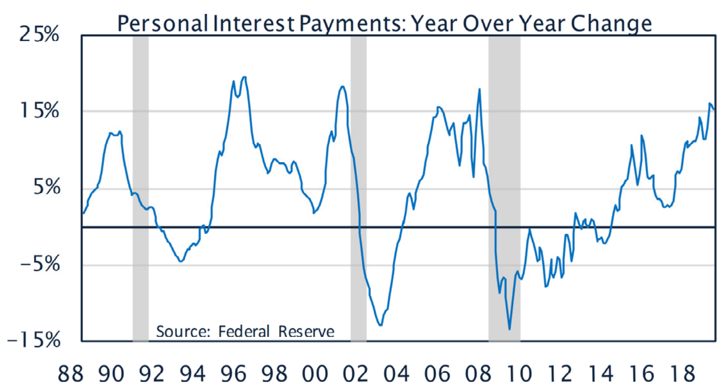
MARCH 2019

Agincourt Capital Management, LLC

INVESTMENT UPDATE

As the US economy rolls along, approaching the tenth anniversary of this economic recovery, it's fair to ask if we're getting near the end of this cycle, and if we should start preparing for the next recession. The Federal Reserve was clearly spooked by the market's negative reaction to its December hike of the benchmark overnight Fed funds rate, which sent the prices of risky assets plummeting. Fearful that a Wall Street sell-off might translate to a Main Street contraction, the Fed performed a policy about-face. By January, the Fed's talking heads, using "open mouth operations," communicated that the US economy was entering into neutral policy territory, and that future rate hikes would be conditional on a further strengthening of economic data.

If you're someone who wants to see the business cycle continue (and why wouldn't you?) the Fed's policy change came as welcome news. We have written often over the past few months about how heavy-handed the Fed's aggressive "normalization" policy has been. It has pushed short rates higher by hundreds of basis points (while also shrinking its Treasury and mortgage-backed securities portfolio) despite this cycle's modest-growth, low-inflation environment. The Fed's policies appear even more ill-advised when one considers the anemic economic growth in Europe and Asia, where monetary policies have continued to aggressively support growth, with little effect. Despite this, the Fed embraced its traditional inflation-fighting ways throughout 2018.



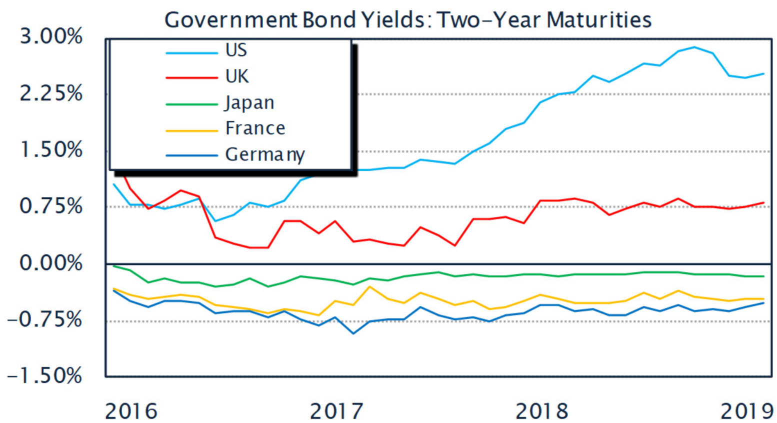
Notwithstanding the Fed's belief that inflation was poised to rise and was being held down due to temporary factors, inflation remained dormant throughout 2018. The Fed's staunch adherence to the Philips Curve (the rule that says that inflation must rise when unemployment falls) pointed the way to once-per-quarter rate hikes. Meanwhile, a lack of inflation exerted little upward pressure on longer-term interest rates, and, combined with the Fed's relentless Fed fund hikes, meant that the benchmark Treasury yield curve continued to flatten, with yields on short maturity bonds rising ever-nearer to yields on ten- and thirty-year bonds. The Fed was able to keep the markets calm by pointing to strong domestic economic growth, although it's now becoming clear that much of 2018's growth was boosted by corporate tax cuts, which caffeinated the US economy.

Again, all that changed after December, and since then, we've seen some significant weakening in important economic indicators. February's employment report showed the smallest increase in hiring since the hurricane-wracked month of September 2017, and the retail sales figures for December had the biggest one-month drop since 2009, with weakness across nearly all sectors. A couple of soft numbers do not establish a trend, and in both cases, the weak data came after strong figures in the previous month. Nevertheless, it's worth noting that there appears to be a widespread slowdown in the broader US economy—with higher interest rates suppressing demand for credit, which in turn has kept a lid on overall consumer spending. Meanwhile, tariffs and the threat of a trade war have impacted exports, further threatening US growth at the same time that the diminishing impact of 2018's tax cuts have made year-over-year comparisons suffer.

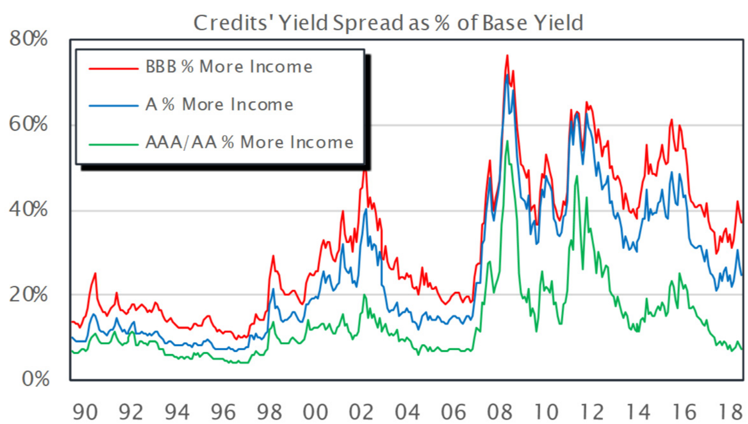
Domestic consumer spending makes up more than 70% of US economic activity—that's 17% of global GDP, which by itself is bigger than any other countries' total economic output; we should be particularly sensitive to reports of weakness in the consumer segment. The tightening financial conditions, as engineered by the Fed, are an early warning sign for the greater economy. As the chart on this page shows, higher borrowing rates plus growth in household debt has pushed the year-over-year change in household interest costs to a level more than 15% above last year's tally. There is no magic number at which point consumer debt begins to stifle growth, but yearly increases above 15% have occurred in the months ahead of the last three recessions (although it also gave out a "false positive" in 1995-96). If interest payments get sufficiently burdensome, they will curtail further purchases of durable goods. In the most recent data available from the Fed, the average interest rate on credit card debt paid by consumers was 16.8%. While rates are obviously lower for auto loans and home mortgages, the high burden of overall consumer interest payments helps explain the recent downturn in both new home sales and vehicle sales, two huge drivers of US industrial output.

INVESTMENT UPDATE CONT.

Fed Chair Jerome Powell recently stated that he saw "nothing in the outlook demanding an immediate policy response." Perhaps not, but he should at least be mindful that, while US economic growth has slowed, our major trading partners have been struggling mightily to generate any growth at all. As the top chart shows, as the Fed was pushing up short-term rates, like-maturity rates of other large countries' bonds have been mired near, or below zero. Two-year maturity government bond yields in Japan, Germany, and France (as well as most other major European countries) have barely budged in recent quarters, reflecting the fact that both the European Central Bank and Bank of Japan's liquidity/QE programs have failed to stimulate demand for credit. Similarly, the PBC, China's central bank, has rolled out successive programs to stimulate growth in its export-dependent economy.



Taken together, it appears that the US economy is, for the first time since the early part of this recovery, moving more or less in tandem with the rest of the developed world; we're all slowing down. If that's the case, as high grade bond investors we need to examine which parts of our market are most vulnerable. The most obvious area is the corporate credit sector, where certain companies may be dependent on a strong economy to support their cash flow needs. Space constraints prevent us from a full examination of the credit sector, but we'd like to hit a couple of highlights.



First, the fundamental credit quality of the average high grade company is fairly solid, even if we subject current metrics to recessionary stress tests. While it's true that corporate leverage is near the highs of this cycle, it's also true that interest coverage—the ability of an issuer to pay interest and principal from its operations—continues to be strong. The main reason for this is that corporate profitability and free cash flow are, in aggregate, near all-time highs. Further, despite the uptick in the general level of US interest rates over the past couple of years, corporate issuers got ahead of the game by retiring old, higher coupon debt obligations and replacing them with lower cost bonds. There are outliers, of course, including companies whose interest costs have ballooned due to debt-funded acquisitions or big stock buy-back programs; accordingly, good security selection will be, as always, critical to good portfolio performance, especially if we slide into recession.

Another important point worth mentioning is that fixed income portfolio managers must be sure to receive adequate compensation for the risks they incur when buying corporate bonds. As total return bond investors, we have choices when it comes to what sectors to buy, and if corporate credits aren't providing an adequate margin of safety, we can easily go "up in quality" and buy government-backed bonds instead. As the bottom chart on the page shows, when we examine the extra yield currently offered by high-grade corporate bonds compared to Treasuries that margin of safety looks pretty solid. When comparing today's corporate yield spread as a percentage of the yield those bonds offer (i.e., the "percent more income"), we see that for BBB-rated credits, that yield advantage is close to the highs seen during the credit crisis of 2001-2002 (the era of Enron and MCI, among other deplorable corporate issuers). Admittedly, yield spreads are well below the nosebleed levels seen in the financial crisis, but those were extraordinary times that we're unlikely to see again anytime soon (fingers crossed!).

Wider yield spreads for credits reflect the current realities of both investor sentiment—it's late in the cycle, and investors are demanding greater compensation to take on credit risk—as well as the fact that the BBB space has become a bit crowded. Today, 47% of the Bloomberg Barclays US Credit Index is composed of BBB issuers, up from 31% prior to the financial crisis.

As the saying goes, "economists have predicted 17 of the past 5 recessions;" unfortunately, business cycles don't run on a schedule, so any predictions of this kind should be taken with a shaker of salt. Nevertheless, the laws of economics, weak as they are, haven't been repealed. There will be a recession, and even if the timing is unknown, we would all do well to examine how the next one might unfold, and how to prepare for it well in advance. We're bond people, after all; cautious and pessimistic is our natural state.