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Global Equity Strategy

2023 Outlook: Bear with it

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More volatility…into the 'Hope' phase

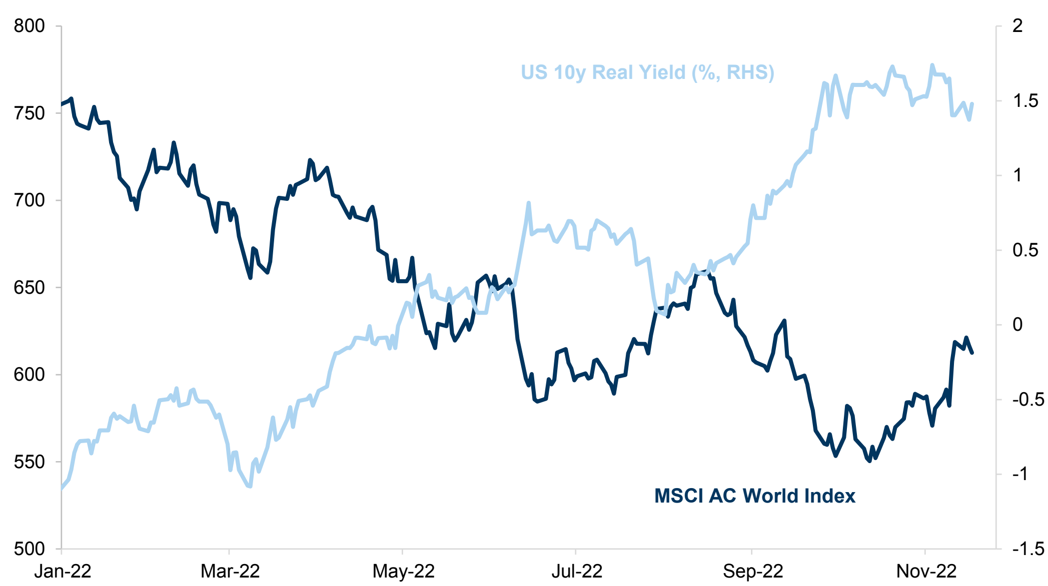
- The bear market is not over, in our view.
- The conditions that are typically consistent with an equity trough have not yet been reached. We would expect lower valuations (consistent with recessionary outcomes), a trough in the momentum of growth deterioration, and a peak in interest rates before a sustained recovery begins.
- We continue to focus on a barbell approach: combining quality, strong balance sheet and stable margin companies with deep value, energy and resources, where valuation risks are limited.
- We like companies that can compound earnings and returns through a combination of reinvestment and dividends over time.
- In contrast to the last cycle, more diversification across styles and regions, as well as a greater focus on valuation, should enhance returns over the course of 2023.
- We expect markets to transition into a 'Hope' phase of the next bull market at some point in 2023, but from a lower level. The initial rebound from the trough is likely to be strong, in common with the beginning of most cycles before transitioning into a 'Post Modern Cycle' with lower returns.

Trending lower…into the ‘Hope’ phase

Why we remain cautious

The MSCI AC World Index is down 19% on the year, largely driven by rising interest rates (Exhibit 1). That said, most of the falls came early in the year. Renewed optimism about a slowdown in the pace of rate increases has triggered a rally that has pushed equities **up nearly 5% from their levels in June (prior to the last major rally), despite real interest rates in the US having increased by close to 85bps since then and US 10y yields rising by more than 50bps.**

Exhibit 1: The MSCI AC World Index is down 19% on the year, largely driven by rising interest rates
MSCI AC World Index with US 10y Real Yield (RHS)



Source: Datastream, Goldman Sachs Global Investment Research

The recent rebound in equities is not the first we have seen in this bear market. In our view, the speed of the rise in interest rates (rather than their absolute level) has the potential to do more damage as investors are likely to increasingly focus on growth and earnings weakness. We continue to think that the near-term path for equity markets is likely to be volatile and down before reaching a final trough in 2023. So while near-term risks are to the downside in global equities, it is likely that they enter a ‘Hope’ phase in 2023; we expect overall returns between now and the end of next year to be relatively low (Exhibit 2).

Exhibit 2: Key market forecasts

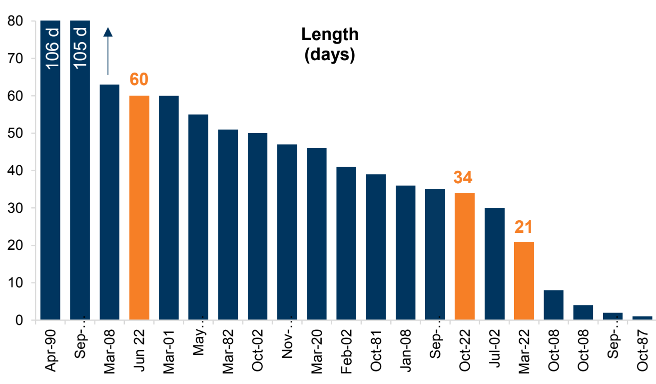
	Index Level		Price Return		Total Return**		2023 Earnings Growth
	Current	2023	Local	USD*	Local	USD*	GS Top-down
S&P 500	3947	4000	1%	1%	3%	3%	0%
STOXX Europe 600	428	450	5%	7%	9%	10%	-8%
TOPIX	1966	2100	7%	7%	9%	10%	3%
MSCI Asia-Pacific ex Jp ($)	494	550	11%	11%	15%	15%	3%
Global Equities***	-	-	3%	4%	6%	6%	-

* GS FX Strategy forecast ** Consensus 12m fwd Dividend *** Mkt cap weighted avg of our regional forecasts

Source: Datastream, Factset, Goldman Sachs Global Investment Research

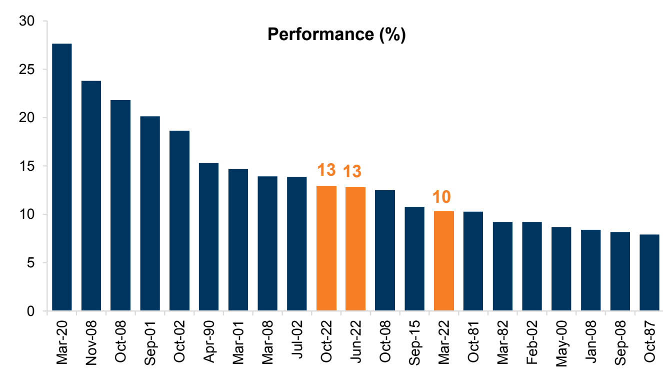
We would characterise the current bear market as 'cyclical'. Cyclical bear markets are those that are driven predominately by the economic cycle and by rising interest rates, driving fears of economic and profit recession. These types of bear market typically experience falls of around 30%, last for 26 months and take 50 months to recover. This is milder than the 60% average falls in 'structural' bear markets, which are largely associated with major asset bubbles and private-sector leverage, and similar in magnitude to 'event-driven' bear markets (those triggered by exogenous shocks). That said, event-driven bear markets tend to be over more quickly, whereas **cyclical ones tend to go on for longer and are interspersed with rallies before they reach a final trough. In common with other cyclical bear markets, these falls have also come in phases interrupted by several sharp rallies.** The first, in March, drove global equities up by 10% and lasted 21 days. The second was triggered by optimism of a 'Fed pivot' in July and pushed equities up around 13% over 30 days, and the current one has, so far, triggered a 13% rally. However, so far at least, these rallies have not lasted; more persistent inflation and hawkish central bank rhetoric, particularly in the aftermath of the Jackson Hole meetings in August, heralded another setback.

Exhibit 3: Duration of Bear Market Rallies
MSCI AC World, since 1981



Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 4: Performance of Bear Market Rallies
MSCI AC World, since 1981



Source: Datastream, Goldman Sachs Global Investment Research

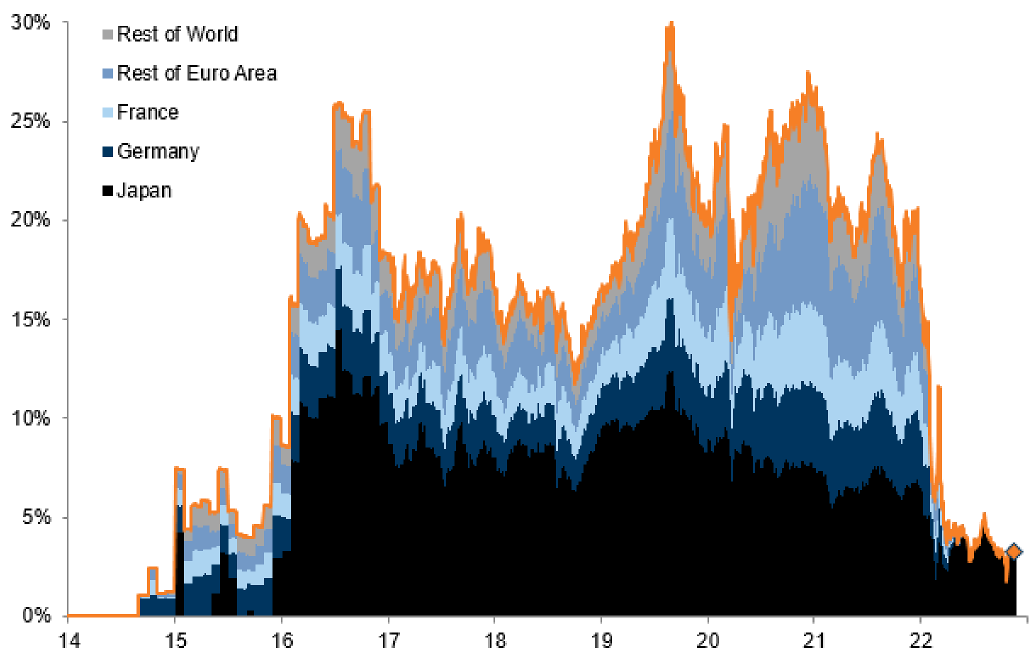
Equity markets are highly sensitive to new information that changes perceptions at the margin. Over the past few weeks a number of factors have been more positive than investors feared a quarter ago:

- US inflation has finally surprised to the downside.
- European weather has been mild and gas prices have fallen sharply.

- Russia has made a military retreat from a key city in Ukraine, and its energy leverage against Europe has faded.
- The US elections had a mixed outcome, reducing risks of an inflationary fiscal expansion.
- China reopening news has improved.
- US/China relations have stabilised with a meeting between Presidents Biden and Xi.
- Fears of contagion over UK pension funds and crypto exchanges have lessened.

Nevertheless, while sentiment has improved and there has been a positioning 'squeeze', we do not think the adjustment in equity markets is yet sufficient to account for the rise in interest rates and the cost of capital. **The expectation going into 2022 was that the US would raise the fed funds rates in two 25bp moves this year and nothing was expected in the Euro area until 2023. There have since been six fed funds rate rises, including four 75bp hikes, and our economists now expect the terminal rate to reach 5.25%. The shift in the level of long-term interest rates is remarkable. A year ago, around one quarter of all government debt in the world had a negative nominal yield, while investors can now receive 3.8% on 10-year Treasury yields (Exhibit 5). The rally in risk assets has also led to a sharp easing of financial conditions, a development that the Federal Reserve is likely to push back against.**

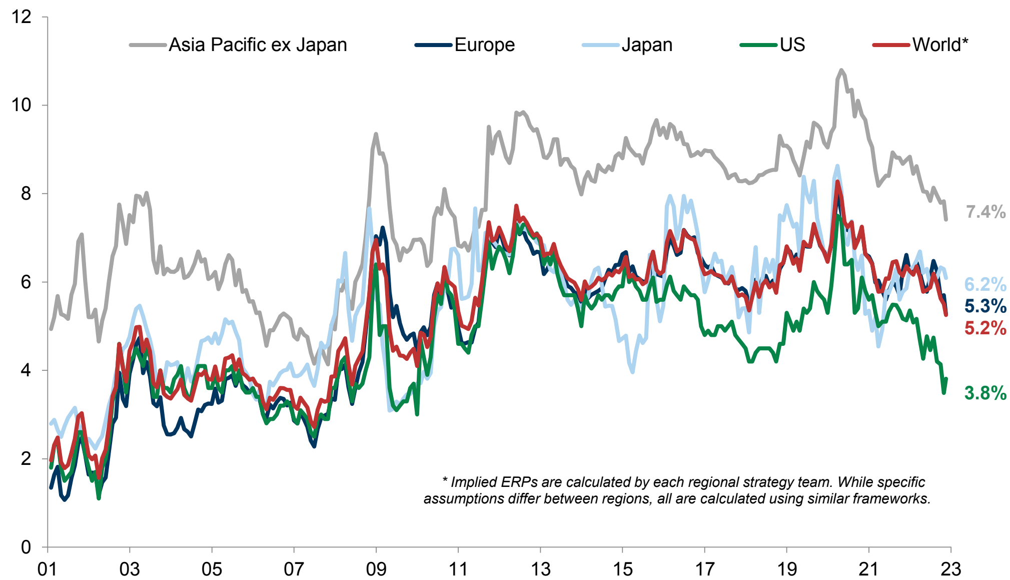
Exhibit 5: A year ago, around one quarter of all government debt in the world had a negative nominal yield
Proportion of negative-yielding global government debt



Source: Bloomberg, Goldman Sachs Global Investment Research

While equities have de-rated, the ERP has fallen (Exhibit 6) sharply, leaving little room for any negative suprises, particularly on growth.

Exhibit 6: Equity Risk Premiums have fallen
Global market implied ERP (%)

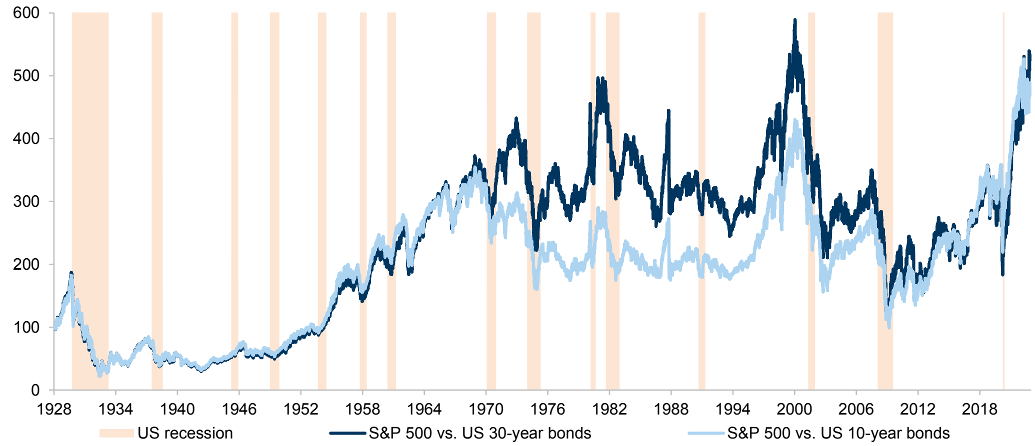


Source: Goldman Sachs Global Investment Research

The outperformance of equities versus bonds is near the Tech Bubble peak (Exhibit 7). Equity vs. bond outperformance has slowed since the beginning of the year as higher yields have also weighed on equities. However, looking at the performance of the S&P 500 vs. US 30-year bonds, which may be more comparable as the actual US equity duration is likely much longer than 10 years due to the large weight in Tech stocks, still points to a strong outperformance YTD.

Even in the event that there is a 'soft landing' in the economy – particularly in the US, as our economists forecast – interest rates may well stay higher for longer than the market is pricing. The downside risks to equities may be moderate, but on a relative basis the hurdle rate suggests a high bar for equities, leaving little room for a re-rating.

Exhibit 7: Post GFC and since the COVID-19 crisis US equities have materially outperformed bonds
Relative total return performance



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

We acknowledge that on a relative basis equities look more attractive than bonds in a more inflationary environment (revenues make a claim on nominal GDP). That said, if inflation moderation turns out to be driven by weaker growth and higher unemployment, equity upside is likely to be capped from current valuation levels as concerns over lower growth could overwhelm any interest rate relief.

In real time, it is difficult to distinguish between a rally in a bear market and a genuine recovery from a trough. To begin with, they can appear very similar, with both experiencing rising valuations and strong returns. So why do we think that the recent rally is not the start of the next bull market?

The reason for this, historically at least, is that several conditions are typically met at bear market lows and, so far, we have not reached these conditions in the current cycle. In particular:

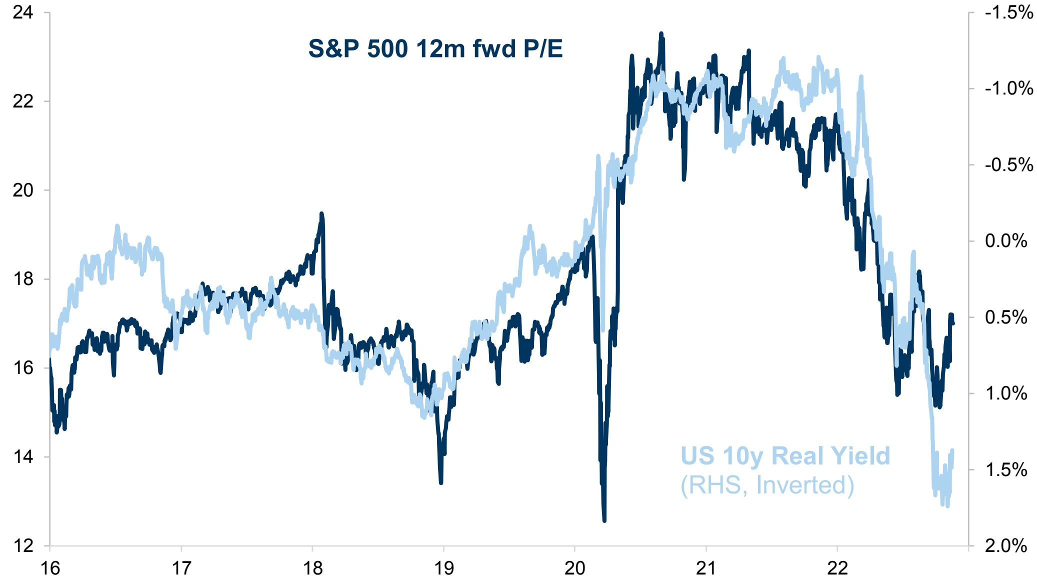
- **Valuations tend to fall to cheap levels** – consistent with an expectation of a recession.
- While equities tend to recover when the economic and profit backdrop is very weak, **they do not typically recover until the rate of deterioration slows.**
- A peak in interest rate expectations is not usually enough. **Equities do not usually trough until inflation and interest rates peak.**
- **Positioning tends to be very low.**

Assessing trough conditions

1. Valuation — further downside risks

Valuations in equities have fallen a long way since the beginning of this year but this doesn't mean to say they are cheap. The problem is that the de-rating has come from an unusually high peak supported by record low interest rates. Rising interest rates, even before we assess the deteriorating path for growth and higher levels of uncertainty, should push valuations lower (Exhibit 8). So, the rise in real rates would imply lower valuations are still likely. As inflation pulls back but the Fed stays the course, real rates are at risk of rising again.

Exhibit 8: S&P valuations remain vulnerable to rising yields
S&P 500 12m fwd P/E and US 10y Real Yield (RHS, Inverted)



Source: FactSet, Goldman Sachs Global Investment Research

The aggregate adjustment in equity prices remains relatively modest when we consider the shifts that we have seen in interest rates. Globally, a simple aggregate of P/E, dividend yield and price to book, has fallen to around the 50th percentile relative to history (Exhibit 9).

Exhibit 9: Globally, a simple index of P/E, dividend yield and price to book, has fallen to around the 50th percentile relative to history
Percentile for World NTM P/E, LTM P/E, LTM P/B and LTM P/D

Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

Historically at least, strong returns over a 12m horizon are usually consistent with this metric falling below the 30th percentile. We are not there yet.

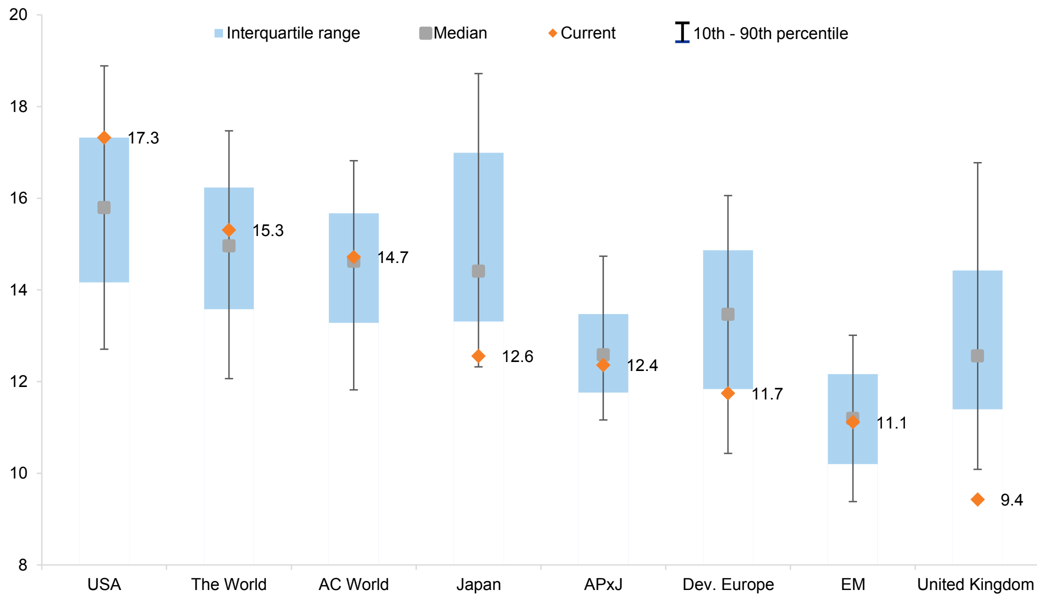
Exhibit 10: Valuations below the 30th percentile of historical averages are associated with positive returns
Average forward return, World

Valuation %ile		Avg fwd return			
from	to	3m	6m	12m	24m
0%	10%	4%	10%	14%	21%
10%	20%	2%	5%	11%	30%
20%	30%	2%	4%	12%	37%
30%	40%	3%	3%	9%	16%
40%	50%	1%	2%	5%	15%
50%	60%	2%	4%	9%	18%
60%	70%	2%	5%	7%	13%
70%	80%	2%	5%	10%	16%
80%	90%	3%	4%	6%	16%
90%	100%	-2%	-2%	-2%	-3%
Unconditional		2%	4%	8%	18%

Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

A further complication is that, while many equity markets around the world are trading at low valuations, the US is not (Exhibit 11).

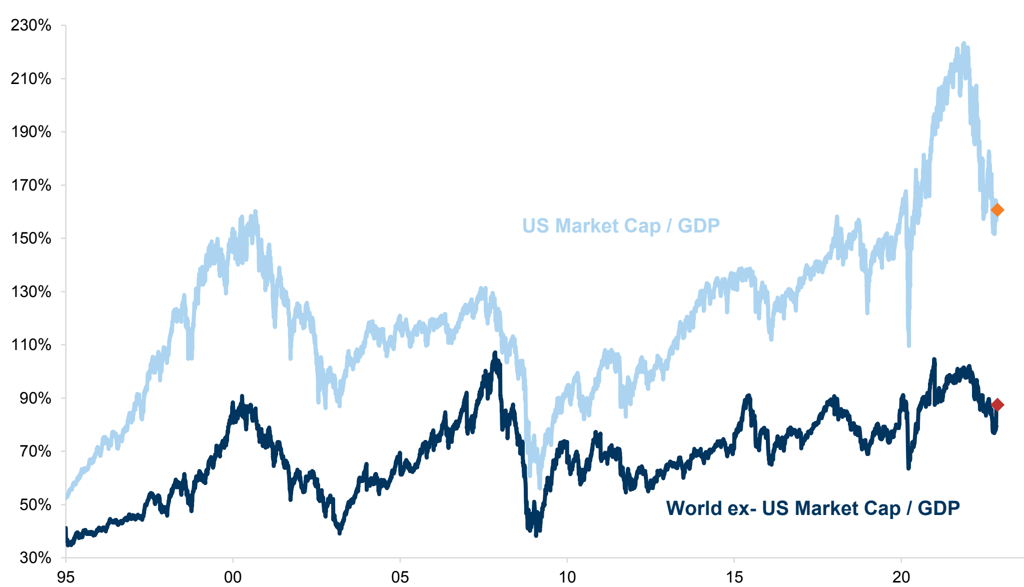
Exhibit 11: Valuation ranges (MSCI Regions) over a 20-year timeline
12m fwd P/E multiple



Source: FactSet, Goldman Sachs Global Investment Research

As a result, while the World Market Capitalisation relative to World GDP has fallen back, it remains above average. In the US, in particular, valuations have also fallen but are only back to levels consistent with the peak of the Technology bubble in the late 1990s.

Exhibit 12: World Market Capitalisation ex-US relative to GDP is back to average
Market Capitalisation to GDP ratio for World-ex US and US



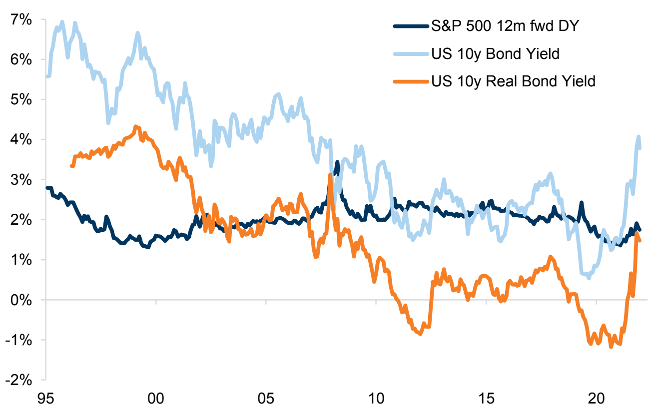
Source: Datastream, Haver Analytics, Goldman Sachs Global Investment Research

While some of this can be explained by sector composition and a better economic outlook, it is difficult to justify why the US is trading in line with its 20-year average (a period of generally high valuations supported by low interest rates), particularly now that large cap Technology stocks are also coming under margin pressure, encouraging a raft of layoffs and cuts to investment plans. 4Q 2022 is on track to be the 11th quarter in the past ten years in which the four mega-cap Tech stocks (Apple, Google, Amazon, and Microsoft) have collectively underperformed the S&P 500, as the characteristic most associated with large cap Tech stocks – superior sales growth – has vanished. While the mega-cap Tech firms posted CAGR sales growth of 18% during the past decade vs. 5% for the S&P 500, sales for mega-cap Tech are forecast to grow by 8% in 2022, below the 13% for the market.

The other problem with valuations is that **risk-free rates and credit markets now offer an attractive alternative to equities (Exhibit 13 and Exhibit 14).** In the decade after the financial crisis both nominal and real bond yields fell well below dividend yields. This made sense in an environment where an aggregate demand shock raised the risk of deflation and was particularly true in Europe where growth prospects were most challenged. The shift in relative yields was also supported by QE, which provided a buyer of last resort in the bond markets. In the current world, bond yields have increased significantly relative to dividend yields. While the gap between dividend and bond yields should close as the tail risk of deflation moderates, the extent of the shift is difficult to justify ahead of a possible recession in earnings. **After the recent move, the US market is back up to a P/E of 17x. Its 20-year average has been slightly under 16x. And the 20-year average bond yield has been 2.9%. We are at 3.8% today.**

Exhibit 13: The US 10y Treasury yield has risen to 4% and is twice the S&P 500 DY

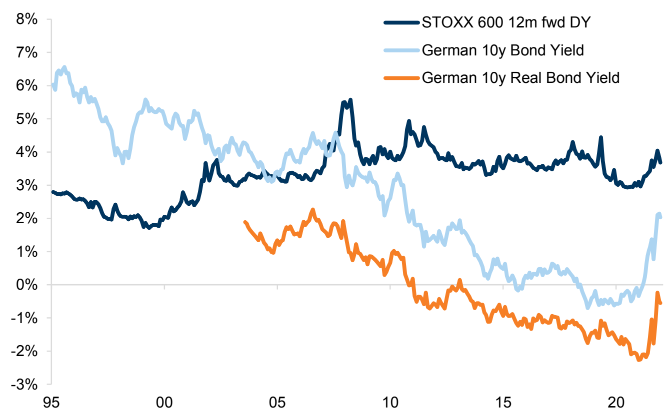
12m fwd DY for S&P 500 and Yields in the US



Source: Datastream, FactSet, Goldman Sachs Global Investment Research

Exhibit 14: Europe offers higher yields to bonds, but gap has narrowed

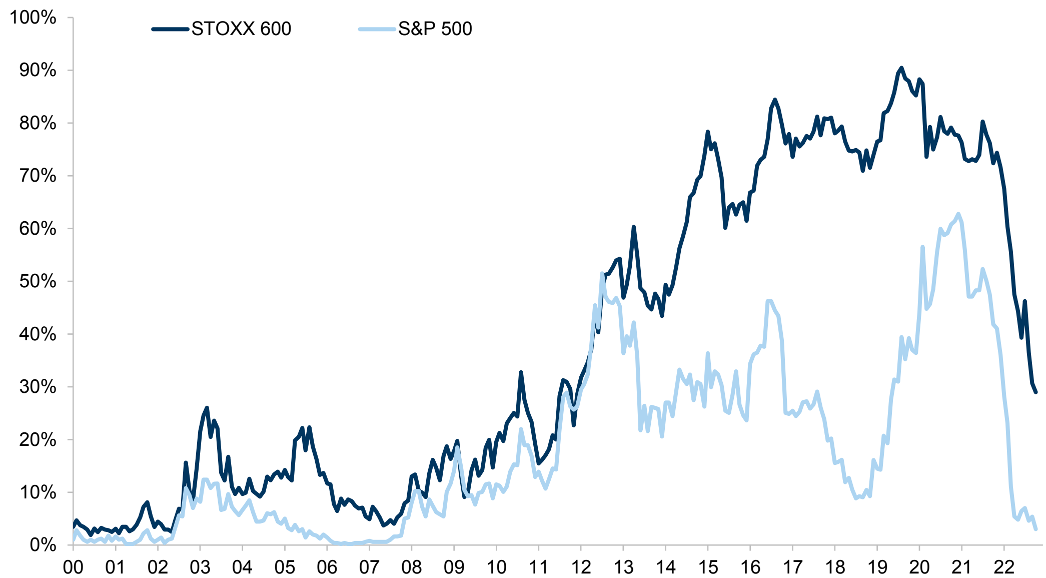
12m fwd DY for STOXX 600 and Yields in Europe



Source: Datastream, FactSet, Goldman Sachs Global Investment Research

Furthermore, while equities had offered attractive yields relative to credit, this is no longer the case, and **there has been a dramatic shift in the proportion of companies that have a dividend yield above the average corporate bond yield** (Exhibit 15).

Exhibit 15: There has been a dramatic shift in the proportion of companies that have a dividend yield above the average corporate bond yield
% of companies with Dividend Yield > Credit Yield

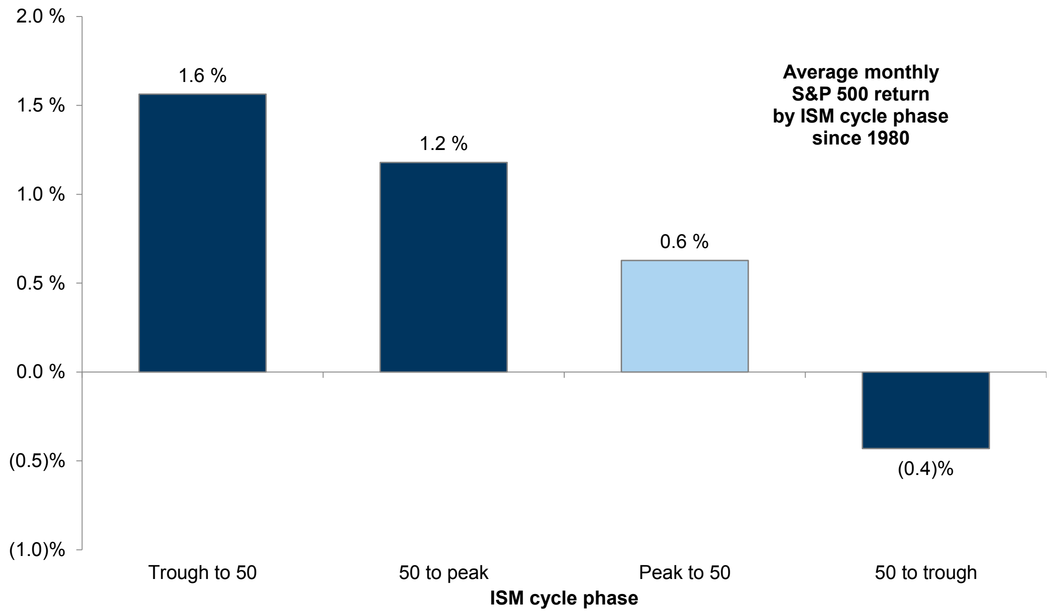


Source: FactSet, Datastream, STOXX, Goldman Sachs Global Investment Research

2. Growth momentum — further deceleration likely to be priced

We have argued that equities tend to generate higher prospective returns when growth is weak than when it is strong. That said, timing is everything. **A weak economy that is still deteriorating is very different from an economy that is getting less bad.** Generally, history suggests that the worst time to buy equities is when growth is contracting and momentum is deteriorating (the last bar on Exhibit 16), and the best time is when growth is weak but moving towards stabilisation (the first bar in Exhibit 16). While we are likely to transition into the phase of improving growth momentum at some point in 2023, the nearer term looks less promising.

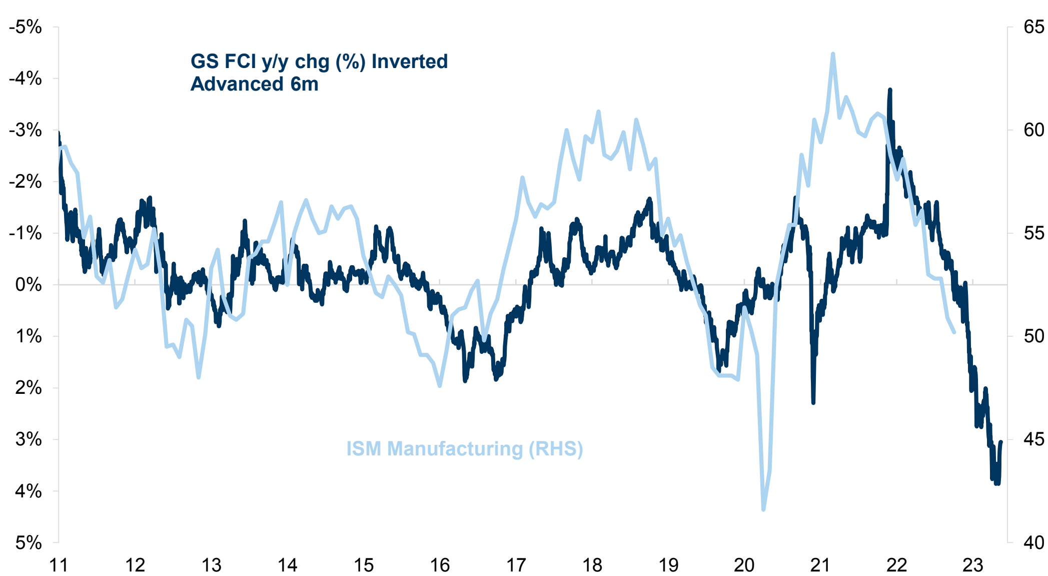
Exhibit 16: Weakest returns tend to be when the economy slows from peak towards contraction
Average monthly S&P 500 return by ISM cycle phase since 1980



Source: Datastream, Goldman Sachs Global Investment Research

Tight financial conditions imply more weakness to come in the ISM, for example – even after the recent easing in financial conditions following the better than expected inflation data (Exhibit 17). We think weaker housing and labour markets, together with renewed crisis in energy prices, may drive further concerns about earnings next year even if a soft landing is achieved.

Exhibit 17: Tight financial conditions imply more weakness to come in the ISM
GS FCI y/y change advanced 6m and ISM Manufacturing



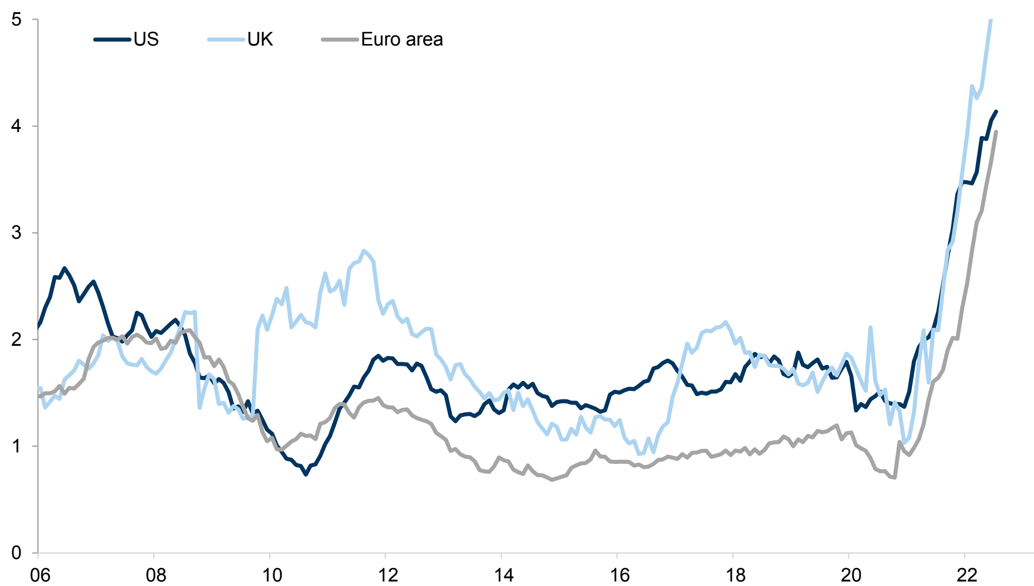
Source: Bloomberg, Haver Analytics, Goldman Sachs Global Investment Research

Our economists already forecast recessions across Europe, although not in the US. **However, even if a US recession is eventually avoided, there is a strong risk that investors will price in a higher probability of one before we see a trough.** Our central scenario for the US is that it avoids a recession and earnings are flat in 2023. However, our US strategists suggest that in their 'recession scenario', US profits would likely fall 11% and the P/E would fall to around 15x.

3. Interest rates at their peak — further rate rises likely

We have no doubt that an easing of interest rate expectations – either triggered by lower inflation components or more dovish policy guidance – is likely to provide relief in risk assets. But there remain two further issues. First, any significant rally would ease financial conditions prematurely relative to the data and labour market conditions, and would likely lead to more rate rises or interest rates staying higher for longer before they eventually start to fall.

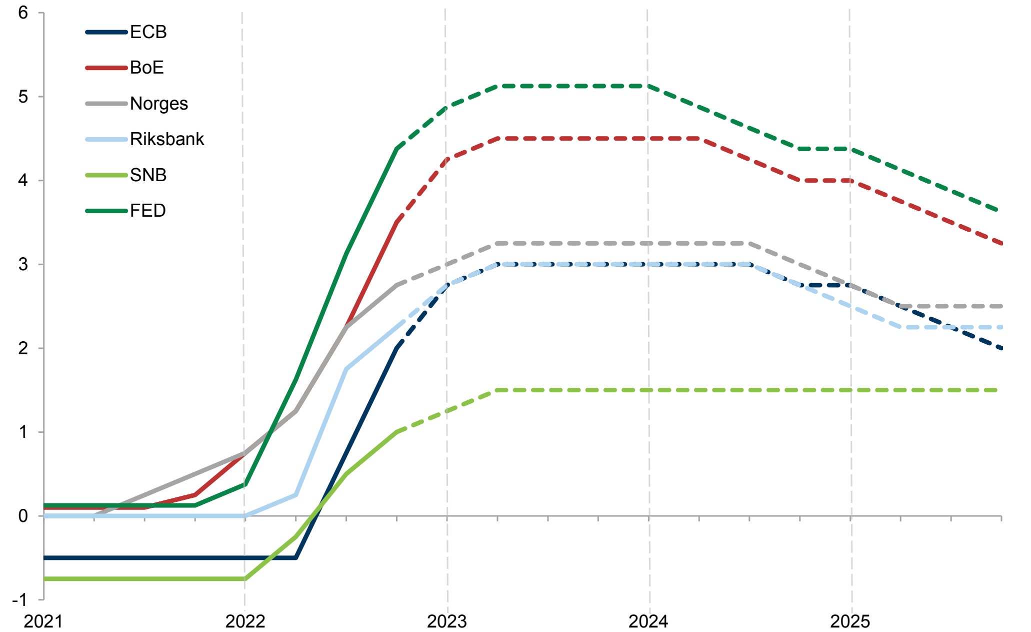
Exhibit 18: Core inflation is on the rise
GS Trimmed Core Inflation measure (y/y % change)



Source: Goldman Sachs Global Investment Research

Second, even if investors are confident that they have adequately priced the peak in interest rates, it remains unclear how long they will remain at these levels before eventually coming down, and our economists expect no rate cuts before 2024 (Exhibit 19). As Fed Chair Powell emphasised in his November testimony, "it is very premature to be thinking about pausing rate hikes".

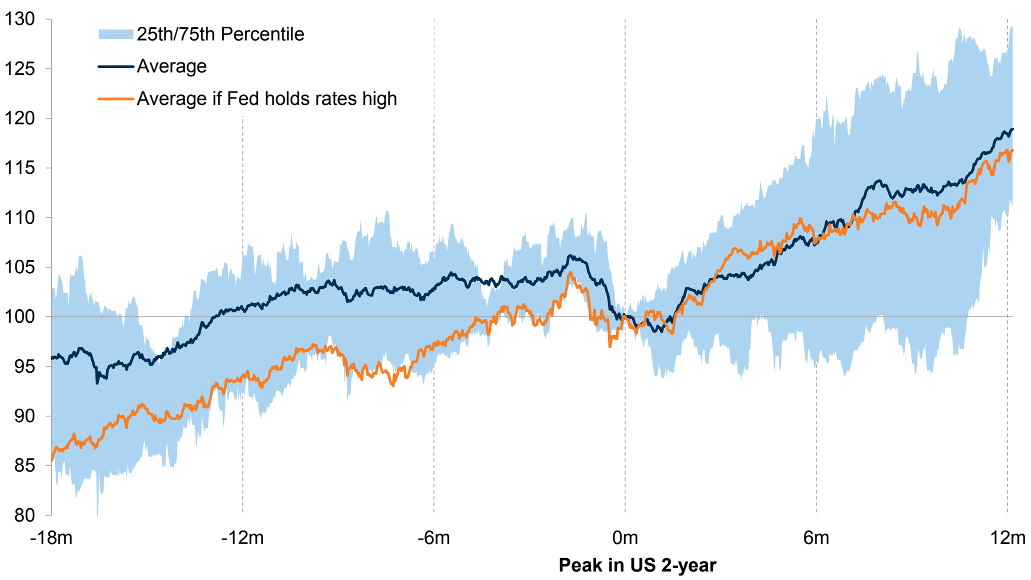
Exhibit 19: Our economists expect no rate cuts before 2024
GS Policy Rate Forecast (%)



Source: Goldman Sachs Global Investment Research

Historically, equity markets are likely to recover close to the peak in interest rates and inflation, but they often weaken into the final rate rises (as growth expectations deteriorate).

Exhibit 20: Equity markets are likely to recover close to the peak in interest rates and inflation, but they often weaken into the final rate rises
S&P 500, data since 1955

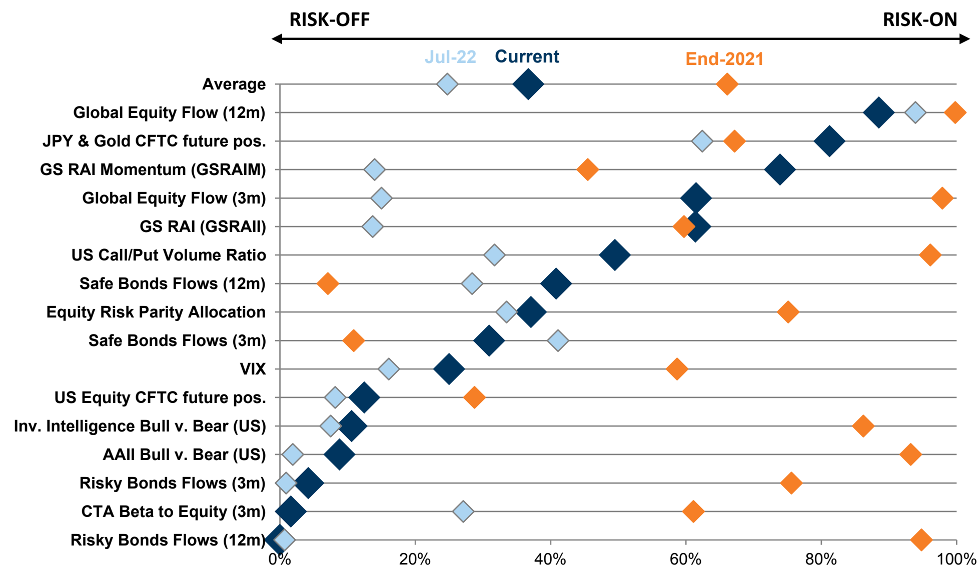


Source: Datastream, Haver Analytics, Goldman Sachs Global Investment Research

4. Positioning — Equity fund flows remain strong

This is also complex. Certainly, there are areas of risk that have moderated. As Exhibit 21 shows, many positioning measures show a shift towards a 'risk off' position. It is likely that these factors have played a part in short covering that has driven the speed and scale of the recent rally.

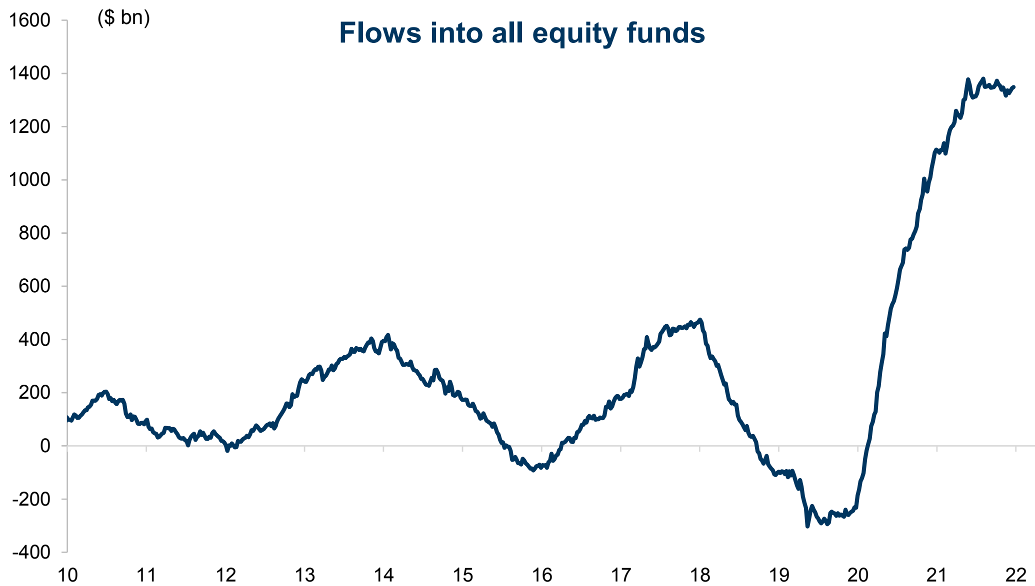
Exhibit 21: Many positioning measures show a shift towards a 'risk off' position
Percentile of Sentiment Indicators - Data since 2007



Source: Datastream, EPFR, Haver Analytics, Robert Shiller, Goldman Sachs Global Investment Research

But equity flows, curiously, have not and these remain robust, particularly in the US. It is true that they have started to moderate in recent months, but on a two-year basis the rollover is very modest so far.

Exhibit 22: Equity flows remain robust in the US
Rolling 24m flows into all equity funds (USD bn)

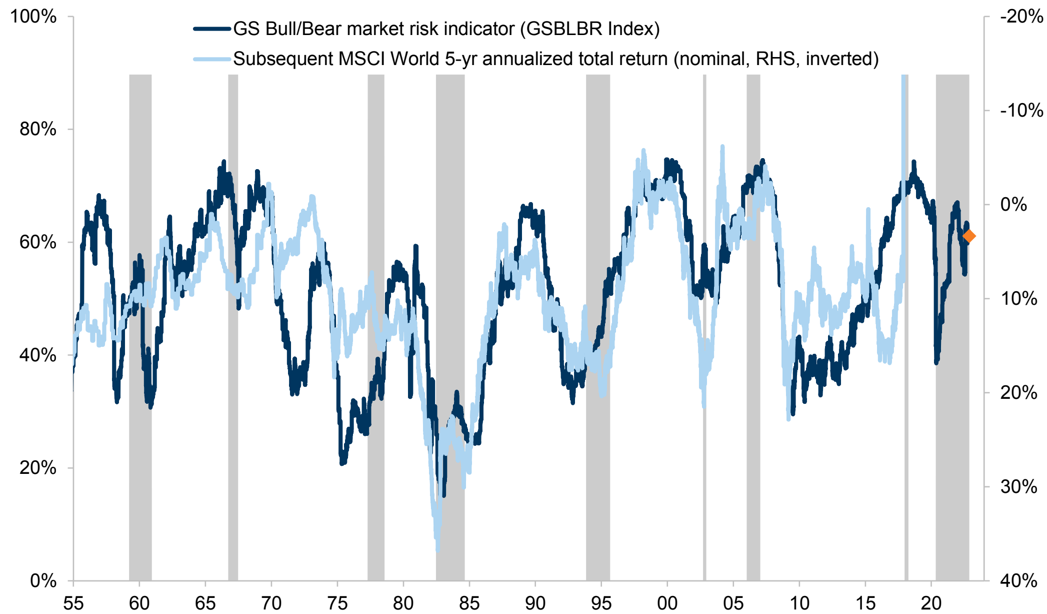


Source: EPFR, Goldman Sachs Global Investment Research

We expect to see more signs of capitulation in risk assets before a trough is established.

An additional point to consider is that our own Bull/Bear Market index, GSBLBR, remains at elevated levels (61st percentile) despite its falls. Admittedly, not all the components of this indicator are stretched, but valuation remains in a high percentile and unemployment very low, which represents a risk to equities as rising unemployment often proceeds recessions. **Even if a hard landing is avoided and inflation moderates from its peak, a tight labour market would imply that interest rates will likely stay at elevated levels for some time. Equally, the high valuation, particularly in the US equity market, would imply relatively low returns over the next cycle. While the current level of our indicator is not in the 'danger zone', it implies relatively low annualised returns over the next 5 years (see Exhibit 23).**

Exhibit 23: GS Bull/Bear Market index, GSBLBR, remains at fairly elevated levels
GS Bull/Bear indicator and subsequent 5-year annualised total returns of MSCI World; shaded area: bear markets

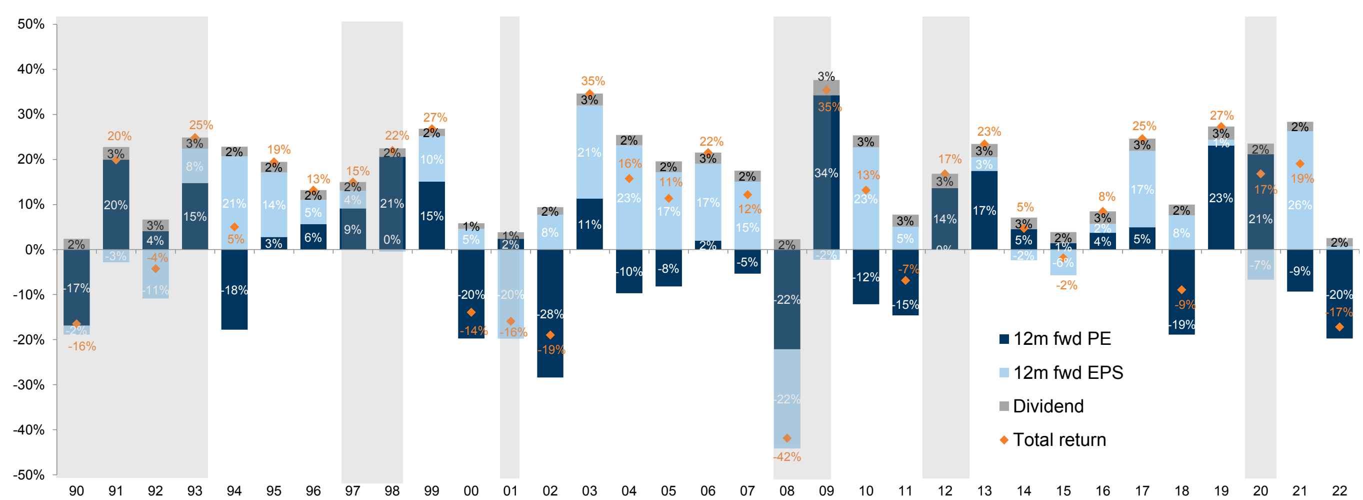


Source: Haver Analytics, Datastream, Robert Shiller, Goldman Sachs Global Investment Research

Transition into the 'Hope' phase in 2023

As we look forward through the balance of 2023, however, it is likely that the conditions for a recovery will start to come together. **This suggests that, from a lower level, the prospects for transitioning into a 'Hope' phase of the next cycle are strong.** These recoveries typically start during recessions (Exhibit 24) and are driven predominantly by valuation expansion and can be costly to miss.

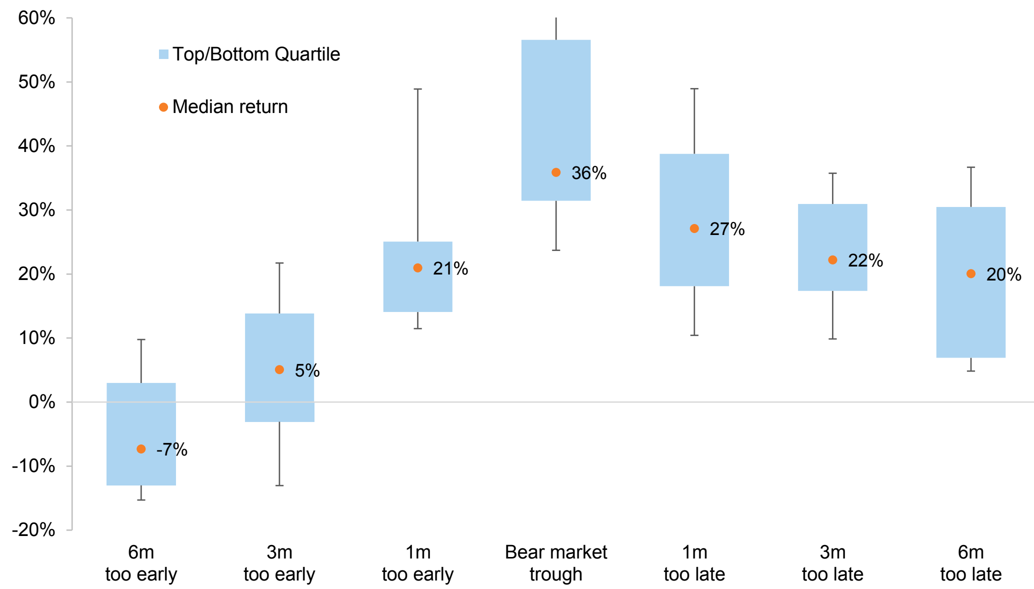
Exhibit 24: Recoveries are driven predominantly by valuation expansion
MSCI AC World contributions to total return; grey shading indicates recessions (US, Europe, Japan, or EM)



Source: FactSet, Datastream, Goldman Sachs Global Investment Research

Nevertheless, the **average returns overall in the following 12 months are very much higher if you wait until one month after the trough than if you invest one month before (Exhibit 25). For this reason, we think it is too early to position for a potential bull market transition.**

Exhibit 25: Average returns overall in following 12 months are higher if you wait until one month after the trough than if you invest one month before
12m share price performance for S&P500

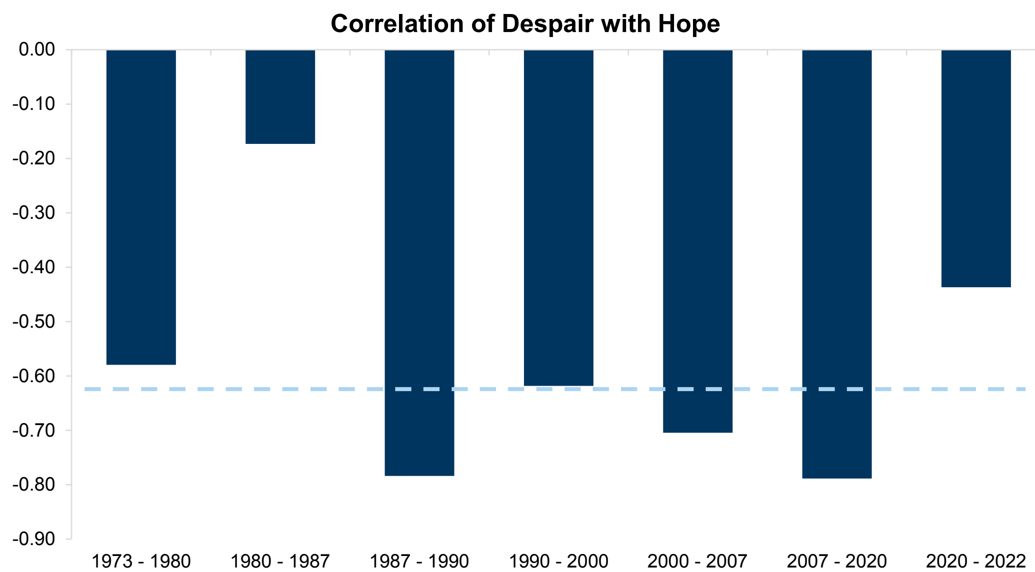


Source: Bloomberg, Goldman Sachs Global Investment Research

The other notable feature of the 'Hope' phase is that the initial recovery tends to be led by the assets that have underperformed most during the 'Despair' or bear market phase (Exhibit 26). **This is what makes these transitions so difficult to navigate – the recovery when it comes tends to be swift and led by the types of companies that investors tend to avoid through the bear market. That said, this is 'the trade after the trade' and we think it is premature to be positioning for this now.**

Exhibit 26: Initial recovery in the 'Hope' phase tends to be led by the assets that have underperformed most during 'Despair' phase

Sector correlation of 'Hope' phase with 'Despair' phase, dotted line represents median - US market data



Source: Datastream, Goldman Sachs Global Investment Research

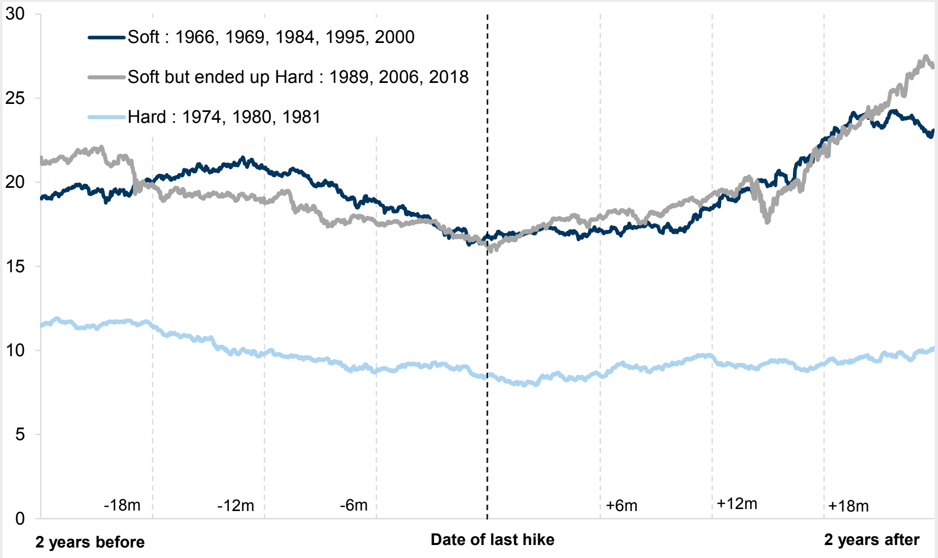
What if we have a 'Soft Landing' in the US

At the current time we do not know whether the economic slowdown will end in a soft or hard landing. Of course, this is usually the case as the growth slows. To be clear, our economists assess a 35% probability of recession in 2023 while they expect hard landings in Europe. The difference between hard and soft landings does matter from an equity market perspective. Unsurprisingly, soft landings result in more moderate falls than hard landings.

From a valuation perspective, **P/E multiples still tend to de-rate in the approach to a soft or hard landing.**

1) Soft landings experience a higher trough, at around 16x compared with around 8x in a hard landing.

Exhibit 27: Soft landings experience a higher trough at around 16x compared with around 8x in a hard landing
12m trailing P/E, S&P 500



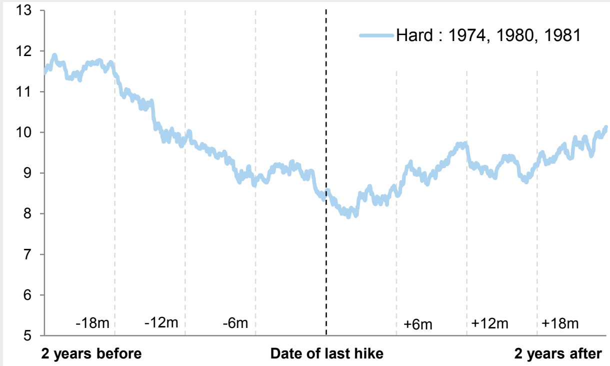
Source: Datastream, Goldman Sachs Global Investment Research

2) Soft landings tend to see a faster recovery in valuations. But given that valuations fall much less in soft landings, the recovery in valuations from the trough is more modest than from hard landing troughs.

Exhibit 28: Soft landings see a faster recovery in valuations...
12m trailing P/E, S&P 500

Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 29: ...but hard landings do not
12m trailing P/E, S&P 500



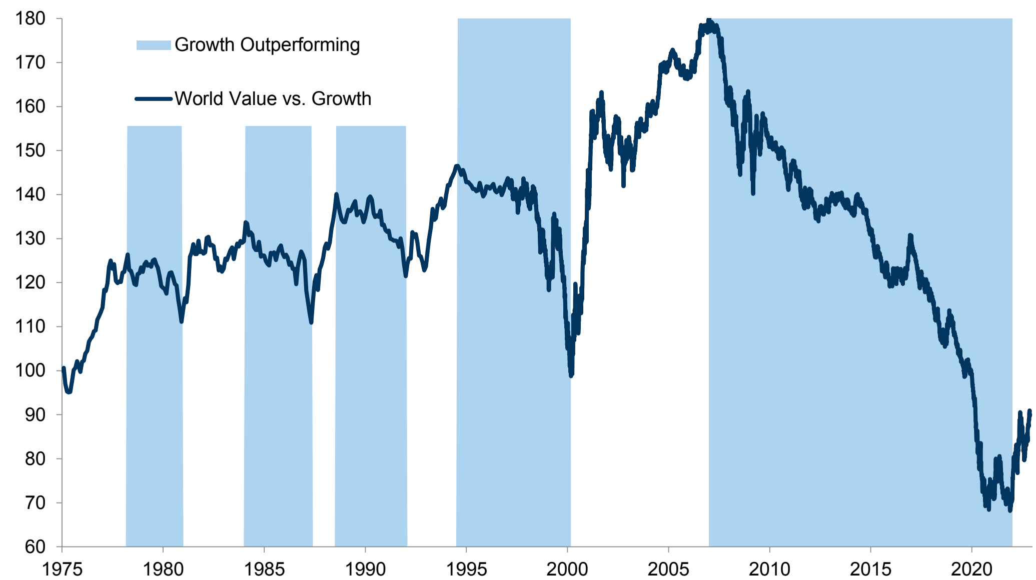
Source: Datastream, Goldman Sachs Global Investment Research

Consequently, a soft landing – if achieved – may well result in an upside to our current view on markets depending, of course, on what level, and how long, interest rates stay at high levels before they are cut. Nevertheless, the high starting valuation, particularly in the US, as well as the supply-driven nature of some inflation drivers, suggest that the upside for the market remains moderate over the next year.

What do we like? Quality & Value

Since the beginning of 2022, we have argued that there is a material change in the fundamentals driving the market and that we were approaching a time for value. Higher rates should reverse some of the conditions that drove one of the longest periods of 'growth' outperformance relative to 'value' in history (Exhibit 30).

Exhibit 30: We have been approaching a time for value
MSCI Indices. Relative price performance in local currency*



*Monthly Frequency until 1996. Daily Frequency from 1997 onwards.

Source: Datastream, Goldman Sachs Global Investment Research

The post financial crisis period led to an unusual degree of bifurcation in equity markets driven by:

- Very low nominal GDP and earnings growth (increasing the attraction of growth).
- Unusually low cost of capital, disproportionately boosting valuations in long duration companies.
- Extraordinary growth in earnings in 'growth' sectors (particularly US Technology, where new monopolies emerged).
- Low returns in traditional 'value' sectors facing unusual headwinds (tighter regulation in Banks and falling commodity prices for commodity companies). Dividends became vulnerable leading to 'value traps'.

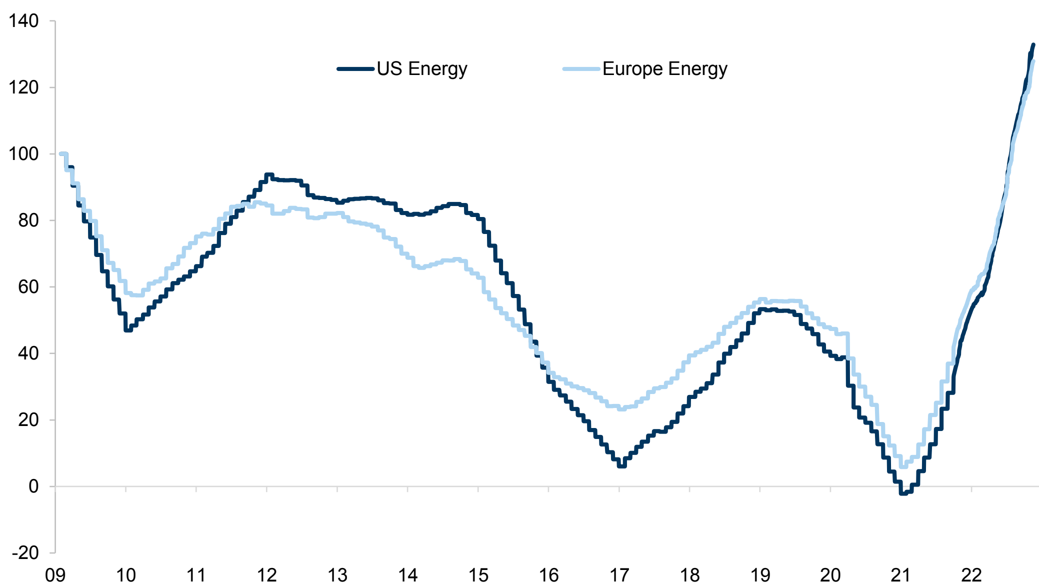
However, in the 'Post-Modern Cycle' environment, much of this is reversing:

- Nominal GDP and earnings have been strong.
- Higher cost of capital has had a disproportionately negative impact on long duration growth.
- Earnings have started to disappoint in large Tech companies.
- 'Value traps' are emerging as value opportunities as underlying fundamentals

improve. Higher rates and commodity prices are boosting profits and very high free cash flow yields make 'value' company dividends attractive and more reliable.

Consequently, there has been a reversal of the fortunes of many 'value' parts of the market – particularly those that are closest to the sources of inflation (commodities) or are the biggest beneficiaries of rising interest rates (Banks). Conversely, the longest duration stocks have the most to lose from rising interest rates. Companies that are vulnerable to margin pressure as a consequence of higher input costs and weaker growth, such as Chemicals, have also underperformed. These factors have resulted in rapid rotations.

Exhibit 31: There has been a reversal of fortunes for the Energy sector
Last 12m EPS for US and Europe Energy (both in local currency)

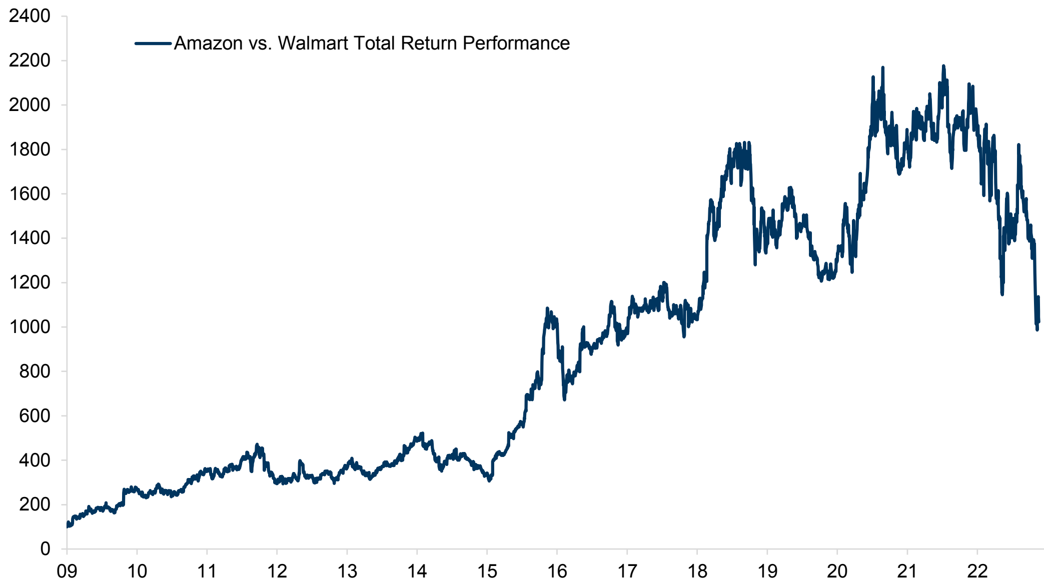


Source: FactSet, Goldman Sachs Global Investment Research

There have been two consequences of this '<u>revenge of the old economy</u>'.

1) There has been something of a reversal of relative fortunes between traditional incumbents and digital new entrants in many industries. An example is Amazon versus Walmart.

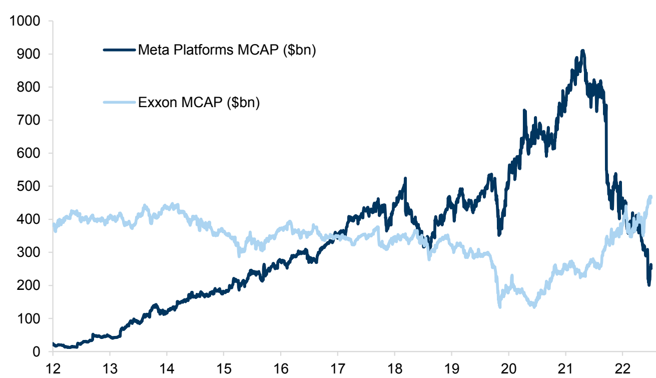
Exhibit 32: There has been a reversal of relative fortunes between traditional incumbents and digital new entrants
Relative Total Return Performance of Amazon vs. Walmart



Source: Datastream, Goldman Sachs Global Investment Research

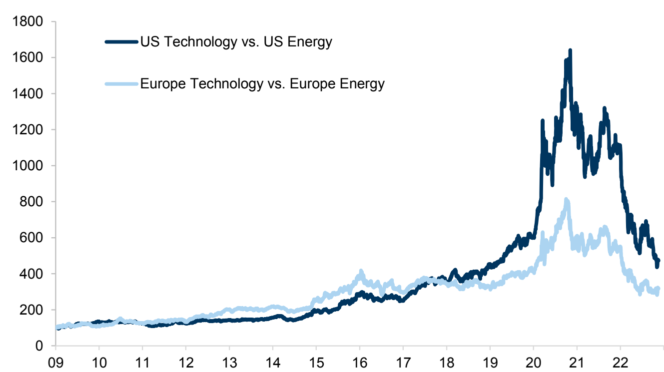
2) There has been a reversal of the leadership of 'growth' and Technology towards more physical and traditional industries. Meta has seen its market cap fall below that of Exxon. The oil and gas company has returned over 80% YTD total return and is generating more free cash flow than Microsoft, despite only holding ¼ the market cap.

Exhibit 33: Meta has seen its market cap fall below that of Exxon
Market Capitalisation in USD bn



Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 34: Energy outperformed Technology in both US and Europe after a decade of underperformance
Relative performance of Technology vs. Energy for Europe and US (both in local currency)

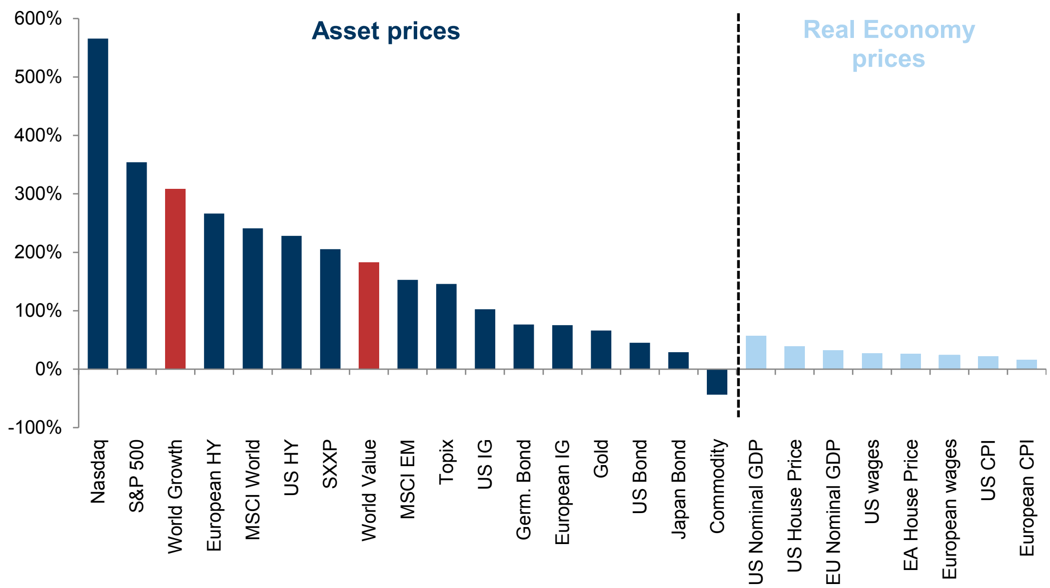


Source: FactSet, Goldman Sachs Global Investment Research

This process has reversed the trend that became established post the financial crisis as we entered a period of monetisation.

As we have argued before, the era of very cheap money and QE resulted in a period during which price rises in the real economy were very limited (for example in wages, nominal GDP growth, CPI inflation), while inflation in financial assets was very high, particularly in real terms. The best financial assets were the longest duration – the S&P, Nasdaq, a basket of global 'growth' stocks (Exhibit 35).

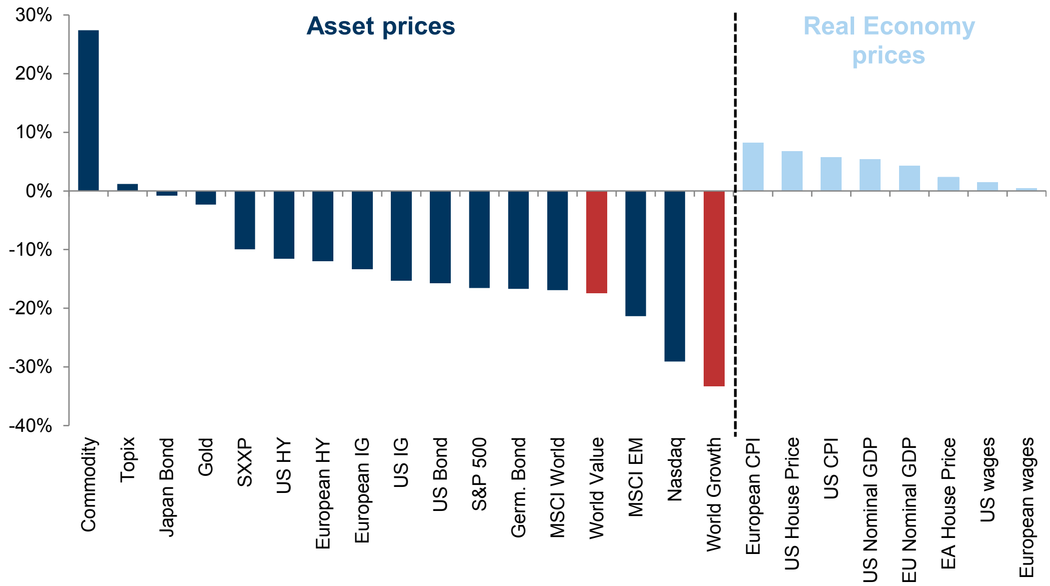
Exhibit 35: The best financial assets were the longest duration – the S&P, Nasdaq and a basket of global 'growth' stocks
Total return performance in local currency, Jan 2009 – Feb 2020



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

In our Post-Modern Cycle research, we showed that in the high inflation period of 1973-1983, the patterns largely reversed. Interestingly, the pattern of returns year to date also shows a reverse of the cycle post the financial crisis. As Exhibit 36 shows, **year to date inflation in the real world (on the right in light blue) has been much higher than in financial assets which achieved negative nominal and real returns. Commodities have been the best-performing asset class and the worst-performing were the longest duration – in particular, our basket of global 'growth' companies and the Nasdaq.**

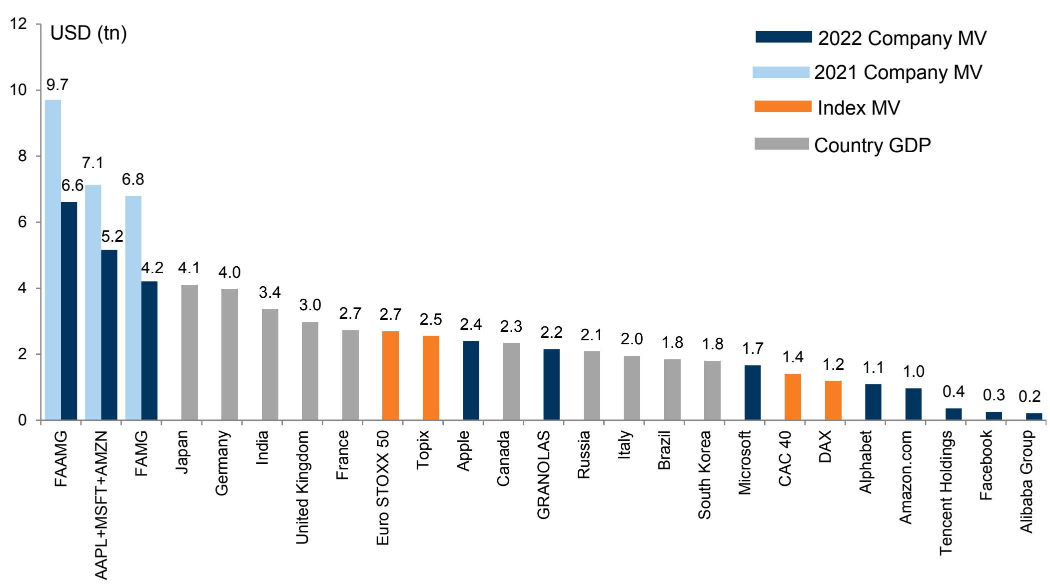
Exhibit 36: The pattern of returns year to date also shows a reversal of the cycle post the financial crisis
Total return performance in local currency YTD



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

Put another way, while the mega-cap Tech stocks remain dominant in terms of their market cap, their loss in market value this year is, so far, significant. As Exhibit 37 shows, the FAAMG stocks collectively have lost more value as the entire market capitalisation of the EuroStoxx 50 or Topix, or a fall in market value equivalent to the annual GDP of the UK or France.

Exhibit 37: The loss of market value for mega Tech stocks this year, so far, is equivalent to the annual GDP of UK or France
Market Value of Tech stocks, Country GDPs and Market Value of Indexes



Source: FactSet, Datastream, Goldman Sachs Global Investment Research

Nevertheless, while 'value' has generally outperformed this year, we would argue that the binary approach to looking at either 'growth' or 'value' – the dominant prism through which investors viewed the markets in the cycle after the financial crisis – is no longer the correct one. In our view, as interest rates rise, revenue growth becomes less valuable, while higher nominal GDP also makes it less scarce. Meanwhile, higher input costs, both energy and labour, are putting downward pressure on margins. Therefore, we have argued that it is no longer appropriate to access the market through 'growth' alone. **With less room for valuation expansion to drive returns on the back of lower interest rates, the ability to compound returns over time becomes more attractive.** The 'quality' sustainability and repeatability of the total return prospects are becoming more important than the revenue growth alone.This is why we have favoured looking at:

- High and stable dividend growers
- Companies with strong balance sheets
- Companies with high and stable margins

The return of valuation and diversification

Over the post financial crisis cycle, **two 'golden rules' of investment seemed to be turned on their heads.**

1) Diversification helps to reduce risk and boost aggregate returns

2) Valuation matters; expensive stocks tend to generate lower forward returns than cheaper ones

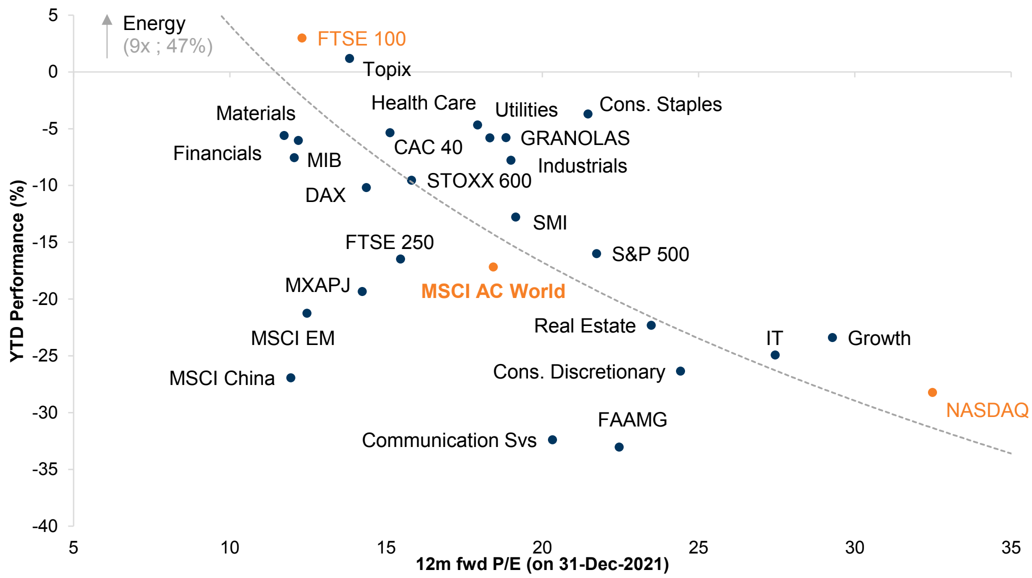
In the last cycle, these two rules seemed to have lost their validity. Diversification did not pay off. In a multi-asset setting, holding a 60:40 equity bond split was sufficient to drive record returns without the need to invest in other asset classes. Meanwhile, within equities, diversification would have reduced returns given the extent to which both Technology and the expensive US equity market outperformed other sectors and regions. Furthermore, expensive companies generally outperformed cheaper ones.

We have argued that these conditions would reverse; **diversification within and across assets and regions should once again help reduce volatility and boost risk-adjusted returns, while valuation should play a bigger part in explaining returns.**

Interestingly, valuation has been an important determinant of returns so far this year. As Exhibit 38 shows, the most expensive markets, such as the Nasdaq, have been the worst performers, while the cheapest, such as the UK, have been the best.

We expect valuation and diversification to play a bigger role in enhancing risk-adjusted returns over the course of 2023.

Exhibit 38: This year, valuation has been an important determinant of returns
YTD Performance (%) and 12m fwd P/E



Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

Exhibit 39: Possible implementations of the themes we like

Inflation & Positive Interest Rates	Regionalisation	Scarce & Expensive Resources	Government Intervention & CAPEX Spending	Margin scarcity
Dividend Yield US: GSTHCASH Europe: GSSTDIVY Asia: GSSZDIVY	**Domestic Consumption** Asia: GSSZDOMC	**High & Stable Margins** Global: GSWDMARG Europe: GSSTMARG Asia: GSSZHMGN	**Fiscal Infrastructure** China: GSSRCNIF *	**High & Stable Margins** Global: GSWDMARG US: GSXUSHGM * Europe: GSSTMARG Asia: GSSZHMGN
Dividend Growth US: GSTHDIVG Europe: GSSTDIVG	**Energy Efficiency** Europe: GSXEEFFI *	**Energy Efficiency** Europe: GSXEEFFI *	**Renewable Energy** Global: GSWDRNEW Europe: GSSBRNEW Asia: GSSZEVMT	**GRANOLAS** Europe: GSXEGRAN *
Short Duration Asia: GSSZSDUR	**Renewable Energy** Global: GSWDRNEW Europe: GSSBRNEW	[AVOID] **High Labour Cost** US: GSTHHLAB Europe: GSXEWAGE * UK: GSXEUKWG *	**High Capex and R&D** Asia: GSSZCAPX	**Stable Growth** Asia: GSSZSTGW
Strong Balance Sheet US: GSTHSBAL Europe: GSSTSBAL			**Energy Efficiency** Europe: GSXEEFFI	
[AVOID] **Weak Balance Sheet** US: GSTHWBAL Europe: GSSTWBAL			**Defence** Europe: GSSBDEFE	

Tickers marked with an asterisk are for baskets that are structured and maintained by the GS Global Markets Division.

Source: Goldman Sachs, Goldman Sachs Global Investment Research

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Reg AC

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