

Investment Strategy Guide

Wealth Management Research

Third Quarter 2011



The summer of *our discontent?*

Economy to escape from soft patch

Resilient profits support equities

Sovereign budget challenges remain key risk

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Editorial



Mike Ryan



Stephen Freedman

Dear Reader,

Let's face it, there is just something about the summer months that tends to both lift our spirits and lighten our burdens. Whether it is the long sun-drenched days, the carefree wandering of children enjoying a (hopefully) well-earned respite from school, or the excitement of that week-long holiday at the beach, summer has a restorative effect on both body and soul. That's not to suggest, however, that challenges ranging from economic "soft patches" and federal debt ceilings to potential Greek defaults can be neglected until the leaves begin to turn and the kids are back in class.

But while investors must remain vigilant in their evaluation of risk in the current unsettled environment, they also must prudently pursue investment opportunities as they present themselves. It remains our view that the economic soft patch is just that — a soft patch. A supportive policy backdrop, robust earnings cycle and attractive valuations suggest that stocks are still positioned to outperform bonds over the balance of the year. Therefore, as first communicated in a special *Investment Strategy Guide Update* published on 26 June, we have used the recent weakness in markets to increase our exposure to equities and reduce our cash position to a normal weighting, while at the same time retaining our cautious stance toward bonds.

Make no mistake, there will certainly be more challenges in the weeks and months ahead; few of the structural problems that triggered the global credit crisis have been resolved. However, we believe the economy will continue to muddle through and markets grind higher.

It may not feel like a perfect beach day, but we do see some breaks in the clouds...

A handwritten signature in black ink, appearing to read "Mike Ryan".

Mike Ryan, CFA
Chief Investment Strategist
Head, Wealth Management Research – Americas

A handwritten signature in black ink, appearing to read "Stephen Freedman".

Stephen Freedman, PhD, CFA
Head, Investment Strategy
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Video feature: To watch Chief Investment Strategist Mike Ryan give a summary of this Investment Strategy Guide, please [click here](#).

Focus

The summer of our discontent?

Risk assets may well come under additional pressure in the weeks ahead as participants continue to focus on risk factors during this summer of discontent. However, it remains our view that the economic soft patch is just that—a soft patch. A still supportive policy backdrop, robust earnings cycle and attractive valuation position risk assets to outperform in the second half of the year. We caution however, that investors need to maintain flexibility to navigate both the challenging macro environment and tight trading range.

No kicking back

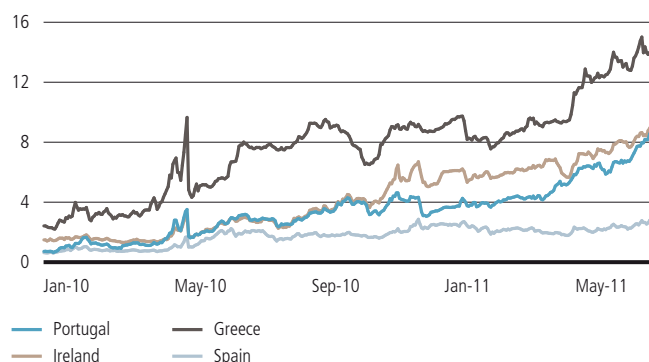
Although the summer months are now upon us, this is hardly the time for investors to kick back, relax or grow complacent. The list of challenges that confront elected officials, policymakers and market participants alike is a lengthy and sobering one. The re-flaring of the sovereign Greek debt crisis serves as a not-so-subtle reminder that the post-crisis world is still rife with macro imbalances and policy instability (see Fig. 1). At the same time, the approach of the federal debt ceiling deadline in the US highlights the challenges of attempting to restore fiscal order during periods of persistently sluggish growth and elevated partisan discord. Even the current accommodative monetary policy backdrop has added to the level of market uncertainty, as Fed officials seek the appropriate path toward normalizing policy by winding down QE2. Finally, the economic impact from the Japanese earthquake has proven far more extensive and damaging to global

growth than most market experts had anticipated. While any one of these factors alone is enough to keep markets on edge, taken together they have contributed to the pervasive negative sentiment afflicting the markets and weighed upon risk assets.

Nonetheless, it remains our view that risk assets will outperform over the balance of the quarter and year. Equity markets have ventured into oversold territory and high-yield spreads have widened once again following the recent sharp sell-off related to the economic soft patch and rising tensions in the eurozone. While markets are apt to remain volatile in the near term — and a further test of the 1250 level for the S&P 500 can't be ruled out — we view the recent decline as transitory. Therefore, as first communicated in a special *Investment Strategy Guide Update* published on 26 June, we have elected to use recent weakness as a catalyst to increase our exposure to

Fig 1: Eurozone yield spreads widen further

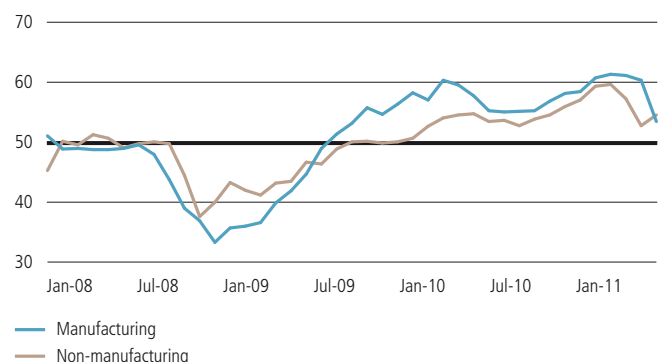
10-year bond yield spreads relative to German Bunds, in %-pts



Source: UBS WMR, Bloomberg, as of 27 June 2011

Fig. 2: US economy to come out of soft patch in second half

ISM Purchasing Managers Indexes (PMI)



Source: Bloomberg, UBS WMR, as of 27 June 2011

Focus

equities and reduce our cash position to a neutral weighting — while at the same time retaining our cautious stance toward bonds.

Better half

We look for markets to rebound during the second half of the year amid a likely improvement in the cyclical outlook, still supportive policy backdrop, continued robust corporate profit picture and attractive valuations. Consider the following:

- Improving cyclical outlook:** While recent data releases have been disappointing, we still look for the cyclical outlook to improve during the second half of the year. As we already noted, the combination of higher energy prices, supply chain disruptions in Japan and weather-related challenges has weighed upon the economy as reflected in the recently reported economic data (see Fig. 2). Keep in mind however that nominal growth rates have remained stable despite the slowdown in real growth, suggesting that a portion of the weakness was related to higher energy prices sapping real purchasing power. With oil having already fallen 15% from the recent highs (see Fig. 3), the drag from surging crude will begin to abate during the coming quarter. At the same time, there is likely to be a sizable rebound in auto sector activity beginning in July — and possibly already in June — as production impacted by the earthquake and related tsunami in Japan comes back on line. While the

employment picture this year has been disappointing and recent unemployment claims reports have showed softness, the rise in the payroll component of ISM manufacturing and non-manufacturing surveys suggests that companies are still adding to headcount — albeit at a sluggish pace (see Fig. 4).

- Still supportive policy backdrop:** At the most recent meeting of the FOMC, policymakers reiterated their intention to wind down the Treasury purchase program commonly referred to as QE2. There are those who see this as a potential challenge to the real economy and risk assets, since the end of last year's soft patch and rebound in equity markets coincided with Bernanke's speech at the Jackson Hole symposium in which he opened the door to quantitative easing. Keep in mind however that the Fed has committed to keeping rates low for an "extended period" and also to maintaining an inflated balance sheet by reinvesting the proceeds of maturing securities in Treasury debt (see Fig. 5). So while a fresh round of quantitative easing doesn't appear likely, the current policy backdrop is certainly supportive of both continued economic growth and a recovery in risk assets.
- Robust profit picture:** While the economic soft patch has raised concerns about the achievability of earnings expectations, we are sticking with our \$100 earnings per share (EPS) estimate for the S&P 500 for 2011 and

Fig. 3: Oil price decline may provide relief

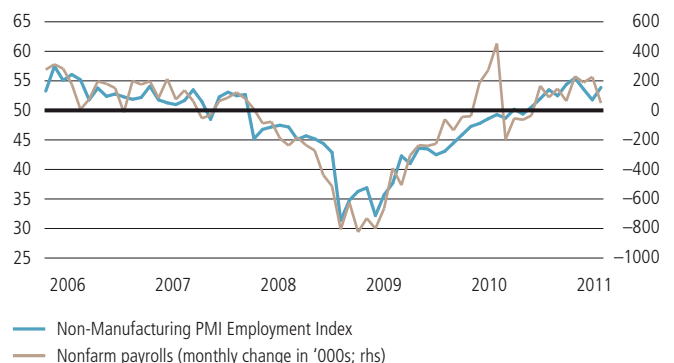
Crude oil prices (WTI and Brent) in USD per barrel



Source: Bloomberg, UBS WMR as of 27 June 2011

Fig. 4: PMI Employment Index suggests labor recovery

Non-Manufacturing PMI Employment Index and Nonfarm payrolls (in '000s)



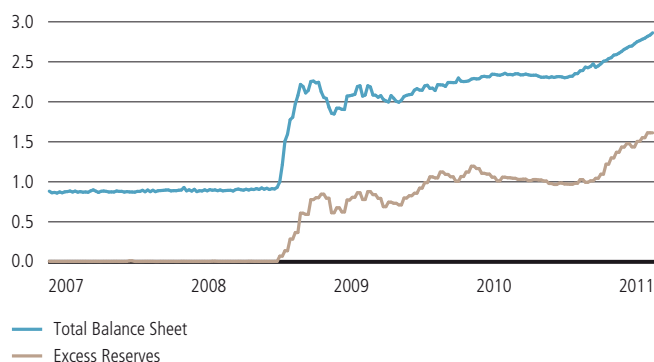
Source: Bloomberg, UBS WMR as of 28 June 2011

\$108 for 2012. The “early reporters” for Q2 earnings season — those companies with a May fiscal quarter end — have already delivered solid results that confirm our view of the profit picture. Of the companies that have reported second quarter results thus far, 18 of 20 have exceeded consensus expectations. But even more important, the guidance has been surprisingly upbeat as well. For example, the CEO of FedEx, a company that serves as a good barometer of overall business activity, noted, “...The near-term softness in the economy will be temporary as fuel prices have retreated from their April highs and the Japanese economy recovers. Going forward, we see stronger economic growth.” While the ratio of companies exceeding analysts’ estimates is certain to decline from these lofty levels over the balance of earnings season — and will likely be more mixed than recent prior quarters — the results still will be sufficient for markets to move higher from here.

- **Attractive valuation:** Although the equity market has only declined about 7½% from the highs posted at the end of May, valuation has become increasingly attractive. The S&P 500 currently trades at roughly 12 times forward earnings — modestly above the trough valuation reached during last year’s economic soft patch. What’s more, with 10-year Treasury notes yields hovering near the 3% mark, the equity risk premium is also at levels not seen since the lows of a year ago (see Fig. 6). While elevated risk premiums are certainly no

Fig. 5: Fed not ready to shrink its balance sheet

Fed Balance Sheet size and excess reserves in USD trillion



Source: Bloomberg, UBS WMR as of 27 June 2011

guarantee of above average near-term returns, history suggests that equity market returns are well above average over both a 6- and 12-month period when equity risk premiums are at such elevated levels (see Fig. 7). Finally, our own proprietary valuation model suggests that equities currently trade about 19% below fair value levels. So while markets may trend lower in the weeks ahead, valuation should serve as a buffer against further material declines. Keep in mind also that the S&P 500 now trades 8% below our year-end price target of about 1410.

Risks still abound

As we’ve already noted, there are a number of risk factors — some obvious, others less so — that will likely weigh upon markets in the days and weeks ahead. While it might seem prudent to simply wait it out until some of these issues have resolved themselves before recommitting to risk assets, our experience has been that trying to time such outcomes is exceedingly difficult. By the time participants have clarity on the resolution, markets are likely to have already re-priced. We must therefore base our investment decisions on our best assessment of valuation, cyclical outlook, policy backdrop and the likely outcome of critical risk factors.

That’s not to say however that risks should be dismissed or ignored simply because they don’t fit neatly into our broader world view. Keep in mind that markets — as with most other things on this earth — still operate outside the realm of certainty. Being informed of likely threats and understanding their potential impact on the real economy, financial markets and policy choices are therefore essential elements in prudent investing. With this in mind, consider the following:

- **Greek default.** While the recent “confidence” vote in the Greek parliament and the passage of an additional austerity bill may have averted a near-term default, the situation in Greece has by no means been resolved. The Greek government has done little more than buy some time and pushed off an eventual day of reckoning. The European Union (EU) and International Monetary Fund (IMF) continue to demand concessions from the Greek government which include implementing both austerity

Focus

spending measures and privatization of state-held assets in return for continued support. However, European Central Bank (ECB) officials have been careful to warn against private sector solutions that might be interpreted by the ratings agencies as having triggered a “selective default” on Greek debt. This leaves elected officials in Greece with an increasingly tight space in which to navigate as they seek to mollify the IMF, ECB and EU without further exacerbating social and economic tensions at home. We therefore look for sovereign risk issues to flare periodically in the eurozone as the EU and IMF look to impose austerity measures and Greece edges closer to default.

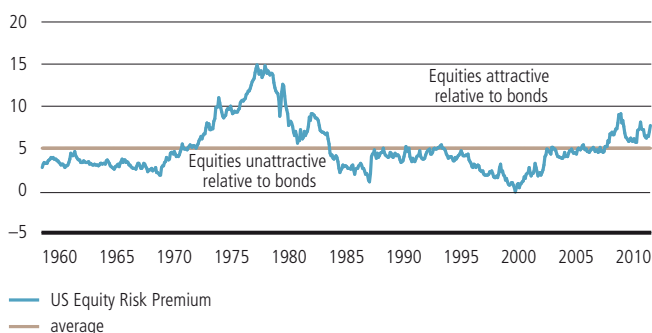
- **Tightening policy.** Emerging markets have been weighed down by policy tightening in a number of different countries aimed at reigning in rising inflation pressures prompted by the surge in food and energy costs (see Fig. 8). While the recent decline in commodity prices offers some respite from accelerating prices, central banks in the emerging markets are likely to continue to ratchet rates up farther during the current quarter. Keep in mind that emerging market central banks lack the level of transparency demonstrated by the Federal Reserve, European Central Bank (ECB), Bank of Japan (BOJ) and Bank of England (BOE). This lack of visibility as to both the timing and magnitude of the tightening cycle in emerging markets raises concerns of a “hard landing” and therefore adds to market volatility.

- **End of QE2.** The end of QE2 is also something of an unknown quantity for market participants. There is considerable uncertainty as to whether the completion of the Fed’s purchase program will materially impact either the real economy or financial markets. Many point to the fact that the rebound in equity markets last summer coincides nicely with Chairman Bernanke’s speech at the Fed’s Jackson Hole symposium where he first broached the subject of a fresh round of quantitative easing. While the market rally was likely driven more by the rebound in the economic data and continued strong earnings gains, the wind down of QE2 does represent another source of uncertainty that will likely contribute to near-term volatility.

- **Debt ceiling.** The approaching deadline for breaching the federal debt ceiling in the US also poses a significant risk to market stability. The recent decision by senior Republican lawmakers to withdraw from bipartisan negotiations being led by Vice President Biden indicates that the two sides have made little progress in jointly crafting a fiscal plan. Our public policy team is still optimistic that a compromise will be reached before the Treasury is forced to default on debt obligations. However, the team also admits that such a resolution is unlikely until the default deadline is nearly upon us. Keep in mind that the ratings agencies have warned that the failure to provide a clear fiscal blueprint for reducing debt could trigger a downgrade of the US’

Fig. 6: High ERP indicates equities are cheap versus bonds

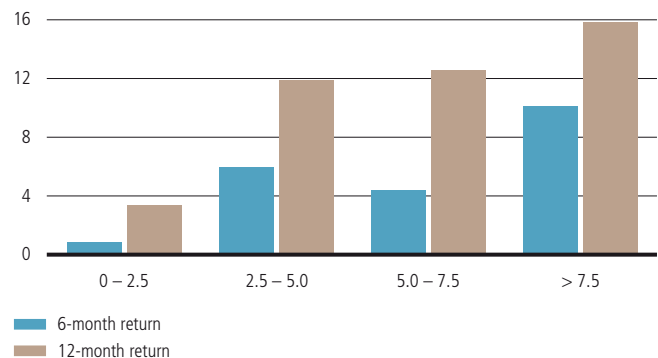
Equity risk premium (ERP): S&P 500 earnings yield minus real bond yield, in %



Source: Bloomberg, UBS WMR as of 27 June 2011

Fig. 7: A high ERP is typically a good entry point for stocks

Average S&P 500 return at varying equity risk premium ranges, in %



Source: UBS WMR, as of 28 June 2011

sovereign debt rating. The longer it takes for elected officials to hammer out a credible agreement, the greater the risk of a downgrade of US credit and/or a technical default on Treasury debt.

- *MENA tensions.* The ongoing hostilities in Libya highlight both the geopolitical and economic risks associated with tensions in the Middle East and North Africa (MENA). The conflict has settled into something of a stalemate, with anti-government forces (aided by NATO) holding assets largely concentrated in the eastern half of the country, while Ghadaffi loyalists are mostly entrenched in the western half. The conflict has clearly taken a toll on oil production, and was even cited by the Obama administration as the principal reason for tapping into the nation's strategic petroleum reserve. With tensions still high in the region, a broadening of the unrest to other oil-producing states would likely trigger another surge in crude prices, and increases the risks that the "soft landing" turns into a hard one.
- *Financial stability.* The Financials sector, still in the process of recovering from the housing bubble and associated credit crisis, is currently beset with a new set of structural headwinds: business restrictions imposed by the Dodd-Frank regulatory reform bill are cutting into some of the banks' more profitable businesses; the flattening of the yield curve has reduced the earnings generated from investment holdings; and Basel III is

prompting banks to increase capital. More concerning however are the prospects for additional losses on real estate holdings and exposure to Greek debt. While the latter is mostly an issue for European banks, experience suggests that balance sheet problems within the Financials sector cannot be "ring fenced"—if it happens somewhere, it matters everywhere. This fresh set of challenges will serve to further restrain bank lending, and could even lead to a fresh round of market de-risking if fears of financial instability or contagion surface.

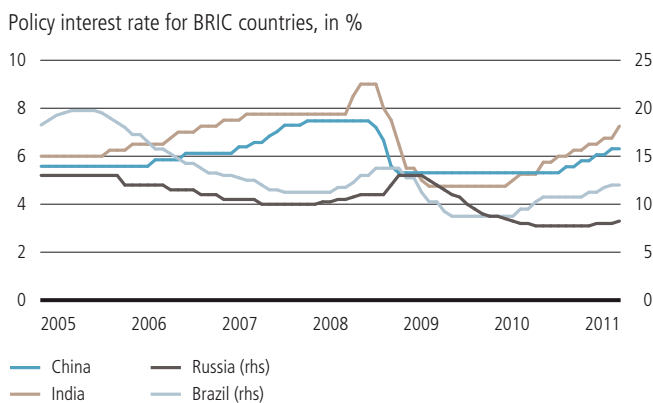
Riding the range

Markets may well come under additional pressure in the weeks ahead as participants continue to focus on exogenous risk factors. As we've noted, there are still ample risks that will serve to limit the upside in risk assets, including the ongoing fiscal stalemate in Washington; festering problems with eurozone debt; ongoing inflation concerns within emerging markets; prospects for continued unrest; further instability in MENA; and challenges to bank balance sheets and earnings. What's more, despite the tendency for "early reporters" to beat consensus expectations, analysts may well cut profit estimates—and companies may also offer more cautious guidance—in the weeks leading up to Q2 earnings season. Markets are therefore likely to trade within a fairly broad 1250-1400 range for the S&P 500 for the balance of the year.

However, with markets still trending toward the lower end of the trading range that has been in place for the past six months, we view recent weakness as an opportunity to increase our exposure to risk assets and increase our weighting to equity markets. It remains our view that the economic soft patch is just that—a soft patch. Additionally, a still supportive policy backdrop, robust earnings cycle, strong corporate balance sheets and attractive valuation suggest that stocks will trend higher and corporate bonds will outperform Treasury securities. We caution, however, that investors need to maintain flexibility and be prepared for additional tactical shifts over the coming months in order to navigate both a challenging macro environment and tight trading range.

Mike Ryan, CFA, Chief Investment Strategist

Fig. 8: Policy tightening continues in Emerging Markets



Source: Bloomberg, UBS WMR as of 27 June 2011

Progress report: will, may or won't?

In our *2011 Outlook* report, we offered our forecasts for the five things that will, may, or won't happen in 2011. In the spirit of accountability, we offer this progress report as to where we stand at mid-year.

Will		
Equity markets will provide normalized returns.	TO DATE: US Stocks are up about 4% so far this year (which would translate into annualized returns of roughly 8%). This is consistent with their long-term historical average and the targets set in our <i>2011 Outlook</i> report.	✓
The sovereign debt crisis will grow more acute.	TO DATE: The sovereign debt of Greece, Portugal and Ireland has sold off sharply since the beginning of the year. Only support from the EU and IMF has allowed Greece to avoid default. The good news is that Spain has made some progress on reforms and may not have to seek outside assistance.	✓
Corporate cash hoarding will end.	TO DATE: Corporations have begun to deploy some of their abundant cash. Capital spending, dividends, share repurchase programs and M&A activity have all increased. Nevertheless, in aggregate, cash continues to build on corporate balance sheets.	?
Geopolitical threats will intensify.	TO DATE: The escalation of tensions in the Middle East and North Africa that includes the toppling of several heads of state and open rebellion in other nations confirms the ratcheting up of geopolitical risks. However, with the exception of Libya, the impact on oil production has so far been limited.	✓
Congress will deteriorate into gridlock.	TO DATE: Congress is more deeply divided than ever, with many votes occurring along strictly partisan lines and nearly all bills needing 60 votes to get through the Senate. Negotiations on raising the government debt ceiling have stalled just five weeks before the August 2 "drop dead" date. While we expect some sort of agreement to avoid default, partisan fighting may only get worse ahead of the 2012 elections.	✓
May		
A high profile municipality may default.	TO DATE: The pace of municipal defaults has subsided since 2010 but a high profile municipality may yet default. Contrary to the views expressed by some market commentators, the risk of systemic default is negligible. That said, investors are advised that idiosyncratic default risk is alive and well and a default by a high-profile issuer may still occur. The vast majority of state and local governments strive to honor their obligations, but there may still be a high profile borrower who fails to do so.	?
The economy and corporate profits may surprise to the upside.	TO DATE: Economic data has clearly surprised on the downside, with growth slowing to around a 2% pace in the first half of 2011. Despite this, corporate profits have surprised to the upside and we have raised our earnings forecasts for both 2011 and 2012. Early results suggest that corporate profits will again beat consensus estimates in the second quarter.	?

Progress report: will, may or won't?

Rising protectionism may trigger a trade war.	TO DATE: Despite ongoing concern over domestic job security and Chinese trade practices, protectionist sentiments and talk of "currency wars" have faded in recent months. This may be a function of a surge in export growth and modest gains in manufacturing jobs.	x
Emerging markets may stumble.	TO DATE: Emerging market equities have underperformed developed markets by around 5% so far in 2011. While economic growth has remained strong, the surge in food and energy prices early in the year spurred inflation, forcing central banks to tighten monetary policy.	✓
Bond market volatility may increase.	TO DATE: The bond market has been volatile, although contrary to our expectations, weak economic data have caused yields to fall sharply since their peak in early February. With the Fed ending its QE2 Treasury purchases, we look for rates to rebound in the second half of the year.	?
Won't		
P/E multiples will not exceed long-term averages.	TO DATE: Despite stronger-than-expected earnings growth, equity markets have risen only slightly so far in 2011, causing P/E multiples to fall farther below their long-term averages. We expect multiples to expand in the second half as the market gains confidence in the sustainability of the economic recovery.	✓
The housing market will not sustain a recovery.	TO DATE: Housing starts have remained extremely weak in the first half of 2011 and home prices have continued to decline. On the positive side, there has been some improvement in delinquency and default rates.	✓
There will not be meaningful progress in deficit reduction.	TO DATE: According to the Congressional Budget Office, the budget deal reached in April cut this year's deficit by just \$352 million, not the \$38 billion touted by politicians. Progress on the reforms needed to put government finances on a sustainable path appears unlikely before 2013 at the earliest.	✓
Commodity prices will not collapse.	TO DATE: Commodity prices have retreated in recent weeks on soft global economic data, but are largely flat year-to-date (YTD) as measured by the Dow Jones/UBS Commodity Index.	✓
Inflation will not be a problem.	TO DATE: The surge in energy prices pushed the CPI inflation rate up to 3.6% in May, and we have revised up our forecasts for 2011 and 2012. Higher prices have hurt consumer spending in real terms, which is one reason that economic growth has been disappointing. However, the recent pullback in oil prices should help to suppress inflation in the months ahead, and core inflation remains modest. The Fed, therefore, faces little pressure to start tightening.	x

Our Best Ideas at a Glance

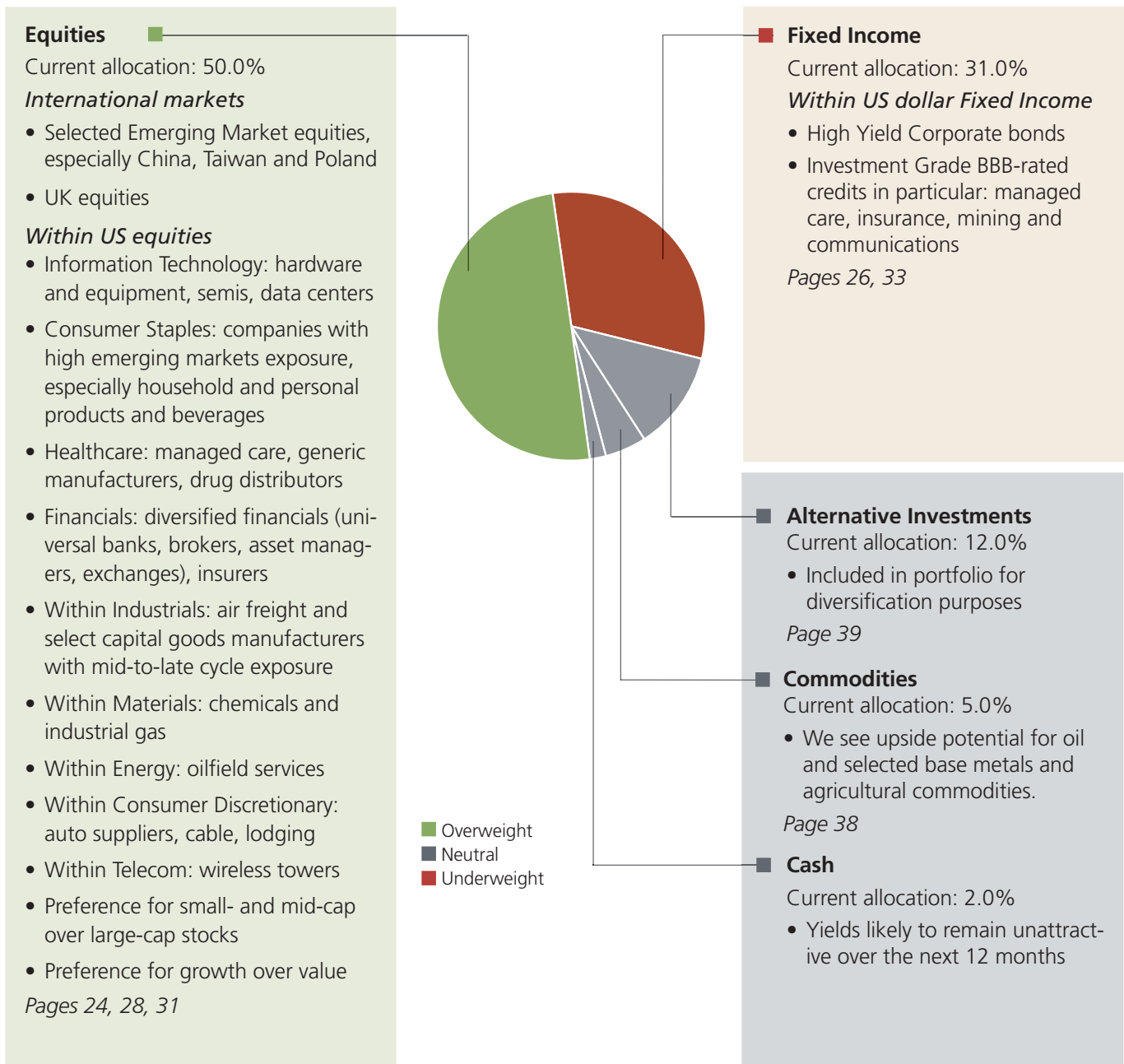
The following list represents investment strategy recommendations that we believe will provide attractive opportunities over the next 9-12 months.

Asset Classes

Preference for Equities over Bonds

Currencies

Avoid Japanese yen. Preference for SEK, NOK, GBP, as well as selected Emerging Market currencies.



For an explanation of current allocation and the underlying benchmark allocation, please see the note on the following page.

Asset Allocation Overview

Asset Allocation Overview	WMR Tactical View	Model Portfolio Moderate Risk Profile (in %)			
		Benchmark Allocation	Tactical Deviation	Change	Current Allocation
Equities Attractive valuations and solid earnings growth favors equities, especially in view of the low yields offered by bonds	Overweight	44.0	+6.0	▲	50.0
US Equities Loose monetary conditions and the prospect for better growth in the quarters ahead are positives. Valuations are less attractive than abroad.	Moderate Overweight	32.0	+2.5	▲	34.5
US Large Cap Value Valuations and our sector tilts suggest preference for growth over value. Large-caps may underperform in a rising market.	Moderate Underweight	11.0	-1.0	▼	10.0
US Large Cap Growth Valuations and our sector tilts suggest preference for growth over value. Large-caps may underperform in a rising market.	Moderate Overweight	11.0	+2.0	▼	13.0
US Mid Cap Valuations expensive vs. large-caps, but M&A activity has been picking up.	Moderate Overweight	5.0	+1.0	▲	6.0
US Small Cap Valuations expensive vs. large-caps, but higher market beta in a rising market and improved financing conditions should be supportive.	Moderate Overweight	3.0	+1.5	▲	4.5
US Real Estate Investment Trusts (REITs) REITs are expensive and may face headwinds from rising interest rates. Commercial real estate market improving but challenges remain.	Moderate Underweight	2.0	-1.0	▲	1.0
Non-US Developed Equities Valuations more attractive than US. However, lower growth potential and fiscal concerns in the eurozone and Japan suggest more cautious stance.	Moderate Overweight	10.0	+0.5	▲	10.5
Emerging Market (EM) Equities Strong valuation, earnings growth and fiscal fundamentals are partly offset by an ongoing battle against inflation.	Moderate Overweight	2.0	+3.0	▲	5.0
Fixed Income We expect bond yields to progressively rise from abnormally low levels as central banks normalize monetary policy.	Underweight	37.0	-6.0		31.0
US Fixed Income Within fixed income we are neutral on the US vs. non-US. The dollar trades near record-low levels against many major currencies but fundamentals remain poor.	Moderate Underweight	29.0	-3.0	▼	26.0
Non-US Fixed Income Extremely low yields and overvalued yen make Japanese debt unattractive. Favor UK fixed income on prospects of rebound in pound vs. the dollar.	Moderate Underweight	8.0	-3.0	▲	5.0
Cash (USD) Yields likely to remain near zero for the rest of 2011.	Neutral	2.0	+0.0	▼	2.0
Commodities We expect overall commodity prices to rise over the next 12 months. Roll yields (resulting from contango term structure of futures prices) have become less negative.	Neutral	5.0	+0.0		5.0
Alternative Investments No tactical view. Included into portfolio for diversification purposes.	Neutral	12.0	+0.0		12.0

"WMR tactical deviation" legend: Overweight Underweight Neutral
Source: UBS WMR and Investment Solutions, as of 26 June 2011.

"Change" legend: ▲ Upgrade ▼ Downgrade
For end notes, please see appendix.

The benchmark allocations underlying this and the previous page are provided for illustrative purposes only by UBS for a hypothetical US investor with a moderate investor risk profile and total return objective. See "Sources of benchmark allocations and investor risk profiles" in the Appendix for a detailed explanation regarding the source of benchmark allocations and their suitability and the source of investor risk profiles. The current allocation is the sum of the benchmark allocation and the tactical deviation. See "Deviations from benchmark allocation" in the Appendix regarding the interpretation of the suggested tactical deviations from benchmark.

Held hostage to the debt ceiling

Katie Klingensmith, Wealth Management Research's economic and policy analyst, sits down with John Savercool, the head of the UBS US Office of Public Policy, to discuss the latest issues in Washington, DC. Economic issues are in focus, and in turn the policy reactions could have major implications for the economy and markets.

Katie Klingensmith (KK): The US is currently operating at the debt ceiling, and Treasury has said that it can do so until August 2. The debate seems to be intensifying in DC. What do you think will be the outcome? Do you think a short-term extension is likely?

John Savercool (JS): There is very little support on Capitol Hill for a short-term lifting of the debt ceiling. Most members of the House and Senate from both parties view such an extension as yet another exercise of "kicking the can down the road" on major issues and are eager to get the current debt ceiling challenge behind them. That being said, however, there is no clear path at this time on how Congress might compromise and finalize a deal. Both sides are dug in philosophically and there is little spirit of compromise on the major issues that divide Democrats and Republicans, specifically over whether tax increases or major changes to our entitlement programs (especially Medicare) should be included in the deal. I believe the current stalemate is part of the negotiating process and that a final deal will be reached in early-to-mid August. The 2 August deadline is not, in my view, written in stone and I believe Treasury has further flexibility and will exercise it. A negative reaction from the market or the development of another painful economic indicator may be the trigger that prompts policymakers into action on a final deal. It is important to keep in mind that we are likely to see this political brinksmanship on future debt ceiling votes whenever they occur, so look for future challenges on the debt ceiling and equally difficult political votes.

KK: As part of the debt ceiling debate, Democrats have discussed a "down payment" on future fiscal cuts. How likely is this and what might this mean?

JS: There will clearly be some federal spending cuts in any

final deal. Whatever the eventual numbers are, many members of Congress will argue that they are too severe or not extensive enough, but I believe that voters will view them as significant once a deal is concluded. Bipartisan negotiators have already identified approximately \$2 trillion in spending cuts, but I believe the ultimate cuts will be much higher. The key will be whether the cuts will actually be made in the future. It is easy for Congress to agree to spending cuts in the future, especially since many of the current members will no longer be serving then, but it is much more difficult to allow the cuts to happen at the time they are scheduled to go into place. Congress has not had a good track record when it comes to following through and enacting previously agreed to spending cuts. For this reason, I expect there to be some sort of mechanism in the final deal that maximizes the likelihood that cuts will be made in an across-the-board fashion if Congress loses the appetite to make the cuts themselves.

KK: The economy is again showing some signs of slowing, with concerns increasing about a potential renewed downturn. Do you think there is any potential for additional short-term stimulus, perhaps as job-creating proposals?

JS: Many in Washington will continue to call for additional stimulus, either through new federal spending or tax cuts,

A negative reaction from the market or the development of another painful economic indicator may be the trigger that prompts policymakers into action.

but I don't believe we will see such measures enacted soon. The strong deficit reduction sentiment in Washington trumps these considerations, and there is doubt among enough lawmakers that such measures would work, as many stimulus measures have already been enacted over the last few years without the anticipated impact. Instead, Congress will tinker with smaller,

more targeted measures that are helpful in creating jobs and generating meaningful economic activity but are not a panacea to the slump we see in the economy today. Free trade agreements, repatriation of overseas corporate earnings and targeted infrastructure improvements are measures that you will hear discussed in this regard.

KK: Trade seems to be a bigger policy issue this year. We had actually initially feared that we might see an increase in protectionism, and the opposite seems to be materializing. Do you expect the free trade agreements with Panama, South Korea and Colombia to pass, along with any others?

JS: There has been some quiet progress made between the Obama administration and Republicans in Congress on this issue. I think it is more likely than unlikely that these trade agreements will be voted on in both the House and Senate this year and that they will pass. Trade votes are always contentious, and these will be very close votes.

Job gains from the passage of these agreements are expected to be around 250,000. They will increase US exports by \$13 billion. Panama, South Korea and Colombia have all signed preferential trade deals with other countries as our agreements with them have languished over the last three years, so passage of these agreements is important for the US to remain competitive in world markets.

KK: There are again reports that Congress may allow a one-time repatriation of corporate profits from overseas. Do you see this as likely?

JS: The repatriation issue has certainly been gaining traction in Washington this summer as lawmakers grasp for policy proposals that could stimulate job or economic growth. We believe there could be more action on repatriation in Congress this year, but at this time, I do not think a repatriation tax holiday is likely to become law in the near term. Congressional Republicans largely support a repatriation holiday, and the House may vote on it before the end of this year. Democrats are divided on the issue, with the most important one in the White House opposed to it. The largest impediment to another one-time repatriation holiday, however, may be the cost. A repatriation tax

holiday by itself is expected to cost in excess of \$75 billion, and that will be difficult for many members of Congress to ignore unless the administration gets behind the bill as a new stimulus. We have not yet seen evidence of that.

KK: Do you expect Obama's healthcare reform law to be changed substantially, now that future waivers are not being granted and more circuit courts have questioned some of the provisions? What do you think would be changed if Republicans win the presidency?

Job gains from the passage of these agreements are expected to be around 250,000. They will increase US exports by \$13 billion.

JS: Congress will not change the new healthcare law in any meaningful ways over the next 18 months. Certainly, action in the courts could strike down the individual mandate to purchase health insurance, and that would have ramifications for other provisions in the law as well. As the courts consider these issues, the Obama administration will remain committed to the law's implementation. Many of its more contentious provisions don't go into effect until 2013 or later. If the courts do not strike down any of the provisions, the only thing that will prevent the new law from being implemented as passed by Congress is a political change resulting from the 2012 elections that would put Republicans in charge of the Senate and the White House, while maintaining their majority in the House. Republicans would clearly revisit the healthcare law at that point, but they would need to control all of these levers of power in Washington to actually make changes or repeal the law.

KK: Will housing policy be addressed before the next elections, including changes to Fannie Mae and Freddie Mac? Are there implications of reductions in loan limits and could that be delayed?

Washington Watch

JS: Reforms to Fannie and Freddie will not be enacted before 2013 due to the political gridlock in Washington. Reforms beyond that will depend on which party is in charge and on the condition of the housing market. Republicans generally see a greater need for reforms than Democrats do at this time, but both parties know that continued softness in the housing market is a signal to proceed cautiously on this issue. Expect lots of noise about Fannie and Freddie but little action until the political environment and housing markets settle a bit.

KK: How do you see energy policy after the nuclear crisis in Japan?

JS: With regard to nuclear energy, Congress seems to have taken a wait-and-see approach, not wanting to overreact with long-term policy changes before the full story on the Japanese crisis is written. For energy policies in general, Congress seems currently incapable of making notable changes to current law. Energy issues have become so political that even if a relatively noncontroversial

... Or are independents turned off by what they may view as a lack of pragmatism, and will they side again with President Obama as the majority of independent voters did in 2008?

energy proposal were to come to a vote on the Senate floor, it would quickly become the target of more controversial amendments. These highly charged issues such as climate change and oil and gas taxes therefore tend to deter any significant energy policy from moving in the Senate. We could see some discussion of targeted tax relief or loan guarantees for energy investments, but even those once-popular proposals are being reevaluated by many of the new members of Congress who question why the government is choosing different sectors for

federal support. At the end of the day, it is the Environmental Protection Agency and the Department of the Interior that are currently setting energy policy in the country.

KK: Finally, on a broader political note, the Republican primaries are coming into focus. Can you share any general thoughts on what you think will happen, and the role of economic issues in the early debates?

JS: Presidential primary elections have historically been exercises in appealing to and exciting the base voters of the political parties. The 2012 Republican presidential primary contest will be no different. The conversation, therefore, among the candidates and active voters will be philosophically conservative. How independent or unaffiliated voters respond to the issues of the primary debate will be crucial, since they now outnumber both Democrats and Republicans nationally and will likely determine who wins the general election. Will they be attracted to the primary debate because they believe the ideas and solutions discussed as well as the ultimate winner are better alternatives to the president? Or are they turned off by what they may view as a lack of pragmatism, and will they side again with President Obama as the majority of independent voters did in 2008?

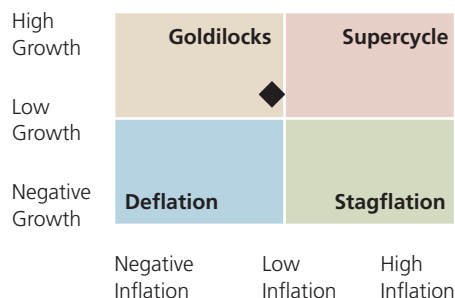
Economic issues will be at the top of every candidate's agenda. These are the issues voters care most about, and voters should have a very clear choice in 2012 on the candidates' competing plans and visions. Much of this has already played itself out in the debate in Washington this year over the proper role of government in managing our economy. Whether the federal government should play a larger or smaller role in our economy is the key question that will underpin most positions the two candidates take on economic issues.

Market Scenarios

Economic data have turned weaker recently, centered on the Manufacturing sector. Consumer spending has been disappointing as unemployment is high, and inflation exceeds wage growth in many countries. The global economy still appears headed for moderate growth in the months ahead. Both fiscal and monetary policies remain generally supportive of growth and the recent pullback in oil prices could help consumption.

Moderate Recovery

60%

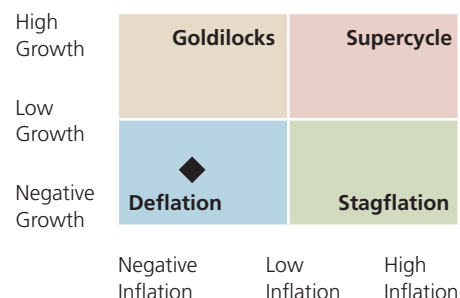


- The global economy remains on a self-sustaining but unspectacular expansion course
- The recovery in developed countries is more subdued than in prior cycles because of deleveraging pressures on the consumer and the Financials sector
- Emerging markets continue to outpace developed markets even as monetary policies are being tightened to restrain inflationary pressure

Renewed Downturn

20%

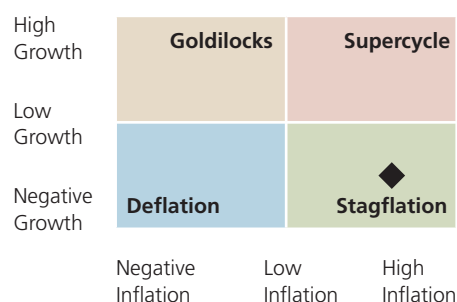
(up from 10%)



- The fragile recovery in the developed economies stalls as fiscal consolidation and initial interest rate hikes create additional headwinds
- High unemployment and falling house prices weigh down consumer spending
- This scenario favors fixed income over equities

Stagflation

15%

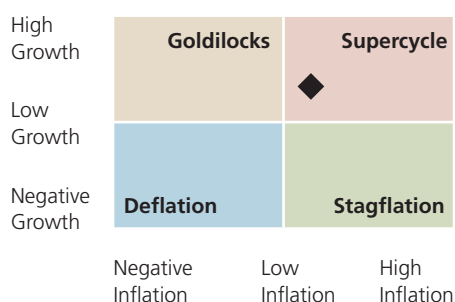


- Commodity prices rise due to political instability in the Middle East and/or poor food harvests, setting an inflationary process in motion
- Rising price levels and weak growth prospects pose significant challenges to most financial assets

Strong Recovery

5%

(down from 15%)



- High profit margins and low interest rates encourage a surge in investment spending
- Businesses gain enough confidence to increase new hires, helping to boost consumer spending and housing demand
- This scenario favors equities over fixed income

Growth to rebound soon

After a real GDP growth deceleration in 1Q11, monthly indicators continue to point to further growth weakness in June. However, evidence pointing to a rebound in real activity is also mounting. We continue to think that by 3Q11 the latest real GDP growth will rebound to a healthier clip. In contrast, the recent acceleration in core Consumer Price Index (CPI) inflation seems persistent enough that we are raising our core inflation forecasts.

Visible growth deceleration

Real GDP decelerated from 3.1% quarter-over-quarter (q/q) annualized in 4Q10 to 1.9% in 1Q11, as the surge in energy prices curtailed real purchasing power of businesses and consumers. Adding to the current growth soft patch, supply disruptions emerged in the aftermath of the Japanese earthquake that have affected the auto and technology sectors in the US. May auto sales fell a whopping 10%, with weakness stemming almost entirely from domestic production as parts supply from Japan was disrupted. The timeliest real activity releases—the regional manufacturing climate indexes for New York State and the greater Philadelphia area—showed further deterioration, with indexes falling into contraction territory. In part, the supply disruptions were to blame in New York, but since the greater Philadelphia area is largely independent of Japanese supplies, the sharp drop in activity there seems to have a more genuine character.

Growth should be better in second half

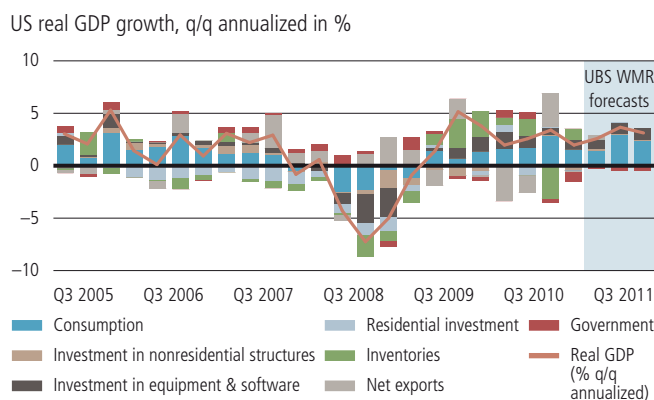
Although part of the growth deceleration seems to be genuine, we think that real GDP growth will accelerate slightly to 2.5% q/q annualized in 2Q11, and more meaningfully to 3.5% in 3Q11. After that, we expect it to settle to a trend-like 3% in 4Q11. First, aggregate nominal payroll earnings accelerated to a 5.8% annual pace in 2Q11 through May from a 4.3% pace in 1Q11. Therefore, the growth of labor income earned by persons that are employed has improved, despite weak payroll growth in May. Second, scheduled auto production as put forward by US auto manufacturers heralds a jump in actual production in June and July as supply disruptions fade. We estimate that the auto sector alone probably shaved off about 1 percentage point at an annual rate of real GDP in 2Q11.

Core inflation acceleration is persistent

Core CPI inflation accelerated from 0.6% y/y in December 2010 to an annualized 2.5% pace through May. The acceleration was primarily due to higher rent and owners' equivalent rent (OER) inflation (0.6 percentage points of the acceleration), followed by vehicle price inflation (0.4 percentage points) and apparel (0.1 percentage points). We think that rent and OER inflation will likely continue to accelerate and thus we raise our core CPI forecast from 1.4% to 1.9% in 2011 and from 1.8% to 2.1% on a 4Q to 4Q basis.

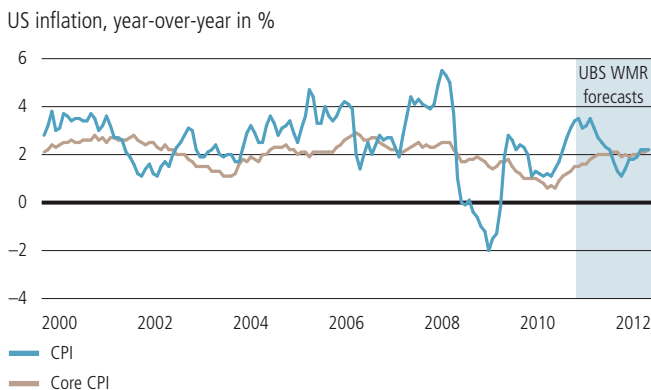
Thomas Berner, CFA, Analyst

Fig. 1: Growth will likely pick up again by third quarter



Note: For full explanation of this chart, please see appendix.
Source: Thomson Datastream, UBS WMR, as of 29 June 2011

Fig. 2: Core CPI inflation is trending higher



Note: For full explanation of this chart, please see appendix.
Source: Thomson Datastream, UBS WMR, as of 29 June 2011

All eyes on Greece

The international economic news flow has been dominated by the events in Greece. We stick to our view that eventually Greece will have to restructure its debt, but the most recent news suggests that it will be able to secure funding for at least a few more months. In China, the growth deceleration continues, prompting downward revisions to consensus growth forecasts. We continue to expect a soft landing, with minimal negative consequences for global growth.

Another round of fiscal woes in Greece

As the disbursement date of the next tranche of bailout funds from the eurozone members and the IMF was nearing, it became clear that Greece had not managed to improve its fiscal situation to the extent agreed upon by the involved parties. This sent Greek bond yields higher and led to another wave of unrest on the streets. Prime Minister George Papandreou narrowly passed a confidence vote that gave him another opportunity to push a fiscal austerity package through Congress in order to meet the requirements for the next bailout funds tranche due in early July. Even if Greece receives its next tranche, the daunting task of rebalancing its fiscal position is far from over. We continue to believe that Greece will eventually have to restructure its debt, and that the resolution of the problem is merely being delayed.

Growth soft patch goes global

The most recent economic activity data suggest that growth is slowing more visibly both in the US and across the globe. European business climate indexes slid further in June, although they still signal positive growth. Similarly, the Chinese business climate also continued to deteriorate, fueling fears that China might face a hard landing. In our view, we still think that China can avert a more severe growth slowdown, as authorities have the financial means to support the economy and have also shown that they are willing to act quickly and forcefully if economic indicators deteriorate.

Japan set for a rebound

Japan has fallen into another recession following the tragic events in March. Politicians continue to bicker over the main reconstruction spending package, and within weeks the Prime Minister is likely to be replaced yet again. However, this should not seriously delay reconstruction efforts, which will in any case take years if not decades to complete. Industrial production is recovering more quickly than initially expected although electricity shortages may constrain output during the summer.

Thomas Berner, CFA, Analyst

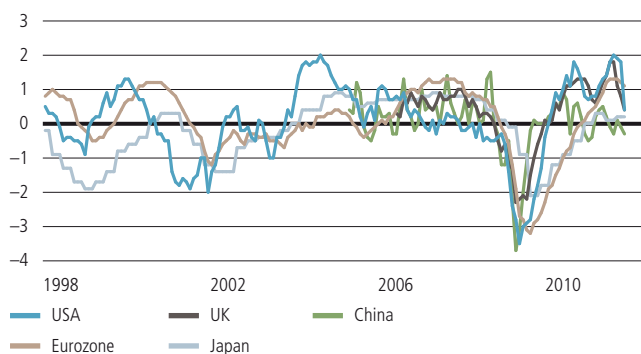
Fig. 3: Growth and inflation forecasts

in %	GDP Growth			Inflation		
	'10	'11F	'12F	'10	'11F	'12F
World	4.2	3.6	4.0	2.9	3.7	3.1
US	2.9	2.6	2.7	1.6	2.9	1.8
Canada	3.2	2.9	2.3	1.8	2.7	2.2
Japan	4.0	-0.4	3.5	-0.7	0.2	0.8
Eurozone	1.8	1.8	2.0	1.6	2.8	2.2
UK	1.3	1.7	2.2	3.3	4.6	2.7
China	10.3	9.3	9.0	3.3	5.0	4.0
India	8.5	7.5	8.5	12.1	7.0	7.5
Russia	4.0	4.8	4.5	6.8	9.6	7.7
Brazil	7.5	4.5	4.5	5.9	6.3	5.5

Note: For full explanation of this table, please see appendix. F: forecast
Source: UBS WMR, as of 29 June 2011

Fig. 4: Manufacturing activity is slowing

Global real activity, standardized (mean=0, standard deviation=1)

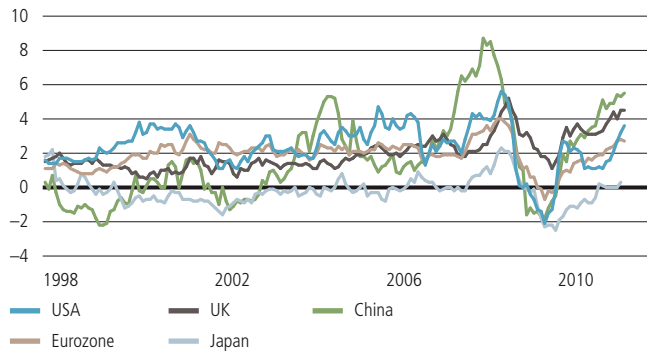


Source: Bloomberg, UBS WMR, as of 29 June 2011

Economic Outlook: Chartbook

Figure 5: Inflation resurgence a key risk in some countries

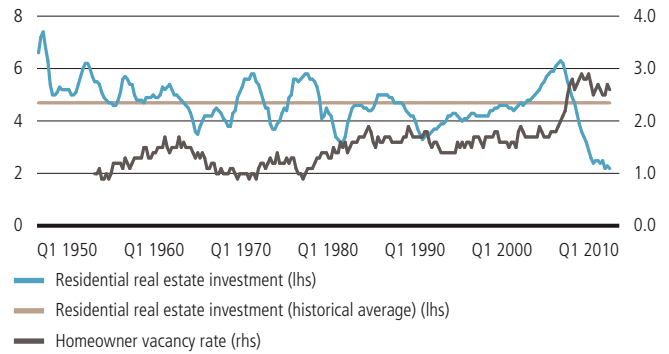
Global CPI inflation rates, year-over-year in %



Source: Bloomberg, UBS WMR, as of 29 June 2011

Figure 6: Housing recovery likely to be lackluster

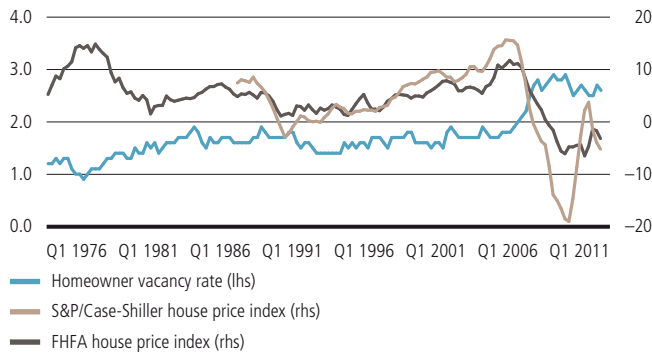
US housing market, left scale in % of GDP, right scale in %



Source: Thomson Datastream, UBS WMR, as of 29 June 2011

Figure 7: House prices to fall again moderately in 2011

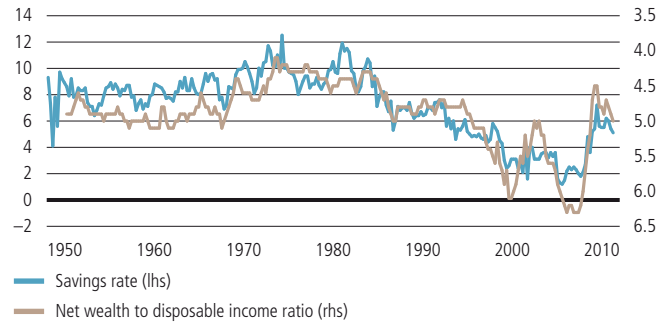
US house prices, left scale in %, right scale in year-over-year %



Source: Thomson Datastream, UBS WMR, as of 29 June 2011

Figure 8: Net wealth is recovering; savings rate stabilized

US household net wealth and savings rate, in % of disposable income

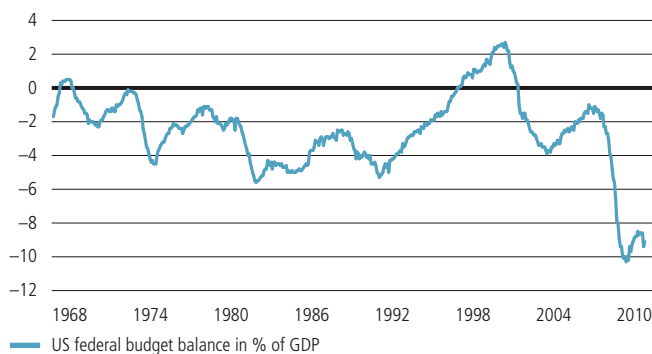


Note: Right scale is inverted

Source: Thomson Datastream, UBS WMR, as of 29 June 2011

Figure 9: Federal deficit likely to narrow further

US Federal budget balance, in %

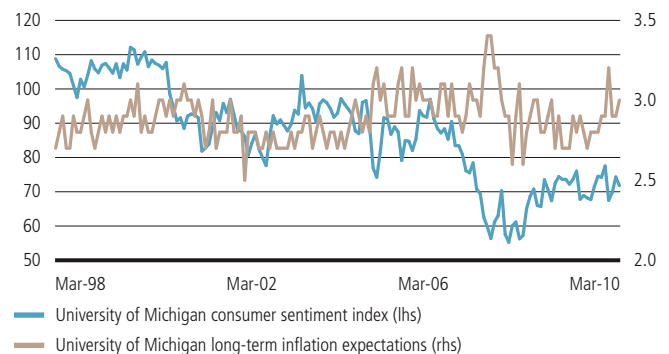


Note: Sum of monthly federal budget balance over the past 12 months divided by current-quarter annualized nominal GDP

Source: Bloomberg, UBS WMR, as of 29 June 2011

Figure 10: US consumer sentiment stuck at moderate level

US consumer sentiment (index level) and inflation expectations (in %)

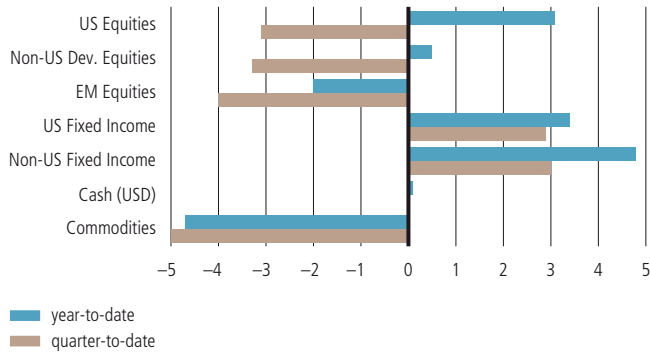


Source: Bloomberg, UBS WMR, as of 29 June 2011

Financial Market Performance

Fig. 1: Asset Classes

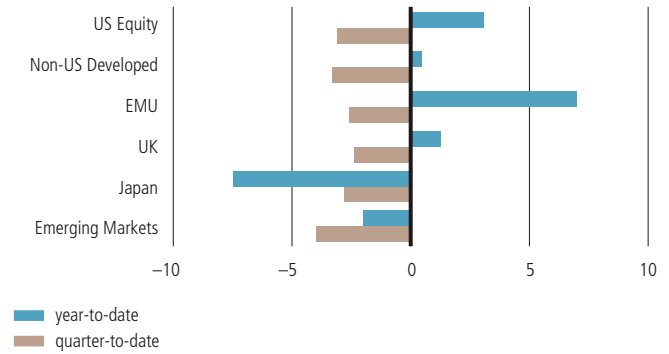
Total return in USD and %



Source: Bloomberg, UBS WMR, as of 27 June 2011

Fig. 2: International Equity

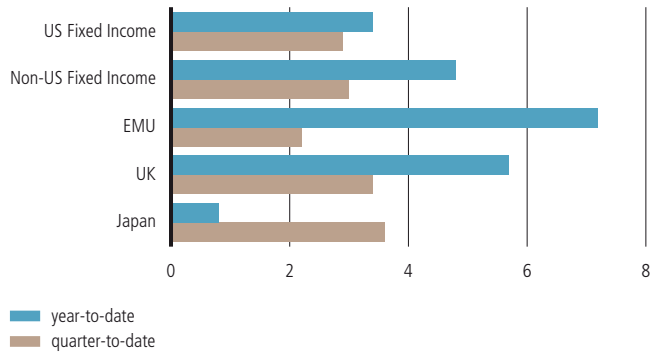
Total return in USD and %



Source: Bloomberg, UBS WMR, as of 27 June 2011

Fig. 3: International Fixed Income

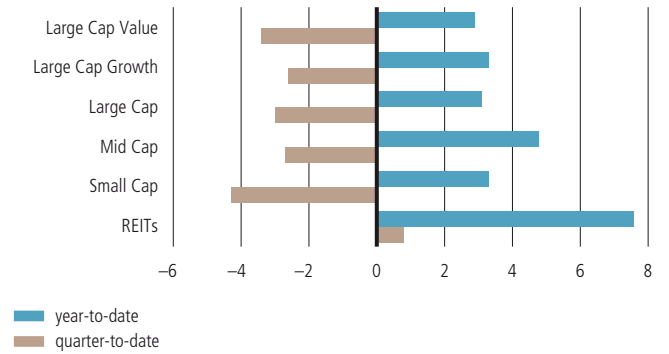
Total return in USD and %



Source: Bloomberg, UBS WMR, as of 27 June 2011

Fig. 4: US Equity

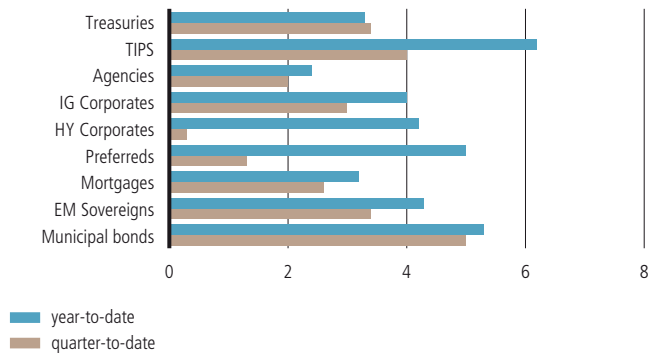
Total return in USD and %



Source: Bloomberg, UBS WMR, as of 27 June 2011

Fig. 5: US Fixed Income

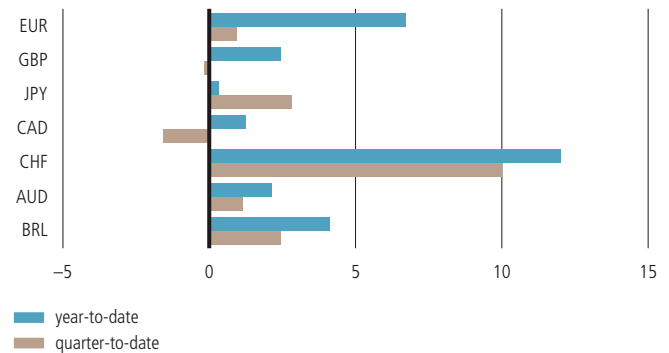
Total return in USD and %



Source: BofAML, UBS WMR, as of 27 June 2011

Fig. 6: Currency appreciation vs. USD

Appreciation vs. USD in %



Source: Bloomberg, UBS WMR, as of 27 June 2011

Looking through the soft patch

With growth set to resume during the second half of the year, and consensus expectations having been downgraded substantially, the bar is rather low for surprises to turn positive. Given attractive equity valuation levels, we believe this creates a supportive backdrop for equities to outperform bonds and cash for the rest of the year. As a result, we have increased our recommended overweight to equities and moved out of cash.

Equities to benefit from return to higher growth

We believe that equities will outperform fixed income and cash over the next 9 to 12 months. The recent pullback has improved equity valuation and provided that the current soft patch does not prove to be a much more severe downturn than we anticipate, equities should provide enough upside to compensate for their inherent risk.

Valuation-wise, global equities exhibit a 19% upside to fair value according to our proprietary dividend discount model. This valuation gap is one which, while not providing any guarantee that a bottom has been reached, is significant enough to suggest an attractive pocket of value for investors willing to look several quarters out. Other valuation indicators, such as the forward price-earnings ratio, confirm the assessment that equity valuations are below average, suggesting upside potential.

How does the cyclical picture then factor into our equity

outlook? Clearly the soft patch in economic data has been a key source of pressure on the market as of late. With uncertainties remaining as to the ultimate length of this phase, we can certainly not exclude that this phase will drag on into the later part of the summer. However, we note that consensus expectations for growth have been adjusted downward quite significantly already and a mere stabilization in the news flow could be enough to help markets move higher. Various economic surprise indexes have reached unusually depressed levels (see Fig. 9 on pg. 27), suggesting that the bar for positive surprises to ensue is now set rather low. While second quarter earnings season may not be as positive as prior quarters in terms of the magnitude and breadth of earnings beats, we think it will be solid enough given reduced macroeconomic expectations.

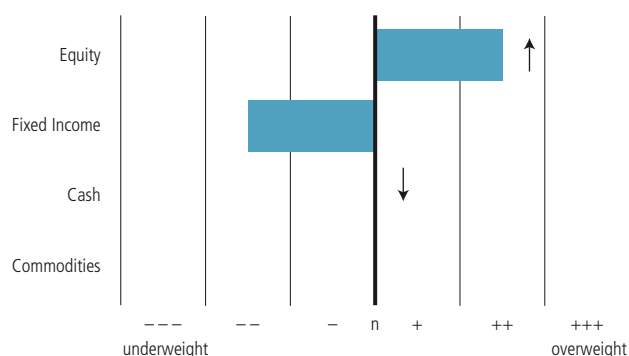
Finally, investor positioning appears to be rather cautious at this stage, among both retail and institutional investors. For instance, short interest, another indicator of bearish sentiment, has been steadily rising since late January. A confluence of such indicators frequently indicates the potential for a rebound when economic data subsequently stabilize or even start surprising positively.

Uninspiring fixed income prospects

We remain underweight fixed income. The Fed's dovish stance combined with weaker economic data has driven bond yields down this year with 10-year Treasury yields

Fig. 1: Asset class preferences

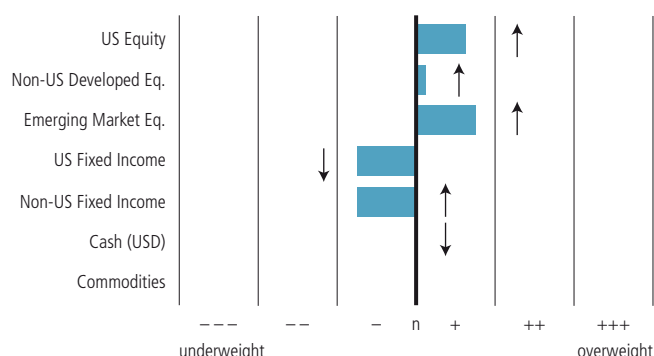
Tactical deviations from benchmark



Note: Black arrows indicate changes as of 26 June 2011. Scale explained in Appendix. Source: UBS WMR, as of 26 June 2011

Fig. 2: Asset class and regional preferences

Tactical deviations from benchmark



Note: Black arrows indicate changes as of 26 June 2011. Scale explained in Appendix. Source: UBS WMR, as of 26 June 2011

breaking below 3% once again. This may well delay the day of reckoning for bonds. However, even if yields take longer to normalize than we had previously anticipated, at this point, return prospects for bonds are at best very muted given low available yields. Moreover, as we have emphasized in our Decade Ahead report earlier this year, we expect yields to rise significantly during the next three to five years. And though the timing of such a rise is uncertain, we can safely state today that investors are not being fairly compensated for the medium-term risks that underlie bond markets. Keep in mind that bond market corrections are often sudden and large. For instance, back in early 2004, at a similar stage in the cycle, all it took was a surprisingly strong labor market report and bond yields rose by more than 1% point over a two-month period leading the broad US bond market to correct by over 4%.

Moderate upside for selected commodities

Commodities have turned less expensive following the 11% correction they experienced since late April. However, on average, spot prices are flat for the year and valuations are still rather demanding relative to gauges such as marginal costs of production. From a cyclical perspective, while we expect commodity demand to continue growing at a steady pace, we note that the cumulative effect of past policy tightening in emerging markets as well as the likely additional future tightening creates a macro backdrop that is less favorable for commodities than the situation during 2010. Keep in mind also that

2010’s QE2 program and the anticipation thereof during the summer was a key driver of commodity performance. We do not anticipate such support going forward. Finally, while commodities are no longer as crowded a trade as they were a quarter ago, long speculative positions are still the norm by far, suggesting that adverse news could still lead to significant price adjustments. Finally, we remind readers that even if spot prices rise, they need to rise by more than the anticipated roll yield costs that arise from rolling over commodities futures positions. We estimate these at around 4%-5% per annum. While this is less than over the long run, it is still a hurdle that spot price returns need to exceed to benefit investors. Overall, while we see pockets of opportunity in selected commodity markets as highlighted by Dominic Schnider on page 38, we are maintaining a neutral tactical stance on the asset class.

Stephen R. Freedman, PhD, CFA, Strategist

Fig. 3: Asset class scorecard

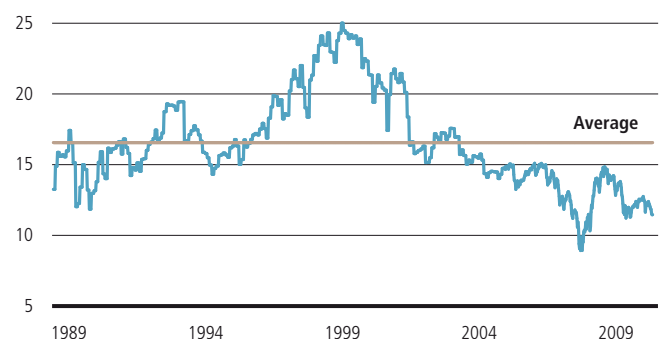
Scores range from -3 (very unattractive) to +3 (very attractive)

	Valuation	Cyclical	Timing	Overall
Global Equities	+2	+1	+0	+1
Commodities	-1	+1	+0	+0
Fixed Income	-2	-1	+0	-1

Source: UBS WMR, as of 29 June 2011

Fig. 4: Attractive global equity valuations

MSCI World Price-Earnings ratio based on 12-month forward consensus earnings



Source: Datastream, IBES, UBS WMR, as of 24 June 2011

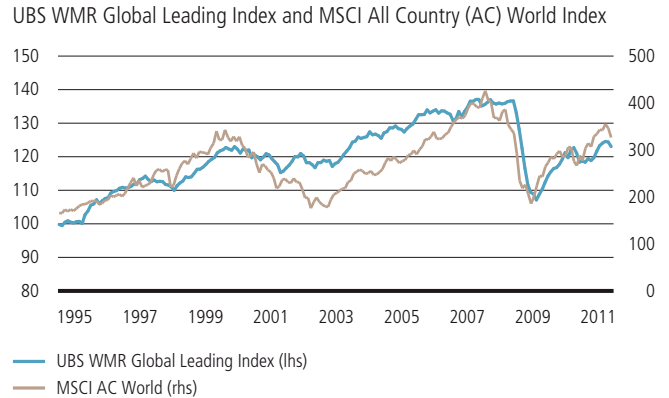
Asset Classes: Chartbook

Fig. 5: Bond yields at multi-decade lows



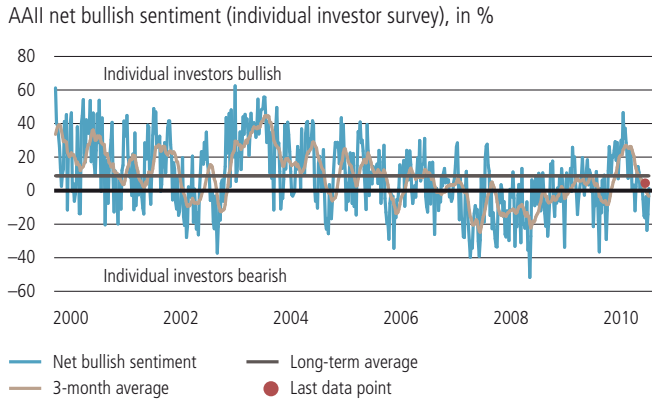
Source: Barclays Capital, UBS WMR, as of 24 June, 2011

Fig 6: Leading index has rolled over



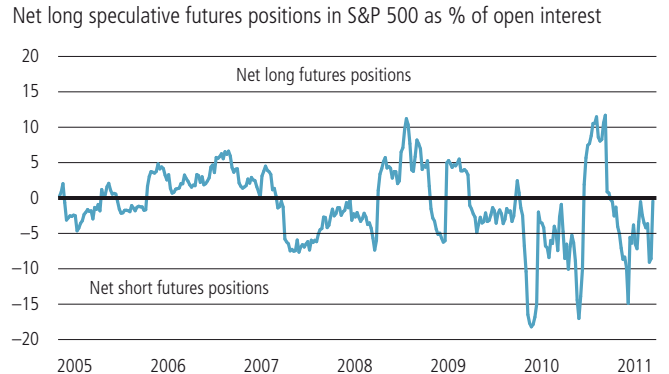
Source: UBS WMR, Bloomberg, as of 27 June 2011

Fig. 7: Investor sentiment remains decidedly cautious



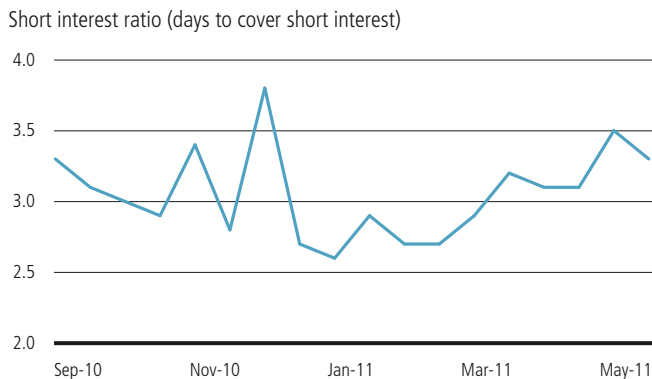
Source: Bloomberg, American Association of Individual Investors (AAll), UBS WMR, as of 27 June 2011

Fig. 8: Bulls and bears offsetting each in futures markets



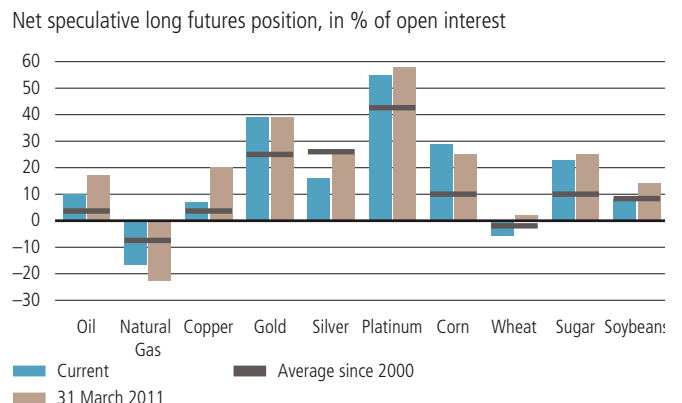
Source: Bloomberg, CFTC, UBS WMR, as of 21 June 2011

Fig. 9: Elevated short positions can support equity market



Source: Bloomberg, UBS WMR, as of 15 June 2011

Fig. 10: Commodity speculative long positions still high



Source: CFTC, Bloomberg, UBS WMR, as of 26 June 2011

Foreign Exchange

Risk in currency markets and the Swiss franc

Given our moderately constructive view on risk and global growth for the rest of 2011, we expect commodity currencies, emerging markets and high-yielding currencies to gain at the expense of low-interest rate and perceived “safe haven” currencies. However, the most important currency pair, EURUSD, remains in precarious balance between major risks in the US and Europe. While we expect the USD to weaken further to 1.48 over the next year, we think EURUSD could still fall below 1.40 in the near term. We continue to like the Canadian dollar, the Swedish and Norwegian kroner, as well as the British pound. While the Australian dollar is attractive from a yield standpoint, it is massively overvalued and we would only recommend buying on dips.

The Swiss franc (CHF) is attractive from a fundamental perspective, yet it is quite expensive for dollar (US dollar, unless otherwise noted) investors at current spot prices. The Swiss franc has traditionally been a very good indicator of overall risk sentiment in global markets. As markets have fretted about a global growth slowdown and the European debt crisis, the franc has been in high demand. Although the dollar has typically also played this role, concerns about the US have pushed the franc toward new highs against both the dollar and the euro, stretching its valuation. We estimate the “fair value” of the EURCHF at 1.39 according to purchasing power parity (PPP) calculations, but the pair is trading below 1.20. This can be explained by Switzerland’s

solid economic expansion with low unemployment (2.9%), low but still positive inflation (CPI at 0.4% y/y) and comparatively sound fiscal position.

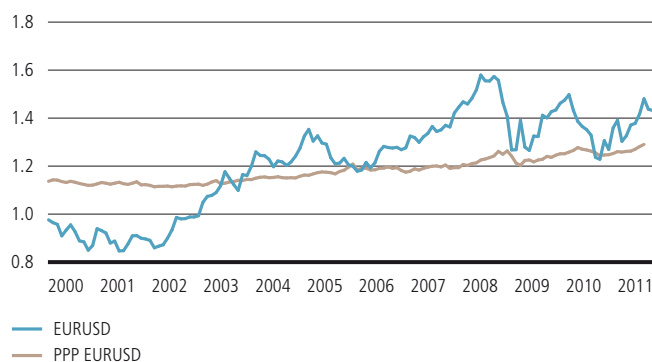
The US dollar, in turn, has lost some of its attractiveness in times of turmoil as much of the stress has originated in America. Most important, the Fed is the only major central bank other than the Bank of Japan to continue actively loosening monetary conditions, while a shift toward hiking rates has been the norm elsewhere. Overall, this has pushed the dollar to record lows against the Swiss franc. Where our PPP calculation for USDCHF would put it at 1.08, the spot price is 0.83.

We expect that, in spite of a strong economy, the Swiss franc’s strength will dissipate against the euro and the dollar as the global recovery gains momentum after the current soft patch. We look for USDCHF to float up to a low 0.88 in a year, and EURCHF to move to 1.30. However, the franc, as well as the Japanese yen — the other typically low-interest rate country whose currency does well in times of stress — could rally once more whenever markets again become panicky. The fundamentals of the franc make it attractive to diversify a portfolio, but for a dollar investor it is very pricey at current levels.

Katherine Klingensmith, Strategist

Fig. 1: Euro remains strong despite debt crisis

Exchange rates and Purchasing Power Parity



Source: Thomson Reuters, UBS WMR, as of 28 June 2011

Fig. 2: Swiss franc stronger than PPP value vs. USD

Exchange rates and Purchasing Power Parity



Source: Thomson Reuters, UBS WMR, as of 28 June 2011

International Equities

Valuations attractive overseas

Solid earnings growth has brought P/E ratios down to attractive levels. We maintain a preference for emerging markets and the UK.

International valuations attractive relative to US

International equities look more attractive than the US on most valuation metrics. The UK and eurozone appear particularly inexpensive, but ongoing trouble in peripheral Europe makes us cautious on eurozone equities. Emerging markets offer superior economic growth while trading at a substantial discount to the US. Japanese equities look less expensive than usual but long-term growth prospects are as bleak as ever.

Exchange rates should be considered

Under normal circumstances, exchange rates are only a secondary consideration when investing in international equities, which our strategy assumes will be conducted without hedging the currency exposure. Exchange rate fluctuations add to risk for dollar-based investors, but this would usually not stop us from recommending an investment in an attractive market. However, with the dollar trading near record lows against many currencies, the potential for exchange rate movements to impact returns has become a more important consideration. In our view, among the developed markets, only the British pound looks reasonably inexpensive versus the US dollar. In addition, many emerging market currencies appear relatively cheap as they have employed massive intervention in the

foreign exchange markets to suppress the value of their currencies.

We continue to favor emerging markets

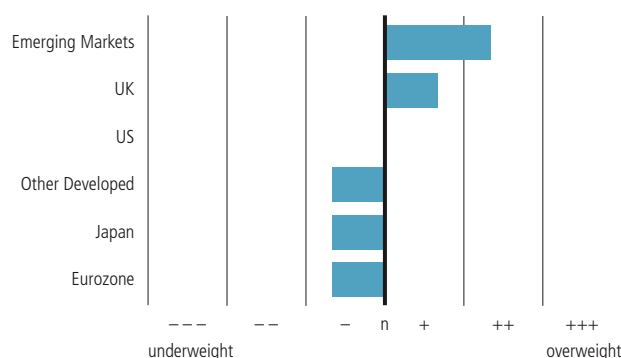
Within international equity markets we continue to favor emerging markets (EM). EM equities have performed poorly so far in 2011. The rise in food and energy prices early in the year pushed up inflation, forcing many EM central banks to raise rates. Inflation has been particularly problematic in the BRIC countries (Brazil, Russia, India, China), which represent a large share of EM equities.

Despite their weak performance in recent months, we believe that EM equities are in a position to offer superior returns over the next 9-12 months. Food and energy prices are back to where they were at the beginning of February. If commodity prices hold steady in the months ahead, inflation should peak in most EM countries by the end of the third quarter. While the situation varies by country, this should at least mark the beginning of the end of the rate-tightening cycle.

Compared with developed markets, EM offer better long-term growth prospects and trade at a discount. While consensus forecasts call for similar earnings growth rates in EM and developed markets over the next 12 months, in our view earnings forecasts are more likely to be achieved in EM, which rely more on revenue growth and less on a further expansion of profit margins from already lofty

Fig. 3: Equity regions

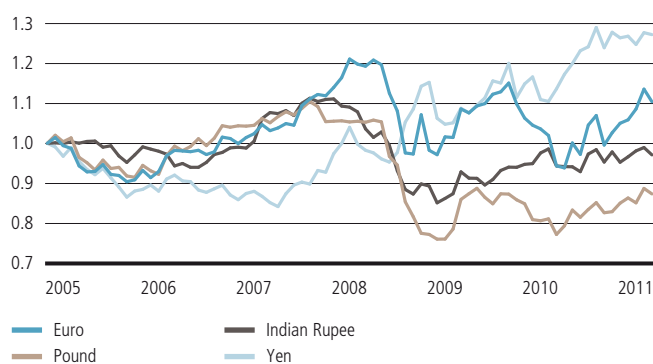
Tactical deviation from benchmark, including view on currency



Note: Scale explained in Appendix.
Source: UBS WMR as of 29 June 2011

Fig. 4: Pound, some EM currencies relatively cheap

Exchange rates versus US dollar, index Jan. 2005 = 1



Source: Bloomberg, UBS WMR as of 27 June 2011

levels. Nominal GDP growth in EM should beat developed markets by at least 5 percentage points over the next year, making it much easier for EM companies to generate revenue growth.

UK offers exposure to commodities and EM

For investors unwilling to invest in EM equities, we suggest developed market stocks that can benefit from EM growth. In the developed markets, the UK looks relatively attractive, in our view. While the domestic economy has been struggling, companies listed in the UK generate around 70% of their earnings overseas, and include a significant share of commodity producers. Valuations look inexpensive with the market trading below 10 times consensus earnings.

Eurozone debt crisis creates downside risks

The eurozone has been one of the best-performing equity markets so far in 2011, mainly because the euro has strengthened against the US dollar. Despite problems in countries such as Greece, the economic data for the eurozone as a whole has held up better than in the US. Eurozone equity valuations are also even more attractive than they were at the start of the year. However, we maintain a moderate underweight recommendation, as we believe that investors should avoid excessive exposure to the ongoing debt crisis. One wrong move could trigger severe disruptions in the financial system, undermining both the equity market and the euro.

Japan: maintain moderate underweight

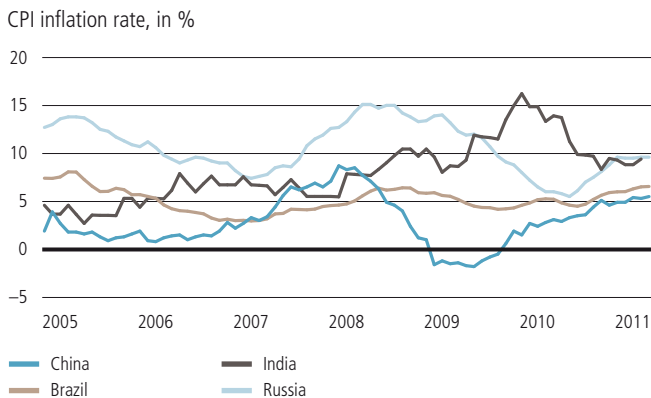
Valuations on Japanese equities appear more attractive than usual, especially considering the prospects for reconstruction spending to temporarily boost economic growth in 2012. However, we maintain our moderate underweight recommendation as long-term growth prospects are poor. Government finances are on an unsustainable path, making the yen vulnerable to a rapid depreciation at some point in the future.

Moderate underweight on other developed markets

While there are some positive aspects among the other developed markets, these are more than offset by negative factors and we maintain our moderate underweight recommendation. Australian equities have fallen so far in 2011, making them more attractive in terms of valuations. However, the economy has been buffeted by both bad weather and cautious consumer spending, while the Australian dollar appears extremely overvalued against the US dollar. The situation in Switzerland is similar, as equity valuations are reasonable but the Swiss franc is severely overvalued. Canada offers relatively strong financial institutions and exposure to commodities, but valuations are unattractive.

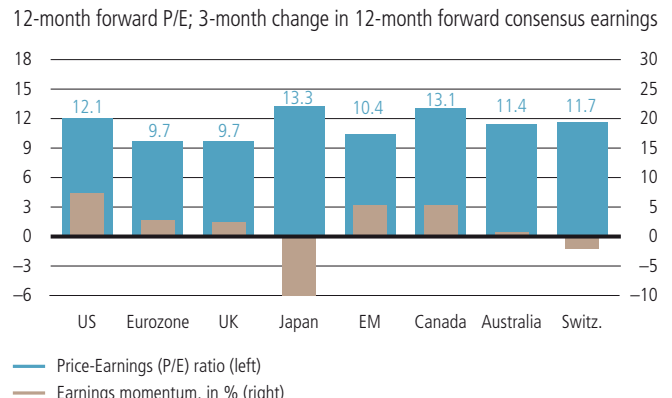
Brian Rose, PhD, Strategist

Fig. 5: Inflation problems in BRICs



Source: Bloomberg, UBS WMR as of 27 June 2011

Fig. 6: Regional equity valuations and earnings momentum



Source: IBES, Datastream, UBS WMR as of 27 June 2011

Back to neutral on non-US fixed income

Within fixed income portfolios we abandon our recommendation to underweight international bond markets, moving back to a neutral position.

Our views on international fixed income are closely linked to the outlook for foreign exchange rates, as the relative performance of US and non-US fixed income investments is mostly determined by changes in the value of the US dollar. Our non-US fixed income benchmark is dominated by euro- and yen-denominated debt. While we see these currencies as overvalued against the dollar, any dollar rebound may be undermined by its poor fundamentals. We are therefore reverting to a neutral position (from moderate underweight) in non-US bonds.

Euro holding up despite debt woes

The euro exchange rate vs. the dollar was little changed during the second quarter. While the ongoing debt crisis in peripheral Europe is an obvious negative, it did not prevent the European Central Bank (ECB) from raising rates in April. Another rate hike is widely expected in July, and our forecasts call for the ECB to continue raising rates by 25 basis points (bps) every three months through the end of 2012. With the Fed likely to remain on hold for the rest of 2011 (and possibly much longer if the economic data continue to disappoint), a widening interest rate differential could work in favor of the euro. Within the eurozone, we continue to recommend avoiding Greek debt. While the sky-high yields may appear tempting, the risk of

restructuring is too high to make this a favorable bet. For both Ireland and Portugal, the risk of near-term restructuring is much lower, but we would still avoid any debt that matures after June 2013.

We favor UK over Japan

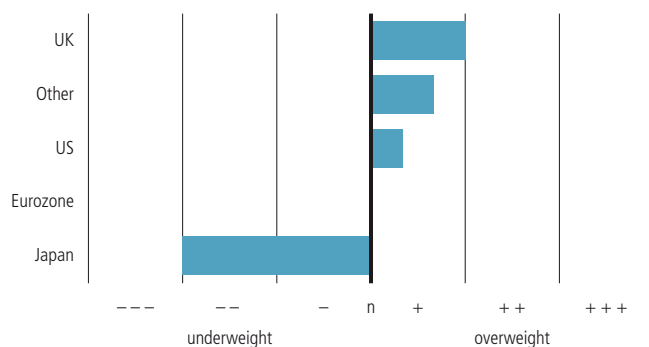
The pound is one of the few currencies that appear cheap against the US dollar. Fiscal policy is being tightened sharply, which should help to hold down government debt levels in the medium term, although the drag on the economy may also make it difficult for the Bank of England to normalize monetary policy. We recommend a moderate overweight in UK bonds as, relative to the other major currencies, there appears to be little room for the pound to depreciate against the dollar.

In Japan, government debt levels are extremely high, while bond yields are extremely low. Reconstruction spending will only add to the pressure on public finances. The yen is also one of the currencies that we expect to depreciate significantly against the dollar over the next 12 months. Once the Fed starts to raise interest rates, the yen may become the preferred currency for conducting carry trades, helping to lift the dollar against the yen. We therefore see Japan as one of the least attractive bond markets.

Brian Rose, PhD, Strategist

Fig. 7: Fixed income regions

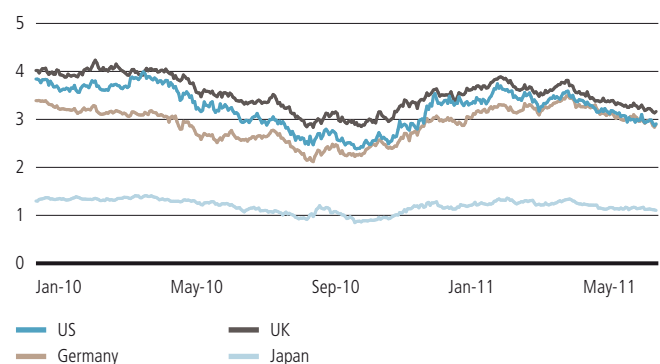
Tactical deviations from benchmark, including view on currency



Note: Scale explained in Appendix.
Source: UBS WMR, as of 29 June 2011

Fig. 8: Bond yield comparison

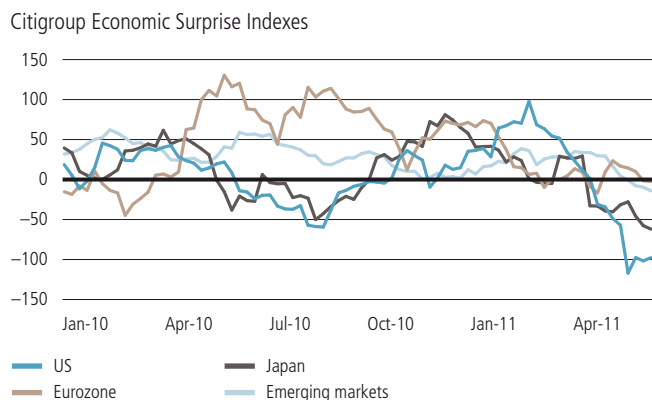
10-year government bond yields, in %



Source: UBS WMR as of 27 June 2011

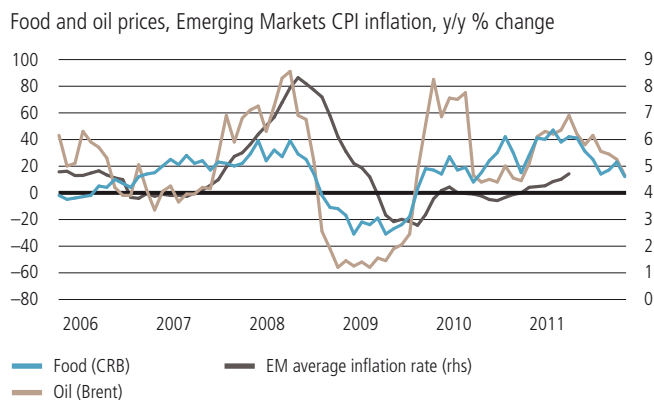
International markets: Chartbook

Fig. 9: Economic surprises mostly negative



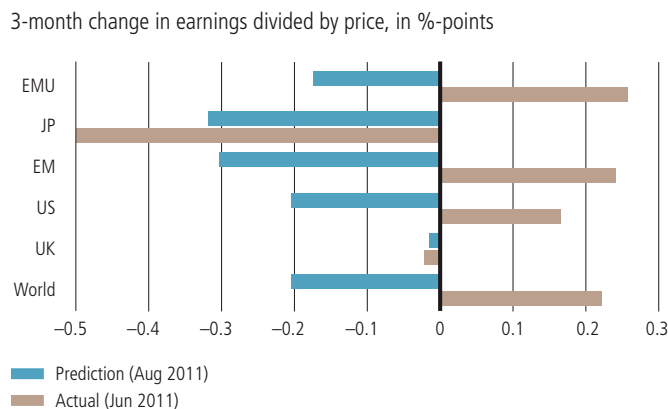
Source: Citigroup, Bloomberg, as of 27 June 2011

Fig. 10: Commodity pressure on EM inflation should wane



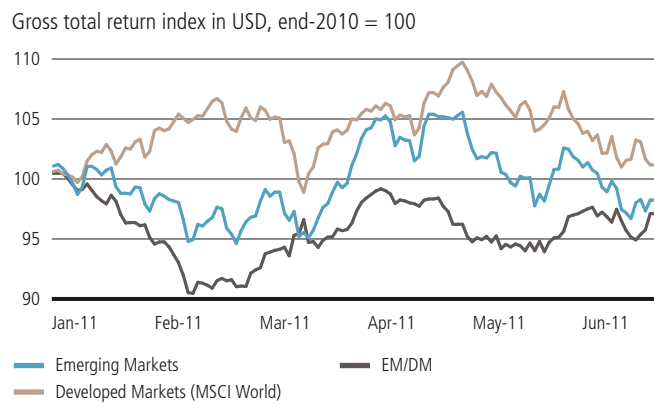
Note: Figures after June 2011 assume food and oil prices remain stable at current levels
Source: UBS WMR, Bloomberg, as of 27 June 2011

Fig. 11: UBS WMR model points to downward earnings revisions



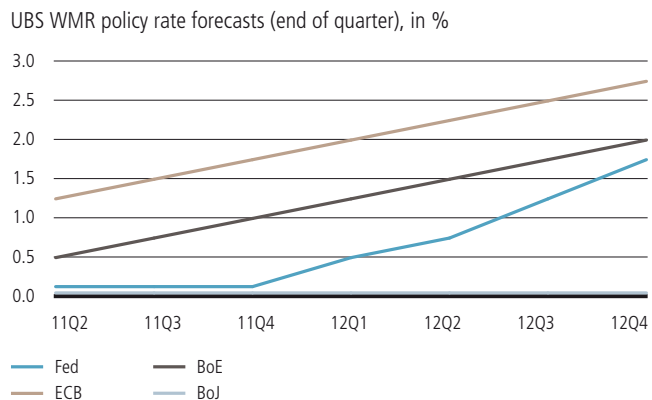
Note: Prediction shows model-generated forecast of consensus earnings revisions
Source: UBS WMR, IBES, as of 27 June 2011

Fig. 12: Emerging market equities lagging in 2011



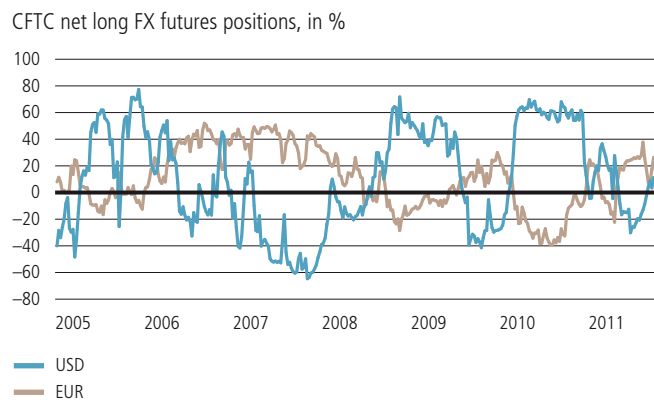
Source: UBS WMR, Bloomberg, as of 27 June 2011

Fig. 13: Major central bank policy rate forecasts



Source: UBS WMR, as of 29 June 2011

Fig. 14: Dollar short positions have closed



Source: UBS WMR, Bloomberg, as of 27 June 2011

Still a balancing act

After significant defensive sector outperformance in Q2, we look for more balanced returns between cyclicals and defensives going forward. We continue to favor “cheap” cyclicals, such as Technology, and we upgrade two sectors that have been the biggest laggards over the past three months — Financials (to overweight from neutral) and Energy (to neutral from underweight). Telecom and Utilities appear expensive and vulnerable to eventual higher interest rates.

Cyclicals vs. Defensives—wild swings continue

Even before the recent soft patch of weaker economic momentum began in earnest, defensive sectors had begun to outperform cyclicals. Since late February, defensive sectors have outperformed cyclicals by 12 percentage points (pp). Keep in mind that the strong relative defensive sector gains came on the heels of a sharp market rally during which cyclicals outperformed defensives by 21pp. Even so, defensives typically outperform cyclicals by “only” 10pp following past historical peaks in leading economic indicators, suggesting that the current outperformance by defensives is quite advanced. These sector gyrations appear consistent with the broader “risk on, risk off” market swings over the past two years as investors continuously question the durability and sustainability of the economic recovery. We expect that the current soft patch will prove to be temporary and growth will pick up

during the second half of the year supporting the broader market, and the earnings outlook for cyclicals.

Looking for recent laggards to rebound—upgrade Financials (overweight), Energy (neutral)

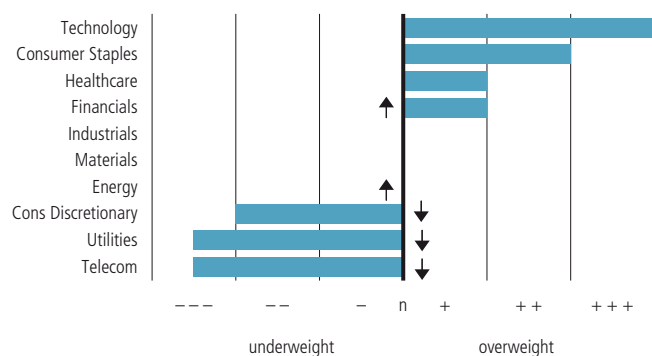
The Financials and Energy sectors were the weakest performers during the second quarter by a wide margin. As of June 27, Financials and Energy have declined 8% and 10%, respectively, quarter-to-date compared to the 3% decline in the S&P 500. Over the past three months, we have held a neutral stance on the Financials sector and a moderate underweight in Energy. In this report, we increase our allocation to both sectors, upgrading Financials to a moderate overweight and lifting the Energy sector to neutral. We explain our rationale for both decisions in the sector overview section below.

Downgrading selected “safe havens”

To fund these upgrades, we eliminate our prior overweight allocation to the Consumer Services industry group (restaurants, hotels, cruise lines) within the Consumer Discretionary sector. Since early April, Consumer Services has outperformed the market by 8pp. Quick service restaurant chains, which dominate the index, are seen as fairly defensive and we tactically downgrade to neutral following such strong relative performance. Additionally, we further reduce our allocation to Utilities and Telecommunications Services. These sectors

Fig. 1: Upgrading Financials, closing Energy underweight

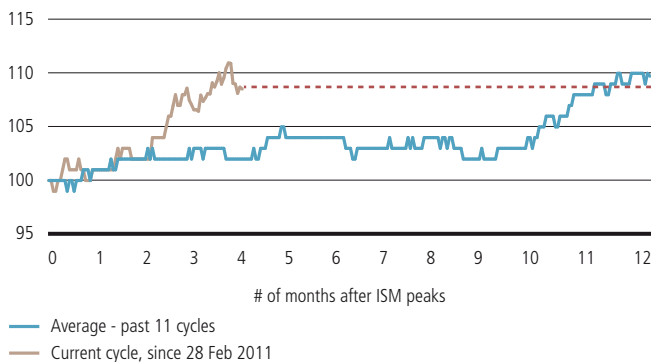
Tactical deviations from benchmark



Note: Black arrows indicate changes as of 29 June 2011. Scale explained in Appendix. Source: UBS WMR, as of 29 June 2011

Fig. 2: Defensive rotation already appears well advanced

Relative performance of defensive versus cyclicals after ISM peaks



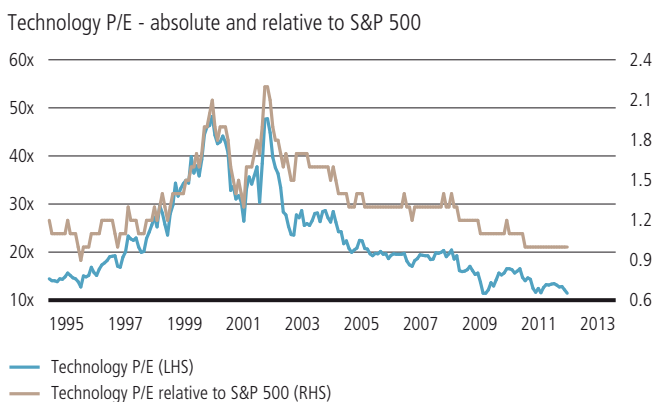
Note: Cyclical sectors: Materials, Industrials, Technology and Consumer Discretionary. Defensive sectors: Utilities, Telecommunications Services, Consumer Staples and Healthcare. Defensives are outperforming when the line in the chart is rising and underperforming when it is falling. Source: DataStream and UBS WMR as of 27 June 2011

have benefited from both the recent rotation into defensive sectors and, perhaps more importantly, from the sharp decline in long-term interest rates. Both Utilities and Telecom have the highest absolute dividend yields of the 10 S&P 500 sectors and “compete” with bonds among income-seeking investors. Utilities and Telecom valuations appear stretched and both sectors are vulnerable to rising interest rates, which we expect as economic growth begins to reaccelerate.

Sector overview

Technology (Strong overweight): For the first time since the mid-1990s, the Technology sector trades at a valuation discount to the S&P 500. We think that this is unwarranted and expect both valuations and earnings to move higher over the next 12 months. Supply-chain interruptions in the aftermath of the disaster in Japan should prove to be transitory and recent production updates have been encouraging. We understand why several of the more mature, mega-cap Technology stocks such as Microsoft, Cisco, and Hewlett-Packard have low valuation multiples relative to their history. However, the low valuation for some mega-cap companies with a stronger secular earnings growth outlook, such as Apple, Google and Intel does not appear warranted, in our view. But our call on technology is not only about its low valuation. Strong exposure to both enterprise spending and the emerging market consumer should underpin earnings growth.

Fig. 3: Technology - growth stocks at value prices



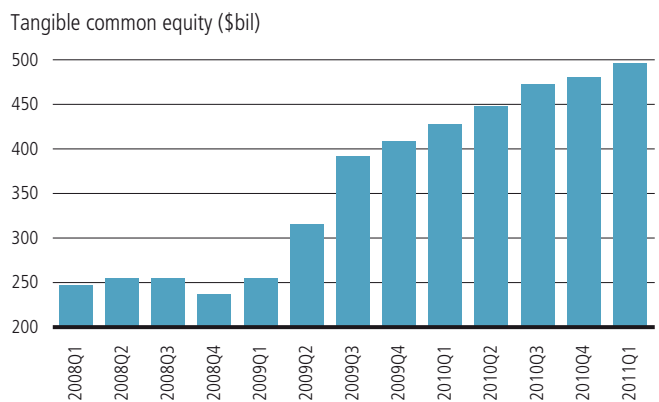
Source: DataStream and UBS WMR as of 27 June 2011

Weak consumer demand for personal computers should be offset by the growing tablet category and strong enterprise demand for servers and storage.

Consumer Staples (overweight): The Consumer Staples group delivered strong relative performance in Q2, rising 3% vs. the 4% decline in the S&P 500 (as of June 27). While the sector clearly benefited from a broad rotation from cyclicals to defensives, sector-specific fundamentals appear to be improving. In late 2010 and early 2011, the sector underperformed the market since profit margins were threatened as price hikes and productivity gains could not keep up with rapidly rising commodity cost inputs. With commodity prices somewhat easing and pricing only beginning to take effect, margin headwinds appear to be abating. We continue to view Consumer Staples as the best source of both dividend yield and dividend growth.

Financials (moderate overweight): Financials underperformed the S&P 500 in Q2 by a wide margin. However, we believe that the recent weakness is overdone and many of the drivers of the sector’s poor performance in Q2 will stabilize or reverse in the second half of the year. Thus, we are upgrading the Diversified Financials (universal banks, brokers, asset managers) to overweight. Loan growth has been anemic, but recent data suggest that business loans and

Fig. 4: Large-cap Financials have raised “high quality” capital



Source: SNL and UBS WMR as of 27 June 2011

US Equities: Sectors

non-mortgage consumer loans are picking up. Uncertainty and speculation over regulatory and capital requirements weighed on the group over the past few months, however recent proposals have been less onerous than many originally feared and policy clarity in and of itself should alleviate the cloud of ambiguity.

Healthcare (moderate overweight): After removing our underweight at the end of Q1, we moved Healthcare to a moderate overweight stance toward the end of May. These changes have proved to be beneficial as Healthcare has been the top-performing sector during Q2.

Fundamentals have not uniformly improved for all segments of the sector, but companies that are “part of the solution,” i.e., that can benefit from lower healthcare costs, should continue to benefit. Managed care organizations, drug distributors and generic manufacturers appear well positioned from that perspective. Large-cap pharma (roughly half the sector by market cap) still faces growth challenges, but current valuations appear to already reflect such realities.

Industrials (neutral): Despite near-term soft patch concerns, fundamentals for the Industrials sector appear to be on solid footing. The large-cap industrial conglomerates are exposed to a diverse set of end-markets. Currently, aggregate demand for infrastructure, manufacturing and commodity end-markets remain strong while activity levels in residential and non-residential construction end-markets are weak, but no longer deteriorating. Valuations are not overly compelling with the sector trading at a 12% premium to the S&P 500, compared to its 5- and 10-year average valuation premium of 6%.

Energy (neutral): After delivering the best performance of any S&P 500 during the first quarter of the year, Energy has been the weakest performer during Q2. The downturn has coincided with the pullback in oil prices, which have declined more than 20% over the past eight weeks from \$114 per barrel to \$90. We removed our sector overweight in late February and downgraded the sector to underweight at the end of Q1, largely based on valuation and our view that in the near term, oil prices would not be sustained above \$110. Following its significant underperformance, we close our underweight stance and

recommend a neutral allocation. The sector’s relative valuation is now in line with its longer-term average.

Materials (neutral): Weaker commodity prices, declining leading economic indicators and continued tightening monetary conditions in China weighed on the Materials sector during Q2. Valuations have become more attractive, but are still close to long-term averages. We focus on companies within the sector that have comparative cost advantages, such as US-based commodity chemical producers, and the more defensive industrial gas companies.

Consumer Discretionary (underweight): The sector consists of five heterogeneous industry groups (Autos, Consumer Services, Media, Consumer Durables and Retailing). Despite the production constraints following the Japan earthquake, we remain positive on Autos. Sales remain at depressed levels and should continue to recover as the economy improves and the existing fleet of current vehicles age. Valuations for Consumer Durables and Retailing are well above historical averages and both currently have poor relative earnings momentum. Media fundamentals have been improving, but we view valuation as fair. We downgrade Consumer Services to neutral from overweight after its strong recent outperformance.

Telecommunication Services (strong underweight): The Telecom sector is trading at its highest valuation in over a decade at a 31% P/E premium to the S&P 500, compared to its 10-year average premium of 3%. Falling interest rates have increased the relative attractiveness of the sector’s high dividend yield, but we do not expect to see interest rates remain at their current low levels.

Utilities (strong underweight): Similarly, Utility stocks have seen their valuations expand to expensive levels relative to history given the broader flight to safety and the decline in bond yields. At a 10% P/E premium to the S&P 500, the sector appears richly valued and vulnerable to rising interest rates.

Jeremy Zirin, CFA; David Lefkowitz, CFA; Joe Sawe, Strategists

Thinking small – upgrade small- and mid-caps

Despite relatively high valuations, we upgrade small-caps and mid-caps, which have outperformed larger companies in each and every market rally since the financial crisis. We continue to prefer growth over value and maintain a cautious view on REITs.

Small- and mid-caps to benefit from market recovery

Year-to-date, company size has not been a differentiating characteristic in equity market performance. As of June 27, the Russell 1000 (large-caps) and the Russell 2000 (small-caps) have delivered nearly identical returns, both up 3%. Mid-caps have slightly outperformed, up 5%. We have been on the sidelines throughout 2011 with a neutral allocation across size cohorts, but we upgrade small-caps, and to a lesser degree mid-caps, as of this report. While small- and mid-cap P/E valuations are high relative to history, smaller companies, and their stock prices, should benefit more than larger companies once signs emerge that the US economy is exiting its current soft patch. All things being equal, falling gasoline prices should disproportionately benefit small-caps, which have greater exposure to domestic consumer spending on non-energy items. From a market perspective, small- and mid-caps have market betas greater than one, meaning they tend to rise more than the large-caps during market advances (and fall by more during market declines). Since the S&P 500 trough on March 9, 2009, small- and mid-caps have outperformed large-caps in all 10 market rallies of greater than 5%.

Growth still underpriced relative to value.

Year-to-date, the Russell 1000 Growth index has slightly outperformed its value counterpart, 4% versus 3%. Growth stocks continue to appear underpriced, in our view, as evidenced by Technology stocks trading at their lowest P/E since 1995. Recently, Russell altered its definition of growth before its annual June reconstitution. The compositional changes did not meaningfully alter the sector biases in the growth and value indexes. Growth and value performance cycles tend to be long and pronounced. Since mid-2006, growth has steadily outperformed value, but by a magnitude that pales in comparison to prior growth cycles. As the current business cycle matures, we think that high-quality secular growth stocks will assume market leadership.

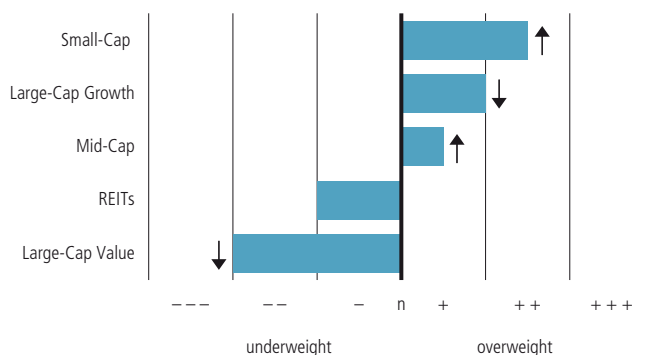
REITs—pricing in perfection?

Similar to 2010, REITs have enjoyed the rare but attractive cocktail of moderate but steady improvements in fundamental metrics (occupancy and delinquency trends) in conjunction with falling interest rates. This dynamic has driven REITs to very expensive valuations relative to history. Our WMR REIT analyst notes, “A significant rise in interest rates could have a negative impact on commercial real estate values, particularly as it pertains to exit cap rates and refinancing costs.” We remain underweight.

Jeremy Zirin, CFA; David Lefkowitz, CFA; Joe Sawe, Strategists

Fig. 5: Thinking Small – upgrade small- and mid-caps

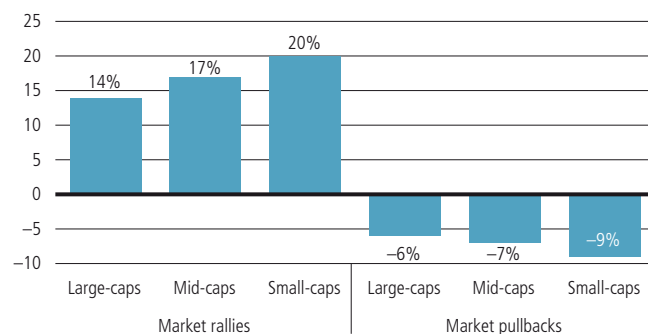
Size, style, and REITs recommended allocation, deviation from benchmark



Note: Black arrows indicate changes as of 26 June 2011. Scale explained in Appendix.
Source: UBS WMR as of 26 June 2011

Fig. 6: Smaller companies have outperformed during recent rallies

Average performance by size during rallies and pullbacks since March 2009, in%

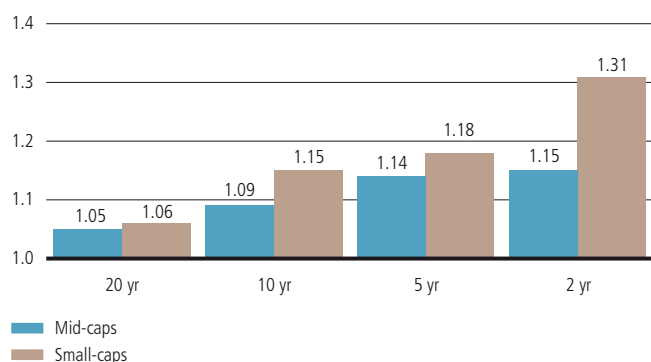


Source: DataStream and UBS WMR as of 27 June 2011

US Equities: Chartbook

Fig. 7: Small- and mid-caps betas have been rising

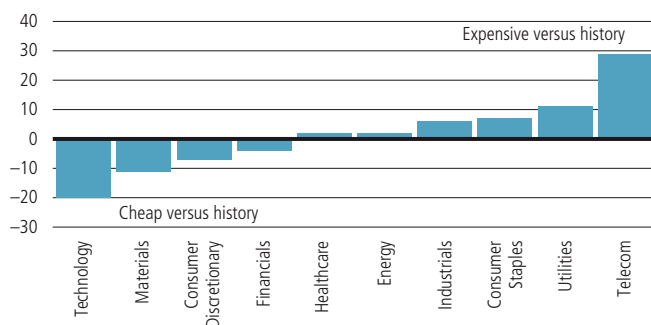
Relative to the Russell 1000 large-cap index



Source: Bloomberg and UBS WMR as of 27 June 2011

Fig. 9: Telecom and Utilities valuations are stretched

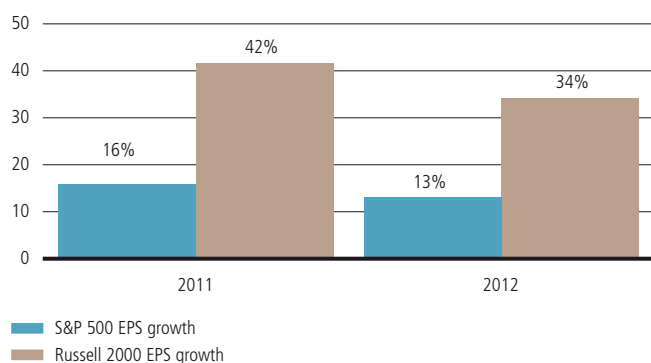
Current relative forward P/E premium/discount to the S&P 500 vs. 5-year average, in %



Source: DataStream, and UBS WMR as of 27 June 2011

Fig. 11: ...but smaller companies should deliver faster EPS growth

Consensus Russell 2000 and S&P 500 EPS growth estimates



Source: FactSet, and UBS WMR as of 27 June 2011

Fig. 8: Based on history, growth outperformance has more room to run

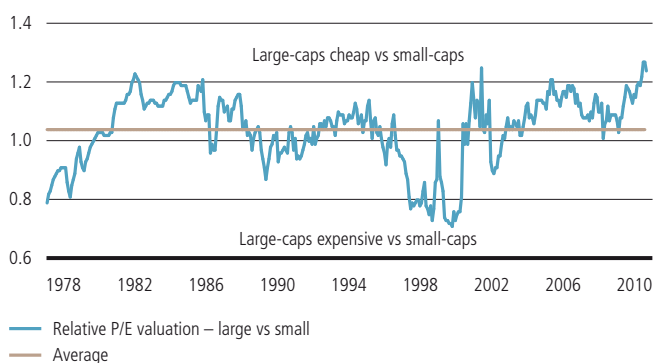
Duration and magnitude of previous style performance "regimes"

Cycle			Performance			
Start	End	Duration (yrs)	Growth	Value	Winner	Outperformance
Jul-79	Nov-80	1.3	64%	32%	Growth	32%
Aug-88	Dec-91	3.3	107%	51%	Growth	56%
Sep-93	Feb-00	6.4	334%	147%	Growth	186%
Average		3.7	168%	77%		91%
Nov-80	Aug-88	7.8	94%	210%	Value	115%
Dec-91	Sep-93	1.8	4%	35%	Value	30%
Feb-00	Jul-06	6.4	-37%	69%	Value	106%
Average		5.3	20%	104%		84%
Jul-06	present	4.75+	34%	6%	Growth	29%

Source: DataStream, Russell Investment Group and UBS WMR, as of 27 June 2011

Fig. 10: Small-cap relative P/E valuations are high...

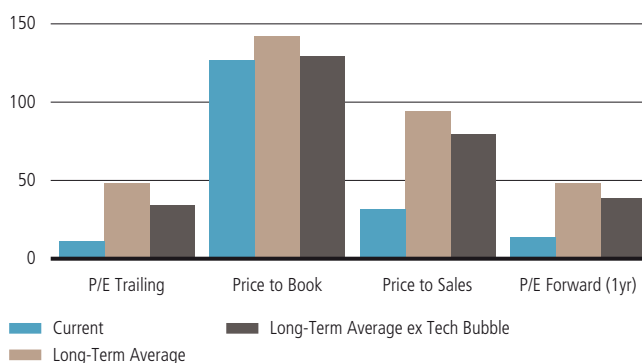
Relative P/E valuation – large (Russell 1000) vs. small (Russell 2000)



Source: FactSet, and UBS WMR as of 27 June 2011

Fig. 12: Growth stocks continue to be underpriced

Relative valuation – growth vs. value, since 1979, in %



Source: DataStream, Russell Investment Group and UBS WMR as of 27 June 2011

Maintain a “risk-on” asset allocation

In light of the recent slowdown in economic growth, renewed weakness in housing prices and unsettled conditions in European sovereign bond markets, we expect Treasuries to remain well-supported in the near term. That said, we still expect Treasury yields to gradually move higher over the next 12 months, primarily due to UBS WMR’s economist’s view that the economic “soft patch” is temporary.

The case for higher Treasury yields

While the transitory nature of the soft patch continues to be debated, we see some evidence that growth will regain momentum. For instance, the run-up in oil in the March-April period has reversed course, with the price of crude falling in recent weeks. This decline triggered a drop in the price of gasoline, and we expect lower prices at the pump will put more money in consumers’ pockets, leading to an improvement in confidence and spending. In addition to slower growth, flight-to-quality buying helped push Treasury yields lower as concerns about a Greek default have intensified. With European officials and the IMF at work on a second bailout for Greece, we believe the “risk off” source of demand for Treasuries should fade once an agreement is reached, leading to upward pressure on Treasury yields in the quarters ahead.

Against this backdrop, we look for both Treasury Inflation-Protected Securities (TIPS) and Treasuries to exhibit similar

mediocre performance, leading us to maintain an underweight allocation on both. TIPS have surprisingly been the best-performing fixed income sector YTD. Part of this strong performance can be attributed to the downward trend in Treasury yields that has affected both nominal and real (TIPS) yields. At the same time, breakeven inflation rates followed energy prices higher through 1Q11 and this combination of lower yields and higher breakevens is a winning formula for TIPS’ performance. TIPS’ excess returns compared with Treasuries’ has declined somewhat since breakevens peaked in early April, a trend we believe will continue through the end of this year.

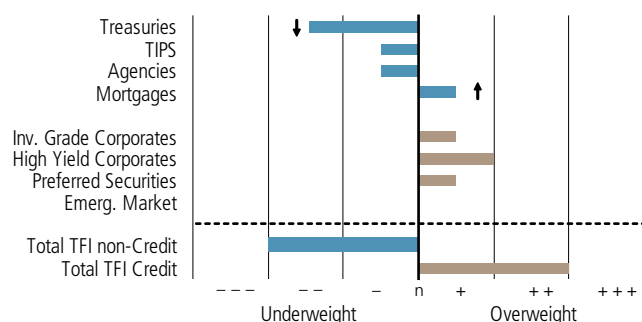
We continue to recommend that investors maintain a neutral duration stance. Given the steepness of the yield curve and historically low absolute yields on bonds with short maturities, investors are being best compensated to hold bonds with maturities in the four to seven year area in most sectors of the taxable bond market, in our opinion. We believe that the Fed will remain on hold until early 2012, anchoring the front end of the curve at exceedingly low levels.

Move to overweight on Mortgage-backed securities

We recommend moving to an overweight on agency mortgage backed securities (MBS) and deepening the underweight on Treasuries. In our opinion, agency MBS offer an attractive pick up in yield versus Treasuries. Since the

Fig. 1: USD fixed income strategy

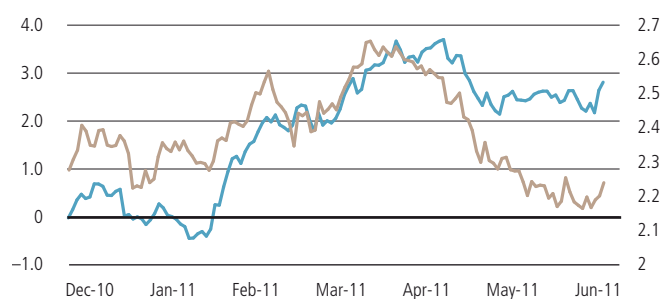
Tactical deviations from benchmark



Note: Black arrows indicate changes as of this publication. Scale explained in Appendix. Source: UBS WMR, as of 29 June 2011

Fig. 2: TIPS excess returns driven by breakevens

Excess return on TIPS versus nominal Treasuries, in %



— Tips excess return vs Treasuries (left)
— 10-yr breakeven rate (right)

Source: BofAML, Bloomberg, UBS WMR, as of 28 June 2011

US Fixed Income

Treasury rally that began in early April, the spread on the Fannie Mae 30-year year current coupon has widened approximately 20bps. At 165 basis points to the blended 5/10 Treasury yield, the spread is at the widest level in over two years. This translates into a yield of 3.1% on the agency MBS index versus a yield of 1.56% on the Treasury index, even though there is no longer a credit component to agency MBS. Finally, the duration of the agency MBS index (3.3) is shorter than the Treasury index (5.3), which could mitigate interest rate risk should our forecast for a rise in interest rates over the next year materialize.

It (still) makes sense to favor corporates

During 1H11, fixed income was a tale of two markets. Early on, market participants were focused on strong corporate credit fundamentals against a backdrop of self-sustaining growth and range-bound to moderately higher Treasury yields. Demand for corporate credit was high, and credit spreads tightened, gradually for investment grade (IG) corporate bonds but much more pronounced for higher beta segments including high-yield (HY) corporates and preferred securities. The result was significant excess returns over Treasuries that reached roughly 5% for HY, 4% for preferreds and 2% for IG through April.

Since then, however, risk aversion has returned with investors shedding risk across markets, but especially in HY and preferreds. Overall, we sit at the halfway point of the year with credit sectors moderately outperforming

non-credit, but to a much lesser extent than appeared possible just a few weeks ago. Looking ahead, we see fixed income markets driven primarily by the macro picture. By early July, we should have clarity regarding the market impact of the end of QE2 (which we believe is largely priced in) and the path forward for Greece. Mid-month, earnings season begins and corporate outlooks will provide some insight as to the health of the economy. As the month ends, headlines regarding the US debt ceiling could roil financial markets if a compromise between Democrats and Republicans has not yet been reached. It is difficult for us to consider a downgrade or default scenario for the US as a base case outcome. However, fixed income markets could grow volatile as we get closer to the August 2 date that Treasury Secretary Geithner has suggested is the deadline for when the federal government can operate without a debt ceiling resolution.

Should these events be resolved in a way that provides support to the macro picture, we believe Treasury rates will trend higher as the flight-to-quality bid recedes. In such a scenario, we would expect 2H11 to look much like the first four months of the year, with credit sectors generating the best total returns. However, we emphasize that there is no shortage of hurdles to be cleared, and each of these issues has the potential to disrupt markets.

Overall, we maintain our preference for credit sectors over non-credit, believing that markets could remain choppy in

Fig. 3: After underperforming early in the year, non-credit segments have rallied of late

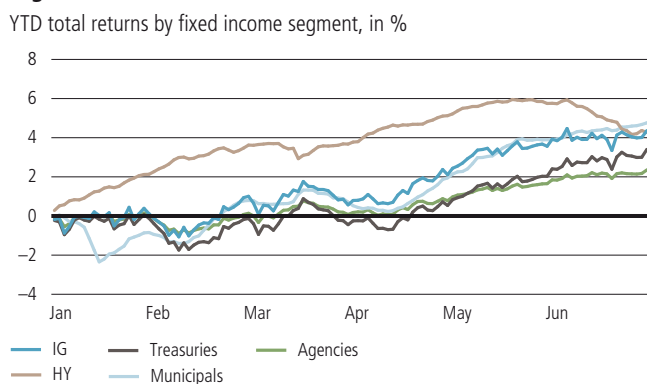
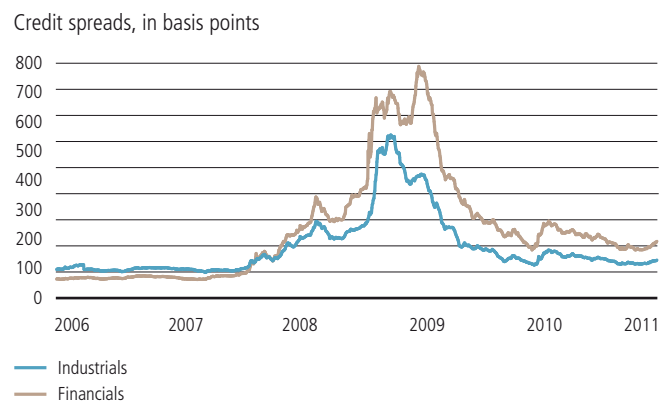


Fig. 4: Financials sector bonds trade at a discount to Industrials



the near term, but that over longer-term horizons, valuations are attractive. Across the quality spectrum, credit spreads have appreciable room to tighten, which would likely lead to outperformance over non-credit sectors in an environment of stable or gradually rising Treasury rates. Still, we have often stated our belief that the potential for credit spread compression is hampered by exceedingly low Treasury rates, which will only be remedied by a more benign macro picture.

IG Financials vs. non-Financials

Within the IG sector, the valuation relationship between the Financials and non-Financials has evolved. Prior to the financial crisis, the Financials index typically traded 30 to 40 basis points richer than the Industrials index. This was due to the perception of the health and strength of the Financials sector, as well as the presumption of government support. Currently, Financials spreads are 60bps cheap to Industrials, after tightening to a recent post-crisis low of 40bps in early May. We believe the relationship could compress back toward those levels, should IG credit spreads improve during the remainder of the year. However, in our view, Financials are unlikely to trade to pre-crisis levels as post-crisis banking regulations aim to protect taxpayers during periods of distress by allowing losses to accrue to bondholders. Overall, we maintain a neutral view between these sectors, as we believe the additional yield offered by Financials is necessary compensation for the greater volatility they exhibit.

Preferred securities: a way to add incremental yield

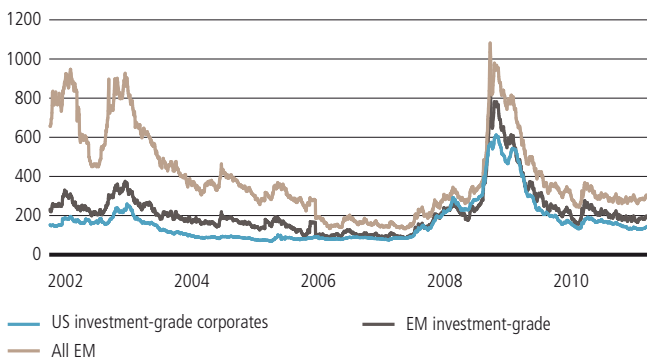
Within credit, we maintain our moderate overweight allocation to preferreds, based on our view that their credit spreads remain wide enough to absorb the moderate move higher in Treasury rates that we expect through the end of the year. This should allow prices of preferreds to remain close to their current levels in the near term; however, we believe that many preferred securities that are not called will eventually move lower in price by varying degrees. This could materialize as Treasury yields edge higher and the supply of new preferreds increase next year (as some US banks issue perpetual preferreds as compliant forms of Tier 1 capital to replace trust preferreds that are being disallowed). Despite our positive asset class view, we look for preferreds to continue to behave as a high beta credit sector due to their structural subordination and industry concentration in Financials. Roughly 20% of the preferreds index is composed of non-US banks and insurance companies that will remain susceptible to volatility stemming from the sovereign debt crisis in Europe. This will be mitigated to some extent by the very large 40% of the market index that is composed of US bank trust preferreds, which will likely be a more stable segment of the market as many of these securities will probably be called by their issuing banks in 2012 and early 2013.

Emerging markets (EM) bonds

EM sovereign debt fundamentals remain sound in our

Fig. 5: EM spread differentials edging wider

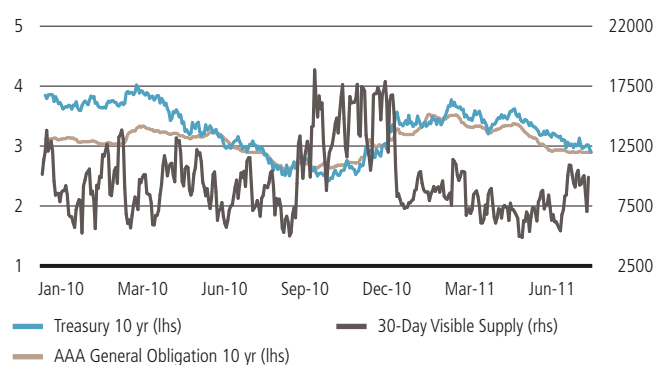
Credit spreads, EM debt and similarly rated US corporates, in basis points



Source: Barclays Capital, as of 27 June 2011

Fig. 6: Municipal bond visible supply and yields

Left hand axis in yield %, right hand axis in USD millions



Source: Bloomberg, UBS WMR, as of 24 June 2011

US Fixed Income

view. The rating agencies seem to agree, as rating actions over the previous three months have been mostly on the favorable side with Colombia, Philippines and Brazil, all receiving upgrades. However, investors' focus has shifted to macro drivers. In times of heightened risk aversion, crossover money usually shies away and total returns of risky assets, including EM, are likely to rely on dedicated investors only, which may not be enough to avoid underperformance.

While we believe that investors should remain involved in EM, we also believe that this is not the time to be overly aggressive, and therefore reiterate our neutral allocation. Spreads of broadly tracked EM indexes have widened to six-month highs, and we find it difficult to identify a catalyst that could trigger a reversal in the near term. Risks to our cautious stance toward EM include positive readings out of China and the US, and a faster- and smoother-than expected resolution to the sovereign debt crisis in Europe. We are also monitoring recent events in Venezuela, which accounts for between 6% and 7% of major EM indexes, as any hint of a change in political leadership in that country could spark a rally. We generally recommend exposure to EM via mutual funds or ETFs, due to their diversification and liquidity. Where appropriate, investors looking for direct exposure to EM may consider quasi-sovereign oil and gas conglomerates.

Municipal bonds: supply fears ease

Total returns are up and defaults are down, despite the ongoing barrage of negative news stories and media attention. Municipal bonds have turned in a positive performance, with year-to-date total returns in excess of 5.0%. This compares favorably to the aggregate taxable fixed income markets' return of 3.7%. At the same time, the pace of actual payment defaults is below the levels that occurred last year. According to a Bloomberg report, only \$642 million in municipal bonds have defaulted in 2011, compared with \$3.2 billion in all of 2010. Although supply moved higher in recent weeks, the increase in new issuance did not appear to pose distribution problems. Supply through mid-June is down 48.3% from the same time last year. Breaking out tax-exempt bond sales reveals a decline of roughly 35% in tax-exempt issuance this year compared to 2010. As a result, we no longer look for an

increase in supply to significantly disrupt the market. Barring a high profile credit event, the direction of Treasury rates should be the principal factor driving the direction of muni bond prices. High seasonal muni redemption payments are apt to fuel near-term investor demand. After Labor Day, we would not be surprised to see muni rates move higher following a rally that may have moved too far, too fast.

Anne Briglia, CFA, Strategist
Barry McAlinden, CFA, Strategist
Donald McLauchlan, Strategist
Kathleen McNamara, CFA, CFP, Strategist
Michael Tagliaferro, CFA, Strategist

Fig. 7: Revised US interest rate forecasts, in %

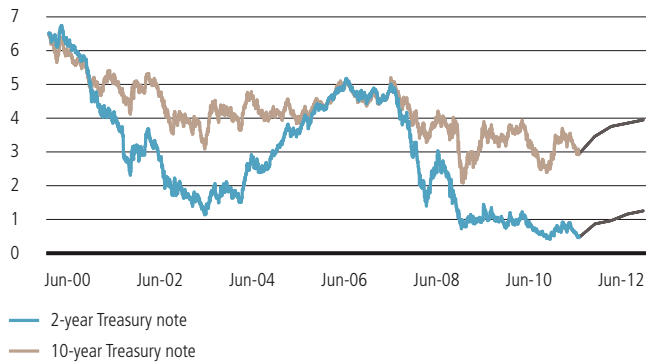
	29-Jun	in 3 months	in 6 months	in 9 months	in 12 months
3-month Libor	0.24	0.30	0.40	0.50	0.60
Previous		0.30	0.40	0.50	0.60
2-year Treasury	0.46	0.80	0.90	1.10	1.20
Previous		1.00	1.10	1.20	1.30
5-year Treasury	1.70	2.00	2.30	2.40	2.50
Previous		2.25	2.50	2.63	2.70
10-year Treasury	3.12	3.50	3.80	3.90	4.00
Previous		3.75	4.00	4.13	4.25
30-Year Treasury	4.38	4.50	4.80	4.90	5.00
Previous		4.75	5.00	5.00	5.00

Source: Bloomberg, UBS WMR, as of 29 June 2011

US Fixed Income: Chartbook

Fig. 1: Treasury yields to rise gradually

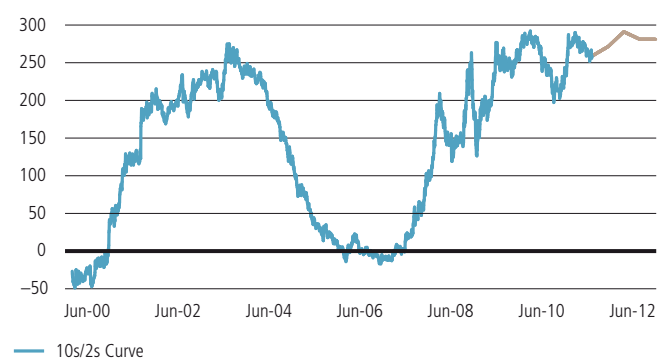
Rate development and UBS WMR forecast, in %



Source: Bloomberg, UBS WMR, as of 27 June 2011

Fig. 2: The yield curve should remain steep

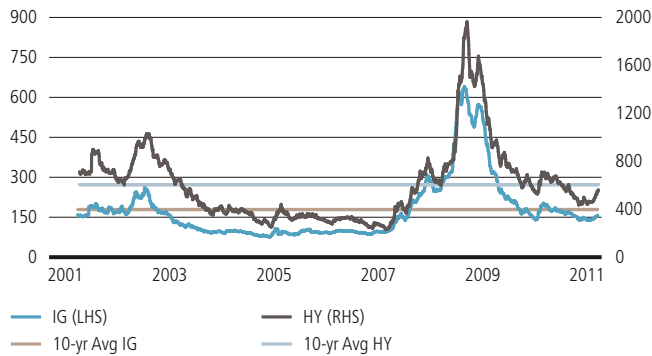
10-year minus 2-year Treasury yield, and WMR forecast, in basis points



Source: Bloomberg, UBS WMR, as of 27 June 2011

Fig. 3: Despite recent widening, IG and HY trade inside 10-year averages

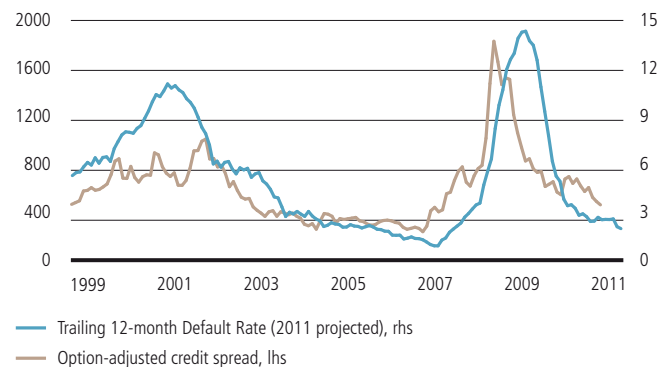
Credit spreads, in basis points



Source: UBS WMR, Barclays Capital, 27 June 2011

Fig. 4: The declining default rate signals tighter HY spreads

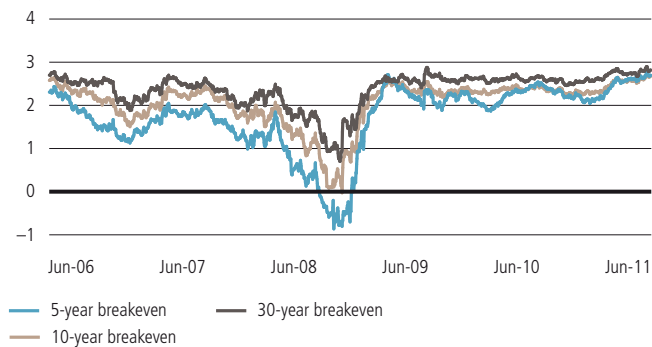
HY credit spreads, in bps, and default rates, in %



Source: UBS WMR, Barclays Capital, 27 June 2011

Fig. 5: Ten-year TIPS breakeven inflation rates have approached historical highs

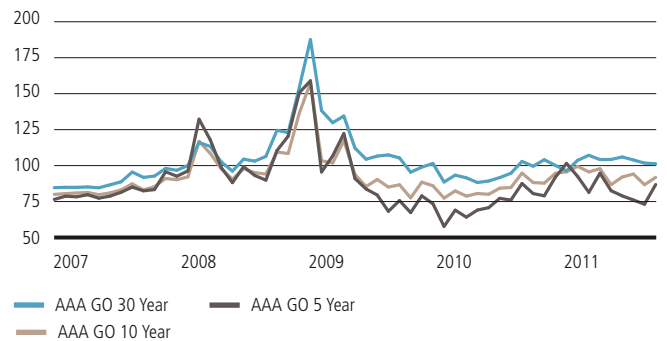
Breakeven yield (in %)



Source: Bloomberg, UBS WMR, as of 27 June 2011

Fig. 6: M/T ratios rise as munis lag Treasury bond rally

AAA muni-to-Treasury (M/T) yield ratios, in %



Source: MMD Interactive, UBS WMR as of 24 June 2011

Commodities

Commodities: a correction, but no trend reversal

Broad commodity indexes dropped by around 10% in early May and have failed to recover. We believe that in most commodity markets the economic soft patch merely means a pause, but not an end to the secular uptrend.

With the outlook on global economic growth taking a hit, so did demand expectations for most commodities, especially the cyclical ones. Crude oil consumption in the developed world has weakened whereas Chinese import growth decelerated further from 1Q. In base metals, mounting inventory levels at exchange warehouses created a challenging environment.

So is the demand outlook for the asset class getting bleak? Even with weaker global growth, we expect crude oil demand to exceed an annual 2% and push consumption above 90 million barrels per day at the end of 2011. With enough initial spare capacity, supply would have been in a position to compensate for such an increase. However, with Libya's oil output down by more than 80%, as well as Yemen, Europe and other countries struggling to hold supply levels, we expect to see larger inventory draws across the globe. Thus, we expect WTI to trade firmly above \$100/barrel over the next 12 months. Near term, the release of strategic reserves by the International Energy Agency should help to keep crude prices within a range. Given ample local supply at Cushing, WTI may continue to trade at a large discount to Brent.

A pause in PBoC's tightening efforts at the end of 3Q should be of help to base metals. With those metals where key mining companies saw production contracting, such as copper, the condition is set for prices to advance. With regard to other base metals we would be rather cautious, as the supply side is able to handle the expected increase in demand.

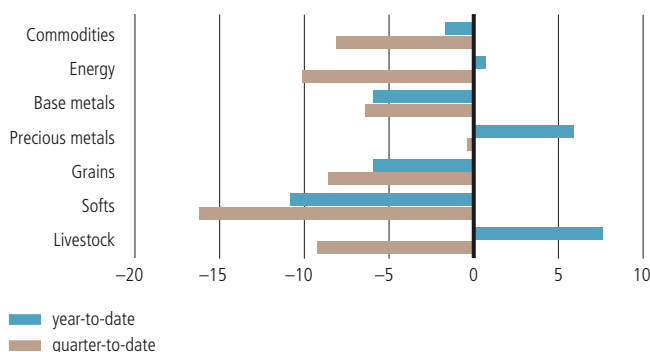
Adverse weather conditions around the globe have firmly supported the grains sub-sector. Since corn or soybeans among others traded in backwardation, investors enjoyed roll yield gains of 5% to 20% year-over-year. In 3Q, we expect grain prices to advance. With sowing behind longer-term averages and other factors in place, productivity (yield per acre) could suffer. Structurally low inventories, however, require a strong harvest, and given solid demand conditions, these markets should remain undersupplied. This will keep stock-to-use ratios at unsustainably low levels and allow price gains of up to 20% in the second half of this year.

Gold was able to gain ground and hold the uptrend seen since January on strong coins and bars demand from EM countries. For 3Q, we expect some price softness in the short run due to technical reasons and seasonally weak demand. That said, we expect prices to reach \$1650/oz over the next 12 months.

Dominic Schneider, Strategist

Fig. 1: Performance of commodity sectors

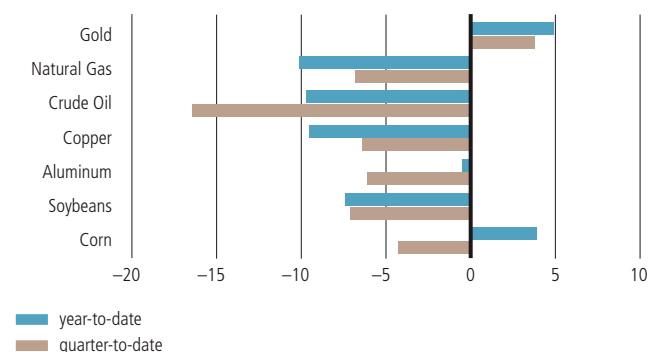
Spot price returns, in USD and %



Source: Bloomberg, DJ UBS, UBS WMR, as of 27 June 2011

Fig. 2: Performance of individual commodities

Spot price returns, in USD and %



Source: Bloomberg, DJ UBS, UBS WMR, as of 27 June 2011

Hedge funds and private equity

Hedge funds: performance to resume in second half

The broad macro factors that have adversely impacted the financial markets in the past couple of months have also been key drivers of hedge fund performance. On average, hedge funds posted a meager positive return during April and May. With risk-taking returning to financial markets in the second half of the year, we expect hedge fund performance to resume.

Global macro: The performance of global macro managers has been negative for the year and flat for the quarter. The investment opportunity set has increased due to a confluence of macro themes such as the end of QE2, peripheral European problems, the earthquake aftermath in Japan and slowing US data. However, average performance has suffered during the second quarter due to reversals of trends in several asset classes, including commodities and foreign exchange.

Equity hedge: While equity hedge managers had difficulty navigating through the markets this year, their performance has come ahead of broad hedge fund indexes. Sub-strategies such as quantitative directional managers have stood out among the overall style. Managers who were defensively postured usually outperformed those who had larger gross and net exposures. Investor sentiment appears to be shifting toward more hedged and

trading-oriented managers. A focus on the Technology sector also appears to be emerging.

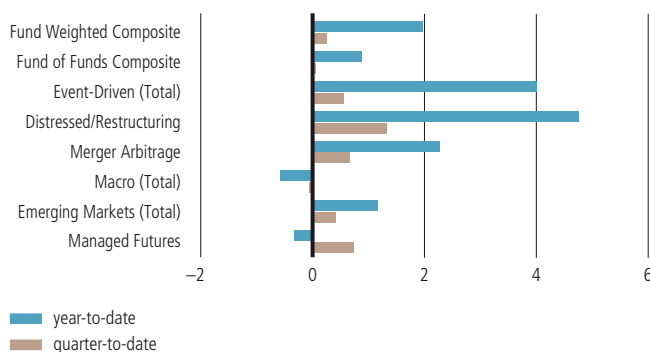
Event driven: Event-driven managers have performed better than other strategies year-to-date. Rising levels of corporate activity with robust M&A deals globally have created opportunities.

Credit strategies: We expect capital structure arbitrage and other catalyst-related trades to dominate the long-biased corporate distressed space, which has otherwise been well picked through. Europe is a significant theme given its lag vs. the US in the bank deleveraging process and the greater reliance on bank debt. Long-short corporate credit is gaining importance as the epic beta rally in yield products shows signs of rolling over. Managers with flexible mandates—those with the ability to toggle between directional and market neutral posture and freely move about the capital structure—are best positioned now and are more likely to be able to benefit from cyclical inflections.

Relative value: While relative value managers have only recently performed slightly better than the overall hedge fund community, fixed income-oriented managers have been a bright spot within the segment. Bull flattening yield curve trades as well as cautious credit spread positioning have been key drivers. There has been a strong focus on mortgages, where we are seeing a shift from

Fig. 1: Performance of selected Hedge Fund strategies

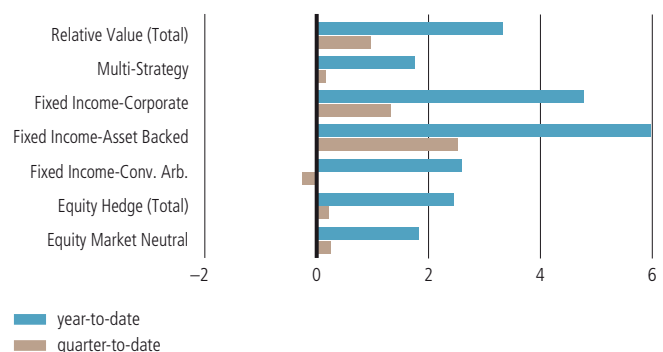
Until 31 May 2011, in %



Source: Bloomberg, UBS WMR, as of 31 May 2011
 Note: All figures based on Hedge Fund Research's HFRI indices, except DJ Credit Suisse for Managed Futures

Fig. 2: Performance of selected Hedge Fund strategies

Until 31 May 2011, in %



Source: Bloomberg, UBS WMR, as of 31 May 2011
 Note: All figures based on Hedge Fund Research's HFRI indices

Alternative Investments

credit-sensitive securities to the agency space. The unwinding of the New York Fed's Maiden Lane assets has impacted the supply and demand picture and caused the recent subprime correction. While the backdrop is still constructive for fixed income relative value, the opportunity set is decaying. Macro uncertainties and active central banks create spread and curve opportunities, yet the outlook has deteriorated as credit markets have normalized.

Managed futures/CTAs: Major commodity trading advisors (CTAs) are participating in bullish trends in fixed income, particularly in the longer-dated instruments. They continue to participate in the long-term bullish trends in precious metals. On the regulatory front, the US Treasury has chosen to exempt FX swaps and forwards from the definition of a "swap" in the Commodity Exchange Act, as amended by the Dodd-Frank Act. This pronouncement will alleviate regulatory burden on CTAs.

Private equity: improving valuations and activity
The public equity markets have recovered about two-thirds of their losses since the 2007 peaks, and private equity (PE) markets that correlate to public markets have followed suit. Most PE portfolios have seen strong uplifts in the last three quarters with venture capital recovering the most. Valuations have generally improved across the board both in the US as well as in Europe.

Emerging market (EM) portfolios have recovered still faster in part because these portfolios tend to be younger in vintage. These markets have seen strong recoveries in their stock markets and the private markets continue to attract funding. Around \$20-25 billion was raised in 2010 and we expect this number to double in 2011. Investment activity continues to outstrip fundraising especially in China, where in 2010 around \$14.3 billion was raised and roughly \$20 billion was invested. Private equity is now a key part of financing private companies in China. Of around \$18.4 billion total IPO volume in Q1 2011, \$9.4 billion was private equity-backed. India exhibits a similar trend in capital invested versus new funds raised. In 2010, \$2.4 billion of new money was raised and \$8.5 billion was invested. Private equity's contribution to IPOs was less than that in China. Of approximately \$10.4 billion total

IPO volume in 2010, around \$1.4 billion was private equity-backed. Venture and growth capital remain the largest sectors of the private funding market in both these countries as well as in many other developing nations. EM fund valuations appear high but given secular growth expectations, the space will continue to bring compelling new opportunities.

The **secondary market** has been more active after a virtual standstill in 2009 and the first half of 2010. New volume is expected to be driven by divestitures from European financial institutions. The secondary market is being driven by primary market growth, an increased emphasis on portfolio management and regulatory changes driving divestitures that have driven pricing levels up from their 2009 lows to 80%-90% of par. On the demand side, the market is well capitalized, buyers are active and competing heavily for large portfolio deals, and mega buyout funds as well as those with likely near-term liquidity are fully valued but still command strong pricing. The rebound in valuations has motivated supply, in particular by enticing pension plans and financial institutions to actively sell and divest their PE fund interests.

The **venture capital (VC)** industry has been resizing with valuations returning after a decade of sub-par performance. VC-backed exits are rebounding. Last year saw around 60 IPOs netting \$7 billion and this figure is likely to be many times higher in the future. However, this will mask a bifurcation in the industry. A few funds that own a limited number of firms with the potential for astronomical valuations (e.g., Facebook, Zynga, Groupon, Twitter) are expected to realize the bulk of the exit gains, while the rest of the industry still faces challenges. Indeed, in order for the VC industry to realize the normally expected two to three times multiple on committed capital, it will have to create around \$60-\$90 billion in annual exits (around \$20-\$30 billion a year has been invested in the venture business), the prospects of which appear rather ambitious. Fundraising has been subdued with most general partners focusing instead on investing. Activity levels including exits have recovered, supporting improved distributions.

Stephen Freedman, PhD, CFA, Strategist

Detailed asset allocation, with non-traditional assets (NTAs)

Investor risk profile ¹	Very conservative		Conservative		Moderate conservative		Moderate		Moderate aggressive		Aggressive		Very aggressive															
	Cash	Equities	Cash	Equities	Cash	Equities	Cash	Equities	Cash	Equities	Cash	Equities	Cash	Equities														
	Bonds	NTAs	Bonds	NTAs	Bonds	NTAs	Bonds	NTAs	Bonds	NTAs	Bonds	NTAs	Bonds	NTAs														
	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴												
Traditional Assets																												
Equity	0.0	+0.0	0.0	19.0	+3.0	▲	22.0	32.0	+5.0	▲	37.0	44.0	+6.0	▲	50.0	54.0	+7.0	▲	61.0	62.0	+9.0	▲	71.0	71.0	+2.0		73.0	
US Equity	0.0	+0.0	0.0	14.0	+2.0	▲	16.0	23.0	+2.0	▲	25.0	32.0	+2.5	▲	34.5	39.0	+3.0	▲	42.0	44.0	+4.0	▲	48.0	52.0	+1.0		53.0	
Large Cap Value	0.0	+0.0	0.0	8.0	+0.0	▲	8.0	8.0	-0.5		7.5	11.0	-1.0	▼	10.0	11.0	-1.5	▼	9.5	11.0	-1.5		9.5	13.0	-3.5	▼	9.5	
Large Cap Growth	0.0	+0.0	0.0	5.0	+1.5		6.5	8.0	+1.5	▼	9.5	11.0	+2.0	▼	13.0	11.0	+2.5	▼	13.5	11.0	+3.0	▼	14.0	13.0	+2.5	▼	15.5	
Mid Cap	0.0	+0.0	0.0	1.0	+0.5	▲	1.5	4.0	+0.5	▲	4.5	5.0	+1.0	▲	6.0	9.0	+1.0	▲	10.0	11.0	+1.0	▲	12.0	13.0	+1.0	▲	14.0	
Small Cap	0.0	+0.0	0.0	0.0	+0.0		0.0	2.0	+1.0	▲	3.0	3.0	+1.5	▲	4.5	5.0	+2.0	▲	7.0	7.0	+2.5	▲	9.5	8.0	+3.0	▲	11.0	
REITs	0.0	+0.0	0.0	0.0	+0.0		0.0	1.0	-0.5	▲	0.5	2.0	-1.0	▲	1.0	3.0	-1.0	▲	2.0	4.0	-1.0	▲	3.0	5.0	-2.0	▲	3.0	
Non-US Equity	0.0	+0.0	0.0	5.0	+1.0	▲	6.0	9.0	+3.0	▲	12.0	12.0	+3.5	▲	15.5	15.0	+4.0	▲	19.0	18.0	+5.0	▲	23.0	19.0	+1.0		20.0	
Developed	0.0	+0.0	0.0	5.0	+1.0	▲	6.0	8.0	+1.0	▲	9.0	10.0	+0.5	▲	10.5	12.0	+0.5	▲	12.5	14.0	+1.0	▲	15.0	14.0	-3.0		11.0	
Emerging Markets	0.0	+0.0	0.0	0.0	+0.0		0.0	1.0	+2.0		3.0	2.0	+3.0	▲	5.0	3.0	+3.5	▲	6.5	4.0	+4.0	▲	8.0	5.0	+4.0		9.0	
Fixed Income	81.0	-1.0	80.0	67.0	-3.0		64.0	51.0	-5.0		46.0	37.0	-6.0		31.0	24.0	-7.0		17.0	11.0	-9.0	▼	2.0	0.0	+0.0		0.0	
US Fixed Income	74.0	-0.5	▼	73.5	59.0	-1.5	▼	57.5	43.0	-2.5	▼	40.5	29.0	-3.0	▼	26.0	18.0	-3.5	▼	14.5	9.0	-7.0	▼	2.0	0.0	+0.0		0.0
Non-US Fixed Income	7.0	-0.5	▲	6.5	8.0	-1.5	▲	6.5	8.0	-2.5	▲	5.5	8.0	-3.0	▲	5.0	6.0	-3.5	▲	2.5	2.0	-2.0		0.0	0.0	+0.0		0.0
Cash (USD)	10.0	+1.0		11.0	2.0	+0.0	▼	2.0	2.0	+0.0	▼	2.0	2.0	+0.0	▼	2.0	2.0	+0.0	▼	2.0	2.0	+0.0	▼	2.0	2.0	-2.0		0.0
Non-traditional Assets	9.0	+0.0		9.0	12.0	+0.0		12.0	15.0	+0.0		15.0	17.0	+0.0		17.0	20.0	+0.0		20.0	25.0	+0.0		25.0	27.0	+0.0		27.0
Commodities	2.0	+0.0		2.0	3.0	+0.0		3.0	4.0	+0.0		4.0	5.0	+0.0		5.0	5.0	+0.0		5.0	6.0	+0.0		6.0	7.0	+0.0		7.0
Alternative Investments⁵	7.0	+0.0		7.0	9.0	+0.0		9.0	11.0	+0.0		11.0	12.0	+0.0		12.0	15.0	+0.0		15.0	19.0	+0.0		19.0	20.0	+0.0		20.0

"WMR tactical deviation" legend: Overweight Underweight Neutral
 Source: UBS WMR and Investment Solutions, as of 26 June 2011

"Change" legend: ▲ Upgrade ▼ Downgrade
 For end notes, please see appendix.

Detailed asset allocation, without non-traditional assets (NTAs)

Investor risk profile ¹	Very conservative	Conservative	Moderate conservative	Moderate	Moderate aggressive	Aggressive	Very aggressive
	■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds	■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds	■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds	■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds	■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds	■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds	■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds ■ Cash ■ Equities ■ Bonds
	Benchmark allocation ² WMR tactical deviation ³ Change Current allocation ⁴	Benchmark allocation ² WMR tactical deviation ³ Change Current allocation ⁴	Benchmark allocation ² WMR tactical deviation ³ Change Current allocation ⁴	Benchmark allocation ² WMR tactical deviation ³ Change Current allocation ⁴	Benchmark allocation ² WMR tactical deviation ³ Change Current allocation ⁴	Benchmark allocation ² WMR tactical deviation ³ Change Current allocation ⁴	Benchmark allocation ² WMR tactical deviation ³ Change Current allocation ⁴
Traditional Assets							
Equity	0.0 +0.0 0.0	22.0 +3.0 ▲ 25.0	37.0 +5.0 ▲ 42.0	52.0 +6.0 ▲ 58.0	67.0 +7.0 ▲ 74.0	83.0 +9.0 ▲ 92.0	98.0 +2.0 100.0
US Equity	0.0 +0.0 0.0	16.0 +2.0 ▲ 18.0	26.0 +2.0 ▲ 28.0	37.0 +2.5 ▲ 39.5	48.0 +3.0 ▲ 51.0	59.0 +4.0 ▲ 63.0	72.0 +1.0 73.0
Large Cap Value	0.0 +0.0 0.0	9.0 +0.0 ▲ 9.0	9.0 -0.5 8.5	13.0 -1.0 ▼ 12.0	14.0 -1.5 ▼ 12.5	15.0 -1.5 13.5	18.0 -3.5 ▼ 14.5
Large Cap Growth	0.0 +0.0 0.0	6.0 +1.5 7.5	9.0 +1.5 ▼ 10.5	13.0 +2.0 ▼ 15.0	14.0 +2.5 ▼ 16.5	15.0 +3.0 ▼ 18.0	18.0 +2.5 ▼ 20.5
Mid Cap	0.0 +0.0 0.0	1.0 +0.5 ▲ 1.5	4.0 +0.5 ▲ 4.5	6.0 +1.0 ▲ 7.0	11.0 +1.0 ▲ 12.0	15.0 +1.0 ▲ 16.0	18.0 +1.0 ▲ 19.0
Small Cap	0.0 +0.0 0.0	0.0 +0.0 0.0	3.0 +1.0 ▲ 4.0	3.0 +1.5 ▲ 4.5	6.0 +2.0 ▲ 8.0	9.0 +2.5 ▲ 11.5	11.0 +3.0 ▲ 14.0
REITs	0.0 +0.0 0.0	0.0 +0.0 0.0	1.0 -0.5 ▲ 0.5	2.0 -1.0 ▲ 1.0	3.0 -1.0 ▲ 2.0	5.0 -1.0 ▲ 4.0	7.0 -2.0 ▲ 5.0
Non-US Equity	0.0 +0.0 0.0	6.0 +1.0 ▲ 7.0	11.0 +3.0 ▲ 14.0	15.0 +3.5 ▲ 18.5	19.0 +4.0 ▲ 23.0	24.0 +5.0 ▲ 29.0	26.0 +1.0 27.0
Developed	0.0 +0.0 0.0	6.0 +1.0 ▲ 7.0	9.0 +1.0 ▲ 10.0	13.0 +0.5 ▲ 13.5	15.0 +0.5 ▲ 15.5	18.0 +1.0 ▲ 19.0	20.0 -3.0 17.0
Emerging Markets	0.0 +0.0 0.0	0.0 +0.0 0.0	2.0 +2.0 4.0	2.0 +3.0 ▲ 5.0	4.0 +3.5 ▲ 7.5	6.0 +4.0 ▲ 10.0	6.0 +4.0 10.0
Fixed Income	90.0 -1.0 89.0	76.0 -3.0 73.0	61.0 -5.0 56.0	46.0 -6.0 40.0	31.0 -7.0 24.0	15.0 -9.0 ▼ 6.0	0.0 +0.0 0.0
US Fixed Income	82.0 -0.5 ▼ 81.5	67.0 -1.5 ▼ 65.5	51.0 -2.5 ▼ 48.5	36.0 -3.0 ▼ 33.0	23.0 -3.5 ▼ 19.5	12.0 -6.0 ▼ 6.0	0.0 +0.0 0.0
Non-US Fixed Income	8.0 -0.5 ▲ 7.5	9.0 -1.5 ▲ 7.5	10.0 -2.5 ▲ 7.5	10.0 -3.0 ▲ 7.0	8.0 -3.5 ▲ 4.5	3.0 -3.0 0.0	0.0 +0.0 0.0
Cash (USD)	10.0 +1.0 11.0	2.0 +0.0 ▼ 2.0	2.0 +0.0 ▼ 2.0	2.0 +0.0 ▼ 2.0	2.0 +0.0 ▼ 2.0	2.0 +0.0 ▼ 2.0	2.0 -2.0 0.0

"WMR tactical deviation" legend: Overweight Underweight Neutral
 Source: UBS WMR and Investment Solutions, as of 26 June 2011

"Change" legend: ▲ Upgrade ▼ Downgrade
 For end notes, please see appendix.

Appendix

Investment Committee

Wealth Management Americas Investment Committee (WMA IC)

The WMA IC is the primary decision-making body within WM Americas for recommended asset allocations across investor risk profiles. As explained more fully below, the WMA IC vets the flagship tactical asset allocation recommendations which appear in this publication, the Investment Strategy Guide (ISG). The WMA IC also reviews and approves (i) inputs relating to WM Americas' strategic asset allocations, and (ii) other tactical asset allocation recommendations which may be developed for ultra high net worth and other specific client groups by business areas other than WMRA.

Composition

The WMA IC currently has seven voting members, and two non-voting members.

The voting members include:

Mike Ryan – Head of Wealth Management Research – Americas (WMRA)

Stephen Freedman – WMRA Investment Strategy Head

Jeremy Zirin – WMRA Equities Head

Anne Briglia – WMRA Taxable Fixed Income Head

Tony Roth – Head of Wealth Management Strategies, Wealth Management Solutions (*)

Mihir Bhattacharya – Head of Strategic Projects and Services, Wealth Management Solutions (*)

Thomas Troy – Head of Market Executions, Wealth Management Solutions (*)

(*) Business areas distinct from WMRA

The two non-voting members are employees of UBS Global Asset Management, an affiliate of UBS Financial Services Inc. They are:

John Dugenske – Global Fixed Income, Head of US Fixed Income

Andreas Koester – Global Investment Solutions, Head of Asset Allocation and Currency

Vetting of WMRA flagship TAA recommendations

At least monthly, WMRA presents to the WMA IC for its review a flagship TAA proposal and supporting investment case for a moderate-risk profile investor. In order to be published in the ISG, the flagship TAA must be accepted by the WMA IC and be supported by a majority of the WMRA members. The flagship TAA recommendations across other risk profiles published in the ISG are further calculated in accordance with a methodology approved by the WMA IC.

Appendix

Portfolio Analytics

The portfolio analytics shown for each risk profile's benchmark allocations are based on estimated forward-looking return and standard deviation assumptions (capital market assumptions), which are based on UBS proprietary research. The development process includes a review of a variety of factors, including the return, risk, correlations and historical performance of various asset classes, inflation and risk premium. These capital market assumptions do not assume any particular investment time horizon. The process assumes a situation where the supply and demand for investments is in balance, and in which expected returns of all asset classes are a reflection of their expected risk and correlations regardless of time frame. Please note that these assumptions are not guarantees and are subject to change. UBS has changed its risk and return assumptions in the past and may do so in the future. Neither UBS nor your Financial Advisor is required to provide you with an updated analysis based upon changes to these or other underlying assumptions.

In order to create the analysis shown, the rates of return for each asset class are combined in the same proportion as the asset allocations illustrated (e.g., if the asset allocation indicates 40% equities, then 40% of the results shown for the allocation will be based upon the estimated hypothetical return and standard deviation assumptions shown below).

You should understand that the analysis shown and assumptions used are hypothetical estimates provided for your general information. The results are not guarantees and pertain to the asset allocation and/or asset class in general, not the performance of specific securities or investments. Your actual results may vary significantly from the results shown in this report, as can the performance of any individual security or investment.

Risk Profile ==>>>	Very conservative	Conservative	Moderate conservative	Moderate	Moderate aggressive	Aggressive	Very aggressive
With non-traditional assets							
Estimated Return	4.81%	5.98%	6.89%	7.65%	8.36%	9.00%	9.56%
Estimated Risk	3.21%	4.70%	6.71%	8.69%	10.53%	12.16%	13.81%
Without non-traditional assets							
Estimated Return	4.46%	5.67%	6.62%	7.44%	8.33%	9.22%	10.00%
Estimated Risk	3.45%	4.78%	6.93%	9.17%	11.73%	14.46%	16.94%

Asset Class	Capital Market Assumptions	
	Estimated Risk	Estimated Return
US Equity		
Large Cap Value	16.4%	8.7%
Large Cap Growth	19.0%	9.3%
Mid Cap	18.4%	10.4%
Small Cap	21.4%	10.6%
REITs	23.0%	9.6%
Non-US Equity		
Developed Markets Equities	17.7%	10.4%
Emerging Markets Equities	26.6%	12.6%
US Fixed Income	3.7%	4.4%
Non-US Fixed Income	8.8%	6.1%
Cash (USD)	0.5%	4.0%
Commodities	17.1%	7.6%
Alternative Investments	8.5%	8.7%

Appendix

Additional Asset Allocation Models

US Taxable Fixed Income Allocation, in %

	Benchmark allocation ¹	WMR Tactical deviation ²		Current allocation ³
		Previous	Current	
Treasuries	12.0	-1.0	-3.0	9.0
TIPS (Treasury inflation-protected securities)	5.0	-1.0	-1.0	4.0
Agencies	22.0	-1.0	-1.0	21.0
Mortgages	20.0	-1.0	1.0	21.0
Inv. Grade Corporates	22.0	1.0	1.0	23.0
High Yield Corporates	10.0	2.0	2.0	12.0
Preferred Securities	4.0	1.0	1.0	5.0
Emerging Market sovereign bonds in US dollar	5.0	0.0	0.0	5.0
TFI non-Credit	59.0	-4.0	-4.0	55.0
TFI Credit	41.0	4.0	4.0	45.0

Non-US Developed Equity Module, in %

	Benchmark allocation ¹	WMR Tactical deviation ²		Current allocation ³
		Previous	Current	
Eurozone	28.0	-5.0	-5.0	23.0
UK	19.0	+15.0	+15.0	34.0
Japan	18.0	-5.0	-5.0	13.0
Other	35.0	-5.0	-5.0	30.0

Non-US Fixed Income Module, in %

	Benchmark allocation ¹	WMR Tactical deviation ²		Current allocation ³
		Previous	Current	
Eurozone	44.0	1.5	1.5	45.5
UK	9.0	16.0	16.0	25.0
Japan	31.0	-29.0	-29.0	2.0
Other	16.0	11.5	11.5	27.5

Source: UBS WMR and Investment Solutions, as of 29 June 2011

¹ The benchmark allocation refers to a moderate risk profile. See "Sources of Benchmark Allocations and Investor Risk Profiles" in the Appendix for an explanation regarding the source of benchmark allocations and their suitability.

² See "Deviations from Benchmark Allocations" in the Appendix for an explanation regarding the interpretation of the suggested tactical deviations from benchmark. The "current" column refers to the tactical deviation that applies as of the date of this publication. The "previous" column refers to the tactical deviation that was in place at the date of the previous edition of the Investment Strategy Guide or the last Investment Strategy Guide Update.

³ The current allocation column is the sum of the benchmark allocation and the WMR tactical deviation columns.

Appendix

Additional Asset Allocation Models

Equity Industry Group Allocation, in %

	S&P 500 Benchmark allocation ¹	WMR Tactical deviation ²				Current allocation ³
		Numeric		Symbol		
		Previous	Current	Previous	Current	
Consumer Discretionary	10.7	-1.0	-2.0	–	--	8.7
Auto & Components	0.8	+1.0	+1.0	+	+	1.8
Consumer Services	1.9	+1.0	+0.0	+	n	1.9
Media	3.3	+0.0	+0.0	n	n	3.3
Retailing	3.6	-2.0	-2.0	--	--	1.6
Consumer, Durables & Apparel	1.0	-1.0	-1.0	–	–	0.0
Consumer Staples	10.6	+2.0	+2.0	++	++	12.6
Food, Beverage & Tobacco	6.0	+0.5	+0.5	+	+	6.5
Food & Staples Retailing	2.3	+0.5	+0.5	+	+	2.8
Household & Personal Products	2.3	+1.0	+1.0	+	+	3.3
Energy	12.7	-1.0	+0.0	–	n	12.7
Financials	15.1	+0.0	+1.0	n	+	16.1
Banks	2.8	+0.0	+0.0	n	n	2.8
Diversified Financials	6.9	+0.0	+1.0	n	+	7.9
Insurance	3.7	+1.0	+1.0	+	+	4.7
Real Estate	1.7	-1.0	-1.0	–	–	0.7
Healthcare	11.8	+1.0	+1.0	+	+	12.8
HC Equipment & Services	4.2	+1.0	+1.0	+	+	5.2
Pharmaceuticals & Biotechnology	7.5	+0.0	+0.0	n	n	7.5
Industrials	11.3	+0.0	+0.0	n	n	11.3
Capital Goods	8.6	+0.0	+0.0	n	n	8.6
Commercial Services & Supplies	0.6	+0.0	+0.0	n	n	0.6
Transportation	2.0	+0.0	+0.0	n	n	2.0
Information Technology	17.8	+3.0	+3.0	+++	+++	20.8
Software & Services	8.6	+0.0	+0.0	n	n	8.6
Technology Hardware & Equipment	6.8	+2.0	+2.0	++	++	8.8
Semiconductors	2.4	+1.0	+1.0	+	+	3.4
Materials	3.6	+0.0	+0.0	n	n	3.6
Telecom	3.1	-2.0	-2.5	--	---	0.6
Utilities	3.4	-2.0	-2.5	--	---	0.9

Source: S&P, UBS WMR, as of 29 June 2011

The benchmark allocation, as well as the tactical deviations, are intended to be applicable to the US equity portion of a portfolio across investor risk profiles.

¹ The benchmark allocation is based on S&P 500 weights.

² See "Deviations from Benchmark Allocations" in the Appendix for an explanation regarding the interpretation of the suggested tactical deviations from benchmark. The "current" column refers to the tactical deviation that applies as of the date of this publication. The "previous" column refers to the tactical deviation that was in place at the date of the previous edition of the Investment Strategy Guide or the last Investment Strategy Guide Update.

³ The current allocation column is the sum of the S&P 500 benchmark allocation and the WMR tactical deviation columns.

Alternative Investment (AI) Benchmark Allocation (All figures in % of total portfolio)

	Risk profile						
	Very conservative	Conservative	Moderate conservative	Moderate	Moderate aggressive	Aggressive	Very aggressive
Tactical Trading	1.0	1.0	1.0	2.0	2.5	3.5	4.0
Relative Value	1.5	2.0	2.0	2.0	2.0	2.0	2.0
Credit Strategies	1.5	2.0	2.0	2.0	2.5	3.0	3.0
Event Driven	1.5	2.0	2.0	2.0	2.0	2.5	3.0
Equity Hedge	1.5	2.0	2.0	2.0	2.0	3.0	3.0
Private Equity	0.0	0.0	2.0	2.0	2.0	2.0	3.0
Private Real Estate	0.0	0.0	0.0	0.0	2.0	2.0	2.0
Total Alternative Investments	7	9	11	12	15	19	20

See "Sources of Benchmark Allocations and Investor Risk Profiles" in the Appendix for an explanation regarding the source of the benchmark allocations and their suitability.

Appendix

Tactical Asset Allocation Performance Measurement

Table A reflects the performance of the tactical asset allocation recommendations published in the Investment Strategy Guide during the time period specified. The performance is based on the benchmark allocations with nontraditional assets for a moderate risk profile investor, and the benchmark allocation with the tactical shift (see detailed asset allocation tables where benchmark allocation with tactical shift is referred to as “current allocation”). Performance is calculated utilizing the returns of the indices identified in Table B as applied to the respective allocations in the benchmark and the benchmark with the tactical shift. For example, if cash were allocated 10% in the benchmark and 12% in the benchmark with the tactical shift, the cash index respectively contributed to 10% and 12% of the results shown.

The performance attributable to the WMR tactical deviations is reflected in the column labeled “Excess return,” which shows the difference between the performance of the benchmark and the performance of the benchmark with the tactical shift. The Information ratio is a risk-adjusted performance measure, which adjusts the excess returns for the tracking error risk of the tactical deviations. Specifically the information ratio is calculated as the ratio of the annualized excess return over a given time period and the annualized standard deviation of daily excess returns over the same period. Additional background information regarding the computation of the information ratio figures provided below are available upon request.

Calculations start on 25 August 2008. Prior to 25 August 2008, WMR published tactical asset allocation recommendations in the “US Asset Allocation Strategist” using a less comprehensive set of asset classes and sectors, which makes a comparison with the current models difficult. In addition, since 25 August 2008, the Investment Strategy Guide has at times published a more detailed set of tactical deviations, whereby the categories “Non-US Developed Equities” and “Non-US Fixed Income” were further subdivided into regional blocks. Only the cumulative recommendations at the level of “Non-US Developed Equities” and “Non-US Fixed Income” were taken into account in calculating the performance shown below.

The calculations assume that the portfolios are rebalanced whenever changes are made to tactical deviations, typically upon publication of the Investment Strategy Guide on a monthly basis. Occasionally, changes in the tactical deviations are made intra-month when warranted by market conditions and communicated through an Investment Strategy Guide Update. The computations assume portfolio rebalancing upon such intra-month changes as well. Performance shown is based on total returns, but does not include transaction costs, such as commissions, fees, margin interest, and interest charges. Actual total returns adjusted for such transaction costs will be reduced. A complete record of all the recommendations upon which this performance report is based is available from UBS Financial Services Inc. upon written request. Past performance is not an indication of future results.

Table A: Moderate Risk Profile Performance Measurement

	Benchmark allocation	Benchmark with tactical shift	Excess return	Information ratio (annualized)	Russell 3000 stock index (total return)	Barclays Capital US Aggregate bond index (total return)
25 Aug. 08 to 31 Dec. 08	-16.59%	-15.64%	0.96%	+2.0	-29.00%	3.33%
2009 Q1	-5.52%	-5.45%	0.07%	+0.3	-10.80%	0.12%
2009 Q2	11.18%	11.37%	0.18%	+1.0	16.82%	1.78%
2009 Q3	10.44%	11.07%	0.63%	+2.1	16.31%	3.74%
2009 Q4	2.99%	3.30%	0.31%	+1.2	5.90%	0.20%
2010 Q1	2.74%	2.56%	-0.18%	-0.9	5.94%	1.78%
2010 Q2	-4.56%	-4.87%	-0.31%	-1.4	-11.32%	3.49%
2010 Q3	8.34%	7.99%	-0.35%	-2.2	11.53%	2.48%
2010 Q4	5.18%	5.17%	-0.01%	-0.1	11.59%	-1.30%
2011 Q1	3.23%	3.15%	-0.08%	-0.4	6.38%	0.42%
2011 Q2 until 28 June 2011	-0.41%	-0.68%	-0.27%	-1.7	-1.79%	2.50%
Since inception	14.48%	15.71%	1.23%	+0.4	11.32%	20.03%

Source: UBS WMR, as of 28 June 2011

Appendix

Tactical Asset Allocation Performance Measurement

Table B: IS benchmark allocations for moderate risk profile investor, and underlying indices (all figures in %)

25 Aug 2008 to 23 Feb 2009		24 Feb 2009 to present	
US Large Cap Value (Russell 1000 Value)	12.5	US Large Cap Value (Russell 1000 Value)	11.0
US Large Cap Growth (Russell 1000 Growth)	12.5	US Large Cap Growth (Russell 1000 Growth)	11.0
US Small Cap Value (Russell 2000 Value)	2.0	US Mid Cap (Russell Midcap)	5.0
US Small Cap Growth (Russell 2000 Growth)	2.0	US Small Cap (Russell 2000)	3.0
US REITs (FTSE NAREIT All REITs)	1.5	US REITs (FTSE NAREIT All REITs)	2.0
Non-US Dev. Eq (MSCI Gross World ex-US)	10.5	Developed Markets (MSCI Gross World ex-US)	10.0
Emerging Markets Eq. (MSCI Gross EM USD)	2.0	Emerging Markets (MSCI Gross EM USD)	2.0
US Fixed Income (BarCap US Aggregate)	30.0	US Fixed Income (BarCap US Aggregate)	29.0
Non-US Fixed Income (BarCap Global Aggregate ex-USD)	8.0	Non-US Fixed Income (BarCap Global Aggregate ex-USD)	8.0
Cash (JP Morgan Cash Index USD 1 month)	2.0	Cash (JP Morgan Cash Index USD 1 month)	2.0
Commodities (DJ UBS total return index)	5.0	Commodities (DJ UBS total return index)	5.0
Alternative Investments (HFRX Equal Weighted Strategies)	12.0	Alternative Investments (HFRX Equal Weighted Strategies)	12.0

Source: UBS WMR and Investment Solutions

Table C similarly indicates the performance of WMR's US Equity Sector Strategy, which has been published in comparable format since 29 October 2007. The Benchmark allocation is the S&P 500.

Table C: US Equity Sector Strategy performance measurement

	S&P 500 Benchmark allocation	Benchmark with tactical shift	Excess return	Information ratio (annualized)
29 Oct. 2007 to 31 Dec. 2007	-4.32%	-4.02%	0.30%	+2.3
2008	-36.97%	-36.98%	-0.01%	-0.2
2009	26.56%	26.28%	-0.27%	-0.3
2010	15.07%	14.22%	-0.85%	-1.5
2011 Q1	5.92%	5.97%	0.05%	+0.4
2011 Q2 until 28 June 2011	-1.72%	-2.09%	-0.38%	-3.6
Since inception	-8.57%	-9.48%	-0.91%	-0.3

Source: UBS WMR, as of 28 June 2011

Finally, table D, provides the performance of the US dollar Taxable Fixed Income Strategy, which has been published by WMR since 31 January 2007. The benchmark allocation and the underlying indices for each segment are available in table E.

Table D: WMR US dollar Taxable Fixed Income Strategy performance measurement

	Benchmark allocation	Benchmark with tactical shift	Excess return	Information ratio (annualized)	Barclays Capital US Aggregate
31 Jan. 2007 to 31 Dec. 2007	4.69%	4.56%	-0.12%	-1.4	7.01%
2008	-1.17%	-2.11%	-0.94%	-3.2	5.24%
2009	11.67%	12.96%	1.29%	+2.8	5.93%
2010	7.97%	8.07%	0.10%	+0.6	6.54%
2011 Q1	1.06%	1.16%	0.10%	+2.5	0.42%
2011 Q2 until 28 June 2011	2.17%	2.11%	-0.06%	-2.5	2.50%
Since inception	28.79%	29.06%	0.27%	+0.2	30.83%

Source: UBS WMR, as of 28 June 2011

Appendix

Tactical Asset Allocation Performance Measurement

Table E : Benchmark allocation for US dollar Fixed Income Strategy and underlying indices used to calculate performance shown in Table D (all figures in %)

	31 Jan. 2007 to 30 July 2007	31 July 2007 to 24 Aug 2008	25 Aug 2008 to 30 March 2009	31 March 2009 to present
Treasuries (BoA ML Treasury Master Index)	10.0%	12.0%	12.0%	12.0%
TIPS (BoA ML Treasury Inflation-Linked Index)	5.0%	5.0%	5.0%	5.0%
Agencies (BoA ML Agency Composite Master Index)	20.0%	22.0%	22.0%	22.0%
Inv. Grade Corporates (BoA ML Corporate Master Index)	20.0%	21.0%	18.0%	22.0%
High Yield Corporates (BoA ML High Yield Master II Constrained Index)	10.0%	10.0%	8.0%	10.0%
Preferred Securities (BoA ML Preferred Stock Fixed Index)	10.0%	10.0%	10.0%	4.0%
Mortgages (BoA ML US Mortgage Master Index)	20.0%	20.0%	20.0%	20.0%
Emerg. Markets (BoA ML Emerging Sovereign Plus Index)	0.0%	0.0%	5.0%	5.0%
Cash (BoA ML US T-Bill 3-month Index)	5.0%	0.0%	0.0%	0.0%

Source: UBS WMR and Investment Solutions

Appendix

End notes for table labeled detailed asset allocations with non-traditional assets (NTAs)

- 1 See "Sources of benchmark allocations and investor risk profiles" on next page regarding the source of investor risk profiles.
- 2 See "Sources of benchmark allocations and investor risk profiles" on next page regarding the source of benchmark allocations and their suitability.
- 3 See "Deviations from benchmark allocations" in the appendix regarding the interpretation of the suggested tactical deviations from benchmark.
- 4 The current allocation row is the sum of the benchmark allocation and the WMR tactical deviation rows.
- 5 UBS WMR considers that maintaining the benchmark allocation is appropriate for alternative investments. The recommended tactical deviation is therefore structurally set at 0. See "Sources of benchmark allocations and investor risk profiles" on next page regarding the types of alternative investments and their suitability.

End notes for table labeled detailed asset allocations without non-traditional assets (NTAs)

- 1 See "Sources of benchmark allocations and investor risk profiles" on next page regarding the source of investor risk profiles.
- 2 See "Sources of benchmark allocations and investor risk profiles" on next page regarding the source of benchmark allocations and their suitability.
- 3 See "Deviations from benchmark allocations" in the Appendix regarding the interpretation of the suggested tactical deviations from benchmark.
- 4 The current allocation row is the sum of the benchmark allocation and the WMR tactical deviation rows.

Emerging Market Investments

Investors should be aware that Emerging Market assets are subject to, amongst others, potential risks linked to currency volatility, abrupt changes in the cost of capital and the economic growth outlook, as well as regulatory and socio-political risk, interest rate risk and higher credit risk. Assets can sometimes be very illiquid and liquidity conditions can abruptly worsen. WMR generally recommends only those securities it believes have been registered under Federal US registration rules (Section 12 of the Securities Exchange Act of 1934) and individual State registration rules (commonly known as "Blue Sky" laws). Prospective investors should be aware that to the extent permitted under US law, WMR may from time to time recommend bonds that are not registered under US or State securities laws. These bonds may be issued in jurisdictions where the level of required disclosures to be made by issuers is not as frequent or complete as that required by US laws.

For more background on emerging markets generally, see the WMR Education Notes "Investing in Emerging Markets (Part 1): Equities," 30 July 2007, "Emerging Market Bonds: Understanding Emerging Market Bonds," 12 August 2009 and "Emerging Market Bonds: Understanding Sovereign Risk," 17 December 2009.

Investors interested in holding bonds for a longer period are advised to select the bonds of those sovereigns with the highest credit ratings (in the investment grade band). Such an approach should decrease the risk that an investor could end up holding bonds on which the sovereign has defaulted. Sub-investment grade bonds are recommended only for clients with a higher risk tolerance and who seek to hold higher yielding bonds for shorter periods only.

Non-Traditional Assets

Nontraditional assets include commodities and alternative investments. Alternative investments, in turn, include hedge funds, private equity, real estate, and managed futures. Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Alternative investment funds are not mutual funds and are not subject to the same regulatory requirements as mutual funds. Alternative investment funds' performance may be volatile, and investors may lose all or a substantial amount of their investment in an alternative investment fund. Alternative investment funds may engage in leveraging and other speculative investment practices that may increase the risk of investment loss. Interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer. Alternative investment funds may not be required to provide periodic pricing or valuation information to investors.

Alternative investment fund investment programs generally involve complex tax strategies and there may be delays in distributing tax information to investors. Alternative investment funds are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits. Alternative investment funds may fluctuate in value. An investment in an alternative investment fund is long-term, there is generally no secondary market for the interests of a fund, and none is expected to develop. Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program. In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- **Hedge Fund Risk:** There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-US securities and illiquid investments.
- **Hedge Fund of Funds:** In addition to the risks associated with hedge funds generally, an investor should recognize that the overall performance of a fund of funds is dependent not only on the investment performance of the manager of the fund, but also on the performance of the underlying managers. The investor will bear the management fees and expenses of both the fund of funds and the underlying hedge funds or accounts in which the fund of funds invests, which could be significant.
- **Managed Futures:** There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- **Real Estate:** There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- **Private Equity:** There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- **Foreign Exchange/Currency Risk:** Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in US dollars, changes in the exchange rate between the US dollar and the issuer's

Appendix

“home” currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a US investor.

- Options: Options are not suitable for all investors. Please read the Options Clearing Corporation Publication titled “Characteristics and Risks of Standardized Options Trading” and consult your tax advisor prior to investing. The Publication can be obtained from your Financial Services Inc., Financial Advisor, or can be accessed under the Publications Section of the Option Clearing Corporation’s website: www.theocc.com.

Description of Certain Alternative Investment Strategies

- Equity Hedge: Investment managers who maintain positions both long and short in primarily equity and equity-derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. Equity hedge managers would typically maintain at least 50% and may, in some cases, be substantially entirely invested in equities, both long and short.
- Event Driven: Investment managers who maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety including, but not limited to, mergers, restructurings, financial distress, tender offers, share-holder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Event-driven exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company-specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.
- Credit Arbitrage Strategies: Employ an investment process designed to isolate attractive opportunities in corporate fixed income securities. These include both senior and subordinated claims as well as bank debt and other outstanding obligations, structuring positions with little or no broad credit market exposure. These may also contain a limited exposure to government, sovereign, equity, convertible or other obligations, but the focus of the strategy is primarily on fixed corporate obligations and other securities held as component positions within these structures. Managers typically employ fundamental credit analysis to evaluate the likelihood of an improvement in the issuer’s creditworthiness. In most cases, securities trade in liquid markets, and managers are only infrequently or indirectly involved with company management. Fixed income: corporate strategies differ from event driven; credit arbitrage in the former more typically involves more general market hedges, which may vary in the degree to which they limit fixed income market exposure, while the latter typically involves arbitrage positions with little or no net credit market exposure, but are predicated on specific, anticipated idiosyncratic developments.
- Macro: Investment managers who trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top-down and bottom-up theses, quantitative and fundamental approaches and long- and short-term holding periods. Although some strategies employ relative value techniques, macro strategies are distinct from relative value strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments, rather than realization of a valuation discrepancy between securities. In a similar way, while both macro and equity hedge managers may hold equity securities,

the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposed to equity hedge, in which the fundamental characteristics of the company are the most significant and integral to investment thesis.

- Distressed Restructuring Strategies: Employ an investment process focused on corporate fixed income instruments, primarily on corporate credit instruments of companies trading at significant discounts to their value at issuance, or obliged (par value) at maturity, as a result of either a formal bankruptcy proceeding or financial market perception of near-term proceedings. Managers are typically actively involved with the management of these companies, frequently involved on creditors’ committees in negotiating the exchange of securities for alternative obligations, either swaps of debt, equity or hybrid securities. Managers employ fundamental credit processes focused on valuation and asset coverage of securities of distressed firms. In most cases, portfolio exposures are concentrated in instruments which are publicly traded, in some cases actively and in others under reduced liquidity but, in general, for which a reasonable public market exists. In contrast to special situations, distressed strategies primarily employ debt (greater than 60%) but also may maintain related equity exposure.
- Relative Value: Investment managers who maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative or other security types. Fixed income strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk-adjusted spread between these instruments represents an attractive opportunity for the investment manager. Relative value position may be involved in corporate transactions also, but as opposed to event-driven exposures, the investment thesis is predicated on realization of a pricing discrepancy between related securities, as opposed to the outcome of the corporate transaction.

Chart Explanations

Figures 1, 2 and 3 in Economic Outlook

In developing the forecasts set forth above, WMR economists worked in collaboration with economists employed by UBS Investment Research (INV). INV is published by UBS Investment Bank. Forecasts (F) are current only as of the dates of the publication and may change without notice.

Appendix

Explanations about Asset Classes

Sources of benchmark allocations and investor risk profiles

- Benchmark allocations represent the longer-term allocation of assets that is deemed suitable for a particular investor. Except as described below, the benchmark allocations expressed in this publication have been developed by UBS Investment Solutions (IS), a business sector within UBS Wealth Management Americas that develops research-based traditional investments (e.g., managed accounts and mutual fund options) and alternative strategies (e.g., hedge funds, private equity, and real estate) offered to UBS clients. The benchmark allocations are provided for illustrative purposes only and were designed by IS for hypothetical US investors with a total return objective under seven different Investor Risk Profiles ranging from very conservative to very aggressive. In general, benchmark allocations will differ among investors according to their individual circumstances, risk tolerance, return objectives and time horizon. Therefore, the benchmark allocations in this publication may not be suitable for all investors or investment goals and should not be used as the sole basis of any investment decision. As always, please consult your UBS Financial Advisor to see how these weightings should be applied or modified according to your individual profile and investment goals.
- The process by which UBS Investment Solutions has derived the benchmark allocations can be described as follows. First, an allocation is made to broad asset classes based on an investor's risk tolerance and characteristics (such as preference for international investing). This is accomplished using optimization methods within a mean-variance framework. Based on a proprietary set of capital market assumptions, including expected returns, risk, and correlation of different asset classes, combinations of the broad asset classes are computed that provide the highest level of expected return for each level of expected risk. A qualitative judgmental overlay is then applied to the output of the optimization process to arrive at the benchmark allocation. The capital market assumptions used for the benchmark allocations are developed by UBS Global Asset Management. UBS Global Asset Management is a subsidiary of UBS AG and an affiliate of UBS Financial Services Inc.
- In addition to the benchmark allocations IS derived using the aforementioned process, WMR determined the benchmark allocation by country of Non-US Developed Equity and Non-US Fixed Income in proportion to each country's market capitalization, and determined the benchmark allocation by Sector and Industry Group of US Equity in proportion to each sector's market capitalization. WMR, in consultation with IS, also determined the benchmark allocation for US dollar taxable fixed income. It was derived from an existing moderate risk taxable fixed income allocation developed by IS, which includes fewer fixed income segments than the benchmark allocation presented here. The additional fixed income segments were taken by WMR from related segments. For example, TIPS

were taken from Treasuries and Preferred Securities from Corporate Bonds. A level of overall risk similar to that of the original IS allocation was retained.

- Alternative investments (AI) include hedge funds, private equity, real estate, and managed futures. The total benchmark allocation was determined by IS using the process described above. The Wealth Management Americas Investment Committee (WMA IC) derived the AI subsector benchmark allocations by adopting IS' determination as to the appropriate subsector benchmark allocations with AI for the following risk profiles: conservative, moderately conservative, moderate, moderate aggressive and aggressive. The WMA IC then developed subsector allocations for very conservative and very aggressive risk profiles by taking the IS subsector weightings for conservative and aggressive risk profile investors and applying them pro rata to the IS AI total benchmark allocations for very conservative and very aggressive, respectively. Allocations to AI as illustrated in this report may not be suitable for all investors. In particular, minimum net worth requirements may apply.
- The background for the benchmark allocation attributed to commodities can be found in the WMR Education Note "A pragmatic approach to commodities," 2 May 2007.

Deviations from benchmark allocation

- The recommended tactical deviations from the benchmark are provided by WMR. They reflect our short- to medium-term assessment of market opportunities and risks in the respective asset classes and market segments. Positive / zero / negative tactical deviations correspond to an overweight / neutral / underweight stance for each respective asset class and market segment relative to their benchmark allocation. The current allocation is the sum of the benchmark allocation and the tactical deviation.
- Note that the regional allocations on the International Equities page are provided on an unhedged basis (i.e., it is assumed that investors carry the underlying currency risk of such investments). Thus, the deviations from the benchmark reflect our views of the underlying equity and bond markets in combination with our assessment of the associated currencies. The two bar charts ("Equity Regions" and "Fixed Income Regions") represent the relative attractiveness of countries (including the currency outlook) within a pure equity and pure fixed income portfolio, respectively. In contrast, the detailed asset allocation tables integrate the country preferences within each asset class with the asset class preferences stated earlier in the report. As the tactical deviations at the asset class level are attributed to countries in proportion to the countries' market capitalization, the relative ranking among regions may be altered in the combined view.

Scale for tactical deviation charts

Symbol	Description/Definition	Symbol	Description/Definition	Symbol	Description/Definition
+	moderate overweight vs. benchmark	-	moderate underweight vs. benchmark	n	neutral, i.e., on benchmark
++	overweight vs. benchmark	--	underweight vs. benchmark	n/a	not applicable
+++	strong overweight vs. benchmark	---	strong underweight vs. benchmark		

Source: UBS WMR

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