

Changing Our Views

The global industrial upturn that we flagged last month is gaining traction. We have raised our US growth forecasts and now expect short-term rates to reach 5% by mid-2006. We no longer expect interest rate cuts in Euroland, though we remain cautious about the growth outlook

Last month, we flagged a nascent upturn in the global industrial production cycle. Though data at that time was limited, we were relatively confident that the industrial slowdown had bottomed. Economic data released since then has confirmed our view. In fact the second half of the year now looks as though it will post more solid growth globally. As a result, we have changed our growth forecasts in the US and our interest rate forecasts in both the US and Europe. We continue to expect strong performance in China and an expanding recovery in Japan.

US: Faster Growth Over the Next Year

Earlier this week we boosted our US economic growth forecasts for this year and next. The inventory cycle that had been weighing on US growth in recent months seems to have come to an end earlier than we had expected, and global growth continues to strengthen. This means the Fed is likely to tighten more, and we now expect to see short-term rates at 5% by mid-2006. We have not, however, significantly changed our views on inflation or long-term rates over the next 12 months.

We now expect real GDP growth to remain above its 3% potential through mid-2006. Growth should average 4.25% (annualized) in the second half of 2005 and 3.5% in the first half of 2006. Our previous estimates were 3.25% and 3.0%. For the second half of 2006, we have cut our forecast to 2.5% from 3.0%. On an annual average basis, these changes yield 3.8% growth for 2005 and 3.5% for 2006, nearly half a percentage point higher than before in both years.

Unemployment should fall to 4.5% by mid-2006, below our previous expectation of 5%. Although most of this change is due to our expectation of stronger growth, recent revisions to official data also imply slower productivity growth—which raises the possibility that unemployment could drop even further. Unemployment might then start to rise in about 18 months if growth does begin to slow again in late 2006.

We expect inflation to move up gradually, to about 2.5% by year-end 2005. This part of our outlook has not changed, nor has the basic rationale. With productivity slowing, unit labor costs have begun to trend up. In time, this is apt to put modest additional pressure on inflation. Although stronger growth could aggravate this process, wage inflation has so far remained stable, and recent inflation surprises have been to the low side.

The Fed will continue to tighten over most of the next 12 months, bringing short-term rates to 5% by mid-2006. We think the market's view—that the 'neutral' level of rates is about 4.0%-4.5% and that the Fed will stop there—is wrong.

We see the 'neutral' rate as well above 4%, given that financial conditions have remained persistently accommodative in the face of Fed tightening so far. We also think rates may well need to rise beyond 'neutral,' given the stronger growth outlook and the fact that the trade-off between output and inflation appears to be worsening. Thus we continue to think that the Fed will surprise markets by tightening for longer than most expect.

continued on page 2

INSIDE:

Japanese Elections Should Not Derail the Recovery 3

CEO Confidence Returns 4

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continued from page 1

Despite our expectation of higher short-term rates, we have not significantly changed our view on long-term yields. We see bond yields rising to nearly 5% by year-end and peaking at 5.1% around the middle of next year. Fed tightening so far has done little to raise longer-term rates. But we do expect long-term rates to fall—and the yield curve to invert—in the second half of 2006, as weaker growth convinces the market that US monetary policy has become too tight.

The major risk on the horizon is that of a downturn in the housing market that undermines consumer confidence and spending. Although the timing of a housing correction is very difficult to predict, it could emerge as a drag on growth in the second half of 2006.

Euroland: Lacklustre Growth, But No Rate Cut

We have also changed our views in Europe. For months we had held an out-of-consensus forecast that the European Central Bank would cut

interest rates in the second half of this year. Despite the ECB's reluctance to consider such a step, we had seen it as necessary to boost growth, particularly Euroland's stagnant domestic demand.

We no longer expect the ECB to cut rates this fall, however. Recent data suggest that the Euroland economy is picking up, with encouraging signs coming from both manufacturing data and business surveys. Survey data show a geographically broad-based (though moderate) rise in sentiment, which will be important if capital spending is to increase.

Our previous forecast was also guided by our expectation of further strength in the euro. In this we have been confounded: the currency is now 9% below its highs of late 2004. This has of course helped Euroland exporters and improved the growth outlook.

As a result, we now expect the ECB to remain on hold for the remainder of this year and to raise interest rates by 50bp in the second half of 2006.

Despite this rate forecast change, we remain cautious about Europe's economic outlook. Most of the manufacturing pickup appears to be due to better global conditions rather than to a stronger domestic impetus. Domestic demand remains firmly in the doldrums. Consumer confidence is weak and the labor market remains lacklustre as corporate restructuring continues.

Until domestic demand improves, the growth outlook will remain cloudy. Though we may make some 'fine-tuning' adjustments in coming weeks, our forecasts are broadly unchanged: 1.1% growth this year, with a slight rise to 1.7% in 2006.

We have also changed our UK views. Weakness in consumption means that the Bank of England, which cut rates by 25bp last week, is likely cut another 25bp in November. The cutting cycle is likely to be shallow and short-lived, however, given the support from easier financial conditions and our expectation that the consumer-led slowdown will be brief. Our growth forecasts are unchanged (at 1.9% this year and 2.3% next), but we now anticipate a rate increase in the second half of 2006. ■

Goldman Sachs GDP Forecasts										
real growth, %yoy	2005	2006	2005				2006			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US	3.8	3.5	3.6	3.6	3.9	3.9	3.9	3.9	3.4	3.0
Euroland	1.1	1.7	1.4	1.1	1.0	1.2	1.2	1.5	1.9	2.0
UK	1.9	2.3	2.1	1.7	1.8	1.8	2.0	2.2	2.4	2.5
Japan	2.0	2.8	1.3	1.5	2.2	2.8	2.4	2.7	3.0	3.2
China	9.2	8.5	9.4	9.5	9.1	9.0	8.7	8.4	8.2	8.6

Goldman Sachs Inflation Forecasts										
consumer prices, %yoy	2005	2006	2005				2006			
			Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US	3.0	2.6	3.0	2.9	3.1	2.8	2.9	2.5	2.6	2.6
Euroland	2.0	1.3	2.0	2.0	2.1	2.0	1.6	1.3	1.2	1.3
UK	2.0	2.1	1.7	1.9	2.1	2.2	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	1.7	2.7	3.0	3.9	3.6	3.3	3.0

Japanese Elections Should Not Derail the Recovery

The defeat of the postal privatization bill has thrown Japanese politics into temporary disarray, but it should not derail the economic recovery.

Our bullish view on Japan has been a key element of our global economic outlook this year. Although the defeat of the postal privatization bill has thrown Japanese politics into disarray, we do not think the upcoming elections will derail the recovery.

Both the domestic and the external sides of the recovery now appear to be on solid footing. Exports, particularly exports to China, are picking up again after a weak patch in the spring, and they should benefit further from evidence of greater momentum in the global industrial cycle. On the domestic side, the labor market is improving, and both personal consumption and private-sector capex are supporting stronger growth.

GDP growth for the second calendar quarter (out this week) will inevitably be slower than the strong pace seen in the first quarter. We expect 1.8% annualized growth, down from 4.9% in the first quarter. But we see this as

a natural slowing to a sustainable 'trend' growth rate, rather than the start of a steeper slowdown.

Our forecasts are for quarterly growth above 2% for the rest of the year, driven by strengthening exports and continued strong domestic demand.

Deflationary pressures are fading, and above-trend GDP growth will help to push core CPI into positive territory by the end of this year. This is slightly earlier than we had previously anticipated. This will not mean an immediate end to the Bank of Japan's policy of quantitative easing, but it will be an important first step. We expect to see higher interest rates in Japan in about 12 months.

Uncertainty Is Political, Not Economic

Although it is difficult to predict the results of next month's elections, we do not think they will have a

meaningful impact on the recovery. Even a new administration would be unlikely to change the focus of fiscal and monetary policies, with the (helpful) exception of postponing potential tax hikes.

At the corporate level, most of the major structural reform efforts are solidly underway. Corporations have undergone aggressive restructuring of both excess capacity and labor, and ROE is on track to hit another post-bubble record high of nearly 11% in fiscal year 2006. Within the banking sector, the disposal of non-performing loans is nearly complete.

Over the longer-term, these elections could pave the way for a more robust two-party system in Japan. This could facilitate more open debate and faster, as well as deeper, reforms in the future. ■

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CEO Confidence Returns

CEO confidence jumps as the US regains its optimism, according to our quarterly survey of corporate clients' views. Strong balance sheets, ample cash and 'the fear of being left behind' are driving M&A.

Our quarterly CEO Confidence Index bolsters our view that the global industrial cycle has turned. With the global business outlook reading swinging to 79 from the breakeven point of 50 in the second quarter, CEOs appear to have regained their confidence and are focusing once again on growth and M&A.

Last quarter, when the index stood at just 50, we noted that the environment seemed to be weakening at the margins rather than crumbling. Since then, economic data has improved and confidence has returned. The US business outlook posted the largest swing in our survey's history—from a dour 40 last quarter to a roaring 91 now—returning to levels last seen more than a year ago. In Europe, the upturn is more muted, but the mood has clearly improved, with the reading picking up from a flat 50 to 67.

This quarterly 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 conditions improving and conditions worsening.

Push and pull behind M&A. The outlook for consolidation has improved, again driven by a strong rise in the US. Bankers attribute this to both push factors—healthier balance sheets and higher cash generation—and pull factors—'peer pressure and the fear of being left behind.'

Others note that 'strong balance sheets and increasing management confidence' are visible in the

'noticeable return of strategic buyers to M&A auctions.' M&A pipelines are filling, with CEOs seeking new markets for growth and 'showing a willingness to look at larger opportunities.' European bankers also note an increase in hostile and unsolicited offers.

Expectations for vertical consolidation (mergers at adjacent stages of the production process) are unusually high. Some in the US, however, see 'a lot of looking and even discussion, but deals continue to take a long time to come to fruition.'

Our survey also flags a potential shift in US attitudes toward international M&A. In previous surveys, US corporates have shown a clear preference for domestic M&A, while Europeans (with smaller domestic markets) have favored international consolidation. This quarter, however, the US reading for international M&A has jumped to 76, a level more commonly associated with Europe and the highest reading in 18 months.

Solid reading but cautious tone on capex. Although the capex reading is strong (79 globally), particularly in the US (94), bankers' comments are tinged with a bit of caution. 'Confidence is there, transactions will follow eventually,' though there is 'still little interest in international capex' among US corporates. In Europe, where the reading is 67, bankers see a focus on capex in Asia and eastern Europe, as well as higher investment in technology, but 'not a substantial change.' ■

