

Global Viewpoint

Economics Research

Top Ten Market Themes for 2013

Today's *Global Economics Weekly* "Moving over the hump" describes the main elements of our economic forecasts for 2013 and beyond. Here, we lay out our Top Ten Market Themes, which represent a broad list of macro themes from our economic outlook that we think will dominate markets in 2013.

1. **Global growth: A 'hump' to get over, then a clear road ahead**
2. **More unconventional easing in the G4**
3. **Termites eat away at the foundations of the 'search for yield'**
4. **Housing stabilisation and private-sector healing in the US**
5. **Euro area a smaller driver of global risk, but still a source of tails**
6. **Continued divergence between core and periphery in the Euro area**
7. **EM growth pick-up revisits capacity constraints**
8. **EM differentiation continues**
9. **Commodity constraint to loosen in the medium term**
10. **Stable China growth, but not like the old days**

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

Francesco Garzarelli

+44(20)7774-5078 francesco.garzarelli@gs.com
Goldman Sachs International

Thomas Stolper

+44(20)7774-5183 thomas.stolper@gs.com
Goldman Sachs International

Noah Weisberger

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

Charles P. Himmelberg

(917) 343-3218 charles.himmelberg@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.

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

Top Ten Market Themes for 2013

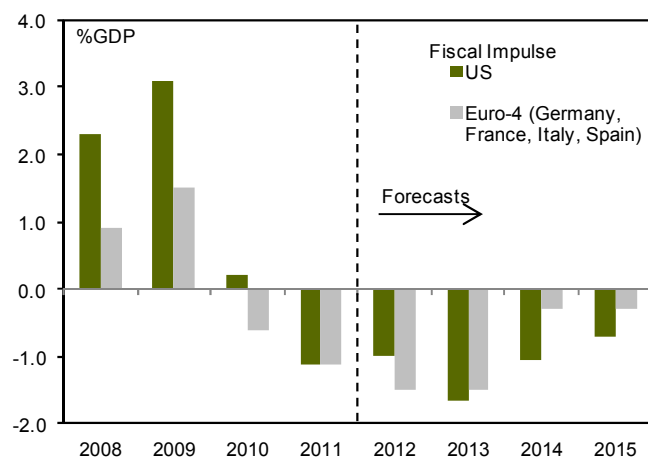
Today's *Global Economics Weekly* "Moving over the hump" describes the main elements of our economic forecasts for 2013 and beyond. This year, we plan to release our Top Trades for 2013 beginning in Monday's *Global Markets Daily*. Here, we lay out our Top Ten Market Themes, which represent a broad list of macro themes from our economic outlook that we think will dominate markets in 2013. For each theme, we discuss the wider implications for markets, and the potential issues and options for investing around them.

1. Global growth: A 'hump' to get over, then a clear road ahead

- Weak growth in early 2013 but a sustained recovery if that period is navigated
- Increased fiscal restraint going into 2013, moderating in 2013H2 and beyond
- Spanish economic and Italian political risks most intense in early 2013
- 'Room to grow' globally given output gaps, particularly in advanced economies
- Relaxation of the global energy supply constraint

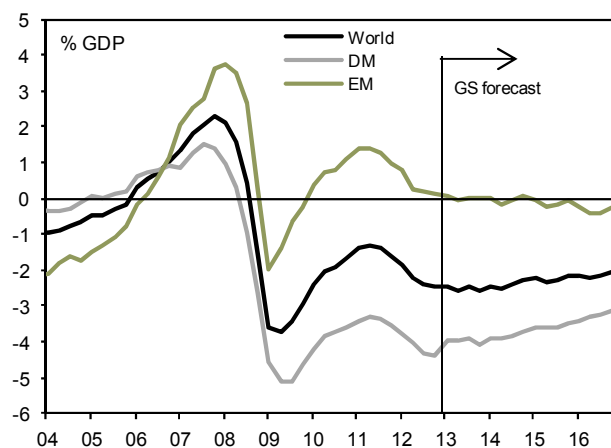
Market issues: On the surface, our global growth outlook for 2013 looks like more of the same: US GDP growth at around 2%; a near-recession in the Euro area; Chinese growth below the average of the last 5-10 years; and below-trend global growth once again – at 3.3%. But there are significant differences below the surface: further healing in the US housing and labour markets; a progressive relaxation of the global energy supply constraint; and 'room to grow', particularly in the developed world. The biggest challenge from a markets perspective is that we see risks to growth concentrated early in the year, with Q1 likely to show a step-down in growth globally. Fiscal restraint plays a major role in that story: we expect a big increase early in 2013, but a significant fading on both sides of the Atlantic thereafter. 'Fiscal cliff' resolution still presents a particularly acute version of that uncertainty. But if that period can be navigated, we envisage a sustained sequential recovery in growth, which builds into 2014 and beyond. This profile means that beyond the next quarter or two, markets may face a steadily improving picture, with a broadening US private-sector recovery.

Exhibit 1: An increase in fiscal drag, then relief



Source: IMF; GS Global ECS Research.

Exhibit 2: 'Room to grow' in DM, less so in EM
Estimated output gaps (forecasts after 2013)



Source: CBO; Haver Analytics; GS Global ECS Research.

If markets recognise this, 2013 could prove to be another solid year for global equities. But the key challenge will be how quickly the market can look beyond near-term macro weakness. In thinking about the extent of the near-term downside, an important question is what growth outcomes are already priced. On our estimates, equity markets are priced for close to 2% GDP growth in the US, and global growth that is further below trend. At those levels, even a period of modestly slower growth may not be too disruptive. But the market has already recognised the relative resilience of the US and may be vulnerable to near-term news that undermines that view. The same timing challenges apply to the cyclical tilt within equity markets. Sharp underperformance of global cyclicals relative to defensives has been a feature of both 2011 and 2012, and we expect this to begin to reverse in 2013. But our forecasts do not imply global growth that is clearly above-trend until 2014, so the risk is that this shift also builds only slowly through the year.

2. More unconventional easing in the G4

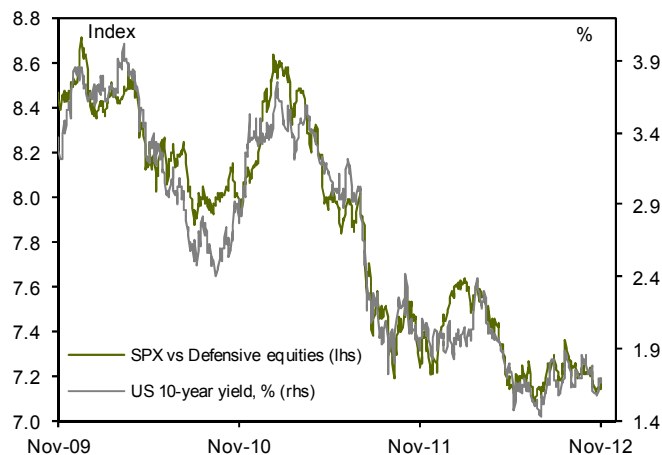
- Ultra-low policy rate environment to continue
- Fed to move towards macro-based criteria; ECB to conduct private asset purchases
- Some chance of a larger shift in BoJ policy, although not our central case

Market issues: 2013 is likely to see more unconventional easing from the major central banks. Our view of the Fed easing profile remains more aggressive than market pricing and we expect a shift towards macro-based rather than calendar-based forward guidance. In the Euro area, beyond the activation of the OMT, our forecast that the ECB may shift to targeted private asset purchases is one that may bolster the appeal of Euro corporate and bank credit at some point. But the shift is likely to come in response to a continued freeze in private-sector credit availability in the periphery, especially Spain.

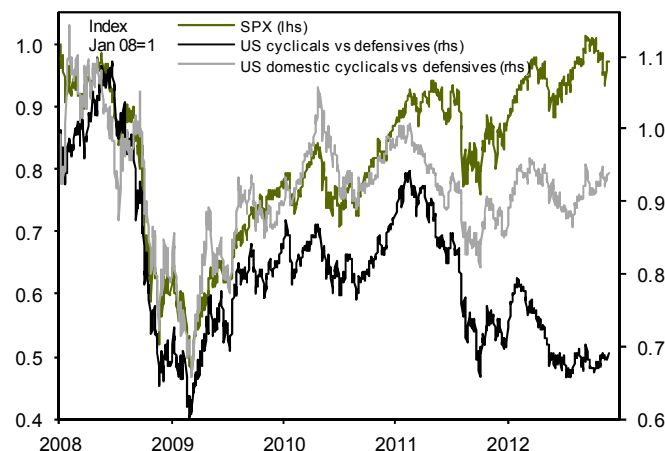
However, the most hotly debated shift currently is whether the BoJ will make a more convincing attempt at easing. We have been sceptical through this year about the potential for JPY weakness on the back of expectations of a larger BoJ move. And while we do expect incremental progress, our central case is not for a quantum leap in BoJ policy, particularly in the near term. But more aggressive comments about 2%-3% inflation targets from the leader of the LDP, Shinzo Abe, and the chance to appoint a new BoJ governor in April make it easier to see changes taking place. The danger of positioning for a weaker JPY is that a convincing shift may require the BoJ to 'out-ease' a committed Fed, which we do not expect. But other assets – the long-underperforming equity market, including banks – could benefit from any increase in absolute (rather than relative) easing commitments. They may be a better 'call option' on a potential policy change, particularly in a supportive global equity environment, though they have already done well in recent weeks.

3. Termites eat away at the foundations of the search for yield

- Higher UST yields in 2013 but no big shock disrupting the search for yield
- Towards 2014, a growing risk to bonds from above-trend growth, diminishing QE
- Search for yield to continue to find corporate credit, but risk-reward deteriorating
- Increased risk that easy credit will lead to corporate re-leveraging

Exhibit 3: Bonds and defensive stocks have rallied together...

Source: GS Global ECS Research.

Exhibit 4: ... but broader cyclicals should outperform as growth accelerates in the coming year

Source: GS Global ECS Research.

Market issues: A sluggish post-bust recovery, significant private-sector surpluses and the impact of QE on term premium have kept 'safe' sovereign yields very low, particularly through an unusually depressed real rate structure. We have shown how, in turn, that has fuelled appetite for carry and for 'safe' risk in general, and led to unusual strength in defensive equities in the US and Europe. In the first half of 2013, there is little in our forecasts to suggest that the basic environment is set to shift, given sub-trend US growth, large ongoing asset purchases and sluggish global GDP growth. Even looking further out to the end of 2013, we expect QE3 to be in full swing and the overall growth environment to improve only gradually. We show an upward drift in our 10-year bond yield forecasts, and our profile for US 10-year yields is above the forwards. But our best guess is that the pace is not enough to deter the search for carry and yield in many places.

Even though we expect the search for yield to continue, the risk-reward is falling. Particularly as we move later into the year, it is easier to think of forces that could push longer-dated real rates more decisively higher. For places where the premium offered is either low in absolute terms (agencies) or relative to the liquidity risk involved (parts of EM credit), we think the risks – while most likely to be avoided in 2013 – are growing, so carry opportunities need to be more substantial to justify taking them. Gold – also supported by ultra-low real rates – is becoming more vulnerable to these same forces. In between those alternatives, corporate credits – which have good fundamentals and a better liquidity profile – should continue to see a slow and modest tightening in spreads. But even here, the risks are greater than in the past couple of years. And we expect tight spreads on plain vanilla instruments to increase demand for structured products. The mirror image of stronger growth and slower private-sector deleveraging towards the end of 2013 and into 2014 is an increase in corporate investment and activity, and a gradual deterioration in balance sheet fundamentals. For 2013 this is probably still only a risk to watch: excluding peripheral Europe, corporate credit quality (as measured by debt-to-earnings measures) remains good in most markets, and this should continue to support the fundamental risk profile of most credit portfolios.

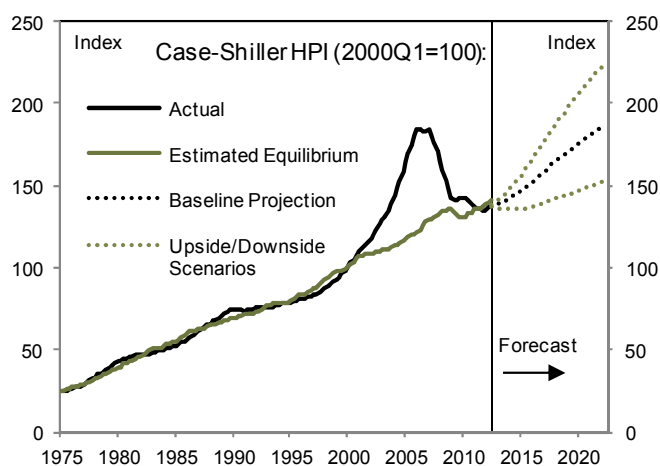
4. Housing stabilisation and private-sector healing in the US

- Further modest US home price gains and continued increase in housing activity
- A gradual reduction in the private-sector financial surplus
- Record-low mortgage rates and slow thawing in US lending conditions

Market issues: The positive surprise from the US housing sector has been one of the big stories of 2012. US homebuilding stocks have doubled and US domestic cyclical stocks have substantially outperformed US global cyclical stocks. While we see continued healing in the household sector and ongoing gains in both housing starts (20% growth in 2013) and home prices (2%-3% growth in 2013), this may now already be priced in by markets. Simple macro comparisons with our Wavefront Housing Basket suggest that pricing of equities most directly related to housing construction (homebuilders, durables) are broadly consistent with the improvement in the data itself.

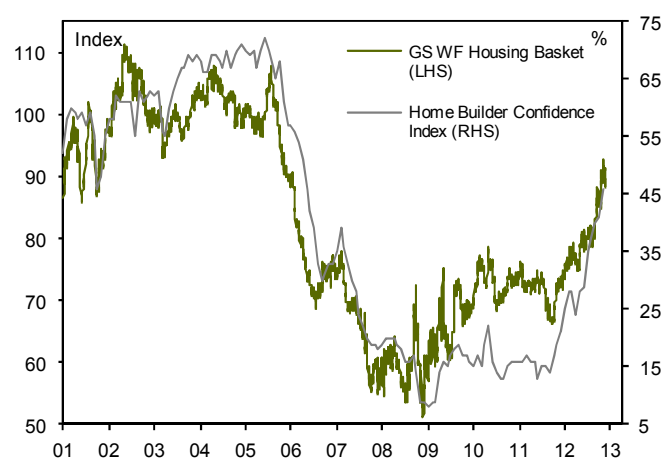
Further progress in housing indicators could still support these areas. But given the strong repricing of assets related to homebuilding, it makes sense to think more about the ripple effects of housing stabilisation beyond these areas. On that front, two kinds of assets come to mind. The first is select vintages of the ABX index on subprime mortgages. The higher-rated tranches have already repriced significantly, but still price in severe future mortgage default assumptions that are more likely than not to surprise on the low side. They are clearly sensitive to further home price strength and may also provide a 'call option' on shifts in housing policy to help underwater borrowers. The second is US domestic banks, which could benefit further from a gradual normalisation of housing credit finance if home prices continue to drift higher. Specifically, given the prevalence of sustained low mortgage rates and wide refinancing spreads, banks should benefit from increases in refinancing volumes. Since the crisis, mortgage exposures are embedded within larger financial institutions, which means that investors take on other risks here alongside exposure to improving housing markets.

Exhibit 5: Further modest house price gains likely on our baseline expectation



Source: Fiserv., GS Global ECS Research.

Exhibit 6: Increase in housing equities in line with improvement in the data



Source: Haver Analytics, GS Global ECS Research.

5. Euro area a smaller driver of global risk, but still a source of tails

- Weak European growth, and a continued 'muddle-through' in central case
- Spanish economic risks intensify in early 2013, mediated by ECB interventions
- Economic pressures ease in Italy, but political uncertainty from general elections
- France fundamentally weak, but easy financial conditions an offset

Market issues: This time last year, Europe played a decisive role in our views of the global risk environment, and the shifts in European risk have been a key driver of both weakness and more recent strength in global asset markets in 2012. In 2013, despite ongoing growth weakness in the Euro area, our central case sees less of a role for European issues to drive the global risk picture. This is partly because policy measures and institutional innovations reduce the deep systemic risks that have been the most likely source of global transmission; but it is also because we expect a continued 'muddling through' by Euro area policymakers that mitigates spikes in local risk. The best opportunities to take directional exposure to Europe have come either when the market believes that the system is close to collapse (as it did again in May) or when there is confidence that the key risks have been resolved. Neither is true right now.

With risk premia still wider than elsewhere, and larger than warranted by fundamentals alone, further policy progress – and an absence of fresh stresses – could see incremental gains in Euro area assets. Even so, investors will need to be prepared to navigate well-flagged downside risks: Spanish economic pressure that could escalate into political risks unless the ECB intervenes to ease financial conditions; and Italian political uncertainty ahead of the March general elections, which could lead to fresh concerns about a slowdown (or reversal) in the pace of reforms in one of the larger EMU members. While low-probability events, we still see these as a key source of risk to global assets, and see areas where the market has now relaxed significantly – the EUR/\$ skew and the EUR/\$ cross-currency basis – as potential hedges. Away from these areas, debt restructuring issues, the treatment of legacy debt in Greece and beyond, Ireland or Portugal potentially regaining market access, and the move towards banking union could provide investment opportunities in 2013.

6. Continued divergence between Euro core and periphery

- Continued divergence in economic outcomes between periphery and core
- More signs of 'overheating' in Germany as forecast horizon extends
- Outperformance of peripheral 'traded' sectors and core 'non-traded' sectors

Market issues: The divergence in growth between the Euro area core (Germany in particular) and the periphery (Spain in particular) is set to continue. Periphery weakness is already well-known, but the potential for German overheating is a more distinctive theme. Non-traded domestic construction and services areas of the German economy are likely to continue to outperform, while traded/manufacturing sectors in the periphery should also outperform, as part of the process of real exchange rate realignment.

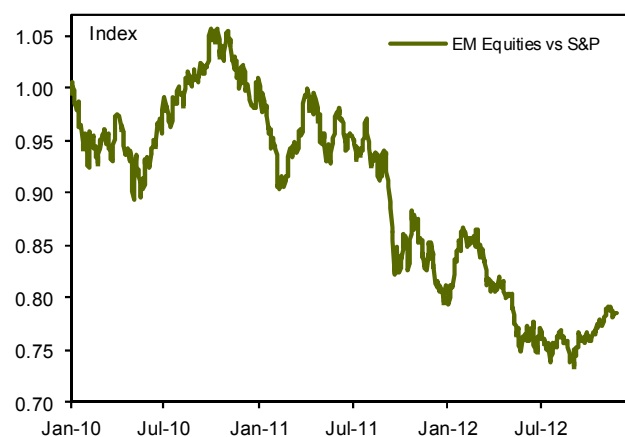
The challenge is finding suitable market implementations. German housing and services sectors are obvious beneficiaries but equity exposure in those areas is limited. The relative profiles priced into inflation markets in Germany and Italy could offer another (more limited) possibility. Beyond that, the scope for this kind of exposure becomes more indirect. Of these, the CE-3 is most intriguing; Poland is the most tightly linked to the German economy and we expect less easing here than the market. This suggests that a stronger German recovery could perhaps reinforce the case for the PLN relative to others in the region, at the price of introducing other idiosyncratic risks.

Exhibit 7: Euro-area sovereign and financial risk has improved, but still a source of tail events



Source: GS Global ECS Research.

Exhibit 8: A better year for EM assets...after 18 months of underperformance?



Source: GS Global ECS Research.

7. EM growth pick-up revisits capacity constraints

- A pick-up in growth across EM in 2013 but less 'room to grow' than in DM
- Limited acceleration in China, followed by stable growth
- Inflation increases tightening risks in places in late 2013 and 2014

Market issues: Growth in the EM world is likely to accelerate significantly between 2012 and 2013, and we have seen some nascent signs of this in the past couple of months. But the market environment here is more complicated than in the DM world, primarily because output gaps are generally not that large in absolute terms, and are certainly more limited than for DMs. In addition, the cyclical upturn in growth in some of the larger EMs (such as China and Korea) needs to be set against the fact that trend growth rates may slow modestly over the long term. Lastly, we forecast a moderate sequential slowing in China in 2013Q1 before limited acceleration for the rest of the 2013 and 2014.

In light of these nuances, the key market issue is how strongly to position for a rebound in EM equities, which have underperformed for much of the last couple of years. We think EM equities should have a better year, but the upside potential may be limited by the fact that inflationary pressure and a potential shift towards tightening could come earlier than the market expects in places. This tightening dynamic – largely absent in the DM world – and lingering concerns about imbalances (domestic ones related to housing or the pace of credit growth in China or Brazil, and external ones linked to current account deficits in India and Turkey) leave us thinking that even if EM equities outperform DM in an absolute sense, the outperformance is unlikely to be enough given the higher risk or variance in outcomes.

8. EM differentiation continues

- Responses to inflationary pressure likely to differ
- Current account imbalances an issue in some economies
- Some idiosyncratic imbalances in EM economies

Market issues: While we expect the EM universe as a whole to see better growth and somewhat more inflationary pressure, the differences across EM are at least as striking as

their similarities. We think some places will deliberately aim for weaker FX (Czech Republic), while others are in tightening mode already (Russia). Current account imbalances are still a significant risk for Turkey, India and (most dramatically given a fixed exchange rate) Ukraine. The 'orthodoxy' of the central bank reaction function to inflation is also likely to vary, and so the risk in some places is that even with building inflationary pressure, policy does not necessarily tighten (Turkey and perhaps Brazil face that risk) or tightens in ways that are not easily reflected in market pricing. Valuation also varies significantly, with some currencies (parts of Asia, the MXN and more recently the ZAR) looking substantially undervalued on a longer-term view, while others look more 'rich'.

The shift to tightening may also be a source of EM opportunities in the year ahead. The market may be underestimating the scope for rate hikes (in some ASEAN markets, such as Indonesia or Malaysia) or overestimating the scope for easing in places (Poland), especially if global yields drift higher as well. It is also possible to envisage policymakers in places that have resisted appreciation lately (Brazil, South East Asia, Korea) tolerating some currency strength as inflation pressures build later in 2013 and in 2014.

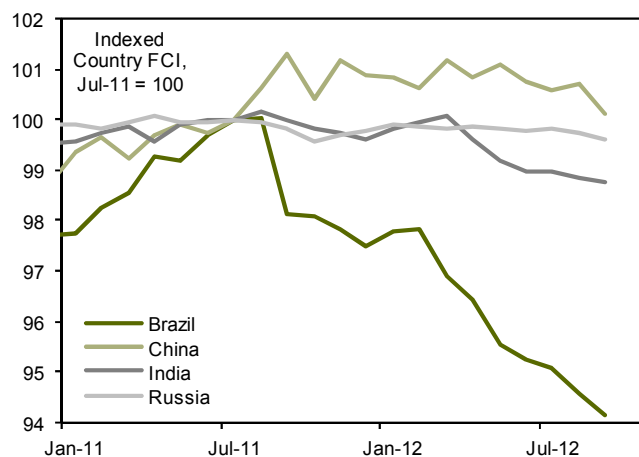
9. Commodity constraint to loosen medium term

- Cyclically tight markets but structurally more stable
- Despite more stable prices, positive carry likely to persist
- US energy supply story gradually loosens global oil constraint
- Pipeline constraints from mid-west US likely to ease

Market issues: The basic structure of our commodity price views has changed substantially in recent months as the implication of US shale production becomes clearer. Having seen markets that were heavily supply-constrained, we are now seeing the supply responses begin to take effect. Most importantly, we expect oil markets to return to a more structurally stable position, where the ability to bring on new supply in the \$80-90/bbl range is rapidly increasing. The relaxation of the energy supply constraint globally reduces one major obstacle to a global recovery as we look to above-trend global growth into 2014 and beyond. Our bias to express cyclical views through directional energy exposures is also lower as a result.

Exhibit 9: Differentiation across EMs in the past, set to continue

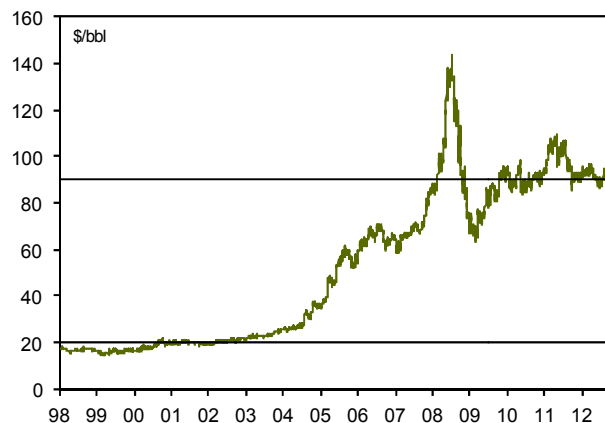
Financial Conditions Indices for BRIC economies



Source: GS Global ECS Research.

Exhibit 10: Long-dated Brent crude prices suggest that the market is becoming structurally stable around \$90/bbl

5-Year forward Brent Oil prices



Source: GS Global ECS Research.

But this takes us back to markets that have a structure which (at higher longer-dated prices) is more like the pre-2003 operating environment. With markets likely to remain cyclically

tight but structurally stable, commodity curves in oil, soy and potentially copper are likely to remain 'backwardated'. So the carry from owning commodity indices (which buy the front end of commodity curves and roll up to spot levels) may be stably higher again. We also think that the pipeline constraints that have kept WTI and Brent at wide spreads for some time are likely to be resolved in 2013, although positioning for that outcome involves significant negative carry, so timing is important.

10. Stable China growth, but not like the old days

- Sequential peaking in China housing cycle puts pressure on iron ore/coal
- Copper supported in the next 6-9 months, and structurally tighter
- Interaction with the peak in the resource investment boom in Australia

Market issues: Although we expect Chinese growth to stabilise next year, the pace of growth we envisage is still only a touch above 8%. So the question of how far the market has already adjusted to the slowing in China's growth profile will remain important. In some areas, stabilisation may be enough to provide some further relief. Our China 'risk factor' analysis suggested that some key assets – Chinese equities and the CNY forward points, in particular – had reflected large downgrades to China growth views. And while there has been a meaningful rebound in the market's pricing of China risk in the last three months, there may still be scope for stability alone to provide relief.

Elsewhere, it is less clear that persistently slower Chinese growth has been fully reflected. Our Commodity Research team's analysis of the Chinese construction cycle suggests that iron ore demand is likely to remain soft as core building demand falls, and that copper will receive a boost from the completion of new buildings in the next 6-9 months, but is likely to peak thereafter. Tim Toohey and team also continue to highlight the peak in Australia's resource investment boom and the risks that continued declines in the terms of trade could pose there. Those dynamics have begun to be appreciated by policymakers and may not have a big impact on the 2013 Australian growth picture. But we expect slower growth and lower rates to be more obvious in 2014. The broader question is whether the market begins to worry about the AUD or other currencies most levered to Chinese growth, or to differentiate more aggressively within the commodity FX universe ahead of that point. These assets may offer independent opportunities or a means of hedging a broader pro-cyclical view in equities.

Dominic Wilson and Kamakshya Trivedi



Our views by asset class

Below we summarise our key views by asset class, with key asset market forecasts in the table below.

Exhibit 11: Key market forecasts, 2012-2016

	Current*	End-2013	End-2014	End-2015	End-2016
Equities					
TOPIX	782	930	-	-	-
MXAPJ	447	520	-	-	-
Stoxx Europe 600	273	310	-	-	-
S&P 500	1,399	1,575	-	-	-
10 Year Bond Yields (%)					
Germany	1.39	1.90	2.00	2.50	3.00
Japan	0.72	1.00	1.25	1.30	1.75
UK	1.79	2.25	2.50	2.75	3.50
US	1.62	2.20	2.75	3.25	3.75
FX					
EUR/\$	1.29	1.40	1.40	1.35	1.25
EUR/GBP	0.81	0.85	0.85	0.85	0.85
AUD/\$	1.04	0.98	0.95	0.89	0.84
\$/JPY	82.2	80.0	80.0	85.0	90.0
\$/CNY	6.29	6.10	6.05	6.27	6.37
\$/BRL	2.09	2.00	2.07	2.16	2.26
\$/INR	55.5	52.0	50.0	51.0	52.0
\$/RUB	31.1	29.0	28.7	30.4	32.4
USD TWI	89.5	86.2	86.1	88.8	92.7
Credit IG (spreads, bp)**					
US	135	104	102	100	99
Europe	179	156	127	115	114
Commodities					
Brent (\$/bbl)	114	105	105	100	85
Soybean (Cent/bu)	1,200	1,200	1,200	1,200	1,200
Corn (Cent/bu)	525	525	525	525	525

* Close November 27, 2012

**Investment grade credit spreads to UST and bunds.

Source: GS Global ECS Research.

The macro rates outlook: Steeper curves and seniority shifts

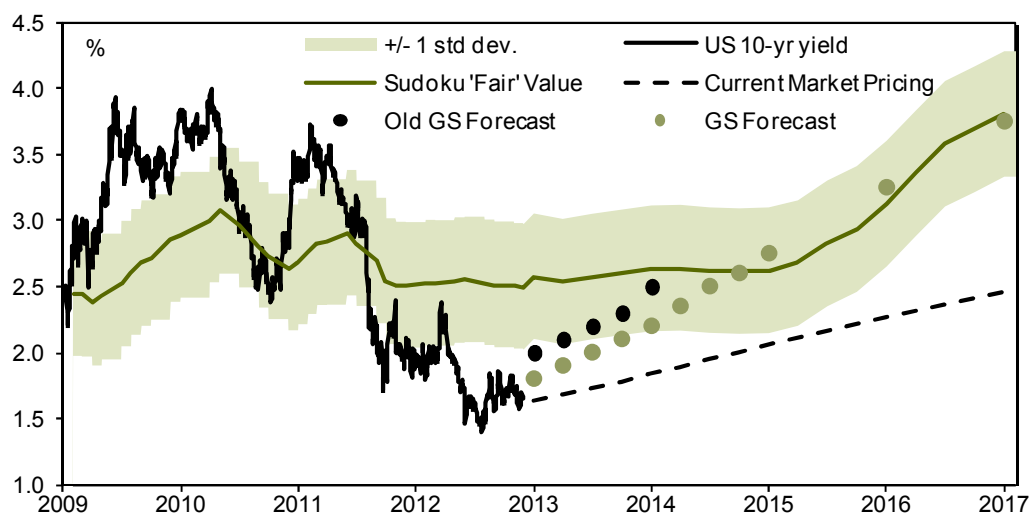
In global macro rates, we see two main themes for 2013: a progressive steepening of yield curves in the major markets after political hurdles are cleared, and a focus on potential shifts in value on private and public legacy debt in the Euro area.

In anticipation of a bigger expansion of the Fed's balance sheet than consensus expects (by an additional US\$2trn), and reflecting a downgrade of our European growth forecasts, we have shaved around 30bp off our end-2013 10-year bond yield projections in the major markets. Nevertheless, we look for 2013 to mark the start of a more sustained increase in intermediate to long-dated government bond yields. From a *valuation* standpoint, our empirical work suggests that (7- to 10-year) maturity bonds are anywhere between 1.5 and 2 standard deviations below levels consistent with the current set of macro expectations. This degree of 'overvaluation' was last observed in the Autumn of 1998, preceding a period of negative returns. From a *cyclical* perspective, we expect the ongoing easing of financial conditions promoted by central bank interventions (asset purchases by the Fed, the ECB's OMT program and, possibly, a more proactive BoJ) to result in higher policy rate forwards, reversing the long-end flattening of the curves seen in 2012. The transition from a time-horizon policy guidance to one tied more explicitly to macro realisations should also increase the term premium. We expect US\$ 10-year real rates to rise back to zero by end-2013, and to return to above 1% by mid-2015. We are comparatively more constructive on

the EUR term structure, reflecting abundant liquidity and a comparatively weaker macro outlook, and neutral to the forwards in Japan. Timing the expression of short views is admittedly crucial. For the time being, once again we recommend paying US\$ 10-year OIS and receiving 10-yr EONIA.

The second theme is around Euro area sovereign bond markets. We think that intra-EMU sovereign spreads will continue to grind tighter, with 5- to 7-year maturity bonds faring best. The process is unlikely to be linear given the political and economic cross-currents involved, but Spain in our projection looks set to outperform other peripherals. This may appear counterintuitive, in light of our weaker macro forecast for Spain. But spreads for Spanish government bonds are 100bp wider than for Italy; moreover, the ECB is likely to act to reduce them from current values from the front-end. We assume Spain 10-year bonds will trade around 300bp over Germany, from around 400bp currently. Note that this is still 100bp above where they stood in the first half of 2011, before the Greek PSI. We currently recommend capitalising on this by being long 5-year Spanish bonds vs. their Italian counterparts.

Exhibit 12: Bond yields above the forwards from 2013



Source: GS Global ECS Research.

We also expect investors to shift their focus in 2013 from the funding of budgetary or external shortfalls to the question of how the stock of legacy debt will be handled. We expect two dynamics to play out. First, the introduction of a new class of national debt carrying collective action clauses, alongside the heavier issuance of supranational debt (the EFSF accounts for around EUR53bn, and ESM issuance could be as high as EUR50-75bn), should keep investors alert to the risk of potential subordination, especially in longer maturity bonds. In this context, we have recently argued that government securities carrying CACs will trade at a premium to vintage bonds for mid-rated issuers such as Italy and Spain. Second, each country will look for ways to reduce liabilities. In Greece, we have just seen another round of official loan modifications. In Spain, the main liability management exercise will revolve mostly around private debt and debt-to-equity transformations. In Italy, a debate on whether to sell public assets or tax private wealth to reduce the heavy public debt burden will likely be part of the political campaign. Translating these shifts into investment opportunities will require a close scrutiny of the policy inclinations as well as legal expertise.

Francesco Garzarelli

The FX outlook: Moderate USD weakness amid broad stability

Our baseline view for the next few years is that the trade-weighted Dollar will remain under broad pressure, although this trend is likely to be less pronounced than in the past. The three key factors leading to Dollar depreciation (a weak US external position, a very dovish Fed and broadly improving risk sentiment) are all features of our macro markets outlook beyond the near-term uncertainties. These factors are not new and are unlikely to change substantially in the near future. Changes in the balance of payments situation are largely driven by the current account balance, and our US forecasts show notable deficits in the foreseeable future. As discussed above, it will be difficult for other central banks to out-ease the Fed in the near term, and improving risk sentiment will likely lead to some broad appreciation of EM currencies vis-à-vis the Dollar in 2013 and, potentially, in 2014. Although we do not assume peak capital inflows as in 2010/11, a number of EM policymakers could potentially have to allow a moderate degree of currency strength to fight growing inflation pressures. We expect NJA currencies to appreciate by around 2%-8% in 2013, with a more mixed picture in other regions (see Exhibit 11).

On that basis, we expect the trade-weighted Dollar to weaken by about 3%-4% in 2013 and then remain relatively stable at weak levels in 2014.

An important driver of currency markets will also be the outlook for the EUR, which we expect to rebound somewhat in 2013 towards 1.40, and then stabilise around this level. The likelihood of a deep systemic crisis has moderated in 2012, and as the focus shifts to fiscal restraint outside the Euro area, a continued gradual reduction of tail risk premia should help the EUR recover some lost ground relative to other currencies: for example, EM central banks have reduced their FX allocation to the EUR by almost 5 percentage points of total allocated reserves since the European crisis started. The balance of payments situation for the Euro area aggregate also remains far stronger than in the US.

Amid the relative stability of FX markets in 2013 and 2014, some interesting directional moves are still likely to occur. The AUD is likely to underperform linked to a notable deterioration in China-related terms of trade, namely coal and iron ore prices. The PHP, INR and ZAR are expected to perform strongly, with the latter two mainly recovering some lost ground linked to recent underperformance. The TRY is one of the few places where we expect notable currency weakness, mainly reflecting central bank preferences. But even then, it is not obvious that shorting the TRY is an attractive carry-adjusted proposition. Relative to our generally benign baseline case, we worry about countries with large external imbalances or acute overvaluation, with warning signs in places such as Turkey, India, Brazil, Indonesia and even Japan.

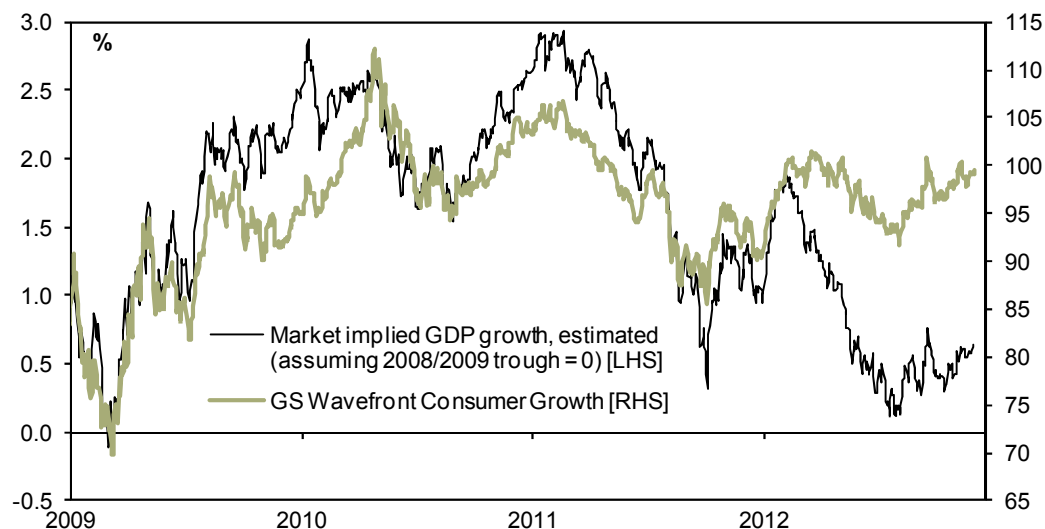
Thomas Stolper

The macro equity outlook: Accelerating growth and risk reduction should underpin a solid 2013 for equities

The macroeconomic themes that we envisage playing out over the course of next year paint a broadly supportive environment for risk assets, and equities in particular. Moreover, unlike other 'growth'-exposed assets, we see fewer potential ancillary cross currents to derail the transmission of improving growth prospects into equity performance (of course, the main thrust of the economic outlook could be wrong, which would lead to derailment). US Treasuries continue to be supported by accommodative policy and an expanding Fed balance sheet, FX crosses are, by their nature, driven by relative growth and rate expectations, and commodities now look to be well supplied in places and perhaps marginally less exposed to pressures from modest incremental growth rates.

Exhibit 13: US cyclical equities pricing an unchallenging forward US growth view

Growth views implied in the US equity market based on broad cyclical/defensive rotations and domestic US cyclical/defensive rotations.



Source: GS Global ECS Research.

Consistent with this view, our Equity Strategy teams see significant upside in all regions, although the drivers of those returns differ slightly. Our US target of 1575 (c.+12% by year-end relative to current prices) is driven in equal parts by earnings growth, owing to improving domestic and global prospects, and by multiple expansion as a result of stretched bond premia, an active Fed and a normalising risk backdrop. In contrast, upside in Europe (a Stoxx600 target of 310, +13%), Japan (a Topix target of 930, +19%) and Asia ex-Japan (a MXAPJ target of 520, +17%) are more a function of expected earnings growth. In Europe, policy-induced valuation expansion is mostly behind us, a view echoed by our quantitative tools, which show that markets have wrung out a good deal of European risk from markets over the past half year. This suggests that from here the market will need to rely on earnings growth. In Japan, earnings optimism is also, in part, a function of policy change, with the possibility that a new regime and renewed focus on deflation will help to boost corporate profits. In non-Japan Asia, the drivers of earnings and returns are primarily from 'organic' home-grown growth, but the support from policy is least clear-cut here, and risk-adjusted reward slightly less attractive as a result.

As growth prospects steadily improve and yields gradually climb, the baton of market support may pass from quality to growth. Cyclical leadership, which can come in any number of flavours, is likely to become a clearer market theme in 2013. In trading 'flavours' of growth, the balance between the degree of visibility of that cyclical improvement and the speed at which the market prices that improvement is a fine one. Although US economic growth measures have picked up over the second half of 2012 and are likely to improve further in 2013, perhaps after a bit of softness in Q1, broader US equity-market cyclical exposures have been fairly inert for much of 2012. Although the S&P and domestic consumer-linked stocks came close to 2012 highs, the macro data was surprisingly strong and measures of current activity are improving, the Wavefront GDP growth basket, which pits the most cyclical industries against the most defensive ones, remains close to 2012 lows (Exhibit 13). Thematically, we think that market growth views, measured in this way, have long been underpriced, and, against a constructive risk and equity backdrop, we remain very comfortable with this sector tilt. Housing-related areas have been swift to price in data improvement and US-focused cyclical areas have generally outperformed global exposures. But even here, there appear to be laggards to the broader theme, including the banks.

Beyond the US, economic acceleration is clearest in emerging markets, according to our forecasts. This forward view comes against a backdrop of equity markets that have underperformed over the last year or so, particularly on a 'growth'-adjusted basis. However, the data there has yet to conclusively turn, and the scope and effectiveness of policy support is more muddled. Although we have long pointed to the underperformance as a valuable repository of 'dry powder', we still think the time to activate that view is down the road. For now, we prefer the visibility of the US policy mix and growth outlook, even though it is more aggressively priced.

Outside of the US, the clearest argument for policy-induced equity exposure is in Japan. A shift in leadership and the potential for a more vigorous approach to monetary stimulus there could provide equity support, although it is by no means certain that policy obliges.

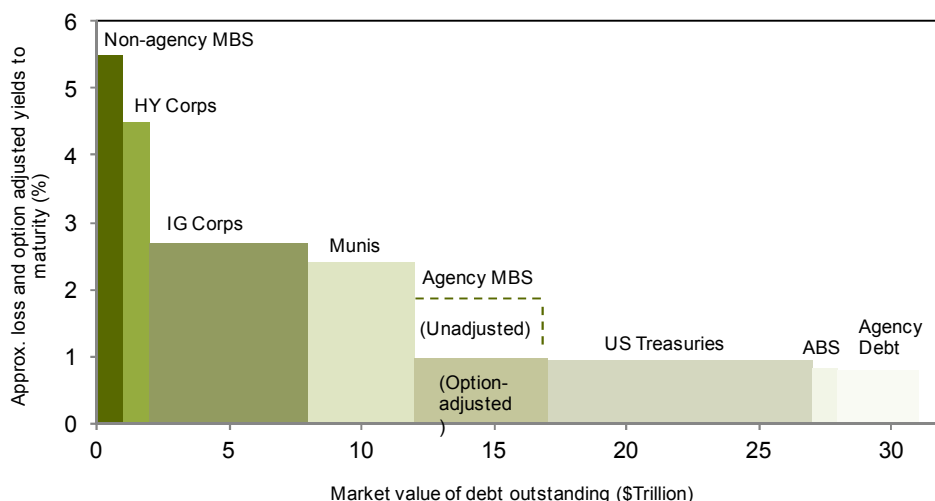
Noah Weisberger

The Credit Outlook: The 'search for yield' has less to find

Search-for-yield motives remain the dominant theme in our 2013 outlook for corporate credit spreads, with still-solid credit fundamentals and a favourable macro picture (sluggish growth, at least initially, low rates and few tail-risk concerns around the Euro crisis) continuing to support the asset class. Although the reward for risk-taking has fallen to increasingly challenging levels, we nonetheless expect spreads to tighten further due to the effective lack of options available to fixed-income investors. Our forecasts for rates and spreads in Exhibit 11 imply total returns for investment grade credit of roughly 1.5% in both the US and Europe, respectively. In high yield markets we expect total returns closer to 8%.

Exhibit 14: The 'search for yield' has few good alternatives to corporate bonds

Horizontal axis shows market size at market value. Vertical axis shows approximate, value-weighted yields adjusted for expected default losses. No attempt is made to adjust for duration differences across assets. Yields for agency MBS are shown on both an option-adjusted basis as well as unadjusted. CMBS, home-equity ABS, and floating rate debt and bank loans are excluded. Estimates of the market value of debt outstanding are rounded to the closest trillion.



Notes: Fixed-rate bond maturities of greater than one year. Estimates of market outstandings as well as adjustments for default loss and optionality are approximate.

Source: Goldman Sachs Credit Strategy.

At a high level, and across the rating spectrum in corporate credit, we continue to recommend that long-only investors seek out yield in the higher-quality (BB/B) name in high-yield. Bond pickers can find pockets of value in lower-rated names, but from a portfolio view, we think the risk-reward in CCCs, for example, is dominated by the higher-rated names. The other sector where we expect to see continued outperformance is in financials. While the spread to nonfinancials has narrowed materially, we think this relative performance is justified by fundamentals, especially for US banks, where we expect a stabilised housing market to put market concerns further at ease.

The biggest risks for corporate credit are three-fold. First, despite our cautiously optimistic view that US growth will gain traction as it exits a slower-patch in 2013Q1, the risks to growth remain skewed to the downside. Second, while central bank actions have done much to short-circuit the feedback loop driving self-fulfilling funding shocks, the global price of credit risk remains exposed to the vulnerability to shocks stemming from the still-weak balance sheets of European banks, the unresolved issues regarding the Euro area's fiscal and monetary institutions, and elevated risks that progress in Europe is derailed by growing political discord. Lastly, we see a growing risk that the easy access to cheap credit will sow the seeds of its own demise as it tempts companies to deploy more leverage in pursuit of higher equity returns.

Charlie Himmelberg



Equity basket disclosure

The Securities Division of the firm may have been consulted as to the various components of the baskets of securities discussed in this report prior to their launch; however, none of this research, the conclusions expressed herein, nor the timing of this report was shared with the Securities Division. Note the ability to trade the Wavefront® basket will depend upon market conditions, including liquidity and borrow constraints at the time of trade.



Disclosure Appendix

Reg AC

I, Charles P. Himmelberg, hereby certify that all of the views expressed in this report accurately reflect my personal views about the subject company or companies and its or their securities. I also certify that no part of my compensation was, is or will be, directly or indirectly, related to the specific recommendations or views expressed in this report.

We, Dominic Wilson, Kamakshya Trivedi, Francesco Garzarelli, Thomas Stolper, Noah Weisberger, 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.

Disclosures

Global product; distributing entities

The Global Investment Research Division of Goldman Sachs produces and distributes research products for clients of Goldman Sachs on a global basis. Analysts based in Goldman Sachs offices around the world produce equity research on industries and companies, and research on macroeconomics, currencies, commodities and portfolio strategy. This research is disseminated in Australia by Goldman Sachs Australia Pty Ltd (ABN 21 006 797 897); in Brazil by Goldman Sachs do Brasil Corretora de Títulos e Valores Mobiliários S.A.; in Canada by Goldman, Sachs & Co. regarding Canadian equities and by Goldman, Sachs & Co. (all other research); in Hong Kong by Goldman Sachs (Asia) L.L.C.; in India by Goldman Sachs (India) Securities Private Ltd.; in Japan by Goldman Sachs Japan Co., Ltd.; in the Republic of Korea by Goldman Sachs (Asia) L.L.C., Seoul Branch; in New Zealand by Goldman Sachs New Zealand Limited; in Russia by OOO Goldman Sachs; in Singapore by Goldman Sachs (Singapore) Pte. (Company Number: 198602165W); and in the United States of America by Goldman, Sachs & Co. Goldman Sachs International has approved this research in connection with its distribution in the United Kingdom and European Union.

European Union: Goldman Sachs International, authorized and regulated by the Financial Services Authority, has approved this research in connection with its distribution in the European Union and United Kingdom; Goldman Sachs AG, regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht, may also distribute research in Germany.

General disclosures

This research is for our clients only. Other than disclosures relating to Goldman Sachs, this research is based on current public information that we consider reliable, but we do not represent it is accurate or complete, and it should not be relied on as such. We seek to update our research as appropriate, but various regulations may prevent us from doing so. Other than certain industry reports published on a periodic basis, the large majority of reports are published at irregular intervals as appropriate in the analyst's judgment.

Goldman Sachs conducts a global full-service, integrated investment banking, investment management, and brokerage business. We have investment banking and other business relationships with a substantial percentage of the companies covered by our Global Investment Research Division. Goldman, Sachs & Co., the United States broker dealer, is a member of SIPC (<http://www.sipc.org>).

Our salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to our clients and our proprietary trading desks that reflect opinions that are contrary to the opinions expressed in this research. Our asset management area, our proprietary trading desks and investing businesses may make investment decisions that are inconsistent with the recommendations or views expressed in this research.

The analysts named in this report may have from time to time discussed with our clients, including Goldman Sachs salespersons and traders, or may discuss in this report, trading strategies that reference catalysts or events that may have a near-term impact on the market price of the equity securities discussed in this report, which impact may be directionally counter to the analysts' published price target expectations for such stocks. Any such trading strategies are distinct from and do not affect the analysts' fundamental equity rating for such stocks, which rating reflects a stock's return potential relative to its coverage group as described herein.

We and our affiliates, officers, directors, and employees, excluding equity and credit analysts, will from time to time have long or short positions in, act as principal in, and buy or sell, the securities or derivatives, if any, referred to in this research.

This research is not an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Clients should consider whether any advice or recommendation in this research is suitable for their particular circumstances and, if appropriate, seek professional advice, including tax advice. The price and value of investments referred to in this research and the income from them may fluctuate. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Fluctuations in exchange rates could have adverse effects on the value or price of, or income derived from, certain investments.

Certain transactions, including those involving futures, options, and other derivatives, give rise to substantial risk and are not suitable for all investors. Investors should review current options disclosure documents which are available from Goldman Sachs sales representatives or at <http://www.theocc.com/about/publications/character-risks.jsp>. Transaction costs may be significant in option strategies calling for multiple purchase and sales of options such as spreads. Supporting documentation will be supplied upon request.

In producing research reports, members of the Global Investment Research Division of Goldman Sachs Australia may attend site visits and other meetings hosted by the issuers the subject of its research reports. In some instances the costs of such site visits or meetings may be met in part or in whole by the issuers concerned if Goldman Sachs Australia considers it is appropriate and reasonable in the specific circumstances relating to the site visit or meeting.

All research reports are disseminated and available to all clients simultaneously through electronic publication to our internal client websites. Not all research content is redistributed to our clients or available to third-party aggregators, nor is Goldman Sachs responsible for the redistribution of our research by third party aggregators. For all research available on a particular stock, please contact your sales representative or go to <http://360.gs.com>.

Disclosure information is also available at <http://www.gs.com/research/hedge.html> or from Research Compliance, 200 West Street, New York, NY 10282.

© 2012 Goldman Sachs.

No part of this material may be (i) copied, photocopied or duplicated in any form by any means or (ii) redistributed without the prior written consent of The Goldman Sachs Group, Inc.

