

## **Carmignac Gestion - Economic Outlook and Investment Strategy**

### **Second Quarter 2009**

#### **I – Economic Outlook**

► **The global economy has entered a normalisation phase**

At the end of the previous quarter, we stated that the economic downturn had bottomed out. The macro-economic data in the last few months have confirmed this assessment. Of course, there is some way to go, and the developed countries' recovery is still hesitant. Nonetheless, it looks as if the global economy has entered a normalisation phase. The political and monetary authorities have set about kick-starting the economic machine, particularly in Anglo-Saxon countries. Their actions and the success of the G20 summit managed to subdue the panic that still prevailed in early March. However, the Geithner PPI plan to relieve banks of their bad debts may now only be implemented to a very limited extent as the sharp improvement in valuation prospects for these assets is encouraging their holders to hang onto them. Moreover, the steepening interest rate curve as a result of the improved perception of the future for the economy and maintenance of interest rates at very low levels, is helping to restore the health of commercial banks: the traditional business of transformation – short-term borrowing and long-term lending – (to the government!) has become extremely lucrative again. The gains generated will hedge future losses on commercial property and credit cards in particular, and will help ensure that the banks are not too encumbered to lend to the private sector.

► **The risk of inflation has been side-lined for the medium term**

The allaying of deflationary fears, replaced by a resurgence of expectations of inflation in the wake of the rise in commodity prices, and the markets' focus on crisis-exit strategies could also be seen as evidence of this change in outlook. We think that the fear of such a resurgence is premature because the weakness of the employment market makes an inflationary spiral fuelled by ballooning wages very unlikely. Furthermore, the low production capacity utilisation rate in the United States represents a powerful brake on any tendency for manufacturers to increase prices.

► **Deleveraging is the order of the day**

US statistics are showing a marked drop in lending and, in particular, a slump in private-sector lending. The positive element for banks is that this fall is largely due to credit granted from outside the banking system (e.g. securitisation, AIG, hedge funds). But although the total volume of credit is falling, the banks are nevertheless likely see an overall increase in their market share of the credit business. The fall in lending is a sign of the deleveraging that is an inevitable prerequisite to any recovery among developed economies. Allowing lending to shrink without hampering economic growth is the crux of the problem for the economic and monetary policies implemented today, although the steepening interest rate curve is already a good sign. It represents firm reassurance that we are emerging from the crisis.

► **Investment must take over from consumption**

US activity is only showing faint signs of improvement thus far. Although the leading growth indicators, in particular the ISM indices, have continued the rally that began in February 2009, actual data is still slow to confirm the proclaimed upturn. Inventory levels continue to adjust to the weakness of global demand, for the time being preventing industrial production from returning to growth... but leaving the potential for a future rally intact! Conversely, United States consumption has held up (e.g. +1.4% in Q1, with even more positive indications for Q2), despite the continuing battering of the employment market, though admittedly jobs are being cut at an encouragingly slower rate (e.g. 345,000 in May, 467,000 in June compared to 741,000 in January). In this context, we will only consider the global recovery to be well set when restocking has really got underway and global trade confirms it has turned the corner – two essential conditions for the resumption of investment. At this stage of the economic cycle, for the economic improvement to be sustained, we need to see that the slightest deterioration in economic data gives way fairly immediately to positive growth figures in the strictest sense. But we are not particularly worried. The US economy is likely to see an upturn in the next few months under the dual impact of the Obama government's budgetary stimulus plan (6% of GDP over two years) and the recovery of the credit market, made possible by the remarkable bailout of the stranded banking system in the second quarter.

► **Global rebalancing gathers pace**

Although developed economies are currently only seeing rather limited dynamism, the same cannot be said of the principal emerging countries. Their resistance to the downturn of the developed countries has been extremely encouraging. Chinese growth is expected to come in at over 7% this year, while India and Brazil continue to enjoy healthy prospects. These developments confirm the validity of our analysis that the global crisis represents an impetus to global rebalancing. They also strengthen our expectation of a return to an environment that is more favourable to the recovery of global activity and investment in equities.

## II – Investment Strategy

### I – International equities

#### ► We think the likely scenario is a non-inflationary upturn

Between the massive injections of cash in the developed countries, which we are not expecting to lead to a resurgence of inflation, and the resilience of the main emerging markets, the economic situation seems to support our belief that the likely scenario is a non-inflationary upturn, although we are not anticipating a linear progression. Sensitivity to macroeconomic data, particularly from the US, will maintain the situation more volatile, since the developed-world recovery is likely to be erratic. However, the scale of the market rally between March and May has little precedent and it seems legitimate to wonder whether or not the equity markets have run a little too far ahead of the economy.

#### ► Equity market valuations continue to offer opportunities

US firms are currently valued at 16.3 times their average earnings over the last 10 years, which represents their median valuation for the last 20 years. They are therefore at their correct price in terms of historic data, although the gloomy economic picture on the other side of the Atlantic could still warrant a lower earnings multiple. Conversely, emerging companies and commodity producers, despite their recent sharp bounce and much rosier outlook, are seeing their earnings estimates for 2009 valued at 20% less than all the securities in the stock market index of advanced countries.

#### ► Pending confirmation of an upturn in the real economy, we are maintaining our defensive component

In this context, we are waiting for the publication of more encouraging signs for investment in the United States before re-exposing the fund to themes that we consider to be the most sensitive to economic growth. We have confidence in the current structure of our portfolios. Carmignac Investissement has thus maintained its barbell structure, which has served so well since October 2008. With 32% of assets in highly defensive investments (e.g. cash, gold and defensive sectors) and 62% in those themes that are best placed to take advantage of the economic recovery, the fund should be capable of weathering any downturn and benefiting from periods of growth.

#### ► The theme of improving living standards in emerging countries remains central

The main emerging markets have a considerably more encouraging outlook than during previous economic slowdowns, due to two principal underlying factors:

- a solid budgetary position, boosted by comfortable foreign exchange reserves and a current account surplus enabling the authorities to implement the necessary fiscal and monetary policies, as demonstrated by the steady rise in lending in China and the relaxation of monetary policy in Brazil; and
- a political consensus in favour of structural reforms in nearly every major emerging economy. The most recent example to date can be seen in the results of the Indian elections and the reforms expected to stem from them.

The outperformance of emerging markets relative to developed markets that began at the end of 2008 gathered pace in the second quarter. The gap has widened, particularly due to the global decline in risk aversion. This is no doubt linked to the positive trend seen in the Chinese economy over the last six months. Several emerging countries have published economic statistics that are much better than the pessimistic forecasts of the start of the year. Indeed, the flood of international capital into emerging markets has been accompanied by significant investment from domestic operators, particularly in Asia (partly due to very low interest rates). In the light of these considerations, the

improvement in living standards in emerging countries is even more central to our fund management, representing 27% of assets.

► **Commodities are enjoying robust demand from China**

Commodities were eroded slightly during the quarter, from almost 25% to 23% of assets, mainly due to negative relative performance. Market predictions of an upturn in investment in developed countries are having a slightly detrimental effect, explaining the market correction in the energy and materials sectors following their significant outperformance since the start of the year. It is worth noting that China's relative dynamism compared with the rest of the world has resulted in a second major change for commodities. In the past, China accounted for 25% to 30% of global demand for the majority of commodities. Given the weakness of developed economies, the proportion is now almost 40%, and even higher for some commodities. This phenomenon, amplified by the acceleration in growth across the emerging world as a whole, has had two consequences: a greater than expected impact on demand in the short and medium term, and the increased risk of a real shortage in supply of certain commodities in the long term. Given the continuing reduction in supply, this situation undoubtedly constitutes a structural factor for investment in companies producing commodities.

► **Boosted by the favourable interest rate environment, the major US banks are returning to growth**

The Anglo-Saxon bank theme represents nearly 12% of Carmignac Investissement investments. The US banks that have cleaned up their balance sheets are now in a particularly enviable competitive position, with the yield curve allowing them, through their transformation activity, to hedge most of the losses generated by their activities that are still exposed to the effects of the crisis.

## **II – Bond performance drivers**

► **Corporate bonds remain our preferred performance vector**

In an interest rate environment with the Eonia at 0.4%, the search for bonds with high yields is an important focus of our management. Corporate bonds issued by leading companies for medium durations (less than 5 years) remain our preferred investment in the bond segment. Credit spreads have narrowed considerably with the normalisation of the economy in recent months. Nevertheless, although the current valuation of risk premiums coincides with an economy poised to emerge from recession, it does not yet reflect the prospect of an upturn and continues to offer performance potential. In this context, we have chosen to structure Carmignac Patrimoine's corporate bond segment, which was increased from 19% to 29% in the quarter, around defensive sectors (e.g. non-cyclical consumption, health) where we do not anticipate a narrowing of credit spreads but which offer a satisfactory yield. Added to this component are bonds from more cyclical sectors (e.g. finance, commodities, industry and cyclical consumption), which not only offer high returns but harbour considerable potential in terms of reduction of risk premiums, which will start to happen once the global economic upturn takes hold.

► **The government bond segment of developed countries has been reduced**

Government bonds of developed countries have been reduced from 21% to 15% of Carmignac Patrimoine's portfolio. Our weighting in this asset class has been kept low and concentrated solely on the short part of the European yield curve. We continue to believe that there is little danger in Treasury bonds (less than 2 years), despite their low yield.

This expectation is all the more valid for Europe, where the prospect of a recovery in 2010 is being put back, making an imminent tightening of ECB monetary policy unlikely.

► **We are taking advantage of the re-establishment of the inflation premium in the United States**

The current phase of “normalisation” has encouraged the markets to re-establish an inflation premium. We are taking advantage of the re-establishment of the gap between nominal rates and actual rates through our arbitrage on index-linked government bonds away from nominal government bonds. Even though we are not for the time being anticipating a significant return of inflation in the medium term, we are benefiting from a return to normal after a period where very low prospects for inflation reflected credit-crunch-driven deflationary fears. In Carmignac Patrimoine, this segment has been increased from 6% to 9%.

► **The emerging countries represent the key component in the recovery**

Emerging bond markets have benefited significantly from the resumption of favourable growth prospects. Our investments have been underpinned by two management themes: the return on countries boosted by endogenous growth momentum (e.g. Brazil, and China via countries likely to be indexed to Chinese demand such as Korea) and European convergence (e.g. Poland). We have initiated positions in this respect, mainly on bonds denominated in strong currencies such as the dollar and euro. For example, we subscribed to the launch of a Korean 5-year dollar-denominated government bond, at a yield of 4% higher than the same maturity US Treasury Bond. At the end of the quarter, the yield was 2.4% higher. These positions have been supplemented by a position on falling rates in Brazil, via the purchase of local debt maturing in 2012 and offering a yield of 11.5%. These emerging market strategies currently account for 3.7% of the Carmignac Patrimoine portfolio, but we intend to double this allocation as market opportunities arise.

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*About Carmignac Gestion*

Founded in 1989 by Edouard Carmignac, Carmignac Gestion is one of the leading independent management companies in Europe today. Its capital is 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 a successful and reknown portfolio management.

With more than 20 billion euros of assets under management, Carmignac Gestion offers 19 funds in all asset classes – equity bond and balanced, as well as a mandate offering delivering a relevant response to investor expectations.

Our funds are actively distributed in 8 European countries: France, Luxembourg, Switzerland, Belgium, Italy, Germany, Spain and the Netherlands. Within the context of its international development, the company also has, since 1999, a Luxembourg subsidiary, and in 2008, two representative offices in Madrid and Milan.