UBS

UBS Investment Strategy Update

We retain a positive bias on equities

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The last few trading days have seen bond yields reach new highs and equity markets correct. Market participants' expectations concerning monetary policy have been revised sharply to the tightening side as a result of the recent streak of strong economic data. As the global profit picture remains intact, we continue to see room for global equities to outperform bonds during the remainder of the year.

This week global equity markets came under pressure as global bond yields continued to rise. While bond markets suffered price declines from rising yields, the retreat in global equities was more pronounced, causing a relative underperformance of equities relative to bonds of about 2% globally. Other asset classes such as listed real estate also suffered a correction, with the global real estate index down by more than 4%.

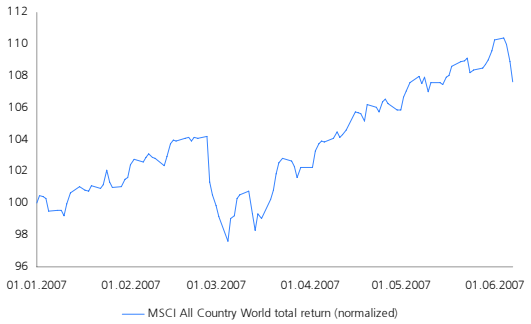
The combined sell-off in global equities as well as global bonds points toward an adjustment in investors' expectations regarding the future direction of monetary policy. This can clearly be inferred from the expectations for short-term interest rates as they are currently embedded in bond yields (term structure of interest rates). Whereas a couple of months ago, the bond market anticipated future easing by the US central bank (Fed), this week the market even started pricing in the possibility of a hike in 2007. Also for other regions, the market's expectations of central bank action have been significantly revised upwards. This is the case for all European central banks, as well as for Japan and Australia.

These shifts in interest rate expectations appear to be linked to recent stronger than expected economic indicators out of the US (namely a surge in the ISM) and continued robust data from the other regions. So far, the US was seen as the weak link in the global economy, with a very soft 1Q07 growth rate. This was interpreted by the markets as a reason for being less concerned about future inflation risks, despite a tightening labor market and increased capacity utilization rates. The signs of a re-accelerating US economy have seemingly been interpreted as adding to global resource constraints, thus causing inflation worries to emerge together with expectations for more hawkish central bank action.

We think that after the most recent increases in bond yields, levels now much better reflect the current fundamental situation for the global economy. We have argued in the past that (real) bond yields were too low in view of the strength and cyclical position of the global economy. Therefore we have kept a short duration stance on most bond markets, except the USD where a little while ago we moved from a short to a neutral duration stance. With hindsight, we acknowledge that this was somewhat pre-mature. However, especially after the recent events, bond markets seem to have awakened to the reality of continued robust global growth. After the recent sell-off, bond prices globally are approaching fair value. We still retain a moderately short

Global equity markets trading down…

MSCI All Countries World total return, rebased



Source: MSCI, UBS WMR

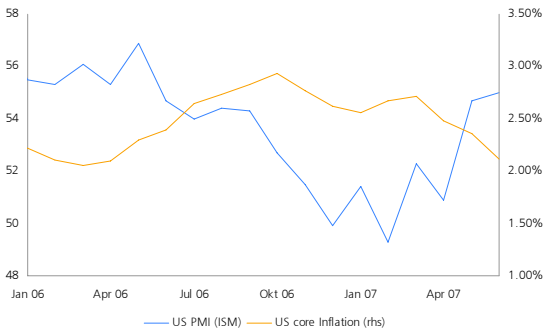
… as bond yields are strongly up

US 10 year government bond yields

Source: Bloomberg, UBS WMR

Growth – inflation mix improved for equities

US PMI (ISM) and US core inflation y/y



Source: Bloomberg, UBS WMR

duration stance in European countries, Japan, Australia and Canada. However, we feel comfortable with a neutral duration in the USD market.

As such, better growth indicators in the US should ultimately be welcomed by equity investors. Indeed, such news further reduces the overall risks to the US economy, which is still under considerable strain from the recession in the private housing market. Stronger data has clearly improved the odds for continued profit growth. On the other hand, higher (real) bond yields imply higher financing costs, and a somewhat higher hurdle that equities overcome in order to outperform fixed income assets. Also, concerns are emerging that central banks may take more severe anti-inflation measures, as "too" much growth risks leading the global economy into bottlenecks. At the moment, equity investors appear worried about such end-of-cycle tightening, which is often followed by a global economic downturn.

We still see the risk of a late-cycle economic downturn as limited. Instead, we expect the global economy to continue growing at a fairly robust pace over the next 1-2 years. Fairly tame inflation numbers suggest that the risks of central banks overshooting on the tightening side also remain under control. In our opinion, the growth-inflation-mix has actually improved in recent months. US economic indicators have strengthened and core inflation has trended down. Weakness in the housing market and higher gasoline prices are likely to weigh on consumer demand, which should also help reduce inflation concerns in the US. Given a fairly favorable growth-inflation mix globally, we think that higher (real) bond yields will not provide a major hurdle for a recovery in global equities over the coming months. Therefore, we retain our stance of a moderate overweight in equities relative to bonds. For the time being, we also retain our neutral allocation in global listed real estate, although we acknowledge that higher real rates mean a more serious hurdle for real estate due to fairly high valuation in comparison with global equities.

Appendix

If the date of this report is not current, the investment opinion and contents may not reflect the analyst's current thinking.

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