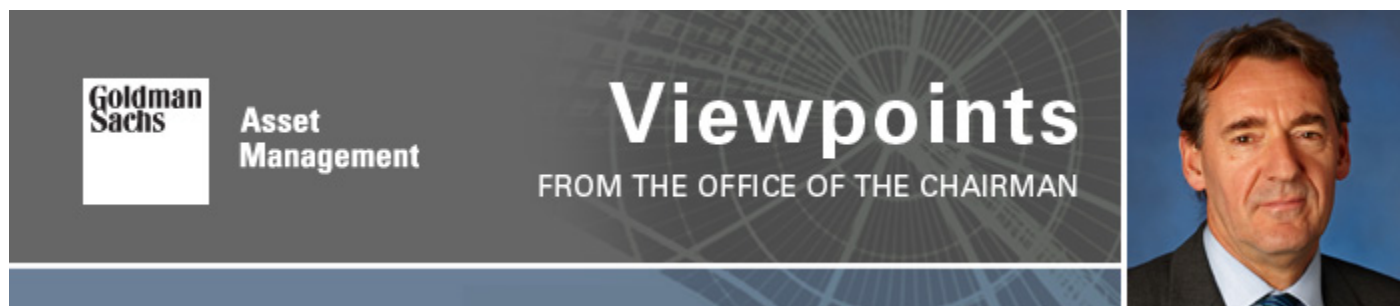


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**From:** O'Neill, Jim [IMD]  
**Sent:** Tuesday, January 03, 2012 1:07 PM  
**Subject:** Starting off 2012 with Pragmatism



### Starting off 2012 with Pragmatism.

Here we go again. A very happy New Year to you all, whatever it may bring.

This is my first piece since mid-December, so I am going to reflect back a little on 2011 as well as discuss the news flow over the holidays and join the scene setting for 2012. In line with the title of this Viewpoint, I am also trying to start the year as a pragmatist, albeit with a bullish bias. After the first 5 days of the US markets trading – at the end of January 9<sup>th</sup> – I will harden up my views.

### Looking Back on 2011.

In some ways, I found last year to be one of the more difficult ones to analyze that I can remember facing in my rather long time in this business. As the barometer of global risk, the S&P closed at 1257.60, almost unchanged from its closing level in 2010. This is virtually unheard of, and in itself, explains partly why 2011 was so difficult to analyze.

As information has become more freely available and transparent, I have learned in recent years to let the market performance itself influence me more. This performance, along with my own judgment of the most relevant data and policy events, has become the foundation of my views – rather than listening to the views of too many others. In this regard, and one of the reasons I mistakenly stuck to a bullish bias last year is that, since 1950, it is fact that when the S&P trades up cumulatively over the first 5 trading days of the year, it has traded up for the year 86.8 pct of the time. Well, last year was the 6<sup>th</sup> time out of 39 years when the accumulative 5 day move was positive, that this didn't happen. So it was a very "odd" year in that sense.

The average market gain over those previous 38 years had been 13.9 pct, so it seemed to me that this was a rule well worth respecting. In January 2011, the S&P actually rose by 2.3 pct for the month, and the statistical accuracy of the whole month had been even slightly higher. Of course, that didn't work either.

While the S&P was flat for the year, it was one of the best performing markets. For example, you would have had to have been a major devotee of investing in Mongolia to have felt especially good, where I believe the market rose by just over 45 pct. Amongst others, 2 of our Next 11 markets, Indonesia and the Philippines, managed very modest positive gains. For virtually everywhere else, markets were down, and it was just a matter of how badly. Interestingly, it didn't make a lot of difference whether it was the BRIC markets or Italy, many were down 20-25 pct. Given that world GDP looks to probably have risen by close to 3.8 pct in 2011, this was quite poor global equity market performance. It is rare for growth to be stronger than the previous 30 years and the equity markets to be so weak.

Other things I underestimated in 2011 included: the global impact of the tragic Japanese earthquake, especially on the US, the initial slow speed by which Chinese inflation would stop rising, and of course, the global obsession with all matters European Union, as well as the repeated inability of the European policymakers to get ahead of the curve. Amongst the small victories I shall claim was the major reversal of the Swiss Franc since the Summer – the biggest single move of any major currency since floating commenced in the early 1970's – and the strengthening recovery of the US towards year end.

## News Over the Holidays.

What has been interesting is the somewhat better tone of the reported economic data around the world, and the absence of widely expected bad news about Europe, and in particular, widely anticipated sovereign downgrades. All of this has been reflected in a better performance of equities over the holidays and, so far, since trading started in 2012.

For a world that is braced for a disappointing 2012 and is expecting lots of bad news, so far the news flow has been somewhat of a positive surprise. Let's see if that situation persists.

Having observed most of the data reported around the world since mid-December, I would say right now, after the generally stronger than expected US ISM and other global PMI surveys today, albeit ahead of payrolls Friday, our 2012 forecast for the US and the world looks too cautious to me.

In addition to the generally better data flow in the US, other places have put up positive surprises too, including China's December manufacturing PMI, which rose back above 50, Korea's December export data, which was much stronger than expected, and continued modest positive surprises in Germany. There have been a lot of other data points too, a couple of which were disappointing, but in terms of ones that are generally globally relevant, I can't see any that have really disappointed. JP Morgan's global PMI rose to 50.8 in December, the strongest since June, and up notably from November with some of the important components showing good signs.

In terms of policy and "events", things have been more mixed. Anyone watching the Middle East would have plenty of reasons to worry, ranging from the Iranian missile exercises to ongoing events in Syria and elsewhere. I had spent a couple of days in the Middle East in early December and had the honour of a short meeting with one of the most seasoned Middle Eastern policymakers. He was not especially optimistic about near-term events in the region. Having said that, he gave me more confidence in my judgment about the power of modern technology and globalization, suggesting to me that both are major forces for good and that the underlying outlook may be improving in the region because of these forces.

Outside of this part of the world, the real news item was the changing of the guard in North Korea and perhaps, separately, the protests in Moscow. I am not sure how one would try to interpret things in Korea, so I am refraining for now. As for Moscow, I am unsure also. I had been led to believe by some insiders before the protests that President elect Putin is more likely to favour bigger changes than many foreign observers anticipate. Therefore, I remain very open to the idea that Russia may positively surprise this year. Perhaps the "R" in BRIC is going to be growing up a little? Of course, I have to remain open to the opposite view also.

As for policy matters in the Euro Area, the real story is just how little news there has been since mid-December. Many people have been involved in a big guessing game as to the timing of the widely-anticipated sovereign credit downgrades. Many are asking why have they not happened? In addition, there are substantial issues about the Greek debt restructuring and what is likely ahead for many other Club Med countries, more of which below and in the future.

And then, of course, is the never-ending excitement about the 2012 Presidential election in the US and the beginning of the selection process for the Republican candidate. I am not at all sure about what to make on this topic.

## The BRICs and Growth Markets.

A number of media commentators have written quite detailed articles about my favourite topic, many of which were inspired by the publication of Global Paper no. 208, authored by Dominic Wilson and some other of my ex-colleagues in GS Economics, entitled "The BRICs 10 Years On: Half Way Through the Great Transformation". A few commentators tried to suggest differences between their views and those of my own, especially as in early December, I published a book; "The Growth Map: Economic Opportunity in the BRICs and Beyond".

Reflective of the mood that prevails – what can go wrong, will go wrong – those commentaries used the paper to suggest the era of BRIC importance has passed and life isn't going to be quite the same. I cannot really understand this mood other than it being reflective of "what can go wrong, will go wrong". While I can't

vouch for the authors' views, their numbers don't suggest anything different from my own.

In particular and of crucial significance, the paper shows that in the decade 2010-2019, world GDP is likely to average 4.3 pct real GDP growth. This is much stronger than the past 30 years and can only happen because of the BRIC economies and some of the key N11 countries that, at GSAM for close to the past 12 months, we have been describing as Growth Markets. The world is likely to have stronger growth this decade than the 30 years I have been following the world economy and it is purely because of the Growth Markets.

Moreover, this is despite the fact that China will grow more slowly this decade than the last one, and I share the author's assumptions that 7.5 pct might be a reasonable outcome. What is less clear is whether the other 3 BRIC countries will grow by less, or more, than the last decade. What is more clear is that a number of the N11 countries are likely to grow more strongly than they did in the last decade, and as they show and I would highlight, Mexico could be the real standout. In my view, this is partly because of the waning effects of a too competitive China.

Even though China is likely to grow more slowly, it is far from obvious to me that this is anything to worry about. On the contrary, it may be really bullish, if it is accompanied by a more balanced set of growth drivers where personal consumption plays a bigger role. It also remains clear to me that many Chinese policy initiatives lie ahead, both in terms of macro economic policy and financial markets planning. Over the holidays, in this regard, it is very interesting to have seen the CNY close 2011 out at a new record fix, and markets reducing the probability of some future CNY decline. It was just as interesting to observe central bank Governor Chou saying that the CNY is likely to fluctuate more in the future and to suggest that China is getting closer to full capital account convertibility. I am still assuming that by 2015, the CNY might be fully convertible.

Two other interesting BRIC "tidbits" to mention. First, even though India badly disappointed with policy developments in December to close out a year to generally forget, yesterday, they announced that foreign investors are going to be able to invest directly in local equities from January 15<sup>th</sup>. I also get some impression that other policy initiatives may be afoot.

The second tidbit is that Brazil overtook the UK to be the world's 6<sup>th</sup> largest economy according to various reports. I am not sure how anyone can really know that yet, as neither has reported their official Q4 data, but it is interesting to see it mentioned.

### As for What Can Go Wrong, Will Go Wrong.

By definition, lots of things could go wrong, possibly including a fresh rise in crude oil prices, especially if Iran plans to cause a lot of fun and games early this year. Against this, and read Roger Altman in today's London Financial Times for an up-to-date view, the energy supply response in recent months is probably still much stronger than many people realize. I suspect that, short of a major problem in the Gulf, this is an overhyped topic – yet again.

As for Europe, I shall leave much of this until coming days and weeks as there is so much out there. Of things that really can go wrong, the Greek debt restructuring strikes me as one of the most likely. As for the coming downgrades, I am not sure they will really matter much, and I would certainly suggest the generosity of the ECB's pre-holiday 3-year LTRO (Long Term Refinancing Operation) to be much more important in keeping things afloat. Plenty more on this topic to come.

Away from the markets and my other favourite topic, there is a rather important rematch coming up with the noisy neighbours at the weekend, which will be at least as interesting as first 5 days of market trading. Once more, Happy New Year.

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