2012 Outlook: Investing *at the crossroads*

With markets settling back to levels similar to that of 2011's open, we recommend a modest defensive bias going into the new year. As the fragile recovery continues, a narrow margin holds between expansion and recession, the brunt of deciding factors resting with policy choices and political leaders. Although risk assets are unlikely to meaningfully recover from their current relatively depressed valuations until sovereign and financial concerns abate, it may be a multi-year process until macro economic uncertainties dissipate. As 2012 begins, we are truly at a crossroads from an economic, political and policy perspective.

While new challenges are certain to develop, we see three trends born from the 2008-09 financial crisis that should interact and ultimately dictate financial market outcomes in 2012: 1) the deleveraging of global balance sheets, 2) continued political leadership changes, and 3) the simultaneous easing of monetary policy by major central banks.

Deleveraging: Although many consumers and US banks began to cut back and recapitalize after the financial crisis, we expect to see the continued deleveraging of consumers, financial institutions and governments limit worldwide growth. Although overall household indebtedness and the ratio of household liabilities to disposable income have decreased since the crisis, consumers are unlikely to releverage their balance sheets rapidly and spending is expected to remain constrained given sluggish employment growth. In Europe, banks have not recapitalized themselves to the same extent as their US counterparts. With private investors showing little interest in providing fresh capital, banks are likely to curb their lending in order to meet heightened capital requirement. This risks exacerbating the European recession. At the crux of the eurozone crisis rests the issue of public debt. While many countries have already begun the deleveraging process, this continued trend of fiscal contraction in Europe should also limit growth.

Political change: Just as deleveraging should continue through this upcoming year, recent leadership changes (as evidenced in the Middle East, North Africa and Europe) are likely to extend through 2012 as well. In fact, these changes should impact some of the most strategically important countries in the world. The three countries/regions with upcoming elections likely to have the greatest potential effect on the global macroeconomic outlook are the US, Europe and China. In the US, if neither party can win decisive control of the political process, the country risks hitting gridlock at a time when fiscal reform is vital. For Europe, France's presidential election will coincide with ongoing concern over the country's AAA sovereign credit rating. Finally, although China's leadership changes are unlikely to be structurally transformative, its increasingly assertive role in world affairs begs a close following.

Central bank easing: Following the 2008 financial crisis, public sector intervention was successful in averting a modern day Great Depression. As the situation in the eurozone progresses, a similar involvement will be needed. This time it appears that only the central banks, with large enough balance sheets, can handle the situation. While the Federal Reserve has engineered the first and second rounds of quantitative easing and "operation

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twist," the European Central Bank has started to support European debt markets with its Securities Market Program purchases. Even emerging market economies – which had increased rates to fend off inflation threats during 2011 – seem to be reversing course to a more accommodative stance. For the first time since the 2008 financial crisis, there is now a universal easing of monetary policy.

Investment recommendations: As far as investment strategy is concerned, we recommend holding an overall modest defensive bias as we wait to see how each of these trends plays out. Specifically, we opt to tactically moderately underweight global equities and see a likely deceleration in global growth from the recession in Europe as reason to underweight commodities as well. Our overweights include bonds and cash.

Within equities we avoid the eurozone, preferring the US and increasing our exposure to emerging markets. We view growth stocks, specifically within the technology, consumer staples and healthcare sectors as more attractive than value stocks.

In more general terms, we also favor income-generating investments as a way to find return amid choppy, range-bound markets. With bond yields across most fixed income markets still hovering near generational lows, the opportunities for producing income seem to have diminished, while the risks associated with those income streams have risen. In this context, we favor domestic high-yield corporate bonds and dividend growth stocks.

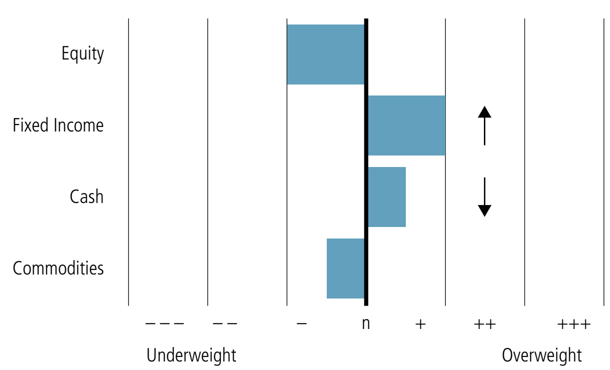
In an atypical environment, it's also important to think beyond the basic asset classes. We recommend thinking of volatility as an asset class and utilizing it by gaining exposure through derivatives. This can help both dampen volatility itself and supplement returns. Additionally, be sure to retain some flexibility and prepare for tactical repositioning throughout the year. We believe that it will be important to be willing to add risk to portfolios following phases of market decline and to trim positions following rallies.

Of course, there remain threats that may unhinge these recommendations. Our baseline forecasts and market outlook may quickly change with risks of an implosion in the eurozone, a hard landing in China, a double-dip recession with a third round of quantitative easing in the US, a conflict with Iran and overall escalating social unrest.

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. Should decision makers rise to the challenge, opportunities should emerge.

Asset class preferences

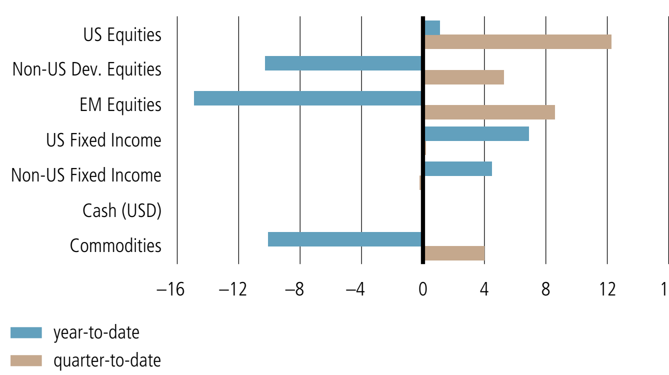
Tactical deviations from benchmark



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

Asset Classes

Total return in USD and %



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

This chart is developed by UBS Wealth Management Research and presents the recommended asset allocation for a hypothetical, average US investor with a moderate risk tolerance, intermediate investment horizon, and total return objective. We expect a short-term phase of consolidation or sideways movement in the context of a broader intra-year upward or downward trend. The weights may not be suitable for all investors or investment goals and should not be used as the sole basis of any investment decision. Please consult your UBS Financial Advisor to see how these weightings should be applied to your individual investment goals. See "Deviations from Benchmark Allocations" in the Appendix of the *Investment Strategy Guide* for an explanation regarding the interpretation of the suggested tactical deviations from benchmark.

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.

Equities

Current allocation: 40.0%

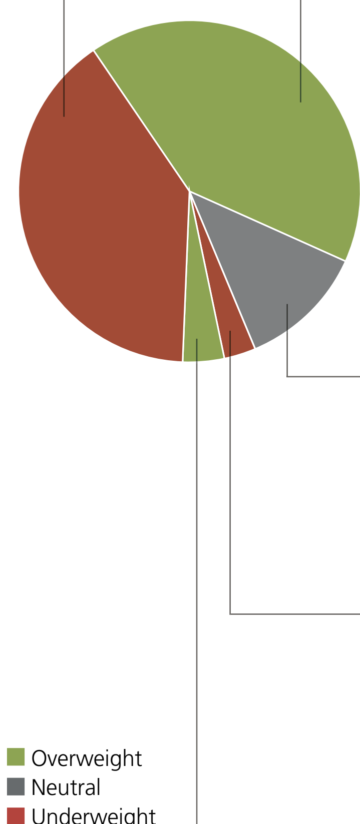
International markets

- UK and US equities
- Emerging Market equities, especially China and India

Within US equities

- Information Technology: semiconductors, data centers
- Consumer Staples: companies with high emerging markets exposure, specifically within household products, cosmetics, and beverages
- Healthcare: managed care, generic manufacturers, drug distributors
- Within Consumer Discretionary: cable & satellite, lodging, apparel
- Within Energy: oil services
- Within Financials: regional banks, exchanges, P&C insurers
- Within Industrials: air freight, faster growing capital goods companies
- Within Materials: industrial gas
- Within Telecom: wireless towers, rural telecom carriers
- Within Utilities: transmission-focused utilities

- Preference for growth over value stocks
- Preference for large cap over mid cap and small cap stocks



Fixed Income

Current allocation: 41.0%

Within US dollar Fixed Income

- Investment Grade BBB-rated credits in particular: managed care, mining, oil and gas, and communications
- Investment Grade senior unsecured debt of well-diversified US banks and select insurance companies
- High yield corporate bonds.

Alternative Investments

Current allocation: 12.0%

- In particular, global macro hedge funds and managed futures

Commodities

Current allocation: 3.0%

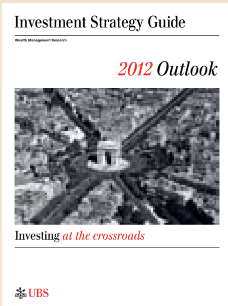
- We see upside potential for gold, platinum, and grains

Cash

Current allocation: 4.0%

- Store of value for the short term and dry powder, while waiting for opportunities elsewhere.

The benchmark allocations underlying this page 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 of the Investment Strategy Guide 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 of the *Investment Strategy Guide* regarding the interpretation of the suggested tactical deviations from benchmark.



Investment Strategy Guide
A flagship publication from UBS Wealth Management Research, this report offers tactical asset allocation recommendations, encompasses scenario analysis and provides a comprehensive investment process organized around seven investor risk profiles.

For a complete copy of this report, please contact your UBS Financial Advisor.

Version as per October 2011.

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