



Financial Market Outlook

July 2009

Wealth Management Research

Overview

◆ Economy

- With the financial crisis continuing to recede, market participants are now left to gauge the strength and sustainability of the turnaround, as well as the long-term structural consequences of the crisis on the economy and asset markets.

◆ Equities

- After the sharp rally since early March, equity markets face a period of consolidation. **Signs of renewed economic weakness would likely weigh on equities, despite the attractive long-term valuation signals.** We favor **emerging markets** and the **energy sector**.

◆ Currencies

- We expect the **USD to weaken**. The need for USD liquidity will likely subside as stress in the financial system abates, which should continue to act as a drag on the USD.

◆ Fixed income

- Long-term government bond yields are likely to move higher, but near-term concerns about the strength of the economic recovery may keep this in check.

◆ Credit

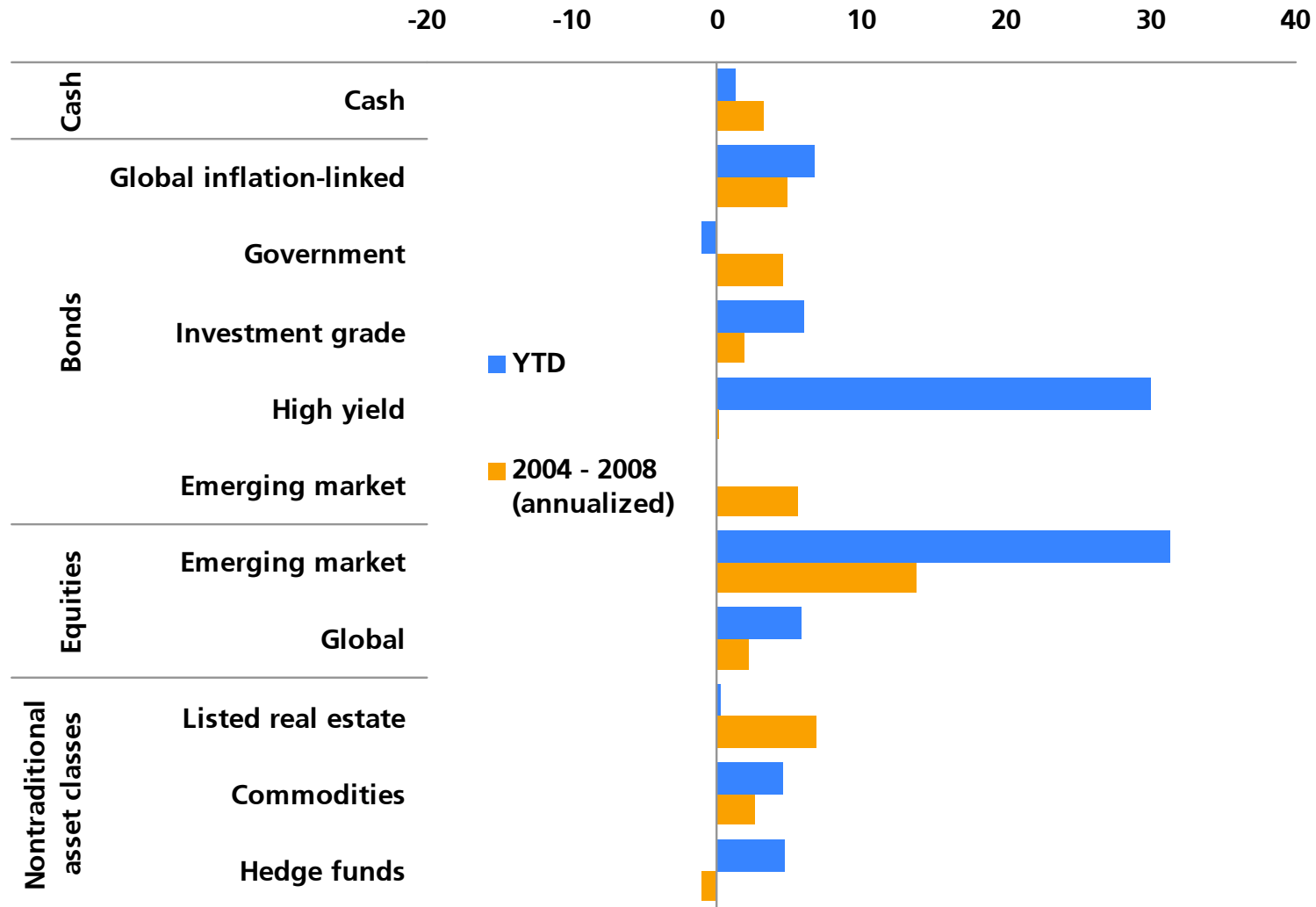
- **Investment grade corporate bonds still offer an attractive yield advantage**, even after the recent strong performance. Meanwhile, the attractiveness of speculative grade bonds has waned.

◆ Nontraditional asset classes

- We expect **commodity prices to trend higher** with the improving economic environment. Global real estate offers limited value, and a short-term correction could set in as rental income has come under pressure.

Market performance review

In %



Note: Information through July 1, 2009. Returns over five years are annualized.
 Source: Bloomberg, GPR, HFR, JP Morgan, Merrill Lynch, MSCI, Thomson Financial, UBS WMR

Economic outlook

Growth and inflation in major regions

◆ **Global economy: Leaving the worst part of the recession**

- The recession is abating due to aggressive policy response and financial sector stabilization
- Leading indicators are pointing to OECD recovery as of the third quarter '09, with the US ahead...
- ...but growth will generally remain sub-par due to household and financial industry deleveraging
- Core inflation will decline into 2010 due to excess capacity and weak labor markets...
- ...but aggressive monetary expansion and high debt levels pose longer-term inflation risks

◆ **Americas: US fiscal stimulus supports economic stabilization**

- Monetary easing and fiscal stimulus expected to lift economic activity later this year. Inventory rebuilding should provide an additional boost over the coming quarters.
- Headline inflation temporarily turns negative in 2009 and core will remain subdued. However medium-term we see the risk of inflation from expansionary monetary policy.
- Brazil will benefit from stronger (Asian) commodity demand, Canada and Mexico from US recovery.

◆ **Europe: Continental Europe lagging behind**

- The recession is expected to end later than in the US eventually extending into 2010. Weaker policy response and the strong currency is holding Continental Europe back. Deflation remains a risk.
- In the UK, recent better housing indicators raise the chance that it could emerge earlier from recession than EMU.
- Eastern Europe is hard hit but a full-fledged currency crisis will be prevented due international capital support

◆ **Asia: China leading the upturn**

- China, India and Indonesia are back to growth due to huge government stimulus, and more resilient private demand helped by falling interest rates.
- The rest of Asia is also showing signs of improvement, but remains much more export dependent.
- Japan has been badly hit by the export downturn, but recent data suggest that activity has started recovering

Economic outlook

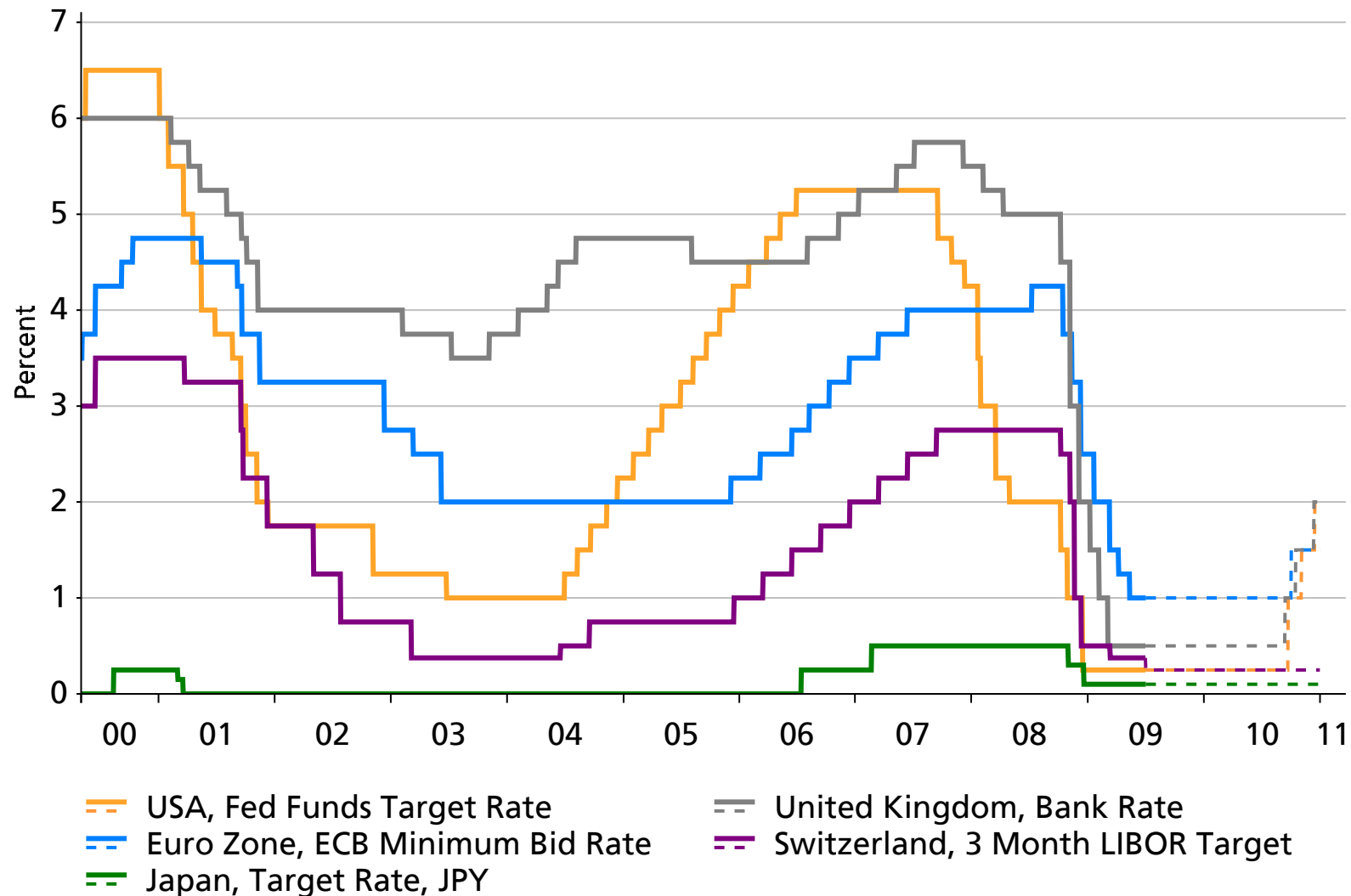
Forecasts for real GDP growth and inflation

GDP (real, % yoy)					Inflation (in % yoy)				
	2007	2008	2009	2010		2007	2008	2009	2010
Americas					Americas				
Brazil	5.7	5.1	-1.2	3.7	Brazil	4.5	5.9	4.5	4.5
Canada	2.7	0.7	-1.5	2.2	Canada	2.4	2.4	0.5	2.1
Mexico	3.2	1.3	-5.4	2.5	Mexico	3.8	6.5	4.4	3.5
USA	2.0	1.1	-2.2	2.0	USA	2.9	3.8	-1.0	1.8
Asia-Pacific					Asia-Pacific				
Australia	4.0	2.5	-1.0	1.0	Australia	2.3	4.4	2.0	2.0
China	13.0	9.0	7.8	8.5	China	4.8	6.1	-1.2	1.6
India	9.0	6.7	6.4	7.5	India	4.8	8.5	0.0	5.0
Japan	2.4	-0.7	-6.0	1.5	Japan	0.0	1.4	-0.8	0.5
Rest of Asia	5.7	2.7	-2.9	3.3	Rest of Asia	2.8	5.6	1.6	2.9
Europe					Europe				
Eurozone	2.6	0.7	-4.0	0.2	Eurozone	1.9	3.3	0.5	1.3
Germany	2.5	1.3	-6.0	0.3	Germany	2.0	2.6	0.5	1.5
France	2.1	0.7	-2.5	0.5	France	1.4	2.8	0.6	1.5
Italy	1.4	-0.9	-4.0	-0.1	Italy	1.9	3.3	1.0	1.8
Spain	3.7	1.0	-2.8	-0.5	Spain	2.2	2.7	2.0	1.8
Russia	8.1	6.5	-5.0	3.0	Russia	11.9	14.0	11.0	9.0
Sweden	2.7	-0.5	-4.5	0.0	Sweden	2.2	3.5	-0.5	0.8
Switzerland	3.3	1.6	-2.8	-0.4	Switzerland	0.7	2.4	-0.4	0.6
UK	3.0	0.7	-3.4	-0.2	UK	2.4	3.6	0.7	1.4
World	5.0	3.2	-0.8	2.8	World	3.8	5.7	1.6	2.8

Source: UBS Wealth Management Research

Monetary policy expectations: Low rates to remain

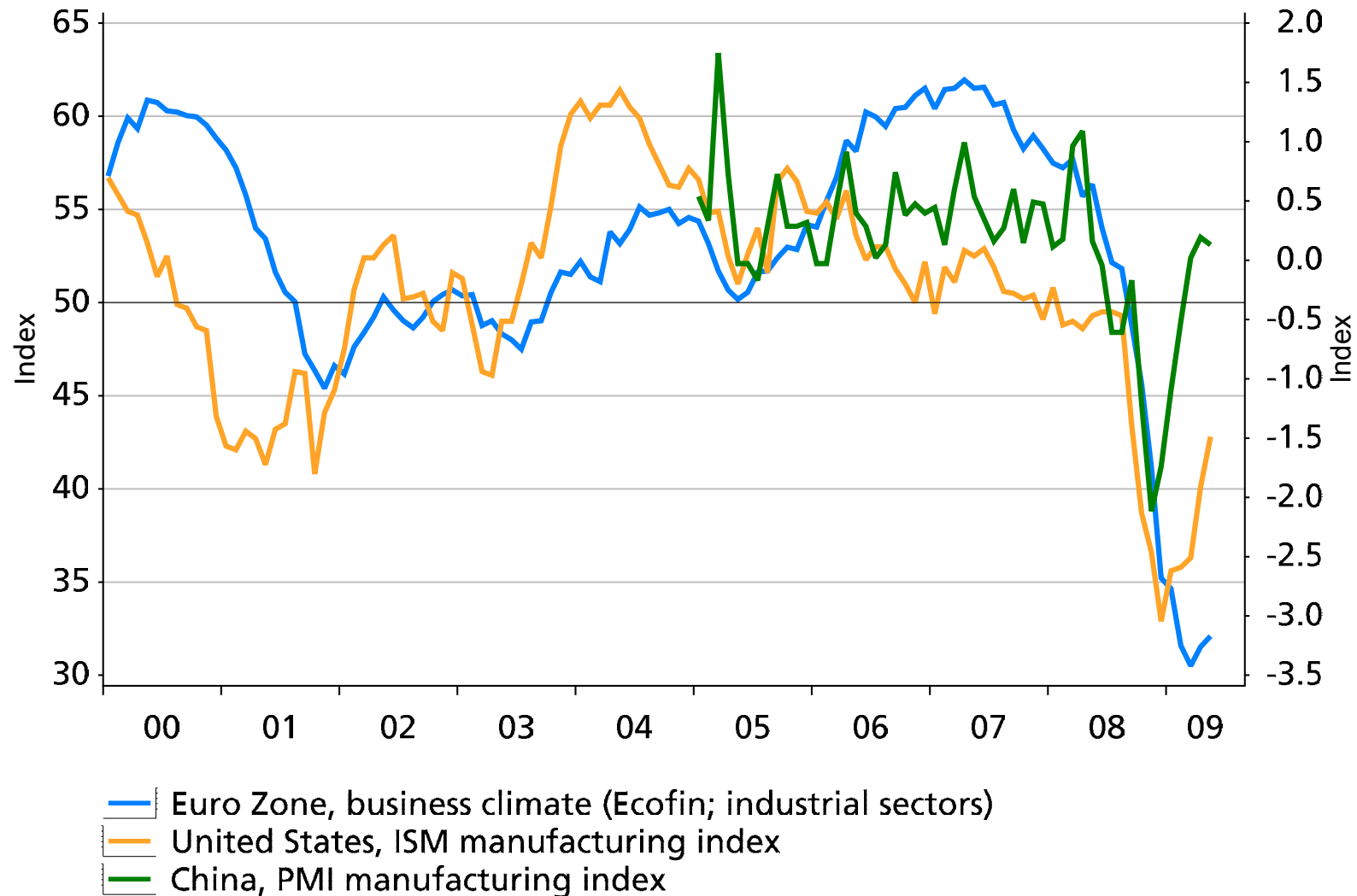
Monetary policy rates are expected to remain low through 2009 with first tightening expected to set in towards end-2010; dotted lines are UBS forecasts.



Source: Reuters EcoWin, UBS WMR

Leading indicators signal stabilisation

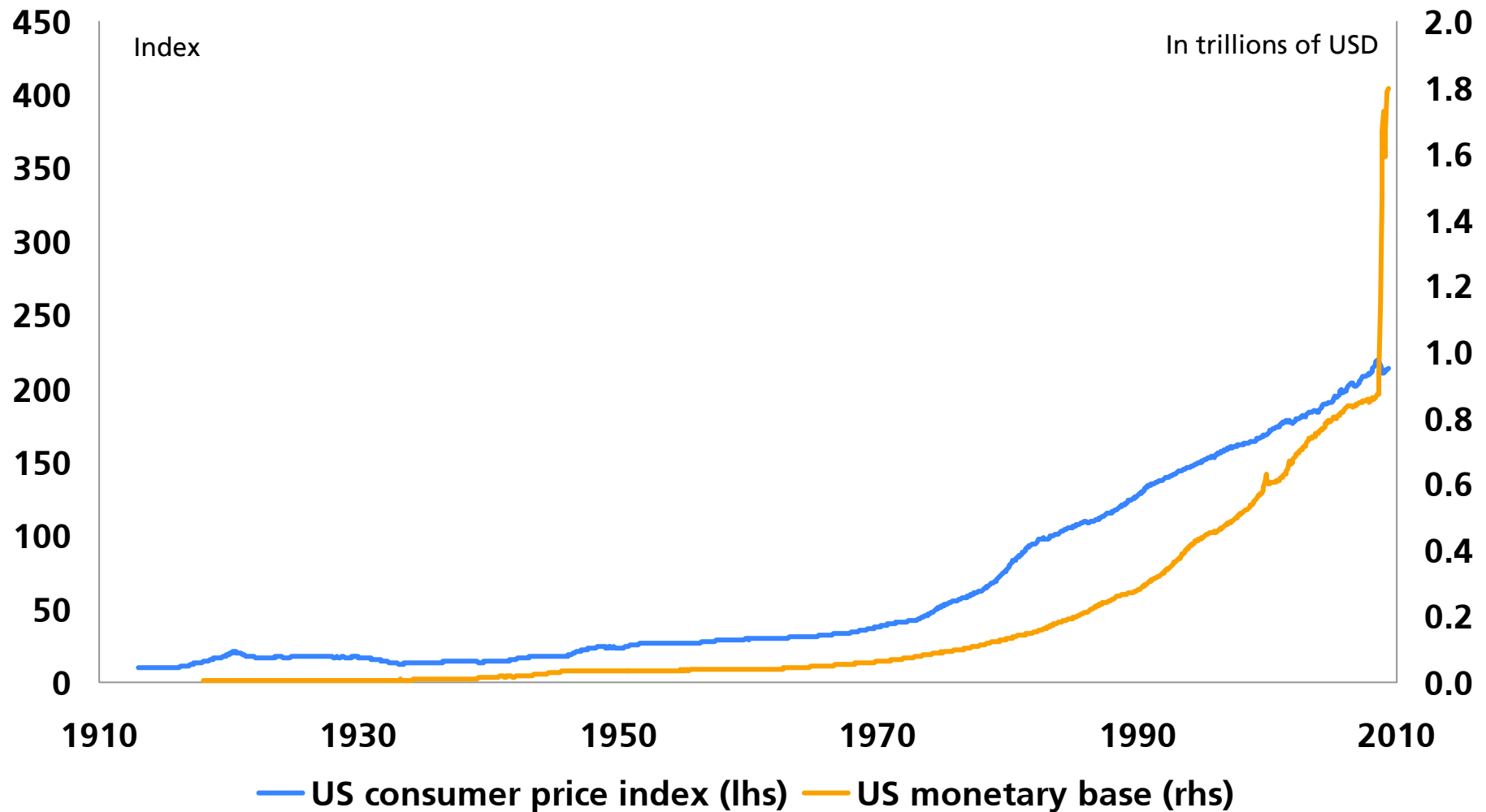
Leading indicators in China signal recovery; US economy is expected to recover in 2H09; Eurozone is lagging behind but should also show further stabilization



Source: Reuters EcoWin

US money supply and prices

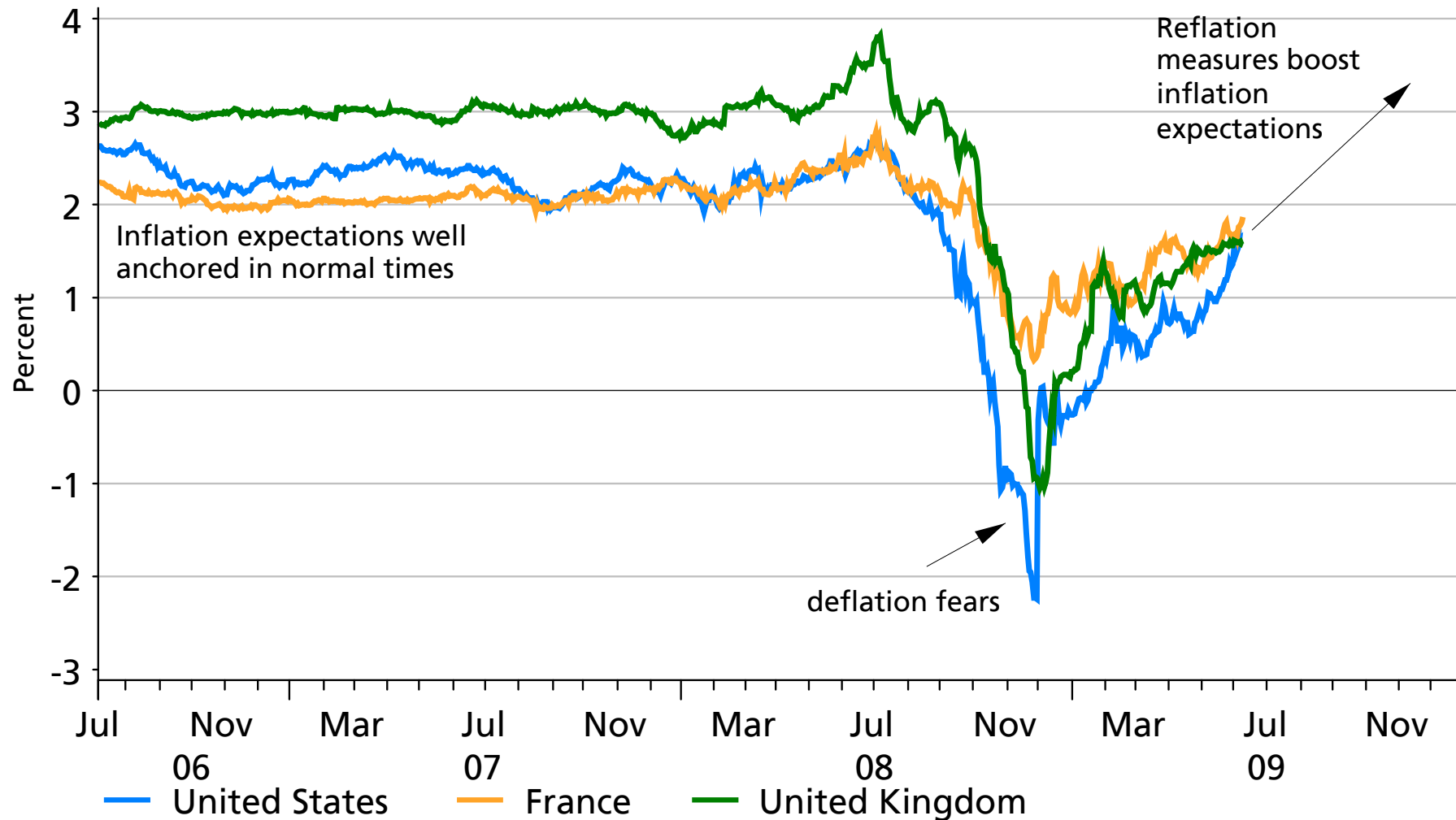
Expansion in monetary base will lead to future inflation if not reined in and decisively enough once the economy rebounds



Source: Thomson Financial, UBS WMR

Break-even inflation rates have recovered

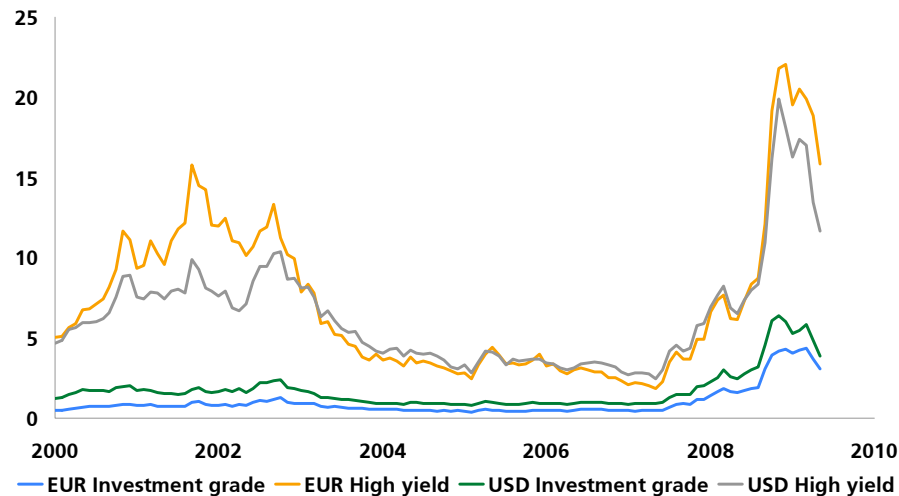
Break-even inflation rates (on 5y maturity ILBs) first collapsed last winter, but now have started normalizing



Source: Reuters EcoWin

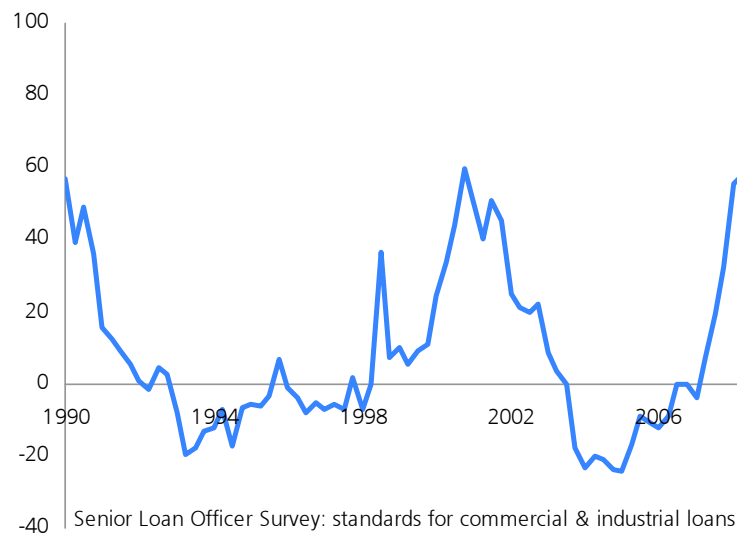
Signs of thawing in credit and money markets

Corporate credit spreads; in pps



- Corporate credit spreads have tightened since the beginning of 2009 but remain elevated in historical perspective.
- Strains in the inter-banking funding market have also subsided following substantial bank recapitalization.
- Standards for bank credit across various segments have improved over the last two quarters but remain in restrictive territory.

Bank credit standards; in %



USD TED-spread; in %



Source: Bloomberg, Federal Reserve, Merrill Lynch, UBS WMR

Asset classes

Relative attractiveness

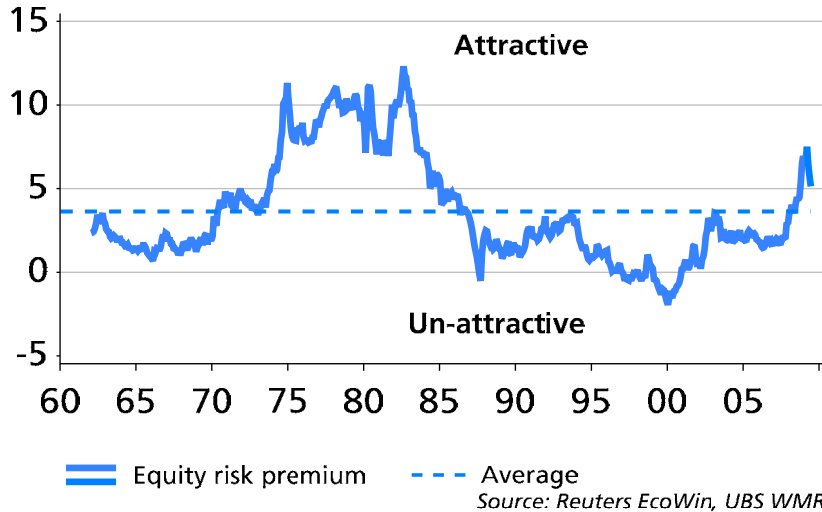
Asset class	Return Outlook*		Comment	Market factors **	
	1-3m	12m		Cycle	Value
Cash	n.a.	n.a.	Cash returns are minimal as a function of exceptionally low policy interest rate levels across the globe and therefore not attractive	n	n.a.
Government bonds	→	⬇️	Government bond yields are not at attractive levels and increasing inflation expectations could push prices lower	-	-
Corporate bonds (IG)	↗️	↗️	Corporate bonds are favoured due to the attractive additional yield offered over government bond yields	n	++
Equities	⬇️	↗️	Equities are good value and should be supported medium term as economic recovery sets in; near term the risk of temporary setbacks has increased after the sharp rally since early March	+	++
Listed Real Estate	⬇️	→	Valuation is fair for listed real estate, but high supply and refinancing needs keep uncertainty high for the asset class	-	n
Commodities	→	↗️	Commodity prices are supported by strong demand from emerging economies and should move higher with the recovery in the global economy	+	+

* Arrows indicate whether the asset class is expected to deliver a sufficient return premium (↗️) above cash over the respective investment horizon. Generally more risky assets, such as equities, commodities and listed real estate, are required to deliver a higher premium than fixed income classes. Also, a less stable environment will call for a higher premium. If the arrow points down (⬇️) this would call for a more cautious stance than normal (→) with regard to an asset class. Besides expected returns, this also takes into account the evaluation of risk over the respective horizon. Depending on individual investment horizons and liquidity needs, investors should weight those signals in their decision making.

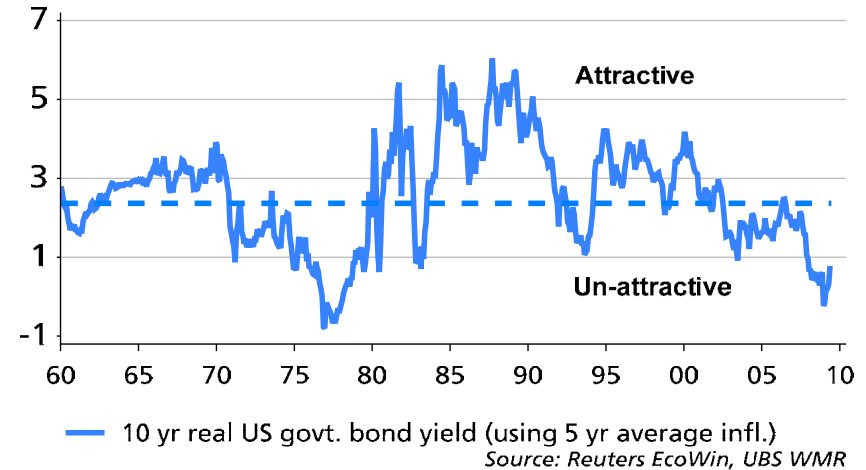
** The evaluation ranges from very negative (---) to very positive (+++); n refers to a neutral or inconclusive expected effect.

Asset class valuation: Corporate assets offer good value

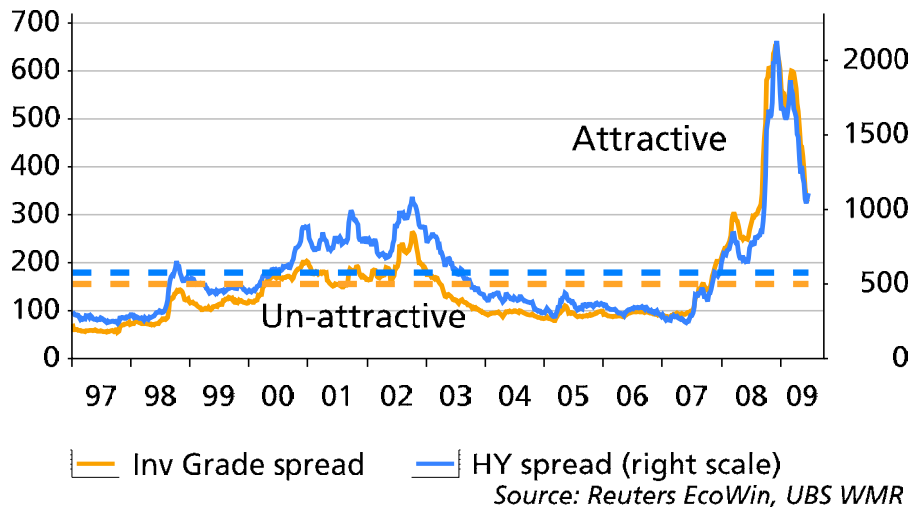
Equities: good value



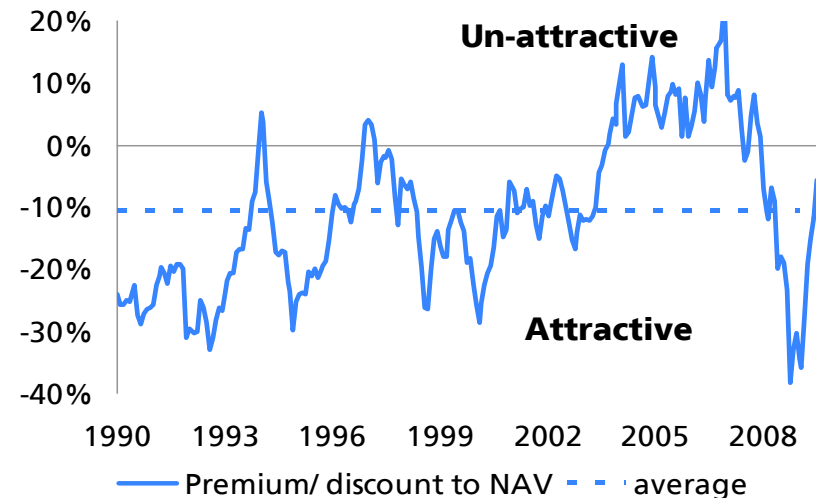
Govt. bonds: expensive



Corporate credit: cheap



Listed real estate: Fair

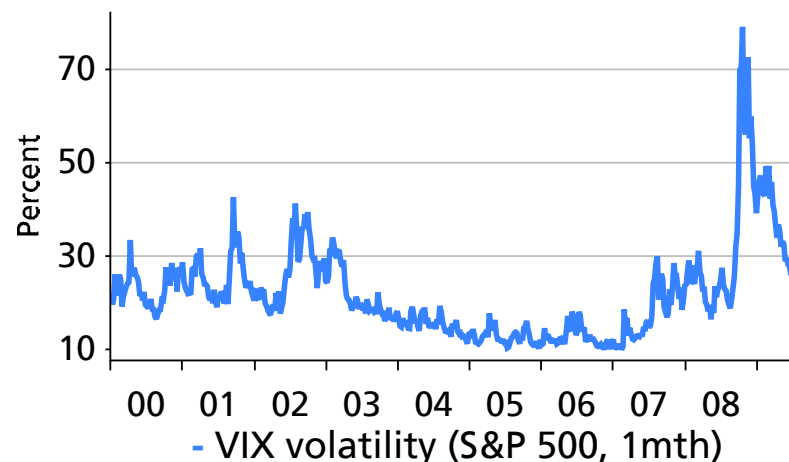


Financial markets: Equity volatility at pre-Lehman levels

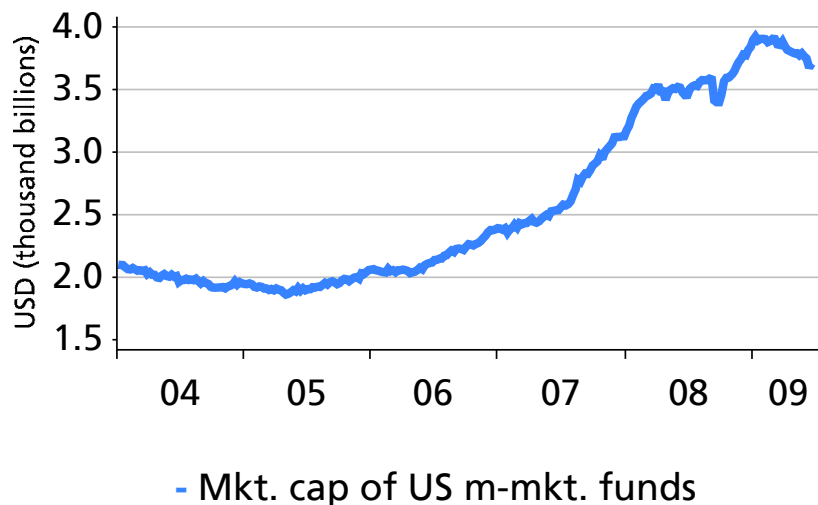
Equity markets have rebounded



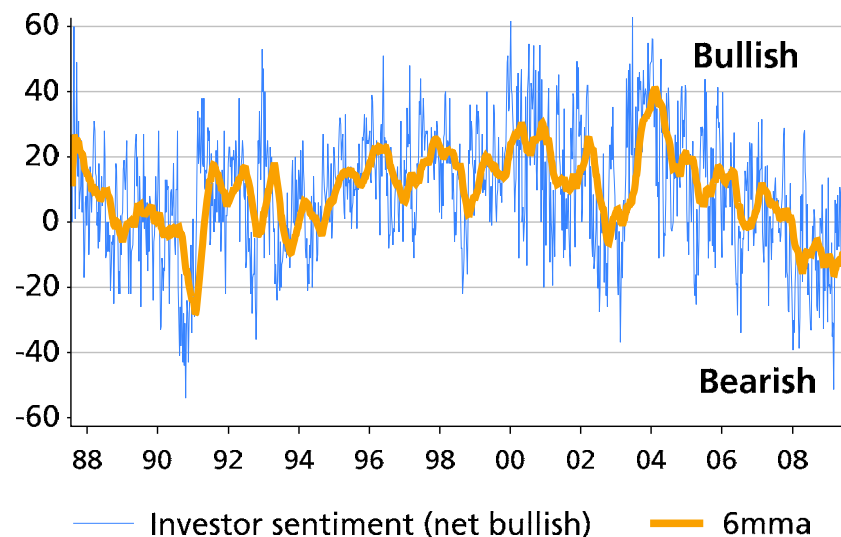
Volatility is receding



Cash still on the sideline



Private investors sentiment



Developed market equities

Relative attractiveness

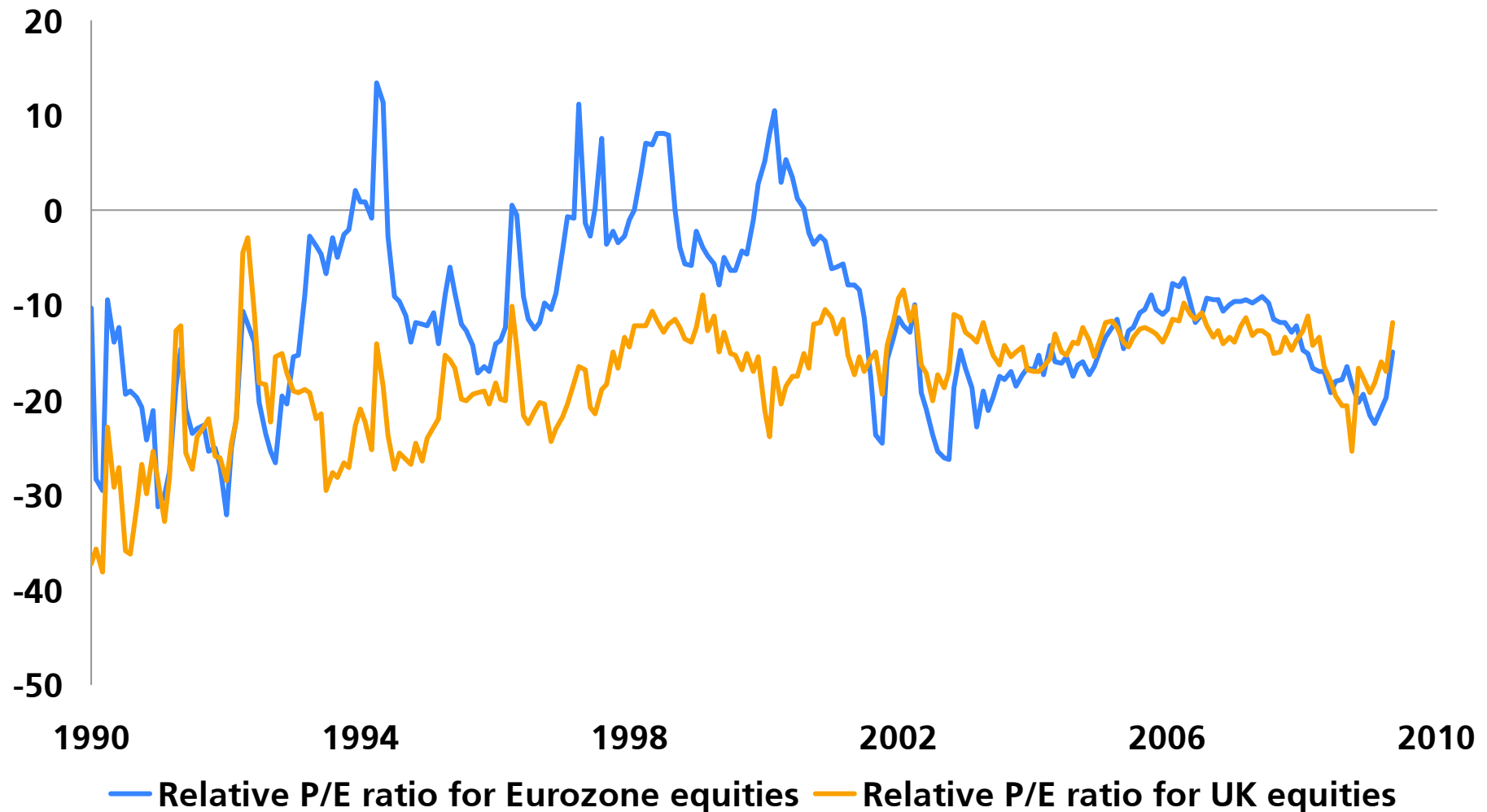
Markets	Outlook*	Comment	Market factors **		
			Cycle	Rel. value	
N. America	USA	→	Bottoming out of economy provides support, positive earnings momentum, still valuation upside	+	n
	Canada	→	Oil price supportive, earnings momentum stable, but relatively expensive market	++	--
Europe	EMU	↗	Attractive valuation, expected uptick in manufacturing activity supportive	+	++
	UK	↗	Very attractive valuation, oil price supportive, but weak earnings momentum	n	+++
	CH	↘	Less geared to economic recovery due to defensive sector composition	-	--
	Sweden	↘	Weak earnings momentum, and a more expensive European market, banks' exposure to Eastern Europe an additional risk	-	-
Apac	Japan	→	Uptick in manufacturing activity supportive, but relatively expensive market, currency strength a headwind	-	-
	Australia	↘	Weak earnings momentum, Australian commodity sectors relatively expensive compared to global peers	-	n
EM	Emg.Mt.	↗	Recovery under way in major countries, structurally higher growth outlook, relatively robust earnings momentum	++	-

* Total return expectations incl. expected dividends over a 6-12m investment horizon; assessment is relative to global equities, in local currency terms.

** Evaluation ranges from very negative (---) to very positive (+++); n refers to a neutral or inconclusive signal; rel. value refers to the value advantage of the respective market relative to the global equity market index.

Eurozone and UK trade at a discount

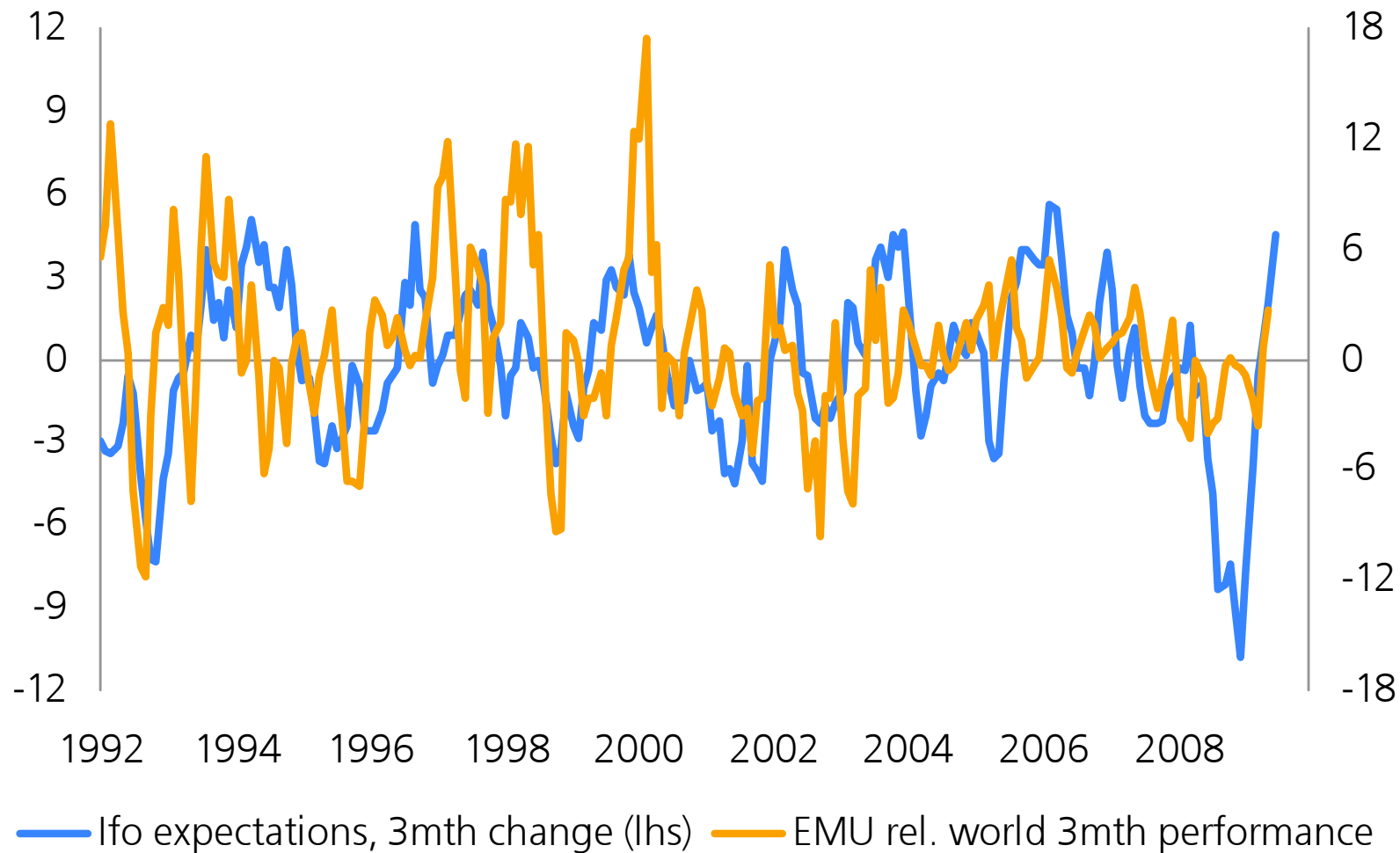
Relative P/E ratio for Eurozone and UK equities based on consensus 12-month forward earnings expectations



Source: MSCI, Thomson Financial, UBS WMR

Business sentiment and European equity performance

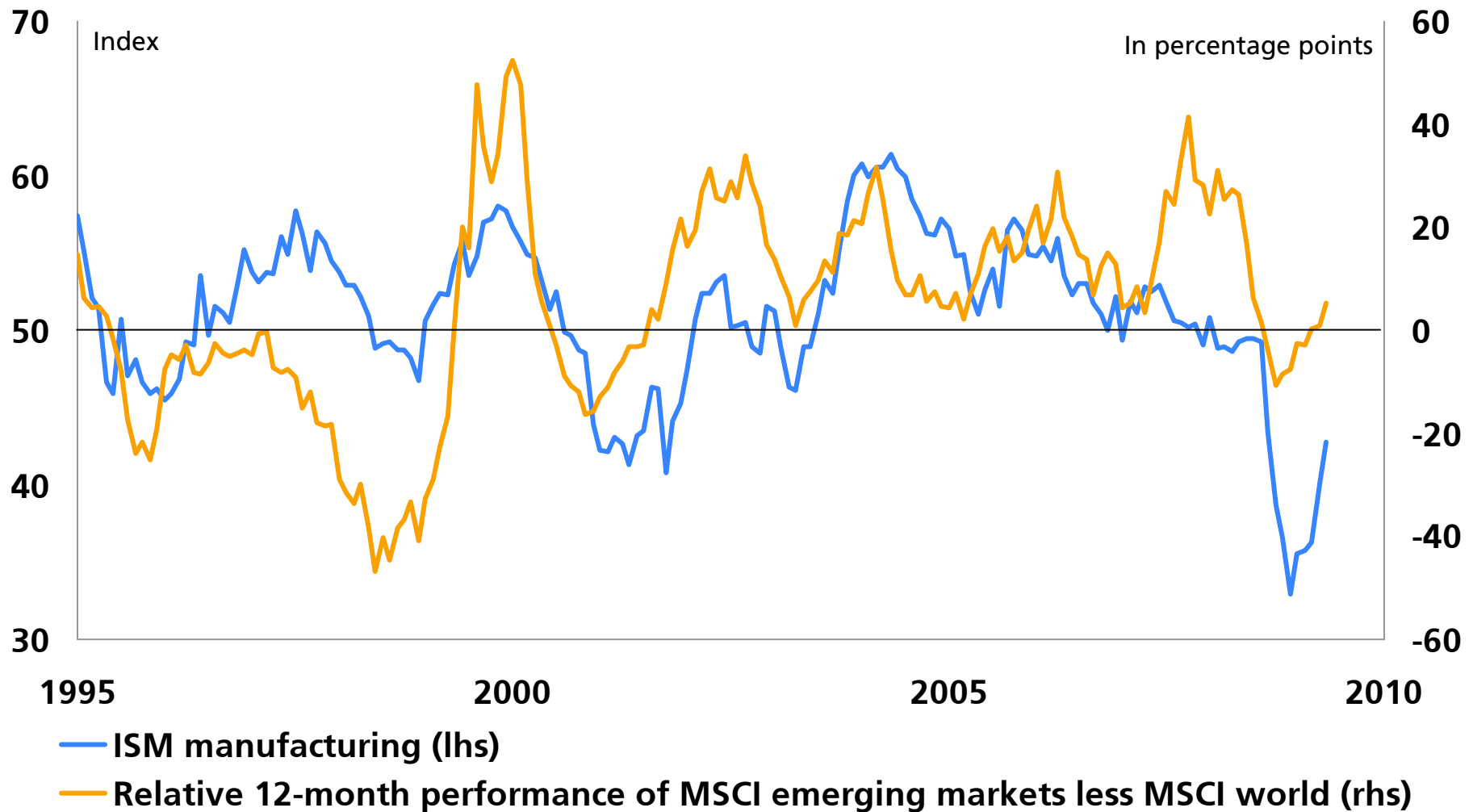
Positive relationship between for EMU equities and German business sentiment; change and performance in %



Source: Thomson Financial, UBS WMR

Economic recovery supports EM equities

Emerging markets tend to outperform global equities when business sentiment improves



Source: Thomson Financial, UBS WMR

Asia ex-Japan and emerging market regions

Relative attractiveness to emerging market index (MSCI)

Markets	Outlook*	Comments	Market factors**	
			Cycle	Rel. value
Asia Ex-Japan	➔	Strongest economic fundamentals; solid outlook for the two largest economies China and India	++	n
EMEA	➔	Most EMEA markets attractively valued; region with the weakest economic fundamentals, we prefer South Africa	--	++
Latin America	➔	Economic fundamentals have not deteriorated dramatically, markets are relatively expensive; we prefer Brazil over Mexico	n	-

* Total return expectations incl. expected dividends over a 6-12m investment horizon; assessment is relative to the emerging market index (MSCI), in USD terms

** Evaluation ranges from very negative (- - -) to very positive (+++); n refers to a neutral or in-conclusive signal; rel. value refers to the value advantage of the respective market relative to the global emerging market index.

Asia ex-Japan equity markets

Relative attractiveness to overall Asia ex-Japan market index (MSCI)

Markets	Outlook*	Comments	Market factors**	
			Cycle	Rel. value
China	↗	Fastest growing economy; relative valuations attractive	+++	+
Hong Kong	↗	Benefiting from liquidity; reasonable valuations	n	+
India	↗	Domestic-oriented economy; prospect of economic reforms	++	n
Indonesia	→	Domestic-oriented economy; demanding valuations	++	--
Korea	↘	Not cheap, overly optimistic consensus earnings expectations	--	-
Malaysia	↘	High dependency on external demand	--	n
Philippines	→	Market appears fairly valued	+	n
Singapore	→	Reasonable valuations; exposed to external demand	--	+
Taiwan	↘	Demanding valuations; bleak outlook for Taiwan IT	--	--
Thailand	→	Attractively valued; political risk remains substantial	--	++

* Total return expectations incl. expected dividends over a 6-12m investment horizon; assessment is relative to overall Asia ex-Jap market index (MSCI), in USD terms

** Evaluation ranges from very negative (---) to very positive (+++); n refers to a neutral or in-conclusive signal; rel. value refers to the value advantage of the respective market relative to the over Asia ex-Jap market index.

Global equity sectors

Relative attractiveness to global equities (MSCI indexes)

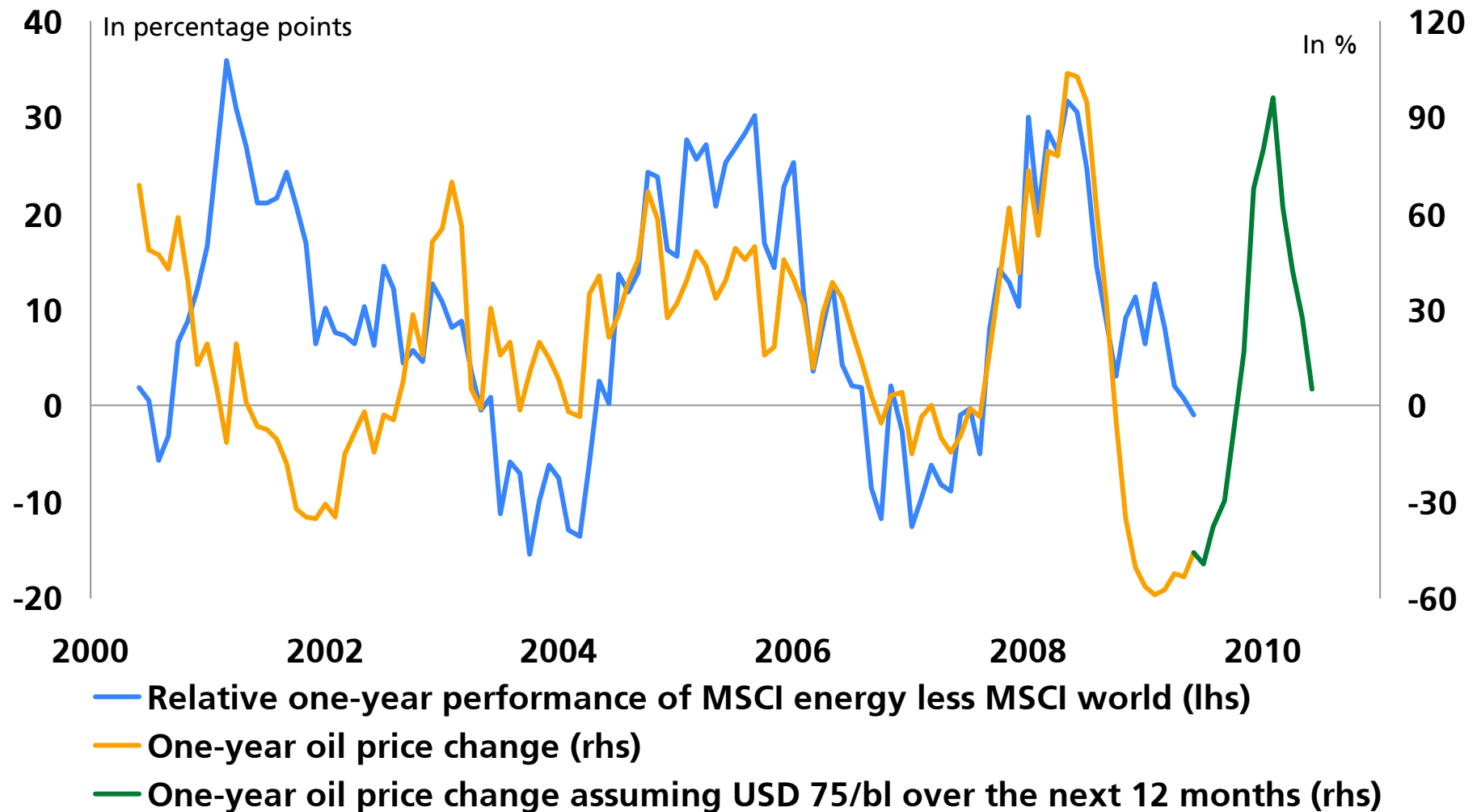
Markets	Outlook*	Comment	Market factors **	
			cycle	Rel. value
Consumer Discr.	↗	Earnings are likely to bottom out over the course of 2009	+	n
Consumer Staples	→	Long-term positive growth outlook, relative high valuation premium	n	--
Energy	↗	Earnings revisions should support the sector, attractive valuation	n	+
Financials	→	Still substantial need for capital, further credit losses expected, valuation upside	-	+
Health Care	↘	Non-cyclical earnings, but relative high valuation premium	n	--
Industrial	→	Earnings are still likely to fall, stabilizing macro indicators should support the sector sentiment	-	n
IT	↗	We prefer US software companies	+	n
Materials	→	Earnings are still in a cyclical downturn, demand pick up from emerging markets starts to support the sector	-	n
Telecom	↗	Attractive dividend yield, but low growth upside	n	+
Utilities	↘	Negative earnings revisions are a drag for the sector; rather defensive sector	n	-

* Total return expectations incl. expected dividends over a 6-12m investment horizon; assessment is relative to the overall global equity index.

** Evaluation ranges from very negative (---) to very positive (+++); n refers to a neutral or un-conclusive signal; rel. value refers to the value advantage of the respective market relative to the global equity market index.

Energy: Recovery in oil price supportive

Relative performance of energy and oil prices are highly correlated. Over the past few months, the sector performance has been lagging



Source: Thomson Financial

Currencies

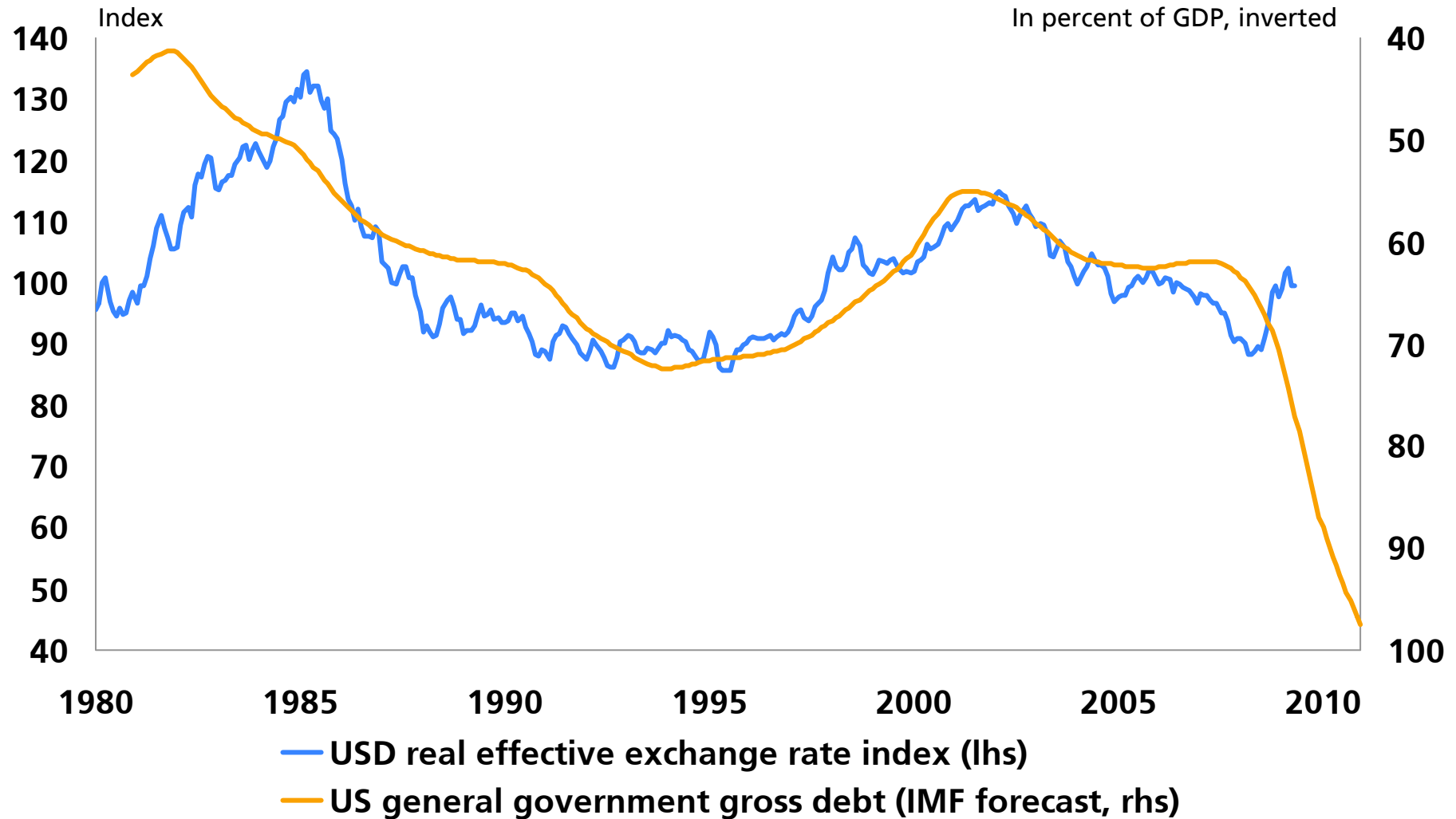
Forecast table

Currency Pair	Forecast				Fair	Market factors *			Comment
	spot	3M	6M	12M	Value	Value	Carry	Drivers	
EURUSD	1.4024	1.37	1.45	1.50	1.25	-	+	+	Waning USD dominance in reserve holdings; US infaltion risks
USDCHF	1.083	1.11	1.05	1.03	1.21	+	-	+	CHF will remain more oriented towards the EUR than USD
USDJPY	96	103.00	105.00	110.00	96.62	n	+	n	Both countries are highly indebted and need strong stimulus
GBPUSD	1.6374	1.61	1.67	1.72	1.72	+	+	+	Long term investors should find current GBP values attractive
USDCAD	1.1598	1.10	1.08	1.05	1.16	n	-	-	High oil prices support the CAD
AUDUSD	0.7962	0.76	0.80	0.83	0.66	-	+	+	Commodities and trade relations to China supportive
EURCHF	1.5196	1.52	1.52	1.55	1.52	n	n	n	SNB limits downside, low interest rate spread limits upside
EURJPY	134.67	141.11	152.25	165.00	120.83	-	++	+	Japanese investors look for investment opportunities abroad
EURSEK	10.871	10.40	10.30	10.00	9.52	-	-	-	Worries about Baltic states falling, but SEK already very weak
EURNOK	8.982	8.60	8.40	8.20	8.60	-	-	-	Stable state finances, rising oil prices supportive for NOK

* Value is based on deviation from spot to purchasing power parity; Carry is based on (a) does the exchange rate rise or fall in a risk taking environment and (b) is the environment risk taking or risk averse; Drivers is an expression for special factors supporting or hurting the exchange rate (details to drivers in Comment)

USD: deficits hurt the USD

Rising government debt-to-GDP ratio suggests further USD weakness



Source: Thomson Financial

Global Bonds

Relative attractiveness

Markets	Outlook*	Comments	Valuation**	Cycle**
Government bonds	⬇️	Government bond yields are not attractive in a historical perspective and do not compensate for the medium-term risk of inflation from the current loose monetary and fiscal policy.	-	-
Investment Grade	↗️	IG corporate bonds remain our preferred credit segment. Overall, investor demand for corporate bonds has increased and we expect flows into the asset class should continue. Nevertheless, uncertainties about the deterioration of corporate credit quality will remain in the focus of investors	++	n
High Yield	➡️	HY spreads have also declined substantially since beginning of the year. Lower company earnings and restricted access to credit for risky borrowers are increasing corporate default rates, which are now well above the long-term average. We expect the failure rate to climb to around 13% in the US. Consequently, the segment's valuation appeal has faded substantially.	n	n
Em. Market USD Debt	➡️	The risk of an outright emerging market crisis has receded after announcements of support from international organizations such as the IMF. While outright EM market debt defaults appear unlikely, we think that EM USD bonds are somewhat expensive compared with USD corporate bonds.	-	n

* Arrows indicate whether the bond segment is expected to deliver above (↗️) or below (⬇️) normal returns. Generally High Yield and Em. Market debt are expected to deliver higher returns than better rated Investment Grade and Government bonds.

** The evaluation ranges from very negative (---) to very positive (+++); n refers to a neutral or in-conclusive expected effect.

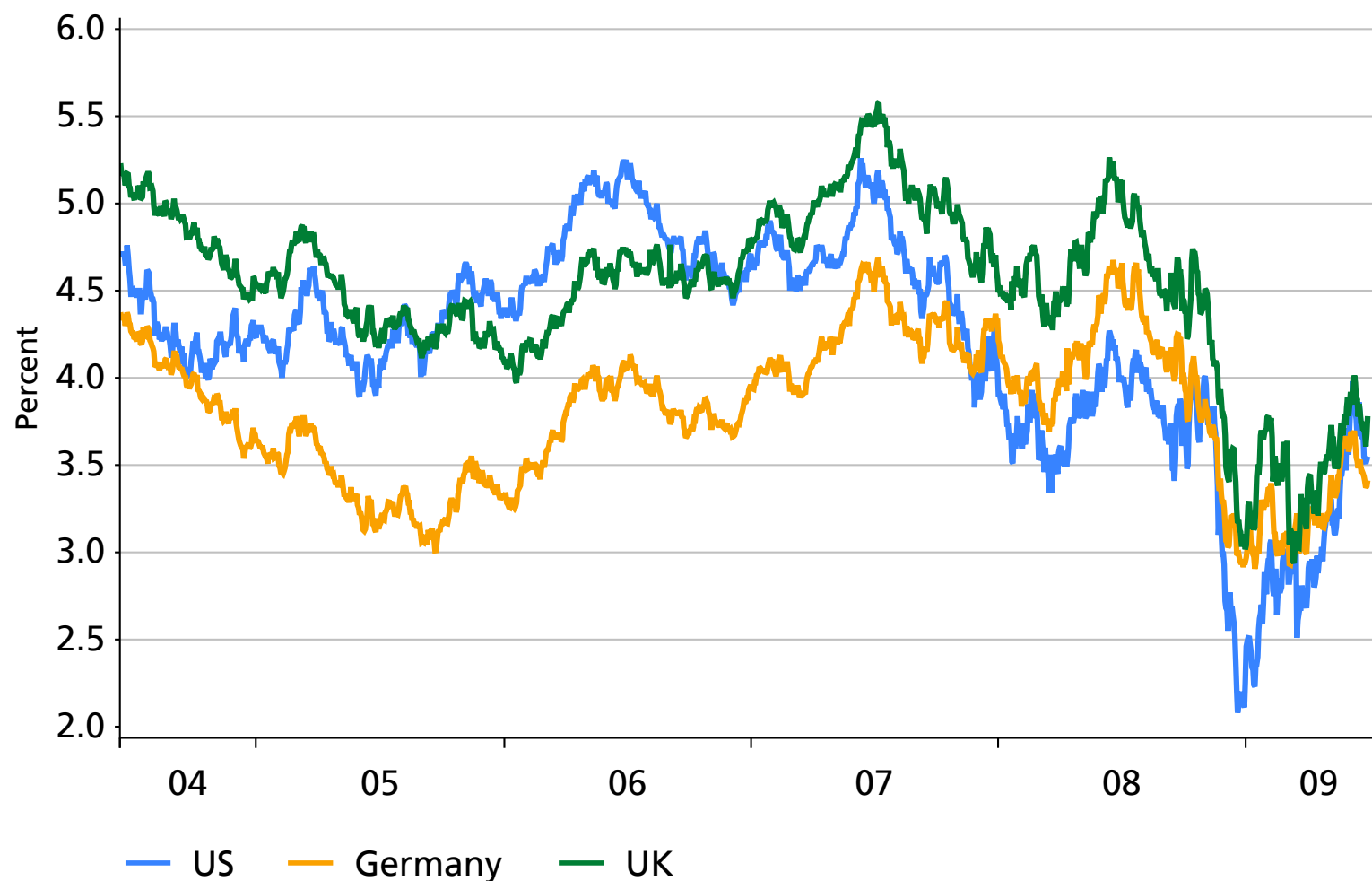
Government Bond Markets

Forecast table

		Forecasts		
Europe	Comment	29.06.09	6 mths	12 mths
EUR 3M Libor	First rate hike by ECB in H2 2010	1.2	1.0	1.0
EUR 10Y Bund	Spread to USD likely to increase as EU lags US recovery	3.4	3.5	4.0
CHF 3M Libor	First rate hike by SNB in H2 2010	0.4	0.3	0.3
CHF 10Y Eidg.	So far deflation risk higher than inflation risk	2.3	2.5	2.8
GBP 3M Libor	Interbank spreads have potential to decline	1.4	0.8	0.6
GBP 10Y Gilt	Economic recovery should drive long rates up	3.6	3.8	4.3
Americas		29.06.09	6 mths	12 mths
USD 3M Libor	First rate hike by Fed in H2 2010	0.0	0.3	0.3
USD 10Y Treas.	Economic recovery should drive long rates up	3.5	3.5	4.3
Asia		29.06.09	6 mths	12 mths
JPY 3M Libor	No end of Zero Interest rates policy to be expected	0.0	0.3	0.3
JPY 10Y JGB	Deflation risk currently increasing	1.4	1.5	1.8
Sources: Bloomberg, UBS WMR				

Government bonds are not attractively valued

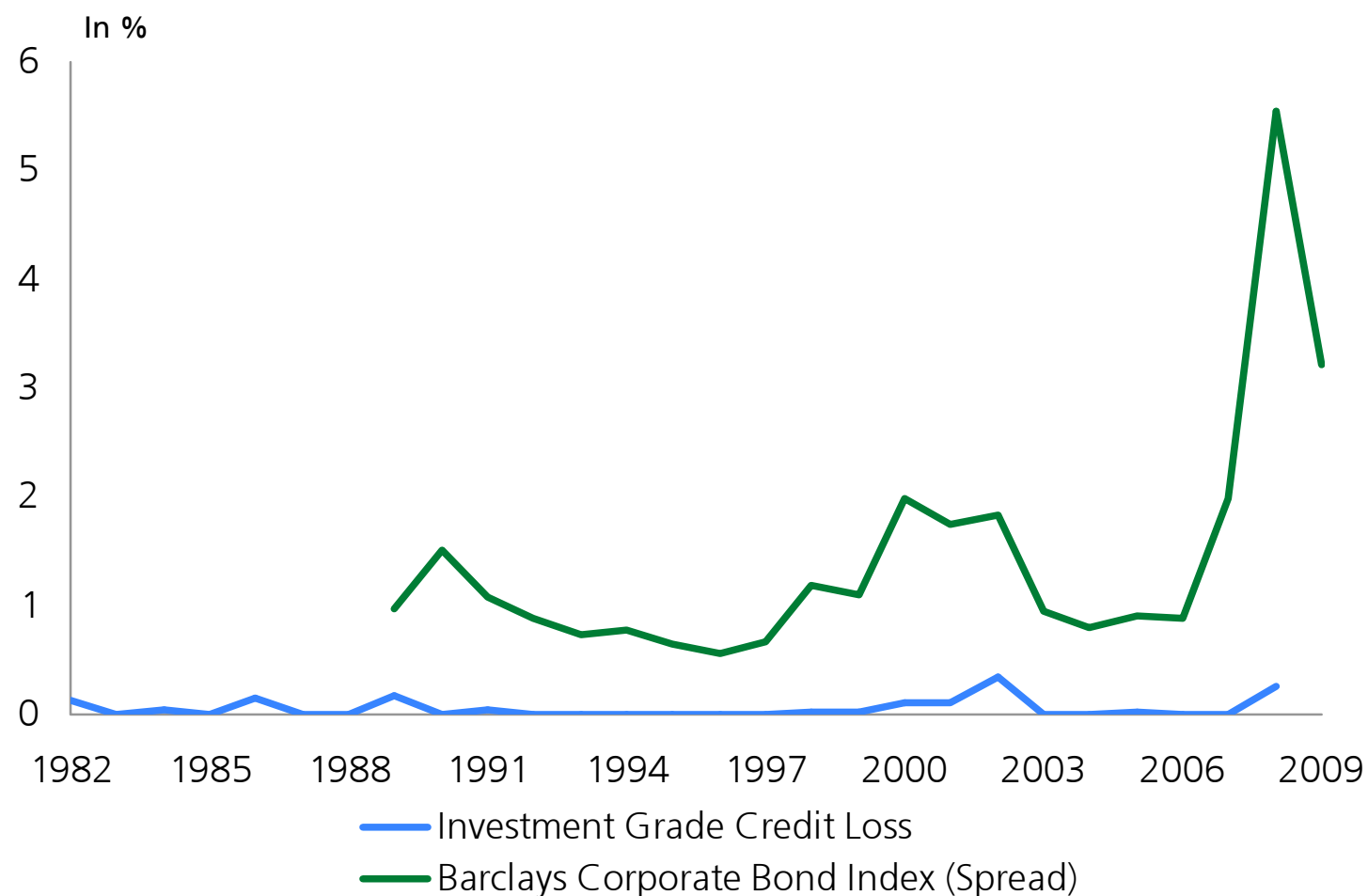
10 year government bond yields have increased recently, but are still not attractive in a historical comparison.



Source: Reuters EcoWin, UBS WMR

Corporate credit is an attractive investment opportunity

Investment grade corporate bond spreads (additional yield over government bonds) are far above historical credit loss experience, indicating attractive value even after recent spread tightening



Source: Moody's, Barclays, UBS WMR

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