UBS

Fixed Income Strategy

Americas

-

Market Comment

UBS Investment Research

Quarterly Market Outlook

12 July 2005

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

Kurt E. Reiman
Lead Strategist
kurt.reiman@ubs.com
+1-212-713 3128

Jeremy A. Zirin, CFA
Strategist
jeremy.zirin@ubs.com
+1-212-713 1219

Navigating a Tight Spot

Gauging the Market Impact at the End of the Tightening Cycle

The future course of monetary policy will require greater discretion as the tightening cycle draws to a close. Precisely how the terminal phase of this tightening cycle plays out is likely to have a material impact on equity and fixed income return prospects in the second half of this year.

Past Not Prologue

The end of the tightening cycle has historically been greeted with enthusiasm by the bond market but largely with ambivalence by the equity market. However, several critical aspects of this cycle differ materially from prior periods of Fed tightening. Thus, we believe financial markets may react differently this time around.

Equities: Modest Upside

Although performance has varied, it is instructive to note that the ends of the four prior tightening cycles have not been systematically negative for equity market returns. We estimate a year-end fair value range for the S&P 500 of 1230-1280, about 1-5% above current levels.

Fixed Income: No End-of-Cycle Rally in Sight

We believe increasing inflation pressures and solid economic growth will force bond yields higher in the intermediate and long end of the maturity spectrum in the months ahead. We recommend: underweight duration; a modest overweight exposure to municipals and mortgages; and a neutral curve allocation.

This report has been prepared by UBS Financial Services Inc.

ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 3

Summary and Key Conclusions

- We expect the terminal phase of the tightening cycle to lead to modestly positive equity market returns but somewhat higher yields in the bond market. Our key macroeconomic forecasts are:
  - *Real GDP* growth of 3.6% in 2005 and 3.0% in 2006, down from 4.4% in 2004, but still near trend levels.
  - *S&P 500 EPS* growth of 11% in 2005 and 3% in 2006, down from 20% in 2004.
  - *Core CPI inflation* of 2.5% in 2005 and 2.8% in 2006, up from 2.1% in 2004.
  - *The Fed funds rate* rises to 4.0% by year-end from its current level of 3.25% as the Fed moves to the terminal phase of the tightening cycle.
- During the past four tightening cycles, equities, on average, have generated "normal" returns in the latter stages of the cycle, as well as three, six, and 12 months following the last rate hike. Market performance has varied in each cycle, but it is instructive to note that the ends (and endings) of past rate cycles have not been systematically negative for equity market returns.
  - **Modest upside for the S&P 500.** Estimated range of S&P 500 fair value for year-end is 1230-1280—a modest 1-5% above current levels.
  - **Pro-cyclicals getting cheap, well positioned for stronger growth.** Although current S&P 500 earnings remain robust and full-year earnings estimates have been rising, stock prices have been flat in 2005, with defensive sectors outperforming cyclicals. With economic growth "stronger for longer," we expect selected cyclical sectors to rebound.
- We believe increasing inflation pressures and solid economic growth will force bond yields higher in the intermediate and long end of the maturity spectrum in the months ahead. We recommend:
  - **Hold a market weight allocation to credit product** for incremental income on expectations of continued healthy profit growth, stable to rising equity markets, and continued strong economic activity.
  - **Limit bond and portfolio duration; pursue coupon-enhancing strategies.** Investors can manage interest rate risk by limiting duration.

  Adopt a laddered portfolio allocation. The magnitude of the flattening in the yield curve suggests limited potential for a significant further narrowing of term spreads.

■ Analyst Certification

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

Required Disclosures

This report has been prepared by UBS Financial Services Inc., an affiliate of UBS AG (UBS).

For information on the ways in which UBS manages conflicts and maintains independence of its research product; historical performance information; and certain additional disclosures concerning UBS research recommendations, please visit www.ubs.com/disclosures.

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**	40%	41%
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**	49%	43%
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%	35%

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 2005.

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.

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

Global Disclaimer

UBS