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A Less Friendly World: Cutting Our Global Forecasts

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We have flagged for some time that our economic forecasts—in the US in particular—have been under review. The news over the past few weeks has confirmed the softening in the US and seen more weakness in Europe, and we are now making comprehensive revisions to our global growth and asset forecasts. Our individual publications across ECS will contain more of the details but we summarise the main revisions here.

The basic story is that we now envisage significantly less growth than before in the US and in Europe—and as a result less tightening in European monetary policy too. The same is true to a lesser degree in the EM world. Overall, we are lowering our global GDP growth forecasts to 4.0% for 2011 and 4.4% for 2012, from 4.1% and 4.6%. Because of these shifts, our forecasts for global yields and for global equity markets have come down too, although we continue to see commodity prices heading higher.

While our aggregate global growth forecasts still appear relatively healthy, we have made significant downgrades in places, particularly in the US. But we would emphasise that as we look ahead to the next 6-18 months it is easy to imagine worse outcomes and the world economy is fragile to new shocks here. In particular, our current forecasts embed assumptions that the US will avoid falling into outright recession, that the European sovereign crisis now receives a more forceful response from the ECB and that large EM economies will largely be able to adjust policy to cushion against the greater external growth risks. If those conditions are not satisfied, a weaker growth forecast—even after accounting for a larger policy response—would make sense. It is this shift in the balance of risks relative to our baseline view that is reflected in the significant changes to our asset market forecasts, and which the market is in the process of pricing.

As we discuss below, the point of maximum risk is likely to be the next 6-9 months. While we are not forecasting a US recession—nor a renewed round of Fed asset purchases—the probability of both has climbed significantly. We now see a recession as a 1 in 3 chance. That issue is likely to be resolved one way or another by early 2012. The constraints on policy—political and economic—in the face of growth and sovereign pressures are an important variable here.

Less Growth, Easier Policy

Tables 1 and 2 outline the main changes:

- **US growth no better than trend.** The biggest adjustments come in our US GDP growth view, now at 1.7% and 2.1% (from 1.8% and 3.0%). On a quarterly basis, we expect 2% annualised GDP growth between 2011Q3 and 2012Q1, and 2.5% GDP for the rest of 2012. This is insufficient to stop the unemployment rate drifting a touch higher.

Table 1: Lower US, Global GDP Growth Forecasts

%yoy	2011		2012	
	Old	New	Old	New
USA	1.8	1.7	3.0	2.1
Japan	-0.8	-0.8	3.0	2.7
Euroland	2.1	1.9	1.7	1.4
UK	1.9	1.5	2.6	2.5
Brazil	4.5	4.5	4.0	4.0
China	9.4	9.3	9.2	9.2
India	7.5	7.3	7.8	7.8
Russia	5.3	4.8	5.6	5.4
BRICs	7.9	7.7	7.9	7.9
Advanced Economies	1.9	1.8	2.8	2.3
World	4.1	4.0	4.6	4.4

Source: GS Global ECS Research

Table 2: Little Change to Global Inflation Views

%yoy	2011		2012	
	Old	New	Old	New
USA	3.2	3.0	2.2	2.1
Japan	0.7	0.6	0.3	0.3
Euroland	2.7	2.7	2.0	1.8
UK	4.2	4.3	2.2	2.4
Brazil	6.6	6.6	6.0	6.0
China	4.7	5.2	3.0	3.3
India	8.6	8.6	5.1	5.1
Russia	8.7	8.7	6.4	6.5
BRICs	6.2	6.5	4.2	4.4
Advanced Economies	2.9	2.8	2.1	2.0
World	4.5	4.5	3.4	3.4

Source: GS Global ECS Research

- **Less growth in Europe.** We now forecast Euro-zone GDP growth of 1.9% and 1.4% (from 2.1% and 1.7%). The latest Euro-zone surveys point to more softening in activity in the near term. And the spread of sovereign stresses to Italy mean that the growth picture is at greater risk there. We show a modest recovery in growth through 2012 on the assumption that those stresses are alleviated by policy action and global demand picks up a little. We continue to show a sharp distinction between a stronger German core and a struggling periphery.

- **A more modest adjustment in the EM world, Japan.** While a slower developed market growth picture would weaken the external side of EM economies, we expect the impact on growth to be smaller on average. The main reason for this is that many EM economies are in the middle of a tightening cycle. As a result, a shift to the policy path more than the growth path is likely to be the first line of defence. Those economies more directly linked to the US (Mexico) should see somewhat more adjustment. We are also making only modest changes to our forecasts for Japan. A weaker export backdrop is offset by a more positive domestic picture as the post-tsunami rebuilding takes hold.

- **Less policy tightening globally.** Slower US growth and a softer core inflation picture reinforce our view that the Fed will be on hold until at least 2013. Beyond this, we now expect a broadening of the forward policy commitment to encompass the size of the balance sheet and a shift in the structure of the Fed balance sheet toward longer-duration securities with the first coming at next week's FOMC meeting. A return to full-blown quantitative easing is also possible, but we think it probably would require a further deterioration in growth and employment beyond what we are forecasting. Elsewhere, we now expect no ECB rate hikes until 2012H2, when we expect 50bp in hikes (and there is still some risk of an October rate hike this year). And we have pushed our first UK rate hike out to 2012Q4. In EM, we expect little further tightening in Latam in the foreseeable future (25bp in Brazil), a step away from tightening pressure in China and more modest tightening than before in much of Asia and 100bp of cuts in India next year.

What has changed

We have already outlined some of the key forces that have weighed on our forecasts in the US and beyond. Four general areas have combined to make the environment more difficult than we initially envisaged.

- **A softer underlying private demand trend in the US in particular.** As our US research has described over the past couple of months, the softness of underlying demand growth through 2011H1 (domestic final sales growth has grown at just 0.4%) reveals greater fragility in underlying demand than we had expected. That softness has continued in the last few months and it is hard to see why a sharp acceleration would take place.

- **Broadening Euro-zone sovereign pressure**. The intensification of the Euro-zone sovereign crisis, and particularly its spread to Italy, has also had a sharper impact both on markets there and now on the likely growth trajectory. The latest European package went further than expected, and the ECB's decision to re-start its bond purchase program is also likely to help. But the tightening in financial conditions (especially in Italy) is unlikely to be reversed soon.

- **An even more constrained policy environment**. Relative to this time last year, the ability of policy to respond to slower growth looks more limited. The most obvious shifts have been on the fiscal side. The European sovereign crisis has led to further tightening in the outlook for fiscal policy in the periphery. And while the US debt ceiling resolution is a relief, the debate has clearly shifted in a way that will make further fiscal stimulus even harder to deliver than we thought previously; indeed, the risk to our assumption that the payroll tax cut will be extended for another year has grown. At the same time, higher inflation globally has generally raised the hurdle for large-scale monetary easing, even though we expect policymakers to step away from tightening. And, of course, in several cases (such as the US and UK), only the (less reliable) unconventional tools for monetary easing remain.

- **A tighter energy constraint**. Since March, it has become clearer that the global energy constraint is tighter than we expected coming into the year, and our

Table 3: Below Consensus in the US, Developed World

%yoy	2011		2012	
	GS	Consensus	GS	Consensus
USA	1.7	2.5	2.1	3.0
Japan	-0.8	-0.7	2.7	3.1
Euroland	1.9	2.0	1.4	1.6
UK	1.5	1.5	2.5	2.2
Brazil	4.5	4.0	4.0	4.2
China	9.3	9.2	9.2	8.8
India	7.3	7.9	7.8	8.4
Russia	4.8	4.5	5.4	4.5
BRICs	7.7	7.8	7.9	7.7
Advanced Economies	1.8	2.1	2.3	2.7
World	4.0	4.2	4.4	4.5

* Consensus Economics July 2011 Source: GS Global ECS Research

commodity forecast path was adjusted higher in May to reflect that. The fact that Brent crude prices are still trading at nearly $110/bbl even after significant downgrades to the market's view of US growth in other assets—and the significant pick-up in gasoline prices in June on tentative evidence of better economic news—continues to suggest that this constraint remains tight.

Post-bust dynamics still dominate

Lying behind these issues, three strands of our own research inform how we see the global economic picture and the ways in which the current cycle is proving to be distinctive.

The first issue is the distinctive nature of post-bust recoveries. We have shown over the past few years that the standard post-bust experience is one in which it is hard to push growth back above trend and where, as a result, the unemployment rate tends to stay high and rates stay low for a very extended period (*Global Economics Weekly 08/14*, "The US Housing Bust in International Perspective"). Those challenges remain clearly visible and the distinction between the quality of recoveries in those that saw housing and banking busts and those that did not is still very clear. A recent *US Economics Analyst* (11/25 "Private Boost, Public Restraint") looked at the likely dynamics of private-sector deleveraging and financial balances. While the picture looks better than it has done, it still points to an environment in which it will be hard to push overall growth above trend.

The second issue relates to the challenges of fiscal adjustment for growth. The policy response to the crisis has involved transferring private-sector problems to public-sector balance sheets. But as we have shown in several pieces of research this year (see, for example, *Global Economics Weekly 11/20*, "The Balancing Act of Fiscal Consolidation"), the subsequent fiscal consolidation process involves a difficult balancing act. Move too slowly and the market reflect concerns about debt sustainability. Move too fast and growth itself may be undermined, alongside any consolidation attempt. Our research also shows that in large economies (such as the US) and those with fixed exchange rates (such as the Euro-zone periphery), the impact on growth may be larger. And we have generally worried more in the US that fiscal policy will tighten too soon than too late. The sharp drop in US yields certainly suggests that investors remain more worried about the growth picture than about the debt picture at present. And the challenges of adjusting fiscal policy without exchange rate flexibility are clearly on display in Europe.

The third issue is the highly divergent cyclical positions of major countries and sectors globally. We have argued since late last year that the unusually high variance in spare capacity across the world's economies is an important and distinctive feature of this recovery (*Global Economics Weekly 11/23*, "Are Cycles Getting Shorter?"). The fact that different parts of the world economy 'need' very different demand impulses has made this cycle more complicated. In particular, large EM economies have been struggling to restrain demand even as large DM economies have struggled to sustain it. Within the Euro-zone, the sharp cyclical divergence between core and periphery has seen the ECB tighten policy in a way that has exacerbated the pressure on the more fragile areas. And commodity pressures have emerged despite substantial slack in many other sectors.

Market views: Lower yields, less equity upside, higher commodities

These shifts in our economic forecasts have clear implications for our market views too. The key features are set out in Table 4. In particular, they translate into:

- **Lower earnings and equity targets.** Our Portfolio Strategy groups have cut earnings and index target estimates across all major regions. While we still show upside to equities from here over the medium term, we expect the near-term outlook to remain challenging. And the degree of upside is smaller. The largest revisions are in Europe, where the damage to equity markets in local currency lately has been largest.

- **Lower bond yields globally.** With less growth, lower core inflation and lower policy rates than previously expected, our forecasts for bond yields have also come down significantly. We now expect US 10-year yields to be 3.0% at the end of 2011 and 3.5% at the enf of 2012. Clearly, any step towards an asset purchase program could add further downward pressure.

- **Still looking for a weak USD.** USD weakness has been a core part of our FX forecasts for some time and remain so under the new forecasts, which acknowledge some of the recent Asian FX strength. The latest economic forecast revisions, which make the sharpest shifts to US growth, generally reinforce that view on our central forecast, although the risks to the Euro-zone and adjustments to rate views there present somewhat more risk to the EUR/$ view than before. We do think that the two currencies that have benefited

Table 4: Market Forecasts

	Units	End-2011		3m	6m	12m
		Old	New			
Equities						
S&P 500	level	1,450	1,400	1350	1400	1450
DJStoxx 600	level	300	265	255	265	280
MSCI Asia Pacific Ex-Japan	level	530	505	490	515	570
TOPIX	level	910	880	850	900	950
10 Year Bond Yields						
US	%	3.75	3.00	2.75	3.00	3.25
Germany	%	3.50	2.75	2.50	2.75	3.00
Japan	%	1.60	1.25	1.10	1.25	1.30
Currencies						
EUR/USD	EUR/$	1.50	1.50	1.45	1.50	1.55
GBP/USD	£/$	1.67	1.67	1.61	1.67	1.85
EUR/CHF	EUR/CHF	1.23	1.15	1.05	1.15	1.20
USD/JPY	$/JPY	80.0	76.0	77.0	76.0	74.0
Energy						
Brent Crude Oil	$/bbl	120	120	117	120	130
WTI Crude Oil	$/bbl	115	115	111	115	126.5
NYMEX Nat. Gas	$/mmBtu	4.25	4.25	4.25	4.50	4.00
Metals						
London Gold	$/troy oz	1,635	1635	1565	1635	1730
LME Copper	$/mt	9,800	9800	9450	9800	11000

Source: GS Global ECS Research

most from risk aversion (the CHF and JPY) will stay stronger for longer and our forecasts have been revised to show that. And we have a softer path for the MXN on the basis of the weaker US and domestic growth picture.

- **Commodities still constrained.** Despite the changes in our economic growth forecasts, we are leaving our key commodity forecasts unchanged. While at first glance that may seem odd, it reflects a balance of forces. The largest revisions to our growth views are coming in the major developed markets. Since EM and Asian demand is now disproportionately important to demand growth for many major economies, the implications for commodity demand are smaller than they might look on a global basis. And our global growth views still point to growth above the threshold needed to tighten key markets over time, particularly since supply growth has also been disappointing in many markets. Brent prices have also been tracking closely along our current forecast path even with the recent slowing in growth, so the reality is that there has been significant upside risk to our oil forecasts that might have ultimately required a higher price forecast without the shifts to our growth views. A sharper slowdown than we forecast—particularly in China—would clearly lead to a shift in commodity views.

Four big questions frame the downside risk

Beyond the central forecasts, our conviction is also lower than it has been for some time. So alongside a more tempered growth view, the environment may be less certain and more volatile both on economics and markets than we envisaged.

The first half of this year has shown that with fragile private demand and constrained policy, the ability to deal with shocks is smaller than usual. And we see more binary outcomes across a range of issues that mean it is easy to see how the outlook could be worse than our current central forecasts acknowledge. So while our current forecasts describe what we see as the most likely outcome, we still think the risks are mostly to the downside.

In particular, four related questions are likely to be critical to the overall outlook and the way that asset markets respond to it:

1. Will the US avoid recession? The fragility of the current demand picture has raised the risk of a shock that pushes the US economy into a fresh recession. And we now attach a probability of about one in three to that occurring. If it does happen, we think it is most likely to occur in the next 6-9 months. One specific issue that could easily push our current revised forecasts lower is the extension of the US payroll tax cut. Our forecast continues to assume that extension will occur, but the risk to this assumption has grown. If it does not occur, the shock to incomes in the first quarter of next year would be sizeable and growth in the early part of 2012 would be significantly lower. The other pressing issue is the possibility that the European crisis spills over more intensely into broader global financial and credit conditions. We have argued before that this is the main way in which European problems could have a significant impact on the US growth picture.

2. Will European policymakers respond sufficiently to stem sovereign pressures? It seems increasingly likely that pressure on weaker European sovereigns will not stop without more concerted policy action. In particular, we think that ECB purchases of Italian and Spanish bonds are a necessary part of the solution to reducing stresses there. If that does not come quickly enough, a larger financial shock may then be felt across many Eurozone economies. Even without that, the task of restoring growth in these economies will be important in convincing the markets of sustainability. The risk even to our new lower forecasts is that to achieve that in the face of recent market pressures, policy might ultimately need to be easier than current ECB plans suggest.

3. Will the rest of the world remain resilient in a US slowdown? The way asset markets respond in the months ahead will depend significantly on whether more sluggish US (and European) growth is accompanied by greater resilience elsewhere, or whether the slowdown is perceived to be more global in nature. In the former case (as in 2006 and 2007), it is more plausible that equity markets overall can remain resilient and asset markets may trade more around the *relative* underperformance of the US to other parts of the world, reinforcing USD weakness and potentially underperformance of developed market equities. A broader global slowing would be more challenging for cyclical assets, and for equities in particular, and would complicate the USD story. Globally, our new forecasts have more of the flavour of the first than the second. This is less a feature of our DM forecasts. Instead, it rests on the assumption that some slowing in the US will be helpful in reducing EM overheating and that the pressures on demand growth will be less intense there. If EM policymakers are slow to react, or if the pressure on their own demand intensifies more quickly (and PMIs in some places have suggested this is a risk), EM resilience may be challenged. That would put a bigger dent in global growth than our forecasts now assume.

4. How much will global policymakers feel constrained in responding to slower growth? The speed with which policymakers react to slowing will also be important. The US policy position looks more constrained than a year ago. And higher inflation and greater concern over fiscal sustainability may mean that there is a higher threshold for policymakers to react than in the past. The reaction in EM (and China in particular) may be particularly important here too. Our assumption is that policy will adjust in a way that allows growth to remain relatively robust. That, in turn, will be helped if the inflation picture improves in the second half of the year, as we expect. Further rises in commodity prices could pose a challenge to that view, but on our forecasts will not become a significant force for headline inflation again until well into 2012.

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We, Jan Hatzius and Dominic Wilson, hereby certify that all of the views expressed in this report accurately reflect personal views, which have not been influenced by considerations of the firm's business or client relationships.