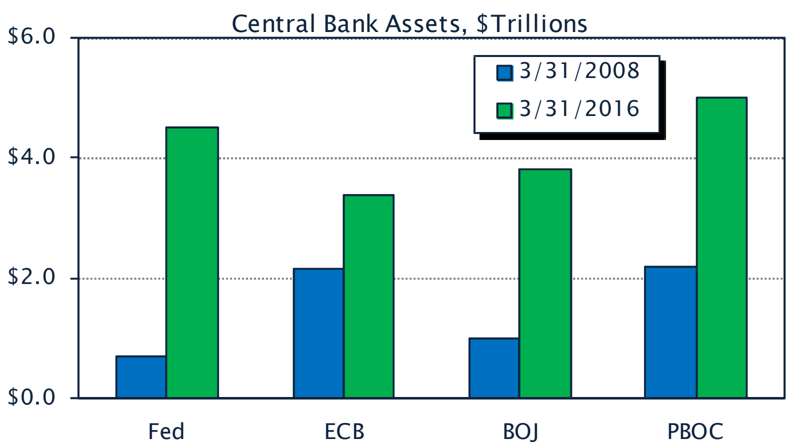
MAY 2016

Agincourt Capital Management, LLC

INVESTMENT UPDATE

A couple of months ago we wrote about the strange phenomenon of negative interest rates, which have become a feature of many of the sovereign bond markets around the world. At this point, nearly half of the government bonds issued in Euros have negative yields, and negative yields prevail in Japanese government bonds all the way out to the 10-year maturity range.

But it's not just the bond market that's been acting strangely. The recent run-up in bond prices has coincided with increases in prices of stocks and commodities, too. As an article in the *Wall Street Journal* rhetorically asked the other day, "how often do stocks, government bonds, and gold rally together?" But there's so much more weirdness, much of it seemingly coming out of China. As Chinese officials have cracked down on speculation in the Chinese stock market, speculators have taken their money and moved into other markets. An April 22 *Bloomberg* article noted that as trading volume of various commodities was skyrocketing, prices soared across disparate markets. How much trading volume, you ask? Contracts on steel rebar (which is used to reinforce concrete) totaled 223 million metric tons in a single day in April, more than the total rebar that China produces in a year. The following week, *Bloomberg* reported that the 41 million bales of cotton which traded on the Zhengzhou Commodity Exchange on a particular day in April were enough to manufacture 9 billion pairs of jeans—one for every single person on planet Earth.



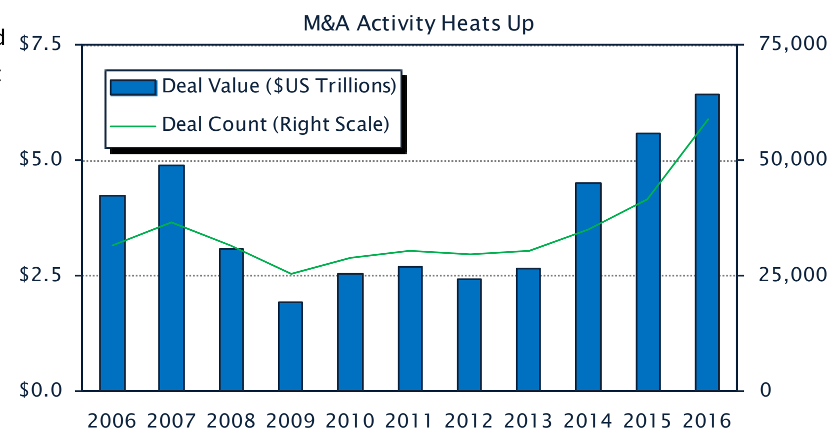
Again, it's not just cotton and rebar (along with stocks and bonds), the speculation is spread across all manner of tradable stuff, from coking coal (whatever that is), to iron ore and eggs. Yes, eggs. A report by Barclays showed that from January to March, eggs and rebar traded with no correlation whatsoever; in April their daily price movements had a near-perfect statistical correlation of 98%. This, for two commodities that share essentially no fundamental supply and demand characteristics; their only commonality is the ability to bet on their prices in China's futures exchanges.

This could be shrugged off as "amateur hour," a game of speculation where neophytes will have some fun until the professionals come to the table and wipe them out. And while that's probably how it should be (prices on many of these commodities have already begun their inevitable steep decline), there is a greater danger that businesses miscalculate, believing that there are fundamental, real-world forces that are pushing prices up, with the possibility that these companies make poor decisions based on those beliefs.

Beyond that, we have to wonder what is behind the rampant speculation, and what it may mean for investors. It seems clear to us that it gets back to the fact that the world is awash in liquidity, due primarily to the expansionary policies of the world's various central banks. As the chart on this page shows, since the financial crisis, "quantitative easing" has meant that every major central bank has expanded its balance sheet, buying up assets (and driving asset prices up) and flooding their economies with money. The worst offender appears to be the Federal Reserve, whose balance sheet expanded more than six-fold since 2008. But that expansion took place relatively early—the Fed's balance sheet, while bloated, hasn't grown over the past two years. More recently, the European Central Bank (whose balance sheet shrunk, temporarily, from 2012-2014) and the Bank of Japan appear to have been most aggressive in monetary stimulus and balance sheet expansion.

Looking at the chart, it appears that the balance sheet of the Chinese central bank (The People's Bank of China) has grown more slowly, having expanded by "only" $3 trillion or so since 2008. But that is misleading, since central bank balance sheet expansion, as important as it is, is not the whole story. Though getting exact figures is difficult, it is estimated that there was an additional $1 trillion in credit issued by Chinese banks and "shadow banks" in the first quarter of 2016 alone, as the Chinese government has redoubled its efforts to stimulate its economy since last summer. That's a lot of cash sloshing around, trying to find a home.

Investors, like the businesses that are directly affected by these wild price swings, must be careful in how they interpret market pricing distortions. As central banks are now realizing, quantitative easing programs can only do so much to encourage real economic investment and growth. At some point—and we're now seeing where that point is—excess currency will be misallocated in unusual and unpredictable ways. With few good opportunities to earn significant returns in the real economy, Chinese investors (and in other countries as well) have increasingly turned to rank speculation. This does nothing to move a weak economy forward, and may cause significant damage, as funds pile up in increasingly-risky financial markets. For us, it makes our job that much more difficult, as market volatility will undoubtedly rise and risks of collapse in certain "rigged" markets become ever-more real.



Switching gears, we have been getting questions from clients lately about where the current US economy stands in the timeline of the business cycle. We will briefly share our thoughts.

Though this economic recovery has been uneven, and there remain areas of the economy that still "feel bad," next month will mark seven years since the official end of the 2007-2009 recession. As such, we are well advanced in this recovery, with the potential that at some point in the not-too-distant future, we could once again be talking about another recession. For a number of reasons, we think that point in the future should still be measured in years, not months.

Arguably the most important measure of an economy's health is its labor markets, and here, the US continues to roll along. Yes, the unemployment rate seems to be having trouble dipping much below 5.0%, where it has been (give or take 0.1%) since last August. On the other hand, since August, the US has added more than 1.8 million net new jobs. The reason why the unemployment rate has remained stable even while payrolls have shown excellent growth is that people are reentering the workforce; if they drop out and stop looking for a job, they aren't counted among the unemployed. This is typical late-cycle behavior, as discouraged former job-seekers are pulled back into the labor force as rising wages become increasingly attractive. In short, there is no sign of any real slowdown in the US labor markets that could signal the end of this recovery.

Another cyclical indicator is merger and acquisition (M&A) activity, which tends to increase as financing becomes plentiful, risk taking increases, expansion plans are implemented, and, often, shareholders become increasingly vocal that a company take action to boost the stock's price. This last point is obviously tied to the fact that earnings growth—and equity prices—often sputter out in the latter stages of a business cycle. The chart on this page graphs the up-and-down nature of M&A activity, showing that both the number of "deals" and their dollar value, after plummeting during the recession, are now exceeding the levels reached during the last expansion in '07-'08.

With earnings now flat for the past two years (using the S&P 500 operating earnings as a proxy), we might conclude that a recession is near. But when we consider that earnings have been depressed due to the red ink of companies in the energy sector, the picture brightens a bit. Corporate profitability is critical to keeping the economy moving forward, not just because it helps keep share prices up, but also because it keeps dividends flowing to investors and retirees, it allows companies to continue to expand and hire new workers, and (especially important for bondholders) it ensures that there's a margin of financial safety to make debt payments in a timely manner.

With oil and other commodity prices having firmed up recently (even after adjusting for the speculators in China), earnings will be closely watched in the coming quarters. If they fail to show fundamental growth, we will start to reconsider the longevity of this recovery. But if earnings rebound as they are expected to, our outlook for the US economy will continue to be one of cautious optimism.