Note: The following is a redacted version of the original report published November 14, 2024 [25 pgs].

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Global Economics Analyst

Macro Outlook 2025: Tailwinds (Probably) Trump Tariffs

- We expect the second Trump administration to bring higher China and auto tariffs, much lower immigration, some fresh tax cuts, and regulatory easing. If so, the US economy should grow 2.5% in 2025, outperforming consensus expectations and other DM economies for the third year in a row. The biggest risk is a large across-the-board tariff, which would likely hit growth hard.
- We have cut our Euro area GDP forecast to a below-consensus 0.8%, reflecting ongoing structural headwinds and a hit from trade policy uncertainty. We have also shaved our 2025 China GDP forecast to 4.5% because of higher US tariffs that are only partially offset by easier macro policies. Risks in both Europe and China are on the downside if tariffs increase beyond our baseline.
- US core PCE inflation should slow to 2.4% by late 2025, higher than our prior forecast of 2.0% but still benign. Our forecast would rise to around 3% with an across-the-board tariff of 10%. In the Euro area, we expect core inflation to slow to 2% by late 2025 and are less concerned about upside risks even with a broader trade war. Lowflation risks have abated in Japan.
- We expect significant further rate cuts over the next year. The Fed is likely to cut to 3.25-3.5%, with sequential moves through Q1 and a slowdown thereafter. We have shaved our ECB forecast to 1.75% on the back of our growth downgrade and also see significant room for policy easing in EMs. However, we expect the Bank of Japan to lift its policy rate to 0.75% by yearend.
- Our baseline forecast implies a benign risk backdrop and US outperformance. We expect modest positive returns across equities, commodities, and DM bonds, alongside gradual USD appreciation. But markets have already moved a long way in a risk-positive direction, and it will be important to limit exposure to the tails around our baseline.
- Moving toward a broader trade war would reinforce USD upside but put pressure on global equities. Unusually high US equity valuations not only dampen long-term expected returns but also amplify the potential reaction to any economic weakness. By contrast, positive tailwinds could emerge if policies shift to be even more corporate friendly, oil prices fall more sharply on spare capacity, or inflation and fiscal fears prove overdone.

Jan Hatzius
+1(212)902-0394 | jan.hatzius@gs.com
Goldman Sachs & Co. LLC

Dominic Wilson
+1(212)902-5924 |
dominic.wilson@gs.com
Goldman Sachs & Co. LLC

Joseph Briggs
+1(212)902-2163 |
joseph.briggs@gs.com
Goldman Sachs & Co. LLC

Vickie Chang
+1(212)902-6915 | vickie.chang@gs.com
Goldman Sachs & Co. LLC

Giovanni Pierdomenico
+44(20)7051-6807 |
giovanni.pierdomenico@gs.com
Goldman Sachs International

Sarah Dong
+1(212)357-9741 | sarah.dong@gs.com
Goldman Sachs & Co. LLC

Megan Peters
+44(20)7051-2058 |
megan.l.peters@gs.com
Goldman Sachs International

Macro Outlook 2025: Tailwinds (Probably) Trump Tariffs

The economic data this year have reinforced our long-standing optimism about post-pandemic normalization. Global GDP growth is tracking at 2.7% in 2024, similar to the 2023 pace and slightly above our estimate of potential, with US growth again leading the way among DMs.[1] Global labor markets have rebalanced, with both unemployment and broader measures such as our jobs-workers gap back to pre-pandemic levels. Inflation has continued to trend down and is now within striking distance of central bank targets. And most central banks are well into the process of cutting interest rates back to more normal levels.

Trumponomics 2.0...

How will US economic policy change in the second Trump administration? Exhibit 1 summarizes our expectations for four areas of focus: trade, immigration, fiscal, and regulation.

Exhibit 1: We Expect New Tariffs on China, Reduced Net Immigration, Modest New Tax Cuts, and a More Relaxed Regulatory Stance in the Second Trump Administration

	Post-Election Policy Changes			
Scenario	Trade	Immigration	Fiscal	Regulation
Base Case	• Tariffs on China: New tariffs up to 60%, averaging to a 20pp increase in the effective tariff rate and mostly reflecting new tariffs on list 1-3 items from the 2018-2019 trade war • Tariffs on the EU: 22.5pp increase in the effective tariff rate on autos • Tariffs on Mexico: 97.5pp increase in tariffs on imports of Chinese-made electric vehicles • Overall: 3.4pp increase in the effective tariff rate for US imports	• Net immigration slows to 750k/year in response to increased funding and tighter enforcement	• Full extension of expiring tax cuts in early 2025 • Expand SALT deduction ($30bn/yr) • Exclude extra 50% overtime from income tax ($20bn/yr) • Exclude tips from income tax ($10bn/yr) • Lower corporate tax for domestic manufacturers to 15% ($25bn/yr) • Reinstate more generous corporate incentives, (e.g., 100% bonus depreciation, R&D expensing, and interest deductibility; $60bn/yr) • Allow enhanced ACA subsidies to expire (-$20bn/yr) • Limitations on green subsidies (-$15bn/yr)	• Antitrust: Enforcement eases somewhat, though major pending tech sector cases proceed • Energy: Easier approval of energy projects, expanding LNG exports, and reversing restrictions on greenhouse gas emission • Financial: Near-term easing of regulatory burden on consumer finance companies, medium-term easing of capital and liquidity requirements
Risk Cases	• More broad-based tariffs: A 10pp surcharge on all imports (40% chance), or a tariff on all auto imports • Revoking Permanent Normal Trade Relations with China (requires legislative action)	• Selective deportation of immigrants with criminal records (up to 1.2mn individuals) • Forced deportations along the lines of "Eisenhower model" that removes up to 2.1mn individuals		

Source: Goldman Sachs Global Investment Research

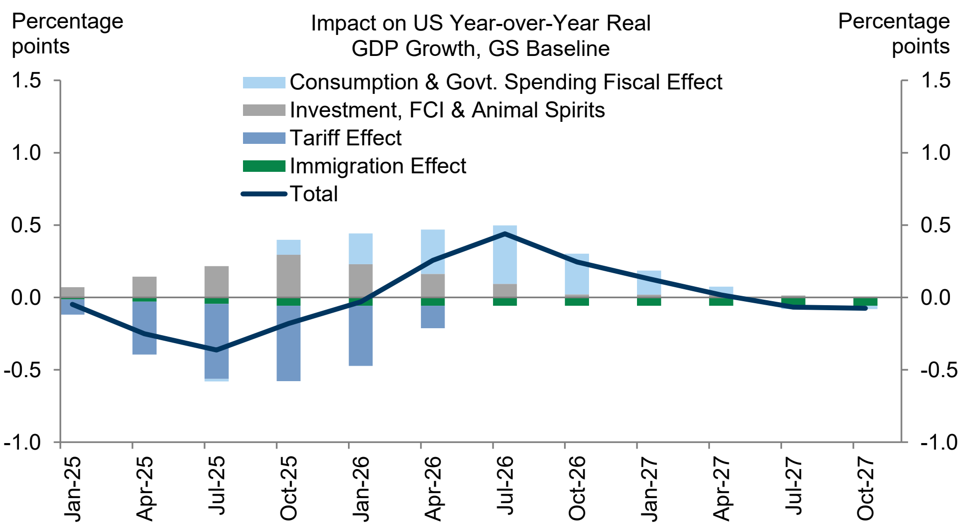
Exhibit 2 shows the effects on US GDP growth under our base case across all policies, while Exhibit 3 shows the effects for our risk case in which President-elect Trump imposes an across-the-board tariff of 10%. If this happens, the most likely timing is 2025H2. This means that there will likely be a period of uncertainty that may tighten financial conditions and weigh on growth. In our base case, the uncertainty resolves and financial conditions ease anew. In our tariff risk case, the uncertainty continues to build and financial conditions tighten further.

The effects from the new policies on US GDP are small and largely offsetting under our baseline outlook. The new administration is likely to announce the China and auto tariffs

[1] We aggregate global GDP growth using market exchange rates. If we used purchasing power parity rates, as the IMF does, our estimates would be about 0.5pp higher.

relatively soon after the January 20 inauguration, which could also fuel uncertainty about broader tariff measures among businesses and market participants. These tariffs would result in a modest hit to real disposable personal income via higher consumer prices, and the broader uncertainty of how much further the trade war might escalate is likely to weigh on business investment. The result is a net drag averaging 0.2pp in 2025. Assuming that the trade war does not escalate further, we expect the positive impulses from tax cuts, a friendlier regulatory environment, and improved "animal spirits" among businesses to dominate in 2026, with a net boost to growth averaging 0.3pp.

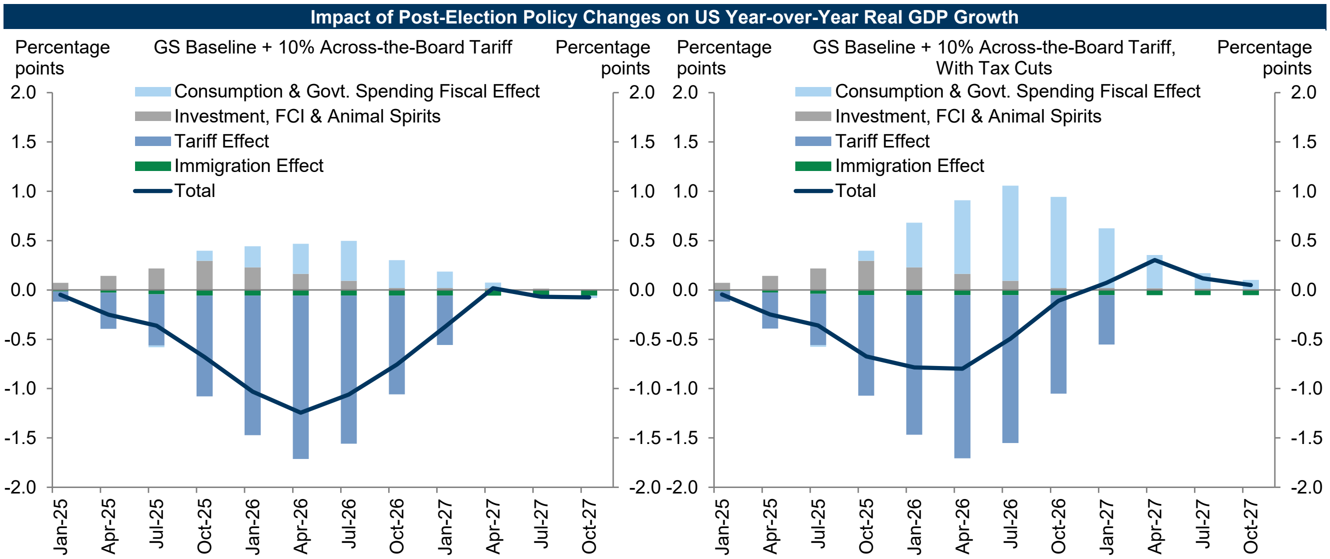
Exhibit 2: We Expect a Small Hit to Growth in 2025 and a Moderate Boost to Growth in 2026 Under Our Baseline Policy Assumptions



Source: Goldman Sachs Global Investment Research

In our tariff risk case, by contrast, the modest negative impulse from the China and auto tariffs gives way to a bigger negative impulse from the across-the-board tariff, both because the hit to real income increases and because trade policy uncertainty builds further. In 2026, this results in a net drag on growth averaging 1.0pp and peaking at 1.2pp, although the peak drag declines to 0.8pp if we assume that the increased tariff revenue is fully recycled into tax cuts.

Exhibit 3: We See a Bigger Hit to Growth Under an Added 10% Across-the-Board Tariff

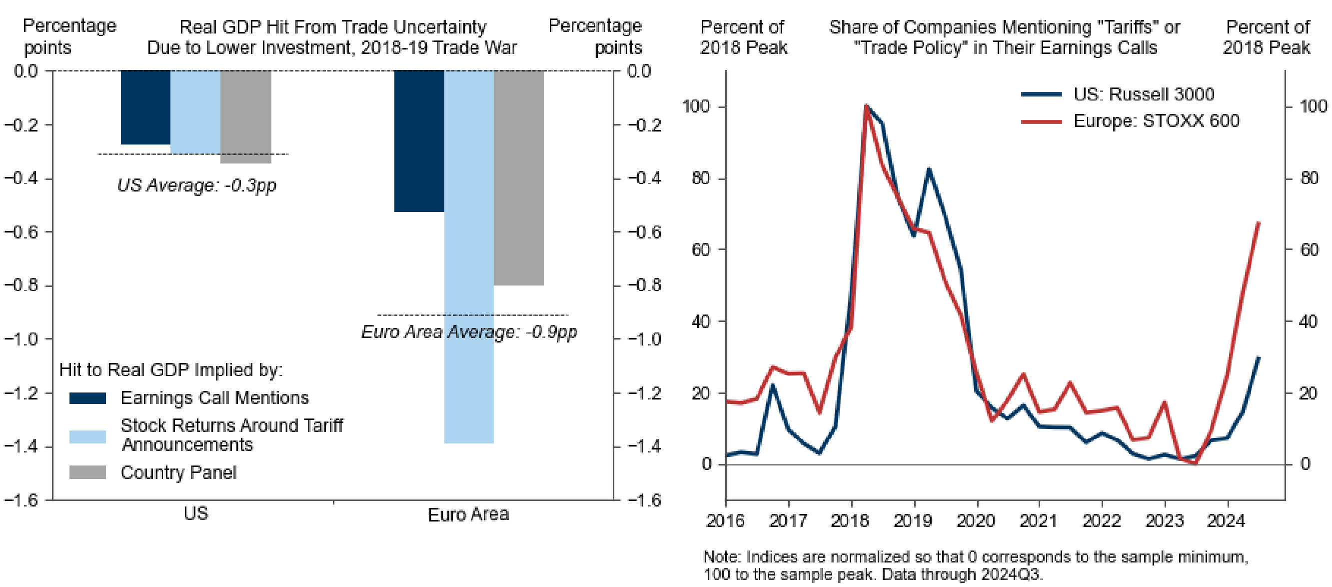


Source: Goldman Sachs Global Investment Research

...And Its Effects on Europe and China

The growth hit from US trade policy is greater elsewhere. One key finding in our research on tariffs is the important impact of trade policy uncertainty (TPU) on growth in the Euro area. The left chart in Exhibit 4 summarizes research suggesting that a rise in TPU to the peak levels of the 2018-19 trade war would subtract 0.3% from GDP in the US but as much as 0.9% in the Euro area. Moreover, the right chart shows that trade policy uncertainty (measured via mentions in corporate earnings reports) has already risen much more in the Euro area than in the US. We therefore cut our 2025 Euro area growth forecast on the back of the US election results by 0.5pp on a Q4/Q4 basis and would likely cut it further if the US imposes an across-the-board tariff.

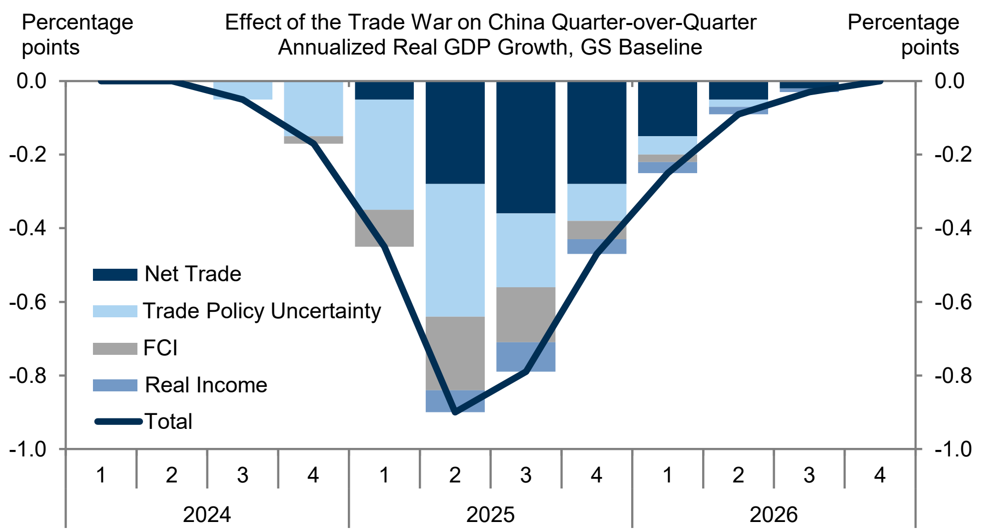
Exhibit 4: Historical Evidence and Recent Trends Suggest Trade Policy Uncertainty Will Disproportionately Weigh on Euro Area GDP



Source: LSEG Data & Analytics, GS Data Works , Goldman Sachs Global Investment Research

The impact is more direct in China, which will almost certainly face tariff increases that we expect will reach up to 60pp and average 20pp across all exports to the US. As shown in Exhibit 5, we estimate that the US tariff increase in our baseline scenario will subtract almost 0.7pp from China growth in 2025. Assuming that Chinese policymakers provide macro stimulus and some of the growth hit is offset by RMB depreciation, we have cut our 2025 growth forecast more modestly, by 0.2pp on net to 4.5%. However, we would likely make larger downgrades if the trade war were to escalate further, either with an across-the-board tariff or more aggressive China-specific measures such as an end to permanent normal trade relations (PNTR) between the US and China.

Exhibit 5: The US Tariff Increase Would Subtract 0.7pp From Chinese Growth in 2025



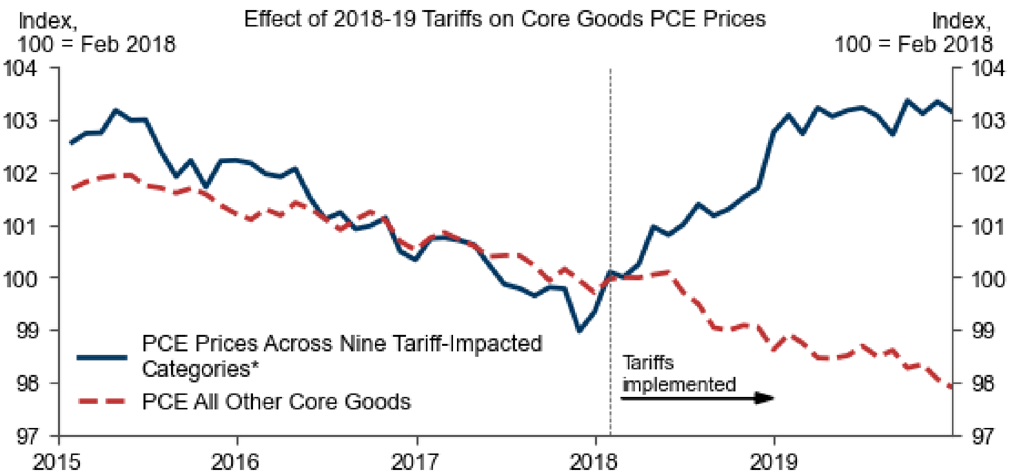
Source: Goldman Sachs Global Investment Research

We also expect a drag from US trade policy in other economies, with larger drags in more trade-exposed economies and potential boosts in certain EMs that are well positioned to gain export share if trade shifts away from China (e.g., Mexico and Vietnam). Overall, we estimate changes to US trade policy will subtract 0.4% from global GDP, although increased policy support should dampen this hit. The impact could be 2-3 times larger if the US imposes a 10% across-the-board tariff.

Modest Price Boosts from Tariffs

Higher tariffs will also raise US inflation, at least in the short term. The experience of the first Trump administration shows that tariffs are largely passed on to consumer prices. This is visible in the fact that prices in tariffed PCE categories rose by almost exactly the tariff amount, while prices in non-tariffed categories remained on their prior trend (Exhibit 6).

Exhibit 6: Tariffs Boosted Consumer Prices During the Last Trade War

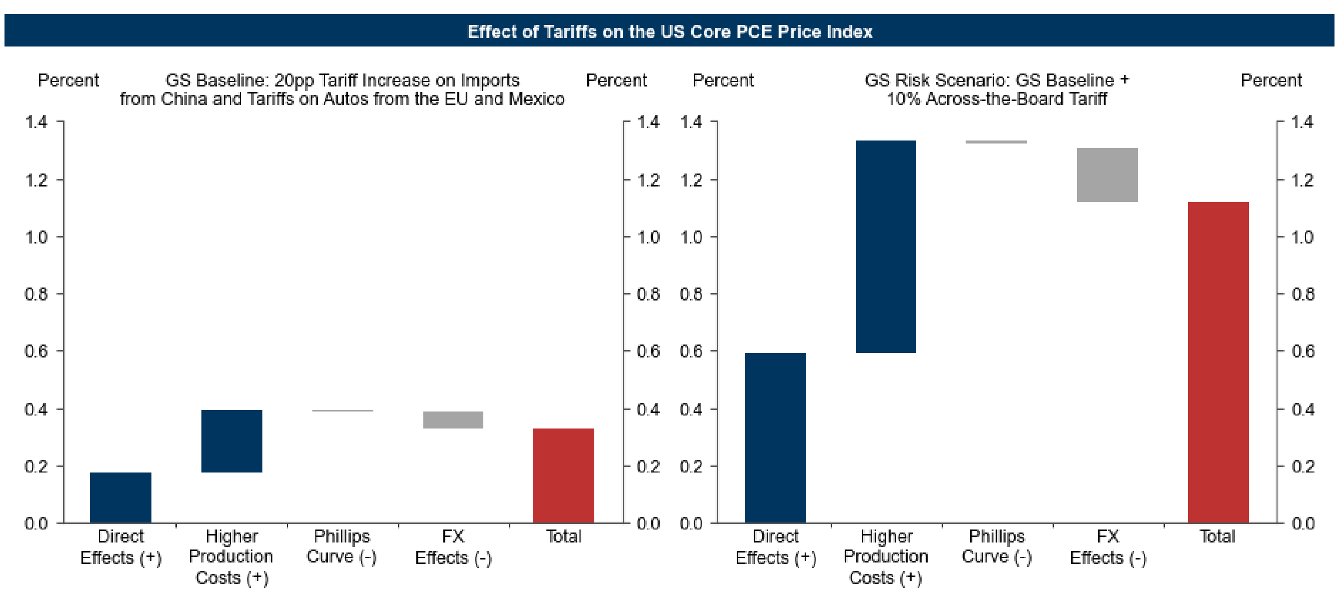


*Includes laundry equipment and other appliances, furniture, bedding, and floor coverings, auto parts, motorcycles, and sport vehicles, housekeeping supplies, and sewing equipment and materials. Items are weighted by relative importance to headline index.

Source: Haver Analytics, Goldman Sachs Global Investment Research

If tariffs are confined to China and autos from Europe and Mexico, this analysis implies that the US inflation impact will be a relatively modest 0.3-0.4pp, as shown in Exhibit 7. If we add a broader 10% across-the-board tariff, the impact rises to almost 1.2pp. Barring significant second-round effects via expectations or wages, however, tariff effects are price *level* effects, so the inflation impact subsides in 2026-2027. Outside the US, inflation effects should be minor even under our assumption of full retaliation.

Exhibit 7: We Expect a Modest 0.3-0.4pp Boost to US Core PCE Inflation Under Our Baseline Tariff Assumptions, With a Larger Impact Under a Broader 10% Across-the-Board Tariff



Source: Goldman Sachs Global Investment Research

Another Solid Year for Global Growth

The upshot is that, barring a broader trade war, policy changes in the second Trump administration are unlikely to change the broad contours of our global economic views.

As shown in Exhibit 8, we expect global growth to average 2.7% in 2025, nearly the same pace as in 2024 and slightly above consensus. Relative to consensus, we are optimistic in the US and pessimistic in the Euro area, with other major economies in between.

Exhibit 8: Solid Global Growth, with US Outperformance Relative to Consensus

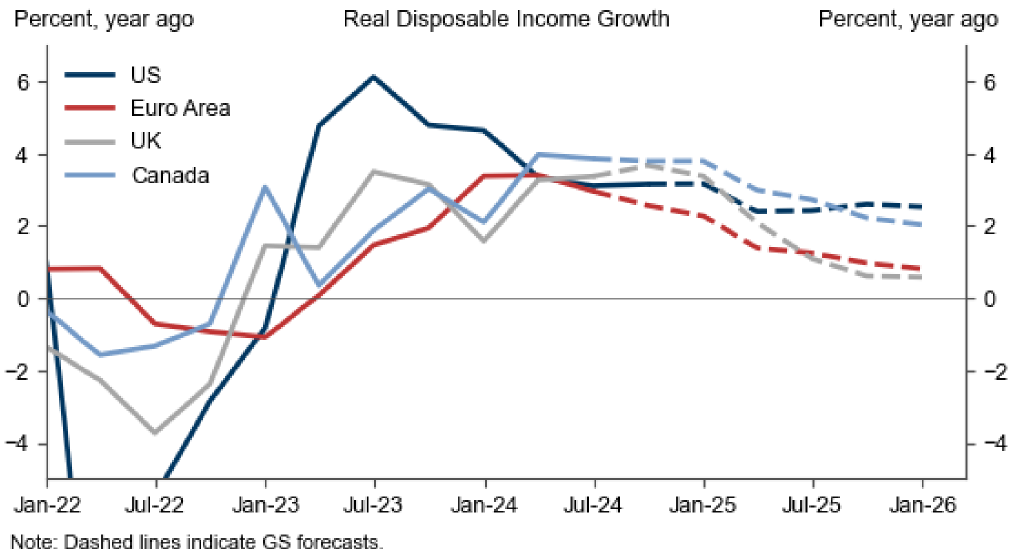
Real GDP Growth	Annual Average						Q4/Q4	
Percent Change yoy	2024		2025		2026		2025	Potential
	GS	Consensus	GS	Consensus	GS	Consensus	GS	GS
US	2.8	2.7	2.5	1.9	2.3	2.0	2.4	2.1
Euro Area	0.8	0.7	0.8	1.2	1.0	1.4	0.6	1.0
Germany	-0.1	-0.1	0.3	0.8	0.8	1.3	0.2	0.8
France	1.1	1.1	0.7	1.0	1.0	1.2	0.8	1.0
Italy	0.5	0.8	0.6	1.0	0.9	1.0	0.6	0.8
Spain	3.0	2.8	2.0	2.2	1.5	1.8	1.7	1.7
Japan	-0.2	0.0	1.2	1.2	1.1	1.0	1.0	0.7
UK	0.9	1.0	1.3	1.3	1.3	1.5	1.2	1.4
Canada	1.1	1.1	1.9	1.8	2.0	2.2	2.0	2.1
Australia	1.2	1.2	1.8	2.0	2.5	2.5	2.0	2.6
China	4.9	4.8	4.5	4.5	4.0	4.1	3.9	4.1
India	6.7	7.0	6.3	6.7	6.7	6.5	6.0	6.2
Brazil	3.1	3.0	2.0	2.0	2.3	2.0	3.0	2.1
Russia	3.5	3.5	1.2	1.6	2.1	1.4	2.3	2.3
World	2.7	2.7	2.7	2.6	2.6	2.6	2.5	2.5

Note: All forecasts calculated on calendar year basis. IMF forecasts used for India 2026 consensus when quarters not available in Bloomberg. Potential refers to GS estimates of potential growth for 2025. Global growth aggregates use market FX country weights and China NSA year-over-year growth.

Source: Bloomberg, Goldman Sachs Global Investment Research

A key reason for optimism on global growth is the dramatic inflation decline over the past two years. This directly supports real income because price inflation has fallen far more quickly than wage inflation, which is still elevated as workers make up for the real wage losses they suffered in the early post-pandemic years. The resulting strength in real hourly wages has helped real disposable household income grow 3-4% over the past year across the major advanced economies, a pace that is likely to moderate in Europe but should remain strong in the US and Canada in 2025 (Exhibit 9).

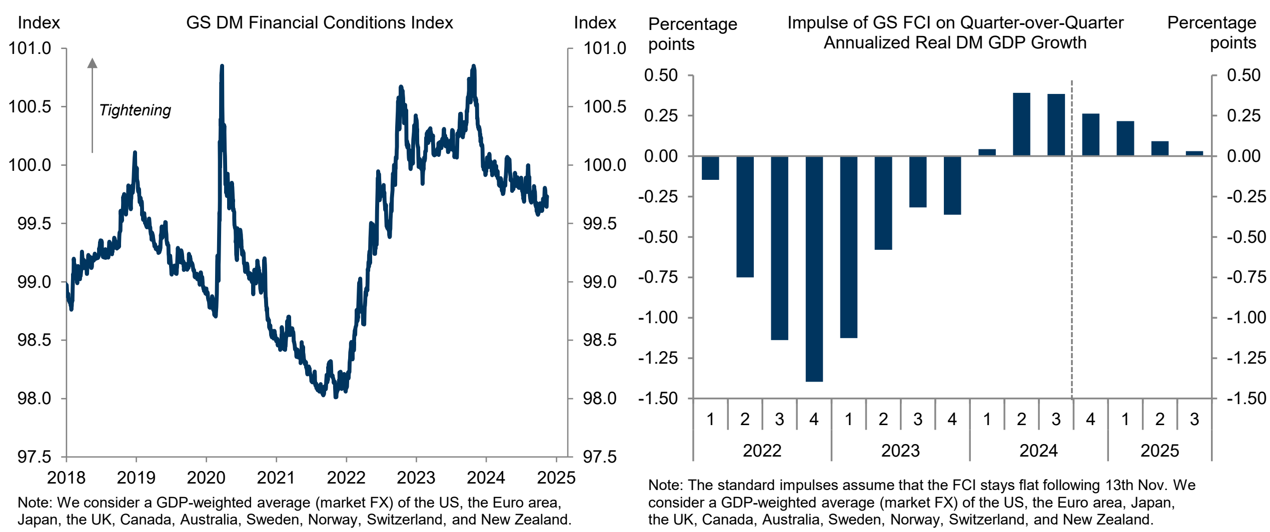
Exhibit 9: Real Income Growth Should Remain Firm in 2025 Due to Strong Real Wage Growth



Source: Haver Analytics, Goldman Sachs Global Investment Research

Just as importantly, the inflation decline also indirectly supports demand by allowing central banks to normalize monetary policy and thereby ease financial conditions. Under the simplifying assumption that our financial conditions indices remain at their latest spot level, we estimate a positive impulse to growth of about 0.2pp across the G10 economies over the next four quarters (Exhibit 10). If financial conditions ease further on the back of solid global growth and central bank policy rate cuts, the positive impulse would be greater.

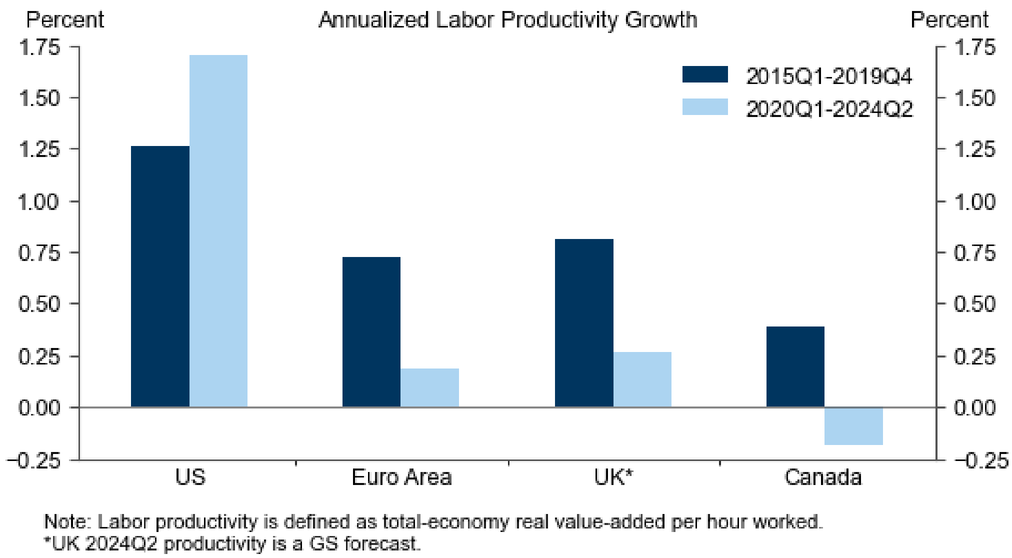
Exhibit 10: Rate Cuts and Financial Conditions Easing Should Support Growth in 2025



Source: Goldman Sachs Global Investment Research

None of this explains why real GDP is growing so much faster in the US than in other advanced economies. The answer, instead, is found on the supply side. Following the recent revisions to the US national accounts, labor productivity in the US has grown at a 1.7% annualized rate since late 2019, a clear acceleration from the pre-pandemic trend of 1.3%. By contrast, labor productivity in the Euro area has grown at a 0.2% annualized rate over the same period, a clear deceleration from an already-mediocre 0.7% before the pandemic. Other advanced economies have shown similarly lackluster trends (Exhibit 11). We expect US productivity growth to remain significantly stronger than elsewhere, and this is a key reason why we expect US GDP growth to continue to outperform.

Exhibit 11: Productivity Growth Has Outperformed in the US, Underperformed Elsewhere

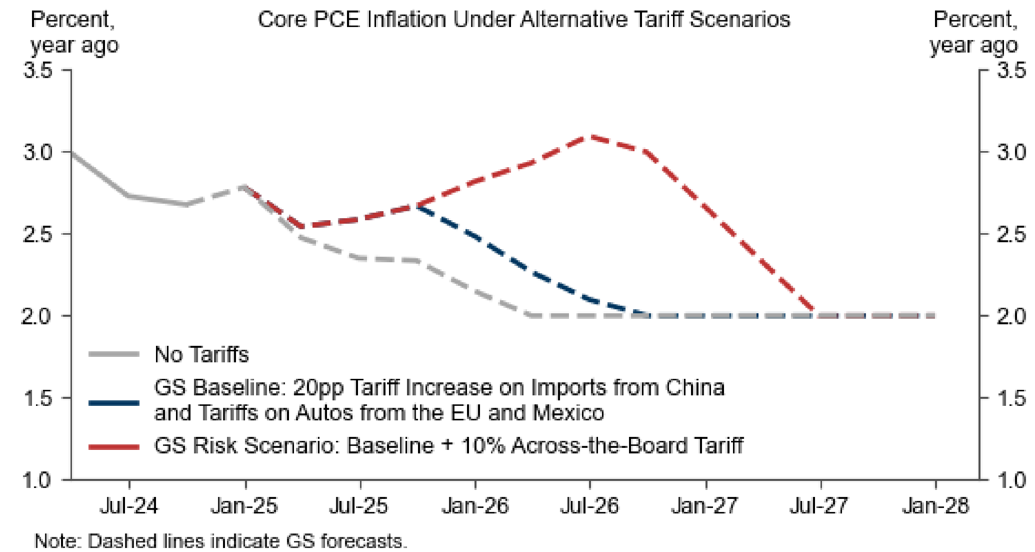


Source: Haver Analytics, Goldman Sachs Global Investment Research

Remember Bumpy Disinflation?

We have revised up our core PCE inflation forecast for late 2025 to 2.4%, from 2.0% before the election. Moreover, the risks are tilted to the high side because of the risk of a broader trade war. An across-the-board tariff of 10% on top of the China and auto tariffs would likely raise core inflation to 3.1% in early 2026 (Exhibit 12).

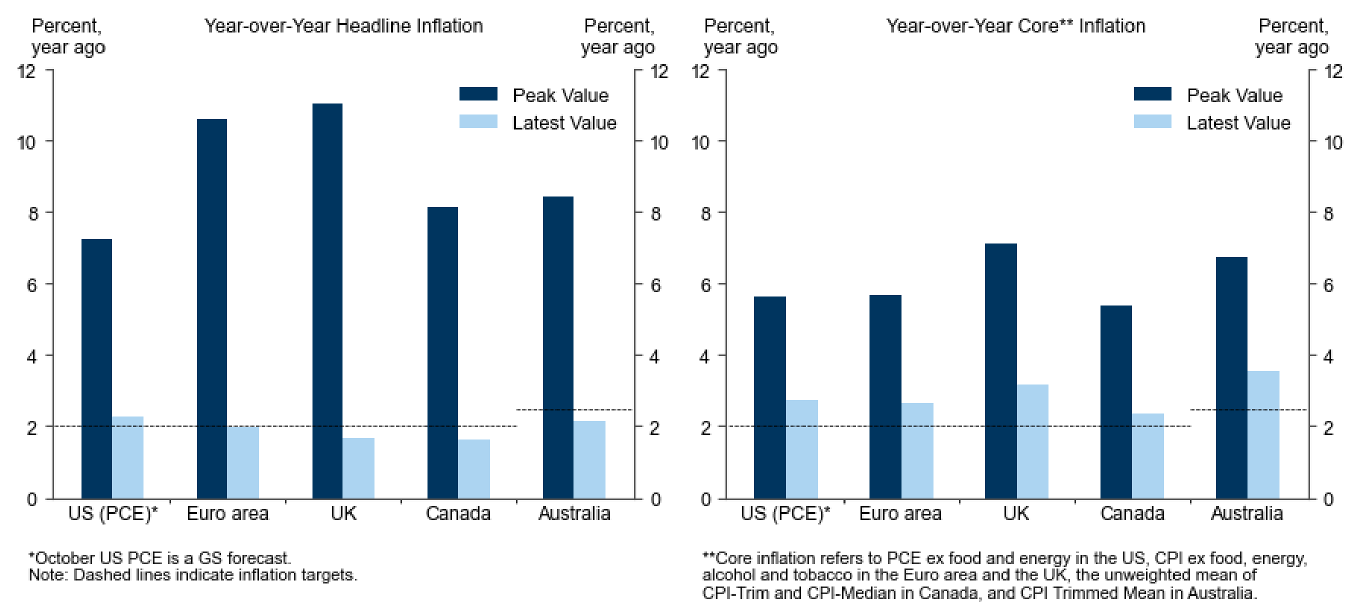
Exhibit 12: China (and Auto) Tariffs Would Modestly Delay Disinflation, But a Broad 10% Tariff Would Cause Reacceleration



Source: Goldman Sachs Global Investment Research

Even our revised US inflation forecast is quite benign, at least in the baseline. This is partly just an extrapolation of recent trends. Although core inflation is still modestly above target, at least on a year-on-year basis, both headline inflation and 3-month annualized core inflation are close to (and in several cases below) target across most major DM economies. Australia is a high-side outlier, but it's worth remembering that the RBA pursues a higher 2-3% inflation target vs. 2% for most other central banks (Exhibit 13).

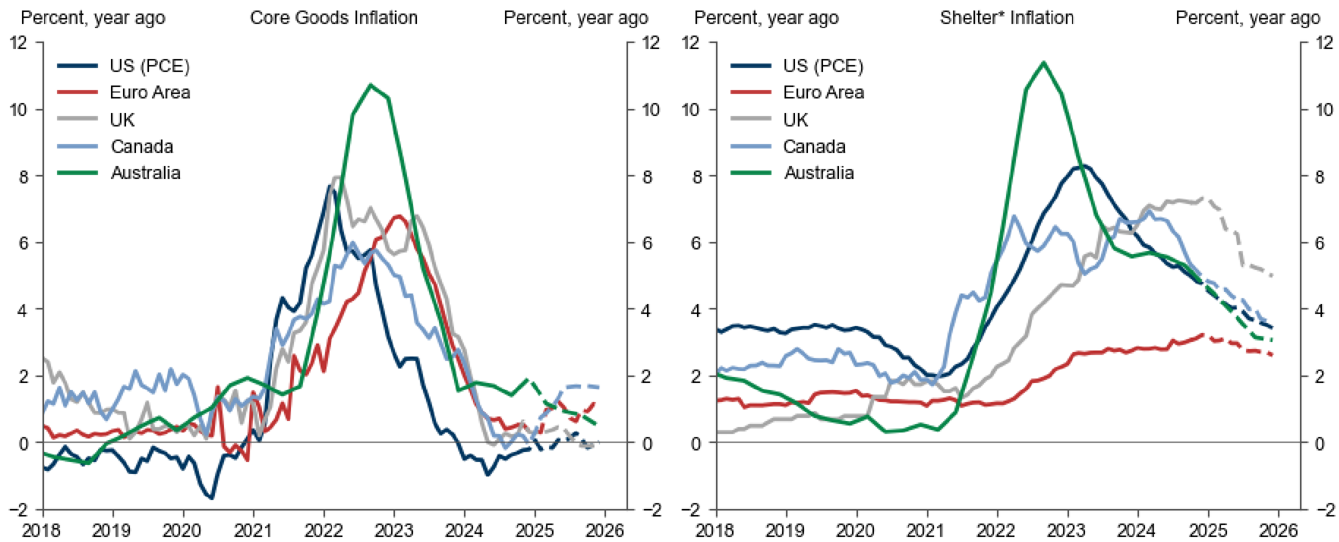
Exhibit 13: Inflation Has Already Returned Close to Target Across DMs



Source: Haver Analytics, Goldman Sachs Global Investment Research

There are also strong fundamental reasons to expect core inflation progress to continue. Aside from a direct tariff boost in the US, core goods inflation should remain low due to continued growth in Chinese exports and inventory normalization in Europe. Meanwhile, shelter inflation should continue to cool, particularly in the US where market rent indicators have looked benign for nearly two years but the official measures are only gradually catching up with reality (Exhibit 14).

Exhibit 14: Core Goods Inflation Has Eased and Should Remain Subdued; Shelter Inflation Should Continue to Trend Down



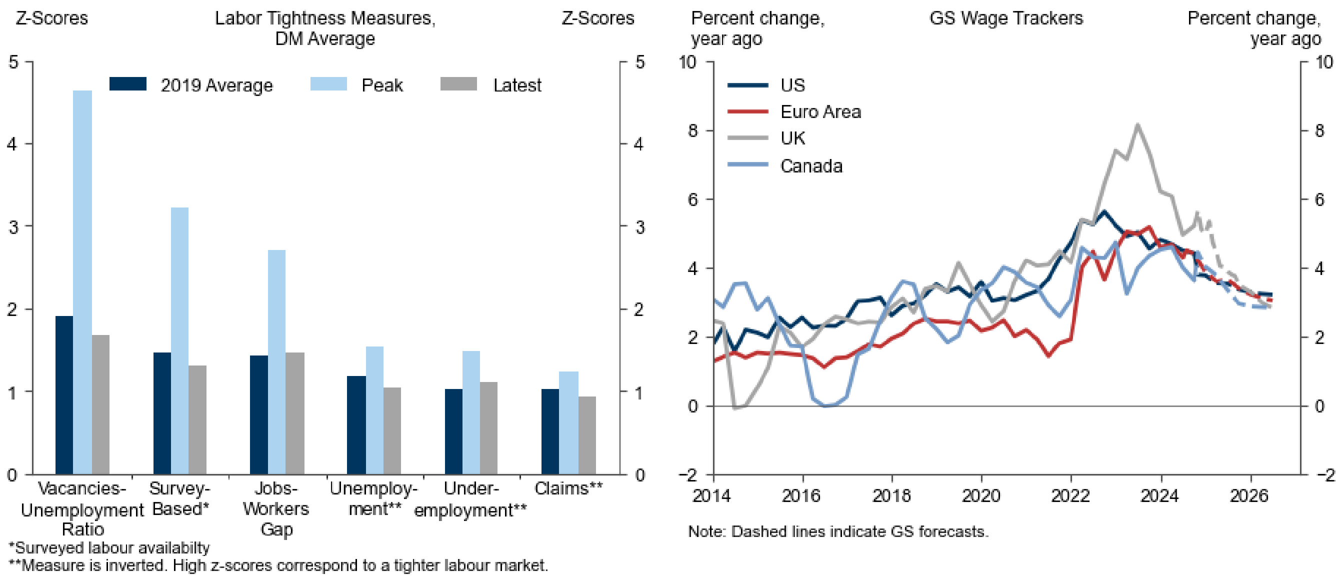
Note: Dashed lines indicate GS forecasts.

*Includes owned housing in the US, Canada, and Australia.

Source: Haver Analytics, Goldman Sachs Global Investment Research

Most importantly, services ex energy and housing—which make up well over half of the core indices—are particularly sensitive to labor costs. It is therefore reassuring that a broad set of labor market tightness measures across advanced economies have returned to pre-pandemic levels. For now, wage growth remains somewhat above the pace compatible with target-consistent inflation assuming productivity grows in line with the long-term trend. However, much of the remaining gap reflects lags in the catch-up of negotiated wages to the earlier price surge, and we expect steady further wage disinflation in 2025 (Exhibit 15).

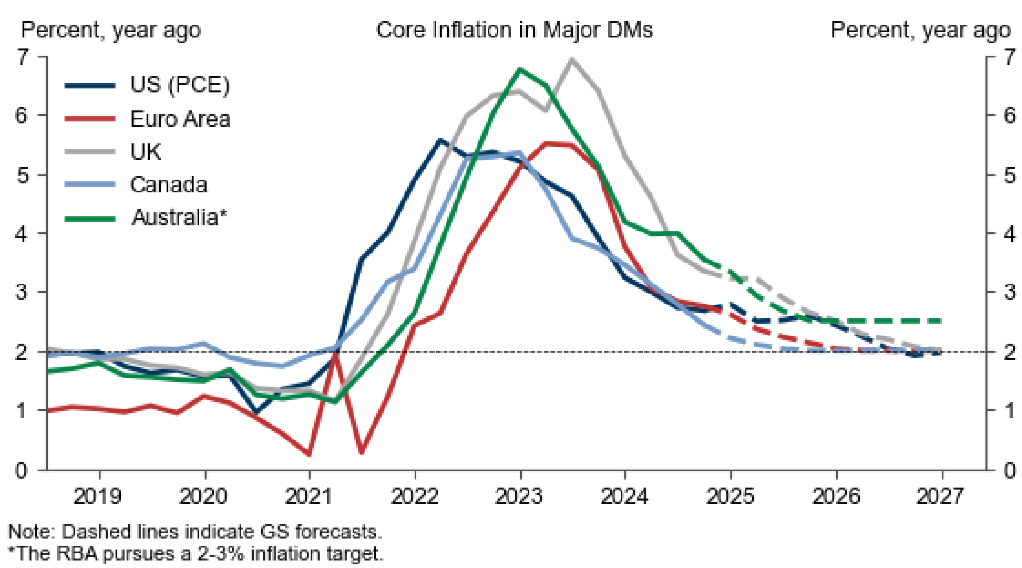
Exhibit 15: Core Services Inflation and Wage Growth Progress Should Continue With Labor Markets Mostly Rebalanced



Source: Haver Analytics, Goldman Sachs Global Investment Research

Thus, both the recent numbers and the fundamentals point to further across-the-board disinflation, as shown in Exhibit 16. While we expect the Euro area and Canada to return fully to 2% by late 2025, the US, the UK, and Australia are likely to cluster around 2½%, with additional declines in 2026 likely. The inflation surge of 2021-2022 is now firmly in the rearview mirror.

Exhibit 16: We Expect Disinflation to Continue



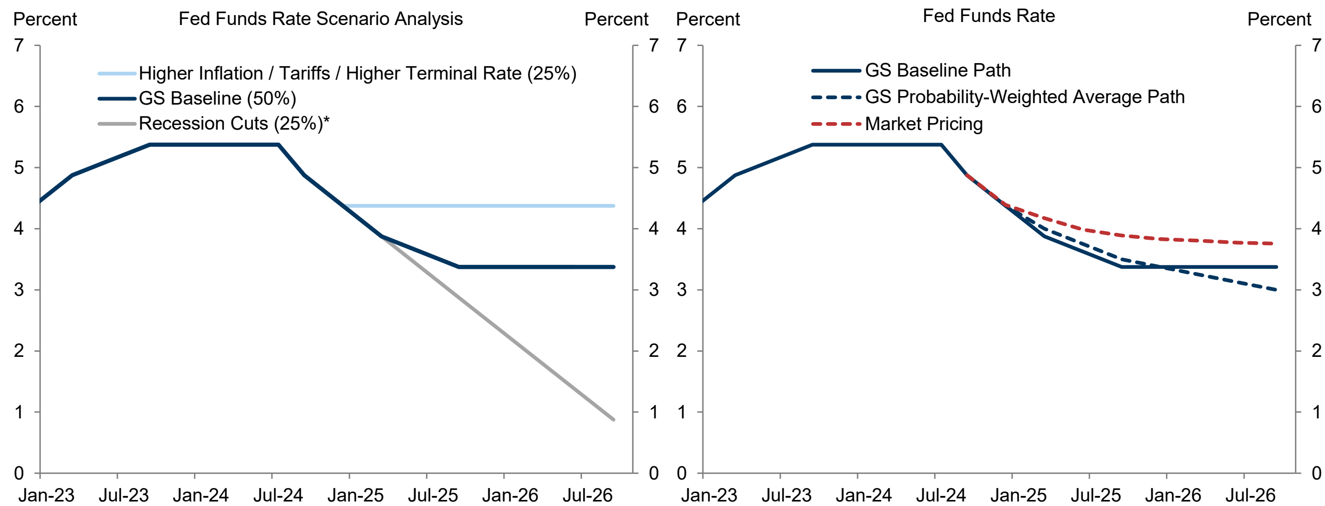
Source: Haver Analytics, Goldman Sachs Global Investment Research

Further Gradual Rate Cuts Ahead

Against this backdrop, we do not expect the US election outcome to derail the policy normalization process that is currently underway, and see most major central banks easing significantly further through 2025.

We forecast that the Fed will cut to 3.25-3.5% with sequential moves through Q1 and a slowdown thereafter. If anything, the threat of a near-term growth drag from tariffs and the Fed leadership's continued preference for frontloaded policy normalization have strengthened our confidence in sequential cuts through early next year. While the pace after Q1 and ultimate stopping point—which may depend on the Fed's willingness to respond preemptively to future inflation boosts from President-elect Trump's policies—admittedly remain uncertain, our baseline and probability-weighted Fed forecasts are meaningfully more dovish than current market pricing (Exhibit 17).

Exhibit 17: Our Fed Scenarios Suggest Risks Around Our Fed Forecast Are Skewed Dovish Relative to Market Pricing



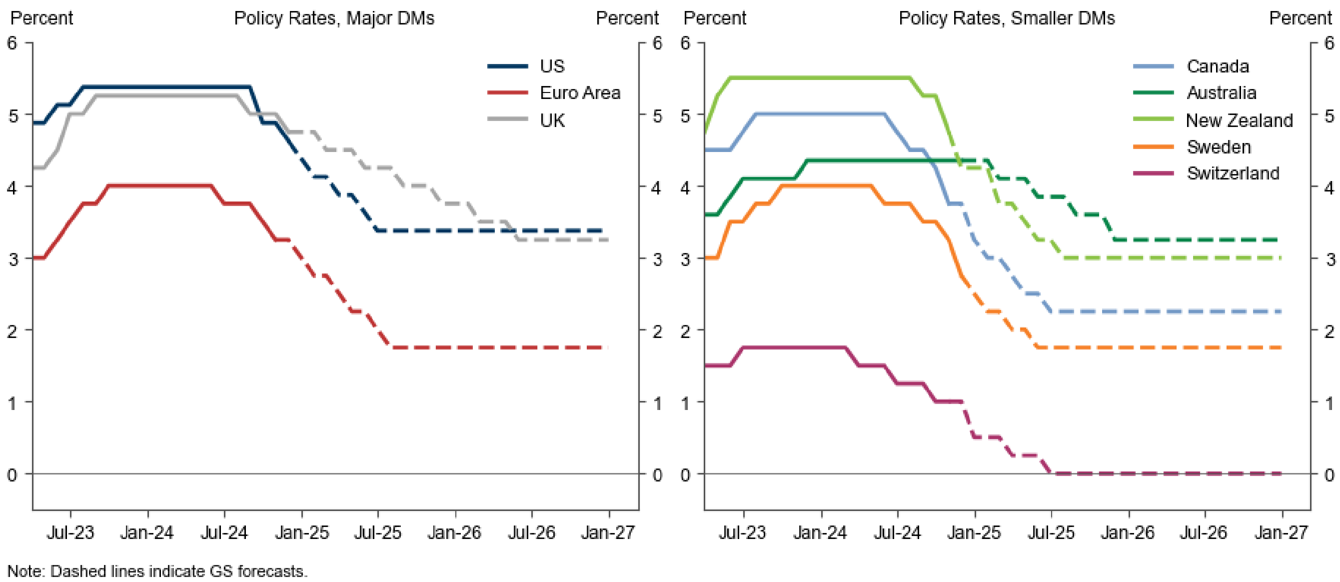
*This is the probability of a recession happening at any point over the horizon shown above. Our 12-month recession probability is 15%.

Source: Goldman Sachs Global Investment Research

Exhibit 18 shows our policy forecasts for other DMs. In the Euro area, we continue to expect sequential ECB cuts and have lowered our terminal forecast to 1.75% on the back of our growth downgrade. In the UK, we are raising our BoE forecast to reflect a better growth outlook following a more expansionary Autumn Budget, and now expect quarterly cuts back to 3.75% by end-2025 and a terminal rate of 3.25% in 2026Q2. We continue to see risks of faster UK cuts if near-term growth disappoints, however, and our terminal rate forecast remains well below market pricing.

We generally expect more aggressive cuts in smaller DM central banks where inflation progress is even more convincing and unemployment rates have risen more meaningfully. The BoC, RBNZ, and Riksbank have already delivered 50bp cuts, and we anticipate the BoC, RBNZ, and SNB will each cut by 50bp at their next meetings. The exception among smaller DMs is Australia, where we continue to expect quarterly rate cuts starting in February. But even here we see risks as skewed dovish given that growth remains weak and inflation indicators aren't that different from other DMs where cutting cycles are well underway.

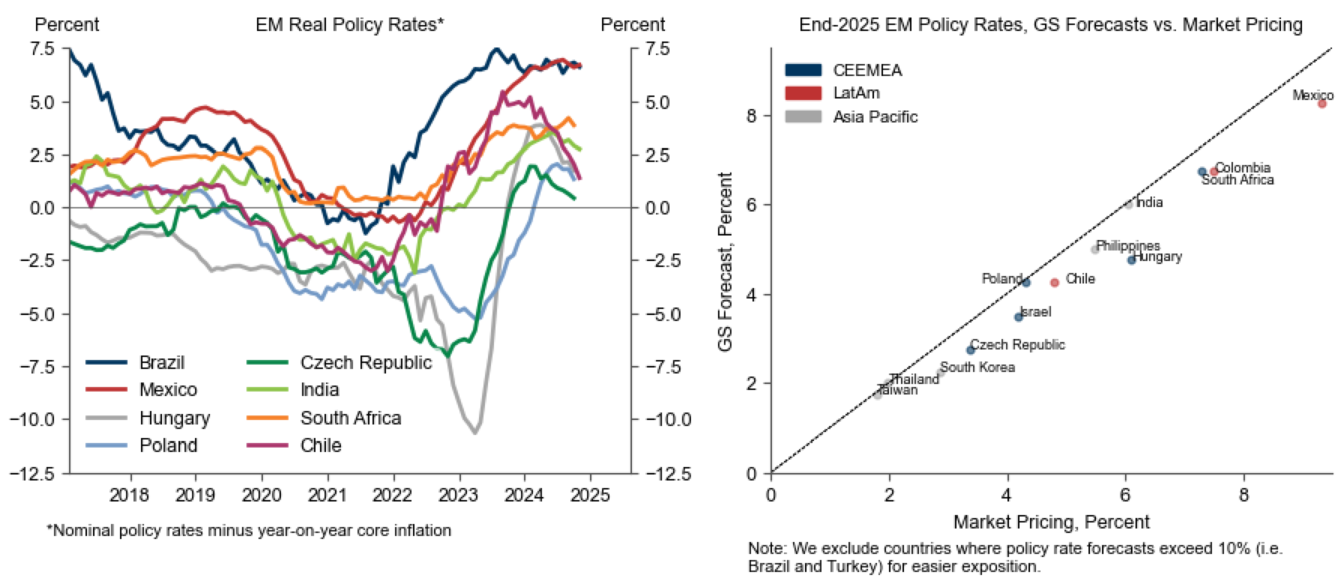
Exhibit 18: We Expect Rate Cuts to Continue, With Larger Steps in Smaller DMs



Source: Goldman Sachs Global Investment Research

We see significant room for monetary easing in EMs as well given that policy rates remain far above neutral (Exhibit 19). This is especially true in Latin America and CEEMEA, but we also expect rate cuts to broaden in Asia over the next few quarters. The main exception to our forecast for EM rate cuts is Brazil, where we anticipate an overheated economy will prompt another 150bp in rate hikes through 2025Q1 (to 12.75%) followed by 125bp in rate cuts (to 11.50%) by end-2025. Our EM policy rate forecasts are quite dovish relative to market pricing.

Exhibit 19: High Real Rates Leave Room for Significant EM Easing

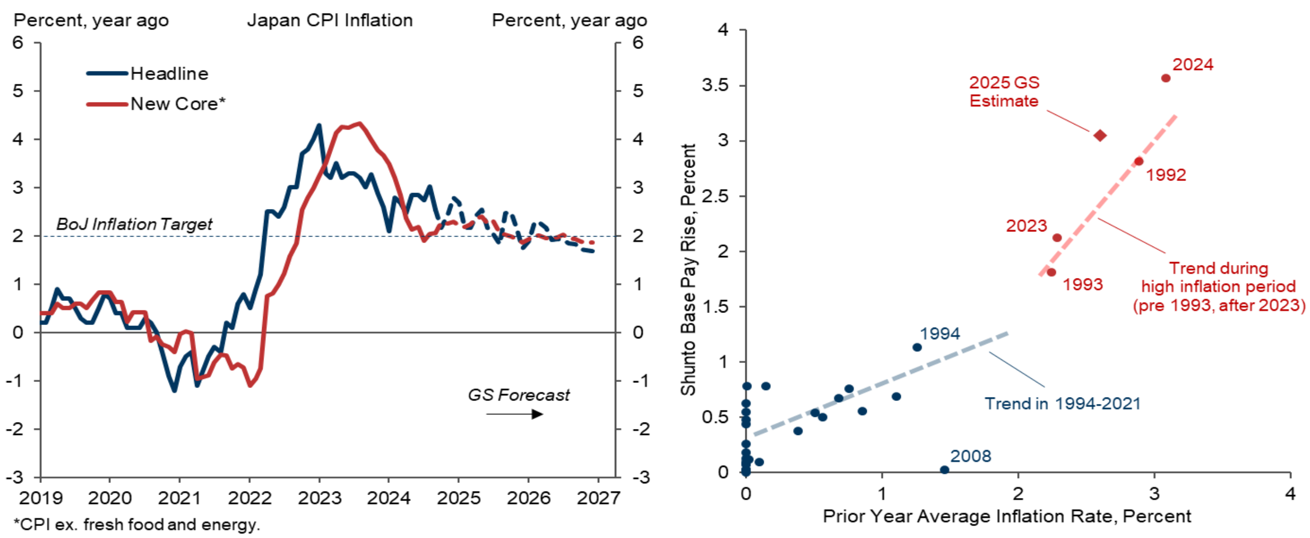


Source: Haver Analytics, Bloomberg, Goldman Sachs Global Investment Research

The main outlier to our forecast for steady rate cuts is Japan. A pickup in inflation and wage growth after three decades of anemic price pressures allowed the BoJ to exit negative interest rate policy in March and hike again in July. We are increasingly confident lowflation risks are behind us and rate hikes will continue. Wage growth should remain firm (we forecast a 3-3.5% base pay increase in spring 2025's *shunto* wage negotiations) and is increasingly correlated with price increases, suggesting that a virtuous wage-price spiral that will help anchor inflation expectations has emerged. In addition, demand looks more robust and policy space has increased relative to the recent past, suggesting less downside inflation risk in the event that activity weakens.

We expect that new core CPI (ex fresh food and energy) will increase by 2.1% year-over-year in 2025 and 2.0% in 2026 on an annual average basis, a target-consistent pace that supports our forecast for 25bp semi-annual hikes to 0.75% by end-2025 and a terminal rate of 1.5% in 2027 (Exhibit 20).

Exhibit 20: Fading Risks of Lowflation Increase Our Confidence that the BoJ Will Gradually Normalize Policy



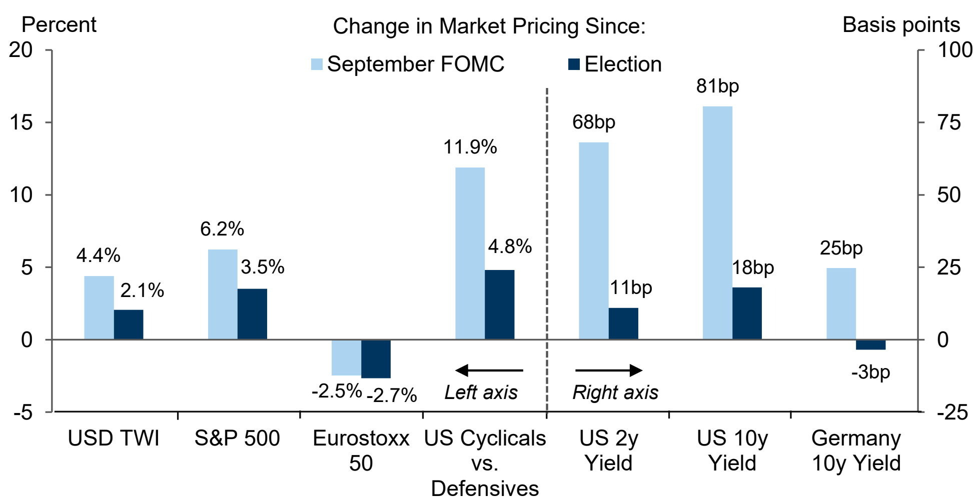
Source: Haver Analytics, Goldman Sachs Global Investment Research

Better US Growth but Better Market Pricing

Our baseline economic forecast for steady growth, cooling inflation, and further non-recessionary rate cuts, as well as policies that could be helpful to corporate earnings, represents a friendly risk asset backdrop for 2025. This view, alongside our economic forecast for continued US outperformance is reflected by our baseline 2025 market forecasts.

A key challenge, however, is that markets have already moved a long way to price this kind of outlook. Our US growth view is once again well above the consensus forecast. But both ahead of and since the election, investors have sharply upgraded the US growth views embedded in assets, pushing US equities and the USD to fresh highs and widening the gap between US and European bond yields (Exhibit 21). We think our baseline forecasts still justify higher equity prices and further USD outperformance, but that judgment is more finely balanced than it was. As US markets take more credit for favorable policies up front, the risk of ultimate disappointment will rise.

Exhibit 21: Market Pricing Has Shifted Towards Our More Positive US Growth View



Source: Bloomberg, Goldman Sachs Global Investment Research

Because the market has moved much closer to our central case, our forecasts for many key assets are not far from current levels. The modest positive returns that we expect for many assets come more from the yield or carry than a big shift in spot prices. This means that the investing backdrop is likely to depend on the distribution around that base case even more than usual. The US election outcome widens the distribution of policy shifts. The core challenge continues to involve maintaining some exposure to a robust US economic outlook, while protecting against the key tail risks.

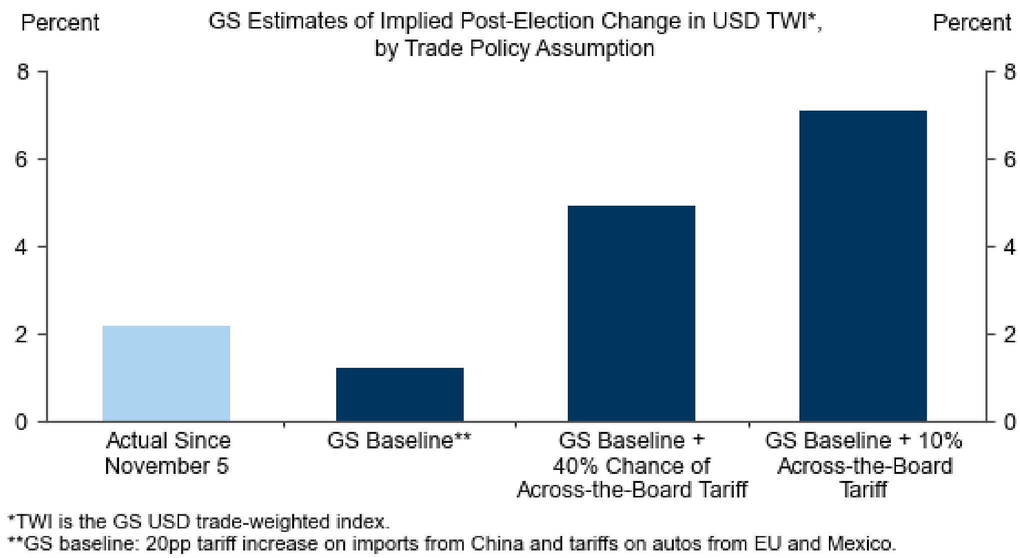
Tail Risks Now a Critical Focus

The potential for a broader trade war looms large among those tails. The narrowly focused tariffs that feature in our baseline scenario are likely to be less disruptive both to the US economic picture and to China's trade and markets, given the experience since the first round of tariffs in 2018-2019 and China's reduced trade exposure to the US. As in 2019, the actual announcement of tariffs could still move markets, including

China's currency. But expectations of action on this front are high and markets are relatively well-prepared for these outcomes.

We think the impact of a broader across-the-board tariff is underpriced, particularly for its potential impact on Europe and some non-China EM economies (the incremental pressure on China should be relatively smaller given that tariffs are already expected). We think a firmer shift in this direction could lead to meaningful further USD upside (Exhibit 22) and add to downward pressure on non-US equities and bond yields. Our baseline forecast is already one in which European GDP growth is below consensus and European yields and EUR/USD decline further. A broader trade war would add to those pressures. The impact on US markets is less certain, but we think across-the-board tariffs and the threat of retaliatory action could weigh on US equities too and might ultimately push US yields lower, as it did in 2019.

Exhibit 22: Markets Do Not Seem to Have Priced the Risk of Broader Tariffs Yet



Source: Bloomberg, Goldman Sachs Global Investment Research

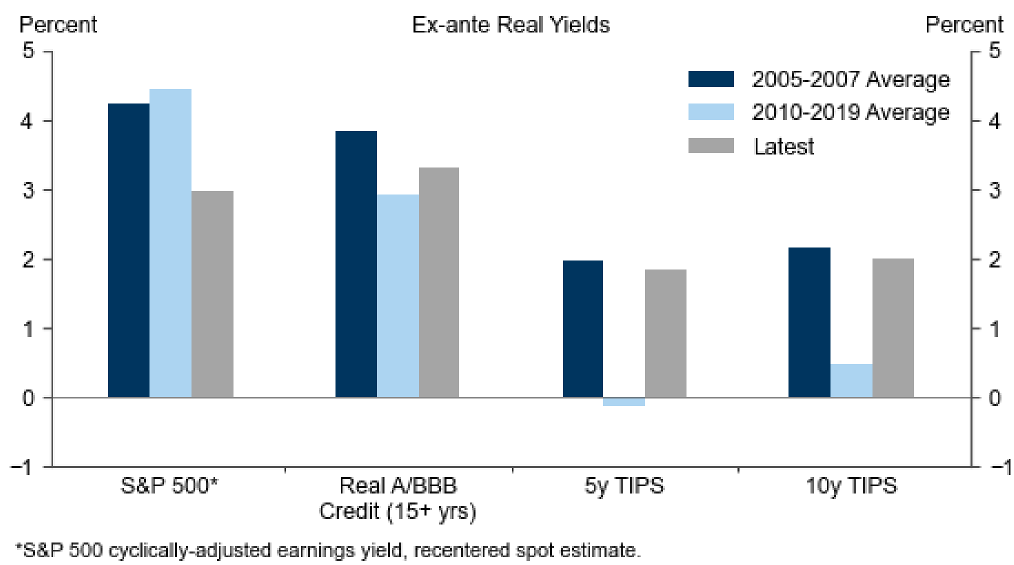
In other areas, we think the risks are more balanced. The US election has clearly increased the possibility of additional fiscal expansion and fresh focus on the sustainability of the US public debt profile. But our central scenario of only modest fiscal stimulus makes us more skeptical that we will see a sharp increase in fiscal risk premium in US Treasury markets. Even in the UK, where the market has worried more in the light of the recent budget, we would look to fade those risks in both rates and currency markets. Given our robust US growth views, the bigger upside risk may simply be an earlier stopping point to the Fed easing cycle, which could prompt markets to judge that the neutral rate is higher than we are assuming. It is only in Japan where our baseline policy path lies well above the market and where we expect bonds to underperform. Near-term inflation risks are also two-sided, after a sharp move higher in market pricing of US inflation over the next couple of years. Short-dated US inflation swaps are priced well above our US inflation forecast, so we think this is one area of the market that already reflects a meaningful chance of broader trade risks.

Oil market tails lie in both directions too. In our baseline forecast, we expect Brent prices to stay in a $70-$85/bbl range. But the risks of breaking that range are growing. In the short term, the new administration raises the risks to Iranian supply, which have already been elevated due to Israel-Iran conflict. That upside tail risk adds to the value of commodity longs in a portfolio context. We think the medium-term risks, however, skew to the downside of our forecast range. That is both because ample supply is still being kept off the market which could begin to find its way back into the system in 2025, but also because broader-based tariff action could hurt global demand. In those scenarios, oil prices might again become a tailwind for disinflation trends.

High Valuations Fatten the Downside

High valuations reinforce the importance of focusing on these tail risks. US equity valuations are now at levels that have not been exceeded in the post-war era except in the late 1990s. Some of the recent uplift comes on expectations that upcoming policies will boost after-tax earnings. But even adjusting for this, US equity valuations look historically high (Exhibit 23). Credit spreads too are near their historical lows, and even those segments of the market that were pricing more elevated risk premium have now compressed. As our Portfolio Strategy team recently showed, the long-term expected returns from equities now look low as a result (they estimate 3% nominal returns over the next decade when accounting for the risks from unusually high market concentration). As a result, prospective returns on government bonds and credit on that longer horizon look relatively better, reflecting historically low levels of the Equity Risk Premium and Equity-Credit Premium.

Exhibit 23: Equity Earnings "Yield" Is Low vs. History

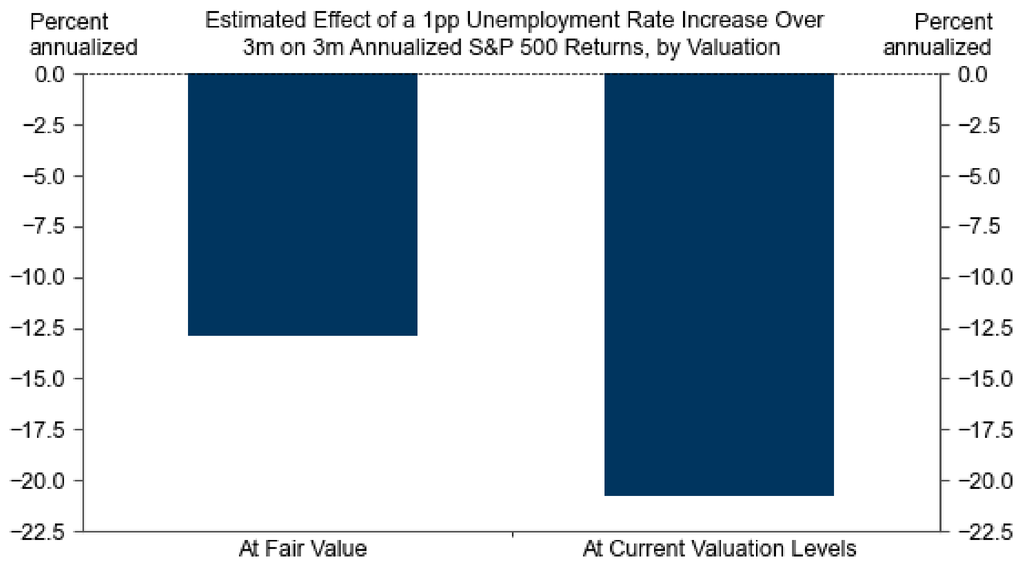


Source: Haver Analytics, Goldman Sachs Global Investment Research

Rich valuations are not an obstacle to further equity gains if the cyclical tailwinds are powerful, as we have seen already in 2024. For US equities, we find that the price for higher valuations is often paid disproportionately when the cycle deteriorates (Exhibit 24). Our baseline forecast means that challenge will most likely be avoided in 2025. But if growth risks do rise more sharply than we anticipate, equity downside could be faster and deeper than normal. The sharp drops in risk assets, and spikes in volatility, in early

August may be a harbinger of that kind of sensitivity. That fatter downside tail also highlights the importance of keeping an eye on another kind of "valuation challenge"—the point at which our more optimistic macro forecasts seem fully reflected in assets. As in 2024, we are likely to push harder on our asset views when the market is clearly in doubt about elements of our macro picture.

Exhibit 24: Richer Valuations Make Equity Markets More Vulnerable to Cyclical Deterioration

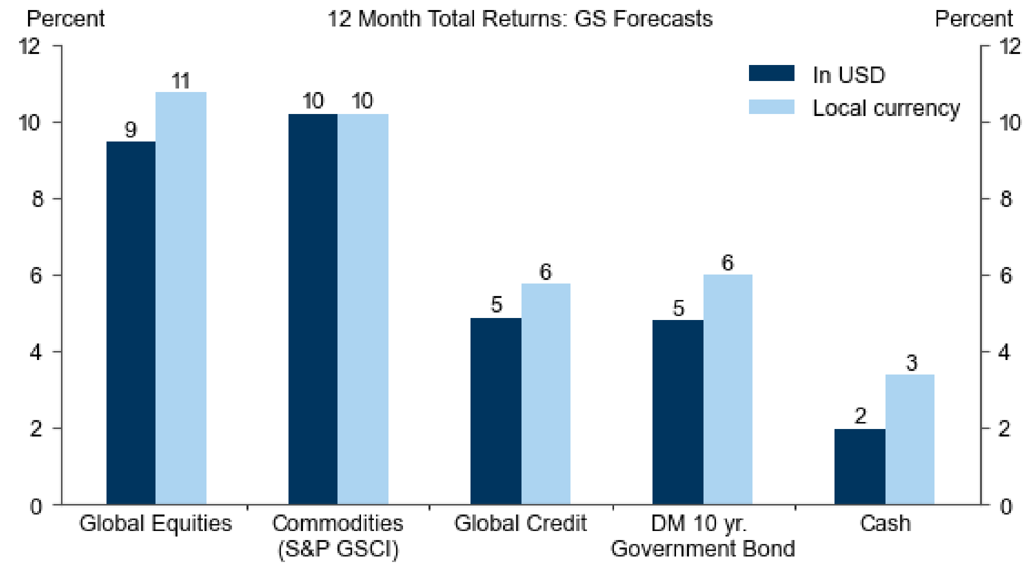


Source: Goldman Sachs Global Investment Research

Maintain Exposure, Limit Tails

Although markets have already moved to reflect key elements of our macro view, we still forecast modest positive returns across the key asset classes (Exhibit 25). US growth resilience should still support outperformance of US equities and underperformance of US bonds, alongside some further expected upside to the US dollar. Given subdued valuations, EM equities are likely to outperform fixed income. And while EM hard currency fixed income should prove more defensive than local currency in a strong USD environment, local currency assets have more scope to perform if the tails are avoided. Commodity markets should continue to benefit from a positive roll return, with lower contribution from price shifts.

Exhibit 25: We Forecast Modest Positive Returns Across Key Asset Classes



Source: Datastream, Bloomberg, Goldman Sachs Global Investment Research

The key challenge is to maintain exposure to these themes, while limiting the major tail risks. Diversification can help address some of these challenges. The ongoing decline in inflation across a range of economies in 2024 has allowed central banks, including the Fed, to focus more on the risks to growth. We see risks from both growth and inflation/policy shocks, particularly in the next few months as the Trump policy agenda takes shape. But although the market may still oscillate between these different risks, we think the correlation of bonds and equities is more likely to drift lower than higher over the medium term. This means that US Treasuries, and even more so Bunds and Gilts, can still play an important diversifying role in portfolios. TIPS too look appealing since real yields have room to fall if growth disappoints, but inflation protection remains valuable. Broadening US equity exposure towards mid-cap equities or a more equal-weighted allocation may mitigate concentration and valuation risks. Long USD positions should also provide protection against both US rate upside and broadening tariff risks, reinforcing the case for US investors to keep hedging their overseas bonds (and equity) exposures.

As in 2024, we think there are strong arguments for using options to provide protection against macro tails. Equity volatility has fallen post-election and this makes it easier to gain upside exposure to US assets through call options again. Deeper downside exposure (including in European equities which are vulnerable to some key risks) also looks more attractively priced. Long USD optionality remains appealing (especially against EUR, CAD, SGD and KRW), while upside in gold and oil can still protect against some key tails. Some assets could also benefit if US policy risks fail to materialize. In 2017, the first year of the first Trump administration, EM stocks and currencies ultimately outperformed. A more restrained US fiscal impulse, or a more narrowly focused trade agenda, could again provide relief to parts of the EM universe where those risks have been most clearly reflected. Some exposure to that kind of upside may be useful too. The wider range of potential market outcomes means that any declines in volatility across assets in 2025 are likely to be opportunities to add hedges.

Disclosure Appendix

Reg AC

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