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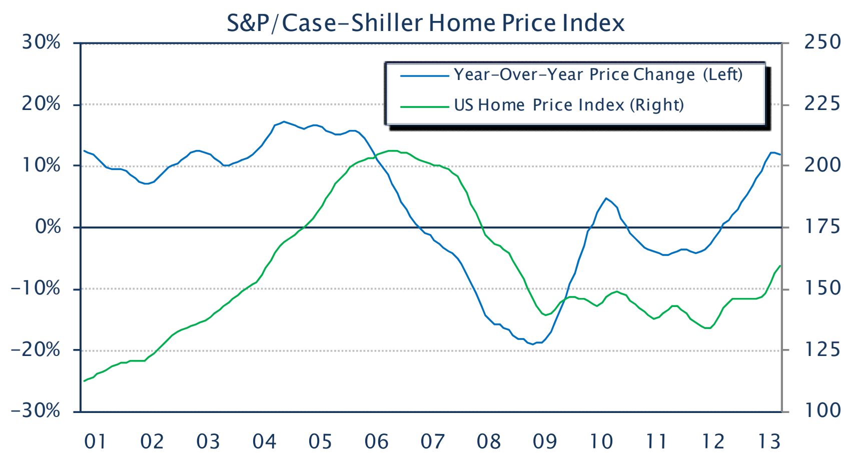
Agincourt Capital Management, LLC

INVESTMENT UPDATE

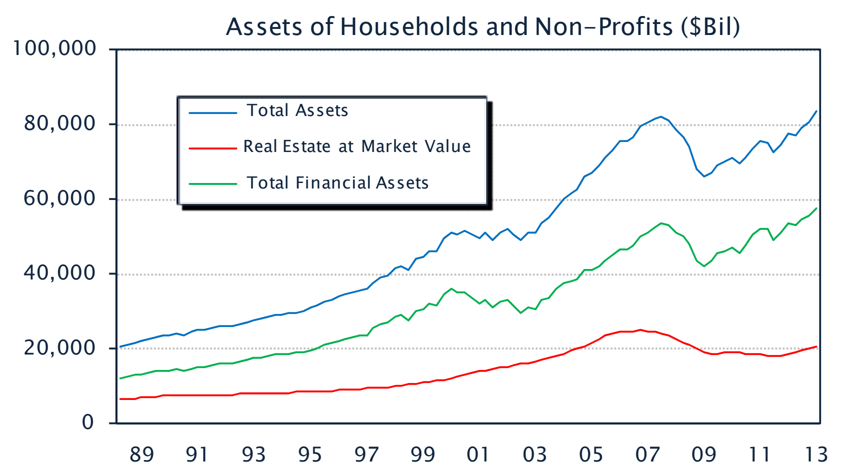
For this month's *Investment Update,* we'll keep it straight and to the point with a quick economic update.

As we've shared over the past few months, 2013 is shaping up as a transition year for the bond market, as investors adjust to a shifting economic landscape. Interest rates have risen more quickly than we had expected, as investors have sold bonds in anticipation of, and well ahead of, any significant change in either economic growth or Federal Reserve policy. The economy is growing in fits and starts, and while the Fed has been talking about changing its policy, there have been zero actual changes up to now. Nevertheless, in 2013 yields have risen by approximately 0.75% (off a very low base) for maturities of five years and longer. Year-to-date total returns for nearly all bond portfolios are negative, and it's looking like another three or four months won't be enough, even if rates stabilize, for bond managers to generate sufficient income to produce positive returns for the calendar year.

While this is certainly disappointing, it's not unexpected; bond yields had fallen so desperately low that they had virtually nowhere to go but up. This was made worse, of course, by the Fed's QE programs, which have bought up more than $2 trillion of Treasury and mortgage bonds, driving their rates even lower than they would have otherwise been by sucking up a significant portion of the new supply of bonds each month. The mere announcement that the Fed would begin to reduce their asset purchases, made in the second quarter, opened up the exit doors and bond investors have been scampering out ever since, with predictable results (more about QE later).

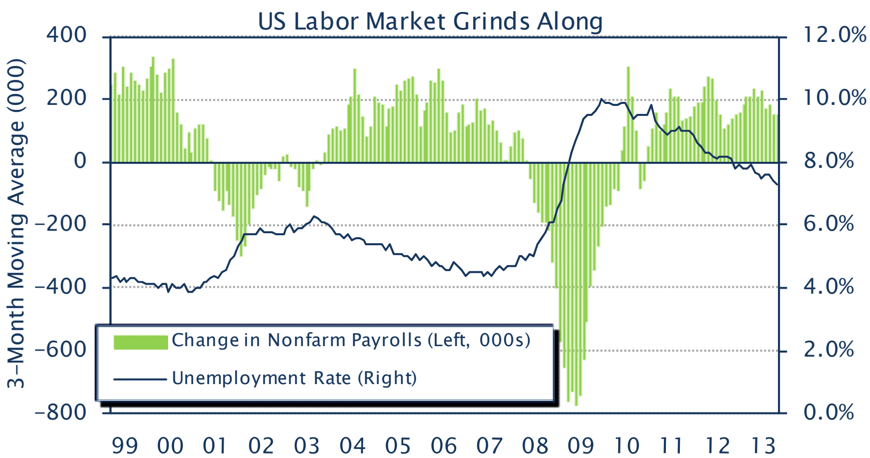


But what has really changed? As the top chart shows, probably the biggest economic news this year has been the strong rebound of home prices over the past few months. After bottoming out in mid-2012, home prices ran up late last year, only to flatten out again in the first few months in 2013. But since then, the S&P/Case-Schiller home price index has risen to a point that is 19% higher than its 2012 low-water mark and more than 12% higher over the last 12 months. Likewise, the National Association of Realtors reports that the average sale price of an existing home was $213,000 in July, almost 14% higher than one year earlier.



Rising home prices have a significant impact on both households and businesses, by boosting household wealth, which in turn encourages consumer spending, pushing up aggregate demand for goods and services. In fact, as shown on the bottom chart, as a result of rising home values, together with this year's improvement in the stock market (and other financial assets), household net worth has finally risen above the highs set before the economic meltdown in 2008. It's taken a full five years, but, in aggregate, US household wealth has finally returned to pre-crisis levels.

Along with the real estate market, the labor markets continue to show steady, if unspectacular, growth. Over the past three months, the US economy has averaged net payroll growth of approximately 148,000 per month, a figure which is consistent with modestly positive economic growth and a steady unemployment rate (see chart below). However, unemployment has continued to fall as the labor force participation rate (LFPR)—the ratio of people who are employed or want to be employed relative to those of working age—has been declining throughout this economic recovery. Some of this is due to discouraged job-seekers who have dropped out of the work force, but most of the decrease in the LFPR is due to the 18-34 year old demographic staying in school instead of joining the work force (nearly 1/3 of this age group is living with their parents, up from 27% pre-crisis). There has also been disappointingly slow improvement on other fronts, including the rate of long-term unemployment, and the number of people who are "underemployed." So while approximately five million jobs have been added since the depths of the recession, this recovery has been characterized by anemic growth in good, full-time jobs compared to previous economic recoveries. The labor markets are moving in the right direction, but the "quality" of the improvement is lacking.



Another bright spot for the US economy comes from the auto industry. After falling to multi-decade lows during the recession, vehicle sales in August came in very strong: 16.0 million (annualized) units, the highest level since November of 2007, and 77% above the lowest monthly total (which occurred in February of 2009 for those of you keeping track). At this level of production, it's estimated that the auto sector is boosting US GDP by approximately 0.3%-0.4%, a very important contribution considering that GDP is expected to grow by only 2% or so this quarter. But even at 16.0 million annual units, some believe that there's still plenty of upside; after all, vehicle sales averaged 16.6 million in the decade prior to the recession, and with sales averaging only 12.2 million from 2009-2012, there is a lot of potential pent-up demand. The rising sales trend has been steady and consistent, and all signs point to continued increases in vehicle sales in the coming months, if not quarters.

Taken together, these economic indicators hint at continued moderate economic growth, sufficient to allow the Fed to begin paring back its purchases of mortgage and Treasury securities. But the Fed surprised practically everyone when they declined, after their two-day meeting this month, to announce the start date of when they might begin to taper their aggressive bond buying program. They mentioned that they needed to see more evidence that economic growth could be sustained against the backdrop of "federal fiscal retrenchment" before they would slow down the rate of bond purchases. They also noted that the current pace of purchases would help to get "inflation moving back toward its longer-run objective;" in other words, they want inflation to go up from here.

We'll admit to not being particularly happy about this announcement. The bond market (and to some extent, the markets for US stocks, as well as non-US and emerging markets, just to name a few) has spent the past four or five months re-pricing itself in preparation for the reality that the biggest buyer in the world (who else is committing $85 billion of new money every month to Treasuries and MBS?) would be backing out of the market. And while the re-pricing seemed a bit premature to us—tapering is not exactly tightening, after all—we were comfortable with the Fed winding this program down. The Fed's buying has distorted the prices in the capital markets, and the bigger the Fed's bloated balance sheet grows ($3.7 trillion and counting!), the bigger the impact will be when they do finally decide to shut QE down. This program was always designed to be a temporary measure to lower longer-term rates in order to encourage borrowing and shore up the housing market. Those goals have been achieved, especially home price stabilization, but at this point QE is looking more like an open-ended buying spree whose eventual unwinding adds far more risk and volatility than any benefit to the greater economy.

But the Fed has made their decision, based on their reading of the economy. Everyone seems to agree that the economy continues to limp along, but some of us are more comfortable than others in allowing the process of recovery to operate without continued government manipulation of the markets. Our jobs are difficult enough without having to play Whack-a-Mole with Bernanke & Co. We can only hope that the next Chairperson will embrace a more traditional role for the Fed.