

Monthly Investment Strategy Update - March 2010

Debt burdens - a legacy of the financial crisis - will suppress growth in major developed economies.

We continue to favour emerging market equities to developed markets, where the financial crisis has had the affect of suppressing longer-term relative growth prospects. The past 60 years' history teaches that deleveraging the consumer, banking and public sectors of the developed economies will take six to eight years, while very high public-sector debt burdens have tended to shave about one percentage point from median growth rates. The corollary to weaker activity in high-debt economies such as Japan, the US, the UK, France, Spain and Greece will be higher average growth in economies with low debt ratios, such as China, Brazil, Australia and Norway.

Excess capacity and fiscal tightening will exert downward pressure on core inflation...

Excess capacity and the necessary tightening of fiscal policy in the major developed economies will keep downward pressure on core inflation rates, despite base effects and a variety of "one-off" factors pushing up headline inflation. This is particularly true of service-sector inflation, which is driven by earnings growth. Against this backdrop, official interest rates will rise much more slowly in the developed than in the emerging economies.

...although large government deficits bring structural inflation risks, making index-linked and corp bonds more attractive than governments.

Nevertheless, it is important to acknowledge that large government deficits bring with them structural inflation risks. Historically banking crises have been followed by debt crises, which have often gone hand in hand with inflation crises as a covert way of defaulting on domestic currency debt (by reducing the real, or inflation-adjusted, debt burden). Consequently, we continue to prefer corporate and index-linked bonds to the government bonds of the major developed economies.

Emerging-market bonds and gold look like better stores of value than Treasuries and gilts.

Indeed **many emerging bond markets, with their low debt ratios and deficits, look like better stores of value than gilts and Treasuries, and so does gold.** For the time being risk aversion, spare capacity and quantitative easing are all keeping a lid on the pressure cookers that are the US and UK bond markets. But eventually, deteriorating fiscal positions are likely to cause bond yields to burst through the lid.

Equities also look like a better place to invest than government bonds, but returns are unlikely to be as strong as last year.

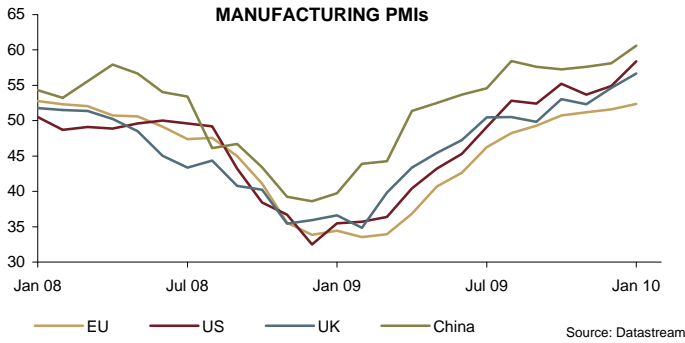
Late last year the global economy made the transition from late recession to a recovery, but one that is likely to be unusually long given the amount of spare capacity and the anaemic growth outlook. As a result developed equity-market returns are likely to be much weaker this year than last. This message is confirmed by the rise in cyclically adjusted PE ratios, from the cheapest to the most expensive quartile, as the equity market has rallied from the lows of last March. Still, **equities are likely to be a more rewarding place to invest than government bonds,** barring a large and disorderly, fiscally induced rise in bond yields in the major developed economies.

The statistical link between equities and fiscal conditions is less clear, but a threat nonetheless.

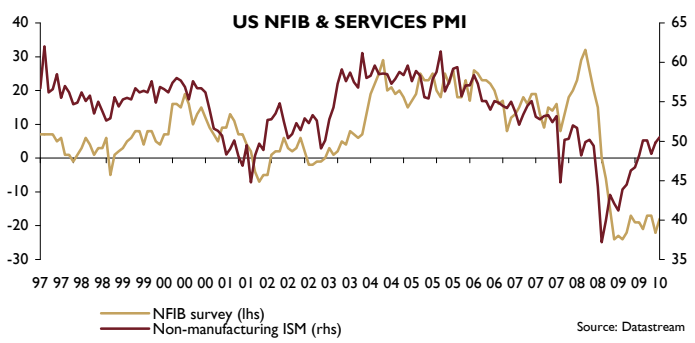
For equities, the statistical link between fiscal conditions and returns is less clear than for bonds. Still, it is hard to see how a rise in bond yields that is caused by fiscal pressures rather than growth and coupled with sharp fiscal tightening – were this to happen - could be positive for equity markets. Consequently, **if the rise in southern European government bond yields shows signs of infecting gilts and US Treasuries, equities are likely to correct strongly** and push valuations sharply lower.

Macro-Economic Scenario in Pictures

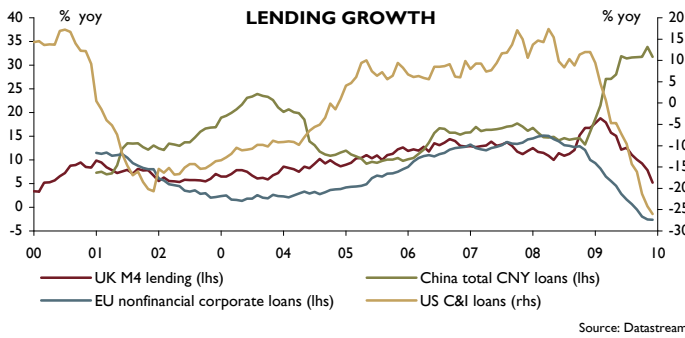
Surveys suggest that the global economy is growing again, albeit more slowly than pre-crisis.



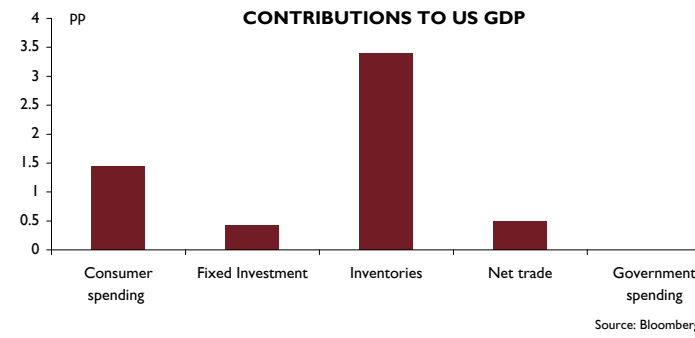
Fiscal steps to stabilise the economy and financial system have in the past resulted in debt crises.



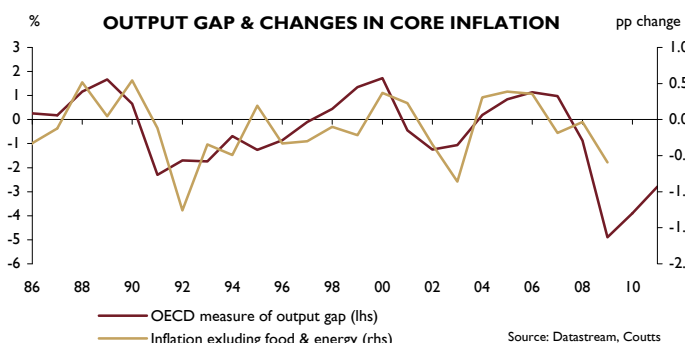
Although big businesses are feeling more confident, small business and consumers are not.



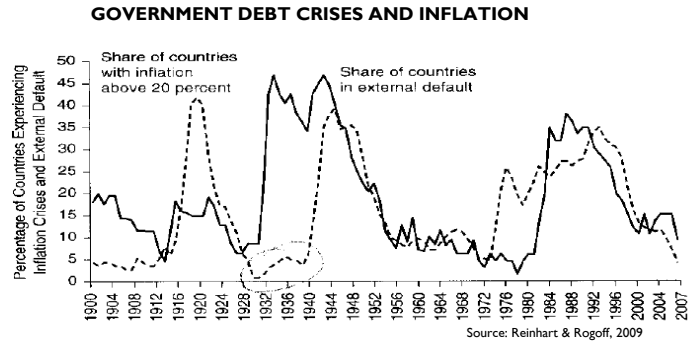
Declining US retail sales have been more than offset by gains in China.



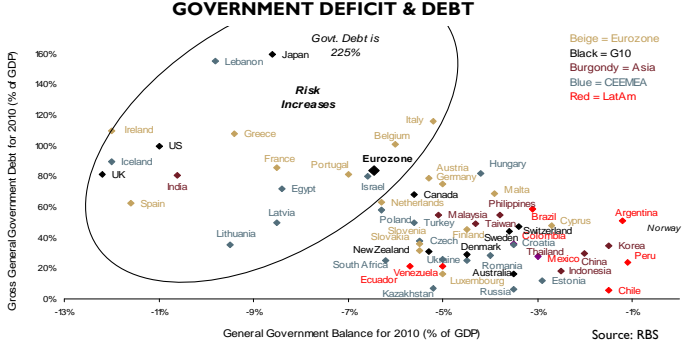
Chinese imports and electricity output have exceeded their pre-crisis highs.



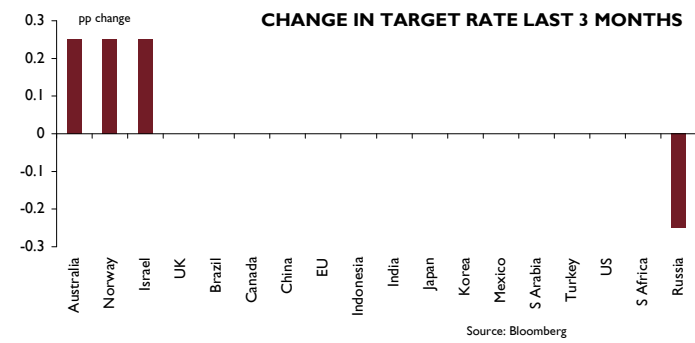
... but history warns that debt crises and inflation often go hand in hand.



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

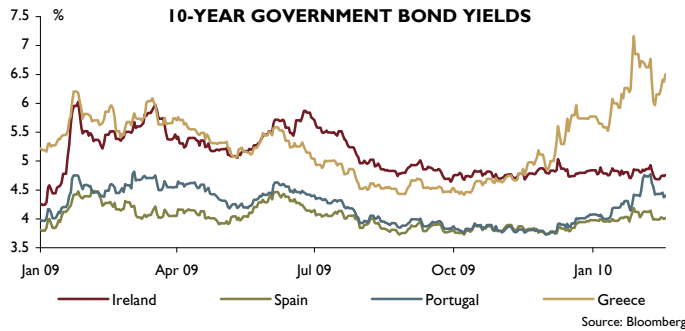


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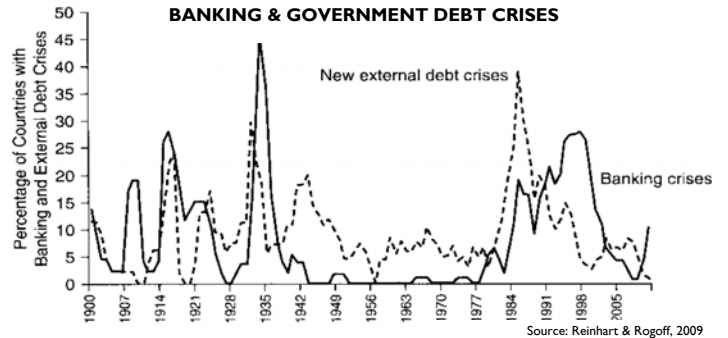


Investment Strategy in Pictures

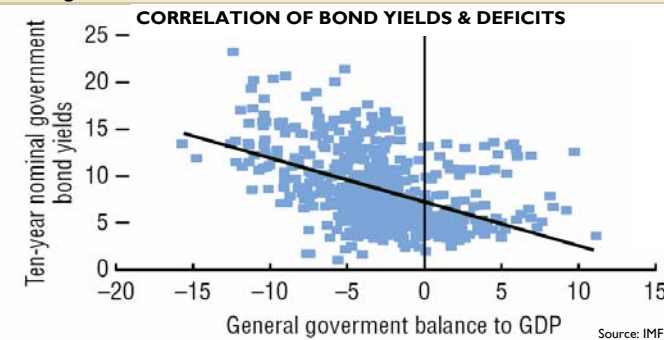
Capacity utilisation has bottomed and unemployment looks to be close to a peak signalling the recovery phase has been entered...



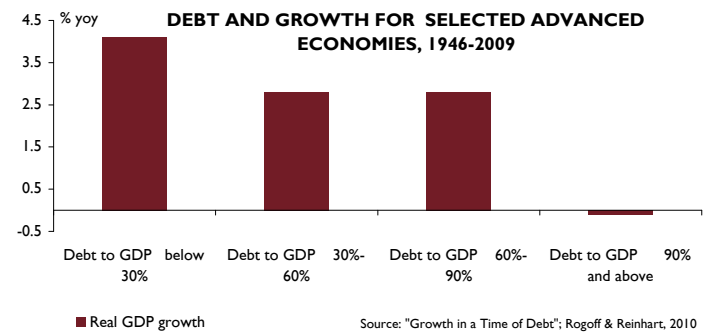
... a message confirmed by our recession probability model.



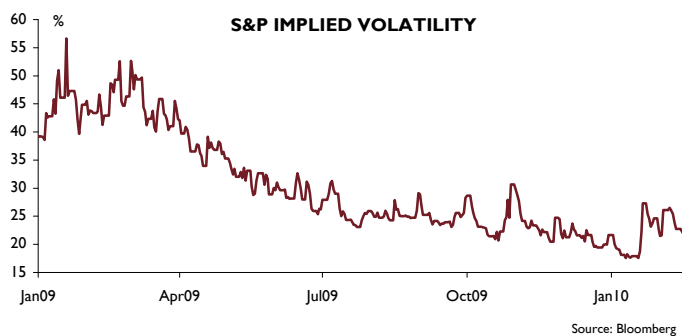
Now that we are in recovery phase, equity returns will be lower and earnings-driven.



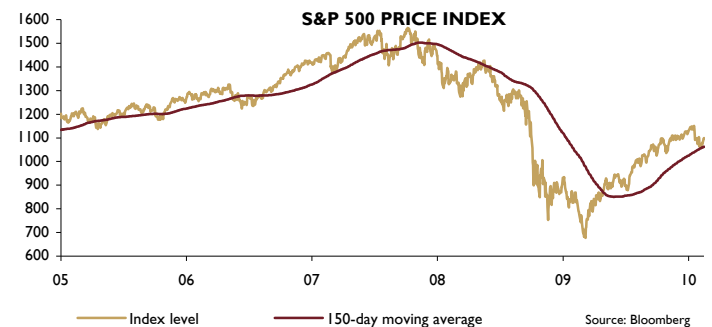
Fiscal concerns point to the risk of a rise in bond yields.



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...

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

... investor sentiment suggest markets are vulnerable.

HISTORIC PERFORMANCE FOLLOWING TIMES WHEN PE WERE AROUND CURRENT LEVELS

Performance after:	6M	1Y	3Y	5Y	7Y	10Y
Average (Annual)	5.7%	6.2%	6.5%	7.8%	8.5%	8.8%
Average (Total)	3%	6%	21%	46%	77%	133%
Worst performance	-40%	-62%	-33%	-58%	-32%	-4%
Probability of loss	37%	37%	23%	11%	3%	0%
Probability of large loss*	11%	14%	12%	6%	2%	0%

* Large loss = loss over 10%

Source: Coutts



Investment Strategy Recommendations

Tactical Recommendations	Short-Term 3 Months	Long-Term 12-18 Months	Relative Performance (17/02/10)					
			Curr.	-1M	-3M	-6M	YTD 2009	
ASSET CLASS								
Equities vs Bonds	Positive	Positive	Loc.	-3.8	-0.4	8.8	-2.6	24.8
Corporate vs Government Bonds	Positive	Positive	USD	0.2	1.8	1.6	0.3	8.7
High Yield vs Government Bonds	Positive	Positive	USD	-0.7	5.6	11.2	0.3	56.8
REGIONAL EQUITY								
US Equity vs Rest of the World	Negative	Negative	Loc.	1.2	-0.2	5.9	1.6	0.9
UK Equity vs Rest of the World	Negative	Positive	Loc.	0.9	-0.3	5.5	-0.2	2.1
Europe Equity vs Rest of the World	Neutral	Positive	Loc.	-1.1	-3.1	-1.4	-2.9	2.8
Japan Equity vs Rest of the World	Neutral	Neutral	Loc.	-3.4	7.2	-14.7	1.7	-18.9
Far East (ex JP) vs Rest of the World	Positive	Positive	Loc.	-0.4	-0.6	-1.8	-1.6	19.8
Emerging vs Developed Equity	Positive	Positive	USD	-1.4	-0.6	5.5	-1.6	48.5
STYLE								
World Small vs Large Equity	Positive	Neutral	USD	1.2	3.7	4.0	2.5	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	Neutral	Positive	-	-	-	-	-	-
Oil vs Cash	Neutral	Positive	USD	-2.3	-6.6	1.1	-4.1	27.5
Gold vs Cash	Positive	Negative	USD	-1.1	-2.0	19.2	2.0	21.4

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

Jean-Maurice Ladure
+44 20 7753 1469

Henry Lancaster
+44 20 7957 2426

George Tsapouris
+44 20 7753 1888