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After the Tightening Begins

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- **The "tug of war" between rising earnings and rising rates**

S&P 500 operating EPS rose 25% in Q403 and 26% in Q104, and are forecast to rise 22% in Q204. However, due to rising rates and tougher comps, EPS growth is likely to slow to 6% in 2005. The "tug of war" between rising earnings and rising rates has stalled major stock indices, with the S&P 500 never more than 4.1% above or 2.5% below levels at the beginning of 2004.

- **Bond yields still biased higher**

While bonds are much better positioned for the beginning of the tightening cycle than they were in 1994—or even just three month ago—it remains our view that yields are biased higher as the Fed continues the process of raising rates. We continue to favor stocks over bonds in this environment, expecting normal 8-10% gains in stocks over the next 12 months.

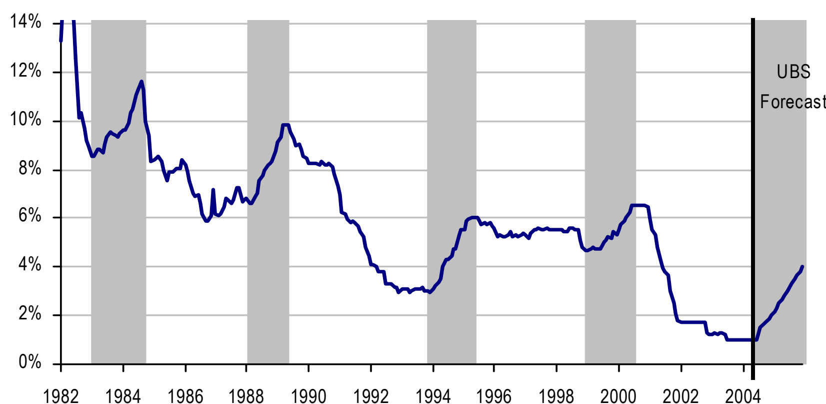
- **Dividend ruler stocks go global**

We update our list of "dividend ruler stocks"—stocks with above-average yield, attractive fundamentals, and a history of consistent dividend growth. In this report, we also introduce a list of non-U.S. based stocks that fit this theme.

- **Preferred securities and closed-end funds**

Preferreds and closed-end funds are highly interest-rate-sensitive and have experienced significant price declines over the past three months. With yields still biased higher, these areas face a challenging macro environment.

Federal Funds Rate



Note: Tightening cycles shaded.
Source: Federal Reserve Board, UBS estimates

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Market Outlook: A Rising Rate Environment

In our last Quarterly Market Outlook report, *"The Waiting is the Hardest Part,"* (April 6, 2004) we provided key signposts to look for as investors anticipated rising interest rates. Specifically, what we were waiting for—sustained job growth, higher inflation, a Fed rate hike, robust corporate profits, and increased geopolitical risk—has occurred over the past three months.

- **Sustainable job creation.** After losing 2.7 million jobs from March 2001 to August 2003, the U.S. economy has retraced more than half those job losses in the last 10 months, with an increase of over 1.5 million jobs.

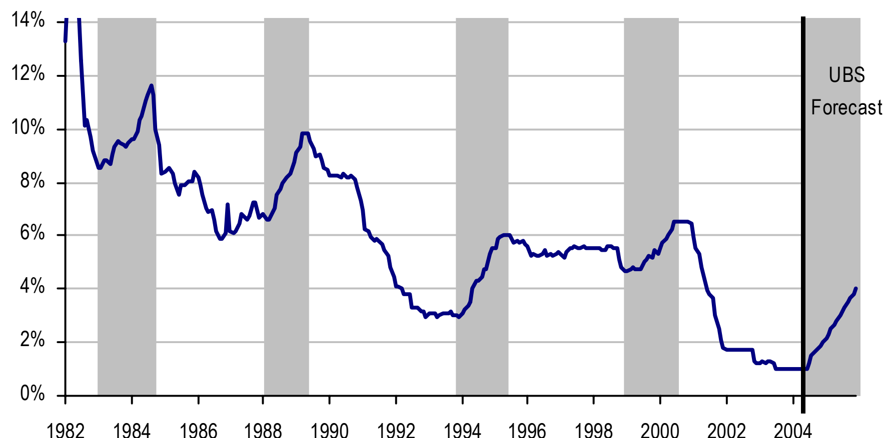
- **Higher inflation.** Headline CPI has jumped from a year-over-year change in March 2004 of 1.7% to 3.0% as of May 2004.

- **A fed rate hike.** The Fed raised the federal funds rate 25 basis points at the June 30 FOMC meeting.

- **Corporate profits.** First quarter 2004 S&P 500 profits came in far above consensus at $15.87—registering a 26% year-over-year gain, and a noteworthy *eight percentage points* higher than consensus expectations at the end of quarter.

- **Geopolitical risk.** As the handover of formal sovereignty approached, violence escalated in Iraq.

Chart 1: Federal Funds Rate



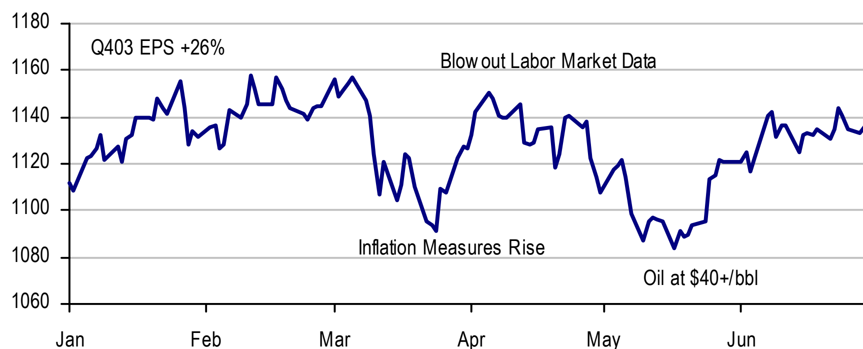
Note: Tightening cycles shaded.
Source: Federal Reserve Board, UBS estimates

UBS forecasts a 25 bp rate hike in August, 50 additional bp of tightening in 2004, and 200 additional bp of tightening in 2005

How have financial markets reacted? The S&P 500 gained 3% in the first six months of 2004, but it was hardly a steady rise (see Chart 2). During the first three months of the year, financial markets waited with bated breath for labor market reports (weekly jobless claims, monthly employment situation) to

confirm that the economy had moved from the recovery stage of the cycle to self-sustained expansion. Once confirmed, markets quickly turned to fears of escalating inflation and sharply rising oil prices, reacting from "data release to data release."

Chart 2: S&P 500 Price—2004 Through June 30



Source: Bloomberg, UBS

The Five "i"s—Today's Wall of Worry

We introduced the five "i"s, or the five most important risk factors concerning markets in our May 18, *"What, Me Worry?"* Market View report. Inflation, interest rates, increased prices at the pump, Iraq, and incumbent or challenger (Election 2004) were the chief concerns of financial markets during the first half of the year, and continue to be uncertainties going forward. Importantly, all five are interrelated: Inflation should drive interest rates; Iraq unrest is a part of the oil pricing story, which feeds directly into commodity inflation; geopolitics are front and center in Election 2004, the winner of which could impact policy that may, in turn, affect Iraq, energy pricing, inflation, and, ultimately, interest rates. Table 1 identifies the peak concern regarding each "i," and gives our latest opinions and forecasts, where applicable.

Inflation, interest rates, increased prices at the pump, Iraq, and incumbent or challenger (Election 2004) were the chief concerns of financial markets during the first half of the year

Table 1: 2003 Market Risks: The Five "i"s

Market Worry	Peak Concern	Our Take
Interest Rates	The onset of the tightening cycle could end the rally in stocks that began in March 2003.	The average stock market gain in years with rising bond yield is a robust 12.3%. With Fed tightening to remain at a "measured" pace and CPI inflation to moderate around 2.5% by year-end 2004, according to UBS forecasts, rising rates are unlikely to have a significant negative impact on equity market returns.
Inflation	The Fed's "looser for longer" policy has left it "behind the curve" and could lead to higher than desired levels of inflation, leading to a more aggressive and less "measured" tightening cycle.	UBS Chief U.S. Economist Maury Harris believes core inflation will moderate over the remainder of the year, after rising by 1.7% year over year through May. To date in 2004, the Fed's preferred inflation gauge, the PCE deflator, has risen 2.3% annualized, far above the Fed's forecast of 1.25% for the year. If inflation moderates, the Fed is likely to be able to maintain a "measured" approach in raising rates; if not, then Fed policy may be more aggressive. Upcoming inflation data releases will be key.
Iraq	Increasing Middle East violence and global terrorist attacks could raise the equity risk premium, capping stock valuations and raising energy prices.	An earlier than expected transfer of power has opened a new page in the Iraq storybook, however increasing violence from insurgents is unlikely to abate soon. Geopolitical risk is the hardest to quantify or anticipate and remains the key wild card in market valuations.
Incumbent or Challenger? (Election 2004)	A close election would likely offer no guidance to policy initiatives until after Nov. 2.	Markets, on average, tend to exhibit normal returns in the months leading up to an election. Gridlock on Capital Hill is actually a historical positive for the markets.
Increased Prices at the Pump	Rising energy costs could take a toll on the consumer, weakening the economic recovery	UBS energy analysts forecast oil at $35.60 by year-end 2004, $28.00 by 2005, and $25.00 by 2006. WTI spot oil prices peaked at $42.35 on June 1, but are down 12.5% as of June 30. While energy prices should continue to moderate through 2004 and 2005, increased levels of global demand will keep prices high relative to recent historical norms, and upside surprises could result from terror-related supply disruptions.

Source: UBS

Market Signposts

The second half of 2004 will likely feature election politics and FOMC rate hike announcements. Table 2 shows a timeline of significant events and dates that are likely to influence financial markets.

Table 2: 2004 Timeline

Date		Signpost		Date		Signpost	
July	9	**Earnings**	GE Earnings Release	Sep.	15	**Energy**	OPEC Meeting
	16	**Inflation**	CPI Release		16	**Inflation**	CPI Release
	15	**Earnings**	Citigroup Earnings Release		21	**Rates**	FOMC Meeting
	21	**Energy**	OPEC Meeting		29	**Inflation**	GDP Release
	20	**Earnings**	Pfizer Earnings Release (E)	Oct.	19	**Inflation**	CPI release
	22	**Earnings**	Microsoft Earnings Release		28	**Earnings**	ExxonMobil Earnings Release
	26	**Election**	Democratic Nat'l Convention		29	**Inflation**	GDP Release
	29	**Earnings**	ExxonMobil Earnings Release	Nov.	2	**Election**	Presidential Election
	30	**Inflation**	GDP Release		10	**Rates**	FOMC Meeting
Aug.	10	**Rates**	FOMC Meeting		12	**Earnings**	Wal-Mart Earnings Release
	12	**Earnings**	Wal-Mart Earnings Release		17	**Inflation**	CPI Release
	17	**Inflation**	CPI release		30	**Inflation**	GDP Release
	27	**Inflation**	GDP Release	Dec.	14	**Rates**	FOMC Meeting
	28	**Election**	Republican Nat'l Convention		17	**Inflation**	CPI Release
					22	**Inflation**	GDP Release

Source: UBS

We Continue to Favor Stocks Over Bonds

As Chart 1 shows, we are entering the fifth Fed tightening cycle since 1982. In each of the prior four cycles, stocks outperformed bonds in both the subsequent six- and 12-month periods (Tables 3 and 4).

Table 3: Performance in Subsequent Six Months *After* First Rate Hike in Cycle

	Mar-83	Mar-88	Feb-94	Jun-99	Average	Average (ex Jun-99)
S&P 500	8.6%	5.0%	1.8%	7.0%	5.6%	5.1%
3 mo. T-bill	4.4%	3.3%	2.0%	2.4%	3.0%	3.2%
10 yr. T-bond	1.2%	2.3%	-4.2%	-2.0%	-0.7%	-0.2%

Table 4: Performance in Subsequent 12 Months *After* First Rate Hike in Cycle

	Mar-83	Mar-88	Feb-94	Jun-99	Average	Average (ex Jun-99)
S&P 500	4.1%	13.9%	4.3%	6.0%	7.1%	7.4%
3 mo. T-bill	9.2%	7.5%	4.7%	5.3%	6.7%	7.1%
10 yr. T-bond	1.1%	4.0%	-1.0%	3.2%	1.8%	1.3%

Source: Bloomberg

As we have noted in prior reports, rising rates, in and of themselves, are not an absolute negative for equities, since the cause of rising rates is typically an economic expansion, which boosts corporate profits—a positive for stocks. Conversely, rising rates, by definition, are a negative for bonds, although Fed tightening monetary policy via raising the Fed funds target rate does not necessarily equate to a rising long-term bond yield. Although 10-year bond yields have already risen 120-140 basis points above their June 2003 lows, we expect yields to drift higher during the current tightening cycle, reaching 5.0% by the end of 2004 and 5.5% by the end of 2005 (a more extensive analysis of fixed income securities is below). Additionally, the relatively strong historical return from T-bills is unlikely to be repeated as cash rates during the current cycle are starting at a much lower base of only 1%.

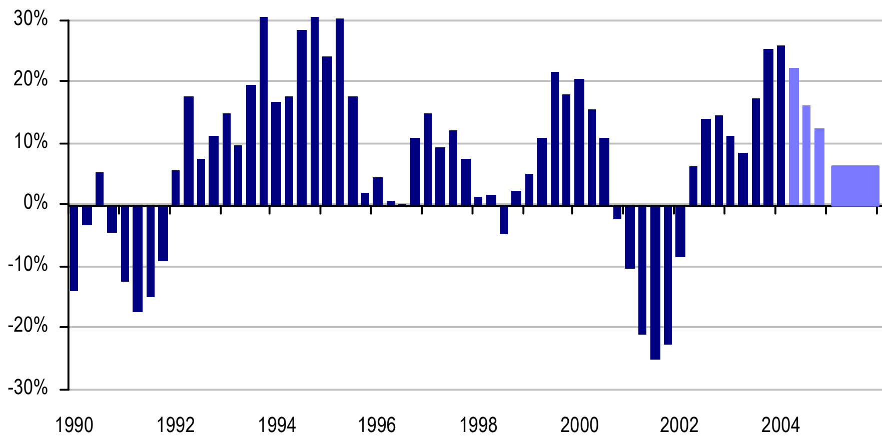
Although 10-year bond yields have already risen well above their June 2003 lows, we expect yields to drift higher during the current tightening cycle

Strong Earnings Continue to Pour In…

Corporate earnings continue to surprise on the upside. The fourth quarter of 2003 was widely considered to be the year-over-year earnings peak at +25%; that was, until earnings in the next quarter came in at +26% (see Chart 3). Earnings strength has been broad-based, largely due to the Fed's "looser for longer" policy stance. Earnings will not be able to continue to grow at a 25% rate, however, and UBS Corporate Profits Strategist Tom Doerflinger expects a slowdown for the remainder of 2004, with growth of 22%, 16%, and 12% in the last three quarters of the year.

Corporate earnings continue to surprise on the upside

Chart 3: S&P 500 Operating EPS—Year-Over-Year Percent Change



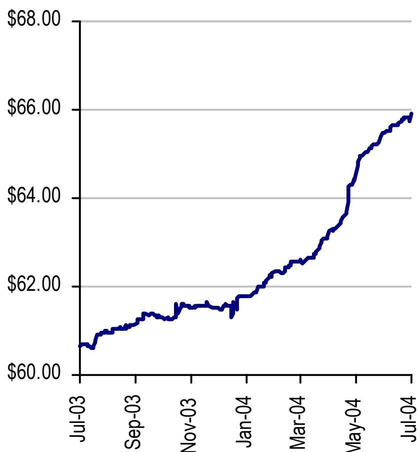
Source: Standard & Poor's, UBS estimates

...And Estimates Keep Rising

Tom Doerflinger recently noted in his Profit Picture Monthly report, June 2, 2004, that "estimates are rising, despite rising costs because sales growth is strong. Estimates are rising for the energy sector, but also for energy users such as materials, industrials, and consumer cyclicals." In aggregate, both the 2004 and 2005 S&P 500 bottom-up EPS estimates have been rising steadily throughout the year. (See Charts 4 and 5.)

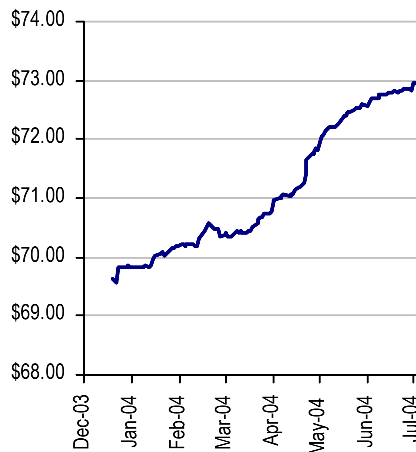
Bottom-up EPS estimates have been rising steadily throughout the year

Chart 4: 2004 S&P 500 Bottom-Up EPS Estimate



Source: FactSet, First Call

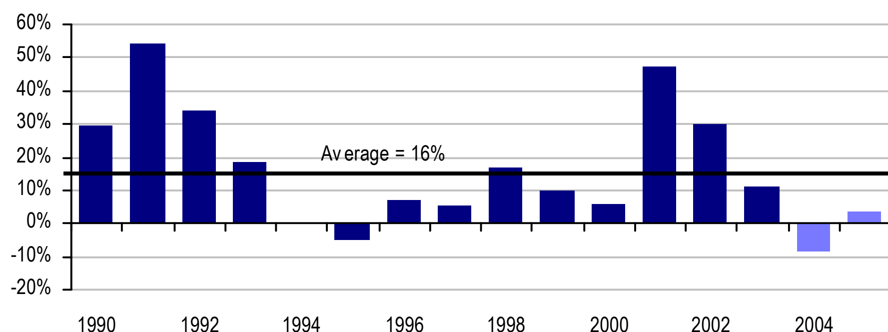
Chart 5: 2005 S&P 500 Bottom-Up EPS Estimate



Source: FactSet, First Call

Note that rising estimates are somewhat atypical, as the "normal" pattern for the bottom-up earnings estimate is to start off too high, and then fall 16% from June of the prior year to the final actual earnings number 18 months later. It is not surprising that the greatest "shortfalls" occur during recessions, however, it is interesting to note that the pattern exhibited after the 1991 recession appears to have been repeated after the 2001 recession. (See Chart 6.)

Chart 6: S&P 500 Bottom-Up Earnings Estimate* Versus Actual Earnings



* Earnings estimate equals the S&P 500 bottom-up number in June of the previous year (i.e., 18 months before the end of the current year)
Source: FactSet, UBS estimates

The "normal" pattern for the bottom-up earnings estimate is to start off too high, and then fall 16%…

…but, 2004 S&P 500 EPS are likely to come in 8% *above* the initial estimate

Table 5 lists the S&P 1500 companies that UBS assigns a Buy recommendation, and where both the UBS analyst's Q204 and full-year 2004 estimates are above consensus estimates. We believe these companies are most likely to have earnings "upside surprises."

Table 5: Second Quarter 2004 Earnings Surprise Candidates

Consumer Discretionary	Ticker	UBS	FC	Industrials	Ticker	UBS	FC
Interpublic Group	IPG	0.13	0.10	United Rentals	URI	0.45	0.36
McGraw-Hill	MHP	0.83	0.81	Lockheed Martin	LMT	0.63	0.61
Meredith	MDP	0.74	0.72	Watson Wyatt & Co Holdings	WW	0.42	0.37
McDonalds	MCD	0.45	0.44	Manpower	MAN	0.53	0.52
Liz Claiborne	LIZ	0.44	0.43	Masco	MAS	0.60	0.58
Jones Apparel Group	JNY	0.61	0.59	HNI Corp	HNI	0.42	0.41
Kellwood	KWD	0.36	0.35				
Kohls	KSS	0.45	0.43				
Federated Dept Stores	FD	0.72	0.67				
Nordstrom	JWN	0.78	0.76				
Meritage	MTH	1.85	1.81				
Disney	DIS	0.29	0.26				
Consumer Staples				**Information Technology**			
Pepsi Bottling Group	PBG	0.52	0.51	KLA-Tencor *	KLAC	0.49	0.45
Coca-Cola Enterprises*	CCE	0.64	0.61	JDA Software Group	JDAS	0.10	0.08
				Cabot Microelectronics	CCMP	0.43	0.39
Energy				**Materials**			
Exxon Mobil	XOM	0.85	0.81	Du Pont De Nemours	DD	0.85	0.81
Burlington Resources	BR	0.89	0.78	Temple-Inland	TIN	0.65	0.63
Newfield Exploration	NFX	1.29	1.23				
Financials				**Health Care**			
American International Group	AIG	1.13	1.11	Millipore	MIL	0.57	0.55
Countrywide Financial*	CFC	2.30	2.24				
Fannie Mae	FNM	1.96	1.92				
Capital One Financial	COF	1.49	1.46				
Safeco*	SAFC	0.86	0.78				

Note: Selected S&P 1500 stocks with a Buy recommendation from UBS and where the UBS estimate is above the Q204 and full-year 2004 consensus estimate; asterisk indicates high level of confidence by analyst.
Source: UBS

Risk to Earnings Likely Lie in 2005

For 2005, the key issue for earnings will be whether, and how quickly, Fed rate hikes slow GDP and, ultimately, earnings growth. UBS expects 2005 S&P 500 EPS growth to slow to a near-trend level of 6%, largely due to margin pressure and tougher comps.

How Much Is Priced In?

With the S&P 500 closing Q204 at 1,140, we believe that much of the strong earnings momentum is priced into the market, and that aggregate market gains will be fairly limited in the next 12 months. UBS U.S. Equity Strategist Gary Gordon calculates "fair value" for the S&P 500 at 1,200, but recently introduced a "target price" of 1,100 due to increased risks of inflation, peaking profits, additional monetary tightening, a China slowdown, and the increased risk of terrorism. Comparing the current market PE multiple to the recent past, at the end of June in both 2002 and 2003, the S&P 500 traded at 16.1 times the next year's bottom-up S&P 500 EPS estimate. Currently, the market is trading at 15.4 times the 2005 bottom-up EPS estimate and 16.1 times Tom Doerflinger forecast for S&P 500 EPS of $70. With the current crosswinds of above-trend GDP driving positive (but slowing) earnings momentum and rising interest rates, we believe that the market multiple will continue to trade in a range of 15-17 times forward earnings. In this environment, stock market indices are likely to be driven primarily by earnings gains. Given UBS's forecast for S&P 500 EPS of $70 (6% growth) in 2005, we would expect markets to generate *normal* gains of approximately 8%—in line with earnings growth. Table 6 highlights our estimate of a likely range of S&P 500 levels if, as we expect, multiples remain at 15-17 times and at earnings levels in the range of the current top-down and bottom-up estimates.

We expect markets to generate *normal* gains of approximately 8%—in line with earnings growth—over the next 12 months

Table 6: S&P 500 Levels at Varying PE Multiples and 2005 EPS

P/E	2005 S&P 500 EPS				
	$66	$68	$70[1]	$72	$74
14x	924	952	980	1008	1036
15x	990	1020	1050	1080	1110
16x	1056	1088	1120	1152	1184
17x	1122	1156	1190	1224	1258
18x	1188	1224	1260	1296	1332
19x	1254	1292	1330	1368	1406
20x	1320	1360	1400	1440	1480

[1] Current UBS top-down 2005 S&P 500 EPS estimate is $70; current bottom-up estimate is $73.
Source: First Call, UBS

With the aggregate market likely to remain range-bound between 1,050-1,250, the importance of sector and stock selection is paramount to overall portfolio performance.

Sector Expectations—Staying Defensive

A rising rate environment has typically benefited defensive sectors. In Table 4, we showed asset class performance subsequent to the initial rate hike; in Table 7, we extend this analysis to show sector performance. Omitting the 1999 tightening cycle which occurred amidst the height of the technology "bubble," on average, defensive sectors—such as consumer staples, health care, and energy—were the top performing sectors.

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Table 7: Performance in Subsequent 12 Months *After* First Rate Hike in Cycle

	Mar-83	Mar-88	Feb-94	Jun-99	Average	Average (ex Jun-99)
S&P 500	4.1%	13.9%	4.3%	6.0%	7.1%	7.4%
3 mo. T-bill	9.2%	7.5%	4.7%	5.3%	6.7%	7.1%
10 yr. T-bond	1.1%	4.0%	-1.0%	3.2%	1.8%	1.3%
S&P 500 Sectors						
Consumer Staples	8.9%	34.1%	13.0%	-15.0%	10.2%	18.6%
Energy	36.3%	14.5%	3.7%	2.6%	14.3%	18.2%
Health Care	-1.7%	15.7%	26.0%	11.8%	12.9%	13.3%
Materials	12.0%	18.2%	0.7%	-24.9%	1.5%	10.3%
Financials	-3.1%	27.0%	5.3%	-10.0%	4.8%	9.7%
Telecom. Services	0.2%	28.4%	-0.8%	-15.0%	3.2%	9.3%
Utilities	10.2%	16.0%	-4.9%	-1.7%	4.9%	7.1%
Information Technology	4.3%	-1.4%	17.8%	46.8%	16.9%	6.9%
Industrials	7.0%	12.1%	0.0%	0.2%	4.8%	6.4%
Consumer Discretionary	-2.6%	19.6%	-7.8%	-5.3%	1.0%	3.1%

Source: UBS

As we did in our last quarterly update, we calculated expected aggregate sector returns, assuming UBS industry analysts' 12-month price targets (for all companies under coverage) are met. The information technology sector has the highest bottom-up expected return at 22%, while the utilities sector has the lowest at 0%. However, we believe investors should consider the level of risk in addition to the absolute expected return. Incorporating risk—as defined here by the standard deviation of sector returns for the past 60 months—we calculated a level of risk-adjusted expected return for each sector (Sharpe ratio). Table 8 tabulates the results, ranked by level of risk-adjusted return. Again, consumer staples seem the most attractive, along with consumer discretionary, financials, materials, and tech, on a risk-adjusted basis.

Table 8: UBS 2004 "Bottom-Up" Expected S&P 500 Sector Returns

	UBS Expected sector return	Standard deviation of monthly sector returns	Sharpe Ratio
Consumer Staples	16%	4%	3.62
Consumer Discretionary	18%	6%	2.83
Financials	16%	6%	2.34
Materials	14%	7%	1.92
Information Technology	22%	11%	1.88
Industrials	9%	6%	1.47
Telecommunication Srvcs	13%	8%	1.44
Energy	8%	5%	1.38
Health Care	6%	5%	1.09
Utilities	0%	6%	(0.20)

* Calculated expected return per unit of risk (i.e., Sharpe Ratio) is equal to the expected aggregate sector return less the risk-free rate (three-month T-bill rate), divided by the standard deviation of the last 60 months of sector returns.
Source: UBS

The consumer staples sector is the most attractive by Sharpe ratio—along with consumer discretionary, financials, materials, and tech

Action: Selected stocks assigned Buy recommendations by UBS in the five most attractive sectors by risk-adjusted expected return are listed in Table 9.

Table 9: Selected Buy 1- or Buy 2-Rated Stocks in Most Attractive Sectors by Sharpe Ratio

Sector	Company	Ticker	Rating	Price (6/30/04)	UBS 12-month Price Target	Dvd Yield	Total Expected Return	Sharpe Ratio
Consumer Staples	Sysco	SYY	Buy 1	35.87	47.00	1.6%	33%	5.0
	Pepsico	PEP	Buy 1	53.88	66.00	1.3%	24%	3.6
	Wal-Mart	WMT	Buy 1	52.76	68.00	0.8%	30%	3.4
	Gillette	G	Buy 1	42.40	51.00	1.5%	22%	2.9
	Procter & Gamble	PG	Buy 1	54.44	64.50	1.9%	21%	2.7
Consumer Discretionary	Centex	CTX	Buy 1	45.75	72.00	0.3%	58%	5.1
	Kohl's	KSS	Buy 1	42.28	65.00	0.0%	54%	5.1
	Comcast	CMCSK	Buy 2	28.10	40.00	0.0%	42%	4.8
	McDonalds	MCD	Buy 2	26.00	35.00	1.7%	37%	4.3
	KB Home	KBH	Buy 1	68.63	97.00	1.5%	43%	4.2
Financials	Fannie Mae	FNM	Buy 2	71.36	120.00	3.0%	73%	9.2
	Freddie Mac	FRE	Buy 2	63.30	100.00	1.6%	61%	8.0
	American Int'l Group	AIG	Buy 1	71.28	93.00	0.4%	31%	3.9
	ACE Limited	ACE	Buy 2	42.28	55.00	2.1%	33%	3.1
	Merrill Lynch	MER	Buy 2	53.98	71.00	1.2%	33%	3.0
Materials	Bowater	BOW	Buy 2	41.59	52.00	1.9%	27%	3.3
	DuPont	DD	Buy 1	44.42	53.00	3.3%	23%	3.0
	Weyerhaeuser	WY	Buy 2	63.12	77.00	2.5%	25%	2.8
	Air Prod. & Chem.	APD	Buy 1	52.45	63.00	1.8%	22%	2.6
	Newmont Mining	NEM	Buy 2	38.76	49.00	0.7%	27%	2.4
Information Technology	Texas Instruments	TXN	Buy 2	24.18	41.00	0.3%	70%	4.2
	Intel	INTC	Buy 2	27.60	41.00	0.3%	49%	3.1
	Linear Technology	LLTC	Buy 2	39.47	56.00	1.0%	43%	2.8
	EMC	EMC	Buy 1	11.40	17.00	0.0%	49%	2.5
	First Data	FDC	Buy 2	44.54	55.00	0.1%	24%	2.5

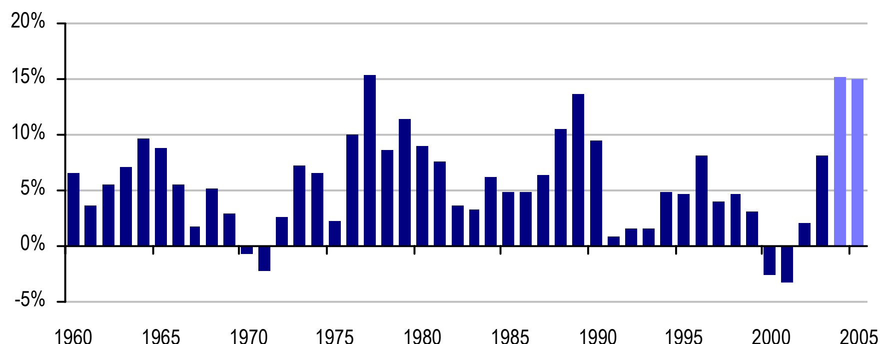
Note: Sharpe ratio uses UBS analysts' price targets to calculate total expected return, subtracting the risk-free rate, and dividing by the trailing 60-month standard deviation of monthly stock prices.
Source: UBS

Dividend Ruler Stocks Go Global

In 2004 and 2005, we expect S&P 500 dividend per share growth of 15%, the highest level since 1976

In late 2003, we introduced the concept of "dividend ruler stocks"—stocks whose historical dividend growth is "as straight as a ruler"—as "a more straightforward way of investing in stocks that should benefit from the re-emergence of dividends." (See *"What Investors Should Know About Dividends,"* October 16, 2003.) In 2004 and 2005, we expect S&P 500 dividend per share growth of 15%, the highest level since 1976 (see Chart 7).

Chart 7: S&P 500 Dividends Per Share—Year-Over-Year Percent Change



Source: Standard & Poor's, UBS estimates

The current list of dividend ruler stocks, as of June 30, 2004, is shown in Table 10. We now include non-U.S. companies, as represented by their American Depository Receipts (ADRs).

Table 10: Dividend Ruler Stocks

Name	Ticker	Price (6/30/04)	Sector	Div. Yield	UBS Rating	DPS 10-yr CAGR	Div Growth Consistency
U.S.-Based Cos.							
Lincoln National	LNC	47.25	Financials	3.0%	Buy 2	6%	99%
Leggett & Platt	LEG	26.71	Consumer Disc.	2.1	Buy 1 (RRD)	15	99
Air Prod. & Chem.	APD	52.45	Materials	2.3	Buy 1	7	98
Alltel	AT	50.62	Telecom	2.9	Buy 1	6	98
Coca-Cola	KO	50.48	Consumer Staples	2.0	Buy 1	10	97
Freddie Mac	FRE	63.30	Financials	1.9	Buy 2	17	96
Clorox	CLX	53.78	Consumer Staples	2.0	Buy 1	9	95
Alcoa	AA	33.03	Materials	1.8	Buy 2	12	91
Fannie Mae	FNM	71.36	Financials	2.9	Buy 2	14	89
Washington Mutual	WM	38.64	Financials	4.4	Buy 2	20	88
JPMorgan Chase	JPM	38.77	Financials	3.6	Buy 2	11	88
Kimberly-Clark	KMB	65.88	Consumer Staples	2.4	Buy 1	5	85
International Cos.	ADR						
Barclays	BCS	34.86	Financials	4.2%	Buy 1	19%	97%
HSBC	HBC	74.91	Financials	4.6	Buy 1	19	94
Westpac Banking	WBK	61.75	Financials	4.5	Buy 1	18	91
Volvo	VOLVY	34.98	Industrials	3.1	Buy 2	13	90
Norsk Hydro	NHY	65.45	Materials	2.5	Buy 2 (RRD)	14	82
Nat'l Australia Bank	NAB	104.26	Financials	5.4	Buy 1 (RRD)	12	79
BBVA	BBV	13.50	Financials	3.4	Buy 2	10	77
BASF	BF	53.85	Materials	4.3	Buy 1	10	76
The Thomson Corp.	TOC	33.46	Consumer Disc.	2.3	Buy 2	10	75

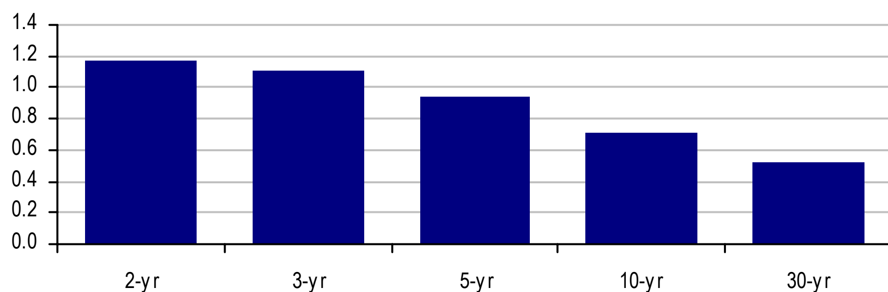
Note: Companies listed have dividend yields greater than the S&P 500, are rated Buy 1 or Buy 2 by UBS analysts, have 10-year CAGR of DPS greater than 5% and are ranked by dividend growth consistency (R^2 of past 40 quarters DPS, relative to linear trendline, of greater than 85% for U.S based companies; 75% for non-U.S. based companies).
Source: FactSet, UBS

Bonds—Ahead of the Fed

While many have understandably focused upon the Fed's decision to raise the target funds rate by 25 basis points at the June FOMC meeting, in our view it was actually the release of the March payroll report back in early April that marked the critical inflection point in the current interest rate cycle. Despite generally favorable economic data, yields had continued to hover near both cyclical and secular lows earlier this year amid still docile finished goods inflation and sluggish payroll growth. Senior Fed officials had made it clear that policy would remain static until three conditions had been met: 1) the economy moved from a fledgling recovery to self-sustained expansion; 2) price pressures finally began to seep through to finished goods; and 3) the employment outlook improved on a more sustained basis. But with these conditions having finally stabilized, the path was cleared for the Fed to initiate a tightening cycle that will now likely extend well into 2005.

Just how well braced is the bond market for such a cycle? The bond market's favorable reaction to the June rate hike suggests that a shift in monetary policy was already fully discounted. Yields had risen sharply well ahead of the June rate hike, with the short/intermediate sector once again bearing the brunt of this re-pricing (see Chart 8).

Chart 8: Treasury Coupon Yield Curve Changes—March 1 to June 29 (%)



Source: Bloomberg

Bonds appear much better braced for the policy shift than they were just three months ago

Against this backdrop, bonds appear much better braced for the policy shift than they were just three months ago. Consider the following:

- The funds futures strip prior to the FOMC rate hike was reflective of more than 100 bp in potential rate hikes by the end of this year, while the Eurodollar curve suggested cumulative rate hikes of 250-300 bp by the end of 2005 (see Chart 9).

- Just prior to the June FOMC meeting, yields on the 2-year note traded more than 180 bp above the target funds rate, compared with just +60 bp just prior to the release of the March payroll report (see Chart 10).

- Re-pricing was not limited exclusively to the front end. Yields had also risen between 130-145 bp across the short/intermediate sector of the coupon curve since mid-March.
- With 10-year/2-year term spreads hovering around the +200 basis point mark, the intermediate/long sector of the curve is arguably even better insulated than the front end for expected Fed rate action (see Chart 11).

Chart 9: 30-Day Eurodollar Futures Strip

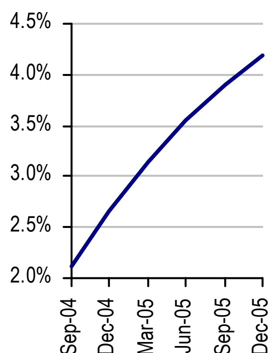


Chart 10: 2-Year Treasury Yield Less Fed Funds Rate

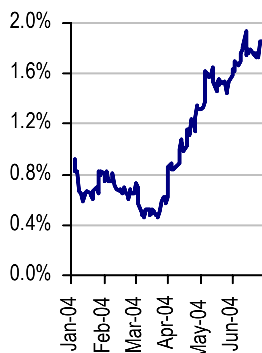
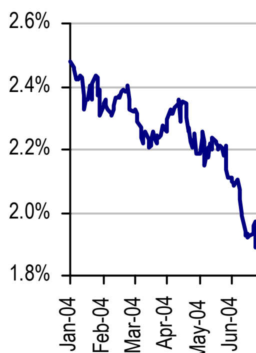


Chart 11: 10s/2s Spread



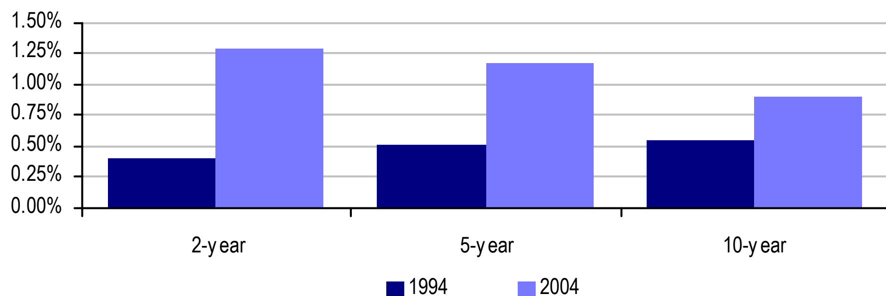
Source: Bloomberg

What made the 1994 tightening cycle so acute was not only the magnitude of the rate hikes, but also how complacent forward curves were in pricing for the impact of a policy shift

Bonds appear much better braced for Fed tightening than they were back in 1994. Keep in mind that 1994 represents the most aggressive tightening campaign in recent memory—and also marks the worst single-year performance for bonds in a generation. *What made the 1994 tightening cycle so acute was not only the magnitude of the rate hikes, but also how complacent forward curves were in pricing for the impact of a policy shift*. This time around, market participants have been much more aggressive in responding to the threat of a protracted cycle. Evidence includes:

- The yield moves over the past three months prior to the June rate hike were about *two- three times* the back-up in yields seen during the three months prior to the first rate hike in 1994 (see Chart 12).

Chart 12: Pre-Tightening Yield Changes—Three Months Prior to Initial Rate Hike



Source: Bloomberg

- Trading within the Eurodollar futures market was consistent with a much more aggressive campaign than had been priced in prior to the beginning of the 1994 tightening cycle.

- While forward curves implied yield increases of between 45-75 bp over a 12-month horizon just prior to the first Fed move in 1994, pricing within the forward curve ahead of the June FOMC meeting was reflective of rate increases between 60-130 bp over the following 12 months.

Bond Yields Still Biased Higher

Bond yields have tended to track movements in the target funds rate fairly closely over time

But while bonds are much better positioned for the beginning of the tightening cycle than they were back in 1994—or even just three months ago—it remains our view that yields are biased higher as the Fed continues the process of raising rates. Keep in mind that bond yields have tended to track movements in the target funds rate fairly closely over time (see Table 11).

Table 11: Correlation With Target Fed Funds Rate

T-Bond	Correlation
2-year	95%
5-year	88%
10-year	81%
30-year	74%

Source: Bloomberg

There is no precedent for yields cresting at the very beginning of a tightening cycle

During three of past four tightening cycles, yields across much of the coupon curve continued to rise along with the funds rate. The only exception was the 1994-95 cycle, during which yields on the long end of the curve crested and began to decline before the Fed had actually completed the tightening cycle. So, while yields have occasionally peaked out before the Fed has finished raising rates, there is *no precedent for yields cresting at the very beginning of a tightening cycle*.

In an effort to try to quantify just how much of the tightening cycle has already been reflected in pricing along the curve—and how much has yet to be discounted—we relied upon a simple one-factor least squares regression model with the target funds rate as the independent variable. As we already noted, yields have tended to track movements in the target funds rate fairly closely over time as suggested by correlations ranging from 75-95% across the coupon curve. Utilizing a forecast for the target Fed funds rate should therefore offer a relatively fair assessment of potential re-pricing along the coupon curve as the Fed extends the tightening cycle. For this analysis we employed UBS Chief U.S. Economist Dr. Maury Harris's forecast for 100 basis points in rate hikes this year and 200 bps next year (or 50 bps per quarter over the next six quarters). Our simple regression model yielded the following results found in Table 12:

- Yields are currently around the levels that would have been expected for the first two one-quarter-point rate hikes. So, in our view bonds already appear fairly well positioned for the initial stages of the tightening cycle.

- However, as the tightening cycle deepens beyond the initial 50-basis-point move, treasury yields would be projected to breech current yield levels.

- 10-year note yields would be expected to approach the 6% mark by Q405 given a target funds rate of 4%. This compares with Dr. Harris's forecast for a 5.3% calendar average during 2005, and our own "fair value" model projection of 5.25% for the 10-year note given current growth and inflation assumptions.

- Expected yield increases are much higher along the short/intermediate sector, consistent with a curve-flattening trend.

- This single-factor model appears to offer a fairly good fit, with an adjusted "r-squared" ranging from nearly .90 for the 2-year note to more than .65 for the 10-year.

Table 12: Treasury Regression Model Analysis—Actual Versus Projected

	Current			Projected				
	Actual	Q2-04	Q3-04	Q4-04	Q1-05	Q2-05	Q3-05	Q4-05
Fed Funds	1.00	1.00	1.50	2.00	2.50	3.00	3.50	4.00
2-year	2.87	2.01	2.45	2.89	3.34	3.78	4.22	4.67
5-year	3.96	3.22	3.59	3.96	4.32	4.69	5.06	5.43
10-year	4.74	4.08	4.39	4.71	5.02	5.34	5.65	5.96

Source: UBS Fixed Income Strategy

10-year note yields would be expected to approach the 6% mark by Q405 given a target funds rate of 4%

Conclusion and Recommendations

While bonds are arguably much better positioned for a shift in monetary policy than they were either three months ago (or just prior to the 1994 cycle) as evidenced by the post-meeting rally, the notion that yields already fully reflect the full impact from a tightening cycle strikes us as wishful thinking. Keep in mind that a tightening cycle—regardless of how measured it may ultimately turn out to be—is never an entirely benign affair. And with the target funds rate still at least 225 basis points below what many consider to be a "neutral" policy stance, the current cycle is apt to be an extended one, in our view. Of course, bond yields could well peak out before the end of the tightening cycle: this is exactly what happened back in 1994. However, as we see it, it is difficult to imagine a scenario where yields crest just as the tightening cycle begins. The recent mini-rally following the FOMC meeting and weaker than expected jobs report is symptomatic of a bond market struggling with assessing the aggressiveness of future Fed policy, not the direction of that policy. So, while yields had risen sharply in anticipation of a policy shift, bondholders remain in harm's way as the Fed embarks on a tightening cycle that is likely to extend well into 2005.

Against this still-threatening backdrop, we recommend:

- **Retain a duration underweight.** While forward curves have been categorized as "punitive," it remains our view that a defensive stance is still warranted. We recommend that accounts retain a duration underweight with the Fed having now initiated a tightening cycle that is likely to extend well into 2005 and could include cumulative rate increases of 300 basis points or more.

- **Continue to overweight spread product (non-treasuries).** A steady narrowing of risk premiums during 2003 and early 2004 has led to marked deterioration in valuation within most non-treasury sectors. However, we continue to recommend an overweight in spread product amid prospects for still higher rates, improvement in credit conditions, and moderate levels of volatility.

- **Stick with premium paper.** With capital gains opportunities limited against a backdrop of higher rates and Fed tightening, we recommend that accounts continue to position within higher coupon premium paper. The higher current yield and somewhat lower duration versus par bonds suggests premium paper offers both better near-term return prospects and more limited downside risk.

- **Selective floating rate debt.** Historically low short-term rates coupled with an exceptionally steep yield curve have served to limit opportunities within the front of the curve. However, with the Fed now poised to begin the process of raising rates, floating rate debt now offers a more attractive return profile over the balance of the next six-12 months.

Preferred Securities—Modest Underweight

Raise Exposure to Floating Rate Securities; Underweight Duration

During the second quarter of 2004, preferreds witnessed the largest quarterly price decline since 1999

During the second quarter of 2004, UBS Preferred Securities Strategist Kurt Reiman notes that preferreds witnessed the largest quarterly price decline since 1999. Since the mid-March trough in interest rates, yields on 10-year treasuries have risen by roughly 100 basis points. Given the magnitude of the bond market correction and the high degree of interest rate sensitivity of most preferred securities, the reaction has been swift and severe. Modestly deteriorating corporate credit conditions as bond yields turned higher exaggerated the decline.

Although there has been significant price erosion over the past few months, the sell-off has not been uniform across all groups of preferred securities. Although most preferreds are either long-dated or perpetual, they are also issued with five-year call options. As a result, preferreds that are approaching their first call date tend to be less sensitive to interest rate moves because the market expects the securities to be called at par. Conversely, preferreds that are not callable for another four to five years tend to be more highly sensitive to interest rate changes. As a result, preferreds with longer call protection periods have shed more than 10% of their value over the past quarter, whereas preferreds with shorter call protection periods are only off 1-4% (see Chart 13).

Preferreds with longer call protection periods have shed more than 10% of their value over the past quarter, whereas preferreds with shorter call protection periods are only off 1-4%

Chart 13: Average Total Return in 2004 Q2 of Various Buckets of Preferreds

Note: Each basket of preferreds is grouped according to length of call protection period.
Source: Bloomberg

Spreads widened considerably during early May following the release of the April employment report and the ensuing sell-off in fixed-income markets. Our preferred option-adjusted spread (OAS) index rose from 120 basis points early in 2004 to a peak of 220 basis points versus treasuries. The combination of higher trading volume and heightened price volatility during that period may have exaggerated the weakness. However, a more stable interest rate environment heading into June coupled with strength in swap spreads provided a backdrop for preferred prices to recover somewhat and for spreads to richen back from the oversold levels witnessed in early May. (See Chart 14.)

Chart 14: Preferred OAS Index Versus Treasuries (%)

Source: Bloomberg and UBS

We recommend that accounts maintain a modest underweight of the preferred market

For the third quarter, we recommend that accounts maintain a modest underweight of the preferred market (equivalent to 9% of total fixed-income holdings versus a neutral allocation of 10%). The primary justification for our underweight continues to rest with the outlook for higher interest rates and is consistent with the UBS fixed income strategy group's overall duration underweight. Moreover, we also do not see much compelling relative value in preferreds since preferred spreads are well below the level that prevailed in early May.

Within the preferred securities universe, we recommend that accounts:

- **Reduce exposure to long-duration preferreds.** These securities tend to exhibit the greatest negative response to rising interest rates relative to the average for the overall preferred market, and they also carry some of the lowest income distributions.

- **Shift into preferreds with short call protection periods.** Although the price of these premium securities will tend to decline toward par as the first call date approaches, the income return will likely outstrip any principal erosion.

- **Raise exposure to floating-rate preferreds.** In particular, we recommend short-term LIBOR-based floating-rate preferreds with frequent (monthly or quarterly) reset provisions. These preferreds will likely experience less price volatility and will begin to participate in rising income distributions as Fed tightening continues.

Table 13: Selected Buy-Rated Preferred Securities

Issuer	Coupon (%)	First Call Date	Maturity	Symbol	YTC(%)
Household Capital Trust VI	8.250	1/30/2006	01/30/2031	HI pr F	5.230
Lehman Brothers Holdings	float	2/15/2009	Perpetual	LEH pr G	2.325
Duke Realty Corporation	8.450	2/1/2006	Perpetual	DRE pr I	6.267
HRPT Properties Trust	9.875	2/22/2006	Perpetual	HRP pr A	5.953

Source: UBS

Closed-End Funds: Less Pain to Come?

During Q204, as bond yields rose, closed-end prices fell 6-11% across all sectors, with the exception of senior loan funds.

Closed-end prices fell 6-11% across all sectors, with the exception of senior loan funds

Table 14: Current Yields and Valuations as of June 30, 2004

Sector	Premium (Discount)	Current Yield	NAV Return since April 1	Market Return since April 1
Senior Loan	7.2%	4.8%	1.9%	0.3%
National Non-Leveraged	-9.3%	6.7%	-1.2%	-6.2%
High Yield	4.2%	10.0%	0.1%	-6.5%
Multi-Sector	-9.9%	7.7%	-2.1%	-7.5%
California Funds	-8.7%	6.9%	-3.8%	-9.4%
National Leveraged	-8.6%	7.0%	-3.4%	-10.1%
New York Funds	-8.9%	6.8%	-4.1%	-10.9%

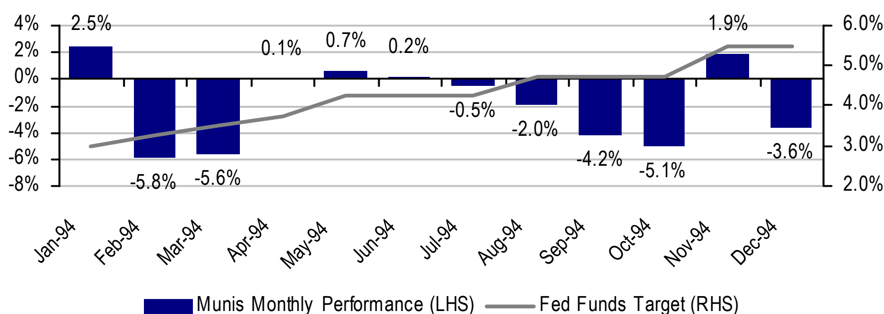
Source: Bloomberg

Prior Tightening Cycles

UBS closed-end fund analysts Jon Maier and Sangeeta Marfatia thought it timely to analyze two prior tightening cycles, 1994 and 1999, in light of the recent rate hike. For purposes of this discussion they focus on closed-end municipal funds.

1994: Municipal closed-end fund stock prices declined dramatically coinciding with the largely unanticipated length and depth of fed rate hikes. Overall muni fund net asset values were down 8%, and on average, the stocks were down 14% on a total return basis.

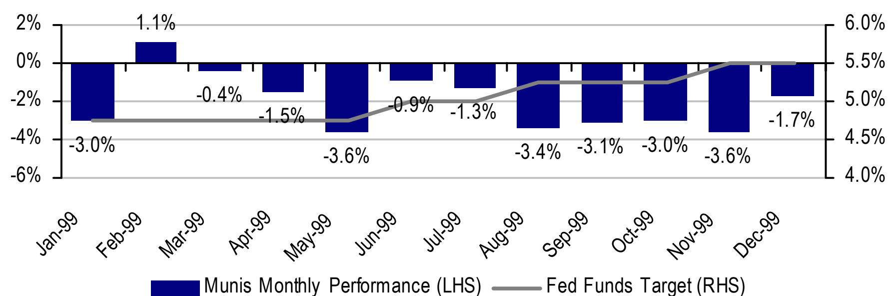
Chart 15: Monthly Performance of Funds Under Coverage 12 Months Following First Fed Rate Increase in 1994



Source: FactSet

1999: Fund prices started to decline *before* the initial rate hike and continued to fall throughout the remainder of the year, as 10-year treasury yields rose 180 bp from 4.63% in January to 6.43% in December. Overall, muni fund net asset values were down on average 6% in 1999, and on average, the stocks were down 18% on a total return basis.

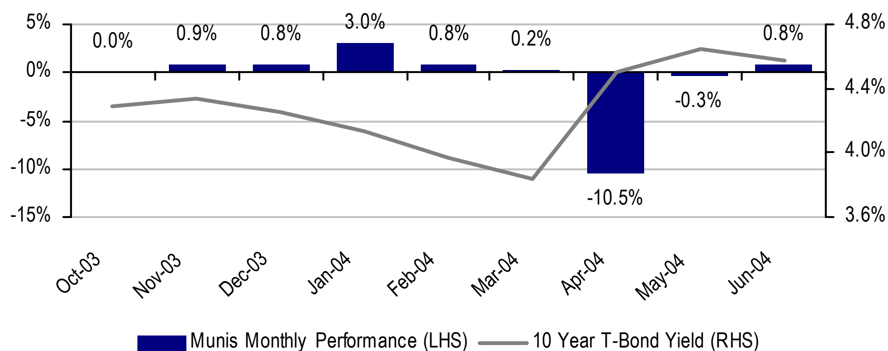
Chart 16: Monthly Performance of Funds Under Coverage 12 Months Following First Fed Rate Increase in 1999



Source: FactSet

2004: In April as the 10-year treasury yield rose to 4.5% from 3.7%, fund prices declined over 10% (see Chart 17). As discounts widened and the average yield on muni funds has reached 7%, prices have stabilized.

Chart 17: Performance of Funds Under Coverage Versus 10-Year Treasury for Six Months Preceding Expected Fed Rate Increase



Source: FactSet

We expect closed-end fund stock prices to be relatively stronger during this tightening cycle

Conclusion: We expect stock prices to be relatively stronger this tightening cycle given both the dramatic pre-tightening price decline experienced in April and the UBS economics group's forecast for a fairly modest rise in the 10-year treasury yield to 5.0% by year-end 2004, and 5.5% by year-end 2005. Additionally, greater stability of dividends, lack of alternatives to replace income, lower fund durations and the projected "measured" pace of future Fed rate hikes relative to past cycles should provide these funds with better performance than previous tightening cycles. The greatest risk to these funds is rates rising faster, and by a greater amount, than anticipated.

Recommendations

- **Municipals.** Below we point investors to two muni funds for the stability of their dividends and sizeable cushions of undistributed net investment income (cushions). Yet we maintain our Neutral ratings: BlackRock Investment Quality Municipal (BKN) and BlackRock Municipal Income Trust (BFK).

- **Taxable.** We continue to find attractive leveraged taxable funds that have hedged their leverage either in part or in full such as Evergreen Income Advantage Fund (EAD), Pioneer High Income Trust (PHH), Nicholas Applegate Convertible and Income Fund (NCV). Non-leveraged favorites are Putnam Master Intermediate (PIM), Putnam Premier Income (PPT), and Managed High Income (MHY).

- **Reduce-rated funds.** We also recommend that investors reduce their position in ACM Income Fund (ACG) and Salomon Bros High Income Fund II (HIX) owing to dividend risk.

Appendix A: Economic Indicators

Chart 18: Real GDP

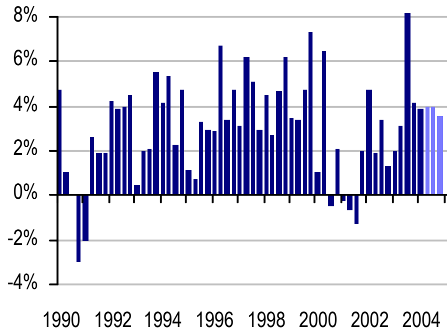
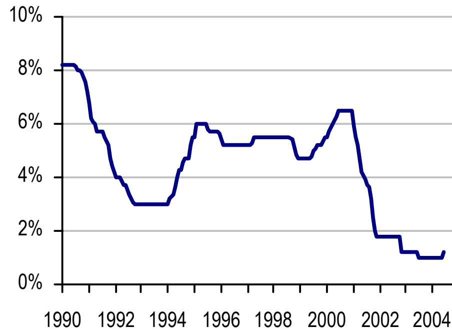


Chart 19: Fed Funds Target Rate



As expected, the Fed raised the federal funds rate 25 bp to 1.25% at the June FOMC meeting. Key question now is the timing and magnitude of future Fed moves

Chart 20: Unemployment Rate

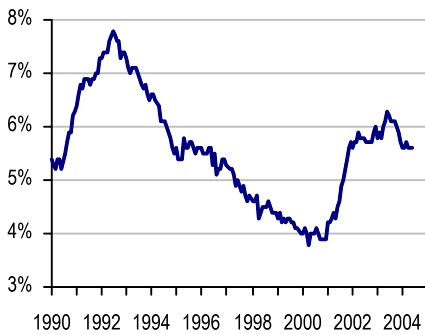
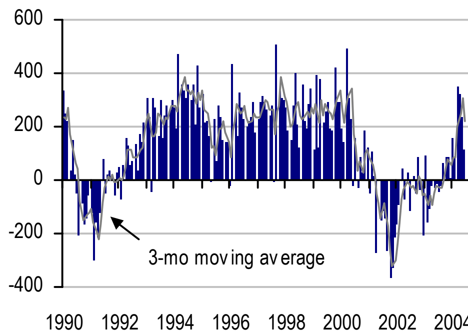


Chart 21: Nonfarm Payroll (monthly change)



Despite a disappointing June labor report, more than half of the jobs that were lost from 3/01 to 8/03 (2.7 mil.) have been created in the last ten months (1.5 mil.)

Chart 22: Inflation—CPI & PPI

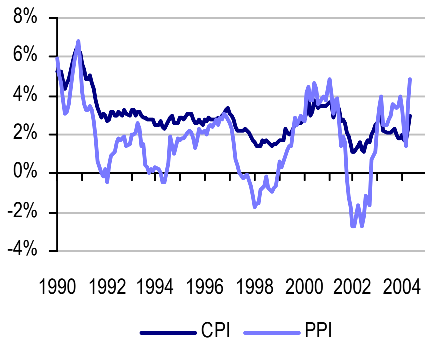
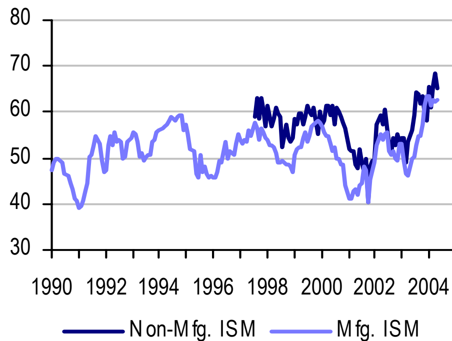


Chart 23: ISM—Mfg & Non-Mfg.



Consumer prices have risen sharply in the last two months…as the ISM continues to signal expansion at a brisk pace

Chart 24: Confidence/Optimism Surveys

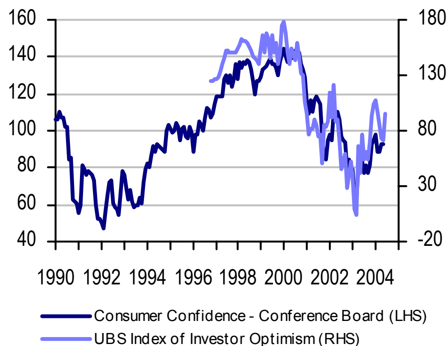
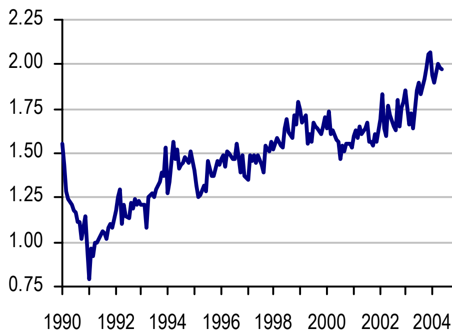


Chart 25: Housing Starts

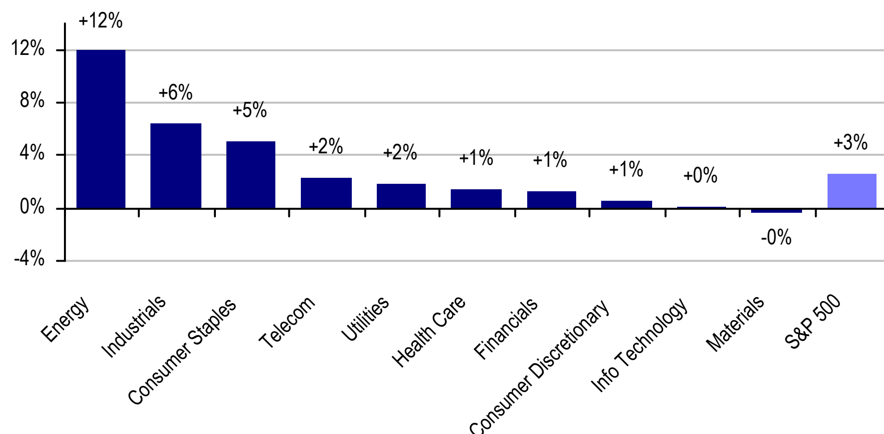


Confidence bounced back in June, after weakening in April and May, but levels are still slightly off peak levels from December/January

Sources for Charts 18-25: Bureau of Economic Analysis, Bureau of Labor Statistics, Census Bureau, Conference Board, Federal Reserve Board, Institute for Supply Management, UBS estimates

Appendix B: S&P 500 Performance Summary

Chart 26: S&P 500 Performance by Sector—2004 Year to Date



Through June 30, 2004. Source: FactSet

Table 15: Best- and Worst-Performing S&P 500 Stocks by Sector—2004 Year to Date

Consumer Discretionary—Best	Ticker	% chg	Consumer Discretionary—Worst	Ticker	% chg
Penney (J C) Co	JCP	44%	Clear Channel Communications	CCU	-21%
EBay Inc	EBAY	42%	Univision Communications Inc	UVN	-20%
Dillards Inc -Cl A	DDS	35%	Viacom Inc -Cl B	VIA.B	-20%
Starbucks Corp	SBUX	31%	Tiffany & Co	TIF	-18%
Harley-Davidson Inc	HDI	30%	Sears Roebuck & Co	S	-17%
Consumer Staples—Best			**Consumer Staples—Worst**		
Avon Products	AVP	37%	Winn-Dixie Stores Inc	WIN	-28%
Coca-Cola Enterprises	CCE	33%	Altria Group Inc	MO	-8%
Coors (Adolph) -Cl B	RKY	29%	Sysco Corp	SYY	-4%
Pepsi Bottling Group Inc	PBG	26%	Kroger Co	KR	-2%
Hershey Foods Corp	HSY	20%	Wal-Mart Stores	WMT	-1%
Energy—Best			**Energy—Worst**		
Valero Energy Corp	VLO	59%	El Paso Corp	EP	-4%
Amerada Hess Corp	AHC	49%	Kinder Morgan Inc	KMI	0%
Burlington Resources Inc	BR	31%	Unocal Corp	UCL	3%
EOG Resources Inc	EOG	29%	Rowan Cos Inc	RDC	5%
BJ Services Co	BJS	28%	Noble Corp	NE	6%
Financials—Best			**Financials—Worst**		
Countrywide Financial Corp	CFC	39%	Schwab (Charles) Corp	SCH	-19%
MGIC Investment Corp/Wi	MTG	33%	Synovus Financial Cp	SNV	-12%
Charter One Financial Inc	CF	28%	E Trade Financial Corp	ET	-12%
Providian Financial Corp	PVN	26%	M & T Bank Corp	MTB	-11%
Loews Corp	LTR	21%	Bank Of New York Co Inc	BK	-11%

Table 15 (cont'd): Best- and Worst-Performing S&P 500 Stocks by Sector—Q104

Health Care—Best	Ticker	% chg	Health Care—Worst	Ticker	% chg
Biogen Idec Inc	BIIB	72%	Watson Pharmaceuticals Inc	WPI	-42%
Bard (C.R.) Inc	BCR	39%	Humana Inc	HUM	-26%
Millipore Corp	MIL	31%	King Pharmaceuticals Inc	KG	-25%
Caremark Rx Inc	CMX	30%	Chiron Corp	CHIR	-22%
Stryker Corp	SYK	29%	Mylan Laboratories	MYL	-20%
Industrials—Best			**Industrials—Worst**		
Apollo Group Inc -Cl A	APOL	30%	Delta Air Lines Inc	DAL	-40%
Cummins Inc	CMI	28%	American Pwr Cnvrsion	APCC	-20%
Robert Half Intl Inc	RHI	28%	Navistar International	NAV	-19%
Tyco International Ltd	TYC	25%	Union Pacific Corp	UNP	-14%
Grainger (W W) Inc	GWW	21%	Block H & R Inc	HRB	-14%
Information Technology—Best			**Information Technology—Worst**		
Autodesk Inc	ADSK	74%	QLogic Corp	QLGC	-48%
Andrew Corp	ANDW	73%	Ciena Corp	CIEN	-44%
Yahoo Inc	YHOO	62%	PMC-Sierra Inc	PMCS	-29%
Apple Computer Inc	AAPL	52%	Sanmina-SCI Corp	SANM	-28%
Waters Corp	WAT	44%	Intuit Inc	INTU	-27%
Materials—Best			**Materials—Worst**		
Nucor Corp	NUE	37%	Freeprt Mcmor Cop&Gld -Cl B	FCX	-21%
Allegheny Technologies Inc	ATI	37%	Newmont Mining Corp	NEM	-20%
Monsanto Co	MON	34%	Alcoa Inc	AA	-13%
Louisiana-Pacific Corp	LPX	32%	Du Pont (E I) De Nemours	DD	-3%
Ball Corp	BLL	21%	Rohm & Haas Co	ROH	-3%
Telecom—Best			**Telecom—Worst**		
AT&T Wireless Services Inc	AWE	79%	AT&T Corp	T	-28%
Alltel Corp	AT	9%	Qwest Communication Intl Inc	Q	-17%
Sprint FON Group	FON	7%	Centurytel Inc	CTL	-8%
Verizon Communications	VZ	3%	Bellsouth Corp	BLS	-7%
Citizens Communications Co	CZN	-3%	SBC Communications Inc	SBC	-7%
Utilities—Best			**Utilities—Worst**		
TXU Corp	TXU	71%	TECO Energy Inc	TE	-17%
Allegheny Energy Inc	AYE	21%	Calpine Corp	CPN	-10%
Centerpoint Energy Inc	CNP	19%	Public Service Entrp Grp Inc	PEG	-9%
Edison International	EIX	17%	Consolidated Edison Inc	ED	-8%
Sempra Energy	SRE	15%	Ameren Corp	AEE	-7%

Source: Reuters, UBS

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UBS Investment Research: Global Equity Ratings Definitions and Allocations

UBS rating	Definition	UBS rating	Definition	Rating category	Coverage[1]	IB services[2]
Buy 1	FSR is > 10% above the MRA, higher degree of predictability	**Buy 2**	FSR is > 10% above the MRA, lower degree of predictability	**Buy**	44%	33%
Neutral 1	FSR is between -10% and 10% of the MRA, higher degree of predictability	**Neutral 2**	FSR is between -10% and 10% of the MRA, lower degree of predictability	**Hold/Neutral**	48%	31%
Reduce 1	FSR is > 10% below the MRA, higher degree of predictability	**Reduce 2**	FSR is > 10% below the MRA, lower degree of predictability	**Sell**	7%	28%

1: Percentage of companies under coverage globally within this rating category.

2: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS; as of 30 June 2004.

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.
Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (an approximation of the equity risk premium).
Predictability Level The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities.
Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.
Rating/Return Divergence (RRD) This qualifier is automatically appended to the rating when stock price movement has caused the prevailing rating to differ from that which would be assigned according to the rating system and will be removed when there is no longer a divergence, either through market movement or analyst intervention.

EXCEPTIONS AND SPECIAL CASES

US Closed-End Fund ratings and definitions are: Buy: Higher stability of principal and higher stability of dividends; Neutral: Potential loss of principal, stability of dividend; Reduce: High potential for loss of principal and dividend risk.
UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Reduce: Negative on factors such as structure, management, performance record, discount.
Core Banding Exceptions (CBE): Exceptions to the standard +/-10% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Companies Mentioned table in the relevant research piece.

Companies mentioned

Company Name	Reuters	Rating	Price
ACM Income Fund	ACG.N	Reduce	US$7.96
BR Inv. Qlty. Trust2[2a,4a]	BKN.N	Neutral	US$13.90
BlackRock Municipal[2b,4a]	BFK.N	Neutral	US$13.02
Managed High Income	MHY.N	Buy	US$6.42
Nicholas-Applegate[2b]	NCV.N	Buy	US$15.74
Pioneer Trust[2c,4b,6]	PHH.N	Buy	US$15.80
Putnam Master Interm	PIM.N	Buy	US$6.46
Putnam Premier Incom	PPT.N	Buy	US$6.18
Salomon Brothers	HIX.N	Reduce	US$12.22

Price(s) as of 5 July 2004. Source: UBS.

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Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

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