Outlook 2012
Global Asset Allocation

Need to Know

14 November 2011

SUMMARY: 2012 FAMILIAR TO 2011

In many respects, the investment **outlook for 2012 will be distressingly familiar to 2011**, with outcomes being dominated by central investor pre-occupations such as the **Eurozone crisis** and doubts about the **sustainability of global recovery**. The implication is that markets will remain **largely range-bound and characterized by unusually elevated levels of volatility and cross-asset correlation,** with global recession remaining the chief risk.

THREE MAJOR DIFFERENCES:

(1) Market prices: Treasury yields are lower, gold is higher and equity markets are flat or lower. Many of the winning strategies of 2011, including long-duration government bonds, investment grade bonds or precious metals, should be less compelling in 2012.

(2) Inflation in emerging economies is receding, allowing policy easing.

(3) Earnings growth is slowing but likely to remain at high levels. High profits and low valuations provide important downside support for equity markets and foundation for credit markets.

WHAT TO OWN? In this likely environment, **income-generating corporate assets** are likely to perform best.

HOW? We **prefer high-yield credit** alongside quality, **dividend-paying stocks**. We are neutral on global equities, but regionally, we **prefer US and emerging equities**. **Hard-currency emerging debt and real estate** also offer income prospects. We also like **agricultural commodities.** Low yields make nominal and inflation-linked **government bonds and cash unattractive.**

Three Key Themes for 2012

- **Sovereign Stress** is a broad concept, given the myriad ways in which the limits to government are now being tested. Those limits are surely financial, as exposed in the Eurozone crisis. But they are also social and political. And they are not confined to the West.
- **Is global recovery sustainable?** Much hinges on the resilience of US recovery. 2012 may also be the year emerging markets make a more decisive breakthrough, shouldering more of the global cyclical risk premium.
- **Profits and Innovation** is the new normal. Story of excess capacity as well as continuous innovation and adjustment in the corporate sector. High profits can be maintained in a sluggish global environment, and support corporate assets, stocks and bonds.

Implications for Asset Allocation

Our tactical outlook:

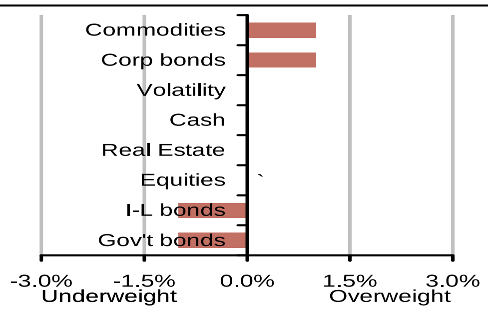
- Elevated political risk leaves us cautious.
- Neutral on global equities, REITs and cyclical commodities.
- Overweight in high-yield credit, hard-currency emerging debt and soft commodities.
- Moderately Underweight in government bonds.

Our medium-term outlook:

- Prefer equities and high-yield credit over government bonds and cash. Above all, **we favour high-yield corporate bonds.**
- For now, favour US and the emerging economies, but Europe could do better in H2 of 2012 if sovereign risk premiums unwind.
- Prefer agricultural commodities over precious metals.

Asset Class Tilts

Asset class tilts – summary



Asset Allocation

- **Equities –** Overweight on EM and US, Underweight Europe
- **Government Bonds –** Overweight EM hard-currency debt, Underweight US, Europe and inflation-linked.
- **Corporate Credit –** Maintain preference for high-yield
- **Commodities** – Prefer livestock and agriculture
- **Listed real estate –** Overweight Asia, Underweight Europe including UK.

Risks to base case

Downside risk:

- **Global recession** could be triggered by a rapid deterioration of the Eurozone crisis, a US double-dip or a Chinese hard landing.
- **Policy in advanced economies has been rendered lame;** investors would probably see a double-dip as the beginning of a more serious slump. Investors would have to flee to liquid and (mostly) safe assets, including Treasuries, gold and the Swiss franc.

Upside risk:

- **A 'technocratic' government in Italy**, more committed and credible in adopting structural reform, could give a big relief to sovereign risk premiums.
- **Faster growth in the US and emerging countries** could also boost earnings expectations and share multiples, producing bigger gains for global equity markets and sell-offs in government bonds.

This report has been prepared by UBS Limited.
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Outlook 2012
Global Equity Strategy

Need to Know

14 November 2011

Summary

Slow growth and decelerating earnings growth meet high volatility and poor cyclical visibility:

This poses challenges to equities as PE multiple re-rating and strong asset allocation flows are unlikely until this outlook changes.

We **advocate defensive positioning and focus on strategies that can provide solid returns** even in choppy market conditions.

We remain **focused on quality and yield**, which often go together, as a way to weather volatile markets. Companies with strong returns on capital, visible and sustainable growth prospects, and solid dividend growth should perform well.

REGIONAL PREFERENCES: We **favour US and GEM,** and upgrade the US to equal overweight with emerging markets. GEM has the best growth prospects and has the most ability to provide stimulus. We retain **underweight Europe** given ongoing pressures. **Downgraded Japan to Underweight** from Neutral. Yen strength should further weigh on profitability. While GDP growth is likely to accelerate, earnings growth expectations unlikely to rise.

SECTOR PREFERENCES: Cautious allocation; seek selective growth opportunities. Market pullbacks should surely favour a more pure defensive posture, but our base case of range-bound and choppy markets argues for selectivity. **Overweight** on **Tech, Consumer Staples and Healthcare. Underweight Financials, Consumer** on **Discretionary, and Utilities.**

Market Trends for 2012

1. Life in the slow lane

- Growth has struggled to rebound sharply. We now view mid-single digit earnings growth in 2012 as our base case.
- Market moves are apt to remain subject to short-term swings in data and sentiment, making trends difficult to follow.

2. Volatility until visibility

- Sovereign debt crisis in Europe poses an ongoing threat to market stability.
- Periodic worries about double-dip risks are likely given the overall slow pace of growth.
- Until a path to resolution in Europe as well as towards faster and more sustainable growth is clear, uncertainty and risk premiums will remain high.

3. Waiting for PE expansion

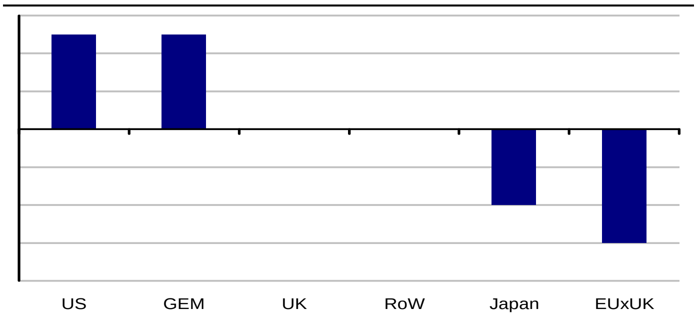
- With decelerating earnings growth, the burden of returns falls to PE multiples.
- However, with such little visibility into the economic outlook, sustainable valuation expansion looks unlikely.

Investment Implications

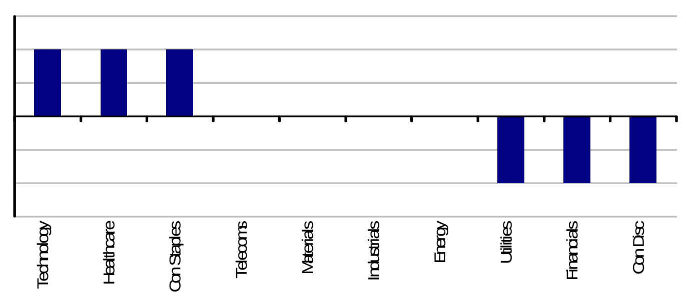
- **Managing poor risk reward:** With expectations for continued volatile and range-bound markets, we continue to advocate for defensive positioning to help smooth some of the volatility in returns.
- **Remain focused on 'quality' and yield:** Although valuations of some 'quality' styles (particularly low earnings volatility and ROIC) have moved toward the higher end of relative ranges, we continue to think companies with strong returns on capital, above-peer growth and profitability, with an ability and proven willingness to return capital to shareholders, will outperform.
- **Growth enters the equation:** We expect the regions, sectors and stocks that exhibit stronger relative and sustainable growth to command a valuation premium. This outcome should also favour 'quality' companies given greater earnings visibility and predictability.
- **Search for yield continues:** With volatile markets and slow growth, dividends are likely to continue to play an important part in total returns and also provide a buffer against volatility. With high cash levels, low payout ratios and limited investment opportunities, we see dividend growth outpacing earnings growth in coming years.
- **ROE and the case for re-leveraging:** Expectations for ROE gains next year stem entirely from expanding profit margins, yet we've already seen margins flatten out. So unless we get some acceleration in asset turns or an increase in leverage, we are likely to see ROE fall. This would be yet another headwind for valuations. There is plenty of cash but as the last year has shown, we will need to see an improvement in visibility and confidence before it gets put to productive use.

Weightings

Recommended regional positioning



Recommended sector positioning



Risks to base case

- **Upside risk:** Stronger-than-anticipated growth; valuation multiples appear slightly cheap relative to our estimate of fair value.
- **Downside risks:** Double-dip in growth; escalation of sovereign challenges; high commodity prices pose risks to recovery.

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Outlook 2012
Global Emerging Markets Strategy

Need to Know
14 November 2011

Summary

There remain **many supporting factors to warrant investing** in emerging market equities.

However, the market environment is unfavourable, **with elevated uncertainty and volatility** manifesting themselves in a high equity risk premium. This has resulted in **depressed valuations.** We estimate 13% upside for GEM equities in 2012 and a fair PE of 10.6 times, at the low end of its historical range.

STRATEGY: We recommend a defensive approach.

SECTORS: We are **overweight sectors related to emerging market consumption**, which protect from lacklustre Western demand.

STYLES: We recommend high **ROE, lowly-indebted, dividend-paying stocks**.

COUNTRIES: We favour **China, India and Brazil** as well as **TIPs** (Thailand, Indonesia, Philippines), which are benefiting from a strong underlying consumption and investment cycle. We also **upgrade Peru** due to reduced political risk and attractive valuations, and **downgrade Mexico** given its high valuation.

RISKS: On the upside, an overdue resolution to the Euro zone difficulties would normalise the equity risk premium; global growth and corporate earnings could accelerate. The chief downside risk is that the Euro zone situation may deteriorate.

Seven Reasons to Own GEM / Pillars of Support

1. Valuation

- GEM equities de-rated through 2010 and 2011, with negative returns despite growth in earnings, leaving it trading on 9.3x 12-month forward earnings at the very low end of historical range.
- GEM equities are trading at a 15% P/E discount to the World; we think this discount is unjustified given that sovereign debt problems are in the West and that the EMs offer superior economic and earnings growth, profitability and healthier balance sheets.
- A re-rating would take time, but when GEM equities have traded at current valuations (c.10x trailing P/E), subsequent three-year returns were very high.

2. It is time for equities

- GEM equities look attractively valued relative to emerging market bonds.
- We believe the wide gap between the bond yield and the equity earnings yield will close over time, most likely driven by a drop in the equity earnings yield as equity multiples expand.

3. Better growth prospects

- Emerging markets remain the fastest-growing economies of the world.

4. Earnings downgrades understood

- A string of disappointing global economic data and the persistent sovereign debt crisis in Europe have already led to downgrades to earnings estimates globally. However, we expect further downgrades.
- There is a lesser downside risk to estimates in GEM relative to the developed markets: GEM aggregate profit margins are in line with their historical average and 2% below their peak, whereas peak margin expectations for 2012 for developed markets look unrealistic.

5. Potential for ROE support

- It is unlikely in a slowing growth environment that top-line growth alone will be sufficient to support current levels of ROE.
- However, leverage should increasingly be used by GEM companies to support ROE.
- Companies also have the capacity to increase dividend payouts.

6. Strong government accounts

- In the emerging markets, debt-to-GDP is around 35% compared to more than 70% for almost all G7 countries.
- The outlook in GEM is more constructive, given balanced or in some cases even positive fiscal accounts.

7. Trends in governance

- Another supportive trend for emerging markets, albeit slow-moving, is that of improving governance.

What went wrong in 2011?

- **January 2011 – Inflation Scare**: Multiples tend to de-rate in high-inflation environments as investors lose confidence in their ability to discount future earnings at a constant rate, and this uncertainty increases volatility and the equity risk premium.
- **August 2011 – The Eurozone crisis, growth problems and high correlations**: Given the high correlations across and between assets, when global equities fell sharply as fears of another global recession escalated, emerging equities followed suit. GEM equities were particularly hard hit because of their high beta.
- **Outflows**: In response to these periods of underperformance, investor outflows from the asset class have been sharp.

Lessons for 2012

Many of the circumstances that led to the underperformance of emerging market equities in 2011 are unlikely to be repeated next year:

- **Inflation should decline.**
- If growth conditions continue to deteriorate, most **governments have the ability to extend both monetary and fiscal support** to domestic economies. This potential for loosening policy is in contrast to the monetary and fiscal tightening in countries in 2011.

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GEM Country Allocation

- **Overweight LatAm**: Overweight every market except Colombia and Mexico.
- **Neutral EMEA:** Balancing an Overweight in South Africa against Underweights in Russia and Turkey.
- **Underweight Asia:** Due to near-zero weight in Taiwan and Korea; despite Overweight in China, India, Indonesia, Thailand and Philippines.

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Outlook 2012: Rates, FX, Credit

November 2011

GLOBAL RATES STRATEGY

KEY TAKEAWAY: As political risk remains high, we recommend running low levels of risk. We are neutral on duration in G10. We believe the eurozone crisis will intensify, possibly producing a 'big bang' that leads to Eurobonds. Until then, refinancing risk is a major issue.

LIKELY THEMES FOR 2012? Potential regime changes given the heavy election calendar; high investor risk aversion for at least the next three months; and yields in the US and core Europe to remain lower for longer given high risk aversion and perhaps surprisingly low growth.

NON-CONSENSUS VIEWS: We expect Gamma to increase secularly, as dealers' ability to absorb fixed income risk should continue its decline, thereby increasing the size of short-term market moves. Supranational debt should perform well as investors eventually reach for yield (in response to the low and stable policy rates we expect), but the market for supras should become increasingly discrete as investors evaluate an issuer by the country it is based in.

HOW WILL 2012 DIFFER FROM 2011? OUR BASE CASE:

(1) 'Regime change' could alter the trajectory of the euro zone crisis;

(2) Financial intermediaries should find it increasingly difficult to play their traditional role as shock absorbers.

TOP RECOMMENDATIONS: We favour curve flatteners in most G10 markets. In the US, we prefer 2s/5s and 10s/30s flatteners, and in core Europe we like 2s/10s. Investors should be long gamma in USD and EUR, and also overweight US low-coupon agency MBS. We are negative on linkers in the US but positive in the eurozone. Avoid the eurozone periphery.

WE EXPECT RATES TO REMAIN LOW AND STABLE

Figure 1: Current Policy Rates, Last Move, and Time Elapsed, 9 Nov 2011

Country	Current Rate	Last Rate Move	Date	Time Elapsed	Implied Move 6mo	Implied Move 12mo
UK	0.50%	-50 bps	3/4/2009	30 months	-2bp	+7bp
Canada	1.00%	+25 bps	9/8/2010	14 months	-22bp	-31bp
Eurozone	1.25%	-25 bps	11/3/2011	-	-25bp	-11bp
US	0.0% - 0.25%	-75 bps	12/16/2008	35 months	+3bp	+5bp
Japan	0.10%	-20 bps	12/19/2008	35 months	-2bp	0bp
Australia	4.50%	-25 bps	11/1/2011	-	-109bp	-108bp
New Zealand	2.50%	-50 bps	3/10/2011	8 months	+8bp	+41bp

Source: UBS, Bloomberg

- It is worth highlighting just how steady policy rates have been for the past two years. While a handful of the major central banks have made a feint towards raising policy rates since the start of the crisis, only Canada has managed to make its snugging stick (while remaining at the still low level of 1.0%).
- We doubt that central banks will change their tune in 2012, with the Fed, Bank of England and Bank of Japan seemingly inclined to leave their rates unchanged for a long time.
- We expect investors to respond to low, stable policy rates by eventually increasing risk. We expect rates investors to increase the duration/curve/spread risk in their portfolios at some point in the next several months.

WHAT WE THINK ABOUT THE EUROPEAN SOVEREIGN DEBT CRISIS

- **OUR BASE CASE – a 'BIG BANG' solution:** We think this will occur only when the clear alternative is breaking up the eurozone, or systemic collapse. EU politicians would be compelled to accelerate fiscal convergence and permit eurobonds to be issued. Naturally, this scenario entails a significant commensurate increase in euro break-up risk in the run-up to the "big bang" denouement.
- **A EURO BREAK-UP?** Euro area policymakers may be unable to make the necessary institutional changes for common issuance with sufficient speed. The political and legal hurdles in bringing 17 eurozone member states on board are formidable. In particular, we think that the September ruling from Germany's Constitutional Court ruling could limit the German government's room to maneuver swiftly, while parliaments in smaller AAA states such as Finland, the Netherlands and Austria would also pose a significant ratification risk. Since there is currently no legal avenue in the EU Treaty by which a state can leave or be expelled from the euro, we presume that exiting the euro also means leaving the EU. We consider 'exit from the bottom' to be the most likely scenario, in particular since Greece could be close to a primary surplus by the end of 2012.
- **CATALYSTS:** (1) Coercive Greek default (we include default via exiting the eurozone); (2) Major bank failures; (3) Long-term yields on Italian and Spanish bonds trade above 7% for a considerable time

REFINANCING RISK LOOMS LARGE

Euro area central government gross sovereign bond issuance, EUR billion

	2005	2006	2007	2008	2009	2010	2011(F)	2012(F)^	Change
Germany	146	162	143	144	156	207	190	184	-6
France*	120	107	108	117	169	211	196	179	-17
Italy**	163	161	170	187	231	250	213	221	8
Spain	33	26	23	47	104	93	94	84	-10
Netherlands	30	21	22	29	48	52	50	45	-5
Belgium	22	21	26	28	30	41	39	35	-4
Austria	16	18	19	10	23	21	19	20	1
Finland	3	4	5	7	10	14	13	10	-3
Portugal	16	12	9	12	15	22	7	0	-7
Ireland	2	0	6	11	32	20	0	0	0
Greece	31	26	36	36	50	18	0	0	0
EU-11	582	557	567	627	867	948	821	778	-44

Source: Source: UBS and national treasuries * Includes funding for the EUR 18bn in debt buy-backs completed so far. ** For Italy CTZ issuance is included. ^ 2012 estimates are net of buy-backs.

The overall driver of the sovereign debt crisis is still the imbalance of supply and demand in peripheral government bonds. The governments of peripheral countries continue to issue at near-record levels while the investor base for the bonds is shrinking. Volatility, default risk and policy failure have been the principle forces bearing down on demand.

2012 ELECTION CALENDAR

Date	Country	Election	Date	Country	Election
14-Jan-12	Taiwan	Presidential & legislative	17-Jun-12	France	Legislative second round
22-Jan-12	Finland	Presidential first round	01-Jul-12	Mexico	Presidential & legislative
01-Jan-12	Croatia	Referendum	01-Jul-12	Mexico	Legislative
05-Feb-12	Finland	Presidential second round	Jul-12	India	Presidential
04-Mar-12	Russia	Presidential	Oct-12e	China	18th Party Congress, Selection of Politburo and its Standing Committee
10-Mar-12	Slovakia	Parliamentary	08-Oct-12	Slovenia	Presidential
22-Apr-12	France	Presidential first round	Oct-12	Czech Republic	Legislative
01-Apr-12	South Korea	Parliamentary	06-Nov-12	United States	Presidential & legislative
06-May-12	France	Presidential second round	Dec-12	South Korea	Presidential
10-Jun-12	France	Legislative first round	2012	Denmark	Referendum (Tentative)

FX OUTLOOK 2012: SUPER-VOLATILITY, THE SEQUEL

KEY TAKEAWAY: This year's super-volatility in currency markets is likely to continue in 2012, driven by weak growth, uncertainty over monetary, fiscal and exchange rate policies; and contrasting sovereign risks in the world's major economies.

THREE THEMES FOR 2012

- **Stronger dollar.** UBS Economics expects stronger US growth relative to the Eurozone. As a result the Fed is unlikely to engage in QE3 while the ECB should cut rates further and the BoE extends its second round of QE beyond February. In addition, we think the greenback's 'exorbitant privilege' is here to stay, as it is the dominant currency in global payments, commerce, asset denomination and funding. As sovereign risks in the Eurozone deepen, so will the market demand for dollars. For the dollar to truly rally, however, we stress the importance of affordable dollar supply for entities not exposed to the Eurozone because this is the lifeline that will help countries and corporates to grow. As it stands US institutions benefit from cheap cost of capital and have the scope (and incentive from Fed staying at zero until 2013) to leverage strongly off their cash piles. We would not rule out comprehensive measures to support the US housing sector. If a tax break for US companies in 2012 is agreed on, the outlook would be even brighter for the dollar. Trades: Sell EURUSD, GBPUSD on rallies.
- **Free lunches.** The SNB and BoJ have adopted increasingly hard-line stances against domestic exchange-rate appreciation. The SNB has set a formal floor under EURCHF at 1.20 while the BoJ has intervened to prevent the USDJPY from breaking 75. Essentially, the two central banks are offering investors free lunches for shorting their currencies ahead of these levels, by protecting the downside risks. Indeed the SNB may even raise its target floor in EURCHF. Trades: Buy EURCHF on dips to 1.20 and USDJPY on dips to 75.
- **Strong sovereigns.** Norway, Sweden, Australia, New Zealand and Canada have all emerged from the credit crunch with much better fiscal positions, banking sectors and growth prospects than the US, UK, Eurozone and Japan. Investors should consider relative values trades for the minor G10 currencies. Trades: Buy AUDNZD as China's economy experiences a soft landing and the Australian dollar acts as a shadow currency for China. Go long NOKSEK if energy prices tighten on Middle East concerns. Buy CADCHF as SNB limits franc strength while the Canadian dollar benefits from America's economic recovery.

OUR G10 FX FORECASTS; PREFERRED G4 CURRENCY FOR 2012 – USD

G10 FX FORECASTS

	Current (Nov.11th)	End 2011	End 2012	End 2013
EURUSD	1.3635	1.35	1.25	1.2
USDJPY	77.40	75	80	85
EURJPY	105.6	101	100	102
EURGBP	0.8565	0.87	0.83	0.8
GBPUSD	1.5925	1.55	1.51	1.5
EURCHF	1.2365	1.2	1.2	1.2
USDCHF	0.907	0.89	0.96	1
EURSEK	9.089	9.25	8.4	8.4
EURNOK	7.7445	7.8	7.1	7.1
NOKSEK	1.1735	1.18	1.18	1.18
USDCAD	1.0205	1.05	1.05	1.08
AUDUSD	1.0155	0.97	1.05	1.05
AUDNZD	1.3065	1.3	1.3	1.3
NZDUSD	0.777	0.74	0.8	0.83

Source: UBS FX Strategy

- **We expect the USD to modestly appreciate** as the US economic outlook improves while Europe stagnates, and as the Fed avoids QE3 while other major central banks ease policy further. We expect the EURUSD will decline to 1.25 and Cable to 1.51 respectively by the end of 2012 while USDCHF and USDJPY should rise to 0.96 and 80 over the same period.
- **Risks to the dollar?** The main risk comes from fiscal policy being prematurely tightened in 2012. In particular this would occur if Congress cannot reach agreement to extend payroll tax cuts that expire at the end of 2011. The other risk comes from the US economy being dragged further down by the US housing sector (and core inflation trending lower from its current 2.0%y/y).
- **We expect intervention in JPY to continue.** Japan's domestic deflation and growth risks perhaps necessitate strong action against the strong yen, and the international political environment also appears to be more accommodating: We expect increased intervention from Tokyo in the years to come. Domestic savers will not head overseas until yields go up (for non-sovereign risk reasons), and it appears that the Fed, ECB, SNB and BoE will all maintain minimal policy rates in the medium term.
- **Further downside in USDJPY is hard to see,** given that exogenous shocks such as fresh Eurozone volatility or Fed balance-sheet expansion would likely be countered by intervention, and there are no other likely drivers of yen strength: asset-manager redemptions and corporate repatriation may slow next year.

OUR EXPECTATIONS FOR EUR, GBP, CHF

- **We expect another year of heightened volatility with the risk for more EUR downside.** We expect the sovereign debt crisis to remain central for 2012. Without more political stability in the hardest-hit countries, and the will to implement additional action to achieve fiscal targets, it will be difficult to sustainably decrease risk premiums in peripheral bond markets. At present, stronger support from any party with the resources to count is unlikely unless troubled Eurozone economies embark on more emphatic reforms. As such, the onus is on national governments to enact structural changes. This will cause currency markets to remain very much driven by political headlines.
- **We expect the ECB to maintain a dovish monetary policy stance**, capping any upside in rate expectations. Uncertain global growth prospects, combined with weakening domestic conditions suggest little scope for inflation risk to increase in the immediate future in the Eurozone. In addition, growth is likely to be severely restrained as several member states implement additional austerity measures.
- **We remain structural sterling bears** as the UK's economic growth is likely to be anaemic at best going forward, dampened by austerity measures. We believe that further deterioration in core macro data will prompt more QE policy which, over the medium term, should have a negative effect on the pound. However, recent price actions have highlighted several structural factors which have prompted inflows into the UK. These themes (e.g. the UK as a safe haven from Eurozone troubles) are likely to last over the short term but a context of BoE policy-easing with an improving US economy should make GBPUSD in particular a sell on rallies.
- **We expect the franc to remain capped.** With interest rates at zero the exchange rate will remain the policy instrument of choice for the SNB. We cannot rule out further central bank actions if both the inflation and growth outlook deteriorate further. We think deflation risks are likely to rise further as forward-looking indicators point to weaker growth and external demand (the Eurozone alone absorbs c60% of Swiss exports) remains lacklustre, justifying policy intervention according to the SNB's own mandates. Nevertheless, we think it will be difficult for the SNB to push the floor well above 1.30 as that is where the franc is close to fair value. If, against our base case, conditions in the Eurozone improve faster than expected, the franc may not only lose some of its safe-haven status but also its appeal as a funding currency in the face of divestment flows (as investors worry that the SNB could start to decrease euro holdings).

CREDIT OUTLOOK & OPPORTUNITIES IN 2012

KEY TAKEAWAY: With the trajectory of corporate credit risk premiums and returns in 2012 largely determined by political events in Europe, credit investors should tread tread cautiously but be opportunistic. At a macro level, we prefer US and EM corps over EU and recommend an overweight allocation to US HY and neutral IG globally.

2012 INVESTMENT THEMES

- **US: Constructive outlook.** Domestically focused, higher beta names should perform well. Long Energy, Telecom, Retail, REITs, Autos. Short Consumer Staples, Media, Defense. Focus single-name shorts on releveraging candidates.
- **EU: Cautious outlook.** Within corporates, three key themes: (i) rising dispersion in cyclicals, (ii) fallen angel risk, and (iii) refinancing concerns are also likely to drive valuations. Recent outperformance in Italian and Spanish corporates should be aggressively faded. Defensives should be favoured over cyclicals, particularly where rollover risks are above average.
- **EM-Asia:** Focus on quality names for carry strategies; use market volatility to scale into higher beta names; absolute-value strategy for deep-discount names.

With Europe being the key to the trajectory of corporate credit risk premiums and returns in 2012, we present a summary of our thoughts on Europe below.

EUROPEAN CREDIT: 2012 – END OF THE WORLD OR BEGINNING OF A NEW ERA?

WILL THE EUROZONE BREAK UP, OR WILL IT EMBRACE FISCAL UNION?

Both are possible, but neither is the most likely outcome – at least not in the next six months. All euro area member states have acknowledged the possibility of a Treaty change, but they also opened up the possibility of a Greek exit from the Eurozone. Currently, an economic governance framework is in the development stage, multiple governments are in political transition, and a fortified ringfencing of Greece is not in place. Barring an asset-price collapse, we think the ultimate solution is unlikely to materialise in the medium term.

- **BASE CASE:** Greece receives the next aid package, national governments extend bank guarantees with an EU backstop and the ECB steps in periodically to support Italian bond yields. Furthermore, the release of concrete details produces some EFSF sponsorship while modest fiscal and monetary policy in the US and EM supports global growth. Transition governments re-commit to fiscal targets and integration talks continue. A mild European recession and continued banking challenges increase idiosyncratic defaults, but ECB liquidity stems a Lehman-like event. Credit indices trade sideways similar to the Q408-Q109 environment, with pockets of weakness from a low/no-growth environment.
- **BULL CASE:** A supersized Greek PSI resets the debt clock and bank debt guarantees are extended with implicit ECB support. Aggressive policy stimulus led by China fuels a rebound in EM and US growth. New governments win popular support and credibly commit to fiscal targets while progress on integration materializes. Credit spreads trade back towards 2011 tights, but sluggish European growth limits full retracement.
- **BEAR CASE:** An unexpected sovereign or financial default occurs. A disorderly Greek default, a product of lack of fiscal discipline, political will and/or PSI, is a possible option. Sovereign and corporate defaults, banking system recapitalisation, and a collapse in trade ensue. Alternatively, the credit crunch accelerates and spreads, capital markets freeze, corporate and financial defaults (away from GSIBs) increase. European banks, given their size and scale in global banking, pull overseas banks into turmoil and the outlook for global growth is severely downgraded. Credit spreads trade wider than 2008-09 levels, reflecting a Euro-centric crisis that drives valuations across banks and peripherals to new highs.

EUROPEAN BANKS – FOUR KEY THEMES

(1) FUNDING NEEDS

European banks face pressures on both short- and long-term funding fronts. From now until year-end 2012, Western European banks are faced with a maturity wall of just over €800bn in term debt – primarily led by senior unsecured debt. Based on 2H11 and FY11 run rates, Western European banks have a funding gap of €450-500bn. Maturity run-off is an option for many banks, but that comes at the expense of lending in the system. As of now, the most likely solution for banks is to continue relying on secured borrowing and the ECB for short-term funding.

At the EU Summit in late October, policy-makers announced term guarantees for senior unsecured funding. Whilst a positive development, in our view, two main questions remain outstanding: <u>(1) Who will provide the bank guarantees and what form will they take?</u> EU officials have proposed a coordinated, EU level approach to be explored with the EBA, EIB, and ECB. Coordinated national commitments, back-stopped by Eurozone-level commitments for peripheral banks, is one possible scenario. In theory, the ECB could also provide assistance in repo operations to provide effective leverage to the EFSF. <u>(2) Will it work?</u> In the absence of improving economic growth, reliable sovereign backstops and bank recapitalisation, an EU-coordinated effort is essential to ensure the benefits of the scheme reach banks outside the core sovereigns of Germany, the Netherlands and the Nordics.

The ECB covered bond purchase program should also be an incremental positive. The ECB will purchase €40bn of covered bonds in the primary and secondary markets. Eligible bonds must be eligible for ECB repo, have at least €300mm outstanding, minimum rating of BBB- and maximum maturity of 10.5 years. The program is due to end in October 2012 at the latest.

(2) RECAPITALISATION

While having sufficient capital buffer is vital, we do not think that it is an end-all solution to ring-fence the sovereign crisis – sovereign solvency, bank liquidity and access to the wholesale market are key to revitalise the banking system. It is also not a 'one size fits all' scenario. Bar Spanish banks, most major European banks should not see capital shortfall to be their primary challenge. We see Italian banks as in a fundamentally much better state than their Spanish counterparts, with limited need for deleveraging since the private sector has very low leverage. French banks are likely to continue to be impacted by rising sovereign bond yields and concerns over a potential French AAA rating downgrade. In addition, they remain susceptible to weaker revenues and higher loan losses due to their bias to Eurozone retail banking.

(3) REGULATORY RISKS

The Capital Requirements Directive (CRD4) is the European implementation of Basel III adopted by the European Commission, to be phased in by 1 January 2019. Unlike Basel III, CRD4 would take the form of binding legislation, pending approval from the European parliament. There are a few main differences in their application:

- National regulators within the EU are not allowed to impose higher standards than what is prescribed by CRD4.
- Basel III rules apply to 'internationally active banks'. CRD4, on the other hand, would be applicable to all banks (more than 8,300) and investment firms in the EU.

(4) RATING RISK – LOOKING AT THE IMPACT OF RATINGS MIGRATION

Some hybrid securities possibly moving to HY post S&P ratings changes

Bond	Tier	Price €	YTM %	Amount Outstanding (€mm)	Current rating	Potential rating shock
UCGIM 4.028 Perp-15s	T1	48	7.9	750	BBB	BB
UCGIM 8.125 Perp-19s	T1	58	14.3	750	BBB	BB
SOCGEN 5.419 Perp-13s	T1	58	6.9	650	BBB+	BB+
CMZB 6.375 19s	LT2	76	11.3	1254	BBB-	BB+

Source: UBS

EUROPEAN CORPORATES – PREFER DEFENSIVES, BEARISH ON HIGH YIELD

- **Our bull, bear and base cases:** <u>Our base case</u> suggests sovereign spreads could be range-bound at elevated levels. <u>In our bull case</u>, sovereign spreads could move tighter if investor confidence returns to the peripheral debt markets. We would expect a convergence in valuations of sovereigns and corporates in the event of a proper fix. <u>Our bear case</u> would likely see sovereign spreads across member states take another leg wider as a financial or sovereign default originates in the periphery. In general, corporates underperform the sovereign in stressed situations on a relative basis as correlations/betas converge towards 1.0.
- **We anticipate positioning in core cyclicals versus non-cyclicals to increasingly drive relative performance.** The dispersion across total returns by high yield sector has been relatively narrow. Since early 2010, the difference between the strongest-performing (technology, 25% cumulative return) and weakest-performing (telecoms, -5%) sectors has been 30 percentage points. By comparison, the same analysis in the 2008-09 downturn yields a peak return differential of 65 percentage points and more differentiation among middle performers. We expect to see further differentiation among sectors and names as default rates increase.
- **The significant rollover risk in 2013–14 presents significant challenges, particularly for loan issuers.** Among rated issuers, the industries with the highest concentration of maturities include the auto, transport, and media/cable sectors. Sectors with higher concentrations of unrated debt maturing predominantly include business services, media/cable, retail and manufacturing.

UBS ECONOMIC FORECASTS

GDP growth

%y/y	Weight*	2010	2011F	2012F	2013F
US	0.23	3.0	1.8	2.3	2.7
Canada	0.02	3.2	2.2	2.0	2.4
Japan	0.07	4.0	-0.6	2.9	1.7
Western Europe	0.22	1.8	1.6	0.4	1.1
of which:					
Eurozone	0.17	1.8	1.7	0.2	1.0
UK	0.04	1.8	0.9	0.7	1.3
Switzerland	0.01	2.7	2.0	0.8	1.8
Asia **	0.23	8.7	6.7	6.4	6.7
of which:					
China	0.10	10.4	9.1	8.3	8.0
India	0.04	8.5	7.2	7.5	7.8
Latin America	0.08	6.8	4.7	4.2	4.6
of which:					
Brazil	0.03	7.5	3.1	3.8	4.8
Emerging EMEA	0.07	4.6	4.4	2.7	3.5
of which:					
Russia	0.03	4.0	4.1	3.3	3.8
Rest of world	0.08	4.0	3.0	3.3	3.5
Advanced economies	0.60	2.8	1.5	1.6	2.1
Developing economies	0.40	6.3	5.5	5.0	5.2
WORLD	1.00	4.3	3.2	3.1	3.4

Inflation

%y/y	Weight*	2010	2011F	2012F	2013F
US	0.23	1.6	3.1	1.8	2.3
Canada	0.02	1.8	3.0	2.7	2.3
Japan	0.07	-1.0	-0.3	-0.2	0.2
Western Europe	0.22	1.8	2.9	1.9	1.8
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