Agincourt Capital Management, LLC

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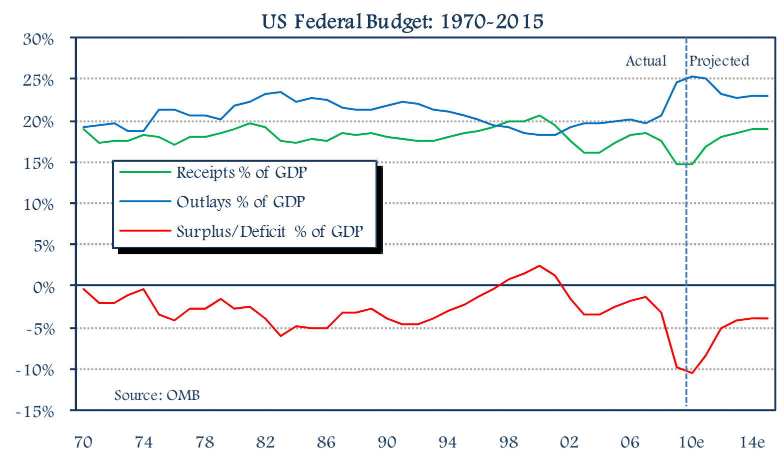
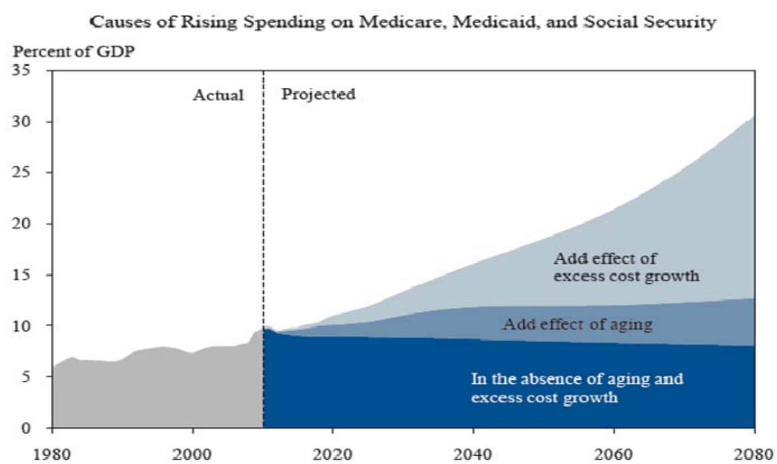
INVESTMENT UPDATE

Those of us who slogged through college economics classes may recall the "guns vs. butter" concept, the idea that a central government's policymakers must make tough budget decisions in allocating its resources. Here in the US, we've been operating under the assumption that we can avoid those difficult choices—committing to costly social programs here at home as well as securing (often with the use of military might) our political and commercial interests overseas. The evidence is mounting that we cannot, in fact, afford to do all of the above, at least with our current tax structure. While this subject is not necessarily one loaded with entertainment value, it's arguably the most important issue facing the US over the next 20 years.

On February 1st, President Obama released the 2011 budget, along with projections for the next few years. While no one should have been surprised at the enormity of this fiscal year's federal budget deficit, the depth and persistence of future deficits, even under the administration's somewhat rosy projections, was headline news. Billions and trillions don't really tell the story or provide a context for the scale of these numbers, but percentages do: last year's deficit was 9.9% of US GDP, next year's is projected to be 10.6%. In the President's Office of Management and Budget (OMB) projections, deficits improve over the next couple of years before "topping out" (if that's the right term for something that's still negative) at approximately 4% from 2012-2020.





Source: Office of Management and Budget (2010).

That 4% number may seem like sweet relief in the context of our current gaping shortfall, but as the top chart shows, 4% is not that much better than the 5-6% deficits that caused the financial markets so much worry in the Reagan administration. Taken another way, even under these somewhat ambitious assumptions (a freeze on discretionary spending, a quick wind-down to the Iraq and Afghan wars, no new economic stimulus, just to name a few), Treasury debt held by the public will increase from 63% of GDP this year to 77% in 2020, with annual interest costs rising from $188 billion to $840 billion over this period. These numbers assume that the previous administration's tax cuts are allowed to expire; if the current tax structure is left in place, the deficit is projected to rise back up to 6% of GDP with the debt burden rising to 87% of GDP by 2020.

And that's the good news.

What's really worrying is what happens past 2020. For the next few years, the US Social Security system will be running a surplus. But the system is getting increasingly top-heavy, with too few workers supporting too many retirees; the OMB predicts that in the next five years the system will begin running in the red and will have to dip into its surplus funds (which in turn are projected to run out by 2043). These same demographic issues will continue to inflate the federal government's funding of medical benefits to an ever-aging population.

But the demographic-driven expenses, which are tied to an increase in the headcount of beneficiaries, pale in comparison to the impact on the US budget deficit due to escalating per-capita costs of medical care. The OMB's base case assumes that "per beneficiary" health care costs will continue to rise at a rate 2% higher than that of US GDP. If unchecked, the cost of Medicare, Medicaid and Social Security will grow by 60% relative to GDP through 2035. As demonstrated on the bottom chart (taken from the *2010 Economic Report of the President*), these mandatory spending programs have the potential to ruin our economy. According to budget

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watchdog group The Concord Coalition, the cost of these three programs alone will soak up resources that are needed elsewhere, "including investments that would be crucial to maintaining [the nation's] economic and military strength in the decades ahead." The US Treasury has never had, even in our most robust economic periods, receipts much more than 20% of GDP—how can we hope to afford *just these three programs* which are projected to rise to more than 25% of GDP in the next 50 years?

Obviously, the time to begin addressing these problems is now. Unfortunately, the current political climate is so toxic that both Republicans and Democrats appear to be more interested in scoring political points than working together to find a solution. There is an inherent weakness in our federal government when those responsible for fiscal decisions are rewarded (i.e., re-elected) for bringing home the pork, and not for managing the greater good of the nation as a whole. Our suggestion is to form an apolitical (or at least a bi-partisan) committee of businessmen, economists, and policy makers to make suggestions as to how best to budget the nation's tax revenues and reform our medical and retirement benefit programs. Politicians simply cannot be relied on to do it—they'll call for discipline one day and criticize the other party the next for trying to "gut Medicare." Both parties are guilty of these stunts, and both need to accept responsibility for their failures.

Meanwhile, across the Atlantic some of our friends in the Euro zone are looking at the US fiscal projections with a sense of *ennui*. "Problems? You Americans know nothing of problems!" they must be saying. Because, as desperate as our situation is over the long term, we're not in imminent danger of defaulting on our Treasury bonds; the same cannot be said for some of our European neighbors.

Specifically, the second-tier economies of the European Monetary Union have had an extremely tough time in the current economic recession. Some of these countries—Greece, in particular, but others, including Portugal, Ireland and Spain, had fiscal discipline problems before they joined the EMU eleven years ago (nine years in the case of Greece), and have been struggling ever since to pare down debt. But in this recession they've been forced to increase their borrowing to make up for revenue shortfalls (sound familiar?), which both violates the EMU's strict fiscal guidelines for member countries and worries existing debtholders. Greece's bonds have been downgraded to BBB (lowest among all EMU countries), while their budget deficit is projected to be 13% of their GDP this year, a gross violation of the EMU's 3% ceiling. While their annual deficit to GDP figure appears to be only slightly worse than ours, their outstanding government debt is 115% of GDP, compared to 63% for the US. In addition, they are far more dependent on outside sources of capital: less than ¼ of our public government debt is held by foreigners, compared to 88% for Greece.

Of course it's not just the potential default of the Greek government bonds that worries investors, as many banks, especially German and French banks, have loans totaling hundreds of billions of dollars to various Greek agencies and private companies. The German Landesbanken have additional exposure to Greek credit default swaps, whose values have plummeted as the cost to insure Greek debt has risen to over 400 basis points in recent weeks (compared to approximately 50 basis points for the US and Germany).

Understandably, the leading EMU countries, led by Germany, are scrambling to find a solution to the Euro credit crisis. While their central bank, the ECB, cannot bail out countries, there are no rules preventing member countries from providing assistance to other members. The timing is critical for the European Union, as the Euro was just beginning to gain credibility as a viable alternative to the US dollar as a global reserve currency; keeping the EU together is therefore both a monetary and political necessity for all member states.

While the details are still being ironed out, Greece (and likely other peripheral states such as Portugal and Ireland) will be forced to swallow a variety of bitter fiscal pills, including severe cutbacks of social programs. Greek pensioners, facing the prospect of having their official retirement age pushed from 60 to 63 will get little sympathy from their German counterparts, where the pension benefits age is being raised from 65 to 67. Greek civil service employees are protesting after being asked to take bonus cuts and the main private union is calling for a national strike on February 24th.

Membership in the EMU means that smaller countries like Greece are now faced with truly unpleasant choices: cut social programs and suffer years of high unemployment and economic pain, or pull out of the Union and try to go it alone. While the second option would give Greece the flexibility to devalue its currency and boost exports at more competitive prices, this option is unacceptable to the EMU leadership, as it puts other members at an immediate currency disadvantage, and incentivizes weaker countries to secede. Germany and France, in particular, have long dreamed of a unified European economy that could compete with the other global powers. Of course, to keep Greece and the other peripheral countries in, Germany and France will have to pay up, either directly, or more likely, by loan extensions and other financial forgiveness plans.

Ultimately, the leading EU countries will save Greece because they can. Greece is "affordable;" its problems can be managed much more easily than a Spain or Italy, two much larger and more influential members. Keeping Greece in the cartel sends a message to all member states, and the world at large, that the EMU has the economic and political strength to hold itself together, even in the most challenging economic environment.

What does it all mean? For high grade bond investors like us, our job has gotten a bit tougher. Traditionally, our credit work has focused almost completely on corporate credits. But the degree of government debt both here and abroad has upped the risk profile of sovereign credits, throwing them into the credit mix. And there are similarities—Greece, with its huge debt burden, high borrowing costs and heavy entitlement programs that stretch to the horizon is the General Motors of the sovereign world. Only time, and Greece's European neighbors, will determine if they can avoid GM's fate.

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