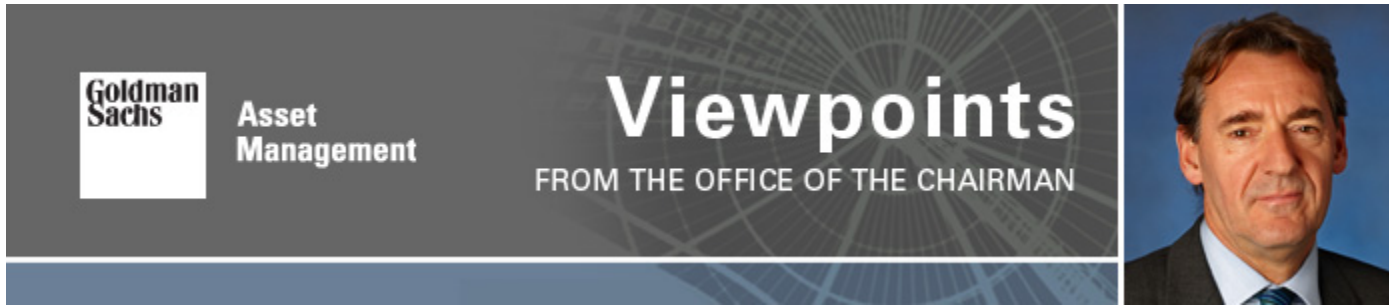

From: O'Neill, Jim [IMD]
Sent: Saturday, October 01, 2011 2:18 PM
Subject: LET'S WORRY ABOUT EVERYTHING



LET'S WORRY ABOUT EVERYTHING.

On Friday in Paternoster Square outside our London offices, there was an Abba tribute band entertaining lunchtime workers in this gorgeous Summer sunshine we are enjoying. I ate my sandwich watching them. It was a beautiful distraction from the prevailing mood of the markets and the economic world. Of course, at the true Abba's pomp in the late 1970's, the world wasn't in a particularly great shape either, so maybe there was something symbolic about it all.

Much of the latter end of the last week has felt rather surreal to me, as much of the economic data and comments from companies have been rather benign. And yet, markets continued to explore the grimmer angles. This was highlighted by the release of the much-better-than-expected Chicago ISM at 60.4, yet the US markets spent the afternoon weakening as the gloomy mood prevailed.

It wasn't just the Chicago ISM that was better than expected. Despite the widespread view of the inevitability of a European and US recession, German data continues to be rather benign with another better-than-expected employment report, this time for September. Unemployment fell 26k, with the rate dropping to 6.9 pct. China has published a better-than-expected PMI for September, coming in at 51.2, Korean exports are holding up well, but in this mood, the markets will no doubt find some holes in these too. Perhaps Korea has started exporting to Jupiter?

It should have been a better week. Following the annual IMF meetings, there is some serious discussion of a "big bang" solution to the European problems. And, the German parliament passed the EFSF, somewhat easier than many had feared.

Judging by the price action, market participants seem to be increasingly convinced of imminent recessions in Europe and the US as well as a prolonged period of "Japanisation," in which positive GDP growth struggles to keep ahead of a weaker underlying growth trend.

If this prospect weren't grim enough, the notion of a "hard landing" in China is back on people's minds with a number of participants promoting the idea, and many newspapers honing in on challenges in the property markets and financial sector.

What is the matter with everyone? Take a look at what happened in the 1980's – after Abba played their last live concert in late 1982 – the world did rather better than expected.

FOREIGN BUYING OF JGB'S!

It all seems a bit surreal. Here is a story that highlights the weird state of everyone's mind. "Foreigners flock to JGBs as Europe continues to flounder" ran the headline on page 6 of this week's English version of the weekly Japanese Nikkei newspaper. According to the story, foreign holdings of JGBs have risen to 7.4 pct by the end of June 2011, up from 6 pct a year ago. More recent data suggests the trend will continue. Why are foreign investors doing this when all anyone talks about is the sovereign debt problem? On exactly comparable data, Japan's debt-to-GDP ratio is two and half times worse than the Euro Area at around 220 pct of GDP.

I often appreciate the argument that JGBs won't weaken because of the internal demand amongst high savers and due to the support from the BOJ. But, for foreign investors to add to their holdings strikes me as most peculiar. Neither the yield nor level of the Yen can be a sensible explanation, so it must simply boil down to some odd combination that a number of central bank reserve holders have too much spare cash, and they know that Japan is not part of EMU.

US DOLLAR BREAK OUT.

Sticking with the surreal, since the start of September, the Dollar has strengthened against many currencies. Indeed, it has managed to break above its 200 day moving average against virtually all cross rates that matter to the US, except for the RMB and – bizarrely – the Yen. I spent quite a bit of time over the past couple of days talking about why the Dollar is doing this with a number of analysts. Virtually all of them seem to think it is not that big a deal, and is purely attributable to "risk off" behavior and perhaps a repeat of the 2008-like scramble for Dollar liquidity.

I can't see the case for sustained US\$ strength against many "Growth Market" currencies. In fact, on the contrary, the \$ should resume weakening against most of them through time. That said, I can see the case for a partial further \$ recovery against the Europeans, perhaps the BRL, and some other liquid developed currencies. The Dollar has been significantly undervalued, the US external balance is slowly improving, the US is not as cyclically challenged as a number of others, especially Europe, and the forthcoming marginal policy developments in terms of monetary and fiscal policy, are perhaps not going to be US\$ negative compared to others. On top of all of this are the major Swiss policy developments. And, as I wrote back at the time, "Swiss never lies". It looks as though it isn't lying this time either.

So, the Dollar needn't be higher purely because of the "risk off" forces. Obviously, if this is the prime reason, it is not good, and hopefully won't last for too long.

While many associate the Dollar move as another "bad" sign for the equity markets and confirmation of other darkening signals, there is no reliability about the consequences of the Dollar breaking above its 200 day moving averages, either as a precursor to sustained Dollar strength, or its consequences. More often than not as Neeti Bhalla from our ISG group pointed out to me, the S+P has been higher at specific 3-, 6- and 12-month internals following such breaks of the Dollar in the era of floating exchange rates. 2008 was a notable exception but there are many instances when the Dollar has appreciated for good, not bad reasons.

As for the future performance of the Dollar itself, time will tell, but if the US economy manages to keep on "creeping" through despite all, perhaps this bounce has more to it than many suspect, at least for a while.

If sanity were to prevail, you might expect \$/Yen to join the picture, but that is still far from clear despite the better close for the week.

UK ADJUSTED PLAN A?

To complete the political party season, the Conservative party starts its meeting this weekend in Manchester. I spent a breakfast with some of their faithful yesterday, and while they interpret the opposition's stance on business and finance as good news for them, they all seem as worried about everything as many others. The big question in my mind is whether the Chancellor will give any hints of, if not a Plan B, a slight adjustment to Plan A? The case for such a move is pretty overwhelming, and sticking with the 1970's theme, perhaps some regionally-g geared infrastructure financing might not go amiss. There appears to be rising talk of the case for a Government Bank also, which is more like the 1950's. I have to say that I find the argument quite compelling, and have for some time, having published a couple of pieces suggesting the idea back in 2008. After all, if you own the majority of some financial institutions and require more lending in the country's national interest, then why not take all 100 pct and go for it?

PUTIN'S BACK.

I could have devoted the Viewpoint to this topic and I shall return to it in coming weeks. If it hadn't been so conceivable, this development could easily sit in the surreal bucket also. I expect an increase in the intensity of emails I receive suggesting the removal of the R from BRIC. I know many close to Medvedev are most disappointed, and this for me is disappointing, but as one wag wrote, while they thought they were working for the other side, the other side was working for the other side...quite remarkable. For those of us who do not live in Russia, I do think we all need to remember that Russia likes its strong leaders, and if this transition is peaceful and things remain stable, that will be more than a decade of stability, which for Russia, is quite an achievement.

THE EURO MESS.

As I said at the start, this should have been a "better" week with the noises emanating from DC and Germany passing the expanded EFSF package. I guess one can only conclude that things have moved on so much, that the market's reaction this week is that the "big bang" ideas are necessary because we are heading for the worst in Greece. This week, we will publish our Monthly Insights and it will be devoted to the issues of EMU and reflect back on much of the discussions we have had about the problems, including a special section from Jonathon Bayliss, who heads up the European Government investing team and has been so on top of all the issues.

The bottom line for me is this: the November G20 is likely to be a major point of inflection, which will either resurrect life or leave us in deep hibernation through the Winter. We need to have by then a credible path for Greece, elements of the big bang in terms of bank recapitalization, and collective buy-in from all of Europe's key players. Not much to ask for...

CHINA. THE REAL THING OR A HARD LANDING?

Monday's FT carried the following headline on the front of its second section, "China the real thing for business rather than the US, says Coke chief". Expanding on the fact that China now accounts for 7 pct of Coke's global business and the first half of 2011 saw them double their sales from 5 years ago, the CEO elaborated about how welcoming many regions of China were to them, and contrasted it with the deteriorating picture in the US.

I picked up this same theme at an Economists' conference on Growth Markets that I had the pleasure of being the closing speaker at on Friday. But back in the surreal world of markets, my inbox was full of really gloomy stuff about hard landings, property collapses, major NPLs and so on. As I said earlier, "what is the matter with everyone?"

It is pretty obvious that you will have some failed property lenders, where a country's policymakers deliberately choose to stop a strong rise in property prices before it gets out of hand like the US and Europe, as the Chinese have done in the past 2 years. I can't understand why it therefore translates into a "hard landing". The Chinese property market has some issues because of deliberate policy. In fact, it is remarkably impressive, and a huge contrast to virtually any evidence I can see from my days in the markets, that a policymaker would choose to prick a property bubble before it gets to the stage that we all know only too well.

China, as I have written about now for nearly a year, has entered a new phase of development where the quality of growth matters more than the pure quantity, and with it, the sustainability of growth. This would suggest that the next 5 years would see an outcome closer to the 7.5 pct average, which the 5 year plan assumes. As a critical part of it, the Chinese consumer is going to be more important, which is why, for me, the Coke CEO's comments are more pertinent than all the nonsense flying around the fast money crowd this week. In the coming weeks, the key in all this will be Chinese inflation, and judging from the chart of agriculture prices that GS's Yu Song sent me Friday, it is coming down. Once that happens, talk of a hard landing will dissipate.

Enjoy the sunshine if you are lucky enough to have what we have in the UK this weekend.

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Viewpoints are also available on our public website. Monthly Insights and Strategy Series are available on www.goldman360.com. If you do not have access, please contact your Goldman Sachs relationship manager.

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