

US Economic Outlook

Maury Harris

Chief US Economist

212 713-2472

maury.harris@ubs.com

April 16, 2007

U.S. economic forecasts: What and why?

“Bottom Line” on UBS U.S. Economic Forecasts

- ◆ Slow calendar average 2007 real GDP growth at 2.0% mainly due to housing-related consumer slowdown. Growth improves in late 2007 and 2008 in response to lower interest rate and dollar levels.
- ◆ 5¼% Fed funds peak followed by 2007 easing to 4½%.
Mostly 4¼% to 4¾% 10-yr Treasury yield range after Q1(07).
- ◆ 2007 core PCE price index inflation slows a bit to 2.0%.

Growth Forecast Fundamentals

- ◆ Terminated real estate boom had added 1% per year to growth.
- ◆ But some late 2007 assistance from eventual interest rate relief.
- ◆ And exports assisted from expected further dollar decline.

Major Growth Risks

- ◆ Housing-related uncertainty following unprecedented boom.
- ◆ Crude oil prices much above our \$60/barrel 2007 forecast.
- ◆ Upside growth risk is hard-to-forecast household formation.

Key Growth Signposts

- ◆ Jobless claims in Q2(07) should rise
- ◆ Capital goods orders have weakened more in early 2007

Core Inflation Forecast Drivers

- ◆ UBS leading inflation index should ease in Q2(07)
- ◆ Owners' Equivalent Rent (OER) to slow
- ◆ Only moderate wage acceleration
- ◆ Slower output and demand growth
- ◆ Productivity slowing to trend
- ◆ Projected lower dollar

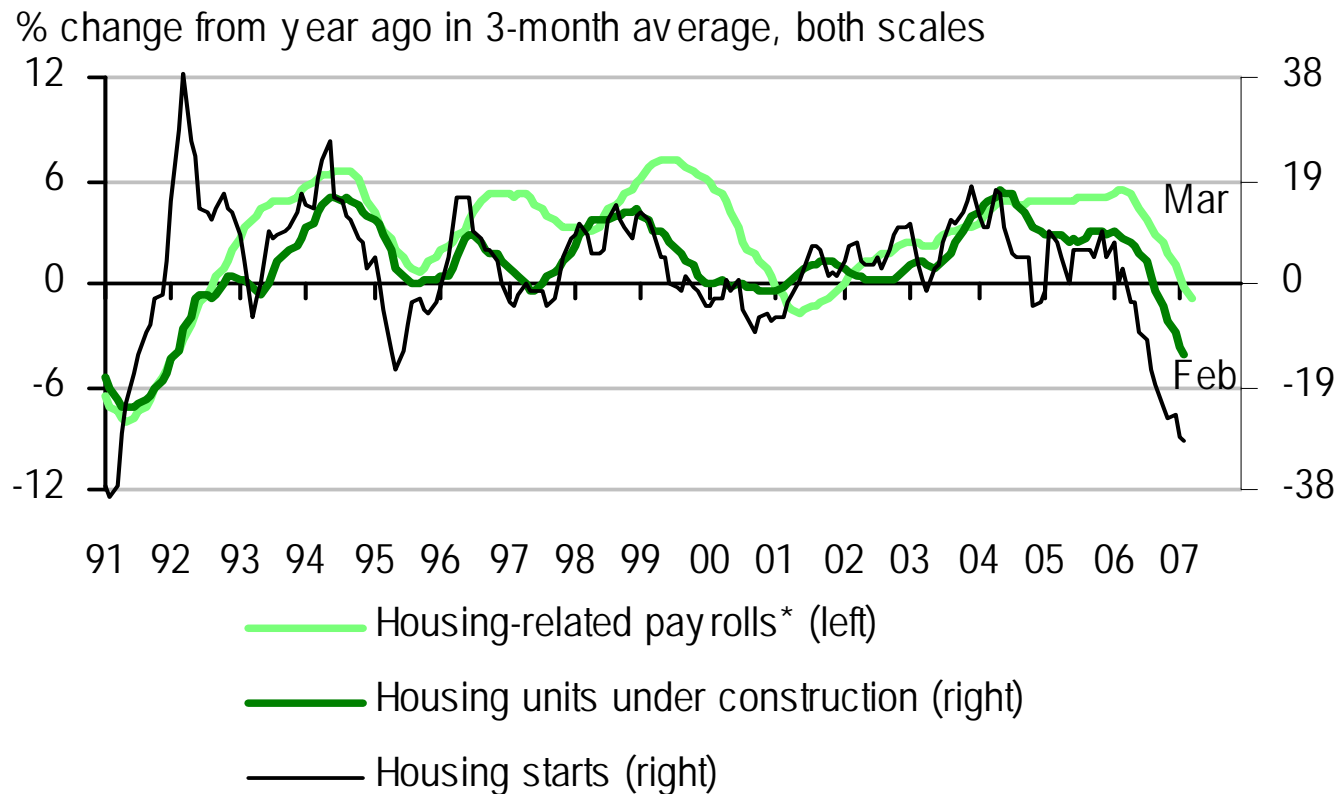
Rate Forecast Drivers

- ◆ Fed funds rate easing to 4.5% “data dependent” on sustained slowing in growth raising unemployment rate to 4.8%.
- ◆ Fed and investors start to see core PCE inflation at no more than top of Fed’s 1%-2% preference range.
- ◆ Foreign savings help real bond yields remain below normal, although such assistance somewhat less in 2007 than earlier.

Forecasts versus Blue Chip Consensus

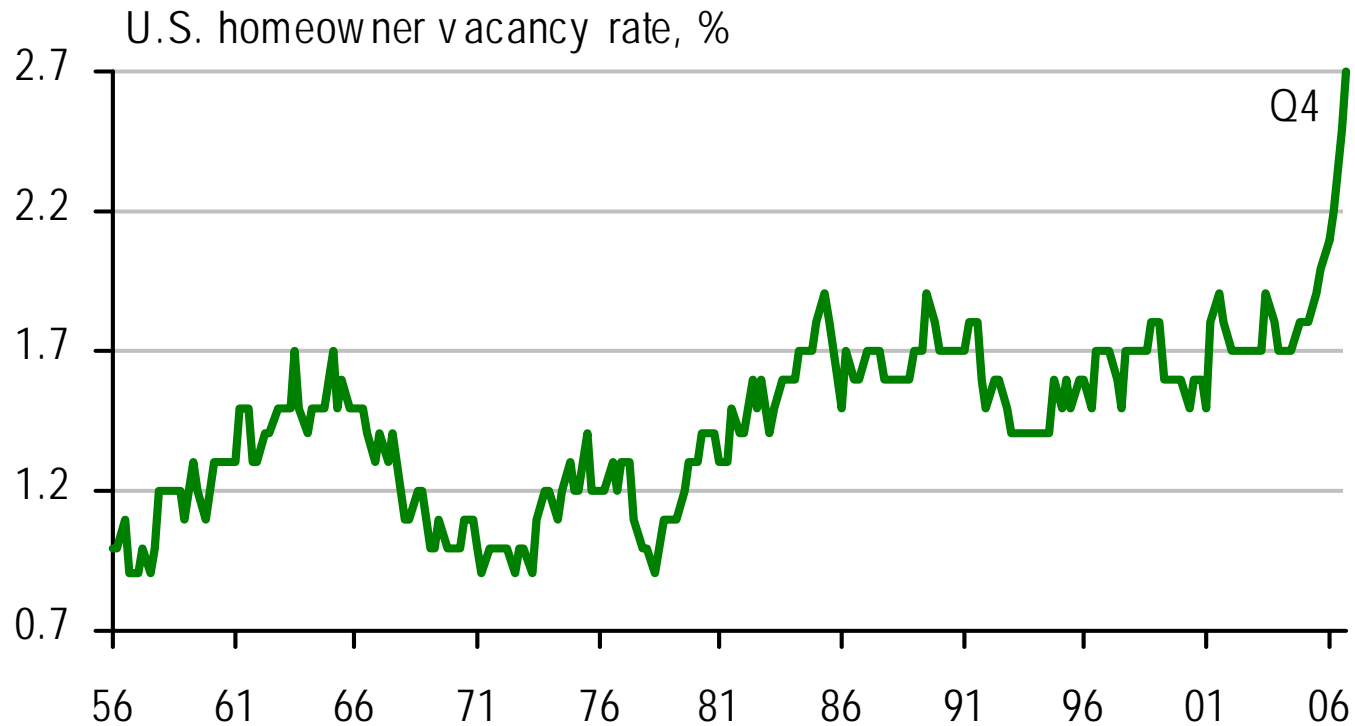
- ◆ Our latest 2.0% 2007 calendar average real growth forecast is 30 basis points under the 2.3% Blue Chip consensus at the start of April. This is mainly why our 4.5% calendar average 10-year Treasury note yield forecast is 20 bp below consensus.

Considerable economic fallout from lower housing starts lies ahead. Much of the construction and jobs associated with a start is typically spread over the following 6 months or so.



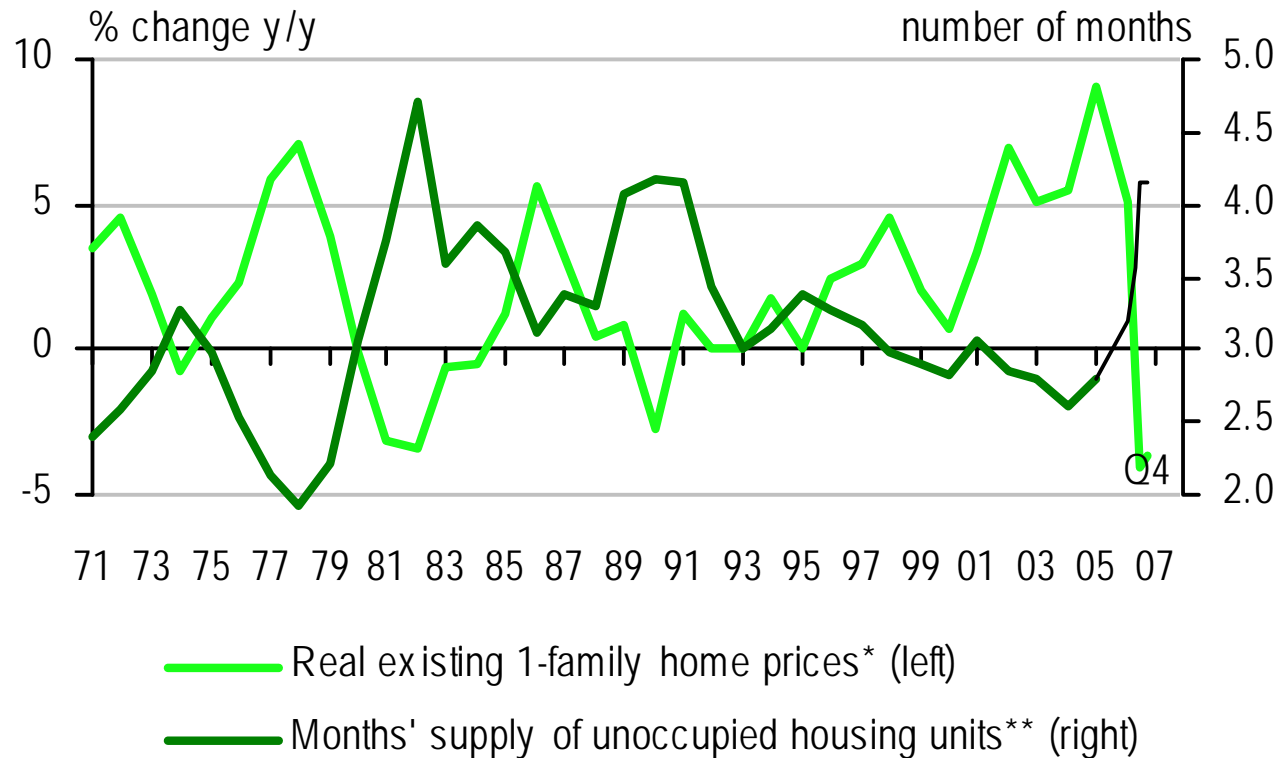
*See bottom left chart on page 5. Source: Bureau of Labor Statistics, Bureau of the Census, and UBS

The percentage of non-rental homes that are vacant and for sale has surged.



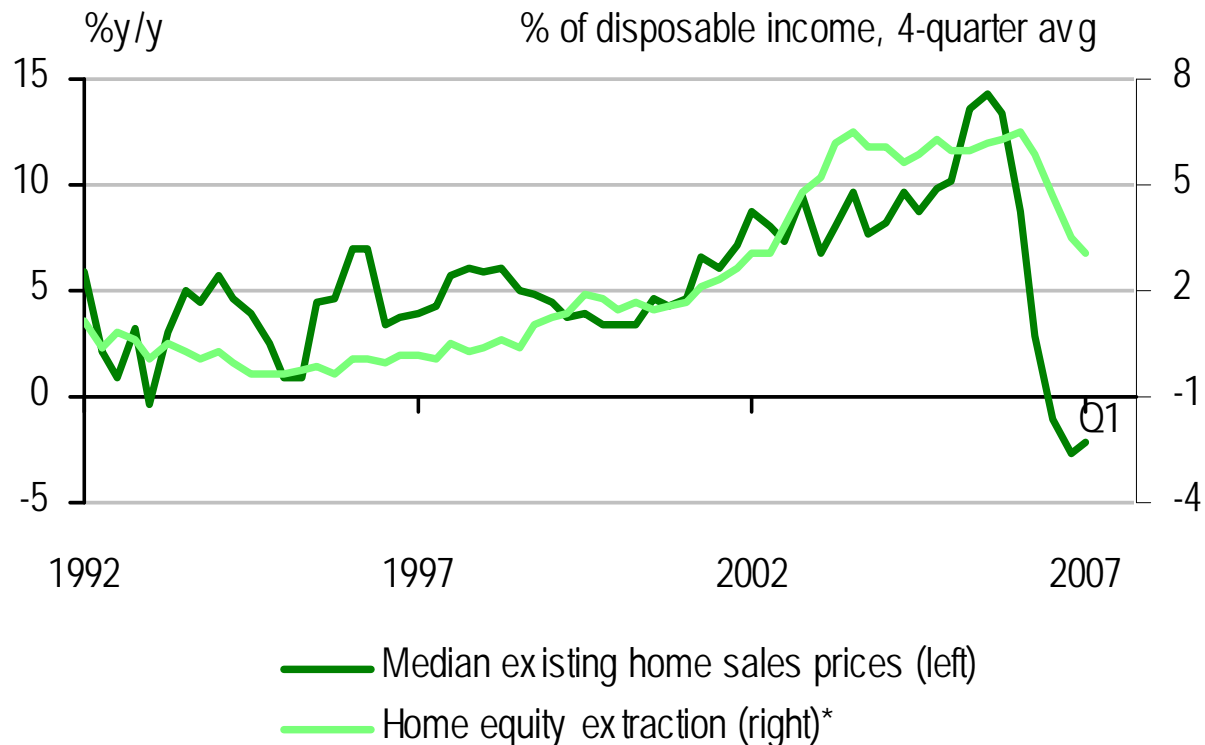
Source: Bureau of the Census

The surge in inventories of vacant unsold homes points to continued downward pressure on home prices.



*Deflated with CPI ex shelter. **Unsold new single-family homes under construction plus vacant housing units for sale divided by average monthly single-family home sales. Source: National Association of Realtors, Bureau of the Census, BLS, and UBS

Home equity extraction will continue to decline in response to the end of the house price boom.



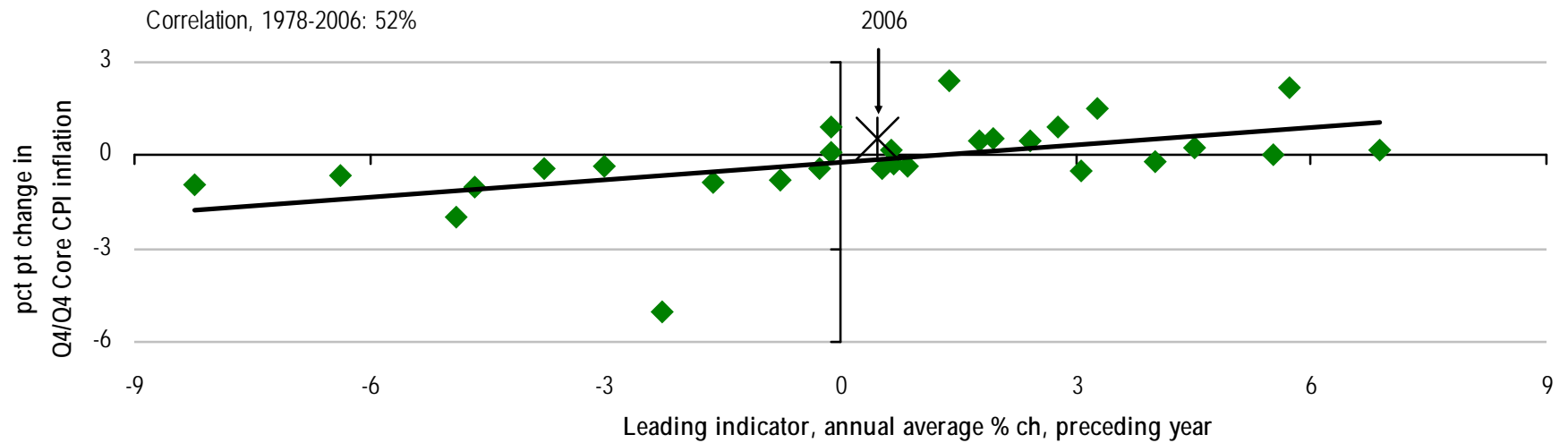
* Home equity extraction 4-quarter average includes data through February 2007.
Source: National Association of Realtors, Federal Reserve Board of Governors, UBS

Core capex orders are weakening.



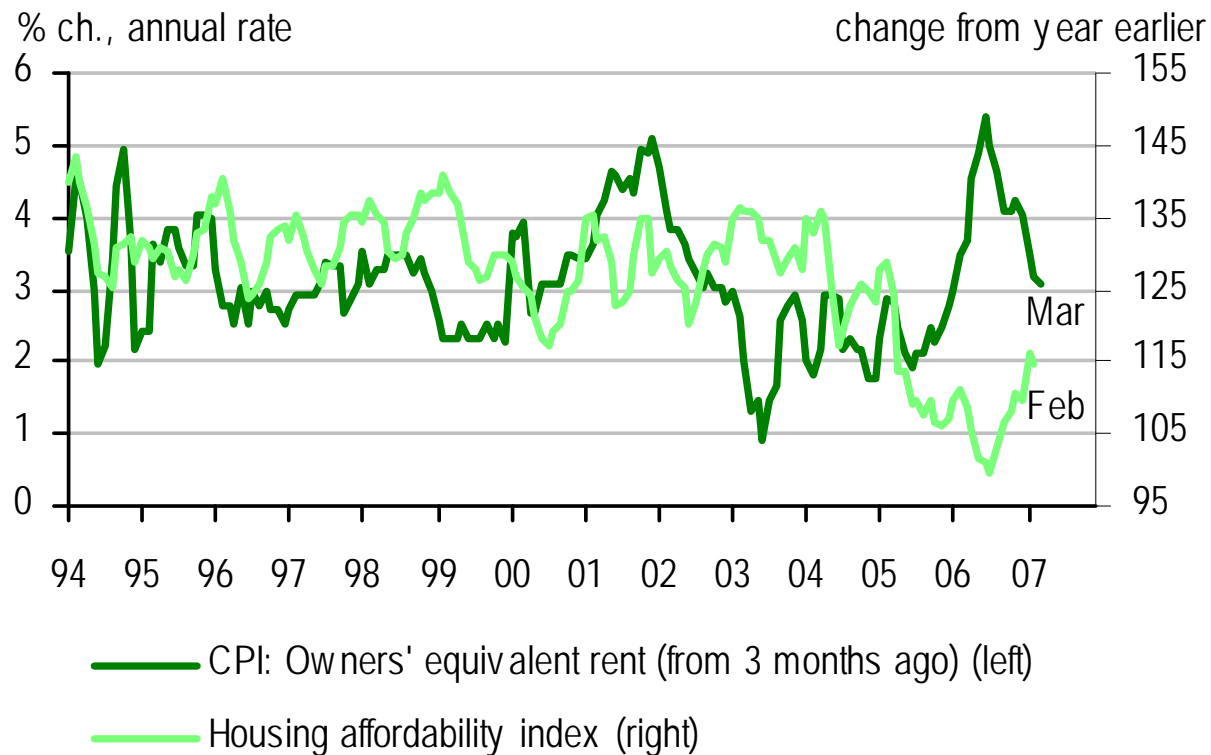
Source: Bureau of the Census

In 22 of the last 29 years, core CPI inflation has moved in the same direction as our leading inflation index (LII) in the previous year. The recent track record: In each of the past eight years, core inflation has moved in the direction indicated by the LII.



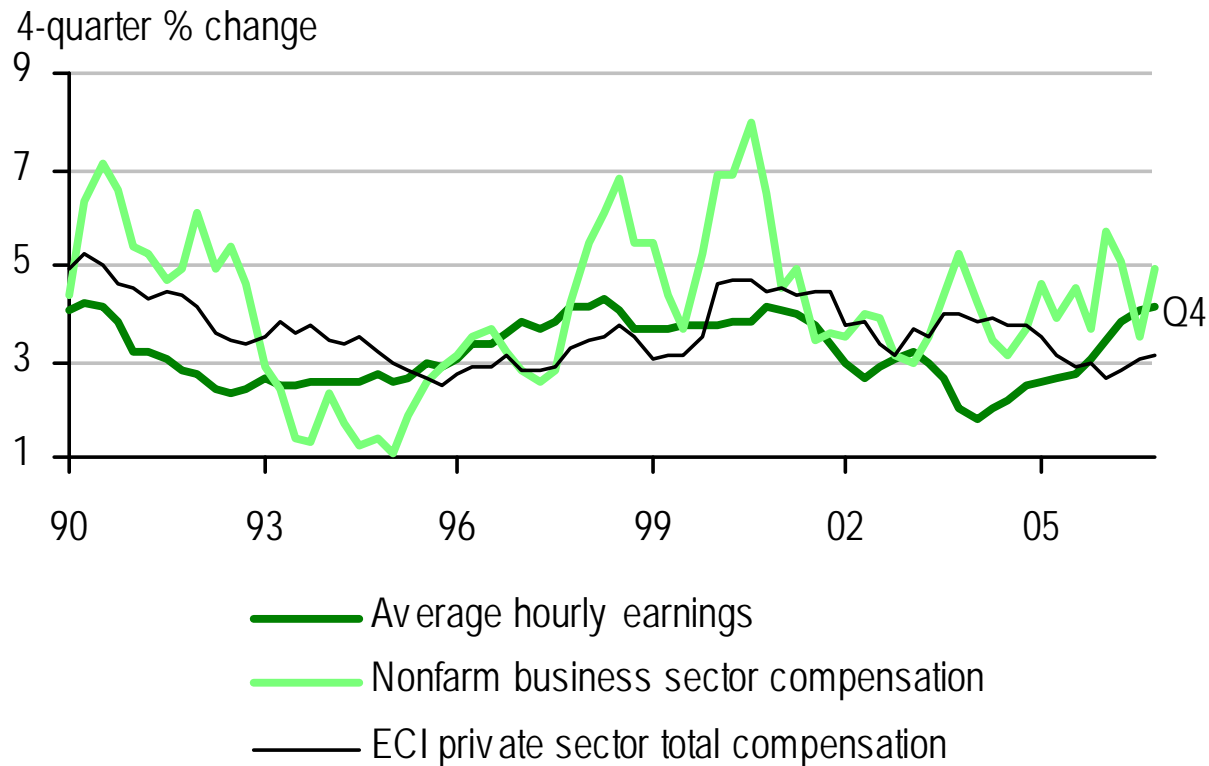
Source: Bureau of Labor Statistics and UBS

The sharp pickup in rents partly reflected relatively low home ownership affordability. As it has started to recover, rent inflation already has started to taper off a bit.



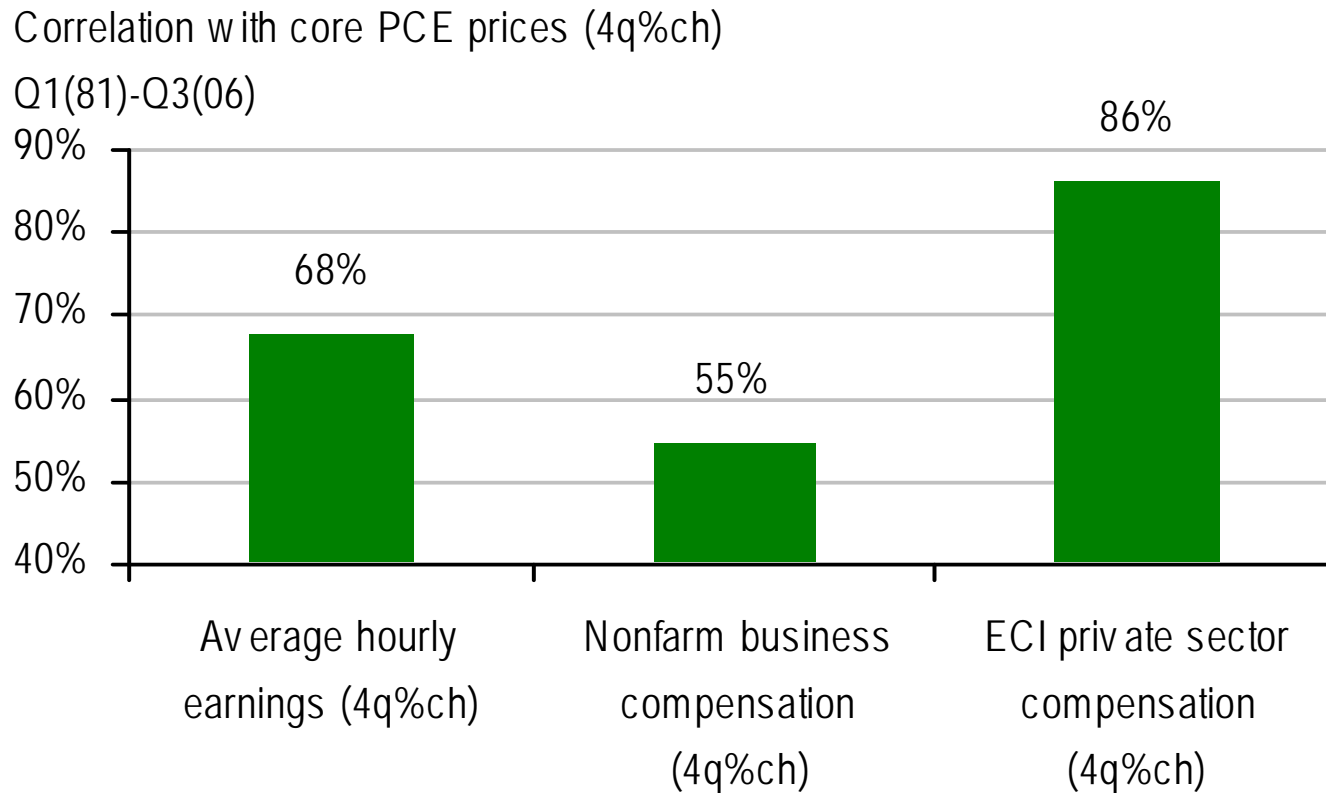
Source: Bureau of Labor Statistics and National Association of Realtors

Average hourly earnings and overall compensation have been rising faster than the Employment Cost Index (ECI).



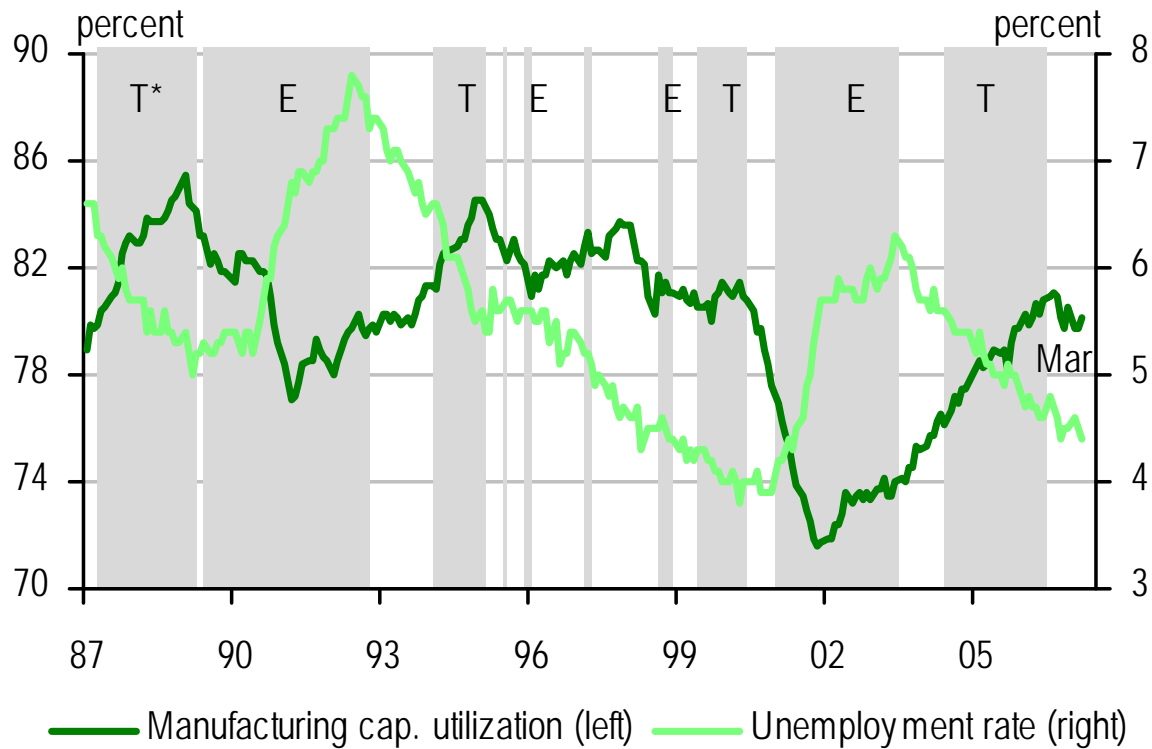
Source: Bureau of Labor Statistics

The ECI is more highly correlated with core PCE inflation than average hourly earnings and hourly overall compensation.



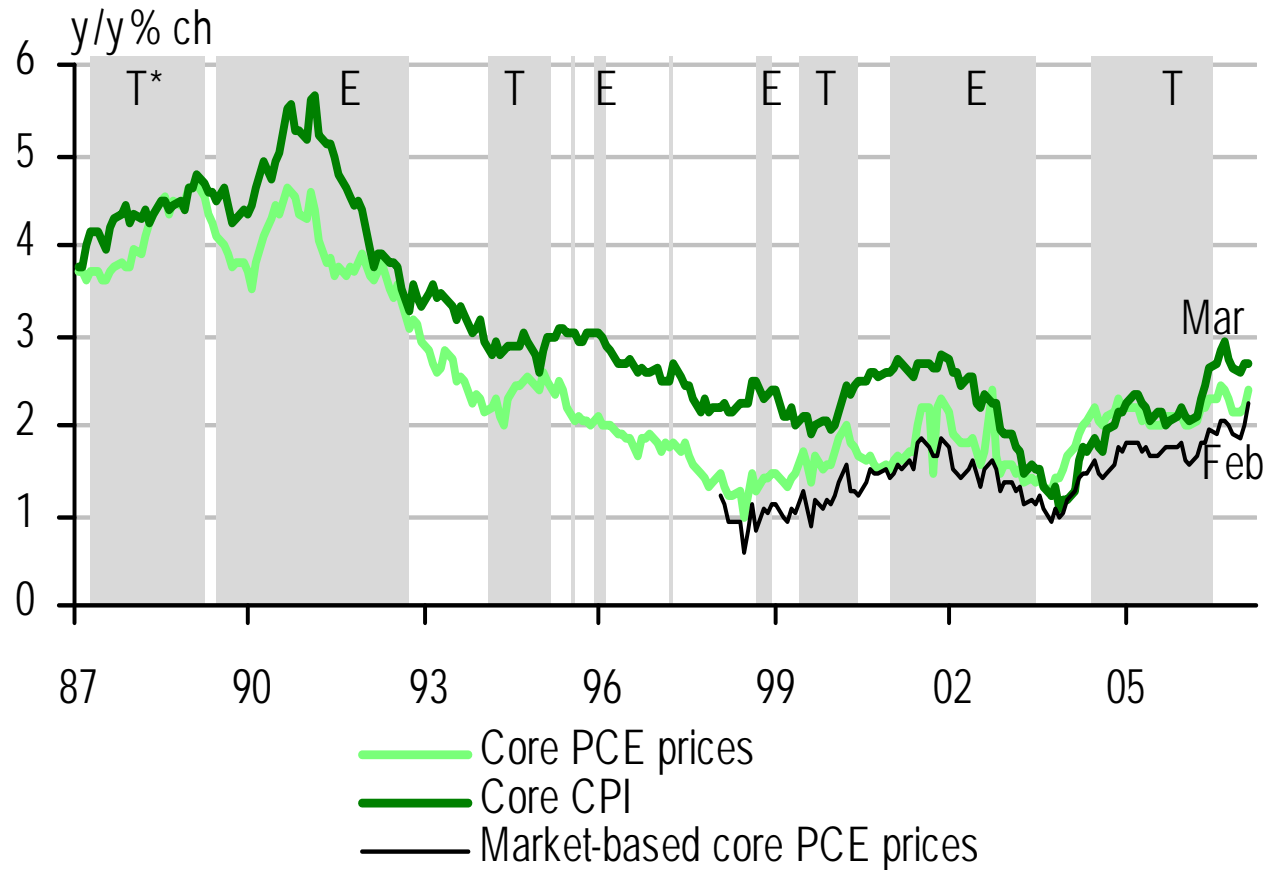
Source: Bureau of Labor Statistics and UBS

The unemployment rate—one key to Fed easing--has yet to show an uptrend.



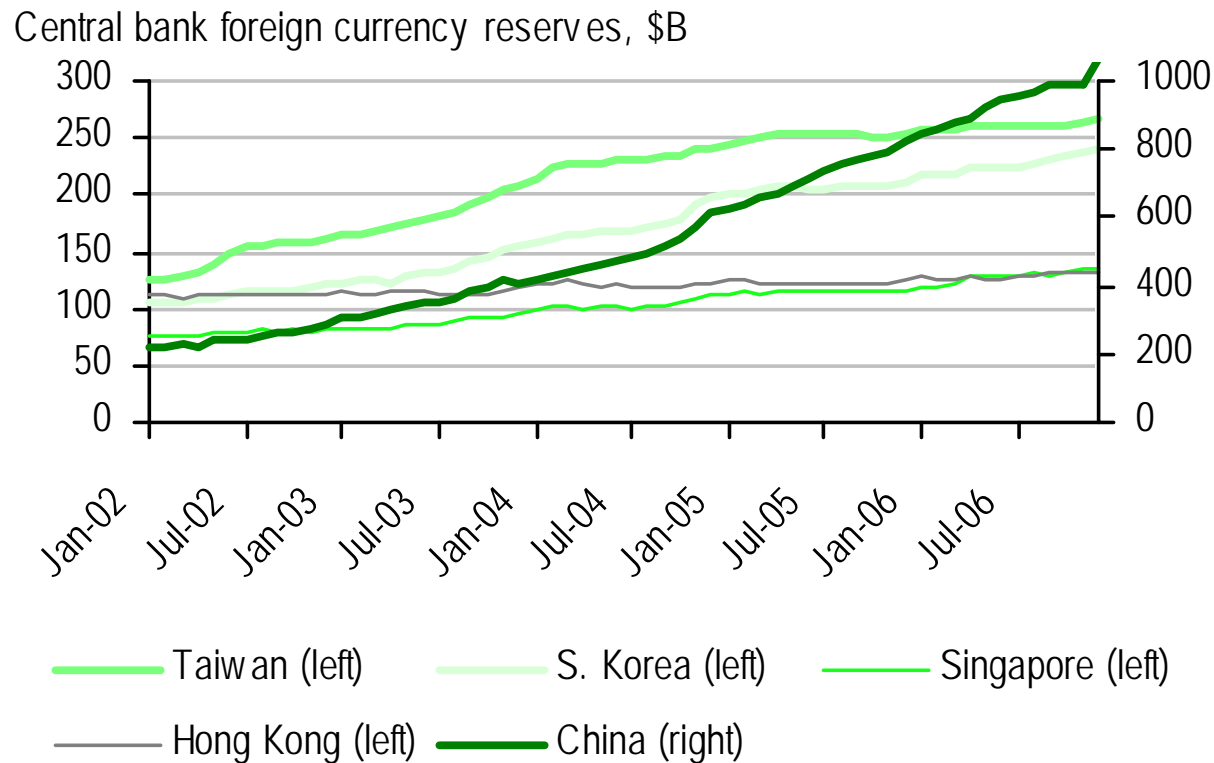
Note: Shaded bars denote Fed tightening (T) and easing (E) periods.
Source: Federal Reserve Board and Bureau of Labor Statistics

Still “too-high” core inflation would not prevent Fed easing if growth is clearly subpar.



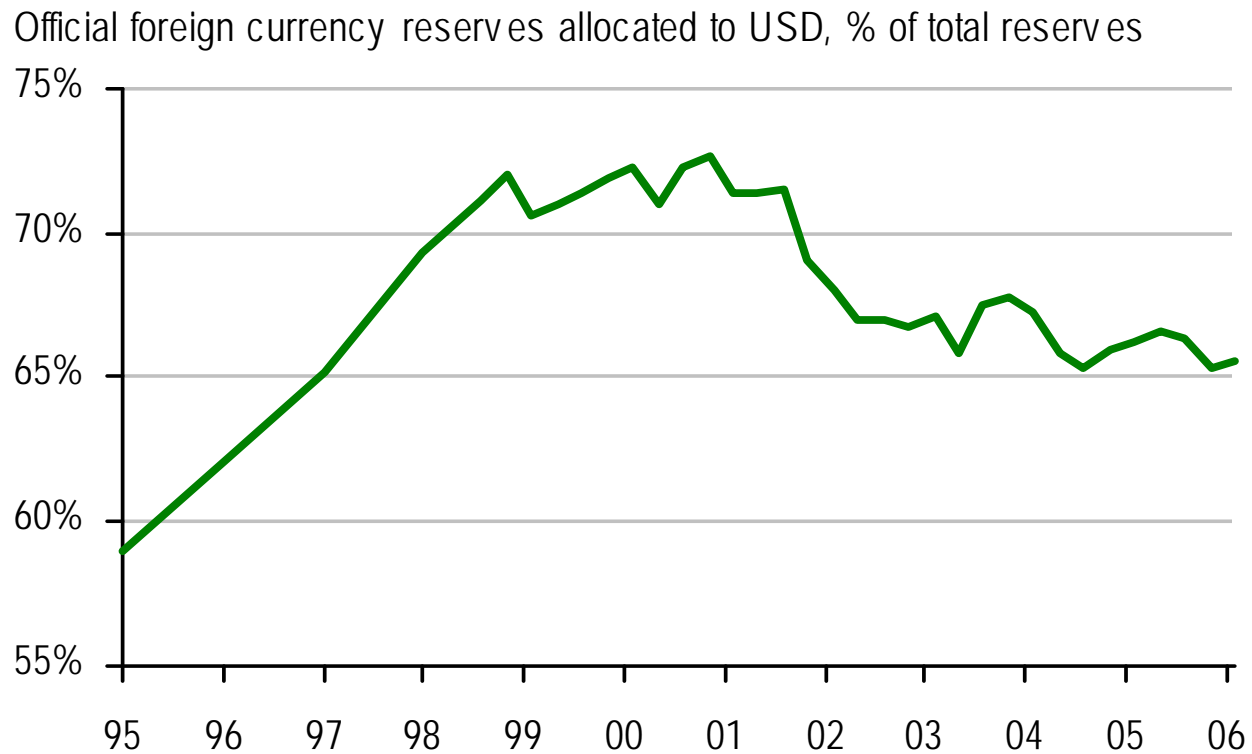
Note: Shaded bars denote Fed tightening (T) and easing (E) periods.
Source: Federal Reserve, Bureaus of Labor Statistics and Economic Analysis

Asian central banks' investment funds are huge.



Source: IMF

Around two-thirds of central bank reserves remain in dollars.



Source: IMF

Trends in approved asset-classes 1998-2006

(% of Central Banks which have approved the asset class)

Asset class	2006	2005	2004	2003	2002	2001	2000	1999	1998
1 U.S. Agencies	84	82	76	78	75	71	62	68	54
2 Supranationals	70	74	63	62	60	62	54	63	60
3 Sovereign Eurobonds	64	60	60	58	58	61	60	66	66
4 Sovereign Globals	53	54	50	56	54	52	44	50	34
5 Pfandbriefes	50	48	44	38	35	37	34	28	12
6 Bank Debt	48	41	21	24	21	26	20	16	4
7 MBS / ABS	44	39	39	27	22	17	19	12	2
8 Corporates	40	38	38	32	28	22	20	15	10
9 Landesbank Debt	40	37	33	27	30	30	32	28	12
10 Yankee Bonds	16	19	12	14	16	22	28	12	18
11 TIPs	28	16	9	na	na	na	na	na	na
12 Local Government	22	14	12	14	16	16	18	18	8
13 Canadian Provinces	11	9	10	10	8	9	10	10	12
14 Equities	18	5	3	2	na	na	na	na	na

Source: UBS Central Bank Surveys, 1998-2006



Global disclaimer

This material has been prepared by UBS Securities LLC, an affiliate of UBS AG (UBS). In certain countries UBS AG is referred to as UBS SA.

This report is for distribution only under such circumstances as may be permitted by applicable law. It has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient. It is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the information contained herein, except with respect to information concerning UBS AG, its subsidiaries and affiliates, nor is it intended to be a complete statement or summary of the securities, markets or developments referred to in the report. The report should not be regarded by recipients as a substitute for the exercise of their own judgement. Any opinions expressed in this report are subject to change without notice and may differ or be contrary to opinions expressed by other business areas or groups of UBS as a result of using different assumptions and criteria. The analysis contained herein is based on numerous assumptions. Different assumptions could result in materially different results. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing and interpreting market information. UBS is under no obligation to update or keep current the information contained herein. UBS relies on information barriers to control the flow of information contained in one or more areas within UBS, into other areas, units, groups or affiliates of UBS. The compensation of the analyst who prepared this report is determined exclusively by research management and senior management (not including investment banking). Analyst compensation is not based on investment banking revenues, however, compensation may relate to the revenues of UBS Investment Bank as a whole, of which investment banking, sales and trading are a part.

The securities described herein may not be eligible for sale in all jurisdictions or to certain categories of investors. Options, derivative products and futures are not suitable for all investors, and trading in these instruments is considered risky. Mortgage and asset-backed securities may involve a high degree of risk and may be highly volatile in response to fluctuations in interest rates and other market conditions. Past performance is not necessarily indicative of future results. Foreign currency rates of exchange may adversely affect the value, price or income of any security or related instrument mentioned in this report. For investment advice, trade execution or other enquiries, clients should contact their local sales representative. Neither UBS nor any of its affiliates, nor any of UBS' or any of its affiliates, directors, employees or agents accepts any liability for any loss or damage arising out of the use of all or any part of this report. **Additional information will be made available upon request.**

For financial instruments admitted to trading on an EU regulated market: UBS AG, its affiliates or subsidiaries (excluding UBS Securities LLC and/or UBS Capital Markets LP) acts as a market maker or liquidity provider (in accordance with the interpretation of these terms in the UK) in the financial instruments of the issuer save that where the activity of liquidity provider is carried out in accordance with the definition given to it by the laws and regulations of any other EU jurisdictions, such information is separately disclosed in this research report.

United Kingdom and the rest of Europe: Except as otherwise specified herein, this material is communicated by UBS Limited, a subsidiary of UBS AG, to persons who are market counterparties or intermediate customers (as detailed in the FSA Rules) and is only available to such persons. The information contained herein does not apply to, and should not be relied upon by, private customers. UBS Limited is regulated by the FSA. **France:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities France SA. UBS Securities France S.A. is regulated by the the Autorité des Marchés Financiers (AMF). Where an analyst of UBS Securities France S.A. has contributed to this report, the report is also deemed to have been prepared by UBS Securities France S.A. **Germany:** Prepared by UBS Limited and distributed by UBS Limited and UBS Deutschland AG. UBS Deutschland AG is regulated by the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin). **Spain:** Prepared by UBS Limited and distributed by UBS Limited and UBS Securities España SV, SA. UBS Securities España SV, SA is regulated by the Comisión Nacional del Mercado de Valores (CNMV). **Russia:** Prepared and distributed by the Moscow Representative Office of UBS Cyprus Moscow Limited. **Switzerland:** Distributed by UBS AG to persons who are institutional investors only. **Italy:** Prepared by UBS Limited and distributed by UBS Limited and UBS Italia Sim S.p.A.. UBS Italia Sim S.p.A. is regulated by the Bank of Italy and by the Commissione Nazionale per le Società e la Borsa (CONSOB). Where an analyst of UBS Italia Sim S.p.A. has contributed to this report, the report is also deemed to have been prepared by UBS Italia Sim S.p.A.. **South Africa:** UBS South Africa (Pty) Limited (Registration No. 1995/011140/07) is a member of the JSE Limited, the South African Futures Exchange and the Bond Exchange of South Africa. UBS South Africa (Pty) Limited is an authorised Financial Services Provider. **United States:** Distributed to US persons by either UBS Securities LLC or by UBS Financial Services Inc., subsidiaries of UBS AG; or by a group, subsidiary or affiliate of UBS AG that is not registered as a US broker-dealer (a "non-US affiliate"), to major US institutional investors only. UBS Securities LLC or UBS Financial Services Inc. accepts responsibility for the content of a report prepared by another non-US affiliate when distributed to US persons by UBS Securities LLC or UBS Financial Services Inc. All transactions by a US person in the securities mentioned in this report must be effected through UBS Securities LLC or UBS Financial Services Inc., and not through a non-US affiliate. **Canada:** Distributed by UBS Securities Canada Inc., a subsidiary of UBS AG and a member of the principal Canadian stock exchanges & CIPF. A statement of its financial condition and a list of its directors and senior officers will be provided upon request. **Hong Kong:** Distributed by UBS Securities Asia Limited. **Singapore:** Distributed by UBS Securities Pte. Ltd or UBS AG, Singapore Branch. **Japan:** Distributed by UBS Securities Japan Ltd to institutional investors only. **Australia:** Distributed by UBS AG (Holder of Australian Financial Services Licence No. 231087) and UBS Securities Australia Ltd (Holder of Australian Financial Services Licence No. 231098) only to "Wholesale" clients as defined by s761G of the Corporations Act 2001. **New Zealand:** Distributed by UBS New Zealand Ltd.

© 2006 UBS. All rights reserved. This report may not be reproduced or redistributed, in whole or in part, without the written permission of UBS and UBS accepts no liability whatsoever for the actions of third parties in this respect.

Contact information

Maury N. Harris
Chief US Economist
maury.harris@ubs.com
+1-212-713 2472

www.ubs.com