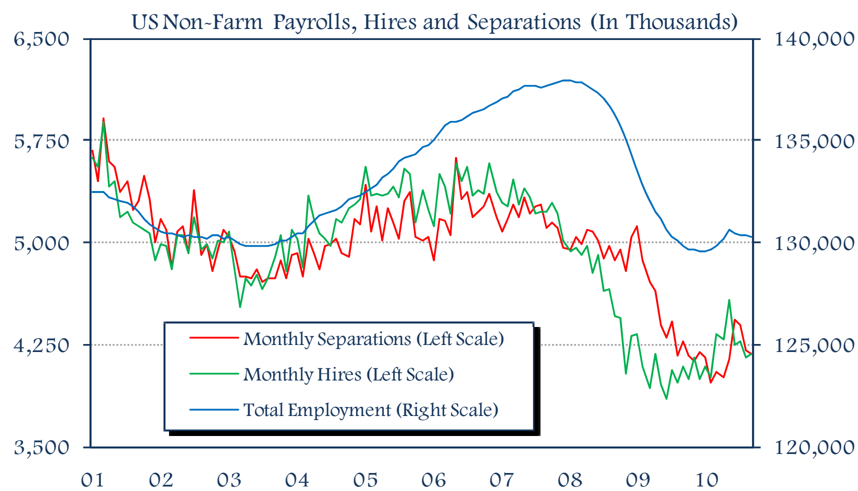
Agincourt Capital Management, LLC

November 2010

Investment Update

Imagine, for a moment, that you run a business that makes consumer products. Sales have been flat over the past few years, and your customers are very price-sensitive, putting pressure on your profitability. What's worse, a few years ago, you expanded your operations, adding to your productive capacity, and you're paying for the expansion with money that you borrowed;. You thought that the increased capacity would be needed, but it hasn't been, so you're paying interest to the bank for excess plant and equipment that's been mostly sitting idle. With sales having stayed relatively static over the past couple of years, you haven't had to lay off any employees, but you've used mostly temporary and contract workers to cover normal attrition, as employing full time workers with full benefits would cut your profits to the bone.

Multiply this snapshot by a few hundred thousand times and we get a general picture of the American business landscape, with companies slogging through an economy that is supposed to be in recovery but which still feels like a recession.



On the other side of this equation is the US consumer. Consumers have been wiped out over the past three years, especially if one was unlucky enough to be a first-time homebuyer at the top the housing market. Those who simply traded up or otherwise extracted some of the equity from their inflated homes in the 2005-2007 era (and especially those who used one of the bull-market financial nightmares known euphemistically as "affordability product") are equally miserable, as many now have negative equity in their homes. Combine this with a stock market that's essentially flat over the last decade and an economy that is barely generating enough new jobs to keep up with the growth in the overall working population, and you have a consumer class that's in the proverbial bunker.

Let's throw one more wrench into the works: We are now facing the possibility of broad price deflation. We've already seen what happens when home prices deflate; what would happen to the behavior of consumers and businesses if they began to believe that all sorts of items that they buy, especially big-ticket items, will be cheaper next year than what they cost this year?

It is just this environment that policymakers are facing, more than two years after the near-collapse of the banking system, and almost three years after the official beginning of the recession.

Let's back up just a bit and take a closer look at the employment situation. Employment is the key to the health of an economy; when people don't have jobs (or even if they're just nervous about job security), they spend less. As the chart on this page shows, there were approximately 138 million full-time jobs in the US economy at the previous economic peak in late 2007. Over the next two years that number dropped by more than *eight million*, with the employment picture improving only slightly in the last twelve months. The nation's unemployment rate spiked from less than 5% to more than 10% over this same period.

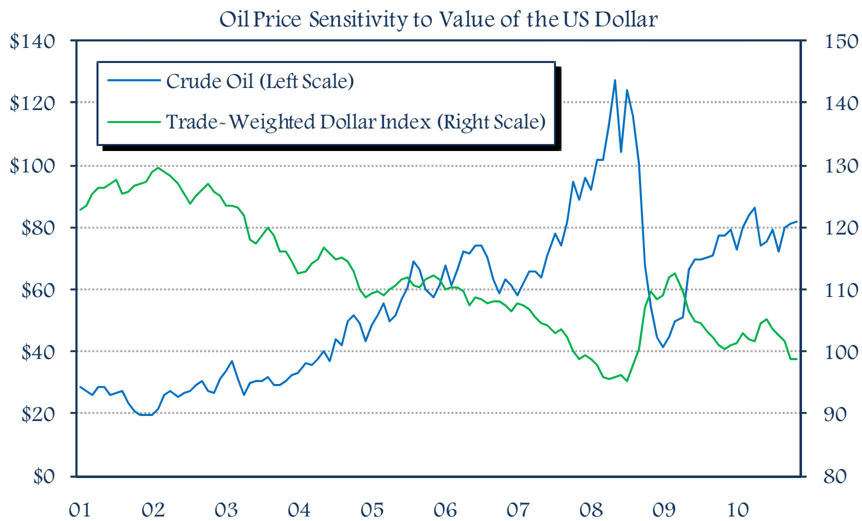
The chart also shows the monthly gains and losses in employment—how many workers were hired and how many suffered "separations" (as the Bureau of Labor Statistics calls them), which includes those who have quit and those who are laid off or discharged. The interesting thing here is the fact that even today, US firms are making more than four million new hires every month. The payroll numbers that are released each month (and which often send investors into apoplectic fits) are net figures—the difference between new hires and separations for that month. So when we hear about the economy needing to "add 125,000 new jobs every month for the unemployment rate to fall," keep in mind that is a net figure. We're making millions of jobs each month, but it's also true that we're losing almost as many.

One last point, and then we'll move on: Notice that in the early stages of the recession, new job creation dropped off dramatically, while separations remained elevated. As it turns out (and it's not shown in detail here), layoffs didn't

600 East Main Street ♦ Suite 2120 ♦ Richmond, VA 23219 ♦ Tel: 804.648.1111 ♦ Fax: 804.648.4475

turns out (and it's not shown in detail here), layoffs didn't rise significantly until late 2008, but "quits" remained at nearly the same elevated level (just shy of three million per month) through the first half of the recession. In other words, the recession had already been in effect for a year, and new hiring had dropped off significantly, before employees "wised up" and stopped quitting their jobs. This second period, from late 2008 to early 2009, was devastating for the US labor market, as net payrolls were shrinking by more than 750,000 jobs per month.

Policymakers have long since run out of conventional tools in putting the spurs to our lethargic economy. The Fed's main fiscal policy tool, the overnight funds rate, has been at or close to zero for almost two years, with little effect. Goldman Sachs' economics research, in fact, estimates that the Fed funds rate today should be almost 7% lower than it currently stands (yes, a *negative 7%),* given the yawning "output gap" of what the economy is capable of producing and what it is currently generating in total goods and services. As a result, the Fed has taken to unconventional steps by ballooning its balance sheet, first with emergency liquidity programs, and then, over the past eighteen months or so, with large scale asset purchases of Treasuries and Agency-backed mortgage bonds, which have lowered interest rates (especially Treasury and mortgage rates) all the way out to the ten year part of the yield curve. But, as we discussed at the top of this piece, firms (and individuals) are not interested in borrowing money, even at these record-low interest rates; the Fed can lead the horse to the financial waters by driving down the price of borrowed money, but they cannot force people to take out loans. As a result, money has been pooling up, and the traditional Money-and-Banking 101 multiplier effect of dollars being replicated in the lending markets has not materialized.



We're seeing that the non-responsive US economy is suffering from what economists call "the paradox of thrift," where an increase in savings unintentionally slows economic growth, a condition that is extremely difficult to reverse. Nevertheless, the Fed has made the decision to engage in another round of asset purchases (the so-called "QE2"), because deflation is an even bigger danger; if consumers and businesses collectively become convinced that prices are inexorably moving lower, we enter a deflationary spiral where the incentive to put off consumption and save becomes psychologically compelling.

OK, we bond geeks are natural-born pessimists; we make our living trying to protect clients from doomsday scenarios, most of which never occur. So, in the interest of full disclosure, we'll pull back the curtains and let a little light in: We think that QE2 is going to help boost the US economy. Not necessarily because it will improve the housing market or inspire consumer confidence—its main benefit is likely to come in the form of increased exports, as the flood of new dollars will weaken their value in the foreign exchange markets. A lower dollar makes US goods and services more affordable to the rest of the world, which will boost US exports. Of course, our main trading partners are none too happy about this arrangement; as President Obama learned in this month's G20 summit, in the zero-sum game of global trade, what we gain, they lose. Accordingly, we'll see an increase in inflation as a result, as imported goods (even with increased exports, we'll still be a net importer) will become more expensive for the US consumer.

And this may, in fact, be the biggest risk of all for the QE2 program: not that it won't work, but that it may work too well, at least in avoiding deflation. Nearly 20% of all US imports are comprised of crude oil/petroleum products, by far our biggest single category (passenger cars are #2 at 6%), and one whose prices are closely tied to a changing dollar. Due to our dependence on imported energy, a lower dollar boosts gasoline and heating oil prices here (see the chart on this page), which acts as a tax on consumers. Economists at Deutsche Bank estimate that every one percent change in the value of the dollar is equivalent to a $3 billion increase in energy "taxes" on US households. Meanwhile, the Fed estimates that the QE2 program will boost US inflation by anywhere from 0.5% to 0.7% over the next couple of years.

The danger is that these estimates prove to be too low, and that energy costs rise more dramatically, robbing wealth from consumers at a pace that completely offsets the benefits from the stimulus.

The fact is, nobody really knows for certain how well this round of stimulus is going to play out. We can have certain guiding principles, and use these to study the historical data, build sophisticated models and make educated guesses about what the likely effects will be, but the global economy is far too complex and dynamic to know what all the effects will be with much certainty.