Agincourt Capital Management, LLC

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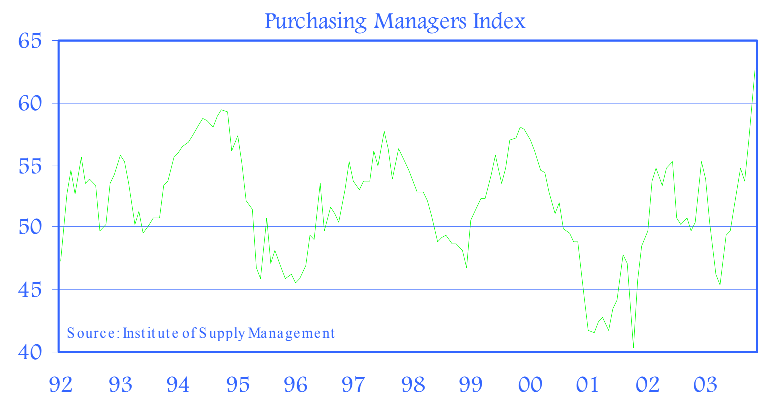
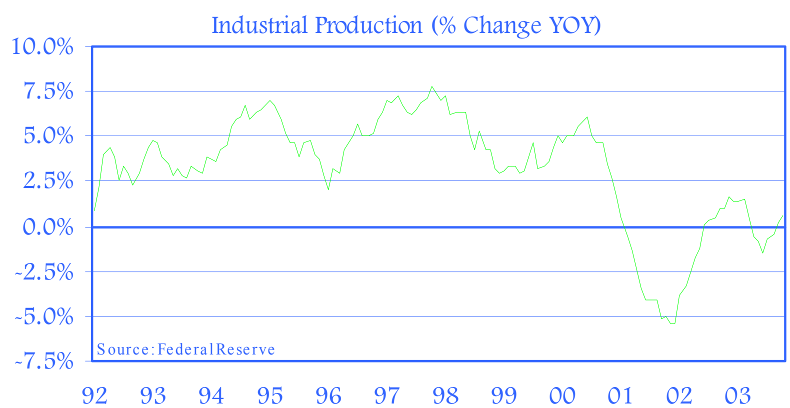
Investment Update

Many investors cheered the headline on the front page of the December 2nd *New York Times* that proclaimed, "Manufacturing at Highest Level in Two Decades." After all, the industrial sector of the US economy has been the "weak sister" in this recovery, limping along after the 1990's technology-driven investment boom left debt-ridden companies with excess productive capacity.



A recovery in the industrial sector would be a welcome event for those hoping for a sustained economic recovery from the bust that came at the end of the last decade. Over the past couple of years US consumers have been doing all the "heavy lifting," encouraged by low rates, rebates and incentives and, most recently, tax cuts. There's not much more the consumer can do, and the economy is in danger of sliding back into recession unless corporate America starts to make investments in hard assets. That now appears to be happening.



To misquote Mark Twain, however, rumors of the manufacturing sector's pre-eminence are greatly exaggerated. The figure that the *Times* referred to was the Institute of Supply Management's Purchasing Managers Index (formerly known as the NAPM Index). Every month the ISM polls a sampling of its members (based on their industry's contribution to GDP), all of whom are employed in the supply management field. The index tabulates the reported monthly change in activity among US purchasing agents. The ISM has proved popular over the years since it is a timely (released on the first business day of each month) and leading indicator of industrial activity.

As the first chart shows, the November reading of 62.8 was a significant improvement in the Index (a reading over 50 indicates a growing manufacturing sector) and, in fact, represented the highest figure since 1983 (this is where the *Times* got the idea that US manufacturing was at a 20 year high). But while this survey of month-to-month activity among purchasing agents flashed its highest reading in decades, US manufacturing is, in fact, barely growing.

The second chart shows a more accurate view of the health of the US manufacturing sector, the year-over-year change in the Industrial Production Index, as calculated by the Fed. Looking back, we see the remarkable string of growth in US manufacturing during the 1990's (industrial production grew at nearly 5% annually from 1992-2000). While it's clear that the recent trend is up (after bottoming out in late '01), manufacturing activity has barely grown over the past year; in fact the value of the Industrial Production Index is still 4% below its mid-2000 peak.

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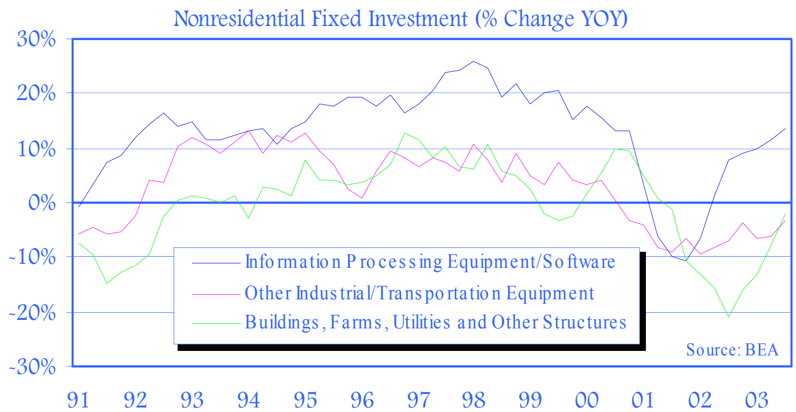
Industrial production is depressed because firms over-invested in plant and equipment in the 1990's to meet the hyped-up demand from the "New Economy." So much productive capacity was added (and so much debt was used to pay for it) that firms are just now beginning to think in terms of making capital expenditures.



According to the Bureau of Economic Analysis (BEA), during the third quarter US businesses increased their spending on fixed investments at an annual rate of approximately 5%. While that growth rate pales next to the steady 10%-15% rates of the mid- to late-1990's, it represents a vast improvement over the 5% to 10% declines of the past couple of years. The chart on this page shows the growth of selected components of capital investment as measured by the BEA. While computer hardware and software spending have rebounded strongly in recent quarters (all those Y2K computers are now four years old!), investments in non-information processing items (e.g., industrial and transportation equipment) and non-residential structures are still below last years' level. This is significant, as these two components represent almost half of all capital expenditures at US businesses. The unwillingness (or in some cases inability) of corporate treasurers to fund spending on plant and equipment has been the primary drag on US economic activity as we have moved out of the last recession.

Which is, at least from a bondholders' standpoint, not necessarily a bad thing!

You see, the last thing we corporate bondholders want to see is any reversal of the progress we've seen in the cleansing of corporate balance sheets. According to Lehman Brothers, the aggregate level of cash is up 42% this year among the 150 largest issuers in the Lehman corporate index. Companies are re-liquefying their balance sheets and conserving much of their excess cash flow. And while most firms aren't actively reducing their outstanding debt, the rebuilding of their cash positions has reduced *net debt* by more than 5% among the largest borrowers. Companies are successfully growing their way out of their heavy debt burdens.

Ultimately, the level of global aggregate demand for US companies' goods and services will determine how much productive capacity needs to be added by US firms. Currently, there is more than enough to keep up with demand, and any modernization can be funded out of current operations. That's just the way we like it. In fact, we would most likely be looking for ways to reduce our portfolio's exposure to corporates (as well as shortening duration for fear of an overheating economy) if the manufacturing sector really was at a "20-year high."

An update: It seems one has to be at least as proficient as a linguist as an economist to be able to understand what the Fed is thinking these days. At the December FOMC meeting the Fed repeated the phrase, used since August, "[monetary] policy accommodation can be maintained for a *considerable period*." [italics ours]. This came as a bit of a surprise to those who spend an unreasonable amount of time studying the Fed's press releases. Most analysts (including us) expected that the Fed would, given the relative strength of the recent economic figures, begin softening up the markets for the inevitable end of the current highly accommodative monetary policy. But instead of dropping or modifying the "considerable period" phrase (which has reportedly been unpopular with some FOMC members), the Committee instead changed the "balance of risks" statement from one warning of possible deflation to stating that the risk of deflation "now appears almost equal to that of a rise in inflation."

What this all means is (as always) open to some interpretation, but our take is that the Fed sees little danger by keeping the monetary pedal to the metal. With only slow improvement in the manufacturing sector and plenty of slack in the labor markets they are likely to keep short rates low for the indefinite future. While this heightens longer-term inflation risks, core inflation is currently at a 40-year low, giving the Fed considerable headroom to keep the stimulus program intact.