



CIO monthly **video**

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UBS CIO Monthly **Extended**

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Section 1

Base slides

Summary

"The recent rise in yields highlights the risks in owning government bonds. We prefer corporate bonds and equities."

- **Economy**

We see global growth on a stronger footing than last year. In the US, rising house prices and ongoing job growth support private consumption. We expect politicians to strike another last-minute fiscal deal and US GDP to grow by around 2% in 2013. The Eurozone economy is expected to lag, and recent data shows large regional divergence. While German business sentiment has improved, the outlook for the French economy remains weak as fiscal tightening still has to catch up to other European countries. Meanwhile, the Chinese economy remains on an uptrend, supported by strong credit growth and rising exports.

- **Equities**

Equities remain supported by improving global growth momentum and we maintain our moderate overweight recommendation. US companies continue to show the strongest earnings momentum, and we expect US earnings to grow by a solid 6% in 2013. Conversely, Canadian equities face relatively weak earnings dynamics, which will likely be made worse by the strong CAD, and are relatively expensive. As a result, this month we have increased our overweight to US equities, and introduced a new underweight position in Canadian equities. We also remain constructive on emerging market (EM) equities. Accelerating economic growth in key countries, stabilizing profit margins and decent valuations speak in favor of the region.

- **Fixed Income**

Government bonds reacted strongly to the improving growth picture and 10-year yields on US Treasuries and German Bunds have risen considerably since the beginning of the year. While we expect rates to remain broadly stable over the next 6 months, real returns on government bonds will likely be negative and hence we maintain our large underweight position. Better alternatives can be found in investment grade (IG), high yield (HY) and emerging market (EM) corporate bonds. IG corporate bonds are expected to achieve a better total return despite limited spread tightening potential. HY corporate bonds still offer good investment opportunities due to low expected default rates and attractive risk premiums over other fixed income segments. And EM corporate bonds offer yield income and some potential for tighter spread, with relatively low volatility.

- **Commodities**

While in particular cyclical commodities profit from accelerating global growth, we see better risk return prospects in other asset classes and maintain a neutral stance. *Platinum: Attractively valued* remains a CIO Preferred theme.

- **Foreign Exchange**

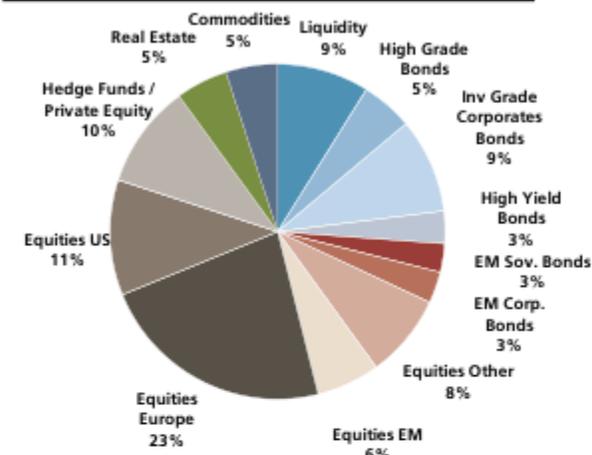
The British pound is our most preferred currency. After weakening year to date, we expect that the currency will be supported as economic data begins to improve. The euro, on the other hand, looks relatively expensive, especially given political risks around the Italian elections. We remain underweight the single currency.

Cross-asset preferences

	Most preferred	Least preferred
Equities	<ul style="list-style-type: none"> • US • Emerging markets • US mid caps • Western winners from EM growth • Swiss high quality dividend yields • Relative value and equity long/short hedge funds 	<ul style="list-style-type: none"> • Canada (↘) • European telecoms
Fixed income	<ul style="list-style-type: none"> • US high yield • Global investment grade credit • EM corporate bonds • Corporate hybrids • Developed Asia banks • Relative value hedge funds 	<ul style="list-style-type: none"> • Too expensive government bonds (↘)
Foreign exchange	<ul style="list-style-type: none"> • Emerging markets • GBP (↗) 	<ul style="list-style-type: none"> • EUR (↘)
Commodities	<ul style="list-style-type: none"> • Platinum 	

↗ Recent upgrades ↘ Recent downgrades

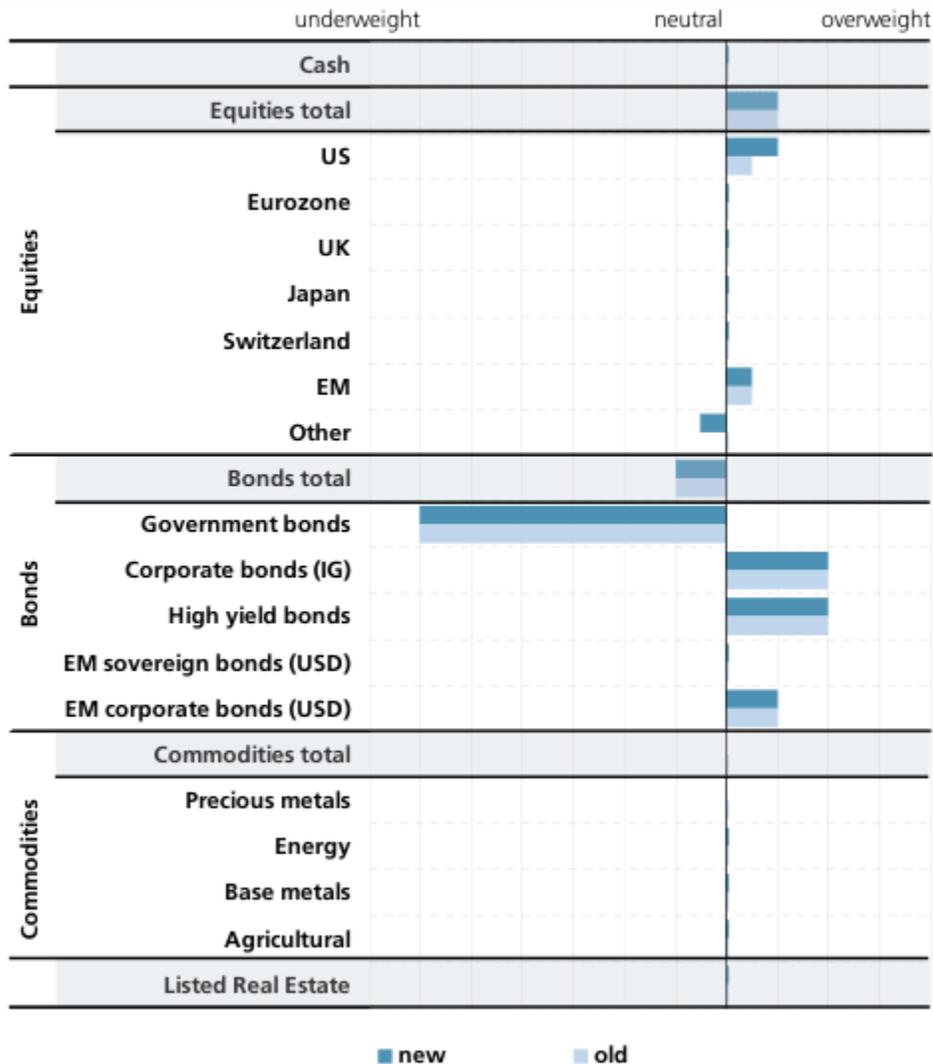
Portfolio weights



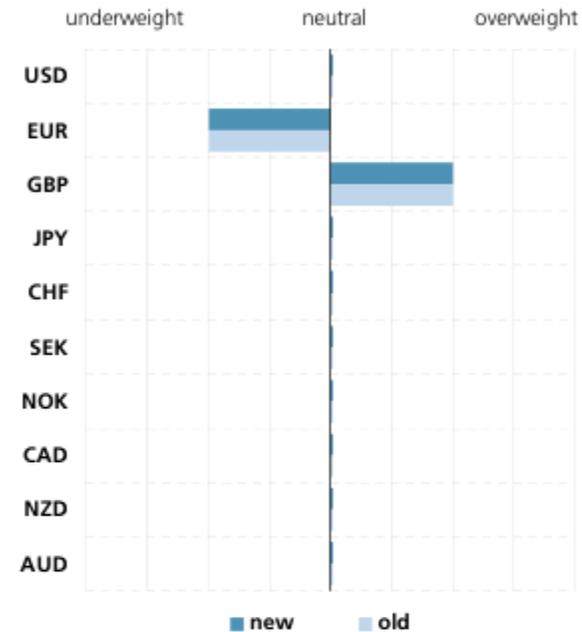
Note: Portfolio weights are for an advisory client with a "EUR moderate" profile. For portfolio weights related to other risk profiles or currencies please contact your client advisor.

Recommended tactical asset allocation

Tactical asset allocation deviations from benchmark*



Currency allocation**



* Please note that the bar charts show total portfolio preferences and thus can be interpreted as the recommended deviation from the relevant portfolio benchmark for any given asset class and sub asset class.

The UBS Investment House view is largely reflected in the majority of UBS Discretionary Mandates and forms the basis of UBS Advisory Mandates. Note that the implementation in Discretionary or Advisory Mandates might deviate slightly from the "unconstrained" asset allocation shown above, depending on benchmarks, currency positions and due to other implementation considerations.

**Note: The currency allocation has been changed on 8 February 2013, introducing the overweight in GBP and the underweight in EUR.

Source: UBS CIO WM Global Investment Office – as of 21.02.2013



Please see important disclaimer and disclosures at the end of the document.

CIO preferred investment themes (1/2)

Liquidity & Foreign Exchange

- **Emerging market currencies: An underappreciated asset class**
The currencies of EM countries, collectively as an asset class and measured using total returns (i.e. including interest received), have the potential to contribute positively to the longer-term returns of a well-diversified portfolio. We believe that this is especially relevant now that the developed world is settling into an extended period of very low interest rates.
- **GBP – the best of the majors** 
The pound has come under pressure after comments from incoming Bank of England Governor Carney suggesting changes to monetary policy targets, Prime Minister Cameron's proposal for a referendum on the UK's membership of the EU, and weak economic data. However, we believe that the weakness of Sterling is overdone and first signs point to stronger economic data in the months to come. As a result, the pound is our preferred major currency.

Fixed Income

- **Yield pickup with corporate hybrids**
The corporate hybrid segment is a lesser known segment of the investment grade credit world that has lagged the broad-based spread recovery. As a consequence, we see attractive opportunities for investors with a suitable risk tolerance or trading-orientation. We expect mid- to high-single-digit returns on selected instruments over a 12-month period.
- **US high yield corporate bonds**
Positive economic growth, robust corporate earnings, and healthy balance sheets provide support to US high yield (HY) corporate bonds. Current yield spreads of ~495 basis points still price in a more dire economic outcome than we expect. Historically, US high yield bonds have delivered similar returns to US equities with lower volatility. We continue to believe that US high yield corporate bonds have a favorable risk/return and expect mid-single digit returns over the next six months. Senior loans are exposed to similar positive fundamentals, and offer an attractive, floating rate alternative to US HY.

- **Emerging market corporates: A growing asset class**
Within EM hard currency debt, we prefer corporate to sovereign due to its more attractive valuation and higher overall yield. Moreover, our relatively constructive current view on risk is another reason to prefer EM corporate over sovereign debt. Over a 6-month horizon, we expect EM corporate bonds to deliver total returns of more than 4%.
- **Top-notch Asian banks shine amid weak competition**
Highly rated banks in developed Asia benefit from a consolidation in the banking industry in Europe and the US, while growth in emerging Asia continues to underpin their fundamentals. These issuers are, on average, AA-rated and we expect them to benefit from the ongoing global bank ratings downtrend. Senior bonds of these developed Asian banks provide moderate yields, whilst subordinated bank bonds of the same issuers provide good potential for credit spread tightening, given the scarcity value of Basel 2 compliant bank capital securities and the absence of regulatory bail-in regimes. Overall, we expect an excess return of a basket of subordinated and senior Asian bank bonds of more than 1% over comparable global issues over the next 6-12 months.
- **Too expensive Government bonds** 
Improving economic data has already led to an increase in government bond yields in most major markets. While tight fiscal budgets and high debt burdens in the US and Europe are unlikely to allow for a large increase in interest rates, even a small further rise would lead to negative total returns on benchmark government bonds, and we believe that the risk-reward in the bonds of most weaker countries is currently poor. We therefore recommend switching out of the affected bonds, which are identified in this theme.



= New investment theme



The CIO preferred investment themes represent the CIO's highest conviction, thematic investment ideas. We aim to recommend ideas that are attractive on a risk-reward basis and which are expected to deliver positive absolute returns. It will include the best investment themes for each of our TAA overweights, further aligning the asset allocation and themes recommendations, along with a range of other short-, medium-, long-term, and SRI themes.

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CIO preferred investment themes (2/2)

Equities

- **US mid caps: The sweet spot**

US economic data has begun to stabilize and forecasts now show an acceleration of growth in 2013. The greater domestic sales exposure of US mid caps, and their more cyclical sector make-up, give greater leverage to the US recovery. For these reasons we believe that mid-cap companies will outperform large caps in the US over the next 6–12 months.

- **Swiss high quality dividends**

The Swiss equity market currently offers a dividend yield of around 3.0%, while bond yields in the Swiss franc fixed income market are typically below 1%. Before 2009, dividend yields tended to be lower than bond yields. Moreover, unlike in the past, the Swiss dividend yield is now clearly higher than in the US and comparable to European peer markets. Overall, Swiss dividends are very attractive, in our view, in particular if investors focus on companies with high quality dividends – meaning that dividends are sustainable and steadily rising.

- **Emerging market equities**

We expect real GDP growth in emerging markets (EM) to accelerate to 5.1% in 2013 from 4.5% in 2012, which should support EM corporate earnings. We see EM earnings growth of around 11% over the next 12 months, as global monetary policy should remain accommodative. EM equities are trading below their longer-term averages on several valuation metrics, and will likely be supported by stronger EM currency performance against the US dollar over the next six months.

- **Western winners from emerging market growth**

Emerging economies continue to grow faster than developed economies. With little need to deleverage and repair balance sheets, Asian economies are also well positioned to continue outpacing their Western peers in the years ahead. We have identified companies from a variety of sectors in Europe, the US and Japan which have significant exposure to the rapidly growing emerging regions. We believe a diversified portfolio of these companies will reward investors seeking to profit from the robust demand growth in emerging economies.

- **No turnaround for European telecoms**

Despite having already underperformed the broader Eurozone equity index, we expect further relative downside in the coming months. Operating results, free cash flows and, most of all, dividends will stay in free fall, and further adjustments to consensus estimates are required for 2013 projections and onward, in our view. Hence, we recommend investors to reduce exposure to Eurozone telecoms.

Hedge Funds & Private Equity

- **The place to be in Hedge Funds**

The favourable conditions for relative value remain unchanged in 2013. A continued improvement in global growth and the supportive monetary policy backdrop supports spread products such as corporate bonds and securitized loans. Moreover, the decline in the number of market participants due to the Volcker rule should provide more opportunities to strategies such as fixed income arbitrage. We now also like equity long short which should benefit from stronger equity markets. The associated lower correlations among stocks should allow good performance for managers picking under- and overvalued stocks. We are now less keen to own event driven strategies as we do not expect distressed debt managers to be able to repeat their excellent 2012 performance in an improving economic environment.

Commodities

- **Platinum: Attractively valued**

Platinum remains our most preferred precious metal. Production costs continue to rise, with marginal production costs now above USD 1,600/oz. If this supply backdrop meets with improved economic activity in the latter part of 1H13 and in 2H13, the platinum market will be undersupplied by 4.5% in 2013. With this supportive backdrop, we target a move toward USD 1,800–1,850/oz during 2013..

Global economic outlook – *Summary*

Key points

- We expect the US economy to remain on its moderate but steady growth path.
- In the Eurozone we think that economic activity is rebounding on the basis of rising sentiment in business surveys and less fiscal austerity relative to 2012.
- In the emerging markets, we expect real GDP to grow at 5% in 2013.

CIO View (Probability: 75%*)

Sluggish expansion

- We expect the US economy to remain on its moderate but steady growth path over the next six months. Stronger private sector demand and reaccelerating inventory accumulation will likely be offset by reemerging fiscal policy uncertainty. We expect Fed's open-ended QE3 program to last till year end and the government to reach another deficit deal. This deal replaces the current sequester spending cuts but does not include further spending reductions.
- In the Eurozone, the sentiment in recent business surveys continues to improve, signaling that the recession will end in 1Q 2013. We expect a return to moderate growth rates in 2013 as the pressure from fiscal tightening declines and the increased macro stability supports business investment spending. Inflation is expected to continue to trend downward below 2%. The ECB is concerned about the risks to money market rates from the early LTRO repayments and the rise of the euro. At this juncture though, the ECB remains in wait-and-see mode.
- The Chinese economy is in a moderate upswing cycle. 3Q12 marked the cyclical bottom in terms of year-on-year growth. Real GDP growth rebounded to 7.9% in 4Q12 and we expect around 8% growth on average in 2013. Headline CPI inflation is likely to rise gradually to 4% by year end. The government aims to keep inflation below 4% so it could be a policy concern later this year. While economic conditions are supportive in Asia and Latin America, EMEA continues to lag in the cycle. We are likely to see increased inflationary pressures in H2 2013, leading to an upward drift in EM rates. In Brazil, Russia and India, inflation has already become a policy constraint.

➤ Positive scenario (Probability: 10%*)

Return to long-term trend

- The Eurozone crisis abates. Financial market conditions recover, mitigating the drag from fiscal austerity.
- Growth in Western Europe turns decisively positive in the early months of the new year and the US economy grows above trend.

➤ Negative scenario (Probability: 15%*)

Recession

- There are three key downside risks to the global economy: 1) a significant escalation of the Eurozone debt crisis; 2) a protracted government shutdown and a sharper fiscal contraction in the US; and 3) a sharp deceleration of the Chinese economy. Each of these risks could precipitate a significant downturn in the global economy.

Key dates

24/25 Feb	EMU: Italian parliamentary elections
1 Mar	US: ISM manufacturing purchasing managers' index (PMI) for February
1 Mar	China: Manufacturing PMI (February)
5 Mar	China: National People's Congress
7 Mar	EMU: ECB press conference
20 Mar	US: FOMC meeting results
21 Mar	EMU: PMI Composite for March (flash)

Global growth expected to be 3.0% in 2013

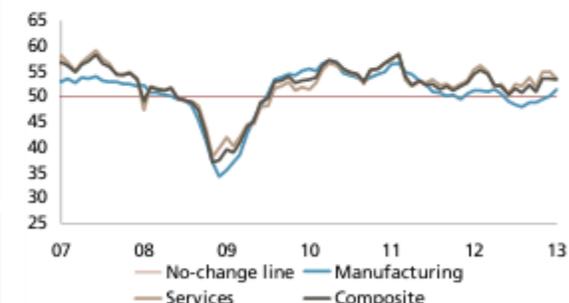
	Real GDP growth in %			Inflation in %		
	2011	2012F	2013F	2011	2012F	2013F
Americas						
US	1.8	2.2	2.3	3.1	2.1	1.6
Canada	2.6	2.0	2.0	2.9	1.6	1.9
Brazil	2.7	1.1	4.0	6.5	5.8	6.2
Asia/Pacific						
Japan	-0.6	2.1	1.3	-0.3	0.0	0.3
Australia	2.4	3.6	3.0	3.3	1.8	2.4
China	9.3	7.8	8.0	5.4	2.7	3.5
India	6.2	5.5	6.5	8.1	8.5	7.4
Europe						
Eurozone	1.5	-0.4	0.1	2.7	2.5	2.1
Germany	3.1	0.9	0.8	2.5	2.1	2.2
France	1.7	0.2	0.4	2.1	2.0	1.3
Italy	0.5	-2.3	-0.4	2.9	3.4	2.6
Spain	0.4	-1.6	-1.7	3.1	2.5	3.2
UK	0.9	0.0	0.8	4.5	2.8	2.9
Switzerland	1.9	1.0	0.9	0.2	-0.7	-0.2
Russia	4.3	3.4	3.5	8.5	5.1	6.8
World	3.2	2.7	3.0	3.9	2.9	2.9

Source: UBS, as of 12 February 2013

In developing the CIO economic forecasts, CIO economists worked in collaboration with economists employed by UBS Investment Research. Forecasts and estimates are current only as of the date of this publication and may change without notice.

Services and manufacturing diverging

Global PMIs



Source: JP Morgan, Bloomberg, UBS; as of January 2012
 Note: Past performance is not an indication of future returns.
 *Scenario probabilities are based on qualitative assessment.

Key financial market driver 1 – *Eurozone crisis*

Key points

- We expect the Eurozone to gradually emerge from recession. Fiscal policy will be less restrictive than in 2012.
- The Eurozone debt crisis is not over but ECB policy provides a credible backstop.
- We think that Spain will need external support in coming months. The debt situation in Cyprus, a possible rating downgrade of Spain to junk, and general elections in Italy could further exacerbate the situation.

CIO View (Probability: 70%*)

Austerity and weak growth

- The Eurozone economy is expected to leave recession behind in 1H 2013 after a weak fourth quarter. We believe that Spain will apply for an aid program in 1H 2013. Italy also risks needing support due to contagion from Spain and its own election uncertainty. Greece's debt remains highly unsustainable, but a near-term euro exit is unlikely. Ireland continues to recover gradually, but is highly indebted. We expect France to deliver negative headlines in 1H 2013 due to rising concerns about its fiscal slippage on the back of economic weakness.
- We expect the Eurozone economy to grow slightly in 1H 2013 (moderately above consensus), with minor downside risks. The latest economic indicators support our base case that the recession will end in 1H 2013 and return to modest positive growth. The increased macro stability on the back of the improving peripheral current accounts and the OMT should support the improving economic trend. Consumer price inflation continues to fall, driven by pressure on output prices and commodity base effects. The ECB is carefully watching the strengthening of the euro and monitoring money market rates following the LTRO repayments, but remains in wait-and-see mode for now.
- We think a revision of Spain's deficit targets by February could lead Moody's to cut the country's credit rating to junk. This would increase the cost of covering its large funding needs and push Spain into a program in the first half of 2013. Italy should remain rated investment grade if the new government continues the recent reform path.
- Even with OMT support, longer-term peripheral yields should stay sensitive to countries' debt trajectories as debt levels remain very high. Banking supervision at the ECB will likely be operational by 2014, but a banking union is unlikely to be formed in the next few years, with the most controversial aspect being joint deposit insurance.
- We think that Greece will fail to meet targets and exit risks will again increase if the current government loses its majority over further austerity demands from the IMF, possibly in 2H 2013.

➤ Positive scenario (Probability: 15%*)

Growth and fiscal stabilization

- Bond yields converge as peripheral countries' budgets stay on track and economic activity across the Eurozone recovers faster than expected. Greece complies with the new austerity plans and market confidence is restored.

➤ Negative scenario (Probability: 15%*)

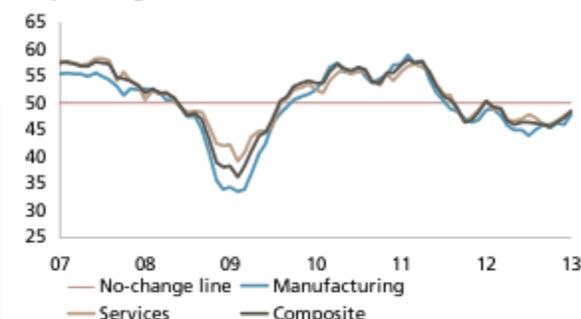
Major shock

- Major shocks include Spain and Italy being cut off from bond markets, i.e. requiring all new funding through ESM/IMF loans, with European rescue funds only able to cover them until the end of 2013; resistance from core countries against further support; a near-term Portuguese debt restructuring; a Greek euro exit in 1H 2013; massive fiscal slippage in France; or a major external shock.

Key dates

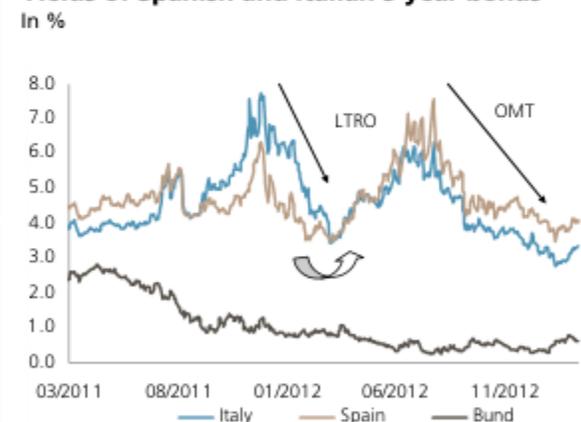
24/25 Feb	Italian parliamentary elections
7 Mar	ECB press conference
14/15 Mar	European Council conference
21 Mar	PMI Composite for March (flash)

Purchasing managers' indices point to improving momentum



Source: Bloomberg, UBS; as of January 2013

Yields of Spanish and Italian 5-year bonds



Source: UBS, Bloomberg; as of 12 February 2013

Note: Past performance is not an indication of future returns.

* Scenario probabilities are based on qualitative assessment.



For further information please contact CIO analyst Thomas Wacker, [redacted] and CIO economist Ricardo Garcia, [redacted]

Please see important disclaimer and disclosures at the end of the document.

Key financial market driver 2 – *US economic outlook*

Key points

- US growth should remain moderate, with accelerating private sector growth partially offset by fiscal tightening.
- Inflation is expected to stay slightly below the Fed's target of 2% over the next six months.
- The Fed's open-ended QE3 has dampened downside growth risk but hasn't dramatically boosted activity.

CIO View (Probability: 70%*)

Moderate expansion

• We expect the economy to stay on a moderate growth path and the unemployment rate to come down gradually over the next six months. UBS forecasts real GDP growth of annualized 3.0% in 1Q 2013 (consensus: 1.5%) and 2.9% in 2Q 2013 (consensus: 2.1%), as private sector demand remains solid and very lean inventories give way to faster inventory accumulation. Inflation should stay slightly below the Fed's target of 2%.

• Relative to 2012 policy, Congress has raised ordinary income, capital gains and dividend income tax rates for high-income earners and curtailed their allowable income exemptions. It has also allowed the payroll tax to expire for all households, raised the estate tax, and introduced healthcare reform tax hikes. The federal budget impact of these policy changes amounts to 0.9% of GDP, but the 2013 GDP growth impact will be more muted as households can lower their savings to offset the drop in after-tax income caused by higher tax rates. Congress extended all other tax and spending provisions and delayed the sequester budget cuts until 1 March. We expect the sequester spending cuts to kick in temporarily and fierce negotiations to bleed into a brief government shutdown after the current continuing resolution expires on 27 March. The culmination will likely be another deficit deal that replaces the current sequester spending cuts but does not include additional spending reductions. The political rift will likely lead to another US sovereign rating downgrade.

• The Fed's open-ended QE3 program linked to labor market conditions – USD 85bn in Treasury and agency MBS purchases – mitigates downside growth risks, as weaker labor market data implies more easing, but has not dramatically boosted growth prospects. We expect QE3 to last until year-end with total purchases of USD 1.2trn.

➤ Positive scenario (Probability: 15%*)

Strong expansion

• Growth accelerates persistently above 3%, propelled by expansive monetary policy, a resolution to the US long-term debt problem, strong growth in housing investment, and improved business and consumer confidence. This leads to higher inflation and the Fed responds by halting QE3 and raising rates sooner.

• Faster-rising tax collection allows the government to cut deficits more aggressively. Fiscal policy tightens by more than 1% of GDP in 2013.

⚠ Negative scenario (Probability: 15%*)

Growth recession

• US fiscal deleveraging and an escalating Eurozone crisis weigh on the cyclical recovery. Falling profit margins weigh on business capital expenditures. Real GDP growth deteriorates. The Fed makes massive purchases of agency MBS and Treasuries under its QE3 program.

• Political gridlock becomes totally dysfunctional, thus leading to a protracted government shutdown in the first half of 2013. The US credit rating is downgraded by multiple notches.

Key dates

1 Mar	ISM manufacturing purchasing managers' index for February
8 Mar	Nonfarm payrolls and unemployment rate for February
13 Mar	Advance retail sales for February
15 Mar	University of Michigan consumer sentiment for March (preliminary)
20 Mar	FOMC meeting results

US growth to rebound after 4Q12 contraction

US real GDP and its components, quarter-over-quarter annualized in %



Source: Thomson Datastream, UBS; as of 12 February 2013

US Current Activity Index (CAI) consistent with moderate growth

US real GDP growth, actual and implied by US CAI, in %



Note: The US Current Activity Index (CAI) is a single composite of 25 growth indicators that correlate strongly with real GDP growth.

Source: Bloomberg, UBS; as of January 2013



Key financial market driver 3 – *China growth outlook*

Key points

- We expect a moderate growth recovery in the coming quarters.
- Key risks to the recovery could come from uncertainties in external demand, inflation and credit.
- Budget for 2013 could be more expansionary than last year's.

CIO View (Probability: 70%*)

Modest growth recovery

- We expect the modest economic recovery to continue in the coming months, driven by some restocking activities, strength in infrastructure investments, moderate recovery in the property sector and the delayed effects of previous easing measures. Our recent on-site meetings with officials and corporations also revealed a cautiously optimistic Chinese macro outlook. We expect GDP growth to improve from 7.8% in 2012 to 8.0% in 2013 (consensus: 8.1%). We think the export sector could underperform the domestic economy given the weak growth in Europe and the battle over the US debt ceiling in the course of the year.
- Given the different timing of the Chinese New Year (it was in January last year but February this year), year-on-year macro data for January or February will be heavily distorted, i.e. January data would be particularly strong and February particularly weak.
- The National People's Congress will be held on 5 March, with the government presenting the growth target for 2013, which is likely to remain at 7.5%, and the budget for 2013. Fiscal policy could be more expansionary, with a larger budgeted fiscal deficit of CNY 1,200bn in 2013 (about 2% of GDP), up from CNY 800bn in 2012. This could pose a moderate upside risk to consensus GDP growth forecasts. Furthermore, several new heads of the regulatory bodies and the central bank will come on board after the meeting, and new policies regarding wealth management products could be announced. Nonetheless, we do not expect a material shift in policies because of the personnel changes.
- The major long-term economic and political reforms will likely be decided in the run-up to the third plenary session of the party's Central Committee in 2H 2013, most likely in October. We believe structural reforms – which aim to rebalance the economy and redistribute incomes and welfare to consumers – will improve the sustainability and quality of China's long-term economic growth.

➤ Positive scenario (Probability: 20%*)

Growth acceleration

- Economic momentum continues to improve and strength persists in 2013. This would require more substantial and effective fiscal, monetary and credit policy support from the government and possibly also a fast improvement in the Eurozone debt crisis and the US fiscal and debt issues.

➤ Negative scenario (Probability: 10%*)

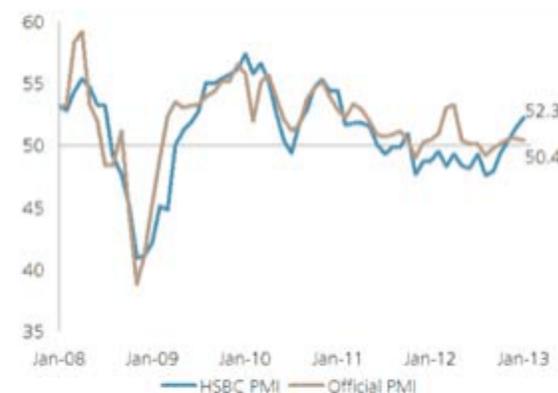
Sharp economic downturn

- Another round of global financial stress or recession, likely due to the Eurozone debt crisis or a fiscal policy-induced downturn in the US, would weigh on Chinese exports.
- Despite soft aggregate demand and economic activity, residential property prices and/or consumer price inflation rise rapidly, which constrains policy maneuvers and its effectiveness in stimulating economic growth.
- A major crackdown on shadow banking tightens liquidity and credit conditions and negatively affects growth.

Key dates

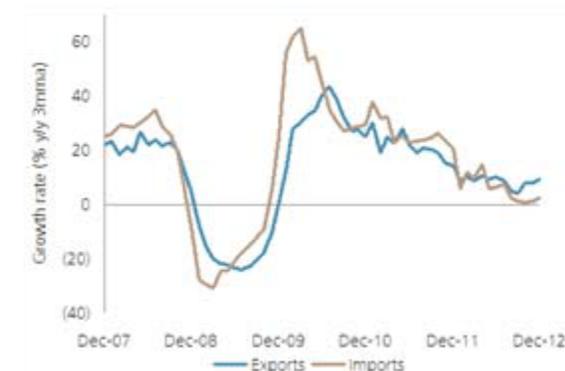
1 Mar	Manufacturing PMI (February)
5 Mar	National People's Congress
9 Mar	Industrial production, fixed asset investment, retail sales (January and February)

Softening in official PMI was largely due to seasonal factors



Source: Bloomberg, UBS; as of February 2013. Index above/below 50 indicates expansion/contraction

Demand from developed economies still casts shadow over export recovery



Source: Bloomberg, UBS; as of February 2013

Note: Past performance is not an indication of future returns.

* Scenario probabilities are based on qualitative assessment.



Section 2

Asset class views

Section 2.A

Asset class views

Equities

Equities overview

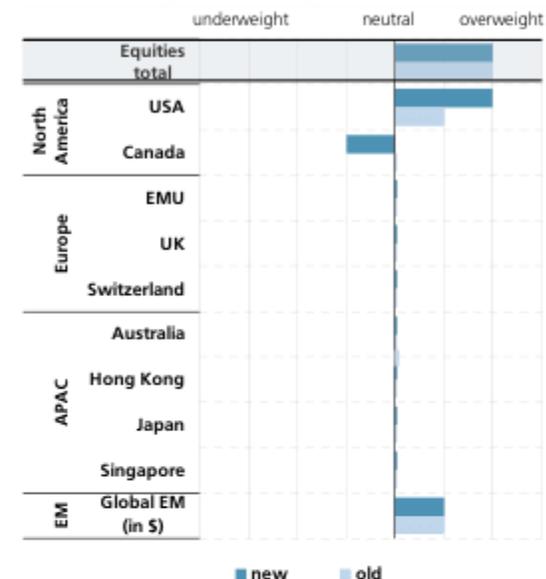
Global equity markets – Key points

- We recommend an overall **overweight allocation in equities** (see summary on slide 3).
- We have increased our **preference for US equities**. Company earnings remain stronger than in other regions. Recent economic data confirms that domestic demand is holding up solidly, underpinning revenue growth. The recent US-dollar weakness provides additional support for company earnings.
- We maintain our **neutral stance on Eurozone equities**. Value is attractive compared to global equities. However, due to recessions in several countries and the recent strengthening of the euro, earnings dynamics remain weak.
- We maintain the **overweight position in emerging market equities**. Economic activity in key countries has bottomed out and is improving (e.g. industrial production, exports). Accordingly company earnings show signs of stabilization in some of the larger emerging markets and we expect them to improve going forward.
- We are adopting a **cautious position on Canadian equities**. Company earnings are currently weaker than in other countries. The currency remains strong, and valuations are high compared to other markets.
- We remain **neutral on Australian equities**. The earnings dynamics of Australian companies continue to lag those of other markets. Still, the pace of downward revisions on earnings in the Materials sector is clearly slowing. Improving commodity demand from China and the recent rise in the iron ore price speak for a more benign outlook.
- We are neutral on **Swiss equities**. Companies are showing solid earnings growth due to the defensive sector composition. On the other hand, the market is trading at a premium to global equities.
- We maintain our neutral view on **UK equities**. In the UK, earnings dynamics lag other markets. The market is trading at a valuation discount, and we expect earnings dynamics to improve over the coming quarters.

Global equity sectors – Key points

- We reiterate our **overweight on IT** as the sector should benefit from increased corporate and consumer spending. With earnings trends and cash flow generation strong, sector valuation is very attractive.
- We confirm our **positive view on Materials** as the global economic outlook is improving, which provides a favorable backdrop for improving sector earnings. We prefer US materials and UK mining over European materials.
- We keep our **overweight on Consumer Staples and Healthcare** which offer superior and long-term earnings growth with low volatility and high free cash flow generation. Both sectors have strong balance sheets, and attractive dividend yields as well as dividend growth prospects. Within Healthcare, we prefer European companies over US ones.
- We remain **underweight on Telecoms** as revenue growth is weak and pricing/margin pressure is high.
- We confirm our **underweight on Utilities** as the business environment (weak demand, regulatory pressure, and lower power prices) remains tough. The earnings outlook remains muted.
- **Consumer Discretionary** should benefit from solid consumer confidence in major countries. While sector earnings growth should continue to be superior, valuation is relatively high. We reiterate our **neutral view**.
- Despite some headwinds in major regions (e.g., regulatory risks, low interest rates), earnings trends for **Financials** are improving and we keep our **neutral view**.
- With expected gradual improvement in leading indicators and early signs of a better global macro environment, **Industrials** should benefit. However, we **remain neutral** as the current sector valuation is fair.

Preferences (six months)



Note: Preference in hedged terms (excl. currency movements)

Sector preferences within global equity markets

Current most preferred sectors

Consumer Staples
Health Care
IT
Materials

Current least preferred sectors

Telecom
Utilities

Source: UBS



For further information please contact CIO asset class specialists Markus Irrgartinger, [REDACTED]

or Carsten Schlufter, [REDACTED]

Please see important disclaimer and disclosures at the end of the document.

S&P 500 (20 Feb): 1,512 (last publication: 1,495)

S&P 500 (six-month target): 1,570

UBS View

- We maintain our preference for US equities relative to other developed equity markets. The recent Q4 earnings season revealed solid earnings growth of about 6% year-over-year. In our base case of ongoing economic expansion, the upcoming fiscal policy issues do not derail the economic recovery.
- This is a precondition for solid earnings growth of 5–7%, which we expect in 2013. This forecast is mainly built on solid revenue growth in 2013. With margins already at high levels, we do not expect margin expansion to drive earnings growth.
- Short-term, the recent US-dollar weakness provides an additional support to earnings.
- The Fed's very pro-growth monetary policy stance is a clear advantage for the local equity market. The end of Operation Twist has been followed by additional large (net) bond buying, which we expect to last late into this year.
- US equities are forecast to gradually advance with earnings growth. Improving manufacturing activity should allow for some modest re-rating in the price-to-earnings ratio from the current level of 14.5 times realized earnings.

➤ Positive scenario

S&P 500 (six-month target): 1,750

- Accelerating US and global economies reduce risks to company earnings. Investors begin to shift funds into more cyclical sectors such as Industrials, IT and Materials in light of better growth prospects. In this scenario, we would expect earnings to grow by around 10% in the next 12 months, and the trailing P/E multiple to expand to around 16x.

⚠ Negative scenario

S&P 500 (six-month target): 1,300

- The US and global economies slide into a recession; failed debt ceiling negotiations might add additional drag. Given such an outcome, corporate earnings would fall over the coming 12 months, and we would expect risk aversion to rise sharply. We would also expect the P/E multiple to contract towards 12.5x trailing earnings.

Note: Scenarios refer to global economic scenarios (see slide 8)

Recommendations

Tactical (six months)

- We keep our exposure to global cyclical sectors within the US equity market that should benefit from a sustained rebound in global growth.
- We confirm our existing overweight tilts in Industrials, IT and Materials as broadening economic growth should translate into higher earnings.
- We remain cautious on Utilities, Healthcare and Telecoms, where revenue growth is low and valuations are unattractive.

Strategic (one to two years)

- We like medium-sized US companies, which are expected to show good longer-term earnings growth.

Current most preferred sectors

Industrials
IT
Materials

Current least preferred sectors

Health Care
Telecom
Utilities

Source: UBS

Note: Past performance is not an indication of future returns.

What we're watching

Why it matters

Business sentiment

The ISM is the key indicator for US manufacturing and services. **Key dates: 1 Mar, ISM manufacturing; 5 March, ISM non-manufacturing**

The Fed

Hints on its monetary policy stance can influence equities. **Key date: 20 Mar, Fed meeting**

Labor market

Improvement in the labor market would support stronger consumption. **Key date: 8 Mar, US labor market report for February**

US earnings season

Consensus forecasts about 3% y/y earnings growth for Q4 results.



Euro Stoxx (20 Feb): 267 (last publication: 269)

Euro Stoxx (six-month target): 271

UBS View

- We maintain a neutral stance on Eurozone equities. Earnings weakness is balanced by attractive valuation.
- The conditional bond-buying program by the ECB (OMT) implies much reduced downside risks from the sovereign debt crisis (see slide 9). Spain will have major refinancing needs in the coming weeks, and we could see higher volatility if it faces problems issuing bonds.
- Italian elections on 24/25 February add additional uncertainty, though our base case calls for a market friendly outcome.
- Besides those uncertainties, economic weakness and Southern European countries being in recession are still dragging down earnings in the Eurozone. The strengthened euro is weighing on overseas earnings.
- Consensus earnings growth expectations for 2013 (bottom-up) have come down to about 7% in recent weeks. We see this growth figure as still too high; we forecast 3% to 5% earnings growth. Still, we expect further re-rating as signs of economic stabilization emerge over coming months, which should more than compensate for earnings misses.

➤ Positive scenario

Euro Stoxx (six-month target): 330

- Global economic growth reaccelerates and Eurozone growth shows clear signs of bottoming out, enabling mid-single-digit earnings growth over the next six months. The trailing P/E ratio could re-rate to about 14.5x from its current reading of 12.4x.

⚠ Negative scenario

Euro Stoxx (six-month target): 210

- Recession and debt crisis lead to renewed market pressure. However, downside risks are expected to be less severe now that the ECB has put its bond-buying program (OMT) in place.
- Earnings could fall about 5% to 10% from current levels over the coming six months, and the trailing P/E ratio could drop to a level of around 10x over a six-month period.
- Failure of debt ceiling negotiations in the US is also likely to affect Eurozone equities negatively.

Note: Scenarios refer to global economic scenarios (see slide 8)

What we're watching

Why it matters

Growth indicators

Economic growth is important to avoid a flare-up of the debt crisis.

Key dates: 1 March, final PMI manufacturing, EMU; 5 March, final PMI services, EMU; 21 March, flash PMI manufacturing and flash PMI services, EMU; 22 March, Ifo business sentiment index, Germany

Policy action

Decisions by European politicians and the ECB affect the course of the debt crisis.

Key date: 7 March, ECB meeting

Recommendations

Tactical (six months)

- We confirm our overweight on Consumer Discretionary as we see increasing evidence of strengthening global growth, which should support sector earnings.
- We like Consumer Staples and Healthcare, which offer good earnings growth, solid balance sheets and growing dividends.
- We are negative on Utilities and Telecoms as earnings trends are negative, balance sheets are stretched and dividends at risk.
- We keep our underweight on Materials as valuations are too high.

Strategic (one to two years)

- We have a preference for stocks paying high-quality dividends.
- We like companies with high exposure to rapidly growing emerging markets.

Current most preferred sectors

Cons Discretionary
Consumer Staples
Health Care

Current least preferred sectors

Materials
Telecom
Utilities

Source: UBS

Note: Past performance is not an indication of future returns.

FTSE 100 (20 Feb): 6,395 (last publication: 6,198)

FTSE 100 (six-month target): 6,475

UBS View

- We maintain our neutral stance on UK equities. Earnings have continued to disappoint, showing one of the weakest dynamics within our market universe. Commodity-related sectors have shown steep earnings declines. Realized earnings in the Energy as well as the Materials sector have continued to be revised down by analysts over the last three months. These two sectors account for 30% of the market capitalization.
- The Healthcare sector suffers from company-specific issues that affect earnings negatively.
- Going forward, the earnings picture is expected to improve gradually. Earnings of materials companies are likely to stabilize in a delayed fashion as iron ore prices have sharply increased since fall 2012. The revision of the Basel III liquidity standards will continue to support the earnings of UK banks.
- UK equities offer a relatively high dividend yield, and the P/E multiple of about 12.7 times realized earnings is below global equities. However, UK equities have traded on a discount to global equities for most of the past 10 years.

➤ Positive scenario

FTSE 100 (six-month target): 7,100

- A rapid strengthening in global growth and recovering demand from emerging markets leads to fast-rising commodity prices, helping the energy and materials sectors to lead the market higher. The market could re-rate to a P/E multiple of 13.5x, and we would expect earnings growth of 5% to 10% over 12 months.

➤ Negative scenario

FTSE 100 (six-month target): 4,900

- A global recession drags down UK earnings by 15% to 20% over 12 months. The market's traditionally defensive characteristics would only partly offset its strong exposure to commodity-related sectors. We would expect the trailing P/E multiple to drop towards 10.5x.

Note: Scenarios refer to global economic scenarios (see slide 8)

What we're watching

Why it matters

Growth indicators

Business survey indicators and consumer spending data provide information on economic developments in the UK. **Key dates: 1 Mar, PMI manufacturing; 5 Mar, PMI services**

Commodity prices

Energy and materials together comprise about 30% of the UK market. Developments in commodity prices affect earnings estimates.

Policy action

Loose monetary policy by the Bank of England supports equities. **Key date: 7 Mar, Bank of England policy meeting**

Recommendations

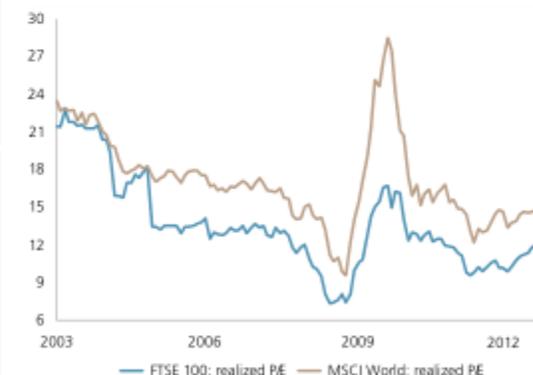
Tactical (six months)

- Equity dividends offer an attractive real income stream in a low yield environment. We recommend stocks with dividends which are well covered by earnings and cash flow, are sustainable and growing, and from companies with sound fundamentals
- We like companies with strong sales exposure to emerging markets.

Strategic (one to two years)

- The UK market's dividend yield of close to 4% provides a good income stream.
- Companies with pricing power are expected to deliver superior earnings growth. High pricing power provides greater margin stability through the cycle.

UK market trades at a P/E discount, based on realized earnings



Source: Thomson Reuters, UBS; as of 18 February 2013
Note: Past performance is not an indication of future returns.

UBS View

- We remain neutral on Swiss equities. Swiss companies are internationally well diversified, with almost two thirds of revenues generated in the US and emerging markets. This provides a basis for solid revenue and earnings growth, despite challenging economic conditions in Europe.
- The defensive sector composition also plays an important role. Swings in global manufacturing activity or commodity prices affect Swiss companies' earnings less than those of companies in other countries.
- In January the Swiss franc weakened by 3% relative to the euro. This movement is too small and recent to have had a material effect on earnings yet. Should it continue, it could provide important support to earnings growth.
- In an environment of moderate economic growth, we like companies with decent earnings growth and solid balance sheets. Unfortunately, these characteristics have their price. Swiss equities trade at a higher valuation than their global peers. Currently they trade at 15.8 times trailing earnings.

SMI (20 Feb): 7,626 (last publication: 7,392)

SMI (six-month target): 7,750

➤ Positive scenario

- Eurozone economic growth reaccelerates considerably, providing further relief to Swiss financials as well as Swiss exporters. Defensive sectors would likely be left behind in a strong global relief rally. In this scenario, we would expect the equity market P/E to trade around 16x and earnings to grow by 5% over the next six months.

SMI (six-month target): 8,100

⚡ Negative scenario

- The global economy slides into a recession. Despite offering less cyclically sensitive products, Swiss companies would also feel the drop in global demand. In this scenario, corporate earnings are likely to drop slightly over the next six months and we would expect P/E to contract toward 12.5x.

SMI (six-month target): 5,900

Note: Scenarios refer to global economic scenarios (see slide 8)

What we're watching	Why it matters
Interest rates and exchange rates	Announcements of domestic interest rates and exchange rate decisions: 1 Mar, SNB meeting
Economic indicators	Announcements of key domestic economic indicators: 27 Feb, KOF Swiss leading indicator; 1 Mar, Manufacturing PMI index
Corporate news	Key corporate announcement dates: 22 Feb, Straumann; 26 Feb, Georg Fischer, Implenia, Swissquote and Temenos; 27 Feb, Holcim and Swiss Life

Recommendations

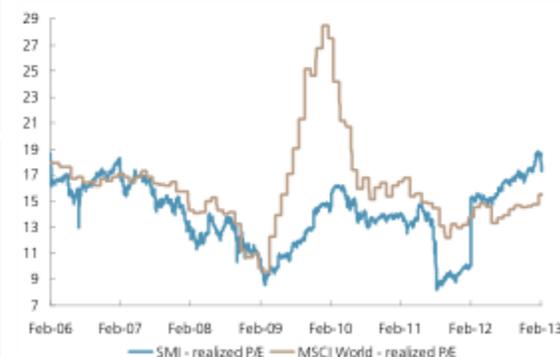
Tactical (six months)

- We like stocks paying high and sustainable dividends, including companies paying income tax-exempt dividends.
- We favor large caps over small caps.
- Within defensives, we favor the Healthcare and Consumer Staples sectors.
- Among the cyclical companies, we prefer those with broad emerging-market exposure and/or cheap valuations, including insurers.

Strategic (one to two years)

- We favor leaders regarding the two key Swiss success factors: innovation and globalization.

Swiss market valuation relative to world equities based on P/E ratio



Source: FactSet, UBS; as of 18 February 2013
Note: Past performance is not an indication of future returns.

UBS view

- We expect earnings growth of 25% over the upcoming 12 months. This relatively high year-over-year growth rate reflects fewer extraordinary items than in 2012, as well as the sharp recent weakening of the yen. Our earnings growth forecast is below consensus of about 35%.
- Investors expect more positive earnings growth in March 2014 on the back of the new government's economic stimulus package and the weaker yen, supported by the BoJ's aggressive monetary easing. We are more cautious on the impact the stimulus package will have on domestic companies' earnings.
- The Abe administration's expansionary fiscal stimulus may create one-time economic momentum and inflation, but we do not expect these measures to lead to sustainable, high GDP growth in the long run.
- We expect the TOPIX (trailing) P/E to drop to around 17 over the coming months, mainly due to the earnings recovery; this will provide room for only moderate price increases after recent strong gains.

Topix (20 Feb): 974 (last publication: 888)

Topix (six-month target): 985

➤ Positive scenario

- Stronger global demand and stabilizing European markets lead to improved risk-taking. Falling risk aversion might lead to a further weakening of the yen, providing an additional boost to earnings. We would expect about 25% earnings growth over the coming six months with the TOPIX target based on 18x trailing P/E.

Topix (six-month target): 1,100

⚡ Negative scenario

- Faltering global growth leads to weak exports, triggering negative earnings surprises. The US dollar/Japanese yen rate strengthening to below 80 and economic conflicts with China could serve as an additional drag on earnings. We would then expect the P/E ratio to contract to 14.7x and earnings to fall during the upcoming six months.

Topix (six-month target): 700

Note: Scenarios refer to global economic scenarios (see slide 8)

What we're watching

Japan industrial production

Why it matters

We expect the weaker yen to boost Japan's industrial production in January. January industrial production should provide valuable data point for assessing the impact of the weaker yen on corporate activity. **Key date: 28 Feb, preliminary industrial production data for January**

BoJ's next governor appointment

In addition to the BoJ governor, two deputy governors will be replaced in late March. **Key date: 19 Mar, BoJ governor appointment by the cabinet**

Recommendations

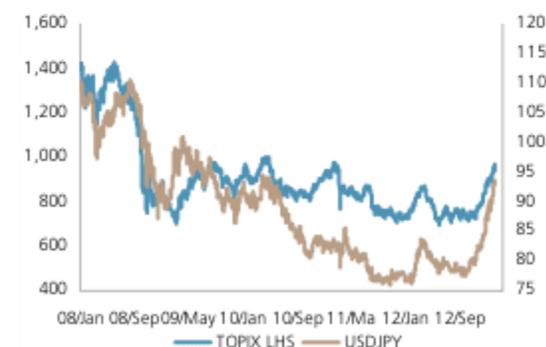
Tactical (six months)

- Since the weaker yen directly contributes to exporters' earnings, we prefer Japanese exporters. Higher inflationary expectations would not boost domestic companies' earnings in the near term.
- Among Japanese exporters, we prefer the auto companies as they still hold a large share of international markets unlike the technology companies.
- In addition, we like trading companies that have continued to invest in mining and other energy resources for the last 10 years. With a weaker yen, the trading companies' net asset values should increase in yen terms.

Strategic (one to two years)

- The recent weakening of the Japanese yen increases the competitiveness of Japanese exporters and companies with international operations.

Weaker Japanese yen supports TOPIX rebound



Source: Thomson Reuters, UBS; as of 8 February 2013
Note: Past performance is not an indication of future returns.

Emerging market equities

Preference: **overweight**

MSCI EM (20 Feb.): **1,068** (last publication: 1,077)

MSCI EM (six-month target): **1,120**

UBS view

- Real GDP growth in the emerging markets is expected to accelerate moderately in 2013 to above 5%, compared to just 1.5% for developed countries. The growth differential between the emerging and developed economies is also forecasted to widen slightly in 2013 in favor of the emerging markets.
- Monetary policy in the US, the Eurozone, and Japan remains supportive of growth more broadly. We believe these low interest rate policies will enhance emerging market (EM) equity returns in US dollars by supporting EM currencies more broadly against the US dollar over the next six months. However, too much currency appreciation too fast – for example, the rapid rise of the Korean won against the Japanese yen – erodes EM competitiveness and equity returns.
- Over a six-month horizon, we do not see any sustained inflationary pressures changing the stance of EM monetary policy from what is currently priced in. However, this could become more of an issue in the second half of 2013.
- In our base case, we see the P/E multiple of the MSCI EM Index staying at about 12x trailing (i.e. realized) earnings over the next six months. Over the next 12 months, we expect EM earnings growth of around 11% (below the latest consensus estimate of 13%).

➤ Positive scenario

MSCI EM (six-month target): **1,330**

- The outlook for the global economy improves, boosting EM's ability to grow more strongly in 2013. This stronger economic growth leads to earnings growth of 15%. Investor confidence improves, leading to a better P/E multiple of 14x trailing earnings. If oil prices were to rise, too, Russia should benefit a little more in this scenario.

➤ Negative scenario

MSCI EM (six-month target): **800**

- A significant escalation of the Eurozone debt crisis, a sharp fiscal contraction in the US, and a big deceleration in Chinese growth could each hit EM's economic prospects. In such a scenario, we would expect a 20% decline in earnings over 12 months. More defensive Malaysia would do better, while more cyclical South Korea and Russia would underperform. We assume, however, that the market would also be expecting some recovery in earnings for 2014, helping the P/E multiple to stabilize around 10x trailing earnings.

Note: Scenarios refer to global economic scenarios (see slide 8)

What we're watching	Why it matters
Industrial production	Investors are trying to figure out in which emerging market economies growth is accelerating and where it might be stagnating. Key dates: GDP, industrial production data and/or PMI manufacturing surveys for South Africa (27 Feb), India (28 Feb), Brazil, China (1 Mar), Turkey (8 Mar), Russia (20 Mar)
Inflation	The Achilles heel of the emerging economies is inflation. Over a six-month view, we do not see any sustained inflationary pressure that would require a change in the stance of EM monetary policy from what is currently priced in. But that could change later in 2013.

Recommendations

Tactical (six months)

- Within emerging markets, we see three main drivers over the next few months: first, a cyclical recovery, supporting some of the higher-beta markets (like Russia, South Korea and Brazil); second, a focus on local recovery stories (like China and Brazil), and third, some rotation away from those markets that have done exceptionally well in recent years, towards markets that have lagged and that start the year under-owned and out of favor (like Russia and Brazil).
- Shorter-term, we see relatively less upside for the more defensive market Malaysia. In the case of South Africa, the currency is in a volatile phase, which is unhelpful to returns in USD terms. We expect some rotation out of Turkey.

Strategic (one to two years)

- Strategically, we would advise that EM portfolios tilt toward cash-rich and faster-growing Asia.

Country preferences within emerging markets (relative to MSCI EM)

Current most preferred markets

Brazil
China
Russia
South Korea

Current least preferred markets

Malaysia
South Africa
Turkey



Asian equities (ex-Japan)

MSCI Asia ex-Japan (20 Feb): 562 (last publication: 560)

MSCI Asia ex-Japan (six-month target): 585

UBS view

- China and South Korea remain our *Most Preferred* markets. China's macro data was distorted to a certain extent due to the timing difference with Chinese New Year (fell in January last year). Jan exports and imports rose 25% and 28.8% YoY beating market expectations, while inflation fell from 2.5% to 2% YoY. The PBOC might gradually shift its focus to inflation in the 2nd half of the year due to a combination of higher labour cost, imported inflation associated with QEs in major economies, rising inflation expectation locally and more importantly, lower downside risk to growth. Nonetheless, valuations remain attractive with 12-mth FWD P/E trading at 16% discount to its peers.
- We maintain our *Least Preferred* ratings on Singapore and Malaysia. Singapore's non-oil domestic exports continue to underperform market expectations in Jan, recording a -1.8% month-on-month decline. Electronic exports continue to disappoint, declining by 5.6% YoY. The Malaysian government is widely expected to dissolve parliament in late Feb/early Mar for elections, with most observers expecting a narrower win for the incumbent party compared to the previous elections. While this in itself would not bring about a significant change in policy direction, a higher possibility this time round of a government formed by the opposition is likely to pose near-term headwinds to the stock market and currency.

➤ Positive scenario

MSCI Asia ex-Japan (six-month target): 680

- More supportive monetary and fiscal policy, stable inflation, sustained domestic demand growth, and an improved global growth outlook lead to a better earnings outlook. In such a scenario, we expect earnings growth of 13% and a trailing P/E of about 15x.

➤ Negative scenario

MSCI Asia ex-Japan (six-month target): 420

- A hard landing in China with a global recession leads to negative earnings revisions. In this scenario, Asia ex-Japan could trade down to about 11x realized earnings.

Note: Scenarios refer to global economic scenarios (see slide 8).

What we're watching

Why it matters

Earnings growth	Consensus is looking at earnings growth of 13.4% for FY2013 for Asia ex-Japan (which might be a tad optimistic should GDP growth disappoint, especially in China).
USDJPY	Sustained USDJPY weakness would be a concern for other major exporters in Asia, particularly South Korea and Taiwan.
Politics	Decisions made about the US debt ceiling are important, as the US is still Asia's most important trading partner. The recent fiscal cliff compromise avoided a severe economic impact. We remain watchful as weaker US growth would hurt Asian exports.
Policy responses	Some other countries in the region have near-term macroeconomic issues to face due to fiscal and current account deficits, as well as hiccups in market and economic reforms. Policy responses often come on an ad-hoc basis.

Recommendations

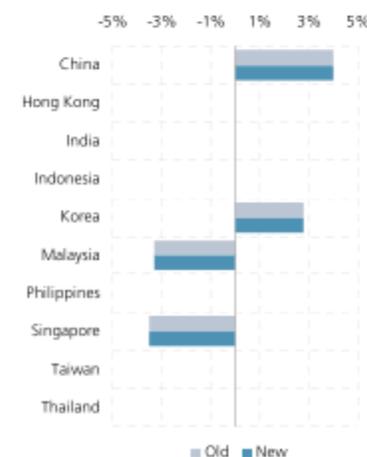
Tactical (six months)

- MSCI Asia ex-Japan is trading at 11.5x 12-month forward P/E, suggesting 10% upside potential assuming a return to historical averages. We advise investors to continue adding Asian equities on any potential weakness in the market.
- Given the more favorable macro backdrop in 2013 and attractive valuations, we are positive on Chinese equities and expect further market re-rating. We also maintain our preference for South Korea. Korean earnings are expected to post 19% earnings growth in 2013 and stay resilient, led mainly by the country's dominant technology companies, due to market share gains and margin expansion.

Strategic (one to two years)

- Consider a portfolio mix of high yield stocks largely found in Singapore, Taiwan and Hong Kong, complemented by growth-oriented stocks in the rest of Asia.

Country preferences within Asia ex-Japan (relative to MSCI Asia ex-Japan)



Equity styles

UBS view

- We believe that medium-sized companies (mid caps) will outperform large caps in the US. US economic data has begun to stabilize and we forecast an acceleration of growth in the second half of 2013 and in 2014. The greater domestic sales exposure and more cyclical sector make-up of US mid caps make them a purer way to gain exposure to the US and will give greater leverage to a US recovery. There is also potential for large caps, which are currently very cash-rich, to put this cash to work and "buy growth" through acquisitions of mid-cap companies.
- Globally, high-quality dividend-paying stocks provide a real and stable income stream to investors in the current low-yield environment. Furthermore, they give exposure to the long-term potential of equity markets while tending to suffer less in declining markets. Importantly, we focus not on those stocks with the highest yield, but instead look for high-quality dividend-paying stocks, which are still able to grow and have less risk of a cut to their dividends.

Prefer mid caps in US, large caps in Europe

➤ Positive scenario

- Leading indicators continue to move higher, and risks related to the Eurozone debt crisis continue to subside. In this case, add deep cyclical value (cheap price/book, price/earnings) regardless of the sector, with high beta and high leverage. In such an environment, small- and mid-cap stocks should also perform well. A dividend strategy would be too defensive to outperform the market.

Prefer value, low quality and small caps

➤ Negative scenario

- The global economic picture deteriorates markedly. In this case, buy high-quality growth companies and large caps. Do not look for value opportunities, but be as defensive as possible with your equity exposure. Look to high-quality, dividend-paying stocks for yield.

Prefer quality and large caps

Note: Scenarios refer to global economic scenarios (see slide 8).

What we're watching

Earnings revisions – see chart (three-month moving average upgrades vs. downgrades)

US and Eurozone PMIs

Why it matters

Watch for signs of improvement in earnings revisions (aggregated from stock level). An improved earnings outlook would cause investors to add more risk – influencing our preferences among equity styles.

PMIs are important for earnings generation and preferences for value, growth and size.
Key dates: 1 Mar, PMI manufacturing Eurozone (final); 1 Mar, US ISM manufacturing

Regional differentiation

- In the US, we prefer mid to large caps. Moderate economic growth should support their earnings generation.
- In the US, there are selective opportunities in value names that also show strong growth.
- Globally, we like high-quality dividend-paying stocks.

Strategic (one to two years)

- We expect value strategies to outperform the European market over a multi-year time horizon.
- Globally, mid-cap stocks provide attractive opportunities over the longer term.

Improving earnings revisions point to mid-cap outperformance

US mid-cap performance relative to large caps



Source: FactSet, UBS; as of 15 February 2013

Note: Past performance is no indication for future returns.

Section 2.B

Asset class views

Fixed Income

Bonds overview

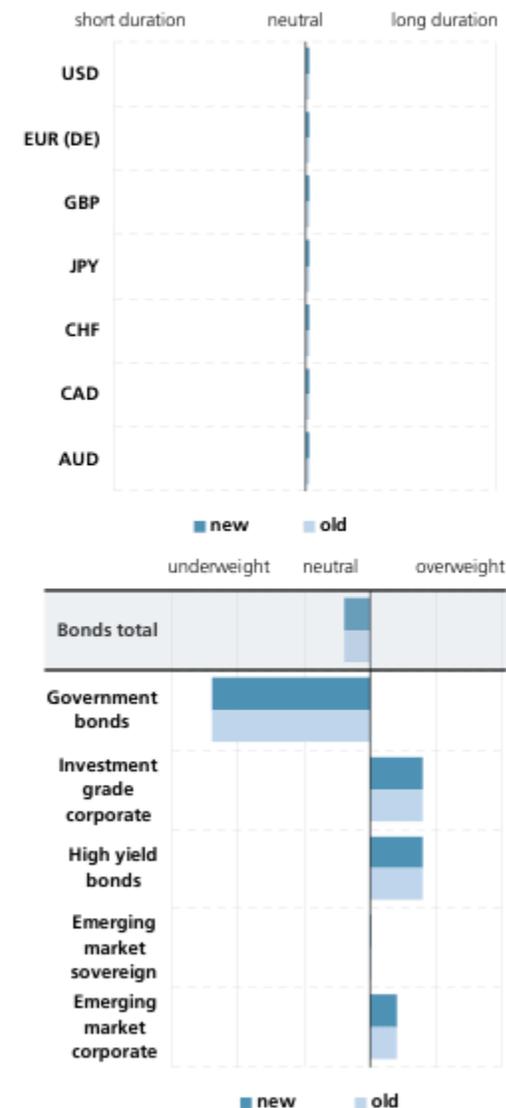
Government bonds – Key points

- We expect government bond yields to move sideways (US and UK) or towards slightly higher ranges (EUR and CHF) over the next six months, as seen in late 2011 and early 2012. This is likely to have a negative effect on most developed market government bond prices, and should result in low or slightly negative total returns.
- Price fluctuations in the month ahead could stem from developments in the Eurozone and the US. These include possible political uncertainties originating in Italy and Spain as well as renewed concerns about Greek debt sustainability over the course of the year. In the US, where the full fiscal cliff has been avoided and the debt limit temporarily suspended, the focus has shifted to the negotiations on sequester spending cuts and to raising the debt limit in early summer. While we still expect a positive outcome following a brief government shutdown, these uncertainties pose a significant downside risk to US growth.
- Long-term yields have risen slightly and have the potential to increase somewhat over the next several months, but we expect the move to be contained. Overall, we recommend avoiding long-term bonds and focusing on short- and medium-term maturities.

Corporate and emerging market bonds – Key points

- We prefer investment-grade (IG) and US high-yield (HY) corporate bonds over government bonds. A strong US corporate sector, the ongoing moderate recovery of the US economy and determined central bank support are likely to further support credit segments. The partial solution to the US fiscal cliff and ongoing support from cyclical indicators provide a positive backdrop for risk assets in H1 2013.
- US HY bonds continue to offer attractive value. The risk premium over US Treasuries is still appealing. We think lower spreads are justified by the favorable default outlook and central bank action. Investor appetite for yield assets is expected to further support US HY bonds in the coming months. While low liquidity remains a key risk for HY bonds, current market liquidity is at a healthy level. US HY thus remains one of our preferred asset classes.
- While the potential for further spread tightening is limited for IG corporate bonds, they will likely continue to outperform government bonds. We thus keep our overweight position, expecting modest positive returns.
- Emerging market (EM) bonds should continue to benefit from better fundamentals than those of developed markets over the medium term. However, valuations for EM sovereign bonds (in USD) are close to fair levels. For EM corporate bonds (in USD), there is still potential for spreads to trend lower in the quarters ahead as these bonds should benefit from a cyclical recovery in EM. We therefore maintain our preference for EM corporate bonds over government bonds from developed markets.

Preferences (six months)



Source: UBS CIO WM Global Investment Office



UBS view

- US 10-year yields increased slightly over the month, validating our forecasts. Improving domestic economic and sentiment data combined with temporary suspension of the debt ceiling drove yields higher. This rise was further supported by the re-pricing of an earlier end to QE3 (FOMC minutes).
- Yields will trend sideways to slightly higher within their old ranges (1.8–2.2%) over a six-month horizon. We expect a final compromise to be reached regarding the sequester spending cuts as well as the debt ceiling in early summer. The Fed's open-ended QE3 stimulus will enable the domestic economy to remain on a moderate growth path with gradually declining unemployment. This represents a clear floor with little chance of retesting the historical lows of July (~1.4%). In addition, the reiterated willingness of the Fed to fall behind the curve in support of the domestic labor market will increase inflation expectations over the medium term. Consequently, higher breakeven inflation expectations could trigger a rise in longer-dated nominal yields in light of a further expansion of monetary stimulus (QE3). This implies steeper yield curves by the end of the year.
- At the same time, US yields should remain capped over a six month horizon due to fiscal anxiety: short-term uncertainties in light of a possible temporary government shutdown during the debt negotiations in spring cannot be excluded. Furthermore, domestic growth is structurally weak and the US economy is still vulnerable to spillover effects from the Eurozone.

US 10-year (20 Feb): 2.0% (last month: 1.9%)

US 10-year (six-month forecast): 2.0%

➤ Positive scenario for US economy/negative scenario for US bonds **US 10-year (six-month range): 2.3–2.6%**

- If US growth recovers with a rapidly improving labor market, then yields rise more significantly.
- The ECB buying short-dated Spanish and Italian sovereign bonds increases risk appetite, EU leaders make progress towards increased fiscal integration. This reduces the flight to quality and represents an upside risk to our forecasts.

➤ Negative scenario for US economy/positive scenario for US bonds **US 10-year (six-month range): 1.4–1.6%**

- US government shutdown beyond our expectations weighs on the cyclical recovery and is a drag on yields.
- A re-escalation of the European debt crisis burdens yields. Risks in the ECB framework remain, given that Spain has not yet made the necessary application to receive secondary market support from the ECB. In addition, Greek debt sustainability could be questioned again in 2013. These uncertainties should result in peripheral spread widening.
- The labor market fails to recover, increasing the likelihood of even more MBS and Treasury purchases or alternative measures, and yields stay low or fall further.

Note: Scenarios refer to global economic scenarios (see slide 8).

What we're watching

Fed policy

Inflation expectations

Sequester spending cuts and debt ceiling

Why it matters

The Fed's assessment of the labor market determines its stance on quantitative easing and is key for yields. **Key dates: 8 March, Nonfarm payrolls; 20 March, Fed FOMC meeting**

Higher breakeven inflation expectations could trigger a rise in longer-dated nominal yields

The extent of the sequester spending cuts will weigh on cyclical growth indicators.

Recommendations

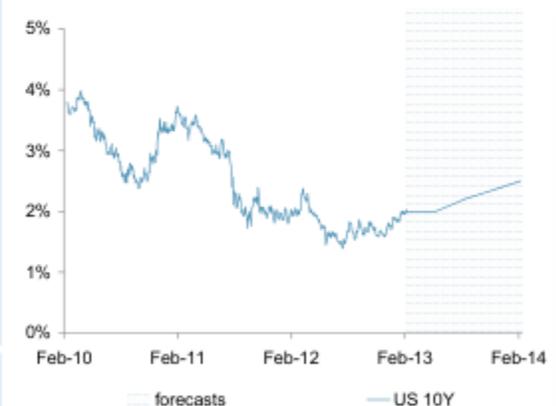
Tactical (six months)

- Yields have the potential to increase somewhat over the coming months. However, upcoming fiscal tightening in the US, ongoing bond market support from central banks and the lingering euro crisis are likely to limit the yield increase.

Strategic (one to two years)

- Yields have significant upside potential over the next couple of years given the extraordinarily low current level of real interest rates in particular. Thus clients with a longer horizon should focus on bonds with short- and medium-term maturities.

US 10-year yields and forecasts



Source: Bloomberg, UBS; as of 11 February 2013
Note: Past performance is not an indication of future returns.

European rates

Duration preference: neutral

EUR (DE) 10-year (20 Feb): 1.6% (last month: 1.5%)

EUR (DE) 10-year (six-month forecast): 1.8%

UBS view

- Bund yields trended slightly higher over the month in response to a less dovish ECB and a normalization of LIBOR markets in response to a higher EONIA rate. Markets thus currently reflect stabilizing fundamentals as well as tentative signs of improving financial conditions. In particular, when compared to the all-time lows witnessed in August (~1.2%), yields are trading at decisively higher levels. This is supported by the ECB's OMT program to act as a lender of last resort. The OMT program has thus far improved money market conditions, reduced fragmentation as well as volatility and boosted cyclical economic indicators as highlighted by Mario Draghi. This progress was reflected in the higher-than-expected 3Y LTRO prepayment, which resulted in higher short-term yields in particular.
- Over a six-month horizon, we expect yields to rise slightly, returning to the old range (1.7–2%). This is due to the decline in excess liquidity, the reduction of tail risk provided by central bank backstops, and the expected mid-term improvement in quarterly EMU growth rates. Additionally, we continue to forecast no further rate cuts as the ECB remains in wait-and-see mode. However, at the same time there is a cap on yields as growth is still structurally weak, and short-term uncertainties remain (US debt ceiling and sequester spending cuts, Spain, Italy).
- In the UK, economic data should stabilize and we expect the BoE to remain on hold and 10-year yields to trade slightly higher.
- In Switzerland, yields increased owing to stabilizing economic data. With less pressure on the CHF, we believe Swiss yields will continue to normalize.

➤ Positive scenario for German economy/negative scenario for bonds 10-year (6-month range): 1.9–2.3%

- A moderate Eurozone economic recovery kicks in. Spain and Italy are ahead on their austerity commitments without needing ECB support. This reduces safe-haven inflows, driving Bund yields higher.

- Alternatively, Germany gives additional guarantees and the Eurozone moves towards a transfer union.

➤ Negative scenario for German economy/positive scenario for bonds 10-year (6-month range): 1.2–1.5%

- Risks in the ECB framework remain, given the pending application of Spain for the OMT program and possible political turmoil in Italy. These uncertainties would result in peripheral spread widening. In addition, Greek debt sustainability could be questioned again in 2013.

- US sequester spending cuts and a positional government shutdown beyond our expectations weigh on the cyclical recovery and are a drag on yields.

- Further non-standard policy measures by the Fed are supportive for Bunds and speak for lower yields.

Note: Scenarios refer to global economic scenarios (see slide 8)

What we're watching

Political risks

Why it matters

The US sequester spending cuts and debt ceiling in early summer, upcoming Italian elections, Greek debt sustainability, and Spain delaying its application for assistance add to policy uncertainty.

Central banks

Key dates: Feb 27, early 2nd LTRO repayment; 7 March, ECB meeting

Economic variables

Economic sentiment and credit conditions (ECB bank lending survey)

Eurozone yield spreads

The level of the peripheral spreads to German bunds reflects risk aversion and thus the safe-haven discount placed on Bunds.

Recommendations

Tactical (six months)

- If the ECB were to intervene with massive purchases in the peripheral bond markets, Bund yields could rise more significantly. However, for the time being, we expect only moderate interventions that do no meaningful harm to Germany's credit quality.

Strategic (one to two years)

- Yields have significant upside potential over the next couple of years. Thus investors with a long time horizon should focus on bonds with short and medium maturities.

Europe 10-year yields and forecasts



Source: Bloomberg, UBS; as of 11 February 2013

Note: Past performance is not an indication of future returns.



For further information, please contact CIO asset class specialists Daniela Steinbrink Mattei, [redacted], Teresa Sardena, [redacted] 26

and Nina Gotthelf, [redacted]

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Investment grade corporate bonds

Preference: **overweight**

Current global spread (20 Feb): 145bps (last month: 142bps)

Spread target (six-month): 140bps

UBS View

- Global IG bond spreads have by and large reached our spread target by January 2013. Over the last month IG spreads moved broadly sideways while government rates increased, causing negative total returns. Still, IG corporate bonds have outperformed government bonds year-to-date.
- While the potential for further spread tightening is limited, IG bonds will likely continue to outperform government bonds, offering low volatility and stable income. We expect a total return of approximately 1% over the next six months.
- IG bonds remain supported by our outlook for sluggish but positive global growth, extraordinary central bank support measures, and ongoing investor appetite for "safe" alternatives to low-yielding government bonds.
- Non-financial corporates: While total yields are at record lows, the pickup over government bonds and money market rates is still attractive. Spreads are expected to remain around current levels.
- Financial corporates: We believe that determined central bank action provides a backstop for financials and supports modest spread tightening. US banks benefit from a better economic backdrop than their European peers and are thus in a better position. Regulatory challenges will likely keep global financial spreads above past lows.

➤ Positive scenario

Spread target (six-month): 120bps

- Global growth accelerates more than expected. This could compress spreads closer to pre-crisis levels. However, in this case, rising benchmark yields would likely lead to slightly negative absolute total returns over six months. Relative to government bonds, IG corporate bonds will do well.

➤ Negative scenario

Spread target (six-month): 380bps

- Main risks include a sharp slowdown of the US economy. Also, risks in the Eurozone persist (e.g. Greek exit, Spain/Italy getting cut off from private funding). Still, we would be unlikely to see the spread levels reached in 2009, given companies' superior balance sheet positions. An additional risk to European financial issuers is a bail-in of senior bond holders, which we think is unlikely to happen before 2018.

Note: Scenarios refer to global economic scenarios (see slide 8).

What we're watching

Why it matters

Core market yields	Developed market sovereign yields are only expected to increase gradually. A sudden rise and high volatility would hurt IG credit. Key dates: 7 Mar, ECB meeting; 20 Mar, Fed FOMC meeting
Corporate fundamentals	Robust corporate earnings and low leverage on corporate balance sheets should help prevent defaults.
New issuance	As financial companies continue to deleverage, net supply on the IG market is expected to remain close to zero. A strong increase in net supply would be a technical headwind.

Recommendations

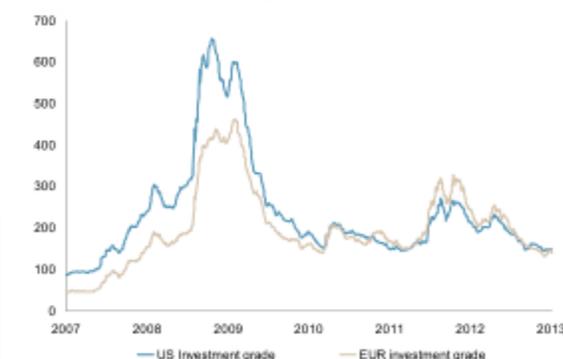
Tactical (six months)

- We keep an overweight in IG corporate bonds over government bonds.
- In Europe, internationally diversified companies from non-financial sectors offer a low but stable income stream for conservative investors.
- Financials in the US are in a better position than their European peers.
- We recommend bonds from the lower IG rating segments (BBB and A) over higher-rated issuers.

Strategic (one to two years)

- We prefer corporate over sovereign debt given how much more robust companies are compared to the structural weakness of public finance in many countries.

Yield spreads over government bonds (bps)



Source: Bloomberg, UBS; as of 18 February 2013
Note: Past performance is not an indication of future returns.

High yield corporate bonds

Preference: **overweight**

Spread USD HY (20 Feb): 492bps (last month: 493bps)
USD HY spread target (six-month): 450bps

UBS View

- We expect low default rates, a favorable demand backdrop from yield-seeking investors, and the commitment of major central banks to provide strong monetary support, which taken together provide a strong backdrop for US high yield corporate bonds. We thus still see potential for tighter spreads around 450bps. The recent outperformance of equities combined with higher rates has led to moderate outflows from HY funds. But a "great rotation" from fixed income assets looks unlikely at this stage.
- While total returns this year are very likely to fall short of the extraordinarily strong performance in 2012 (+16%) we expect attractive total returns of 4–5% over the next six months.
- The default rate of US high yield issuers stood at 1.4% in January (US dollar par-weighted), far below its long-term median of 4%. We expect only a very gradual increase in defaults through 2013. A heavy load of new issuance in recent months means that HY companies will be faced with a lower risk of failed refinancing going forward (e.g. in case of an unexpected economic slump).
- Thus, US HY bonds continue to offer attractive value. The risk premium over US Treasuries is still at appealing levels. We think lower spreads are justified by the favorable default outlook and central bank action. The ongoing slow recovery of the US economy, healthy company balance sheets, robust earnings, and strong investor appetite for yield assets provide a good backdrop. US HY thus remains one of our preferred asset classes.

➤ Positive scenario

USD HY spread target (six-month): 350bps

- Even in the positive economic scenario, spreads are unlikely to tighten to pre-crisis lows of below 300bps due to lower market liquidity for the asset class. Benchmark yields would rise in this scenario, limiting HY returns to around 7% over 6 months.

➤ Negative scenario

USD HY spread target (six-month): 850bps

- A US recession is the major risk for US HY bonds. Based on the robust state of the US corporate sector, we would not expect spreads to surpass "usual" recession levels of around 1,000bps. Short-term spikes are possible due to liquidity suddenly drying up, but we would expect a quick normalization.

Note: Scenarios refer to global economic scenarios (see slide 8).

What we're watching

Credit quality/
default cycle

New issuance

Bank lending standards

Why it matters

Balance sheets are backed by high cash levels and low debt ratios. Against this backdrop the default rate will likely remain below its long-term average. Recent US company earnings were sufficient to maintain stable leverage and coverage ratios.

For now, favorable conditions in the primary market have mainly been used for refinancing. More aggressive issuance activities should be monitored.

Bank lending provides an important source of funding. US banks continued to relax standards in 4Q 2012 according to the Fed's latest senior loan officer survey.

Recommendations

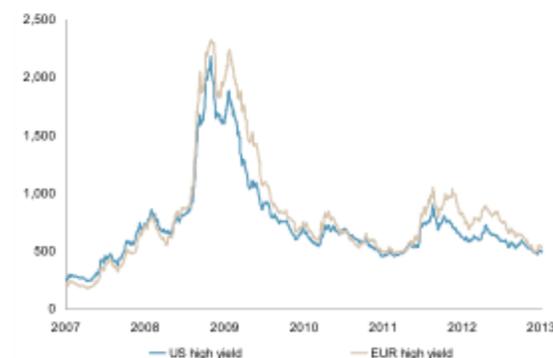
Tactical (six months)

- US HY corporate bonds offer an attractive return outlook and should be overweight.
- We prefer US over European issuers given the high proportion of peripheral and financial issuers in the European HY universe, the poorer economic outlook in Europe and the strong decline in European HY spreads over recent months.
- New issuance set a new annual record in 2012 at USD 365bn and maturities in the year ahead have been reduced meaningfully.

Strategic (one to two years)

- We expect US defaults to remain at below-average levels for longer. Significant re-leveraging is unlikely in the medium term.
- We believe US high yield corporate bonds will provide good returns both relative to other fixed income and for absolute return-oriented investors.

Yield spreads over US Treasuries (bps)



Source: Bloomberg, UBS; as of 18 February 2013
 Note: Past performance is not an indication of future returns.



Emerging market bonds

Preference: **overweight**

EMBI Global/CEMBI spread (20 Feb): 277bps / 316bps (last month: 265bps / 309bps)

EMBI Global/CEMBI spread target (six-month): 250bps / 270bps

UBS View

- Spreads of emerging market (EM) sovereign bonds have widened slightly in recent weeks, with EM corporate bonds moderately outperforming EM sovereign bonds. We think that EM corporate bonds offer a more attractive opportunity for investors than EM sovereign bonds. The gradual recovery in EM that we expect over the coming quarters should support the performance of EM corporate bonds more than that of EM sovereign bonds, and the shorter average duration of EM corporate bonds should offer better protection against rising US Treasury yields in the quarters ahead. Corporate bonds tend to outperform sovereign bonds during periods of accelerating growth.
- However, absolute returns of EM bonds will be lower than in the past year, we think, as the room for spreads to tighten further has become more limited. We expect total returns of 2% for EM sovereigns and close to 4.5% for EM corporate bonds over the next six months.

➤ Positive scenario

EMBI Global/CEMBI spread target (six-month): 235bps / 230bps

- Yield stability in Europe's core markets and higher-than-expected growth in the US provide a favorable backdrop for EM fixed-income spreads. In such an environment, issuers of lower credit quality would likely fare better. Average spreads could tighten to below 240bps in such an environment.

➤ Negative scenario

EMBI Global/CEMBI spread target (six-month): 555bps / 750bps

- An environment of renewed escalating risk aversion in Europe, deteriorating EM funding markets, weakening global growth prospects, and lower commodity prices could impact EM credit negatively. Liquidity in emerging market bonds could dry up and spreads could spike.

Note: Scenarios refer to global economic scenarios (see slide 8).

What we're watching

Why it matters

Core market yields

The direction of US Treasury and German Bund yields are important for EM fixed income spreads, especially for US dollar- and euro-denominated bonds.

Key dates: 7 Mar, ECB interest rate decision; 20 Mar, FOMC Rate decision

Capital flows

The European debt crisis may lead to further periods of outflows and weaker prices, which could offer attractive entry levels for investors.

Monetary policy cycles

Inflationary conditions and monetary policy remains a key topic for local currency bonds. We look for inflation data releases in key markets. Upcoming **key policy rate decisions: Russia (1 Mar), Brazil (6 Mar), Poland (6 Mar), Indonesia (7 Mar), Mexico (8 Mar)**

Recommendations

Tactical (six months)

- EM corporate bonds are particularly attractive due to their favorable valuations, solid fundamentals, and relatively short duration. We advise investors to focus on investment grade bonds in the current environment. We recommend taking profit on selected EM sovereign bonds. Please refer to our EM bond list for issuer- and bond-specific guidance.

Strategic (one to two years)

- EM bonds are attractive for longer-term investors looking for higher yields.
- Local markets in Asia offer interesting opportunities for longer-term investors because of a supportive currency outlook.

EM sovereigns relatively expensive compared to EM corporates

Spreads of EM bonds over US Treasuries, in bps



Source: JP Morgan, UBS; as of 12 February 2013

Note: Past performance is not an indication of future returns.



For further information please contact CIO asset class specialists Michael Bolliger, [redacted] and Kilian Reber, [redacted]

Please see important disclaimer and disclosures at the end of the document.

Section 2.C

Asset class views

Foreign Exchange

Foreign exchange overview

Foreign exchange – Key points

- The European Central Bank dampened the "euro-phoria" at its February meeting as President Draghi implicitly put a cap on further **EUR** strength, suggesting that further appreciation could affect the price level in the medium term and thus could lead to interest rate cuts. The euro looks expensive now, given political risks in Italy, Greece and Spain. We keep an underweight.
- We expect **EURUSD** to trade between 1.30–1.35 in the next months. An improved growth outlook after the partial solution to the US "fiscal cliff" and the fact that the US Federal Reserve is likely to continue its current QE program until year-end would support a higher EURUSD. However, the uncertainty around the upcoming US debt ceiling and budget negotiations, as well as uncertainty around Italian elections, suggest that the next move is to the lower bound around 1.30.
- The **CAD** weakened in January, as the Bank of Canada pushed expectations of first rate hikes further out. We see this only as a short-term drag, as it doesn't change the general view that the BoC will be the first major central bank to start hiking rates. The CAD remains a favorite currency for the longer term.
- **GBP** has been the weakest G10 currency year-to-date, besides the yen. Market expectations for UK economic growth are already subdued and negative data surprises should begin to fade. Also, the speculation about a change in the Bank of England's (BoE) mandate is overdone. We thus see potential for the pound to reverse the year-to-date weakness and recommend an overweight in the GBP.
- **EURCHF** still trades above 1.23. We believe the EUR strength will only be temporary and don't see potential for an even higher exchange rate. A level above 1.25 is unsustainable as long as EUR 1-month deposit rates stay close to zero and the ECB shows no intention of hiking rates. A normalization of the yield differential would be needed for a higher EURCHF.
- Sweden and Norway stand out for their low debt-to-GDP ratios and current account surpluses. As a consequence, both the **SEK** and the **NOK** have appreciated on diversification inflows in recent years. The Swedish Riksbank is likely to abstain from further rate cuts, contrary to some market expectations. Furthermore, economic data has started to improve. We thus think the SEK remains an attractive target for currency diversification.
- The yen depreciation has gone a long way; USDJPY is up to 94 from 80 (+17.5%) within about three months. But it started topping out at the beginning of February. We don't recommend adding further JPY short positions unless the government announces a very dovish new Bank of Japan governor. We stay neutral on the JPY.
- For commodity currencies, the **AUD** and **NZD** continue to trade at the top of their well-established ranges. Consequently investors should stay somewhat cautious. Short-term, AUDUSD may fall a bit lower given the current weakness in the Australian domestic economy and the possibility of further policy rate cuts. Clients with a lot of AUD exposure should start diversifying into the NZD and CAD at current levels.
- Our most preferred emerging market currencies are presently the KRW, SGD, RUB, MXN, BRL, PLN and ZAR. We also expect the **CNY** to appreciate gradually against the USD. Internationally marketable instruments (such as CNH, the offshore version of the Chinese currency traded in Hong Kong) have similar appreciation potential.

Preferences (six months)



Source: UBS CIO WM Global Investment Office

G10 currencies

UBS View

See table for current exchange rates and CIO forecasts

- We continue to believe that the fair range for EURUSD is 1.30–1.35. Over the medium term, a recovery in the eurozone could lead to further upside. However, recent statements by ECB President Draghi put a cap on further EUR upside. The immediate risks in the US might be limited, but a possible US rating downgrade could still lead to a short-term spike of the USD.
- The **GBP** has weakened considerably year-to-date. As negative economic surprises should begin to fade and speculation about a change in the BoE's policy had been overdone, we believe in a rebound of the pound.
- Downside pressure on the **JPY** has been strong recently. We expect a consolidation around USDJPY 90.
- The SNB has shown that it can defend the **EURCHF** floor, so 1.20 is fixed on the downside. However, despite the recent move higher, we see any moves above 1.25 as unsustainable as long as the yield differential stays low.

Positive scenario

FX targets: EURUSD >1.35 / EURJPY 125

- A stronger-than-expected acceleration of global growth or further European integration would be EURUSD-positive. The yen should get weaker as the Bank of Japan intervenes to weaken its currency by increasing its asset purchase program.

Negative scenario

FX targets: EURUSD <1.25 / EURJPY 100

- The European growth outlook would deteriorate again falling back into recession in 2013. The euro could rapidly fall below 1.25. A European debt default cascade (triggered by a disorderly euro exit by Greece or political uncertainty after Italian elections) is a tail risk for the single currency. Risk aversion would lead to a USD and JPY rally.

Note: Scenarios refer to global economic scenarios (see slide 8).

What we're watching

Why it matters

Chinese growth

We expect Chinese growth to gradually pick up. In the base case, a Chinese recovery should support the AUD in the medium term. If China's recovery disappoints, then risk-unwinding would support the USD and the JPY vs. risk-taker currencies – especially AUD.

European sovereign crisis, ECB policy

The main focus lies on the budget review in Spain and the Italian elections, which could both trigger an application for ESM/ECB or at least dampen risk sentiment.

Key dates: 25 Feb, Italian elections; Mid-Feb (tbd,)Spanish budget review

US growth and Fed policy response

The decisions on spending cuts and the debt ceiling will shape up over coming weeks and it will be interesting to see how the Fed responds to any fiscal tightening.

Key dates: Late March, debt ceiling and spending cut decisions

Recommendations

Tactical (six months)

- We remain neutral on EURUSD as we expect the pair to trade between 1.30 and 1.35 in the coming months.
- GBP remains our most preferred currency, against an underweight in EUR.

Strategic (1 to 2 years)

- We recommend that investors diversify from large USD and EUR exposures into minor currencies. Structural financing issues weigh on all the major currencies.
- We continue to have a longer-term preference for the GBP, as it benefits from diversification out of the EUR.
- The best diversifiers based on long-term macroeconomic fundamentals are the CAD and the SEK. The AUD, NOK and CHF should only be added at better entry levels.

UBS CIO FX forecasts

	21-02-13	3M	6M	12M	PPP
EURUSD	1.3192	1.30	1.32	1.34	1.30
USDJPY	93.3	88	88	90	79
USDCAD	1.019	0.97	0.94	0.92	0.95
AUDUSD	1.024	1.02	1.02	1.02	0.76
GBPUSD	1.5221	1.65	1.68	1.70	1.68
NZDUSD	0.8339	0.82	0.82	0.82	0.61
USDCHF	0.9313	0.93	0.92	0.92	1.01
EURCHF	1.2288	1.21	1.21	1.23	1.31
GBPCHF	1.4177	1.54	1.54	1.56	1.70
EURJPY	123.07	114	116	121	102
EURGBP	0.8664	0.79	0.79	0.79	0.77
EURSEK	8.4655	8.20	8.00	8.00	8.65
EURNOK	7.4713	7.30	7.20	7.20	8.43

Source: Thomson Reuters, UBS; as of 21 February 2013

Note: Past performance is not an indication of future returns.



For further information please contact CIO asset class specialist Thomas Flury, [REDACTED]

Please see important disclaimer and disclosures at the end of the document.

Emerging market currencies

UBS View

See table for current exchange rates and CIO forecasts

- We continue to like emerging market (EM) currencies over a medium-term horizon. We think monetary policies of major central banks will remain loose for longer, whereas the easing cycle in several emerging markets is over. This should support EM currencies relative to major currencies (USD, EUR, and JPY). Long-term investors should therefore diversify into EM currencies, using surplus exposure in USD, EUR or JPY for funding.
- In Europe, higher yielding currencies like the Polish zloty (**PLN**) and the Russian ruble (**RUB**) look attractive over the medium term, but we remain cautious on the Hungarian forint (**HUF**). The Turkish lira offers an attractive carry, but the appreciation potential is severely limited. The South African rand (**ZAR**) is currently fair to attractively valued, but investors should be willing and able to tolerate periods of volatility due to political uncertainty, a cyclical economic slowdown or shifts in global sentiment.
- In Asia, we like the Korean won (**KRW**) for its relatively cheap valuation, the Singapore dollar (**SGD**) for the central bank's policy of gradual currency appreciation and the Chinese renminbi (**CNY**) for its stability.
- In Latin America, the Mexican peso (**MXN**) is still attractively valued at current levels and offers an attractive yield pick-up over the USD. However, near-term volatility seems likely, given event risks in the US and Europe. In Brazil, authorities will likely restart exchange rate market interventions if the Brazilian real trends below USDBRL 1.95. While the BRL has an attractive carry, we think structural imbalances point towards it weakening in the longer term.

➤ Positive scenario

> 5% outperformance of EM FX against G4 currencies over a six-month horizon

- Macroeconomic data comes in stronger than expected and Europe stabilizes further. EM exchange rates could appreciate swiftly against major currencies (USD, EUR, and JPY).

➤ Negative scenario

> 5% depreciation of EM FX across regions against USD over a six-month horizon

- Global growth prospects suffer a prolonged deterioration and the European debt crisis intensifies. EM exchange rates could see a significant, although likely temporary, sell-off across regions.

Note: Scenarios refer to global economic scenarios (see slide 8).

What we're watching

Why it matters

Inflation dynamics in EM

Inflation dynamics are important for the forecasting of central bank policy rate decisions. Monetary easing typically weighs on EM currencies, while rate hikes tend to be supportive. **Upcoming key policy rate decisions: Russia (1 Mar), Brazil (6 Mar), Poland (6 Mar), Indonesia (7 Mar), Mexico (8 Mar)**

European sovereign crisis

Setbacks in sentiment will likely lead to bouts of EM currency depreciation, providing attractive entry points for longer-term investors.

Growth

Growth in the US, Europe and China is key for sentiment and growth prospects in EM. **Key dates: 7 Mar, ECB interest rate decision; 20 Mar, FOMC Rate decision**

Recommendations

Tactical (six months)

- Several EM currencies look attractive at current levels and we advise investors to keep existing holdings for further gains while increasing exposure to our currently preferred EM currencies (CNY, KRW, SGD, MXN, PLN, RUB), using the EUR as our preferred funding source.

Strategic (1 to 2 years)

- We recommend EM currencies backed by stable fundamentals to diversify currency exposure out of major DM currencies.
- Our long-term favorites include the Chilean peso, Mexican peso, Czech koruna, Polish zloty, Chinese renminbi, Korean won, Malaysian ringgit and Singapore dollar.

UBS CIO EM FX forecasts

	21.02.2013	3-month	6-month	12-month
Americas				
USDBRL	1.96	2.05	2.00	1.98
USDMXN	12.7	12.5	12.4	12.0
Asia				
USDCNY	6.24	6.22	6.20	6.15
USDINR	54.4	54.0	53.0	52.0
USDIDR	9'701	9'400	9'400	9'400
USDKRW	1'085	1'100	1'080	1'050
USDSGD	1.24	1.21	1.20	1.18
EMEA				
EURPLN	4.16	4.20	4.10	4.00
EURHUF	291	300	300	300
EURCZK	25.4	26.0	25.5	25.0
USDTRY	1.79	1.78	1.80	1.83
USDZAR	8.91	9.00	8.70	8.50
USD RUB	30.3	30.5	30.5	30.5

Source: Thomson Reuters, UBS; as of 21 February 2013
Note: Past performance is not an indication of future returns.



Section 2.D

Asset class views

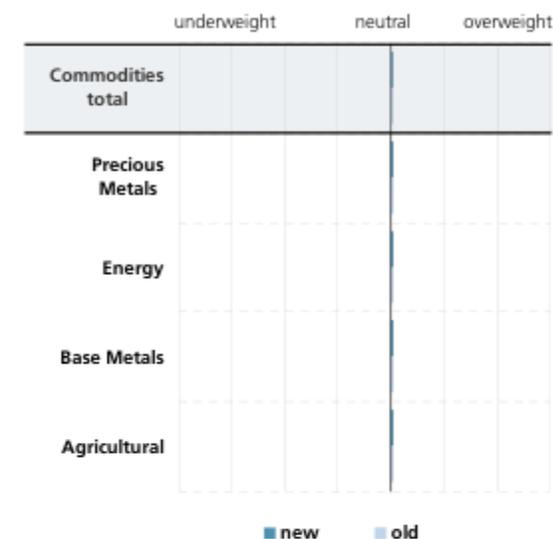
NTAC: Commodities, Listed real estate, Hedge funds and Private equity

Commodities overview

Commodities – Key points

- Broadly diversified commodity indices have delivered a moderate performance this year, up by less than 2.5% on average. The underperformance of the asset class versus other risky assets is mainly driven by the weakness in agricultural commodity prices. Since industrial activity and fixed asset investments in China should gain further momentum after Chinese New Year, the upward trajectory of some cyclical commodity prices is set to continue.
- The structural story for a higher **gold** price (6-month target USD 1,825/oz) remains in place, although investment demand shows not much willingness to chase a stronger price at present. Within the precious metals our preferred positions relate to industrially sensitive metals like **platinum, palladium and silver**. Supply challenges in South Africa and fewer Russian government stock sales are putting these metals in a sweet spot during 1H13.
- The window for more pronounced setbacks in **base metal** prices is closing. On the back of stronger industrial activity, more infrastructure investments and stronger credit growth after Chinese New Year, base metal demand should gather strength. Moreover, the drag from Europe on metal demand is likely to moderate, while the US adds marginally to global metal consumption. From this angle an expected price move of 10% is possible. The strongest and most volatile performance should be visible in zinc and nickel, while copper and aluminum should deliver moderate but steady price increases as inventories get drawn down.
- An array of supply curtailments, geopolitical concerns and improved forward looking macroeconomic data have pushed **crude oil** prices to multi months highs. Despite this favorable news flow at first glance, we stick to our negative crude oil view. A stronger non-OPEC supply side in the months ahead and adequate OPEC output, should allow inventories to build. Demand growth in 1Q13 is expected to remain tepid as well. Our 6-month forecast remains therefore unchanged at USD 110/bbl. Additional pressure on the **energy sectors** should come from US natural gas prices, which have room to drop to USD 3/mmbtu with less inventory withdrawals than envisaged by markets. Lower natural gas demand and a pick up in supply should provide the necessary downside pressure.
- The poor performance of **agricultural commodities** is likely to continue. Although we see more prices weakness in the grains, investors should be aware of the structurally low US inventories in corn and soybeans. Thus, our bearish stance does come with considerable forecast risks, if harvest estimates starts the surprise negatively on the back of unforeseen weather conditions. An opposite price development should be visible in the softs, where the severe price weakness in 2012 should have cut into investments and allow market surpluses to fade over the next 6-9 months.

Preferences (six months)



Source: UBS CIO WM Global Investment Office

Gold (20 Feb): USD 1,568/oz (last month: USD 1,684/oz)

Gold six-month target: USD 1,825/oz

UBS View (gold)

- The performance of gold has not met expectations - market participants and ours - in recent months. With prices showing no sign of an uptrend, financial market interest in the yellow metal started to wane.
- The short-term market focus was on the technical picture: The uptrend from May last year met the consolidation trend from last October. The combination of the broken May uptrend and lower-than-expected inflation data on a global level now lead us to change our short-term view. However, this short-term adjustment is not altering our long-term structural view on gold, merely pushing out the timing for prices to trend higher again.
- From a long-term perspective the metal's far most important competitor, "paper money," is still at risk as monetary policy is mingling with fiscal policy to secure growth. Expanding central bank balance sheets is not a cost-free exercise and will take a stronger toll on money's pricing power at some stage. We expect central banks to be cautious in tightening monetary policy conditions compared to what a prudent monetary policy approach would request. Hence, a time window in which negative real interest rates drop further should allow the gold price to reach our 6-month target at USD 1,825/oz.

➤ Positive scenario

- The need for the ECB to widen its balance sheet once again in order to prevent a Eurozone breakup. On the other hand, considerably higher US and EM inflation readings that lead to a further drop in real interest rates.

six-month target: USD 1,950/oz

➤ Negative scenario

- Stronger fiscal adjustments in the US and a constant deceleration in China's economic activity causing fading price pressure. The Fed backing off from its current monetary policy stance by providing signs of higher interest rates.

six-month target: USD 1,250/oz

What we're watching

Why it matters

Physical demand/supply

- Review of gold purchases by central banks. **Key dates: mid-May** (WGC 1Q13 report)
- An initiative (**20 Mar**) in Switzerland that would force the SNB to hold 20% of its foreign reserves in gold. Impact of recent tax hike on Indian jewelry demand.
- Supply wise, structural mining issues related to South Africa remain unsolved and should command extra attention, especially for platinum and indirectly for palladium.
- With the gold price dipping below USD 1,650/oz, scrap supply should dry up and help to balance the market as investment demand fails to increase.

Investment flow

- In order to reach our target, demand for bars/coins and ETF products need to pick up again. Moreover, outflows in gold futures positions by non-commercial accounts have to reverse as well. At present, gold futures positions of non-commercial accounts stand at around 13.7 mn ounces while gold holdings in ETF products are at 88 mn ounces.

Monetary policy

Key dates: 19–20 Mar Fed meeting, **and monthly** US and EM inflation readings

Recommendations

Tactical (up to six months)

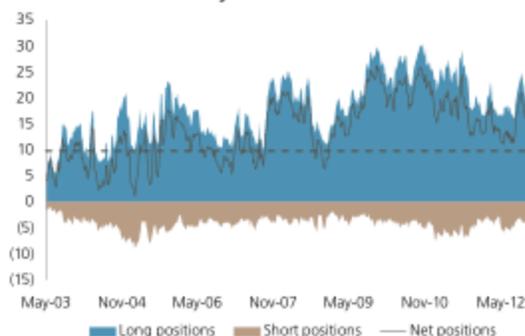
- Platinum remains our most preferred precious metal. Rising production costs in the high single digits and a marginal production cost base above USD 1,600/oz set the preconditions that stronger economic activity in 2013 will cause an undersupplied market. We estimate a market deficit of 4.5% for the full year and a price move into the range of USD 1800-1,850/oz. Since our call has closed in on our price target, setbacks should be used to add new positions. Risk-seeking investors can opt for palladium, which should be in a deficit of almost 9% in 2013. With a 12-month forecast at USD 925/oz palladium offers a higher expected return, but with more risks.

Strategic (1–2 years)

- To protect investors' portfolios from unorthodox monetary policy measures, holding some gold exposure is a viable and attractive strategy to hedge against excessive fiscal spending and monetary debasement of the USD, EUR and JPY.

Short term oriented investors have reduced gold exposure, which could decline further

We expect gold futures positions to bottom out at 10 mn ounces by non-commercial accounts



Source: Bloomberg, UBS, as of February 2013

Note: Past performance is not an indication of future returns.



Brent (20 Feb): USD 115/bbl (last month: USD 111/bbl)

Brent six-month target: USD 110/bbl

UBS View (crude oil)

- Brent and WTI prices rose to their highest level since May and September 2012 respectively due to a combination of improving macroeconomic data, rising geopolitical tensions in the Middle East/North Africa (MENA) and reduced oil supply from OPEC-12 (-0.6 to -1.0mbpd in Jan13 vs. Nov12). Furthermore, speculative net-long positioning at NYMEX and ICE skyrocketed to record highs above 500mb. The crowded positioning holds the key for a firm price reversal, should the current positive sentiment turn.
- US petroleum oil demand declined by 2.5% y/y to 18.6mpbd in November 2012. Preliminary data for January showed further weakening to around 18.3mpbd. Despite improvements in US economic leading indicators, we expect US oil demand to remain largely stable, declining moderately by 0.1mbpd y/y in 1H13, and rising by 0.1mbpd y/y in 2H13.
- In China, tax changes should have incentivized higher refinery runs in 4Q12. This coupled with an ongoing inventory build-up suggests that actual end user demand might not be as strong as production data would suggest.
- We therefore expect global oil demand of only around 0.8 mbpd y/y in 1Q13. Further, the crude oil supply picture outside OPEC looks promising as well. In 2Q13 we expect crude oil production to increase by 1.1 mbpd y/y or more, thereby reducing the need for OPEC oil supply marginally. Thus, we stick to our negative price bias in the absent of a further escalation in the MENA region and target a price drop to USD 105/bbl for Brent in 1Q13.

➤ Positive scenario

Brent six-month target: USD 140–185/bbl

- Iranian oil exports are subject to a complete embargo, draining another 0.75–1 mbpd out of global crude oil supply. Alternatively, a military confrontation affecting the supply of crude oil via the Strait of Hormuz would be the ultimate supply shock and require crude oil to be rationed on a large scale.

➤ Negative scenario

Brent six-month target: USD 75–80/bbl

- Economic activity in the Eurozone does not stabilize and raises break up concerns, which would lead to meaningful weaknesses in global trade and crude oil consumption. A restoration of Iranian exports and a sharp increase in US tight oil production would push oil inventories up firmly and weaken Brent prices towards USD 80/bbl.

What we're watching

Why it matters

Middle Eastern tensions

Iran's nuclear ambitions could escalate after the ultimatum from the US and Israel expires in 1Q13 with no visible changes. Further implemented US sanctions on Iran could reduce Iran's exports in the next months. We also track the crude oil flows in MENA countries.

Supply

Non-OPEC supply should rise driven by higher US and Canadian oil supply in 2013. Saudi production levels are likely to stabilize at levels slightly above 9mbpd, keeping OPEC production above the "call on OPEC" in 1H13.

Demand

One-off factors have supported Chinese crude oil demand in 4Q12, likely to weigh on demand in 1Q13. Improving economic indicators should support demand from 2Q13 onwards.

Oil market reports

Key dates: 12 Mar, EIA Short-term energy outlook; 13 Mar, IEA Oil market report

Recommendations

Tactical (six months)

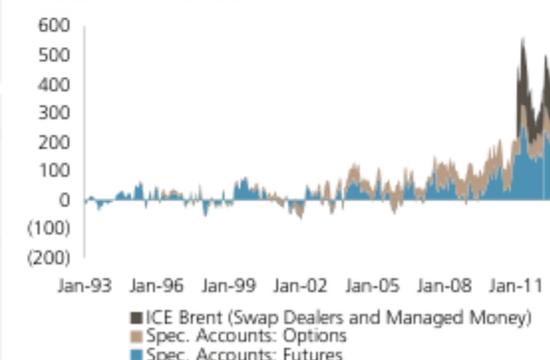
- With OPEC in a good position to balance the oil market and demand likely to pick up at the end of 1H13 and into 2H13, price setbacks in 1Q13 should be used to build up some longs at or below USD 105/bbl for Brent. Stronger oil consumption than envisaged by markets in the latter part of 2013 makes the oil market more vulnerable to geopolitical concerns as OPEC needs to step up crude oil production.

Strategic (3–5 years)

- To satisfy emerging market demand in the long run, long dated crude oil prices around USD 90–95/bbl are unlikely to secure the needed investments to keep supply growing. This gives strategically oriented crude oil investors the opportunity to build up some long-term crude oil exposure over the next three to five years.

Financial investors are heavily positioned

Values in mn barrels



Source: Bloomberg, UBS, as of February 2013

Note: Past performance is not an indication of future returns.



Current (20 Feb) (last month): **Copper USD 7,960/mt** (7,963); **Nickel USD 17,170/mt** (17,190); **Aluminum USD 2,065/mt** (2,015)

UBS View

Six-month target: Copper: USD 8,800/mt; Nickel: USD 20,500/mt; Aluminum: USD 2,250/mt

- Improved economic prospects have rendered some support to base metal prices in early 2013. That said, recent price advances have largely been driven by optimism in broader markets and to a lesser degree by specific base metal fundamentals. Lingering concerns over stronger supply growth, higher levels of inventory and rather sluggish physical demand until now have hindered prices from taking off.
- Nevertheless, a more pronounced acceleration in industrial activity should provide the necessary base for a true demand pickup on the metal side. And here the focus falls on China, which holds the key in providing the needed stimulus for base metal prices to appreciate another 10% over the next 3-6 months.
- Leading indicators for China, credit activity and corporate earns data are giving promising signals for fixed asset investments and industrial activity after Chinese New Year. While some Chinese figures might be distorted due to the last year's Chinese New Year, an uplift in activity should be underway. Combined with a seasonal increase in EM base metal demand and a lower demand drag from Europe, global inventories should start to come under pressure.
- Copper and aluminium, the two heavy weights when it comes to sector indices, are likely to appreciate modestly but should see steady price advances. Mine supply growth in copper should expand 6% yoy in 2013 and ample production capacities in aluminum together with high physical premiums provide a firm supply backdrop. More strength is expected from "smaller" metals like zinc and nickel where demand swings by China and supply challenges with regards to refining activity or new mine additions hold the key to stronger price swings.

Positive scenario

- China eases monetary policy aggressively, thereby allowing money growth to reach 20% y/y in 2013. Central banks and politicians stabilize economic growth in Europe and provide a lift to US industrial activity.

Negative scenario

- Chinese authorities act too passively by keeping GDP growth on a constant deceleration path. An escalation of the Eurozone crisis or a military confrontation in the Strait of Hormuz could affect global trade and metal prices severely.

Upside potential for the sector: + 20%

Downside potential for the sector: - 25%

What we're watching

Demand

Why it matters

- Hard economic data (IP and FAI) from China has yet to confirm a pick up in metal demand, suggested by leading indicators and financing conditions in January.
- Better PMI readings from Europe as well as political risk events related to the region
- Export activity of copper by Chile and Peru should be tracked closely in order to gauge the expected improvements in supply. Moreover, we like to have a close eye on treatment charges for zinc, as it will define the recovery in Chinese zinc output. And for nickel we focus on Chinese NPI production and supply disruptions of new nickel projects.

Supply

Economic data

Key dates: 1-3 Mar, Chinese / US leading indicators; 9 Mar, Chinese IP and FAI data

Recommendations

Tactical (six months)

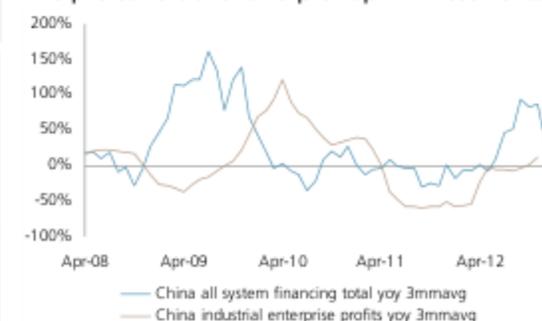
- We see room for higher base metal prices over the next 3-6 months. The return potential on a sector level should be 10% with an expected volatility of around 15% (UBS CMCI Industrial Metals). The key drivers behind this call root on stronger Chinese industrial activity and a general pull in EM metal consumption starting March. The pick up in demand should be visible in lower LME warehouse inventories.

Strategic (two years)

- One of the strongest price performers over the next two years could be zinc, as mine supply tops out due to ageing mines in 2014/15. In order to compensate for mine closures and structurally higher demand, new zinc mine capacity will be needed. At current price levels we are unlikely to see this expansion in supply. Hence we see prices trending towards USD 2,750/mt in the long run.

A pick up in Chinese metal demand expected

The pre conditions for a pick up in investments



Source: Bloomberg, UBS, as of February 2013

Note: Past performance is not an indication of future returns.



Current (20 Feb) (last month): **Soybeans, USD 14.63/bu** (14.14); **Corn, USD 6.90/bu** (7.31); **Wheat, USD 7.40/bu** (7.83)

UBS View

Six-month target: Soybeans, USD 12.8/bu; Corn, USD 6.2/bu; Wheat, USD 6.95/bu

- Despite two consecutive quarterly grains reports showing lower inventory levels, grains prices were not able to rise back to levels seen during mid-2012. Beside the lack of supply disappointments as of late, the market has started to focus more on South America's solid crop prospects for the grains in the coming months. Even prevailing weather concerns related to Argentina's crop prospects failed motivate higher price until now.
- For corn, some demand weakness is still required to secure minimal inventories for the start of the upcoming marketing year. Thus, there is still scope for higher corn prices towards USD 8/bu in the near term before the US harvest kicks in. In the case of soybeans, a solid increase in South American output within the next 2-3 months should ease supply concerns, push global inventories meaningfully up and weigh on prices. Additional upward pressure on inventories and downward pressure on prices should come with a 92mn ton soybean harvest in the US. And lastly wheat, better supply prospects outside the US (India, Europe) and a lack of demand particularly for US exports should lead to further price downside 1H 13. That said inventories in wheat are likely to increase the least in 2013/14.
- The poor performance of softs in 2012 partially continued in January this year. We think the severe price weakness in 2012 should have cut into investment activity, which should allow market surpluses to fade over the next 6-12 months. At the same time prices are likely to bottom out during 1H13. Our top choice is a long position in sugar.

➤ Positive scenario

Corn six-month USD 10/bu; Soybeans six-month USD 19/bu

- Downward revisions to South America's harvest would require additional demand rationing and lead to higher prices. Poor soil moisture in the US could potentially undermine yield prospects for the grains in the coming quarters.

➤ Negative scenario

Corn six-month USD 6/bu; Soybeans six-month USD 12.5/bu

- Higher-than-expected South American crop and US export slowdown. Strong supply outlook for next year's crop due to higher acreage and normalizing yields.

What we're watching

USDA WASDE report (monthly)

Why it matters

The March WASDE report will focus on South American crop and US grains demand. Since there was no downward revision in Argentine wheat output; we can expect some supply cuts in wheat and further downward revisions in corn output. **Key date: 8 Mar**

US grains stock report (quarterly)

Since the latest stock quarterly report has shown less demand rationing than expected; demand during Dec'12-Feb'13 is likely to be higher as well. **Key date: 28 Mar**

Prospective planting report (Annual)

Prospective planting report should provide guidance for all grains planting acreage. Corn and soybeans acreage will be crucial to watch. **Key Date: 28 Mar**

COT (weekly, Friday)

Investors' net-long positions in grain futures remain stable at high levels.

Recommendations

Tactical

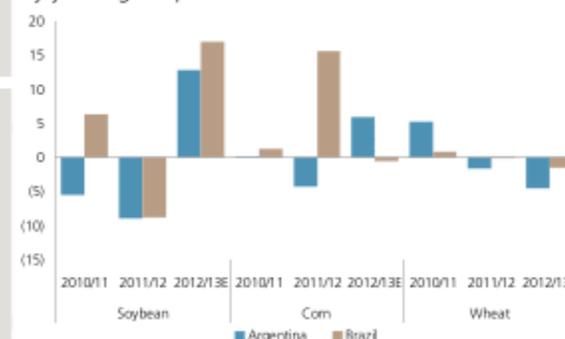
- Investor with existing corn positions should still hold on to their longs over the next month. Demand rationing is still required to limit the drag on inventories in the short run. The expected upside potential for such a position is limited at around 10%.

Strategic

- Our expected return outlook for the grains stands at around -7 % over the next 12 months. With grain prices at elevated levels from an historical standpoint, the supply side is very likely to expand considerably in 2013/14 and pressurize prices over the next 6-12 months. Hence, we recommend no long positions over a 12-month horizon.

Soybean will be the most relieved grain from South America's upcoming harvest

y/y change in production – Values in mn tons



Source: USDA, UBS, as of February 2013

Note: Past performance is not an indication of future returns.

UBS Global Index DTR (20 Feb): 1,660 (last month: 1,619)

UBS Global Index DTR (six-month target): 1,680

UBS View

- In the current environment we continue to recommend a neutral stance. Listed real estate's valuation is slightly expensive versus equities whereas it offers a favorable valuation relative to corporate bonds. Yet, we continue to see low financing costs, low supply and a good yield pick-up relative to corporate bonds as REITs are expected to continue to grow their dividend yield payout in 2013.
- Loose monetary policies in the developed world are keeping refinancing rates low, providing cheap financing for REITs and supporting ongoing slight value appreciation. We see evidence of listed real estate companies refinancing their debt at lower yields and with longer durations. The global supply is still comparatively low. Slightly improved leasing activities should help rents to increase slightly. Global REITs offer a good yield pick-up relative to IG corporate credit across all major markets.
- We maintain our preference for Asia over the UK on valuation and over Continental Europe, where market fundamentals are still comparatively weak and rental growth is at risk despite the fact that tail risks have diminished. The Hong Kong and Singapore governments continue to fight the overheating residential property markets by various measures that should affect developers, while Chinese developers expect an ongoing rebound in markets.

➤ Positive scenario

- Ongoing reflationary monetary policies across the world push investors towards risky assets and the expectation of an increase in inflation favors real estate as an inflation hedge, while attracting more loss-making bond investors. Real estate provides a good exposure to the recovery with a beta over 1.

➤ Negative scenario

- Global growth rates disappoint investor expectations and new recession risks trigger a tightening of credit standards that would cut real estate companies from the capital market, making listed real estate more dependent on bank financing. Real estate underperforms global equities.

UBS Global Index DTR (six-month target): 1,760

UBS Global Index DTR (six-month target): 1,400

Note: Scenarios refer to global economic scenarios (see slide 8).

What we're watching

Global transaction volumes and rental growth in direct markets

Capitalization rates and rental yields

Credit markets and financing costs

Why it matters

Global real estate markets delivered around USD 440 billion in commercial transactions in 2012. Volumes should reach USD 500 billion in 2013, with upside in Asia and in the best secondary US markets. Increased optimism translates into renewed growth in leasing activities with modest prime rent increases by 2–3%. A shortage of high quality and low levels of construction support a decreasing office vacancy rate to below 13%.

We do expect capitalization rates to stay supportive at low levels or to only slightly decrease. Rental yields have already been pushed down by decreasing bond yields but they remain favorable compared to history. A flat interest curve continues to help long-term refinancing in a low-growth environment despite the recent upturn in rates.

Lending conditions are still challenging for developers and private investors, which is supportive for public companies that have very good access to credit and capital.

Recommendations

Tactical (six months)

- We continue to recommend to hold global listed real estate at benchmark. Yield gaps still speak in favor of the asset class against bonds, whereas the asset class is slightly expensive relative to equities. Another supportive factor is the current low interest rate and low growth environment along with strong earnings stability and income visibility. We maintain an Asian bias and are slightly underweight in UK and continental Europe based on soft fundamentals.

Strategic (1–2 years)

- The asset class is expected to deliver comparatively solid return on investment. Refinancing conditions are supportive and we expect gradually higher payout ratios coupled with portfolio optimizations. Balance sheets of listed companies are increasingly healthy. Weak economic growth and rightsizings limit rental income growth.

Our market preference (six months)

For listed real estate relative to global real estate*

Current most preferred	Current least preferred
Hong Kong Landlords	Continental Europe
Japan Property	UK
Japan REITs	
Australia	

* This is our relative preference within the global real estate markets based on UBS Global Real Estate Index domestic total return, which is not the overall sector view

Source: UBS, as of 7 February 2013

Note: Past performance is not an indication of future returns.

Hedge funds

UBS view

- HF managers attempt to capture most of the upside of risky assets while limiting drawdown. Capital protection is crucial to the process as large losses are detrimental to the rate at which capital compounds. Some HF strategies have shown to be less tied to stocks and bonds, offering important diversification in times of equity distress and rising interest rates.
- The recovery of the US housing market and cyclical upswings in most regions, with China and the rest of Asia rebounding strongly, are now underway. These trends benefit **equity long/short**, notably net long. Falling intra-stock correlations add to the positive environment for bottom-up fundamental equity long/short strategies.
- **For relative value**, the stable macroeconomic backdrop supports (non-treasury) spread products such as corporate bonds, emerging markets and securitized products (e.g. residential mortgage-backed securities). Long/ short credit managers could allocate away from duration-sensitive products over time into securities not tied to the interest rate cycle. Market participant numbers have declined significantly following the adoption of the Volcker rule, which forced firms to exit from proprietary trading desks conducive to fixed income arbitrage strategies.

Prefer relative value and equity long/short

➤ Positive scenario

- Robust economies should drive up risky assets, including equities, lower intra-stock correlation and volatility, and boost the ██████ cycle. These developments should help bottom-up fundamental strategies such as equity long/short and event-driven managers the most.

Prefer equity long/short and event-driven

⚡ Negative scenario

- Short-term reversals due to central bank interventions and stimulus effects continue to plague the market – an obstacle for trend-following managers. Still, unmanaged European deleveraging (or the US fiscal deficit) could threaten risky assets. Trading can do well if such a scenario unfolds.

Prefer trading (Global Macro + CTA)

Note: Scenarios refer to global economic scenarios (see slide 8).

What we're watching

Global equity direction/
economic cycle

Correlation

Leverage

Volatility

Liquidity

Regulation

Why it matters

The outlook for global equities is an important HF performance driver. The economic cycle affects strategies differently.

Correlation is an important performance/alpha driver for equity long/short, the primary HF strategy by assets under management.

Gross and net leverage are key to monitoring risk.

The direction influences certain HF strategies (e.g. convertible arbitrage).

Important in particular for large, less nimble HFs, as it enables them to enter and exit their strategies.

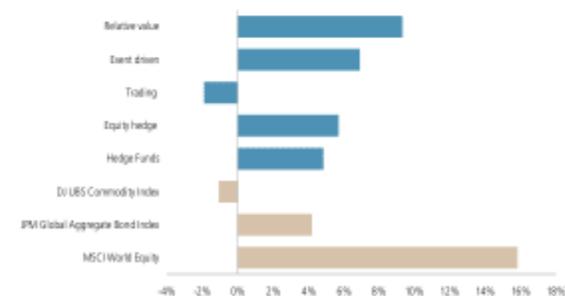
Volcker rule, USCITS III/IV

Recommendations

Strategic (1–2 years)

- **Recommendation:** We recommend equity long/short and relative value strategies. We are becoming more positive about global equities with intra-stock correlations falling, an environment conducive to equity long/short strategies. The stable macro economic backdrop and diminishing competition from bank propriety traders help relative-value arbitrageurs.
- **Value proposition:** Hedge funds should achieve robust performance over an extended horizon while displaying limited volatility vis-à-vis equities and other risky assets. Hedge funds try to minimize downside losses in adverse market conditions (through active risk management), which plays a crucial role in wealth appreciation. Similarly, hedge fund managers attempt to capture most of the upside of risky assets owing to a valid value proposition.

Performance, comparison



Source: HFRI, Bloomberg, as of 31 December 2012

Note: Past performance is not an indication of future returns.



Private equity

Prefer small-/mid-cap buyouts in US/emerging markets; distressed debt in Europe

UBS View

- Global volume has continued its downward trend since 2010, down 3% on 2011, and still a heavy 41% below the peak achieved in 2007. However, H2 2012 was up 13% vs. H1, driven by a strong fourth quarter, the highest figure in two years, showing improved confidence for deal makers. Private equity investors are also increasingly active again, with deal volumes in H2 2012 up 40% vs. the first half of the year. Exit activity also continues at a healthy pace, with diversified private equity investors obtaining attractive distributions from their mature portfolios.
- We prefer buyout strategies in North America, given reasonable valuations, liquid debt markets and our house view of economic outperformance vs. Europe. Emerging markets offer compelling opportunities for PE investors, especially outside the main hubs (China, Brazil), which have become expensive. Direct lending to companies is also attractive in Europe, where debt markets are less liquid and still dominated by banks.

➤ Positive scenario

- An abating Eurozone debt crisis and improved business confidence would increase deal flow and exit opportunities for private equity managers, but would also increase entry prices. In such a positive scenario, we would perceive commitment strategies to secondary funds as attractive for building exposure to an invested private equity portfolio.

➤ Negative scenario

- A renewed escalation of the debt crisis would significantly impact deal activity, the availability of debt and company owners' willingness to sell. At the same time, it would offer even more attractive opportunities within distressed strategies and lower entry prices for long-term private equity investors.

Note: Scenarios refer to global economic scenarios (see slide 8).

Prefer small-/mid-cap buyout and secondaries

Prefer distressed debt

What we're watching

Why it matters

Credit markets

In 2012, leveraged loan issuance, an important ingredient of PE activity, grew 34% y/y in the US, but fell by more than 34% in Europe. The US debt market is much deeper than Europe's, raising over EUR 360bn of leveraged debt while Europe raised only EUR 29bn with more restrictive debt structures.

Exit activity

Exit activity is an important indicator of the health of the PE market and a key return driver for investors. Despite the difficult macro environment, 4Q 2012 distributions from portfolio sales (USD 73bn) have held up, and grew >65% yoy.

Prices for LBOs

Average purchase prices for new buyouts in the US are at 8.3x EBITDA (full-year 2012 figures), in line with the 10-year average (8.2x); Europe is more expensive (9.3x), 5% above 2011 and 10% above the 10-year average (8.5x).

Recommendations

Strategic (1–2 years)

- The current economic environment that includes global deleveraging, banking disintermediation in Europe and emerging market growth offers attractive opportunities for illiquid private equity strategies.

Private equity preferences

- Global **private equity secondaries** to capitalize on regulation-driven sales by banks and insurance companies at attractive discounts of 15–20% to net asset value.
- **Direct lending** to companies in Europe, where debt markets are less liquid than in the US and still dominated by banks, which are reducing lending.
- **Growth and buyout capital** in emerging markets, to access superior growth and attractive consumer dynamics.
- Within real assets, we like **opportunistic strategies** in US real estate and lending strategies within European commercial real estate, which are attractive as banks shrink their loan portfolios.

Investment preferences (new PE commitment strategies)

Current most preferred strategies

Current least preferred strategies

Secondaries (global)

Large-cap buyout (Europe)

Direct lending (Europe)

Venture capital (Europe)

Small-cap buyout (Latin America, South-East Asia)



For further information please contact CIO asset class specialist Stefan Brägger, [redacted]

Please see important disclaimer and disclosures at the end of the document. 42

Note: We emphasize the equal importance of fund manager selection and the commitment strategy. Please note that private equity is an illiquid asset class and must be held at least until the end of the fund (10+ years). Please note that UBS might not have a product available which reflects our UBS CIO private equity recommendations. Private equity is only suitable for qualified investors (> USD 5m investable assets).

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