

## **Third quarter 2010**

### **Economic Outlook and Investment Strategy**

#### **I – Economic Outlook**

##### **► Europe remains under pressure**

The European situation remains that of an economy subject to heavy deflationary pressures exacerbated by the fiscal austerity demanded by the markets. Admittedly, the sharp depreciation of the euro since November and the continuation of a necessarily expansionist monetary policy partly counterbalance the effects of fiscal discipline by giving European export companies some air. Are the austerity plans introduced in most member states ambitious enough to structurally reassure the markets? We doubt it. At the very least, though, combined with the ECB and IMF's joint support package, they should be able to offer some respite. Beyond this, Europe continues to be weakened by high public debt, whose reduction will in no way be easy given the poor outlook for growth. Therefore, it seems inevitable that other crises in confidence might affect the debt of certain member states.

##### **► The United States is experiencing a mid-cycle lull while awaiting a pick-up in exports**

The economic recovery in the United States is now slowing down. Several leading indicators such as consumer confidence and the ISM manufacturing index have started to fall and the property market is showing signs of persistent weakness (housing starts down by more than 30%, the lower point of a cycle that began in 2006). Inventory building, which accounted for 70% of the 2.7 points of growth in the first quarter, is slowing and is responsible for most of the economic downturn, which is inevitable at this stage of the cycle. While the weakening of US growth is significant, the same cannot be said for US businesses, which continue to benefit from the effects of streamlining and the renewed competitiveness of their exports. Nevertheless, shaken by the unprecedented suddenness of the decline in activity at the end of 2008, US businesses remain highly cautious in terms of both production and job creation. They are wary of US consumers who, due to current deleveraging, can no longer be the economic agents who would traditionally have helped businesses find the path back to growth after a recession. Given the circumstances, we believe that the trigger for US businesses will be the end of restrictive monetary policies in the main emerging countries as this would guarantee new outlets for US exports.

► **China's strength is not waning and will benefit from the renewed appreciation of the yuan.**

In the emerging world, the Chinese authorities maintained their monetary tightening, primarily to slow activity by limiting the amount of loans granted to businesses and to prevent the development of a property bubble. This policy is beginning to produce tangible effects. Furthermore, the Chinese authorities' decision to revert to a more flexible exchange rate mechanism offers reassurance about the country's ability to continue its growth and play an important positive role in global rebalancing. Indeed, this decision regarding the yuan coupled with the decision not to oppose pay rises – and even to encourage them - reflects the authorities' desire to rely more on domestic consumption to generate growth, while also tackling the inflation issue.

► **Global rebalancing in favour of emerging countries is now more than ever a reality**

Having shown their ability to grow despite the recession in developed nations, emerging countries are about to prove that if there is dependency between the two worlds, it now goes in the opposite direction. The sustainability of global growth now primarily depends on the quality of economic and monetary policies applied in the emerging world, which fortunately has accustomed us to sound management in recent years. Through the public and private spending cuts required in developed economies, deleveraging is hastening global rebalancing beyond our expectations.

## II – Investment strategy

### I – International equities

► **We are maintaining our exposure to a dollar rise against the euro.**

The end of restrictive monetary policies in the emerging world is on the horizon. This will help to strengthen emerging currencies. It will also benefit the United States much more than Europe, which must act rapidly to improve its public finances. The dollar should thus continue to rise after the recent correction resulting from the US slowdown. Underweighting the euro therefore remains a key theme of our strategy despite the single currency's technical recovery at the beginning of the third quarter – which is in our opinion, a temporary development.

► **While awaiting a catalyst, we are maintaining a balanced portfolio structure**

Waiting for the end of monetary tightening in China could mean some tense moments, which does not exclude the possibility of a further correction in the equity markets, following on from the one that began in April after 13 months of strong growth. However, the fall of nearly 20% in leading Western indices shows that current macroeconomic doubts have already been taken into account and leaves us with valuations that, with interest rates very low, now appear rather attractive. As we await a catalyst, our global strategy is to preserve the portfolio structure that enabled us to work our way through the markets' mood swings last quarter.

► **The theme of improving living standards in emerging countries has been strengthened**

The theme of improving living standards in emerging countries has been increased from 27.7% to 29.9% of the Carmignac Investissement portfolio. We have further raised the weighting of Asian companies, which now account for almost 79% of the stocks comprising this theme. Indeed, China's decision to resume - however gradually - the revaluation of the yuan is excellent news for the entire region. The main areas for consolidation were our positions in Bank Central Asia and Astra International (conglomerate) in Indonesia, and DLF Limited (property development) and GMR Infrastructures in India.

► **The gold component remains significant with aftershocks still possible in Europe**

The European crisis, from which there could be further aftershocks in the coming months, may lead to more budgetary slippage, bolstering the role of gold as a safe haven. With this in mind, we have increased the weighting of gold mines from 10.8% to 14.7% of Carmignac Investissement, primarily by strengthening our positions in Newmont, Red Back Mining, Goldcorp and Barrick Gold.

► **The theme of US growth has been reduced**

The US growth theme was reduced sharply, from 17.8% to 11.7% of the Carmignac Investissement portfolio, on the first tangible signs of a US slowdown. US banks, which we included in this theme, have been kept despite their disappointing performance over the quarter. We still believe that, unlike European banks, balance sheets are now purged and that, given the need for the soundest possible banking system now that leverage has been reduced, the US authorities will be realistic and make regulatory changes that will not unduly penalise the sector.

► **Natural resources: the energy sector represents an important source of value**

With the US economy slowing, the weighting of the base metals sector was reduced from 10.6% to 6.6% of Carmignac Investissement's assets under management. In the aftermath of the BP disaster in the Gulf of Mexico, the oil services sector was hit by political decisions affecting its activity in application of a principle of precaution that is understandable given the circumstances, albeit inevitably temporary. The rig involved belongs to Transocean while Anadarko Petroleum holds a minority stake in the oilfield. Present in our portfolio, both companies suffered. Our view of their liability in the accident led us to strengthen our position in both companies after falls exceeding 40%. Meanwhile, we closed our position in Norway's Seadrill and reduced the Schlumberger and National Oilwell positions. After massively underperforming, this investment theme represents an important source of value that could start to show its potential over the weeks ahead with the success of operations to close the well.

## **II – Bond performance drivers**

► **Government bonds: we remain suspicious of second-rate issuers**

Last quarter confirmed that deleveraging in the developed world has entered a new phase where converting private debt into public debt can no longer guarantee that the economy will go back to normal. As the main economic risk is that of deflation in the developed world, we still feel it justified to look for sensitivity on the long end of the German and US curves, although the low yields available do call for some caution. As the markets' perception of issuers' ability to repay their debt is key in a deflationary environment, we remain wary of second-rate sovereign issuers. The government bond component accounts for 7.5% of Carmignac Patrimoine's assets.

► **Corporate bonds: value from US and European companies**

Corporate bonds account for 33% of Carmignac Patrimoine's assets. Although risk premiums stopped falling last quarter, depriving the asset class of its main performance driver, fundamentals continue to improve. The strongest US and European corporate issues seem to offer value, with little risk on short-dated bonds. At quarter's end, we took advantage of the pressure on certain sectors to seize opportunities with attractive valuations. For example, we added 5-year Anadarko bonds at 9%, a level that fully prices in the risks arising from the oil slick. Similarly, regarding the European banking sector, apparently credible stress forecasts and a recapitalisation campaign that will follow the publication of stress test results on 23 July could encourage us to strengthen our position in this segment. Generally speaking, the weakness of yields on top-tier government bonds will lead investors to seek higher yields from corporate issuers, which should represent a considerable performance driver.

► **Our emerging local debt exposure has been increased slightly**

The weighting of the emerging local debt component has risen from 6% to 7% of Carmignac Patrimoine's assets. Times are changing. Whereas emerging local debt would once have suffered the effects of contagion, it held up well last quarter. For example, Turkish and Mexican yields eased by 0.25% and 0.70% while the currencies gained 5.7% and 6% respectively. In Brazil, bold action by the central bank pushed 2-year yields up by 0.35% but this was easily offset by an appreciation of nearly 9% in the currency. We remain confident in this component and recently increased our positions in Indonesia.

► **The cash allocation has increased significantly and our position on the euro maintained**

Within Carmignac Patrimoine, the cash instrument allocation has risen sharply from 8.7% to 19% of assets. During last quarter, 14% of this cash was invested on the US market, enabling the Fund to benefit from the weakening of the euro. Given that the dollar should continue to benefit from the growth differential favouring the US economy, we are maintaining our defensive position with regard to the euro.

**Press contact:**

**CARMIGNAC GESTION**

**Josipa FINK**

Tel.: +316 215 178 20

[jfink@carmignac.com](mailto:jfink@carmignac.com)

***About Carmignac Gestion***

Founded in 1989 by Edouard Carmignac, Carmignac Gestion is one of the leading independent asset management companies in Europe today. The company's shares are held entirely by its managers 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 ensures the freedom required for its successful and renowned portfolio management.

Managing €47 billion of assets, Carmignac Gestion has developed a range of 18 funds across all asset classes, including equity funds and balanced funds, as well as a mandate offering.

Our funds are actively distributed in eleven countries: France, Luxembourg, Switzerland, Belgium, Italy, Germany, Austria, Spain, the Netherlands, Sweden and Singapore. As a platform for its international development, the company has had a subsidiary in Luxembourg since 1999. In 2008 it opened representative offices in Madrid and Milan.