From: O'Neill, Jim [IMD]
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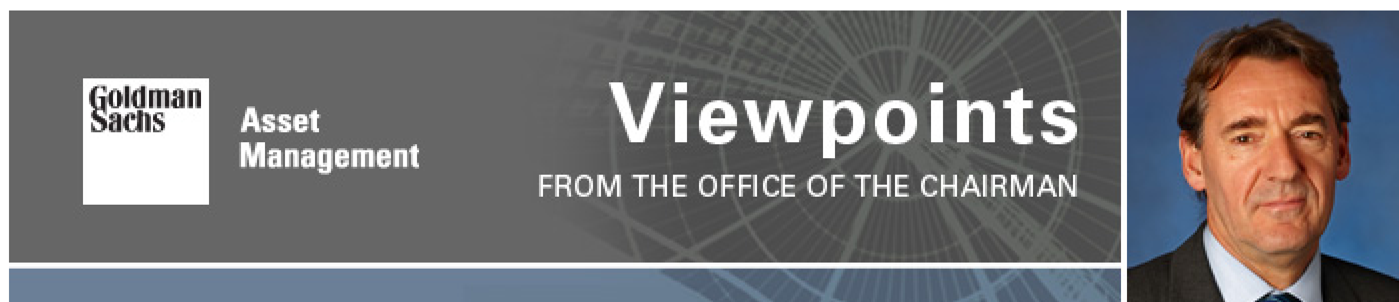

SAFE HAVENS, ALTERNATIVE INVESTMENTS, VALUATION AND BENCHMARKING.

A fresh somber mood returned to the markets in a dramatic way last week with the latest FOMC decision unsettling the markets as well as the ongoing crisis in Europe. As a result, markets are now looking for broader solutions as the annual IMF meetings take place, with a number of policymakers suggesting that the November G20 will be a major event. Some allude to the success of the London G20 in the Spring of 2009 as a key event that helped the global recovery back then and look to November for a repeat. Whether the markets will accept the luxury of 6 weeks grace remains to be seen. I can only believe that, in the interim, policymakers will have to feed markets with hope as to what might arrive in November, and then not disappoint.

Against this background, investors are increasingly nervous about any and all of their strategies. This week, some more of the recognized winners of post-crisis markets suffered especially badly, notably Gold. As I shall discuss below, the large correction in Gold will force many to rethink the relevance of the safe haven concept, just as the weakness of the Swiss Franc since late August will have. In my judgment, all financial investments have a relevant valuation about which investors need to be aware. Any thoughts about persistent safe havens (other than perhaps cash under your mattress) are dangerous. At the same time, the ongoing structural changes in the world economy and markets will result in investors searching for new and alternative investments as well as benchmarks. Consistent with the Growth Markets concept, this week GSAM has published a very exciting paper about a new approach to equity market investing.

A DISAPPOINTING AND A DISAPPOINTED FED?

Last week’s FOMC decision to ease monetary policy further was met with a negative reaction in financial markets. Despite a further notable drop in 10-year government bond yields, the degree of the sell off in equities, combined with a modest rise of the trade-weighted Dollar, caused overall financial conditions to tighten. This is the first time that such an “unintended” tightening has occurred since the global recovery in the Spring of 2009. It suggests that the Fed may have fired a bullet off the target and is an additional worrying aspect of the deteriorating crisis in markets. While it will probably be greeted inside the Fed as a sign that they might have to undertake even more dramatic easing steps, in my opinion, it suggests that fiscal policy actions are more likely to be effective in lifting the US economy from its current weakness. The latest US Economics Weekly from GS has a valuable discussion of the whole topic and suggests additional easing combined with fiscal policy would be an appropriate step to consider. I think US policymakers need to consider specific steps to encourage cash-rich corporate US to spend more on employment and investment in the US and, if they succeeded, the gloom about the US economy might lift quite readily. As ex-GE executive Jack Welch said on a CNBC Squawk Box discussion that I briefly shared yesterday morning, corporate America seems to be in rude health.

NO NEW SPECIFICS, BUT MORE IDEAS IN THE EURO AREA.

The disappointing FOMC meeting occurred while the European issues seemingly got worse, with still no signs of a credible solution to the considerable, varied and rising challenges. The more time that passes, the bigger the challenge seems.

I have written so much about the topic for weeks on end, it seems as though there is little left to say, but alas there is plenty. Two national issues seem specifically worrying at the moment, and a broader critical third core problem. As usual, Greece is under the spotlight and discussions as to whether they will get their latest disbursement of aid are underway, while at the same time, a justified focus on a major debt rescheduling continues. The second, in my view,

more worrying situation, is Italy, where doubts about the stability of the political leadership add to the complexity of the third issue – a broad bold EMU-wide policy solution.

I was in Frankfurt for the day Wednesday, and while the financial community is not Germany, it was fascinating to hear a group of investors at lunch offer their views on the European challenge. Not one of those around the table thought Germany would or should leave the Euro and, at some stage, they believed the "right" thing would happen. There was no consensus on what exactly the "right" thing would be, but interestingly a couple offered quite bold ideas about levering the expanded EFSF and the use of insurance policies on covering the risks of holding sovereign debt rather than persistent cash buying by the ECB or EFSF. Many seemed to think that ultimately some closer fiscal union and genuine Euro bonds would emerge but, in the near term, something urgent was needed to allow such a longer term to be relevant.

Variations of this idea appear to be the "new" idea on the table. I suspect that, in the coming days and weeks, more thought about levering the EFSF (assuming it gets ratified in its proposed format) may be the way forward.

The other rapidly-changing notion is that the ECB is indeed going to reverse its first-half monetary easing and reduce interest rates in coming weeks. I am assuming that this is a given, although many see me as too hopeful. I cannot see any reason for the ECB to not fully adjust back the 50 bps they hiked, given the rapid deceleration in coincident indicators, the lessening of inflationary pressures and the escalating mess they are in the middle of.

G20 TO A 2011 RESCUE?

"Global Economy Pushed to the Brink" is the Saturday front page FT headline, and virtually every domestic UK newspaper has something similar. Many are focusing in on the comments made by UK Chancellor Osborne that policymakers have 6 weeks – the time until the November G20 meeting – to put a floor under the crisis.

This suggests that this meeting is now essentially the equivalent of the World Cup final for policymakers. It is probably a slight relief that so many of the non-G7 members of the G20 are now calling for action. While a direct parallel to the London 2008 G20 is difficult, one can easily imagine a combined package being presented involving interest rate cuts in the BRIC countries as well as the Euro Area, fresh unconventional monetary easing in the UK and US, some specific fiscal support in some less market-challenged countries, all on top of a credible announcement involving Greece restructuring and an expanded EFSF. Given that many of us will be raising such ideas, one cannot imagine the market and economic consequences of a disappointing meeting.

All this being said, the fact that the November G20 is being floated as a major turning point does raise the idea of travelling in hope for a few weeks. When I see so many UK newspapers with such grave headlines this weekend, the value and contrarian investor in me wants to see the upside.

SAFE HAVENS.

For many weeks, investors and journalists have been asking for my views on the next safe havens. My usual response, especially since the bold actions of the Swiss National Bank, is that such things don't really exist. Many instruments and currencies especially, can sometimes appear as safe havens, but as we have seen with the CHF, once policymakers choose to pursue certain policies, any notion of safe haven rightly vanishes. The decline of the Swiss Franc immediately after the SNB's move to announce a "floor" under the EUR/CHF at 1.20 was probably the fastest and largest single currency move in the history of major currency movements since floating. This should make all market participants think long and hard about "safe havens".

In this past week, the decline in gold prices has been dramatic, exhibiting the largest weekly fall since 1983. Not bad for a safe haven? Following the reversal of the Swiss Franc's strength, it is tempting to explore the idea that the "crisis" might be coming to an end and, indeed, when one looks at the value on offer in equity markets and the inevitability of some major G20 policy response, it is not just idle temptation. For now, it is perhaps wiser to assume the gold decline is a savage correction, but it could be the end of its rally. It certainly has experienced some damage to many chart technicians' views.

I am never entirely convinced about the idea of a persistent safe haven as it really depends on the economic and policy circumstances.

ALTERNATIVE INVESTING, BENCHMARKING AND VALUE.

As I mentioned last weekend, that previous week I had spent 3 days in Japan supporting the marketing efforts of a major third party distributer of a Growth Markets equity-based fund. I have also been talking to other investors in other countries about similar sorts of funds, and this adds to my belief that this crisis is forcing investors to think more laterally about the changing world.

Against this background, this week we published a paper explaining a very exciting new approach to benchmarking for international equity investing. The research, led by Don Mulvihill demonstrates that investors can achieve lower overall portfolio risk despite having more exposure to the 8 equity markets that we define as Growth

Markets. The approach combines aversion to market cap benchmarks with valuation and revenue growth, and I believe is cutting edge for all forward-thinking investors. Based on my conversation with literally hundreds of investors in my first 12 months at GSAM, I think many will migrate towards this way of thinking. Of course, a similar approach could be applied to fixed income investing, which we plan to turn our attention towards next.

I continue to believe that, ultimately, valuation is critical for all investing, whether it is equity markets, fixed income or currencies. The recent reversal of the Swiss Franc is an excellent example, and in this spirit, I am also enclosing this week a very interesting table showing cyclically- adjusted PE (CAPE) ratios for many equity markets. It was constructed by James Wrisdale who works closely with me. It is a rather conservative approach to valuing equity markets since, by definition, it smoothes out earnings over the cycle. The table also shows the one year ahead consensus PE, which is the methodology I often prefer. As it shows, in many markets it seems very low, undemanding and therefore attractive. What the table also shows is that, for a few markets, the current CAPE is dramatically below its average (I think James chose 5 years because of data consistency, but it was closely correlated to 10 years where it was available). From the 8 Growth Markets, China and Turkey look like bargain investments, and all, except Indonesia, are below their average. What is also interesting is that Japan and much of Europe, especially Italy and Spain, is exceptionally attractive on such a criteria.

I shall now get in the White Van that is sitting outside our front door. Have a good weekend.

Jim O'Neill
Chairman, Goldman Sachs Asset Management

Viewpoints are also available on our website.

Jim O'Neill is the Chairman of GSAM, which is a separate operating division and not part of the Global Investment Research (GIR) Department. The views expressed herein by Mr. O'Neill do not constitute research, investment advice or trade recommendations and may not represent the views and/or opinions of GSAM's portfolio management teams and/or the GIR Department. Copyright © 2011 Goldman Sachs. All rights reserved. Please visit our website for additional disclosures.

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