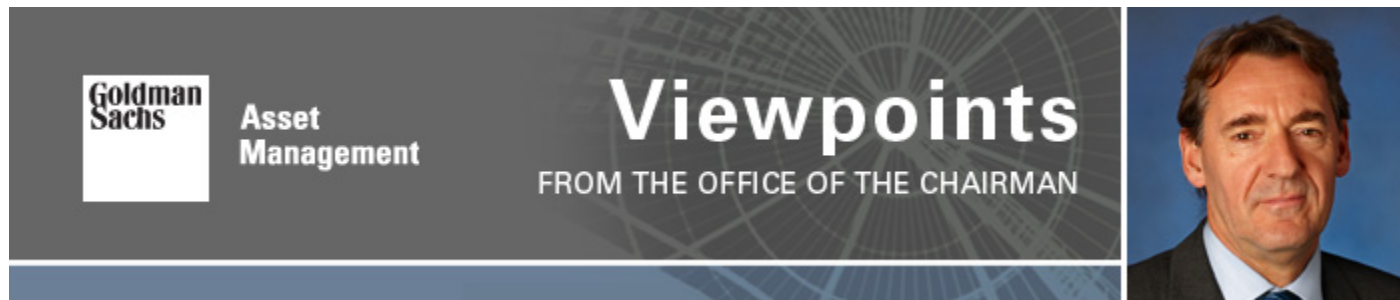


From: O'Neill, Jim [IMD]
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Subject: THE ST LEGERS TO THE RESCUE - OR NOT?



THE ST LEGERS TO THE RESCUE – OR NOT?

Another tumultuous week comes to an end, coinciding with the 10 year anniversary of 9/11 adding to a weekend mood of reflection on the past decade.

There have been a remarkable number of things happening this week, especially on the policy front. Unfortunately, this has not included major policy developments on the European front, which continues to be the biggest source of disturbance to world markets. Worryingly, the hole in which the Euro Area seems to be slipping into is getting broader and the scale of the solution is getting tougher.

That being said, Saturday saw the Doncaster annual horse race, the St Leger. I think it was a little bit earlier in the month than usual. Perhaps someone knows markets need that extra helping hand.....(those who are more baffled than usual by my comments , there is a famous phrase re markets in the UK, “ sell in May and Go Away, Come Back on St Leger’s Day”. As we all know too well, the May part worked rather well this year.

CLEAR, BUT CONTROVERSIAL STEPS IN THE US.

The US economy had a slightly better week for data with the services ISM for August and the July trade data positively surprising. After reducing forecasts of coincident GDP growth, a number of people are now talking about possible upside risks. To me, it looks as though the US may be growing in the vicinity of 2 pct.

At our latest internal CIO call at GSAM, I hosted a discussion of our views and stance on the US with our fixed income and equity portfolio managers. The above views of the economy reflected the broad stance of views offered from a macro perspective. The equity teams offered their views based on very up-to-date readings from many US companies across many sectors. Their conclusion had a similar flavor to the message from the Fed’s latest Beige Book: an economy with modest momentum but, importantly, no real signs of a downward shift. When it translated into a discussion of the US equity market, the general conclusion was that the market is – pending external events – more likely to rise than fall.

The major US highlight of the week was Thursday’s speech by President Obama to Congress where he unveiled a larger than expected proposed fiscal stimulus, aimed at targeting job growth and infrastructure spending. According to the GS Economics Department, if implemented, the proposal would take fiscal policy from a 1.5 pct of GDP reduction to a 0.5 pct stimulus. Put together with a clear bias to explore additional ways of monetary stimulus from the Fed, it is tough for me to see the big downside risks to the US economy, at least cyclically.

Of course, somebody that had arrived back on earth from a few weeks in Jupiter might ask, “Is this stimulus being proposed by the same country that was berating credit rating agencies at the start of August for regarding its fiscal stance as not credible?”

I raise this because one of the most interesting aspects of post Obama market trading was how unenthusiastic the market response was. Whether this is because investors doubt its effectiveness, doubt the likelihood of it being supported by Congress, because markets rose in advance on leaks of most of the content, or probably, in my view, bigger negative concerns elsewhere, it will no doubt have added to concerns of the US contingent coming to Europe for the Marseille G7 meeting.

CHINA IS THE STILL THE BIGGEST TRUE HOPE FOR EXCITEMENT.

I had an odd past two days, as I have become more and more concerned about aspects of the Euro mess, which I discuss below, but this was more than offset by excitement over a Bloomberg story Thursday suggesting that senior Chinese policymakers have been giving out signals that they are now aiming for full convertibility of the Yuan by 2015.

This is hugely important, not least as I don't recall a specific close timetable being cited before. It is unlikely that such a major initiative would be unveiled without being announced by the leadership. But according to some of my conversations, this notion is certainly not being dismissed. It follows a growing feeling I have had since early August that Beijing is definitely in a mood to accelerate RMB and other reforms. It also comes a few weeks after the French G20 hosts announced that a working group had been established to develop a plan for RMB inclusion in the SDR basket.

I cannot emphasize enough as to how important, and positive, such a development would be. 2015 is not much more than 3 years away. To reach and achieve this goal, a whole host of parallel developments would be likely. These would range from less accumulation of FX reserves, steps to develop the Shanghai stock market including the listing of many non Chinese multinationals, and major development of the domestic bond market. It would also move in-step with successful efforts to adjust the economy's leadership from exports to domestic – consumption led – demand.

It is no surprise to see stories of more central banks talking about diversifying into the RMB with this week, with both Chile and Nigeria giving some such signals.

To add to the flavor of the opening up of the RMB, on Thursday, Chinese officials issued a joint press release with the UK to announce that London would be allowed to undertake offshore RMB trading.

Friday brought the important news that CPI inflation in China slowed from 6.5 to 6.2 pct. It is very likely to have peaked for the year, and base effects alone suggest a move down to 5 pct or less by early next year. I said to some G7 policymakers I saw in London yesterday that this is something they should all be embracing instead of berating the Chinese about the RMB this weekend. For the massive challenges facing the US and most of Europe, lower inflation in China (and other Growth Markets) represents the most likely escape from years of weak growth, as it would allow strong increases in personal consumption to occur.

Further good news appears to have come this weekend with the August trade data surprising on the downside as a result of stronger imports. I continue to be amazed by the lack of awareness of how much the Chinese trade balance has improved. This week I appeared at the UK Treasury Select Committee, along with Gerard Lyons of Standard Chartered, and the members seemed to have similar views to most I come across. I also participated as a panelist at a Chatham House event on the Global Economy on Friday where the new head of the IMF repeated a comment I have seen written by Fund staff that improvement in global imbalances has stalled. This is simply not true. After the August trade data, we now have 8 months of the 2011 year. And, the 12-month running total trade surplus is around \$182.7 bn, down from last month and about 2.5 pct of GDP. Moreover, the trend of import growth is quite strong. Year to date annualized they have risen by around \$ 350 bn.

So if all of this is such good news, why did Chinese equities not rally? I don't know, but I suspect it is because the CPI improvement was smaller than hoped for, and without an "all clear" regarding the inflation outlook from the Chinese leaders, investors are nervous about jumping the gun. But it certainly seems to me the ingredients for a big Chinese rally are improving.

EUROPE. CAN THE SWISS RUN EMU PLEASE?

What another staggering week in Europe. The more it progressed, the more "emergency" calls I was asked to join for clients all over the world about the deteriorating dynamics of European Monetary Union (EMU). Major institutional investors, large private equity firms and big international corporate were all asking the same underlying question, "How can this thing survive?"

Jonathan Bayliss from our Fixed Income team this week led a 2-day onsite/offsite about the future for the Euro Area and we will be providing clients with a flavor of these discussions. Many different outside experts were invited to contribute. It seems as though "the muddle through" path is the one that most see as the most realistic one ahead, with more and more thinking ultimately we get "more Europe" with tighter, clearer fiscal rules and genuine Euro bonds. The depth of market fragility questions whether time will allow for such a long road. There are lots of key event risk factors coming up this month, but the vicious circular mood that has taken hold means that, not only does it seem as though something "big" has to happen with Greece pretty soon, but something "big" needs to happen for European bank capital, the clarity and determination of ECB policy making and, most importantly, where Germany wants to lead EMU.

I can't help concluding that it actually isn't as difficult as many European leaders seem to think. Bang in the heart of Europe is Switzerland, and having seen their competitiveness potentially devastated by the mess that surrounds them, this week the Swiss National Bank (SNB) went ahead and announced the extraordinary step of putting a formal, temporary floor under the Franc at 1.20 against the Euro. It seemed to me pretty obvious this was coming and, within minutes of the announcement, the Franc fell by over 8 pct, which I think has to perhaps be the single fastest large move of a major currency since floating markets commenced in the 1970's. I applaud the SNB for such a bold step, and find myself amused at the tons of people who have suggested to me that it won't work. When a central bank uses words like "unlimited" and puts a new currency arrangement at the core of its monetary policymaking, especially when they are trying to turn a grossly misaligned currency, my experience suggests it should be followed. Moments such as these in

foreign exchange are all too rare and they are usually the ones that distinguish currency investors.

When quizzed about the SNB move, predictably, the ECB stated that while they were made aware, it was a solo act of the SNB. While this is obviously the case, the tone of that statement sums up for me many of the shortcomings of Euro Area policymaking. Is it that most of them lives in some kind of time warp? Or is the more subtle interpretation that the key actors know the really powerful decisions need an appearance of real crisis before the German electorate can be persuaded to support them?

At least there has been some spectacular Premier League football especially from a certain team this weekend.

Jim O'Neill
Chairman, Goldman Sachs Asset Management

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

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