Agincourt Capital Management, LLC

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INVESTMENT UPDATE

A few months back, we wrote of the paradox of poor corporate bond performance in a period of extremely strong economic growth. Corporate bonds had underperformed Treasury bonds by a historic margin in the first half of the year, a period of unexpectedly exuberant economic growth. The primary reason, we explained, was that an overheating economy had lead to significant rate hikes by the Fed, inverting the Treasury curve and upsetting the market for interest rate swaps. Higher swap rates forced corporate yield spreads wider, as swaps were used to (among other things) hedge Wall Street's corporate inventory. So even though the strong economy was good for a company's fundamental credit quality, it was bad from a technical standpoint for those who trade corporate bonds. Our opinion was that corporate bonds' performance would improve if the economy slowed to a more modest pace of growth, which would 1) allow the Treasury yield curve to revert to a normal, upward slope, and 2) continue to provide a healthy environment for corporate credits.

Despite the hoped-for slowdown (it now appears that the economy has slowed from a 5% to 6% growth rate to a much more friendly 3% to 4% rate) corporates have continued to lag the performance of Treasuries. While there is some concern that the current slowdown could lead to a recession, we don't think that's the cause of all the nervousness. Consider the following economic statistics:

	1999	1st Half 2000	2nd Half 2000	2001
Real GDP	4.2%	5.3%	*3.2%*	*3.5%*
Real Final Sales	5.8	6.3	*4.3*	*4.2*
Core CPI	2.1	2.4	*2.6*	*2.5*
Productivity	2.9	5.5	*3.5*	*3.6*

Forecasted figures are in italics

Obviously, the forecasted numbers are simply our best educated guess of where the economy is heading; they are sure to change. The important point, however, is that our "base case" scenario is for continuation of healthy GDP growth, strong retail sales, moderate inflation and high productivity. Our forecast is very much in the consensus of most economic projections for 2001. This should be an excellent macro environment for corporate bonds.

Yet the bond market seems to be displaying all the signs of a classic "flight to quality", as investors are shunning lower quality corporates in favor of higher quality issues, forcing quality spreads (the yield differential between higher and lower quality bonds) to widen. October was a particularly vicious month for lower quality corporate bonds as AA-rated corporates outperformed BBB-rated corporates by almost one full percent.

We believe that the underperformance of corporates in general and lower-grade corporates in particular is not primarily due to a deterioration of the macroeconomic environment, but rather to more specific concerns among corporate bond investors. First of all, the corporate market has still not completely shaken off the effects of the 1998 Asian crisis—after losing their shirts, brokerage firms continue to be reluctant to carry a large inventory of corporates, and are still struggling to find good hedging vehicles for the positions they are carrying. At the same time, investors are skittish, detecting a slight but unmistakable erosion of certain credit measures, primarily due to the sell-off in the equity market (i.e., "debt to market cap"-type measures deteriorate when a company's stock price falls). In addition, there have been a number of restructuring announcements from high-profile investment grade issuers this year (Xerox and AT&T, among others).

But perhaps the biggest factor weighing on the corporate market comes from the junk bond market. Defaults are way up among non-investment grade bond issuers, as banks have tightened their lending standards just as many of these borrowers are looking for further infusions of cash. Without access to the capital markets (there's no appetite among investors for new issue junk bonds), no help from the banks, and not having the power to generate sufficient cash internally, many weaker credits are going belly-up. The insufficiency of cash flow has not only devastated the junk bond market this year, but has infected the market for high quality corporate bonds as well. High-grade investors have now taken to using junk bond cash flow measures ("EBITDA analysis") to try to identify the next problem credit. Investors have developed a zero tolerance for any company who shows weakening cash flow trends; not only do these bonds get sold out of portfolios, but there are no bids from the normally risk-tolerant medium grade buyers of this paper.

Whole investment-grade sectors have been devastated by this combination of events. The performance of bonds in the retail industry has been abysmal this year. The average price of outstanding bonds of JC Penney, Saks, Kmart, and Dillard's have fallen 22%. Bonds issued by companies that have asbestos-related exposure have been pummeled as well, not due to fundamental cash flow problems but because of a huge new number of claimants seeking payment for asbestos-related health problems. Owens Corning, a firm who was rated "BBB" as recently as the first quarter, sent shock waves through the investment-grade market when they filed for bankruptcy on October 5th, unable to handle the flood of new asbestos claims.

For managers who specialize in corporate bonds, including Agincourt, it has been virtually impossible to sidestep all the landmines that have gone off in the corporate market this year. While we may have never seen the current combination of factors disrupt the market as they have this year, we have been through ugly markets before and have eventually profited from them. We expect to do the same this time.

As we mentioned in our third quarter review, we are re-evaluating and stress-testing each corporate credit in our clients' portfolios to ensure that we are being more than compensated for the risks we are assuming. In general, corporate bonds offer yield spreads over Treasuries at levels that imply significant defaults for investment-grade bonds, an event that has a statistical likelihood of zero.

In general, high quality corporates still look very attractive: they have significant excess yield and will outperform Treasuries by a wide margin once yield spreads normalize. On the other hand, there's no denying that the potential for an economic "hard landing" has increased, and that even without a recession, there are problems with certain credits and industries. While still maintaining a significant yield advantage over the market, we are making deliberate upgrades to the portfolio, staying diversified and increasing liquidity. We will also be adding to our allocation of US Agency notes and mortgage securities for their combination of yield, liquidity and relative absence of credit concerns.

Sometimes it's best just to keep things simple, so we would like to repeat our mantra, a mathematical truth in the bond market: Yield Wins Over Time.