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Europe: Portfolio Strategy

Outlook 2010: Sector views

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More differentiation in 2010

As we move from the 'hope' to the 'growth' phase of the cycle, we expect sector performance to be driven increasingly by the *sustainability* of growth. This should not preclude some cyclical sectors from outperforming, but those that we prefer reflect expected growth over the course of the cycle rather than economic sensitivity *per se*.

Stay exposed to commodity-related sectors

Commodities and BRICs exposure are two areas of sustainable growth; we maintain our overweights on oil & gas, basic resources, industrial goods and autos. We raise personal household goods to overweight, reflecting the high EM exposure, particularly for luxury and tobacco.

Less positive on financials

We downgrade banks to neutral following strong performance, but continue to favour large global retail banks (GSSBBKGL). We downgrade insurance to underweight as it faces structural issues and is likely to be constrained by low rates.

Our sub-sector basket recommendations

Using sub-sector baskets to refine these views, we have added tobacco (GSSBTOBA), beverages (GSSBBEVS) and steel (GSSBSTEL) to our longs. We recommend short positions in food products (GSSBFOOP), general retail (GSSBGERE) and hospitality and leisure (GSSBHOLR).

Our new STOXX 600 sector recommendations relative to the benchmark

	Sector	Ticker	Market weight	Deviation from Benchmark (bp)
+ Overweight	Oil & gas	SXEP	10.21%	75 bp
Overweight	Automobiles & parts	SXAP	1.76%	50
Overweight	Basic resources	SXPP	5.01%	50
Overweight	Personal & household goods	SXQP	4.43%	50
Overweight	Industrial goods & services	SXNP	7.89%	25
Neutral	Construction & materials	SXOP	2.69%	0 bp
Neutral	Banks	SX7P	16.90%	0
Neutral	Financial services	SXFP	1.56%	0
Neutral	Food & beverage	SX3P	7.20%	0
Neutral	Media	SXMP	2.00%	0
Neutral	Technology	SX8P	2.98%	0
Neutral	Telecommunications	SXKP	6.78%	0
Neutral	Travel & leisure	SXTP	1.12%	0
Neutral	Utilities	SX6P	6.22%	0
Underweight	Chemicals	SX4P	3.85%	-25 bp
Underweight	Insurance	SXIP	5.51%	-50
Underweight	Real Estate	SX86P	1.11%	- 50
Underweight	Retail	SXRP	3.35%	- 50
– Underweight	Health care	SXDP	9.42%	-75

Source: Goldman Sachs Global ECS Research.

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Differentiate

In our *Outlook 2010: Strategy and themes*, we highlighted our view that we are entering a new phase of the equity bull market. The hope phase, that has characterized the past nine months, is typically associated with very strong market returns while the economy remains in recession and profits are falling or weak. We expect 2010 to mark the transition towards a more fundamentally driven growth phase. This is typically a longer period, characterized by strong profit growth but an environment in which the market fails to keep up with earnings.

As we showed in *The Equity Market Cycle part 2: Investing in the phases*, October 29, 2009, the despair and hope phases tend to have relatively clear sectoral patterns based on economic sensitivity, but the growth phase tends to exhibit a much less clear pattern. This does not mean that there is little difference between sector returns, but rather that the relative returns become less a function of beta, leverage or economic sensitivity *per se*, and more about underlying margin and sustainability of earnings growth.

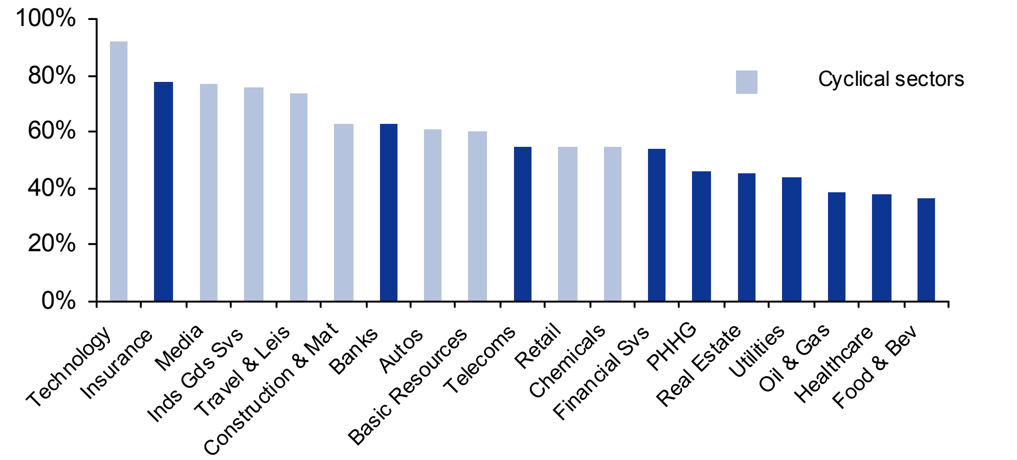
Sustainable growth rather than beta is the key

As we look into 2010, therefore, our key theme is differentiation. In our view this does not mean necessarily rotating out of traditional cyclical sectors simply because they have done well, but selection on the basis of underlying growth potential. This leads us to continue to like some cyclical areas, while also favouring some traditional defensive sectors. Ultimately we think that generating top-line growth, higher margins and returns will be the key determinant over more usual styles such as cyclical vs. defensive, high vs. low leverage of high vs. low beta.

This shifting pattern of returns was evident in the transition from the strong hope phase of early 2003 into early 2004, and the subsequent consolidation in the market as it shifted into the growth phase. The market was stuck in what we describe as a 'flat and skinny' trading range between March and October 2004.

Exhibit 1 shows that when the market went up 49% between March 2003 and March 2004, all sectors went up together, but the very clear outperformers were typical cyclical sectors like technology (also the sector that had led the previous collapse), media, industrial goods and services, travel and leisure, construction, autos and basic resources. All the worst performers were 'traditional' defensive sectors: food and beverages, healthcare, oil & gas and utilities.

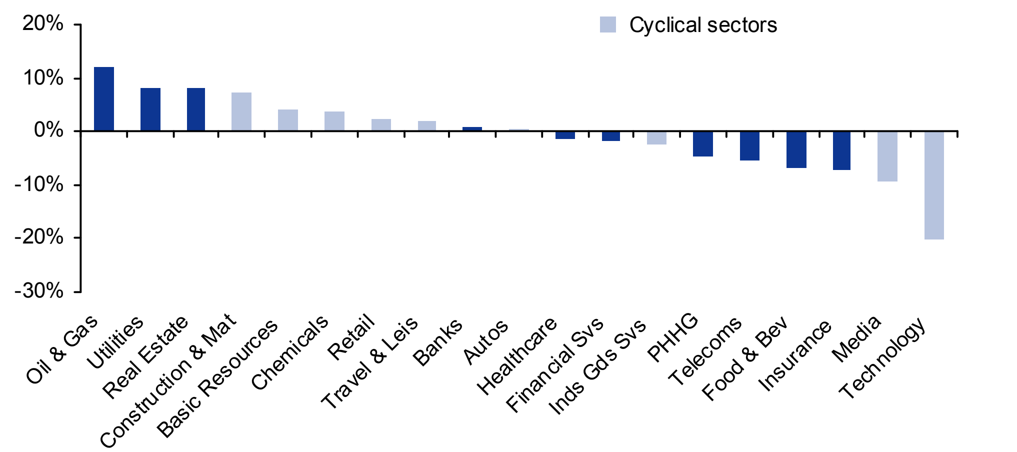
Exhibit 1: Cyclicals dominate the out performers
Total return per sector from March 2003 to March 2004



Source: Datastream, Goldman Sachs Global ECS Research.

When the market started to transition into its growth phase from March 2004, sector dispersion was still significant; indeed, some sectors went up 10% or more, while others went down 10% or more. **The relative winners, however, were a mix – some cyclical, such as construction, and resources, and some defensive, such as utilities. Also, among the worst performers were cyclicals, such as technology and media, but a number of defensives which had already performed badly continued to do so, such as personal and household goods, telecoms and food and beverages. It was valuation and margins that really mattered, not leverage and beta.**

Exhibit 2: a mix of cyclical and more defensive sectors did best
Total return per sector from March 2004 to September 2004



Source: Datastream, Goldman Sachs Global ECS Research.

As we look into 2010 we believe sustainable growth (rather than a one-year 'survival bounce') is key, In general there are two areas that are likely to generate this:

- **BRICs –** we think that companies and sectors that are highly geared into BRICs demand – infrastructure of consumption – are more likely to enjoy strong top-line growth than companies and sectors heavily dependent on government or consumer demand in the developed world.

- **Commodities –** the combination of very low interest rates and strong emerging market growth should be supportive for commodity prices, particularly oil. Our Commodity Strategy team forecasts oil prices to average US$90 in 2010. Unlike the period from late 2005 through 2006, when oil stocks underperformed despite higher oil prices, this time could be much more like 2004/5 when costs were lower and oil prices rose. We think this is likely over the coming months.

Our updated recommendations for sectors in the DJ STOXX 600 are shown in Exhibit 3. We continue to have a cyclical bias but not exclusively so.

Main upgrades

We have upgraded personal and household goods to an overweight from neutral.

We have put tobacco, beverages and steel into our sub sector recommended overweights.

We have removed sub sector baskets of building materials, mining and trucks as recommendations

Main downgrades

We downgrade banks to neutral and insurance to underweight.

We have put the sub sector baskets of food retail, food producers and hospitality and leisure in our recommended underweight.

Exhibit 3: Our new STOXX 600 sector recommendations relative to the benchmark

	Sector	Ticker	Market weight	Deviation from Benchmark (bp)
+ Overweight	Oil & gas	SXEP	10.21%	75 bp
	Automobiles & parts	SXAP	1.76%	50
	Basic resources	SXPP	5.01%	50
	Personal & household goods	SXQP	4.43%	50
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	Banks	SX7P	16.90%	0
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	Real Estate	SX86P	1.11%	- 50
	Retail	SXRP	3.35%	- 50
–	Health care	SXDP	9.42%	-75

Source: Factset, Goldman Sachs Strategy Research.

Exhibit 4: Still pro-cyclical but with focus on sustainable growth
Bold denotes change in weight

STOXX 600 Supersector Recommendations		
Overweight	**Neutral**	**Underweight**
Automobiles & parts	**Banks**	Chemicals
Basic resources	Construction & materials	Health care
Industrial goods & services	Financial services	**Insurance**
Oil & gas	Food & beverage	Real Estate
Personal & household goods	Media	Retail
	Technology	
	Telecommunications	
	Travel & leisure	
	Utilities	

Source: Goldman Sachs Global ECS Research.

Refining our sector views through sub-sector recommendations

To fill the gap in the European market for sector products, and to enable clients to take views on more specific industries, we have created tradable equally-weighted sub-sector baskets around narrowly defined industries; these aim to decrease intra-sector dispersion and increase inter-sector dispersion. We allow overlaps between the sub-sectors if companies have exposures to several industries, and aim to strike a balance between relevance and diversification with the number of companies included. See our Bloomberg page GSPM (type GSPM 5 <GO>) for details on price performance and constituents.

Our sub-sector recommendations have performed well since our last report (see *Why the market has further to rise*, September 3, 2009). Our focus remains sustainable growth and exposure to emerging markets and commodities.

Exhibit 5: Taking profits on our long on trucks (GSSBTRUC) and mining (GSSBMINE)

Sector	Trade	Bloomberg ticker	Since 03-Sep-09	YTD	Since 03-Mar-09	Since 01-Jun-07
Mining	Close Long	GSSBMINE	**35.2%**	181%	193%	-28%
Oil Services	Long	GSSBOILS	**19.3%**	106%	94%	-24%
Food Products	Initiate Short	GSSBFOOP	**13.7%**	31%	56%	-32%
Beverages	Initiate Long	GSSBBEVS	**12.3%**	53%	71%	-23%
Luxury Goods	Long	GSSBLUXG	**11.8%**	55%	88%	-26%
Trucks	Close Long	GSSBTRUC	**11.4%**	23%	68%	-56%
Banks - Global Retail	Long	GSSBBKGL	**10.3%**	53%	154%	-27%
Steel	Initiate Long	GSSBSTEL	**8.3%**	37%	67%	-50%
General retail	Initiate Short	GSSBGERE	**8.2%**	60%	68%	-39%
STOXX 600		**SXXP**	**7.2%**	**21%**	**57%**	**-38%**
Building Materials	Close Long	GSSBBUIL	**5.8%**	37%	110%	-53%
Hospitality & Leisure	Initiate Short	GSSBHOLR	**4.4%**	23%	57%	-70%
Tobacco	Initiate Long	GSSBTOBA	**3.1%**	29%	32%	-7%

Source: Bloomberg, Goldman Sachs Global ECS Research.

Changes

We take profits on our long positions of the trucks (Bloomberg ticker GSSBTRUC) and mining (Bloomberg ticker GSSBMINE) sub-sector – they are up 11.4% and 35.2% respectively since our last update on September 3, 2009; the STOXX 600 was up 7.2% in the same period. We also close out of our long building materials position (Bloomberg ticker GSSBBUIL) at a small loss; the basket is up 5.8% and down 1.3 % relative to the STOXX 600.

We introduce long positions on tobacco (Bloomberg ticker GSSBTOBA), beverages (Bloomberg ticker GSSBEVS) and steel (GSSBSTEL). We introduce short positions on food products (Bloomberg ticker GSSBFOOP), general retail (Bloomberg ticker GSSBGERE) and hospitality & leisure (Bloomberg ticker GSSBHOLR).

Exhibit 6: Refining the focus on emerging markets growth and commodities
Bold denotes addition

Goldman Sachs Sub-Sector Baskets	
Long	**Short**
GSSBBEVS (Beverages)	**GSSBFOOP (Food Products)**
GSSBBKGL (Banks - Global Retail)	**GSSBGERE (General Retail)**
GSSBLUXG (Luxury Goods)	**GSSBHOLR (Hospitality & Leisure)**
GSSBOILS (Oil Services)	
GSSBSTEL (Steel)	
GSSBTOBA (Tobacco)	

Source: Goldman Sachs Global ECS Research.

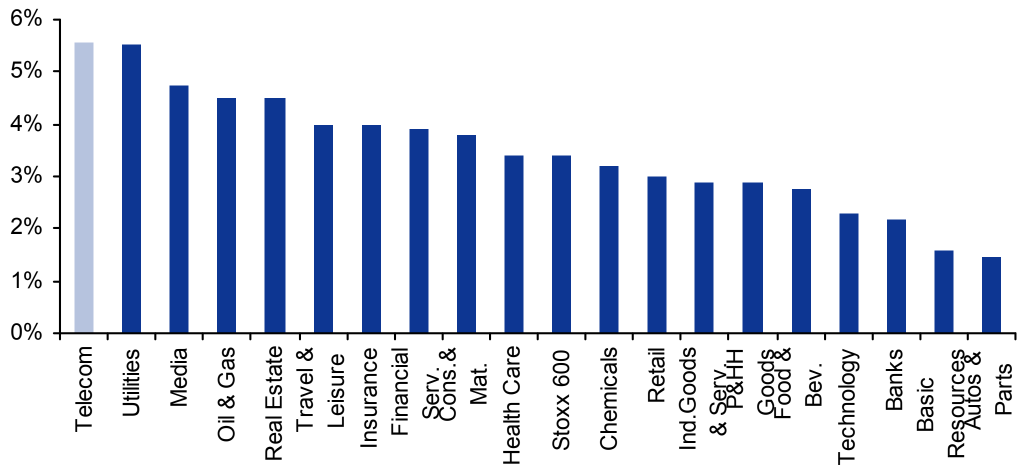
Defensives: Prefer personal household goods

Telecoms: Neutral

As in the case of almost all defensive sectors, telecoms have performed poorly this year. The sector has suffered from the re-risking that started in March and that fuelled a strong recovery from cyclicals.

Following such a long period of underperformance, the sector displays attractive valuations. With a 12-month forward P/E standing just above 10x, the sector trades at a discount to the market. Furthermore, telecoms has the highest dividend yield among all sectors. With a double-digit free cash flow yield, the risks of a cut to dividend payments are, in our view, limited. Margins showed resilience and stayed at 2007/2008 levels.

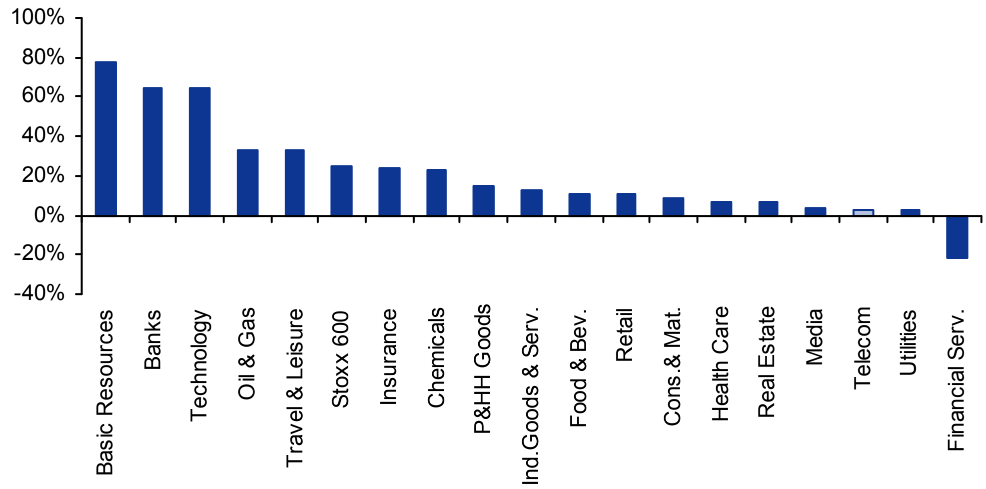
Exhibit 7: Telecoms has the highest dividend yield among all sectors…
Based on consensus data



Source: Factset, I/B/E/S, Worldscope, Goldman Sachs Global ECS Research.

Against this positive backdrop, earnings growth is likely to be weak in 2010. While consensus expects 24% earnings growth for the market, it forecasts a meager 3% growth for telecoms. Our analysts are slightly more positive but still only expect a single-digit growth figure. As we move from the hope phase to the growth phase (for more details, please see *Strategy Matters: The equity cycle part I: Identifying the phases,* October 23 2009), in which earnings growth should outpace returns, it is difficult to imagine a strong re-rating of the sector. This is why we take a neutral stance on telecoms despite the attractive yield. We would look to overweight this sector, perhaps, later in the year as the typical seasonal pattern tends to support the sector in 2H.

Exhibit 8: …but the sector offers poor growth prospects in 2010
Based on consensus data



Autos & parts not meaningful

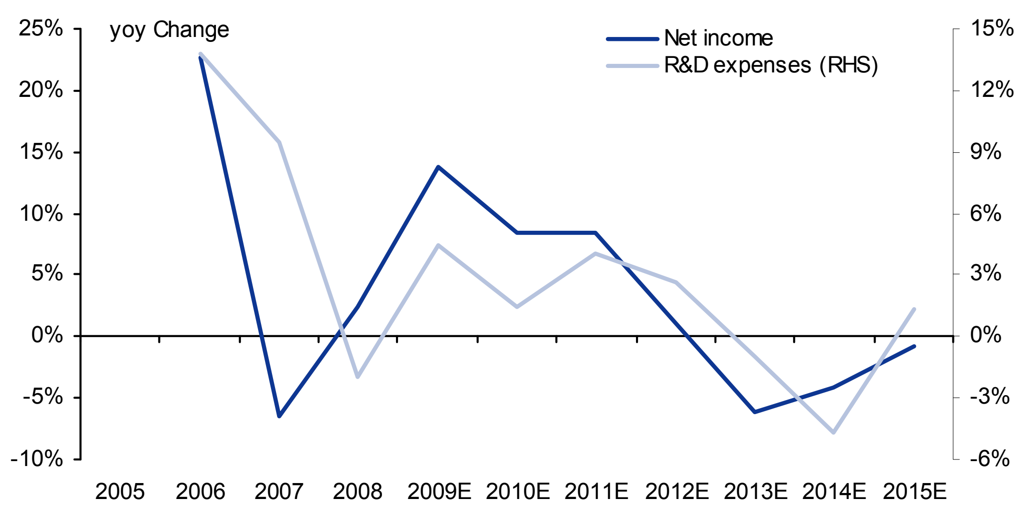
Source: Factset, I/B/E/S, Worldscope, Goldman Sachs Global ECS Research.

Healthcare: Underweight

We have been underweight healthcare for the past six months, as it is one of the more defensive sectors and, we thought, would not benefit as much as more cyclical areas of the market from the recovery. It has a strong negative correlation with the ISM and has underperformed the market as leading indicators recovered as we feared.

Although margins have expanded in 2009, the top-line growth is limited and returns are falling as capex stay high. This will likely get worse as we move closer to 2012, when most of the current blockbusters' patents expire. The emerging market exposure helps sustain top-line growth, but at the expense of margins. The contribution is also limited as emerging markets still account for a small proportion of pharmaceuticals' revenues.

Exhibit 9: Healthcare offers poor growth prospect after 2012



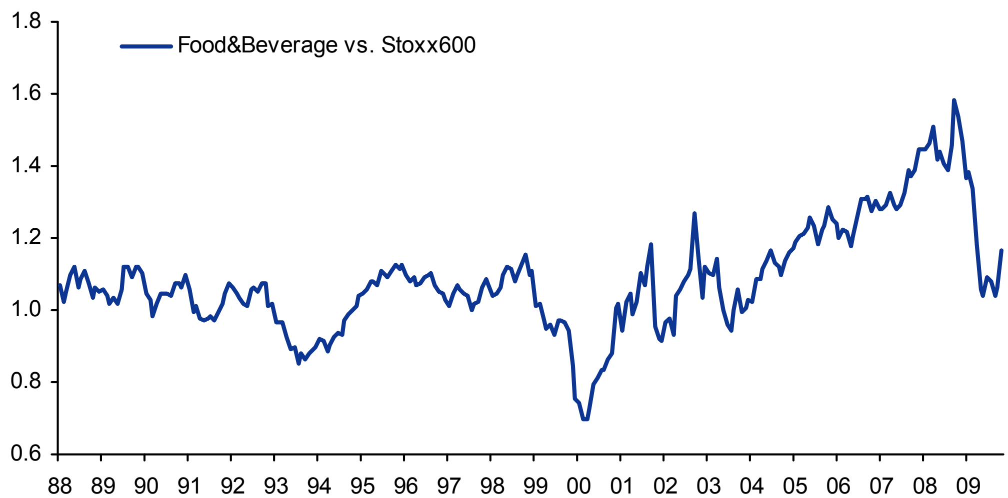
Source: Goldman Sachs Research estimates, Quantum database.

On top of that, the ongoing discussions regarding healthcare reform in the US have weighed on the sector. It is still difficult to assess the exact impact for European companies, but our analysts estimate that the impact will shave a few percentage points off bottom-line growth. As we are constructive on the market and see no changes to the bleak outlook for healthcare, we remain underweight. Many investors argue that the sector is historically cheap, but that is true for most sectors, and we think that the extent to which the sector is experiencing structurally lower margins is not fully reflected in the valuation. For example, the EV/sales of the sector remains at an expected 2.6x for NTM compared with 1.7x for personal and household goods and 1.9x for telecoms.

Food & beverage: Neutral

Food & beverage fared better than other defensives during the recovery. It has performed in-line with the market year-to-date. Valuations are not cheap but the sector is not now trading at a significant premium as it did at the end of last year. The valuations are still below mid-cycle.

Exhibit 10: Food & beverage is not as expensive as it was in 2009
Relative 12-month P/E

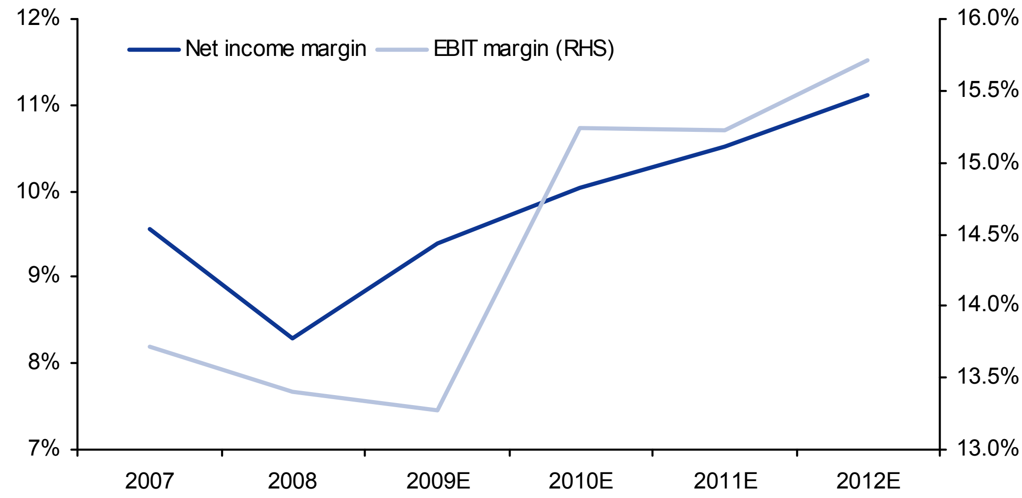


Source: Factset, I/B/E/S, Worldscope, Goldman Sachs Global ECS Research.

Within the sector, **we prefer beverage to food companies** as we believe beverage companies, especially brewers, are more cyclical and should benefit from the ongoing recovery and from their exposure to emerging markets. **We recommend going long our sub-sector basket of beverage companies (Bloomberg ticker GSSBBEVS) and short the food products sub-sector basket (Bloomberg ticker GSSBFOOP).**

Margins for food and beverage have been resilient in 2009 and our analysts expect them to rise to a new high in 2010, above the previous peak. This improved profitability stems from restructuring, increased operating leverage and lower commodity costs. The benefits from lower commodity costs come with a lag as companies roll their hedges.

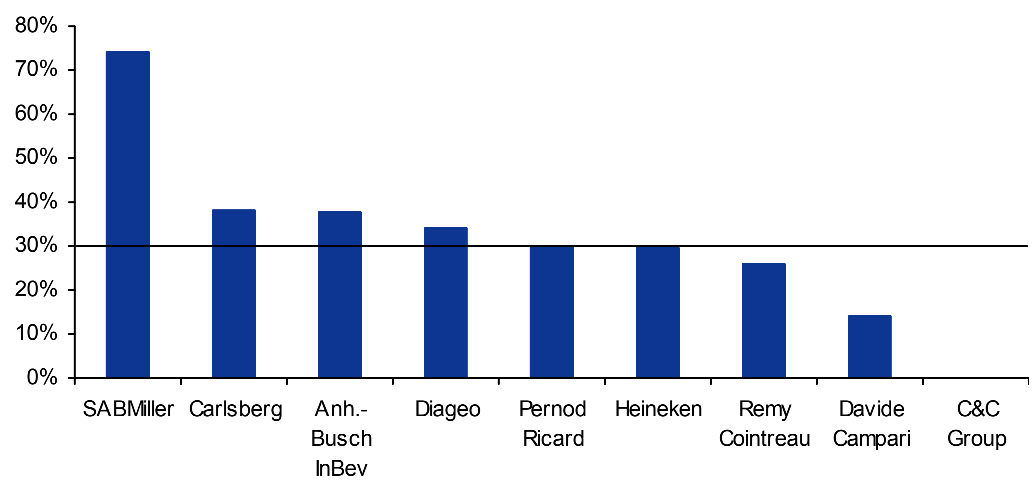
Exhibit 11: Food and beverage margins should reach a new high in 2010



Source: Goldman Sachs Research estimates, Quantum database.

Beverages should benefit from their significant exposure to emerging markets. Our Economists expect emerging markets to grow at 7.7% in 2010, well ahead of advanced economies (2.1%). In the BRICs, the growth should be even more pronounced and we believe that companies with a strong end market are set to outperform companies exposed to more lackluster domestic growth.

Exhibit 12: Emerging market exposure of beverage companies



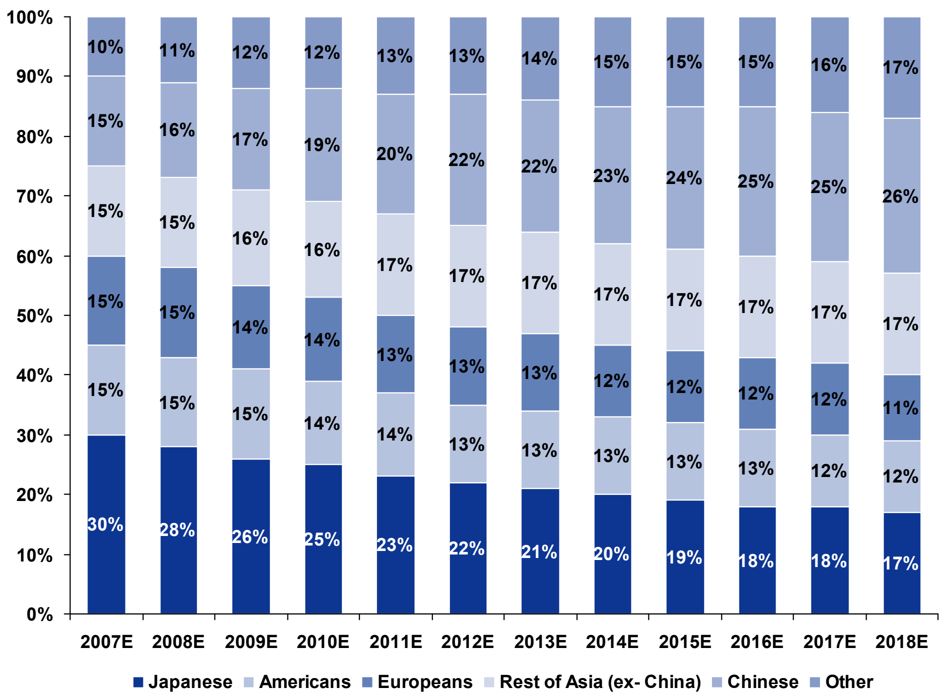
Source: Company filings, Goldman Sachs Research.

Personal & household goods: Overweight (from Neutral)

We are upgrading personal & household goods to overweight from neutral. Although this sector is a diversified mix of sub-sectors (UK homebuilders, personal goods, luxury goods, tobacco), we have a positive view on most of them.

These sub-sectors tick a few boxes among the themes we highlight for 2010 (for more details, see *Outlook 2010: Strategy and themes, December 2, 2009*). Luxury goods (Exhibit 13) and tobacco have significant exposure to emerging markets. We also expect tobacco stocks to expand margins through good pricing power and further cost saving. Personal care and UK homebuilders should also fare well in an environment where growth is rewarded. In some cases, Electrolux for example, our analysts expect margins to make new highs.

Exhibit 13: Luxury goods are increasingly exposed to the strong growth in Asia



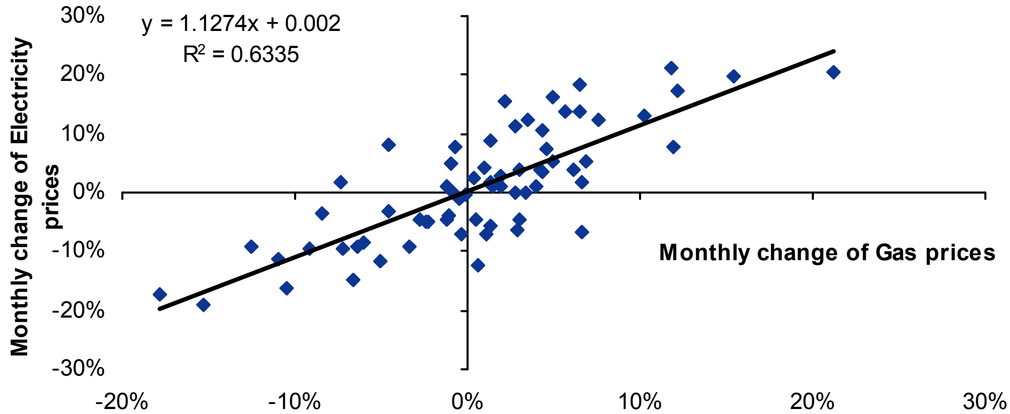
Source: Company filings, Goldman Sachs Research estimates.

We prefer tobacco and luxury goods among the sub-sectors. We recommend taking a long position in our sub-sector baskets (Bloomberg ticker GSSBTOBA and GSSBLUXG respectively) to reflect this positive bias.

Utilities: Neutral

We are keeping utilities neutral. Utilities underperformed dramatically in 2009 and is the only sector with a negative return year-to-date. As gas prices lagged the recovery in oil, power prices remain at low levels. Despite the underperformance, we remain neutral on the sector. The pace of balance sheet restructuring through asset disposals has slowed but there is still pressure on some companies to restructure further. Capex remains at very high levels. As a result the cash flow yield remains negative for the sector as a whole. Relative to other defensive sectors we think the valuations are unattractive. While dividend yields are relatively high there are still concerns on sustainability for some companies. In addition, clarity on German nuclear life extensions is unlikely until late 2010.

Exhibit 14: European power prices exhibit strong correlation with gas price
Based on monthly data back to May 2004



Source: Goldman Sachs Global ECS Research.

The major risks to the upside are higher gas prices and a strong pick-up in industrial production, which could push up prices and increase margins. The gas price, which is more relevant for European utilities, has not recovered in line with the oil price. Oil and gas tended to trade in a similar pattern. Our Commodity analysts believe that a combination of the cyclical weakness in industrial demand observed in 2009 and the structural shift in natural gas supply brought about by a surge in global liquefaction capacity, and technological innovation, explains the divergence between the oil complex and gas prices.

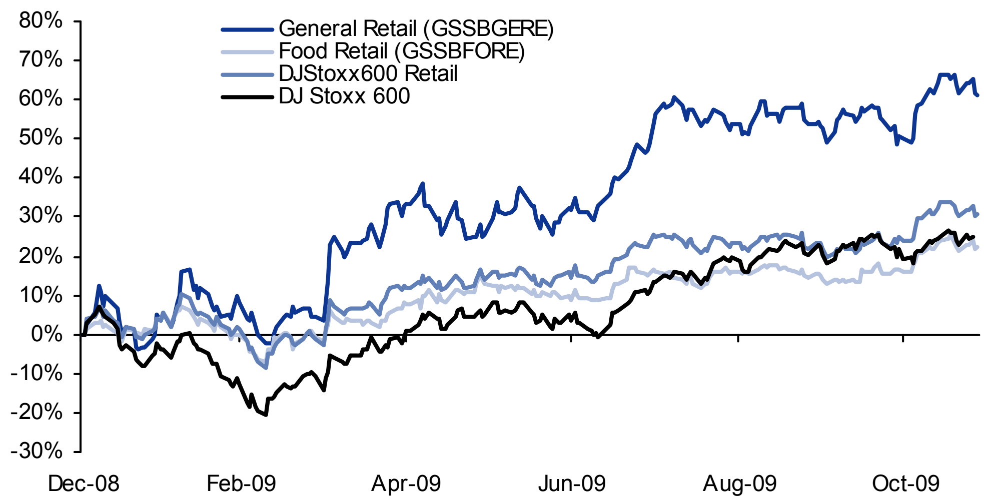
We do not forecast a swift recovery in gas prices but any sign of tangible turnaround in European gas prices would make us more positive on utilities. Equally, further weakness in the gas market would weigh on the sector in our view.

Consumer cyclicals: Local macro headwinds vs. BRICs exposure

Retail: Underweight

We remain underweight the retail sector. Although valuation is fairly cheap, we think there is better value in luxury goods. Since the beginning of the year the SXRP has performed strongly (+30%), mostly driven by a recovery of the general retail sub-sector. The food retail sub-sector has performed in line with the market.

Exhibit 15: General retail sub-sector outperformed the broader index

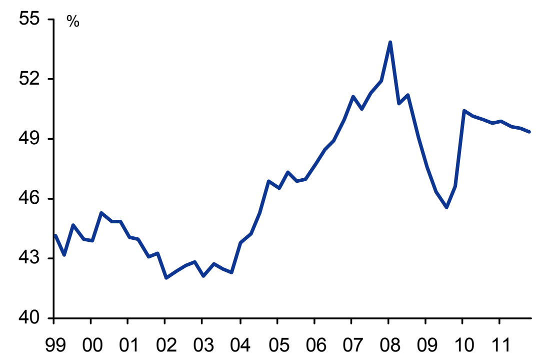


Source: Bloomberg, Goldman Sachs Research.

We expect macro headwinds for the most domestically focused sectors such as general retail. As the impact of the stimulus wears off and fuel prices, tax and mortgage costs increase, we expect retail sales growth to slow. In addition, there is a risk that unemployment increases or a higher savings rate results in lower consumer spending. We think that the Christmas season will be good for UK general retailers but we equally believe that most of it is already priced in. **We recommend a short position of the general retail sub-sector (Bloomberg ticker GSSBGERE).**

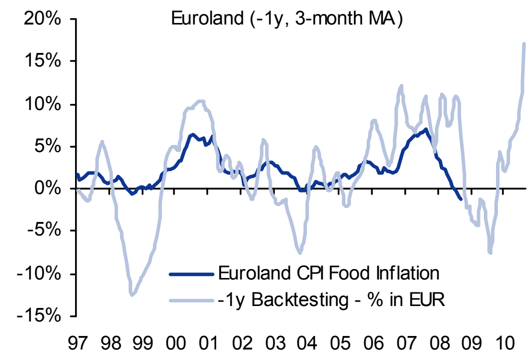
Our analysts also see limited value in food retail companies, as they expect continued food price deflation in 2010. Emerging markets exposure is key for relative performance in the sector. We believe that it could be a factor of differentiation between companies exposed to fast growing emerging economies and those struggling with a sluggish domestic market where high unemployment and potentially increasing rates pose a serious threat to demand.

Exhibit 16: Stimulus impact to wear off in the UK
Combined cost of taxes, energy, food and mortgages as a share of disposable income



Source: ONS, Goldman Sachs Research estimates.

Exhibit 17: We expect continued deflation of food prices



Source: ONS, Goldman Sachs Research estimates.

Technology: Neutral

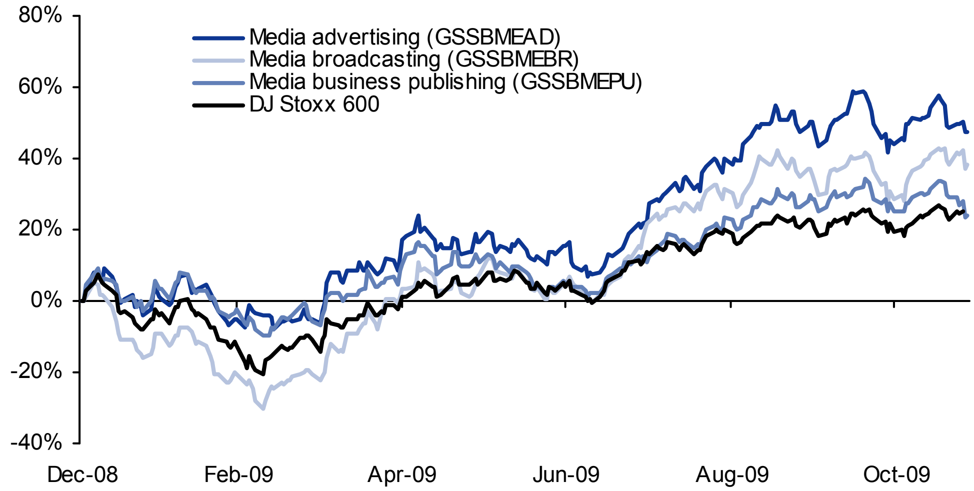
We remain neutral on the technology sector. Historically, technology has shown a high correlation with economic indicators. Recent IT spending surveys point to an upturn and the semiconductor cycle has gained positive momentum as shown by the 3Q09 capacity utilization data released by the SIA (Semiconductor Industry Association). However, the sector is very concentrated on a few stocks – Nokia, SAP, Ericsson and ASML are c.65% of the index. The semiconductors, IT services and software sub-sectors generally have a relatively low weight. We are rated Neutral on Nokia ($13.41, 24% potential upside), SAP ($48.19, 18% potential upside) and ASML (€21.20, 21% potential upside) and have a Conviction Buy on Ericsson ($9.85, 42% potential upside). One positive for the sector, however, is that stocks typically have strong balance sheets; this could lead to increased M&A activity.

Media: Neutral

Mixed trends in the media sector keep us neutral. The sector consists of three sub-sectors – advertising, broadcasters and publishers – and Vivendi is c.25% of the sector. While the more cyclical parts such as advertising and broadcasters have performed very well since the beginning of the year, the more defensive publishers and Vivendi have lagged and performed in-line with the market only.

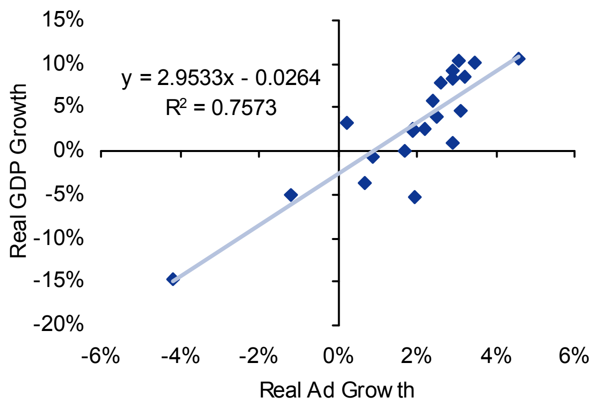
Advertising accounts for c.60% of sector revenues, and is beginning to recover in line with improving macroeconomic conditions. Historically, advertising revenues exaggerate swings in real GDP by 2-3x, and are highly correlated in most markets (see *Europe: Media, Further increase to forecasts but slight switch towards publishers*, September 3, 2009). Based on our Economists' GDP growth forecasts we would expect this recovery to continue and further drive upgrades to earnings forecasts. Based on gross advertising data and discussions with major media buyers in the main west European broadcast markets, our analysts find evidence of a modestly stronger than expected recovery in 3Q and 4Q TV ad markets. The exception is Spain where estimates are broadly unchanged.

Exhibit 18: The advertising sub-sector basket has outperformed the broader index



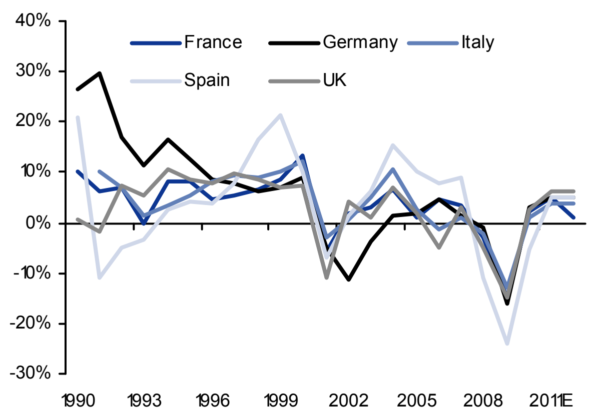
Source: Bloomberg, Goldman Sachs Strategy Research.

Exhibit 19: Advertising spending shows strong correlation with GDP



Source: Zenith Optimedia, Advertising Association, Goldman Sachs Research estimates.

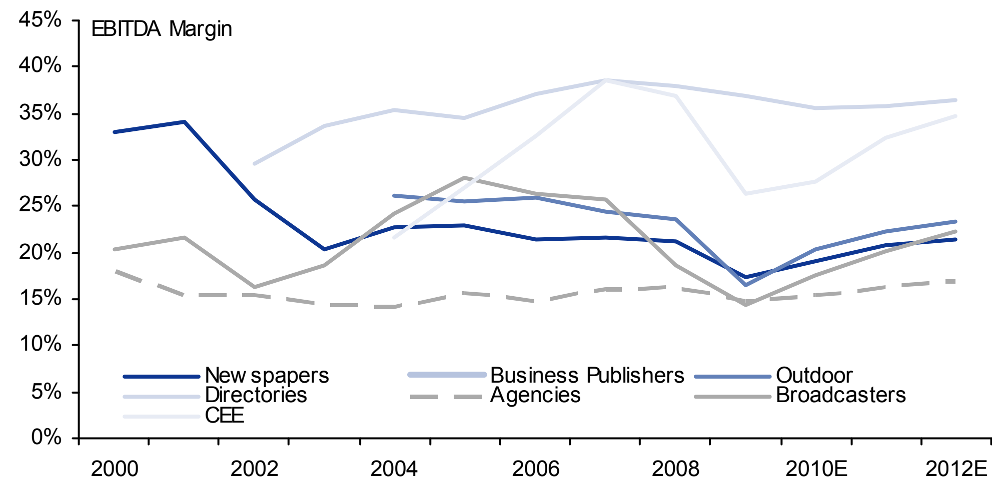
Exhibit 20: Growth in TV advertising spend by country



Source: Goldman Sachs Research Estimates

Despite the speed and scale of cyclical recovery, there continue to be significant structural forces in the media sector from digital developments, which affect both the near-term and long-term outlook. Over the next few years those developments will continue to put newspapers and directories under pressure and, increasingly, free TV. Nevertheless our analysts expect strong margin improvement in the short term as a result of the recovery. But they do not expect margins for free TV, newspapers and directories to return to historical levels; only margins for agencies and professional publishers are likely to increase above historical peak levels.

Exhibit 21: Significant differences in scope of margin improvement post recovery



Source: Goldman Sachs Research estimates.

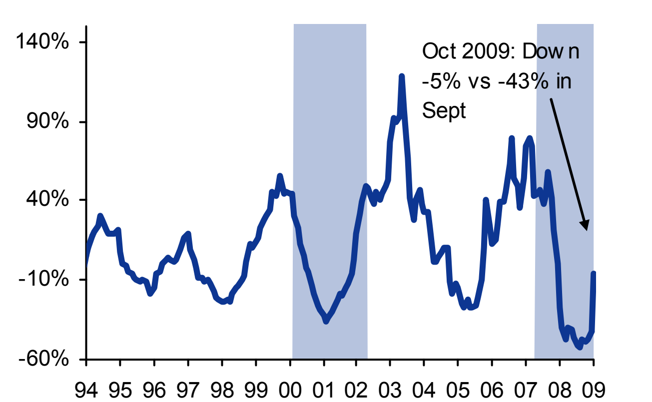
Travel & leisure: Neutral

We stay neutral on the travel & leisure sector, which has underperformed the market YTD. Again we expect continued divergence in performance between the different sub-sectors: airlines, bus & rail, hospitality & leisure and gaming.

As shown by our GS transportation value index (Exhibit 22), activity data on transportation is improving following stronger demand, mainly from emerging markets and China – this is shown by stronger volumes across ports, airports, canals, roads, rail and to some extent hotels. This should benefit airlines with cargo exposure. Low inventory in OECD countries, coupled with good Christmas prospects, is encouraging retailers to restock and use airfreight to ship goods as rapidly as possible to customers.

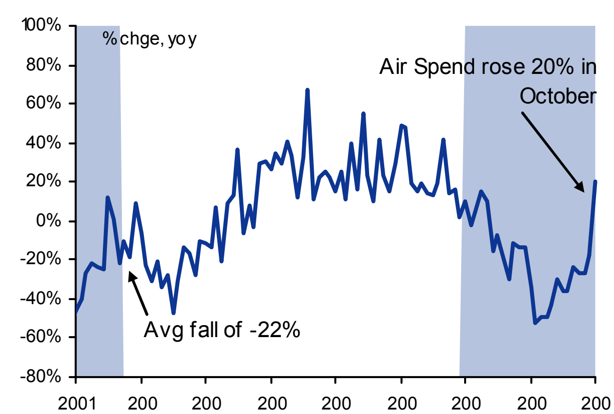
However, passenger traffic is not recovering as fast as cargo – the implied cost of reactivating the idle fleet is providing good support to rates. Business travel is recovering according to our GS investment banking travel index, increasing 20% yoy in October. At the same time pricing power for airlines has improved as capacity has decreased. A combination of improving volumes plus recovery in pricing means airlines should return to profitability in 2010 in our view.

Exhibit 22: GS transportation value index



Source: Goldman Sachs Research estimates.

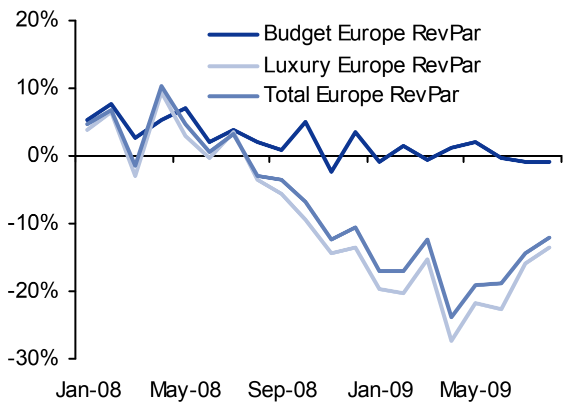
Exhibit 23: GS investment banking air travel index



Source: Goldman Sachs Research estimates.

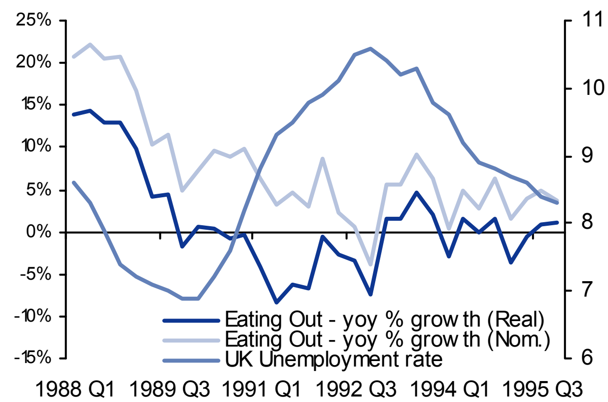
While UK consumer-facing parts of the travel & leisure sector such as restaurants and pubs are unlikely to see trading improve materially in 2010 due to a combination of VAT rising and higher year-on-year unemployment in 1H 2010, we believe that the focus will eventually switch to declining unemployment levels and the benefit that could bring in 2011. Hotel revenue per available room (RevPar) has seen significant declines over the past year and we forecast it to turn positive in 2Q 2010 in the UK and 3Q in Europe. Another issue for the sector remains the relatively high level of leverage among airlines, pubs and hotels which could lead to reduced capex budgets, disposals, lower dividends or even equity raising in certain situations. **We recommend a short position of the hospitality & leisure sub-sector (Bloomberg ticker GSSBHOLR).**

Exhibit 24: European RevPar is now picking up



Source: MKG Consulting.

Exhibit 25: The eating out market shrank for almost four years in the early 1990s

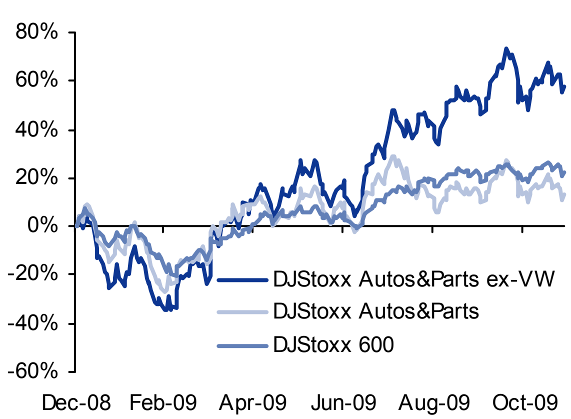


Source: ONS.

Autos & parts: Overweight

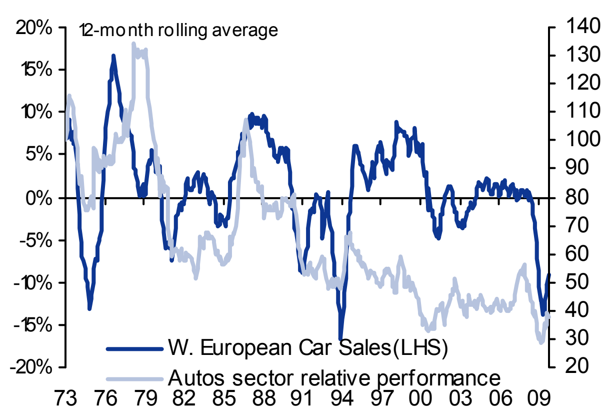
We remain overweight autos & parts as our analysts believe the sector can continue to deliver positive earnings surprises. The sector has lagged the market performance YTD. However, this has been caused by the negative performance of Volkswagen around the resolution of its merger with Porsche. Excluding Volkswagen from the SXAP shows that the sector has been one of the strongest performers YTD. This strong rebound is in line with historical recoveries if sales volumes are stabilising (Exhibit 27).

Exhibit 26: Excluding Volkswagen the autos sector has outperformed the broader index



Source: Bloomberg, Goldman Sachs Global ECS Research.

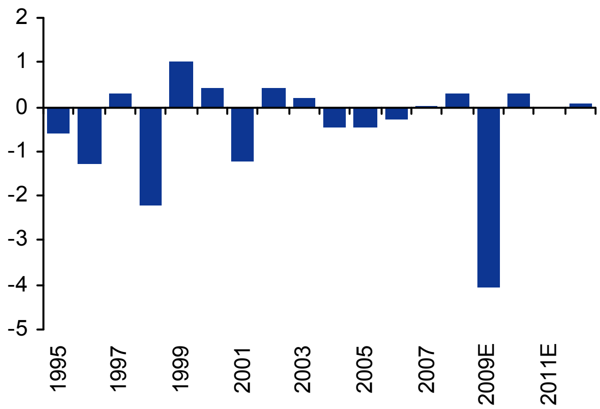
Exhibit 27: As car sales are stabilising, the autos sector is likely to perform well



Source: ACEA, Datastream, Goldman Sachs Research estimates.

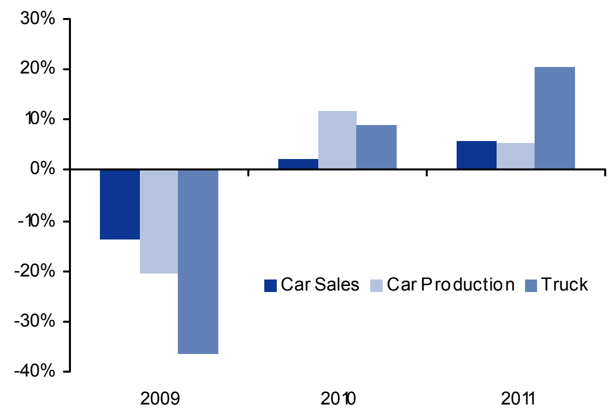
Near-term news flow is likely to be dominated by the end of scrappage schemes across the globe. However, the sector should benefit from a reversal of the estimated 10% global underproduction and all-time low inventories, which will result in better capacity utilisation and strong operating leverage. While scrappage schemes will run out, they expect increasing demand from corporates renewing their fleets, also are there might be some new tax incentives. In addition our analysts expect the reduction of one-time discounting to reduce inventory, more restructuring and the potential for M&A.

Exhibit 28: Over/(under) production relative to sales, global passenger car volumes



Source: Company data, Goldman Sachs Research estimates.

Exhibit 29: We expect global car production to decline 15% in 2009 including China

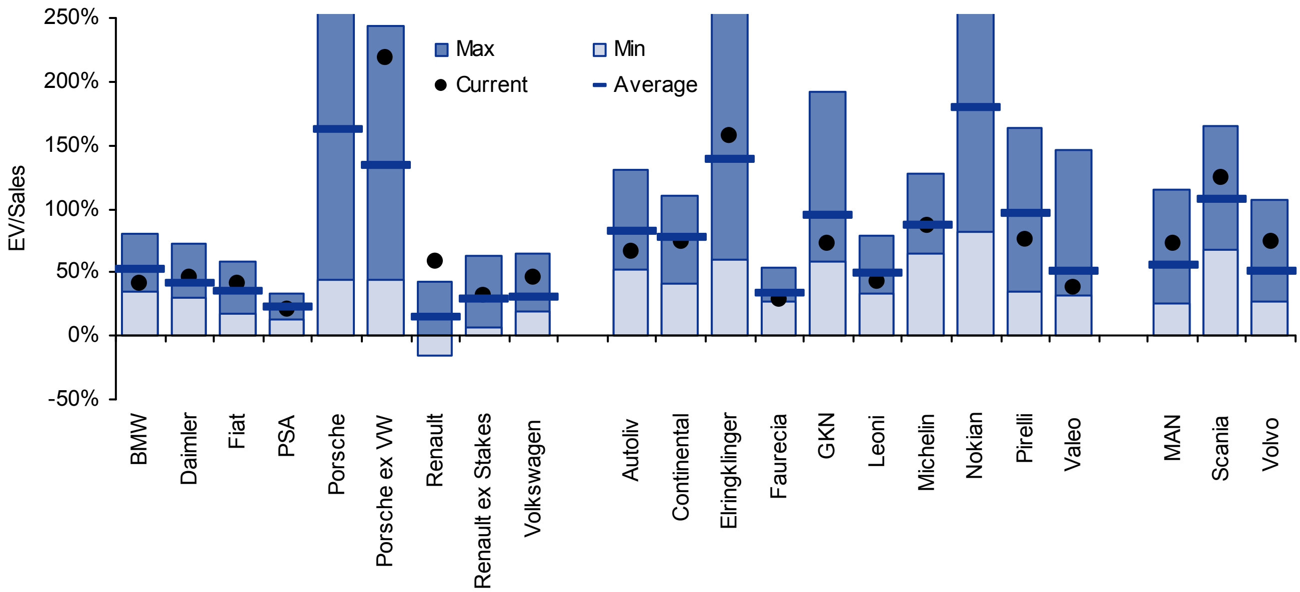


Source: Company data, Goldman Sachs Research estimates.

We believe there continues to be substantial value in the European auto sector as the earnings upgrade and deleveraging cycle continues. Our analysts see three key value drivers:

- **Top-line growth:** On average, our coverage universe sales, on an underlying basis, are down c.20% relative to the peak levels in 2007 and we forecast a 6% increase in 2010. Better than expected economic growth, particularly in Europe and North America, poses upside risk to these estimates.
- **Multiple expansion:** Half of our coverage universe trades below historical average EV/sales levels with all companies below their peak EV/sales. With volume growth, operating leverage is likely to drive margin expansion likely to trigger multiple expansion.
- **Deleveraging**: Better profitability likely to drive free cash generation reducing leverage of the sector. Despite significant positive share price moves since March lows (the sector is up 99% ex VW vs. a 32% rise for the Euro Stoxx) on average, our coverage universe continues to trade 50% below their respective 24-month highs.

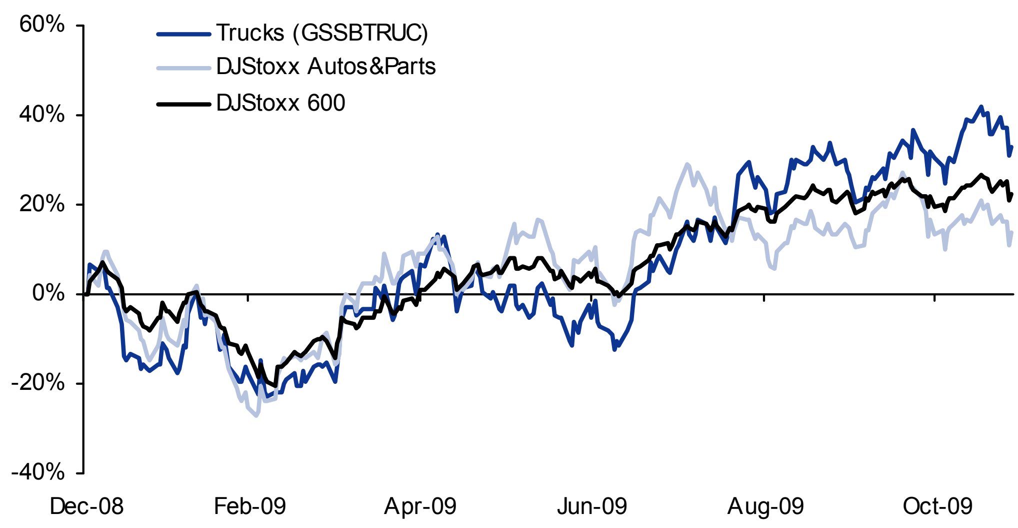
Exhibit 30: 50% of the auto companies trade below their 10-year EV/sales average
EV/sales range over the last ten years



Source: Goldman Sachs Research estimates.

The trucks sub-sector (Bloomberg ticker GSSBTRUC) has performed strongly (Exhibit 31) and we are taking profits on this trade. It is up 11.4% (3.9% relative to the DJ STOXX 600) since inception on September 3, 2009.

Exhibit 31: The trucks sub-sector has outperformed



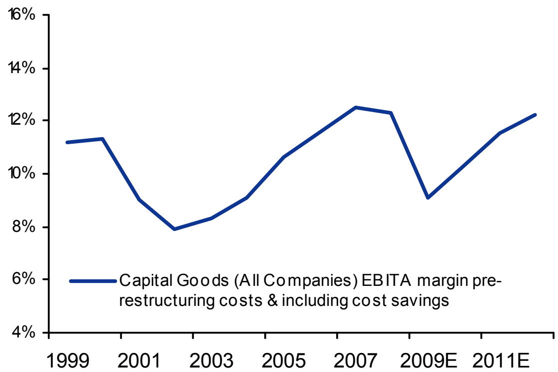
Source: Bloomberg, Goldman Sachs Global ECS Research.

Industrial cyclicals: We prefer industrial goods

Industrial goods & services: Overweight

We remain overweight industrial goods & services as a result of the constructive macro backdrop. Our analysts believe that margins have troughed at higher levels than previously and the next mid-cycle margin will be equivalent to the 2007 peak. Industrial engineering companies have controlled costs well in an environment which saw volumes fall faster than witnessed for many years. Companies have also reduced their breakeven point during this downturn with some assistance from short-term working agreements.

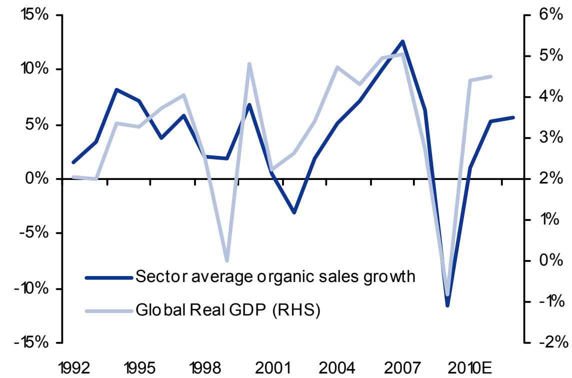
Exhibit 32: Our analysts expect peak margins in 2012



Source: Goldman Sachs Research estimates.

Exhibit 33: There is upside risk to our analysts' sales growth forecasts

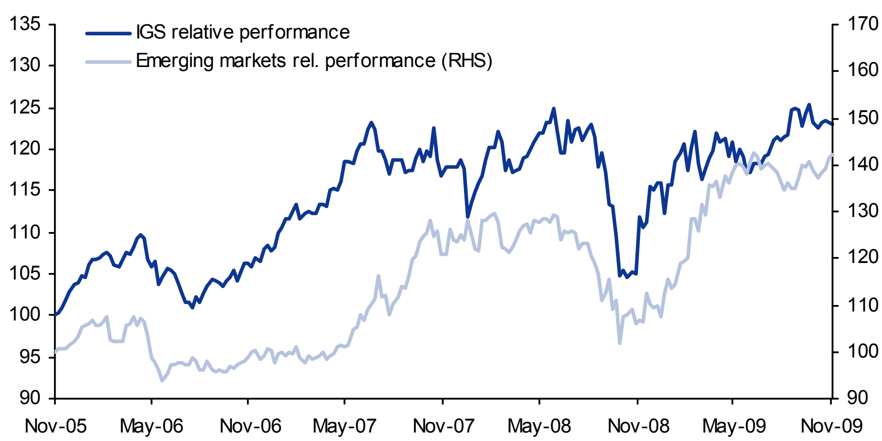
Relationship between real global GDP and sales growth



Source: Goldman Sachs Research estimates, Goldman Sachs Global ECS Research.

We do not, however, believe that this means operating leverage will be lower into the next upturn than it was in the past upturn. This, combined with a favourable geographic sales exposure, leads us to expect sector organic growth of twice the rate of global GDP over the next cycle. The long-term positive story reflects the sector's exposure to infrastructure investments in emerging markets. As can be seen in Exhibit 34, industrial goods & services relative performance correlates well with emerging market performance.

Exhibit 34: Industrial goods and services has performed in line with emerging markets



Source: Datastream, Goldman Sachs Global ECS Research.

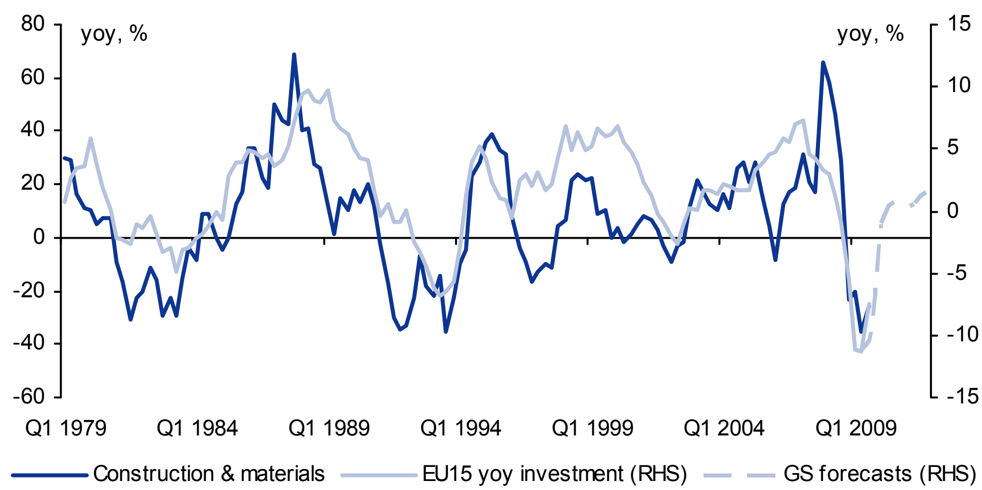
Historically we have found a strong correlation between the ISM and IFO indices and European capital goods sector performance relative to the market, with continued improvement in both indices correlating well to periods of relative outperformance versus the market. Following a 59% rally from the March 9 lows, the sector has moved to discount a mid-cycle multiple on 12-month forward earnings, which remain close to their cyclical trough.

Earnings in the sector are set to trough at a higher level this cycle as a result of increased labour flexibility, cost-cutting measures, good price discipline and lower input costs. Twelve-month forward estimates however only just begin to include the potential earnings benefit from operating leverage over the next cycle, and remain significantly below potential mid-cycle earnings. Given this factor and that this point in the cycle offers the highest potential earnings growth for the capital goods sector, we believe the sector should trade at an above average multiple at this point in the cycle, supporting our continued overweight recommendation.

Construction & materials: Neutral

Construction & materials has outperformed the market year-to date. However, no upturn has yet been seen in building materials as fiscal stimulus money has failed to materialize in developed markets. Construction in emerging markets has demonstrated resilience with material producers (except in Russia and Eastern Europe) often running close to full utilization. We have seen second derivatives improvement for building materials demand in 3Q with cement volume on average down 8.4% yoy vs. 9.7% in 2Q for Lafarge and Holcim.

Exhibit 35: The outlook for fixed investment in Euroland in 2010 is improving
Construction & materials earnings, yoy % change



Source: Datastream, Goldman Sachs Global ECS Research.

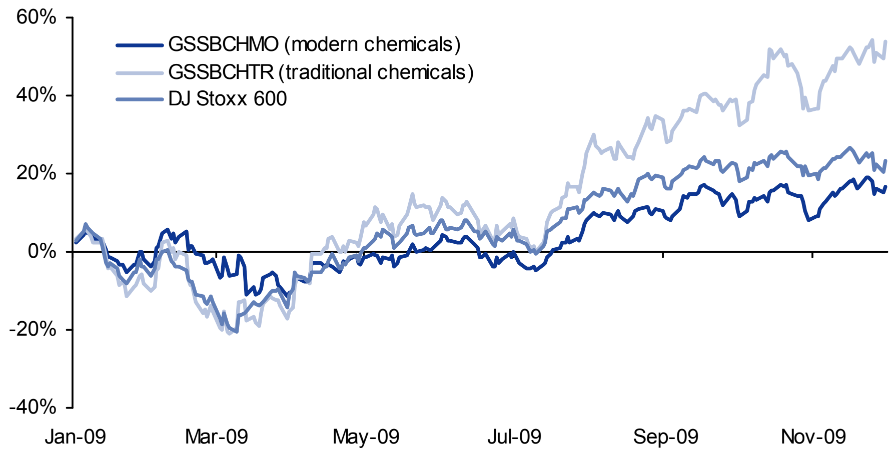
In terms of margins, contractors margins improved slightly as their book order continues to benefit from building out long-term contracts, with falling input costs. However, margins may deteriorate going forward, as more competitively priced contracts are recognized. On the building materials side, margins have not been supported by cost cutting plans as in other sectors. Margins have however been relatively resilient with EBITDA margin only falling by 3%. **We close out of our short position of the building materials sub-sector (Bloomberg ticker GSSBBUIL).**

In terms of valuation, the sector currently appears more expensive than the market on 12-month forward P/E (13.6x vs. 12.4x), and on EV/EBITDA (7.3x vs. 6.7x). Between the positive macro backdrop and the expensive valuations, we take a neutral stance on the sector.

Chemicals: Underweight

The chemicals sector has outperformed the market since January, mainly driven by strong performance from the cyclical stocks in the sector (Exhibit 36).

Exhibit 36: Traditional chemicals have outperformed



Source: Bloomberg, Goldman Sachs Global ECS Research.

The key themes emerging from 2009 earnings have been: 1) cyclical recovery continuing, in part driven by government stimulus programmes; 2) oil-based raw material/energy cost relief while pricing generally held up, leading to the more cyclical names beating our analysts' and consensus expectations on earnings, while sales have typically been in line; 3) emerging markets sales growth driving performance and helping to offset low levels of demand from North American and European markets; and 4) earnings supplemented by cost saving programmes, which are typically on track or ahead of plan. Based on our Economists' positive GDP forecasts, in particular for the BRICs economies and the detailed cost saving programmes for many of the companies, we expect these themes to continue into 4Q09 and in part for 2010.

However, we note that rising commodity prices are likely to become more of an issue for the sector and in particular for the traditional chemicals companies. In our opinion, this could lead to bifurcation between those companies that can cope with a higher level of input costs (i.e. by passing through the costs and via cost savings) and those that struggle on pricing power, leading to margin squeeze and lower returns.

We recommend an underweight position in chemicals.

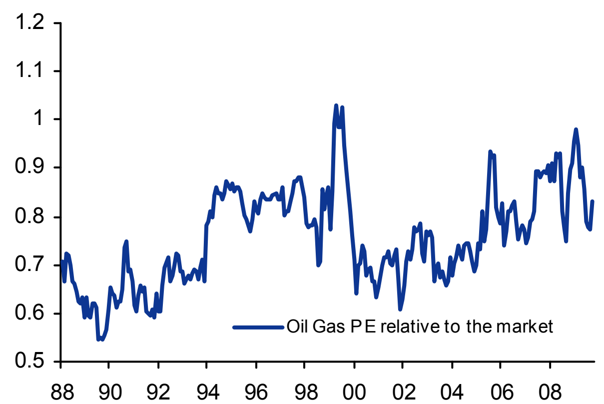
Commodity-related sectors: Still constructive on oil & resources

Oil & Gas: Overweight

We remain overweight the oil & gas sector as we expect oil prices to increase further, and it is very cheap relative to history and the market. It also has one of the highest dividend yields with a relatively low payout ratio and good free cash flow cover. Our Commodity analysts have increased their short- and long-dated oil forecasts. They believe that the recent rally was caused mostly by credit normalization, and as a result the market has not yet priced in an economic recovery, and that energy shortages could drive WTI to US$95/bbl by year-end 2010 (average of US$90/bbl for 2010). In the same vein, our equity analysts believe that growth in the BRICs economies will drive commodity demand growth, and expect the impact to be greatest on copper, steel, iron ore and oil.

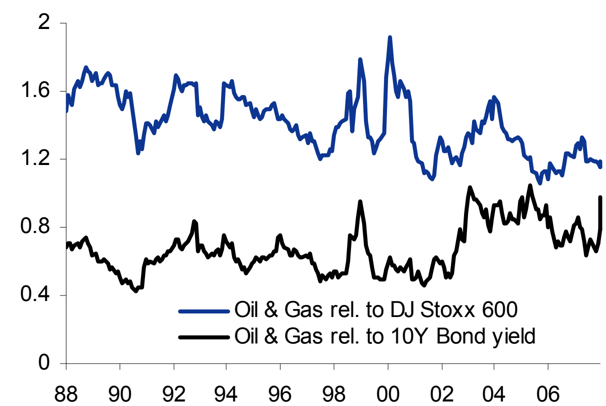
The 16% discount to the market suggests that the sector will not be able to maintain returns. Our analysts think that this is too conservative and there is further potential upside if the industry is able to retain cost efficiency.

Exhibit 37: Oil & gas is trading at a discount to the market



Source: Worldscope, Goldman Sachs Global ECS Research.

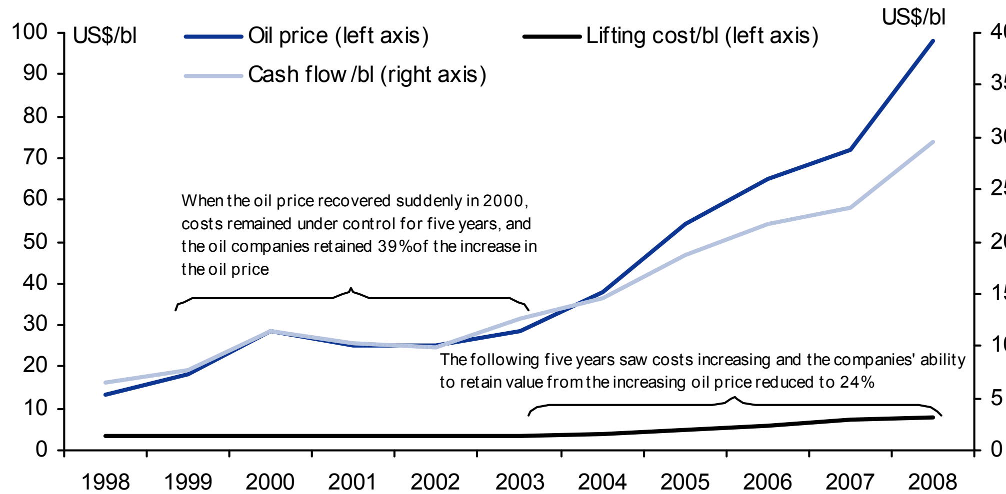
Exhibit 38: The sector is offering attractive yields versus the market



Source: Worldscope, Factset, Goldman Sachs Global ECS Research.

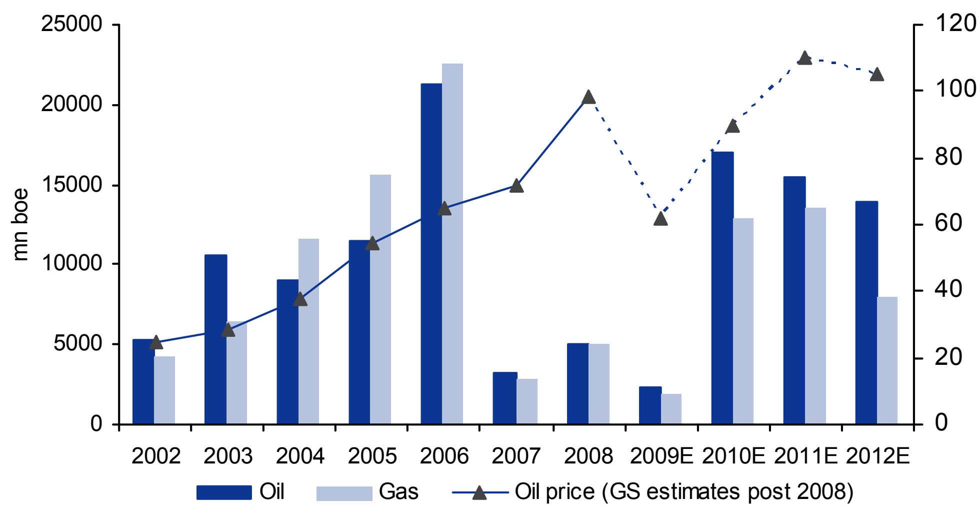
Exhibit 39 shows that the industry was able to retain 39% of the oil price increase in the five years after the oil price increase in 2000 as costs were kept under control. We expect costs to decline in 2009, and to remain under control at least in 2010. We also expect the ratio of non-producing capital as a % of market cap to fall in 2011-2012. This capital coming into production should start generating cash flow. On this basis, we believe our expectation of 28% cash flow capture in coming years could be conservative.

Exhibit 39: Cash flow/bl for European integrateds vs. the oil price and the lifting costs/bl



Source: Company data, Goldman Sachs Research.

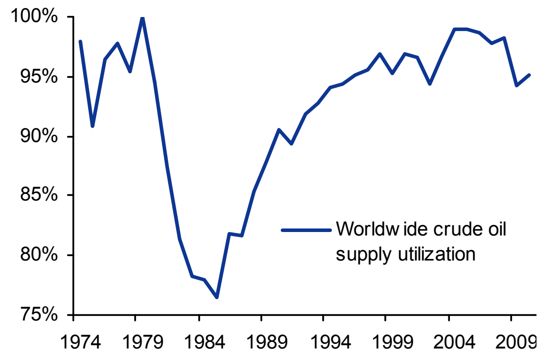
Exhibit 40: The industry has sanctioned very few projects in 2007-09



Source: Company data, Goldman Sachs Research estimates.

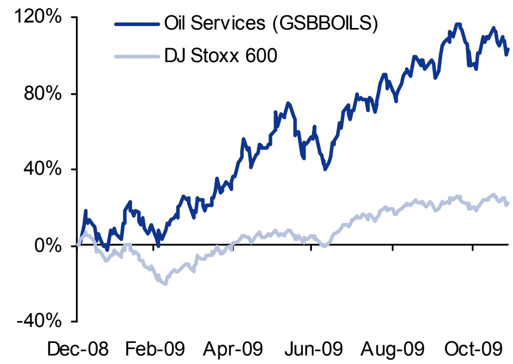
We continue to recommend a long position in the oil services sub-sector (Bloomberg ticker GSSBOILS). This trade has performed strongly relative to the market. With oil sector utilization troughing at 94% on our estimates, as shown in Exhibit 41 (i.e. spare capacity of 6%) despite the lower demand environment, we believe significant investment in new growth projects will be needed over the coming years to meet rising energy demand from emerging economies. In our view, the oil services companies will be the main beneficiaries of this investment. Further upside could come from M&A in the sub-sector. While we do not expect oil majors to be acquirers, we think that consolidation within the sub-sector and buying interest from financial investors could lead to increased M&A activity.

Exhibit 41: Worldwide crude oil supply utilization remains far from historical lows



Source: BP statistical review, Goldman Sachs Research.

Exhibit 42: Oil services (GSBBOILS) has outperformed the market



Source: Bloomberg, Goldman Sachs Global ECS Research.

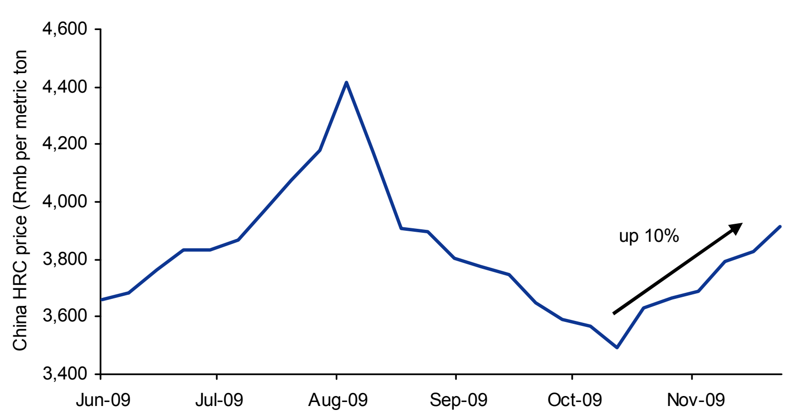
Basic Resources: Overweight

We remain overweight basic resources, which has been one of the strongest performing sectors YTD. Basic resources is among the most leveraged sectors to growth in the BRICs economies, and particularly China. This growth, combined with investments in infrastructure and urbanization, and a shortage of supply, should drive commodity prices higher, which should ultimately drive higher earnings for these companies.

Because of strong expected steel production growth, driven both by recovering Western world steel production as well as strong Chinese production growth, our analysts see raw material markets tightening over the next 12 months before capacity additions and logistics expansions ease market conditions. As a result, we expect coking coal benchmark settlement increases to US$180/tonne from US$125/tonne and also expect a 20% increase for the iron ore April 2010 benchmark settlement.

However, we are getting less positive on mining and more positive on steel sub-sectors. Investors were concerned that the fall we have seen in Chinese steel prices since August could trigger imports that would hurt EU pricing. Now that Chinese prices are rising again, the small import threat is diminishing as regional price arbitrages are no longer available (Exhibit 43). **As a result we are taking profits on our long position on the mining sub-sector (Bloomberg ticker GSSBMINE); the sub-sector rose 35.2% (+26.1% relative to the STOXX 600) since our last update on September 3, 2009. We recommend taking a long position on our steel sub-sector basket (Bloomberg ticker GSSBSTEL).**

Exhibit 43: China HRC steel price (Rmb per metric ton)



Source: CRU, CISA, Mysteel.

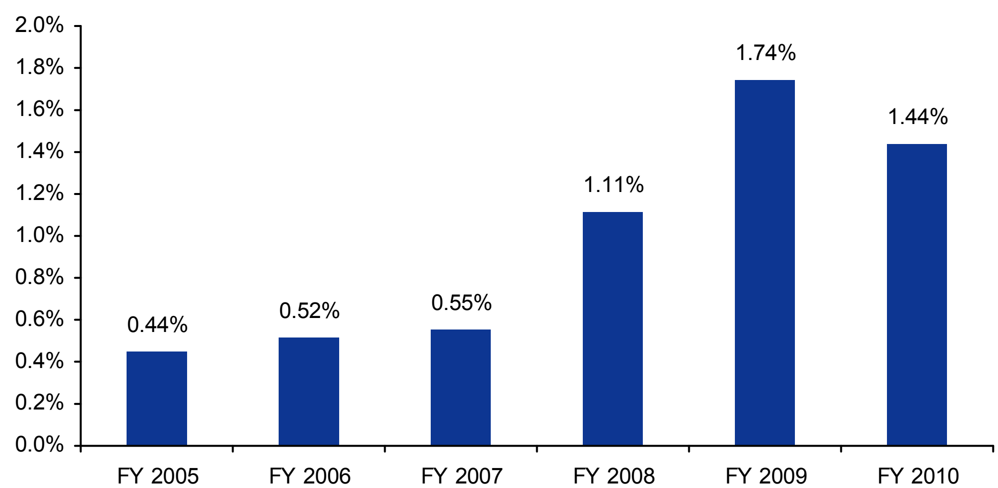
Financials: A grim outlook for the super-sector

Banks: Neutral (from Overweight)

The banks have done very well this year as increased risk appetite and fears of liquidity driven banking failures have receded. A combination of unprecedented liquidity support and various forms of implicit and explicit government guarantees on bank debt have materially reduced both the real and perceived tail risk and have thus reduced the cost of equity for banks. However, we believe this is primarily a re-risking driven rally. Fundamentals for the banking industry are still challenging. Banking is a volume business and it is very difficult for the sector do well without asset growth.

In this recession, we believe that the pace of Non-Performing Loans (NPLs) formation has been reduced by the extraordinary low interest rate environment with rates at or close to 0%, as banks have been able to restructure loans to interest-only to reduce defaults. Reported impairments have been further helped by reduced coverage ratios and many banks now also suggest that impairments will peak in 2009, in contrast to previous recessions when reported impairments peaked between one and three years after the trough in the economy. However, any increase in short-term rates and withdrawal of some of the liquidity support given by central banks has the potential to re-accelerate NPL formation and impairments and thus put pressure on bank earnings. If the global economic growth is robust and broad based, higher cash flows in the corporate sector and lower unemployment should be able to offset higher interest rates, but the journey towards normalisation of bank earnings is likely to take several years.

Exhibit 44: NPLs should go down in 2010, but there are risks if interest rates move higher

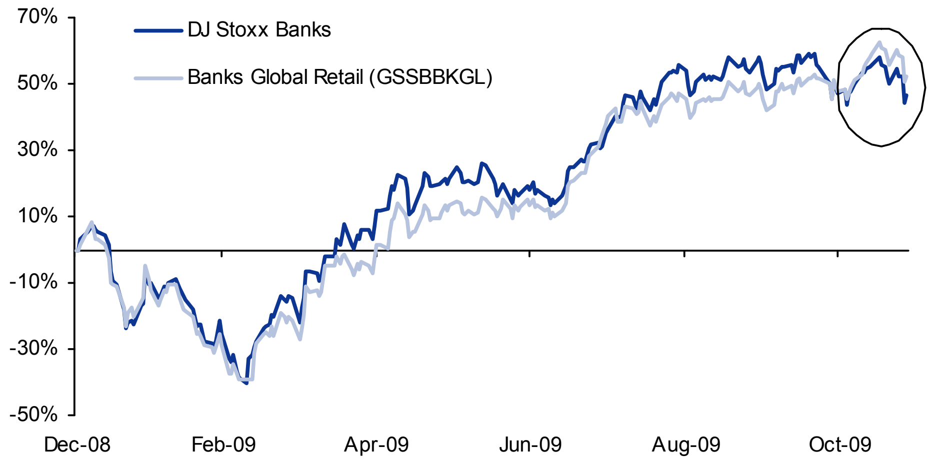


Source: Goldman Sachs Research estimates.

We have been recommending our sub-sector basket of global retail banks (GSSBBKGL) as we believe that these banks are better placed to weather the current environment than other banks. This basket has outperformed the rest of the banking sector and we continue to believe that exposure to global markets (Asia, LatAm and CEE), where we expect growth prospects to be brighter than in Europe, should be rewarded. **We continue to recommend investing in the global retail banks sub-sector basket (Bloomberg ticker GSSBBKGL).**

We downgrade the sector from overweight to neutral. The largest stocks in the sector are most likely to benefit from their global exposure. This is why we do not want to move outright to an underweight. **However, we would look to move the sector down to underweight as soon as interest rates hikes are in sight.**

Exhibit 45: Global retail banks have recently outperformed the broader index



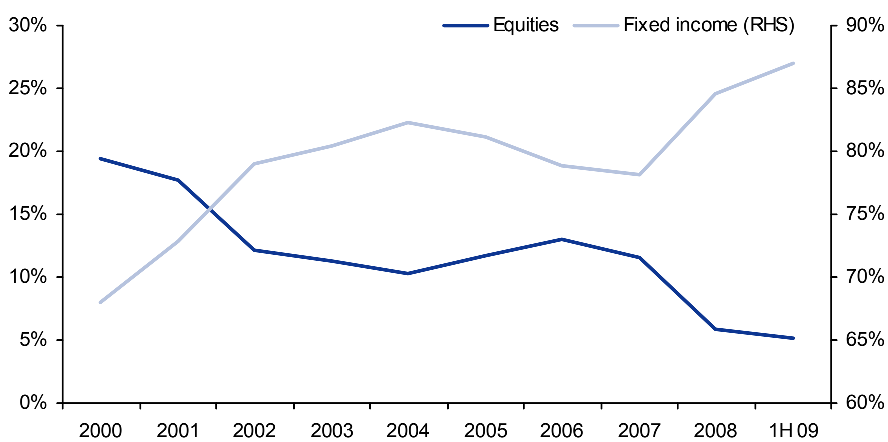
Source: Bloomberg, Goldman Sachs Global ECS Research

Insurance: Underweight (from Neutral)

Insurance has been the worst performing sector among financials and the only one to underperform the market year-to-date. Despite this poor performance, we recommend moving to underweight the sector.

While we have a positive view on equity markets, we see the impact as more muted than historically, given the reduction in equity exposure for most companies, partly due to the desire to protect capital during the recent crisis, but also due to the longer term response to increased capital requirements from rating agencies (and prospectively from Solvency II) for holding equities. Those companies more exposed to pure asset gathering or unit linked business should stand to benefit still from rising markets (as this will drive up fee income) although pure plays on this theme in the sector remain limited. For the rest of the sector we see a number of ongoing headwinds:

Exhibit 46: Insurance companies have significantly reduced their exposure to equities
Asset allocations for 10 major European insurance companies (Aegon, Allianz, Aviva, AXA, Generali, ING, Munich Re, Swiss Re, Zurich Financial Services)



Source: Company reports, Goldman Sachs Global ECS Research.

Our analysts think that we might see more disposals and/or capital raisings in the sector and this introduces execution risk. While disposals at low valuations could still the help specific sellers, it could serve to put a cap on wider sector valuations.

The sector will have to deal with a new regulatory framework, Solvency II. We note the current implications appear onerous for industry capital, although the ultimate outcome is still hard to assess given ongoing consultation, debate and lobbying from the industry. Nevertheless, the uncertainty is likely to weigh on the sector in our view, with risks more skewed to the downside than upside.

Book values have benefited from the impact of falling yields and credit spreads on the value of fixed income portfolios. However, an ongoing low yield environment is not supportive as: a) it restricts the ability of insurers to price in adequate spread margins on life business; b) unmatched asset portfolios are rolling over into lower yielding assets, creating a drag on earnings; and c) non-life investment income will remain under pressure as new reserves are invested at lower yields.

Non-life pricing remains lacklustre in light of generally improving capital bases and a benign large claims environment. This will pressure the top-line outlook and underwriting margins.

Financial Services: Neutral

We maintain our neutral view on financial services, in line with our neutral views on banks. The sector is highly heterogeneous. The market structure (e.g. exchanges and interdealer brokers) and asset management firms are highly correlated with the overall financials sector, while the holding companies are driven by a much broader range of economic and industry factors.

One of the largest companies in the sector is Deutsche Börse, which should benefit from a cyclical recovery in financial markets. Our analyst also expects the narrowing of sovereign credit spreads in Europe to drive a recovery in volumes in the group’s interest rate derivative products, where open interest is currently back at 2004 levels.

Real Estate: Underweight

The sector has performed surprisingly well, however it has been a story of two halves. After some significant equity capital raisings earlier in the year, the sector has been able to turn around significant underperformance so that it has performed in-line with the market year to date. We believe the prospects for new commercial real estate (CRE) lending are unlikely to improve significantly for an extended period as banks will probably reduce lending in order to increase their capital strength. Although valuations appear to be stabilizing, with some notable increases in some areas in the UK, our analysts believe this is due to supply/demand imbalances in investment markets given very little supply. However, we do not expect significant growth in prices in 2010 given that supply is likely to rise as banks seek to work out existing CRE loans. The risks to such a forecast remain high given a number of significant variables, including the unprecedented level of debt re-financing in some markets such as the UK.

Our Economists expect the ECB and the BoE to start increasing rates in 2010. The increase in rates does not bode well for the sector. It would reduce the attractiveness of the yield investors get from real estate and would also make the financing for potential buyers more difficult to secure. All in all, we believe that valuations for the real estate stocks are relatively demanding while growth is likely to be limited compared to other sectors given a combination of late cycle features, lack of operating leverage and limited exposure to the BRICs economies.

Other Disclosures

The Equities Division of the firm has previously introduced the basket of securities discussed in this report. The Equity Analyst may have been consulted as to the composition of the basket prior to its launch. However, the views expressed in this research and its timing were not shared with the Equities Division. Note: The ability to trade this basket will depend upon market conditions, including liquidity and borrow constraints at the time of trade.

RegAC

We, Peter Oppenheimer, Gerald Moser, Christian Mueller-Glissmann, CFA, Anders Nielsen and Matthieu Walterspiler, hereby certify that all of the views expressed in this report accurately reflect our personal views about the subject company or companies and its or their securities. We also certify that no part of our compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

Disclosures

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