Agincourt Capital Management, LLC

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INVESTMENT UPDATE

This month, while Ronald Reagan celebrated his 90th birthday in Southern California, the main topic in Washington was eerily Reaganesque: tax cuts. The US Treasury, after posting the largest budget deficits in our country's history just a few years ago (due at least in part to the tax cuts of the 80's), now finds its account bulging with surplus funds. We thought it might be instructive to look back at how the US got its fiscal house in order, and what continued budget surpluses may mean for bond investors in the years ahead.

A transformation in the workplace occurred in the late 1980's/early 90's. As a result of the widespread corporate restructurings and layoffs during the last recession (impacting all levels of the workforce) people stopped looking at their employers as their caretakers and began looking out for themselves: upgrading their skills, learning new trades, and opening small businesses. At the same time, years of heavy spending on technology finally began paying off for corporate America. Companies were able to do more with fewer employees, and the remaining employees learned how to manage their workday more efficiently.

These productivity improvements propelled the expansion of the past ten years and continue today. Sustained growth with little inflation was the hallmark of the 90's. As the economy soared, so did incomes, the stock market, and government tax receipts (marginal tax rates for individuals were also bumped up). With the demise of the Cold War, defense spending was pruned. During this period the US didn't just reduce the annual budget deficits; we began generating budget surpluses.

How things have changed. Surpluses are now considered the norm and are even projected to accelerate over the next few years.

But when the federal budget is heavily in the black, what does the Treasury do with its excess funds? For the past few years they have used surplus funds to pay off existing debt as it matured while issuing fewer new bills, notes and bonds; in 2000 the Treasury began buying bonds in the open market, actively reducing the amount of long maturity Treasuries in circulation (while creating a mini-mania for these bonds, and an inverted Treasury yield curve). Marketable Treasury debt has shrunk dramatically; since year-end 1997 Treasuries have decreased from 43% of the Lehman Aggregate Index to 26% today. During this same period marketable Treasuries shrunk from $2.1 to $1.6 trillion. If the current pace of net buybacks continues (including scheduled maturities) all marketable Treasury securities will be gone in approximately seven years.

A balanced budget is desirable, but a budget perpetually in surplus may not be. Retiring all outstanding Treasury debt, especially if done rapidly, could create numerous problems. Elimination of Treasuries means that investors lose the primary benchmark in the US bond market. Corporate treasurers and bond investors, accustomed to looking at incremental yields over Treasuries for analyzing the value of "spread product" are adopting new tools, using the interest rate swaps market as an alternative benchmark. Yet swaps contracts don't have the intuitive appeal of Treasuries, nor are they substitutable for Treasury holdings for most investors. Another issue to be dealt with is that the government itself has a strong interest in maintaining an active Treasury market; the Treasury wants to maintain its flexibility to efficiently auction new issues should the need arise in the future. The Fed needs a viable Treasury market to manage monetary policy (i.e., buying and selling securities in open market operations). Finally, tendering all outstanding Treasury debt would become increasingly expensive, as many risk-averse investors (including foreign governments) would be reluctant to sell their Treasury holdings.

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Perhaps the biggest unanswered question of all is what will the Treasury purchase with its surplus funds once all the available Treasuries are retired. If the Treasury began buying corporate bonds obvious conflict of interest questions arise—how can the Treasury avoid playing favorites when it chooses one company's bonds over another? They could buy Agency issues, but that goes against the Treasury's current push to see the Agencies operate more autonomously from the government.

Which brings us back to taxes. The top marginal tax bracket has crept up to 39% from 28% in 1989. The American public seems fairly satisfied with the current level of government programs and despite some minor skirmishes spending appears to be under control. There is widespread agreement that the time has come to reduce tax rates in the US. It is preferable that individuals make the investment and spending decisions with their after-tax income, rather than have the government make some of those choices for them. This was Greenspan's main thrust in his recent testimony to the Senate Budget Committee:

> *…having the federal government hold significant amounts of private assets would risk sub-optimal performance by our capital markets, diminished economic efficiency, and lower overall standards of living… it is far better, in my opinion, that the surpluses be lowered by tax reductions than by spending increases.*

Cutting taxes to prop up a slowing economy may, in Greenspan's words, "do noticeable good", but should be a secondary consideration—tax cuts are "difficult to implement in the time frame in which recessions have developed" and therefore not nearly as powerful a tool as changing short-term rates in controlling the growth of the economy.

A tax cut is coming, and that's good news for everyone who earns a paycheck. For bond investors, the "structural" benefits of a tax cut may even outweigh the potential economic benefits. While it now appears that the Treasury market, as we know it, will eventually be pared down to zero, any move to extend this transition period of the restructuring of the bond market will have a calming effect on investors.

In the meantime, we will be managing our clients' portfolios while making preparations for a world without Treasuries. With buybacks certain to continue in the foreseeable future and considering today's steeper yield curve, long Treasury bonds offer better relative value than in the recent past; now may be a very good time to boost our holdings in longer maturity Treasuries. The Agencies will continue to be aggressive issuers of new bonds and are growing almost as fast as Treasuries are shrinking; Agencies will continue to play an important role in our client's portfolios. In our analytical work, we've adjusted our models so that we can analyze corporate and mortgage securities' valuations compared to swap spreads as well as Treasuries. We place a high priority on the continuing development of our analytics to ensure that we remain one step ahead of the changes we foresee in the bond market over the next few years.

As a quick addendum, we are pleased to report that the corporate sector posted very good returns in January. Considering the slower economy, the path that corporates take this year will likely have some bumps in it, yet we remain highly confident that the corporate sector will be the top performer in 2001. We consider January a "good start".

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