

INVESTMENT UPDATE

For this month's *Investment Update* we thought we might do something a little different and use a question-and-answer format to cover some of the important issues currently facing bond investors. As you'll see, we tried not to abuse the privilege by asking ourselves a series of "lay-up" questions, but asked the type of questions that we've received lately in conversations with our clients. We hope you will find the Q&A informative.

Q: No lay-ups? OK, what is your forecast for interest rates?

A: As we've said many times, our clients' portfolios are not structured on the basis of our interest rate forecast...but if we must have a forecast, here's our best guess: Interest rates are likely to be a little higher a year from now.

Q: Would you elaborate, please?

A: Interest rates, especially rates on US Treasuries, are likely to rise in the second half of 2003 as the economy slowly pulls out of the lackluster growth pattern it has been stuck in for the last two or three years. In particular, we see a greater chance that the yield curve will "flatten" later this year, with short-term rates rising more than long rates. Of course, interest rates won't move much higher unless the economy picks up from here.

Q: What's going to get the economy going at this point?

A: It's important to recognize that both fiscal and monetary policy have been highly stimulative over the past two years, and more stimulus is coming—the Fed has hinted that it can lower rates further if needed, while Congress is ironing out the details on the administration's tax cuts. The lowest short-term rates in more than 40 years have spurred the consumer sector (housing in particular) and are allowing businesses to repair the damage done to their balance sheets in the go-go 1990's. High productivity and (in the manufacturing sector) low raw materials prices are keeping costs down, providing the positive net cash flow and profit growth that will encourage companies to expand and put the economy back on a higher growth path.

Q: The dollar has been weakening; how will that impact the US economy?

A: A weaker dollar (down 21% vs. the Euro over the past year) is generally good for US companies, as it makes US-produced goods more affordable

in foreign markets. This should add to US firms' profit growth. However, it is also true that the weaker dollar makes imported goods more expensive to US consumers. As a result, we expect that the US' huge trade deficit (our purchases of imported goods and services have exceeded our exports for more than a decade) should see significant improvement.

Q: So, Agincourt's interest rate outlook is dependent on an economic forecast?

A: Not entirely, although economic fundamentals are the most important variable. The other primary driver in our outlook for higher Treasury rates has to do with technical (i.e., supply and demand) factors. The Treasury is once again running up a huge deficit (\$300-\$400 billion this fiscal year, with only a modest improvement forecasted for the next few years) as spending has ramped back up while tax receipts have fallen. The new stimulus plan will only make these numbers worse. As a result, net Treasury issuance, which was negative in recent years, has exploded—the Treasury is coming to market this month with the first new 3-year maturity since 1998 (\$22 billion worth), while new 5-year Treasuries will be issued now every month and 10-year auctions will be coming eight times per year.

Q: Investors have seemed willing to absorb the Treasury's supply; why shouldn't the demand for Treasuries remain robust?

A: While it's possible that demand for Treasuries may remain high, foreign investors in particular are beginning to show signs of nervousness. US rates are lower than most other developed countries' Government bonds and a weakening US dollar makes Treasuries look even worse when returns are translated back to the home currency. Foreigners hold more than 40% of outstanding US Treasuries; their appetite for low-yielding, currency-challenged bonds from a country with a relatively strong economy has to be questioned.



Q: How about the Fed? When will they begin raising short-term rates?

A: We think the Fed's main objective has shifted in recent months from fighting inflation to ensuring a sustained economic recovery. As a result, they will maintain their highly accommodative monetary policy stance, keeping the Fed funds rate at 1.25% (or lower) for the remainder of the year even if the economy begins to grow at a more vigorous pace. The Fed wants to make absolutely sure that the US economy doesn't slip back into recession, and seems willing to run the risk of higher future inflation by leaving the monetary spigot on full blast.

Q: The yield curve is steep—is there anything the Fed can do to bring down long-term rates?

A: Historically, a more restrictive monetary policy has tended to bolster investors' confidence that inflation will remain under control, which keeps some downward pressure on long rates. The Fed's current accommodative monetary policy is having the opposite effect, keeping long Treasury yields at higher levels than they might otherwise be. However (and this is a big "however"), the Fed has recently indicated that they may be willing to buy, in the open market, longer-maturity Treasury bonds in order to bring long rates down if they believe that short rates alone aren't doing enough to stimulate the economy.

Q: Has the Fed ever bought long-dated Treasuries in the open market in the past?

A: Not for the purpose of lowering long-term rates. This would set a new precedent.

Q: Corporate bonds had one of their worst years ever in relative terms last year. How have they been doing lately?

A: Extremely well. In fact, April marked the seventh month in a row that corporates outperformed Treasuries. If they hold on to their current gains for the next few weeks, high-grade corporates will have outperformed Treasuries for three consecutive quarterly periods for the first time since 1997. After being left for dead late last year, corporates have recovered to the point where the average high-grade yield spread relative to Treasuries is at a two-year low.

Q: Why the turnaround for corporates?

A: In short, the conditions that conspired to produce the worst market in memory for corporate investors have eased. The main fundamental factor was the piling on of leverage by corporate borrowers in the late 1990's which, when

combined with a slower economy, led to a liquidity crisis for many companies last year. Add to that corporate accounting scandals, banks refusing to lend, leveraged speculators taking massive short positions on corporate credit, and a heavy supply of new debt from companies "terminating out" their short-term borrowings, and you have a recipe for a credit market trainwreck. Over the past few months, investors have become much more positive on the prospects for improvements in fundamentals, as companies are taking giant steps to reduce their debt, while the accounting messes have largely been cleaned up and hedge funds have taken off their big bets against credit. And unlike the Treasury market, new supply of corporates has slowed, and is expected to remain quiescent this year.

Q: You've had an overweight in corporates, any thought to paring back that position?

A: Our work shows that corporates are still attractive, despite their recent stellar performance. Clearly, much of the "easy money" has been made in the corporate sector, and the biggest gains will be made by those with the best ability to pick winners over the next few months. We think we're holding a pretty good hand right now.

Q: Can you bring us up to date on the mortgage sector?

A: Mortgage rates are at their lowest levels in 40 years, and as a result homeowners are refinancing their homes at an alarming rate. For example, MBS backed by 30-year mortgages with rates as low as 6½% are prepaying at a rate where half the homeowners with these mortgages will refinance their homes within the next 12 months. At current rates, the MBS sector resembles a money market universe, where the typical security has an effective maturity inside one year. Despite this prepayment onslaught, MBS have performed very well over the past six months or so. The key to future outperformance will be to carefully balance the risk of prepayment (the "imbedded optionality" of the bond) to the price of the security.

Q: Enough about bonds; any predictions for the stock market?

A: No thanks, we'll just stick to bonds!

*This Investment Update, as well as past editions, is available on our website:
www.agincourtcapital.com*

