

**From:** Jim O'Neill [IMD]  
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### RENESAS, RUSSIA AND RESCUE!

I returned from yet another trip Saturday. This time, I went to Tokyo, and came back via St. Petersburg. In Tokyo, I visited with many of Japan's largest investors and their policymakers. This was my first visit to Tokyo in my role as GSAM Chairman. I went to St. Petersburg to participate in the annual Forum, which is increasingly becoming a Davos-like event. I don't think it was the jet lag, but as I travelled, I couldn't help think that the world had suddenly become a more fragile place. The remarkable ongoing saga of the European mess is troubling. Equally troubling, is the message sent by the second consecutive decline in the Philadelphia Fed survey of business activity in the US. More on these two later.

#### RENESAS.

For those of you who may not be familiar, Renesas – based in Japan -- is one of the world's largest manufacturers of semiconductor systems for mobile phones and automotive applications. It is also the world's largest manufacturer of microcontrollers and the second largest manufacturer of application processors. Could the fortunes of this company's production rebuild post-tsunami be a key for the world cycle in coming weeks? This question, and the likely developments surrounding Tepco, were two of my main takeaways from my trip to Japan. On the long flight back, I pondered about Renesas especially. Back in March, I was one of those that mistakenly believed that Japan's tragedy would have little consequences beyond their shores, aside for any higher energy prices that might occur. It now seems as though I was wrong. In addition to the higher prices that the crisis did indeed help engineer and the evidence that this has tightened consumer pockets around the world, it seems as though the supply chain consequences of the disaster have been quite significant.

I had never heard of Renesas until my trip. On checking, Kathy Matsui, my colleague from GS research days, tells me that Renesas Technology was originally a joint venture between Hitachi and Mitsubishi Electric. In 2010, it merged with NEC Electronics to become Renesas Electronics. She also tells me that on June 10, Renesas confirmed that their Naka factory output had been hit hard.

At one of my meetings, someone suggested that their high tech chips fed into 40 pct of the world's auto output, especially all the Japanese ones. Another joked that his brother-in-law worked for Renesas and, until recently, he believed that his family member had been demoted when he went to work there. He now realizes how important he is. A policymaker told me that he would guess there would have been powerful fallout for the UK, followed by the US, China, Thailand and Indonesia, in that order, reflective of the importance of Japanese offshore auto facilities. Certainly, some of the weakness recently in the US can be accounted for by this sudden development as the latest Beige Book highlighted. As Renesas rebuilds and Japanese auto companies retool, this part of the recent world slowdown will turn back up. Toyota confirmed this week what I had heard before I went, that they will be back to normal by July.

#### JAPAN BEYOND THE QUAKE.

So, it seems that Japan is now in post-tragedy recovery mode. Structurally, I didn't hear too much about Japan leaping into a stronger future. If anything, the opposite unfortunately might be more true. Some feel that the supply side of the economy might be negatively affected as global suppliers look to alternative geographies to produce and, at some stage, taxes are going to be raised to help cover the ever-rising levels of Japanese debt. To counter all of this, Japan needs quite powerful reforms, but I didn't hear much evidence that much is in the pipeline.

#### THE MOOD OF JAPANESE INVESTORS.

I had an action-packed two days, meeting with lots of investors, as well as being interviewed by a Japanese legend, Akira Ikegami. Over the course of those two days, I found myself marveling at Japan's attention to detail in so many



GSAMflower1.jpg

areas. The attached GSAM logo, inside a real flower, was a particular highlight, as was the craftsmanship with some of the dishes presented at another dinner hosted by a large client. If Japan could "bottle" these sorts of skills in a big way, their long term future might be better.

Japanese investors appear to have a deep thirst for knowledge, especially on all things foreign that offer a yield. This is especially true for retail investors, but also relevant for institutional ones. Again, I found myself thinking that perhaps Europe's leaders should really introduce a true Euro-denominated bond to help solve their crisis and funding needs for the periphery. Japanese investors would be major buyers, especially if EMU were renamed "Emerging EMU" or "EMU with BRICs". In contrast to my trip to the US last week, Japanese investors can combine caution about their home economy –and a need for cash – with a lot of interest in the BRIC and Next 11 theme. Fixed Income, "Balanced" and Equity products of a "Growth Market" flavor have lots of potential.

As for the Yen, I am afraid to say that I didn't detect much angst about its strong level against the Dollar from policymakers, although it seems to me that the post-tsunami supply issues suggest that they should be more eager to reverse its strength than before. The local counterpoint to this view is that the US is heading down the same path that Japan has experienced. And, with the Fed's mandate, it is tough for the Yen to weaken against the background.

I had an enthralling, albeit exhausting, two days. Thank you to all in Tokyo for their wonderful courtesy and hospitality.

**RUSSIA. A TWIN ENGINE ECONOMY AND A DETERMINED PRESIDENT MEDVEDEV.**

From Tokyo, I went on to the Summit after a long, yet pleasant Aeroflot flight. I arrived amid the clear blue skies of a mid summer evening in St Petersburg. At this time of the year, if you are lucky with the weather, it really is a beautiful place.

I participated in two panels at the conference. One of them was a televised debate about BRICs, BUCKS and Beyond, the other the Internet, Russia and the World. Before any of this, I had the pleasure of listening to President Medvedev and President Hu. There had been some talk of a panel discussion with them both and some others, but I suspect the Chinese leadership was not keen on this format. Of course, much of the time in between meetings and the panels, I was in deep discussion on the topic on everyone's lips: Would Putin or Medvedev be the new leader next year? I heard every possible twist you could imagine and, not surprisingly, no one has the slightest idea. I found myself wondering whether either of those two do either.

President Hu's speech was fascinating, not least just to see him there, especially for me when he uttered the phrase "BRIC". His comments were quite brief, and the most interesting part was when he stated that they had agreed on a target to raise bilateral trade to \$100 bn by 2015, and to double that to \$200 bn by 2020.

For me, however, a major highlight of the two days was President Medvedev's opening speech. Not only did he tell all the massed ranks of global CEO's and others what they wanted to hear, but his tone was stronger and he seemed more specific than when I have seen him speak before. He included a lot of specifics, including suggesting that major initiatives about judicial law were afoot. Many of the well-known CEO's sitting near me were as positively shocked as I was on hearing all of this. If many Russian bears would have been present, I suspect there would be quite a bit for you to think about. If just a small part of what he highlighted in his plans is delivered, I suspect Russia is heading for a re-rating.

Interestingly, at the end of the BRIC plus panel I was on, all nine participants were asked to indicate their favourite geographical investment. Russia was suggested by four of the panelists, more than anywhere else.

**RUSSIA IS NOT JUST OIL AND GAS.**

The other panel I participated in was focused on the Internet, Russia and the world. In addition to wondering exactly what I was supposed to contribute, I found it fascinating. Many of the recent high profile names from the space were fellow panelists. For all those that believe Russia starts and ends with energy, you should have been in that room. Where else in Europe are there such cutting-edge Internet-based companies? It was most illuminating, especially when half way through, the President joined the audience and decided to make a few remarks.

Russia has lots of well-known important problems and challenges. In addition to excessive dependency on resources,

the demographic challenge, rules of law and corporate governance and, of course, corruption. The Internet panel suggests to me that the perceived number one problem is changing. Another policymaker confirmed what I have heard repeatedly in the past year – that the demographics are starting to turn. Clemens Grafe the GS Russian Economist also shares this view and has charts to show the improving trend. On the other two big problems, it seems clear to me that President Medvedev and those closest to him have strong plans to improve them. Let's see if they can deliver. If they do, many people are in for a pleasant surprise.

#### THE WORLD SLOWDOWN.

Unfortunately, the world slowdown seemed to gather speed this week following the release of the important monthly Philly Fed survey. A second consecutive steep fall suggests that there is more afoot than the Japanese supply chain issue. A repeat of summer 2010 is occurring. Unlike last year when a temporary tightening of financial conditions could explain it, this time the drivers must be different. Possible drivers include some combination of the supply chain issues, higher food and energy prices, perhaps fears of inevitable fiscal tightening and worryingly perhaps the consequences of excessive regulation over banks making it more difficult for them to lend. Last year, the abrupt US slowdown turned out to be temporary, with the inevitability of QE2 probably playing a role. The renaissance of Renesas in Japan and the world auto industry can play some of that role. If it isn't sufficient, then some of us are going to be getting more worried than we have been.

#### EUROPEAN MONETARY UNION.

As I half-joked about to Japanese clients, right now, you could swap the Growth Market eight economies with any eight EMU members (except Finland) and you would immediately have an EMU much closer to fulfilling the Maastricht criteria than the current bunch. I hadn't realized this fully before preparing for this trip, but the fiscal deficits and debt of all the Growth Market economies as we define them are in good shape. Alas, that is not the case for the current EMU members. On top of that, you have weak governance and leadership and no real out-of-the-box vision as was arguably there in the days of Schmidt, Kohl, Mitterrand, et al. A couple of years ago, I happened to be at a major European economic forum just after Manchester City had been bought by a Middle Eastern owner. At the time, it was thought to have been a Sovereign Wealth Fund (SWF), but it turned out to be a wealthy citizen. At the conference, one panel focused on Europe and its competitiveness, and it included literally most of the top policymakers. The biggest topic of discussion was SWFs and how to stop them buying European assets. Somewhat dismayed at the end, I pointed out that at least the blue half of Manchester thought they were rather a force for good, not evil, right then.

Improving Europe's competitive position was, and still is, about finding more people to work and in a productive way. Fast forward to today, Europe's leaders could benefit by going with a begging bowl to SWFs around the world, as well as to Japanese investors, with some creative ways of presenting European assets to them. I can't see why the notion of all countries having 60 pct of GDP in debt being converted into a true Euro bond isn't going to eventually emerge from this. I understand why some countries like Germany object, but if you wanted EMU, you have got to start delivering it. On a high level, this crisis is all about whether Europe's policymakers want this thing to survive or not. A common Euro-denominated bond for the permissible amount of debt the Treaty allowed, perhaps supported with Trichet's recent idea of a European Finance Minister, seems to me the only true way out of this mess. It could well be, in addition, that for those with a lot of debt beyond this, real trophy assets – more of the Manchester United than City variety! – might have to be put on the table. If we don't have this sort of forward-looking thinking, it is starting to look as though the great post-war European creation could be under major stress.

I am going to Brussels Wednesday for the annual board meeting of BRUEGEL, a European think tank of which I am a board member. They will also host a conference about the EMU situation. It promises to be quite interesting to put it mildly.

Jim O'Neill  
Chairman, Goldman Sachs Asset Management

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