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Goldman Sachs Asset Management

Viewpoints

FROM THE OFFICE OF THE CHAIRMAN

THE SWISS FRANC NEVER LIES – PART 2

Back in August, I wrote about the Swiss Franc both before and just after the Swiss authorities undertook a rather dramatic policy decision to try and reverse the strength of the currency. I am returning to it now because last week the Franc weakened beyond its 200-day moving average against the Euro for the first time in over 2 years, despite the overwhelming grim mood that is around. It is fascinating to think about, at least for someone like me schooled in the "Swissie never lies" camp.

As you can see in the attached chart, it is not really since 2007 that the Franc showed a persistent trend to weaken against the Euro. It did trade back above its 200-day average for a brief period in 2009, but over most of the "crisis" era since 2008, the Franc proceeded on this strengthening trend, which, if uninterrupted, would have probably caused significant trouble for Switzerland. The efforts of the SNB since August appear to have possibly reversed things, and the move back above the 200-day average this week raises the possibility that they have done enough for the market to take over their desires for them as trend following participants step in. (The Franc experienced the same reversal against the Dollar somewhat earlier.)

Could the Franc's possible reversal be a symptom of broader things to come? Could it be that the US economy is not in the process of moving back into recession? Could it be that European policymakers are finally about to put a floor under their immense problems? Or is it just a reflection of SNB determination and nothing more? And indeed, could it be that the Franc won't stick to this weakening trend?

MY WEEK.

I have been in and around London for most of the week – for a change – chatting with colleagues, meeting lots of clients and speaking at some events. A notable feature to the start of the week was a number of quite punchy emails I received to last week's Viewpoints from some eager bears, especially in the hedge fund world that suggested that White Van I had mentioned a week earlier was sitting outside my house still waiting to take me off to hospital. The week ended with me chairing a panel at a GS Pension and Insurance conference. The panel was on the "Best Asset Classes over the Next 5 Years," and there were 3 CIO's who were guest speakers. As I joked about given it was the last session of the conference, the staff would have to ensure that there were some strong drinks available at lunch to raise the audience's mood from the rather grim mood of my panelists.

As I sat through this panel and thought about the tone, along with the wise council that had come into my inbox, I also kept thinking about the Swiss Franc. Which was more likely to be more relevant?

UNCERTAINTY, FORECASTING AND RETURNS.

One of the common threads running through the panel and the inbox council was that we are living in unprecedented times. We face a degree of uncertainty about the future that many of us have never encountered, and of course, there is now a widespread belief that we are stuck with low returns for a long time. While it is quite possible that many aspects of this are true, it seems to me that the future is always uncertain. While many of us now realize today is that the future is uncertain, is this really any different, other than the fact more of us realize this? Before the horrors of 9/11, the future was uncertain, as it was before the beginnings of the credit crunch in the Spring of 2007. What is different today is that we know it is uncertain, or at least we think we do. It is the confidence in our belief of that uncertainty (and/ or negativity) that has changed.

In this regard, on our panel, I tried to suggest that, as it relates to financial markets, today's level of the so- called equity risk premia (ERP) is a useful tool when thinking about the future. Being the Chair, I was limited in how far I could talk, so I tried to be restrained. But my point was, at the start of the Noughties, everyone seemed so confident in fact the ERP was close to zero. Equities were not giving any excess return over the so-called risk free rate – 10-year Treasuries – which should have been a major warning sign that the prevailing confidence was misplaced. Today, 11 years later, the ERP is extremely high, and along with it, the dividend yield for many companies in many sectors is very high, but of course, the mood is so grim. I know which I would rather believe.

When I combine today's high global ERP, the cyclically-adjusted PE ratios for many markets (as I showed a few weeks ago), and then I see some signs of the Swiss Franc's 4-5 year strength being reversed, I want to take notice.

BUT ISN'T IT WORSE TODAY THAN 2008?

One of the panelists was sufficiently bleak that he suggested things were worse today than 2008 because the conventional policy options for the West in terms of monetary and fiscal policy are used up. While it is observable that reported fiscal deficits throughout much of the West are dangerously high, and short and long term interest rates very low, supporting that contrast to 2008, there are few signs that financial conditions have deteriorated anything like 2008, as of yet.

Moreover, when it comes to real GDP growth, at least in terms of the underlying trend, it is the supply side that matters, not the demand side. The growth of the working population and its productivity is what drives trend growth. And, it is what happens here that ultimately matters more towards investment returns.

Of course, other bearish-minded observers could also suggest that the Western "supply side" is deteriorating also because of increased regulatory measures both in and outside the financial services industry, excessive waste of resources, etc, etc. But while this is what everyone feels, is it really all that one way? At the end of the week when we mourn the passing of Steve Jobs, there is a reminder of the remarkable technological progress going on that affects so many people. And one of the consequences of the sovereign debt crisis is that retirement ages are finally starting to rise in many Western societies which will, amongst other things, boost the size of the working population.

And I haven't even mentioned China and the other BRICs.

One brighter spot during my week was at a well known London hotel when I turned up to speak at a lunch. The entrance was mobbed with people, especially cameramen, which I thought was a little bit odd for a GS event. Sadly, they were there for the imminent hotel departure of Lady Gaga. I had thought about quizzing her on the Swiss Franc's relevance, but alas I couldn't get near.

THE US ECONOMY.

What is certainly quite interesting in the context of the above discussion is that the US just posted another week in which the economic releases positively surprised, and this time, it included the monthly payrolls. With both the manufacturing and services ISM releases better than expected, as well as the weekly job claims staying close to recent lows, most tracking estimates of Q3 GDP activity are being revised back above 2 pct and, unless there is something that deteriorates soon, many estimates of Q4 will also.

Of course, the mood amongst investors remains as bleak as ever, but the evidence is not so poor, at least not yet.

EUROPE AND EMU.

I want to have an EMU-free Viewpoint this week, but I attach the latest Monthly Insights, which is devoted to this topic. We discuss most of the usual issues. This weekend, there is yet another "crisis" meeting between Merkel and Sarkozy, and no doubt, the outcome of that meeting will dominate markets early next week.

SOME OTHER THINGS TO PONDER.

Amongst other things of interest;

1. The Bank of England restarted its own QE this week, with the Bank announcing an even bigger £75 bn worth of gilt-buying than expected. Anthony Hilton had a rather interesting article in the London Evening Standard the night before questioning how useful this would likely be, concentrating on the additional problems this would create in terms of corporate pension deficits if gilt yields depressed further, suggesting the consequences might add to the cautious investment behavior of corporations. Together with the Treasury's own plans for "credit" easing, UK policymakers are fighting to avoid the worst consequences of events swirling around the continent and beyond.
2. Japan and Japanisation. Together with a colleague, I had lunch with some Japanese policy officials this week, and we discussed many topical issues. But, in the context of the above discussion regarding "uncertainty," the most interesting thing was that the most senior person asserted that one major difference between Japan's

deflation and the challenges facing the US was that Japanese wages had adjusted lower so powerfully. I had to quiz him carefully to be sure what he was suggesting, and indeed, in contrast to what an overwhelming consensus would be believe, he was saying that the Japanese labour market is more flexible than the US. I shall be exploring this further, but to check my suspicion, I mentioned it to 3 different people, and they were all surprised.

3. Russia. I had a visit from an interesting person who is steeped in their modern history. He wanted to get my views and input into their aspirations to develop Moscow as a financial centre. I admitted that when I first heard about this 18 months ago, I didn't treat it seriously. But, if they are to persist, then it should be done in the context of Putin's "Eurasia" goals. We then spent the rest of time discussing recent announcements, and he made it clear that anyone who is surprised by it didn't understand Russia or the power status. It left me thinking that many of us – me included – really find it difficult to understand the country, but also, as long as this transition back to Putin is stable and there is no major crisis, perhaps many overseas are misunderstood by giving it too much negative importance.

Meanwhile, England goes out of the Rugby World Cup, and someone forced King Wayne to kick an opponent in the England Montenegro football game. There is no TV evidence of it, but I am sure it was someone trying to rile him ahead of next weekend's Manchester United planned thrashing of Liverpool…

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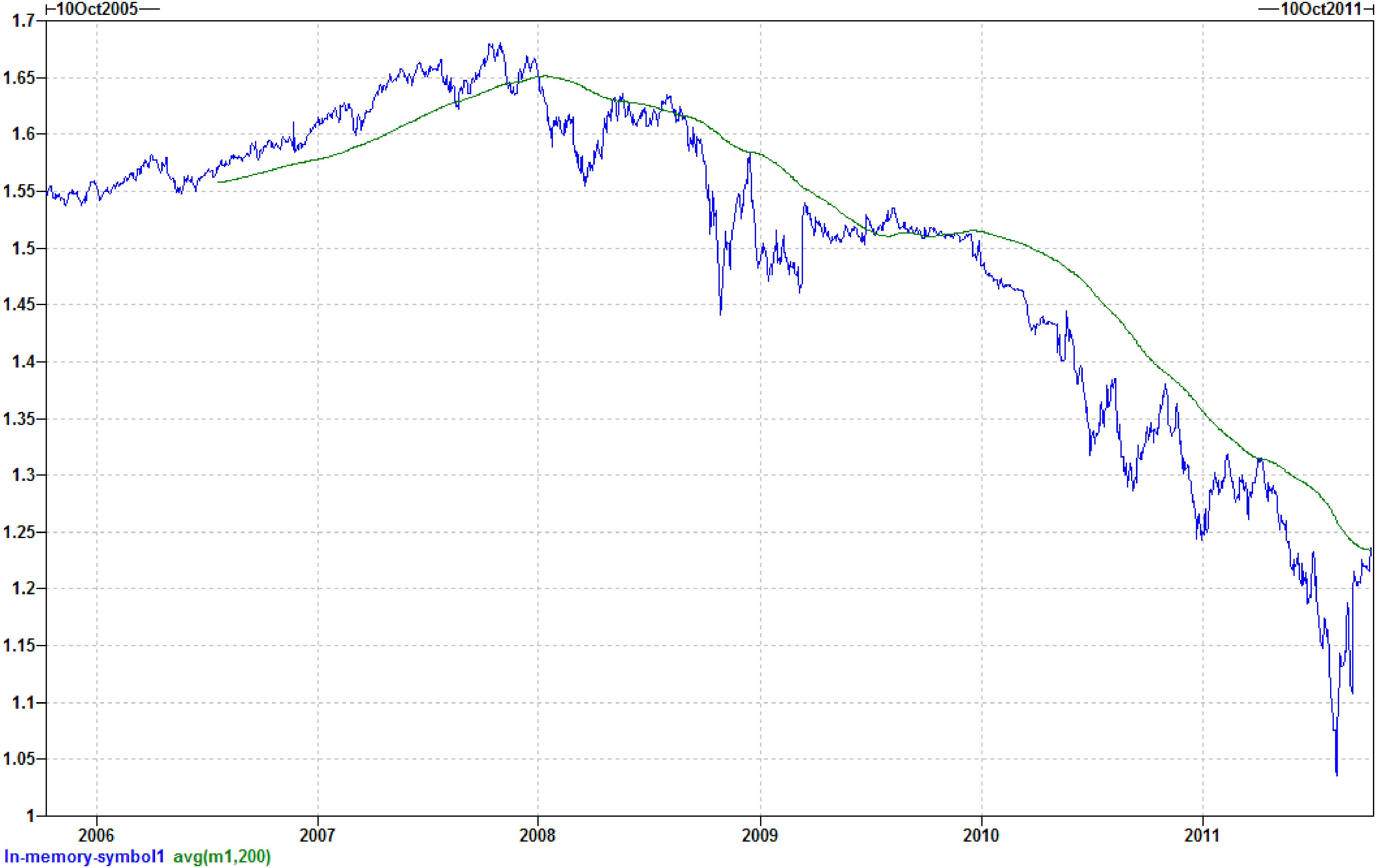
Viewpoints are also available on our public website: www.gsam.com/jimoneill. Monthly Insights and Strategy Series are available on www.goldman360.com. If you do not have access, please contact your Goldman Sachs relationship manager.



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