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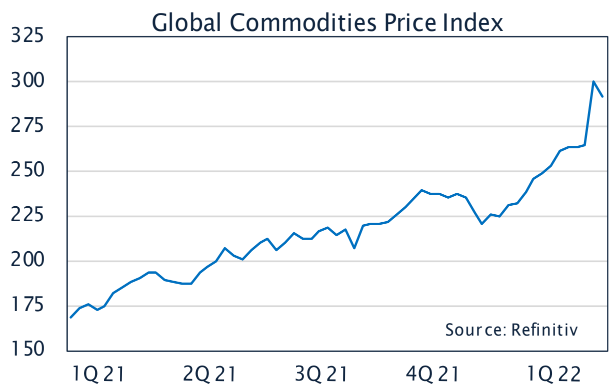
Agincourt Capital Management, LLC

INVESTMENT UPDATE

The war in Ukraine has changed the narrative for investors in a period that was already full of challenges. Russia's historic aggression—the most egregious violation of European border sovereignty since the Second World War—has the potential to disrup the global balance of power over the long term. In the short term, it has already upended the lives of millions of Ukrainians, and killed thousands of combatants and innocent citizens. Worse, there seems to be no way of stopping Russia from carrying through on its attempts to fully occupy Ukraine and unseat a democratically-elected government.

We can only scratch the surface of the sources and implications of this crisis in a two-page document. Nevertheless, we need to try to understand what this war may mean for the free world; what are the risks to democracy, global capitalism, free trade, the capital markets, and bond investors? Let's get started.



First, let's be clear: Russia is a global superpower only because of its military strength. Economically, Russia remains an also-ran, with an annual GDP similar to that of Brazil or South Korea. Unlike most western economies, however, Russia's economy is heavily dependent on the exportation of commodities; oil and natural gas, minerals, and chemicals represent more than two-thirds of Russia's exports. Russia's demographics are dire; with an aging population, low birth rates and little to no immigration (outside of the former USSR), the population is shrinking and is forecast to decline by at least 20 million in the coming three decades. Currently the world's ninth most populous country, it's expected to fall to 17th by 2050. The World Bank calculates Russia's per capita GDP, as measured by purchase price parity, at less than $30k annually, which ranks 58th in the world. Russia has roughly 45% of the population of the US, but generates only about 7% of our GDP.

Despite these obvious weaknesses, Russia has shown that it can wreak havoc on its neighbors. As Russia has been "playing nice" since the fall of the Soviet Union (at least when compared to their long history), European countries have ramped up their trade with Russia over the past two decades. As a result, Europe has been sourcing roughly 40% of its natural gas and 25% of its crude oil from Russia. Germany has grown especially dependent on Russian energy imports, so much so that it formed a joint venture with Russia and European energy companies to build a second undersea pipeline (Nord Stream 2) to deliver natural gas directly from Russia to Germany. Even though the pipeline was nearly completed, Germany pulled funding for the pipeline last month after Russian troops invaded Ukraine.

The immediate impact on global markets is already being felt. The prices for crude oil, natural gas, and other commodities that Russia exports have skyrocketed as Western leaders are cutting off imports from Russia. Negotiations are ongoing with the heads of other large energy producers, including Venezuela and Iran, two countries currently under trade sanctions, as well as Saudi Arabia and UAE, to try to ease supply concerns. These negotiations—as well as easing regulations here at home to ramp up energy extraction—are not likely to make up for the loss of Russian oil in the short-term. Thus, we see the sharp uptick in commodity prices as shown in the graph on this page.

From a bondholder's standpoint, these supply shocks could hardly come at a worse time. As we've written about previously, US inflation is at a 40-year high, mostly driven by supply/demand imbalances among commodities and manufactured goods. Additional strain on the commodities markets will, at a minimum, delay the easing of inflationary pressures that we had been expecting to occur in the first half of this year. That means that it's very likely that we haven't seen peak inflation yet, and may not for many months to come, depending on how the conflict plays out.

Higher inflationary pressures due to spikes in energy prices are clearly bad news for bond investors, as rising inflation erodes the value of the fixed coupon and principal payments that bond holders receive, some of which may not be paid for 10, 20, or 30 years from now. Bond prices should be expected to fall—and corresponding yields and rates should rise—during periods of rising inflation. But that hasn't occurred over recent weeks, because there are countervailing forces at work.

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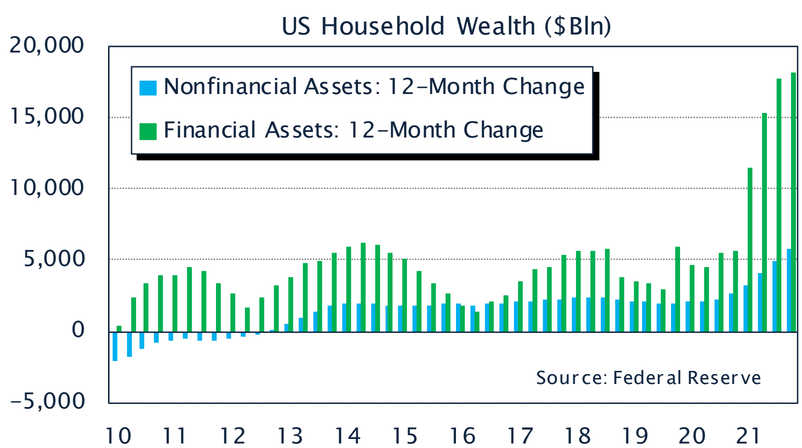
The predominant offsetting factor holding down long-term inflation expectations is the belief that the Federal Reserve's recent pivot towards tougher monetary policies will suppress this round of inflation before it gets out of hand. Certainly, the Fed can be proud that its inflation-fighting credentials over the past four decades have firmly anchored longer-term inflation expectations. February's survey of consumers' one-year inflation expectations rose to a 40-year high of 5.4%, but the five-year inflation expectations remained firmly planted at 3.0%, only 0.1% above its 12-month average. We remain concerned that our market has not fully priced in the possibility of policy error from the Fed, or even an acknowledgement of the Fed's limitations in controlling commodity prices.

The other factor that appears to be suppressing inflation expectations is the notion that inflation itself could cool demand, as the rising cost of necessities—heating one's house, buying groceries, and fueling one's car (for starters) acts as a tax on consumers, reducing disposable income for other purchases. Especially when combined with higher mortgage and rental rates, a spike in prices for necessary household goods will have a measurable impact on demand as consumers tighten their belts.



Some commentators believe that the combination of tighter Fed policy, higher prices for household goods, and the end of COVID-related fiscal stimulus programs have already sowed the seeds for the next recession, reminiscent of the "bad old days" of the 1970s and 80s when the Fed would trigger every recession by clamping down hard on inflationary pressures with multiple rate hikes. While this is a possibility, we don't see this as a near-term concern, due to the healthy condition of the average household's balance sheet. Unlike previous periods of high inflation, this one exists in an environment where interest rates and interest burdens of households are low. As a percent of personal disposable income, interest costs are near the lows of the past 50 years, and more than 30% below levels that existed just prior to the meltdown in home prices in 2007. Households are awash in cash right now, with the Fed reporting that cash and checkable deposits have grown from less than $1 trillion to more than $4 trillion over the past two years.

The reason for this increase in cash is due to, again, a combination of factors. Certainly, many households have deferred vacations and other expensive expenditures over the past two years. Others received emergency funds that they saved, in whole or in part. And some invested funds in the stock market, or purchased/upgraded their homes, inflating prices and enhancing wealth further. As the last chart on this page shows, both financial (stocks, etc.) and nonfinancial (real estate) assets have boosted household wealth dramatically over the past couple of years. Bottom line: household wealth (if not income) is very strong right now, and should help lower the chance of an inflation-triggered recession.

As for what happens in Ukraine, while it's still too early to know for certain, neither side appears to be backing down. Certainly not the Ukrainians, who understandably will dig in, as most people would do, in the face of a foreign invasion. If Putin was looking for a quick "shock and awe" attack using overwhelming force on a timid populace, he miscalculated badly. Nevertheless, this is a man who in 2005 claimed that the breakup of the Soviet Union was the "greatest geopolitical catastrophe" of the 20th century; if he cannot reassemble the USSR (and he cannot), he remains hell-bent on putting certain stepchildren under his thumb. If this means bombing innocent people and reducing their cities to rubble (as he did in Syria), so be it.

If there are any positives that come from this, it's that Putin has woken the world up to the inherent disaster that comes to those who embrace egomaniacal despots who pose as populists. Putin's style of tough-guy authoritarianism plays well to his home crowd, and has spawned wannabe-strongmen in places like Turkey, Brazil, and the Philippines. There has been a creeping erosion of what it means to be "democratic" over the past couple of decades, as shown in the decline of freedom as measured by institutions like Freedom House and the Heritage Foundation. Putin has, in short, united the free world in a way that no other politician or movement could: by exposing rank hypocrisy, and showing that unbridled power, unchecked by a corrupt political system, is a formula for massive human suffering.

Russia will suffer as well. It is being ring-fenced by the free world, and will remain an international pariah for years, if not decades. Desperate for foreign currency, it will struggle to find new trading partners (outside of their despotic allies, China, North Korea, and India). Ultimately, it's the Russian people who will suffer. Putin and his inner circle will remain wealthy beyond reason while his people starve. It's a colossal disaster on a historic scale.