From: O'Neill, Jim [IMD]
Subject: LOOKING THROUGH THE FOG
Date: Saturday, August 13, 2011 1:08:53 AM

LOOKING THROUGH THE FOG.

In the past week, we have experienced remarkable turmoil in financial markets, which have brought back memories for many people of the darkest days of late 2008. Are direct parallels to 2008 valid? Many other questions also come to mind. Are current market valuation levels correct in assuming that most of the G7 and Europe are set for multiple years of Japan-style weak growth? And unlike Japan, will it carry high unemployment and social unrest? Are my beloved BRICs and Growth Markets set to keep the world above water, or are they doomed also? And of course, how do investors make money?

I am afraid I don't have all the answers. I thought I would reflect back on the past couple of weeks, review the major news flow this week, and offer a few perspectives against my own underlying judgment about the long term path for the world economy. I shall also give a flavor of the intense daily discussions we have been holding amongst the CIOs and senior portfolio managers across Goldman Sachs Asset Management (GSAM), which has been extremely stimulating.

Generally speaking, collectively, we remain quite sanguine about the world. We think that the markets are excessively worried about the US and, while there is less agreement amongst us about Europe, we are impressed by the policy response. In terms of equities, while aware of the risks, we believe that there are very attractive valuations on offer, including in the US financial sector. In fixed income markets, while there is little value, the strength of the US and European policy response has been such that markets have momentum from the policy support, at least for now. On currencies, we find it difficult to be attracted to any of the major currencies, but continue to find attraction in some in the Growth Markets. The increased rate of CNY appreciation this week is highly interesting and pertinent in this regard.

US STOCKS, US AND GLOBAL FINANCIAL CONDITIONS.

At the lows of Monday of this week, the S&P had lost more than 200 points since the highs of late July, and around 265 points from the highs at the end of April and start of May. Understanding why a move of such power has occurred, and what its implications are, seem critical for thinking about the US going forward and maybe the rest of the world too. Much of the decline occurred between August 1st, post the weak July ISM release, and August 8th, the first trading day after the S&P downgrade.

As discussed by many analysts on Wall Street, the degree of weakness prevailing earlier this week would be consistent with a stronger degree of evidence of economic weakness and a high probability of recession. However, this is in contrast to the most recent economic evidence, which includes some better-than-expected releases. For example, the fresh decline in weekly US job claims, to 4-month lows, is particularly striking, along with evidence of a continued pick up in auto sales. In the GS Global Leading Indicator (GLI), the change in US weekly job claims is one of the more powerful components and has a good statistical track record in foreshadowing changes in the US stock market.

With the weakness of the financial sector, in particular, and despite the clear message given from the FOMC meeting after their "easing" this week, US markets appear to be assuming Japan-style multi-year weak growth, and have concluded that trend growth in the US is significantly impaired.

There are many differences between the US and Japan, and although the post-crisis recovery in the US has been quite disappointing so far, it is not at all clear to us that direct comparisons are valid. The US has much better demographic dynamics and its policymakers are still quite flexible. Under this Federal Reserve, overall financial conditions are kept extremely accommodative.

In 2008, the reason why the world fell into a quick and deep recession was because a large and quick unintended tightening of overall US and OECD financial conditions. As of yet, this is not the case in 2011. In fact, if we close the

week where the S&P is trading as I write, we will have witnessed the tiniest of tightening in overall US financial conditions.

Despite all the gloom, the S&P will have recovered to trade close to 2 pct of its close last Friday.

As part of ensuring recovery, I am presuming that a rising goal of US policymakers will be to try and encourage US companies to use the huge amounts of cash they are holding for investment and job creation, preferably at home. I assume there will be further efforts along these lines despite the challenges of the fiscal deficit.

STRONG EUROPEAN POLICY RESPONSE.

In last week's Viewpoint, I discussed three major issues that seemed to be troubling the world and markets, one of which was the US. The biggest of the three was the Euro Area, the third being China, which I will discuss below. It is impossible to not be concerned about the Euro Area as the contagion has spread to Italy, Spain, and now France. Greek-style financing problems in all three of these countries would make the problem quite considerable and extend way beyond Europe.

However, just as the Fed responded quickly and appropriately to the sudden undesired tightening of US financial conditions, Europe's policymakers have responded to the problems facing the latest Club Med countries. The controversial move by the ECB to purchase Italian and Spanish bonds has so far had a powerful impact.
While there is considerable debate about exactly how eager the ECB has been to embrace these purchases, the impact has been quite considerable. 10-year Italian yields have fallen back below their "breakout" of the late Spring, and Spanish yields are back to lows of the year. Many analysts are suggesting that this is only going to be temporary as when the market realizes how little the ECB has actually bought, then it will be a sign of how uncommitted the ECB really is. While this is one interpretation, I am not sure it is the correct one. The opposite is just as rational. Perhaps, in fact, the ECB hasn't had to buy that many in order to turn the trend. Moreover, perhaps they are more focused on better timing and tactics in terms of their intervention. Time will tell.

Either way, despite the obvious opposition from a number of participants and a conservative Germany, the policy response was forthcoming. And that is all one can ask for.

The bigger issue of the week in the Euro Area, however, became the sudden attention on France that, in many ways, appears to be a byproduct of the S&P downgrade of the US. Many US commentators seem quite irritated by the fact that France has a higher credit rating, especially when they perceive a country with a bloated government sector and an economy with weak trend growth. Whether this was the exact spark or not – France's massive exposure to Italy is probably more the underlying cause – the attention has certainly been on France and its financial institutions. Friday's news of a flat GDP in Q2 was seized upon by French skeptics, although dismissed as temporary by others, including most analysts.

France has survived the week intact, with all the credit rating agencies reiterating their support for a AAA rating.

We now have news of another Sarkozy-Merkel meeting next Tuesday. This is likely to be a rather important affair and its outcome may determine European sentiment for the week.

The battle lines of the meeting are drawn. The conservative Germans seem to be protesting at any move Merkel makes towards European gestures. Despite the publicity all these comments get, it shouldn't be ignored that opposition forces are encouraging Merkel to be pro-European and, German leaders, like other country's leaders, have to sometimes do just that, lead. As I am fond of reminding people, Chancellor Kohl wasn't advised to swap West Marks for East Marks at 1 to 1, but he did.

The chorus of voices rising in support of closer fiscal union in the Euro Area and, as part of it, a true Euro bond, is getting louder. The most articulate argument in favour of a Euro bond was provided by the think tank, BRUEGEL, in 2010. The idea of a common bond, backed by a stronger EU institution that will ensure stronger fiscal discipline, is rising. What the EU has to say about this topic in September is probably just as important, if not more so, than the national approval of the recent EFSF proposals. Analysts will be searching for any clues about this topic from the Sarkozy-Merkel meeting also.

On top of everything else, there is the matter of a fresh short sales ban imposed on the equity of financial companies by troubled Euro Area countries, which is obviously not going to permanently solve anything. But it does prove how determined policymakers remain to put up a fight.

SHOULD WE ALL BE BUYING EUR/CHF?

I mentioned in last week's Viewpoint that both the Yen and Swiss Franc were now at ludicrous valuations and that I

doubted either would be close to those levels come September. Well, the Franc has already experienced a significant correction primarily over the last two days. Justifiably alarmed by the speed and size of the Franc's acceleration, Swiss National Bank (SNB) policymakers have indicated that they are prepared to undertake extraordinary measures to reverse this overvaluation. They have suggested measures to introduce negative interest rates, which they temporarily did in the 1970's, and the more intriguing option of announcing a direct, albeit temporary, peg to the Euro. Many people talk of a 1.15-1.20 peg as being the area they would consider. Such a step would require them to add persistent excess liquidity until the Franc was in this range against the Euro. Given the likely damage the Franc's strength will eventually cause, it seems to me a policy worth considering, especially given that all other efforts have not succeeded.

When I thought about the idea on Thursday morning, I thought it would be a rather smart thing for the ECB, and perhaps the entire G20, to support! Given how the Franc has played a central role in "risk off" behavior, perhaps a collective G20 effort to bring it closer to fair value might be good for everyone else as well as Switzerland. By the way, the GS estimate of fair value for EUR/CHF is 1.44.

Needless to say, just the mere talk of these ideas has caused EUR/CHF to recover by around 7 pct, which in itself is a sign of how many people have been using the currency pair as a global bearish hedge.

Watching what the SNB says and does next week will be almost as interesting as the Sarkozy-Merkel meeting, and possibly more lucrative.

CHINA TO THE RESCUE?

The third issue I raised last week was China, ahead of the slew of monthly data that we were due, including the all-important CPI. It was as important as expected. While the year-on-year CPI came in at the highest end of expectations at 6.5 pct, many analysts are now convinced that we will see a sharp reversal by year-end and beyond. Many expect August CPI to be less than 6 pct, and by year end, for inflation to be back to less than 5 pct. This all makes sense to me, and I can't emphasize how critical this is to the Chinese outlook, especially because of their importance to the rest of us. This is fundamentally good news.

It is interesting to see so many media commentators highlight the surprisingly large monthly trade surplus for July – yet another sign of how alarmist everyone wants to be. But, they failed to mention that the year-to-date surplus is just more than $180 bn or approximately 2.1 pct of GDP on an annualized basis. It is remarkable how few people still realize how much the underlying surplus has declined.

Anyhow, given the better outlook for the CPI from here, and perhaps realizing once more both their need to be more dependent on themselves for growth and not the G7, Chinese policymakers have suddenly allowed a faster speed of CNY appreciation and have stopped talking so hawkishly about monetary policy. This is just what the doctor, and more importantly the world, would recommend, and needs.

As I said last week, it is my belief that the next big global equity rally will start from a shift in Chinese policy, and I continue to think the same. It is most interesting to have seen the local "A" share market quite resilient all week.

All in all, what a week. But for those that can look through the August fog (and there actually is quite a bit of that too where I am right now), there are quite a few hopeful signs. We are far from out of the woods especially given the Euro Area complexities, but it seems to me that things are not as bleak as many still think.

And for good measure, despite the horrible events that occurred on the streets of England this week, the Premiership is back. Hopefully, that will help put a week to forget, both here and in the global markets, to the memory of the past.

Jim O'Neill
Chairman, Goldman Sachs Asset Management

Viewpoints are also available on our website.

Jim O'Neill is the Chairman of GSAM, which is a separate operating division and not part of the Global Investment Research (GIR) Department. The views expressed herein by Mr. O'Neill do not constitute research, investment advice or trade recommendations and may not represent the views and/or opinions of GSAM's portfolio management teams and/or the GIR Department. Copyright © 2011 Goldman Sachs. All rights reserved. Please visit our website for additional disclosures.

This message may contain information that is confidential or privileged. If you are not the intended recipient, please advise the sender immediately and delete this message. See http://www.gs.com/disclaimer/email for further information on confidentiality and the risks inherent in electronic communication