



## Monthly Investment Strategy Update - November 2009

**Growth has returned to the global economy, but will fall short of pre-crisis levels for some time.**

The global economy is expanding once again, led by Asia and emerging markets. But the pace of recovery is slow and activity remains far below pre-crisis levels. **Over the next few years, household and financial sector de-leveraging will exert considerable downward pressure on developed economy activity.** Consequently, the pace of growth will not return to the rates experienced before the recession.

**Risks are waning, but policy action and banks' health still have the power to de-rail the recovery.**

Downside risks to growth are receding gradually, but remain a concern. **The main short-term risk is that the recovery stalls and deflationary forces become entrenched,** either because of a premature exit from very accommodative monetary and fiscal policies, or as further bank write-downs cause credit conditions to deteriorate further.

**Risk assets are in the ascendant in this phase of the cycle...**

With activity recovering and enough excess capacity to rule out imminent rate rises, we are in the phase of the cycle which tends to favour risk assets. **Equities and corporate bonds tend to outperform government bonds, and emerging market equities usually lead developed markets.** This is also a time when, typically, oil outperforms cash and, as the recovery gains strength, so does UK commercial property.

**...suggesting equities will continue to advance - but gains will be checked by rising valuations.**

It is unlikely that equity markets will continue to rise anywhere near as quickly as they have done over the past six months. As tends to happen at this stage of the cycle, PEs have risen sharply, as markets have rallied in anticipation of an earnings recovery. However, **even though the equity-to-bond-yield ratio has also deteriorated, equities look fairly valued compared with government bonds.** So, on balance, valuation does not represent a significant obstacle to further equity outperformance. Yet gains will be harder won and now need to be driven by positive earnings surprises rather than by re-rating. We still favour Pacific ex Japan and emerging equity markets, as they don't face the same headwinds to growth as Western economies: consumer de-leveraging; credit constraints; and the need to rebuild public finances. However, their recent outperformance means that they are expensive.

**Corporate and index-linked bond returns should outstrip those of conventional government bonds.**

Within the bond asset class, we continue to favour corporate bonds and index-linked government bonds. Although no longer priced for a severe depression and despite recent strong advances, **corporate bond spreads offer an attractive yield pick-up over historically-low government bond yields.** Linkers offer insurance against long-term inflation risk from quantitative easing (QE) and large budget deficits.

**UK commercial property appears attractively valued...**

Valuation and momentum argue in favour of UK commercial property. **At 8%, the yield on UK commercial property is attractive relative to yields on cash and government bonds.** The momentum of commercial property is persistent, so its outperformance in August and September is a significant development. However, a lack of credit growth means that progress will be slow, and it's unlikely that another bubble is imminent.

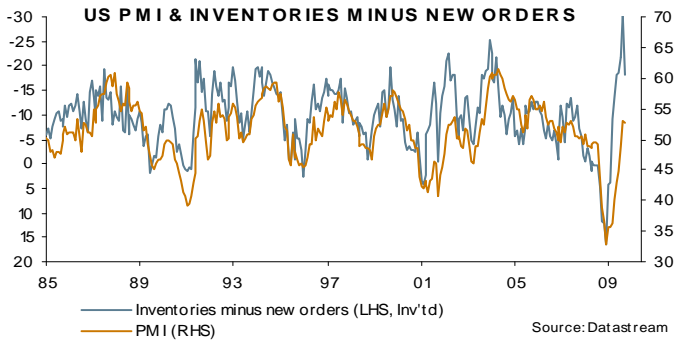
**...while commodities also remain in favour.**

**A weak dollar and a global recovery led by Asian and emerging economies are buoying commodity prices.** Dollar weakness, because of concerns about the potential inflationary impact of QE and large budget deficits, is also supportive.

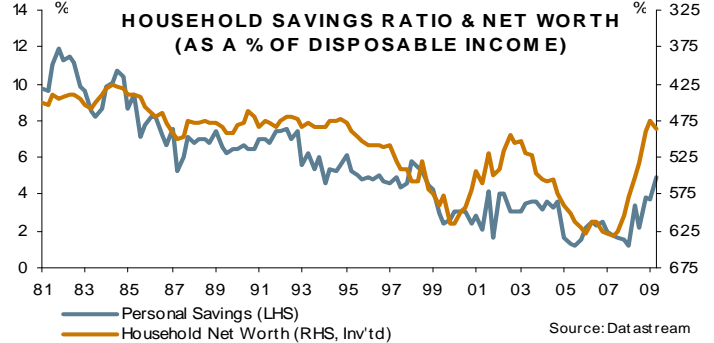


## Macro-Economic Scenario in Pictures

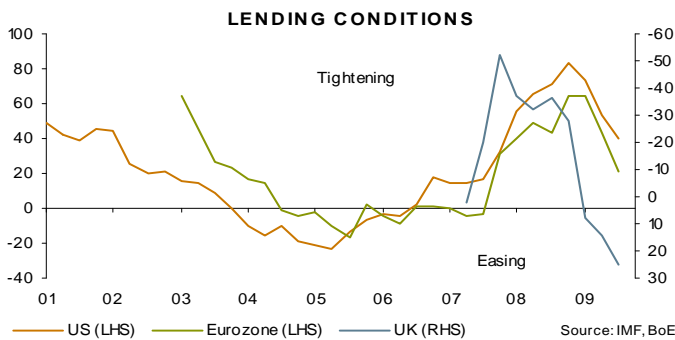
Manufacturing surveys show that the global economy is expanding again, led by a strong performance from Asia...



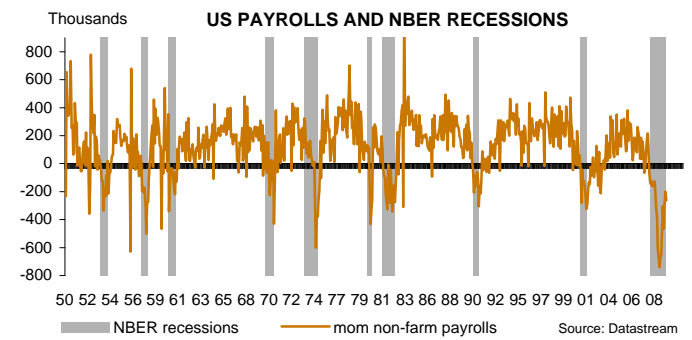
...but the pace of growth in the major developed economies will not return to pre-crisis levels, as consumers de-leverage...



...and financial conditions, although improving, remain difficult.



Because of the anaemic nature of the recovery, labour markets will remain weak for the next 12-18 months.



The process of weaning the economy off stimulus means that the recovery will be sawtoothed, with an upward trend.

Headwinds to growth from de-leveraging and constrained banking systems are less severe in emerging markets.

### US FISCAL STIMULUS

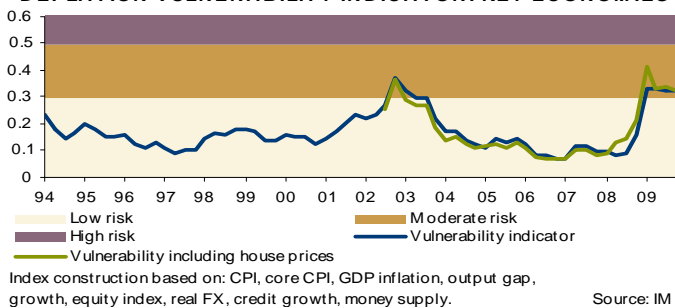
	Total Amount (\$ billions)	Share Disbursed in each Fiscal Year		
		2009	2010	2011
Discretionary spending	308	11%	36%	25%
Entitlements	267	32%	41%	18%
Revenues	212	31%	80%	8%
<b>Total</b>	<b>787</b>	<b>24%</b>	<b>50%</b>	<b>17%</b>
Impact (% GDP)	5.5	1.3	2.8	0.9

Source: Coutts, CBO

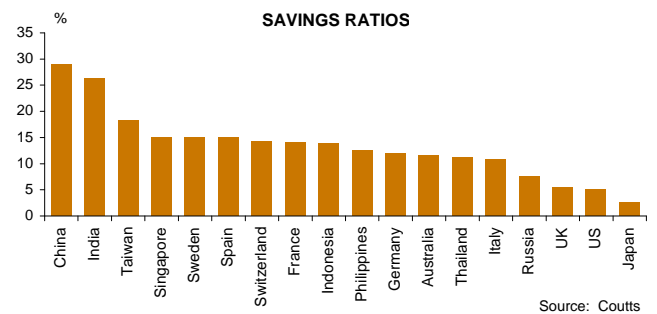
The main short-term risk is that the recovery stalls and deflationary forces become entrenched.

Excess capacity will keep inflation in check and interest rates on hold until the second half of 2010 at the earliest.

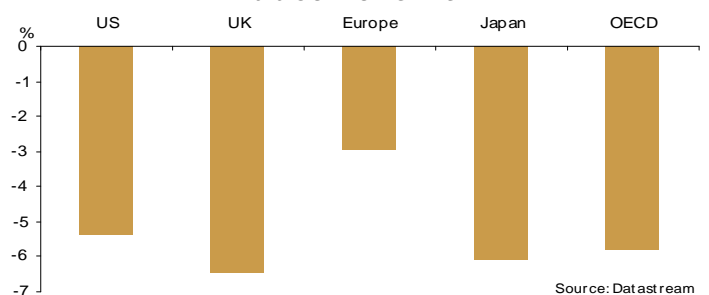
### DEFLATION VULNERABILITY INDICATOR: KEY ECONOMIES



### SAVINGS RATIOS



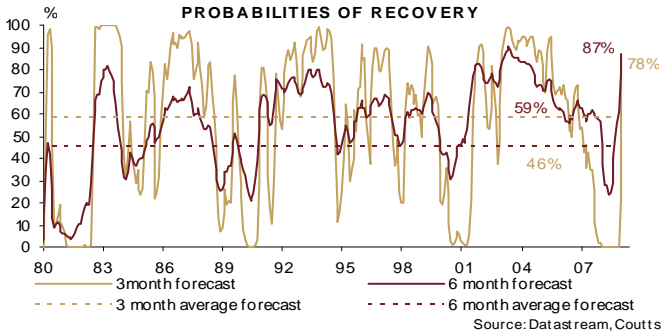
### 2010 OUTPUT GAPS





# Investment Strategy in Pictures

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



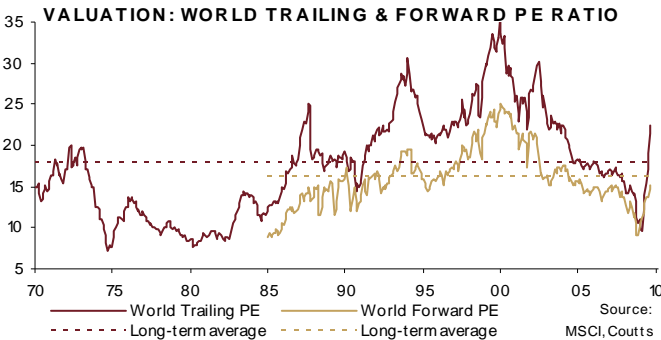
...a phase of the cycle which tends to favour cyclical assets, such as equities.

**PROBABILITY OF ASSET CLASS OUTPERFORMANCE**

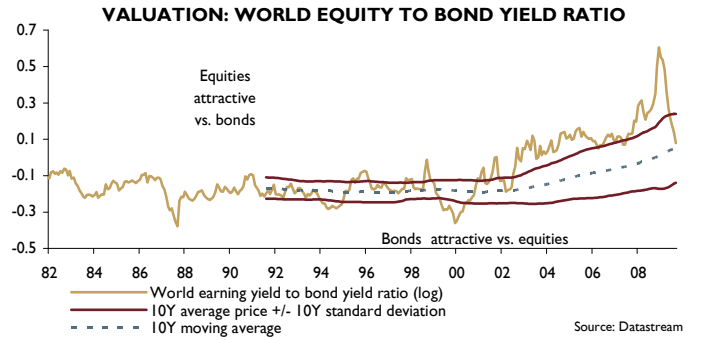
	Recovery	Expansion	Slowdown	Early Recession	Late Recession
Corp vs. Gov	57	50	49	40	61
HY vs. Gov	55	54	37	33	63
HY vs. Corp	57	56	37	41	59
Eq vs. Bonds	61	68	39	44	56
Corp vs. Equity	41	33	55	53	44
EM vs. Dev	65	53	53	57	68
Oil vs. Cash	59	58	68	41	68
Gold vs. Cash	48	35	47	54	44
UK Prop vs. Cash	82	91	58	28	56

Source: Coutts, Datastream

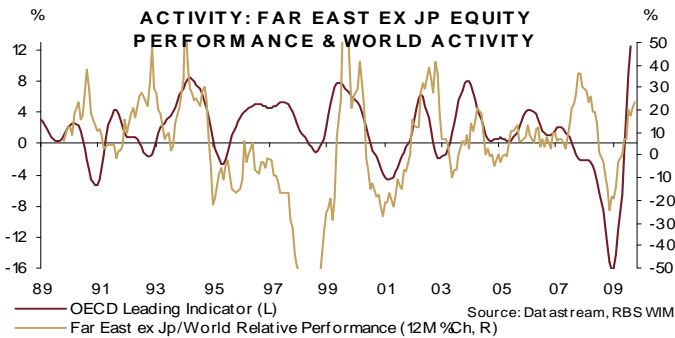
In absolute terms, equities no longer look cheap...



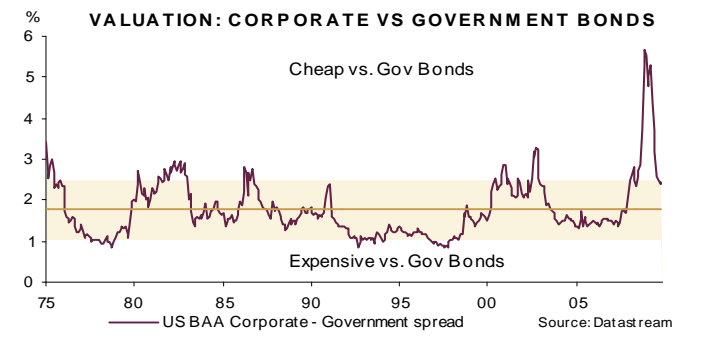
...but they remain fairly valued compared with government bonds.



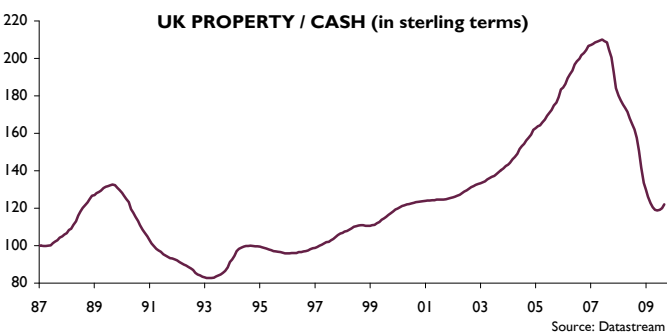
We still favour Asian and emerging equity markets, which are cyclical and don't face the same headwinds as the West.



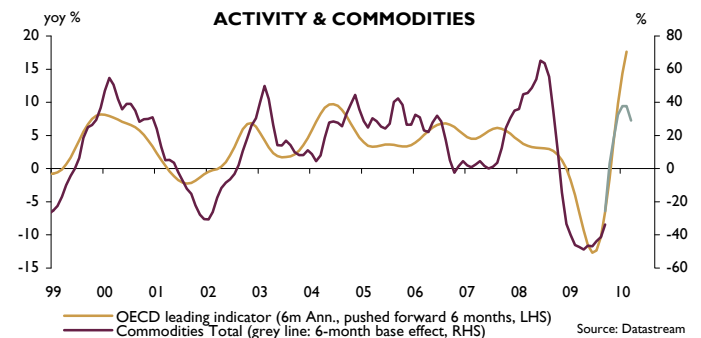
Despite their recent strong performance, corporate bonds continue to offer attractive yield pick-up over government bonds.



Valuation and now momentum argue in favour of UK commercial property.



Dollar weakness and a recovery led by emerging economies is supporting commodity prices.





## Investment Strategy Recommendations

Tactical Recommendations	Short-Term 3 Months	Long-Term 12-18 Months	Relative Performance (23/10/09)					
			Curr.	-1M	-3M	-6M	YTD	2008
<b>ASSET CLASS</b>								
Equities vs Bonds	Positive	Positive	Loc.	0.9	9.0	25.0	21.5	-47.8
Corporate vs Government Bonds	Positive	Positive	USD	0.4	0.8	2.7	7.6	-10.3
High Yield vs Government Bonds	Positive	Positive	USD	2.1	10.0	27.0	50.8	-37.1
<b>REGIONAL EQUITY</b>								
US Equity vs Rest of the World	Negative	Negative	Loc.	1.9	0.5	2.6	-0.6	2.1
UK Equity vs Rest of the World	Positive	Positive	Loc.	1.2	6.0	7.6	0.9	11.2
Europe Equity vs Rest of the World	Positive	Positive	Loc.	-0.6	3.1	5.0	3.8	-4.8
Japan Equity vs Rest of the World	Negative	Neutral	Loc.	-4.8	-11.6	-20.9	-16.9	-4.4
Far East (ex JP) vs Rest of the World	Positive	Positive	Loc.	2.1	6.8	10.0	22.1	-3.5
Emerging vs Developed Equity	Positive	Positive	USD	4.0	5.3	18.4	46.4	-12.6
<b>STYLE</b>								
World Small vs Large Equity	Positive	Neutral	USD	-0.9	3.7	7.1	14.5	-1.2
<b>ALTERNATIVE ASSETS</b>								
UK Real Estate vs Cash (as Sep'09)	Positive	Positive	GBP	1.7	2.8	-0.6	-8.7	-29.4
European Real Estate vs Cash	Positive	Positive	-	-	-	-	-	-
Oil vs Cash	Positive	Positive	USD	14.7	10.0	45.0	32.1	-57.3
Gold vs Cash	Positive	Negative	USD	4.1	10.2	15.4	17.1	-0.2

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