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Goldman Sachs Asset Management

Viewpoints
FROM CHAIRMAN JIM O'NEILL

Can January's Better Mood Continue?

It has been a fortnight since I last wrote and the early better mood for the new year continued through the end of the month, albeit at a lesser pace in most places. So for those of us who were feeling not quite so down about the world, January was quite a pleasant experience. In equity market terms, not only did the five day S&P "rule" pass with flying colours, but the January month "rule" has followed through. Based on past experience, passing the two rules means there is an 80 pct plus likelihood for a double digit up year for the S&P. Given the obvious correlation with other markets, this is presumably good news in a broader sense if history is repeated. Of course, given that the positive returns were quite high – the strongest in the US since 1997 and elsewhere since the 1980s – it is quite unlikely that one can annualize the month (you wish!). Nonetheless, it will be most welcome if it occurs.

This positive spirit carried through the first couple of days of February and this period has coincided with and resulted from evidence of better than expected economic data from many places around the world and a much better mood – albeit from an exceptionally low level – about Europe.

While we are due for some sort of setback, it seems to me that it will not be so difficult for this better mood to continue.

A Variety of Interesting Things.

During the past fortnight, I have been out and about as usual meeting lots of interesting people. I have been on two brief trips – to Mannheim in Germany and Prague – and have also been observing all the data and chatting with clients, and my colleagues. Lots of interesting things have caught my attention, of which I will give some flavour below.

The Economic Data.

In the US, the strong run of positive surprises and rapidly improving mood – until Friday – had shifted to a more mixed period. The 2.8 pct annualised Q4 estimate for GDP was slightly below expectations and the contribution from final demand was only 0.9 pct. Predictably, the bears pounced on this to argue it was all inventory driven and the underlying trend is weaker. They fail to mention that both government spending and business investment both declined sharply, neither of which, at least in the same quarter, are likely to reoccur. The very latest consumer sentiment numbers were a touch below expectations too, and the January ISM, while higher, didn't show the same breadth of strength as the December number. It didn't give much back though, and on top of all of this, weekly job claims declined again, with the trend in continuing claims dropping to September 2008 levels. The much awaited January employment report showed, for the third consecutive month, a better performance than expected, and importantly, unemployment dropped again. At this rate, some are soon going to start thinking that this trend might be for real.

In addition, there are more and more anecdotes about the rebirth of manufacturing in the US, along the lines that I wrote about two weeks ago, with both the weak Dollar and declining energy costs being cited in more industries. This really could be quite a major story in its infancy and it is of great relevance for investors globally.

Outside the US, data has remained more mixed. In contrast to the fourth quarter, however, there have been a lot more positive surprises. The most noteworthy "eyebrow raiser" for me was Korea's January export data which disappointed somewhat. Given their early reporting and the significant openness of Korea to all points of the world, this was a bit of a surprise. On the positive side, a number of countries reported much better PMIs including India and the much battered and bruised UK. There is some life in the UK after all……..

Of great relevance, the improved “flash” manufacturing PMI for the Euro Area was confirmed by the final reading with even Italy’s PMI – albeit still very low – showing a modest improvement. At the aggregate, and surely the story of the year so far, Germany is showing distinct signs of actually picking up, far from the fears many have assumed.

News from around the BRIC world has been generally quite good. In addition to the positive surprise from India’s PMI, Russia reported a stronger-than-expected 4.3 pct GDP for 2011, taking the $ value of GDP to $1850 bn, creeping up towards the levels of Italy. It was also suggested that it might be revised higher to 4.5 pct. Not bad for an economy that people – tediously – still tell me shouldn’t be regarded as a BRIC.

The German Machine.

The German machine seems to have entered 2012 forgetting that it is in the middle of a major financial crisis. On top of reporting improved PMIs, which followed another higher-than-expected IFO, unemployment has now dropped to a 20-year low – yes, a 20-year low – and the mood within Germany appears to be quite buoyant. Nobody appears to have told them that they are supposed to be heading for a recession.

What is behind this? I think it is pretty simple. Germany is very well plugged in to the BRIC story and the broader Growth Markets. While some big German corporations reported softer earnings from China in Q4, there are so many signs that Germany continues to better position itself for more success. Amongst the most interesting emails I received in the past fortnight was an email from Lufthansa informing me that they will be starting direct flights to both Shenyang and Qingdao, which brings the number of direct flights into China to six. If China – which is discussed further below – continues to make progress towards a “soft landing,” Germany seems pretty well placed to benefit.

German Attitudes Towards the EMU.

I visited Mannheim the week before last to speak at the annual massive retail investor conference. As I joked at the start of my speech to 2,000 plus people, “who needs Davos, when they’re in Mannheim?” The evening before we hosted a dinner for about 130 investors, and at the end of my brief remarks, I decided to conduct an impromptu survey about the EMU. I asked for a show of hands on a few questions:

1. The EMU will not exist by the end of 2012? No hands raised.

2. Greece will leave the EMU by the end of 2012? Seven hands.

3. Greece will leave the EMU before the end of 2020? Half the room.

4. Portugal to leave the EMU? UK to join the EMU? Quite remarkably, a few more hands were raised in favor of the UK joining the EMU …(not many hands raised in general to either – but you get the gist).

So, it doesn’t seem as though Germans think the EMU is as inevitably doomed as many outside observers seem to think. We shall see who is right.

Life in Prague.

I participated in a very interesting event about the state of the world, which included one of the Czech Republic’s top policymakers and a well-known journalist. Afterwards, we were joined at dinner by around 10 leading business and policymaking figures. I also spent the weekend there. It is a fascinating place to think about the EU and Euro Area issues. I bored my wife endlessly by going on about their GDP per capita being close to that of Greece and Portugal and that given their history and adjacency to Germany, they would be a much more natural EMU bedfellow than some current members. At the dinner, I had been reminded how unpopular the idea of joining currently is, but it was also suggested by a number of attendees that a stronger core is going to develop with deeper ties which will make it more and more difficult for those happy to be in the EU and not the EMU. It all seemed quite persuasive to me. I would also add that Prague struck me as being rather cheap compared to virtually any other city I have visited in recent years. The only disappointing thing is that there were plenty of outlets showing live football and I witnessed United’s FA Cup exit to “them” in their lovely city. But guess what was the most interesting anecdote? The concierge at our small hotel told us that in recent weeks some wealthy Chinese visitors had been in town trying to snap up all the work of their most valued artists. (Are these the same ones who, according to the London Evening Standard on January 29th, are trying to buy up all the best old-fashioned British furniture?)

China. Have I Ever Mentioned it Before?

So China’s “slowdown” in Q4 at 8.9 pct resulted in their annual 2011 GDP being worth just the $7.3 trillion. Apart from the fact this is a massive $1.4 trillion increase in just a year, China is now about close to double the size of

Germany, and easily more than 10pct of global GDP. I had been fond of saying China creates the equivalent of another Greece every four months. Well, last year, it created one every 11 weeks. In 2011, China created the equivalent of two new Switzerlands, or two new Turkish economies, or one-half of a new UK, or 80 pct of a new India or Russia. Astonishing.

And beyond just this, it seems more and more evident that the balance of growth is shifting. We don't have any details yet, but given that the trade surplus ended 2011 at only just over 2 pct of GDP, it seems clear that net trade negatively contributed more and more as the year progresses. Consumption, therefore, must have started to rise as a share of GDP. And certainly my travel anecdotes would suggest so. The China Daily, European Weekly edition, had a fascinating article the week of Jan 20-26th in which two authors linked to the all important NDRC – National Development and Reform Commission – wrote about the "hurdles ahead." In this piece, when discussing the trade balance, they suggest import growth was 4.6 pct higher than export growth last year. They also wrote that "general trade" grew by 29.2 pct compared to "processing trade" which grew by 12.7 pct, which is suggestive of an economy changing its balance. And in case you don't realize how strong trade between the BRICs and/or Growth Markets is becoming, their bilateral trade last year grew by 23.9 pct, 34.5 pct, 42.7 pct and a whopping 76.7 pct with each of ASEAN, Brazil, Russia and South Africa. Not bad for a country whose trade surplus overall is declining.

The Next 11 or N-11.

In recent weeks, a number of countries from this interesting group have seen some volatile times. In addition to the general uncertainty about Iran, the ongoing challenges in Pakistan and fresh disturbances in Egypt, Nigeria has witnessed a worrying escalation in violence. A number of people have asked me whether I regret the N-11 idea. The answer is, "No, and Why?" As I have said for a long time, its origin was merely a phrase to describe the next eleven largest populated countries after the four BRIC nations – nothing more. That was all. They are a very diverse bunch. As it relates to investing, 75 pct of the "benchmark" for our N-11 strategy is concentrated in four countries: Indonesia, Korea, Mexico and Turkey. We refer to these four, together with the BRICs, as "Growth Economies." In addition to the eight N-11 constituents discussed above, Bangladesh, the Philippines and Vietnam are in this grouping. And while there are disturbances in some of these countries, they do not necessarily outweigh the opportunities for business. In fact, in some ways, some of the disturbances are about the spoils and shares of rising wealth, and others about trying to ensure an environment more conducive to that goal. These are usually good things for investors.

I continue to pick up more anecdotes about Mexico being seemingly better positioned to share in the global economy, and noticed that this week's Japanese Nikkei mentioned that Honda is planning to shift some production there.

Japanese Trade and So On.

Talking of Japan, as many had expected, it is now officially in trade deficit – not that the ridiculously overvalued Yen has noticed. There is now a big debate between analysts as to whether this is permanent or not. Some argue that if global growth is picking up, so will Japanese exports. Others suggest Japan is losing competitiveness, which is more of a structural story than a cyclical one. For me, there is clearly an important cyclical element that will be reversed, but there is also a growing structural malaise as evidenced by the Honda anecdote. Anyone who looks at the challenges facing Japan's once big electronics firms can testify to this as well. Another bout of FX intervention cannot be far off at all, and one of these days, it will work.

Swissie?

While on that topic, acting SNB Head Thomas Jordan gave an interview to the FT emphasizing how committed they are to their Swiss Franc "floor" policy despite the domestic political shenanigans, but the market has not paid a lot of attention. Along with a weaker Yen, it still strikes me that renewed Swiss Franc weakness is a better place to put capital than the persistently complex space of the EUR/$, but the SNB might need to give it a more decisive shove to get it moving again.

EMU.

I have taken all this time before I returned to this never-ending topic. Another week ends with no deal being agreed to on Greek restructuring and, importantly, a further drop in Italian bond yields. Life doesn't seem quite so troubling here, at least for now. There are plenty of potential banana skins of course, all the way out until May and the French election. What I found nearly as interesting as Lufthansa's email was the news that German Chancellor Merkel has entered the French election campaign to support Sarkozy. Now why would such a supposedly cautious person do that? Answers on a postcard please.

And that leaves us to the weekend and some more rather exciting football, and hopefully a more enjoyable outcome for some of us than last weekend!

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