

**INSIDE:**

**CEO Confidence Stumbles**

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## Worries About Global Growth Intensify

**Asset markets are increasingly worried about the global growth outlook, and our proprietary indicators are pointing to slower growth ahead. But not all the news flow is bad. More balanced growth would be better for the world economy, even if it is a bit weaker.**

The major theme across asset markets over the last few weeks has been renewed concern about global economic growth. These concerns accelerated following unexpectedly weak US data for March and signs of slowing momentum elsewhere.

Two of our own proprietary indicators also reflect weakness, having returned to levels last seen in the spring of 2003. Our Global Leading Indicator (GLI), which provides an early look at the global industrial production cycle, stands at less than a third of its level a year ago. Monthly momentum has stabilized, but if the GLI does not rise in coming months, this will signal slower growth ahead. Our CEO Confidence index has also tumbled. After a strong reading in the first quarter, it now points to an even balance between those who think the business outlook is improving and those who think it is worsening.

The acceleration in growth seen at the start of the year has clearly come to an end. Yet not all of the evidence is bad. In the US, the labor market looks healthy, housing sales have held up well, financial conditions remain relatively loose and persistently low bond yields are providing a cushion against headwinds from elsewhere. Oil prices, though still high, are down more than 10% from their early April highs. China shows few signs of slowing, and

we are far more optimistic than most about the prospects for a sustainable recovery in Japan.

### Growth May Weaken Further

Having fallen steadily for the past year, our Global Leading Indicator has reached its lowest level since June 2003. We had expected to see signs of improvement by now. There is some good news from our monthly momentum reading, which suggests that the outlook has not taken a sharp turn for the worse in recent weeks.

Stabilization is not enough, however. If the GLI does not improve from here, it will be consistent with a further slowdown in growth over the next few quarters. In fact mere stabilization would imply global industrial production growth falling to 2% by late summer and global GDP growth falling to about 2% by the end of the year. This is much worse than we currently forecast—and worse than the market has priced in.

We estimate that markets have already priced in US growth in the range of 3% for this year and next. Anything much worse than this could trigger a further market fall.

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### GS Economic Forecasts

% change year-on-year	GDP			CPI		
	2004	2005	2006	2004	2005	2006
<b>US</b>	4.4	3.4	3.1	2.7	3.0	2.6
<b>Euroland</b>	1.8	1.1	1.7	2.1	1.8	1.2
<b>Japan</b>	2.7	1.6	3.0	0.0	-0.3	0.2
<b>China</b>	9.5	8.8	8.5	3.9	2.6	3.5

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### CEO Confidence Also Stumbles

Further discomfoting news comes from our second-quarter CEO Confidence Index, which has also fallen to its lowest level in two years. While clearly disappointing on the surface, the details of our survey are less gloomy, suggesting that the outlook is fading rather than crumbling. *Full details of the survey are on page 4.*

### US Weakness Should Be Short-Lived

Unexpectedly weak data in March recently led us to cut our second-quarter GDP growth forecast to 3.0% from 4.0%. This has not changed our longer-term outlook, however. We still expect growth to stay close to 3% through the end of 2006. Our views on monetary policy and interest rates have also not changed. We still expect steady interest rate tightening to 4% by year-end and expect 10-year bond yields to reach 5% by early autumn.

Recent weak data are likely to be transitory. In fact, April's nonfarm payroll data shows that the March weakness did not hurt the labor market. The drivers of US growth—consumer and capital spending—have

not changed materially. The labor market looks solid, and house prices are still climbing, which should help keep consumer spending on track.

On the corporate front, all signs point to strong capital spending ahead. Annualized growth in the capital stock, at about 2%, is still well below the growth rate of real GDP, and the return on capital is still fairly high. Cash flow for the corporate sector as a whole is roughly equal to gross investment. Most companies that need external funds still have good access to credit, either from banks or in the capital markets.

Financial conditions, our preferred measure of assessing the impact of monetary policy, remain key to the economic outlook. Repeated interest rate hikes have failed to tighten financial conditions—which is highly unusual. Interestingly, the index did tighten in March, driven by rising US bond yields and soggy equity markets.

This may be one explanation for the weakness in first-quarter growth: high levels of personal indebtedness may mean that tighter financial conditions have a quicker and bigger impact on the economy than in the past. Nonetheless, the tightening has stalled in recent weeks, as a reversal in bond yields has offset weakening equity prices. Pressures on consumers have thus lessened.

Key factors to watch in coming months are core retail sales, orders for capital equipment and housing starts. The latter two will need to rebound quickly if our fundamental view is to remain intact. Any signs of deterioration in the labor market will also be critical.

### Japan: Recovery Ahead, At Last?

Despite a string of disappointing data

releases in Japan, we still expect well-above consensus real GDP growth of 1.6% this year and 3.0% next year. Our optimistic call turns on three factors: an expansion in consumer spending; strong export growth, particularly to China; and a recovery in capital spending in the non-manufacturing sector.

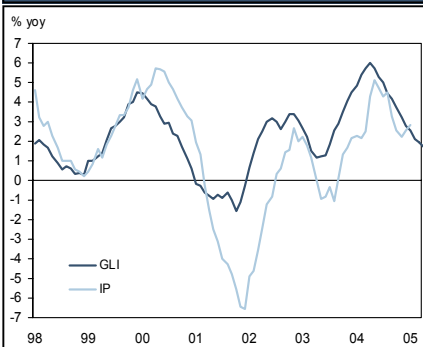
Of these three, the most important is consumer spending, which has been depressed by lingering deflation. Recent labor market data, fortunately, point to higher spending in coming months. Domestic reflation would also greatly improve the outlook for consumer spending. Signs of rising land prices and higher inflation expectations are therefore encouraging signals that reflation may soon be at hand. The first-quarter GDP figures to be released mid-month will provide an important clue as to whether Japan can in fact embark on a self-sustaining recovery this year.

### China: Revaluation At Any Time

China remains one of the bright spots in the global economy. GDP growth has accelerated after a policy-induced slowdown in mid-2004. Export growth is rising while domestic demand continues to grow strongly. Inflation pressures look likely to rise again after dipping last year.

Financial markets are squarely focused on the likelihood of a Chinese currency revaluation. Our view is that a revaluation makes sense not only from a political standpoint but—more importantly—from China's domestic economic standpoint. A currency shift would give the government more scope to address domestic imbalances: re-emerging inflationary pressures, overinvestment and overly accommodative financial conditions.

**GS Global Leading Indicator at Its Lowest Point in Two Years**



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Political and economic pressures for a revaluation are now coming to a head, and the revaluation could happen at any time. The most likely scenario is that China will peg the RMB against a basket of currencies, with an effective move against the dollar of 2%-3% initially, rising to 5%-10% within a year. Even a 5% appreciation in the real exchange rate would go a long way toward reducing most of China's trade surplus, given the economy's high level of openness and price-sensitivity.

### More Disappointments in Euroland

Euroland remains the most disappointing player in the global economy. Industrial output in the first quarter was flat, and preliminary surveys suggest continued weakness in the second quarter. Net trade is contributing positively to growth, but this reflects falling imports rather than rising exports. High oil prices and the overvalued euro are still preventing a pickup in industrial activity.

Accordingly, we have cut our GDP growth forecasts for this year and next to 1.1% and 1.7% (from 1.4% and 1.9% previously). This is well below potential growth, which we estimate to be 2.0%. Nonetheless, we do not expect this downturn to accelerate into a recession. Non-industrial sectors will remain strong, thanks to low interest rates and the benefits of past reforms.

The pickup in Euroland domestic demand that we have long awaited still shows no signs of materializing. Europe is sorely in need of policies that encourage demand. Government efforts at reform have focused on supply-side improvements to encourage corporate restructuring, reduce rigidities in the labor market and improve social security systems. While these are all critical for Europe's long-term growth prospects, they are weighing on consumer sentiment and spending. More stimulative fiscal policy, more active management of the exchange rate and looser monetary policy would all help to balance the economy and boost growth.

We have raised our inflation forecasts slightly due to higher oil prices, but even so it will remain tame at just 1.8% this year and 1.2% in 2006. Despite the ECB's steadfast refusal to consider cutting rates, we continue to see a cut as not only essential but likely. We forecast a 50bp cut, to 1.5%, in the third quarter.

### More Balanced World Growth?

We continue to hope that global rebalancing will play out this year, with domestic demand in Japan and even Europe accelerating in order to relieve the pressure on the US and China to drive global growth. In this sense, disappointments in export-led growth are part of the process of global rebalancing and should help to spur a shift to domestic-led growth outside the US. More balanced growth—even if it is weaker—might set the course for a more sustainable longer-term economic outlook. ■

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## CEO Confidence Stumbles

**Our CEO Confidence Index has tumbled, indicating that the acceleration in growth has come to a halt. But the environment appears to be weakening at the margins rather than crumbling.**

Our CEO Confidence Index indicates that the improvement in the business outlook seen since last fall has clearly come to a halt. After an extremely strong reading early in the year, the index now stands at 50, the dividing line between ‘conditions are improving’ and ‘conditions are worsening.’

But half of our respondents describe the outlook as unchanged from the first quarter—suggesting that the environment may be weakening at the margins rather than crumbling. And the outlook for M&A and capital spending is still solidly in positive territory.

This survey polls our investment bankers as to their corporate clients’ views on the general business outlook and the prospects for M&A and capital spending. We report the results as a diffusion index, with 50 as the breakpoint between ‘improving’ and ‘worsening.’

### Business Outlook Turns Cloudy

On the surface, the fall in the business outlook reading to 50 from 82 in

February sends a negative message for the world economy. The reading is lower than during the soft patch for global growth last fall and is in fact the lowest in two years. On a regional basis, the deterioration is starkest in the US, where the index falls below the key 50 threshold for the first time since the fall of 2002. Negative responses in the US clearly outweigh the positives, and comments reflect concerns about a credit slowdown and choppy economic data.

But the details of our responses paint a more complicated picture. Globally, the responses are neatly split. Half our respondents think conditions are unchanged from the high first-quarter reading—suggesting that growth remains on track. The other 50% is evenly divided between ‘better’ and ‘worse’ responses.

In other words, 75% of our bankers indicate that conditions are the same or improving. In Europe, the mood appears better than the reading of 50 suggests, with comments from our bankers pointing to ‘stable’ and ‘pretty strong’ levels of CEO confidence. In Asia, the mood is upbeat.

specific factors can support merger activity even when the macro outlook is cloudy.

Our survey points to cheap financing, the need for growth and increased participation by financial sponsors as key drivers of consolidation.

The regional divergence is again quite marked, with the optimistic M&A responses clustered in Europe and Asia. The US reading is the lowest in two years. As is typical, bankers globally expect M&A to occur among companies within the same industry (horizontal consolidation), rather than among firms at different levels of the production process (vertical consolidation). US firms are far more interested in domestic acquisitions, while European firms prefer international M&A.

### Capital Spending Outlook Is Bright

The capital spending outlook reading is the brightest part of our survey this quarter. Although the global number dipped to 71 from 81 in February, it remains strong across the board, with the US reading essentially unchanged from last quarter. Our bankers indicate that ‘capital is not a constraint for sensible capex projects.’ With balance sheet improvement largely complete and cash flow high, the prospects for a solid increase in capital spending this year are good. ■

### M&A Outlook Is More Robust

The outlook for consolidation has held up better than the overall business outlook, remaining solidly in positive territory at 66 and suggesting that the robust pace of merger activity seen since the start of the year should continue. In fact the consolidation reading has been higher than the overall outlook for most of the life of our survey, suggesting that company-

