UBS

# Fixed Income Strategist USD

## Reduce credit exposure

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- We move to an underweight on investment grade and high-yield corporate bonds, as credit spreads should be pressured wider as corporate profit growth slows.
- With spreads on mortgage-backed securities (MBS) narrow and volatility low, we shift to a market weight from an overweight. Given the sharp deterioration on sub-prime loans, our concern is that volatility could gap wider, hurting performance.
- As an offset to the reduced exposure in the corporate bond and MBS markets, we increase the allocation on the Treasury market to overweight from underweight and increase the allocation on agencies to neutral from underweight.

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### Treasury market rallies on flight-to-quality buying

The Treasury market staged a powerful flight-to-quality rally on 27 February. The meltdown in the sub-prime mortgage market, comments from former Fed Chairman Greenspan that the US economy may slip into recession later this year, and the 9% drop in Chinese equities set the stage for a sell-off in US equities that sent Treasuries soaring. Market expectations for Fed easing jumped, with the fed funds futures strip pricing in a 66% probability of an easing in June, up from 20% on February 26 and 8% in mid-February. The August fed funds contract is now fully priced for an ease.

### Cracks in the foundation: sub-prime delinquencies rise

Rising delinquencies on mortgage loans made to sub-prime borrowers have led to wider spreads on sub-prime mortgage-backed securities. The BBB- portion of the ABX index, a gauge of risk perceptions on sub-prime MBS, has widened to record levels. We believe the problems plaguing the sub-prime MBS market will remain confined to this niche market sector and not spillover into the MBS market or trigger a market wide contagion. In the near term, however, the turmoil in the sub-prime market may cause investors to reassess risk premiums, particularly those in the MBS market. With option adjusted spreads on MBS narrow and volatility low, we have decided to pare back our allocation on agency MBS to market weight from overweight. In the long run, we do not anticipate a major re-pricing of risk premiums due to the fall out from the sub-prime market. While lax lending standards have caused sub-prime delinquency rates to spike a sharp 86 bps to 12.56%, mortgage loans to creditworthy borrowers are performing significantly better, with delinquencies up just 15 bps to 2.44%.

**US Fixed Income Recommendations**

| Sector | Strategy | Preferred Maturity |
|---|---|---|
| High-Yield | Underweight | n/a |
| Investment Grade | Underweight | 2-7 year |
| Agency | Neutral | 1-2 year |
| TIPS | Neutral | 20-year |
| Treasury | Overweight | 1-2 year |
| | Strategy | Coupon |
| Mortgages | Neutral | 5% and under |
| Preferreds | Neutral | Fixed rate; 6.3% to 6.625% |
| | Credit Quality | Preferred Maturity |
| Municipals | High grade | 8 -15 year |

Source: UBS WMR, as of 28 February 2007

**This report has been prepared by UBS Financial Services Inc. ("UBSFS") and UBS AG**

**ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 13**

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## Duration Strategy and Interest Rates

**We are changing our duration allocation on the Treasury market to neutral from a moderate underweight and adjusting our interest rate forecast. With the 10-year Treasury note trading at our six-month target forecast of 4.5%, we have scaled back our year-end forecast to 4.8% from 4.9%. Our forecast for the 10-year Treasury yield in 12 months remains at 4.9%.**

### Bonds rally on Fed testimony and softer data

Fed chairman Bernanke's testimony to congress on February 14 turned out to be much less hawkish than bond investors had feared, setting the stage for Treasury yields to fall. Although still worried about inflation, Bernanke's remarks suggest he expects slower growth in the months ahead to dampen inflation pressures. In addition, softer economic data in February followed a string of stronger than expected releases in December and January that were largely due to milder weather. And, jitters over Iran's nuclear program and rising delinquencies on sub-prime mortgage loans have also helped to support Treasury prices.

### Lower 10-year Treasury forecast for year-end 2007

We are making just one minor adjustment to our interest rate forecast this month—trimming our 2007 year-end forecast to 4.8% from 4.9%. Having recently pushed back the timing of the first Fed rate cut to late June, we now expect to see a bit less upward pressure on Treasury yields by year-end. Multiple rate cuts by the Fed in the second half of the year should cause the term premium—and thus long maturity Treasury yields—to rise. Our forecast for the 10-year yield in 12 months remains at 4.9%.

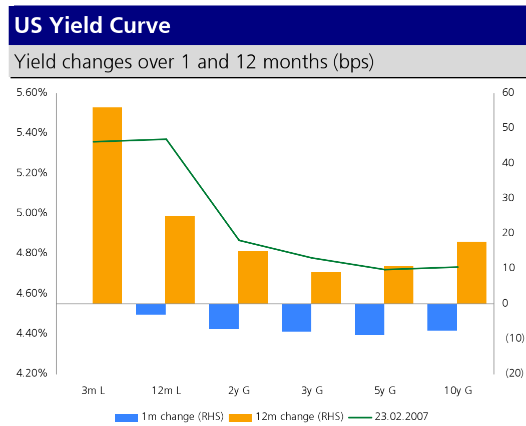
### Moving to a neutral duration

We are increasing our duration exposure to neutral from a slight underweight. Given the relatively narrow trading range we anticipate this year, there is not a compelling reason to either under or overweight duration, in our opinion.

**Anne Briglia, CFA**

**US Yield Curve**

Yield changes over 1 and 12 months (bps)




Source: UBS WMR, as of 28 February 2007

**Interest Rate Forecasts (%)**

| | 27 Feb/ | in 6 mos | in 12 mos |
|---|---|---|---|
| 3-month LIBOR | 5.36 | 5.00 | 4.40 |
| 10-year Treasury | 4.50 | 4.50 | 4.90 |

Source: UBS WMR, as of 27 February 2007

# Fixed Income Strategy: Reduce exposure to credit sensitive bonds

**We move to a moderate underweight on investment grade and high-yield corporate bonds, as credit spreads should be pressured wider as corporate profit growth slows. Because spreads on mortgage-backed securities are narrow and volatility is low, we shift to a market weight from an overweight on MBS. Given the sharp deterioration on sub-prime loans, our concern is that volatility could gap wider, hurting performance. Conversely, we move to an overweight on the Treasury sector and a neutral allocation on the agency sector from underweight as an offset.**

**Cash and Equivalents (neutral):** With short-term interest rates expected to move lower as the market begins to discount Fed easing in the second half of the year, we recommend a neutral allocation on cash and cash equivalents.

**Treasuries (overweight):** We move to an overweight from a moderate underweight on Treasury securities this month as an offset to our reduced exposure to the credit markets.

**Agencies (neutral):** We move to a neutral allocation in the agency market this month from an underweight. Agency spreads should continue to be supported by the supply/demand mix at the same time that the credit markets look vulnerable to spread widening pressure.

**Mortgages (neutral):** We recommend that investors move to a neutral allocation in the mortgage sector from a moderate overweight. We are paring back exposure because of concerns about a potential spike in volatility, which is currently at very low levels.

**Preferred Securities (neutral):** Although we expect a modest rise in long-term interest rates and some pressure on credit spreads, our forecast this year calls for preferreds to generate positive total returns, driven mainly by their coupon income.

**TIPS/Treasury Inflation-Protected Securities (neutral):** We recommend holding a neutral allocation in the TIPS sector as breakeven inflation spreads continue to offer cheap "inflation risk protection". We expect that TIPS breakeven inflation spreads, especially in the long-end, will increase this year to reflect higher inflation risk premium.

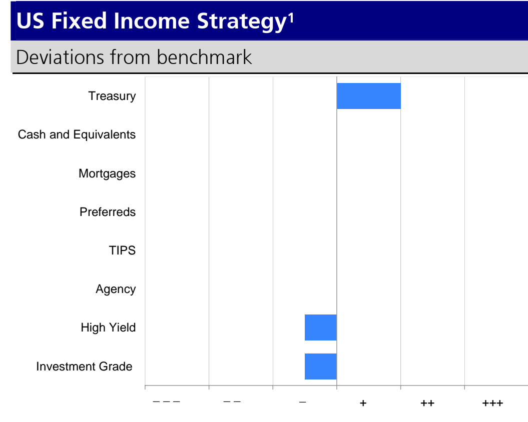
**High-Yield (HY) Corporate Bonds (moderate underweight):** High-yield bonds have become increasingly expensive relative to the Treasury market. In our view, the market will not be able to keep ignoring these fundamentals forever. As a result, we move to an underweight allocation from a neutral exposure.

**Investment-Grade (IG) Corporate Bonds (moderate underweight):** The macro backdrop is becoming more crucial as there is increasing evidence of deteriorating credit fundamentals, corporate performance, and liquidity. Therefore, we reduce our weighting in the corporate sector to a moderate underweight.

**Anne Briglia, CFA**

**US Fixed Income Strategy[1]**

Deviations from benchmark




Source: UBS WMR, as of 28 February 2007

**US Fixed Income Sectors**

| | | Market Returns in % | |
|---|---|---|---|
| | Strategy[1] | 2006 | YTD[2] |
| Cash & equivalents | n | 3.5 | 0.65 |
| Agencies | n | 3.1 | 0.81 |
| IG Corporate | - | 0.4 | 1.48 |
| HY Corporate | - | 4.2 | 2.64 |
| Mortgage | n | 4.6 | 0.96 |
| Preferred | n | 11.8 | 0.96 |
| TIPS | n | 8.3 | 1.12 |
| Treasuries | ++ | 5.2 | 0.75 |

Source: UBS WMR, Yield Book, Ryan Labs.

[1] n = neutral; +++ strong overweight; ++ overweight; + moderate overweight, --- strong underweight; -- underweight; - moderate underweight. [2] YTD = year-to-date as of 23 February 2007.

**US Fixed Income Asset Allocation**

| | Benchmark allocation | Active deviation | Recommended alloc. |
|---|---|---|---|
| Cash & equivalents | 5% | 0% | 5% |
| Agencies | 20% | 0% | 20% |
| IG Corporate | 20% | -1% | 19% |
| HY Corporate | 10% | -1% | 9% |
| Mortgage | 20% | 0% | 20% |
| Preferred | 10% | 0% | 10% |
| TIPS | 5% | 0% | 5% |
| Treasuries | 10% | 2% | 12% |

Source: UBS WMR, Bloomberg, as of 28 February 2007. This table presents the recommended asset allocation for the US Fixed Income portion of a portfolio. It is developed by UBS Wealth Management Research for a hypothetical, average US investor with a moderate risk tolerance, intermediate investment horizon, and total return objective. The weights 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 to your individual investment goals.

# Sector Focus

## USD Agencies (neutral)

**We move to a neutral allocation in the agency market this month from an underweight, a reassessment driven by the divergence in our outlook for spreads on GSE debt versus corporate bonds. While corporate spreads look increasingly vulnerable to slowing economic growth, agency spreads are more likely to stay firm.**

### The outlook for spreads shifts

Although credit spreads are narrow in both the agency and the corporate market, we believe that agency spreads are likely to stay firm while corporate spreads may be poised to widen. As a result of this divergence in the outlook for spreads, we move to a neutral allocation in the agency market to offset a moderate underweight in the corporate market. (For a discussion on corporate bonds, see page 5).

The biggest factor underpinning narrow agency spreads should continue to be the supply/demand mix. Net new issuance, which has been significantly below the levels experienced in the early part of the decade, should once again be restrained this year because of regulatory restrictions on GSE portfolio growth. On the other hand, demand remains robust, particularly from overseas investors. The TIC data showed purchases by overseas investors, which were very weak in both October and November, rebounded in December to $28 bln, above the $24 bln average of the last 12 months. The impact of deteriorating conditions on the sub-prime mortgage market has been somewhat contained so it seems likely that any re-pricing of risk premiums in the agency market will be rather limited.

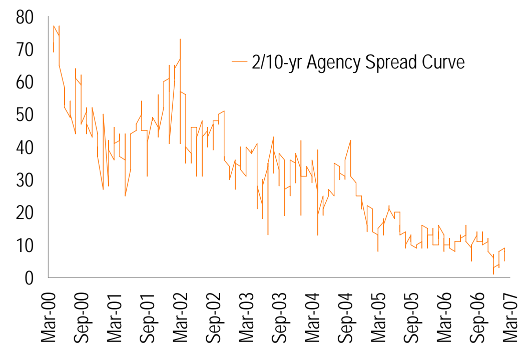
### Stick with short maturities

We continue to recommend bullet agency securities with maturities in the 1- to 2-year area. The agency credit curve is very flat, with just a 9 bps increase in incremental spread for an extension between the 2- and 10-year maturity range. (See top Chart.) The inversion of the Treasury yield curve, coupled with very narrow spreads along the term structure, mean that the highest absolute yields in the agency market are in the front end of the curve. (See middle Table.)

**Anne Briglia, CFA**

**Bullet Agency 2s/10s Credit Curve (bps)**

The yield pick-up for extending from the 2- to the 10-year portion of the yield curve is very tight




Source: UBS WMR, as of 23 February 2007

**Agency Yield Curve**

| Maturity | Yield (%) | Spread (bps) |
|---|---|---|
| 1-Year | 5.17 | L-16 |
| 2-Year | 4.93 | 35 |
| 3-Year | 4.75 | 25 |
| 5-Year | 4.76 | 30 |
| 10-Year | 4.87 | 37 |
| 30-Year | 5.04 | 41 |

Source: UBS WMR, as of 27 February 2007

**Recommendation**

| Agency Market | |
|---|---|
| Yield Curve Positioning | Bullet |
| Preferred Maturity | 1-2 years |

Source: UBS WMR, as of 27 February 2007

## USD Corporates (moderate underweight)

**Year-to-date, credit spreads have remained solid and markets have managed to shrug off negative news. However, we believe the fundamental picture is becoming more crucial as there is increasing evidence of deteriorating credit fundamentals in terms of the macro environment, corporate performance, and liquidity. In addition, high-yield bonds have become increasingly expensive relative to the Treasury market. In our view, the market will not be able to keep ignoring these fundamentals forever. Therefore, we reduce our weighting in the corporate sector to a moderate underweight on investment grade and high-yield corporate bonds.**

### Narrow credit spreads prompt move to moderate underweight

Corporate earnings growth is slowing, however companies continue to post results ahead of market expectations, pushing equity to record high levels. Spreads are reflecting a "Goldilocks" economic environment, supported by recent economic data. But based on further negative headlines from the housing market, ongoing leveraged buyouts transactions, and a pick-up in new issue supply, we expect that spread developments going forward could slightly deteriorate from currently low historic levels. There is little evidence of a spillover effect from mortgage lenders to other housing related or credit related sectors. Based on the quarterly Federal Loan Officer survey, lending conditions became considerably tighter at the beginning of 2007. It is difficult to predict the turning point to wider spreads but we think risk has grown and the bond markets, especially the high- yield bond market, are getting increasingly expensive relative to the Treasury market.

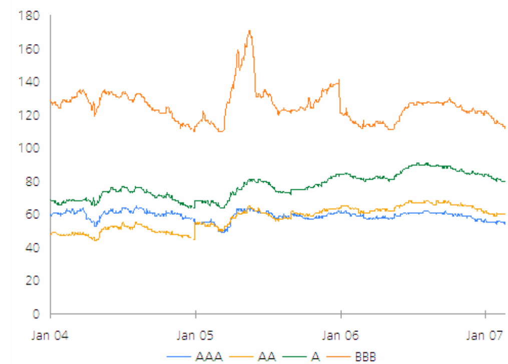
### Credit quality trend

Re-leveraging incentives for corporate companies exists but should not lead to an abrupt deterioration of very healthy balance sheets. According to Moody's, the unfavorable trend of recent high yield-credit rating changes warns of wider spreads. To date for first quarter 2007, the high-yield upgrade ratio is 40%, up from 38% in Q406. Note, however, that they both lag September 2006's ratio of 49%. The longer such an unfavorable distribution of high yield- credit rating revision persists, the more likely it is that a higher default rate and a widening of speculative grade bond yield spreads will occur. We expect that the default rates will increase at a slow pace. Finally, the sentiment survey of investors indicates they plan to shorten their duration as they look to reduce exposure to the long-end.

**Pierre Conrad**

**Credit Spreads (bps)**

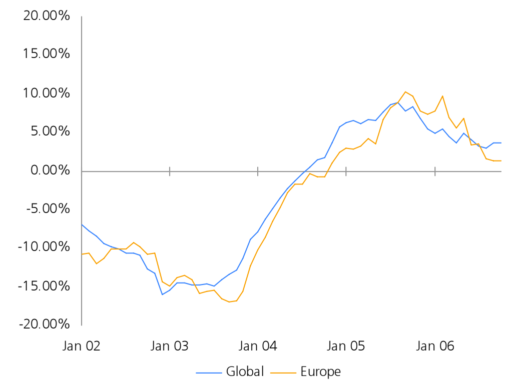
Credit spreads are narrow from an historical perspective




Source: UBS WMR, as of 28 February 2007

**12- Month Rating Drift**

Rating Drift=(Issuer Upgrades - Issuer Downgrades)/Rated Issuers




Source: UBS WMR, as of 28 February 2007

**Recommendation**

| Corporate Sector | |
|---|---|
| Yield Curve Positioning | Bullet |
| Preferred Maturity | 2-7 years |

Source: UBS WMR, as of 28 February 2007

## USD Mortgages (neutral)

**We recommend that investors move to a neutral allocation in the mortgage sector from a moderate overweight. We are paring back exposure because of concerns about a potential spike in volatility, which is currently at very low levels. However, mortgage sector returns should be well supported by range-bound Treasury yields and continued foreign demand.**

### Volatility concerns and the Fed

The mortgage sector continued to perform positively in February with broadly unchanged spreads amid lower refinanceability and volatility. (See top Chart.) However, we expect higher volatility over the next 12-months, which would be damaging for mortgages given their negative convexity. A spike in volatility could be driven by signs that the Fed is beginning to consider a rate cut and the yield curve is re-steepening from its current inversion. We believe that the Fed will start easing in June and that the long-awaited curve steepening will materialize over 2007.

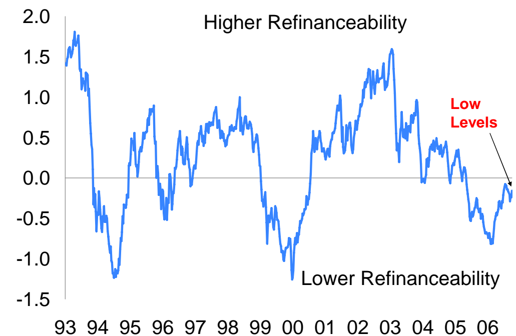
### Will the deterioration in the sub-prime sector trigger contagion?

The bond market's attention in February turned to the deterioration in the sub-prime mortgage market. Wider sub-prime spreads were driven by the overall weakening in the housing market, slowing home price appreciation, and the depletion in the availability of home equity withdrawals. Sub-prime loans, which comprise about 10% of outstanding mortgage debt, usually have credit profiles below the prime agency sector and charge higher interest rates than loans to lower–risk borrowers. Initial signs of weakness began to show in various statistics in 2006. According to the Mortgage Bankers Association, delinquency rates on mortgage-loans deteriorated across the board in the third quarter of last year, notably in the sub-prime sector. While the delinquency rate increased 15 bps for prime loans (from 2.29% to 2.44% percent), it spiked 86 bps on sub-prime loans (from 11.70% to 12.56%). (See middle Chart.) We do not see a broad spillover of sub-prime sector distress to the prime agency sector and thus expect a very limited impact on prime mortgage spreads. Nevertheless, we consider that expectations for somewhat weaker loan performance this year might be an additional reason for investors to adopt a neutral allocation on the mortgage sector at this time.

**Viktoria Beromelidze, CFA**

**Rate Attractiveness Index**

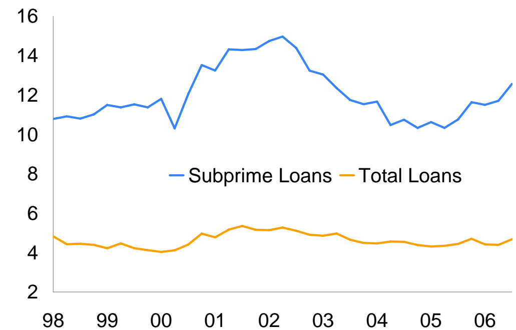
Based on Freddie Mac 30-year survey rate




Source: UBS WMR, Mortgage Bankers Association, as of 22 February 2007. Note: Rate attractiveness defined as the 3-year moving average minus the current rate

**Residential Mortgage Delinquencies as % of All Outstanding Loans**

Delinquencies were most notable in the sub-prime sector




Source: UBS WMR, as of September 2006

**Mortgage Data**

| | 2005 | 2006 | Current |
|---|---|---|---|
| Option-Adjusted Spread (bps) | 52 | 42 | 48 |
| Freddie Mac Survey Rate 30-Year (%) | 6.22 | 6.18 | 6.22 |
| Freddie Mac Survey Rate 15-Year (%) | 5.76 | 5.93 | 6.97 |

Source: UBS WMR, Yield Book, Mortgage Bankers Association, as of 21 February 2007. Note: Commitment rate for week ended 23 February 2007

**Recommendation**

| MBS Market | |
|---|---|
| Good Relative Value | Seasoned 15-year agency pass-throughs |
| Coupon | 5% and lower |

Source: UBS IB, as of 20 February 2007

## Preferred Securities (neutral)

**Fixed-rate preferred securities underperformed other fixed income sectors in February that were more responsive to lower Treasury yields and tighter corporate credit spreads. However, this lagged price reaction caused the spreads of preferreds to moderately rise off the low-end of their recent range. With spreads not quite as extended and an average coupon income of 6.6%, we maintain our neutral weighting to preferred securities.**

### DRD-eligible preferreds and floaters perform well

Overall fixed-rate preferred prices have shown reluctance this year to respond to fluctuations in long-term Treasury yields. However, two types of preferreds that have been responsive to other factors include the floating-rate and fixed-rate tax-advantaged segments. (See top Chart.) Securities eligible for the dividends-received-deduction (DRD) have appreciated from strong demand by institutional investors. Prices of floating-rate preferreds benefited from tighter credit spreads and expectations that the Fed may be on hold longer than anticipated.

### Market outlook

Our forecast this year calls for preferreds to generate positive total returns driven by their coupon income should long-term interest rates and credit spreads end the year higher than current levels. With yields expected to decline in the medium-term, however, we look for the prices of fixed-rate preferreds with above-average effective durations to edge higher. On an individual security basis, we continue to see relative value in the more recently issued trust preferreds of high-quality financial institutions. With greater concern that narrow corporate credit spreads could start to widen, we favor preferred securities of strongly-rated issuers.

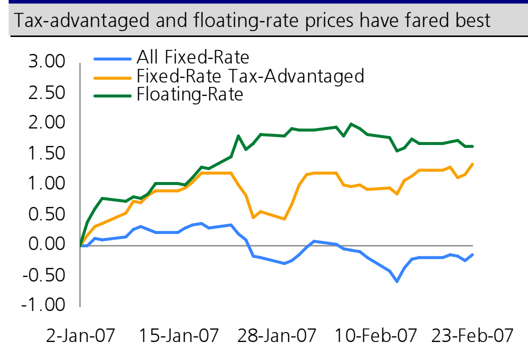
### Floating-rate preferreds appear stretched

While the prices of floating-rate preferreds have low sensitivity to changes in long-term interest rates, prices are influenced by credit spread levels. (See middle Chart.) Should spreads start to gradually widen and the Fed start lowering rates—as WMR expects to begin in June—the recent price gains on floaters would likely be retracted, in our view. In addition, since lower short-term rates would expose investors to reinvestment risk, we continue to maintain our preference for fixed-rate securities.

**Barry McAlinden, CFA**

**Average Price Change Since Jan 2007 (%)**

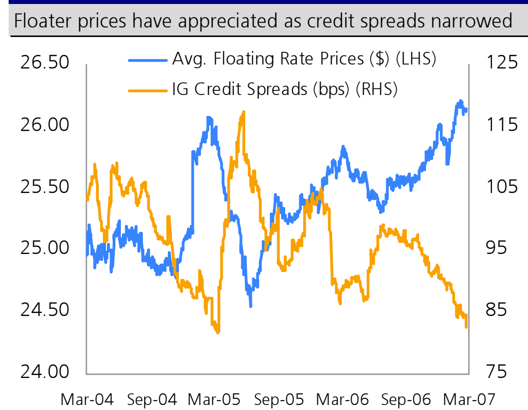
Tax-advantaged and floating-rate prices have fared best




Source: UBS WMR, Bloomberg, as of 23 February 2007

**Floater Prices ($) and IG Credit Spreads (bps)**

Floater prices have appreciated as credit spreads narrowed




Source: Bloomberg, Yield Book, UBS WMR, as of 23 February 2007
Note: Shows the average trading price of selected floating-rate preferreds versus the Yield Book investment grade credit index.

**Option-Adjusted Spread vs Treasuries**

| S&P Rating | Trust Pfds | REITs | Sr. Notes | Sub. Notes |
|---|---|---|---|---|
| AAA | N/A | N/A | 21.34 | N/A |
| AA | N/A | N/A | 46.01 | N/A |
| A | 44.52 | N/A | 66.45 | N/A |
| BBB | 93.35 | 82.45 | 98.80 | 105.16 |

Source: Ryan Labs, UBS WMR, as of 23 February 2007

**Recommendation**

| Preferred Securities | |
|---|---|
| Credit/Sectors | High-quality financials |
| Coupon | Fixed rate; 6.3% to 6.625% |

Source: UBS WMR, as of 23 February 2007

## USD TIPS (neutral)

**We recommend holding a neutral allocation in the TIPS sector as breakeven inflation spreads continue to offer cheap "inflation risk protection". We expect that TIPS breakeven inflation spreads, especially in the long-end, will increase this year to reflect higher inflation risk premium.**

### Energy and Fed drive TIPS breakevens

Crude oil prices rebounded in late January pushing TIPS inflation expectations higher with the 5- and 10-year sector reaching 2.38% and 2.40%, respectively. (See top Chart.) However, TIPS breakevens reversed course following Bernanke's testimony in mid-February, which was less hawkish than expected. The long-end declined back to the 2.30% and 2.50% area in the 10- and 20-year sector, respectively. The short-end rebalanced lower as well following a decline in crude prices with the 2-year plunging below 2.50%. TIPS real yields declined modestly in February, resulting in positive returns for the TIPS sector, with the 10-year sector trading within the 2.30% range. (See middle Chart.) As long as the Fed is perceived to be on hold, nominal yields at the very front-end of the yield curve will likely trade within current ranges. In our view, front-end real yields and breakevens should continue to move with the energy market. Long-end real yields and breakevens, more stable relative to the short-end, should depend on Fedspeak and fluctuations of nominal yields.

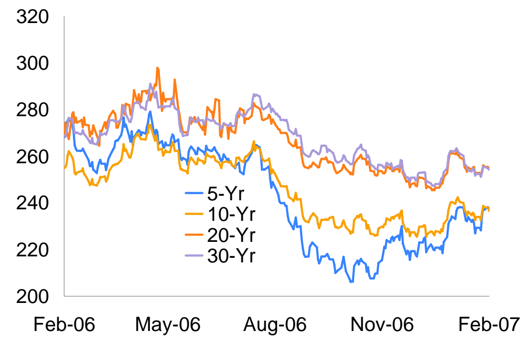
### We favor the 20-year sector

We look for long-end inflation expectations to move higher in 2007 and the TIPS breakevens curve to re-steepen to price in higher inflation risk premiums. Given our forecast on the 10-year nominal Treasury yield at 4.90% over a 12-month horizon and range-bound or lower real yields, the 20-year sector TIPS breakevens should rebound from the 2.50% area this year. In our opinion, real yields will likely move lower amid a weaker economy and Fed easing in the second half of 2007. Therefore, we favor the 20-year TIPS over nominals in 2007 and recommend buying on weakness.

**Viktoria Beromelidze, CFA**

**Inflation Expectations (bps)**

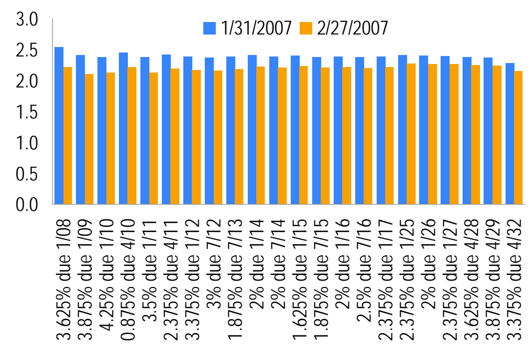
Breakeven inflation spreads are pricing in a benign inflation scenario in 2007




Source: Bloomberg, as of 27 February 2007

**TIPS Yield Curve**

Real yield (%)




Source: Bloomberg, as of 27 February 2007

**Real Yields vs Nominal Yields (%)**

| | Real | Nominal | Breakevens |
|---|---|---|---|
| 5-year | 2.10 | 4.46 | 2.36 |
| 10-year | 2.15 | 4.51 | 2.36 |
| 20-year | 2.20 | 4.73 | 2.53 |
| 30-year | 2.09 | 4.63 | 2.54 |

Source: UBS WMR, as of 27 February 2007
Note: The breakeven inflation spread—the yield difference between TIPS and matched-maturity Treasuries—represents the expected average inflation rate that would result in equivalent total return performance.

**Recommendation**

| USD TIPS | |
|---|---|
| Yield Curve Positioning | Bullet |
| Preferred Maturity | 20-year sector |

Source: UBS WMR, as of 27 February 2007

## USD Treasury (overweight)

**We move to an overweight allocation from a moderate underweight on Treasury securities this month as an offset to the reduction in credit exposure we are taking. Given the inversion of the yield curve and our expectation for Fed easing beginning in June, we favor Treasuries with short maturities.**

### Adopt an overweight Treasury allocation

Our overweight allocation to the Treasury market is based on the outlook for spreads in the corporate market, as well as risk premiums in general. We are no longer comfortable being underweight the (credit risk free) Treasury sector at a time when we are growing concerned that spreads on corporate bonds may widen. (See discussion on page 5). An additional consideration in our decision to overweight the Treasury sector is the potential impact of deteriorating conditions in the sub-prime mortgage market on risk premiums in general. While we believe the direct market impact of the sub-prime market meltdown should be largely confined to this niche market, investors may recalibrate risk premiums, and demand wider spreads, at least in the short-term, on both corporate and mortgage-backed securities. More importantly, however, the unfolding crisis in the sub-prime market reinforces the likely impact of broader slowdown in the housing sector. We have long believed that the bursting of the housing bubble would lead to slower consumer spending and, in turn, economic growth. Although it is too soon to tell, the melt-down in sub-prime housing sector may turn out to be the catalyst that convinces the Fed it should ease monetary policy.

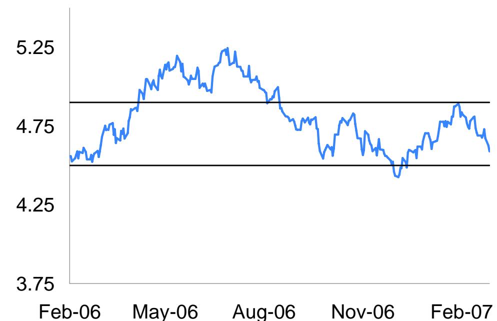
### We favor short maturities

For investors with new money to put to work, we favor Treasuries in the 1 to 2 year area. The yield curve is saucer shaped—with the lowest yields on bonds with intermediate maturities. (See middle Chart.) Although we look for the 10-year Treasury yield to follow a V-shaped path this year, we expect a 100 bps decline in 3-month Libor along side the drop in the 100 bps drop in the fed funds rate that our economists project this year. We don't forecast the yield on the 2-year note but short maturity Treasury yields are highly correlated with changes in the fed funds rate—and thus should be pressured lower in sympathy. Implicit in this rate forecast is the expectation that the yield curve will pivot around the 5-year area, with yields in the intermediate portion of the curve likely to remain fairly steady. Against this backdrop, we recommend Treasury maturities in the 1- to 2-year, where the absolute level of yields is the highest.

**Anna Briglia, CFA**

**10-Year Treasury Note Yield (%)**

The yield on the 10-year Treasury note is at our 6-month forecast




Source: UBS WMR, as of 27 February 2007

**Treasury Yield Curve**

| Maturity | Yield (%) |
|---|---|
| 3-month bill | 5.11 |
| 6-month bill | 5.09 |
| 1-year note | 4.85 |
| 2-year note | 4.58 |
| 3-year note | 4.50 |
| 5-year note | 4.46 |
| 10-year note | 4.50 |
| 30-year bond | 4.63 |

Source: UBS WMR, as of 27 February 2007

**Recommendation**

| US Treasury | |
|---|---|
| Yield Curve Positioning | Bullet |
| Preferred Maturity | 1-2 year |

Source: UBS WMR, as of 28 February 2007

## Municipal Market

**Since the end of January, overall yields in the municipal market have decreased across the curve and issuance has been manageable. Spreads remain tight, however, there are opportunities for income-oriented investors, especially in the 8-15 year range of the curve. In addition, narrow spreads offer credit-quality conscious investors an opportunity to switch out of lower quality municipal bonds and into higher quality ones at relatively little give-up in yield.**

**February market review**

February started the month overloaded with bonds from the hefty new issuance of January, as well as faced a slew of economic releases and an FOMC meeting. The first round of economic releases and a more manageable calendar contributed to the market finally garnering some positive price appreciation, after two months of rising yields. By mid-month all eyes were on the Fed Chairman and his upcoming testimony before Congress. The Fed Chairman's comments brought relief to a tense market and prompted a Treasury rally that municipals followed through the rest of the week. In addition, economic releases for the week were mostly bond-friendly aiding the rally. Supply for February was manageable, and comprised a number of high-grade offerings with good structure. Short maturities saw yields decrease by 3-4 bps. The ten-year area of the curve saw yields drop 9 bps, while the 15-year and 20-year saw yields decrease by 13 and 11 bps, respectively. Longer maturities, 21- to 30-years, saw yields drop 9-10 bps.

**Spreads and opportunities**

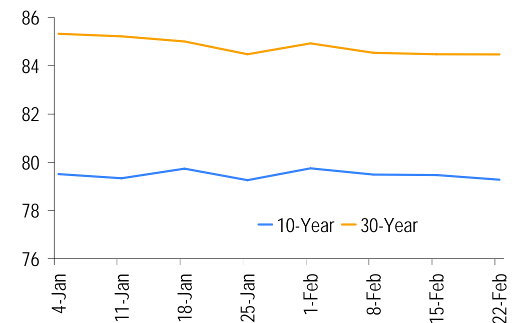
While the AAA general obligation (GO) curve remains positively sloped, the spread between the 2- and 30-year maturities decreased slightly over the past month from 54 bps to 46 bps resulting in a flatter yield curve. The M/T ratios for the 10- and 30-year maturities are 79.5% and 84.7%, respectively. While these ratios remain tight, the continued inversion of the Treasury curve, especially in the front-end through the 10-year, is making municipals attractive especially on a taxable-equivalent yield basis. However, since overbuying in this part of the curve has eroded some of its value, we suggest investors move out to the 11- to 15-year part of the curve.

Credit spreads since the beginning of the year have also remained tight. The AAA/A 10-year spread has been steady at either 24 bps or 25 bps, while the AAA/A 2-year spread has remained between 12 bps to 14 bps. In our opinion, these narrow spreads offer credit-quality conscious investors an opportunity to swap out of lower quality paper and into higher quality paper at relatively low costs.

**Dennis Porcaro**

**The Municipal/Treasury Ratio YTD**

The 30-year M/T ratio continues to hover just below 85%




Source: UBS WMR, as of 22 February 2007

**AAA Municipal Spread to Treasuries**

| | Municipals (%) | Treasury (%) | TEY (%) | Spread (bps) |
|---|---|---|---|---|
| 1-Year | 3.60 | 5.08 | 5.54 | 46 |
| 5-Year | 3.63 | 4.72 | 5.58 | 86 |
| 10-Year | 3.75 | 4.73 | 5.77 | 104 |
| 15-Year | 3.96 | 4.78 | 6.09 | 131 |
| 20-Year | 3.98 | 4.80 | 6.12 | 132 |
| 30-Year | 4.08 | 4.83 | 6.28 | 145 |

Source: UBS WMR, as of 22 February 2007, Note: assuming 35% Federal Tax Rate

**Rich/Cheap Analysis (27/Nov/06-22/Feb/07)**

| Muni/ Treasury | Current (%) | Average (%) | Maximum (%) | Minimum (%) |
|---|---|---|---|---|
| 1yr/1yr | 70.9 | 70.4 | 71.3 | 69.3 |
| 5yr/5yr | 76.9 | 7642 | 77.6 | 75.3 |
| 10yr/10yr | 81.6 | 79.3 | 80.1 | 78.2 |
| 15yr/15yr | 80.8 | 81.9 | 83.5 | 80.8 |
| 20yr/20yr | 82.8 | 83.6 | 85.1 | 82.7 |
| 30yr/30yr | 84.5 | 85.0 | 86.6 | 84.1 |

Max = Muni cheap to Treasury; Min = Muni rich to Treasury
Source: Thomson Financial, UBS WMR as of 22 February 2007

**Recommendation**

| Municipal Market | |
|---|---|
| Yield Curve Positioning | Bullet |
| Preferred Maturity | 8-15 years |
| Credit Positioning | High Grade |

Source: UBS WMR, as of 22 February 2007

**Statement of Risk**
Bond market returns are difficult to forecast because of fluctuations in the economy, investor psychology, geopolitical conditions and other important variables.

# Appendix

**Terms and Abbreviations**

| Abbreviation | Description / Definition |
|---|---|
| ABS | Asset Backed Securities |
| ann. | annualized |
| Avg. CPI Change (%) | Average Change of the Consumer Price Index in % |
| Bloomberg | Bloomberg Ticker (Ticker for obtaining financial information from Bloomberg system) |
| BOE | Bank of England |
| BOJ | Bank of Japan |
| CA | Current Account |
| CDO | Collateralized debt obligation, |
| CDS | Credit Default Swap |
| Change in Employment Rate (%) | Change in the Number of Employed Workers divided by the Total Civilian Labour Force in % |
| Concensus expectation | Market expectation |
| Core CPI | Consumer Price Index less Food and Energy |
| CPI | Consumer Price Index |
| cum. | cumulated |
| Datastream | Thomson Financial Datastream Ticker (Ticker for obtaining financial information from Datastreamg system) |
| ECB | European Central Bank |
| EMU | European Union's Economic and Monetary Union |
| f | Forecast |
| Fed | Federal Reserve System |
| Fed Rate | Federal Funds Rate; interest rate at which depository institutions lend balances (federal funds) at the Federal Reserve to other depository institutions overnight |
| G | Government |
| GDP | Gross Domestic Product |
| Gov. Gross Debt/GDP (%) | Government Gross Debt divided by Gross Domestic Product in % |
| GSE | Government Sponsored Enterprises |
| HY | High Yield |
| IG | Investment Grade |
| L | Libor |
| LHS | Left Hand Scale |
| Libor | London Interbank Offered Rate |

For continuation please see next page

# Appendix

**Terms and Abbreviations (continued)**

| Abbreviation | Description / Definition |
|---|---|
| Mac. Dur. | Macaulay Duration |
| MBS | Mortgage Backed Securities |
| mom | month-on-month |
| n.a. | not available |
| n.r. | not rated |
| nsa | non-seasonally adjusted |
| OATi | Obligation assimilable du Trésor indexée |
| OFHEO | Office of Federal Housing Enterprise Oversight |
| PMI | Purchasing Managers' Index |
| qoq | quarter-on-quarter |
| Real GDP Growth (%) | Real Gross Domestic Product Growth in % |
| Reuters | Reuters Ticker (Ticker for obtaining financial information from Reuters system) |
| RHS | Right Hand Scale |
| S | Swap |
| sa | seasonally adjusted |
| SNB | Swiss National Bank |
| Spread to Swap | Credit Risk Premium of an Investment compared to a Risk Free Asset; measured in Basis points |
| TIPS | Treasury Inflation-Protected Securities |
| Unemployment Rate (%) | Number of Unemployed Workers divided by the Total Civilian Labour Force in % |
| VAT | Value Added Tax |
| wow | week-on-week |
| yoy | year-on-year |
| YTM | Yield to Maturity |

# Appendix

## Required Disclosures

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# Appendix

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# Appendix

**Credit Issuer/Bond Recommendation Definitions**

| Recommendation | Time Horizon | | WMR Terminology | Definition |
|---|---|---|---|---|
| WMR Credit Rating | Longer Term | Investment Grade | AAA | Issuer / Bonds have exceptionally strong credit quality. AAA is the best credit quality. |
| | | | High AA | Issuer / Bonds have very strong credit quality. |
| | | | Mid AA | |
| | | | Low AA | |
| | | | High A | Issuer / Bonds have high credit quality. |
| | | | Mid A | |
| | | | Low A | |
| | | | High BBB | Issuer / Bonds have adequate credit quality. This is the lowest Investment Grade category. |
| | | | Mid BBB | |
| | | | Low BBB | |
| | | Non-Investment Grade | High BB | Issuer / Bonds have weak credit quality. This is the highest Speculative Grade category. |
| | | | Mid BB | |
| | | | Low BB | |
| | | | High B | Issuer / Bonds have very weak credit quality. |
| | | | Mid B | |
| | | | Low B | |
| | | | High CCC | Issuer / Bonds have extremely weak credit quality. |
| | | | Mid CCC | |
| | | | Low CCC | |
| | | | CC | Issuer / Bonds have very high risk of default. |
| | | | C | |
| | | | D | Obligor failed to make payment on one or more of its financial commitments. This is the lowest quality of the Speculative Grade category. |
| WMR Credit Trend | 12 months | | Improving | The WMR Credit Trend reflects the analyst's expectation as to how the company's credit fundamentals will change. |
| | 12 months | | Stable | |
| | 12 months | | Deteriorating | |
| | review within 3 months | | Watch + | Increased likelihood of UBS WMR Credit Rating upgrade(s). |
| | review within 3 months | | Watch - | Increased likelihood of UBS WMR Credit Rating downgrade(s). |

| Recommendation | Time Horizon | WMR Terminology | Definition |
|---|---|---|---|
| Bond Recommendation | 12 month | Outperform (OP) | The bond is expected to earn a higher total return than a liquid bond benchmark representing a comparable level of risk. |
| | | Market Perform (MP) | The bond is expected to earn a total return in line with a liquid bond benchmark representing a comparable level of risk. |
| | | Underperform (UP) | The bond is expected to earn a lower total return than a liquid bond benchmark representing a comparable level of risk. |
| | | Sell (Sell) | In light of substantial downside credit or default risk, investors should sell their bonds. |