



Ulster Bank Wealth

GLOBAL INVESTMENT THEMES 2010

- 1. Commodities and in particular agricultural commodities offer attractive immediate investment opportunities.**
- 2. The outlook for global equity markets is positive but returns will be more moderate than in 2009.**
- 3. The rebalancing of global growth continues to present opportunities in emerging market equities, bonds and currencies.**
- 4. Government bonds in developed markets are increasingly at risk.**
- 5. A search for “true” diversification will see a renewed focus on alternative asset classes**

Macroeconomic Backdrop

The last twelve months have seen a dramatic shift in the outlook for the global economy as fears of an economic depression dissipated and renewed optimism emerged. Strong growth in emerging economies, increased global trade, unprecedented monetary easing and government induced demand have all played varying roles in this recovery. There remain a number of headwinds to a sustainable expansion including the ongoing de-leveraging by consumers, tight credit conditions and removal of fiscal stimuli. However, looking ahead the outlook is that 2010 will see renewed economic growth. Our colleagues in RBS Coutts forecast growth of 2.5% for US GDP and a return to positive economic growth in all of the major economies (see table). The latest macroeconomic data releases are in line with the theme of continued economic improvement with the employment and consumer spending data in the US showing a clear trend towards improvement and Chinese industrial production data continuing to show strength.

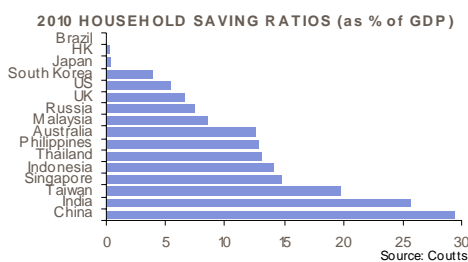
GDP Growth Forecasts (% YoY)			
	2008	2009(F)	2010(F)
US	0.4	-2.5	2.5
Eurozone	1.0	-4.0	1.75
UK	0.7	-4.5	1.25
Japan	-0.7	-5.0	3.0
Asia Pacific	6.6	5.0	7.0
China	9.0	8.5	9.0
India	7.5	5.5	6.5
Latin America	4.3	-3.0	3.0

Source: Coutts

In thinking about the global economy and the opportunities for investment in the year ahead, three key trends shape our thinking:

1. Global economic growth will continue but will increasingly be rebalanced from developed to emerging economies.
2. As recovery gathers momentum speculation surrounding central bank “exit policies” will dominate investors’ minds.
3. Although the large amount of spare capacity in the global economy should keep inflation in check, future inflation *concerns* amongst investors may rise over the year.

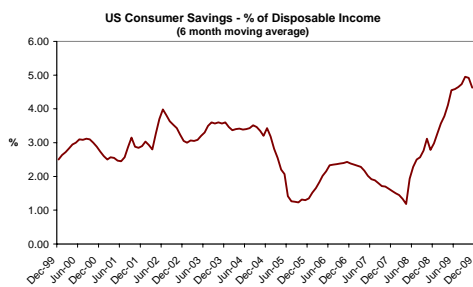
Global Rebalancing. 2009 provided the clearest evidence yet of economic “decoupling” (the phenomenon whereby emerging economies managed to post growth even in the face of economic contraction in the developed world). Up until then global growth had typically been synchronised and driven by strong consumption in the Anglo Saxon economies, particularly in the US, in tandem with strong levels of production in the emerging economies, such as China. This led to a number of imbalances: a very low savings rate and high levels of personal debt in the US, extremely high savings rate in China, trade imbalances and a surge in foreign currency reserves in emerging economies. Economists have long recognised the need for more “balanced” global growth where all economies contribute more evenly. Consumers in the West have now started to save more and rebuild balance sheets, while consumers in the emerging markets are slowly becoming more affluent and starting to consume more, as we start to see this rebalancing.



Source: Coutts

This development is important for a number of reasons:

- First, global economic growth should be more sustainable and less reliant on the US consumer.
- Second, the savings rate in the US has already moved from its 2008 low of 1%, to c. 5% and expectations are that this rate may rise to as much as 8%.



Source: Bloomberg/UB Wealth

If this occurs, other sectors of the US economy, such as the export sector will have to grow more strongly to take up the slack.

- Third, in emerging economies consumption of foreign manufactured goods will rise which will be positive for developed market exports, and consumption of base commodities for production and agricultural commodities through food consumption will continue to grow sharply.

Focus on “exit policies”. Last year we saw a return to the era of big government with the implementation of expansionary fiscal policy and the use by central banks of unconventional monetary policy tools. This year will see a phasing out and in some cases withdrawal of many of these policy initiatives. The G-20 economies enjoyed a discretionary fiscal stimulus of 2% of GDP last year. RBS Coutts estimate that this will fall to around 1.6% of GDP this year. However, looking further out given the poor state of many government finances, the likelihood is that the focus in many economies (e.g. the UK) will shift to fiscal tightening over the next two years.

3mth Libor Market Expectations

	Current	Expected End June '10	Expected End Dec '10	Expected End June '11
US	0.25%	0.49%	1.23%	2.05%
Eurozone	0.65%	1.01%	1.66%	2.21%
UK	0.61%	0.86%	1.76%	2.67%

Source: Bloomberg

Speculation regarding the nature and timing of central bank exit policies from the unprecedented monetary policy measures enacted in the last two years will be a more immediate driver for financial markets. Investors are currently pricing in official interest rates starting to rise in the US and in the Euro-zone in the second half of this year. As we enter the second quarter, speculation will intensify around the timing and magnitude of the policy reversal. Given the stronger economic growth and price pressures that exist in emerging markets, local central banks there will be forced to act more aggressively in terms of rate hikes or allowing domestic currency appreciation.

Growing inflation concerns. In the developed economies inflation has unsurprisingly been tame in the last twelve months as economic demand has slumped. Indeed a year ago deflation fears dominated. While the substantial amount of spare capacity in the economy and the presence of what central bankers call a large “output gap” (the fact that the total output of the global economy is well below its potential level) augur for further containment of inflationary pressures there are growing concerns amongst investors that inflation may ultimately pick up. While we do not expect a substantial rise in actual core measures of inflation this year, it is easy to envisage a scenario where investor concerns about inflation grow particularly if central bankers are perceived to be too slow in reversing accommodative monetary policies. A substantial rise in commodity prices and/or fall in the US Dollar are other factors that could accentuate that trend, particularly in the US.

With these macroeconomic trends in mind we see five key investment themes for investors to focus on in 2010.

1. Commodities and in particular agricultural commodities offer attractive immediate investment opportunities.

As the global economic recovery gathers momentum, commodities in general should continue to benefit from the increase in demand. Oil and Gold in particular performed strongly in 2009. The rise in Oil reflected the recovery in economic growth as well as a growing appetite amongst investors to invest in commodities as an inflation hedge. This was even more noticeable in Gold which benefited through the economic turmoil from its safe haven status but continued to rise even as risk aversion subsided later in the year. Demand from central banks for Gold to diversify their reserves was symptomatic of Gold's growing status as an important portfolio diversifier. These trends may continue, particularly as concerns about paper currencies remain, however there may be better opportunities elsewhere in commodity markets.

We are particularly positive on the outlook for agricultural commodities.

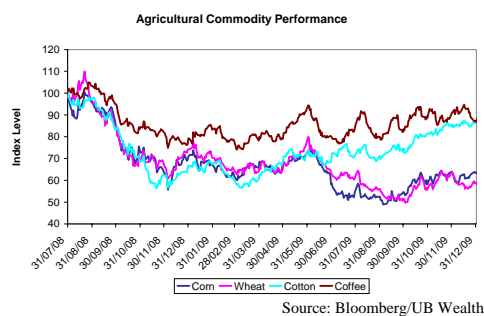
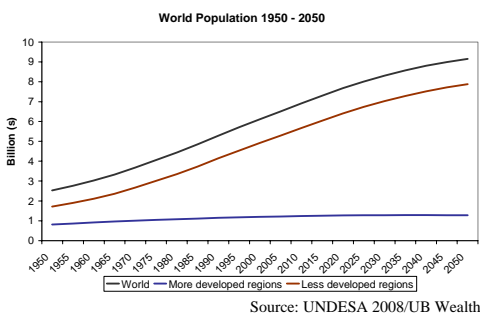
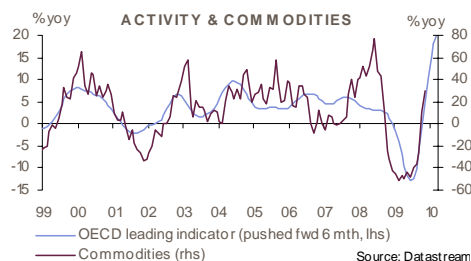
Demand for agricultural commodities is likely to be stronger, in particular from emerging economies as their economic growth picks up momentum. However, a number of structural factors also underpin the positive outlook. As developing economies become more affluent, their dietary requirements change as they substitute more protein into their diets, putting upward pressure on grains (a key input in the production of meat). The growing world population is also likely to support demand with food production estimated to need to rise by 70% by 2050 to meet the rising demand. The growing importance of climate change has added support to the use of ethanol and biodiesel as alternatives to traditional fossil fuels increasing the demand for corn and sugarcane from which they are derived.

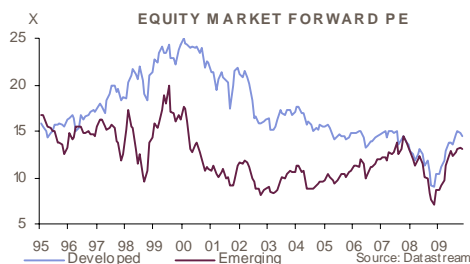
Supply constraints are equally important, as climate change and the El Nino phenomenon have caused droughts in Asia and excess rainfall in Latin America in recent months, resulting in a supply shortfall and negatively impacting the prospects for future harvests in many agricultural commodities. The growth rate in crop yields has been following a downward trend due to a lack of investment in agriculture. Yields in the US are growing by only 1-2% per annum, while in African countries yield are flat at best. This issue is exacerbated by the lack of available arable land and the growing concern over water availability, a major input in the production of crops.

Given these structural arguments in favour of further commodity price appreciation, investors are increasingly allocating capital to this asset class. We expect this to continue through 2010 particularly as investors look for protection from the possibility of a rise in inflation at some point in the future. Further weakness in the US Dollar would also be positive for commodity prices generally.

2. The outlook for global equity markets is positive but returns will be more moderate than in 2009.

Equity markets recovered strongly through 2009 as financial markets moved from pricing in the possibility of a depression, to pricing in a more normal recession and then anticipating an economic recovery. As such the fact that the





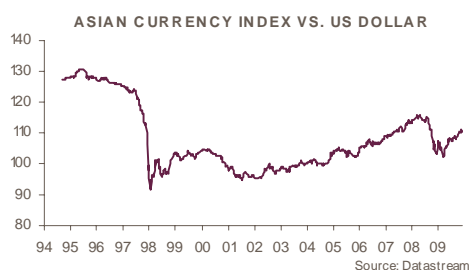
outlook for the global economy in 2010 is much more positive is now largely discounted. However, a number of factors still support equity markets, particularly in the early part of 2010. Monetary policy remains accommodative and the low levels of interest rates appear to be one factor encouraging investors to continue to move into risky assets such as equities. Valuation measures such as the price/earnings ratio of the major equity markets are still below historic averages when earnings are based on *forward* earnings. So assuming the economic and earnings growth that most are expecting comes through, valuation measures are not an impediment to further equity market gains. Mergers & Acquisition activity has already picked up slowly through the second half of 2009 and this is likely to be a further support to equities in 2010 as financing conditions for deals improves.

However valuations are no longer very cheap and there is unlikely to be the same substantial shift in the market's appreciation of the economic outlook that drove the market higher in 2009. As such while the outlook remains positive for the year ahead, and on a multi-year view, returns are likely to be more moderate than in 2009. Later in the year the unwinding of the substantial monetary stimulus that central bankers enacted will be a headwind for the market as the beginning of a Fed rate tightening cycle has historically (such as in 1994 and 2004) been associated with volatility in equity markets. Emerging market equities may continue to offer better potential on a medium term outlook given the structural trends in these economies. Alternatively having exposure to developed market companies with high exposure to China and the emerging markets makes sense.

3. *The rebalancing of global growth presents opportunities in emerging market equities, bonds and currencies.*



As noted above, global growth is likely to become more balanced going forward reflecting higher consumption levels in emerging economies. However there are other reasons to be more optimistic about the growth outlook in emerging economies. (i) Emerging economies have not experienced the same destruction in household wealth as many developed economies. Both consumer and business balance sheets are in a much stronger position, therefore reducing the need for de-leveraging. (ii) Their financial sectors have not suffered anywhere near the same degree of turmoil that engulfed the developed markets. Indeed stronger government finances in these regions will mean that governments will not need to increase taxes and cut spending as will be the case in developed economies. (iii) From a longer term perspective emerging economies' demographics are favourable given the sheer sizes of population involved and the more youthful composition of that population.

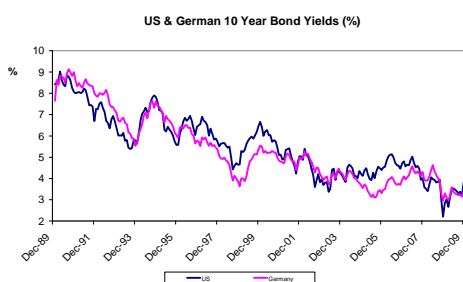


The obvious way to express this positive outlook is through emerging market equities or through developed market equities with high exposures to emerging economies. However emerging market bonds and currencies offer an alternative way to play this structural trend of development. Factors supporting emerging market currencies include (1) Central banks in these economies may be forced to raise interest rates more aggressively than in developed markets given the stronger economic growth (2) Policy makers may alternatively allow greater local currency appreciation as a way to stem domestic inflation pressures (3) Given the huge amounts of liquidity in the global financial system capital inflows may be attracted to those markets with the strongest growth potential thus boosting capital inflows into emerging markets.

In addition many of these economies are now showing a substantially improved credit profile as a result of the strong economic growth in recent years. In some cases their debt instruments are now rated investment grade or higher comparing favourably with developed markets (e.g. Russian and Brazilian long term foreign currency bonds are now rated BBB+ by Standard and Poor's, the same as Greece). Whereas the risks in developed market government bonds are now rising, emerging market government bonds appear to have a more favourable fundamental story.

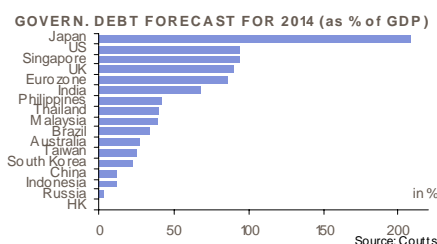
4. Government bonds in developed markets are increasingly at risk.

A year ago the outlook for government bonds, particularly in the major markets, looked positive. Global economic activity had collapsed and the near term outlook was very uncertain. Interest rates were at historic lows and looked set to remain at those levels for a considerable period. Extreme risk aversion encouraged investors to move into government bonds and direct purchases by central banks as part of their "quantitative easing" efforts also provided support. The net effect was that yields in many developed government bond markets touched all time lows in 2009.



Source: Bloomberg

Looking ahead many of those positive factors are now dissipating and indeed a number of significant risks for developed bond markets lie ahead. As the economy recovers, investors will increasingly speculate as to the timing of the end of the ultra accommodative monetary policies. The first part of this has already effectively passed with some central banks signalling an end to direct purchases of government and other asset backed securities. A draining of liquidity will be the next step and ultimately rate rises will follow. While rate rises may be delayed to the second half of 2010 or even possibly later, the anticipation of the tightening cycle is something that is likely to be negative for bonds in 2010. Rising fears of inflation (fuelled to some extent by rising commodity prices) is another factor that may weigh on government bonds as will the explosion in the government deficits and rise in debt/GDP ratios in the major economies. Yields on government bonds in many developed economies are already relatively low in nominal terms so valuation is another negative. As such unless global growth disappoints the potential returns from investing in government bonds in many of the developed markets looks limited and the risks are certainly higher.



Source: Coutts

5. A search for "true" diversification will see a renewed focus on alternative asset classes.

With equity markets now having discounted an economic recovery and the risks associated with investing in government bonds now rising, investors are likely to look again to alternative investments in a search for true diversification. Commodity markets (Gold in particular) have benefited from this trend in 2009 as investors have increased allocations to diversify portfolios. This trend should continue in 2010 with hedge funds strategies likely to see renewed inflows after the strong performance in 2009 as investors again return to alternative asset classes. However the feeling that some of these asset classes failed to offer sufficient diversification in 2007 and 2008 when it was most required may see investors increasingly explore less mainstream asset classes. There are compelling structural arguments for investing in areas such as water and renewable energy. We are likely to see a renewed focus on these opportunities

as investor appetite for alternative investments continues to rise and as the imperative to address climate change increasingly dominates the economic and political landscape.

Summary

The economic outlook has improved substantially over the last 6-9 months. Although a number of headwinds to a sustainable economic expansion persist the outlook for 2010 is for a return to positive growth. Some asset classes have already discounted this recovery but there remain interesting investment opportunities for the year ahead and for the next number of years.

Growth minded investors should look to commodities, equities and emerging markets to deliver attractive returns on a multi year view. Given our view that the risks to government bonds will likely rise through the year conservative investors focussed on Wealth Preservation should consider increasing exposure to capital protected strategies, cash and corporate bonds.

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Alternatively please contact 01 608 5279 if you require further assistance.