DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter
Q1 2017

Fixed Income Strategy
Doucet Value Momentum Portfolio
Doucet Value Income Portfolio
Mutual Fund Strategy

January 2017

Can the Market Get Out of Its Purple Haze?

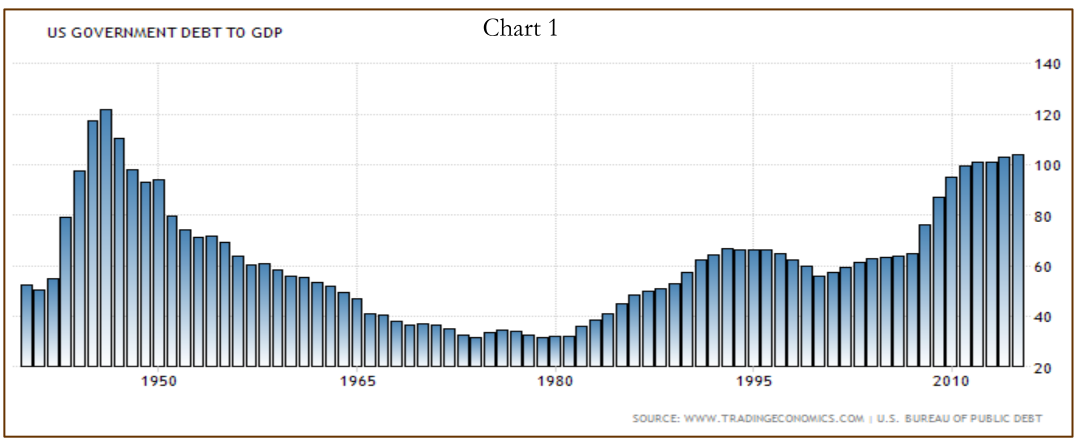
"There must be some kind of way outta here
Said the joker to the thief
There's too much confusion
I can't get no relief"

All Along the Watchtower- Written by Bob Dylan and popularized by Jimi Hendrix

Jazz, blues, and rock legend Jimi Hendrix died of a drug overdose; bond bull markets die of old age; stock market rallies die of excess euphoria, and I am convinced Keith Richards of the Rolling Stones will never die. The hope that President-elect Trump will somehow be able to produce the perfect cocktail of tax cuts, an ease in government regulations and economic stimulus has had a Mount Vesuvial effect on both the markets and sentiment around the world. Bonds plunged $1.8 trillion in value in only two weeks; stocks increased by the same amount; small business sentiment hit a 12-year high, and consumer confidence reached levels not seen since 2004. Even the American farmer is optimistic. And the animal spirits, that have been noticeably absent throughout this entire stock market rally, have finally returned. But will the current Trump Bump continue long enough to make inflation great again and give us a chance to finally say goodbye to the 35-year old bond bull market, or will this exuberance be tweeted away?

Debt Mountain is HUGE

Relief for the economy may spell *confusion* for the markets. The Trump Administration is inheriting a global financial world which has built a mountain of debt made possible by one of the most disinflationary periods in history. This, in turn, has resulted in heavily inflated asset prices. Global debt has now reached $217 trillion or 325% of global GDP[1], up from $142 trillion in debt and 269% of GDP at the end of 2007.[2] Central banks may have averted a more severe financial crisis with their various versions of Quantitative Easing, but it came at a high price. As Chart 1 clearly illustrates, even government debt-to-GDP in the U.S. has not been at these dizzying heights since the end of World War II.



Emerging market non-bank borrowers have also gotten into the act. Bloomberg suggests these economies have piled on an estimated $3.3 trillion in U.S. Dollar-denominated debt alone, $340 billion of which is expected to mature through 2018[3]. According to Geoffrey Smith of *Fortune Magazine*, the U.S. Dollar (USD) just hit a 14-year high. To make matters worse, he expects the USD to go even higher if the U.S. economy continues to strengthen and returns on capital continue to rise. In contrast, the Bank of International Settlements cautions problems with emerging markets could worsen. "With the growth in some emerging-market economies slowing and financial strains increasing, it is crucial to understand these developments can spill over globally." The recent Trump victory has already helped fuel several emerging market currency dislocations making it even more expensive for these foreign borrowers to pay back their principal and interest in USD.

Along with this worldwide historic increase in debt levels and volatility in the currency markets comes the re-emergence of inflation which has been aided by the rise in the price of commodities like oil. While commodities helped keep inflation fears muted a year ago with their plummet to the lowest levels since 1991, they have experienced a boomerang effect and are now expected to be a major driver of inflation over the next several quarters. With rates poised to re-inflate around the world, political leaders, both domestic and abroad, may be hard pressed to find *some kinda way outta here* as higher interest rates make it harder to both refinance and service their debt.

Bond gurus like Bill Gross and Jeffrey Gundlach have already eulogized the bond market. As a matter of fact, most speculators would agree with them. According to Reuters, net short positions in the 10-year Treasury and the 5-year Treasury both hit record highs last week. A net short position is a situation where investors' short position exceeds their long position. Market speculators are betting more than they ever have that interest rates will go up. In our Q12016 newsletter entitled "Say Adios to the Zihuatenejo Market," we suggested that the net speculative short position in oil when at $30 a barrel was not sustainable in the short term. While the Treasury shorts (Chart 2) may be ultimately right about the direction of interest rates, they have probably risen too quickly and bearish sentiment is too high to be sustainable in the near-term.

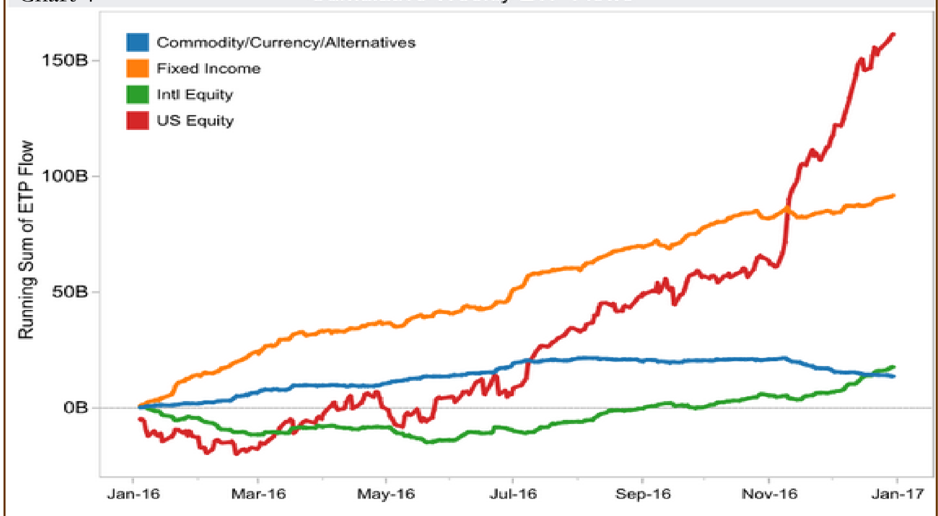
Cheap Stocks – The Other Fake News

If the bond market seems to be getting ahead of itself, the stock market has felt like it has been ahead of itself for years. As mentioned previously, Main Street feels like they finally have something to cheer about and it is showing up in every survey from small business sentiment surveys to consumer confidence. But this is where it gets a little tricky. What may be good for the economy may not be good for the stocks in 2017. Felix Zulauf, owner and president of Swiss-based hedge fund, Zulauf Asset Management believes "Trump will do a lot for business. Obama was antibusiness, but the stock market triples during his two terms because he had a great starting point and the central bank was working with him. Trump is starting out with a highly valued stock market, and the Fed won't be working with him to the same degree. That suggests a different outcome." He went on to say "the U.S. stock market is valued higher than it was 95% of the time in the past 100 years." Analysts and money managers continue to sing tales of how 'cheap' equities are relative to bonds. Mr. Zulauf's comments might suggest this is tantamount to saying Mussolini wasn't that bad a guy when compared to Hitler given how historically expensive equities really are right now.

It is difficult to find any fundamental metric by which stock prices are not expensive. Price-to-EBITDA levels have not been this high since 1999 (Chart 3); GAAP price-to-earnings ratios have only been this lofty three previous times since the 1880s, and price-to-sales ratios have not been this extreme since the tech bubble bust. *So let us stop talkin' falsely now,* as the song goes. By any definition, *it is but a joke* to try and convince investors the market is not richly priced. Moreover, if the bond bears are right and bond yields do continue to rise, stocks are going to need earnings to increase and taxes decrease just to stay at current levels, never mind rally further.

Scott Black, founder of Delphi Management, suggests "we have had a euphoric rally" since the election, and "there is some euphoria built into expectations." Investment flows seem to support his statements. According to BlackRock, Global Exchange Traded Products (ETPs) recorded record new inflows in 2016 of $379.5 billion. $82.3 billion of those fund flows were in U.S. Large Cap stocks and $130 billion in total U.S. Equity inflows (Chart 4). Investors are excited about the prospect of a reduction in some costly regulations, lower taxes, global fiscal stimulus, and a generally better business environment in 2017. However, the expectation of a more de-globalized economy and slower world trade, potential populist victories in upcoming European elections, and any delay or size reductions in the Trump stimulus programs could cause the euphoria to fade.

Chart 4



Source: Credit Suisse Trading Strategy, Factset. Data through 12/30/2016.

Conclusion

President-elect Trump's success in igniting the domestic economy and creating higher paying jobs in America will ultimately depend on his ability to avoid trade wars, all the while hoping the USD doesn't break out more to the upside. Charles Shor, former CEO of the world's largest paper bag manufacturing company in the world, Duro Bag, has traded in billions of dollars-worth of product in dozens of currencies over the past 40 years and he agrees. He stated that "the two most important issues facing the U.S. economy in 2017 are trade and currency headwinds." The 100 basis point rise in yields on the 10-year Treasury since last summer has aided in the ascent of the USD, and the expectation is for the Federal Reserve to raise interest rates three more times in 2017. Not to be a doubting Thomas on this point, but the Fed has been atrocious at forecasting. In 2016, their 'dot plots' suggested there would be four rate hikes in, but they raised rates once. But the threat of another rate increase will likely keep the USD strong and could prove to be a drag on margins and earnings of U.S. companies, making Trump's job all the more difficult.

The times they are a-changin as Bob Dylan would say. During the Great Recession, both good news and bad news were effectively **bad** news for the market. As the Fed became active and rolled out its various versions of Quantitative Easing, good news was **bad** news for the markets and bad news was **good** news. Now we are in a time where both good and bad news seem to be **good** news for stocks. For the time-being, fundamentals on equities may trade at near all-time highs, but the fear gauge for investors is near record lows. These current realities should conjure images for investors of the frog in boiling water antidote. Stick a frog in a pot of boiling water and he will jump out. But put him in a pot of water and bring to a boil slowly and the frog will not perceive it is in danger and be cooked to death.

As noted in our Fixed Income Quarterly, our fixed income model significantly outperformed the index despite the extreme short duration of the portfolio. However, our equity portfolios underperformed due to their high cash concentrations. While we are not predicting an outright end to the bond bull in 2017, we do believe we will see a series of spread widening events in credit markets much like we did in the beginning of 2016, and that Treasury yields may have a difficult time breaking through their December 15th high in the first half of 2017. However, we feel strongly now, more than ever, it is imperative investors keep bond durations short and remain cash-heavy in equity portfolios until dislocating market events give investors more attractive entry points in which to deploy capital. There are too many caution signs flashing to be bullish on the markets, but we are hopeful the economy will see positive momentum in 2017. As a result, reports of the death of the bond market may be premature, but I am hoping President-elect Trump can avoid the markets' gray swans and make corporate earnings and the economy great again.

Sincerely,

Chris L. Doucet

Chris L. Doucet, CEO

Footnotes

[1] *Debt and (not much) Delveraging*, Makensey Global Institute, February 2015

[2] *Global Debt Hits 325% of World GDP*, Zero Hedge, January 2017

[3] Bloomberg

Admin Notes

- Form ADV: Please contact our office at (205) 414-9788 if you would like to receive a current copy of our Form ADV II or the Schedule H Brochure. Proxy Solicitations: If you receive calls regarding proxy voting, we suggest that you inform the caller that you have delegated Doucet Asset Management full authority to vote the proxy on your behalf. Please note that we are not able to prevent these calls from being placed to you directly.