DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter
Q3 2017
Fixed Income Strategy
Doucet Value Momentum Portfolio
Doucet Value Income Portfolio
Mutual Fund Strategy

July 2017

The Gutenberg Market

"The best laid schemes of mice and men go often askew."

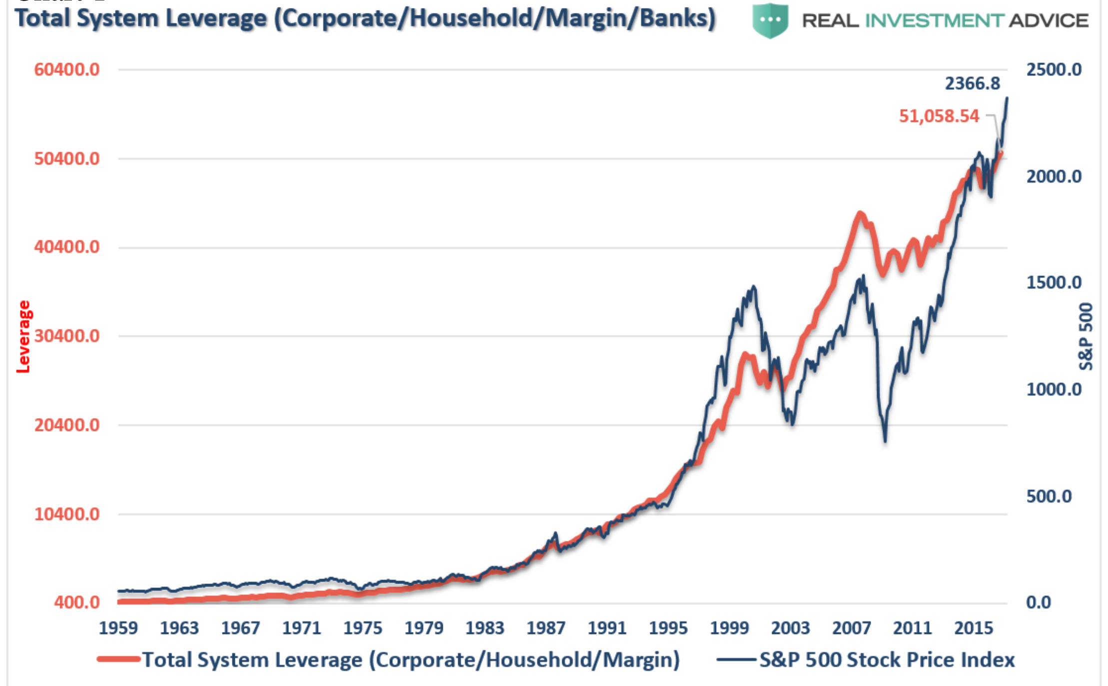
-Robert Burns, To a Mouse

In the mid-15th century, a German by the name of Johannes Gutenberg worked in secret to create something that he hoped would unite the warring factions in Christendom and make him a fortune in the process. The world in which he lived was not much unlike the world of his ancestors. Ptolemy's 1300 year old theory of the "earth-centered" universe was still widely accepted and the medical practice of bloodletting with the aid of leeches was just as popular as it was in the days of Hippocrates 1800 years earlier. Gutenberg's clandestine labor would ultimately result in the invention of the printing press which helped spark movements like the Renaissance, standardized knowledge, and hastened the spread of new ideas. And while he may have changed the world, he failed in his two primary goals. His creation fanned the flames of a theologian revolt known as the Protestant Reformation and he lost control of his business due to excessive leverage which left him a pauper.

Saving the World from Debt with More Debt

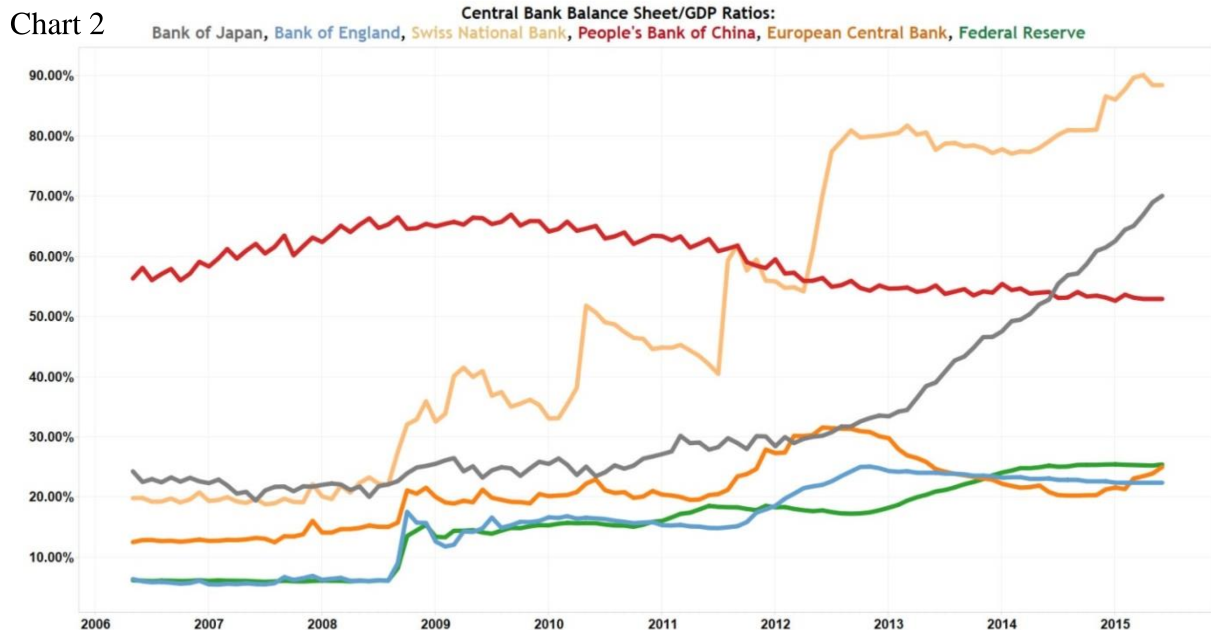
Over the past 9 years, world Central Banks proved that the printing press is alive and well. They purchased trillions of dollars' worth of assets in an attempt to save the world from the worst debt crisis in modern history. In the process, they also drove interest rates, asset prices, and market volatility to unsustainable levels. A negative side-effect of these artificially low interest rates is the amount of debt now in the financial system. As shown in Chart 1, total system leverage has now significantly eclipsed pre-crisis levels and continues to rise at an alarming pace. While low rates may make it easier to service debt, the amount of debt raises the overall risk levels inherent in markets. How ironic would it be if the machinations of central banks which were initiated to lift both Main Street and Wall Street out of the Great Recession resulted in a predicament far more draconian than the last major debt crisis?

Chart 1



The Elephant in the Room

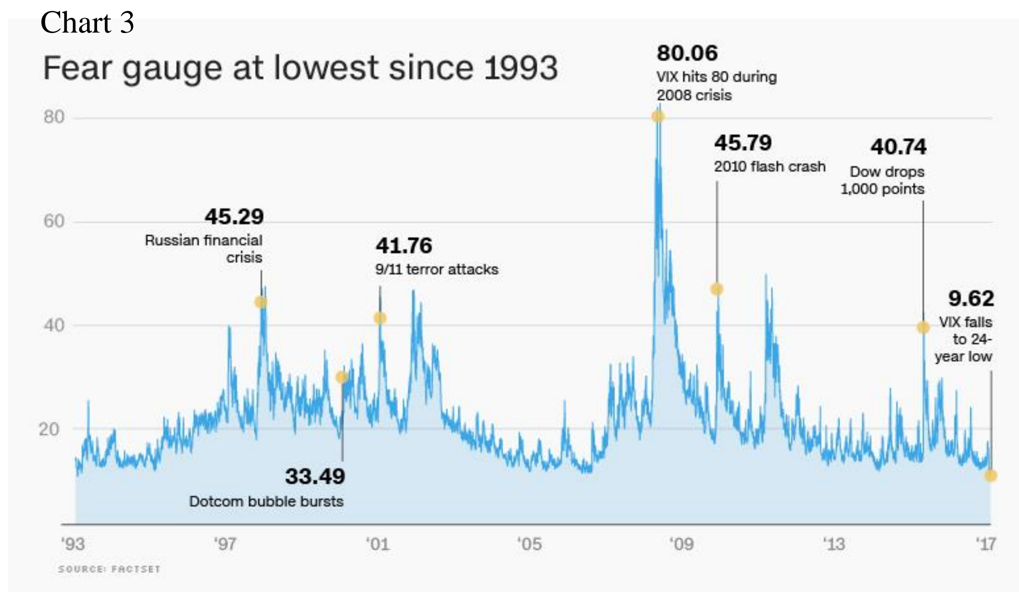
In the past, central banks influenced the bond market. Today, they have literally *become* the bond market. They are the "elephant in the room." As evidenced in Chart 2, the BOA/Merrill Lynch Global Investment Strategy Group stated recently that over 50% of all global market returns can be explained by changes in central bank's balance sheets[1]. The numbers support their statement. In the 10 years prior to the financial crisis, the Fed balance sheet as a percentage of GDP stood at 6%. But in the past 9 years, it has ballooned to 25% of GDP, distorting market valuations both here and abroad as this monetary experiment has evolved into a worldwide phenomenan.



It is important to remember that the Federal Reserve was founded in 1913 as a buyer of "last resort" to help calm markets in times of bank runs and financial panics. It was never intended to *be* the market. But over 100 years later, the Fed is now the buyer of *first resort*. Some foreign central banks have actually taken their perceived mandate to a whole new level as they now have begun to *directly* influence the equity markets. Two high-profile examples are the Japanese central bank (BOJ) and the Swiss central bank (SNB). The BOJ is now a top 10 holder in 90% of all Japanese stocks, and the SNB owned $63 billion worth of US shares at year end 2016. In short, there is an argument to be made that these institutions may be causing more harm than good.

Drinking at the Trough of the Fed

Excess consumption of the Fed's punch bowl has helped will Wall Street to new record highs. While the lack of fear in those same markets has hit a 24-year low as depicted in Chart 3. Therefore, it is only fitting that many financial and economic experts have come out of the proverbial woodwork to claim victory over things that *formerly* presented risks to markets suggesting they may have also drank too much of the central bank cool aide. Famed *value* money manager, Jeremy Grantham, proclaimed recently, "This time seems very, very different." [2] American Nobel Laureate and Professor of Economics at Yale University, Robert Shiller said recently, "stay in the market because it could go up 50% from here" in almost the same breath that he stated his famous CAPE ratio was around 30, also near an all-time high[3]. Janet Yellen stated in late June that "another financial crisis is unlikely in our lifetime." [4] Is this Fed *stimulus* talking or is this time really that different?



Weapons of Financial Mass Destruction

The Internet Revolution is producing tidal waves of change throughout the world much like the printing press did five and a half centuries ago. Consumers have been the ultimate winners as there has been a sea change in the way people communicate, order a cab, book a flight, buy a product, listen to their favorite music, and pay bills and much more. Not one to be left out, Wall Street has always tried to keep ahead of the technological curve with new products that provided solutions for both issuers and investors. When used properly, these products performed as expected; when overused or when excess leverage is applied, they can became weapons of financial mass destruction like investment trusts in 1929, portfolio insurance in 1987 and mortgage-backed securities (MBS) and credit default swaps (CDS) in 2008.

Two of Wall Street's in-favor innovations are Exchange Traded Funds (ETFs) and algorithmic trading. ETFs have grown by about 20% compounded annualized over the past 12 years (Source: Seeking Alpha). One negative side-effect is they "indiscriminately mix 'good' assets with 'bad' assets, interlinking them in a rigid mechanical way…allowing the bad to rise jointly with the good" and vice versa. This notion was recently highlighted as the now convicted Brazilian President was implicated in criminal activities. I-Shares MSCI Brazil Capped ETF (ARCX: EWZ) declined more than 15%. What was interesting is "pretty much all of its component stocks were also down roughly" 15% even though "they represent a wide variety of companies that even cursory fundamental analysis would show to be of rather diverse quality and valuation." In other words, the good was sold with the bad with almost identical results for the underlying stocks.

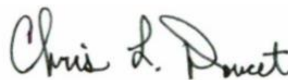
As frightening a prospect as the death of fundamental investing may be, the idea that algorithmic trading machines now control the majority of trading volume in the markets could be worse. According to Doug Kass, Founder and President of Seabreeze Partners, "quant strategies and their algorithmic computer strategies now account for 60% of the total trading volume" in the markets[5]. Some may recall the Flash Crash that occurred on May 6, 2010 when the S&P 500 plunged more than 10% in only a few minutes. The real damage could occur due to its potential to amplify systemic risk. Once it gets started, it will be hard to stop it.

How to Avoid the Fate of Gutenberg

Four major central banks have now indicated they would like to begin unwinding their balance sheets. There is an old saying in Wall Street parlance "don't fight the Fed," but Wall Street prefers the adage "as long as the music is playing, you've got to get up and dance." (Chuck Price, Citibank CEO, Financial Times, July 10, 2007) If Central Banks really do unwind their largess, conventional wisdom suggests there will be no exit big enough and it will be difficult not to hurt Main Street in the process. Picture for a moment Quantitative Easing (QE) in reverse. QE was highlighted by zero interest rates, large buying by foreigners of US securities, a record level of stock buybacks by corporations, the proliferation of algorithmic buying strategies, the growth of passive ETFs, historically high valuations, mushrooming levels of debt and record investor complacency. "The lower the volatility, the more risk investors are willing to or, in some cases, required to incur" according to Jim Mooney, Baupost's president and head of public investments. He went on to add "while leverage is not directly responsible for every financial disaster, it usually can be found near the scene of the crime."

It is always difficult to predict what will be 'the straw that will break the camel's back' and trigger the next downturn. It could be Quantitative *Tightening* (QT), another 9/11, a conflict with North Korea, a financial crisis for a large municipal issuer like Illinois, or perhaps a collapse of pensions around the world. What is certain is that the combination of excessive risk-taking and complacency is creating plenty of kindling to ignite the flames of a market contagion. And at this point, central banks and governments of the world will have few tools to combat the next crisis because of their already bloated balance sheets. In the interim term, we continue to accumulate cash, take some money off of the table in stocks, weed out poor credits, shorten duration and upgrade credit quality in our bond portfolios. In other words, we are de-risking our portfolios so we can avoid the fate of Gutenberg and will hopefully soon have the opportunity to be the buyer of last resort.

Sincerely,



Chris L. Doucet, CEO

Firm News

We are pleased to announce a new addition to the Doucet Asset Management team! Wil Dedmon has joined us as a Portfolio Manager where he will help manage equity and asset allocation strategies. He brings many years of experience and in previous roles, Wil managed institutional portfolios for high net worth families and foundations. He holds his Series 65 and 7 registrations and recently sat for the CFA Level III exam. In the community, Wil serves on the Samford University's Brock School of Business Advisory Board of Finance and Economics.

Additionally, Chris was recently featured in the The Bond Buyer discussing Jefferson County, AL's historic return to bond markets after their 2013 bankruptcy.

Footnotes

[1] *The Only Thing That Matters For Bond Traders, In One Chart*, Zero Hedge, July 2017

[2] *Grantham Says High Valuations Will Persist,* Financial Times, June 2017

[3] *Nobel winner Robert Shiller: Stay in the market because it 'could go up 50 percent from here'*, CNBC, May 2017

[4] *Fed's Yellen expects no new financial crisis in 'our* lifetimes', Reuters, June 2017

[5] *Like Something Out of 'The Twilight Zone,' This Market Is About Machines*, The Street, June 2017

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.

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