

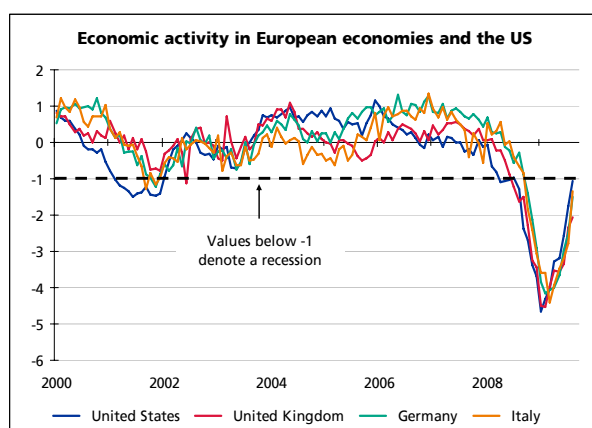
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1. Is the recovery sustainable?

In Q3, economic activity across the globe has been stronger than thought possible in spring.

Consequently, forecasts for 2009 and, due to basis effects, also for 2010 were lifted. The International Monetary Fund (IMF) estimates that global growth, after contracting by about 1% in the current year, will pick up to 3% in 2010, well below the rates seen before the crisis. However, average growth rates mask a profound shift in economic gravity. The recovery is carried by emerging economies (particularly in Asia) where growth will reach almost 5% next year, while advanced economies are expected to grow a paltry 1¼%, after shrinking 3½% in 2009. The main impulse for the recovery in advanced economies came from fiscal spending. Hence, the key question is whether the rebound is a harbinger of a sustained recovery, or whether there will be a setback once fiscal stimuli have been withdrawn.



Although the US recession may have ended in September, prospects for a sustained recovery are slim.

Our proprietary economic activity index, for which we have near-complete data through August, is close to the threshold separating recessions from expansions (see graph above). Under normal conditions, we could expect a virtuous circle of rising confidence, improving financial conditions and strong growth of consumption and investment. However, as the unemployment rate rises above 10% households are prone to save more to reduce debt bur-

dens. At the same time banks are under continued pressure to deleverage. Hence, the expansion will likely be credit-less and subdued. The IMF predicts that US potential growth will stay below 2% for a considerable time.

Europe keeps lagging, and the recovery may be more subdued.

In the wake of asset price collapses (mainly housing) the decline in economic activity was particularly sharp in **Ireland, Spain** and the **UK**, while a few emerging countries in **Eastern Europe** were burdened by excessive foreign debt, which required belt tightening and IMF programs to bridge over external credit constraints. **Germany**, the dominant economy in Euroland, initially suffered from collapsing exports and is now benefiting from the recovery of global trade, while the recession in **France** was less pronounced than elsewhere, due to the comparatively closed economy and large public sector. However, the strong euro in combination with widening differentials in competitiveness across Euroland and a rigid labor market that is likely to push the unemployment rate above 12% by 2011 contribute to a sluggish recovery. **Switzerland** made good use of its monetary policy sovereignty. However, absent strong fiscal spending, the return to sustainable growth is likely to depend even more than elsewhere on the recovery of global trade.

Asia's recovery continues to provide strong impulses for the global economy.

While export-driven economies were hit hard initially by the collapse of global trade, the rebound in the inventory cycle in combination with large fiscal impulses (above all in **China** and **Japan**) supported a quick turnaround. It also helped that Asian banks were not contaminated by toxic assets. This enabled them to partially fill the gap caused by the withdrawal of credit flows from advanced economies. Similarly, sound policy frameworks made many **Latin American** countries much more resilient compared to previous downturns. Policy reforms undertaken by **Brazil** are finally paying dividends; it is expected to lead the recovery in the Western Hemisphere.

However, we should make no mistake; the recovery particularly in the advanced economies is skating on thin ice. The current performance is largely predicated on inventory rebuilding, faster export growth (particularly in the US), and massive fiscal spending. But inventory adjustments can only go on for so long. The US cannot devalue its curren-

cy indefinitely. And fiscal spending as well as monetary easing must eventually be phased out. The question then is whether private consumption and investment spending can pick up the slack, and the cautious answer must be “probably not.” To echo our last outlook, the risk of a setback – a so-called W-shaped recovery – continues to be real.

Diminished expectations for the medium to long term

As the global economy recovers from the deepest recession since World War II the big question is how quickly it will return to precrisis conditions. To be sure, growth rates in the second half of 2009 look comparatively strong. However, the recession has left deep scars, and if history provides any guidance, it will take many years for global output to return to its precrisis trend.

In an analysis of 88 banking crises that occurred over the past four decades, the IMF found that “output tends to be depressed substantially and persistently following banking crises, with no rebound on average to the precrisis trend over the medium term.” In fact, after seven years, output was on average nearly 10% below precrisis trend, with lower employment, lower capital formation (investments) and lower productivity contributing in nearly equal parts to the adverse outcome.

This is on average, and one may harbor the hope that this time it will be different, that the recovery will be stronger. Many refer to postwar recoveries when idle resources were quickly put back to work and to the reasonably well coordinated policy reaction that managed to stop an otherwise fatal decline. However, against hope stands that the crisis was unusually well synchronized (with the notable exception of emerging market countries in Asia and Latin America) and that it may take consequently take much longer for all affected economies to dig themselves out of the hole.

By the time the recession is over, as many as 25 million people may have lost their jobs in the 30 advanced OECD member countries, and several million may never get back into employment. Given the low degree of capacity utilization it may also take years for capital formation to pick up. And the financial system continues to be dysfunctional, putting the brake on a speedier recovery.

Moreover, disequilibria between spending patterns in advanced and emerging countries – one of the root causes of the current crisis – continue to exist. It will take time for the rebalancing from public to private spending and from consumers in advanced economies to consumers in emerging markets to take place. This suggests that previous crises may have indeed been prologue, that growth will be anemic, and that it will take years for output in advanced economies to return to precrisis trend.

In short, prospects for our insurance business will likely be diminished for a long time. Lower income and lower employment will keep demand for personal lines below precrisis trend, and since businesses are likely to keep capital expenditures low, demand for commercial insurance and the business in our large corporate accounts will also stay below precrisis trend. The sobering recognition that we must cope with diminished expectations raises the pressure to open new avenues for business with new products and fresh ideas for attractive insurance solutions.

Perhaps not atypical for turnaround situations, risks are different in the short and long term.

Short-term risks:

- **Downside risks** include stalling activity in advanced economies, particularly if stimuli should be withdrawn prematurely. It could amplify what the IMF calls a “vulnerability to mild deflation”, which is estimated to be relatively high through the end of 2010.
- **Upside risks** could feed off a self-reinforcing process in which financial stabilization leads to increased consumer and business confidence and faster than anticipated growth. Output gaps would disappear also faster, resulting in undesired inflation, particularly if central banks failed to withdraw monetary stimulus in a timely manner.
- **Vulnerability to external shocks**, which could be triggered by rising oil prices or an H1N1-induced pandemic and amplified by the continued weakness of the financial sector.

Long-term risks:

- **Fiscal crisis risk** is high in advanced economies and could be exacerbated by stagnation or a renewed recession. Difficulty in deficit financing could lead to a crisis of confidence, generating rapidly

rising interest rates, wide swings in foreign currencies, and inflation.

- **Labor market hysteresis** is an acute risk in Europe, where labor markets tend to have a long memory and are lastingly affected by severe recessions. High unemployment rates could further stress government finances and foster political instability.
- **The failure to complete financial restructuring** is a risk that must be seen in the context of political resistance to bankers (perceived as solely responsible for the crisis), resulting in a lasting credit crunch and a sluggish development along the lines of Japan's lost decade.
- **The risk of oil price shocks** could increase in the long term given the substantial under-investments in exploration and refining capacity. It could be exacerbated by emerging market countries where growth tends to be more energy-intensive than in advanced economies.
- In response to the financial crisis, many countries resorted to the protection of domestic industries through subsidies and non-tariff trade barriers, which increased the **risk of a retrenchment from globalization**.

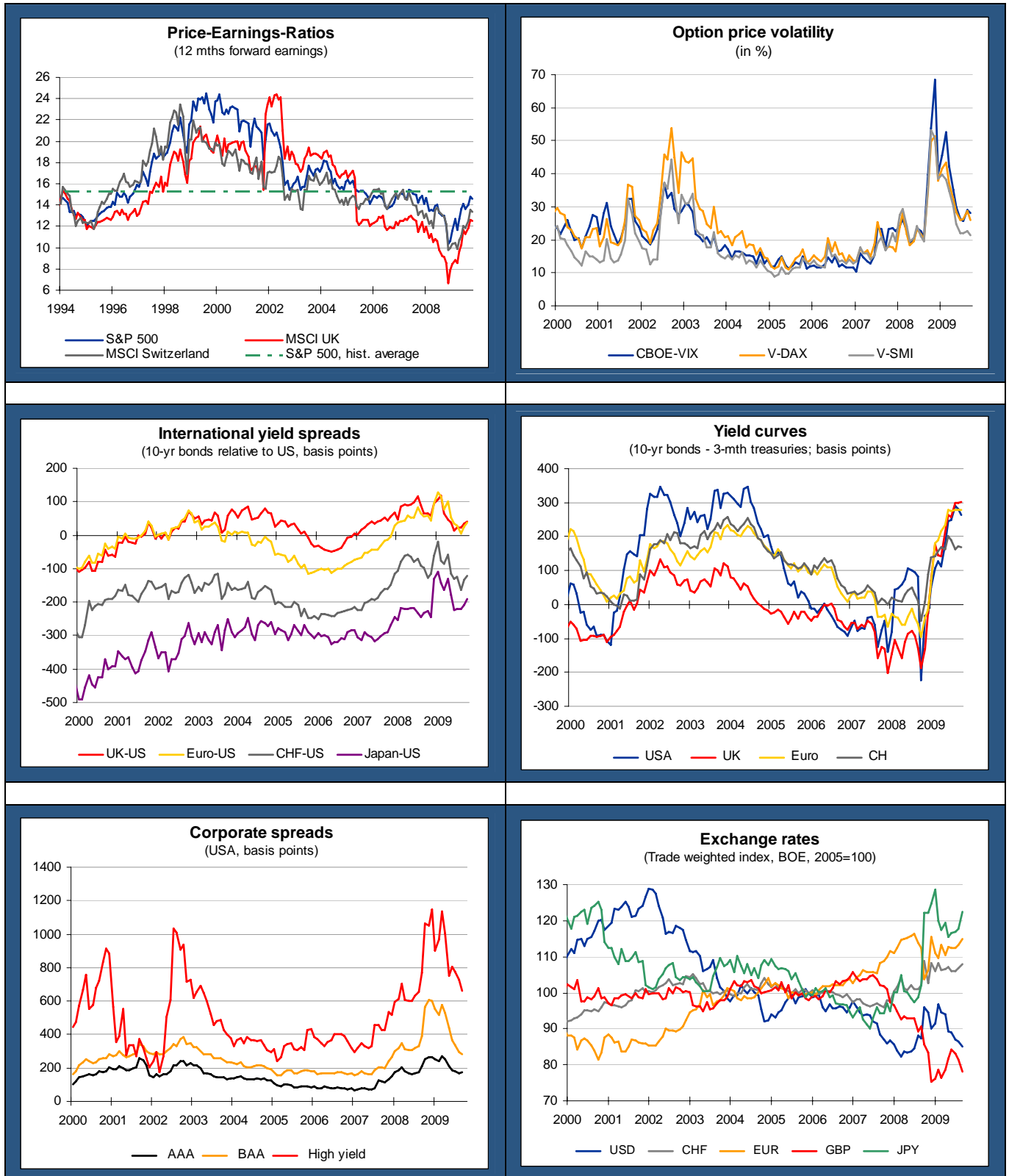
The outlook revised

The outlook table reflects upward corrections in the estimates for the second half of 2009 and corresponding corrections for 2010. As typical at turning points, forecasts diverge widely, with some forecasters predicting growth rates that are on average higher by up to 200 basis points. Our forecast, conditioned by historical patterns, is located at the mainstream and to the lower end of the spectrum.

Outlook for Main Regions (Δ in %)												
	GDP, real			Inflation (CPI or HPCI)			Interest Rates					
	09	10	11	09	10	11	3 month libor rates			10-year bond yields		
	F	F	F	F	F	F	Actual	3mF	12mF	Actual	3mF	12mF
USA	-2.7	1.5	2.1	-0.4	1.7	2.8	0.28	0.30	0.80	3.38	3.50	4.25
Euroland	-4.2	0.3	1.5	0.3	0.8	1.8	0.74	0.80	1.50	3.55	3.65	4.30
Japan	-5.4	1.7	1.5	-1.1	-0.8	0.1	0.53	0.55	0.70	1.27	1.40	1.50
GBR	-4.4	0.9	2.4	1.9	1.5	1.9	0.57	0.70	1.50	3.53	3.80	4.50
SUI	-2.0	0.7	1.6	-0.3	0.5	1.1	0.29	0.40	0.75	1.98	2.10	2.70
China	8.5	9.0	9.5	-0.1	0.7	2.0	<i>A = Actual</i>					
India	5.4	6.5	7.5	8.7	8.4	7.5	<i>E = Estimate</i>					
Latin America	-2.0	3.0	4.0	6.3	5.3	5.9	<i>F = Forecast</i>					
CEE	-5.0	1.8	2.5	4.6	4.0	4.5						

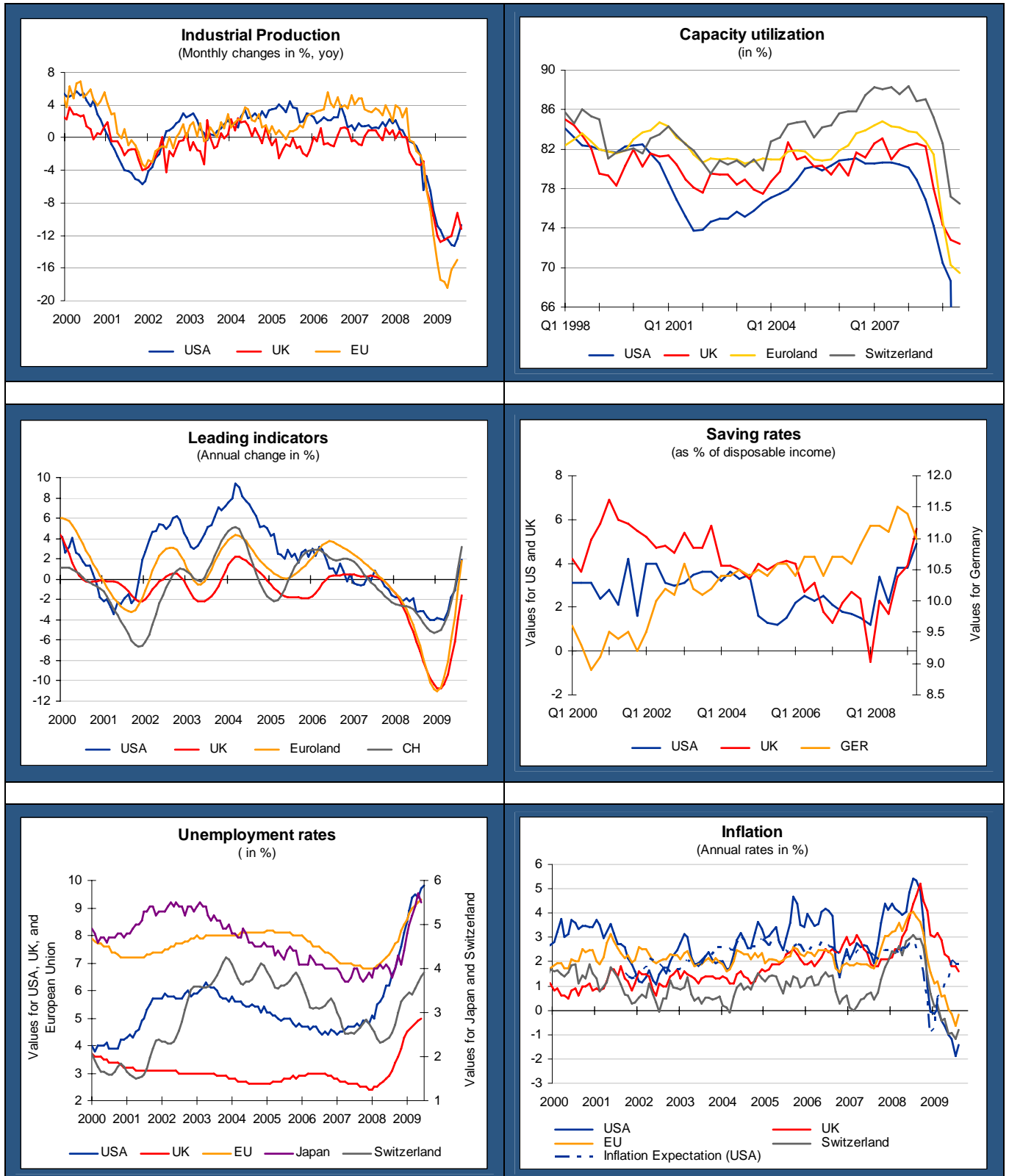
Sources: Thomson Datastream, OECD, IMF, Seco, Zurich

2. Financial sector data



Source: DataStream

3. Real Sector Data



Source: DataStream

Recent issues

All recent issues are available upon request.

Issue No.	Date	Topics
Issue No. 1	Dec 10, 2005	– The global economy may not be as robust as it appears
2006		
Issue No. 2	Feb 09, 2006	– Smooth sailing on treacherous waters – Catastrophes and capacity
Issue No. 3	May 10, 2006	– Downside risks are increasing
Issue No. 4	Jun 06, 2006	– Volatile markets and increased downside risks
Issue No. 5	Aug 10, 2006	– Prospects for better balanced growth / Clouds on the horizon
Issue No. 6	Nov 07, 2006	– A successful rebalancing – at least for now
2007		
Issue No. 7	Feb 01, 2007	– A soft landing, but growing concerns about inflation
Issue No. 8	Apr 03, 2007	– What a difference a (turbulent market) day makes
Issue No. 9	Jun 04, 2007	– Rebalancing is still on track
Issue No. 10	Aug 06, 2007	– Dr. Jekyll and Mr. Hyde meet the global economy
Issue No. 11	Dec 11, 2007	– The (perfect) storm brewing
2008		
Issue No. 12	Feb 04, 2008	– Significant slowdown ahead
Issue No. 13	Apr 01, 2008	– Strong market headwinds
Issue No. 14	Jun 04, 2008	– All clear on the economic front?
Issue No. 15	Aug 08, 2008	– In a tight spot
Issue No. 16	Oct 15, 2008	– And now for the global recession
Issue No. 17	Dec 03, 2008	– Driving against a wall
2009		
Issue No. 18	Feb 02, 2009	– Falling off a cliff
Issue No. 19	April 2, 2009	– The downturn intensifies
Issue No. 20	June 10, 2009	– A light at the end of the tunnel
Issue No. 21	Aug 3, 2009	– A weak recovery head

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