August 2012

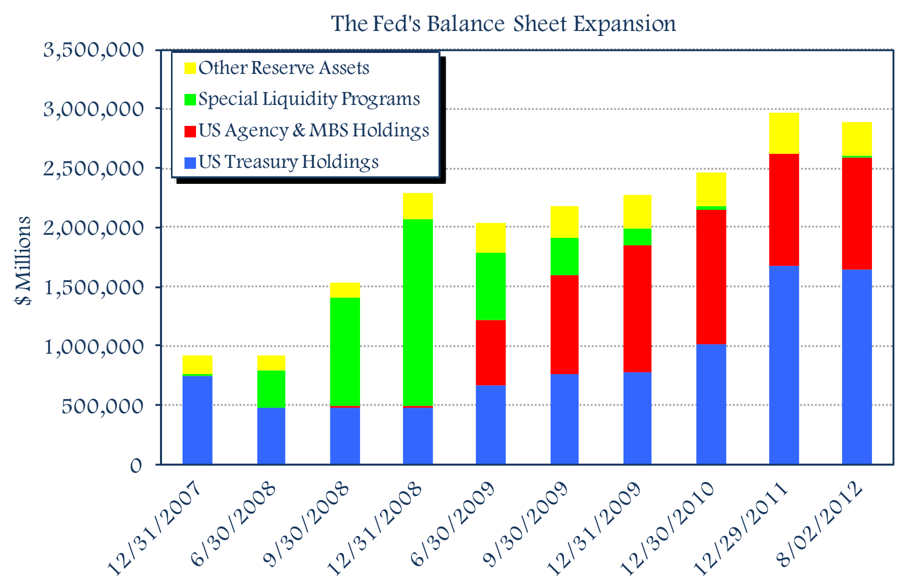
Agincourt Capital Management, LLC

INVESTMENT UPDATE

More than any time in history mankind faces a crossroads. One path leads to despair and utter hopelessness, the other to total extinction. Let us pray that we have the wisdom to choose correctly.
Woody Allen

Seems the Federal Reserve is stuck between a rock and an Everest-sized mountain these days. Or it has run out of bullets. Or it might crash up against a rocky shore if it listens to the Siren's calls. Or maybe it has to get off the pot. All we know is that something must be done. Or maybe not.

We'll admit to being confused, but who can blame us? Depending on who happens to be speaking for the Fed on any given day, we either conclude that round three of the Fed's "quantitative easing" program needs to be started immediately, or that too much stimulus has already been put in place, and any further easing places the country in grave danger.



We saw this recently when the Presidents of two Federal Reserve Bank regions, Eric Rosengren of Boston and Richard Fisher of the Dallas Fed, spoke about the next step the Fed should take in dealing with our sluggish economy. They couldn't have been more different, with Rosengren calling not just for a new round of QE, but making it more-or-less open ended. Unlike the previous rounds, which were spelled out both by the dollar amount of bonds that should be purchased and the duration of how long the program should be run, Rosengren thinks the Fed should buy up mortgage and Treasury bonds "until it's clear that you're no longer treading water…you continue to do it until you have documented evidence that you're getting growth in income and the unemployment rate consistent with your economic goals."

Meanwhile, Fisher, a well-known inflation hawk and frequent (at least by the Fed's standards) voice of dissent, took a completely different tack, saying in an interview that he did not favor additional monetary stimulus, partially because he doesn't want the Fed to appear to be motivated by politics in an important election year, but also because he simply doesn't think it will do much to stimulate the US economy. Fisher believes that the main reason for stubbornly high unemployment and weak consumer spending is attributable to the political gridlock in Washington: "We (the Fed) have hit a wall and that wall is called Congress." As for another round of QE, Fisher said, "Those that do not like us as central bankers I think will be apoplectic" if the Fed ramped up for QE3.

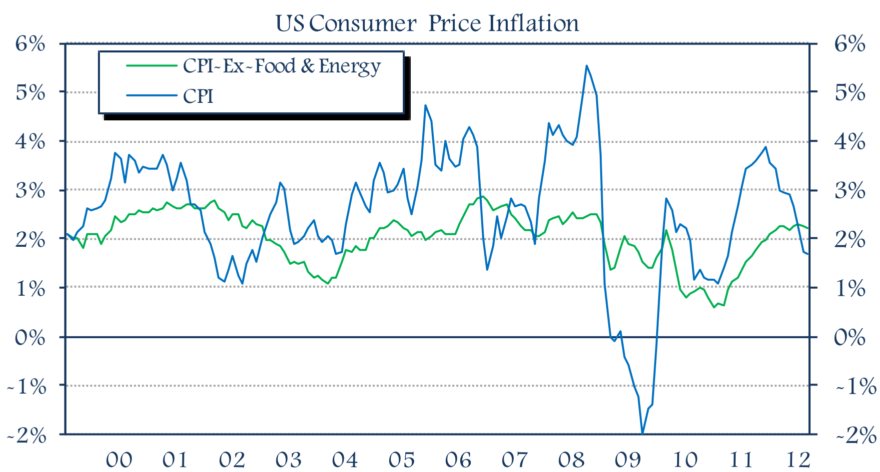
Clearly, there's a difference of opinion here. Fed officials are frustrated; despite the extraordinary measures they've taken over the past four years to stimulate the economy—including tripling the size of the Fed's balance sheet (see chart)—economic growth has remained below both historical trends and the Fed's own targets. If there's any good news at all, it's that consumer price inflation has remained pretty well in-check, despite fears that an inflationary spike would arise after the Fed turned the monetary spigot up full blast.

Undoubtedly, the relatively benign inflation outlook, despite massive conventional and unconventional monetary easing, is giving inflation doves like Eric Rosengren the cover to keep the stimulus pedal to the metal. After all, the Fed has a dual mandate: price stability AND full employment. Rosengren is calling for further stimulus, but not just to boost the growth side of the mandate—on August 6th, he said "We should take action to get back to the inflation target." In other words, even though we are only 0.3% below the Fed's targeted rate of 2.0% when

200 South 10th Street ♦ Suite 800 ♦ Richmond, VA 23219 ♦ T: 804.648.1111 ♦ www.agincourtcapital.com

measured by the CPI, and 0.2% *above* the Fed's target on "core" CPI (see chart below), Rosengren thinks inflation is too low. In this respect, Rosengren is voicing an opinion, which has been gaining some momentum in the dusty halls of the Fed, that boosting growth is more important right now than maintaining price stability, even if that means overshooting on the inflation side of the equation.

Perhaps the "open-mouth operations" of these two Regional Fed Presidents could be brushed aside, since neither is currently a voting member of the FOMC, the Fed's policymaking committee. But it's a bit harder to dismiss the consistent objections to the Fed's ongoing easing program coming from voting FOMC member Jeffery Lacker, President of the Richmond Fed. Lacker has lodged a dissenting vote in each of the five most recent FOMC meetings, gaining a reputation as the Fed's biggest inflation hawk, if not the nemesis of Chairman Ben Bernanke.



In an interview this month, Lacker said that there's really not much more the Fed can do to bring down the stubbornly high level of US unemployment. In doing so, he contradicted Bernanke (once again) who told Congress last month that the Fed could and would take further steps, as needed, to spur economic growth and create jobs. Lacker, like his Dallas counterpart Fisher, has always expressed more concern about future inflation than growth, and objects to the Fed's announced intention to extend its current near-zero rate policy to year-end 2014. Lacker believes that the Fed funds rate may need to be raised as soon as early next year. In the interview, Lacker also took Congress to task for proposed legislation that would give it greater oversight over the Fed, stating, "This seems to be clearly designed to give Congress an ability to harass us, intimidate us and to politicize monetary policy."

As bond managers, we tend to side with inflation hawks like Lacker and Fisher; after all, our clients' returns will suffer if inflation takes an upward trajectory and causes bond prices to fall. And we're quite sympathetic towards the notion that the central bank should be free from political meddling. Given Congress's inept handling of the current fiscal situation, the idea that they should also be involved with setting monetary policy makes us reach for the proverbial barf bag.

We also agree with Fisher and Lacker that Fed policy alone cannot be expected to drive the US economy to higher levels of growth. The fact is, most US interest rates are as low today as they have been in at least two generations, yet the demand for borrowing remains dead in the water. This is not just true for consumers, but for industry as well. Economic growth comes from a combination of population growth, productivity growth and leverage, and right now, nobody wants to borrow money and "lever up," whether it's a family renting a house or a company looking at the future prospects for their business. With population growth slowing due to demographic trends, productivity gains have become the de facto driver of economic growth and profitability. Productivity gains come from "doing more with less" and that means little demand for labor.

Which brings us around to fiscal policy. We think the Fed oversteps its bounds when high-profile members make recommendations on fiscal policy, as Fisher and Lacker have done over the past weeks (to be fair, this goes back to the Greenspan era, if not earlier). However, in this case, their comments are spot-on. US fiscal policy is a mess right now, with looming threats of another debt ceiling showdown, sequestration and automatic budget cutting, and a reversion of higher income tax rates across essentially all income levels with the possible year-end expiration of the "Bush tax cuts." Businesses and households are equally concerned about what future US fiscal policy may mean to them, and are choosing to wait and see rather than make important buying and spending decisions.

Unfortunately, the political will, especially in this election year, to make tough decisions to secure the long-term fiscal health of the US is not present. We've criticized the Executive and Legislative branches of the government before for ignoring the solid recommendations of the Simpson-Bowles plan, which would move us back towards a balanced federal budget, and we'll take this opportunity to do the same. With US public debt trending towards 100% of our GDP, we all know that difficult and even painful measures on spending and taxes must be taken. We need a cooperative, bi-partisan solution.

With the Federal Reserve all but out of bullets, that's the only way to move forward.