

## Decoupling: Economies vs. Markets

**As the second half approaches, we take stock of the global economic outlook, focusing on the prospects for a slowdown in the US and the ability of markets—not just economies—in the rest of the world to withstand one.**

**Ed McKelvey (Senior US Economist):** On the US side, the data have come in pretty consistent with our growth outlook up until this point. Going forward, we still expect a meaningful deceleration into the 2%-2.5% range later in 2006, but I emphasize that this is still forecast rather than fact. The slowdown we have seen up to this point is probably mostly a response to energy prices, and it doesn't really either confirm or deny the likelihood of a housing-driven slowdown to the extent that we are forecasting.

Obviously the thing that has changed relative to our views at the beginning of the year is that the Fed is putting more weight on—or at least waving the flag on—inflation. Therefore, we see a slightly bigger risk that the Fed will overshoot. If our baseline forecast is in fact correct, and the Fed tightens by an extra 50 basis points, there could be a sharper slowdown toward the end of the year and into 2007. This may not necessarily culminate in a recession, but the risk of that has gone up a little bit.

On the upside, the principal risk is the one we usually have, namely, the risk of 'underselling' the consumer.

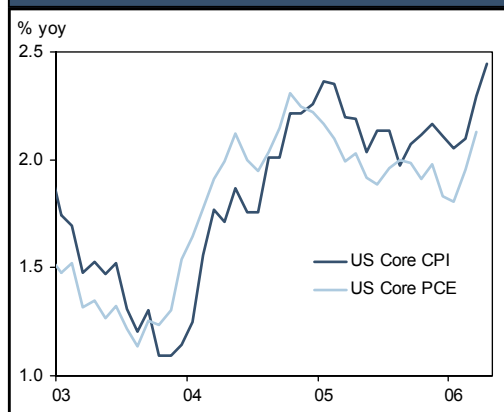
**Sandra Lawson (Senior Global Economist):** One thing we discussed at the start of the year was whether 2006 would be the year that Asia became confident, as we have long forecast, and demonstrated its ability to 'decouple' from any US slowdown. Sun Bae, you stressed in January that Asian decoupling was still more forecast than reality. How do you feel about it now as the US slowdown comes closer?

**Sun Bae Kim (Co-Director of Asia Economics Research):** Financial markets are certainly reassessing the likelihood of Asian decoupling as our US slowdown forecast comes closer to being reality. I don't think there is any reason to jettison the baseline case—that Asia should be able to weather a meaningful slowdown in the US, from about 3.5%-4% to something like 2%-2.5%. We are staking our bets on Asian domestic demand to increasingly take the front seat in driving regional growth. The evidence so far supports our case, especially in the larger Asian economies, namely China, Japan and Korea.

A more severe slowdown in the US, something that could involve a recession, would be somewhat more difficult. But that is not our baseline case from here.

**SL:** One critical issue for decoupling, as well as for global asset markets, is whether the Bank of Japan can end the zero interest rate

### Core US Inflation On the Rise, Increasing Risk of Fed Overshooting



*continued on page 2*

**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

## Decoupling: Economies vs. Markets

*continued from page 1*

policy smoothly.

**Tetsu Yamakawa (Co-Director of Asia Economic Research):** That really depends upon to what extent the view would be tightening from fear. Our main scenario is that we will see a 50 basis point hike by the end of this year and another 50bp by middle of 2007. Even with 100bp by next summer, Japanese monetary policy will still be accommodative.

That said, there have been a lot of similarities between what happened in the market since Japan announced the end of quantitative easing and when Japan ended the zero interest rate policy in 2000, despite the improving fundamentals since 2000. As financial markets have been discounting the possibility of a policy shift, the risk premium has been rising quite sharply. This will lead to adjustment in other markets despite the improving fundamentals.

This is something that the BoJ will need to pay close attention to when it ends the zero interest rate policy. We expect that they will do this in July or possibly August, but it will depend on whether the market stabilizes.

**Jim O'Neill (Head of Global Economic Research):** There's another risk worth considering, one we didn't think about in the past regarding Japan. What if Abe does not win the election, and the fiscal conservatives win, leading to strong pressure to introduce a sizeable consumption tax? Would we find, in contrast to what we have hoped, that Japan is still dependent on foreign demand for growth leadership?

**TY:** The consumption tax hike is not likely to happen until 2008 or 2009, regardless of who is prime minister. Japan has also seen a sizeable improvement in the fiscal balance over the past two years, mainly on the back of the improvement in tax revenue both on the corporate side and on the household side. This will give the government more freedom in terms of the timing of the consumption tax hike, even if the economy does deteriorate on the back of some unanticipated shocks. So we do not see this as a big stumbling block for monetary policy.

At the same time, judging from the economic indicators, mainly in capital expenditure, there are more and more convincing signs that the economy is being driven by domestic demand. This should provide support if the US slows, especially if the US is able to manage a soft landing.

**Nicolas Sobczak (Senior European Economist):** In Europe we too think the economy could easily weather a US slowdown, especially one driven by US consumer spending and housing. This is in large part because Euroland exports are predominantly directed toward Western and Central Europe, Russia, the Middle East and Asia, where we see no fundamental clouds. The strong upturn in business investment in Germany is an

important driver, though it is true that the consumer remains weak.

There is still the risk, though, that policy mis-management could erode the European recovery. The well-known lack of coordination means that the combination of tighter fiscal and monetary policy could turn over-restrictive in the next 12 months. And the exchange rate policy remains a weak spot, since responsibility is shared among the ECB and 12 governments. Any undesirable appreciation could prove a serious handicap for European growth.

**SL:** How much does BoJ tightening matter to markets elsewhere?

**JO'N:** I think it is—as always—the amount of collective G7 tightening that matters, not just what any one of the major central banks does. I do not believe this prevalent idea that the BoJ terminating quantitative easing has been a core factor behind why markets struggled in May and early June. I think it is more the collective amount of G7 tightening and the prospect of G7 tightening against the background of some concerns about inflation globally and some panicked risk reduction amongst leveraged financial market participants. If one of the new fears, in the US more than elsewhere, is that the Fed is going to have to go to 6%, then that is something which I don't think is factored into our or market prices yet.

**Dominic Wilson (Director of Global Macro and Markets Research):** Echoing that, it seems to me that laying the burden of market weakness on Japanese tightening is a stretch. It strikes me that there are a couple of things that have changed and that the market is wrestling with. As we noted

*continued on page 3*



## Decoupling: Economies vs. Markets

*continued from page 2*

at the start of the year, markets were already priced for pretty benign outcomes, and I think that they are coming to terms with that as we begin to see signs of slowing in the US and greater concerns about inflation. Earlier this year a lot of markets had pretty narrow risk premia and low volatility. As the cycle matured it was natural to expect some of that benign pricing would begin to unravel.

Growth expectations have been very high, particularly in terms of the way US growth has been priced into a lot of asset markets. Although we have obviously seen that scaled back over the last couple of months, market expectations are still pretty generous relative to views of how the US slowdown may play out. It is not clear to me that the market is yet at a point that is consistent with the kinds of forecasts we have for the US, so there is still ongoing risk.

I think the point that both Ed and Jim

made about the nature of rate hikes changing is critical to understanding what has been going on. When rates were going up because growth was good, that was a much more digestible backdrop for riskier assets. Things look different now, when rates may be going up largely because inflation is a problem. That is going to be the dilemma that we continue to wrestle with over the next couple of months.

**EMcK:** I would note that US inflation really does not reflect an underlying degree of strength—particularly in labor costs. So any further US tightening is not so much a response to genuine inflation, but a response to perceived inflation or an effort to shore up credibility, if you will. So one might argue that tightening could do a little more damage to the economy. If the underlying trend isn't as robust as one might generally associate with a pick-up in inflation, then the response will increase the downside risk. This is a 6-12 month risk rather than an immediate risk.

**SL:** What other risks should we watch for over the next six months?

**JO'N:** I think the risk is that the US slows and the rest of the world turns out to be more dependent on US growth leadership than we currently believe. That is obviously a big risk, because what we are forecasting is something that hasn't really happened in the last decade. Recent evidence to support our view of strength in the rest of the world has actually been pretty good. The Chinese retail sales dates are showing acceleration, which is particularly important. But we need to see more of that.

**EMcK:** I think you need to see more of that in the context of a more genuine slowing in the US.

**JO'N:** I agree with you.

**Francesco Garzarelli (Director of Global Macro and Markets Research):** That is one of the problems we have on the fixed income

*continued on page 4*

Copyright 2006 The Goldman Sachs Group, Inc. All rights reserved.

This material should not be construed as an offer to sell or the solicitation of an offer to buy any security in any jurisdiction where such an offer or solicitation would be illegal. We are not soliciting any action based on this material. It is for the general information of clients of The Goldman Sachs Group, Inc. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual clients. Before acting on any advice or recommendation in this material, clients should consider whether it is suitable for their particular circumstances and, if necessary, seek professional advice. The price and value of the investments referred to in this material and the income from them may go down as well as up, and investors may realize losses on any investments. Past performance is not a guide to future performance. Future returns are not guaranteed, and a loss of original capital may occur. The Goldman Sachs Group, Inc. does not provide tax advice to its clients, and all investors are strongly advised to consult with their tax advisers regarding any potential investment. Certain transactions - including those involving futures, options, and other derivatives as well as non-investment-grade securities - give rise to substantial risk and are not suitable for all investors. The material is based on information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied on as such. Opinions expressed are our current opinions as of the date appearing on this material only.

We endeavor to update on a reasonable basis the information discussed in this material, but regulatory, compliance, or other reasons may prevent us from doing so. We and our affiliates, officers, directors, and employees, including persons involved in the preparation or issuance of this material, may from time to time have "long" or "short" positions in, act as principal in, and buy or sell the securities or derivatives (including options) thereof of companies mentioned herein. For purposes of calculating whether The Goldman Sachs Group, Inc. beneficially owns or controls, including having the right to vote for directors, 1% of more of a class of the common equity security of the subject issuer of a research report, The Goldman Sachs Group, Inc. includes all derivatives that, by their terms, give a right to acquire the common equity security within 60 days through the conversion or exercise of a warrant, option, or other right but does not aggregate accounts managed by Goldman Sachs Asset Management. No part of this material may be (i) copied, photocopied, or duplicated in any form by any means or (ii) redistributed without The Goldman Sachs Group, Inc.'s prior written consent.

The Global Investment Research Division of Goldman Sachs produces and distributes research products for clients of Goldman Sachs, and pursuant to certain contractual arrangements, on a global basis. Analysts based in Goldman Sachs offices around the world produce equity research on industries and companies, and research on macroeconomics, currencies, commodities and portfolio strategy.

This research is disseminated in Australia by Goldman Sachs JBWere Pty Ltd (ABN 21 006 797 897) on behalf of Goldman Sachs; in Canada by Goldman Sachs Canada Inc. regarding Canadian equities and by Goldman Sachs & Co. (all other research); in Germany by Goldman Sachs & Co. oHG; in Hong Kong by Goldman Sachs (Asia) L.L.C.; in Japan by Goldman Sachs (Japan) Ltd; in the Republic of Korea by Goldman Sachs (Asia) L.L.C., Seoul Branch; in New Zealand by Goldman Sachs JBWere (NZ) Limited on behalf of Goldman Sachs; in Singapore by Goldman Sachs (Singapore) Pte. (Company Number: 198602165W); and in the United States of America by Goldman, Sachs & Co. Goldman Sachs International has approved this research in connection with its distribution in the United Kingdom and European Union. This material has been issued by The Goldman Sachs Group, Inc. and/or one of its affiliates and has been approved for the purposes of section 21 of the Financial Services and Markets Act 2000 by Goldman Sachs International, which is regulated by the Financial Services Authority, in connection with its distribution in the United Kingdom, and by Goldman Sachs Canada, in connection with its distribution in Canada. Goldman Sachs International and its non-US affiliates may, to the extent permitted under applicable law, have acted on or used this research, to the extent that it relates to non-US issuers, prior to or immediately following its publication. Foreign-currency-denominated securities are subject to fluctuations in exchange rates that could have an adverse effect on the value or price of, or income derived from, the investment. In addition, investors in securities such as ADRs, the values of which are influenced by foreign currencies, effectively assume currency risk. In addition, options involve risk and are not suitable for all investors. Please ensure that you have read and understood the current options disclosure document before entering into any options transactions.

Further information on any of the securities mentioned in this material may be obtained on request, and for this purpose, persons in Italy should contact Goldman Sachs S.I.M. S.p.A. in Milan or its London branch office at 133 Fleet Street; persons in Hong Kong should contact Goldman Sachs (Asia) L.L.C. at 2 Queen's Road Central; persons in Australia should contact Goldman Sachs JBWere Pty Ltd. (ABN 21 006 797 897), and persons in New Zealand should contact Goldman Sachs JBWere (NZ) Ltd. Persons who would be categorized as private customers in the United Kingdom, as such term is defined in the rules of the Financial Services Authority, should read this material in conjunction with the last published reports on the companies mentioned herein and should refer to the risk warnings that have been sent to them by Goldman Sachs International. A copy of these risk warnings is available from the offices of Goldman Sachs International on request. A glossary of certain of the financial terms used in this material is also available on request. Derivatives research is not suitable for private customers. Unless governing law permits otherwise, you must contact a Goldman Sachs entity in your home jurisdiction if you want to use our services in effecting a transaction in the securities mentioned in this material.

## Decoupling: Economies vs. Markets

*continued from page 3*

side. The markets that seem to find support from the domestic side, because real rates are closer to their neutral levels, are the English-speaking ones. These markets are finding it difficult to rally because growth is still strong globally. This is prompting monetary adjustment elsewhere, as Jim said earlier, which in turn requires a higher expected return in these markets.

I think the jury is still out on the pace of deceleration of US growth. I fully agree with the forecasts that we have for the US consumer—the fundamentals if anything look much more stretched than at the beginning of the year—but we haven't really tested the consumer slowdown yet. The data on profits we track for our work on credit use has been extremely good. On the inflation side we are not seeing a genuine deterioration, though data have become a bit more mixed than they were this time last year.

Putting it all together I think the risk may be that G7 central banks will have to do more than markets now anticipate before we can confidently re-enter long positions on rates. And

again that is not in the forwards.

**SL:** Ed, any thoughts on the specter of the Fed at 6%?

**EMcK:** Obviously we can't rule it out. I think it is extremely unlikely unless the growth numbers show a pretty significant rebound. Certainly if we saw a 6% funds rate then the economy would be really set to weaken in 2007.

**DW:** I agree. I think the issue of decoupling which is embedded in our forecast is absolutely critical. I think there are two layers of worry that you can have about that. The first is whether the economies in the rest of the world can decouple if the US slows down. This is clearly the primary source of concern at the moment. The second is whether markets can decouple in these economies even if it is only the US that slows. One thing the last couple of months might have highlighted is that everyone's markets are vulnerable to US growth and rate views to some degree, even if their economies are doing quite well.

**NS:** This is particularly true in Europe. It is striking to see that European equity markets are even more leveraged to US growth than the US equity market itself! And the effects would be felt in the real economy as well. A strong correction in global equity markets would dampen business confidence in Euroland and would risk stopping the investment cycle and the gradual consolidation of the labor market. More generally, a rise in risk premia and a widening in credit spreads may affect European companies, which have strongly increased their leverage in recent years. Banks may also turn less prone

to distribute easy credit to households.

**JO'N:** While Dominic's argument is true in most markets, one of the most interesting things is the fact that the Chinese market has not suffered. The Chinese stock market has held up better than most overseas indices since early May, and there is also evidence that Chinese demand is accelerating.

**DW:** I agree, but it's also true that the insulation didn't spread very far. Korea and Japan have gotten a lot less protection from China than you might think.

My other worry turns on the notion of financial risk and the problems of leverage. It's not clear how well people are prepared for more persistently higher volatility and for changes in the incredibly benign financial environment we have been in. This has to be more of a concern now than six months ago.

**JO'N:** The good way of looking at this is that credit spreads and CDOs haven't blown up. The not-so-good way is that this still could happen.

**FG:** That is exactly the impression we have, looking at the corporate statistics from the macro side. Credit shows a higher sensitivity to growth changes than the risk to inflation/interest rate changes. From the micro side, it seems that most of the propositions that have been financed are usually immunized for interest rate risks of some magnitude, but are predicated on the view that growth and the cash flow associated with the growth will continue for years to come. That view may be drawn into question, at least in the near term, should the US slow more rapidly than we project right now.

**Similar Nikkei Reaction to Monetary Tightening in 2000 and 2006**

