UBS Investment Strategy Update

London terrorist attacks do not change fundamental market outlook

After the London blasts of Thursday morning, initial market reactions were substantial but rather short-lived. We recommend not to alter current investment strategies based on these events. Direct real economic impacts should be limited nor does the fundamental assessment of asset classes and markets change. As long as terrorist activity does not intensify, which there is no factual evidence for right now, risk premia should normalize. Since markets have already reversed to a large extent this does not offer a buying opportunity neither.

Strategy Overview – currency hedged

as of July 7 2005

	Bonds	Equities	Currency
USA	-1.00	-1.50	n
Canada	n	-0.50	n
EMU	1.25	1.25	n
UK	4.00	0.75	-1.00
Switzerland	-4.25	0.75	0.50
Sweden	n	n	0.50
Japan	-4.00	n	1.00
Australia	4.00	-0.75	-1.00
Hong Kong	n.a.	n	n.a.
Singapore	n.a.	n	n.a.
Em. Markets	n	n	n.a.
World	n	n	n.a.

n = neutral; + = overweight; - = underweight; n.a. = not applicable

The bond and equity weighting in the first two columns only take into account expected market returns in local currencies not due to exchange rate changes.

What has happened?

On Thursday July 7, around 09.50 am CET, a series of explosion on the London Underground and on at least one bus. In the afternoon estimates of casualties stood at 33 deaths, 45 seriously injured and more than 300 lighter casualties.

The explosion, during the peak rush hour, caused massive disruption for commuters. Streets around the capital were packed with people trying to find other ways of getting to work and mobile networks were jammed as people attempted to call their families and colleagues.

Who is behind the bombings?

It is still not clear who is behind these attacks. A group calling itself the al Qaeda Organization in Europe claimed responsibility for the attacks. It also warned Italy and Denmark to withdraw troops from Iraq and Afghanistan in a statement posted on Islamist web site al-Saha. However, it may take quite some time until the true authors of the attacks are identified.

How did markets react?

Markets reacted considerably right after the news, but recovered later on.

Asian ***equity markets*** were already closed as the news came in. European markets were down around 3.5% immediately, but then recovered to around minus 2% in early afternoon trading. In London the FTSE was down from 5229 to 5022 (-4%) but later on rebounded to around 5125 (-1.5%). Among the largest losers were air carriers and insurance companies. U.S. futures fell sharply Thursday morning as news of blasts on London's transportation system rattled investors. At opening, the S&P as well as the Dow Jones were down only 0.5% on the previous day.

On the ***bond markets***, US and UK two years government bond yields dropped by 20 bps on the news but later rebounded and were only 10 bps down in early afternoon. On the ***money market***, UK September futures were down 20 bps suggesting that markets now see a greater chance for the Bank of England to cut rates at its next policy meeting. US 10 year Treasury bill yields also dropped shortly but recovered to around 4% in early afternoon trading.

On the ***currency markets***, the traditional save haven currencies such as CHF and EUR gained immediately after the bombings. However, the gains were eroded relatively quickly. Still the rebound in EURUSD might mark a trigger for a bottoming out in EURUSD. The GBP dropped significantly on basically all crosses (most pronounced against CHF, -1.8%).

Crude ***oil prices*** were volatile as the information was absorbed. Brent crude was down on the news and early indicators were pointing to lower WTI crude prices as well. The lower prices for Brent and WTI crude was due in part to traders reflecting on 9/11, when oil prices spiked briefly, but subsequently fell due to the realisation that demand would be weaker as a result of the tragedy. However, in the US, the focus has returned to the reality that the hurricane season has got into full swing with hurricane Denis expected to touch the US coastline on Sunday (July 10). With this in view, we take the stance that any supply disruption will have a significant upside impact to the oil price.

Gold reacted sharply to the news of the incidents in London. Gold spiked to $428.88 after closing at $423.76 on Wednesday. However, gold has settled down and was later trading up $2.44 from Wednesday's close. ***Silver*** also spiked higher but has settled lower as the news is digested.

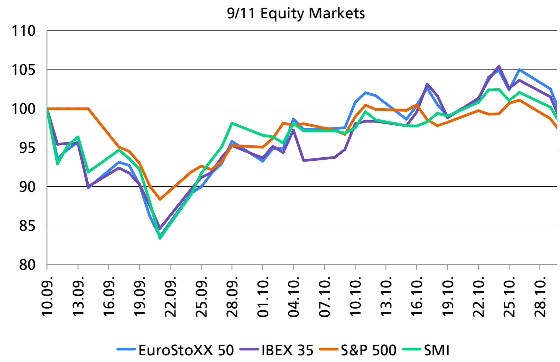
How do markets tend to react overall?
Following terrorist events, markets tend to follow a rather systematic pattern: the initial reaction is brisk, it takes several days until the full scale and background information is established and there is a tendency for overshooting. Once sentiment swings back, there is usually a partial rebound with the normal market regime re-established within 2-3 weeks. The exact amplitude and duration of market corrections are, of course, dependent on the specific circumstances

What factors must be considered for current investment decisions?
All factors influencing future cash-flow streams or the interest rate used to discount these back to the present are driving market prices.

1) Growth and earnings impact: Since impact on real economic activity can be assumed to be limited, immediate macroeconomic effects are rather negligible. One potential venue for a growth impact could be higher oil prices. They have corrected downwards, though, on the back of an expected lower demand for transportation purposes and no adverse impact on the supply side. Longer-term, the main risk lies in further US-led interventions in the Middle East (aggressive diplomacy or military), which is given substance in this case since the prime ally of the US has been hit directly.
2) Risk premia: The degree to which investors want to be compensated for taking market risk depends strongly on the uncertainty that is induced by the events. Somewhat perversely, the sensitivity has somewhat decreased since 9/11. As long as no escalation of terrorist activity is to be expected and geopolitical tensions remain in check, there is no reason for the risk premia to fundamentally edge higher.

Equity markets after 9/11

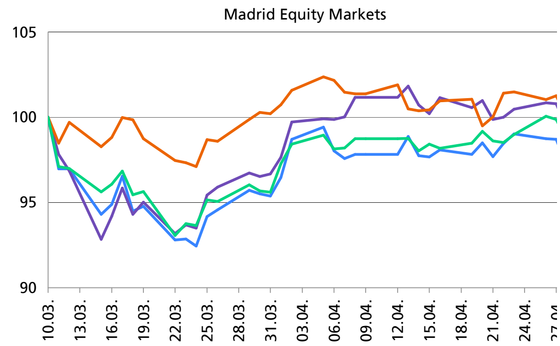
Indexed to 10.09.2001 = 100



Source: Datastream

Equity markets after Madrid bombings

Indexed to 10.03.2004 = 100



Source: Datastream

How is the impact on equity sector allocation?
While consumer discretionary (transportation) and the energy sector are usually the most directly exposed, the reduction in risk appetite favours defensive sectors.

Do we change our investment strategy?
No! Due to their assumed limited real economic impact these attacks in London do not significantly alter our fundamental assessment on asset classes and markets. Since additionally market reaction in general was benign in relative terms and has already reversed to a large extent this does not offer a significant buying opportunity either.

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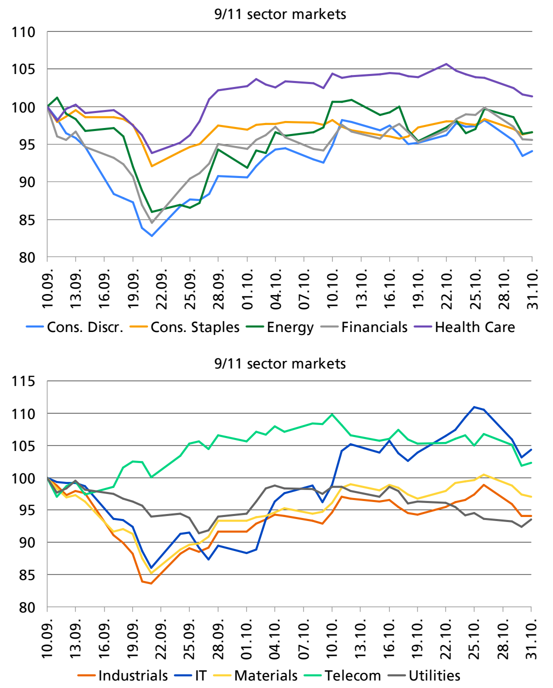
Equity sectors after 9/11

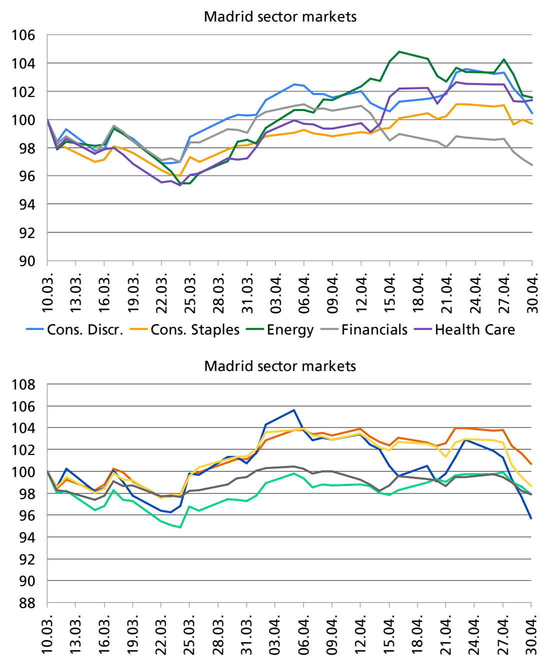
Indexed to 10.09.2001 = 100



Source: Datastream

Equity sectors after Madrid bombings

Indexed to 10.03.2004 = 100



Source: Datastream

Appendix