



January 2012

## Debt Doesn't Have to Be a Four Letter Word

*"A billion here, a billion there, and pretty soon you're talking about real money."*

- Senator Everett Dirksen (1896-1969)

In the late 18<sup>th</sup> century, the American Republic gave the world a blueprint of different means by which a government can eliminate debt. They defaulted on a portion of their debt and did the modern equivalent of a "cram down" on creditors. Additionally, American leaders put in place a fair taxing system that helped foster economic growth and used revenues generated from asset sales and taxes to pay off debt. They even proved to be early innovators in currency debasement as they used the printing press to create fiat paper currency, much like the historical standard of simply using lesser amounts of silver in their coinage. This allowed them to inflate away much of the debt.

America funded the majority of its Revolutionary War effort by printing \$200 million worth of paper currency known as "Continental," which were backed ostensibly by nothing. By the end of the War, Congress had revalued earlier Continentals at only 2.5% of their original face; thus the term "not worth a Continental" was coined. By 1790, inflation had been running as high as 200%, and the newly formed United States of America was in default on its government debt. A plan was devised by Alexander Hamilton, the first Secretary of the Treasury, to "redeem old national debts on generous terms," issue new bonds to pay for it, create a plan of taxation which would not be "oppressive" and assume the \$18 million in war debts incurred by the 13 states.<sup>1</sup>



Figure 1: Continental Currency

Much like today's Eurozone countries, these individual states resembled independent countries with varying, divergent interests and differing views on paying off ones debt. Virginia had already repaid most of its war debt while some New England states had not, which made passage of the bill by Congress nearly impossible. Finally, an eleventh hour backroom deal was struck, and Congress passed a plan which was put into place in 1792.

*"A national debt, if not excessive, will be to us a national blessing."<sup>2</sup>*

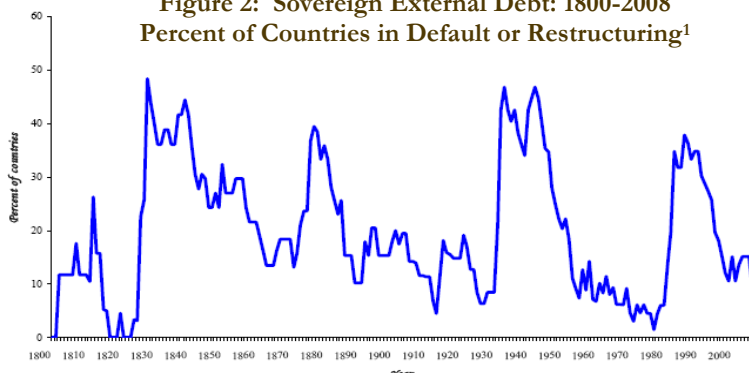
In 1834, after many years of budget surpluses sustained by strong economic growth, land speculation, a fair taxing system, and a stable government, President Andrew Jackson announced that the national debt was completely paid off.<sup>2</sup> The nation soon learned that "a national debt, if not excessive, will be to us a national blessing."<sup>2</sup> However, widespread government land sales, which was predominantly leveraged with bank debt, caused banks to implode. Wall Street experienced its inaugural major market crash in 1837, and America entered its first "great depression" which would last until 1843.

America then realized that the blessing of debt, if overused, will become a curse.

### The Great Debt Malaise

The world learned precious little from this experience as evidenced by the fact that it has reached its largest relative debt levels in history. According to Kyle Bass of Hayman Capital, the total "credit markets in the world have grown from \$80 trillion to \$210 trillion in the past nine years" alone. This represents an 11% compounded annualized growth rate while gross domestic product (GDP) only grew by 4% during the same timeframe. According to

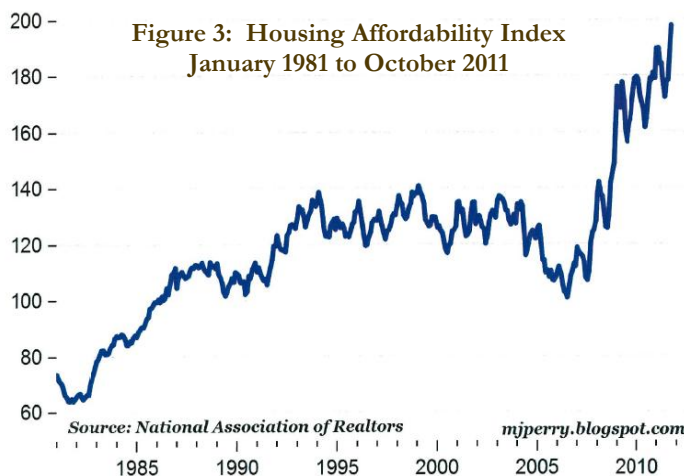
Figure 2: Sovereign External Debt: 1800-2008  
Percent of Countries in Default or Restructuring<sup>1</sup>



Sources: Lindert and Morton (1989), Macdonald (2003), Purcell and Kaufman (1993), Reinhart, Rogoff, and Savastano (2003), Suter (1992), and Standard and Poor's (various years).  
Notes: Sample size includes all countries, out of a total of sixty six listed in Table 1, that were independent states in the given year.

Bloomberg News, in 2012 alone, \$7.6 trillion of sovereign debt matures in the G-7 nations and the BRIC countries (Brazil, Russia, India and China). If there is a silver lining to this, it is that \$5.8 trillion of this debt is from countries that currently have ready access to the debt markets, namely Japan and the U.S., and will likely mature without much ordeal. However, what seems to be lost on the leaders of the U.S. and the EU (the “twin towers of financial disaster”) is that investor confidence is required in order to grow out of the worldwide debt saturation problem that currently exists. If politicians continue to create bridge loans to nowhere and play chicken with investor confidence, the current problems become increasingly dire, the solutions more expensive, and the palatable options finite.

“On average, government debt rises by 86% during the three years following a bank crisis,”<sup>1</sup> making the current global debt malaise not atypical. However, the evaporation of confidence in the markets can elevate a typical debt crisis into a catastrophic situation. Just as the high degree of “labor mobility” is causing wage deflation and employment fragility, the high degree of “currency mobility” can wreak havoc on an economy. This “currency mobility” leads to a high level of instability by causing hyperinflation or making it nearly impossible to reissue maturing debt. Continued inaction on the part of the EU and Washington will only ensure the current crisis is exacerbated. As the possibility that Greek currency may be redenominated into worthless Drachmas looms, there is a high likelihood that Greek citizens will take their Euros out of Greek banks and put them into German banks to circumvent the effects of a bank run.<sup>4</sup> Though Greece’s population is only roughly equivalent to that of Ohio, history suggests sovereign defaults “often occur in clusters.”<sup>1</sup> A failure on the part of the EU to act decisively could result in a contagion effect that could make investors long for the “good ole days” of 2008.



### A Fragile U.S. Recovery

While the European debt crisis, shenanigans in Washington, and economic slowdowns in the EU and China dominate the news headlines, there are “quiet signs” that the US economy is healing. Most retailers had a good holiday season, and companies are posting record profits. With stated unemployment down to 8.5% and U-6 unemployment down to 15.2%,<sup>4</sup> jobless claims are the lowest they have been since April 2008.<sup>3</sup> Additionally, the most recent report from the National Association of Realtors suggests housing is becoming more affordable than it has been in 40 years. Though the report may be slightly biased, housing affordability is the highest levels since April 2010, and housing appears to be bottoming.

While the U.S. economy has made positive strides in recovering from the “Great Recession” which began a few years ago, there is a real risk that these strides may be short-lived should both the U.S. and Europe not successfully implement the right mixture of austerity measures and growth initiatives into their respective economies. The world has witnessed the current economic crisis in its various forms – from housing bust to banking crisis to liquidity issues. Now, the final stage of the economic crisis is a debt crisis. Simply stated, debt, as a percentage of GDP, is too high and needs to be reduced. The prudent way to dissolve world debt is to dilute it by growing the economy, which fulfills the blueprint of eliminating debt, as established by our Founding Fathers. Economic growth produces tax revenues that can be used to pay down the debt and eliminates the need to default on debt. Economic growth, in conjunction with austerity measures, is the key to global deleveraging and continuing economic recovery.

### It’s Not Freakonomics

Job creation is first in order of necessity for economic growth to occur, and not just the “shovel ready jobs” that Washington is quick to tout as an easy fix for getting people back to work. In reality, this quick fix solution contributes nothing to creating true wealth. On the flip side of that token, large corporations aren’t necessarily the solution either, as their motive is to create profits for their stakeholders rather than to create jobs and growth in the overall economy. While this goal of stakeholder wealth creation can lead to job growth, it can just as easily go the other way and lead to job contraction when businesses streamline in order to function more efficiently.

So where does real job growth come from if not from governments or large corporations? Historically, it is new and small businesses that create real job growth and wealth as depicted in Figure 4. While this may seem rather simplistic, sometimes policy makers cannot see the forest for the trees, so to speak. Resultantly, new and small businesses face formidable regulatory, legal, and tax headwinds, thus impeding their ability to create real job growth and wealth. While politicians like to give lip service to fostering economic growth, small businesses are often left out in the cold due to the fact that they do not employ the number of lobbyists or have the influence of large corporations. Therefore, while inefficient, most of a

politician's clout goes to protecting big business, unions, and social programs. Doing so, however, does very little to effect real, positive change.

Rather than grandstanding and focusing on all the wrong things, policy makers in the U.S. would be wise to shift their attention towards implementing pro-business measures, such as repealing ineffective legislation like Dodd-Frank and Obamacare, creating small business tax incentives, and reducing the influence of lobbyists in Washington. As is often the case with governments, less is usually more. Not only would focusing on such items help to foster real growth and job creation, but it would also go a long way towards right-sizing the government and its entitlement programs to correspond with the new economic realities of the world.

The European solutions are within the same vein; however, the degree of difficulty in their

implementation is significantly higher. In their march towards increasingly socialized government over the last half of the 20<sup>th</sup> century, European nations have adopted labor laws that are inconducive to creating real job growth and reinforced the expectation of its citizenry to solve all of its woes. While Europe, collectively, seems to be trying to kick the can down the road, further bailouts and Draconian austerity measures will not likely yield a different result from that which Europe has already seen over the past couple of years. As is the case with the U.S., jobs, pro-growth business measures, and more responsible government is the prescription for the ailments of Europe's economy.

### Election Year Economics

Despite ominous headlines and a sluggish economy in 2011, the Value Income and Value Momentum portfolios significantly outperformed the S&P 500. As always, our overriding investment approach is an opportunistic approach to investing where we seek to find relative value in inefficient markets. However, success in 2011 required us to do more than simply buying quality names in out of favor sectors. The markets forced investors to have the discipline to be sellers when the EU "bridges to nowhere" were announced and the fortitude to be buyers when market volatility peaked and market values plunged. Significant macro headlines and central bank intervention were partly responsible for such an unusually high degree of correlation among stocks. As one manager put it, it was as if all S&P 500 companies were run by the same CEO, sold the same product and had the same strategy. According to Grants, "in the entire history of the S&P 500, there has never been a day when all 500 stocks in the index go up or all go down. There have been 11 days when 490-plus stocks all moved in the same direction on a given day. Of those 11 instances, six have occurred since July 2011." As 2012 dawns, it inexplicably feels like Ground Hog Day. Once again hopeful explanations and plans emanate from Europe, the Volatility Index is low, and cash levels in our accounts are unusually high. We are confident that there will be ample opportunity in 2012 for us to redeploy capital in a prudent fashion since areas of the markets will be inefficient as political leaders fail to act decisively and, instead, do what is in their best interest - after all, it is an election year.

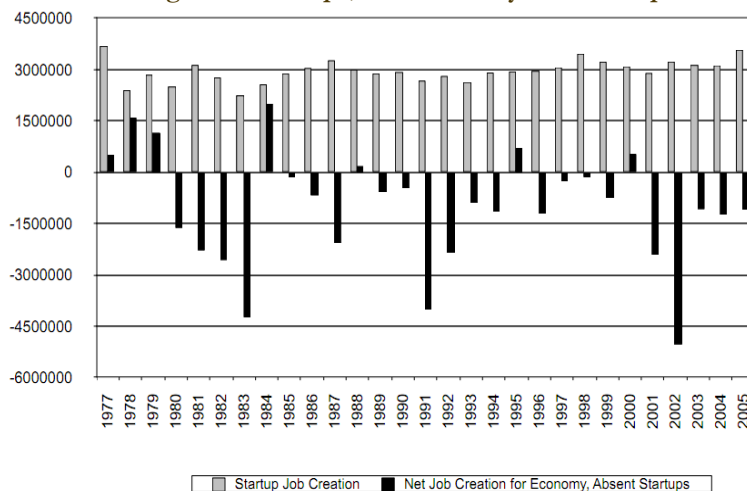
### Firm News

We are excited to introduce two new members to our team, Will Aycock and Laura Vaughn.

Will Aycock currently holds the position of Fixed Income Specialist. His primary role is to identify, monitor, analyze, and trade both current and potential investments within the fixed income arena. Will came to Doucet Asset Management with over 10 years of direct investments experience. Throughout his career he has held management positions in various trading, portfolio management, and analysis capacities. Most recently he held the position of Fixed Income Portfolio Manager, with a focus on the municipal market. Will earned his B.S., *summa cum laude*, from Birmingham-Southern College and an M.B.A. from the University of Alabama at Birmingham. He is currently a Level 3 Candidate in the Chartered Financial Analyst program. In his spare time, Will enjoys cooking, travelling, skiing, playing golf, and spending time with his wife, Lindsay. Additionally, Will is active with the Rotaract Club of Birmingham and serves on the board of the Junior Patrons of the Birmingham Museum of Art.

Laura Vaughn returns to Doucet Asset Management in the role of Equity Analyst after working as a CPA at Ernst & Young, LLP. There she gained valuable experience through her involvement with tax compliance, advisory, and assurance engagements for various corporate clients. In addition to security analysis, Laura will manage client relationships,

Figure 4: Startups, and Economy sans Startups<sup>6</sup>



Source: Census Bureau, Business Dynamics Statistics,  
[http://www.ces.census.gov/index.php/bds/bds\\_database\\_list](http://www.ces.census.gov/index.php/bds/bds_database_list)

administer asset allocation strategies, and monitor and re-balance client portfolios. Laura graduated *summa cum laude* with a degree in Accounting and Finance from the University of Alabama at Birmingham, where she served as the Chief Investment Officer on the student managed portfolio, The Green & Gold Fund. She is a Certified Public Accountant (CPA) and is a candidate for the Certified Financial Planner™ (CFP®) certification. Laura enjoys reading, cooking, and spending time with her husband Tom.

Sincerely,



Chris L. Doucet  
Chief Executive Officer

#### **Footnotes**

<sup>1</sup> Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different*. (Princeton, New Jersey: Princeton University Press, 2009).

<sup>2</sup> John Steele Gordon, *Hamilton's Blessing: The Extraordinary Life and Times of Our National Debt*. (New York, New York: The Penguin Group, 1998).

<sup>3</sup> Jack Hough, "Signs of Hope for Investors Waiting to Get Back In," *The Wall Street Journal*, December 24, 2011 (<http://online.wsj.com/article/SB10001424052970203686204577116463528268458.html>)

<sup>4</sup> J. Kyle Bass, Hayman Capital Management Letter to Investors, December 14, 2011 (<http://www.scribd.com/doc/75784106/Hayman-Capital-Letter-Dec-14>)

<sup>5</sup> Bloomberg data

<sup>6</sup> Dane Stangler, *The Economic Future Just Happened*, (Ewing Marion Kauffman Foundation, 2009), 13.

#### **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.
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