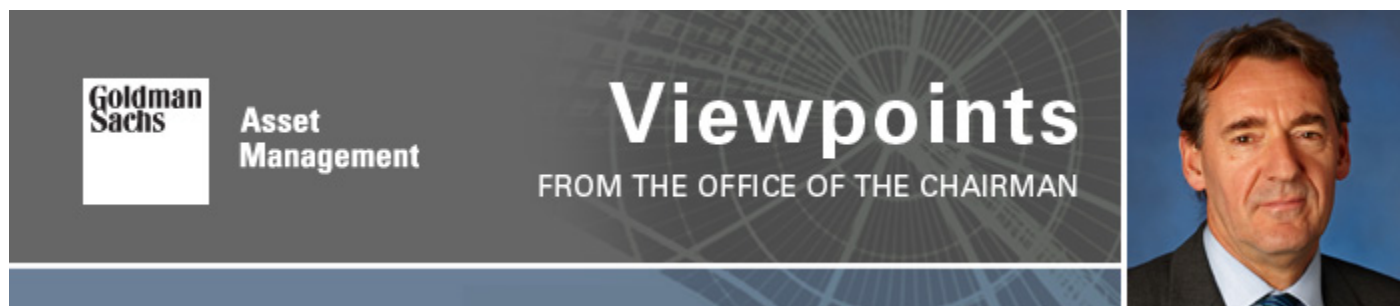


**From:** O'Neill, Jim [IMD]  
**Sent:** 21 October 2011 18:09  
**Subject:** Strange Thoughts from 40,000 Feet.



### Strange Thoughts from 40,000 Feet.

I just returned from 4 days in the US, split between Texas and NY. This followed a mad dash to Hong Kong late last week, which leaves me a little more exhausted than usual, but also looking forward to a week's holiday next week where I am planning to avoid reading any emails and news about the outside world, especially about European Summits! You will be pleased to read that I shall not be writing a Viewpoint next weekend either, with the usual service returning the weekend after.

Anyhow, it was a fascinating trip, not the least of which was due to the variety of events I participated in. I hope to give you a flavor of them below.

### Market Prices and Consensus Forecasts.

As I mentioned in a couple of the meetings and the speeches I gave in NY, it now seems as though the consensus economic forecasting community agrees that, implicit in the prices of equities and bonds, the major G7 economies are set for at least another 12 months of Japan-style weak growth, with some expectation that this will go on for years. I return from the US thinking that the "Japanisation" of the US is quite unlikely, and while I can sympathize more with the idea regarding Europe, it is far from obvious to me.

In contrast to this "agreement," a more interesting development is occurring in the background about China. Influenced by recent published data, the forecasting consensus shares my general sanguine views that China is facing a near term outlook somewhere between "no landing" and a "soft landing". The markets, however, appear to be giving a rising probability to the chances of a hard landing, citing the continued poor performance of Chinese equities, bonds and, especially interesting now, the CNY. As pointed out to me by a highly experienced crisis FX investor, the skew of the options market is demonstrating a belief that we may have RMB devaluation, rather than a never-ending rise of the currency. In my view, the only way devaluation would happen would be if China is indeed heading for something more akin to a hard landing.

So, this is the background behind what I have discussed this week. On the top of the list, of course, is the desire for everyone to spend endless hours talking about Europe and its likelihood of entering into a perpetual abyss. As I joked about off camera to the hosts of the CNBC Squawk Box show I did Thursday, when I am on for 2 hours and we don't talk at all about China, and one of their own reporters is flown to Athens to present live news on their strikes, the relative focus seems a little bit out of kilter. Perhaps people will be telling me in 13 years that there should be a "G" in BRICs (for Greece), the same way 13 years after Indonesia was never believed to ever have a chance of growing again, I am supposed to now incorporate an "I".

### China.

I spent quite a bit of time discussing China at the Texas event, but importantly, there was also a panel discussion from 3 top strategists about Emerging Markets and China especially. I would describe two of them as soft landing guys, and one, hard landing. The hard landing case seems to be centred around the difficulty of reducing the reliance of public investment going forward, and a belief that it will be impossible for Beijing to keep the investment boom/bubble going. Of course, there are lots of colourful anecdotes around that can easily be cited to support such views, ranging from stories of further delays to the high speed rail network, the opening up of regional bond markets for the first time since 1994 (both highlighted in Friday's FT) and, of course, the endless videos of supposed empty cities. At times, some of these facts are quite scary, but as I mentioned last week, we hosted our own internal GSAM focus on the country with a guest who is at the lower end of GDP forecasts for the next 3 quarters and expects an additional 10 pct drop in house prices.

From all of that, his view is for 5 pct non-performing loans and, linked to the high likelihood of CPI inflation returning below 4 pct early next year, expects fresh policy stimulus to result in growth returning above 8 pct in the second half of 2012.

I continue to believe that China is in the early stages of moving to a new, softer GDP trend of 7-8 pct, which contrary to widespread belief now, is actually really bullish for Chinese markets and their influence and participation in the world economy. The Chinese authorities want to reduce the role of public investment (and exports) and hope to have consumption rise as a share of GDP. The inflation path remains key to this view for coming months.

While I was in NY, I had a quick meeting with the CEO of Teach for All which is the global umbrella organization for the various national organizations such as Teach for America and Teach First. There are now 23 such national entities including Teach for China. It was fascinating to listen to the early developments of Teach for China, especially as it has quite a bit of US influence on a daily basis. It seems like it is being strongly embraced by important decision makers in the country. Those that don't believe China can adapt and change should take a look (and support its expansion across the BRIC world!).

### The US.

So, I went to the States thinking that the US is doing better than many realize and I returned thinking the same. About the only really disturbing published data point I have seen since the late July market meltdown was the August Philly Fed plunge. This week's survey, for October, shows a major reversal of that decline, suggesting it was false. The ongoing trend in job claims is ok, as is other generally reliable coincident and lead data (not consumer confidence which has no reliability). Many corporate CEOs appear to continue to be pretty sanguine also across a number of sectors. And, after watching hours of financial TV, I noticed more and more of the money centre banks reporting evidence of a pickup in commercial and industrial (C&I) loans, something which the data is now showing too.

While the domestic financial media is highly focused on Europe and the Occupy Wall Street movement, one thing that is not getting enough attention are efforts to get the housing market sorted out. Alan Blinder published an interesting article on the topic in Thursday's WSJ, which coincidentally follows a most interesting discussion I was part of at a hedge fund lunch I attended Wednesday. Until this topic was raised at the lunch, the mood was as gloomy as it had been at a similar event back in June. But, when the idea was put on the table that it was inevitable that something is going to be "done" to solve the supply overhang and refi problem, I detected a shift mid-lunch. GSAM's own Tom Teles is highly focused on the topic, and I have returned thinking that this topic could be a big – bullish – wild card for late this year and into 2012 for the overwhelming bearish consensus.

As a final odd US anecdote, I also found myself thinking that flying around the US didn't seem as much as a miserable experience as I had remembered for most of my career. For readers that think I am always bullish, for a considerable part of the 1990's and Noughties, I used to think that the general poor standards of domestic flying around the US were a clear lead indicator that the hype surrounding the productivity miracle was just that. Hype. Not only did the AA in-flight magazine have a 6-page special about the Centre of the Universe (and its football team), but I enjoyed my first ever JetBlue flight, which I found as enjoyable as some suggested it may be. It allowed me to watch an additional 4 hours of financial TV too, which means I am now an expert on riots in Greece as well as various Apple apps. Perhaps my experience was just a fluke, but it left an impression.

### Ongoing Other Global Data.

There have been two very interesting data releases today, the German IFO and the 20-day October Korean trade data. The latter showed a pickup in sequential momentum, which adds to the evidence that comparisons with 2008 seem wildly off the mark. Korea trades with other countries on this planet, not another one. The German IFO slowed further, but as pointed out by many, the current conditions remain extremely strong compared to the long term average, consistent with the ongoing strength of Germany. The forward-looking expectations component continues to weaken, which is either a cause for concern or simply a sign that survey participants are as worried about the same stuff as everyone else, and it might not end up being true.

In the same context as the latest Korean trade evidence, Hugo Scott-Gall showed me a very interesting map of the developing trend of global trade over the past decade, and surprise surprise it shows rampant trade growth between the BRIC and many N11 countries. In other words, the world is not being driven by the US and Europe.

### Europe.

So here we are, ahead of yet another dramatic weekend of smoke-filled rooms, and this one set up to be the meeting to end all meetings. Except for the fact that they have now told us there will be another Summit next Wednesday. If it weren't so important, it would be hilarious. As I joked about during our own latest internal CIO call Thursday, perhaps the true solution is to pre-announce Summit meetings through the end of the year?

Of substance, it seems to me that we are creeping towards a much bigger PSI initiative on Greece, some enforced recap of banks and, one way or another, some enhanced capability of the EFSF. In my view, the only really important consequence of it all is to stop the major downside risk, especially for Italy. If the worst happens there, then it could be

enough to derail the world in the way that so many people seem so convinced of. If next week's fun and games credibly ring fence Italy, then I am not sure it is likely to be dominating attention the way it is today for much longer.

The real marginal thing to watch is what our dear friends at the ECB decide to do, both in terms of attitude as well as substance. I think Paul de Grauwe's article about them having only the real "bazooka" was an excellent read in Thursday's FT also.

Anyhow, happy hunting – unless you are a Man City supporter – who, with a bit of luck, will be put back in their " Noisy Neighbour " box this weekend.

Jim O'Neill  
Chairman, Goldman Sachs Asset Management

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