UBS

Fixed Income Strategy

United States

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Market Comment

UBS Investment Research

Credit Market Relative Value

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Monthly Update

Preview

Recently released economic data confirm that the economic expansion has gained a firm footing. This change in the cyclical outlook has not been lost on policy makers. The wording of the statement following the December 9th FOMC meeting signals the beginning of a process that will ultimately entail a tightening of policy.

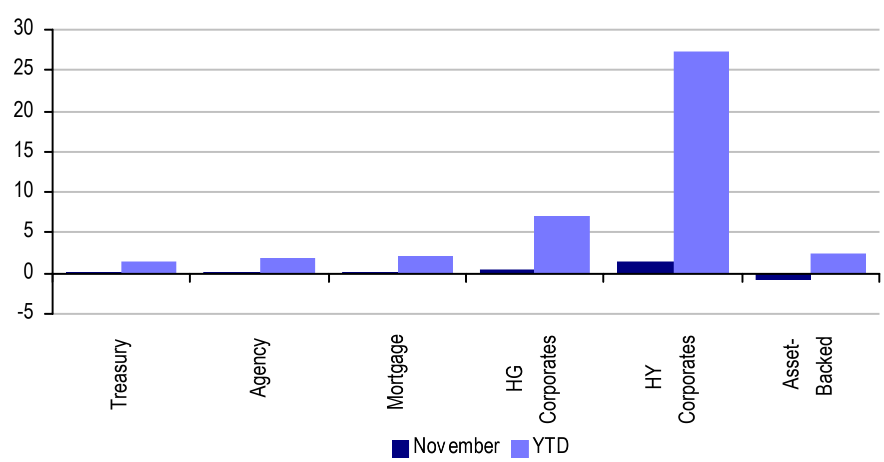
Sector Outlook

Credit spreads remain well above the previous cyclical lows reached back in the mid-1990s. Given moderately higher yields, still low rate volatility, a deteriorating fiscal outlook and improving credit conditions, we recommend that accounts maintain a selective overweight within spread product this month.

Performance Profile

Performance within the bond market thus far during the fourth quarter has been dictated by steadily higher rates, a continued tightening of credit risk premiums and gradual ratcheting down of volatility.

Chart 1:Performance Profile – YTD and November Fixed Income Returns (%)



Source: Yield Book

Preview

- Recently released economic data confirm that the economic expansion has gained a firm footing. At the same time, assorted measures of pipeline price pressures suggest that deflationary risks are easing, and that crude and intermediate goods inflation will gradually build.

- This change in the cyclical outlook has not been lost on policy makers. The wording of the statement following the December 9th FOMC meeting signals the beginning of a process that will ultimately entail a tightening of policy. This could well keep rates biased higher through the balance of the month as market participants continue to discount a less supportive Fed policy.

- Given improvement in the cyclical outlook, prospects for monetary tightening and further deterioration in the fiscal position, we opt to retain a modest duration underweight for December despite the fact that year-end liquidity concerns could well prompt temporary flows into the treasury market.

- The Treasury coupon curve remains historically steep and therefore prone to flatten further through 2004. Against a backdrop of higher rates, gradual unwinding of accommodative monetary policy and increased financing pressure on the front end, the wings are apt to outperform the intermediate sector of the curve over the intermediate term.

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- As we look ahead to 2004, there are a number of key issues that will likely be crucial in determining the outcome for bonds during the year. They include: 1) monetary tightening; 2) further deterioration in the fiscal position; 3) the Fed's likely policy response during an election cycle; and 4) the potential for non-traditional fixed income alternatives to offer more attractive returns.

Sector Outlook

- **Treasury:** Given expectations for continued improvement in cyclical conditions and prospects for further expansion in treasury issuance, we recommend that accounts continue to underweight treasuries relative to spread product. Our interest rate models indicate a "fair value" yield of 4.8% for the 10-year note, around 50 basis points higher than current levels. Should rates increase by 50 basis points over the next six months (as our models suggest), the treasury market could be expected to lose 0.44% compared to gains 0.46%, 0.69% and 0.1%, for the agency, mortgage and investment-grade corporate sectors, respectively.

- **Agency:** Relative supply dynamics clearly favor the GSEs. However, the general direction of rates and lingering headline/political risk could be a source of upward pressure on spreads going forward. With little time left in the year and no evidence agencies will benefit from a pure "December effect" we do not see compelling evidence to shift away from our current neutral position.

- **Mortgage:** Mortgages continued to do well over the past month and the perfect current coupon mortgage is now 16 bps rich according to our model. Although mortgage debt is currently rich, they could remain so for a while. Thus, given the still favorable technical backdrop and positive carry, we elect to move our mortgage allocation from an underweight back to neutral.

- **Corporate:** We retain our modest overweight in investment-grade corporates. Heading into year-end, we expect spreads to continue to edge tighter and spread volatility to be fairly subdued. What's more, we remain enthusiastic about the sector's longer-term prospects. Our longer-term enthusiasm is predicated on our belief that we are poised to re-enter a sustained period of low spreads and low volatility. Lastly, we continue to anticipate curve positioning and issue selection to provide the most attractive sources of excess return.

- **High-Yield:** While spreads have now narrowed considerably since peaking in October of 2002, we believe spreads should remain well-supported going into year-end and maintain our modest overweight. A declining default rate, improving profit picture and strong technicals suggest further spread compression in December. We also recommend diversifying across multiple sectors and focusing on sectors that are likely to continue benefiting from economic recovery while limiting exposure to sectors that may now be at historically tight levels.

Tactical Recommendation

Sector Allocations

	Treasury	Agency	Mortgage	Corporate
Ryan Labs Index	27.72%	11.94%	34.15%	26.18%
UBS Model Weightings	29.47%	9.42%	43.04%	18.06%
Constraints	42% - 12%	25% - 0%	49% - 19%	41% - 11%
Sector Outlook	↓	↔	↔	↑
Suggested Allocations	26.22%	11.94%	34.15%	27.68%

Source: Ryan Labs and UBS Fixed Income Strategy

Tactical Duration Weighting

	Market Duration	Allocation Duration	As % of Benchmark
Treasury	5.46	5.23	95.71%
Agency	4.19	3.97	94.60%
Mortgage	3.28	3.28	100.00%
Corporate	5.73	5.53	96.49%
Aggregate	4.64	4.49	96.97%

Source: Ryan Labs and UBS Fixed Income Strategy

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