Agincourt Capital Management, LLC

INVESTMENT UPDATE

Well it's December, and since the year is coming to a close with so many unanswered questions, we thought it would be helpful to bring back the Bond Answer Man, who last graced these pages three or four years ago (we really can't be bothered to look it up). The Bond Answer Man (known to many as, simply, "BAM") is our go-to guy when we need the inside poop on the bond market. He's also a lot of fun at parties—that is, if your idea of fun is talking about binomial distributions and drinking sugar-free cherry cola out of a can with a straw. What follows is an edited transcript from a recent conversation with BAM.

Agincourt: Bond Answer Man, thanks for being here. What have you been up to lately?

BAM: I've been working on an algorithm that explains—

Agincourt: —Hey, that sounds interesting. Is that a pocket protector you've got there?

BAM: Yes, indeedy! Keeps these pens from messing up my shirt.

Agincourt: Hmm, yeah, that's quite a pen collection. OK, let's get straight to the main topic—Why are interest rates so low?

BAM: Well, you see, it all comes down to supply and demand.

Agincourt: I know I'll regret this, but would you care to elaborate?

BAM: Of course. Every few weeks, the US issues tens of billions of Treasury notes and bonds—the benchmark securities for the US bond market—to cover our budget deficit. But despite the huge supply of these bonds, the demand for Treasuries is even higher, and that demand has been driving bond prices up and bond yields down.

Agincourt: Where does the demand come from?

BAM: Many different sources. Banks have been huge buyers, since owning relatively safe Treasuries doesn't require as much regulatory capital on their books as, say, corporate bonds or mortgage loans. Foreign central banks, which are loaded with dollars from US consumers and companies buying their country's products, buy Treasuries to protect their home currency. Global investors like the liquidity and relative safety of Treasuries, especially when Treasury yields are higher than those in most other developed countries, as they are right now. And, of course, the Fed is still buying Treasuries hand-over-fist.

Agincourt: The Fed? But the Fed buying program is over, isn't it?

BAM: Didn't you read your own November *Investment Update*? The Fed is reinvesting all the cash flow—maturities and income—generated by their $4+ trillion bond portfolio. They'll be buying Treasuries by the billions for the foreseeable future.

Agincourt: So, when will the Fed begin to allow these bonds to mature without reinvesting the proceeds?

BAM: They haven't directly answered that question, only that it's "data dependent;" in other words, it depends on the strength of the US economy. As much as most of us would like to see the Fed step back and allow the capital markets to operate more freely and have bond prices set by "the market," it's not going to happen any time soon. Now, if inflation makes a shocking comeback, or US economic growth takes an unexpected turn higher, all bets are off. In the absence of either of those events, expect the Fed to keep reinvesting its portfolio for at least all of 2015.

Agincourt: OK, so "technical" factors are keeping rates low, but what about the improving fundamentals of the US economy, including a tightening labor market? Why aren't investors balking at these ultra-low rates? After all, the Fed has made it clear that they'll begin raising the overnight "Fed funds" rate next year…

BAM: Yes, but short-term rates have, in fact, been rising ahead of the Fed's expected rate hikes. The yield on the 2-year Treasury note hit its highest level for 2014 just the other day. Admittedly, the 2-year Treasury is only yielding 0.60%, but at least it's on an uptrend. On the other hand, you're right—longer rates, especially 10 years and out, have been falling over the past few months. Longer-maturity bonds are much more sensitive to inflation than to Fed policy, and with commodity prices plummeting, inflation is falling. With the unemployment rate below 6% and jobs being added at more than 200,000 per month, I had been expecting upward pressure on wages, but that hasn't happened yet. It's quite perplexing, and I've been tweaking my models by looking at the Kuhn-Tucker conditions for fractional optimality—

Agincourt: —Yeah, maybe we can get back to that later. You mentioned oil prices—what impact do lower oil prices have on the bond market?

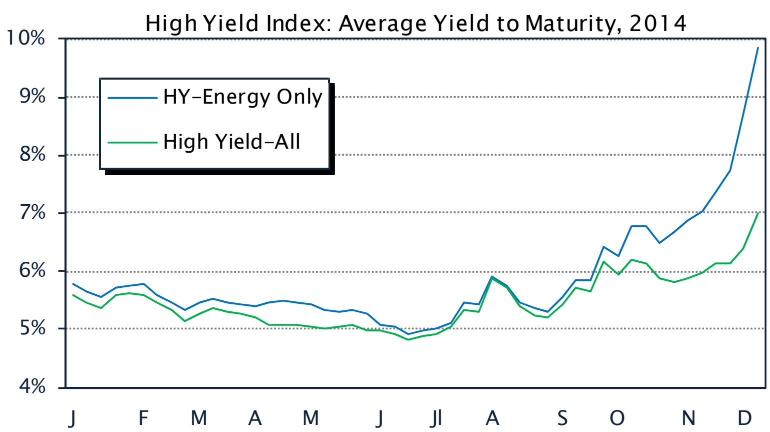
BAM: You know about fracking and how that's keeping oil prices down, and while it's true that increased supply has suppressed crude oil prices, in reality low oil prices are just one example of the widespread sell-off of commodity prices that's happening right now, all of which are related to weakening global demand combined with the strength of the US dollar. You see, when the dollar rises, as it has, it keeps import prices low for US companies and consumers, which suppresses the prices we pay for manufactured goods. Basically, we have normal inflation—roughly 2.5%—in the service sector of the US economy, but goods inflation is zero. At the same time, slower economic growth in Asia and Europe has suppressed demand for commodities, including oil. Bottom line is that low crude oil prices keep overall inflation low, and that eases pressure on long interest rates, and also allows the Fed to drag their feet on raising short rates.

Agincourt: Will this delay the first Fed rate hike?

BAM: Yes, my calculations show that a sixteen percent decline in crude oil prices pushes back when the Fed will increase the funds rate by...let's see here...63.7 days.

Agincourt: Is that a...a slide rule?

BAM: You betcha! I never leave the house without my trusty slide rule!



Agincourt: There are negatives from falling oil prices, though, aren't there?

BAM: In general, falling oil prices are good for US consumers and most US companies, and therefore a net positive for the US economy. But there are a lot of poorly-capitalized oil exploration companies with high cost structures, and crude oil prices at less than $70 per barrel have the potential to put them out of business. This includes a few of the weaker companies in the junk bond market, where energy borrowers make up 16% of the high yield index. Expect defaults to increase in 2015 among these low-quality borrowers. Oh, and I would stay far, far away from anything Russia-related.

Agincourt: Will the weakness in Russia and other economies who depend on oil exports impact Fed policy?

BAM: Not likely. The Fed has always based its decisions on a decidedly US-centric view, and low oil prices will tend to spur our economy, on balance. They will not be deterred by economic weakness in Russia.

Agincourt: You mentioned higher defaults among weak energy companies. Defaults are bad for the credit markets—should investors be scared of all corporate bonds?

BAM: High grade corporates offer incremental yields only slightly above historic averages, but credit quality is very high for investment-grade bonds and default rates are expected to remain essentially non-existent for these strongly-capitalized companies. Weak oil and commodity prices will negatively impact the profitability and free cash flow of nearly all commodity producers, but the stronger and more diversified businesses—the large integrated oil companies like ExxonMobil, for instance—will be fine. There has already been a sympathetic widening of yield spreads in the junk market as investors are nervous over the potential for a more widespread weakening of credit quality [see attached chart, showing rising yields in the junk market this year]. But for the average high-grade industrial, utility or finance credit, lower oil and commodity prices are a positive for both their cost structure and the potential to free up consumer discretionary spending. There will be winners and losers—a lot more losers in the junk market—but very few truly endangered issuers among high grade companies. In fact, spread widening among high-grade oil companies could present a buying opportunity in early 2015. So, do your credit homework, kids—be selective!

Agincourt: And the US housing market? What's going on there?

BAM: My friend, the housing market is so 2012. The easy money has been made. Look for home prices to continue to grind higher at a rate not much more than the inflation rate over the next couple of years. Residential investment is also growing at a much slower rate than in the past few decades, and won't pick up substantially unless the 20-somethings move out of their parents' basements.

Agincourt: I heard that you live in your parents' basement.

BAM: It's an apartment! I have my own apartment!

Agincourt: Sorry, didn't mean to strike a nerve...This looks like a good time to sign off!