Strategy Matters

Time for Value

- One of the most enduring features of the post-GFC period has been the secular outperformance of Growth vs. Value. There have been rotations, but these have generally been short-lived.
- The drivers of this long-term trend are well understood – low rates, low inflation and low economic growth.
- We think these drivers for the most part remain in place; the secular trends still favour growth or growth-defensive stocks (such as the GRANOLAS).
- But, in the next few months we expect some policy and economic shifts that support a temporary rotation; and these rotations can be quite large.
- There have been 15 into Cyclicals and out of Defensives since the GFC, lasting on average 4 months and delivering 15% outperformance for Cyclicals. Value stocks also outperform during these shifts – albeit by less.
- These rotations occur when BYs are rising (which GS expects) and when growth is improving (which GS expects).
- While highly uncertain, our economists expect that the FDA will approve at least one vaccine this year and that large shares of the US and European populations will be vaccinated by the end of Q2-2021 and Q3-2021, respectively.
- A 'Blue wave' outcome in the US election and a rise in fiscal spend would also be supportive.
- Finally, while not a catalyst, we also factor in the extreme valuation discount of Value.
- Given this, we upgrade Banks and Autos to OW, downgrade Tech to Neutral and downgrade Food/Bev/Tobacco to UW.
- We also move to a Long on our Recovery basket (GSSTRCOV) and this joins a long on Fiscal Infrastructure (GSSTFISC).

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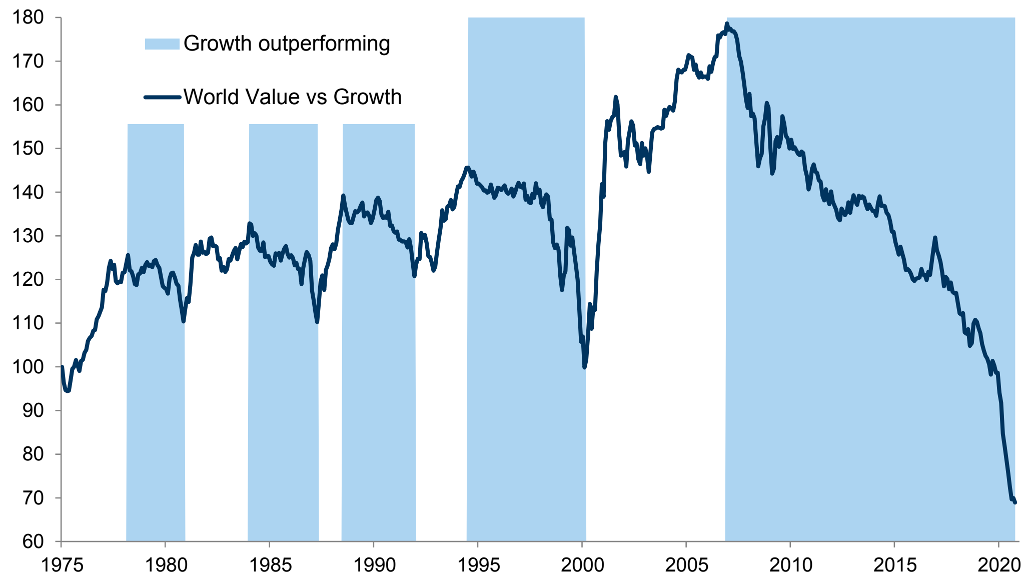
The secular Growth outperformance

One of the most enduring features of the post financial crisis period has been the secular outperformance of Growth versus Value (Exhibit 1).

Exhibit 1: Growth has outperformed since the GFC
Relative price performance in local currency



Source: Datastream, Goldman Sachs Global Investment Research

There are three major reasons why this has occurred, in our view:

1. **The secular decline in bond yields** and inflation expectations has boosted the value of longer-duration Growth companies (while hitting Value companies most at risk of deflation).
2. **A secular decline in long-term growth expectations**, together with greater uncertainty about growth.
3. **The bifurcation of industry returns,** with impressive growth in the returns of the Technology sector and, at the same time, a secular decline in returns in sectors such as Banks and Oil.

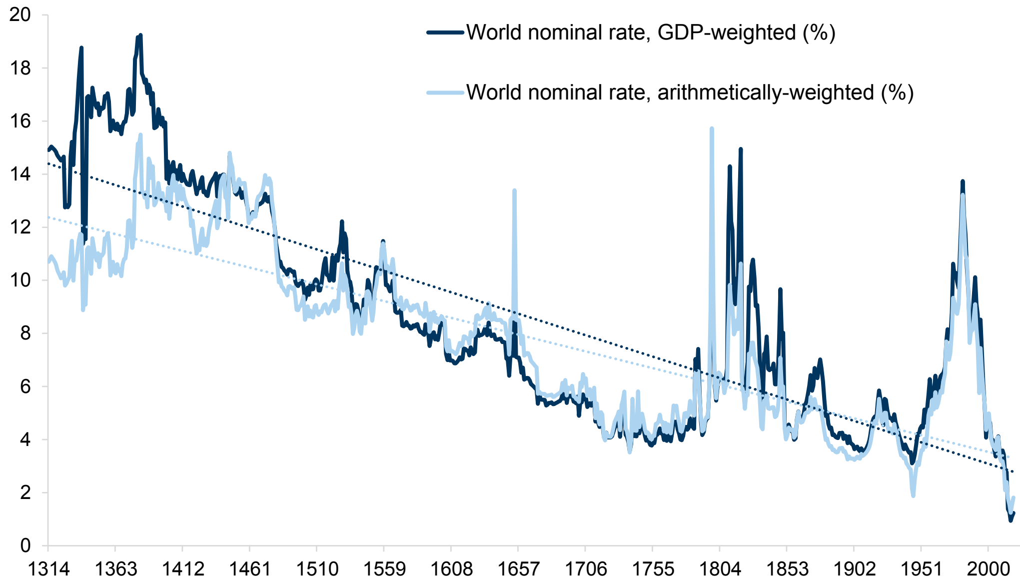
1. The decline in bond yields

The secular decline in bonds yields globally started at the peak of inflation in the 1980s and has resulted in remarkable returns in bond markets ever since then. However, it is the declines since the start of this century, in the aftermath of the technology bubble, and even more so after the financial crisis of 2008, that have had the most dramatic impact on factor leadership within equities.

It is hard to imagine now, but on the eve of the financial crisis in 2008, 10-year Treasury yields and Bund yields were around 4%. Many people at the time thought that these yields were too low. But since then they have collapsed, with Bund yields reaching a low of -0.9% and 25% of global debt having a negative yield.

As Exhibit 2 shows, this has resulted in global bond yields falling to their lowest levels in history (back to the 1300s).

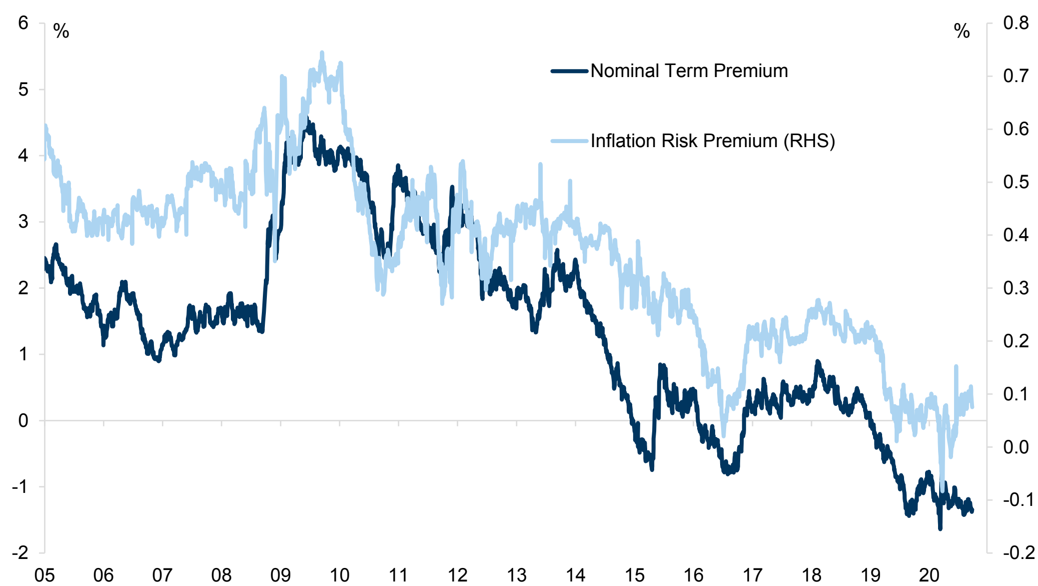
Exhibit 2: The decline in nominal interest rates has been a long-term trend
Nominal bond yields, GDP- and arithmetically-weighted, 1314-2018



Source: Bank of England

Most crucially, the falls in bond yields over the past decade have reflected a collapse in term premia.

Exhibit 3: Term and inflation risk premia have gradually declined since the GFC
10y EUR inflation risk premium and 10y Euro area nominal term premium



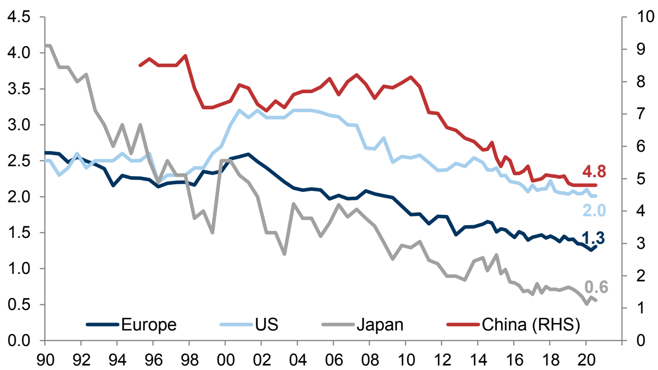
Source: Goldman Sachs Global Investment Research

2. The decline in growth expectations

Long-term growth expectations have deteriorated since the financial crisis both for trend GDP growth and for long-term profit growth. Exhibit 4 shows the long slowdown in consensus real GDP growth 6-10 years forward in all major regions. With lower inflation, revenue growth has also slowed materially in the US and Europe, and has approached the kind of growth rates that Japan has experienced over the past couple of decades (Exhibit 5). Slower growth means that companies that are perceived to be able to achieve growth are considered more valuable, and all the more so given the collapse in the risk free rate.

Exhibit 4: Long-term real global GDP growth forecast is at a historical low

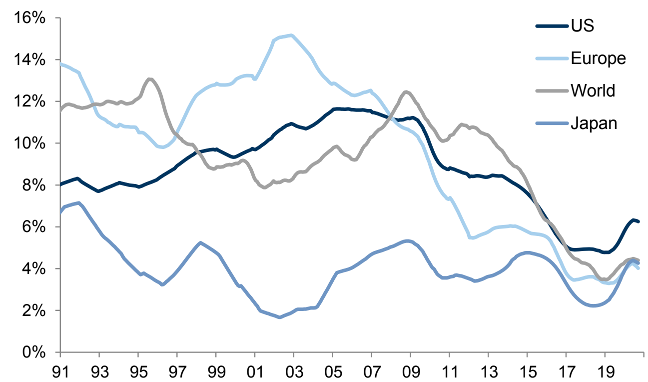
Long-term (6-10y) GDP growth from Consensus Economics



Source: Consensus Economics, Goldman Sachs Global Investment Research

Exhibit 5: Top-line growth has been falling along with declining nominal GDP

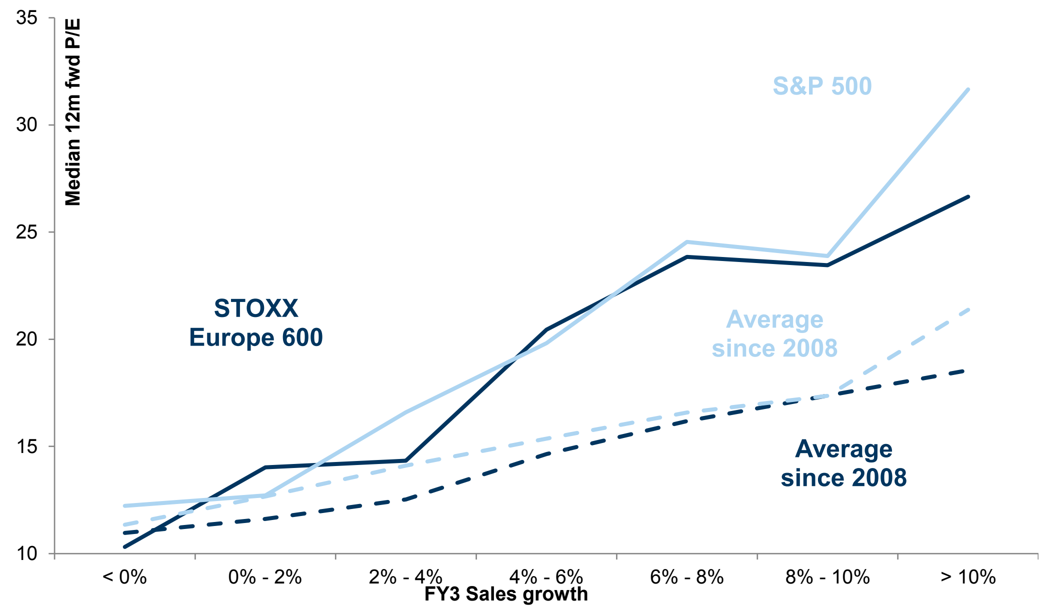
yoy sales growth (10y rolling average), Market ex Financials



Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

Exhibit 6 shows the P/E of US and European companies in different bands of expected future sales growth. While this tends to be upward sloping (investors are prepared to pay more for higher growth), it has become steeper now than we have tended to see on average in the past. Investors are paying more now for higher expected growth, especially safe top-line growth. The scarcity of growth means that investors are prepared to pay a big premium for stable secure growth in the few areas that offer it.

Exhibit 6: Investors are willing to pay a high growth scarcity premium
Median 12-month forward consensus P/E by consensus sales growth bands (FY3 estimates)

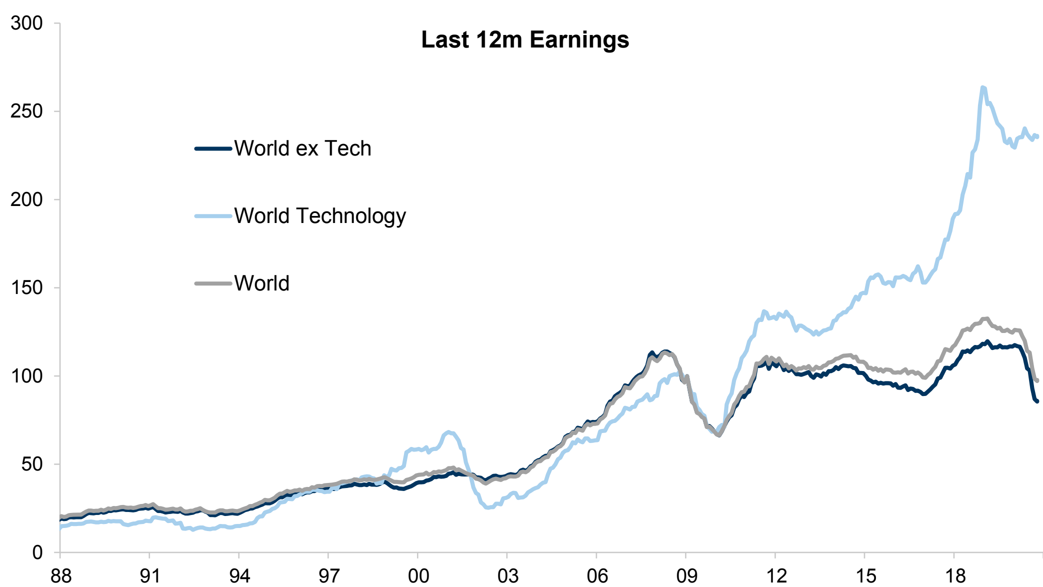


Source: Datastream, I/B/E/S, Goldman Sachs Global Investment Research

3. The success of Technology

The other major development of the past 12 years has been the remarkable success of the Technology industry in driving higher ROE and EPS. As Exhibit 7 shows, the World ex Technology has achieved no progress in terms of EPS since the 2008 crisis.

Exhibit 7: Tech earnings have outstripped those of the global market
12m trailing EPS (USD) – Indexed to 100 on Jan-2009



Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

The drivers of change: Can we get a rotation?

Just as the three drivers above contributed to the extraordinary period of growth outperformance, they also have the power to reverse it. The two most important contributors to a reversal would be a rise in inflation expectations/bond yields and a rise in growth. The two typically move together.

Exhibit 8 shows the permutations under which Value tends to outperform Growth.

Exhibit 8: Value outperforms Growth when economic growth is high or accelerating
Median Value vs. Growth y/y return since 1990

Change in growth rate	Economic growth rate: < 2%	2% to 4%	> 4%
< -0.25pp	-7.0%	-4.1%	5.7%
-0.25 to 0.5pp	-1.0%	-1.0%	0.6%
> 0.5pp	-1.2%	2.6%	1.9%

Economic growth = STOXX 600 Sales-weighted CAI

Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 9: Cyclicals outperform Defensives when economic growth improves
Median Cyclicals vs. Defensives y/y return since 1990

Change in growth rate	Economic growth rate: < 2%	2% to 4%	> 4%
< -0.25pp	-10.6%	-2.7%	6.8%
-0.25 to 0.5pp	-4.3%	-1.8%	3.0%
> 0.5pp	-11.0%	1.3%	5.7%

Economic growth = STOXX 600 Sales-weighted CAI

Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

Over the past 12 years, there have been several rotations of leadership into Value and Cyclicals (see Exhibit 11) but, as yet, none have lasted. They nearly all coincided with a rise in bond yields in the US (Exhibit 10). But bond yields did not sustain their increases and quickly reversed. Is this about to change?

Exhibit 10: These rallies into Cyclicals generally coincide with higher bond yields and better growth
CAI: Current Activity Indicator

Rallies in Europe Cyclicals vs. Defensives					
Start Date	End Date	US 10y BY (bp. change)	German 10y BY (bp. change)	US CAI (pp. change)	Euro Area CAI (pp. change)
21-Jan-08	08-May-08	16	17	-0.3	-3.1
20-Jan-09	11-Jun-09	152	68	9.4	9.8
08-Jul-09	14-Oct-09	13	-6	0.8	1.2
12-Feb-10	26-Apr-10	11	-15	2.8	1.7
25-Aug-10	14-Feb-11	108	116	1.4	2.0
04-Oct-11	27-Oct-11	61	45	0.0	0.0
23-Nov-11	20-Feb-12	16	-7	1.3	0.1
23-Jul-12	14-Jan-13	42	39	1.4	0.4
18-Apr-13	15-Jan-14	120	59	0.6	1.5
02-Feb-16	18-Mar-16	1	-10	0.6	-0.1
07-Jul-16	25-Jan-17	114	57	1.9	0.9
06-Jun-17	21-Feb-18	80	42	1.6	-0.9
03-Jan-19	22-Apr-19	4	-13	-0.2	-0.2
03-Sep-19	07-Nov-19	46	47	0.1	0.0
19-Mar-20	28-Aug-20	-41	-28	46.8	45.1
25-Sep-20	*13-Oct-20*	*7*	*-3*	*-*	*-*
Average		49.4	27.4	4.6	3.9
Median		42.4	39.0	1.3	0.4
SD		54.6	40.1	11.9	11.7
Positive change		14/15	9/15	12/15	9/15

Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 11: There have been 15 rallies into Cyclicals (vs. Defensives) of 7% or more since the GFC

Rallies in Europe Cyclicals vs. Defensives							
Start Date	End Date	Length (months)	Cyclicals vs. Defensives	STOXX 600	Value vs. Growth	Financials vs. Staples	Banks
21-Jan-08	08-May-08	4	14%	7%	-2%	4%	7%
20-Jan-09	11-Jun-09	5	35%	16%	10%	31%	65%
08-Jul-09	14-Oct-09	3	14%	25%	10%	21%	40%
12-Feb-10	26-Apr-10	2	9%	12%	-1%	4%	15%
25-Aug-10	14-Feb-11	6	12%	17%	-1%	5%	6%
04-Oct-11	27-Oct-11	1	12%	15%	1%	10%	19%
23-Nov-11	20-Feb-12	3	15%	22%	0%	15%	38%
23-Jul-12	14-Jan-13	6	15%	14%	9%	25%	45%
18-Apr-13	15-Jan-14	9	12%	18%	7%	25%	33%
02-Feb-16	18-Mar-16	1	7%	2%	4%	5%	4%
07-Jul-16	25-Jan-17	7	30%	14%	15%	37%	51%
06-Jun-17	21-Feb-18	9	15%	-2%	2%	18%	4%
03-Jan-19	22-Apr-19	4	10%	17%	-3%	1%	15%
03-Sep-19	07-Nov-19	2	10%	7%	6%	18%	18%
19-Mar-20	28-Aug-20	5	20%	28%	-3%	14%	11%
25-Sep-20	*13-Oct-20*	*-*	*2%*	*4%*	*0%*	*2%*	*7%*
Average		4	15%	14%	4%	16%	25%
Median		4	14%	15%	2%	15%	18%
SD		2	8%	8%	6%	11%	19%
Positive change		-	15/15	14/15	10/15	15/15	15/15

Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

Just as the rotations nearly always occur when the market rises, they are nearly always associated with all factors rising in absolute terms. It is unusual for the outperformance of Cyclicals and/or Value to be associated with Growth or Defensive sectors falling; they just tend to underperform (Exhibit 12).

Exhibit 12: The market rose in 14 of the past 15 Cyclical rallies
Absolute price performance of styles

Rallies in Europe Cyclicals vs. Defensives								
Start Date	End Date	Length (months)	Cyclicals vs. Defensives	STOXX 600	Cyclicals	Defensives	Value	Growth
21-Jan-08	08-May-08	4	14%	7%	13%	-1%	5%	8%
20-Jan-09	11-Jun-09	5	35%	16%	34%	-1%	21%	10%
08-Jul-09	14-Oct-09	3	14%	25%	33%	17%	30%	19%
12-Feb-10	26-Apr-10	2	9%	12%	16%	7%	11%	12%
25-Aug-10	14-Feb-11	6	12%	17%	23%	10%	16%	17%
04-Oct-11	27-Oct-11	1	12%	15%	19%	6%	15%	14%
23-Nov-11	20-Feb-12	3	15%	22%	29%	12%	21%	21%
23-Jul-12	14-Jan-13	6	15%	14%	24%	8%	18%	8%
18-Apr-13	15-Jan-14	9	12%	18%	27%	13%	21%	13%
02-Feb-16	18-Mar-16	1	7%	2%	5%	-2%	5%	0%
07-Jul-16	25-Jan-17	7	30%	14%	28%	-2%	22%	6%
06-Jun-17	21-Feb-18	9	15%	-2%	5%	-8%	-1%	-3%
03-Jan-19	22-Apr-19	4	10%	17%	22%	11%	14%	18%
03-Sep-19	07-Nov-19	2	10%	7%	11%	1%	11%	4%
19-Mar-20	28-Aug-20	5	20%	28%	41%	17%	24%	28%
25-Sep-20	*13-Oct-20*	-	*2%*	*4%*	*6%*	*3%*	*4%*	*4%*
Average		4	15%	14%	22%	6%	16%	12%
Median		4	14%	15%	23%	7%	16%	12%
SD		2	8%	8%	11%	8%	8%	8%
Positive change		-	15/15	14/15	15/15	10/15	14/15	14/15

Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

The new policy mix

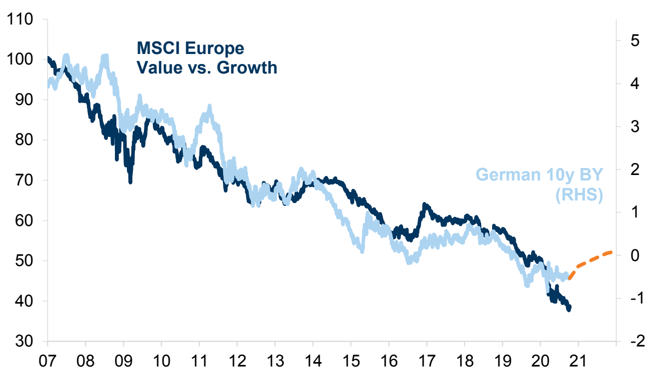
In *Inflation Implementation: How to position for a rise in expectations*, September 30, 2020, we argued that some of these macro dynamics are on the brink of change. In the period after the financial crisis, the emergence of QE (then widely described as "unconventional" monetary policy, but now commonly viewed as part of the permanent monetary toolkit) led many people to worry about inflation, including the ECB. Nevertheless, while the general policy mix in the aftermath of the financial crisis was to offset monetary easing with fiscal tightening, if not austerity, in this crisis governments have borrowed very large sums of money. This new approach to economic policy, involving ultra-low interest rates and forward guidance together with massive fiscal easing, is more likely to have an impact on inflation expectations.

According to our economists, a 'blue sweep' in the US election would likely result in a further fiscal package of around $2.2trn. They estimate that the output gap in 2021-22 would be 2-2.5pp lower with unified Democratic control relative to the current baseline, and that this could bring forward the timing of a 'lift-off' in rates in the US by up to two years – see *A Blue Wave Through the Fed's Eyes*, September 21, 2020.

In this scenario, the combination of a growth boost from higher expenditures, a potential Covid-19 vaccine and an easy monetary stance would all lead to a larger drop in unemployment, but it would also likely lead to a wider dispersion and a positive skew to analysts' forward-looking estimates of growth and inflation outcomes (relative to a divided government scenario). Our Rates Strategists' fundamentals-based term premium model suggests that the changes on net would lead to upward pressure on bond risk premia, in the order of about 30bp. The supply implications of higher budget deficits are would also likely weigh on Treasuries – see *US yields could trend higher post-election*, September 23, 2020.

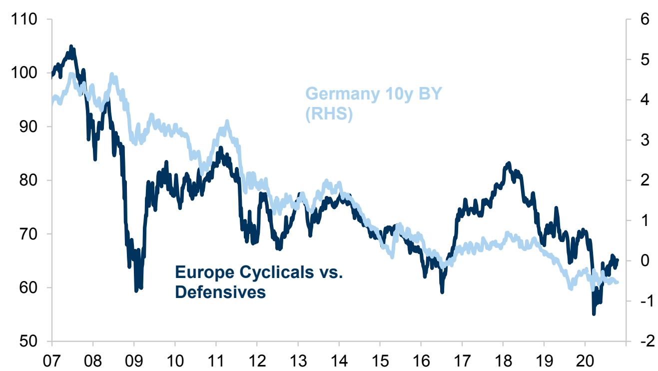
Our Rates Strategists argue that a Democratic sweep would lead to a material sell-off in US bonds, while a divided government would imply a more modest move. The sell-off would largely reflect the possibility of substantially higher spending. In this case, our Rates team expect a cumulative 30-40bp increase in US 10yr yields over the subsequent month.

Exhibit 13: If bond yields rise, this would support Value stocks in Europe
Orange line: GIR Economics forecast



Source: Datastream, Goldman Sachs Global Investment Research

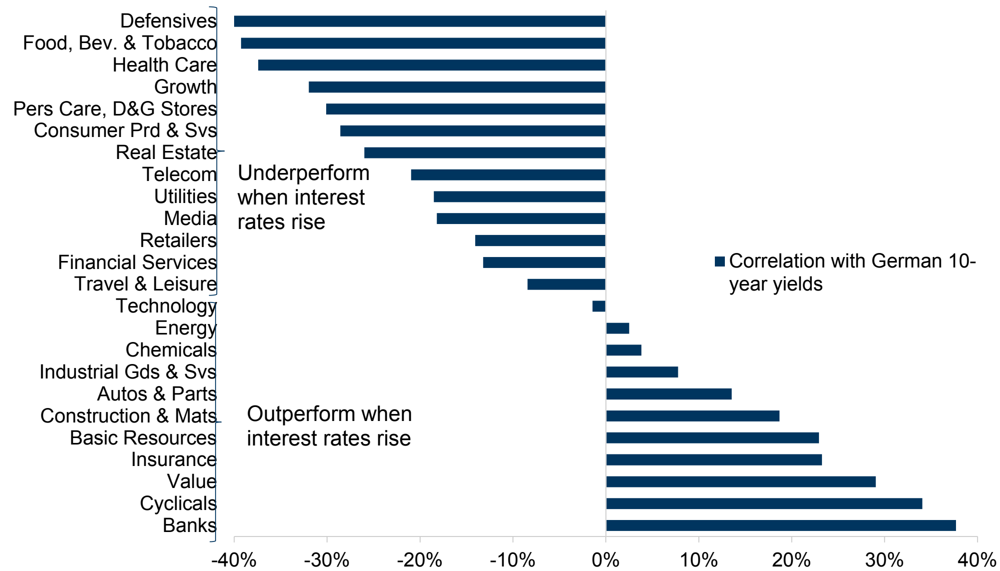
Exhibit 14: Bond yields tend to rise when Cyclicals outperform Defensives



Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

Large moves in US yields would likely spill over into most other sovereign bonds—our Rates Strategists estimate by as much as 70% for UK and German yields. We show European sector correlations to yields in Exhibit 15: Food, Beverages & Tobacco and other Defensives, as well as Consumer Staples, would likely suffer if yield curves steepen, whereas Banks, Value and Cyclicals would likely gain.

Exhibit 15: Growth and Defensive sectors are the most negatively correlated with bond yields, while Cyclicals and Value are the most positively correlated
Correlations since 2007 based on weekly performance vs. SXXP in EUR



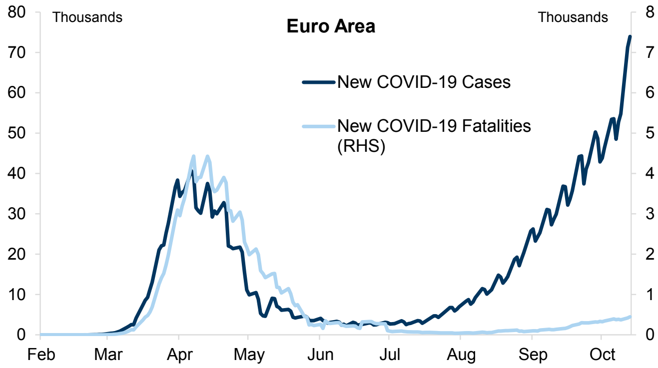
Source: Datastream, Goldman Sachs Global Investment Research

What if a vaccine is approved?

New Covid cases have risen sharply in recent weeks, with daily infections surpassing their mid-April peaks. Governments have therefore paused the reopening of their economies and, in some places, adopted renewed containment measures (Exhibit 16).

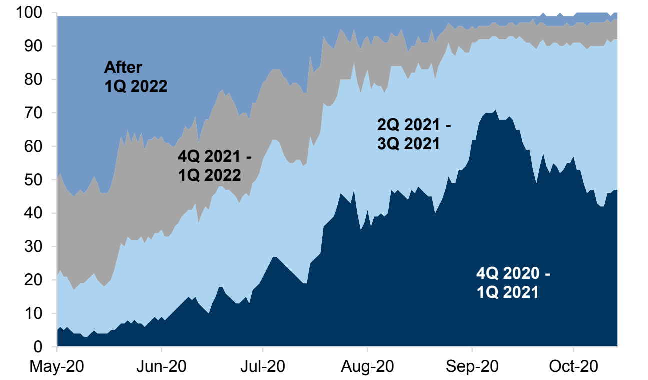
While highly uncertain, our economists assume in their forecasts that the FDA will approve at least one vaccine this year, and that large shares of the US and European populations will be vaccinated by the end of Q2-2021 and Q3-2021, respectively (Exhibit 17). We maintain our constructive view on the economy and still expect the Euro area economy to return to its pre-Covid level in Q4-2021. Our Global Economics Team estimates that a vaccine would boost US growth by 3% and Europe by 2%.

Exhibit 16: New Covid cases have risen sharply in recent weeks
7-day moving average



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 17: Vaccine optimism has risen in recent months
When will enough doses of FDA-approved COVID-19 vaccine(s) to inoculate 25 million people be distributed in the US? (Superforecaster probabilities)

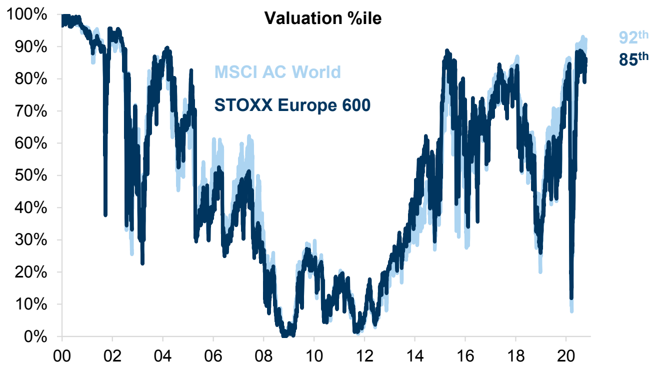


Source: The Good Judgement Project, Goldman Sachs Global Investment Research

Our conversations with clients suggest that this is relatively well priced by the market as a whole. The recovery of global equities from the trough has been the fastest in history. European equities trade on their 85th percentiles compared with history – on a 24m fwd Consensus P/E basis (Exhibit 18).

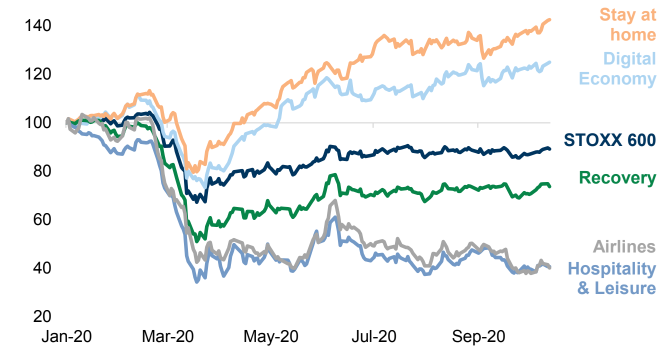
While there might be less potential for strong index level returns from here, we think there is still potential for a material rotation below the market surface. If the market is really pricing an early vaccine and a quick recovery, then we believe it is pricing it in the wrong slices of the market. Indeed, with an early vaccine, we would expect some reversal of the trades that worked well during the coronacrisis, but the companies that have done well year-to-date are still holding up well relative to the market. In Exhibit 19, we show that our Digital Economy (GSSBDIGI) and 'Stay-at-Home' (GSXESTAY) baskets are not underperforming, and in the meantime the heavily hit Airlines (GSSBTRAA) and Hospitality & Leisure (GSSBHOLR) baskets have not recovered. We find a similar pattern in the US.

Exhibit 18: European equities trade on their 85th percentiles compared with history
24m fwd P/E percentile vs. history



Source: Datastream, I/B/E/S, Goldman Sachs Global Investment Research

Exhibit 19: Below the market surface, there is space for a rotation
Europe - YTD performance

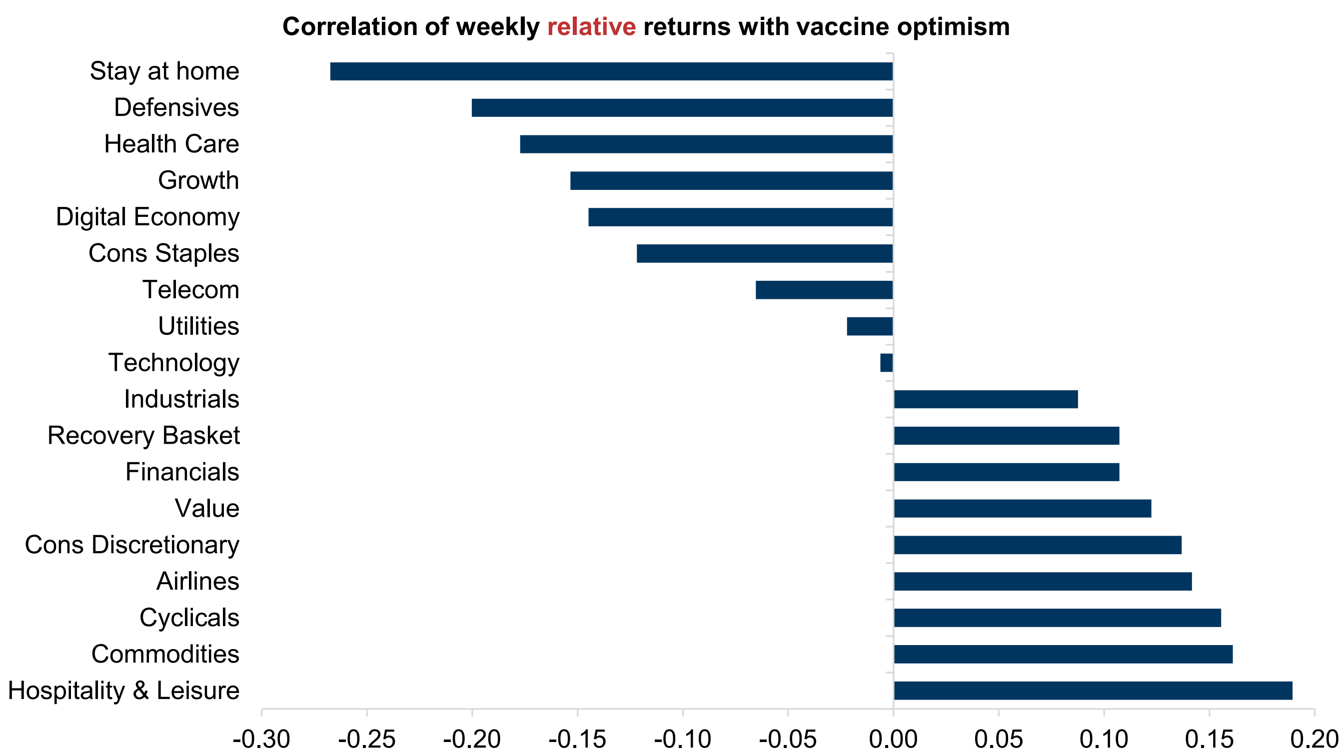


Stay-at-home: GSXESTAY; Digital Economy: GSSBDIGI; STOXX 600: SXXP; Recovery: GSSTRCOV; Airlines: GSSBTRAA; Hospitality & Leisure: GSSBHOLR

Source: Bloomberg, Goldman Sachs Global Investment Research

The correlation of equity returns with the prospects for a vaccine suggest that *Value* and *Cyclicals* should outperform *Growth* and *Defensives* in Europe if one is approved. In terms of sectors, Energy, Consumer Discretionary and Financials should outperform Healthcare, Consumer Staples and Technology (Exhibit 20)

Exhibit 20: Value and Cyclicals relative returns are positively correlated with vaccine optimism
Correlation of weekly changes in vaccine optimism with the weekly performance vs. STOXX 600 (since May-2020)



Stay-at-home: GSXESTAY; Digital Economy: GSSBDIGI; Recovery: GSSTRCOV; Airlines: GSSBTRAA; Hospitality & Leisure: GSSBHOLR

Source: The Good Judgement Project, Datastream, Goldman Sachs Global Investment Research

Indeed, a medical solution should accelerate the path to economic normalisation, which we believe would lift the earnings and prices of the most cyclical slices of the market. This potential improvement in economic growth should boost inflation and increase longer-term rates. This would penalise *Growth* stocks, which are long-duration assets (i.e., we pay today for strong future cash flows). *Value* stocks have the shortest duration, so they should outperform as the discount rates rise.

Lastly, one could expect the vaccine to be an absolute positive for the entire economy; however, we find that our Digital Economy basket (GSSBDIGI) and the Stay-at-Home basket (GSXESTAY) exhibit negative correlations of *absolute* returns with the prospects for a vaccine.

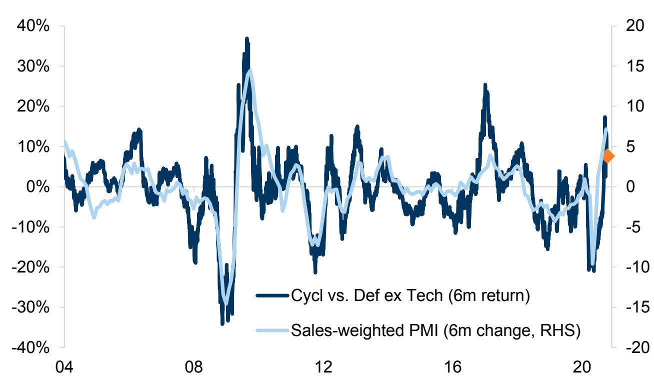
Our Recovery basket (GSSTRCOV) is a relatively well-diversified way to invest on an early vaccine boost.

Growth is key

The improvement in growth is key. Assuming a) there is a positive vaccine announcement and b) there is a 'thin' free trade deal between the UK and the EU agreed by mid-November, then we would expect 6.7% Euro area GDP growth in 2021 and 8% UK growth. Of course, both are from a very low base.

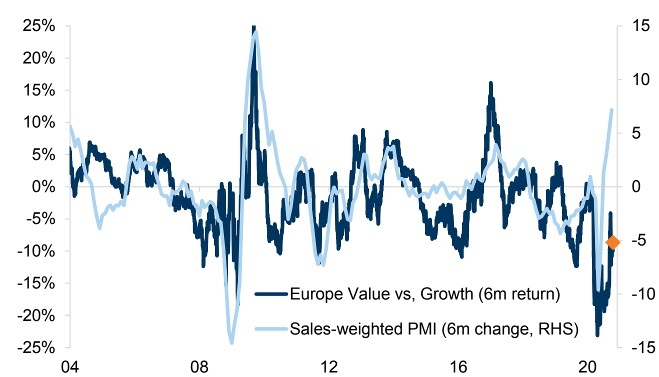
We find that the recent moves in Cyclicals versus Defensives are slightly under-pricing the improvements in the data, although the difference is not extreme (Exhibit 21). The big difference is for Value areas of the market, where these stocks have failed to rally despite the improvement in economic growth from the lows (Exhibit 22).

Exhibit 21: Cyclicals are slightly under-pricing the improvements in the data ...
Sales-weighted Manufacturing PMI



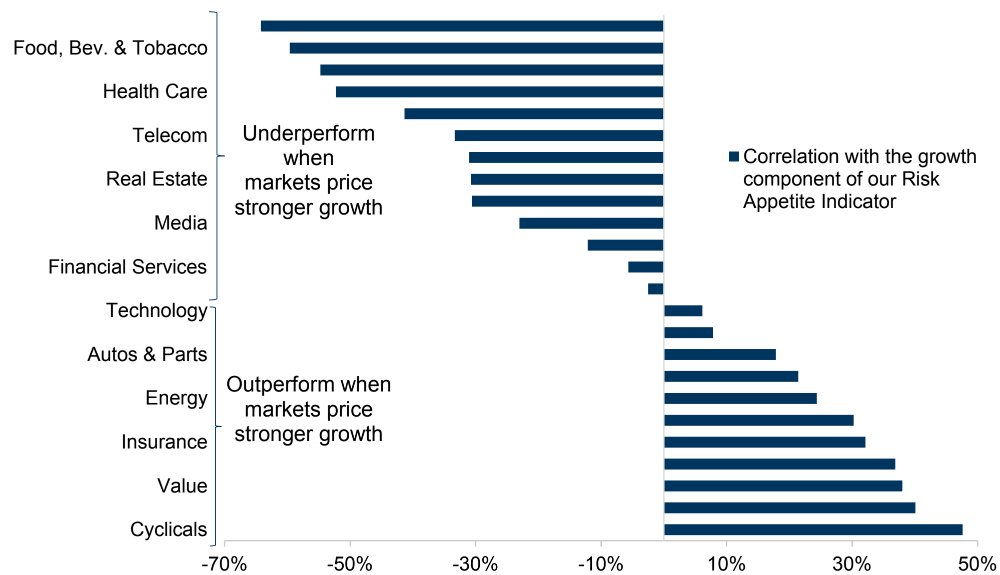
Source: Datastream, Worldscope, Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 22: ... but the gap is wider for Value
Sales-weighted Manufacturing PMI



Source: Datastream, Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 23: Growth and Defensive sectors are the most negatively correlated with growth, while Cyclicals and Value are the most positively correlated
Correlations since 2007 based on weekly performance vs. SXXP in EUR



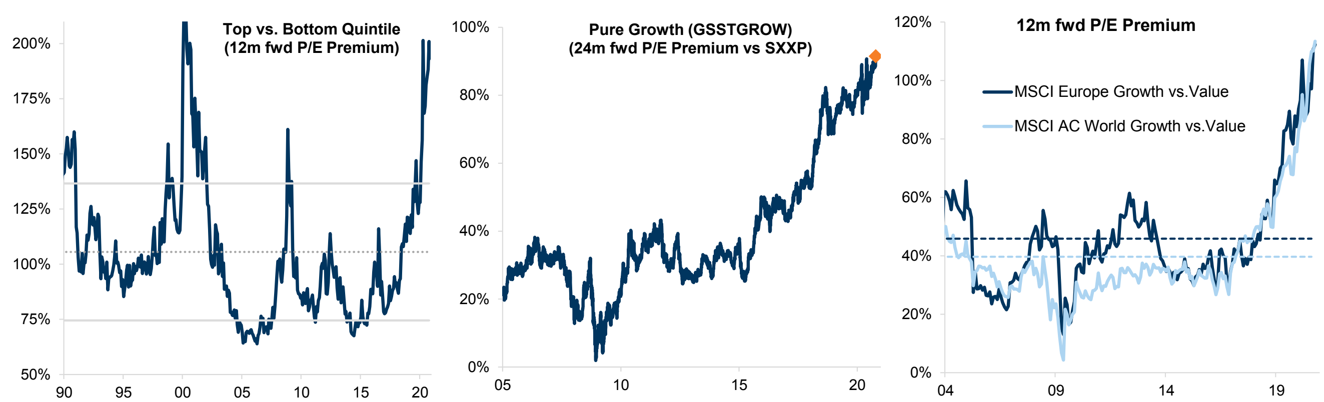
Source: Datastream, Goldman Sachs Global Investment Research

Valuation and positioning – Extreme but a catalyst is needed to see a shift

The premium for Growth companies has become more extreme than at almost any time in the past. We calculate the rating of the highest quintile of companies versus the lowest by P/E. The premium for the top quintile is around 190% (Exhibit 24).

The premium for our High Sales Growth basket (GSSTGROW) versus the market is 90%, close to an all-time high. Looking at MSCI Growth versus Value alone shows that the gap between the two has reached an extreme.

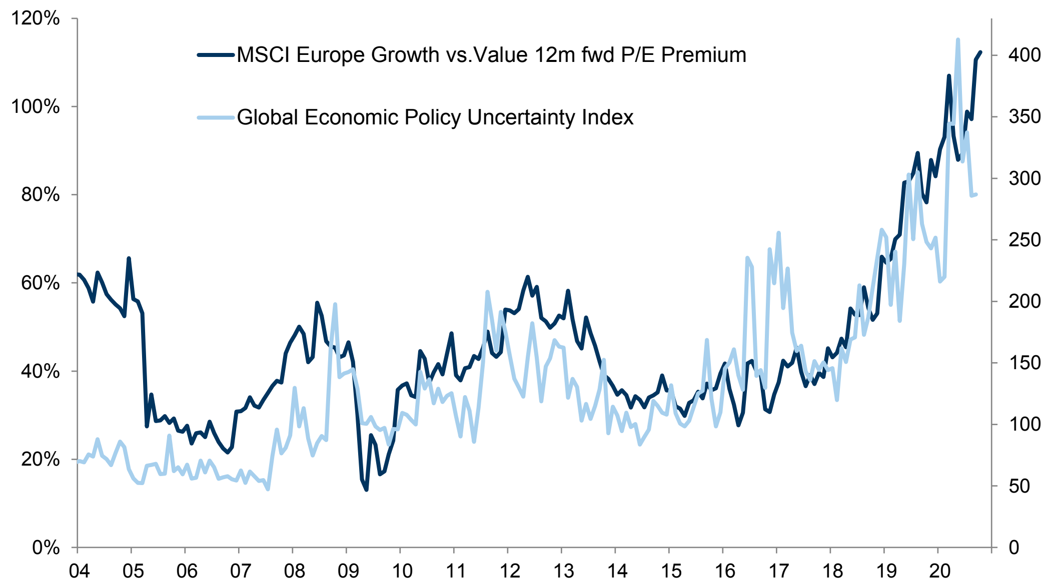
Exhibit 24: The premium for growth has risen and now looks extreme
Europe



Source: FactSet, Datastream, Worldscope, Goldman Sachs Global Investment Research

The spread in valuation between MSCI Growth and Value has moved in tandem with policy uncertainty (Exhibit 25) – likely a reflection of the uncertainties driven by high global debt levels (especially for governments), low rates and a weak output level. That said, the spread has continued to rise even as uncertainty has faded slightly.

Exhibit 25: The premium for Growth companies is a function of high policy uncertainty



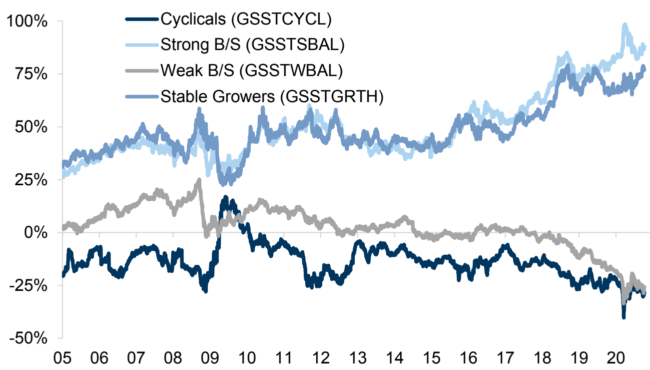
Source: FactSet, Haver Analytics, Goldman Sachs Global Investment Research

We think that for valuation differentials to narrow we would need to see a shift in uncertainty and rates. This is something we expect to happen in the next few months.

That said, more medium/longer term, we think that rates will stay relatively low. The low levels of underlying inflation and the pressures on governments from high debt burdens militate against a sustained large rise in yields. Given this, we do not expect anything more than a short-lived rotation that lasts a few months, rather than a change in the secular trend.

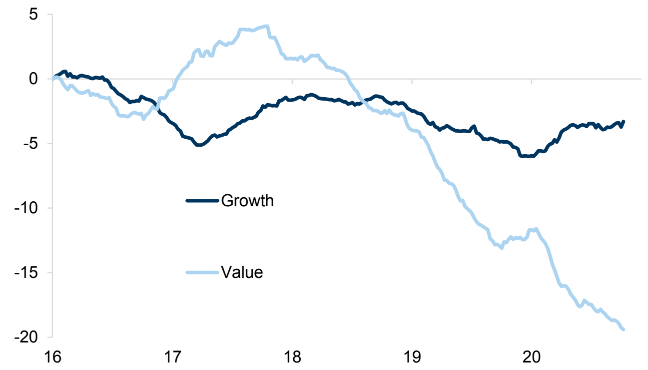
In terms of positioning, flows into Value funds in Europe have been very negative in recent years; the last pick-up in flows was in late 2016, which coincided with the reflation rally back then.

Exhibit 26: Valuation gap between Quality companies and non-Quality stocks is high
24m fwd Premium(Discount) vs. STOXX Europe 600



Source: FactSet, Goldman Sachs Global Investment Research

Exhibit 27: Substantial outflows from Value-style funds; the last time we saw inflows was 2016/17
Cumulative flows into style European equity funds, USD bn



Source: EPFR, Goldman Sachs Global Investment Research

Recommendations – Upgrade Banks, Downgrade Tech

We make four sector changes: we upgrade Banks and Autos to Overweight (both from Neutral), and we downgrade Tech to Neutral and Food, Beverages & Tobacco to UW (from Neutral).

We also take off our long-held Long view on our Digital Economy basket (GSSBDIGI). We add a Long recommendation on our Recovery (GSSTRCOV) basket vs. SXXP. This joins our Fiscal Infrastructure spending basket (GSSTFISC), which we continue to recommend.

Exhibit 28: Our sector recommendations

Strategy Sector and Subsector Recommendations

Overweight	Neutral	Underweight
↑ Autos and Parts (SXAP)	Chemicals (SX4P)	↓ Food, Bev and Tob (S600FOP)
↑ Banks (SX7P)	Financial Svs (SXFP)	Pers. Care, Drug and Grocery Stores (S600PDP)
Basic Resources (SXPP)	Industrial G&S (SXNP)	Retailers (SXRP)
Construct. and Mat. (SXOP)	Insurance (SXIP)	Telecoms (SXKP)
Consumer Prods and Services (S600CPP)	Media (SXMP)	Utilities - Regulated (GSSBUTRE)
Energy (S600ENP)	Real Estate (SX86P)	
Healthcare (SXDP)	↓ Technology (SX8P)	
Civil Aerospace (GSSBCIVA)	Travel and Leisure (SXTP)	
Luxury Goods (GSSBLUXG)	Utilities (SX6P)	
Renewables (GSSBRNEW)		

Trade Recommendation

Fiscal infrastructure (GSSTFISC) vs. STOXX Europe 600
Recovery (GSSTRCOV) vs. STOXX Europe 600
DAX vs. STOXX Europe 600

Source: Goldman Sachs Global Investment Research

We downgrade **Food, beverages and tobacco** purely as a function of the sector's sensitivity to some of the macro changes we expect: rising rates and an improvement in growth. As we show above, the sector is the most negatively correlated to rises in bond yields.

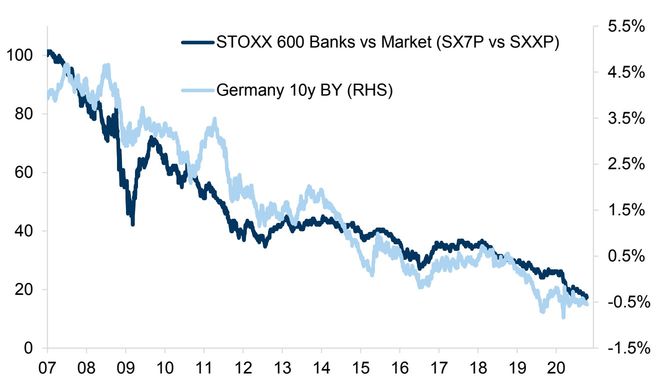
We downgrade **Technology** to reflect our expectation of a near-term bounce in Value. The sector trades on a 24-month forward Consensus P/E of 23.5x at a 60% premium to the market, versus a 5-year average premium of 30%. However, we retain a Neutral as we continue to believe that in a low nominal growth world the market will continue to pay a premium for reliable top-line and bottom-line growth, and this sector is one of the few in Europe to deliver that. Indeed, the CAGR of EPS 2019-2021 is expected by consensus to be 9% – far higher than any other sector.

We upgrade **Banks** to OW. This is the most sensitive sector to rates and growth and, despite low underlying returns in recent years, we think it offers exceptional value. The 24-month forward dividend yield is over 7%. And while regulation prevents the payment of dividends currently, our Equity analysts expect this to change - see *Dividends: From "permission" to "ability" to distribute*, October 1, 2020.

Based purely on stock price data (not earnings or company fundamentals), we find (using weekly changes since 2007):

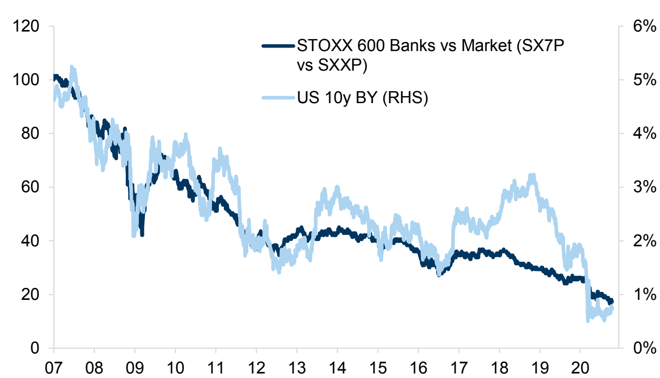
- A +100bp rise in the German 10yr bond yield implies a +19% rise in Banks share price (+10% against STOXX 600).
- A +100bp rise in the US 10yr Treasury yield implies a +15% rise in Banks share price (+7% against STOXX 600).

Exhibit 29: Falling German Bund yields have weighed on Banks equities
Relative total return. Indexed in 2007



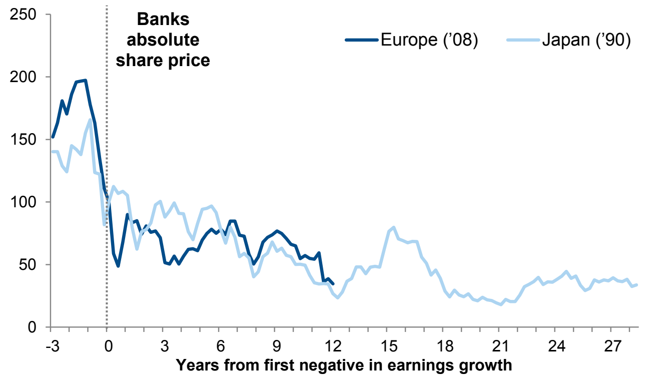
Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 30: Bond yields have also fallen in the US
Relative total return. Indexed in 2007



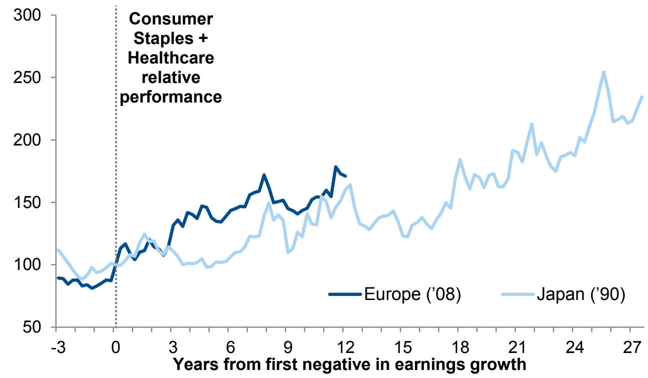
Source: Datastream, Goldman Sachs Global Investment Research

Exhibit 31: Japanese Banks' underperformance was sustained post the 1990s bubble, like that of European banks post 2008
Time 0 = 4Q 1990 Japan, 3Q 2008 Europe



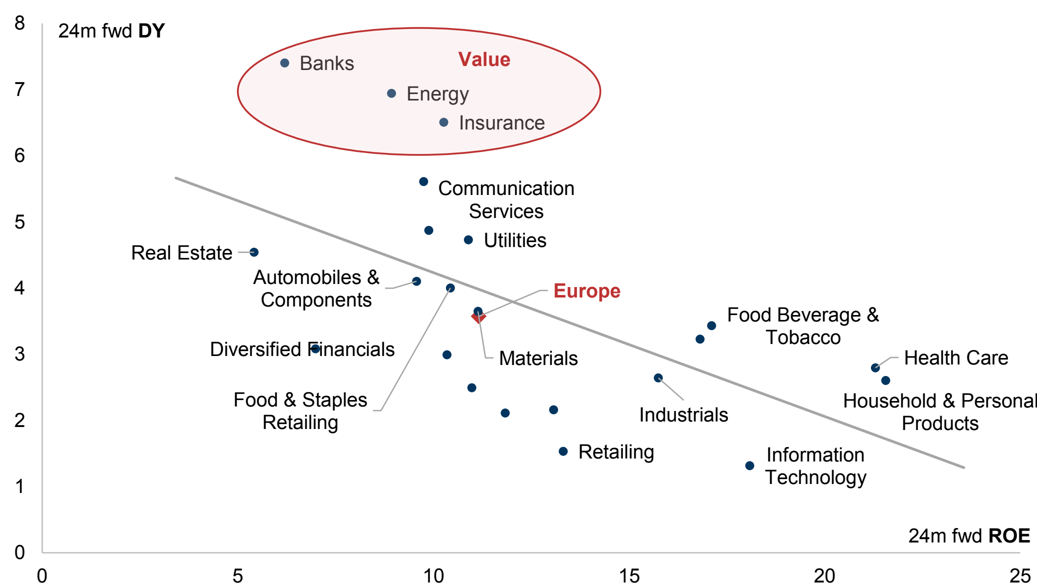
Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

Exhibit 32: 'Growth defensives' outperformed in Japan post the 1990s bubble and in Europe post 2008
Time 0 = 4Q 1990 Japan, 3Q 2008 Europe



Source: Datastream, Worldscope, Goldman Sachs Global Investment Research

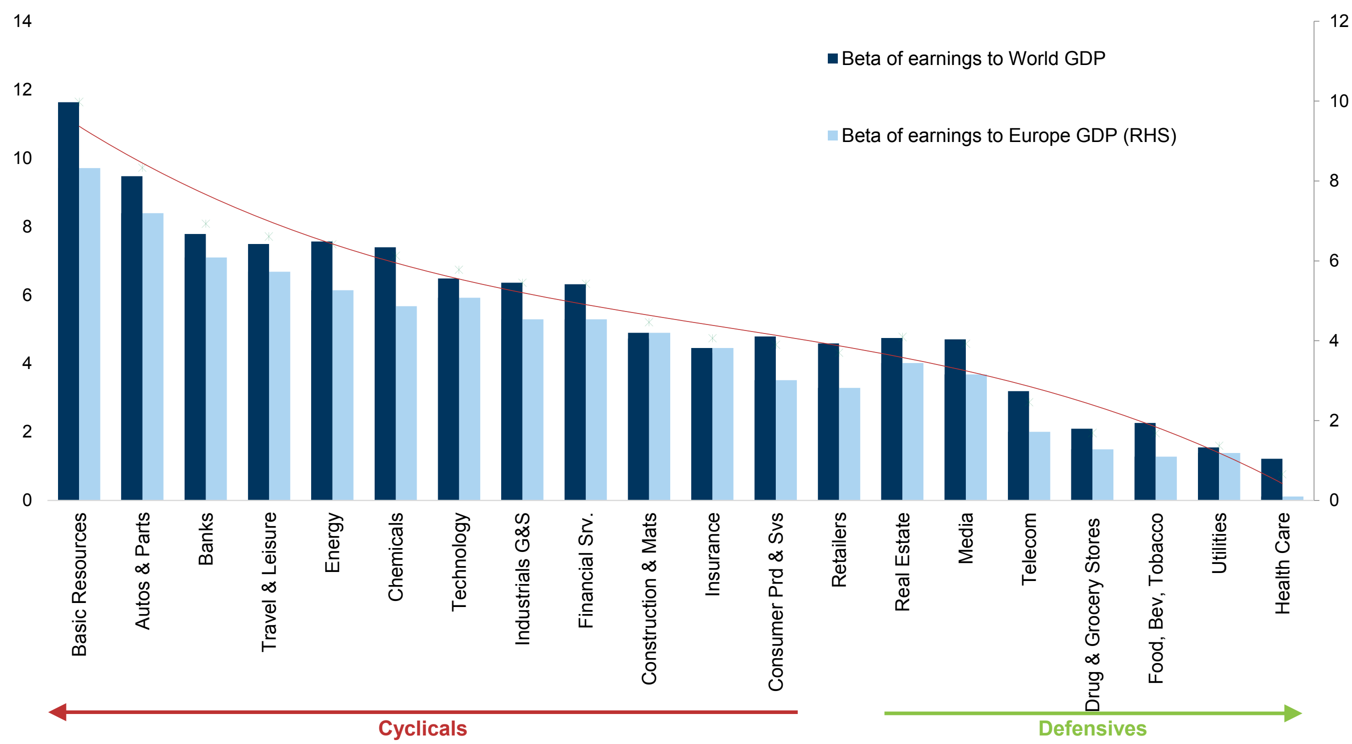
Exhibit 33: Value sectors look attractive on a dividend yield basis
MSCI indices



Source: FactSet, Goldman Sachs Global Investment Research

We also upgrade **Autos** to an Overweight, also because it is one of the most sensitive sectors to economic growth (Exhibit 34), along with Basic Resources (where we remain OW).

Exhibit 34: Cyclicals/Defensives: The sensitivity to economic activity



Source: Datastream, Goldman Sachs Global Investment Research

Baskets: Long Fiscal infrastructure and Recovery

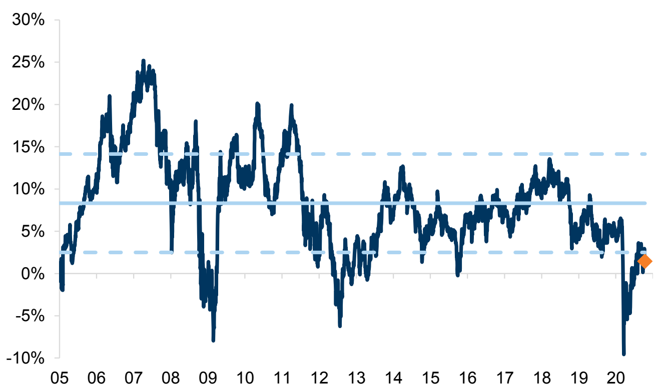
We reiterate our long recommendation on our Fiscal Infrastructure basket (GSSTFISC).

GSSTFISC includes companies from Europe ex-UK that generate more than 30% of their revenue in Europe and are in sectors that governments have specifically targeted for investment and/or our economists expect to be targeted:

- **Renewable** energy/infrastructure.
- **Construction & Materials**: Beneficiaries of investments in public infrastructure.
- **Industrial** machinery, railroad equipment, electrical components - again beneficiaries of public infrastructure, housing and rail infrastructure (Germany is subsiding rail travel and recently announced spending measures on public transport).
- **Technology** stocks which already have some sales exposure to governments, given the need to "future proof" to meet technological changes (this is something the Dutch and German governments have emphasised).
- **Defence** - these companies tend to be areas of high government spending.

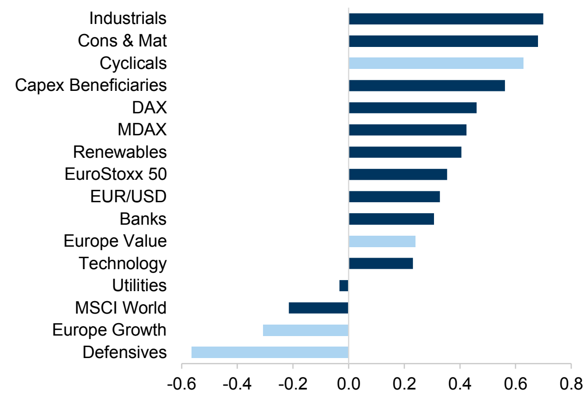
Our Fiscal Infrastructure basket (GSSTFISC) has historically traded relatively closely with our Renewables (GSSBRNEW) and Capex Beneficiaries (GSSTCAPX) baskets. Looking at the correlation with different factors, our GSSTFISC basket is correlated with cyclical companies and has a bias towards Industrials and Germany. Given that Germany has, in our view, most scope for additional fiscal spending, we are happy with this sensitivity.

Exhibit 35: Our Fiscal Infrastructure spending basket (GSSTFISC) trades in line with the market
24m fwd P/E Premium(Discount) vs. STOXX Europe 600



Source: FactSet, Goldman Sachs Global Investment Research

Exhibit 36: Fiscal infrastructure (GSSTFISC) is most highly correlated with industrials, capex and German indices
Correlation of w/w relative returns of our GSSTFISC with different slices of the market (3y)



Source: Bloomberg, Goldman Sachs Global Investment Research

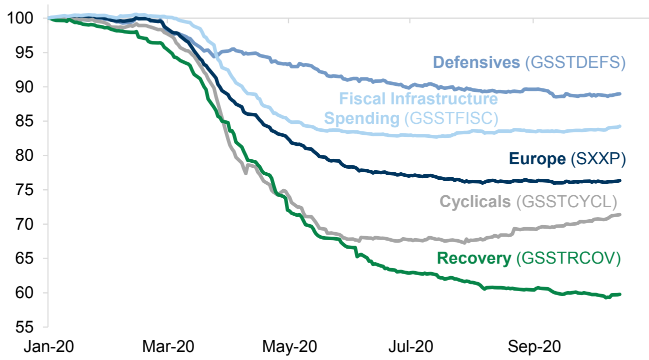
We initiate a Long recommendation on our Recovery basket (GSSTRCOV).

We think our Recovery basket (GSSTRCOV) is a relatively well-diversified way to invest on an early vaccine boost. We discuss this in our *Strategy Matters: Bear Essentials: Europe Q&A*, March 26, 2020. This basket is based on the following criteria:

- High operating leverage: 20-year degree of operating leverage (ratio of EBIT growth to sales growth) > sector median and market median.
- High financial leverage, i.e., weak balance sheets: FY0 Altman z score < sector median and market median. (For a definition and discussion of the Altman z score see here.)
- Value companies: P/E < sector median and market median.

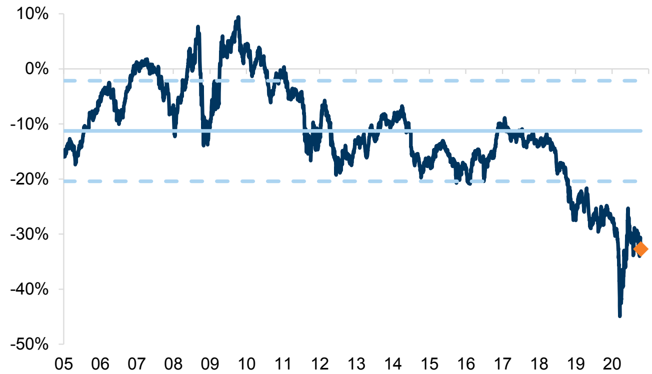
These companies should be most levered to better economic growth. Our Recovery basket continues to look cheap – it trades at over a 30% discount to SXXP based on 24-month forward Consensus EPS (Exhibit 37 and Exhibit 38).

Exhibit 37: The EPS of our Recovery basket have been the most impacted by the Coronacrisis
2021E EPS. Indexed in January 2020



Source: FactSet, Goldman Sachs Global Investment Research

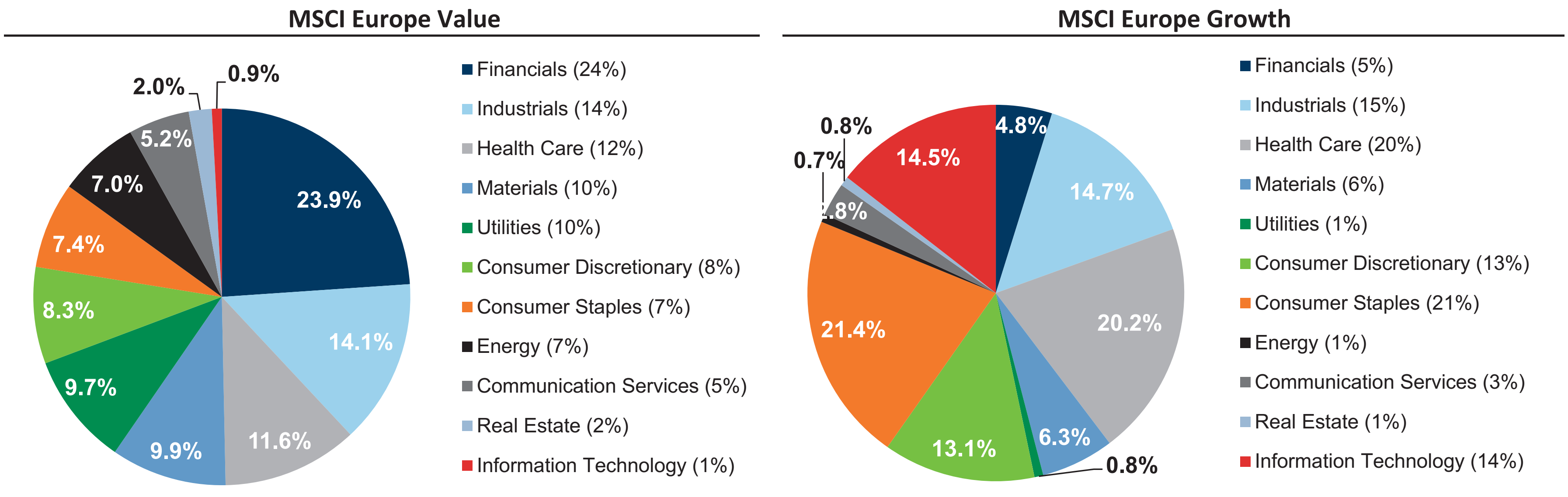
Exhibit 38: Recovery basket (GSSTRCOV)
24m fwd P/E Premium(Discount) vs. STOXX Europe 600



Source: FactSet, Goldman Sachs Global Investment Research

Appendix

Exhibit 39: Sector breakdown of MSCI Europe Value and Growth indices
GICS Level1 classification



Source: MSCI, Datastream, Goldman Sachs Global Investment Research

Exhibit 40: Recovery basket (GSSTRCOV)

Recovery (GSSTRCOV)						
Company Name	Basket weight	Market Cap (EUR Bn)	P/E 12m fwd	Altman z-score FY0	DOL 20y med.	P/E 2021
Automobiles & Parts	**4%**					
Volkswagen Pref.	2%	28.6	7.7	1.0	5.5	6.5
Renault	2%	6.6	NM	0.4	6.2	12.8
Basic Resources	**4%**					
Arcelormittal	2%	13.0	NM	1.4	2.4	11.3
Voestalpine	2%	4.2	NM	1.9	3.7	15.3
Chemicals	**12%**					
Basf	2%	49.9	17.7	2.2	4.1	16.1
Evonik Industries	2%	10.9	14.1	1.7	3.6	13.3
Solvay	2%	8.2	12.6	1.6	2.5	12.1
Arkema	2%	7.2	15.4	2.1	3.5	14.3
Covestro	2%	8.1	25.3	2.1	6.9	19.9
Lanxess	2%	4.4	13.8	1.6	2.5	13.5
Construction & Materials	**6%**					
Heidelbergcement	2%	11.0	9.5	1.3	2.1	8.7
Eiffage	2%	7.1	11.1	0.9	3.3	9.8
Acs Activ.Constr.Y Serv.	2%	7.3	9.4	1.3	1.6	9.1
Food & Beverage	**4%**					
Anheuser-Busch Inbev	2%	83.7	19.9	0.9	1.9	18.7
Coca-Cola Hbc	2%	7.8	16.8	1.7	2.4	15.7
Health Care	**4%**					
Glaxosmithkline	2%	79.9	12.2	1.5	2.1	12.2
Bayer	2%	44.0	6.6	1.2	1.6	6.5
Industrial Goods & Services	**32%**					
Airbus	2%	49.9	27.9	0.8	3.3	23.0
Deutsche Post	2%	51.4	16.8	2.0	1.5	16.2
Volvo B	2%	27.7	17.1	2.0	2.8	15.5
Bae Systems	2%	17.2	10.3	1.5	1.8	9.8
Aena Sme	2%	17.5	31.2	1.9	1.5	28.3
Thales	2%	14.0	12.0	1.6	3.1	11.1
Cnh Industrial	2%	9.8	21.0	1.7	5.9	16.5
Smurfit Kappa Group	2%	8.3	14.2	1.9	3.4	13.9
Kion Group	2%	9.3	21.6	1.1	3.6	20.5
Prysmian	2%	7.1	19.7	1.7	2.4	18.0
Metso Outotec Oyj	1%	5.3	14.1	3.6	2.7	14.0
Smith	2%	4.6	11.7	1.4	2.4	10.8
Rheinmetall	2%	3.3	13.7	1.9	2.7	10.3
Rexel	2%	3.3	11.6	1.9	2.2	10.6
Valmet	2%	3.2	13.1	2.2	3.1	13.0
Leonardo	2%	2.8	5.2	0.9	1.8	4.8
Neles Oyj	1%	1.7	27.7	1.2	1.7	26.0
Media	**4%**					
Wpp	2%	8.9	9.7	1.1	2.0	9.0
Eutelsat Communications	2%	1.9	6.8	1.0	1.6	6.9
Oil & Gas	**6%**					
Repsol Ypf	2%	10.0	8.1	1.3	1.6	7.2
Aker Bp	2%	5.0	13.6	0.7	1.7	13.9
Sbm Offshore	2%	2.8	11.1	1.2	2.0	11.1
Personal & Household Goods	**4%**					
British American Tobacco	2%	68.9	7.9	1.6	1.4	7.6
Electrolux B	2%	6.0	17.3	1.8	5.5	15.5
Retail	**2%**					
Dufry 'R'	2%	2.4	NM	0.7	2.3	NM
Technology	**8%**					
Nokia	2%	19.4	12.3	1.2	2.3	11.9
Atos	2%	7.8	9.5	1.6	2.8	9.3
Ams	2%	5.9	25.3	1.4	2.6	14.4
Ses Fdr	2%	2.5	19.3	0.5	1.4	13.9
Telecommunications	**2%**					
Orange	2%	25.9	9.0	0.7	3.4	9.0
Travel & Leisure	**6%**					
Intl.Cons.Airl.Gp.	2%	5.4	NM	1.1	1.4	NM
Deutsche Lufthansa	2%	4.5	NM	1.1	6.6	NM
Easyjet	2%	2.5	NM	1.5	2.7	NM
Utilities	**2%**					
Rwe	2%	23.0	17.7	0.5	2.3	17.5
Median		**7.8**	**13.6**	**1.4**	**2.4**	**13.0**

Source: Datastream, I/B/E/S, FactSet, Goldman Sachs Global Investment Research

Exhibit 41: Fiscal Infrastructure Spending (GSSTFISC)

Fiscal Infrastructure Spending (GSSTFISC)											
Company Name	**Basket weights**	**Sub-sector**	**Europe exposure**	**Market Cap (EUR Bn)**	**12m fwd P/E**	**Company Name**	**Basket weights**	**Sub-sector**	**Europe exposure**	**Market Cap (EUR Bn)**	**12m fwd P/E**
Chemicals	**5.8%**										
Air Liquide	1.9%	Renewables	34%	64.2	25.4	Signify	1.9%	Building Materials	33%	4.6	10.8
Umicore	1.9%	Renewables	43%	9.2	26.0	Trelleborg	1.9%	Industrial Machinery	51%	4.0	14.5
Wacker Chemie	1.9%	Renewables	41%	4.9	29.0	Georg Fischer	1.9%	Industrial Machinery	52%	3.8	26.9
Construction & Materials	**23.1%**					Rheinmetall	1.9%	Defense	55%	3.3	13.8
Vinci	1.9%	Construction	78%	44.8	16.5	Rexel	1.9%	Electrical Components	54%	3.3	11.6
Sika	1.9%	Building Materials	41%	31.2	40.3	Valmet	1.9%	Industrial Machinery	30%	3.2	13.1
Crh	1.9%	Building Materials	39%	25.9	15.4	Leonardo	1.9%	Defense	51%	2.8	5.2
Assa Abloy	1.9%	Building Materials	35%	21.7	24.5	Andritz	1.9%	Industrial Machinery	36%	3.2	12.5
Saint Gobain	1.9%	Building Materials	67%	20.1	13.5	Oc Oerlikon Corporation	1.9%	Industrial Machinery	52%	2.3	25.0
Geberit	1.9%	Building Materials	81%	19.1	32.2	Nexans	1.9%	Renewables	48%	2.0	14.8
Kingspan Group	1.9%	Building Materials	53%	14.6	38.3	**Oil & Gas**	**5.8%**				
Bouygues	1.9%	Construction	77%	11.7	12.9	Vestas	1.9%	Renewables	27%	29.9	34.4
Heidelbergcement	1.9%	Building Materials	30%	11.0	9.5	Siemens Gamesa Renew.	1.9%	Renewables	52%	17.5	58.6
Skanska	1.9%	Construction	43%	7.4	13.9	Nordex	1.9%	Renewables	45%	1.4	NM
Eiffage	1.9%	Construction	95%	7.1	11.1	**Technology**	**7.7%**				
Acciona	1.9%	Renewables	52%	5.3	18.6	Sap	1.9%	Technology	41%	164.1	24.1
Consumer Goods	**1.9%**					Hexagon	1.9%	Technology	32%	23.0	29.0
Hella	1.9%	Automobiles & Parts	62%	4.8	23.2	Capgemini	1.9%	Technology	59%	19.0	15.6
Industrial Goods & Services	**38.5%**					Atos	1.9%	Technology	66%	7.8	9.5
Abb	1.9%	Electrical Components	33%	49.4	25.2	**Utilities**	**17.3%**				
Safran	1.9%	Aerospace	40%	34.2	23.7	Enel	1.9%	Renewables	65%	78.4	14.5
Legrand	1.9%	Electrical Components	35%	19.0	23.5	Iberdrola	1.9%	Renewables	51%	70.8	19.2
Knorr Bremse	1.9%	Railroad Equipment	43%	16.8	29.4	Orsted	1.9%	Renewables	100%	58.0	50.1
Thales	1.9%	Defense	51%	14.0	12.0	Engie	1.9%	Renewables	75%	29.4	12.2
Worldline	1.9%	Technology	89%	13.4	38.1	E On	1.9%	Renewables	82%	25.5	14.0
Schindler	1.9%	Industrial Machinery	45%	9.4	31.7	Rwe	1.9%	Renewables	93%	23.0	17.8
Alstom	1.9%	Electrical Components	49%	9.4	19.1	Edp Energias De Portugal	1.9%	Renewables	83%	18.4	20.0
Prysmian	1.9%	Electrical Components	44%	7.1	19.7	Fortum	1.9%	Renewables	71%	16.0	12.7
Gea Group	1.9%	Industrial Machinery	37%	5.5	23.5	Verbund	1.9%	Renewables	100%	9.1	32.8
Median			**51%**	**13.7**	**19.2**						

Source: Datastream, I/B/E/S, FactSet, Goldman Sachs Global Investment Research

Disclosure Appendix

Reg AC

We, Peter Oppenheimer, Sharon Bell, CFA, Guillaume Jaisson, Lilia Peytavin and Andrea Ferrario, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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