

Economic Outlook and Investment Strategy for Q4 2011

I – Economic Outlook

- ▶ With the European crisis spiraling out of control, the issue of growth needs to top the agenda

The situation in Europe is particularly worrying. In a developed world decreasingly capable of generating economic growth, the markets' attacks on countries with the most obvious fiscal slide will only encourage austerity policies, thereby amplifying recessionary trends. As it is, any attempt to tackle the Greek problem and prevent contagion to other member states will be in vain if no substantial measures designed to stimulate short-term growth are implemented simultaneously. Without growth, the deficit and debt reduction will be impossible. Europe is currently opting for the Japanese method of tackling over-indebtedness. This is suicidal: its exports are too low to offset the negative effects of austerity policies on domestic demand, and impatient foreign creditors are not willing to let "time take its course". Furthermore, the weakening of European banks, which are structurally vulnerable to tougher refinancing conditions (with a credit/deposit ratio of 165% versus 81% in the United States), will encourage them to pressure households and businesses into repaying their debts too. Bearing in mind that the weight of bank loans in relation to GDP is 164% in the eurozone compared with 62% in the United States, one can imagine the risk presented by this accelerated deleveraging, which a forced recapitalisation of banks would slow down at best.

- ▶ The ECB needs to implement a zero interest rate policy and devalue the euro

Given the extent to which the European political establishment is struggling to come up with a quick, credible solution to peripheral countries' problems, it is left to the Central Bank to take a radical initiative without delay, orchestrating a sharp reduction in both the value of the euro and enfeebled governments' refinancing costs. This means slicing key interest rates to close to zero and buying up non-sterilised endangered countries' public debt. The consequent depreciation of the euro would spur growth by making exports more competitive, while massive liquidity injections would counter deflationary pressures and maybe even generate a little inflation, thereby easing the debt burden. This initiative on the part of the ECB is absolutely imperative, but Germany is blocking it despite the fact its 2012 growth forecasts were cut from 1.9% to 1.2% between August and September.

- ▶ The US has greater fiscal leeway, though the political situation may hinder the introduction of any stimulus measures

The US economy has not yet had to deal with impatient creditors, as reflected in the lower Treasury bond yields that followed the rating downgrade by Standard & Poor's. The US Federal Reserve also seems more determined than the ECB to do all it can to offset the deflationary pressures sparked by deleveraging. However, the electoral campaign will probably dissuade public authorities from introducing any bold measures to support the economy. On its own, failure to extend the tax cuts made during the Bush era (which is conceivable given the political establishment's dogmatic

posturing) would – all other things being equal – reduce growth by 1.3% in 2012, mainly by weakening consumer spending. Between January and September, the consensus growth forecast for 2012 dropped from 3.3% to 2.1%, which we think is still far too optimistic.

► Inflation is becoming less of a problem in emerging countries, as reflected in the first round of interest rate cuts

Emerging countries remain subject to inflationary pressures, due in part to the delayed effects of higher commodity prices but also to more structural factors such as intentional whether managed wage growth. For example, excluding food, Chinese inflation has risen from 1.4% to 3.0% over the last 12 months. The downswing in industrial and agricultural commodity prices will doubtless ease inflationary pressures in China – something other emerging countries seem to have anticipated with "surprise" interest rate cuts in Brazil, Turkey, Russia and Israel.

► Emerging countries enjoy substantial financial leeway, making them capable of withstanding the risk of contagion

Our analysis leads us to believe that the considerable reserves built up by exporting countries in the emerging world will shield them from the contagion feared by many observers. For example, the recent sharp fall in some emerging currencies against the dollar and in both foreign and local debt securities does not point to future structural financing problems for the leading players in the emerging world. Between the situation that prevailed before the Asian crisis at the end of the 1990s and the current situation, emerging countries have gone from being indebted to the rest of the world to being its creditor of last resort. However, this structural change in the balance of power between the two worlds must not lead to complacency. Unlike in 2008 when the Chinese stimulus package prevented a global recession, China now sees no need to reverse its restrictive monetary policy or to adopt revival plans. First because, at 6.2%, its inflation remains high and, second, because its economy is still running close to full throttle.

► A renewed appreciation of the yuan would act as a catalyst for emerging markets

Emerging markets will not be able to completely free themselves of the problems impacting developed economies without a powerful catalyst. We think the reversal of Chinese monetary policy will be this catalyst. Once stimulus measures are approved (reduction in banks' required reserve ratio), the sheer scope and variety of measures available to China will contribute to a firm recovery, strongly supported by equity markets whose valuations have returned to their 2008 levels: historical lows that are increasingly attractive to investors. Such an upturn should push up the value of the yuan, which would then help revive the global economy.

II – Investment strategy

I – International equities

► We are maintaining a defensive stance

Our economic analysis has led us to maintain our defensive positioning. European authorities' incomplete response to the debt crisis, as well as political deadlock in the United States and China's desire to leave in place its restrictive monetary policy to curb lending and inflation, are all making a more pronounced economic slowdown highly likely in developed countries, bringing the markets down even further. We are therefore keeping equity exposure low as we enter the quarter. However, as a tactical move, we plan on increasing the portfolio's exposure to take advantage of market sentiment, which is sure to improve ahead of joint EU and IMF initiatives in early November. But unless the measures announced target short-term growth, our fund managers will maintain a defensive bias, in particular by minimizing the portfolio's exposure to the euro.

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

Though still predominant by a fair margin, the theme of improving living standards in emerging countries has seen its weighting cut from 38.6% to 34.0% of the Carmignac Investissement portfolio, largely through a relative weakening of emerging market equities then amplified by the depreciation of certain currencies at the end of the period. Forced selling by some global funds proved a burden towards the end of a disastrous quarter for stock markets. The only addition to the portfolio was Sun Art Retail, a promising joint venture involving Auchan in the Chinese retail sector. In terms of sales, we closed our position in Haci Omer Sabanci (Turkey) and reduced our investment in LVMH.

► Our gold component remains unchanged

The second most important theme is henceforth gold mining, which has been increased from 11.2% to 14.4% of the Carmignac Investissement portfolio due to the sector's relatively marked appreciation, which resulted in a positive absolute performance over the quarter. The theme was also developed with the addition of a new Canadian company: Detour Gold. We subscribed to the company's last public offering before it starts tapping a particularly attractive deposit. We also strengthened our position in Randgold.

► We have scaled back our exposure to the commodity and innovation sectors

Reduced from 15.5% of the Carmignac Investissement portfolio to 12.2%, the emerging market theme was hindered by our fears as regards global growth. We sold our positions in National Oilwell and Galp Energie and trimmed back our Schlumberger holding. Once our base materials positions have been taken into account, the natural resources theme currently accounts for 14.8% of the portfolio. The innovation theme was reduced from 11.6% to 10.7% of the portfolio, even if we did strengthen the position in Apple, which never ceases to amaze and seems capable of further success despite the death of its founder. The Mediatek position was closed owing to a lack of visibility in the face of stiffer competition. Lastly, Hewlett Packard's bid for Autonomy at an 80% premium was a source of great satisfaction. The

allocation to defensive stocks was raised by one point to 13.3% of Fund assets.

► The cash component has been increased

The increase in the cash allocation, to 11.7% of the portfolio from 6.2% three months ago, reflects our ongoing distrust in equity markets. Along with gold and the portfolio's defensive stocks, it makes up a defensive component that accounts for 40% of the portfolio, compared with 60% allocated to growth themes.

II – Bond performance drivers

► The flexibility of our asset allocation is proving particularly useful in this tumultuous environment

With the risk of recession dampening global economic growth, our allocation to our various performance drivers is more flexible than ever. Given the lack of visibility that exists at the end of the quarter over both the extent of the US economic slowdown and the euro rescue plan, the Carmignac Patrimoine portfolio has been structured to overcome the risk of these recessionary pressures intensifying. Of course, a clearer view of these two major uncertainties would prompt us to make tactical adjustments.

► German and US government bonds offer a safe haven in this economic slowdown

If bold decisions are not taken and implemented immediately in Europe, recessionary and deflationary pressures will persist in the short term, thus conferring essential safe haven status on leading government bond markets (United States, Germany). The developed country government bond component was stepped up from 3.65% to 10.4% of Carmignac Patrimoine's assets. We ramped up the weighting of this component by increasing our German government bond allocation until mid-July. Indeed, the European crisis led us to seek out safe haven securities. However, proposed solutions to the European crisis make any further investment in Germany too risky with the ECB refusing to monetise the debt owed by the weakest member states. Since mid-July, our exposure has been concentrated on the United States. The Fed has taken further unorthodox measures, promising to keep interest rates at zero until 2013 and introducing a program to extend the average maturity of its US Treasury bond commitments.

► The emerging government bond weighting has been reduced

The emerging government bond component has fallen from 4.3% to 2.5%, with 1.7% invested in local emerging debt. Investors' positioning remains the primary technical factor weighing on short-term prospects. We will not hesitate to build up our investments in this asset class if the scenarios of a deep recession in the United States or of a major systemic risk prove unfounded. Indeed, the recent decline in emerging currencies and bonds will soon present a worthwhile opportunity as fears of developed countries' problems spreading seem highly exaggerated, even if the wait for growth-friendly policies in the emerging world may give some cause for concern in the immediate future.

► Offering high upside potential, the corporate bond component remains essential

Carmignac Patrimoine's corporate bond allocation was cut from 32% to 26.3% by selling the issues that seemed most vulnerable to an economic slowdown. As the situation stood at the end of September, the credit component of the portfolio should act as an important performance driver, even in periods of economic slowdown, yielding an average of 6.41% for average duration of 5.6 years (compared with 1.32% for German government bonds of the same maturity). Such a yield spread – close to that seen in the depths of the 2008 crisis – seems unjustified given the quality of issuers held in the portfolio. Caused mainly by banks' withdrawal from the secondary market just when some fund managers were making precautionary sales, this widening of corporate bond spreads appears to present a real opportunity on the market.

► Skeptical of how the European crisis is being handled, we have reduced our euro exposure while ramping up our cash position

The euro will have to weaken, as its devaluation is the only way to ensure its survival. Our skepticism about the handling of the European crisis led us to reduce our exposure to the single currency, hedging our euro-denominated assets by forward buying dollars and yen. Similarly, most of our cash, which increased from 17% to 23% of assets over the quarter, was invested in US and Japanese government bonds, enabling us to benefit from these currencies' appreciation against the euro over the third quarter (7% and 1% respectively).

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Press contacts:

CARMIGNAC GESTION

Marie VANBREMEERSCH

Tel: +33 1 70 92 33 85

mvanbremeersch@carmignac.com

CITIGATE FIRST FINANCIAL

Edi COHEN

Tel: +316 215 178 20

edi.cohen@ciftigateff.nl

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