Agincourt Capital Management, LLC

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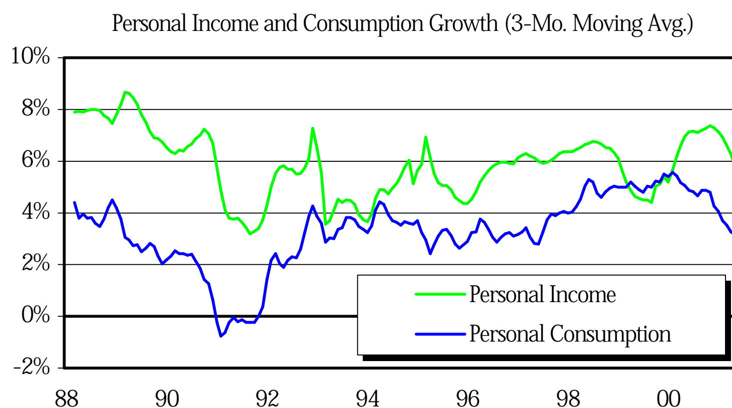
INVESTMENT UPDATE

A recent joke goes something like this:

> *Fed Chairman Alan Greenspan turns 75 years old this week. Sources close to Greenspan, however report that he is trying to convince his colleagues to lower his age to 74 ¾.*

We're not convinced that Greenspan can turn back time, but he certainly has been influential this year, leading the Federal Open Market Committee and putting in place the most aggressive economic stimulus plan in a generation. By the end of this month, the Fed funds rate will most likely be at 3.5%, cut nearly in half from where it started the year.

The Fed's stimulus plan, in a classic textbook sense, should begin to pay off in the next few months. In fact, while there are still obvious signs of weakness in the current US economy, we are growing more comfortable with the idea that the economy has bottomed.



As has been the case all year, the consumer is the pillar of strength in the US economy.

Despite the obvious "anti-wealth" effect from falling stock prices, consumers have continued to spend at a fairly robust rate this year. While the financial press has focused on unfavorable comparisons of some individual retailers' "same-store sales", we are much more interested in the macroeconomic picture. From an economy-wide perspective we see that personal consumption, while slowing from a very high level, is still growing at an annual rate of approximately 3% this year (as shown in the chart).

The chart also shows the main source of consumers' liquidity: Personal income is still growing at approximately 5% year over year. This may surprise some observers who've been following the news of layoffs in the manufacturing sector. But the layoffs still constitute a small part of the overall employment picture—there are more people in the US workforce than practically ever before (the peak was in January), and these people are still earning a paycheck and still spending money.

Another source of income for consumers is coming from the housing market. Many homeowners have used the modestly lower interest rates this year to refinance their older, higher-rate mortgages. Even more importantly, many of these consumers have used "cash take-out" refinancing, liquefying some of the built-up equity that's come from escalating home prices. Consumer's willingness to add to their debt burden by taking out some of the equity in their residences is a very positive indicator of consumer confidence.

There is no question that consumer spending will increase as a result of the tax rebate checks that are arriving in mailboxes all across the country. These $300 and $600 checks add up to $40 billion in readily-liquid funds that can be used to pay off credit cards, buy back to school supplies, or set aside for holiday shopping (some may even be saved!). We have already seen ads on TV encouraging consumers to "Bring in your rebate check!" to home improvement centers and new car dealerships.

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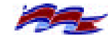
As we mentioned earlier there are still risks to the current economic turnaround, mainly from the manufacturing sector, and especially the technology and telecom industries. With consumer spending moderating , and after the massive investment in capital equipment of the past decade, manufacturers have found themselves with overcapacity and excess inventories. The net result has been production slowdowns and scattered layoffs as firms adjust their output to meet a more modest level of demand.

But even here we are seeing encouraging signs from the statistics on second quarter inventories, which showed major reductions in the available stock of manufactured goods. This is significant because the more inventories are drawn down today, the less the inventory "drag" will be going forward. That is, with lean inventories there is a very direct relationship between demand and production. Unless demand plummets, positive economic growth is assured.

Unfortunately, manufacturers shouldn't expect to get much help from overseas, as our major trading partners' economies are weakening even as ours appears to be stabilizing. The Japanese Ministry of Finance has recently renewed their "zero-rate" monetary policy, mandating interest-free lending to businesses in a desperate effort to encourage investment and growth. In Europe, despite sluggish demand the Central Bank is pursuing a tight monetary policy in order to prop up the value of the Euro currency. While the Euro has gained some ground recently, the European Monetary Authority may soon find it in their best interest to allow the Euro to weaken and boost the affordability of European goods in the global market.

Yet while these risks to recovery are real, our outlook is fairly positive. It now seems clear that, after helping to slow down the economy, energy prices have peaked. With inflation concerns on the back burner the Fed retains a high degree of flexibility to lower rates further in the months ahead if the economy fails to respond adequately to the stimulus already in place.

This slower-growth, low-inflation environment we have described should continue to be favorable for bondholders, yet most likely will continue to challenge equity investors. Earnings growth will be tough to come by as companies continue to adjust production to meet a lower baseline of aggregate demand. In contrast, as we have mentioned before, bondholders will benefit as corporate treasurers use this transition period to repair their balance sheets, reduce leverage and improve their credit ratings.



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