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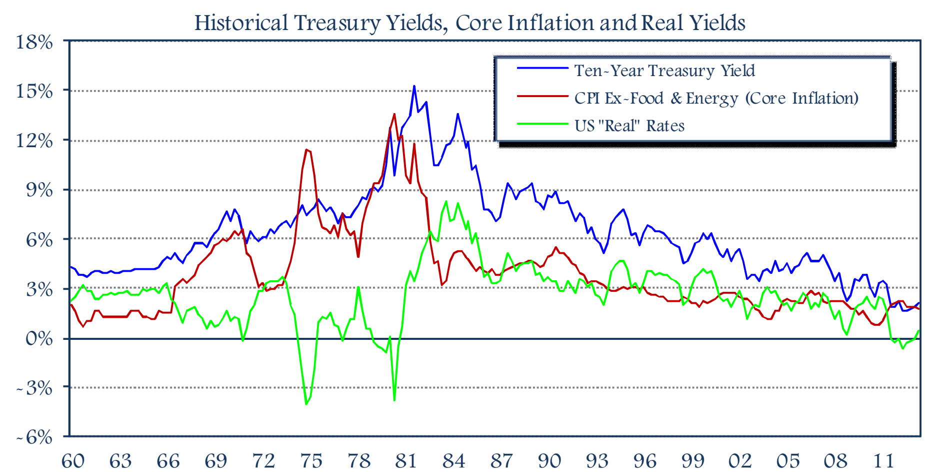
Agincourt Capital Management, LLC

INVESTMENT UPDATE

Back in the dark ages of the early 1980s, when the senior members of Agincourt's investment team were making their transition from bushy-tailed grad students to hoary old portfolio bond portfolio managers, the greatest threat to their professional careers could be summed up in one word: Inflation.

During the four-plus decades leading up to that period, bond managers had been beaten to death (figuratively speaking of course; even in the prehistoric 1980s it was unlawful to actually beat a portfolio manager) by inflation. Inflation was, and is, the mortal enemy of bond holders. It is our Kryptonite, sapping the value of our funds, eating away at the monetary worth of all those future interest and principal payments that are contractually owed to us. And by the early 1980s, inflation had taken its toll on the bond market, driving down the prices of bonds almost as soon as they were issued. Bonds became known as "certificates of confiscation" by bond investors who'd grown weary of seeing their investments shrink in value. Anyone who chose to actually manage bond funds for a living was thought to be a little odd. It was not uncommon, when introducing yourself as a bond portfolio manager, to be laughed at.



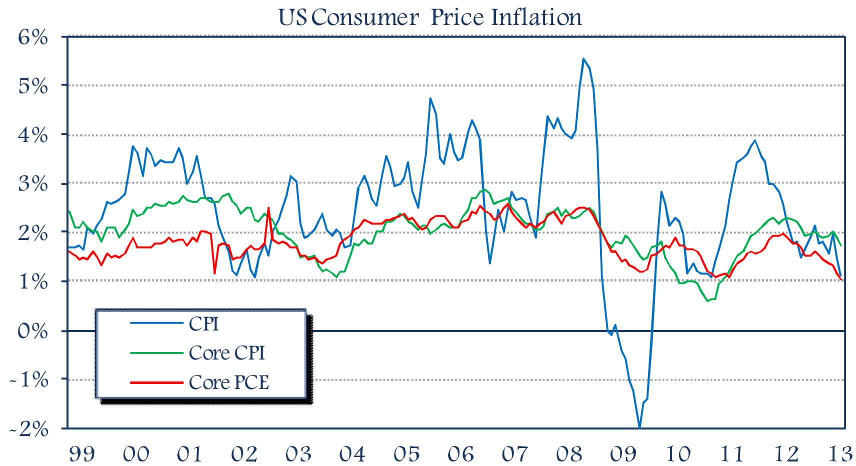
By 1984, the "on-the-run" 30-year Treasury bond, with a 12% coupon and a maturity in 2013 (2013? An eternity to a 20-something!) was trading at 87 cents on the dollar, yielding more than 13%. Inflation had been falling for four years at that point, with core CPI (i.e., CPI excluding the volatile food and energy components) hovering around 5%, providing a real, after-inflation yield to maturity in excess of 8% (see the green line in the chart on this page). Even at these levels, many investors were still reticent to buy long-maturity bonds, having been burned by decades of rising inflation. Old habits die hard, and few wanted to swap good money for a promised return that might evaporate with an unexpected hike in the CPI.

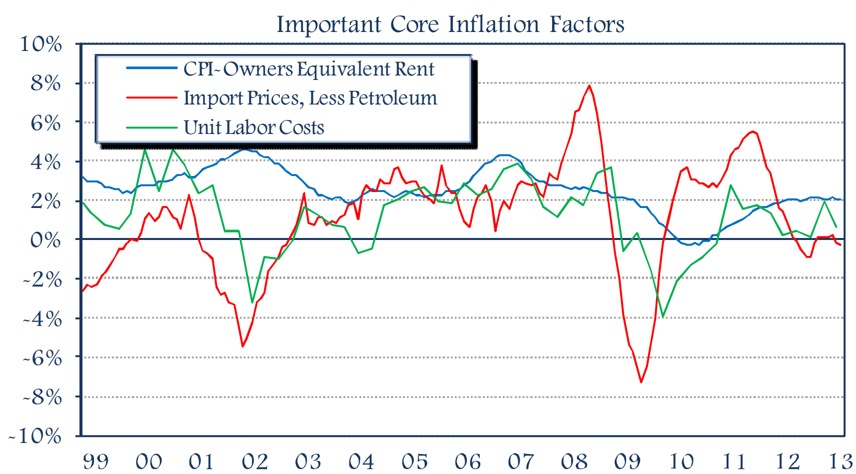
But every dog has his day, and it was no different for bond investors. Core inflation did not head back up, but remained below 5% for the entire second half of the decade (core CPI did rise to 5.5% in mid-1990, but hasn't been near 5% since), calming the fears of bond investors and even boosting stock prices by driving down borrowing costs for corporate America. With the inflation spiral broken, bond investors who stepped up were rewarded with outsized returns—in the ten years ending in December 1993, the broad-based Aggregate Bond Index returned, on average, 11.9% annually. And for the 30 year period just ended in May, the average annual return has been 8.1%. Who's laughing now?

Of course, none of this would have been possible if consumer price inflation had remained elevated. But inflation, throughout the last few business cycles, has been remarkably stable, especially compared to the wild ride of the 1970s and early 80s. The reasons for the relative stability of inflation over the past 30 years is beyond the scope of our little discussion, but clearly a combination of demographic and global economic factors played major parts in restraining the pace of price inflation, particularly in the level of wages and other factors of production.

The near-elimination of inflation from the economic landscape over recent years has changed the macro outlook. In previous decades, inflation was a cyclical phenomenon: it rose and fell with the business cycle. Not that long ago, it was taken for granted that it was impossible to have a recession without a spike in consumer prices. Often, the inflation spike was the actual cause of recession; prices of consumer goods and services would eventually rise to such an extent that it would snuff out economic activity and recession would follow.

What was once axiomatic is now a quaint, old fashioned notion. Or is it? Have the economic laws of supply and demand been repealed? Has inflation, for whatever reason, been permanently snuffed out? You might be forgiven for thinking so, given our current state of affairs. Over the past couple of years, concerns have grown that the Fed's massive money-making operation (AKA "quantitative easing") would lead to a significant uptick in inflation. After all, when the Fed has the capacity to create dollars and then turn right around and buy up bonds with those dollars, the result is a flood of currency into the financial system. With the additional incentive of nearly-free overnight borrowing costs, the banks are more than happy to keep cash reserves high while they seek out credit worthy individuals and organizations to lend money to. As the housing crisis fades and consumers rebuild their personal balance sheets, households and businesses should eventually begin spending—and borrowing—money, putting upward pressure on inflation.





But that hasn't really happened. Counter to expectations, measures of consumer price inflation have been falling over the past few months, even as the housing market and consumer spending have been rebounding, as shown in the top chart on this page. In fact, the Fed's favored measure of inflation, the price change of core personal consumption expenditures, is barely above 1% on a year-over-year basis. What the heck is going on?

A closer look at some of the most important components of inflation (see bottom chart) reveals that there is simply no push on inflation from any of the "usual suspects," including labor and housing. Unit labor costs, over time, have proven to be the most highly-correlated series of economic data with core consumer price inflation. In our modern, service-driven economy, when the cost of paying wages and benefits rise, those costs will either cut into profits or be passed through to the customers; right now, these costs are growing at less than 1%, year-over-year. Likewise, even with home prices rising, the CPI housing inflation measure ("owners' equivalent rent" in the quasi-language of the Bureau of Labor Statistics) has been remarkably stable over the past few months at less than a 2% annual change. Meanwhile, prices on imported goods, after inflating at a 4% annual rate for much of 2011-2012, have been essentially flat for more than a year.

With inflationary pressures muted, the Fed has additional leeway in pursuing its aggressive monetary easing program; indeed, if consumer prices were rising at 2.0-3.0% instead of 1.0-2.0%, the asset purchase program would probably already have been stopped. Which begs the Really Big Question: Has the Fed's QE program created a different kind of inflation—the inflation of Treasury and mortgage-backed securities' prices? And if that is indeed the case, shouldn't these large asset purchase programs be put to bed sooner rather than later, in order to cut the problem off at the root?

Given the rough treatment of bonds in our formative years we will always be concerned about consumer price inflation and its impact on bond prices. But things are very different today, and it's clear that we've been looking for inflation in all the wrong places. All those newly-minted dollar bills the Fed has printed have to go somewhere, and with households and businesses still holding back their purchases, that money has instead gone into the financial markets to shore up banks' capital with offsetting investments in financial assets by both financial and non-financial firms, as well as households.

What this means is that interest rates, and not inflation, are likely to rise as the Fed's quantitative easing programs end. Treasury and other government-backed bonds have been the biggest beneficiaries of this weird inflation, and are likely to be penalized most when the money flow stops.