

Investment Strategy Guide

Wealth Management Research

2012 Outlook



Investing *at the crossroads*

Deleveraging headwinds restrain economic activity
Policy and politics dominate investment landscape
Maintain defensive stance entering 2012



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Editorial



Mike Ryan

Dear reader,

As we close the books on 2011, we reflect on one of the most challenging and eventful years since the onset of the global financial crisis and Great Recession. The fact that equity markets in the US are ending the year pretty much where they began belies the extraordinary events that transpired over the past 12 months. Markets were often whipsawed this year by events ranging from radical leadership changes that rippled across the Middle East and North Africa to the escalation of the debt crisis within the eurozone to the first downgrade of the sovereign credit rating in the US.



Stephen Freedman

So what will 2012 hold for investors? There is a tendency to view the immediate future as merely an extension of the most recent past. Given the current environment, this may be tempting but would also be imprudent. The world has arrived at a crossroads as we enter 2012: voters face tough decisions over their country's future leadership, policymakers must choose between reviving economic growth and exerting fiscal discipline, and European officials have to pick between further integration or disintegration. So although many of the same challenges that prompted such a volatile repricing across financial markets in 2011 continue to fester, they are unlikely to play out in precisely the same manner during 2012. Moreover, other opportunities and threats are certain to emerge amid global balance sheet deleveraging, continued political leadership changes and simultaneous easing of monetary policy.

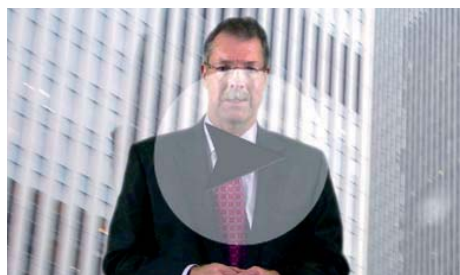
How then should investors position for the year ahead? We recommend entering 2012 with a modest defensive bias with underweights to global equities and commodities, and corresponding overweights to bonds and cash. We continue to avoid eurozone exposure, and instead prefer the US and emerging market equities. We also maintain our focus on both quality growth stocks and income-generating investments amid choppy and range-bound markets. And finally, we not only advocate more flexibility with regard to tactical positioning, but we also recommend that investors seek ways to leverage volatility in order to improve performance. Because while 2012 is certain to be yet another eventful year, we also want to make sure it is a prosperous one. Happy New Year!

A handwritten signature in black ink, appearing to read "Mike Ryan".

Mike Ryan, CFA
Chief Investment Strategist
Head, Wealth Management Research – Americas

A handwritten signature in black ink, appearing to read "Stephen Freedman".

Stephen Freedman, PhD, CFA
Head, Investment Strategy
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To watch Chief Investment Strategist Mike Ryan give a summary of this report, please click the play button.

Summary & Highlights

Outlook

We see three key trends playing out during 2012 that are likely to impact both the real economy and financial markets:

- **The pace of balance sheet deleveraging:** While the rebuilding of consumer savings has progressed and US banks largely have been recapitalized, European financial institutions now must deleverage balance sheets and governments need to seriously address their own fiscal imbalances.
- **Continued political leadership changes:** Leadership changes may well extend to some of the largest and most strategically important countries in the world including the US, France, India, Iran, Korea, Russia, Taiwan and China.
- **Simultaneous easing of monetary policy by major central banks:** While the pace and scope of policy actions will differ across regions, each of the major global central banks will be pursuing easier monetary policy conditions for the first time since the financial crisis.

Investment recommendations

We recommend that investors enter 2012 with a modest defensive bias that includes underweights to global equities and commodities, and corresponding overweights to bonds and cash. Additionally we recommend that investors:

- **Avoid the eurozone:** Within equity markets, continue to avoid eurozone exposure, but retain a preference for the US and increase exposure to the emerging markets.
- **Maintain a preference for growth stocks:** Favor growth over value stocks and sectors such as Technology, Consumer Staples and Healthcare which deliver high secular earnings and dividend growth, reasonable valuations and strong earnings achievability.
- **Focus on income:** Continue to focus on income-generating investments including high-yield bonds and dividend growth stocks to reap reasonable returns amid choppy, range-bound markets.
- **Remain opportunistic:** We advocate more flexibility with regard to tactical positioning and also recommend that investors seek ways to leverage elevated levels of market volatility to improve portfolio performance.

Risks

We see five primary threats to our baseline forecasts and market outlook:

- **Eurozone implosion:** A break-up prompted by a Greek default or downgrade of a core sovereign credit would trigger a more acute phase of the global financial crisis.
- **Hard landing in China:** An abrupt growth decline could prompt a global recession and a collapse in corporate profits given slow demand growth in developed economies.
- **QE3:** A third round of quantitative easing would lead to a sharp decline in the dollar and trigger both a fresh wave of inflation and new phase of central bank tightening in emerging markets.
- **Conflict with Iran:** Armed conflict would trigger a sharp surge in oil prices and further dampen global growth prospects.
- **Escalating social unrest:** Growing dissatisfaction could touch off a new round of leadership changes in both developed and developing nations.

Focus: Investing at the crossroads

We stand at a crossroads where the pace and scale of balance sheet deleveraging, political leadership change and easing of monetary policy will most profoundly impact the outcome for both the real economy and financial markets.

As we prepared this *Outlook* for 2012, we were struck by just how dependent economic fundamentals and market valuation had become upon the wisdom of policy choices and the will of political leaders. The economic recovery is still in a fragile state amid structural challenges – especially within the developed countries – suggesting that the margin between expansion and recession is an uncomfortably narrow one. Although risk assets appear attractively priced relative to most historical benchmarks, they are likely to remain so as long as concerns linger over sovereign risks and financial stress. We quite literally stand at a crossroads from an economic and political as well as a policy perspective. It is against this still challenging and uncertain backdrop that we see three trends playing out which are likely to have a profound impact on the outcome for both the real economy and financial markets over the course of next year: 1) *the pace of global balance sheet deleveraging*; 2) *continued political leadership changes*; and 3) *simultaneous easing of monetary policy by major central banks*.

While each of these trends can be viewed as distinct, they do in fact share a common catalyst – the 2008-2009 global financial crisis. The bursting of the housing bubble set in motion an adjustment process that

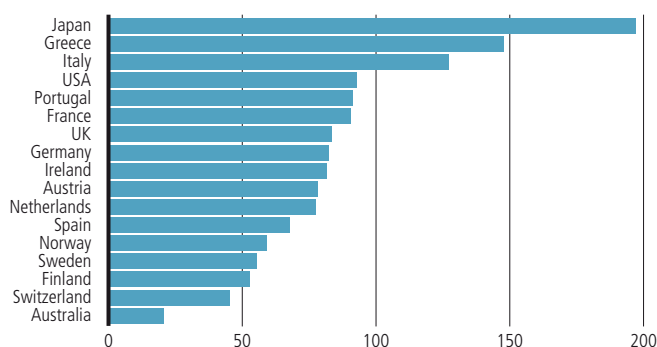
continues to play out across geographic regions, asset classes and market sectors. It is with this in mind that we recommend investors enter 2012 with a modest defensive bias which includes moderate underweights to global equities and commodities, and corresponding overweights to bonds and cash. Within equities, we continue to avoid eurozone exposure, but retain a preference for the US – especially growth stocks – and increase our exposure to the emerging markets. We continue to focus on income-generating investments in an effort to produce reasonable rates of return amid choppy, range-bound markets. Finally, we advocate more flexibility with regard to tactical positioning and also recommend that investors seek ways to leverage elevated levels of market volatility to improve portfolio performance.

Pace of global balance sheet deleveraging

The deleveraging process that started in the immediate aftermath of the financial crisis will proceed at a varying pace across the consumer, financial and government sectors during 2012. While the rebuilding of consumer savings has progressed, corporations remain awash in cash and US banks have largely been recapitalized, European financial institutions must now deleverage their balance sheets and governments need to seriously address their own fiscal imbalances. Public debt burdens – which have risen to unsustainable levels across much of the developed world – must now be pared back in order to avert another global crisis (see Fig. 1). Keep in mind that this deleveraging process will be an uneven and potentially disruptive one.

Fig. 1: High government debt levels lead to slow (or no) growth

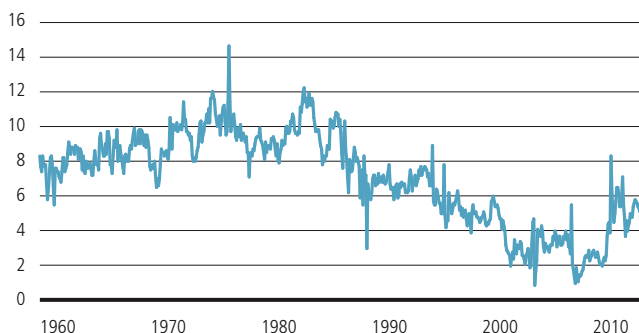
Public debt-to-GDP ratio in 2010, in %



Source: Datastream and UBS WMR, as of 5 December 2011

Fig. 2: Personal saving rate higher than during last decade

US personal saving rate as a % of disposable income



Source: Datastream, U.S. Department of Commerce and UBS WMR, as of 5 December 2011

Specifically, this multi-tiered deleveraging process will continue to have a dampening effect on global growth prospects. Consider the impact of each on both the real economy and the challenges that policymakers must address:

- Consumer** – As we've already noted, consumer deleveraging has progressed at a fairly healthy clip since the end of the financial crisis. US personal savings rates have settled above the low levels characteristic of the housing boom (see Fig. 2). There has been a corresponding decline in the level of household indebtedness – partly through debt repayments and partly through defaults. The stock of consumer debt has declined by about \$690 billion over the past three years. At the same time, continued increases in personal income and further declines in borrowing costs have also eased the pressure on consumers. The ratio of household liabilities to disposable income has declined from approximately 130% in October 2008 to 120% in the second quarter of 2011 (see Fig. 3). While consumer deleveraging will be an ongoing and extended process, there will be pauses along the way – which helps to explain the resiliency of the US economy during the second half of 2011. Given how sharply debt has already fallen, it would appear that there is some capacity for the consumer to continue to reengage during 2012.

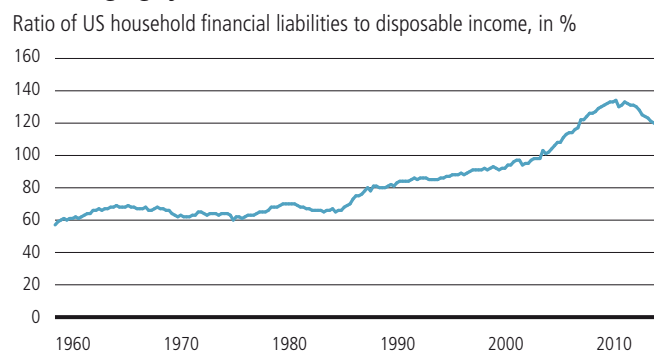
But make no mistake, spending still will be at a constrained level as employment prospects remain meager and balance sheet adjustments continue. With little ability to take on new debt, any increases in expenditures in the consumer sector will need to be funded entirely

through either wage growth or investment income. Although the unemployment rate is likely to trend lower over the course of the year, the still fragile macro backdrop and overall sense of caution on the part of employers suggests that both salary and payroll gains will be limited. Meanwhile, more modest returns from investment portfolios, the ongoing slump in the housing market and lingering concerns over longer-term growth prospects have led to a higher propensity to save within the household sector than in the previous decade.

- Financial** – Despite efforts to recapitalize the banks following the financial crisis, the fact is that the global financial system is in need of further deleveraging. This is especially true in Europe, where banks have yet to make the same sort of painful adjustments that US banks were forced to make. Many banks across the eurozone bear heavy exposure to European sovereign debt. Liquidity problems have become increasingly acute, and most European financial institutions are now entirely dependent on the European Central Bank (ECB) for financing (see Fig. 4). If left unaddressed, these local funding problems would almost certainly broaden and pose a threat to the entire global financial system. Eurozone banks are therefore under pressure to raise capital in order to provide a cushion against potential losses, restore confidence to the system and ease funding distress.

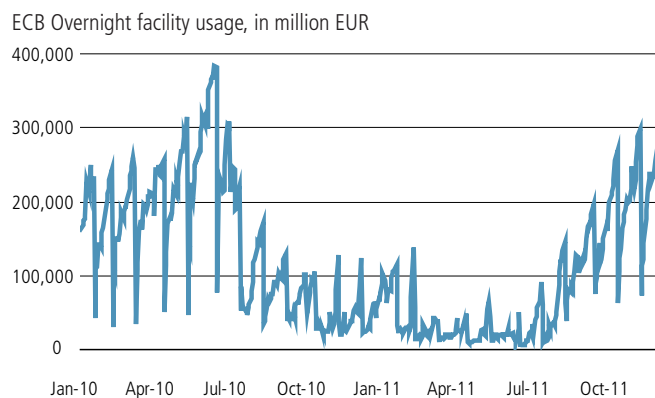
Private investors, however, have shown little appetite for sinking additional funds into vulnerable European banks. Governments across the region have balked at a

Fig. 3: In the early-to-middle innings of consumer deleveraging cycle



Source: Datastream, U.S. Department of Commerce and UBS WMR, as of 5 December 2011

Fig. 4: Tight Eurozone liquidity has led to increased ECB reliance



Source: Bloomberg, UBS WMR, as of 6 December 2011

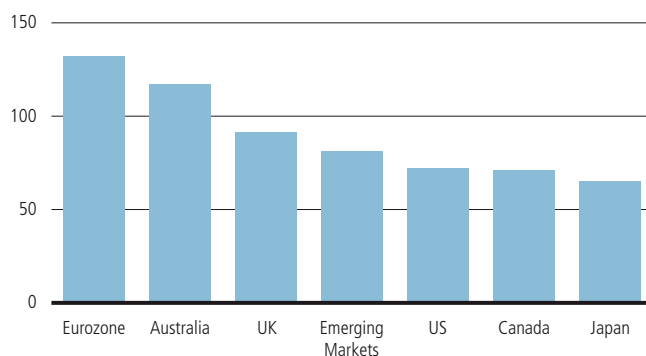
Focus

broader state-sponsored recapitalization plan. This means that European banks will largely have to deleverage by shrinking balance sheets. With a current loan / deposit ratio of 1.32, our global banking team estimates that balance sheets would need to contract by more than 10% in the event no additional capital is raised through either private or public sources (see Fig. 5). This contraction will severely constrain lending across the region and contribute to the already stiff headwinds confronting the eurozone economy. We are already looking for a recession in Europe this coming year, but if the deleveraging process is accelerated – or if funding problems grow more acute – the recession could be both deeper and longer than our forecast.

- **Government** – Perhaps the biggest threat from deleveraging in 2012 comes not from private sources but rather from public ones. Until quite recently, government has filled the demand void created by the bursting of the housing bubble and associated collapse in spending. This in turn has triggered a surge in government budget deficits and a massive increase in public indebtedness, which lies at the very core of the European crisis. Governments across Europe have already begun the deleveraging process as evidenced by the austerity measures put in place by Ireland, Portugal, Greece, Spain and now Italy (see Fig. 6). But still more is likely to come in the year ahead. With its prized AAA sovereign credit rating now in jeopardy, even France is committing to further fiscal consolidation. Our economics team projects that fiscal contraction within the eurozone will amount to about 1.6% of GDP in 2012.

Fig. 5: Eurozone deleveraging will hurt growth

Loan to deposit ratio, in %



Source: Bloomberg, UBS WMR, as of 5 December 2011

This retrenchment of government budgets has yet to hit the US in any meaningful way however. While state and local government spending has been reduced amid lower revenues and constitutional limits on borrowing, the federal debt level has continued to grow (see Fig. 7). With the US Congress Joint Select Committee on Deficit Reduction (the so-called “super committee”) failing to reach agreement on deficit reduction measures, \$1.2 trillion in budget cuts will now be imposed automatically as part of the sequestration process. However, these cuts don’t take effect until 2013. Meanwhile, it still appears likely that Congress will reach some sort of agreement on extending the payroll tax cuts which were scheduled to expire at the end of 2011. This means that any meaningful deficit reduction measures will have to wait until after the 2012 presidential elections. So while deleveraging across the public sector will have a material effect on global growth prospects overall, the impact will be unevenly distributed as fiscal consolidation progresses at different rates around the world.

Continued political leadership changes

One of the most striking events of 2011 was the magnitude of the political leadership changes sweeping the globe. No place was more acutely impacted by this trend than the Middle East and North Africa (MENA) where the “Arab Spring” ushered in a wave of regime change that included the governments of Tunisia, Egypt, Libya and Yemen. What started out as a series of protests over high food prices eventually morphed into open rebellion against authoritarian leaders and despotic regimes. But

Fig. 6: Government austerity in Europe set to accelerate

Public deficits in the eurozone, in % of nominal GDP



Source: Haver, UBS Investment Research, UBS WMR, as of 5 December 2011

this desire for political change wasn't limited to MENA. Europe also witnessed a stunning shift in leadership – born largely out of frustration with the pace and scale of fiscal austerity measures. Both the Greek and Italian prime ministers were forced to step down, while voters in Spain also swept the governing party from power in recent elections. While some of these changes were seen as constructive developments by market participants, others were viewed less benignly. What's more, the events that preceded these leadership changes were often marked by political dysfunction, social unrest, economic dislocations and elevated market volatility.

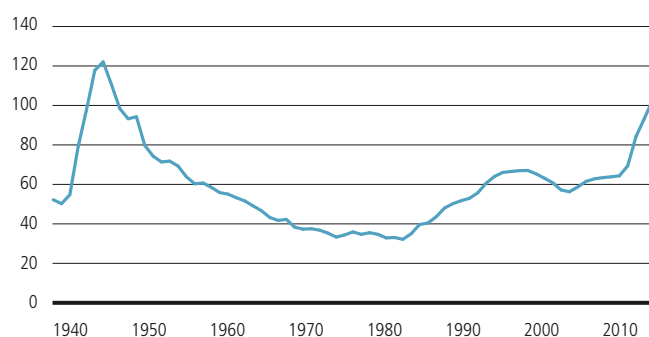
This trend toward leadership turnover will not only continue in 2012, but may well extend to some of the largest and most strategically important countries in the world. This includes presidential elections in the US, France, India, Iran, Korea, Russia and Taiwan, as well as a leadership transition in China. All told, the countries facing potential political leadership changes next year represent nearly 50% of global GDP (see Fig. 8). While each is likely to have some impact, the three with the greatest potential to affect the global macroeconomic outlook are those occurring in the US, Europe and China.

Consider the following:

- **United States** – 2012 will be a crucial election year as control over the White House, House of Representatives and Senate is in play. While it is still too early to handicap the outcome of the US elections, our colleagues in UBS's US Public Policy office (John Savercool, Peter Rowan and Andy Blocker) have worked through the

Fig. 7: US public debt reaching unsustainable levels

Gross federal debt, in % of nominal GDP



Source: Datastream, US Office of Management and Budget and UBS WMR, as of 5 December 2011

Fig. 8: Key political events around the world in 2012

Date	Country and leadership events	in % of global GDP
1 January	EU: Denmark assumes presidency of the European Council	
January–March	Egypt: Parliamentary elections (3rd round of People's Assembly on 3 January, 1st/2nd/3rd round of Shura Council on 29 January, 14 February and 4 March)	.33
14 January	Taiwan: Parliamentary and presidential elections	.72
22 January	Finland: Presidential elections (2nd round: 5 February)	.39
19 February	Greece: Parliamentary elections (brought forward)	.45
29 March	Iran: Parliamentary elections	.68
4 March	Russia: Presidential elections	2.69
22 April	France: Presidential elections (2nd round: 6 May)	4.01
April	South Korea: Parliamentary elections	1.66
May	Algeria: Parliamentary elections	.26
June	Egypt: Presidential elections	
10 June	France: Parliamentary elections (2nd round: 17 June)	
17/18 June	G20: Summit in Los Cabos (Mexico)	
1 July	EU: Cyprus assumes presidency of the European Council	
1 July	Mexico: Parliamentary and presidential elections	1.69
July	India: Presidential elections	2.63
September	Hong Kong: Parliamentary elections	.35
28 October	Ukraine: Parliamentary elections	.23
October	China: 18th National Congress of Chinese Communist Party	9.97
6 November	US: Congressional and presidential elections	21.50
December	Kazakhstan: Presidential elections	.26
December	South Korea: Presidential elections	
December	Venezuela: Presidential elections	.44
Percentage of global GDP for countries with elections		48

Source: UBS WMR, IMF

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most likely scenarios given current public approval ratings, macroeconomic indicators, congressional remapping and likely apportionment of electoral votes. What they found is that if the elections were held today, the Republicans would maintain a comfortable margin in the House of Representatives, would win control of the Senate and would have better than even odds of capturing the White House. Such a sweeping leadership change in the US could have dramatic implications for a whole host of critical issues ranging from energy policy and healthcare to regulatory relief, tax reform and fiscal discipline. It's therefore not surprising that political pundits have categorized this election as perhaps the most important in half a century.

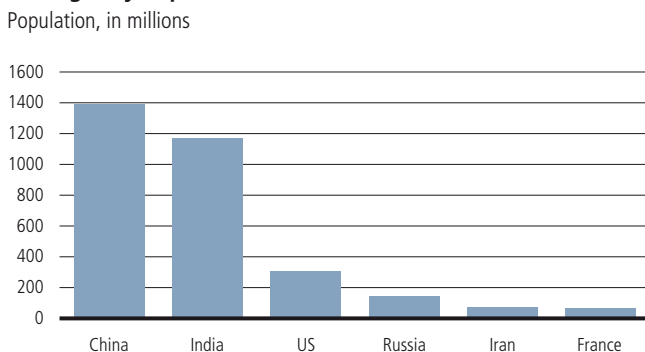
But even if the Republicans were able to capture control of both the executive and legislative branches – which is still far from certain – we might find ourselves mired in the same sort of partisan gridlock and political dysfunction that weighed so heavily upon markets this past year. As our colleagues from the public policy team have repeatedly emphasized, the political culture in Washington has become increasingly polarized with each election. Congressional gerrymandering means that members of Congress are typically elected by the more ideologically extreme elements within each party. So while legislative solutions of the past were typically crafted and brokered with a large moderate bloc, the process today is dominated by the more extreme elements of the political spectrum. This means that the success of legislative initiatives depend not only on a majority of Congress and leadership in

the White House, but also on a filibuster-proof majority in the Senate. An inability for either party to win decisive control of the political process threatens to touch off an even more virulent strain of gridlock given the pressing need for reforms after years of kicking the can down the road.

- **Europe** – The stakes also appear high in next year's French elections, given that France sits (along with Germany) at the very core of the eurozone. President Nicolas Sarkozy has taken the lead in efforts to preserve the euro and avert a full blown market meltdown. He also played a crucial role in crafting a more flexible approach toward fiscal integration. Although the gap has narrowed somewhat in recent weeks, Sarkozy still trails his Socialist rival Francois Hollande by a margin of 58% to 42% in political polls (see Fig. 10). A new French President – even a decidedly eurocentric one – would still need time to forge effective working relationships with other key partners across the region. In contrast to Greece and Italy which installed technocratic "caretaker" leaders, Hollande would presumably need to stake out his own stance on key issues in order to mollify his own political constituents. Precious weeks and even months could be lost building a new political consensus on reform measures.

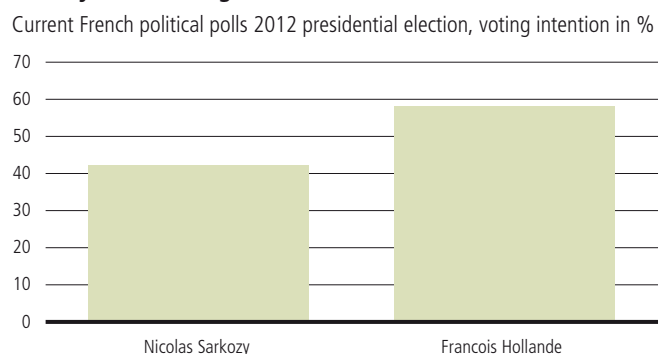
With more than five months remaining until the French elections are held, it's far from certain that Hollande will be able to maintain a lead once Sarkozy begins to campaign in earnest. But even if the Socialists are able to unseat Sarkozy, it is unlikely that they would chart a

Fig. 9: Possible surge in political changes in most strategically important countries



Source: Datastream and UBS WMR, as of 5 December 2011

Fig. 10: French President Nicolas Sarkozy trails his Socialist rival by a wide margin



Source: Bloomberg and UBS WMR, as of 5 December 2011

materially different course on eurozone reform measures. Hollande may be a vocal critic of efforts to forge fiscal union through the European Court of Justice, but he has expressed support for an expansion in the European Financial Stability Facility, a more active role for the ECB and the introduction of a mutually and jointly guaranteed “eurobond.” The most critical issue for France then may have less to do with who wins the presidency, and more to do with whether they are able to retain their AAA sovereign credit rating. Our chief global economist, Andreas Hoefert points out that a ratings downgrade may actually prompt more radical realignment within the eurozone as France allies more with the vulnerable states and less so with Germany.

- **China** – China also faces a leadership transition in 2012. And while there is less drama about who will succeed the current governing core there is still a fair amount of uncertainty over how they will govern. Little if anything about China’s governing structure will actually change. Unlike the Middle East, leadership changes in China will not usher in an era of structural transformation. The Communist Party will continue to dominate the economic, political, social, cultural and military affairs of the country through the Politburo. Moreover, in the lead-up to the 18th party Congress and the associated leadership change (likely to take place in October) UBS’s China economist, Tao Wang, expects the central government to emphasize policy stability and to largely maintain its current macroeconomic policy stance.

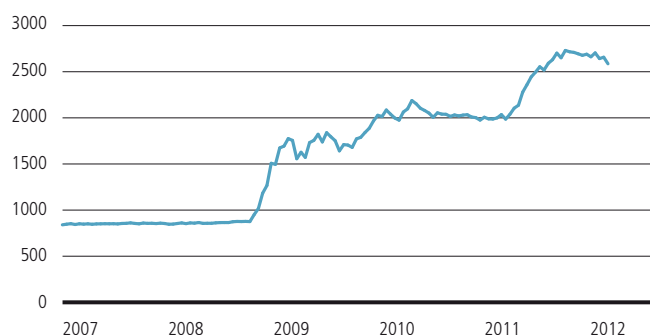
However, the expected change in seven out of the nine members of the Politburo Standing Committee next year could still materially alter the way China engages allies, rivals and adversaries across the globe. Its approach toward global engagement has been in transition over the past two decades. Having moved beyond Chairman Deng’s policy of economic reintegration and political disengagement, China has pursued a more assertive role in world affairs in recent years. The up-and-coming crop of leaders in China is seen as more nationalistic and aggressive than its predecessors. Although China is unlikely to prove disruptive on the world stage during a leadership transition year, the first test of this heightened nationalism could come from across the Taiwan Strait. Presidential elections are being held in Taiwan in January. China looks on the rising popularity of the opposition Democratic Progressive Party with suspicion, as it fears this could complicate years of rapprochement between the two nations. So although China’s leadership change may prove benign from an economic standpoint, a potentially more confrontational China poses yet another variable in an already complex and volatile geopolitical environment.

Simultaneous easing of monetary policy

Most economists credit aggressive public sector intervention (on the fiscal and monetary policy fronts) for preventing a replay of the Great Depression following the bursting of the housing bubble and related credit crunch in 2008-2009. Massive stimulus programs, wholesale bank recapitalizations and radical expansions in

Fig. 11: Fed balance sheet remains elevated

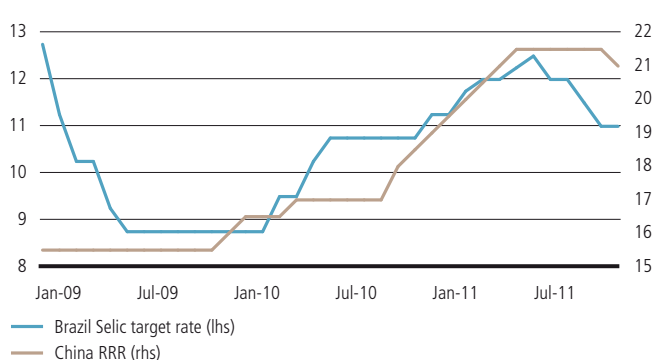
Federal Reserve assets, in billion USD



Source: Federal Reserve Bank of St. Louis and UBS WMR, as of 5 December 2011

Fig. 12: Emerging markets begin monetary easing

Brazil central bank target rate and China reserve requirement ratio, in %



Source: Bloomberg and UBS WMR, as of 5 December 2011

Focus

the central bank balance sheet helped to stabilize the economy, restore a degree of confidence in the financial system and unblock clogged credit channels. In short, the balance sheet problems in the Consumer and Financials sectors were absorbed by the public sector. The effectiveness of these aggressive – and in many cases unprecedented – policy steps have not been lost on either market participants or most elected officials.

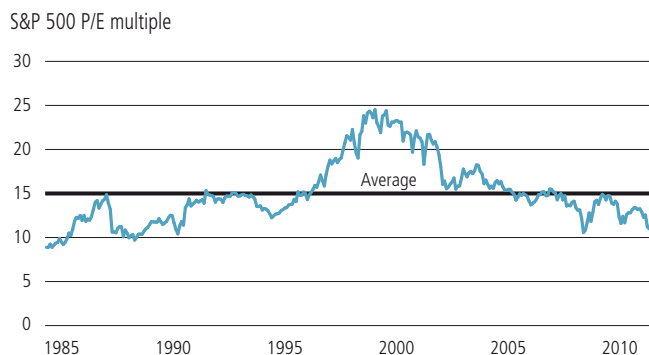
With the world facing yet another debt dilemma – this one potentially even more destabilizing than the last one – the search is on once again for a balance sheet large enough to absorb eurozone sovereign stresses. With fiscal options more limited due to the massive deficits that have accumulated over the past several years, the only balance sheets large enough to provide the level of support necessary to defuse the crisis are those of the central banks. Until recently however, central banks had adopted starkly different policy approaches due largely to domestic considerations: deflation threats in the US; rising core inflation in Europe; and surging food, energy and property prices in the emerging markets.

Amid evidence of decelerating inflation and softening growth prospects, that has now started to change. Each of the major central banks around the world is either committed to maintaining an already accommodative policy stance or in the process of shifting toward one. In the US for example, the Fed has made it clear that in addition to keeping short rates low for an extended period of time, they will also continue to aggressively employ extraordinary measures to help promote growth and ease

financial stresses. The Fed balance sheet, which virtually exploded immediately following the crisis, has remained elevated as the Fed has successively engineered several separate phases of quantitative easing and, most recently, “Operation Twist” to offset structural drags (see Fig. 11). And although we see the prospects as less than 50-50, there is still a chance that the Fed will expand the balance sheet further with QE3.

The ECB on the other hand has only recently warmed to the notion of an easier policy stance. In something of a surprise to most market participants, newly installed president of the ECB, Mario Draghi, helped orchestrate a 25-basis point reduction of the base lending rate in his first week on the job. We look for the base rate to go as low as 0.5% in 2012 as the recession deepens. But even more important than the rate cuts has been the greater willingness by the ECB to begin support of vulnerable European debt markets through the use of the Securities Market Programme. Mario Draghi recently expressed a willingness to extend even further support to stressed financial markets as a sort of quid pro quo for more enforceable budget rules across the eurozone. While the ECB is unlikely to engage in the sort of broad-based quantitative easing measure employed by the Fed, a ramping up of secondary market purchases and some expansion in the ECB balance sheet is likely in the months ahead. ECB engagement is contingent on stricter and enforceable fiscal budget rules in the eurozone. This would not only reduce funding challenges for more vulnerable countries such as Spain and Italy, but would also serve to ease the pressure on European banks and provide them greater breathing

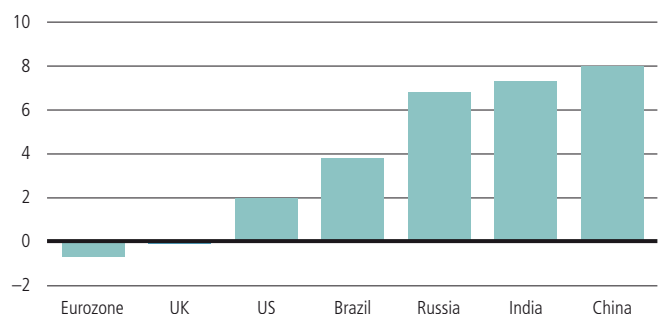
Fig. 13: We do not expect any material re-rating of stocks next year



Source: Datastream and UBS WMR, as of 5 December 2011

Fig. 14: Economic slowdown won't be uniform in 2012

UBS WMR economic growth forecasts 2012 (Real GDP; % change y/y)



Source: UBS WMR, as of 5 December 2011

room as they move to deleverage balance sheets.

But perhaps the biggest directional shift in monetary policy has been the recent moves by emerging market (EM) central banks to ease policy. After having ratcheted up rates in the early part of 2011 in response to increased inflation threats, central bankers across the EM group have now begun to reverse course. A moderation in price pressures coupled with a corresponding deceleration of growth has enabled EM central bankers to shift from a restrictive stance to an accommodative one. Brazil, for example, has cut rates from 12.5% to 11% this year, and China has moved to ease reserve requirements (see Fig. 12). Keep in mind that equity underperformance across EM through the first nine months of 2011 had less to do with global growth scares than with inflation fears. So for the first time since the financial crisis of 2008-2009, each of the world's major central banks will be pursuing more accommodative monetary policy. This more accommodative policy backdrop will help ease some of the tail risks, and also place a floor under financial asset prices for 2012.

Investment recommendations

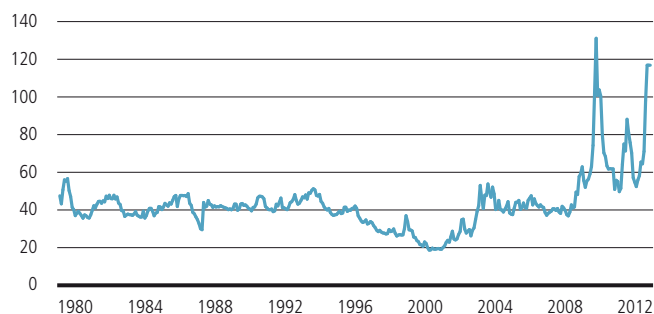
These three broad trends (balance sheet deleveraging, political leadership change, synchronized central bank easing) will each have an important (but also at times conflicting) impact on the financial markets this coming year. Since there is a tendency to view the immediate future as a mere extension of the most recent past, we must assess what is different about the current environment and act accordingly. This will allow us to position portfolios in a

manner that leverages the opportunities likely to emerge – and make no mistake about it, opportunities will emerge – but also protects against the threats that are certain to persist. Investors should therefore consider the following strategies:

- **Remain defensive** – Those with an investment horizon that spans 5 to 10 years should be rewarded for owning equities at current market valuation levels. The near-term outlook however is more mixed, given still fragile global growth prospects and a lingering threat of escalation in the eurozone sovereign debt crisis. While equity markets may appear somewhat cheap relative to historical benchmarks, decelerating earnings growth and political uncertainty will prevent any material re-rating of stocks in 2012 and thereby limit intermediate-term return prospects (see Fig. 13). Likewise, a slowing of global growth due to recession in Europe should weigh selectively on commodity prices over the course of the year. We therefore recommend that investors begin 2012 with more limited exposure to risk assets, including below-benchmark weightings to equities (mainly reflecting caution on eurozone equities) and commodities, and overweight to fixed income and cash.
- **Focus on quality growth stocks** – With growth poised to decelerate next year, it is even more important than ever to remain selective with regard to positioning within risk assets. Keep in mind that this economic slowdown won't be uniform (see Fig. 14). While the eurozone will likely suffer through a relatively shallow recession, the US is expected to continue

Fig. 15: Dividend yields are attractive versus interest rates

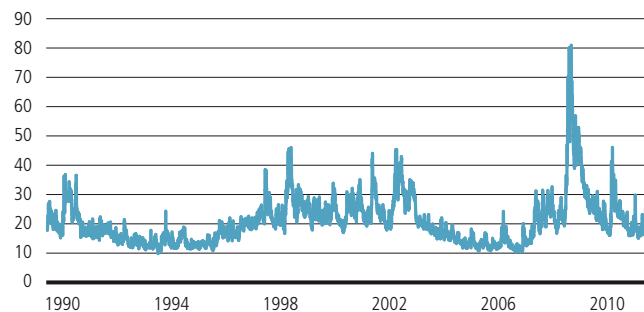
S&P 500 dividend yield as % of 10-year treasury



Source: Datastream and UBS WMR, as of 5 December 2011

Fig. 16: Volatility will likely remain high in 2012

Chicago Board Options Exchange (CBOE) Volatility (VIX) index



Source: Bloomberg and UBS WMR, as of 5 December 2011

Focus

growing at a modest but still respectable 2% pace. Meanwhile, the deceleration of economic growth in EM could actually be constructive for their equity markets, as the associated decline in inflation pressures offers policymakers ample latitude to ease monetary conditions. We therefore recommend that investors focus on stocks in both the US and emerging markets, while avoiding eurozone equity exposure. Within the US, we favor growth over value stocks and sectors such as Technology, Consumer Staples and Healthcare which deliver high secular earnings and dividend growth, reasonable valuations and strong earnings achievability.

- **Focus on income** – With most equity markets likely to remain both choppy and largely range-bound throughout the year, investors must continue to focus on income-generating investments and strategies in order to produce reasonable rates of return within investment portfolios. However, with yields across most fixed income markets still hovering near generational lows, the opportunities for producing income have diminished, while the risks associated with those income streams have risen. Although we do have a preference for domestic credit markets – especially high-yield – investors also must look beyond traditional sources of income to supplement their portfolios' return. Our equity strategy team's Dividend Ruler Stock List offers investors a healthy combination of defensive characteristics, growth prospects and income generation.
- **Be prepared for a volatile, range-bound environment** – While 2012 is not apt to unfold in precisely the same manner as did 2011, one aspect that the two periods are likely to share in common is episodic rallies and periodic setbacks as financial markets remain volatile. This means that retaining a flexible approach which includes tactical repositioning during the year will be essential. We will of course continue to monitor progress on the economic and policy fronts for any change in the fundamental outlook. In the absence of such changes, we will look to add risk during periods of underperformance and market stress, but take risk off the table should markets move above our price targets.
- **Utilize volatility** – As already noted, volatility is expected to remain high next year amid a backdrop of elevated macro and political uncertainty (see Fig. 16). Volatility is often viewed as a negative for most market participants in that it often leads to elevated risk

premiums and more modest returns. However, it can also be viewed opportunistically. As our colleagues in the Portfolio Advisory Group (PAG) point out, volatility can also be viewed as an asset class. By monetizing volatility through the use of certain types of derivative instruments, investors can both dampen variability within portfolios as well as supplement returns. What's more, strategies that leverage volatility, such as covered call writing against core equity holdings, can also serve to enhance portfolio income.

Conclusion

With so much in 2012 depending on the wisdom of policy choices and the will of political leaders, there is an understandable tendency to wait until there is greater clarity before making investment decisions. But our experience suggests that such clarity rarely exists – and when it does markets will have already repriced and moved on to the next set of challenges and opportunities. So as we counseled last year at this time, we have to position ourselves to best leverage the trends as we see them playing out over the course of the year. We need to focus on those asset classes, regions and sectors that will likely perform best in the environment we foresee in 2012 – and avoid those that are expected to lag. But we must also be prepared to make changes to our portfolios should the fundamental outlook change, valuations become more or less compelling and / or the policy course be altered. So although we enter the year with a modest defensive bias, we must be prepared to make changes as needed throughout the year. We are, after all, at a crossroads where both wisdom and will are certain to be tested in many ways.

Mike Ryan, CFA, Chief Investment Strategist

The beginning of the end of the eurozone crisis

So much depends on Europe

The interplay among balance sheet deleveraging, political leadership changes and shifts in central bank policy has manifested itself most directly and acutely within the eurozone. European leaders have struggled mightily to hold the monetary union together in the wake of the global financial crisis. While the crisis itself didn't cause the structural imbalances in the eurozone, it has certainly served to expose them. Budget deficits and accumulated debt burdens have reached levels that now threaten the solvency of the more vulnerable issuers in the region. However, the process of reforming fiscal practices has been a difficult and painful one. Elected officials across the region have disagreed about the right approach – with most favoring the course that is best aligned with their own national interests. This has resulted in a seemingly ad hoc and frustratingly incrementalist approach to the problem as leaders search for consensus. Finally, the European Central Bank (ECB) has demonstrated little ability or willingness to directly involve itself in the crisis. The strict and explicit mandate passed down to the ECB as part of the Maastricht accord has constrained central bankers from acting more aggressively to provide support to beleaguered bond markets.

Getting serious

But things may well be moving toward an end game in Europe. German Chancellor Angela Merkel has maintained a hard line on fiscal reform and forced elected officials across the eurozone to make difficult but necessary choices. This in turn has prompted a series of leadership changes in several key countries such as Greece and Italy, where career politicians were replaced by technocrats who take a more pan-European view of both the problems and solutions. The end result has been more credible and implementable austerity measures. At the same time, the change in leadership at the ECB also appears to have ushered in a more pragmatic approach. While the ECB under its president Mario Draghi won't engage in the sort of massive balance sheet expansion that the Fed has implemented, the ECB has ramped up purchases of eurozone debt under its Securities Markets Programme. Assuming agreement is reached toward broader fiscal union with enforceable budget rules, the ECB will likely play a larger and more supportive role in the future.

The challenge of course is whether or not the efforts of eurozone leaders to address the crisis will prove adequate. Like a roofer continually applying flashing to a leaky roof,



the hope is that the cumulative effects of the assorted programs engineered by eurozone leaders will be enough to stem the crisis. A great deal of hope is therefore being placed in the latest initiative toward fiscal integration being put forth by Germany and France. But this too will take time to implement – and there is a risk that credit conditions could deteriorate before policymakers are able to respond. Keep in mind that S&P recently placed the sovereign debt rating for 15 euro nations under review for possible downgrade. The loss of a AAA rating for one or more of the core eurozone nations could still undermine efforts to stabilize the crisis.

At the crossroads

Either way however, we have now entered the beginning of the end of the eurozone sovereign debt crisis. Leaders across the region have charted a course that will either move them grudgingly toward a tighter fiscal union – or the ultimate dissolution of the common currency. Half measures, ad hoc responses and remedial efforts are no longer adequate. The year 2012 will therefore be a pivotal one for both the overall economy and global financial markets as the future of the euro is ultimately determined. Milton Friedman, Nobel Prize-winning economist, founder of the monetarist school of economic theory, and vocal critic of the euro, argued repeatedly that the common currency would not last beyond its first major economic crisis. This may well turn out to be the year we find out whether Dr. Friedman was right...

Will...May...Won't?

15 Developments for 2012

Welcome to our third annual listing of the 15 developments we see playing out over the coming year. As was the case with the two prior installments, we focus on five things that we believe will happen, five things that may happen and five things that won't happen during 2012. While the format is the same as in prior years, we took a slightly different approach toward vetting the list this time around. Instead of simply preparing a laundry list of likely outcomes, we considered each development with respect to the three trends that are expected to have the most profound impact on the outcome for the real economy and financial markets over the course of next year: deleveraging, leadership change and monetary easing. This list is hardly exhaustive, but it does reflect our take on the major issues that will shape the world during 2012.

Will

European sovereign credit quality will deteriorate

Despite efforts by elected officials and policymakers across the eurozone to more forcefully address structural fiscal problems, sovereign credit quality will continue to deteriorate in 2012. While a potential Greek default would be the most dramatic illustration of this trend, it is a likely downgrade to France's sovereign credit rating that could be the most impactful. Keep in mind that France has closed ranks with Germany and held a hard line on structural reform measures. But as our chief global economist Andreas Hoefert points out, a downgrade of France's AAA rating would be a potential game-changer in Europe. France might well become the defender of the Mediterranean countries, instead of shadowing Germany as it does now. With France's weight, the supposedly "weak" countries might get additional relief from the European Central Bank. In short, a rift between Germany and France could mark the beginning of the end of the euro crisis. Keep in mind however, that this will still be a messy and disruptive process.

Global earnings growth will stall

Corporate profits have recovered impressively over the past two years following the crisis-inspired earnings

collapse of 2008-2009. While 2010's strong earnings rebound was largely driven by the absence of multi-billion dollar losses at financial institutions and a snap back from depressed levels for more cyclical industries, 2011's fairly broad-based earnings gains reflected continued cost discipline and resilient top-line growth. In 2012, we expect that earnings growth will stall amid decelerating global GDP growth rates and tougher year-over-year comparisons. So-called "bottom-up" consensus estimates for 2012 corporate profits for the S&P 500 are still too high at about \$108 per share, despite recent downward revisions, implying growth in the low teens. We instead look for S&P 500 earnings to rise by only 0-5% 2012 to the \$98 level. The threat to profit growth is even more pronounced in Europe. Analysts are still looking for nearly 10% earnings growth in 2012, even as economists have sharply reduced economic growth projections and now forecast a recession for the eurozone.

Risk premiums will remain elevated

Given the challenging macro backdrop and continued uncertainty on the leadership front, we look for risk premiums to remain elevated next year. That's not to suggest that markets won't stage periodic rallies during the year – or that selective asset classes won't perform well. A more accommodative policy stance should support risk assets in general, while progress in Europe toward fiscal union will greatly reduce tail risks. It's simply that a "normalization" of risk premiums across the board would likely require both greater clarity with regard to the sustainability of the global economic expansion as well as clearer resolution of the most vexing fiscal challenges confronting developed countries. Both appear unlikely.

Central banks will ease further

As we've already noted, each of the major global central banks will be pursuing easier monetary policy conditions for the first time since the financial crisis. While the pace and scope of policy actions will differ across regions based on the strength of the economy, the level of inflation and the extent of structural challenges, the overall mix will likely include expansions in central bank balance sheets and further reductions in base lending rates. This more accommodative policy backdrop will help ease some of

Will...May...Won't? 15 developments for 2012

the tail risks, e.g., Chinese hard landing; eurozone implosion; bank funding crisis, and also place a floor under financial assets next year.

Economic growth prospects will “decouple”

With most economists now calling for a recession within the eurozone, there is an understandable concern that the US could be dragged along for the ride. After all, there has been a fairly high historical correlation between eurozone GDP and US GDP. It is our view, however, that such simple comparisons are misleading, and that global growth prospects will “decouple” in 2012 with the US and emerging markets continuing to expand even as Europe falls into a shallow recession. Keep in mind that the correlation between US and European GDP has risen dramatically due to the financial crisis and Great Recession. Once that period is stripped out, the correlation becomes statistically insignificant. But perhaps even more importantly, correlation should not be mistaken for causality. The US appears statistically to lead Europe – not the other way around. This suggests that economic shocks have tended to originate in the US and then spread to Europe. The recession in Europe will be driven largely by austerity measures, deleveraging of bank balance sheets and weak demand growth. The US meanwhile, will continue to benefit from improving lending conditions and stabilization in the housing sector and some level of consumer re-engagement. (Note that there are precedents such as 1993, when the US grew while Europe was in contraction mode.) So while the global economy will certainly be impacted by the eurozone recession, we still look for the US to expand at a modest but sustainable pace during 2012 barring a global credit crunch.

May

Bank deleveraging may create a global credit crunch

As we've already noted, banks – especially European banks – will likely need to shed assets in an effort to further delever balance sheets in the absence of any material capital infusions. It may well be that the agreement being hammered out across the eurozone to implement enforceable budget rules and a more active role by the ECB

helps stabilize the sovereign crisis and ease funding stresses. However, sovereign debt isn't the eurozone banks' only problem. With the economy poised for recession and the prospects high for further deterioration in asset quality, banks will need to continue to shrink balance sheets. This in turn could prompt a broader crunch amid a tightening of credit standards and contraction in loan books. This could pose a broader threat to growth if the credit crunch expands beyond just the European financial system.

Geopolitical tensions may lead to another energy shock

The surge in oil prices during 2011 were caused in large part by disruptions to production in Libya and concerns that the broader unrest could affect other oil-producing states in the region as well. While oil prices have backed off their highs, they remain elevated overall amid still solid demand in Asia and tight inventory levels. There is a growing threat that a further escalation of tensions in the Middle East could prompt yet another energy shock that threatens global growth. The most critical flashpoint in the region is Iran. Keep in mind that Iran is the second-largest producer in OPEC behind Saudi Arabia, and is estimated to have the third-largest oil reserves in the world. With Iran continuing to pursue nuclear weapons – having also made an alleged assassination attempt on a Saudi ambassador on US soil – Washington appears committed to reigning in what it sees as an increasingly belligerent and potentially unstable regime. China and Russia however, have shown little enthusiasm for placing any further restrictions and see US efforts in the region as meddling. A broadening of tension in the region to include Iran could well push oil prices above their 2011 highs.

The eurozone may make decisive steps toward a fiscal union

Progress in addressing the eurozone fiscal crisis has been fleeting and tentative thus far, as few leaders have been willing to make the sort of concessions – such as austerity measures, sovereignty losses or joint debt guarantees – that are necessary for a credible fiscal union. However, with German Chancellor Merkel having held firm on the need for budget reforms as a pre-condition for any

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deeper integration, the eurozone appears closer to a workable union than at any time since the crisis began. By refusing to compromise on the basic principles for deeper integration, Merkel has forced weaker players to undertake necessary but painful reforms. The wild card of course, remains France. Were France to lose its AAA rating before a framework is fully in place, progress toward fiscal union could lose momentum.

US capital expenditure may accelerate

In stark contrast to both the consumer and government sectors, corporate balance sheets are in better shape than they've been in over half a century. Lack of conviction about the broader macro outlook and limited investment opportunities have prompted CFOs to hoard cash over the past several years. While a fair portion of excess corporate cash is likely to be returned to shareholders in the form of share repurchases and dividend increases, we may well see an acceleration in capital expenditures as well with corporate America still focused on raising productivity. Keep in mind that investment spending has lagged behind prior cycles, and while this could hardly be categorized as a "normal" business cycle, capital still needs to be updated and replaced. However, greater visibility into end-market demand and increased clarity on intermediate-term fiscal policy are still necessary preconditions before a pronounced pickup in business spending can take shape.

Crises may erupt in individual emerging market economies

Thus far, the fallout from the fiscal crisis in Europe has done little more than dampen growth across much of the emerging markets. However, with the eurozone economy now poised for recession, there is a risk that selective emerging market countries in Central and Eastern Europe could be vulnerable to crisis. Not only are countries such as Poland, Turkey, Hungary and the Ukraine exposed to a deceleration of growth in Europe, but they – along with the Czech Republic and Romania – are also deeply vulnerable to a credit crunch as eurozone banks try to delever their balance sheets.

Won't

US will not achieve meaningful fiscal consolidation

The failure of the Special Joint Committee on Deficit Reduction (the so-called "super committee") to reach agreement on \$1.2 trillion in deficit reduction measures is confirmation that Washington has little appetite for fiscal austerity – especially before the 2012 presidential elections. Despite rules that would have made any agreement simpler to implement (e.g., no amendments, simply "up or down" majority vote), the two sides were still unable to find common ground on spending / revenue measures. And so there is virtually no chance that any meaningful consolidation will occur before 2013 at the earliest when automatic spending cuts are scheduled to take place as part of the sequestration process.

China will not experience a hard landing

Fears that China is headed for a hard landing are overblown, in our view. While measures to deflate potential bubbles within the property market will certainly dampen growth, we still look for China to grow at a relatively healthy 8% clip in 2012. The country will certainly be impacted by a recession in Europe, however, the continued emergence of domestic demand drivers and solid regional growth prospects suggest that the Chinese expansion remains intact. What's more, with inflation pressures having eased during the second half of 2011, the Bank of China has greater latitude to loosen monetary policy.

Eurozone will not break up in 2012

There has been a fair amount of speculation over the prospects for an implosion of the eurozone. But as our colleague, Paul Donovan, recently pointed out, a break-up of the pan-European common currency is neither desirable nor a solution to the problem. The costs associated with dissolution of the euro would be staggering – even for the strongest players in the union. Our economics team estimates that the direct and indirect costs of a break-up of the eurozone would range from a low of about 30% of GDP for a country like Germany, and could total as much as 80% of GDP for one of the more vulnerable nations such as Greece. What's more, simply

reverting to domestic currencies does little to solve the competitiveness problems plaguing some of the more vulnerable players. With both Greece and Italy having recently installed more technocratic leaders committed to implementing austerity measures and steps being taken toward a fiscal union, the threat of a break-up of the common currency has declined dramatically.

Social unrest will not subside

2011 was a year marked by the ratcheting up of social unrest across the globe. While the emergence of the “Arab Spring” was perhaps the most visible and violent manifestation of this unrest, the trend wasn’t limited to the Middle East and is unlikely to subside quickly in 2012. The fragile nature of the economy, coupled with rising income inequality and a growing sense of disillusionment with the political status quo, has prompted protest movements across the developed and developing world. The Occupy Wall Street movement was initially dismissed by some, but the growing sense of dissatisfaction which it has come to represent is likely to become a more permanent feature of the political and social discourse in 2012.

The US dollar will not lose its safe haven status

There has been much speculation of late that the US dollar may begin to lose its safe haven status and could even be supplanted as the primary reserve currency. It’s true that rivals to the dollar will almost certainly emerge in the years ahead as China becomes more assertive – and assuming Europe is able to work through its fiscal challenges – but we still don’t see any serious contenders to the greenback in 2012. While some argue that the Swiss franc is a more stable store of wealth than the US dollar, the size of the Swiss economy and the decision to link the franc to the euro suggest this is simply not a viable alternative to the dollar on any sort of broad scale. Likewise, those who see gold as a more favorable alternative to the dollar will find that both liquidity issues and supply constraints limit its appeal as well.

Looking back at 2011

A report card

In the spirit of accountability, we offer this year-end report card on our “will, may, won’t” list.

Will

Equity markets will provide normalized returns.	X
The sovereign debt crisis will grow more acute.	✓
Corporate cash hoarding will end.	X
Geopolitical threats will intensify.	✓
Congress will deteriorate into gridlock.	✓

May

A high profile municipality may default.	✓
The economy and corporate profits may surprise to the upside.	X/✓
Rising protectionism may trigger a trade war.	X
Emerging markets may stumble.	✓
Bond market volatility may increase.	✓

Won't

P/E multiples will not exceed long-term averages.	✓
The housing market will not sustain a recovery.	✓
There will not be meaningful progress in deficit reduction.	✓
Commodity prices will not collapse.	✓
Inflation will not be a problem.	✓

Our Best Ideas at a Glance

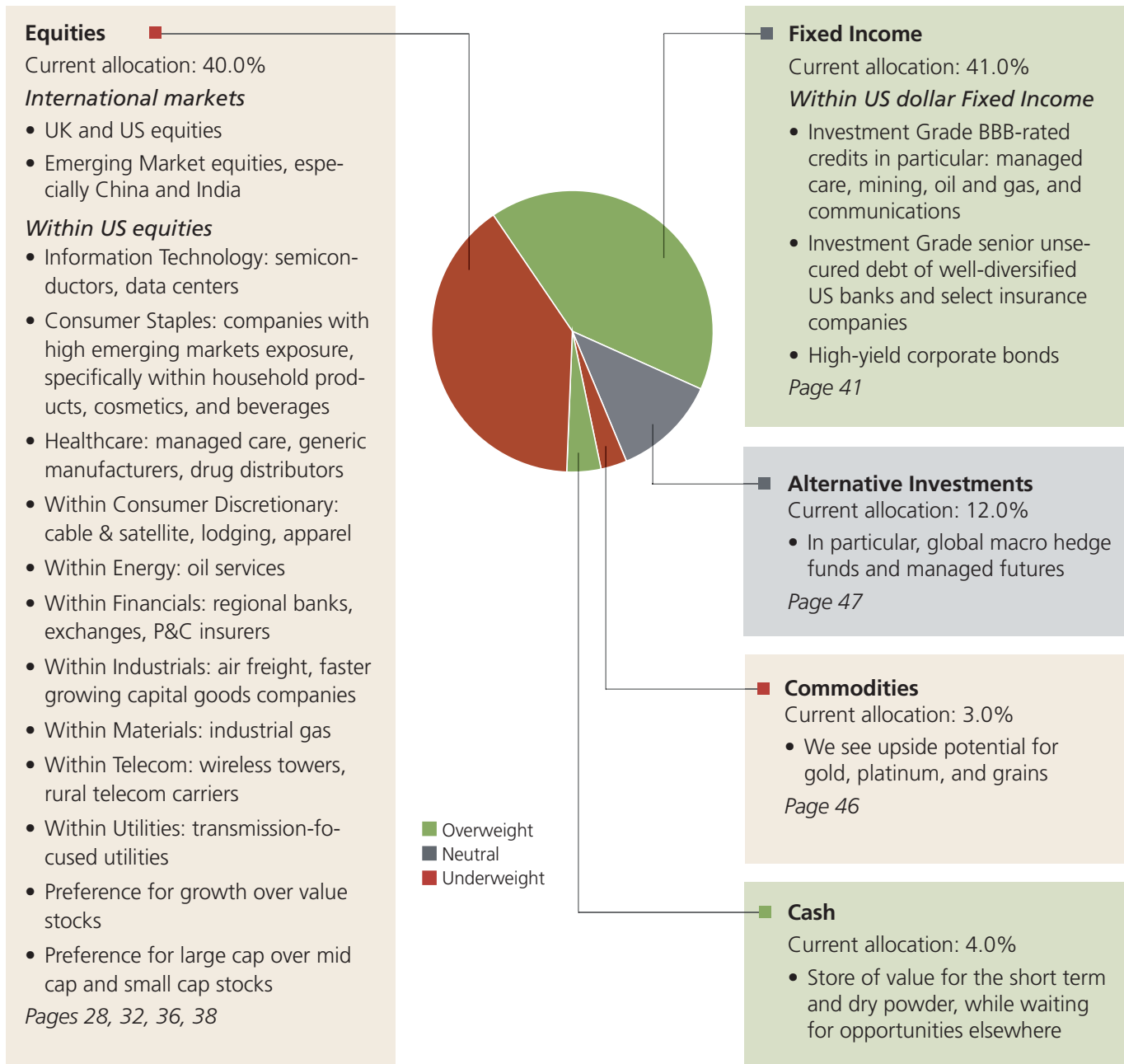
The following list represents investment strategy recommendations that we believe will provide attractive opportunities over the next 9-12 months.

Asset Classes

Preference for cash and bonds over equities and commodities

Currencies

Avoid Japanese yen. Preference for SEK, NOK, GBP, among developed currencies. Selected Emerging Market currencies for long-term appreciation potential.



For an explanation of current allocation and the underlying benchmark allocation, please see the note on the following page.

Asset Allocation Overview

Asset Allocation Overview	WMR Tactical View	Model Portfolio Moderate Risk Profile (in %)			
		Benchmark Allocation	Tactical Deviation	Change	Current Allocation
Equities Equity valuations are attractive relative to bonds but slowing economic growth and problems in the eurozone create downside risks for earnings.	Moderate Underweight	44	-4.0		40.0
US Equities Valuations are less attractive than in overseas markets. However, the US economy and corporate earnings have shown resilience.	Moderate Underweight	32	-0.5	▼	31.5
US Large Cap Value Valuations, our sector tilts and our defensive positioning suggest preference for growth over value. Large caps cheap relative to small and mid caps.	Moderate Underweight	11	-1.5	▼	9.5
US Large Cap Growth Valuations, our sector tilts and our defensive positioning suggest preference for growth over value. Large caps cheap relative to small and mid caps.	Moderate Overweight	11	+3.0		14.0
US Mid Cap Valuations expensive vs. large caps, and little support from M&A activity.	Moderate Underweight	5	-0.5		4.5
US Small Cap Valuations expensive vs. large caps, and little support from M&A activity.	Moderate Underweight	3	-1.5		1.5
US Real Estate Investment Trusts (REITs) The prospect of interest rates remaining low is positive for the REIT industry. Valuations less stretched than they have been over the last 12 months.	Neutral	2	+0.0		2.0
Non-US Developed Equities Valuations more attractive than US. Slowing growth and eurozone debt crisis suggest a more cautious stance.	Moderate Underweight	10	-4.0		6.0
Emerging Market (EM) Equities Growth likely to continue slowing in first half of 2012 but monetary policy has turned toward loosening which could allow P/E multiples to rebound.	Moderate Overweight	2	+0.5	▲	2.5
Fixed Income Yields at historically low levels but many central banks will maintain loose policy to offset negative impact of deleveraging.	Moderate Overweight	37	+4.0	▲	41.0
US Fixed Income Within fixed income we favor the US vs. non-US. The dollar may gain in the short term as the Fed holds steady while other central banks loosen policy.	Moderate Overweight	29	+4.0	▲	33.0
Non-US Fixed Income Extremely low yields and overvalued yen make Japanese debt unattractive. European sovereign debt concerns remain a risk.	Neutral	8	+0.0		8.0
Cash (USD) Store of value for the short term and dry powder, while waiting for opportunities elsewhere.	Moderate Overweight	2	+2.0	▼	4.0
Commodities Decelerating global demand growth suggests further downside for commodity prices.	Moderate Underweight	5	-2.0		3.0
Alternative Investments No tactical view. Included in portfolio for diversification purposes.	Neutral	12	+0.0		12.0

"WMR tactical deviation" legend: Overweight Underweight Neutral
 Source: UBS WMR and Investment Solutions, as of 7 December 2011.

"Change" legend: ▲ Upgrade ▼ Downgrade
 For end notes, please see appendix.

The benchmark allocations are provided for illustrative purposes only by UBS for a hypothetical US investor with a moderate investor risk profile and total return objective. See "Sources of benchmark allocations and investor risk profiles" in the Appendix for a detailed explanation regarding the source of benchmark allocations and their suitability and the source of investor risk profiles. The current allocation is the sum of the benchmark allocation and the tactical deviation. See "Deviations from benchmark allocation" in the Appendix regarding the interpretation of the suggested tactical deviations from benchmark.

Elections amid widespread disapproval

On the eve of what will surely be a captivating election year and in the midst of persistent congressional gridlock, we turn to our colleagues stationed on the political front lines for their unique perspective and advice. In this outlook edition of Washington Watch, Kurt Reiman, WMR's Head of Thematic Research, moderates an insightful discussion with John Savercool, Head of the UBS US Office of Public Policy.

Kurt Reiman: Politics frustrates (make that infuriates) most Americans, which in turn erodes their confidence in the economy and their outlook for financial markets. Do you think voters' frustration will produce any meaningful change in Washington, DC.?

John Savercool: Yes, voter frustration will continue to drive some change in Washington, but how much change it will continue to drive is an open question. Many of the issues Congress is debating now are the result of growing voter interest and demand, such as the annual budget deficit and high federal debt. Those issues were not nearly as prominent over the last two decades, which is one reason the country has a historic level of debt. Clearly, though, many sources of voter frustration relating to policy issues have not been dealt with effectively in Washington.

Election results generally send the strongest message to Washington about what voters want. Strong messages were sent in both 2008 and 2010, and we'll have to see what voters say in 2012.

KR: As further evidence of this paralysis, the Joint Select Committee on Deficit Reduction failed to agree on how to trim the deficit by \$1.2 trillion, triggering automatic sequestration in 2013. First, will the sequestration process move ahead or will Congress find other ways to tackle the deficit? Second, in the long term, do you think politicians will find common ground to tackle the deficit before it's too late, or are we destined to follow the same fate as Europe where the financial markets force discipline on politicians?

JS: Efforts in Congress will be made in 2012 to replace the sequester targets with alternative but equal savings. Some in Congress will propose that the automatic cuts in defense spending should be reduced, while others will argue that the cuts in domestic programs are too severe. I believe the current version of sequestration will remain intact unless Congress passes a significant deficit reduction measure, as the "super committee" was tasked with this year. That prospect is doubtful in an election year, so I expect the sequesters to take effect in 2013 unless the election results are such that a new majority in Congress can change them. The dynamics in Congress today make the passage of a meaningful deficit reduction bill very unlikely, so I don't expect serious action on this front until 2013 at the earliest.

The dynamics in Congress today make the passage of a meaningful deficit reduction bill very unlikely, so I don't expect serious action on this front until 2013 at the earliest.

KR: What do you think the administration's policy priorities will be during 2012? Is there any chance that we will see new legislation to tackle key issues, such as deficit reduction, high unemployment and housing reform, given the seeming unwillingness of elected officials to tackle tough issues?

JS: The Obama administration and congressional Republicans will surely focus their efforts in 2012 on job creation. When more people are employed, other economic problems will start to improve and the road to a more robust recovery will then be evident. I do not expect Democrats and Republicans in Washington to agree on much of anything in 2012, since both will spend their time contrasting to voters how they would lead if given an opportunity to do so following the 2012 elections. Most or all of the big issues will be kicked into 2013 when, hopefully, a more flexible political environment will

exist to solve some of the most challenging problems our country faces.

KR: What will be the fate of the Bush-era tax cuts (both income and dividends) that expire at the end of 2012? Will this be decided by the election in November? What will happen to the payroll tax cuts and unemployment insurance benefits that expire at the end of this year? Is Congress likely to make meaningful progress toward fundamental tax reform in 2012 for passage after the presidential election? And if so, are certain tax shelters such as the mortgage interest deduction and municipal tax exemption at greater risk of elimination?

JS: My view is that Congress and President Obama will not resolve the future of the Bush tax cuts before the November elections. It is difficult to see how the issue could possibly be resolved before November when the two positions – extend all of the tax cuts or part of the tax cuts depending on income levels – are firmly entrenched. I believe they will instead be resolved after the elections in the lame-duck session in November and December. As for the extension of payroll tax relief, I feel it will be approved this month once congressional Democrats and Republicans agree on a way to pay for it. This relief will then be subject to year-end 2012 negotiations as well, along with the Bush tax cuts. Many very significant decisions will be made in the 2012 lame-duck session. With regard to broader tax reform, both parties recognize the need for it, and I am convinced you will see an earnest effort by Congress to tackle this beginning in 2013.

KR: If the unemployment rate remains above 8% on Election Day as we expect, what are President Obama's reelection chances? Some have even speculated that he may decide not to run for reelection in 2012, or that another Democratic candidate could emerge, given lukewarm support at best among fellow Democrats. Is either of these scenarios plausible in your opinion?

JS: I don't believe the rumored scenarios of President Obama not seeking reelection or being replaced by another candidate on the ticket have any legitimacy at all.

The Democratic ticket in 2012 will be Obama-Biden. President Obama faces significant headwinds with the current high unemployment rate and the broad economic anxiety hanging over the country. What voters will be looking for is visible progress on the unemployment rate and other measures. If they sense that the unemployment rate is on a clear, downward trend that will be lasting, they may reward the president with their support. Without a sense that the trend is viable, they are less likely to support him.

If the Occupy movement can rally behind a single issue that reflects the economic anxiety among voters or can effectively move younger voters to vote in greater numbers, they could be a meaningful force in next year's elections.

KR: If it's not impossible for Obama to be reelected, what would need to happen for him to overcome such seemingly insurmountable odds?

JS: The 2012 race will be very close, and I don't think there is a favorite at this time. Of course, voters will make their judgments not just on President Obama and his record, but on other things as well, such as whether they think the alternative candidates on the ballot would do a better job. A lot will happen between now and November 6 of next year that we cannot even predict, and many of these developments will shape voter sentiments on whom they will support. Progress on the leading economic indicators would help the president more than anything, however.

KR: The Republican field is thinning, but when can we expect a viable presidential frontrunner to emerge?

Washington Watch

JS: I think Republicans will have a nominee by late February or March of next year. That will set up a one-on-one contest that will be very different from the current primary elections. Expect both candidates to address the issues and concerns of those independent voters who are not registered as Democrats or Republicans. Whichever candidate can win these votes and maintain a high degree of support and enthusiasm within his or her own party will win.

KR: Do you think the Occupy Wall Street protests can have an impact on the 2012 elections and, if so, how? How would you compare this grassroots effort to the Tea Party movement?

JS: The Occupy movement has already had an impact on politics in general albeit a modest one. The movement has lost some momentum in the past month and has lacked focus on a single issue that may resonate with more voters and better define the movement. The Tea Party movement's success in 2010 was due to its ability to rally behind a single issue – escalating federal debt – that also appealed to voters outside their group, which added to their influence. If the Occupy movement can rally behind a single issue that reflects the economic anxiety among voters or can effectively move younger voters to vote in greater numbers, they could be a meaningful force in next year's elections.

KR: As the US war in Iraq nears an unceremonious end, new foreign policy priorities will soon emerge. China's military presence is growing in the Asia Pacific region, Iran poses a nuclear threat to its

neighbors and the world and Americans remain the potential target of terrorist attacks as a reprisal against the death of Osama bin Laden. Is there a particular area where you think the administration will devote a lot of its attention?

Most voters may not be thinking of Iran at this time, but it is a major issue in Washington and one that will grow in importance.

JS: Absolutely yes. Iran is a topic of growing discussion and concern in Washington every day. It will be a major issue in 2012 and it will continue to be as the region and broader international community struggles to manage the risks presented by Iran. Most voters may not be thinking of Iran at this time, but it is a major issue in Washington and one that will grow in importance.

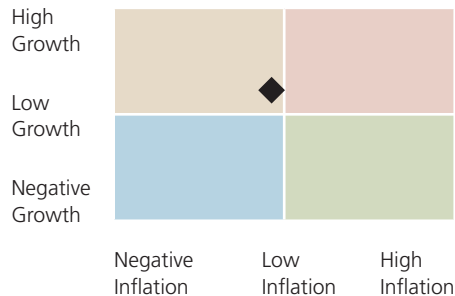
Market Scenarios (next 12 months)

A eurozone recession alongside weaker-than-normal growth in the US and emerging markets is our base case for 2012. The risk of a global recession, either due to a credit crunch or to higher commodity prices, remains unusually high. For the next 12 months, we distinguish the following four scenarios for global growth and inflation:

Slow Growth

55%

Down from 60% in October

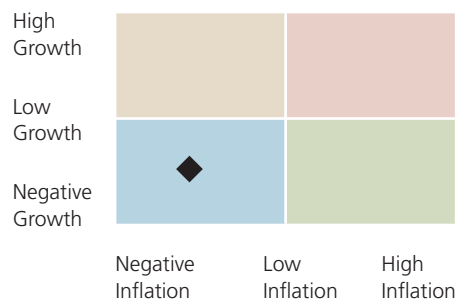


- While the eurozone enters a relatively shallow recession, the US recovery proves to have enough momentum to keep growth positive though sluggish.
- Deleveraging pressures keep growth below historical trends in most developed countries, with unemployment rates remaining far above their pre-financial crisis levels.
- Growth in emerging markets continues to outpace developed markets, though their growth slows as well.

Renewed Recession

25%

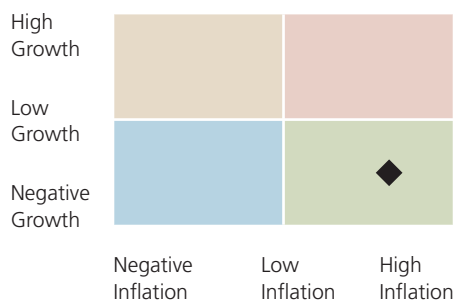
Up from 20% in October



- Bank deleveraging and fiscal consolidation triggers a negative feedback loop, driving Europe into a deeper recession.
- Stress in bank funding markets result in a global credit crunch, which forces consumers and businesses to cut back on spending in the US and globally.
- Weak demand generates deflationary pressures.

Stagflation

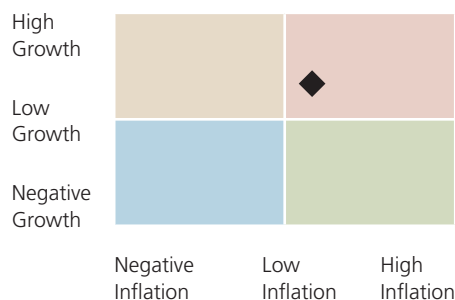
10%



- An energy price shock and / or rising inflation expectations create inflationary pressures. Higher prices erode consumers' purchasing power curbing demand. The US follows Europe into recession.
- The combination of rising price levels and weak growth prospects poses significant challenges to most financial assets.

Strong Expansion

10%



- Loose monetary policy, as well as credible resolution of the eurozone crisis restores the flow of credit. Business and consumer confidence improve, leading to a pickup in spending.
- Improvements in the labor and housing markets set the stage for a more dynamic consumer recovery.

US Growth remains resilient...

US growth has been rather resilient in 2011 despite multiple negative shocks. We think this persistence will carry over to 2012 and that the US economy will continue to expand despite a eurozone recession. A better capitalized US banking system, cyclical activity that is already depressed and an ultra-expansive Fed build a case for an ongoing yet moderate expansion. The risk to our forecasts, however, remains on the downside.

Remarkable US growth resilience

US growth has shown a remarkable resilience to negative shocks in 2011. Despite spiking oil prices, Japan-related supply disruptions and domestic and foreign sovereign debt woes, US growth remained positive, almost reaching its post-recession pace. In part we attribute this resilience to already historically depressed cyclical activity. Consumer discretionary spending as a share of GDP remains near troughs carved out in all prior post-war recessions. There is simply not much more room for a downside correction, barring new, very sizable negative shocks. Furthermore, the Fed has remained ultra expansive and has consistently telegraphed that it would do more if warranted by economic conditions.

Eurozone recession is the biggest risk in 2012

As long as the US banking system remains sufficiently shielded from the eurozone debt crisis, the imminent

eurozone recession does not necessarily have to lead to a US recession. This view is embedded in our US growth forecast, and will be put to the test in the year ahead. We argue that the US banking exposure to eurozone public and private sector balance sheets is limited, so we don't expect a credit crunch in the US. The recent onerous Fed stress test – with the unemployment rate soaring to 13% – showed that the US banking system is well capitalized. We accounted for the estimated eurozone recession by lowering our US forecasts for business capital expenditures and exports. We expect 2012 real GDP growth of 2%, which is below the Bloomberg consensus of 2.2%.

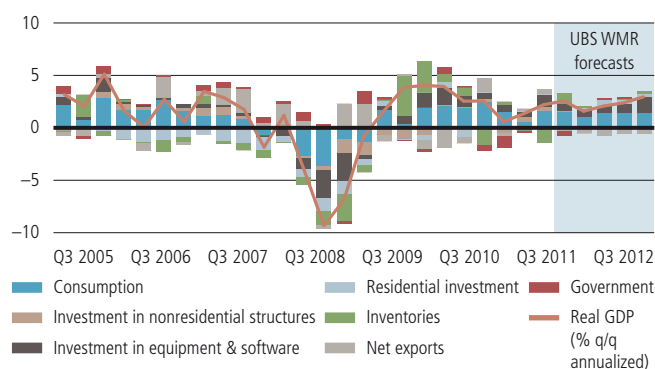
Inflation and the Fed most likely sidelined in 2012

In 2012, growth likely will continue to be a bigger concern than inflation. We therefore expect core CPI inflation to trend sideways at slightly above 2% and forecast 2.1% by year-end. Barring another sizable spike in oil prices, we expect headline CPI inflation to continue its recently initiated downtrend as the effects of past oil price spikes fade. By year-end, we expect 2.2% inflation, down from currently above 3%. With a decent growth / inflation mix, we don't expect the Fed to embark on another round of quantitative easing. The risk case is that growth disappoints and / or core inflation trends lower and the Fed expands its balance sheet.

Thomas Berner, CFA, Analyst

Fig. 1: US growth to stay moderate

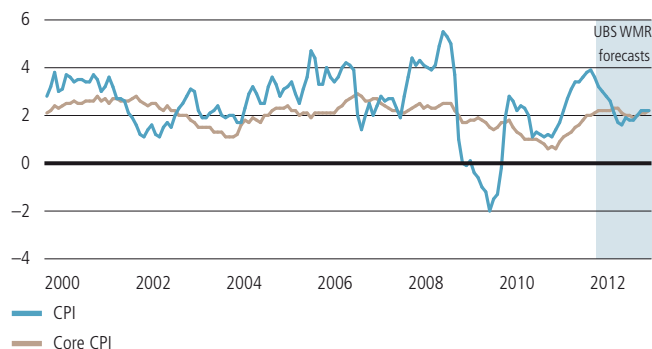
US real GDP growth, quarter-over-quarter annualized, in %



Source: Thomson Datastream, UBS WMR, as of 5 December 2011

Fig. 2: US core CPI inflation to trend sideways

US inflation, consumer price index, year-over-year, in %



Source: Thomson Datastream, UBS WMR, as of 5 December 2011

...while global growth weakens

We expect 2012 to be a recession year for large parts of Europe. With the US also growing at a sluggish pace, emerging markets will slow as their export growth weakens, in our view. While we are not calling for a global recession, our expected global GDP growth rate of 2.7% is clearly no longer far removed from such a scenario.

Eurozone recession cannot be avoided

The sovereign crisis in the eurozone has reached a point where the collateral damage is significant enough that a recession can no longer be avoided. Business sentiment surveys are already in contraction territory and we believe that growth will be negative in the fourth quarter. The bank deleveraging and fiscal consolidation processes will unavoidably lead to a longer economic slump. We have recently downgraded our forecasts and now look for eurozone GDP to contract by 0.7% in 2012. While there is clearly a risk that the outlook could deteriorate further should financial sector stress become more acute, we note that capital expenditure is already at depressed levels, not having fully recovered from the 2008-2009 recession, and that therefore the downside is somewhat limited.

The eurozone's woes should adversely affect the broader pan-European outlook. As a nation on the doorstep of Europe, we do not expect the UK to be immune to these recessionary tendencies. We expect the UK to enter a

double-dip recession in the first half of 2012 but pick up in the third quarter thanks to the Olympics.

Japan should post growth of 2.7% in 2012, higher than the rest of the developed world. However, this is largely a reflection of the post-tsunami reconstruction effort, and growth should be slowing again in 2013.

No Chinese hard landing

Data from China shows growth continuing to slow, and we expect this trend to persist into early 2012. News regarding the real estate market is getting worse, but we maintain the view that a hard landing will be avoided. Inflation has peaked, and a gradual shift from policy tightening to loosening has started. The central bank's recent 50 basis-point cut in the reserve requirement ratio indicates that it is willing to act to support the economy. Growth should pick up again in 2H 2012.

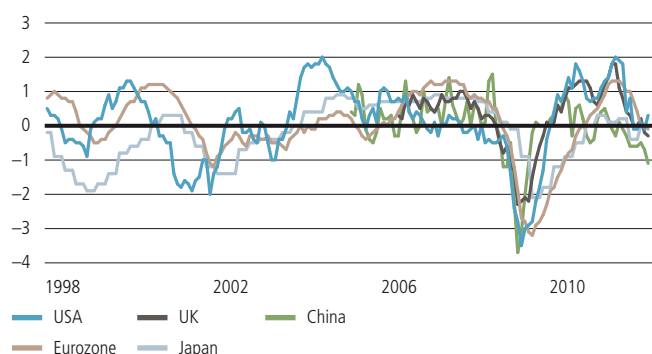
Emerging markets to slow and loosen policy

Within the broader emerging markets group, slowing growth and reduced inflationary pressure has allowed monetary policy to turn from tightening to easing. Several countries have cut rates. However, real rates are already very low in most countries and inflation is still elevated, so dramatic loosening is unlikely.

Stephen R. Freedman, PhD, CFA, Strategist
Brian Rose, PhD, Strategist

Fig. 3: Manufacturing activity has slowed significantly

Global real activity, standardized (mean=0, standard deviation=1)



Source: Bloomberg, UBS WMR, as of 5 December 2011

Fig. 4: Growth and inflation forecasts

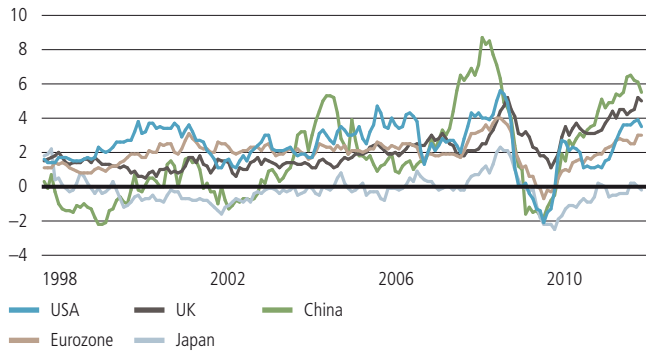
in %	GDP Growth			Inflation		
	'11F	'12F	'13F	'11F	'12F	'13F
World	3.2	2.7	3.4	3.9	2.9	3.1
US	1.7	2.0	2.6	3.1	1.8	2.3
Canada	2.2	2.0	2.4	3.0	2.7	2.3
Japan	-0.3	2.5	1.8	-0.3	-0.2	0.2
Eurozone	1.6	-0.7	0.8	2.7	1.7	1.8
UK	0.9	-0.1	1.1	4.4	2.7	2.0
China	9.2	8.0	8.0	5.4	3.5	4.0
India	6.9	7.3	7.8	7.4	6.8	7.0
Russia	4.1	3.0	3.8	8.7	6.8	6.5
Brazil	3.1	3.8	4.8	6.6	6.1	6.5

Note: For full explanation of this table, please see appendix. F: forecast
Source: UBS WMR, as of 7 December 2011

Economic Outlook: Chartbook

Fig. 5: Inflation seems to be peaking

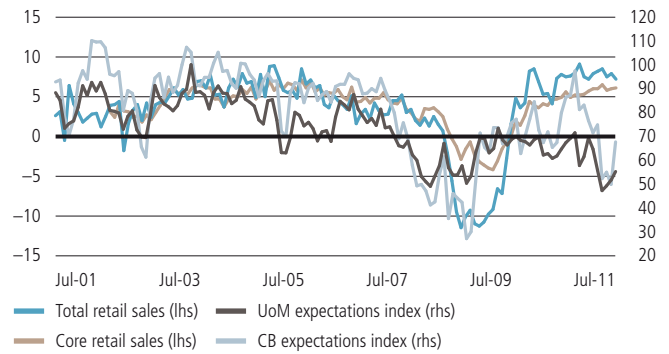
Global CPI inflation rates, year-over-year in %



Source: Bloomberg, UBS WMR, as of 5 December 2011

Fig. 6: US consumer sentiment is improving

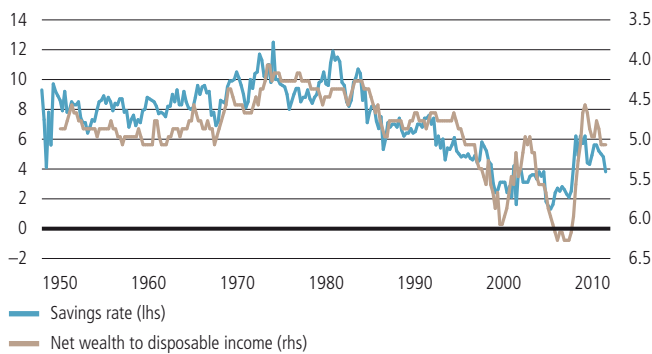
US consumer sentiment (in index levels) and retail sales (year-over-year in %)



Note: UoM = University of Michigan, CB = Conference Board
Source: Bloomberg, UBS WMR, as of 5 December 2011

Fig. 7: Net wealth and the savings rate have stabilized

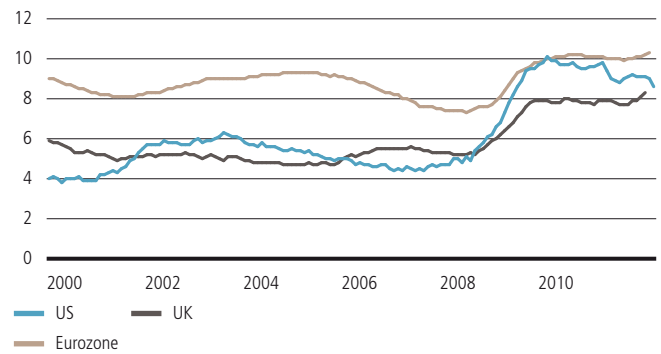
US household net wealth and savings rate, in % of disposable income



Note: Right scale is inverted
Source: Thomson Datastream, UBS WMR, as of 5 December 2011

Fig. 8: Unemployment rates remain elevated

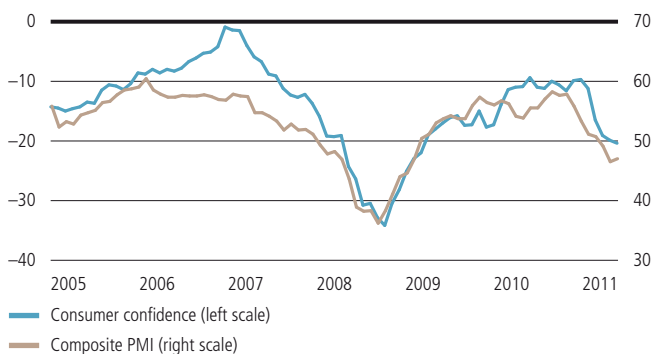
Unemployment rate, in %



Source: Bloomberg, UBS WMR, as of 5 December 2011

Fig. 9: Eurozone back into recession

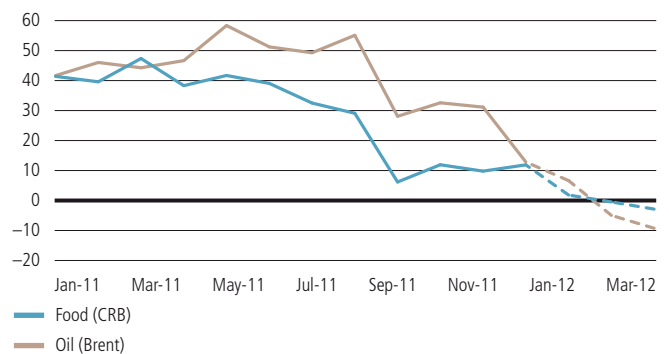
Eurozone Composite PMI and consumer confidence index



Source: Bloomberg, UBS WMR, as of 5 December 2011

Fig. 10: Commodity-driven inflation should ease in 2012

CRB Food Index and Brent crude oil, y/y change, in %

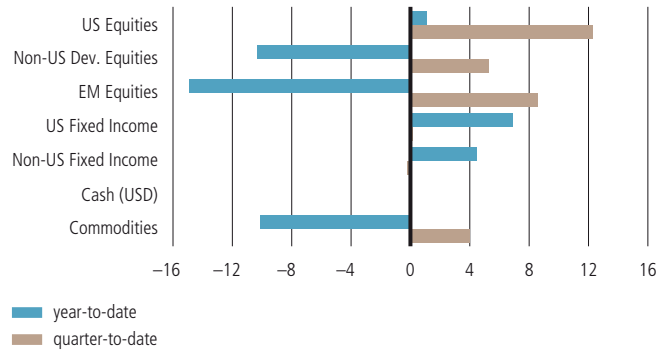


Note: Dashed lines assume prices remain constant at current levels
Source: Bloomberg, UBS WMR, as of 5 December 2011

Financial Market Performance

Fig. 1: Asset Classes

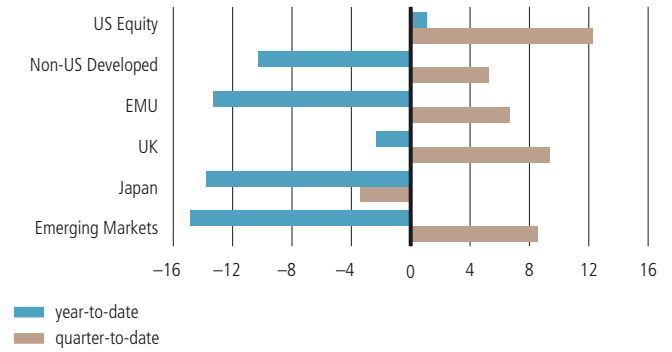
Total return in USD and %



Source: Bloomberg, UBS WMR, as of 6 December 2011

Fig. 2: International Equity

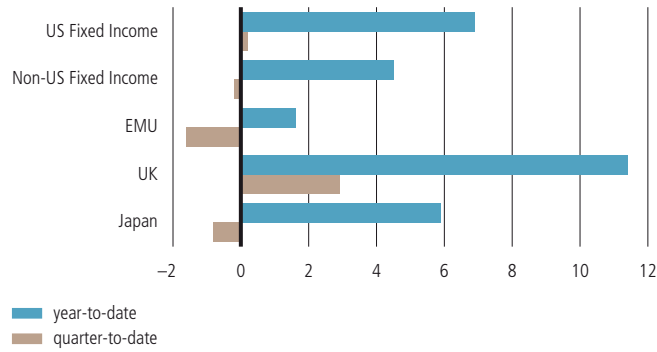
Total return in USD and %



Source: Bloomberg, UBS WMR, as of 6 December 2011

Fig. 3: International Fixed Income

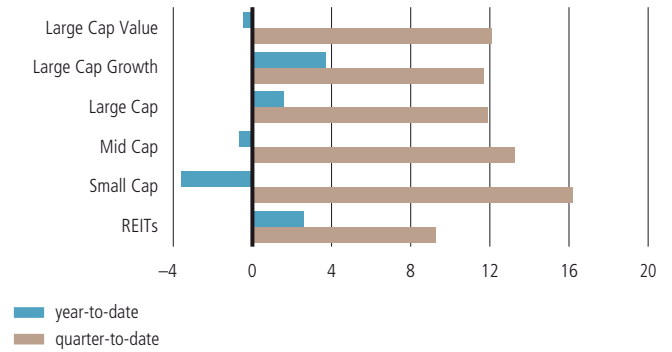
Total return in USD and %



Source: Bloomberg, UBS WMR, as of 6 December 2011

Fig. 4: US Equity

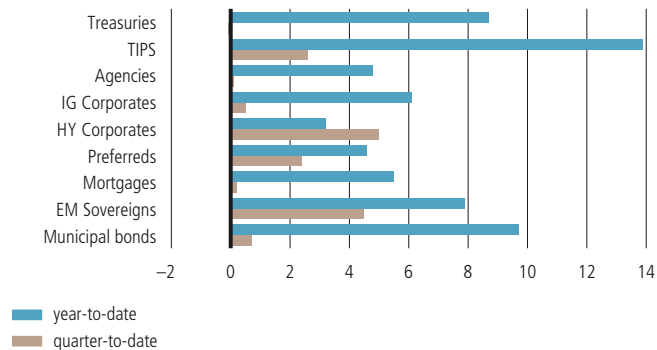
Total return in USD and %



Source: Bloomberg, UBS WMR, as of 6 December 2011

Fig. 5: US Fixed Income

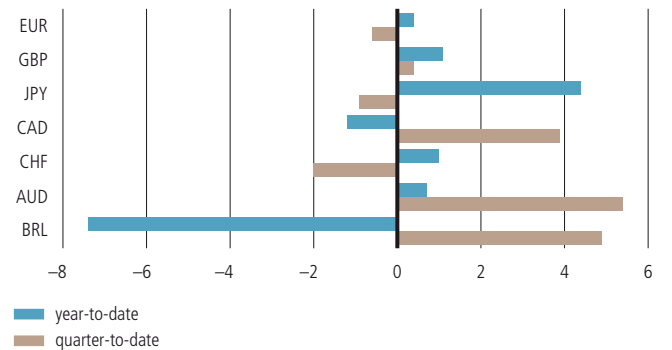
Total return in USD and %



Source: BoAML, UBS WMR, as of 6 December 2011

Fig. 6: Currencies

Appreciation vs. USD in %



Source: Bloomberg, UBS WMR, as of 6 December 2011

Asset Classes

In search of the least ugly asset

With weak global growth, parts of the world in recession and financial stability concerns by no means fully resolved, we expect 2012 to be a challenging year for investors. While on balance we expect that global equities will exhibit some upside during the year, we also think there will be a better time to enter equity markets and therefore recommend entering 2012 defensively positioned.

As 2011 makes way to 2012, it is hard to find an attractive asset class. Stocks appear cheap but are no place to hide should financial and economic stress become more acute. Bonds remain an attractive safe haven but are expensively valued. Commodities would appear set to decline should global growth decelerate further and cash offers a certain zero return. In this context, our asset class selection largely seeks to find the “least ugly” among these asset classes.

All things considered we are electing to remain defensively positioned. We maintain a moderate tactical underweight to the global equity market, largely reflecting a cautious stance on the eurozone, while the US, emerging markets and the rest of the world appear less exposed. We are shifting funds away from cash and thereby upgrading fixed income from neutral to moderate overweight. Within fixed income this largely reflects a preference for credit-sensitive segments such as high-yield corporate

bonds. Finally, we remain moderately underweight commodities.

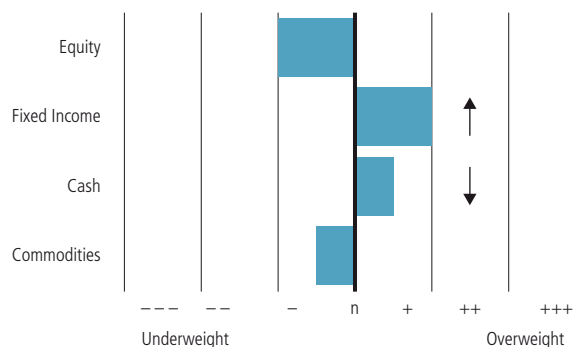
Equities: not cheap enough for adverse scenarios

When deciding whether to invest in stocks, we currently face a challenging problem. Stocks are cheap if one assumes that the world will normalize over the next few years. The price / earnings ratio for global equities is currently a 10.7x consensus forward earnings vs. a historical average of 16.5x since 1985. In the US, the current earnings multiple is 11.4x vs. a historical average of 15.5. Similarly, our proprietary dividend discount model indicates an upside to fair value of 35% for global stocks. However, if one acknowledges that many of the structural problems the world is facing – such as a protracted phase of private and public balance sheet deleveraging – will take a number of years to be fixed, then one is inclined to adjust such lofty valuation gaps downwards.

It is true that equity valuations may already be reflecting a considerable amount of bad news. However, we believe that neither a US recession nor a credit crunch of global scope is priced into the market at this stage. Ultimately, our baseline scenario of a shallow recession in Europe and low but positive US growth would be compatible with high single-digit returns for stocks over the next 12 months. However, we also need to acknowledge that the downside risk to our baseline is high in terms of both

Fig 1: Asset class preferences

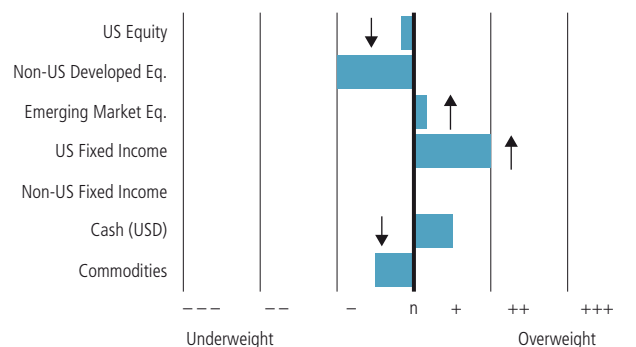
Tactical deviations from benchmark



Note: Black arrows indicate changes as of 7 December 2011. Scale explained in Appendix
Source: UBS WMR, as of 7 December 2011

Fig 2: Asset class and regional preferences

Tactical deviations from benchmark



Note: Black arrows indicate changes as of 7 December 2011. Scale explained in Appendix
Source: UBS WMR, as of 7 December 2011

probability and adverse impact. We therefore choose to maintain a cautious stance on equities, mainly by keeping a reduced eurozone exposure.

Bonds: balancing portfolio stabilization and yield pickup

Government and related securities are trading at near historically low yields. This means income from investments in such bonds will be limited. Furthermore, over a three- to five-year horizon, we would expect yields to rise significantly as the economy normalizes, thereby further depressing returns. Yet with the Fed on hold possibly until mid-2013 and ready to implement QE3 if the economy were to weaken further, we do not expect yields to rise sharply in 2012. Moreover, if any of the adverse scenarios discussed above were to materialize, US Treasuries would likely remain the best-performing asset. This means that bonds are currently an overvalued asset class with limited near-term downside, which offers some potential to help stabilize portfolios if things go bad.

It is in this context that we are shifting funds away from zero-yielding cash and into fixed income. We note, as discussed in the US fixed income section of this publication, that within fixed income we have a clear preference for credit-sensitive segments such as corporate bonds – high-yield corporates in particular, which offer a yield pickup relative to government bonds and should benefit from the balance sheet strength and solid rating trends of corporate America.

Fig. 3: Asset class scorecard

Scores range from -3 (very unattractive) to +3 (very attractive)

	Valuation	Cyclical	Timing	Overall
Global Equities	+1	-1	-1	-1
Commodities	-1	-1	+0	-1
Fixed Income	-1	+2	+0	+1

Source: UBS WMR, as of 7 December 2011

Commodities: not time to step in yet

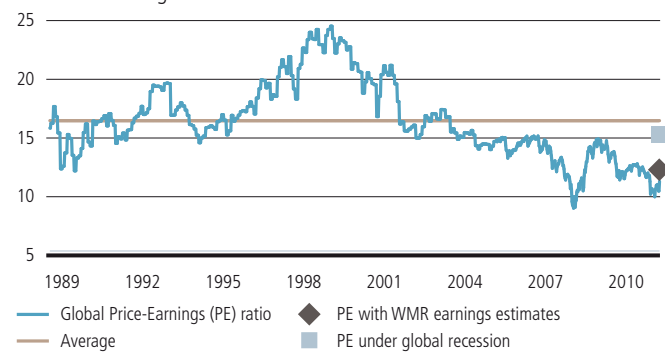
While US indicators have picked up recently, global growth indicators remain under pressure. Commodity markets continue to be a largely cyclical asset class that reacts to trends in demand conditions. We believe that, given the global outlook, the upside for commodities should be limited in the near term, with potential downside risks still in place. Over the full year, commodities are likely to be better supported given supply constraints and steady demand growth in emerging markets (see Dominic Schnider’s article on page 46).

Consider also that, unlike equities and bonds, which offer current income, commodities offer no yield. Currently for broad commodity indexes, there is even a negative cost of carry. The roll yield, incurred in any investment that relies on commodity futures, is typically negative. It has been -6% over the last 12 months. With the commodity forward curve somewhat steeper than average, we would expect a -8% roll yield over next year, i.e., spot prices would have to rise by more than this percentage for a broad commodity investment to yield a positive total return. We recommend waiting before entering the commodity space and maintain a moderate tactical underweight to the asset class.

Stephen R. Freedman, PhD, CFA, Strategist

Fig. 4: Global stocks are cheaper than average but for a reason

MSCI All Countries World index, 12-month forward Price-Earnings ratio on consensus earnings

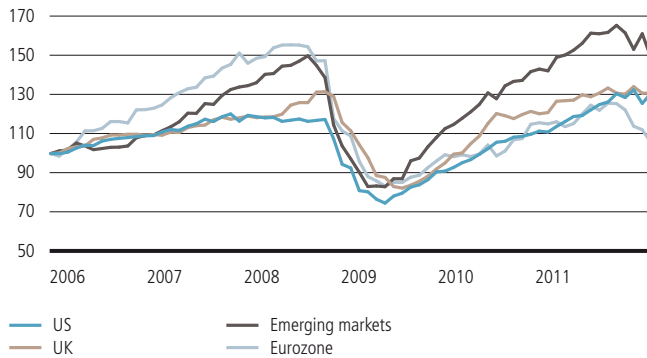


Source: IBES, UBS WMR, as of 5 December 2011

Asset Classes: Chartbook

Fig. 5: Earnings downgrades especially large in eurozone

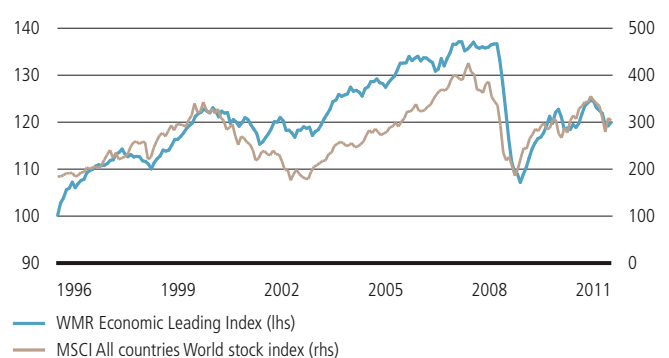
12-month forward consensus EPS forecasts, indexed Jan. 2006 = 100



Source: IBES, Datastream, UBS WMR, as of end-November 2011

Fig. 6: Economic leading index flattening out

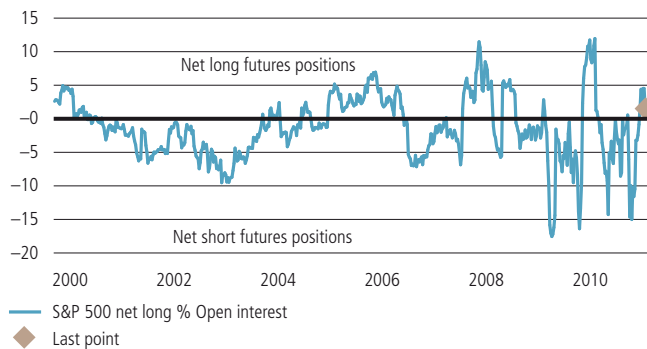
WMR global economic leading index and MSCI AC World equity index



Source: UBS WMR, Bloomberg as of 6 December 2011

Fig. 7: Stocks are no longer oversold

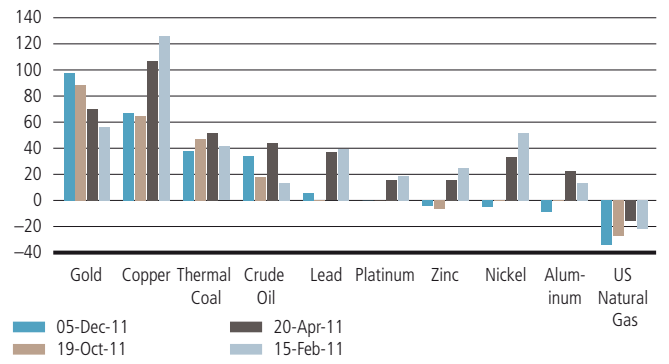
S&P 500 net speculative long futures position in % of open interest



Source: CFTC, Bloomberg, UBS WMR, as of 29 November 2011

Fig. 8: Commodity prices are above costs

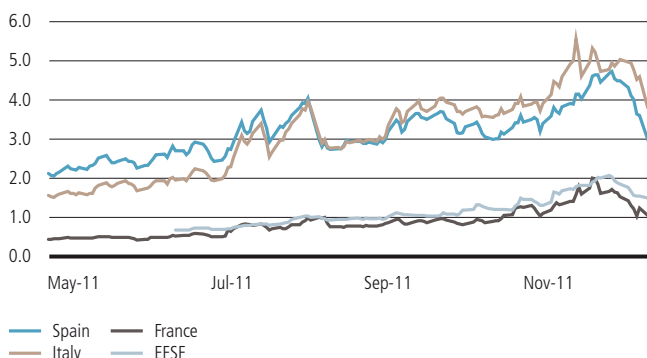
Valuation premium vs. marginal costs of production, in %



Source: Bloomberg, UBS WMR, as of 5 December 2011

Fig. 9: European spreads have narrowed but remain elevated

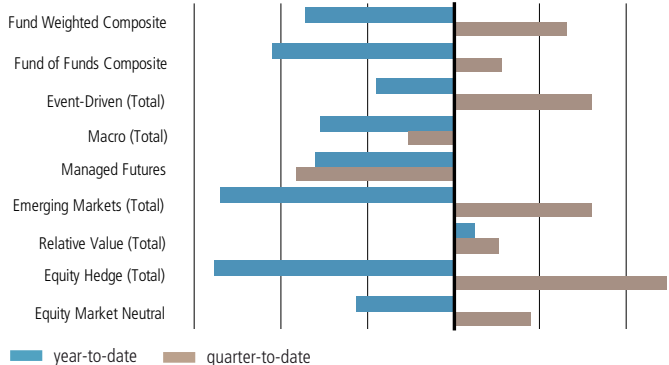
10 year bonds, yield spread over Germany, in %



Source: Bloomberg, UBS WMR, as of 6 December 2011

Fig. 10: Performance of selected hedge fund strategies

Until 30 November 2011



Note: All figures based on Hedge Fund Research HFRI indices
Source: Bloomberg, UBS WMR, as of 30 November 2011

Dollar rally to be short-lived

The four major currencies – the US dollar, euro, pound and yen – all have serious structural problems. Government as well as private sector debt could pose a fundamental risk for the stability of each currency, one which will not be resolved in the short term. Currencies with more positive fundamentals have appreciated strongly over the past few years and therefore have only limited return potential. The outlook on currency markets for 2012 is therefore not characterized by any clear tendencies.

Dollar may come under renewed pressure by end of 2012

Over the next few months the sovereign debt crisis in Europe is likely to keep pressure on the euro, and this could work in favor of the dollar against other currencies as well. However, we expect the dollar to be weaker again by the end of 2012. The US has the highest outstanding foreign debt of any country and continues to run large trade deficits. It therefore remains dependent on foreign financing. China, the Middle East and other potential buyers of US government bonds are normally somewhat more reserved with their purchases when growth slows. The presidential elections will likely be of little help in propping up the dollar, because neither party will present a credible dollar-friendly savings program.

If it turns out that an economic slowdown becomes a minefield for the euro and the US dollar, then we believe

this will also apply in a certain sense to the most liquid alternative currencies – the Australian and Canadian dollars, the Swiss franc and both Scandinavian crowns – a group we refer to as the “favorite five” based on their solid long-term currency fundamentals. However, it has become difficult to recommend these smaller currencies given their present overvaluation. The Swiss National Bank has put a clear stop to the franc’s appreciation. Other currencies are so overvalued that there is a significant risk of correction. However, we still believe that our favorite five have a high intrinsic value and are worth buying on dips.

This also applies to the stronger emerging market currencies, such as Brazil, Singapore, China and Poland. Yet, in turbulent times, any of these currencies could experience a devaluation as recession fears and risk aversion are a dangerous mix for currencies that have surged in recent years.

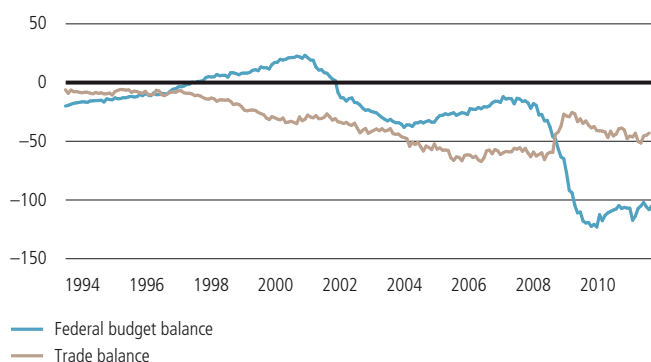
The yen is due for a significant depreciation. However, this will probably happen only after interest rates rise globally, which is not likely to happen in 2012. The British pound is the only major currency that looks cheap against the dollar. The UK appears headed for recession, but if the economy begins to improve in the second half of 2012, the pound could gain significantly.

Brian Rose, PhD, Strategist

Thomas Flury, Strategist

Fig. 1: Twin deficits may keep pressure on dollar

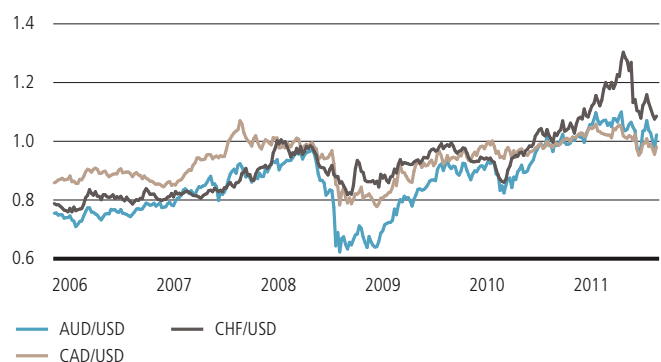
Federal budget balance (12-mo. moving average) and trade balance, in USD bn.



Source: Bloomberg, UBS WMR, as of 5 December 2011

Fig. 2: Many currencies remain overvalued against the US dollar

Exchange rates, higher figures reflect weaker US dollar



Source: Bloomberg, UBS WMR as of 2 December 2011

Favor EM and US over non-US developed equities

Economic growth is weakening in most countries overseas and it appears that the eurozone is already in recession. We expect earnings downgrades to be the norm in 2012. Against this backdrop, we favor emerging markets and the US over the non-US developed markets. Within emerging markets we prefer China and India as high-growth countries in a low-growth world. Among the developed markets, we favor the UK and recommend an underweight position in the eurozone.

Earnings likely to disappoint

Despite the gloomy economic picture, hope springs eternal, at least among equity analysts. Consensus forecasts call for double-digit growth in 2012 global earnings, which looks too optimistic, in our view. Earnings forecasts have been cut substantially in recent months, and we expect this trend to continue in the months ahead. While valuations are of course important, the key to relative performance in 2012 is likely to be the degree to which companies can live up to analysts' earnings expectations.

Favor the UK over the eurozone within non-US developed markets

In our view, the eurozone has already fallen into recession, and we expect negative GDP growth in 2012. The situation in the UK is not much better, as fiscal austerity measures are weighing heavily on consumers and another dose of budget cuts is in store for 2012. However,

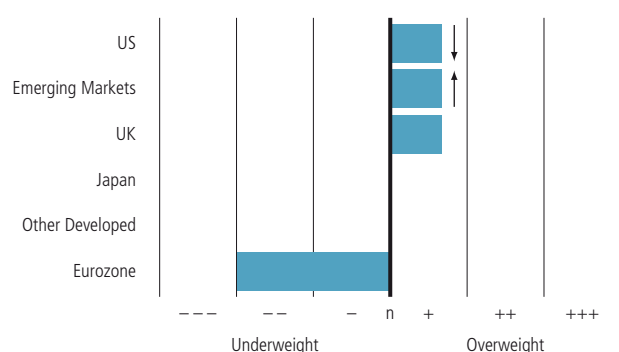
we have a clear preference for the UK over eurozone equities. Valuations are similar, with the markets priced at just over 9x consensus earnings forecasts. With 70% of UK earnings generated outside of the country, including considerable exposure to the emerging markets, there is a reasonable chance that earnings growth will at least be positive in 2012 despite the weak domestic economy. By contrast, we see very little reason to expect eurozone earnings to get anywhere close to the bottom-up consensus of +9%. Furthermore, the pound looks cheap against the dollar, offering hopes for exchange rate movements to add to returns in dollar terms.

Japan looks more attractive than usual

Japan was a disappointment again in 2011, matching the eurozone as the worst performer among the developed markets as a result of the tragic earthquake and tsunami. The good news is that the lower prices leave valuations looking more attractive than they have in the past, and earnings appear likely to grow in 2012 as reconstruction spending gives the economy a boost. While it is much more tempting than usual to go overweight, there are still enough negatives to keep us with a neutral stance. The yen looks overvalued, especially against the Korean won, allowing Korea manufacturers to grab away market share in everything from autos to flat-panel TVs. Furthermore, the huge pile of debt left over from previous attempts to stimulate growth is a negative with investors increasingly concerned about government finances.

Fig. 3: Equity Regions

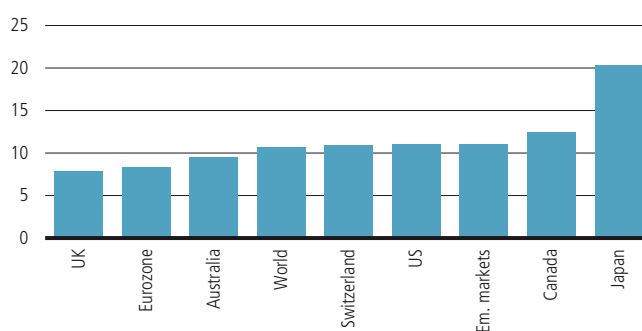
Tactical deviation from benchmark



Note: Black arrows indicate changes as of 7 December 2001. Scale explained in appendix. Source: UBS WMR as of 7 December 2011

Fig. 4: Consensus earnings estimates appear too high

Consensus estimates for 12-month forward earnings per share, y/y % change



Source: IBES, Datastream as of 5 December 2011

A mixture of positives and negatives among other developed markets

The other non-US developed markets offer a mixture of positives and negatives, leading us to recommend a neutral stance. Canada has relatively strong fundamentals and its close link to the US could be an advantage with Europe in turmoil. However, valuations look more expensive than in other developed markets. Australia appears attractive in terms of valuations and its relatively high growth potential, but the strong currency makes it difficult to recommend the market to dollar-based investors. Switzerland features defensive sectors and strong balance sheets, but is a bit too expensive.

Emerging markets may “reemerge” in 2012

We have upgraded emerging markets from neutral to moderate overweight within our international equity model. They have performed more like “submerging” markets so far in 2011, falling more than even the eurozone when measured in dollars. The trouble started with a surge in food and oil prices at the beginning of the year. The larger economies, including China, India and Brazil, had relatively little slack in their economies, leading to a particularly difficult battle against inflation. The authorities repeatedly tightened policy, which eventually had an impact on economic growth and earnings. Furthermore, against our expectations, many emerging market currencies lost ground against the dollar, pushing down returns in dollar terms.

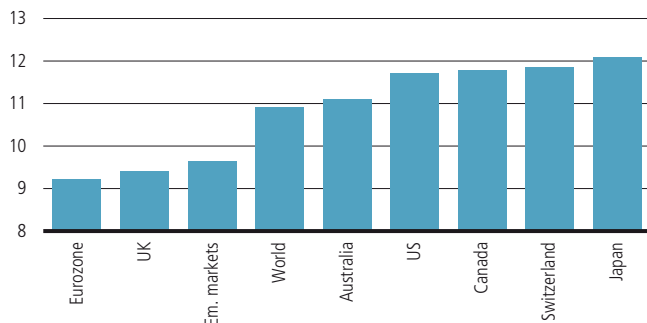
The good news is that inflation is now heading lower, which should lead to better market performance in 2012. Brazil has already started cutting interest rates, while China cut its bank reserve requirement ratio, making it easier for credit to expand. Inflation remains at uncomfortable levels in India but rate cuts should be possible at some point in 2012. Although we expect slower economic growth and weak exports to limit earnings to single-digit gains in 2012, looser monetary policy could allow the price-to-earnings multiple to rebound at least modestly.

Within emerging markets, we recommend an overweight on both China and India. After two years of underperformance, China now trades at a substantial discount to the rest of emerging markets and simply looks too cheap given its rapid economic growth rate. However, we do have some doubts on the very short-term outlook as we expect the real estate market to deteriorate further, which could scare many investors out of the equity market. India looks relatively expensive on some valuation measures, but we are comfortable paying 12x forward earnings given its exceptionally strong long-term growth prospects. Relative to China, India is still at an early stage of development, and its demographics suggest that the labor force will continue expanding for decades.

Brian Rose, PhD, Strategist

Fig. 5: Valuations look attractive in most markets

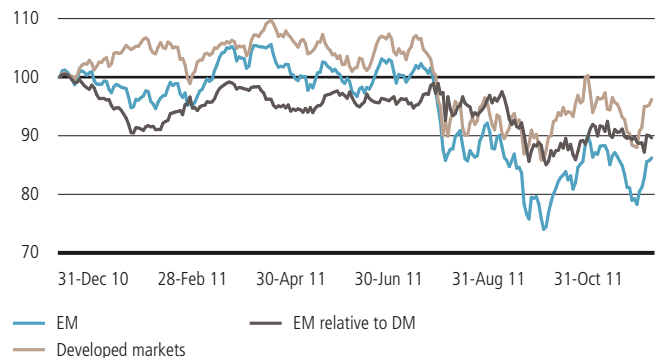
Price to earnings ratio based on consensus estimates for 12-month forward earnings



Source: IBES, Datastream, UBS WMR as of 5 December 2011

Fig. 6: Emerging market equities have underperformed in 2011

Performance in USD, indexed end-2010 = 100



Source: Bloomberg, UBS WMR as of 5 December 2011

Stick with strong fundamentals

With yields on US Treasuries near record lows, the higher yields offered by certain international bonds appear attractive. However, very high yields are usually a sign of danger; we advise leaning toward countries with stronger fundamentals while avoiding the riskiest debt and recommend a preference for US vs. non-US fixed income.

Important to keep exchange rate risk in mind

Our views on international fixed income are closely linked to the outlook for foreign exchange rates, as the relative performance of US and non-US fixed income investments is often dominated by changes in the value of the US dollar. As noted in the Foreign Exchange section, we expect the dollar to be under renewed downward pressure by the end of 2012. However, we expect short-term dollar rallies will offer opportunities to diversify into foreign bonds at more favorable exchange rates and are therefore adopting a short-term preference for US over non-US fixed income.

Long-term opportunities in the "favorite five"

The governments of the "favorite five" countries (Canada, Australia, Switzerland, Norway and Sweden) all have relatively solid finances. With the exception of Switzerland, where bond yields are extremely low, these countries are good candidates for fixed income investments. The British pound's weakness against the dollar also makes UK bonds appear reasonably attractive.

Stay cautious on eurozone bonds

Some of the highest yields offered in international markets are from eurozone sovereign bonds. With two-year Treasuries yielding 25 basis points, the double-digit yield on Portugal's government bonds or the triple-digit yield for Greece can seem awfully tempting. However, we recommend extreme caution when it comes to debt of the weaker eurozone members. With most of the eurozone already in recession, governments are likely to miss their budget deficit targets, adding pressure to bond markets. Even though we think it is unlikely that the eurozone will break apart, we still expect Greece to default early in 2012. Investors may eventually recover only a small fraction of the bonds' face value. Even for countries that we believe face little risk of default in the short run, ratings downgrades are likely.

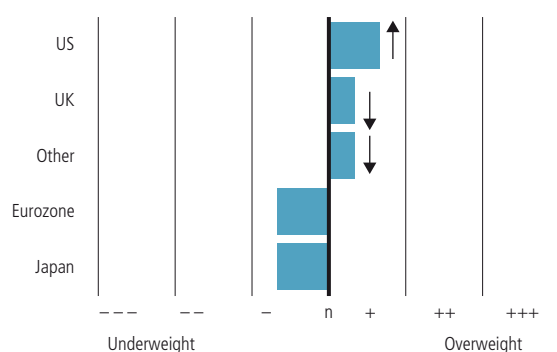
No value in Japan

Japanese government bonds offer the worst of all worlds. The government's debt-to-GDP ratio is above 200%, yet 10-year bond yields are near 1%. The yen is also near record-high levels against the dollar. While we do not expect a major deterioration in 2012, at some point we expect a sell-off in Japanese government bonds and the yen to weaken sharply. Although considered a safe haven by some, we recommend avoiding Japanese debt.

Brian Rose, PhD, Strategist

Fig. 7: Fixed Income Regions

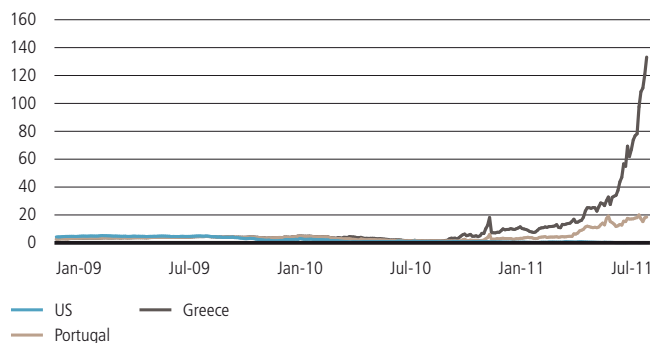
Tactical deviation from benchmark



Note: Black arrows indicate changes as of 7 December 2011. Scale explained in appendix. Source: UBS WMR as of 7 December 2011

Fig. 8: Beware Greeks bearing high yields

2-yr government bond yields, in %

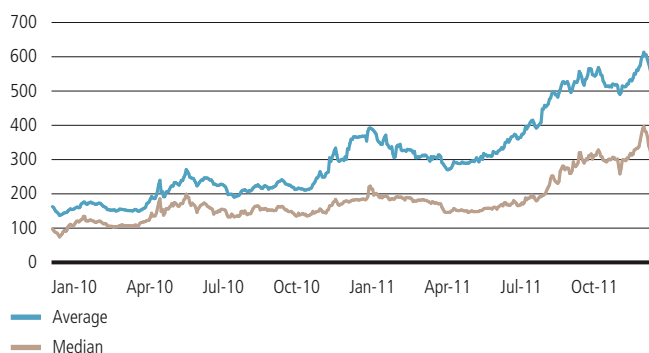


Source: Bloomberg, UBS WMR as of 2 December 2011

International markets: Chartbook

Fig. 9: European banks under stress

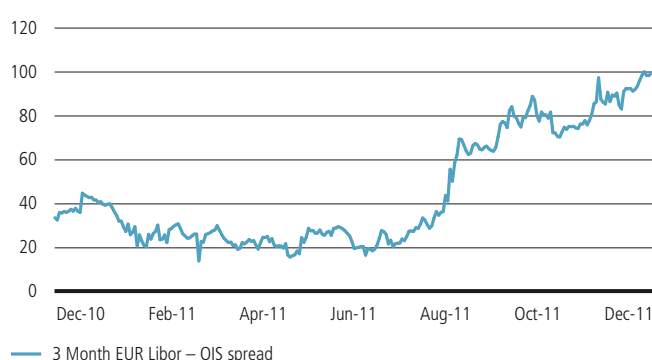
5-year CDS spreads for European banks, in basis points



Source: Bloomberg, UBS WMR as of 6 December 2011

Fig. 10: European interbank market remains under stress

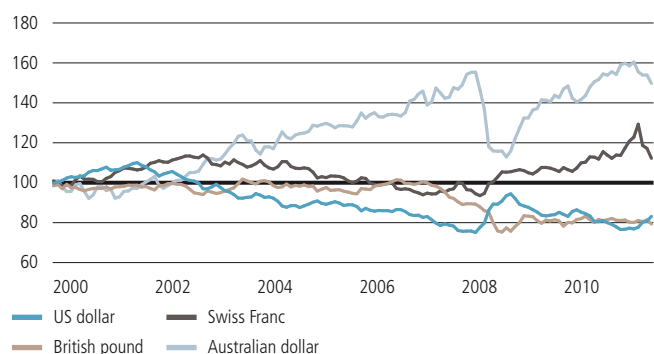
Spread between euro 3-month Libor and Overnight Index Swap, in basis points



Source: Bloomberg, UBS WMR as of 6 December 2011

Fig. 11: US dollar and pound are undervalued, aussie overvalued

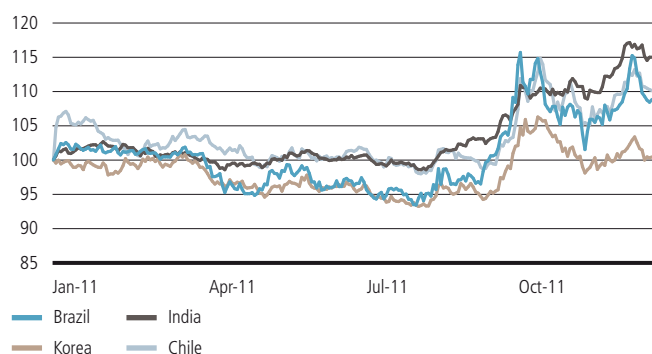
JP Morgan Real Effective Exchange Rate, CY2000 = 100



Source: Bloomberg, UBS WMR as of 6 December 2011

Fig. 12: Many emerging market currencies have weakened

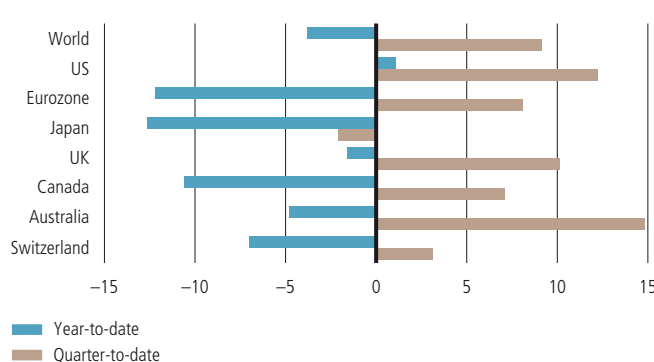
Exchange rate vs. USD, higher figures indicate weaker rate vs. USD



Source: Bloomberg, UBS WMR as of 6 December 2011

Fig. 13: US outperformed global equities in 2011

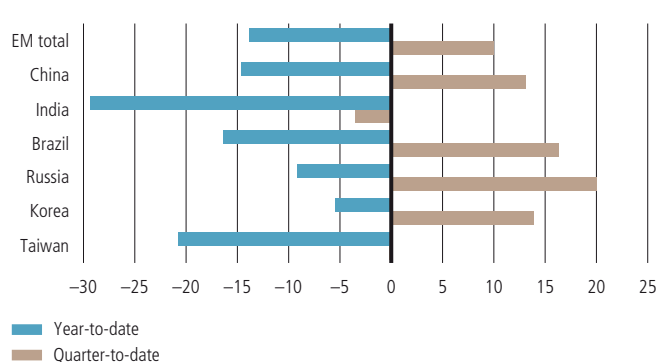
Developed market returns in USD, %



Source: Bloomberg, UBS WMR as of 6 December 2011

Fig. 14: 2011 a rough year for emerging market equities

Emerging market returns in USD, %



Source: Bloomberg, UBS WMR as of 6 December 2011

Quality, secular growth and yield to be rewarded

With S&P 500 earnings growth set to slow, we favor Technology, Consumer Staples and Healthcare – sectors with strong balance sheets and defensive growth characteristics. Low interest rates should continue to support relatively high Telecom and Utilities valuations. We are cautious on Financials and global Cyclical due to outsized exposure to Europe.

In 2012, equity investors will have to contend with a recession in Europe, sluggish US growth and decelerating activity in emerging markets. Despite these headwinds, bottom-up analyst estimates still call for S&P 500 earnings to grow 10% in 2012, on top of 2011's record earnings. We believe estimates are too high and look for only 2% profit growth next year, driving our outlook for only modest gains in the overall equity market.

Given this backdrop, we favor defensive sectors such as Healthcare and Consumer Staples where earnings are less correlated to the overall economic cycle and consensus expectations appear achievable. These sectors also benefit from relatively high and growing dividend yields. Low interest rates should continue to enhance the appeal of the high dividend-yielding sectors, Telecom and Utilities. As noted in the following section, growth stocks should outperform due to a maturing profit cycle, which should benefit Technology stocks. We begin the year with a focus on stable growth and high-quality market segments that are best positioned to outperform in a volatile and range-bound equity market environment.

Information Technology (overweight)

We keep Technology at overweight but upgrade semiconductors and downgrade hardware. Tech remains our preferred cyclical sector and we expect it to report the fastest earnings growth of any sector in 2012. Tech also boasts low valuations, rock solid balance sheets, growing dividends and often dominant shares in markets that are benefitting from large and growing emerging markets demand. Strong product cycles in tablets and smartphones underpin our view. The scheduled introductions of a new Intel chip that reduces power consumption by one-third and a new Windows operating system both have the potential to spur replacement PC demand.

Consumer Staples (overweight)

Consumer Staples remains our favored means of participating in emerging markets consumer demand growth and one of our preferred defensive sectors. Rising wealth in emerging markets should support earnings and dividend gains for many years to come. However, valuations are elevated (the sector trades at a 24% P/E premium to the market versus a long-term average premium of 10%). The high relative valuation drives a reduction in our rating from strong overweight to overweight.

Healthcare (overweight)

We upgrade Healthcare to overweight. We like pockets of growth within the space which are largely uncorrelated to the economy and also the sector's attractive dividend yields. Managed care organizations are benefitting from gains in enrollment as the baby boomers qualify for Medicare, while drug distributors benefit from the transition to generic drugs. Even the outlook for shares of large-cap pharmaceutical companies is beginning to brighten after years of underperformance as the wave of patent expirations has already begun. With this headwind mitigating in 2013 and the group trading at a P/E multiple of under 10x, higher-yielding pharma stocks look increasingly attractive.

Consumer Discretionary (neutral)

The Consumer Discretionary sector is somewhat of a heterogeneous group that spans e-commerce, homebuilders and media companies, among others. In general we like the sector's lower-than-average exposure to Europe and strong market shares for a number of large companies. Within the sector we prefer industries that have companies with strong brands (and thus pricing power) and lower sensitivity to the aggregate level of consumer spending.

Energy (neutral)

Despite a slowdown in global economic growth in 2012, we expect oil prices to remain elevated. Demand in Europe will contract but continued emerging markets growth should keep oil markets reasonably tight. Libyan production will return to the market but Saudi Arabia has already announced output reductions in order to maintain prices near its target of \$100 per barrel. Social unrest and geopolitical tensions will likely remain elevated, creating

the risk of an upward spike in oil prices. We raise our rating from moderate underweight to neutral.

Telecom (neutral)

The US government’s suit to block the proposed merger between AT&T and T-Mobile means that wireless pricing is likely to remain fairly intense. Additionally, telecom companies continued to lose market share in broadband to cable operators. With valuations elevated relative to history, we downgrade the sector from moderate overweight to neutral. A 5.5% dividend yield should continue to be attractive to yield-oriented investors.

Utilities (neutral)

We lower Utilities from moderate overweight to neutral. Similar to the Telecom sector, Utilities offers relatively high and stable dividend yields (currently 4.1%). However, the group has had a strong run in 2011 outperforming the S&P 500 by 14% – the best relative performance since the Tech bubble burst in 2000 – leaving relative valuations somewhat stretched. In addition, the recent pullback in power prices will be a headwind for the merchant power generators.

Financials (underweight)

Financials will likely remain a high-beta and volatile sector tethered to events in Europe. We find the risk / reward trade-off for US financials unattractive given the prospects for further eurozone sovereign stress. While

a comprehensive solution to the European financial crisis would be a positive catalyst, policymakers have so far been unable to devote the financial resources and implement the structural reforms necessary to ease investor concerns. Even if progress is made in the near term, we fear that implementation will be difficult and subject to periodic bouts of extreme market anxiety which would negatively impact US Financials.

Industrials (underweight)

With global growth decelerating and European economies now expected to be in recession in 2012, we see scope for earnings disappointments for Industrials. Capital goods companies derive 20-25% of revenues from Europe. Valuation support is limited – Industrials trade at a 24% price-to-book premium to the market versus an average of 18% over the last five years.

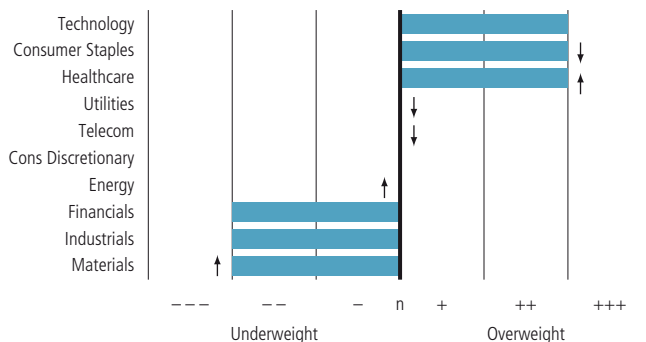
Materials (underweight)

Outside of the Financials sector, materials have the poorest earnings revisions momentum of all ten sectors. With over 25% of revenues from Europe and 2012 consensus expectations still calling for 10% earnings growth, look for further estimate cuts. Valuation appears only fair. We continue to expect further underperformance but after significant estimate cuts have already occurred, we trim our allocation from strong underweight to underweight.

Jeremy Zirin, CFA; David Lefkowitz, CFA; Joe Sawe, Strategists

Fig. 1: Defensive growth sector bias

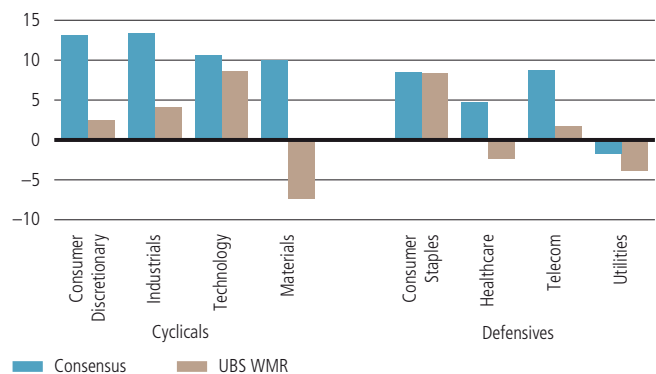
Tactical deviations from benchmark



Note: Black arrows indicate changes as of 7 December 2011. Scale explained in appendix. Source: UBS WMR, as of 7 December 2011

Fig. 2: Further earnings cuts for cyclicals

Consensus and UBS WMR 2012 earnings growth estimates, in %



Source: Factset and UBS WMR, as of 5 December 2011

Growth over value in 2012 (again)

Slowing corporate earnings growth and modest equity market return expectations in 2012 suggest that large-caps and growth stocks are best positioned to outperform. Real estate investment trusts still appear pricey, but remain attractive to yield-oriented investors.

Modest return expectations favor large-caps in 2012

The large-cap Russell 1000 Index is on track to outperform the small-cap Russell 2000 Index by 5% in 2011 as of December 6. The bulk of the relative outperformance was delivered during the second half of the year when stocks of all sizes came under pressure from both the deepening European sovereign debt crisis and deteriorating outlook for global growth. Small-cap stock indexes have a high beta – or market sensitivity – meaning that they tend to outperform in rising markets and underperform in falling markets. Currently, the two-year beta of small-cap stocks is 1.30 compared to its 30-year average of 1.11, implying that the direction of the broad market is likely to continue to be a powerful factor in driving the relative performance between small- and large-cap stocks.

Typically, small-cap stocks deliver their strongest gains during the early stages of the economic cycle. This pattern once again occurred in the current cycle with small-caps significantly outperforming following the market bottom in March 2009 through December 2010. But as economic growth disappointed and equity markets stalled in 2011, small-caps have lagged. In part, this dynamic is driven by

the fact that small-caps have greater exposure to cyclical sectors (see Fig. 4).

Our 2012 year-end S&P 500 price target of 1300 implies low single-digit returns in 2012. Using history as a guide, modest broad market returns and slowing profit growth do not bode well for small-caps relative to large-caps. Over the past 33 years, large-caps tend to outperform when broad market indexes produce annual returns less than 10% (see Fig. 5). Fundamentally, the stage appears to be set for another year of large-cap outperformance – particularly on a risk-adjusted basis. Large-cap valuations are low compared to small-caps and very low relative to mid-caps. Our defensive sector bias would also suggest large-cap outperformance. Also keep in mind that small- and mid-cap indexes have a much higher weight in the Financials sector, which we currently underweight.

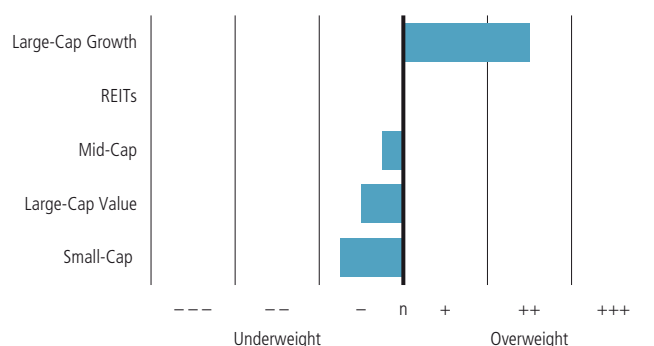
Finally, although mid- and small-caps are highly correlated, we have a modest preference for mid-caps over small. Mid-cap valuations appear relatively high, but in range-bound markets mid-caps may offer the best of two worlds – the relative stability of large, more established companies with ample trading liquidity and the higher earnings growth potential of small-caps.

Growth over value remains our highest conviction call

Since mid-2006, growth stocks have steadily outperformed value stocks. We look for more of the same in

Fig. 3: Favor large-cap growth

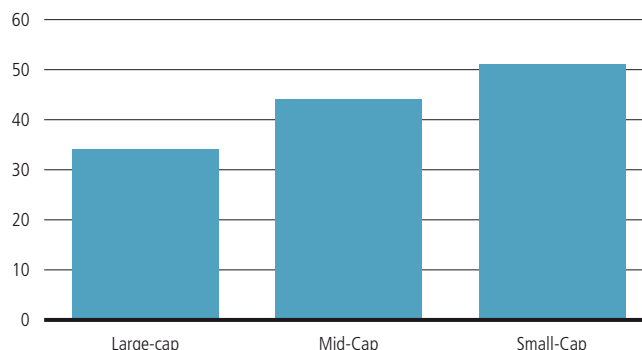
Size, style, and REITs recommended allocation, deviation from benchmark



Source: UBS WMR as of 7 December 2011

Fig. 4: Small-caps have high cyclical exposure

Net cyclical exposure (cyclicals mkt cap less defensives mkt cap), in %



Source: Bloomberg and UBS WMR as of 5 December 2011

US Equities: Sectors: Size and style, REITs

2012 driven by three factors. First, growth stocks tend to outperform value stocks when the profit cycle slows. While this may at first blush seem counterintuitive (growth is slowing, after all), it is precisely because fewer companies have cyclical tailwinds to boost their earnings growth rate that an increased scarcity value for secular growth stocks results. Historical evidence backs up this conclusion. Since the inception of the Russell 1000 Growth and Value Indexes in 1979, growth stocks have outperformed by 760 basis points on average when earnings growth is “flattish” (see Fig. 6). With corporate earnings growth set to decelerate from roughly 15% in 2011 to low single-digits in 2012, growth stocks are in solid position to outperform once again.

Regular readers of our equity style views will be familiar with our assertion that sector influences play an important role. Specifically, the relative performance of growth versus value is highly correlated to the relative performance of the Technology versus the Financials sector given the outsized representation of Tech in the growth index and Financials in the value index. Heading into 2012, we strongly favor the prospects for Technology stocks over Financials. Low valuation, strong earnings exposure to both emerging markets and corporate over consumer spending end markets, as well as fortress balance sheets boost the investment case for Technology. Meanwhile, Financials appear poised for another difficult year as US economic growth remains subtrend and global

financial market strains emanating from Europe are likely to remain.

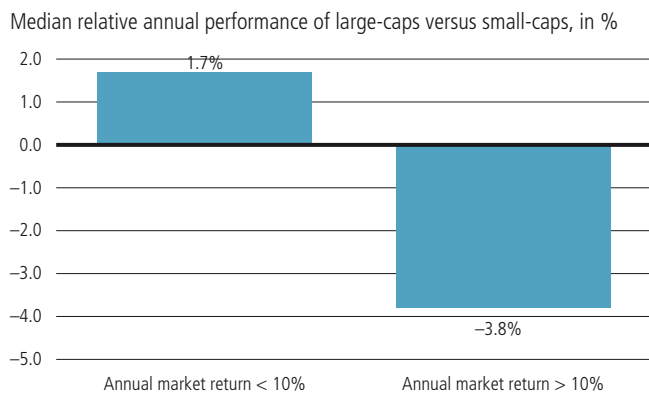
Last, despite outperforming for much of the past five years – and by 5% in 2011 – relative valuations continue to favor growth stocks. Even excluding the late 1990’s Tech valuation bubble, growth stocks have typically traded at roughly a 40% premium to value stocks. Currently, growth stocks command a 26% premium (see Fig. 11).

Real estate investment trusts (REIT) – attractive yield, but at a high price

REIT shares sharply outperformed the S&P 500 through August 2011, but gave back much of their prior outperformance over the last four months. REIT fundamentals have benefited from improved pricing, limited new capacity and ultra-low interest rates. In fact, interest rates alone have been a fairly good predictor of REIT relative performance versus the S&P 500 (see Fig. 12). To start the year, we remain neutral on REITs. Dividend yields are high compared to Treasuries, which should continue to provide support for the shares, despite relative valuations versus stocks that are at the high end of historical ranges. Within REIT subsectors, multifamily / apartment REIT shares should continue to benefit from strong pricing power as an increasing number of Americans switch from owning to renting their primary residence.

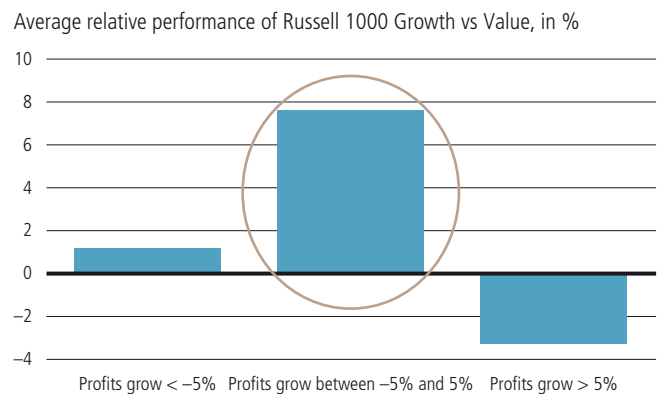
Jeremy Zirin, CFA; David Lefkowitz, CFA; Joe Sawe, Strategists

Fig. 5: Large-caps better positioned for low returns



Note: Annual market return determined by Russell 3000 (all-cap) index
Source: FactSet and UBS WMR as of 5 December 2011

Fig. 6: Growth outperforms when profits are “flattish”



Source: DataStream and UBS WMR as of 5 December 2011

US Equities: Chartbook

Fig. 7: Earnings estimates have further to fall

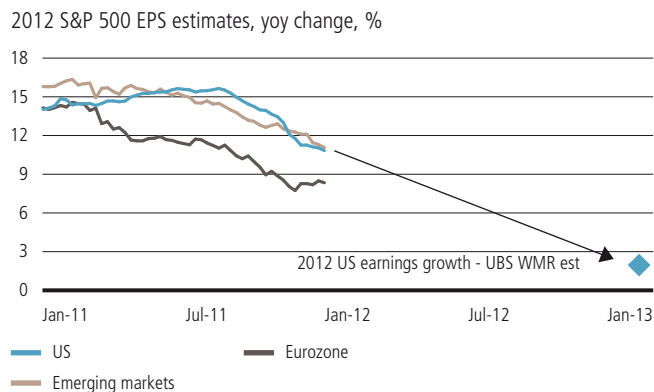


Fig. 8: Defensive growth over defensive value

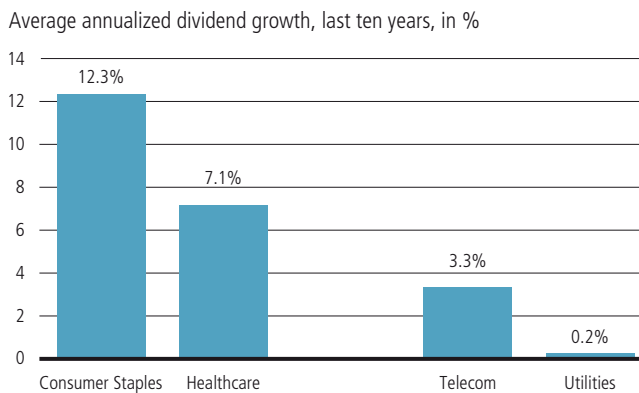


Fig. 9: Tech vs financials drives growth vs value

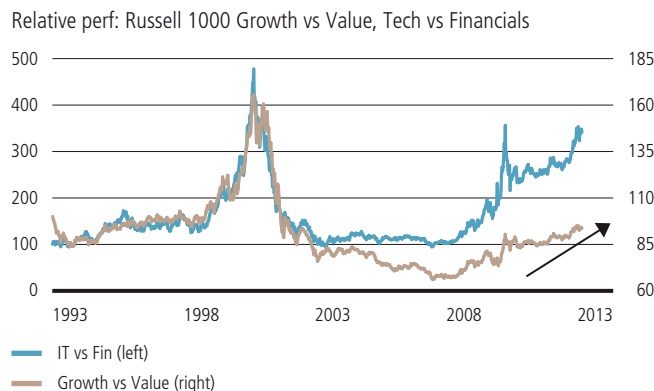


Fig. 10: Europe recession to hit S&P 500 EPS

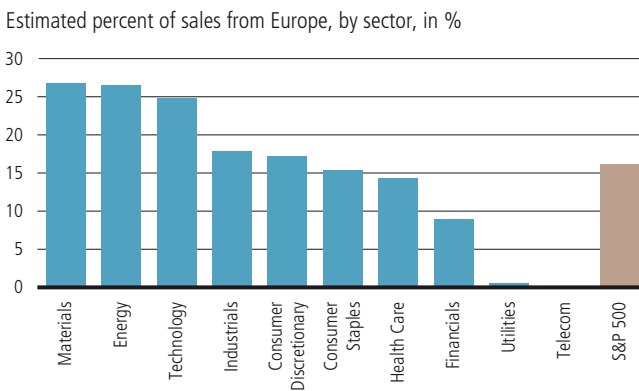


Fig. 11: Growth stocks continue to be attractively valued

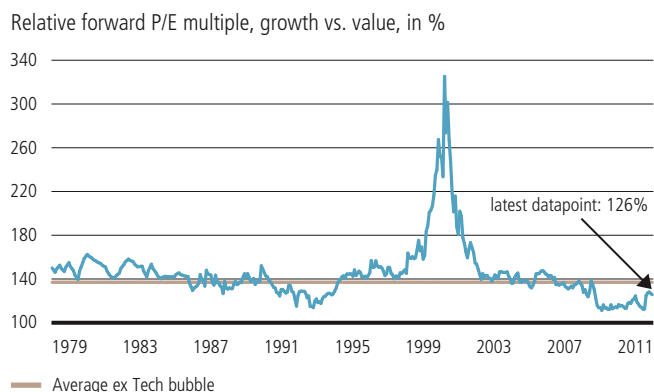
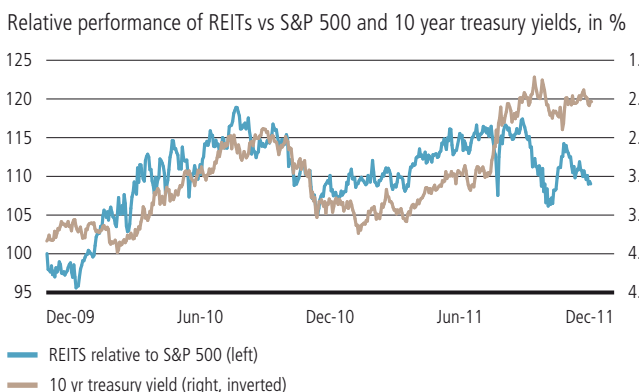


Fig. 12: REIT shares remain rate sensitive



Differentiated returns

A market environment characterized by slow economic growth, low benchmark Treasury yields and a steep yield curve is supportive for corporate credit. Although investment grade (IG) and high-yield (HY) bonds outperformed Treasuries in 2009 and 2010, Treasuries are on pace to outperform corporate credit this year. However, we believe the tide is likely to turn once more in 2012 and expect corporate credit to again outperform, as Treasury yields drift moderately higher, while credit spreads improve. We expect municipal bonds to post more modest total returns in 2012 than in 2011 as fiscal stress continues, headline risks stay elevated and credit risk is perceived to be higher. On a relative basis, municipal bonds offer value versus Treasuries, in our view.

A positive fundamental backdrop

Corporate credit spreads, which are the main valuation gauge for evaluating credit, tell a compelling story about the value in corporate credit. In the IG bond market, spreads levels are currently at 260 basis points (bps) according to BofAML Index data. This is wider than where spreads began 2010 and 2011 and remain near the levels where spreads peaked during the 2002 credit cycle. Despite the high level of credit risk compensation, corporate fundamentals remain healthy. Corporate balance

sheets are in solid shape, with nearly \$1tn in cash on hand. The all-corporate default rate, which is currently running at 1.1%, should remain below the long-term average of 1.6%, according to Moody's.

IG corporate bond yields to remain low

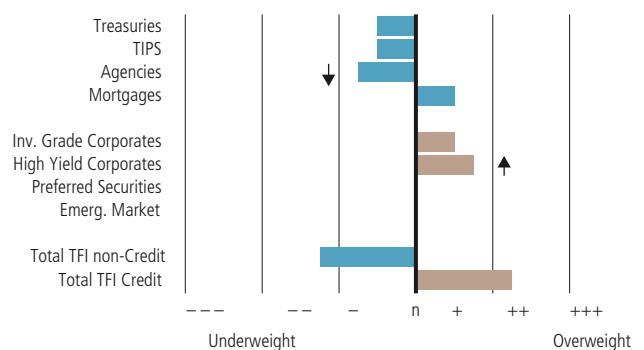
Despite the attractive spread pickup that IG credit offers compared to Treasuries, overall yield levels remain historically low on an absolute basis. IG bonds yield 4%, on average, which is at the low end of the 4% to 6% pre-crisis yield range. We believe IG bond yields will remain near the 4% level throughout 2012, as a modest rise in US Treasury yields will likely be offset by improvement in credit spreads. Low overall yields likely will be supportive for bond issuers who look to refinance existing debt. The relative yield pickup versus government bonds, as well as investor focus on income, will likely lead to continued strong investor demand for IG bonds.

High-yield corporate bonds in a low-yield environment

For investors looking to take incremental credit risk to capture higher yields, we believe HY bonds exhibit attractive risk / reward characteristics. Coupon yield levels over 8% are roughly in line with the average level that HY has exhibited on a pre-crisis historical basis. Credit spreads are roughly 770bps over Treasuries, which provides adequate

Fig. 1: US dollar taxable fixed income (TFI) strategy

Tactical deviations from benchmark



Note: Arrows indicate changes adopted in this report.
 Source: UBS WMR, as of 7 December 2011. Scale explained in Appendix. See the appendix for a detailed asset allocation illustration in the context of a moderate-risk taxable US dollar fixed income portfolio. See explanations in the Appendix regarding the interpretation of the suggested tactical deviations from benchmark.

Fig. 2: US interest rate forecasts

In %

	5-Dec	in 3 months	in 6 months	in 12 months
3-month Libor	0.53	0.30	0.30	0.30
2-year Treasury	0.26	0.20	0.20	0.50
5-year Treasury	0.97	1.00	1.00	1.30
10-year Treasury	2.09	2.00	2.10	2.50
30-Year Treasury	3.08	3.30	3.40	3.80

Source: Bloomberg, UBS WMR, as of 5 December 2011

US Fixed Income

compensation relative to the low rates of corporate defaults that are expected in 2012. The asset class' high coupon income should help to smooth out total returns even if our outlook for credit spread tightening proves incorrect. For example, assuming that Treasury rates remain range-bound at today's levels, we estimate the HY breakeven spread is 320bps over a 12-month horizon, meaning that spreads would have to widen by this amount to offset the coupon and provide a zero return.

The preferred securities market also offers higher income levels in exchange for increased credit risk. In terms of market sector composition, however, preferreds are dominated by US and European Financials, which have more direct ties to macro events in Europe. Although we remain constructive on the fundamentals of many systemically important European banks, we think the above-average credit spread valuations that preferreds exhibit are necessary in the current environment to compensate investors for these tail risks, especially since preferreds are subordinated in the capital structure.

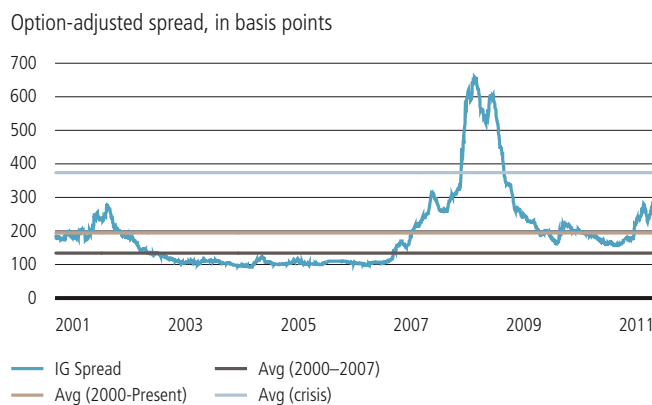
Macro risks to remain elevated

We believe that risks to the corporate bond market in 2012 stem largely from the macro environment and the secondary effects that the European debt crisis abroad and policy risk at home could have on bond market liquidity. UBS economists project GDP will contract in Europe during 2012, which could keep risk premiums

elevated. The IG market contains US dollar debt that is issued by European companies, but it constitutes roughly 15% of the market and is spread across industry groups. The exposure that the HY bond market has to Europe is more limited and HY contains only 10% exposure to Financials. Nonetheless, much like we've experienced in the last two years, we believe corporate credit will be prone to pockets of volatility. During such episodes, HY and preferred spreads will likely remain most sensitive to credit spread widening should we encounter gaps in bond market liquidity driven by systemic concerns.

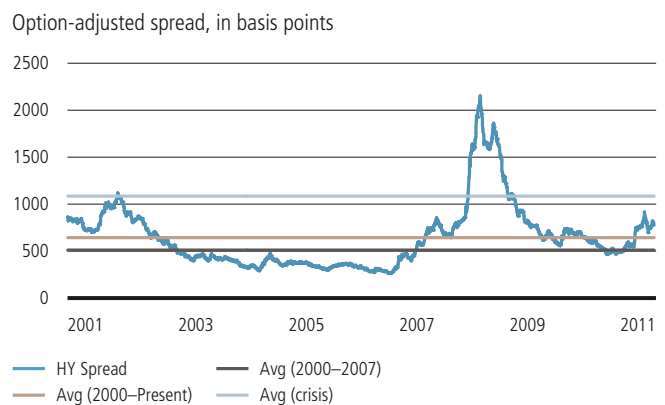
Based on our full-year outlook, we enter 2012 with overweights to both IG and HY; we believe corporate HY will likely produce the highest total return under our baseline scenario, but could exhibit the greatest volatility on any setbacks. Thus, we recommend that investors looking to add HY exposure consider portfolio strategies that could dampen price variability, such as low-beta, investment grade corporate bonds in the Utilities or Consumer non-Cyclical sectors. Within IG, we see value in certain "mid-beta" sectors that offer a combination of attractive credit spread and mild volatility characteristics. This includes BBB-rated credits. Our sector preferences include Managed Care, Insurance, Mining and Communications. Due to high spread volatility, we remain neutral when it comes to Financials but see value in shorter maturity bonds issued by large diversified US banks.

Fig. 3: Investment grade corporate bond spreads



Source: Bank of America Merrill Lynch, as of 5 December 2011

Fig. 4: High yield corporate bond spreads



Source: Bank of America Merrill Lynch, as of 5 December 2011

Interest rates to drift higher

For much of 2011, Treasury yields' twin drivers were the pace of economic growth and the sovereign debt crisis in Europe. We expect these factors will continue to be the primary drivers of Treasury yields in 2012, but Federal Reserve policy and developments in Washington are also likely to be important during an election year. With the Federal Reserve apt to hold the target fed funds rate at zero to 25bps until mid-2013, short-term bond yields should remain anchored at historically low levels. As a result, the yields on short-term deposits and money market funds will remain negligible for a fourth consecutive year. We look for Treasury yields to remain range-bound near current levels for the first half of 2012, before trending higher in the second half. We continue to favor the 4- to 10-year maturity range for taxable bonds, and maintain a neutral duration stance.

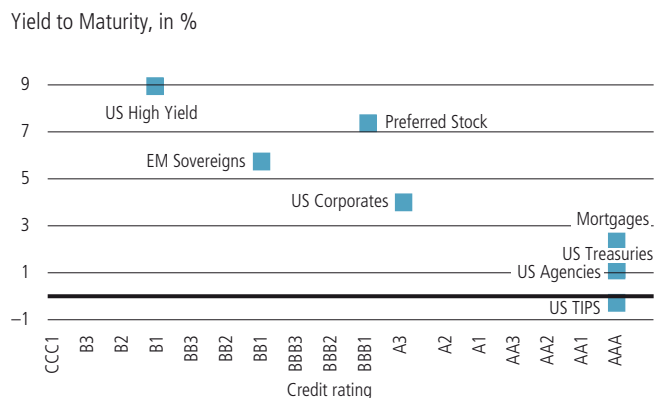
While the slow and steady economic growth forecasts from our economics team suggests a modest rise in Treasury yields over the course of the next year, we see several tail risks that could cause yields to deviate from this benign path. A disorderly sovereign default in Europe or a further deepening of the sovereign debt crisis to France and Germany would likely exert forceful downward pressure on Treasury yields, as investors sought the safety of Treasuries. We caution, however, that the "risk-free" status Treasury securities have enjoyed for decades cannot be taken for granted. The credit outlook on US

Treasury debt was lowered to negative by all three credit rating agencies in 2011, with S&P lowering the credit rating to AA+ from AAA. Bond investors shrugged this off, and Treasury yields fell to historic lows in late August. However, the fractious debate over raising the debt ceiling illustrates the difficulty of addressing the country's fiscal challenges. The failure of the "super committee" to reach an agreement will trigger automatic spending cuts beginning in January 2013, and some in Congress have said that they will attempt to override portions of them. If this were to occur, we believe Moody's and Fitch would probably lower the triple-A rating they assign to US sovereign debt. While a credit risk premium on US debt could emerge in the next several years if Congress fails to establish a credible deficit reduction plan, we believe this is a tail risk for 2012.

Municipal bonds: Expect more modest returns

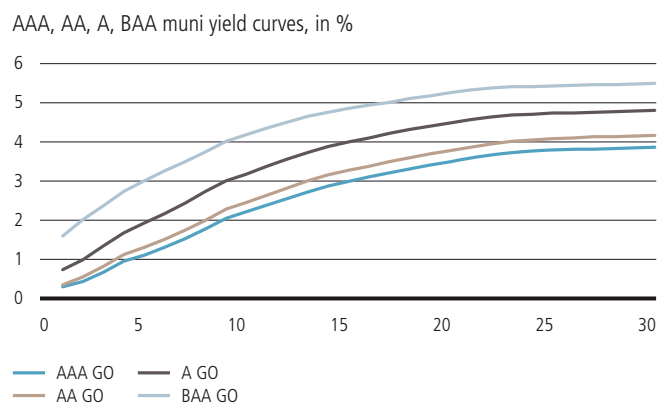
Slow economic growth for longer translates into continued fiscal stress for US public finance issuers. Additionally, in fiscal 2012 a significant amount of state funding made available by the American Recovery and Reinvestment Act of 2009 will wind down and exacerbate the tight fiscal conditions for US states. The municipal bond market is bedeviled by two principal credit challenges: first, Medicaid expenditures are growing faster than the pace of revenue growth; and second, unfunded pension liabilities are likely to increase further in the absence of substantive reform. Both of these challenges do not lend

Fig. 5: Yield-Rating Relationship



Source: Bank of America Merrill Lynch, as of 5 December 2011

Fig. 6: Muni credit spreads are wide; yield curves remain steep



Source: MMD, UBS WMR as of 5 December 2011. Note: GO=General Obligation bond

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themselves to an easy fix. Consequently, investors should be prepared for the negative media attention that will surely accompany the political debates surrounding these issues.

On a positive note, munis should benefit from flight-to-safety flows. We expect to see bouts of “risk-off” trades from investors seeking shelter from the European crisis. As a result, Treasuries may benefit from flight-to-safety flows and munis are apt to attract some solid demand from risk-averse investors. Individual investors are likely to continue to buy munis since few tax-advantaged investment opportunities exist. We expect supply / demand dynamics to be favorable in the early months of the year and anticipate more state and local governments will seek to lock in the low rates and refund outstanding bonds. We anticipate new issue volume in the range of \$320bn, an increase of about 10% from 2011 estimated levels.

Stick with high quality

Sector and security selection will remain important in 2012. In light of the continued fiscal challenges facing municipal issuers and recession risk, we think investors will increasingly look for sectors and individual credits with resilience during a slow economic growth cycle. We continue to favor: essential purpose revenue bonds in the water / sewer and public utility sector; broad-based sales tax bonds with ample coverage and a conservative additional bonds test; major established transportation agency issuers; and voter-approved general obligation bonds.

Intermediate-term range still optimal

Given that the municipal yield curve is still relatively steep, the best opportunities, in our view, are beyond the 5-year maturity range. Yields on very short maturities are anchored at a low level due to the continuation of accommodative monetary policy. Our analysis of the expected 12-month total return, which factors in roll effects, identifies that the intermediate-term maturity range of 8 to 13 years as offering value to investors. The exception is the 10-year maturity spot. We attribute this to typical retail investor demand; the 10-year muni bond is often the most sought-after maturity. We believe there are a variety of risks that could emerge over the course of the next year and negatively impact the value of long-term bonds. Beyond 20 years, incremental yield opportunities are more limited and do not justify the associated price volatility, in our view.

Anne Briglia, CFA, Strategist

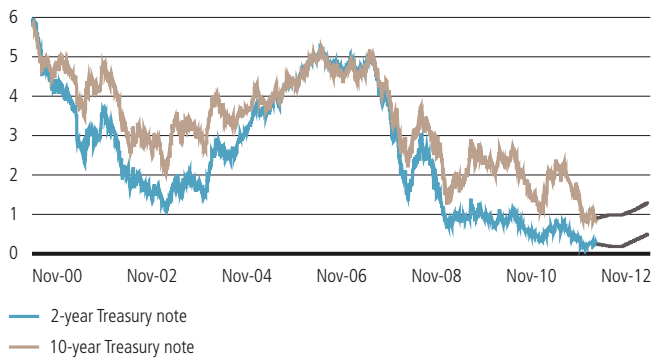
Barry McAlinden, CFA, Strategist

Kathleen McNamara, CFA, CFP, Strategist

US Fixed Income: Chartbook

Fig. 7: Treasury yields to rise gradually

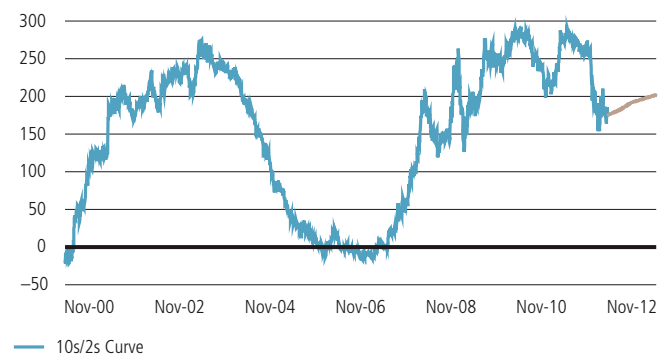
Rate development and UBS WMR forecast, in %



Source: Bloomberg, UBS WMR, as of 5 December 2011

Fig. 8: The yield curve should remain steep

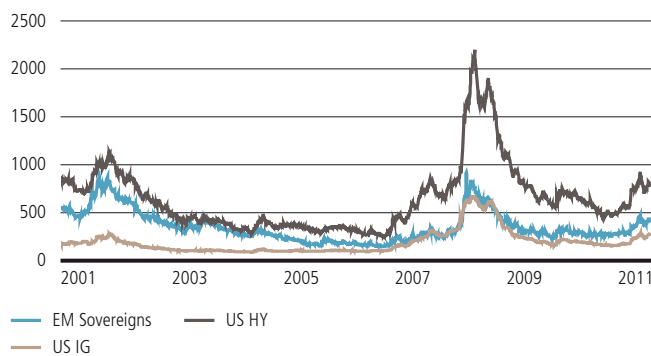
10-year Treasury yield minus 2-year Treasury yield, and WMR forecast, in basis points



Source: Bloomberg, UBS WMR, as of 5 December 2011

Fig. 9: Emerging market and US corporate bond spreads

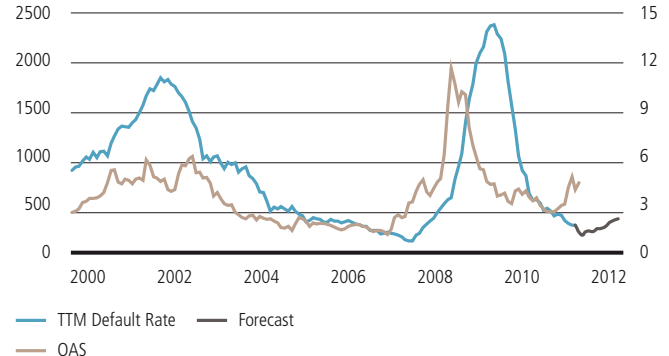
Option-adjusted spreads, in bps



Source: Bank of America Merrill Lynch, as of 5 December 2011

Fig. 10: The declining default rate signals tighter HY spreads

HY option adjusted credit spreads, in bps and default rates, in %

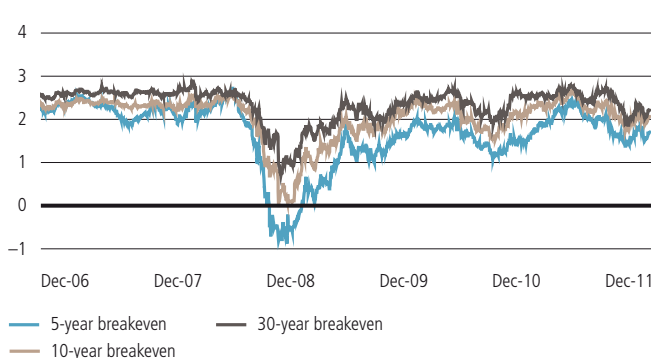


Note: TTM= Trailing 12-month

Source: Bank of America Merrill Lynch, Moody's, UBS WMR, as of 5 December 2011

Fig. 11: TIPS breakeven inflation rates recently declined

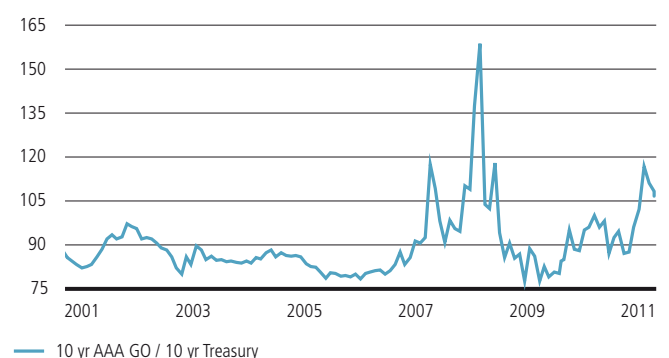
Breakeven yield (in %)



Source: Bloomberg, UBS WMR, as of 5 December 2011

Fig. 12: Munis offer relative value opportunities

10-year AAA muni to Treasury yield ratio, in %



Source: MMD Interactive, UBS WMR, as of 5 December 2011

Commodities

Expect a difficult start with strong finish

The recent decline of broad commodity indexes is likely to find a bottom in the coming months. While this still leaves the asset class with room for short-term price weakness, on average we expect commodity prices to trade sideways. This view clearly hinges on our expectations that Europe's sovereign debt crisis will peak in 1Q 2012 and emerging central banks will turn more growth supportive. We have already seen that the People's Bank of China (PBoC) lowered its reserve requirement ratio by 50 basis points. Further monetary easing should pave the way for accelerating Chinese commodity demand. Hence, we expect 2012 to end on a strong note. However, if the move by the PBoC turns out to be merely a fine tuning exercise, with no additional stimulus, commodity prices will not hold up.

As important as China is the fact that commodity demand in developed countries stands at lower levels than early 2008, with G3-country consumption of copper or crude oil, for instance, never fully recovering to pre-crisis levels. Hence, a potential demand shortfall by G3 economies should have less price impact than in 2008-2009. This means that it will be easier for emerging markets to drive increased demand for global commodity consumption – especially for base metals.

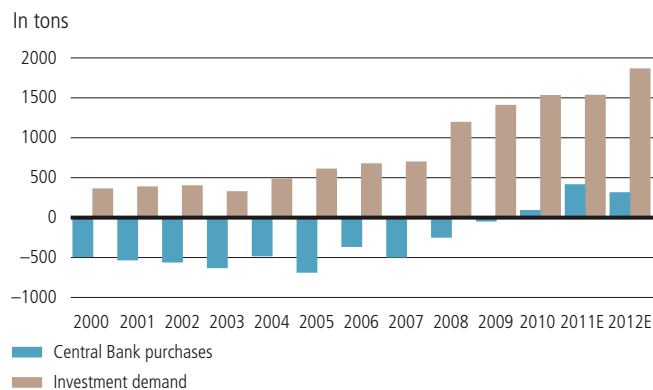
So what are our favorite areas within commodities for 2012? We think gold will still offer investors the best risk / reward in the short run, followed by platinum and

the grains. Gold's low industrial use and the prospects for more quantitative easing around the world should pave the way for firm investment demand of around 1900 tons. Together with strong central bank purchases of at least 300 tons next year, the market for the yellow metal should be cleared, despite rising mine production. The case for higher agricultural prices is also solid. Depleted inventories in the US require excellent weather conditions for South America in order for inventories to be rebuilt during 2012. We think this favors the grains, especially soybeans followed by corn.

While base metals should benefit from China, crude oil will not enjoy the same support, since China only accounts for 11% to 12% of global demand. Moreover, we expect OECD demand for crude to decline by 0.5 million barrels per day, bringing the West Texas Intermediate benchmark (WTI) close to \$75/barrel (bbl) and Brent toward \$83/bbl. Lower prices than that are not expected on strong OPEC pricing power and general policy stimulus. A firmer directional uptrend for cyclical commodities should start at the end of 1Q12. Thus, we feel comfortable with our 12-month Brent crude oil forecast of around \$115/bbl (WTI trading at a 5% discount) and a copper price target of \$8,800/metric tons.

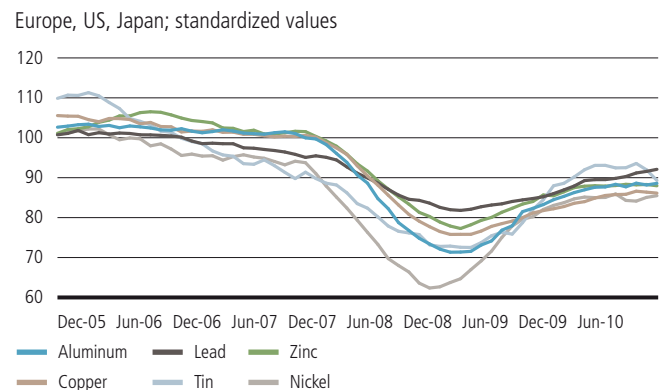
Dominic Schnider, Strategist

Fig. 1: Gold – strong investment and central bank demand



Source: WGC, UBS WMR, as of 30 November 2011

Fig. 2: G3 base metal consumption below pre-crisis levels



Source: WBMS, Bloomberg, UBS WMR, as of 30 November 2011

Hedge funds: opportunities in defensive strategies

Lackluster performance in a very challenging environment. In 2011, hedge funds experienced one of the most challenging market environments in the past three years, posting declines across most strategies. And while their risk stance has become distinctly more defensive, with a bias toward capital preservation, many strategies have outperformed passive traditional equity investments on a risk-adjusted basis.

For hedge funds, the year began on an optimistic note led by positive performance and capital inflows. However, sentiment reversed mid-year, driven by a number of factors, such as deteriorating economic conditions and the eurozone crisis. As a result, many trading opportunity sets for hedge funds were continually disrupted, leading managers to de-risk and re-risk more cautiously. Additionally, hedge funds reduced gross leverage from their year-to-date highs in the second quarter while paring back net exposure, especially in the European region, through September. In general, fund managers who exhibited active portfolio and risk management outperformed funds that were slower to respond.

Along with the constant change between risk-on and risk-off, correlations within asset classes and elevated levels of volatility detracted from performance; volatility (implied VIX) has remained high in the 30% to 50% range. In addition, an increase in equity correlations reduced gains from security selection, which resulted in negative performance for fundamental stock pickers and long-biased portfolios.

Equity hedged: The HFRI Equity Hedge (Total) Index, down -5.5% (11/15), was one of the worst-performing strategies in 2011. While fundamental value managers are still able to identify excellent stocks trading at deep discounts to fair value, such as those within Financials, broader market themes continue to suppress these stocks. We maintain our view that equity hedged managers will experience a challenging environment as long as markets are influenced by systematic themes such as the ongoing European crisis. We expect that equity hedged managers who have lower long exposures, such as equity market neutral managers, may outperform their directional oriented peers and passive long-only managers.

Macro: The HFRI Macro (Total) Index was down -3.1% (11/15). This has been somewhat disappointing for we expected global macro managers to outperform given their flexible discretionary mandate, and to benefit from major dislocations across regions, government action and policy action on currencies and economics. In part, this underperformance seems to be driven by inaction as many funds have either positioned themselves rather defensively or sat on the sidelines looking for more clarity and direction. Despite this underperformance, we continue to believe that the market environment is attractive for global macro strategies.

Systematic: HFRI Macro: Systematic Diversified Index (largely comprised of managed futures) was down -3.2% (11/15) due to choppy / range-bound markets given a lack of trends. From a longer-term point of view, we believe that Commodity Trading Advisors (CTAs) in general are well positioned to capitalize on the broader macro-economic environment and persistent global imbalances, given their exposure to multiple asset classes and geographies.

Relative value: The only broad-based strategy to post gains for the year was the HFRI Relative Value (Total) Index gaining 0.5% year-to-date (11/15). Performance remains mixed among sub-strategies as fixed income asset-backed, and yield alternatives have outperformed convertible arbitrage and multi-strategies. Credit market liquidity deteriorated in Q3, reporting lighter volumes and lower inventories at investment banks. We believe that as liquidity improves, relative value strategies will continue to do well.

Going forward, in an environment with low liquidity, high volatility, high correlation and uncertain economic growth and policies, hedge fund managers will remain cautious, stay focused on preserving capital and continue in a risk-on / risk-off mode until there is greater clarity.

Sameer Jain, UBS

Sameer Jain is an employee of the UBS Alternative Investments team within UBS Wealth Management Solutions and is not a part of Wealth Management Research (WMR). WMR may have views that differ or are contrary to the views expressed herein.

Alternative Investments

Private equity: patience and discipline should be rewarded

Private equity (PE) buyout activity remains muted

Coming out of the financial crisis in early 2010, buyout activity, which had been at a near standstill, took off meaningfully. For most of 2010, high yield financing was easily available, which resulted in a flood of companies participating in sponsor-to-sponsor transactions. According to alternative investment research firm Preqin, PE exits started off strong in early 2011; 201 exits valued at \$120 billion occurred in Q1 followed by 300 exits in Q2. This however changed in Q3 2011. Macroeconomic concerns, particularly with Europe and the U.S. downgrade, have since created an overhang in the deals market. In Q3 2011, 254 exits valued at \$56 billion were announced, a steep decrease of 54% from the prior quarter. This decrease was primarily due to a marked absence of exits valued at over \$1 billion, of which there were only 12. There were no exits over \$5 billion, unlike in previous quarters. Given volatility in public markets, valuations are likely to continue to vary from quarter to quarter. Also, the larger banks have been reluctant to lend except for very safe assets, the loans market is dry, the HY market remains tepid and regional middle-market buyout deals have come to be increasingly dependent on "house banks / relationships."

Realizations slowing but portfolio companies improving

While there has been pressure from some limited partners (LPs) for realizations, most are content to wait. The average holding period for PE companies is now around five years and many that were acquired in the time leading up to the 2007 crisis are still under water. A prevailing sentiment seems to be that the current environment is more favorable to capital deployment rather than to actively pursue realizations. Most LPs recognize that the pace of economic recovery will be slow and capital markets are headed for an extended period of volatility. They do take comfort in the fact that purchase prices will remain high for quality assets and will wait it out so long as the general partner communicates activities that suggest value creation.

The 2011 macro environment notwithstanding, during the year until Q2, there was a significant increase in carrying

values for most PE companies. Much of it was driven by a continued focus on improving operating performance post-recession. The better PE firms have had a relentless focus on revenue and earnings (EBITDA) growth and debt pay down. Aging portfolios seems to have been worth it. Investors are increasingly accepting that realizations are intimately linked to exits at the "right" valuations, and not exits for the sake of exits and returning capital.

Until market uncertainty declines to a more palpable level, we see no reason for the most recent results to materially improve in the next quarter or perhaps two. We foresee more disposition / sales transactions among PE firms rather than public market exits. We are less constructive on the initial public offering (IPO) market opening up soon. Very few IPOs have occurred since Labor Day and 200 companies have filed for registration. Large strategic buyers that are flush with cash appear to be better bets.

Fundraising remains on track

Despite the talk about excess "dry powder," industry-wide fundraising is still on pace to top the \$92 billion raised in 2010. Around 90 European funds have raised \$37 billion – more than they raised in all of 2010 – and 110 U.S. private equity funds have raised over \$95 billion. Secondary funds however are losing favor. Unlike past years, they have raised just \$4 billion this year.

Patience and discipline

We believe that it is especially important now to be patient and disciplined. The best fund managers are staying informed by diligently monitoring leading economic indicators within their portfolio companies and continuing to champion value-added strategies. Most are protecting the downside with sustainable capital structures, pushing out maturing debt to 2015 and beyond, and thinking of ways to optimize exits even as they manage for longer holds in 2012. We continue to remain constructive on this asset class.

Sameer Jain, UBS

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Detailed asset allocation, with non-traditional assets (NTAs)

Investor risk profile ¹	Very conservative				Conservative				Moderate conservative				Moderate				Moderate aggressive				Aggressive				Very aggressive												
All figures in %																																					
	■ Cash		■ Equities		■ Cash		■ Equities		■ Cash		■ Equities		■ Cash		■ Equities		■ Cash		■ Equities		■ Cash		■ Equities		■ Cash		■ Equities										
	■ Bonds		■ NTAs		■ Bonds		■ NTAs		■ Bonds		■ NTAs		■ Bonds		■ NTAs		■ Bonds		■ NTAs		■ Bonds		■ NTAs		■ Bonds		■ NTAs										
	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴									
Traditional Assets																																					
Equity	0.0	+0.0	0.0	19.0	-2.0	17.0	32.0	-3.0	29.0	44.0	-4.0	40.0	54.0	-5.0	49.0	62.0	-6.0	56.0	71.0	-6.0	65.0																
US Equity	0.0	+0.0	0.0	14.0	+0.0	14.0	23.0	-0.5	22.5	32.0	-0.5	31.5	39.0	-1.0	38.0	44.0	-1.0	43.0	52.0	+1.0	53.0																
Large Cap Value	0.0	+0.0	0.0	8.0	-0.5	7.5	8.0	-1.0	7.0	11.0	-1.5	9.5	11.0	-1.5	9.5	11.0	-2.0	9.0	13.0	-1.5	11.5																
Large Cap Growth	0.0	+0.0	0.0	5.0	+1.0	6.0	8.0	+2.0	10.0	11.0	+3.0	14.0	11.0	+3.5	14.5	11.0	+4.0	15.0	13.0	+6.0	19.0																
Mid Cap	0.0	+0.0	0.0	1.0	-0.5	0.5	4.0	-0.5	3.5	5.0	-0.5	4.5	9.0	-1.0	8.0	11.0	-1.0	10.0	13.0	-1.0	12.0																
Small Cap	0.0	+0.0	0.0	0.0	+0.0	0.0	2.0	-1.0	1.0	3.0	-1.5	1.5	5.0	-2.0	3.0	7.0	-2.0	5.0	8.0	-2.5	5.5																
REITs	0.0	+0.0	0.0	0.0	+0.0	0.0	1.0	+0.0	1.0	2.0	+0.0	2.0	3.0	+0.0	3.0	4.0	+0.0	4.0	5.0	+0.0	5.0																
Non-US Equity	0.0	+0.0	0.0	5.0	-2.0	3.0	9.0	-2.5	6.5	12.0	-3.5	8.5	15.0	-4.0	11.0	18.0	-5.0	13.0	19.0	-7.0	12.0																
Developed	0.0	+0.0	0.0	5.0	-2.0	3.0	8.0	-3.0	5.0	10.0	-4.0	6.0	12.0	-5.0	7.0	14.0	-6.0	8.0	14.0	-6.0	8.0																
Emerging Markets	0.0	+0.0	0.0	0.0	+0.0	0.0	1.0	+0.5	1.5	2.0	+0.5	2.5	3.0	+1.0	4.0	4.0	+1.0	5.0	5.0	-1.0	4.0																
Fixed Income	81.0	+1.0	▲	82.0	+2.0	▲	69.0	+3.0	▲	54.0	+4.0	▲	41.0	+5.0	▲	29.0	+6.0	▲	17.0	+0.0	0.0																
US Fixed Income	74.0	+1.0	▲	75.0	+2.0	▲	61.0	+3.0	▲	46.0	+4.0	▲	33.0	+5.0	▲	23.0	+6.0	▲	15.0	+0.0	0.0																
Non-US Fixed Income	7.0	+0.0		7.0	+0.0		8.0	+0.0		8.0	+0.0		8.0	+0.0		6.0	+0.0		6.0	+0.0	0.0																
Cash (USD)	10.0	+0.0	▼	10.0	+1.0	▼	3.0	+2.0	▼	4.0	+2.0	▼	4.0	+2.0	▼	4.0	+3.0	▼	5.0	+9.0	11.0																
Non-traditional Assets	9.0	-1.0		8.0	-1.0		11.0	-2.0		13.0	-2.0		15.0	-2.0		18.0	-3.0		22.0	-3.0	24.0																
Commodities	2.0	-1.0		3.0	-1.0		2.0	-2.0		2.0	-2.0		3.0	-2.0		3.0	-3.0		3.0	-3.0	4.0																
Alternative Investments⁵	7.0	+0.0		7.0	+0.0		9.0	+0.0		11.0	+0.0		12.0	+0.0		15.0	+0.0		19.0	+0.0	20.0																

¹“WMR tactical deviation” legend: Overweight Underweight Neutral
Source: UBS WMR and Investment Solutions, as of 7 December 2011

²“Change” legend: ▲ Upgrade ▼ Downgrade
For end notes, please see appendix.

Detailed asset allocation, without non-traditional assets (NTAs)

Investor risk profile ¹	Very conservative			Conservative			Moderate conservative			Moderate			Moderate aggressive			Aggressive			Very aggressive					
All figures in %																								
	Cash	Equities	Bonds	Cash	Equities	Bonds	Cash	Equities	Bonds	Cash	Equities	Bonds	Cash	Equities	Bonds	Cash	Equities	Bonds	Cash	Equities	Bonds			
	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴	Benchmark allocation ²	WMR tactical deviation ³	Change	Current allocation ⁴
Traditional Assets																								
Equity	0.0	+0.0	0.0	22.0	-2.0	20.0	37.0	-3.0	34.0	52.0	-4.0	48.0	67.0	-5.0	62.0	83.0	-6.0	77.0	98.0	-6.0	92.0			
US Equity	0.0	+0.0	0.0	16.0	+0.0	16.0	26.0	-0.5	25.5	37.0	-0.5	36.5	48.0	-1.0	47.0	59.0	-1.0	58.0	72.0	+1.0	73.0			
Large Cap Value	0.0	+0.0	0.0	9.0	-0.5	8.5	9.0	-1.0	8.0	13.0	-1.5	11.5	14.0	-1.5	12.5	15.0	-2.0	13.0	18.0	-1.5	16.5			
Large Cap Growth	0.0	+0.0	0.0	6.0	+1.0	7.0	9.0	+2.0	11.0	13.0	+3.0	16.0	14.0	+3.5	17.5	15.0	+4.0	19.0	18.0	+6.0	24.0			
Mid Cap	0.0	+0.0	0.0	1.0	-0.5	0.5	4.0	-0.5	3.5	6.0	-0.5	5.5	11.0	-1.0	10.0	15.0	-1.0	14.0	18.0	-1.0	17.0			
Small Cap	0.0	+0.0	0.0	0.0	+0.0	0.0	3.0	-1.0	2.0	3.0	-1.5	1.5	6.0	-2.0	4.0	9.0	-2.0	7.0	11.0	-2.5	8.5			
REITs	0.0	+0.0	0.0	0.0	+0.0	0.0	1.0	+0.0	1.0	2.0	+0.0	2.0	3.0	+0.0	3.0	5.0	+0.0	5.0	7.0	+0.0	7.0			
Non-US Equity	0.0	+0.0	0.0	6.0	-2.0	4.0	11.0	-2.5	8.5	15.0	-3.5	11.5	19.0	-4.0	15.0	24.0	-5.0	19.0	26.0	-7.0	19.0			
Developed	0.0	+0.0	0.0	6.0	-2.0	4.0	9.0	-3.0	6.0	13.0	-4.0	9.0	15.0	-5.0	10.0	18.0	-6.0	12.0	20.0	-6.0	14.0			
Emerging Markets	0.0	+0.0	0.0	0.0	+0.0	0.0	2.0	+0.5	2.5	2.0	+0.5	2.5	4.0	+1.0	5.0	6.0	+1.0	7.0	6.0	-1.0	5.0			
Fixed Income	90.0	+0.0	90.0	76.0	+2.0	78.0	61.0	+3.0	64.0	46.0	+4.0	50.0	31.0	+5.0	36.0	15.0	+6.0	21.0	0.0	+0.0	0.0			
US Fixed Income	82.0	+4.0	86.0	67.0	+2.0	69.0	51.0	+3.0	54.0	36.0	+4.0	40.0	23.0	+5.0	28.0	12.0	+6.0	18.0	0.0	+0.0	0.0			
Non-US Fixed Income	8.0	-4.0	4.0	9.0	+0.0	9.0	10.0	+0.0	10.0	10.0	+0.0	10.0	8.0	+0.0	8.0	3.0	+0.0	3.0	0.0	+0.0	0.0			
Cash (USD)	10.0	+0.0	10.0	2.0	+0.0	2.0	2.0	+0.0	2.0	2.0	+0.0	2.0	2.0	+0.0	2.0	2.0	+0.0	2.0	2.0	+6.0	8.0			

¹“WMR tactical deviation” legend: Overweight Underweight Neutral
Source: UBS WMR and Investment Solutions, as of 7 December 2011

²“Change” legend: ▲ Upgrade ▼ Downgrade
For end notes, please see appendix.

Appendix

Investment Committee

Wealth Management Americas Investment Committee (WMA IC)

The WMA IC is the primary decision-making body within WM Americas for recommended asset allocations across investor risk profiles. As explained more fully below, the WMA IC vets the flagship tactical asset allocation recommendations which appear in this publication, the Investment Strategy Guide (ISG). The WMA IC also reviews and approves (i) inputs relating to WM Americas' strategic asset allocations, and (ii) other tactical asset allocation recommendations which may be developed for ultra high net worth and other specific client groups by business areas other than WMRA.

Composition

The WMA IC currently has seven voting members, and two non-voting members.

The voting members include:

Mike Ryan – Head of Wealth Management Research – Americas (WMRA)

Stephen Freedman – WMRA Investment Strategy Head

Jeremy Zirin – WMRA Equities Head

Anne Briglia – WMRA Taxable Fixed Income Head

Tony Roth – Head of Wealth Management Strategies, Wealth Management Partnerships (*)

Mihir Bhattacharya – Head of Strategic Projects and Services, Wealth Management Solutions (*)

Thomas Troy – Head of Market Executions, Wealth Management Solutions (*)

(*) Business areas distinct from WMRA

The two non-voting members are employees of UBS Global Asset Management, an affiliate of UBS Financial Services Inc. They are:

John Dugenske – Global Fixed Income, Head of US Fixed Income

Andreas Koester – Global Investment Solutions, Head of Asset Allocation and Currency

Vetting of WMRA flagship TAA recommendations

At least monthly, WMRA presents to the WMA IC for its review a flagship TAA proposal and supporting investment case for a moderate-risk profile investor. In order to be published in the ISG, the flagship TAA must be accepted by the WMA IC and be supported by a majority of the WMRA members. The flagship TAA recommendations across other risk profiles published in the ISG are further calculated in accordance with a methodology approved by the WMA IC.

Appendix

Portfolio Analytics

The portfolio analytics shown for each risk profile's benchmark allocations are based on estimated forward-looking return and standard deviation assumptions (capital market assumptions), which are based on UBS proprietary research. The development process includes a review of a variety of factors, including the return, risk, correlations and historical performance of various asset classes, inflation and risk premium. These capital market assumptions do not assume any particular investment time horizon. The process assumes a situation where the supply and demand for investments is in balance, and in which expected returns of all asset classes are a reflection of their expected risk and correlations regardless of time frame. Please note that these assumptions are not guarantees and are subject to change. UBS has changed its risk and return assumptions in the past and may do so in the future. Neither UBS nor your Financial Advisor is required to provide you with an updated analysis based upon changes to these or other underlying assumptions.

In order to create the analysis shown, the rates of return for each asset class are combined in the same proportion as the asset allocations illustrated (e.g., if the asset allocation indicates 40% equities, then 40% of the results shown for the allocation will be based upon the estimated hypothetical return and standard deviation assumptions shown below).

You should understand that the analysis shown and assumptions used are hypothetical estimates provided for your general information. The results are not guarantees and pertain to the asset allocation and/or asset class in general, not the performance of specific securities or investments. Your actual results may vary significantly from the results shown in this report, as can the performance of any individual security or investment.

Risk Profile ==>>>	Very conservative	Conservative	Moderate conservative	Moderate	Moderate aggressive	Aggressive	Very aggressive
With non-traditional assets							
Estimated Return	4.81%	5.98%	6.89%	7.65%	8.36%	9.00%	9.56%
Estimated Risk	3.21%	4.70%	6.71%	8.69%	10.53%	12.16%	13.81%
Without non-traditional assets							
Estimated Return	4.46%	5.67%	6.62%	7.44%	8.33%	9.22%	10.00%
Estimated Risk	3.45%	4.78%	6.93%	9.17%	11.73%	14.46%	16.94%

Asset Class	Capital Market Assumptions	
	Estimated Risk	Estimated Return
US Equity		
Large Cap Value	16.4%	8.7%
Large Cap Growth	19.0%	9.3%
Mid Cap	18.4%	10.4%
Small Cap	21.4%	10.6%
REITs	23.0%	9.6%
Non-US Equity		
Developed Markets Equities	17.7%	10.4%
Emerging Markets Equities	26.6%	12.6%
US Fixed Income	3.7%	4.4%
Non-US Fixed Income	8.8%	6.1%
Cash (USD)	0.5%	4.0%
Commodities	17.1%	7.6%
Alternative Investments	8.5%	8.7%

Appendix

Additional Asset Allocation Models

US Taxable Fixed Income Allocation, in %

	Benchmark allocation ¹	WMR Tactical deviation ²		Current allocation ³
		Previous	Current	
Treasuries	12.0	-1.0	-1.0	11.0
TIPS (Treasury inflation-protected securities)	5.0	-1.0	-1.0	4.0
Agencies	22.0	-1.0	-1.5	20.5
Mortgages	20.0	+1.0	+1.0	21.0
Inv. Grade Corporates	22.0	+1.0	+1.0	23.0
High Yield Corporates	10.0	+1.0	+1.5	11.5
Preferred Securities	4.0	+0.0	+0.0	4.0
Emerging Market sovereign bonds in US dollar	5.0	+0.0	+0.0	5.0
TFI non-Credit	59.0	-2.0	-2.5	56.5
TFI Credit	41.0	+2.0	+2.5	43.5

Non-US Developed Equity Module, in %

	Benchmark allocation ¹	WMR Tactical deviation ²		Current allocation ³
		Previous	Current	
Eurozone	26.0	-25.0	-25.0	1.0
UK	20.0	+15.0	+15.0	35.0
Japan	19.0	+5.0	+5.0	24.0
Other	35.0	+5.0	+5.0	40.0

Non-US Fixed Income Module, in %

	Benchmark allocation ¹	WMR Tactical deviation ²		Current allocation ³
		Previous	Current	
Eurozone	41.0	-10.0	-7.50	33.5
UK	9.0	+10.0	+7.50	16.5
Japan	34.0	-10.0	-7.50	26.5
Other	16.0	+10.0	+7.50	23.5

Source: UBS WMR and Investment Solutions, as of 7 December 2011

¹ The benchmark allocation refers to a moderate risk profile. See "Sources of Benchmark Allocations and Investor Risk Profiles" in the Appendix for an explanation regarding the source of benchmark allocations and their suitability.

² See "Deviations from Benchmark Allocations" in the Appendix for an explanation regarding the interpretation of the suggested tactical deviations from benchmark. The "current" column refers to the tactical deviation that applies as of the date of this publication. The "previous" column refers to the tactical deviation that was in place at the date of the previous edition of the Investment Strategy Guide or the last Investment Strategy Guide Update.

³ The current allocation column is the sum of the benchmark allocation and the WMR tactical deviation columns.

Appendix

Additional Asset Allocation Models

Equity Industry Group Allocation, in %

	S&P 500 Benchmark allocation ¹	WMR Tactical deviation ²				Current allocation ³
		Numeric		Symbol		
		Previous	Current	Previous	Current	
Consumer Discretionary	10.6	+0.0	+0.0	n	-	10.6
Auto & Components	0.7	-0.7	-0.7	-	-	0.0
Consumer Services	2.1	+1.0	+1.0	+	+	3.1
Media	3.1	-1.0	-1.0	-	-	2.1
Retailing	3.8	+0.7	+0.7	+	+	4.4
Consumer, Durables & Apparel	1.0	+0.0	+0.0	n	n	1.0
Consumer Staples	11.3	+3.0	+2.0	+++	++	13.3
Food, Beverage & Tobacco	6.4	+1.0	+1.0	+	+	7.4
Food & Staples Retailing	2.4	+0.5	+0.0	+	n	2.4
Household & Personal Products	2.4	+1.5	+1.0	++	+	3.4
Energy	12.5	-1.0	+0.0	-	n	12.5
Financials	13.6	-2.0	-2.0	--	--	11.6
Banks	2.6	+0.0	+0.0	n	n	2.6
Diversified Financials	5.5	-1.0	-1.0	-	-	4.5
Insurance	3.6	-1.0	-1.0	-	-	2.6
Real Estate	1.8	+0.0	+0.0	n	n	1.8
Healthcare	11.5	+1.0	+2.0	+	++	13.5
HC Equipment & Services	3.9	+1.0	+1.0	+	+	4.9
Pharmaceuticals & Biotechnology	7.5	+0.0	+1.0	n	+	8.5
Industrials	10.7	-2.0	-2.0	--	--	8.7
Capital Goods	8.2	-1.0	-1.0	-	-	7.2
Commercial Services & Supplies	0.5	+0.0	+0.0	n	n	0.5
Transportation	2.0	-1.0	-1.0	-	-	1.0
Information Technology	19.5	+2.0	+2.0	++	++	21.5
Software & Services	9.7	+1.0	+1.0	+	+	10.7
Technology Hardware & Equipment	7.4	+1.0	+0.0	+	n	7.4
Semiconductors	2.5	+0.0	+1.0	n	+	3.5
Materials	3.6	-3.0	-2.0	---	--	1.6
Telecom	3.1	+1.0	+0.0	+	n	3.1
Utilities	3.7	+1.0	+0.0	+	n	3.7

Source: S&P, UBS WMR, as of 7 December 2011

The benchmark allocation, as well as the tactical deviations, are intended to be applicable to the US equity portion of a portfolio across investor risk profiles.

¹ The benchmark allocation is based on S&P 500 weights.

² See "Deviations from Benchmark Allocations" in the Appendix for an explanation regarding the interpretation of the suggested tactical deviations from benchmark. The "current" column refers to the tactical deviation that applies as of the date of this publication. The "previous" column refers to the tactical deviation that was in place at the date of the previous edition of the Investment Strategy Guide or the last Investment Strategy Guide Update.

³ The current allocation column is the sum of the S&P 500 benchmark allocation and the WMR tactical deviation columns.

Alternative Investment (AI) Benchmark Allocation (All figures in % of total portfolio)

	Risk profile							
	Very conservative	Conservative	Moderate conservative	Moderate	Moderate aggressive	Aggressive	Very aggressive	
Tactical Trading	1.0	1.0	1.0	2.0	2.5	3.5	4.0	
Relative Value	1.5	2.0	2.0	2.0	2.0	2.0	2.0	
Credit Strategies	1.5	2.0	2.0	2.0	2.5	3.0	3.0	
Event Driven	1.5	2.0	2.0	2.0	2.0	2.5	3.0	
Equity Hedge	1.5	2.0	2.0	2.0	2.0	3.0	3.0	
Private Equity	0.0	0.0	2.0	2.0	2.0	2.0	3.0	
Private Real Estate	0.0	0.0	0.0	0.0	2.0	2.0	2.0	
Total Alternative Investments	7.0	9.0	11.0	12.0	15.0	19.0	20.0	

See "Sources of Benchmark Allocations and Investor Risk Profiles" in the Appendix for an explanation regarding the source of the benchmark allocations and their suitability.

Appendix

Tactical Asset Allocation Performance Measurement

Table A reflects the performance of the tactical asset allocation recommendations published in the Investment Strategy Guide during the time period specified. The performance is based on the benchmark allocations with nontraditional assets for a moderate risk profile investor, and the benchmark allocation with the tactical shift (see detailed asset allocation tables where benchmark allocation with tactical shift is referred to as “current allocation”). Performance is calculated utilizing the returns of the indices identified in Table B as applied to the respective allocations in the benchmark and the benchmark with the tactical shift. For example, if cash were allocated 10% in the benchmark and 12% in the benchmark with the tactical shift, the cash index respectively contributed to 10% and 12% of the results shown.

The performance attributable to the WMR tactical deviations is reflected in the column labeled “Excess return,” which shows the difference between the performance of the benchmark and the performance of the benchmark with the tactical shift. The Information ratio is a risk-adjusted performance measure, which adjusts the excess returns for the tracking error risk of the tactical deviations. Specifically the information ratio is calculated as the ratio of the annualized excess return over a given time period and the annualized standard deviation of daily excess returns over the same period. Additional background information regarding the computation of the information ratio figures provided below are available upon request.

Calculations start on 25 August 2008. Prior to 25 August 2008, WMR published tactical asset allocation recommendations in the “US Asset Allocation Strategist” using a less comprehensive set of asset classes and sectors, which makes a comparison with the current models difficult. In addition, since 25 August 2008, the Investment Strategy Guide has at times published a more detailed set of tactical deviations, whereby the categories “Non-US Developed Equities” and “Non-US Fixed Income” were further subdivided into regional blocks. Only the cumulative recommendations at the level of “Non-US Developed Equities” and “Non-US Fixed Income” were taken into account in calculating the performance shown below.

The calculations assume that the portfolios are rebalanced whenever changes are made to tactical deviations, typically upon publication of the Investment Strategy Guide on a monthly basis. Occasionally, changes in the tactical deviations are made intra-month when warranted by market conditions and communicated through an Investment Strategy Guide Update. The computations assume portfolio rebalancing upon such intra-month changes as well. Performance shown is based on total returns, but does not include transaction costs, such as commissions, fees, margin interest, and interest charges. Actual total returns adjusted for such transaction costs will be reduced. A complete record of all the recommendations upon which this performance report is based is available from UBS Financial Services Inc. upon written request. Past performance is not an indication of future results.

Table A: Moderate Risk Profile Performance Measurement

	Benchmark allocation	Benchmark with tactical shift	Excess return	Information ratio (annualized)	Russell 3000 stock index (total return)	Barclays Capital US Aggregate bond index (total return)
25 Aug. 08 to 31 Dec. 08	-16.59%	-15.64%	0.96%	+2.0	-29.00%	3.33%
2009 Q1	-5.52%	-5.45%	0.07%	+0.3	-10.80%	0.12%
2009 Q2	11.18%	11.37%	0.18%	+1.0	16.82%	1.78%
2009 Q3	10.44%	11.07%	0.63%	+2.1	16.31%	3.74%
2009 Q4	2.99%	3.30%	0.31%	+1.1	5.90%	0.20%
2010 Q1	2.74%	2.56%	-0.18%	-0.9	5.94%	1.78%
2010 Q2	-4.56%	-4.87%	-0.31%	-1.4	-11.32%	3.49%
2010 Q3	8.34%	7.99%	-0.35%	-2.1	11.53%	2.48%
2010 Q4	5.18%	5.17%	-0.01%	-0.1	11.59%	-1.30%
2011 Q1	3.23%	3.15%	-0.08%	-0.4	6.38%	0.42%
2011 Q2	0.62%	0.47%	-0.16%	-0.9	-0.03%	2.29%
2011 Q3	-7.65%	-8.56%	-0.90%	-2.5	-15.28%	3.82%
2011 Q4 until 6 December 2011	4.84%	4.47%	-0.37%	-1.3	12.25%	0.20%
Since inception	11.99%	11.81%	-0.18%	-0.0	7.76%	24.61%

Source: UBS WMR, as of 6 December 2011

Appendix

Tactical Asset Allocation Performance Measurement

Table B: IS benchmark allocations for moderate risk profile investor, and underlying indices (all figures in %)

25 Aug 2008 to 23 Feb 2009	24 Feb 2009 to present		
US Large Cap Value (Russell 1000 Value)	12.5	US Large Cap Value (Russell 1000 Value)	11.0
US Large Cap Growth (Russell 1000 Growth)	12.5	US Large Cap Growth (Russell 1000 Growth)	11.0
US Small Cap Value (Russell 2000 Value)	2.0	US Mid Cap (Russell Midcap)	5.0
US Small Cap Growth (Russell 2000 Growth)	2.0	US Small Cap (Russell 2000)	3.0
US REITs (FTSE NAREIT All REITs)	1.5	US REITs (FTSE NAREIT All REITs)	2.0
Non-US Dev. Eq (MSCI Gross World ex-US)	10.5	Developed Markets (MSCI Gross World ex-US)	10.0
Emerging Markets Eq. (MSCI Gross EM USD)	2.0	Emerging Markets (MSCI Gross EM USD)	2.0
US Fixed Income (BarCap US Aggregate)	30.0	US Fixed Income (BarCap US Aggregate)	29.0
Non-US Fixed Income (BarCap Global Aggregate ex-USD)	8.0	Non-US Fixed Income (BarCap Global Aggregate ex-USD)	8.0
Cash (JP Morgan Cash Index USD 1 month)	2.0	Cash (JP Morgan Cash Index USD 1 month)	2.0
Commodities (DJ UBS total return index)	5.0	Commodities (DJ UBS total return index)	5.0
Alternative Investments (HFRX Equal Weighted Strategies)	12.0	Alternative Investments (HFRX Equal Weighted Strategies)	12.0

Source: UBS WMR and Investment Solutions

Table C similarly indicates the performance of WMR's US Equity Sector Strategy, which has been published in comparable format since 29 October 2007. The Benchmark allocation is the S&P 500.

Table C: US Equity Sector Strategy performance measurement

	S&P 500 Benchmark allocation	Benchmark with tactical shift	Excess return	Information ratio (annualized)
29 Oct. 2007 to 31 Dec. 2007	-4.32%	-4.02%	0.30%	+2.3
2008	-36.97%	-36.98%	-0.01%	-0.2
2009	26.56%	26.28%	-0.27%	-0.3
2010	15.07%	14.22%	-0.85%	-1.4
2011 Q1	5.92%	5.97%	0.05%	+0.4
2011 Q2	0.11%	-0.22%	-0.33%	-2.8
2011 Q3	-13.88%	-14.06%	-0.18%	-0.8
2011 Q4 until 6 Dec. 11	11.73%	10.83%	-0.91%	-2.6
Since inception	-10.49%	-12.21%	-1.72%	-0.7

Source: UBS WMR, as of 6 December 2011

Finally, Table D, provides the performance of the US dollar Taxable Fixed Income Strategy, which has been published by WMR since 31 January 2007. The benchmark allocation and the underlying indices for each segment are available in table E.

Table D: WMR US dollar Taxable Fixed Income Strategy performance measurement

	Benchmark allocation	Benchmark with tactical shift	Excess return	Information ratio (annualized)	Barclays Capital US Aggregate
31 Jan. 2007 to 31 Dec. 2007	4.69%	4.56%	-0.12%	-1.4	7.01%
2008	-1.17%	-2.11%	-0.94%	-3.2	5.24%
2009	11.67%	12.96%	1.29%	+2.8	5.93%
2010	7.97%	8.07%	0.10%	+0.6	6.54%
2011 Q1	1.06%	1.16%	0.10%	+2.5	0.42%
2011 Q2	2.13%	2.09%	-0.04%	-1.3	2.29%
2011 Q3	1.74%	1.42%	-0.32%	-3.4	3.82%
2012 Q4 until 6 Dec. 11	1.09%	1.09%	-0.01%	-0.4	0.20%
Since Inception	32.42%	32.30%	-0.12%	-0.1	35.82%

Source: UBS WMR, as of 6 December 2011

Appendix

Tactical Asset Allocation Performance Measurement

Table E : Benchmark allocation for US dollar Fixed Income Strategy and underlying indices used to calculate performance shown in Table D (all figures in %)

	31 Jan. 2007 to 30 July 2007	31 July 2007 to 24 Aug 2008	25 Aug 2008 to 30 March 2009	31 March 2009 to present
Treasuries (BoA ML Treasury Master Index)	10.0%	12.0%	12.0%	12.0%
TIPS (BoA ML Treasury Inflation-Linked Index)	5.0%	5.0%	5.0%	5.0%
Agencies (BoA ML Agency Composite Master Index)	20.0%	22.0%	22.0%	22.0%
Inv. Grade Corporates (BoA ML Corporate Master Index)	20.0%	21.0%	18.0%	22.0%
High Yield Corporates (BoA ML High Yield Master II Constrained Index)	10.0%	10.0%	8.0%	10.0%
Preferred Securities (BoA ML Preferred Stock Fixed Index)	10.0%	10.0%	10.0%	4.0%
Mortgages (BoA ML US Mortgage Master Index)	20.0%	20.0%	20.0%	20.0%
Emerg. Markets (BoA ML Emerging Sovereign Plus Index)	0.0%	0.0%	5.0%	5.0%
Cash (BoA ML US T-Bill 3-month Index)	5.0%	0.0%	0.0%	0.0%

Source: UBS WMR and Investment Solutions

Appendix

End notes for table labeled detailed asset allocations with non-traditional assets (NTAs)

- 1 See “Sources of benchmark allocations and investor risk profiles” on next page regarding the source of investor risk profiles.
- 2 See “Sources of benchmark allocations and investor risk profiles” on next page regarding the source of benchmark allocations and their suitability.
- 3 See “Deviations from benchmark allocations” in the appendix regarding the interpretation of the suggested tactical deviations from benchmark.
- 4 The current allocation row is the sum of the benchmark allocation and the WMR tactical deviation rows.
- 5 UBS WMR considers that maintaining the benchmark allocation is appropriate for alternative investments. The recommended tactical deviation is therefore structurally set at 0. See “Sources of benchmark allocations and investor risk profiles” on next page regarding the types of alternative investments and their suitability.

End notes for table labeled detailed asset allocations without non-traditional assets (NTAs)

- 1 See “Sources of benchmark allocations and investor risk profiles” on next page regarding the source of investor risk profiles.
- 2 See “Sources of benchmark allocations and investor risk profiles” on next page regarding the source of benchmark allocations and their suitability.
- 3 See “Deviations from benchmark allocations” in the Appendix regarding the interpretation of the suggested tactical deviations from benchmark.
- 4 The current allocation row is the sum of the benchmark allocation and the WMR tactical deviation rows.

Emerging Market Investments

Investors should be aware that Emerging Market assets are subject to, amongst others, potential risks linked to currency volatility, abrupt changes in the cost of capital and the economic growth outlook, as well as regulatory and socio-political risk, interest rate risk and higher credit risk. Assets can sometimes be very illiquid and liquidity conditions can abruptly worsen. WMR generally recommends only those securities it believes have been registered under Federal US registration rules (Section 12 of the Securities Exchange Act of 1934) and individual State registration rules (commonly known as “Blue Sky” laws). Prospective investors should be aware that to the extent permitted under US law, WMR may from time to time recommend bonds that are not registered under US or State securities laws. These bonds may be issued in jurisdictions where the level of required disclosures to be made by issuers is not as frequent or complete as that required by US laws.

For more background on emerging markets generally, see the WMR Education Notes “Investing in Emerging Markets (Part 1): Equities,” 30 July 2007, “Emerging Market Bonds: Understanding Emerging Market Bonds,” 12 August 2009 and “Emerging Market Bonds: Understanding Sovereign Risk,” 17 December 2009.

Investors interested in holding bonds for a longer period are advised to select the bonds of those sovereigns with the highest credit ratings (in the investment grade band). Such an approach should decrease the risk that an investor could end up holding bonds on which the sovereign has defaulted. Sub-investment grade bonds are recommended only for clients with a higher risk tolerance and who seek to hold higher yielding bonds for shorter periods only.

Non-Traditional Assets

Nontraditional assets include commodities and alternative investments. Alternative investments, in turn, include hedge funds, private equity, real estate, and managed futures. Interests of alternative investment funds are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of alternative investment funds, and which clients are urged to read carefully before subscribing and retain. An investment in an alternative investment fund is speculative and involves significant risks. Alternative investment funds are not mutual funds and are not subject to the same regulatory requirements as mutual funds. Alternative investment funds’ performance may be volatile, and investors may lose all or a substantial amount of their investment in an alternative investment fund. Alternative investment funds may engage in leveraging and other speculative investment practices that may increase the risk of investment loss. Interests of alternative investment funds typically will be illiquid and subject to restrictions on transfer. Alternative investment funds may not be required to provide periodic pricing or valuation information to investors. Alternative investment fund investment programs generally involve complex tax strategies and there may be delays in distributing tax information to investors. Alternative investment funds are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits. Alternative investment funds may fluctuate in value. An investment in an alternative investment fund is long-term, there is generally no secondary market for the interests of a fund, and none is expected to develop. Interests in alternative investment funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in an alternative investment fund and should consider an alternative investment fund as a supplement to an overall investment program. In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- **Hedge Fund Risk:** There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, “junk bonds,” derivatives, distressed securities, non-US securities and illiquid investments.
- **Hedge Fund of Funds:** In addition to the risks associated with hedge funds generally, an investor should recognize that the overall performance of a fund of funds is dependent not only on the investment performance of the manager of the fund, but also on the performance of the underlying managers. The investor will bear the management fees and expenses of both the fund of funds and the underlying hedge funds or accounts in which the fund of funds invests, which could be significant.
- **Managed Futures:** There are risks specifically associated with investing in managed futures programs. For example, not all managers focus on all strategies at all times, and managed futures strategies may have material directional elements.
- **Real Estate:** There are risks specifically associated with investing in real estate products and real estate investment trusts. They involve risks associated with debt, adverse changes in general economic or local market conditions, changes in governmental, tax, real estate and zoning laws or regulations, risks associated with capital calls and, for some real estate products, the risks associated with the ability to qualify for favorable treatment under the federal tax laws.
- **Private Equity:** There are risks specifically associated with investing in private equity. Capital calls can be made on short notice, and the failure to meet capital calls can result in significant adverse consequences including, but not limited to, a total loss of investment.
- **Foreign Exchange/Currency Risk:** Investors in securities of issuers located outside of the United States should be aware that even for securities denominated in US dollars, changes in the exchange rate between the US dollar and the issuer’s

Appendix

“home” currency can have unexpected effects on the market value and liquidity of those securities. Those securities may also be affected by other risks (such as political, economic or regulatory changes) that may not be readily known to a US investor.

- Options: Options are not suitable for all investors. Please read the Options Clearing Corporation Publication titled “Characteristics and Risks of Standardized Options Trading” and consult your tax advisor prior to investing. The Publication can be obtained from your Financial Services Inc., Financial Advisor, or can be accessed under the Publications Section of the Option Clearing Corporation’s website: www.theocc.com.

Description of Certain Alternative Investment Strategies

- Equity Hedge: Investment managers who maintain positions both long and short in primarily equity and equity-derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. Equity hedge managers would typically maintain at least 50% and may, in some cases, be substantially entirely invested in equities, both long and short.
- Event Driven: Investment managers who maintain positions in companies currently or prospectively involved in corporate transactions of a wide variety including, but not limited to, mergers, restructurings, financial distress, tender offers, share-holder buybacks, debt exchanges, security issuance or other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated, and frequently involve additional derivative securities. Event-driven exposure includes a combination of sensitivities to equity markets, credit markets and idiosyncratic, company-specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative), with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.
- Credit Arbitrage Strategies: Employ an investment process designed to isolate attractive opportunities in corporate fixed income securities. These include both senior and subordinated claims as well as bank debt and other outstanding obligations, structuring positions with little or no broad credit market exposure. These may also contain a limited exposure to government, sovereign, equity, convertible or other obligations, but the focus of the strategy is primarily on fixed corporate obligations and other securities held as component positions within these structures. Managers typically employ fundamental credit analysis to evaluate the likelihood of an improvement in the issuer’s creditworthiness. In most cases, securities trade in liquid markets, and managers are only infrequently or indirectly involved with company management. Fixed income: corporate strategies differ from event driven; credit arbitrage in the former more typically involves more general market hedges, which may vary in the degree to which they limit fixed income market exposure, while the latter typically involves arbitrage positions with little or no net credit market exposure, but are predicated on specific, anticipated idiosyncratic developments.
- Macro: Investment managers who trade a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top-down and bottom-up theses, quantitative and fundamental approaches and long- and short-term holding periods. Although some strategies employ relative value techniques, macro strategies are distinct from relative value strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments, rather than realization of a valuation discrepancy between securities. In a similar way, while both macro and equity hedge managers may hold equity securities,

the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices, as opposed to equity hedge, in which the fundamental characteristics of the company are the most significant and integral to investment thesis.

- Distressed Restructuring Strategies: Employ an investment process focused on corporate fixed income instruments, primarily on corporate credit instruments of companies trading at significant discounts to their value at issuance, or obliged (par value) at maturity, as a result of either a formal bankruptcy proceeding or financial market perception of near-term proceedings. Managers are typically actively involved with the management of these companies, frequently involved on creditors’ committees in negotiating the exchange of securities for alternative obligations, either swaps of debt, equity or hybrid securities. Managers employ fundamental credit processes focused on valuation and asset coverage of securities of distressed firms. In most cases, portfolio exposures are concentrated in instruments which are publicly traded, in some cases actively and in others under reduced liquidity but, in general, for which a reasonable public market exists. In contrast to special situations, distressed strategies primarily employ debt (greater than 60%) but also may maintain related equity exposure.
- Relative Value: Investment managers who maintain positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed income, derivative or other security types. Fixed income strategies are typically quantitatively driven to measure the existing relationship between instruments and, in some cases, identify attractive positions in which the risk-adjusted spread between these instruments represents an attractive opportunity for the investment manager. Relative value position may be involved in corporate transactions also, but as opposed to event-driven exposures, the investment thesis is predicated on realization of a pricing discrepancy between related securities, as opposed to the outcome of the corporate transaction.

Chart Explanations

Figure 4 in US Equities

Note: Cyclical include Consumer Discretionary, Financials, Industrials, Tech and Materials. Defensives include: Staples, Healthcare, Telecom, and Utilities.

Figures 1, 2 and 4 in Economic Outlook

In developing the forecasts set forth above, WMR economists worked in collaboration with economists employed by UBS Investment Research (INV). INV is published by UBS Investment Bank. Forecasts (F) are current only as of the dates of the publication and may change without notice.

Appendix

Explanations about Asset Classes

Sources of benchmark allocations and investor risk profiles

- Benchmark allocations represent the longer-term allocation of assets that is deemed suitable for a particular investor. Except as described below, the benchmark allocations expressed in this publication have been developed by UBS Investment Solutions (IS), a business sector within UBS Wealth Management Americas that develops research-based traditional investments (e.g., managed accounts and mutual fund options) and alternative strategies (e.g., hedge funds, private equity, and real estate) offered to UBS clients. The benchmark allocations are provided for illustrative purposes only and were designed by IS for hypothetical US investors with a total return objective under seven different Investor Risk Profiles ranging from very conservative to very aggressive. In general, benchmark allocations will differ among investors according to their individual circumstances, risk tolerance, return objectives and time horizon. Therefore, the benchmark allocations in this publication may not be suitable for all investors or investment goals and should not be used as the sole basis of any investment decision. As always, please consult your UBS Financial Advisor to see how these weightings should be applied or modified according to your individual profile and investment goals.
- The process by which UBS Investment Solutions has derived the benchmark allocations can be described as follows. First, an allocation is made to broad asset classes based on an investor's risk tolerance and characteristics (such as preference for international investing). This is accomplished using optimization methods within a mean-variance framework. Based on a proprietary set of capital market assumptions, including expected returns, risk, and correlation of different asset classes, combinations of the broad asset classes are computed that provide the highest level of expected return for each level of expected risk. A qualitative judgmental overlay is then applied to the output of the optimization process to arrive at the benchmark allocation. The capital market assumptions used for the benchmark allocations are developed by UBS Global Asset Management. UBS Global Asset Management is a subsidiary of UBS AG and an affiliate of UBS Financial Services Inc.
- In addition to the benchmark allocations IS derived using the aforementioned process, WMR determined the benchmark allocation by country of Non-US Developed Equity and Non-US Fixed Income in proportion to each country's market capitalization, and determined the benchmark allocation by Sector and Industry Group of US Equity in proportion to each sector's market capitalization. WMR, in consultation with IS, also determined the benchmark allocation for US dollar taxable fixed income. It was derived from an existing moderate risk taxable fixed income allocation developed by IS, which includes fewer fixed income segments than the benchmark allocation presented here. The additional fixed income segments were taken by WMR from related segments. For example, TIPS

were taken from Treasuries and Preferred Securities from Corporate Bonds. A level of overall risk similar to that of the original IS allocation was retained.

- Alternative investments (AI) include hedge funds, private equity, real estate, and managed futures. The total benchmark allocation was determined by IS using the process described above. The Wealth Management Americas Investment Committee (WMA IC) derived the AI subsector benchmark allocations by adopting IS' determination as to the appropriate subsector benchmark allocations with AI for the following risk profiles: conservative, moderately conservative, moderate, moderate aggressive and aggressive. The WMA IC then developed subsector allocations for very conservative and very aggressive risk profiles by taking the IS subsector weightings for conservative and aggressive risk profile investors and applying them pro rata to the IS AI total benchmark allocations for very conservative and very aggressive, respectively. Allocations to AI as illustrated in this report may not be suitable for all investors. In particular, minimum net worth requirements may apply.
- The background for the benchmark allocation attributed to commodities can be found in the WMR Education Note "A pragmatic approach to commodities," 2 May 2007.

Deviations from benchmark allocation

- The recommended tactical deviations from the benchmark are provided by WMR. They reflect our short- to medium-term assessment of market opportunities and risks in the respective asset classes and market segments. Positive / zero / negative tactical deviations correspond to an overweight / neutral / underweight stance for each respective asset class and market segment relative to their benchmark allocation. The current allocation is the sum of the benchmark allocation and the tactical deviation.
- Note that the regional allocations on the International Equities page are provided on an unhedged basis (i.e., it is assumed that investors carry the underlying currency risk of such investments). Thus, the deviations from the benchmark reflect our views of the underlying equity and bond markets in combination with our assessment of the associated currencies. The two bar charts ("Equity Regions" and "Fixed Income Regions") represent the relative attractiveness of countries (including the currency outlook) within a pure equity and pure fixed income portfolio, respectively. In contrast, the detailed asset allocation tables integrate the country preferences within each asset class with the asset class preferences stated earlier in the report. As the tactical deviations at the asset class level are attributed to countries in proportion to the countries' market capitalization, the relative ranking among regions may be altered in the combined view.

Scale for tactical deviation charts

Symbol	Description/Definition	Symbol	Description/Definition	Symbol	Description/Definition
+	moderate overweight vs. benchmark	-	moderate underweight vs. benchmark	n	neutral, i.e., on benchmark
++	overweight vs. benchmark	--	underweight vs. benchmark	n/a	not applicable
+++	strong overweight vs. benchmark	---	strong underweight vs. benchmark		

Source: UBS WMR

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