DOUCET ASSET MANAGEMENT, LLC

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

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End of the Illusion

"People only accept change in necessity and see necessity only in crisis."
- Jean Monnet

Greece has been in some stage of default or restructuring of its government debt for more than 50% of the time since it declared independence from the Ottoman Empire in 1821.[1] So why should it matter that Greece pays the equivalent of payday loan rates on its sovereign debt and receives cash infusions from the European Central Bank just to pay *interest* on its obligations? Why would the investing public become so fixated on a country whose economy makes up a mere 0.44% of the global economy, population is roughly the size of Ohio, and debt has a long and illustrious career of being in default? The popular (and perhaps correct) answer is a Greek sovereign debt default, if not carefully handled, could cause a contagion which, in retrospect, might make the Lehman Brother bankruptcy fallout look tame. But the larger issue, much ignored by the press and investors alike, is Greece represents a microcosm of the present conditions which confront most developed countries, including the United States. What are some of these issues? How do investors survive, and even thrive, in these tumultuous times? In the short term, "11th hour" deals with accompanying political rhetoric may help the markets avert catastrophe, but they will do little to rectify the alarming economic realities which face every developed economy. Rest assured, however, attractive investment opportunities will abound for those investors who are under no illusions about these present realities and future economic challenges.

The DUD Syndrome

Most developed countries in the world are suffering from what Doucet Asset Management has termed the "**DUD Syndrome**." Developed countries try to support social programs which were created at a time when **demographics** were more favorable, **unemployment** rates remain chronically high, in part, due to the off shoring of their manufacturing industries coupled with weak housing markets, and **debt** and deficit spending has ballooned to unsustainable levels. As a result, every economic recovery which has occurred since 1990 has paled in comparison to previous turnarounds, or simply put, they have been "DUDs."

Demographics

Most social programs were initiated at a time when the life expectancy of the average citizen was much shorter and the number of births per adult was much higher. The simple math of funding these social programs, in their existing forms, simply no longer works…and has not for some time. Unfortunately, election cycles make long term fiscal planning virtually impossible. The political will needed to avoid various inevitable financial disasters is elusive, and politicians are keenly well aware that supporting austerity measures, higher taxes and benefit reforms will not likely help them with re-election. This new political math will only get harder to justify in the future. For example, in the U.S. there are currently about 3 workers for every Social Security beneficiary versus 42 workers per recipient in 1945.[2] The numbers only get worse from here as the Baby Boomer population ages and birth rates dwindle. While younger people tend to buy more houses, cars and big ticket items with their money, retirement aged people are typically more concerned with converting retirement savings into income streams. This is not a cycle that will be broken by lower interest rates.

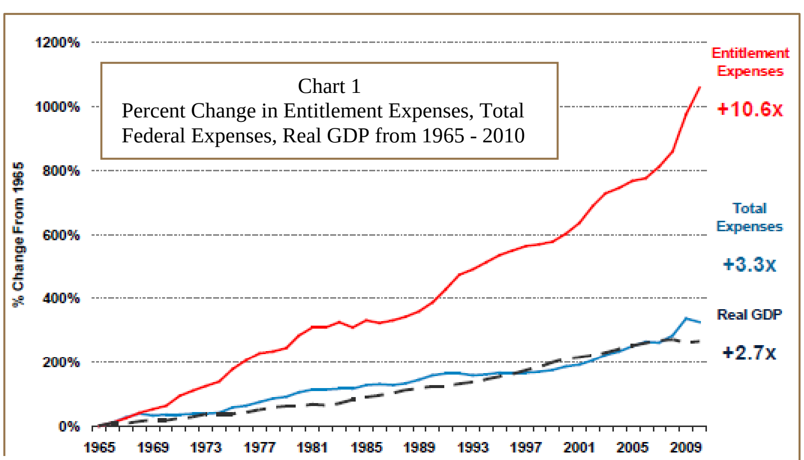


Chart 1
Percent Change in Entitlement Expenses, Total Federal Expenses, Real GDP from 1965 - 2010

Source: White House Office of Management and Budget:; USA Inc. February 2011

Debt

Since 1970, entitlement expenses have grown 5.5 times faster than GDP, as depicted in Chart 1. Common sense dictates that debt in any country cannot grow faster than income forever. Governments of most developed economies are spending more than they collect in taxes. In 2011, the U.S. Government has borrowed approximately 36 cents out of every dollar spent, or otherwise stated, 156% of its taxes and other revenues.[3] Since government spending is a component of Gross Domestic Product (GDP), and the level of government spending is only possible, in large part, by borrowing, it is correct to deduce that its contribution to GDP growth is being fueled by debt. The inability to borrow to fuel spending could represent a sizable contraction in GDP. Government debt eventually crowds out private investment, hampering longer term, sustainable, healthy economic growth. Japan is the poster child example of this fact, as public debt exploded while revenues collapsed over the past two decades. Since 1990, Japan's contribution to the global economy has fallen from 14% to approximately 8%.[4]

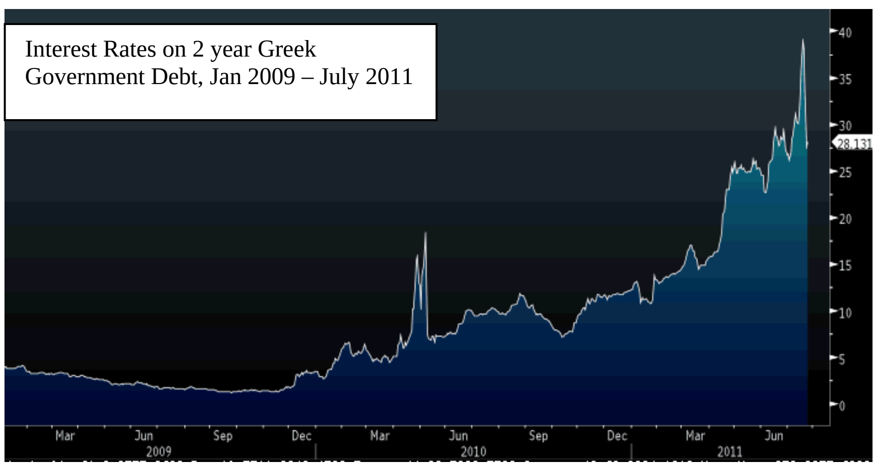
Unemployment

Evidence that unemployment in most developed countries has become "structural" in nature and not "cyclical" becomes much clearer with every new economic downturn. With the portability of labor in the new global economy, manufacturing jobs and other lower level skilled jobs continue to be exported to developing economies; with similar housing booms and busts in the countries of many developed economies, construction and housing-related jobs will be slow, at best, to return until the market is able to absorb the excess supply of real estate; with higher levels of regulation, taxes, and social programs, it is increasingly difficult for a developed economy to compete with an emerging economy given the unlevel playing field the absence of the aforementioned brings. In the U.S., the structural changes in the labor force are evidenced by the significant disparity in unemployment rates between the well educated and the poorly educated. While the unemployment rate among people with at least a college degree is only 4% in the U.S., the unemployment rate among high school dropouts is 15%.

The Deficits Are Worse Than You Think

U.S. debt has risen significantly for decades, but plunging interest rates have kept the cost of supporting it relatively steady. Through the first nine months of 2011, interest paid on federal debt held by the public was $202 billion, based on $9.754 trillion of debt held by the public. This interest bill would have been $439 billion, or 118% higher, if rates had been at their 30-year average of 6% (vs. approximately 2.76% currently).[5] Just holding debt equal to current levels (a very conservative assumption since there has been a $1.1 trillion increase since July 2010), increasing the interest rate to the 30 year average would add an additional $3 trillion in government spending over the next 10 year period. So, just to pay interest on our debt at normalized interest rates would wipe-out nearly all the progress from the proposed spending cuts being so intensely debated in Washington. Higher interest rates could become a type of "governor" on future borrowing and the ability increase debt.

Fleeting Confidence



Which brings us back to Greece. As recently as November 2009, the yield on the Greek 2-year note was as low as 1.35%. This week, the yield hit 40%![6] So what changes occurred over the past 20 months to cause this Greek tragedy and what immediate lessons can the U.S. learn? Total debt in Greece grew by only 10% during this time, however, the perception of their fiscal reality changed dramatically. While the bond market's confidence in Greece's *ability* to repay its debt was always in question, its trust in the Hellenic *willingness* to pay waned significantly. The result was the bond market's refusal to roll-over its short term Greek sovereign debt holdings at anything short of payday loan rates. Governments, including the U.S., cannot run deficits in excess of the growth in GDP without eventual consequences. As evidenced in Greece, imbalances can persist for a while, and then, in a moment, bond investors' support of a credit at any price disappears.

Market's Shot Across the Bow

It is a fallacy to believe that investor confidence in U.S. backed debt and its corresponding credit quality are not invariably linked. On April 18, 2011, Standard and Poor's (S&P) became the first domestic rating agency to make a "shot across the bow" to help dispel this belief. S&P put the U.S. on negative credit watch, stating policy makers need to agree on and begin "meaningful implementation" of a plan by 2013 to reduce budget deficits and the national debt. The action of S&P infers that the sovereign debt of the U.S. is not managed at a level that would merit the top-level AAA ranking. Likewise, while China continues to own 12% of all publically held U.S. Treasury debt,[7] and have even added to their long term holdings over the past two months, Beijing-based rating agency Dagong International Credit Rating Company rates U.S. credit only AA and has the

Source: Dagong International Credit Rating Company

No.	Sovereigns	Local currency		Foreign currency	
		ratings	outlooks	ratings	outlooks
1	Norway	AAA	stable	AAA	Stable
2	Denmark	AAA	Stable	AAA	Stable
3	Luxembourg	AAA	Stable	AAA	stable
4	Switzerland	AAA	Stable	AAA	Stable
5	Singapore	AAA	Stable	AAA	Stable
6	Australia	AAA	Stable	AA+	Stable
7	New Zealand	AAA	Stable	AA+	Stable
8	Canada	AA+	Stable	AA+	Stable
9	Netherlands	AA+	Stable	AA+	Stable
10	China	AA+	Stable	AAA	Stable
11	Germany	AA+	Stable	AA+	Stable
12	Saudi Arabia	AA	Stable	AA	Stable
13	United States	AA	Negative	AA	Negative
14	South Korea	AA-	Stable	AA-	Stable
15	Japan	AA-	Negative	AA	Stable
16	Britain	AA-	Negative	AA-	Negative
17	France	AA-	Negative	AA-	Negative

U.S. on negative credit watch to be potentially downgraded again. Fiscal responsibility and healthy economic growth afforded the U.S. many benefits including the advantages of being the world's "reserve currency." If confidence in domestic public debt is not restored, that too will be in jeopardy.

Trends That Can't Continue, Won't

"With the ratio of debt to GDP already elevated, we will not be able to continue borrowing indefinitely to meet these demands. Addressing the country's fiscal problems will require a willingness to make difficult choices."
- Ben Bernanke, June 3, 2009

Economist Herbert Stein said, "Something that cannot go on will stop." Without drastic measures, the DUD syndrome will eventually result in much higher interest rates. In its recently released Annual Report 2010/11, the Bank for International Settlements (BIS) – essentially a central bank for central banks – indicated that "the persistence of very low interest rates in major advanced economies delays the necessary balance sheet adjustments of households and financial institutions. And it is magnifying the risk that the distortions that arose ahead of the crisis will return. If we are to build a stable future, our attempts to cushion the blow from the last crisis must not sow the seeds of the next one."

Playing the Hand You're Dealt

The DUD Syndrome creates a reality that is unsettling, at a minimum. While there is no shortage of hopeful explanations and plans which could remedy the world's current economic plight, it would be naïve to believe amelioration of these problems will be quick and easy. One would be equally misguided to deduce there will not be significant investment opportunities which will arise as a result of this fiscal "house of cards." It is incumbent upon investors to understand the hand they have been dealt and invest accordingly.

At some point in time before the next Presidential election, we would like to be overweight in domestic equities….just not right now. As we observe the investment environment, there are several reasons to be optimistic.

- QE 2 has ended, but there is still much "stimulus" present in our economy: The Fed continues to reinvest its self-amortizing mortgage backed security portfolio in Treasury markets and the 2% payroll tax reduction, just to name two.
- The U.S. consumer is deleveraging. (See side panel)
- Corporate earnings continue to be strong. In the current quarter, more than 80% of S&P 500 companies have exceeded analysts' expectations. These beats are happening despite the fact that analysts are boosting profit forecasts. S&P 500 earnings are now expected to rise to $99.61 in 2011 from $84.58 last year. That's an increase from the previous forecasts of $95.37 on Jan. 3 and $98.70 on April 29. [8]
- S&P companies are still sitting on an estimated $2 trillion of cash and cash equivalents. When investors become comfortable that the economy is no longer at risk of falling into another recession, there will be increased pressure from investors for these companies to either increase dividends, purchase other companies, expanded organically, or buyback their own shares.
- Finally, the next Presidential and Congressional elections are not much more than 12 months away. Not to sound (overly) cynical, but our professional politicians #1 job is getting themselves re-elected. That is typically one of the reasons why the pre election and election years (3rd and 4th years) of a President's term are the best for the markets.

Rebounding U.S. Consumer?

Quietly occurring on the peripheral:

- Avg U.S. credit score – a predictor of the likelihood lenders will be paid back – rose to 696 in May, the highest in four years (according to credit reporting bureau Equifax).
- Delinquencies on consumer loans have dropped 30% in two years, according to Federal Reserve data.
- Over the last 10 quarters, consumers have reduced debt by more than $1 trillion, according to Federal Reserve Bank of New York.
- Discover's rate of 30 day delinquencies was 2.79% in Q2 2011, the lowest in its 25 year history according to a company statement on its June 23rd conference call.

Today's investment environment necessitates a management style which allows investors to more actively navigate volatility in the markets. Several of our stocks hit price targets last Spring, but we were unable to justify raising price targets as we believe much of the GDP growth in the U.S. has been fueled by overleveraging on the part of the Government. **We view this buildup of cash in our portfolios as an offensive weapon, not a defensive one.** Jason Zweig calls what is currently going on in Washington with U.S. debt talks a potential "neon swan" event, or an "event that is unthinkably rare, immensely important and blindingly obvious." [9] If the debt ceiling sideshow currently playing in Washington miraculously turns around and a solid long term plan is established to put America's fiscal house in order, the upside investors lose by having so much cash is nominal; if politicians fail to devise a feasible plan in the next week or so to adequately address deficit spending and debt reduction, the downside the market could realize is potentially significant. In the short term, a healthy cash position, coupled with patience and prudence, is the best strategy for now.

In our opinion, the potential tail risks associated with debt issues surrounding most developed economies dictates a fixed income strategy of buying securities in "out-of-favor" classes, buying high quality paper within those subsets and keeping maturities and average lives of the bonds in our portfolios very short. The likelihood has risen significantly that one of several events will occur which will give investors the opportunity to buy high quality assets at very cheap levels in the short term.

The lesson politicians should have learned from the Lehman Brothers crisis is confidence is a critical ingredient for any market – currency, bond or equity – to function properly. The longer it takes to resolve an issue like the debt ceiling and create the certainty the markets crave, the more collateral damage to the economy investors can expect and the more expensive the problem becomes to resolve. Of this fact, we have no illusion. However, while this American tragedy is painful to watch, for investors with cash and the courage, a historic buying opportunity may be in the making.

Sincerely,

Chris L. Doucet
Chief Executive Officer

Footnotes

[1] National Bureau of Economic Research Working Paper Series: "This Time is Different: A Panoramic View of Eight Centuries of Financial Crisis." Carmen Reinhart and Kenneth Rogoff.
[2] Social Security Administration; Mary Meeker, "USA Inc. A Basic Summary of America's Financial Statements," (February 2011): 135
[3] Congressional Budget Office (CBO) Monthly Review, July 2011 (www.cbo.gov)
[4] Mauldin, John and Jonathon Tepper, *Endgame, End of the Debt Supercycle and How it Changes Everything.* (John Wiley & Sons, Inc), 249
[5] Mary Meeker, "USA Inc. A Basic Summary of America's Financial Statements," (February 2011): 12
[6] Bloomberg Data, Intraday high on 7.19.2011
[7] Data as of May 2011, U.S. Treasury (www.treas.gov/tic)
[8] Bloomberg Data
[9] "Forget About Black Swans, the One Floating Ahead is Neon," *Wall Street Journal*, July 23, 2011, Jason Zweig

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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