MARCH 2020

INVESTMENT UPDATE

This promises to be a different kind of *Investment Update,* as we attempt to dive into the impact of the coronavirus that is sweeping across the globe. Please note that since our understanding of the virus and its impact on the bond market are so preliminary, it should be recognized that there's every likelihood that whatever we write today will be revised tomorrow. Having said that, we feel relatively comfortable sharing some information that we believe is important.

Agincourt's team is a seasoned group that has been through multiple business cycles together, but none of us have experienced an economic crisis triggered by a global pandemic. Nevertheless, we are confident that Agincourt has in place policies and systems to ensure that our clients' portfolios will be serviced, without interruption, if it becomes necessary for us to work remotely. For more than 20 years, Agincourt has had documented guidelines and procedures contained in our Business Continuity Plan, a document that has been systematically expanded and updated (most recently less than six months ago) to address back-up plans covering all areas of our business operations.

Like many service-oriented companies, Agincourt depends on the integrity and accessibility of information, including up-to-the-second market information, as well as client data and the systems we use to analyze and manage our clients' portfolios on an ongoing basis. To that end, in 2016 we moved to a secured "cloud based" data storage facility that protects the integrity and safety of this data, but also provides for flexibility of access. When combined with remote access (VPN), employees can access any files, and perform the same analytical job functions anywhere with a secure internet connection, including trading, credit research, administration functions, and all back-office operations (trade affirmation and settlement).

In addition to the systems considerations, Agincourt has assigned teams, with responsibilities allocated to various employees, and procedures outlining how our teams will communicate and delegate duties if we are forced to work remotely. There are additional procedures for redirecting our telecom system and for long-term disruptions (not likely part of the current scenario). There are many more details, but rest assured that in the case of a disruption of "normal operations," we are confident that we will be able to deliver the same services we currently offer, in a timely and efficient manner.

Equally important to ensuring that we can continue normal operations in case of "stay home" policies, we are closely monitoring the impact of the virus on the capital markets. Again, the situation is fluid, so our analysis is subject to revision if there's a significant change in the outlook.

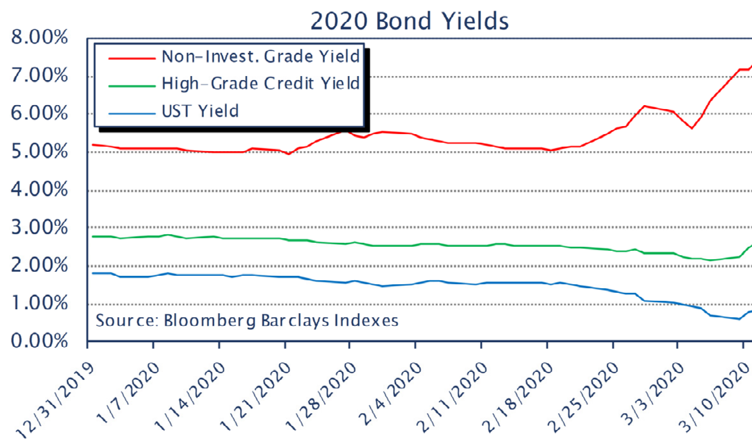
The overriding question facing investors is to what extent this outbreak has a lasting impact on the global economy. If we're facing temporary factory shutdowns and interruptions in the global supply chain, it's conceivable that economies around the world could simply start back up once the work force is given the green light to return to work. In this scenario, as disruptions are repeated around the globe as the virus waxes and wanes, pent-up demand from delayed purchases mean that sales lost today will simply ramp up later. A historical precedent was the brief economic slowdown that occurred just after the terrorist strikes of September 11, 2001; the shock of the attacks sent asset prices and economic activity into the cellar, but sentiment—and economic growth—rebounded fairly quickly (NYC tourism and the airline industry were notable exceptions).

We're not at all convinced that's the most likely scenario, however. This is a global—not local—issue, with far-ranging implications, impacting essentially the entire world's population. Further, like any virus, its transmission plays out over weeks and months; this is not a one-time shock to the economic system. Its effects will put pressure on businesses over an extended time period, and over different geographic areas, making a quick snap-back in economic activity very unlikely.

The impact of the virus will not hit all industries equally. Not only will companies dependent on face-to-face transactions suffer, but whole sectors stand to lose revenues that will not be replaced. Consider the tourism and events businesses, which impacts airlines, hotels, restaurants, car rental, and planners. Activities will be canceled, not rescheduled; there's no "snap-back" next period for lost revenue today. Likewise, sports events, education, public transportation, religious and social services, casino gambling—the list goes on. The economic impact is likely to be deep, with estimates hinting at a second quarter US GDP hit of -3% from the previous baseline.

Those are the direct effects, but if companies are forced to lay off workers due to plummeting revenues, the economic impact grows and the time period of economic weakness extends, as households are forced to tighten their belts. And that is the larger risk for the US (and other) economies—namely, that layoffs lead to declining sales, which hurts revenues and leads to further layoffs—a negative spiral that leads to economic recession.

If that wasn't enough for us to deal with, the Russians took this opportunity to play a game of economic chicken with OPEC, refusing to go along with crude oil production cuts proposed by the Saudis. With a glut in the global supply of crude, and forecasted slowing demand due to the virus, OPEC wanted to reduce oil supplies to help stabilize prices. When the Russian oil minister said "Nyet," and walked out of the meeting, the Saudis and other OPEC members lost the ability to control prices, with predictable results. Crude oil plummeted, and global stock investors began dumping equities. Share prices tumbled, reflecting the fears that a global recession, already a distinct possibility from the coronavirus, was now even more likely as the energy industry, a key driver of US industrial growth, was sure to take a big hit to revenues.



Finally, in the bond market, we are seeing a recessionary-type response in both yield levels and credit spreads. Global investors have pumped money into the Treasury market, looking for a relative safe haven amid the crisis. Yields for 10- and 30-year maturity Treasuries recently fell to all-time lows, trading well through levels seen during the financial crisis. Earlier this month, the Federal Reserve cut its overnight lending rate by 50 basis points to 1.25%, and investors are expecting short-term rates to fall to nearly zero in the coming weeks. The Fed is providing additional liquidity through its open market operations, with $1 trillion in additional repo transactions scheduled over the next month, and purchases of intermediate and longer term maturity Treasury notes and bonds (instead of T-Bills) as part of the liquidity program which was implemented last September.

Meanwhile, yields on most high quality corporate bond have moved lower, but yields are highly correlated with credit quality. The good performance of high quality bonds stands in stark contrast to non-investment grade bonds, where yields have moved dramatically higher, as shown in the chart on this page. As a result, high-grade bond portfolios, like those managed by Agincourt, have produced solid returns year-to-date, as lower yields have translated into higher bond prices.

As you may recall from recent communications, we have been de-risking our clients' portfolios for the past couple of years, as the relative value of corporate bonds has faded over recent quarters, a typical occurrence in the late stage of the economic cycle. We have also been emphasizing "low beta" corporate credits, focusing on strong and stable companies in economically-defensive industries, and avoiding credits that depend on rapid economic growth, or an ebullient investor base. This has, and should continue to benefit our clients, as lower quality bonds are (as typical when sentiment turns sour) behaving more like stocks than bonds.

While the reasons behind a possible global economic recession are different this time, our investment philosophy and strategies remain consistent. Our markets have been fairly orderly so far, but liquidity is variable; some days are pretty good, and on other days even Treasuries are difficult to sell. This is nothing particularly new; we've managed through periods of volatility and illiquidity before (hello, 2008!) with good results and we fully expect to be able to do the same in this environment. Our emphasis on strong, defensive credits, and an ample allocation to US Treasuries and government-backed mortgage securities should provide an adequate margin of safety.

Volatility and uncertainty are running high right now, which in a typical market could provide opportunities to find mispricings among certain bonds. As value managers, we will be on the lookout for those opportunities, but our primary focus right now is making sure our clients' needs are taken care of.

This is an uncertain time for all of us. We wouldn't be human if we weren't concerned for those most vulnerable to this contagion. At the same time, our job is to serve our clients and manage their funds with care and with all the skill and experience our team can offer. As always, please email or call if we can be of service to you in this difficult time.