Investment Strategy Group

2010-11 US Economic and Financial Market Outlook

June 2010

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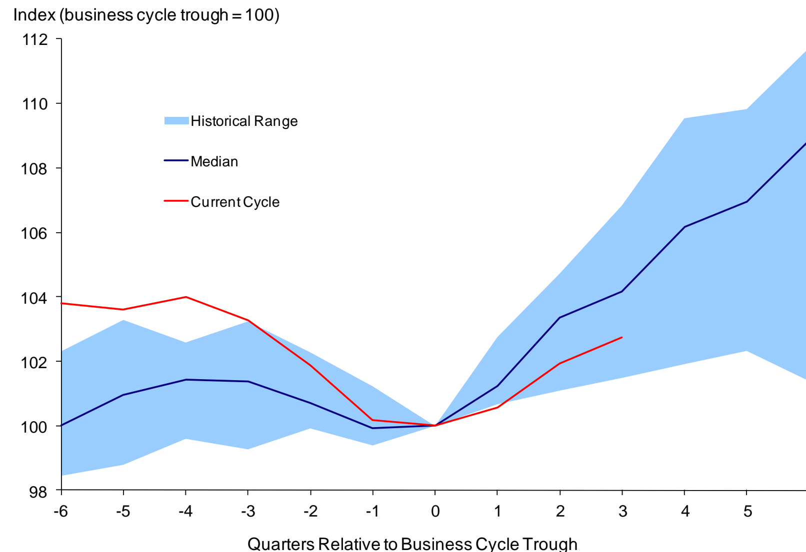
I. 2010-11 US Economic Outlook

We Expect the Recovery to Continue to Track In Line with Historical Experience

1. Real GDP
All 1950-2009 Business Cycles



•The US recovery has so far been in line with the historical range of recoveries in US recent episodes and we expect this to continue.

•While we do not expect a double dip scenario, we do expect the momentum of growth to start slowing from the second half of 2010 and for uncertainty to remain higher than normal.

Source: Datastream, Investment Strategy Group

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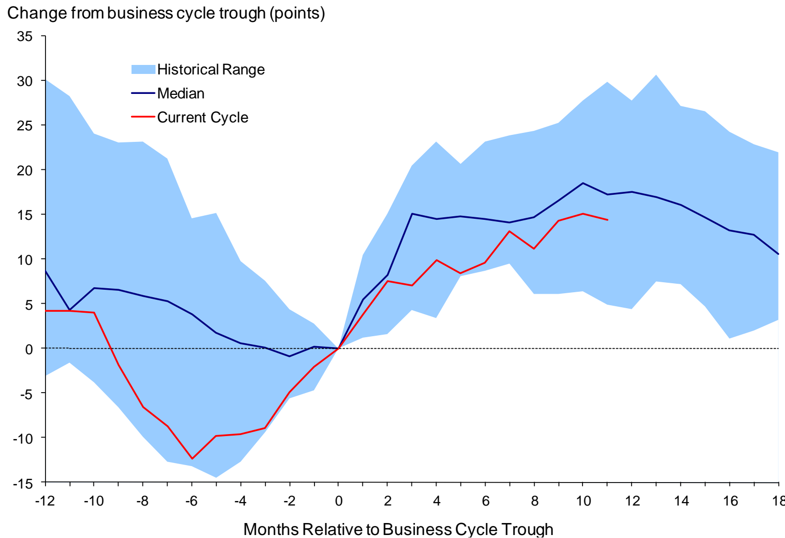
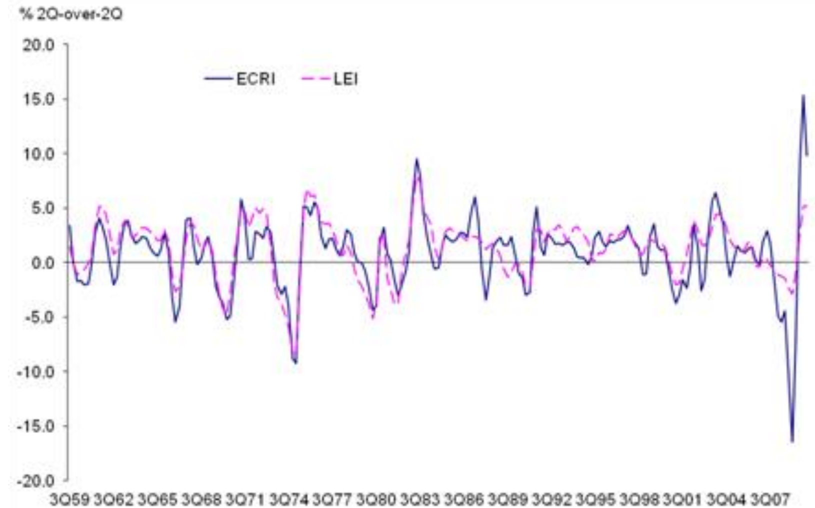
A Double Dip Is Unlikely

Leading Indicators Point to Continued Growth

1. ISM Manufacturing Index (1950-2010)



2. US Leading Indicators, 6 month change (Through to May 2010)



- A key question regarding the economic outlook is whether the US is headed for another recession (the “double dip” scenario).
- Leading indicators appear to have peaked. This generally portends slowing growth, but not a double dip:
  - The ISM and the Conference Board Leading Economic Indicator have historically led growth by one and two quarters, respectively. Their current levels imply GDP growth of around 5% q-o-q annualized in the second half of 2010.
  - The ECRI, which leads GDP growth by 2-3 quarters is more volatile; current level implies 1.5% qoq annualized growth.
  - Overall, while the relationship between leading indicators and GDP growth is noisy, current levels do not suggest an imminent recession.

Economic Cycle Research Institute (ECRI) Components: money supply; stock and bond mutual funds; ECRI industrial metal price index; mortgage applications; bond spreads; stock prices; bond yields; initial jobless claims

Leading Economic Indicators (LEI) Components: Average weekly hours worked by manufacturing workers; Average number of initial applications for unemployment insurance; Amount of manufacturers' new orders for consumer goods and materials; Speed of delivery of new merchandise to vendors from suppliers; Amount of new orders for capital goods unrelated to defense; Amount of new building permits for residential buildings; S&P 500; The inflation-adjusted monetary supply (M2); The spread between long and short interest rates; consumer sentiment

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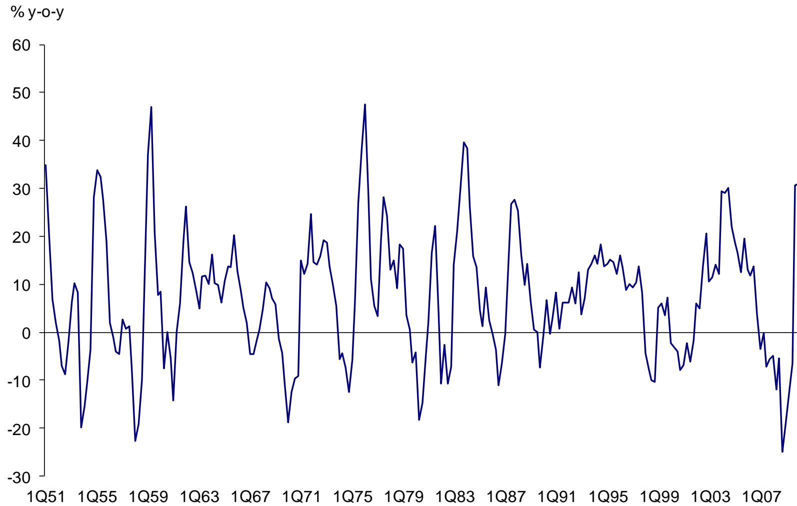
A Double Dip Is Unlikely

Corporate Profits Point to Continued Growth

1. Corporate Profits (% y-o-y, Q1 1951-Q1 2010)



2. GDP Growth and Job Creation Following Profit Growth (1950-2010)

First Quarter of 30%+ Profits Growth	% Growth in Following Year	
	Real GDP	Nonfarm payrolls
Q4 1950	5.2	2.9
Q1 1955	3.1	4.9
Q1 1959	5.1	3.2
Q4 1975	4.3	3.2
Q3 1983	6.9	4.9
Q3 2004	3.1	1.9

- Corporate profits have rebounded strongly from the trough thanks to deep cost cutting and improving demand.
- Historically, such improvements in firms' profitability have led to robust GDP and employment growth in the following year.

Source: Datastream, Investment Strategy Group

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A Double Dip Is Unlikely

Historical Experience Suggests Double Dips Are Rare

1. US Recession & Recovery Durations (1950-2009)

	Duration of Recession	Duration of GDP Expansion Before 1 Quarter of Negative Growth
1954	3	7
1958	3	5
1961	3	35
1970	4	10
1975	5	10
1980	2	4
1982	5	32
1991	2	39
2001	3	25
2009	6	
Average	3.6	18.6
Median	3	10

- Double dip recessions have been rare historically. For example, the US economy typically experiences more than 10 quarters of uninterrupted growth following a recession.
- We do not expect that this time will be different for the US. While we expect the pace of US growth to slow somewhat, our base case remains for positive growth.

Source: National sources, Investment Strategy Group

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We Maintain our 2010 Growth Views, Revise Down Rate Views

1. ISG End 2010 U.S. Outlook Scenarios

	Good Case (20%)	Central Case (60%)	Bad Case (20%)
Real GDP Growth	> 3.25%	2.75 – 3.25%	< 2.75%
Monetary Policy - End 10	0.0 – 0.5%	0.0 – 0.25%	0.0 – 0.25%
10Y Bond Yield - End 10	> 4.0%	3.5 – 4.0%	< 3.5%
Inflation (Core CPI) - avg 2010	> 1.25%	0.75 – 1.25%	< 0.75%
Inflation (Headline CPI) - avg 2010	> 2.0%	1.5 – 2.0%	< 1.5%

Key changes:

- The Fed is unlikely to raise rates this year due to uncertainty around Europe and lower inflation data.
- Lowering the 10-year yield forecast from 4.25-4.75% to 3.5-4.0%.
- Inflation has surprised to the downside. We are lowering our core CPI range to 0.75-1.25% from 1.0-1.5% and our headline CPI range to 1.5-2.0% from 1.75-2.25%.

Source: Datastream, Investment Strategy Group

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We Expect the Recovery Will Continue Into 2011

1. ISG End 2011 U.S. Outlook Scenarios

	Good Case (20%)	***Central Case (55%)***	***Bad Case (25%)***
Real GDP Growth	> 3.25%	2.75 – 3.25%	< 2.75%
Monetary Policy - End 11	> 1.0%	0.75 – 1.0%	< 0.75%
10Y Bond Yield - End 11	> 4.5%	4.0 – 4.5%	< 4.0%
Inflation (Core CPI) - avg 2011	> 1.25%	0.75 – 1.25%	< 0.75%
Inflation (Headline CPI) - avg 2011	> 1.75%	1.25 – 1.75%	< 1.25%

- We expect GDP to grow 2.75-3.25% in 2011. Investment will likely recover from its low levels; consumption should continue to grow at a moderate pace.
- The Fed is unlikely to raise rates until some time in 2H 2011 unless employment growth and/or inflation surprise to the upside.

Source: Investment Strategy Group

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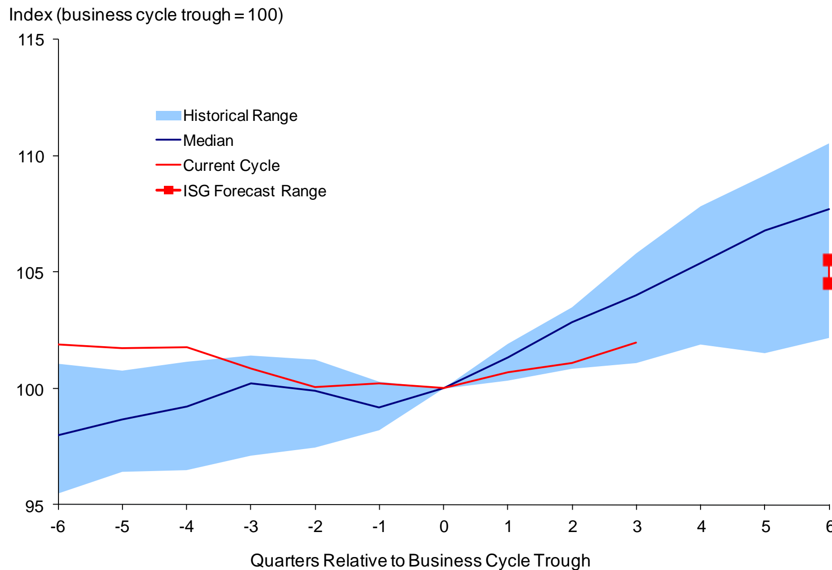
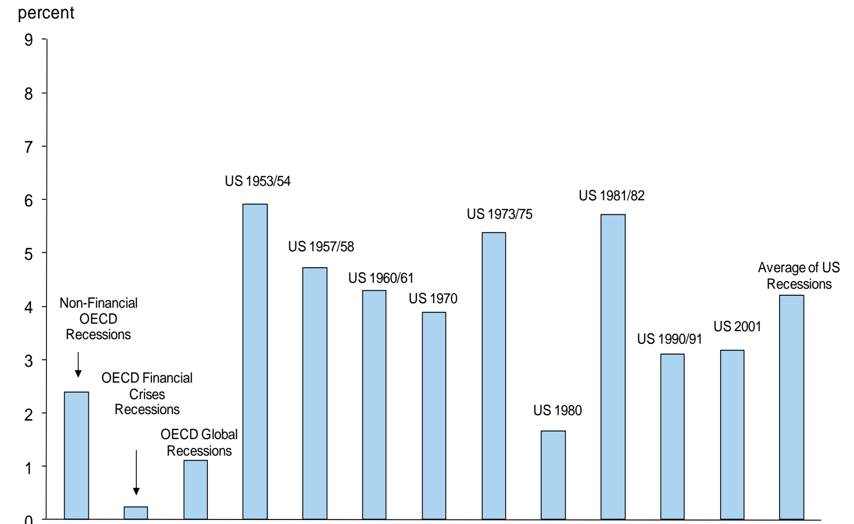
The Outlook for Consumption

We Expect the Current Moderate Pace of Growth to Continue Through 2011

1. Personal Consumption Expenditures 1950 – Current Business Cycle



2. Consumption Growth During Recoveries (% Change, 2 Year Annualized, Based on US Recessions During 1950-2009)



- **Where are we now?** So far consumption has recovered in-line with historical recoveries, albeit at the lower end of the range.
- **What does history tell us?** Consumption recoveries tend to be more muted in OECD countries following financial crises and global recessions. However, the US experience is quite different. Past recoveries suggest that consumption should rebound strongly, growing by as much as 4% annualized.
- **ISG's outlook**: We think this consumption recovery is unlikely to be as strong as previous US recoveries and we expect growth of 2.5-2.75%, driven by some growth in real disposable income and net worth.

Source: Datastream, Investment Strategy Group

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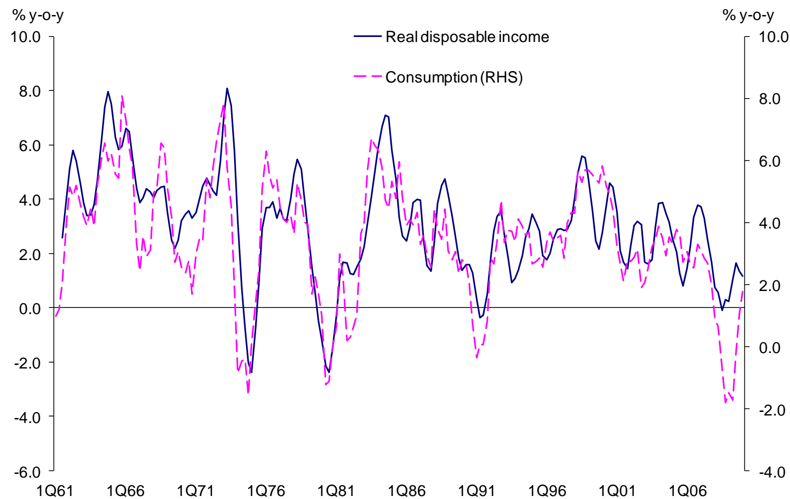
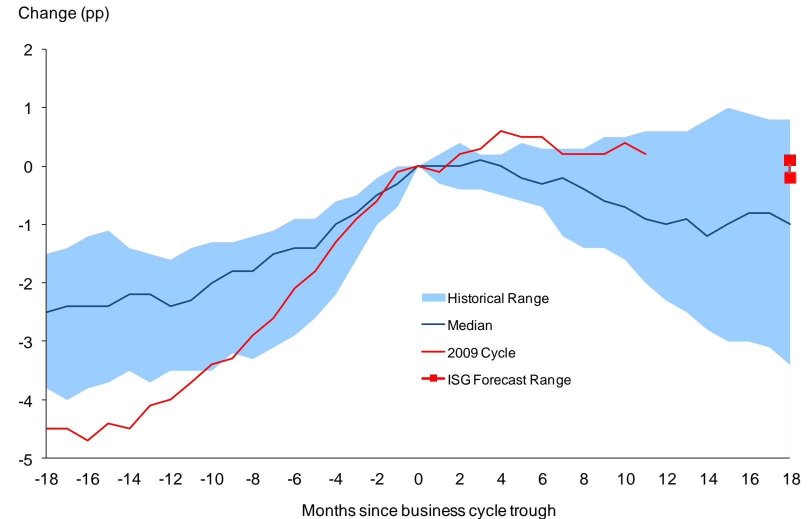
The Outlook for Consumption
Labor Income Will Grow, Albeit at a Slow Rate

1. Private Consumption and Real Disposable Income (Through Q1 2010)



2. Expected Path of the Unemployment Rate All 1950-2009 Business Cycles



- We continue to expect that the current recovery should not be a jobless one. Businesses were particularly quick to reduce payrolls and we do not expect them to wait to rehire as the cuts were deep.
- As noted earlier, corporate profit growth has been robust, which could result in some hiring.
- We expect, however, that the unemployment rate will decline only slowly over time, which should cap growth in real wages and salaries, a key determinant of consumption growth.

Source: Datastream, Investment Strategy Group

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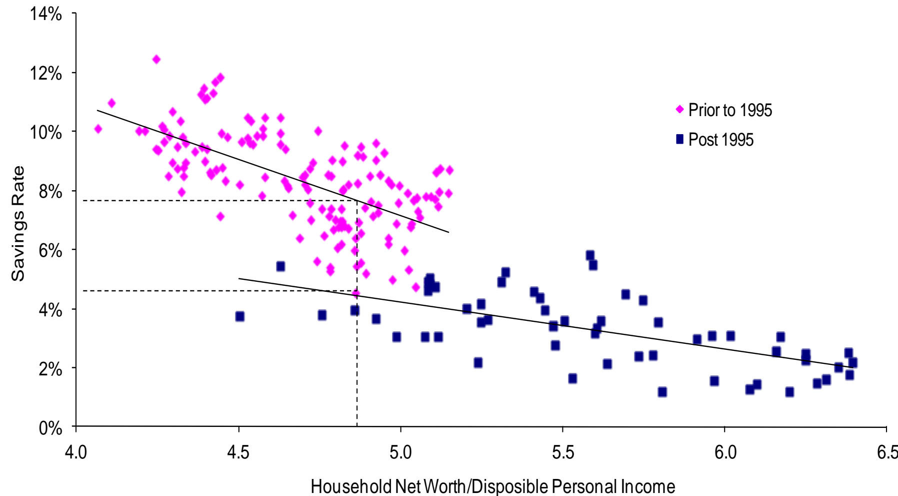
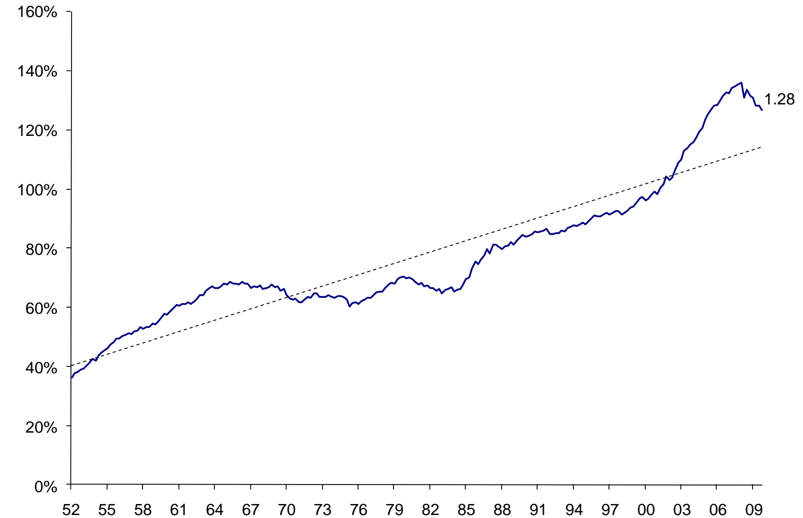
The Outlook for Consumption

Household Balance Sheets Not as Supportive





- The other key determinant of consumption growth is household wealth, composed mostly of equities and housing.
- Based on the recent historical relationship, the current net worth to disposable personal income ratio of 4.9% would suggest that the savings rate be slightly higher than its current level of 3.6%, as household balance sheets remain highly leveraged.
- Whether the savings rate continues to rise from here or stabilizes at current levels will have implications for consumption growth over the next 12-18 months. A savings rate in the range of 3.5-4.5% would imply consumption growth between 2.75% and 2.25% respectively.

Source: Datastream, Investment Strategy Group

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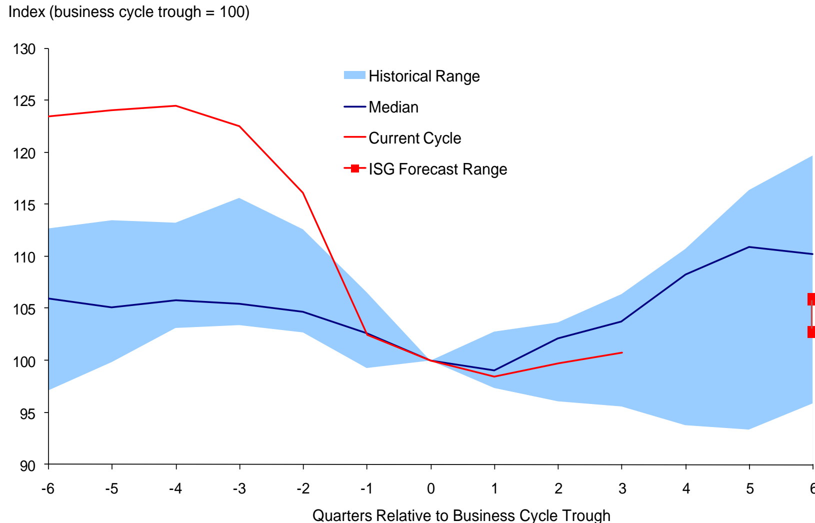
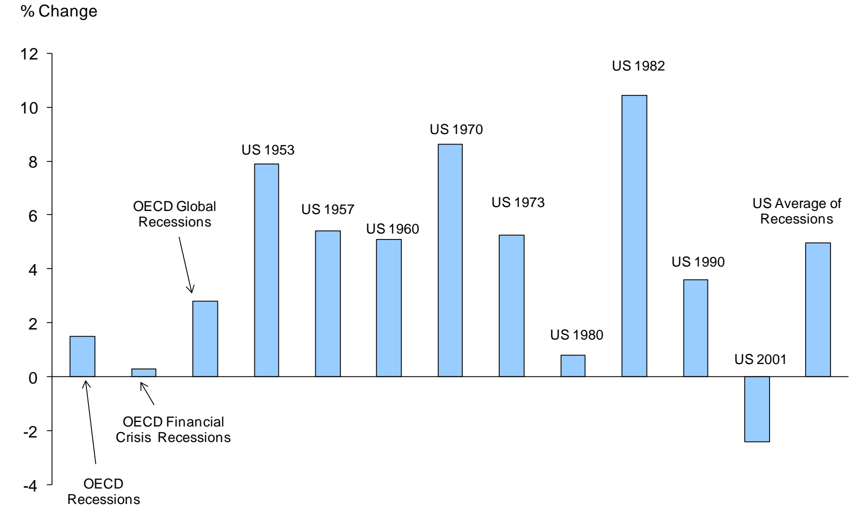
The Outlook for Business Investment

We Expect Business Investment to Grow Modestly

1. Recovery in Non-Residential Investment (Based on US Recessions During 1950-2009)



2. Recovery in Non-Residential Investment (% Change 2Y Annualized, Based on US Recessions During 1950-2009)



- **Where are we now?** Business investment troughed one quarter after GDP, similar to other recessions. The recovery has thus far been in line with historical experience but below the median recovery (Exhibit 1).
- **What does history tell us?** Investment rebounds tend to be muted in OECD recessions following financial crises and global recessions. However, the US experience again is quite different. Business investment usually rebounds strongly, once recovery is under way, rising about 8-10% over a couple of years.
- **ISG's outlook**: We expect business investment to grow about 6-7% in 2011 driven by some pent up demand and corporate profit growth.

Source: Datastream, Investment Strategy Group

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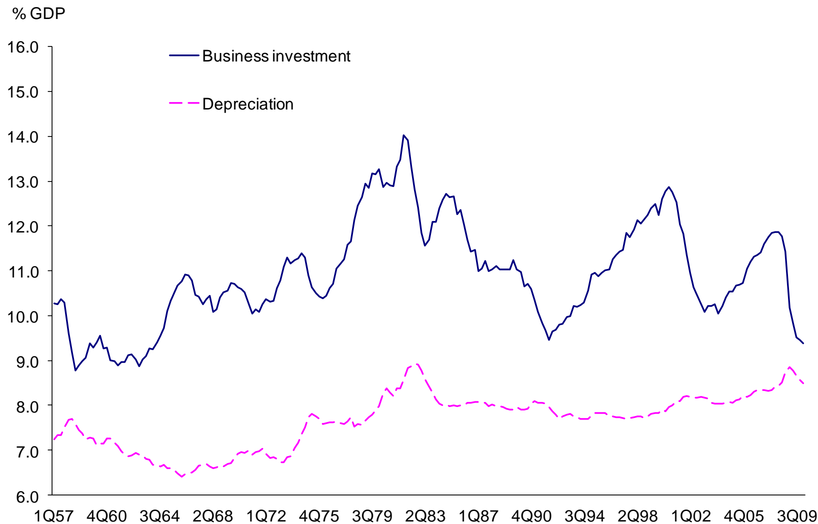
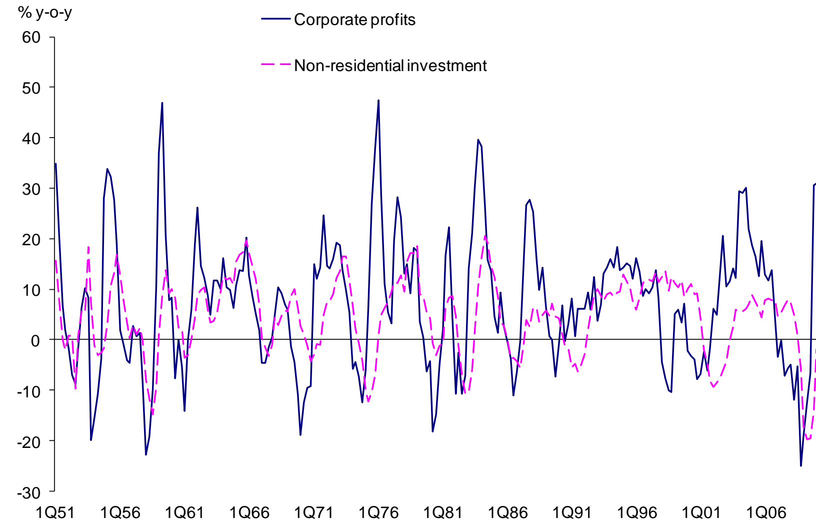
The Outlook for Business Investment

Pent Up Demand and Profit Growth are Supportive, Uncertainty is Not

1. Depreciation and Business Investment (% of GDP) (Through Q1 2010)



2. Business Investment & Corporate Profits (% y-o-y, Through Q1 2010)



- Positive drivers of business investment outlook:
  - Some signs of pent up demand. For example, we expect equipment and software investment (~70% of business investment) to rise, as investment has fallen close to the rate of depreciation of capital.
  - Profits rebounding suggest a pick up in business investment.
- On the other hand, uncertainty with regard to end demand is high, which may reduce firms' willingness to invest.

Source: Datastream, Investment Strategy Group

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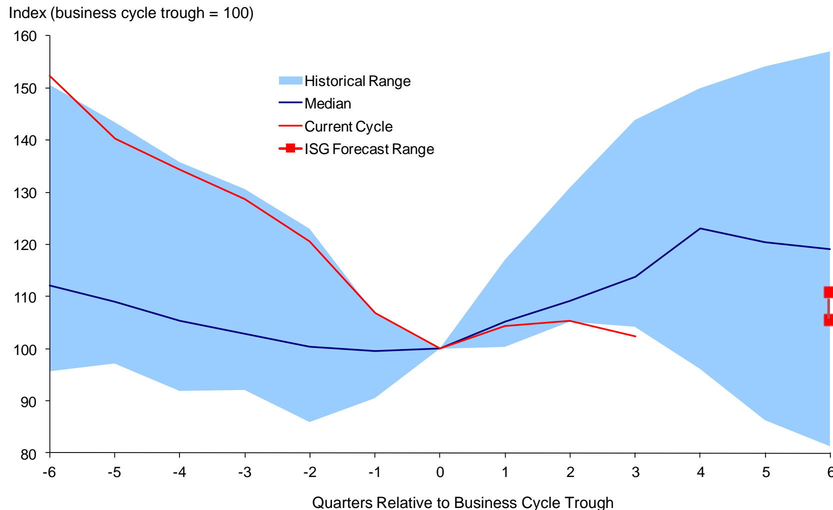
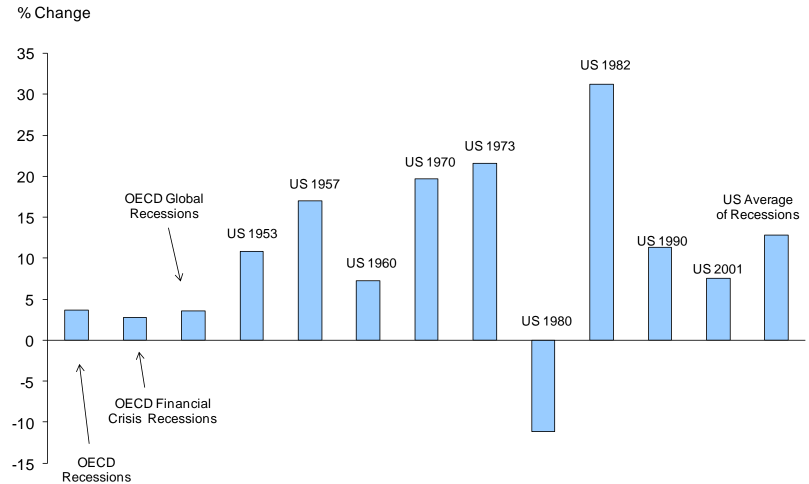
The Outlook for Residential Investment
Residential Investment Is Likely to Grow Modestly

1. Residential Investment
1950 – 2009 Business Cycles



2. Recovery in Residential Investment
(% Change 2Y Annualized, Based on US Recessions During 1950-2009)



- **Where are we now?** Residential investment seems to have stabilized since mid 2009 after declining dramatically (about 55% peak to trough).
- **What does history tell us?** Recovery in residential investment tends to be slower in OECD countries following financial crises and global recessions. The US experience is somewhat mixed although still stronger than the overall OECD recessions.
- **ISG's outlook**: We expect residential investment to grow 8 to 10% in 2011 as the housing market stabilizes and residential investment rebounds from historically low levels.

Source: Datastream, Investment Strategy Group

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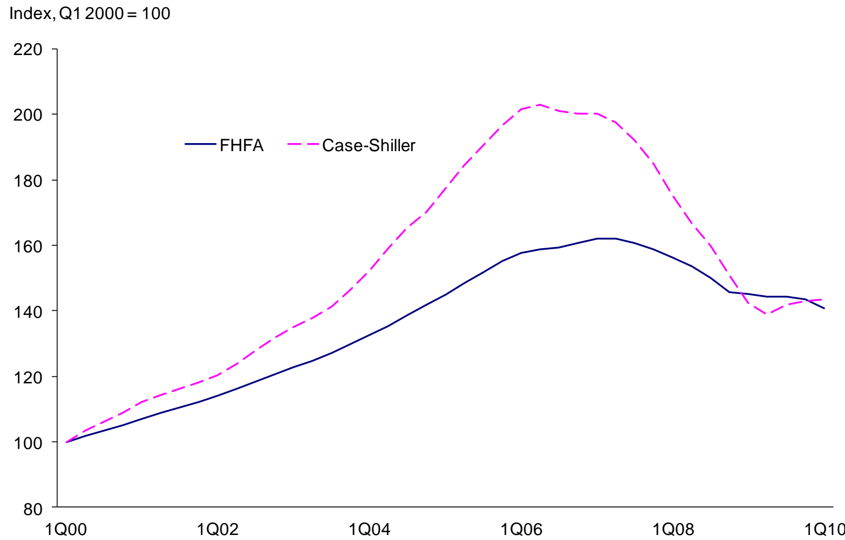
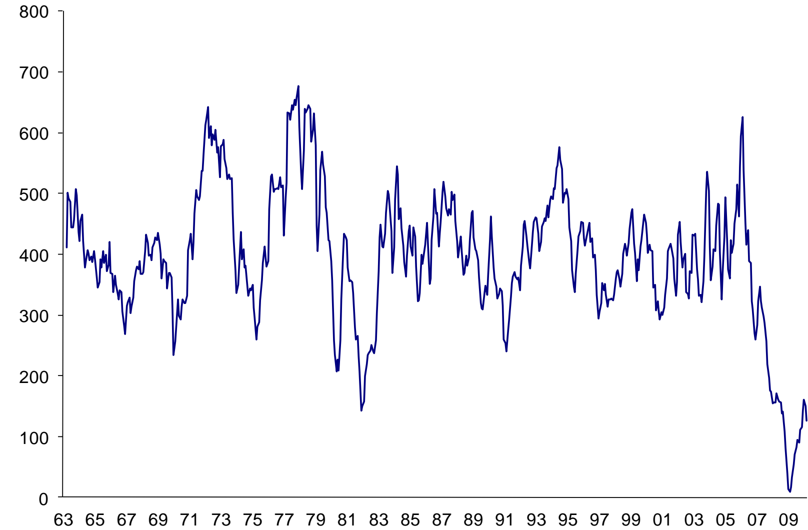
The Outlook for Residential Investment
Residential Investment Is Likely to Grow Modestly





- Several tailwinds should support residential investment: house prices stabilizing (Exhibit 1); housing starts still at a historically low level (Exhibit 2); high home affordability; and population growth.
- Some important headwinds remain, however. Home inventories remain high; the homeowner vacancy rate has only started to improve (currently at 2.6% vs. a peak of 2.9% in Q1 2008 and a historical average of 1.6%); and foreclosures have started to pick up again recently.

Source: Datastream, Investment Strategy Group

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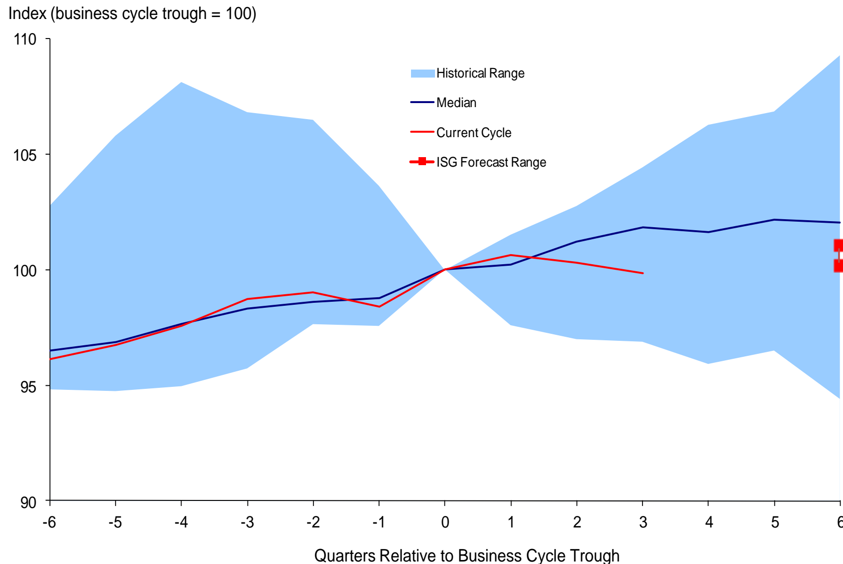
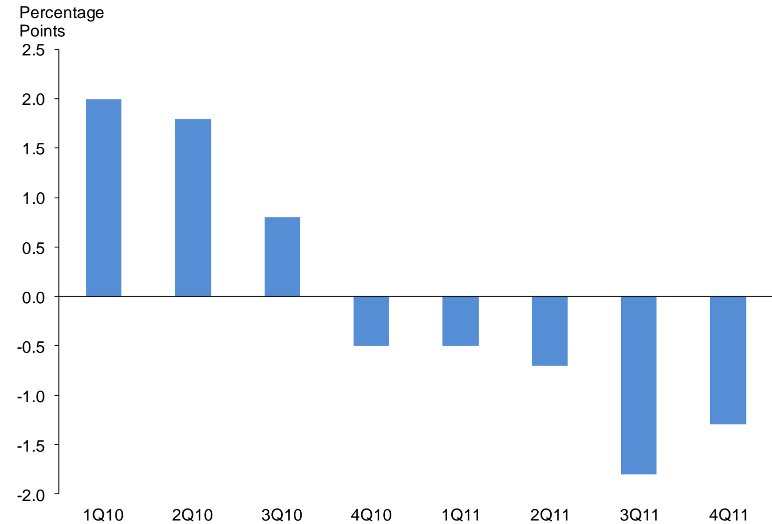
The Outlook for Government Expenditures

Fiscal Stimulus Will Turn Into Fiscal Constraint Later This Year

1. Government Expenditures
1950-2009 Business Cycles



2. Evolution of Fiscal Stimulus Contribution to GDP Growth (GS Research Estimates)



- **Where are we now?** Fiscal stimulus has been a contributor to growth since early 2009.
- **What does history tell us?** Government spending varies greatly across recoveries (Exhibit 1).
- **ISG's outlook**: We expect government spending to decline modestly through 2011 as the stimulus fades out (Exhibit 2).

Source: Datastream, Goldman Sachs Global Investment Research, Macroeconomic Advisers, Investment Strategy Group

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US Economic Growth Outlook

Contributions to GDP Growth

1. ISG Forecast: Contributions to GDP Growth 2010-2011

Component	Share of GDP*	2008	2009	ISG Central Case: 2010	ISG Central Case: 2011
	in %	*in %*	*in %*	*in %*	*in %*
Consumption	70%	-0.2	-0.4	1.8	1.9
Residential Investment	3%	-1.0	-0.7	0.0	0.3
Non-Residential Investment	11%	0.2	-2.1	0.2	0.5
Change in Inventories	-1%	-0.3	-0.6	1.0	0.2
Government	19%	0.6	0.4	0.1	0.0
Net Trade	-2%	1.2	1.0	0.0	0.0
Total	100%	0.4	-2.4	2.75 - 3.25	2.75 - 3.25

*** Data as of 2009. All components may not add up to 100% due to rounding.**

- Our view is that the growth baton will be passed successfully from inventories and government spending to consumption and investment so growth should remain positive over the next 12-18 months.

- That said, we expect that growth in consumption and investment will be moderate.

Source: Datastream, Investment Strategy Group

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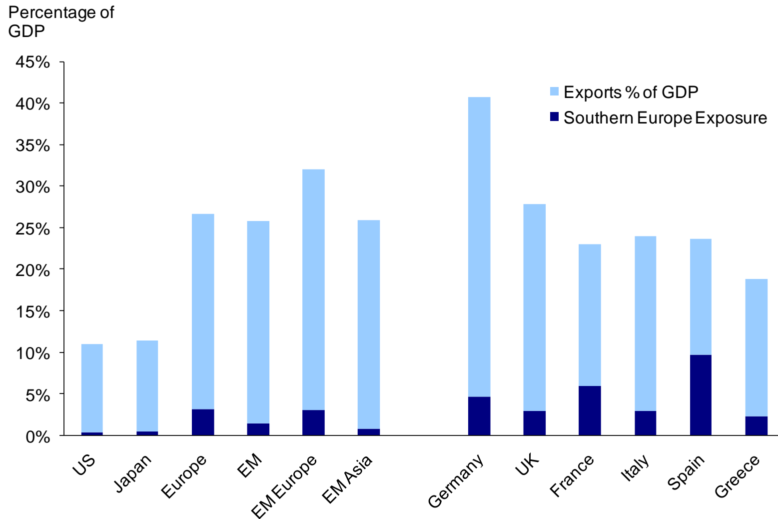
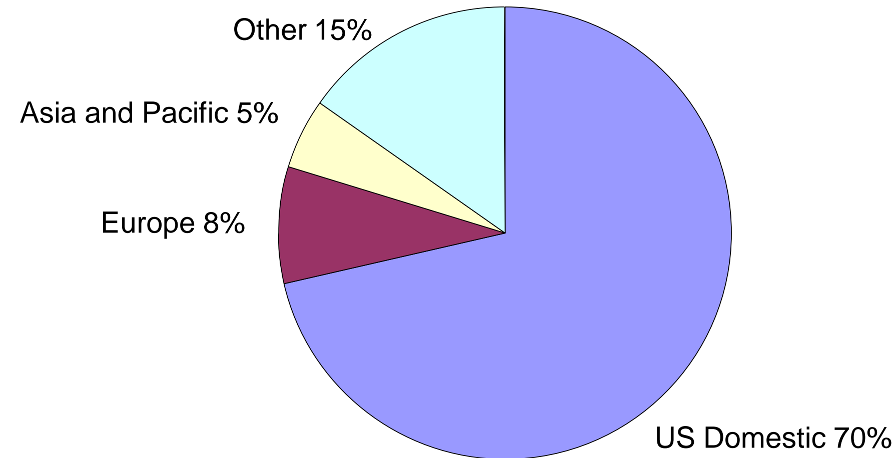
Risks to Our Outlook for the US

Contagion From Europe





- US growth does not rely much on exports (exports are only 12% of GDP) and Europe is not a large export destination. Exports to Euroland account for 15% of US total exports or 1.8% of US GDP. Also, only 8% of S&P 500 sales are to Europe.

- The channel that we are most concerned about is a loss of confidence and/or financial contagion. As we have noted previously, this channel is difficult to forecast as so much of the outcome depends on the policy response both in the US and Europe. This clearly contributes to higher uncertainty.

- Although the US dollar has strengthened vs. the EUR and financial conditions have tightened somewhat, lower oil prices and interest rates provide an offset.

Source: Datastream, Bloomberg, Investment Strategy Group

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Risks to Our Outlook for the US

1. Estimated Impact of a 1% Increase in the Government Deficit on 10-Year Government Bond Yields

Study	Countries	Sample	Impact (bp)
Bovenberg (1988)	US	1961-85	100
Cebula (2000)	US	1973-95	86
Elmendorf (1993)	US	1971-87	40
Evans (1987)	US	1980-1984	0
Faini (2004)	Euro area	1979-2002	35
JPMorgan (2005)	US	1959-2004	31
Kitchen (1996)	US	1981-94	4
Knot et al. (1995)	DE, FR, IT, NL, UK	1960-89	50
Knot et al. (1999)	Germany	1987-93	0.3
Laubach (2003)	US	1976-2003; 1985-2003	20
Linde (2001)	Sweden	1982-96	20
Orr et al. (1995)	17 OECD countries	1981-94	15
Thomas et al. (1988)	US	1970-86	94

Average	Average US Only
38	47

Other risks include the following:

- **Long-term rates rising sharply**, as markets concerns over US deficits rise. How budget deficits impact long-term rates is uncertain. The estimated impact varies widely across studies (Exhibit 1). Long-tem rates could rise substantially above our forecast if budget deficits impact rates more than we assume. Higher rates would hurt investment and consumption, and hence GDP growth.
- **China slowing**. The impact would likely be small, as exports to China (including Hong Kong) account for only 9% of total US exports.
- **Disorderly USD appreciation**. USD appreciating more sharply would hurt US exports. The US being a relatively closed economy mitigates the impact, however. GIR estimates that USD TWI appreciating 10% takes less than 0.1% off GDP growth.
- **Oil prices rising**. Oil prices rising sharply –and permanently- would hurt consumption and investment, and hence GDP growth. GIR estimates that oil prices rising $10/barrel shaves about 0.2% off GDP growth.

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Outlook for Inflation

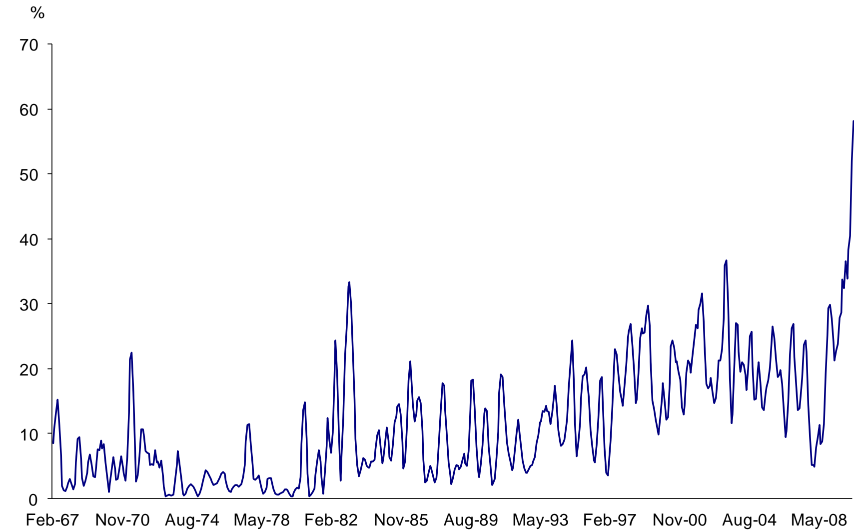
Spare Capacity and Weak Shelter Prices Keep Inflation Low

1. US: Different Inflation Measures (% YoY)
As of April 2010

	Current	1 Year Ago	*Change*	3 Year Average	10 Year Average
Headline Inflation					
Headline CPI	2.2%	-0.7%	*2.9%*	3.0%	2.8%
Headline PCE	2.0%	0.1%	*1.9%*	2.7%	2.4%
Market-Based Headline PCE	2.0%	0.2%	*1.8%*	2.7%	2.3%
Core Inflation					
Core CPI	1.0%	1.9%	*-0.9%*	2.4%	2.2%
Median CPI	0.5%	2.5%	*-2.0%*	3.0%	2.7%
Trimmed Mean CPI*	0.9%	2.2%	*-1.3%*	2.8%	2.4%
Core PCE	1.2%	1.7%	*-0.5%*	2.3%	2.0%
Market-Based Core PCE	1.1%	2.2%	*-1.1%*	2.2%	1.8%

* The Trimmed Mean is calculated by the Federal Reserve Bank of Cleveland and removes from overall CPI inflation the top and bottom eight percent of the distribution of price changes. This is done to remove the impact of large relative price changes in each month.

2. Share of the CPI Basket Experiencing a Price Decline
(3M Moving Average, Through April 2010)



- Inflation looks set to remain low over the next 18 months. In fact, 60% of the components in the consumer price index are actually falling.
- Shelter prices (which account for 32% of the CPI basket) should remain under downward pressure due to high vacancy rates.
- Additionally, given our unemployment outlook, we expect wage growth, a primary determinant of inflation, should remain moderate.
- We expect core CPI inflation to settle around 0.75-1.25% on a year over year basis in 2011.

Source: Datastream, Investment Strategy Group

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Outlook for Interest Rates

We Expect the Fed to Remain on Hold Until at Least H1 2011

We expect the Fed to remain on hold until at least H1 2011:

1. Inflation is likely to remain low for both 2010-11.
2. Unemployment has come down from its peak but remains at elevated levels.
3. Inflation expectations remain well anchored.
4. Fiscal concerns in Europe may make the Fed reluctant to withdraw policy stimulus early.

Uncertainty around when the Fed will start tightening remains high, however, due to:

1. Labor market outlook: A faster than expected improvement in the labor market could lead to earlier tightening. Similarly, weaker labour markets would delay tightening.
2. Fiscal outlook: Early fiscal consolidation in the US can have a negative impact on growth and keep monetary policy looser.

Source: Datastream, Investment Strategy Group

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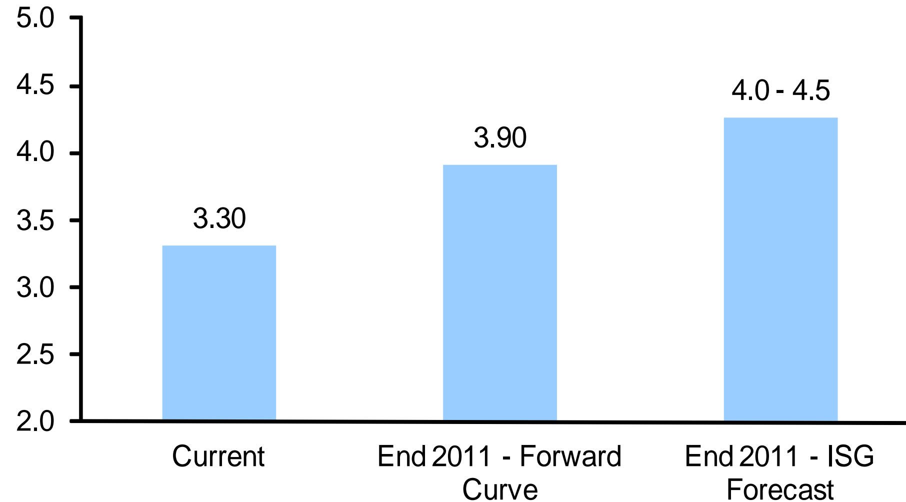
Outlook for Interest Rates

We Expect Long-Term Rates to Increase to 4.0 – 4.5% in 2011

1. US 10-Year Rates Forecast



- 10-year rates have increased substantially over the past 12 month, rising to around 4% before coming back to the current level of 3.30%. Rates are still low by historical standards, however.
- We forecast 10 year rates to be around 3.5 - 4% at the end of 2010 and 4.0 – 4.5% at the end of 2011 due to the following factors:
    - The start of the Fed tightening cycle putting upward pressure on 10-year rates.
    - High budget deficits in the US putting mild upward pressure on 10-year rates.
- The “safe haven” status of US treasuries means that 10-year rates tend to fall when risk aversion rises, however. As a consequence, rates would likely remain below our forecast if risk aversion were high.

Source: Datastream, Bloomberg, Investment Strategy Group

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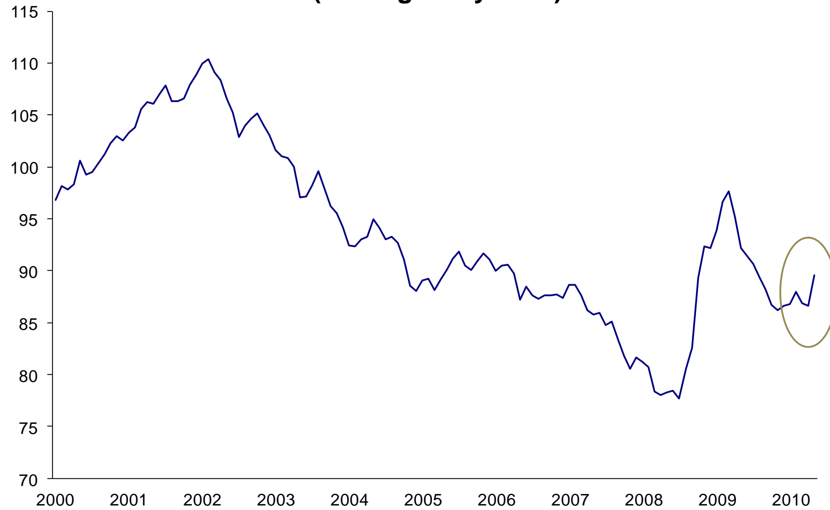
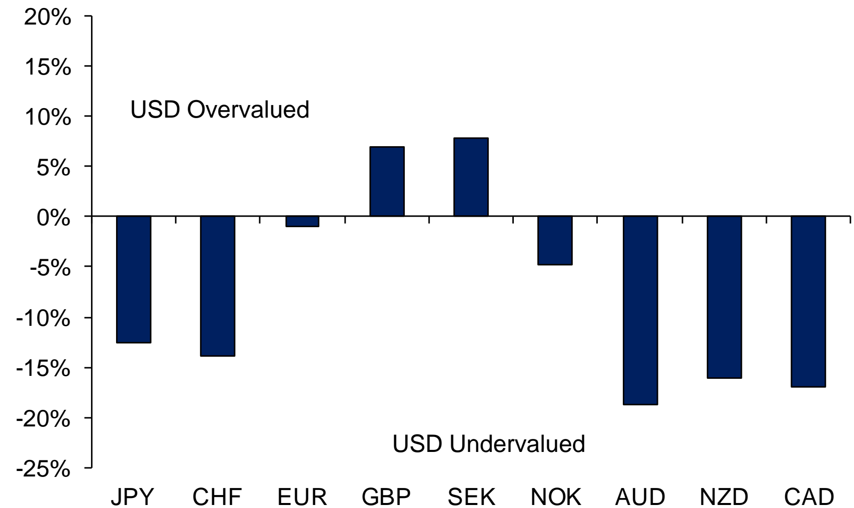
Outlook for the US Dollar





- The US dollar has appreciated by nearly 6% in real trade weighted terms since last November (Exhibit 1).
- US dollar valuation is more mixed than a few months ago. The dollar remains cheap vs. AUD, NZD and CAD and somewhat overvalued vs. GBP and SEK (Exhibit 2).
- We maintain our tactical tilt to long US dollar vs. short Euro:
    - While valuation is not as compelling as at the beginning of the year, relative fundamentals suggest the Euro should trade at a discount to the dollar:
        - The US has stronger growth prospects than Euroland.
        - Fiscal concerns in Greece and some other EMU countries should lead investors to reassess the risk attached to the euro. This reduces the Euro's appeal as a reserve currency and puts the ECB on hold.
    - Negative sentiment over the Euro is a short-term risk for the tilt, however.

* Average of GSDEER, PPP, Deutche Bank, Barclays and Credit Suisse Valuation Models

Source: Datastream, Bloomberg, Goldman Sachs Global Investment Research, Investment Strategy Group

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II. 2010-11 US Equity Market Outlook

US Equity Outlook

Four primary factors determine our equity market viewpoint

Key Factor	ISG Viewpoint
Valuation	• Today's valuations stand at or below post-war averages, leaving equities priced for reasonable returns, particularly relative to bonds and cash.
Fundamentals	• Leveraging the global supply chain and still significant operating leverage are enabling companies to increase earnings on even moderate revenue improvement, suggesting EPS growth will continue to outpace GDP growth.
Technicals	• The S&P 500's inability to recapture its 200 day moving average, considered the dividing line between technical strength and weakness, is negative. • That said, long-term momentum remains in an uptrend, as do measures of breadth (such as the cumulative advancing less declining stocks line).
Sentiment / Positioning	• Both mutual fund flows and recent investor surveys demonstrate extreme pessimism, a contrarian positive for equities.

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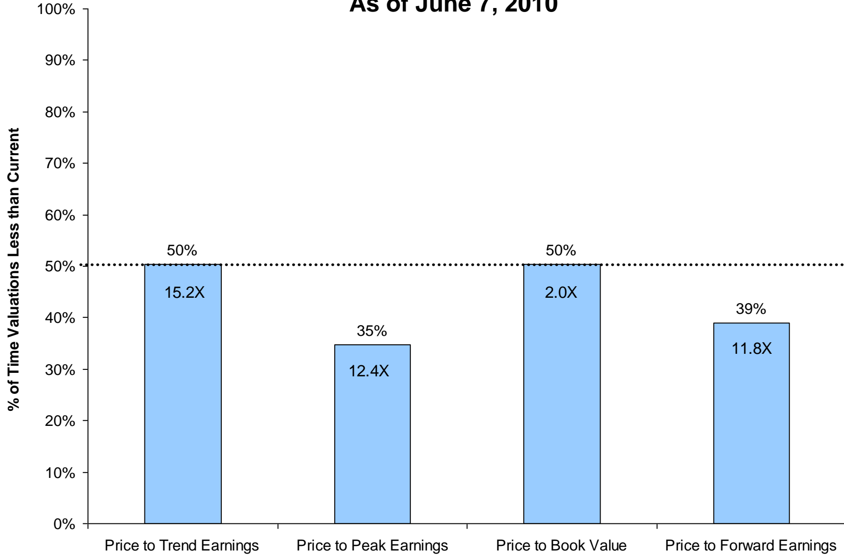
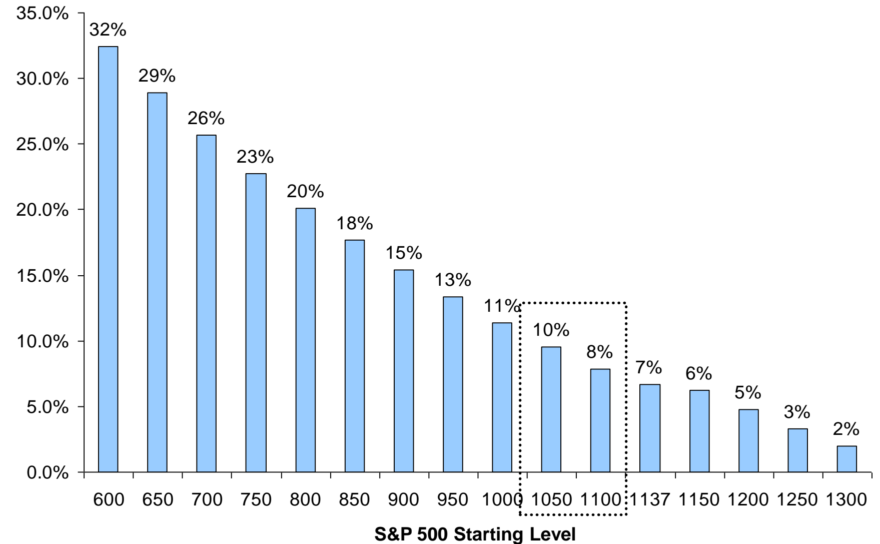
US Equity Outlook: Valuations

Regardless of measure, today's valuation levels are at or below their historical postwar ranges

1. US Equity Valuation Metrics[1]
As of June 7, 2010



2. S&P Compound Annual Returns on Normalized Multiple (17x) and Normalized Earnings Over 3 Years



- Today's valuation levels are undemanding, residing at or below their historical postwar ranges.
- In contrast, the last two major market peaks were characterized by top quartile valuations.

- As a result, equities are priced to deliver reasonable 8-10% annual returns.
- The implication is that clients should continue to use market weakness to build toward or maintain their strategic equity allocation.

[1] Price to peak earnings and price to trend earnings based on data since 1950. Price to forward earnings based on data since 1976. Price to book based on data since 1965.
Source: Investment Strategy Group, Empirical Research Partners

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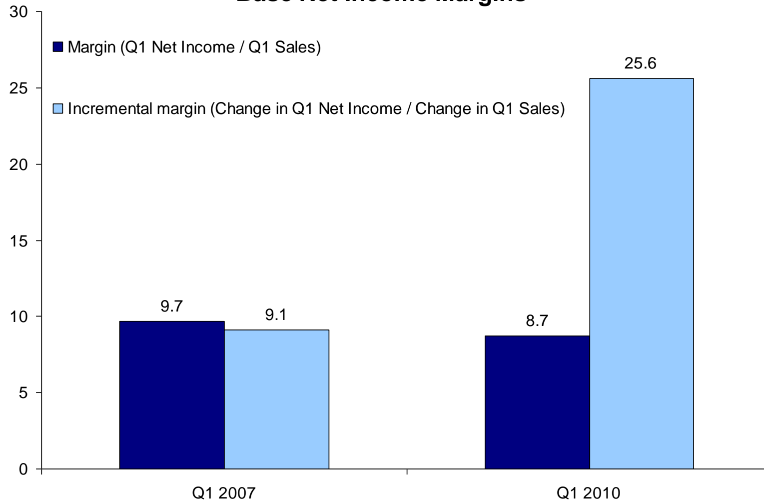
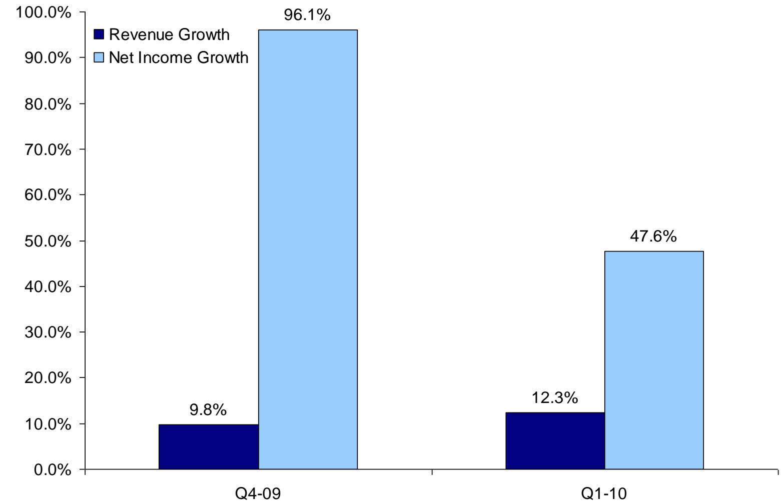
US Equity Outlook: Fundamentals

Earnings growth should continue to drive market returns, compliments of expanding margins



- When incremental margins fall below the base margin level, profit ratios peak, as the growth in costs exceeds that of revenues. This occurred in early 2007 as margins rolled-over.
- In contrast, every dollar of incremental sales generated 26 cents of net profit in Q1. This 26% incremental margin was well above the quarter's 8.7% profit margin.
- Importantly, this large positive gap provides a healthy buffer for further margin expansion, even as firms begin to hire and increase capex from low base levels.



- This last point was clear in Q1. As firms tentatively increased expenses, operating leverage fell relative to Q4. Even so, earnings growth still significantly exceeded revenue growth.
- To wit, 12% top line growth generated roughly 48% earnings growth in Q1.
- The upshot: it won't take significant GDP growth to witness continued strong earnings growth.

Source: Bloomberg

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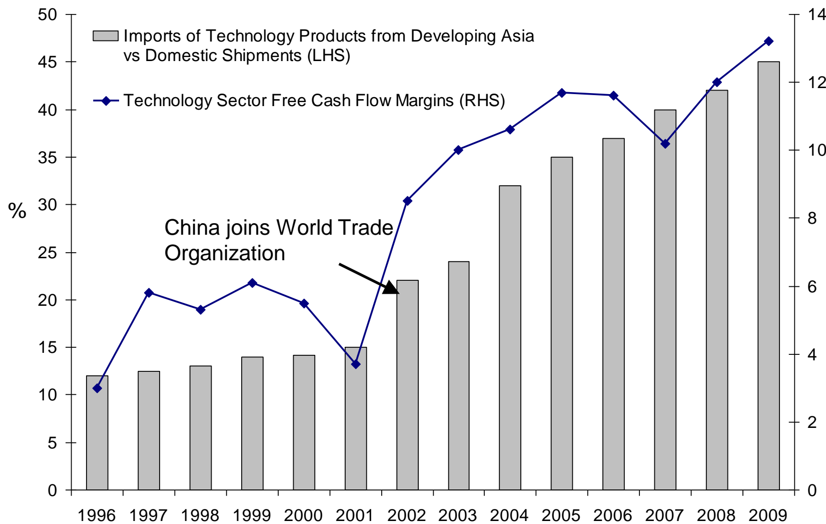
US Equity Outlook: Fundamentals

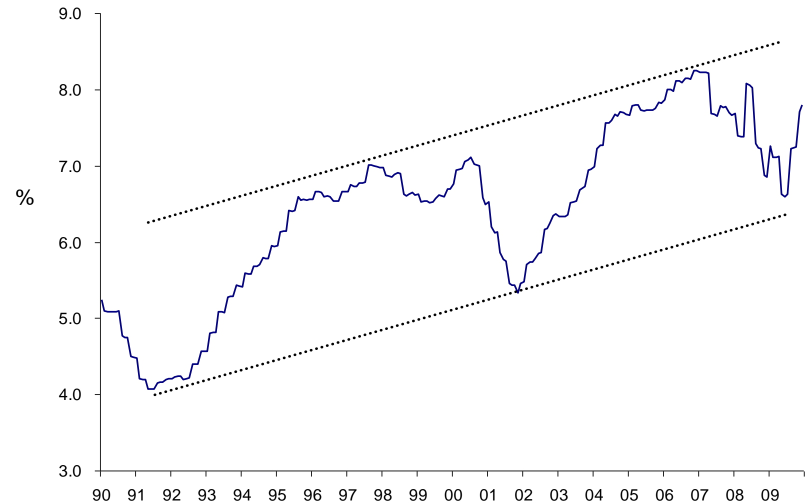
Structural factors further support the resilience of earnings

1. S&P 500 Technology Sector Free Cash Flow Margins vs. Asian Imports of Tech Goods (1996 – 2009)



- Structurally, US firms have leveraged the global supply chain to lower capital intensity (both capex and working capital) and increase productivity.
- The result has been a corresponding rise in free cash flow margins.

2. S&P 500 Operating Margins (1990 – June 2010)



- The resulting operating leverage and increased productivity has allowed operating margins to trough at successively higher levels and trend higher over time.
- The historical trajectory suggests margins will peak at a higher level than in 2007.

Source: Empirical Research Partners, Bloomberg, Investment Strategy Group

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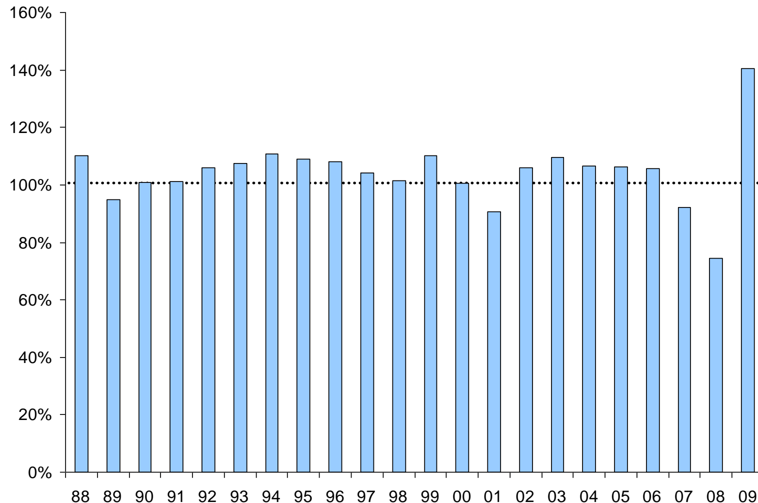
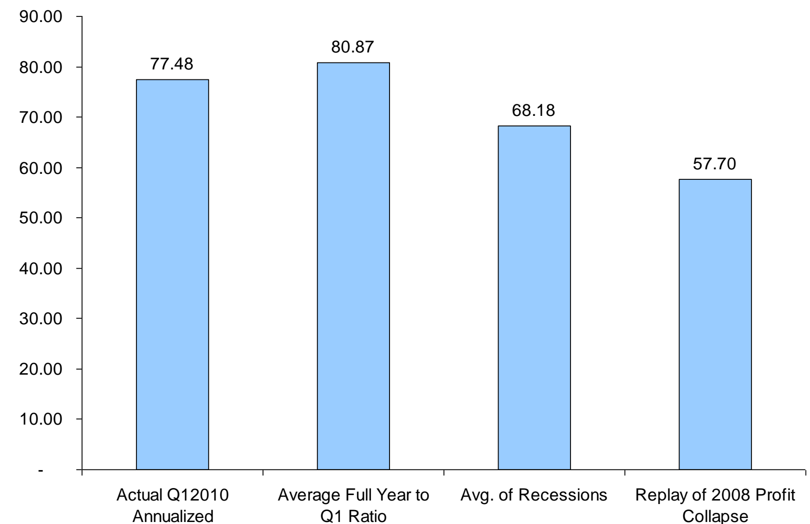
US Equity Outlook: Fundamentals

Q1 2010 operating earnings suggests a strong trajectory for the balance of 2010

1. Full Year Operating EPS as Percent of Annualized Q1 EPS (1988-2009)



2. Implied 2010 Operating EPS Under Different Historical Q1 to Full Year EPS Relationships



- The level of first quarter earnings is a consistent barometer of full year earnings, deviating significantly only during deep earnings recessions.
- In fact, full year EPS is greater than the annualized Q1 level 82% of the time since 1988, by 4% on average.

- Given the strong $19.37 of operating EPS reported in Q1 2010, historical precedence would argue for earnings of around $80 this year.
- Moreover, even the average of the 4 recession analogues would point toward around $70, merely the low end of our central case.
- It would take a repeat of the profit collapse of 2008 to undermine the Q1 strength.

Source: Intrinsic Research, Investment Strategy Group

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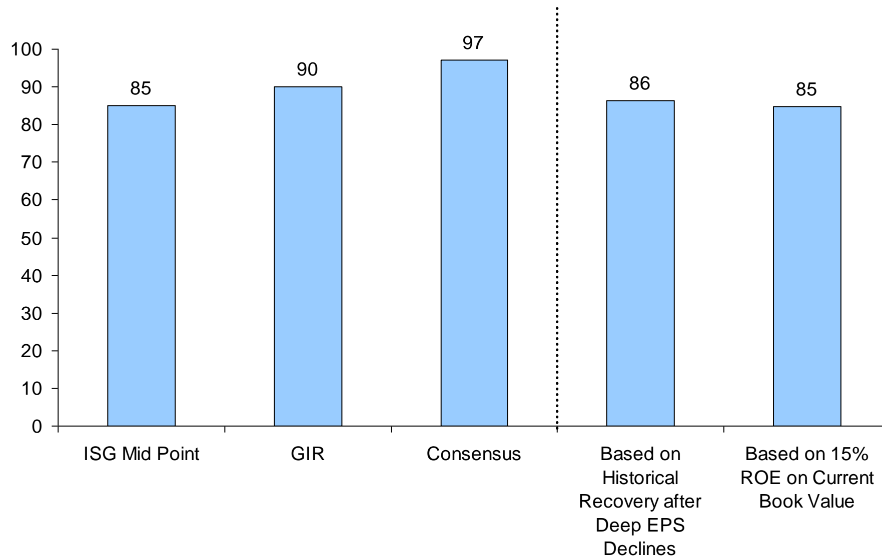
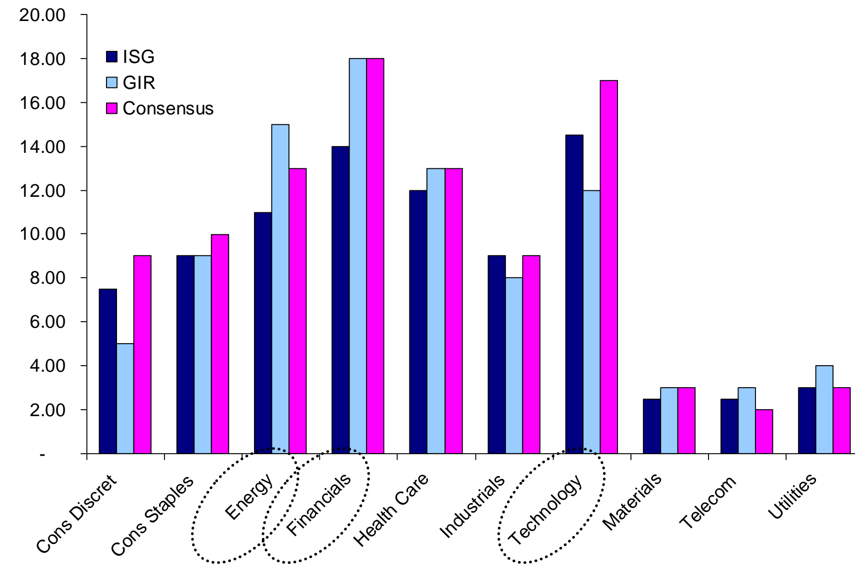
US Equity Outlook: Fundamentals

Our estimates for 2011 EPS show further growth, but stand below consensus

1. ISG 2011 Operating EPS Estimate in Context



2. S&P 500: 2011 Operating Earnings Estimates by Sector



- The mid-point of our 2011 EPS target is consistent with the historical recovery in earnings seen after 50%+ EPS declines, similar to the one which preceded this rebound.
- Moreover, our estimate is inline with a 15% peak ROE, a level which would represent a natural resistance point given historical levels.

- The primary differences between the forecasts stems mainly from sector level assumptions for energy, technology and financials.

Source: Investment Strategy Group, Goldman Sachs Global Economic, Commodities and Strategy Research, First Call

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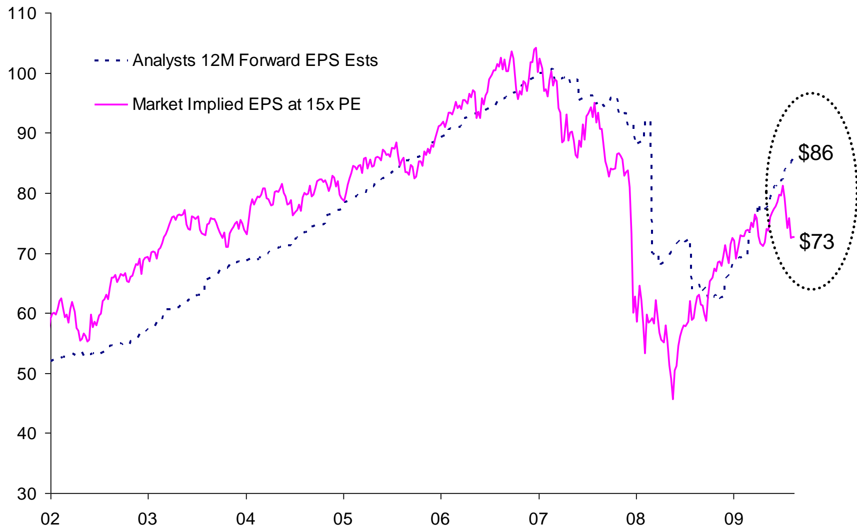
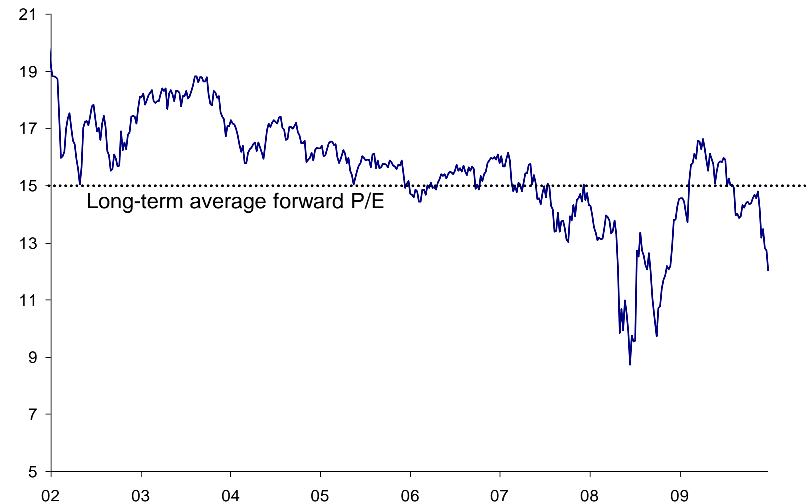
US Equity Outlook: Fundamentals

Our below consensus EPS view is still consistent with a rising market, as the market appears to be discounting a number even lower than our estimate

1. Next 12 Months Operating EPS (2002- June 2010)



2. S&P 500 Forward P/E Multiple (2002 – June 2010)



- The average forward P/E multiple on the S&P 500 in the post war period has been 15x.
- On that basis, a large gap has recently opened between consensus expectations for the next 12 months and what the market appears to be discounting.
- This could reflect concern about a double dip in the economy or a view that margins have already peaked, neither of which is our central case.

- Alternatively, the market may be applying a higher than average risk premium to forward earnings, given high levels of uncertainty.
- Either way, delivery on our earnings expectations should be positive for the market, as the onus will now be on the macro and micro data to corroborate the market's pessimistic view.

Source: Intrinsic Research, Investment Strategy Group

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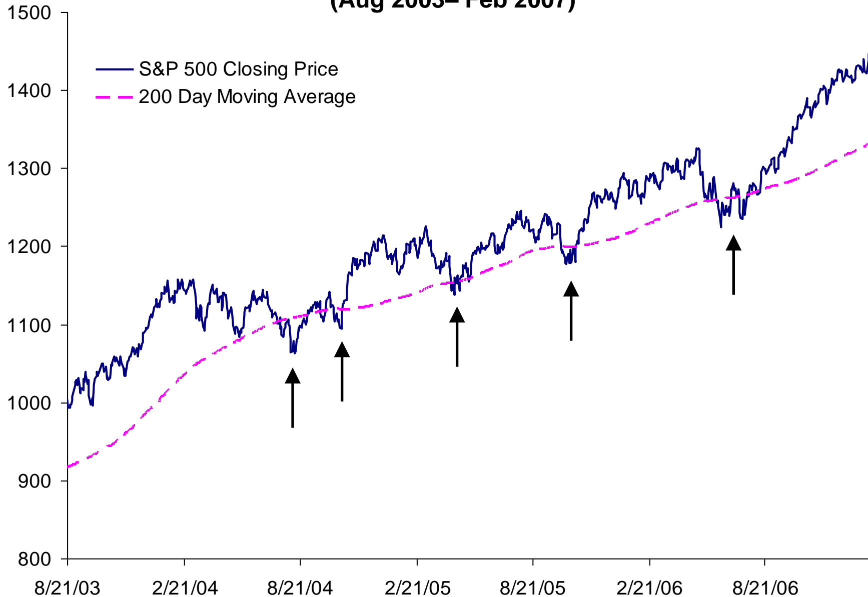
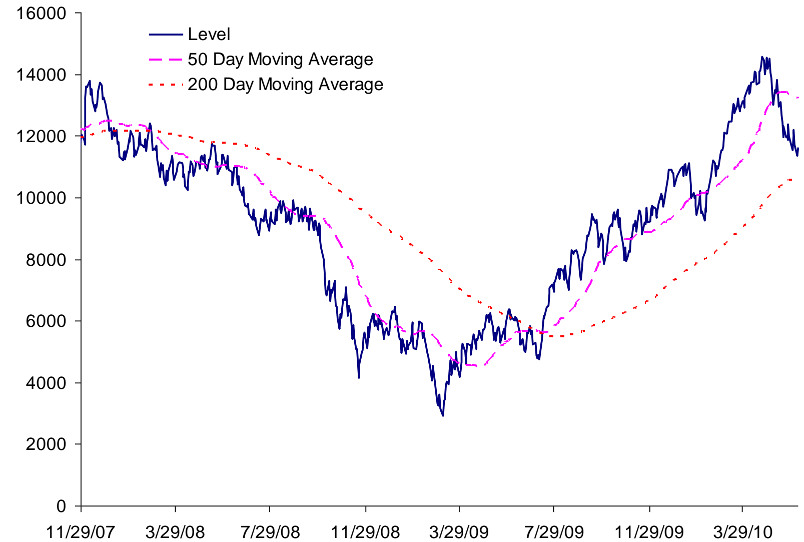
US Equity Outlook: Technical Analysis

Longer term momentum and breadth remain supportive





- At around 1060, the S&P has been consolidating below its 200 day moving average (~1107), a negative technical development as most institutions view the 200 day MA as the dividing line between technical strength and weakness.
- That said, closing below the 200 day MA is a necessary, but not sufficient criteria for a trend reversal.
- To wit, the market had no less than 5 consolidations below the 200 day MA during its uptrend from the 2003 lows.

- Despite the recent market weakness, market breadth continues to remain in a solid uptrend and in fact remains above its February pullback low and its 200 day MA. This demonstrates that the average stock is holding up better than the market.
- Moreover, longer-term momentum indicators, like the monthly MACD, remain on a buy signal, as it did throughout the pullbacks below the 200 day during the 2003-2006 uptrend.

Source: Bloomberg

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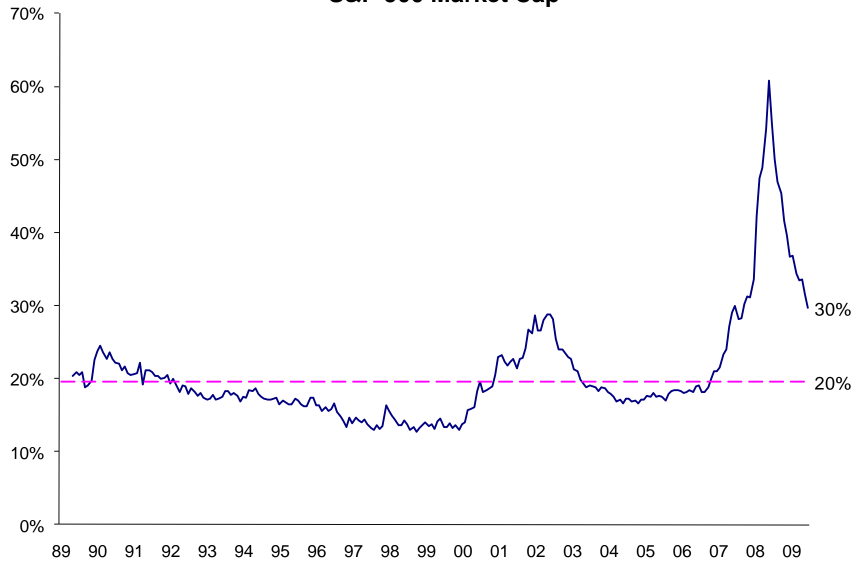
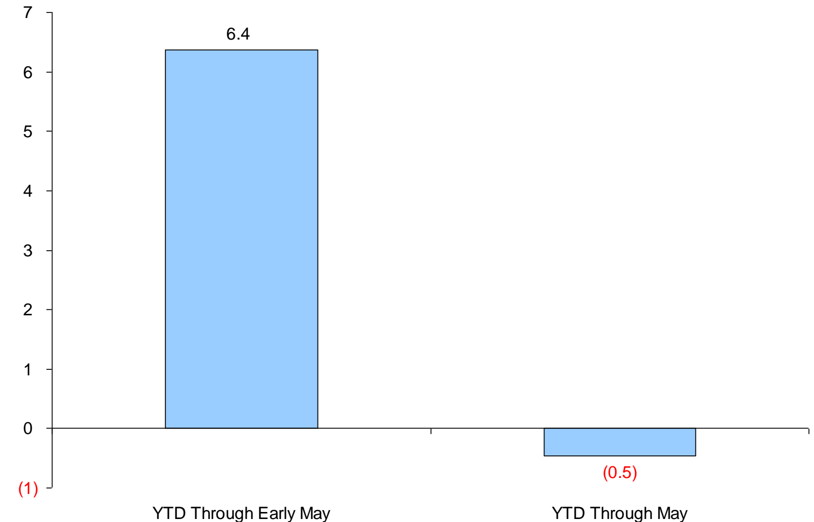
US Equity Outlook: Sentiment / Positioning

Sentiment and positioning remain skeptical, a positive from a contrarian standpoint





- Significant cash remains parked in money market funds earning virtually no return. Search for incremental yield provides a tailwind to risky assets, including equities.

- Investors had begun to tiptoe back into equity mutual funds into early May, but completely liquidated holdings over the course of the month, resulting in YTD outflows.
- This continues a trend from last year, making it hard to argue that retail investors are excessively bullish or complacent about the stock market.

Source: Datastream, ICI/AMG, AAII

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US Equity Outlook: 2010 Forecast

We remain comfortable with our 2010 forecast

2010 Year-End	Good Case (25%)	Central Case (60%)	Bad Case (15%)
End 2010 S&P 500 Earnings	Op. Earnings $85 Rep. Earnings $75 Trend Rep. Earnings $69	Op. Earnings $70-75 Rep. Earnings $60-64 Trend Rep. Earnings $69	Op. Earnings ≤ $55 Rep. Earnings ≤ $45 Trend Rep. Earnings ≤ $69
S&P 500 Price to Trend Reported Earnings	18.5-20.0x	15.5-18.5x	10-11x
End 2010 S&P 500 Fundamental Valuation Range	1277-1380	1070-1277	690-760
End 2010 S&P 500 Price Target (based on a combination of trend and forward earnings estimate)	1330	1150-1225	760

- The factors supporting our 2010 equity view:
  - Our return expectations starting the year were modest, with the mid-point of our central range implying mid-single digit returns.
  - Because we already assumed EPS growth would exceed GDP growth given operating leverage, we did not increase our equity targets when we revised our GDP growth rate higher.
  - The strong earnings performance in Q1 suggests that risks to our $70-75 operating earnings range are to the upside, a positive offset to the potential for slower GDP growth in the back half.

Source: Investment Strategy Group

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US Equity Outlook: 2011 Forecast

Our central case assumes further earnings growth, but a more balanced risk skew relative to 2010

2011 Year-End	Good Case (20%)	Central Case (60%)	Bad Case (20%)
End 2011 S&P 500 Earnings	Op. Earnings $97 Rep. Earnings $85 Trend Rep. Earnings $73	Op. Earnings $82-87 Rep. Earnings $70-74 Trend Rep. Earnings $73	Op. Earnings ≤ $65 Rep. Earnings ≤ $42 Trend Rep. Earnings ≤ $73
S&P 500 Price to Trend Reported Earnings	18.5-20.0x	15.5-18.5x	10-11x
End 2011 S&P 500 Fundamental Valuation Range	1341-1450	1124-1341	725-800
End 2011 S&P 500 Price Target (based on a combination of trend and forward earnings estimate)	1400	1225-1300	800

- As before, a key swing factor will be the path of credit costs.
  - Bank charge-off rates are already at 75 year highs and provisions are running north of 3% of loans. Most of these charge-offs have been concentrated in consumer credit, where we have started to see signs of early delinquencies peaking.
  - The employment backdrop is key, as financials charge-off cycle typically peak 2-4Qs after unemployment
  - Every 10 bps reduction in the loan loss provisions rate results in 40c of S&P 500 EPS

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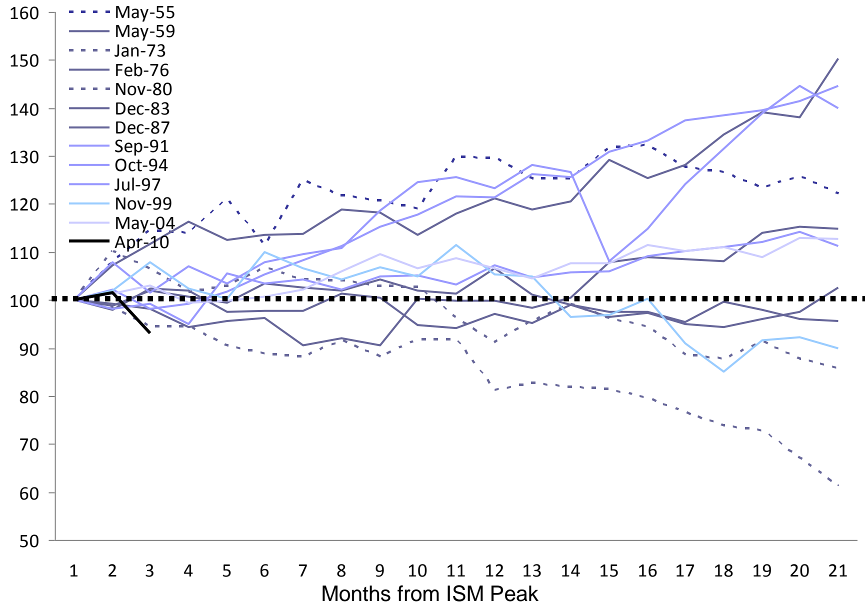
US Equity Outlook

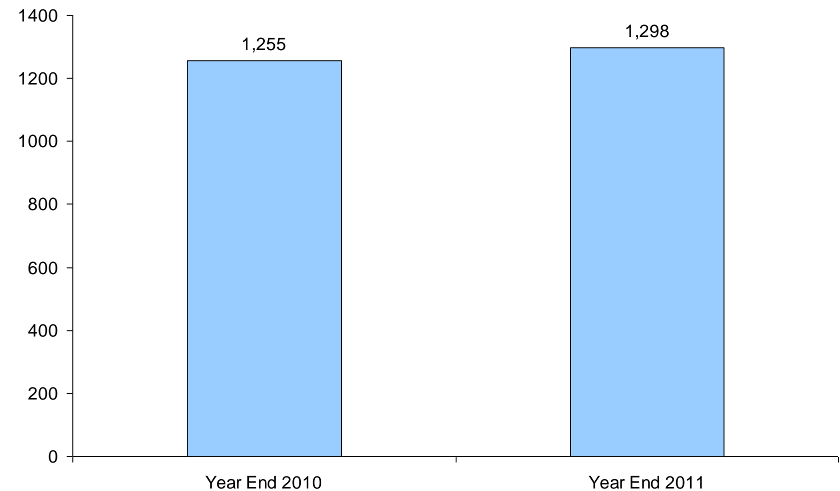
Our central case equity targets are consistent with a peak in leading indicators, such as the ISM

1. S&P 500 Price Returns: Indexed from Peak in ISM (1955-2010)



- The impact of peaking leading indicators, such as the ISM, is not as detrimental to forward equity returns as intuition might suggest.
- Importantly, a deceleration in the rate of growth is not the same as negative growth.
- That said, peaking leading indicators do temper annual returns to the mid-single digit range on average.

2. Year-End S&P 500 Targets Based on Average of Peaking ISM Precedents



- More specifically, if we assume the ISM peaked in April at an S&P level of 1,202, the average historical experience would suggest only modest forward returns from that level of 4.4% (to 1,255) and 8% (to 1,298), respectively,

Source: Datastream

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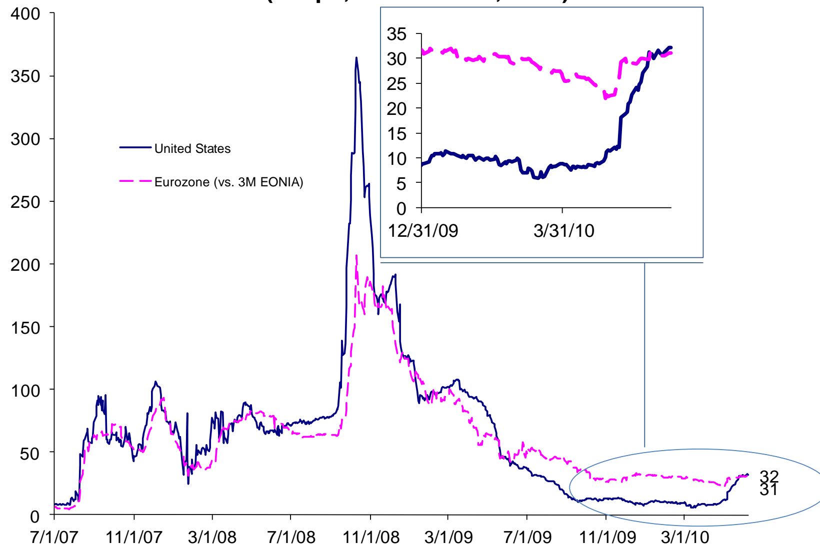
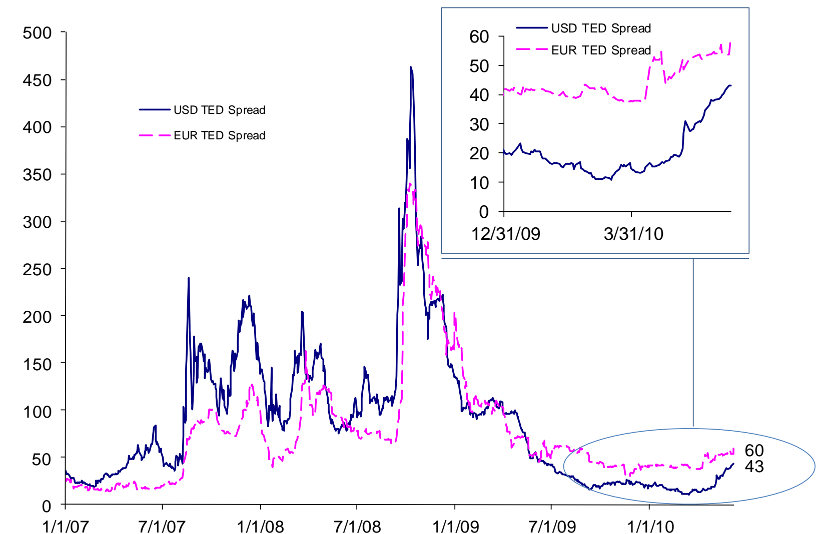
Appendix

Financial Sector Stress and Market Sentiment

We Continue to Watch for Signs of Stress in the Financial Markets





- The recent uptick in key financial market stress indicators appears small when compared to the 2008 highs.
- That said shifts in sentiment can occur quickly, reinforcing negative feedback loops.
- Given the linkage between the financial markets and the European fiscal situation, we will continue to monitor these measures for signs of stress.

Source: Bloomberg, Investment Strategy Group

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Appendix
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Alternative Investments are not required to provide their investors with periodic pricing or valuation information.

We refer you to the offering materials for a more complete discussion of the risks relating to an investment in any particular Alternative Investment.
You are urged to read all of the offering materials, including the entire offering memorandum, prior to any investment in any Alternative Investment, and to ask questions of the investment manager or sponsor of such Alternative Investment.

Investment Restrictions apply to many of Goldman Sachs' Alternative Investments.

Appendix
Important Information

There may be conflicts of interest relating to the Alternative Investment and its service providers, including Goldman Sachs and its affiliates, who are engaged in businesses and have interests other than that of managing, distributing and otherwise providing services to the Alternative Investment. These activities and interests include potential multiple advisory, transactional and financial and other interests in securities and instruments that may be purchased or sold by the Alternative Investment, or in other investment vehicles that may purchase or sell such securities and instruments. These are considerations of which investors in the Alternative Investment should be aware. Additional information relating to these conflicts is set forth in the offering materials for the Alternative Investment.

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