Market Outlook & “The Decade Ahead”

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Chief Equity Strategist

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Key economic and investment messages

**Economics**

Sustainable economic recovery is on firm ground – but some soft spots are likely along the way.

Recovery has come with a pretty hefty price tag.

**Investment Strategy**

Our base case: profits continue to drive stocks higher in 2011.

Overweight emerging markets and secular growth stocks.

Interest rates likely to rise from very low levels.

**The Decade Ahead**

Equities unlikely to suffer another “lost decade”.

Low valuation starting point bodes well for long-run returns.
Economic Outlook

A low growth, but sustainable expansion
Near-term “soft patch” to be transitory

US real GDP, quarter over quarter annualized

Source: DataStream, UBS WMR estimates
Home prices continue to “bounce along the bottom”

S&P/Case-Shiller Home Price Index, 20 city composite

Source: Bloomberg, UBS WMR
Home prices certainly no longer “expensive”

Median home price divided by median household income

Source: Bloomberg, UBS WMR
Housing affordability at all-time highs

US Housing Affordability Index

Source: DataStream, UBS WMR
Manufacturing rebound remains on solid footing

ISM Manufacturing PMI Composite Index

Source: Bloomberg, UBS WMR
Labor market recovery has significantly lagged past cycles…

US non-farm payroll growth following recessions

Source: Bloomberg, UBS WMR
...but is improving

Initial jobless claims – 4 week moving average

Source: Bloomberg, UBS WMR
Small business sentiment is rebounding

NFIB index of small business optimism

Source: Bloomberg, UBS WMR
Improved lending standards highly correlated to job growth

Nonfarm payrolls and lending standards

Source: Bloomberg, UBS WMR
Monetary policy to tighten but remain very accommodative

Fed funds target rate, in %

Source: DataStream, UBS WMR
In the early-to-middle innings of consumer deleveraging cycle

Ratio of US household financial liabilities to disposable income

Source: Thomson Reuters, UBS WMR
Deficit reduction tactics lie ahead

US federal budget breakout, in %

Source: Office of Management and Budget estimates, UBS WMR
Tactical Asset Allocation

Better relative value in stocks
Stocks still poised to outperform

Core asset allocation, Tactical deviations from benchmark

<table>
<thead>
<tr>
<th>Equity</th>
<th>Fixed Income</th>
<th>Cash</th>
<th>Commodities</th>
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<tbody>
<tr>
<td>++</td>
<td>++</td>
<td>+</td>
<td>++</td>
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<tr>
<td>moderate overweight vs. benchmark</td>
<td>moderate overweight vs. benchmark</td>
<td>neutral, i.e. on benchmark</td>
<td>strong overweight vs. benchmark</td>
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<tr>
<td>overweight vs. benchmark</td>
<td>underweight vs. benchmark</td>
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<td>+++</td>
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<td>strong overweight vs. benchmark</td>
<td>strong underweight vs. benchmark</td>
<td>(n)</td>
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Source: UBS WMR
Equity valuations are undemanding

S&P 500 P/E based on next 12 months consensus earnings estimates

Source: FactSet, S&P, UBS WMR
30-year bull market in bonds is likely over

Source: Bloomberg and UBS WMR
Corporate profits have rebounded sharply

S&P 500 earnings per share

S&P 500 EPS, y/y percent change

Note: 2011-2012 UBS WMR earnings estimates. Source: FactSet, UBS WMR
S&P 500 EPS is not US GDP

* Other include: Technology, Healthcare, Telecom, Utilities, Financials. Source: FactSet, UBS WMR
Corporate cash continues to build

S&P 500 (ex-financials) cash as a % of assets

Note: Current constituents. Source: Bloomberg, UBS WMR
Strong increases in dividends should follow surging profits

S&P 500 dividends per share and earnings per share year-over-year percent change

Source: FactSet and UBS WMR
Shifting focus to mid-cycle, global beneficiaries

Sector allocation, tactical deviations from benchmark

<table>
<thead>
<tr>
<th>Sector</th>
<th>Tactical Deviation</th>
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<tbody>
<tr>
<td>Tech</td>
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</tr>
<tr>
<td>Industrials</td>
<td>++</td>
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<tr>
<td>Consumer Staples</td>
<td>+</td>
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<tr>
<td>Materials</td>
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<td>HealthCare</td>
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<td>Telecom</td>
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<tr>
<td>Energy</td>
<td>+</td>
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<tr>
<td>Cons Discretionary</td>
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Tactical deviations from benchmark: Scale for charts - Symbol Description/Definition

- +   moderate overweight vs. benchmark
- ++  overweight vs. benchmark
- +++ strong overweight vs. benchmark
- -   moderate underweight vs. benchmark
- --  underweight vs. benchmark
- ---  strong underweight vs. benchmark
- n   Neutral, i.e. on benchmark

Source: UBS WMR
Emerging markets best positioned regionally

Regional asset allocation, tactical deviations from benchmark

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Source: UBS WMR
Emerging markets the source for growth in the world economy

Contribution to global GDP growth, in %

Source: International Monetary Fund, UBS WMR
Key investment debate #1

Have corporate profits only benefited from cost cutting?
Decent revenue growth

S&P 500 (ex-financials) revenues, year over year percent change

Source: FactSet, UBS WMR
Key investment debate #2

Are profit margins are unsustainably high?
Little evidence of margin collapse barring recession

Average change in profit margins for a given change in nominal GDP growth

Note: Profit margin proxy for this analysis was based on the Bureau of Economic Analysis ‘Corporate profits with inventory valuation and capital consumption adjustments’ account dividend by nominal GDP. Change in nominal GDP growth rate is equal to the last 12 months nominal GDP growth rate minus the prior 12 month nominal GDP growth rate. Source: Bureau of Economic Analysis, UBS WMR estimates
Key investment debate #3

Will end of QE2 dry up market liquidity?
End of QE1 not a template for end of QE2

S&P 500 & Fed balance sheet

S&P 500 & fed funds target rate

Source: Bloomberg, UBS WMR
Key investment debate #4

Will rising oil prices derail equity market rally?
Oil prices haven’t reached the “tipping point”

Correlation between S&P 500 and change in oil prices

Source: Bloomberg, UBS WMR
Key investment debate #5

Won’t stocks suffer when leading economic indicators roll over?
The “macro trade” has been all that has mattered recently

ISM Manufacturing Index and S&P 500 y/y percent change

Source: FactSet, UBS WMR
A maturing business cycle does not mean weak market returns

S&P 500 12-month performance after ISM peaks

Source: Bloomberg, UBS WMR

<table>
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<th>Period</th>
<th>Performance</th>
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<tbody>
<tr>
<td>All periods</td>
<td>2.0%</td>
</tr>
<tr>
<td>Recession follows</td>
<td>-5.4%</td>
</tr>
<tr>
<td>No recession follows</td>
<td>7.1%</td>
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Key investment debate #6

Are large-caps much cheaper than small-caps?
Neutral between large- and small-caps

Relative P/E valuation – large vs small

Earnings growth rate - consensus

Note: earnings estimated growth are consensus. Source: FactSet, UBS WMR
The Decade Ahead

*Stocks poised to outperform bonds*
GDP growth is not the only driver of stock returns

Real US GDP growth rate and S&P 500 total return, in %

Source: Bureau of Economic Analysis, Standard and Poor's, UBS WMR
Stocks were extremely expensive ten years ago

Price-to-earnings (P/E) ratio, earnings based on trailing 10-year adjusted real operating earnings per share

Source: Shiller (2011), Standard and Poor's, UBS WMR estimates
Valuation negatively correlated with decade-ahead returns

P/E ratio versus annualized S&P 500 total return of next 10 years, in %

Source: Shiller (2011), Standard and Poor's, UBS WMR estimates
Higher sector concentration increases market risk

Difference between first- and second-largest S&P 500 sector, as % of S&P 500

Source: FactSet, UBS WMR
Stocks likely to rebound after pronounced weakness

10-year rolling compound annual return of stocks minus bonds, in %

Source: Shiller (2011), Standard and Poor's, UBS WMR estimates
Estimated 9% CAGR for S&P 500 total return for next 10 years

2020 S&P 500 “target” or fair-value estimate for S&P 500: 2450

- Trend S&P 500 earnings = $165 per share by the end of 2020
- Applying the average P/E multiple since 1940 of 14.7x
- 2020 S&P 500 target: 2450
- 6.5% annualized gain + 2.0% dividend yield = 8.5% annual return

Source: UBS WMR estimates