary cost of supplying short-term bank credit rather than the market cost of borrowing via long-term public debt. This is partly because the latter may entail unintended costs, such as driving yields to levels that encourage poor risk-taking decisions. But, more importantly, we suggest it is because risky investment activity — the investments that drive innovation and economic growth — tend to be funded primarily via short-term bank credit.

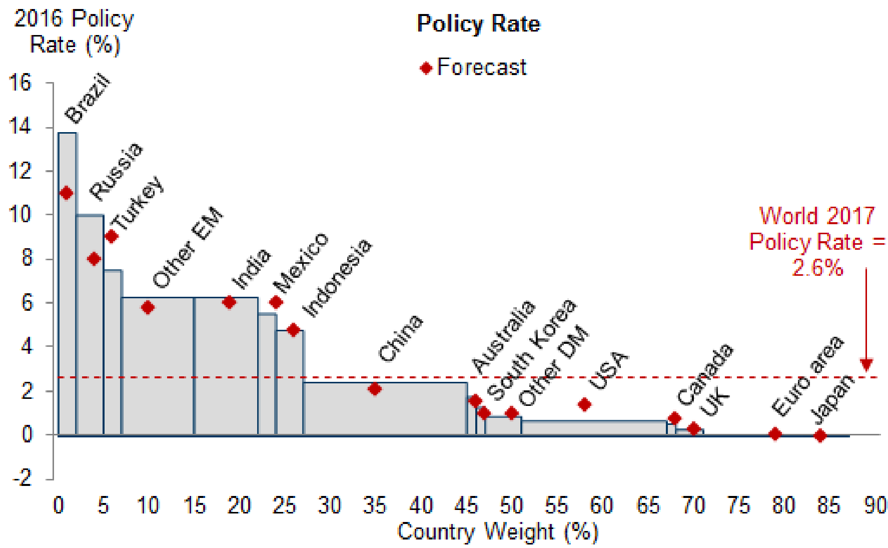
Which policy tools best encourage investors and business owners to take the kinds of risks that help drive innovation and economic growth? We think this is the question that monetary policy makers will increasingly be asking themselves in the year ahead. If monetary policy could be targeted, it would ideally aim to create incentives for the pools of capital that are best-equipped to take the kinds of risks that help drive innovation and economic growth. These growth investments and their investment risks are typically borne by small business owners, entrepreneurs, private equity funds, venture capitalists and hedge funds. These investors traditionally rely more heavily on equity, so monetary policy is arguably limited in what it can do. But to the extent that such investors also rely on credit, they tend to rely on shorter-term bank credit.

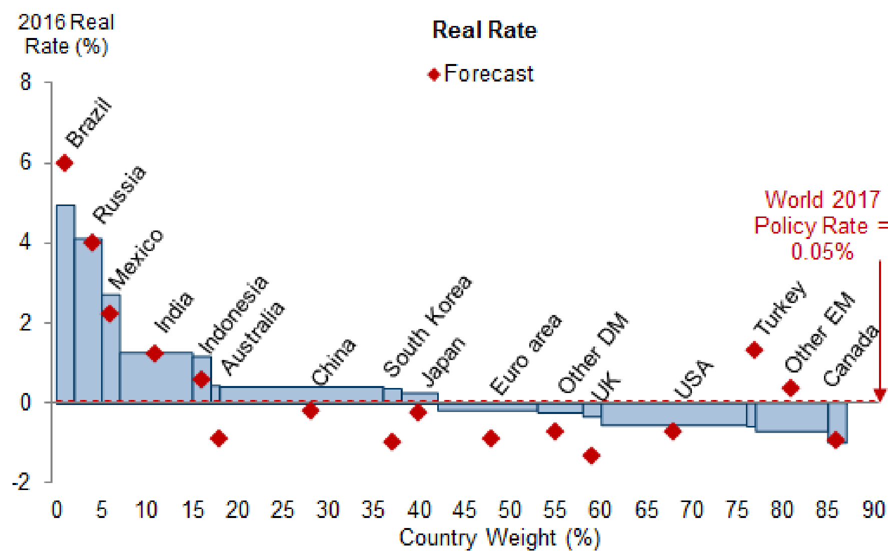
It is not clear that this goal is well-served by tools such as QE which aim to reduce long-term yields. Access to long-term debt market is more or less restricted to governments and large, well-established corporations. Even if lowering the cost of capital for such borrowers does not lead to risk-taking distortions, neither does it promote growth, since it provides more benefit to 'capital in place' than to 'growth capital'.

So what are the alternatives to QE-type instruments? Taking policy rates into negative territory is one alternative, but it is difficult for banks to pass negative rates on to depositors for fear of triggering a run into cash. Negative rates thus cut into bank earnings, limiting their ability to (re-)build capital and expand their balance sheets through credit creation ("Monetary policy transmission: When rates are (very) low, the bank lending channel is weak", *European Economics Analyst*, 15 September 2016). Negative rates, in other words, may be self-defeating from a credit perspective. The BoJ, and possibly also the ECB in the future, are abandoning purchase quantity objectives, which have amplified bond yield movements, and resorting instead to forms of price guidance along the yield curve. We consider this to be an improvement in the conduct of QE.

Better, in our view, are instruments such as forward guidance and 'funding for lending' schemes. By reducing the risk of maturity transformation for lenders — stabilizing short-term borrowing to finance long-term lending — such schemes reduce the riskiness, and hence cost, of credit risk intermediation. This makes it more likely that credit reaches those pools of active equity capital that are in the best position to identify and pursue growth-enhancing investment opportunities. The tools of unconventional monetary policy vary widely in their ability to encourage growth. In our view, the monetary policy conversation will soon be putting more focus on instruments that encourage (or at least do not discourage) the intermediation of credit risk.

Exhibit 6: We expect policy rates to remain near zero across most of DM, with rising inflation driving real rates lower





Source: Goldman Sachs Global Investment Research

7. Corporate revenue growth recession: Signs of inflection

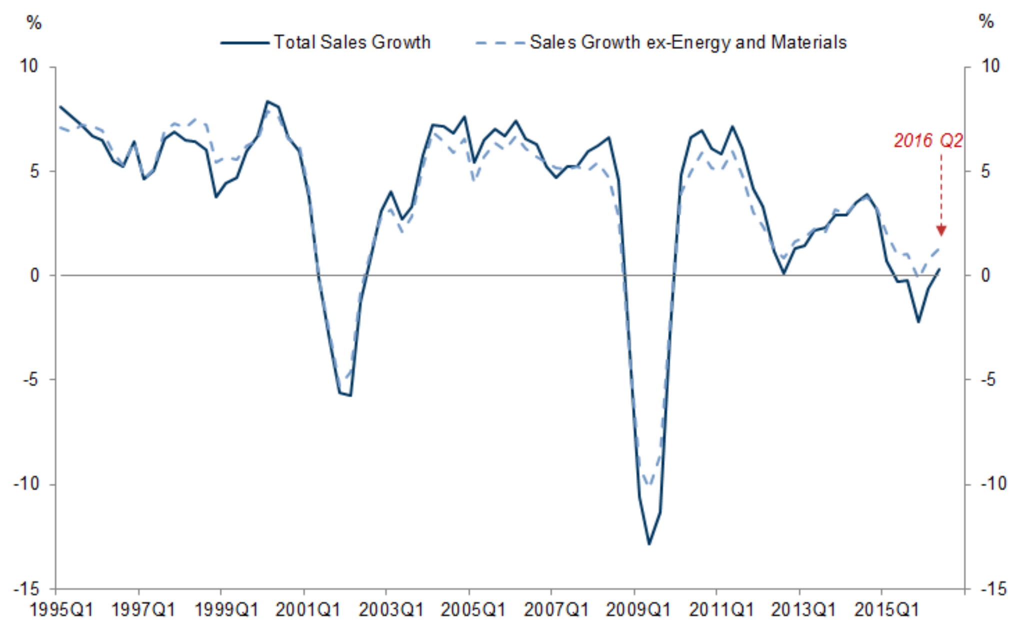
We expect 2017 to confirm that the US corporate sector has emerged from its recent 'revenue recession'. Indeed, as Exhibit 7 shows, 2016 has already seen a bounce in the %yoy growth of real quarterly revenue. Some of this is due to the rebound in oil prices, but most of it reflects a rebound in macroeconomic conditions. In a recent research report, we identified these macro drivers as industrial production, payroll employment, oil prices, and the trade-weighted Dollar. Using these monthly indicators, our 'nowcast' of revenue growth suggests that the worst of the revenue recession is over ("The US corporate revenue recession is recovering," *Global Markets Daily*, 19 October 2016).

Exhibit 7 shows the extent to which US corporate revenue fell in the fourth quarter of 2015. The most important macro driver of this decline was oil (largely due to its influence on the Energy and Materials sectors). The collapse of oil prices alone accounts for roughly half of the model-predicted 6.7%yoy drop in quarterly revenues as of Q4 2015 (the realized drop was 9.1%). The weaker Dollar contributed an additional 1.2% to the drop, and weaker industrial production added another -1.1%. In 2016, by contrast, the negative contribution from all three factors diminished significantly, while employment growth remained stable. Through Q3, the 'nowcast' from the model (not shown) implies a -2.3%yoy growth rate for a broad measure of US quarterly revenues. Although still negative, it is a meaningful improvement from the 9.1% decline in 2015, and the realized %yoy growth rate for Q3 came in over 2% higher than its forecast. While not much stronger than the recovery in US GDP more generally, it does at least appear that the revenue recovery from the oil shock is underway.

For 2017, our US Portfolio Strategy team expects that modest improvements in the macroeconomic backdrop will help lift S&P 500 operating EPS by 10% to $116 and they have a year-end S&P 500 target of 2200. We expect two issues to drive the earnings discussion next year. For one, we expect the US economy to remain on the same slow growth trend trajectory that has characterized the past 10 years. Owing in part to demographic headwinds and lower productivity growth, trend growth rates of GDP have fallen for most EM and DM economies. For the US — the DM economy on which we are arguably most bullish — our economists estimate that the trend growth of GDP has fallen to around 1.75%, down from 2.50-2.75% in the pre-crisis period. Second, S&P 500 margins remain at historically high levels. While we expect margins to increase slightly next year (primarily owing to improvements in the Energy sector), the scope for upside margin expansion would appear limited.

We also expect better corporate earnings in EM markets driven primarily by companies outside of commodity and financial sectors. Companies that are cyclically geared to rebound in domestic growth should see the largest improvements. In markets with positive growth stories (India, Poland and Brazil), companies exposed to domestic growth should benefit most. In Asia EM, the Philippines and Indonesia are the equity markets most heavily weighted toward the domestic sector. The riskiest part of the EM story is China (27% of the EM equity complex), where we do not expect EPS improvement. But in EM ex-China more generally, EPS should continue to improve.

Exhibit 7: The corporate revenue recession – which was more than just energy – is recovering



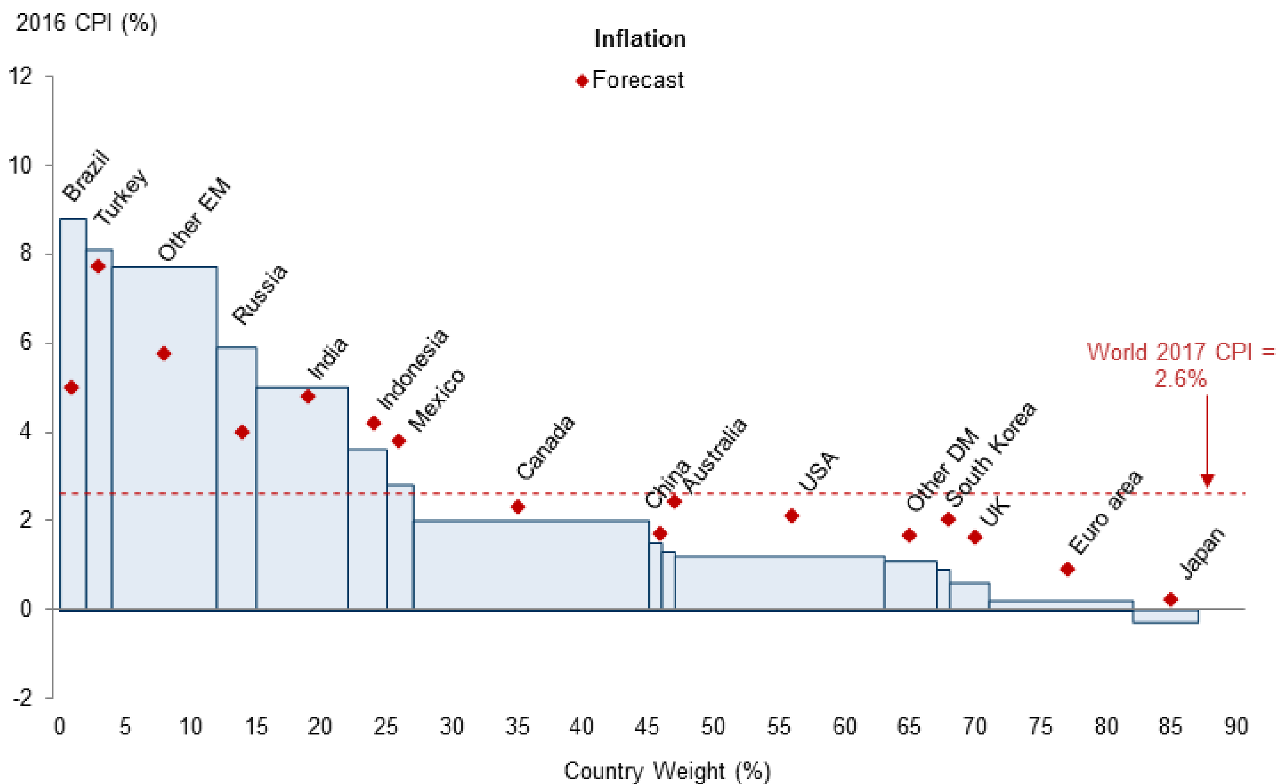
Source: Compustat, Goldman Sachs Global Investment Research

8. Inflation: Moving higher across DM

'Reflation' is the theme *du jour* following Donald Trump's unexpected emphasis on infrastructure spending in his acceptance speech on election night. Since then, market participants have been hard at work trying to figure out the policy agenda that Trump the president might pursue (distinct from the rhetoric of Trump the candidate). What seems clear to us, as argued above, is that economic issues, notably tax cuts, infrastructure spending and defense spending, are high on the agenda — a recipe for reflation.

There was a strong case for rising inflation in the US even before Trump's victory. Our call for higher rates in long bonds this past year was premised more on a repricing of inflation risk and inflation risk premia than on a rise in real rates. And, globally, we expect rising energy prices to push up headline CPI across the major advanced economies in early 2017. After years of deleveraging and highly accommodative monetary policy, we expect inflation to gain momentum in 2017 just as many countries are shifting their policy focus to fiscal instruments. For example, we are forecasting large boosts to public spending in Japan, China, the US and Europe, which should fuel inflationary pressures in those economies. Moreover, having had to work so hard for so long to get inflation even to the current low levels, the major central banks in developed markets sound increasingly willing to let inflation run above 2% targets.

Exhibit 8: We forecast CPI inflation rates in 2017 to fall in EM, and rise in DM



Source: Goldman Sachs Global Investment Research

9. The next credit cycle: Kinder and gentler

In our view, the inflection point in the credit cycle is unlikely to materialize in 2017. And, when it does, we expect the credit losses to mean-revert faster relative to the 2001/2002 and 1990/1991 cycles, more in line with the fast recovery seen in the aftermath of the Global Financial Crisis.

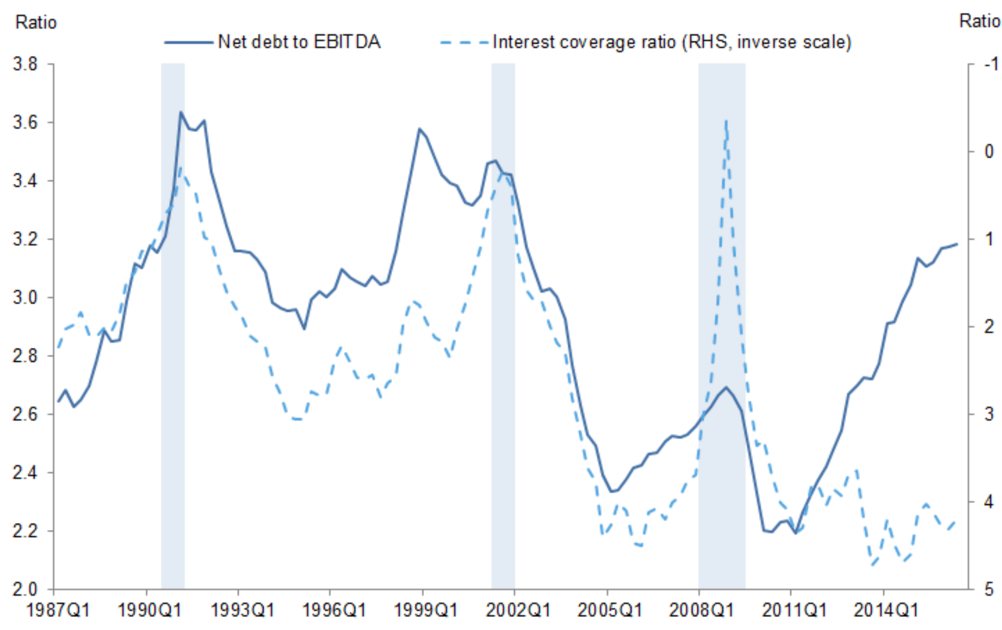
Coming into 2016, our central thesis for corporate defaults and downgrades was 'what happens in commodities stays mostly in commodities'. We essentially expected little contagion from the Energy and Metals and Mining sectors to the rest of the investment grade and high yield universes, a view that has largely played out. With the past few months providing clear evidence that HY defaults and downgrades are moving over the commodity hump, the debate among market participants will likely shift again to the timing of the inflection point in the credit cycle, as well as the magnitude and the persistence of the subsequent losses for credit portfolios.

As shown by Exhibit 9, the evidence from the past three cycles suggests the timing of the inflection is overwhelmingly determined by the stage of the business cycle. Regardless of the state of balance sheet fundamentals, recessions lead to a meaningful acceleration in defaults while expansions keep defaults low. We expect the same playbook in this cycle. The strong 'business cycle' component in the behavior of HY defaults, and our view that US recession risk remains low in 2017,

leave us comfortable with the view that the inflection point is unlikely to materialize next year, despite the weak state of corporate balance sheets.

In contrast to past cycles, however, we expect that the next cycle will likely be kinder and gentler than the cycles of the early 1990s and 2000s. This reflects the better mix of leverage and interest coverage today. As shown by Exhibit 9, since mid-2011, there has been a growing contrast between worsening leverage, which has increased to post-crisis highs, and interest coverage which has greatly benefited from ultra-low rates and remained quite elevated. This contrast is the key differentiator for this cycle vs. the early 1990s and 2000s. Although net leverage ratios are unambiguously high — in the vicinity of the peaks seen in the late 1990s — we think the much higher levels of interest coverage ratios provide a meaningful offset to higher leverage ratios. Barring an abrupt shift in monetary policy that would significantly increase interest expenses, the comfortable cushion built into interest coverage ratios means that the next recession — whenever that might be — will result in less severe losses than in the 2001/2002 or 1990/1991 recessions.

Exhibit 9: Corporate credit quality is better than it looks



Source: Compustat, Goldman Sachs Global Investment Research

10. The 'Yellen Call' 2.0: Now with 'contingent knock-in'

Last but not least, our tenth top theme for 2017 is an update of an old 2016 theme, the 'Yellen Call'. The 'Yellen call', as we first explained in our "Top Ten Market Themes for 2016", is the idea that the 'Bernanke Put' might gradually be replaced by a tendency to raise policy rates in response to a favorable easing of financial conditions ("Top 10 Market Themes for 2016", *Global Markets Analyst*, November 19, 2015). We cautioned that this could cap the upside potential for risky assets, and for equities in particular ("The 'Bernanke put' vs the 'Yellen call'", *Global Markets Daily*, 2 December 2015).

For 2017, this intuition seems as relevant as ever, especially given that President-elect Trump has promised a material fiscal stimulus. This makes it more likely that

the FOMC will need to reverse the dovish signals it sent earlier this fall when it looked as if the pace of hikes would be more gradual, pushing the Yellen Call further out of the money. Extending the above intuition, a 'contingent knock-in' has been added to the 'Yellen Call' — that is, conditional on a large fiscal stimulus in 2017, the FOMC will be obliged to respond more aggressively to an easing of financial conditions, all else equal.

It is by no means obvious that financial conditions will ease. On the contrary, we think the rates and USD components of financial conditions are likely to rise materially. Our GS FCI has already tightened roughly 50bp this fall, and will continue to tighten on our forecast for a rate hike in December and three more rate hikes in 2017. We expect this to drive the Dollar higher as well, which implies that equities and credit spreads would have room to rally further without causing a significant tightening of financial conditions. In other words, whereas we originally thought the Yellen Call would be a constraint on equity valuations, it turns out to be at least as much of a constraint on the US Dollar. Should the Dollar strengthen too much, causing the Fed to slow, it would create a little more 'headroom' in our FCI for equities to rally, and conversely. So, we will be more flexible in 2017, keeping a close eye on the 'contingent knock-in' (fiscal legislation) while monitoring our FCI to determine whether the Fed is successfully navigating its exit.

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Disclosure Appendix

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