Agincourt Capital Management, LLC

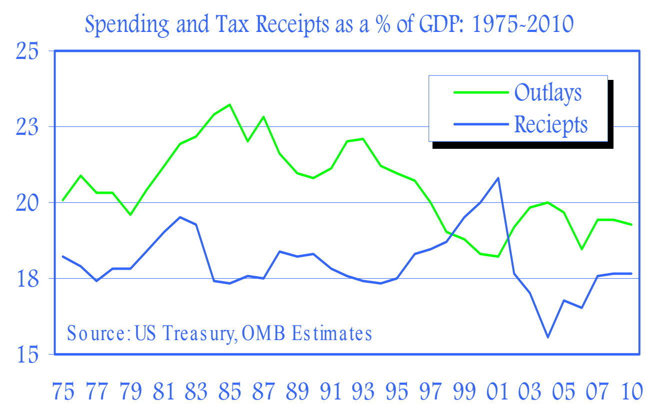
March 2004

INVESTMENT UPDATE

The economist John Kenneth Galbraith once wrote: "The only function of economic forecasting is to make astrology look respectable." With that in mind, and with apologies to horoscope readers everywhere, we wincingly look back at the topic of our February 2001 *Investment Update*, budget surpluses and the looming shortage of Treasury securities. While it pains us to reprint it, here's a little snippet of our thoughts from just three years ago:

> "[Budget] surpluses are now considered the norm and are even projected to accelerate over the next few years…If the current pace of net buybacks continues (including scheduled maturities) all marketable Treasuries will be gone in approximately seven years."

OK, so some of our predictions were a little "off." Like how investors should be "making preparations for a world without Treasuries." Wrong, wrong, wrong. Perhaps we should have seen that the economy was heading into the toilet, that the bubble of the "New Economy" was about to burst, and along with it the gravy train of tax receipts from all those day-trading profit-takers. Maybe we could have predicted the impact of lower personal tax rates and capital gains taxes the newly-inaugurated G.W. Bush was already promising, in order to "return" the surpluses back to the taxpayers.



While the stock market "correction" and tax cuts bit into the surpluses, the shocking events of September 11, 2001 had an even bigger effect in de-railing the US fiscal balance. The initial impact of 9/11 was on consumer behavior, as American (and to some extent, global) consumers "hunkered down," unsure of what the future might hold. The Fed immediately provided liquidity, accelerating the drop in short rates that began early in the year (by 12/31/01, the Fed funds rate would stand at 1.75%, a mind-boggling 4.75% lower than its level at year-end 2000). Despite the Fed's encouragement, the industrial sector (with the exception of the interest-sensitive auto and housing sectors) weakened considerably and the recession was officially on.

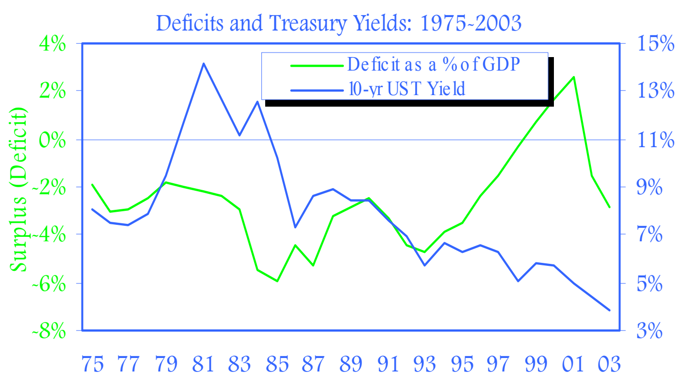
On the spending side of the ledger, priorities changed after September 11, marking an end to the decade-long policy of fiscal prudence in favor of defense and homeland security programs necessary to wage the "War on Terror." Troops were deployed almost immediately to Afghanistan and new programs were ramped up for increased domestic security (e.g., the Transportation Safety Administration).

Subsequent tax cuts for individuals, war and reconstruction efforts in Iraq, and additional fiscal largesse to stimulate the domestic economy (total non-defense spending grew 10% annually from '01 to '04!) has only exacerbated the domestic budget shortfall in the three years since those halcyon days of early 2001. For the current budget year, the deficit is projected at more than $500 billion (4.5% of GDP), and while the President's proposed budget (the "OMB baseline") shows the deficit shrinking over the next five years to $237 billion in 2009 (1.6% of GDP), there are no surpluses on the horizon. The relatively optimistic Congressional Budget Office projection calls for surplus by 2014 (a paltry $13 billion), but this surplus metamorphoses into a $700 billion *deficit* in 2014 if the current tax changes are made permanent and if discretionary spending grows at its recent rate relative to inflation.

We see even more pain further down the road. While these projections should all be taken with a large dose of salt (just look at how much has changed in the past three years) recent estimates from budget watchdog group The Concord Coalition paint a grim picture for US finances over the coming decades. The problem isn't either insufficient tax receipts or massive spending—it's both. This year, the Bush administration's budget shows taxes coming in at 15.7% of GDP, the lowest since 1950 (see chart), while expenditures will rise to more than 20% of GDP, the highest since 1996 (see chart). If the President has his way and the current tax cuts are made permanent, then the CBO's projected rosy scenario is nearly impossible, as GDP growth alone cannot sufficiently increase revenues.

Without tax hikes, very deep spending cuts must be made, yet these seem equally unlikely given the demand for increased social programs (e.g., the new ten-year, 1/2 trillion dollar Medicare prescription drug program) and additional spending necessary to fund Iraq's reconstruction as well as continued defense and security measures. In the peace-dividend and New-Economy rich 1990's deficit reduction was relatively painless; going forward, balancing the budget will require either significant cuts in discretionary spending, cuts in defense/security spending, or a massive boost in tax receipts.

Moving beyond the CBO projections, huge demographic changes are coming our way, as Social Security and other taxpayer-funded retirement benefits will begin to draw funds from the Federal coffers (Social Security taxes are currently net providers to the budget). As the US Comptroller General stated in a speech last September, "long-range budget simulations show that this nation faces a large and growing structural deficit…in less than ten years, due primarily to the retirement of the baby boom generation, the United States will be hit by a huge demographic tidal wave that is *not expected to ever recede*" (emphasis ours).



What this has to do with the bond market, of course, is that the US Treasury will have to borrow the funds to pay for all the programs that tax receipts don't cover. The amount of new Treasury issuance that is coming over the next few years is massive, and is likely to exceed, as a percentage of US GDP, the huge supply of Treasuries we saw in the 1980's.

Conventional wisdom asserts that deficits cause interest rates to rise, as the finite demand for bonds cannot easily absorb the resulting Treasury supply. Empirical evidence is shaky on this point—as the chart on this page shows, yields on ten-year Treasuries actually fell during the great deficits of the 80's, and haven't risen at all in response to the worsening of the current fiscal outlook.

But the law of supply and demand has not been repealed and we must ask whether there will be sufficient demand for all the securities that the Treasury will be issuing in the coming years. Currently, the US trade deficit is helping to support the demand for Treasuries—as US consumers purchase more foreign goods than we sell overseas, our currency ends up in the hands of foreigners, who are investing those dollars in the US bond market. If these countries don't "repatriate" their dollars, their currency gains strength, and the last thing that export-dependent economies (think: Japan) want is a strong currency that makes their products more expensive to foreigners.

The foreign buying of US Treasuries can be viewed as both good and bad—good since foreign demand helps keep our yields down (and US Treasury borrowing costs low), but bad in the sense that we may become dependent on these foreign flows and vulnerable to them going away. Some would argue that we are already dependent on foreign support for our bond market, citing year-end 2003 data that showed a year-over-year increase of 36% in net purchases of US securities, including a massive 128% increase in net Treasury purchases by foreign investors. Of all the buyers, Asian countries have been the biggest "funders" of our deficit, with Japan adding $167 billion to its net Treasury holdings in 2003 (more than five times the much-hyped Chinese buying program). In just the first two months of this year, Japanese authorities have purchased dollars totaling $95 billion to keep the yen from rising.

As a result, perhaps the biggest risk to the future supply-demand balance is a strengthening of the Asian economies over the next few years; higher domestic growth in Japan, for instance, would ease their dependence on exports. If that happens, they might not need to defend against a rising yen by buying as many Treasuries.

Clearly, the US cannot depend on foreign investors and central banks to fund our deficit indefinitely; the budget deficit is an American problem and the US needs to find a solution to it. Given our shaky track record at forecasting the US fiscal balance, we should probably refrain from making any predictions. But we feel comfortable making this one: make way for higher taxes and fewer benefits.