November 19, 2014

Global Viewpoint

Economics Research

Top Ten Market Themes for 2015

Today's *Global Economics Weekly*, 'Keeping the faith', describes the main elements of our economic forecasts for 2015 and beyond. Here, we lay out the top macro themes that we think will dominate asset markets in 2015. We also summarise our outlook for broad asset classes.

1. A Broadening Recovery

2. DM Divergence Lives On

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Top Ten Market Themes for 2015

1. A Broadening Recovery

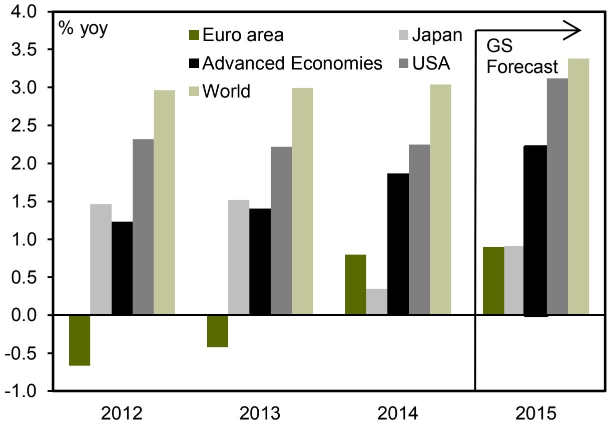
- US recovery remains firm – still the primary engine driving global growth.
- Europe/Japan helped by oil and financial conditions.
- Somewhat better EM profile outside China.
- Shocks from Euro area, China still the big risks.

We expect the shift to sustained above-trend growth in the US that took place in 2014 to be maintained in 2015. While the US activity picture is to a degree 'more of the same', it remains the strongest anchor of the global recovery. By contrast, the growth picture in Japan and the Euro area – while much less impressive in absolute terms – is likely to look a little better, at least relative to the notable weakness in mid-2014. Easing financial conditions, lower oil prices and some relaxation in lending conditions should all help. So the DM activity picture should look a little better overall. And although China's growth is likely to slow further in underlying terms, other parts of EM should also see better growth as the DM recovery flows through. Our forecasts for global growth are therefore also somewhat higher than for 2014.

The key market question, as always, is how much that view is already priced. Much of the forecasting community agrees that the US growth picture will remain stable. Even so, we think our own views and conviction remain higher than others. We also have more confidence in our view that the US expansion has several years to run and in the resilience of the US economy to weak overseas demand. Cyclical/defensive splits in US equities suggest that, while the market has recovered a lot of ground from the October 'growth scare', it still may not have fully reversed its worries there. We think our view that Euro area growth may be set to improve a little is more controversial, even though that too is reflected in many forecasts. While we also think there is a real downside risk scenario in the Euro area, we are not convinced that the market is adequately reflecting the prospect of improved US growth over the next few months.

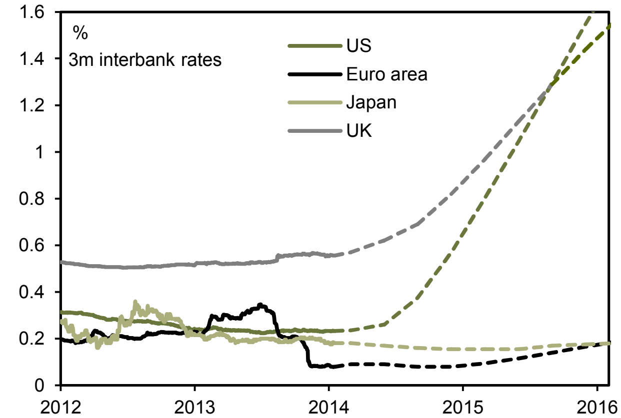
The extent to which non-US activity can reassure investors is central to how to position for recovery. Through 2014, US stocks have outperformed not just in USD terms, but also in local currency. The continuation of USD strength will continue to eat into non-US returns on an unhedged basis. But to the extent that monetary easing is accompanied by better growth in the Euro area and Japan, local equity markets (FX hedged) may do better than the pairing of a long US equity view with a long USD position. The biggest risks to some broadening in the DM and global recovery stem – in our view – from the Euro area and China. The risks we worry about most are a re-emergence of Euro area political tensions, a switch to a 'deflationary mindset' in Germany, or a sharper downward shock from China's housing and credit imbalances. And it is against these risks that portfolio protection may prove to be most useful.

Exhibit 1: The global growth recovery broadens out
Real GDP growth



Source: Haver Analytics, Goldman Sachs Global Investment Research

Exhibit 2: The 'Great Divergence'
Dotted lines show path implied by forward contracts



Source: Bloomberg, Goldman Sachs Global Investment Research

2. DM Divergence Lives On

- Europe and Japan fail to match above-trend US growth.
- Fed moves towards exit as ECB and BoJ maintain easing.
- De-synchronised monetary exits, reminiscent of US-Germany in early 1990s.

Divergence between the US and other DM economies – particularly the Euro area – has already emerged as a key theme in 2014. And the gap between US growth and Euro area growth (even adjusting for trend) is likely to remain wide. On an annual average basis, we expect that gap to widen. But, in reality, much of that reflects the unusual weakness of the US 2014Q1 GDP numbers. Measured through the year, the modest acceleration in non-US growth means that growth differentials between the US and others are probably set to narrow a little.

This does not mean, however, that divergence as a market theme is past its peak. With GDP growth only clearly above trend in the US (of the major economies) even in 2015, output gap divergence is likely to come with it. And differentials in core inflation dynamics are also likely to remain wide. Most clearly, divergence in monetary policy is set to extend, with the Fed likely to start its hiking cycle (in September 2015), while the ECB and BoJ continue to head down a path of easing and balance sheet expansion. This divergence has both an absolute and a relative dimension. In absolute terms, within DM economies, the continuation of softer growth and lower inflation in much of the non-US DM world will continue to keep the US yield structure lower than it would otherwise be. That force is likely to be less intense than it was in 2014, when Bund yields have helped to drag UST yields lower. But it is one reason to be confident that the rise in US yields will continue to be relatively moderate. On a relative basis, we think there is still scope for front-end rate differentials between the US and many others to widen further, which is a key driver of our view of a stronger USD (more in Theme 5 below).

Divergence will not simply be a G3 phenomenon. A key question for 2015 is whether the smaller open economies like the UK and Norway will 'follow the Fed' and raise rates (we expect the BoE to hike in Q4 and Norges Bank to hike in December), or whether they are pushed later by the winds of slow growth and low inflation blowing in from the Euro area. In addition, political uncertainty may raise its head again, with elections in Portugal, the UK and Spain through the year.

3. The New Oil Order

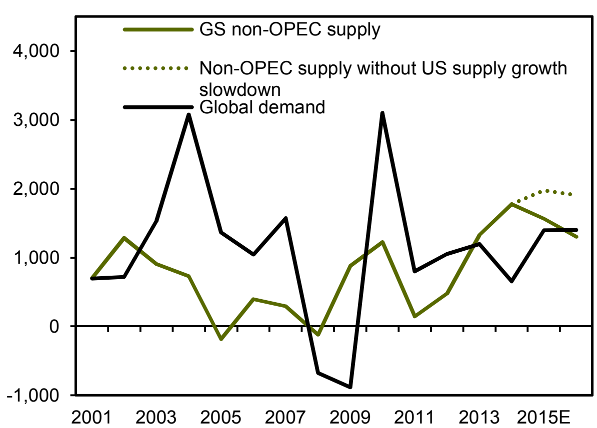
- Oil falls further; commodities disinflation continues.
- A positive impact on disposable income and growth.
- A stimulus for consumers and stress for producers, with far-reaching effects.

The $30/bbl fall in oil prices since the summer has announced the arrival of the 'new oil order' with a bang. This fall came earlier than our forecasts, although we have been highlighting the risks from the positive supply shock to oil production from tight Shale formations in the US and the concomitant downside risks to oil prices for at least a couple of years now. And while it would be natural to see a period of consolidation after such sharp moves (and our forecasts show limited further downside from here), it is important to note that the scope for downside surprises is not finished. A material expansion in oil service capacity in recent years is likely to lead to 5%-15% cost deflation across oil developments, and positive production surprises from Libya, Iraq and Iran could further reinforce an oversupplied market in the coming year.

The direct implications of this price shift are significant. Oil is an important input into several production processes, including other commodities such as industrial metals, so this is likely to reinforce the downside risks to copper and aluminium prices. The disinflationary impulse from lower commodity prices sweeping across the world is likely to be manifested first in lower headline inflation rates. But, by boosting disposable income, there is also likely to be a positive impact on GDP growth in EM and DM oil importers that should become visible as the year progresses.

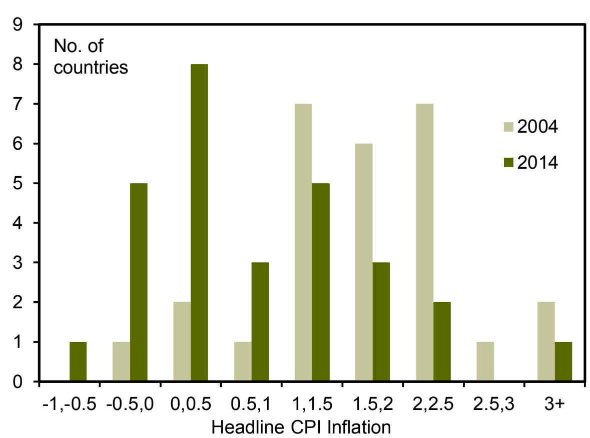
Beyond the direct implications for commodity prices, these shifts will also have far-reaching secondary implications. Equities and credits in oil producer and oil service companies are likely to be most affected, especially where business models and leverage levels are based on significantly higher oil price assumptions. Analogously, pressure is also likely to build on countries where oil (and commodity) exports are a key source of revenues, although this can manifest in different ways: weaker currencies (which can shield local currency revenues to a limited extent), a squeeze on fiscal spending or a sharp fall in investment. Some of these dynamics, primarily on the currency front, are playing out in Russia and Nigeria. On the flipside, for oil-importing consumer sectors and countries (e.g., India or Turkey), this should have positive effects all around (growth, margins and revenues).

Exhibit 3: Non-OPEC oil supply growth is outpacing demand growth
YoY, thousand barrels per day



Source: IEA, Goldman Sachs Global Investment Research

Exhibit 4: Low inflation rates across the world as the Fed contemplates a new hiking cycle
Sample includes DMs and 'DMs of EM'



Source: Haver Analytics, Goldman Sachs Global Investment Research

4. Lowflation and the Fight Against It

- Slack remains large and wage pressure slow to return.
- Commodity disinflation flows through.
- Negative rates, asset purchases, FX interventions.

Inflation trends have played a big role in markets in 2014, particularly the focus on falling Euro area inflation, and are likely to continue to do so in 2015. Despite some modest improvement in growth, disinflationary forces are likely to remain powerful. Even in the US, where growth has been strongest, the very moderate rate of wage inflation supports our view that the labour market still has plenty of effective slack. Those forces are even more powerful in much of Europe. Declining oil prices are likely to reinforce the downward pressure on headline and – to a lesser extent – core inflation until well into 2015.

As a result, a large number of central banks – not just in DM but in several of the smaller EM economies – face inflation below their targets. Indeed, excessively low inflation and now technical deflation, on a headline basis at least, has already been a visible and unwelcome new development in several places. Moreover, undesirably low inflation has been a major force in prompting fresh central bank action in recent months, including from the ECB, Riksbank and BoJ. The Euro area is likely to remain at the heart of this debate. Although our central case sees a modest stabilisation in inflation this year, there is a meaningful risk that a more acute deflationary mindset takes hold instead.

We think the response to that kind of risk, where it emerges, is likely to be a powerful force in markets. The ECB is already moving along its path towards credit easing. And while we see the ECB as more reluctant to embrace sovereign QE in our central case, we think a clearer shift towards a more negative scenario would ultimately trigger a more aggressive QE program than the market expects. The Kuroda-led BoJ has also forcefully reaffirmed its commitment to raising inflation expectations. Both in Japan and in Europe, if those attempts are successful, alongside pushing real rates lower, they are likely to imply further weakness in forward and spot exchange rates. The same dilemmas are likely to see a number of the 'DMs of EM' – Israel, Korea, Poland, the Czech Republic and even Hungary – consider further steps towards easing, or at least welcome further currency depreciation as part of their own efforts to prevent inflation from falling further.

5. The Dollar Bull Market

- Broad-based USD strength …
- … particularly against G10.
- A multi-year trend in a multi-year US recovery.

USD strength has been a feature of our views in 2014 and its continuation, particularly against G10, arguably remains our strongest asset market view looking through 2015. Within that view, continued declines in the EUR/$ rate are the single most important element, but we expect further meaningful weakness in the JPY as well. We think the combination of widening 2-year rate differentials, downward pressure on oil prices and continued resilience in the US growth picture all support that view.

Given that the USD was among the strongest global currencies in 2014, that the view that USD strength will continue is now quite well-subscribed and that forward markets already price a significant widening in US policy rates versus many others, the key question is why it should continue. We think rate differentials have scope to widen further still, even versus the forward pricing, and if the ECB and BoJ are successful in raising inflationary expectations, as they are trying to do, real rates may move in the USD's favour even without much movement in the nominal structure. We forecast EUR/$ at 1.15 and $/JPY at

130 by end-2015 (moving to parity and 140 in 2017). The bigger story is that we are in a multi-year phase of USD recovery, as the forces that drove the long period of USD weakness reverse, and that the market may be underestimating the scope and persistence of that trend. Relative to a long historical perspective, the USD strength so far looks modest. Nor does the USD look strong on that basis relative to much of the G10. Given that the view is more subscribed – and that positioning therefore tends to build – we think it makes sense to be more ambitious about targets and size and structure positions accordingly.

The USD is also likely to strengthen against much of EM (although not always clearly more than the forwards). In addition to the scope for rate differentials to widen, we think currency depreciation will remain (i) an important channel of adjustment in ZAR and BRL, where current account deficits are still wide, (ii) a means of rebalancing economies towards non-commodity-producing sectors in the commodity producers (including in RUB and COP), and (iii) a tool in the battle against very low rates of inflation, including in KRW, ILS and Central and Eastern Europe (including the HUF, RON, CZK and PLN).

6. Fed: Later, Steeper, Further, Calmer

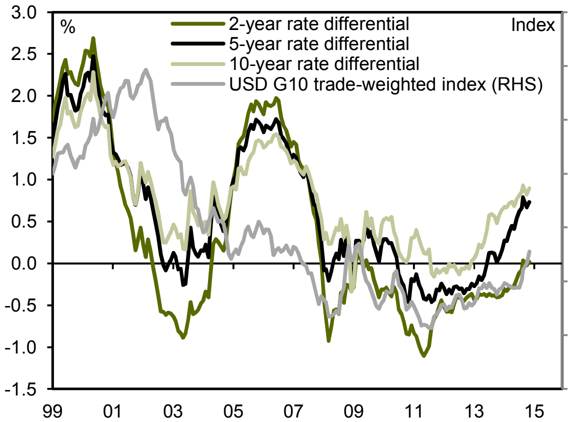
- Fed's first hike likely to come late.
- Exit should prove more manageable than feared.
- But the path may be steeper and the terminal rate higher.

We have had a long-standing view that the Fed's first rate hike would come relatively late, given a benign inflation picture and the asymmetric risks around moving too early. In the last two months, the market has moved close to our view of a September 'lift-off' date, so our near-term views are no longer clearly dovish to market pricing, although the skew around our September forecast is for a later start. Once the Fed begins to hike, however, our implied path is more hawkish than the market in two respects. First, we think the Fed is likely to move the funds rate somewhat faster than the market now expects (although slower than in past cycles). Second, we think that the neutral rate is still around 4% and so rates will ultimately climb further than the market is pricing. As a result, our view of the rates path further out in the forecast is now clearly above what the market is pricing and by a significant margin by 2017.

As a result, an important judgment is when the debate might shift from the lift-off date – where our view is still friendly – to a focus on where the funds rate is ultimately heading. In the run-up to tightening in 2003-04, the initial market repricing did not occur until the first hike was relatively close at hand. And once the tightening cycle began, the market *systematically* underestimated the hikes that would be delivered. In that case, many of the highest risk-reward opportunities to express the view began only once the Fed was already in motion. There may be an element of that in this cycle too, which counsels for keeping some powder dry for that point. But, given the recent rally, this means that the opportunities look better than at the start of 2014, even as a bruised investor base seems less willing to pursue them.

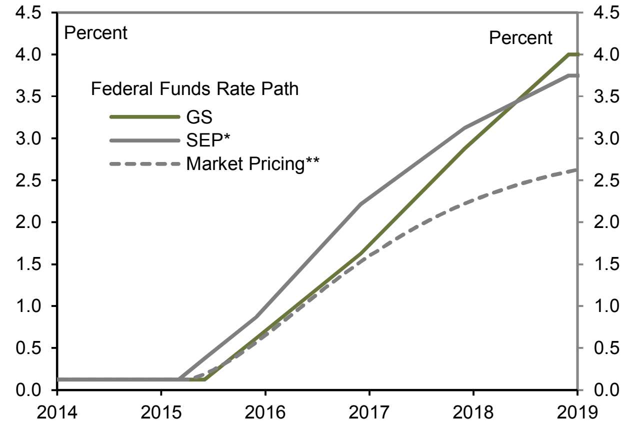
Although we think the Fed will probably take the funds rate higher than the market expects, we also have a stronger view than many others that the tightening process will prove manageable. A gradual normalisation of policy rates in line with an improving economy may lead to bouts of volatility (as in 2004) and a flattening of the equity market uptrend. But we doubt that it will prove disruptive for risk assets or the economy in a sustained way. Dire predictions for the impact of tapering asset purchases have proved wrong. The downward pressure on long-dated yields from overseas easing and disinflation has been helpful here. But with some of that likely to continue, a calmer reaction may make it easier for the Fed to proceed more deliberately, since financial conditions tighten only modestly.

Exhibit 5: USD strength will extend as front-end differential widens



Source: Goldman Sachs Global Investment Research.

Exhibit 6: A late lift-off but we expect a hiking cycle that is steeper and goes further



** Path implied by 5th-lowest SEP dot. We use mid-2019 for the longer-term funds rate projection, in line with previous FOMC communications that the funds rate would rise gradually over 2-3 years after 2016.** Derived from Eurodollar futures - Fed Funds basis swaps. Source: Federal Reserve, Bloomberg, Goldman Sachs Global Investment Research.*

7. China's Bumpy Downshift Continues

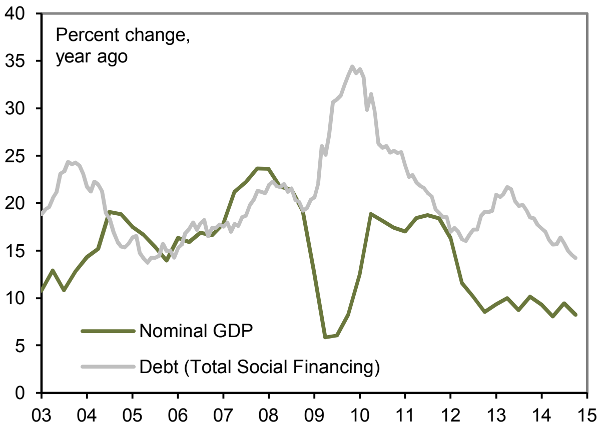
- A further fall in potential and actual growth.
- Stop-start demand management to continue.
- Working through imbalances will increase macro and market volatility.

The 2015 picture in China remains multi-faceted. At the most apparent level, markets will focus on the month-to-month fluctuations in activity and policy, the anti-corruption campaign and the shift towards a 'cleaner' growth model. Peel away a layer and the picture is likely to be dominated by efforts to deal with the excessive build-up of leverage in corporates and local governments, and a housing market with large inventory levels. Behind these medium-term challenges is an economy with slowing potential growth. While we still expect relatively solid GDP growth of between 6% and 7% over the next couple of years – a sharper slowing would make the medium-term challenges that much more difficult to manage – this does suggest that the upside in China-linked assets is somewhat capped in the coming year, and the best opportunities to express positive market views are likely to come when investors move towards extreme pessimism such as earlier this year or in the summer of 2013.

In general, investors should expect more volatility in macro outcomes out of China, in contrast to the steady upward trajectory before the GFC, and this is likely to be reflected in markets. In the CNY market, two-way volatility is an explicit policy aim, and the recent trade-weighted strength of the CNY stands out relative to weakness in close trading partner currencies, such as the JPY and KRW. If growth weakens sequentially into the turn of the year, the backdrop is likely to be similar to earlier this year when the CNY depreciated sharply in February/March.

The ongoing structural shifts in China, combined with the higher macro volatility, is likely to create local opportunities. On the positives, the implementation of the Shanghai-Hong Kong Connect scheme should draw capital into the A-share market, which may continue to outperform H-shares. On the negatives, we would be more cautious on property credits in China relative to other high-yielding names in light of the concerns over sector leverage. Beyond Chinese assets themselves, the slowing housing and investment cycle is likely to be a source of continued pressure on copper and commodity prices more generally.

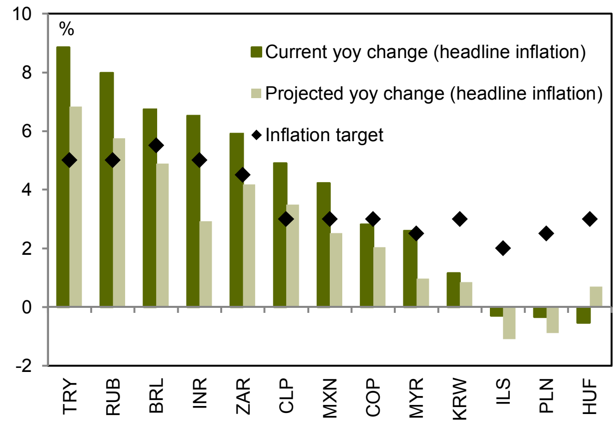
Exhibit 7: China's challenge – defusing a credit build-up in a time of slowing growth



Source: Chinese National Bureau of Statistics, Goldman Sachs Global Investment Research

Exhibit 8: EM Inflation projected to decline due to commodity disinflation

Projections based on methodology in EM Weekly 14/36



Source: Haver Analytics, Goldman Sachs Global Investment Research

8. EM: More Relief, More Polarisation

- Improving imbalances in many EMs.
- Disinflation will help, then give way to slightly stronger growth.
- Commodities a key axis of differentiation, a source of potential crises.

Coming into 2013, Emerging Markets as a group had seen deteriorating external balances, high domestic absorption and elevated inflation – making them especially vulnerable to the 'taper tantrum' and a rise in US rates. And as EM financial conditions tightened in 2013 and early 2014, along with a slowing China, EM growth in 2014H1 was the weakest since the global financial crisis. Two years on, EMs are likely to enter 2015 in better health – external imbalances have improved in several countries, with India, Thailand and Chile among the stand-outs. And the disinflationary impulse from lower international food and oil prices is driving headline EM inflation lower everywhere. The relief from this source is likely to allow EM local currency bonds to perform well – supporting front ends in Turkey, where inflation is likely to decelerate sharply; intermediate maturity bonds in Israel, Hungary and Romania, where 'lowflation' will likely persist for longer; and 5-10 year bonds in India, where lower inflation is also likely to further entrench the credibility of the new inflation target and create additional fiscal space in the medium term.

But 2015 will also see more polarisation between countries that have addressed their macroeconomic imbalances, and are on the right side of the oil import/export divide, and those that have not. India is the clearest example of the former, and we expect to see Indian assets (equities, INR, in addition to rates) trade well through the year, and Turkish equities and the TRY should benefit from falling oil prices even though the external adjustment is not complete there. South Africa and Brazil are in the opposite camp: external imbalances are still very wide, the falls in commodity prices are hurting their terms of trade, and significant further currency weakening is likely in both cases. In Colombia, with significant oil exports, a slowing business cycle and a wide current account deficit, the currency is likely to bear the brunt of the adjustment and rates may fall further.

Finally, we may more see severe credit issues in 2015 in Venezuela, Ukraine, Argentina and even Russia, especially if commodity prices fall significantly further. International reserves have declined in Venezuela and Ukraine, and – without further international help –

concerns about debt repayment will grow. In Argentina, disagreements with creditors and the macro situation could worsen before year-end elections, and if the recent re-escalation of the conflict between Russia and Ukraine brings about a fresh round of sanctions, this is increasingly likely to expose fragilities within the financial system in Russia.

9. The Low-Vol World and its Challenges

- The Great Re-Moderation continues.
- Outside rates, lower market volatility may persist.
- But low liquidity means ongoing temporary spikes.

We have argued this year that low levels of volatility – particularly within equities – are not inappropriate but largely reflect fundamental forces. Despite the periodic spikes in volatility, most notably in October, the VIX average for 2014 is the lowest of the recovery so far. We think this basic environment will persist into 2015. The volatility of economic data has fallen to new lows (the 'Great Re-moderation'); unemployment continues to decline steadily; macro-prudential measures are restraining leverage; the imbalances that end expansions are still some way off; and (US) recession risk looks low. Our simple models imply that equity volatility could be modestly higher on average in 2015 than in 2014, but not in a material way. The same set of forces informs our still quite benign view of US credit.

Volatility curves generally slope upwards, so the market is priced at a premium to our central case. But the slope is not steep enough for it to be systematically attractive to position for lower volatility, so more active approaches are likely to be required. Spikes in volatility will remain a recurring feature, of course. So we think that, like this year, they will offer opportunities to add risk and to fade the notion of a more persistent problem. And in FX and equities, the low level of implied volatility means that options generally still offer attractive ways to express directional views in ways that are self-liquidating.

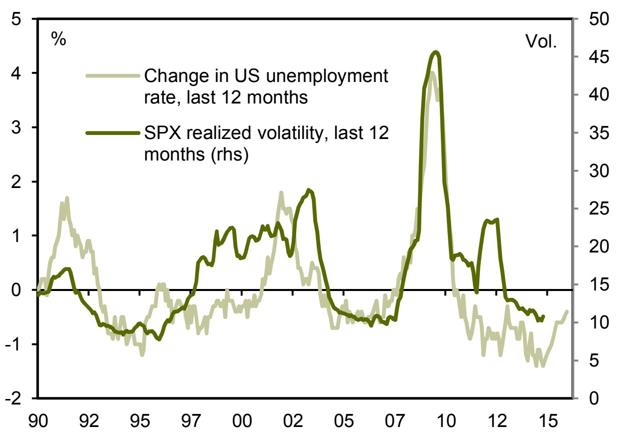
As the labour market tightens further, there will be increased risk that equity volatility finds a more permanent floor. Fresh financial shocks – not our central case – could also change the landscape. And we see a higher chance that rate volatility does move more persistently higher in 2015, since Fed easing policies have arguably played a more direct role in suppressing volatility here. Diminished liquidity – on display in the October 'growth scare' in markets – may also exacerbate the magnitude of these shifts, particularly where positioning is heavy. But, here too, we think these are more likely to present chances to fade the fear than to anticipate it.

10. Living in a Low-Return World

- Major asset classes offering low absolute returns.
- Equity yield still looks better, especially in EM.
- FX a more important component of returns given low returns elsewhere.
- And entry points matter more with flatter trend.

Our market outlook overall is quite benign. But, under the surface, it is striking that many asset prices are priced to offer low absolute rates of return over the coming years. Comparing expected real returns from a range of core assets, the earnings yield on equities (and on a vol-adjusted basis, on parts of credit) still makes them more attractive than sovereign bonds on a relative basis. We also think we are in an environment where equity multiples are likely to stay above average and – even in the US – have the potential to move higher still. So we do not see the valuation picture as one that incorporates a high risk of large falls in equity prices. But, even here, the upside may be less compelling than it has been, and our forecasts are for relatively modest nominal returns outside Japan and parts of EM.

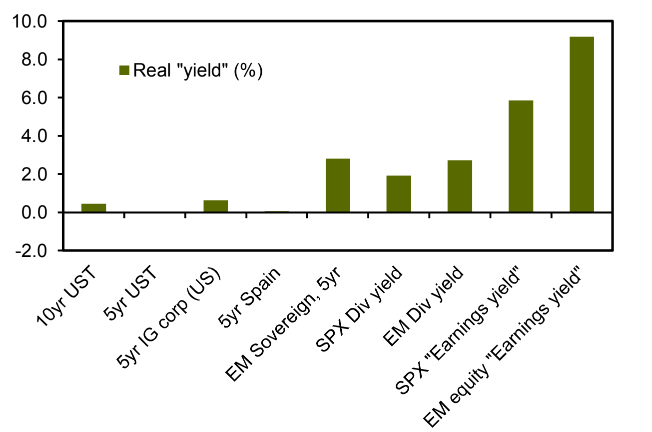
Exhibit 9: A benign macro backdrop will keep volatility low



Source: Goldman Sachs Global Investment Research.

Exhibit 10: Equity 'yield' still attractive in a low-yielding world

Equities "earnings yield" is the inverse of the PE ratio



Source: MSCI, Goldman Sachs Global Investment Research.

We think the challenge of a shallower trend in equities – in which drawdowns can be large relative to more modest underlying gains – and of low risk premia in bonds has already been a stronger theme in 2014 than in 2013. One implication is that in equity markets, given a flatter trend, it has been more important to be able to modulate exposure. Already this year, we have seen sharp rallies (as in the last six weeks) but we have also seen a number of pullbacks that quickly eroded several months of modest gains. The value of being able to increase exposures into these pullbacks – which means not being over-exposed beforehand – has been even higher than normal, and we expect that to remain the case. That is easier said than done. But, given our view that volatility is likely to revert to low levels outside spikes, it has made sense to be patient and add risk when volatility rises significantly – or when there is a concrete disagreement with the market's macro views – and to reduce it as volatility moves back to low levels.

In a low-vol/low-return world, there will also continue to be pressure to take on leverage to increase yield/returns either through financial gearing or through use of options. If returns on core assets prove lower than average, FX returns are likely to be a more important component of overall asset returns across countries and hedging choices more critical as a result. That was already the case in 2014, but on our forecasts should remain the case in 2015. Finally, of the major asset classes, it is striking that EM equities now trade with earnings yields that are above their long-run averages. That on its own is no reason to own them. But for the first time in a while, we find ourselves thinking that they offer at least the *possibility* of significantly higher returns than in DM over the medium term, even if they still offer significantly more risk.

Our views by asset class

Below we summarise our key views by asset class. Exhibit 11 sets out our forecasts across a selection of asset markets.

Exhibit 11: Key market forecasts, 2014-2018

	Current*	End-2014	End-2015	End-2016	End-2017	End-2018
Equities						
TOPIX	1,395	1,425	1,650	1,800	1,900	-
MXAPJ	476	490	520	570	615	665
Stoxx Europe 600	339	-	365	400	440	-
S&P 500	2,052	2,050	2,100	2,200	2,300	2,400
10 Year Bond Yields (%)						
Germany	0.80	1.00	1.25	1.75	2.50	3.00
Japan	0.51	0.65	0.80	1.15	1.40	1.60
UK	2.12	2.25	2.75	3.25	3.50	3.75
US	2.32	2.50	3.00	3.50	3.75	4.25
FX						
EUR/$	1.25	1.23	1.15	1.05	1.00	1.00
EUR/GBP	0.80	0.77	0.73	0.70	0.65	0.65
AUD/$	0.87	0.86	0.82	0.82	0.82	0.82
$/JPY	116.90	120.00	130.00	135.00	140.00	140.00
$/CNY	6.14	6.16	6.16	6.12	6.06	6.00
$/BRL	2.59	2.55	2.75	2.94	3.10	3.28
$/INR	61.75	62.00	63.00	64.50	66.00	68.00
$/RUB	46.81	46.20	49.60	52.20	55.90	57.00
USD TWI	97.4	97.9	102.2	106.5	109.2	110.1
Credit IG (spreads, bp)**						
US IG	99	73	69	68	68	68
USD HY	453	332	305	285	280	275
EUR IG	99	99	89	85	85	84
Commodities						
Brent ($/bbl)	79	85	85	90	90	90
Copper ($/mt)	6,631	6,600	6,000	6,600	7,500	7,500
Soybean (Cent/bu)	10.23	8.00	8.75	10.00	10.00	10.00
Gold ($/troy oz)	1,197	1,050	1,050	1,200	1,200	1,200
Corn (Cent/bu)	3.85	3.00	3.75	4.50	4.50	4.50

**Close November 18, 2014*
*** Investment grade credit spreads to UST and bunds*
Source: Goldman Sachs Global Investment Research

The Macro Rates Outlook: Bond Premium Normalisation

As we head into 2015, both nominal and real yields in the major advanced economies are much lower than in similar phases of past recoveries. Furthermore, the forwards discount that central bank rates will eventually end up at levels considerably below the norms of previous business cycles. What is particularly striking is that survey-based expectations of medium-term growth, inflation and terminal policy rates have remained stable above what is implied by current market pricing, suggesting that the global bond premium is now very low. On our preferred metric, it is nearly as depressed as it was in 2012, at the height of the Euro area crisis.

We have taken the view that the compression in the bond premium over the balance of this past year was in large part influenced by the ECB and the BoJ, which have taken up the baton in the QE relay after the Fed ended its bond purchases in October. With short-term rates constrained by the zero nominal bound, both central banks have put in place policies aimed at lowering long-term rates in order to influence relative asset prices and the exchange rate, and thus help inflation rise towards their 2% target.

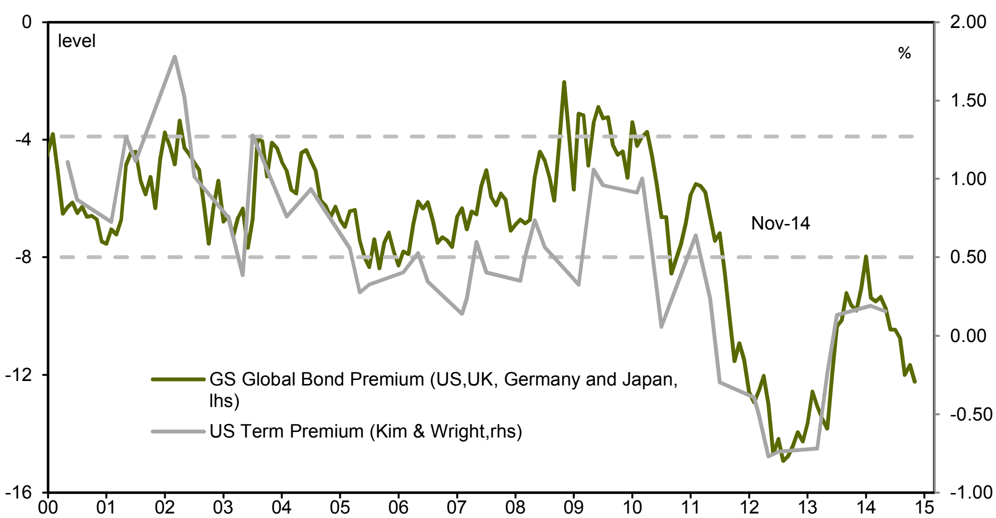
The collapse in crude oil prices since June has led to a corresponding steep decline in CPI inflation market curves, led by the front end. On our metrics, longer-dated inflation forwards are now too low in the Euro area, in the US and in Japan. In Japan, we expect the inflation premium to rise as the BoJ undertakes more aggressive actions. Lower trailing inflation has also encouraged investors to push later their expectations of the lift-off in policy rates in the US and the UK. In both economies, we think the positive implications for activity growth from lower commodity prices are underestimated.

Our nominal 10-year government bond yield forecasts for 2016 are above the forwards, reflecting a baseline case where the decline in the bond premium comes to an end, and gradually reverses. Consistently, we forecast that US Treasury yields – currently trading at 2.30% – will reach 3% by end-2015, or 30-50bp above the forwards. The biggest increase in long-term yields we project relative to the forwards is in countries where central bank policies have been most effective in depressing them. Admittedly, this makes the forecasts more uncertain. We expect German Bund yields to end 2015 at 1.25% (from 80bp currently), and Japanese 10-year rates to be at 80bp (from 50bp at the time of writing). In both markets, we assume that bond yields will remain well below where our *Sudoku* macro-econometric model would place them based on macro factors alone.

Across the European Monetary Union, sovereign yields are much lower than over the past couple of years, but the 'peripheral' yield curve (and the corresponding term structures of intra-EMU spreads) are much steeper than in the 'core' economies of the union. Subtracting annual CPI inflation in each of the main Euro area countries from their respective 5-year benchmark yield illustrates that, in real terms, the differential across EMU constituents is even starker. Our central outlook for 2015 calls for this dispersion in intra-EMU spreads to decline. We assign a 1-in-3 probability to the ECB engaging in sovereign QE during 2015. This reflects the probability of the Euro area economy falling back into recession, increasing the risk of more pernicious asset deflation. Faced with such circumstances, we would expect the ECB to attempt to bring about a quicker convergence of real rates across the region through the launch of a bond purchase program. Such a course of action would benefit our view that peripheral EMU curves will flatten, but contradict our forecast of rising German yields, at least to the extent we currently show, with possible spill-over effects into other markets.

Exhibit 12: The bond premium is stretched

GS estimate of global term premium computed as latent common factor in a regression of G-4 10-year government bond yields



Source: Haver Analytics, Goldman Sachs Global Investment Research

The Credit Outlook: Navigating Potholes

We entered 2014 expecting the macro environment for credit to be 'carry-friendly'. Our view was that a friendly mix of steady growth, stabilising credit metrics, low volatility, low inflation and accommodative monetary policy would reduce the risk of default while supporting the appetite for risk. This view remains largely intact for 2015. In particular, we expect the US recovery to remain good but not great, and not very inflationary. This implies that monetary policy should remain predictably accommodative. And with global growth expected to pick up only modestly, we expect the macro environment to remain in the 'sweet spot' for credit risk appetite.

From a bottom-up perspective, we have become more comfortable with leverage trends in the IG market, but not in HY ('US credit quality: Stable in IG, less so in HY', *The Credit Line*, September 22, 2014). This divergence between IG and HY is primarily driven by operating income, which has improved for IG but not for HY. That said, given the still-elevated levels of HY credit spreads, we expect spreads to grind tighter from here, although we expect CCC-rated credit and certain sector stories (e.g., Energy) to lag (more on this below).

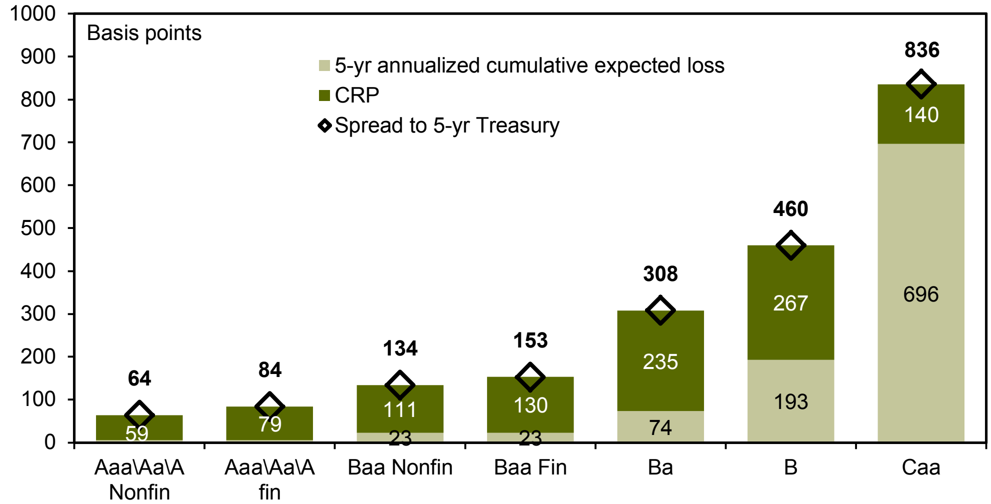
Perhaps the biggest shift in our market view this year has been our increased conviction that economic growth has entered into a 'Greater Moderation' of structurally lower volatility of growth and inflation ('Macroprudential policy and prospects for a 'Greater Moderation'', *Global Economics Weekly*, June 19, 2014). We argue that this reflects not only the long-running success of monetary policy (which was primarily responsible for the first 'moderation' from 1985 to 2007), but also the impact of macro-prudential regulation. This regulatory approach represents a sharp departure from past practice and, while its implementation remains a challenge, we think it is already 'muzzling' the economy's financial accelerator and thus structurally depressing the volatility of growth and inflation, and ultimately the volatility of asset markets.

A Greater Moderation of growth logically implies organic support for credit risk appetite (alongside the enhanced thirst for yield whetted by low yields, which we take for granted). For one, it implies a lower downside risk of recession, which in our framework translates directly to better risk and risk appetite. Second, because it symmetrically implies a lower upside risk of stronger-than-expected economic data, it ought to lower risk of unexpected inflation scares, and thus reduce the likelihood of risk-reducing monetary tightening. In short, despite the modest elevation of financial market volatility over the past several months, we think the fundamentals continue to favour a strong and steady bid for credit risk.

The above logic also underscores our view that episodic spikes in credit risk premia are a high frequency phenomena with strongly mean-reverting properties. It also explains why we expect this credit cycle to be longer-lived than past cycles ('Does low volatility signal the end of the credit cycle?', *Global Markets Daily*, May 15, 2014). In sum, we see a credit market in 2015 that is not only carry friendly, but also amenable to strategies that seek to trade the range.

That said, we see a few *new risks* – more like *potholes* than landmines – that credit markets will have to navigate. The biggest of these new risks stems from the unexpectedly rapid onset of the 'exploitation phase' of the commodity super-cycle. According to our colleagues in Commodity Strategy, we are seeing the supply-side benefits resulting from many years of R&D and capital spending on productive capacity. In their view, the recent re-pricing of many global commodities (especially oil) was inevitable, but it is coming sooner than expected because the global outlook for growth is turning out to be somewhat weaker than expected ('Oil: Long-term surpluses create near-term shortages', Commodities Research, October 16, 2014.).

Exhibit 13: Credit risk above CCC remains fairly valued
5-year spread decomposition into our estimates of expected losses and CRP (bp)



Source: Moody's, iBoxx, BAML, Goldman Sachs Global Investment Research.

This mix of heavy indebtedness and excess capacity likely implies an elevation of idiosyncratic risk in credit markets, with companies at the HY end of the spectrum tending to underperform higher-rated companies. If global oil prices remain in our forecast range of $80-$90/bbl (with more risk to the downside), fuelled in large part by rapid improvements in the technology of shale oil production, then we see a reasonably high risk that the recent re-pricing of many sub-industries within the Energy sector could continue lower. We see some potential for some short-run tactical relief over the next few months driven by the low levels of current oil inventories. But longer term, the operating environment for the Energy sector looks challenging.

The Macro Equity Outlook: Focus on impact of policy differentiation, growth re-convergence and oil price relief

Looking back on the past year, the divergence in market outcomes was a dominant global equity market dynamic. US equity index performance – particularly in USD terms – stood out relative to its global peers. This divergence paralleled the performance of other markets as US yields widened relative to, say, those in Europe and the USD strengthened. These shifts can, in turn, be traced back to a year in which US growth indicators pointed to solid and, critically, accelerating activity for much of the year, while growth outcomes outside of the US did not keep pace.

Looking ahead, several market themes are likely to be particularly impactful for global equity markets: stable growth in the US and accelerating growth in other DMs, leading to some measure of growth convergence; continued policy divergence, with still-accommodative policy in Europe and Japan coming against the backdrop of a shift to tightening in UK and the US; and oil price relief, boosting EM importer growth and potentially shifting the EM inflation/policy balance.

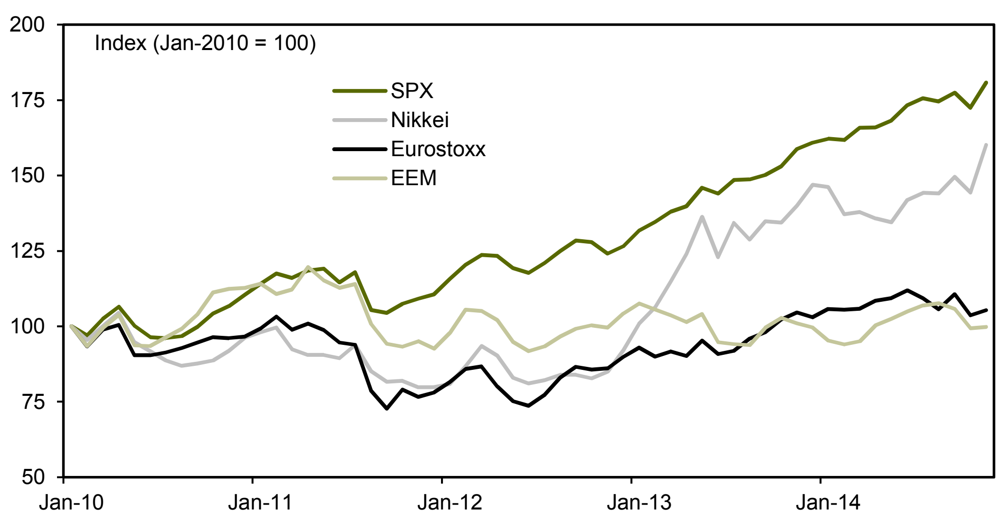
From an equity market perspective, we tend to place a great deal of emphasis not only on economic growth, but also on its rate of change. Hence, a year in which, at the outset, we do not envisage much scope for US improvement is a substantially different environment to recent years. In contrast, the forecast pick-up in growth could be meaningful for non-US markets, particularly after a year of lagging significantly. To be sure, this expectation comes with risks, specifically in Europe, where our Economists have highlighted the precarious nature of the policy and growth balance, with a non-negligible probability of a return to recession.

In addition to an expected pick-up in growth, as has been the case for the last several years, accommodative policy is naturally seen as a plus for forward-looking risk assets. Here, we think there is incremental scope for equity support not only from currently aggressive central banks like the BoJ and ECB, but also in several EMs where, if oil-price-induced inflation relief does materialise, policy makers would have increasing room to ease policy over the course of the coming year. Oil price relief may also have more direct impacts on growth prospects, with the US consumer and EM energy-importing economies well-positioned to gain ground.

The flipside of easy policy is that, among the major markets, we expect to see a shift in the UK and US towards monetary tightening later in the year. Yet, by itself, this is unlikely to be a meaningful headwind for global equity markets. Historically, so long as robust economic growth is the driving factor behind a shift towards monetary tightening, that shift in policy tends to be well-digested by equity markets, with some jitters during the initial months of the tightening cycle. But beyond that, typically, both economic growth and equity markets can continue on their pre-hike-cycle trend paths both during the rate-hike cycle itself and beyond.

In sum, while there is still plenty of room for economic and equity market optimism, the cross currents this year are somewhat stronger than in years past, and this is reflected, in part, by a more subdued set of index targets. Expectations for US returns are modest, with a 2015 target of 2100 for the S&P 500. This forecast suggests a price return of about 3% from current levels, and a total return of 5%, amid still-low realised and implied volatility. The US multiple, which reached 16.7 in 2014, is expected to moderate to 16, as the Fed starts to tighten. Expectations are more robust in Europe: our 2015 Stoxx600 target of 365 is almost 9% from current levels (in EUR), with earnings growth expected to be 8%, better than the expected US earnings growth of 5% over the same period. In Japan, expectations are higher still, despite recent economic weakness. With policy and falling currency providing tailwinds, the year-end forecast for TOPIX is 1650, 18% above current levels in JPY, or 6% in USD. We also expect robust earnings growth of 22% in 2015. Lastly, we expect Asia ex-Japan to grow moderately, with the expected 2015 year-end equity appreciation at 7% (in local currencies), boosted in part by 8% earnings growth.

Exhibit 14: US equities have led the rally, with Japan joining in the last two years



Source: Bloomberg, Goldman Sachs

The Commodities Outlook: Supply Differentiation to Remain Key

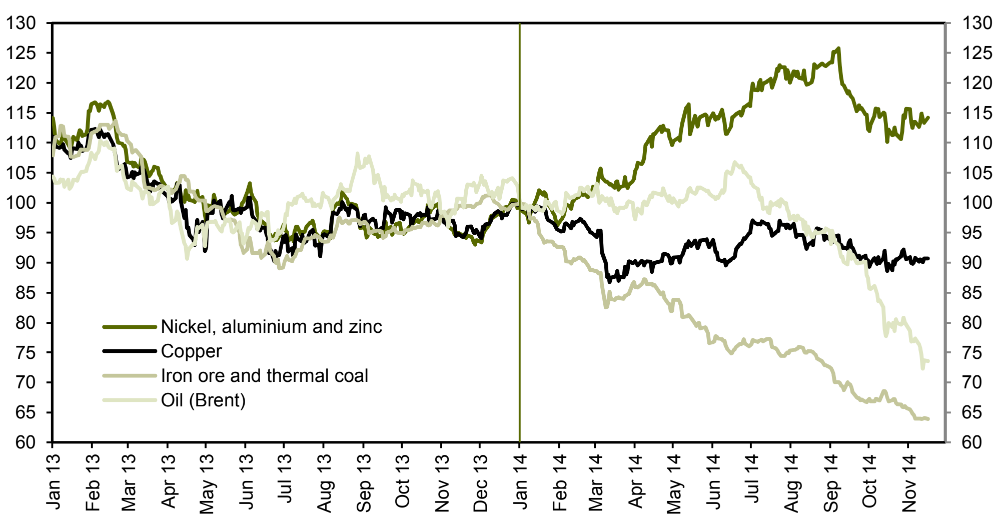
In the face of sluggish global demand growth, supply differentiation has been a key theme in 2014, resulting in major dispersion in commodity price performance over the year. We expect 2015 to present similar opportunities, as the exploitation phase continues in most major commodities (oil, copper, iron ore), while other markets present cyclically or idiosyncratic bullish supply dynamics (zinc, aluminium, nickel, palladium).

Following the spectacular oil price decline in recent months – the culmination of the US shale revolution, lower OPEC disruptions and anaemic demand growth – we forecast that prices will need to remain around current low levels in 2015. This will be necessary because (1) accelerating non-OPEC production growth outside North America will outpace demand growth, leaving the oil market oversupplied; (2) the scale and sustainability of US shale oil production is driving the global cost curve lower and sustaining cost deflation; and (3) OPEC will no longer act as the first-mover swing producer and US shale oil output will be called on to fill this role. In the near term, however, we expect significant price volatility as the market grapples with cost support, producer hedging demand and seasonally strong demand during the Northern Hemisphere winter.

The relaxation of the energy supply constraint globally reduces one major obstacle to a global recovery as we look to gradually improving global growth into 2015 and beyond. Indeed, to the extent global demand growth is supported cyclically via lower oil prices, or by a DM-led acceleration in global demand growth more broadly, commodities with the most bullish supply dynamics – below-trend supply growth and/or marginal costs of production in USD or RMB terms – should outperform. In this regard, we expect nickel, zinc and aluminium to continue to outperform over the course of 2015.

On the other hand, a stronger USD and higher US real interest rates would be particularly bearish for gold. And copper should continue to underperform other metals in 2015 on relative supply, and high exposure to late-cycle China property completions.

Exhibit 15: Major commodity price dispersion in 2014
Index = 100, Jan 2014

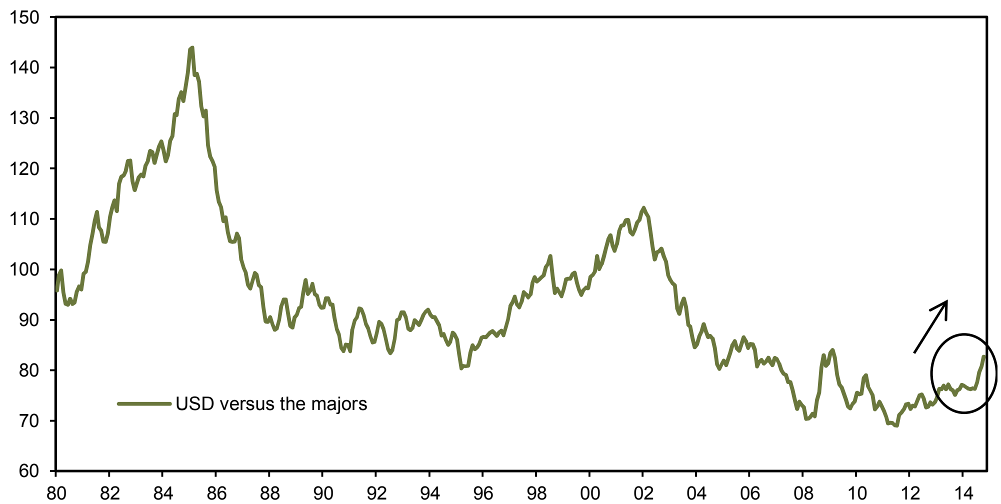


Source: IEA, Goldman Sachs Global Investment Research.

The G10 FX Outlook: Dollar Strength to Continue

We expect USD strength across the rest of the G10 complex to continue through 2015, likely posting a 6% appreciation on the Fed's major trading partner TWI by the end of next year, on top of the 9% appreciation since the beginning of July 2014. As the Fed moves towards, and then starts, tightening policy in September 2015, this will provide a key driver for Dollar strength, particularly as the central banks in the other major economies continue to ease. Our projections for Fed policy are marginally more hawkish than currently discounted by the market, particularly in the outer years of our forecast horizon. As yet, US monetary policy has played second fiddle to the substantial easing surprises by the ECB and BoJ in propelling the Dollar TWI higher, so Dollar strength in 2015 could rest more on US domestic factors than has arguably been the case so far. Finally, the US external balance is unlikely to be a barrier to further Dollar strength – we do not expect the current account deficit to deteriorate meaningfully and oil is unlikely to be a drag as it has been in the past (see *FX Views*, November 5, 2014).

Exhibit 16: Only modest USD strength in historical perspective



Source: Federal Reserve, Bloomberg, Goldman Sachs Global Investment Research

High conviction that Dollar strength will be most pronounced against Euro and Yen

We have high conviction that Dollar strength is likely to be most pronounced against the Euro and Yen. We forecast EUR/USD at 1.15 by end-2015 and now see USD/JPY at 130, up from 120. The latter reflects a recent forecast revision after the disappointing Q3 GDP data, which indicates that the BoJ is likely to have to ease further. We expect the weakness in both currencies against the Dollar to be prolonged past the end of 2015, and expect EUR/USD to trade at parity in 2017 and USD/JPY at 140 (up from 125 previously).

Our thought process is similar for both crosses. First, Euro and Yen depreciation rest on a much easier monetary policy stance from the ECB and BoJ compared with the Fed. Both central banks have surprised the market in 2014 by easing more than anticipated, and both could ease further in 2015. We pencil in further easing from the BoJ in 2015H2 to ensure that inflation momentum continues to rise, and should growth disappoint and inflation fail to rise meaningfully in the Euro area, the 1-in-3 chance we ascribe to sovereign QE from the ECB would likely rise.

Second, the external balances of the Euro area and Japan are likely to deteriorate as domestic investors buy more foreign assets. Easing by both central banks appears to have encouraged the outflow of funds looking for a higher return, and this trend is likely to continue. In the case of Japan, the recent announcement of the rebalancing of the GPIF into 40% foreign assets, even if that rebalancing takes five years, is likely to lead to persistent and Yen negative outflow.

This means the dynamics of EUR/JPY will likely continue to be driven by whichever of the two central banks is in the driving seat at the time. At the moment, BoJ easing is pushing the cross higher, but should ECB easing be stepped up, a weaker Euro would likely dominate the cross.

Renminbi: More of the same

In early 2014, the Chinese authorities modified their management of the CNY by widening the currency's daily trading band and increasing the volatility of the daily fix. This adjustment was designed to squeeze out speculative long positioning in CNY and therefore reduce the pace of FX reserve accumulation. This appears to have worked and the pace of FX accumulation has reduced significantly. Going into 2015, we expect the authorities to continue with this policy, which should also imply that the currency can more fully reflect its fundamentals. On the one hand, a current account surplus of 2% of GDP argues for CNY strength, while, on the other, softening growth and inflation and the need to start the reform process in earnest would point towards a weaker CNY. We expect the authorities to deal with both of these issues by fixing the CNY in a stable but wide range. In terms of Dollar direction, we do not believe that a stronger Dollar necessarily means a weaker CNY, particularly if the recent outflows from China reverse (see *FX Views,* November 14).

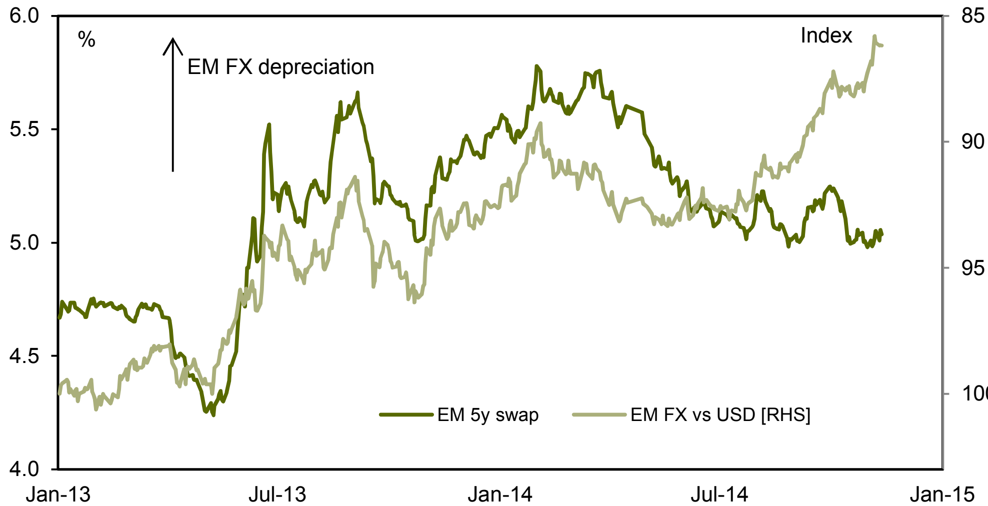
The rest of the G10: Weaker against the Dollar but stronger against the Euro and Yen

Largely as a function of relative monetary policy, we expect the rest of the G10 currencies to trade weaker against the USD through the course of 2015, but stronger against the EUR and Yen. We expect the Bank of England and Norges Bank to hike rates in 2015Q4, and the Riksbank to start its tightening cycle in early 2016. We expect the GBP to appreciate by 5.1% against the Euro by end-2015, and have changed our forecasts for the NOK and SEK to assume a more limited appreciation against the Euro of 5.7 and 6.3% respectively over the same timeframe. This equates to end-2015 forecasts of EUR/NOK 8.00, up from 7.37 previously, and EUR/SEK 8.70, up from 8.27. We have also raised our longer-term forecasts for both crosses slightly to EUR/NOK 7.50 from 7.10 previously and EUR/SEK 8.20 from 8.0 previously. The commodity currencies – AUD, NZD and CAD – will continue to face depreciation pressures from an ongoing decline in their terms of trade, reflecting recent commodity price falls. In addition, while none of these central banks are talking as if they are close to easing policy, they are likely to lag the Fed in eventual tightening, which should prevent undue currency strength. The respective central banks continue to try and talk their currencies lower towards their view of what would be more sustainable levels. This commentary is likely to continue through 2015.

The EM Outlook: The Fallout from Commodities – Disinflation, growth relief, producer stress

EMs will enter 2015 in better health than in the last couple of years. Current accounts have improved in several countries, and some combination of monetary tightening and currency weakness has been delivered to address domestic imbalances in economies that were viewed as most vulnerable in 2013 and early 2014. The external backdrop is also likely to be friendly for EM assets in the coming year: lower commodity prices will provide inflation relief, a broadening DM recovery should help EM exports, and the BoJ and the ECB should continue to anchor a friendly fixed income environment through their words and actions, although the scope for volatility around the Fed lift-off remains.

Exhibit 17: Lower commodity prices and EM disinflation have supported EM rates as EM FX has depreciated



Source: Goldman Sachs, Goldman Sachs Global Investment Research.

Of these, the disinflationary impulse from lower oil and food prices will be the most important market dynamic for EM assets in the first part of 2015. It should create room to ease in some EMs (India and Turkey), mitigate the need for sharp tightening in others (Mexico and South Africa) and reinforce the fight against 'lowflation' in yet others (Korea, Israel, Hungary). For commodity consumers such as India and Turkey, the disinflation comes alongside a boost in terms of trade and a current account improvement. For commodity exporters such as Russia, Colombia, South Africa and Brazil, the disinflation is helpful as well, but the hit to export values, and potentially to fiscal revenues, will pose distinct headwinds.

As 2015 rolls on, we would expect the market to shift its focus from inflation relief to growth. Our forecasts call for a modest improvement in EM growth – to 5.1% in 2015 from 4.5% in 2014. We expect growth to tick up in India, most of the ASEAN and in Latin America, with the key exception being China. The gradual deceleration in potential and actual growth in China as it tackles its substantial housing and credit imbalances is an important distinguishing feature of the EM landscape, and argues for more selectivity in expressing constructive views across EM assets. Even in China, however, we expect Q1 to be the weakest growth quarter, and so the EM growth picture should look better and EM equity risk may be better supported as the year progresses.

Our asset market views in EM flow directly from this constellation of global and EM-specific macro impulses:

- **We think EM local bonds should continue to perform well,** particularly where inflation relief is clearest and policy responses have the scope or the need to be incrementally dovish. Going into 2015, we favour Turkey curve steepeners, long positions in 5-year ILS and HUF yields, and exposure to India duration in the 5-10-year part of the curve.
- **We think EM FX will remain under pressure versus the USD.** The solid outlook for US growth means US yields are likely to drift slowly higher, and the gap between US yields and EM yields (and European yields for that matter) is likely to shrink. In addition, we think currency depreciation will remain (i) an important channel of adjustment in South Africa and Brazil, where current account deficits are still wide, (ii) a means of rebalancing economies towards non-commodity-

producing sectors in the commodity producers (including in Russia and Colombia), and (iii) a tool in the battle against very low rates of inflation, including in Korea, Israel and parts of CEE.

- **Value in EM equities, but China risks remain.** This should also typically be a supportive environment for EM equities and EM credits, although here the outlook is slightly more mixed. It is hard to argue for broad-based EM equity outperformance without a more convincing improvement in the China growth outlook. The earnings yield on EM equities as a group does, however, look more attractive than for many other markets after range-bound returns since 2010, and specific equity indices that offer exposure to US growth, oil relief and better macro fundamentals should do well: Taiwan, India, Mexico and Korea offer some combination of these. Brazil and China are two of the most inexpensive EM equity markets globally, and a clearer shift in macro policy backdrop and structural reform agenda will be required for a rerating here.
- **Differentiation in EM credits.** The macro backdrop we have described, encompassing low volatility, low inflation and stabilising growth, should be supportive for EM credits, as should the fact that our Credit Strategy team expect US corporate credit to remain well-supported for another year. But clouds are darkening over some of the higher-yielding credits, such as Venezuela, Argentina and Ukraine. Falling commodity prices may reinforce weakness here, and contribute to financial fragility even in Nigeria or Russia.

The Mortgage Outlook: Tight Spreads, But Constructive Supply Technicals

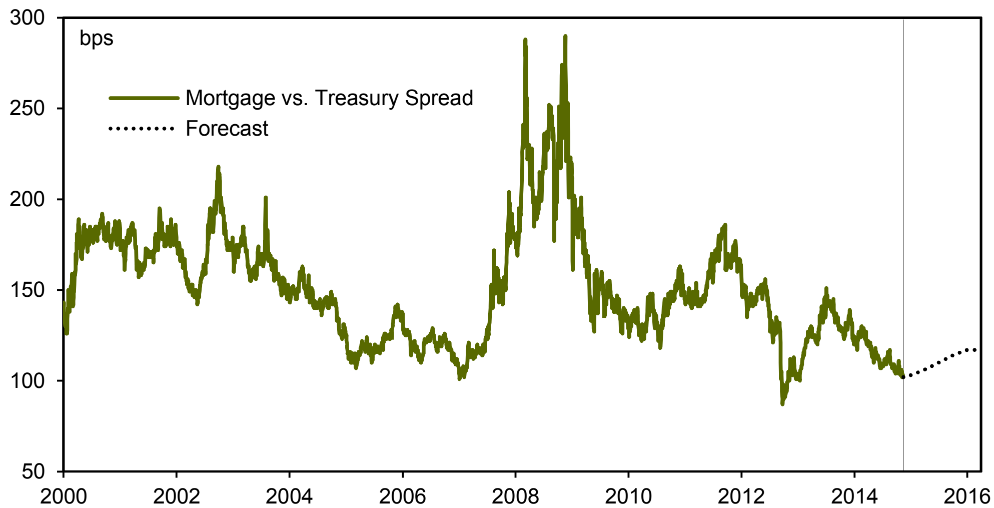
Spreads between agency current coupon mortgage rates and US Treasury rates are at very tight levels vs. their history. The mortgage vs. Treasury rate basis started 2014 at its 20th percentile relative to its range over 2000-2013, and has since tightened to the 1st percentile, with agency mortgage backed securities (MBS) spreads now tighter than in 2006. Thus, the expected extra carry earned for holding mortgages instead of Treasuries is greatly diminished relative to the risk of future spread widening.

Some of the tightening in mortgage spreads can be explained by fundamentals. In particular, the low level of interest rate volatility has reduced the cost of the refinance option embedded in US mortgages. In addition, the tight credit standards in the US mortgage market have made it difficult for borrowers to exercise their prepayment options, again reducing the embedded option cost. But even on an option-adjusted basis mortgage spreads are at historically tight (10th percentile) levels.

While mortgage spreads look tight relative to fundamentals, supply/demand technicals remain constructive. Since September 2008, Treasury debt outstanding has expanded by US$7trn, or 120%, while agency MBS debt outstanding has expanded by just US$0.7trn, or 16%. The Federal Reserve currently holds US$1.7trn of agency MBS, which is over 30% of total face value outstanding. At a projected runoff rate of 11% per year, it will still hold over US$1trn in balance through 2020. We expect the Federal Reserve to reinvest MBS principal paydowns through 2016Q1, so the Quantitative Easing program will continue to affect the MBS market through both stock and flow effects.

On net, we expect mortgage spreads to widen modestly (10-20bps) over the next year. This view reflects both the tight current level of mortgage spreads and the slow reversal of the very positive supply technicals to date. Given a mortgage spread duration of 7, this spread widening could lead to price declines comparable to the extra carry earned by MBS over a one-year horizon. Thus, we remain neutral but cautious on the sector. On a relative value basis, we prefer to be overweight up-in-coupon, to reduce duration exposure.

Exhibit 18: Our mortgage spread forecast anticipates a modest widening for next year
Spread, 30-year current coupon mortgage rate vs. blended 5/10-year Treasury rate



Source: Goldman Sachs Global Investment Research.