DOUCET ASSET MANAGEMENT, LLC

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Doucet Value Momentum Portfolio
Doucet Value Income Portfolio
Bienville Model

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When Reflection Leads to Inflection: *It's a Wonderful Life* or *Misery*

"After all, tomorrow is another day." Scarlett, Gone with the Wind (1939)

The end of a year and beginning of a new one invariably leads people to reflect on the past and contemplate the future. In fact, doing so is big business. Just look at the entertainment industry with its awards season consisting of the Grammys, Oscars, and Emmys or the sporting world with its pre-season polls. Money managers are no different in this respect and can actually be some of the worst culprits. Performance reviews, market re-caps, and economic forecasts are common phrases this time of year, as e-mail inboxes become cluttered with write-ups from managers masquerading as historians and prophets. While these sorts of pieces have their place, they can sometimes miss the forest for the trees.

Admittedly, having just celebrated my half-century mark on this earth and 27th year in the business, I have been in a somewhat more reflective mode than usual. Even so, the beginning of this year, in particular, calls for a renewed focus on the *now*. There have been times in my career that I was certain were *inflection* points in the markets: the summer of 1987, fall of 1999, and March of 2009. Now is another one of those times.

Weird Science

Over the past few years, the Fed has embarked on a road of unprecedented monetary experimentation which resulted in ultra-low interest rates and record corporate earnings. It has had the effect of markets on steroids as asset prices have been inflated to record levels. This is starting to change, however, and many of the factors that have propelled stock prices higher and bond yields lower have quietly begun to subside. Market multiples are rising, economic indicators are changing course, and the Fed is finally tapering. So as the Motion Picture Association of America looked back on 2013 and made their Academy Award nominations, we found it incredibly ironic that the two films receiving the most nods were *American Hustle* and *Gravity*. Could 2014 be the year when an American hustle of a different kind comes to an end and gravity brings security prices back down to earth?

Columbia Pictures

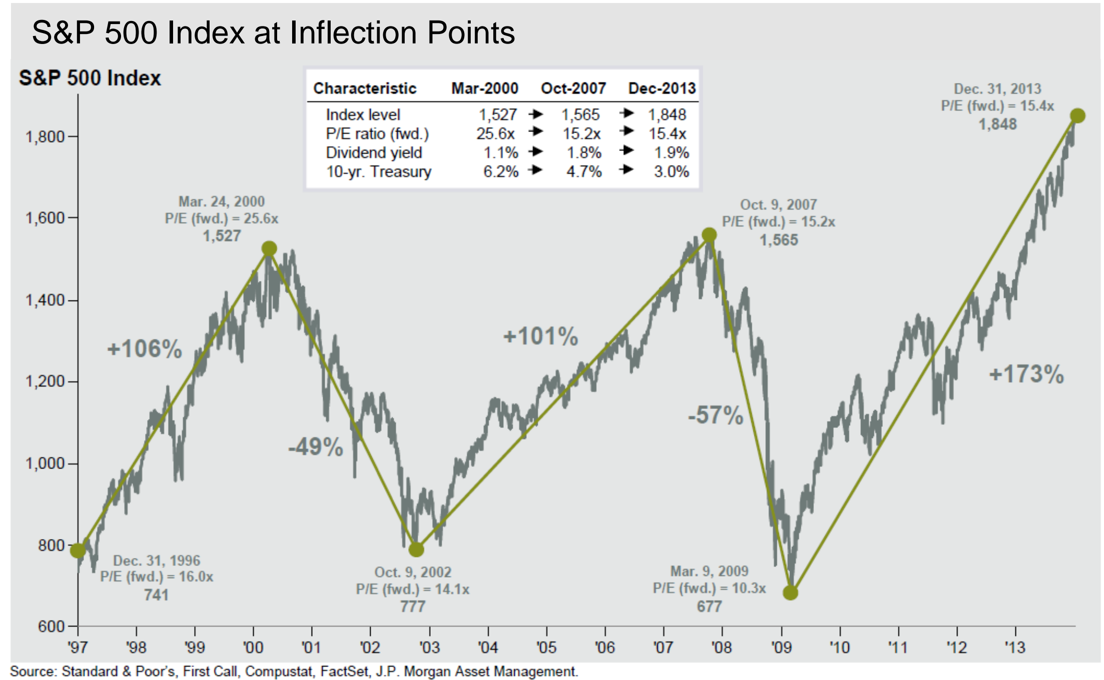
Warner Bros. Pictures

P/Eter Pan

On the surface, it is not hard to see why the bulls have outnumbered the bears over the past couple of years. Record low interest rates pushed all sorts of investors to venture out further on the risk curve to realize a decent return on their capital. As investors poured into the equity market to compensate for the dismal yields on bonds, they justified the extra risk by citing, among other things, low earnings multiples. The fact that price-to-earnings (P/E) multiples have been favorable (or at least not *un*favorable) from a historical perspective made equities a natural place to go, or so the logic went.

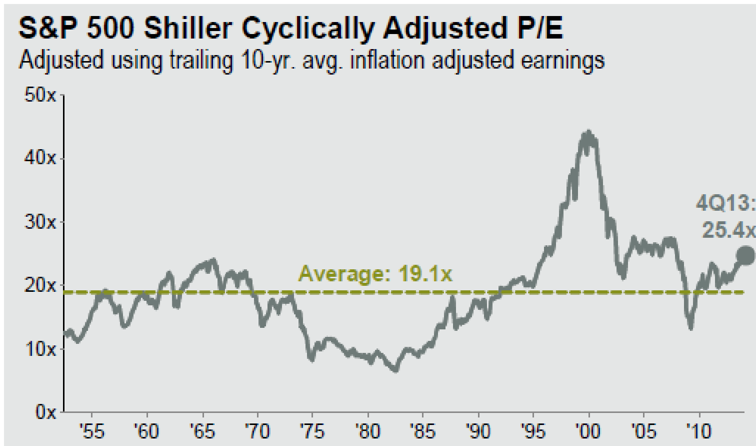
But what happens when the 'E' part of the P/E equation starts to moderate, and stocks start to look more expensive? This is no longer a what-if scenario, but rather a new reality, as the rate of growth of corporate earnings is slowing, margins are plateauing, and according to Factset, the number of companies issuing negative earnings guidance has risen.[1]

Taking a closer look at current market multiples and their recent movement seems to validate this new reality. The S&P 500 is now trading at a higher forward P/E multiple than it was on October 9, 2007 (15.4x vs. 15.2x) before the financial crisis took full-hold and equities sold off, en masse. Even more telling, each of the major valuation measures (P/E, P/B, P/CF, and P/S) are trading at multiples greater than their 10-year averages.[2]



Characteristic	Mar-2000	Oct-2007	Dec-2013
Index level	1,527 →	1,565 →	1,848
P/E ratio (fwd.)	25.6x →	15.2x →	15.4x
Dividend yield	1.1% →	1.8% →	1.9%
10-yr. Treasury	6.2% →	4.7% →	3.0%

Source: Standard & Poor's, First Call, Compustat, FactSet, J.P. Morgan Asset Management.



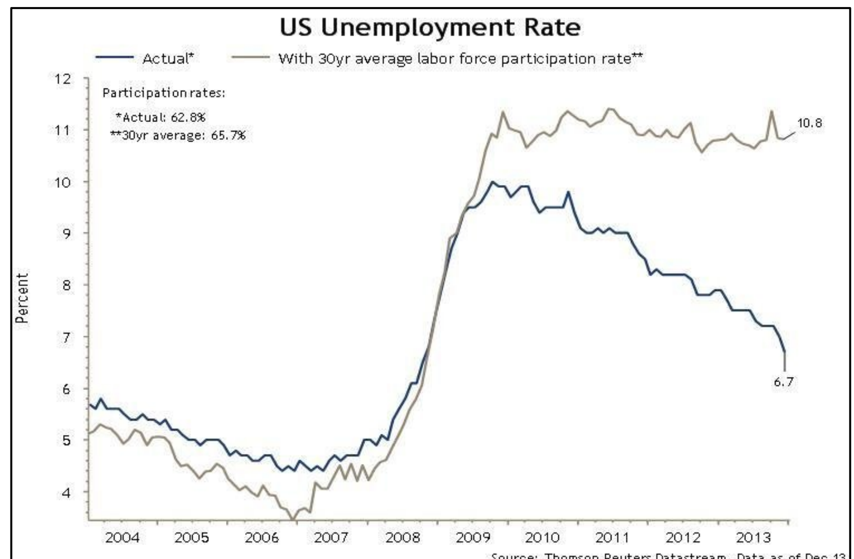
Source: Standard & Poor's, FactSet, Robert Shiller Data, J.P. Morgan Asset Management

C.A.P.E. Fear

Those playing devil's advocate may argue, and rightly so, that multiples are not foolproof predictors of future market performance and that they can be clouded by short-term fluctuations in the economy and investor sentiment. For that very reason, Robert Shiller, the famed Yale professor, came up with his cyclically adjusted price-to-earnings ratio (CAPE). Shiller's CAPE smoothes short-term fluctuations by dividing the current market price by trailing 10-year average inflation-adjusted earnings. At 25.4 times adjusted earnings, CAPE is well-above the 19.1x average since the 1950s, and within shouting distance of the 27x level seen at the October 2007 market peak.[3] According to John Mauldin, "Not only does today's CAPE of 25.4x suggest a seriously overvalued market, but the rapid multiple expansion of the last few years coupled with sluggish earnings growth suggest that this market is also seriously overbought." [3]

Baby Boom or Bust

In addition to the technical *inflection* point that can be seen in earnings multiples, there are some fundamental economic headwinds that may change the markets current course of momentum. Take employment: there is no question that the headline unemployment rate of 6.7% is a marked improvement from the recent past.[4] However, this number does not tell you that, at 62.8%, the labor force participation rate is the lowest it has been since 1978.[4] If the unemployment rate was based on the 30 year average labor force participation rate, it would be a whopping 10.8%.[5] This does not exactly point to a healthy, growing



Source: Thomson Reuters Datastream, Data as of Dec 13

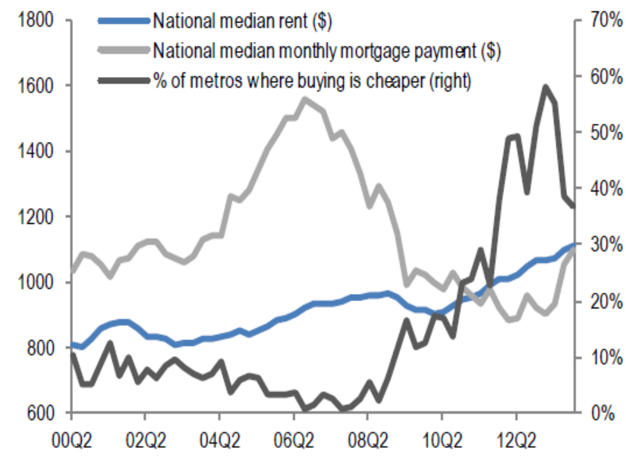
economy. The alarming pace at which baby boomers and discouraged workers have exited the labor force is unsustainable. However, we may be finally reaching an *inflection* point where the true state of employment is no longer masked by a declining participation rate.

Not Just Cyclical

"Despite strong HPA (Home Price Appreciation), household formation failed to maintain last year's upward trend, as more young adults have chosen to live with their parents in the midst of a sluggish job market. According to a report by Pew Research Center last year, 36% of adults between 18 and 31 years old were living with their parents, the highest share in at least 40 years, and only 63% of that age group had jobs, compared to 70% five years ago." [6]

That's 37% percent of 18 to 31 year olds unemployed, a number that sounds more like Greece than the United States! The low labor force participation rate is not just older workers dropping out of the workforce, it is equally attributable to younger workers missing out on the formative years of their careers. This is a structural issue likely to have ramifications for years to come.

Exhibit 15: While on par with renting nationally, buying is no longer cheaper for 175 of 277 largest metros

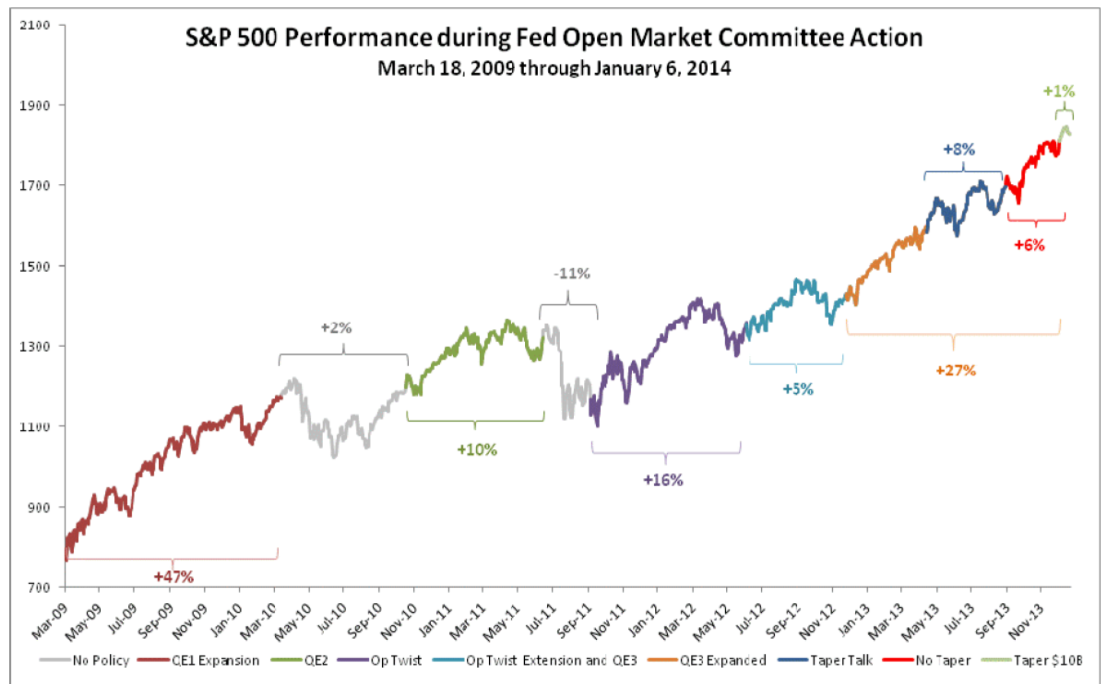


Source: J.P. Morgan, Federal Reserve Board, CoreLogic, Axiometrics
Note: The monthly payment is calculated for a typical 30-year fixed-rate mortgage assuming a 20% down payment, 1.25% property tax, and 0.5% PMI.

Home Alone

Housing is similar to employment in that the recovery is losing steam. It is undeniable that housing has shown incredible resilience in bouncing back from the bust and has been a major positive for the economy. Even so, JPM demonstrates in the chart to the left that, "with home prices improving substantially in 2013, buying now looks on par with renting after being cheaper for almost two years, on average nationally." And, "the buy-vs-rent comparison at the metro level indicates that is no longer a good time to buy for over two thirds of the nation's 277 largest metros."[6] This diminished affordability statistic, coupled with higher mortgage rates, calls into serious question whether or not housing can continue its rapid expansion.

Taper Off, Taper *On*



Source: Bloomberg, Doubleline Capital

Of course, much of this currently changing reality can be directly attributed to the Federal Reserve. Its policies are so important that it has required considerable restraint to not write every single newsletter solely about the Fed. After what seems like years of 'will they, won't they' speculation about tapering, they finally did it in December, and did it again in January. Most people have a tendency to draw a straight line from tapering to higher interest rates. While this relationship has not exactly held true so far in 2014, it is more likely to do so over the long-term. What investors may not see is that Fed tapering is tantamount to Fed tightening in the eyes of parts of the world, and there are a barrage of consequences.

Some of these consequences are more obvious than others. *More tapering → less money in the system → more expensive access to capital → and so on.* Still, there are numerous other unintended consequences that will likely have equally important impacts on both domestic and foreign economies. *More tapering → less money floating around looking for a home → currency displacements similar to the 80s and 90s.* Some countries, especially emerging markets, may be compelled to raise their interest rates in order to protect their currencies, a move that could ultimately lead to an economic slowdown on their own turf. The Mexican Tequila Crisis,

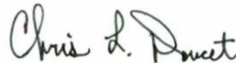
the Asian Flu, the Russian Flu, and the Zimbabwe Hyperinflation Crisis are just a few examples. This is all putting the cart ahead of the horse. No one knows exactly how tapering will play out, but the main takeaway is that this *inflection* is happening now and its effects are already beginning to reverberate throughout global markets and will likely continue to do so for the foreseeable future.

Conclusion

We, at Doucet Asset Management, have been anticipating these changes in the market and economy for a while and have positioned accounts accordingly. To be clear, we are not vulture investors looking to make money as the world falls apart. Rather, we actually view these seemingly negative events as being quite healthy, as markets and economies can only remain overly efficient for so long.

To cite another Oscar nominee, we have been in *Something's Gotta Give* mode for some time. And like that film, which came out in 2003, we were just a bit early in timing the market's *inflection* point. While our portfolios fully benefitted from the recovery in the equity markets and dislocations in the bond markets from 2009 through last summer, our defensive stance cost us in the second half of 2013. But more importantly, and to bring it back to the *now*, we are very pleased with the way our accounts are positioned as we head deeper into 2014. Our equity portfolios remain cash heavy, and our bond portfolios remain short duration in nature. This positioning is already proving positive on the equity side, as YTD performance seems to suggest that more and more investors are beginning to agree that an impending *inflection* point is upon us.

Sincerely,



Chris L. Doucet
Chief Executive Officer

Footnotes

1. "Company Earnings Warnings are at Record-Highs," *The Tell - Market Watch*, Jan. 6, 2014, (http://blogs.marketwatch.com/thetell/2014/01/06/company-earnings-warnings-are-at-record-highs/)
2. "1Q 2014 Guide to the Markets," *J.P. Morgan Market Insights,* Dec. 31, 2013
3. Mauldin, John, "Forecast 2014: The CAPEs of Hope," Thoughts from the Frontline, Jan. 26, 2014 (http://www.mauldineconomics.com/editorial/thoughts-from-the-frontline-forecast-2014-the-capes-of-hope)
4. Bureau of Labor Statistics
5. Perlberg, Steven, "Here's the Disturbing Unemployment Rate Chart that Continues to have Everyone Worried," *Business Insider*, Jan. 10, 2014 (http://www.businessinsider.com/unemployment-labor-force-participation-2014-1)
6. "J.P. Morgan 2014 Securitized Products Outlook," Nov. 27, 2013, 79-81

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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