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CIO WM Global Investment Office

CIO monthly video

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For smartphone users: scan the code with an app like "scan"

UBS CIO Monthly Extended

November 2012

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Section 1

Base slides

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Summary

"Global growth is showing broad-based signs of improvement."

- **Economy**
  Global growth is showing broad-based signs of improvement, supported by decisive monetary policy from the world's major central banks. In the US, the housing market recovery continues and the labor market remains on a modest uptrend. This has helped improve the sentiment of US consumers, and consumption remains the most important contributor to US GDP growth. Growth has also begun to pick up in key areas of the emerging markets, including China and Brazil. While the Eurozone economy remains weak, we expect Q3 2012 to mark the bottom, and that growth will begin to get "less bad" from Q4 2012.
- **Equities**
  Equity markets have been supported by central bank action and the recent improvements in economic data. Our preferred markets remain the US and Emerging Markets (EM). Investor funds have started to flow back into EM, as economic data is improving and inflation remains under control. Canada and Australia remain our least favored regions due to falling earnings.
- **Fixed Income**
  US high yield bonds remain supported by strong corporate fundamentals, modest economic growth, and the broad demand for yield-generating assets. Given this, we see potential for further spread tightening. Meanwhile, benchmark rates are expected to rise gradually on better economic data, while short rates remain ultra-low. While investment grade corporate bond spreads are approximately fair value, we continue to view their absolute yields as attractive.
- **Commodities**
  We keep a neutral stance on commodities. Increased global liquidity has pushed prices up over the last few months, however, for a more sustained price increase we likely need to see further evidence of an acceleration in global growth.
- **Foreign Exchange**
  We remain underweight the Japanese yen. The Japanese economy continues to weaken against its peers, leading to rising pressure for the Bank of Japan to engage in further quantitative easing. We have closed our preference for the Canadian dollar following its recent strength, and therefore close our offsetting short CHF position.

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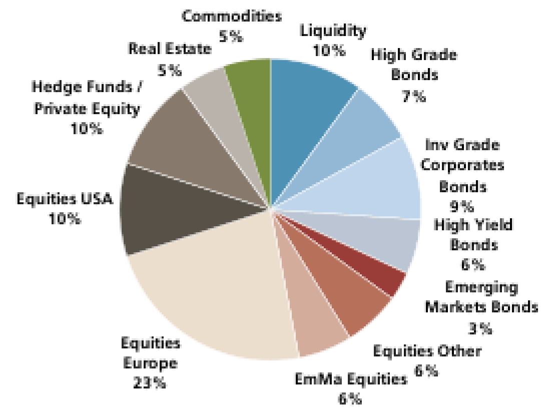
Cross-asset preferences

	Most preferred	Least preferred
Equities	• US • Western winners from EM growth • High quality dividend yields • Event-driven and relative value hedge funds • Natural gas growth gainers	• Canada • Australia
Fixed income	• US high yield • Global investment grade credit • EM corporate bonds • Event-driven and relative value hedge funds	• Developed market government bonds
Foreign exchange	• GBP • Emerging markets (↗)	• JPY
Commodities		

Portfolio weights



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

↗ Recent upgrades ↘ Recent downgrades

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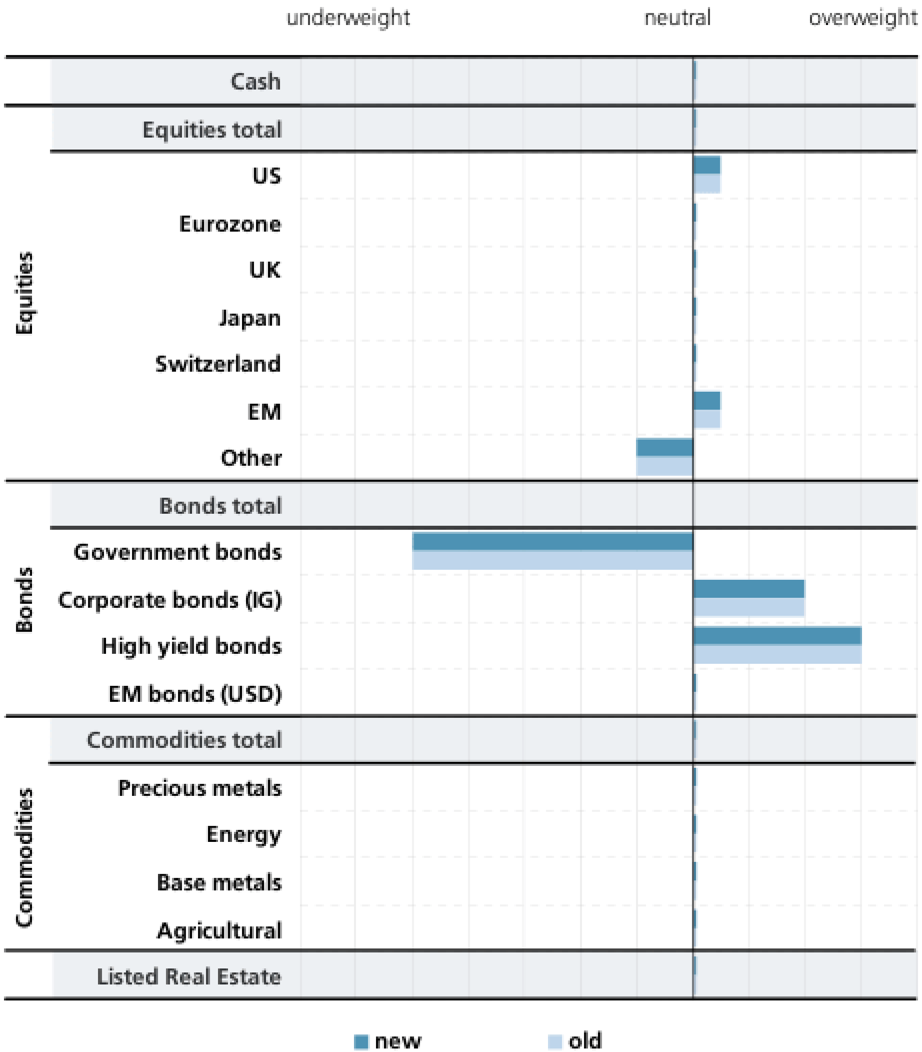
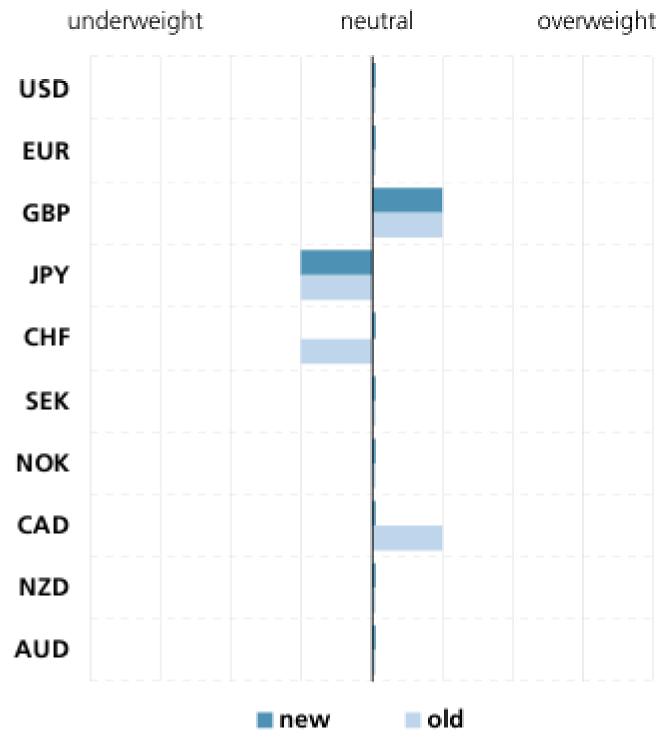
Recommended tactical asset allocation

Tactical asset allocation deviations from benchmark*



Source: UBS CIO WM Global Investment Office – as of 25.10.2012

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 slightly deviate from the "unconstrained" asset allocation shown above, depending on benchmarks, currency positions and for other implementation considerations.

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Preferred themes

- **High quality dividend yields (sourced from existing European and UK equities)**
  High quality companies with geographically diversified business models that pay sustainable dividends offer an attractive income stream in a low yield world. Historically, dividends have made a substantial contribution to total returns, and we expect this to remain the case in the current environment.

- **Western winners from emerging market growth (sourced from existing equity holdings)**
  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 to outpace 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.

- **Natural gas growth gainers (sourced from existing equity holdings)**
  Natural gas is a relatively clean source of energy, and we think it will benefit from continued substitution for other energy sources over the long term. We have examined the dynamics of the global market and the various components of the gas value chain, and identified the areas we see as the most significant beneficiaries currently. These include producers in Europe and Asia, suppliers of infrastructure, services and related machinery, and Master Limited Partnerships (MLPs) in the US, that offer both attractive yields and growth.

- **EM corporates: a growing asset class (sourced from global government bonds – CIO UW)**
  Given our relatively constructive current view on risk, we regard EM corporate debt as more attractive than EM sovereign debt due to its higher overall yield. Over a 6-month horizon, we expect EM corporate bonds to outperform US Treasuries and deliver total returns of close to 4%.

- **Government bond alternatives (sourced from government bonds – CIO UW)**
  Developed world government bonds offer a comparatively small cushion against future interest rate hikes and many face increasing credit risk. We expect selected bonds of supranational or national agencies, sub-national governments, multinational corporates, and covered bonds to outperform government bonds. We recommend switching out of government bonds into these alternatives.

- **US high yield corporate bonds (sourced from government bonds – CIO UW)**
  Positive economic growth, robust corporate earnings and healthy balance sheets provide support to US high yield corporate bonds. Current yield spreads of 540 basis points still price in a more dire economic outcome than we expect. Historically, US high yield bonds have delivered similar returns as US equities with lower volatility. We continue to believe that US high yield corporate bonds represent a more favorable risk/return potential than equities and expect mid single digit returns over the next 6 months. Senior loans are exposed to similar positive fundamentals, and offer an attractive, floating rate alternative to US high yield.

- **The place to be in Hedge Funds**
  Growth in most developed markets remains muted. In this environment, less directional hedge fund strategies, such as relative value and event driven, should offer above average returns.

- **EM currencies: An underappreciated asset class (sourced from government bonds – CIO UW)** ★
  The currencies of emerging 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.

★ = New theme

Global economic outlook – *Summary*

Key questions
- What are the prospects for the global economy in 4Q 2012 and 1Q 2013?
- What are the risks that the US economic recovery will falter in the near term?
- When is the European economy likely to emerge from contraction?
- What is the near-term outlook for the Chinese economy?

CIO View (Probability: 75%*) **Sluggish expansion**

• Global economic activity has shown signs of improvement over the last month – albeit from a low base. Importantly, the JPM global composite PMI (a survey measuring economic activity) rose significantly to 52.5 in September from 50.9 in August. The increase was driven by improvements in both manufacturing and service sector activity. Thus, the global manufacturing PMI rose marginally to 48.9 from 48.1, while the services PMI jumped two index points to 54.
• Geographically, improvements were concentrated in the emerging markets and the US. Indeed, we think that downside risks in the US have diminished lately and we expect the moderate recovery to continue ahead. Chinese data are still mixed, but we think that an improvement in the economic momentum is in the cards in 4Q. In the EMU and UK, recent PMI surveys deteriorated but we still expect the EMU to improve gradually in coming quarters. Overall, we expect the moderate improvement in global economic activity to continue ahead. A key driver here is the latest wave of ultra-expansionary monetary policy. Downside risks have diminished somewhat in recent months. We expect Greece to stay in the euro this year and sign a new memorandum in November. In the US modest fiscal tightening is expected with the Fed mitigating downside growth risks. The risk of an idiosyncratic slowdown in Asia has declined as the latest Chinese data confirms that the economy has bottomed."
• Global consumer price inflation peaked in summer 2011 and has since fallen gradually. Base effects and rising commodity prices since June may push up the global headline rate of inflation in coming months.

↗ **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 by early 2013 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 sharp fiscal contraction in the US, and 3) a sharp deceleration of the Chinese economy. Each of these risks could precipitate a significant downturn of the global economy.

Key dates	
TBA	Troika report on Greece
2 Nov	Nonfarm payrolls and unemployment rate for October
6 Nov	US presidential and congressional elections
8 Nov	The 18th National Congress of the Communist Party of China
22–23 Nov	European Council

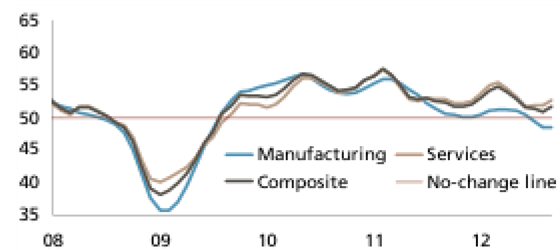
Global growth expected to be around 3% in 2012 and 2013

		Real GDP growth in %			Inflation in %		
		2011	2012F	2013F	2011	2012F	2013F
Americas	US	1.8	2.1	2.3	3.1	2.1	1.7
	Canada	2.4	2.0	2.3	2.9	2.0	2.3
	Brazil	2.7	1.5	4.5	6.5	5.4	6.5
Asia/Pacific	Japan	-0.8	2.3	2.0	-0.3	0.0	0.3
	Australia	2.1	3.7	3.2	3.4	1.7	2.5
	China	9.3	7.5	7.8	5.4	2.8	3.6
	India	6.5	5.5	6.5	8.0	7.5	7.0
Europe	Eurozone	1.5	-0.4	0.2	2.7	2.4	1.9
	Germany	3.1	0.9	1.1	2.5	1.7	1.5
	France	1.7	0.2	0.4	2.1	2.0	1.3
	Italy	0.5	-2.4	-0.2	2.9	3.3	2.7
	Spain	0.4	-1.6	-1.7	3.1	2.4	2.7
	UK	0.9	-0.3	1.0	4.5	2.7	2.3
	Switzerland	1.9	1.1	1.4	0.2	-0.5	1.2
	Russia	4.3	3.8	3.7	8.5	5.1	6.8
World		3.2	2.7	3.1	3.9	2.9	3.0

Source: UBS CIO, as of 24 October 2012

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, 3-month moving averages)



Source: Bloomberg, UBS CIO, as of September 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 questions
- What do we expect from the economy and ECB policy?
- Can Spain and Italy continue to tap the primary market if they ask for a support program?
- How much more support will Greece receive and will it be able to stay in the Eurozone next year?

CIO View (Probability: 70%*) **Austerity and weak growth**

• We think the Eurozone economy troughed in 3Q. We expect flattish growth in 4Q 2012 and 1Q 2013 (in line with consensus). Beyond this, uncertainties regarding the debt crisis and continuing fiscal austerity efforts will likely keep the pace of recovery subdued. The ECB is still in easing mode but after announcing a conditional bond purchasing program, it would take a marked worsening of the debt crisis and/or a worsening of economic data to trigger any further policy action.

• There is political pressure on Spain to apply for official financial support (OMT by the ECB and direct support from the EFSF/ESM). However, the government may hesitate until market pressure rises and/or clear political benefits are on offer. We think that Italy will have to apply for an aid package similar to Spain's. We see a high probability of Spain being downgraded to junk by at least one rating agency.

• OMT bond purchases in the secondary market will focus on maturities of up to three years and countries will be expected to maintain their funding profiles by also issuing longer-dated bonds. Hence, longer yields should stay elevated as bondholders remain concerned about countries' ability and willingness to implement necessary reforms, and about the de-facto subordination to ECB holdings and official loans. The central banking supervision at the ECB is unlikely to be ready by January 2013, meaning that direct bank recapitalization through the ESM remains unavailable.

• We think Greece will not exit the euro in 2012 but will sign a new memorandum by November, although further delay is possible. We think that Greece's failure to meet targets may trigger a cut-off from funding by early 2013 and a possible gradual exit later. Portugal and Ireland should remain on track with their bailout packages, Cyprus will likely get a new package and Slovenia may ask for help soon.

↗ **Positive scenario (Probability: 15%*)** **Return to macro stability**

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

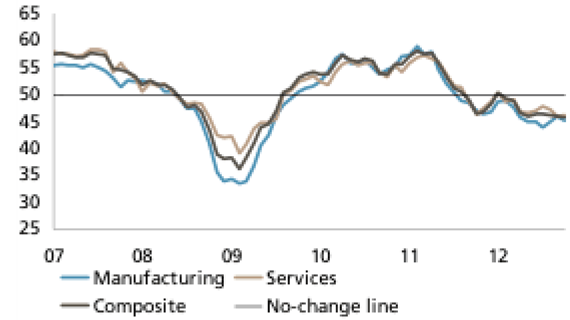
↘ **Negative scenario (Probability: 15%*)** **Major shock**

• Major shocks include Spain and Italy being fully cut off from bond markets, i.e. requiring all new funding through EFSF/ESM/IMF loans, with European rescue funds only able to cover them until the end of 2013; resistance from core countries against the ECB program and further support; a Portuguese default; a Greek euro exit before the end of 2012; or a major external shock.

Key dates

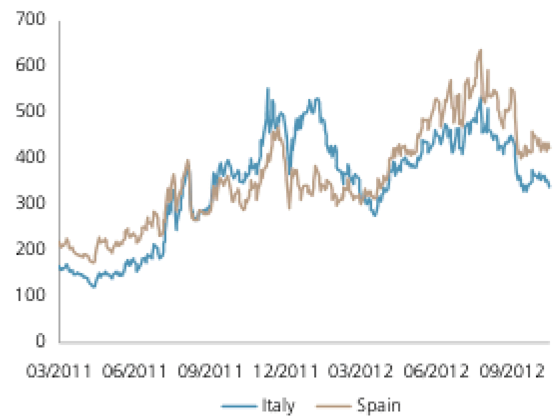
TBD	Troika report on Greece
8 Nov	ECB press conference
12 Nov	Eurogroup meeting
15 Nov	Eurozone GDP 3Q: first estimate
22 Nov	Eurozone composite purchasing managers index
22–23 Nov	European Council

Purchasing managers indices point to ongoing contraction in 3Q



Source: Bloomberg, UBS, as of October 2012

Yield of Spanish and Italian 10-year bonds over German Bunds (in bps)



Source: UBS, Bloomberg, as of 16 October 2012

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

* Scenario probabilities are based on qualitative assessment.

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

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Key financial market driver 2 – *US economic outlook*

Key questions

- Is the nascent growth recovery sustainable? Will the Fed stimulus boost growth?
- How will the election result change fiscal policy deliberations?
- Can politicians find an agreement to avoid a sharp fiscal contraction in early 2013 (i.e. the "fiscal cliff")?

CIO View (Probability: 70%*) **Moderate expansion**

• The economy stays on a moderate growth path but the unemployment rate comes down only very gradually – the September report exaggerated the pace of improvement. Core personal consumption expenditure (PCE) inflation stays slightly below or close to the Federal Reserve's target of 2%. UBS forecasts real GDP growth of 2.0% in 3Q 2012 (consensus: 1.8%) and 1.6% in 4Q 2012 (consensus: 1.9%). The Fed has added considerable stimulus: it extended Operation Twist and its interest rate forward guidance, indicated that it will stay highly accommodative even after the recovery strengthens, launched an open-ended agency mortgage-backed securities (MBS) purchase program of USD 40bn per month, and shows a strong easing bias tied to the state of the labor market. The Fed actions effectively mitigate downside growth risks, but they are unlikely to dramatically boost growth.

• In the elections, Republicans will likely lose seats in the House on a net basis but retain a majority; we expect them to be even with Democrats in the Senate. Obama will likely retain the White House. Such an electoral outcome would prolong the existing gridlock between Republicans and Democrats.

• Due to the ongoing political gridlock, we expect modest fiscal tightening. The government will likely let unemployment benefits phase out and payroll tax cuts expire, but postpone income tax hikes and sequester spending cuts. Such a decision would lower the federal deficit by 0.7% of GDP, with a likely lower real GDP growth impact as households could buffer the income loss with lower savings.

↗ Positive scenario (Probability: 10%*) **Strong expansion**

• Propelled by expansive monetary policy and a fading Eurozone crisis, growth accelerates persistently above 3.0%. This leads to higher inflation and the Fed responds by halting QE3 and raising rates sooner.

• The better economic outlook raises the odds of an Obama reelection and makes it harder for Republicans to gain seats in Congress. Faster-rising tax collection and a Democratic stronghold leads to some tax hikes and limited spending cuts. Fiscal policy tightens by about 1.2% of GDP in 2013.

↘ Negative scenario (Probability: 20%*) **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 much further. The Fed massively purchases agency MBS and Treasuries under its QE3 program.

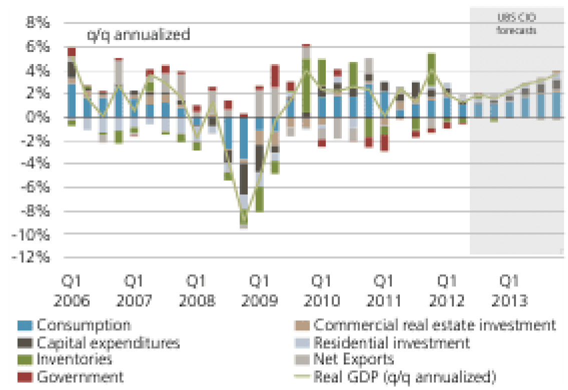
• The debt limit is reached earlier and the Treasury runs out of money before year-end. Political gridlock becomes dysfunctional, thus sending the country over the "fiscal cliff," with fiscal policy tightening by USD 607 billion (3.7% of UBS estimate of 2013 GDP) in 2013. The US credit rating is downgraded.

Key dates

30 Oct	Conference Board consumer confidence
1 Nov	ISM manufacturing purchasing managers index for October
2 Nov	Nonfarm payrolls and unemployment rate for October
6 Nov	US presidential and Congressional elections

US growth to pick up throughout 2013

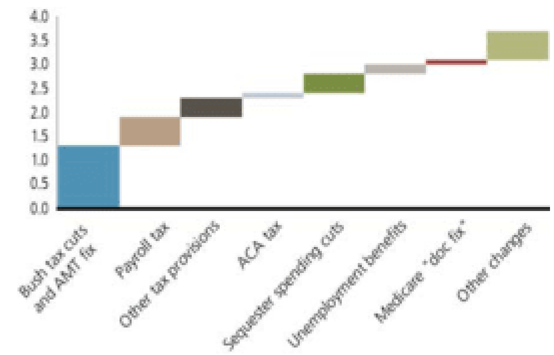
US real GDP and its components, quarter-over-quarter annualized in %



Source: Thomson Datastream, UBS, as of 15 October 2012

Budget impact of US fiscal cliff in 2013

Cumulative budget effects of fiscal cliff components, in % of UBS estimate of 2013 GDP



Note: AMT = Alternative Minimum Tax, ACA = Affordable Care Act

Source: CBO, UBS, as of 9 October 2012

* Scenario probabilities are based on qualitative assessment.

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

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For further information please contact US economist Thomas Berner, [redacted]

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

Key financial market driver 3 – *China growth outlook*

Key questions
- What are the drivers for a modest sequential growth recovery?
- What is our policy expectation?
- How strongly will the recently announced infrastructure projects boost growth?

CIO View (Probability: 70%*) **Stabilization in economic momentum**

• We continue to expect a sequential recovery in the growth momentum in the current quarter. Inventory reductions should be less of a drag on growth and the government is rolling out more investment plans. At the same time, political uncertainty should diminish after the power handover in November. We think that real GDP will grow 7% y/y in 4Q (consensus: 7.7%) before improving mildly to 7.3% in 1Q 2013 (consensus: 7.9%).

• Indicators measuring inventory levels have fallen recently, showing that the destocking cycle is well advanced. In addition, domestic prices for some major raw materials appear to have bottomed out, which should support a mild rebound in production activity in the coming months. However, this may not be sustainable without a genuine recovery in final demand.

• While the government has recently announced trillions of infrastructure investment projects, the spending will span several years and the source of funding remains unclear. In addition, real estate investment growth is likely to stabilize but not rebound strongly in the months ahead. We therefore do not expect a sharp rise in investment growth. Fiscal support measures should help to stabilize economic growth, but are unlikely to result in a strong growth boost.

• The 18th National Congress of the Communist Party of China will be held on 8 November, which is exactly the same date as in the previous leadership handover in 2002. With the transition of the senior Communist Party leadership taking place in this meeting, political uncertainties should be reduced. Execution of policy easing measures could improve, although a substantial new stimulus is unlikely in the near term. In terms of monetary policy, we do not expect any interest rate cut for the rest of the year, but a reserve requirement cut is still possible to manage liquidity.

↗ **Positive scenario (Probability: 20%*)** **Higher-than-expected growth**

• Chinese GDP grows above 7.7% in 2012. This would require more effective fiscal and monetary policy support from the government and possibly also a fast improvement in the Eurozone debt crisis.

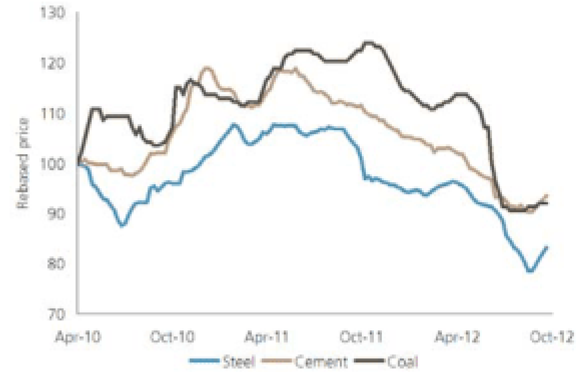
↘ **Negative scenario (Probability: 10%*)** **Hard landing**

• Chinese GDP grows below 6%, i.e. a hard landing of the economy. This could be triggered by a global financial crisis/recession, causing a slump in Chinese exports, or domestic policy staying adrift during the leadership transition period. Other risks include a sharp movement in residential property prices, or a surge in inflation that forces the PBoC to significantly tighten monetary policy.

Key dates

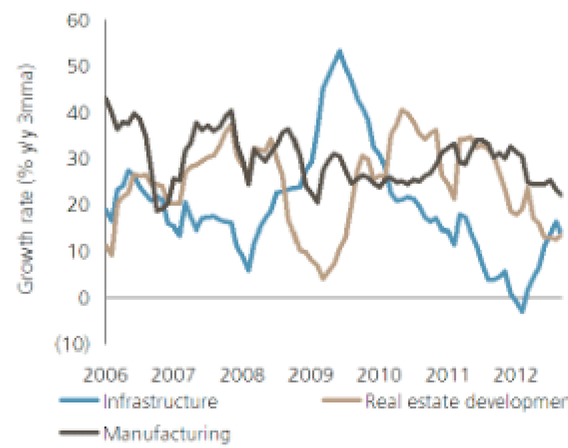
1 Nov	Manufacturing purchasing managers index (October)
8 Nov	The 18th National Congress of the Communist Party of China
9 Nov	Consumer price inflation, industrial production, fixed-asset investment (October)
10-15 Nov	New bank lending, M2 (October)

Nascent rebound in domestic commodity prices



Source: CEIC, Wind, UBS, as of 15 October 2012

Investment staying supportive to growth



Source: Bloomberg, UBS, as of 15 October 2012

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

* Scenario probabilities are based on qualitative assessment.

Section 2

Asset class views

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Section 2.A

Asset class views

Equities

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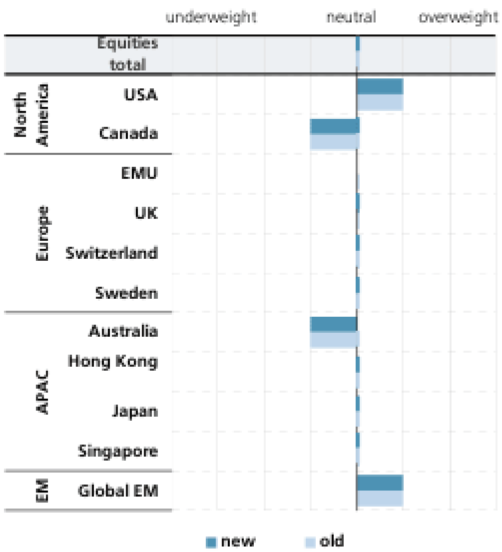
Equities overview

Global equity markets – Key points

- We keep an overall **neutral allocation to equities** (see summary on slide 3).
- We keep our **preference for US equities**. Resilient company earnings still speak for an overweight stance. Continued economic growth should underpin earnings also in 2013.
- We keep our **neutral stance on Eurozone equities**. Value is attractive compared to global equities. However, due to the recession in several countries the earnings dynamics remains weak. In addition, uncertainty as to when and under what conditions Spain will sign a memorandum of understanding keeps us from taking a more positive stance.
- We have an **overweight position in EM equities.** Monetary easing as well as fiscal stimulus in key countries, coupled with relatively attractive valuations, are supporting factors. Economic activity is likely to improve gradually over the coming quarters, supporting company earnings.
- We keep our **negative stance on Canadian equities**. Corporate earnings continue to decline, showing a weak development relative to the global trend. In addition, valuation is not compelling.
- We are **cautious on Australian equities**. Realized earnings continue to come down for the market.
- We are neutral on **Swiss equities**. Companies show solid earnings growth, which is expected to hold up better than in other regions. Although the Swiss franc is still overvalued, the weakening to the USD and related currencies since this summer provides additional earnings support.
- We keep our neutral view on **UK equities**. In the UK the earnings dynamics lags behind other markets. Also, the recent strengthening in the pound is a drag for earnings measured in local currency terms.

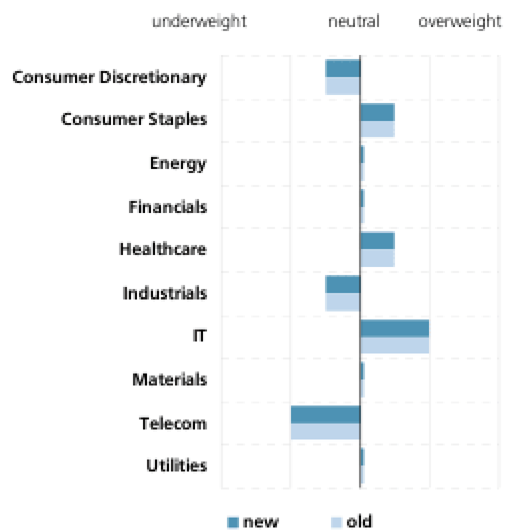
Preferences (6 months)



Note: Preference in hedged terms (excl. currencies)

Global equity sectors – Key points

- We **keep our overweight in Consumer Staples.** Among the defensives it offers good earnings growth prospects due to its geographically diversified revenue generation.
- We reiterate our **preference for global IT** due to a superior growth outlook and as we are in the seasonally strong second half year. With healthy balance sheets and good cash flows, sector valuation is in line with the overall market, while we believe it deserves a larger premium.
- We continue to **like Healthcare** as it offers solid long-term earnings prospects with low volatility and strong balance sheets. We **reiterate our underweight in Telecoms**, where we expect ongoing weak revenue growth as well as margin pressure.
- We are **negative on Consumer Discretionary** as earnings expectations may be too optimistic. With leading indicators in major regions still deteriorating, we keep our **underweight in Industrials**. We have concerns over weak manufacturing momentum leading to increased earnings revisions.
- The earnings outlook for US and Asian Financials is solid. We are **neutral globally on Financials**. While the ECB's OMT program reduces tail risk for Financials, it has limited impact on sector earnings.



Source: UBS

US equities

Preference: overweight

S&P 500 (24 Oct): 1,409 (last publication: 1,433)

UBS View

S&P 500 (6-month target): 1,460

• We keep our preference for US equities relative to other developed equity markets. Earnings continued to hold up better than in other regions during the recent economic slowdown. Continued economic growth should allow companies to show mid single digit earnings growth over the coming 12 months.
• The US central bank's (Fed) very pro-growth oriented policy stance is a clear advantage for the local equity market; the recent introduction of additional quantitative easing (QE 3) is positive for riskier assets.
• We still expect some potential for re-rating over the coming 6 months, in terms of increases in the price-to-earnings ratio (P/E).
• The debate around the fiscal cliff implies increased uncertainty over the coming months. However, we think that a 20% discount compared to the long-run PE-average provides some cushion, and our base case assumes that politicians will finally achieve a compromise to avoid economic contraction.

↗ Positive scenario **S&P 500 (6-month target): 1,700**

• An accelerating US and global economy reduces risks to company earnings. Investors begin to shift funds into more cyclical sectors such as Industrials 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 (6-month target): 1,250**

• The US slides into a recession and corporate earnings fall over the coming 12 months. If this were coupled with an escalation of the Eurozone debt crisis, we would expect the P/E multiple to contract towards 12.5x trailing earnings.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Business sentiment	The ISM is the key indicator for US manufacturing and services. **Key dates: 1 Nov, ISM manufacturing; 5 Nov, ISM non-manufacturing**
The Fed	Hints on further quantitative easing can influence equities. **Key date: 11 Nov, minutes of Fed meeting** (of 24 October)
Labor market	Improvement in the labor market would support stronger consumption. **Key date: 2 Nov, US labor market report for October**

Recommendations

Tactical (6 months)

- We continue to like IT. The sector trades at the lowest valuation multiples seen since the early 1990s. Product launches support superior earnings growth.
- Industrials are preferred as they benefit from a pick up in manufacturing activity.
- Consumer Staples is our preferred defensive sector offering the best combination of dividend growth and attractive valuation.
- We are still cautious on Telecoms, due to high valuations, as well as Materials, where margins remain under pressure.

Strategic (1 to 2 years)

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

Our sector stance in the US

Sectors	US
Consumer Discretionary	→
Consumer Staples	↗
Energy	→
Financials	→
Healthcare	↘
Industrials	↗
IT	↗
Materials	↘
Telecom	↘
Utilities	→

Source: UBS

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

Eurozone equities

Preference: neutral

Euro Stoxx (24 Oct): 247 (last publication: 247)

UBS View

Euro Stoxx (6-month target): 249

• We keep our neutral stance on Eurozone equities. While the sovereign debt crisis remains a risk factor (see slide 8), the conditional bond buying program by the ECB (OMT) and the introduction of the ESM have significantly reduced downside risks.

• Near-term we might see volatility increasing as politicians wrangle about the steps needed to provide a more lasting solution to the debt crisis (setup of a single banking regulator, solving the banking related problems in Spain, etc.). We think that attractive valuations sufficiently compensate for those risks.

• The weak economic environment with recessions in the southern countries continues to weigh on corporate earnings. Consensus expectations (bottom up) of about 10% to 15% earnings growth in 2013 is too high, in our view. In contrast, we forecast just about 3–5% earnings growth next year.

↗ Positive scenario — **Euro Stoxx (6-month target): 320**

• 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 about 11.7x.

↘ Negative scenario — **Euro Stoxx (6-month target): 200**

• The debt crisis leads to renewed pressure on Spain and Italy. However, downside risks are expected to be less severe now, after the ECB has put its new bond-buying program 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 around 10x over a six-month period.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Growth indicators	Economic growth indicators provide information on the development of a potential Eurozone recession. **Key dates: 2 Nov, final PMI manufacturing, EMU; 6 Nov, final PMI services EMU; 22 Nov, flash PMI manufacturing, EMU, France and Germany; 23 Nov, Ifo business sentiment index, Germany**
Policy action	Decisions by European politicians and the ECB affect the course of the debt crisis. **Key dates: 8 Nov, ECB meeting**

Recommendations

Tactical (6 months)

- We continue to recommend defensive sectors like Consumer Staples and Healthcare. We also like the Energy sector.
- We are negative on Industrials and Consumer Discretionary as industry sentiment remains subdued.
- We remain cautious on Financials – especially Banks and diversified Financials. The need for recapitalization remains a major concern.

Strategic (1 to 2 years)

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

Our sector stance in the Eurozone

Sectors	Eurozone
Consumer Discretionary	↘
Consumer Staples	↗
Energy	↗
Financials	↘
Healthcare	↗
Industrials	↘
IT	→
Materials	→
Telecom	↘
Utilities	→

Source: UBS

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

UK equities

Preference: neutral

FTSE 100 (24 Oct): 5,805 (last publication: 5,768)

UBS View

FTSE 100 (6-month target): 5,850

- We keep our neutral stance on UK equities. Earnings have continued to disappoint, showing one of the weakest dynamics within our market universe. Commodity related sectors show steep earnings declines, which is expected to moderate only in a lagged fashion to stabilizing commodity prices. The Healthcare sector suffers from company specific issues which affect earnings also negatively.
- With the oil price expected to trade down over the next 3 months, earnings of companies in the energy sector - comprising about 20% of the market – should remain depressed over the coming quarters. Within financials, law suits related to mis-selling of insurance related products represent a special risk factor.
- Recent strengthening of the British pound is also a headwind for the competitiveness of UK companies, as earnings measured in the local currency are negatively affected.
- The PE of UK equities looks attractive at first sight. But over the past 10 years, UK equities traded on average at a discount to global equities.

Positive scenario **FTSE 100 (6-month target): 7,000**

- A fast 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 13.0x, and we would expect earnings growth of 5–10% over 12 months.

Negative scenario **FTSE 100 (6-month target): 4,750**

- A global recession drags UK earnings down by 15–20% 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 10x.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Growth indicators	Business survey indicators provide information on economic development in the UK. **Key date: 1 Nov, PMI manufacturing; 5 Nov, PMI services**
Commodity prices	Energy and Materials together comprise about 30% of the UK market according to market capitalization. Developments in commodity prices affect earnings estimates.
Policy action	Loose monetary policy by the Bank of England supports equities. **Key date: 8 Nov, Bank of England policy meeting**

Recommendations

Tactical (6 months)

- The UK offers an attractive 4% dividend yield. We still like companies with high quality income streams.
- We like Consumer Staples in the UK. The sector should provide steady earnings growth through its exposure to emerging markets.

Strategic (1 to 2 years)

- The UK market's close to 4% dividend yield provides a good income stream.
- Companies with pricing power are expected to deliver superior earnings growth.

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

Source: Thomson Reuters, UBS, as of October 24, 2012

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

Swiss equities

Preference: neutral

SMI (24 Oct): 6,627 (last publication: 6,540)

UBS View

SMI (6-month target): 6,700

• We stay neutral on Swiss equities relative to global ones. Swiss companies are internationally well diversified, with about 2/3 of revenues generated in the US and in emerging markets. This provides the basis for solid revenue and earnings, despite economic weakness in Europe.

• Swiss companies are trying to mitigate concerns about global economic prospects and a strong Swiss franc using tight cost controls. This should protect operating margins.

• While the Swiss franc remains overvalued, the currency is not longer a drag. In fact, after depreciating since summer versus the USD and related currencies, Swiss companies' earnings will show positive currency translation and margin effects.

• Especially in an environment of low economic growth we like the properties of decent earnings growth, solid balance sheets and a reasonable valuation.

Positive scenario — **SMI (6-month target): 7,500**

• Eurozone economic growth is reaccelerating 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 be re-rated to 15x and earnings to grow by 5% over the next six months.

Negative scenario — **SMI (6-month target): 5,600**

• The global economy slides into a recession. Despite being less dependent on the global business cycle, Swiss companies will 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 the P/E to contract toward 12.0x.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Economic indicators	Key announcements of domestic economic indicators: **Nov 1, Manufacturing PMI index; Nov 30, KOF Swiss leading indicator;**
Monetary and economic policy	Key Swiss monetary policy dates that could impact Swiss equities: **Nov 1, SNB meeting**
Corporate news	Key corporate announcement dates: **Oct 30, Geberit, Oerlikon, Straumann & UBS; Oct 31, Lonza & Sika**

Recommendations

Tactical (6 months)

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

Strategic (1 to 2 years)

- We favor leaders in regards to the two key Swiss success factors: innovation and globalization.

Swiss market relative to world equities

Source: Thomson Reuters, UBS, as of October 24, 2012

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

Japanese equities

Preference: neutral

Topix (24 Oct): 743 (last publication: 743)

UBS view

Topix (6-month target): 756

- We expect earnings growth of about 25% over the upcoming 12 months. A relatively high growth rate still reflects last year's sharp decline caused by two natural disasters. Still, the earnings recovery has disappointed so far. Earnings growth continues to slow down and is expected to move toward a more normal single-digit growth in 2013.
- The government started implementing its JPY 18 trillion recovery budget in Q4 2011; we expect it to boost GDP by 0.5-1.0% in FY2012, and about 0.5% in 2013.
- However, we see only limited scope for an additional earnings boost from the local economic recovery. Slowing export markets also curtail the outlook. June quarter-earnings results revealed emerging market demand was below expectation, capping earnings growth.
- We expect the TOPIX trailing P/E to drop to around 13.5x from 15.0x over the coming months, mainly due to the earnings recovery; this provides room for moderate price increases only.

Positive scenario — **Topix (6-month target): 970**

- Stronger global demand and stabilizing European markets lead to improved risk-taking. Falling risk aversion is likely to lead to a weaker yen, providing an additional increase in earnings. We expect 10-15% EPS growth in FY2013 and the TOPIX target is based on 16.0x trailing P/E.

Negative scenario — **Topix (6-month target): 575**

- Faltering global growth leads to weak exports, triggering negative earnings surprises. USD-JPY rate strengthening to below 75 and potential economic conflicts with China might serve as an additional drag on earnings. We would then expect the P/E ratio to contract to 13.0x and earnings to fall during the upcoming six months.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
JPY and exports	The exchange rate is an important factor for the Japanese equity market. Japan's trade balance could be in deficit and may impact USD-JPY rates. **Key date: Nov 21, Japanese trade balance**
BoJ's monetary policy board meeting	If the Bank of Japan makes additional commitments to its asset-purchase program, which is currently JPY 70 trillion in size, it would lead to a weaker yen, in our view. **Key date: Oct 30, BoJ policy meeting**

Recommendations

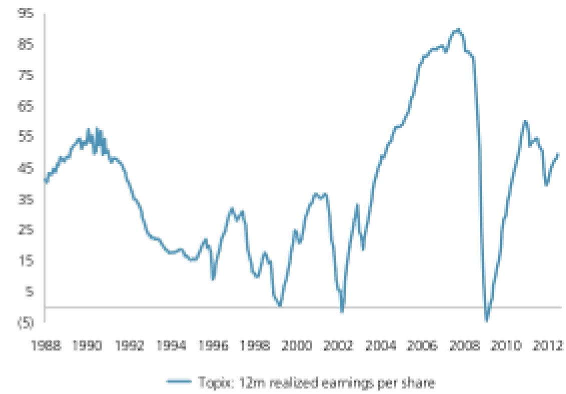
Tactical (6 months)

- Japanese value stocks have under-performed growth stocks by more than 20% for the last four months. We see this as an overreaction to concerns on the slower global economy, and recommend picking some value stocks with high dividend yields.
- We prefer companies that are using cost-reduction initiatives to maintain price competitiveness during periods of yen strength.

Strategic (1 to 2 years)

- A weaker USD-JPY rate may drive Japanese companies' earnings recovery beyond a technical recovery from natural disasters. Japanese exporters and companies owning international operations would benefit from such a development.

Japanese realized earnings likely to recover further going forward



Source: Thomson Reuters, UBS, as of October 22, 2012
Note: Past performance is not an indication of future returns.

UBS

For further information please contact CIO asset class specialist Toru Ibayashi, [redacted]

Emerging market equities

Preference: overweight

MSCI EM (24 Oct.): 995 (last publication: 990)

UBS View

MSCI EM 6-month target: 1,040

- The downward revisions to the emerging market GDP growth forecasts appear to be coming to an end. We expect emerging market GDP growth to accelerate to 5.3% in 2013 from this year's 4.7%.
- Monetary policy in the US, the Eurozone, and Japan remains supportive. One implication of these low interest rate policies, we believe, will be to enhance emerging market (EM) equity returns in USD by supporting EM currencies more broadly against the USD over the next six months.
- In our base case, we see the P/E multiple of the MSCI EM Index staying around the current level of 11x trailing (i.e. realized) earnings over the next six months. Over the next 12 months, we expect EM earnings growth of around 11% (slightly below consensus).
- Over the past month, structural reforms that will have longer-term benefits were announced in India (retail sector), Russia (energy sector) and Mexico (labor market). This highlights that the emerging economies have options to improve the competitiveness of their economies, if they choose to do so.

↗ Positive scenario — **MSCI EM (6-month target): 1,325**

- 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 rose too, Russia would benefit in this scenario.

↘ Negative scenario — **MSCI EM (6-month target): 800**

- A significant escalation in the Eurozone, a sharp fiscal contraction in the US, and a rapid deceleration in Chinese growth could each hit EM's economic prospects. In such a scenario, we would expect a 20% decline in earnings over six months. More defensive Malaysia would do better, whereas 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 recover to 10x trailing earnings.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Emerging market monetary policy	Investors are trying to figure out which emerging market central banks still have room to ease monetary policy and where rates may be heading up. **Inflation data is due for Russia (6 Nov), Brazil (7 Nov), China (9 Nov), India (14 Nov) and South Africa (21 Nov).**
Food and oil prices	The prices of grains and oil are higher than this time last year. For now, negative output gaps should counterbalance some of this inflationary pressure.

Recommendations

Tactical (6 months)

- Within emerging markets, we have a preference over six months for the large equity markets, Brazil, China and South Korea. We expect an acceleration of growth into 2013 in Brazil and South Korea, and a stabilization in the case of China. We see relatively less upside for more defensive Malaysia. We believe that South Africa and Indonesia are expensive. The ECB's announcement that it stands ready to buy the bonds of compliant Eurozone governments has lessened the tail risks for the smaller European emerging equity markets (Turkey, Hungary, Poland), but their equity markets are susceptible to setbacks.

Strategic (1 to 2 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	Current least preferred markets
Brazil	Indonesia
China	Malaysia
South Korea	South Africa

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For further information please contact CIO asset class specialist Costa Vayenas, [redacted]

Asian equities (ex-Japan)

MSCI Asia ex-Japan (24 Oct): 518 (last publication: 510)

UBS view

MSCI Asia ex-Japan (6-month target): 545

- China released a set of positive data for September. While the headline 3Q GDP number only met expectations at +7.4% YoY (consensus +7.4%, prior +7.6%), the higher frequency data was better. Industrial production of +9.2% YoY (consensus +9.0%, prior +8.9%), retail sales of +14.2% YoY (consensus +13.2%, prior +13.2%), and fixed asset investment of +20.5% (+20.2% consensus, prior +20.2%) all came in higher.
- Chinese H-Shares are up almost 10% in the last month, while the S&P 500 is within 0.4 index points of where it was a month ago. Valuations of MSCI China remain extremely attractive as the market continues to price in a hard landing scenario, although sentiment is clearly turning. In India, the government has proposed several key economic reforms, but there are implementation risks and consensus GDP forecasts still have downside risk, while Indonesia's economic momentum is on track.
- We expect 12.8% earnings-per-share growth over 12 months for the MSCI Asia ex-Japan. It trades on 11.0x 12-m forward earnings and 1.6x price-to-book. We expect a stable earnings multiple in the next six months. Economic growth should stabilize and earnings downgrades come to an end toward the end of 2012.

↗ Positive scenario — **MSCI Asia ex-Japan (6-month target): 670**

- 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 15% and a trailing P/E of about 15.0x.

↘ Negative scenario — **MSCI Asia ex-Japan (6-month target): 400**

- A hard landing in China with a global recession leads to negative earnings revisions for 2012. In this scenario, Asia ex-Japan could trade down to about 10.5x realized earnings.

What we're watching	Why it matters
Politics	Leadership in China is set to change, resulting in a newly defined future economic policy. The US Presidential elections have implications on the outcome of the Fiscal Cliff. **Key dates: Nov 6, 57th US Presidential Elections; Nov 8, 18th Communist Party Congress**
Policy responses	Some other countries in the region have near-term macroeconomic issues 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

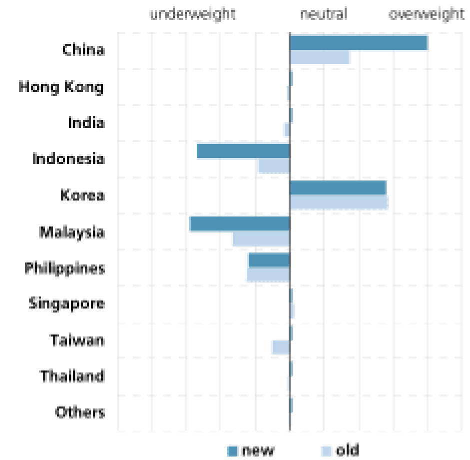
Tactical (6 months)

- The Fed's implementation of QE3 provides support to Asia ex-Japan equities. In conjunction with improving growth prospects we see good near term upside.
- Should economic growth surprise to the upside, more defensive markets such as Singapore and Malaysia are likely to underperform. Instead, higher beta, export-oriented markets like South Korea, Taiwan, Hong Kong and China are likely to take advantage from a strengthening in global growth.

Strategic (1 to 2 years)

- Consider a portfolio mix of high yield stocks largely found in Singapore, Taiwan & HK, 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 **Prefer mid caps in US, large caps in Europe**

• We believe that medium-sized companies (mid caps) will outperform large caps in the US. US economic data is forecast to stabilize and then show moderate economic growth in the second half of 2012 and into 2013. The greater domestic sales exposure of US mid caps reduces the earnings risk coming from Europe.

• In Europe, we prefer companies with a large market capitalization (large caps) over ones with a small one (small caps) in the current very challenging economic environment. Small caps generate more sales in Continental Europe than large caps. Thus, they are more negatively affected by weak domestic demand. Small caps also have a more cyclical earnings exposure than large caps.

• Globally, high-quality dividend paying stocks promise to 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.

↗ Positive scenario **Prefer value, low quality and small caps**

• Leading indicators continue to move higher, and risks related to the Eurozone debt crisis 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.

↘ Negative scenario **Prefer quality and large caps**

• 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.

Note: Scenarios refer to global economic scenarios (see slide 7).

What we're watching	Why it matters
Earnings revisions – see chart (3-month moving average upgrades vs. downgrades)	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.
US and Eurozone PMIs	PMIs are important for earnings generation and preferences for value, growth and size. **Key dates: Nov 2, PMI manufacturing Eurozone (final); Nov 1, US ISM manufacturing**

Regional differentiation

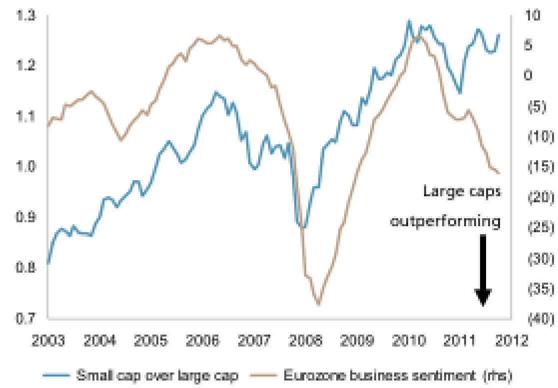
- In the US, we prefer mid caps to large caps. Moderate economic growth should support their earnings generation.
- In the US, there are opportunities in value names that also show strong growth.
- Within Europe, we avoid small caps and instead rotate into large caps.

Strategic (1 to 2 years)

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

Avoid small caps and favor large caps in Europe

DJ STOXX small over large and business confidence



Source: Thomson Reuters, UBS, as of September 29, 2012

Note: Past performance is no indication for future returns.

UBS

For further information please contact CIO's asset class specialist Christopher Wright, [redacted]

Section 2.B

Asset class views

Fixed Income

UBS

Bonds overview

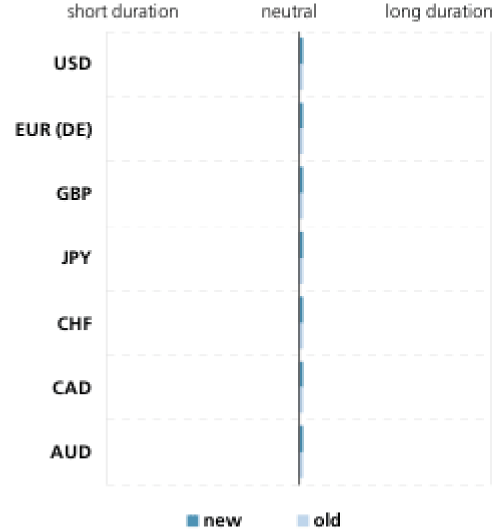
Government bonds – Key points

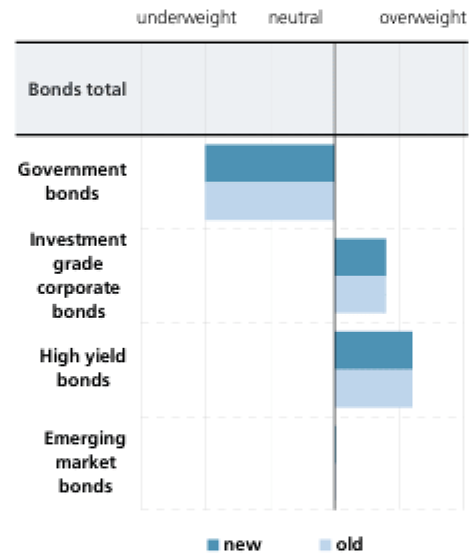
- We expected government bond yields to move towards slightly higher ranges over the next 6 months, as seen in late 2011/early 2012. This is likely to have a slightly negative effect on most developed government bond prices, and is likely to result in a total return around zero over this period.
- Price fluctuations in the month ahead could originate from developments in the Eurozone and the US. They include the Troika report on Greece, Spanish local elections/referendum and the possible delayed request for additional ECB support in Europe. In the US, the extent of the fiscal cliff is dependent on the election outcome and the results from the debates in the subsequent lame duck session of congress. While we expect the full cliff to be avoided, it poses a significant downside risk to domestic growth.
- Overall, we suggest keeping the duration close to neutral, as we expect global growth to remain lackluster and central banks to continue supporting bond markets.

Corporate and emerging market bonds – Key points

- We maintain a preference for investment-grade (IG) and US high-yield (HY) corporate credit. A strong (US) corporate sector, the ongoing moderate recovery of the US economy, determined central bank support and a strong technical backdrop are likely to further support credit segments.
- Investment-grade corporate bonds have achieved a total return of more than 10% so far this year, at remarkably low volatility. While absolute returns will likely be moderate in the next six months (1-2%), the asset class should continue outperforming government bonds, offering higher liquidity than HY bonds. We see the highest return potential in the lower-rated IG segments (BBB and A).
- US corporate bonds of lower credit quality (HY) remain fundamentally supported by solid balance sheets and a benign US growth outlook. Given the low risk of default losses, valuations are attractive at an effective yield of above 6%. For US HY, we expect mid single-digit total returns in the next six months. US senior loans are an attractive alternative to traditional fixed income assets.
- Emerging market (EM) bonds should continue to benefit from better fundamentals than those of developed markets over the medium term. However, valuations have now moved towards a fair level for sovereign bonds (in USD) and we take profits on selected sovereign bond issuers. For EM corporate bonds in USD, there is still some potential for spreads to trend lower in the quarters ahead, and we continue to recommend this area as a CIO-preferred theme.

Preferences (6 months)





Source: UBS CIO WM Global Investment Office

US rates

Duration preference: neutral

US 10-year (24 Oct): 1.8% (last month: 1.8%)

UBS view

US 10-year (6-month forecast): 2.0%

• US 10-year yields traded largely sideways within a narrow range. Improving domestic economic and sentiment data was balanced by concerns of the elections/fiscal cliff weighing on the US economy. However, both the ECB and the Fed have provided substantial and credible backstops that significantly reduce tail risks. This reduces the flight to quality and the risk discount placed on Treasuries in the event of a re-escalation of the European debt crisis. This represents a clear floor with little chance of retesting the historical lows of July (~1.4%). In addition, the Fed's willingness to fall behind the curve in support of the domestic labor market will increase inflation expectations over the medium term. This implies steeper yield curves.

• In addition, the credible and conditional central bank backstops have already improved sentiment and should help to kick-start growth if politicians provide the necessary tailwinds. Yields will then return to their slightly higher, previously stable ranges over a six-month horizon (1.8%-2.1%).

• At the same time, US yields should be capped, as the US economy continues to be vulnerable to spillover effects from the Eurozone. Structurally weak growth which will be dampened by the upcoming US fiscal consolidation, will add to volatility and limit the increase in yields.

↗ Positive scenario for US bonds — **US 10-year (6-month range): 1.4–1.6%**

• US fiscal deleveraging beyond our expectations weighs on the cyclical recovery and is a drag on yields.

• A re-escalation of the European debt crisis burdens yields. Implementation risks in the ECB framework remain, given that Italy and Spain have not yet made the necessary application, which will result in the peripheral spread widening. At the same time, Greece is likely to announce a second debt restructuring and leave the Eurozone next year.

• The labor market fails to recover, increasing the likelihood of even more MBS purchases or alternative measures, and yields stay low or fall further.

↘ Negative scenario for US bonds — **US 10-year (6-month range): 2.1–2.5%**

• If the ECB buying of short-dated Spanish and Italian sovereign bonds increases risk appetite, it would reduce the flight to quality more substantially and this represents an upside risk to our forecasts.

• If EU leaders make progress toward increased fiscal integration, and US growth recovers with a rapidly improving labor market, then yields could rise more significantly.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Fed policy	The Fed's assessment of the labor market determines its stance on quantitative easing and is key for yields. Key dates: **Nov 2, NFP; Dec 11 Fed FOMC meeting**
Inflation expectations	Current yields do not reflect low real-interest rates, but rather normal inflation expectations. Inflation expectations increased on the back of the latest Fed action, leading to more upside risk for long maturity yields.
US presidential election/Fiscal cliff & debt ceiling	The US presidential election will guide fiscal spending for the coming years.

Recommendations

Tactical (6 months)

• Weak global growth momentum, ongoing bond market support from central banks and the lingering euro crisis are likely to keep yields at extraordinarily low levels for some time. Tactically, we suggest a neutral duration position.

Strategic (1 to 2 years)

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

USD 10-year yields and forecasts

Source: Bloomberg, UBS, as of October 15, 2012

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

UBS

For further information please contact CIO's asset class specialist Daniela Steinbrink Mattei, [redacted]

European rates

Duration preference: neutral

EUR (DE) 10-year (24 Oct): 1.6% (last month: 1.6%)

UBS view

EUR (DE) 10-year (6-month forecast): 1.8%

• Bund yields have trended sideways over the month, lacking a directional trigger. Markets still await crucial developments in Spain, Greece and the extent of the US fiscal cliff, and have not fully reflected mixed but stabilizing fundamentals. However, when compared to the all-time lows witnessed in August (~1.2%), yields are still trading at decisively higher levels. This is supported by the ECB announcement to act as a lender of last resort by intervening in the secondary markets with unlimited and conditional government bonds purchases. In addition, the open-ended Fed stimulus hinging on the labor market contributed to improving sentiment. This provides a cap for short-term peripheral yields and a floor for Bund yields.

• Over a six-month horizon, we expect yields to trend slightly higher, returning to previously higher ranges. The central bank backstops have already improved confidence and resulted in convergence between the periphery and the core. This speaks for slightly better growth prospects and thus slightly higher yields.

• However, growth is still structurally weak, and short-term uncertainties (US elections, fiscal cliff, Spain) remain. Consequently, short-term downside risks persist around year end. The ECB, however, will limit the spread from widening, providing a bottom to Bund yields as well.

• In the UK, economic data stabilized and we expect the BoE to extend quantitative easing in November.

• In Switzerland, yields rose only slightly owing to mixed economic data. The Swiss National Bank stands ready to act. With much negative news priced in, we believe Swiss yields will gradually start to normalize.

↗ Positive scenario for German bonds — **10-year Bund yield (6-month range): 1.2–1.5%**

• Implementation risks in the ECB framework remain, in particular the need for Italy and Spain to apply for aid. At the same time, Greece may announce a second debt restructuring and is likely to leave the Eurozone in 2013.

• US fiscal deleveraging beyond our expectations weighs on the cyclical recovery and is a drag on yields.

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

↘ Negative scenario for German bonds — **10-year Bund yield (6-month range): 1.8–2.3%**

• 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.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Political risks and fiscal cliff	The US fiscal cliff, Greek negotiations, Spanish local elections and Spain delaying its application for assistance add to policy uncertainty.
Central banks	Key dates: **Nov 8, ECB; Dec 11, Fed FOMC meeting**
Economic variables	Credit conditions (ECB bank lending survey)
Eurozone yield spreads	The level of yield spreads to German bonds influences the level of German Bund yields due to safe-haven flows.

Recommendations

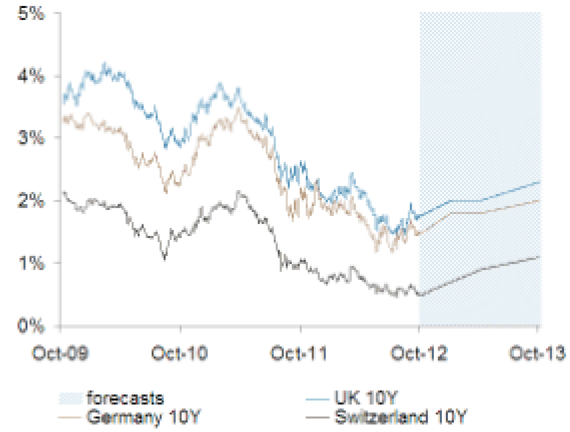
Tactical (6 months)

- If the ECB were to intervene with massive amounts in the peripheral bond markets, Bund yields would rise more significantly. But, for the time being, we expect only moderate interventions that do no meaningful harm to Germany's credit quality. We recommend staying neutral on duration tactically.

Strategic (1 to 2 years)

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

EU 10-year yields and forecasts



Source: Bloomberg, UBS, as of October 15, 2012

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

UBS For further information, please contact CIO's asset class specialist Daniela Steinbrink Mattei, [redacted], Sebastian Vogel, [redacted] or Nina Gotthelf, [redacted]

Investment grade corporate bonds

Preference: overweight

Current global spread (24 Oct): 150bps (last month: 173bps)

UBS View

Spread target (6-month): 140bps

• Given the recent rally in investment grade (IG) bonds, spreads have approached fair levels, in our view and are likely to trade more or less sideways in the coming 6 months. Still, IG bonds will likely continue to outperform government bonds, offering low volatility and stable income.

• We lower our spread target from 170bps to 140bps due to the improved global macro and risk environment after recent central bank action and the pickup in economic data. IG bonds remain supported by our outlook for sluggish but positive global growth, ongoing investor appetite for income-generating assets, and expected negative net issuance.

• Non-financial corporates: While total yields are at record lows, the pickup over government bonds and money market rates is still attractive. Aggressive re-leveraging by companies looks unlikely.

• Financial corporates: Due to regulatory challenges, spreads are expected to remain above past averages. US banks are in a more favorable position than their European peers as they are better capitalized and earnings have been strong recently. US financial spreads are thus likely to tighten further.

↗ Positive scenario

Spread target (6-month): 130bps

• Global growth accelerates more forcefully than expected. This could compress spreads closer to pre-crisis levels. Spreads for Financials are likely to remain elevated due to regulatory challenges. However, in this case, rising benchmark yields would likely lead to slightly negative IG returns over six months.

↘ Negative scenario

Spread target (6-month): 380bps

• Main risks include a sharp slowdown of the US economy (e.g. the "fiscal cliff"). 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 spread levels reached in 2009, given companies' superior balance sheet positions. European financial issuers would be most at risk.

Note: Scenarios refer to global economic scenarios (see slide 7)

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: 8 Nov, ECB rate decision; 11 Dec, US Fed rate decision**
Corporate fundamentals	Robust corporate earnings and low leverage on corporate balance sheets should help prevent defaults. **Key dates: US "earnings season" (ongoing)**
New issuance	As companies continue to deleverage, net negative supply on the IG market should support higher prices.

Recommendations

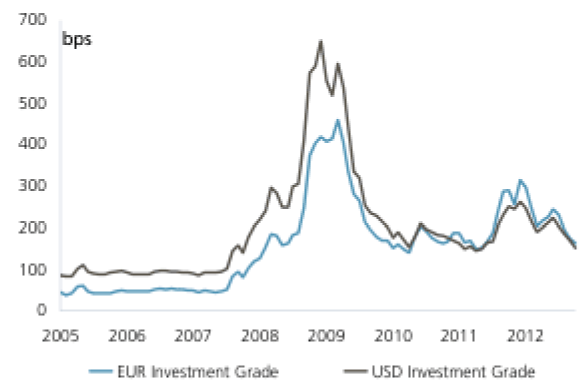
Tactical (6 months)

- We keep an overweight in IG corporate 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 (1 to 2 years)

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

Yield spreads



Source: Bloomberg, UBS, as of 16 Oct 2012

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

UBS

For further information please contact CIO's asset class specialist Philipp Schöttler, [redacted]

High yield corporate bonds

Preference: overweight

Spread USD HY (24 Oct): 540bps (last month: 573bps)

UBS View **USD HY spread target (6-month): 475bps**

• We reiterate our spread target of 475bps based on still robust corporate fundamentals, a favorable technical backdrop and the commitment of major central banks to provide strong monetary support. In particular, the Fed's buying of mortgage-backed securities (MBS) is likely to provide further support for the credit universe.

• Thus, US high yield (HY) bonds continue to offer attractive value although spreads tightened considerably in Q3. We think the recent rally has been justified in light of 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 continue to push spreads lower. US HY thus remains our preferred asset class.

• Despite the recent uptick in defaults, in the absence of a renewed US recession, we expect the default rate to remain stable at 3.5% until the end of the year. A heavy load of new issuance so far this year 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).

Positive scenario **USD HY spread target (6-month): 400bps**

• Even in the positive economic scenario, spreads are unlikely to tighten to pre-crisis lows of below 300bps due to lower liquidity and a generally higher risk premium after the financial crisis. Benchmark yields would rise, limiting HY returns to around 7%. European HY outperforms the US.

Negative scenario **USD HY spread target (6-month): 1,000bps**

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

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Credit quality/ default cycle	US earnings were roughly flat in 2Q compared to 1Q. A modest pickup is expected in 2H. 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.
New issuance	For now, favorable conditions in the primary market have mainly been used for refinancing. More aggressive issuance activities should be monitored.
Bank lending standards	Bank lending provides an important source of funding. US banks relaxed standards further in early 3Q. **Key dates: late October, US Fed Senior Loan Officer Survey**

Recommendations

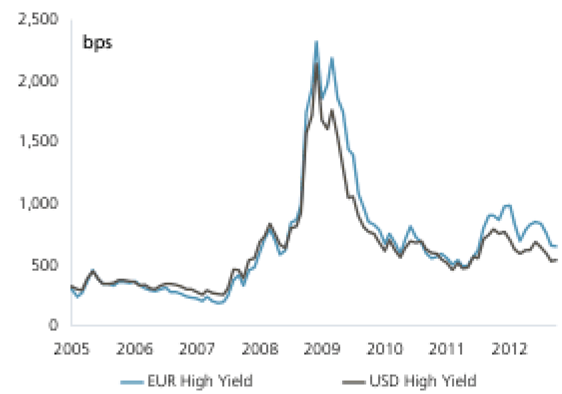
Tactical (6 months)

- US high yield corporate bonds offer an attractive return outlook and should be overweighted.
- We prefer US over European issuers given the increasing proportion of peripheral and financial issuers in the European HY universe and the poorer economic outlook in Europe.
- Inflows into HY mutual funds have been strong so far in 2012. New issuance was strong in Q3.

Strategic (1 to 2 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



Source: Bloomberg, UBS, as of 16 Oct 2012

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

UBS

For further information please contact CIO's asset class specialist Philipp Schöttler, [redacted]

Emerging market bonds

Preference: neutral

EMBI Global/CEMBI spread (24 Oct): 281bps / 334bps (last month: 292bps /363bps)

UBS View

EMBI Global/CEMBI spread target (6-month): 275bps/290bps

• Current spread levels of EM sovereign bonds are roughly in line with fundamentals. We think valuations of EM corporate bonds are more attractive than valuations of EM sovereign bonds. Additionally, the gradual recovery in EM we expect over coming quarters should support the performance of EM corporate bonds relative to EM sovereign bonds. 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, we think, as the room for spreads to tighten further has become more limited. We expect total returns of less than 2% for EM sovereigns and close to 4% for EM corporate bonds over the next six months.

• Negative headlines from the Eurozone or global growth fears might put renewed short-term pressure on EM bond prices. We think that periods of price weakness offer attractive entry points.

↗ Positive scenario **EMBI Global/CEMBI spread target (6-month): 235bps/230bps**

• Yield stability in Europe's core markets and higher-than-expected growth in the US would 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 (6-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 7)

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 USD- and EUR-denominated bonds. **Key date:** Dec 6, European Central Bank meeting
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	Monetary policy easing remains a key topic for local currency bonds. We look for central bank policy announcements in key markets. **Key policy rate announcement dates:** Nov 11, Indonesia; Nov 20, Turkey; Nov 22, South Africa; Nov 30, Mexico

Recommendations

Tactical (6 months)

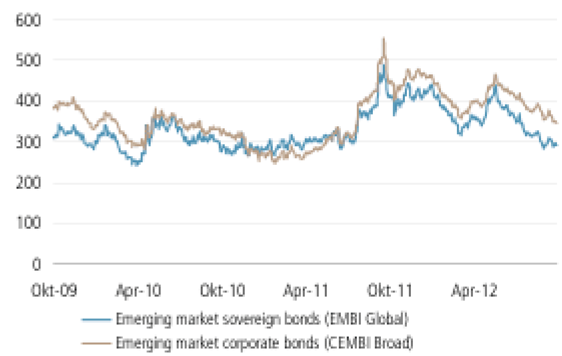
- EM corporate bonds are particularly attractive due to their favorable valuations, solid fundamentals, and relatively short duration. We advise clients to focus on investment grade bonds in the current environment. We recommend taking profit on selected EM sovereign bonds. Please refer to our EM bond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

Strategic (1 to 2 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 15 October 2012

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

Section 2.C

Asset class views

Foreign Exchange

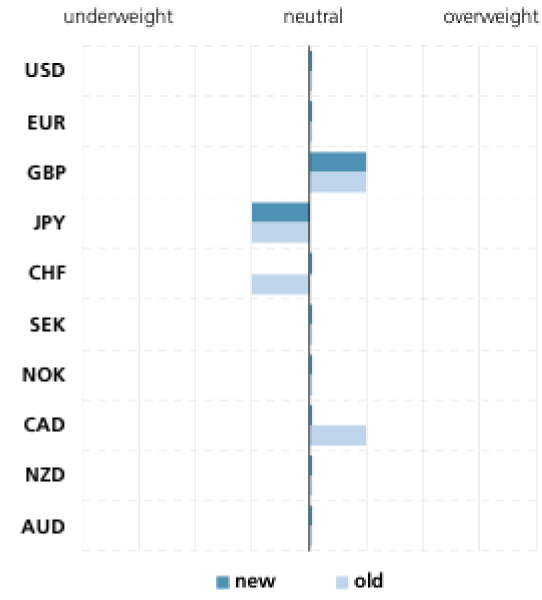
UBS

Foreign exchange overview

Foreign exchange – Key points

- The ECB's announcement of Outright Monetary Transactions (OMT) has reduced tail risk in the Eurozone considerably, while the Federal Reserve announcing a new round of potentially unlimited asset purchases at their September 13 meeting has weakened the USD. Given that the ECB action was EUR-positive and the Fed action USD-negative, EURUSD has jumped considerably, but since then moved little.
- We believe the risks to the pair are now more balanced, and see a range between **EURUSD** 1.28–1.35 for the months ahead. A Spanish ESM/OMT request would be EUR positive. While the US elections and US fiscal cliff could lead to short term USD strength, we see the USD weaker over the next 6 months.
- The **CAD** remains supported by better growth dynamics in Canada and QE in the US. However, we believe the recent appreciation against the USD could see a near-term setback and we close the overweight.
- We keep the overweight position in the **GBP** despite the current asset purchasing program by the Bank of England (BoE), which we believe will be terminated in November. The GBP remains well supported given the recent rebound in economic data, the expectation of a stronger economy in 2013 and because investors are seeking liquid alternatives to the EUR, the USD and the JPY.
- **EURCHF** has traded higher in our 1.20–1.23 range recently and we continue to see the pair in that range. The SNB protects the downside, while a strong upside move is also limited by a potential flare-up in the euro crisis and reserve unwinding of the SNB at some point. Given this balance, we have decided to close the underweight in the CHF.
- Sweden and Norway stand out for their lower debt-to-GDP ratios and current account surpluses. Both the **SEK** and **NOK** have appreciated on diversification and safe-haven inflows, but economic data in both countries has become weaker recently, which led to a setback in the SEK. A rate cut in Sweden cannot be ruled out, but seems to be priced in already.
- Longer-term debt issues and weak competitiveness of major exporters are hurting the Japanese economy and PMIs have disappointed. We therefore think the Bank of Japan and Ministry of Finance will maintain an expansive policy bias and continue trying to weaken the **JPY**. We are underweight JPY.
- For commodity currencies, the **AUD** and **NZD** continue to trade at the top of their well established ranges. We got the expected rate cut in Australia and expect another cut by year end. Do not buy AUD above AUDUSD 1.00. We have a preference for the NZD over the AUD.
- We maintain a positive medium-term view on **emerging market (EM) currencies**. This is supported by higher short-term rates which provide an attractive yield pick-up relative to developed market currencies as monetary policies are expected to remain loose for longer. We think investors should increase EM FX exposure across regions. Lower tail risks in Europe should be especially supportive of the higher-yielding currencies in **EMEA** and **Latin America**.
- Our most preferred emerging market currencies are currently the **MXN, ZAR, PLN, KRW and SGD.**We expect the **CNY** to appreciate 2% against the USD, moving towards 6.20 over the coming 12 months. Internationally marketable instruments (such as CNH, the offshore version of the Chinese currency traded in Hong Kong) have similar appreciation potential.

Preferences (6 months)



Source: UBS CIO WM Global Investment Office

G10 currencies

UBS View **See table for current exchange rates and CIO forecasts**

- We believe the risks to the **EURUSD** currency pair are now more balanced, as tail risks on the European side have been considerably reduced.
- The **GBP** trended higher despite stimulus measures by the Bank of England. The main reason is the need for diversification out of the EUR and USD and decisive UK policy making. We maintain an overweight after the strong rebound of economic data in 3Q 2012 which we expect to persist into 2013.
- The **CAD** remains supported by better growth dynamics. However in the short term, around the US elections and fiscal cliff debate, a setback cannot be ruled out. We also remain underweight in the **AUD**.
- The SNB has shown that it can defend the **CHF** floor. With EUR tail risk reduced the CHF likely recovers together with the EUR against most other currencies. Thus we close the CHF underweight.
- We expect stronger policy intervention in Japan to weaken the **JPY** over the coming months.

↗ Positive scenario **FX targets: EURUSD >1.35 / EURJPY 115**

- The announcement of unlimited QE in the US, as well as a stronger-than-expected acceleration of global growth or further European integration would be EURUSD positive. EURUSD should trade above 1.35 in this case. Yen weakness should come as the Bank of Japan intervenes to weakens its currency.

↘ Negative scenario **FX targets: EURUSD <1.25 / EURJPY 90**

- The European growth outlook deteriorates further with continued recession in 2013. The euro could rapidly fall below 1.25. A European debt-default cascade (possibly triggered by a disorderly Greece euro exit) is a tail risk for the single currency. Risk aversion would lead to an extended USD and JPY rally.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Chinese growth	We expect China to land softly and then recover. Should China disappoint with a hard landing, then risk-unwinding would support USD and JPY vs. risk-taker currencies. In the base case, a Chinese recovery should support the AUD in the medium term, but a dip below parity is likely in the short term.
European sovereign crisis, ECB policy	The main focus lies on the Spanish application for ESM/ECB support, which would be EUR positive; a rate cut (not expected) would hurt the EUR. **Key date: Nov 8, ECB meeting**
US growth and Fed policy response	What will the Fed do once Operation Twist ends at year end? How will the presidential elections change political power in Washington? **Key dates: Nov 6, US presidential elections; Dec 12, FOMC meeting**

Recommendations

Tactical (6 months)

- We continue to have a preference for the GBP and keep the short in the JPY.

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.
- 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. The GBP also remains attractive.

UBS CIO FX forecasts

	24-10-12	3M	6M	12M	PPP
EURUSD	1.294	1.30	1.32	1.34	1.30
USDJPY	79.75	80	82	86	79
USDCAD	0.991	0.94	0.94	0.92	0.98
AUDUSD	1.0322	0.97	1.00	1.05	0.74
GBPUSD	1.6018	1.65	1.68	1.70	1.69
NZDUSD	0.8138	0.78	0.80	0.83	0.60
USDCHF	0.9346	0.93	0.92	0.92	1.03
EURCHF	1.2097	1.21	1.21	1.23	1.33
GBPCHF	1.4974	1.54	1.54	1.56	1.73
EURJPY	103.27	104	108	115	102
EURGBP	0.8079	0.79	0.79	0.79	0.77
EURSEK	8.6577	8.20	8.00	8.00	8.86
EURNOK	7.4373	7.30	7.20	7.20	8.53

Source: Thomson Reuters, UBS, as of 15 October 2012
Note: Past performance is not an indication of future returns.

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 to these currencies.

• In Europe, both the Polish zloty (**PLN**) and the Turkish lira (**TRY**) have supportive fundamentals in the long-term and could benefit from inflows into their fixed-income market which offers attractive yield relative to G4 currencies. Due to structural reasons we remain cautious on the Hungarian forint (**HUF**).

• The South African rand (**ZAR**) is currently attractively valued, but Investors should be willing and able to tolerate bouts of volatility due to the current strikes and a cyclical slowdown of the economy.

• In Asia, we like the Korean won (**KRW**), the Singaporean dollar (**SGD**) and the Malaysian ringgit (**MYR**) as all three countries have a strong economy and should benefit from increasing liquidity and a recovering Chinese economy.

• In Latin America, the Mexican peso (**MXN**) remains attractively valued, despite its recent rally.

↗ Positive scenario — **> 5% outperformance of EM FX against G4 currencies over a 6-month horizon**

• Macroeconomic data comes in stronger than expected and contagion risks in Europe subside 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 6-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 7)

What we're watching	**Why it matters**
Inflation dynamics in EM	Inflation dynamics are important to forecast central bank policy rate decisions. Monetary easing typically weighs on EM currencies, while rate hikes tend to be supportive. **Key policy rate announcement dates: 11 Nov, Indonesia; Nov 20, Turkey; Nov 22, South Africa; Nov 30, Mexico**
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 risk sentiment, growth prospects in EM. **Key date: Dec 6, European Central Bank meeting**

Recommendations

Tactical (6 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 preferred EM currencies (KRW, SGD, MYR, MXN, TRY, PLN, ZAR), using the JPY, USD, and EUR for funding.

Strategic (1 to 2 years)

- We recommend EM currencies backed by stable fundamentals as a strategy to diversify currency exposure.
- Our 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

	24.10.2012	3-month	6-month	12-month
Americas				
USDBRL	2.02	1.95	1.90	1.85
USDMXN	12.9	12.7	12.5	12.3
Asia				
USDCNY	6.25	6.30	6.30	6.20
USDINR	53.6	53.0	54.0	55.0
USDIDR	9,615	9,400	9,400	9,400
USDKRW	1,103	1,100	1,080	1,050
USDSGD	1.22	1.21	1.20	1.19
EMEA				
EURPLN	4.12	4.30	4.15	3.90
EURHUF	280	290	300	300
EURCZK	24.9	26.0	25.0	24.3
USDTRY	1.80	1.75	1.75	1.72
USDZAR	8.66	8.20	7.90	7.80
USDRUB	31.1	33.0	32.0	31.0

Source: Bloomberg, UBS, as of 15 October 2012
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

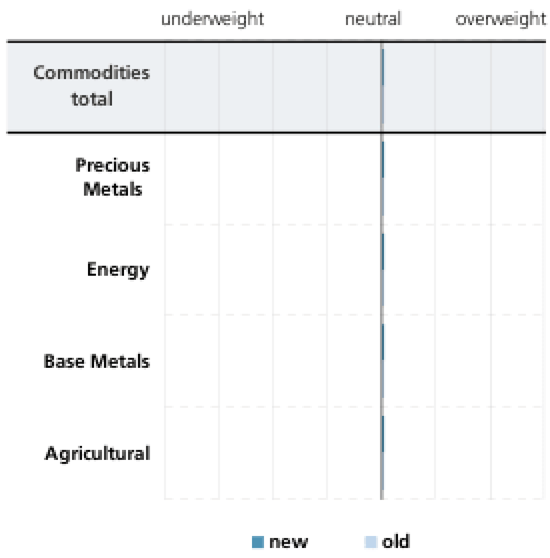
UBS

Commodities overview

Commodities – Key points

- The impact of new quantitative easing (QE) measures on commodity prices is losing strength, as broadly diversified commodity indices have not been advancing anymore on a month-on-month basis. Investors have started to reflect on the underlying economic challenges that motivated the easing decisions by key central banks. With global economic growth barely accelerating, the asset class will struggle to appreciate firmly over the coming months. We therefore advise investors to have only **low single digit return expectations for commodities warranting a neutral stance.**
- **Gold** is less depending on economic growth, however the metal could be a beneficiary of ample liquidity provided by central banks. But ebbing QE news flow at a later stage (6-12 months) might challenge the necessary investment demand inflows to balance the market. Hence, **we stay neutral on precious metals**.
- The return outlook of the **energy** sector remains not compelling in 4Q12 and we **stay neutral**. Global crude oil supply should expand firmly and surpass incremental demand in 4Q12. We think this will bring Brent crude oil prices temporarily towards USD 95/bbl while WTI should slide towards USD 78/bbl in 4Q12. However, a weaker USD due to QE3, ongoing social turmoil in the Middle East and North Africa and the risk that Iranian tensions have the potential to heat up after the US presidential elections are likely to keep the oil price at around USD 105-110/bbl in 6 months. In addition, demand growth from EM countries in 1Q13 could start to gather pace.
- **Base metal** prices should hold their ground, with China's growth deceleration coming to an end. So we keep our **neutral stance**. That said, it is too early to call for a strong extension of the liquidity driven price rally seen until now, despite the RMB 1 trillion in infrastructure approvals by the NDRC (National Development and Resource Commission) in rail, highways, ports and other infrastructure projects. Many of the announced projects are already part of the 12th 5-year plan. The incremental demand impact of speeding up investments should therefore be rather muted this time compared with previous stimulus packages. Besides that, China's steel intensity for one unit of RMB of investment (FAI) has halved over the last 5 years.
- A 15% increase in **grain prices** remains our base case for 4Q12, with room for prices to top out in 1Q13. Demand rationing in case of corn and soybeans is still needed to limit the damage done to global inventories by lower supply. The quarterly stock and the monthly WASDE report by the USDA are reiterating the critical conditions of US grain inventories. The **softs**, on the other hand, should remain under pressure due to ample South American production and export activity. That said, the sub-sector already weakened quite a bit, which will limit the downside in the short run and we **remain neutral**.

Preferences (6 months)



Source: UBS CIO WM Global Investment Office

Precious metals

Preference: neutral

Gold (24 Oct): USD 1,702oz (last month: USD 1,764/oz)

UBS View (gold)

Gold 6-month target: USD 1,875/oz

• So far we saw inflows into gold of around 4 million ounces via physically backed ETFs since Bernanke's speech at Jackson Hole. We expect this trend to continue and to lead to an undersupplied market, with financial demand also finding its way into gold futures and physical gold bars and coins.
• Additional demand support comes from central banks, which are likely to further increase their foreign reserve allocation to the yellow metal. At the same time the drag from India's jewelry demand is set to fade with an already lower base in 2H11 and a stabilizing Indian rupee.
• Securing sufficient investment demand to push prices sharply higher is different from securing the needed demand over a long period of time, and along these lines we see less support for the price over a 6-month perspective. Secondly, from a portfolio perspective we currently prefer to take some risk off the table instead of on, and we thus maintain our neutral stance on gold.

↗ Positive scenario — **6-month target: USD 2,250/oz**

• Unorthodox monetary policy measures by the Fed start to weaken the USD persistently. Moreover, the risk of a Eurozone breakup intensifies, which triggers a tidal wave of investment demand for gold.

↘ Negative scenario — **6-month target: USD 1,450/oz**

• A hard landing of China and India or the Fed backing off from the recent monetary policy announcements would be a key drag on the yellow metal. The latter would have the strongest impact.

What we're watching	Why it matters
Physical demand/supply	In the months ahead, with the festive season in India starting and monsoon activity having improved considerably, supporting rural incomes, Indian physical demand is likely to pick up. **Key dates: World Gold Council mid-November release**. Mining activity in South Africa is unlikely to return to normal in the coming months. Hence, we are closely tracking mining news from South Africa, including the aggregated PGM IP numbers to assess the overall situation.
Investment flow	In order to see the gold price reaching our target, investment inflows into physically backed ETFs need to continue. To gauge investor interest in gold (sector) a build-up in futures positions is likely to materialize as well.
Monetary policy	**Key dates: 2 Nov US payrolls; 8 Nov ECB meeting, 12 Dec Fed meeting**

Recommendations

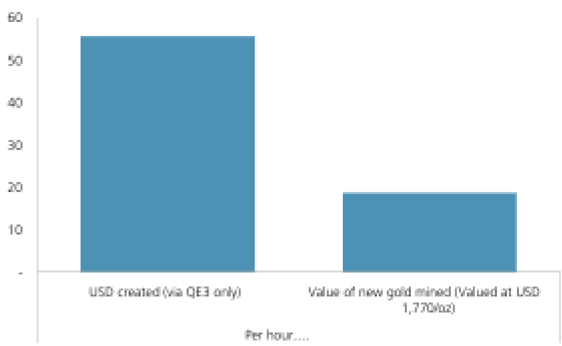
Tactical (up to 6 months)

• Although it is possible for gold to test its all-time high in the next three months, we are aware that the metal has already appreciated firmly ahead of the QE3 announcement, which requires an ever growing amount of investment demand to hold the current upward trajectory.

Strategic (1 to 2 years)

• To protect investors' portfolios from unorthodox monetary policy measures, holding gold exposure is a viable and attractive strategy. Alternatively, we recommend palladium as well as platinum. Structural supply issues with regard to platinum and a reduction in Russian stock sales of palladium speak in favor of PGM exposure, despite higher volatility.

Money created per hour (in mn USD)



Source: WGC, Bloomberg, UBS, as of Oct. 2012
Note: Past performance is not an indication of future returns.

Energy

Preference: neutral

Brent (24 Oct): USD 109/bbl (last month: USD 111/bbl)

UBS View (crude oil) **Brent 6-month target: USD 105-110/bbl**

- Growing fear over an escalation of the Syrian civil war, involving Turkey, allowed crude oil prices to move higher again. While Syria's crude oil exports already dropped to near zero due to international sanctions, the oil market's concerns relate to the Kirkuk–Ceyhan oil pipeline (Iraq-Turkey – capacity of 0.4mbpd) and the crude exports from the Turkish port of Ceyhan, around 70km from the Syrian border.
- Though we believe that Syria and Turkey are not interested in a military confrontation, a stop of crude oil flows from Iraq via Turkey would curb global incremental crude oil supply in 4Q12 by more than 50%. It would also tighten up the market balance in early 2013 and put additional pressure on the structurally low spare capacity in the crude oil market.
- In the absence of a further escalation, which remains our base case, ebbing news related to Syria-Turkey is likely to ease supply concerns. This should keep the market focus on weak demand growth and strong crude oil output from North America, allowing the Brent price to temporarily reach USD 95/bbl.
- A weaker USD, reduced economic tail risk for Europe, ongoing social turmoil in the Middle East and North Africa and the risk that the Iranian topic heats up again after the US presidential elections are likely to keep the Brent price around USD 105-110/oz in 6 months.

Positive scenario **Brent 6-month target: USD 140–180/bbl**

- Iranian oil exports are subject to a complete embargo, which would drain another 0.5–0.75 mbpd of global crude oil supply. Alternatively, a military confrontation that affects crude oil supply via the Strait of Hormuz would be the ultimate supply shock, requiring crude oil to be rationed on a large scale.

Negative scenario **Brent 6-month target: USD 75–80/bbl**

- Political tensions lead to a breakup of the Eurozone or intensify the economic contraction. At the same time, the Fed is not successful in promoting growth. Supply-wise, a restoration of Iranian exports and no supply cuts by OPEC would push oil inventories firmly up and weaken Brent prices towards USD 80/bbl.

What we're watching	Why it matters
Iran tensions	The biggest risk related to a potential military confrontation is an Israeli air strike on nuclear facilities in Iran. A preemptive strike could easily destabilize the region even further and threaten global crude oil supply.
Supply	Changes in the US gasoline blending mandate with ethanol (made from corn) might fuel higher crude oil prices as spare capacity increases slides further.
	US crude oil supply progress (room to grow by 1.3 mbpd from 2011 to 2013) is a vital offsetting factor to supply outages seen in the MENA region.
Demand	Most of China's demand growth seems to be related to stock building (strategic and by refineries). If this is true, the import should stay on the weak side y/y.
Oil market reports	Key date: **13 Nov,** IEA Oil market report

Recommendations

Tactical (6 months)

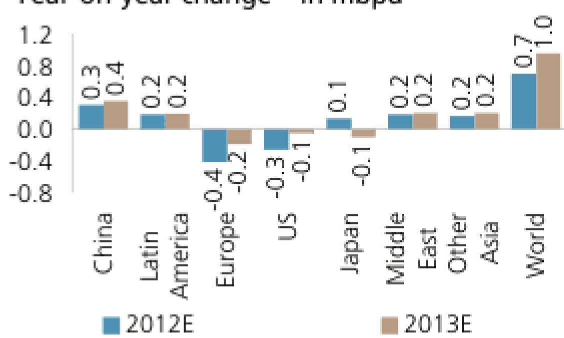
- OPEC is in a good position to balance the oil market, which should limit the price weakness. Along with central banks' support and with the geopolitical risks remaining, we believe that the potential downside for the oil price has declined, thereby warranting allocation.

Strategic (3–5 years)

- We regard the long end of the forward curve in crude oil as mispriced. To satisfy emerging market demand in the long run, prices around USD 90–95/bbl are unlikely to secure the needed investments to keep supply growing adequately. 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.

Petroleum demand in selected markets

Year-on-year change – in mbpd



Source: UBS, as of Oct. 2012

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

Base metals

Preference: neutral

Current (24 Oct) (last month)**: Copper USD 7,815/mt** (8,271); **Nickel USD 16,336/mt** (18,351); **Aluminum USD 1,912/mt** (2,079)

UBS View **6-month target: Copper: USD 8,800/mt; Nickel: USD 19,000/mt; Aluminum: USD 2,100/mt**

- After the swift uptick in prices, base metals have been under renewed pressure. The initial price strength – a simple catch up with Chinese prices triggered by a shift in demand expectations – is losing strength.
- In order to continue the price rally, a firm increase in final metal demand is needed. Since global economic growth is far from seeing such a demand uptick in industrial activity during 4Q12, we think that prices are likely to trade only sideways in the coming months before trending higher in 1Q13.
- Loose monetary policy is a good precondition for activity to pick up, but not a guarantee after so many rounds of monetary stimulus. We therefore look east to China. Although industrial activity growth in China is likely to bottom out, the upcoming leadership change in the country (November 2012 to March 2013), will likely delay a bigger investment program into 1Q13. The latest stimulus program will probably prevent Chinese IP from decelerating even further, but will not lift it meaningfully higher.
- On a single commodity level, we favor copper and nickel. For nickel, short-term supply issues due to a slower ramp up of new and existing projects have temporarily brought the market closer to balance than initially expected. Furthermore, we should see higher Chinese stainless steel demand with stabilizing housing activity and a demand pick up in stainless steel related products.
- With regards to copper, we expect import activity to remain strong, as seen in the import figures for September. Overall, the copper market should remain undersupplied, which could widen if financial demand is finding some store of value in the metal. We think this puts structurally low LME inventories at risk and should push the metal price towards USD 8,800/mt or higher over six months.

Positive scenario

- China eases monetary policy aggressively, pushing credit growth to 20% y/y. In the US the Fed is able to lift GDP growth via QE3 and the ECB puts an effective backstop to declining industrial activity.

Negative scenario

- To passive Chinese authorities keep GDP growth on a constant deceleration path. A severe escalation of the Eurozone crisis (room for a break-up) triggers a setback in investment activity – including in Germany.

What we're watching	Why it matters
Demand	China's growth deceleration should come to an end. But hard economic activity indicators, especially for China, have yet to catch up with the increase in prices. Hence, the current base metal market is already reflecting considerable growth goodwill that is in need of a demand confirmation by China, the US or Europe.
Supply	Copper output continues to undershoot market expectations and should be watched closely, as investment activity in mines increased sharply. For zinc, prospects for mine closures have been delayed and should keep the market oversupplied.
Economic data/forward curve	Chinese economic data – trade data, CPI, IP and loan growth by financial institutions. **Key date: 10-15 Oct**

Recommendations

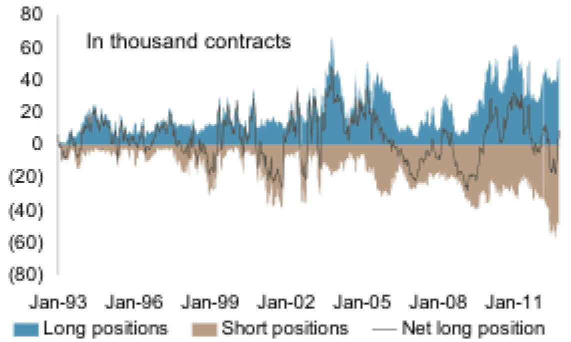
Tactical (6 months)

- We reiterate that the strong uptick in base metal prices is skating on thin ice, in our view. Real activity has yet to follow and support prices over a longer time period. 50% of the upside potential on a 6-month horizon is likely to be behind us, making only copper and nickel attractive, with +10% expected return.

Strategic (2 years)

- Although the strongest performance should be visible in zinc and lead, with existing mine capacity expected to peak in 2014/15, the recent price strength makes such an investment unattractive now, based on timing. Given a structurally solid supply side, investors should avoid aluminum and nickel. A firmer supply side should also limit the upside in copper.

Net speculative copper position at Comex are far from being overstretched



Source: Bloomberg, UBS, as of Oct. 2012
Note: Past performance is not an indication of future returns.

Agriculture

Preference: neutral

Current (24 Oct) (last month)**: Soybeans, USD 15.17/bu** (16.12)**; Corn, USD 7.54/bu** (7.44)**; Wheat, USD 8.84/bu** (8.87)

UBS View **6-month target: Soybeans: USD 17.0/bu; Corn: USD 9.0/bu; Wheat: USD 9.5/bu**

- Major US supply surprises on the **grains** side are rather unlikely in the near term as harvesting is in full swing. However, we think that demand is unlikely to drop as quickly as the USDA expects. According to the latest USDA grain stocks and WASDE reports, feed demand remained surprisingly resilient in 3Q12. To effectively ration demand, especially on the feed side, in an environment of critically low US corn and soybean stocks, higher prices are still required. For wheat, global production estimates were further lowered due to production losses in Australia, EU, Russia for 2012/13, which likely keeps prices supported in the near term. We expect corn and soybean prices to appreciate by 15% in the coming months.
- On the other side, the **softs** are likely to remain well supplied, which should keep prices under pressure. Improved export activity of coffee and strong stock selling from Vietnam in 4Q12 should weigh on coffee prices in the short-term. For sugar, higher production from Brazil and other producers should continue to burden prices in the near term, but also offer buying opportunities on a 12-month perspective.
- Aggregating the above points, the risk/reward for being long across the entire sector is not a given. We therefore reiterate our neutral sector stance.

↗ Positive scenario **Corn 6-month USD 10/bu; Soybeans 6-month USD 19/bu**

- With a reduced probability of El Niño, the yield potential for South American crops is likely to be lower. Any deterioration in South American supply prospects would require additional demand to be rationed.

↘ Negative scenario **Corn 6-month USD 6/bu Soybeans 6-month USD 12.5/bu**

- A change of the US ethanol-gasoline blending mandate would be a game changer. Increases in planted acreage combined with a steep decline in US demand for exports and feed would weigh on prices.

What we're watching	Why it matters
USDA WASDE report (monthly)	Revisions in acreage and yield estimates for the US crops remain a topic. Demand estimates are important, too, as they are key drivers behind inventory levels at the end of the year. **Key date: 9 Nov**
US grains stock report (quarterly)	The latest stocks data is not correctly reflecting the demand for Jun-Aug'12 as it contains both old and new crop stock figures. We expect stocks as of 1 Dec to reflect the true demand picture. **Key date: Jan 2013**
USDA crop progress (weekly, Monday)	Faster US grain harvests than usual have been exerting downward pressure on prices in the short run, which have reversal potential at a later stage.
COT (weekly, Friday)	Investors' net long positions in grain futures are still at high levels, but stable

Recommendations

Tactical

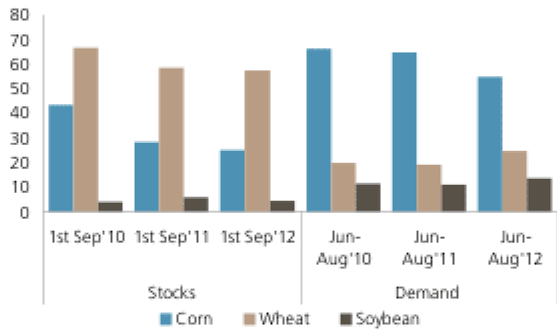
- Despite the recent setback in corn prices, risk-seeking investors should still hold on to long positions in corn. Demand rationing is still required to limit the drag on inventories. The expected return target for a long position in corn stands at 15%.

Strategic

- Our expected return outlook for grains stands at around –10% over the next 12 months. With grain prices not far below historical highs, the supply side is highly likely to expand meaningfully in 2013/14 and pressurize prices at a later stage. On the soft side, 3Q12 does not offer the right timing to build up positions.

US grains stocks continue to drop, demand remains resilient

Values in mn tons



Source: USDA, UBS, as of Oct. 2012

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

Listed real estate

Preference: neutral

UBS Global Index DTR (24 Oct): 1,490 (last month: 1,500)
UBS Global Index DTR (6-month target): 1,600

UBS View

- Since July global listed real estate has again performed well. Despite the good performance the asset class remains slightly attractive based the high dividend yield and implied property yield compared to bonds. Asia has been the strongest performer and Europe has outperformed the US year-to-date as tail risk was reduced by the ECB launching the OMT. QE3 is not an imminent performance driver but provides a support for capital values going forward and helps to keep interest levels low.
- Due to the current search for yields, listed real estate companies are able to refinance their investments at lower yields with longer maturities. The implied property yields to bonds and earnings yields over five-year swap rates are even more attractive due to low interest rates offering good opportunities within the global real estate space.
- Low to decent supply of commercial surfaces helps to push vacancy rates down which in turn increases the rent. We further see capital appreciation as possible in the light of overall stable fundamentals.
- Asia remain the positive performance generators in our view as this is the more cyclical market, whereas Australia is supported by high dividend yields. Overall Europe remains comparatively weak, while the UK and the US have already priced in some market improvements.

↗ Positive scenario — **UBS Global Index DTR (6-month target): 1,650**

- Improving fundamentals maintain listed real estate in fairly valued territory, despite stronger performance as occupancy rates grow faster than expected and rental income accelerate. Ongoing reflationary monetary policies across the world help to maintain favorable spreads between rental yields and bonds, maintaining real estate as a comparatively attractive asset class. Refinancing costs remain low.

↘ Negative scenario — **UBS Global Index DTR (6-month target): 1,300**

- US, European and Chinese growth rates disappoint investor expectations and cause the comparatively high valuation levels in the US to partially correct. Furthermore, a more severe recession in Europe triggers a tightening of credit standards and cuts real estate companies from the capital market, making listed real estate more dependent than ever on bank financing. Real estate underperforms global equities.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Corporate bond yields	This is one of the best indicators for listed real estate as a low yield helps reduce financing costs. A steep yield curve is furthermore a signal that the overall economic environment is improving. Both are currently supportive.
Rental yield and capital appreciation	The rental yield is usually inflation linked, as the upcoming supply is currently low this pushes up the occupancy rates and thus increasing the rents. Capital appreciation is expected to be stable to positive. Overall are both supportive.
Credit markets and financing costs	Lending conditions are still challenging for developers and private investors. Public companies by contrast have very good access to credit and capital.

Recommendations

Tactical (6 months)

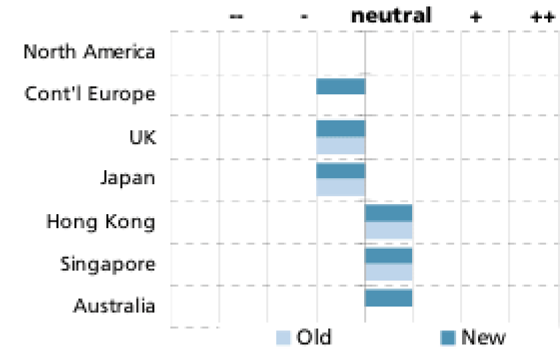
- We continue to be neutral global listed real estate recommending to have exposure to the Hong Kong, Singapore and Australia markets. The asset class is overall slightly attractive on relative valuation and the current low interest rate is supportive, but the uncertain environment warrants a neutral stance.

Strategic (1 to 2 years)

- Real estate is supported by several factors in the long term. We anticipate a gradual increase in payout ratios coupled with portfolio optimizations and ongoing cost-cutting. A weak economy limits strong rental growth, but low supply supports high occupancy rates keeping rents up.

Preference (6 months)

Our market preferences for listed real estate*



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

Source: UBS, as of 16 October 2012

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

UBS

Hedge funds

UBS View — **Prefer Relative-value and Event-driven**

• We expect hedge funds (HF) to offer positive asymmetric return characteristics due to active risk management and stop-loss strategies. On the active risk side of the equation, we have seen lower gross exposure and net-market exposure within the overall hedge funds group, with traders being cautiously positioned. With systemic risk at bay, we favor relative-value (RV) and event-driven (ED) strategies.

• The inherent hedging in relative value is appealing. Credit relative-value managers should perform well in this environment of higher fixed-income volatility and increasing pricing anomalies created by central bank interventions and limited competition.

• While ED managers share some of the performance drivers, idiosyncratic bets reduce the correlation to markets. The real reason to own this strategy, however, is the potential for outsized returns in distressed, high-yield, and other credit investments as the Eurozone crisis plays out.

↗ Positive scenario — **Prefer Equity long-short**

• Reduced uncertainty (e.g. resolution in Europe) lowers equities' correlation and volatility. This helps bottom-up fundamental analysis and equity long/short managers the most. Also, CEOs will likely make more corporate transactions that can be monetized by event-driven managers, and a clearer macroeconomic environment with more persistent trends would support CTA managers.

↘ Negative scenario — **Prefer Trading (Global Macro + CTA)**

• So far this year, the market has remained plagued by short-term reversals, due to central banks' intervention and stimulus effects, an obstacle for trend-following managers. Still, if the European deleveraging (or fiscal cliff, China hard landing) is unmanaged, this could threaten risky assets. Trading can do well if such a scenario unfolds.

Note: Scenarios refer to global economic scenarios (see slide 7).

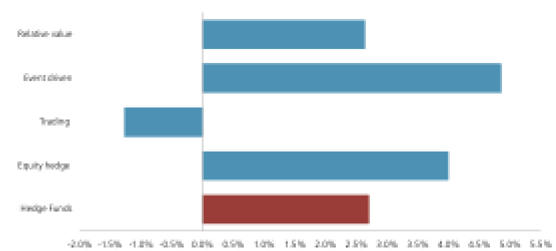
What we're watching	Why it matters
Global equity direction/ economic cycle	The outlook for global equities is an important HF performance driver. The economic cycle impacts the strategies differently.
Correlation	Correlation is an important performance/alpha driver for equity long/short, the largest HF strategy by assets under management.
Leverage	Gross and net leverage are key to monitoring risk.
Volatility	The direction influences certain HF strategies (e.g. convertible arbitrage).
Liquidity	Important in particular for large, less nimble HFs, it enables them to enter and exit their strategies.
Regulation	Volcker rule, USCITS III/IV

Recommendations

Strategic (1 to 2 years)

- **Recommendation**: Active risk management is instrumental for capital preservation during adverse market conditions. At the moment, we therefore favor relative-value and event-driven strategies, since they are less correlated to equity markets and other risky assets than trading.
- **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 (e.g. 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 owning to valid value preposition.

Performance, year-to-date



Source: HFRI, UBS, as of 31 Sep 2012

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

UBS

Private equity

UBS View

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

• Global [redacted] volume has continued its downward trend since Q4 2010, falling by -20% quarter-by-quarter in Q3 2012, with a drastic decline in Europe of -46%, the third lowest quarter since 2001. However, private equity withstood the negative [redacted] environment as global activity grew by +13% in Q3, and the US posted its strongest quarter since Q3 2007. The importance of private equity in emerging markets continues to grow, now accounting for 13% of global activity, strongly driven by Asia, but increasingly also by Africa.
• 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. Distressed strategies which focus on acquiring complex/illiquid loan positions from banks in Europe are also attractive.

↗ Positive scenario

Prefer small-/mid-cap buyout and secondaries

• 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

Prefer distressed debt

• 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 7)

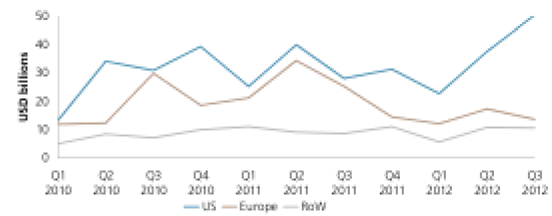
What we're watching	Why it matters
Credit markets	In H1 2012, leveraged loan issuance, an important ingredient of PE activity, dropped 17% y/y in the US, but over 41% in Europe. The US debt market is much deeper than Europe, raising over EUR 153bn of leveraged debt, while Europe achieved only EUR 16bn in 1H 12 at less attractive conditions.
Exit activity	Exit activity is an important indicator for the health of the PE market and a key return driver for investors. Despite the difficult macro environment, distributions from portfolio sales (USD 69bn) have held up, and grew 20% yoy.
Sector activity	Transactions in consumer discretionary and in energy & utilities remain the most preferred sectors for private equity investors in 2012.

Recommendations

Strategic (1 to 2 years)

- In Europe, the ongoing deleveraging has led to attractive opportunities for special situations. We thus recommend pursuing less liquid investment strategies with a preference for debt to benefit from the macroeconomic adjustment process and selling pressure for many European banks.
- We prefer small-/mid-cap buyouts in North America given the better economic outlook vs. Europe, higher transaction certainty and more attractive entry prices.
- Investors looking for downside protection during economic uncertainty can consider large-cap buyouts in the US, which offer exposure to large, diversified companies at more attractive prices and are supported by liquid debt markets.
- We advise investors make an ongoing allocation to private equity in emerging markets, which offer an attractive way to capture superior long-term growth and gain access to small-/mid-cap companies unavailable on the stock market.

The US has seen its strongest quarter since Q3 2007, while sentiment in Europe remains weak



Source: S&P, UBS CIO, as of October 2012
Note: Past performance is not an indication of future returns.

UBS

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

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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