Agincourt Capital Management, LLC

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Investment Update

Few words strike fear in the heart of bond investors faster than the "I" word—inflation. It conjures up images of the bad old days of the 70's and early 80's—gas lines, "WIN" buttons, Paul Volker in a cloud of cigar smoke, Jimmy Carter in his cardigan. Scary stuff.

But it's not just old film from dusty newsreels. The really scary part, at least from our professional standpoint, is what inflation does to the value of your average, humble fixed income security. Bonds, in their simplest form, are nothing more than a promise of scheduled future cash flows. These payments are fixed (typically), and obligatory (default may be the only thing scarier to a bond holder than inflation), and therefore dependent on a low and stable rate of inflation. Since rising inflation insidiously erodes the present value of these future cash flows, investors are understandably sensitive to any uptick in overall prices.

Now we find ourselves getting a whiff of inflation. Not 70's polyester-bellbottom style, but a more modern version that's put a chill into an already dysfunctional bond market.

And we've got nobody but ourselves (or, more specifically, our policymakers) to blame, as much of the rise in inflation is a direct result of actions we've taken to "fix" other problems. Let's start with the 800-pound gorilla, energy prices.

Over the past year, gasoline prices (as measured by the CPI) have risen 33%, driven up by the skyrocketing price of crude oil, which has risen by 60% over this period. As has been pointed out by our friends at OPEC, a large part of this increase has come as a result of the weak US dollar. If we measure the rise in crude oil prices not in dollars but in euros, we see that crude is up "only" 42% over the past twelve months. In other words, the weak dollar policy put in place by the US Treasury has contributed to the pain we feel at the gasoline pump. The remaining difference in gasoline and crude prices is related to stockpiles of older (and less costly) crude reserves being used up, and a squeeze in profitability among refiners, distributors and retailers (though it's doubtful that anyone in the oil industry is suffering too much).

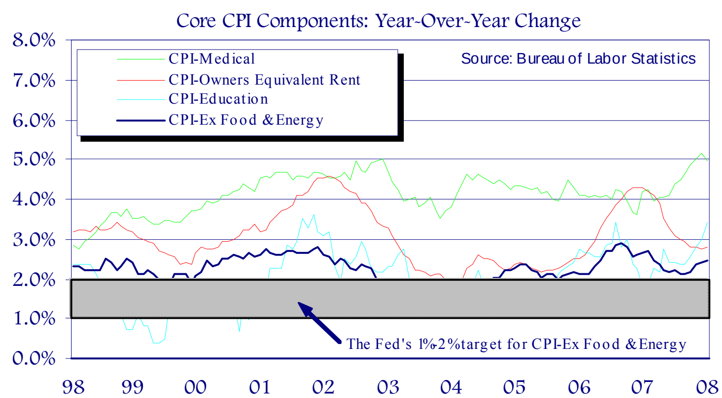
As inflated as energy prices are, we should remind ourselves that we're nowhere close to the situation we were in during the oil embargo of 1973-74. Those of us with grey hair recall that OPEC actually shut down exports to the US in protest of our support for Israel in the "Yom Kippur War" of 1973. When the Arab members of OPEC refused to export oil to the US, we had a true "shortage" of supply. That's not really the case today—now we're seeing the effects of rising global demand for oil-based products amid a carefully *controlled* supply of crude oil, a far more benign scenario than what the US faced in the 1970's.

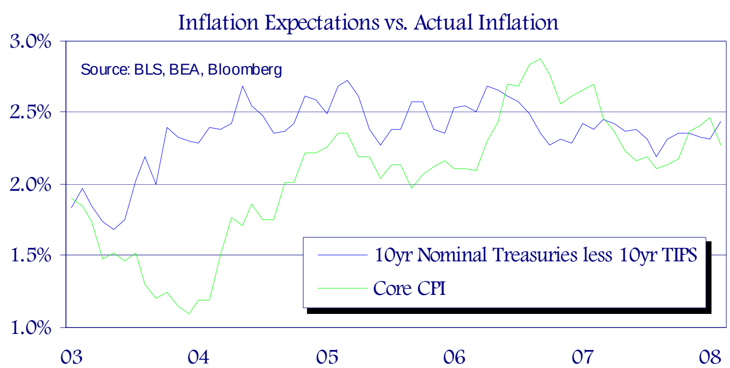
The oil embargo of the 70's lead to massive changes both in personal lifestyle and official US policy and regulation. While we are likely to see some of that this time around, policy-makers must be careful not to make things worse. A case in point is the Energy Policy Act of 2005. This act offered tax incentives for hybrid vehicles, oil exploration, and nuclear, wind and tidal power. In addition, the Act included a mandate that bio fuels (e.g., ethanol) be mixed with gasoline in increasing percentages over the next decade. This has had a dramatic, and expensive, impact on US consumers over the past two and one-half years that the writers of this act may not have envisioned.

The main problem is that, here in the US, the most cost-effective source of ethanol comes from corn. So Kelloggs of Battle Creek, Michigan is now in competition with Exxon/Mobil; both are now huge buyers of corn products. As demand for corn has skyrocketed with ethanol mandates, prices have risen for corn and its by-products; not only has this added to the price of gasoline (and incidentally, reduced its performance, as ethanol is only about 85% as efficient as gasoline) and corn flakes, but many other goods—including feed for livestock, which has driven up meat and dairy prices, too. Meanwhile, other crops have been phased out in favor of corn, pushing up the prices of soy beans and other agricultural goods. The result is that the food component of the CPI has risen more rapidly in the past year than in any previous 12 month period in nearly two decades. Surprisingly, a recent publication by Purdue University predicts *less* acreage devoted to corn in 2008 (implying a 5% drop in production), despite all those new ethanol plants driving up overall demand for corn by an estimated 10% this year! Fasten your seatbelts.

The food and energy components, collectively, are up 10.4% over the past 12 months, pushing total CPI to 4.1%, 1.8% above the current level of "core CPI" (AKA "CPI ex-food and energy"). Economists often exclude the food and energy components of the CPI, preferring to focus on the other 75% of core CPI. The reasoning behind the preference for core CPI is that food and energy prices are volatile and noisy, and therefore may give false readings as to the true, underlying level and direction of consumer prices; besides, it's argued, food and energy prices eventually get filtered into all other consumer prices anyway.

But inflationary pressures aren't coming solely from the food and energy components; as the top chart on this page shows, core CPI has been rising over past few months, driven by increases in medical and education components—this, despite the rapid deceleration of the "owners equivalent rent" component, which represents nearly 1/3 of core CPI.





The recent rise in core CPI should have investors spooked. Evidence of investor nervousness as to the direction of future inflation can be found in the market for TIPS, Treasury Inflation-Protected Securities, a special type of Treasury note that adjusts in value to compensate holders for upticks in inflation. By looking at the trading levels of TIPS, we can observe what investors are willing to pay for inflation protection. If inflationary fears are rising, that should be reflected in higher TIPS prices (and, thus, lower yields on TIPS) relative to conventional Treasury notes. Surprisingly, that is not what we're seeing right now.

As the bottom chart demonstrates, investors aren't paying up for inflation protection—the yield difference between "regular" Treasuries with ten year maturities and ten-year TIPS has remained essentially flat, at approximately 2.3%, for the past year. If investors were really concerned about the long-term direction of future inflation, we'd expect to see this line rising well above the current level of core inflation; but that's not happening.

This is a little counter-intuitive; after all, just about every tool currently being used by US policy-makers is inflationary: The Fed has pushed down short-term rates six times in the last six months, to 2.25%, and opened new lines of borrowing for both banks *and* securities dealers. On the fiscal side, consumers are not being asked to tighten their belts, they're being sent "rebate checks" in order to keep the cash registers ringing. And, as we've seen, the US dollar has been "managed lower" in order to make US manufactured goods attractive overseas, even if that means that prices of imports will rise for US consumers; import prices are up 4.5% over the past year, even after excluding petroleum imports, the highest 12-month reading in 13 years.

What's behind investors' apparent lack of concern for inflation, given all we've seen? The best explanation is that the Treasury market is distorted, as the current flight to quality in the bond market has elevated prices for Treasuries beyond the point of reasonable value. For example, 10-year Treasuries currently yield just 3.3%, or only 1.0% after subtracting core CPI, the lowest level of "real" 10-year yields since 1980. If real 10-year Treasuries were at their average level of the past five years, the difference between nominal Treasuries and TIPS in the lower chart would be nearly 1% higher. In other words, our best tool for measuring investors' expectations for future inflation is distorted due to a mad grab for "risk free" Treasuries.

Yet if we dig a bit deeper, there are signs that investors are indeed concerned about inflation, as there is ample evidence of "fast money" being pumped into the commodities markets, the traditional safe haven in inflationary times. Although it has fallen from its recent highs, the CRB index, the main commodities price benchmark, has risen 27% since last summer. Gold alone is up almost 40% over this same period.

Maybe it's a big head fake and inflation will fade in this weak economic environment. But we remain skeptical, especially with the Fed paying more attention to economic growth than to price stability. We can't help