Investment Strategy Guide

Wealth Management Research
Fourth Quarter 2011

Quarterly

Between a block *and a hard patch*

Recession risks remain elevated
Still a long way to go to stabilize eurozone
Keep a defensive portfolio positioning

UBS

Publication details

Publisher
UBS Financial Services Inc.
Wealth Management Research
1285 Avenue of the Americas, 13th Floor
New York, NY 10019

This report has been prepared by UBS Financial Services Inc. ("UBS FS") and UBS AG. Please see important disclaimers and disclosures at the end of the document.

This report was published on 28 September 2011.

Editor in Chief
Stephen Freedman

Editor
Marcy Tolkoff

Authors (in alphabetical order)
Thomas Berner
Anne Briglia
Ravi Cheruvu (UBS Alternative Investments)
Stephen Freedman
Katherine Klingensmith
David Lefkowitz
Barry McAlinden
Donald McLauchlan
Kathleen McNamara
Brian Rose
Mike Ryan
Joe Sawe
Dominic Schnider
Jeremy Zirin

Project Management
Paul Leeming
John Bellomo

Desktop Publishing
George Stilabower
Cognizant Group – Basavaraj Gudihal, Srinivas Addugula and Virender Negi

Contents

Video Feature (electronic version only) 2
Focus: Between a block and hard patch 3
Progress Report: will, may or won't? 8
Our Best Ideas at a Glance 10
Asset Allocation Overview 11
Washington Watch 12
Market Scenarios 15
Economic Outlook 16
Financial Market Performance 19
Asset Classes 20
Foreign Exchange 23
International Markets 24
US Equities 28
US Fixed Income 33
Commodities 38
Alternative Investments 39
Detailed Asset Allocation 41
Investment Committee 43
Portfolio Analytics 44
Additional Asset Allocation Models 45
Tactical Asset Allocation Performance Measurement 47
Disclaimers/Disclosures 50

Click on each chapter title to jump directly to that page.

Editorial

Mike Ryan

Stephen Freedman

Dear Reader,

The world feels like a very different place since we last penned this editorial letter for our Quarterly Outlook in June. In three months, we've seen a deepening of the sovereign debt crisis across Europe that has prompted a serious debate over the future of the eurozone; a Washington standoff that brought us to the brink of default on Treasury debt; and a first-of-its-kind downgrade of the United States' sovereign credit rating that radically altered the perception of what constitutes a risk-free asset. Unsettling developments like these serve to remind us that we live in a world in which political considerations often trump both fundamentals and valuation in the investment decision-making process.

So what challenges does the world have in store for us over the next three months? Neither the fiscal crisis in Europe, nor the political gamesmanship in DC, nor the recession fears sweeping the globe have been eliminated, so risks remain. But these threats are all fairly well understood by now – even if the solutions to them are not. We therefore enter the fourth quarter with a moderately cautious stance and continue to monitor economic, financial and policy developments, standing ready to adjust our asset weightings to help you navigate the opportunities and risks that emerge.

In the pages that follow, you will find the cross-sector guidance of our senior strategists, perspectives from our policy experts in Washington and, for the first time, hedge fund commentary from our colleagues on the UBS Alternative Investments team.

As always, we hope you find this content valuable and encourage you to discuss the key themes with your Financial Advisor.

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

Stephen Freedman, PhD, CFA
Head, Investment Strategy
Wealth Management Research – Americas

To watch Chief Investment Strategist Mike Ryan give a summary of this report, please click the play button.

Focus

Between a block and a hard patch

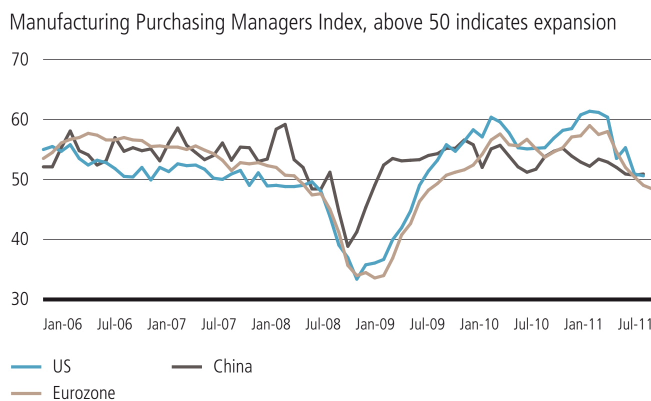
How markets perform this quarter will depend to a large extent on the actions of policymakers within the eurozone, the resiliency of demand growth throughout the emerging markets and the wisdom of elected officials across the globe.

Financial markets came under acute selling pressure toward the end of July amid an escalation of the fiscal crisis across the eurozone and evidence that the global economic recovery process was losing traction (see Fig. 1). Little that transpired over the ensuing two months has fundamentally altered this dynamic. The failure of European leaders to act in a credible and decisive manner has allowed the Greek sovereign debt crisis to fester to a degree that more strategically important players in the region (i.e., Italy and Spain) are now also at risk. While eurozone officials may have bought some time with temporary measures, policymakers must now consider more radical steps as the monetary union faces its most serious economic and political crisis since inception. Meanwhile, a series of shocks – both acts of God and human failures – have also driven the global economy to the very brink of recession. The ongoing deleveraging process in the developed world, coupled with the recent tightening of policy within the emerging markets in response to higher inflation, has left precious little margin for error.

Financial markets therefore begin the fourth quarter trapped between the structural flaws of the common currency block on one side, and a deepening soft patch in the global economy on the other. But where we end this quarter will depend to a large extent on the actions of policymakers within the eurozone, the resiliency of demand growth throughout the emerging markets and the wisdom of elected officials across the entire globe. Should leaders falter or growth stall, risk assets are likely to continue to languish through the balance of the year. It is against this still uncertain political and cyclical backdrop that we retain a cautious approach for now. Markets are trading at increasingly attractive valuation levels, but require both the resolution of fiscal problems in Europe and confirmation that the global recovery remains intact before we would aggressively recommit funds. In the meantime, we continue to underweight equities with a preference for the US and the emerging markets over the eurozone. We also retain a neutral allocation in fixed income, but maintain a modest bias for investment grade

Fig. 1: Economic recovery losing traction

Manufacturing Purchasing Managers Index, above 50 indicates expansion



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

Fig. 2: European banks under pressure

Average 5-year CDS spreads of major European banks, in basis points

Note: CDS = Credit Default Swap
Source: Bloomberg, UBS WMR, as of 27 September 2011

corporate debt. Finally, we recommend a reduction in exposure toward commodities with a corresponding increase to our overweight in cash.

Euro woes

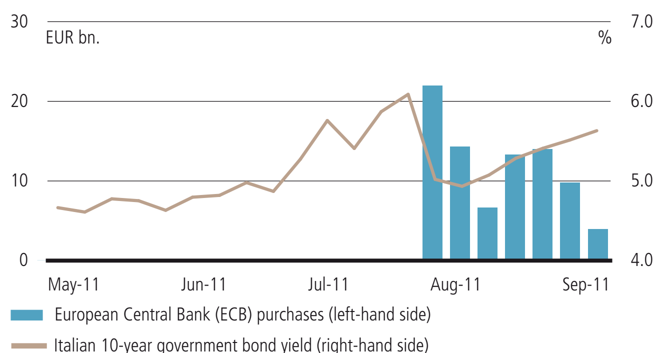
The situation in the eurozone has continued to deteriorate, as the fiscal woes in Greece and other peripheral nations have begun to infect more strategically important players in the region. This in turn has increased the pressure on European banks that bear heavy exposure to European sovereign risk (see Fig. 2). Elected officials and policymakers have been forced to respond with a series of temporary measures intended to help support the financial system until more permanent financing structures can be put into place. The European Central Bank (ECB) did an ideological about-face during the third quarter by ramping up purchases of "at risk" sovereign debt – most notably Spanish and Italian paper. It appears that the ECB expanded holdings of peripheral debt by more than EUR 80bn since resuming its purchase program in August (see Fig. 3). This helped push spreads lower on Italian and Spanish debt, easing pressure on the financial system. At the same time the ECB – working in conjunction with the Fed and other central banks – extended dollar-based credit to European banks to alleviate funding problems within the European financial system.

But in the end these measures have amounted to little more than holding actions and are therefore insufficient to defuse the eurozone sovereign debt crisis. Legislatures across the eurozone are currently in the process of approving an already agreed to expansion in the lending capacity of the European Financial Stability Facility (EFSF) to EUR 440bn. The agreement in principle also included enhanced operational flexibilities of the EFSF such as directly providing capital to the banking system. The EFSF was introduced as a bridge vehicle for providing financial support to countries in need until a permanent facility is up and running in 2013. While there has been a fairly sharp political backlash within some of the smaller countries in Northern Europe, we still anticipate approval of an expansion in the EFSF by the end of October. The problem however is that even at EUR 440bn, the EFSF is still inadequate to fully address fiscal problems in some of the larger players in the eurozone. It's estimated that as much as EUR 150bn in EFSF funds has already been committed to bailouts in Greece, Ireland and Portugal. Were Italy or Spain to require assistance from the facility, funding levels would have to be expanded even further, to perhaps EUR 1tn or more. This means the EFSF is inadequately sized to deal with the crisis – even after it is fully funded.

In order to effectively address sovereign issues across the eurozone, European leaders will need to consider even more aggressive measures going forward. These range all the way from a further modest expansion of the EFSF to a full fiscal union. The problem of course is that each of these initiatives requires both the time to implement and

Fig. 3: ECB helping to support bond market

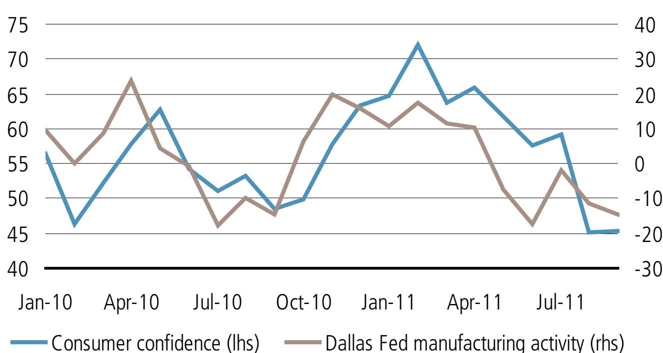
ECB purchases under Securities Market Program



Source: UBS WMR, as of 27 September 2011

Fig. 4: Confidence has been declining

Consumer confidence and Dallas Fed manufacturing activity



Source: Bloomberg, UBS WMR as of 28 September 2011

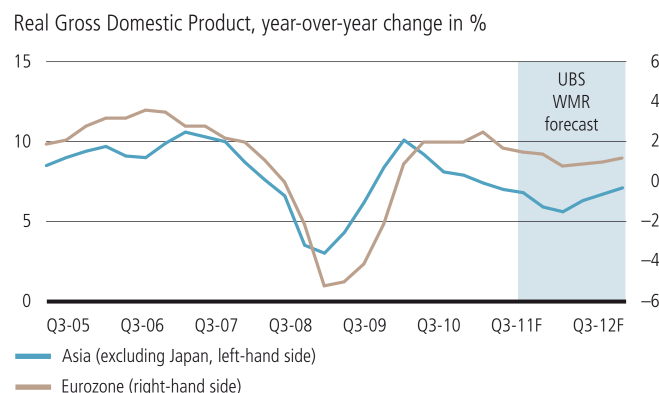
the political will to execute. While the former is rapidly running out, the latter has always been in short supply. Keep in mind that many national legislatures have not yet formally voted on the expansion of the EFSF agreed to by the heads of state in July. More radical changes in the eurozone structure, such as the introduction of joint guarantees of debt across member nations, would likely take too long to implement. Efforts instead need to focus on a mix of pragmatic steps intended to address short-term funding needs and broader-based political considerations. These would likely include: 1) approval of the already planned expansion in the EFSF; 2) enabling the EFSF to "leverage up" contributions to further expand the size of potential assistance packages; 3) expanding ECB purchases of troubled eurozone debt; and (4) recapitalizing European banks to inoculate them against an inevitable default on Greek debt. Failure to act in such a comprehensive manner would allow the sovereign debt crisis to continue to fester, and could ultimately pose a greater threat to both the real economy and financial system than even the Lehman failure.

Whither the recovery?

The economy stumbled during the first half of the year as a series of shocks, ranging from higher food and energy prices to the earthquake and tsunami in Japan, undermined an already fragile recovery process. Things didn't improve much in the third quarter, as the combination of the debt ceiling debacle in Washington and deepening of the fiscal crisis in Europe further undermined business, consumer and investor confidence. This decline in confidence was clearly reflected in both sentiment-based indicators and measures of regional manufacturing activity (see Fig. 4). There are growing concerns that the US may now be hitting "stall speed" whereby the level of growth is at such a low level that the economy simply rolls over into recession. These concerns appear to be shared by senior Fed officials as well. In the statement following the most recent FOMC meeting in September, Fed officials noted "significant downside risks to the economic outlook, including strains in global finance." These risks were significant enough to prompt the Fed into extending the maturity structure of Treasury holdings in the Fed's balance sheet in an effort to drive down longer-term interest rates even further ("Operation Twist").

Fig. 5: Growth to continue slowing in eurozone and Asia

Real Gross Domestic Product, year-over-year change in %



Note: For full explanation of this chart, please see Appendix.
Source: UBS WMR, as of 27 September 2011

Growth projections for the rest of the world have also been ratcheted down following the escalation of sovereign risks on the continent and the tightening of monetary policy across the emerging markets. Our economics team is now looking for the year-over-year growth rate within the eurozone to slow from 2.1% in the first half to just 1.4% during the second half, and for Asia, from 7.2% in the first half to 6.4% in the second half (see Fig. 5). The fiscal reform measures required in return for assistance from both the European Union (EU) and International Monetary Fund (IMF) have already triggered sharp contractions in growth across the peripheral countries. The concern, of course, is that the fiscal tightening also prompts a more pronounced slowdown within the most critical drivers of the eurozone economy – Germany and France. It's unclear just how much of a sustained impact the tightening of policy across the emerging markets will have on regional growth prospects. While Brazil has already reversed course and begun cutting rates in response to deteriorating cyclical conditions, other central banks have simply moved to the sidelines as growth remains robust. The good news is that inflation risks across the emerging markets have moderated sharply; the bad news is that the plunge in local currencies limits the extent to which central banks can cut rates. Overall, we look for just a moderate slowing of growth in emerging markets.

Despite a softening in some of the economic data and persistent political headline risk, it remains our view that neither the US nor the world in general is poised to relapse into recession. While the sentiment-based indicators reflect a sharp deterioration in the cyclical outlook, more recent hard data instead show an economy that is weak but still growing. Keep in mind that the decline in energy costs and overall easing of inflationary pressures since the end of April should lead to an increase in disposable income and a corresponding acceleration in GDP. Although the Fed's Operation Twist is unlikely to materially alter the growth outlook, the decision to manage down longer-term rates while recycling funds back into the purchase of mortgage-backed securities should provide some relief for the beleaguered housing sector. The president's latest stimulus package is unlikely to survive the Congressional gauntlet intact. However, certain pieces of the package – extension of payroll tax cuts and unemployment benefits – are likely to pass and should have an overall positive impact on growth. Finally, it appears that the ECB may cut rates at its next policy meeting. This marks the first time since the global financial crisis that all the world's major central banks are adopting an accommodative policy stance at the same time.

So what will it take?

We are repeatedly asked by investors what it would take for us to turn more constructive on risk assets amid the current uncertain environment. While any number of variables could alter our outlook on the margin, it would likely take the right combination of the following six factors for us to become more bullish overall:

(1) Credible resolution of the eurozone fiscal crisis: We've already noted that there are a number of pragmatic steps European leaders could take to ease the current fiscal crisis. The question, however, is whether or not the political will exists to take those steps in a timely manner.

(2) Confirmation that the economic recovery process remains intact: The biggest challenge for global financial markets remains the threat of a renewed economic downturn. While stock prices typically fall quite sharply during recessions, the equity markets are already discounting a fair amount of bad news. Should evidence emerge that the current economic slowdown is just another transitional "soft patch," we would shift more aggressively into risk assets.

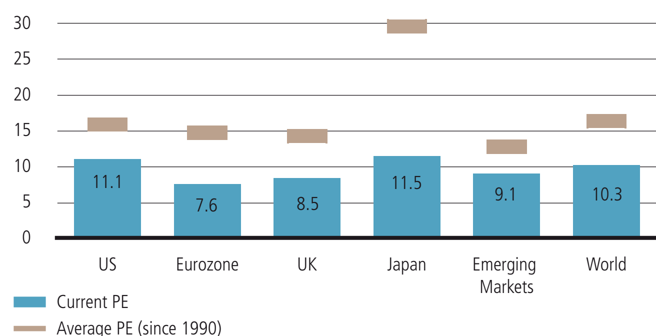
(3) Initiation of QE3: We have noted repeatedly that the bar is set pretty high for the Fed to engage in a third round of quantitative easing (QE3). However, with the financial system showing some signs of stress, recession risks having risen and inflation now rolling over, the Fed is closer to expanding the balance sheet than they were just three months ago. Keep in mind that with regional bank presidents poised to rotate off the FOMC, the most vocal dissenters against further easing of policy won't be around after December. While any rally likely would be more muted that the one following the announcement of QE2, further policy easing would be generally constructive for markets.

(4) Continued resilient corporate earnings: Equity market gains have been driven in large part by the ability of companies to continue to post solid profits despite a less than ideal business climate. However, analysts have begun to more aggressively cut earnings estimates given both a softening of growth prospects and more conservative guidance by corporations. As earnings projections are revised lower, companies have much better prospects for meeting or exceeding consensus estimates.

(5) Compelling valuation: Most equity markets around the

Fig. 6: Most equity markets appear cheap

Current market price-earnings (PE) versus historical averages



Source: Datastream and UBS WMR, as of September 27, 2011

globe trade at attractive valuations relative to historical norms (see Fig. 6). However, political risks currently trump both fundamentals and valuation as drivers of performance. But let's not forget there is a level where stocks are so compellingly cheap that much of the political risk has already been reflected in the equity risk premium.

(6) Progress on the fiscal front in the US: Given the continued partisan sniping on Capitol Hill, the bar is set incredibly low for the Special Joint Committee on Deficit Reduction ("Super committee"). Should the committee reach agreement on a series of measures that provide credible reforms to spending without jeopardizing near-term economic growth, business and consumer confidence would likely rise.

Properly positioned
Unless and until we see some of those factors begin to play out in the right combination, we retain an overall cautious approach toward the markets. We therefore recommend that investors consider the following allocations across asset classes:

- Retain a moderate underweight to equities with a preference for both the US and emerging markets over europe. While eurozone equities are among the cheapest in the world, they are likely to remain so until some resolution of the fiscal crisis can be achieved.

- Within US equities, we have moved toward a more defensive stance. We retain our primary overweights to Consumer Staples and Technology, but have also added modest overweights to Telecom, Utilities and Healthcare. The higher dividend yield of these sectors is increasingly attractive relative to low-yielding fixed income alternatives. We have now adopted a bias toward large cap over small cap, and keep a preference for growth over value.

- We maintain a benchmark or "neutral" weighting on fixed income, with a tilt toward investment grade corporate debt. We don't find sub 2% Treasury yields very appealing. However, as long as growth remains sluggish, policy remains accommodative and inflation continues to decelerate, repricing risks will be limited. Given the health of corporate balance sheets, investment-grade corporate debt represents a lower-risk alternative for capturing additional returns.

- We have reduced our exposure to commodities, but retain a preference for precious metals over both industrial metals and energy. While the correction in gold appears overdone, industrial metals and oil will continue to be weighed down by sluggish growth in the developed world.

- We have further increased our weighting to cash. We look for either cheaper re-entry points or resolution of existing political roadblocks before recommitting funds. Until then, we are content to keep some powder dry.

- For those able to invest in the hedge fund space, some consideration should be given to holding global macro and managed futures strategies as protection against extreme outcomes. As our colleagues in the Alternative Investments team and the Portfolio Advisory Group rightly point out, both strategies have tended to hold up well during periods of acute market stress.

Conclusion
The third quarter was marked by heightened risks of recession, a ratcheting up of fiscal concerns in Europe, increased political dysfunction in Washington and elevated levels of market volatility. But what catalysts will prevail during the next quarter? While the problems that plagued markets last quarter remain, they are also already well known to business owners, consumers, investors, policymakers and elected officials alike. This suggests that changes – either for good or for ill – will likely be driven by a different set of sources as more than a few surprises emerge over the next three months. We will therefore continue to monitor developments both in the real economy and financial markets, as well as on the policy front and in the political arena and make any changes to our asset weightings during the quarter that we feel are necessary to take advantage of emergent opportunities and avoid excessive tail risks.

Mike Ryan, CFA, Chief Investment Strategist

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 with three quarters behind us.

Will		
Equity markets will provide normalized returns.	TO DATE: US stocks are down about 7% so far this year, and would have to rally strongly in the fourth quarter to reach their long-term historical average return or the targets set in our *2011 Outlook* 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, and contagion has spread to Spain and Italy. We now expect Greece to default within the next six months.	✓
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, cash continues to build on corporate balance sheets against an uncertain economic outlook.	?
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. The government debt ceiling was raised just barely in time to avoid default. There is no budget in place for the fiscal year which starts on 1 October and the "super-committee" charged with finding $1.2tn in deficit reductions shows no signs of reaching a compromise. 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 defaults is negligible. That said, investors are advised that idiosyncratic default risk is alive and well. The vast majority of state and local governments strive to honor their obligations, but there may still be a high profile borrower that 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 1% pace in the first half of 2011. Despite this, corporate profits still surprised to the upside. However, we believe that consensus earnings forecasts for the rest of 2011 and 2012 are too high and will have to be revised lower.	?

Progress report: will, may or won't?

Rising protectionism may trigger a trade war.	TO DATE: Despite ongoing concern over the economy and occasional complaints on Chinese policies, protectionist sentiments and talk of currency wars have faded in recent months. This may be a function of robust export growth and modest gains in manufacturing jobs.	✗
Emerging markets may stumble.	TO DATE: Emerging market equities have underperformed developed markets by around 11% so far in 2011. While economic growth has remained reasonably 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.	?
Won't		
P/E multiples will not exceed long-term averages.	TO DATE: Despite stronger-than-expected earnings growth, equity markets have declined so far in 2011, causing P/E multiples to fall further below their long-term averages.	✓
The housing market will not sustain a recovery.	TO DATE: Housing starts have remained extremely weak so far in 2011 and home prices have been bouncing along the bottom. It still appears that it could take years for the housing market to recover.	✓
There will not be meaningful progress in deficit reduction.	TO DATE: The debate over raising the debt ceiling resulted in legislation meant to reduce the deficit over the next 10 years. However, a grand bargain that would 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, and are now down around 12% year-to-date as measured by the Dow Jones/UBS Commodity Index.	?
Inflation will not be a problem.	TO DATE: The surge in energy prices at the beginning of the year pushed up prices, and the headline CPI inflation rate hit 3.8% in August, higher than we expected in the *2011 Outlook*. However, the recent pullback in oil prices and soft economic growth should help to suppress inflation in the months ahead, and inflation has not forced the Fed to tighten policy.	?

Our Best Ideas at a Glance

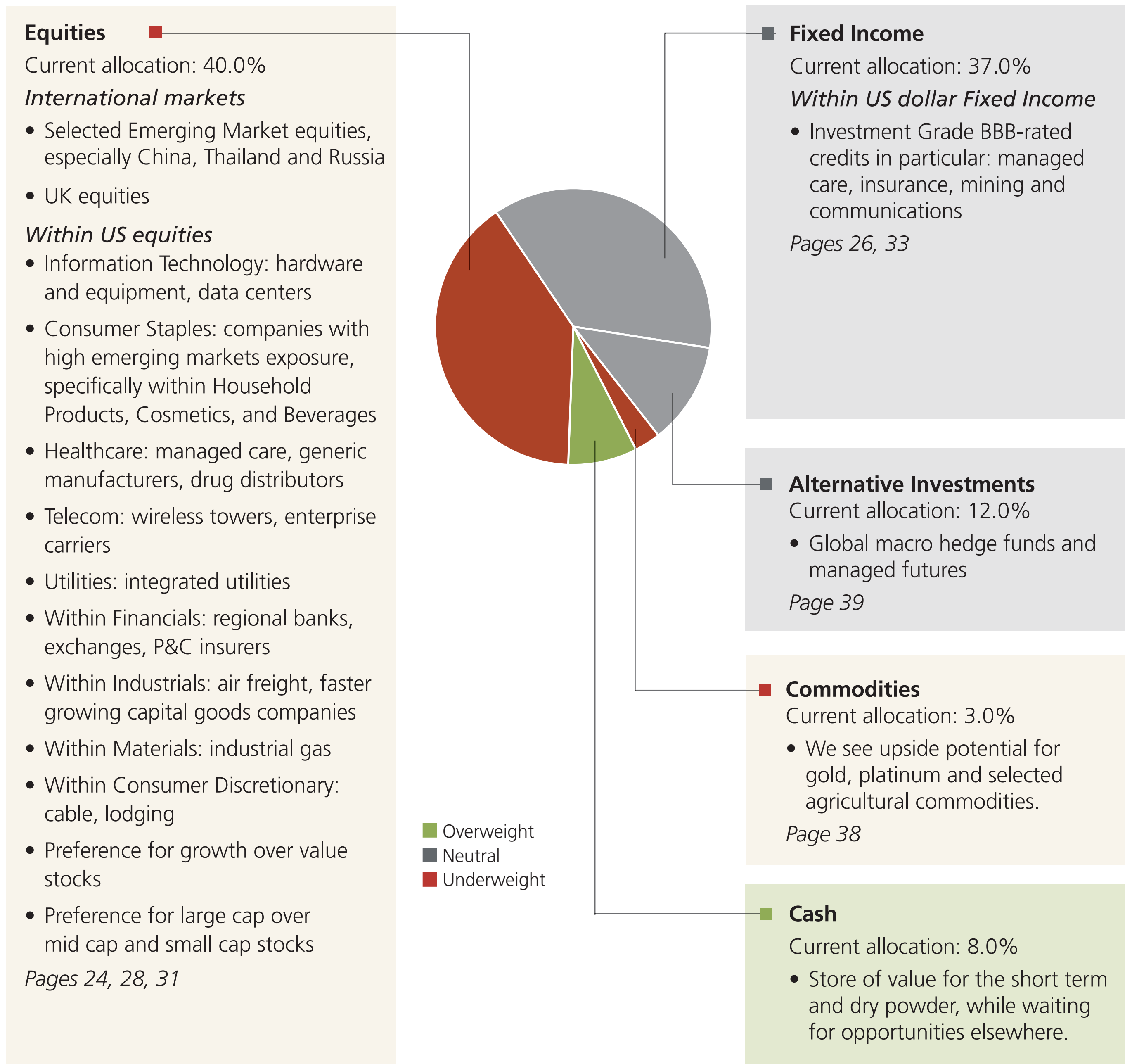
The following list represents investment strategy recommendations that we believe will provide attractive opportunities over the next 9-12 months.

Asset Classes

Preference for Cash and Bonds over Equities and Commodities

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 equity valuations are not enough to offset the macro risks arising from weak economic data and problems in the eurozone.	Moderate Underweight	44.0	-4.0		40.0
US Equities Valuations are less attractive than in overseas markets. However, the US has defensive characteristics and a smaller exposure to the Financials sector, which is currently beneficial.	Neutral	32.0	+0.0		32.0
US Large Cap Value Valuations, our sector tilts and our defensive positioning suggest preference for growth over value. Large-caps cheap relative to small and mid caps.	Moderate Underweight	11.0	-1.0	▲	10.0
US Large Cap Growth Valuations, our sector tilts and our defensive positioning suggest preference for growth over value. Large-caps cheap relative to small and mid caps.	Moderate Overweight	11.0	+3.0	▲	14.0
US Mid Cap Valuations expensive vs. large caps, and little support from M&A activity.	Moderate Underweight	5.0	-0.5	▼	4.5
US Small Cap Valuations expensive vs. large caps, and little support from M&A activity.	Moderate Underweight	3.0	-1.5	▼	1.5
US Real Estate Investment Trusts (REITs) The Federal Reserve's "pledge" to keep rates low thorough mid-2013 is positive for the interest-rate sensitive REIT industry, offsetting stretched valuations.	Neutral	2.0	+0.0		2.0
Non-US Developed Equities Valuations more attractive than US. sovereign debt and Financials sector concerns in the eurozone suggest a more cautious stance.	Underweight	10.0	-4.0		6.0
Emerging Market (EM) Equities EM equities are attractive from a fundamental perspective. However, they remain a high beta segment and could underperform if global markets come under renewed pressure.	Neutral	2.0	+0.0		2.0
Fixed Income Yields at historically low levels but weak economic data are likely to keep many central banks on hold longer than previously anticipated and delay the rise in bond yields.	Neutral	37.0	+0.0		37.0
US Fixed Income Within fixed income we are neutral on the US vs. non-US. The dollar has rebounded against most currencies but is still at relatively low levels.	Neutral	29.0	+0.0		29.0
Non-US Fixed Income Extremely low yields and overvalued yen make Japanese debt unattractive. European sovereign debt concerns remain a risk.	Neutral	8.0	+0.0		8.0
Cash (USD) Store of value for the short term and dry powder, while waiting for opportunities elsewhere.	Overweight	2.0	+6.0	▲	8.0
Commodities Decelerating global demand growth suggests further downside for commodity prices. Avoid broad exposure.	Moderate Underweight	5.0	-2.0	▼	3.0
Alternative Investments No tactical view. Included in portfolio for diversification purposes.	Neutral	12.0	+0.0		12.0

"WMR tactical deviation" legend: Overweight Underweight Neutral

"Change" legend: ▲ Upgrade ▼ Downgrade

Source: UBS WMR and Investment Solutions, as of 28 September 2011.

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.

Conflict abounds

Against a backdrop of persistent political uncertainty and on the eve of a presidential election year, Economic and Policy Analyst Katie Klingensmith resumes her quarterly Washington Watch dialogue with John Savercool, Head of the UBS US Office of Public Policy.

Katie Klingensmith (KK): Proposals from DC are once again generating headlines, with Congress back in session and the economy still threatening to return to recession. Do you think the overall atmosphere has changed since Congress recessed?

John Savercool (JS): No, the atmosphere has not changed very much since the summer break. Lawmakers feel a little more pressure to get things done, since they know voters want results, but the political conflicts in Washington will continue to prevent resolutions to many pending issues. I don't expect the atmosphere to improve as we head into an election year.

KK: Most of our clients are probably very happy to not be thinking about the debt ceiling right now. However, the Budget Control Act (BCA) which allowed for this increase is still very much in play. Can you review what this legislation involves?

JS: The BCA set into motion two important policies. The first was to clearly increase the debt ceiling and avoid a default. This is being done in increments: the first increase happened in August, the second in September and a third increase in the debt ceiling will occur in January of 2012. The three combined increases in the debt ceiling should last until early 2013. The second important policy triggered by the BCA was deficit reduction, initially through spending cuts and caps that should amount to roughly $917bn in savings over 10 years. The BCA also created a new Joint Select Committee (JSC) tasked with the "goal" of finding $1.5tn in additional savings by November 23. Whatever measures the JCT approves must also be approved by the full Congress (by December 23) and President Obama. Should the amount of deficit reduction approved through this process be less than $1.2tn, then beginning in 2013 the BCA requires automatic spending cuts to make up the difference (up to $1.2tn).

KK: You mentioned the Joint Select Committee, or "Super committee." What are the chances that this committee succeeds in identifying sufficient savings to the deficit? Could failure to reach an agreement spill over into other policy areas, making gridlock even worse?

JS: I know that all 12 of the committee members feel enormous pressure to come to some kind of an agreement. They understand that failure to come to an agreement may result in greater scrutiny by the financial markets and possibly downgrades. Most members of the committee also want to avoid the "sequestration" process that will follow if an agreement is not negotiated, which will provide for automatic spending cuts that will target defense and Medicare provider funding. I believe it is probable that the committee will ultimately reach an agreement in the $1.2tn range because of the ramifications of not finding an agreement. Moreover, the parties have already agreed to some spending cuts that get very close to this amount in other deficit reduction negotiations that have been held over the last few months. They can serve as a basis for a bigger deal.

I know that all 12 of the committee members feel enormous pressure to come to some kind of an agreement.

KK: How does sequestration work? If the committee identifies $1.2tn in cuts, and Congress approves it, can Congress increase spending anyway?

JS: The sequestration process will only apply if the committee does not find up to $1.2tn in deficit reduction over 10 years and then pass it in Congress. However, Congress can always increase spending in the future if it decides to and the BCA does not change that fact.

KK: Before we even get to these proposals, Congress will have to approve an appropriations bill. Should we expect big changes? Is there the chance of a government shutdown?

JS: Funding for the government for the new fiscal year (starting 1 October) will be provided initially through a "continuing resolution," which is in place at this time. This is a temporary measure that will fund the government until the House, Senate and White House can agree on a full one-year spending plan. The total amount of government spending for next year is already set at $1.043tn. There will certainly be fighting about how to split up that pie, and these disagreements could indeed lead to a threat of a government shutdown. The temporary measure now in effect expires on 18 November, so expect to hear media talk of the potential of a government shutdown leading up to that date. We do not expect there to ultimately be a shutdown, however, as Congress will very likely agree on a package by 18 November.

KK: President Obama's "American Jobs Act" has been getting a lot of attention. Can you walk us through the different parts of this proposal?

JS: Broadly speaking, the president's jobs proposal includes temporary tax cuts in the form of payroll tax reductions and holidays for both employees and employers; incentives for businesses to invest in new equipment; new federal spending for infrastructure (including the creation of a national infrastructure bank), schools unemployment benefits and for states to retain teachers and public safety officers. To pay for the cost of these items the President has proposed increased taxes on higher-income individuals, investment partnerships (carried interest) and oil and gas producers.

KK: How likely do you think the bill in totality or in part is to pass?

JS: Very little, if any, of the package will be enacted this year. It is possible that some provisions, such as the extension of the payroll tax relief or unemployment insurance, could be added to the broad deficit reduction bill under negotiation by the super committee, but this is very much up in the air at the time. There is not a consensus in the Congress for most components of the president's plan.

KK: What about the president's proposals for additional deficit reduction: Are any of these politically tenable?

JS: Lawmakers are taking a close look at some of the spending cuts the president has proposed, and some may be considered for deficit reduction. However, the large tax increases the president has put forth are not likely to be approved by Congress.

We do not expect there to ultimately be a shutdown, as Congress will very likely agree on a package by 18 November.

KK: Changes in the tax code seem to come up under a number of the different proposals. Do you think there is a chance that we could see any increases in taxes, including on higher-income earners? What about a more fundamental reform of the tax code?

JS: I don't believe any new taxes on higher-income individuals will be enacted this year. Look for a big debate and some resolution on the Bush tax cuts next year, including the prospects of higher income tax rates and a higher estate tax on higher-income individuals and small businesses. Virtually everyone in Congress wants to enact very comprehensive tax reforms to simplify the tax system, but this will not happen this year. It is too big an undertaking to be done as part of the deficit reduction committee. I expect a big tax reform debate to take at least a year and to begin in earnest in 2013.

KK: Various portions of healthcare reform are being reconsidered by both parties. Do you think there are parts of this legislation that are vulnerable at this point? What about further down the road?

JS: Congress will watch to see what happens in the Supreme Court next year when it is expected to rule on the constitutionality of the "individual mandate" provision, which requires Americans to purchase health insurance or pay a fine. This decision will set the tone for any future healthcare debate. Realistically, Congress will likely address healthcare issues more in depth in 2013, and how they address it will depend on the outcome of the 2012 elections.

KK: At this juncture, do you see much likelihood of legislation that would allow for repatriation of US overseas earnings (a new Homeland Investment Act)?

JS: It is not very likely until comprehensive tax reform is considered. The White House has been consistently opposed to another round of repatriation, particularly outside of tax reform. Although House leaders support a repatriation tax holiday, and may try to advance one, it will be tough for them to overcome the White House opposition.

Although House leaders support a repatriation tax holiday, and may try to advance one, it will be tough for them to overcome the White House opposition.

KK: What about patent reform – this seems to be an area of progress in DC. Can you tell us what the new legislation means?

JS: The new patent reform legislation has been signed into law by President Obama after having passed the House and Senate on a bipartisan basis – a rare bipartisan victory indeed! US patent laws had not been reformed for 60 years, and the passage of this legislation is meaningful to many individual entrepreneurs and industries that create and build things. The new law revises how the US awards patents to a "first to file" system and addresses many legal issues associated with frivolous patent lawsuits.

KK: It seems the White House is not seeking reform of major entitlement programs, but some on The Hill are. Is there any chance Medicare or Social Security would be meaningfully reformed this year?

JS: No. These two programs are simply untouchable from a political perspective in an election year. They could be addressed in a meaningful way in 2013 but not earlier.

KK: Finally, do you have any expectations about the Republican primaries at this juncture? Do you expect the differences in economic policy perspectives will be important in the primary race?

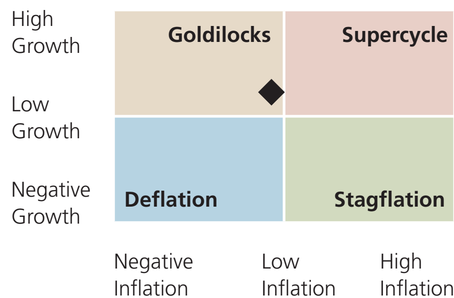
JS: Republican voters appear split and not completely satisfied with their current choices. This could change as the process unfolds. Many voters are just getting to know the candidates, and impressions they have today may not be those they have tomorrow. So, it is best to reassess in November when the field is likely set and candidates have had adequate exposure. Debates over job creation and policies to revive the economy should dominate both the primary and general elections.

Market Scenarios (next 12 months)

The economic data flow remains mixed to somewhat negative. Sentiment indicators are depressed, while hard data is very sluggish but not contracting. The much awaited second half rebound has not materialized yet. The US and Europe appear to be close to recession.

Slow Growth

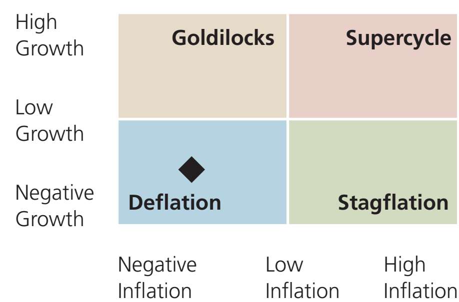
55%



- The global economy remains on a very fragile expansion course with government policies achieving low but positive growth.
- Deleveraging pressures keep growth below historical trends, with unemployment rates remaining far above their pre-financial crisis levels.
- Growth in emerging markets continues to outpace developed markets, though their growth slows as well.

Renewed Recession

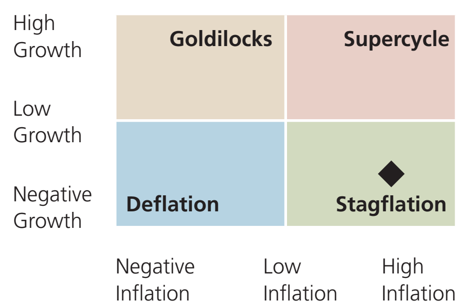
30%



- The recent trend toward weaker growth continues as financial system stresses and fiscal consolidation choke the fragile expansion.
- The eurozone crisis flares up further. A credit crunch leads consumers and businesses to cut back on spending.
- Weak demand keeps inflation under control.

Stagflation

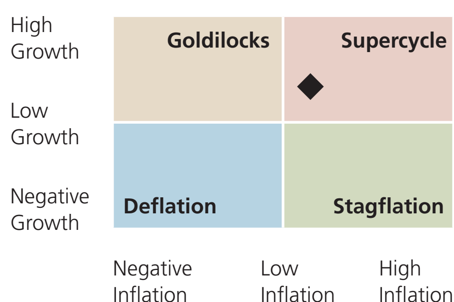
10%



- Further monetary loosening boosts commodity prices without helping the economy, setting an inflationary process in motion.
- The combination of rising price levels and weak growth prospects poses significant challenges to most financial assets.

Normal Expansion

5%



- Loose monetary policy, as well as greater political clarity in the US and Europe encourages a surge in investment spending.
- Improvements in the labor market and in credit conditions allow a more dynamic consumer recovery.

Source: UBS WMR

US Economic Outlook

Festering confidence crisis

Since August, business and consumer sentiment have deteriorated sharply. In contrast, "hard" data have not shown the same degree of weakness. The huge disconnect between sentiment and actual behavior is disconcerting. For now we still expect some pick-up in growth in 3Q11, but the risk of recession remains high.

Weak sentiment not fully reflected in "hard" data

Some regional manufacturing climate indexes have been in contraction territory for four months, while the national ISM manufacturing index remains barely in expansion territory. In contrast, industrial production continued to advance in August. A similar disconnect between sentiment and "hard" data or actual behavior exists currently in the consumer sector. Consumer expectations as measured by the University of Michigan have slightly undershot the 2008-2009 lows and at face value suggest a retrenchment in sequential consumer spending. At odds with this, retail sales through August remained fairly robust on a year-over-year basis. However, after inflation, they have been essentially flat since February.

Our growth rebound story will be put to the test

We recently lowered our 3Q11 real GDP growth forecast from 2.5% to 1.5% quarter-over-quarter annualized, as incoming data have been weaker than anticipated. As real consumption started the quarter with a strong jump in July, it would be very hard to see a much weaker growth number in 3Q11. For 4Q11, we expect 2%.

Small disconnects between sentiment and actual behavior have historically persisted for long periods. But the current magnitude of the gaps is huge and has raised the recession probability – which we currently peg at between 30% and 40%. Real activity is already low in the aftermath of the financial crisis and US household balance sheet deleveraging has already stabilized the savings rate. Furthermore, double-dip recessions are very rare even after a banking crisis. We still think that there will be modest growth in the quarters ahead, but we fear that the US economy is only one negative shock away from being pushed into recession.

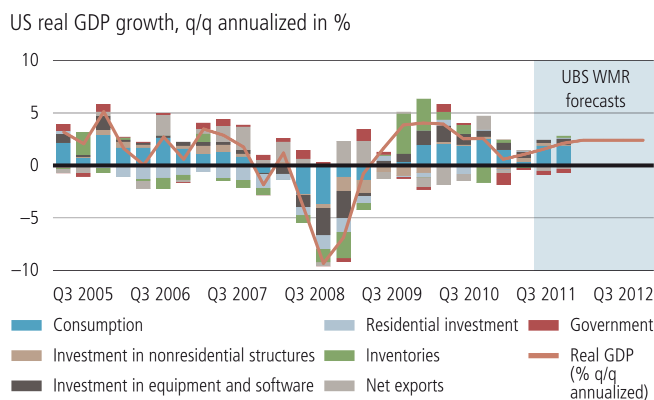
Fed's fear overshadows operation twist

The Federal Open Market Committee (FOMC) announced that it saw "significant downside risks to the economic outlook." Those are strong words for the Fed and markets took them at face value. The Fed's fear seemed to overshadow its intent to convert $400bn of short-dated into longer-dated Treasuries to push long rates lower. In our view, lowering interest rates further will support growth, but if sentiment remains depressed, a further slowdown cannot be avoided.

Thomas Berner, CFA, Analyst

Fig. 1: US growth will likely pick up again

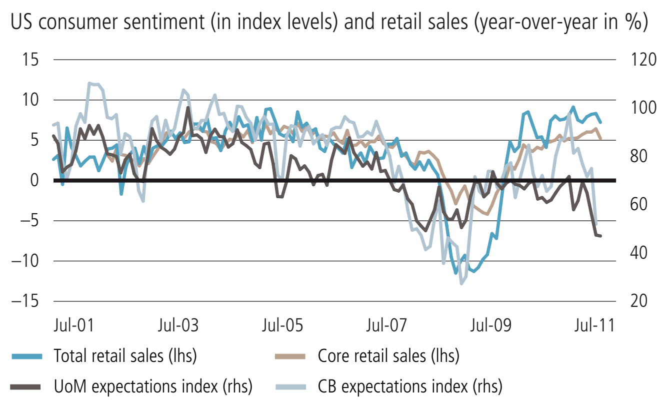
US real GDP growth, q/q annualized in %



Note: For 2012 growth is spread evenly over all four quarters to be consistent with our calendar average growth rate forecast of 2.2%. For a full explanation of this chart, please see appendix. GDP = Gross Domestic Product, q/q = quarter-over-quarter
Source: Thomson Datastream, UBS WMR, as of 25 September 2011

Fig. 2: US consumer sentiment and spending disconnected

US consumer sentiment (in index levels) and retail sales (year-over-year in %)



Note: UoM = University of Michigan, CB = Conference Board
Source: Bloomberg, UBS WMR, as of 25 September 2011

Global Economic Outlook

Eurozone crisis threatens global economy

Growth is slowing in most countries. The risk of recession is high in many of the developed economies as governments struggle to get debt levels under control. Emerging markets are relatively strong but inflation remains a problem in some countries.

Eurozone in grave danger

The sovereign debt crisis is causing increasing stress in the eurozone financial system which, combined with tighter fiscal policy, is hurting growth in the real economy. Greece has failed to deliver on its promised reforms and at this point it is not clear if it will receive the next tranche of bailout funds. We believe that the authorities in Europe would like to avoid an immediate default and that the next tranche will be provided, but this would only keep Greece going until December. In our view a default is likely within the next six months. The impact of a default would depend largely on how politicians respond. Aggressive support measures for the financial system could help to limit contagion, and it is still possible that a recession can be averted. However, if politicians remain behind the curve, then the outcome could be much more severe, and in the worst case scenario some countries might even leave the eurozone. If the eurozone were to break apart, it would likely trigger a global recession.

Japan rebounding, UK weak

Japan has rebounded from the earthquake and tsunami in March. Production is back near pre-quake levels and life has returned to normal in most of the country. Recent data suggests that the most rapid phase of recovery is ending, but reconstruction spending should provide support in 2012. The strong yen is pushing manufacturers to shift more of their capacity overseas.

Growth in the UK has been weak as the government implements strict austerity measures, including both tax hikes and spending cuts. Unemployment jumped during the global financial crisis and has not improved at all since then. Private consumption began to shrink in the second half of 2010, and this trend could continue. It would not take much of a shock to push the economy into recession.

Emerging markets relatively strong

While economic conditions are weak in most developed economies, the situation in the emerging markets is relatively healthy, particularly in Asia. Many countries are operating near full capacity and growth remains robust although the trend is toward a slower rate of expansion. China is on pace to grow 9% this year and we expect 8% growth in 2012. Inflation remains a problem in some countries, but the recent pullback in commodity prices should help in the months ahead. The main risk to the economic outlook is that a recession in the developed markets will lead to a slowdown in exports, and this could trigger a downturn in countries that rely on external demand.

Brian Rose, **PhD**, Strategist

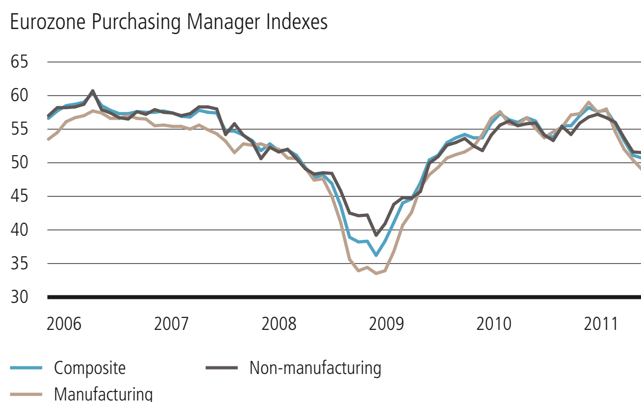
Fig. 3: Growth and inflation forecasts

	GDP Growth			Inflation		
in %	'10	'11F	'12F	'10	'11F	'12F
World	4.2	3.2	3.3	2.9	3.6	2.9
US	3.0	1.6	2.2	1.6	2.9	1.8
Canada	3.2	2.2	2.0	1.8	3.2	2.4
Japan	4.0	-0.6	2.9	-1.0	-0.3	-0.2
Eurozone	1.7	1.8	1.0	1.6	2.5	1.8
UK	1.4	1.1	1.5	3.3	4.5	2.9
China	10.3	9.0	8.3	3.3	5.2	3.5
India	8.5	7.2	7.8	12.1	7.4	6.8
Russia	4.0	4.1	3.4	6.9	8.9	7.3
Brazil	7.5	3.1	3.5	5.9	6.7	5.8

Note: For full explanation of this table, please see appendix. F: forecast
Source: UBS WMR, as of 27 September 2011

Fig. 4: Eurozone has slowed in recent months

Eurozone Purchasing Manager Indexes

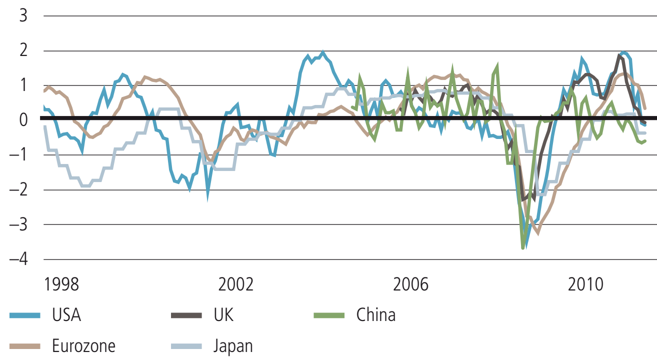


Source: Bloomberg, UBS WMR, as of 26 September 2011

Economic Outlook: Chartbook

Fig. 5: Manufacturing activity has slowed significantly

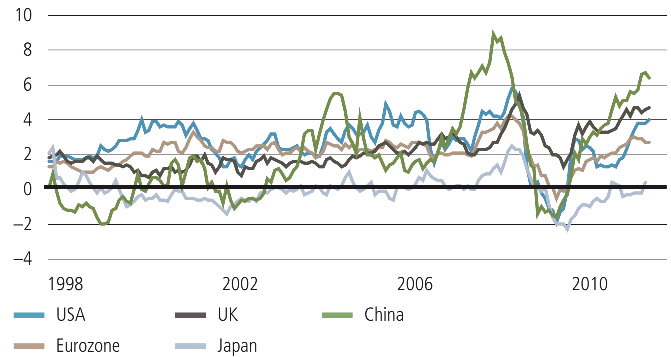
Global real activity, standardized (mean = 0, standard deviation = 1)



Source: Bloomberg, UBS WMR, as of 25 September 2011

Fig. 6: Inflation seems to be peaking

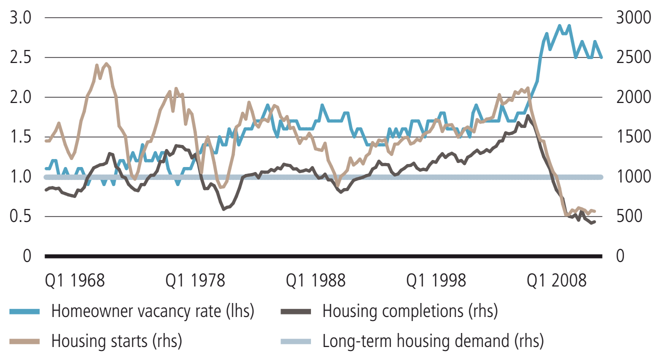
Global CPI inflation rates, year-over-year in %



Source: Bloomberg, UBS WMR, as of 25 September 2011

Fig. 7: US housing supply is stabilizing

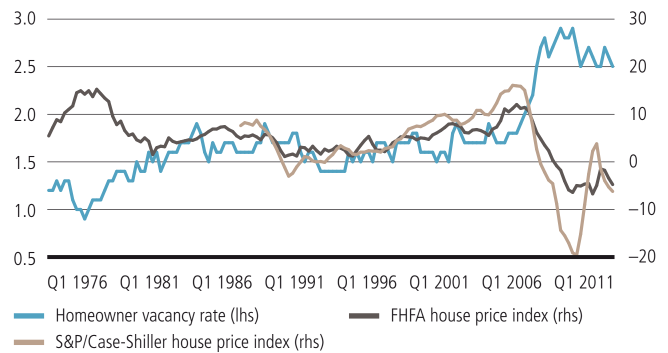
US housing supply (annualized in thousands) and homeowner vacancy rate (in %)



Source: Thomson Datastream, UBS WMR, as of 25 September 2011

Fig. 8: US house price inflation is stabilizing

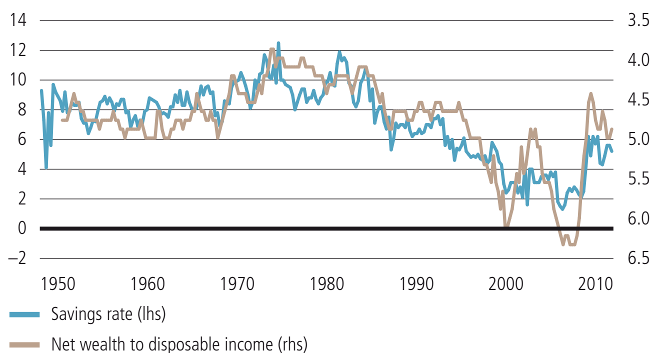
US house prices (year-over-year in %) and homeowner vacancy rate (in %)



Note: FHFA = Federal Housing Finance Agency
Source: Thomson Datastream, UBS WMR, as of 25 September 2011

Fig. 9: Net wealth and the savings rate have stabilized

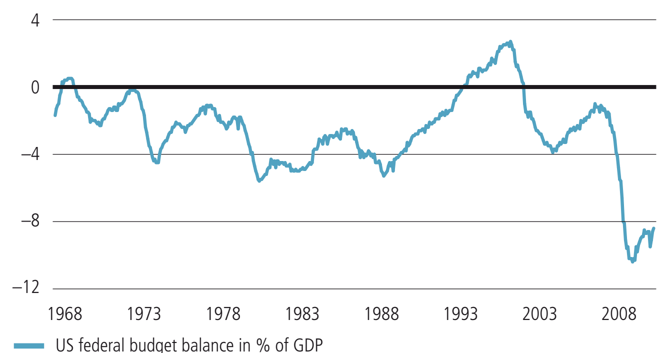
US household net wealth and savings rate, in % of disposable income



Note: Right scale is inverted
Source: Thomson Datastream, UBS WMR, as of 25 September 2011

Fig. 10: Federal deficit likely to narrow further

US Federal budget balance, in %

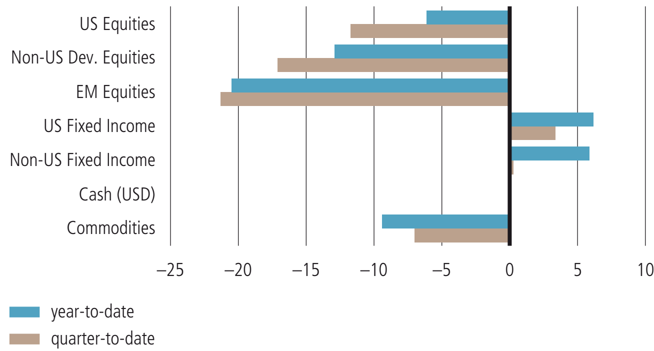


Note: Sum of monthly federal budget balance over the past 12 months divided by current-quarter annualized nominal GDP
Source: Bloomberg, UBS WMR, as of 25 September 2011

Financial Market Performance

Fig. 1: Asset Classes

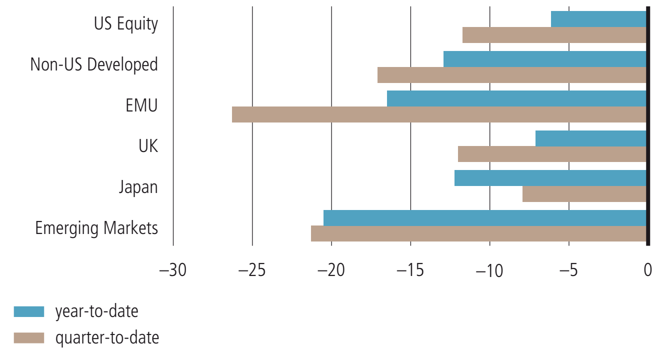
Total return in USD and %



Source: Bloomberg, UBS WMR as of 27 September 2011

Fig. 2: International Equity

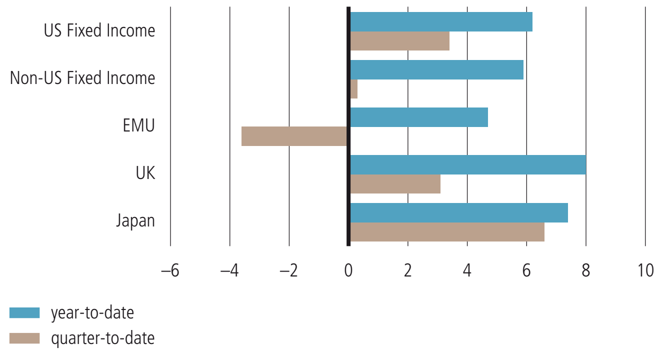
Total return in USD and %



Source: Bloomberg, UBS WMR as of 27 September 2011

Fig. 3: International Fixed Income

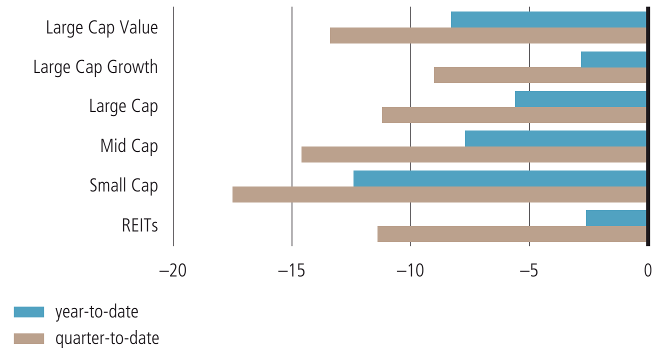
Total return in USD and %



Source: Bloomberg, UBS WMR as of 27 September 2011

Fig. 4: US Equity

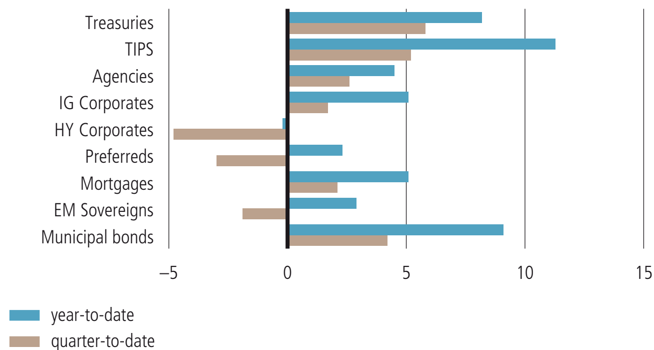
Total return in USD and %



Source: Bloomberg, UBS WMR as of 27 September 2011

Fig. 5: US Fixed Income

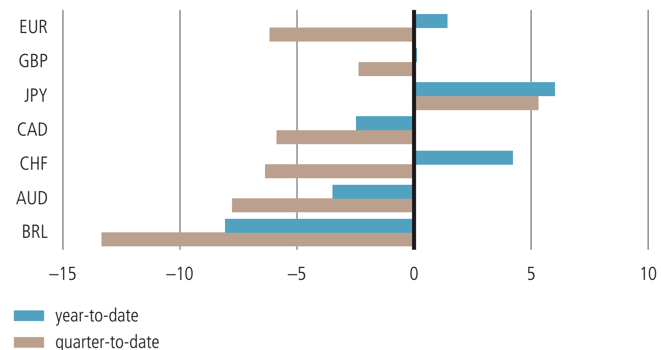
Total return in USD and %



Source: Bloomberg, UBS WMR as of 27 September 2011

Fig. 6: Currencies

Appreciation vs. USD in %



Source: Bloomberg, UBS WMR as of 27 September 2011

Asset Classes

Downside risks too great to ignore

A deteriorating global growth picture and the potential for further fallout in the eurozone suggest moderate portfolio tilts away from equities and commodities into cash and corporate bonds.

Equities not cheap enough given existing risks

We remain concerned that risks may be skewed to the downside for global equity markets. The macroeconomic backdrop remains very challenging, with both the US and European economies hardly growing and in a position where they could easily be tilted into recession by any shock. In addition, we believe the still unresolved eurozone fiscal and financial crisis remains a significant source of downside risk for markets over the next quarters. A Greek default is appearing very likely during the next six months and we struggle to see how even an orderly debt restructuring could be conducted without some element of contagion and collateral damage to global growth and financial markets.

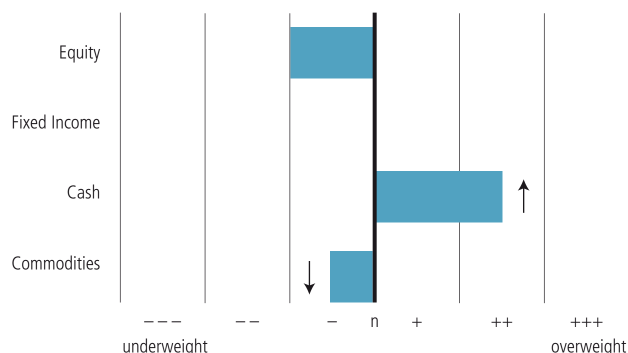
It is true that equity valuations and investor sentiments are at sufficiently low levels that they could start to indicate a nearing market bottom. However, we believe that both may not be depressed enough to truly offset the risks on the macro front. On the valuation front, our dividend-discount model indicates an upside to fair value of 35%. This is a significant positive signal but is still shy of the 50% upside that markets reached in March of 2009.

Similarly, the S&P 500 forward price-to-earnings (PE) ratio, currently at 11.3x, is significantly below its long-term average value of 15x. However, this does not suggest that stocks are a screaming buy. For one, in the current post-Great Recession environment, with lower growth prospects and increased macroeconomic uncertainties, a fair PE is likely to be lower than average. We believe that a fair PE should lie in the 12 to 14x range. In other words, while valuations appear attractive at first sight, deeper digging suggests that they are not outright compelling given the risk associated with the current environment.

Similarly, various measures of investor sentiment have deteriorated significantly since early summer. This begs the question whether Warren Buffet's famous quote "Be fearful when others are greedy, and be greedy when others are fearful," applies at this juncture. Overall, we believe that surveys of sentiment among both retail and institutional investors, although low, are not as low as they have been in the past during significant market bottoms (see Fig. 8, pg. 22). In other words, we have not reached panic or capitulation mode. We therefore believe that given the cyclical challenges in the US and Europe, together with the potential for a further unraveling of the situation in the eurozone, things will probably have to get worse and investor sentiment deteriorate further before markets can stabilize.

Fig. 1: Asset class preferences

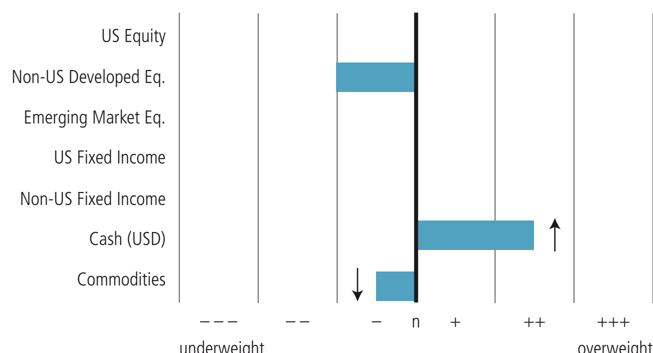
Tactical deviations from benchmark



Note: Black arrows indicate changes as of 28 September 2011. Scale explained in Appendix.
Source: UBS WMR, as of 28 September 2011

Fig. 2: Asset class and regional preferences

Tactical deviations from benchmark



Note: Black arrows indicate changes as of 28 September 2011. Scale explained in Appendix.
Source: UBS WMR, as of 28 September 2011

As a result, we believe that recommending a moderate underweight tactical portfolio positioning to the equity asset class is appropriate at this stage.

Bonds: expensive but not at risk for now

The current environment is one where valuation considerations may not provide the most appropriate indication of near-term market direction. This applies in particular for the bond market. We have stated in the past that, for investors interested in putting funds to work for five years and longer, bonds would likely provide very disappointing returns (see WMR report, *The decade ahead*, February 7, 2011). With 10-year Treasury yields having now reached new historical lows, this remains true. However, over the next 6 to 12 months, with the Fed clearly committed to ever-looser monetary policy, we think the upside for bond yields should be limited. Moreover, we expect high grade bonds to continue benefiting from episodic phases of flight to safety. In our tactical asset allocation, we are recommending a neutral fixed income allocation, as well as a neutral duration position (i.e., in line with portfolio benchmarks).

Commodities: avoid broad exposure

We recommend that investors currently fully invested up to our long-term recommended commodity allocation (see tables on page 41 for allocation recommendations by investor risk profile) reduce their positions to a tactical underweight. Investors not fully allocated to commodities should refrain from adding positions for the time being.

We expect global commodity demand to decelerate further. Growth in developed economies has already slowed significantly during the first half of the year. Growth in emerging markets has been relatively strong but has also been slowing. This should weigh on commodity demand from giants such as China.

Commodity prices have already lost ground recently as a result of the deteriorating outlook. The DJ UBS commodity index has lost 15% from its peak in late April and 11% alone in September. However, keep in mind that in past commodity cycles, prices have declined anywhere between 17% in the early 1990s to 50% in 2008 – 2009. Moreover, large portions of the commodity space are still trading above marginal costs of production. Should global demand growth decline further, we would expect commodity prices to converge further toward marginal costs. Therefore, a further price decline of 10-15% appears realistic. Additionally, we note that commodities continue to present a negative roll yield, which we expect to amount to -5% during the next 12 months.

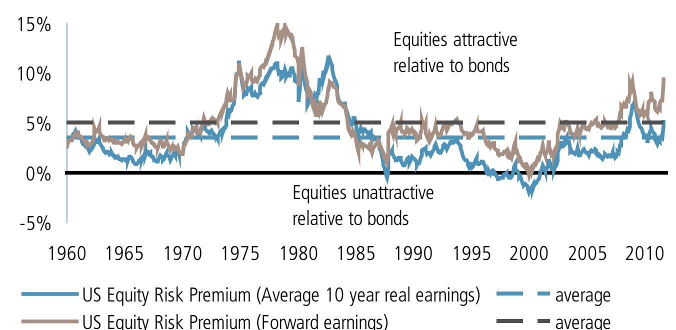
Stephen R. Freedman, PhD, CFA, Strategist

Fig. 3: Asset class scorecard
Scores range from –3 (very unattractive) to +3 (very attractive)

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

Source: UBS WMR, as of 28 September 2011

Fig. 4: Equities are fundamentally cheap to bonds
S&P 500 earnings yield minus real bond yield

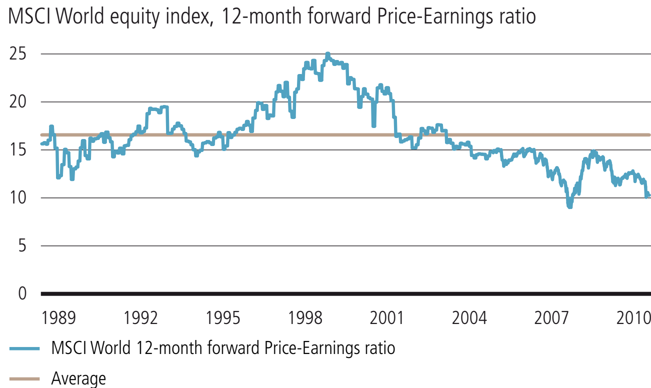


Source: Shiller, IBES, Datastream, UBS WMR as of 27 September 2011

Asset Classes: Chartbook

Fig. 5: Global equities are cheap versus historical valuations

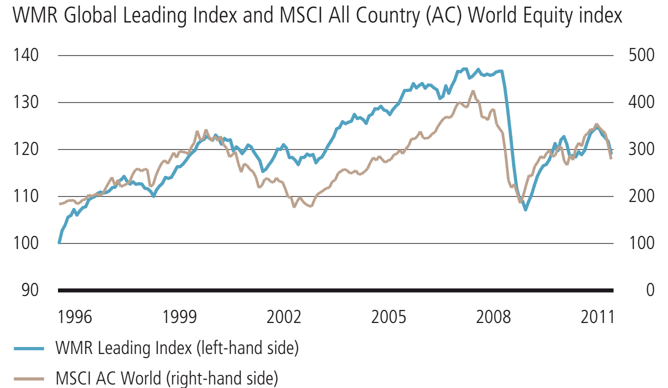
MSCI World equity index, 12-month forward Price-Earnings ratio



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

Fig. 6: Leading index has rolled over

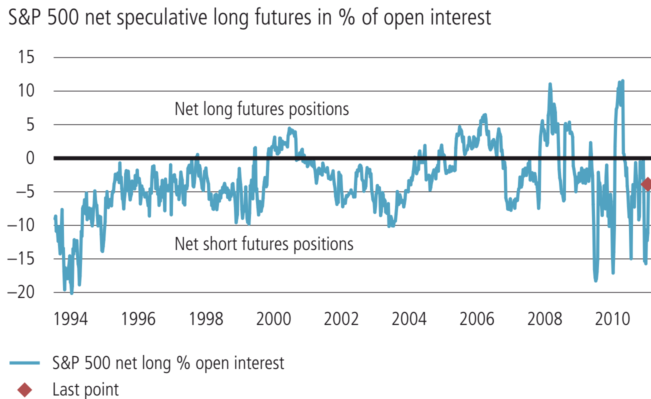
WMR Global Leading Index and MSCI All Country (AC) World Equity index



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

Fig. 7: Speculative positioning bearish but not extreme

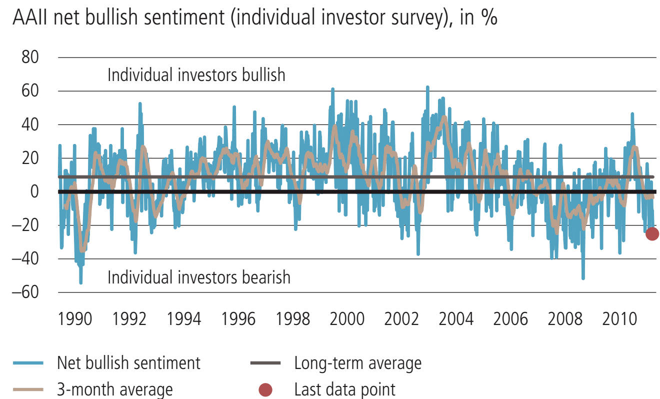
S&P 500 net speculative long futures in % of open interest



Source: CFTC, Bloomberg, UBS WMR, as of 20 September 2011

Fig. 8: Investor sentiment depressed, but not rock-bottom

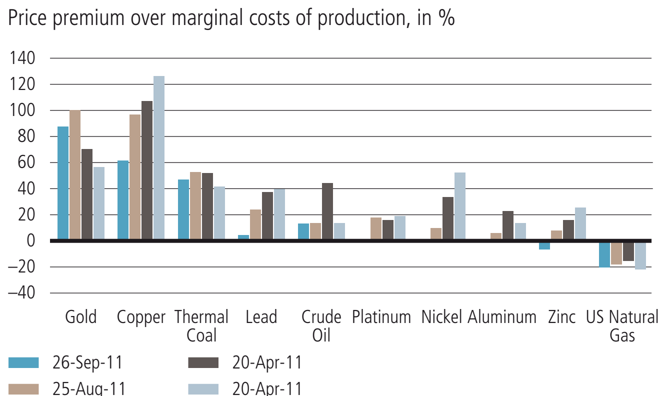
AAII net bullish sentiment (individual investor survey), in %



Source: American Association of Individual Investors (AAII), Bloomberg, UBS WMR, as of 22 September 2011

Fig. 9: Commodities remain pricey

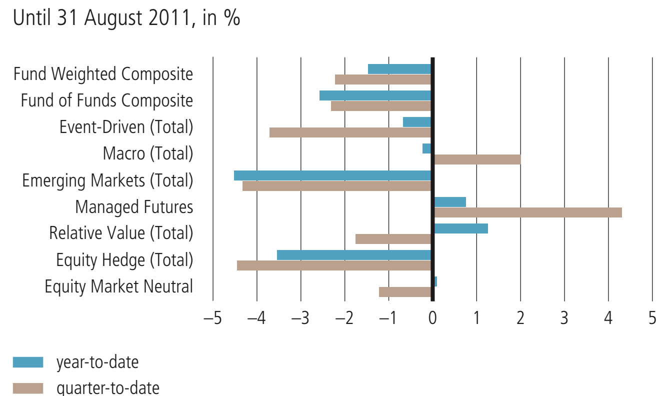
Price premium over marginal costs of production, in %



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

Fig. 10: Performance of selected Hedge Fund strategies

Until 31 August 2011, in %



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

Foreign Exchange

The dollar strengthens, but why?

Certainly there are plenty of reasons why the euro versus the US dollar (EURUSD) would have been highly volatile over the past year. The US government nearly defaulted, the Fed maintained a huge balance sheet and confidence in a continued recovery has faltered. In Europe, economic momentum has collided against ever-deepening troubles in Greece and other "peripheral" nations. Yet, EURUSD is almost exactly where it was a year ago, and for a full six months – between March and August – the pair moved only within a 10% range. However, the dollar has recently started to strengthen, for reasons that may not be the first to come to mind.

So why did EURUSD finally shift lower? There have been plenty of truly ugly headlines out of Europe – from the union falling apart to global banking failures – but these were unlikely the primary causes. EURUSD has moved in lock-step with interest rate differentials. There has been plenty of controversy about the European Central Bank's (ECB's) rate hikes – now up to 1.5% – as many countries in Europe struggled to retain access to credit. The ECB, however, focused on the inflation risk in the core of Europe, mostly Germany. While we do not yet expect a rate cut from the ECB, clearly the central bank is focused on the downside risks; the structure of the union is in question and economic activity has nearly stalled even in the most successful countries. Lower interest rate expectations for the euro have put pressure on its value versus the dollar.

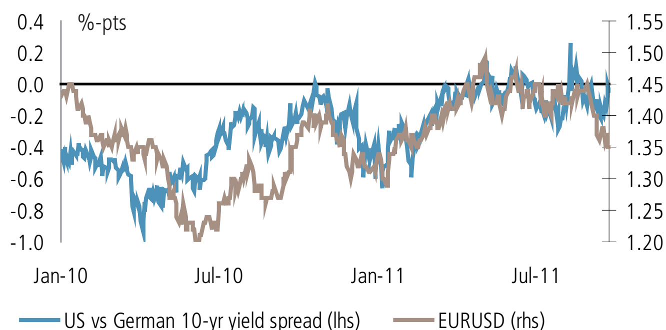
While it may at first appear spurious, another potential cause of the dollar's recent rise against the euro was a controversial decision by the Swiss National Bank to limit the appreciation of the Swiss franc. Switzerland has attractive economic fundamentals, but perhaps more important, its traditional status as a safe haven has been magnified by the crisis in the eurozone. Before the introduction of the euro, the German mark was often in demand in times of general financial market and economic strain. Now with uncertainty about the future of the euro, Switzerland's unique status as a little island of monetary independence surrounded by the eurozone meant that there was a huge demand for the Swiss franc. This demand drove up the price of the currency, which gained nearly 40% against the euro from its pre-crisis highs. Fears over the eurozone were thus causing an overvalued franc, which in turn was threatening to send Switzerland into a deflationary recession. To block this appreciation, the SNB finally resorted to an extreme measure: promising to intervene without limit to prevent the franc from getting any stronger than 1.20 to each euro. This ceiling on franc strength means that those investors seeking to exit euro positions can no longer look to the franc as an alternative – arguably forcing some of these flows into long dollar positions.

Overall, we remain concerned that any further flaring up of the eurozone crisis will weaken the euro further.

Katherine Klingensmith, Strategist

Fig. 1: Interest rate differential drives EURUSD

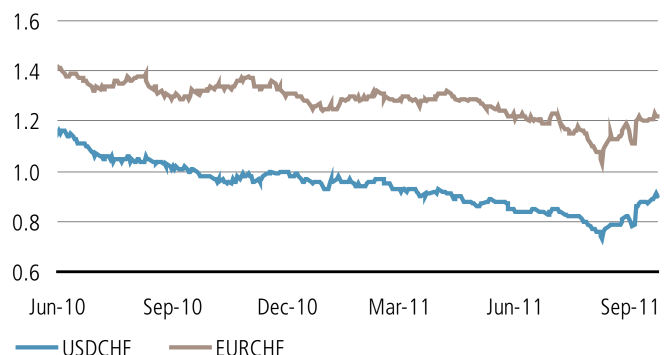
US vs. German 10-yr government bond yield spread, EURUSD exchange rate



Source: Factset, UBS WMR as of 26 September 2011

Fig. 2: Swiss franc has stopped strengthening

USDCHF and EURCHF exchange rates



Source: Factset, UBS WMR as of 26 September 2011

International Equities

Risk elevated overseas

International valuations are attractive relative to the US, but higher than normal risk keeps us underweight on non-US developed equities.

We recommend caution despite attractive valuations
International equities look more attractive than the US on most valuation metrics. However, US equities have been outperforming global markets in recent months. At the same time, the dollar has rebounded off of its lows, hurting returns on non-US equities when measured in dollar terms. Risk remains higher than normal in overseas markets, leading us to prefer US over non-US equities.

The ongoing sovereign debt crisis makes us particularly cautious on eurozone equities, which remain our largest underweight. Our only overweight outside of the US is in the UK, which looks inexpensive both in terms of valuations and the low level of the pound against the dollar. Emerging markets (EM) should deliver superior economic and earnings growth going forward, but historically they have been riskier than developed markets and have underperformed during global bear markets. On September 19, we reduced EM from moderate overweight to neutral.

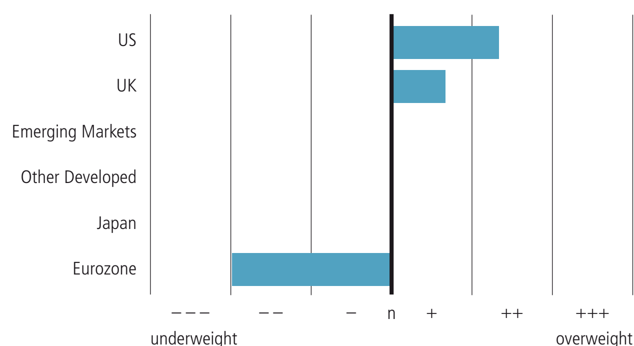
Avoid excessive risk in the Eurozone
Eurozone equities have dropped dramatically since their peak in May, losing 30% in dollar terms. Valuations look very inexpensive based on 12-month forward consensus earnings estimates. However, earnings forecasts have been dropping sharply in recent weeks, and we expect this trend to continue. The financial system has been showing increasing signs of stress, and economic growth has been slowing even in the core economies. In our view, the prospects of a Greek restructuring during the next six months means that eurozone equities could still fall from current levels despite their depressed valuations.

UK attractive despite weak economy
The UK has been struggling in recent months and appears to be on the edge of falling into recession. However, companies listed in the UK generate around 70% of their earnings overseas and provide exposure to rapidly growing emerging markets. Valuations look inexpensive with the market trading around 9 times consensus earnings. The pound also looks cheap against the dollar after falling to new lows for the year during September.

Japan upgraded to neutral
Valuations on Japanese equities are more attractive than usual although they are by far not as cheap as the eurozone and UK. The economy has been recovering well from the March earthquake and reconstruction spending should temporarily boost economic growth in 2012. We expect the dismal state of public finances to lead to a rapid depreciation of the yen at some point in the future. However, with interest rates on the other major currencies likely to remain near zero for quite some time and investors less willing to accept the risk of short-selling the yen,

Fig. 3: Equity regions

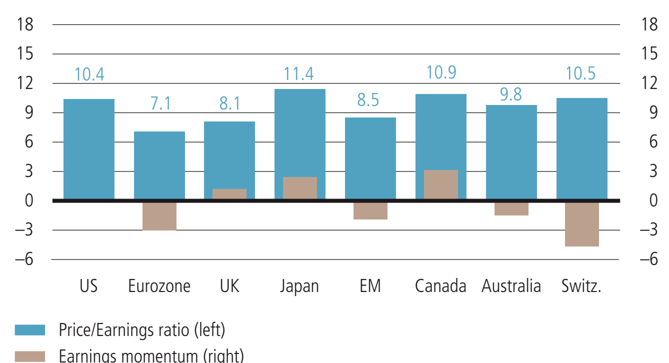
Tactical deviation from benchmark, including view on currency



Note: Scale explained in Appendix.
Source: UBS WMR as of 28 September 2011

Fig. 4: Regional equity valuations and earnings momentum

12-month forward P/E; 3-month change in 12-month forward consensus earnings



Source: IBES, Datastream, UBS WMR as of 26 September 2011

the currency appears less vulnerable for the moment. We have therefore upgraded Japan from moderate underweight to neutral.

Neutral on other developed markets

Valuations in Australia and Switzerland appear reasonable. While their currencies remain expensive, the recent rebound of the dollar has eliminated some of the overvaluation, reducing exchange rate risk for dollar-based investors. Economic growth in Australia has been disappointing so far in 2011, but conditions remain stronger than in most developed economies and long-term prospects are good. The high weight of defensive sectors in the Swiss market is attractive under current circumstances. Canada is still one of the more expensive markets but offers relatively strong financial institutions and public finances and can therefore justify a valuation premium. We are neutral on these markets.

Emerging markets: long-term prospects remain strong

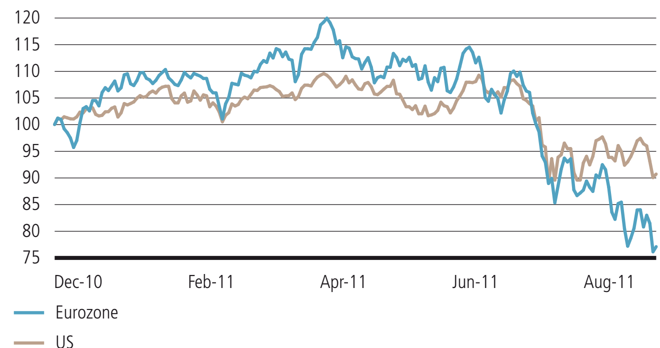
EM equities have performed poorly so far in 2011. The rise in food and energy prices early in the year pushed up inflation, forcing many EM central banks to raise rates. Inflation has been particularly problematic in the BRIC countries (Brazil, Russia, India, China), which represent a large share of EM equities. Many EM currencies have fallen sharply against the dollar in recent weeks as investors have shunned risk, hurting the performance of EM equities in dollar terms. Currency weakness will also add to inflationary pressure in some countries, requiring central banks to remain vigilant on monetary policy.

In our view, EM offers superior long-term growth prospects, and they trade at a discount to developed markets. We expect economic growth and earnings to hold up better than in developed markets in 2012. While EM equities remain attractive for long-term investors, they appear unlikely to outperform significantly in the next few months. Money has been flowing out of EM equity funds, and institutional investors may be reluctant to increase their allocation to EM until global risks subside.

Brian Rose, PhD, Strategist

Fig. 5: Eurozone equities down sharply since May peak

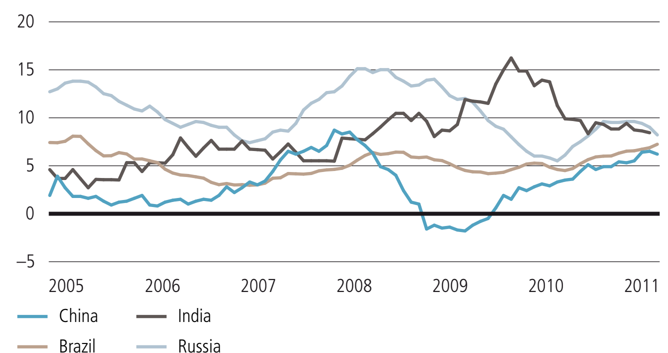
Performance in US dollars, end-2010 indexed to 100



Source: Bloomberg, UBS WMR as of 23 September 2011

Fig. 6: Inflation remains elevated in BRICs

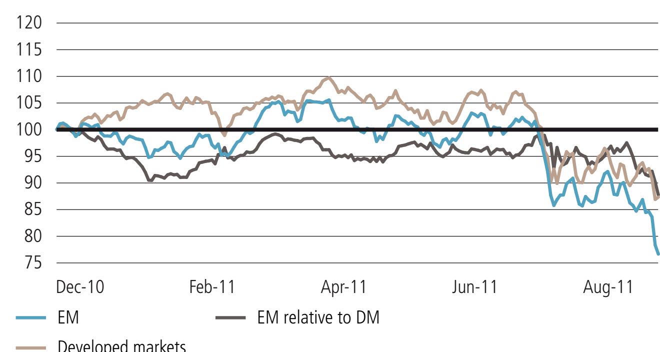
CPI inflation rate, in %



Source: Bloomberg, UBS WMR as of 26 September 2011

Fig. 7: Emerging markets have underperformed recently

Performance in US dollars, end-2010 indexed to 100



Source: Bloomberg, UBS WMR as of 26 September 2011

Avoid peripheral European debt

High yields on Greek government bonds may appear tempting, but we maintain our recommendation to avoid the debt of the weaker countries in the eurozone. The recent rally in the dollar makes overseas bonds more attractive.

Resist temptation of higher-yielding bonds
With 2-year bonds offering a yield above 60%, it is understandable why some investors are interested in Greek government bonds. However, it is important to understand that the coupon on the bonds is not that high. The "yield" only looks high because the bonds are trading around 40 cents on the euro, reflecting market expectations that the government will default on its debt. In our view, Greece is likely to default within the next six months, and the bonds could still drop 50% or more from current depressed levels. While the other countries in the eurozone are less likely to default in the near future, we remain cautious, especially on the higher-yielding bonds.

Japanese bonds offer little value
Government debt levels are far higher in Japan than in most other countries, including Greece, yet yields remain extremely low. For example, 10-year bonds offer a meager 1% yield. On top of this, the yen is close to a record high against the dollar on foreign exchange markets despite Japan falling into a trade deficit since the earthquake in March. We therefore see little value in Japanese bonds and recommend investors put their money elsewhere.

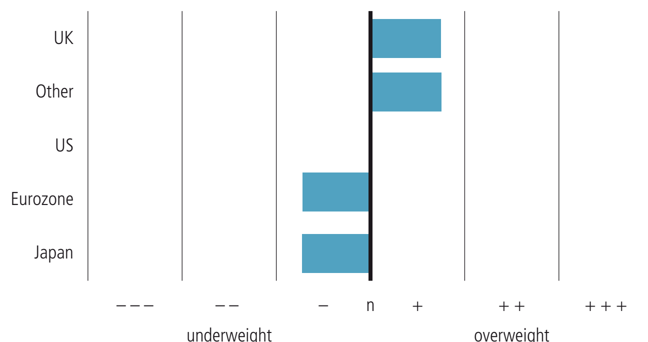
Keep foreign bonds at benchmark despite low yields
While yields are at unusually low levels in international bond markets, foreign bonds still belong in the portfolio of most investors and we recommend maintaining a benchmark (neutral) allocation. Consider the many troubles that will negatively affect the US economy in the long term: 1) the US will need to impose austerity or face difficulty in continuing to attract foreign investors to finance its large government overruns; 2) the Federal Reserve will need to eventually reduce the amount of money in circulation; and 3) the US must address structural challenges with high unemployment, and an aging population. In the long run, these issues could weigh on the value of the dollar and US government bonds.

As is increasingly apparent to many investors, diversification among currencies is important to maintaining a portfolio's performance. The dollar's recent gains make foreign currencies less expensive, and it is reasonable to take some currency exposure with international bonds. Rather than looking for bonds with the highest possible yield, we recommend concentrating on developed countries with strong fundamentals. These fundamentals include reasonable long-term growth prospects, manageable levels of public debt, relatively small budget deficits and currencies that are not trading too far above their fair value.

Brian Rose, PhD, Strategist

Fig. 8: Fixed income regions

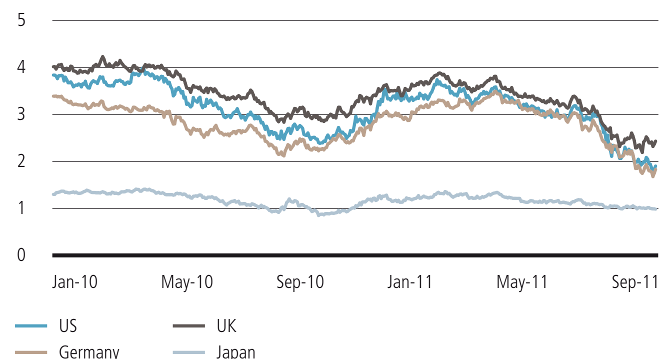
Tactical deviations from benchmark, including view on currency



Note: Scale explained in Appendix.
Source: UBS WMR, as of 28 September 2011

Fig. 9: Bond yield comparison

10-year government bond yields, in %

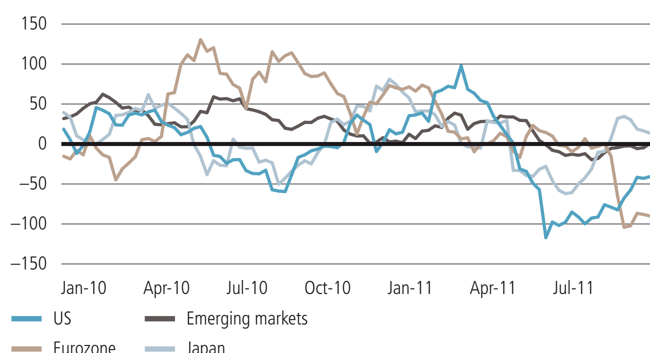


Source: Bloomberg, UBS WMR as of 26 September 2011

International markets: Chartbook

Fig. 10: Economic surprises worst in Eurozone

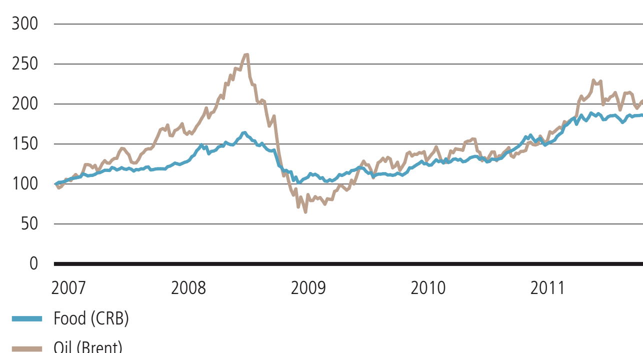
Citigroup Economic Surprise Indexes



Source: Citigroup, Bloomberg, as of 26 September 2011

Fig. 11: Stable food and energy prices will help inflation ease

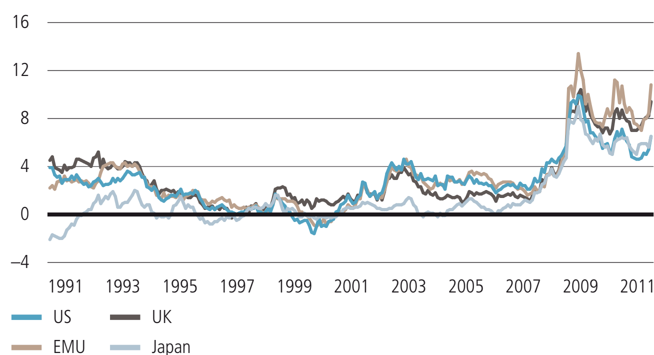
CRB Food Index and Brent oil price, Jan. 2007 = 100



Source: Bloomberg, UBS WMR, as of 26 September 2011

Fig. 12: Equity risk premium higher than usual

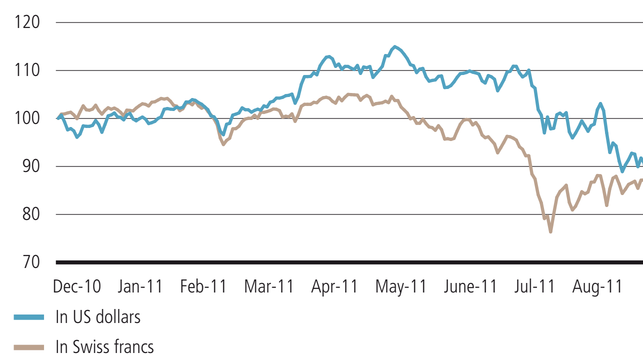
Earnings yield minus 10-year real bond yield, in %



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

Fig. 13: Exchange rate movements impact equity returns

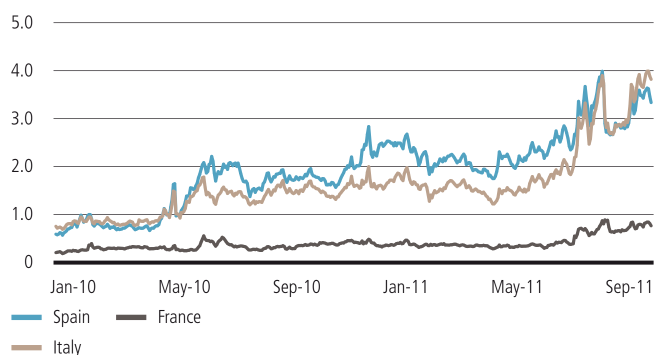
Swiss equity market performance, end-2010 indexed to 100



Source: Bloomberg, UBS WMR, as of 26 September 2011

Fig. 14: Contagion has spread to Italy and Spain

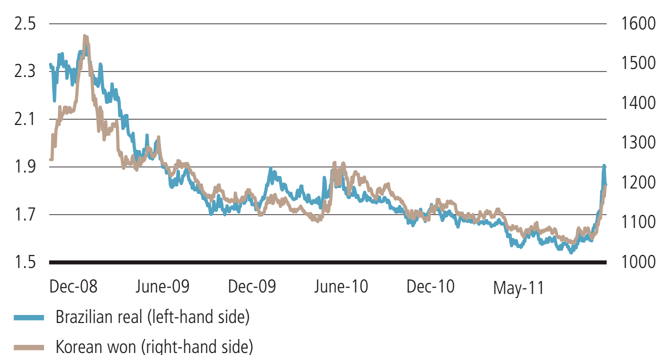
10-year bond yield spreads relative to German Bunds, in %



Source: Bloomberg, UBS WMR, as of 26 September 2011

Fig. 15: EM currencies have retreated against dollar

Exchange rate versus US dollar



Source: Bloomberg, UBS WMR, as of 26 September 2011

Seeking yield, growth, and downside protection

Stocks are inexpensive, but are also unlikely to mount a sustainable rally until macroeconomic conditions improve and a credible, unified solution to the European sovereign debt crisis is in place. Downside risks dominate both issues in the near term. We shift our sector strategy to focus on sectors and industries that offer high dividends and secular rather than cyclical growth opportunities.

As the cycle turns

Weakening leading economic indicators have us concerned that the US economy is teetering on the brink of recession. Fed Chairman Ben Bernanke did not do the markets any favors by noting that there are "significant downside risks to the economic outlook." While that may be an honest assessment, it was interpreted negatively by markets following the Fed's overly optimistic stance of the past two years.

Last month, we shifted to a moderately defensive sector stance and we are choosing to expand our defensive positioning at this stage given the macro risks that appear asymmetric to the downside. Cyclical sectors may appear to have more attractive valuations than most defensive sectors, but those "cheap" valuations are based on 2012 projected earnings estimates that are far too high, in our view. We expect that consensus 2012 S&P 500 earnings estimates are roughly 10% too high, with the bulk of the negative revisions likely to come from the Financials, Energy and Materials sectors. Looking at a less volatile valuation metric such as price-to-book value, cyclicals still appear fairly expensive (see Fig. 2).

Most important to our decision to be more defensive is our expectation that growth continues to moderate. Examining historical sector performance when the ISM Manufacturing Index falls below 50 provides a guide as to how the market typically reacts to a weakening domestic growth outlook. Since 1973, the average annualized defensive sector performance during periods when the ISM falls below 50 (and is falling) is +6%. In contrast, cyclical sectors significantly underperform and fall 10% on average (see Fig. 3).

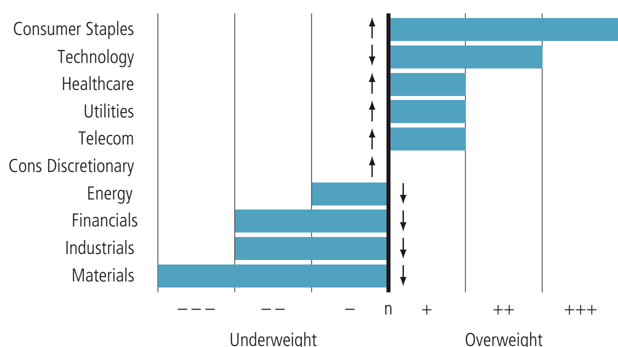
Sector overview

Consumer Staples (strong overweight)

Consumer Staples has long been our favorite defensive sector and we are boosting our positioning to a strong overweight. In a difficult macro environment, the sector's low beta of 0.57 is attractive. But unlike other low-beta sectors, Consumer Staples offers significant dividend growth prospects. Even over the past 10 years, a period with subpar US GDP growth relative to history, the Consumer Staples sector increased dividends at a 12.3% annualized growth rate. This compares to the S&P 500's dividend growth of 5.1% and much lower dividend

Fig. 1: A more defensive tilt

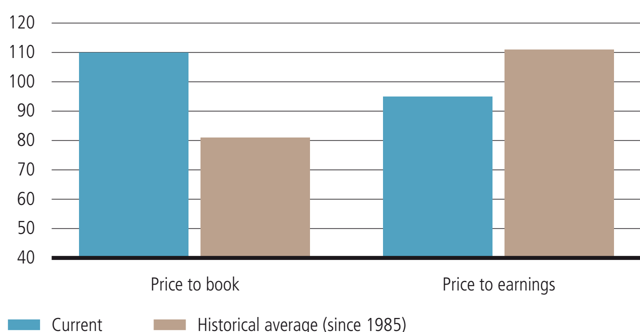
Tactical deviations from benchmark



Note: Black arrows indicate changes as of 28 September 2011. Scale explained in Appendix.
Source: UBS WMR, as of 28 September 2011

Fig 2: Mixed valuation signals between cyclicals and defensives

Cyclicals relative to defensives, in %



Cyclical sectors: Materials, Industrials, Technology and Consumer Discretionary.
Defensive sectors: Utilities, Telecommunications Services, Consumer Staples and Healthcare.
Source: DataStream and UBS WMR, as of 26 September 2011

growth for the highest-yielding sectors (telecom, 3.3%, and utilities, 0.2%). High exposure to faster growth in emerging economies combined with the prospects of declining commodity input prices should drive robust earnings and dividend growth over the next several quarters.

Technology (overweight)

The Technology sector has held up fairly well in the recent market downdraft falling just 6% in 3Q compared to the 14% decline in the S&P 500. Strong demand for smartphones and tablets, continued strength in emerging markets and a sustained corporate refresh cycle for Tech infrastructure has helped offset weaker trends in developed market consumer PC unit sales. The sector also boasts very strong balance sheets, which is an attractive attribute during periods of financial stress. Our expectation for continued resilient growth prospects, along with current low valuations, leads us to find appeal in the sector. However, we shuffle our intra-sector weights to favor the more defensive software and hardware sub-sectors over semiconductors based on a higher percentage of recurring revenues (software) and selected strong product cycle opportunities (hardware).

Utilities (moderate overweight)

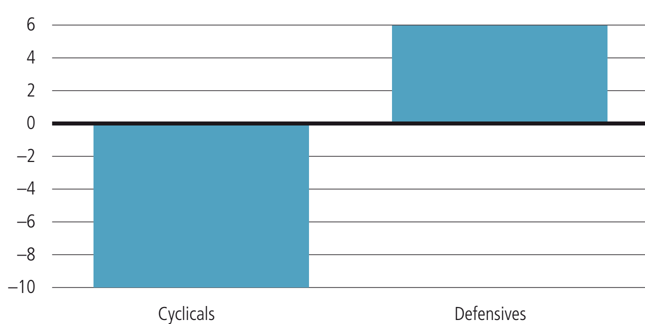
We raise Utilities from neutral to moderate overweight as the sector's attractive dividend yield of 4.3%, low earnings volatility and lack of exposure to Europe should continue to be rewarded. Utilities currently trade at a 21% premium to the S&P 500 on a forward P/E basis, but its absolute forward P/E of 13.4 is nearly identical to its 5-year average P/E of 13.3. Perhaps most importantly, Utilities should continue to act as a safe haven for investors. Forward-looking earnings estimates are far more secure than in other more economically sensitive sectors. Relative earnings revisions (percentage of positive revisions for the sector compared to the S&P 500 (see Fig. 7) have been steadily improving for the past six months and we expect this trend to continue.

Healthcare (moderate overweight)

Of the four traditional defensive S&P 500 sectors (Consumer Staples, Utilities, Telecom and Healthcare), Healthcare is the least expensive by a wide margin. The sector trades at a P/E of 10.8, compared to the 13-15 range for the other defensives. This is largely due to: 1) the anticipation of slower earnings as a result of the so-called "patent cliff" when over USD $100bn of branded pharmaceutical sales are expected to lose patent exclusivity and face generic competition; and 2) fears of draconian cuts to federal government programs. We believe the patent expiration risks are well understood by investors and, while there could be some cuts to government healthcare expenditures, the long-term demographic trends are still very favorable. We upgrade the sector to moderate overweight based on its defensive characteristics, improving relative

Fig. 3: Weakening cyclical momentum favors defensive sectors

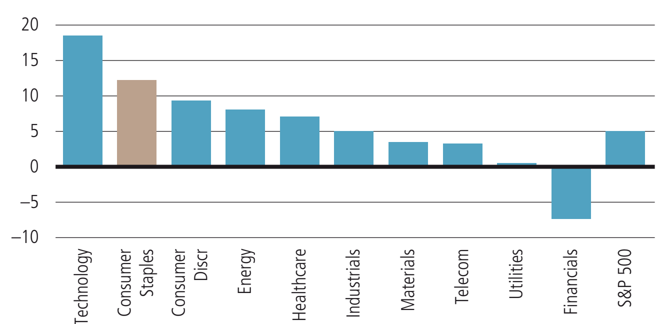
Annualized performance when ISM Manufacturing Index falls below 50 since 1973, in %



Note: ISM = Institute for Supply Managment
Source: DataStream and UBS WMR, as of 26 September 2011

Fig. 4: Consumer Staples has highest dividend growth among defensives

Annualized dividend per share growth over last ten years, in %



Source: Factset and UBS WMR, as of 26 September 2011

earnings momentum and the strong fundamental outlook for the non-pharmaceutical segments of the sector, notably the drug distributors and managed care organizations.

Telecommunication Services (moderate overweight)

We upgrade the Telecom sector to a moderate overweight, despite its high relative valuation. Telecom offers the highest dividend yield in the S&P 500 at 5.6%, nearly 4 percentage points above the 1.9% yield on the 10-year US Treasury bond – a gap that will be hard for investors to ignore. The big cap stocks that dominate the Telecom index should continue to generate strong cash flows to fund additional moderate increases in dividends over the next few years.

Consumer Discretionary (neutral)

We upgrade the sector to neutral, favoring the more defensive consumer services and retailing industries over autos and media. Consumer services offers investors defensive characteristics since the group is dominated by global quick service restaurants and other companies with strong global brands. The retailing index is benefitting from the secular shift from brick and mortar to online consumer purchases. We think this trend will continue and likely accelerate in an economic slowdown benefitting retailing at the expense of the more broadly consumer-exposed autos and media industries.

Energy (moderate underweight)

We expect more near-term weakness in commodity and energy prices. WMR commodity strategist Dominic Schnider expects oil prices to fall to the lower end of his USD $68-$96 per barrel range over the next three months driven by slowing global crude oil demand and a recovery in Libyan oil supplies. We see less scope for natural gas price declines, despite continued excess supply, since prices are already trading near production costs, but weakening US growth will put downward pressure on prices. As such, we downgrade the Energy sector to a moderate underweight. The large cap integrated oils are the most defensive and attractively valued sub-sector within Energy.

Industrials (underweight)

With purchasing managers indexes in major northern European economies falling below 50 and the US ISM Manufacturing Index just barely above that expansion / contraction line, we move to underweight in the Industrials sector. Historically, Industrials have performed poorly when the ISM falls below 50 and continues to decline. Valuations for transports remain high despite earnings risks that are skewed to the downside given weakening macro conditions. Capital goods manufacturers have high exposure to slowing European industrial activity and earnings revisions have turned decidedly negative, but have more downside risks as growth decelerates.

Financials (underweight)

The deepening of the European sovereign debt crisis combined with the struggling US housing market, a flattening of the yield curve and a hostile regulatory environment continued to punish US financials in 3Q. Unfortunately, we see limited scope for a reversal of those headwinds and we move to underweight. Results in capital market activities are likely to be poor as investment banking volumes slow and customer activity levels in fixed income sales and trading have declined. While US financials have far less exposure to European sovereign and corporate debt than their European counterparts, concerns over counterparty risks are likely to remain until a credible "ring fence" surrounding a Greek default is established. We favor REITs and the more domestically oriented bank industries over diversified financials and insurance.

Materials (strong underweight)

We deepen the underweight that we established at the end of August to the Materials sector. We expect commodity prices to continue to soften over the next several weeks, pressuring the sector. With significant exposure outside of the US, the recent strength of the US dollar will be a headwind to both commodity prices and sector earnings. Declining leading economic indicators typically are consistent with Materials sector underperformance. The biggest upside risk for the sector is stronger-than-expected global growth or additional asset purchases by the Fed, which would likely weaken the dollar and bolster commodity prices.

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

US Equities: Size & Style, REITs

Growth and large caps best positioned

Growth over value stocks is our highest conviction call. We upgrade large caps to overweight relative to small and mid caps.

Large caps gain appeal: upgrade to overweight

Equity market volatility will likely remain high until there is a credible solution to the stresses plaguing Europe and concerns about global economic growth subside. In this environment we believe large caps will outperform. The stresses in the financial markets will likely lead to further credit spread widening, an environment that typically leads to large cap outperformance. In addition, we expect consensus earnings expectations to decline as a result of the still softening economic data. Economically sensitive cyclical companies constitute a greater percentage of the small cap index versus the large cap's more defensive bias, indicating that small caps have greater downside earnings risk (see Fig. 6). Valuation considerations continue to favor large caps. Large cap P/E multiples are 10% lower than both mid and small caps and our estimate of normalized valuations indicate that large caps are approximately one standard deviation cheap versus both small- and mid-sized companies.

Growth to continue to outperform value

With growth in the economy becoming increasingly scarce, companies that are benefitting from secular growth driven by new products or market share gains (think Apple or Amazon) will continue to gain appeal. Stated another way, from a business cycle perspective, growth stocks typically outperform in the later stages of an economic expansion and through the early part of a recession because there is more earnings risk for companies in the value index. So even if the US avoids a recession, growth stocks should be well positioned. In addition, we are becoming more cautious on the Financials sector (see the preceding sector discussion), the biggest component of the value index. On the other hand, we still favor the Tech sector, the largest sector in the growth index. Despite growth's more favorable drivers, and growth stock outperformance year-to-date, the growth index still trades at a valuation discount to the value index. Growth over value remains our highest conviction call.

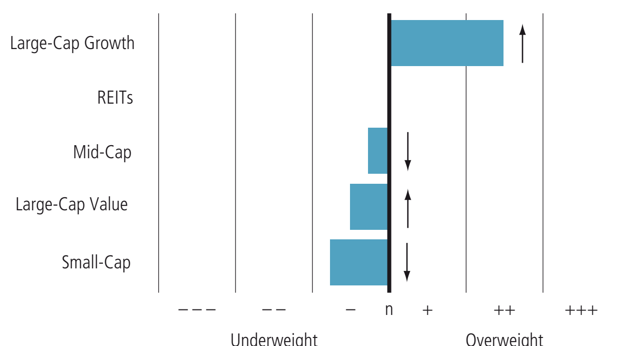
REITs — remain neutral

The decline in interest rates over the past few weeks certainly makes the REIT sector dividend yield of 5% more attractive versus the paltry interest rates in the fixed income market. But if the economy enters a renewed downturn, rental income would suffer and REIT dividend payments could fall as businesses scale back their real estate needs. These two countervailing forces keep us neutral on REITs. If we gain confidence that a domestic recession will be avoided, upside risks may predominate since moderate cash flow growth and ultra-low interest rates is an attractive mix for REIT share prices.

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

Fig. 5: Large-cap growth stocks best positioned

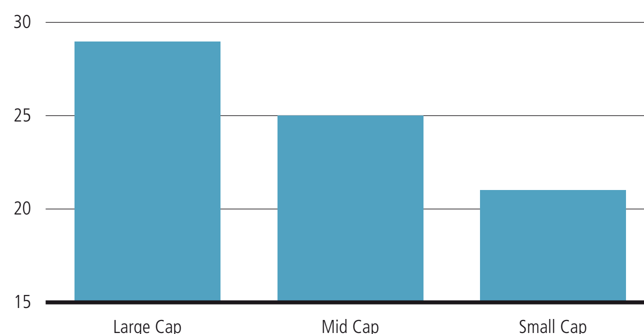
Size, style, and REITs recommended allocation, deviation from benchmark



Note: Black arrows indicate changes as of 28 September 2011. Scale explained in Appendix.
Source: UBS WMR, as of 28 September 2011

Fig. 6: Large-caps are cheaper and more defensive

Defensive sector weights as percent of index, by size (in %)

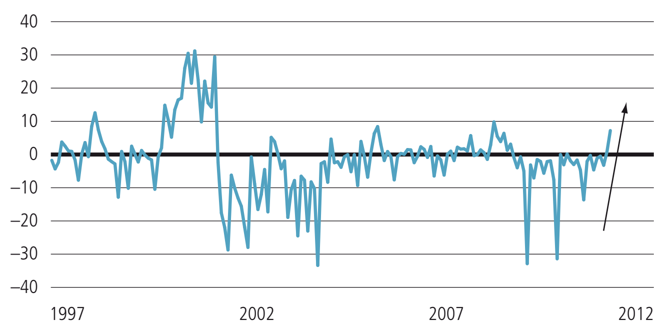


Source: Bloomberg and UBS WMR, as of 26 September 2011

US Equities: Chartbook

Fig. 7: Utilities relative earnings revisions have been improving

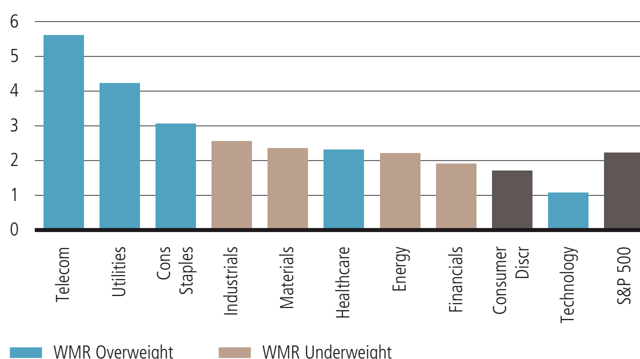
Percentage of Utilities earnings estimate changes that are positive, relative to S&P 500 estimate changes, in %



Source: Datastream, and UBS WMR, as of 26 September 2011

Fig. 8: Low interest rates support higher yielding sectors

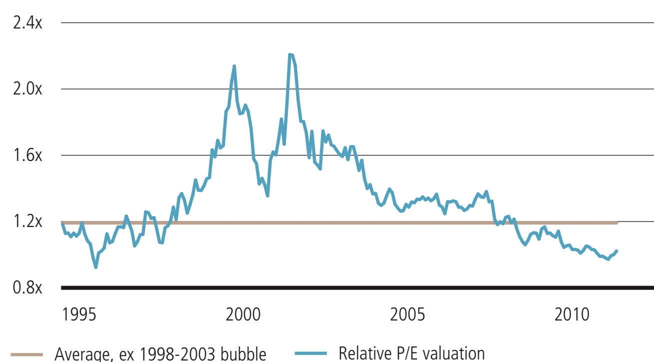
S&P 500 dividend yield by sector, in %



Source: Bloomberg and UBS WMR, as of 26 September 2011

Fig. 9: Tech valuations are compelling

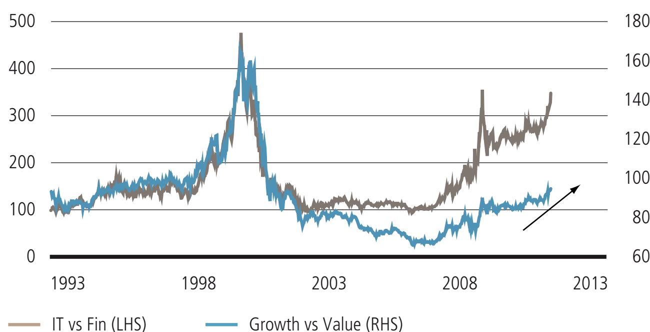
Technology sector P/E relative to S&P 500 P/E



Source: DataStream and UBS WMR as of 26 September 2011

Fig. 10: Tech stocks to drive growth over value

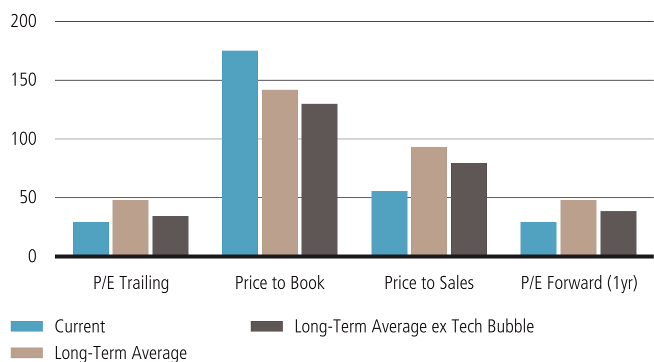
Relative performance of Russell 1000 Growth vs. Russell 1000 Value and S&P Tech vs. S&P Financials, indexed to 100 since 1993



Source: Bloomberg, Russell Investment Group and UBS WMR as of 26 September 2011

Fig. 11: Growth stocks continue to be attractively valued

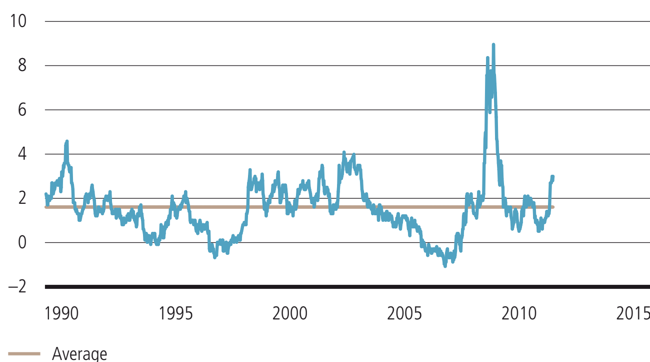
Relative valuation – growth vs. value, since 1979, in %



Source: DataStream, Russell Investment Group and UBS WMR as of 26 September 2011

Fig. 12: REIT yields are attractive vs treasuries

REIT dividend yield less 10 year treasury bond yield, in %



Source: DataStream and UBS WMR as of 26 September 2011

US Fixed Income

Seeking safe spreads

Last month, with economic growth slowing and the European debt crisis dragging on with no resolution in sight, we recommended reducing risk. Since then, growth indicators in the US have continued to disappoint, while the potential for a Greek default has increased. Against this backdrop, we recommend investors seek incremental income through overweights in investment grade credit and agency mortgage-backed-securities. We lowered our interest rate forecasts to reflect the rising chance of a double-dip recession, as well as increased pessimism that European leaders will be able to contain the debt crisis any time soon.

A differentiated credit market

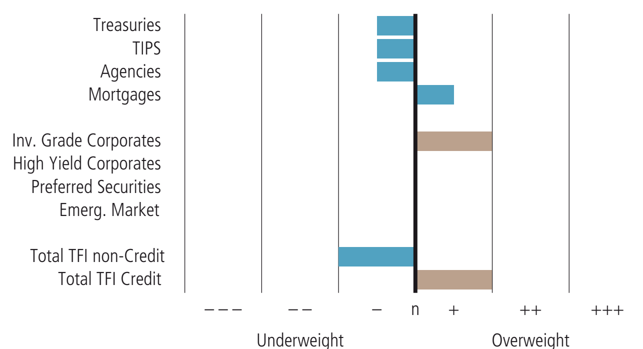
After outperforming earlier this year, credit segments of the bond market underperformed government-related segments, following the sharp summer correction that occurred because of renewed fears of a growth slowdown and European debt concerns. Spreads on investment grade (IG) bonds, as measured by the Barclays Corporate Index, stood as low as 135 basis points (bps) in mid-April, but now hover around 235bps. Spreads in the high-yield (HY) market troughed at roughly 450bps in April according to the BofA ML High Yield index, and have widened to nearly 800bps. In both cases, these spread levels have surpassed the May/June 2010 credit correction and now stand at levels last seen in late 2009 (see Fig. 3 on pg. 37). The direction of yields within credit and non-credit segments of the market has also taken a diverging path. While the yields on Treasury bonds have plummeted, this has not been the case within credit. IG yields stand at roughly 3.7%, near their 3.4% historical lows in early August. Yields in HY, however, have increased toward 9% as the magnitude of spread widening has caused absolute yield levels to rise.

Through the volatility, we witnessed some notable performance trends. First, IG outperformed HY, EM and Preferreds, as the latter three contain incremental credit risk relative to IG. Even though IG spreads moved higher, their absolute performance benefited from the decline in benchmark Treasury rates. Although the IG market is more heavily weighted to Financials (35%) than HY (11%), systemic risk concerns exert a more dramatic spread impact on the most credit-sensitive sectors. We attribute this to the lower credit ratings of the HY and EM (50% of countries are rated below investment grade), and the structural subordination characteristic of the Preferred sector.

While EM performance held up reasonably well in August, this wasn't true in September. We believe specific events in August, such as the S&P downgrade of the

Fig 1: US dollar taxable fixed income (TFI) strategy

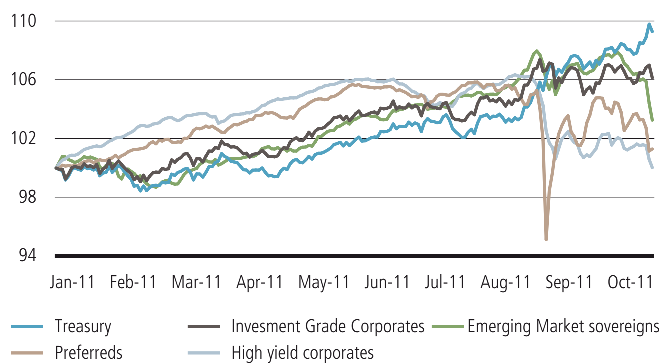
Tactical deviations from benchmark



Note: Arrows indicate changes adopted in this report.
Source: UBS WMR, as of 28 September 2011. See the Appendix for a detailed asset allocation illustration in the context of a moderate-risk taxable US dollar fixed income portfolio and for the interpretation of the suggested tactical deviations from benchmark.

Fig. 2: Treasuries have outperformed credit segments

Normalized total returns, year-to-date



Source: UBS WMR, as of 23 September 2011

US sovereign rating, put pressure on developed markets relative to EM. Preferreds exhibited the most extreme drop in prices in early August as the smaller relative size of the preferred market can often lead to thin liquidity when markets become concerned about systemic financial risk. Despite the fact that valuations are cheapest within the riskiest credit segments of the bond market, we continue to see the best opportunities in IG and maintain a moderate overweight. We believe that IG offers the best upside/downside qualities in different possible macro-driven market environments. IG provides an attractive yield advantage over government bond yields and is less susceptible to macro risks than HY, EM and Preferreds. As we saw recently, IG can still perform relatively well in a period of acute market shock as this sector benefits from the flight-to-quality trade that causes benchmark Treasury yield to decline. On the flipside, should macro risks subside – perhaps from signs that the probability of recession has declined or if European policymakers agree to a larger bailout facility – then IG spreads are likely to tighten and outperform non-credit sectors, in our view. Furthermore, from a fundamental standpoint, company balance sheets are in strong shape, and despite turbulent market conditions, the IG bond market remains open for issuers, albeit primarily non-Financials, to take advantage of the low yield levels.

Financials to remain volatile

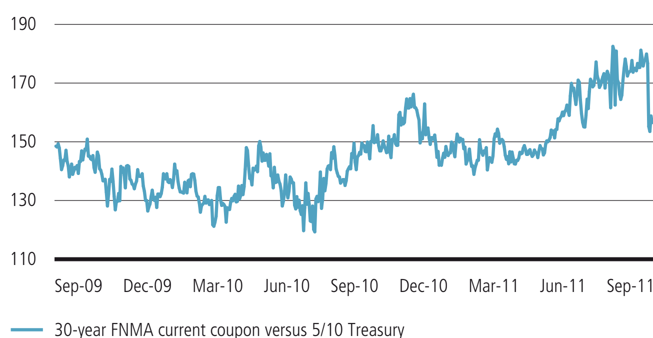
Despite the wider credit spread differential between Financials and non-Financials, we believe that further spread widening will continue amid further market volatility. US and European banks are in fundamentally better shape than they were during the financial crisis and the credit spreads for some banks have widened to mid-2009 levels. We believe the risk of impairment to senior unsecured bondholders of systemically core banks is extremely low. However, we believe Financials spreads will continue to be higher beta relative to non-Financials and we therefore generally favor non-Financial positions for investors putting new money to work in the corporate bond market. Within non-Financials, we continue to prefer BBB-rated credits in the managed care, insurance, mining and communications industries.

Maintain neutral recommendation for emerging markets bonds

We agree with the view that emerging markets boast relatively strong fundamentals, but the likelihood of decoupling from other asset classes seems very low. Brazil, Colombia, Panama and Peru were rewarded with positive rating actions over the prior six-month period. In addition, we regard growing signs that China is capable of an economic soft landing as encouraging and supportive of our view that the virtuous cycle, although likely to decelerate, is not over. However, we also believe that

Fig. 3: Agency MBS spreads plunged following "operation twist"

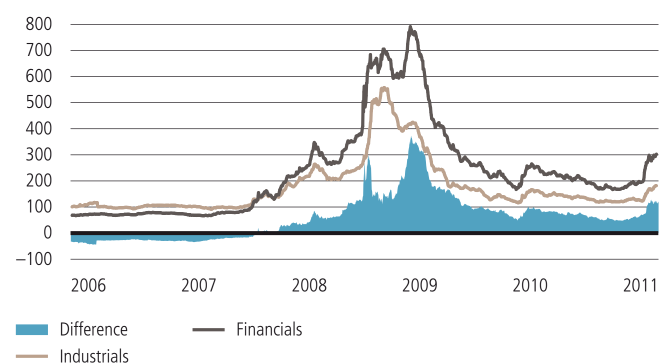
30-year FNMA current coupon spread, in basis points



Note: MBS = mortgage-backed security, FNMA = Federal National Mortgage Association
Source: UBS WMR, as of 23 September 2011.

Fig. 4: Financial spreads have widened relative to Industrials

Credit spreads, in basis points



Source: Barclays Capital, UBS WMR, 22 September 2011

contagion risk may have increased due to the ongoing sovereign debt crisis in the eurozone, and uncertainties about the pace of growth in the US and the developed world (DW). Furthermore, while EM technicals are still supportive, as new supply is expected to be limited (market consensus is for negative net sovereign bond issuance through year-end), the picture may weaken a bit in the future. Downward growth revisions in the DW are likely to be followed by similar dynamics in EM, which could in turn result in weaker fiscal balances, and in higher than first originally expected funding needs. That said, relatively low debt-to-GDP ratios and high levels of foreign reserves in many of the major EM economies should partly offset that risk. Unfortunately, not all EM countries are equal. We see significant potential for additional negative spillover effects to lower-rated credits, and note that approximately 50% of the countries in most broadly followed EM indexes are rated below investment grade. We are mostly concerned with the vulnerability of countries that have adopted unorthodox policies such as Venezuela, and with those located in Eastern Europe. Valuations have improved in recent days, and while we like the carry, we cannot rule out further widening of spreads. We therefore reiterate our neutral asset allocation recommendation for dollar-denominated EM sovereign debt.

Retain overweight on agency MBS

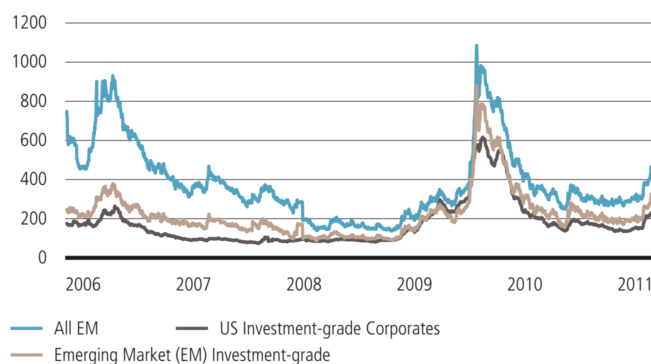
Following the 21 September FOMC meeting, the Fed decided to reinvest the proceeds of principal payments from its holdings of agency debentures and mortgage-backed securities (MBS) into agency MBS. In reaction to the announcement, spreads versus the blend of the 5/10-year Treasury narrowed to approximately 155bps from the 175bps area in early September. We continue to recommend an overweight allocation to agency MBS. Despite the 20bps of spread tightening, agency MBS continue to offer attractive carry in an environment of low absolute yields. The drop in Treasury yields will likely lead to a rise in prepayments but we note that the refi response is more muted than has historically been the case. Approximately 20% of mortgages are underwater, which trims the pool of borrowers that can take advantage of lower rates. Capacity constraints in the mortgage industry and tighter underwriting standards have also dampened the refi response. We believe these trends will persist, which suggests that the market may be overestimating the amount of prepay risk faced by MBS investors. As a result, we continue to recommend a slight overweight allocation.

Interest rate outlook: lower for longer

Uncertainty over the strength of the US economy and the European debt crisis are twin concerns which led us to lower our Treasury forecasts on 20 September. Indeed, the Fed validated our concerns in the statement released after the FOMC meeting, citing "significant downside risks to the economic outlook, including strains in global

Fig. 5: EM spread differentials continue to widen

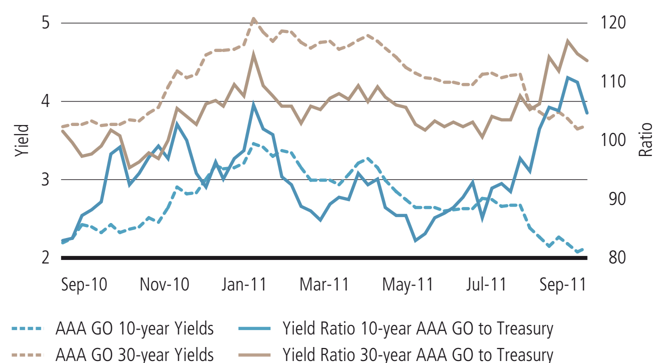
Credit spreads, EM debt and similarly rated US corporates, in basis points



Source: Barclays Capital, as of 23 September 2011

Fig. 6: Municipal Yields and Ratio to Treasury

Yield, in %



Note: GO = General Obligation

Source: Municipal Market Data, UBS WMR, as of 22 September 2011

financial markets." Stalling growth in the US, coupled with the deepening European debt crisis, is consistent with a lower interest rate path than we previously forecasted. In the near term, yields should continue to experience downward pressure from flight-to-quality flows out of European banks and sovereign debt into Treasury securities; longer-term, slower growth in Europe may prove to be an additional headwind for growth in the US.

The Fed made a notable change to monetary policy this month in an effort to boost economic growth. However, we believe the program, dubbed Operation Twist, may have only a limited effect in lowering Treasury yields. The Fed plans to sell USD $400bn Treasury securities with maturities of 3 years or less from its portfolio and purchase USD $400bn of Treasury securities with maturities between 6 and 30 years by the end of June 2012. The Fed last attempted to flatten the yield curve by lowering long-term yields in 1961. It was joined in this effort by the Treasury Department, which shifted a portion of Treasury issuance to shorter maturities and away from the long end. (This time, Treasury has no plans to alter the borrowing mix and remains committed to gradually extending the average maturity of outstanding debt in order to reduce rollover risk.) A paper recently published by the Federal Reserve Bank of San Francisco estimated that the previous Operation Twist lowered long maturity yields by approximately 15bps – an amount too small to make much of a difference to the level of real economic growth. We believe insufficient demand, which is a by-product of consumers shedding debt against a backdrop of stagnant wages is what ails the economy, rather than the level of interest rates. That said, the Fed has made it abundantly clear that monetary policy will remain extremely accommodative for the next few years. We believe this will translate into a lower rate path, and recommend investors maintain a neutral duration stance.

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

	28-Sept	in 3 months	in 6 months	in 9 months	in 12 months
3-month Libor	0.37	0.30	0.30	0.30	0.30
Previous		0.30	0.30	0.30	0.30
2-year Treasury	0.24	0.20	0.20	0.35	0.50
Previous		0.30	0.40	0.50	0.60
5-year Treasury	0.96	1.00	1.00	1.13	1.30
Previous		1.00	1.30	1.50	1.80
10-year Treasury	2.00	2.00	2.10	2.30	2.50
Previous		2.30	2.50	2.75	3.00
30-Year Treasury	3.09	3.30	3.40	3.60	3.80
Previous		3.80	3.80	4.00	4.30

Source: Bloomberg, UBS WMR, as of 28 September 2011

Municipal bonds hold relative value

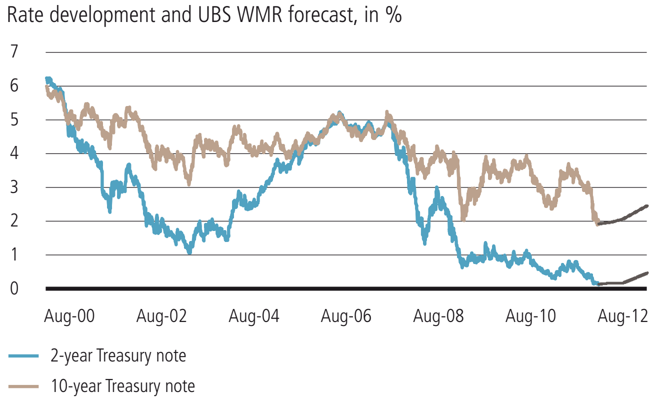
Another sharp rally occurring in the US Treasury bond market helped pull muni yields along to record lows last week. Yet, the outperformance of Treasury securities drove AAA muni-to-Treasury (M/T) ratios to over 110% all along the curve on 22 September 2011 and above the recent highs attained on 9 August 2011. Presently, AAA tax exempt M/T ratios at the 5-year, 10-year and 30-year maturity spots stand at 103.4%, 107.6% and 119.0% respectively. In our view, munis offer value relative to Treasuries at current levels.

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

US Fixed Income: Chartbook

Fig. 1: Treasury yields to rise gradually

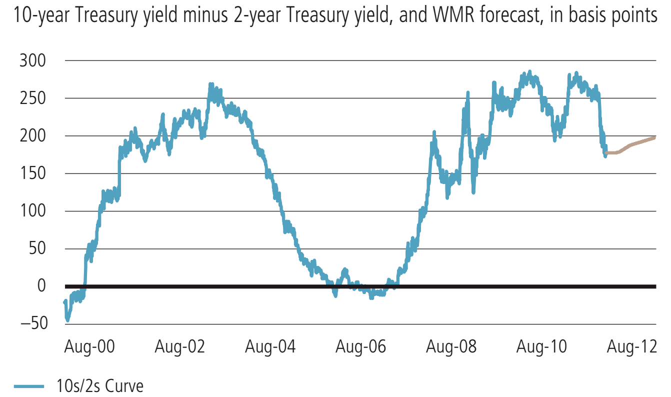
Rate development and UBS WMR forecast, in %



Source: Bloomberg, UBS WMR, as of 22 September 2011

Fig. 2: The yield curve should remain steep

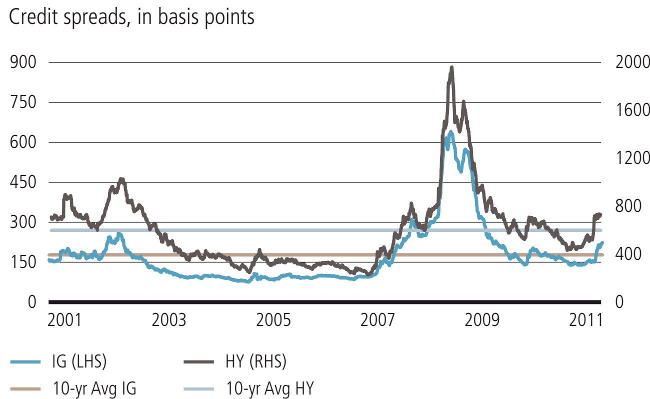
10-year Treasury yield minus 2-year Treasury yield, and WMR forecast, in basis points



Source: Bloomberg, UBS WMR, as of 22 September 2011

Fig. 3: IG and HY now trade above 10-year averages

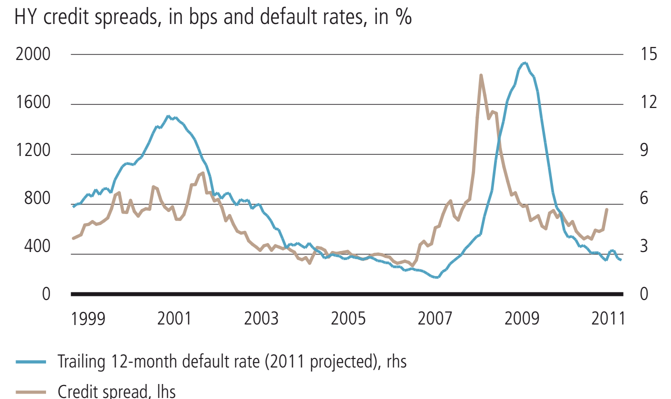
Credit spreads, in basis points



Source: UBS WMR, Barclays Capital, 22 September 2011

Fig. 4: HY spreads have decoupled from projected default rates

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

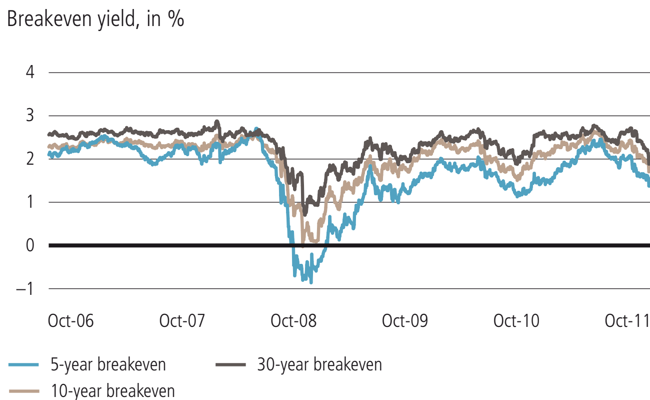


Note: TTM= Trailing 12-month

Source: BAML, Moody's, UBS WMR, as of 22 September 2011

Fig. 5: TIPS breakeven inflation rates recently declined

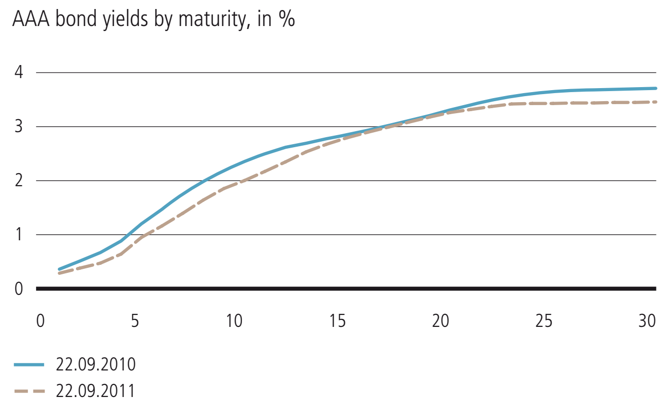
Breakeven yield, in %



Source: Bloomberg, UBS WMR, as of 23 September 2011

Fig 6: AAA municipal bond yield curve change

AAA bond yields by maturity, in %



Source: MMD, UBS WMR as of 22 September 2011

Commodities

Avoid broad commodity exposure

The weakness seen in commodity prices toward the end of 3Q is likely to continue during 4Q. With global growth slowing further, demand for commodities should soften, keeping prices under downward pressure.

While leading indicators already point to a substantial slowdown in economic growth and in some cases a contraction, growth in emerging markets has been holding up well so far. But with export growth from emerging markets potentially stalling in the coming months, so should incremental commodity demand from countries like China. With commodity demand in the developed world likely to contract, diversified commodity indexes can easily slide by 25% from peak levels. This leaves the asset class with another 10% to 15% downside potential from current levels.

Sector-wise, cyclical commodities are the most vulnerable. Ongoing supply challenges have kept Brent crude oil prices up compared to the West Texas Intermediate benchmark (WTI), which at one point dipped below $80/bbl (barrel). Along with crude oil supply from Libya returning by 0.6 mpbd (million barrels per day) over the coming six months, the tight supply and demand balance in Europe should ease considerably and pave the way for Brent prices to drop to $83/bbl (currently $104/bbl) and WTI to around $70/bbl. Natural gas should hold up better with prices already trading close to marginal production costs (MPC). Coal should continue to benefit from strong structural demand from China and India. Further downside is also expected for base metals prices, which we expect to reach or even drop below MPC. This leaves copper with an additional 20% of downside potential. Aluminum, which already trades at MPC, has the least downside potential.

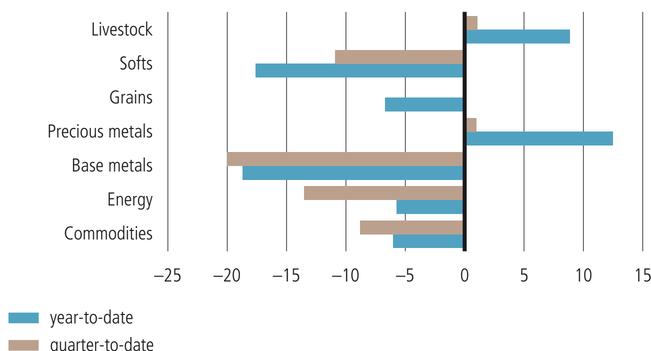
Regarding precious metals, we advise investors to be very selective. We still remain constructive on gold, as we expect currency risks related to the euro and US dollar as well as sovereign debt problems in the developed world to motivate a sufficient investment demand for the yellow metal. Our 12-month target stands at $2200/oz. Palladium and silver, which have greater industrial use, are at risk and should be avoided. Although platinum is also driven by industrial demand, it is likely to do well as it is trading below parity to gold, which is unlikely to last.

The fundamentals supporting higher agricultural prices remain in place. US inventories have failed to recover for corn, soybeans and even sugar. With such tight conditions, poor weather conditions in South America can easily push prices up by 15% or more. Short-term downside risk comes from lower emerging market currencies, which weigh on production costs. Lower oil prices could also weigh on the sector.

Dominic Schnider, Strategist

Fig. 1: Performance of commodity sectors

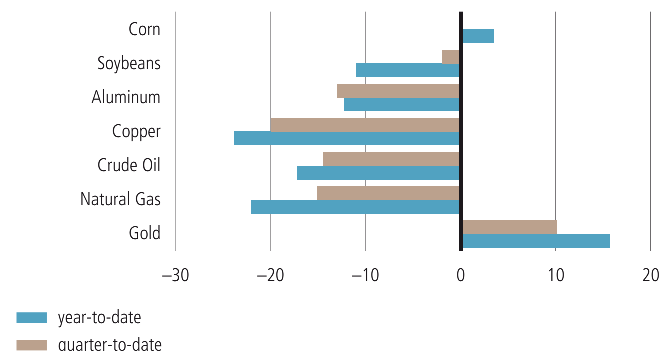
Spot price returns, in USD and %



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

Fig. 2: Performance of individual commodities

Spot price returns, in USD and %



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

Hedge funds: a glass half full

During Q3, return dispersion among strategies was high with global macro and CTAs posting meager positive returns, while equity hedge strategies were down, though outperforming the S&P 500.

Among hedge funds (HF) and fund of funds, risk posture has turned defensive, with a mindset around capital preservation. We see no evidence of HFs re-gearing or becoming more opportunistic. The acute change in sentiment, driven by deteriorating economic conditions, has proven challenging for most HF strategies. Broadly speaking, most of the HF strategies generated losses for the quarter, but outperformed traditional equity investments (see Fig. 10, pg. 22).

Global Macro managers are set to benefit from the current environment. With their focus on global economic imbalances, they are well positioned to react quickly to fiscal / monetary policies that central banks and governments may take to combat the current crisis. Common themes reflected in their often defensive positioning include: 1) increased risk of European sovereign default; 2) vulnerable global growth; 3) increased demand for precious metals; and 4) prolonged softness in equities.

Managed Futures/CTAs: The statistical or momentum-based approaches employed by many commodity trading advisors (CTAs) are designed to benefit from increasing volatility, as long prices follow a trend. In the medium term, we think CTAs can be well positioned to capitalize on persistent global imbalances, given their exposure to multiple asset classes and geographies. In the short term, results may prove less predictable given the propensity for price trends, such as those in metals, to reverse abruptly. We therefore favor a multi-manager approach that may offer varying strategies with differentiated holding periods, or elements that are not fully dependent on pure price momentum.

Equity Hedge was one of the worst-performing strategies during the quarter and we believe it will continue to face challenges as long as markets are influenced by technical factors driven by macro concerns. While such managers are usually able to find companies with strong earnings and balance sheets trading cheaply, they are finding it difficult to trade equities in the current high volatility, with index hedges not proving to be effective. Finding alpha-generating shorts is challenging, as many stocks trade at low multiples. As a result, managers are reducing net exposures to preserve capital. We believe that Equity Market Neutral strategies, in which net exposure is managed close to 0%, are better positioned to outperform directional equity strategies.

Event Driven (ED) strategies have been negatively impacted by distressed funds, particularly post re-org and European-distressed. ED managers are generally fundamentally oriented with long-term investment horizons and are usually not active traders. While the current environment could foster corporate M&A activity, we do not believe it is conducive for ED managers. The strategy could gain appeal when macro concerns abate.

Within **credit strategies,** we expect capital structure arbitrage to outperform catalyst-driven or long-biased credit. Managers are finding credit at the top of the capital structure to be attractive but are defensively positioned due to technical factors. We believe that long-biased credit strategies, including those focused on Europe, will be attractive once markets normalize.

We see a challenging period ahead for **Relative Value** (RV). These strategies tend to rely on leverage to generate returns, which is currently difficult. Within fixed income RV, US curve flatteners and outright long positions in US Treasuries have helped but the longevity of these trades is questionable. Convertible arbitrage suffered after solid performance the last two years. New issuance slowed down and the strategy is less attractive at the moment. Asset-backed securities performed well on a relative basis and we expect managers to opportunistically increase exposures to this strategy.

Ravi Cheruvu, UBS Alternative Investments

The author of this article is an employee of the UBS Alternative Investments team within UBS Wealth Management Solutions and is not a part of Wealth Management Research (WMR). WMR may have views that differ or are contrary to the views expressed herein.

Alternative Investments

Private equity: opportunities in a low-growth environment

As growth slows in developed economies and financial risks rise, selected portions of the private equity market offer opportunities to benefit from such a macro backdrop.

Within **Opportunistic Special Situations Private Equity (PE)**, we see a developing trend with managers becoming more active in identifying dislocations and inefficiencies in securities finance markets – a hybrid approach that straddles trading and investing. Traditionally, managers have largely focused on making equity investments in buyouts. Some of the better opportunities have arisen due to the prolonged period of dislocation in the business sector and in securities markets. Illiquidity has been exacerbated and there exists a general lack of alternative solutions for borrowers with complex financing needs. Also, capital constraints have been forcing lending institutions, funds and companies to execute distressed sales. Active investors in this space have been targeting transactions in a risk position senior to traditional equity and subordinate to investment grade corporate debt or traditional first mortgages (within real estate). We expect opportunistic PE funds to benefit from general market consolidation, remaining very active in situations involving continued balance sheet deleveraging, portfolio and asset repositioning as well as asset recapitalization.

We expect **distressed investing** to be another area of growth. Within the US, there has been a growing accumulation of distressed assets over the past year. However, improving valuations have increased the velocity of transactions and the pace at which managers have been putting money to work. In Europe too, we expect that forced bank divestitures will bring new transactions to the marketplace as new bank and insurance firm regulations impact lending and direct holdings. With the banking and sovereign crises in Europe, risks remain at elevated levels. Distressed debt prices have been substantially marked down in thinly traded markets and tremendous uncertainty still remains. We expect that this will create the largest debt funding gap globally and indeed many dedicated funds are in the process of being raised to address this opportunity.

Emerging Markets Private Equity should benefit from the deteriorating growth outlook and rising fiscal and financial risks in developed economies, in our view, and therefore continue to garner private equity investor attention. While emerging markets are unlikely to decouple from developed markets, our longer-term secular outlook for the former remains robust. This view seems to resonate with institutional PE investors. Indeed, according to the Emerging Markets Private Equity Association, in the first half of 2011, PE firms raised $22.6bn across 89 funds dedicated to emerging markets, just short of the $23.5bn raised in all of 2010. In 2011, fundraising appears to be on its way to reaching $40bn. The prospects for investing in these markets remains high as rapid standard of living improvements and economic growth are expected to continue over the next decade. In India, rapidly evolving lower-end sectors, businesses filling gaps in the supply chain and higher-end consumption sectors are especially attractive. Asset-light companies and the consumer sector are particularly attractive in China judging by flows from PE funds. Despite the run-up in public markets valuation, value investing is still very possible in emerging market PE as purchase multiples – typically 7 to 10 times earnings – remain much lower than public stock valuations. We believe that going forward, a combination of purchase price multiple expansions and rapid earnings growth has the potential to create avenues for meaningful returns in emerging markets private equity over the long term.

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			
All figures in %	Cash Equities Bonds NTAs				Cash Equities Bonds NTAs				Cash Equities Bonds NTAs				Cash Equities Bonds NTAs				Cash Equities Bonds NTAs				Cash Equities Bonds NTAs				Cash Equities 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]	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	-2.0		17.0	32.0	-3.0		29.0	44.0	-4.0		40.0	54.0	-5.0		49.0	62.0	-6.0		56.0	71.0	-6.0		65.0
US Equity	0.0	+0.0		0.0	14.0	+0.0		14.0	23.0	+0.0		23.0	32.0	+0.0		32.0	39.0	+0.5		39.5	44.0	+0.5		44.5	52.0	+1.0		53.0
Large Cap Value	0.0	+0.0		0.0	8.0	-0.5	▲	7.5	8.0	-0.5	▲	7.5	11.0	-1.0	▲	10.0	11.0	-1.0	▲	10.0	11.0	-1.5	▲	9.5	13.0	-1.5	▲	11.5
Large Cap Growth	0.0	+0.0		0.0	5.0	+1.0		6.0	8.0	+2.0	▲	10.0	11.0	+3.0	▲	14.0	11.0	+4.0	▲	15.0	11.0	+4.5	▲	15.5	13.0	+6.0	▲	19.0
Mid Cap	0.0	+0.0		0.0	1.0	-0.5	▼	0.5	4.0	-0.5	▼	3.5	5.0	-0.5	▼	4.5	9.0	-0.5	▼	8.5	11.0	-0.5	▼	10.5	13.0	-1.0	▼	12.0
Small Cap	0.0	+0.0		0.0	0.0	+0.0		0.0	2.0	-1.0	▼	1.0	3.0	-1.5	▼	1.5	5.0	-2.0	▼	3.0	7.0	-2.0	▼	5.0	8.0	-2.5	▼	5.5
REITs	0.0	+0.0		0.0	0.0	+0.0		0.0	1.0	+0.0		1.0	2.0	+0.0		2.0	3.0	+0.0		3.0	4.0	+0.0		4.0	5.0	+0.0		5.0
Non-US Equity	0.0	+0.0		0.0	5.0	-2.0		3.0	9.0	-3.0		6.0	12.0	-4.0		8.0	15.0	-5.5		9.5	18.0	-6.5		11.5	19.0	-7.0		12.0
Developed	0.0	+0.0		0.0	5.0	-2.0		3.0	8.0	-3.0		5.0	10.0	-4.0		6.0	12.0	-5.0		7.0	14.0	-6.0		8.0	14.0	-6.0		8.0
Emerging Markets	0.0	+0.0		0.0	0.0	+0.0		0.0	1.0	+0.0		1.0	2.0	+0.0		2.0	3.0	-0.5		2.5	4.0	-0.5		3.5	5.0	-1.0		4.0
Fixed Income	81.0	+0.0		81.0	67.0	+0.0		67.0	51.0	+0.0		51.0	37.0	+0.0		37.0	24.0	+0.0		24.0	11.0	+0.0		11.0	0.0	+0.0		0.0
US Fixed Income	74.0	+0.0		74.0	59.0	+0.0		59.0	43.0	+0.0		43.0	29.0	+0.0		29.0	18.0	+0.0		18.0	9.0	+0.0		9.0	0.0	+0.0		0.0
Non-US Fixed Income	7.0	+0.0		7.0	8.0	+0.0		8.0	8.0	+0.0		8.0	8.0	+0.0		8.0	6.0	+0.0		6.0	2.0	+0.0		2.0	0.0	+0.0		0.0
Cash (USD)	10.0	+1.0	▲	11.0	2.0	+3.0	▲	5.0	2.0	+5.0	▲	7.0	2.0	+6.0	▲	8.0	2.0	+7.0	▲	9.0	2.0	+9.0	▲	11.0	2.0	+9.0	▲	11.0
Non-traditional Assets	9.0	-1.0	▼	8.0	12.0	-1.0	▼	11.0	15.0	-2.0	▼	13.0	17.0	-2.0	▼	15.0	20.0	-2.0	▼	18.0	25.0	-3.0	▼	22.0	27.0	-3.0	▼	24.0
Commodities	2.0	-1.0	▼	1.0	3.0	-1.0	▼	2.0	4.0	-2.0	▼	2.0	5.0	-2.0	▼	3.0	5.0	-2.0	▼	3.0	6.0	-3.0	▼	3.0	7.0	-3.0	▼	4.0
Alternative Investments[5]	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 28 September 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			
All figures in %	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	-2.0		20.0	37.0	-3.0		34.0	52.0	-4.0		48.0	67.0	-5.0		62.0	83.0	-6.0		77.0	98.0	-6.0		92.0
US Equity	0.0	+0.0		0.0	16.0	+0.0		16.0	26.0	+0.0		26.0	37.0	+0.0		37.0	48.0	+0.5		48.5	59.0	+0.5		59.5	72.0	+1.0		73.0
Large Cap Value	0.0	+0.0		0.0	9.0	-0.5	▲	8.5	9.0	-0.5	▲	8.5	13.0	-1.0	▲	12.0	14.0	-1.0	▲	13.0	15.0	-1.5	▲	13.5	18.0	-1.5	▲	16.5
Large Cap Growth	0.0	+0.0		0.0	6.0	+1.0		7.0	9.0	+2.0	▲	11.0	13.0	+3.0	▲	16.0	14.0	+4.0	▲	18.0	15.0	+4.5	▲	19.5	18.0	+6.0	▲	24.0
Mid Cap	0.0	+0.0		0.0	1.0	-0.5	▼	0.5	4.0	-0.5	▼	3.5	6.0	-0.5	▼	5.5	11.0	-0.5	▼	10.5	15.0	-0.5	▼	14.5	18.0	-1.0	▼	17.0
Small Cap	0.0	+0.0		0.0	0.0	+0.0		0.0	3.0	-1.0	▼	2.0	3.0	-1.5	▼	1.5	6.0	-2.0	▼	4.0	9.0	-2.0	▼	7.0	11.0	-2.5	▼	8.5
REITs	0.0	+0.0		0.0	0.0	+0.0		0.0	1.0	+0.0		1.0	2.0	+0.0		2.0	3.0	+0.0		3.0	5.0	+0.0		5.0	7.0	+0.0		7.0
Non–US Equity	0.0	+0.0		0.0	6.0	-2.0		4.0	11.0	-3.0		8.0	15.0	-4.0		11.0	19.0	-5.5		13.5	24.0	-6.5		17.5	26.0	-7.0		19.0
Developed	0.0	+0.0		0.0	6.0	-2.0		4.0	9.0	-3.0		6.0	13.0	-4.0		9.0	15.0	-5.0		10.0	18.0	-6.0		12.0	20.0	-6.0		14.0
Emerging Markets	0.0	+0.0		0.0	0.0	+0.0		0.0	2.0	+0.0		2.0	2.0	+0.0		2.0	4.0	-0.5		3.5	6.0	-0.5		5.5	6.0	-1.0		5.0
Fixed Income	90.0	+0.0		90.0	76.0	+0.0		76.0	61.0	+0.0		61.0	46.0	+0.0		46.0	31.0	+0.0		31.0	15.0	+0.0		15.0	.0	+0.0		0.0
US Fixed Income	82.0	+0.0		82.0	67.0	+0.0		67.0	51.0	+0.0		51.0	36.0	+0.0		36.0	23.0	+0.0		23.0	12.0	+0.0		12.0	.0	+0.0		0.0
Non–US Fixed Income	8.0	+0.0		8.0	9.0	+0.0		9.0	10.0	+0.0		10.0	10.0	+0.0		10.0	8.0	+0.0		8.0	3.0	+0.0		3.0	.0	+0.0		0.0
Cash (USD)	10.0	+0.0		10.0	2.0	+2.0		4.0	2.0	+3.0		5.0	2.0	+4.0		6.0	2.0	+5.0		7.0	2.0	+6.0		8.0	2.0	+6.0		8.0

"WMR tactical deviation" legend: Overweight Underweight Neutral

"Change" legend: ▲ Upgrade ▼ Downgrade

Source: UBS WMR and Investment Solutions, as of 28 September 2011

For end notes, please see appendix.

Confirm no changes

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	-1.0	11.0
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	+2.0	+2.0	24.0
High Yield Corporates	10.0	+0.0	+0.0	10.0
Preferred Securities	4.0	+0.0	+0.0	4.0
Emerging Market sovereign bonds in US dollar	5.0	+0.0	+0.0	5.0
TFI non-Credit	**59.0**	**-2.0**	**-2.0**	**57.0**
TFI Credit	**41.0**	**+2.0**	**+2.0**	**43.0**

Non–US Developed Equity Module, in %

	Benchmark allocation[1]	WMR Tactical deviation[2]		Current allocation[3]
		Previous	Current	
Eurozone	27.0	-25.0	-25.0	2.0
UK	19.0	+15.0	+15.0	34.0
Japan	19.0	+5.0	+5.0	24.0
Other	35.0	+5.0	+5.0	40.0

Non–US Fixed Income Module, in %

	Benchmark allocation[1]	WMR Tactical deviation[2]		Current allocation[3]
		Previous	Current	
Eurozone	42.0	-10.0	-10.00	32.0
UK	9.0	+10.0	+10.00	19.0
Japan	33.0	-10.0	-10.00	23.0
Other	16.0	+10.0	+10.00	26.0

Source: UBS WMR and Investment Solutions, as of 28 September 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] Numeric Previous	Numeric Current	Symbol Previous	Symbol Current	Current allocation[3]
Consumer Discretionary	**10.8**	**-2.0**	**+0.0**	**– –**	**n**	**10.8**
Auto & Components	0.6	+1.0	-1.0	+	–	-0.4
Consumer Services	2.1	+0.0	+1.0	n	+	3.1
Media	3.1	-1.0	-1.0	–	–	2.1
Retailing	3.9	-1.0	+1.0	–	+	4.9
Consumer, Durables & Apparel	1.1	-1.0	+0.0	–	n	1.1
Consumer Staples	**11.5**	**+2.0**	**+3.0**	**++**	**+++**	**14.5**
Food, Beverage & Tobacco	6.5	+0.5	+1.0	+	+	7.5
Food & Staples Retailing	2.4	+0.5	+0.5	+	+	2.9
Household & Personal Products	2.6	+1.0	+1.5	+	++	4.1
Energy	**11.7**	**+0.0**	**-1.0**	**n**	**–**	**10.7**
Financials	**13.7**	**+0.0**	**-2.0**	**n**	**– –**	**11.7**
Banks	2.6	+0.0	+0.0	n	n	2.6
Diversified Financials	5.7	+0.0	-1.0	n	–	4.7
Insurance	3.5	+0.0	-1.0	n	–	2.5
Real Estate	1.8	+0.0	+0.0	n	n	1.8
Healthcare	**11.9**	**+0.0**	**+1.0**	**n**	**+**	**12.9**
HC Equipment & Services	4.2	+0.0	+1.0	n	+	5.2
Pharmaceuticals & Biotechnology	7.8	+0.0	+0.0	n	n	7.8
Industrials	**10.3**	**+0.0**	**-2.0**	**n**	**– –**	**8.3**
Capital Goods	7.8	+0.0	-1.0	n	–	6.8
Commercial Services & Supplies	0.6	+0.0	+0.0	n	n	0.6
Transportation	1.9	+0.0	-1.0	n	–	0.9
Information Technology	**19.6**	**+3.0**	**+2.0**	**+++**	**++**	**21.6**
Software & Services	9.7	+0.0	+1.0	n	+	10.7
Technology Hardware & Equipment	7.4	+2.0	+1.0	++	+	8.4
Semiconductors	2.4	+1.0	+0.0	+	n	2.4
Materials	**3.5**	**-2.0**	**-3.0**	**– –**	**– – –**	**0.5**
Telecom	**3.2**	**-1.0**	**+1.0**	**–**	**+**	**4.2**
Utilities	**3.9**	**+0.0**	**+1.0**	**n**	**+**	**4.9**

Source: S&P, UBS WMR, as of 28 September 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	**7.0**	**9.0**	**11.0**	**12.0**	**15.0**	**19.0**	**20.0**

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%	+1.1	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%	-2.1	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	0.62%	0.47%	-0.16%	-0.9	-0.03%	2.29%
2011 Q3 until 27 September 2011	-5.91%	-6.92%	-1.02%	-2.9	-11.74%	3.42%
Since inception	8.84%	8.94%	0.10%	+0.0	0.01%	23.89%

Source: UBS WMR, as of 27 September 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%	-1.4
2011 Q1	5.92%	5.97%	0.05%	+0.4
2011 Q2	0.11%	-0.22%	-0.33%	-2.8
2011 Q3 until 27 September 2011	-10.56%	-10.84%	-0.28%	-1.5
Since inception	-16.71%	-17.75%	-1.04%	-0.5

Source: UBS WMR, as of 27 September 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%	+2.4	0.42%
2011 Q2	2.13%	2.09%	-0.04%	-1.3	2.29%
2011 Q3 until 27 September 2011	1.63%	1.31%	-0.33%	-3.5	3.42%
Since inception	30.85%	30.73%	-0.12%	-0.1	35.03%

Source: UBS WMR, as of 27 September 2011

Note that in Tables A, C, and D, the information ratio calculations have been altered relative to prior publications. The annualization of daily data is now conducted based on trading days rather than weekdays. The new figures may differ slightly from the previous ones.

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

Verify no changes

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

Verify no changes

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

Figure 5 in Focus and 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.

Verify no changes

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

Verify no changes

Disclaimer

Wealth Management Research is published by Wealth Management & Swiss Bank and Wealth Management Americas, Business Divisions of UBS AG (UBS) or an affiliate thereof. In certain countries UBS AG is referred to as UBS SA. This publication is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness (other than disclosures relating to UBS and its affiliates). All information and opinions as well as any prices indicated are currently only as of the date of this report, and are subject to change without notice. Opinions expressed herein may differ or be contrary to those expressed by other business areas or divisions of UBS as a result of using different assumptions and/or criteria. At any time UBS AG and other companies in the UBS group (or employees thereof) may have a long or short position, or deal as principal or agent, in relevant securities or provide advisory or other services to the issuer of relevant securities or to a company connected with an issuer. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, divisions or affiliates of UBS. Futures and options trading is considered risky. Past performance of an investment is no guarantee for its future performance. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. Changes in FX rates may have an adverse effect on the price, value or income of an investment. We are of necessity unable to take into account the particular investment objectives, financial situation and needs of our individual clients and we would recommend that you take financial and/or tax advice as to the implications (including tax) of investing in any of the products mentioned herein. This document may not be reproduced or copies circulated without prior authority of UBS or a subsidiary of UBS. UBS expressly prohibits the distribution and transfer of this document to third parties for any reason. UBS will not be liable for any claims or lawsuits from any third parties arising from the use or distribution of this document. This report is for distribution only under such circumstances as may be permitted by applicable law.

Distributed to US persons by UBS Financial Services Inc., a subsidiary of UBS AG. UBS Securities LLC is a subsidiary of UBS AG and an affiliate of UBS Financial Services Inc. UBS Financial Services Inc. accepts responsibility for the content of a report prepared by a non-US affiliate when it distributes reports to US persons. All transactions by a US person in the securities mentioned in this report should be effected through a US-registered broker dealer affiliated with UBS, and not through a non-US affiliate. The contents of this report have not been and will not be approved by any securities or investment authority in the United States or elsewhere.
Version as per June 2011.

© 2011. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved.

©2011 UBS Financial Services Inc. All rights reserved. Member SIPC. All other trademarks, registered trademarks, service marks and registered service marks are of their respective companies.

UBS Financial Services Inc.
www.ubs.com/financialservicesinc

UBS Financial Services Inc. is a subsidiary of UBS AG.
Order # R395