



INVESTMENT UPDATE

Let's say you had a semi-clear crystal ball back in January of this year. With this crystal ball you were able to pull two pieces of information: First, in the US, an effective COVID vaccination would become available to everyone aged 12 and older in the first half of the year (and even earlier for adults), and secondly, the annual rate of change in the consumer price index (CPI) at year-end 2021 would stand at nearly 7%, the highest rate in decades. Knowing these two facts, how would you have structured your bond portfolio?

Having this information ahead of time, you might surmise that the US economy would be well on its way to a full recovery from COVID by December of 2021. Further, even though inflation was expected to rise off its very low base from 2020, you'd conclude from the CPI data that the recovery was so strong that inflation was getting out of control—a 7% rate of inflation is a pretty shocking number. As a bond manager you'd probably take this information and reduce your bond portfolio's duration—its degree of price sensitivity to interest rates—in anticipation of rising rates. Since longer interest rates have more duration than shorter bonds, you'd want to sell these bonds first, especially since long rates are most sensitive to rising inflation. You'd probably also boost your corporate bond holdings, as they'd be expected to perform pretty well, supported by an economy that's growing strongly as it fully recovers from 2020's horrific COVID experience.

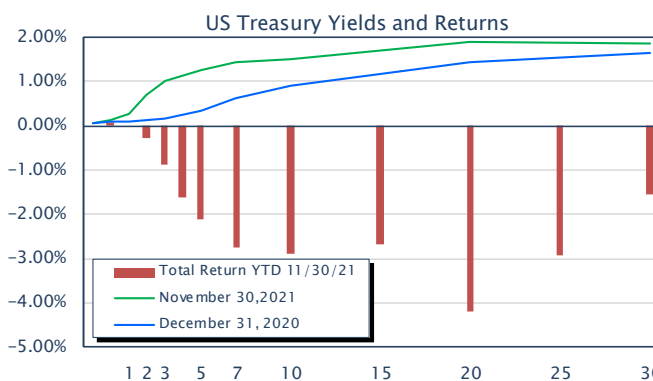
If you're still reading (and who could blame you if you're not?!), you've already guessed where this is heading: The bond market has been a big mess in 2021, frustrating those of us who use analytic tools, tempered with prior experience, to make investment decisions. Markets often react in ways seemingly to perplex the greatest number of people, but 2021 exceeded all expectations for weird outcomes. Despite the fact that core CPI moved to a 30-year high in November, as the chart on this page shows long Treasury yields moved up less than 0.25% since year-end 2020 (when core inflation was barely above 2%). That doesn't just fly in the face of logic, it does loopy-loops.

The chart also demonstrates that year-to-date performance for Treasury bondholders has been dreadful no matter where you placed your money, with total returns for most maturities in the

–2% to –4% range for the first eleven months of the year. But it's especially shocking to see that, despite the alarming rise in inflation, returns for long (25+ year maturities) Treasuries have been better than those of shorter, more defensive maturities. For portfolio managers who moved to shorter maturities to preserve the principal value of their holdings from rising inflation, this is one of those “you got your outlook right, but it didn't matter” moments that we all dread.

At the same time, corporate bonds are on track to record negative returns for the year as well. Corporates have outperformed like-duration Treasuries so far in 2021, but those excess returns all occurred in the first half of the year. Since then, credits

have languished, despite continued strong fundamentals and a solid outlook for corporate credit quality—in 2021, upgrades have outnumbered downgrades by a wide margin, and even in the high-yield market, defaults have declined to almost nil. Unless there's a big rally to end the year, both Treasuries and corporates will generate negative returns for 2021. And that stinks for bondholders.



But instead of wringing our hands, we'd prefer to take some lessons from our experience in 2021. In no particular order, here are some things we learned over the past few months.

First, never forget that markets don't have to act in a way that seems rational. Markets are simply a reflection of the prices people are willing to pay for things—and the key word here is “people.” While investment fundamentals—a company's financial strength, Fed policy, global trade, etc.—will hold sway over longer periods of time, history is riddled with periods of seemingly irrational behavior, driven by peoples' peculiar motivations and desires. The proliferation of “meme stocks” in 2021 is the most obvious recent example, as prices of underdog stocks were driven to stratospheric levels based on fantastical thinking. Sticking to fundamentals and steering clear of fads doesn't make for great entertainment, but we're bond managers, not YouTube personalities.

Second, don't get attached to your forecast. The world moves fast these days, and digging your heels in and refusing to accept that the outlook has changed does not work. Yes, this year has

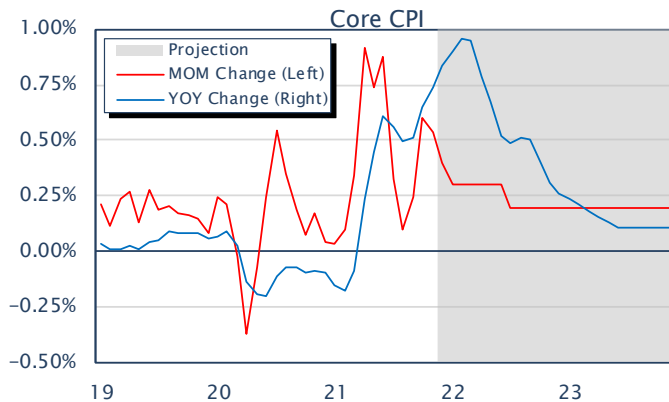
generated some surprising outcomes, and we've had to adapt to new information as it's come in. Agincourt's outlook is relatively short-term in nature, and doesn't pretend to predict the future. Rather, we use current data and trends as a foundation for our relative value analysis, so that we can put bond prices and bond yields in the context of the larger world. Those with a fixed view of the world, and who bet their client's money on an interest rate forecast tied to this view are too slow to pivot when necessary. To their credit, even the notoriously hard-headed and institutionalized Federal Reserve has now backed off its forecast that this year's inflation is "transitory."

Third, don't put too much faith in one month's economic data. We're not suggesting that there's some sort of sinister force manipulating the various measures of the US economy; it's just that the methods used to collect data are fraught with complications, which often leads to inconsistent or misleading readings. For instance, there are two main statistical surveys of the US labor market—the so-called "household survey," which focuses on measuring unemployment, and the "establishment survey," a completely different series that examines business' hiring, and produces the all-important nonfarm payroll figures each month. These two surveys can produce wild month-to-month swings, with results from one survey seemingly at odds with the other. Particularly when the economy is transitioning from one phase of the business cycle to another—just when investors are most desperate to get a handle on the strength of the economy—these surveys often fail to produce accurate or consistent results, which are often revised in subsequent periods. The best way to use this data (and the same goes for any number of other economic data series) is to look at the numbers in the context of other incoming data, averaged over a period of months, rather than on a single data point. That's cold comfort to those of us dependent on the most recent data, but making important investment decisions on one month's payroll figure is a fool's errand.

The fourth lesson from 2021 is that "You may be done with COVID, but COVID is not done with you." Look, we're all tired of having to deal with COVID, but the recent Omicron variant is a reminder that we're nowhere near done with this disease. In retrospect, we were overly optimistic by thinking that effective vaccines would make it quickly go away. And while vaccine skepticism—not just in the US, but globally—has weakened our collective efforts to eliminate the virus, that's only part of the story, as vaccines remain in extremely short supply in less developed countries (less than 2% of the African continent is vaccinated). Until we control the spread of COVID globally, the virus will con-

tinue to mutate and disrupt lives and businesses for many months to come. When virtually every business owner in the world is having to adjust work schedules and accommodate employees, output suffers one way or another. We applaud the efforts of the scientists and researchers who are wrestling with this disease, as COVID is proving to be remarkably resilient.

Primarily due to the ongoing COVID pandemic, lesson number five is that the current high level of inflation is likely to hang around well into 2022. As mentioned, the Fed has made big revisions to its inflation and growth outlook, and has begun to remove its monetary stimulus by tapering new bond purchases and signaling that it will begin raising the Fed funds rate by the middle of 2022. Meanwhile, the ongoing complications of restoring "normal service" to global trade will continue well into next year, and efforts to avoid future bottlenecks and shortages by repatriating manufacturing back to the US will take many years. Indirectly related to the pandemic, the US labor market is getting ever tighter, with wages rising at a higher rate than we've seen in



years as employers struggle to fill job openings. As the chart on this page shows, while month-over-month core CPI is expected to ease in the coming months, even if we assume core inflation halves its recent pace (it's risen by more than 0.5% per month over the past three quarters), we won't see core inflation fall below 3% until 2023.

Our last lesson—or more accurately, a reminder that we sometimes fail to appreciate—is an old Wall Street adage: "Money makes price." When you're confused about asset prices—whether it's Treasury bonds or GameStop shares—remember that, for better or worse, prices move up and down based on the flow of money moving in or out of that asset. If 2021 will be remembered for anything, it's that the huge amount of liquidity that has rained down from both fiscal and monetary policy sources over the past 18 months has distorted (and by that we mostly mean "inflated") prices for all sorts of goods. Policies designed to keep the economy afloat have lifted demand, straining global capacity and spurring consumer price inflation (used vehicle prices were up 43% from 2020 in November), while also inflating non-essentials, including high-priced residential real estate and other luxury goods, global stocks, and yes, long-maturity Treasury bonds. Again, there's nothing particularly sinister at work here; policymakers moved the emergency funds out quickly, and on a massive scale. The fact that it still hasn't been allocated efficiently, and has added to weaknesses and shortages not previously visible is an unfortunate byproduct.

As always, we thank you for your support this year. From the entire team at Agincourt, we hope you enjoy a happy holiday season and a healthy and prosperous 2022!