Agincourt Capital Management, LLC

INVESTMENT UPDATE

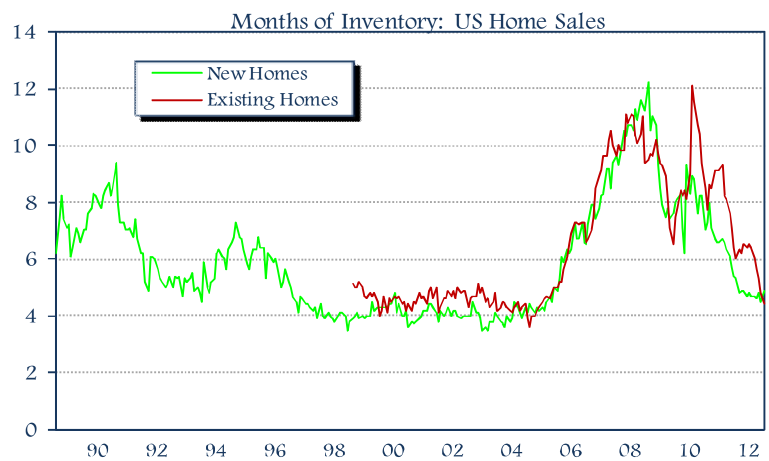
If you think the notion of a strengthening US economy is just "a bunch of pants," you may be absolutely right. It seems that the underwear indicator is flashing signs of a stronger economy ahead.

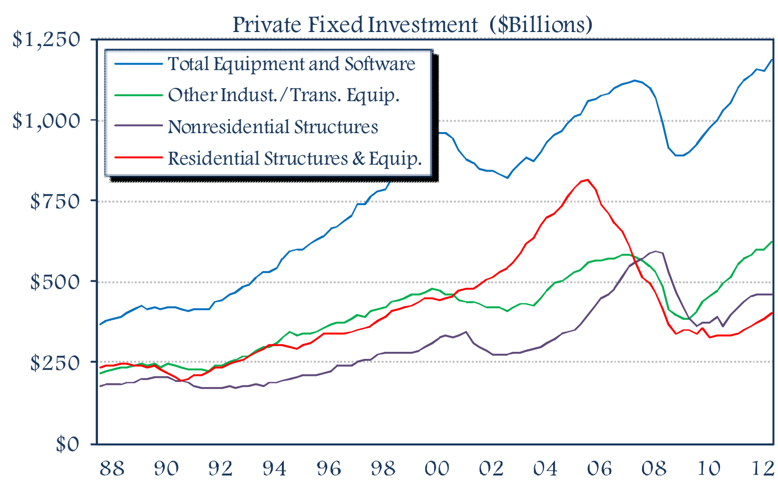
Yes, we said, "the underwear indicator." According to the British semi-newspaper *The Daily Mail*, men are gravitating away from plain white and gray underwear, as they do when the economy picks up, choosing to go instead with brighter colors. In this way, it's similar to the "hemline indicator," where hems on women's dresses and skirts tend to rise when the economy thrives, and fall during recessions. It's scientific, see?

Call us calloused old traditionalists, but we're quite content to look at more conventional indicators of economic strength--which, as it happens, are indeed pointing up.

As we've written a number of times over the past few years, there can be no economic recovery in the US until the housing market rebounds. And that is now happening.

There are any number of ways of measuring the strength of the housing market. Obviously, home price indexes are the most straightforward, and all of these measures show home prices currently on the rise. One measure, the National Association of Realtors (NAR) home price index, shows home prices rising between December of 2011 and December of 2012 by 11.5%. But two other data series interest us even more, because they provide some insight as to what is driving home prices. The first is the amount of housing inventory out there, as shown in the top chart on this page. This measure places housing inventory in the context of how many months it would take to sell all the homes currently on the market, given the current rate of home sales. The results are pretty surprising: After more than tripling from 2004 to 2008, we are all the way back to a "normal," pre-crisis, level of housing inventory in the US for both new and existing homes.

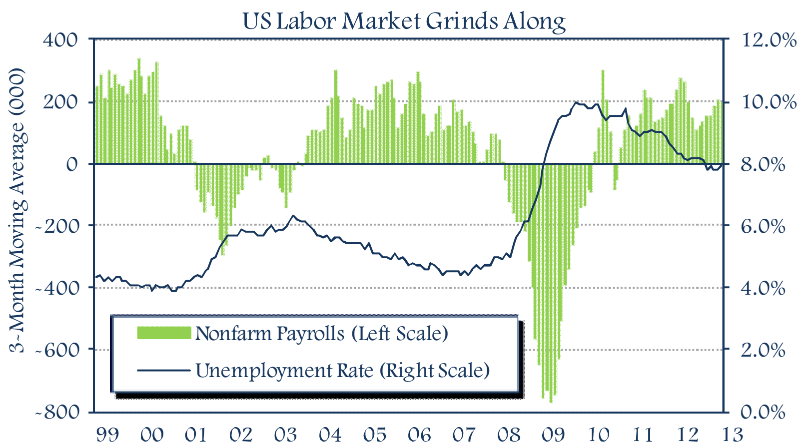




It shouldn't be too surprising that housing inventories have come down. After all, with interest rates at levels not seen in at least fifty years and home prices, despite the recent uptick, still down by more than 20% from their mid-2006 peak (again, using the NAR's index), home affordability recently hit an all-time high; the index showed that a household with a median level of income could afford a median-priced home more than two times over. Combined with a stronger labor market (more about this later), slightly less-stringent bank lending standards for home buyers, and new housing formations on the rise (the college grads are finally moving out of mom and dad's basements!), the demand for housing has got to be picking up.

The decline in supply is also due to the near-shutdown of the home building industry, especially for single-family homes. As the second chart shows, at its peak, investment in residential structures and equipment, which includes new single- and multi-family residences, dormitories, manufactured homes, net sales, improvements on existing properties, and brokers' commissions, was pumping more than $800 billion annually into the US economy. By mid-2010, that figure had dropped by 60%, to $330 billion, dragging down the economy with it. To put these figures into perspective, in 2006, residential investment was more than 6% of US GDP; four years later, it had fallen to barely 2%. But the chart also shows a nascent uptrend in residential investment, clearly a response to the clearing of new home inventories and the uptick in new home sales.

The recent upturn in residential investment is absolutely vital to the recovery of the US economy. As one of the pillars of capital investment in the US, any recovery that did not include a significant pickup in residential investment was always going to disappoint. In fact, the chart, and the corresponding data, understates the importance of the housing market, as it doesn't include the durable goods purchases that typically go hand-in-hand with buying a new home: additional appliances, carpets, furniture, and any number of other items. And then there is the inevitable spending on services that comes from moving and settling into a new house. Finally, as home prices move up, it allows formerly-underwater mortgage-holders to refinance or sell their homes without having to write a check at closing. This, in turn, encourages banks to lend and helps propel the economy further. It's hard to overstate the importance of a strong housing market to the US economy.



Which brings us back to the labor markets. An improving housing market produces more jobs, not just for new home construction (and the increased demand for building products) but, again, for all the other goods and services that go along with moving into that new residence, as well as improved employment prospects for real estate agents, mortgage lenders and other financial service providers. As the chart on this page shows, US payrolls have been growing fitfully over the past three years, but now appear to be trending up, as we are now adding approximately 200,000 new jobs per month.

More jobs means higher consumer confidence, encouraging those who have been sitting on the sidelines to buy a house, which in turn spurs even more homebuilding, further benefitting the labor markets. This "virtuous cycle" is precisely what the Federal Reserve, with its massive stimulus plans and quantitative easing programs, has been hoping for. Up until quite recently, there had been little evidence that the Fed's efforts were working; yes, interest rates were very low but households (and businesses, for that matter) had all the "plant and equipment" they needed, and there was little desire to add debt, despite ultra-low rates. Driving down interest rates was only the first step in the process, as many other factors—recapitalizing the banking system, clearing out foreclosed properties, and improved prospects for jobs, just to name three—needed to happen before new loans were going to be offered, much less desired.

Yes, the prospects for the US economy have clearly brightened, but we need to make some important caveats. First, the economy is highly unlikely to "blast off" in any meaningful way over the next few quarters. While the Fed has every intention to keep its highly accommodative policies in place for the foreseeable future, fiscal policy is taking a decided turn in the opposite direction, with major cuts in federal programs very likely, and new taxes already taking effect. While not enough to derail the economic recovery, these changes will brake economic growth by a measurable degree. The Congressional Budget Office is projecting 2013 real GDP to grow by only 1.4%, and is on record as stating, "that slow growth reflects a combination of ongoing improvement in underlying economic factors and fiscal tightening that has already begun or is scheduled to occur."

Likewise, a growing economy plants the seeds of its own slowdown. We have already seen a 13% increase in crude oil prices in the past three months in reaction to better economic news, despite reports that worldwide energy demand is somewhat subdued. While the US economy is nowhere near as sensitive to crude oil prices as it was 20 or 30 years ago, higher oil prices still act as a tax on consumers, slowing economic growth. Likewise, if home prices continue to inflate, that will eventually suppress the demand among potential buyers, ultimately keeping a lid on residential investment and its stimulative impact on the economy.

And finally, while residential investment has picked up significant momentum, most other categories of private investment are growing at a tepid rate. Companies are making good profits, but they haven't yet seen a big enough jump in aggregate demand to justify large capital investment. As a corporate bondholder, we like to see companies manage their balance sheets conservatively, but we also recognize that capital investment drives long-term economic growth.

So, colorful underwear or not, the economic outlook is a bit brighter. Could 2013 prove to be the year that our economy finally starts to build a little momentum?