Agincourt Capital Management, LLC

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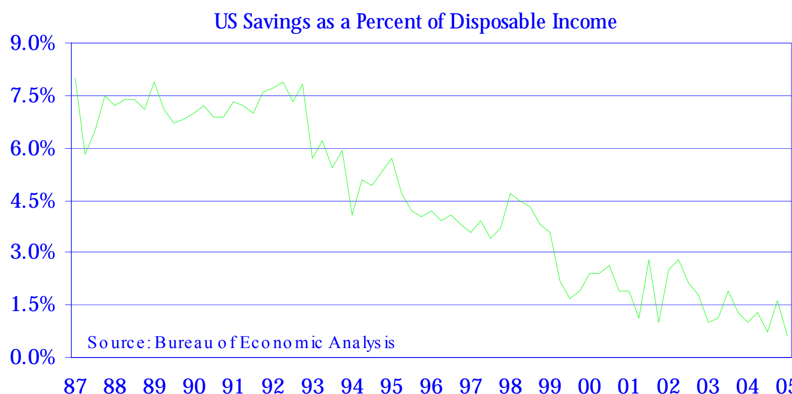
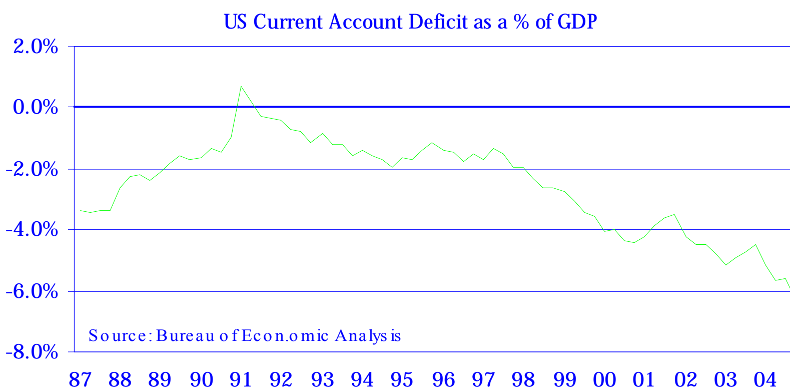
INVESTMENT UPDATE

Americans like to buy stuff. Take a trip to your nearest magazine rack and you'll find buying guides for all sorts of stuff. We can't seem to get enough stuff. In fact, a popular new magazine aimed at young men and their love of gadgets is titled (did you see this coming?) "*Stuff*." As the top chart shows, US consumers are spending nearly all of their disposable income on stuff, with the savings rate now down to less than 1%.

This buying spree has been going on for decades. Consumerism took hold in the US in a big way after World War II and has propelled our economy for more than 50 years. Increasingly, though, the manufacturing of stuff has moved overseas, especially to the Far East. Japan was the early leader, as in the immediate post-war years they began carefully copying the best European consumer goods (Canon cameras in the 1950's were clones of German Leicas), both for domestic buyers who couldn't afford fancy imported goods, but especially for export markets in order to rebuild their war-wracked economy by bringing in foreign money. Over the next few decades, as Japan's economy matured and their labor force became more skilled and more highly compensated, manufacturing facilities moved to other, less developed countries with lower-cost labor.





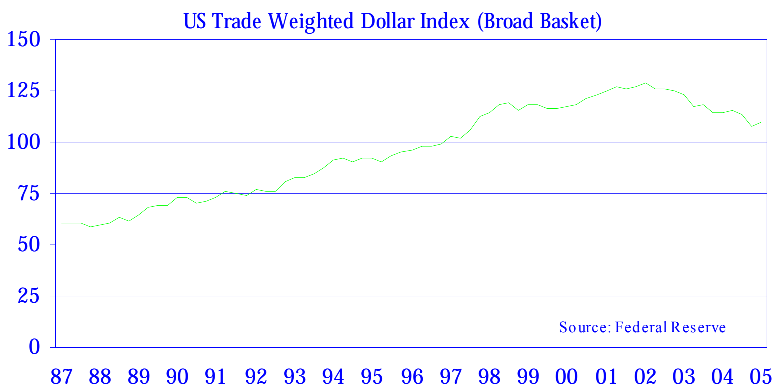
Thus, we saw the emergence of the "Asian Tigers" from the 1970's to today, a list that includes South Korea, Hong Kong, Taiwan, Singapore, Malaysia, and more recently, China. Of these, China is obviously an economic force to be reckoned with. Despite an estimated per capita GDP of only $900, when applied to a population of 1.3 billion, China is the world's sixth largest economy—and growing. China's GDP growth, in real terms, has led all other countries' over the past two decades, averaging nearly 10% annually.

The value of goods and services that China exports far exceeds their imports. Unfortunately, getting a firm grip on the numbers isn't so easy. As the Federal Reserve pointed out in one of their periodic discussion papers released last month ("Adjusting Chinese Bilateral Trade Data: How Big is China's Trade Surplus?"), China understates the value of its exports to the US (and other countries), mainly by using Hong Kong as an "intermediate stop" for much of the goods it sends overseas. So, if something is produced in China and sent through Hong Kong, it may be mistakenly reported as a good exported from Hong Kong. Including adjustments, the Federal Reserve estimates that the US bought between $110 and $124 billion more "stuff" than China bought from us in 2003. Estimates for 2004 are at least $20 billion higher. That's a big number, representing approximately 9% of China's GDP.

The US current "account balance" is the accumulated accounting of international transactions for goods, services and transfers (government grants, money sent back to family members abroad, etc.) between countries. When US consumers buy imported goods, dollars flow overseas, and our current account deficit grows. As the chart on the bottom of this page shows, the US account deficit has worsened dramatically over the past few years, and today stands at over 6% of US GDP, the highest level in modern history.

At modest levels, a current account deficit can be dismissed as reflective of the relative strength of the US economy and the comparative advantage that countries with low-cost labor have in the manufacture of goods. Besides, when foreigners "hold" dollars instead of their own currency, they bring down the borrowing cost of US debt. But there is nothing positive about a current account deficit that grows unchecked. It is a mounting debt that must be repaid.

Any economics textbook will point out that large current account deficits are only temporary in a market with free exchange rates. When capital flows become imbalanced, the currencies adjust accordingly and flows reverse. But today, despite the globalization of the capital markets, not all currencies are free to "float" to their equilibrium level. Policy makers routinely manipulate the price of their currency to achieve a desired outcome—social, economic or political. In the most extreme cases, governments "peg" their currency to some benchmark currency, nullifying the self-correction mechanism that a supply-demand imbalance naturally produces.



This is exactly what has happened between the US and China. China's economy is dependent on exports, and its policymakers must suppress the prices that foreigners (read: Americans) pay for Chinese goods. To quash the inevitable inflation of the Chinese yuan that should naturally occur from their massive trade surplus, the Chinese government fixed its value to the US dollar.

What are the possible solutions to this matter? One alternative is for US policy makers (in this case, the Fed) to continue to raise interest rates. Higher rates give US consumers more of an incentive to save, and makes it more expensive for them to borrow in order to purchase "stuff." But this doesn't necessarily do anything to help the trade deficit, since it doesn't directly impact the price of imported goods, especially those whose prices are held down by artifice. The other problem is that this is not part of the Fed's mandate, which is to maintain "full employment" with "price stability." We don't believe the Fed is likely to face the US trade deficit head-on in its policy deliberations.

A much more effective solution is to devalue the US dollar, especially versus the Chinese yuan. There is little sympathy towards China among US policy-makers. Politicians and commentators are now aware that China has been obfuscating the magnitude of its trade surplus with the US by shipping goods through Hong Kong. The US Congress is hearing every day from their constituents about the outsourcing of jobs to Asia and unfair trade practices, and has already proposed two bills to deal with the issue: in the Senate, there's the Schumer-Graham Free Trade bill which calls for the US and China to negotiate a fair value for the dollar-yuan exchange rate in 180 days, or else all Chinese imports will be hit with a 27.5% tariff. The House's Hunter-Ryan China Currency Act sets forth definitions on currency manipulation and makes it easier for US firms to seek remedies by equating manipulation with illegal subsidies. The Bush Administration has supported a softer approach to dealing with China's trade surplus, but may have to change their tactics to "stay ahead" of this issue, as it has the potential to be a major issue in the 2006 elections.

We don't think it will come to this; we believe that China will find a way to revalue the "peg" without looking like they are bowing under US pressure to do so. While they might not allow the yuan to freely float, they may allow a "dirty" float, whereby the currency is managed up to a more acceptable level. Some estimates place the true value of the yuan approximately 25%-30% higher than where it's currently pegged.

Let's circle around to the central question for us: What does this mean for the bond market? As the chart on this page shows, even though the US dollar has slipped lately against a "trade-weighted" average of global currencies, it stands well above its long-term average. While we've singled out the yuan, it seems clear that there is a broad revaluation ahead for the dollar. The impact will be felt first in US consumers' pocketbooks, as retail prices are likely to rise with the higher cost of imports. Conversely, US goods will become more affordable overseas as the dollar weakens.

While these factors are a mixed bag for US companies' sales and profits (export-dependent firms will benefit, those who rely on cheap imports may suffer), higher consumer inflation is likely to put upward pressure on longer US interest rates. At some point, these higher rates attract demand (even among US non-savers!) and become self-correcting. In any case, our cautious stance on US interest rates continues.