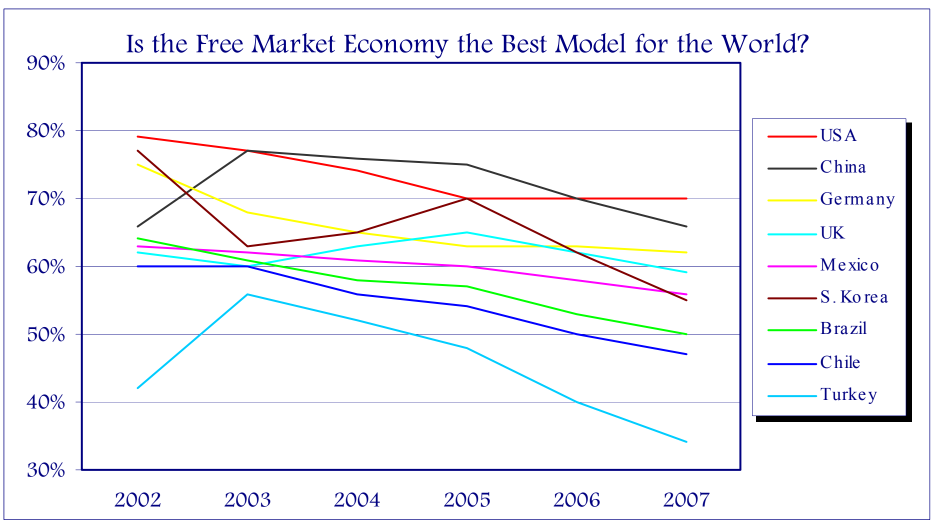
Agincourt Capital Management, LLC

May 2008

Investment Update

It seems like only yesterday that the entire world was enthusiastically embracing free markets, global trade and "Western" liberal democracy. Starting with the collapse of the USSR, followed by the reforms following the Tiananmen Square protests in China and the bloody breakup of the former Yugoslav republics, by the late 1990's capitalism was sweeping across the globe. Influential American political economist Francis Fukuyama went so far as to pronounce "The End of History" (the title of his 1992 book), proclaiming "the end point of mankind's ideological evolution and the universalization of Western liberal democracy as the final form of human government."

Yet, over the past few years, there seems to be a growing level of discontent with the concept of unfettered free markets across the world. How did it come to pass that even the United States seems to be pulling back on its commitment to economic freedom?



Clearly, a lot has happened since the turn of the century, the most obvious being the events of 9-11, which literally shook the Western world to its roots, and caused us to re-examine many of our most deeply-held notions of our place on this planet. Our economic vision of the world, where countries provide support and resources according to their relative strengths, cannot be sustained if we have to worry about foreigners blowing us up. Americans had to question the motives of these fanatics—why do they hate us, and what do they have to offer the world that is better than what we've got?

While we may never be able to answer those imponderables, we have had to come to grips with the fact that not everyone is ready to embrace the "universalization of Western liberal democracy." Not only do they reject the organizing principals of our society, they have the means to disrupt (some would say "destroy") Western culture through terrorism. That's a bitter pill to swallow for those of us who've grown accustomed to the relative peace and prosperity of post-World War II America.

The terrorist attacks came hard on the heels of the economic recession that resulted from the inevitable popping of the late-1990's internet-fueled, debt-financed overexpansion of the US industrial sector. Combined with the sense of foreboding that settled over the post-September 11th attacks, US consumers, after getting hammered in the stock market, ran for the relative comfort and stability of tangible assets—specifically, housing. While the US economy recovered (albeit at a relatively slow rate, and with a historically anemic rate of job growth), consumers invested heavily in real estate, driving up housing prices and spawning a myriad of new mortgage products.

As a result, the seeds of the next wave of speculation were planted, and this one has turned out to be a doozy. Mortgage products were developed based on the assumption that home prices would inexorably rise, as loans were extended to those who couldn't really afford them, further boosting demand for housing and encouraging home builders to run full-tilt. When the inevitable happened and home prices topped out, hundreds of billions of dollars worth of mortgages and bonds based on those loans plummeted in value. An industry built to feed a previously-voracious appetite for low-quality mortgage products collapsed. And it's not over yet—the aftershocks will reverberate for at least another year, as teaser rates on mortgages continue to expire, and homeowners ill-equipped to deal with higher payments face their own dates with destiny.

This brings us to our current, rather unhappy state of affairs. The US population is steeped in a deep funk

600 East Main Street ♦ Suite 2120 ♦ Richmond, VA 23219 ♦ Tel: 804.648.1111 ♦ www.agincourtcapital.com

right now, as they seem to have lost faith in the basic tenants underpinning our economic system, and appear ready to accept a higher degree of government intervention than we've seen in decades. This is a real about-face. Since at least the first Reagan administration, most Americans have been ready to accept Thoreau's adage "that government is best which governs least."

Yet an updated survey by GlobeScan shows that support for the free market system is on the decline. As the chart on the front page demonstrates, when once again asked if "the free enterprise system and free market economy is the best system on which to base the future of the world" respondents in many countries answered "strongly agree" and "somewhat agree" to a smaller extent than in past surveys. And while we might be tempted to write this off as a recent, and uniquely American, phenomenon brought on by the collapse of the US housing market, such a conclusion would be erroneous. As the chart shows, faith in free markets has been declining world-wide for years. In fact, the 2007 survey was conducted last summer, before the beginning of the subprime meltdown.

The reasons for the decline? Opinions vary, but most point to a type of "capitalism fatigue" brought on by inflated expectations of what free markets could deliver after the fall of the Iron Curtain. Pure capitalism could not possibly solve all the troubles brought about by forty-plus years of central planning, and in fact, was bound to create new problems of its own for those who had grown accustomed to a caretaking central government. Likewise, those of us in the west may have overstated the positive impact that free markets could bring to these newly-free countries.

In addition, the opening of these economies (as well as formerly closed Asian economies) freed up a massive supply of cheap labor that is now available to those industrial companies with the flexibility to move production overseas. Of course, this has added to the unemployment rolls of many thousands, if not millions, of formerly well-compensated industrial laborers in developed countries, furthering the skepticism that free markets are the solution to the world's economic problems.

The second half of this survey showed widespread agreement for the notion that free markets work in society's best interest when accompanied by "strong government regulations." The majority of respondents in fifteen of the eighteen countries surveyed favored strong regulation of free markets; less than half the respondents in just two countries (Turkey and Brazil) agreed, and in France, only 50% agreed that the combination of free markets and regulation served society's interests best. Perhaps the most disturbing trend, at least in the context of US foreign policy's goal of spreading economic freedom, is the lack of faith both in free enterprise and government assistance in the world's only Islamic democracy—Turkey.

Here at home, one need only look at this year's Presidential candidates to see how the socio-political winds are blowing; early on, voters in the primaries knocked out the most hard-line free marketers in favor of those who support more government involvement in economic affairs. John McCain, the Republican candidate, recently spoke about the need for additional environmental regulation, a traditionally Democratic position (although, in fairness, the EPA *was* put in place by the Nixon administration). There is little talk on the campaign trail from the candidates about fiscal restraint, and plenty of promises for universal health care, relief for over-extended borrowers, tax "rebates" and other government assistance programs.

This matters to investors, of course, because how the populace feels about these important issues will help determine how our elected officials shape fiscal policy, social welfare programs and federal and state regulations. These decisions, in turn, have important long-term ramifications on the capital markets. For bond investors, the current trend towards larger Government virtually guarantees heavy issuance of Treasury securities over the next few years, as tax revenue is unlikely to be sufficient to fund all the programs that are being promised by the politicians, and will be expected by the populace.

More regulation also means higher costs for consumers, as companies pass on the costs of meeting new standards and guidelines (e.g., tougher pollution standards for coal-fired power plants). Companies unable to pass through higher costs will see profits decline, which could lead to weaker US labor markets, or (in the absence of regulation preventing such a move) continued off-shoring of jobs to cheaper labor markets.

Of course, all is not necessarily gloom and doom, and we can point to the fact that fully 70% of the US population surveyed still believes in the free enterprise system, the highest percentage of any of the countries surveyed in this study. The US is still the global leader in this respect, and has proven over the last century that free market economies produce relative prosperity for its citizens. A quick glance at the survey results also shows that China has been running neck-and-neck with the US as the strongest proponents of free markets.

As we look ahead, the success of free markets in places like China is essential. To the extent that economic freedom succeeds in raising the standard of living and opportunities for people in developing economies, the torch is passed, assuring the continued acceptance, if not success, of the free enterprise system.