

Global Viewpoint

Economics Research

Our Top Trade Recommendations for 2015

We release the first eight of our recommended Top Trades for 2015. These trades represent some of the highest conviction market articulations of the economic outlook and investment themes we laid out in two separate research notes published yesterday.

Top Trade #1: EUR/\$ downside via a one-year EUR/\$ put spread.

Top Trade #2: 10-year US Treasuries above 3% but not below 2% in mid-2015, through cap and floor spreads at zero cost.

Top Trade #3: Long a Dec-2015 Eurostoxx 50 'bull' call spread.

Top Trade #4: Long US High Yield credit risk via 5-year CDX HY junior mezzanine tranches.

Top Trade #5: Long an equity basket of EM crude oil importers (Taiwan, Turkey and India).

Top Trade #6: Short CHF/SEK.

Top Trade #7: Bearish Copper relative to Nickel, on supply divergence.

Top Trade #8: Long US Dollar against a basket of ZAR and HUF.

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

Our Top Trade Recommendations for 2015

The *Top Trade Recommendations* we present here have a mildly pro-cyclical flavour and revolve around several of the economic and policy dynamics we think will characterise the year ahead. Specifically:

- The trades crystallise the idea that the US economy, which is ending 2014 on a strong note, will continue to expand at an above-trend rate. This should progressively drive up real rates, and lead to an appreciation of the Dollar. On long-run historical comparisons, the greenback is still a 'cheap' currency on a trade-weighted basis.
- They are also geared to the notion that Euro area economic activity will start to see the benefits of an increasingly expansionary monetary policy, guided by the ECB's proactive pursuit of a larger balance sheet. A mild relaxation of the fiscal stance (in the bigger economies individually and at the supranational level) and structural reforms should also support domestic demand.
- A third 'theme' that runs through the trades is what we have dubbed 'the New Oil Order' in our Commodity Research. An expansion and redistribution of supply should keep headline CPI inflation lower (providing central banks more leeway to keep or expand monetary accommodation), further support disposable income growth in the advanced economies and lead to a greater differentiation across the emerging economies, most evidently along the oil dependency spectrum.

As always, there are idiosyncratic risks surrounding our Top Trade recommendations and in a low-volatility/low-expected-return environment, the timing and sizing of risk exposures will be a key consideration, as has been the case in 2014. Some of the 'common' or systematic risks that our set of trades would be most exposed to include the following:

- Should the US economy not live up to our expectation of further outperformance, the normalisation of interest rates could be delayed (although there is much less risk expressed in a bearish rate direction heading into 2015 than there was at the start of 2014), the Dollar could slide back and HY credit could find itself in a tug-of-war between the 'search for yield' and higher asset volatility.
- Political polarisation and social unrest fuelled by high unemployment could decrease the chances of seeing the modest pick-up in demand growth that we are forecasting in the Euro area. General elections in Spain and, possibly, in Italy could lead to uncertainty, as could the vexed issue of the UK's position vis-à-vis the European Union. Developments in Greece, which so far have been confined to the sovereign, have the potential to become systemic again should EMU participation be brought in question. This may be only a 'tail risk', but it is one that investors will need to take into consideration in 2015, particularly during the first quarter.
- The decline in crude oil prices, which has been material since June, could prove to be a 'red herring'. A sharp rebound in energy prices led by a combination of supply-side disruptions meeting underlying strong demand could question the amount of disinflation ahead of us, and our thesis of differentiation across emerging economies.
- China is a key part of the investment outlook and our global growth forecasts. But, barring a sharp increase in credit woes in the country, along with the ramifications of such an increase for broader risk sentiment, some growth disappointments from China should not directly harm the performance of our recommended Top Trades.

How Did Our 2014 Top Trades Fare?

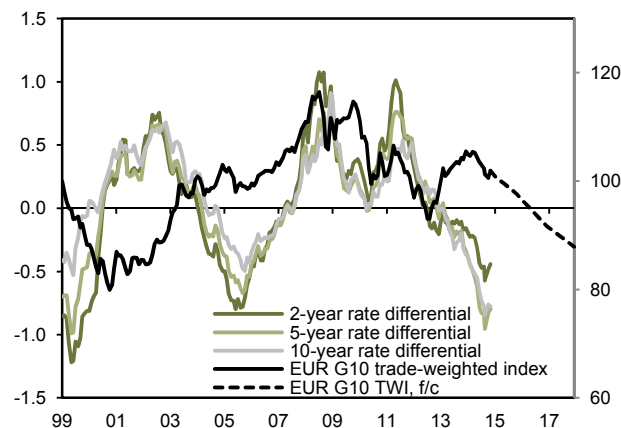
In 2014, the Global Macro Markets team recommended **6 Top Trades** tied to our 10 Investment Themes for the year. Characteristically for the year, the latter worked out in some cases better than we were able to crystallise through the former. **Long S&P500 funded out of Australian Dollar** (Top Trade no.1) is a case in point. We recommended closing the trade for a potential gain of 9.3%, after hitting a trailing stop during the mid-October 'growth scare'. Had we let the trade run, it would now be close to our target gain of around 20%. Similarly, we advised coming out of **long positions in 5-year EONIA vs short positions in 5-year US Treasuries** (Top Trade no.2) in April, after a 38bp move in the direction we sought. The trans-Atlantic rate divergence – which the trade was designed to capture – extended, however, all the way to the target we had set originally (130bp). Had we stayed the course, potential returns would have been double. **Long China stocks through the HSCEI Index and short Dec-14 Copper** (Top Trade no.4) proved too optimistic about the equity picture in China and got off to a particularly bad start. We recommended closing this position after a 13.5% potential loss in January 2014, following a fall in the HSCEI Index and little offset from the Copper hedge (the position recovered during the rest of the year, but would still have fallen short of our target). In currencies, **long USD/CAD** (Top Trade no.3) reached our target (+7.4% gain), while our bullish US credit trade, **long 7-year CDX IG21 junior mezzanine tranche** (Top Trade no.5), exceeded the target, for a potential unlevered gain of 824bp. Finally, being **long the bank stock indices of Japan, US and Europe** (Top Trade no.6) 'muddled through' the year, and we recommended closing it earlier this week, booking a small 3.5% potential gain – admittedly inadequate for the volatility of the position. **All told, 4 of our Top Trades were in the black, 1 was in the red, and 1 a little better than a 'draw'.** Being disciplined about both targets and stops, and holding on to positions during sudden 'risk-off' draw-downs, appear to have been crucial performance factors this year.

Francesco U. Garzarelli

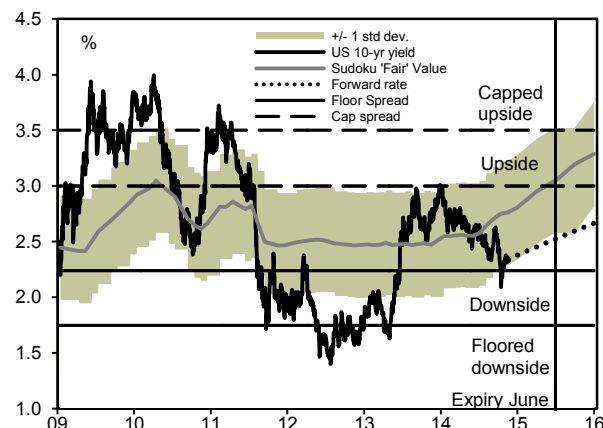
Top Trade #1: EUR/\$ downside via a one-year EUR/\$ put spread

Position for EUR/\$ downside via a one-year 1.20/1.15 put spread for around a 4.5 to 1 potential maximum payout.

We forecast that EUR/\$ will fall to 1.15 over the next 12 months, in equal parts a reflection of our Dollar bullish view and Euro bearish outlook. In particular, given that HICP inflation is unlikely to rebound in coming months, there is a chance that additional ECB easing, including possibly sovereign QE, comes sooner rather than later, setting the stage for EUR/\$ to move meaningfully lower in the short term. Meanwhile, we expect the Fed to begin to raise rates next year. In short, monetary policies are set to diverge between the Euro area and US, a reflection of diverging growth and inflation outlooks. One of the main push-backs to our view is that Euro downside is widely discussed and therefore consensus. This recommendation reflects our belief that indicators such as the IMM may exaggerate Euro short positioning and that decent leverage can be had in expressing EUR/\$ downside. We recommend a one-year EUR/\$ put spread (1.20/1.15) with a breakeven around 1.19, reflecting our view that EUR/\$ will make a sizeable move to the downside in the year ahead (and most likely sooner rather than later). The maximum potential net payout on this recommendation is roughly 4.5 to 1 if EUR/\$ converges to our 12-month forecast.

Exhibit 1: A weaker Euro against the rest of the G10

Source: Bloomberg, Goldman Sachs Global Investment Research

**Exhibit 2: US Treasuries above 3%, but not below 2%
Sudoku model 'fair' value and market forwards**

Source: Bloomberg, Goldman Sachs Global Investment Research

Top Trade #2: 10-year US Treasuries above 3% but not below 2% in mid-2015, through cap and floor spreads at zero cost

Buy a constant maturity 10-year US Treasury 3.00-3.50% 'cap spread' at zero cost by selling a corresponding 2.24-1.75% 'floor spread', both expiring on June 30, 2015.

We expect 10-year US Treasuries (TY10), currently yielding around 2.3%, to trade at or above 3.0% next June – one quarter ahead of the market-implied lift-off date for the Federal Funds rate. Our *Sudoku* model indicates that TY10 are already trading 'expensive' relative to our Economics team's global macro outlook, and puts yields in a 3.10-3.50% range in the second half of next year. TY10 outcomes higher than 3.5%, implying a 5-year forward rate of over 4.0%, are unlikely over this horizon, especially considering that German Bund and JGB yields are still capped by the respective central banks. We also assign a much lower probability than the market currently does to TY10 yielding back below 2% – a two standard deviation event, according to our model forward estimates of 'fair value'. Indeed, our baseline view is that US domestic demand will maintain above-trend momentum in 2015, and that monetary policy stimulus in the Euro area and Japan will work its way through to the real economy in coming quarters. The option structure we propose captures the main traits of these views, at a zero upfront cost. The options are chosen to expire after the June 18-19 FOMC meeting. The lower strike of the 'floor spread' helps to protect against the risk of a sharp drop in yields in an unforeseen 'risk-off' scenario.

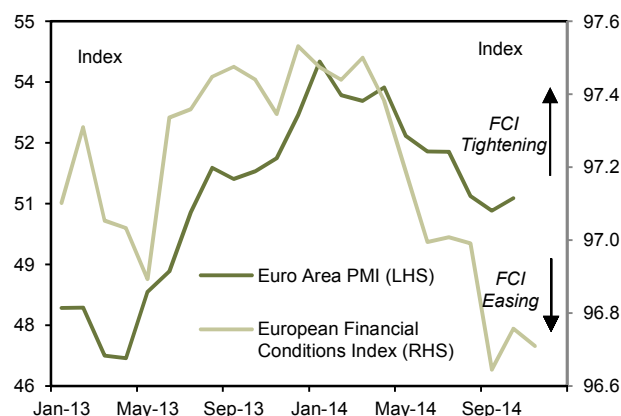
Top Trade #3: Long a Dec-2015 Eurostoxx 50 'bull' call spread

Go long Dec-2015 Eurostoxx 50 3150/3450 'bull' call spread (buying the Dec-2015 3150 strike call and selling the Dec-2015 3450 strike call), currently at 101.5 (Bloomberg: SX5E 12/15 C3100 Index vs. SX5E 12/15 C3400 Index).

The (nearly) at-the-money 3150 call costs 170.6, while selling the 3450 call costs 69.10 (both priced as of the close on November 19), giving this position a maximum potential 2-to-1 payout. There are two routes by which European equities could move higher. In our central case, we see scope for a pick-up in Euro area growth in 2015, which we think is not reflected in market prices. At the same time, our European economists see a significant risk of a downside case in which activity and inflation disappoint. And, in that case, the ECB would move to more forceful QE, so initial asset market pressure would subsequently be

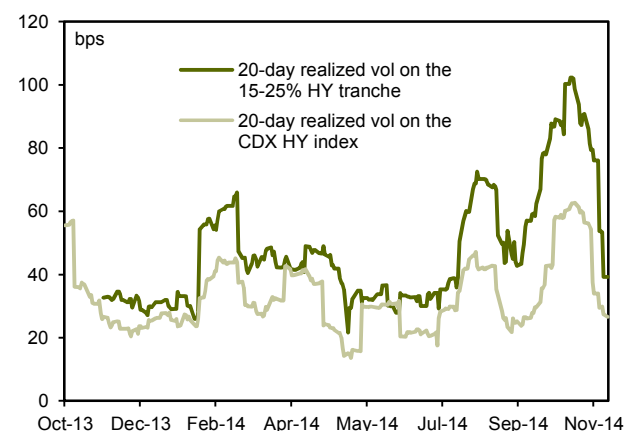
reversed. Because of these binary outcomes, we have chosen to express the view through a call spread rather than a long-only position. This allows for the structure to be self-liquidating in the case of a downside 'tail' but also makes it easier to maintain exposure if the path higher is bumpier than we expect.

Exhibit 3: Euro area financial conditions have eased, while leading indicators of activity may stabilise



Source: Institute for Supply Management, Haver Analytics, Goldman Sachs Global Investment Research.

Exhibit 4: The junior mezzanine tranche has a higher beta and is slightly more volatile relative to the CDX HY index



Source: Goldman Sachs Global Investment Research.

Top Trade #4: Long US High Yield credit risk via 5-year CDX HY junior mezzanine tranches

Go long risk (sell credit protection) on the 5-year CDX HY Series 23 junior mezzanine tranche (the 15-25% portion of the loss distribution), at a running spread of roughly 495bp per year for a target of 440bp (implying a potential return of over 700bp) and a stop at 580bp.

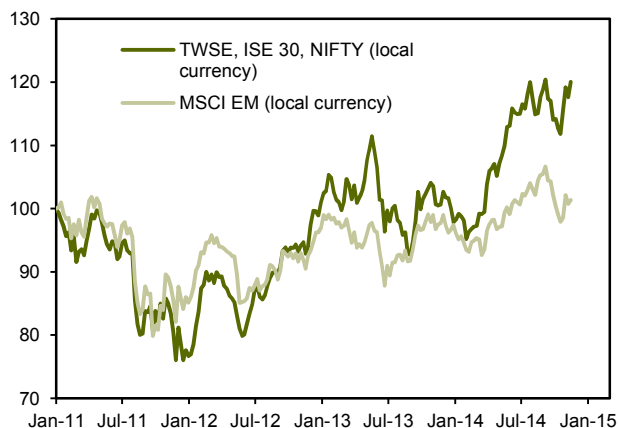
We think the recent underperformance of the US High Yield (HY) market should prove transitory. Our current best understanding for this underperformance is that a portion of the HY investor base remains burdened by recent losses on a number of crowded trades. Our choice of the junior mezzanine tranche, which provides a reasonable level of subordination for default losses, is partly informed by our long-standing 'up-in-quality' view on the HY market. With idiosyncratic risk concerns weighing on the CCC end of the quality spectrum – a trend we think will persist – we continue to think that the high end of HY offers the best loss-adjusted spread (that is, the best buy-and-hold credit risk premium). Given the intensity of recent concerns about the Energy sector, it is worth noting that only four of the 100 names in CDX HY 23 have positive betas to crude oil, and two of those are nearly Investment Grade quality. Hence, the idiosyncratic risk that concerns us is concentrated mainly in the weakest retail names. While the junior mezzanine tranche has a higher beta and is slightly more volatile relative to the CDX HY index, it nonetheless provides a good hedge against idiosyncratic defaults while offering attractive carry and roll-down features. In addition to an annualised carry of 495bp, our spread target would imply potential mark-to-market gains of roughly 240bp over the course of the year. Assuming no default losses on the tranche, a reasonable assumption for this stage of the cycle, our spread target translates into an unlevered, annualised potential return of around 735bp.

Top Trade #5: Long an equity basket of EM crude oil importers (Taiwan, Turkey and India)

Buy an equally-weighted basket of Taiwan (TWSE), Turkey (XU030) and India (NIFTY) stock market indices, priced at 100, with an initial target of 115 and a stop at 93.

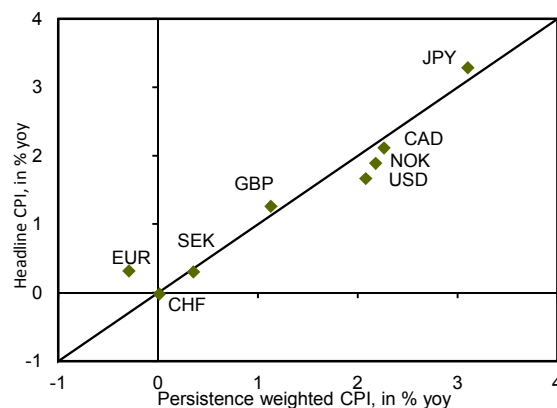
The decline in crude oil prices has the potential to boost activity growth, particularly for oil-importing countries in Emerging Markets (EM). We propose an equally-weighted basket of several of the biggest EM petroleum importers. Each of the basket's constituent countries adds elements that, in our view, fit with our global baseline macro outlook. Taiwan is an exporting economy that is exposed to a growing US, and has lagged the recent move higher in US equities along with the broader EM complex. Admittedly, the Indian market has already rallied in 2014. But, on the back of a still-strong reform dynamic, the oil boost, followed by lower policy rates, could prove significant. Lastly, the move down in oil prices also has the potential to shift the balance of Turkish monetary policy towards a more dovish stance, providing an additional boost to that market. Valuation is broadly supportive of EM equity, which trades half of a standard deviation below average across Price/Earnings, Price/Book and Price/Dividend metrics. Taken together, these three markets represent 22% of the MSCI EM benchmark and trade, on average, in line with historical valuation levels. We will be monitoring this trade on an unhedged basis. Given our views of USD strength, US-based investors may consider hedging their FX exposure.

Exhibit 5: Oil-importing EM equity markets begin to pull away from the crowd



Source: Factset, MSCI, Goldman Sachs Global Investment Research.

Exhibit 6: The most persistent CPI components suggest more downside to Euro area inflation from here



Source: Haver Analytics, National Sources, Goldman Sachs Global Investment Research

Top Trade #6: Short CHF/SEK

Go short CHF/SEK at the current spot of around 7.70 with a target of 7.00 and a stop at 8.10.

Euro weakness has been reflected in EUR/\$ and EUR/GBP this year, to name just two Euro crosses, but EUR/SEK is a notable exception. In large part, this reflects the fact that inflation in Sweden is almost as low as in the Euro area, with recent dovish surprises from the Riksbank reinforcing the view that Sweden and the Euro area are suffering from the same 'lowflation' problem. We do not agree with this. After all, low inflation in the Euro area has a heavy structural component, as the internal rebalancing in the monetary union involves lower prices/wages in the periphery and the opposite dynamics in the core markets. In contrast, we see low inflation in Sweden as temporary and think it will move higher in

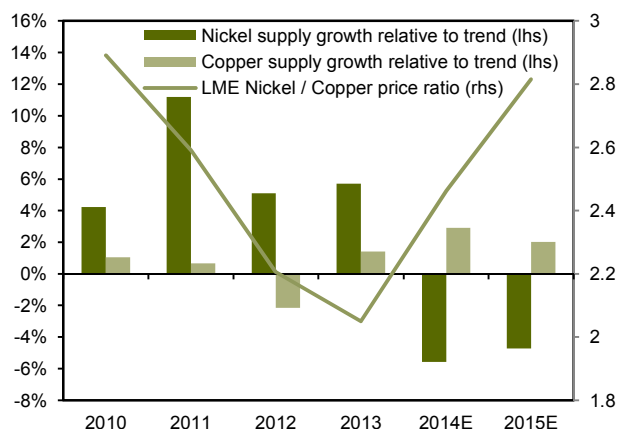
coming months, in line with the Riksbank's October forecast. As a result, we think monetary policy in Sweden and the Euro area is likely to diverge, which should pull EUR/SEK lower. In this context, we think that EUR/CHF close to the 1.20 floor provides an opportunity to leverage the view.

Top Trade #7: Bearish Copper relative to Nickel, on supply divergence

Position for Copper underperformance relative to Nickel via Dec-15 LME futures, using equal notional amounts, for a potential 20% upside.

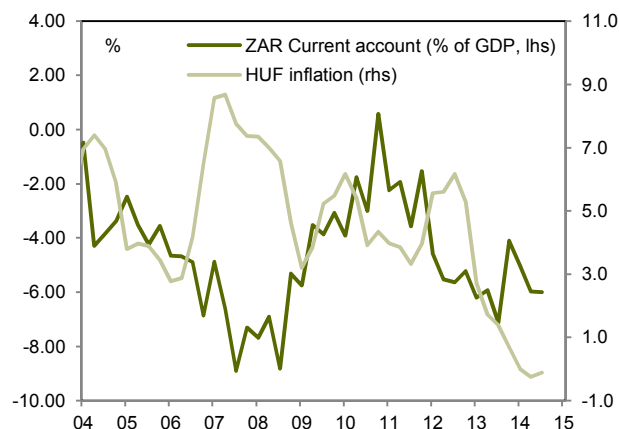
The short Copper/long Nickel trade highlights some important features of our set of market views for 2015 in the commodities space, particularly the theme of 'supply differentiation'. Copper has entered a once-in-20-year supply cycle, resulting in above-trend supply growth, while Nickel supply continues to be constrained by the Indonesian export ban. This should result in rising (falling) visible inventories of Copper (Nickel) in 2015. The trade has an initial target of around 20% on the combined position (assuming that collateral is half of the notional amount of the two positions), and a stop on the LME close of around -10% on the combined position.

Exhibit 7: Copper and nickel supply outlooks set to diverge



Source: Goldman Sachs Global Investment Research, Wood Mackenzie, LME.

Exhibit 8: Imbalances in South Africa and 'lowflation' in Hungary creates room for FX weakness



Source: Haver Analytics, Goldman Sachs Global Investment Research

Top Trade #8: Long US Dollar against a basket of ZAR and HUF

Go long USD against a basket of HUF and ZAR at 100, with a spot target of 113 and a stop at 94. The 'cost-of-carry' for the basket is around 3.75% per annum, which we will account for in terms of our stop-loss throughout the year.

Our global outlook is consistent with USD strength against EM currencies. The strengthening US recovery should see US yields pushing higher from current levels, while EM rates stay suppressed due to the broader commodity-driven disinflation trends in the first half of the year. The compression in interest rate differentials should ultimately result in USD/EM strength. Two buckets of EM currencies are most exposed. The first bucket includes countries facing persistent imbalances. South Africa stands out: its external imbalance has remained large despite a weaker currency, higher yields and softer activity performance. Moreover, the fall in oil prices is likely to feed through to a broader deflation in metals prices, posing downside risks to South Africa's terms of trade and reinforcing the

case for ZAR weakness. Relative to other high yielders such as the BRL, being long USD/ZAR costs less in terms of carry. Moreover, the ZAR is a less clear beneficiary of lower commodity prices than the TRY. The second bucket includes currencies in economies where inflation is very low, activity trends are weak and where currency weakness would be welcomed by policy makers as part of a broader requirement to ease monetary conditions. In Hungary, headline inflation is negative, activity faces headwinds from a stagnant Euro area and the Russia-Ukraine situation, and there is room for monetary policy to deliver further easing compared with a steep curve. In addition, EUR/\$ downside will further reinforce this trend and, if the ECB eases further, the temptation for the NBH to follow suit would increase.

The Global Macro Markets Team

