Monthly Investment Strategy Update - June 2010

Fiscal retrenchment will not be limited strictly to peripheral Europe...

Financial markets are in the process of getting to grips with the implications of the fiscal crisis that has followed in the wake of the 2008/09 banking crisis. The problems are not confined to the periphery of Europe, but are spread fairly widely through advanced economies, with some 60% by economic weight having concerning debt-to-GDP ratios. So **it is not just in Europe that major fiscal adjustment is required over the coming years, but also in the US, Japan and the UK.**

…but the cuts will be felt there the most keenly, driving vulnerable economies into a double dip.

The European fiscal bail-out package announced in early May provides sufficient liquidity to buy time. But it does not resolve the underlying issue of lack of solvency, meaning periphery economies will need to accelerate fiscal consolidation in order to regain the confidence of markets. Such action is likely to drive these economies into recession. When combined with the export impact on the core economies, which will also undergo some fiscal retrenchment of their own, we believe euro-zone growth overall is likely to stagnate over the next couple of years. Indeed, **the economic pain that fiscal adjustments will inflict on peripheral economies is so severe as to make debt restructuring, devaluation and the printing of money by the European Central Bank tempting policy options.** At an investment level, this bodes badly for the euro but well for gold and German exporters on a relative basis. Equity markets will remain under pressure until the solvency issue is addressed.

The UK will bear the brunt of weaker European imports.

Weak European demand will hit the UK harder than the US or Asia, given that the UK sends just over half of its exports to Europe. This comes at a time when the UK is poised to experience its own sharp fiscal tightening under a new coalition government keen to get ahead of the bond market and to avoid a sovereign debt downgrade.

Trade and severe forced fiscal tightening are less of an issue in the US than further banking sector stress.

In the US, the threat comes less from trade impacts and more from the potential for further banking sector stress or the danger that the fiscal crisis results in a severe forced fiscal tightening. However, the dollar's standing as a reserve currency and the bond market's safe-haven status mean the US is less likely to be forced into a sharp fiscal tightening than a small European economy. It is also not in the interests of China or Japan, which hold over 40% of US debt, to force a sell-off. The banking system, though, is of more concern. While the US banking system has very little exposure to the governments, consumers and businesses of the euro-zone periphery – unlike the German, French and UK systems – **the banking crisis of 2008/09 is an object lesson in the interdependence of the financial system and how problems can spread.** The moderate pick-up in Libor recently is a symptom of this issue.

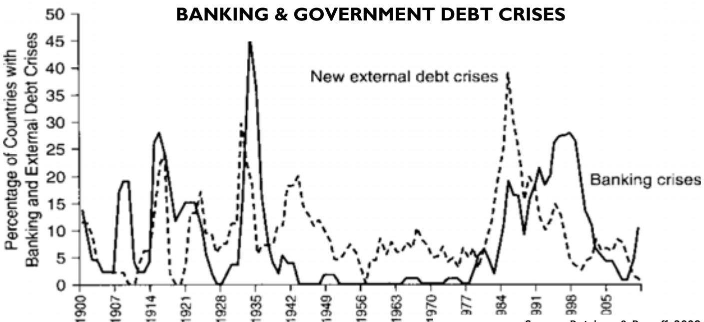
Markets may not yet have bottomed, but longer-term investors may soon find equity valuations attractive.

Equity markets are still in the process of pricing in a more realistic growth outlook for Europe and the risk that the fiscal crisis spreads and materially suppresses the global recovery. This means that it is probably too early to start buying risk assets. However, **at times like these it is important for longer-term investors to use valuation as an anchor.** At 12.3, the forward PE of world equities is below its historic average of 16.6 and getting close to the 10.4 seen when the market bottomed in March 2009. Since 1973, an investor buying UK equities on their current PE has on average made a one-year return of 13%. Of course, no return is guaranteed, investors buying UK equities at their current multiple have lost money13% of the time.

Carl Astorri	James Butterfill	Henry Lancaster	Julien Seetharamdoo	Georgios Tsapouris
+44 20 7753 1612	+44 20 7753 1618	+44 20 7957 2426	+44 20 7753 1576	+44 20 7753 1888

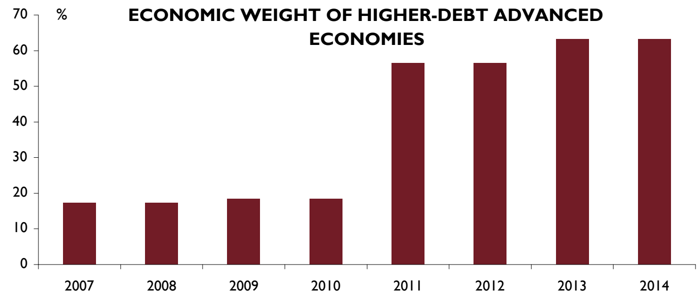
Macro-Economic Scenario in Pictures

Debt crises have historically followed banking crises. This time is no different.



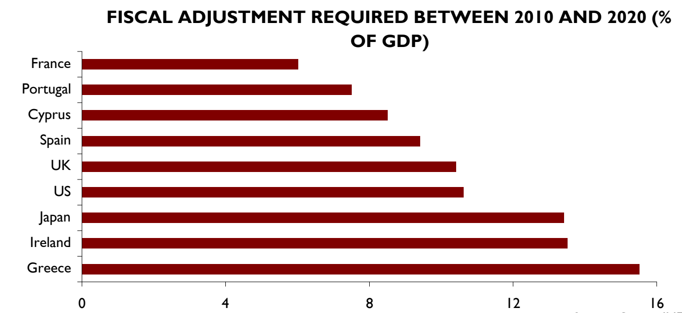
Source: Reinhart & Rogoff, 2009

Fiscal problems are widespread throughout the developed world…



Source: IMF

…and are not just the sole preserve of peripheral euro-zone economies.



Source: Coutts, IMF

Fiscal tightening is likely to keep euro-zone periphery 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

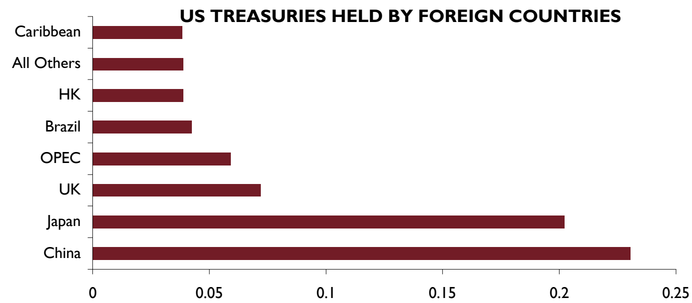
Source: Consensus Economics, Coutts

Trade links will have a knock-on effect on the UK and, to a lesser extent, Asia.

IMPORTANCE OF EXPORTS TO EU			COUNTRY IMPACT ON GLOBAL ECONOMY	
Country	Exports to EU / GDP	Exports to EU / total exports	Country	Share of global GDP
US	2	21	UK	3
Japan	2	14	Japan	7
Asia ex Japan	6	16	Eurozone	16
UK	9	55	US	21
Switzerland	23	60	Asia ex Japan	28

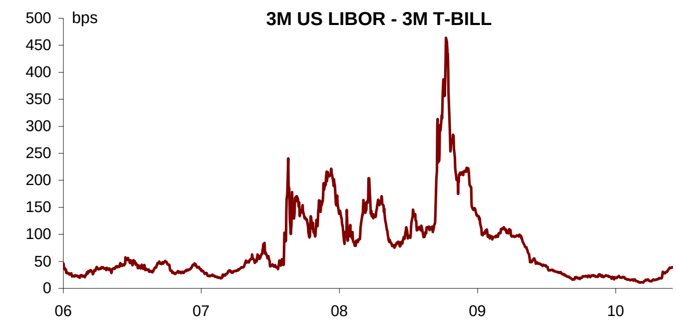
Source: Coutts

The US is less vulnerable to a run on its bond market than a small European nation.



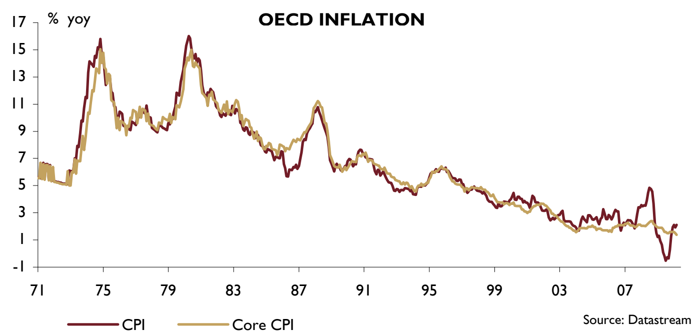
Source: Bloomberg

Banking sector stress is more likely in Europe than the US.



Source: Bloomberg

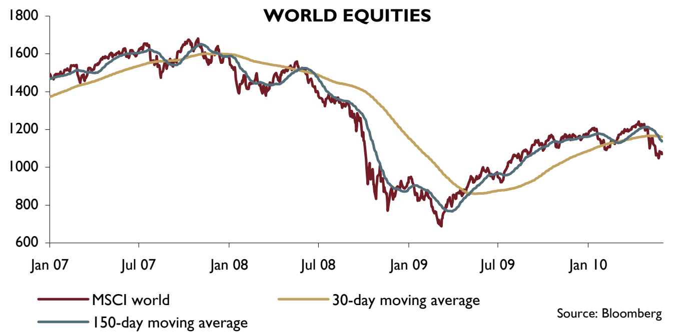
Fiscal tightening will add to global deflation pressure.



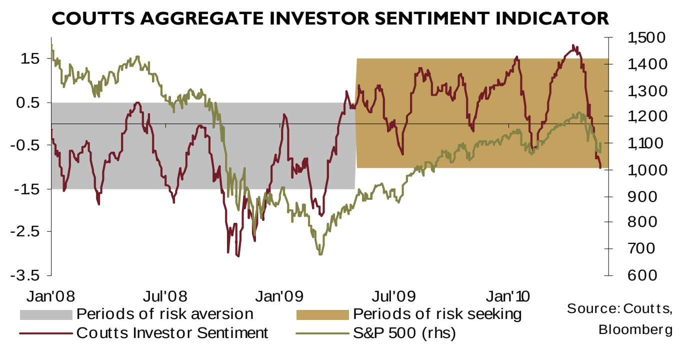
Source: Datastream

Investment Strategy in Pictures

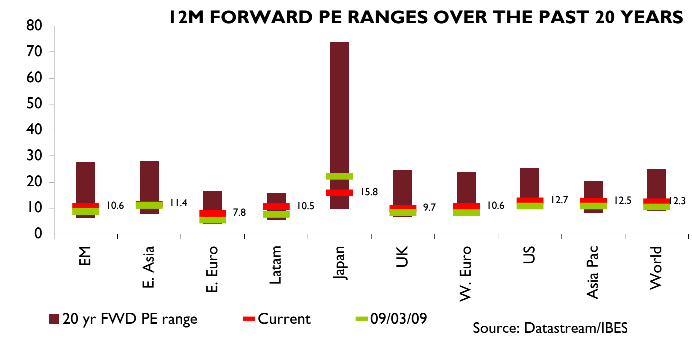
Equity markets are in the process of pricing in a poorer growth outlook.



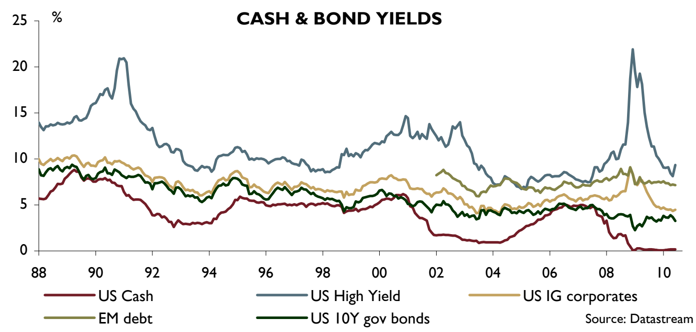
Investor sentiment has been hit hard.



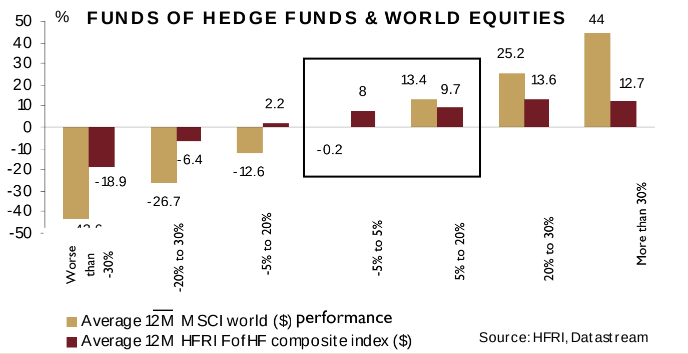
Valuations are getting close to 2009 trough levels.



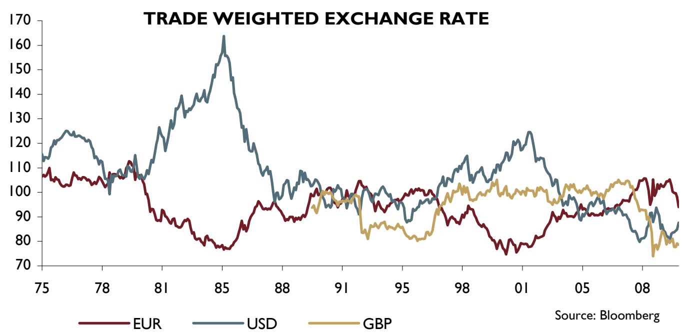
Corporate bonds offer yield pick-up in a low rate environment.



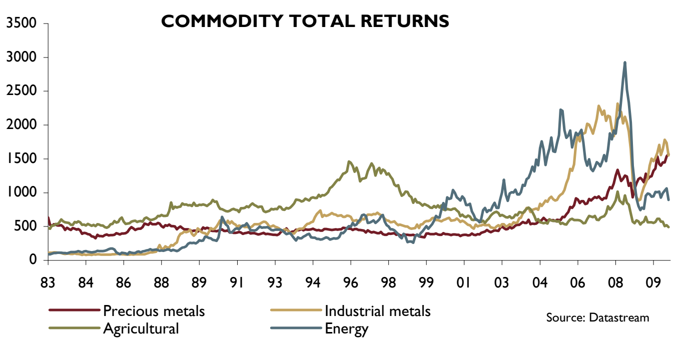
Hedge funds have the potential to outperform when equity returns are low or negative.



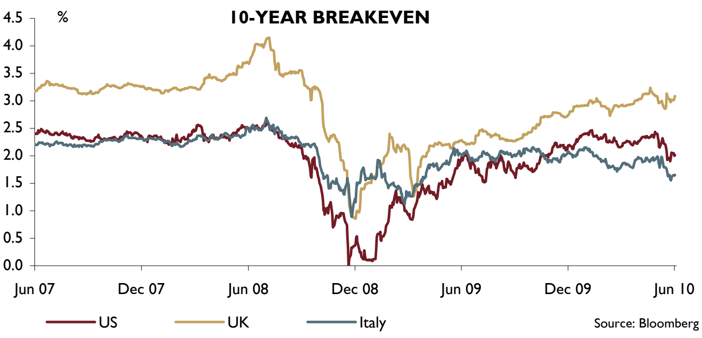
Currency weakness in Europe and the UK is part of the policy solution…



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



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



Investment Strategy Recommendations

Tactical Recommendations	Short-Term 3 Months	Long-Term 12-18 Months	Curr.	Relative Performance (01/06/10) -1M	-3M	-6M	YTD	2009
ASSET CLASS								
Equities vs Bonds	Neutral	Positive	Loc.	-10.5	-5.1	-3.9	-7.0	24.8
Corporate vs Government Bonds	Positive	Positive	USD	-0.9	1.0	3.6	1.2	8.7
High Yield vs Corporate Bonds	Negative	Positive	USD	-4.2	2.6	10.8	3.9	56.8
REGIONAL EQUITY								
US Equity vs Rest of the World	Positive	Negative	Loc.	-3.5	-1.0	-1.1	1.0	0.9
UK Equity vs Rest of the World	Negative	Positive	Loc.	2.9	-0.1	1.0	1.0	2.1
Europe Equity vs Rest of the World	Negative	Positive	Loc.	4.2	1.2	-0.7	-1.5	2.8
Japan Equity vs Rest of the World	Negative	Neutral	Loc.	-2.1	1.7	6.2	1.2	-18.9
Far East (ex JP) vs Rest of the World	Neutral	Positive	Loc.	1.9	-2.0	-2.7	-3.5	19.8
Emerging vs Developed Equity	Neutral	Positive	USD	1.0	1.9	1.9	0.1	48.5
STYLE								
World Small vs Large Equity	Neutral	Neutral	USD	-1.3	3.5	9.2	6.7	14.1
ALTERNATIVE ASSETS								
UK Real Estate vs Cash (as Apr'10)	Positive	Positive	GBP	1.4	5.4	14.1	6.7	0.0
Oil vs Cash	Negative	Positive	USD	-19.2	-7.1	-13.0	-10.3	27.5
Gold vs Cash	Positive	Positive	USD	3.5	9.4	1.8	11.5	21.4