

Economic Outlook and Investment Strategy for Q1 2011

I – Economic Outlook

► The US economic recovery is gathering pace

In the United States, the desire to maintain strong growth again resulted in joint action by the Federal Reserve and the government. The Fed's launch of a second round of quantitative easing came on top of a fiscal support package renewing the tax cuts introduced in the Bush era for two years, and alongside the extension of long-term unemployment benefits and a reduction in social security contributions for all those in employment. This monetary and fiscal coordination firmly staves off the threat of a double-dip recession. Sentiment among consumers and business managers is therefore much higher and the tentative improvement in the labour market is gathering pace to such an extent that the 2011 US growth forecast has been raised to 3.5%.

► Although the economic recovery has a solid foothold, it remains to be seen whether it will continue beyond June

At this stage, uncertainty seems to relate not to the reality of this recovery but to its ability to become self-sustaining beyond June, when the current programme of quantitative easing comes to an end. If this is the case, long-term interest rates could rise, with the market having to finance a fiscal deficit of nearly 10% of GDP. If not, Ben Bernanke will have to commit to further stimulation of activity as only sustained growth - with a little inflation - is capable of resolving the problem of a real unemployment rate close to 17%, public over-indebtedness and high private debt in the United States.

► The economy recovery is pushing up interest rates

Faced with a pick-up in US economic activity, the bond markets were quick to respond, with 10-year yields rising from 2.5% to 3.3% in less than 10 days. Where would the market find its equilibrium? If we estimate the potential for sustainable US growth to be 2% and take the historical average real interest rate of 2%, a yield of 4% would seem a reasonable target. Low core inflation (0.8%), kept down by surplus unused production capacity and key interest rates

bordering on zero, means bond buyers will probably expect moderate yields. Conversely, we cannot rule out the possibility that in the run-up to June (when the current quantitative easing programme is due to end) yields will surpass this equilibrium, as the idea that the market alone could finance a US fiscal deficit approaching 10% of GDP seems unrealistic at a time when the economic recovery will itself require vast amounts of capital.

► **Deflationary pressures persist in Europe**

The situation remains complicated in Europe and deflationary pressures persist. The ECB still faces a dilemma with regard to Germany, which can boast near-full employment and economic growth justifying higher interest rates, and the eurozone's weakest members. These countries are facing a public finance catastrophe and will probably not be able to avoid restructuring their debt. In these circumstances, until peripheral countries' debt has been rescheduled, the improvement in European markets will remain temporary, suggesting the euro will be highly volatile.

► **The emerging markets are experiencing inflationary pressures but these differ between countries**

Unlike the situation in developed countries, the challenge for the emerging countries is not to reduce debt through growth but rather to control inflationary pressures, which have in part resulted from monetary stimulation in developed countries looking to ease the burden of their own debt. Faced with an overabundance of capital inflows and higher commodity prices, they are having to rein in their currencies and mitigate imported inflationary pressures, which come on top of those generated by such robust growth. This exerts upside pressure on their interest rates, which in turn enhances the appeal of their currencies, and so on. Taken as a whole, they are vulnerable to rising agricultural commodity prices but here again it is important to distinguish between countries where inflation is relatively unaffected by infrastructural bottlenecks (China, Turkey, etc.) and those less fortunate (India, Brazil).

II – Investment strategy

I – International equities

► The equity markets are benefiting from a high risk premium

Given the US economic recovery, visibility seems much better for US equities compared to bonds. Even if long-term yields continue to tighten, the high risk premium on equities (4.10%) – in other words the difference between the returns available on equities and bonds – should enable them to progress if growth firms up. In these conditions, Carmignac Investissement has kept high exposure to the international equity markets at the beginning of 2011, with an allocation that focuses mainly on themes capable of benefiting the most from global growth, drawing strength from the ongoing ascent of the emerging markets - even if these are being held back by less accommodating monetary policies - and from the US economic recovery.

► The theme of improving living standards in the emerging countries remains predominant

Improving living standards in the emerging countries remains the primary theme in the Carmignac Investissement portfolio, representing 33.4% of assets compared with 35.1% three months ago. The inflationary pressures seen in the emerging countries have discouraged us from increasing the weighting of this theme, however profitable it may have been last quarter. However, we have chosen to ramp up our exposure to growth in emerging market consumption by increasing the weight of our LVMH and Richemont holdings and adding Hermès, which also has a degree of speculative appeal. In the financial sector, we took advantage of weakness on the Chinese stock markets to strengthen our positions in ICBC and China Construction Bank in particular. We also opened new positions in Latin America with the Credicorp bank in Peru and Grupo Financiero Galicia, which stands to gain handsomely from any improvement in Argentinian country risk - something we think will happen. Conversely, we reduced our investments in the banks Itau Unibanco in Brazil and Sabanci in Turkey, which may suffer from the pursuit of less accommodating monetary policies.

► Commodities continue to benefit from abundant liquidity

The commodities theme saw its weighting increase from 9.7% to 12.4% of Carmignac Investissement's assets. Driven by the Fed's quantitative easing, this sector's appreciation means we can expect inflationary pressures - for which QE2 is largely to blame - to settle down in the emerging countries. First Quantum and Equinox Minerals, two copper producers listed in Canada, have been used to increase our exposure to copper, one of our favourite mining segments. Elsewhere, we opened a position in the US company Intercontinental Exchange, which trades on the major commodity markets, enabling us to benefit from their current popularity. We added to

our position in Potash Corp, which is reaping the full benefits of the surge in agricultural commodities. The energy theme also saw its weighting increase, from 14% to 15.4% of Carmignac Investissement's assets. Indeed, the rise in demand from OECD members comes on top of that from China and is exerting upside pressures on fuel prices.

► **Defensive stocks and exposure to gold mining were reduced**

We cut the weighting of defensive stocks significantly, from 8% to 4.7% of Carmignac Investissement's assets. The global economy's positive short-term trend led us to reduce this component so that we could expose more of the portfolio to themes that benefit the most from growth. The weighting of gold mining stocks diminished from 13.6% to 12.3%. The prospect of a less accommodating European monetary policy is weighing heavily on gold prices, as is the rise in real bond yields in developed economies. However, in our opinion, gold remains the ultimate insurance in this very specific economic environment in which fears of deflation are contributing to the devaluation of government issues and currencies.

II – Bond performance drivers

► **Corporate bonds continue to dominate our allocation**

In 2011, corporate bonds will benefit from macroeconomic improvement but face the risk of higher yields. We have adapted our allocation by moving away from those bonds most sensitive to this upturn, the impact of which on absolute performance is not linear. The effects depend on the lending margin, whose compression tends to offset the negative impact of a rise in yields. Our investments will focus on bonds that benefit from this kind of "shock absorber" effect.

► **The high-yield segment will remain packed with opportunities**

Like equities, high-yield bonds can generate a positive absolute performance during a restrained rise in interest rates. This is true of BB-rated issues (premium of between 300 and 450 basis points) and even more so of B-rated issues (premium of more than 450 basis points). We are prepared to finance slightly more indebted companies for which visibility remains good at a time of economic recovery. For example, we have invested in Fortescue, one of Australia's biggest producers of iron ore, rated B with a 4-year yield of 6.4%.

► **The government bond weighting has been reduced slightly**

Carmignac Patrimoine's weighting of government bonds in developed countries was reduced to 6.6%. Massive public debt, high valuations, the position taken by investors as a result and reflationary policies are all problems for this asset class, although the combination of low inflation

and the Fed's accommodating policy should prevent a massive surge in yields. Our remaining exposure is justified as insurance against disappointing growth figures despite the resources

deployed, or an escalation of the European crisis with the possibility of contagion to other countries such as Spain. Our exposure comprises bonds with an average maturity of 4.3 years. The interest rate risk on this position is fully hedged through the sale of US and German bond futures. The emerging government bond weighting was also reduced. It accounts for 7.8% of Carmignac Patrimoine's assets with 6.6% invested in local emerging market debt.

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About Carmignac Gestion

Founded in 1989 by Edouard Carmignac, Carmignac Gestion is one of the leading independent asset management companies in Europe today. Its share capital is entirely held by its management team and staff. In this way, the company's long-term viability is ensured by a stable shareholding structure, reflecting its spirit of independence. This fundamental value is of utmost importance to the company as it ensures the freedom required for successful and renown portfolio management.

With EUR 55 billion in assets, Carmignac Gestion has developed a comprehensive range of 18 funds across all asset classes - equities, bonds and multi-strategy, as well as mandate offering. Our funds are actively marketed in 11 European countries: France, Luxembourg, Switzerland, Belgium, Italy, Germany, Spain, Austria, The Netherlands, Sweden and United Kingdom. Within the context of its international development, Carmignac Gestion has a subsidiary in Luxembourg and two offices in Madrid and Milan, and recently registered its range of products for professional investors in Singapore.