

Monthly Investment Strategy Update - February 2010

China is overtaking the US as the driver of global growth.

The US economy, traditionally the driver of global growth, appears to have transitioned from recession into recovery, although recent data has been mixed. This contrasts strongly with China, where recent statistics have exceeded market expectations. Indeed, **whereas US economic activity remains significantly below pre-crisis levels, many indicators in China have surpassed their previous peaks.**

The US economy has made the transition from late recession to recovery...

The recent stabilisation in US unemployment and slight rise in industrial capacity utilisation suggest the economy has made the transition from late recession to recovery. This confirms existing signals from our recession probability model and has important implications for asset class returns. In the second half of a recession risk assets such as equities and corporate bonds typically perform very strongly and P/E ratios rise in anticipation of recovery, as has been happening over the last ten months.

...a harbinger of more muted equity returns in 2010.

Yet once recovery takes hold equity returns tend to be much lower than in the final stages of the recession. Earnings grow strongly, but returns weaken as equity markets have already anticipated and priced-in rising profits. Nevertheless equities tend to outperform government bonds, whose prices move inversely to rising yields. This is what we expect to happen over the course of 2010.

Government bonds face a combination of cyclical pressure and fiscal-policy concerns.

In addition to the ordinary cyclical pressures that are expected to push bond yields higher in 2010, there is also a positive correlation between bond yields and both government deficits and debt-to-GDP ratios. **If politicians do not come up with more credible plans to restore public finances, markets will force them to** via some combination of higher bond yields and weaker currencies.

Index-linked and corporate bonds look set to outperform government debt.

In this environment **we continue to favour index-linked over conventional government bonds.** Index-linked bonds offer protection against the temptation for governments to use inflation as a covert way of defaulting on their debt. **We also favour credit over government bonds,** due to the yield pick-up and the potential for high-grade corporate bonds to surpass government debt as the new risk-free benchmark.

The first signs of tightening usually trigger a correction, which proves to be a buying opportunity...

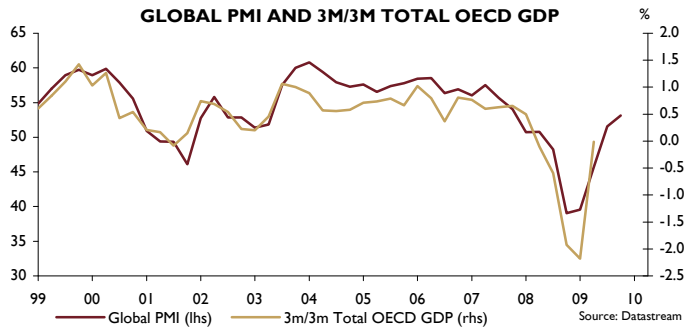
In the near term there is a very good chance of a sell-off in equity markets. History shows that in recoveries from big secular bear markets, like the recent one, the first monetary tightening tends to trigger a big correction. The correction usually proves to be a buying opportunity, however, as it becomes clear that recovery is continuing. **Past corrections tended to be triggered by the US Federal Reserve (Fed).** For now the Fed continues to signal steady rates for at least another twelve months.

...but this time the trigger is likely to be China and not the Fed.

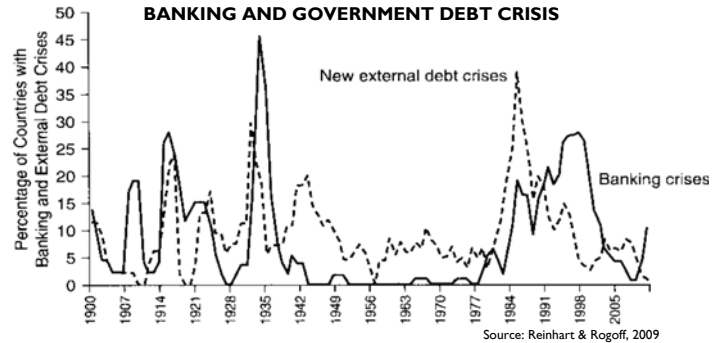
But the Fed is no longer the only game in town. China's central bank has started to tighten policy by increasing bank reserve requirements, curbing bank lending and increasing rates by a token amount. The Chinese, via rapid lending growth and very aggressive fiscal stimulus, have almost single-handedly kept the global economy afloat over the past year. Chinese tightening is a significant development with potential to upset markets, and has come against the backdrop of dangerously bullish equity-market sentiment.

Macro-Economic Scenario in Pictures

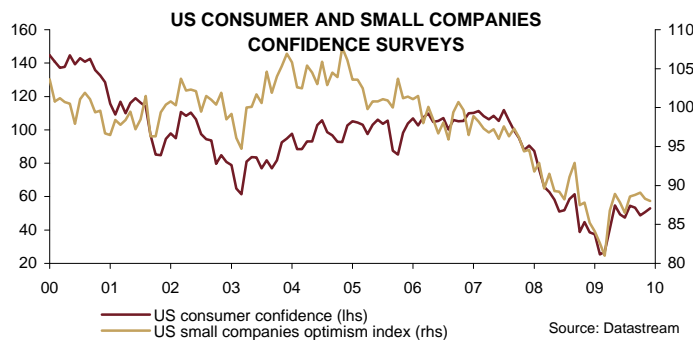
Surveys suggest that the global economy is growing again, albeit more slowly than pre-crisis.



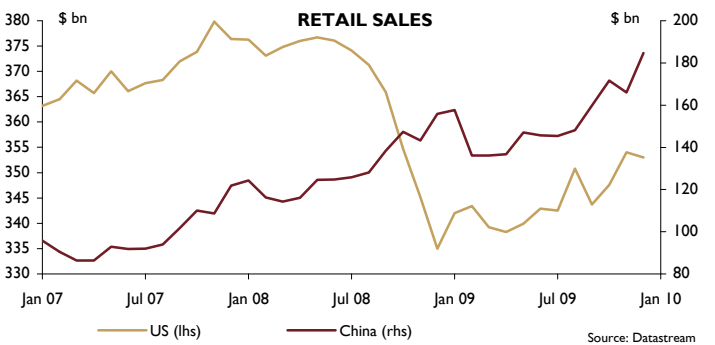
Fiscal steps to stabilise the economy and financial system have in the past resulted in debt crises.



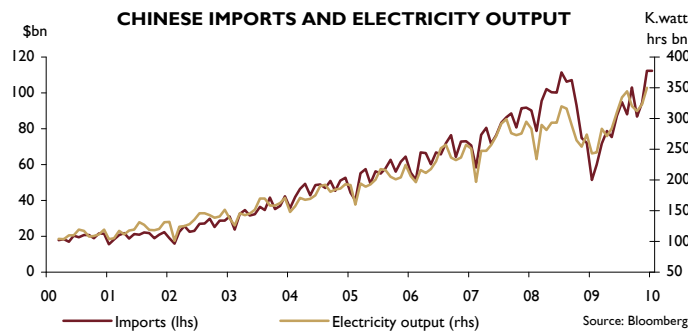
Although big businesses are feeling more confident, small business and consumers are not.



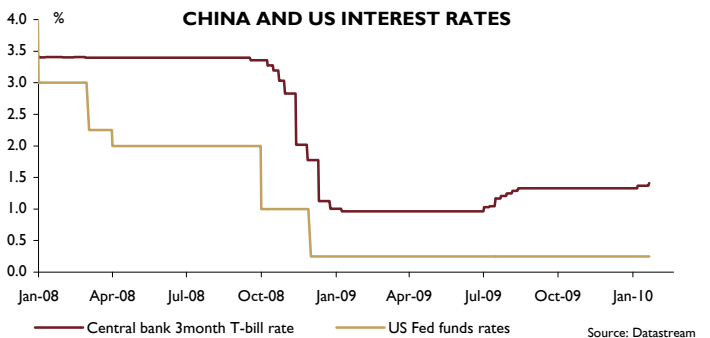
Declining US retail sales have been more than offset by gains in China.



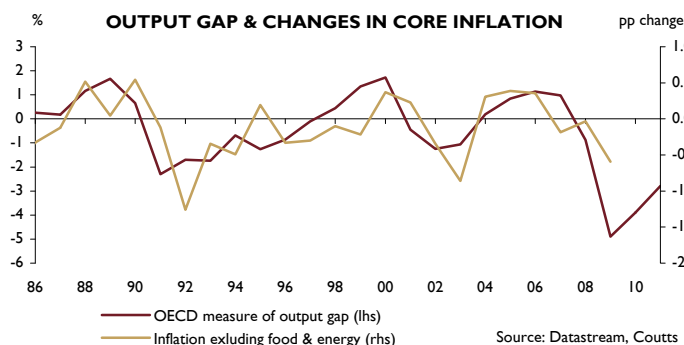
Chinese imports and electricity output have exceeded their pre-crisis highs.



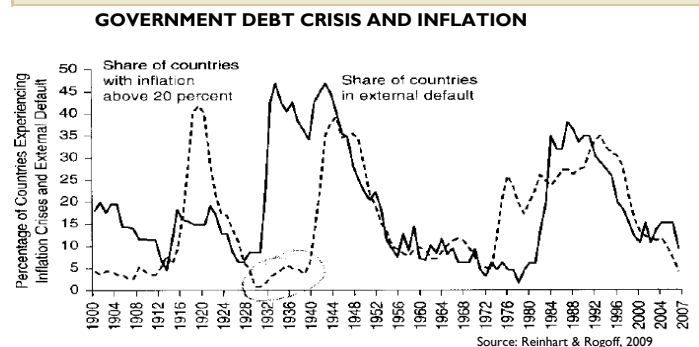
Unlike the major developed economy central banks, China has started tightening.



Cyclical forces will continue to put downward pressures on core inflation rates...

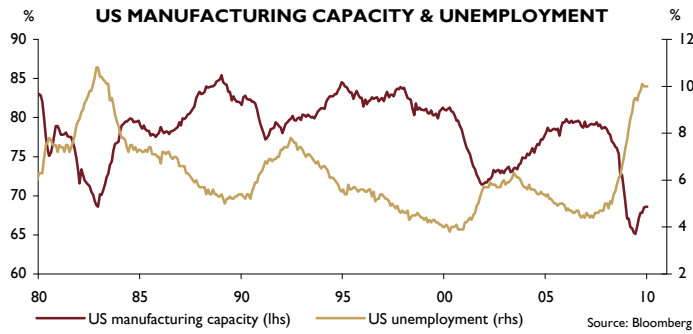


... but history warns that debt crises and inflation often go hand in hand.

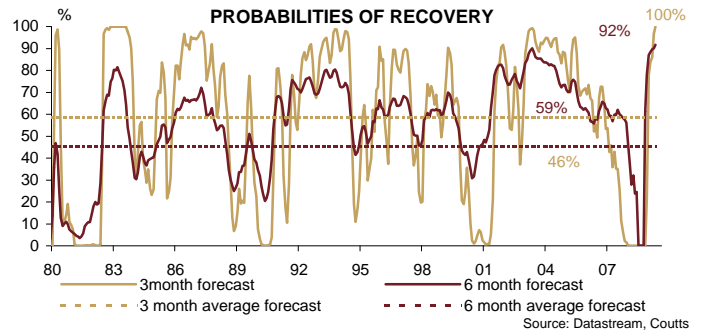


Investment Strategy in Pictures

Capacity utilisation has bottomed and unemployment looks to be close to a peak signalling the recovery phase has been entered...



... a message confirmed by our recession probability model.

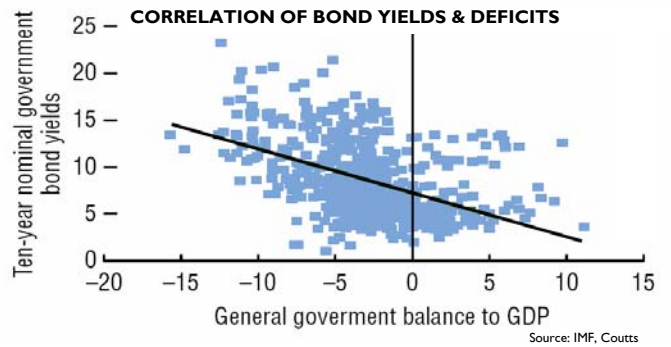


Now that we are in recovery phase, equity returns will be lower and earnings-driven.

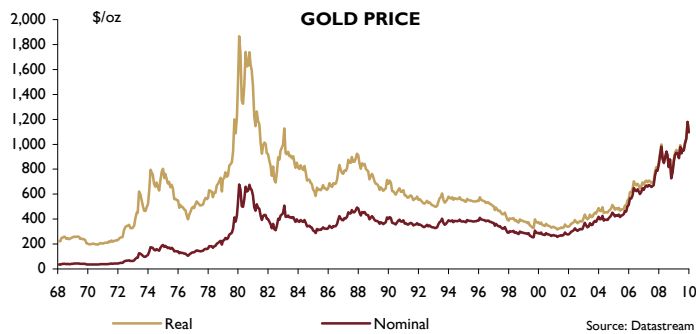
ECONOMIC CYCLE & EQUITY VALUATION				
Cycle phase	Duration (in months)	% Δ Real PE	% Δ Real Earnings	% Δ Real Price
Early Recession	15	2	-10	-7
Late Recession	9	39	-5	24
Recovery	20	-8	16	5
Expansion	20	5	24	29
Slowdown	9	3	-10	-8

Source: MSCI, Coutts

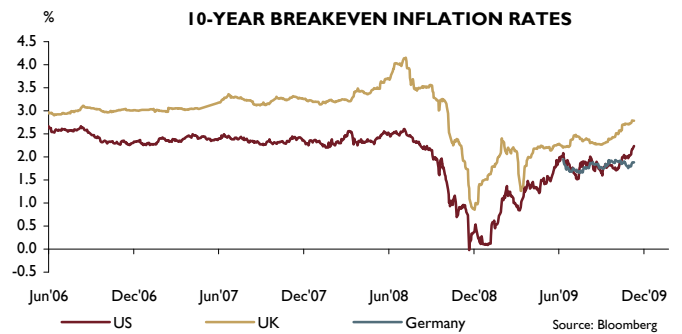
Fiscal concerns point to the risk of a rise in bond yields.



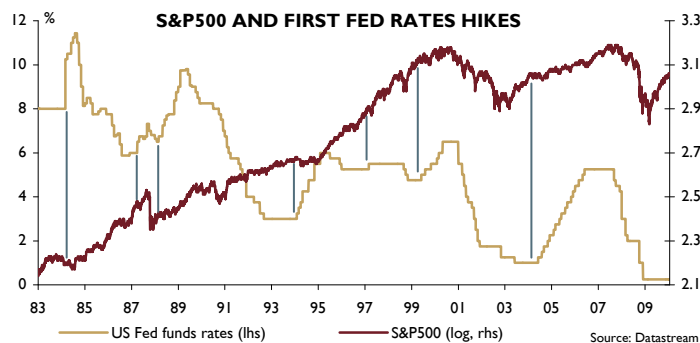
Gold is an alternative liquid store of value to government bonds.



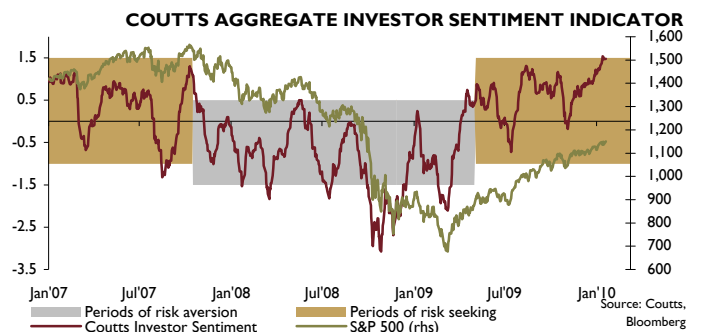
Linkers still offer the opportunity to hedge inflation risk.



Equity markets are often hit by the first rate tightening and...



... investor sentiment suggest markets are vulnerable.





Investment Strategy Recommendations

Tactical Recommendations	Short-Term 3 Months	Long-Term 12-18 Months	Relative Performance (21/01/10)					
			Curr.	-1M	-3M	-6M	YTD	2009
ASSET CLASS								
Equities vs Bonds	Positive	Positive	Loc.	1.2	1.7	14.2	-0.5	24.8
Corporate vs Government Bonds	Positive	Positive	USD	1.0	1.8	2.7	0.4	8.7
High Yield vs Government Bonds	Positive	Positive	USD	3.2	6.5	18.5	1.5	56.8
REGIONAL EQUITY								
US Equity vs Rest of the World	Negative	Negative	Loc.	-1.3	2.7	3.4	0.6	0.9
UK Equity vs Rest of the World	Positive	Positive	Loc.	-0.4	-0.4	5.2	-1.6	2.1
Europe Equity vs Rest of the World	Positive	Positive	Loc.	-2.0	-4.4	0.0	-2.2	2.8
Japan Equity vs Rest of the World	Negative	Neutral	Loc.	7.4	3.9	-8.6	6.0	-18.9
Far East (ex JP) vs Rest of the World	Positive	Positive	Loc.	2.4	-2.4	1.8	-1.3	19.8
Emerging vs Developed Equity	Positive	Positive	USD	2.7	0.9	4.9	-0.7	48.5
STYLE								
World Small vs Large Equity	Positive	Neutral	USD	1.9	1.3	6.1	1.7	14.1
ALTERNATIVE ASSETS								
UK Real Estate vs Cash (as Dec'09)	Positive	Positive	GBP	3.6	9.3	12.4	-	0.0
European Real Estate vs Cash	Positive	Positive	-	-	-	-	-	-
Oil vs Cash	Neutral	Positive	USD	1.3	-9.2	4.5	-5.1	27.5
Gold vs Cash	Positive	Negative	USD	0.6	3.4	15.8	0.6	21.4

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