

## Monthly Investment Strategy Update - January 2010

**The new year should usher in better fortunes for the world economy, but headwinds are likely to preclude a return to pre-crisis growth levels.**

The prospects for the global economy in 2010 are brightening, with boosts from policy stimulus, inventory rebuilding and, for Asian economies, a recovery in world trade. That said, we expect the path of the recovery to be sawtoothed, with scope for the occasional quarter of economic contraction. **The pace of growth is unlikely to match that of the pre-crisis boom years, with consumer de-leveraging, credit constraints and fiscal tightening expected to dampen momentum.** Growth should also ease slightly from the second half as policy stimulus is replaced by private sector demand.

**The lack of an inflation threat in developed economies suggests interest rate rises are off the cards for now.**

The large amount of spare capacity in the economy means that deflation remains more of a risk than inflation over the next couple of years in the major developed economies. This suggests that **central banks are only likely to start increasing interest rates in the second half of 2010 at the earliest, though it will probably be sooner for emerging markets** as capital inflows, managed currencies and rapid money growth pose greater asset or goods inflation risks over the next two years.

**Risk assets are in the ascendant in this phase of the cycle, but gains will be less pronounced than in 2009.**

The environment of moderate growth, subdued inflation and low interest rates is positive for risk assets, which should outperform government bonds until markets start to worry about rate rises in the US or China. However, returns are expected to fall short of gains made in 2009. **Lack of scope for further re-rating suggests equity advances will be harder won and more limited, with the onus on fundamentals, including earnings, to drive returns.** The sawtoothed nature of the economic recovery should also fuel volatility in equity markets. Emerging markets, particularly Asia, remains our preferred regional equity market and the world's top growth engine. The resource-intensive nature of this region's growth should also underpin advances in commodity prices.

**Corporate and emerging market bonds should outpace conventional government bonds...**

Within bond markets, government bond yields are unlikely to rise significantly in the near term given large output gaps. Further out, however, global recovery, the end of quantitative easing and large fiscal deficits should exert upward pressure. We believe **more favourable markets are corporate bonds and emerging market bonds, which still offer yield pick-up over developed economy sovereigns and some scope for further spread narrowing.** Emerging market bonds are also a way of benefiting from potential emerging market currency strength.

**...as should index-linked bonds.**

Meanwhile, base effects which are pushing up headline inflation should allow index-linked bonds to again outperform conventionals in 2010. However, the margin should be less than in 2009 given that the hefty illiquidity discount present at the start of the year has been largely arbitrated away. **Linkers also offer insurance against the risk of policy stimulus proving more inflationary than envisaged.**

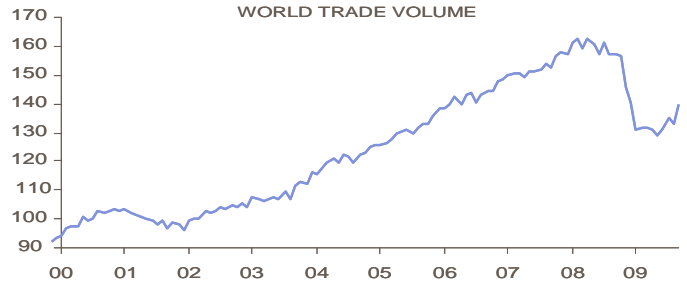
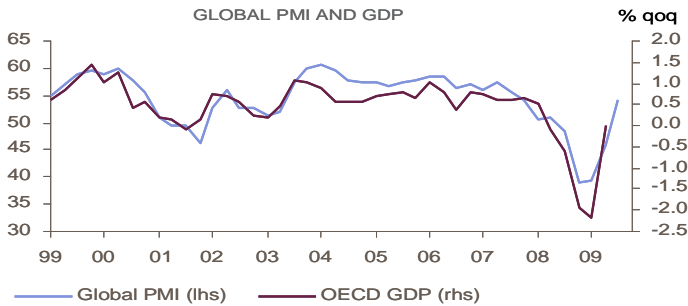
**UK commercial property is likely to return to favour.**

Within alternative asset classes, **UK commercial property should deliver positive returns in 2010 for the first time since 2006**, with yields comparing very favourably with those of government bonds. However, returns may be below those of the boom era because of the lack of credit to fuel a bubble. If a property bubble does emerge over the coming years, it is more likely to be in emerging markets with pegged or managed exchange rates.

# Macro-Economic Scenario in Pictures

Prospects for the global economy in 2010 are considerably brighter...

...thanks to stimulus, inventory rebuilding and a recovery in trade.

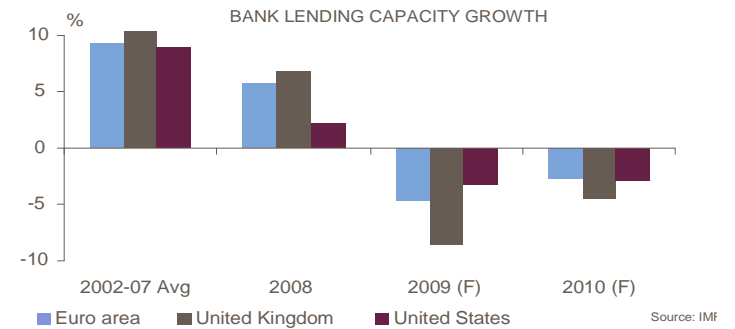


But the pace of growth will not match that of the boom years...

...given headwinds, such as constrained bank lending...

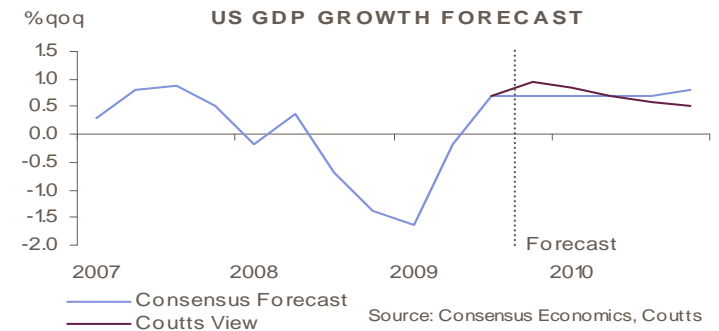
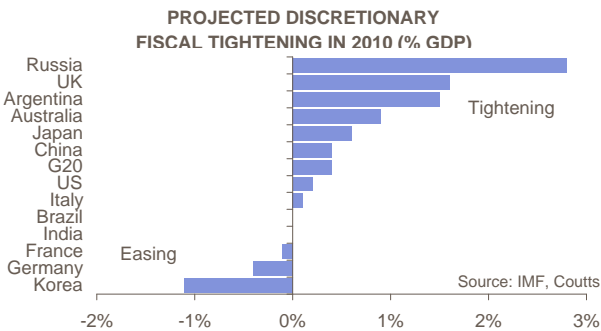
**GDP GROWTH FORECASTS (%)**

	90-05 Avg	2006	2007	2008	2009 (F)	2010 (F)
US	2.9	2.8	2.0	0.4	-2.5	2.5
UK	2.4	2.8	3.0	0.7	-4.5	1.25
Eurozone	1.9	2.9	2.7	1.0	-4.0	1.75
Japan	1.5	2.0	2.4	-0.7	-5.0	3.0
Asia-Pacific	7.6	8.8	9.5	6.6	5.0	7.0
China	9.6	11.6	13.0	9.0	8.5	9.0
India	5.7	9.9	9.2	7.5	5.5	6.5
Latin America	2.9	5.1	4.6	4.3	-3.0	3.0
Emerging Europe	1.2	6.9	7.0	4.5	-5.0	2.0
World (PPP)	3.5	5.1	5.2	3.0	-1.5	3.75



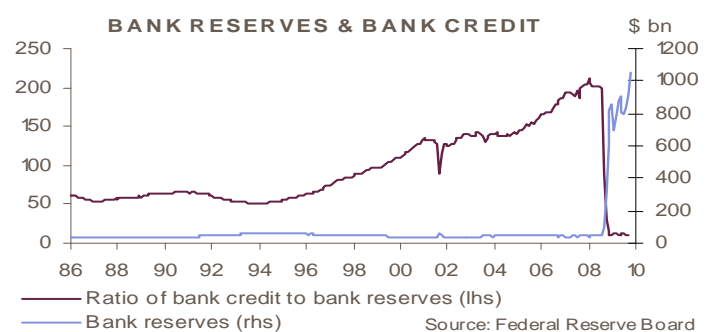
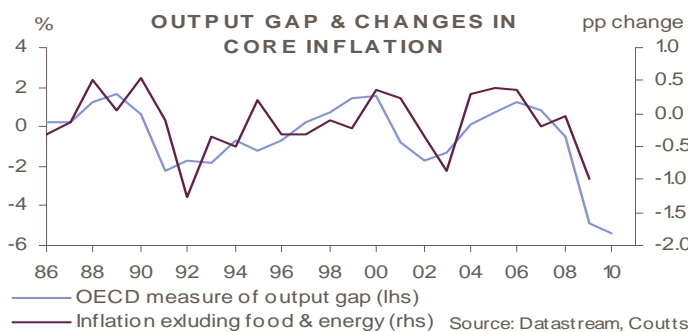
...and as governments eventually tighten their belts.

Growth may also lose momentum in the second half of 2010 as stimulus fades.



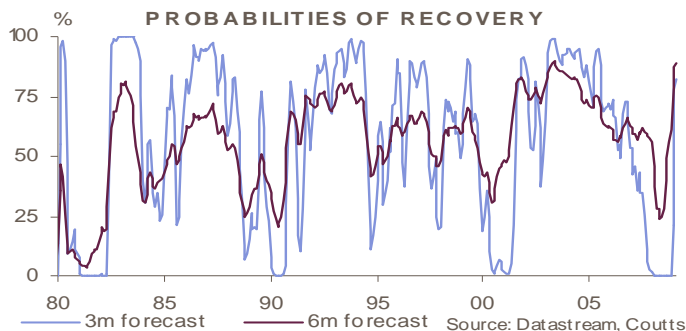
Given excess capacity, deflation is more of an immediate threat than inflation in developed economies.

Money created by central banks is trapped in the banking system. QE is currently anti-deflationary, not inflationary.



# Investment Strategy in Pictures

The global economy is moving from recession to recovery...



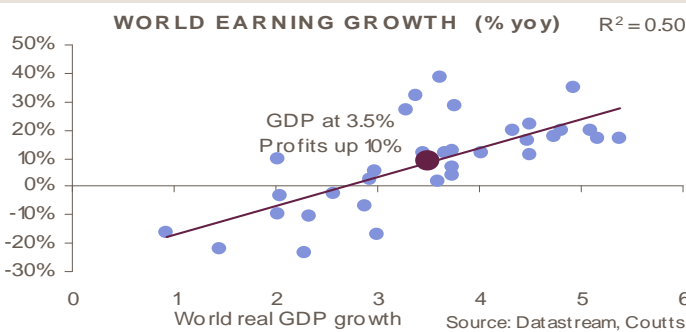
...a phase of the cycle which tends to favour cyclical assets - though returns are usually lower than the late recession phase.

HISTORICAL ASSET CLASS PERFORMANCE (Total Return annualised in %)

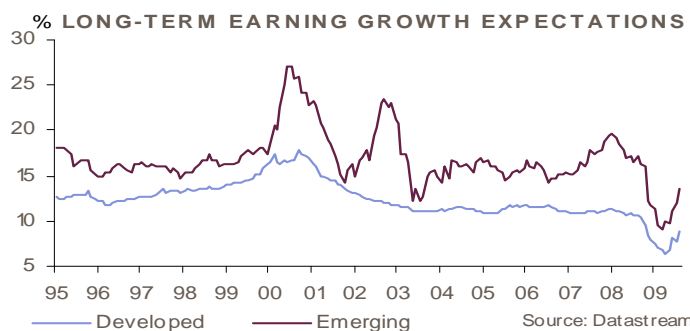
	Late Recession	Recovery	Expansion
US Government Bonds	11	7	7
US Investment-Grade Bonds	13	6	12
US High-Yield Bonds	31	8	13
US Equities	20	6	24
Emerging Equities	59	22	31
US Small-Cap Equities	27	4	22
Commodities	15	5	20
Crude Oil	32	19	19
Industrial Metals	9	11	30
Gold	6	2	1
Direct Property (IPD)	3	15	16

Source: Coutts

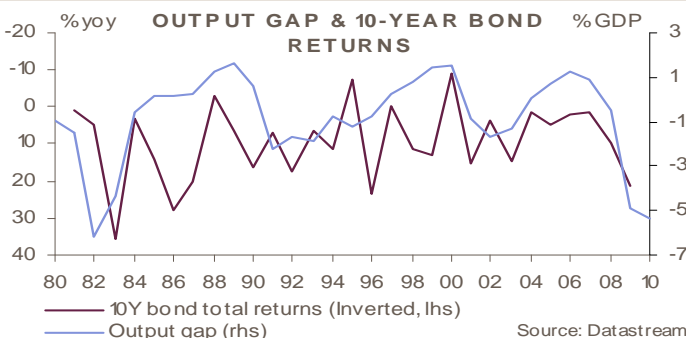
Equity returns should be more limited than in 2009, with gains driven by profits rather than re-rating.



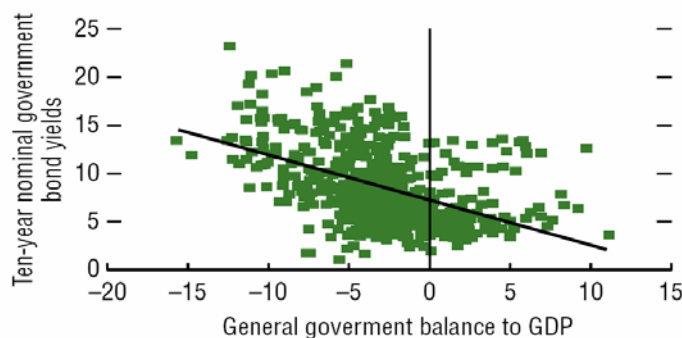
We favour emerging markets because of superior growth prospects.



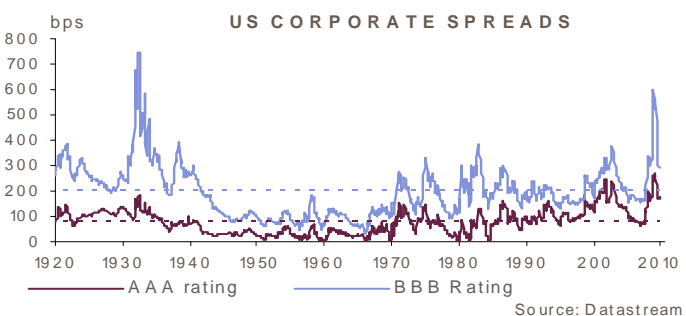
Large output gaps mean there is little immediate threat of a large rise in government bond yields...



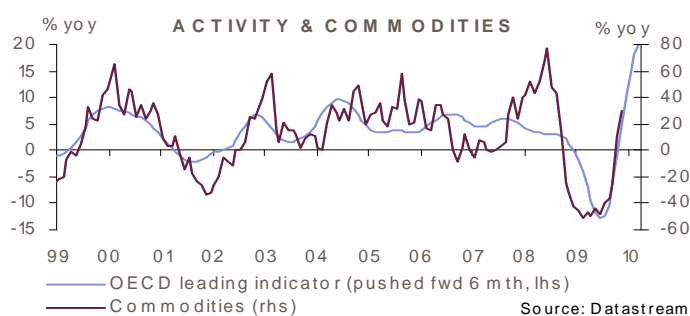
...but over the longer term, there should be upward pressure from trends such as increasing budget deficits.



We prefer corporate bonds, given their yield pick-up and some scope for spread narrowing.



Commodities also have further upside given the economic recovery story.





## Investment Strategy Recommendations

Tactical Recommendations	Short-Term 3 Months	Long-Term 12-18 Months	Relative Performance (16/12/09)					
			Curr.	-1M	-3M	-6M	YTD	2008
<b>ASSET CLASS</b>								
Equities vs Bonds	Positive	Positive	Loc.	0.3	1.9	15.8	22.9	-47.8
Corporate vs Government Bonds	Positive	Positive	USD	0.3	0.7	0.9	7.5	-10.3
High Yield vs Government Bonds	Positive	Positive	USD	2.6	5.1	12.2	53.5	-37.1
<b>REGIONAL EQUITY</b>								
US Equity vs Rest of the World	Negative	Negative	Loc.	-0.5	2.7	6.3	1.9	2.1
UK Equity vs Rest of the World	Positive	Positive	Loc.	-1.5	1.9	6.3	1.1	11.2
Europe Equity vs Rest of the World	Positive	Positive	Loc.	-0.7	-0.7	3.4	3.0	-4.8
Japan Equity vs Rest of the World	Negative	Neutral	Loc.	4.8	-5.4	-21.9	-19.1	-4.4
Far East (ex JP) vs Rest of the World	Positive	Positive	Loc.	-1.9	-0.8	1.3	16.0	-3.5
Emerging vs Developed Equity	Positive	Positive	USD	-0.1	4.0	6.1	45.9	-12.6
<b>STYLE</b>								
World Small vs Large Equity	Positive	Neutral	USD	0.2	-2.5	2.9	12.9	-1.2
<b>ALTERNATIVE ASSETS</b>								
UK Real Estate vs Cash (as Nov'09)	Positive	Positive	GBP	2.9	7.3	8.1	-3.5	-29.4
European Real Estate vs Cash	Positive	Positive	-	-	-	-	-	-
Oil vs Cash	Positive	Positive	USD	-6.7	0.4	-1.0	21.7	-57.3
Gold vs Cash	Positive	Negative	USD	-0.4	11.2	21.0	25.9	-0.2

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