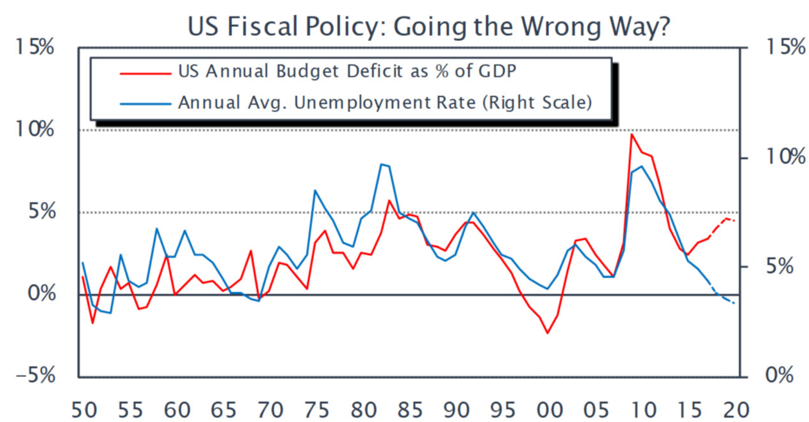
MAY 2018

Agincourt Capital Management, LLC

INVESTMENT UPDATE

The US economy just passed a significant milestone; Now just one month short of its ninth birthday, the current economic recovery is the second-longest in modern history. For it to set a new record, we will need to avoid recession for another 14 months or so. Given current conditions, there is little reason to think that won't happen—despite the usual first quarter slowdown, we are still growing at a decent clip and few economists are calling for a recession any time soon.

Given that we are, by nature, pessimistic bond investors (our motto: "We smile when it rains!"), we're uncomfortable with the assumption that the relatively rosy economic outlook will continue indefinitely. If we are to believe the Federal Reserve, the US economy has suffered no ill effects and will be able to continue to plug along despite the ratcheting up of its key overnight lending rate. As the Fed's policymaking Open Market Committee stated in this month's press release, economic growth is expected to continue "at a moderate pace in the medium term…in a manner that will warrant further gradual increases in the federal funds rate."



While it's hard to argue with the Fed's current assessment, we worry about where we might be, say, 18 months from now. We've already had six 25 basis point rate increases since December 2015; if the Fed remains on its recent pace of rate hikes, we will have another six or seven by the end of 2019, and the Fed funds rate will be above 3.25%. In a recent talk, New York Fed President-Elect John Williams stated that a 3.5% funds rate in 2020 would seem "about right." But a general rule of thumb is that when the funds rates exceeds nominal GDP growth, the risk of recession becomes ever more real. During this recovery, nominal US GDP has grown, on average, at a pace of approximately 3.7%. In other words, we should expect (all things being equal, which they never are) that this cycle probably has another 18 to 24 months to go before the funds rate begins to threaten economic growth.

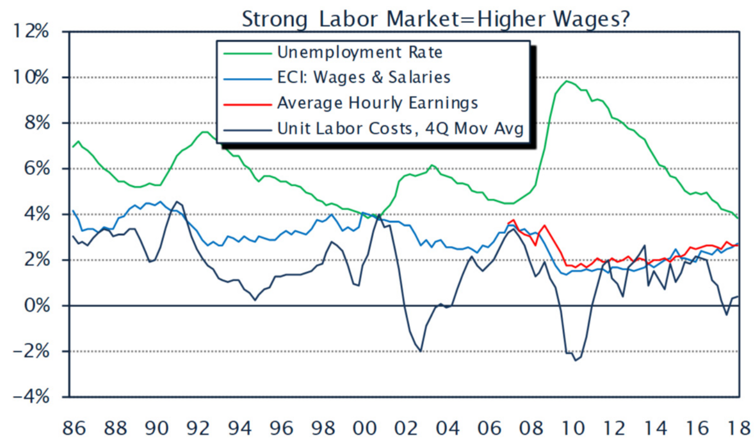
The Fed controls not just the Fed funds rate, but essentially all of the "short end" of the yield curve. After all, two- and three-year maturity Treasury notes are simply a reflection of where investors see the funds rate in the not-too-distant future. But as one moves further out the maturity range, bond yields are increasingly determined by factors that impact the supply of, and demand for, those maturities. And if we look at the supply side of the Treasury market, there's plenty of reasons to be concerned.

As the chart on this page demonstrates, despite a fairly healthy economy, the US fiscal situation is deteriorating. Not since the Vietnam War have we had federal deficits increasing while unemployment was sinking. Economics 101 tells us that deficits are a necessary evil during recessions, when tax revenues shrink and expansive fiscal policies (tax cuts and spending programs) are needed to spur economic growth. But during economic expansions, governments should balance their books as tax revenues pour in, and rein in spending and other stimulus measures. We find ourselves in a situation where our elected leaders have apparently lost their will to make difficult but timely cuts to spending programs, while simultaneously pursuing tax cuts—a combination of policies that piles on debt that future generations will have to pay off.

While the fiscal stimulus may give us a few extra months—and possibly a couple of tenths of a percentage point—of economic growth as the current cycle grinds on, we are most concerned with the enormous stack of new Treasury bonds that will be auctioned to make up the wider budget shortfall. How much new debt? The Congressional Budget Office projects that, just as a result of recent legislation (mostly due to tax cuts), the US will add an additional $1.6 trillion in debt over the next ten years. To put that into perspective, the amount of federal debt held by the public will nearly double, from approximately $15.5 trillion today, to $28.7 trillion in ten years, or from the current 77% of GDP (already a post-WWII record) to 98% of GDP by 2028. The CBO's estimates are based on current law, which assumes some of the recent tax cuts will expire over the next few years; if these cuts are made permanent, the situation becomes even worse, with annual budget deficits of $2 trillion in ten years' time, and debt held by the public soaring to 105%

of GDP by 2028. To quote the non-partisan watchdog Committee for a Responsible Federal Budget, "Recent legislation took a dismal fiscal situation and made it much more dire."

We are already beginning to experience, for the first time in recent memory, investor pushback from the increasing supply of new Treasury notes, bills and bonds. Recent auction results show a widening "bid to cover ratio," the most widely-used measure of the success of Treasury auctions. That's worrisome, as the amount of new issuance is already ramping up quickly, not just as a result of fiscal indiscipline, but from the Fed's well-telegraphed plan to shrink its Treasury holdings over the next few years. Together, it's expected that investors will have to absorb around $1.6 trillion in marketable debt in 2019, up from approximately $600 billion in 2017.



So clearly, the supply side of the equation is cause for concern, but what can we say about demand in the next couple of years? Making predictions like these come with a wheelbarrow full of caveats, and estimating future demand for bonds is far tougher than estimating upcoming supply, but arguably the biggest factor impacting the demand for bonds is inflation. No matter what else is occurring, if inflation begins to overheat, demand for bonds will dry up. Fortunately, we don't foresee that happening. Yes, we've seen a bit of an uptick in inflation recently, as certain one-time factors (cellphone contracts, for one) that were holding prices down last year are now boosting year-over-year measures. The most recent reading of the core consumer price index (i.e., CPI less food and energy) shows that we have breached the 2.0% rate over the past year by a tenth of a percent. The Fed's preferred inflation measure, the core personal consumption expenditures index (core PCE) remains below 2.0% by a couple of tenths.

Despite recent increases, inflation remains stubbornly low, by historical standards, at this point in the economic cycle. Retailers are having difficulty passing along price increases, and consumers have become increasingly adept at either deferring purchases or substituting brands or products in the face of higher consumer prices. Perhaps the biggest driver of higher prices in past cycles—higher wages—remains remarkably muted, even at this mature stage of the business cycle. As the chart on this page shows, the major measures of wage inflation—the employment cost index (ECI), unit labor costs, and average hourly earnings—remain well below the levels of what we would expect with an unemployment rate at 3.9% (an 18-year low). The last few times we've seen US unemployment rate below 5% , wage growth was in the 4% range; today, wages aren't even growing at a 3% annual rate. No wonder inflation can't seem to rise above the 2% level, even when the Fed is pulling out all the stops to push it higher.

If inflation doesn't appear to be a "clear and present danger" to bond demand over the next few months, what else do we know about investor demand? Perhaps the biggest swing factor over recent years has been the involvement (or lack thereof) of foreign investors. Foreign investors hold approximately 43% of US government debt, but that percentage has actually come down in recent years (it was more than 50% as recently as 2013). We've been warned repeatedly that the US is vulnerable to foreign selling of our bonds, but the reality is that foreign entities (led by China) have been net sellers of US government bonds for years. Since mid-2015, foreign investors have sold, net of purchases, more than $350 billion in US government debt.

But that trend (as erratic as it can be) appears to be turning. Despite fears that a US-China trade war might lead to China dumping US bonds as a retaliatory measure, the chances of that are slim. China's US holdings are a by-product of their large trade surplus with the US—they have excess dollars as result, and invest those in US government bonds. A large liquidation of those holdings would strengthen the yuan and make Chinese goods more expensive, a dangerous policy for a country that depends on exports. Now, after allowing their currency to reflect market-based flows for a few years, the yuan has moved to a three-year high relative to the dollar, and the Chinese central bank (PBOC) has begun buying US government bonds once again to put an end to this trend.

With US dollar-backed interest rates having risen more than in most other countries, foreign investors beyond the Chinese are beginning to add to their dollar holdings as well. Obviously, current trends can change, but as of now, with foreign holdings up approximately 7% from a year ago, demand for US government bonds looks solid. As long as US inflation remains in the 2% area and the Fed continues to move deliberately, longer US rates can move up relatively slowly and the dollar should remain in a tight range, supporting foreign investors.

On balance, our fiscal indiscipline at this point in the economic cycle raises risks for US investors and leaves little room for error for policymakers. Fortunately, relatively stable inflation should keep a lid on interest rates, at least during the current cycle. Longer term, US policymakers will have to come to grips with our dependence on borrowed funds; it is an existential threat to our country's future.