CEO CONFIDENTIAL

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A Happy Slowdown?

We forecast a 'happy' slowdown for the rest of 2006 and into 2007, as strong domestic demand in Japan, the BRICs economies and Europe helps to offset a housing-driven US slowdown.

As we enter the tail end of the year, we take stock of our forecasts for the world economy for 2006 and 2007. Our forecasts suggest some softening of world growth, led by weaker domestic demand in the US. We see this as a 'happy' slowdown because we expect some improvement in the US external position that will partially offset the slowing in US demand. This would allow US real GDP to rise more than demand, while the softening of demand would allow the modest inflationary pressures that have built up to ease gradually.

Elsewhere, we also see growth slowing modestly in the Eurozone in response to the demand slowing in the US. More importantly, we expect 2007 domestic demand to remain strong in China, and to accelerate in Japan and the BRIC economies collectively. As part of this happy scenario, we project that the contribution to world demand from Japan and from the BRICs will likely exceed that of the US from now through 2007. We forecast that global inflation will ease modestly, in line with softer US domestic demand, helped by more stable energy prices, although inflation is likely to accelerate in China and Japan.

Our overall forecasts do not differ significantly from consensus expectations. Indeed, the fact that both our GDP and inflation forecasts for the world as a whole are close to market consensus is a signal that unexpected developments could influence markets. Our forecasts now differ most from consensus primarily in three areas (and possibly an important fourth);

- Our forecast for slowing US demand results in a weaker GDP forecast than consensus (2.4% in 2007 vs. 2.7%).
- We expect the Fed to cut short-term rates by a total of 125bp by the end of 2007 – much more than is priced in by the futures markets.
- Although the gap has narrowed, our projections for real GDP growth in Japan, led by very strong demand, remain notably higher than the consensus.
- The possible fourth difference – which is difficult to determine given the scarcity of publicly comparable consensus data for less developed economies – is our projection

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GDP Forecasts: GS vs Consensus*

% Chg yoy	2004	2005	2006(f) Goldman Sachs	2006(f) Consensus*	2007(f) Goldman Sachs	2007(f) Consensus*
US	3.9	3.5	3.5	3.4	2.4	2.7
Japan	2.3	2.6	2.9	2.9	2.9	2.2
Euroland	1.7	1.5	2.6	2.3	2.0	1.8
UK	3.3	1.8	2.7	2.5	2.5	2.4
China	10.1	10.2	10.5	10.3	9.1	9.0
BRICs	8.8	8.3	8.7	8.5	7.9	7.7
Advanced Economies	3.1	2.6	3.2	3.1	2.6	2.5
World	4.7	4.2	4.6	4.4	3.9	3.8

*Consensus Economics August 2006

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that domestic demand will accelerate modestly in the BRIC economies collectively, even as the US slows. This could be an important source of surprise, especially for equity investors.

Based on our forecasts and consensus expectations, our views appear to be broadly friendly towards bond markets (although cross market strategies might be more rewarding), supportive of equities (especially the Asian and BRIC markets) and negative for the US Dollar (especially over the next six months).

Inflation Forecasts: GS vs Consensus*

% Chg yoy	2004	2005	2006(f)		2007(f)	
			Goldman Sachs	Consensus*	Goldman Sachs	Consensus*
US	2.7	3.4	3.7	3.6	2.9	2.8
Japan	0.0	-0.3	0.2	0.6	0.6	0.7
Euroland	2.1	2.2	2.3	2.3	2.2	2.2
UK	1.3	2.1	2.3	2.2	2.4	2.1
China	3.9	1.8	2.2	1.8	2.8	2.3
Advanced Economies	2.1	2.3	2.6	2.6	2.3	2.3
World	3.2	3.3	3.3	3.3	3.1	3.0

*Consensus Economics August 2006

Mixed Signals from Leading Indicators

A close look at a number of leading indicators, especially our own proprietary indicators, turns up mixed signals. Most appear to support our view of a modest softening in global growth; a couple suggest a more sinister outcome, and some suggest a slowdown may not happen at all!

As has been discussed widely in the media, the shape of the US yield curve (the gap between short- and long-term interest rates) is one of the more gloomy leading indicators. At the time of writing, parts of the curve are again modestly inverted, with the 2-year note above the yield on 10-year bonds. Historically, an inverted curve has often been consistent with a sharp slowing in US economic growth – and sometimes with a recession.

However, the advent of highly sophisticated financial markets means that we are not at all convinced of the accuracy of the yield curve as a leading indicator. Neither, it seems, is the Federal Reserve Board.

Among our own preferred lead indicators, our quarterly CEO confidence index looks to be the most gloomy. The latest reading, from early August, shows a sharp drop in confidence about the prospects for the third quarter. We would caution against reading too much into this one result, but it is worth noting that other leading indicators, such as US consumer confidence and the German ZEW index, have also fallen sharply.

Our monthly global leading indicator, the GLI, suggests some modest softening of growth, but little more. Our final reading for August came in at 3.9% year on year, down slightly from the May peak of 4.2%. Monthly momentum appears reasonably stable, although well below the peak seen in June. Key components of the GLI send out mixed messages, but again no collective signs of significant slowing. The divergence between the US and non-US components has been rising since May, with the non-US factors accounting for most support to the reading.

Our financial conditions indicators (FCI) suggest, if anything, that conditions have become more conducive to future growth. In the US, after a steady tightening in the first half the year, revised market expectations for short- and long-term interest rates have allowed a notable easing in financial conditions in recent weeks. While we would not wish to exaggerate the precision of our FCI (nor of the other indicators), it does not suggest a dramatic slowing of US growth. We tend to regard the FCI as more reliable than the slope of the US yield curve, as it incorporates both equity and credit prices, both of which influence the confidence and behaviour of the modern US consumer and business person.

The picture is also mixed elsewhere in the world. Our proprietary indicators for China suggest that Chinese growth has eased slightly. Rather than anything sinister, this merely suggests growth has softened from the above-11% levels reported for the second quarter. The Chinese authorities may well undertake further administrative and market-based measures in an attempt to reduce growth further (especially investment spending).

Interestingly, our Euroland lead indicator suggests there may be still some upside risk to our (and the consensus) forecast for real GDP. Despite some levelling out, the lead indicator suggests that industrial production, and therefore real GDP growth, could surprise further on the

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upside. The breakdown of second-quarter growth in several key European countries also points to growth becoming more dependent on domestically-generated growth – which would be crucial if our forecast of a US slowdown materialises.

Lastly, signals have become more mixed in Japan. The next Japanese Tankan survey, to be released on October 3, is likely to be very important.

Risks to Our Views

What are the chances of a less happy outcome? Historically a shifting world has not resulted in a benign outcome, especially in the context of persistent global imbalances.

Perhaps the biggest risk is that other sectors of the US economy fail to support growth as housing weakness slows the all-important consumer spending. We regard this as a genuine risk and are not persuaded by the argument we often hear – that the US housing market can slow without affecting the consumer. It is conceivable that continued weakening of the national housing market could result in an abrupt slowing of consumption, undermining business confidence and leading to weakness in investment spending.

We cannot deny that this risk exists. However, given continued evidence of corporate profitability, strong cash flows, the benign nature of financial conditions and, importantly, signs of accelerating export growth, global opportunities seem abundant for US-based companies, even in the event of a sharper slowing of the US consumer.

Although improving exports cannot fully compensate for a slowing consumer, the climate for a notably healthier contribution from external demand are much improved. Export growth is accelerating and imports have softened; both trends look likely to continue.

Inflation the Bigger Risk?

Judging by the tone of some Fed officials, higher-than-desired inflation remains their biggest concern. After the recent benchmark revisions to US GDP accounts, the picture on unit labour costs certainly looks less benign than we had thought earlier in the summer.

We forecast that core and headline CPI will gradually ease from the elevated levels of recent months. But we do see risks, especially if import prices accelerate as a consequence of further Dollar declines and the strength of activity overseas. If inflation is in fact ‘stickier’ than we anticipate, this could aggravate the downside risks for the consumer. Without help from future Fed easing, and with lower real incomes, the pain for consumers could escalate.

Monitoring the behaviour of US import prices will be very important. Given activity in the rest of the world,

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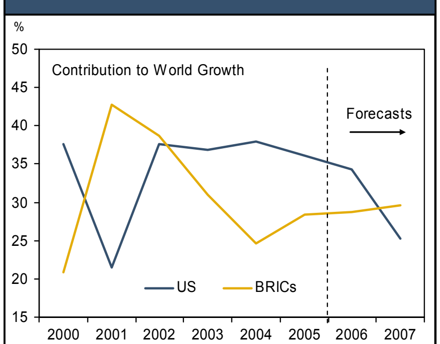
it could be argued that the external terms of trade forces influencing the US are slowly turning less kind than they were for much of the late 1990s and the early part of this decade. Evidence that wages may be rising in China, for example, together with continued strong commodity prices and a weak Dollar, cannot be seen as a recipe for a repeat of the past decade.

Help From the BRICs

Other risks outside the US are obvious. Perhaps the most important is China, given its growing global importance. From recent policy actions, it appears that policymakers in Beijing are introducing more forceful measures to slow growth, including more market-based steps, such as raising interest rates and allowing a more rapid appreciation of the currency. Given the huge contribution of both investment and exports to Chinese growth for many years, this is a source of increased risk.

We expect that personal consumption will actually accelerate in China, as a result of increased fiscal and micro-economic impulses as well as the improving terms of trade through an appreciating currency. But downside risks do exist.

Soon BRICs Will Be Contributing More to Global Growth Than US



Source: World Bank, IMF, GS

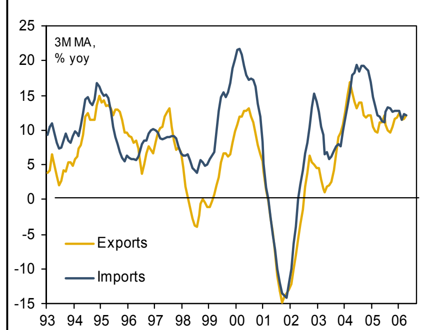
In the event of a sharp slowing in the US and a larger-than-expected or than-desired slowing in China, it would be difficult to remain optimistic about world growth. But we do not expect China to slow sharply. Doom-mongers have been worried that Chinese growth would slow abruptly since 1998. They were wrong then and there is really no fresh reason why they may be right now (other than that double-digit growth cannot go on for ever). And, as we discussed earlier, demand in many other parts of the world looks more sustainable than in the past.

Indeed, it looks as though domestic demand in the BRIC countries – Brazil, Russia, India and China – combined will accelerate. We are effectively forecasting that domestic demand in the BRIC economies could contribute more than the US to global growth for the remainder of 2006 and through 2007. Accelerating demand in Brazil and Russia, together with the persistence of already buoyant demand in China and India, suggests that these remain the great strategic opportunities of our time for multinational corporations and investors.

Asset Market Implications

If our macro projections are correct, then US bonds should continue to rally (perhaps more slowly). This, together with lower short-term US interest rates, should eventually provide a solid backdrop for many global equity markets, once there is evidence that global demand can survive the slowdown expected in the US. We expect economic and market divergence (although a weaker Dollar and good exports should also provide decent returns for the S&P).

Accelerating US Export Growth Implies Abundant Global Opportunities for US-Based Companies



Source: Bureau of the Census, Haver

On the foreign exchange market, the combination of weaker US demand, strength overseas, the Fed switching from tightening to easing, and China allowing more strength of the CNY are all ingredients for a notable Dollar decline in the next six months, which we continue to forecast against most currencies, especially those in Asia.

All in all, our projections suggest that markets are highly unlikely to remain as quiet as they have been in the past couple of months. ■