Agincourt Capital Management, LLC

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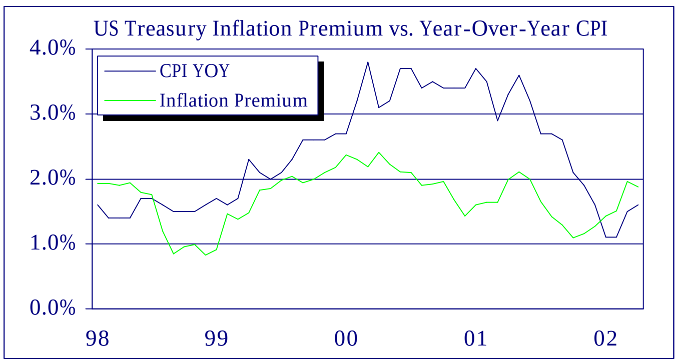
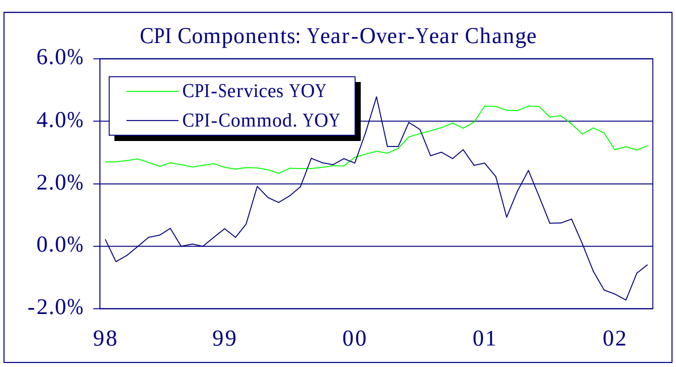
INVESTMENT UPDATE

Inflation is the bane of investors, eroding the value of the fixed payments that bondholders expect to receive and driving down P/E ratios for stock investors. When inflation was at its worst—as it was in the 1970's in the "bad old days" of oil embargoes, expansive monetary policy and leisure suits—bond and stock prices plummeted and bond yields rose ever higher to persuade investors to try their luck. Even after inflation began to fade in the early 80's, the damage inflation caused to investors' psyche persisted. With a decade of bond market misery still fresh in investors' minds, buying Treasury Bonds with yields of 14% was still considered "risky" in 1984, even though inflation had begun its long move downward.



What's fresh in investors' minds right now is the polar opposite of what they were thinking in 1984. In today's global economy, inflation is dead, as anyone will tell you. Earlier this year the US Consumer Price Index hit its lowest levels since the early 1960's. Yet we cannot help but feel, with gold prices suddenly shooting up, the dollar falling, fiscal deficits deepening, and a "what, me worry" attitude from the Federal Reserve, a growing sense of *déjà vu*. Could investors be as blind today to a possible upswing in inflation as they were 20 years ago to the historic drop in consumer prices? Let's look at the evidence.



The first thing to note is that investors today are just not that concerned with inflation. The top chart shows the historical inflation premium (the difference in yield between a 10-year US Treasury Note and a 10-year Treasury Inflation Index security) over the past few years; the chart also shows the actual rate of trailing 12-month CPI. Over the past four years, the premium investors have demanded for an inflation-exposed security relative to an inflation-protected security has consistently been less than the actual inflation rate. In other words, investors have been, and for the most part continue to be, overly optimistic regarding the future rate of inflation.

The first chart also shows a nascent, yet troubling reversal in the recent downward trend of year-over-year inflation. A closer look at the major components of CPI is revealing. The CPI is split between measures of services (59% of total CPI) and "commodities" (41%) inflation. As the second chart shows, over the past few years, the commodities component (which includes manufactured consumer goods) has fallen dramatically due to lower energy costs, a lack of pricing power among retailers, excess capacity overseas, and the strong dollar. By comparison, services inflation has been fairly stable, but at a much higher level of more than 3.0%.

However, the second chart demonstrates that the "tailwinds" from the deflationary non-services items appear to be subsiding, as CPI-Commodities' prices are suddenly on the rise. Part of this is due to higher energy prices, but it's also a result of the sudden weakness of the US dollar. A weaker dollar, while helping to make US goods more attractive overseas, drives up the prices

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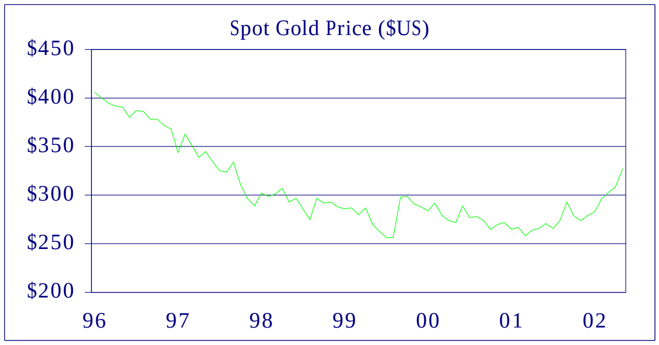
of imported goods here at home. Continued weakness in the dollar would remove much of the disinflationary benefits we've enjoyed since the mid-90's.

There are other troubling signs of building inflationary pressures. The Federal Reserve continues to pursue an aggressive monetary policy to revive the economy, even though GDP has been growing at a healthy clip for more than six months. The Fed is just now willing to admit (May 7th FOMC Press Release) that conditions are becoming "balanced" between growth and inflation—for the first time in more than one and one-half years (and 14 Committee meetings) the FOMC isn't saying that "economic weakness" is the prevailing concern. While that's a start, the Fed continues to maintain the funds target rate at 1.75%, despite annual growth of M3 (a broad measure of money market and other short-term funds) of nearly 10%. Call us old-fashioned monetarists, but rapid money growth in a growing economy makes us nervous about the prospect of higher inflation.



We're becoming increasingly concerned about US fiscal policy as well, as budget deficits mount. While this can partly be attributed to needed defense spending, we are seeing unmistakable signs of "pork" in the numbers. Not long ago the major political parties were fighting over the high ground of fiscal responsibility. Not anymore. This fiscal year, Federal outlays are projected to grow by almost 9%, the fastest rate since 1992; we expect a budget deficit of approximately $200 billion this fiscal year. Projections show little hope for improvement over the next few years.

The final, and for some, most disturbing warning sign of higher inflation is the recent rapid rise in the price of gold. Gold has long been the favorite hedge against higher inflation, as it has "intrinsic value" that cannot be eroded by inflation. As the chart shows, after spending more than five years in a narrow trading range, gold is at its highest level since mid-1997; year-to-date, gold has already produced its best returns since 1987.

We hope we're wrong, and these warning signs are just a series of head-fakes. The Fed may be privately concerned about inflation, but avoiding the subject in order to buttress consumer confidence; they may even be in favor of a small increase in inflation to give producers some pricing power (hopefully boosting profits and, ultimately, the stock market). The dollar could rebound versus other currencies, keeping import prices down. The demand for gold could simply be a reflection of investors' desire to own hard assets in an uncertain world where developing countries have the capability to wage nuclear war and reports of terrorism are the days' top stories. We could even get an unexpected (but unlikely, considering Middle East tensions) drop in the price of oil that could offset some or all of the factors pushing consumer prices up.

In any case, we are carefully monitoring these and other signs for clues to the future direction of inflation. We may need to pull back the average maturity/duration of our clients' portfolios if we begin to see the "whites of the eyes" of inflation, in order to protect against declining bond prices. We may also have to shift our yield curve weightings around, de-emphasizing inflation-sensitive longer maturities, should actual inflation pick up dramatically. We'll keep you posted. We know how to deal with higher inflation; leisure suits, on the other hand…

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