Agincourt Capital Management, LLC

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INVESTMENT UPDATE

"…In the judgment of the Federal Open Market Committee, the probability of an unwelcome substantial fall in inflation over the next few quarters, though minor, exceeds that of a pickup in inflation."
Federal Reserve Chairman Alan Greenspan, May 2003

"It is therefore quite unacceptable for a central bank to declare war on inflation at one time and to promote it at another…it is essential that the central bank adhere at all times to the single policy objective of averting inflation or deflation." Former Bank of Japan Governor Masaru Hayami, September 1998

It has been more than a month since the Federal Open Market Committee announced that even though it was leaving the Fed funds rate at 1.25%, the Committee was becoming increasingly concerned with the continued lack of growth in the US economy and the need to battle the forces of deflation. In the weeks since, these concerns were repeated, both by Greenspan in his May 21 Congressional update and on May 16 by Vice Chairman Roger Ferguson. Interest rates have responded by falling further as investors have priced in even more Fed easing and more economic weakness.

There is no question that what the Fed has on its mind right now is Japan. Japan, whose economy soared for four decades after World War II, now represents the greatest failure of the world's modern central banks. If there is any scenario that haunts the dreams of central bankers around the globe, it is that their economy becomes "The Next Japan". Of the many problems facing the Japanese economy, none loom larger than the issue of deflation. The Bank of Japan has been criticized (even by the Fed) for failing to respond more forcefully to the forces of deflation—the quotes above contrast the BOJ's critical failure to acknowledge the dangers of deflation in 1998 with the Fed's current preoccupation with even a "minor" risk of deflation.

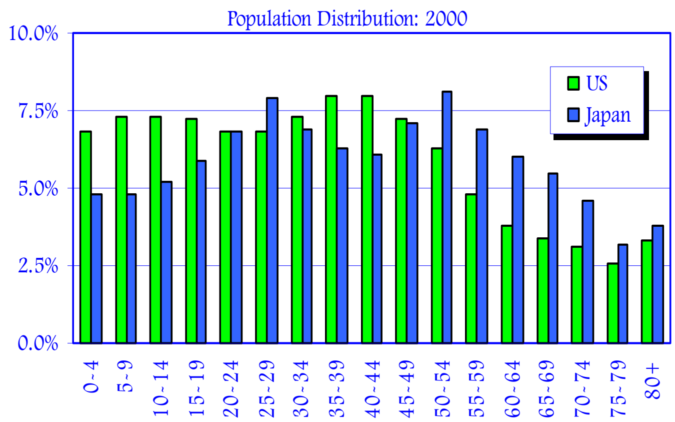
The Fed has every right to be concerned with deflation; as Japan has learned in a very painful way, once it sets in, deflation is even more difficult to reverse than inflation. In an inflationary environment, the central bank can always raise interest rates higher to shut down the creation of credit and slow down an economy and its inflationary tendencies. But once deflation sets in, even zero percent interest rates result in positive "real" (i.e., deflation-adjusted) rates—that is, monetary policy is still "tight" even when money can be borrowed for free! In a deflationary environment there is no incentive for business and individuals to spend (much less borrow) since prices will be lower tomorrow than they are today. Likewise, the value of inventory and other assets decline in the face of deflation; remarkably, saving is the best route, even when nominal returns are zero.

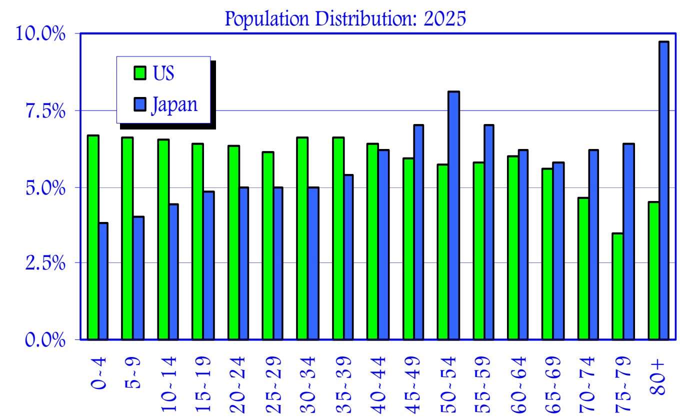
The Fed's new role as a deflation fighter is a radical change from its policies of the last quarter-century. Ever since the cigar smoke-screen days of Paul Volker, the Federal Reserve (and its Open Market Committee) has been engaged in a long and successful battle to cast out the demons of inflation from the US economy. The Fed's new goal, to *reflate the economy*, represents a "sea change" at the US central bank.

Since the Fed operates behind closed doors, it is often difficult to get firm details of how its members may be thinking about the important issues of the day. Fortunately, to get a handle on the Fed's views on deflation, we can go directly to the source—the Fed's very own June 2002 study entitled, "Preventing Deflation: Lessons from Japan's Experience in the 1990's". This paper, while not exactly a John Grisham page-turner, presents a thorough analysis of what happened to the Japanese economy in the first half of the 1990's and the policies that were undertaken (and which were not, but should have been) to stimulate their economy and avoid a deflationary spiral.

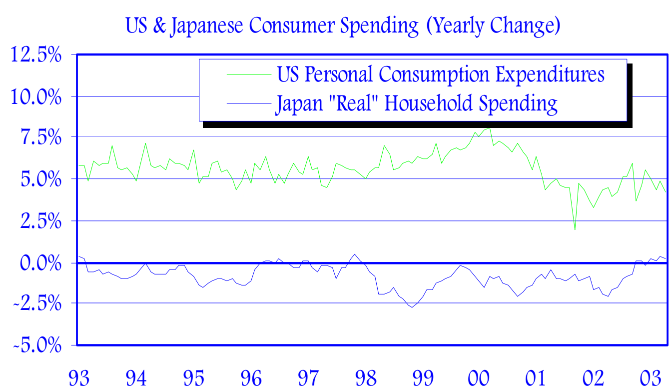
At the risk of spoiling your own reading of this piece, we'll give you the main conclusions that the Fed drew from the Japan experience: Japanese policy-makers failed to recognize the depth of their economic problems and were overly timid in providing both the fiscal and monetary stimulus to get their economy back on track. By the time they realized the severity of their own situation, deflation had already set in and their ability to stimulate was severely compromised. With the full benefit of hindsight, the Fed suggests that had the BOJ and the Japanese government put forth a stimulus program (both monetary and fiscal) that was *more aggressive than what the baseline forecasts called for*, they might have been able to boost their economy.

Before we get too worked up about the US sliding down the same slippery slope as the Japanese economy, we should take a moment to point out some of the major differences between the US and Japan. The first among these is the very different age demographics between our two countries. As the first two charts show, not only does the US have a much younger and more evenly distributed population today, but by 2025 Japan's demographics become even more "top-heavy", with nearly 30% of its population aged 65 or higher. During this 25-year period, the age of the average American will extend from 35 to 38 years, while the average Japanese will extend from 41 to 50 years of age.





This partly explains the difficulty that Japanese policymakers have been facing in stimulating their economy: an elderly, less productive population is much more focused on saving than spending. The lowering of interest rates haven't been able to make up for the powerful demographic forces that have been at work. The bottom chart shows the failure of the Japanese stimulus program compared to the relatively strong consumer sector that the expansionary US policy has produced. Clearly, lower rates in the US have stimulated personal spending where they failed in Japan.



Another factor holding Japan's economy down is its banking system, which is still struggling as the government continues to bail out failing institutions. Last month, an estimated $17 billion in taxpayer money was used to rescue Resona, Japan's fifth largest bank. Meanwhile the US banking system is thriving; there is talk that both Wells Fargo and Citigroup's banking units may soon be upgraded to "AAA". Japan's poorly capitalized banks are in no position to support struggling Japanese businesses.

Finally, there is the matter of fiscal policy. Even with relatively high tax rates, the Japanese government's debt to GDP ratio is the worst among G-7 countries, leaving them little flexibility to carry out the reforms that the government keeps promising. On the other hand, the recent US fiscal stimulus plan has already been implemented, with provisions to stimulate both US consumers and businesses.

There are many other factors separating the US and Japan, including labor markets, corporate structures and (perhaps greatest of all) cultural differences between our two countries.

In conclusion, while the US can and should learn from Japan's mistakes over the past decade and a half, the US economy is far less susceptible to a deflationary episode than Japan.

Nevertheless, we expect Greenspan & Co. to keep interest rates lower than they might otherwise prescribe, and for a longer period of time, as "cheap insurance" to prevent a Japanese-type scenario. We are confident that the Fed's efforts will be successful, and will be supported by ongoing fiscal stimulus to further encourage the consumer sector of the US economy, while allowing the industrial sector to rebuild in time for the next expansion.