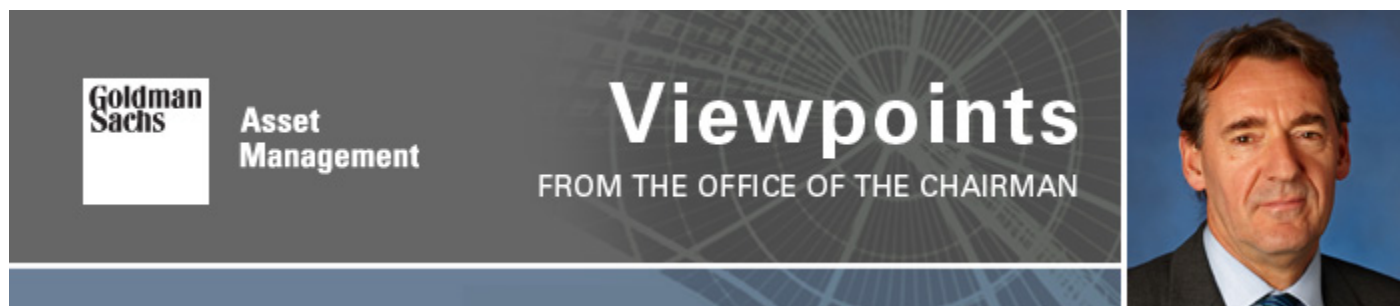

From: O'Neill, Jim [IMD]
Sent: Saturday, November 19, 2011 1:24 PM
Subject: Surreal Times



Surreal Times.

Another fascinating week passes with the European mess understandably dominating the minds of everyone around the world. It is quite surreal. There are no signs of any real collective central leadership, many key players are hardening their positions, other regions of the world are increasingly worrying about it, and markets ended the week with a sort of eerie silence.

As I often have said since the European troubles escalated in August, there is life outside of Europe. That remains the case. But virtually wherever and whoever I talk to or with, people are so focused on the European issues. In the week ahead, I will be participating in a board meeting of BRUEGEL, the European think tank, which will be most interesting. Anyhow, more of this topic and others below.

Good Lord – Gaylord!

My last week started with a brief 2-day trip to Maryland and back. I thought I was going to Washington DC, but, in fact, it was a few miles out in what seemed like a new purpose-built area called National Harbour. I had been invited to participate in a panel at an event for UBS (Paine Webber) at a get together of their most senior nationwide sales team. I had the honour of being on a panel with Alan Greenspan, Otmar Issing and Ken Rogoff to discuss and debate the world. I think I was there to make the drinks (and offer some perspectives on the so-called emerging world too). The venue was the Gaylord Hotel, which seemed to expand for miles. Think one of those so-called Ghost cities in China or Vegas, but a few miles outside DC. Most surreal. But it was fascinating and thanks to the hosts for inviting me.

I took away two things from this discussion. The first is that everyone wants to talk about Europe, and most people are so negative about it all. I didn't hear much positive sentiment there myself, but I will repeat what I wrote last weekend. I can't see how the EMU can survive without Italy, and I can't see Italy surviving with 6-7 pct 10-year bond yields. Something has to give, which is actually why it is quite exciting now – even if it is somewhat scary. The second takeaway, and more important one, is that my confidence in the US cyclical recovery picking up momentum is higher than before I joined this panel, not least of which because I heard independent confirmation of the things I notice. I don't think it is appropriate to mention what others actually said, but it was consistent with my own thoughts. In addition to most actual points of reference supporting this view – another modest decline in job claims this week – I detect more minds coming around to my thinking that we may be close to a turning point in the US housing market.

As I start to think seriously about 2012 and where GDP might be, both absolutely and relatively to consensus, it seems to me that there are notable upside risks to the US outlook. Of course, there are plenty of things that might go wrong, but there are also plenty of things that could go right.

China and the RMB.

As I write this Viewpoint, there are some interesting comments on the wires that imply that Beijing is exploring widening the trading bands of the RMB. This wouldn't surprise me at all. While many will see this as purely a sign of likely renewed appreciation of the RMB against the Dollar, I am not sure that is the real key. In the reported comments, Premier Wen has said that China will "strengthen the Yuan's trading flexibility in either direction," which could suggest

that if the US\$ were to appreciate significantly, then the RMB might actually decline against the Dollar. This will ultimately be what happens, i.e., the RMB will become more volatile as it becomes more open and less controlled. It will go up as well as down.

What is more clear to me is that such a development is all part of what might be an accelerating path towards opening up the RMB as Beijing moves towards full convertibility. I am now assuming that 2015 is a realistic goal, and if this statement is soon backed up by evidence, happening so soon after the G20 meeting, it is a rather good sign for the world. It is also extremely exciting for anyone involved in the asset management business, as it means we are likely to see considerable developments in the Chinese bond and equity markets. And, this will all be consistent with the 5- year plan and China moving towards a more domestic consumer-driven economy.

Like many other weeks, I had many interesting conversations with people about China (and the other Growth Markets) this week. On Friday, I had a particularly interesting chat over a sandwich lunch about the big picture with an investor. This gentleman shares my own optimism, but he had been asked to stress test the rather negative views of his colleagues who couldn't join us. In particular, they wanted to really delve into who is going to buy all the things that China will produce in the future, implying that they won't be able to produce much, and that China is heading for a hard landing. I think this is an understandable, but also a weird question. It is understandable because so many Western observers, especially from my generation, simply can't get their minds around China becoming a significant consumer. It is weird because it is so Western-minded. My best way of answering this beyond repeating all the numbers I have worked on with my colleagues, is to cite 2 anecdotes. One comes from a meeting 12 months ago or so with the CEO of one of the world's best known retailers who has been expanding considerably in China. He wanted my views on when he should plan to exit, as he thought it was inevitable that China would find a credible domestic competitor at some stage. The second relates to a personal investment I made many years ago in a Chinese luxury company, which continues to grow rather well. It has a number of suitors, including European ones.

As I ended up saying, even in the consumer's share of total output weren't to rise above 35 pct of GDP by 2020, China will create at least \$3,500 trillion worth of consumption value between now and then – about 10 times the size of Greece. If it were to rise to 45 pct, at least an additional \$5 trillion, or the equivalent of 2½ new Italy's.

Europe and the Euro Area.

What another remarkable week. We are all fond of saying that Europe doesn't move very quickly, but look at the events that have occurred in Italy this past fortnight. Berlusconi is gone, Mario Monti is in place, and the country now has a technocratic government led by a collection of reformist-minded individuals and a very pro-European leader. Mario unveiled the broad path of likely initiatives, and from where I sit as someone who has followed the Italian economy closely for 30 years, it looks quite exciting. Not only are there ideas to deal with important deficit and debt challenges, but of greater importance, ideas to boost Italy's supply side potential, including steps to encourage and help women enter the labour force and to attract the young and brightest from not going overseas to seek opportunity. A significant part of me thinks that 7 pct 10-year bonds for Italy may turn out to be a bargain.

However, there are so many hurdles.

The ECB doesn't seem to regard 10-year Italian bonds as a bargain and, of course, it is rather tricky as they need to be sure that Monti will deliver. In turn, this means that what is really important is that Mario gets support from those in the background and, ultimately, the Italian voters.

And then there is Spain. And still, of course, the troubling Greek situation. And ultimately, the complex world of Berlin and Frankfurt. As many European newspapers are asking in recent days, does Germany actually really still want the EMU? And, as I shall now provocatively ask, does the Euro Area? All very surreal.

Is it Time for a Referendum?

One of the most interesting things that didn't get that much press this past week is that German Chancellor Merkel is now openly saying that she believes the Treaty surrounding the EMU should be changed. I think I am right in saying this is the first time she has stated this definitive goal, and may be seen as a signal that Germany thinks it can take Europe, or the Euro Area, or at least those that want and can stay in it, down the path of more fiscal and political union. This, as I have written about many times, is what key German thinkers have believed was ultimately inevitable and should have been agreed before the EMU started in 1999. Beyond all the critical short-term questions, renegotiating the Treaty for more substantive changes is a really big step in my view. It is probably a sensible step to take, as it would allow everyone in Europe a fresh say on what they are really signed up for. As I have also written before, this crisis is not

really a sovereign debt crisis, but a crisis of the EMU's structure and leadership. In this context, I found myself thinking why not actually use this as an opportunity to do something really radical and seek more legitimacy from the European people? As part of a new Treaty, why not allow or encourage all 27 member countries to hold a referendum on what the new Treaty would be and, therefore, seek genuine support from our citizens? In the rather unlikely event that this would happen, it would seem to me that many of the persistent alternative views between different EMU players, including the ECB, would probably disappear.

It seems like a very unlikely thing to happen, but given the remarkable unfolding events across Europe, how can anything be ruled out, especially when it would probably allow the EMU to be strengthened and help the legitimacy of the EU itself.

And Finally, a Brief Note on Japan.

The Economist magazine this week has a most interesting short piece pointing out that Japan showed stronger GDP per capita growth in the past decade than either the US or Europe. That simple, but important, analysis comes at the end of a week when Japan reported 6 pct annualized growth last quarter, not far off BRIC-like standards and way above the US and Europe. I published an op-ed online in the FT about this last week, and pointed out that markets seem pretty disinterested in the Japanese growth numbers. This is especially interesting when Japanese equities are at such a remarkably low valuation compared with certainly any metric. And, at the other extreme, the Yen is so idiotically expensive. Something has to give here also. I suspect what it might end up being is that markets start to realize that the US is not going down the path of Japan, and the Yen begins to reverse, perhaps significantly. It might take more involvement from the monetary authorities to help it along. If this outcome doesn't happen, then Japan's relative growth outperformance might end up being even more temporary than many expect, as more big Japanese corporations abandon domestic production. All very interesting, and yet another source of big opportunity going forward.

It looks to me that there are so many opportunities for investors as we near the end of 2011 and into 2012. We just have to figure out what side of them to be on!

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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.

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