

An Upbeat Picture for the World Economy in 2006, But a Slowdown Looms for 2007

2005 is ending on a strong note, and we expect a third consecutive year of above-4% global growth in 2006. Growth is increasingly well-balanced across the major regions, which should help the world weather the slowdown that looks likely for 2007.

2005 is ending on a strong note, with solid growth across much of the globe and even laggard regions such as Europe showing signs of an upturn. We expect the world economy to post real GDP growth of 4.1% this year. We are even more optimistic for 2006, with our 4.2% forecast suggesting that the world will see three consecutive strong years. We are notably more optimistic than the consensus for 2006 in China, Japan and, for the first half, in the US.

We expect headline inflation to stabilize next year as oil prices rise by a lesser degree than in 2005 (although they will remain strong). Core CPI inflation will rise in some parts of the world, including the US and, at last, in Japan. Eurozone core inflation will ease slightly.

US short-term rates are likely to reach 5% by mid-year, with 10-year yields also reaching that level before declining in the second half of the year. In Europe we expect an additional 25bp rate hike in the spring, but no further hikes for the balance of the year. In Japan, positive core inflation should lead the central bank to modify its current interest rate policy by the spring and to raise policy rates around year-end 2006.

This global growth and inflation environment is likely to be positive for equities,

particularly in Japan and the rest of Asia. Major bond yields should rise, although we are not forecasting significant increases. Strong global growth will continue to fuel demand for commodities—including gold, despite its recent run-up in price. After a strong performance in 2005, we expect the US dollar to resume its weakening course, as investors again focus on the currency's poor fundamentals.

World Growth Becoming Well-Balanced

One of the most interesting aspects for the world economy over the past several years has been the rise of the BRICs—Brazil, Russia, India and China—as more than just ‘emerging markets stories’. As we have noted before, these countries are playing an increasingly key role in the global economy. Our work finds that the BRICs (with the major exception of Brazil) have become major contributors to global growth.

Since the start of the decade, the BRICs in aggregate have contributed more than one-quarter of total world growth—well ahead of either Japan or the major European countries in aggregate. China has accounted for more than half the BRICs’ share, and India and Russia together have contributed nearly half as much to the global total as have France,

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GS Forecasts for 2005-2007										
% change yoy	US		Japan		Euroland		China		Non-Japan Asia	
	GDP	CPI	GDP	CPI	GDP	CPI	GDP	CPI	GDP	CPI
2005	3.7	3.3	2.6	-0.2	1.4	2.2	9.4	1.7	7.7	2.9
2006	3.6	2.9	2.7	0.3	2.0	2.0	9.0	2.2	7.5	3.4
2007	2.6	2.2	2.9	0.7	1.7	1.9	8.5	2.0	7.1	2.6

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Germany, Italy and the UK combined.

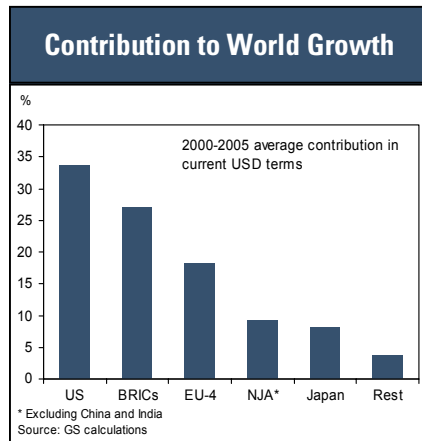
China may in fact now be the world's fourth largest economy. Recent speculation about a restatement of Chinese GDP, to be confirmed next week, suggest that China is 20% larger than thought under previous estimates. If so, China has now overtaken the UK and France in current US dollar terms.

In addition to the encouraging BRICs story, there is other evidence that global growth is becoming more balanced and less dependent on the US. This is most notable in Asia, where Japan, China, India and Korea are all ending the year on firm footing, with a good outlook for a pickup in domestic demand in 2006. This breadth of economic growth in Asia is unprecedented in recent years. Solid growth in Asia is especially helpful because it may help the world to weather the consequences of a consumer-led slowdown in the US.

The US housing market has been a key risk to our views for some time, and we are increasingly confident that 2006 will be the year that this risk becomes reality. Signs of slowing in the housing market are already evident, and interest rates continue to rise. Our US economists expect that the downturn in the housing market will begin to hit consumer spending in the second half of 2006. Although the impact on GDP growth will mainly be felt in 2007, this raises the risks to the global economy.

Equity Risk Premium Remains Historically High

The equity risk premium, on our calculations, is currently around 3%. While below its highs of 2005, it is



above the average level of the past 25 years. (The table on page 3 shows our calculations of the ERP.) If the next decade were to witness global growth of 4%—not an unreasonable assumption given the recent trend in global growth, the strength of the BRICs and the ongoing evidence of stronger productivity growth in many areas—then the current ERP would be 4.5%, well above levels prevailing in the last 25 years.

In addition to suggesting that equities are 'well cushioned', an ERP of 4.5% would suggest that markets could cope better with any large rise in nominal and real bond yields in the future. Our forecast is for 10-year yields to rise modestly in the first half of 2006 before falling again in the second half. However, there is a significant risk that yields will instead rise further. By almost any common valuation measure, bond yields are significantly below equilibrium; we estimate about 150bp below in the G7. Real yields also remain more than one standard deviation below their 20-year average.

If real bond yields were to move back to their 20-year average, the ERP would be around 1.5% lower. From an ERP base of 3%, a conservative (2.5%) assumption of trend global



growth could imply significant challenges for equity markets. However, if world growth is sustained around 4%, then equity markets could quite feasibly cope with bond yields rising back to equilibrium.

The Outlook for 2006

In the US, we expect another year of above-trend growth. Our full-year forecast is for 3.6%, just slightly below this year's 3.7%. The growth pace will be strong through the summer, as a strong corporate sector, a powerful inventory cycle and faster demand growth in Europe and Asia outweigh the gradual slowing in the consumer sector. The unemployment rate should fall to about 4.75% from 5% now.

The housing-led slowdown is likely to bite late in the year, however, subtracting as much as 1.5 percentage points from real GDP growth by 2007. Both a fall in residential investment and a sharp decline in mortgage equity withdrawal will contribute to the slowdown. The effects of this will be exacerbated by a fading inventory cycle. Unemployment is likely to rise again late in the year and into 2007.

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Inflation is likely to rise in 2006, but neither sharply nor to excessively high levels. Core inflation (excluding food and energy) is likely to rise by about 50bp over the course of 2006, to 2.25% annualized. Although energy prices dominate the headlines, the key issue for core inflation is that above-trend growth in an environment of full employment is likely to push unit labor costs higher.

We still expect the Fed to raise rates to 5.0% by mid-year, reflecting the risks of overheating and the still-accommodative financial conditions.

10-year yields should rise to a similar level. But this picture will change in the second half as first the bond market and then the Fed react to slowing activity and easing inflationary pressures. The yield curve is likely to invert, with 10-year yields falling to about 4.5% by year-end.

Japan's domestic-led recovery will continue to gain traction in 2006. Our forecast of 2.7% real GDP growth is at the top of market expectations, and growth may well be higher than this. Personal consumption and private-sector demand will remain the key drivers. We expect the ongoing capital spending recovery to extend

beyond the manufacturing sector to include building and IT investments.

With the long period of deflation is at last coming to an end, CPI should turn positive within the next few months and continue to strengthen throughout 2006, driven first by higher import prices and then by stronger domestic demand. We expect core inflation for 2006 to reach 0.4%, meaning that Japan will see an end to the inversion of nominal and real GDP growth for the first time in nearly a decade. The sharp upturn in nominal GDP growth, from 1.4% to 2.4%, will allow

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Updated Estimates for the Equity Risk Premium*

	Real GDP Growth	Real Earnings Growth	Dividend Yield	Expected Real Return	Real Bond Yield	Implied ERP	Expected Inflation	Expected Nominal Return
US	3.0	3.0	1.8	4.8	2.2	2.7	2.0	6.8
Japan	1.5	1.5	0.9	2.4	1.0	1.4	0.5	2.9
UK	2.5	2.5	3.2	5.7	1.1	4.5	2.0	7.7
Europe ex UK	2.3	2.3	2.3	4.6	1.1	3.4	2.0	6.6
World	2.5	2.5	2.0	4.5	1.6	3.0	1.8	6.3

*Calculated as of 13 December 2005.

Source: Datastream; real GDP growth and expected inflation are GS Economics Research forecasts.

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corporate sales to accelerate and profits to resume double-digit growth.

Eager not to let monetary policy derail the recovery, the Bank of Japan is likely to maintain its accommodative policy even as deflation ends. We expect the BoJ to modify—if not terminate—its quantitative easing policy next spring, but we think it will then hold policy rates at zero for a considerable time. Our forecast is for policy rates to rise by only 15-25bp, and only in late 2006 or early 2007. Real interest rates will be negative for much of 2006, further stoking the recovery.

Europe is also showing encouraging signs for the first time in several years. Helped by a favourable external environment and a long-awaited pickup in domestic demand, Euroland should see growth of about 2% in 2006. Export growth should remain strong despite a slight appreciation of the euro.

Domestic demand is at last picking up. Although balance-sheet restructuring is long completed, companies facing the restructuring challenges brought about by globalization (from both the BRICs and Eastern Europe) have remained reluctant to invest. This is now starting to change, with a rebound in German investment spending a particularly positive sign. Private consumption has improved only marginally this year, and we do not expect it to accelerate significantly in 2006.

After raising rates by 25bp this month, the ECB appears split between hawks who would like to tighten further and those who think the one cut will suffice. Our forecast is for one further hike, to 2.5%, in the

spring, and then for no change through year-end. But the decision is likely to depend on the economic data released in coming months.

China 'bears' are likely to be frustrated again in 2006. We expect real GDP growth to maintain a solid pace of 9.0% in 2006, compared with the consensus forecast of 8.4%. Comprehensive policy adjustments in the next few years—including accommodative monetary policy, stimulative fiscal policy, banking sector reforms and greater rural investment—should help rebalance China's growth away from reliance on exports and towards domestic demand.

If the revisions to Chinese GDP mentioned above are in fact correct, it will suggest that Chinese growth is on a sounder footing than many observers believe. The investment-to-GDP ratio, along with other important ratios, will look less worrisome. And because the revision to GDP will come largely from faster growth in the services sectors, the Chinese economy is likely to be much more efficient than is widely credited.

The main upside risk to our positive view on China for both 2006 and 2007 is a sharp deterioration in global growth. There is also a risk that stronger-than-expected external demand, amid accelerating domestic demand, could bring a modest but unwelcome renewal of overheating pressures. But if China's robust growth continues as we expect, it raises hopes that the world is now in a better position to withstand a slowdown in the US.

An Early Look at 2007

We have just this week launched our economic forecasts for 2007. With the caveat that our 2007 thoughts are

necessarily more speculative than our 2006 forecasts, our early numbers point to a moderate slowdown in global growth to 3.8%. The slowdown will be more marked in the advanced economies, where growth should fall from 3.0% to 2.5%. Emerging markets will fare somewhat better, with growth slowing from 6.5% to 6.2%.

Inflation globally will fall by 50bp to 2.7%. Driven largely by lower inflation in the US, inflation in the advanced economies will fall to 1.9%; in the emerging markets it will fall more significantly, by 100bp, to 4.2%.

The US will see GDP growth fall from 3.6% to 2.6%, driven mainly by the ongoing impact of a housing-related slowdown on consumption. Inflation will fall 70bp to 2.2%. We expect the Fed to cut rates by about 100bp, and 10-year yields to fall from around 5% in mid-2006 to around 4.4% at end-2007.

Euroland will also slow, from 2.0% to 1.7%. Although France will accelerate due to expected pre-election fiscal easing, Germany will slow significantly, thanks to tighter fiscal policy, including a planned VAT hike. Consumer prices will edge down to 1.9%.

Japan will see sustained growth of nearly 3.0%, driven by steady domestic demand, with some frontloading of demand for consumption, capex and housing investment in 2007 before the consumption tax rises in 2008. The BoJ's accommodative stance in 2006 will also boost 2007 growth. Inflation will rise but remain low at just 0.7%.

China will slow from 9.0% to a still-impressive 8.5%. ■