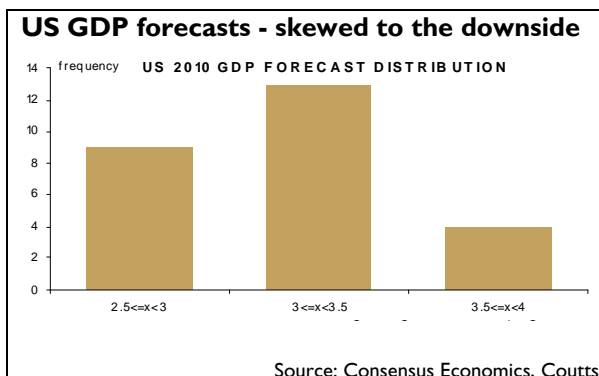


Markets may be surprised by sustained recovery

Investors are still viewing the glass as half empty, but fears that recovery will stall as government and central bank stimulus measures are withdrawn may be overblown. We expect further evidence of a revival in private demand, as broader recovery takes over from inventory rebuilding, and this will help risk assets to continue outperforming government bonds. Within the equity markets, this should also favour cyclical over defensive sectors.

Misplaced apprehensions

As the global economic recovery has gained increasing traction over the past several months, consensus GDP forecasts for all the major economies have gradually edged upwards. Nevertheless, there is considerable apprehension that the upswing will run out of steam and that a double-dip recession will ensue. As the chart below shows, this is reflected in a distribution of GDP forecasts that is skewed to the downside. Of a total of 26 forecasts, nine predicted 2010 GDP growth between 2.5% to 3.0%, whereas only four saw growth in the 3.5% to 4.0% range, while the consensus estimate was for 3.1% growth.

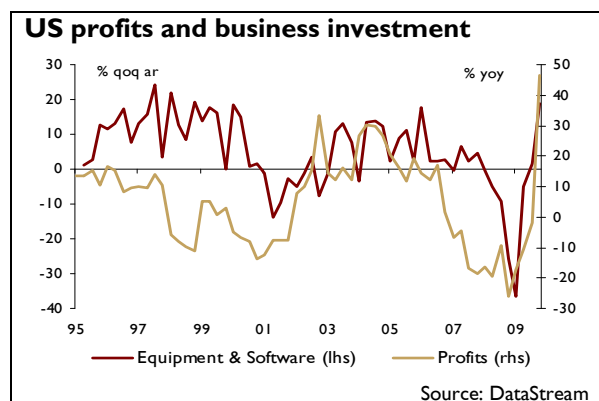


Specifically, it is feared that either private sector demand will fail to take over from fiscal and monetary stimulus and the inventory cycle as the

driver of recovery, or that loose monetary and fiscal stances will be tightened too sharply. Consequently, further good economic news would come as a surprise.

Making the transition to sustained recovery

There are increasing signs that a sustained revival of private-sector demand is underway, making the transition from inventory rebuilding to a broader global recovery. Crucially, company profits are recovering worldwide, which should in turn drive the overall economic recovery. Where profits lead, business spending tends to follow - whether on inventory, business equipment or labour.



According to the US national accounts, a strong pick-up in US IT business investment is underway. This began to rise in the second quarter (Q2) of 2009 but expanded at an annualised rate of 25% in Q4 2009, its strongest quarterly performance since Q1 2000. High-tech capital expenditure was cut back more severely in the 2008/09 recession than in the wake of the over-investment boom of the late 1990s. It is likely that US companies are now spending heavily on IT in an effort to secure further productivity gains. German capital goods orders and the euro-zone confidence survey suggest that capital spending will strengthen in Europe as well.

Carl Astorri
+ 44 20 7753 1612
firstname.lastname@coutts.com

Jean-Maurice Ladure
+ 44 20 7753 1469

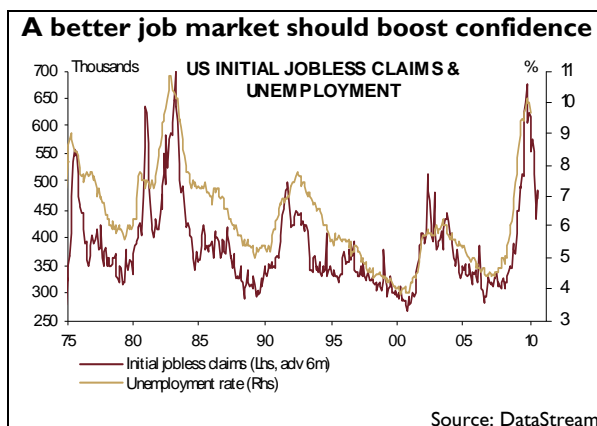
Henry Lancaster
+ 44 20 7957 2426

Georgios Tsaouris
+44 20 7753 1888

Labour markets have turned a corner too

Labour markets are also responding increasingly favourably. The employment components of the ISM surveys of the US manufacturing and services sectors have shown sustained improvement in recent months. US jobless claims data also suggest that the unemployment rate will fall further, helping to boost consumer confidence and spending. In Europe the latest German and Belgian business confidence data are pointing to a renewed upswing, after appearing to peak a couple of months ago.

If we are right, and private-sector demand is experiencing a sustained revival, equities and corporate bonds should continue to outperform government debt, and companies that are more exposed to changes in the economic cycle are likely to continue to be favoured over defensive sectors.



Carl Astorri
+ 44 20 7753 1612
firstname.lastname@coutts.com

Jean-Maurice Ladure
+ 44 20 7753 1469

Henry Lancaster
+ 44 20 7957 2426

Georgios Tsapouris
+44 20 7753 1888

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