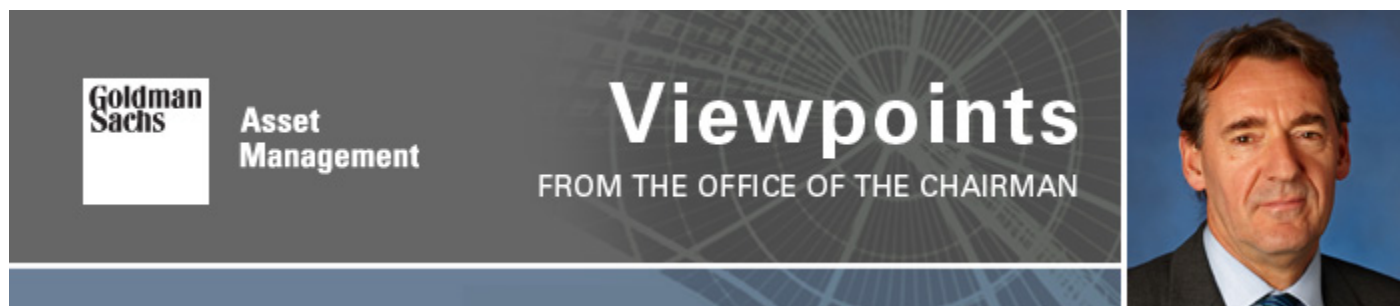


**From:** O'Neill, Jim [IMD]  
**Sent:** Saturday, July 30, 2011 9:02 AM  
**Subject:** PRAYING FOR SOMETHING



### PRAYING FOR SOMETHING.

Did you manage to distract yourself from the US budget fiasco this past week? Or did you spend the whole week wondering about what might happen if the US doesn't pass its debt ceiling on August 2<sup>nd</sup>? I had a visit from a really smart hedge fund from Outer Space, and the CIO said that he expected US Treasuries to fall significantly as a result of Congress' inability to reach a deal and the US being downgraded. I told him that while it seemed very sound reasoning, here on Planet Earth, things don't necessarily pan out that way. In fact, Treasuries would be the major beneficiary as investors adopted a "risk off" mentality and sold higher risk assets instead. Not to confuse my interesting visitor from Outer Space, I did tell him this didn't apply to the Dollar, which would fall because investors would be far happier owning the Euro despite all its apparent problems. While the US might have a large budget deficit and the global benchmark was on the verge of losing its AAA credit rating, US Treasuries were a better alternative than anything else. Not surprisingly, my new CIO friend decided that he should rapidly disappear. He got in his spaceship and flew away.

I shall return to this remarkable budget fiasco below. First, however, I shall focus on two other topics that consumed more of my interesting week than the Summer Washington theatre.

### CHINA, HIGH SPEED RAIL AND ECONOMIC GROWTH.

Last weekend, there was a tragic accident on one of China's new high speed train tracks. This has the possibility of becoming quite a big issue. The opening of such vast high speed trains was supposed to be another symbol of China's dramatic growth and transformation to a leading hi-tech infrastructure economy. To us China bulls, this was another symbol of the nation's emergence. Some, now with hindsight and perhaps considerable wisdom, question whether, in fact, the opposite has occurred. Has high speed rail become now more of a symbol of how China is trying to move too quickly? Is China now heading for considerable difficulties? That is certainly how the rather noisy bear camp will see this development.

Clearly, this is an issue. As a number of international newspapers wrote, this is the 2<sup>nd</sup> such accident in the past few years. In comparison, Japan has apparently had, to date, no fatal accidents. There are lots of articles appearing on the internet debating the specifics of the crash and what it might mean.

One consequence is probably commercially positive for many overseas hi-tech infrastructure firms who have perhaps been worrying that they will soon face more and more Chinese competition, not just from inside of China, but in other third world markets and possibly their own domestic markets. I suspect this is now somewhat less likely.

The other, more important issue is what does this mean about future investment spending and the speed of China's economic growth? To my mind, already convinced that China is entering a new era of more focus on the "quality" of growth as opposed to the "quantity", this is simply a vivid sign of why Chinese authorities are going to have to choose this path. For investors, they will have to weigh the pros and cons of a period of softer than recently experienced and currently expected growth, which is usually negative for equity prices, versus a more sustainable, balanced and higher quality led growth, which is usually very positive for equity prices.

By coincidence, some Bank of Japan staff have published an extremely interesting article this month about Japan's experience and any lessons for China. Written by Tomoyuki Fukumoto and Ichiro Muto, "Rebalancing China's Economic Growth: Some Lessons from Japan's Experience", the paper argues that China should deliberately push for slower investment spending before the pace of GDP growth slows too much. They suggest that if China waits until the economy slows, then the investment bust which many observers fear might occur. I recommend this paper to one and all. The

authors of this paper had previously written a very useful – and balanced – article on China's property market, concluding that there was no nationwide problem.

As always, China is fascinating. I should add that while the above development is a key issue, it is not as important as the ongoing debate about when, and if, CPI inflation might peak. In this regard, news that pork prices showed a decline in the latest week is supportive of those of us who are more optimistic.

#### MY DEBUT IN ISRAEL.

I made my first visit to Israel this week, spending about 24 hours in Tel Aviv. I felt embarrassed to tell anyone that I met that I had never visited before, given how global I am supposed to be. Even worse, I was present for such a short space of time, I couldn't visit Jerusalem. People were very diplomatically kind, but I suspect they thought I was nuts. As it happens, I made up for the last part, because I managed to sneak in a helicopter ride over to Jerusalem before I left. That was a remarkable experience. What a staggeringly complex and fascinating place. From above, you can see so much of the history and controversy below, all within such a tiny geographic area.

Anyhow, on the more business side of life, there were three takeaways from my meetings with leading business figures, important clients, a major policymaker and the rest of the crowd I had fun with in my intense 24 hours:

1. Israel's business elite is up to the game when it comes to the BRIC and Growth Market story, surprise surprise. Many of the business people at a 2-hour round table I enjoyed are not only at ease with the concept, but quite a few of them are actively involved. I found myself thinking: are Israeli companies another way of making the Growth Market bet?
2. On Egypt, not surprisingly, most people are worried and not particularly optimistic about the near- and medium-term path. I wouldn't have really expected anything else, given how the previous Egyptian regime was a source of stability from an Israeli perspective. But, as some acknowledged, if the whole troubled region is ever going to move to a more lasting peaceful future, Egypt moving into a better more successful future is something to be encouraged. Interestingly, one gentleman had a particularly important commercial link. His view was that neither of the more extreme outcomes was likely to emerge. When I asked whether he would invest again today, he answered yes.
3. Street protests. Remarkably and ironically given the above, in the past fortnight, Israel has its own street protest about rising prices for food and, in this case, property. Many seemed understandably troubled by it. Some apply blame to the central bank for having kept interest rates too low for too long, which given that Stan Fischer and his team were the very first "developed" central bank to raise them, is quite interesting. It will be fascinating to see where this issue goes.

Overall, it was a fascinating 24 hours, and I rather suspect, it won't be my last.

#### PRAYING IN WASHINGTON.

Many people I met on my brief trip had wonderful humour and more than one suggested perhaps we should go to the Wailing Wall to pray for sanity in Washington DC. What a weekend coming up on the budget discussions.

When I was in NY in the Spring for our Growth Market conference, I had the privilege of interviewing President Clinton at a dinner, and amongst all the topics we explored globally, reducing the US budget deficit was his priority number one. Coincidentally, the following day was the first day that a rating agency threatened to put the US on watch. Since then, it has been clear to me that something was going to have to happen.

There has been so much written about the topic by so many, I am not sure that I have too much insight to add, but I will leave you with three observations;

1. For my hedge fund friend from Outer Space, I suspect the reason why the bond market has rallied and the Dollar and equities have fallen, is because there is going to be a budget deal, which the markets worry will weaken the cyclical GDP growth outlook further.
2. I am assuming that this weekend there will be a deal, but it might not be enough for the US to escape a rating downgrade. I am not sure, especially after all the intense focus, that a downgrade itself will have huge market ramifications, at least in the near term.
3. That being said, as I wrote about two weeks ago, if you were looking for a "perfect" Monetary Union, other than Finland from the current Euro Area, you would not currently select any. Of the rest of the so-called developed world, you certainly wouldn't select the US. You might select Australia, Sweden and perhaps Canada. But you would select at least 6 of our 8 Growth Market countries, and probably all eight. The slow long path to finding new benchmarks and alternative global investments may be about to get another boost, unless something different happens than we all have now been conditioned to expect this weekend.

Go on President Obama and Congress; give us a nice pleasant Summer surprise!

Jim O'Neill  
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Viewpoints are also available on our [website](#).

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