Monthly Investment Strategy Update - July 2010

Aggressive fiscal tightening intensifies the headwinds impeding global recovery.

At the start of the year our central scenario for 2010 and 2011 saw three major headwinds impeding global recovery: fiscal tightening, households rebuilding savings and banks shrinking balance sheets. With governments running scared of bond markets, fiscal tightening is now being aggressively pursued in the euro-zone and the UK. This heightens the key risk to our central scenario – that intensifying headwinds overpower the fledgling private-sector recovery, leading to deflation. **Central banks will therefore keep ultra-low rates in place for longer than generally anticipated and stand ready to intervene swiftly with a further injection of quantitative easing.**

The UK emergency Budget improves the outlook for gilts and sterling.

The UK Budget will come to be seen as a watershed event for the economy, sterling and the gilt market. It materially reduces the risk that gilts get downgraded and takes pressure off sterling against the euro and dollar. The euro looks overvalued against sterling and now that the UK has a fiscal plan, markets will increasingly focus on the US government's deficit. The US will need to come up with a credible consolidation plan after November mid-term elections, or be forced to by the bond markets. Part of the US solution is likely to be currency weakness, a tempting option for all indebted developed economies that will boost gold as the ultimate liquid store of value.

Fiscal tightening to unleash deflationary forces, helping keep rates close to zero for longer.

Fiscal tightening takes demand out of the economy and is a deflationary process. It will pretty much wipe out growth in the euro-zone as a whole and take a major chunk out of UK growth, reducing the need for inflation hedges like index-linked bonds and commodities. To offset the drag on growth US, UK and European **central banks will need to keep interest rates close to zero for much longer than previously expected and ramp up quantitative easing.** In such a low-rate environment corporate bonds, commercial property and high-yielding equities should be held to enhance yield.

Ultra-low rates in the developed world will put pressure on emerging currencies to appreciate.

An extended period of **ultra loose monetary policy in the advanced economies will put pressure on Asian and emerging-market economies to allow their dollar-linked currencies to appreciate**, as China recently did. Consequently, currency appreciation is likely to be an important part of emerging-market returns for dollar, sterling and euro-based investors.

A more-pronounced slowdown in global growth and earnings than expected.

Another central tenet of our 2010 outlook was **a slowdown in global growth in the second half of 2010 and in 2011**, amid the difficult transition from stimulus-driven momentum to self-sustained growth fuelled by the private sector. Consensus US growth estimates have begun to be downgraded, but only from 3.3% this year to 3.1% in 2011. We expect the slowdown to be more pronounced, falling to somewhere in the region of 1.8-2.3%. We also see 2011 US profit growth slowing to 10-12%, well below the 18% consensus.

Adjusting to lower expectations will keep equities volatile.

Based on current prices, this suggests an end 2011 price-to-earnings ratio (PE) for the US equity market of 12.6-12.9, compared to the current 11.7 forecast. Even at this level PEs would still be well below their long-term average of 16.8, implying room for modest further gains over the next 12 months. But returns are likely to fall well short of the near-20% seen over the past 12 months. **The process of adjusting to lower expectations will keep equity markets volatile and we may yet see fresh lows for 2010.**

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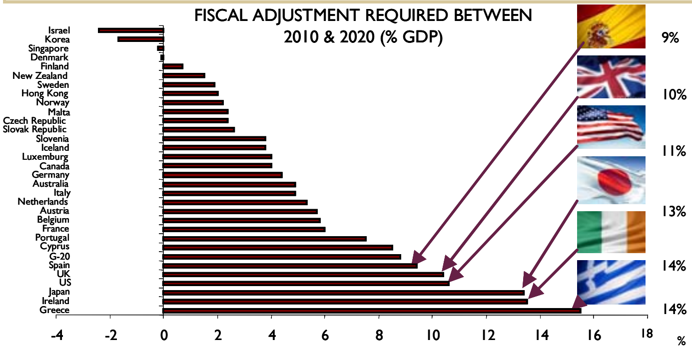
Macro-Economic Scenario in Pictures

Substantial fiscal consolidation ahead for developed economies in next 10 years



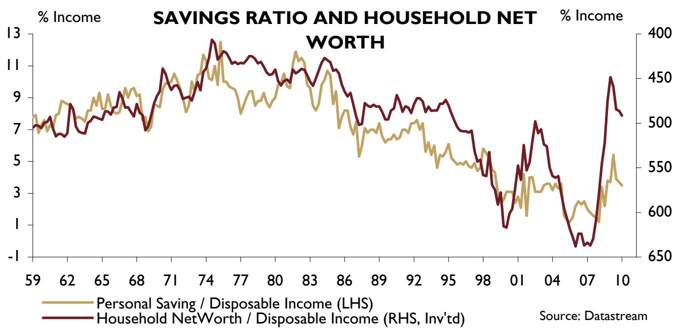
Source: International Monetary Fund

Fiscal tightening is likely to keep debt-laden euro-zone countries in recession

Country / Region	Consensus economics 2010 growth forecast (as of March*), %	Impact on growth (via fiscal tightening)	Adjusted 2010 growth forecast, %
Ireland	-1.0	-1.9	-2.9
Greece	-0.1	-4.3	-4.4
Spain	1.0	-1.8	-0.8
Portugal	0.4	-1.4	-1.0
France	1.4	-1.1	0.4
Italy	0.0	-0.5	-0.5
Germany	1.7	-0.4	1.3
Euro-zone	1.1	-0.8	0.3

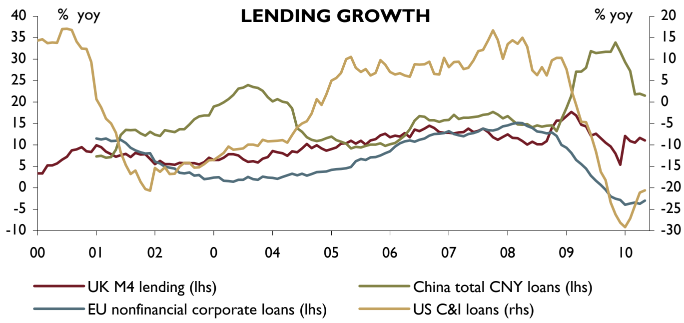
Source: Consensus Economics, Coutts

Unless US house prices bounce back, the savings ratio will rise as households rebuild their wealth



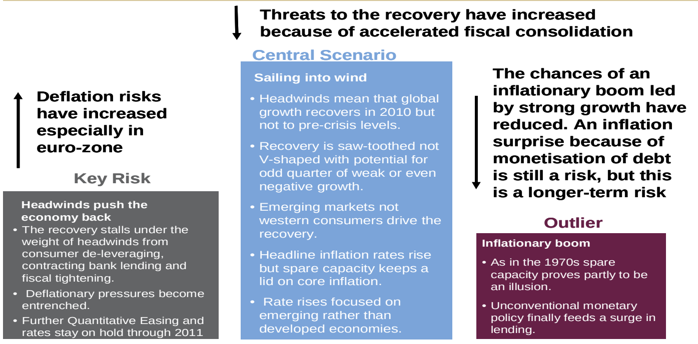
Source: Datastream

Lending remains weak across the major developed economies and is slowing in China



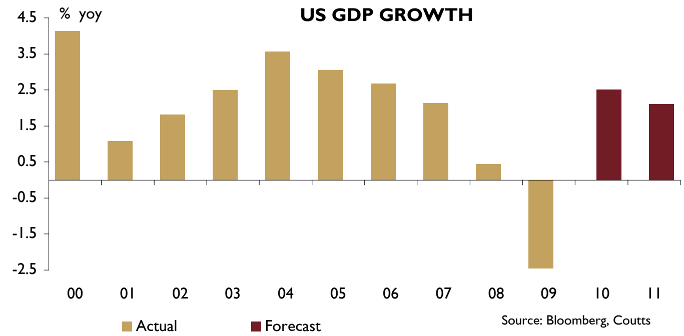
Source: Datastream

Aggressive fiscal consolidation intensifies deflationary pressures, increasing the key risk to our central scenario for 2010



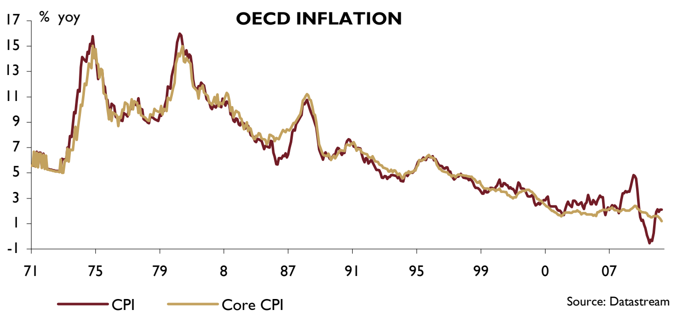
Source: Coutts

We forecast a lacklustre US recovery, well short of previous recoveries and current consensus



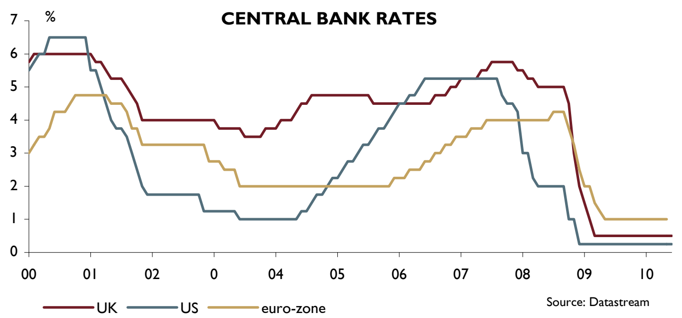
Source: Bloomberg, Coutts

The downward inflation trend in the major developed economies looks set to continue…



Source: Datastream

…and central banks are likely to maintain very low interest rates for longer than generally anticipated

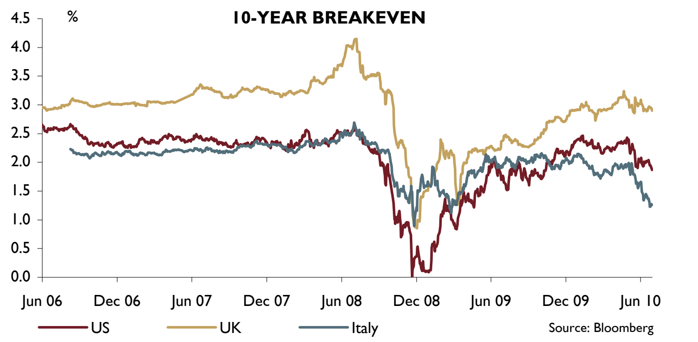


Source: Datastream

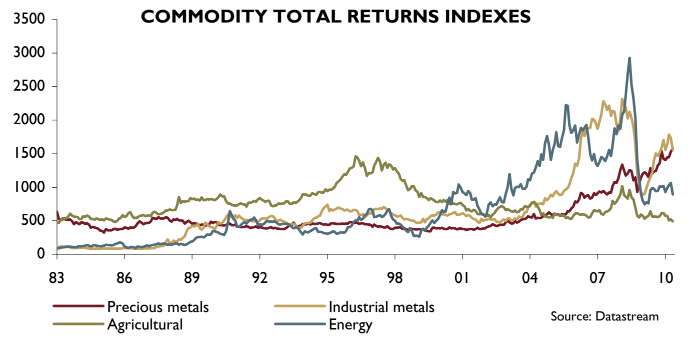
All charts are as at 30/06/10.

Investment Strategy in Pictures

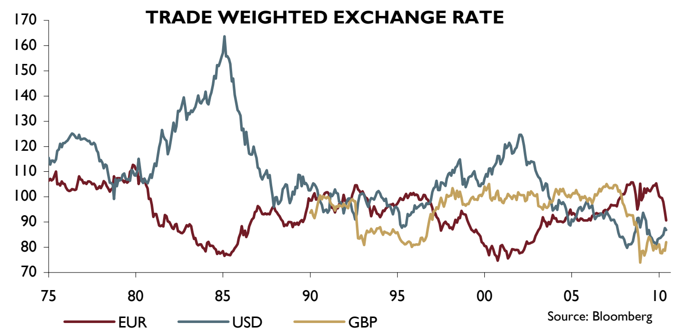
Fiscal tightening is deflationary, reducing the need for inflation protection, particularly in Europe…



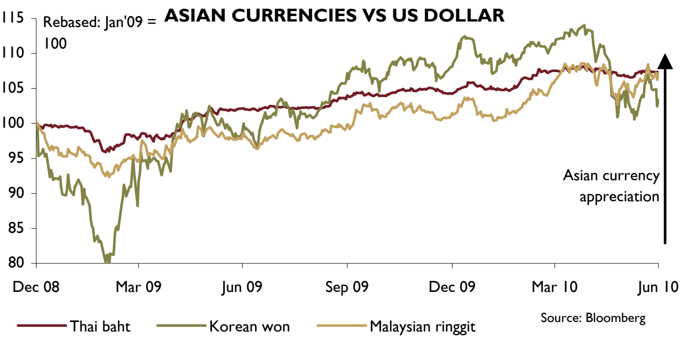
…with precious metals benefiting from 'reserve' currency weakness.



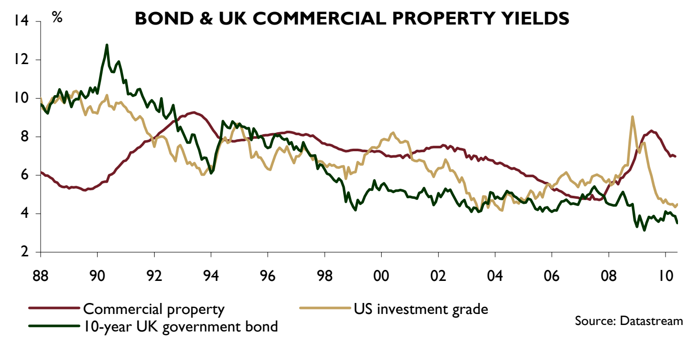
Currency depreciation is a tempting option for countries looking to increase their export competitiveness



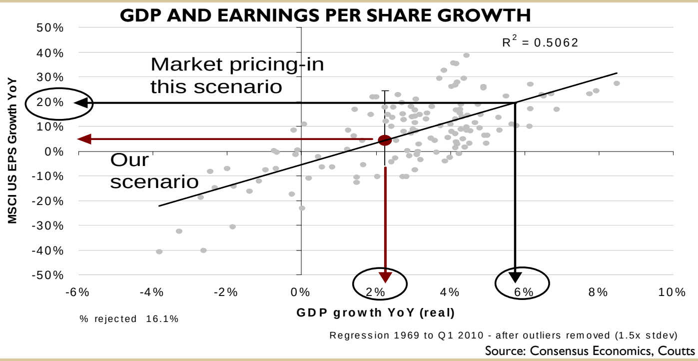
Asian economies face pressure to allow their dollar-linked currencies to appreciate, as China recently did



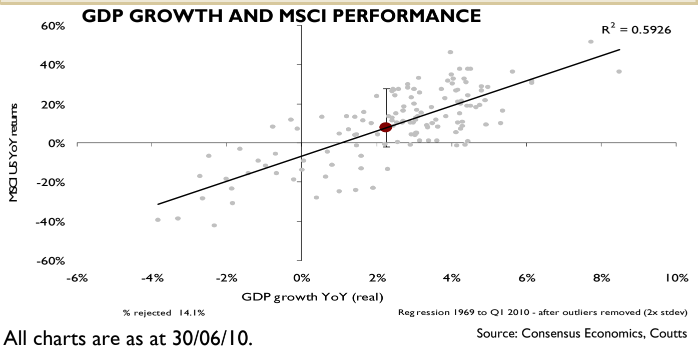
In a low-yield environment for government bonds, commercial property yields look attractive



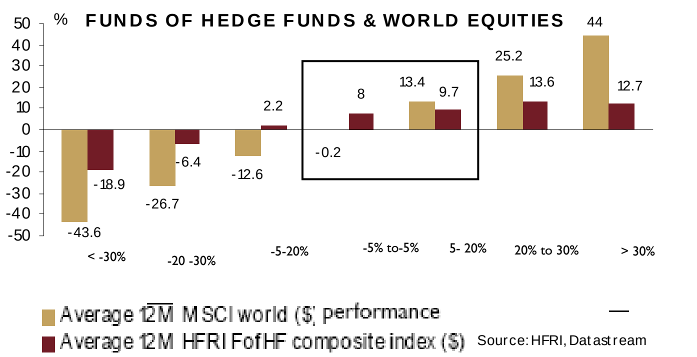
Our analysis of the relationship between GDP and earnings growth suggests weaker profit growth than consensus forecasts…



…but still scope for positive returns from US equities even on our lower GDP forecast



Hedge funds have the potential to outperform when equity returns are low or negative



All charts are as at 30/06/10.

12-Month Asset Class Outlook

Asset Class		Outlook
EQUITIES	Developed-market	An anaemic economic recovery, improved corporate earnings and attractive valuations point to low but positive returns over the next 12 months, accompanied by greater volatility.
	Emerging-market	Have come through the developed-economy-focused crisis of the past couple of years with their superior long-term return potential intact.
FIXED INCOME	Government bonds	Risk aversion and substantial spare capacity will push yields for 'safe-haven' governments down, while deficit worries will keep yields higher for the less fiscally fit.
	Index-linked	Looking expensive, although still offer a way of protecting against the tail risk that fiscal deficits are inflated away.
	Emerging-market	Offer higher yields with, in many cases, less fiscal risk than the major bond markets.
	Investment-grade	Expected to advance in a positive but sluggish growth environment, and as investors search for yield.
	High-yield	A more sluggish and uncertain recovery will result in increased volatility for high-yield bonds.
CASH	3-month cash rates	In stark contrast to emerging markets, the combination of large output gaps and large fiscal deficits will keep short rates low in major developed economies.
COMMODITIES	Oil	As with industrial metals, oil tends to be one of the best-performing commodities at this stage of the cycle, but the weakness of the recovery will limit the upside.
	Gold	Offers a hedge against the depreciation of FX majors to boost export growth and the threat of more quantitative easing.
PROPERTY	UK commercial	In a low-rate environment the yield will draw investors in, but returns will be capped by a lack of lending to this sector.