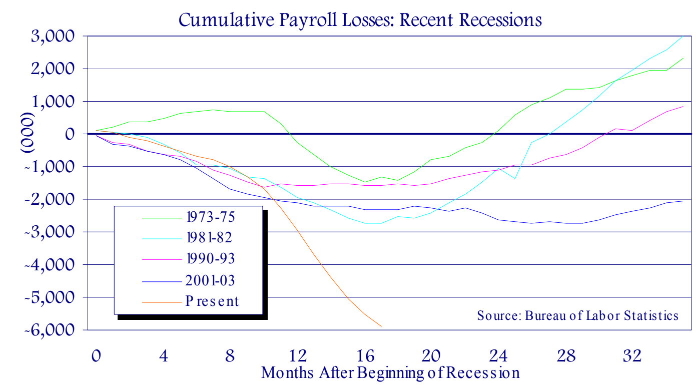
Agincourt Capital Management, LLC

June 2009

Investment Update

Out there in the bond world, the news is mixed, and that's a good thing. Just a few months ago the landscape was entirely bleak and the news flow was consistently and unrelentingly bad.

For several weeks following the Lehman Brothers implosion, the credit markets went catatonic, with investors putting their money (both literally and figuratively) in their mattresses, while home prices took a sharper trajectory downward, the equity market sank to a fraction of its weeks-earlier levels, and global economies shed jobs by the millions. By December, the rout was on, with short-maturity Treasuries hitting rock-bottom due to Fed policy and a frantic flight to quality (three-month Treasury Bills were auctioned on December 18th at an interest rate of 0.00%). Longer maturities followed suit, as deflation fears began to take hold. By year-end, 10-year Treasuries had fallen to a multi-decade low yield of 2.1%.



Relief seemed a distant hope, with only the promise of Government assistance (not exactly music to a news-fatigued capitalist's ears) to warm the spirits as we headed into 2009. But slowly, the investment outlook began to shift. Perhaps it was the fact that a new year provides investors with 12 new months to try to beat the market, but the "avoid risk at all costs" mindset began to change. In mid-March, the stock market bottomed and interest rates on Treasuries began to rise, as investors bought equities and higher risk corporate and mortgage-backed bonds.

Over the past few weeks, the stock market has continued to climb (the S&P has risen by more than 35% since March 9th), Treasuries have been dumped (10-year Treasury yields are up by 175 basis points since their year-end lows) and high-grade corporates are back to their pre-Lehman levels (relative to Treasuries). Consumer confidence has bounced, and is now back to levels last seen more than a year ago, when the consensus view still favored a mild recession.

Naturally, as bond investors, we have to look at things through jaundiced eyes and dig a little deeper. Are things that much better today relative to where we were a few short months ago? Alternatively, were the markets simply pricing in too much bad news in the November-to-February period? Let's take a good look at the economic fundamentals.

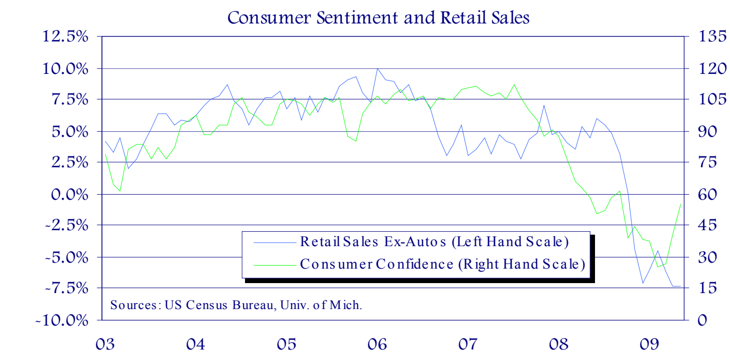
Any analysis of the US economy must begin with the consumer (who is, after all, responsible for 70% of our economic growth), and clearly the consumer is still hurting badly. Homeowners have lost a huge chunk of equity in their homes, which has both a psychological and a real, monetary impact as lost equity can be neither extracted nor borrowed against. As a share of household real estate, homeowners' equity today stands at 41%, the lowest level in at least sixty years, and down significantly from a reading of 55% as recently as 2006. Meanwhile consumers' investment portfolios are in shambles, with the S&P 500, (despite its recent run-up) down 40% from its October 2007 highs and still 30% lower than where it stood a decade ago. In total, US household net worth has declined by a staggering $14 trillion since its peak in 2007.

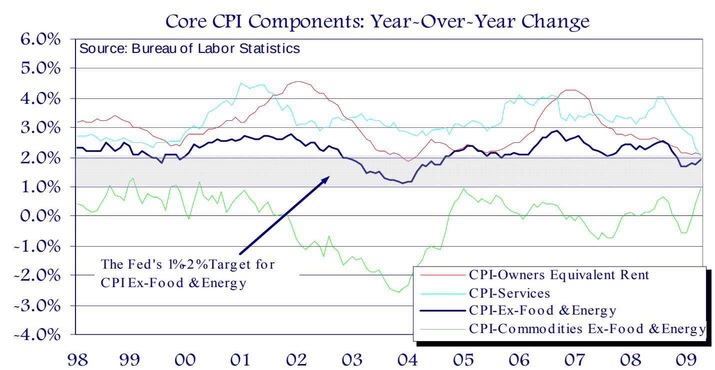
Adding to consumers' woes is the job market. As the chart on this page shows, the current recession has impacted the US labor market to a much greater degree than previous recessions. In just 18 months the US economy has, cumulatively, shed nearly six million jobs. Even when adjusting for the growth in the US labor market over the past sixty years, the recent job losses still outpace all post-war experience, representing a loss of nearly 5% of US payrolls, compared to a little more than 3% for the next deepest recession (1981-82). And though the trend is improving, (we lost 345,000 jobs in May, 300,000 fewer than the average for the previous six months) all indications point to continued job losses over the next few months. Before the economy turns around, we may end up losing six and a half to seven million jobs.

As we've mentioned before, statistics on the labor market tell us more about the state of the economy than any other measure of economic health. When people have jobs, or at least perceive that jobs are reasonably available, they spend more and save less—just the opposite of what we're seeing right now. Retail sales, excluding autos, are down 7.5% year-over-year, after having averaged an annual growth rate of more than 5.0% from 2000-2008. Meanwhile, consumer savings rates have risen to 5.7% from zero a year ago.

600 East Main Street ♦ Suite 2120 ♦ Richmond, VA 23219 ♦ Tel: 804.648.1111 ♦ Fax: 804.648.4475

The other main driver of the economy is the lending/borrowing system, and the news is not much better here. While there have been hundreds of billions pumped into the banking system, that money is not yet generating growth. In monetarist's terms, there is no "money velocity" right now—those funds have gone to fill the black holes in capital adequacy that the banks suffered as a result of their poor lending and investing practices in the US housing market. Despite the banks' protests that they are making loans, the numbers say they are not. This only reinforces just how weak the economy is, as low interest rates should lead to an increase in "turnover" of money, with businesses and individuals anxious to borrow at low rates. The Fed is pumping out the money, but the economy is not growing.





Clearly, we are still in a tough economic environment, so how do we account for the improvement in stock prices and the narrowing of credit spreads in the bond market? Where's all this optimism coming from?

The number one factor that's been seeping into the collective conscious of the investing public is the obvious point that economic cycles have a lifespan. As bad as things are right now, we've most likely seen the worst of this cycle. Clearly, each recession is unique, and while none are resolved in exactly the same way, they do all eventually get resolved. Just as it's nearly impossible to know exactly when the recession begins until after the fact, we will only know later the point at which the recovery actually began. But we're comfortable going on the record and saying that even though we're not yet out of the recession, the trough is now in the rear-view mirror.

That opinion is not just ours. Consumer confidence has bounced pretty significantly recently. As the top chart on this page shows, consumers say that they're feeling much more optimistic even though they're not actually acting on it yet. Much like the banks and lending, consumers are saying one thing and doing another. Not that that's a bad thing—the first step in the healing process is to turn an overly pessimistic mindset into one that's a little more balanced. Especially considering the continued profound weakness in the labor markets, it's no wonder that retail sales are still in the cellar even while sentiment is improving.

But a change in mindset isn't enough to turn things around; there are conditions that typically must be met for the economy to begin growing, and some of those are starting to come into place. Manufacturers' inventories of consumer goods are down 12% year-over-year, despite the fact that retail sales have plummeted. With production having been cut to the bone and inventories at very low levels, any uptick in aggregate demand will necessitate a sizable ramp-up of production. Capital spending is the other big swing factor that's been suppressing GDP growth and will, when it turns positive, indicate a fundamental turn in the economy. Capex fell by 28% in the fourth quarter and an additional 34% in the first quarter as companies cut back amid slack demand and reduced cash flows. While we're not looking for a significant increase in capex in the near term, we are looking for the big declines to flatten out.

Which brings us to our favorite topic: inflation. While there's plenty of angst regarding the possibility of an increase in inflation stemming from the massive injection of money from US policymakers, we see little inflationary pressures in the near to intermediate term. For all the reasons given above, there's simply not enough upward price pressure on the sources of production, nor sufficient demand from consumers, to sustain higher prices. Labor costs are the main cost for many (if not most) US companies and are more highly correlated with core inflation than any other economic indicator. The extreme slack in the US labor market virtually eliminates employment costs as a source of inflation over the next few quarters. Likewise, the manufacturing sector is, by some measures, at its lowest utilization rate since the Great Depression, so there is plenty of slack there, too. As the bottom chart on this page shows, among major components of core CPI, only core commodity prices are showing an upward tendency, but their rate of change is still below 1%.

On balance, we see a continued slow emergence from the depths of this recession, with below-trend GDP and profit growth, but with little risk of a near-term spike in inflation. An acceptable environment for good quality bonds, but not the bonanza that the stock market or junk bond market may be looking for.

600 East Main Street Suite 2120 Richmond, VA 23219 Tel: 804.648.1111 Fax: 804.648.4475