Goldman Sachs Asset Management

Monthly Insights

FROM THE OFFICE OF THE CHAIRMAN

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The Outlook for 2013 and 2014

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Introduction

As this year draws to a close, we update our GDP growth forecasts for 2013 and introduce our first look at 2014. Our overarching theme for next year is a gradual recovery in real GDP growth but at a relatively slow pace, with most economies falling short of reaching their underlying growth trends.

Our updated 2013 global growth forecast is 3.6% which is just slightly above consensus, at 3.4%. We would be further above consensus were it not for our view on China's growth where we remain relatively cautious on the cyclical rebound. We are more optimistic than consensus in the developed world, primarily in the US, as well as BRICs excluding China, particularly India and Russia. In other Growth Markets, we are more upbeat on growth prospects in Mexico and Turkey.

The continued risk themes around the Euro area and the US that have dominated our thinking and discussions this year are likely to remain on our radars. The probability of an extreme outcome in the **Euro area** has been reduced, mainly by the ECB policy action, as well as some progress on structural reforms in the periphery. As long as the ECB commitment remains credible, the main source of risks in Europe for next year will revolve around reform implementation. We believe that Italy could become an upside growth surprise for the year, especially given the low starting base and the negative sentiment surrounding it.

In the **US**, fears about a policy gridlock related to the fiscal cliff and associated growth implications are now at the forefront of most immediate US-related concerns. If a credible fiscal deal is reached in the next couple of months, which is our base case, 2013 could start on an encouraging note. We still believe that the US can grow at 2.3% in 2013, which is above consensus. However, a prolonged period of negotiations and/or a less "growth-friendly" fiscal deal would be the main sources of downside growth surprises and market volatility.

Among other risks for next year, we also highlight policy and growth surprises in **Japan**. The country's difficult macroeconomic situation consisting of sluggish growth, deflation, a weakening current account driven by declining export competitiveness and a seemingly unsustainable fiscal situation, suggests to us that decisive policy action is needed. A meaningfully weaker Yen and a credible fiscal sustainability package should prevent the economy from going into another deep recession and the debt markets from unravelling. Without these policies, we see considerable downside risks to our growth forecast.

In terms of asset market implications, the moderate global cyclical rebound that we are forecasting should be mildly supportive for risk assets in 2013, particularly in those areas where valuations remain suppressed. Risk assets should be further helped by the continuing monetary accommodation by major central banks. We believe the Chinese equity market could finally rally, and equities in Russia, Brazil and Italy, could also perform well, particularly if growth surprises on the upside. In fixed income, developed market yields should generally remain low, particularly at the front end. In currencies, we think the USD will remain range-bound against most currencies, except the USD/JPY, where we expect a meaningful rally.

Wrapping Up 2012

At the end of last year we started to introduce our own GSAM growth forecasts for the major developed countries and eight Growth Markets. Since then we have added a number of tools to our forecasting framework aimed at improving the accuracy of forecasts and giving us a rationale for any revisions. As this year draws to a close, we assess how our original 2012 growth forecasts have fared relative to consensus as well as actual outcomes.

We started the year below consensus for global growth overall as well as forecasts for the two main groupings, Developed and Growth Markets. Over time, consensus expectations have converged down towards our forecasts in a number of places, particularly in the Euro area, China and India. In the end we had to lower our 2012 forecast further with the actual outcome in the vicinity of 3.1% which is 30bp lower than our initial expectation and 60bp lower than that of consensus (as of November 2011).

Thinking about what we got right and where we went wrong, our initial forecasts for most of the developed world, except the UK, were close to the current numbers, particularly for the Euro area. In Growth Markets, downside growth surprises in China, India, Brazil and Korea stand out. While we were correct in three of these places versus consensus expectations (China, India and Korea), we initially underestimated the degree of slowdown these economies experienced relative to 2011. On the other hand, we were too pessimistic on Russia and Turkey at the start, but made upward adjustments early in the year as it became clear they could do better than expected. In terms of the main risks we highlighted for this year, upside growth surprises in Russia and Turkey as well as a downside growth surprise in China were indeed on the list.

Looking into 2013 and 2014

Table 1 shows our updated 2012 and 2013 real GDP growth forecasts versus consensus as well as our first take on the 2014 outlook. It also shows our view of the underlying growth trend in each of the countries and country groups.

Our overarching theme for next year is a gradual growth recovery but at a relatively slow pace, with most economies falling short of reaching their underlying growth trends on average for the year. In our view, only China, Mexico, Indonesia and Turkey can achieve, or even beat, their growth trends. In terms of momentum, we expect mild growth acceleration in the developed world, mainly driven by the UK and the Euro area coming out of recession. Japan is the only country in our universe where we expect a slowdown from this year's growth. Within Growth Markets, momentum should pick up more meaningfully in Brazil and Turkey and moderately in other places, particularly in Asia.

Table 1: GSAM and Consensus real GDP growth forecasts

	Trend Growth	2012		2013		2014
		GSAM	Consensus*	GSAM	Consensus*	GSAM
US	2.5	2.1	2.2	2.3	1.9	2.5
UK	2.3	-0.2	-0.1	1.5	1.3	2.0
Canada	2.5	2.0	2.0	2.0	2.0	2.5
Euro Area	2.0	-0.4	-0.5	0.2	0.0	1.5
Japan	1.5	1.9	1.8	0.7	0.8	1.5
Brazil	5.0	1.8	1.6	4.0	3.9	5.0
China	7.5	7.7	7.7	7.9	8.1	7.7
India	7.5	5.9	5.6	7.0	6.6	7.5
Russia	5.0	4.0	3.7	4.0	3.6	5.0
Mexico	4.0	3.9	3.9	4.0	3.6	4.0
Korea	3.5	2.5	2.3	3.3	3.3	4.0
Indonesia	5.8	6.0	6.2	6.3	6.0	6.0
Turkey	5.0	3.0	2.9	5.0	4.0	5.0
Advanced	**2.2**	**1.1**	**1.1**	**1.4**	**1.1**	**2.0**
BRICs	**7.0**	**6.3**	**6.1**	**6.9**	**6.8**	**7.1**
Growth Markets	**6.5**	**5.7**	**5.6**	**6.4**	**6.3**	**6.6**
World	**4.1**	**3.1**	**3.1**	**3.6**	**3.4**	**4.1**

*As of November 2012.

Source: Consensus Economics, GSAM

Our latest 2013 global growth forecast is 3.6% which is just slightly above consensus, at 3.4%. We would be further above consensus were it not for our view on China's growth where we remain relatively cautious on the cyclical rebound. We are more optimistic than consensus in the developed world, primarily in the US, as well as BRICs excluding China, particularly India and Russia. In other Growth Markets, we are more optimistic on growth prospects in Mexico and Turkey.

This ongoing gradual turnaround in the global cycle should become more visible throughout 2013 and is already tentatively backed up by a number of leading indicators. The Global Leading Indicator (GLI) produced by GS Global ECS Research points to a positive outlook for the months ahead. As *Exhibit 1* shows, the GLI momentum flipped into the positive territory in September and had been creeping higher since until the interruption of Hurricane Sandy. While this is a certainly a good sign, the improvement has been tentative so far, suggesting that it might take a few months for global growth recovery to become well-entrenched.

Looking beyond next year we see a theme of gradual convergence to trend growth as opposed to any sharp rebound as a result of the continued withdrawal of government stimulus in developed countries. This means that most of our country GDP forecasts for 2014 are near trend with the exception of both Europe and the UK which remain below.

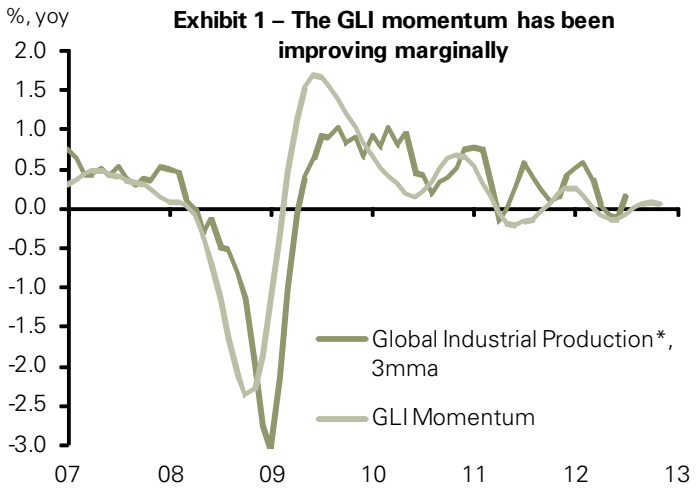


Exhibit 1 – The GLI momentum has been improving marginally

Source: GS Global ECS Research

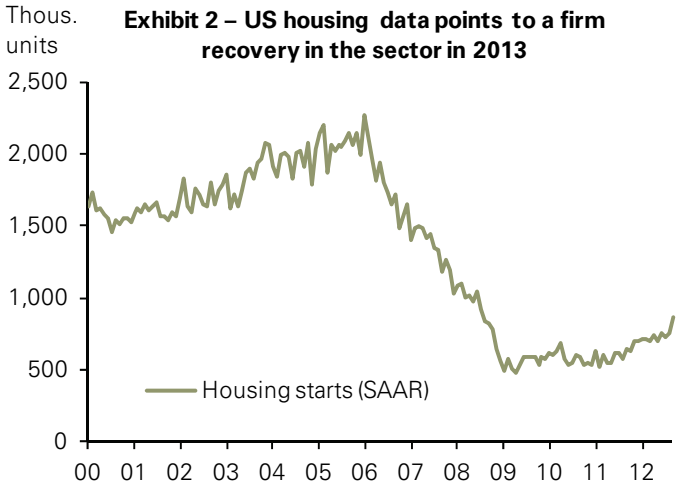


Exhibit 2 – US housing data points to a firm recovery in the sector in 2013

Source: Haver Analytics

US Growth Acceleration with Shorter Term Risks

While we turned less optimistic on the US during the course of this year, recent data has improved with some areas showing renewed signs of improvement. The labour market, consumer confidence, some housing indicators and trade have all positively surprised in recent weeks. However, these surprises have been marred by the looming fiscal cliff at the end of the year. With the election outcome maintaining the status quo, fears about a policy gridlock surrounding the fiscal cliff and associated growth implications are the main source of short-term risks to next year's outlook.

If a credible fiscal deal is reached in the next couple of months, which is our base case, 2013 could start on an encouraging note. We assume that the fiscal tightening will amount to around 1.0-1.5% of GDP. Offsetting the fiscal drag will be the housing market which, after bottoming out this year, should stage a firm recovery in 2013, in our view. Recent housing market data has been positive, with housing starts, for example, gaining momentum over the last few months, as illustrated in *Exhibit 2*. In addition, once the uncertainty related to the fiscal cliff resolution is out of the way, we might also see a turnaround in the investment cycle and a continued improvement in the labour market, adding to the positive growth dynamics.

We expect real GDP to grow at 2.3% in 2013, which is above consensus of 1.9% and just marginally higher than the likely final growth outcome for 2012. While there are clear downside risks to this view, mostly associated with the fiscal cliff, we can also see a possibility of upside surprises, particularly if the pick-up in the rest of the world turns out to be faster than expected.

Euro Area (Just) Out of Recession

Current data continues to suggest that the Euro area economy is still in recession on aggregate. This raises the likelihood of some negative momentum in Q4 carrying over into Q1 of next year. The recent signs of further slowdown in Germany have been particularly worrying. The PMIs remain below 50, i.e. in the contractionary territory, and other indicators of activity and confidence remain subdued.

Despite this negative backdrop, we believe the Euro area can deliver moderately positive growth, at 0.2% in 2013 and 1.5% in 2014. This is driven by a number of factors. Firstly, we expect the current slowdown in Germany to be short-lived, with growth recovering in Q1 on the back of domestic demand and exports. The latter will be a particularly important part of Germany's 2013 growth story as the global cycle turns and demand for exports picks up, particularly from China and the US.

In addition, we believe that Italy could become an upside growth surprise for the year, especially given the low starting base and the negative sentiment surrounding it. In terms of growth, while recession continues, our current activity indicator for Italy suggests that we are past the bottom of the cycle. One risk to this view is the pace of structural reform implementation. As *Exhibit 3* illustrates, Italy is the only country in the European periphery where there has been no progress on lowering the relative unit

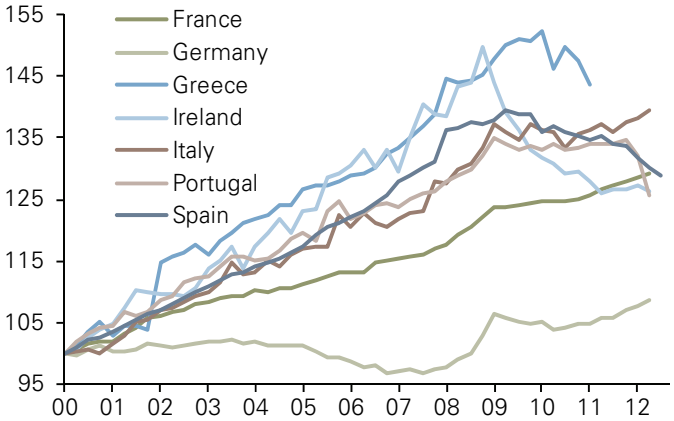
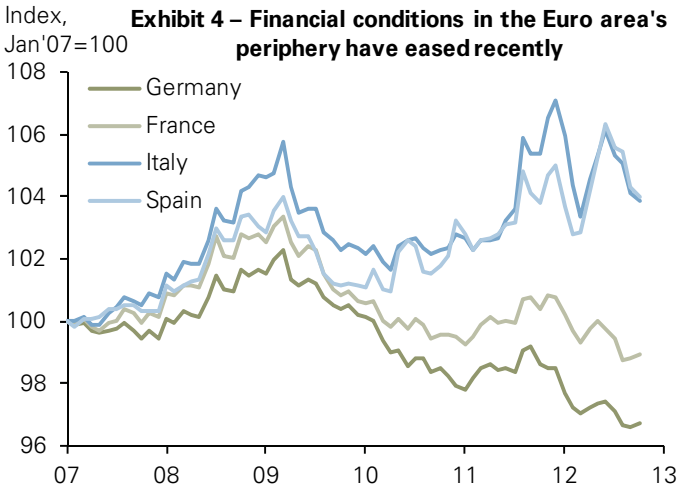
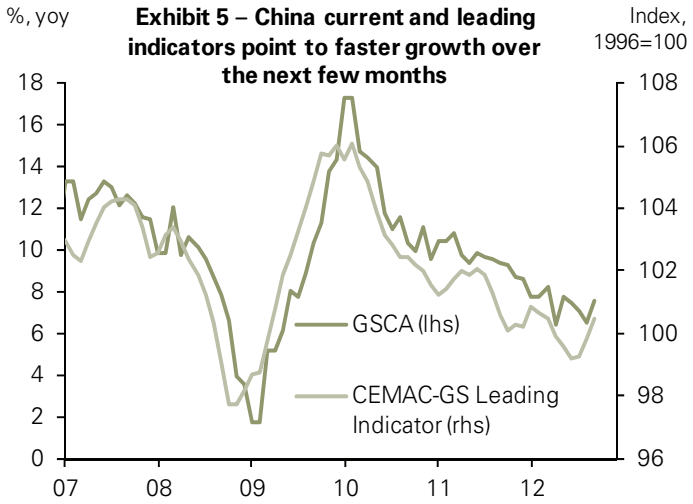


Exhibit 3 – Most peripheral countries have lowered their unit labour costs, except Italy

Source: Haver Analytics, GSAM calculations



Source: GS Global ECS Research



Source: GS Global ECS Research

labour costs (ULCs). If planned structural reforms, particularly the labour market package, do get pushed through, this could temporarily cap Italian growth. Linked to this, other countries in the European periphery have already improved their competitiveness which should support growth in places next year.

Finally, financial conditions in the core continue to remain extremely accommodative and, given the strong ECB commitment, should, in our view, stay at all-time lows throughout next year. It is encouraging to see that the recent leg of easing in financial conditions has not been solely driven by loosening in Germany (as has previously been the case) but mainly by the periphery, as *Exhibit 4* illustrates. Linked to these easier financial conditions, there have been some signs of improved European credit markets recently—a modest but positive development.

Apart from the usual risks surrounding the state of the Euro area crisis, risks to our forecasts also include lower-than-expected growth in the core. It is true that the data we are currently seeing out of France and Germany is weak. We believe this will prove temporary but were this to continue into next year we would undoubtedly lower our Euro area forecast. Also, any cyclical headwinds to the global cycle are likely to prolong the Euro area recession.

China Cyclical Rebound versus Structural Slowdown

With the political transition out of the way, we are now looking for further signs of a moderate cyclical rebound in China. The risk related to a hard landing has subsided in light of better data recently pointing to the bottom of the cycle at the end of 2012. As *Exhibit 5* shows, China's current activity and leading indicators are pointing to incrementally faster growth over the next few months. With inflation well below the target and the housing sector in a better shape, further monetary easing also seems likely. For now, we forecast only a relatively minor acceleration for 2013, to a growth rate of 7.9% which is below consensus, followed by 7.7% in 2014.

Our relatively cautious view on China's cyclical rebound is based on our continuous belief that, instead of focusing on the quality of growth, Chinese policymakers will likely continue rebalancing the economy towards a slower, more sustainable growth model driven by private consumption. A resolute push towards rebalancing would cap the cyclical rebound by limiting the traditional engines of Chinese growth, such as exports. We will, however, be mindful of any faster-than-expected acceleration in growth, which might lead us to revise up our 2013 forecast.

The interplay between the cyclical pick-up and rebalancing towards slower growth should become the defining focus of the China story in 2013-2014. With the new leadership in place, delivering the structural reforms outlined in the 5-year plan should take centre stage. To be clear, we do not expect bold changes, but a gradual progress on the reform path started last year. This means further focus on lifting the role of the consumer in driving growth, raising welfare and living standards, moving towards higher energy efficiency and better environmental sustainability. We also expect further steps towards the RMB internationalisation and opening up of financial markets to foreign investors.

Other Growth Markets to Pick-up Slowly

We forecast an acceleration in Growth Markets momentum, from around 5.7% this year to 6.4% in 2013 and 6.6% in 2014, in line with the global growth rebound. There is some heterogeneity within the group. For example, Brazil and Turkey are expected to accelerate more meaningfully, while Russia and Mexico are likely to repeat a similar growth pace to that seen in 2012.

In Brazil, the sluggish investment cycle remains the main drag on growth. One of the urgent tasks for Brazil's policymakers next year is holding onto the new regime of lower real interest rates and less overvalued currency at the same time as implementing reforms to encourage private sector investment, including the recently announced measures. In India, we are looking for further reforms in the

infrastructure sector, capital markets, as well as fiscal consolidation. In Russia, we expect continued focus on keeping inflation low as well as on diversifying the economy away from commodities.

Global Risks Remain

Thinking about the risks to our outlook, we turn to the global risks around which we have structured our macro and market views for 2012.[1] While the nature of those themes has evolved throughout the year, it is clear that most of them will continue to be on the radar. For 2013-2014 we identify the following risk areas: (1) the EMU crisis; (2) the US fiscal cliff; (3) Japan policy and growth surprises; (4) the Middle Eastern tensions and oil prices.

The risk related to the **EMU sovereign debt crisis** still remains but the probability of extreme outcomes has been reduced, mainly by the ECB policy action, as well as some progress on structural reforms in the periphery. Significant set-backs on the path towards higher growth and fiscal sustainability could prolong the recession and unsettle the markets. On the other hand, given the low expectations, we could see upside growth surprises, particularly if any structural progress in the periphery gets more visibility. We remain constructive Europe's medium- to long-run prospects.

The looming **US fiscal cliff** is now at the forefront of most immediate US-related concerns. A prolonged period of negotiations and/or a less "growth-friendly" fiscal deal would be the main sources of downside growth surprises and market volatility as we have already discussed.

Among other risks for next year, we would highlight **policy and growth surprises in Japan**. The country's difficult macroeconomic situation consisting of sluggish growth, deflation, a weakening current account driven by declining export competitiveness and a seemingly unsustainable fiscal situation, suggests to us that decisive policy action is needed. A meaningfully weaker Yen and a credible fiscal sustainability package should prevent the economy from going into another recession and the debt markets from unravelling. Without these policies, we see downside risks to our growth forecast.

While the **Middle Eastern tensions** continue, the implied risk premium of a serious supply disruption in the oil price seems to have compressed, at least for now. Depending on the turn of events, a prolonged supply shock remains one of the key risks to global growth. From a long-term perspective, we continue to see lower oil prices.

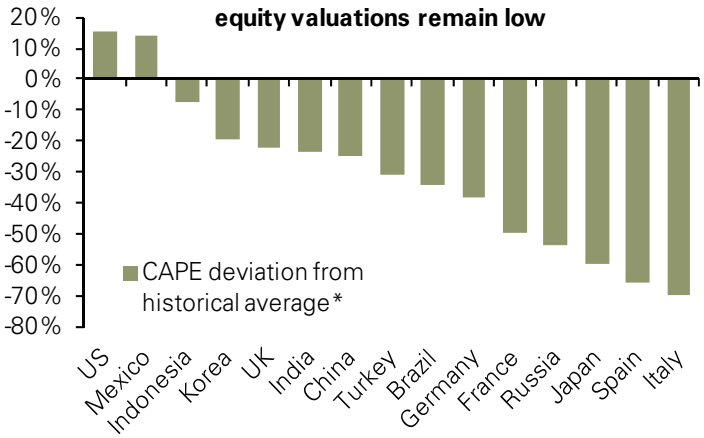
Asset Market Implications

Our thinking about the implications of this growth outlook for asset markets in 2013 revolves around the strength of the cyclical forces, valuations, the probability of tail risk events as well as central bank policies. Overall, the moderate global cyclical rebound that we are forecasting should be mildly supportive for risk assets in 2013, particularly in those areas where valuations remain suppressed. A rally should be further helped by the continuing asset accumulation by major central banks.

For many **global equity markets**, especially outside the US, valuations remain extremely low, both in absolute terms and on a relative basis. Europe, Japan and the BRICs, as *Exhibit 6* illustrates, all look cheap on a cyclically-adjusted PE (CAPE) basis (although a word of caution is warranted about Japan's rather inflated history) and could also perform well, particularly if growth surprises on the upside. On the other hand, US and Mexican equities look relatively expensive. As we discussed on our October *Monthly Insights*, which broadly focused on the Equity Risk Premium (ERP), the fact that major developed bond markets are so expensive should be supportive for equities. Amongst other things, the high ERP is a reflection of both central bank purchases and investor over-exposure to fixed income. For example, since the start of January 2007, fund flows into US fixed income mutual funds have totalled $1.2 trillion versus outflows of $420 billion from equity funds.[2] Therefore, even in places such as the US where the absolute valuation argument is not as strong, both positioning and valuation relative to other asset classes could provide support to equities.

In **fixed income**, the global low yield environment is set to prevail for now. In the US, we expect the Fed to continue to keep the front end of the Treasury curve well-contained.

Exhibit 6 – CAPE ratios suggest overall global equity valuations remain low



* The length of historical series for each country varies. Generally, for DM it is over 30 years while for Growth Markets it is 15 years.
Source: Haver Analytics, Datastream, GSAM calculations

[1] "Global Risks and Investment Implications", *GSAM Monthly Insights*, September 2012.

[2] "The Search for Yield Turns to Equity", GS Global ECS Research, 14 November 2012.

However, the long end could be more vulnerable to a sell-off on the back of potential upside growth surprises. In Europe, we believe the tug-of-war between the markets, policymakers and the ECB will continue into next year, making it difficult at the moment to have too strong a view on European bonds. It is likely that market sell-offs will remain an important part of the mechanism to force policymakers and the ECB to do more. So far, the ECB rhetoric has been enough to hold down the spreads between the core and periphery. Given the ECB's commitment, we believe that further spread widening could present a good buying opportunity.

In **currencies**, it seems to us that there is no strong bull or bear case for the USD, at least for now. On most fair value models the USD remains cheap which could continue as long as the Fed maintains its easy stance. Unless global growth disappoints significantly and/or some of the downside risks materialise, the USD will remain range-bound against most currencies, including the EUR. One exception is the USD/JPY which we expect to stage a meaningful rally in 2013 (arguably, we are already seeing the first signs of that) based on the risks surrounding the Japanese economy discussed above.

In **commodities**, we continue to see downside risks to energy prices. The 5-year forward oil price, which is a good proxy for a medium-term equilibrium price, remains well-anchored between $80-$90bbl, suggesting little structural upside to the current spot price. Short-term supply and demand shocks should provide buy/sell opportunities around this level.

Appendix

GDP Growth Forecasts: GSAM vs Consensus

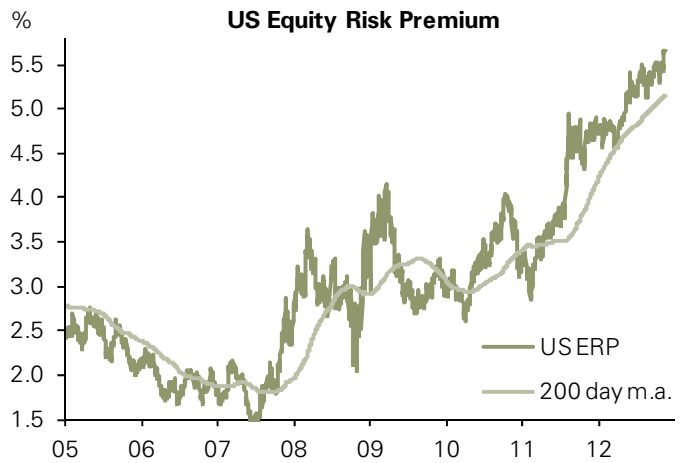
	GSAM Trend Growth	2011	2012		2013		2014
			GSAM	Consensus*	GSAM	Consensus*	GSAM
US	**2.5**	1.7	2.1	2.2	2.3	1.9	2.5
UK	**2.3**	0.7	-0.2	-0.1	1.5	1.3	2.0
Canada	**2.5**	2.5	2.0	2.0	2.0	2.0	2.5
Euroland	**2.0**	1.5	-0.4	-0.5	0.2	0.0	1.5
Japan	**1.5**	-0.7	1.9	1.8	0.7	0.8	1.5
Brazil	**5.0**	2.7	1.8	1.6	4.0	3.9	5.0
China	**7.5**	9.2	7.7	7.7	7.9	8.1	7.7
India	**7.5**	6.9	5.9	5.6	7.0	6.6	7.5
Russia	**5.0**	4.2	4.0	3.7	4.0	3.6	5.0
Mexico	**4.0**	3.9	3.9	3.9	4.0	3.6	4.0
Korea	**3.5**	3.6	2.5	2.3	3.3	3.3	4.0
Indonesia	**5.8**	6.5	6.0	6.2	6.3	6.0	6.0
Turkey	**5.0**	8.5	3.0	2.9	5.0	4.0	5.0
Advanced	**2.2**	1.3	1.1	1.1	1.4	1.1	2.0
BRICs	**7.0**	7.4	6.3	6.1	6.9	6.8	7.1
Growth Markets	**6.5**	7.0	5.7	5.6	6.4	6.3	6.6
World	**4.1**	3.8	3.1	3.1	3.6	3.4	4.1

*As of November 2012. Source: GSAM and Consensus Economics

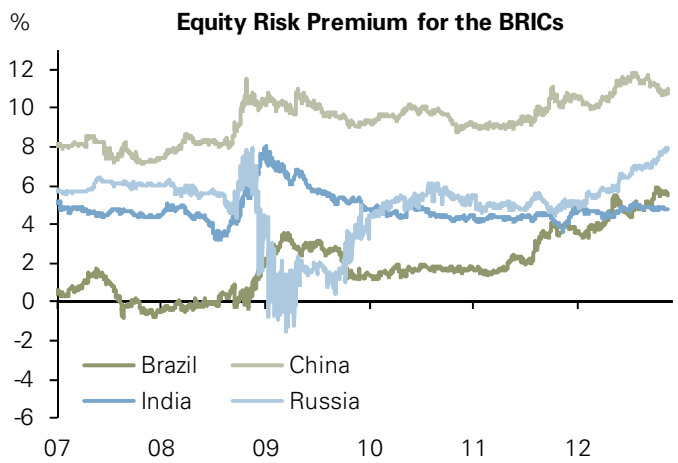
Global Equity Risk Premium*

	Real GDP Growth Trend	Real Earnings Growth	+	Dividend Yield	=	Expected Real Return	-	Real Bond Yield	=	Implied ERP	Expected Inflation	Expected Nominal Return
US	2.5	2.5		2.3		4.8		-0.8		**5.7**	2.0	6.8
UK	2.3	2.3		3.6		5.9		-1.3		**7.1**	2.0	7.9
Europe ex UK	2.0	2.0		3.7		5.7		0.0		**5.7**	2.0	7.7
Japan	1.5	1.5		2.6		4.1		0.4		**3.7**	1.0	5.1
Brazil	5.0	5.0		4.0		9.0		3.5		**5.5**	4.5	13.5
China	7.5	7.5		4.0		11.5		0.5		**11.0**	3.0	14.5
India	7.5	7.5		1.5		9.0		4.2		**4.8**	4.0	13.0
Russia	5.0	5.0		4.4		9.4		1.4		**8.0**	6.0	15.4
GDP-weighted												
Advanced	2.2	2.2		2.9		5.1		-0.4		**5.4**	1.8	6.9
BRICs	6.7	6.7		3.7		10.5		1.6		**8.8**	3.8	14.2
World	3.5	3.5		3.1		6.6		0.2		**6.4**	2.4	9.0
PPP-weighted												
Advanced	2.2	2.2		2.9		5.1		-0.4		**5.5**	1.9	7.0
BRICs	6.9	6.9		3.5		10.4		1.7		**8.7**	3.7	14.2
World	4.1	4.1		3.1		7.2		0.4		**6.8**	2.6	9.8

*As of 09 Oct 2012. Source: GSAM calculations



Source: GSAM calculations



Source: GSAM calculations

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