

UBS Investment Research

Global Economic Perspectives

Ten surprises for 2008

■ Risk scenarios

In our final publication of 2007, and in keeping with our year-end tradition, we've drawn on the expertise from our teams in Global Economics, Global Asset Allocation and Global Equity Strategy to compile a list of 10 possible 'surprises' for the coming year. Our aim is to identify plausible scenarios, representing risks—up or down—to consensus investor thinking and, in some cases, to our own baseline views.

■ Our list of 'what ifs' includes:

1) Global growth surprises on the upside; 2) Oil prices plummet; 3) The dollar appreciates; 4) World trade clouds; 5) Developed economy deflation, emerging economy inflation; 6) Financials outperform; 7) Emerging equity markets underperform; 8) Japanese equities outperform; 9) Equity volatility settles at lower levels; 10) Chinese inflation falls sharply

■ Seasons Greetings

Finally, we'd like to take this opportunity to wish our readers a joyous holiday season and extend our best wishes for the New Year. Our regular publications will resume in early January.

14 December 2007

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Ten surprises for 2008

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What to watch for

1) Global growth surprises on the upside

As regular readers know, according to our baseline scenario global growth will slow in 2008, largely due to the ongoing US housing recession, but also as a result of more restrictive financial conditions and the impact of higher energy prices. While the slowdown is expected to be concentrated in developed economies, developing economies will also feel some pain due to slower export growth as US consumption weakens. Our global growth forecast of 4.3% for 2008 (down from 4.9% in 2007) is marginally below the current consensus, but we emphasize that the risks to growth lie to the downside.

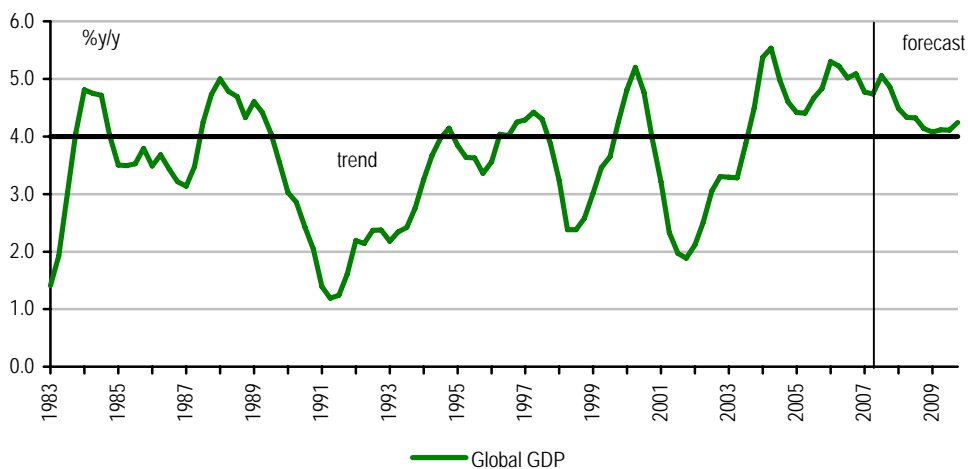
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Global GDP growth



Source: UBS

The surprise, therefore, would be a year of more robust global economic activity. How might that come about? To begin, the recent initiatives from central banks might do more than just ameliorate illiquid financial conditions; they could generate increased confidence and hence borrowing and spending. It is possible, though unlikely, that the US housing sector adjustment could proceed quickly, allowing for a sharper recovery in residential investment and a more resilient US consumer by the second half of 2008 than we presently envisage.

Another year of robust economic activity would be a surprise

Firmer domestic demand growth in emerging economies is also possible. Asia's vast current account surplus (mostly in China) provides ample scope for stronger domestic activity in the region which could, in theory, be re-channelled into the

world economy via an increase in import demand offsetting the drag emanating from the US.

A more positive global growth environment would provide more support to corporate profitability than we or the markets now anticipate, possibly even underpinning yet another year of higher profit margins. Global equity markets would almost certainly benefit from positive earnings surprises and valuation support. Stronger growth, however, might also re-ignite inflation fears and would probably reverse expectations for easier monetary policy in the advanced economies. Finally, more robust US growth would provide support for a stronger US dollar, particularly versus European currencies.

Market implications

2) Oil prices: Is 50 the new 20?

With oil prices having nearly reached \$100 a barrel in 2007, and a strong market conviction that some combination of a US soft landing and Chinese and emerging energy demand will keep prices close to or above this level, the 2008 surprise may be that oil prices surprise on the downside. Until the end of 2003, West Texas oil averaged about \$20 a barrel, rarely straying too far away for very long. We don't dispute expensive energy. It's quite evident that demand for non-OPEC oil is rising far faster than production can increase, that even OPEC oil production is close to maximum capacity, and that therefore OPEC's role in the determination of prices is becoming increasingly important. The world of 'Peak Oil' may be close, even if we haven't already arrived at the summit. Of the 2.5m bpd expected rise in global oil production in 2008, 60% is expected to come from OPEC. But realising the 2.5m bpd rise is considered a bit of a stretch.

Geopolitics and Middle Eastern politics aside, the big risk on oil prices is that despite China's demand for energy, the slowdown in US and OECD economic growth will be sufficient to cause global oil demand to stabilise at around 85-86 million bpd or even slip, while some production expansion takes place. Clearly, the sharper and more protracted the economic slowdown in the OECD, the greater the adverse impact on oil prices. It is conceivable, therefore, that oil prices, far from continuing to rise inexorably in a straight line, will be under some downward pressure in 2008, and perhaps to a new short-term 'equilibrium' level of around \$50-60 a barrel. Clearly, in the event of a US recession and a harder economic landing in other OECD countries, the knock-on effects on emerging markets and consequently on energy demand would be more pronounced and might possibly cause a spike down to even lower levels. A steady decline of the US dollar might act to sustain US dollar oil prices to some degree, regardless of volume changes on the demand side. But equally, we should be alert to the chances of a change in pricing structure – it is said that one or two OPEC countries are already accepting payment in currencies other than the US dollar.

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Slower global oil demand could cause oil prices to fall sharply

WTI oil price



Source: Haver

3) The dollar appreciates

In recent years we, along with the majority of economic and currency scribes, have been forecasting further US dollar depreciation. And for good reason. An outsized US current account deficit, less favourable interest differentials between the US and other major economies, along with poor price-related valuation fundamentals (e.g. PPP estimates) have provided fertile ground for dollar bears.

In the near-term, we suspect that the dollar will remain vulnerable to continued downward pressure, particularly against the euro. Sluggish US growth along with our forecast for aggressive easing from the Fed (we look for a further 75bps of Fed easing by mid-year with risks tilted toward more easing, not less) provides the principal justification for further dollar depreciation risk. Beyond the middle of next year, however, we think there is scope for a dollar recovery, as the impact of slower US growth takes its toll on other major economies (and most notably Europe), prompting other central banks including the ECB to follow the Fed's lead and cut interest rates. By mid-2008, for example, we forecast the ECB will trim rates 25 basis points with a further 25bps of easing probable in Q3.

The surprise would be an earlier and more pronounced dollar reversal. How might that happen? Well, forward-looking indicators of European activity have been heading south in recent weeks in some cases at a fairly alarming rate (e.g., Germany's ZEW index). Dollar bulls are also right to note that the US trade and current account deficits are now shrinking, a trend likely to continue throughout 2008. On our forecasts, for example, the US current account deficit will narrow from its cyclical peak near 6.5% of GDP in 2006 to below 4.6% of GDP in 2008.

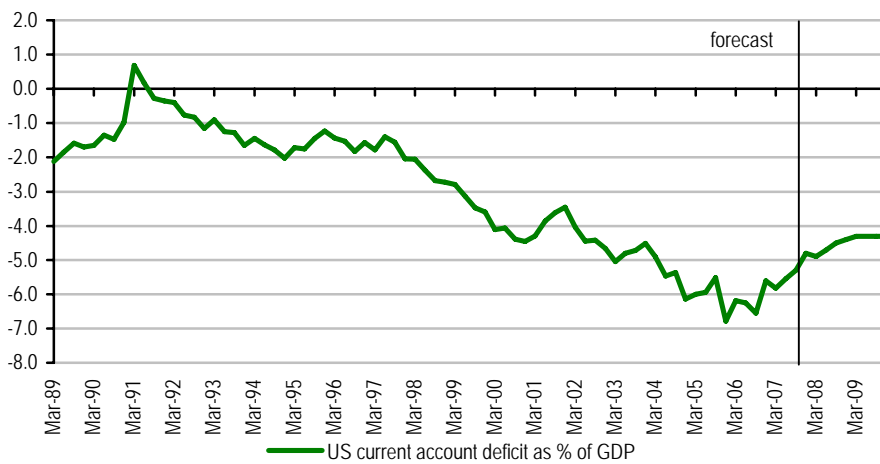
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Dollar still vulnerable in the near-term

But an early and pronounced reversal in the dollar is possible

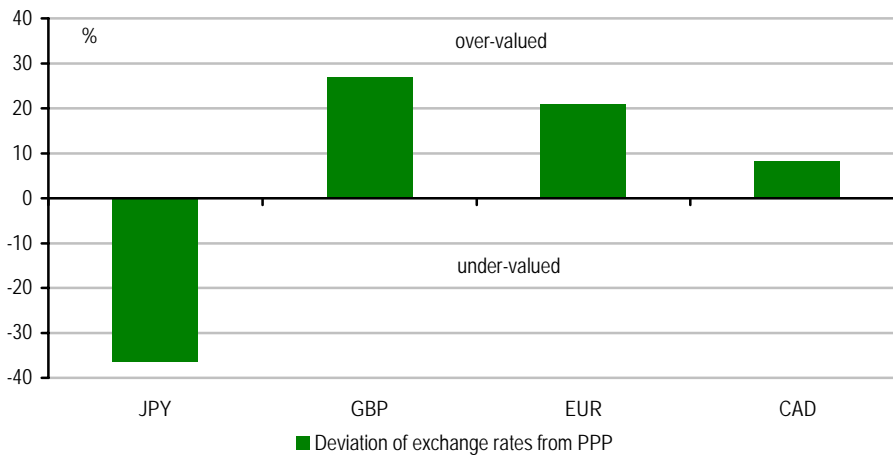
US current account deficit



Source: Haver/UBS

Finally price-related valuation metrics, such as purchasing power parity estimates, suggest the US dollar is now significantly under-valued against sterling, the euro and the Canadian dollar. To the extent that foreign investors view US dollar assets as cheap, a wave of overseas acquisitions could reverse the dollar’s fortunes. To be sure, valuation support is less compelling versus Asian currencies, where most remain under-valued relative to the US dollar.

Bilateral US dollar deviations from purchasing power parity, in %



Source: UBS

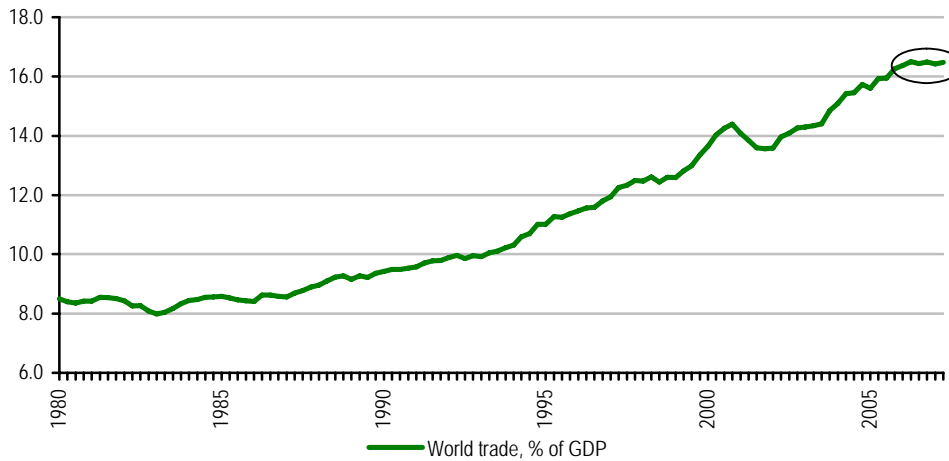
4) World trade clouds

January 2008 represents the 60th anniversary of the world’s multilateral trading system, institutionalized in the form of the World Trade Organization. With some trepidation, there is also some risk that it may also mark something of a turning point in the world trade cycle for two reasons—cyclical and institutional-political. The West’s banking and real estate crises are expected to lead to a significant slowdown in OECD economic growth, especially as regards

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consumer spending. Thus, the 10% growth in real world exports in 2007, following an average annual 6% growth in the prior ten years, is likely to slow significantly. The knock-on effects for emerging markets may prove challenging, depending on the degree of openness, but there will also be secondary effects as even large economies like China cut back their imports from suppliers.

World trade share of GDP



Source: OEF/UBS

The politics of trade, moreover, are likely to become more fractious. The six year old Doha Round of trade negotiations lingers on only because no one wants to be seen to be the assassin. No progress is being made on reciprocity, the lynchpin of the system, because emerging markets don't want to cut manufacturing tariffs, advanced economies don't want to make meaningful cuts in agricultural subsidies, and the private sector in industrial economies is no longer enthusiastic about multilateralism because it can realize market access goals through bilateral deals that governments are keen to conclude. Moreover, against a background of growing Western angst about globalization, inequality and a cyclical slowdown, the pressures on politicians to restrict the freer flow of goods, labor or capital might well prove irresistible.

Politics of trade are becoming more fractious

US presidential candidate, Hilary Clinton told the *Financial Times* in December 2007 that if she were elected president, she would "take stock" of U.S. trade policy and of whether the so-called Doha round of world trade negotiations is still needed or best serves the interests of American workers. This was on top of saying that she would oppose renewing President Bush's fast-track authority while he remains in office.

Similar trade restraint sentiment is in evidence in European capitals, especially aimed at China. And the new protectionism that is quite likely to gather momentum is that targeted at Sovereign Wealth Funds and state-owned companies in emerging nations—both looking to acquire real assets in Western economies instead of depreciating monetary assets.

5) Developed deflation, developing inflation

2008 is expected to see developing economies growing at around their trend rates of growth, while the OECD economies are forecast to slip below trend. This raises the risk of significant inflation divergence. Indeed, it is possible that we will see upside inflation surprises in emerging markets against deflation surprises in developed economies.

For emerging markets, the risk of higher CPI inflation comes from supply shocks in the context of trend-like demand. Emerging markets are vulnerable to supply shocks in commodities. Food and energy account for over 40% of the Chinese CPI basket, and roughly 35% of the Brazilian basket. Increases in commodity prices therefore have a direct, visible and potentially significant impact on consumer inflation. Because the emerging market economies also tend to be commodity intensive in production and consumption, commodity demand and prices may be supported by the resilience of their economies. Further supply-induced price jumps could therefore feed into higher commodity prices and accelerating CPI inflation in the emerging complex.

For the OECD economies, the situation is significantly different. Commodities are far less important to overall CPI. Food and energy weights comprise around 17% of Anglo-Saxon economies' CPI, and a little over 25% for the Euro area. Moreover, food inflation in advanced economies bears little relation to commodity prices—labour costs are a significant chunk of OECD retail food prices, given the extensive processing and distribution chain involved.

Labour, indeed, comprises around 70% of OECD inflation. In an environment where OECD growth is below trend, wage bargaining will be compromised. And, already, domestic-determined price pressures are ebbing. US core inflation excluding housing costs fell to 1.8% y/y in October. The US corporate deflator turned negative in Q3 for the first time in over 50 years (see chart below). The UK BRC shop price index, measuring inflation for consumer goods, was a mere 1.1% y/y in November and excluding food is already in deflation territory at -0.4% y/y. European inflation excluding food, energy and tobacco was just 1.9% in October. And in Japan core CPI is still firmly deflationary (-0.3% y/y in October, marking nearly a decade of deflation).

In other words, deflation is a distinct possibility for important parts of the developed world. Nor is it a great leap of faith to suggest that domestic deflation forces will dominate commodity price developments in the advanced economies, suggesting that the OECD will experience CPI dis-inflation in 2008, with some sub-components of price indices registering outright declines.

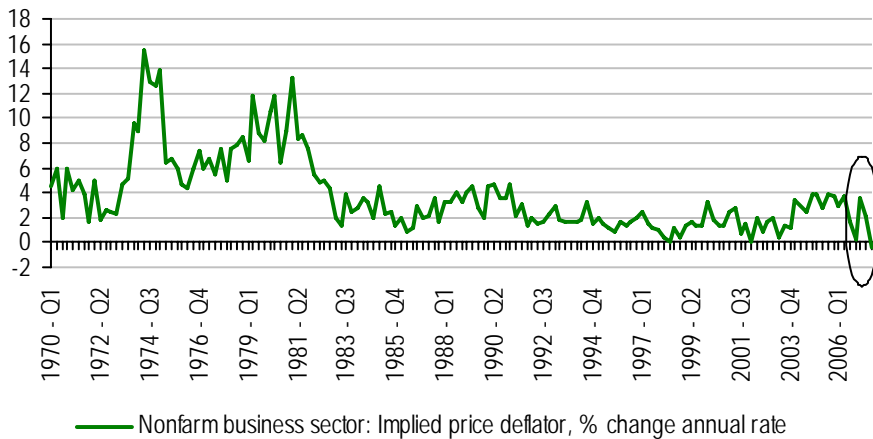
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Emerging economies face risk of higher inflation

OECD economies face risk of lower inflation and in some cases deflation

US business sector deflator



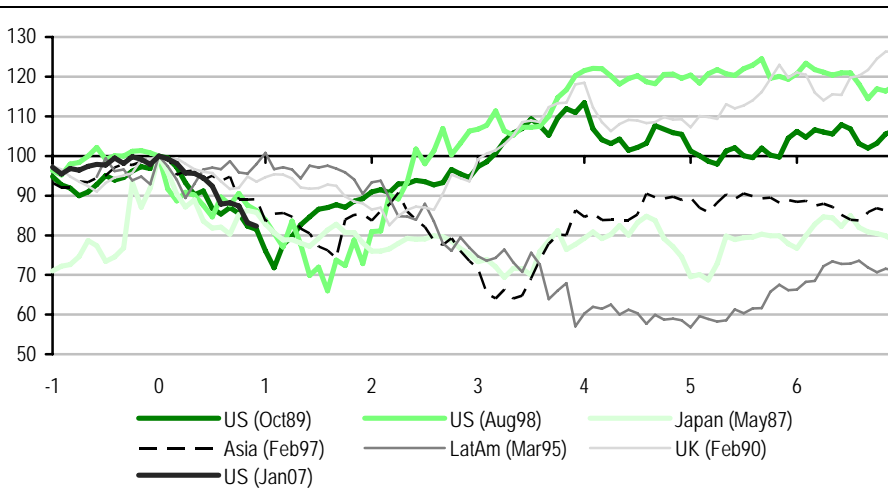
Source: UBS/Haver

6) Financials outperform

Within Global Equity Strategy, we recently cut our position on Financials to neutral. Valuations remain extremely cheap on almost any measure, but this is unlikely to matter much so long as uncertainties persist over asset values, write-downs and the future level of balance sheet gearing, let alone near-term earnings. So what’s the risk that financials bounce back in 2008? It could happen, but that would also require the sub-prime affair to be among recent history’s briefer and less toxic episodes of financial retrenchment.

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Chart 1: Local Financials relative to Local Market (rebased to peak=100 at year 0)



Source: UBS, Thomason Datastream

In practical terms, a sustainable market recovery for the financial services sector will require a re-rating, which in turn depends on a lessening of uncertainty and associated risk premia. That, in turn, probably requires clarity on the following tests. First, that the sub-prime issue is a contained phenomenon and not just the tipping point of much wider credit woes in the household and corporate sectors. Second, hard-landing risks—above all in the US—would need to recede. Third,

Many tests need to be passed for financials to out-perform

illiquid inter-bank lending conditions would need to abate, if not normalise. Finally, delinquencies would need to slow sufficiently to foster expectations that loss provisioning has been adequate or even excessive, potentially creating the prospect for eventual write-backs. In short, for financials to surprise on the upside in 2008, the adverse news drivers of prevailing sentiment would have to reverse.

7) Emerging equity markets under-perform

With global emerging markets having delivered compound 35% annual returns over the last five years with an ever-higher market beta, it may not be difficult to envisage disappointing returns in 2008, particularly if a US 'hard landing' is not avoided.

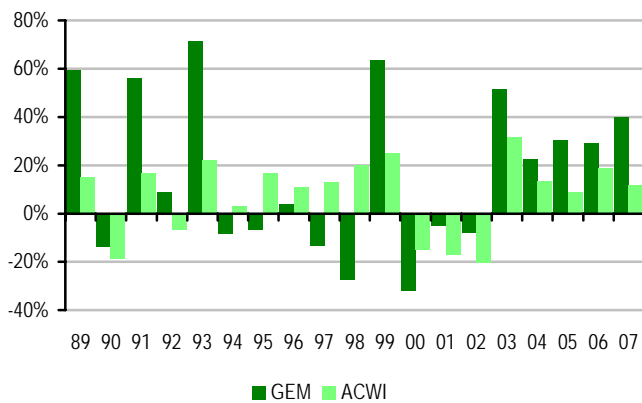
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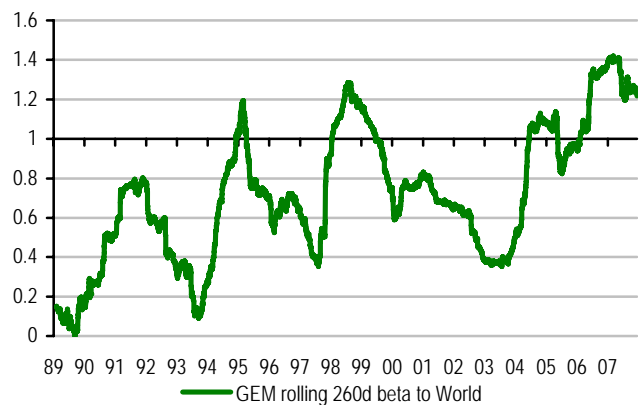
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EM vs. World annual price performance



Source: UBS, MSCI

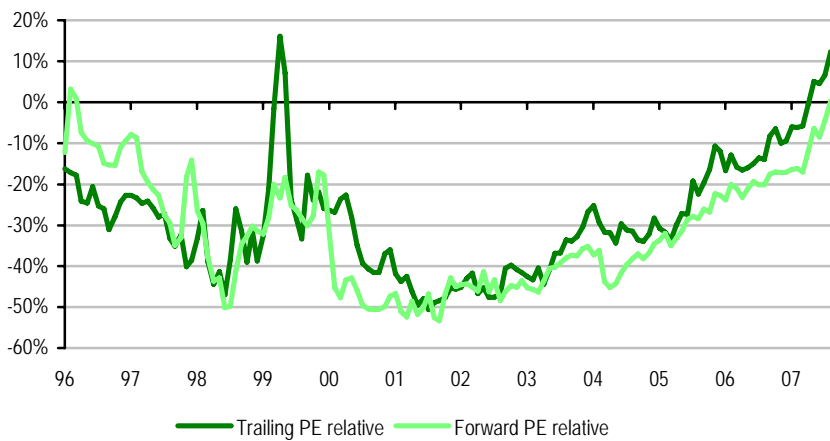
Emerging markets beta to World



Source: UBS, MSCI

However, this is not the whole story. Rather more interesting is the prospect of a soft landing where GEM nevertheless underperforms. Such a scenario is not impossible. With GEM already trading at a premium to global valuations on a trailing earnings' basis (at parity on forward consensus earnings estimates), and at similar levels of RoE, out-performance from here depends on sustained faster earnings growth, positive earnings surprises, and similar volatility to peer markets.

Emerging Market PE relative to World

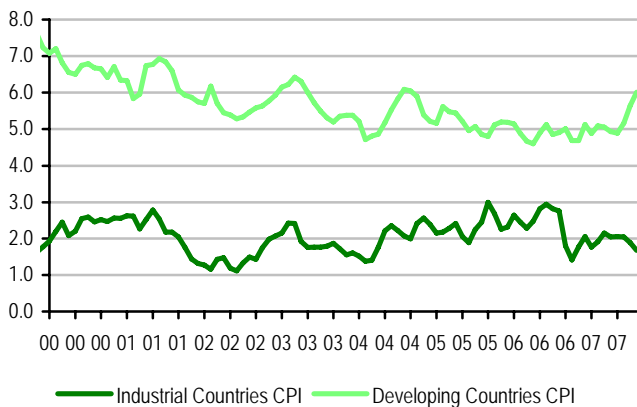


Source: UBS, MSCI, I/B/E/S

Investors should not take these assumptions for granted: there are grounds for concern. Why? For one, inflation in many emerging markets is beginning to turn higher. While monetary tightening should contain inflation pressures in most emerging economies, wage demand pressures could nevertheless pose risks to profit margins and earnings growth. Second, sector biases continue to suggest earnings risk should commodity price momentum moderate. After all, energy, materials and industrials have made strong contributions to the out-performance of emerging equity markets in recent years. Finally, emerging economy “coupling” to China is significant and rather less well-flagged than to the US, highlighting earnings risks in any scenario where Chinese growth slows.

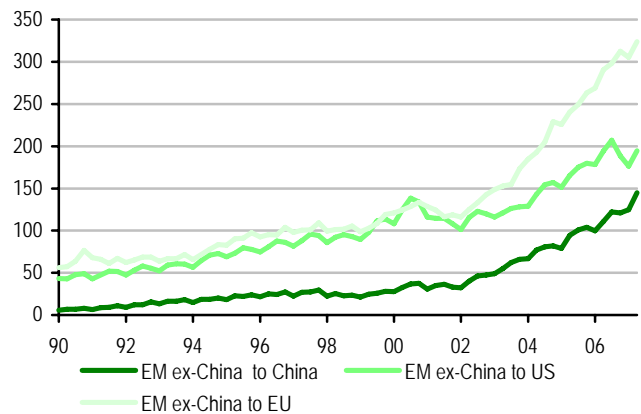
Grounds for concern over GEM include inflation risk, commodity prices and Chinese exposure

Industrial versus Developing Country CPI



Source: IMF, Haver

Non-China EM exports to China (quarterly \$bn)



Source: IMF

8) Japanese equities outperform

Our next surprise candidate for 2008 is the possibility that Japanese investors take a liking to their domestic equity market. The associated re-orientation of Japanese savings and capital flows could have potentially significant impacts on relative regional equity market performance and might also usher in an important shift in currency markets, transferring the locus of dollar weakness from Europe to Asia.

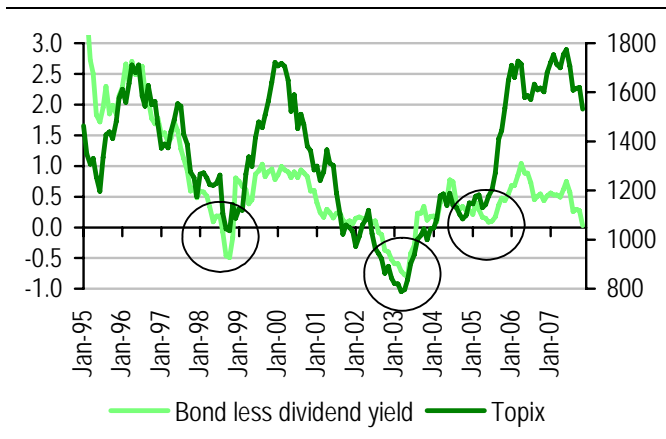
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Why might Japanese investors be attracted to their domestic equity market?

One reason is relative returns. The lacklustre performance of the Japanese equity market over the past two years has compressed valuations to peer equity markets. Also, following the recent strength of global government bond markets, ten-year JGB yields have fallen to levels roughly equal to the dividend yield on the Topix market. As the accompanying chart shows, when Japanese bond and dividend yields converged in 1999, 2003 and 2005, the Japanese equity market rebounded. Importantly, despite the fall in bond yields and associated growth concerns, Japanese dividends remain well-supported by strong corporate earnings.

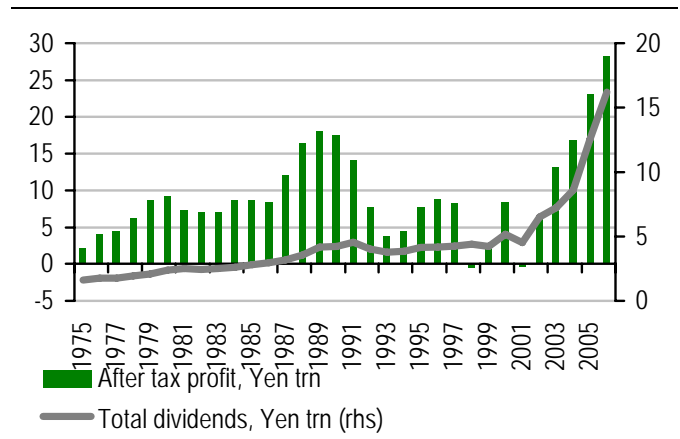
Japanese investors have many reasons to be attracted to their domestic equity market

Chart 2: Japanese bond-dividend yield and share prices



Source: Haver, UBS Note: 10-year JGB yield less average TSE dividend yield

Chart 3: Japanese profits and dividends



Source: MoF, UBS Note: Net profits and total dividends, non-financial corporations

Ironically, risk considerations might also be a source of support for Japanese equities. In recent years, Japanese households have invested heavily in foreign notes and bonds, largely un-hedged against currency risk, in search of higher yields. But as interest rates have begun to fall in the US, UK and Europe, and as the gloss has come off credit fixed income returns, global fixed income options have shrunk. Moreover, a stronger yen has eaten away at un-hedged foreign bond returns. Accordingly, Japanese households may decide to allocate their risk budget elsewhere. Global equities are one possibility, but with Japan's market trading on more reasonable multiples and on favourable terms relative to domestic bonds, it is conceivable that domestic equities may finally take a bigger share of the Japanese household risk budget.

Risk considerations might act as a source of support

If so, the shift would likely boost the relative performance of the Japanese stock market relative to its global peers. But equally, a slowing of Japanese capital outflows would lift the yen in the world's foreign exchange market.

Finally, what might be the catalyst for a re-orientation of Japanese capital flows? One candidate would be a pick up in corporate activity, including mergers & acquisitions, share buybacks, or hikes in dividend payout ratios. Steps in that direction would signal a friendlier shareholder environment with the prospect of higher (true) dividends. The trouble, of course, is that Japan's track record on corporate reform provides few grounds, as yet, for optimism.

9) Equity volatility settles at lower levels

Implied equity volatility in the US—and elsewhere—has risen significantly since the lows registered at the start of 2007, with the VIX trading between 20-30% today, up from around 10% at the beginning of the year. Against a backdrop of credit stress, liquidity constraints, heightened uncertainty and opaque financials exposure to defaults, the rise in equity volatility is hardly surprising. Indeed, if the credit and liquidity crises persist, equity volatility will remain elevated and could even push higher.

Hence, a fall in equity volatility next year would come as a surprise. Yet it is not impossible. While the VIX is unlikely to revisit the lows of this cycle anytime soon, some (anti-consensus) decline in market volatility could occur if overall investor sentiment stabilizes. Even if improved confidence results in higher market P/Es, corporate re-leveraging would arguably take longer to manifest itself, given still-reasonable earnings and liquid balance sheets, as well as residual credit restraint. Falling risk premiums could, therefore, lead to a decoupling of implied volatility from its empirical link to valuations.

10) Chinese inflation falls sharply

A major surprise for China is that headline CPI inflation, which shot up from 2.5% y/y to nearly 7% y/y over the past few quarters, should broadly dissipate by the middle of 2008. Observers on the street are increasingly convinced that China now faces a burgeoning, onerous inflationary problem, driven by rising wage and energy costs from the supply side and fuelled by aggressive liquidity growth as well. However, to date we see no evidence that price pressures have broadened beyond a few temporary food supply shocks (i.e., meat and eggs), and the actual gap between domestic and global energy prices is smaller than commonly believed. Broad money growth is indeed very strong, but sterilization policies have kept lending growth from following at the same pace, i.e., the monetary transmission mechanism is not fully functioning.

A second surprise, which follows from our inflation call, is that the PBC's recent and highly-publicized shift to monetary tightening should be short-lived, petering out in the middle of next year once credit growth falls below 15% y/y and headline CPI inflation is back around 3%. Again, many investors are worried that we are now facing a repeat of 2004, in which draconian central tightening measures brought credit to a near halt and sent construction and infrastructure spending spiralling slower. However, by our count total domestic expenditure contributed nearly 12 percentage points to real GDP growth in 2002-03, with a sharp rise in the investment share of the economy and domestic lending of 26% y/y. By contrast, over the past year the domestic contribution has slowed to less than 9 percentage points, credit growth is only 17% y/y and the investment/GDP ratio has been falling for three years. In this environment, with inflation fears fading next year, we see no reason for the government to try for a repeat of the 2004 experience.

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Falling equity volatility would come as a surprise

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The consensus could be surprised by how quickly China's inflation falls and how short-lived the recent shift to monetary tightening becomes

Re-capping last year's surprises

Below, we reprint our list of 'surprises' from last year and contrast our conjecture to actual outcomes. Credit and liquidity crises appear to have trumped most of our surprise scenarios, underscoring the importance of 'tail risk'.

- **Upside global growth surprises, leading to more monetary restraint:** Global growth was, indeed, robust at the start of the year, but began to lose momentum around mid-2007, exacerbated thereafter by tighter credit conditions owing to market turmoil. The Fed eased rates by 100bps in 2007, and while other major central banks remained hawkish for most of the year, the tenor of global policy rhetoric clearly started to change as 2007 drew to a close.

Did it happen? No.
- **Equities rise more than 20%, spurred by significant multiple expansion:** P/E multiples did expand, especially for emerging markets. However, heightened uncertainty surrounding financial losses and the associated risks to growth capped global share price gains at around 5-10% in 2007.

Did it happen? No.
- **Volatility remains near all-time lows across major asset classes:** Implied equity volatility moved sharply higher in February and again in H2 2007. Similarly, volatility across most other asset classes rose as investor sentiment deteriorated in the second half of 2007.

Did it happen? No.
- **The dollar rises:** In 2007 the dollar depreciated more than 10% against the euro, which hit record highs. Against the yen, the dollar fell about 5%.

Did it happen? No.
- **Credit spreads tighten:** Investment grade and high-yield credit spreads widened as sub-prime default concerns spread across the credit universe.

Did it happen? No.
- **Profit margins expand (again):** According to our Global Profit Picture data, profit margins contracted slightly in the US, but rose almost everywhere else, pushing global margins up from 9.3% in 2006 to 9.4% this year.

Did it happen? Yes.
- **Policy error:** Throughout much of the year, most central banks guarded against inflation risk. However, the Fed responded to financial and economic risk in the second half of 2007 by cutting rates 100 basis points. Central banks initially responded in un-coordinated fashion to the liquidity crises, with at least one notable failure: the first UK bank run since the 19th century. Whether recent coordinated efforts to improve market liquidity will work remains unknown. Equally, whether central banks will misjudge cyclical risk in this environment will only be revealed in 2008, if even then.

Did it happen? Too early to tell

UBS Global Economics: Overview

Global growth

- **Slower growth:** We expect global growth to slow to a 4.3% pace in 2008, about half a point slower than this year's projected rate of 4.8%. While developed economies are most at risk, a synchronised slowdown is expected to unfold with no genuine decoupling between the US and emerging economies.
- **Downside risks:** The slump in the US housing market, high oil prices, and further instability in financial markets are our chief concerns. Our model estimates currently suggest a 30% chance of a US recession next year.
- **Trend growth in 2009:** Global growth is expected to slow to 4.1% in 2009, roughly in line with the world economy's underlying trend

Inflation

- **Food and energy:** Measured rates of headline inflation are likely to move higher in the near-term given the significant weights attached to food and energy prices in CPI baskets. In selected emerging economies the reduction of energy subsidies is also likely to lift headline rates of inflation.
- **Underlying inflation:** If US growth remains below trend and global growth decelerates toward trend, underlying inflation risk ought to recede. The world economy – on our estimates – is still operating with a modicum of spare capacity in many sectors and unit labour cost inflation is still relatively benign.

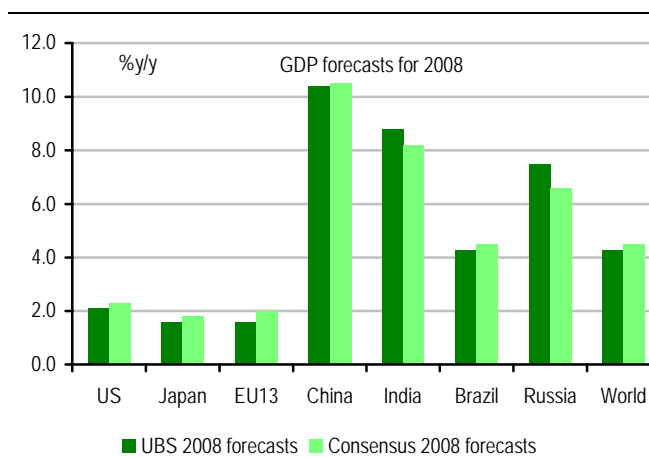
Monetary policy and interest rates

- **The Fed:** We expect the Fed to deliver a further 75bps of easing by the middle of 2008 taking the Fed funds rate down to 3.5%. The chief risk is for weaker-than-expected macroeconomic outcomes in H1 2008, prompting the Fed to ease even more aggressively than we now forecast.
- **The ECB:** The ECB is expected to ease monetary policy by 50bps next year with 25bps pencilled in to our forecast for Q2 and another 25bps for Q3. However, high current levels of headline inflation are likely to keep the ECB cautious in the near-term despite the likely growing threats to economic activity in the region.
- **The BoE:** We expect the MPC to deliver another 100bps of easing in 2008 taking Bank rate down to 4.5%. UK growth risks are skewed to the downside.
- **The BoJ:** We expect the BoJ to resume its campaign of monetary policy normalisation in July of next year, lifting the call rate by 25bps. Thereafter we expect a further hike of 25bps in mid-2009 taking the call rate to 1%.

Exchange rates

- **Euro:** In the near-term we think the dollar will remain vulnerable to some deterioration in fixed income returns and more aggressive Fed easing. We therefore forecast EUR 1.50 by mid-2008. Thereafter the dollar should find support as short-term interest differentials between the US and Europe narrow as the ECB eases monetary policy. The dollar also ought to be supported on valuation grounds. We forecast EUR 1.35 at end-2008.
- **Yen:** Given its still fragile economy and presence of deflation Japan cannot match Europe or the US on interest rates and we suspect that the yen will struggle to make much further headway in the near-term. We forecast JPY 110 at end-2008.

UBS GDP forecasts for 2008 versus consensus



Source: Consensus Economics/UBS estimates

Regional assessment

- **US:** GDP is on track for annualised growth of just 1.2% in Q4 2007 and only 1.4% in H1 2008. Thereafter, the lagged effects of Fed easing are expected to stabilise the housing market and provide some boost to the economy, allowing growth to recover to a 2.3% average rate in H2 2008—still below trend.
- **Eurozone:** Growth in the Euro area already appears to be slowing and we expect further deceleration over the coming quarters. Specifically, we anticipate growth of just 1.6% in 2008 after 2.6% in 2007.
- **China:** China's growth in recent years has been propelled by strong capex and a sharply expanding trade surplus. Both of these drivers are expected to decelerate, exerting some drag on activity over the year ahead.
- **Japan:** Japan's economy is expected to weather the global slowdown relatively well. We look for growth of 1.6% in 2008 after 1.9% in 2007.

Global Asset Allocation: Overview

Allocations

- **Equities: Overweight.** Investors continue to grapple with earnings uncertainty in financials, still-challenged credit conditions, as well as signs of macroeconomic deterioration in the US. Equity volatility is likely to remain high. Still, valuations are undemanding, and earnings resilience in Asia and the 'global growers' in the US offers opportunity.
- **Government bonds: Overweight.** Weaker growth, subdued underlying inflation, and monetary easing offer fundamental support for government bonds, particularly in non-US dollar markets.

Equities

- **Valuations.** At about 13.5x forward earnings, the global P/E is not demanding and can withstand some earnings downgrades.
- **Earnings growth.** S&P500 earnings growth has decelerated, dragged lower by financials. Non-financials and especially 'global growers' remain better positioned.
- **Corporate health.** Most non-financial companies remain flush with cash, which should support necessary expenditures in capital equipment and, eventually, a resumption of share buybacks and M&A, provided access to credit recovers.
- **Regional tilts.** We believe the strong relative out-performance of Europe vs. the US is over, as European growth slows. We prefer US large-cap companies exposed to global growth trends. Emerging market equities have come off their recent highs and benefit from earnings resilience.

Fixed income

- **The Fed.** The Fed will ease rates another 75bps by mid-2008 in response to weak growth and moderating inflation.
- **Wider credit spreads.** Stress in the mortgage market has impacted sentiment in corporate bonds. Wider spreads over time are likely, reflecting warranted concerns about slower growth and re-leveraging. Investment grade is attractive relative to high yield.

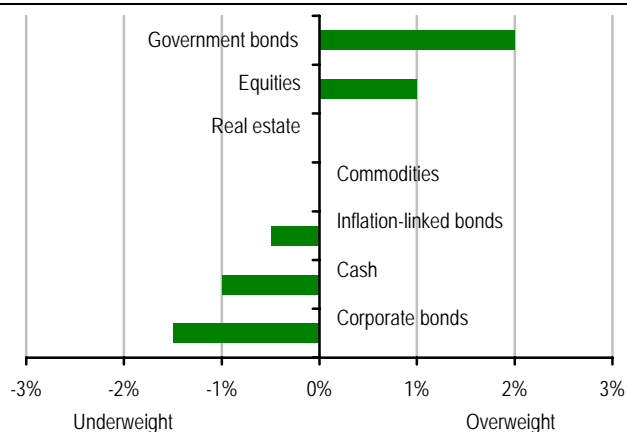
Other assets

- **Commodities. Neutral.** Peaking global growth is likely to introduce some cyclical weakness in commodity prices, including energy. The long-term outlook for soft commodities remains favorable. Financial market uncertainties and dollar weakness provide support for high gold prices.
- **Real Estate.** Market uncertainties and concerns about access to credit may weigh on real estate returns. Structural interest in the asset class remains strong. Asia is the preferred region on strong growth fundamentals.

Risks to the view

- **Credit spillover:** Ongoing contagion from the sub-prime credit malaise to the wider credit and risk markets, or a wholesale tightening of lending standards, continue to pose the main risks to financial markets and asset returns. High oil prices are another concern. Global growth may also slow more than expected.

Recommended global asset allocation portfolio



Source: UBS

Fundamental assessment: US

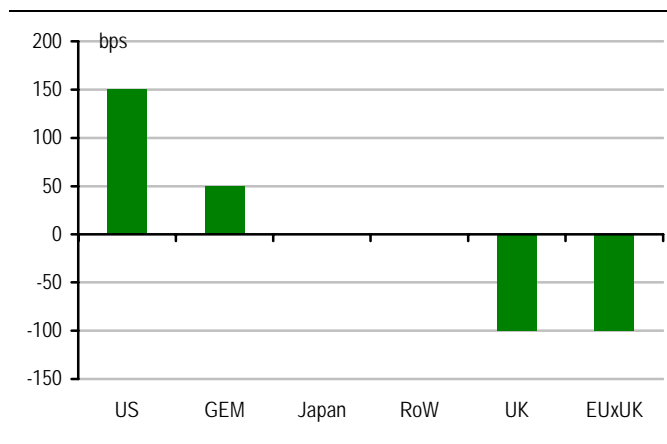
- **Growth & Fed.** US growth was challenged even before the recent market tumult, as excess housing inventories put downward pressure on prices and activity in the sector. The Fed will need to respond with further easing.
- **Capital.** Business investment spending has been comparatively weak in the US, despite high capacity utilization and strong profits. Investment spending—along with net exports—will be required to cushion the US economy from housing- and consumption-related weakness.

Fundamental assessment: Rest of world

- **Europe.** Corporate restructuring supports profitability in Europe, but economic activity will slow. The ECB will keep policy rates on hold this year, but will ease in 2008.
- **China.** Concerns about Chinese overheating are overdone. Elevated inflation is confined to food prices. Pressure on China to allow a more rapid RMB appreciation is likely to escalate in 2008.
- **Japan.** Japan's growth has mildly disappointed and a BoJ rate hike is postponed until mid-2008. Soft domestic demand and the absence of corporate restructuring are negatives for a market which is otherwise becoming more attractive on a valuation basis.

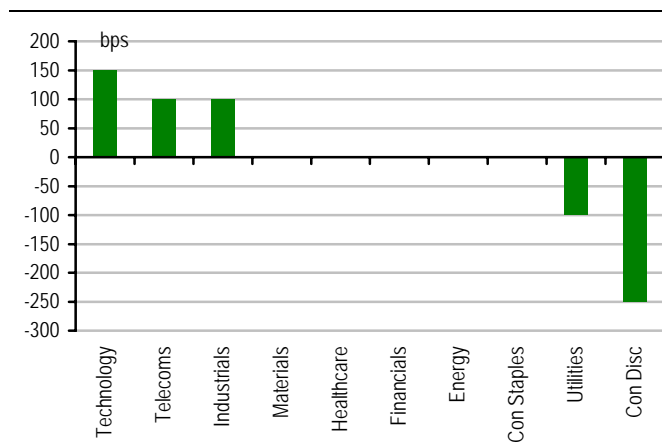
Global Equity Strategy Overview

Regional Equity Tilts



Source: UBS

Global Sector Tilts



Source: UBS

Investment Themes

- **Downward revision risk to earnings.** Our top down earnings estimates suggest mid single digit growth next year. But, with bottom-up estimates well in to double digits, we think downgrades are likely. So long as earnings growth remains positive, equity markets should be supported.
- **Multiple expansion as the driver of returns.** With slowing earnings growth in 2008, multiple expansion will have to take over as the driver of returns. Valuations remain undemanding and have room to expand.
- **Reduce cyclical exposure.** With slowing global growth and the most cyclically exposed sectors looking at risk, we favour a less 'pure' pro-cyclical equity allocation.

Sectors

- **Overweight Technology, Telcos and Industrials.** We maintain our belief that business spending should hold up better in a slowing growth environment than consumer spending, since corporations have healthier balance sheets than households.
- **Cutting Financials to Neutral.** Cheap valuations for most banks, alone, are likely to be insufficient to draw investors back to the sector. Until we get better visibility on earnings, the risk-reward trade-off for investors remains unattractive and material re-rating higher is unlikely

- **Raising Consumer Staples to neutral.** These companies offer more stable and defensive earnings profiles with modest but reasonable growth increases.

Regions

- **A preference for the US over Europe.** European equities have more headwinds to overcome in 2008 including slowing GDP growth, larger earnings downgrades and a strong Euro eroding competitiveness.
- **Closing our underweight to Japan.** On many metrics Japan looks to offer value. Investor sentiment remains cautious however waiting for a catalyst for improved performance.
- **Maintain a moderate overweight to GEM.** While external sectors are likely at risk from slowing global demand, domestic industries are better protected, and more highly leveraged to growth and increasing wealth of emerging consumers.

Styles

- **Large Cap, Growth.** We maintain a preference for both large over small caps and growth over value. Valuations, fundamentals, and the desire to differentiate growth prospects favor these markets.

Risks to the view

- **A 'Hard' landing.** If the US slips into recession, we believe growth globally will be impacted and earnings will struggle to remain positive.

Economic forecasts

Table 1: GDP growth

%/y	Weight*	2006	2007F	2008F	2009F
US	0.22	2.9	2.2	2.1	2.5
Canada	0.02	2.8	2.6	2.0	2.5
Japan	0.07	2.4	1.9	1.6	1.8
Western Europe	0.21	2.9	2.6	1.8	1.9
of which:					
EU "13"	0.16	2.9	2.6	1.6	1.7
UK	0.03	2.8	3.1	1.8	2.0
Switzerland	0.01	3.2	2.7	1.6	1.8
Asia **	0.30	8.7	8.8	8.5	8.1
of which:					
China	0.15	10.7	10.9	10.4	9.5
India	0.06	9.4	8.4	8.8	8.8
Latin America	0.07	5.3	5.3	4.4	4.0
of which:					
Brazil	0.03	3.7	5.3	4.3	4.0
Eastern Europe	0.07	6.2	6.4	5.8	5.3
of which:					
Russia	0.03	7.0	7.5	7.5	7.0
Rest of world	0.04	7.3	6.8	6.4	5.6
Advanced economies	0.57	3.0	2.5	2.1	2.3
Developing economies	0.43	8.0	8.0	7.1	6.4
WORLD	1.00	5.1	4.9	4.3	4.1

Source: UBS calculations and estimates

* Based on purchasing-power-parity-adjusted GDP levels;

** includes Australia and New Zealand.

Table 2: Inflation

%/y	Weight*	2006	2007F	2008F	2009F
US	0.22	3.2	2.9	2.5	1.7
Canada	0.02	2.0	2.1	1.7	1.8
Japan	0.07	0.3	0.0	0.7	0.9
Western Europe	0.21	2.2	1.9	2.1	2.1
of which:					
EU "13"	0.16	2.2	2.1	2.5	1.9
UK	0.03	2.3	2.3	2.2	1.9
Switzerland	0.01	1.1	0.7	1.3	1.2
Asia **	0.30	3.6	4.1	3.8	3.9
of which:					
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India	0.06	6.8	4.8	5.0	5.0
Latin America	0.07	4.8	5.3	5.3	5.5
of which:					
Brazil	0.03	3.1	4.3	4.2	4.5
Eastern Europe	0.07	7.0	8.0	7.7	6.0
of which:					
Russia	0.03	9.0	10.5	10.0	8.0

Source: UBS calculations and estimates

* Based on purchasing-power-parity-adjusted GDP levels;

** includes Australia and New Zealand.

Table 3: Interest rate forecasts

%	14-Dec-07	Jun-08	Dec-08	Dec-09
US				
Fed Funds Rate	4.5	3.5	3.5	3.5
10 year yield	4.2	4.1	4.3	4.6
Canada				
Bank of Canada Rate	4.5	4.0	4.0	4.0
10 year yield	4.1	4.3	4.5	4.8
Japan				
Call Rate	0.8	0.5	0.8	1.0
10 year yield	1.6	1.7	1.9	2.1
Germany				
Repo Rate	4.0	3.8	3.5	3.5
10 year yield	4.3	3.9	3.9	4.3
Sweden				
Repo Rate	4.0	4.3	4.0	4.0
10 year yield	4.4	3.9	3.8	4.3
UK				
Repo Rate	5.5	5.0	4.5	4.5
10 year yield	4.9	4.8	4.8	4.9
Switzerland				
3 month rate	2.8	2.5	2.5	2.5
10 year yield	3.1	2.8	3.0	3.0
Australia				
Cash Rate	6.8	6.8	6.8	6.8
10 year yield	6.3	6.1	6.4	6.7
New Zealand				
Cash Rate	8.0	8.0	7.3	7.5
10 year yield	6.4	6.3	6.0	6.3

Source: UBS calculations and estimates

Table 4: Foreign exchange forecasts

	14-Dec-07	Jun-08	Dec-08	Dec-09
EUR/USD	1.46	1.50	1.35	1.30
USD/JPY	112.45	115.00	110.00	105.00
EUR/JPY	164.23	172.50	148.50	136.50
GBP/USD				
GBP/USD	2.04	2.08	1.90	1.91
EUR/GBP	0.72	0.72	0.71	0.68
USD/CHF	1.14	1.10	1.21	1.23
EUR/CHF	1.67	1.65	1.63	1.60
USD/CAD				
USD/CAD	1.02	0.90	1.05	1.10
AUD/USD	0.88	0.94	0.87	0.82
NZD/USD	0.78	0.70	0.66	0.68
EUR/SEK				
EUR/SEK	9.43	9.10	9.20	9.20
EUR/DKK	7.46	7.46	7.46	7.46
EUR/NOK	7.94	7.70	7.80	7.80

Source: UBS calculations and estimates

Asset allocation overview

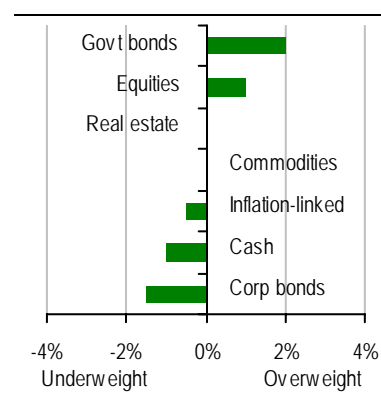
Overview of global asset allocation recommendations

	Benchmark	Current	Previous*	Load (x)	Prev load (x')
Equities					
N. America	27.0%	27.5%	27.5%	1.02	1.02
Japan	4.5%	4.5%	4.0%	1.00	0.89
United Kingdom	5.0%	5.0%	5.0%	1.00	1.00
Europe	9.5%	9.5%	9.5%	1.00	1.00
Asia	3.0%	3.5%	3.0%	1.17	1.00
Rest of world	1.0%	1.0%	1.0%	1.00	1.00
Total equities	50.0%	51.0%	50.0%	1.02	1.00
Government					
United States	7.0%	7.0%	8.25%	1.00	1.18
Europe	9.0%	10.5%	10.25%	1.17	1.14
UK	2.0%	3.5%	3.5%	1.75	1.75
Japan	3.5%	2.0%	2.25%	0.57	0.64
Dollar bloc	1.0%	1.5%	1.0%	1.50	1.00
Total gov't bond	22.5%	24.5%	25.25%	1.09	1.12
Inflation indexed					
United States	1.0%	0.5%	1.0%	0.50	1.00
UK	1.0%	1.0%	1.0%	1.00	1.00
Europe	0.5%	0.5%	0.5%	1.00	1.00
Total infl. indexed	2.5%	2.0%	2.5%	0.80	1.00
Corporate bonds					
US inv. grade	6.0%	5.5%	4.75%	0.92	0.79
US high yield	1.5%	1.0%	1.25%	0.67	0.83
Euro inv. grade	2.0%	1.5%	1.5%	0.75	0.75
Sterling inv. grade	0.5%	0.5%	0.5%	1.00	1.00
Total corp. bonds	10.0%	8.5%	8.0%	0.85	0.80
Commodities					
Energy	1.0%	0.5%	0.5%	0.50	0.50
Industrial metals	1.0%	1.0%	1.0%	1.00	1.00
Precious metals	1.0%	1.0%	1.0%	1.00	1.00
Agriculture	1.0%	1.5%	1.25%	1.50	1.25
Livestock	1.0%	1.0%	1.0%	1.00	1.00
Total commodities	5.0%	5.0%	4.75%	1.00	0.95
Listed real estate					
United States	2.5%	2.25%	2.25%	0.90	0.90
Europe	0.5%	0.5%	0.5%	1.00	1.00
UK	0.5%	0.5%	0.5%	1.00	1.00
Japan	0.5%	0.5%	0.5%	1.00	1.00
Asia	1.0%	1.25%	1.25%	1.25	1.25
Total real estate	5.0%	5.0%	5.0%	1.00	1.00
Cash	5.0%	4.0%	4.5%	0.80	0.90

Source: UBS estimates

Note: Load (x) = current weight / benchmark weight; * current as of 3 December 2007, previous as of 2 November 2007

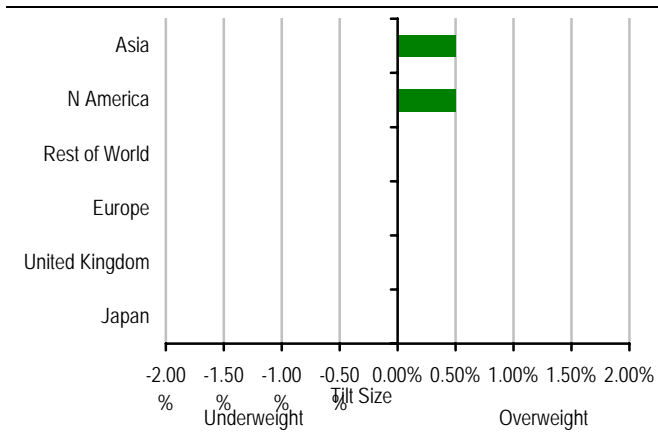
Chart 1: Asset class tilts



Source: UBS

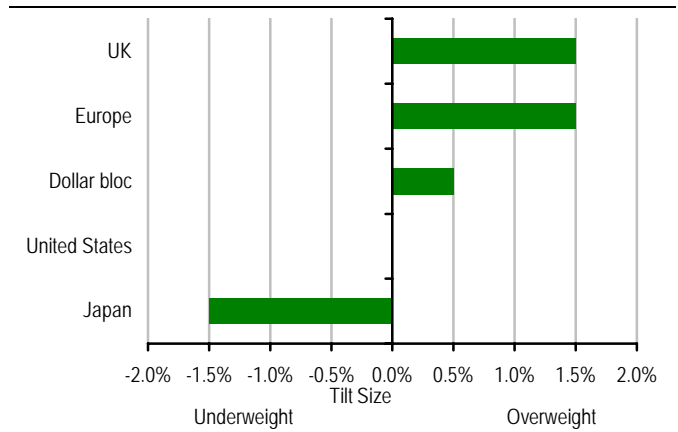
Asset class tilts by region

Equities



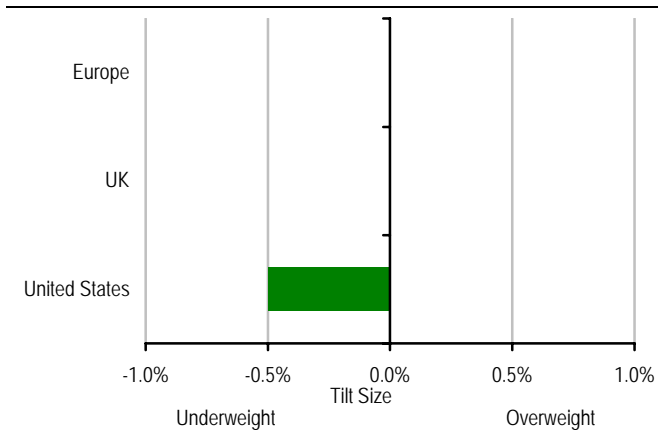
Source: UBS. Note: Calculated as current weight minus benchmark weight

Government bonds



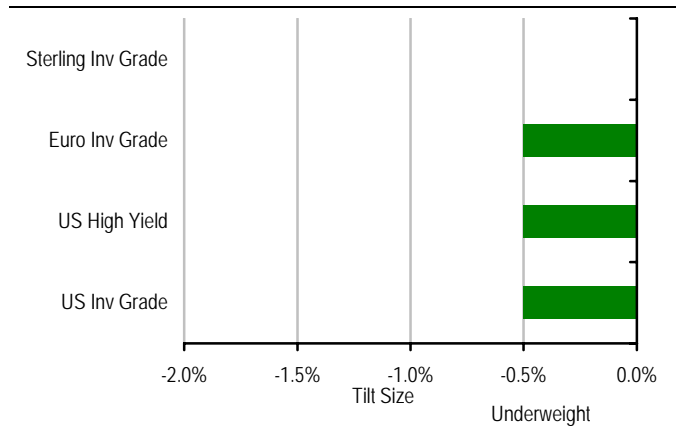
Source: UBS. Note: Calculated as current weight minus benchmark weight

Inflation-indexed bonds



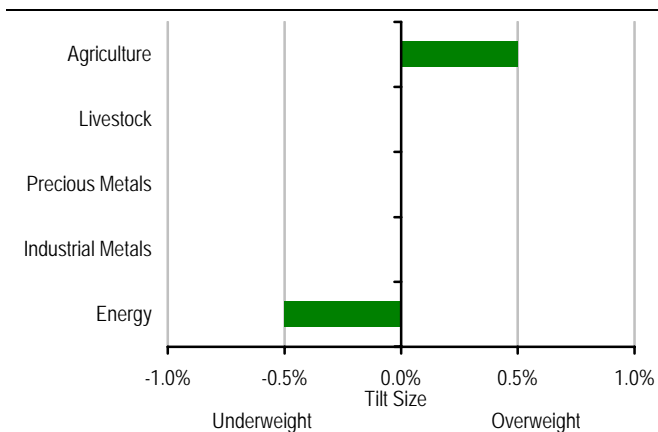
Source: UBS. Note: Calculated as current weight minus benchmark weight

Corporate bonds



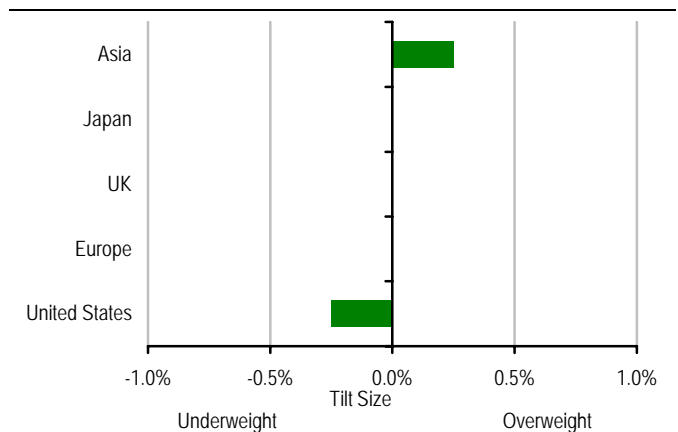
Source: UBS. Note: Calculated as current weight minus benchmark weight

Commodities



Source: UBS. Note: Calculated as current weight minus benchmark weight

Listed real estate



Source: UBS. Note: Calculated as current weight minus benchmark weight

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