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Sandra Lawson
Senior Global Economist
sandra.lawson@gs.com
+(1) 212 902 6821

Roopa Purushothaman
Associate Global
Economist
roopa.purushothaman
@gs.com
+ (44)20 7774 5061

Sabine Schels
Research Assistant
sabine.schels@gs.com
+(44) 20 7774 6641

[http://www.gs.com/
ceoconfidential](http://www.gs.com/ceoconfidential)

Strategic Opportunities in the 'Decade of Security'

The post-September 11th security drive has opened up new opportunities for interaction between the public and private sectors, consolidation and investment spending

Enhancing security has become a global imperative in the wake of September 11th. Although primarily driven by governments, this effort has also benefited from private-sector efforts to increase their own security programs. No longer just the remit of a few specialized firms, the security field now encompasses a wide range of industries, including financial institutions, communications technology, IT services and aerospace and defence. Discussions with more than 50 of the market's major players suggest ample opportunities for public/private co-operation and M&A in coming years.

Competitive Landscape and Emerging Opportunities

Government-driven demand has led security industry experts to forecast 10%-15% annual growth in the sector, which could be worth \$180 billion by 2010. We expect the private sector to adopt government-driven security products, comprising one-half to two-thirds of total market demand by 2010. Security could become a major driver of technological and market innovation in this decade, much the same way that personal computers did in the 1980s and the internet in the 1990s. As the industry matures, opportunities for the commercialization of security technologies and services will become more visible.

Today's security market is highly fragmented, with about 6,500 companies ranging from small private companies to divisions of public companies. This absence of major integrated players presents an opportunity for consolidation. We expect to see continued M&A activity in which traditional defense and security players team with multi-industry industrial companies, information technology, communication and financial service firms. This type of cross-sector partnerships will help to make security products and services to become more efficient, affordable and marketable. Governments can facilitate this process by offering tax incentives and reduced legal liability to companies with 'qualified security products,' which can make them more attractive as investments and bolster their market strength.

We expect that the principal players in the new security market will initially be the traditional defence and security players, along with information technology and integration service companies. These industries have experience navigating government procurement processes and understand the importance of marketing integrated packages to governments.

Multi-industry industrial players have also become active in developing their homeland security programs, teaming with technology and service providers. Industrial companies bring efficient manufacturing skills and broad distribution, which will allow for the commercialization of emerging products. They will partner with traditional government service providers who offer contacts and knowledge of government procurement processes. Major industrial firms have stepped up their purchases of niche players with important capabilities, in both the US and Europe, as well as major purchases of firms offering integration service capabilities.

Financial sponsors and venture capitalists are also interested in building out their portfolios in this area. Security-related companies now account for 4.5% of all venture capital investments, up more than 100% over the past five years. Venture capital participation is especially important for the advancement of technological research and intelligence analysis that is critical to the development of security solutions.

Issues on the Table

On the macro side, we see several ongoing trends:

Terrorism as a tax. Terrorism effectively serves as a tax on the economy, with heightened security objectives leading to less efficient spending, longer processing times, increasingly expensive goods and slower inventory cycles. In the past, there was little financial incentive for the implementation of technologically advanced security products, but regulation and the heightened threat perception and possible liabilities have changed this, providing

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Strategic Opportunities in the 'Decade of Security'

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some return on this expenditure. As the market consolidates and security improves, more efficient products will reduce processing times and costs.

New business opportunities.

Government interests are currently defining the market and generating new business areas, in areas such as training services for first responders, anti-money laundering technologies, next-generation database products and terrorism risk insurance packages. Elsewhere, we see scope for private and government demand for private intelligence services and for third-party facility inspectors.

Technology transformation. As is now underway with airport screening, security is migrating from labor-intensive processes to technology- and information-enabled screening. The use of RFID technology (chips that replace barcodes) is another example. Technology should allow for lower security transaction costs and higher throughput, accuracy and reliability.

Convergence of physical and logical security. Physical security (protection of facilities) is converging with logical security (protection of computers and communications systems). New applications that merge these two areas can allow more sophisticated security protocols and risk assessments. This is an important area that has already attracted much corporate attention.

Key Role for the Private Sector

The US government's National Strategy for Homeland Security identifies two areas that should see significant growth: emergency preparedness and response; and border and transportation security. Several advanced technologies will be crucial to the future domestic security landscape. All can be developed in and by the private sector. Key among these are biometrics, materials detection, radio frequency ID and smart cards, sensors, integration services, IT security and smart software.

While government standard-setting is important, the private sector will also want to draw up its own proposals for security and self-governing frameworks. Over 85% of the US infrastructure is privately owned. Moreover, security frameworks that emerge from private-sector initiatives are more likely to be widely embraced.

Governments Can Help

The joint public/private approach to the Y2K bug of the late 1990s suggests ways in which governments can help spur the private sector to move ahead in security now. Similarly helpful steps now could include:

■ **Capital raising.** The US government can encourage capital-raising in public markets for protection against terrorism by eliminating the Alternative Minimum Tax for certain infrastructure projects, such as explosive detection systems and other security measures at airports and seaports.

■ **Liability coverage.** The risk of unmitigated liabilities resulting from a terrorist attack has deterred some suppliers from seeking US government contracts. Procuring indemnification for security products under the SAFETY Act is a new development that will affect potential liabilities and further technological development.

■ **Funds flow.** The flow of funds in the private sector and municipalities has been slow and sporadic. The government can establish a grant program for security projects that has consistent fund-flow characteristics which can be securitized in the public markets.

■ **International co-operation.** An integrated approach to international commerce, including the sharing of intelligence and responsibilities could dramatically improve the security of international shipping and air transport.

■ **Performance-based initiatives.** Governments can issue market-based security standards, not rely on regulatory rule-making. This will allow companies to respond creatively to the long-term development of the market.

■ **Technology investment to drive scale.** Governments can roll out technologies rapidly to reduce costs and to allow for corporate or even consumer adoption.

■ **Standards.** Government-driven standards have yet to be broadly developed and implemented for technologies like biometrics, radio-frequency ID and smart cards.

■ **Market consolidation.** Governments can encourage consolidation by providing tax breaks. ■

Further information on the topics in this report is available on the GS Financial Workbenchsm. For access, please go to www.gs.com/ceoconfidential

Contributors: Mike Buchanan, Themistoklis Fiotakis, Binit Patel, Dominic Wilson, Anne Yang

House Prices: Rebalancing or Threatening the Recovery?

House prices look modestly overvalued in the US and more overvalued in the UK and Australia. A decline in house prices back towards fair value could help to rebalance the global economy—but it could be destabilizing if house prices overshoot on the way down. To compensate, policymakers could relax fiscal and monetary policy, with implications for bond yields, currencies and equities

Real house prices have risen dramatically in the US (up 37%) and even more in the UK (up 96%) since 1995. Prices have more recently taken off in France, Spain and Italy, although they remain stagnant in Germany. Australia has seen a dramatic boom, with prices up by 82% in real terms since mid-1990s, and there is increasing evidence that the long property bust in Japan is coming to an end.

There are clear explanations for the sharp rise in real house prices in many economies. Declining real and nominal interest rates have raised the amount of debt households can sustain on a given income and have lowered the equilibrium rental yield. Lower volatility of interest rates has reduced the riskiness of large variable-rate mortgages. Higher incomes from real wage growth, lower unemployment and an increase in dual-income households have all boosted housing demand, as have rising populations and changing demographics in many countries.

In the US, the UK and Australia, house prices were undervalued in the mid-1990s and rose in response to improving fundamentals. They have now moved too far. We estimate that house prices are overvalued by 10% in the US, 15% in the UK and 29% in Australia. Prices look precarious even at today's relatively low interest rates, and they would be even more worrying if rates rose significantly.

The Impact on Consumption

Higher house prices have clearly coincided with higher consumption, but do higher house prices *cause* an increase in consumer spending? If so, falling house prices would hurt consumption. But if higher consumption largely reflects other factors, like lower interest rates and higher consumer confidence (which might also have pushed up housing prices), then a correction in the housing market by itself might have little impact.

In the US, recent financial market liberalization has made it easier for households to refinance, and we find evidence that this has increased the effect of housing wealth on consumption. In the UK, the wealth effect has actually fallen in the last 10 years, perhaps because the painful housing crash of the early 1990s is still fresh in the minds of UK households. The wealth effect in Australia seems to have been relatively more stable.

Looking at the extent of house-price overvaluation along with the sensitivity of consumption to housing wealth allows us to estimate the possible impact on consumption if housing prices were to fall back to fair value. In the US, the modest overvaluation estimate means that consumption would fall by 1.1%. In the UK, the higher overvaluation estimate but lower wealth effect suggests a decline of 0.6%. In Australia, the news is grimmer: a very high overvaluation estimate and a higher impact of house prices on consumption combine to give a reduction on consumption of 1.8%.

Once house prices start to fall, they typically undershoot fair value for some time. Furthermore, if interest rates rise, the estimate of overvaluation would rise. Allowing for undervaluation in line with past experience, and for a 100bp increase in mortgage rates, the total impact on consumption in the US, UK and Australia could be 1.5%, 1.4% and 2.4% respectively.

Australia Leads the Way, and the World?

The Australian housing market seems already to have turned, even without a significant rise in interest rates and even while employment is at record levels. Housing prices are also showing signs of softening in the UK. Should house prices fall in the US and UK, the resulting reduction in consumption might provide a useful mechanism to rebalance the global economy. Strong growth in recent years in

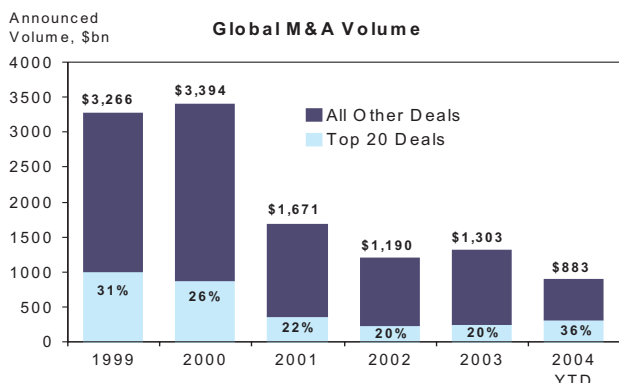
part reflects the resilience of the consumer, especially in the US.

The flip side is that this has left household balance sheets looking stretched, and so a moderate retrenchment by households could provide a way of restoring balance to these economies. If consumption holds up better in Euroland and Japan, where house prices look generally less stretched, it could also help rebalance the global economy.

But there is a risk that the necessary correction in housing markets accelerates into something worse. To stem this risk, policymakers can react by cutting interest rates and/or relaxing fiscal policy.

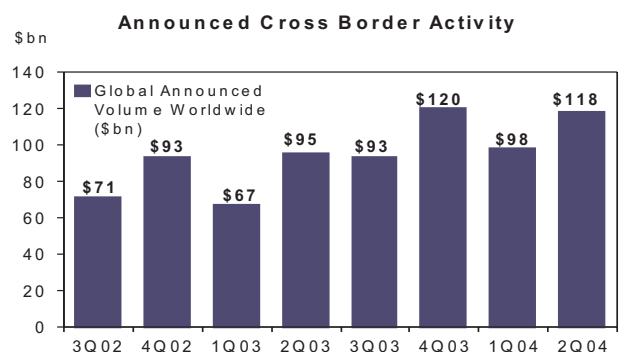
- The US has the least flexibility to compensate for a housing downturn, since both fiscal and monetary policy are already extremely loose.
- The UK also has little room for manoeuvre on fiscal policy, but it could more easily cut interest rates if a housing downturn seemed to threaten the overall economy.
- Australia has the greatest flexibility, given that its budget is still roughly balanced and that interest rates are close to a neutral level.

Even if policymakers can offset the impact of a housing market slowdown, this would keep bond yields and probably currencies weaker than would otherwise be the case. Equity valuations would be hurt by lower growth but helped by lower bond yields. ■



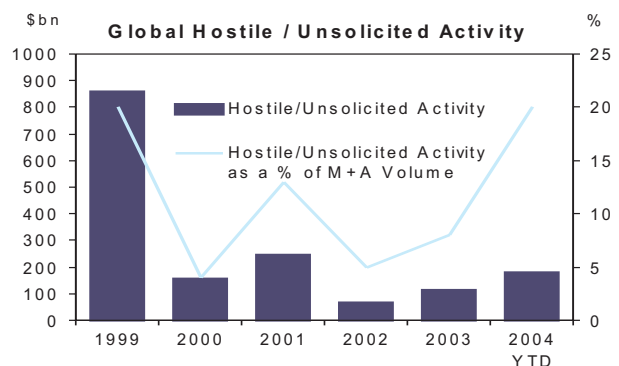
Strong M&A Year Starts With a Record First Quarter

- Global announced merger volume grew by a striking 46% in the first half of the year, reaching \$883 billion in the year to date. Activity in the first quarter, when three \$40 billion-plus deals went to market, set new records. Second-quarter volumes were lower but still ahead of much of 2003.
- The 20 largest deals in the first half of this year accounted for 36% of overall volume, significantly above the five-year average of 24%. North American-targeted activity (worth 49% of total global M&A volume) outpaced European-targeted activity (31%).



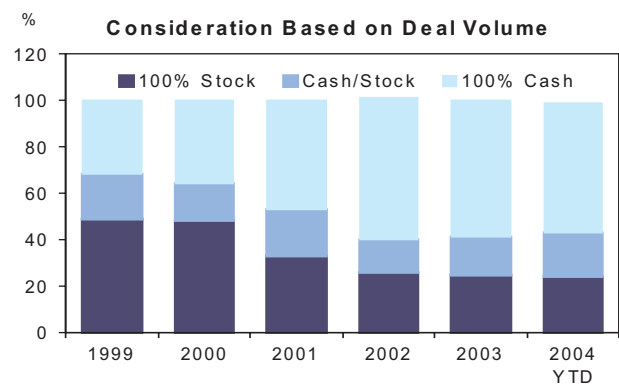
A Second-Quarter Pickup in Cross-Border Deals

- At \$118 billion, announced cross-border merger volume in the second quarter of 2004 exceeded the \$98 billion seen in the first quarter. The six-month total represents 24% of total merger volume, below the five-year average of 32%.
- So far this year, North American purchases of non-North American companies have gained a \$5 billion edge over European purchases of non-European companies.



2004 Hostile Activity Already in Excess of 2003

- Hostile and unsolicited activity accounts for 20% of global announced M&A in the year to date. At an impressive \$181 billion in the first half it already exceeds the full-year 2003 volume by more than 60%.
- 2004 has seen somewhat of a resurgence in traditional unsolicited M&A activity. Three of the largest transactions announced this year have been hostile offers. The US has seen a trend towards increased activism, in which shareholders have tried to force a sale transaction but have not made a bid for the company.



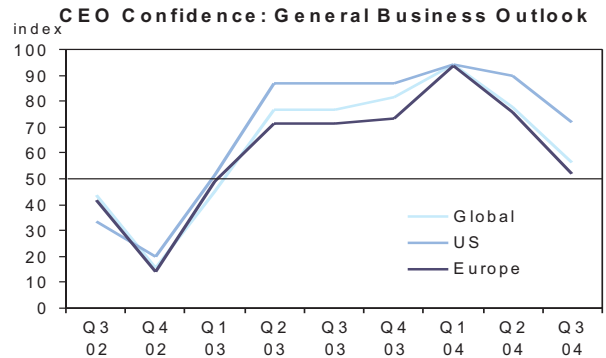
Cash Is Still King for Mergers

- On a deal-volume basis, cash remained the dominant transaction currency. Despite the resurgence in merger activity, all-stock deals accounted for 24% of all transaction volume, relatively flat to the levels seen in 2003 but well below those seen during the boom of the late 1990s.
- In general, the type of consideration paid depends on the size of the deal. Mega-deals over \$10 billion have tended to be stock deals. The prevalence of deals of smaller transaction value, as well as the volatility in equity markets, increased the cash consideration.

Source: Thomson Financial Securities Data; Goldman Sachs.

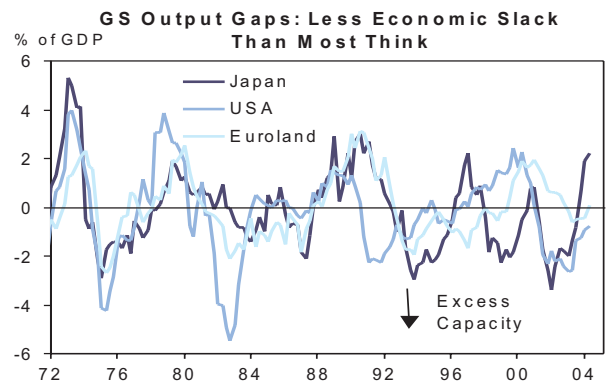
CEO Confidence Hits the Lowest Point in a Year

- Our quarterly survey of CEO Confidence shows a decline in the overall business outlook to 56.5, the lowest reading since the spring of 2003. This quarter's decline in the overall outlook is much more notable in Europe than in the US (see page 8 for more detail).
- Still, the outlook for M&A and capital spending remain strong. The US figure for capital spending is a high 81.3, in line with our US industrials analysts' view. After three years of declines in capex, their surveys indicate that capital spending will rise nearly 20% this year.



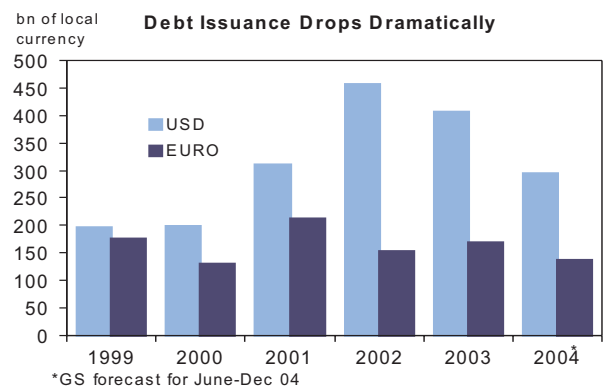
Output Gaps: Little Excess Capacity Left

- We think the trade-off between growth and inflation is set to deteriorate, yielding slower growth and higher inflation, at least in the US. One important reason is that there may be less effective 'slack' in the global economy than most think.
- Our measure of the output gap—how much slack an economy has—indicates that there is significantly less excess capacity now than a year ago. Given our view of G3 GDP growth close to trend over the next year, inflationary pressure is likely to remain an issue.



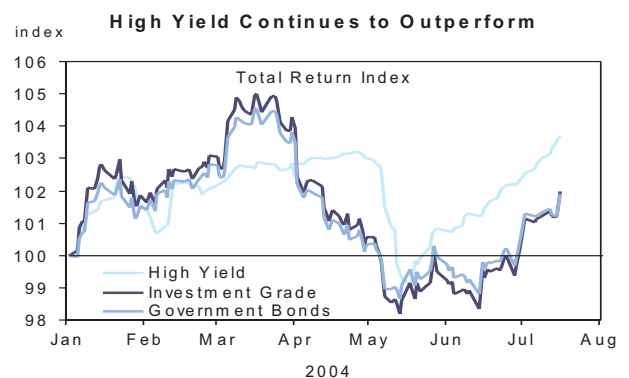
Considerable Drop in Corporate Debt Issuance

- Issuance of fixed rate debt by US and European corporates has come down from recent peaks. In the US, we expect corporates to issue just under \$300 billion of debt in 2004, down from \$400 billion last year.
- A negative corporate financing gap (i.e. cash surplus) in the US makes financing internally more attractive rather than issuing debt. In addition, much of the debt that comes to expire in 2004 was refinanced in 2003 to lock in relatively low yields and corporate bond spreads.



High Yield Continues to Outperform

- In relation to investment grade and government bonds, high yield has considerably outperformed year to date. This is because spreads are already fully valued, and the 'carry' over government bonds is partly lost because of negative rating migration.
- Total returns on investment grade and government bonds are heavily determined by the outlook for interest rates and inflation. Although the credit fundamentals remain very constructive, there is little room for outperformance through further spread compression.



Source: Goldman Sachs.

	Outlook	Key Issues
United States	We expect GDP growth to decelerate slightly in the third quarter, with core CPI inflation pacing up due to one-off factors, namely higher commodity prices. In 2005, however, inflationary pressures could turn more fundamental, as upward pressure on unit labor costs is likely to offset the more benign impact of stabilizing commodity prices. The dollar will have to slide considerably further on a trade-weighted basis to generate a sustainable trade improvement.	Fed officials will remain in a 'measured' tightening mode next year as a result of the worsening outlook for productivity growth. Our projections for the federal funds rate are 2.25% and 3.50% for year-end 2004 and 2005 respectively. There are two risks to this forecast. On the one hand, a downside risk could be a sharper-than-expected growth slowdown. On the other hand, a decline in the secular productivity trend could pose a risk to the upside.
Japan	Underpinning robust personal consumption are: a recovery in consumer confidence on the back of job stability, the wealth effect produced by higher equity prices, and a declining savings rate due to demographics. We forecast that over the next few years, growth in consumption (at 2%-3%) will continue to surpass growth in workers' income (around +1%).	The Japanese economy remains in a self-sustaining recovery phase. We are more optimistic than consensus on the sustainability of the recovery. Economic strength is causing deflationary pressures to ease faster than most had anticipated. This supports our forecast of 2% for 10-year notes by the end of FY2004. The BoJ is nonetheless unlikely to end its quantitative easing policy before 2006.
Europe	Several factors will make the ECB slow to hike rates. We expect the euro to appreciate to 1.32 against the dollar over the next six months. Domestic demand weakness in Germany will also argue for caution. Finally, the inflation outlook is not inconsistent with price stability. Although the tightening cycle in the US has begun, the first tightening move by the ECB is likely to take place early next year.	Falls in real consumer prices, related partly to outsourcing, have been an important source of real income growth for UK households in recent years. The effect has apparently been much smaller in continental Europe. But competition should ensure that Euroland consumers eventually enjoy the same gains from trade as their counterparts in the UK.
Non-Japan Asia	We do not foresee a significant decline in Asia's terms of trade in the near term. On the import price side, higher volatility in oil prices could hurt terms of trade in the near term. The situation should, however, stabilize later this year. Furthermore, the near-term outlook for DRAM prices is positive, which should help stabilize export prices.	China will need to adopt an exit strategy from the current administrative tightening measures and replace them with market-based mechanisms to ensure a soft-landing. Reforms were recently announced to improve the investment approval process by minimizing the government's involvement. This could imply that some administrative tightening may have to be eased further down the line.
Latin America	With the help of sensible macroeconomic policies and favorable external conditions, the macroeconomic outlook of Brazil continues to improve. Argentina's government has not made significant progress in introducing the fiscal reforms that are key for the country's sustainable economic growth.	Latin America as a whole remains vulnerable to tighter global financial policies. One reason for this is that the region has not taken full advantage of the rebound in exports. Additionally, Latin American countries have not yet implemented measures to boost domestic savings, to attract external savings and to reduce public debt.
Central and Eastern Europe, Middle East and Africa	In Poland we expect aggressive monetary policy tightening during the next few months as the MPC becomes convinced that upward price pressure is not simply a temporary factor due to EU accession. Russian macroeconomic data are strong, but the weakness of institutions and the generally questionable rule of law are highlighted by the Yukos affair, which is dominating the headlines.	To speed up convergence with the older EU members, more ambitious structural reforms are needed from the new EU countries. With Slovakia the only exception, reform momentum in the region has declined in recent years. Political realities give little reason to expect momentum in the next 1-2 years, creating a mixed medium-term growth outlook.

KEY ECONOMIC AND MARKET FORECASTS					
	GDP (%)	Consumer Prices (%)	3M Rate Forecasts* (%)	Bond Yields** (%)	Exchange Rate Forecasts
US	2004: 4.3 2005: 3.0	2004: 2.7 2005: 2.5	3m: 2.1 12m: 3.3	Current: 4.4 12m: 5.3	-- --
Japan	2004: 4.4 2005: 2.9	2004: (0.1) 2005: 0.2	3m: 0.1 12m: 0.3	Current: 1.8 12m: 2.1	3m \$/JPY: 105 12m \$/JPY: 98
Euroland	2004: 2.0 2005: 2.4	2004: 2.1 2005: 1.9	3m: 2.2 12m: 2.9	Current: 4.2 12m: 4.8	3m EUR/\$: 1.27 12m EUR/\$: 1.32
UK	2004: 3.5 2005: 2.8	2004: 1.4 2005: 1.7	3m: 4.9 12m: 5.5	Current: 5.1 12m: 5.4	3m GBP/\$: 1.87 12m GBP/\$: 1.81
Non-Japan Asia	2004: 8.4 2005: 7.5	2004: 4.0 2005: 3.7	3m: 3.8 12m: 3.8	Current: 5.1	3m \$/KRW: 1125 12m \$/KRW: 1025
Latin America	2004: 4.8 2005: 3.5	2004: 7.1 2005: 5.3	3m: 7.0 12m: 7.5	Current: 8.0 12m: 10.1	3m \$/MXN: 11.40 12m \$/MXN: 11.75
Central and Eastern Europe	2004: 4.8 2005: 4.2	2004: 5.5 2005: 5.6	3m: 7.3 12m: 8.5	Current: 7.9 12m: 9.0	3m EUR/PLN: 4.30 12m EUR/PLN: 4.35

* 3-Month Rates: Euroland: average of Germany and France; Non-Japan Asia: Korea; Latin America: Mexico; Emerging Central Europe: Poland.

** Bond Yields: US: 10-year Treasury note; Japan: 10-year JGB; Euroland: average of Germany 10-year Bund and France 10-year OAT; UK: 10-year Gilt; Non-Japan Asia: Korea 10-year sovereign; Latin America: Mexico 5-year sovereign; Emerging Central Europe: Poland 5-year sovereign.

Potential Surprises in August

Continued from page 8

This would also focus attention on the prospect of Japan breaking out of its deflationary trap. If the second-quarter GDP release in August also surprises positively, the latest round of worries about the sustainability of Japan's recovery could be pushed into the background again.

Oil Prices Move Sharply, in Either Direction

On the upside, further attacks on Middle East oil facilities (particularly on Iraqi oil pipelines), the cessation of Yukos crude oil production, further strikes in Nigeria and a global heat wave are all possible catalysts for higher oil prices. On the downside, a terrorist attack on a commercial plane, a slowdown in Chinese energy consumption or major currency devaluation in a key oil-consuming country could push oil prices down quite sharply.

On balance, we see the upside risks as more plausible, with higher oil prices adding to the case of less growth and more inflation in the world economy in the months ahead.

More German Companies Secure Longer Working Hours

Germany's powerful IG Metall union has recently made significant concessions on working hours in agreements with Siemens and DaimlerChrysler. Several other German companies have already started or are set to negotiate new labour contracts in the coming months, and some could be concluded in August. Alongside further news that Europe's recovery is more robust than expected, more good news on the labour front could provide a boost to European equity markets.

US Election Swings Decisively

We expect the presidential polls to fluctuate until the election, but believe it will be a close race until November, leaving the White House essentially up for grabs. In August, the Kerry-Edwards ticket may enjoy its first significant lead since Kerry became the likely Democratic nominee. Since 1964, the average post-convention bounce has been about six points, with the challenger typically doing about one point better than the incumbent. Applying this six-point bump to the recent polls, we could expect poll results to widen

to as much as 55%-38%, not including Ralph Nader.

In many cases, the bounce is irrelevant because the incumbent holds such a wide lead. But in some cases, such as 1992, the convention can play an important role. Then-Governor Clinton was trailing the first President Bush 40%-48% going into the convention, but emerged with a 56%-34% lead. This 16-point bounce had mostly faded by October, but it was enough to carry him through the election.

A Terrorist Attack

While the unpredictability of terrorist attacks remains the biggest unquantifiable risk to our views, our research has shown that geopolitical events generally only create 'bumps' in the mood for risk aversion. They do not seem to prompt a change in the underlying trend regarding investor risk aversion, which is largely determined by economic and financial conditions. But the short-term response would likely involve further headwinds for equities and support for bonds. ■

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Potential Surprises in August

August can be a volatile month. We highlight some things that could go wrong—and right—this month, potentially triggering significant market activity in the context of low liquidity

For a while, it has seemed as though summer has already begun. Major asset markets have been stuck in ranges for several months. Equity market volatility—both implied and realized—has generally been grinding lower. Volatility in bond and currency markets is also at recent lows.

Yet August can be a volatile month. Surprise events combined with low levels of liquidity can produce significant market activity. A brief list of August highlights includes the Mexican debt crisis in 1982, the Asian financial crisis in 1997 and Russia's financial meltdown in 1998. More recent Augusts have seen tumbling rate expectations and higher oil prices in 2002 and a bond market sell-off in 2003.

With this in mind, we identify potential events that could surprise this month. The list could potentially be endless, but we have chosen events with a realistic probability of occurring.

US July Data Confirm June Weakness

We see US GDP growth slowing in the second half of the year, although the consensus expects stable growth. Since then, the data released for June have shown a bigger-than-expected loss of momentum in the economy. Only consumer

confidence offered much in the way of good news in June.

While we think the economy is on a weaker growth trajectory, the June data is likely to have overstated the decline in activity. Consumer confidence remains high, regional manufacturing surveys firmed in July, and the claims data suggest that the labour market is still recovering steadily. But June's weakness has clearly raised the stakes for July's data. If the forthcoming data do not bounce back, or if they show a further loss in momentum, this would be strong evidence that the US economy is slowing more quickly than even our below-consensus expectations.

China Tightens Policy Further

Fears of an economic hard landing in China have upset equity markets this year, particularly in Asia. Following the introduction of restrictive administrative controls in May, markets have become concerned that China will also raise interest rates. The marked slowing in sequential GDP growth seen in the second quarter thus came as a relief. Beijing appears to be backing away from further tightening as evidence of slower growth gathers.

Like the US Fed, however, the People's Bank of China is hostage to the data. If July data show both strong activity and a further

rise in inflation, the central bank is likely to raise interest rates, and equity and commodity markets are likely to respond negatively. If both are softening, a rate hike will be postponed and the status quo maintained. The most difficult call will be if activity softens further but inflation continues to rise. We think the PBOC would then be forced to wait, but pressure to tighten would remain. Of course, the biggest surprise would be if China tightened monetary policy via a currency revaluation. To us it seems more likely that the PBOC will prefer to use interest rates.

Japan Generates Inflation

Since 2002, Japan's deflation has been easing steadily as strong growth has eaten into spare capacity. Japan's recovery has been longer-lived, more robust and more domestically driven than initially expected.

There is quite a good chance that Tokyo's core CPI will show a positive number in August, for the first time since 1998. Although the difference between +0.1% and -0.1% is not particularly material in economic terms, a positive inflation outcome would be symbolically meaningful, underlining the difference between the latest recovery and previous disappointments.

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Economics and Geopolitics Begin to Weigh on CEO Confidence

Geopolitical concerns and worries over the sustainability of the economic recovery have pulled down our third-quarter CEO Confidence Index. At 56.5, the general business outlook is now the weakest in a year in both the US and Europe. Our bankers cite interest rates, oil and commodity prices and 'overall geopolitical risk' as the issues most worrying their corporate clients. The decline is most notable in Europe, where, for the first time since the spring of 2003, the reading (51.8) has fallen near the key 50 level (which indicates an equal balance between those who think conditions are improving and those who think they are worsening). In the US, the reading is also the lowest since the spring of 2003, but it has fallen only to 71.9 (from 90.0 last quarter) and so remains firmly in positive territory (see page 6 for chart).

The outlook for M&A activity remains robust, despite the decline in the overall outlook. The US consolidation reading has risen to 78.1 (from 75.0), while Europe has dipped to a still-positive 64.3 (from 74.1). 'Companies are running out of growth and have strong balance sheets,' according to one European banker. A US banker echoes this, noting that companies are feeling better about their prospects and are 'flush with cash.' But the mood is not gung-ho; one European banker cautions that 'capital markets remain quite skeptical about M&A, and asset prices are quite high.' The outlook for capital spending is good in both regions, with readings of 81.3 in the US and 60.7 in Europe.

In Europe, our survey results are somewhat at odds with the economic data, which show that the recovery is at last beginning to take hold. In the US the optimistic tone appears better supported, despite the weak activity data in June. ■