UBS

Fixed Income Strategy

Americas

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Market Comment

UBS Wealth Management Research
On the Run

US Government Commentary

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www.ubs.com/financialservicesinc

Michael P. Ryan, CFA
Research Director
mike.ryan@ubs.com
+1-212-713 4671

Anne Briglia, CFA
Lead Strategist
anne.briglia@ubs.com
+1-212-713 3149

Jennelyn Tanchua
Strategist
jennelyn.tanchua@ubs.com
+1-212-713 3553

Viktoria Beromelidze
Associate Strategist
viktoria.beromelidze@ubs.com
+1-212-713 9854

■ Overview
The data on inflation, housing, and manufacturing should be important drivers of the price action over the next two weeks. Looking further ahead, the data between the March and May 10 FOMC meetings should cool enough to keep the Fed on hold, with the fed funds rate topping out at 4.75%.

■ Yield Curve
The potential for the 2-year note auction to be postponed because of the debt ceiling has dampened selling pressure in the front end of the curve.

■ Agencies
We maintain a modest overweight allocation in agencies as the credit dynamics of the market have improved. Valuation levels still appear attractive, despite the 2 to 5 basis point narrowing in bullet spreads this year. Given the flatness of the Treasury curve and the low absolute level of bond yields, we believe investors will continue to look to the agency market for incremental income.

■ Publication Note: Final Edition of On The Run
As part of our continuing mission to deliver research tailored to the needs of individual investors, we are discontinuing On The Run and introducing the Fixed Income Guide in April. This new Wealth Management Research publication will provide commentary on developments in the bond markets and recommendations for allocation and duration management.

This report has been prepared by UBS Financial Services Inc.

ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 5

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Overview

Fed Rate Decision Looms

The data on inflation (CPI, PPI), housing (starts and permits; new and existing home sales; mortgage applications), and manufacturing (Philadelphia Fed survey) should be important drivers of the price action over the next two weeks. With the Fed about to enter a quiet period before the March 28 FOMC meeting, the market's focus should rest squarely on the data. The consensus expectation is for tame readings on the inflation data, further evidence of slowing in the housing sector, and a steady reading on the Philadelphia Fed survey. (See Table 1.) Looking further ahead, the data between the March and May 10 FOMC meetings should cool enough to keep the Fed on hold, with the fed funds rate peaking at 4.75%, where we expect it will hold steady for the balance of the year.

Table 1: Select Economic Indicators

Date	Indicator	Period	Time	Consensus	Last
3/16/2006	CPI (MoM)	February	8:30 AM	0.10%	0.70%
3/16/2006	CPI, ex food & energy (MoM)	February	8:30 AM	0.20%	0.20%
3/16/2006	CPI (YoY)	February	8:30 AM	3.75	4.00%
3/16/2006	CPI, ex food & energy (YoY)	February	8:30 AM	2.10%	2.10%
3/16/2006	Housing starts	February	8:30 AM	2,030k	2,276k
3/16/2006	Building permits	February	8:30 AM	2,110k	2,217k
3/16/2006	Philadelphia Fed	March	12:00 PM	13.5	15.40%
3/21/2006	PPI (MoM)	February	8:30 AM	-0.20%	0.30%
3/21/2006	PPI, ex food & energy (MoM)	February	8:30 AM	0.20%	0.40%
3/23/2006	Existing home sales	February	10:00 AM	6.50m	6.56m
3/24/2006	New home sales	February	10:00 AM	1.210k	1.233k

Source: Bloomberg

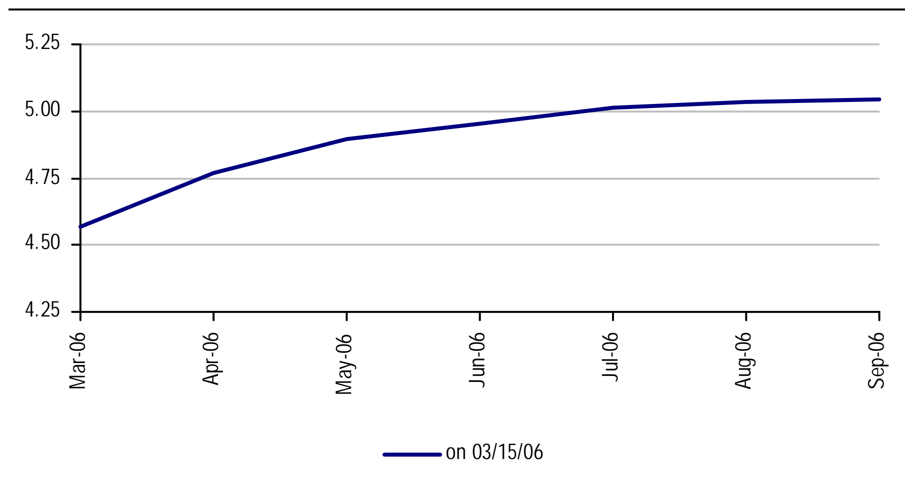
Although our economists foresee just one more tightening from the Fed, the consensus view anticipates additional rate hikes. (See Chart 1.) Presently, the fed funds futures contract is pricing an 82% probability of a rate increase in May and a smaller 6% probability of a June increase. Consensus expectations for additional tightening should help to temper the recent resteepening of the curve, particularly after the debt ceiling limit is raised.

Debt ceiling limit threatens to disrupt Treasury calendar

The Treasury may bump up against the debt ceiling limit over the next several weeks, depending on the magnitude of corporate tax receipts, the amount of issuance of nonmarketable debt, and whether Congress acts to increase the debt ceiling before recessing on March 17. Congress could lift the debt ceiling before leaving Washington this Friday. However, if Congress delays raising the debt ceiling until returning on March 27, it is possible Treasury would have to postpone the announcement of the 2 and 5-year auctions which is scheduled for March 23. The 2 and 5-year issues are slated to be auctioned on March 27 and March 29, respectively, for settlement on March 31. In addition, there could be a

disruption to bill sales, producing a bunching of issuance at the end of the quarter.

Chart 1: Fed Funds Futures Strip (%)



Source: Chicago Board of Trade

Yield curve continues to steepen

After flirting with inversion several times in December and January, the yield curve became inverted on a sustained basis in February, with the 10s/2s term spread trading as negative as minus 17. In early March, however, the inversion was nearly erased on profit taking on curve trades ahead of the February employment report. And over the last two weeks, the curve has continued to resteepen, with the 10s/2s term spread trading at +8 on March 15. The potential for the 2-year note auction to be postponed because of the debt ceiling has also helped limit selling pressure in the front end of the curve and helped to bias the curve steeper. Because of large short positions in the issue, the 2-year note is trading very special in the repo market. (The 2-year has traded in the 0.25% to 0.50% area in the repo market versus 4.5% for general collateral). Once this technical condition is corrected, however, we would expect the front end to trade heavy, given consensus expectations for additional Fed tightening.

Agency spreads steady

Agency spreads were little changed over the last two weeks, with bullet spreads a basis point wider in the 3 and 5 year area and unchanged in the back end of the curve. The 6 bps widening in bullet spreads versus Treasuries was largely a function of the richness of the 2-year note which was squeezed in the repo market. The yield on the 2-year note is trading approximately 5 bps rich to sounding issues. Benchmarked against Libor, however, bullet spreads were just 1.3 bps wider in 2-years and unchanged to 0.5 bps wider along the rest of the curve.

The agency market shrugged off Fannie Mae's announcement on March 13 that it has uncovered additional accounting errors. The latest batch of errors relate to accounting for guaranty fees and foreclosure costs. In a statement accompanying the announcement, Fannie Mae CEO Daniel Mudd said Fannie Mae has finished identifying accounting issues and would likely complete a restatement of its

financials in the second half of the year. Market reaction was also muted to the testimony on March 14 from former Senator Rudman before the House Committee on Financial Services. Rudman characterized Fannie Mae's culture as arrogant, noted it had few checks and balances, and broke accounting rules in order to smooth earnings. These latest developments, together with an upcoming report from OFHEO that may be released at the end of March, could give a boost to stalled GSE reform efforts by putting the issue back in the spot light. Still, given the shorter legislative calendar during this election year and the significant difference between the House and Senate proposals, we believe the chance of GSE reform legislation passing this year is a 50-50 proposition.

We are maintaining a modest overweight allocation in the agency sector as the credit dynamics of the market have improved. In addition, valuation levels still appear attractive, despite the 2 to 5 basis point narrowing in bullet spreads this year. Given the flatness of the Treasury yield curve and the low absolute level of bond yields, we believe investors will continue to be attracted to market sectors that offer incremental income. Finally, the modest increase in supply expected this year, following a contraction in the size of the market last year, should be easily absorbed without pressuring spreads much wider.

Table 2: Callable Issuance and Redemption Activity ($ millions)

	Redemptions				*Callable Issuance*				
Week Ending	FNMA	FHLMC	FHLB	*Total*	FNMA	FHLMC	FHLB	Total	Net Total
3/10/2006	0	0	154	*154*	255	1,894	2,492	*4,641*	*4,487*
3/3/2006	0	50	850	*900*	780	3,714	2,647	*7,141*	*6,241*
2/24/2004	45	35	357	*437*	4,335	3,239	1,959	*9,533*	*9,096*
2/17/2006	100	0	482	*582*	1,892	1,371	3,658	*6,921*	*6,339*
2/10/2006	200	0	265	*465*	2,473	2,202	2,509	*7,184*	*6,719*
2/3/2006	125	0	160	*285*	1,035	3,296	1,531	*5,862*	*5,577*
2006 YTD Average	62	49	505	*617*	1,634	2,313	1,870	*5,817*	*5,201*
2006 YTD Total	620	493	5,053	*6,166*	16,342	23,133	18,696	*58,171*	*52,005*

Source: FNMA, FHLMC, FHLB (Data through 03/10/06)

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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**	11%	30%

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 31 December 2005.

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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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