

INVESTMENT UPDATE

On the morning of September 11th, as the towers of the World Trade Center crumbled, we knew that our lives would never be the same. Our first thoughts were for the victims of these horrific acts, their families and friends. Our second thoughts, as we huddled around the TV in our trading room, was for our clients' portfolios. We recognized that many of our assumptions about the world and the global financial markets had been suddenly and violently rendered obsolete.

While it will be many months before the reverberations from this attack subside, we don't have the luxury to wait and see what develops. As always, we have to make decisions on behalf of our clients with limited information. That's normal. What's not normal this time around is the extent of the change in the macro environment as a result of the events of September 11th.

First, the current situation.

Operationally, the bond market is in remarkably good shape. Despite the devastating loss of life suffered by Cantor Fitzgerald, a major Government bond "brokers' broker", the bond market was open two days after the attacks. While some Wall Street firms have been forced to move to their back-up facilities (Y2K contingency plans finally came into good use), there has been little interruption of service. The volume of trades, however, has been only a fraction of what it was before the attacks. As with the airline industry, the bond market is up and running, but with few travelers.

The trades that have taken place, beginning the morning of the bombings, have shown all the signs of a classic "flight to quality"—prices of US Treasury securities, especially those with short-to-intermediate maturities, have risen dramatically as investors poured money into the US Government bonds market. As one would expect in period of high uncertainty, investors have largely shunned corporate and mortgage-backed bonds.

In the days immediately following the attacks the Fed acted quickly, first by providing a massive injection of liquidity into the banking system, fol-

lowed by an inter-meeting reduction of the target on the federal funds rate from 3.5% to 3.0% on Monday, September 17. This last move, coming a little more than an hour before the re-opening of the US stock market was timed for full impact, to assure investors (especially US equity holders) that the Fed would use its full power in backing the US financial system. The Fed vowed to "continue to supply unusually large volumes of liquidity to the financial markets, as needed, until more normal market functioning is restored". Over the next few days, the degree of liquidity in the system was so high that the *actual* fed funds rate fell to less than 1%.

As we look ahead, we are focusing our resources on ensuring that we have a handle on the major "inputs" that influence the dollar-denominated bond market.

Of all these considerations, the reaction of consumers is undoubtedly the most important. Prior to the attacks, our view was that the consumer would continue to power the US economy ahead and keep US GDP in positive growth territory. That view must change, as we believe that consumers will now choose to save more and spend less. This is partly attributable to the damaging psychological impact of the terrorist's acts, and partly due to fundamental economics—many more consumers will now be without a paycheck.

The labor market, which over the past few years has been such a strong feature of the US economy will now become a major drag on growth. Certain high profile US employers wasted no time (despite calls for "patriotism") in announcing major layoffs in the wake of the hijackings—within a week the airline and aerospace industries alone announced plans to let go almost 100,000 employees. This may prove to be just the first round of layoffs, as we expect a broadening of the present weak economic conditions into other industries, including retailers, lodging, automobiles and securities dealers. It will take months for the labor market to fully adjust to a much lower level of demand for many goods and services that we anticipate in the period ahead.



Consumer confidence and consumption will also be affected (at least temporarily) by the steep sell-off in the stock market. The S&P 500 Index is now down more than 30% over the past 12 months; the NASDAQ is 60% lower than its level one year ago. Even though most consumers' stock holdings are in retirement funds that should have no impact on current expenditures, many folks will still feel that "I'm not as rich as I used to be" and will pull back accordingly.

Not all is gloom and doom, however; there are reasons to be optimistic about the economy's prospects in the months ahead.

The vicious cycle of weak demand leading to higher unemployment will be mitigated by the first \$40 billion in stimulus approved by Congress after the terrorist attacks. We expect the Bush administration to provide an aid package to the airlines given the critical role the industry plays in the US economy. A buildup in defense spending is also a given, and will give a much-needed shot in the arm of the manufacturing and tech sectors. We could even see a reversal of the recent pattern, with the manufacturing sector eventually pulling the economy along while consumer spending lags.

Another positive factor: the US economy had been slowing for many months prior to the attacks. The adjustment to a much slower pace of growth will therefore be far less dramatic than it might otherwise be. Likewise, despite the dramatic drop in US equity prices in the first days since the re-opening of the markets, the stock market was already well below its historical highs, having already adjusted to a slower pace of economic growth.

Finally, the massive injection of money the Fed has put into the system will eventually spur spending and investment. In fact, the combination of a highly accommodative monetary policy and heavy spending by the Government makes it much more likely that we will see an even stronger recovery than we would have expected before the attacks, once we get past the adjustment phase of the cycle. Of course, the downside for bond investors is that too much stimulus now might lead to a spike in inflation down the road. That discussion can wait for now.

Our clients' portfolios will require very little adjustment in the aftermath of September 11th. Despite the likelihood of recession, "defensive" high-quality corporate bonds possess return prospects that far exceed their risks. In fact, because of the defensive tilt of the corporates we own, our clients' portfolios have held up relatively well over the past two weeks even though the sector has underperformed. Going forward, thorough credit analysis and careful security selection will be even more essential. Our strong preference has been and will continue to be to invest in those companies that are positive cash flow generators with improving balance sheets. Thus, our emphasis is on oligopolistic telecoms, tobacco companies, electric utilities, and high-quality finance companies. Similarly, the mortgage securities we own are quite defensive, tilted toward lower-coupon US Agency pass-throughs that should perform well in the steep yield curve, high prepayment environment that we anticipate.

As our country prepares for a war against a nearly invisible enemy in a campaign that is likely to bear little resemblance to any historical precedent, our markets will remain volatile. Our clients can take comfort knowing that Agincourt has a highly experienced team with the skills to operate in uncertain markets. Our value-based approach, based on investment fundamentals, is designed to outperform in difficult markets. Our job today, perhaps more than ever, is to be the traditional, rock-solid "anchor to windward" in our clients' portfolios.

