DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter
Q2 2017
Fixed Income Strategy
Doucet Value Momentum Portfolio
Doucet Value Income Portfolio
Mutual Fund Strategy

April 2017

The Great Financial *Repression*

"Bubbles are far more dangerous when they are fueled by debt, as in the case of the global housing price explosion of the early 2000s."
— Carmen M. Reinhart, This Time Is Different: Eight Centuries of Financial Folly

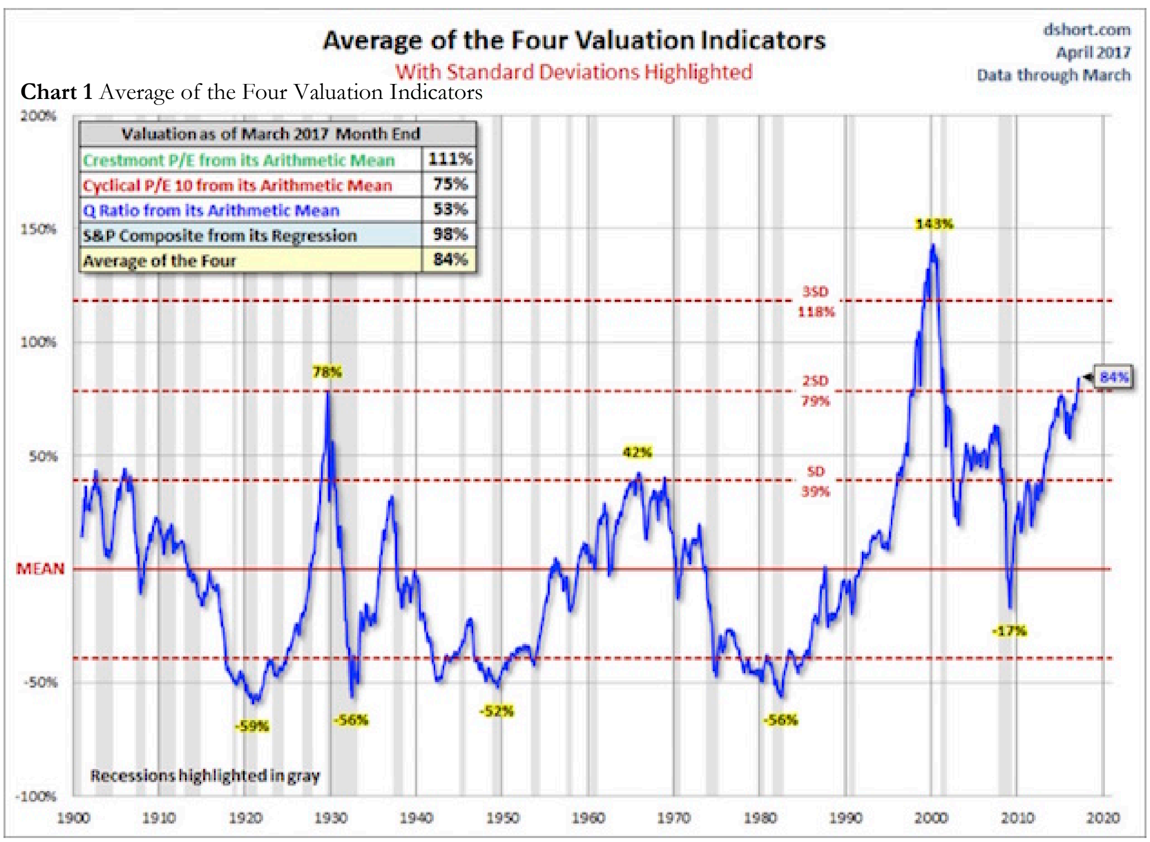
There have been several seminal events in history where the prices of certain financial assets became disconnected from economic realities. Investors fell under the illusion that a new era in valuations had begun, only to have their complacency and exuberance replaced with ruinous collapse and despair. Some of the more significant market calamities are commemorated with memorable titles, such as: the Great Crash of 1929, the Tronic Boom of the late 1950s, the Nifty Fifty stocks of the 1970s, Black Monday in 1987, the Dot.com bubble of the late 1990s and the Housing Bubble in 2008. Each of these aforementioned events was presaged by a similar backdrop-sentiment indicators soared, the underlying economy was actually quite healthy, but asset valuations were absorbinent and had to be *rationalized* by market pundits. In each case, investors were convinced that this time was different. But as the old saying goes, 'valuations don't matter until they matter.'

Today, central banks around the world have enacted repressive policies which have distorted the financial landscape and asset valuations. But news of improving soft economic data coupled with the hope of a plethora of Trump Administration initiatives have old-time financial evangelists clogging the media airwaves with their versions of fire and brimstone speeches about the evils of *not* participating in the current equity rally. However, a few of the less faithful have started to proclaim the end to this eight year a bull. Expensive stocks have simply gotten more expensive since 2014; and the recovery on Main Street has been anemic; US government debt levels have only been this sinfully high after major wars; underfunded pensions are beyond a crisis point. Yet, one would never know any of this by gauging recent market volatility. With this combination of no fear in the markets, high valuations, imploding pensions and exorbitant government debt, what label will the future ultimately ascribe to the current snapshot in time?

We're #2!

By any definition, stocks are expensive. You have heard all of the arguments why: 'earnings will explode in the second half of the year;' 'stocks aren't that expensive when compared to bonds;' 'multiples are not as bad as you think they are when adjusted for forward looking earnings estimates and not trailing 12 month GAAP earnings.' In other words, even if it has not been the case in the past, *this* time *really* is different.

Chart 1 Average of the Four Valuation Indicators

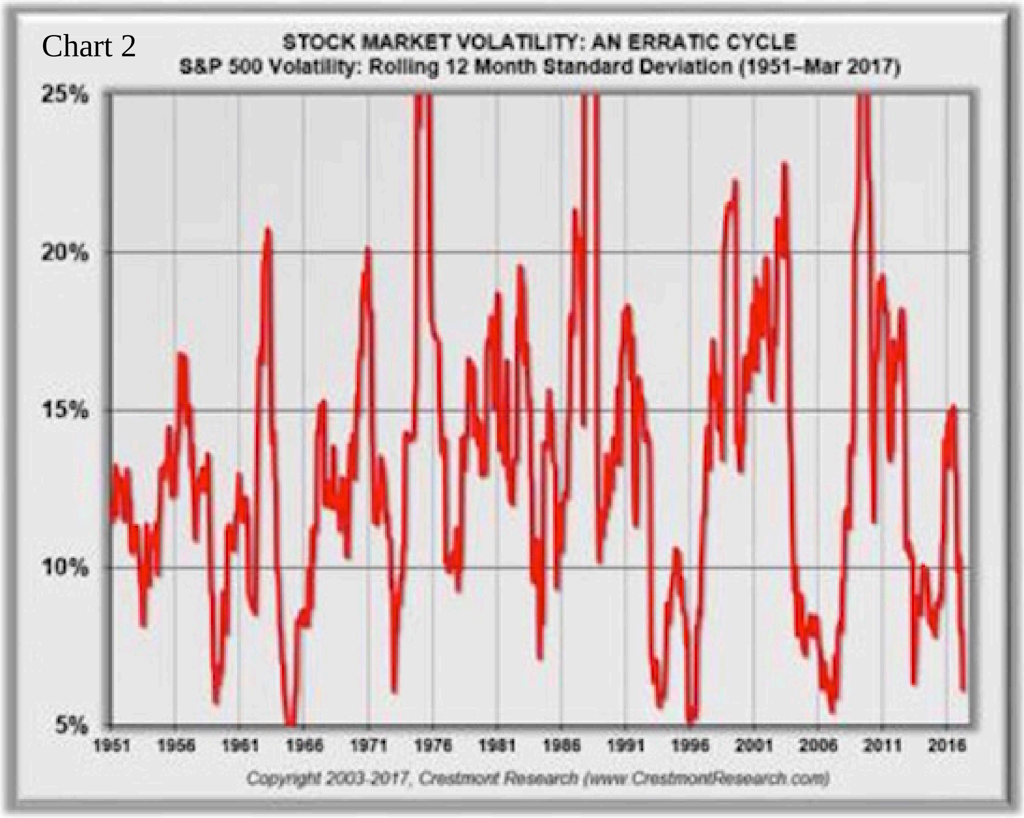


The only thing different about this time, we would argue, is the reason why. Artificially low interest rates have been the culprit this time around. They have significantly distorted assets values to a point where stocks are actually at the second most expensive levels in US history.

In *Thoughts From the Frontline*, John Mauldin took four different valuations metrics, provided him by dshort.com, and averaged them to determine just how expensive stocks currently are versus other historical times. Based on data dating back to 1900 (as illustrated in Chart 1 above) the current market is the second most overvalued in history, including 1929, and is only eclipsed by the Dot.Com bubble. When other metrics like price-to-sales, price-to-book and price-to-EBITDA are taken into consideration, similar results are found.

Volatility On Sale

According to a recent CNBC survey, 83% of mutual fund managers believed that US stocks were overvalued.[1] At the same time, the American Association of Individual Investors Sentiment Survey has gone from 46.2% bullish at the beginning of the year to 25.7% about 100 days later, versus a historical average of 30.5% .[2] Given the extent of geopolitical tensions around the world, coupled with the aforementioned data, one would think that investors would display a heightened level of fear. But according to Crestmont Research, "volatility has now plunged to 4%, the lowest level in all rolling 12-month periods since 1950."



Ten Lean Years-The New Normal

Ned Davis Digest conducted an interesting study in attempt to predict the future 10-year annualized return of stocks based on the median price-to earnings ratio (P/E) of the S&P 500. They took a study sample from 1926 through 2014, and broke down the data for the median P/E into five different quintiles, quintile 1 representing the cheapest 20% of P/Es and quintile 5 representing the most expensive. Today's median P/E of 24x puts the current market firmly in quintile 5. Not surprisingly, what they found is fundamentals do matter. Quintile 1 stocks performed the best and Quintile 5 stocks performed the worst over the next 10-years. While stocks purchased in Quintile 5 averaged a 4.3% return over the subsequent 10-year period, "that forward return number goes down considerably if we are in the top 10% or top 5%, which is where we are today." [3]

Chart 3

Returns by P/E Quintile

P/E Ratio Quintile (1= Lowest, 5= Highest)	Return (Median Annualized Total Return Subsequent 10 Years)
1	15.7%
2	12.9%
3	9.9%
4	7.8%
5	4.3%

Source: Ned Davis Research

Conclusion

Those who claim this time is different are partially correct-the world has never been this awash in debt when multiples were this high. Historically high leverage in the financial system and elevated multiples are just two of the negative side effects of current Fed policy. But as the Fed attempts to unwind its $4.5 trillion balance sheet, it is unclear what impact this may have on future markets and the economy. We simply have no way of knowing since the Fed has never been this active in its 104 year history.

What is clear though is that this financial repression unleashed by central banks has yielded impressive returns on financial assets. But just as we argued a year ago that it was time to buy value stocks as the similarities between 2000 and 2016 were too significant to ignore, we now believe the parallels to other expensive times in market history are not trivial and investors should await a better entry point. At these lofty levels, the opportunity cost is negligible.

We have put our money where our mouths are. Cash levels in our equity accounts currently hover around 50% and the modified duration of our Fixed Income Composite is down to a mere 1.59 years. Investors may, in fact, make positive returns in equities over the next 10 years if they put money to work at these current levels; however, they need to understand they are doing so with the knowledge that it took 8 years of financial repression to get stocks to current levels. What will be the encore to get stocks to the next level? The current rally is steeped in the hope that the Republican victories last November in both the Executive and Legislative branches of government would represent a cohesive coalition for rapid economic change. But so far, what we see is a political party as disjointed as any since the Adams Administration and the Federalist Party in 1800.

At some point, valuations will matter again and there will be a reversion to the mean. When this happens, how will this period of time be remembered?

Sincerely,

Chris L. Doucet

Chris L. Doucet, CEO

Firm News

Doucet Asset Management, through its Broker/Dealer, Institutional Securities Corp., acted as the Sole Selling Group on a $5.7 million asset-backed deal backed by a fixed annual assessment tax on property located in Phase 11 of the successful Castle Hills neighborhood of Carrollton, TX. The proceeds were used to repay the developer, Bright Realty, LLC, for public infrastructure expenses incurred in the development of the new subdivision which included roads, sidewalks, street lights, water and sewer. The bonds were priced to yield 6% in 10 years with a 6-year average life and 7% in 20-years with a 17-year average life.

Footnotes

[1] CNBC.com, April 2017

[2] AAII Investor Sentiment Survey, April 20, 2017

[3] Ned Davis Digest, Ned Davis Research

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.