UBS global outlook

Wealth Management Research
December 2011

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Dear readers,


Andreas Höfert

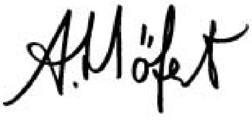

Alexander S. Friedman

In the latest round of doomsday scenarios, some are claiming that the ancient Mayas predicted the end of a cosmic cycle on 21 December 2012 – or even the end of the world. We are not quite that pessimistic, but we still have to acknowledge that we are witnessing a climate change, as 2012 will likely be another year of sub-trend growth as the aftermath of the financial crisis continues to unfold.

To describe 2011 as eventful would be an understatement. The Arab Spring and the Fukushima nuclear catastrophe in Japan dominated the headlines, but markets stayed largely focused on the developed economies' debt woes. Just think of the protracted debt ceiling debate in the US last summer, which led to the first credit downgrade in American history. Or the series of "last chance" European summits in the fall, which haven't managed to resolve the euro crisis.

The political dithering and lack of leadership currently on display by developed world decision-makers can be explained fairly easily: Governments find the potential solutions to the public debt problematic either unappealing, unfeasible, or a combination of the two. Moreover, with presidential elections looming next year in France and the US, we don't think the world can expect Presidents Obama and Sarkozy to make any bold moves if these would jeopardize their chances for reelection.

Many investors want to know what the ultimate asset is in an environment still characterized by heightened uncertainty. We would respond by saying that such an asset doesn't exist, and the old diversification rule remains valid even after the financial crisis. But diversification doesn't mean buying anything and everything: A conservative tilt to the portfolio in 2012 may not secure investors huge returns, but it should at least help them to avoid many major pitfalls. And in 2012, avoiding the myriad pitfalls of this volatile environment would already count as a major investment success.



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Key investment views
Diversify broadly

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The Eurozone debt crisis and concerns about growing US debt will both drive investment returns in 2012. For conservative investors, finding safe-haven assets that offer acceptable real returns could become even more challenging than it was this past year. Investors focusing on wealth preservation cannot simply rely on government bonds or cash to form the bulk of their investment portfolios.

Diversifying into resilient forms of corporate assets is one key ingredient to overcoming the twin troubles of sovereign bonds' deteriorating quality in the US and Europe and the discouraging volatility in equity markets.

In order to withstand the challenging investment environment we expect in 2012, it is crucial for investors to construct prudent and highly diversified portfolios. The new reality of fiscally strong emerging countries needs to be taken into account in any globally diversified portfolio. Furthermore, diversifying into non-traditional asset classes such as hedge funds could also prove highly valuable. Every well diversified portfolio should take advantage of the following investment themes.

Resilient corporate assets: acceptable returns, acceptable volatility
Solid multinational corporations distinguish themselves through strong balance sheets with modest leverage and ample liquidity reserves. This positions them particularly well in the current environment. Their earnings prospects are also more predictable, and their business models create attractive sustainable dividends for equity investors. Bond investors can find stable yields in highly rated non-financial corporate issuers. Our view that the US economy will avoid a recession is reflected in our preference for US high-yield bonds as a yield-enhancing addition to a globally diversified portfolio.

Currency risks remain high: Focus on minor currencies
Fluctuations of exchange rates between the main currencies will remain strong in 2012. We generally recommend avoiding significant exposure to exchange rate risks. Client-specific home biases in currency preferences need to be addressed to accommodate specific personal circumstances. In a portfolio context, we recommend diversifying into minor currencies. We prefer currencies from countries rich with natural resources, such as Canada and Norway. In addition, we also favor certain Asian currencies with solid fundamentals such as the Singapore dollar and the Chinese renminbi, although we expect their appreciation potential to be modest in 2012. We strongly recommend analyzing valuations to avoid expensive entry points.

Emerging markets still generating stronger growth
We expect slower growth in the US and a recession in the Eurozone to take their toll on emerging markets. Nevertheless, growth should still remain resilient. Exposure to emerging market sovereign bonds offers an attractive opportunity to diversify out of US and Eurozone government bonds.

For equity investors, emerging economies' superior growth prospects create a positive long-term outlook. Volatility in European and US equity markets will affect emerging market equities, and investors need to assess their risk tolerance carefully. The growing demand in emerging markets for basic, branded consumer goods presents an opportunity to limit volatility when seeking exposure to emerging market growth.

Debt will also dominate 2012

Andreas Höfert, Chief Economist, Global Head Wealth Management Research

In our view, sovereign debt concerns will also dominate 2012. It will become more and more evident that repackaging debt and moving it from one institution to the next does not make it disappear.

The only three long-term solutions which could help to overcome the sovereign debt crisis would be more growth, a daunting task when the whole economy is deleveraging; debt monetization, with a subsequent risk of inflation: or plain vanilla default, with a depression as a possible result. While the US and the UK prefer to go the path of mitigated deleveraging and debt monetization, the Eurozone has chosen the austerity variant and is currently heading back into recession. At this juncture, only emerging markets have enough power to reignite their growth engines in case they stall.

US: Torn between debt and election
The biggest forecasting surprise of 2011 was the lack of growth in the US. Remember, back in the fall of 2010, the fear of a double-dip recession was omnipresent. In December 2010 it led the US government to pass a tax relief, unemployment insurance reauthorization, and job creation act with an estimated overall stimulus of 858 billion US dollars. Moreover, the Federal Reserve flanked this by launching a 600 billion US dollar government bond-buying program known as "Quantitative Easing 2." How-

Picture: Hugo (Fotolia.com)

ever, the result of those two significant measures was a dismal overall growth rate for the US economy of barely 2% on average in 2011. The US unemployment rate hardly moved in 2011 and is currently still around 9%.

Autumn 2011 was almost a replay of 2010. Fears of a double-dip were mounting again. Many analysts estimated the likelihood of the US heading back to recession to be roughly one third. This led the US government to consider a new job creation bill of 447 billion US dollars (two thirds in the form of tax cuts, one third in the form of expenditures). This bill is still stuck in Congress.

The Fed also started its own stimulation of the economy with a program called "Operation Twist," aimed at increasing the maturity of bonds on its balance sheet and hence lowering the yields at the long end of the yield curve. We remain skeptical. None of the fiscal or monetary packages will be able to boost the US economy, which continues to be on a deleveraging path. They will only be able to mitigate the deflationary pressures.

Powerless monetary stimulus
The US is confronted with a liquidity trap, which leaves monetary stimulus powerless, and with a debt-to-GDP ratio of over 100%, which seriously hampers any attempts at fiscal stimulus. While we do not expect a reversion to recession, the US will continue to have rather dismal growth in 2012. The federal funds rate will continue to stay around zero, and once Operation Twist is finished in June 2012, we might see calls for further quantitative easing. However, in our view the latter would be difficult to implement, since the nation will be in the middle of the presidential election campaign.

European sovereign debt crisis unresolved
The European sovereign debt crisis was the running story during most of 2011, with no less than three new plans (bringing the total to seven) to resolve the crisis of the euro once and for all. The least we can say is that so far this problematic will continue to dominate the news at the beginning of 2012. Moreover, it will also dominate the European macroeconomic environment, weighing on growth.

All the rescue plans so far have fallen short of what would be needed to end the crisis. They were too little and too late. We see three options to end this nightmare.

First and foremost, a credible haircut on the Greek debt must be granted. Otherwise this economy will either default in a disorderly manner, triggering credit default swaps, it will have to leave the Eurozone, or it might face a combination of both.

Secondly, to avoid financial crisis contagion should Greece default, European financial intermediaries need significant recapitalization. The 106 billion euros allocated in Brussels back in October 2011 are, in our view, not enough. Our own calculations conclude that roughly three times this amount would be the right price tag to stabilize European banks.

Finally, the European Financial Stability Facility (EFSF) can so far be seen as an empty shell, not able to limit geographic contagion. Even an EFSF leveraged up to one trillion euros would, in our view, not be enough to hinder explosive debt dynamics in Italy and Spain. Only the commitment of the European Cen-

Pictures: antonio scarpi, kavring, BSpieler (fotolia.com)

tral Bank (ECB) can do the trick. However, at the time of writing, Germany still strongly opposes any measures which would come close to monetizing some of the European toxic debt.

Austerity measures in the European periphery have pushed those economies back into recession – if they ever left it – and in some cases to the border of depression. In 2012, Greece should experience its fifth year of negative growth in a row, bringing its GDP to a level more than 20% below its peak in 2007, a condition comparable to the Great Depression in the US. The rate of unemployment in Spain, meanwhile, will hover above 20%. These dramatic evolutions have been accompanied by social tensions which are likely to increase further in 2012.

Even Germany…

But recession characterizes more than the periphery now. Even Germany, which started solidly in 2011, has seen growth falter on the back of waning export demand from the European periphery; hence we expect it to fall back into recession by year-end 2011. We think it will stay there at least another quarter into 2012.

In this environment, the European Central Bank will keep interest rates low and might even lower them further. However, as mentioned above, at this stage we do not expect any measures from the ECB similar to the quantitative easing policies in the US and the UK.

Leading indicators from large emerging markets like China and Brazil were slowing significantly towards the end of 2011. Nevertheless, we think that there is a fundamental cyclical difference between emerging markets and developed economies. While the latter lack the fiscal and monetary means to stimulate their economies, the former still have room to do so, if needed.

China will play a pivotal role

In this context, China will again play a pivotal role. In 2011, the world's second-largest economy was characterized by a risk of overheating. This was reflected in high inflation rates, booming credit activity, and a housing market which in many parts of the country was in bubble territory. With a rather restrictive monetary policy, the Chinese authorities had managed to lower inflation towards year-end 2011. Instead of the usual double-digit growth, China "only" achieved 9.1% annualized growth in 3Q 2011.

While many analysts and economists still see the Chinese housing market as "the mother of all bubbles" and one of the biggest risks for the world economy going forward, we are less concerned, at least in the short term, acknowledging the risk but also pointing out that China has the means to stem contagion from first-tier cities across the nation.

More generally, we see the slowdown in emerging market growth continuing in the first half of 2012, but with the possibility for those countries to reaccelerate growth through more expansive policies in the second half of the year.

Overall, world growth will be around 3% in 2012, roughly of the same order of magnitude as 2011. Despite sustained expansive monetary policies, we don't see inflation accelerating on a global scale, an evolution only forecast within a five-year time horizon. The negative risks to the world economy remain an uncontrolled

Pictures: gvoeii, hperry, fkotton (Fotolia.com) deepening of the euro crisis, to the extent that some countries would exit the common currency, a more pronounced deceleration of the US economy, and a Chinese economy which slows much faster than forecast due to a credit crisis there.

Conservative diversification
In an environment with low growth and risks skewed to the downside, we maintain our preference for a well diversified yet conservative portfolio. Moreover, due to the low interest environment, we favor investments with comparatively higher yields.

In a balanced portfolio, we currently have a tilt towards the fixed income portion, focusing specifically on high-quality corporate bonds and emerging market sovereign debt, and are more critical towards the bonds of the highly indebted developed economies. For risk takers, high-yield bonds in US dollars are currently cheap relative to similarly risky assets on the US equity market, because these bonds have priced in a US recession, while equities have not.

In the equity portion of the portfolio, we favor defensive sectors like Healthcare, Telecom and Consumer Staples. The Consumer Discretionary and Industrials sectors should underperform due to the current slowdown in the world business cycle. One should be cautious about the Financials sector, especially in Europe, which continues to struggle with the debt problematic. Regionally, we prefer the US and Switzerland over Europe and would also put emphasis on some selected emerging markets.

Specific problems for major currencies
The major currencies continue to suffer from specific problems. The euro should be under pressure in the coming months, but this does not mean that we like the US dollar in the long term; we see the USD depreciating further, due to a continued expansive monetary policy. The Japanese yen is very expensive and is under the threat of further intervention by the Bank of Japan. Finally, the British pound is the currency of the first country to experience stagflation after the financial crisis.

In the euro crisis, breaking taboos is no longer taboo

There was a whole list of taboos for European politicians at the beginning of the euro crisis: a full-fledged national bankruptcy, monetization of debt through the European Central Bank (ECB) and the exit of a member state from the monetary union were just as unthinkable as a collectivization of debt or fiscal transfers. But these taboos are gradually eroding: The ECB has started purchasing government bonds, while Eurozone politicians have created a bilateral aid package for Greece and established the EFSF rescue fund and since expanded its capacity and used the G20 meeting to look for ways for the IMF to provide additional funds. In the fall, politicians agreed that a rescheduling of Greek debt by private creditors should occur by way of "voluntary" participation, shortly after which a full-blown default on Greek debt was publicly discussed. The hasty emergence of the idea of a Greek referendum made an exit of Greece from the Eurozone a real option for the first time.

We expect a haircut on Greek debt in March 2012 at the latest, when high debt payments will come due. This will not be the last time we see former taboos being broken.

Snap elections as an outlet
The euro crisis has unleashed a series of changes of government over the last year. Following the announcement by the Irish government at the beginning of the year that it would be holding early elections, six other countries have shortened their legislative terms: Portugal, Spain, Slovenia, Slovakia, Greece and most recently, Italy (only the cabinet). A striking trend has developed, whereby the opposition brings about a change of government by coupling their agreement to pass measures to overcome the crisis with the condition that the government steps down or that new elections are held. We believe that political continuity will remain a victim of the euro crisis in the coming year.

Jürg de Spindler
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Gesche Niggemann
Economist, UBS AG

China enters the year of the dragon on 23 January. The country should manage to maintain good growth next year.

With interest rates at zero and a Swiss National Bank committed to defending the 1.20 level against the euro by any means, the Swiss franc is currently not among our currencies of choice either. In the developed economies, we still favor the Scandinavian currencies and the Canadian dollar, and are also looking at some emerging market currencies in Southeast Asia. We expect the Chinese renminbi to continue appreciating. Both the Brazilian real and the Australian dollar offer attractive yields, but are very expensive.

We think that cyclical commodities like base metals and oil will be under pressure in the coming months due to the global slowdown. Precious metals, especially gold, continue to have our favor in an uncertain environment, in which the only long-run certainty is inflation.

Fig. 1: UBS macroeconomic forecasts

		Real GDP growth in %			Inflation in %		
		2010	2011F	2012F	2010	2011F	2012F
Americas	US	3.0	1.7	2.0	1.6	3.1	1.8
	Canada	3.2	2.2	2.0	1.8	3.0	2.7
	Brazil	7.5	3.1	3.8	5.9	6.6	6.1
Asia/Pacific	Japan	4.0	–0.3	2.5	–1.0	–0.3	–0.2
	Australia	2.7	1.7	3.3	2.8	3.4	2.7
	China	10.4	9.2	8.0	3.3	5.4	3.5
	India	8.5	6.9	7.3	12.1	7.4	6.8
	Asia ex Japan	8.7	6.7	6.0	4.9	5.2	3.9
Europe	Eurozone	1.8	1.6	–0.7	1.6	2.7	1.7
	Germany	3.6	3.2	0.6	1.1	2.5	1.7
	France	1.4	1.6	–0.8	1.5	2.0	1.5
	Italy	1.2	0.9	–1.0	1.6	2.7	1.9
	Spain	–0.1	0.6	–1.5	1.5	3.0	1.3
	UK	1.8	0.9	–0.1	3.3	4.4	2.7
	Switzerland	2.7	1.7	0.4	0.7	0.4	0.3
	Russia	4.0	4.1	3.0	6.8	8.7	6.8
World		4.3	3.2	2.7	3.0	3.9	2.9

Interest rates	3-month LIBOR		10-year govt. bond	
in %	6 mths	12 mths	6 mths	12 mths
US	0.30	0.30	2.10	2.50
Eurozone	1.00	1.00	2.30	2.60
Japan	0.20	0.20	1.20	1.50
UK	0.80	0.80	2.50	2.90
Switzerland	0.01	0.01	1.10	1.30
Australia	4.50	4.50	4.40	4.80
Canada	1.30	1.50	2.30	2.50
Sweden	2.30	2.30	1.90	2.30
China[1]	5.60	4.60	3.10	3.50

Exchange rates	6 mths	12 mths	equilibrium[2]
EURUSD	1.34	1.45	1.30
USDJPY	81	81	82
GBPUSD	1.65	1.70	1.71
EURCHF	1.25	1.25	1.37
USDCAD	1.05	0.98	0.95
AUDUSD	0.96	1.00	0.73
NZDUSD	0.77	0.80	0.59
USDSEK	6.42	5.86	6.89
USDNOK	5.60	5.17	6.64
USDCNY	6.25	6.10	n.a.

Note: F = Forecasts as of 1 December 2011
[1] 7-day Interbank rate instead of 3-month LIBOR
[2] Purchasing power parity
Source: UBS
Past performance is not an indication of future returns.

Global risks:
High and interconnected

The Eurozone sovereign debt crisis is likely to be the biggest, but not the only, risk factor that investors have to deal with in 2012. Similar to 2011, financial markets will mainly be driven by the uncertainty related to political and economic challenges. Therefore, investor risk management seems more important than ever.

Investors can choose from a wide spectrum of activities for hedging against risk (see Box on p. 11). In the rough environment that we expect, investors need to balance their portfolios between significant political and macroeconomic risks on one the side, and return opportunities on the other, not least in light of poor return expectations from so-called "risk-free" (in reality "low-risk") investments. A pragmatic way out of this is to select investments which should do well in a baseline and in a risk scenario.

The table on page 11 ranks potential financial market hotspots in 2012. While clearly not encompassing all risks, the list helps to prioritize investment decisions.

In general, the very distinct risk environment requires a cautious stance towards equity. Also, given that our top risks (risks 1–3) all imply significant cyclical hindrances in 2012, equity investors should be better off with defensive sectors like Healthcare, Telecom and Consumer Staples.

Bond investors may prefer globally diversified companies (multinationals) and bonds of agencies and supranational institutions. Those bonds are expected to outperform government bonds in a world characterized by ongoing sovereign debt concerns (risks 1 and 7).

The present risk environment provides opportunities to diversify the currency exposure into minor currencies. While not immune to global turbulence, the Scandinavian and Canadian currencies could do better than the majors, which have their very specific problems (risks 1, 2 and 7). This will be particularly true should global currency tensions intensify (risk 6).

These examples provide ideas as to how investors can position for the ongoing and new challenges ahead. We believe a better understanding of risk issues can only improve investor decisions. However, investors must also recognize that some degree of risk-taking is probably necessary to achieve their long-term financial goals.

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Rank*	Risk	Risk dimensions** Probability	Market impact	Time horizon	Geo. dimension	Risk scenario description	Potential investment impact
1	**Eurozone breakup**					After Greece defaults, other struggling Eurozone countries could follow, which could lead to major global financial market disruptions and prolonged Eurozone recession.	While all cyclical asset classes would suffer, Financials equities would be particularly at risk. Government bonds from stable countries would likely benefit.
2	**US double-dip and QE3**					Renewed recession in the US. This would likely be countered by the US Fed with a third round of quantitative easing.	Post-QE3-impact: The US dollar would suffer, commodity prices would rise due to inflation. Gold would likely be the best hedge in such a scenario.
3	**China hard landing**					A GDP growth rate below 6%, e.g., due to policy errors, would lead to contracting Chinese demand. This would hit exports to China hard.	In such a scenario, cyclical assets such as commodities and equities would suffer, particularly those with close trade linkages to China.
4	**China housing bubble**					The overheated Chinese property market renders a drastic price adjustment likely. This could be a blow to the Chinese economy.	This would particularly affect emerging market equities, and more generally cyclical equities. As investors repatriate funds, the USD should benefit.
5	**Debt in Hungary**					Swiss franc mortgages and consumer lending by Austrian and some German banks are a looming risk in Eastern Europe, particularly in Hungary.	This risk especially affects Eurozone Financials stocks, and more generally Eurozone and Eastern European equities. Government bonds of stable countries should benefit.
6	**Currency competition**					Competitive currency devaluation in several large countries would lead to currency volatility and inflation, and would hamper international trade relations.	Currencies of smaller countries would likely appreciate against the devaluating countries. Precious metals would benefit as an alternative to currencies.
7	**Sovereign debt concerns**					Rising sovereign debt concerns in major countries outside the Eurozone such as the US, the UK and Japan.	This would particularly hit the local government bond market, which depending on the degree of crisis, could lose its safe-haven status.
8	**Trade conflict**					Escalation of current trade tensions between the US and China into a global trade war, which is a risk to global trade activity and thus economic growth.	In a trade war, stocks from very export-oriented countries like Germany would suffer, while those in rather closed economies like the US could benefit.
9	**Social unrest*** **					Social unrest in countries of economic, commodity-producing or geostrategic importance (see pp. 12–13).	Regional equity markets would suffer. In the case of commodity-producing countries, commodity prices are likely to rise.

* Ranking according to expected market impact, which is the average of the four risk dimensions (probability, geographic and time dimensions, and market impact).
** Colors indicate intensity: green, low; yellow, medium; orange, high; red, very high.
*** Market impact and geographic dimensions depend on the country actually affected by social unrest

Why risk monitoring for individual investors?

Thorough monitoring of key global market risks is essential for any investment decision. Ultimately, it aims at preserving investor capital. The following are ways to mitigate market risks:

1. Exit markets or reduce exposure
The outright sale of exposed assets is probably the most straightforward way to react to an emerging risk. However, this can be problematic when the investor only wishes to reduce exposure temporarily. Timing challenges also arise, as investors run the risk of exiting the market either too early or too late.

2. Hedge overlay and strategies
Hedging can often be a more effective way of reducing risk exposure, especially when the objective is downside protection for a limited period. However, as many hedging strategies involve derivatives such as options, futures and structured products, this investment response requires knowledge about how these solutions function.

3. Diversification
Diversification across asset classes and regions remains one of the most straightforward pre-emptive investment solutions, since it limits exposure to different sources of risk. However, as major financial market events often have a significant international dimension and tend to affect more than one asset class, a high degree of correlation across markets occurs, making it difficult to be fully immune to a market disruption.

4. One size fits most strategy
To circumvent the timing problem of the first and the complexity challenge of the second solution, a pragmatic compromise strategy is to give preference to those investments that are supposed to do well in a base-case and a risk scenario.

Source: UBS WMR, Global Risk Watch: A systematic market risk-monitoring framework, October 2010 and *UBS research focus: How to invest*, April 2011.

Preserving wealth or looking to increase it

Pierre Weill
Economist, UBS AG

As markets bounce from extreme optimism to extreme pessimism in a matter of days, investors are torn between wanting to preserve wealth and wanting to participate in the upside. A longer investment horizon is often the best approach.

Before you consider your preference for preserving wealth or increasing wealth, you should look at your personal financial situation and needs, balancing future expected income and your assets. What is your regular income and how much do you need to live the life you want? Is this the life you can afford? And are you investing on behalf of future generations, which would significantly increase the investment horizon?

A helpful exercise is to split future financial needs into different horizons. This means that the expenses to be incurred over the next few years will be kept in lower-risk assets, given the heightened volatility, whereas parts of the investment for future consumption – or even future generations – can be invested into riskier assets for which there is an attractive valuation case.

If you can live as you wish from your income, without taking money from savings except for a treat, such as a special vacation or a new car, then we advise playing it safe in these volatile times, targeting a profit which equals the inflation rate and thus preserving the real value of your assets. Or, devote a smaller part of your assets to riskier investments. You do need, however, to be able to afford losing this investment – financially and emotionally.

If you live partially or fully from your savings and assets, the question of preservation or growth becomes trickier. You will need a higher return on assets than others so that your wealth does not diminish too quickly. At the same time, you do not want to risk losing too much of your assets' value, because you have to live from them. The approach here is that you invest a larger portion of your assets in investments with growth potential. You must still be able to afford temporary losses, however. Otherwise you have to focus at least temporarily on preservation, even if it means living from your savings without making any profit from your assets.

Given the dedication and skill needed to perform well on a shorter investment horizon, many investors choose a longer-term perspective, with the focus either on wealth preservation or capital appreciation. While longer-term capital appreciation can be targeted via valuation metrics if shorter-term volatility can be accepted, preserving wealth has become more challenging given the risk that even many developed market government bonds present these days.

Preserving wealth

Textbooks will tell you that a risk-free asset is a short-term developed market government bond. Recent experience though, in particular from Europe, challenges traditional wisdom, and even government bonds of such larger Eurozone countries as Italy have been on a roller coaster ride during the Eurozone debt crisis. So what would a safer portfolio look like?

Traditional safe-haven investments such as US Treasuries, German Bunds and gold have shined the most during market turbulence. However, diversification into a number of different assets should help lower portfolio risk. Having equities in a portfolio can help lower overall risk, bringing in an element of inflation hedge. Especially within sectors such as Consumer Staples, in which earnings visibility is high and high input prices can be passed on to consumers relatively easily. Non-traditional asset classes such as commodities and real estate are also part of a well diversified portfolio.

Growing wealth

With a longer-term investment horizon, valuation metrics are the best tool for trying to capture attractive longer-term returns. For equities, a price-to-earnings ratio is often used as a simple measure of attractiveness. Such a ratio is particularly interesting when a longer-term earnings trend or average earnings level is used. Presently such a model would suggest that equities are roughly fairly valued, with a reasonable return outlook and some element of inflation hedge. Government bonds are more at risk over the longer-term investment horizon, as current yields hardly compensate for inflation.

Social unrest unnerves financial markets

Jürg de Spindler
Political analyst, UBS AG

Price increases in the Arab countries led to an Arab Spring. The austerity in the highly indebted EU member states is impacting more and more segments of the population and triggering social uprisings. In some Asian countries with centrally planned economies, there is also a burgeoning risk of political unrest. This growing potential for social unrest poses a serious threat for the financial markets.

WMR's system of risk assessment also takes account of risks with a political background. These are grouped as geopolitical risks and evaluated using an in-house analytical approach. One such risk is social unrest – an issue that has gained in importance over the course of 2011 and looks set to remain a determining factor for the markets well into 2012.

Dissatisfaction among the population can quickly degenerate into social unrest in countries already mired in a deep crisis, which in turn can spiral out of control and strike at a country's very stability – politically as well as economically. Investors react to developments like these by taking refuge in secure investments, such as gold, and withdrawing their money from riskier positions, such as in equities. If commodities are produced in the affected region – like oil, for example – their prices will also rise, as was the case in the wake of the Arab Spring, which in February 2011 saw the price of a barrel of crude leap by 15% from USD 100 to around USD 115.

The risks engendered by this social unrest can take several forms, although they do not necessarily all occur at the same time. They include:

- The protection of property and rule of law are no longer guaranteed. This means there is no longer a basis for ensuring security. Conditions like these are unattractive for investors, which hinders economic development.
- The national economy suffers, since production in industrial firms and the provision of services is restricted or in some cases even suspended completely.
- A country's existing economic fundamentals are threatened if the unrest disrupts production and infrastructure facilities.

Assessing the causes of social unrest
The outbreak of social unrest – as in the case of the Arab Spring – is impossible to predict. However, the analysis and assessment of these events form the basis for deriving appropriate measures for investors' portfolios. The political economic approach, as is used at WMR, takes account not only of the relevant players, but also of their interests and motives. This context allows facts and observations to be classified and interpreted in a targeted manner.

We draw a fundamental distinction between the breeding ground for social unrest and the immediate triggers. The first category includes

Selected political dates for 2012

01.01.2012	**EU:** Denmark assumes presidency of the European Council
January–March 2012	**Egypt:** Parliamentary elections (3rd round of People's Assembly on 03.01, 1st/2nd/3rd round of Shura Council on 29.01, 14.02 and 04.03)
14.01.2012	**Taiwan:** Parliamentary and presidential elections
22.01.2012	**Finland:** Presidential elections (2nd round: 05.02.)
19.02.2012	**Greece:** Parliamentary elections (brought forward)
29.03.2012	**Iran:** Parliamentary elections
04.03.2012	**Russia:** Presidential elections
22.04.2012	**France:** Presidential elections (2nd round: 06.05.)
April 2012	**South Korea:** Parliamentary elections
May 2012	**Algeria:** Parliamentary elections
June 2012	**Egypt:** Presidential elections
10.06.2012	**France:** Parliamentary elections (2nd round: 17.06.)
17./18.06.2012	**G20:** Summit in Los Cabos (Mexico)
01.07.2012	**EU:** Cyprus assumes presidency of the European Council
01.07.2012	**Mexico:** Parliamentary and presidential elections
July 2012	**India:** Presidential elections
September 2012	**Hong Kong:** Parliamentary elections
28.10.2012	**Ukraine:** Parliamentary elections
October 2012	**China:** 18th National Congress of Chinese Communist Party
06.11.2012	**US:** Congressional and presidential elections
December 2012	**Kazakhstan:** Presidential elections
December 2012	**South Korea:** Presidential elections
December 2012	**Venezuela:** Presidential elections

inadequate conditions with regard to the three dimensions that define a country's socio-political and economic-political framework:

– scope for economic development
– rule of law
– political codetermination

Shortcomings in any of these areas create a situation that not only infringes on people's everyday lives, but also severely restricts economic activity and makes investing in a country less attractive. The one exception is investments that enjoy privileged protection by the ruling political forces. This is why North Korea has set up special economic zones, for example.

The role of framework conditions
Deficiencies along the three dimensions outlined above can also be represented with key data to a certain extent. A government can offset deficiencies by ensuring adequate economic supply for the population at large, for example through broad-based social home-building programs, thus keeping the risk of social unrest in check. By contrast, if these deficiencies are compounded by other factors such as rising food prices, extraordinary supply bottlenecks and spiraling social grievances, the situation can soon get out of control. By their very nature, the immediate triggers are extremely difficult to predict and usually occur by chance. Thus, sharply increasing food prices in the Arab countries at the beginning of 2011 were one of the factors that prompted the revolts.

Idealist motives, such as a general will to restructure a society or to implement egalitarian principles are, in our view, not enough to trigger social unrest, since they alone do not provide sufficient motivation for organizing and mobilizing the population. However, shared grievances, such as the ones defined above, elicit an immediate need for a change and do not require much effort to convince people to join the common cause.

Social unrest and the markets
In the worst-case scenario, the unrest is nipped in the bud by the ruling political party by means of direct intervention. However, if the ball gets rolling unchecked, the unrest can quickly lead to a change in regime. But a new government in itself is no sure solution to a political and social shake-up if the reforms do not tackle the underlying political and socio-economic conditions.

A sustainable improvement can only be achieved if progress is made along all three dimensions – scope for economic development, rule of law and political codetermination. This requires changes at the level of the constitution – changes which define the framework conditions for the economy and politics in such a way that they create a stable environment both for citizens and for investors.

Individual Arab countries such as Tunisia, Egypt and Morocco are currently undergoing this process of change. The elections (some of which are being held without manipulation for the first time), coupled with the official endorsement of party pluralism, are indications that the situation is improving long-term; however, there is no guarantee for this.

Highly indebted European countries such as Portugal and Greece are working hard to implement the strict austerity measures imposed on them. These measures will make living conditions more difficult in the short term, and even if these measures are supported by a freely elected parliament, there is a growing danger that the hardship they create could trigger social unrest among segments of the population.

In some Asian countries which do not have a very good track record in terms of their scope for economic development, rule of law or political codetermination, social unrest could gain in significance in the medium to long term. If changes of this nature are triggered in the central Asian republics, for example, this could pose major challenges for the countries in question – even extending to neighboring China.

WMR will therefore keep a close eye on how the unrest in the Arab world might spread to other regions as part of its geopolitical risk assessment for the year ahead.

Equities: *Be patient, but alert*

Markus Irngartinger
Strategist, UBS AG

Christopher Wright
Strategist, UBS AG

Carsten Schlufter
Strategist, UBS AG

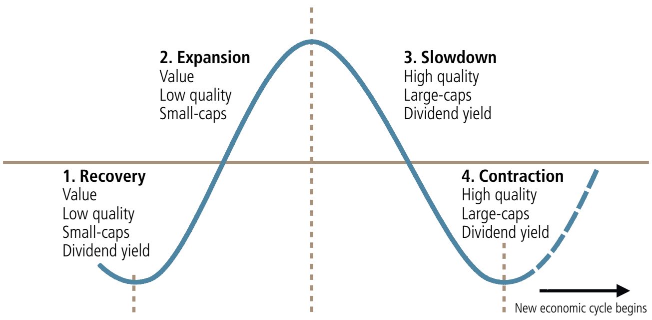
The sovereign debt crisis in Europe will keep volatility elevated also in 2012. We recommend starting the year with an exposure towards US, UK and emerging market equities. Over the course of 2012, value opportunities might arise in the Eurozone.

In Europe, the sovereign debt crisis will enter its third year, and will likely lead to continued volatility in equity markets. While tighter monetary policy in emerging markets was a burden for most of 2011, easier monetary policy in emerging markets in 2012 could prove beneficial. Thus, we would recommend starting 2012 by avoiding Eurozone equities and focusing on US, UK and emerging market equities. In a low interest rate environment, investors might also look for stocks paying high dividend yields. Regarding sectors, we would start the year with a preference for defensive sectors like Consumer Staples, Healthcare and Telecom. We also like the IT sector, where growth is attractive and valuation modest.

In 2012, we expect the US economy to grow moderately. While not stellar, there should be sufficient demand for US companies to achieve revenue growth of around 5%. While profit margins are elevated, they should hold up. With the unemployment rate high, wage pressures remain contained. All in all, we expect US companies to grow earnings in the mid-single-digit range, supporting US equities. We see

Fig. 2: Equity style choice depending on economic cycle

More risk in stages 1 and 2, more safety in 3 and 4

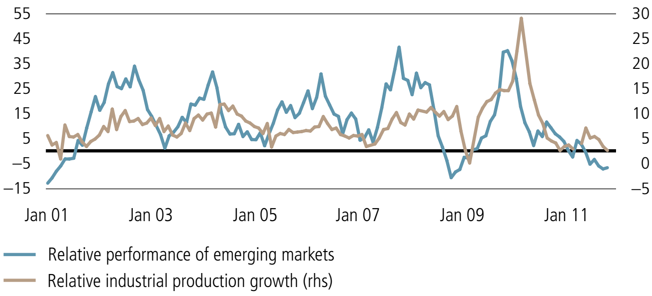


Source: UBS WMR

Past performance is not an indication of future returns.

Fig. 3: Emerging market equities supported by economic strength

MSCI EM relative to MSCI World (yoy, in %) and EM relative to G7 industrial production (yoy, in %, rhs)



Source: Thomson Reuters, UBS WMR

Within the US, we see potential for mid caps stocks and value strategies to outperform in 2012.

them trending higher and expect the S&P 500 to finish 2012 in the 1250 to 1350 range.

We particularly like the IT sector, in which growth is attractive and valuation modest. The sector enjoys both offensive and defensive characteristics due to a combination of secular growth drivers and recurring revenue streams. Additional positives include reasonably attractive valuations and solid cash positions. We recommend a combination of industry leaders with good near-term visibility and companies exposed to fast-growing segments such as smartphones and tablet PCs, the Internet, and the emerging markets.

Within the US, we see potential for mid-caps stocks and value strategies to outperform in 2012. With company earnings proving resilient, the mid-cap area of the market will be rewarded for providing stronger growth than the large caps. Similarly, for value strategies to perform well, investors also need to have confidence in earnings. Given our expectation of stabilization in US economic data, value investing might become a winning strategy in 2012.

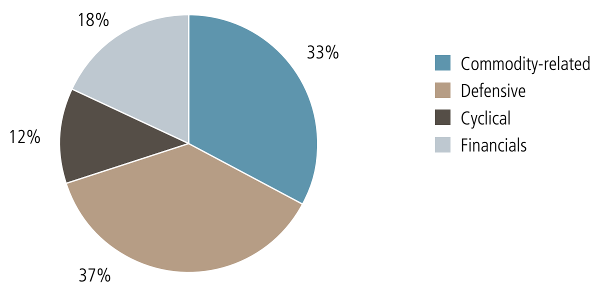
Europe – UK, dividends and large caps

In the Eurozone, the various austerity measures agreed in 2011 will choke off economic growth in 2012 – affecting company earnings negatively, in our view. Foreign demand, which accounts for 35% of sales of Eurozone companies, will only partly offset domestic demand weakness. We keep our cautious stance on Eurozone equities compared to global equities when entering 2012. While valuations look very appealing, investors should resist the temptation to invest until a credible solution for the sovereign debt crisis has been achieved. Spring might be a decisive period, as Greece has major refinancing payments and economic indicators could reach a bottom.

For long-term investors interested in investments within the Eurozone, we still advise focusing on German equities. Germany remains a relatively strong economy compared

Fig. 4: UK market dominated by defensive and commodity-related sectors

Proportion of market capitalization, in %

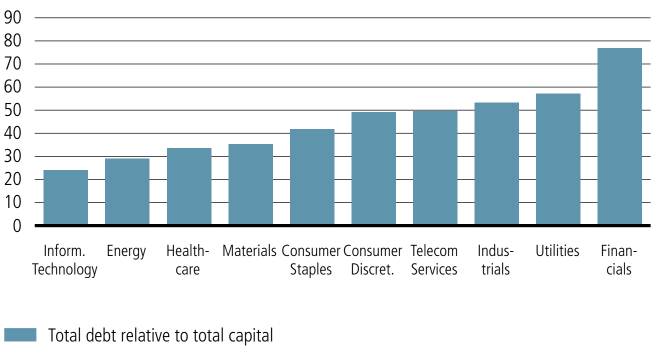


Source: Thomson Reuters, UBS WMR, as of 31 October 2011

Past performance is not an indication of future returns.

Fig. 5: IT is the least–leveraged sector

Total debt relative to total capital, in %



Source: FactSet, UBS WMR

Picture: Gary (Fotolia.com)

to Southern Europe. In particular, German companies benefit from Asian and US demand.

We keep our preference for UK equities. The market offers a high dividend yield and is defensive due to its Healthcare and Telecom sectors. Due to its high exposure to commodity-related sectors like Energy and Materials, the market's overall performance should benefit from economic dynamics in the US and emerging markets.

While Swiss equities also offer defensive characteristics, the strength of the currency weighs on their companies' competitiveness and profit margins. Thus, we recommend only selective exposure to sectors like Consumer Staples and Healthcare.

Financials are unlikely to improve regarding structural issues. The macroeconomic outlook, the debt crisis and the low interest rate environment, as well as tougher regulations, are hitting banks and insurance companies hard. Visibility on the business outlook remains low and the need to improve capital positions, especially for Eurozone banks, could make valuation ratios look less favorable. Thus, we would still avoid the industry.

All in all, in Europe we recommend a defensive strategy for the first quarter, favoring large-cap stocks and those that have high and stable dividend yields. They can be found among Telecom stocks. Bank recapitalizations will likely lead to less lending, which could be a hindrance for small-cap stocks. Value could become a winning strategy in Europe later in 2012, but only once companies stop seeing earnings downgrades and economic data begins to stabilize. Therefore investors should start the year defensively positioned, but be prepared to move into riskier strategies when signs of stability emerge.

Prefer Asia over Eastern Europe

Since we forecast solid economic growth for emerging economies next year, company earnings are also likely to grow at a high single-digit rate. We believe that current valuations of emerging markets indicate that investors should be rewarded over 12–18 months.

We expect Asia to perform well if the global risks – especially in Europe – do not escalate. For the short term, we like domestically oriented stocks such as some of the "oversold" Materials, IT, and bank names, since we still believe that Asia's growth picture remains intact and these stocks could benefit from the potential fiscal stimulus and monetary policy easing in 2012. For the medium term, we prefer the more defensive sectors such as Consumer Staples and Telecom amid a sub-par global economic growth environment. We recommend a cautious stance on Eastern Europe for at least the first half of 2012 due to its close economic links with the Eurozone.

Where to invest

Dividends remain a favorite theme for the foreseeable future. Investors should look for companies that pay high and historically stable dividends. Examples can be found in the **European Telecom sector**.

Emerging markets and those companies that have strong earnings exposure to emerging markets will continue to benefit from the much stronger GDP growth than is being achieved in developed markets.

UK equities is a preferred market, largely due to the high dividend yield. Cheap valuation and its exposure to emerging markets also make it attractive.

US equities should be solid, as it appears the country will avoid a recession. Company earnings look very resilient and are still seeing growth. We particularly like the **Information Technology** sector, which benefits from strong demand from Asian economies.

Materials and **Energy** stocks may have a difficult few months early in 2012, but valuations are already pricing in a rather negative outlook. Therefore we believe there will be attractive entry points into these sectors in the first half of the year.

Currencies
Growth slump promises turbulence

Thomas Flury
Analyst, UBS AG

The outlook on currency markets for 2012 is not characterized by any clear tendencies. Investors face a dilemma: The attractive currencies have appreciated strongly over the past few years and therefore have only limited return potential.

The major currencies – the euro, US dollar, pound and yen – all have serious structural problems. Government as well as private sector debt could pose a fundamental risk for the stability of each currency, one which will not be resolved in the short term.

Neither a breakup of the Eurozone nor a brutal sell-off of the US dollar is currently among our main scenarios. However, the risk of larger currency movements against one or the other of the two major currencies has grown significantly. Both regions must pay down debt, something that will become increasingly difficult if global growth falls. In a Eurozone recession, the goals of deficit reduction and bank recapitalization would be more difficult to achieve.

The highest foreign debt

The US economy has the highest outstanding foreign debt, with decision-makers so far unable to present a convincing plan on how the trade deficit should be reduced. For this reason, the country is and remains dependent on foreign financing. China, the Middle East and other potential buyers of US government bonds are normally somewhat more reserved with purchases of US dollars when growth slows, which is likely to weigh on the US dollar. The US presidential elections will be of little help in propping up the dollar, because neither of the major parties will present a dollar-friendly savings program. We expect a depreciation of the euro over the next few months, followed by larger dollar losses and an increase in the EURUSD rate.

If it turns out that an economic slowdown becomes a minefield for the euro and the US dollar, then we believe this will also apply in a certain sense to the most liquid alternative currencies – the Australian and Canadian dollars, the Swiss franc and both Scandinavian crowns – a group we refer to as the five friends. It has become difficult to recommend these smaller currencies given their present overvaluation. With regard to Switzerland, the Swiss National Bank has put a clear stop to the franc's appreciation. Other currencies are so overvalued that there is a significant risk of correction.

Keep your powder dry

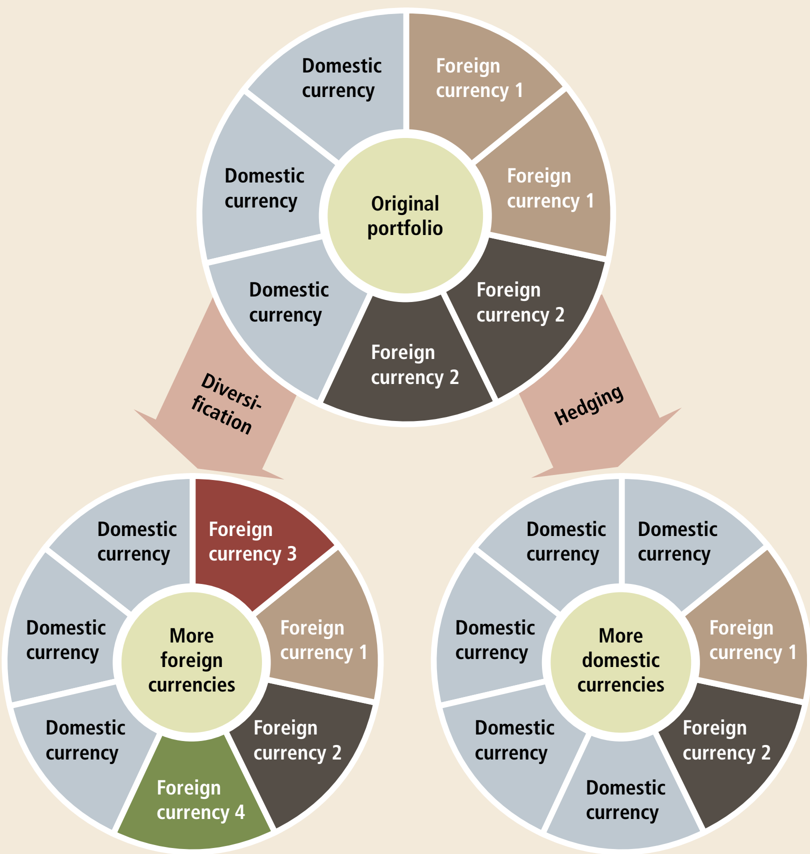
The best recommendation we can give in these uncertain times is to keep your powder dry, wait for corrections and buy when prices drop. We still believe that our five friends have high intrinsic values that promise long-term stability. This also applies to the more stable currencies in emerging markets, especially in Asia, which include the Singapore dollar and the Chinese renminbi, among others. However, in turbulent times, any of these currencies could experience

Picture: Luftbildfotograf (Fotolia.com)

a devaluation as recession fears and risk aversion are a dangerous mix for currencies that have surged in recent years. The desire grows to pocket profits from these currencies as soon as the financial market environment becomes more volatile.

The yen is due for a significant depreciation. However, this will probably happen only after interest rates rise globally, which is not likely to happen in 2012. For this reason, a yen appreciation is constantly held in check through interventions. A long-term depreciation, however, can hardly be accomplished by these means. Exchange rate trends in 2011 showed that the British pound is also suitable as a diversification currency. Even if the growth outlook and monetary policy are not convincing, the currency has repeatedly experienced an attractive appreciation when all others are suffering due to turbulence.

Hedging and diversifying



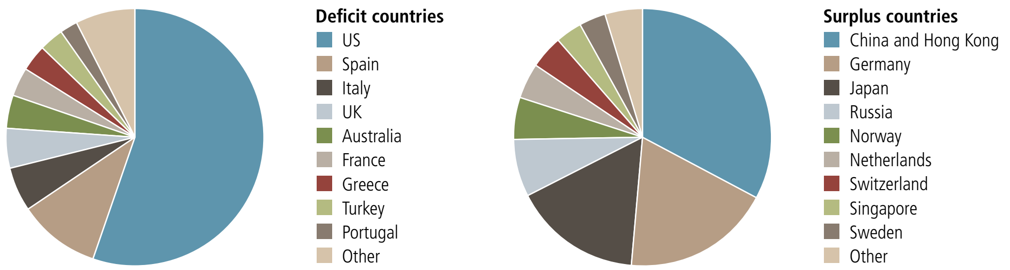
Investors who want to protect their portfolios against currency fluctuations have a choice of two strategies: hedging and diversifying. By hedging, we mean a transaction that brings the outstanding investment in foreign currency back into the home currency. This can be done by means of a forward contract, an option or something similar. The purpose of hedging is to reduce exposure to foreign currencies. Alternatively, investors can decide to distribute their outstanding currency positions across several currencies, i.e., to diversify. This reduces the exposure to any single currency and weakens the average impact of currency fluctuations on the portfolio. Hedging reduces currency risk radically. The drawback is that it also limits the scope for currency gains.

The current account balance as a sign of long-term stability

The current account balance measures how much a country saves compared to other countries. When the government, people and companies together produce more than they spend on consumption and capital investment, the result is a positive current account balance. The additional value that has been exported results in foreign borrowers owing saved capital to producers at home. The main big savers over the last five years have been China, Germany, Japan and Russia. If national expenditure exceeds domestic production, this inevitably results in a current account deficit that has to be funded by an outflow of bonds or other securities abroad. The two diagrams show those countries that have racked up surpluses and deficits over the years. It is notable that the surplus countries are the ones that came through the financial crisis in the best shape and still have the best outlook for their economies and currencies today. The only exceptions to this are Japan and Australia; we expect Japan to gradually become a deficit country as the population ages, while Australia should soon become a surplus country thanks to its commodity exports. Anyone looking to spice up their portfolio with foreign currencies should definitely look closely at how their portfolio is funded.

Fig. 6: How to separate the winners from the losers

Current account balance averages between 2006 and 2010, in USD bn



Source: Bloomberg, UBS WMR

Past performance is not an indication of future returns.

Is the EUR or the USD the better reference currency?

Many international clients ask our advice on the best reference currency. Latin American and Asian clients with the USD as a reference currency feel uncomfortable due to the money creation of the US Federal Reserve and the huge losses the USD has incurred in the last 10 years. Clients with the EUR as a reference currency, mostly from Central and Eastern Europe, feel uncomfortable due to the European debt crisis and the structural issues affecting the euro. The discomfort with the regions only underlines the need of an operable solution, since people need a liquid currency as a benchmark, and therefore need to look at these two currencies. Our best advice is to suggest looking at a basket which includes both these currencies and additional currencies as well.

Such a basket as a reference is not easy to book and to manage. However, clients who implement this approach appreciate that the currency volatility of the benchmark and the portfolio are greatly reduced. This helps to concentrate strategic positions and hedging on the true performance drivers, and to abstract from mean-reverting moves in EURUSD.

Government bonds *likely to continue drifting apart*

In 2012, the yields of industrialized countries are likely to be further impacted, primarily by the European debt crisis and the uncertain global economic outlook. After spreading to core European countries, the sovereign debt crisis is now affecting the real economy of the entire Eurozone, and is even slowing growth drivers such as Germany.

Daniela Steinbrink Mattei
Economist, UBS AG

Thomas Wacker
Analyst, UBS AG

While in early 2011, yield premiums for countries such as Portugal, Ireland and Spain rose sharply, this trend has spread to less well positioned core countries such as Italy, Belgium and France, and is expected to intensify greatly in 2012 without the intervention of the ECB. Even though none of these countries has solvency problems in the medium term, a lack of investor confidence as a result of high regulatory and bank financing requirements could lead to a liquidity problem.

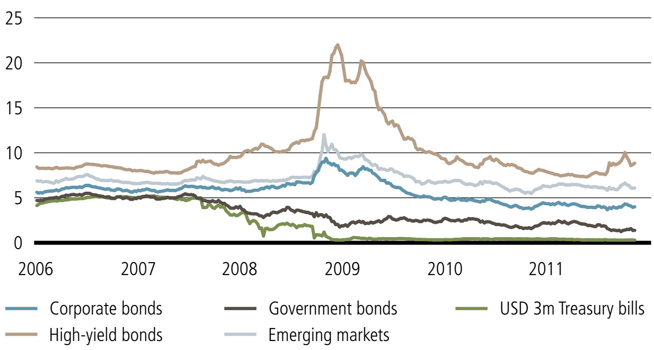
In contrast to the "problem countries," demand for government bonds of the US, Germany, Switzerland, the UK and the Scandinavian countries seems to be uninterrupted, and their yield levels are therefore at historic lows. This is not likely to change much over the medium term, and we expect the yields of US, UK, German and Swiss government bonds to stay within a rather stable range. The Federal Reserve, Bank of England, Bank of Japan and the Swiss National Bank are standing by their expansive monetary policy, with the Fed even having clearly communicated that it will not raise interest rates until at least mid-2013. In an environment of slow growth in the US and a high probability of a contraction in the Eurozone, inflation is unlikely to be an urgent problem or put any significant upward pressure on long-term yields. While in Europe only the slightest sign of renewed concern for Europe's periphery would suffice to increase demand for more solid government bonds, and thus weigh on Bund yields, economic surprises in the US could push yields up to the upper limits of the range.

Focus on security and avoid government bonds

Investors who don't just want to securely "park" their money for the short term, and are not dependent on high liquidity to be able to sell at any time, should continue to avoid government bonds. Given the very low premiums, in many cases the loss of purchasing power is not even covered. Investors seeking a high level of security and who are willing to hold the bonds until maturity can currently benefit from record-high liquidity premiums. The irrevocable bonds issued by the development bank KfW, which is guaranteed by Germany, offers around 0.8% higher returns than the comparably secure Bunds. The same applies to bonds issued by multinational development banks, most of which are supported by all major industrialized countries. Since only a few countries are free of debt concerns, however, we recommend focusing increasingly on high-quality Pfandbriefe. When selecting an investment, we look for several factors. First, a solid legal framework, which ensures that if the issuing bank becomes insolvent the Pfandbrief holders have unlimited access to the security. Secondly, the security must also be of a high level of quality; here, we prefer private mortgages in economically solid regions to loans to public entities. And lastly, we look for good credit quality of the issuing bank.

Fig. 7: Focus on security and avoid government bonds

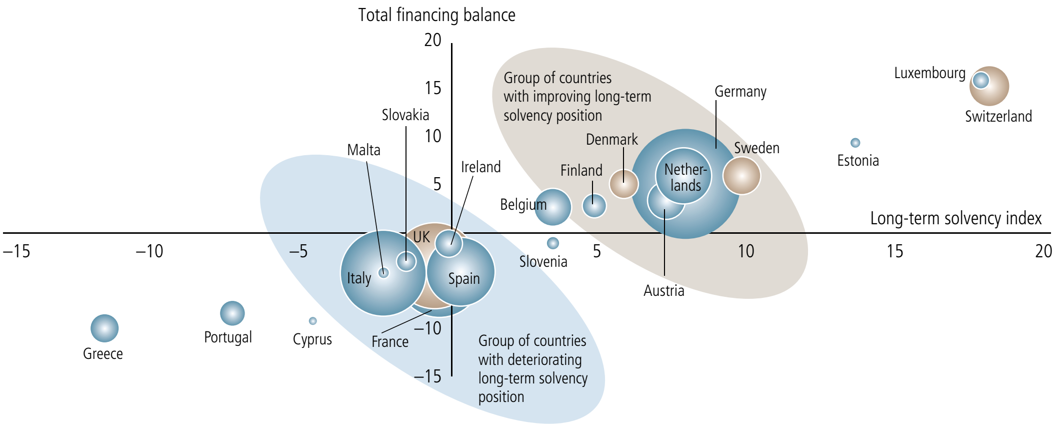
Yield to maturity on USD-denominated bonds, in %



Source: Bloomberg, UBS WMR

Past performance is not an indication of future returns.

Fig. 8: Long-term solvency positions of European countries
Long-term solvency index versus total financing balance (2010)



Source: AMECO database, UBS WMR
Past performance is not an indication of future returns.

Attractive returns for moderate risk

Asset value preservation remains our primary goal in 2012. High-quality corporate bonds of companies that are well positioned globally and less cyclical should also retain a high level of stability in 2012. We also recommend selected bonds with a somewhat lower credit quality from non-cyclical sectors or from well diversified companies with a low exposure to the European periphery. Although financial securities will continue to be very volatile, we are less skeptical than a year ago. Heightened capital adequacy requirements and stricter rules should serve to make banks more robust, while the risk premiums for senior bank securities have jumped sharply, meaning that bondholders are now considerably better compensated for assumed risk. Even though banks in Greece may indeed default, we do not anticipate any defaults on senior bonds of a major European bank. Given high price fluctuations, for the time being we recommend a lower weighting of financials compared with corporate bonds and a focus on more solid banks, such as Canadian, Australian and Scandinavian banks as well as insurance companies. We would recommend reinvesting in European bank bonds only after the European debt crisis has taken a decisive turn for the better.

Hedge funds

Trading: same old, same old

Compared with recent recoveries, the current one is steered by and is more dependent on political interventions. Hence, such maneuvers are becoming more influential for asset valuations. With confidence and market sentiment shifting sharply, managers adhering to bottom-up fundamentals to assess value will be severely challenged going into 2012. We therefore believe that trading (global macro and managed futures) strategies, which are less anchored to this investment approach, will be better off.

Corporate investments contributed significantly to US GDP growth in 2011. These investments were likely attributable to the catch-up from the bleak 2008–2009 years. Ultimately, though, these are driven by the firms' underlying demand for products, which should weaken since the current environment is conducive to higher savings rates. Should a recession unfold, trading managers should be the best positioned, mainly due to managers' ability to actively invest across asset classes and reduce their dependence on equities.

Listed real estate

A weakening macro environment brings uncertainty

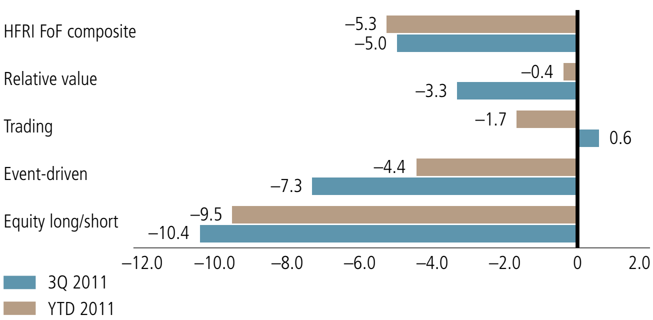
As real estate lags the economic cycle, slowing economies make local cuts in rents likely. There are signs that leasing activities have slowed and that large capital investment and hiring plans have been put on ice. As credit standards could tighten further, real estate stocks might underperform, as the correlation between the availability of credit and short-term performance is high. Currently, real estate stocks are cheap compared to direct real estate, and also attractive compared to their own valuation history, but not particularly cheap compared to equities. Consequently, we globally diversify risks. Some markets have already factored capital value declines into stock prices. Risk rallies are probable. But valuation could still come down before a new growth path materializes. Nonetheless, core commercial rental markets remain quite solid. Additional supply is low. Consequently, we still expect listed companies with generally high-quality properties, long leases and balance sheets that are not stretched to withstand the growth deceleration relatively well.

Cesare Valeggia
Analyst, UBS AG

Thomas Veraguth
Economist, UBS AG

Fig. 9: Trading strategies shine in 2011, and are well positioned for 2012

Year-to-date and third-quarter performance of different hedge fund strategies, in %

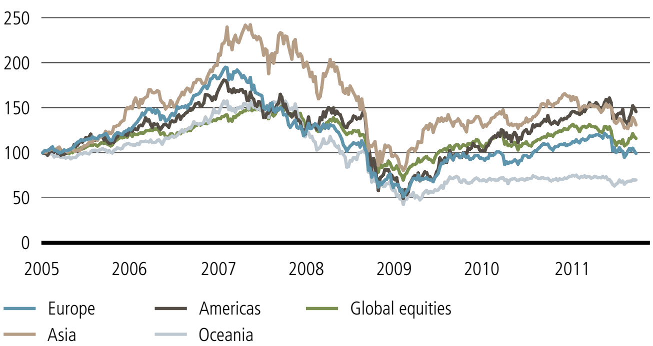


Source: Bloomberg, UBS WMR

Past performance is not an indication of future returns.

Fig. 10: Europe and Asia in bear market territory

Performance of global equities and global listed real estate (indexed: 01.01.2005 = 100)



Source: Bloomberg, MSCI, GPR, UBS WMR, as of 11.11.2011

Commodities

Buying opportunity to emerge in early 2012

We expect broad, diversified commodity indices to find a trough in late 1Q or early 2Q 2012. This view hinges on our expectations that Europe's sovereign debt crisis will peak in 1Q 2012, and emerging central banks will turn growth supportive. With inflation pressure now lower, central banks in emerging markets should ease monetary policy – especially in China. This should allow solid incremental demand for commodities and offset weak OECD (industrialized nation) demand. Cyclical commodities, constrained in supply, are likely to deliver a strong relative performance after initial price correction. Thus, we feel comfortable with our 12-month Brent crude oil forecast of around USD 105/bbl and a copper price target of USD 8,800/mt. The case also exists for higher agricultural prices. Depleted inventories in the US require excellent weather conditions for inventories to rebuild in 2012, which favors the grains. Gold and platinum should witness fewer price swings. With mounting risk of Eurozone debt being monetized and no liquidity crisis emerging, our 12-month gold price target remains unchanged at USD 2,200/oz.

Private equity

Dominic Schnider
Strategist, UBS AG
Stefan Brägger
Analyst, UBS AG

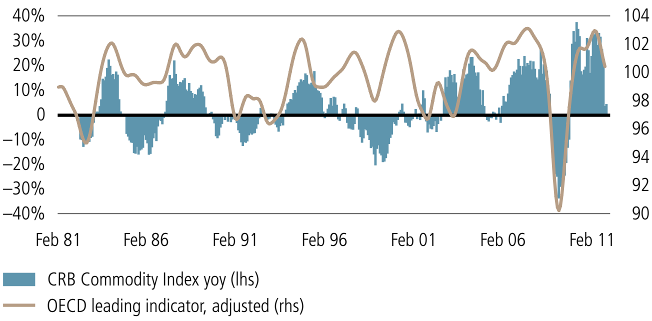
Operational expertise more important

Global deleveraging has only just begun: Operational skill should thus become the key performance driver, as private equity will have to rely less on debt. Recent years have shown that the most successful fund managers are those who can create value during periods of uncertainty and sluggish growth (Fig. 12). We therefore advise investors to select experienced managers with strong operational capabilities.

We expect valuations to remain flat in 2012, with no significant increases until the economic picture improves. After significant exit activity throughout 2011, investors should be prepared to see distributions slow down. However, investment activity will continue; fund managers are sitting on over USD 900bn of uninvested capital. With developed markets stagnating, we recommend an ongoing allocation to emerging markets. However, the current market dislocations in Europe and the US also offer attractive long-term opportunities for managers capable of spotting undervalued and undermanaged companies.

Fig. 11: The OECD leading indicator points to weaker commodity prices

The CRB Index is a broad, diversified commodity index on a spot return basis

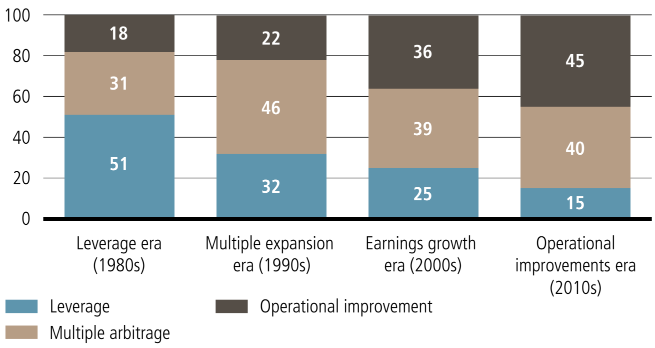


Source: Bloomberg, UBS WMR

Past performance is not an indication of future returns.

Fig. 12: Operational skill is key, role of debt diminishes

Source of value creation, in %

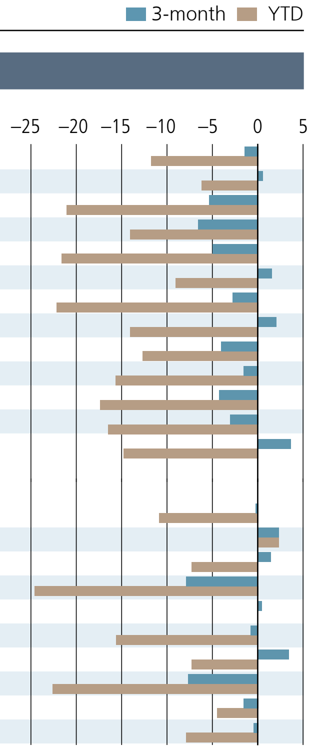


Source: Boston Consulting Group, Goldman Sachs, UBS WMR

Financial market performance

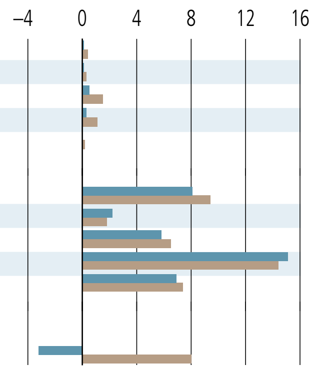
Equities

Markets	Total return, in local currency and % YTD	3-mo	1-yr	5-yr	Total return, in USD and % YTD	3-mo	1-yr	5-yr
Global	–11.8	–1.5	–8.3	–3.8	–12.0	–4.3	–7.8	–2.8
US	–6.2	0.5	–1.3	–1.4	–6.2	0.5	–1.3	–1.4
Japan	–21.1	–5.4	–18.6	–13.2	–17.6	–5.7	–12.4	–5.9
Canada	–14.1	–6.6	–10.4	0.4	–18.4	–12.2	–13.7	2.0
Eurozone	–21.6	–5.0	–20.4	–8.4	–22.5	–12.2	–21.0	–8.2
UK	–9.1	1.5	–5.9	0.3	–10.1	–3.4	–7.6	–4.1
Sweden	–22.2	–2.8	–18.5	–1.4	–25.2	–11.8	–19.2	–1.6
Switzerland	–14.1	2.0	–14.9	–6.6	–14.1	–12.8	–8.9	–1.6
Australia	–12.7	–4.1	–9.9	–1.7	–16.9	–10.5	–10.4	2.9
Emerging markets	–15.7	–1.6	–13.1	3.6	–21.7	–9.3	–17.9	3.0
Asia	–17.4	–4.3	–14.5	4.1	–20.5	–8.9	–16.8	3.0
Emerging Europe, Middle East & Africa	–16.5	–3.1	–12.7	–2.3	–22.4	–11.6	–18.5	–3.2
Latin America	–14.8	3.6	–13.5	6.4	–24.4	–9.9	–21.3	7.0
Sectors								
Consumer Discretionary	–10.9	–0.3	–9.3	–3.4	–10.4	–2.3	–8.1	–1.6
Consumer Staples	2.3	2.3	4.0	5.2	2.0	–1.3	4.7	6.0
Energy	–7.3	1.4	–0.4	1.9	–8.3	–1.3	–1.1	1.6
Financials	–24.6	–7.9	–21.0	–15.4	–25.1	–11.2	–20.7	–14.4
Healthcare	0.0	0.4	1.7	–0.1	–0.2	–3.0	2.5	0.6
Industrials	–15.6	–0.8	–11.3	–3.6	–15.3	–3.5	–10.1	–1.8
IT	–7.3	3.4	–4.4	–1.0	–7.0	2.7	–3.7	0.2
Materials	–22.6	–7.7	–17.4	–0.4	–23.8	–11.9	–17.5	1.1
Telecom	–4.5	–1.6	–2.8	0.8	–4.7	–5.2	–2.5	1.2
Utilities	–7.9	–0.5	–6.4	–2.9	–7.6	–3.0	–5.6	–2.1

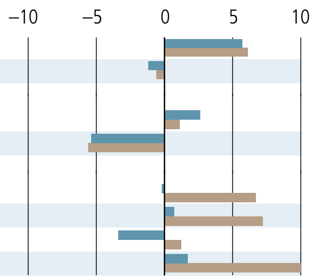


Fixed income

Money market	Total return, in local currency and % YTD	3-mo	1-yr	5-yr	Historical 3-month LIBOR rates, in % Current	3-mo	1-yr	5-yr
US	0.4	0.1	0.4	2.5	0.5	0.3	0.3	5.4
Japan	0.3	0.1	0.3	0.7	0.2	0.2	0.2	0.5
Eurozone	1.5	0.5	1.6	3.1	1.4	1.5	1.0	3.6
UK	1.1	0.3	1.2	3.5	1.0	0.9	0.7	5.2
Switzerland	0.2	0.0	0.2	1.6	0.1	0.0	0.2	1.9
Government bonds					Historical 10-year govt. yields, in %			
US	9.4	8.1	38.8	6.9	2.0	2.2	2.9	4.5
Japan	1.8	2.2	12.5	2.4	1.0	1.0	1.2	1.7
Germany	6.5	5.8	30.7	5.9	2.3	2.2	2.7	3.7
UK	14.4	15.1	43.0	6.8	2.3	2.5	3.4	4.5
Switzerland	7.4	6.9	24.7	4.6	0.9	1.0	1.6	2.3
					Total return, in USD and % YTD	3-mo	1-yr	5-yr
Global inflation-linked bonds	8.0	–3.2	8.3	5.4	8.3	0.3	8.5	5.8

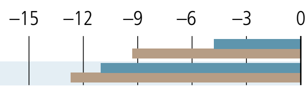


Investment-grade corporate bonds	Total return, in local currency and % YTD	3-mo	1-yr	5-yr	Option-adjusted spread, in bps Current	3-mo	1-yr	5-yr
USD-denominated	6.1	5.7	35.2	6.8	265	225	177	92
EUR-denominated	–0.6	–1.2	15.2	3.4	306	265	176	51
High-yield corporate bonds								
USD-denominated	1.1	2.6	40.1	7.7	800	743	593	315
EUR-denominated	–5.6	–5.4	22.2	4.8	949	876	599	248
Emerging markets USD sovereign bonds								
Global	6.7	–0.2	4.7	7.9	442	368	285	197
Asia	7.2	0.7	4.4	9.2	289	240	166	158
Eastern Europe	1.2	–3.4	0.0	7.3	434	362	280	186
Latin America	10.1	1.7	8.5	7.7	490	430	349	206



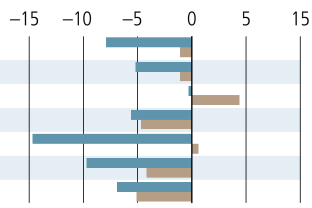
Non-traditional asset classes

	Total return, in local currency and % YTD	3-mo	1-yr	5-yr	Total return, in USD and % YTD	3-mo	1-yr	5-yr
Listed real estate	–9.3	–4.8	–5.8	–7.1	–10.1	–7.3	–5.5	–5.4
Commodities	–	–	–	–	–12.7	–11.0	–3.6	–16.0



Currencies

	Change versus the USD, in % YTD	3-mo	1-yr	5-yr	Exchange rates	Current		Current
EUR	–1.1	–7.9	–0.9	0.2	EURUSD	1.32	USDCNY	6.38
GBP	–1.1	–5.2	–2.1	–4.4	GBPUSD	1.54	NZDUSD	0.74
JPY	4.4	–0.3	7.6	8.3	USDJPY	78	EURCHF	1.23
CAD	–4.7	–5.6	–3.6	1.6	USDCAD	1.05	EURGBP	0.86
CHF	0.6	–14.7	7.6	5.4	USDCHF	0.93	EURJPY	103
SEK	–4.2	–9.7	–0.8	–0.3	USDSEK	7.01	EURSEK	9.28
AUD	–5.1	–6.9	–1.0	4.5	AUDUSD	0.97	EURNOK	7.85



Note: Information through 25 November 2011. Returns over five years are annualized. Past performance is not an indication of future returns. The market prices provided are closing prices on the respective principal stock exchange. This applies to all performance charts and tables in this publication.
Source: Bloomberg, J.P. Morgan, BoA Merrill Lynch, Thomson Reuters, UBS WMR

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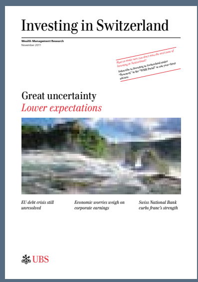

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