Goldman Sachs Asset Management

Monthly Insights

FROM THE OFFICE OF THE CHAIRMAN

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2012: Not a Repeat of 2010 and 2011

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Introduction

Having generally delivered upside surprises through most of the first quarter, global macro data turned patchy in April and is sending mixed signals. Global growth concerns, ongoing uncertainty about the Euro area crisis and the approaching "fiscal cliff" in the US are the main points of focus for investors today. On the back of this, markets have, to some extent, started discounting a re-run of 2010 and 2011.

We are using this edition of *Monthly Insights* to evaluate our macro and market views and associated risks. While some data has raised questions about the state of the global economy, China appears to be showing signs of improving. In addition, global financial conditions remain at very supportive levels. This suggests to us that the tentative weakness in the global industrial activity data may prove to be temporary. For now, we are still expecting global growth to remain moderate in the second half of 2012. We stick to our forecast of 3.6% for this year and 4.1% for next, with the individual country forecasts unchanged.

Risks to the economic outlook, by definition, continue. We are concerned about downside risks but also some upside ones. On the one hand, we remain worried about Europe. For now, we are sticking to our call for a 0.4% contraction this year, but risks are perhaps skewed to the downside. In the US, the recent weakness in the labour market data has raised questions about our forecast, but we believe the softness will not continue for long. We keep our 2.5% growth view for 2012-2013.

On the other hand, it is increasingly likely that China could deliver an upside surprise to our current forecast of 8.2% for this year. We might revise this number in light of lower inflation and further policy easing steps. From a more fundamental perspective, we remain optimistic about China's ability to rebalance towards higher quality growth driven by private consumption. While this might bring more volatility, if the transition to a different growth model is sustained, the bullish case for Chinese equities may become even stronger.

Political shifts are taking a somewhat different form this year relative to 2011. Today, most of the political risks are related to elections and government transitions in the developed world (US, Euro area and Greece in particular) as well as China and Russia. However, in China and Russia, the current political transitions are overall positive developments, in our view.

In equity markets, valuations in the Euro area periphery have now reached extremely low levels. In Growth Markets, we are most positive on China, given the pessimism that has surrounded the country's growth story so far this year. In currencies, a potential improvement in US macro data and more easing from the Bank of Japan (BoJ) should provide a new leg to the USD/JPY appreciation. We continue to expect a weaker EUR given the cyclical position of the Euro area and the current stance of the European Central Bank (ECB). Regarding the Swiss franc (CHF), we believe that the Swiss National Bank (SNB) may still move the floor again this year as the cyclical pressure builds up.

Leading Indicators are Softening

So far this year, consensus growth expectations have converged towards our initial forecasts. US data improved in Q1, while the Euro area disappointed and slipped into a mild recession. China also saw a slowdown in growth momentum at the start of the year, but we believe this has now likely bottomed out. Thus far, the impact of the Euro area's sovereign debt crisis on the rest of the world has been limited. This is due, in part, to the effectiveness of a number of central bank policies, chief among them the ECB's Long-Term Refinancing Operation (LTRO).

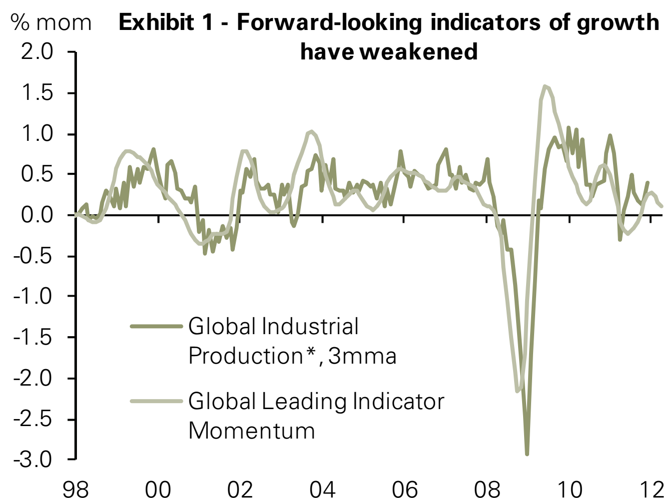
In the past few weeks, however, the data turned mixed. On the back of this, the markets have, to some degree, started discounting a re-run of 2010 and 2011. A number of the leading indicators that we monitor, the earliest gauges of the global industrial cycle, are now showing signs of weakness. Certain key metrics decelerated in April, including PMI surveys (particularly in Europe), consumer confidence and Korean exports. At the same time, there also have been some positive signs, including the improvement in China's PMI and upside surprises in both the headline number and individual components of the April US ISM report.

Table 1: Our GDP forecasts remain unchanged

	2010	2011	2012		2013	
			GSAM	Consensus	GSAM	Consensus
US	3.0	1.7	2.5	2.3	2.5	2.5
UK	2.1	0.7	1.0	0.7	1.8	1.8
Canada	3.2	2.5	2.2	2.1	2.5	2.3
Euroland	1.9	1.5	-0.4	-0.4	1.0	0.9
Japan	4.4	-0.7	1.9	2.0	1.3	1.5
Brazil	7.5	2.7	3.6	3.3	5.0	4.4
China	10.4	9.2	8.2	8.4	8.0	8.5
India	10.6	6.9	7.2	7.2	8.0	7.7
Russia	4.3	4.2	4.0	3.8	5.0	3.8
Mexico	5.5	3.9	3.6	3.4	3.8	3.4
Korea	6.3	3.6	3.4	3.3	4.8	3.9
Indonesia	6.2	6.5	6.0	6.0	6.1	6.4
Turkey	9.0	8.5	3.0	2.5	5.0	4.7
Advanced	3.1	1.3	1.4	1.3	1.8	1.8
BRICs	9.1	7.4	7.0	7.1	7.4	7.4
Growth Markets	8.5	7.0	6.4	6.4	6.9	6.8
World	5.3	3.8	3.6	3.5	4.1	4.1

Source: GSAM and Consensus Economics (as of April 2012)

Exhibit 1 - Forward-looking indicators of growth have weakened



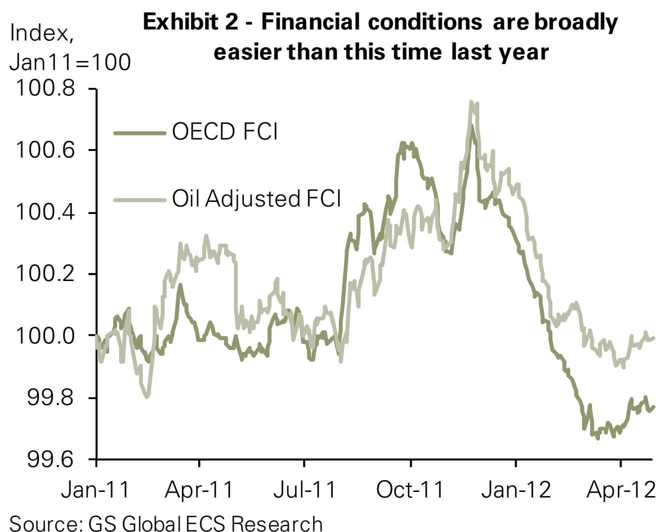
Source: GS Global ECS Research and Haver Analytics

Our favourite indicator that aggregates these and other timely variables, the Global Leading Indicator (GLI) produced by GS Global ECS Research, tentatively echoes this reversal.[1] As *Exhibit 1* illustrates, the final April reading confirmed a slowdown in momentum. This suggests a mixed outlook for global growth.

Despite this backdrop of slowing activity, financial conditions remain at accommodative levels. The OECD Financial Conditions Index (FCI), shown in *Exhibit 2*, has eased by over 50 bp since the start of the year. It is also around 90 bp below its peak last November.[2] Despite a minor tightening since the start of April, we are clearly at the most accommodative levels since last year. Adjusting for oil tightens the FCI, however, it is still below the levels seen this time last year.

For now, we continue to expect global growth to accelerate over the second half of the year. As *Table 1* shows, we have kept to our forecast of 3.6% for this year and 4.1% for next, with the individual country forecasts unchanged.

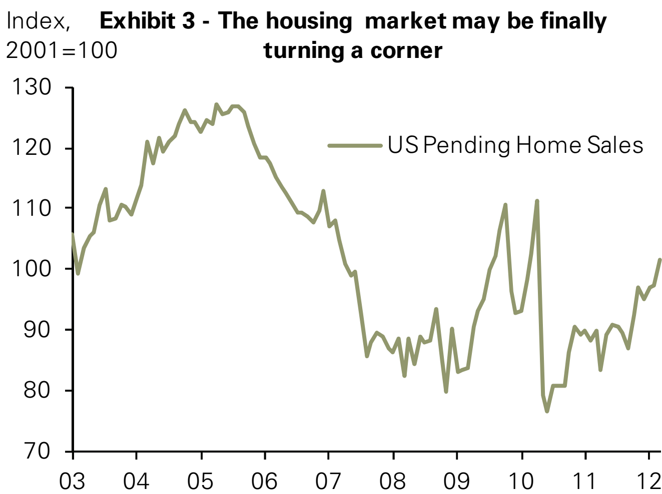
Exhibit 2 - Financial conditions are broadly easier than this time last year



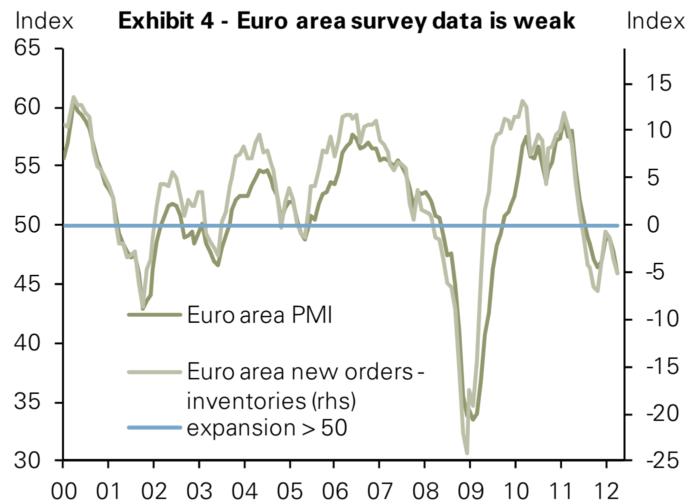
Source: GS Global ECS Research

[1] The Global Leading Indicator (GLI) is a Goldman Sachs proprietary indicator that is meant to provide an early signal of the global industrial cycle on a monthly basis. See GS *Global Economics Paper* No. 199: "An Even More Global GLI (Global Leading Indicator)".

[2] The OECD FCI is a GDP weighted average of US, Euro area, UK and Japan indices. The US FCI is a revamped version of the index which includes credit spreads and house prices. See GS *Global Economics Paper* No. 213 for further details.



Source: Bloomberg



Source: Haver Analytics

US Slowing, Temporarily

Our US growth forecast was one of our most significant out-of-consensus calls this year. We started the year with a real growth forecast of 2.5% vs consensus of 2.1% which has since moved up to 2.3%. The recent weakness in the labour market data has raised questions about our forecast, but we believe the softness will not continue for long.

We continue to see several fundamentals factors supporting the growth story, including low gas prices, a more competitive US manufacturing sector and an improving housing market. Last December we highlighted the housing market as an area of improvement that could provide some basis for optimism this year and, particularly, in 2013. Indeed, we have already seen some evidence suggesting the sector might be hitting the bottom. Among other indicators, US pending home sales are now approaching their post-crisis peaks as *Exhibit 3* illustrates. The S&P Homebuilding Index, a good leading indicator of housing construction activity, is also at its highest levels since 2008, up 30% year to date.

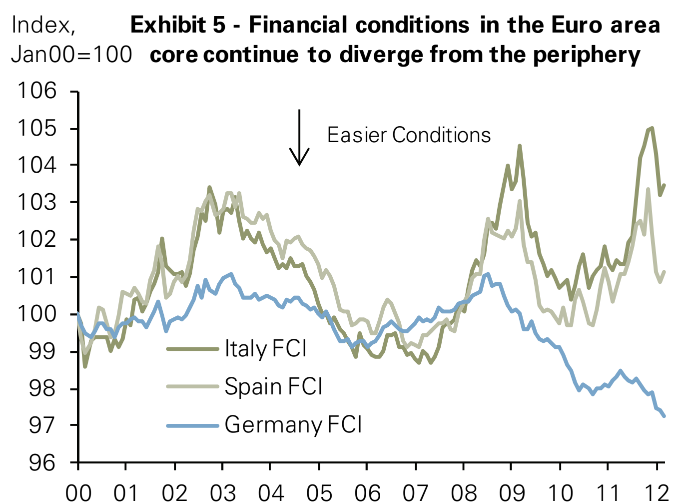
More generally, growth expectations are at a much lower base today relative to this time last year when consensus expectations for 2012 US growth were at 3.3%. Thus, we are unlikely to see downward growth revisions of similar magnitudes and the associated market re-pricing that we saw last year.

Europe in a Weak Spot

March and April saw a renewal of investor concern about Europe on the back of poor business activity data, as well as political events. As *Exhibit 4* shows, the Euro area composite manufacturing PMI fell in April to its lowest level since June 2009, and the new orders less inventories component also declined sharply. This was driven, in large part, by new, post-financial crisis lows in Germany and France, as well as a substantial dip in Italy. For now, we are sticking to our call for a 0.4% contraction in the Euro area this year, but risks are perhaps skewed to the downside. Our tools for tracking growth across different Euro area countries suggest that the core is still hanging on to positive growth (around 0.5%) and that the periphery, especially Italy, is contracting.

On the political front, attention has focused on a wobble in the Dutch government and elections in France and Greece. Against this backdrop, a debate on the trade-off between fiscal austerity and growth in the Euro area has intensified. Given these countries' cyclical positioning, it seems that policy flexibility and more gradual fiscal tightening may be more optimal. With the new leadership in France, stronger focus on growth-supporting policies is now indeed more likely. Greece's uncertain political situation and the repeat elections in June pose a far greater risk to the stability of the single currency area. Greece remains important given the precedent it sets for other struggling countries.

With the Euro area contracting, a more benign central bank policy stance would be most welcome. The ECB appears steadfast in its relatively hawkish stance and, for now, is



Source: GS Global ECS Research

largely focused on providing liquidity to alleviate stresses in the system. But, as *Exhibit 5* shows, the financial conditions in the core and periphery continue to diverge. For Germany, this should help offset its weak external environment and keep growth positive for this year. But for the periphery, still tight financial conditions are compounding the negative impact of fiscal tightening. Without a more flexible and arguably targeted approach from the ECB, it is tough to see this divergence being rectified quickly.

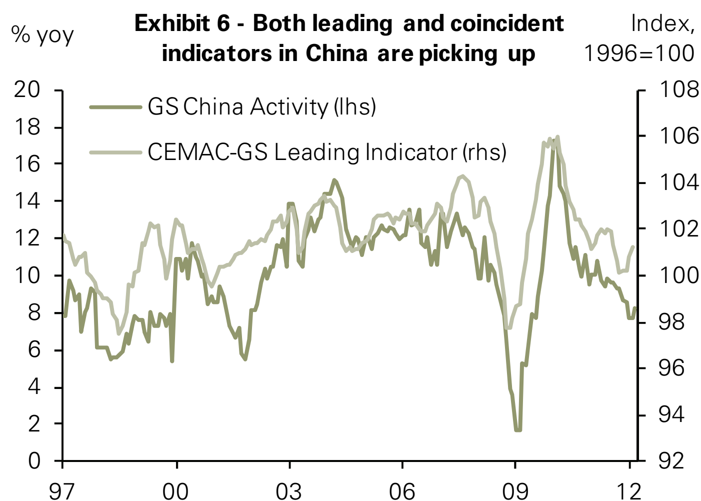
China's Soft Landing

Judging from the data so far this year, we believe that growth in China has bottomed in Q1 and is now strengthening. The general negative coincident activity data reversed direction in March, with the PMI, retail sales and business activity numbers pointing to improving momentum. The current activity indicator in *Exhibit 6* suggests a trough in February and a rebound in March, while the leading indicator has been on the rise since November of last year. The latest April PMI reinforced this trend and a few leading indicators, such as freight volumes, quasi money supply and cement production, look strong.

So far this year, the People's Bank of China (PBoC) has delivered a few policies designed to loosen financial conditions, although this has been somewhat constrained by the uptick in March inflation. As inflation falls back to the "target" of 3% or lower towards the end of the year, the government should be able to do more to ease conditions. While for now we stick to our forecasts of 8.2% for this year (and 8.0% for 2013), we currently have a strong bias for revising the 2012 number higher.

From a more fundamental perspective, we remain optimistic about China's ability to rebalance its economy in favour of higher quality growth driven by private consumption. There are already some positive signs confirming this trend. For example, we estimate that in Q1 the share of private consumption in GDP was approaching 39%, which is 4 pp up from the post crisis average. It is also clear to us that the government is becoming more reform minded, and in this respect, we do not see the upcoming political transition as a risk to the growth outlook. On the contrary, it will most likely accelerate necessary reforms. The recent widening of the CNY trading band signals the government's increasing focus on internal demand. If this transition to a different growth model is sustained, the bullish case for Chinese equities may become even stronger.

Exhibit 6 - Both leading and coincident indicators in China are picking up



Source: GS Global ECS Research

Risks to Year End

Risks to the economic outlook, by definition, continue. We are concerned about downside risks but also some upside ones. On the one hand, we remain worried about Europe. If the data continues to deteriorate significantly, we will have to adjust our growth forecasts. While we are still relatively optimistic on the US, risks to our forecast seem skewed to the downside. On the other hand, signs of an improving macro environment in China make upside growth surprises here increasingly likely.

Rising energy prices, one of the risks that we discussed in our March *Monthly Insights*, seem to have subsided for now. As argued before, there are few strong fundamental reasons for oil prices to rise well above current levels. In our view, oil is more likely to remain in the US$ 80-100 per barrel range for now. However, any escalation in geopolitical tensions could potentially disturb this equilibrium.

Recently, rising prices of certain agricultural commodities, particularly soybeans, have raised fears about global food inflation. A commodity price rally on the scale seen in the second half of 2010 and the start of 2011 would certainly pose some concerns, particularly for Growth and EM inflation. Evidence of significant inflationary pressure has yet to appear, however, and the S&P GS Agriculture Index has been relatively stable in 2012. While agricultural prices do not appear to present an immediate risk, they are worth watching.

Finally, political and social shifts that we also highlighted before are taking a somewhat different form this year relative to 2011. Today, most of the political risks are related to elections and government transitions in the developed world (US, Euro area and Greece in particular) as well as China and Russia. However, in China and Russia, the current political transitions are overall positive developments, in our view.

Market Themes

After the initial rally at the start of the year, equity markets have started to diverge. At the time of writing, the US has held onto gains in excess of 8% as have Germany and Japan. The UK and France remain just in positive territory while Italy and Spain have dropped around 9% and 20%, respectively. The significant underperformance of Spain and Italy reflects the deterioration of their cyclical positions. It has, at the same time, pushed valuations in Europe and in these two countries in particular to extremes, in our view. As *Table 2* shows, Italy's and Spain's cyclically-adjusted PE ratios (CAPE) are 70% below their historical averages. They are also now below their respective forward-year PE ratios (FYPE), implying a very pessimistic outlook on earnings growth relative to history. It is rare for a country's CAPE to drop below its FYPE.[3] When this has occurred previously, it has been a strong buy signal.

In Growth Markets, China A- and H-share markets have made strong gains over the past few weeks. The pessimism surrounding China's growth trajectory are overdone, in our view, and given that it has some of the lowest valuation metrics in the Growth Market world, we expect it to continue to outperform. Russia and Turkey continue to stand out on valuations too.

In fixed income, the US Treasury yield curve flattened in response to the weaker April data, and 10-year yields have moved back into the range they occupied in the second half of last year. A renewal of the positive momentum should move the curve steeper once again. Emerging Market debt has seen huge inflows in Q1, more than for the whole of 2011, with the asset class indices delivering a return of around 7% since the start of the year. As investors continue to search for yield outside the developed world, this trend should continue.

Table 2: Valuations in Europe's periphery are stretched

	CAPE	CAPE vs History*	CAPE vs FYPE
US	22.1	18%	75%
UK	11.0	-20%	11%
Brazil	11.1	-28%	15%
Russia	7.5	-48%	47%
India	16.3	-27%	25%
China	14.3	-19%	57%
France	9.5	-52%	2%
Germany	11.7	-39%	21%
Italy	6.2	-72%	-19%
Spain	5.7	-69%	-30%

* The historical series for each country varies. Generally for developed markets it is over 30 years while for the BRICs it is 15 years.
Source: Datastream and GSAM calculations

In currencies, a potential improvement in the US macro data should provide impetus for a new leg to the USD/JPY appreciation we saw at the beginning of the year. We expect additional easing from the BoJ on top of the recently announced measures. If the bank is to meet its 1% inflation target, this will need to come in large part through a weaker Yen.

As for the EUR, it should ultimately head lower. While it is currently receiving support from stretched short positioning and a resolute central bank, we believe the ECB will have to soften its stance at some point. Regarding the CHF, we believe that the SNB may still move their floor again this year. While the peg to the EUR continues to hold strong, the CHF trade-weighted index continues to grind higher. This is putting increased pressure on its exports which are on a declining trend. Given the notably weaker April Swiss PMI, the pressure may soon build back up on the central bank to intervene further.

[3] Expectations of nominal earnings growth as opposed to contraction generally keep the FYPE below the CAPE which is based on long-run historic earnings.

Appendix

GDP Growth Forecasts: GSAM vs Consensus

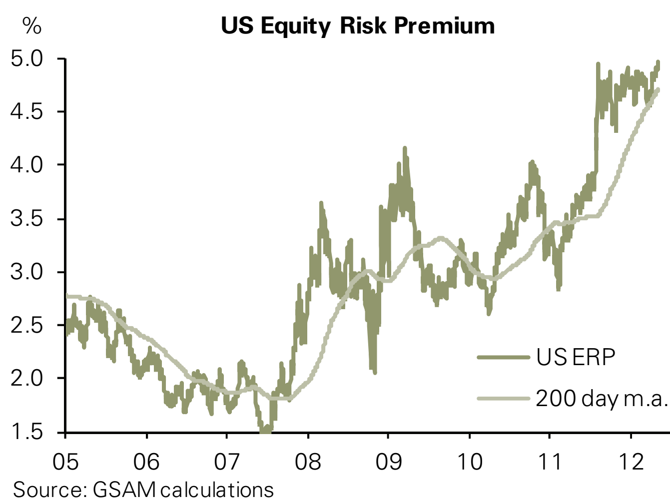
	Trend GSAM	2011	2012		2013	
			GSAM	Consensus*	GSAM	Consensus*
US	**2.5**	1.7	2.5	2.3	2.5	2.5
UK	**2.3**	0.7	1.0	0.7	1.8	1.8
Canada	**2.5**	2.5	2.2	2.1	2.5	2.3
Euroland	**2.0**	1.5	-0.4	-0.4	1.0	0.9
Japan	**1.5**	-0.7	1.9	2.0	1.3	1.5
Brazil	**5.0**	2.7	3.6	3.3	5.0	4.4
China	**8.0**	9.2	8.2	8.4	8.0	8.5
India	**8.0**	6.9	7.2	7.2	8.0	7.7
Russia	**5.0**	4.2	4.0	3.8	5.0	3.8
Mexico	**3.0**	3.9	3.6	3.4	3.8	3.4
Korea	**4.8**	3.6	3.4	3.3	4.8	3.9
Indonesia	**5.8**	6.5	6.0	6.0	6.1	6.4
Turkey	**5.0**	8.5	3.0	2.5	5.0	4.7
Advanced	**2.2**	1.3	1.4	1.3	1.8	1.8
BRICs	**7.3**	7.4	7.0	7.1	7.4	7.4
Growth Markets	**6.8**	7.0	6.4	6.4	6.9	6.8
World	**4.2**	3.8	3.6	3.5	4.1	4.1

*As of April 2012. Source: GSAM and Consensus Economics

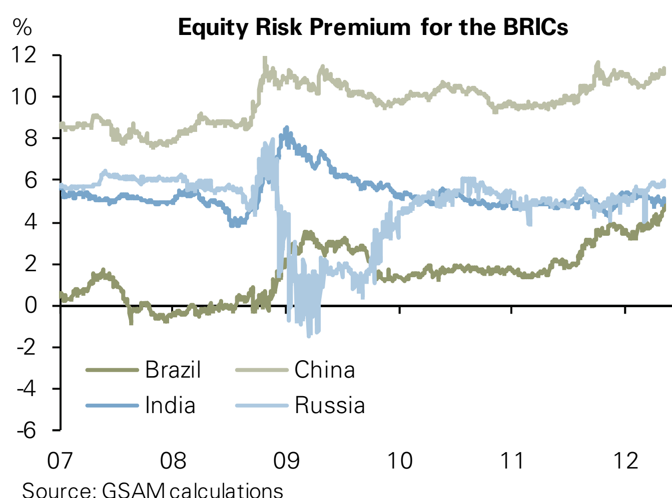
Global Equity Risk Premium*

	Real GDP Growth Trend	Real Earnings Growth	+	Dividend Yield	=	Expected Real Return	-	Real Bond Yield	=	Implied ERP	Expected Inflation	Expected Nominal Return
US	2.5	2.5		2.1		4.6		-0.3		**5.0**	2.0	6.6
UK	2.3	2.3		3.6		5.8		-1.2		**7.1**	2.0	7.8
Europe ex UK	2.0	2.0		3.9		5.9		0.8		**5.1**	2.0	7.9
Japan	1.5	1.5		2.4		3.9		0.6		**3.3**	1.0	4.9
Brazil	5.0	5.0		3.8		8.8		4.2		**4.6**	4.5	13.3
China	8.0	8.0		3.9		11.9		0.5		**11.4**	3.0	14.9
India	8.0	8.0		1.7		9.7		4.6		**5.1**	4.0	13.7
Russia	5.0	5.0		3.0		8.0		2.2		**5.7**	6.0	14.0
GDP-weighted												
Advanced	2.1	2.1		2.9		5.1		0.2		**4.9**	1.8	6.9
BRICs	7.0	7.0		3.4		10.5		2.0		**8.5**	3.8	14.3
World	3.5	3.5		3.1		6.6		0.7		**5.9**	2.4	8.9
PPP-weighted												
Advanced	2.2	2.2		2.9		5.0		0.1		**4.9**	1.9	6.9
BRICs	7.3	7.3		3.3		10.6		2.0		**8.6**	3.7	14.4
World	4.2	4.2		3.0		7.3		0.9		**6.4**	2.6	9.9

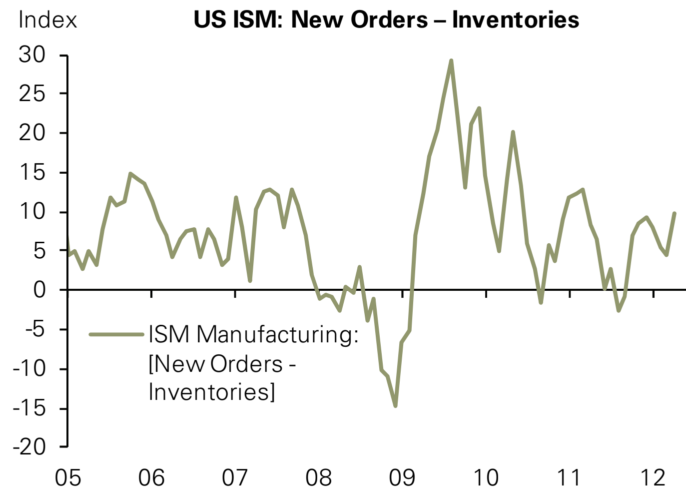
*As of 09 May 2012. Source: GSAM calculations



Source: GSAM calculations

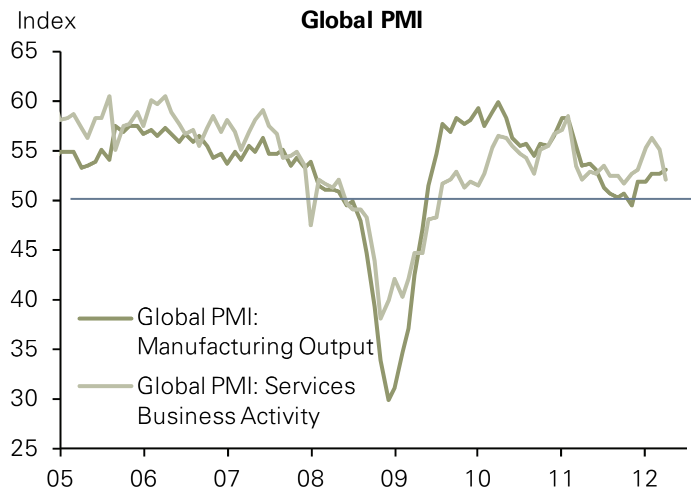


Source: GSAM calculations



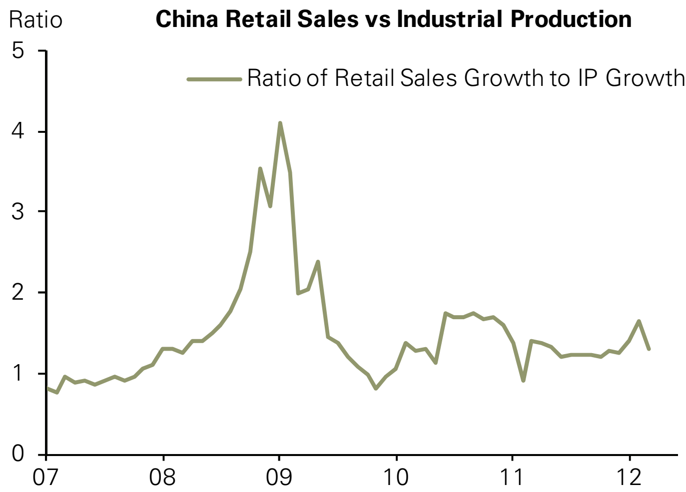
Source: Institute for Supply Management, Haver Analytics

ISM is a key industrial US survey. The new orders less inventories component is one of the main leading indicators for the US and the global industrial cycle.



Source: JP Morgan, Haver Analytics

The Global Purchasing Managers Index (PMI) is a PPP-weighted average of different countries' PMI headlines. The PMI headline gives a snapshot of economic activity.

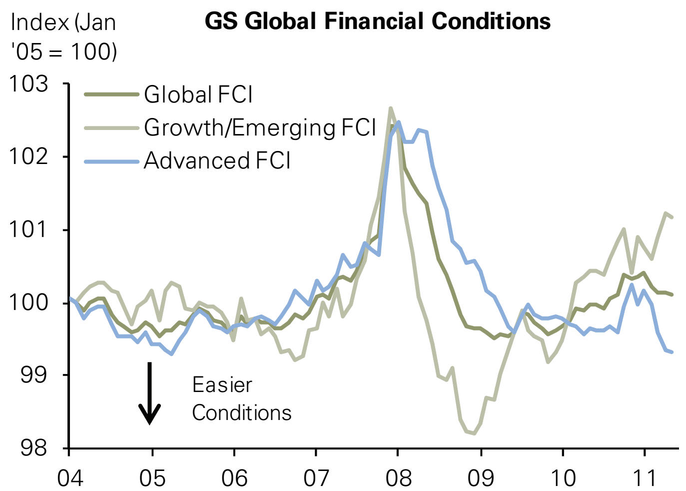


Source: Haver Analytics, GSAM calculations

We monitor Chinese retail sales relative to industrial production as another guide to the rebalancing of the economy.

Source: Korea Customs Service, Haver Analytics

Korean exports are a key leading indicator for world trade and the global industrial cycle. This is the first trade statistic to be published at the beginning of every month.



Source: GS Global ECS Research, Haver Analytics, GSAM calculations

The GS FCI is a weighted average of real 3-month interest rates, long-term interest rates, trade-weighted exchange rate and equity market cap/GDP. The FCI measures the direct and indirect effects of monetary policy on economic activity.

Source: GS Global ECS Research

The FSI is an aggregate of indicators reflecting liquidity risk, counterparty risk, refunding risk and broader risk aversion. The FSI is designed to capture tensions in the US financial markets, controlling for the stage of the business cycle.

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