

INSIDE:

A Roadmap for the US in Early 2005

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Goldman Sachs Intl.
Peterborough Court
133 Fleet Street
London EC4A 2BB
England

Jim O'Neill
jim.oneill@gs.com
+44 (0)20 7774 2699

Sandra Lawson
sandra.lawson@gs.com
+1 212 902 6821

Roopa Purushothaman
roopa.purushothaman@gs.com
+44 (0)20 7774 5061

www.gs.com/ceoconfidential

The Economic Outlook for 2005 and Into 2006

Despite a slowdown from 2004, we expect respectable world economic growth and tame inflation in 2005. The key story to watch will be the rebalancing of the US trade deficit

As 2005 begins, we are relatively optimistic about the world economy. We are forecasting above-trend global GDP growth and expect the slowdown that has been underway since last summer soon to give way to a renewed pickup. For the world as a whole, we are forecasting 3.8% real GDP growth this year and a slight rise to 4.0% in 2006. While both years will be slower than the 4.8% we expect in 2004, they will still be slightly above the 3.7% trend of the past two decades. We see the first quarter of this year as the weakest of the next eight, with growth of around 3.6% and a modest acceleration to follow.

Inflation will not be a major concern this year, but it will move more decisively onto the radar screen in 2006. We expect the US Fed to move back closer to a 'neutral' policy stance in the face of strong economic activity and an upward creep in core inflation; our forecast is for the Fed funds rate to reach 3.0% by mid-year and 3.5% by yearend, from 2.25% now. Inflation could, however, move higher than we expect if we were to see further slowing in productivity growth, higher commodity prices and intensified dollar weakness. The prospect of a new Fed Chairman in early 2006 could make markets more jittery than they might otherwise be.

In Europe, core inflation should fall to 1.5% from 2.0% last year, further strengthening the case for a 50bp rate cut by mid-year—more than the market currently expects. In Japan, where deflation is at last coming to an end, the Bank of Japan has made it fairly clear that there will be no change in the interest rate policy until 2006.

Our forecasts should be supportive of equity markets and less helpful for bonds and for the US dollar.

The Year of Global Rebalancing?

The world economy has been unbalanced for several years, with the US still acting as the main engine of global growth, and the US consumer doing most of the work. We have long hoped for a more sustainable dynamic, in which US corporates would take some of the burden from the consumer, and Europe and Japan would generate sufficient domestic demand to put their own recoveries on a stronger footing.

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GS GDP Forecasts			
real GDP, %yoy	2004	2005	2006
US	4.4	3.4	3.1
Euroland	1.8	1.5	2.0
Japan	3.1	1.8	3.0
UK	3.0	2.7	2.7
China	9.7	8.1	8.5
Asia ex Japan	8.3	6.8	7.4
Latin America	5.6	4.1	3.7

GS Inflation Forecasts			
CPI, %yoy	2004	2005	2006
US	2.7	2.6	2.5
Euroland	2.1	1.7	1.5
Japan	-0.2	-0.1	0.4
UK	1.3	1.7	2.1
China	3.9	2.6	3.5
Asia ex Japan	3.8	3.0	3.5
Latin America	6.7	5.9	5.0

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We think 2005 may finally be the year in which the world economy turns a corner. This year should see the long-awaited turn in the US trade deficit, which has risen from 1% of GDP in 1994 to about 5% of GDP in 2004, in the process slicing about 0.5% per year from US real GDP growth. To offset this, US domestic demand has had to grow by a similar 0.5% faster than potential to keep total output close to trend and inflation stable.

We now think the dollar has fallen enough that the trade deficit should start to turn. With the dollar down some 16% from its peak in early 2002 on a trade-weighted basis, our models suggest that the deficit should start to improve soon. While the recent release of November's record deficit underscores the notion that this is forecast, not fact, two key bilateral balances—with Europe and Canada—already seem to have turned. Improvement in both should accelerate throughout 2005. The pace of trade deterioration with China should also begin to slow this year as US demand slows.

GS Interest Rate Forecasts					
3 month rate, %	Current	3-Month Horizon		12-Month Horizon	
		Forward	Forecast	Forward	Forecast
US	2.6	2.9	3.1	3.6	3.8
Euroland	2.2	2.2	2.1	2.6	1.8
Japan	0.1	0.1	0.2	0.2	0.4
UK	4.8	4.9	5.0	4.8	5.3

We therefore see continued dollar weakness as helpful to the global economy. Our forecasts are for the dollar to fall a further 2.4% on a trade-weighted basis over the next 12 months, reaching \$1.40 against the euro and 95 against the yen. Notably, our forecasts incorporate an expected revaluation in China, which would stimulate a broader currency appreciation across Asia and take much of the pressure off the euro.

The US Adjustment

The US economy is operating at close to full employment. If trade does start to improve, then growth will need to slow to well below trend (or potential), in order to prevent overheating. In concrete terms this means that real GDP growth needs to slow from the 4% pace of the past year to about 3%. Particularly if foreign trade begins to turn, domestic demand will need to slow even more sharply—to about 2.75% from 4.5%.

How will this adjustment occur? It seems unlikely that households will 'voluntarily' reduce their spending and increase their savings—even though we would like this to be the case, given that we see consumer finances as stretched from a long-term perspective. Financial conditions have eased recently, oil prices have fallen, house prices are still rising strongly, consumer confidence is increasing and the labor

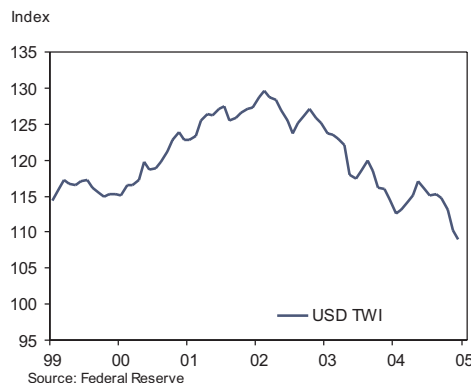
market is improving. All of this suggests that the consumer spending spree that has sustained the world for the past few years is unlikely to abate without a strong push.

The trigger for a slowdown in domestic demand is likely to be tighter financial conditions. This would involve a combination of higher short rates (to 3.5% by year-end), a rise in bond yields by about one percentage point, further dollar weakness and an increase in stock prices that is in line with nominal GDP growth. If bond yields did not rise in the face of Fed tightening, this would raise the risk of inflationary pressures in 2006 and beyond, meaning that the Fed might tighten more aggressively now.

We think households are more likely to bear the brunt of this spending adjustment than are corporates. Household spending, particularly residential investment, is much more interest-rate sensitive than is business spending, and households are more vulnerable to a decline in the availability of credit than is the US corporate sector, which is currently able to finance all of its investment spending through internal funds. Households are also more vulnerable to a weaker dollar.

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Trade-Weighted Dollar Sharply Off Its Peak



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Europe: Restructuring Will Weigh on Growth

Euroland's recovery suffered a sharp loss of momentum last summer that only now appears to be stabilizing. Although 2004 was a better year than the previous two, it was a disappointment in the context of above-trend growth globally. Barring a strong upswing in global growth, Euroland's real GDP growth once again looks set to remain below potential in 2005.

Consumption and investment spending have both disappointed, despite healthy corporate balance sheets and record-low real interest rates. Firms have remained extremely cautious in their hiring and investment decisions, which weights heavily on consumer sentiment. It appears that European firms are going through a deep restructuring process that is unlikely to end soon.

The strength of the euro—which we expect to persist throughout the year—does not help matters. Although it will help to push inflation lower, it will also depress trade and hinder job creation. Firms will have no choice but to cut their costs aggressively. In the long run, corporate restructuring will boost productivity and restore profit growth. But over the near term, it will hurt domestic demand.

We expect the ECB to respond to slower growth by cutting rates 50bp in the second quarter. The ECB has begun to tame its hawkish rhetoric and is likely, over the next few months, to respond to disappointing growth and inflation that is well below its price target. With inflation settling at 1.5%, a 50bp cut in rates to 1.5% would keep real interest rates at

zero for a bit longer, helping to push domestic demand back on track. We think the ECB will ultimately act in a pragmatic way to encourage growth.

Japan: An End to Deflation in Sight

We see the recent slowing in Japan as a 'soft patch' rather than a significant setback. Our forecasts call for the business cycle to regain momentum from this spring, driven by export growth to China, a recovery in capital spending and improved consumer spending. The stronger labor market and higher corporate profits should bolster domestic demand. The expansion should continue to accelerate into 2006, when real GDP growth is forecast to reach 3.0% as deflationary pressures subside.

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GS Exchange Rate Forecasts					
exchange rate	Current	3-Month Horizon		12-Month Horizon	
		Forward	Forecast	Forward	Forecast
EUR/\$	1.35	1.35	1.35	1.36	1.40
\$/¥	103	102	98	100	95
£/\$	1.90	1.89	1.86	1.87	1.86

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An end to the Bank of Japan's quantitative easing policy is slowly coming into sight. We do not expect any formal move until the fourth quarter of 2006, but we think markets will begin to prepare for the shift, and yields will begin to rise, as core CPI turns positive late this year.

What Would Surprise Us?

While there are always risks to the upside, we think the downside risks to our world GDP forecasts are greater this year. Several indicators, including our own Global Leading Indicator, suggest that growth may already have slowed more than the markets currently have factored in. Other downside risks include:

Weaker growth in the US, driven by a larger-than-expected slowdown in consumer spending or by further weakness in business investment. In either case, the Fed would likely stay on hold rather than tighten rates.

Corporate caution. Corporate risk appetite appears to be on the rise, as reflected in better investment spending, faster job creation and more M&A and IPO issuance. But corporates remain cautious and are still running a financial surplus in the US.

A disorderly fall in the dollar. As we discussed above, we think the dollar's fall has been good for the world economy. In fact we think a further 15% decline over time is needed to put the US current account on a sustainable footing. But a disorderly sell-off would clearly rattle financial markets. On the flip side, a strong dollar this year would increase the chances of an abrupt adjustment to the US current account in 2006, which would also be negative for the world.

There are of course risks to the upside as well. An important one is stronger growth in Germany. German underperformance has been a striking feature of the European economic scene in recent years. In particular,

German firms have had to adapt to a higher cost of capital as banks have sought to improve margins. Recent business and consumer surveys have, however, surprised to the upside, and the competitive position of the German economy has improved considerably. Investment spending could turn up this year, boosting domestic demand. This would be helpful for Euroland—but might persuade the ECB not to cut rates.

Other—less likely, in our view—upside risks include stronger-than-expected investment spending, higher consumer confidence and sharply lower oil prices.

Geopolitical events offer scope for both downside and upside surprises. A quick laundry list of flash points—including Iraq, Iran, Israel/Palestine, Korea etc.—might suggest that the risks are skewed to the downside. But the difficulty in envisioning a positive outcome means that any turn for the better could provide a significant boost to confidence and to equity markets. ■

A Roadmap for the US in Early 2005

The key theme for the US economy this year will be the transition private spending as the driver of growth to trade improvement. We expect the US consumer to do most of the adjusting and to rely more heavily on labor income to finance the spending increases that do occur. Some evidence of this should begin to emerge in coming months. Our roadmap for early 2005 will look for:

1. Stabilization, if not a slight reduction, in the US trade deficit, particularly in the second half.

2. A modest acceleration in capital goods orders. The fundamentals for business spending are good, and the US exports a lot of capital equipment. If trade is set to improve, then it should show up as fatter order books for US capital goods manufacturers.

3. Sideways movement in the ISM index and a modest acceleration in industrial production.

4. Stagnation in vehicle sales and smaller gains in non-auto retail sales.

5. A modest downtrend in housing starts and sales.

6. A modest pickup in payroll gains, to about 225,000 per month in the first half from an average of 168,000 over the past six months and 186,000 over the past 12. We also expect steady performance of jobless claims, around the current 345,000 level.

7. Steady year-to-year core inflation of about 2.2% in the first half. ■