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Subject: A Shifting Mood?

Goldman Sachs Asset Management
Viewpoints
FROM CHAIRMAN JIM O'NEILL

A Shifting Mood?

I spent most of this past week in New York, and to my slight surprise, there appears to be some shift in the mood about the state of life. Whether this is because it is the start of the year, asset prices have been perkier, or there is some recognition that the US economy and other parts of the world are not as bleak as the second half of 2010 is not so clear. It was certainly quite nice to hear and, in my judgment, is more reflective of what is going on.

The US improvements.

I have talked in many Viewpoints since last August that I thought the US recovery would be stronger than people realized. Most of the additional data being published gives fresh support to this view. A renewed drop in weekly job claims and some further better-than-expected housing data occurred this week. These releases coincided with more signs from the business world and beyond that the economy may be improving. Four different areas pricked up my ears. The first is repeated evidence of a pick-up in commercial bank lending from their Q4 results and, with it, the reported money supply from the Fed. The second is a changing mood about the housing market, in addition to a better tone of some of the data. Third, there is a lot of growing marginal evidence about US manufacturing becoming more competitive, including another interesting story in the US edition of the FT on Wednesday. And fourth, there is considerable talk about the rapidly-improving domestic energy supply situation in the US which, in itself, is helping boost the domestic industrial plans of some of corporate America. All four of these items were things I suspected were happening, but it was quite refreshing to hear so much talk about them.

About the only thing left to sort out is the staggering amount of wasted time one encounters going through passport control at JFK these days…

I continue to believe that the consensus on the 2012 US outlook needs to get a bit cheerier since most professional forecasters have not yet captured this mood. There is a view that much of the improvement has been seasonal. While possible, I have increasing anecdotal evidence and belief to suggest it is more. We are still forecasting 2.5 pct real GDP for 2012 at GSAM, which is above consensus.

Outside the US. China.

The mood I encountered about the world outside the US wasn't quite as dreadful as I had heard on previous visits, with a couple of people telling me that the ECB's 3-year LTRO was a "game changer". More on that in a minute. In addition, I didn't hear quite as much passion about the Chinese hard landing view either. This might be because on Tuesday, the Chinese stock market enjoyed its largest one-day rally in a long time, coinciding with a set of much better-than-expected economic reports and talk of forthcoming monetary easing. This week's Economist has a very interesting piece about the latest Chinese data, suggesting that the share of consumption in GDP might have started to pick up. As I have maintained as the number one global topic for this year, if China can combine "slower" growth with a rising consumer, a softer external surplus and lower inflation, this is as close to nirvana as you might get. As the Economist piece suggests, there are some strong hints of this already in the Q4 GDP report. While China's GDP at 8.9 pct was its weakest quarter for over 2 years, it was better than expected. And, while we have sketchy details, the trade surplus ended the year barely above 2 pct of GDP and the latest retail sales were above 18 pct.

One other point for all the China bubble watchers out there. Official Chinese estimates now show that just over 50 pct of the population is urbanized. Based on most people's estimates, including work I have been involved in, it is likely to move to 70 pct before one can assume China is urbanized. This involves around another 200 million people moving into cities. Quite how there is supposed to be a nationwide house price bubble with this prospect ahead I have no idea, but many don't seem to appreciate this. Moreover, as I pointed out at the GS macro conference where I spoke, in complete contrast to the US, Chinese house prices have reversed in the past 18 months because policymakers deliberately stopped them from rising. At some point, when they reverse policy tightening, the house price "problem" will turn out to be not as big a deal as so many fear.

Linked around Chinese developments, as I showed in the one slide that I was allowed to show at the macro conference, the rising power of the 8 Growth Market economies will actually boost the world economy's growth potential this decade to somewhere close to 4.5 pct, not the grim world most believe in.

A couple of other things caught my eye in this context this week. Indonesia had its credit rating revised back to investment grade by Moody's this week, only 14 years since it was revised down to junk. (There is hope for Portugal and Greece too eventually.) And another FT story I saw suggested India, disappointed by 7 pct growth – close to the rate we assume for the decade – is considering a large public sector stimulus.

And Europe?

It was a better week for European markets again, despite the S&P downgrades and occasional fears about Greek debt restructuring. Some of this appears to reflect the changing appreciation of the 3-year LTRO that the ECB undertook in December, another of which is coming in February. As mentioned above, a couple of people I spoke to seem to think this is a possible "game changer". While it obviously can't solve deep fundamental issues facing Euro Area economies, it certainly has dramatically reduced the chances of a systematic banking crisis and, in the process, cut the vicious circle between that and sovereign debt holdings, and in addition, greatly reduced the risk of contagion beyond Europe. I am somewhat baffled as to why so many people still worry about this risk now. I saw a presentation while I was in NY that considered various risk scenarios around a central growth forecast for the US a touch below our official one. It contained a probability of a banking crisis of 25 pct – linked to Europe – and just 10 pct for "normality" for the US, or growth back at 3 pct. I cannot see this risk being anything close to this in the next 3 years. In my view, because of the LTRO, it can't be much at all.

On top of this, we had another impressive performance from Mario Monti, the new Italian PM this week. In addition to presenting a number of important supply side structural reforms, he took to giving the FT a most interesting interview this week. In addition to being one of the few leading policymakers who wasn't moaning about credit rating agencies, he suggested that lots of changes and reforms are necessary. The most interesting part was reserved for his suggestion that Italy needed some kind of "reward" for its efforts to get its fiscal house in order, which follows up the previous week's suggestion that the ECB can relax as and when the so-called Fiscal Compact is agreed, possibly at the end of the month.

Both of these forces suggest to me that the improved performance of the Italian bond market makes a lot of sense, and I suspect it is set to continue.

There are plenty of things that can still go wrong, but it is true that, apart from the above, the European markets have started the year in better shape despite the widespread credit downgrades, all the fears about the French election and, of course, the uncertainties surrounding Greek debt talks.

I am wondering whether it is because there is also some acknowledgement that the German economy is not only holding up better than the worst case scenarios, but it is also adjusting more to stronger domestic demand. I heard one of the better ex ECB board members this week suggest that this was happening, citing the easiness of German financial conditions and apparent evidence of a strengthening construction sector. As he suggested, this is actually how the EMU can and should work as the system adjusts.

Markets and What Can Go Wrong?

Given that the successful passing of the 5-day S&P rule has transferred into apparently the market's best start since 1987 (let's not worry about the October factor that year for now), and there are continued signs of less intense correlations across asset classes, it all feels rather nice for those of us who have maintained a more cheery view of the world.

My comments last weekend regarding Japan, its debt, JGBs and the Yen got picked up on quite a bit at the macro conference and one or two people are starting to think that "this may be the year". Certainly, if the Yen were to move back above Y78.30-ish, I suspect quite a few might want to explore that idea. As I wrote and said at the event, looking out over the next couple of years, this is a lot more interesting now than the European story.

Trying to maintain my emphasized fresh 2012 focus, I think we need to watch the flash European PMI's in the week ahead to see whether the macro picture is stabilizing as December suggested or whether it was just a temporary factor. And, of course, the early February data the week later will be most interesting in terms of global trade patterns at the start of the year (Korea's first 20 days of January looked a touch softer, but let's see the whole month.) The GS Advance Leading Indicator for January shows further signs of improving global momentum, which is good to see, so let's see if it is maintained.

When I was quizzed last week about what could go wrong, I found myself thinking in terms of the Middle East. I think I noticed during my travels that Saudi Arabia is now suggesting it wants a $100 per barrel oil price, which suggests they are struggling to finance their big boost in domestic spending. I say this, because from everything I increasingly read and hear, it seems to me as though the fundamentals for the energy markets are turning. Natural Gas prices continued to drop in the US last week linked to the remarkably rapidly shifting US supply and demand changes, and the IEA is revising down its estimates of global oil demand. The implied consequences for energy prices is obviously good, but if this is where things may head, some countries that have gotten used to constantly rising prices are in for some challenges. (Russia is obviously one of these countries, which is why Putin needs to deliver on his frequent suggestions of shifting the balance of their economy.)

Beyond this, it seems to me that there are so many exciting things going on, lots of focus on changing equity and bond market benchmarks and so on. We have done a lot of work on the equity benchmarking issue, and I am increasingly thinking we need to turn our attention to bond market benchmarks now too.

You may be pleased (or not) to know that I won't be writing a Viewpoint next weekend as I shall be in Prague. Some big football matches in the UK this weekend, also exciting, at least ahead of them!

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Viewpoints are also available on our public website: www.gsam.com/jimoneill. Monthly Insights and Strategy Series are available on www.goldman360.com. If you do not have access, please contact your Goldman Sachs relationship manager.

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