JAKE SIEWERT

This is *Exchanges at Goldman Sachs* where we discuss developments currently shaping markets, industries and the global economy. I'm Jake Siewert, global head of Corporate Communications here at the firm.

Today we'll be talking to Sharmin Mossavar-Rahmani, chief investment officer of Private Wealth Management here at Goldman. Sharmin is going to be talking through her team's 2020 investment outlook entitled "Room to Grow," Sharmin, welcome to the program.

SHARMIN MOSSAVAR-RAHMANI

Thank you, Jake.

JAKE SIEWERT

So Sharmin, at the beginning of every year, your team and you put out an outlook for investors, and this year the title is “Room to Grow,” but what I love is to look at the cover art, and it’s always interesting. It’s always symbolic, and this year it’s a baobab tree which I have heard of the baobab tree, but I don’t know exactly what it means. So could you explain to me the significance of the tree?

SHARMIN MOSSAVAR-RAHMANI

As you point out, we always spend a lot of time on the cover. We want our clients to be able to look at the cover and literally get the key message from that alone, and the title, “Room to Grow,” here is to suggest that both the economy has further room to grow as well as this bull market, because all our clients are saying, “Isn’t this expansion coming to an end? Isn’t this bull market coming to an end?”

And the reason we chose a baobab tree is because it’s a tree that lives for a very long time. It’s called “tree of life,” but we’re also signaling that while we can have this expansion and this bull market last a little bit longer, like every tree, trees don't grow to the sky, so this will not last forever, but for 2020 our expectation is that it's going to continue to grow.

JAKE SIEWERT

Sharmin, for the last ten years you've been recommending that clients stay invested, stay in the market, and that's proven to be a phenomenal advice, often against the grain. Why is that recommendation still valid after such a long run, positive run, in the equity markets?

SHARMIN MOSSAVAR-RAHMANI

Jake, that is the exact question our clients are asking. How can we still recommend clients stay invested when we have had such an extensive bull market? For every dollar invested in March of '09, our clients now have six dollars, so a 500 percent return, and how is it that we think there's further room to grow? That view is driven by a couple of key concepts.

First and foremost, if one is in an expansion, the probability of a positive return is 87 percent. So that means the odds favor staying invested because the likelihood of a positive number is so high. So even in the absence of a view on valuation or on earnings growth, the economic backdrop suggests staying invested. Then we look at data preceding recessions, and it shows us that if on average we're a year away from a recession, maybe 18 months away from a recession, the actual price return of the S&P in that window is quite attractive. For a six-month period, it's about eight, nine percent.

So the message again here is that there's a lot of up side left if we are still a ways away from a recession, and the probability of a recession in our view is actually quite low. We're about 20 to 25 percent probability, maybe a little bit closer to 20, and so that suggests we should stay invested because the likelihood of positive returns and strong positive returns is quite high.

JAKE SIEWERT

Why is the level of conviction that a recession is a low-probability event so high? Why are you convinced that a recession isn't in the cards or is unlikely?

SHARMIN MOSSAVAR-RAHMANI

When we look at the factors that have caused recessions in the past in the U.S., generally there have been three drivers. First and foremost, aggressive Fed tightening, and we certainly aren't in that environment. We've had the Fed tighten. They paused. They lowered rates, and our view is they're going to be on hold now for the rest of the year, obviously barring any exogenous shocks like what happens with the coronavirus. So an environment where the Fed is on hold and they have paused, that has usually extended the life of expansions, and since we believe that history is a useful guide, our view is that their pause is going to extend the life of this expansion.

The second cause of recessions has been significant imbalances in the economy. Our colleagues actually in Global Investment Research in the Economics Department have an excellent what we call a heat map. They call it the excess monitor, and it shows where there are imbalances in the economy. For example, is there an imbalance in housing? Is there an imbalance in commercial real estate? Is there an imbalance in equity market valuations, in the amount of leverage in the system? And that heat map shows us that we are actually below average in terms of imbalances, that the economy is actually particularly balanced.

For example, households have de-levered significantly. They have a very high savings rate. U.S. financial companies obviously have de-levered significantly. So when you're looking at these imbalances, we don't see any that would cause the U.S. economy to be very vulnerable to any external shocks, so it's on a very solid footing, and those are the key drivers of our low probability of recession.

The third cause of a recession historically has been an exogenous shock, and those are things we can't predict by definition. Otherwise, they wouldn't be called shocks. So obviously if things were to happen in a significant way in terms of geopolitical risks with Iran and the U.S. or the coronavirus becomes much bigger of a pandemic, then our view could change, but those aren't things one can anticipate, and our recommendation to our clients is you need to invest based on what we call the steady fundamental factors, not based on the unsteady undertow of geopolitical issues or the possibility of exogenous shocks.

JAKE SIEWERT

So since the financial crisis, you've also been very, very bullish on the United States in particular, and this theme of American preeminence – we've talked about this year after year – has been a centerpiece of your investment advice and outlook. So is that theme still intact as well?

SHARMIN MOSSAVAR-RAHMANI

Yes. So the same way our stay invested theme is intact, our theme of American preeminence is intact and, as you pointed out, we developed that theme when everybody was saying that because of the global financial crisis, this was the end of the American century and the beginning of the Chinese century, and we actually took a very strong stand against that, and we went through a whole list of reasons why U.S. was preeminent and China was not.

And we actually have shown that since then the gap has actually widened whether we're talking about favorable demographics, we're talking about labor productivity, U.S. export competitiveness, when we talk about natural resources per capita or earnings per share growth and the diversity of that source of earnings. On all those factors, in fact, the gap between the U.S. and other parts of technology world has, in fact, widened.

So our view of U.S. preeminence is very much intact, and what that means for our clients is a larger strategic allocation to U.S. equities relative to market capitalization indexes and an underweight strategically to developed and non-developed, meaning emerging market equities.

JAKE SIEWERT

Another thing that is obviously in the air is the political season. We're in the middle of the primary season on the Democratic side at least. Do the elections in the fall pose any risk to your view?

SHARMIN MOSSAVAR-RAHMANI

We obviously pay a lot of attention to this because there are going to be so many headlines, and we know some of these headlines can be alarming, and clients ask us a lot of questions. So we actually devoted a fair amount of time on analyzing historical patterns of returns and volatility during election years, and on our publication which is available on GS.com, we actually have outlined some of these observations.

The first observation is that the third and fourth years of a presidential year of the first term, meaning you can't just make a generic comment. You need to look at the first

term and the second term, and the third and fourth years of the first term have very attractive equity returns, but you can't just say the fourth year, because the fourth year of the second term actually has very bad returns. So if one is in the first term of a president ...

JAKE SIEWERT

Running for reelection.

SHARMIN MOSSAVAR-RAHMANI

... running for reelection, the third and fourth years are very attractive. Then we can talk about volatility, and generally in fact the fourth year of a first term has very low volatility, but the problem is there's not that much data. How many examples do we have in terms of history with daily pricing? We only have data since the 1920s. So one has to recognize that while we can make these observations, the data is not statistically significant.

The other observation that we make for our clients is that if the election is very predictable, then there's very low volatility, but if the election is very close, then you have much more volatility. Now where are we going to be on this election? We don't even have the Democratic candidate at this point, so it is really too early to tell whether this will be a predictable election or a close election, and that will drive the volatility.

JAKE SIEWERT

So you mentioned Iran. Are there other risks to your view, geopolitical or beyond that that you think are significant?

SHARMIN MOSSAVAR-RAHMANI

We certainly are focused on a pretty long list actually of geopolitical issues. One would be China. We think China is going to be a geopolitical risk for the foreseeable future. It's not just a 2020 issue and a phase one agreement or a phase two agreement. We think this is going to be something on the horizon for a very long time. Obviously we worry a little bit about escalation and risk of accidents in the Middle East that could have a big impact on risk premium, not just because of risks with oil prices but just risk premium in general if tensions were to escalate and we see more incidents like we saw late in December.

We also worry about North Korea. They talked about a Christmas present. We haven't seen it yet, but that could be a risk. Obviously cyber attacks, terrorism; all of those are factors that we focus on, but these aren't things one can anticipate, so we recommend our clients not adjust their portfolios just because these could be on the horizon at some point in the future.

JAKE SIEWERT

So in the '70s and '80s, central bankers were supposed to fight inflation, and that was their raison d'être, and these days it seems like central bankers across the world are trying to create or see a little inflation with very little success. There's a little pickup here and there in inflation rates. Does that pose any sort of risk to your view?

SHARMIN MOSSAVAR-RAHMANI

One of the themes we have actually had now for close to a decade along with the U.S. preeminence and stay invested has been that we are in a disinflationary period, and that impulse has come basically from the growth of China and China joining the WTO and exporting cheap goods, exporting cheap labor even with their increase in wages, even with the appreciation in their currency, the increase in their land prices. They are still exporting much cheaper goods, and that puts a dampener in our perspective in terms of inflation.

And then domestically when we look at wage inflation, we see no evidence of a Phillips curve that is responding to very low unemployment rates. So our view is that even if we continue to see some improvement in the unemployment rate going lower and lower, we still are not going to see a significant pickup in inflation.

JAKE SIEWERT

So obviously the topic of the week or the last week or so and has been rocketing around the markets is the coronavirus. Still early days, but do you think that poses any sort of risk to your outlook as well?

SHARMIN MOSSAVAR-RAHMANI

History is a very useful guide in our view when we're looking at any particular topic, so we actually went back and looked at all the past significant pandemics, all the way to the Spanish flu, and we looked at SARS. We're looking at the swine flu, avian flu, MERS, and basically when we look at these, the initial reaction of the market is a flight to quality with Treasuries appreciating and the equity market going down, and then over time the underlying fundamentals of the equity market and the economy actually assert themselves.

When we're looking at this current virus, the data is obviously ... it's too early to draw any major conclusions, but the expectation so far is that the mortality rate is a lot lower. In terms of the transmission, it's a little bit less than SARS. So if the mortality rate is somewhere between two to three people, two to three percent, SARS was closer to ten percent. If we're looking at how infectious people are and how many other people do they transmit the virus to, it's much less than for example SARS.

So in general when we look at the data, our view is that we're going to have a volatility for maybe a couple of months, but then whatever the underlying trend is in the economy and in the U.S. will assert itself. Short term, there are some sectors that will benefit like pharmaceuticals and sectors like the energy sector, commodities like oil prices, copper prices, U.S. companies exposed to China. Chinese equities are the ones that will get hurt, and we believe actually for a while this will dampen growth in China.

JAKE SIEWERT

So you've been on the road since you put your outlook out and talk to clients all over the place. What are the main questions you're getting from clients right now?

SHARMIN MOSSAVAR-RAHMANI

I think the biggest question is what you had asked earlier about how can this last. How can this expansion continue? How can this bull market continue? And one of the comments we have made repeatedly now is that expansions in the developed economies have actually all been getting longer. So if you look at data let's say prior to the 1950s and then you look at the pace of expansions and how long they last, they actually last longer now, whether it's because of better central bank policy, whether it's because of better social safety net when one has a recession, but generally expansions have lasted a lot longer.

So that's one big question, and then the question especially with clients who have had a lot of U.S. assets and have significant gains is, why not take a little bit of money off the table and wait for a pullback? The reason we suggest clients be a little bit more careful about that is because the tax liability is going to be significant.

So for example, for a client that had a dollar invested in March of '09, and they live New York City or they live in California and have very high capital gains taxes, even if it's long-term capital gains, the equity market has to go down about 29 percent to just break even with the taxes that they're going to have to pay. So for every hundred dollars, once you've paid all those taxes, you're going to have a lot less assets to reinvest.

JAKE SIEWERT

To reinvest.

SHARMIN MOSSAVAR-RAHMANI

So it's very important to be just aware of that.

Exactly, exactly.

JAKE SIEWERT

There's always taxes. Well, Sharmin, thank you for joining us today. That concludes this episode of *Exchanges at Goldman Sachs*. Thanks for listening, and if you've enjoyed the show, we hope you subscribe on Apple Podcasts and leave a rating or a comment, and for more from Goldman Sachs experts as well as influential policymakers, academics and investors, be sure to check out our other podcast, *Top of Mind at Goldman Sachs* hosted by Allison Nathan, a senior strategist in the firm's Research division. Thank you very much.