DOUCET ASSET MANAGEMENT, LLC

Fixed Income Quarterly

April 2017

For the 1st quarter of 2017, the Doucet Asset Management Fixed Income Strategy Composite modestly outperformed its benchmark, to the tune of 18 bp. The Composite's 1% quarterly return is in keeping with our opinion that yields are biased higher, and that any positive return in 2017 is more likely to come from carry than from price appreciation.

In our January *Fixed Income Quarterly*, we raised the debate as to whether the *lower for longer* thesis regarding interest rates was dead. With a dovish 25 bp hike in March to 0.75-1.00%, the Federal Reserve moved the needle ever so slightly towards the *yes* side of this debate. The ECB did the same with President Draghi making comments highlighting a more favorable back-drop in the European growth and inflation picture.

Figure 1: Doucet Asset Management FI Strategy Composite Performance

	YTD	1Q17	2016	2015	Since Inception
Doucet Fixed Income Composite	1.00%	1.00%	10.64%	0.73%	5.41%
Barclays US Aggregate Bond	0.82%	0.82%	2.65%	0.55%	1.78%
+/- Benchmark	0.18%	0.18%	7.99%	0.18%	3.63%

*Performance calculated by Morningstar Office, periods over 1 year are annualized

Even so, these were baby steps and far from emphatic, table-pounding events. According to Morningstar, the market-implied probability of two more hikes in 2017 is 55%, which would put the fed funds rate at a still-low 1.25-1.50% at year-end. And while the comments out of the ECB seemed to infer a move away from extremely dovish monetary policy, they left short-term interest rates negative and maintained their EUR 60 billion monthly purchase program. So, it was not exactly lift-off!

Again, here at Doucet Asset Management we continue to believe that yields are ultimately biased higher, but that it is going to be slow going. And as geopolitical risks have sharply risen, one cannot fully discount the possibility of a flight to safety that could slow things further and breathe new life into the *lower for longer* camp.

Bond Market At-a-Glance

Across sectors and the curve, fixed income returns were largely positive, albeit anemically so, as yields pulled back. In terms of positioning, the long-end of the curve was the place to be, as the Morningstar Long-Term Core Bond index returned 1.54% compared to .50% and .68% for the Short-Term Core Bond and Intermediate-Core Bond indices, respectfully. Once again, high-yield was the best performing sector, as the Bank of America Merrill High Yield Master II index returned 2.71% and was the sole sector to crack 2%. Municipals also showed some resiliency with the Barclays Municipal index returning 1.58%, as the threat to the value of their tax exemption from the prospect of sweeping tax reform abated, to some degree.

Figure 2: Index Returns

	1Q17	YTD
Broad Market Equity Indexes		
DJIA	5.19%	5.19%
S&P 500	6.07%	11.96%
Broad Market Bond Indexes		
Barclays US Aggregate Bond	0.82%	0.82%
Bank of America Merrill High Yield	2.71%	2.71%
Morningstar Core Bond	0.85%	0.85%
Morningstar Short-Term Core Bond	0.50%	0.50%
Morningstar Intermediate Core Bond	0.68%	0.68%
Morningstar Long-Term Core Bond	1.54%	1.54%
Bond Indexes by Sector		
Morningstar Corporate Bond	1.38%	1.38%
Morningstar US Govt Bond	0.73%	0.73%
Morningstar Mortgage Bond	0.47%	0.47%
Morningstar TIPS	1.38%	1.38%
Barclays Municipal	1.58%	1.58%

*Source: Morningstar

In the Treasury market, the 2-Yr, 5-Yr, 10-Yr, and 30-Yr finished at 1.25% (+6 bp), 1.92% (-1 bp), 2.39% (-5 bp), and 3.01% (-6 bp), respectively for a 2s-30s steepness of 176 bp. The 2-Yr, 5-Yr, 10-Yr, and 30-Yr AAA benchmark municipal finished at 1.03% (-20 bp), 1.58% (-22 bp), 2.26% (-9 bp), and 3.07% (-1 bp), respectively, for a 2s-30s steepness of 204 bp.

Figure 3: U.S. Treasury Market Snapshot

	US Treasury Actives							AAA Benchmark Muni		
	1Q17	*4Q16*	*1Q16*	*Qtr change*	*Qtr Change*	*Yr Change*	*Yr Change*	*1Q17*	*%UST*	Tax Equiv*
2-Yr	**1.25%**	**1.19%**	0.72%	6	5.04%	53	73.61%	**1.03%**	*82.40%*	1.82%
5-Yr	**1.92%**	**1.93%**	1.21%	(1)	-0.05%	71	58.68%	**1.58%**	*82.29%*	2.79%
10-Yr	**2.39%**	**2.44%**	1.77%	(5)	-2.05%	62	35.03%	**2.26%**	*94.56%*	3.99%
30-Yr	**3.01%**	**3.07%**	2.61%	(6)	-1.95%	40	15.33%	**3.07%**	*101.99%*	5.42%

Source: Bloomberg

*TE assumes current top 43.4% Fed tax rate

Within credit, investment-grade spreads widened 2 bp and high-yield spreads narrowed 42 bp to finish at 113 bp and 419 bp, respectively. According the Morningstar, the three best performing corporate sectors on an OAS basis were: Basic Industries (-18.9 bp), Finance (-11.2 bp), and Bank (-7.7 bp). The worst performers were: Telecom (+6.9 bp), Retail (+2.5 bp), and Consumer Products (-0.4 bp). As of quarter-end, the three cheapest sectors were: Gas Pipelines (174.2 bp), Telecom (164.8 bp), and Basic Industries (161.2 bp).

Figure 4: Fixed Income Spreads by Sector

Source: Bloomberg

Final Re-cap and Look Ahead

In January, we commented that "the positing of the Composite is the most conservative it has been in its two year history as we head into 2017". This holds true today, and in fact, it's positioning is even more conservative now than it was then. Still, composite characteristics and asset allocation are more or less the same, and targets remain intact.

As a total return minded firm, we are always looking for situations where we believe assets are mispriced and there is an opportunity for mean reversion. Right now in fixed income, we just are not seeing any such situations. As with equity valuations, we believe fixed income valuations are stretched and are not reflective of their inherent risks, be it credit risk, interest rate risk, liquidity risk, or other. We do not believe the sky is falling, by any stretch. Until we have more conviction, however, we intend to remain conservatively positioned. While it is not exciting, with the market priced to perfection, the opportunity cost downside if we are wrong is far outweighed by the potential outperformance if we are right, in our opinion.

Figure 5: Doucet Asset Management Fixed Income Composite Characteristics

	Portfolio	Benchmark	+/-	% of Benchmark	Target
Workout Date	2.56	7.94	*-5.38*	32%	65%
Coupon Rate	4.89	3.06	*1.83*	160%	>100%
Modified Duration	1.59	6.05	*-4.46*	26%	65%
Yield to Worst	3.26	2.56	*0.70*	127%	>125%
Yield to Maturity	4.32	2.56	*1.76*	169%	>150%
Current Yield	5.03	2.98	*2.05*	169%	>150%
Convexity	0.15	0.76	*-0.61*	20%	50%
OAS	190.20	38.11	*152.09*	499%	>200%
Rating	A	AA			
Corporate Debt	25.43%	26.87%	*-1.44%*		25.0%
Government Debt	0.02%	41.99%	*-41.97%*		0.0%
Preferred Shares	6.33%	0.00%	*6.33%*		5.0%
Securitized Debt	5.61%	30.48%	*-24.87%*		10.0%
U.S. Municipal Debt	62.60%	0.66%	*61.94%*		60.0%

Note: Stated Benchmark is Barclays U.S. Agg Bond TR

Source: All characteristics calculated using Bloomberg Portfolio & Risk Analyitics

Sincerely,

Will Aycock, CFA

Footnotes:

[1] Morningstar Corporate Credit Research Highlights, *First Quarter Fixed-Income Index Review*, April 3, 2017

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.