



October 2013

The Big Chicken Drop on the Potomac

“Politics is the gentle art of getting votes from the poor and campaign funds from the rich, by promising to protect each from the other.” – Oscar Ameringer, “The Mark Twain of American Socialism”

Pick up a paper or turn on a TV in the last few weeks, and the lead story is likely to have been about the government shutdown and the self-imposed possibility of a U.S. default. Of course, MSNBC blamed the Republicans, Fox News blamed the Democrats, and each side blamed the other. The political endgame in Washington devolved from discussing a ‘Grand Bargain’ on fiscal policy to an old fashioned game of Chicken. Neither side flinched until the supposed day of default was upon them. With the government temporarily shut down, 800,000 government employees were flushed from the workforce,¹ funding for various programs was eliminated, and ridiculous tales of outdoor monuments being closed and protected by armed guards emerged. As if this was not enough, both parties further backed themselves into a corner by threatening a default on U.S. Treasury debt and painting a picture of financial Armageddon if the other party did not give in. If my old Cajun grandfather were still alive today, he would say that Washington has gone from playing a game of Chicken to the lesser-known game of *Chicken Drop*.



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Making Chicken Drops Out of Chicken Salad

Chicken Drop is not a game of skill, but rather a game of chance.

Participants draw numbers from a container, each representing a space on a large playing board. Much to the chagrin of PETA, a live chicken is then brought to the edge of the board and allowed to roam freely (bringing new meaning to the phrase ‘free-range chicken’). Inevitably, the chicken will relieve itself on the board, and the holder of the corresponding number on which the chicken ‘drops’ is the big winner. Everyone else loses. Wagering is usually involved; it is gambling in its purest sense.

Much like the current situation in Washington, Chicken Drop is a game of multiple outcome scenarios. Rather than diligently working towards a fiscal compromise, the fate of our economy (and economies around the world for that matter) was being left to a game of chance with multiple unseen outcomes. Most countries go to great efforts to create a grand façade of risk-free lending with their sovereign debt, while Washington played a giant game of Chicken Drop for their own political gain. The stakes the U.S. government played for may have been big, but the wagers were bigger. Welcome to Democracy ‘in-action’.

Ben ‘Atlas’ Bernanke

As Washington is broken and continues to play to the cameras in its theater of the bizarre, the Fed has continued to exercise more power and take more extraordinary measures than any Fed in U.S. history. While it is true that individual and corporate balance sheets have slowly de-levered and improved, it has been at the expense of the Fed’s own balance sheet. Political bickering and indecisiveness have encouraged a massive levering-up on the part of the Fed through its various means of stimulative policy, including *QEternity*. Much like Atlas from Ayn Rand’s seminal novel *Atlas Shrugged*, the weight of the economic world has shifted from the backs of the private sector onto the back of the public sector. Unlike in Rand’s novel, however, individuals and corporations have discovered that Atlas, in the form of the Federal Reserve, has not shrugged... at least not yet.

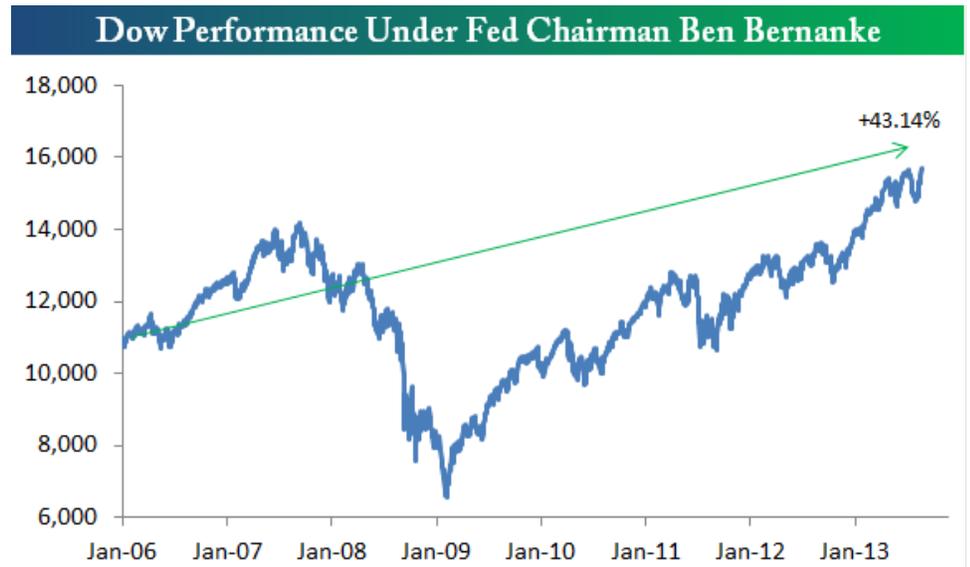
Over the past couple of years, we have been critical of the Fed for exercising too much influence over the economy and capital markets. The events of the past few weeks, however, have provided a somewhat different perspective (dare we say an

appreciation) for their actions and motives. After all, at least the Fed does not have midterm elections or a base with whom to pander. When they surprised markets last month by deciding not to taper, maybe it was because they knew better than the rest of us just how dysfunctional Washington has become.

Regardless of how pristine the Fed's motives may be, for every action there is a reaction, and their actions are proving the law of unintended consequences. As with a chicken, you put something in one end, and something you may not want will come out the other end. The same can be said for money printing and the economy. The unintended consequences have been a weakened dollar, a rise in the price of commodities, and overall economic instability. Soon to be ex-Fed Chairman Bernanke points to rising valuations of 401(k) accounts as irrefutable proof that his policies are working. However, recent history suggests that the wind down of the same policies might have the opposite impact on the markets.

Off the Mark-et

Speaking of markets, if you think you truly have the current market figured out, just wait and it will change. Forget earnings, free cash flow, and Economics 101; both stock prices and bond yields have implicitly become matters of government policy. Stories that would typically garner front page news, like Tesla stock at \$185 or Facebook stock north of \$50, nowadays take a back seat to news about some meeting in Washington with no resolution or hype over the most recent Fed statement.



As old school analytics have made way for a new world order of trying to handicap political and macroeconomic events, many investors are engaging in a Chicken Drop of their own. For these investors, chance is being substituted for prudence, thus creating a very slippery slope, indeed. Although volatility is apparently non-existent in the market today (at least according to the Volatility Index), that does not mean this will still be the case tomorrow. Trying to hedge against such things as another downgrade of the U.S. credit or a default of payment is dicey business. After all, when S&P downgraded the U.S. back in 2011, bonds surprisingly rallied.

Chairman Bernanke is absolutely right in that 401(k) balances have gone up over the past couple of years. But one must be careful not to give too much credit to the Fed. Much of the rise in value of the market was simply a reversion to mean prices. The market went down too much in 2008-2009, and then it returned to more normalized pricing. While historically low interest rates, produced in large part by the Fed, helped corporations repair balance sheets, the economic downturn forced companies to reduce costs across the board. The net result is corporations are now experiencing record gross profit margins. Since the trough of the credit crisis, stocks have gone from being severely undervalued to slightly overvalued. Now that stocks have reached these levels, the easy money policies of the Fed will likely have less and less of an impact.

The Great 'Escape Velocity'

There is a buzz phrase in the market that is getting a lot of press these days: 'escape velocity'. In physics, escape velocity is the speed at which an object needs to travel to break free of the earth's gravitational pull. Pertaining to markets, it is the growth rate in GDP that the economy needs to reach in order to be able to break the gravitational pull of falling back into recession. For the past couple of years, the Fed has been trying to keep the economy headed in the right direction until it could reach escape velocity. The economy has made strides. Still, those in Washington seem unable, or unwilling, to get out of their own way and allow progress to happen. Instead of removing obstacles to this acceleration, headwind after unnecessary headwind continue to be added, casting serious doubt on whether the economy will be able to break through the atmosphere, so to speak.

11% of Americans Approve of Congress...Are They Crazy?

The dysfunction in Washington is yet another one of these unnecessary drags on the economy. In the end, it does not matter whose fault it is. In the court of public opinion, they are all complicit. That is why Congress is currently running an 11% approval rating,² the IMF has essentially told the U.S. to grow up and act like the largest economy in the world, and the Chinese official government news agency recently came out with the statement

“It is perhaps a good time for the befuddled world to start considering building a de-Americanized world.”³ Couple this dysfunction with other headwinds, such as: oil in excess of \$70 a barrel, Obamacare, too much Fed stimulus, and full-time jobs being replaced with part-time jobs, and the economy has its work cut out for it.

To Be Continued...

If the events of the last 26 years have taught me anything, it is that financial turmoil and subsequent compelling buying opportunities come along with great frequency. This is the longest period of time the market has gone in some time without a major or minor implosion. There may not be many compelling values out there right now, but just wait, and this too shall change. While we believe the market may get some benefit from expanding earnings multiples, it is undoubtedly becoming more fully valued. However, it is not a market completely devoid of opportunities, and the values we do see are more one-off, event-driven opportunities. Therefore, in the interim, cash should not be such a 4-letter word. Eventually, political parties and private interest groups will get what they want, and the U.S. will go back to their daily lives again. The giant game of Chicken Drop will end, and Americans will be left with what is on the Chicken Drop playing board. While it is true we are living through perhaps the most fiscally irresponsible time in U.S. history, ultimately the power of the printing press will rule the day, and the U.S. will NOT default on its debt. Much like the game of Chicken Drop, the threat of default is just theater and U.S. citizens are forced to watch this daily drama unfold. To be continued...

Sincerely,


Chris L. Doucet
Chief Executive Officer

Footnotes

- ¹ <http://abcnews.go.com/Politics/government-shutdown-numbers/story?id=20424204>
- ² <http://www.gallup.com/poll/1600/congress-public.aspx>
- ³ <http://www.washingtontimes.com/news/2013/oct/14/china-warns-world-its-time-de-americanize/>

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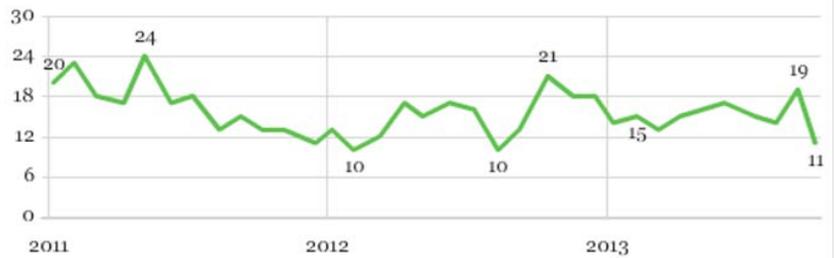
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Do you approve or disapprove of the way Congress is handling its job?

Recent trend

■ % Approve



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