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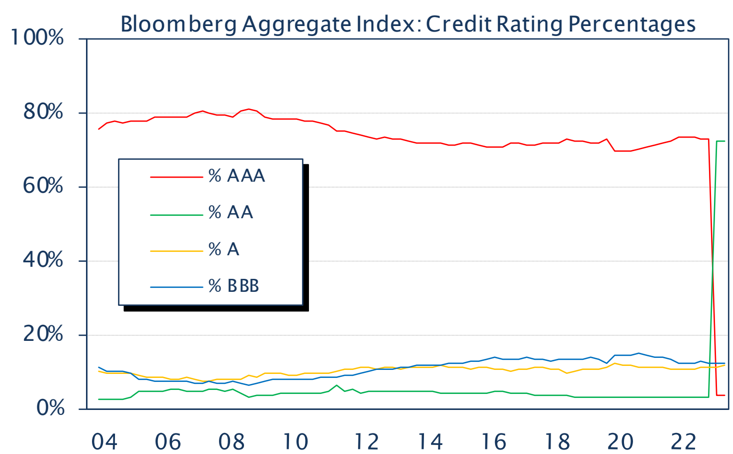
Agincourt Capital Management, LLC

# INVESTMENT UPDATE

You may not have noticed, but there have been some big changes in the major bond indexes over the past few years, reflecting the shifts occurring among different classes and categories of bonds. Some of these changes are small in quantity but have a big impact on how we think about the bond market, while other changes in the indexes appear to be bigger than they really are. We'll do our best to explain.

First, in the category of "big, but not that big of a deal" is the recent downgrade of the ratings for US government bonds, including Treasury securities. Back in 2011, when Congress and then-President Obama were wrangling over budget issues, Standard & Poor's (S&P) downgraded its ratings of US government debt from AAA to AA+. S&P noted that the one-notch downgrade was due to a lack of progress on spending cuts while also pointing out that "the political brinksmanship of recent months highlights what we see as America's governance and policymaking becoming less stable, less effective, and less predictable than what we previously believed." Some things never change.




The downgrade was a shock; after all, US Treasury securities were thought of as the world's safest investments—at least from a default risk standpoint—with short-maturity Treasury Bills representing the very essence of a risk-free asset. But that shock soon wore off, and after a few months, it faded out of view. The reality was (and still is) that the taxing power of the US government, while not unlimited, was so large that the risk of actual default—the loss of timely payment of principal and interest—was insignificant. Outside the bubble of the ratings agencies, nothing really changed. Investors didn't sell Treasuries in search of higher quality bonds elsewhere (hint: they didn't exist) and regulators continued to treat Treasury and US agency securities as the highest quality bonds in assessing regulatory capital. To this day, the chance that the US will refuse to pay its outstanding debt obligations remains extremely remote.

A dozen years passed before the fiscal battles of 2023 caused another major rating service, Fitch Investors, to follow S&P's lead and downgrade US government bonds one notch, to AA+. Unlike in 2011, there was little market reaction last August when the downgrade was announced. That could be due to the fact that Fitch is the least influential of the three major bond rating agencies, having come on the scene well after Moody's and S&P had established themselves. More likely, the subdued reaction was because investors had "seen this show before," and remained convinced that there continued to be a near-zero chance of a US government default.

So far, so good, with one significant caveat: with two of the three major rating agencies having knocked US government debt down to "AA," the Bloomberg bond indexes had to follow suit, since they use the average (or middle) of the three agencies' ratings. As the chart on this page shows, this caused a giant flip in the quality distribution of the broad-based Bloomberg US Aggregate Index in the third quarter of 2023, as the combination of Treasuries, US agency mortgage-backed securities (MBS), and agency debentures make up 70% of the Aggregate Index. Not only did 70% of the Index drop from AAA to AA, the average credit quality of the Index fell as well, from AA to AA- (i.e., "low AA"). Accordingly, an actively managed core bond portfolio with any measurable overweight in corporate bonds (nearly all of which are rated single-A and triple-B) will now have an average portfolio quality of single-A, if not lower.

The bottom line here is that the "advertised" credit quality of the US bond market has been downgraded; whether, in fact, the credit risk of our market is higher today than this time last year is very much open to debate. Either way, managers who are bound by average quality guidelines may find their ability to overweight lower rated bonds inadvertently constrained by the downgrades of US government bonds. In those cases, plan sponsors may want to reconsider revising their managers' investment guidelines to reflect the new, lower, ratings of the high grade US bond universe.

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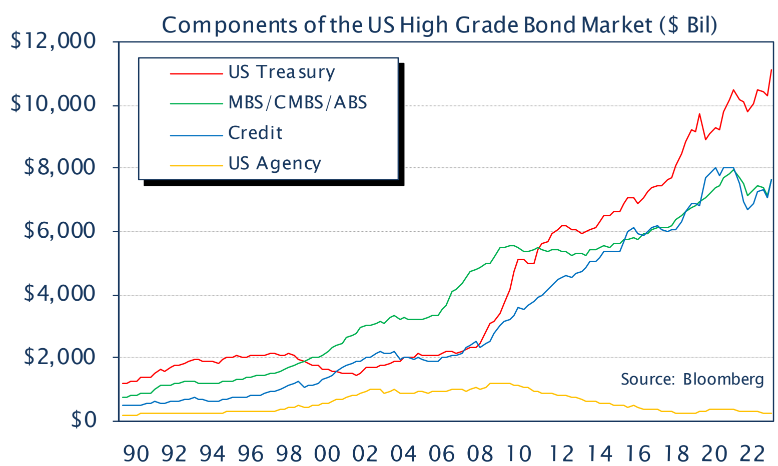
But the downgrade of US government bonds isn't the only change in the composition of the bond market we've seen over the past few years. As the chart on this page shows, both the size and distribution of the high-grade market is markedly different than it was just a few years ago. The biggest change, clearly seen by the red line in the chart, is the acceleration of growth in Treasury securities, both in absolute terms and as a percentage of the US bond market.

You may recall (if you're of a certain age, or happen to have a good memory) that around the turn of the millennium, US Treasuries were a shrinking asset class. With the end of the Cold War came significant cuts in fiscal spending, which coincided with a strong US economy with growing tax receipts. This resulted in the US running budget surpluses for the first time since the 1960s. Those surpluses allowed the US Treasury to retire outstanding Treasury securities. From mid-1998 to early 2002, the market value of outstanding Treasuries fell from $2.1 trillion to $1.5 trillion. The potential for market disruptions as a result of the falling supply of Treasuries was highlighted in our February 2001 *Investment Update*, which focused on what could happen if Treasuries lost their global benchmark status.




Clearly, that's no longer the case, as successive crises—the global war on terror, the great financial crisis, and the COVID pandemic—led to significant increases in federal spending for defense and domestic fiscal programs, while tax revenues have not kept up with the pace of spending over the same period. The result, predictably, has been massive budget deficits, which are being funded by trillions of dollars of new Treasury Bills, Notes and Bonds. That $1.5 trillion low water mark for Treasuries in 2002 is now more than $11 trillion. Looked at another way, in 2002 Treasuries represented 21% of the Bloomberg Aggregate Index; today they represent 42% of the Index.

The chart also shows how the mortgage-backed securities category (which includes commercial MBS and asset-backed securities), has grown very slowly over the past dozen years. After seeing explosive growth prior to the financial crisis of 2007-2008, the MBS market also shrank, as millions of home mortgages were foreclosed in the painful aftermath of the collapse of the US housing market. The value of existing mortgage bonds likewise fell, and with the economy struggling to right itself, there was no growth in the market value of mortgage bonds from 2008 to 2014.

More recently, COVID-era emergency support programs for businesses and households, along with global supply chain and commodity shortages, led to a spike in inflation and falling bond prices, reflected in the shrinking market values of both MBS and credits (the green and blue lines in the chart). Some easing of inflation has led to a partial recovery of MBS and corporate bond market values, but both remain below pre-COVID levels. Likewise, US agency debentures now make up only 1% of the index, down from 11% in 2009, as the mortgage-related government agencies (GNMA, FNMA, and FHLMC) follow far more conservative balance sheet/funding strategies since they came under government conservatorship.

Finally, the post-COVID runup in inflation led to the biggest increase in interest rates in decades, with the average yield of the Aggregate Index rising from 1.7% to 5.0% over the past four years. While that move up in rates led to poor returns over the past few years (the average price of a bond in the Index has dropped by 20 points over the same period), that "reset" in yields now provides a significant tailwind for prospective returns for bond investors. Earlier in the decade, yields had fallen to the point that bond investors could only count on bonds as a deflation hedge; yields were too low to generate much in the way of future returns. That is not the case now, as bond yields are high enough today to stand on their own and make a real contribution in the coming years to total return-oriented investors.

What this all demonstrates is the fluid nature of the capital markets, where homeowners, institutions, and governments access the funds they need to keep operating. In the bond market, that access is conditioned on the borrower to "pay the freight" of interest costs. The cost to borrow funds was, in retrospect, held at attractive levels for years following the financial crisis, and the US Treasury and corporations took the opportunity to issue bonds at will. With interest costs moving higher, we should expect continued changes going forward in the composition of our market, as demand and supply for various classes of bonds continue to shift. Our job is to take advantage of any inefficiencies that may arise as a result of those changes.