Investment Management Division

Goldman Sachs

Investment Strategy Group

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Will the European Sovereign Debt Crisis Derail Global Growth?

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Since the S&P 500 peak in early April, global equities have fallen by 10%. US equities have fared slightly better, dropping 8.7%, compared to drops of 18% in Italy and Spain, and 14% and 18% in Brazil and Russia, respectively. Inevitably, our clients are asking how to interpret this recent downdraft: is it simply an overreaction to the looming threat of a Greek exit from the Eurozone against a backdrop of expanding corporate earnings and mixed, but not poor, economic data; or, more worryingly, should they view it as the beginning of a bear market driven by concerns about the banking system in Spain and the real risk of contagion from a Greek exit from the Eurozone?

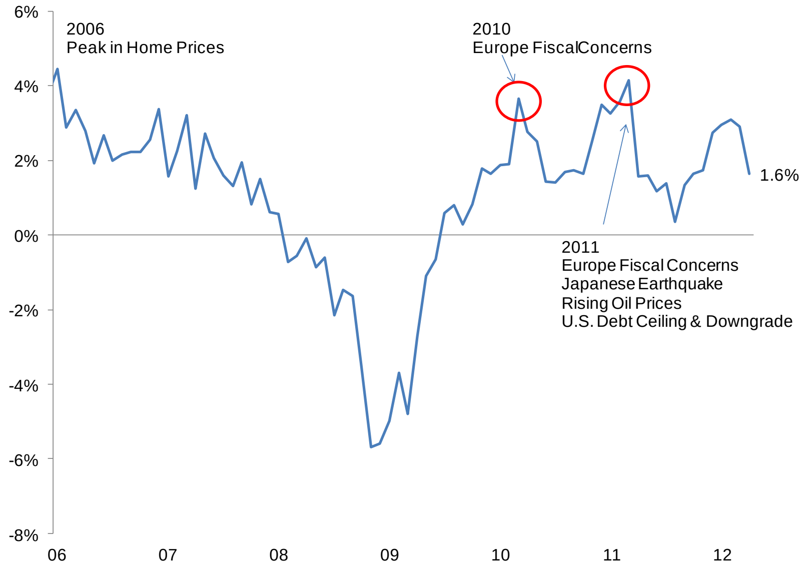
As we examine the data, we believe that economic fundamentals, corporate earnings, and the Spanish banking system alone do not justify concerns about a significant bear market. The Greek crisis, on the other hand, has created tremendous uncertainty and led to an onslaught of inflammatory commentary—"disorderly implosion"[1]; "catastrophic contagion"[2]; "a future of horrible crises"[3] — which themselves undermine investor and consumer confidence. Even though Greece is less than 0.5% of global GDP and about 2% of Europe's GDP, it has been the epicenter of the European sovereign debt crisis since early 2010 given concerns about contagion to other peripheral European countries and the risks to the long-term viability of the European Union itself.

We shall briefly touch upon the more recent economic data and earnings reports to clarify why we believe they should not be the major source of concern. We will then focus on Europe and the risks and implications of a Greek exit, which we believe is the major catalyst for the sell-off. In fact, one can argue that the market agrees with this assessment since prior to the Greek elections, the S&P 500 had dropped only 3.5% from its high, well within the normal range of equity market volatility.

Mixed But Not Poor Economic Data

In the US, data over the last month has been somewhat mixed with the majority pointing towards modest growth and in line with our central case expectation of about 2% GDP growth in 2012. For example, the ISM Manufacturing Index surprised to the upside at 54.8, while its non-manufacturing counterpart was lower than expectations at 53.5, but still above the 50 threshold that implies positive growth. Core retail sales, housing starts, industrial production, and the University of Michigan Confidence Index all increased, while initial jobless claims have held steady near the 370,000 mark. Less favorable data includes the Philadelphia Fed manufacturing Index (which was a harbinger of economic and equity market weakness when it peaked in March 2011 last year), and the Conference Board Leading Economic Indicator (which has not been a great predictor of economic weakness and recessions). The Goldman Sachs Current Activity Index, which we had shown in our last Sunday Night Insight and is updated below, has fallen further to 1.6%, making it easier to draw parallels to 2010 and 2011. In short, the above mixed-but importantly not poor-data, coupled with strong corporate balance sheets, much improved household balance sheets and a significantly deleveraged financial sector, is still consistent with positive US economic growth. This is important, as the US accounts for 22% of world GDP and 47% of global equity market cap.

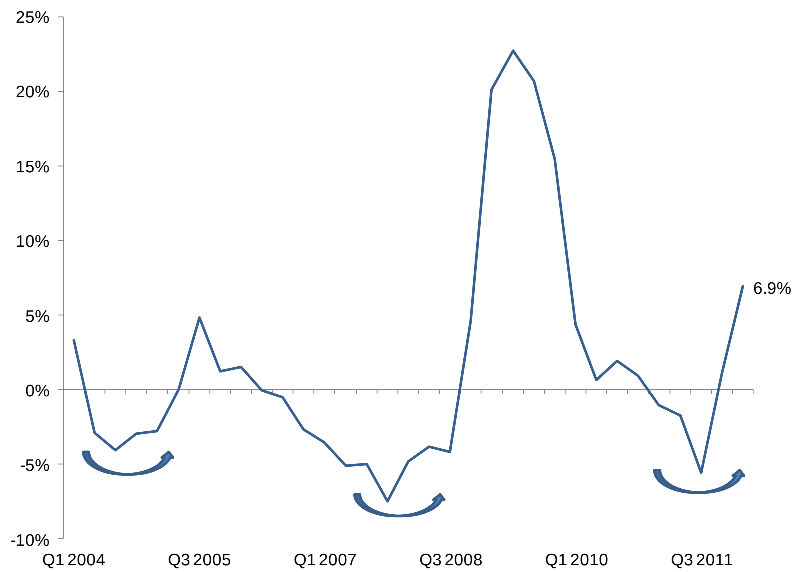
1. Goldman Sachs Current Activity Index
Through April 2012



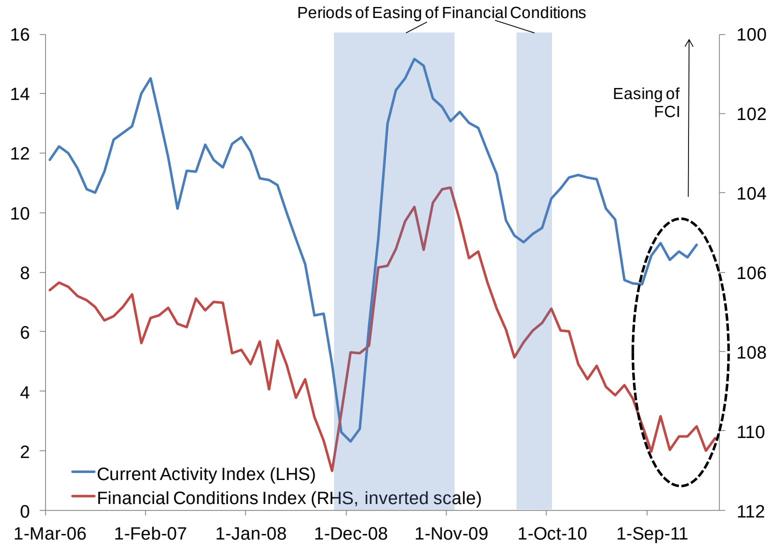
Source: Investment Strategy Group, Goldman Sachs Global Investment Research

In China, which accounts for 11% of world GDP, the preponderance of data has pointed to weaker growth. Industrial production, exports growth, retail sales, fixed asset investment, and some monetary indicators like new loan growth and M2 have slowed relative to prior data and relative to market consensus. But even at slower growth rates, the absolute levels are quite high. For example, while the pace of growth in industrial production has slowed, it is still up 9%. Similarly, retails sales are 14% above last year's level and fixed asset investment is 20% above last year's level. We maintain our central case growth expectation of about 8% for China and believe that China has both the means and resources to avert a hard landing through aggressive easing of policy measures, if necessary. China policy makers have already lowered the required reserve ratios by 1.5% since Autumn of 2011 and may well go further; they can also start lowering interest rates in light of lower producer price and consumer price inflation. Furthermore, broad money growth continues to exceed GDP, thereby injecting liquidity and portending an easing of financial conditions in China, as shown in Exhibit 3 below.

2. Chinese "Excess Liquidity": M2 Growth less Nominal GDP Growth
Data Through Q1 2012



3. China: Current Activity Index and Financial Conditions Index (% through April 2012)



Source: Investment Strategy Group, Goldman Sachs Global Investment Research, CEIC, BCA Research.

In Japan, much of the data has been strong, partly because of post-earthquake rebuilding and recovery from the Thai floods. In fact, first quarter GDP increased by 4.1% on an annualized basis driven by private sector consumption, net exports, public works, and business inventories. While this pace of growth will undoubtedly slow, we nevertheless expect Japan to grow by just over 2% in 2012. Keep in mind that Japan accounts for 8% of world GDP.

In the Eurozone, which represents 19% of world GDP, growth is a tale of two groups: the core countries, headed by Germany, with a growth rate of 0.5% in the first quarter and the weak peripheral countries, including Greece, Ireland, Italy, Portugal and Spain, where first quarter GDP has ranged from -0.3% in Spain, -0.8% in Italy, and -7.3% in Greece. While we can speculate on the sustainability of economic momentum in Germany, fueled as it has been by cheap credit, capital inflows from the troubled periphery, and a weaker euro given the Eurozone crisis, the outcome in Greece will ultimately dominate the trend of growth in all European countries for the rest of the year.

Robust Earnings

In both the US and Europe, which jointly account for 70% of the market capitalization of global equities, earnings have grown at a faster pace than economic growth. With about 95% of the S&P 500 having now reported, aggregate earnings are up 7.7% year-on-year with sales growth of roughly 6%. Earnings growth was much better than the 2% consensus expected in early April. Despite this strong earnings performance, where 2/3rd of companies exceeded earnings expectations by an average of about 5%, the S&P is down 8.7% from its peak in early April, with Financials and Materials being the biggest underperforming sectors at around 13%.

Similarly in Europe, 93% of the European Stoxx 600 companies that report quarterly earnings have recently done so, registering sales growth of about 6% for the quarter. Earnings growth was also much better than expected, with 45% of companies exceeding expectations by more than 5%. In spite of this stronger than expected earnings performance, European equities are down anywhere from 11% in Germany to 18% in Spain and Italy. Greek stocks fell 23%.

Clearly, it is not the current fundamentals of companies that is precipitating this downdraft. Instead, it is largely the uncertainty surrounding the fate of Greece and its implications for the Eurozone.

A Greek Exit?

Since the Greek elections on May 6, where the governing coalition of Pasok (led by Venizelos) and New Democracy (led by Samaras) lost its majority of 83%, the future of Greece and the Eurozone has been thrown into turmoil. At the root of the upset was the Radical Left Party, Syriza, headed by Alexis Tsipras, who won a surprising 17% of the votes from a 2009 level of just 4%. Worryingly, this party has been calling for the abrogation of the austerity/bailout package agreed upon with International Monetary Fund and the European Union in February. Not surprisingly, European policy makers' have unanminously warned that such a unilateral abrogation by Greece would result in the suspension of its international funding support from the IMF, the EU, and the ECB, which in turn would force a Greek exit from the Eurozone. In fact, shortly after the Tsipras post-election comments, Jorg Asmussen, a European Central Bank executive board member and senior European policy maker, raised for the first time the possibility of a Greek exit.[4] Since then, numerous European policy makers including the newly elected French President Francois Hollande and German Chancellor Angela Merkel have stated that they would like Greece to stay in the euro but that would only be possible if Greece "honored" its commitments.

Currently, market participants are following two critical trends: 1) the outflow of deposits from Greek banks and 2) opinion polls on the three key parties in Greece in anticipation of the elections on June 17.

1. Outflow of Deposits: As Jacob Kirkegaard, guest speaker at our client call last Monday (European Sovereign Crisis: Is Political will Fading?), has stated, bank deposits in Greece are being withdrawn at an accelerating pace. Even before the election,

about one-third of deposits had been withdrawn. If this pace continues, and fears of a bank run increase meaningfully, the hope is that the electorate in Greece will recognize the risks of Tsipras's populism and turn back to Pasok and New Democracy. Jacob actually goes so far as to say that the Greek president could "reconvene political leaders to try to salvage the situation" in the face of a bank run led by retail depositors.[5] So on the one hand, allowing a bank run could be beneficial for the markets in the near-term, as it could strengthen the hand of the pro-austerity parties, allowing them to reclaim their majority. On the other hand, such a strategy could be quite risky, as a bank run in Greece could spread to other periphery countries.

2. Opinion Polls: As Miranda Xafa, another guest speaker on our client call stated, everyone is watching the Greeks polls to see whether voting is dictated by "fear" or "anger." In other words, is anger toward austerity and the Troika (ie the IMF, EU and ECB) driving the Greek electorate vote, which would clearly favor Syriza, or is fear of bank runs and explusion from the Eurozone the driver, which would support Pasok and New Democracy. While Pasok and New Democracy will support austerity, they will, in all likelihood, ask for some forbearance and pro-growth support from the Troika. This recognition, as well as continued turmoil in the markets and greater clarity regarding the negative implications of a Greek exit, has already reduced Syriza's standing in the polls while that of New Democracy or the governing coalition has increased slightly. Miranda Xafa is hopeful that the Greeks realize that an exit will mean "a very abrupt and hard landing…..shortages of goods like gasoline, food stubs, medicines…much chaos", and a decline in exports.

While all of our guest speakers, including Huw Pill, Chief European Economist at Goldman Sachs, acknowledged that the probability of a Greek exit had increased following the May 6th election, none had a Greek exit as their base case in the next several months.

Possible Path Over the Next Month or So

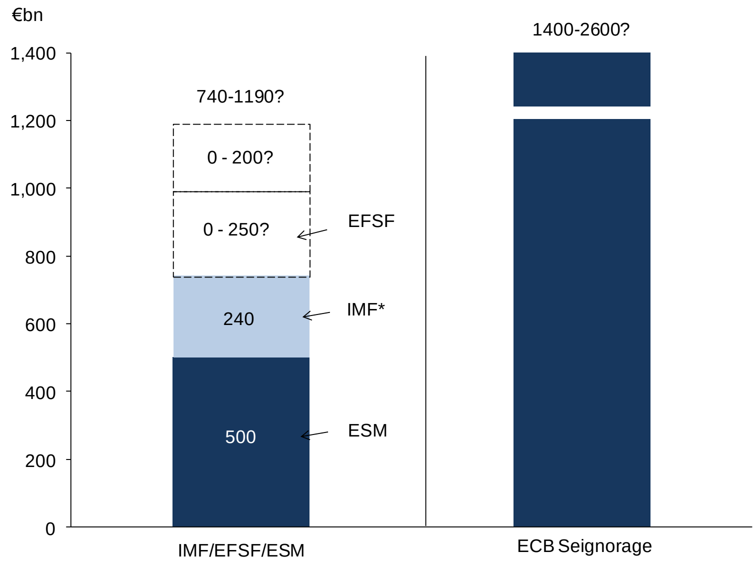
Turning again to the experts in the field, we asked our guest speakers to outline what we can expect over the next month or so beyond extreme volatility. There were three key areas of focus: the political will for continued austerity in Europe, the role of the ECB and the size and effectiveness of the firewall to protect the rest of the Europe in the event of a Greek exit.

First and foremost, our speakers cautioned that we should not interpret the French elections, the Italian municipal elections, the loss of Chancellor Merkel's CDU party in local elections in Schleswig-Holstein and North Rhine-Westphalia nor the collapse of the Dutch coalition government as "anti-austerity" outcomes or as an indication of fading political will to implement much needed reform. Instead, it seems these elections were more about balancing austerity with some pro-growth measures in the form of support for investments. In fact, the latest polls in Ireland show continued support for the Fiscal Compact and in turn, further fiscal integration in Europe. Notably, all the peripheral countries seem to have the will and governance capacity to implement needed reforms, provided they are given some leeway on their deficit targets and some pro-growth measures are added to their packages.

Second, the ECB will continue to be the lender of last resort and will use its balance sheet and innovative measures like the Long Term Refinancing Operations as needed to stabilize the financial markets, maintain funding for the banks, and minimize the risks of deposit flight out of Spain—even contain the crisis should Greece exit. Very importantly, both Huw Pill and Jacob Kirkegaard suggested that the ECB will allow Bank of Greece's Emergency Liquidity Assistance (ELA) to continue if mandated by Eurozone political leaders so that the ECB is not seen as forcing Greece out of the Eurozone by withholding support for the Greek banks.

Third, the expectation is that the firewall is large enough to contain the crisis from spreading to Spain and to provide some additional funding for Portugal given that it will not be able to tap the capital markets by 2013 as originally anticipated. As shown below, the new IMF contributions totaling $435 billion, the establishment of the European Stability Mechanism (ESM) with 500 billion euros, and the ECB's balance sheet capacity indicate that significant resources and institutional support have been added since the European Sovereign debt crisis started in 2010. But the firewall will only be effective if Eurozone leaders act boldly and with force. For example, Christine Lagarde, IMF chief, has suggested that the ESM should be able to lend directly to banks and not only to sovereign governments, although this would require a change in ESM's charter. French President Hollande has suggested what BCA Research has called the Nuclear Option: "the ECB could lend directly to the ESM".[6] So while the pessimists dominate the day, it is important to keep in mind that Eurozone policy makers still have options and resources—albeit all difficult options.

4. Resources Available to Fight the Crisis



Note: Assumes that half of IMF new and existing funds are used for the Eurozone, net of Spain and Italy's contributions and a prudent 1/6 bufffer.
Source: Investment Strategy Group, Goldman Sachs Global Investment Research, EBA, IMF, ECB.

Investment Implications

Clearly these are volatile and uncertain times. The long-term implications of a country leaving the eurozone are significant and the short-term uncertainty is immense, hence the significant downdraft in European equities. Mega cap multi-national companies, as represented by Eurostoxx 50, now trade at a 55% discount to S&P 500 companies—the cheapest since 1980. And with the S&P 500 below 1300, the index is trading at a 17% discount to its historical trailing PE multiple since 1972. That said, we note that there could be further downside in both European and US stocks. Indeed, it would take an additional 10% sell-off in US stocks to match the trough PE multiple reached during the worst of last year's downdraft.

In spite of such downside, we believe that stocks in the Eurostoxx 50 offer very compelling value and we recommend a small tactical tilt in this basket of multinational companies. Examples of such companies are Total, Anheuser-Busch Inbev, Siemens, Sanofi, LVMH-Moët, Daimler, and BMW and, in aggregate, close to half their sales come from outside the Eurozone—hence their ability to grow sales at 6% despite slow to no growth in the Eurozone. While a tremendous amount of uncertainty remains around the outcome of the upcoming Greek elections, the Irish referendum, the Spanish banking sector, and underlying growth in Europe, this uncertainty is the very reason investors can today gain access to these world-class global brands at a significant discount. As such, while volatility is likely to remain high, we feel purchasing these global brands at today's depressed valuations will ultimately reward patient investors.

Sources: Investment Strategy Group, Datastream, Bloomberg, Goldman Sachs Global Investment Research, CEIC, Nouriel Roubini, BCA, *The Financial Times*, The Peterson Institute for International Economics, Deutsche Bank, IMF, ECB, EBA.

[1] "Greece Must Exit" by Nouriel Roubini. Project Syndicate. May 17, 2012.
[2] "In Case of Emergency Grexit. BCA. May 17, 2012.
[3] "A Permanent Precedence" by Martin Wolf. *Financial Times*. May 17, 2012.
[4] "Greek Left Attacks Barbarous 'Austerity'." *Financial Times*. May 8, 2012.
[5] "The Endgame in Greece—How a Bank Run Can be Part of the Solution" by Jacob Kirkegaard. Peterson Institute for International Economics. May 16, 2012.
[6] "In Case of Emergency Grexit. BCA. May 17, 2012.

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