

## Global Outlook: A Turn in the Industrial Cycle

**The second half of 2005 is likely to see an improving global environment, featuring solid, if unspectacular, growth; an end to the global industrial slowdown that has prevailed over the past few months; and steps toward monetary easing in Europe.**

Our expectation for the second half of the year is largely for more of the same: steady economic growth in the US and China, continued positive surprises in Japan, and prolonged disappointment in Europe. We think the industrial production slowdown that has marked the past few months is already coming to an end. Our interest rate views are out of consensus, as we expect the Fed to continue raising rates (to 4.0% by yearend and 4.5% by the middle of next year) and the ECB to cut rates 50bp, to 1.5%, at yearend.

Within global asset markets, we expect some reversals from the pattern that prevailed in the first half. A bear trend in global bond markets could reemerge, against the background of a stronger global industrial production, rising inflation and further Fed tightening. We also expect a period of near-term dollar strength to be followed by renewed structural weakening. Equity valuations relative to government bonds are as cheap as they have been since

the early 1980s, and in both the US and Europe, the equity risk premium is at a record high relative to the credit risk premium.

Two recent developments could be important catalysts for further shifts in asset markets. The first is the move, particularly in Europe, towards renewed easing in monetary policy. This has begun a shift toward the combination of tighter policy in the US and easier policy elsewhere that is needed to underpin global rebalancing. The second comes with signals that the global industrial cycle is steadying. Taken together, these two factors would improve the prospects for a sustainable global recovery.

### Two First-Half Surprises

Although our economic views since the start of the year have largely been borne out, two important features of global asset markets

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**Goldman Sachs International**  
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  
+1 212 902 5804

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

GS Real GDP Forecasts										
%yoy	2005	2006	2005				2006			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
USA	3.5	3.1	3.7	3.6	3.5	3.2	3.1	3.1	3.0	3.0
Euroland	1.1	1.7	1.4	1.0	1.0	1.2	1.2	1.6	1.9	2.0
UK	2.0	2.5	2.1	1.8	2.0	2.1	2.3	2.5	2.6	2.6
Japan	2.0	2.8	1.3	1.5	2.2	2.8	2.4	2.7	3.0	3.2
China	8.8	8.5	9.5	9.2	8.4	8.3	8.1	8.6	8.5	8.6

GS Inflation Forecasts										
%yoy	2005	2006	2005				2006			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
USA	3.0	2.6	3.0	3.1	3.2	2.9	2.9	2.4	2.6	2.6
Euroland	1.9	1.3	2.0	2.0	1.9	1.8	1.5	1.3	1.2	1.3
UK	2.0	2.1	1.7	1.9	2.1	2.1	2.1	2.1	2.1	2.0
Japan	-0.1	0.3	-0.2	0.0	0.0	-0.2	0.3	0.3	0.4	0.4
China	2.6	3.5	2.8	2.5	2.6	2.6	3.9	3.6	3.3	3.0

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have come as a surprise. The first is the ongoing strength in the dollar, at least against the majors; the dollar is up 11% against the euro and 8% against the yen and sterling. The second is the behavior of US long-term bond yields, which are slightly lower than at the start of the year and 45bp below the 4.64% peak reached in late March—even though, as we had forecast, the Fed has continued to tighten at every meeting.

The dollar's strength has reflected the market's focus on narrowing interest rate differentials, the relative outperformance of the US, tentative signs of improvement in the US trade balance and political uncertainty in Europe—rather than on structural imbalances in the US economy. The dollar has, however, weakened against many emerging market currencies, particularly in Latin America. On the second point, lower bond yields reflect the ongoing structural forces that have kept global savings high, as well as the slowing global industrial cycle.

In both cases, we have modified our views. Last month we changed our FX forecasts to show continued near-term strength in the dollar against the majors. While we still look for bond yields to move higher, we think the process may now be more gradual and more dependent on further signs of improvement in both the US and the global industrial cycle. In fact, Europe's industrial cycle appears to be an important influence on US yields. We also now expect rate cuts where we did not at the start of the year, including in the UK.

## Key Features of the Outlook

Key features of our macro view remain intact going into the second half of the year:

Global economic growth is likely to continue at a solid, if unspectacular, rate of roughly 3.8%. The US should record steady growth in the near-term, and we think the risk of a near-term correction to the US housing bubble is low. We expect Chinese activity to remain solid despite ongoing (and as yet unfounded) worries about a slowdown. We expect continued sluggish growth in Europe.

In our eyes, Japan is the most likely major upside surprise. We see strong growth, led by domestic demand, and expect CPI finally to turn positive at yearend. The Bank of Japan is likely move toward changing its monetary policy late this year and to raise interest rates 12 months or so later.

We look for further rebalancing in demand, with capital spending likely to outperform consumer spending, particularly in the US. Furthermore, we would look for the consumer and housing adjustment process to remain important; it has already begun in the UK and Australia and appears to be reaching New Zealand.

We think the market is underestimating the Fed's resolve to continue tightening beyond 4% and is too sanguine about the inflationary consequences of the sharp slowdown in US productivity growth. By contrast, we think the ECB will cut rates by 50bp this year, despite its currently hawkish stance.

We also believe the US balance of payments situation is ultimately unsustainable and that a further

significant and broad-based fall in the dollar will be needed to resolve it.

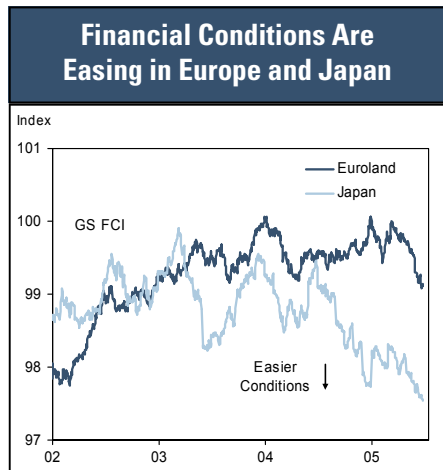
There are also some familiar risks to the outlook: higher oil prices; a larger-than-expected household adjustment causing below-trend growth in the US; another downturn in Japanese domestic demand; the lingering vulnerabilities from the outsized US current account deficit; and somewhat disappointing global investment.

Two developments that will be key to the second half outlook have begun to stir more forcefully.

## Europe Begins to Ease

First, Europe has seen a meaningful shift towards renewed easing in monetary policy. Sweden has already cut rates, and the UK is moving towards that point (we expect 25bp cuts in August and November). Speculation is growing that the ECB may also cut—albeit reluctantly—particularly if inflation falls below 1.5%, as we predict. The shift toward easing may broaden to include Australia and New Zealand.

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With the Fed increasingly an outlier in tightening and many currencies weaker against the dollar, non-US financial conditions have been easing. This is underpinning some easing in global financial conditions. In addition, the divergence between US and non-US monetary policy stance is heading in the right direction for a rebalancing of global demand—which has been sorely absent so far in 2005.

### Global Industrial Cycle Turning Positive

Second, the global industrial cycle appears to be stabilizing. Although it is still early, we think the signs point to an end to the industrial slowdown that has marked the past few months. The positive data are broad-based, and only in Europe do we still have significant doubts that any real improvement is underway (although a stronger global cycle would clearly help there). This more positive view has only just begun to be reflected in markets.

The latest signs of life are broad-based. Markets witnessed a June sweep of regional business confidence

surveys, with the Japan Tankan, US ISM and Euroland and UK PMIs all turning upward, above market expectations. Japan, the UK and the US showed a better improvement than consensus forecasts had expected, while Euroland's slight bounce was a welcome boost amid generally sluggish data.

Perhaps even more importantly, the better news has been accompanied by signs of progress in the inventory adjustment process, in particular in the US. And, finally, these positive signals take place against the backdrop of steady demand growth in the US, China and Japan.

Further encouraging evidence comes from the Asian trade cycle, which also shows signs of improvement after weakness earlier this year. And our Global Leading Indicator (GLI), which incorporates signals from these business surveys as well as Asian trade data, also suggests that a trough in the global industrial cycle may be in sight. The year-on-year figure rose in May, stopping the decline underway for more than a year, and monthly momentum also accelerated.

### Remnants of Doubt

Though these signs of hope are encouraging, they are far from uniform. Most importantly, the evidence in most cases reflects only a single month's data. Budding signs of recovery are also balanced by mixed evidence in the major regions, including soft US manufacturing payrolls; weak Japanese machinery orders and trade data; and the worst export and import growth in two years in Taiwan. Moreover, in Europe, where the signs of recovery are least evident, domestic demand remains soggy. The lack of job creation in Euroland's main economies, due to restructuring, has dampened real income growth and heightened the consumer pullback, leaving the region dependent on exports.

### Four Reasons to Believe

Yet there are four reasons why we think the current signs of stabilization presage a real recovery:

**1. Signs of recovery are broad across regions.** The fact that surveys

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in all of the major regions have improved and that Asian exports confirm some of these signals suggest that the June bounce is more than a statistical quirk. This kind of uniformity is comparatively rare.

**2. Orders drove the bounce, boding well for production.** In the UK, Euroland and the US, where breakdowns on the components of the industrial surveys are available, the rise in the indices was driven by firmer new orders. In the US, new orders bounced but export orders did not, suggesting that the bounce is domestically driven. In the UK and Euroland, export orders improved (though these include exports to other EMU countries), which is more consistent with overseas strength.

Inventory-to-sales ratios have turned down as new orders have bounced while inventories have remained under control. Although the US inventory-to-sales ratios are still more consistent with industrial stabilization rather than a significant rebound, they have begun to move in the right direction. For the US and Europe in

particular, the inventory-to-sales ratios tend to lead the broader industrial indices by a month or so.

**3. Demand growth remains solid in US, China, Japan.** The difference between shallow adjustments and more persistent industrial weakness comes largely from the behaviour of final demand. Demand growth remains solid in the US, particularly on the consumer side. This fits with the view of our US economists, who have expected the slowdown to be modest on the back of a relatively strong starting point, supportive financial conditions, and few signs of spillover into other parts of the economy.

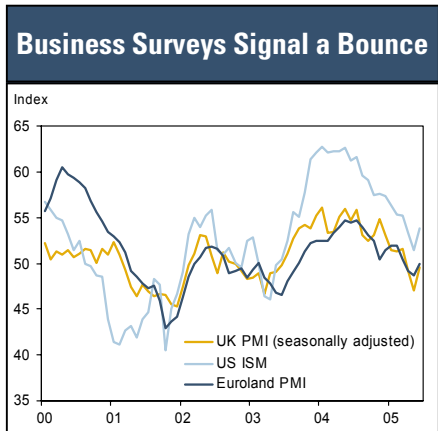
In Japan, most evidence suggests that domestic demand has remained at healthy levels through the second quarter. And our leading indicators point to continued health in Chinese growth, as non-tradable investment picks up and consumer spending continues to grow strongly. Chinese import growth appears to have bottomed out from its first-quarter trough, suggesting that inventory adjustment concerns here may also have passed. Only in Europe do we continue to see few signs of improvement in the demand picture.

While averages obscure the variation across cycles, they do suggest that there would be nothing unusual about a trough now.

### Firmer Industrial Outlook Not Yet Priced

Recent signs do suggest that the global industrial cycle is set to improve in coming months. Since the slowdown in most regions has been relatively shallow so far, any rebound is also likely to be relatively mild.

Even a modest recovery is likely to create asset market opportunities, given that markets are only just beginning to reflect the likelihood of further industrial improvement. If markets do embrace the optimistic view, cyclical equities are likely to be strong, bond yields could come under renewed upward pressure, and the shift toward easier short-term rate views that has recently dominated markets could unwind. A better global picture might also allow renewed dollar weakness against a broader group of currencies. ■



**4. The 'normal' duration of industrial slowdowns would point to an end around now.** The average peak-to-trough duration of the OECD industrial production cycle since 1993 has been 14 months; for our Global Leading Indicator it is 15 months. Given the latest peaks (May 2004 for the GLI), an 'average duration' slowdown would be expected to end in July 2005.

