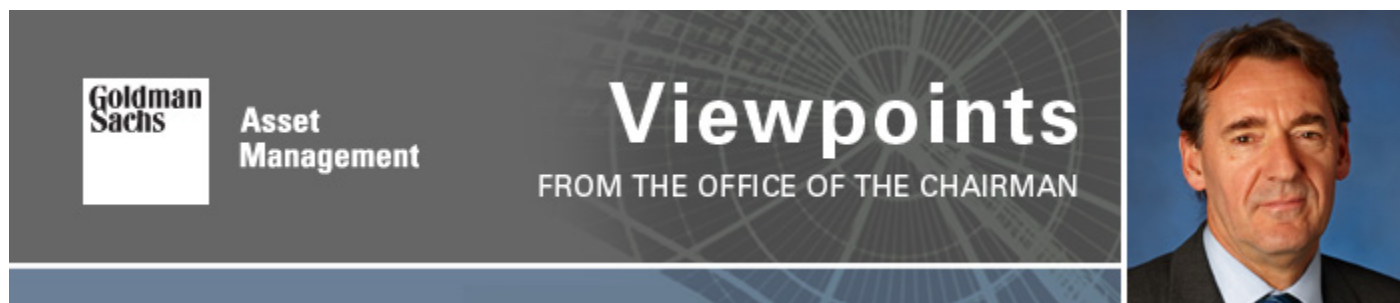

From: O'Neill, Jim [IMD]
Sent: 11 June 2011 19:00
Subject: THE WORLD SLOWDOWN AND SO ON.



THE WORLD SLOWDOWN AND SO ON.

Dear reader, contrary to what a number of you have suggested, I have not abandoned writing Viewpoints because of the unfortunate events that took place at Wembley 2 weeks ago. Admittedly, it did take me quite some time to get over the mauling United received, but last weekend I was walking in the Swiss Alps for a couple of days, and was travelling all week.

Since I last wrote, I have been at the FT Annual Luxury Goods Conference in Lausanne, and then on for a few very interesting days in New York. I have to say the mood amongst some people I met in the two different places was quite a contrast.

Over the past two weeks, we have seen widespread evidence that the world economy has lost some momentum. Not surprisingly, many financial markets participants and policymakers are concerned. Following the poor equity market performance in May, it seems ominous to many. "Sell in May" is taking on some mystic belief. Here is my take on it all, as well as some of the tidbits I picked up on my travels.

SWITZERLAND.

Aspects of my Swiss visit were in stark contrast with aspects of my NY trip.

We went hiking around Les Diablerets for about 3 days. Near the village is a ski lift that you can ride up to the glacier for panoramic views at 3,000 metres. It costs a whopping CHF 77 to ride there and back. Given today's exchange rate, it is not exactly a bargain! My wife, who thinks I live in cloud cuckoo land, thought it was a bit extravagant. While we were debating it, an Indian gentleman came up to the kiosk, handed over five crisp CHF 100 notes and paid for six of them without a blink! We finally decided to go up. Needless to say, it was cloudy at the top, and within 40 minutes, we were back down to carry on with our walk. On the lift run up and down, virtually everyone else was Indian. On the way down, we noticed a rather large advertising board extolling the virtues of a well-known bank and its expertise as the choice private banker for the emerging markets. I remember days of the late 1980's when there were special train sections for Japanese tourists up to the Jungfrau. How times are changing!

The pre-conference dinner for speakers at the Lausanne event carried the same mood. A number of leading luxury goods CEO's were present and they all seemed rather upbeat – not surprising given the BRIC demand for their products. Just today I read a piece suggesting that Chinese buyers might be responsible for around 50 pct of all European luxury goods sales.

I was there to participate in a panel about the state of the world with my ex-colleague Gavyn Davies, along with Martin Wolf from the FT. As a sign of the abrupt shift down in the developed world, the first question we were asked to consider a few weeks in advance was where the recovery was the strongest and likely to be the most robust? Martin used some nifty footwork to ask it differently, and Gavyn kicked off the answers by pointing out how slow everything had been recently. Within minutes, the idea of "QE3" in the US came up as a policy discussion and all three of us agreed that, if necessary, the Fed would provide it. I suspect we might differ on the likely need, but we never got really into that.

Where we did diverge was on the importance of the large emerging world, and not for the first time, Martin and I especially differed on China. I pointed out that that weekend, the well-regarded Chinese Academy of Social Science

(CASS) had released a study, forecasting that the US\$ value of consumption would double from around \$2 trillion by 2015. But Martin didn't seem too excited about that. I didn't have time to emphasize that this would be consistent with something equivalent to a 4 pct per annum vicinity in the glory pre-crisis days of the US consumer. As I found out at a hedge fund lunch later in the week, the issue of imbalances seems to worry so many still. I increasingly suspect that many Western minds, including some of the smartest, just simply don't really look at the evidence when it comes to China. It either can't be true or, if it is, it must be unsustainable! Friday we got the very latest Chinese trade data, which once more was softer than expected, and for the first 5 months of 2011, it is less than \$30 bn. This is around 1 pct of GDP annualized, and a far cry from its heady days of 10 pct or more. Imports, while a bit softer for the month, are \$156.7 bn higher than they were a year ago, which when annualized is about \$ 376 bn. At this pace, China's import growth will be strong enough to import another full Greek economy, as it did in 2010.

NEW YORK.

From the modest heat of Switzerland via a quick return home, I went to the blistering furnace that New York suddenly became last week. On 4 of my previous 5 trips this year, it was covered in snow and freezing. But, as the week wore on, the heat did little to lighten the mood.

On the first day, I was due to be interviewed on CNBC about the world. But, I found myself in competition with Fed Chairman Ben Bernanke and his Q+A. I joked with Maria Bartiromo that I thought it was highly inappropriate for me to be kept waiting, but we both had the pleasure of hearing Jamie Dimon grill the Chairman about the economic impact of excessive regulation. Like a number of others that I spoke to the rest of the week, I was quite surprised by his candid answer that the Fed thought it was too difficult to judge. Even for someone who is trying to see the US glass half-full like me, it was not pleasant to hear.

BRIEF LATAM DIVERSION.

Just to complete a nice relaxing day, and my specific purpose for being in the Big Apple, I attended a Latin American educational charity function, Worldfund. I was an honoree for my services to charitable education. As I joked about when I received the award, I rather suspect it was more for putting the "B" in BRIC. I also added that deciding to put the "B" in there was one of the better things I had done in the last decade, along with helping set up the specific educational charity, SHINE. As there were many Mexicans present including one of the other honorees, I also said that if I hear more evidence about the smart steps going on with teaching efforts in Mexico, maybe I should add the "M" at last for it to become BRIMC. And, for good measure, I suggested that the existence of a certain Chicorito was taking me in that direction. For full measure, in case there were any Argentineans, I also added there would be no chance of an "A" being added, unless somebody kidnapped Messi and forced him to play at Old Trafford.

MEETING WITH US CORPORATION PENSION FUNDS.

The following day, I spent much of the time with a number of US corporations, especially their pension fund investment teams as well as some pension advisors. Along with discussing the state of the world, the dominant and reoccurring discussion point was the appropriate benchmark for investing in global equities. This happened to be very timely, as we continue to work on creating something which I think is extremely interesting for such investors. We shall keep you posted.

GLOOM IN THE NUMBERS AND HEDGE FUND MINDS.

On Thursday lunch time, I joined some Goldman Sachs colleagues for a lunch with some leading macro hedge fund investors, most of which I had enjoyed a similar lunch with last October. The mood this time couldn't be more different. I guess it is kind of understandable given the recent run of data, the markets and the apparent policy impasse in DC on fiscal matters. But it seemed to me it was all a bit over the top. The general mood around that lunch table was gloomy, whether it was about the US, Europe or China, both with respect to data and policy options. I was regarded as a raving lunatic for suggesting it was possible that US unemployment might fall below 6 pct by the end of 2013.

Having witnessed the Bernanke speech and Q+A, I can understand the mood regarding risks of excessive regulation. But, while a QE3 would clearly involve "externalities," it seems obvious to me that if the recent weak US data is for real, then there is a good chance that the Fed would deliver on something more. After all, their mandate is pretty clear. That being said, I return from the US far from convinced that the Fed is going to have to worry about this. I was rather relieved to observe that the Beige Book included many references to the impact of supply chain disruptions from Japan in the recent period. I suspect that this, along with higher oil prices, is the main culprit for the significant soft patch the US has recently been through. As I pointed out to the lunch group, US financial conditions had eased since we all had met last October. Given that, I can't see why the US is suddenly into a sustained downturn, unless the impact of regulatory measures is hurting credit provisions that much. There is not much evidence of that in the data. Anyhow, we shall soon see.

JAPAN.

This discussion has left me thinking that perhaps the key place, oddly for the world momentum in coming weeks, might actually be Japan. Luckily, I am off there Monday for a brief trip, my first since the tragedy earlier this year. One of our

European portfolio managers, Ed Perkins, had suggested soon after the tragedy that the supply chain impact was likely to be considerably bigger than many realized. It looks like he was right. Interestingly, at our latest CIO call last Thursday, his evidence from companies was that Japan was in significant production rebuild mode. I hope to hear more about this in coming days. If it is true, then a number of parts of the world might suddenly do a bit better than people think.

CHINA.

The contrast between the report from CASS, the tone of top European luxury goods companies and the mood I heard from many in NY about China was really quite striking. It will be fascinating to observe all their data releases in coming days. For me, the key is when the CPI will start to turn, allowing the PBOC to take its foot of the monetary brakes. It seems clear to me still that the economy is slowing cyclically more than the revised-lower consensus think. And, in contrast to the "hard landing" mood of more and more observers, once they are happier about inflation, I think the next phase of their transition emerges, and the basis for the next global equity market rally.

What is also clear is that their actions continue to be the absolute near-term key for energy demand. This week, the annual BP Statistical Review confirmed that in 2010, China overtook the US as the world's biggest energy consumer, taking 20.3 pct compared to the 19.0 pct of the US. Global demand actually rose more than global GDP, by 5.6 pct versus 4.9 pct. This is the sort of thing that excites both commodity bulls and equity bears. They share the common belief that there are simply not enough resources for all of this to continue.

At the same time, there appears to be growing excitement about aspects of the alternative energy world, in which China is so actively investing. There was a fascinating clip in the FT one day last week quoting the US Energy Information Agency, suggesting that within 3 years, the cost of solar power will drop by another 60 pct making it comparable to other conventional energies. All most interesting.

EUROPE.

What a complex state of affairs. Aside for the strength of Germany, and some other pockets of European export driven strength, I tend to share the mood I heard from all those macro hedge funds. On one level, it is all rather exciting theatre as Europe's key policy actors continue to debate how to reduce the burden of Greek debt without causing excessive pain for key players. Perhaps an interim European Football Championship can be organized between the banks, the ECB, the IMF, the French Authorities, the German Finance Ministry and the German Chancellor's Office. Oh, and I guess someone should invite the EU to play also.

I shall offer a couple of comments. Firstly, I can't see how the Euro can stay above 1.40 against this background and the not inconsiderable risk that something goes wrong. Secondly, and in contradiction to that, am I that naïve to believe that the policymakers have not figured out what might happen if they make a mess of the Greek debt discussions? Surely, this is not that big a deal, so long as Spain and Italy don't get dragged down?

Anyhow, I will be in both Japan and Russia next week, after which I hope to be on terra firma for some considerable time.

GROWTH AND EQUITY RETURNS.

On Friday, we published the second part of our analysis about economic growth and returns. Anna and James have at least as much stimulating evidence in this article as the first. It also includes some simple but also important data showing the low correlations between the US and China. And interestingly for me, ahead of my trip to St. Petersburg for their big Summer conference, this approach highlights the cheapness of the Russian market in the event of a positive surprise to the consensus.



Linking GDP Growth
and Equity ...

Good luck!

Jim O'Neill
Chairman, Goldman Sachs Asset Management

Viewpoints are also available on our [website](#).

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