Agincourt Capital Management, LLC

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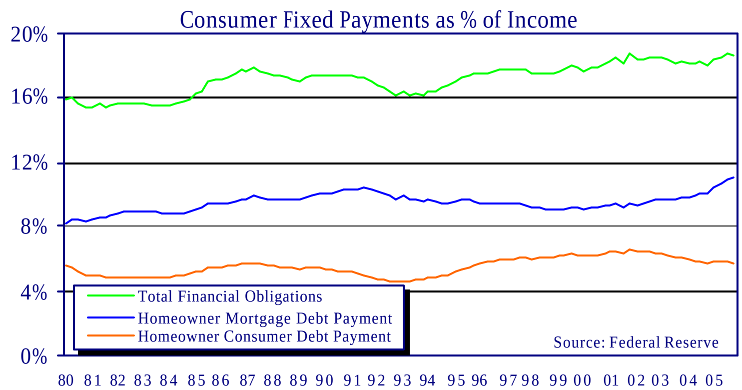
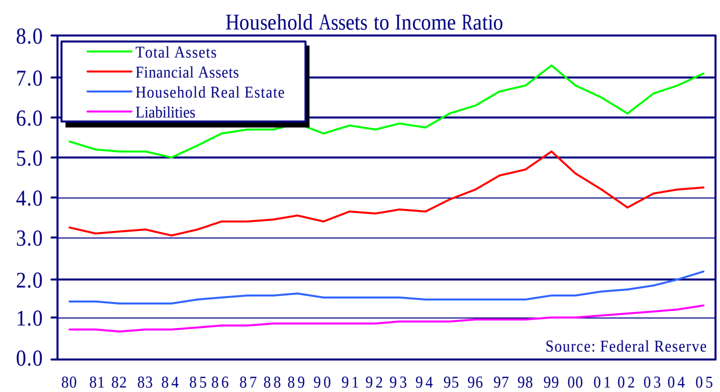
INVESTMENT UPDATE

"Some say the world will end in fire/Some say in ice…"
—Robert Frost, *Fire and Ice*

While we're not ready to tackle the end of the world in this month's *Investment Update* (or in any month's, just to put you at ease), we do think it's a good time to pause and take a look at the current business cycle and get a handle on just how close to the end we may be. After all, excluding the temporary disruptions immediately following the September 11 attacks, we're now in the sixth year of the current recovery. While this is shorter than the duration of the average post-war business cycle, there have been recoveries that lasted even less time. More importantly, the US Treasury yield curve has inverted—with short maturities' yields higher than those of longer bonds—the classic end-of-cycle indicator, marking the point at which the Fed's monetary tightening has raised short rates to the choking point.



Funny thing is, there's precious little choking in the financial markets right now. True, the Federal Reserve has been on the warpath, pushing up the overnight funds rate at each of their last fourteen FOMC meetings, boosting short rates by a staggering 350 basis points (3.50%) over the past twenty months. But we must keep in mind where the Fed started the tightening campaign: the funds rate was at 1%, the lowest rate in 60 years, as the Fed had the monetary spigot open full blast in a desperate effort to keep the US economy from slipping into a deflationary spiral. Now, with the Fed funds rate at 4.5% and the rate of core inflation at a little more than 2%, "real" inflation-adjusted short-term interest rates look fairly normal. Not overly restrictive, but normal.

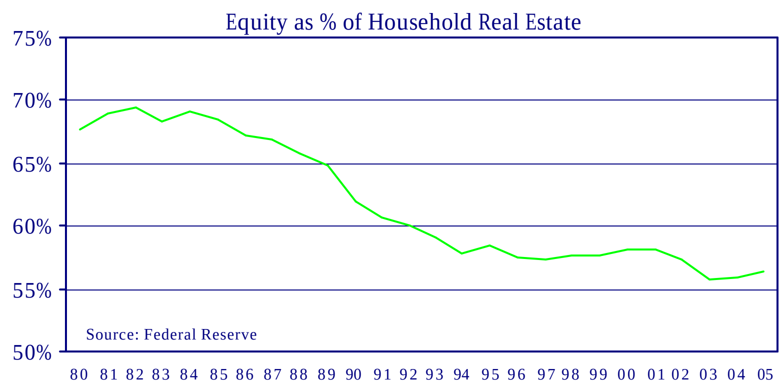


Yet these rising short-term rates have shown little impact on US businesses—the Fed's own surveys of banks show no tightening of standards, no increases in lending margins, and continued strong demand for commercial and industrial loans. Credit spreads (the extra yield corporations must pay above Treasuries to borrow in the capital markets) remain very tight by most historic measures, and with longer-term rates barely changed over the past two years, long-term funding for companies is relatively cheap and plentiful.

It's a slightly different story for consumers, and this is where one could make a case that higher short-term rates are starting to take a bite out of US economic growth. As has been well documented, the consumer pulled the economy out of the last recession, and has been the big driver throughout the current expansion. Much of the fuel for this expansion has come from the US housing market, which has had indirect psychological benefits ("Did you see what someone paid for the Johnson's house?") and direct financial benefits for homeowners; the direct benefits have mostly come in the form of mortgage equity withdrawal (MEW), as consumers liquefy a portion of the price appreciation of their homes with cash-out refinancing, home equity loans, or by an outright sale of their home.

As the top chart on this page demonstrates, consumers are now paying more than 18.5% of their personal disposable income on fixed costs (including rent), the highest rate ever recorded by the Federal Reserve's statisticians. Much of this is attributable to rising debt service on home mortgages, due both to higher balances as well as rising interest rates. You'll notice that "regular" consumer debt owed by homeowners has been declining, relative to income, over the past couple of years, as part of MEW has been used to reduce other forms of debt, including credit cards and auto loans.

Is this cause for concern? Certainly, the level of fixed payments relative to income appears high, maybe even dangerously high, but consumer debt payments must also be considered relative to the value of the assets they support. As the second chart shows, consumers suffered a massive hit to their wealth in the stock market meltdown of '99-'01. Interestingly, the US housing market had nary a blip even during the darkest days of the dot-com bust. In the past four years, the rapid appreciation of home prices has boosted consumer assets almost back to their 1999 peak. Once again it's shown here as a percent of personal disposable income, but the "raw" numbers tell a similar story, with the value of real estate assets growing by 150% over the past decade and total assets up nearly 100% over the same time. Clearly, real estate has been the savior for many households hit hard by losses in the stock market.



Also, you'll notice that total liabilities have been rising as a percent of income, in tandem with the increase in home values. Yet the overall debt as a percent of both assets and income remains fairly low. While personal leverage is rising, it does not appear to be growing out of proportion to the underlying assets of households.

Aided and abetted by the inflation of their real estate holdings, and the equity they've extracted from it, consumer spending has increased at an 8.5% annual rate over the past two years. Recent data clearly show that the US housing market is slowing. Most forecasters are calling for a leveling off, or at worst, a modest decrease in home prices. Under these conditions, it appears that consumer spending will slow from its recent torrid pace, but not enough to send the economy into a tailspin.

Of course, the scenarios become significantly more unnerving in the instance of a broad decline in home prices. Fixed charges have been creeping up for homeowners and a drop in the value of their assets has the potential to pull the proverbial rug out from under consumer confidence. As the chart on this page shows, homeowners have pulled down the equity in their homes to levels not seen in the post-war era. The equity "cushion" that supports consumer sentiment is far skinnier than it used to be.

During a period where corporations have been rebuilding their balance sheets—shoring up equity and paying down debt—the US consumer has been doing just the opposite. Clearly, corporate CFOs learned something in the last recession that was lost on consumers—namely, that leverage is benign only to the extent that your asset values remain inflated and your revenues continue to grow. While we don't foresee an imminent collapse of the US economy (in fact, our base-case scenario for the US economy points to two or three more years of decent growth), there's evidence that consumers are starting to pull back. A severe correction in home prices would only accelerate this trend, and could conceivably lead to the beginning of the end of the up phase of this business cycle.

Furthermore, in this asset-collapse scenario, the resulting marked slowdown in consumer spending would likely lead to weakness in the labor markets as aggregate demand for goods and services hit the skids. History has shown that nothing hurts leveraged balance sheets, corporate or personal, like a drop in income, whether it's a decline in revenue from your customer base or the loss of a paycheck.

Again, this meltdown scenario is not what we expect to see over the next year, but the rapid inflation of the US housing market, with its Greenspanian "frothy" overtones, and its important connection to consumer finances and behavior, is our economy's Achilles' heel right now. While we expect that there will be a fairly muted correction in home prices, one that will not kill off consumer confidence or force an early collapse of consumption, we have to be prepared for alternative scenarios.

So how do we see this economic expansion ending? No time too soon, and when it does come, not in a flaming ball of overindulgence and risk-taking, but in a slow cooling of conditions. Not in fire, but in something closer to ice.