

# Investment Strategy Guide

Wealth Management Research

May 2012 issue

Monthly

## No *replay*



*Replay of the past  
two years is unlikely*

*Structural challenges  
remain in place*

*Selective reengagement in  
markets warranted*

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## Highlights

- Following a surprisingly fast start during the first quarter, equity markets have been choppy this past month amid softening economic data, a re-flaring of the eurozone crisis, lingering tensions in the Middle East and concerns over a hard landing in China.
- Some fear a replay of 2010 and 2011 when stocks got off to similar strong starts – only to experience subsequent sharp and broad-based corrections. It is our view, however, that these concerns are largely overblown this time around.
- We look for markets to remain largely range-bound over the balance of the year – albeit with both periodic surges and episodic setbacks likely along the way. The recovery in the US has become more durable, activity in China is poised to re-accelerate, monetary policy will remain accommodative, markets are fairly valued and earnings growth rates remain positive.
- While a replay of recent market swoons is unlikely, challenges remain and risk assets will continue to be negatively impacted by issues ranging from regional economic weakness, to sporadic escalation of geopolitical risks, to the re-flaring of the eurozone sovereign debt crisis.
- Against this backdrop, we recommend that investors continue to maintain a benchmark or “neutral” tactical allocation across each of the major asset classes.
- However, we recommend selective and opportunistic positioning with a modest pro-risk bias in both equity and fixed income markets. Within equities this includes overweights to emerging markets and a preference for technology, consumer staples, healthcare and now also the energy sector in the US. Within fixed income, we recommend overweights in high yield bonds and dollar-denominated emerging market debt and preferred stock.

# No *replay*

*While a strong first quarter followed by a choppy start to the second may appear reminiscent of 2010 and 2011, we believe concerns about a renewed broad-based correction are exaggerated. Nonetheless, risk assets are unlikely to experience further outsized gains given the existing structural challenges and potential tail risks.*

Following a surprisingly fast start during the first quarter, equity markets have been choppy over this past month amid softening economic data, a re-flaring of the eurozone crisis, lingering tensions in the Middle East and concerns over a hard landing in China. This has served to rekindle fears of a replay of 2010 and 2011 when stocks got off to similar strong starts – only to experience sharp and broad-based corrections (see Fig. 2). It is our view, however, that these concerns are largely overblown this time around. Keep in mind that the principal catalysts behind the meltdowns of the past two years were fears of a double-dip US recession, concerns that the deepening eurozone debt woes could prompt another financial crisis and/or a series of one-off exogenous shocks such as the Japanese tsunami. But with the US economy now on much firmer footing and European Central Bank (ECB) officials having demonstrated their willingness to address bank funding stress when necessary, we don't foresee a replay of the spring / summer swoons that afflicted markets in each of the past two years.

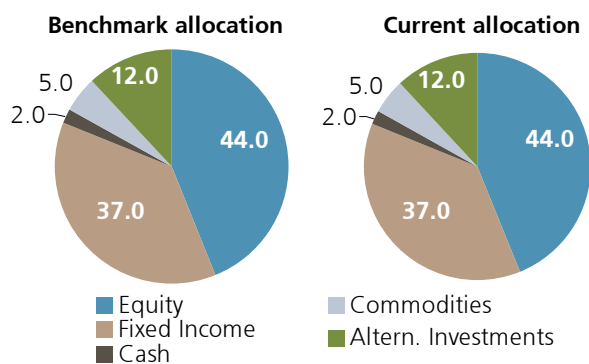
### Markets will remain largely range bound...

Instead, we look for markets to remain largely range-bound over the balance of the year – albeit with both periodic surges and episodic setbacks likely along the way. The following suggests that a replay of these recent market meltdowns is increasingly unlikely:

- The recovery in the US has become more durable amid better labor market conditions, improvements in bank lending activity, continued resiliency in manufacturing and a bottoming out in the housing sector (see Fig. 3). So while the economy is still unlikely to break out of the 2-3% “growth channel” that has persisted since the end of the recession, the prospects for a repeat of last year’s “growth scare” appear limited.
- Economic activity in China is poised to reaccelerate following a temporary late-winter soft patch. Recently released PMI data improved somewhat, and

**Fig. 1: Benchmark and current allocation**

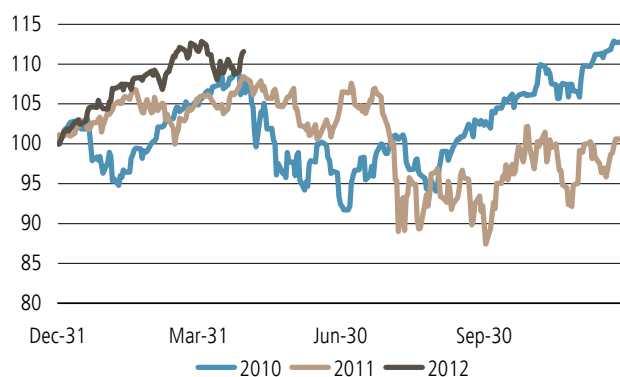
Percentage of portfolio (moderate risk portfolio)



Source: UBS Investment Solutions and WMR, as of 30 April 2012. See Sources of benchmark allocations and investor risk profiles in the Appendix for a detailed explanation regarding benchmarks and their suitability. The current allocation is the sum of the benchmark allocations and tactical deviations. The Tables on pages 24 and 25 in the Appendix also show asset allocations applicable to risk profiles other than the moderate risk profile shown here, both with and without nontraditional assets.

**Fig. 2: Early-year rallies in last three years**

S&P 500 index, rebased 31 December of previous year=100



Source: Bloomberg, UBS WMR, as of 27 April 2012

the rise in new orders and bank lending suggest that growth is likely to rebound in the months ahead (see Fig. 4). Fears of a Chinese hard landing are therefore exaggerated, in our view.

- Monetary policy will remain broadly accommodative within each of the major developed economies as the Federal Reserve (Fed), European Central Bank (ECB), Bank of England (BoE) and Bank of Japan (BoJ) each appear willing to both keep rates low and expand their balance sheets even further if necessary. In contrast to last year, we now know that the ECB has both the ability and political latitude to address funding stresses within the financial system. While the policy responses will be less uniformly supportive across the developing world, a repeat of last year's inflation-induced tightening cycle in the emerging markets is unlikely.
- Even after a first quarter surge that pushed the S&P 500 back above the 1400 mark, equity markets are still not trading at levels that would suggest stocks have become overly expensive. Not only do each of the major equity markets in the world trade either at or below their historical P/E ratios, but equity risk premiums (the incremental yield on stocks over bonds) remain well above normal (see Fig. 5). While valuations may not be the key driver of market moves in the very near term, attractive valuation does represent an important source of support over an intermediate to longer term horizon.
- US corporate earnings results continued to impress in the first quarter, although expectations were admittedly quite low and forward-looking estimates are likely overly optimistic. We still look for S&P 500 EPS growth rates to remain positive – but to slow to low-to-mid single digits by year-end.

**...but still eventful**

But while an identical replay of the past two years is unlikely, challenges remain and risk assets will continue to be negatively impacted by a whole host of issues ranging from regional economic weakness, to sporadic escalation of geopolitical risks, to the re-flaring of the eurozone sovereign debt crisis. Consider the following:

- The eurozone economy remains in recession and the sovereign debt crisis has been rekindled. While the actions of the ECB helped to ease stress within the financial system, ongoing deleveraging within the banking system and the impact from austerity measures now suggest a deeper recession (see Fig. 6). Meanwhile the sovereign crisis has spread beyond familiar peripheral players such as Spain and Italy and now includes core countries such as the Netherlands (see Fig. 7).

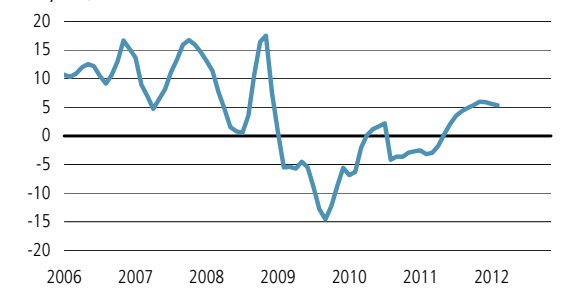
**Table 1: Asset Class Scorecard**

	Valuation	Cyclical	Timing
Equities	+1	0	+1
Commodities	-1	+1	0
Fixed Income	-1	-1	0

Range: -3 (very unsupportive) to +3 (very supportive)  
Source: UBS WMR, as of 30 April 2012

**Fig. 3: US recovery underpinned by growing bank lending**

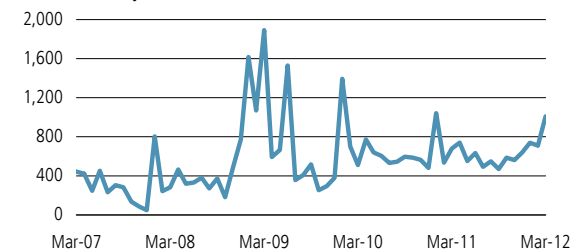
US commercial bank loans and leases, quarterly growth annualized, in %



Source: Bloomberg, UBS WMR, as of 27 April 2012

**Fig. 4: Rising bank lending suggests Chinese soft landing in Q1**

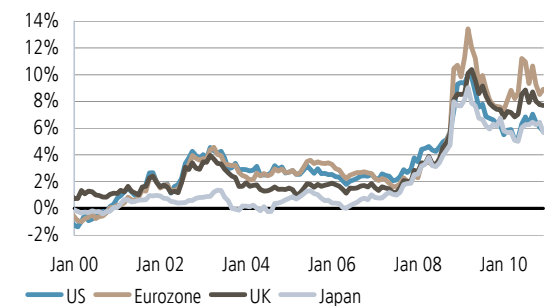
China monthly new loans (CNY billion)



Source: Bloomberg, UBS WMR, as of 26 April 2012

**Fig. 5: Elevated equity risk premiums**

Equity risk premiums (earnings yield minus real bond yield)



Source: DataStream, UBS WMR as of 27 April 2012

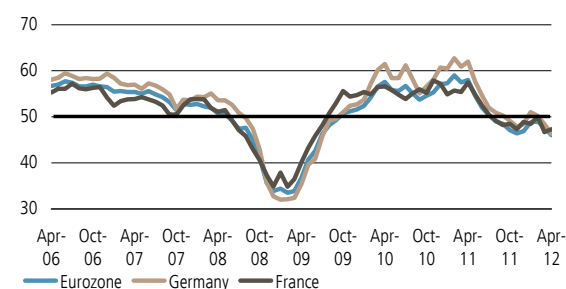
While the prospects for another Greek-style default appear limited, there is a clear risk that European assets may have to selloff further before policymakers are driven to take decisive action.

- Tensions in the Middle East remain an important risk to the global outlook through the significant impact they could have on energy prices. However, with Iran and Israel appearing somewhat more conciliatory following the resumption of talks in Istanbul and with energy prices coming off their recent peak (see Fig. 8), the geopolitical situation may be turning into less of a headwind.
- It remains our view that growth in China is reaccelerating following the winter “soft patch.” However, there is still a chance that the lagged impact from selective tightening of policy, concerns over the changes in political leadership and/or the transition away from an export / infrastructure led economy could push growth below both our own and officials estimates. Given how important a role China plays in the world today amid balance sheet deleveraging in the developed world, a “hard landing” in China would have broad implications for both the real economy and financial markets.
- Likely changes in the political landscape – including new leadership in such critical eurozone players as France and Greece – pose another near-term threat to markets. Although the US Presidential and Congressional elections are still about six months away, increased high-stakes partisan bickering around the debt ceiling, taxes and healthcare reform prior to the election could also weigh periodically upon risk assets.
- The US also faces a potential “fiscal cliff” with both tax cuts and spending measures set to expire at the end of this year. However, any serious budget discussions have effectively been pushed off until after the election through temporary extensions. While this delay may enable elected officials to engage in more thoughtful discussions without the specter of an election looming in the background, it still represents an immediate and daunting challenge for the next Congress and Administration.

### Remain selective and opportunistic

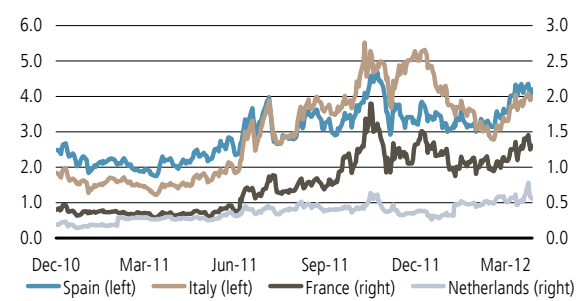
Against this backdrop we recommend that investors continue to maintain a benchmark or “neutral” allocation across each of the major asset classes. Equity markets appear mostly fairly valued at current levels, but a material re-rating of stocks is unlikely amid continued balance sheet deleveraging and lingering geopolitical risks. While interest rates are apt to drift higher over the course of this year, still moderate growth prospects, a largely docile inflation outlook and continued accommodative monetary policy conditions serve to limit re-pricing risks for bonds as well. Commodity

**Fig. 6: No improvement in eurozone indicators**  
Manufacturing Purchasing Manager Indexes



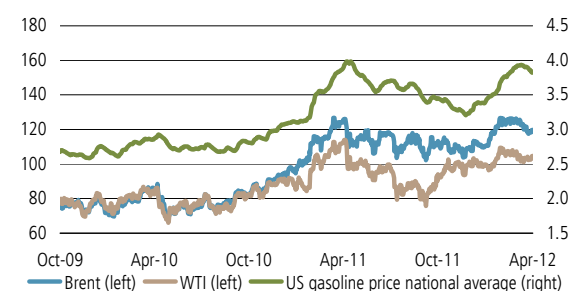
Source: Bloomberg, UBS WMR, as of 27 April 2012

**Fig. 7: Renewed financial stress in eurozone**  
Yield spread over 10-year German government bond, in %



Source: Bloomberg, UBS WMR, as of 27 April 2012

**Fig. 8: Energy prices coming off recent peaks**  
Crude oil and US gasoline prices, in USD per barrel and gallon



Source: Bloomberg, UBS WMR, as of 27 April 2012

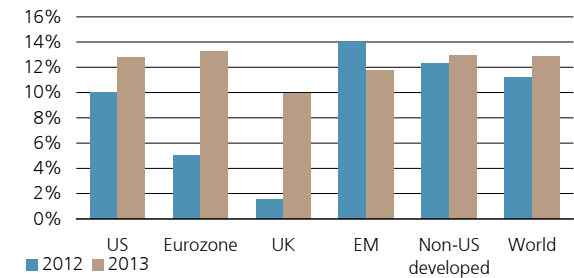
prices meanwhile, are also apt to remain largely range-bound – but with sharp divergences likely between the energy, precious metals, base metals and agricultural sectors over the next several months.

But while we advocate a largely neutral allocation across the major asset classes, we continue to recommend selective and opportunistic positioning with a modest pro-risk bias in both equity and fixed income markets. Consider the following:

- While equity markets appear fairly valued, the profit picture is still something of a mixed bag. Emerging markets earnings have room to surprise to the upside, but US companies will find comparisons more challenging in the second half of the year and European companies are apt to disappoint amid still lofty earnings expectations (see Fig. 9).
- We therefore continue to overweight emerging market equities given still solid growth prospects, a positive earnings outlook, an absence of any material policy tightening and attractive valuations.
- Despite the cheapest valuations across developed markets, we retain our underweight in eurozone equities (see Fig. 5). As we've already highlighted, the re-flaring of the sovereign debt crisis, prospects for a deepening of the recession and likely disappointment in the earnings outlook suggest Europe will continue to lag. Don't mistake cheap for inexpensive.
- We maintain a neutral allocation to US equities amid only fair valuations and prospects for low- to mid-single-digit earnings gains this year and next year. However, we continue to recommend overweights in technology, consumer staples and healthcare. Undemanding valuation levels, an attractive earnings outlook, strong balance sheets and superior secular growth prospects support each of these three sectors to varying degrees. We also upgrade Energy to a moderate overweight following the sector's significant year-to-date underperformance coupled with our expectation for positive catalysts to emerge as the year unfolds.
- We continue to underweight US Treasury bonds. While rates are unlikely to rise very sharply amid still accommodative monetary policy, modest capital demand and limited inflation pressures, the return outlook remains underwhelming with coupon income at historical lows and the medium-term direction of yields biased upward. Treasuries should therefore be maintained largely as a hedge against any rise in geopolitical tensions and/or exogenous shocks to the economy.
- Despite the continued tightening of credit spreads, we retain our preference for credit-sensitive parts of the fixed income markets. Corporate balance sheets are in the best shape in

**Fig. 9: Earnings expectations unrealistic in eurozone**

Consensus earnings-per-share growth estimates



Source: IBES, Datastream, UBS WMR, as of 26 April 2012

half a century, as companies have been reluctant to over-commit on either capital spending or payroll expansions. This suggests that default rates will remain below historical averages, while default compensation through credit spreads is higher than average (see Fig. 10). Absent systemic financial shocks, further spread tightening is likely. We currently favor high yield over investment grade corporate paper – but also have a preference for dollar-denominated emerging market debt and preferred securities.

### No waiting for the whistle

Markets have continued to behave erratically – alternating between impressive “risk-on” rallies and gut wrenching “risk-off” retrenchments. For those of us who spent our summers in public pools as children, the market’s increasingly fickle nature is somewhat reminiscent of a lifeguard blowing the whistle to signal when it was time to get in or out of the pool. While this may work just fine for a group of city kids looking to escape the summer heat, it’s not a very efficient way for investors to engage in markets. There are likely to be periods when markets suffer corrections amid a still challenging macro backdrop and lingering geopolitical risks. The balance sheet adjustment process across the developed world will continue to constrain growth, the situation in the Middle East between Iran and Israel remains both unsettled and unsettling, China’s transition to more consumer led growth will continue to be a bumpy one and the scope and scale of potential political leadership changes (including both the US and France) promises to introduce yet more uncertainty into the mix.

Despite these risk and challenges, investors need to remain committed to markets. There is no lifeguard poised to blow the whistle to let us know each time it is safe to go back in the water. We therefore need to engage selectively in those sectors and regions that not only offer the best return prospects, but are also priced at levels that fairly reflect the risks being taken. It remains our view that the economic recovery will progress – albeit at an uneven and moderate pace. Central bankers meanwhile appear willing to take the policy steps necessary to prevent either a sharp deceleration of growth or freezing up of financial markets. This should serve to limit the downside risks. So while periodic setbacks are likely along the way, we don’t look for a replay of the sort of steep and protracted selloffs that defined the past two years.

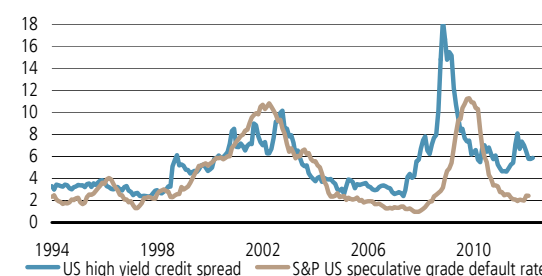
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**Fig. 10: High yield corporates offer value**

US high yield credit spread and S&P speculative grade default rate, in %



Source: S&P, Bloomberg, UBS WMR, as of 27 April 2012

## 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.

<b>Asset Classes</b>	Neutral tactical preferences across the main asset classes
<b>Currencies</b>	Japanese yen set to weaken. Preference for GBP, CAD, AUD and NZD among developed currencies. Selected Asian Emerging Market currencies for long-term appreciation potential.
<b>Equities</b>	<p><b>International markets</b></p> <ul style="list-style-type: none"><li>• UK and Emerging Market equities</li><li>• Within Emerging Market equities: China, Mexico and Brazil</li></ul> <p><b>Within US equities</b></p> <ul style="list-style-type: none"><li>• Consumer Staples: companies with high emerging market exposure</li><li>• Information Technology: semiconductors, data centers</li><li>• Healthcare: managed care, generic manufacturers, drug distributors</li><li>• Energy: oil services</li><li>• Within Consumer Discretionary: cable &amp; satellite, lodging</li><li>• Within Telecom: wireless towers, enterprise and rural telecom carriers</li><li>• Within Utilities: transmission-focused utilities</li><li>• Within Financials: REITs with growing dividends, capital market-exposed banks, exchanges, P&amp;C insurers</li><li>• Within Industrials: capital goods companies that are outgrowing the market</li><li>• Within Materials: industrial gas</li><li>• Preference for growth over value stocks</li></ul>
<b>Fixed Income</b>	<p><b>Within US dollar fixed income</b></p> <ul style="list-style-type: none"><li>• Within investment grade corporates, short- to medium-term issues of larger, well-capitalized diversified banks, insurers and REITs.</li><li>• Fixed and floating rate preferred securities of well capitalized banks</li><li>• Emerging markets sovereign debt, in particular from Asian and Latin American issuers.</li><li>• High yield corporate bonds</li><li>• High quality municipal bonds in particular: 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.</li></ul>
<b>Commodities</b>	We see upside potential for selected base metals and precious metals during second half of the year.

# Asset Allocation Overview

Asset Class Comments	WMR Tactical View	Model Portfolio Moderate Risk Profile (in %)		
		Benchmark Allocation	Tactical Deviation	Change Current Allocation
<b>Equities</b> Equity valuations are still attractive relative to bonds and downward revisions to earnings estimates have slowed.	Neutral	44	+0.0	44.0
<b>US Equities</b> Valuations are less attractive than in overseas markets but economic recovery and earnings growth is more solid than in many other developed countries.	Neutral	32	+0.0	32.0
US Large Cap Value Valuations, our sector tilts and moderating earnings growth favor growth over value.	Moderate Underweight	11	-2.5	8.5
US Large Cap Growth Valuations, our sector tilts and moderating earnings growth favor growth over value.	Moderate Overweight	11	+1.5	12.5
US Mid Cap Valuations expensive vs. large-caps and little support from M&A activity, but less exposure to Europe.	Neutral	5	+0.0	5.0
US Small Cap Valuations expensive vs. large-caps and little support from M&A activity, but less exposure to Europe.	Neutral	3	+0.0	3.0
US Real Estate Investment Trusts (REITs) Improving fundamentals and low interest rates are positives for the REIT industry, dividend yield attractive vs. Treasuries.	Moderate Overweight	2	+1.0	3.0
<b>Non-US Developed Equities</b> Valuations more attractive than US, but eurozone risks suggest a more cautious stance.	Moderate Underweight	10	-2.0	8.0
<b>Emerging Market (EM) Equities</b> Valuations are attractive and robust economic growth supports earnings.	Moderate Overweight	2	+2.0	4.0
<b>Fixed Income</b> Yields at historically low levels but market supported by loose monetary policy stance of the major central banks. Useful portfolio hedge in the case of adverse scenarios.	Neutral	37	+0.0	37.0
<b>US Fixed Income</b> 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	+2.0	31.0
<b>Non-US Fixed Income</b> Extremely low yields and overvalued yen make Japanese debt unattractive. European sovereign debt concerns remain a risk.	Moderate Underweight	8	-2.0	6.0
<b>Cash (USD)</b> Store of value for the short term and dry powder, while waiting for opportunities elsewhere.	Neutral	2	+0.0	2.0
<b>Commodities</b> Demand from emerging markets to provide support in the second half of 2012.	Neutral	5	+0.0	5.0
<b>Alternative Investments</b> No tactical view. Included into portfolio for diversification purposes.	Neutral	12	+0.0	12.0

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.

"WMR tactical deviation" legend: **Overweight** **Underweight** Neutral

Source: UBS WMR and Investment Solutions, as of 30 April 2012.

"Change" legend: ▲ Upgrade ▼ Downgrade

For end notes, please see appendix.

## Market Scenarios (next 12 months)

Economic surprises have lost some momentum but data releases remain compatible with our slow growth base case. Headwinds from tighter fiscal policy and deleveraging in developed markets will continue in 2012, making a strong recovery difficult to achieve. Monetary policy remains very loose on a global basis. Oil pressures are receding. For the next 12 months we distinguish the following four scenarios for growth and inflation.

### Slow growth: Base Case Scenario

Probability: 60% (up from 55% previously)

- The global economy remains on a very fragile expansion course with government policies achieving low but positive growth with the exception of the eurozone.
- 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 vs. 2011.

### Strong expansion: First Alternative Scenario

Probability: 20%

- Loose monetary policy, as well as greater political clarity in the US and Europe encourages a surge in investment spending.
- Improvements in the labor and housing market set the stage for a more dynamic consumer recovery.

### Renewed recession: Second Alternative Scenario

Probability: 10%

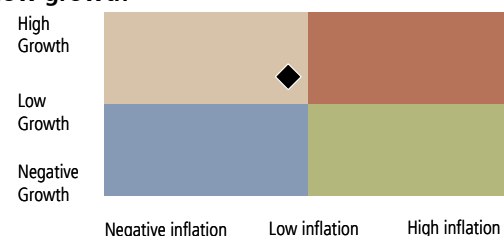
- Bank deleveraging and fiscal consolidation triggers a negative feedback loop, driving Europe into a deeper recession.
- Stress in bank funding markets result in a global credit crunch, which forces consumers and businesses to cut back on spending in the US and globally.
- Weak demand generates deflationary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

### Stagflation: Third Alternative Scenario

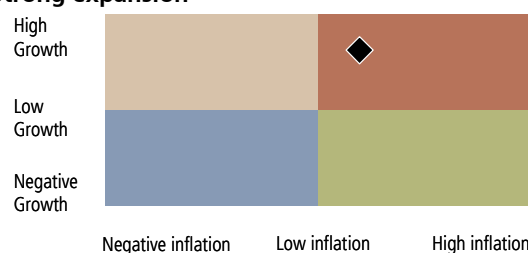
Probability: 10% (down from 15% previously)

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

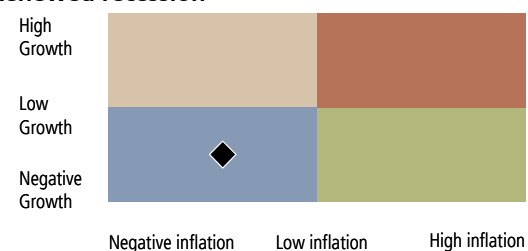
#### Slow growth



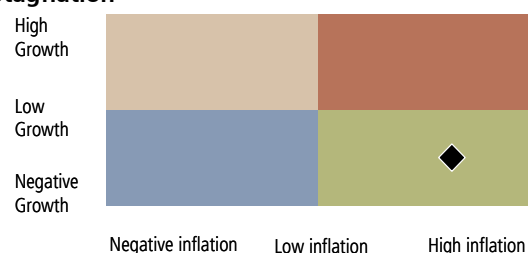
#### Strong expansion



#### Renewed recession



#### Stagflation



Source: UBS WMR

Stephen R. Freedman, PhD, CFA, Strategist, UBS FS Inc.

## Cyclical spring amid structural headwinds

Despite a recent bout of weaker US growth indicators, the cyclical recovery from the growth slump last summer is still on track. This effectively lowers the risk of a renewed downturn. Structural headwinds, however, cap the growth upside, leaving the US economy on a moderate but sustainable growth path. In the eurozone, Spain is now the center of attention as a renewed recession meets stringent fiscal austerity. We don't expect Spain to need debt restructuring, but the growth risks remain acute.

### US cyclical rebound is more robust than last year

After a visible acceleration in growth since late last summer through February, some key indicators have disappointed recently. Payrolls and claims have reversed their improvement trends somewhat, and consumer and business confidence has stalled. Despite these developments, we argue that the cyclical recovery is on a more solid footing this spring than last. Therefore, we deem the US economy to be more resilient to negative shocks and less prone to a sizable growth scare like last summer's. The first key difference relative to last year is that labor market conditions are healthier, even when accounting for the recent bout of weakness (see Fig. 11). Second, some housing market indicators have rebounded and broken out of their multi-year sideways trends. The NAHB Housing Market Index, which reflects homebuilders' confidence, is back to levels not recorded since mid-2007. A similar pattern has emerged for pending home sales (see Fig. 12). Moreover, house prices seem to be bottoming, which stabilizes banks' loan loss provisions and boosts consumer sentiment. Last but not least, we are one more year into the balance sheet healing process and bank and household balance sheets have improved further, creating less of a headwind. Taken together these developments suggest less severe downside risk to the growth outlook.

### Structural headwinds cap the growth upside

Despite less pronounced downside US growth risk, the structural headwinds are still large and, in our view, cap the growth upside in the US and globally. This means that the US economy is probably mired in a moderate but sustainable growth path. Topping the list of structural headwinds are the fiscal woes in Europe. The Greek debt restructuring bought some time, but now Spain's resolve and ability to hammer through painful austerity measures is questioned. After missing last year's deficit target and negotiating with its eurozone partners for a higher target this year, Spain's bonds sold off. A resurgence of financial market turmoil in the eurozone would weigh heavily on global growth. This, however, is not our base case. Although less visible, fiscal woes in the US also constrain the growth upside. The US government hasn't even started to consolidate its fiscal position. But by year-end the gov-

Table 2: Growth and inflation forecasts

in %	GDP Growth			Inflation		
	'11	'12 F	'13 F	'11	'12 F	'13 F
World	3.1	3.0	3.5	3.9	3.0	3.0
US	1.7	2.3	2.6	3.1	2.1	1.6
Canada	2.5	2.1	2.4	2.9	2.1	2.3
Japan	-0.7	2.5	2.0	-0.3	-0.1	0.3
Eurozone	1.5	-0.4	1.1	2.7	2.2	2.0
UK	0.8	0.6	1.4	4.5	2.3	1.8
China	9.2	8.5	8.5	5.4	3.5	4.0
India	6.7	7.3	7.8	8.3	6.8	7.0
Russia	4.3	3.5	4.0	8.5	4.9	6.9
Brazil	2.7	2.9	4.8	6.5	5.4	6.4
APAC ex Japan	6.7	6.4	6.9	5.4	3.9	4.4

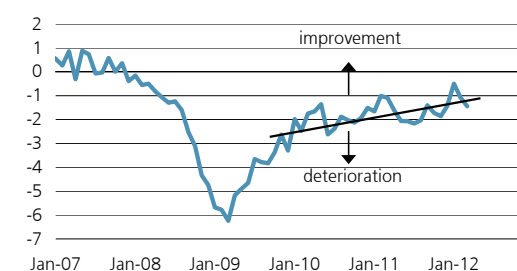
Note: F= forecast; APAC=Asia Pacific

Source: UBS WMR, as of 25 April 2012

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 and estimates are current only as of the date of this publication and may change without notice.

Fig. 11: Labor market conditions on a healthy uptrend

Combined measure of labor market conditions



Note: The labor market indicators used to calculate the combined measure are: Average duration of unemployment in number of weeks, average hourly real earnings month-over-month growth for the goods and services sectors, four-week average of initial jobless claims, ISM manufacturing employment index, nonfarm payroll month-over-month growth (from the establishment survey), nonfarm employment month-over-month growth (from the household survey), unemployment rate, monthly change in the workweek of private nonfarm industries.

Source: Thomson Datastream, Bloomberg, UBS WMR, as of 27 April 2012

ernment will have to find an agreement on fiscal policy as a plethora of tax and spending provisions including the so-called Bush tax cuts, the payroll tax cut and unemployment benefit extension will all expire. Additionally, sequestration spending cuts are scheduled to start in 2013. If no agreement on these issues is reached, the result would be a fiscal tightening of about 3.5% of GDP, which would likely derail the economic recovery. While this is not our base case, it certainly doesn't seem easy these days for Republicans and Democrats to compromise.

### Eurozone economic malaise lingers on

The two Longer Term Refinancing Operations (LTROs) conducted by the European Central Bank (ECB) have helped to slow the severe tightening of lending standards (see Fig. 13). However, credit demand shrank at an even faster pace. April Purchasing Manager Index data pointed to a moderately deeper growth contraction and crushed hopes that the eurozone economy could climb out of recession in the second quarter. This points to downside risk to our eurozone real GDP growth forecast of -0.4% in 2012. The renewed recession will make it harder for governments to meet their budget deficit targets, as the real GDP contraction cuts into tax collections. The political leaders seem to acknowledge that austerity measures alone will not solve the crisis and that pro-growth programs need to be adopted as well. ECB President Draghi encouraged eurozone leaders to incorporate pro-growth reforms in the fiscal compact. Critical elections in France and Greece raise the risk of political backlash to the agreed upon austerity packages. But even if the necessary austerity and pro-growth measures are taken, the latter will only start to bear fruit with a lag of up to two years.

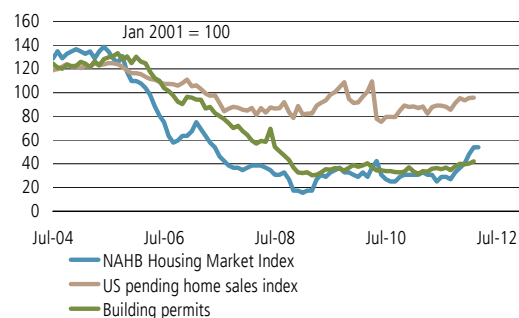
### Fed and ECB on hold

The FOMC did not signal additional monetary easing in its April meeting. It conditioned further easing on a deterioration of the economic outlook. With the FOMC projections showing lower unemployment and higher inflation over the next three years than in the January projections, the median FOMC participant actually raised the future fed funds rate target path slightly. Instead of expecting a funds rate level of 0.75% at year-end 2014, it now stands at 1%. We continue to expect no additional easing and the first rate hike in the third quarter of 2013, earlier than the late 2014 date suggested by the FOMC. The ECB also didn't show any appetite for further easing as the liquidity injections lowered the financial strain. However, if growth slows further, the ECB would likely have to step in again. The threshold for such action, however, is fairly high and acute financial turmoil would likely have to precede it.

**Thomas Berner**, CFA, Economist, UBS FS Inc.

**Fig. 12: Some US housing statistics are on the rebound**

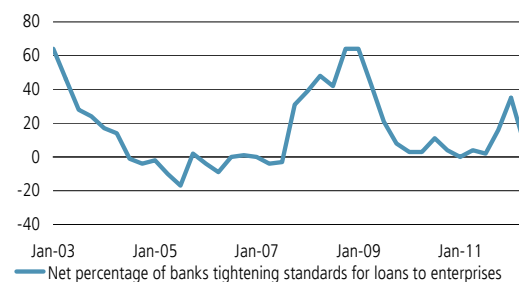
NAHB Housing Market Index, pending home sales and building permits, index (January 2001 = 100)



Source: Bloomberg, UBS WMR, as of 27 April 2012

**Fig. 13: Less acute tightening of lending standards in the eurozone**

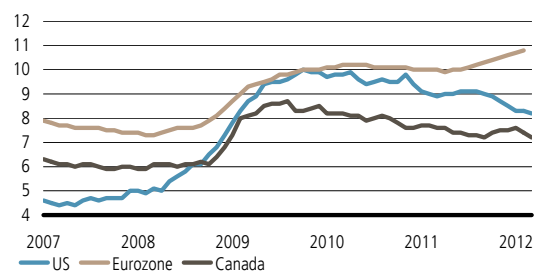
Net percentage of banks tightening standards for loans to enterprises, in %



Source: Bloomberg, UBS, as of 27 April 2012

**Fig. 14: Unemployment rising in eurozone**

Unemployment rate, in %



Source: Bloomberg, UBS WMR, as of 27 April 2012

## Eurozone risks weigh on performance

**We maintain our preference for emerging market equities over developed markets as their valuations remain reasonable even after their outperformance year to date. Within international fixed income, we find US bonds more attractive than non-US bonds despite the historically low level of US yields. We reiterate our cautious stance on eurozone assets as risks appear to be rising. We are also underweight Japanese assets due to the poor long-run economic outlook.**

### Emerging market equities have room to rise

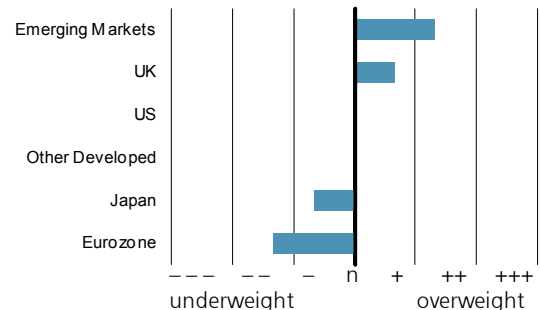
Emerging market (EM) equities have modestly outperformed developed markets so far in 2012, rising 12% in dollar terms, although they have given up some of their gains in recent weeks. We continue to favor EM over the developed markets. The macroeconomic backdrop remains favorable although in most countries, we expect slightly slower GDP growth in 2012 due to weaker export growth, especially to Europe. Inflation has been trending lower, helped by lower agricultural commodity prices, which are down around 15% year-over-year. This has allowed some central banks to loosen monetary policy when needed to spur growth. In sharp contrast to the developed economies, most EM countries have solid public finances and are under no pressure to implement fiscal austerity measures. Solid economic growth should help 2012 earnings to grow faster than in the developed markets. Valuations still look reasonable at around 10-times consensus earnings forecasts, a substantial discount relative to developed markets.

Within EM equities, one of the countries we favor is China. Investors have been gradually shifting toward our view that there will not be a hard landing in the near term, helping the market to outperform the rest of EM in April. Economic growth slowed to an annualized rate of around 6% in the first quarter and property prices have been trending lower. However, stronger loan growth in March was an encouraging sign that monetary easing is starting to have an impact on the real economy. We expect growth to pick up speed in the second half of 2012, and with Chinese equities trading around 9-times consensus earnings forecasts, valuations look too low for a country with strong growth prospects.

Our other favored markets within EM equities are Brazil and Mexico. Brazil has been struggling lately but stimulatory fiscal and monetary policies should help to boost growth. Valuations are attractive. Mexico is relatively expensive but its close ties with the US are an advantage with the Eurozone in recession. Presidential and legislative elections could bolster hopes for the enactment of structural reforms.

**Fig. 15: Equity regions**

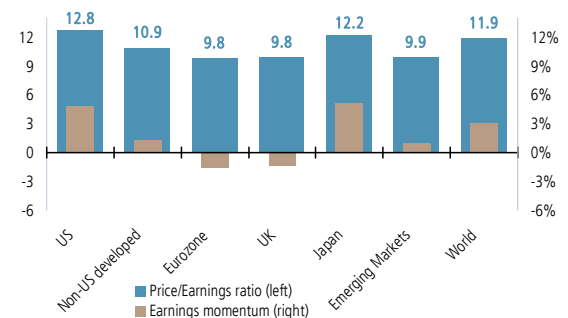
Tactical deviations from benchmark, incl. view on currency.



Source: UBS WMR, as of 30 April 2012. Scale explained in Appendix. Note: arrows indicate changes adopted as of this report.

**Fig. 16: Regional valuations and earnings momentum**

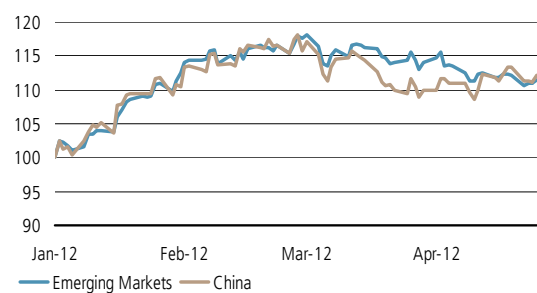
12-month forward Price-Earnings Ratio; 3-month change in 12-month forward consensus earnings-per-share estimates



Source: Datastream, IBES, UBS WMR, as of 26 April 2012

**Fig. 17: China has caught up to the rest of EM**

Equity market performance, end-2011 indexed to 100



Source: Bloomberg, UBS WMR, as of 26 April 2012

## We remain underweight eurozone assets

Concerns over the situation in the eurozone have flared up recently, especially in regards to Spain, and this has been weighing on both the equity and bond markets. After surprising to the upside earlier in the year, recent economic releases have been disappointing. This suggests that even with more aggressive action from the European Central Bank, it may be difficult for the region to escape from recession. Further, political uncertainty has been rising as “austerity fatigue” among voters could see more incumbents voted out of office, which is potentially dangerous given the need for close cooperation between countries.

With eurozone equities slumping in recent weeks, valuations look even more attractive than they used to, with the market trading below 10-times consensus earnings forecasts. However, in our view, the better valuations are offset by the increased risks, and we remain underweight the eurozone within global equities.

## UK assets relatively attractive despite economic woes

First quarter 2012 GDP unexpectedly fell by 0.2% quarter-on-quarter, putting the UK into a technical recession. Government austerity measures will keep downward pressure on growth, but there are at least some signs of improvement in the recent data. Despite the weak macro backdrop, we find UK equities and bonds to be attractive relative to the other non-US developed markets. Equity valuations are inexpensive, and about 70% of earnings are generated overseas, helping to minimize the impact of weak domestic demand. The pound also looks inexpensive among the major currencies, offering the potential for exchange rate movements to contribute to returns in dollar terms.

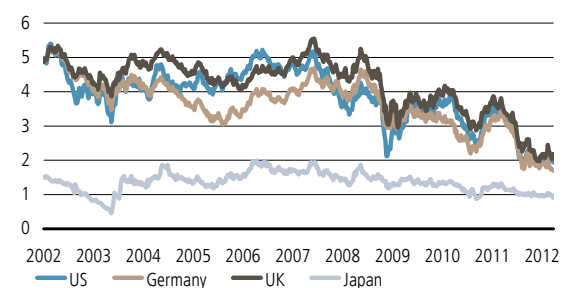
## Japan should pick up speed but long-run outlook poor

Japan was hit hard by the global financial crisis and last year’s earthquake was another tough blow. Growth should improve in the quarters ahead as reconstruction spending boosts demand. Consensus forecasts look for earnings to grow by 76% over last year’s depressed levels. However, long-run prospects remain poor as the population ages and the labor force shrinks. Nuclear power plants remain offline, and the uncertainty over electricity supply has become another reason for manufacturers to move capacity overseas. Equity valuations are more attractive than they have been in the past but are still expensive relative to most other markets and we therefore remain underweight. For most investors, Japanese government bonds should be avoided. Japan’s massive government debt may come under renewed scrutiny now that its trade surplus has disappeared.

**Brian Rose**, PhD, Strategist, UBS FS Inc.

**Stephen R. Freedman**, PhD, CFA, Strategist, UBS FS Inc.

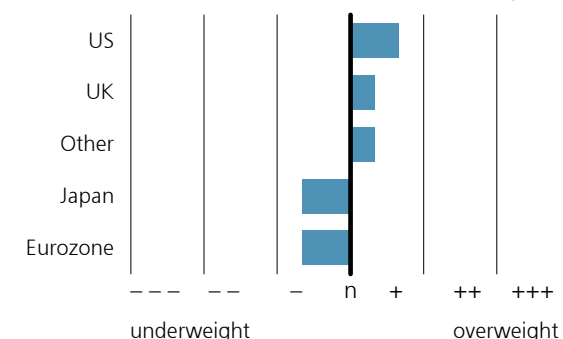
**Fig. 18: International bond yields remain low**  
10-year government bond yields, in %



Source: Bloomberg, UBS WMR, as of 27 April 2012

**Fig. 19: Bond regions**

Tactical deviations from benchmark, incl. view on currency.



Note: Arrows indicate changes adopted in this report.

Source: UBS WMR, as of 30 April 2012. Scale explained in Appendix.

See appendix for detailed asset allocations. See explanations in the Appendix regarding the interpretation of the suggested tactical deviations and the procedure for combining asset class and country allocations.

## Energy stocks poised to recover

The US energy sector has significantly lagged the market in 2012 due to “hard landing” fears in China, plunging domestic natural gas prices, and concerns that rising retail gasoline prices would lead to demand destruction and increased oil price volatility. We believe these fears are overblown and with relative valuations at a three-year low, we upgrade Energy to a moderate overweight.

### Be selective with cyclicals: prefer domestic to global

While financial markets appear to have entered a “risk-off” phase over the past few weeks, we do not expect the magnitude of the sell-off in US equities to be as pronounced as the nearly 20% summer swoon in 2011 or the 16% peak-to-trough decline in 2010 (see our 23 April 2012 Weekly Guide, *Not déjà vu all over again*). But this does not mean that investors should position for a strong cyclical recovery by tilting portfolios towards economically-sensitive equity market sectors. Leading economic indicators in Europe have disappointed recently – including countries outside of the weaker periphery – signaling that the banking and sovereign stress in Spain and Italy are impacting the economies of the “core” (i.e., Germany, France). Further strains in eurozone sovereign debt markets combined with more mixed domestic developments should push equity market volatility higher and pressure cyclical sectors (Fig. 21). Within cyclicals, we favor Technology (overweight), Consumer Discretionary and Financials (market weight) over the more European-exposed Materials and Industrials sectors (underweight).

### Adding Energy to sector overweights

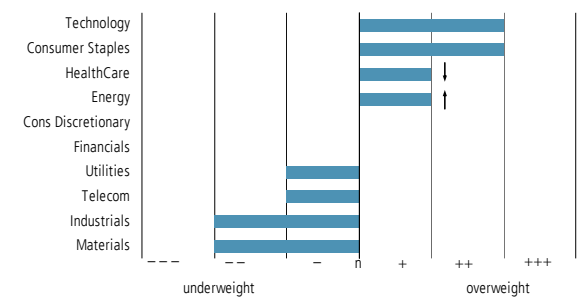
Energy stocks have significantly lagged in 2012, rising just 1.9% versus the 11.6% gain in the S&P 500 (through 27 April). With earnings estimates holding steady, sector P/E multiples have contracted leaving the sector trading at a 20% P/E valuation discount to the S&P 500 – its cheapest level since late 2008. 2012 earnings expectations appear undemanding at just +1% – a low bar considering the year-to-date strength in oil prices and our expectations that West Texas Intermediate (WTI) crude oil prices will average USD 105 per barrel this year. Signs that emerging market economies are gaining momentum over the next 6-9 months coupled with a bottoming of depressed US natural gas prices (today’s low prices are partially due to abnormal weather) should help drive outperformance for the US Energy sector. To fund this change, we downgrade Pharmaceuticals from moderate overweight to neutral.

**Jeremy Zirin**, CFA, Strategist, UBS FS Inc.

**David Lefkowitz**, CFA, Strategist, UBS FS Inc.

**Fig. 20: Upgrading Energy**

Tactical deviations from benchmark



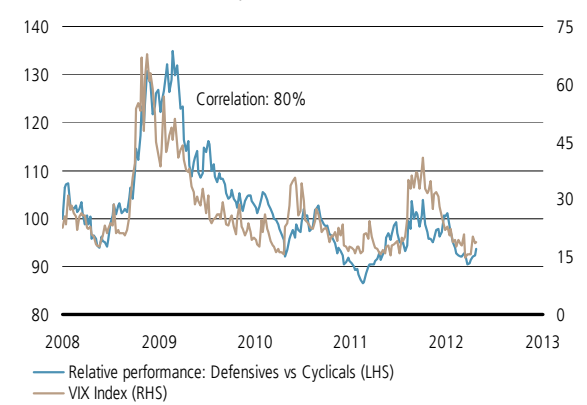
Note: Arrows indicate changes adopted as of this report

Source: UBS WMR, as of 30 April 2012.

See explanations in the Appendix regarding the interpretation of the suggested tactical deviations from benchmark.

**Fig. 21: Rising volatility a risk to cyclicals**

Defensive sectors versus cyclicals and VIX Index



Source: Bloomberg, UBS WMR, as of 24 April 2012

## Growth continues to shine

**Growth over value remains one of our highest conviction calls. We do not expect returns to vary significantly between equity market size cohorts in a range-bound market. Real estate investment trusts stand to benefit from a moderate, but steady, low-growth and low-interest rate environment.**

### **Growth over value – despite financials run, the beat goes on for growth**

We have long argued that sector influences play an important role in driving the relative performance between the Russell 1000 Growth and Russell 1000 Value indices. Specifically, there is a strong positive correlation between the relative performance of technology (growth) versus financials (value) and the relative performance of growth versus value (Fig. 23). Our preference for technology over financials helps shape our style call for growth over value. Additionally, other factors such as valuation and business cycle dynamics also currently favor growth. Interestingly, year-to-date, both the Financials and Tech sectors have been the top performing S&P 500 sectors (both up 19-20% through 27 April), yet the Russell 1000 Growth index has outperformed the Russell 1000 Value index by 510 basis points. We believe this speaks to the current low valuation premium assigned to growth stocks and signs of a more significant rotation into the relatively few large-cap secular growth stories currently available to investors.

### **Still a mixed outlook for large- versus mid- and small-caps**

Over the past several weeks, the US economy has shown greater economic resilience vis-à-vis a struggling Europe. But despite the fact that small and mid-cap stocks have greater sales exposure to the US relative to large caps, smaller stock indices have failed to outperform large-caps. This is likely due to their higher market beta; small- and mid-caps tend to underperform in falling markets. Additionally, the very strong year-to-date performance of selected mega-cap financial and technology stocks has meaningfully contributed to the gains for large-cap indices.

### **REITs – beneficiary of “lower for longer” interest rates**

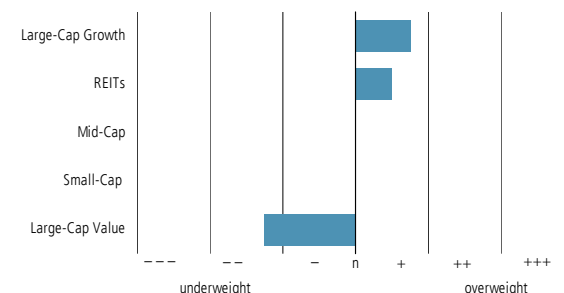
April has been a strong month for REITs. The FTSE NAREIT index rose 2.7% compared to the S&P 500 decline of 0.4%. We upgraded REITs on 28 February due to strengthening fundamentals and we expect that continued moderate but steady economic growth amid a low-interest rate environment will continue to be an attractive backdrop for REITs.

**Jeremy Zirin**, CFA, Strategist, UBS FS Inc.

**David Lefkowitz**, CFA, Strategist, UBS FS Inc.

**Fig. 22: Favor growth stocks and REITs**

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

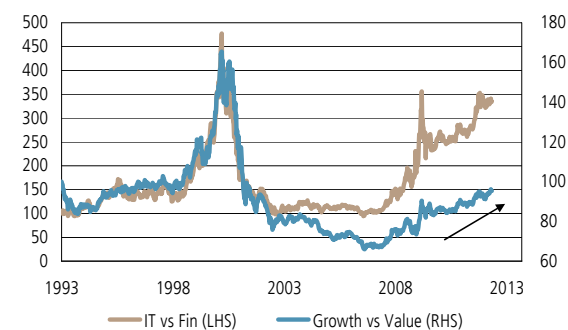


Source: UBS WMR, as of 30 April 2012

See explanations in the Appendix regarding the interpretation of the suggested tactical deviations from benchmark.

**Fig. 23: Tech vs financials drives our growth over value call**

Relative performance of Russell 1000 Growth vs. Russell 1000 Value and S&P Tech vs. S&P Financials



Source: Bloomberg, UBS WMR, as of 26 April 2012

## Corporate credit: crunched

**Spread widening caused corporate credit to underperform the Treasury market in April, as Treasuries benefitted from somewhat softer economic data and a renewed focus on the eurozone debt crisis. Although it was a disappointing month for corporate securities on a relative basis, absolute performance remained positive. In the taxable markets, we remain positive on credit versus government bonds. We see Treasury yields locked in a range over the next several months and recommend a neutral duration exposure. We also look for munis to perform well in the near term.**

### A round trip move on yields

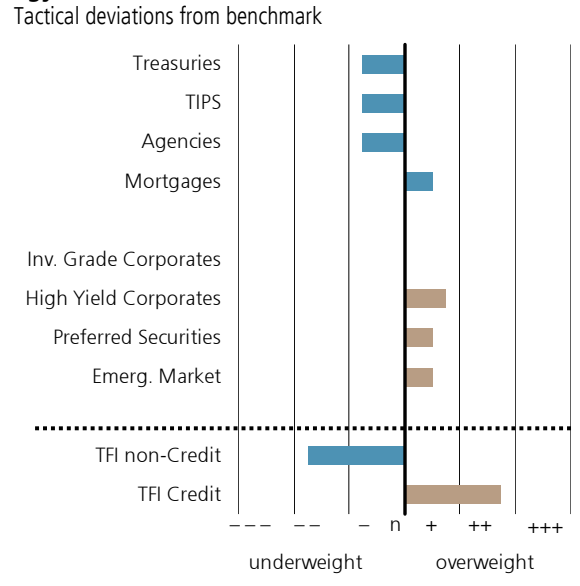
Somewhat slower economic data, as well as a renewed focus on the eurozone debt crisis, sent Treasury yields lower in April. From a high of 2.3% on 3 April, the yield on the 10-year note dropped below 2.0%. Treasury yields have traded in a range between 1.7% and 2.4% since August 2011. The primary drivers of interest rates during this period have been the pace of US economic growth and the eurozone debt crisis. Beginning with the weaker-than-expected nonfarm payroll report released on 6 April, fears of a payback from the mild winter weather have dominated discussions about the pace of growth in 2Q12. In addition, upward pressure on Spanish and Italian government bond yields rekindled concerns about the eurozone debt crisis.

Elections in France and Greece are further muddling the policy response in the eurozone, given the likely change in leadership. We believe that the macro backdrop and the ongoing eurozone debt crisis are likely to keep Treasury yields range bound for the next several months, followed by slightly higher yields over a 12-month horizon. Our interest rate forecasts project a 2.5% yield on the 10-year Treasury at year end and a 2.7% yield in 12 months. We reiterate our recommendation for a neutral duration, given our projections for expected total returns on Treasury securities over this horizon. The expected total returns incorporate our Treasury forecasts and the performance benefit for rolling down the steep yield curve. In the taxable market, we continue to favor maturities in the four- to seven-year range.

### IG and HY credit: manageable correction

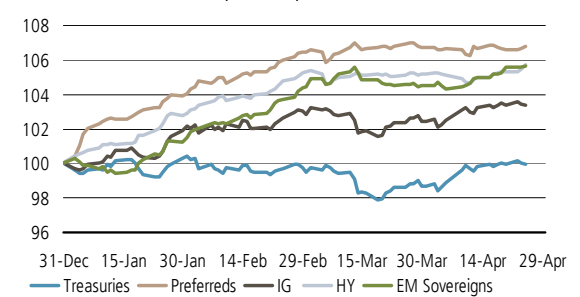
During periods such as April when macro factors drive market direction, we often find that credit spreads move inversely with Treasury rates. Right around 19 March when the 10-year Treasury peaked at 2.4%, Investment Grade (IG) and High Yield (HY) spreads reached year-to-date (YTD) lows of 189 basis points (bps) and 582bps, respectively, before moving back to their current

**Fig. 24: US dollar taxable fixed income (TFI) strategy**



Note: Arrows indicate changes adopted as of this report.  
 Source: UBS WMR, as of 30 April 2012. See the appendix for a detailed asset allocation illustration in the context of a moderate-risk taxable US dollar fixed income portfolio and explanations regarding the interpretation of the suggested tactical deviations from benchmark.

**Fig. 25: Treasury returns are flat year-to-date**  
 Cumulative Total Return, in USD, index 31 Dec. 2011=100



Source: BofAML, UBS WMR, as of 25 April 2012

higher levels of 202bps and 608bps. Both IG and HY credit benefitted from the favorable direction of Treasury movements, which prevented index bond prices from declining during the month. In fact, the BofA/ML Corporate Master (IG) index actually appreciated by 0.7% in price terms as the average yield-to-worst (YTW) retraced back to the historically low 3.4% level. The overall price level of the BofA/ML HY Constrained Index remained mostly unchanged as the YTW stayed steady near 7.15%.

We look for this inverse relationship to persist between credit spreads and Treasury rates, and our outlook for tighter credit spreads into year-end incorporates our year-end forecast for the 10-year Treasury at 2.5%. Our preference for HY credit over IG is based on the fact that HY exhibits higher coupon income, lower duration, and greater spread tightening potential, which are all features that should allow HY to outperform in a slow growth and rising rate environment. In fact, for the remainder of the year, IG credit could experience a slight price decline due to longer duration that IG exhibits overall. This could cause IG credit to produce total returns for the next eight months that fall short of the approximately 3% coupon income. We look for prices of HY bonds, on the other hand, to end the year at or above current levels and look for additional total return performance of approximately 6% through year end.

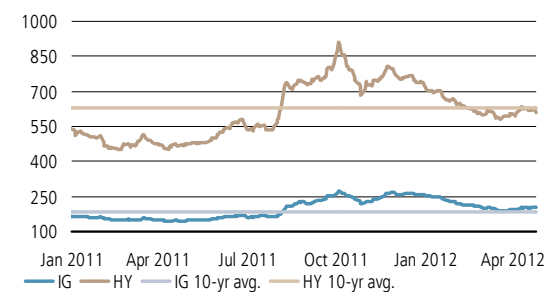
### Preferred securities: US bank earnings overshadow Europe

Even though the market vigor of early 2012 has subsided and eurozone fears have shown signs of flaring up again, preferred securities remain a bright spot within the US fixed income markets. According to the BofA/ML Fixed Rate Preferred Stock Index, preferreds are the highest performing sector YTD with total returns of 6.9%. Month-to-date, preferreds have shown resilience to macro concerns as strong earnings reports for US banks helped support the large financial sector weighting within the asset class. In terms of prices, preferred securities were mostly unchanged as lower Treasury yields helped offset the modest spread widening that took place. While we see further price upside as limited, we continue to find preferred securities generally attractive based on their coupon income and our constructive credit sector view on US banks.

### EM sovereign debt: overweight, but wider year-end target

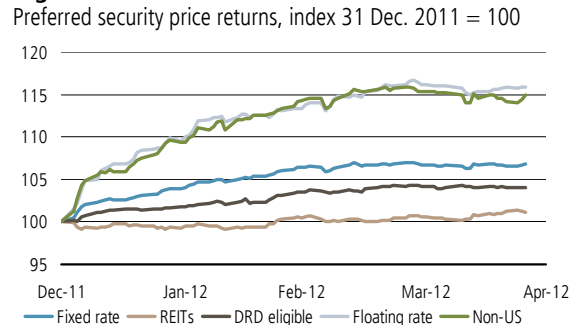
We reiterate our overweight recommendation for emerging market (EM) USD-denominated sovereign debt, as EM sovereigns exhibit stronger fundamentals and expectations for faster growth relative to the developed world. In addition, supply/demand technicals still show positive signs with EM debt funds reporting YTD aggregate inflows in excess of USD 25bn through 18 April. Although the pace of inflows has decelerated in recent weeks,

**Fig. 26: IG versus HY corporate bond spreads**  
Option-adjusted spreads, in basis points



Source: BofAML, UBS WMR as of 25 April 2011

**Fig. 27: Floaters and non-US preferreds performing best**  
Preferred security price returns, index 31 Dec. 2011 = 100



Source: BofAML, UBS WMR, as of 25 April 2012

the year-to-date figure is arguably high by prior years' standards and equates to about 31% and 54% of total inflows in 2010 and 2011, respectively.

That said, we are increasing our year-end spread target for the BofA/ML's IGOV index to 325bps from 300bps, on our perception that concerns about the pace of growth in China, and the ongoing eurozone crisis will likely have an influence on the pace of inflows by EM fund managers, which we regard as the ultimate market movers. With UBS economists expecting China to accelerate in the second half; concerns about an economic hard landing should eventually fade away. The eurozone crisis will likely stay with us for longer and should continue to dictate risk appetite in today's on-and-off market. We believe that countries with sound fundamentals such as Mexico (10.4% of IGOV index), Brazil (11.2%), Colombia (4.3%), Peru (3.1%), and Indonesia (6.3%) are likely to remain in favor. Conversely, countries with relatively high exposure to Europe such as Turkey (10.1%) and Russia (9.2%), or those deemed as grossly mismanaged such as Argentina (1.5%) and Venezuela (7.9%) may not. At this stage, Venezuela appears as the most relevant upside risk to our revised, less-bullish year-end spread target.

**Municipals**

Municipals continued to perform well in April despite some negative effects from bouts of higher supply and tax-related selling leading up to the tax filing deadline. The sector turned in about 1.0% in total return, which lifted the YTD performance for munis to over 3.0%. Compared to the taxable fixed income markets on a MTD basis, munis performed in line with corporate bonds and slightly behind the stronger performance that occurred in the US Treasury bond market. Year-to-date, muni returns of 3.2% are outperforming Treasuries 0.05% return by 3.1%. By contrast, the 3.5% returns on IG corporate bonds are outpacing munis by about 0.3%.

In the near-term, supply/demand dynamics appear favorable, in our view. The 30-day visible supply stands at just USD 6.2bn. On the demand side, the typically heavy redemption season of June and July is not too far away. Barring any sharp sell-off in the Treasury bond market or an unexpected credit-related event, we expect municipals to perform reasonably well in the near term.

- Anne Briglia**, CFA, Strategist, UBS FS Inc.
- Barry McAlinden**, CFA, Strategist, UBS FS Inc.
- Donald McLauchlan**, Strategist, UBS FS Inc.
- Kathleen McNamara**, CFA, CFP®, Strategist, UBS FS Inc.
- Henry Wong**, Strategist, UBS FS Inc.

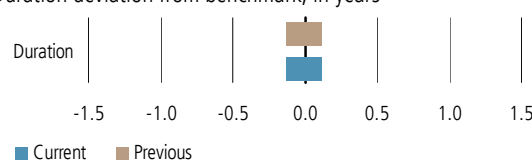
**Table 3: US interest rate forecasts, in %**

	30 Apr.	in 3 months	in 6 months	in 12 months
3-month LIBOR	0.47	0.50	0.50	0.50
2-year Treasury	0.26	0.30	0.40	0.50
5-year Treasury	0.81	1.10	1.10	1.30
10-year Treasury	1.91	2.10	2.30	2.70
30-year Treasury	3.11	3.40	3.50	3.90

Source: Bloomberg, UBS WMR, as of 30 April 2012

**Fig. 28: Duration recommendation**

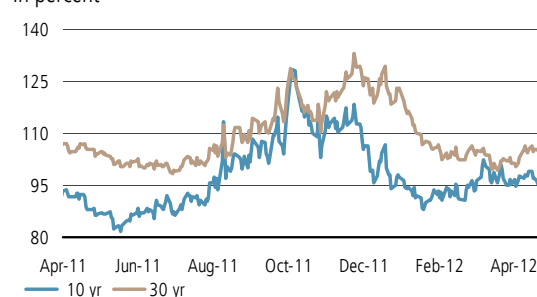
Duration deviation from benchmark, in years



Source: UBS WMR, as of 30 April 2012

**Fig. 29: AAA muni-to-Treasury yield ratios**

In percent

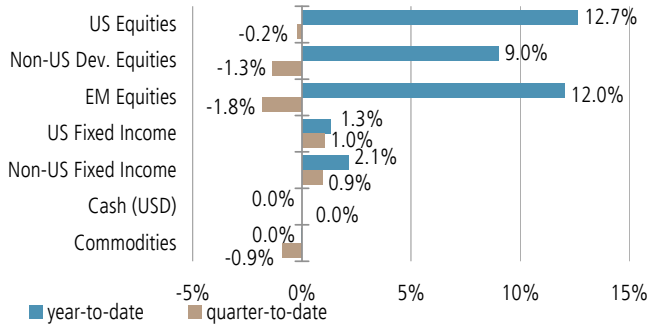


Source: MMD, UBS WMR, as of 26 April 2012

# Financial Market Performance

**Fig. A1: Asset Classes**

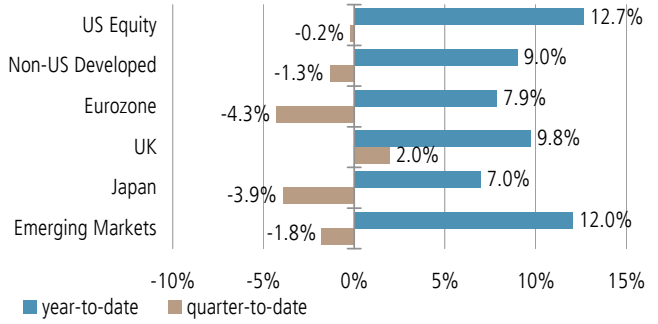
Total Return in USD and %



Source: Bloomberg and UBS WMR, as of 27 April 2012

**Fig. A2: International Equity**

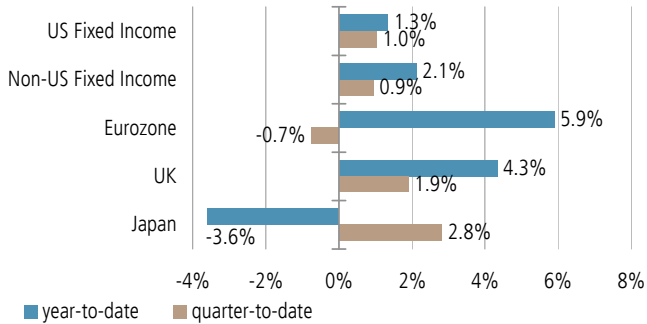
Total Return in USD and %



Source: Bloomberg, UBS WMR, as of 27 April 2012

**Fig. A3: International Fixed Income**

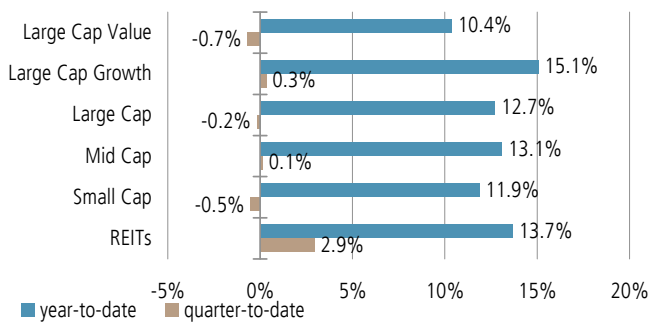
Total Return in USD and %



Source: Bloomberg, UBS WMR, as of 27 April 2012

**Fig. A4: US Equity**

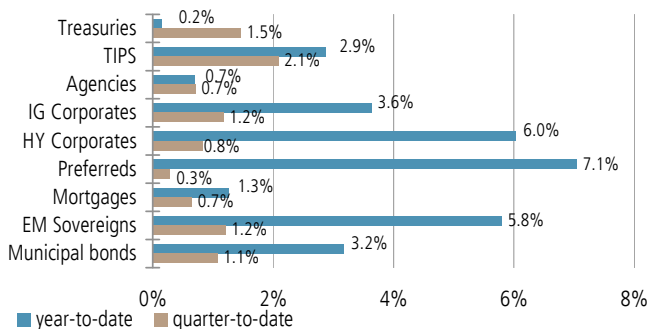
Total Return in USD and %



Source: Bloomberg, UBS WMR, as of 27 April 2012

**Fig. A5: US Fixed Income**

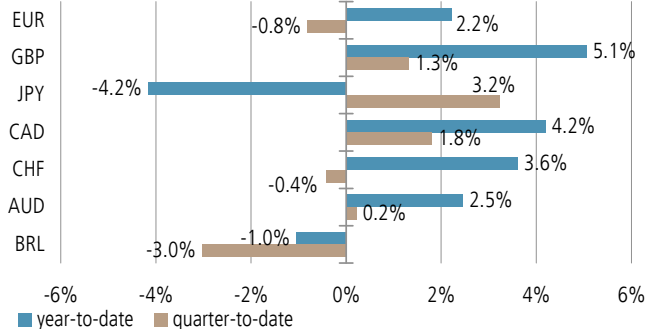
Total Return in USD and %



Source: BoAML, UBS WMR, as of 27 April 2012

**Fig. A6: Currencies**

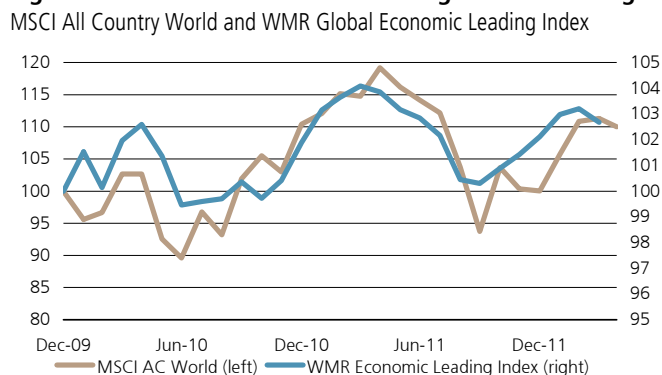
Appreciation vs. USD in %



Source: Bloomberg, UBS WMR, as of 27 April 2012

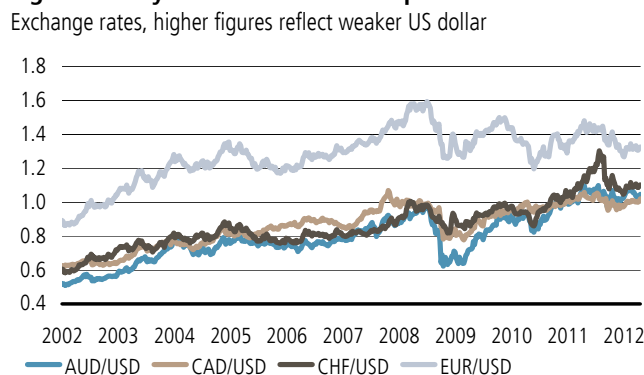
## Economic Outlook and Asset Classes

**Fig. A7: WMR Global Economic Leading Index softening**



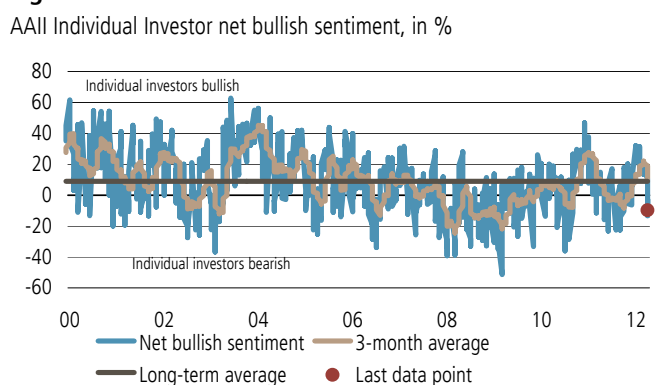
Source: UBS WMR, Bloomberg, as of 27 April 2012

**Fig. A8: Many currencies remain expensive vs USD**



Source: Bloomberg, UBS WMR, as of 27 April 2012

**Fig. A9: Investor sentiment has turned cautious**



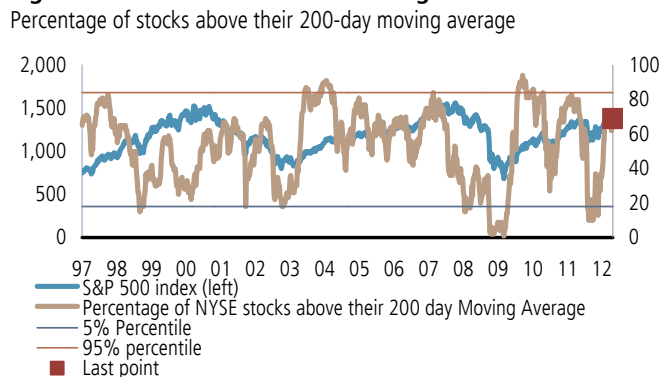
Source: Bloomberg, American Association of Individual Investors (AAIL), and UBS WMR, as of 26 April 2012

**Fig. A10: Global equity valuations cheap vs. history**



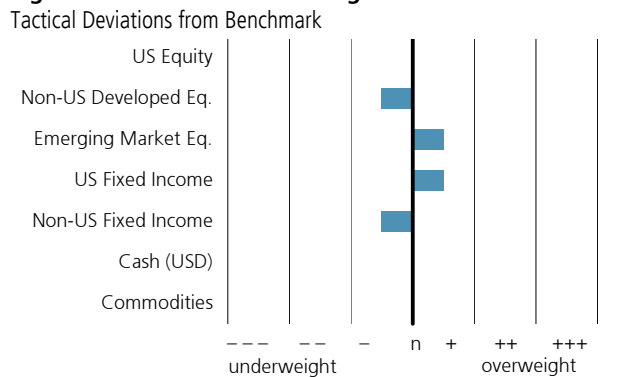
Source: IBES, Datastream, and UBS WMR, as of 27 April 2012

**Fig. A11: US stocks close to overbought**



Source: Bloomberg, UBS WMR, as of 27 April 2012

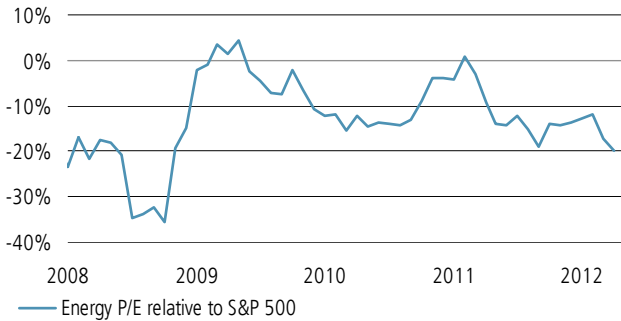
**Fig. A12: Asset Classes and Regional Preferences**



Source: UBS WMR, as of 30 April 2012. See explanations in the Appendix regarding the interpretation of the suggested tactical deviations from benchmark.

## US Equities

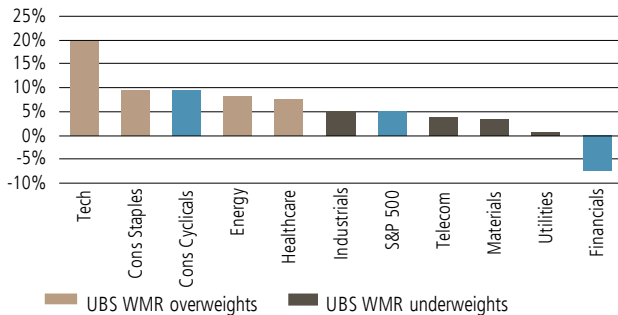
**Fig. A13: Energy sector relative valuation at 3-year low**  
S&P 500 Energy sector forward P/E premium (discount) to S&P 500



Source: Datastream and UBS WMR as of 26 April 2012

**Fig. A15: Technology and consumer sectors offer best dividend growth**

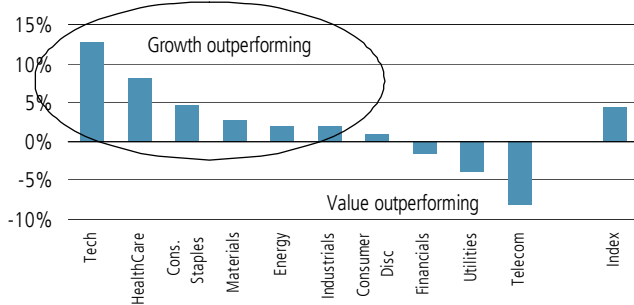
Annualized 10-year dividend per share growth



Source: DataStream and UBS WMR as of 26 April 2012

**Fig. A17: Growth beating value in 7 of 10 sectors**

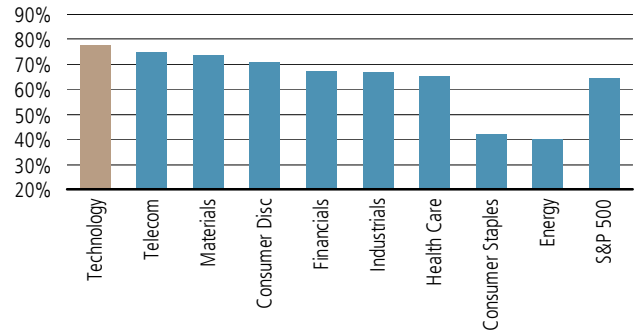
Difference between sector growth and value index performance



Source: Bloomberg, UBS WMR, as of 26 April 2012

**Fig. A14: Technology earnings continue to impress**

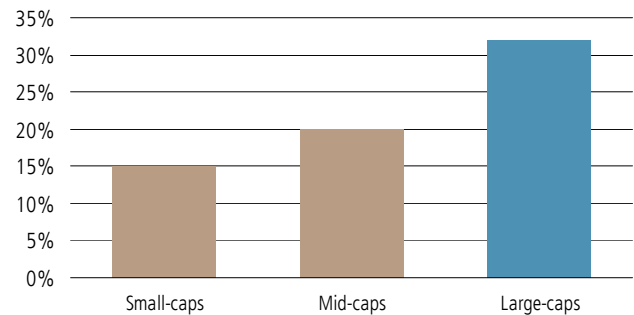
S&P 500 companies beating consensus earnings estimates for 1Q12, in %



Source: FactSet and UBS WMR as of 26 April 2012. Note: Includes the 55% of S&P 500 companies that have reported as of 26 April. Utilities excluded.

**Fig. A16: Europe less of a headwind for small and mid-cap earnings**

Percentage of sales derived abroad



Source: FactSet and UBS WMR as of 26 April 2012

**Fig. A18: April was a strong month for REITs**

REITs performance relative to the market

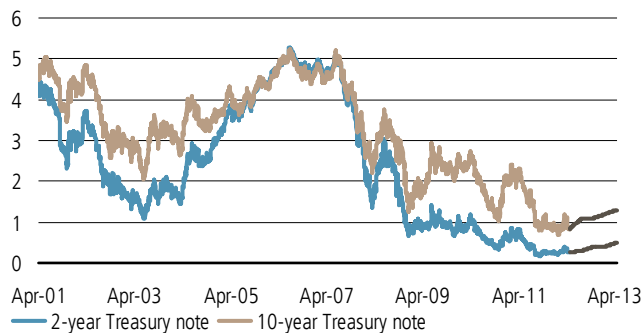


Source: Bloomberg and UBS WMR as of 26 April 2012

## US Fixed Income

**Fig. A19: Treasury yields should rise gradually**

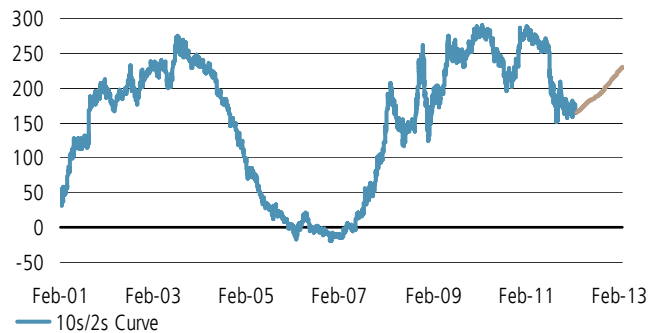
US rate development and UBS WMR forecast, in %



Source Bloomberg, UBS WMR, as of 26 April 2012

**Fig. A20: The yield curve should remain steep**

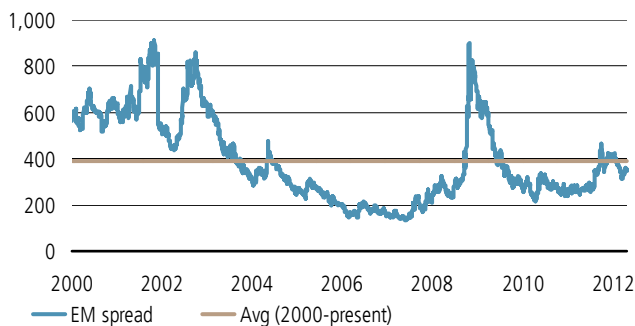
US 10-year minus 2-year Treasury yield, and WMR forecast, in basis points



Source: Bloomberg, UBS WMR, as of 26 April 2012

**Fig. A21: Emerging Market sovereign bond spread**

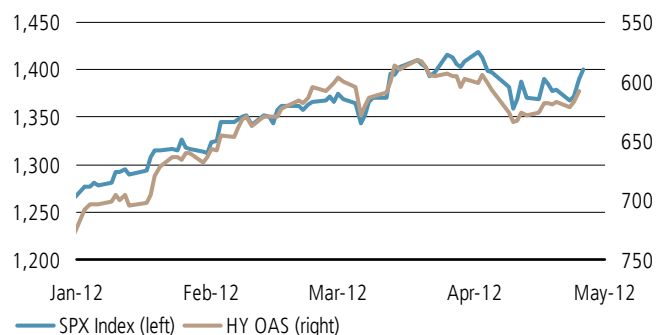
Index option-adjusted spreads, in basis points



Source: BofAML, UBS WMR, as of 25 April 2012

**Fig. A22: High Yield (HY) spreads have moved directionally with equities**

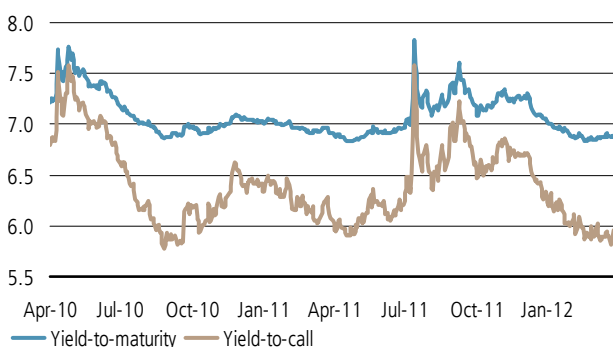
HY option adjusted spread (OAS), in basis points and S&P 500 Index



Source: BofAML, UBS WMR, as of 25 April 2012

**Fig. A23: Preferred yield-to-call near post-crisis lows**

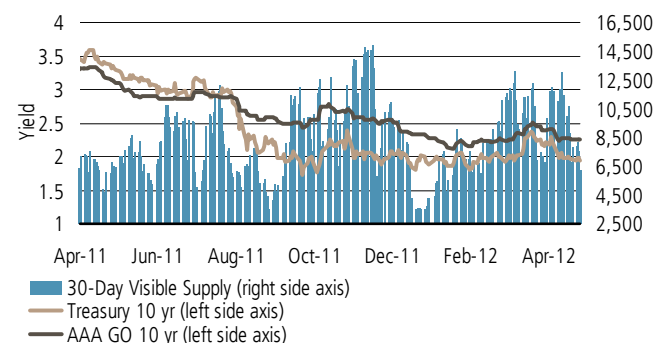
Fixed rate preferreds yield-to-maturity and yield-to-worst, in %



Source: BofAML, UBS WMR, as of 25 April 2012

**Fig. A24: Municipal visible supply and yields**

Left hand axis yield in %, right hand axis USD in millions



Source: Bloomberg, UBS WMR, as of 26 April 2012

## Detailed asset allocations with non-traditional assets (NTAs)

Investor Risk Profile <sup>1</sup>	Very conservative		Conservative		Moderate conservative		Moderate		Moderate aggressive		Aggressive		Very aggressive								
All figures in %																					
	Benchmark allocation <sup>2</sup>	WMR tactical deviation <sup>3</sup>	Change	Current allocation <sup>4</sup>	Benchmark allocation <sup>2</sup>	WMR tactical deviation <sup>3</sup>	Change	Current allocation <sup>4</sup>	Benchmark allocation <sup>2</sup>	WMR tactical deviation <sup>3</sup>	Change	Current allocation <sup>4</sup>	Benchmark allocation <sup>2</sup>	WMR tactical deviation <sup>3</sup>	Change	Current allocation <sup>4</sup>					
<b>Traditional Assets</b>																					
<b>Equity</b>	0.0	+0.0	0.0	19.0	+0.0	19.0	32.0	+0.0	32.0	44.0	+0.0	44.0	54.0	+0.0	54.0	62.0	+0.0	62.0	71.0	+0.0	71.0
US Equity	0.0	+0.0	0.0	14.0	+1.0	15.0	23.0	+0.0	23.0	32.0	+0.0	32.0	39.0	+0.0	39.0	44.0	+0.0	44.0	52.0	+0.0	52.0
Large Cap Value	0.0	+0.0	0.0	8.0	-0.5	7.5	8.0	-2.0	6.0	11.0	-2.5	8.5	11.0	-3.0	8.0	11.0	-4.0	7.0	13.0	-5.0	8.0
Large Cap Growth	0.0	+0.0	0.0	5.0	+1.5	6.5	8.0	+1.0	9.0	11.0	+1.5	12.5	11.0	+2.0	13.0	11.0	+2.5	13.5	13.0	+3.0	16.0
Mid Cap	0.0	+0.0	0.0	1.0	+0.0	1.0	4.0	+0.0	4.0	5.0	+0.0	5.0	9.0	+0.0	9.0	11.0	+0.0	11.0	13.0	+0.0	13.0
Small Cap	0.0	+0.0	0.0	0.0	+0.0	0.0	2.0	+0.0	2.0	3.0	+0.0	3.0	5.0	+0.0	5.0	7.0	+0.0	7.0	8.0	+0.0	8.0
REITs	0.0	+0.0	0.0	0.0	+0.0	0.0	1.0	+1.0	2.0	2.0	+1.0	3.0	3.0	+1.0	4.0	4.0	+1.5	5.5	5.0	+2.0	7.0
Non-US Equity	0.0	+0.0	0.0	5.0	-1.0	4.0	9.0	+0.0	9.0	12.0	+0.0	12.0	15.0	+0.0	15.0	18.0	+0.0	18.0	19.0	+0.0	19.0
Developed	0.0	+0.0	0.0	5.0	-1.0	4.0	8.0	-1.5	6.5	10.0	-2.0	8.0	12.0	-2.5	9.5	14.0	-3.0	11.0	14.0	-4.0	10.0
Emerging Markets	0.0	+0.0	0.0	0.0	+0.0	0.0	1.0	+1.5	2.5	2.0	+2.0	4.0	3.0	+2.5	5.5	4.0	+3.0	7.0	5.0	+4.0	9.0
<b>Fixed Income</b>	81.0	+0.0	81.0	67.0	+0.0	67.0	51.0	+0.0	51.0	37.0	+0.0	37.0	24.0	+0.0	24.0	11.0	+0.0	11.0	0.0	+0.0	0.0
US Fixed Income	74.0	+4.0	78.0	59.0	+3.0	62.0	43.0	+2.5	45.5	29.0	+2.0	31.0	18.0	+1.5	19.5	9.0	+1.0	10.0	0.0	+0.0	0.0
Non-US Fixed Income	7.0	-4.0	3.0	8.0	-3.0	5.0	8.0	-2.5	5.5	8.0	-2.0	6.0	6.0	-1.5	4.5	2.0	-1.0	1.0	0.0	+0.0	0.0
<b>Cash (USD)</b>	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	+0.0	2.0
<b>Non-traditional Assets</b>	9.0	+0.0	9.0	12.0	+0.0	12.0	15.0	+0.0	15.0	17.0	+0.0	17.0	20.0	+0.0	20.0	25.0	+0.0	25.0	27.0	+0.0	27.0
<b>Commodities</b>	2.0	+0.0	2.0	3.0	+0.0	3.0	4.0	+0.0	4.0	5.0	+0.0	5.0	5.0	+0.0	5.0	6.0	+0.0	6.0	7.0	+0.0	7.0
<b>Alternative Investments<sup>5</sup></b>	7.0	+0.0	7.0	9.0	+0.0	9.0	11.0	+0.0	11.0	12.0	+0.0	12.0	15.0	+0.0	15.0	19.0	+0.0	19.0	20.0	+0.0	20.0

"WMR tactical deviation" legend: Overweight Underweight Neutral  
 Source: UBS WMR and Investment Solutions, as of 30 April 2012

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

## Detailed asset allocations without non-traditional assets (NTAs)

Investor Risk Profile <sup>1</sup>	Very conservative	Conservative	Moderate conservative	Moderate	Moderate aggressive	Aggressive	Very aggressive
All figures in %							
	Benchmark allocation <sup>2</sup> WMR tactical deviation <sup>3</sup> Change Current allocation <sup>4</sup>	Benchmark allocation <sup>2</sup> WMR tactical deviation <sup>3</sup> Change Current allocation <sup>4</sup>	Benchmark allocation <sup>2</sup> WMR tactical deviation <sup>3</sup> Change Current allocation <sup>4</sup>	Benchmark allocation <sup>2</sup> WMR tactical deviation <sup>3</sup> Change Current allocation <sup>4</sup>	Benchmark allocation <sup>2</sup> WMR tactical deviation <sup>3</sup> Change Current allocation <sup>4</sup>	Benchmark allocation <sup>2</sup> WMR tactical deviation <sup>3</sup> Change Current allocation <sup>4</sup>	Benchmark allocation <sup>2</sup> WMR tactical deviation <sup>3</sup> Change Current allocation <sup>4</sup>
<b>Traditional Assets</b>							
<b>Equity</b>	0.0 +0.0 0.0	22.0 +0.0 22.0	37.0 +0.0 37.0	52.0 +0.0 52.0	67.0 +0.0 67.0	83.0 +0.0 83.0	98.0 +0.0 98.0
US Equity	0.0 +0.0 0.0	16.0 +1.0 17.0	26.0 +0.0 26.0	37.0 +0.0 37.0	48.0 +0.0 48.0	59.0 +0.0 59.0	72.0 +0.0 72.0
Large Cap Value	0.0 +0.0 0.0	9.0 -0.5 8.5	9.0 -2.0 7.0	13.0 -2.5 10.5	14.0 -3.0 11.0	15.0 -4.0 11.0	18.0 -5.0 13.0
Large Cap Growth	0.0 +0.0 0.0	6.0 +1.5 7.5	9.0 +1.0 10.0	13.0 +1.5 14.5	14.0 +2.0 16.0	15.0 +2.5 17.5	18.0 +3.0 21.0
Mid Cap	0.0 +0.0 0.0	1.0 +0.0 1.0	4.0 +0.0 4.0	6.0 +0.0 6.0	11.0 +0.0 11.0	15.0 +0.0 15.0	18.0 +0.0 18.0
Small Cap	0.0 +0.0 0.0	0.0 +0.0 0.0	3.0 +0.0 3.0	3.0 +0.0 3.0	6.0 +0.0 6.0	9.0 +0.0 9.0	11.0 +0.0 11.0
REITs	0.0 +0.0 0.0	0.0 +0.0 0.0	1.0 +1.0 2.0	2.0 +1.0 3.0	3.0 +1.0 4.0	5.0 +1.5 6.5	7.0 +2.0 9.0
Non-US Equity	0.0 +0.0 0.0	6.0 -1.0 5.0	11.0 +0.0 11.0	15.0 +0.0 15.0	19.0 +0.0 19.0	24.0 +0.0 24.0	26.0 +0.0 26.0
Developed	0.0 +0.0 0.0	6.0 -1.0 5.0	9.0 -1.5 7.5	13.0 -2.0 11.0	15.0 -2.5 12.5	18.0 -3.0 15.0	20.0 -4.0 16.0
Emerging Markets	0.0 +0.0 0.0	0.0 +0.0 0.0	2.0 +1.5 3.5	2.0 +2.0 4.0	4.0 +2.5 6.5	6.0 +3.0 9.0	6.0 +4.0 10.0
<b>Fixed Income</b>	90.0 +0.0 90.0	76.0 +0.0 76.0	61.0 +0.0 61.0	46.0 +0.0 46.0	31.0 +0.0 31.0	15.0 +0.0 15.0	0.0 +0.0 0.0
US Fixed Income	82.0 +4.0 86.0	67.0 +3.0 70.0	51.0 +2.5 53.5	36.0 +2.0 38.0	23.0 +1.5 24.5	12.0 +1.0 13.0	0.0 +0.0 0.0
Non-US Fixed Income	8.0 -4.0 4.0	9.0 -3.0 6.0	10.0 -2.5 7.5	10.0 -2.0 8.0	8.0 -1.5 6.5	3.0 -1.0 2.0	0.0 +0.0 0.0
<b>Cash (USD)</b>	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 +0.0 2.0

"WMR tactical deviation" legend: **Overweight** **Underweight** Neutral  
 Source: UBS WMR and Investment Solutions, as of 30 April 2012

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

# Investment Committee

The Wealth Management Americas Investment Committee (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 (\*)  
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.

## Additional Asset Allocation Models

### US Taxable Fixed Income Allocation, in %

	Benchmark allocation <sup>1</sup>	WMR Tactical deviation <sup>2</sup>		Current allocation <sup>3</sup>
		Previous	Current	
Treasuries	12.0	-1.5	-1.5	10.5
TIPS (Treasury inflation-protected securities)	5.0	-1.5	-1.5	3.5
Agencies	22.0	-1.5	-1.5	20.5
Mortgages	20.0	+1.0	+1.0	21.0
Investment grade corporates	22.0	+0.0	+0.0	22.0
High yield corporates	10.0	+1.5	+1.5	11.5
Preferred securities	4.0	+1.0	+1.0	5.0
Emerging Market sovereign bonds in US dollar	5.0	+1.0	+1.0	6.0
Total TFI non-Credit	59.0	-3.5	-3.5	55.5
Total TFI Credit	41.0	+3.5	+3.5	44.5

Source: UBS WMR and Investment Solutions, as of 30 April 2012

### Non-US Developed Equity Module, in %

	Benchmark allocation <sup>1</sup>	WMR Tactical deviation <sup>2</sup>		Current allocation <sup>3</sup>
		Previous	Current	
EMU / Eurozone	25.0	-15.0	-15.0	10.0
UK	21.0	+15.0	+15.0	36.0
Japan	19.0	-5.0	-5.0	14.0
Other	35.0	+5.0	+5.0	40.0

Source: UBS WMR and Investment Solutions, as of 30 April 2012

### Non-US Fixed Income Module, in %

	Benchmark allocation <sup>1</sup>	WMR Tactical deviation <sup>2</sup>		Current allocation <sup>3</sup>
		Previous	Current	
EMU / Eurozone	41.0	-7.5	-7.5	33.5
UK	10.0	+7.5	+7.5	17.5
Japan	33.0	-7.5	-7.5	25.5
Other	16.0	+7.5	+7.5	23.5

Source: UBS WMR and Investment Solutions, as of 30 April 2012

<sup>1</sup> 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.

<sup>2</sup> 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 previous edition of Investment Strategy Guide or the last Investment Strategy Guide Update.

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

## Equity Industry Group Allocation

US equity industry group allocation (%)						
	S&P 500 Benchmark allocation <sup>1</sup>	WMR Tactical deviation <sup>2</sup>				Current allocation <sup>3</sup>
		Numeric		Symbol		
		Previous	Current	Previous	Current	
<b>Consumer Discretionary</b>	<b>11.2</b>	<b>+0.0</b>	<b>+0.0</b>	n	n	<b>11.2</b>
Auto & Components	0.7	-0.7	-0.7	-	-	0.0
Consumer Services	2.1	+0.0	+0.0	n	n	2.1
Media	3.2	+1.0	+1.0	+	+	4.2
Retailing	4.1	+0.7	+0.7	+	+	4.8
Consumer, Durables & Apparel	1.1	-1.0	-1.0	-	-	0.1
<b>Consumer Staples</b>	<b>10.8</b>	<b>+2.0</b>	<b>+2.0</b>	++	++	<b>12.8</b>
Food, Beverage & Tobacco	6.3	+1.0	+1.0	+	+	7.3
Food & Staple Retailing	2.2	+1.0	+1.0	+	+	3.2
Household & Personal Products	2.3	+0.0	+0.0	n	n	2.3
<b>Energy</b>	<b>11.1</b>	<b>+0.0</b>	<b>+1.0</b>	n	+	<b>12.1</b>
<b>Financials</b>	<b>14.7</b>	<b>+0.0</b>	<b>+0.0</b>	n	n	<b>14.7</b>
Banks	3.0	+0.0	+0.0	n	n	3.0
Diversified Financials	6.0	-1.0	-1.0	-	-	5.0
Insurance	3.6	+0.0	+0.0	n	n	3.6
Real Estate	2.1	+1.0	+1.0	+	+	3.1
<b>Health Care</b>	<b>11.4</b>	<b>+2.0</b>	<b>+1.0</b>	++	+	<b>12.4</b>
HC Equipment & Services	3.8	+1.0	+1.0	+	+	4.8
Pharmaceuticals & Biotechnology	7.5	+1.0	+0.0	+	n	7.5
<b>Industrials</b>	<b>10.6</b>	<b>-2.0</b>	<b>-2.0</b>	--	--	<b>8.6</b>
Capital Goods	8.2	-1.0	-1.0	-	-	7.2
Commercial Services & Supplies	0.5	+0.0	+0.0	n	n	0.5
Transportation	1.8	-1.0	-1.0	-	-	0.8
<b>Information Technology</b>	<b>20.4</b>	<b>+2.0</b>	<b>+2.0</b>	++	++	<b>22.4</b>
Software & Services	9.6	+1.0	+1.0	+	+	10.6
Technology Hardware & Equipment	8.4	+0.0	+0.0	n	n	8.4
Semiconductors	2.4	+1.0	+1.0	+	+	3.4
<b>Materials</b>	<b>3.5</b>	<b>-2.0</b>	<b>-2.0</b>	--	--	<b>1.5</b>
<b>Telecom</b>	<b>2.9</b>	<b>-1.0</b>	<b>-1.0</b>	-	-	<b>1.9</b>
<b>Utilities</b>	<b>3.5</b>	<b>-1.0</b>	<b>-1.0</b>	-	-	<b>2.5</b>

Source: UBS WMR, as of 30 April 2012

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.

<sup>1</sup> The benchmark allocation is based on S&P 500 weights.

<sup>2</sup> 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.

<sup>3</sup> 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
<b>Total Alternative Investments</b>	<b>7</b>	<b>9</b>	<b>11</b>	<b>12</b>	<b>15</b>	<b>19</b>	<b>20</b>

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

# Appendix

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

<sup>1</sup> See "Sources of benchmark allocations and investor risk profiles" on next page regarding the source of investor risk profiles.

<sup>2</sup> See "Sources of benchmark allocations and investor risk profiles" on next page regarding the source of benchmark allocations and their suitability.

<sup>3</sup> See "Deviations from benchmark allocations" in the Appendix regarding the interpretation of the suggested tactical deviations from benchmark.

<sup>4</sup> The current allocation row is the sum of the benchmark allocation and the WMR tactical deviation rows.

<sup>5</sup> 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)

<sup>1</sup> See "Sources of benchmark allocations and investor risk profiles" on next page regarding the source of investor risk profiles.

<sup>2</sup> See "Sources of benchmark allocations and investor risk profiles" on next page regarding the source of benchmark allocations and their suitability.

<sup>3</sup> See "Deviations from benchmark allocations" in the appendix regarding the interpretation of the suggested tactical deviations from benchmark.

<sup>4</sup> 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 U.S. 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", 27 August 2007, "Emerging Market Bonds: Understanding Emerging Market Bonds," 12 August 2009 and "Emerging Markets 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

Non-traditional 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-U.S. 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 no-tice, 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 U.S. dollars, changes in the exchange rate between the U.S. dollar and the issuer's "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 U.S. 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](http://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, shareholder buy-backs, 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

## Appendix

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.

### 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		

## Explanations about Asset Allocations

### 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 FS.
- 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 "Bond 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.

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