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To: Jeffrey Kogan <[REDACTED]>

Subject: FW: Goldman Sachs Investment Strategy Group: "The Optimism is Justified"

Date: Mon, 27 Jul 2009 19:51:27 +0000

Attachments: The_Optimism_is_Justified.pdf

From: Shamasdin, Jamil [mailto:[REDACTED]]

Sent: Monday, July 27, 2009 1:55 PM

To: Faith Kates

Subject: Goldman Sachs Investment Strategy Group: "The Optimism is Justified"

Faith,

Please find below (and attached) the most recent market overview from our Private Wealth Management Investment Strategy Group. We hope that you find this helpful, and please let us know if you have any questions.

Best regards,

Your Goldman Sachs Team (Ward, Leslie, Ben, Chris, Jamil, HT, Colleen, Kimberly, & John)

July 27, 2009

The Optimism is Justified

With a generally favorable earnings season in full swing with 55% of companies in the S&P 500 reporting earnings for the second quarter of 2009 and a slew of economic data pointing to either further stabilization or in some cases actual improvement, global credit markets have rallied to reach highs not seen since June of last year and global equity markets are back to levels not seen since early in the fourth quarter of last year. In the US, the S&P 500 closed at 979.3 on July 24th, for a price return of 46.9% from its trough of 666.8 on March 6, and a total return of 48.1%. Meanwhile, MSCI EAFE had a price return of 52.2%, MSCI Emerging Markets a return of 81.3%, and the high yield market as measured by the Barclays US corporate high yield Index had a total return of 49.1% from its trough on December 12. It is interesting to note that, as was the case in the 2003 market recovery, US equities and high yield securities have had very similar total returns. Given the strong support from favorable earnings, let's first review the earnings results reported over the last few weeks.

Earnings Continue to Positively Surprise

In our May 11th email, we highlighted how the combination of companies' aggressive cost cutting, abatement in the pace of financial write-downs and persistent analyst skepticism despite better Q1 earnings could conspire to produce upside risk to Q2 results. With 55 percent of the S&P 500 Q2 earnings reported, that upside seems to be coming to fruition. Thus far, 76% of reporting companies have beaten expectations, better than the 68% which did so in Q1 and well above the historical average of 59%. Moreover, the pace of financial write-downs has slowed dramatically, providing a sizable tailwind to earnings growth. In the second quarter, financial firms took roughly \$46B of write-downs, half the rate of Q1 and some 80% below the \$243B recorded in the 4th quarter of 2008. Part of this write-down improvement has been driven by declining delinquency trends, a positive sign of improving loan book health. In fact, as charge-off rates peak over the next several quarters, it's not inconceivable that financial firms could begin releasing reserves in 2010, as evidenced in the recent results of E*TRADE Financial Corp. Just as building reserves was a sizable headwind to financial earnings over the last 2 years, so too could reserve releases become an important tailwind to financial earnings growth going forward.

In reviewing the composition of Q2 reports, the primary driver of improved earnings performance continues to be aggressive cost cutting by management. Thus far in Q2, firms have reduced Selling, General and Administrative (SG&A) costs by 5% over last year, building on similar percentage declines in Q1. The resulting operating leverage is meaningful, as firms don't need to see a significant improvement in top line revenue to drive impressive earnings improvement. For example, GIR estimated that within their technology hardware coverage universe, a 1% increase in revenue now yields between a 3 to 9% increase in earnings, depending on the specific company.

Of course, while this potential operating leverage is the biggest source of earnings upside going forward, cost cuts could quickly reach the point of diminishing returns. Most of these SG&A reductions have been in headcount, as painfully evident in the employment statistics, but management will find it increasingly difficult to reduce employees further without compromising their basic business models. As such, it will be pivotal next quarter to see a transition from cost reduction to stabilizing/improving top line results. With nascent signs of end-demand stabilization, and the majority of fiscal stimulus taking hold in the next 2 quarters, there is some basis for optimism. Indeed, we are already starting to see early signs of sales improvement. Thus far in Q2, some 50% of companies have beaten revenue expectations, an improvement over Q1's 39%. Of equal importance, yearly sales growth rates have started to improve, currently tracking at negative 7% in Q2 vs. consensus expectations of negative 16% and last quarter's negative 14% rate.

Will Economic Fundamentals Support the Earnings Momentum?

Since the Investment Strategy Group's Stabilization Index crossed the 65 threshold in the US in January, in the Eurozone in March, in the UK in April, and in Japan in May, we have continued to see signs of improvement in a broad range of leading economic indicators¹. The Goldman Sachs

Global Leading Indicator Momentum Index rose for the seventh consecutive month to its highest level ever at 1.04%.

In the US, there are several signs that a bottom in housing is near. While the S&P Case Shiller Home Price Index showed some tentative signs that the rate of price declines might be slowing when reported at the end of June, the more recent FHFA House Price Index reported last week showed an actual increase of 0.9%. Existing home sales in June rose 3.6%, housing starts increased by 3.6%, and building permits increased 8.7%. While the excess supply of housing inventory is still high and we are not expecting a significant contribution from residential investment in the next year or so, we do expect housing to bottom by the end of 2009 or early 2010.

Macroeconomic data is also stabilizing elsewhere. University of Michigan Consumer Sentiment improved slightly in July, albeit remaining at very low levels. While initial jobless claims increased to 554,000 from a revised 524,000, the increase was mostly due to some distortions in seasonal adjustments. And at 554,000, claims are substantially lower than the numbers in the 650,000 plus levels seen in mid-March through early April. This is not to say that the unemployment rate, which has been a lagging indicator at all economic turning points, will be bottoming any time soon. In fact, our economists at Goldman Sachs expect unemployment to reach 10.5% by 2010. To put this number in perspective, unemployment peaked at 10.8% in the 1980-82 recession.

In the Eurozone, preliminary PMI for Germany's manufacturing and services sectors rose, and the Ifo Index which is a survey-based business index rose for the fourth straight month and exceeded consensus expectations. Early in the month, German industrial production surged the most in almost 16 years in May, showing that the largest economy in Europe is also bottoming. In the UK, retail sales volumes were higher than expectations and business surveys were stronger as well. In Japan, exports have risen 7% from the February 2009 bottom, and on a month-by-month basis, exports were up 1.1% in June. Exports are also improving in South Korea and Taiwan. In China, our Goldman Sachs economists estimate sequential quarter-on-quarter GDP growth to reach 16.5% with reported year-on-year real GDP growth of 7.9% in the second quarter of 2009.

Such improvements over the last several months have prompted an economist or two to mention how various economies such as the US and a handful of other economies in Asia might actually surprise to the upside. For example, Professor Alan Blinder's latest article in the Wall Street Journal² mentioned a "reasonable chance--not a certainty, mind you, but a reasonable chance--that the second half of 2009 will surprise us on the upside." As we have noted in the recent past, there have been several studies that show the strength of a recovery is highly correlated with the depth of the prior recession. According to Macroeconomic Advisors and Michael Mussa of the Peterson Institute for International Economics, if history is to repeat itself, real GDP growth in the US would exceed 6% by 2010. We still expect US GDP growth of 2% for 2010, however we do believe that there is a higher probability that growth will surprise us to the upside.

In spite of renewed optimism in the market place, the S&P at 979.3, and a generally favorable earning season to date, we are leaving our year-end 2009 target range for the S&P at 1050-1150

(with a mid-point of 1100) and our year-end 2010 target range at 1100-1200 (with a mid-point of 1150) unchanged. We continue to maintain an overweight to S&P 500 and to high yield securities, as well as to home builders, technology companies, and oil services. This brings us to an important question regarding our views on the energy sector.

Crude Oil Investment Strategy

Spot oil prices have registered one of the highest returns of any sector or country from its trough in late December to its peak in June 11. Using Bloomberg data for West Texas Intermediate Spot Oil to be delivered at Cushing, Oklahoma (pricing data that aligns with Platts), spot oil prices had risen by 131%, compared to MSCI China up 124%, MSCI Indonesia up 151%, and S&P banks up 128%. Based on closing prices on Friday (which were off their peak in June), spot prices were up about 112% since late December. Such an increase has prompted our clients to ask why they have not participated in such a rally. The answer is quite straightforward: those returns are not available to financial investors.

Let's address the first issue of investing in energy futures versus owning physical oil through the spot market. It is critical for investors to know that as financial investors, they cannot participate in the real physical market--and the returns described above were only available to real physical buyers or owners of crude oil. Investors cannot actually take delivery of thousands of barrels of oil, store the barrels, insure the barrels and then deliver them to another buyer at some future date. And investors who tried to participate in the oil market via the futures markets did not receive any such returns. The S&P GSCI oil total return between late December to June 11 was up about 20% (compared to 131% using Bloomberg and Platts data for spot physical crude) and through Friday, it was up only 10.6% (compared to 112% using Bloomberg and Platts data for spot physical crude). This substantially lower return is due to the "contango" in the futures market where near term oil contracts have lower prices than oil contracts further into the future. The shape of the forward curve is partly determined by supply and demand imbalances, and the current economic downturn has dampened demand for oil, leading to a substantial build up of inventories. At 1,118 million barrels, US commercial inventories are at their highest level in 10 years and only 0.8% below their all-time high. OECD commercial inventories (only monthly data is available) stand at 2,768 million barrels, well above the 5-year range, and just below the highest level of inventory relative to forward use since 1990. Therefore, even if clients had participated in the energy sector through the futures markets, the contango of the last 7 months due to the inventory overhang would have limited their return to only 10%.

However, given a long-term increase in expected demand from emerging markets and an increase in demand from OECD countries when global growth recovers, we favor the oil services sector to a direct investment in the futures markets. The Oil Services sector has a high beta to oil (roughly 0.4), making it an indirect way to express an oil view. Moreover, while energy valuations broadly are neutral relative to the last 20 years, we note that rising year over year growth in oil prices has historically supported above average valuation multiples in the space. Easier comparisons from last year would imply that yearly growth in oil prices will turn positive in the coming months (even if oil prices stay flat at current levels) providing room for valuation expansion. Moreover, oil service firms continue to trade at a discount to the broader energy sector, providing further scope for positive re-rating.

In addition, we think it is important to invest in oil with a view towards the risks entailed by such an investment. From its then peak of \$39.5 in July 1980, oil prices dropped to a nominal price of \$11.28 in December 1998 (using historical spot physical crude data available from Dow Jones), a drop of 71.4% over 18 years. Over the same time period, energy stocks were up 11% annualized or 526% on a cumulative basis. In other words, despite a 71.4% drop in crude prices, energy companies managed to invest appropriately, generate positive earnings and return value to shareholders. Therefore, given the volatility of energy prices and the tremendous uncertainty of prices in the next year or two, we prefer investing either through oil services or directly through private equity.

¹ The threshold of 65 is significant as, once crossed, it signals stabilization in leading economic indicators and suggests that the current recession might end in the next 5-8 months. Please contact your Goldman Sachs representative for more information on the ISG Stabilization Indexes.

² Blinder, Alan. "The Economy Has Hit Bottom." (*The Wall Street Journal*, July 24, 2009).

Sources: Investment Strategy Group, Dow Jones, Peterson Institute for International Economics, Bloomberg, Datastream, Platts.

The Goldman Sachs Global Investment Research referred to in this email may be available by requesting a copy from your Private Wealth Professional. For the Global Investment Research, disclosure information is also available from Research Compliance, One New York Plaza, NY, NY 10004.

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