DOUCET ASSET MANAGEMENT, LLC

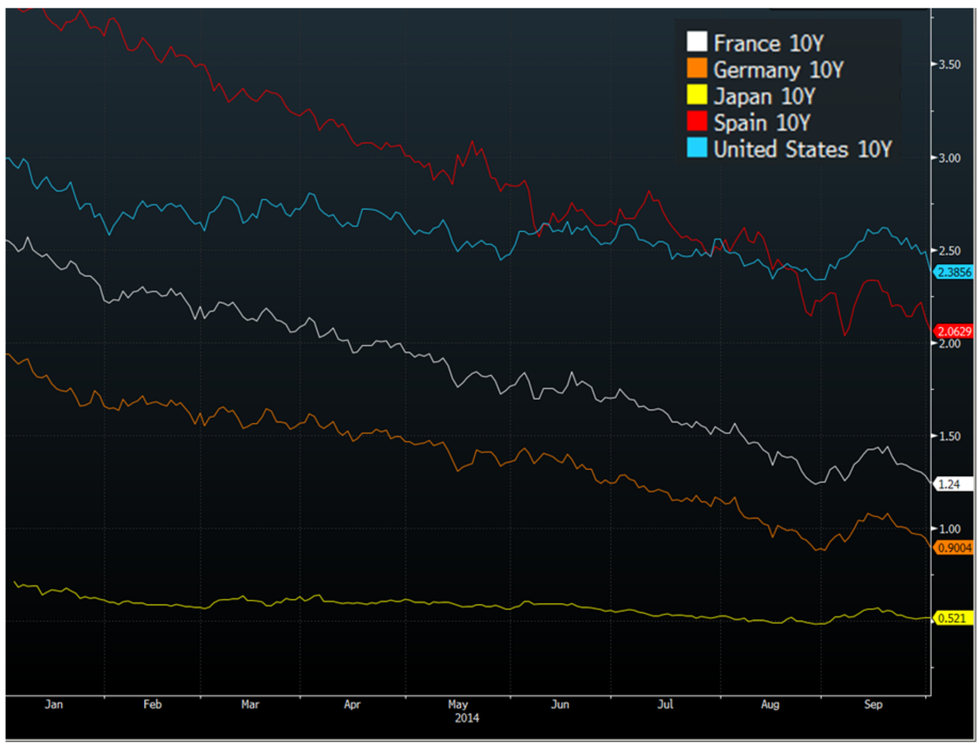
Quarterly Newsletter
Q4 2014
Doucet Value Momentum Portfolio
Doucet Value Income Portfolio
Bienville Model

October 2014

Appetite for Distortion?

Market bubbles don't grow out of thin air. They have a solid basis in reality, but reality as distorted by a misconception. –George Soros

Did you hear the one about the two guys who went into a bank to get a loan? The first had a FICO score of 400 and was looking to buy a million dollar house in a neighborhood where 25% of the homeowners were unemployed. He was able to lock in a 10-year fixed rate loan at 2.1%! Feeling assured, the second guy, with an 800 FICO looking to buy a half-million dollar home in a neighborhood with 5.9% unemployment, hurried into the same bank to get his loan. Thinking that if the first guy got 2.1%, he would surely come out with a few 1/8ths better, he was shocked when the same mortgage broker greeted him with a smile and a 10-year fixed rate of 2.4%.[1] Sounds absurd, right? Well, substitute Spain for guy 1 and the United States for guy 2 and you have your punchline, as well as a general sense about just how distorted financial markets around the world have become as we enter the 4th quarter. As a matter of fact, global financial markets are so distorted these days that as many as six countries in Europe have recently had negative yields on their two-year government bonds![2]



Source: Bloomberg

Multiple Personality Disorder

The market for sovereign debt is not the only one that has been schizophrenic as of late. All financial markets, to some degree, have become distorted as investors across the globe have reached for yield and capital appreciation. The trailing twelve month price-to-earnings ratio (P/E) of the S&P 500 has gone from about a 12 P/E to an 18.6 P/E in the past few years, versus a long-term median P/E of 16.7.[3] While many Wall Street analysts suggest the market is fairly priced based on forward-looking earnings estimates, analysts have a bad habit of being chronically overly optimistic, so extreme caution is advised.

While the pitfalls of looking at multiples, especially in isolation, are well-documented, they are rarely heeded. There is still an awful lot of noise in the earnings part of the equation in the form of low interest rates, stock buybacks, and record margins that does not seem to be fully accounted for as analysts extrapolate their estimates forward. The price-to-sales ratio (P/S) tells a more Draconian story altogether. The S&P 500 median P/S ratio is more than double its average since 1965, according to Ned Davis Research.[4] So even if one could talk himself into the stock market not being expensive based on forward-looking P/E's, doing so starts to look more and more like wishful thinking when taking other ratios and factors into consideration.

EUlogizing QE3

Market distortions are nothing new. Here at Doucet Asset Management, we have been arguing for quite some time that markets have been manipulated by the Fed and that caution should be taken. What is new, however, is that it is finally time to pop the proverbial cork on QE3, as the Fed's bond buying program is at long last expected to end this month. As QE comes to a close, it leaves a trail of benevolent destruction in its wake. Sure, stimulus helped to bring us back from the edge, but at what cost and are the seeds for the next crisis all but sown? And even more, did it really do anything other than postpone the inevitable? These are big questions that only time will tell.

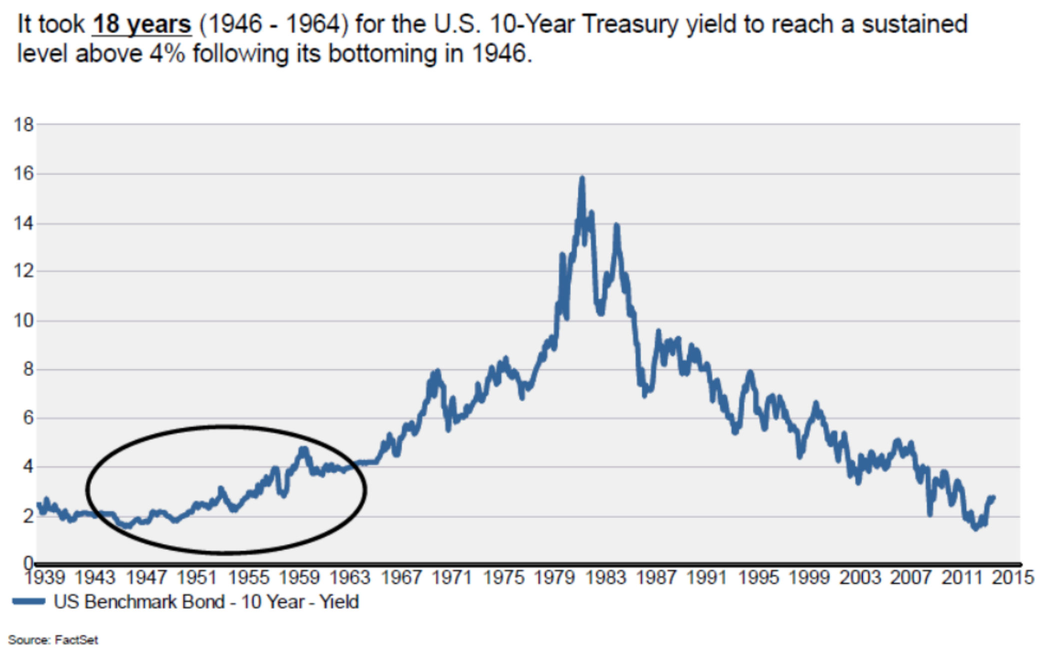
Even as the Fed exits stage left, do not count on accommodative policy going away any time soon. The EU is just getting started with their own version of QE, as GDP in that part of the world has slowed to about 0.3%. This slowdown in Europe may be the fly in the Fed's ointment of raising interest rates early-to-mid 2015, as is widely predicted. The dollar has strengthened precipitously against most major currencies since the spring. This will likely hold down the price of imports and slow any potential short-term inflation. Even though the U.S. economy has shown improvement since the beginning of QE3, the Fed may be backed into a corner and unable to raise short-term rates as aggressively as they would like…or at all for fear of harming the economies of our trading partners. If this is the case, it would not be the first time the Fed succumbed to political pressure.

Famed economist John Maynard Keynes suggested it was Benjamin Strong (not Alan Greenspan) who was the pioneer of the modern central banker. Strong served as the Governor of the New York central bank from 1914-1928. Following a sharp and quick mini-depression shortly after World War I, Strong (unofficially and temporarily) abandoned the gold standard and began buying (and later selling) government bonds in the open market in an attempt to lower domestic interest rates and spur growth in the economy. This act may have actually aided war-torn and gold-starved Europe, and may have helped them regain their financial footing. However, due to pressure from Europe (especially England), Strong was too slow in raising rates to help curb speculative excesses that existed in both the domestic economy and the stock market in the late 1920s for fear that it would harm the European markets. Unfortunately, he died in 1928 of tuberculosis and the Fed was left paralyzed to do anything without him. Leverage in the markets grew, along with multiples, and you know the rest of the story. In short, it did not end well! Is history about to repeat itself?

Proxies, Proxies Everywhere

In July, we wrote about the need for investors to get their financial castles in order, suggesting that the combination of increasingly rich valuations, geopolitical turmoil, and pockets of financial instability was the perfect recipe for softer equity markets. So far, the trading activity of the 4th quarter has been very supportive of this notion, as volatility has spiked and the S&P is down about 5%. It is too early to call it a correction, or certainly a bear market, just yet, but it sure feels as if markets are looking for a reason to sell off. There seems to be more of a collective acceptance that bubbles do exist, and that stocks are no longer cheap but fairly-priced at best. Growth in China and Europe are slowing, ISIS is alive and well in Syria, and Ebola has come to the U.S. So what has changed in the financial world other than perception? And while the world view is just beginning to change, many markets are already officially in bear territory including: small caps, oil and gas, precious metals, mining stocks, just to name a few.

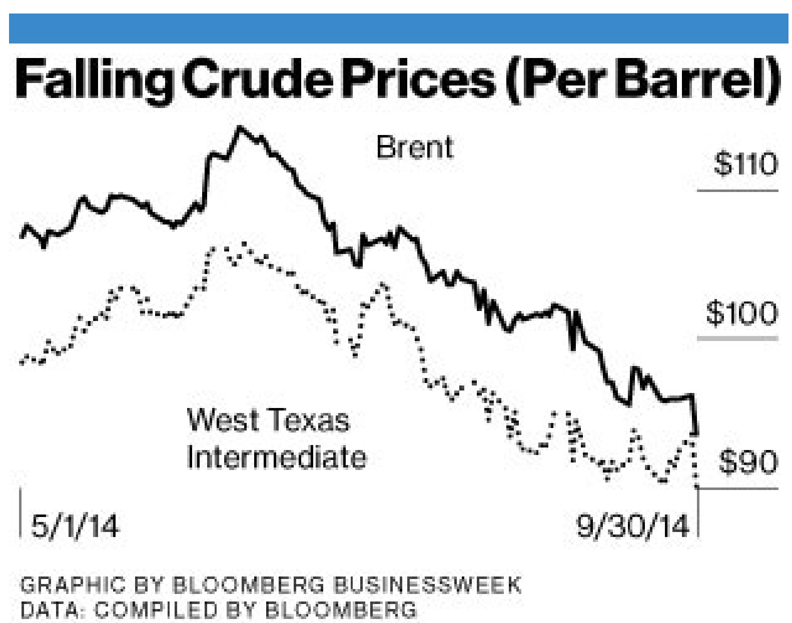
All of these issues, coupled with the actions of the EU, look to serve as proxies for the Fed and will likely keep interest rates low for the foreseeable future. Undoubtedly, the hope of the Fed was to be in a position by now to be able to raise rates so that they would have some ammunition for the next economic downturn. However, just as was the case with Fed Governor Strong in the 1920s, it might just be too late or painful to raise them now. And even if they were to raise short-term rates, which is still the expectation, there are plenty of catalysts out there to keep a lid on long-term rates, as money crosses borders and asset classes seeking safety.



So Fed or no Fed, accommodation is likely here to stay for a while, making the 'lower for longer' thesis on interest rates and a flatter yield curve look less like a possibility and more like a foregone conclusion. This, too, is not without precedence, as it took 18 years (1946-1964) for the U.S. 10-Yr Treasury to reach a sustained level above 4% following its bottoming in 1946.[5] Ironically, it is for this reason, not compelling value or multiples, that stocks might actually have the legs to trend higher for yet another round. In the long-run, corporate profits and record margins buoyed by ultra-low rates, company stock buybacks, and the practice of discounting future cash flow streams by an artificially low discount rate resulting in correspondingly high valuations is not sustainable.

Silver Linings Playbook

With all the distortions in the global markets today, there are still some silver linings. While Fed stimulus is winding down, consumers have received stimulus of another sort. Food and energy prices have declined to multi-year lows, giving the average consumer more spending power despite anemic wage growth in recent years. Food-based commodities, like corn and soybeans, have declined for 6 straight months, while oil prices have declined more than 20% in the same timeframe. Lower prices are a windfall for consumer spending. However, they may also be a sign of disinflation in much of the developed world. Nonetheless, there still is a healthier hue to the U.S. economy versus the rest of the world.



However, one might say the best place in the short-term for an investor to be is in the fetal position. This is probably overstating it a bit, but there is validity in the idea of being careful and exercising caution, as principal protection could become more important than capital appreciation in a hurry. Generally speaking, as a firm, we live for dislocations and inefficiencies in the market. The problem is the vast majority of the many dislocations that are out there in the market are in the wrong direction; they are distorted to the expensive side. Sure, a 2-Year German government bond yielding -0.06% makes a 2-Year Treasury look dirt cheap at 0.38%, but does that mean we would recommend loading the boat with 2-Year Treasuries? No way! The same can be said for the S&P 500 close to all-time highs with a P/E multiple north of 18x or the U.S. long bond under 3%. These are not the kind of dislocations we care to exploit.

Investing in equities will continue to necessitate seeking out growth themes not wholly correlated with the macro market, coupled with an ample supply of cash to exploit the right types of dislocations, such as those in energy and food-based commodities. There may also be some opportunities in European equities should they take a major hit. If there is a lesson to be learned from QE, it is that while stimulus may not fix an ailing economy, it can create a temporary floor and supportive environment for stocks, so any EU actions merit following. On the fixed income side, while we may believe that interest rates stay lower for longer, we do not see a lot of compelling reason to extend duration too far, as you just are not being compensated to do so. Rather, trading strategies, optionality in instruments like convertible bonds, and correctly anticipating spread-widening events will assist us in finding yield in a yieldless environment. Simply stated, there are just too many bear traps in financial markets today to assume that complacency will be the norm forever.

Sincerely,

Chris L. Doucet

Chris L. Doucet
Chief Executive Officer

Footnotes

1. US and Spain unemployment data and 10 year government bond yields from Bloomberg
2. Edwards, Ben, "European Bond Yields Go Negative," *Wall Street Journal,* Sept. 30, 2014
3. Blumenthal, Steve, "Stock Market's High P/E Suggests Lower Returns Ahead," *Forbes*, June 18, 2014
4. Hay, David, "Future Bull," *Mauldin Economics Outside the Box*, Sept. 24, 2014
5. "Investment Themes for 2014", *Fidelity Investments*

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.