

From: O'Neill, Jim [IMD]
Subject: BEAR HUNTING
Date: Sunday, October 16, 2011 6:26:04 AM



BEAR HUNTING.

Last week, we saw the biggest weekly rally of the S&P since the Autumn of 2009. Many other markets did the same. This activity has brought many markets back to the high end of the rollercoaster range we have seen since the breakdown of markets at the start of August. So the question I find myself asking is: Will 2011 turn out to be a classic "Sell in May and Go Away, Come Back on St Legers Day" or is this the chance for the bulls to recognize the gloomy reality all those noisy bears have been going on about? You can see the situation in the attached chart pretty clearly. One would guess the recent rally has to extend above the 1280 area, which is the level above both the August "breakdown" and close to the 200-day moving average to force the bears to go into hibernation.

In this context, this next 3 weeks worth of "news" as we approach the November 3 - 4th G20 Leaders meeting is going to be really interesting. Judging by what the Finance Ministers told us this weekend, we can expect more raising of expectations for a "big bang" European package. This notion, combined with more evidence that the US economy is doing just fine and that China is creeping closer to a soft landing, will perhaps give us a test of the breakout levels. What follows post G20 will depend on whether our major leaders are really guiding us to a safer place, especially with respect to Europe. It seems to me, therefore, that the guidebook is reasonably clear for the next fortnight.

CHINA AND SOFT LANDING OR NOT.

I just returned from a rather insane 24-hour trip to Hong Kong early Saturday, having previously planned to be in the China region for a week. I had to change my earlier plans in view of the European mayhem, but I had committed to a speech at the Hong Kong University of Science and Technology (HKUST) for the Institute for Advanced Study's UC Rusal Forum. It was a pleasure and, in addition to meeting two very important clients in town, I met with a number of interesting people. Coincidentally, before I went, I had hosted our latest internal GSAM "CIO call" on China, where we included an outside guest who appears to have the lowest GDP number on the street for the next 2-3 quarters. We also have started to see the latest monthly economic data released and, of course, the RMB is back in focus.

On our CIO call, we tried to focus on the issues related to the "hard landing" scenario and what could go badly wrong. Much of the discussion was focused on the domestic property market and regional lending. Our guest is amongst those that believe property prices will drop somewhat in coming months and that the angst surrounding regional finances will rise. However, from the subsequent discussions about resulting bad loans and the likely policy response, even under such a scenario, the costs for China will be very muted. He thought something around 5 pct of GDP, although he believed that some of the costs of the fallout would be met by other forms of finance including local bond issuance.

From what I heard from this meeting and my discussions with people on my trip to Hong Kong, I continue to believe that a soft landing is very much in place. While our guest sees a chance of year-on-year GDP below 7 pct by Q1 2012, he also sees CPI inflation below 4 pct in Q1. And, not surprisingly, he sees both a monetary and fiscal policy response, and GDP growth to be back above 8 pct by the second half of 2012.

We have started the usual monthly data releases and, so far, they are pretty helpful to the soft landing view, with a further notable slowing in M2 monetary growth, another soft trade report, and crucially, CPI slowing – albeit only a touch – to 6.1 pct and, encouragingly, a notable slowdown in PPI inflation to 6.9 pct.

CHINA AND RMB ISSUES.

I was particularly interested to hear the thoughts of people I visited about the development of RMB, especially with respect to the path to convertibility. I had not been out there since May and, as I have mentioned, I have gathered the

impression that since the global market volatility escalated in August, Chinese policymakers may be actually accelerating plans to liberalize the use of the RMB. There has even been some talk of a 2015 target for convertibility. When I quizzed people, no one disabused the notion of 2015 as being possible, although they doubted any formal target would be cited, as it really depends on ongoing circumstances and how the handover to the next leadership transpires. However, everyone I asked thinks it is quite feasible, and many think it is quite likely, that we will be looking at a much wider use of the RMB by 2015, including its usage in the SDR basket. At one of my HK meetings, I was told that a new reform was about to be announced allowing greater use of RMB-denominated FDI, which indeed has been subsequently announced.

It is against this background that DC is enjoying its latest bout of the sporting pastime known as blaming the RMB for all evils. Even though the RMB has risen close to 30 pct in both nominal and real terms against the Dollar since around 6 years ago, and China stops any tendency for the RMB to share in other currency weakness when the \$ experiences those brief periods of appreciation, and even though the ongoing Chinese trade surplus declines, it remains the excitable mood that the RMB is massively undervalued (40 pct usually cited), and that China is garnering all these unfair advantages. It is frankly embarrassing to observe this ongoing dialogue and I can't understand why Congress persists with these efforts. Despite the latest bill passing through Congress, all I hear is that it has little chance of success in the House and the President would not allow its passage. Nonetheless, all seem to share in its tone. The only source of evidence to still support these claims may be China's vast foreign exchange reserves.

China's trade surplus year-to-date – now 9 months data available – is just over \$180 bn annualized, and it remains not much over 2 pct of GDP. The surplus is less than ¼ of what it was pre-2008 credit crisis and it is declining as a result of an improving trend in imports and a weaker trend in exports. There is no basis for the kind of action that DC is pursuing. There might have been 7-8 years ago, but not anymore.

EUROPE'S BIG BANG.

Judging by various comments on newswires and many headlines in the newspapers Sunday, the G20 Finance Ministers meeting saw more progress on the "big bang" solution to the Euro crisis. Three legs seem to be getting more attention, with a more realistic Greek haircut, bank recapitalization, and extra power for the EFSF, although the word leverage is "verboden". On the latter, background chatter about Paul Achleitner's proposal for an insurance scheme is now out publicly, with Paul himself writing an Op-Ed in the FT on the matter. Various G20 policymakers have added to their pushing from the late September IMF meetings with Messrs Geithner and Osborne again suggesting Europe is getting there. Interestingly, once more French and German leaders are telling us that they have a plan, but don't intend to spoil the surprise just yet. (Perhaps this can be a permanent solution, given its success to date compared to all other past failed ones. Don't actually tell anyone what the plan is?)

Anyhow, we now have another hyped up European leaders meeting to look forward to, this time, October 23rd, and then of course, the November 3rd - 4th G20. It is shaping up to be the G20 meeting of all time, so expectations are rising.

G20 AND IMF CAPITAL.

Another reason why markets increased their optimism (or reduced their pessimism) is probably because of media speculation that the large Emerging Economies are pushing for a further increase in IMF resources as a way to indirectly invest in the Euro Area's debt funding requirements. The BRIC countries would appear to be in favour of adding to their contributions, probably as a route to gaining further accelerated voting rights. In what appears to be typical international IMF "stuff," the US is against such ideas, and argues that the IMF has sufficient resources from its last recapitalization. One suspects that the US opposition might also have something to do with giving up too much IMF power too soon to the BRIC guys. But, in any case, all of this will be interesting to observe as we approach the November G20 meeting, as will any hints on SDR reform /RMB early inclusion, which I suspect some Western leaders favour.

EVIDENCE ON THE GLOBAL ECONOMY.

As we approach the mid-month period and once the rest of China's data is out of the way, we enter the usual macro data vacuum until late in the month. We will get all the flash PMIs for this month, and the official PMI and ISM data ahead of the G20 meetings along with Korean trade data, so we will be able to see more signs of the fallout from the markets' late Summer panic. So far, based on everything that has been published, comparisons with Autumn 2008 seem way off the mark. The US is showing continued modest signs of positive surprises with more and more analysts revising up their Q3 and Q4 estimates, and some European data is also surprising on the upside. The UK is a notable exception to this recent pattern, where the reported data has been notably disappointing. It is not the case elsewhere though. Of the data we will get for the remainder of October, the Philly Fed in the US will be interesting to see as its weakness since August has not been repeated in any other useful data.

SO ARE THE BEARS BEATEN?

As tempting as it is, alas I think not – at least yet.

I have maintained throughout the extreme moves of the past 3-4 months, that the bull market in early 2009 had its source in 2 things: China moving to a more domestic-driven consumer-led recovery and the strong asymmetric monetary bias in the US. As big a problem as Europe has been, and is, I don't see European economic activity as key to driving world economic growth and markets. In order for my theory to be true, we need to see more evidence of slowing China inflation, a shift in China's policy bias, and evidence that their own consumer continues to do just fine, as well as ongoing evidence that the US is not being dragged down by Europe.

While the Euro challenges are immense, I don't see them as being necessarily of the power to drag down either China or the US, or both. While it is perfectly possible, the US and China have coped perfectly well with Japan's weakness for a long period, so I don't see why they can't cope with a struggling Europe. A collapsing Europe would be a different story, but a struggling Europe, that shouldn't be too demanding.

As for Europe, the bar has been raised these past few weeks, as markets have recovered and expectations of a Big Bang increased. There are all sorts of dilemmas remaining, ranging from Berlusconi's tentative hold of power in Italy to the divergence of stances on the right broad European solution. What we really need from Europe is to just not implode, that would be a problem for the rest of us and the markets.

This weekend, Manchester United showed that lot from 38 miles west down the M62 far too much respect in what Sir Alex described as the most important ongoing football club rivalry in the world. Hopefully, that means his top players will be fully refreshed to demonstrate to that other lot from 2 miles east in the same city what it really is like to be a top team next weekend. Perhaps a stage setter for the G20?

Jim O'Neill
Chairman, Goldman Sachs Asset Management

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

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.

This message may contain information that is confidential or privileged. If you are not the intended recipient, please advise the sender immediately and delete this message. See <http://www.gs.com/disclaimer/email> for further information on confidentiality and the risks inherent in electronic communication

