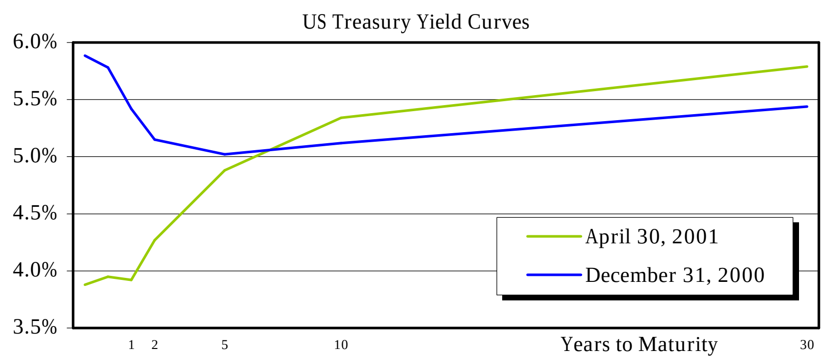
Agincourt Capital Management, LLC

May 2001

INVESTMENT UPDATE

At a recent presentation by Al Broaddus, the President of the Federal Reserve Bank of Richmond, we were surprised to hear no mention of inflation. As you may know, Dr. Broaddus is a well-known inflation "hawk", earning a reputation as one of the most outspoken critics of easy Fed policy over the years. Yet in a speech to the Richmond Society of Financial Analysts, he spoke only of the work the Fed was doing to ensure economic growth. There were no cautionary warnings that stimulating the economy might lead to higher consumer prices down the road.



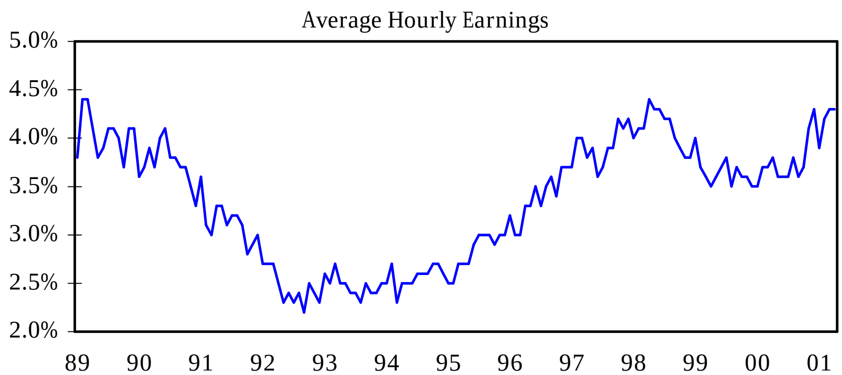
On this score, Dr. Broaddus was following the current Fed "party line". In recent statements, Fed officials have spoken almost exclusively about the importance of policies to keep the economy rolling. Easier monetary policy is needed because, in Fedspeak, "the risks are weighted mainly toward conditions that may generate economic weakness" [April 18th FOMC Press Release]. The present accommodative policy is in marked contrast to the Fed's typical *modus operandi*—as recently as November, the FOMC stated "the risks continue to be weighted mainly toward conditions that may generate heightened inflation pressures in the foreseeable future". In the Fed's world, consumer price inflation is off the radar screen.

The Fed's actions have backed up their statements. Since the beginning of the year, the Fed has implemented the most aggressive easing program in more than 20 years. Greenspan and company have cut the Fed funds rate by a cumulative 250 basis points, with other short-term rates following suit. Yet, tellingly, despite the weakness in the economy the yields of longer-maturity bonds have actually *risen* in the first four months of the year. The pattern of lower short rates and higher long rates continued even after the unexpectedly weak May 4th employment report.

Is the yield curve telling us something?

Some market pundits have commented that the recent rise in long-term rates is due to the Bush administration's attitude towards fiscal policy: tax cuts mean smaller budget surpluses, in turn slowing buybacks of long-dated Treasury Bonds. In this line of thinking the Treasury's redemption of long-maturity T-Bonds last year drove their yields lower than yields on short-and intermediate-maturity Treasuries. A close examination of the facts, however, shows that the current administration is continuing the pace of Treasury buybacks, and the planned tax cuts will do little to slow down the continued paydown of Treasuries for at least the next three or four years (anything beyond that is purely guesswork).

We believe that the rise in long Treasuries this year is due primarily to investors' concerns towards the Fed's laissez faire attitude on inflation. Bond investors, perpetually on the outlook for signs of higher inflation, can be forgiven if the current environment of high gasoline and energy prices, tumbling stock markets, rising unemployment and easy monetary policy bring back dark thoughts of 1973.



We don't believe that we're going back to the bad old days of stagflation; we look for inflation to hold steady for now. The main culprit keeping prices up is the persistently high cost of labor. Productivity dropped in the first quarter for the first time in six years; lower productivity means higher unit labor costs (see chart).

A lower rate of productivity and higher per-unit labor costs are to be expected in the late stages of a business cycle as demand slackens and companies suddenly find they have more than enough workers. What we are concerned about longer-term is that the Fed may not be allowing the normal process of Darwinistic capitalism to take place, a process necessary to weed out the weaker players. By pumping liquidity into the market, firms that should cut back may not, reducing long-run productivity and risking higher inflation in the years ahead.

Accordingly, we are beginning to believe that the Fed should consider taking a somewhat slower approach to further rate cuts. The dramatic reduction in the Fed funds rate in the first four months of the year hasn't begun to take effect yet. Monetary policy takes time to work into the system, typically six to nine months. We believe that we have arrived at a point where the Fed can ease off the gas pedal and allow the impact of lower short-term rates to stimulate spending and investment. To continue to ease when the economy may already have sufficient liquidity risks the long-term containment of inflation.

Our expectation is that at some point later this year, long Treasuries will offer the potential for significant excess returns. In addition to their distinct yield advantage over shorter Treasuries, they will also provide excess relative price appreciation should their yield advantage over intermediate maturity Treasuries revert to a more normal historical relationship. We believe this move to a "flatter" yield curve will occur once investors begin to believe that the Fed's easy monetary policy is nearing an end. We will be watching closely for any signals of change in Fed policy, as that will be our signal to increase our allocation to long-dated Treasuries.

600 East Main Street Suite 2120 Richmond, VA 23219 Tel: 804.648.1111 Fax: 804.648.4475