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The post-shutdown slowdown market lowdown

Markets have relaxed on the Fed but worried about growth

After the Fed's 'non-taper' and a trip to shutdown and back, we look at how the market appears to have shifted its views of growth and monetary policy as the impacts of these events have been digested. We also examine how the market is likely to change its views between now and year-end. The clearest change in market views has been in the pricing of US monetary policy, where the combination of events has seen a significant postponement in the pace of US exit. But the market also appears to have priced in somewhat greater risk to the US recovery profile.

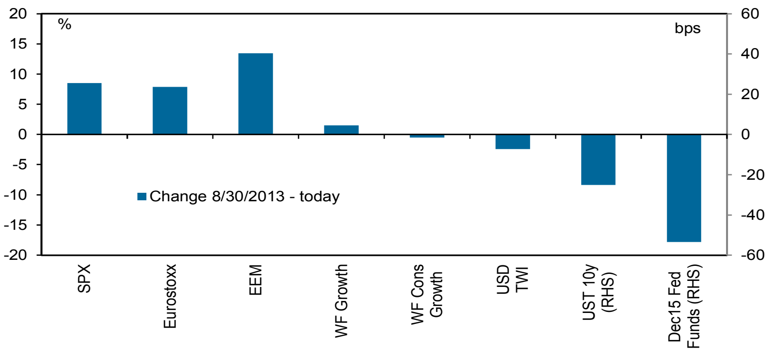
Scope to be more relaxed on growth, less so on Fed policy

Looking beyond evidence of a 'shutdown slowdown' in the next few weeks, we think the market has scope to relax about US growth risk again towards the end of the year. And while the most likely outcome is that we learn little from the Fed in the near term, we think the risks are probably tilted more towards discovering that the FOMC is still mulling over its exit than towards a longer delay than the market already expects.

Still positive for equities; more risk from rates than growth

Although the data may be hard to interpret over the next week or two – and could conceivably reinforce concerns about growth risk – this broader picture is still supportive for equities. The main risk to that story is if yields begin to move up again. After the latest shifts, this means that it has become more interesting to think about short bond and long USD positions again, not yet on a stand-alone basis, but at least against long positions in risk assets.

Markets price a shift towards a friendlier Fed



Source: Haver Analytics, Goldman Sachs Global Investment Research.

Dominic Wilson
(212) 902-5924 dominic.wilson@gs.com
Goldman, Sachs & Co.

Kamakshya Trivedi
+44(20)7051-4005 kamakshya.trivedi@gs.com
Goldman Sachs International

Noah Weisberger
(212) 357-6261 noah.weisberger@gs.com
Goldman, Sachs & Co.

Aleksandar Timcenko
(212) 357-7628 aleksandar.timcenko@gs.com
Goldman, Sachs & Co.

Jose Ursua
(212) 357-2234 jose.ursua@gs.com
Goldman, Sachs & Co.

George Cole
+44(20)7552-3779 george.cole@gs.com
Goldman Sachs International

Julian Richers
(212) 855-0684 julian.richers@gs.com
Goldman, Sachs & Co.

The post-shutdown slowdown market lowdown

At the start of September, we analysed the market implications of the US recovery and how to balance these against the other cross-currents from monetary policy and the rest of the world. It has been an eventful two months since then, with the Fed's 'non-taper' and a trip to shutdown and back again.

We use the same framework to look at how the market appears to have shifted its views of growth and monetary policy as the impacts of the Fed and the shutdown have been digested. We also examine how the market is likely to change its views between now and the end of the year.

We think that much of that comes down to the balancing act between the shifts in the market's views on growth and monetary policy. The clearest change in market views over that period has been in the pricing of US monetary policy, where the combination of events has seen a significant postponement in the pace of US exit. But the market also appears to have priced in somewhat greater risk to the US recovery profile.

We have more sympathy with the first of these shifts than with the second. Near-term uncertainty in the data picture, alongside the September FOMC decision, supports the idea of a later start to Fed tapering (our own central case has shifted to March 2014). But beyond some temporary weakness in the upcoming data, we do not think the risks to the 2014 US growth recovery story that has been in our forecast all year have increased materially. And given the extent of the shift in the market's view of the Fed, we think it will be harder for the market to price more dovish outcomes unless growth disappoints.

Looking beyond evidence of a 'shutdown slowdown' in the next few weeks, we think the market has scope to relax about US growth risk again towards the end of the year. And while the most likely outcome is that we learn little from the Fed in the near term, we think the risks are probably tilted more towards discovering that the FOMC is still mulling over its exit than towards pricing a longer delay than the market already expects.

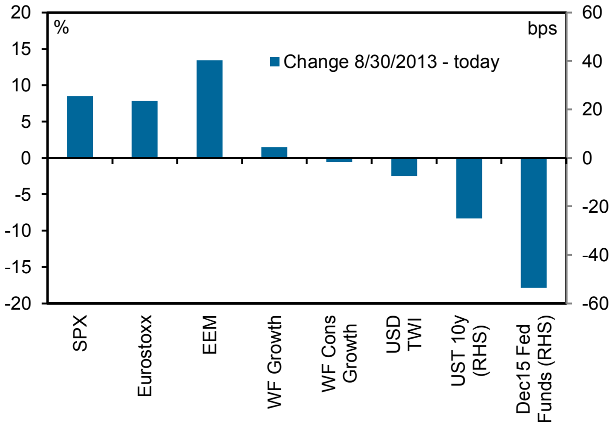
Although the data may be hard to interpret over the next week or two—and may fail to alleviate concerns about growth risk—this broader picture is still supportive for equities. The main risk to that story is if yields begin to move up again. After the latest shifts, this means that it has become more interesting to think about short bond and long USD positions again, not yet on a stand-alone basis, but at least against long positions in risk assets.

Bonds and equities rally through FOMC, shutdown

We look first at the performance of some key assets over the recent period. Since the end of August, we have seen a sharp rise in equity markets, particularly in EM; lower UST yields and a significant fall in expectations of where the Fed funds rate will be at the end of 2015; a weaker US Dollar; and modest outperformance of global over US domestic cyclical stock (Exhibit 1).

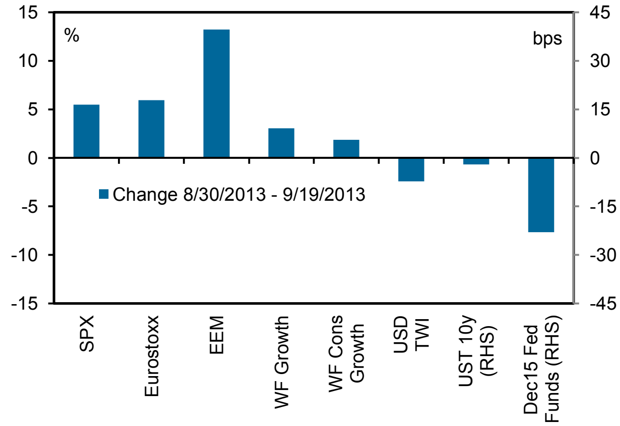
Alongside the data flow, this period encompasses a number of different events: the withdrawal of Lawrence Summers' candidacy for Fed Chair (September 15); the FOMC 'non-taper' (September 18); the shutdown and its resolution (October 1-16); and the nomination of Janet Yellen to the Fed Chair (October 9). This suggests it is also helpful to split the longer period into smaller periods.

Exhibit 1: Equities up, yields down as markets relax about Fed risk since late August



Source: Haver Analytics, Goldman Sachs Global Investment Research.

Exhibit 2: Equities rally through the FOMC…

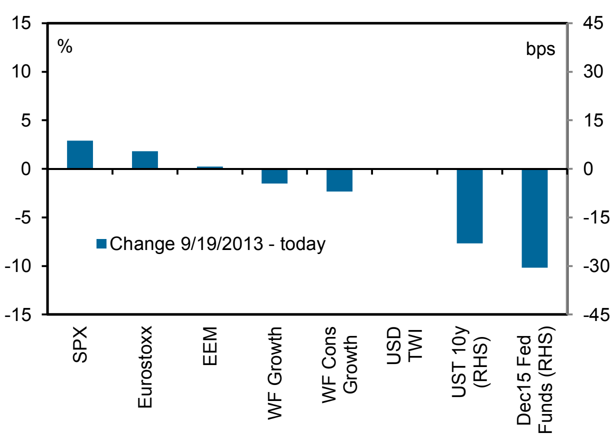


Source: Haver Analytics, Goldman Sachs Global Investment Research.

Exhibits 2 and 3 show the performance of assets over the longer period split into the period up to September 19 (the day after the FOMC) and the period afterwards. The bulk of the gains in equities were recorded over the period including the FOMC, with EM outperformance particularly striking and cyclical stocks clearly gaining. The 10-year UST yield fell relatively little over that period, although front-end rate expectations were scaled back. In the second period, including the shutdown and its resolution, equity gains have been more modest, cyclical stocks have underperformed and both UST yields and Fed fund expectations have fallen further.

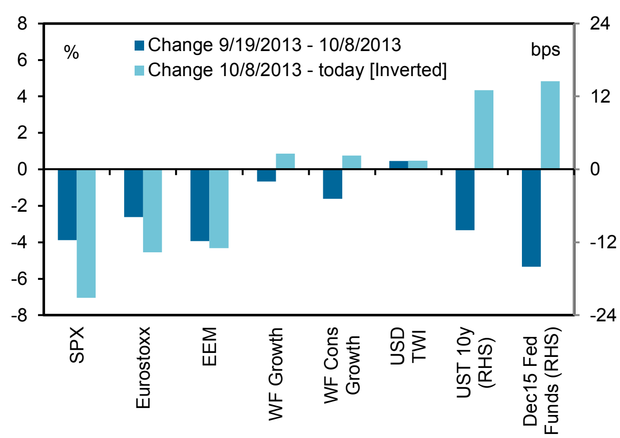
Exhibit 4 subdivides the period since September 19 and this time into two further sub-periods, centred on October 8. This immediately precedes both the Yellen nomination and the first signs of a resolution in the shutdown. As the shutdown approached and deepened, equities sold off, domestic US cyclical stocks underperformed and bonds rallied. But, as the exhibit shows, in the period since then, equity indices have (more than) reversed that damage, while yields have continued to fall and domestic cyclical underperformance has extended.

Exhibit 3: …bonds rally more since then



Source: Haver Analytics, Goldman Sachs Global Investment Research.

Exhibit 4: Shutdown pressure reverses, but not in rates



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

Exhibit 5: Looking at macro 'drivers', recent moves look most like a US easing 'shock'

	Response of asset to shock:	Easier US Monetary	US Growth	European Growth	EM/China Growth
Stocks	**US**	+	++?	+?	+?
	Domestic cylicals	+	++	0	0
	Global Cyclicals	+	+	+	+
	Defensives	+?	+?	0	0
	Non-US DM	+	+	++?	+?
	EM	++	+	+?	++?
Rates	**US yields**	--	++	+	+
	Non-US DM yields	--?	+	++	+
FX	**$**	-	+?	-	-
	$/JPY	-	+	0	+?
	$/Europe	-?	+?	- -?	-
	$/EM	--	+	0	-
Relative equity	**EM vs DM**	+	-	-	+
	EM vs US	+	-	0	+
	Glob Cyc vs Def	+?	+?	+	+
	Dom Cyc vs Def	+?	++?	0	0

Note: Scale shows likely response to each shock ranging from most positive to most negative on the following scale ++, ++?, +, +?, 0, -?, -, - -?, - -. For negative shocks, signs would be reversed. (See GEW 13/27).
Source: Haver Analytics, Goldman Sachs Global Investment Research.

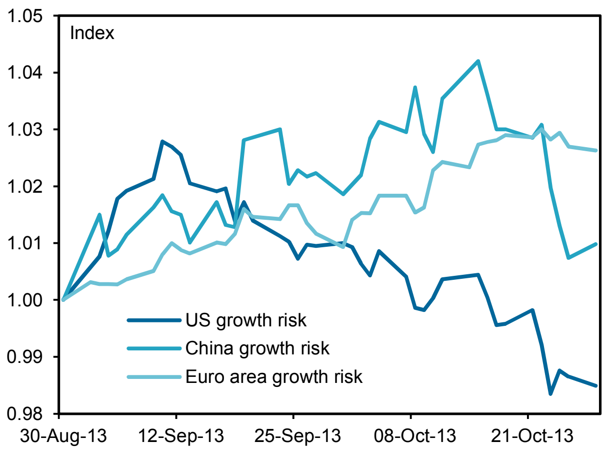
Markets have relaxed a lot about the Fed, worried a little about growth

These shifts provide important clues as to how the market has been changing its views. To interpret those shifts, our starting point, as in September, is to think about how we would expect different asset markets to respond to individual macro 'shocks' – where we can interpret those as shifts in the market's views on a key macro driver. Exhibit 5 shows a version of the table we presented at that time, looking at four axes: shifts in the US monetary policy reaction function (i.e., monetary policy shifts that are not simply the consequence of the growth picture); shifts in US growth views; and shifts in views of growth in Europe and China. As an example, a shift towards thinking that the US would conduct easier monetary policy for any given growth outlook would be expected to boost equities, push yields lower, weaken the Dollar, help the relative performance of cyclical stocks and arguably help EM versus DM assets. We can then think about which combination of these four shifts best corresponds to the kinds of asset movements seen in Exhibits 1-4 (essentially adding the columns in Exhibit 5).

Looking over the entire period from the end of August, the market movements are most consistent with two main shifts:

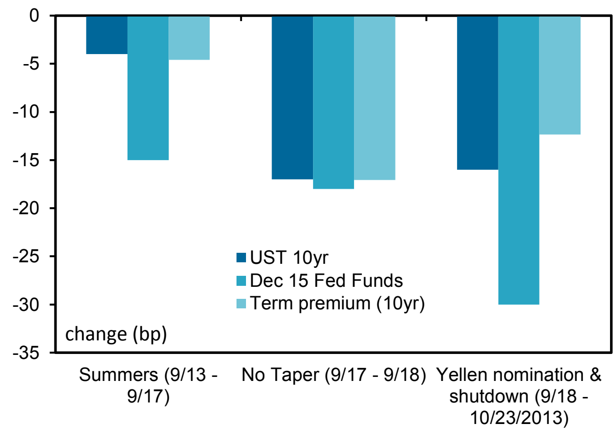
1. **A significant relaxation about US monetary policy.** The combination of higher equities, a weaker USD and (most clearly) lower yields is most consistent with that story. The sharp shift in expectations of Fed policy is the most obvious 'smoking gun' but the fact that equities have moved higher rather than lower suggests that a significant part of the shift has been driven by changing perceptions of how the Fed will react, not simply by greater concern about the growth picture.
2. **A modest downgrade to US growth views.** If all that happened is that the market had relaxed about the Fed, Exhibit 5 implies that it would be natural to expect cyclical stocks to outperform (as they did in the first three weeks of September). The fact that domestic cyclical stocks in particular underperformed over the longer period (and specifically through the shutdown and its resolution) is evidence that alongside Fed relaxation, the market has worried more about the growth picture, at least in the US, through October.

Exhibit 6: US growth views downgraded, some China pressure too



Source: Haver Analytics, Goldman Sachs Global Investment Research.

Exhibit 7: View of funds rate shifts more than term premium, alongside shift in Fed Chair nominee



Source: Haver Analytics, Goldman Sachs Global Investment Research.

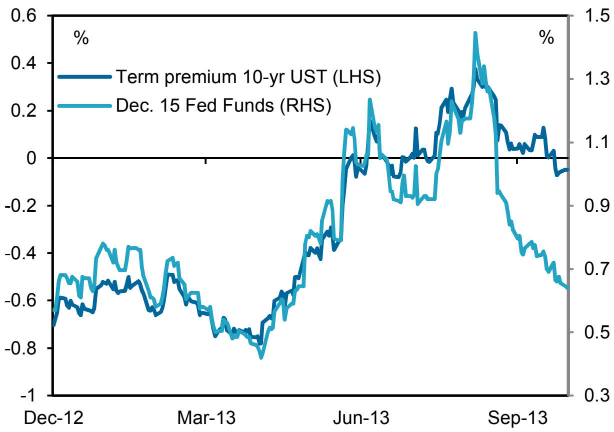
This notion of a modest growth downgrade centred on the US is supported by our 'three risk' factors (China growth risk, US growth risk and Euro area financial risk). These interpret asset market movements through a slightly different lens, using the common components of assets that are linked to each driver to identify potential shifts in the market view on each axis. Exhibit 6 supports the idea that the market has downgraded its US growth view since late September, while becoming more positive on the Euro area risk picture.

Exhibit 6 also shows that after upgrading its China growth view through September and early October, there has been sharp pressure on China-related assets—and so implicitly market views of China risk—in the last week or so. This has been related to renewed concerns about tightening liquidity in interbank markets (and the recent rise in SHIBOR, in particular). This has sparked memories of the sharp rise in interbank rates in the summer, which prompted a sustained downgrade to the China asset complex. Seen against the context of the downgrades in May and June, those shifts—while rapid—are still quite modest.

The fact that, since the end of August, shifts in the US monetary policy outlook are the dominant change in market views matches the fact that this was a period of significant new information on that front. Coming into September, the market expected a Fed tapering in the middle of the month and a Summers nomination for Fed Chair. It will leave October with a consensus that tapering will begin in March 2014 (a full six months later) and a Yellen nomination.

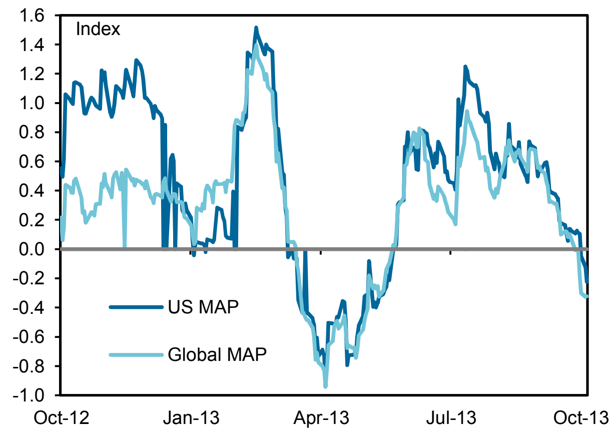
Exhibit 7 takes a closer look at the shift in expectations for the Fed funds rate for December 2015, the term premium on a 10-year UST yield and the UST yield itself since September 12, identifying the period of the Summers withdrawal, the period that includes the September FOMC meeting and the period since then that encompasses the Yellen nomination. What is striking is that although the primary policy shift was the decision to delay tapering of asset purchases, it has been the shift in front-end rate views that has been disproportionately large. Ironically, as Exhibit 8 shows, the Fed has made more progress in the last two months in separating the market's views of the term premium (asset purchases) from its views of forward guidance (future fund rate expectations) than it has managed to do all year.

Exhibit 8: Finally, some success in separating forward policy path from term premium



Source: Haver Analytics, Goldman Sachs Global Investment Research.

Exhibit 9: US and Global MAP indices show shift to negative surprises lately



Source: Haver Analytics, Goldman Sachs Global Investment Research.

What we have learnt on growth and monetary policy

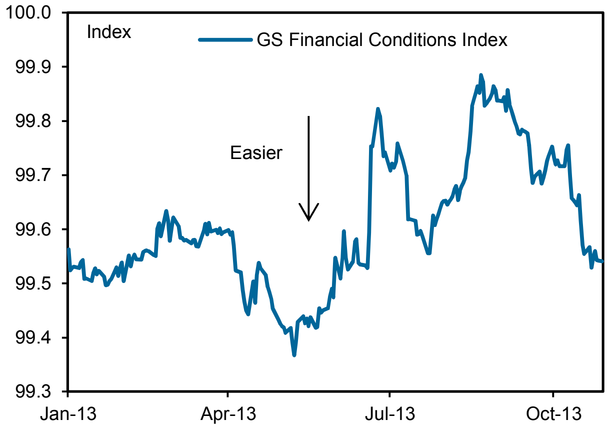
Relative to these shifts in market pricing, what has the news of the last two months taught us about the outlook?

On the growth front, our core views of the outlook have not changed much. The pre-shutdown news was relatively neutral overall. There was a clear slowing in the pace of payrolls growth in the three months prior to the shutdown, but our CAI indicates that overall activity held up relatively well through September. And our analysis implies that payrolls growth is a much less useful predictor of the future path of the economy than indicators such as the Philly Fed index and ISM, which have looked stronger. Our MAP scores in the US were positive through September, but have turned more clearly negative more recently (Exhibit 9). Some of this softening is in data that precedes the shutdown. But a significant part reflects data that—like consumer confidence—have been affected by the shutdown itself.

We expect the impact of the shutdown to be largely temporary. Our analysis suggests that the direct hit to federal spending and the rise in associated uncertainty are likely to be associated with a roughly 0.5pp hit to Q4 GDP. But that effect should be concentrated in October data, with reacceleration beyond. The exact path of the near-term data is hard to judge with much confidence, but the basic point is that we see the shifts here more as an influence on the timing of activity than on the underlying path. Our confidence that US growth will accelerate towards a 3%-ish pace as we move into 2014 is largely unaffected. The basic logic of that story—a private sector that has healed to a significant degree alongside diminishing public sector drag—is intact. There are risks to that view, of course. There is some risk that renewed conflict over the debt ceiling in the spring raises uncertainty again on that front. On balance, however, we think those risks are smaller than in the October impasse. On the other side of the ledger, one of the risks that worried us over the summer—the sharp tightening in financial conditions—has reversed in the last month, as Exhibit 10 shows. Our GSFCI is now 35bp below its peaks. Oil prices are lower too. So, relative to the late summer, this area has in fact improved.

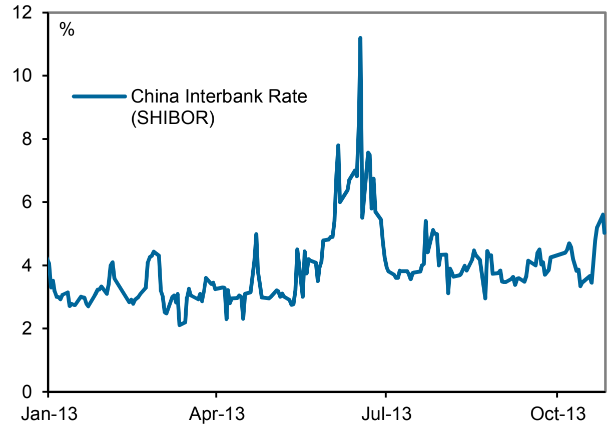
The global picture has also changed relatively little. Our global MAP scores have turned modestly more negative (Exhibit 9 again), including outside the US, as expectations have caught up with the acceleration in global industrial indicators in Q3. Our GLI also suggests that that period of acceleration may be coming to an end, although there are as yet few signs of any significant slowing.

Exhibit 10: US Financial Conditions have reversed the summer tightening



Source: Haver Analytics, Goldman Sachs Global Investment Research.

Exhibit 11: Recent spike in China's interbank rates is much smaller than in June so far



Source: Haver Analytics, Goldman Sachs Global Investment Research.

On the monetary policy front, the slower recent pace of jobs growth and the muddiness of the near-term data now make it harder to envisage a rapid shift towards tapering. This is why we now think that a March taper is most likely. But it is important to understand that much of this shift may be about wanting more certainty about the underlying economic path before acting, and not a shift in the economic path itself. How much the Fed's own reaction function has shifted is less clear, particularly since—as Jan Hatzius has described (see *US Economics Analyst: 13/43* – 'Back to Fed Basics')—we are now less certain about the Fed's 'QE reaction function' and whether it thinks of the tapering decision as 'tightening' or a 'shift in the mix of instruments'. Nor have we had much recent elaboration of how Fed Chair nominee Yellen thinks on these issues.

The shift in the market's pricing of Fed expectations has been large. The expected Fed funds rates for end-2015 and end-2016 (0.6% and 1.6%) are now below the centre point of the Fed's 'dots' (0.75% and 1.75%, respectively). While we thought the market was worrying too much about tightening in the late summer, we are struck by the confidence with which many investors now believe that tapering is off the table for a lengthy period of time. Tapering decisions in December and January seem less likely than March but they are not zero-probability events.

Looking to year-end: More relaxed about growth, less about monetary policy

We can return to Exhibit 5 to assess where the difference between our views and the shifts in market views leaves us in terms of the key drivers out to the end of the year.

We think the strongest implication is that the market again has scope to relax about the US growth profile. We are uncertain about how the market will react to possible near-term data weakness, although we would see any strong reaction as a mistake, given the temporary nature of the shock. But having seen the market lose some confidence in the 2014 US recovery story, we think the underlying picture has changed less. Our forecast for that recovery is not much different to the consensus. But, put simply, once again we seem to believe it more than others.

On monetary policy, our views on the funds rate have been very dovish (we continue to forecast the first rate hike in 2016Q1). So in that sense the recent shifts have taken pricing much closer to our 'terminal' view. But the moves here have been very large and it is reasonable to assume that some risk premium is likely to remain in funds rate pricing that is still more than two years away, particularly if growth moves above trend. Therefore, without growth disappointments, we now think there is much more limited room for the market to price a substantially more dovish outlook. And looking ahead to the October FOMC minutes, Fed speeches and perhaps Janet Yellen's nomination hearings, we think the risks to current market views of the Fed's 'reaction function' over the next few months are probably at best neutral. Certainly, we worry that the market is now much more exposed than it was two months ago to the risk that there has been a smaller shift in Fed thinking than the market is pricing.

On the relative risks to non-US growth views versus US growth views, our conviction on the near term is less strong. There is policy event risk in the next month or two in both Europe (the Asset Quality Review) and China (November Plenary sessions). There are also some signs that the global acceleration phase may be drawing to a close. Recent worries—given the shutdown—have focused mostly on the US. So, at the margin, we see more concrete reasons for relief there. But this is not a strongly-held view compared with at some points earlier in the year.

On the non-US front, the key near-term question is likely to be how seriously to take the recent concerns about signs of fresh liquidity tightening in China, which have put pressure on the China-related asset complex in the past week. These shifts do appear to be occurring partly in response to recent signs of consumer and asset price inflation. But we think the stresses in the interbank market are likely to reverse somewhat and do not reflect the extent of deliberate policy shift that was engineered in June (Exhibit 11). This suggests there may be modest scope for relaxation there in the coming weeks.

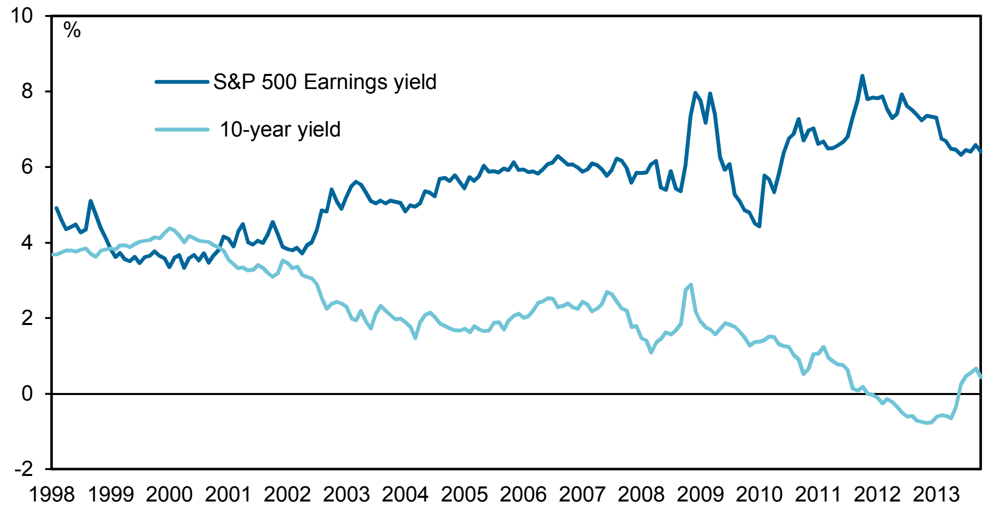
Still a positive equity picture, but more risk from rates than growth

Putting the pieces together, this adds up to a view that there is a) scope for some relaxation about US growth risks over the next couple of months and b) a more neutral view on potential shifts in the monetary policy reaction function, but with more concern about the impact of hawkish surprises.

A relaxation in the US growth risk outlook should be broadly friendly for equity markets in this context over the remainder of the year. Domestic cyclical sectors such as banks that have underperformed may also find themselves better placed once again. With the near-term data likely to be soft, the shift to greater confidence in the recovery story may not occur immediately. But under our forecasts, it should probably begin to take place before year-end. A more neutral monetary policy environment but stable to improving growth is also likely to be one in which volatility remains relatively low in the central case.

There is clearly nervousness about equity valuations given the latest run-up. But a milder version of the arguments for equity upside that we made earlier this year still applies. The earnings yield on US stocks is currently around 6.5% (a P/E multiple of 15.3 on forward earnings). The real 10-year US bond yield is now back to 30bp and current forward markets price it at just 70bp by the end of 2015. At that point, our forecasts (and the consensus) predict that we will have seen a nearly two-year period of 3%-plus US GDP growth. We think this combination is unlikely to justify a risk premium that remains a lot higher than normal (Exhibit 12). Put differently, if yields stay anchored alongside a growth recovery, further equity upside seems plausible even from current levels. The main risk to that story—other than a failure of recovery—still comes from a faster real yield rise than is discounted by current forward pricing.

Exhibit 12: Despite the rally, still an unusually large gap between real bond yield and earnings yield



Source: Haver Analytics, Goldman Sachs Global Investment Research.

That highlights the main vulnerability. A shift back towards higher yields and renewed rate volatility would constitute the main challenge to this more benign asset market picture. Given the extent of the shift in rate views, we again see that as a clearer risk. Our Fed view is still very benign (no hikes until 2016) but our US 10-year yield forecasts are now once more above the forwards. On that basis, long USD positions and perhaps even short positions in front-end rate contracts—while not yet compelling on their own—have become more interesting as hedges to long positions in risk assets.

That same combination of macro risks also points to the potential for renewed pressure on EM currencies, where our structural view has been most cautious among the major EM asset classes. We think rates will ultimately head higher there too, although paying rates remains a tricky proposition from a timing perspective. We have been more constructive about EM equities for the last few months. Logically, that stance should continue into year-end on an absolute basis. But with significant Fed relief and some China relief behind us, the case for EM outperformance now looks weaker than it did in late August.

Dominic Wilson

Global economic forecasts

Real GDP, %ch yoy

	2013	2014	2015	2016
G3				
USA	1.6	2.8	3.2	3.0
Euro area	-0.4	0.9	1.2	1.5
Japan	1.9	1.8	1.4	1.5
Advanced Economies				
Australia	2.2	2.0	2.4	3.7
Canada	1.7	2.7	2.7	2.5
France	0.0	0.5	1.0	1.3
Germany	0.6	2.0	2.1	2.2
Italy	-1.8	0.4	0.9	1.0
New Zealand	2.8	2.6	1.8	2.6
Norway	1.0	2.4	1.9	1.9
Spain	-1.4	0.0	1.0	1.8
Sweden	1.0	2.7	3.0	2.8
Switzerland	1.8	1.4	1.4	1.5
UK	1.4	2.3	2.5	2.7
Asia				
China	7.6	7.7	7.8	7.8
Hong Kong	3.2	3.4	4.5	4.2
India	4.2	5.0	7.2	7.5
Indonesia	5.4	5.5	6.4	6.7
Malaysia	4.6	4.8	5.2	5.5
Philippines	6.8	5.5	5.6	5.8
Singapore	2.3	3.2	4.2	4.5
South Korea	2.9	3.7	3.8	4.0
Taiwan	2.8	3.9	4.0	4.0
Thailand	4.0	4.3	5.1	5.6
CEEMEA				
Czech Republic	-1.0	2.0	2.4	2.5
Hungary	0.5	1.4	1.9	2.0
Poland	1.0	2.8	3.4	3.5
Russia	2.0	3.3	3.7	3.1
South Africa	2.2	3.4	3.8	3.2
Turkey	4.5	2.7	3.7	3.0
Latin America				
Argentina	5.3	1.9	1.9	3.6
Brazil	2.6	2.3	3.2	3.4
Chile	4.2	4.1	4.6	4.6
Mexico	1.1	3.3	3.4	3.6
Venezuela	1.7	2.5	2.6	1.0
Regional Aggregates				
BRICS	5.8	6.2	6.8	6.9
G7	1.2	2.3	2.5	2.4
EU27	0.0	1.3	1.6	1.8
G20	2.8	3.6	4.0	4.1
Asia ex Japan	6.1	6.4	7.0	7.1
Central and Eastern Europe	0.4	2.4	2.9	3.1
Latin America	2.8	3.0	3.4	3.7
Emerging Markets	5.2	5.6	6.1	6.2
Advanced Economies	1.2	2.2	2.4	2.5
World	2.8	3.6	4.0	4.1

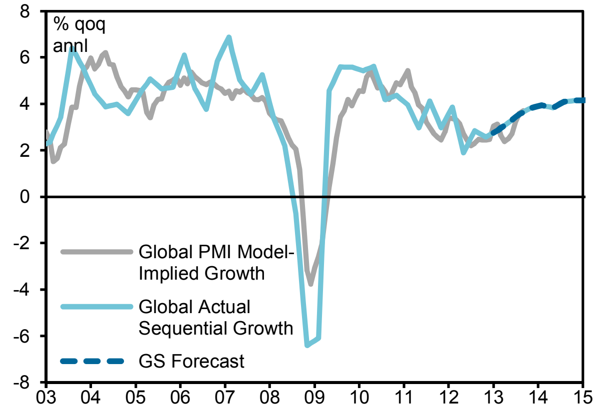
Consumer Prices, %ch yoy

	2013	2014	2015	2016
G3				
USA	1.6	1.8	1.9	2.1
Euro area	1.5	1.5	1.6	1.8
Japan	0.2	2.3	1.7	2.1
Advanced Economies				
Australia	2.0	2.5	2.6	2.8
Canada	–	–	–	–
France	1.1	1.5	1.2	1.5
Germany	1.8	2.0	2.5	2.9
Italy	1.6	1.3	1.4	1.5
New Zealand	1.2	1.9	2.0	2.0
Norway	2.2	2.1	2.1	2.4
Spain	1.6	0.9	0.8	0.8
Sweden	0.1	1.4	2.3	2.8
Switzerland	-0.3	0.9	1.1	1.6
UK	2.7	2.5	2.0	1.8
Asia				
China	2.6	2.7	3.0	3.0
Hong Kong	3.6	3.3	3.4	3.1
India	6.5	6.7	5.5	4.7
Indonesia	8.2	6.8	5.5	5.5
Malaysia	2.3	2.4	2.8	2.8
Philippines	3.2	3.8	3.5	3.5
Singapore	3.0	3.3	3.5	3.2
South Korea	1.5	2.6	2.8	2.9
Taiwan	1.8	1.7	2.0	1.9
Thailand	2.5	3.2	3.5	3.4
CEEMEA				
Czech Republic	1.6	1.7	1.9	2.1
Hungary	1.8	1.4	2.6	3.0
Poland	1.0	2.0	2.0	2.1
Russia	6.5	5.6	5.3	4.6
South Africa	5.9	5.7	5.8	5.2
Turkey	7.5	7.7	7.5	7.8
Latin America				
Argentina	10.6	12.4	12.4	12.0
Brazil	6.2	5.7	5.5	4.9
Chile	1.8	3.1	2.8	3.1
Mexico	3.8	3.2	3.3	3.0
Venezuela	36.7	39.6	26.6	20.8
Regional Aggregates				
BRICS	4.1	4.0	3.9	3.6
G7	1.4	1.8	1.8	2.0
EU27	1.6	1.7	1.7	1.9
G20	2.7	2.9	2.8	2.9
Asia ex Japan	3.5	3.6	3.5	3.4
Central and Eastern Europe	1.3	1.9	2.1	2.2
Latin America	7.9	7.1	6.2	5.6
Emerging Markets	4.9	4.7	4.4	4.1
Advanced Economies	1.4	1.8	1.8	2.0
World	2.8	3.0	2.9	2.9

Source: Goldman Sachs Global Investment Research
For India we use WPI not CPI. For a list of the members within groups, please refer to ERWIN.
For our latest Bond, Currency and GSDEER forecasts, please refer to the Goldman Sachs 360 website: (https://360.gs.com/gs/portal/research/econ/econmarkets/).

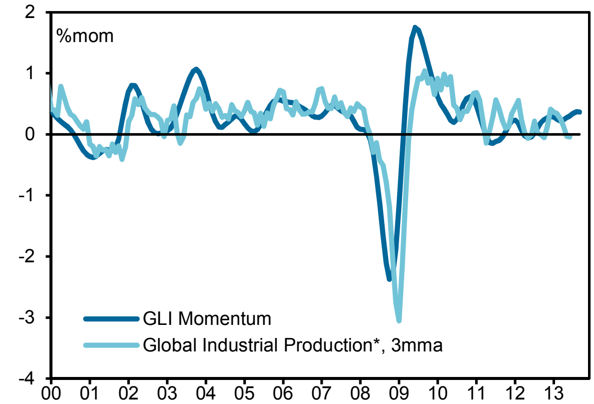
Global macro and markets charts

PMI-implied global growth



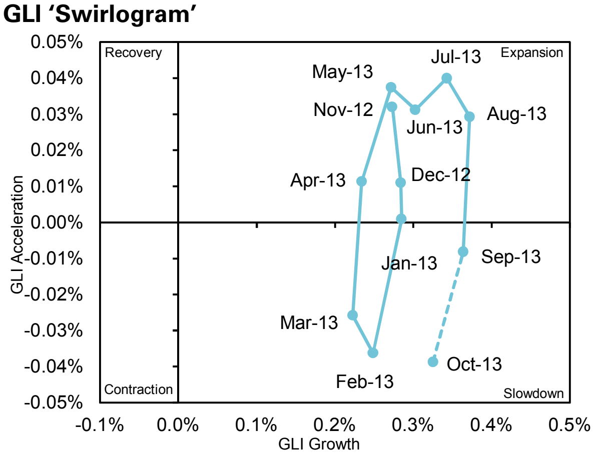
See *Global Economics Weekly 12/18* for methodology
Source: OECD, Goldman Sachs Global Investment Research

GLI momentum vs. global industrial production*



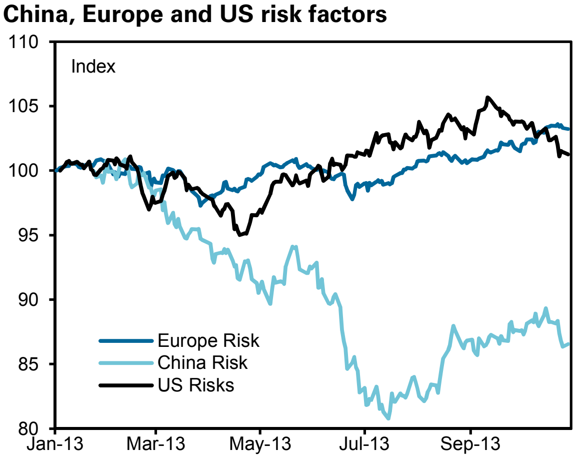
* Includes OECD countries plus BRICs, Indonesia and South Africa
See *Global Economics Paper 199* for methodology
Source: OECD, Goldman Sachs Global Investment Research

GLI 'Swirlogram'



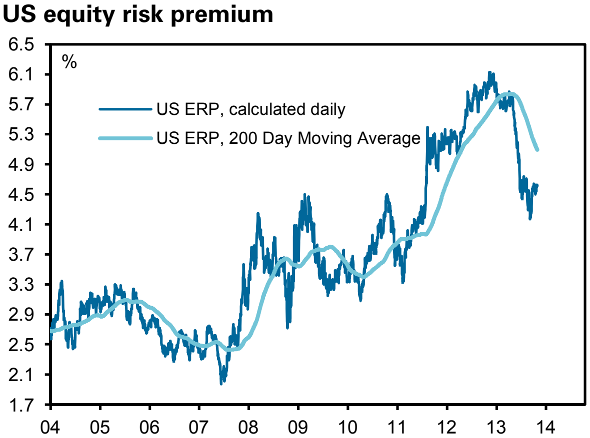
See *Global Economics Paper 214* for methodology
Source: OECD, Goldman Sachs Global Investment Research

China, Europe and US risk factors



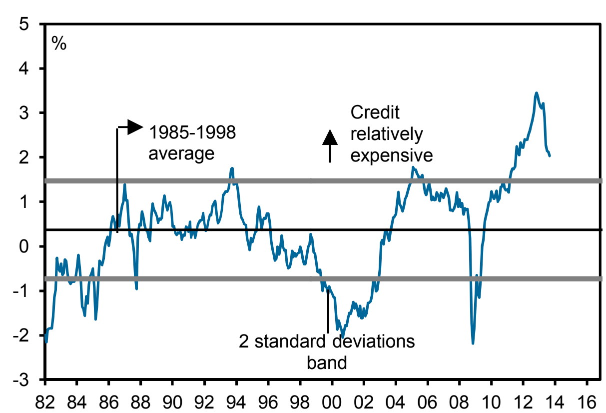
See *Global Economics Weekly 12/15* for methodology
Source: Goldman Sachs Global Investment Research

US equity risk premium



See *Global Economics Weekly 02/35* for methodology
Source: Goldman Sachs Global Investment Research

US equity credit premium



See *Global Economics Weekly 03/25* for methodology
Source: Goldman Sachs Global Investment Research

The world in a nutshell

THE GLOBAL ECONOMY

	OUTLOOK	KEY ISSUES
UNITED STATES	We expect below-trend annual growth of 1.6% in 2013 followed by an acceleration to 2.8% in 2014. Growth should then remain slightly above that rate in 2015 and 2016. On an annualised sequential basis, we expect growth of 2.0% in the last quarter of the year. Looking into 2014 and beyond, we expect above-trend growth at around 3%-3.5%.	Our forecast for near-term weakness but long-term strength is based on competing impulses from the private and public sectors. We expect the 'sequester' to continue to be a significant drag on growth this year, while in the intermediate and long term we expect further strength in the private sector, led by the ongoing housing recovery, rising business investment and financial rebalancing in the household sector.
JAPAN	We expect real GDP growth of 1.9% in 2013 and 1.8% in 2014, and a further deceleration in 2015. On a sequential basis, our forecasts show quite wide swings. We expect strong growth over the coming quarters buoyed by public works spending, a recovery in exports and a sharp rise in personal consumption ahead of a consumption tax hike in April 2014.	Structurally, Japan is poised to reach above-trend growth rates in step with an improvement in the global economy towards the end of our forecast horizon in 2016. The new leadership at the BoJ has led to a regime shift in Japanese monetary policy with much more aggressive, Fed-style easing capabilities. While this potentially offers a way out of more than a decade of deflation, reaching the 2% inflation target remains a tall order.
EUROPE	For the Euro area as a whole, we expect a continued contraction, by -0.4% in 2013, and a return to positive growth of 0.9% in 2014. Our baseline is still that the Euro area will 'muddle through' but remain intact. Cross-country divergence remains a key theme in this baseline scenario, however, with economic weakness especially pronounced in Spain and Italy. Meanwhile, we also expect growth to decelerate temporarily in Germany in 2013.	The 'long grind' we forecast for 2013 is the result of the damaging but necessary combination of continued public-sector austerity and private-sector deleveraging. Still, with financial conditions having eased quite substantially through enacted and prospective ECB policy, a sharper contraction has been avoided. ECB policy will aim to reduce the segmentation of financial markets further with targeted measures such as the Outright Monetary Transaction (OMT) programme.
NON-JAPAN ASIA	For Asia ex-Japan, we expect growth of 6.1% and 6.4% in 2013 and 2014, respectively. We expect 2013 to be a transition year for the region, with external risks in the US and Europe to be navigated in the first half of the year. Subsequently, after the slowdown in 2012, we see the regional economies with 'room to grow' at around trend in the coming years.	In China, we expect 7.6% and 7.7% growth in 2013 and 2014, respectively. Although growth is slightly below trend, the recent tightening in financial conditions sends the signal that policy makers are willing to tolerate slightly lower growth in order to tackle structural problems and to foster more sustainable medium-term growth.
LATIN AMERICA	We forecast that real GDP growth in Latin America will reach 2.8% in 2013, and 3.0% in 2014. Against a more favourable global backdrop, the divergence between those economies with more challenging (Brazil) and more stable (Mexico) policy outlooks is likely to increase.	In Brazil, we expect real GDP growth of 2.6% and 2.3% in 2013 and 2014, respectively. Despite two consecutive years of sub-par growth, inflation has been sticky above the inflation target of 4.5%. BRL weakness will likely force the Copom to continue to hike policy rates.
CENTRAL & EASTERN EUROPE, MIDDLE EAST AND AFRICA	With growth across the region forecast at 2.5% in 2013 and 3.3% in 2014, we expect CEEMEA to recover visibly. Helped by improvements in external demand conditions, large output gaps provide fertile ground for recovery from the 2012 soft patch, although current account deficit countries in particular will continue to face stiff challenges.	The EM differentiation theme is again visible across the region. While we forecast strong and steady growth in Israel and Russia, we see a similar recovery in Turkey as less sustainable. Growth in South Africa and Ukraine will likely be dragged down by idiosyncratic political and economic risks.

CENTRAL BANK WATCH

	CURRENT SITUATION	NEXT MEETING	EXPECTATION
UNITED STATES: FOMC	The Fed funds rate is at 0%-0.25%. The Fed initiated a new round of asset purchases and extended its rate guidance on September 13, 2012.	Dec. 18 Jan.29, 2014	We expect the Fed to keep the funds rate near 0% through 2015, and to continue asset purchases until 3Q2014.
JAPAN: BoJ Monetary Policy Board	The overnight call rate is at 0%-0.1%. The BoJ significantly extended asset purchases, as well as the related maturity horizon, on April 4, 2013.	Oct. 31 Nov. 21	We expect the BoJ to keep the policy rate near 0% through at least 2016, and to expand its monetary easing efforts through ongoing asset purchases.
EURO AREA: ECB Governing Council	The refi/deposit rates are at 0.50%/0.00%. The ECB announced the OMT programme for conditional purchases of Euro area sovereign bonds in Sept. 2012 and cut the refi rate by 25bp on May 2, 2013.	Nov. 7 Dec. 5	We expect the ECB to keep policy rates on hold through mid-2015. If, however, activity were to weaken further significantly, a rate cut and/or credit easing could become potential options.
UK: BoE Monetary Policy Committee	The BoE policy rate is currently at 0.5%. The BoE announced threshold-based forward guidance for the path of the policy rate on August 7, 2013.	Nov. 7 Dec. 5	We expect the BoE to keep the policy rate unchanged until mid-2016, with the possibility of further unconventional easing ahead.

Disclosure Appendix

Reg AC

We, Dominic Wilson, Kamakshya Trivedi, Noah Weisberger, Aleksandar Timcenko, Jose Ursua, George Cole and Julian Richers, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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