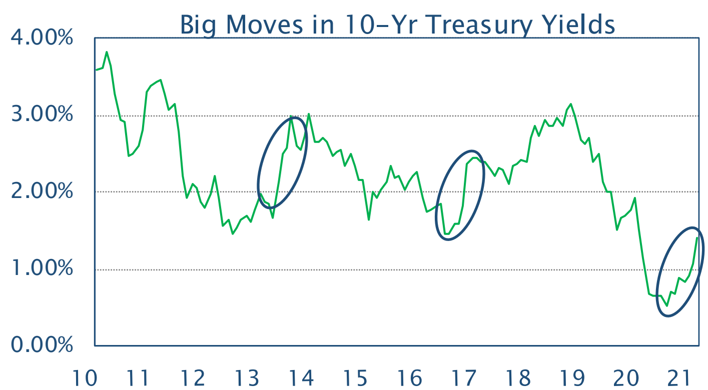
MARCH 2021

Agincourt Capital Management, LLC

INVESTMENT UPDATE

The first quarter is shaping up to be a rough one for the bond market, with prices falling and yields rising, especially for longer maturity bonds. Through the first half of March, the Bloomberg Barclays Aggregate Index has returned roughly -3.25%, which, if it stands, will be the worst quarterly performance for the broad bond market since the third quarter of 1981. It will also be only the fifth quarterly period in the past 30 years with a three-month return worse than -2.50%.

When we look at a chart of historical bond yields (on this page, we're using 10-year US Treasury notes as a proxy), we can see that the recent run-up in rates is not particularly noteworthy; while rates have been in decline for the past 30+ years, there have been a lot of bumps on the way down. That so few have resulted in painful quarterly reporting periods may be a statistical anomaly; it's also likely due, at least in part, to the fact that today's ultra-low yields don't provide much income to offset price declines that persist for months at a time. The current low rate environment leaves investors more vulnerable to interest rate spikes.



Nevertheless, we thought it might be helpful to look back at recent periods of rate spikes to see if we can learn anything that might help navigate the current environment. The most recent of these occurred in the fourth quarter of 2016, right after Donald Trump was elected, when yields rose and bond prices fell in anticipation of a promised expansion of infrastructure spending. While the market was wrong about infrastructure, it was correct that an expansion was coming, but it came as a result of big cuts in corporate taxes (and smaller income tax cuts). That propelled the US economy to relatively strong economic growth in 2017 and 2018, and eventually pushed rates on benchmark 10-year yields to rise above 3% by mid-2018 (as shown in the chart on this page).

Many commentators have been citing an earlier spike as the more relevant one. It occurred in mid-2013, a period that has become known as the "taper tantrum." By 2013, the global financial crisis (GFC) was well in the rear-view mirror, aided in no small part by the Fed's ongoing quantitative easing program, which had begun its third round in late 2012. The Fed, led by Ben Bernanke (and with current Fed Chair Jay Powell in his first term as Fed Governor) was purchasing $85 billion in Treasuries and agency mortgage-backed securities (MBS) per month, but with the US economy showing sustainable growth, was looking towards winding down its asset purchase program.

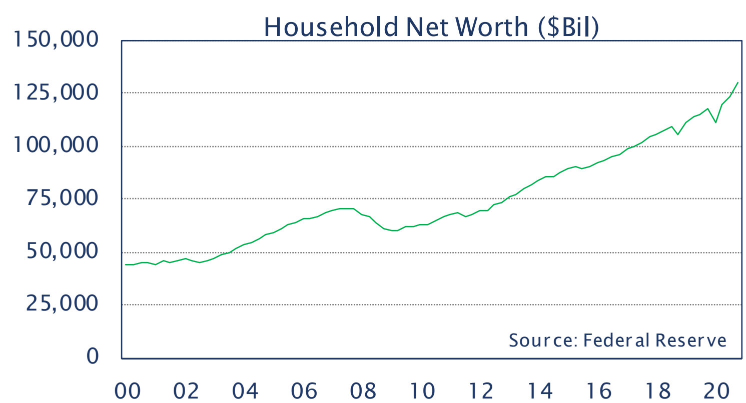
We now know (by way of detailed transcripts that were released in 2019) that the Fed's Open Market Committee (FOMC) had been discussing tapering, and ultimately ending, its asset purchases as early as January of 2013. But the Fed had kept those deliberations quiet, until a routine congressional appearance by Bernanke on May 22nd. Bernanke offered this seemingly non-controversial response during the Q&A session: "If we see continued improvement and we have confidence that that's going to be sustained then we could in the next few meetings ... take a step down in our pace of purchases." Ten-year Treasury yields, which had been bouncing between 1.50% and 2.00% for the previous few months, took off, hitting 2.60% in the next 30 days, and 3.00% by early September 2013. Credit spreads widened and equity prices tumbled, as investors scrambled to adjust to a financial landscape that would eventually be unsupported by the Fed's ample asset purchases.

With the economy improving (unemployment fell by 1% during 2013) the Fed made it official at the December 2013 FOMC meeting, announcing that it would slow the purchases of Treasuries and MBS by $10 billion per month. Further reductions were implied, but the FOMC suggested (correctly so, in retrospect) that there would be no increases in the overnight Fed funds rate any time soon. By year-end, bond investors were licking their wounds as ten-year Treasuries remained above 3%, and the Aggregate Index generated a negative calendar year return (-2.02%) for only the third time since its inception in 1976. Meanwhile, the S&P 500, on the back of steadily improving economic news, plowed through its mid-year blip, returning 26% for the year.

Obviously, today we're dealing with a very different environment, as global economies are still operating far below their potential, despite the optimistic outlook for growth over the next few months. In 2013, we were three or four years into an economic recovery, and fiscal policy had turned fairly restrictive, as a split Congress was holding the purse strings tightly. The Fed was moving towards normalizing its policies in 2013, while today the Fed's

QE program is running full-tilt. It took the Fed more than five years to expand its balance sheet by $3 trillion from 2008-2013; this time around, the Fed has done it in the past 12 months. But monetary policy, as expansive as it is currently, pales in comparison to the fiscal spending that's been put in place over the past year. And this, in particular, is where the comparisons to 2013 become tenuous.

This month, the Biden administration passed its promised $1.9 trillion relief bill to support individuals, state and local governments, and businesses as the economy recovers from the loss of jobs and income due to the pandemic. Not only is this an enormous sum of money, it follows three previous rounds of economic relief that went out in 2020. Taken together, US fiscal stimulus over the past year totals approximately $5.8 trillion, equal to approximately 25% of US GDP. Except for the US and China, that $5.8 trillion is more than any other country's GDP, and $1 trillion more than the GDP of Japan, the world's third-largest economy. Remember the hotly-debated $700 billion TARP bill that was signed in 2008 to help the US economy during the GFC? We've now surpassed that level of stimulus more than six times over, even after adjusting for inflation.



There's no doubt that this amount of stimulus, combined with the Fed's efforts to support the economy, will mean that we should recover more quickly from the effects of the pandemic. Estimates from the Brookings Institution (using Congressional Budget Office projections) show that the new package alone will add 4% to US GDP by the end of 2021 and 2% by year-end 2022, while pulling forward by one quarter the time it will take to reach pre-pandemic levels of output. Not surprising, their research also shows varying payoffs for the different categories of aid, with direct deposits to lower-income households providing the biggest "bang for the buck." Assistance to financially-vulnerable households, since they're expected to spend essentially all of their aid on goods and services, creates $1.20 of cumulative economic growth for every $1.00 of assistance, while aid to businesses generates only 30 cents, on average, of cumulative economic growth. This "marginal propensity to consume," as economists call it, is a critical consideration for policymakers when deciding how best to allocate stimulus money.

How does all this impact the bond market? In two ways. First, a growing economy creates demand for credit, as households and businesses gain the confidence to borrow money to buy homes, make improvements, upgrade durable household and productive goods, and (in the case of businesses) expand their operations—all putting upward pressure on interest rates. Secondly, an expanding economy, especially one that has been flooded with liquidity from monetary and fiscal stimulus, eventually creates imbalances where consumer demand exceeds available supply, providing retailers the opportunity to raise prices ("demand-pull" inflation), or suppliers of raw materials (including labor) to demand more for their services and materials, which retailers will try to pass on in the form of higher prices ("cost-push" inflation). In either case, all that stimulus is creating inflationary pressures, and rising inflation is the bond market's mortal enemy.

So far, the only clear-cut signs of inflation are in real assets; prices of stocks, residential real estate, and commodities have seen big increases since the early days of the pandemic. This can be seen in the statistics for household wealth—the difference between US household's assets (mostly housing and investments) and liabilities (mostly mortgage and consumer loans) has never been higher. This is in stark contrast (once again) to the previous recession, when it took households more than five years to recover their lost wealth. Is there any doubt that stimulus funds are already having an impact on prices, at least for those who own real estate and stocks?

It remains to be seen in the coming months and years if prices for ordinary consumer goods will rise with any alacrity. Looking back again to the two previous bond sell offs, there was no follow-through in either higher inflation or persistently higher rates. After the 2013 taper tantrum, 10-year Treasuries fell back to below 2% over the next 18 months, while the 2016 sell off ran out of steam in early 2017. In both cases, inflation fears proved unfounded, as they have for the better part of the past 25+ years.

The FOMC's March economic forecast, now reflecting the impact of the new stimulus package, barely changed from January, with core inflation expected to top out at 2.2% this year (it's 1.4% now) before falling back to 2.0% in 2022. This seems about right to us, as the stimulus is front-loaded, with its impact fading next year. Likewise, there are now three (up from one in January) FOMC members expecting a Fed funds rate hike in 2022, but the majority of the committee still predicts no hikes until at least 2024. Unlike the bond market, the Fed is not particularly concerned about an overheating economy or a big pop in inflation.

Like the Fed, we're not convinced inflation will get out of control any time soon. Nevertheless, there's no real penalty, in this environment, for dialing back portfolio risk in the face of rising rates.