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Global macro and market outlook: Challenges and opportunities for maturing EMs

Magdalena Polan

Senior CEEMEA Economist

Magdalena.Polan@gs.com

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Outline

- Global market and macro outlook
- EM – an increasingly important player in global economy
- EMs in the next decade – ‘not your older brother’s emerging markets’
- Changing trade patterns and benefits of transition into developed markets, benchmark reclassification

Global macro outlook

Our macro markets conviction list points to benign view

- An above-trend US growth path from here on
- Euro area – progressing but slower adjustment
- Still room to grow without rapid inflation pressure
- Fed hikes: later but steeper
- DM equity valuations to stay higher than average
- Volatility to stay low
- Incomplete adjustments in some countries, more relief in China
- Renewed focus on Japan

5 key risks to the benign view

- Growth: Deleveraging headwinds keep growth weak
- Capacity: Less room before growth leads to inflation
- Overseas crises: larger spillover from Europe, China or EM, or US
  - more risk, and…
  - …stronger transmission of shocks
- Rates: A sharper, more disruptive rise in rates on the "exit" from accommodative policies in the US, Europe
- Valuation: Too much good news is already priced
- Plus the "usual suspects": geopolitical risk, policy errors and other unexpected shocks

Global recovery expected to pick up further in H2, led by US and China

GDP Growth, %yoy	2012	2013	2014		2015	
			GS	Consensus*	GS	Consensus*
USA	2.3	2.2	2.1	2.1	3.1	3.1
Japan	1.5	1.5	1.1	1.5	1.2	1.2
Euro Area	-0.6	-0.4	0.8	1.0	1.4	1.5
UK	0.3	1.7	3.4	3.1	3.0	2.6
Brazil	1.0	2.5	0.8	1.0	1.3	1.4
China	7.7	7.7	7.3	7.4	7.6	7.2
India	4.8	4.7	5.1	5.4	6.3	6.2
Russia	3.5	1.3	0.5	0.0	1.5	1.1
BRICs	5.4	5.2	4.6	4.5	5.3	5.1
Advanced Economies	1.2	1.4	1.9	1.9	2.5	2.4
World	3.0	3.0	3.1	3.1	3.7	3.6

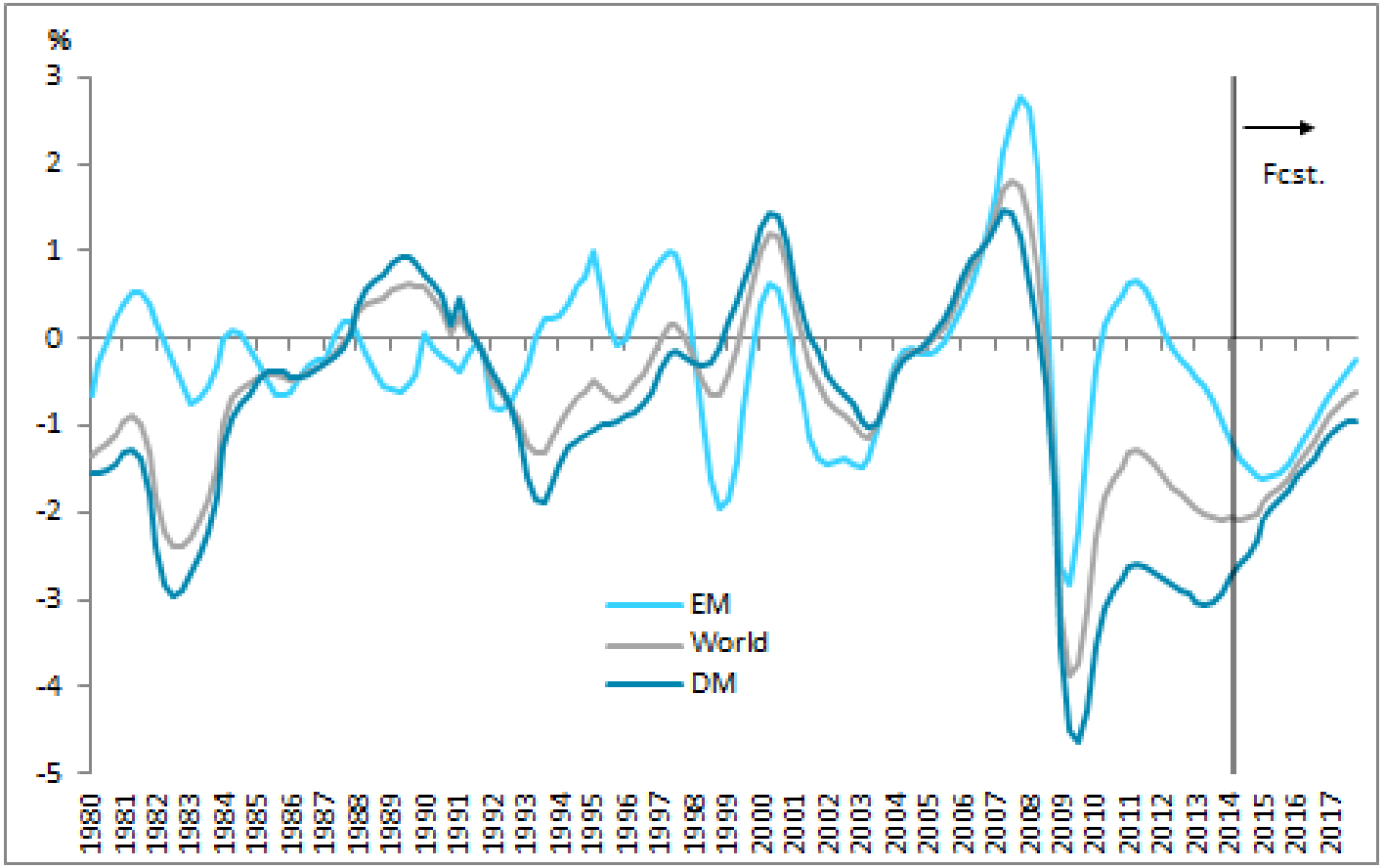
Source: Consensus Economics, Goldman Sachs Global Investment Research

* Consensus forecasts refer to July 2014

The benign consensus

Negative output gaps around the world, but much more "room" in developed markets

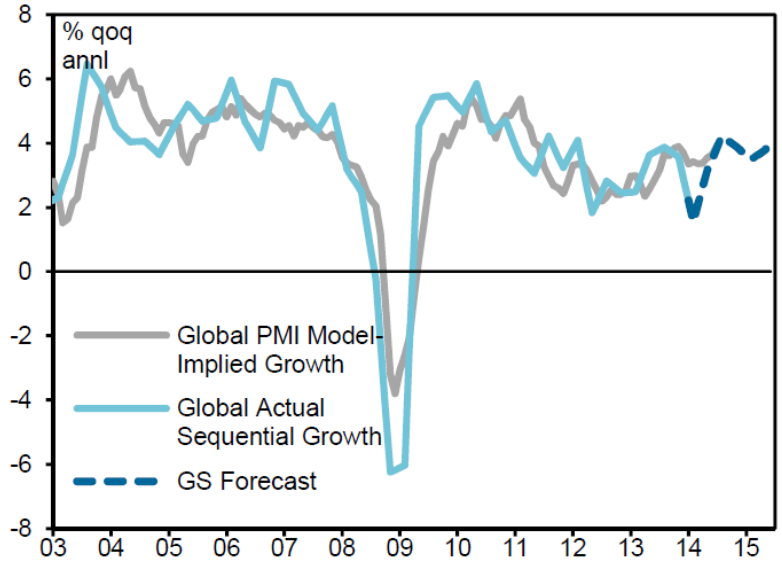
Difference between actual and potential GDP (% of potential)



Source: Goldman Sachs Global Investment Research

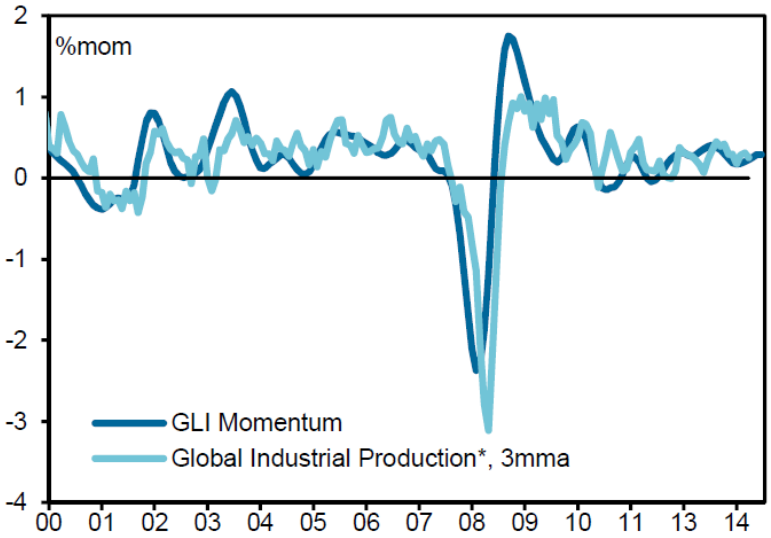
Cyclical indicators point to sustained global growth…

PMI-implied global growth



See *Global Economics Weekly 12/18* for methodology
Source: OECD, Goldman Sachs Global Investment Research

GLI momentum vs. global industrial production*

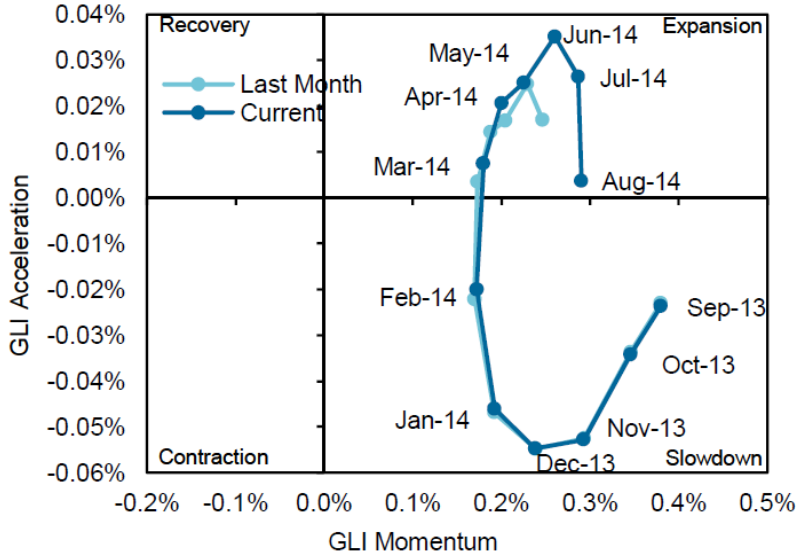


* Includes OECD countries plus BRICs, Indonesia and South Africa
See *Global Economics Paper 199* for methodology
Source: OECD, Goldman Sachs Global Investment Research

GLI – Global Leading Indicator

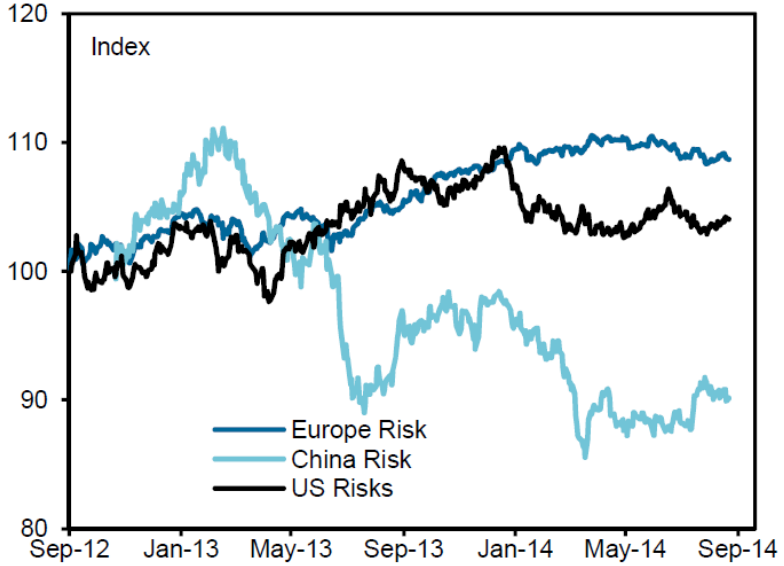
...as the cycle matures and some global risks abate

GLI 'Swirlogram'



See *Global Economics Paper 214* for methodology
Source: OECD, Goldman Sachs Global Investment Research

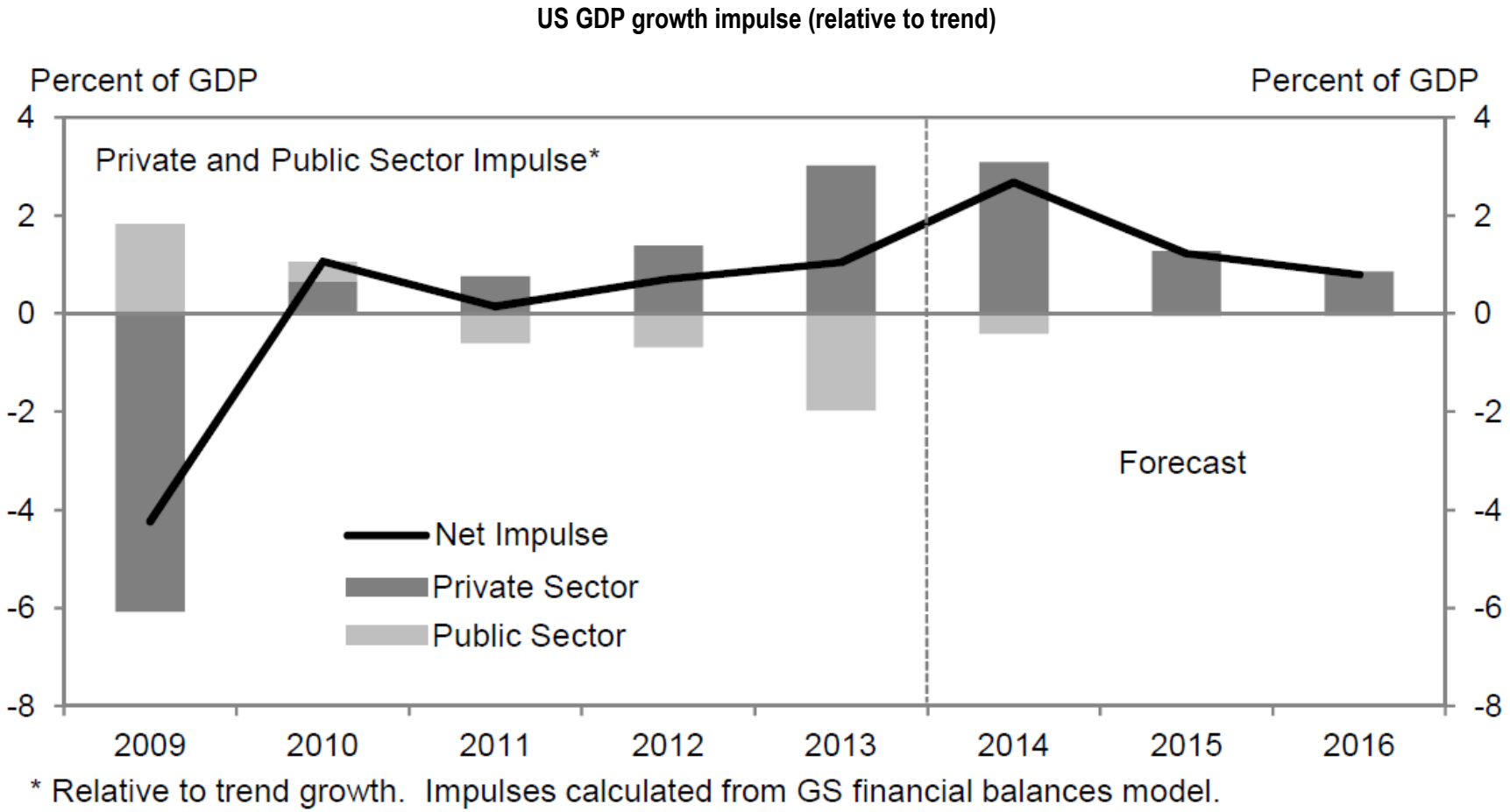
China, Europe and US risk factors



See *Global Economics Weekly 12/15* for methodology
Source: Goldman Sachs Global Investment Research

US

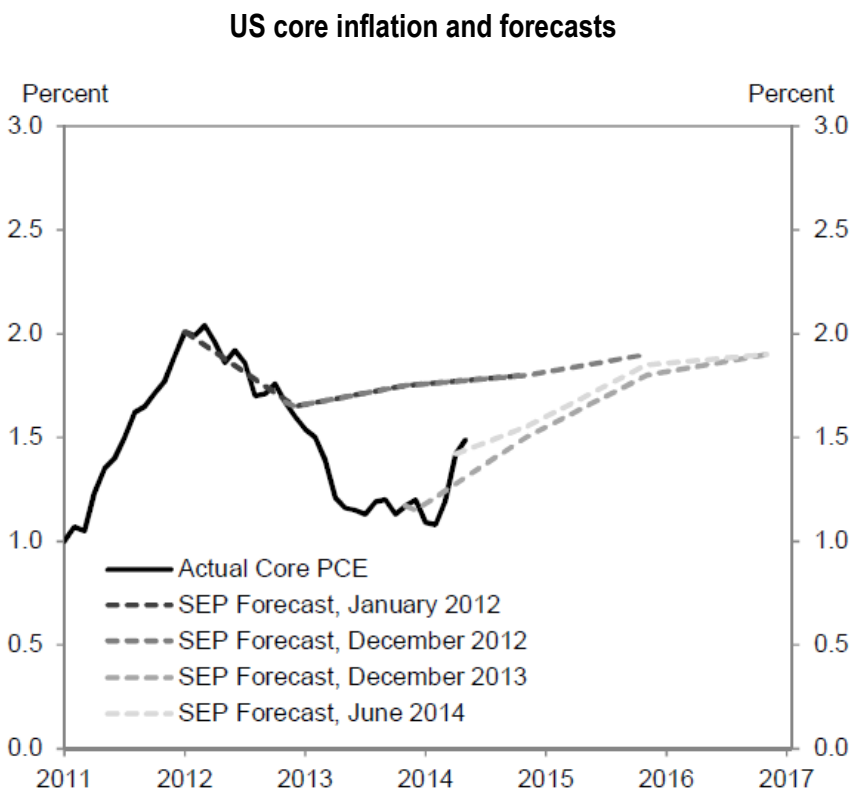
Growth in the US picking up to above trend as fiscal drag recedes

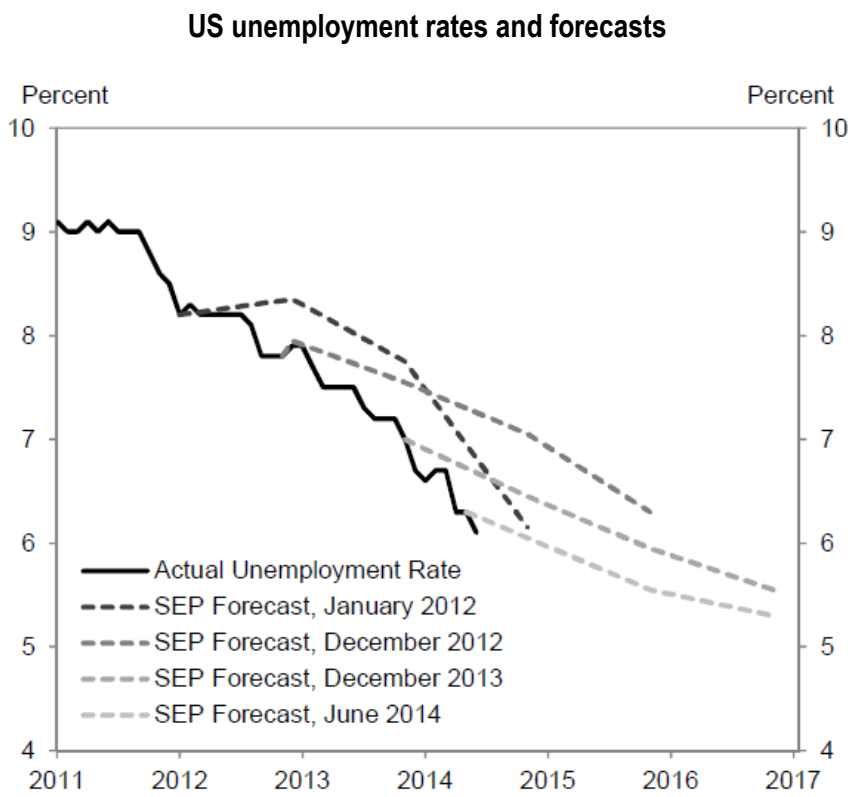


Source: Goldman Sachs Global Investment Research

The benign consensus

Inflation higher as unemployment falls more quickly than expected

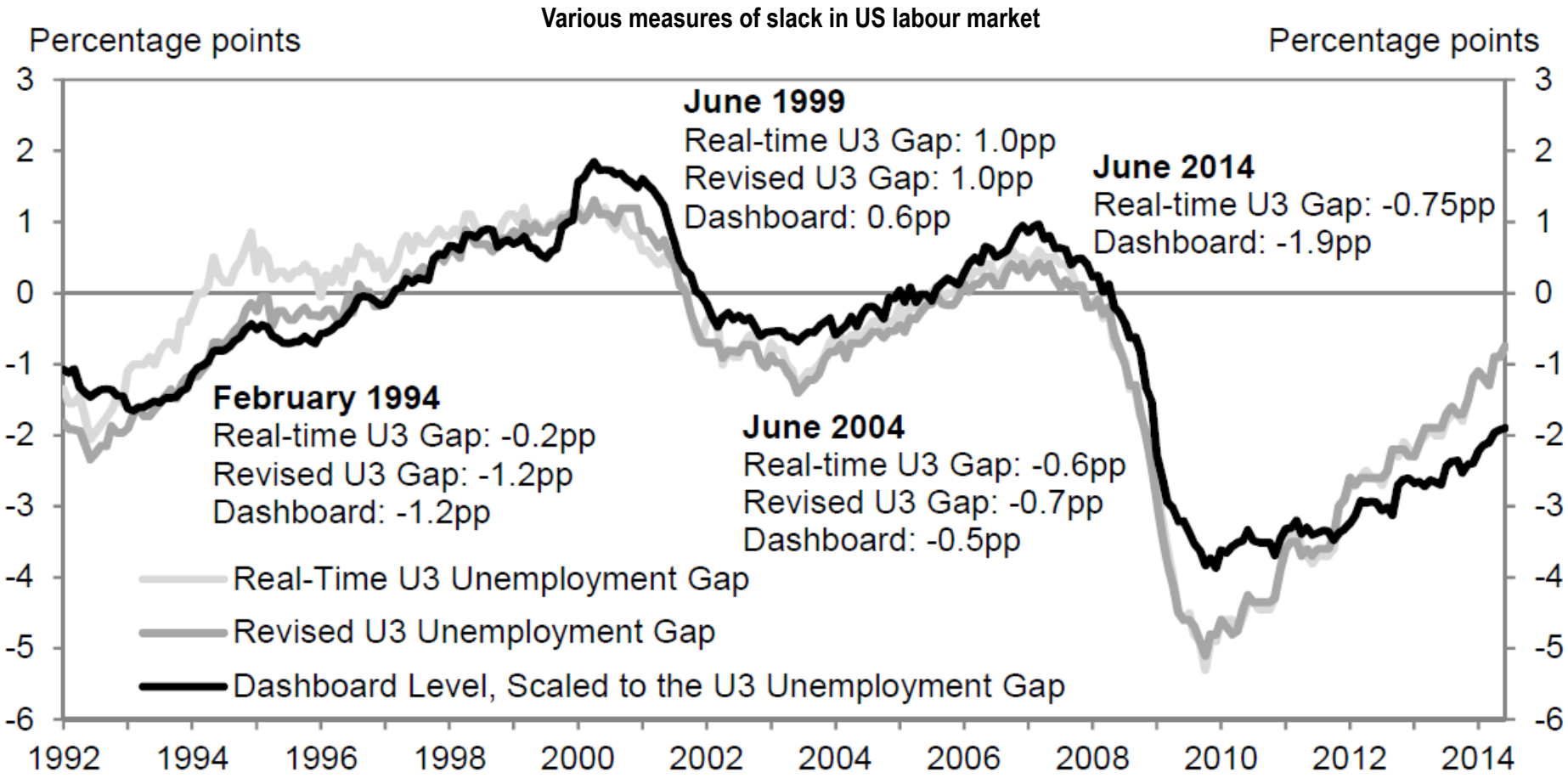




Source: US Commerce Department, Federal Reserve Board

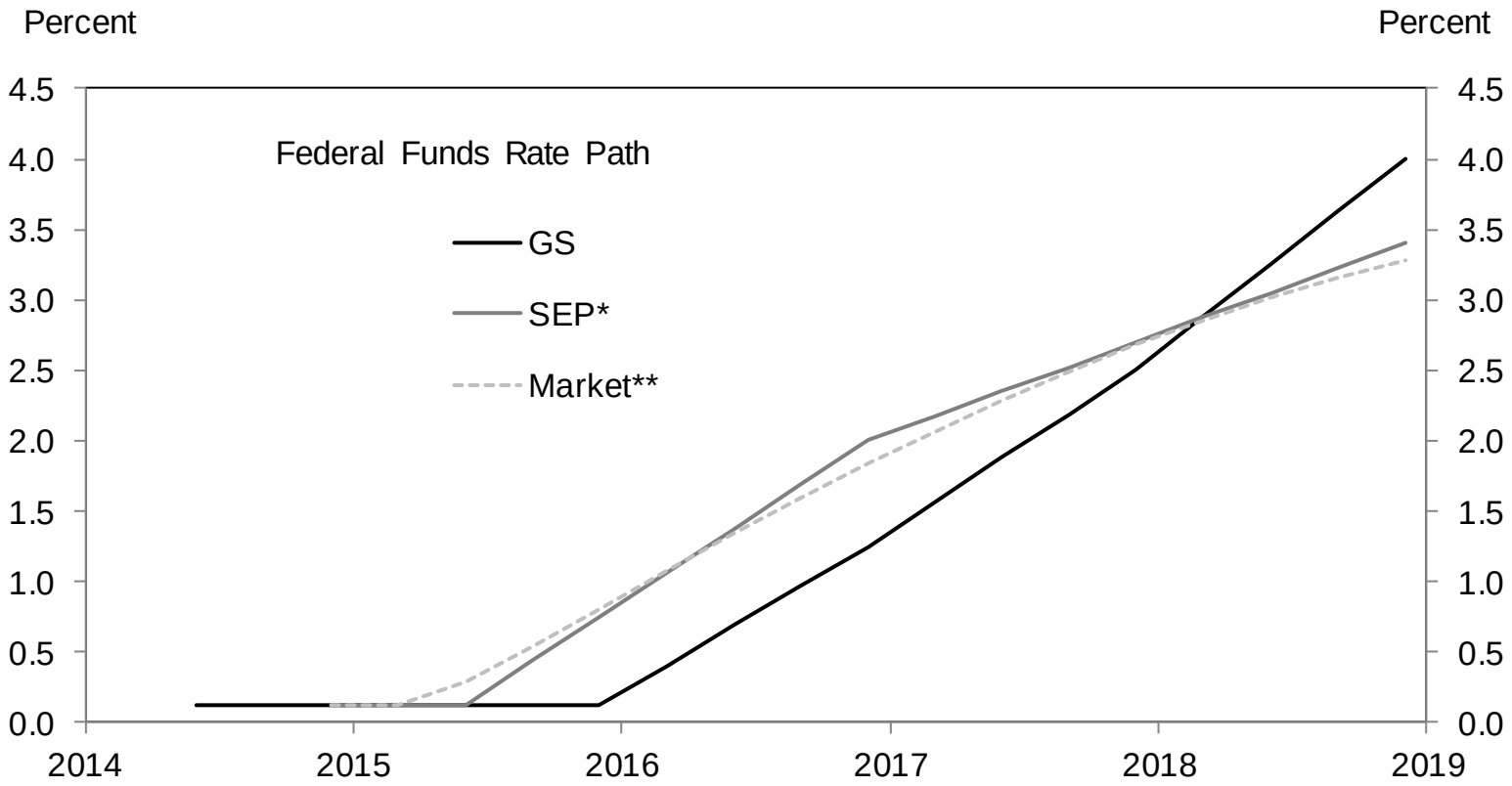
The benign consensus

While there is uncertainty, our view is that significant 'slack' remains



Source: Goldman Sachs Global Investment Research
U3 Unemployment rate: people without jobs who have actively looked for work within the past four weeks (ILO definition)

We expect a patient and gentle Fed exit from monetary stimulus



*Path implied by 5th-lowest SEP dot. We use mid-2019 for the longer-term funds rate projection, in line with previous FOMC communications that the funds rate would rise gradually over 2-3 years after 2016.
**Risk-neutral curve derived from Eurodollar futures.

The benign consensus

Source: Goldman Sachs Global Investment Research

China

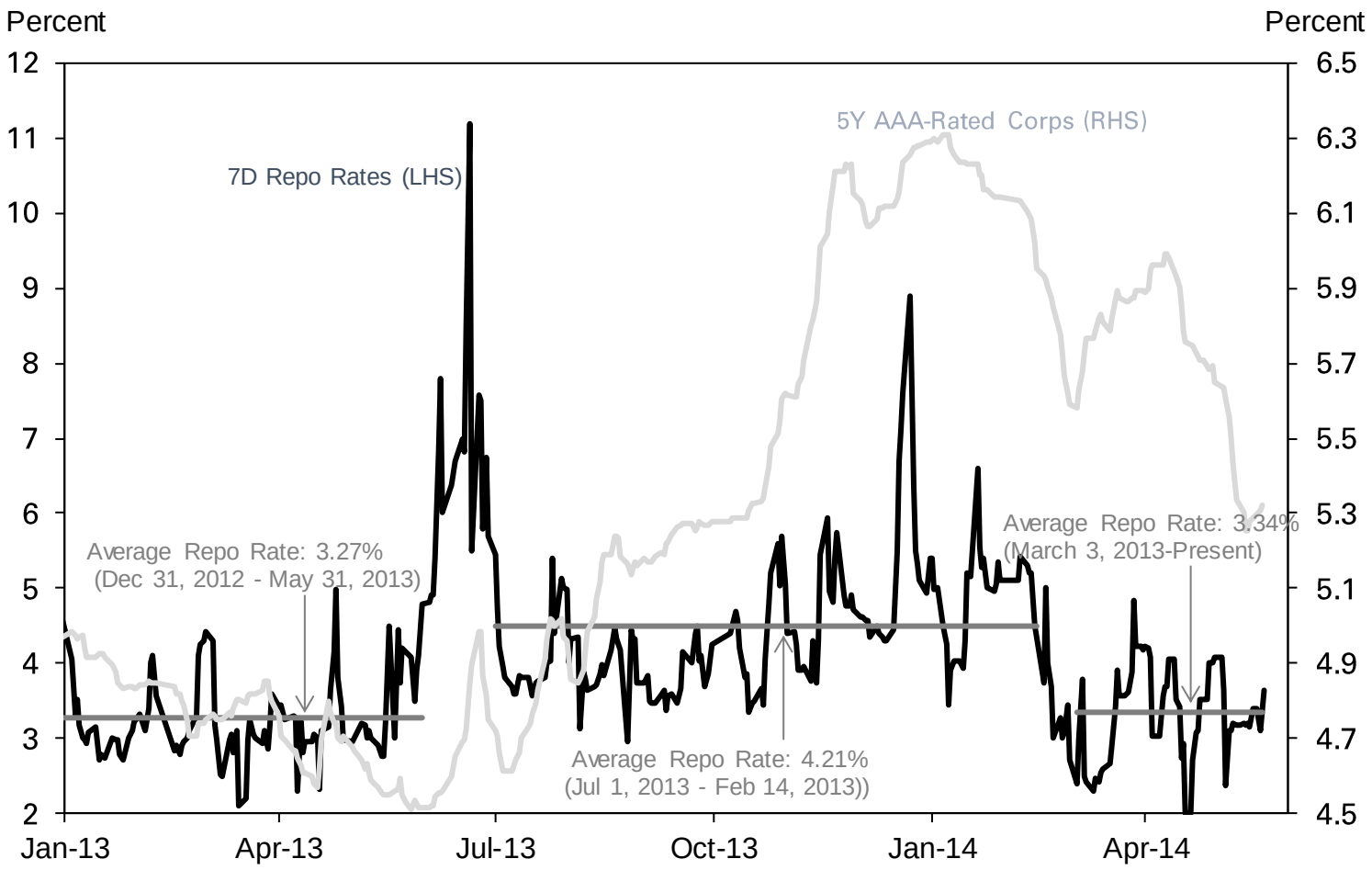
Chinese exports have picked up in recent months ...

Note: Major trading partners include the G-3, ASEAN (Philippines excluded), Korea, India, Taiwan and Hong Kong

Source: Haver Analytics, Goldman Sachs Global Investment Research

The benign consensus

… and previous monetary policy tightening has been unwound, supporting growth

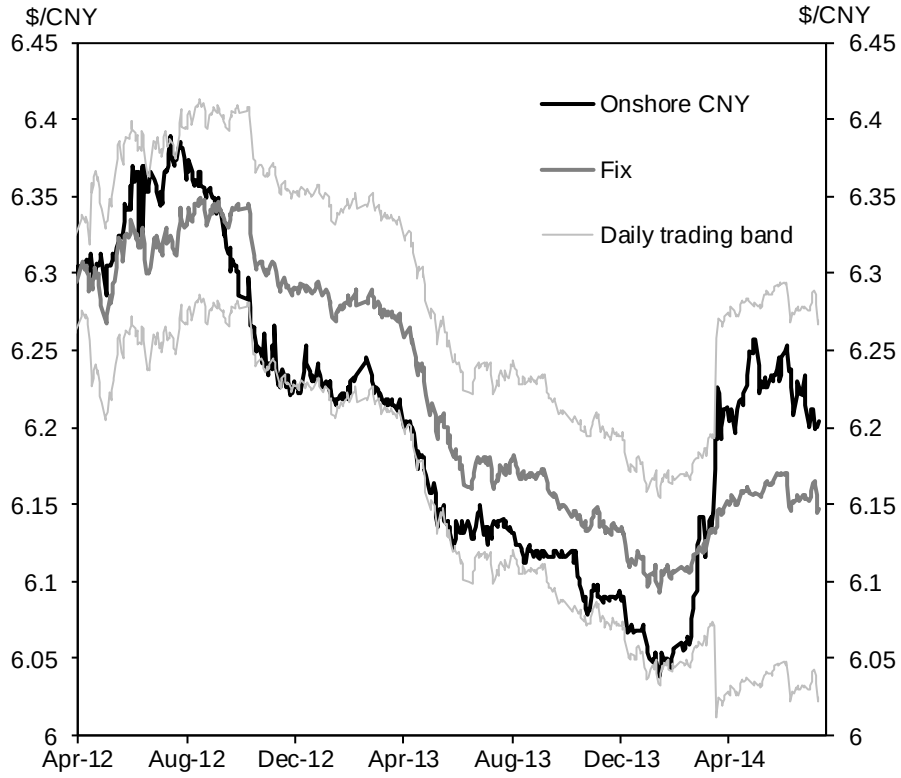


Source: Bloomberg

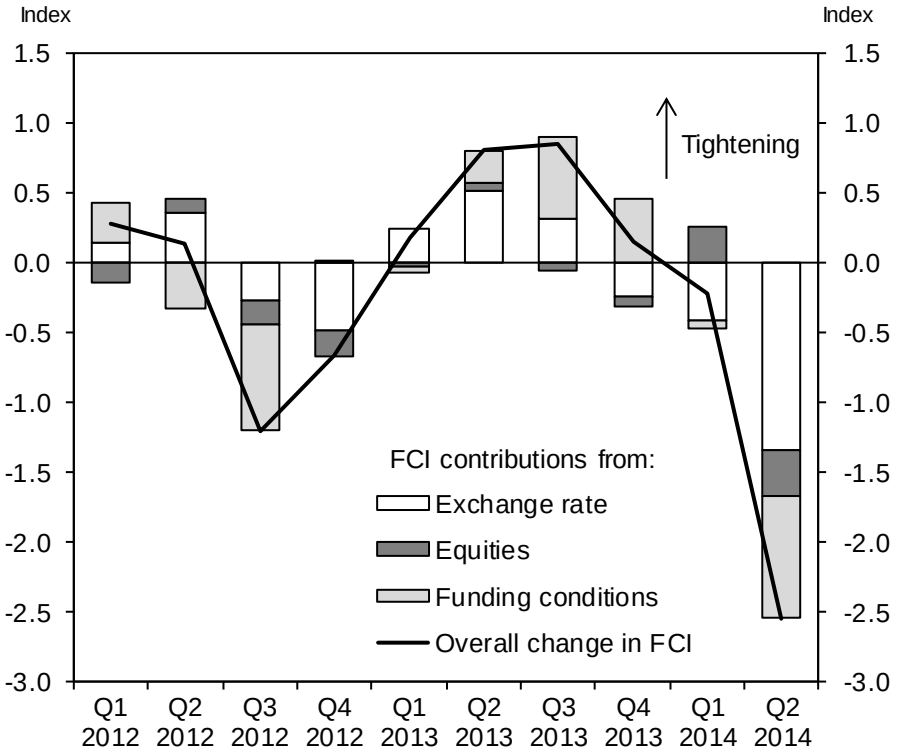
The benign consensus

Chinese financial conditions have eased, largely thanks to weaker currency

Currency appreciation was significant in 2013, but has mostly been unwound …



… helping to ease broader financial conditions



Source: Goldman Sachs Global Investment Research

The benign consensus

Inflation

Global inflation appears benign, given the extent of slack …

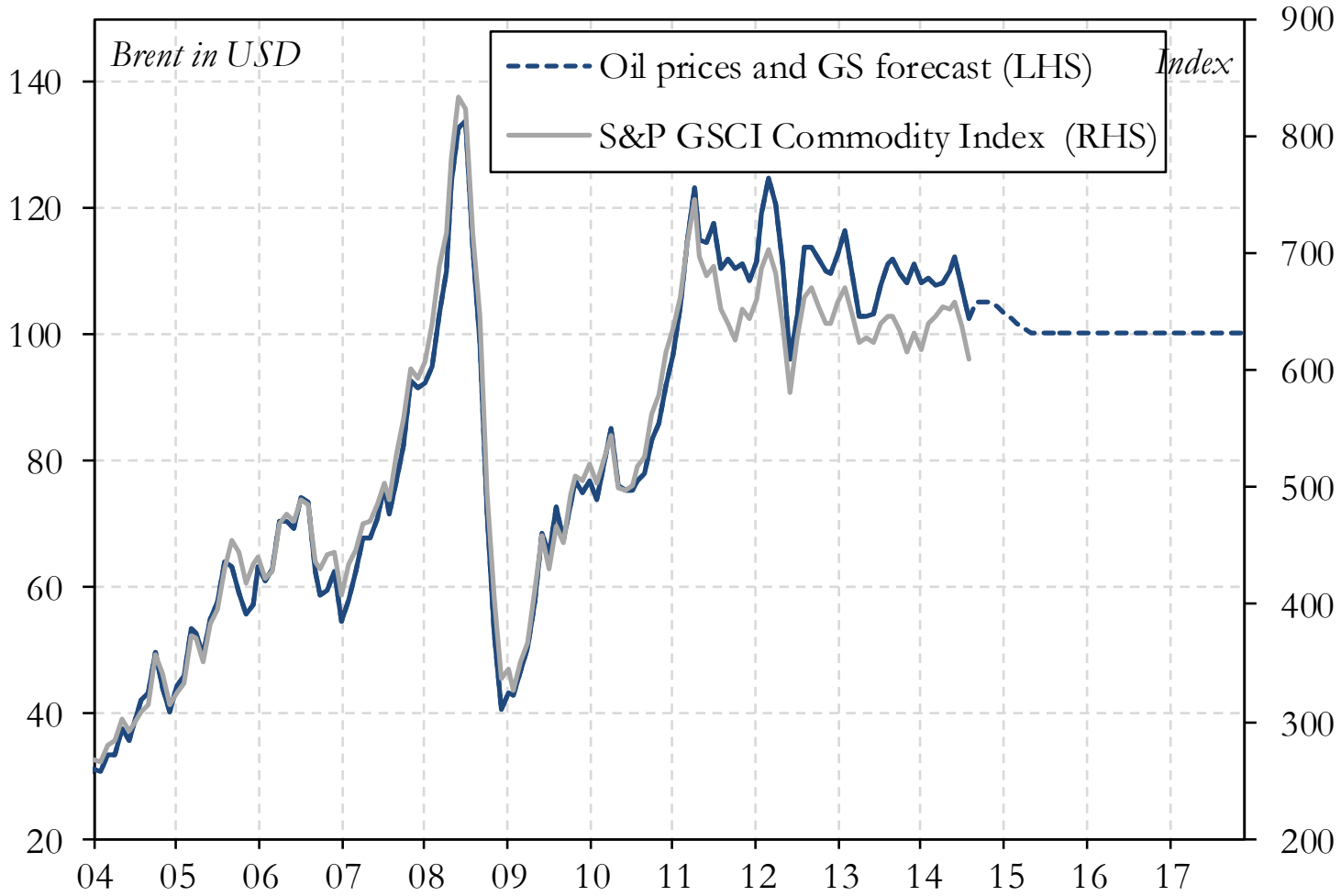
Inflation, %yoy	2012	2013	2014		2015	
			GS	Consensus*	GS	Consensus*
USA	2.1	1.5	1.9	1.9	2.0	2.1
Japan	0.0	0.4	2.8	2.7	1.7	1.8
Euro Area	2.5	1.3	0.6	0.6	1.1	1.1
UK	2.8	2.6	1.6	1.7	1.6	2.0
Brazil	5.4	6.2	6.3	6.4	6.2	6.1
China	2.7	2.6	2.4	2.4	3.0	2.9
India	7.5	6.3	6.1	5.5	6.1	5.5
Russia	5.1	6.6	7.5	7.1	5.6	5.6
BRICs	4.8	4.9	6.2	6.2	5.9	5.6
Advanced Economies	2.0	1.4	1.6	1.6	1.7	1.8
World	3.2	2.8	3.6	3.6	3.6	3.5

Source: Consensus Economics, Goldman Sachs Global Investment Research

* Consensus forecasts refer to July 2014

The benign consensus

… and expectation that oil and commodity prices will fall from here…

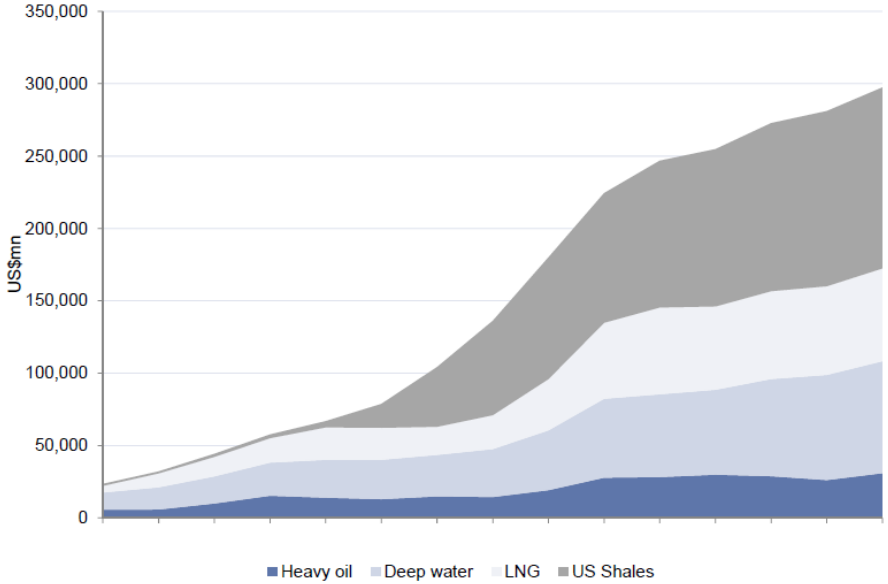


The benign consensus

Source: Datastream, Goldman Sachs Global Investment Research

… with the US 'shale revolution' playing a central role

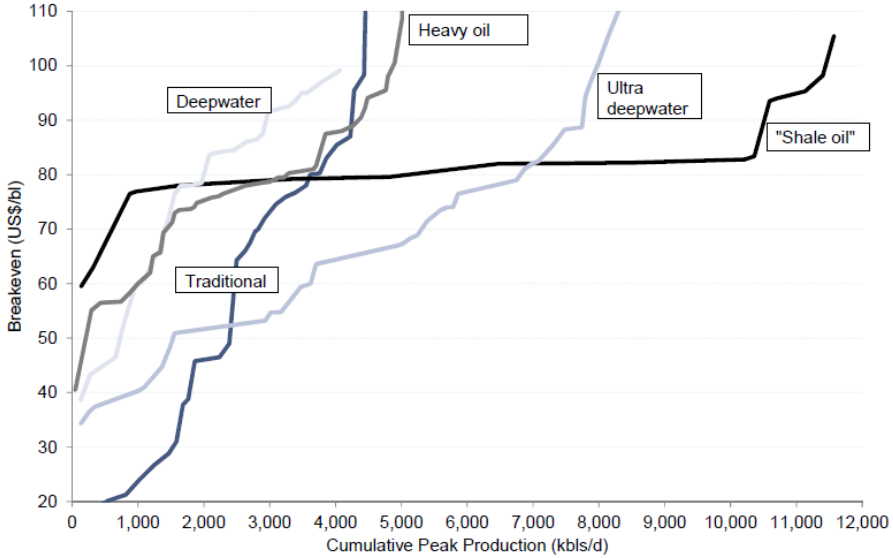
Growth in unconventional developments has dominated the past decade



Source: Company data, Goldman Sachs Global Investment Research.

Shale oil substitutes the need for projects with US$85/bl+ breakeven

Top 400 breakeven of non-producing oil assets by category

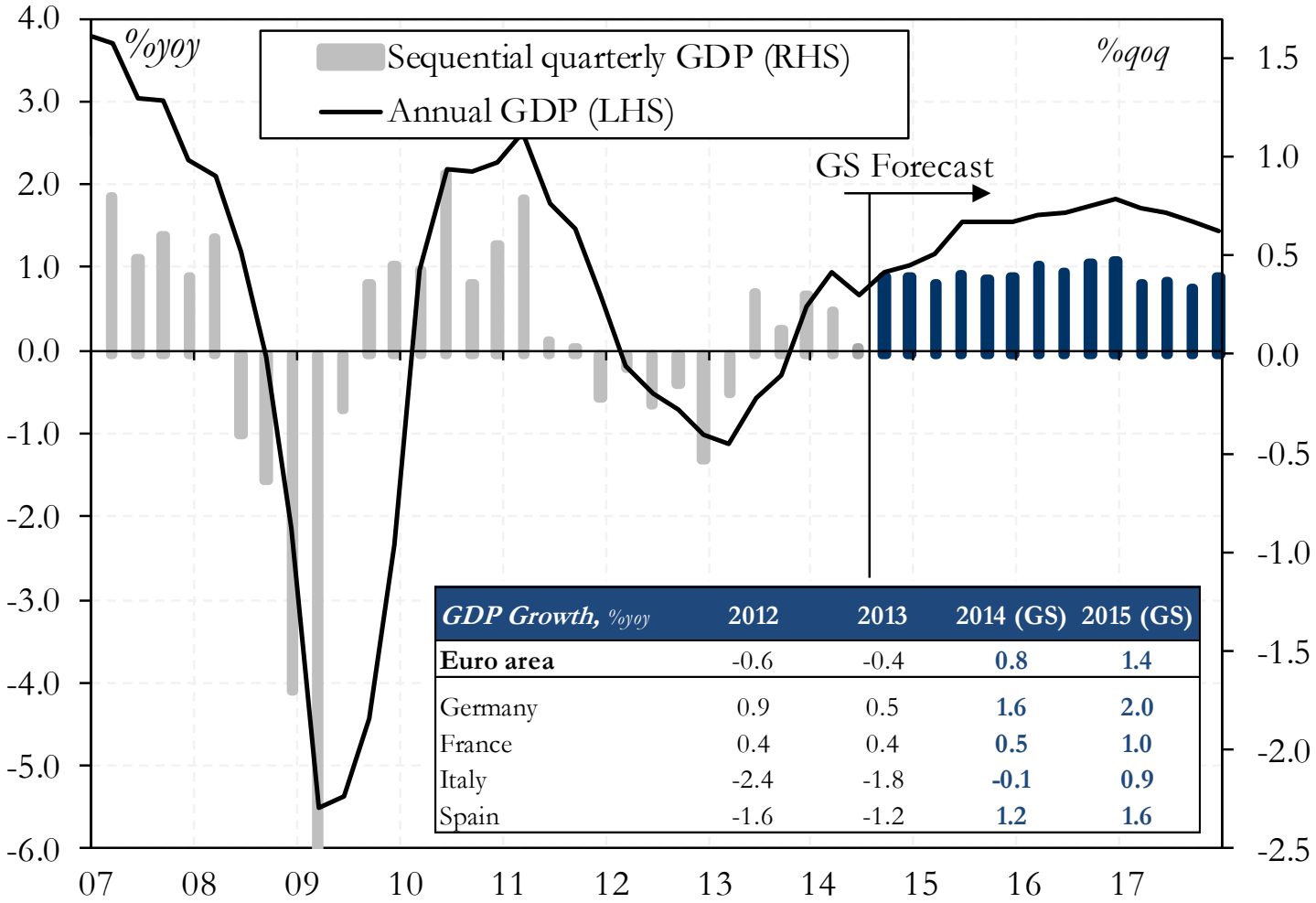


Source: Company data, Goldman Sachs Global Investment Research.

The benign consensus

Euro area

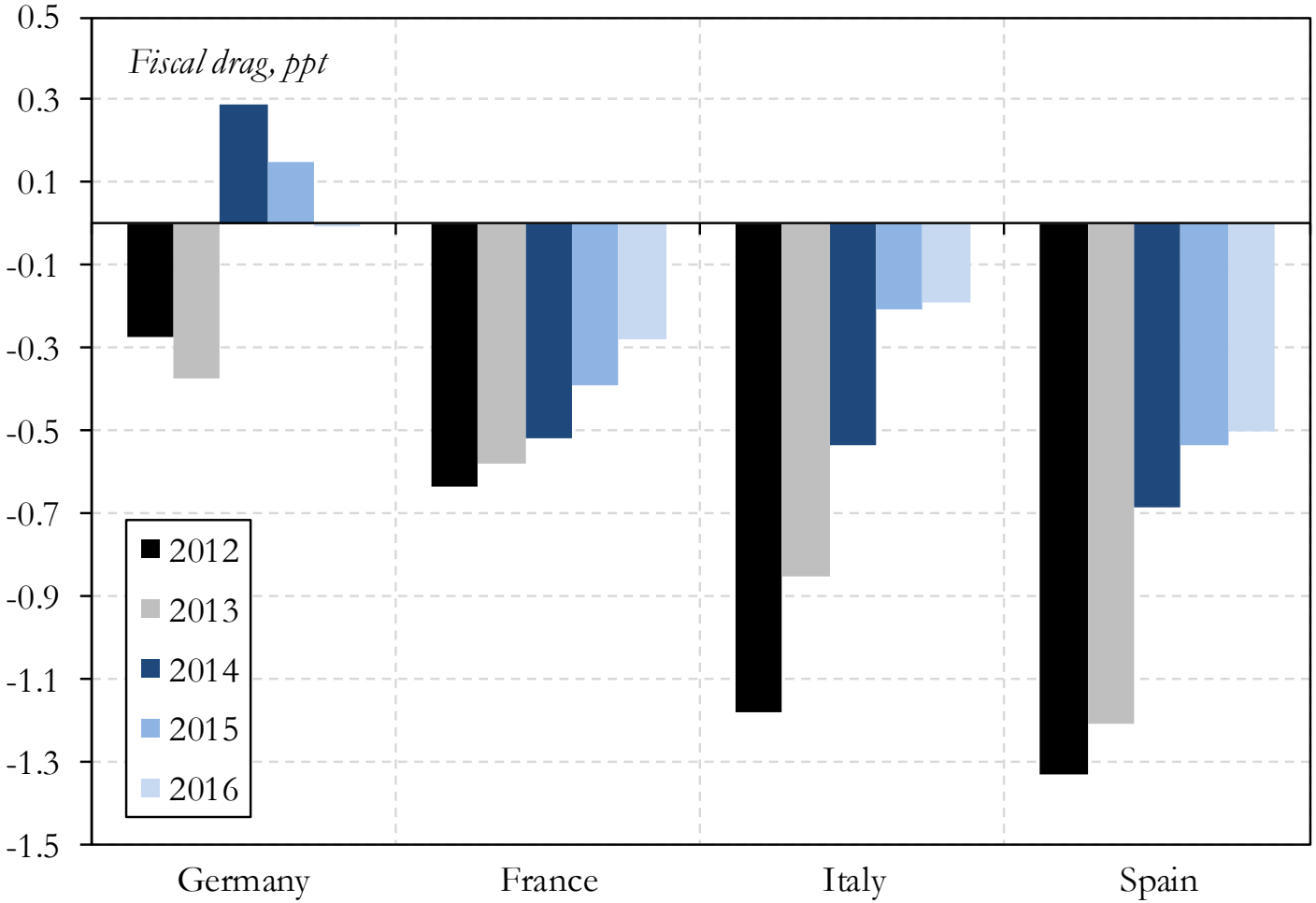
We expect a below-trend recovery for Euro area economic activity …



GDP Growth, %yoy	2012	2013	2014 (GS)	2015 (GS)
Euro area	-0.6	-0.4	**0.8**	**1.4**
Germany	0.9	0.5	**1.6**	**2.0**
France	0.4	0.4	**0.5**	**1.0**
Italy	-2.4	-1.8	**-0.1**	**0.9**
Spain	-1.6	-1.2	**1.2**	**1.6**

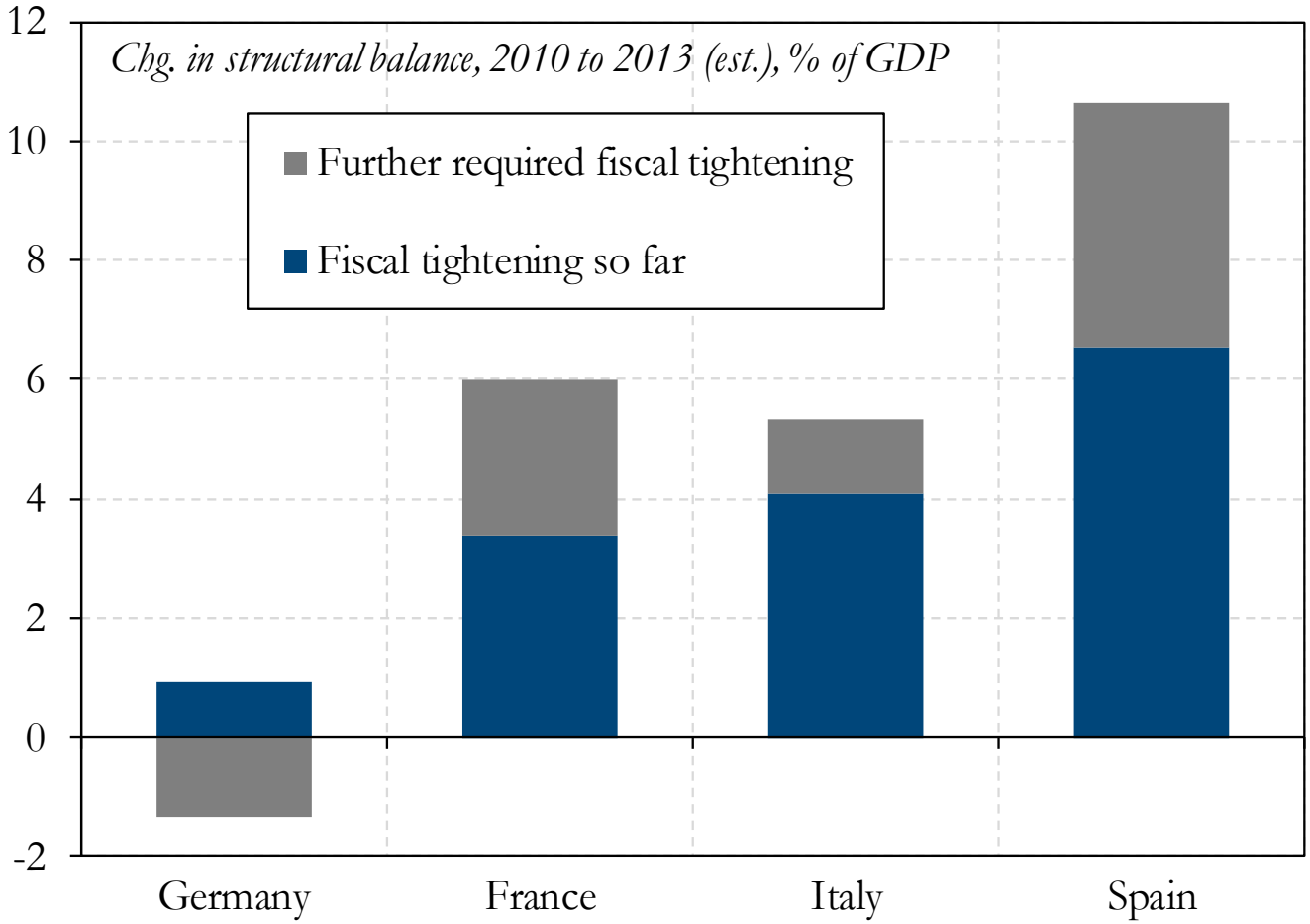
Source: Eurostat, Goldman Sachs Global Investment Research

... and fiscal drag on growth diminishes as the pace of austerity eases ...



Source: Goldman Sachs Global Investment Research

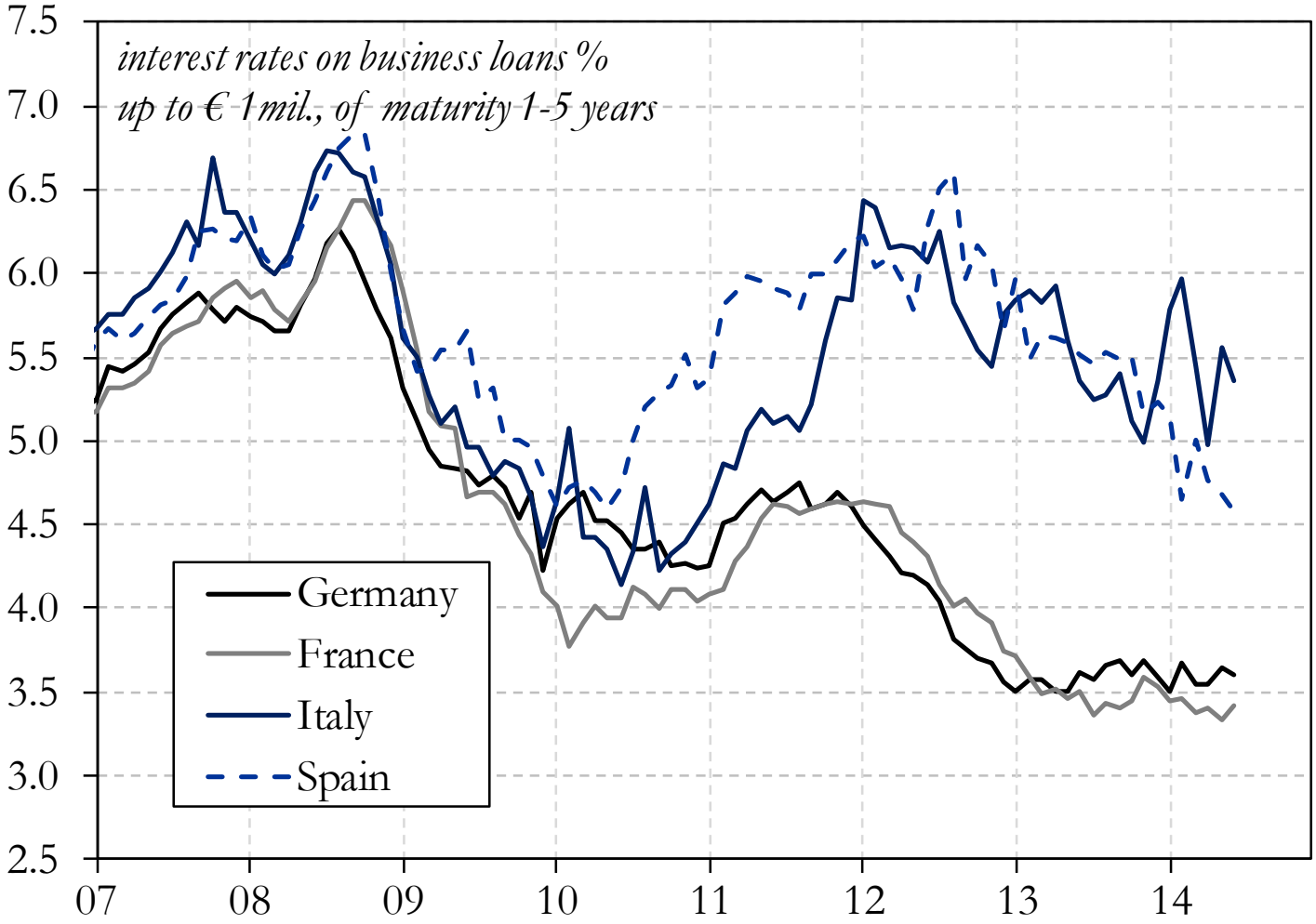
… despite the need for further fiscal consolidation in several countries



Required improvement in structural budget balance to reach a level of debt-to-GDP of 60% over a 20 year period, starting from projected debt peaks.

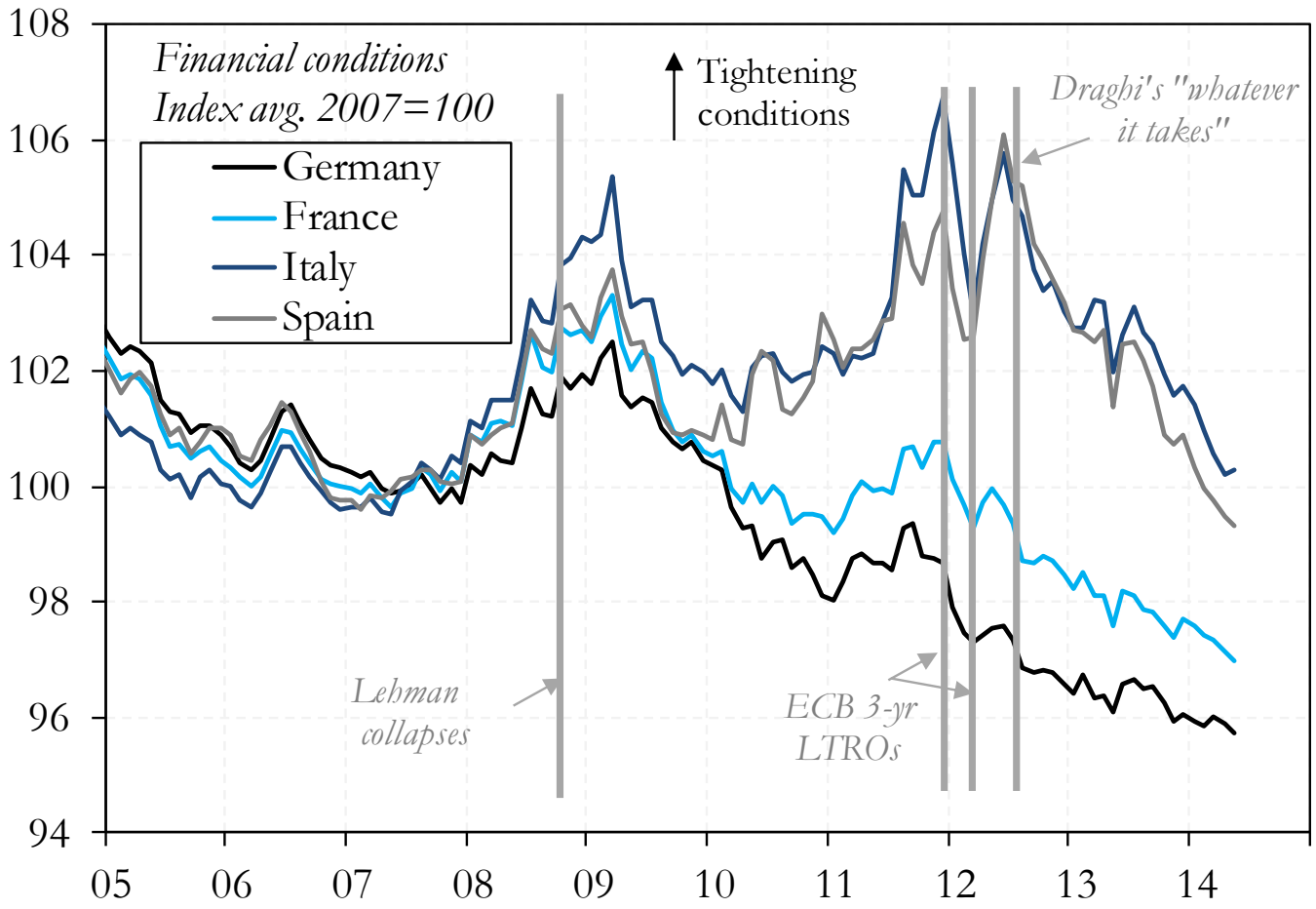
Source: Goldman Sachs Global Investment Research, ECB

Interest rates are declining, supporting recovery



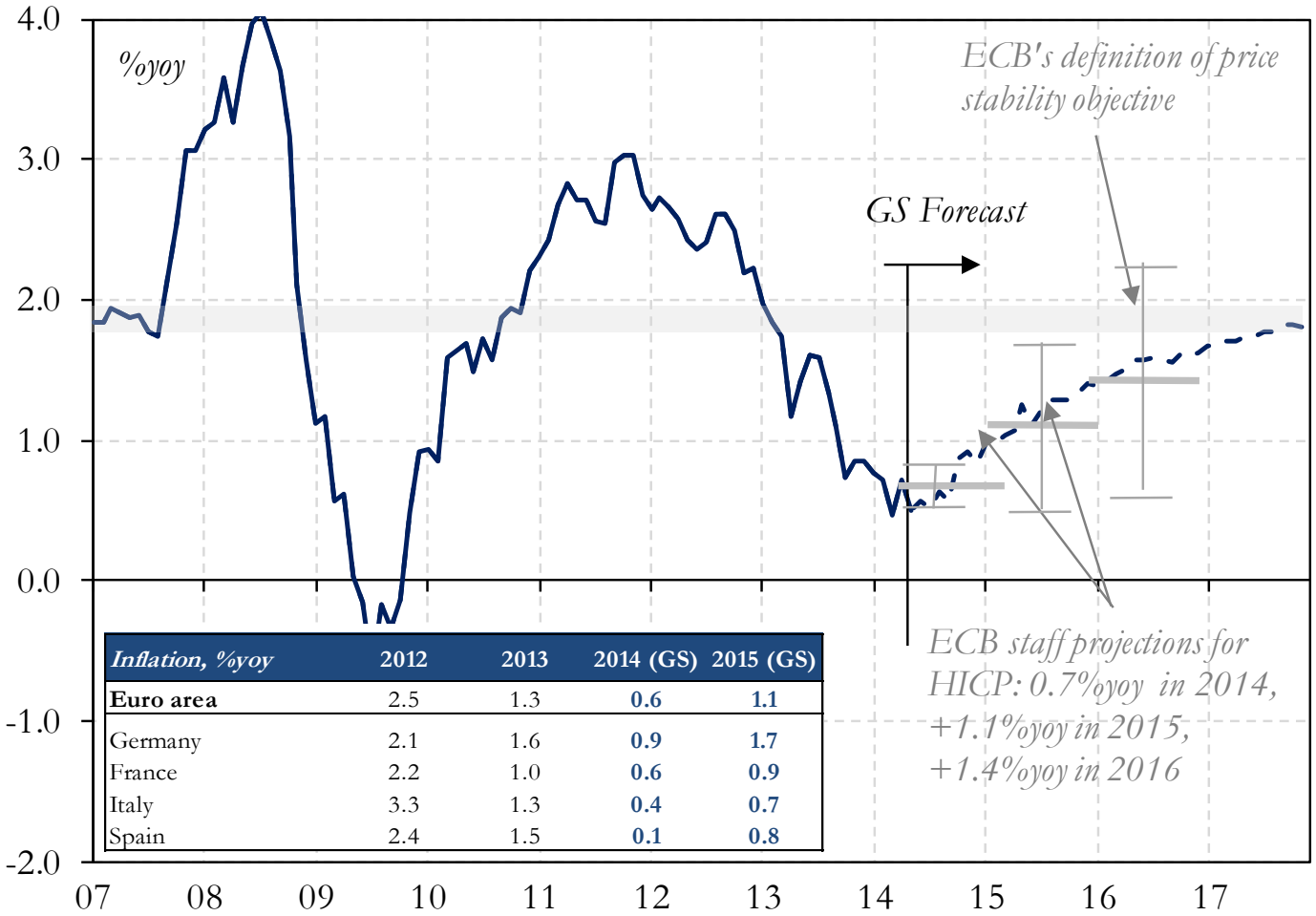
Source: ECB

Financial conditions improving, despite remaining cross-country differences



^^ average of Italy and Spain
The index includes four variables: real 3-month interest rates, real long-term interest rates, real trade-weighted value of the exchange rate and equity market performances
Source: Goldman Sachs Global Investment Research, ECB

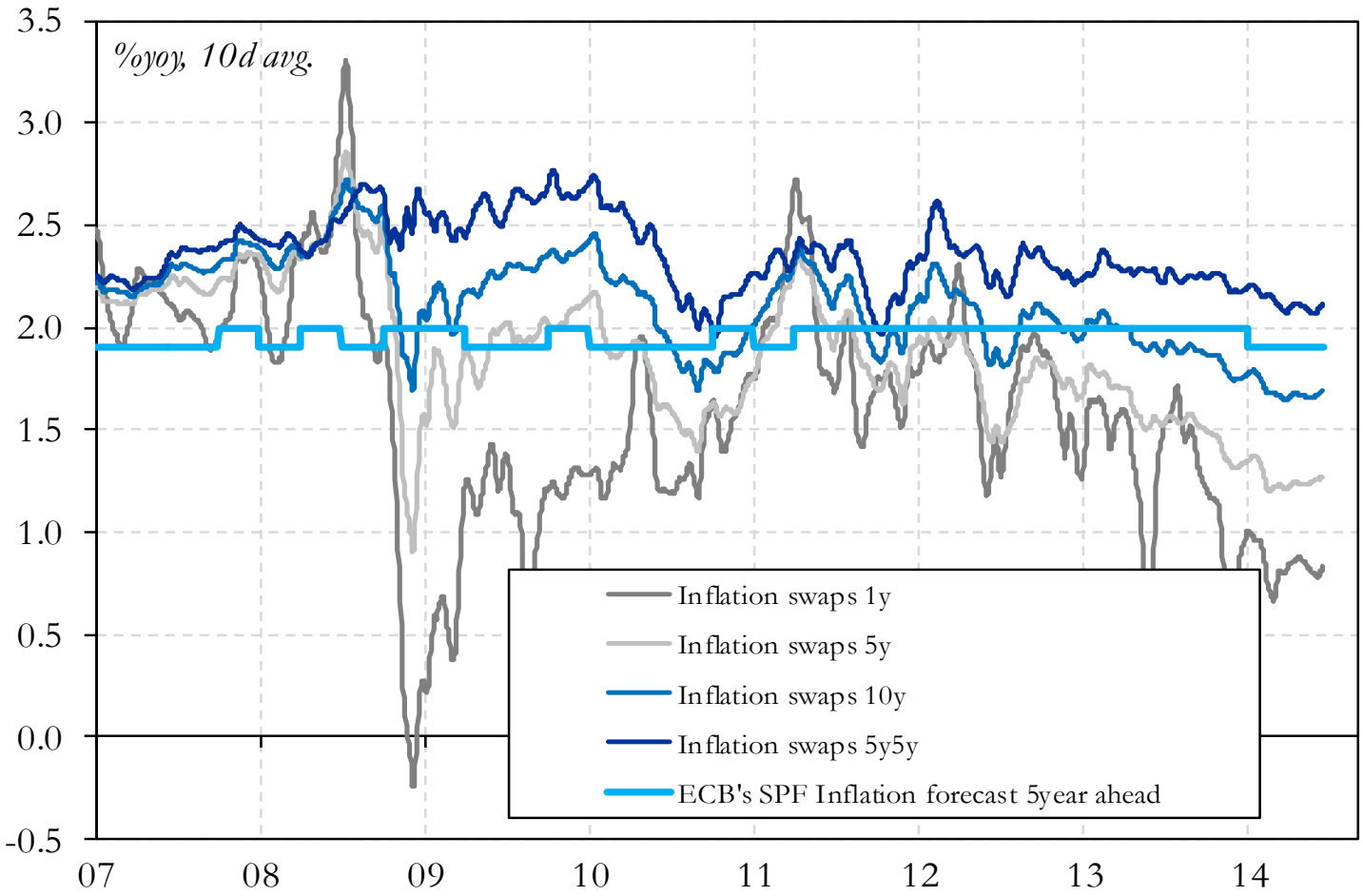
Deflation risks exist, but remain modest at the area-wide level over medium term



Inflation, %yoy	2012	2013	2014 (GS)	2015 (GS)
Euro area	2.5	1.3	**0.6**	**1.1**
Germany	2.1	1.6	**0.9**	**1.7**
France	2.2	1.0	**0.6**	**0.9**
Italy	3.3	1.3	**0.4**	**0.7**
Spain	2.4	1.5	**0.1**	**0.8**

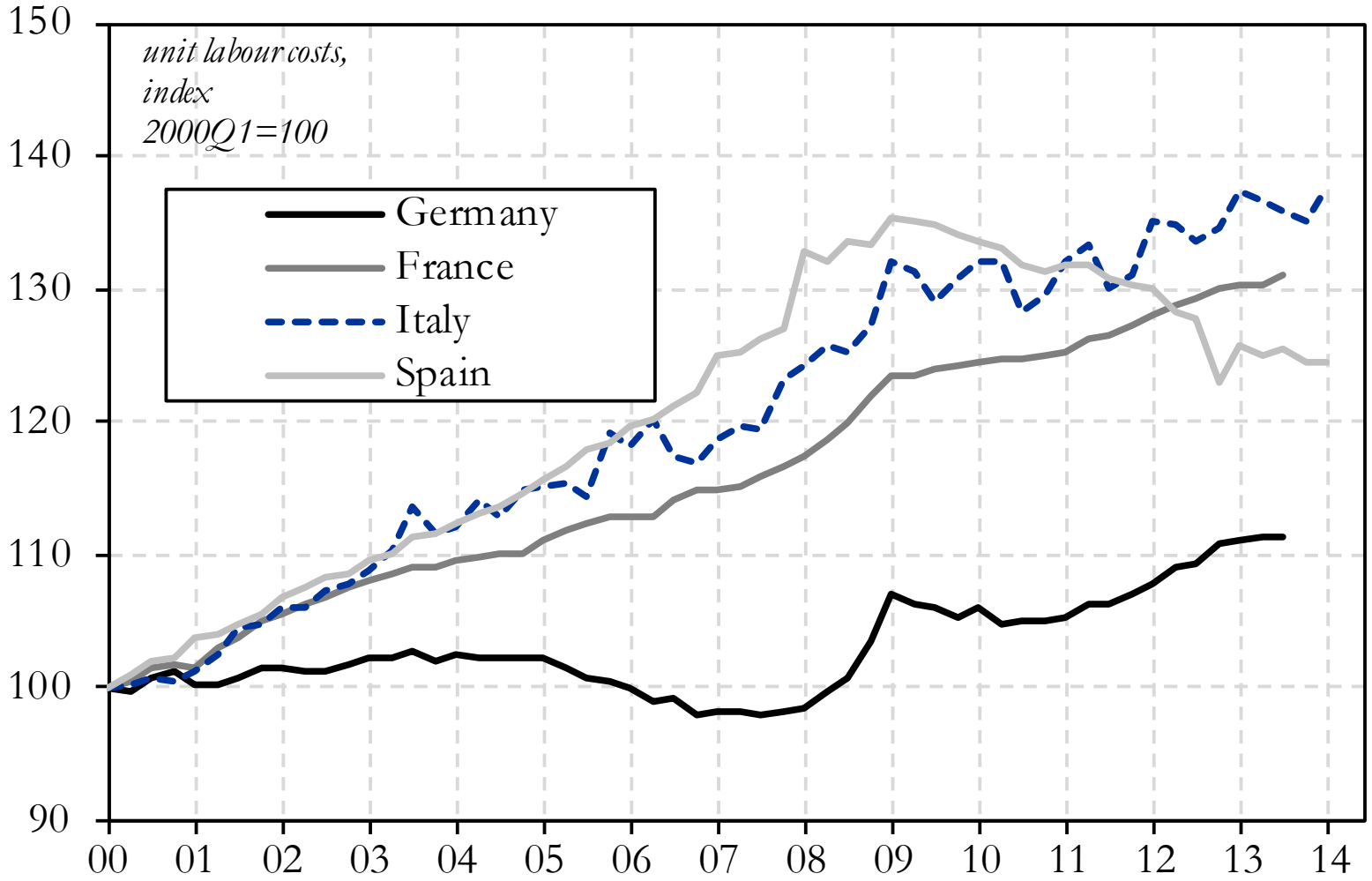
Source: Eurostat, Goldman Sachs Global Investment Research

Medium- to long-term inflation expectations well anchored in Euro area



Source: Eurostat, Goldman Sachs Global Investment Research

In part, low Euro area inflation reflects cost adjustment in the periphery



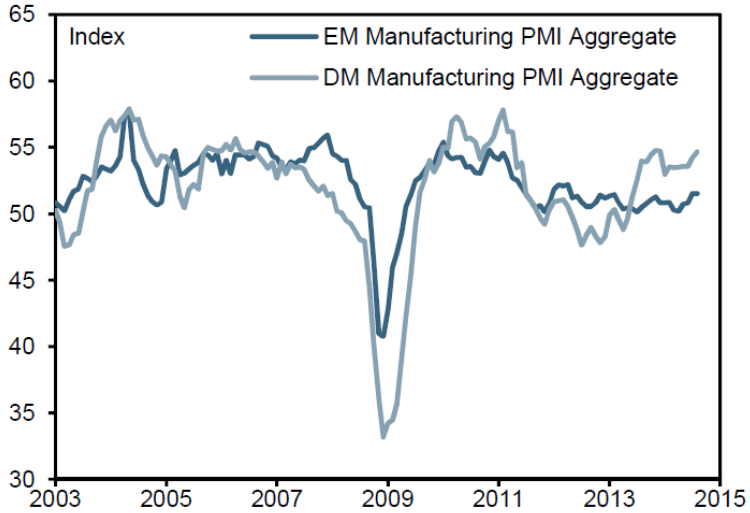
Source: Markit, Ministerio de Vivienda (Spain), Statistisches Bundesamt (Germany), Eurostat, Goldman Sachs Global Investment Research

CEEMEA and EMs

EM activity picking up again in Q3, despite tightening financial conditions

EM and DM Manufacturing PMI

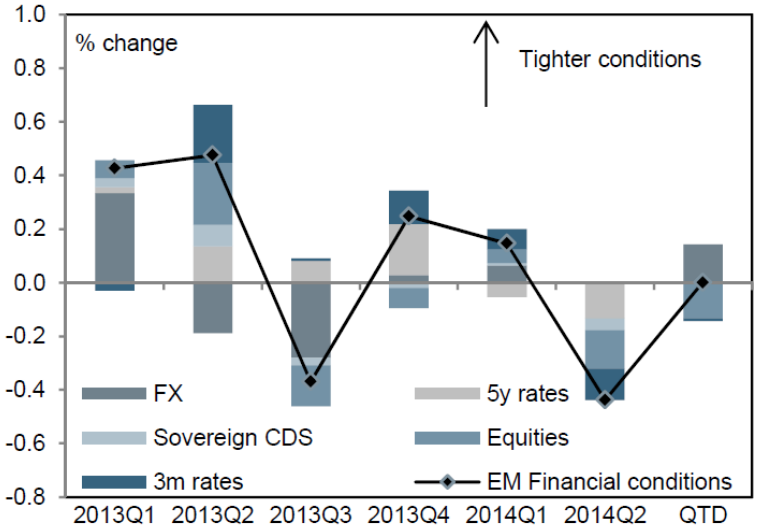
SA, 50+ = Expansion



Source: Haver Analytics, Goldman Sachs Global Investment Research.

EM Financial Conditions

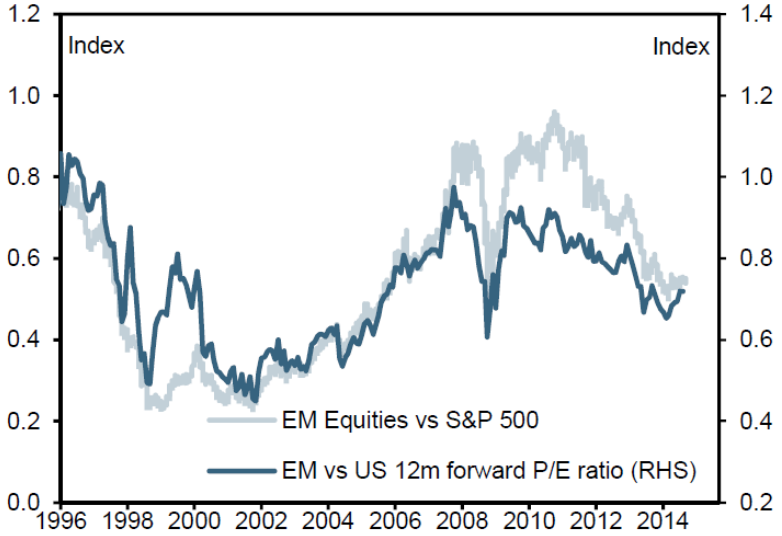
For details of construction see *EM Macro Daily*, July 22, 2014



Source: Goldman Sachs, Goldman Sachs Global Investment Research.

EM stocks posting some turnaround, but currencies unlikely to repeat their run

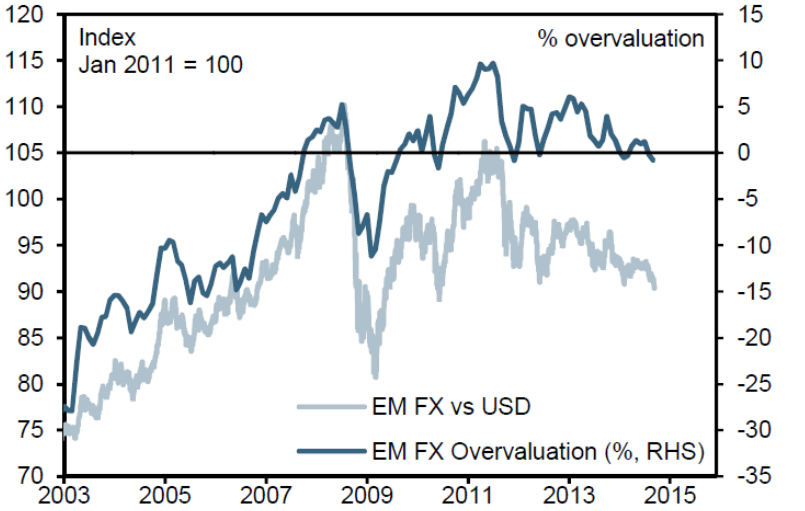
EM Equities versus US



Source: MSCI, Goldman Sachs Global Investment Research.

EM FX versus USD and EM FX overvaluation

Major EMs, overvaluation calculated using GSDEER values

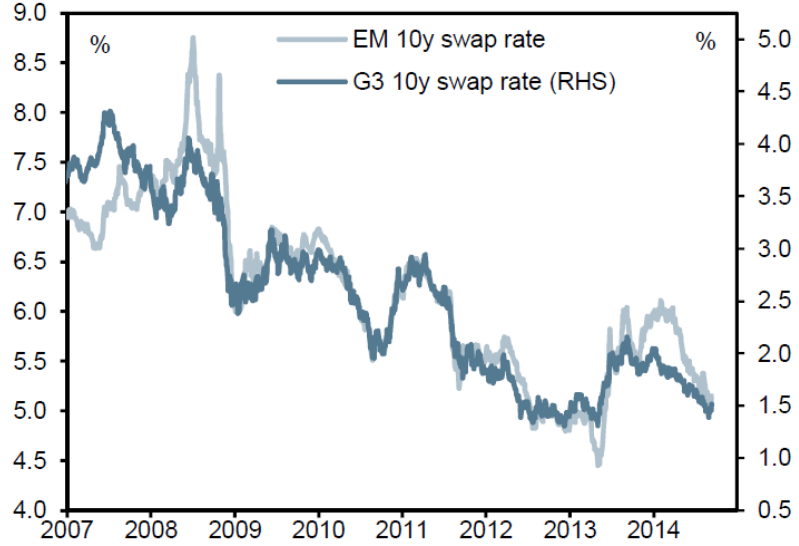


Source: Goldman Sachs, Goldman Sachs Global Investment Research.

EM rates still declining and sovereign funding risk still improving

EM versus G3 10-year rates

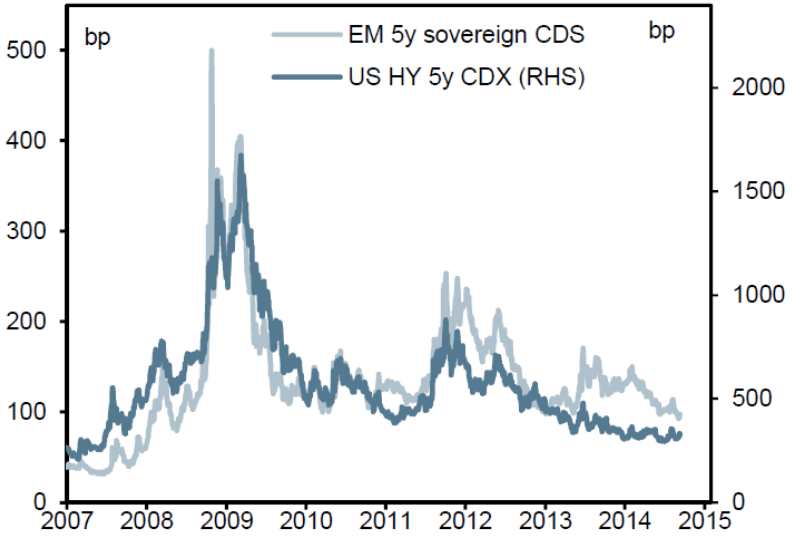
Major EM 10-year swap rates



Source: Goldman Sachs, Goldman Sachs Global Investment Research.

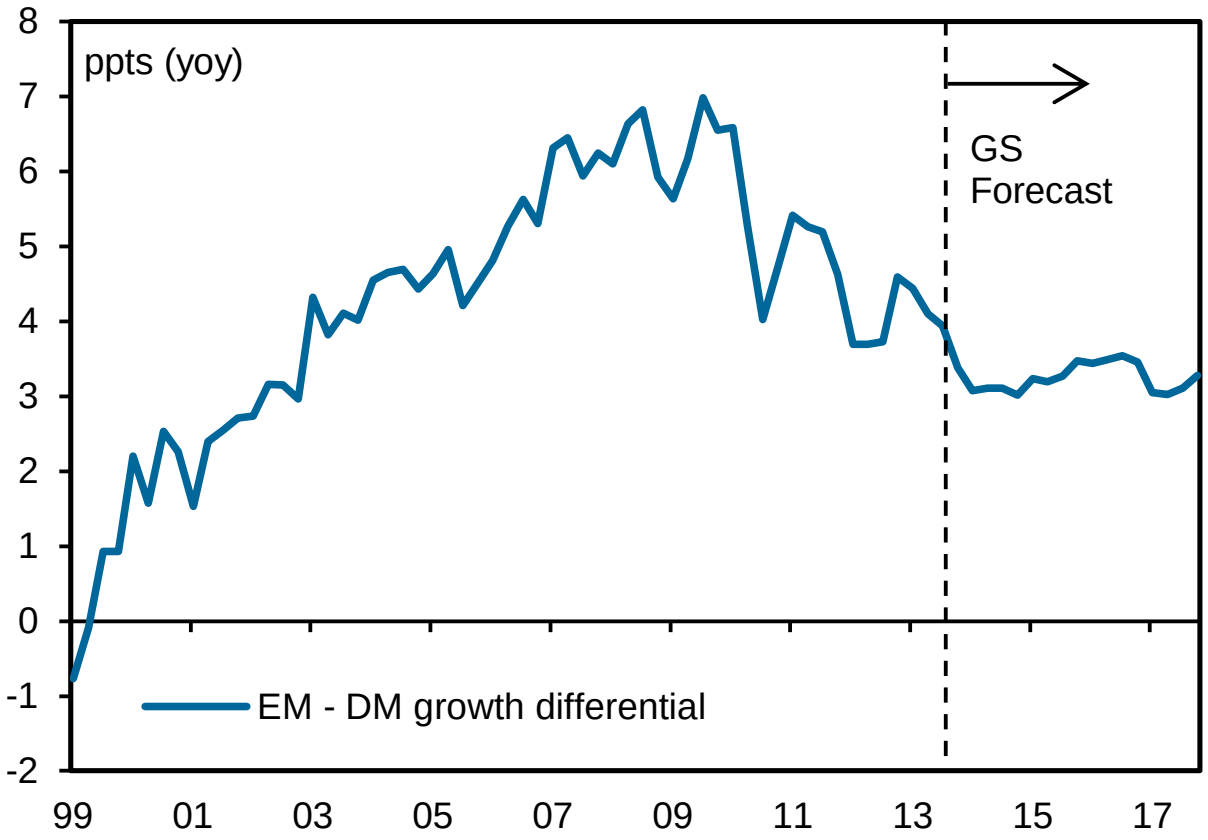
EM sovereign CDS versus US HY CDX

Major EM (ex-Argentina) 5-year sovereign CDS



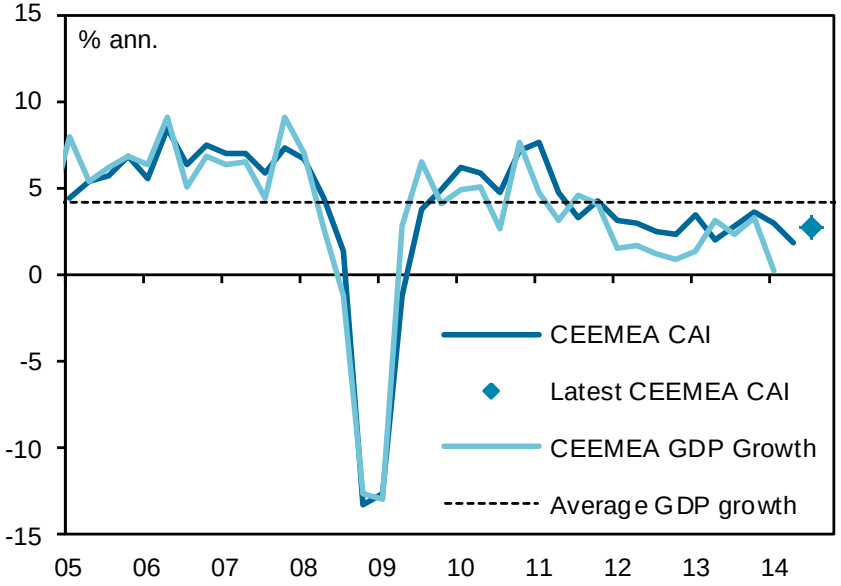
Source: Goldman Sachs, Goldman Sachs Global Investment Research.

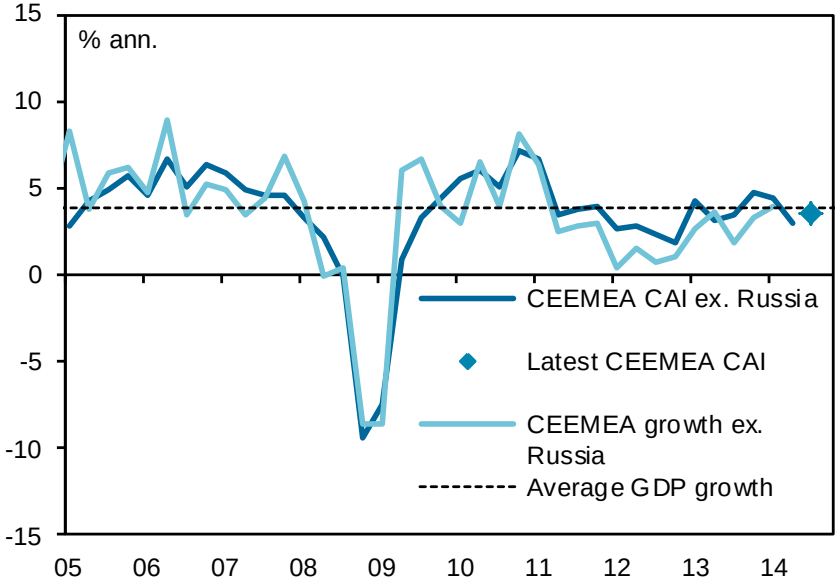
But, overall, EM growth differential to DM will narrow further in 2014



Source: Goldman Sachs Global Investment Research

CEEMEA growth also turning up after weaker Q2...

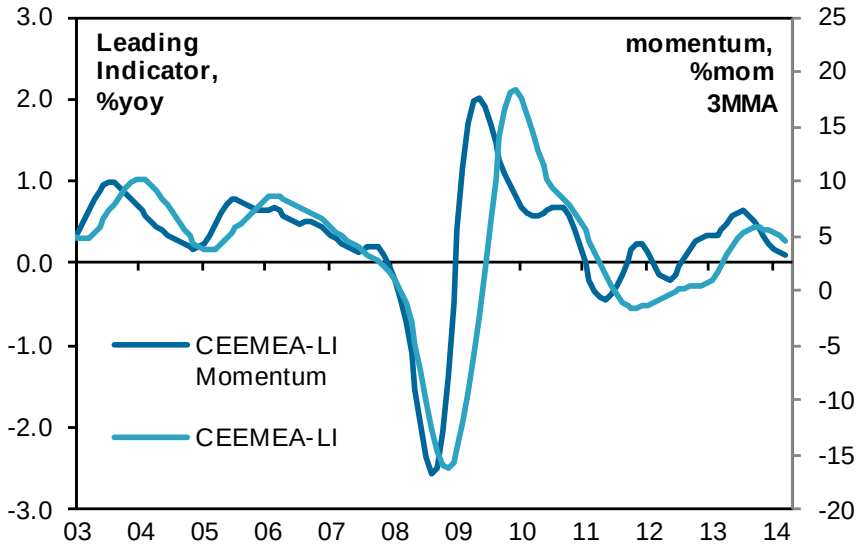


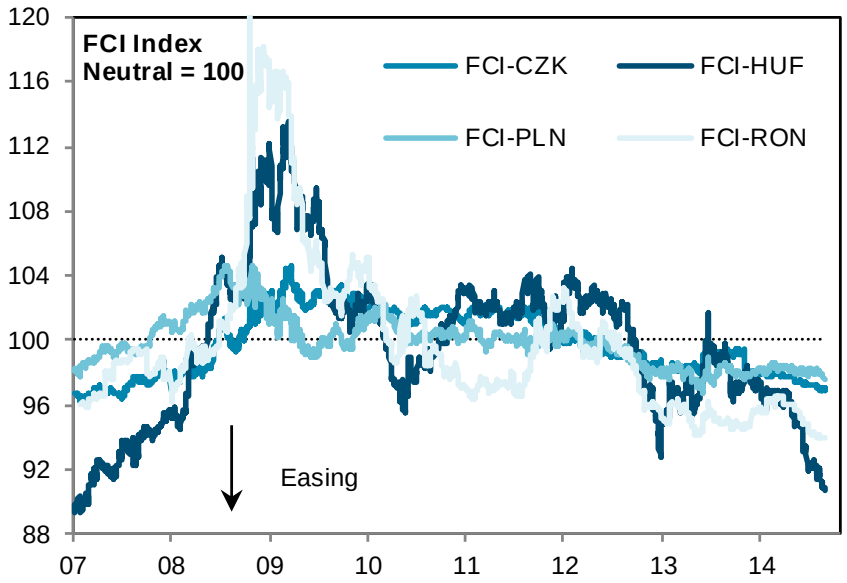


CAI – current activity indicator

Source: Goldman Sachs Global Investment Research

...in part thanks to easier financial conditions in some countries





FCI – Financial Conditions Index

Source: Goldman Sachs Global Investment Research

CEEMEA Growth Forecasts

Real GDP growth: GS vs. Consensus

%yoy	2010	2011	2012	2013	2014		2015	
					GS	Consensus	GS	Consensus
Czech Republic	2.3	1.8	-0.9	-0.9	2.6	2.6	2.4	2.7
Hungary	1.0	1.6	-1.7	1.2	2.2	2.9	2.0	2.2
Israel	5.7	4.6	3.4	3.4	2.8	3.1	4.0	3.4
Poland	3.9	4.5	2.1	1.6	3.4	3.2	3.3	3.5
Romania	-1.1	2.2	0.7	2.4	3.1	3.0	3.4	3.3
Russia	4.5	4.2	3.5	1.3	0.5	0.0	1.5	1.1
South Africa	3.1	3.6	2.5	1.9	1.8	1.6	3.0	2.9
Turkey	9.2	8.8	2.1	4.0	3.5	3.0	1.8	3.5
Ukraine	4.2	5.1	0.2	-0.1	-8.0	-5.6	1.0	0.8
BRICS	9.1	7.6	5.9	5.9	5.4	5.1	6.1	5.3
CEEMEA	4.9	4.9	2.7	2.3	2.4	1.2	2.5	2.5
Advanced Economies	3.0	1.7	1.2	1.4	1.9	1.9	2.5	2.4
World	5.1	3.8	3.0	3.0	3.1	3.1	3.7	3.6

*Consensus Economics August 2014

Source: Consensus Economic, Goldman Sachs Global Investment Research.

Inflation – low in CEE

- Inflation sharply below target in CEE but some signs that momentum is turning more positive
- Inflation sharply above target in Russia, Turkey and South Africa but some signs that momentum is turning more negative
- Food inflation is currently the key differentiating factor of inflation developments in the CEEMEA region

	Objective	Realised inflation, %yoy (Jul-14)						Forecast, %yoy (end-2014)	
	2014	Headline	Momentum	Core	Momentum	TRIM	Surprise	GS	Consensus
Czech Republic	2.0 +/- 1.0	0.5	+ (+)	0.8	+ (-)	1.7	+ + (-)	0.8	0.5
Hungary	3.0	0.1	+ (+)	2.6	+ (+)	1.1	+ (-)	1.1	0.3
Israel	2.0 +/- 1.0	0.3	+ (-)	0.3	unch. (unch.)	0.2	- ( )	0.4	1.3
Poland	2.5 +/- 1.0	-0.2	+ (+)	0.4	unch. (unch.)	0.8	(+)	0.2	0.4
Romania	2.5 +/- 1.0	1.0	- (unch.)	0.3	- (-)	1.9	- (-)	2.3	n/a
Russia	5.0 +/- 1.5	7.5	- (-)	7.8	- (unch.)	7.1	(+)	8.0	7.1
South Africa	3.0 - 6.0	6.3	unch. (-)	5.7	unch. (unch.)	6.4	- (-)	6.7	6.3
Turkey	5.0 +/- 2.0	9.3	unch. (unch.)	9.7	unch. (-)	9.3	+ + (+ +)	9.2	8.7

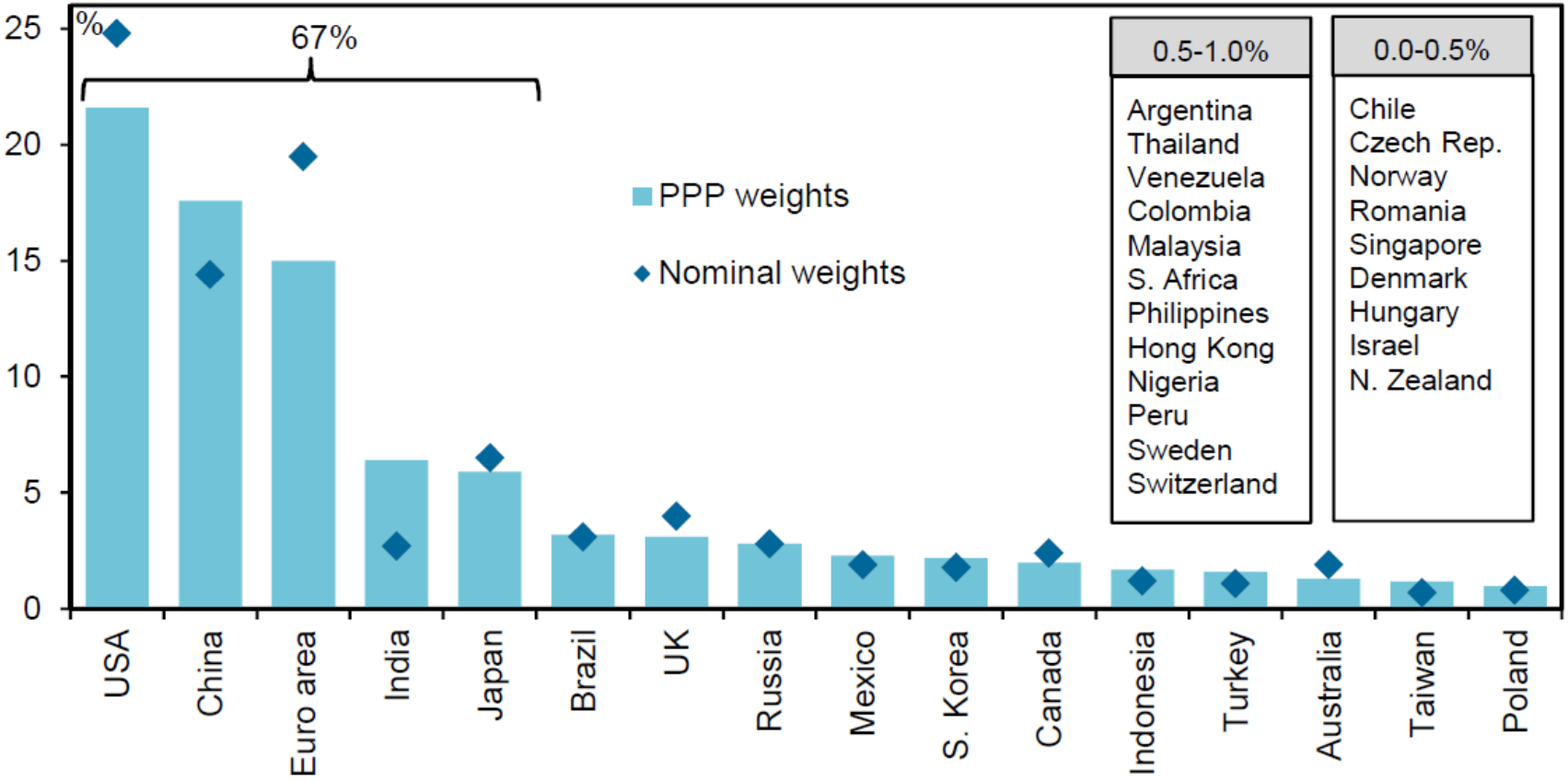
bank target range; (3) Momentum is 3mma annualised inflation, threshold for being "unchanged" is change of less than 10% of target midpoint; (4) Surprise is to Bloomberg consensus forecast (+ indicates headline inflation up to 1 s.d. above consensus); (5) Momentum/surprise from previous month in parentheses.

Source: National central banks, Consensus Economics, Haver Analytics, Goldman Sachs Global Investment Research.

Structural aspects of EM ‘transition’

EMs becoming a larger part of global economy and markets

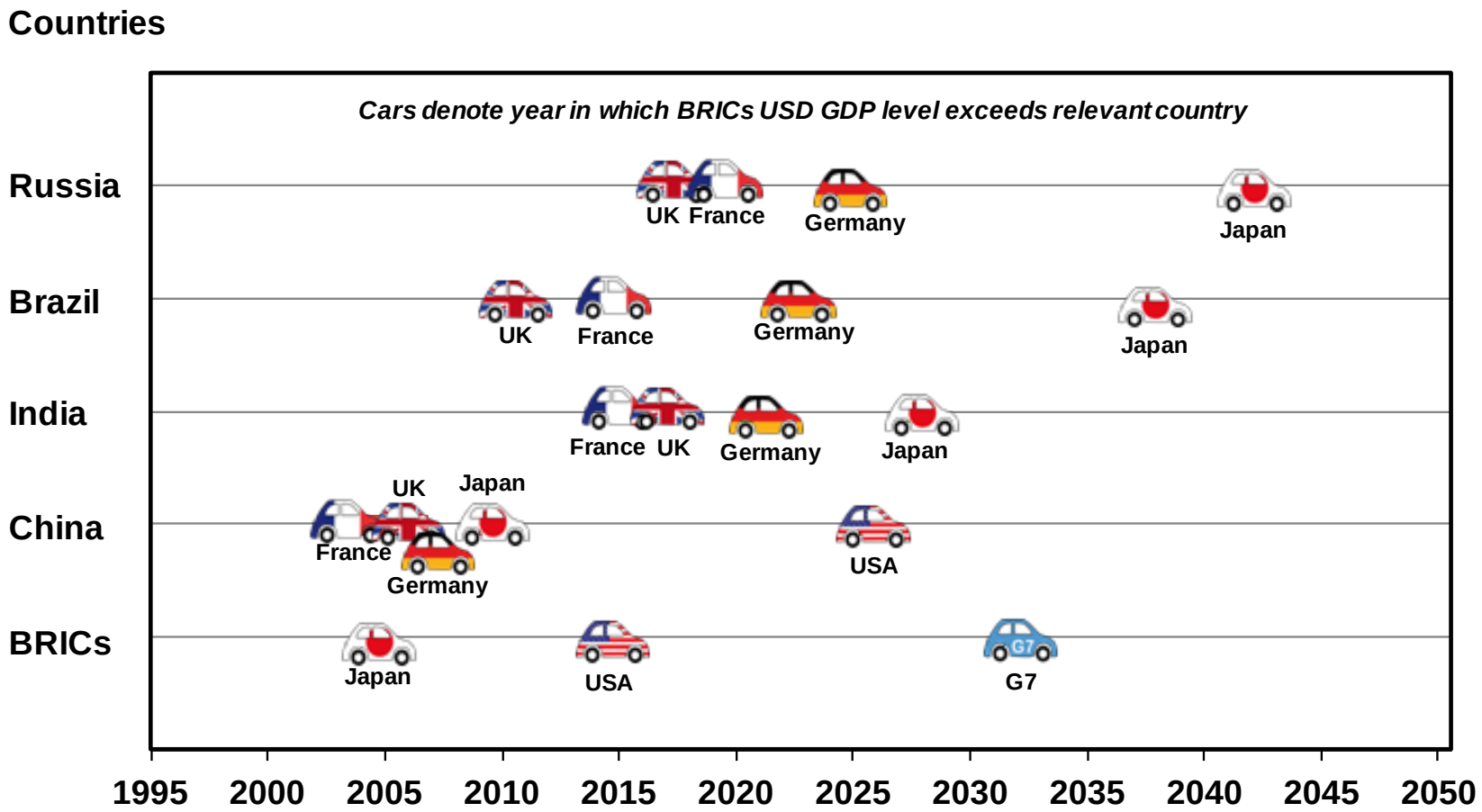
Weights in global GDP as of 2014



Source: Goldman Sachs Global Investment Research

Looking ahead: BRICs to overtake major Developed Markets…

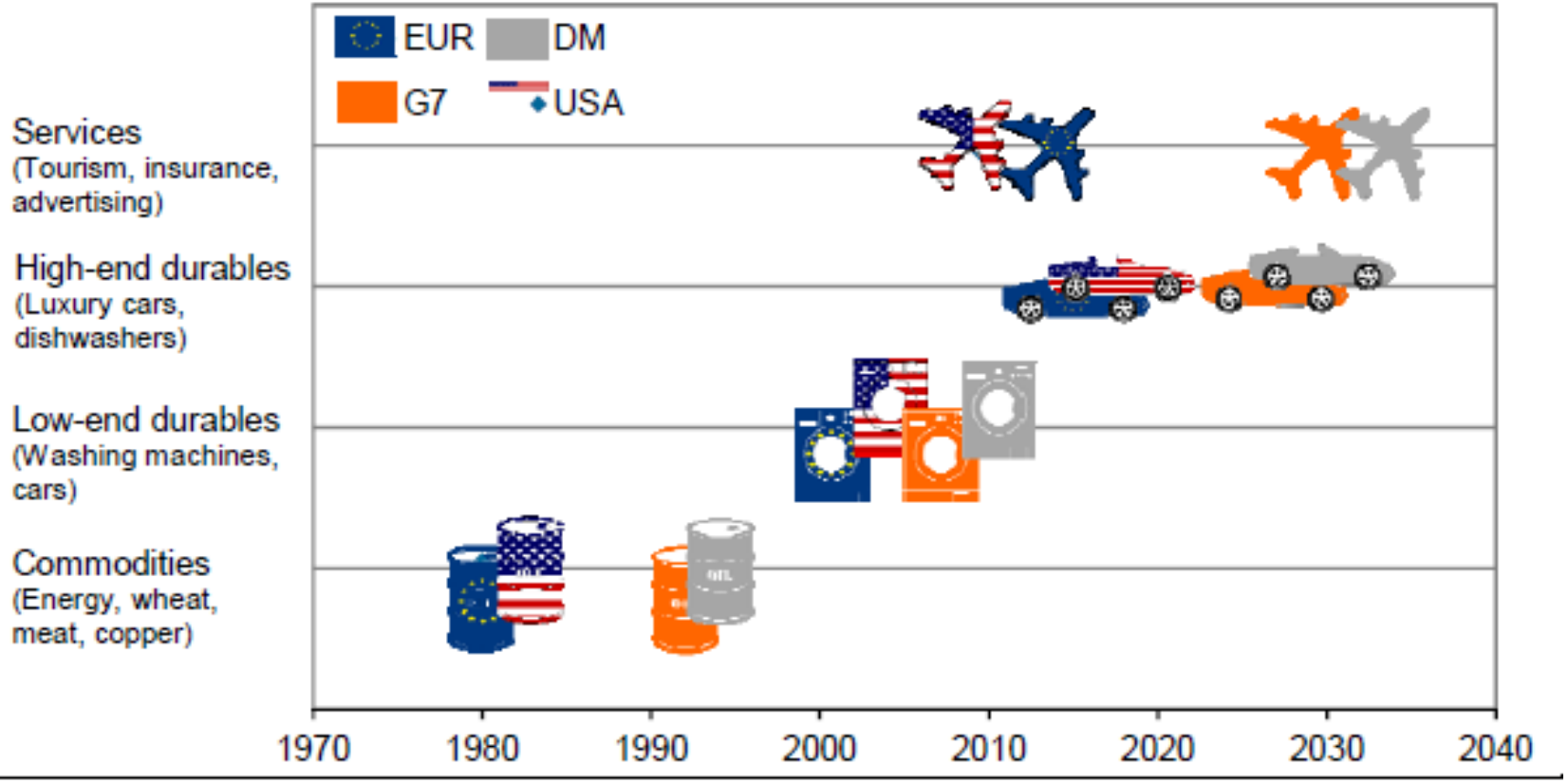
…changing global growth and trade patterns



Source: Goldman Sachs Global Investment Research

"What the World Wants": Total demand in EMs overtakes DMs in coming decades

Icons denote the year in which EM demand overtakes US, EUR and DM aggregates. For commodities, data start in 1980

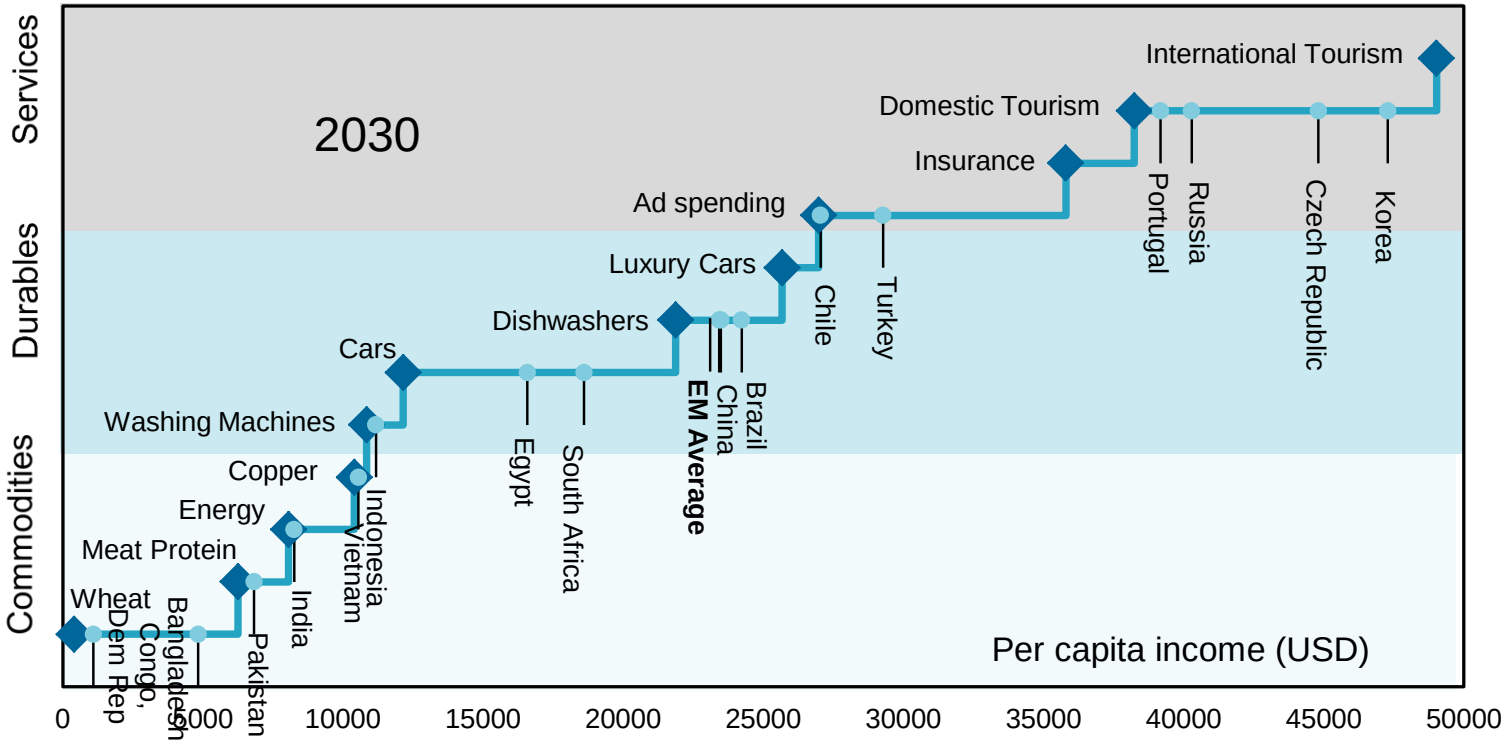


Source: Goldman Sachs Global Investment Research.

"What the World Wants": The ladder of spending in 2030

EM growth will change global consumption patterns

The marker for each spending category denotes the 'sweet spot' or income level at which per capita demand is at its maximum (income level associated with peak spending impact)

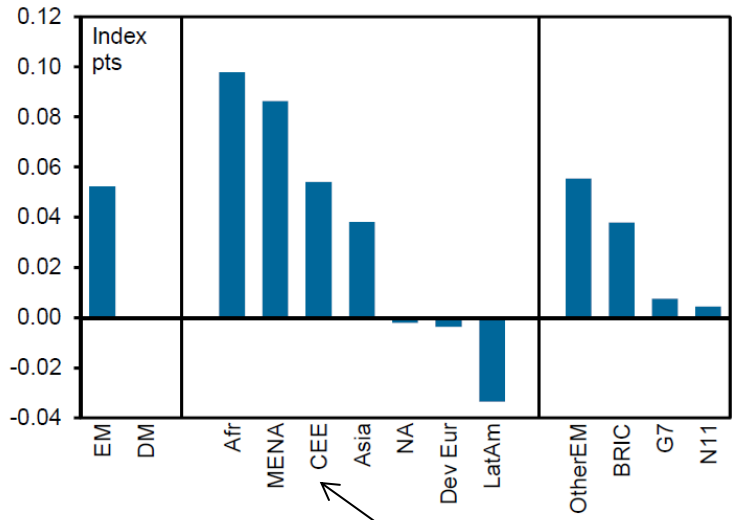


Source: Goldman Sachs Global Investment Research

Growth Environment Scores (GES)

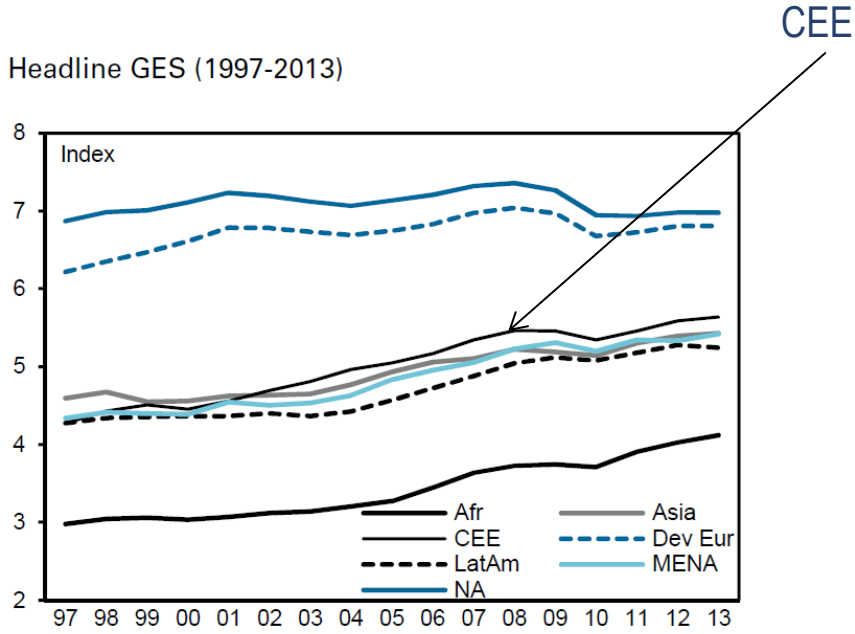
EM scores improving, DM still struggling to recover from effects of the crisis

Change in headline GES (2012-2013)



Source: Goldman Sachs Global Investment Research.

Headline GES (1997-2013)

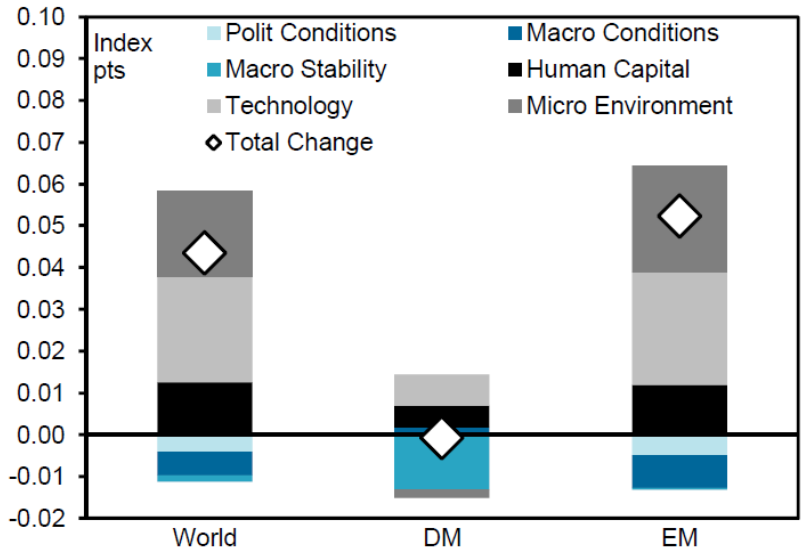


Source: Goldman Sachs Global Investment Research.

GES is a multi variable measure of growth conditions, including measures of macro and political stability, human capital, technology, and business environment, among others

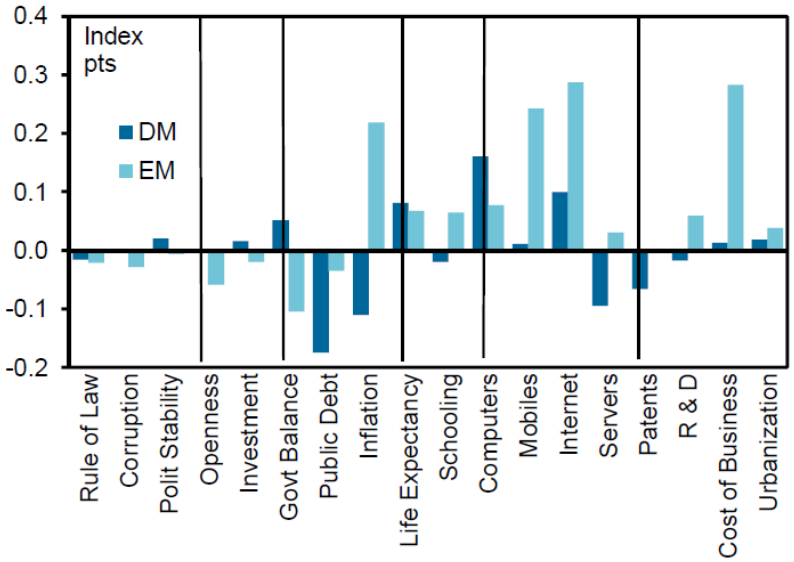
EMs saw largest improvements in GES recently…

Contribution to GES change (2012-2013)



Source: Goldman Sachs Global Investment Research.

Changes in 2013 vs. 2012 by component

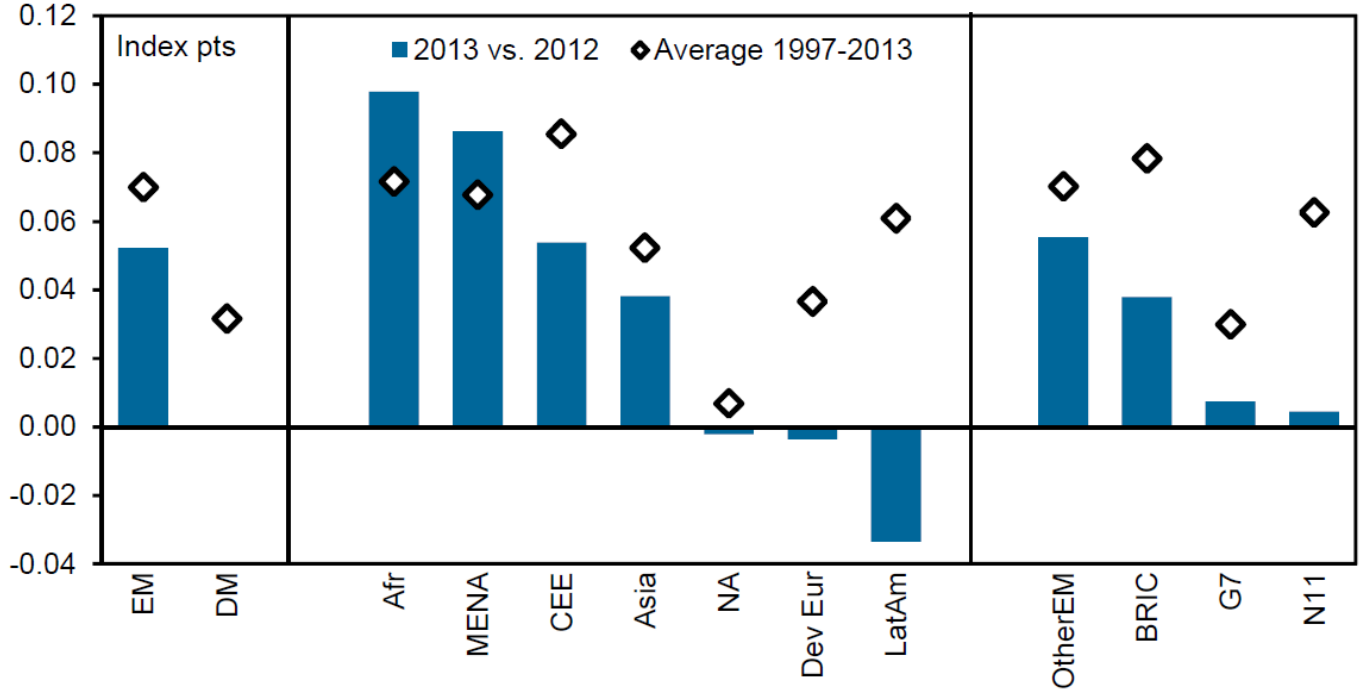


Source: Goldman Sachs Global Investment Research.

…thanks to continued improvement in technology, human capital and other aspects of institutional environment

...but the pace of improvement is declining for the most advanced EMs

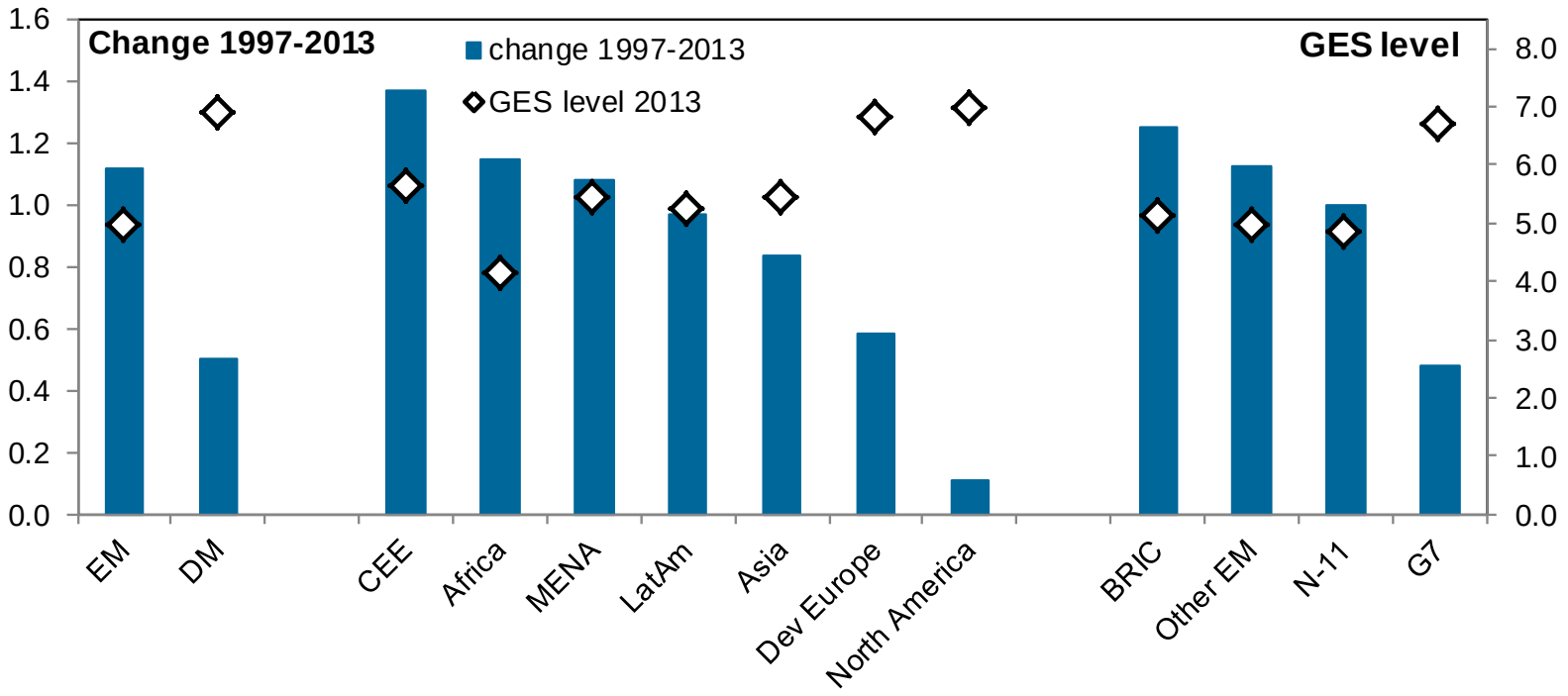
Changes in 2013 vs. average yoy historical changes



Source: Goldman Sachs Global Investment Research.

...like the CEE region

Still, CEE countries saw most improvement among all EM regions since 1997



Source: Goldman Sachs Global Investment Research

Human capital and technology are driving the improvement…

Scores by bucket and country group in 2013; arrows indicate positive, negative or no change in 2013 vs. 2012

Aggregate	GES Buckets					
	Polit Conditions	Macro Conditions	Macro Stability	Human Capital	Technology	Micro Environment
World	4.84 ↓	4.31 ↓	6.72 ↔	6.72 ↑	4.08 ↑	4.92 ↑
DM	7.63 ↔	3.84 ↑	6.20 ↓	9.12 ↑	7.66 ↑	6.79 ↓
EM	4.33 ↓	4.40 ↓	6.82 ↑	6.27 ↑	3.41 ↑	4.35 ↑
Africa	3.80 ↓	4.38 ↑	6.71 ↑	3.85 ↑	2.11 ↑	3.39 ↑
Asia	5.09 ↑	4.70 ↑	6.67 ↓	7.06 ↑	3.92 ↑	5.26 ↑
CEE	4.85 ↑	4.73 ↑	6.95 ↓	7.90 ↑	4.74 ↑	4.64 ↑
Dev. Europe	7.65 ↓	3.67 ↓	6.20 ↓	9.17 ↑	7.83 ↑	6.31 ↓
Latin America	4.82 ↓	3.80 ↓	6.66 ↔	7.34 ↑	4.09 ↑	4.43 ↓
MENA	4.03 ↓	4.40 ↑	7.17 ↑	7.65 ↑	4.00 ↑	5.35 ↑
North America	7.79 ↑	3.18 ↓	5.55 ↑	8.80 ↑	8.27 ↓	8.30 ↓
BRICs	3.97 ↑	4.25 ↓	6.81 ↑	6.94 ↑	3.70 ↑	4.93 ↑
N-11	3.58 ↑	3.99 ↓	6.50 ↓	6.66 ↑	3.69 ↑	4.50 ↑
G7	7.33 ↔	3.21 ↓	5.35 ↑	9.23 ↑	7.65 ↑	7.36 ↔
Other EM	4.40 ↓	4.43 ↓	6.84 ↑	6.25 ↑	3.40 ↑	4.33 ↑

Source: Goldman Sachs Global Investment Research.

… while political risks weigh on less advanced EMs

Not Your Older Brother's Emerging Markets

What drove the EM success in the last decade? EM 'tailwinds'

- A sharp increase in the impulse from China and the BRICs to the world economy
- Anchored inflation
- Falling core real yields
- A long (sovereign) deleveraging and improving external balance sheets
- A secular rise in commodity prices
- A virtuous macro circle plus high risk premia (mutually reinforcing tailwinds) was a perfect mix for EM assets

But EM tailwinds are waning…

- The stronger-than-expected growth impulse from China's integration is largely complete
- Inflation is unlikely to come down much more (would have to be negative in some countries)
- Real yields in the US are likely to move higher – but not in Europe
- External balance sheets are unlikely to improve much further and private sector leverage has increased – mostly in less developed EMs
- The long uptrend in long-dated commodity prices is probably over – not that important for CEE

...Making EM as a group a less attractive asset class...

The unwinding of imbalances in EM and DM poses near-term challenges

- **The adjustment to stronger US growth and higher US rates is challenging**
- **Risks of a bumpy ride as financial conditions tighten in China and growth downshifts**
- **And negative feedback loops pose crisis risk in some countries**

But positives remain

- **Sovereign balance sheets are generally much better than in late 1990s**
- **China risks are probably manageable**
- **And the big picture is for increased EM share of activity, and of growth in durable and services spending**

Differentiating between countries more important…

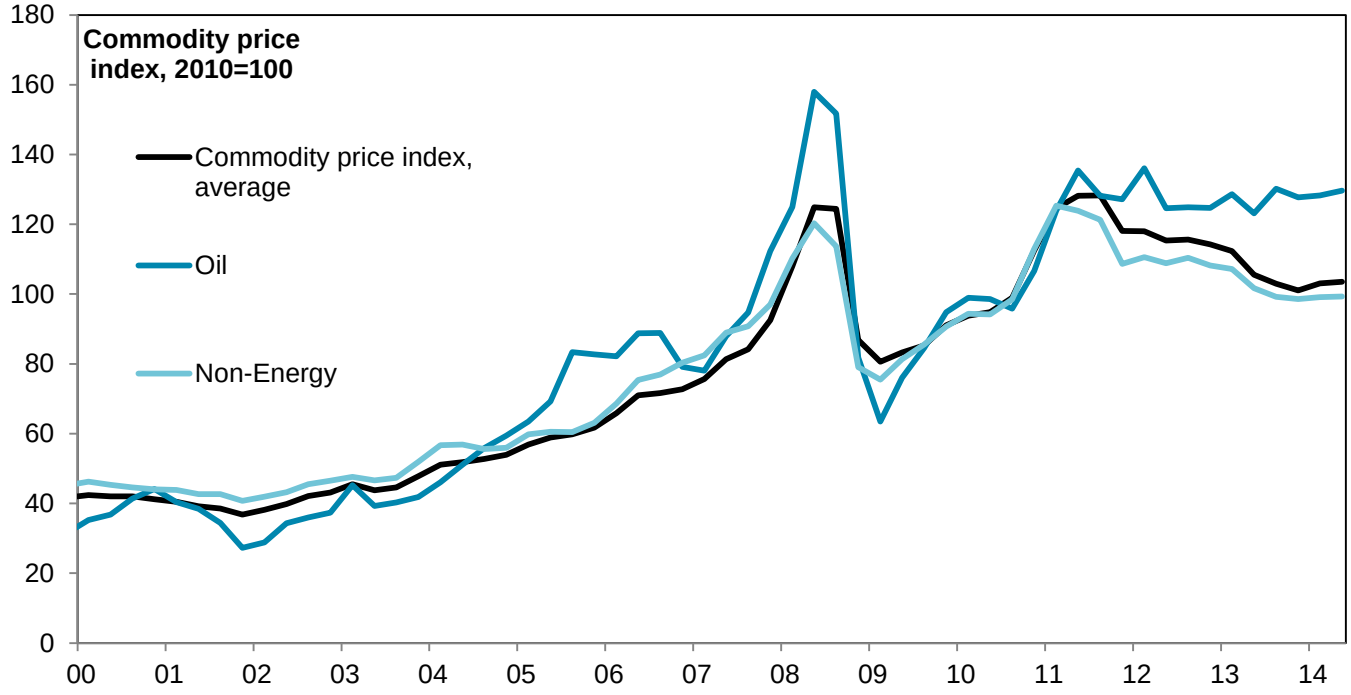
- Risks better recognized and some countries are adjusting/some are not
- Watch those with: CA deficits, above-target inflation, rising leverage, weak institutions
- DM recovery will help EM exporters, but is no panacea
- Different growth and trade drivers are an important differentiation area…
- …as is the quality of policies and institutions (GES)

…and most advanced EMs can benefit from reclassification as 'DM'

- With higher incomes, some EMs have already crossed the DM income thresholds (e.g.,Czech Rep.)
- For smaller, less active markets, this can mean a drop in investors' interest…
- …even though it implies larger, more stable investor base
- For larger, active markets (such as Poland), a reclassification would open large pools of capital, more interest of 'traditional' DM investors
- This transition already happening, without formal benchmark reclassification

Key tailwinds are abating, becoming headwinds – commodity prices

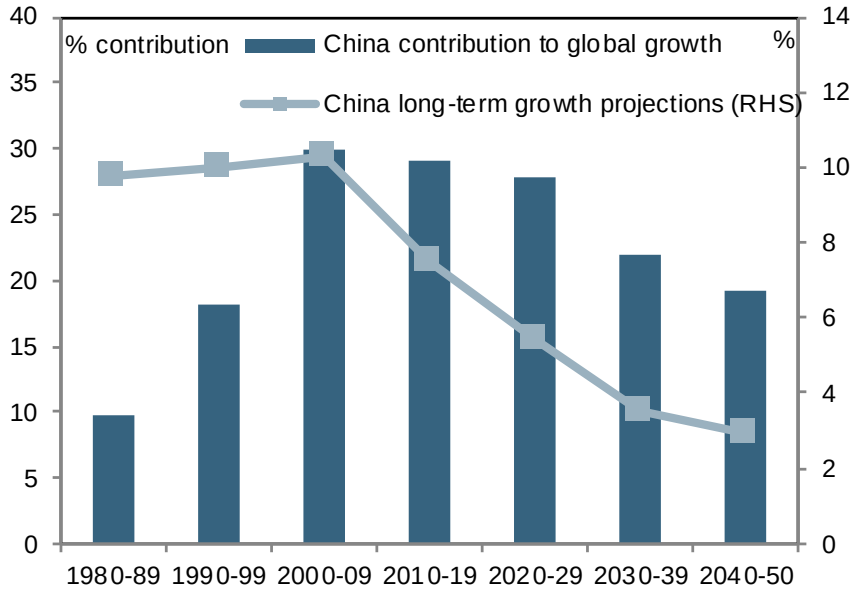
Secular rise in commodity prices is now reversing, worsening the less developed EMs terms of trade, improving the terms of trade of DMs and more developed EMs (like CEE)

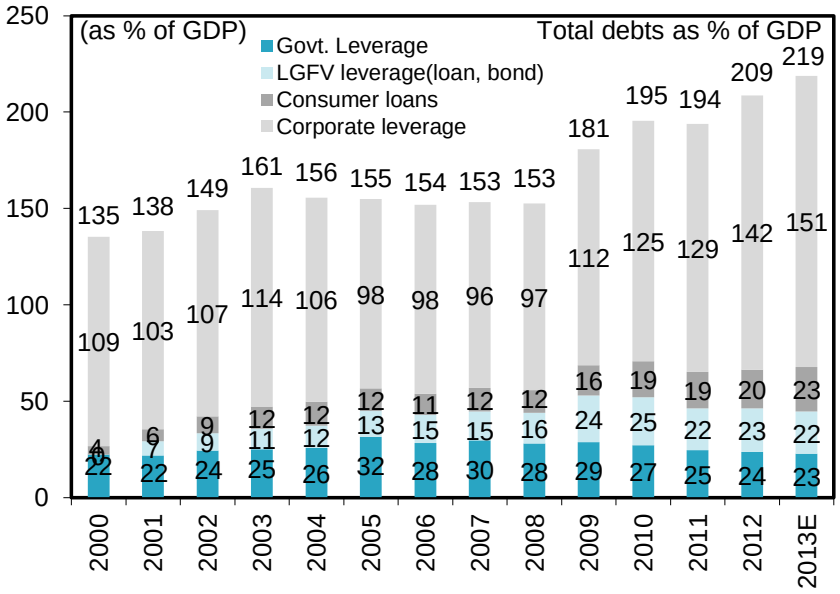


Source: World Bank (Commodity Price Index for Emerging Countries), Goldman Sachs Global Investment Research

China growth is shifting down at a time of high debt levels..

Growth tailwinds are waning



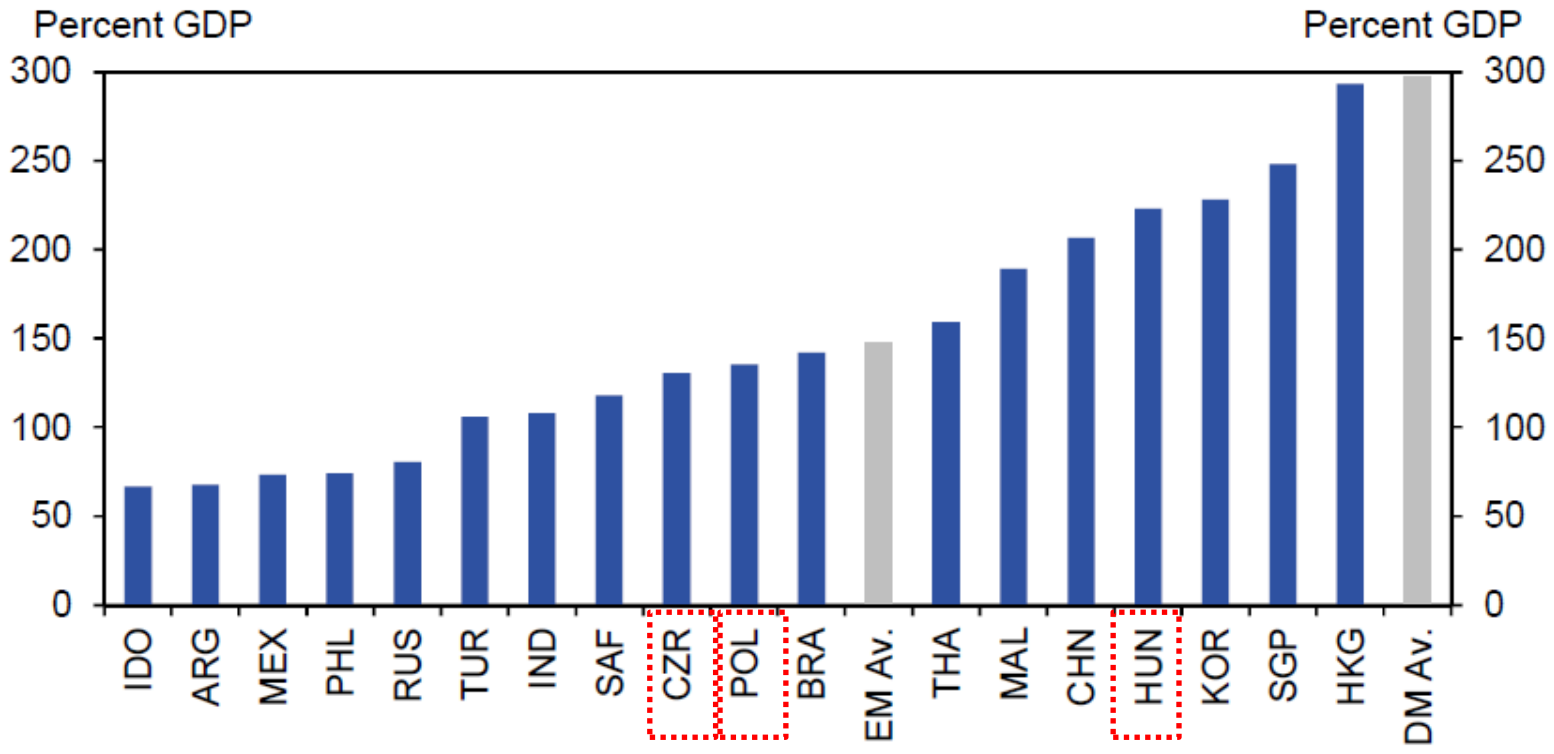


Source: CEIC, Goldman Sachs Global Investment Research

High debt levels in some EMs, especially in AEJ

Deleveraging and debt repayments may slow growth, keep interest rates lower

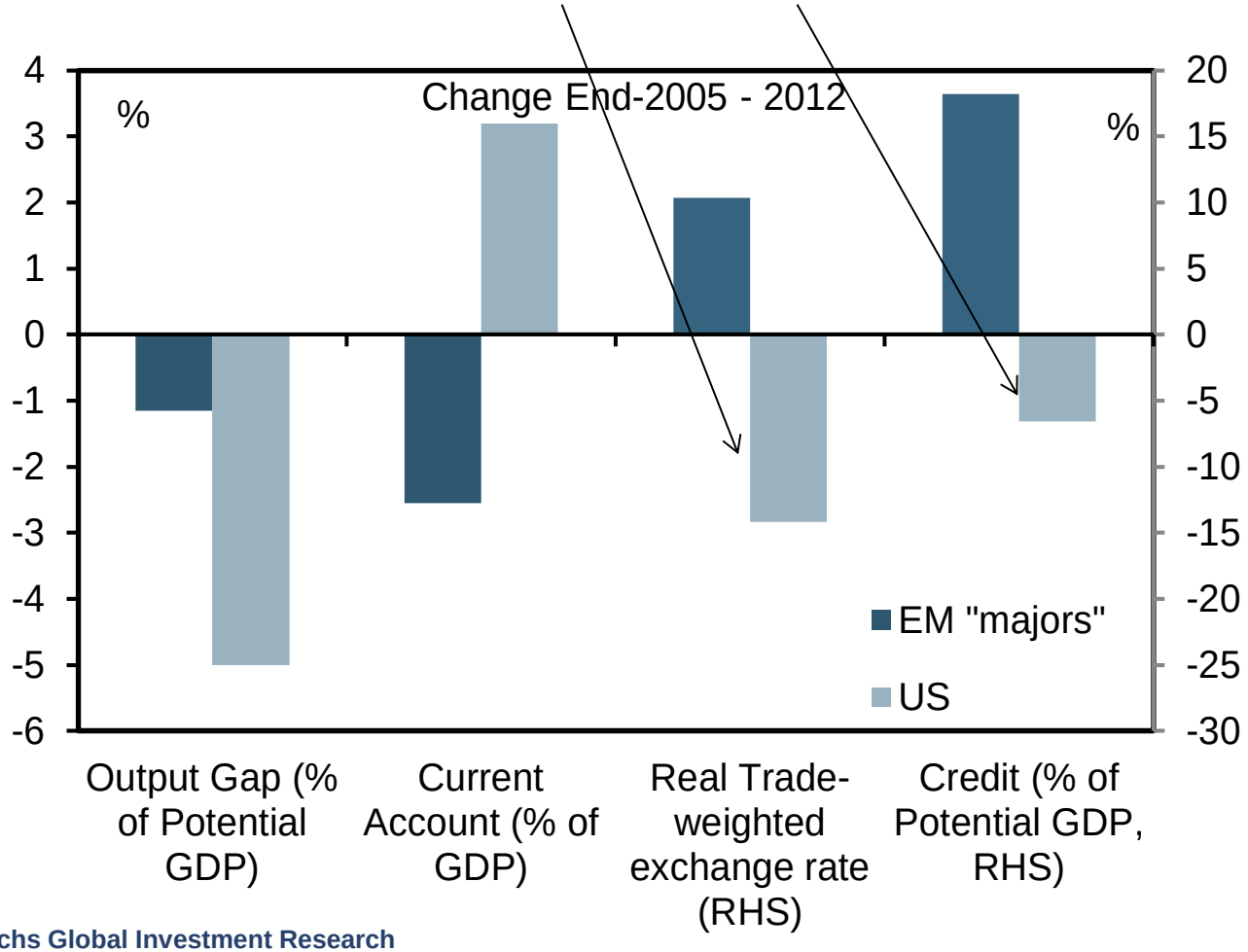
Total Debt as a % of GDP (government debt plus credit to private nonfinancial sector)



Source: Haver, IMF, BIS, Goldman Sachs Global Investment Research.

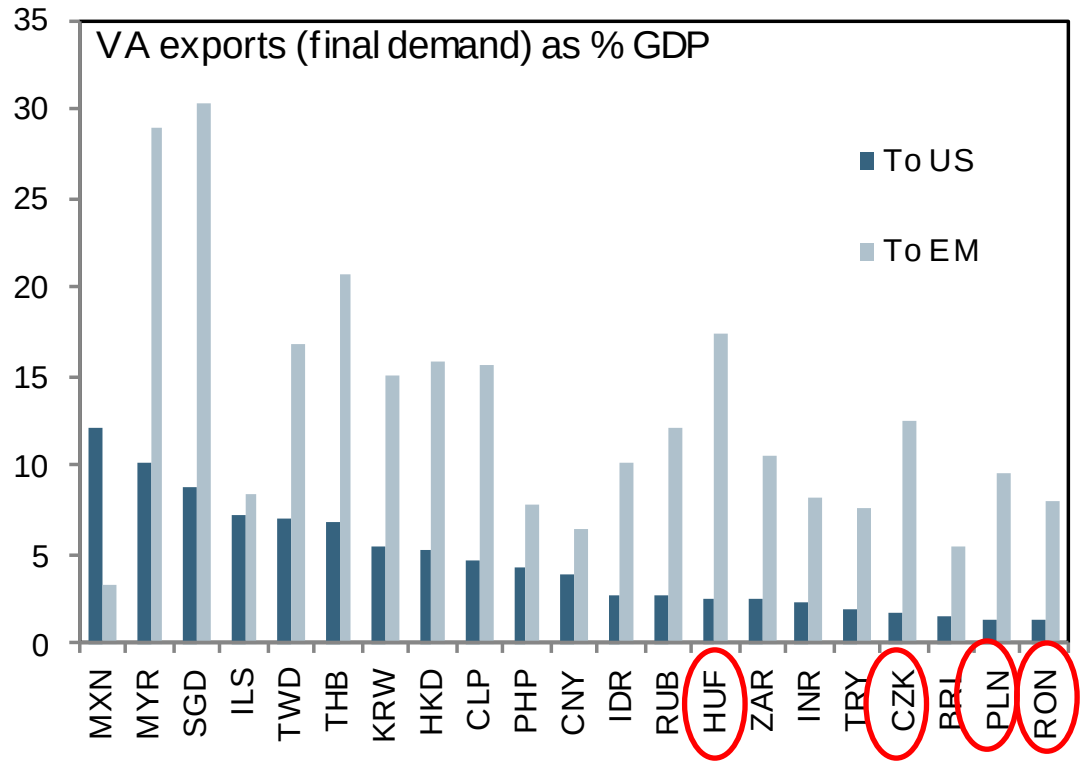
US recession, QE led to big shifts until now - some will reverse

Changes in DMs coming out of the crisis may affect some of the EMs, especially as DM currencies gain and credit grows again



Source: Goldman Sachs Global Investment Research

Some EMs will benefit more from a US recovery, but no panacea

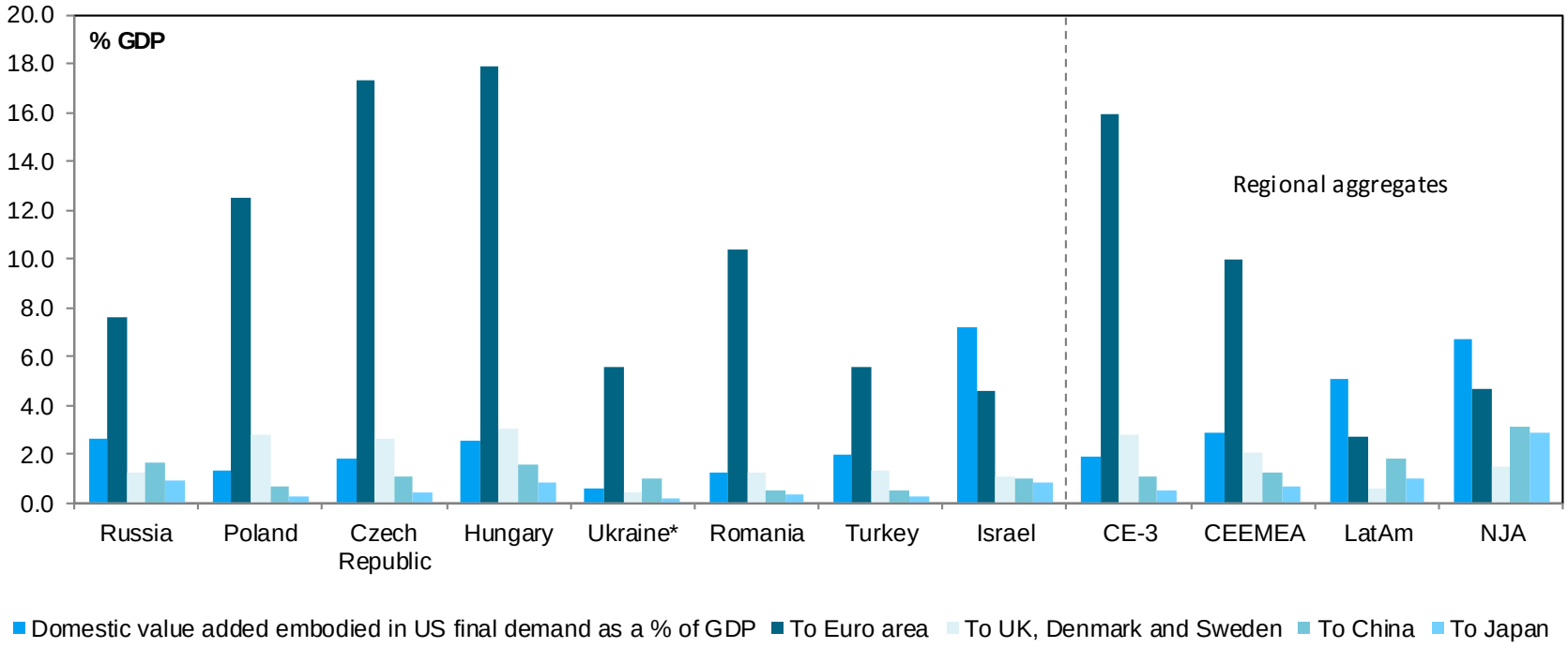


Domestic value added is amount of trade corrected for re-exports,
measures the share of GDP exposed to final demand in export destination

Latest data: 2009

Source: OECD, WTO, Goldman Sachs Global Investment Research

But CEE is uniquely positioned to benefit from Euro area recovery

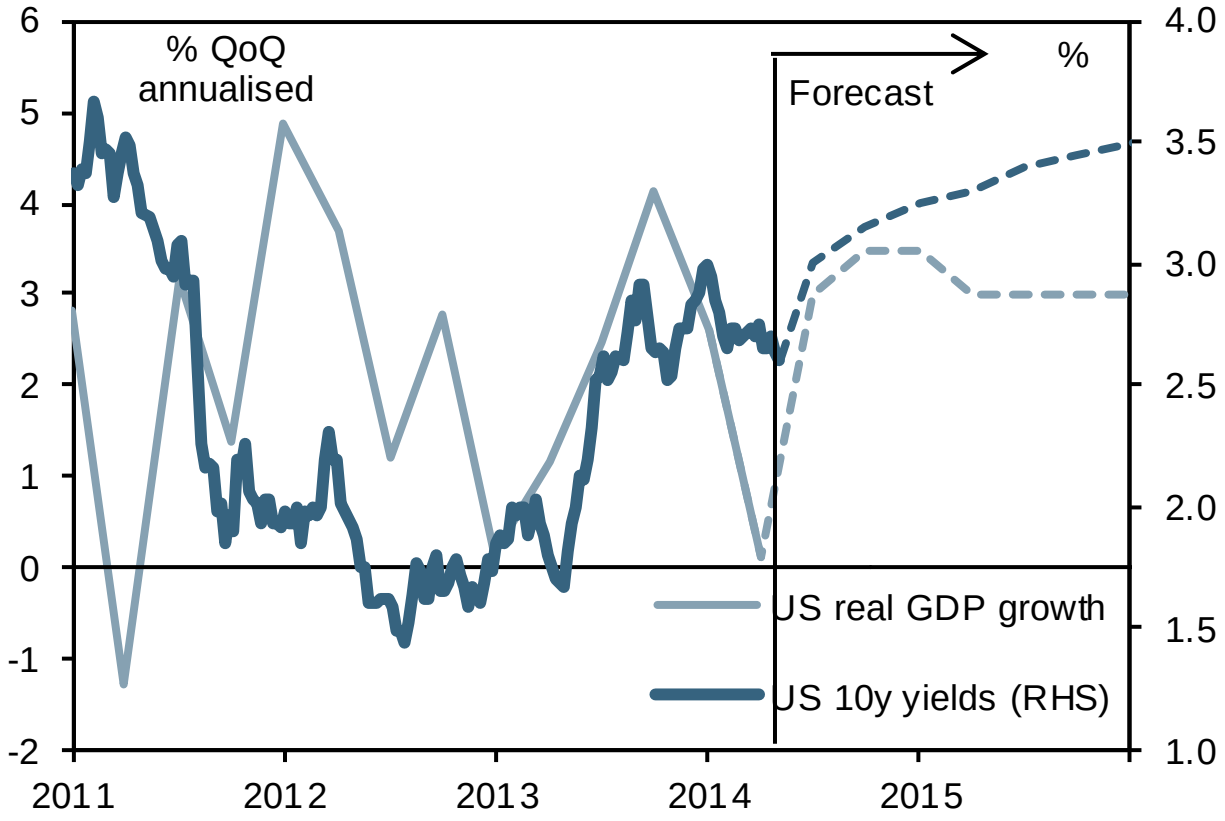


Domestic value added is amount of trade corrected for re-exports, measures the share of GDP exposed to final demand in export destination

Source: OECD, WTO, Goldman Sachs Global Investment Research

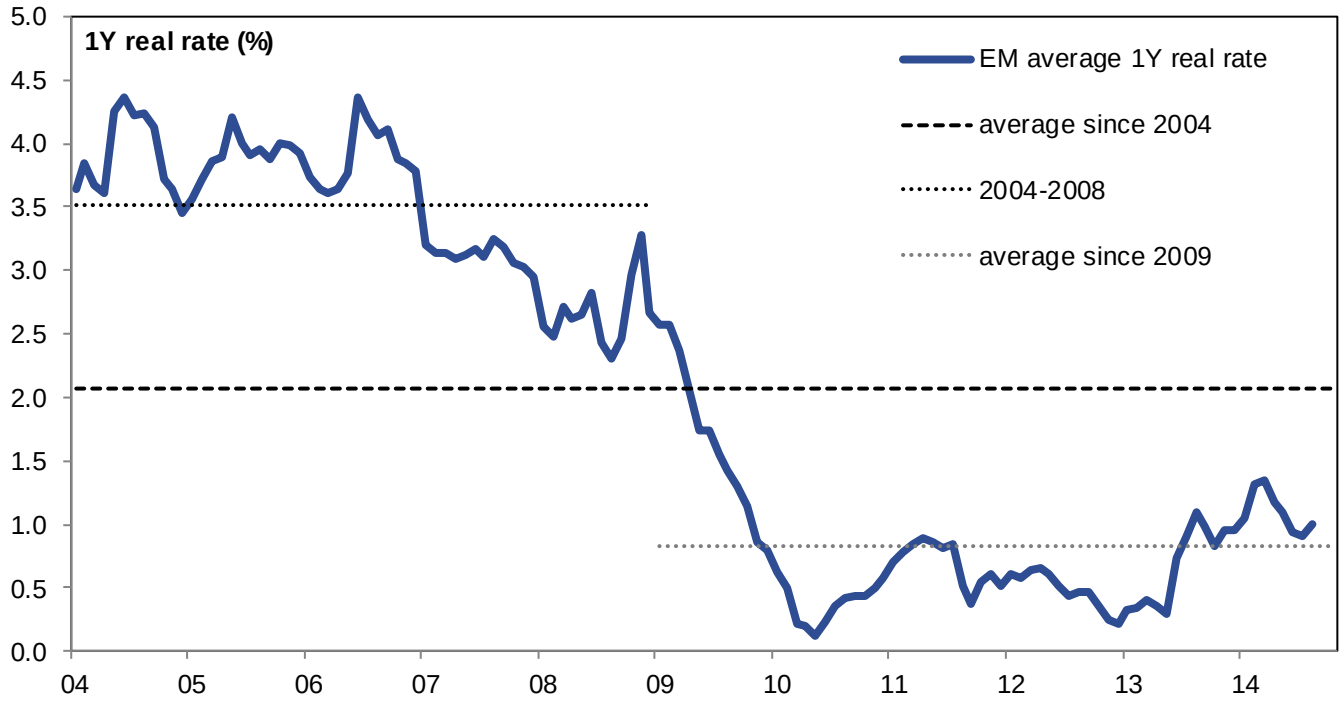
US recovery driving higher rates globally…

Falling core real yields likely to reverse with US recovery, put pressure on EM rates and currencies



Source: Bloomberg, Goldman Sachs Global Investment Research

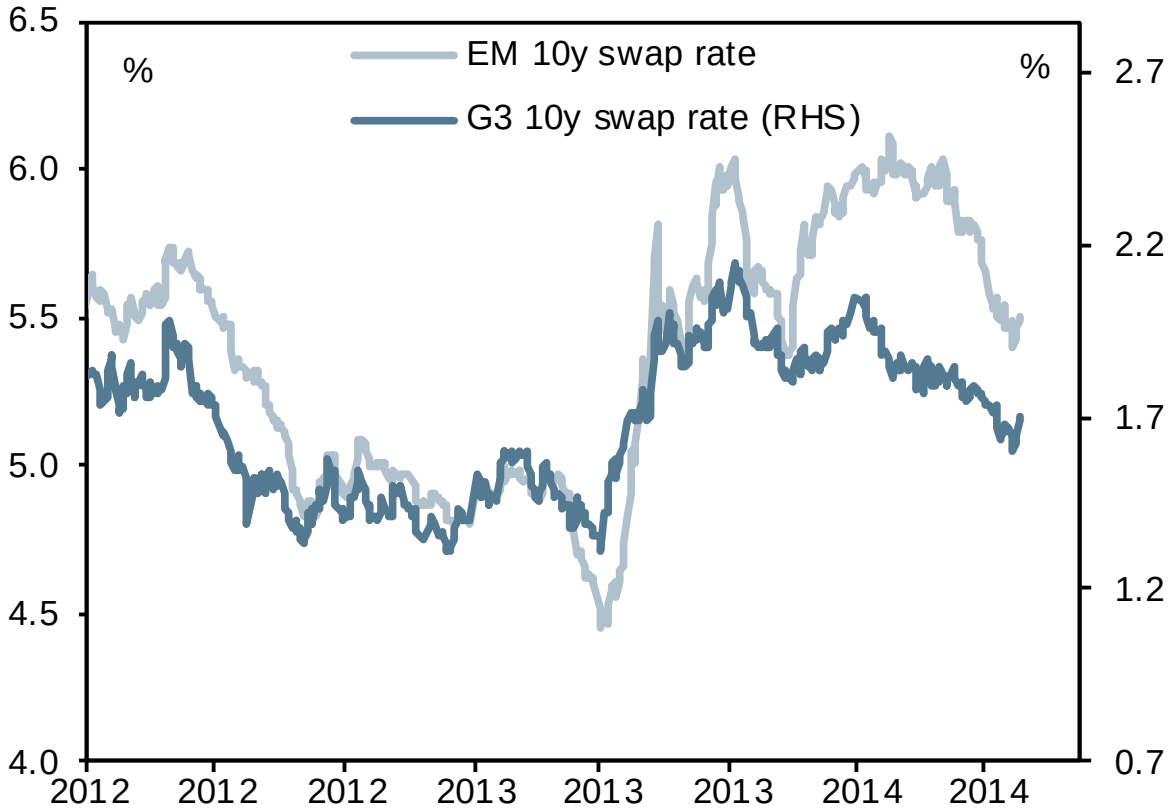
… and EM real rates are already heading higher



EM average 1y rates, includes BRL, CLP, MXN, HUF, ZAR, PLN, KRW, TRY

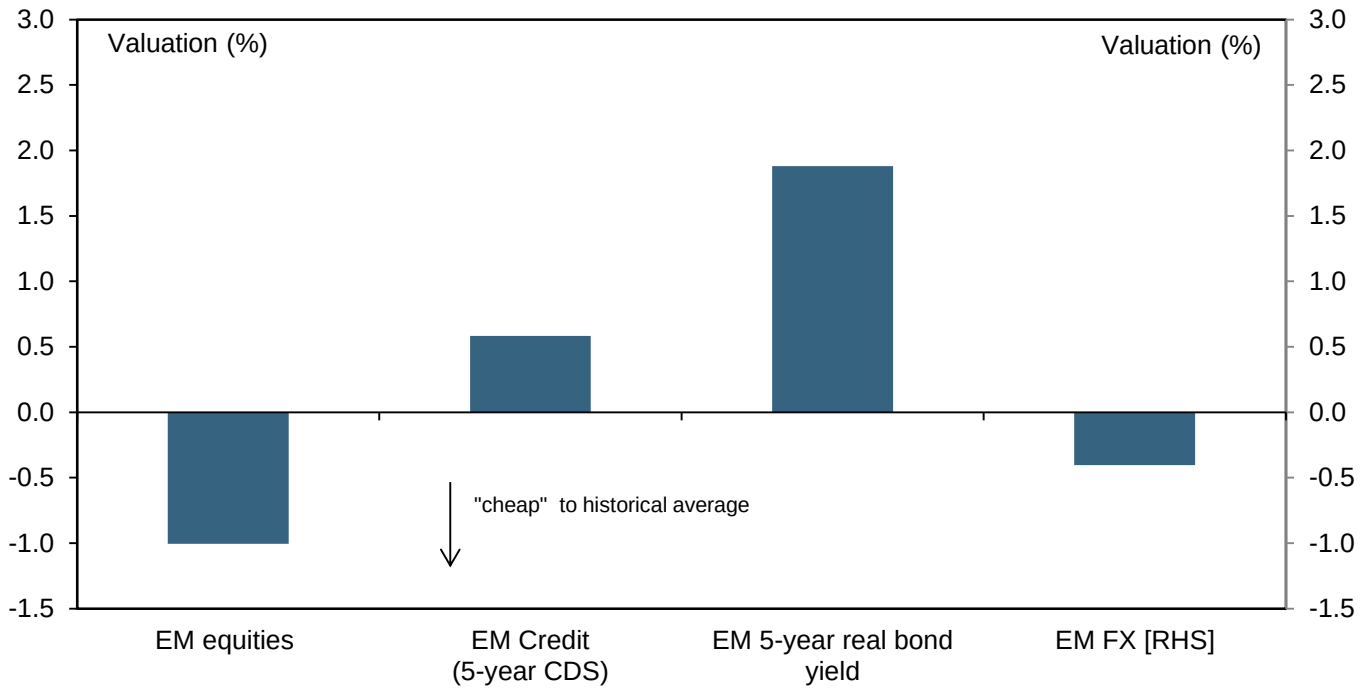
Source: Consensus Economics, Bloomberg, Goldman Sachs Global Investment Research.

EM vs G3 Rates Gap Narrowing, making more vulnerable EMs less attractive



Source: Goldman Sachs Global Investment Research

EM equities offer most value, EM bonds the least

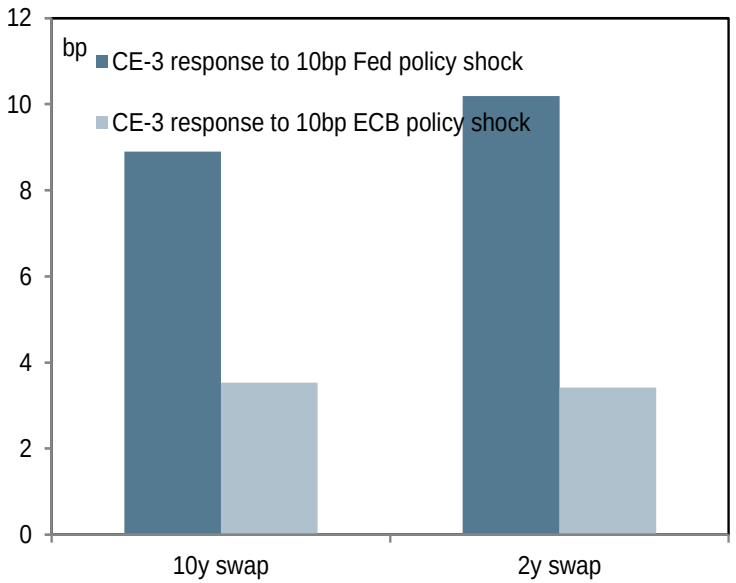


Source: Goldman Sachs Global Investment Research

ECB Easing – benefits developed, nearby EMs, such as the CEE

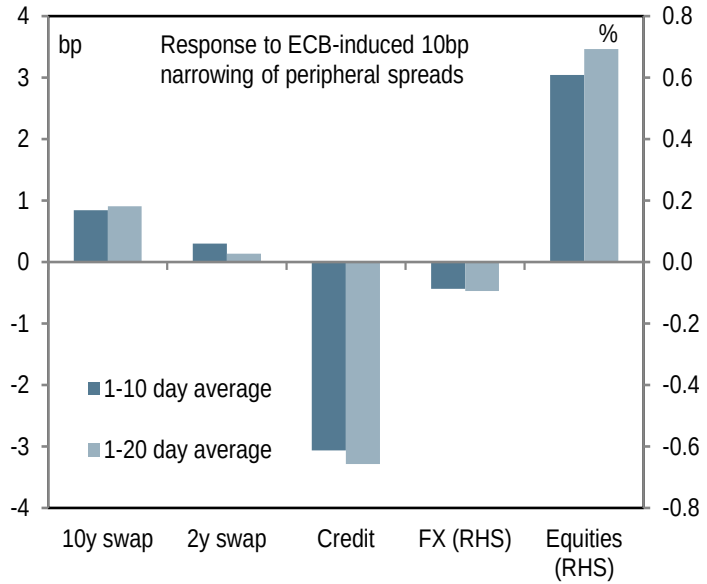
ECB easing matters for EM assets, especially CE-3, but Fed shocks matter more

Response of EM assets on ECB / Fed meeting days 2004-2014



Not all ECB easing is alike – tighter peripheral spreads helps EM credit and equity

Response of EM assets on ECB meeting days 2004-2014



CE-3 fixed income benefits from ECB buffer, deep integration with DMs, unlike most other EMs, reclassification as a DM would offer additional protection

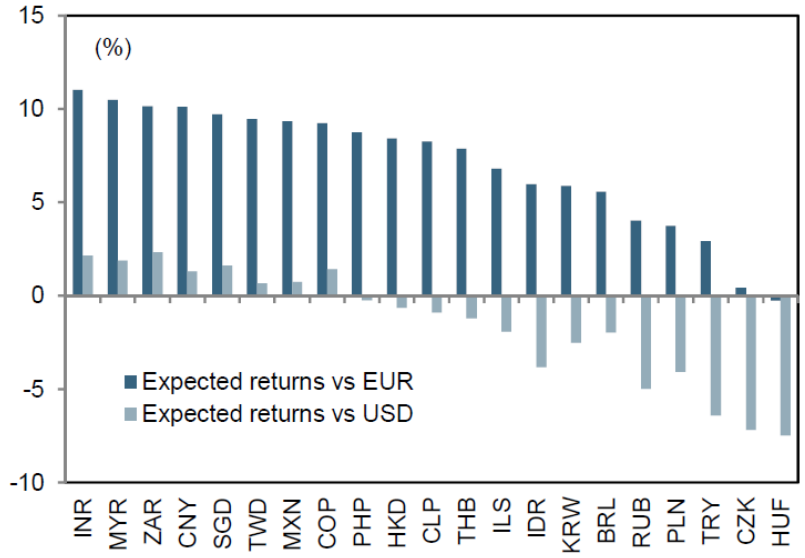
EM credit and equities – especially in CEE – also benefit from ECB easing

Source: Goldman Sachs Global Investment Research

Higher US rates, stronger US Dollar to put pressure on EM currencies

With US rates higher and USD stronger, we expect number of currencies to underperform

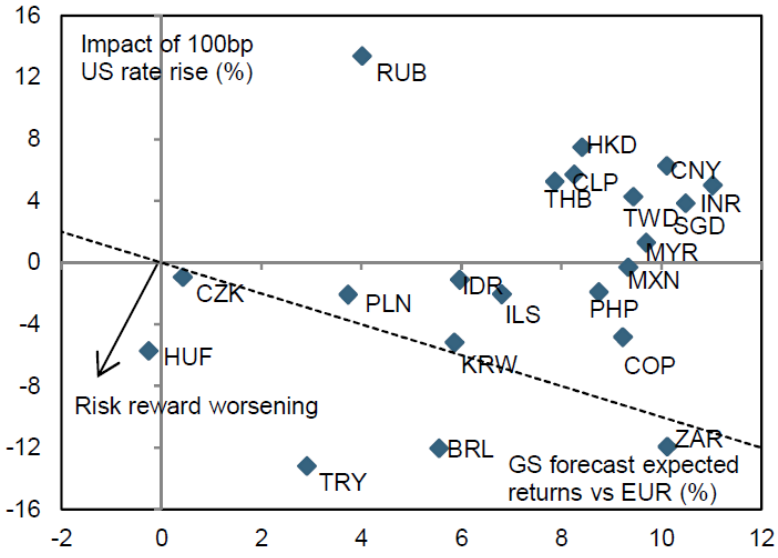
Expected returns from GS 12m forecasts vs forwards



Source: Goldman Sachs Global Investment Research.

Increase in US rates likely most negative for high yielders vs EUR, CEE currencies (because of a strong EUR connection)

Impact of 100bp US 10y policy shock on EM vs EUR crosses



Source: Goldman Sachs Global Investment Research.

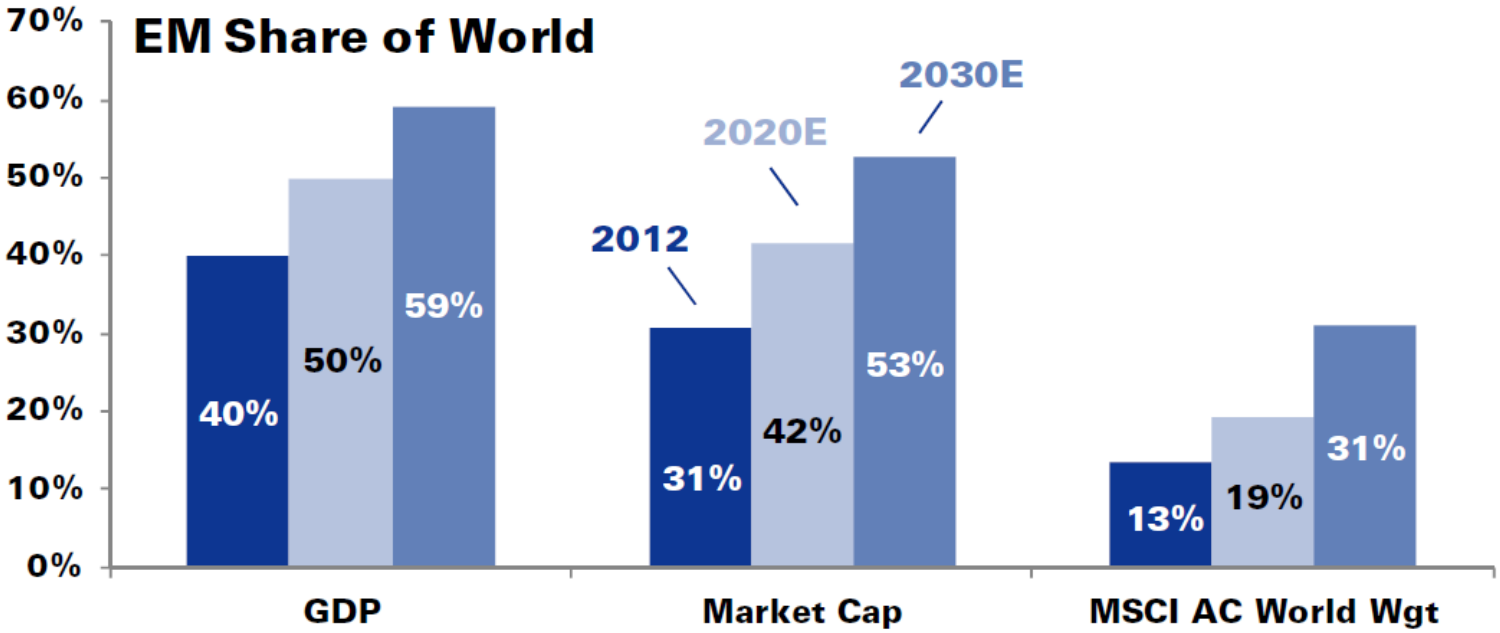
More advanced EMs with better risk metrics will be affected less – like CEE

- **Signs of persistent imbalances:**
  - Weak growth combined with…
  - …High inflation and…
  - …A wide current account deficit
  - Additional risk – concerns about policy quality
- **CEE**
  - Solid growth
  - Low inflation
  - Improvement in current account balances
  - Plus – high scores on institutional quality metrics (GES)

Market Implications of a move to 'mature' EMs as DMs recover

- ***Weaker EM currencies where vulnerabilities higher***
- ***Steeper EM curves, where little ECB 'offset'***
- ***DM credit and equities better placed to trade DM recovery, but…***
  - *CEE uniquely positioned to gain from DM (especially EA) recovery…*
  - *…while less pronounced vulnerabilities support market stability*
  - *Can help CEE assets offset the effects of overall lower future growth and lower risk premia*
  - *Future reclassification as DM to further support and stabilize these markets*

Equity market long-term prospects 1



Source: FactSet ,MSCI, IMF, Worldbank, World Federation of Exchange, Goldman Sachs Global ECS Research estimates

EM's share of global GDP and equity cap could overtake DM share by 2030…
…although by that time some current 'EMs' will become 'DMs'

For details, see: GOAL – Global Strategy Paper No. 7, Goldman Sachs Portfolio Strategy Research

Equity market long-term prospects 2

Asset allocation for major DM conventional asset managers (a subset of OECD countries covering US, EU, Japan and Canada)

Fund Type	Total AUM ($ tril)	Equity AUM ($ tril)	Equity AUM split by DM Domicile				Share of Equity Assets invested in EM
			US	Europe	Canada	Japan	
Pension Funds	**29**	**13**	67%	18%	5%	10%	4%
Mutual Funds, ETFs	**22**	**11**	71%	23%	4%	1%	10%
Insurance Funds	**21**	**2**	29%	56%	5%	9%	2%
Total	**72**	**26**	**66%**	**23%**	**5%**	**6%**	**6.3%**

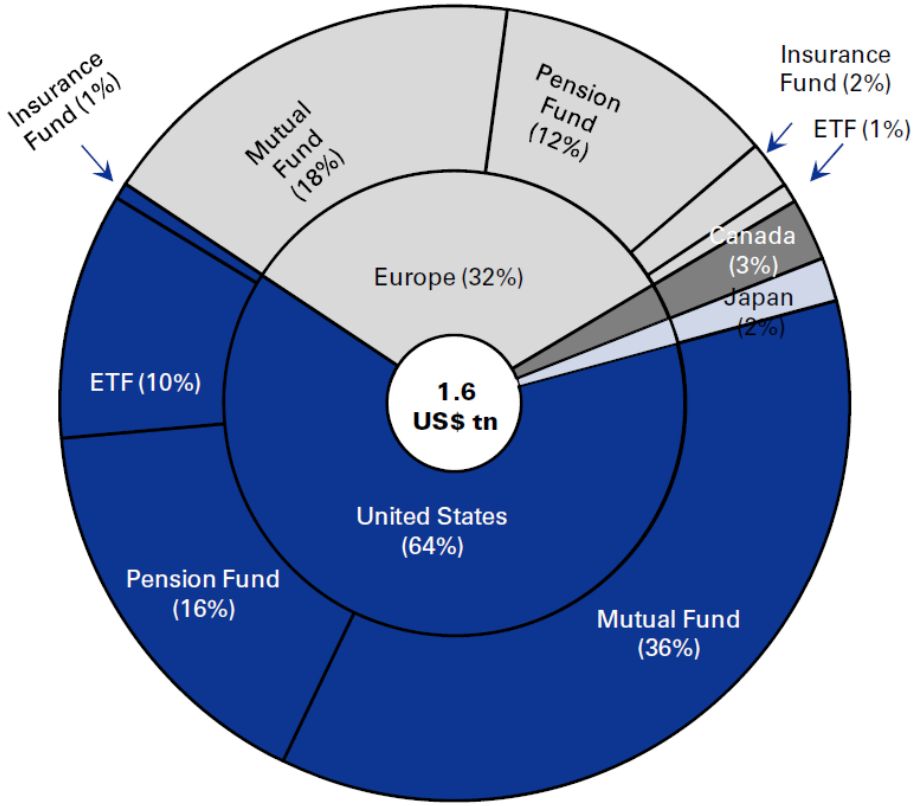
Source: IFSL, OECD, TheCityUK, ICI, Towers Watson, Industry associations in Canada, Goldman Sachs Global ECS Research

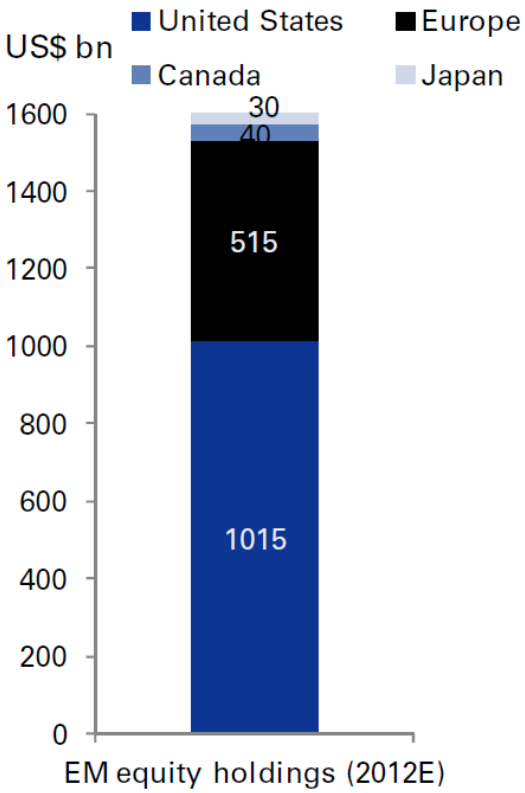
By 2013, major DM conventional asset managers held 6.3% of equity assets in EM…

…Reclassification as DMs would open large pools of new capital

For details, see: GOAL – Global Strategy Paper No. 7, Goldman Sachs Portfolio Strategy Research

Equity market long-term prospects 3

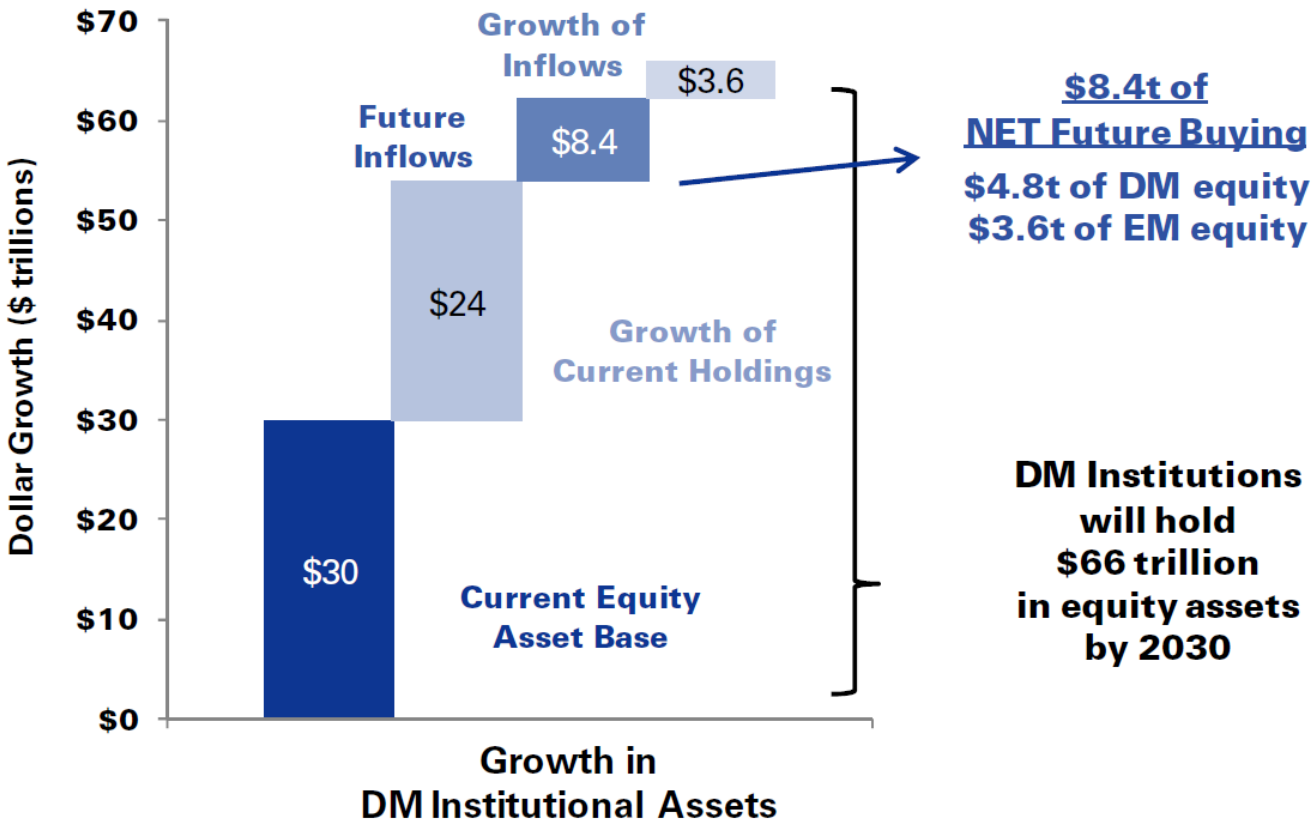




Source: IFSL, OECD, TheCityUK, ICI, Towers Watson, Industry associations in Canada, Goldman Sachs Global ECS Research

By end-2012, major DM conventional asset managers owned about US$1.6trn-worth of EM equity holdings

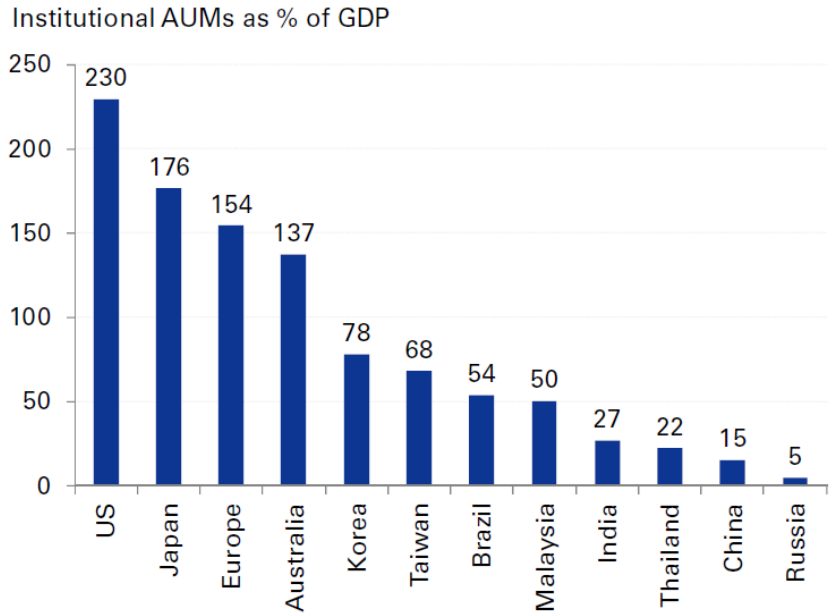
Equity market long-term prospects 4

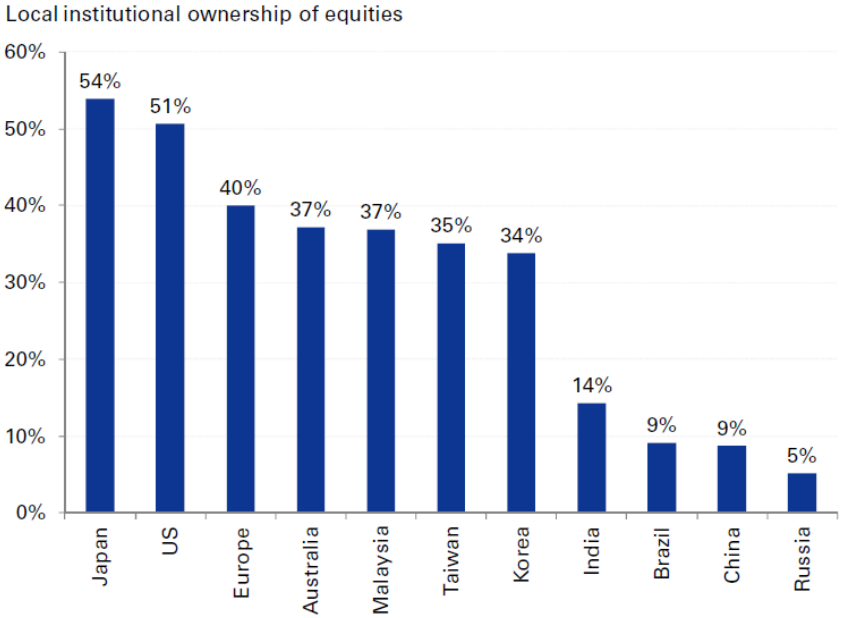


Source: Goldman Sachs Global ECS Research estimates

Composition of projected growth in equity assets of DM institutional investors by 2030

Equity market long-term prospects 5

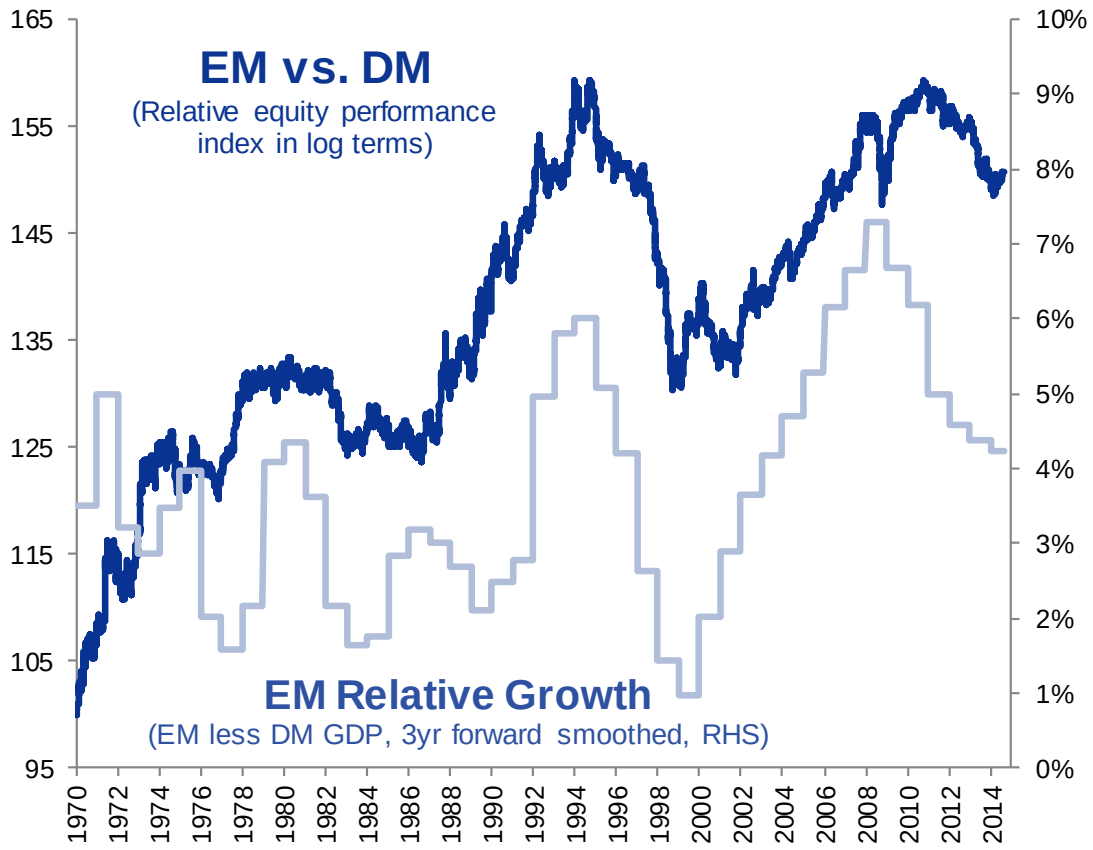




Source: CEIC, IMF, OECD, Wind, local stock exchanges, Goldman Sachs Global ECS Research estimates

- **Institutional funds in emerging markets are still early in their development stage**
- **Institutional funds in emerging markets own a lower percentage of the overall market capitalization**

Equity market long-term prospects 6



Lower relative growth may reduce the positive effects of higher inflows; benchmark reclassification could help overcome this risk

Source: Goldman Sachs Global Investment Research

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I, Magdalena Polan, hereby certify that all of the views expressed in this report accurately reflect my personal views, which have not been influenced by considerations of the firm's business or client relationships.

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