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“Turmoil in the financial markets is the main risk for the global economy.”

Global growth slowing, but not weak

We expect global economic growth to cool in 2008 on the back of a slowdown in the USA. However, in light of the ongoing strength of the emerging markets, the solid expansion in the world economy should continue.

The global economy performed patchily in 2007. Europe and Asia posted fairly good growth despite the sluggish performance in the USA. But is this decoupling sustainable? Admittedly the dependence of many large economies on the USA has declined in recent years. In 1999, for example, a third of Japanese exports were destined for the USA; that figure is now less than a quarter. The economic significance of the major emerging economies – and hence trade between them – has been growing steadily. At the same time, however, the subprime mortgage crisis and its repercussions have once again underscored the mutual interdependence of the international financial markets.

USA: Housing market correction continues

The US housing market had already been falling for two years, but the downturn accelerated sharply in 2007. We originally thought that the knock-on effects would initially affect US consumer spending, but in the event the financial sector was the first victim of the subprime crisis. The effects are only now feeding through to consumers, and eventually the labour market is also likely to be affected. We think that the USA will just about avoid a recession, with the Federal Reserve playing a key role in the outcome. It began lowering interest rates in September to help cushion the economy against the turmoil in the financial markets. We see further cuts in store, with the fed funds rate coming down to 4% during the first quarter of 2008.

Europe: Growth slackens, but remains solid

The economic upturn in Europe lost a little momentum in the first half of 2007, particularly in the area of consumer spending. However, capital expenditure held up well, reflecting high capacity utilization, good profitability and an optimistic business outlook. Export growth also remained buoyant. We see a slight acceleration in wage growth in 2008 and 2009 as bottlenecks are emerging in some areas of the labour market. This should contribute to very healthy consumer spending growth, especially in Germany. Nevertheless, the prospects for Europe are overshadowed by the recent financial market upheavals, which could spill over into the real economy. Economic growth in the 13 eurozone countries averaged around 2.6% in 2007, and we expect this to slip to 1.8% in 2008. In this environment, the European Central Bank is likely to hold interest rates steady until well into 2009.

Asia: Chinese inflation makes further tightening necessary

After posting growth of an extraordinary 11.1% last year, we expect the Chinese economy to ease somewhat to 9.8% in 2008. However, this is not primarily due to the weak outlook for the USA. We regard growing inflationary pressure as a greater threat, and think the authorities will take decisive action to counter this. Further tightening measures would allow the economy to cool and CNY to appreciate further. Japanese growth weakened after a lively start to 2007 as investment and residential construction slowed down again. We expect domestic demand to pick up, however, and forecast average GDP growth of 1.6% for 2008, compared with 1.8% last year. Interest rates will likely remain unchanged until Bank of Japan governor Toshihiko Fukui retires in March. We also see growth easing off slightly in most other Asian countries with the exception of India, where we think it will be more or less in line with the year-ago level of 8.5%.

As we believe that the other major emerging economies, such as Brazil, Russia and Mexico, will also post continued strong growth in 2008, the world economy as a whole should remain on a sound footing. ■

Swiss economy remains robust

The turbulence in the international financial markets has not yet adversely impacted the Swiss economy. Growth in real gross domestic product rebounded in the third quarter of 2007 continued to be strong and broadly underpinned. Although we continue to view the prospects as positive, it will be advisable to keep a close eye on whether or not the dark clouds of the subprime mortgage crisis in the USA develop into a storm.

Domestic economy takes over

The Swiss economy has been booming now for roughly four years, which is increasingly reflected in the labour market picture. Adjusted for seasonal fluctuations, the unemployment rate was 2.6% in November 2007 – noticeably lower than the 3.7% rate registered two years ago. Employment growth has thus accelerated in line with the economy, with full time employment rising 2.7% y/y in the third quarter 2007. We anticipate that the positive trend will continue in the current year as well, taking the jobless rate possibly even below the 2% mark at times. Moreover, base salaries will likely increase by 2.4% this year, according to the latest UBS compensation survey. With such favourable prospects for employment and incomes, consumer spending by private households should surge noticeably and private consumption should become the most significant pillar of growth this year. The greatest risk to this outlook would be a drastic, sustained downturn in the financial markets, which could dampen consumer confidence.

Growing demand for consumer goods generally leads to higher growth in imports. Given the expected slight cooling of the global economy, we presume that the high pace of growth in exports recorded in recent years cannot be maintained in the long run. In addition, the Swiss franc appreciation that we expect should have an additional dampening effect on foreign demand. As a result, the positive contribution to growth emanating from net exports (i.e. change in exports minus imports) should decline noticeably overall in the course of the year.

Credit squeeze unlikely

Could the current global credit and liquidity crisis lead to limited availability of bank loans or rising bank lending rates for small- and medium-sized enterprises in Switzerland? Swiss banks learned their lesson from the consequences of the credit and real estate market crisis of the 1990s, altering their corporate lending policies from asset-based financing to a lending approach based on future income streams. Consequently, lending excesses such as those that emerged in the US mortgage market are to a large extent unlikely, making any corrective measures unnecessary. In addition, many companies financed their capital projects from their own abundant supply of cash during the initial phase of the upswing, with demand for bank loans only beginning to pick up a few quarters ago. Given continuing high capacity utilization of roughly 90%, investment activity in the Swiss economy will likely remain robust for the time being. The resulting need for credit financing should be met fairly easily given the continuing intense competition among banks. Hence, there is no reason to fear that bank lending policies will act as a brake on the economy in Switzerland. If investment activity does weaken in the coming year, it will more likely be because companies become less optimistic about the future outlook for the economy and sales, and react by reducing their capital spending budgets.

Overall, we expect the robust economic trend to continue, albeit at a weakened pace in the course of the year. In terms of numbers, we forecast real growth in gross domestic product of 2.3% and 1.8% for this year and next, respectively. The Swiss economy would thus once again be growing above potential. The positive outlook is nonetheless dampened by the uncertainties surrounding the outcome of the US subprime crisis. The greatest threat to the economy would be if the US economy fell into recession. As a result, the global economy would probably cool down more severely than expected and, in turn, the financial markets could come under increased pressure. This would have a noticeable impact on Switzerland due to the significant role that the export industry and financial sector play for the country's economy. But there is still a good chance that things will not turn out so bad. ■

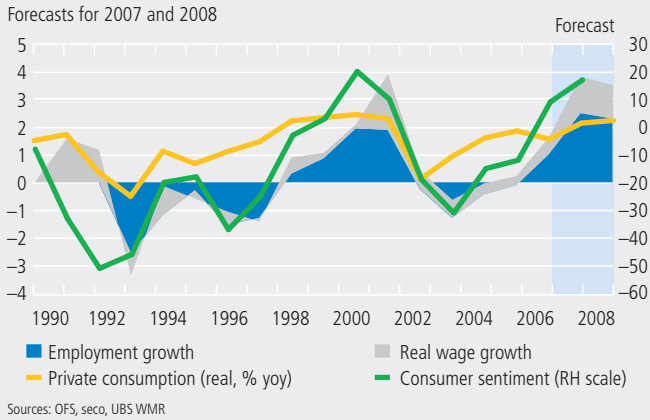


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“Clouds may gather on the economic horizon.”

Forecasts at a glance

Strong growth expected in employment and wages



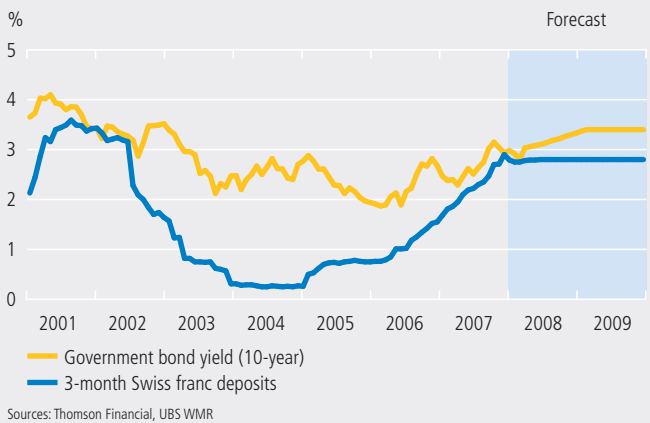
According to a UBS survey of wages in Switzerland, nominal wages are set to rise by 2.4% this year. At the same time employment has started to increase perceptibly. This should drive personal spending up further.

Swiss economic indicators

Year-on-year real change in %						
	Level*	2005	2006	2007F	2008F	2009F
Gross domestic product	464.0	2.4	3.2	2.6	2.3	1.8
Private consumption	274.0	1.8	1.5	2.1	2.2	1.5
Government spending	50.4	0.5	-1.4	-1.0	-0.4	0.8
Capital spending	102.4	3.8	4.1	2.8	1.6	0.8
Construction	43.2	3.5	-1.4	-3.6	-1.9	0.7
Equipment	59.4	4.0	8.9	7.7	3.4	0.8
Exports	249.3	7.3	9.9	9.3	5.3	3.6
Imports	215.2	6.7	6.9	4.9	6.6	3.4
Number of unemployed in 1000		148.5	131.5	110.0	90.0	95.0
Unemployment rate in %		3.8	3.3	2.8	2.3	2.4
Inflation		1.2	1.1	0.7	1.2	1.4

Sources: SFSO; F: Forecast UBS WMR; *Year 2006 (in CHF bn at current prices)

Swiss interest rates



The SNB will keep money market rates stable for the larger part of 2008. The imminent threat of inflation in the global economy will push bond yields up again, however.

Interest and exchange rates

End of year	2005	2006	2007	2008F	2009F
3-month deposits	1.0	2.1	2.8	2.8	2.8
10-year gov. bond yield	1.9	2.5	3.0	3.4	3.4
Exchange rates CHF:					PPP*
EUR	1.56	1.61	1.65	1.56	1.47
USD	1.31	1.22	1.13	1.20	1.24
JPY	1.12	1.02	1.01	1.07	1.30
GBP	2.26	2.39	2.25	2.21	2.09

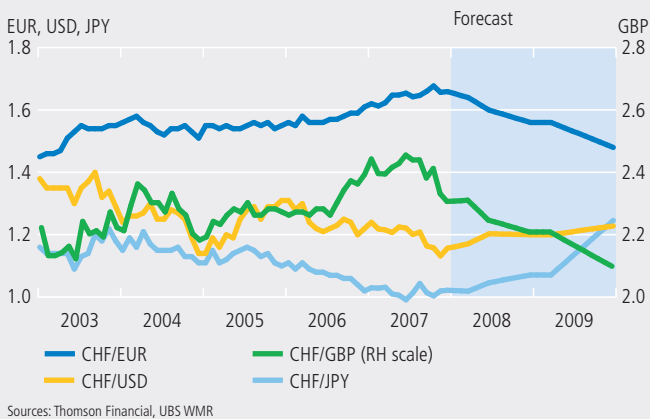
Sources: Bloomberg; F: Forecast UBS WMR; *PPP = Purchasing power parity

Global growth trends

Real GDP growth in %					
	2005	2006	2007F	2008F	2009F
Switzerland	2.4	3.2	2.6	2.3	1.8
EMU	1.6	2.9	2.6	1.7	1.7
Germany	0.9	2.8	2.7	2.0	1.9
France	1.7	2.2	1.8	1.5	1.6
Italy	0.2	1.9	1.8	0.9	1.2
Spain	3.5	3.9	3.8	2.2	1.6
Austria	2.0	3.3	3.2	2.5	2.6
United Kingdom	1.8	2.8	3.1	1.7	1.9
United States	3.2	2.9	2.0	1.8	2.3
Japan	1.9	2.2	1.8	1.6	1.8
China	9.9	11.1	11.1	9.8	10.5
Asia¹	7.5	8.4	8.2	7.5	7.9
Latin America	3.8	3.8	5.1	5.1	5.1
Central/Eastern Europe	5.2	5.2	6.2	6.2	6.1
World	4.9	5.4	5.2	4.8	5.0

¹excluding Japan
F: Forecast UBS WMR

Swiss franc exchange rate



The weakness of the franc against the euro is nearing an end and the exchange rate should move back in line with purchasing power parity. On the other hand the US dollar will likely back off its lows but will firm only marginally.

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Turmoil helps the franc

The currency markets face major challenges in 2008. The franc's weakness against the euro has reached a point where a sharp correction is probably called for.

The positioning against the US dollar in the market has recently been so negative that the greenback can be expected to rebound, at least temporarily. In the eurozone, meanwhile, the negative consequences of the strong single currency are slowly feeding through, thus arguing in favour of a reversal in the euro's appreciation. Overall, the currency markets are in for a testing time as the trends of 2007 gradually give way to new ones. Overreactions can never be ruled out in situations like these.

The interest rate markets will also have an increasingly rough ride this year. Global inflationary pressure is creeping up, so there is a case for a degree of monetary tightening. At the same time, in light of the US subprime crisis, investors and authorities are worried about the stability of various financial institutions and about economic growth. Their preference would be for an expansive monetary policy. The different sides of the argument carry more or less weight depending on the region, so monetary policies are diverging.

Switzerland only semi-autonomous on interest rates

Switzerland is in a healthy situation where, despite the recent price rises in some categories of goods, robust domestic demand has not yet led to accelerated inflation. We consequently expect the SNB (Swiss National Bank) to leave its monetary policy unchanged, with the Libor target rate remaining at 2.75% for the whole of 2008. At the same time, there is serious concern in the eurozone over price and wage trends. As a result, the ECB (European Central Bank) has raised its inflation forecast for 2008 to 2–3%. It obviously no longer sees any possibility of meeting its original target of less than 2%. This explains why the guardian of monetary stability has adopted such a hawkish tone. Even so, in light of the global problems and strong euro, the ECB is unlikely to resort immediately to interest rate hikes. By contrast, in the US and the UK, where there had been a property market boom in recent years, the economy and banking system appear to be more directly affected. Further rate cuts are therefore inevitable in those two countries. It is the danger of a rate cut fuelling this inflationary pressure – which is already relatively strong – that makes weighing up a decision harder for the Bank of England and the US Fed than for their Swiss counterpart.

Although the SNB will presumably leave its monetary policy unchanged, we expect a slight rise in Swiss capital market rates. The last few years have shown that returns on franc deposits closely follow those on eurozone deposits, with the yield differential remarkably stable at 120 basis points. On the basis that inflationary pressure in the eurozone is rising slightly and that the ECB is warning of upside risks to price stability, we must expect higher rates of interest in Europe, which will also affect the Swiss market.

Franc to stage a comeback

But will this help the franc? Given the excellent fundamentals of the Swiss economy, the extent of the franc's deterioration against the euro has been astonishing. Will the franc continue to weaken in future, or has this just been a temporary phenomenon? These were the questions that had us puzzling last year, but we now think we have an answer – one that would be good news for the Swiss currency. Our hypothesis is that the franc never actually lost its safe-haven status, but that its attractions in this respect were overshadowed by carry trades. These are investments in high-yielding currencies, financed by borrowing in low-yielders like the franc (or the yen). Carry trades are gradually losing their appeal, as they are risky transactions, and investors are likely to avoid them following the global increase in risk aversion. The uncertainties over growth in the US, the risks of inflation and higher borrowing costs all point to a reduction in carry trades and a comeback for the Swiss franc. ■



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“The focus is back on fundamentals.”