Economic Outlook

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Content:

1. The global economy may not be as robust as it appears

At year end, the global economy appears to be moving on a **strong trajectory**. Business confidence is improving. Orders and inventories are in support of sustained activity. North America and most of Asia continue to move forward without any loss of speed. Japan has picked up momentum. The larger economies on the European continent are recovering from long lingering bouts of weakness on the strength of strong exports and domestic orders. Labor market conditions are slowly improving, and inflation, while differing across regions, continues to be moderate.

The key word is **resilience**. Global growth is surprisingly vigorous despite large increases in oil and commodity prices. The US economy has absorbed the shock of exceptionally severe natural catastrophes, and global financial markets have barely blinked in the face of the monetary tightening administered by the Federal Reserve. The resilience displayed by our tightly integrated global economy lends plausibility to the argument that the current expansion will last for some time to come. Moreover, the widely anticipated acceleration of growth in Japan and Europe could support a gradual unwinding of the current account imbalances, thereby slowly mitigating one big downside risk to any global forecast.

However, there are **considerable risks** to this benign scenario. First, central bankers in Europe and the US are quite bluntly warning that **inflation** may be around the corner, and they have begun, or will continue, a course of monetary tightening. Such policies always entail the risk of over-reaction, which could negatively impact asset prices and generate an unnecessary recession.

Second, there are also more complex arguments why the world, led by the US economy, may be in for an **endogenous** (as opposed to policy-induced) **slowdown** in the second half of 2006 and perhaps even a **recession** beginning in 2007. The more pessimistic view draws its arguments from the expectation that US corporate earnings have peaked and that capital spending will be slowing markedly in 2006. The drivers of this development will be higher interest rates and signs to watch include an inversion of the US yield curve, a widening of corporate spreads, and a decline in US asset prices (mainly real estate).

Third, there is a distinct probability that the **global imbalances** will force an abrupt correction. The **US current account** deficit is expected to exceed 7% of GDP in 2007, which in light of past experience is considered not sustainable. While the disorderly unwinding of current account imbalances would primarily be forced through a sizeable exchange rate adjustments (i.e. dollar weakening), we could also observe a dramatic shift in financial market preferences away from dollar-denominated assets. The consequences would be unpalatable: an increase in long-term interest rates, declining asset prices, and deflation in areas such as Japan and the Eurozone where inflation is low or already negative, resulting in weak global growth or an outright recession.

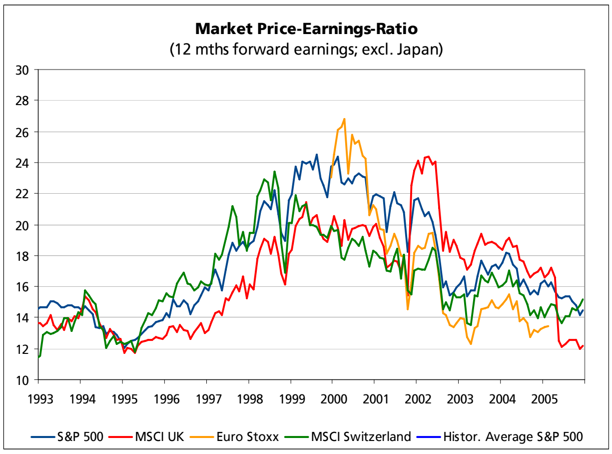
The forecast presented below is pursuing a middle course. Contrary to the consensus and to official forecasts such as the one just presented by the OECD, we expect a slowdown in the US to begin in the second half of 2006 and continue into 2007, but we abstain from the pessimistic view of a hard landing caused by an abrupt current account adjustment. The slowdown in the United States is likely to stifle the strong momentum seen currently in Japan and the nascent expansion in Europe. Since much of the economic activity in Asia is export-driven, we should also expect a concomitant slowdown in this region.

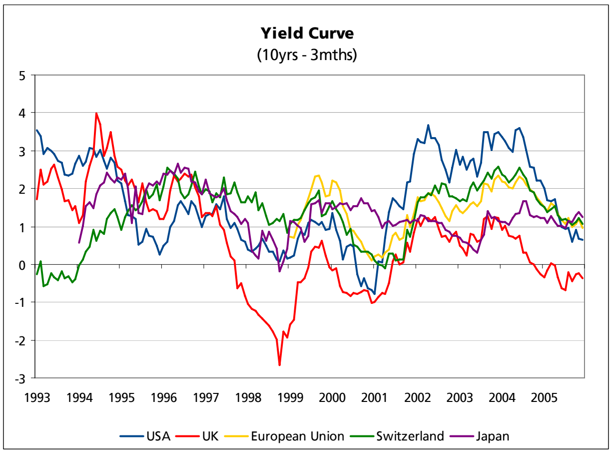
	Outlook for Main Regions (Δ in %)													
	GDP, real				Inflation (CPI or HPCI)				Interest Rates					
									3 month libor			10-year bond		
	04	05E	06F	07F	04	05E	06F	07F	Actual	3mF	12mF	Actual	3mF	12mF
USA	4.2	3.8	3.2	2.8	2.7	3.5	3.5	3.0	3.93	4.40	5.25	4.52	4.80	5.50
EMU-12	1.8	1.4	1.8	1.4	2.1	2.2	2.4	2.0	2.45	2.50	3.00	3.43	3.60	4.00
Japan	2.7	2.5	2.3	2.0	0.0	-0.3	0.5	0.5	0.21	0.20	0.20	1.52	1.60	1.90
UK	3.2	1.8	2.4	2.5	1.3	2.1	2.0	2.0	4.56	4.45	4.20	4.29	4.30	4.40
CH	2.1	1.4	1.8	1.4	0.8	1.2	1.5	1.2	1.04	1.25	1.50	2.10	2.20	2.50
China	9.5	9.0	8.0	7.5	6.5	5.5	4.5	4.5						
India	7.0	7.0	6.5	6.0	4.7	5.0	5.0	5.0						
Asia 5	6.1	6.0	5.0	5.0	3.7	3.4	3.4	3.4						
Mercosur	4.8	4.0	3.5	3.0	5.8	6.0	6.0	6.0						
C-Amer	3.6	3.0	2.5	2.5	6.7	5.0	5.0	5.0						
EU AC	4.9	5.0	4.0	4.0	5.3	4.0	5.0	5.0						

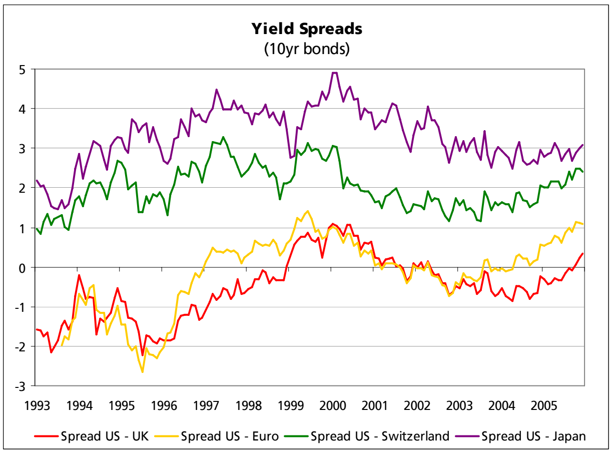
E = Estimate
F = Forecast
Asia 5 = Indonesia, Malaysia, Philippines, South Korea, Thailand
C-Amer = Central America incl. Mexico
EU AC = EU Accession Countries

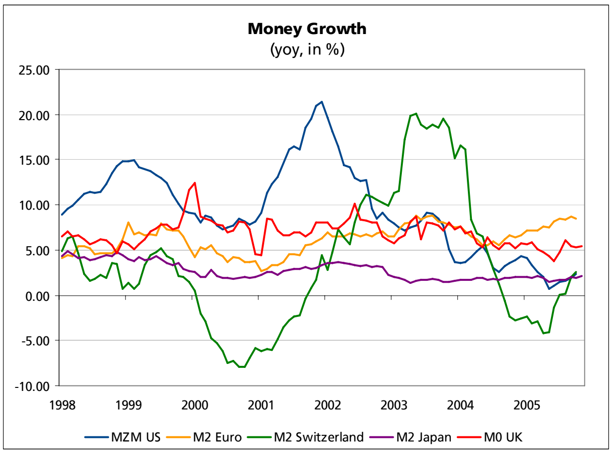
Sources: IMF, OECD; Zurich Financial Services

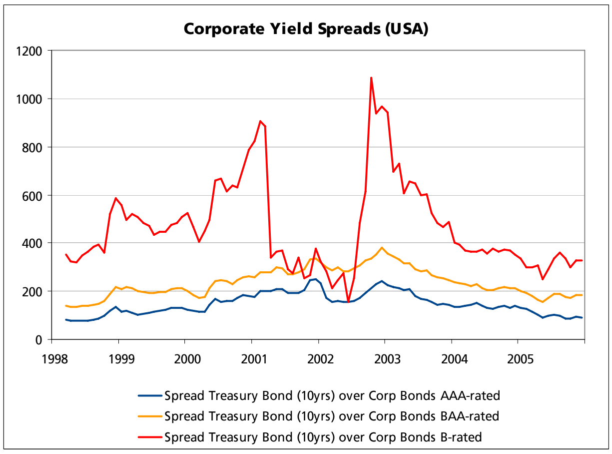
2. Financial sector data

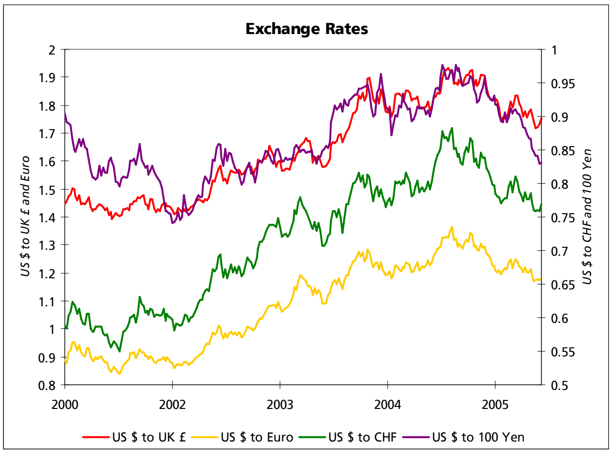






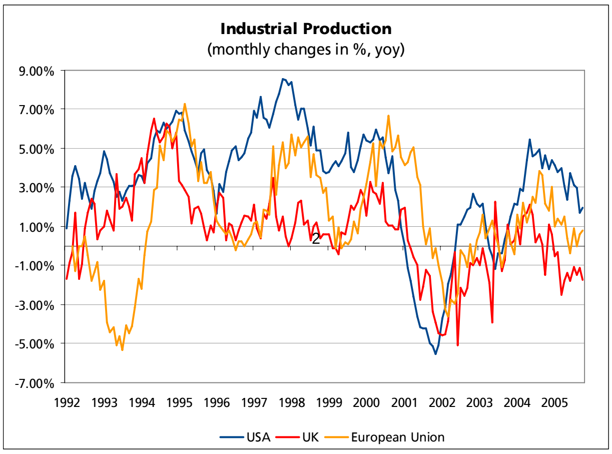


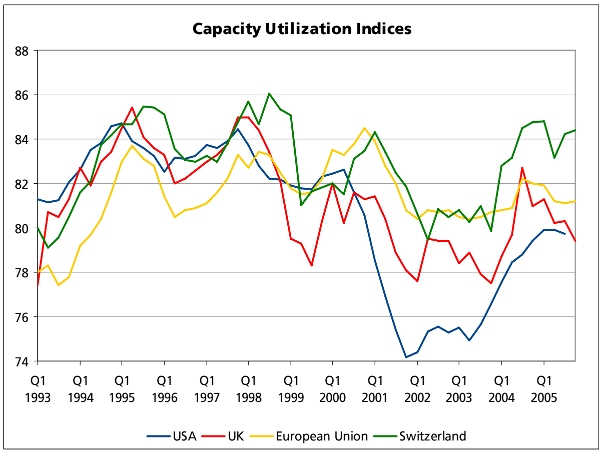


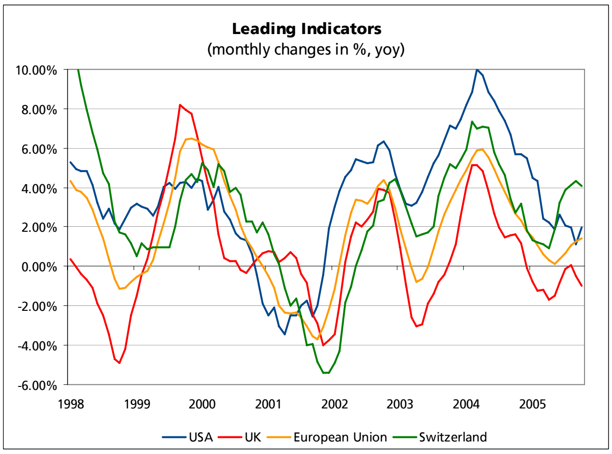


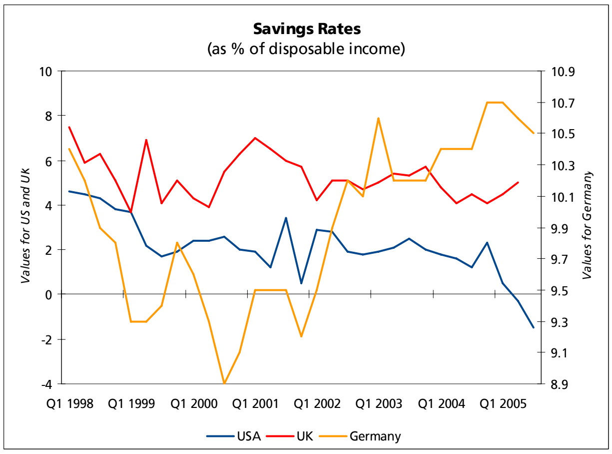
Source: Datastream

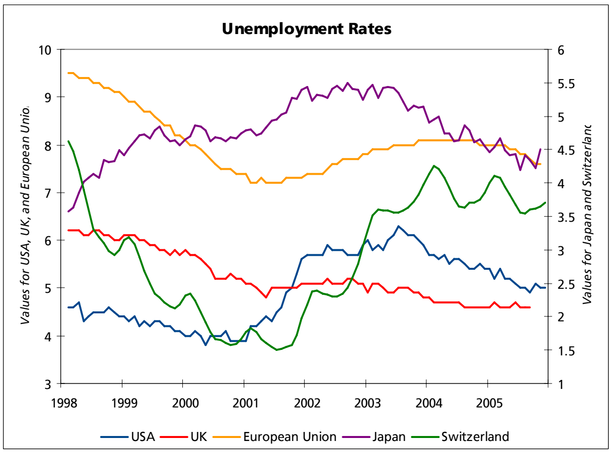
3. Real Sector Data

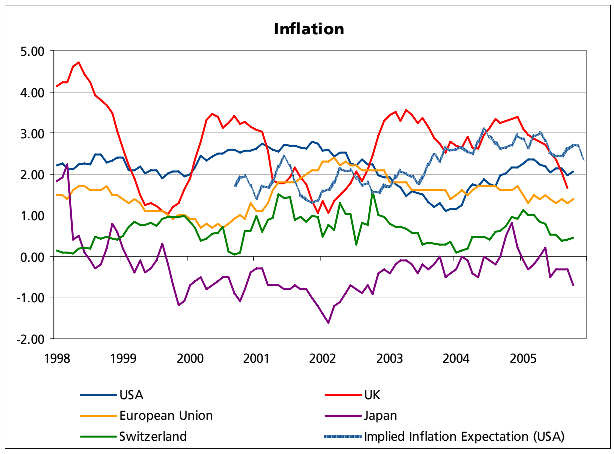












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