Agincourt Capital Management, LLC

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INVESTMENT UPDATE

Well, it's August, a time when one-third of the developed world goes on vacation while the rest of us (i.e., non-Europeans) plow on, dreaming of cool nights and fresh breezes. This time of year, we're not in the mood for something heavy, we're looking to escape; we don't want *War and Peace*, we want an umbrella-festooned drink and a tawdry dime-store novel. And when it comes to the bond market, we don't want to hear about negative convexity and default rates in August—can't that wait 'til we get the kids back in school?

Unfortunately, there's some weird stuff going on in the bond market that we feel compelled to address. To help ease us back into the real world, the Bond Answer-Man has agreed to answer our reader's questions. OK, we made that part up—we came up with the questions, but he's still going to answer them. But we've told him to take off that stupid propeller beanie for this occasion, and we warned him not to stray down the lane of technobabble or to pull out his slide rule. So, sit back, relax, and try to keep awake as we address the issues of the day.

Question: Mr. Answer-Man, what the heck is going on in the subprime market?

Answer-Man: Next question! Hey, I'm just kidding, put down that crow-bar! Can we back up a little before I answer that? Quit groaning, this won't take THAT long…

OK, US residential mortgage borrowers can be divided into three buckets—prime borrowers (only those with excellent credit history and plenty of "cushion" to make their monthly payments), "Alt-A" (borrowers with seemingly good credit, but who can't or don't want to fully document their income), and subprime borrowers, the least creditworthy of the three. Subprime borrowers have a higher level of debt relative to income, and, often, a more checkered credit history than either of the other two. In most circumstances, they are deemed to be able to be able to make their mortgage payments, but are more likely to get into trouble quickly, given their lack of income relative to their debt and past payment history.

Q: Why on earth would a bank or mortgage company extend credit to them if they're risky?

A: Because these borrowers pay higher rates and fees to the lender—at some price, nearly anyone can get credit. When the value of the collateral (home prices) was skyrocketing, home lending was a safe bet. And the economy has been strong and jobs fairly plentiful, so lenders have been lenient in their extension of credit over the past couple of years.

Q: How much of the US mortgage market do they represent?

A: Subprime borrowers make up approximately 14% of the US mortgage market and Alt-A borrowers another 11%. But there's more to it than that.

Q: Don't leave us in suspense.

A: OK, but this one might take another couple of minutes. It's not just that there are impaired borrowers, but market conditions are making things much worse in at least two ways: First, more than two-thirds of the loans made to subprime borrowers have adjustable rates that are only now beginning to reflect the reality of today's higher short-term rates (to which most adjustable mortgages are tied); if these folks were barely credit-worthy before, they are truly impaired today. Secondly, home prices are falling, and the supply of houses is growing (the average time to sell a house today stands at almost nine months, more than double what it was two years ago). The net result is that many impaired borrowers can't afford their monthly payments, and can't sell their houses and get out from under their payments, either. The worst of these are those who bought their houses or refinanced with these adjustable mortgages in the 2005-2006 era, when home prices were at their highest and lenders were most generous with low-cost teaser rates and easy terms (90%+ loan-to-value). We may see foreclosures on these adjustable subprime loans at 50% before it's all over.

Q: So, what's this have to do with the high-grade bond market?

A: Theoretically, there's essentially no connection between high-grade bonds and low-grade mortgage loans. But there are a multitude of indirect connections, the most obvious being those high-grade companies (mortgage lenders, brokerage firms, consumer finance companies) with investments in and exposure to subprime. In the first quarter of this year, we saw prices of bonds (and stocks) of financial companies fall, especially among risk-averse investors wishing to "clear the decks." By May, it looked as though the re-pricing might be coming to an end for high-grade companies. But in June, two large subprime mortgage hedge funds managed by Bear Stearns Asset Management collapsed due to rising defaults and poor marketability of the funds' subprime securities, as well as a high degree of borrowed money used by the portfolio managers. As the parent company stepped in to shore up capital, fear spread throughout the entire mortgage sector, and investors grew concerned that there were widespread problems with other mortgage funds. Leveraged mortgage funds began to liquidate holdings to raise capital, selling bonds that they could get good prices on—namely, the highest quality bonds in the portfolio. A massive glut of high quality mortgage- and asset-backed securities (MBS/ABS) hit the streets, with few buyers interested in catching the proverbial falling knife. Incredibly, for the month of June, US Agency pass-throughs (GNMA's, FNMA's and FHLMC's), securities backed by (at a minimum) the moral obligation of the US Government, bonds with no direct link with the subprime market, underperformed Treasuries by 57 basis points (0.57%).

Q: Yikes. All due to fear?

A: Yep, fear of not knowing how bad things could get ("what else is out there?"), as well as the supply/demand imbalance of funds and trading desks dumping perfectly good bonds in order to either hedge or meet margin calls on the bad stuff they couldn't sell.

Q: But things calmed down in July, didn't they?

A: Unfortunately, July was even worse than June, as rising subprime delinquencies began to have a broader impact, including forcing one of the largest subprime originators out of business. Investors became fixated on a scenario where a meltdown in the subprime market might have broader macroeconomic implications. Investors sold off bonds and stocks across all industries, concerned that credit, which has been so plentiful over the past four years, was going to be harder to come by for both consumers and companies. Under this "credit contagion" scenario, the healthy cash flow and strong profit growth that had been supporting the stock and corporate bond markets would grind to a halt.

Q: How realistic is this scenario? Can't the Fed keep it from happening?

A: There's little question that the US real estate market is hurting, as is a segment of the population who got out over their skis. But this is a classic case of easy credit leading to "malinvestment" in one inflated asset (dot-com stocks, anyone?). The Fed has an interest in seeing the speculative element driven out of the real estate market and will do nothing to keep that from happening (in fact, at least one Fed Governor has publicly applauded the losses of the subprime lenders). But the Fed is carefully monitoring the rest of the economy for signs that higher borrowing costs for businesses and individuals, as well as the psychological impact of the market's summertime gyrations don't do more than simply suppress the speculative excesses of the recent past. And don't forget, the labor market, the single most important determinant of economic health, is still very strong; as long as folks have jobs, the Fed believes the economy can tough it out.

Q: What about these CDO's we keep hearing about? Ratings agencies says they're "AAA," but defaults are rising.

A: We predict continued pain in those areas of the bond market, including collateralized debt obligations, where the underlying asset is of low quality. We believe the ratings agencies will end up with egg on their faces for assuming that a financially-engineered package of subprime mortgages somehow can be transformed into a high quality investment. You may be able to tier the defaults in a way to keep some investors whole, but the rating agencies' models weren't calibrated to deal with 50% foreclosure rates.

Agincourt's rule for structured investments is simple: Only buy bonds backed by underlying securities you would put in the portfolio, regardless of what the ratings agencies say. Junk collateral in a pretty wrapper is still junk. As in metallurgy, there is no alchemy in finance.

Q: Is there any good news for high-grade investors?

A: Actually, there is. Due to the disarray in the corporate bond market, especially among lower-quality issuers, "shareholder enhancement" strategies are sure to slow, at least for a while.

Q: Please explain. In English this time.

A: Of course! Some of the recent share buyback programs and nearly all of the recent merger and acquisition activity are being funded with debt. Look at Chrysler—they're being sold to a private equity firm (Cerberus) who is currently using short-term bank debt to pay Daimler; but that bank debt must be paid back soon. Cerberus is counting on being able to issue billions in bonds to high yield investors and using those proceeds to pay off the bankers. But the junk bond market has ground to a halt due to a glut of pending deals as well as fear among yield-seeking investors, making it prohibitively expensive to issue new bonds. The bankers are holding the bag, and they're none too happy about it. Banks have essentially closed their doors to firms looking for loans to acquire or restructure "target" companies—at least until the existing overhang gets placed, and that could take a while.

As a result, the investment grade bond market may actually be less risky for many industrial credits, since their ability to add debt to their balance sheet is far more nettlesome than it was just a few weeks ago. And while the market for high-quality bonds is much better off than the junk bond market, even high-grade yield spreads have widened to levels not seen in four years. For investors willing to accept a potentially bumpy ride, high-grade corporate bonds appear to be decent value. That's your good news.

Q: So when can we expect to see some real improvement in the capital markets?

A: Depends on what part of the capital markets you're talking about—direct investments in subprime, either in the securities themselves, or the companies with direct exposure to the borrowers, are likely to get worse before they get better. Some projections of foreclosures on 2006-vintage adjustable-rate subprime mortgages are as high as 30, 40, even 50 percent. Putting lipstick on that pig won't make it any more attractive. And, despite the fact that these problems originated in the US, European markets seem to be having a tougher time dealing with their subprime exposure, so we would steer clear of most European finance credits.

On the other hand, we may have seen the worst for securities that were unreasonably maligned during the MBS housecleaning of this summer. Agency-backed MBS, and (as mentioned earlier) high-grade corporates may turn out to be very good investments through the end of 2007.

Q: Good grief, I'm worn out! Let's change subjects—What about next year's Presidential election?

A: Sorry, the Bond Answer Man doesn't talk religion or politics. Besides, everybody knows that Ron Paul is a shoo-in!

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