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

Magdalena Polan
Senior CEEMEA Economist
Magdalena.Polan@gs.com

September 2014

Investors should consider this research as only a single factor in making investment decisions. For Reg AC certification and other important disclosures, see the Disclosure Appendix, or go to www.gs.com/research/hedge.html.
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

<table>
<thead>
<tr>
<th>GDP Growth, %yoy</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>2.3</td>
<td>2.2</td>
<td>2.1</td>
<td>3.1</td>
</tr>
<tr>
<td>Japan</td>
<td>1.5</td>
<td>1.5</td>
<td>1.1</td>
<td>1.2</td>
</tr>
<tr>
<td>Euro Area</td>
<td>-0.6</td>
<td>-0.4</td>
<td>0.8</td>
<td>1.4</td>
</tr>
<tr>
<td>UK</td>
<td>0.3</td>
<td>1.7</td>
<td>3.4</td>
<td>3.0</td>
</tr>
<tr>
<td>Brazil</td>
<td>1.0</td>
<td>2.5</td>
<td>0.8</td>
<td>1.3</td>
</tr>
<tr>
<td>China</td>
<td>7.7</td>
<td>7.7</td>
<td>7.3</td>
<td>7.6</td>
</tr>
<tr>
<td>India</td>
<td>4.8</td>
<td>4.7</td>
<td>5.1</td>
<td>6.3</td>
</tr>
<tr>
<td>Russia</td>
<td>3.5</td>
<td>1.3</td>
<td>0.5</td>
<td>1.5</td>
</tr>
<tr>
<td><strong>BRICs</strong></td>
<td>5.4</td>
<td>5.2</td>
<td>4.6</td>
<td>5.3</td>
</tr>
<tr>
<td><strong>Advanced Economies</strong></td>
<td>1.2</td>
<td>1.4</td>
<td>1.9</td>
<td>2.5</td>
</tr>
<tr>
<td><strong>World</strong></td>
<td>3.0</td>
<td>3.0</td>
<td>3.1</td>
<td>3.7</td>
</tr>
</tbody>
</table>

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

GLI momentum vs. global industrial production*

---

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

GLI – Global Leading Indicator

* Includes OECD countries plus BRICs, Indonesia and South Africa
See Global Economics Paper 199 for methodology
Source: OECD, Goldman Sachs Global Investment Research
...as the cycle matures and some global risks abate

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

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

US GDP growth impulse (relative to trend)

Private and Public Sector Impulse*

Percent of GDP


Net Impulse
Private Sector
Public Sector

* Relative to trend growth. Impulses calculated from GS financial balances model.

Source: Goldman Sachs Global Investment Research

The benign consensus
Inflation higher as unemployment falls more quickly than expected

**US core inflation and forecasts**

**US unemployment rates and forecasts**

Source: US Commerce Department, Federal Reserve Board
While there is uncertainty, our view is that significant ‘slack’ remains.
We expect a patient and gentle Fed exit from monetary stimulus

Federal Funds Rate Path

- GS
- SEP*
- Market**

*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.
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
... 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 ...

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

*Consensus forecasts refer to July 2014

Source: Consensus Economics, Goldman Sachs Global Investment Research

The benign consensus
... and expectation that oil and commodity prices will fall from here...
... with the US ‘shale revolution’ playing a central role

Growth in unconventional developments has dominated the past decade

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

Source: Eurostat, Goldman Sachs Global Investment Research
... and fiscal drag on growth diminishes as the pace of austerity eases ...

<table>
<thead>
<tr>
<th>Year</th>
<th>Germany</th>
<th>France</th>
<th>Italy</th>
<th>Spain</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>-1.5</td>
<td>-1.3</td>
<td>-1.1</td>
<td>-0.9</td>
</tr>
<tr>
<td>2013</td>
<td>-1.3</td>
<td>-1.1</td>
<td>-0.9</td>
<td>-0.7</td>
</tr>
<tr>
<td>2014</td>
<td>-1.1</td>
<td>-0.9</td>
<td>-0.7</td>
<td>-0.5</td>
</tr>
<tr>
<td>2015</td>
<td>-0.9</td>
<td>-0.7</td>
<td>-0.5</td>
<td>-0.3</td>
</tr>
<tr>
<td>2016</td>
<td>-0.7</td>
<td>-0.5</td>
<td>-0.3</td>
<td>-0.1</td>
</tr>
</tbody>
</table>

Source: Goldman Sachs Global Investment Research
... despite the need for further fiscal consolidation in several countries

Chg. in structural balance, 2010 to 2013 (est.), % of GDP

- Further required fiscal tightening
- Fiscal tightening so far

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

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.
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

**EM Financial Conditions**

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

*Source: Haver Analytics, Goldman Sachs Global Investment Research.*

*Source: Goldman Sachs, Goldman Sachs Global Investment Research.*
EM stocks posting some turnaround, but currencies unlikely to repeat their run

**EM Equities versus US**

- **EM Equities vs S&P 500**
- **EM vs US 12m forward P/E ratio (RHS)**

**EM FX versus USD and EM FX overvaluation**

- Major EMs, overvaluation calculated using GSDEER values

Source: MSCI, Goldman Sachs Global Investment Research.

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

**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

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

*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

<table>
<thead>
<tr>
<th>Country</th>
<th>Objective 2014</th>
<th>Realised inflation, %yoy (Jul-14)</th>
<th>Forecast, %yoy (end-2014)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Headline</td>
<td>Momentum</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>2.0 +/- 1.0</td>
<td>0.5</td>
<td>+ (+)</td>
</tr>
<tr>
<td>Hungary</td>
<td>3.0</td>
<td>0.1</td>
<td>+ (+)</td>
</tr>
<tr>
<td>Israel</td>
<td>2.0 +/- 1.0</td>
<td>0.3</td>
<td>+ (-)</td>
</tr>
<tr>
<td>Poland</td>
<td>2.5 +/- 1.0</td>
<td>-0.2</td>
<td>+ (+)</td>
</tr>
<tr>
<td>Romania</td>
<td>2.5 +/- 1.0</td>
<td>1.0</td>
<td>- (unch.)</td>
</tr>
<tr>
<td>Russia</td>
<td>5.0 +/- 1.5</td>
<td>7.5</td>
<td>- (-)</td>
</tr>
<tr>
<td>South Africa</td>
<td>3.0 - 6.0</td>
<td>6.3</td>
<td>unch. (-)</td>
</tr>
<tr>
<td>Turkey</td>
<td>5.0 +/- 2.0</td>
<td>9.3</td>
<td>unch. (unch.)</td>
</tr>
</tbody>
</table>

Notes: (1) Core inflation from national sources (SA for Czech Republic, Hungary, Turkey; NSA elsewhere); (2) Objective is midpoint of central 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.

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

Cars denote year in which BRICs USD GDP level exceeds relevant country

Source: Goldman Sachs Global Investment Research
“What the World Wants”: Total demand in EMs overtakes DMs in coming decades
“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

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

Source: Goldman Sachs Global Investment Research.
EMs saw largest improvements in GES recently...

...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

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

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
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

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

Expected returns from GS 12m forecasts vs forwards

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
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)

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

*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
By end-2012, major DM conventional asset managers owned about US$1.6trn-worth of EM equity holdings
Composition of projected growth in equity assets of DM institutional investors by 2030

Source: 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.

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

Source: Goldman Sachs Global Investment Research
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.

Global product; distributing entities
The Global Investment Research Division of Goldman Sachs produces and distributes research products for clients of Goldman Sachs on a global basis. Analysts based in Goldman Sachs offices around the world produce equity research on industries and companies, and research on macroeconomics, currencies, commodities and portfolio strategy. This research is disseminated in Australia by Goldman Sachs Australia Pty Ltd (ABN 21 006 797 897); in Brazil by Goldman Sachs do Brasil Corretora de Titulos e Valores Mobiliarios S.A.; in Canada by Goldman, Sachs & Co. regarding Canadian equities and by Goldman, Sachs & Co. (all other research); in Hong Kong by Goldman Sachs (Asia) L.L.C.; in India by Goldman Sachs (India) Securities Private Ltd.; in Japan by Goldman Sachs Japan Co., Ltd.; in the Republic of Korea by Goldman Sachs (Asia) L.L.C., Seoul Branch; in New Zealand by Goldman Sachs New Zealand Limited; in Russia by OOO Goldman Sachs; in Singapore by Goldman Sachs (Singapore) Pte. (Company Number: 198602165W); and in the United States of America by Goldman, Sachs & Co. Goldman Sachs International has approved this research in connection with its distribution in the United Kingdom and European Union.

European Union: Goldman Sachs International authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority, has approved this research in connection with its distribution in the European Union and United Kingdom; Goldman Sachs AG and Goldman Sachs International Zweigniederlassung Frankfurt, regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht, may also distribute research in Germany.

General disclosures
This research is for our clients only. Other than disclosures relating to Goldman Sachs, this research is based on current public information that we consider reliable, but we do not represent it as accurate or complete, and it should not be relied on as such. We seek to update our research as appropriate, but various regulations may prevent us from doing so. Other than certain industry reports published on a periodic basis, the large majority of reports are published at irregular intervals as appropriate in the analyst's judgment.

Goldman Sachs conducts a global full-service, integrated investment banking, investment management, and brokerage business. We have investment banking and other business relationships with a substantial percentage of the companies covered by our Global Investment Research Division. Goldman, Sachs & Co., the United States broker dealer, is a member of SIPC (http://www.sipc.org).

Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients and our proprietary trading desks that reflect opinions that are contrary to the opinions expressed in this research. Our asset management area, our proprietary trading desks and investing businesses may make investment decisions that are inconsistent with the recommendations or views expressed in this research.

The analysts named in this report may have from time to time discussed with our clients, including Goldman Sachs salespersons and traders, or may discuss in this report, trading strategies that reference catalysts or events that may have a near-term impact on the market price of the equity securities discussed in this report, which impact may be directionally counter to the analysts' published price target expectations for such stocks. Any such trading strategies are distinct from and do not affect the analysts' fundamental equity rating for such stocks, which rating reflects a stock's return potential relative to its coverage group as described herein.

We and our affiliates, officers, directors, and employees, excluding equity and credit analysts, will from time to time have long or short positions in, act as principal in, and buy or sell, the securities or derivatives, if any, referred to in this research.

The views attributed to third party presenters at Goldman Sachs arranged conferences, including individuals from other parts of Goldman Sachs, do not necessarily reflect those of Global Investment Research and are not an official view of Goldman Sachs.

Any third party referenced herein, including any salespeople, traders and other professionals or members of their household, may have positions in the products mentioned that are inconsistent with the views expressed by analysts named in this report.

This research is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Clients should consider whether any advice or recommendation in this research is suitable for their particular circumstances and, if appropriate, seek professional advice, including tax advice. The price and value of investments referred to in this research and the income from them may fluctuate. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Fluctuations in exchange rates could have adverse effects on the value or price of, or income derived from, certain investments.

Certain transactions, including those involving futures, options, and other derivatives, give rise to substantial risk and are not suitable for all investors. Investors should review current options disclosure documents which are available from Goldman Sachs sales representatives or at http://www.theocc.com/about/publications/character-risks.jsp. Transaction costs may be significant in option strategies calling for multiple purchase and sales of options such as spreads. Supporting documentation will be supplied upon request.

In producing research reports, members of the Global Investment Research Division of Goldman Sachs Australia may attend site visits and other meetings hosted by the issuers the subject of its research reports. In some instances the costs of such site visits or meetings may be met in part or in whole by the issuers concerned if Goldman Sachs Australia considers it is appropriate and reasonable in the specific circumstances relating to the site visit or meeting.

All research reports are disseminated and available to all clients simultaneously through electronic publication to our internal client websites. Not all research content is redistributed to our clients or available to third-party aggregators, nor is Goldman Sachs responsible for the redistribution of our research by third party aggregators. For all research, models or other data available on a particular security, please contact your sales representative or go to http://360.gs.com.

Disclosure information is also available at http://www.gs.com/research/hedge.html or from Research Compliance, 200 West Street, New York, NY 10282.