Agincourt Capital Management, LLC

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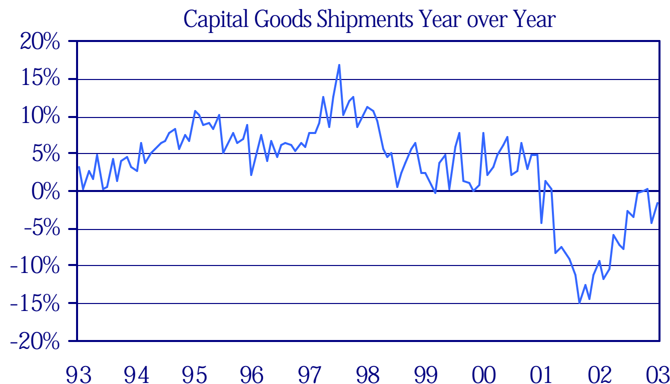
INVESTMENT UPDATE

The conventional wisdom is that war is good for economic growth. The building of weapons and other military goods boosts industrial production, propping up the demand for labor and providing income. Technology spending ramps up in times of armed conflict. Demand for transportation and shipping increases as people and supplies are moved to where they are needed. The industrial buildup that came with the US' entry into the Second World War was the main contributing factor in pulling the domestic economy out of the Great Depression. Likewise, the Vietnam War was associated with one of the longest expansions in US economic history; conversely, the years following the pullout from Southeast Asia marked the worst recession of the second half of the 20th Century.



Yet as we draw near to war with Iraq, the US economy has, if anything, lost momentum. Less than two months ago the US economy appeared to be moving towards full recovery. Not only had consumer spending (the pillar of strength in the low-rate post-September 11 era) been growing steadily, but the industrial sector was finally showing signs of life. Capital spending rose slightly in the fourth quarter, and as shown in the chart above, capital goods shipments had been heading back towards positive growth territory.

Yet in February, a series of economic statistics began to show a widespread slowdown in both consumer and industrial activity here in the US. Auto sales were down, personal spending fell and so did consumer credit. Even the housing market slowed, with building permits falling and new home sales dropping to their lowest level in a year. The Philadelphia Fed manufacturing outlook survey fell from 11.2 in January to 2.3 in February (a reading below zero indicates recession). Perhaps most troubling of all the recent releases was the very weak February employment numbers, which showed a broadly-dispersed drop in non-farm payrolls.

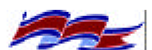
Measures of consumer confidence (the University of Michigan Consumer Sentiment Index and the Conference Board's Consumer Confidence Index) hit their lowest levels in nearly ten years in February. These readings were even lower than those recorded immediately after September 11.

It should be painfully obvious that what's going on is that the prospect of this war has left us all, from consumers to CEOs, deeply worried about the immediate future. In September 2001, shortly after the terrorist attacks, we wrote:

> *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.*

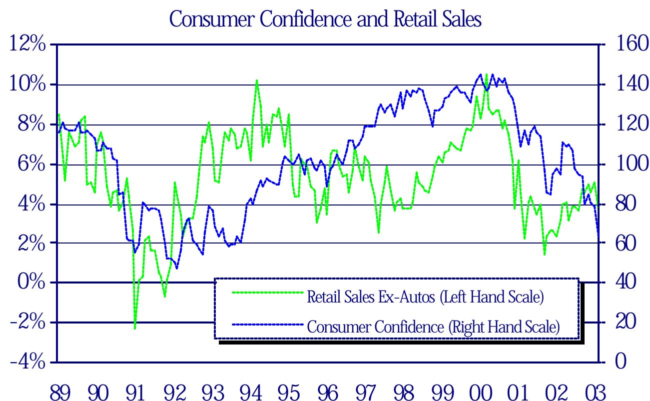
True enough, yet it is likely that most Americans never thought that the riskiest, most dangerous, and most thankless aspects of the fight against global terrorism would look so much like a one-man show. Unlike the last time we had to deal forcefully with Iraq, most of our "allies" are now lined up against us. Is there any doubt that this feeling of isolation (despite the "globalization" of our modern world) has permeated the public psyche, adding to our collective confusion and anxiety towards the war?

The big unknown at this point is whether the public's collective apprehension will result in a lasting economic downturn. As the chart on the top of the next page shows, personal spending and consumer confidence are highly correlated. Yet over the past

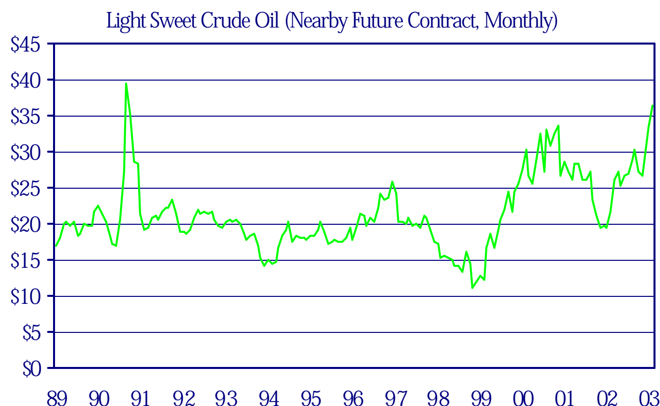


year the strong pace of consumer spending has been squarely at odds with the surveys of consumers' confidence. For comparison, look at how closely consumer sentiment and retail sales tracked each other in the '89-91 recession.

Our main concern, given the fragile state of our economic recovery, is that consumers (and businesses) pull into their shells for a protracted period of time, postponing purchases and curtailing "risky" investments on the basis of not knowing what the future holds. As we've seen, there is growing evidence that this war has the potential to put the economy back into recession.



There is one final consideration that we haven't yet examined: the recent hike in energy prices. While we can only guess what the psychological impact on the economy will be from the conflict in Iraq, there's no question that the recent spike in energy prices will have a significant negative impact on consumer behavior and will depress the profit outlook for many companies. Recent studies show that a $10/barrel increase in the price of crude oil has both direct and indirect effects on growth sufficient to depress US GDP by approximately 1%. Higher energy prices act as a tax increase, transferring wealth from energy consumers to energy producers. In 1990, we had a very short spike in the price of crude oil; will we be fortunate enough to have a similar experience this time around?



Bottom line: the current uncertainty among households and businesses makes it extremely difficult to predict the direction of the economy and make estimates of the other macro inputs impacting the price of bonds. This war comes at a time when both investor confidence and economic activity are in a very fragile state. A quick resolution (as the US military planners foresee) could mean a fairly benign pause in the US economic recovery. But we fear (and we believe we are not alone) that the resolution of this conflict may not be wrapped up into a neat little package. While we're cautiously optimistic that Saddam will be put out of power quickly and with little loss of life, we must also be prepared for less favorable scenarios.

Accordingly, our clients' portfolios possess a more defensive tilt than we might otherwise favor. High quality corporate bonds in noncyclical industries offer the best risk/return trade-off in this environment. Agency mortgage pass-throughs with low variability of prepayments remain attractive. As value investors, we have a hard time warming up to short/intermediate Treasury securities with their negative inflation-adjusted yields but understand their role as a "place to hide out" for many investors. The Fed will likely keep short interest rates low for longer than expected, so it's probably too early to shorten the average maturity of our clients' holdings.

Ultimately, we cannot shape the course this war may take. Our job is to position our clients' portfolios based on our assessments of value and risk, and to be prepared to make any mid-course corrections as needed. In times of uncertainty, a portfolio manager's best weapon is flexibility.

This Investment Update, as well as past editions, is available on our website: www.agincourtcapital.com