DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter
Q1 2018

Fixed Income Strategy
Doucet Value Momentum Portfolio
Doucet Value Income Portfolio
Mutual Fund Strategy

February 2018

The Market's Achilles Heel

"For every action, there is an equal and opposite reaction"
- Newton's Third Law of Motion

In Greek mythology, Achilles is said to have been the greatest Greek warrior of the Trojan War. According to legend, his mother, Thetis, dipped his body into the waters of the River Styx to make him invincible. But when Thetis immersed her infant son into the river, she held onto him by his heel which left that area covered by her finger and her thumb vulnerable. It was in this small opening that the poisonous arrow from the bow of the Trojan warrior, Paris, would find its mark and end the life of the Greek hero.

Like Thetis, the Fed has bathed its baby (the markets) in an ocean of liquidity over the past decade. This has provided a safety net for stocks that has proven to be near impenetrable as multiples and associated prices have been propelled to historic heights. But are high stock prices alone enough of an *Achilles Heel* to end this aged bull market?

Tragedy or Legend?

It is safe to say there are as many opinions on the market as there are Greek gods! Famed investor Jeremy Grantham said in his recent newsletter, "we can be as certain as we ever get in stock market analysis that the current price is exceptionally high" with most multiples being eclipsed only by some highs set in 1929 and 1999. Equity values have gotten so high that it prompted David Eihorn of Greenlight Capital in his most recent newsletter to ask, "What if equity value has nothing to do with current or future profits and instead is derived from a company's ability to be disruptive, to provide social change, or to advance new beneficial technologies, even when doing so results in current and future economic loss?" Despite already elevated numbers, equities showed signs of a "melt-up" driven by a stampede of investors with a fear of missing out on any possible future returns. It became such a popular sentiment that Bridgewater Associates founder, Ray Dalio, stated recently at the World Economic forum in Davos, Switzerland that "if you're holding cash, you're going to feel pretty stupid." Economic "growth is good" and "inflation isn't a problem." But Jim Paulsen with Leuthold Weeden Capital Management has a different view. "A weak U.S. Dollar in a fully employed economy with rising inflation overtones combined with still very low bond yields and high P/E ratios is probably not a good cocktail for the financial markets."

S&P 500 Date	1/1/2018	1/1/2008	1/1/2000
Price/Earnings	21.77	17.45	28.16
Price/Book Value	3.27	2.77	4.64
EV/Sales	2.55	2.44	2.79
EV/EBIT	19.27	18.79	22.67
EV/EBITDA	13.27	10.66	13.15
Dividend Yield	1.89	1.93	1.3
			Source: Bloomber Data

Rising interest rates are generally negative for the financial markets because value investors will often discount the free cash flow of a company based on the 'risk-free' rate to assess how much a company, a stock or a cash-flow producing property is worth.
An overly simplistic view is financial assets should trade at a much higher level if the 10-year Treasury yields 1.5% versus 3% all other things being equal.

So who is right? If Mr. Paulsen is correct, the markets are long overdue for a series of price adjustments including a rise in interest rates. And there has been no better backdrop since the beginning of the Great Recession than today for an interest rate phoenix to rise from the ashes of artificially low yields. Signs of higher rates abound. From the current cycle of the synchronized global recovery to signs of wage inflation in the US to central banks worldwide either tightening or taking their

collective feet off of the liquidity accelerator. There is enough evidence out there that the old market mantra "lower for longer" might not be applicable anymore.

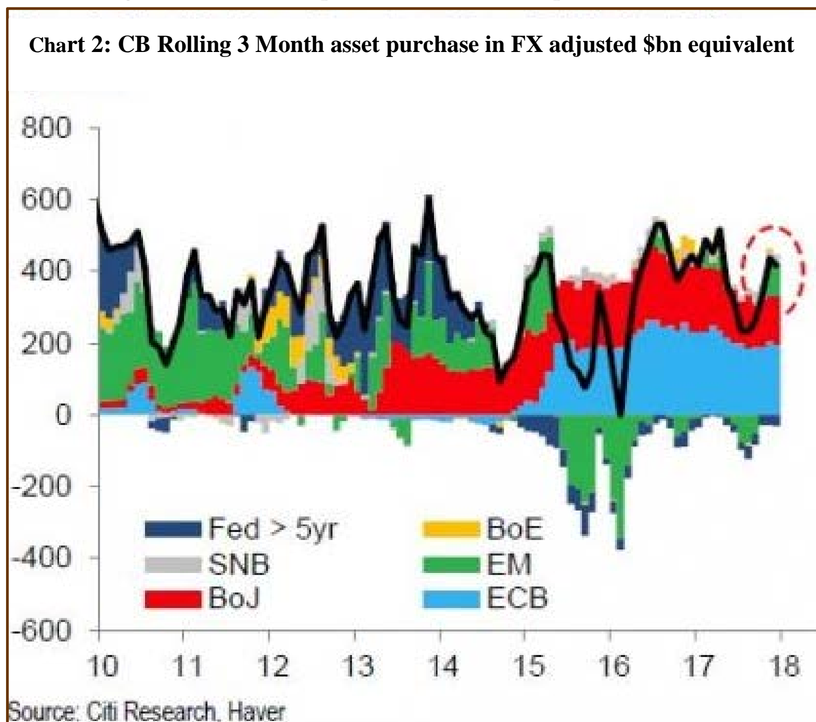
QE is the New River Styx

As Chart 1 indicates, markets rose dramatically when the alphabet soup of Fed action began in 2008 (ZIRP, NIRP, QE, Twist). As Fed assets grew in size, investors were forced out on the risk curve and away from safe haven assets. Stock values rose through a combination of modest earnings increases and multiple expansions. Central bank action around the world drove down nominal yields, but they also had a draconian impact on real yields (nominal yields less inflation). From the beginning of 1998 through the end of 2006, yields on the 10-year Treasury averaged about 295 basis points above inflation. Since then, the average is a mere 41 basis points[1]. But as long as confidence in central banks continue to exist and policies of the recent past do not change, risk assets will remain in vogue, bonds will continue to trade in a tight yield range, and volatility can remain at a 50-year low.

Who Took the Place of Zeus?

Both markets and real yields in the US might have begun to normalize in 2015, but other central banks stepped up their buying. The Bank of Japan (BOJ), the European Central Bank (ECB), the People's Bank of China (PBOC), and others picked up where the Fed left off. As seen in Chart 2, foreign central banks have purchased a combined total of about $500 billion per quarter in additional assets since 2015 thus prolonging any normalization process in asset pricing. Since the Shanghai Accord in February, 2016, the PBOC has unleashed a torrent of buying and, coincidentally, the S&P 500 has been up a startling 22 out of the last 23 months[1].

Chart 2: CB Rolling 3 Month asset purchase in FX adjusted $bn equivalent



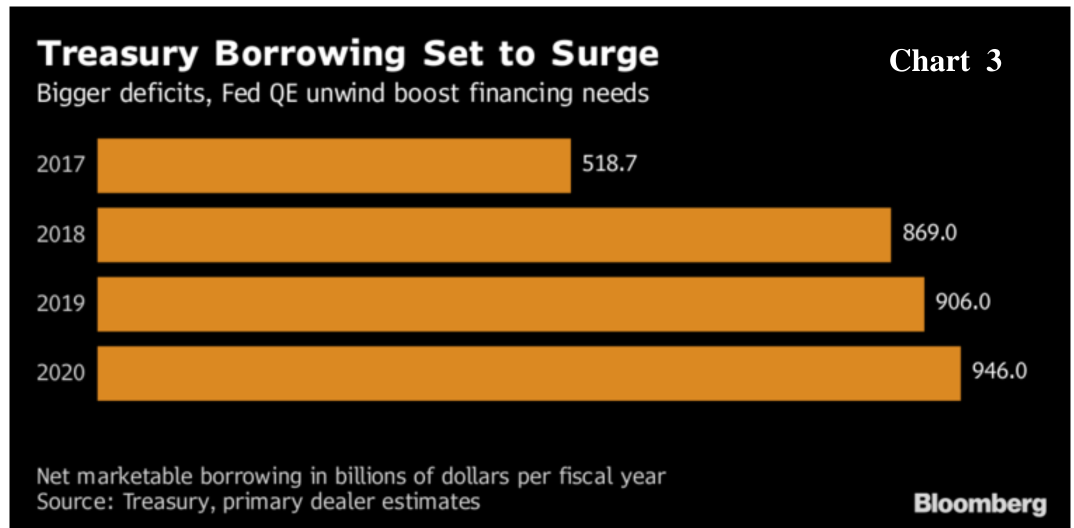
Source: Citi Research, Haver

As 2018 progresses, central banks, including the Fed, are expected to significantly curtail their asset purchases and reach a neutral buying level by year end. Financial experts and market pundits alike believe a "beautiful deleveraging" is expected to be accomplished by the Fed simply *not* reinvesting principal maturities and interest back into their portfolio. In theory, because it will happen in such a slow deliberate fashion, markets will continue to rise during this

period. In reality, this goldilocks scenario may be more of a challenge as the needs of the Treasury will increase and the primary buyers of the last decade are expected to fade.

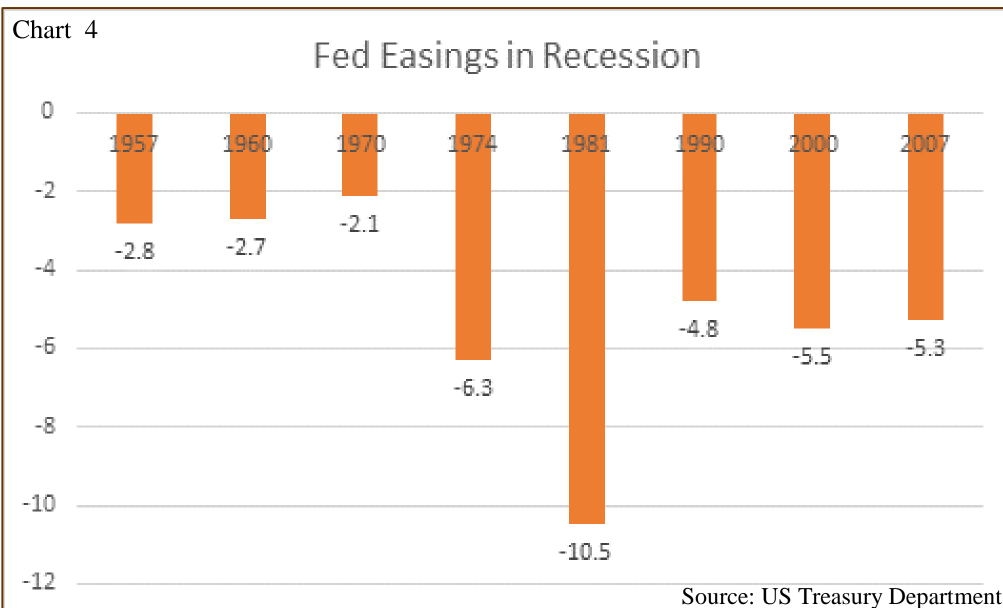
When Will Debt Become a Four Letter Word…Again?

Earlier this year, the US Treasury unveiled a larger issuance of debt for the first time since 2009. In 2017, the Treasury came to market with $518 billion of securities; in 2018, that amount is expected to increase by 67% to $869 billion due to an increase in deficit spending and maturities which need to be rolled over. As Chart 3 illustrates, the demands the Treasury will put on the market are expected to increase every year into the foreseeable future. The timing of these increased capital requirements could not have come at a worse time. The Fed is raising rates, inflationary fears are surfacing, the Fed will no longer be the "buyer of first resort" and there are now talks of a new $1.5 trillion infrastructure plan coming to Capitol Hill which almost certainly will not be revenue neutral. All of these will provide significant headwinds for already stretched markets in the short term.



Conclusion-Ambrosia of the Markets Disappear

As a practical matter, there is only so much inflation expectations in the US can add to interest rates. The economy provides a natural ceiling for rates. If they go up to fast, the markets falter and investors crowd into bonds for safety. And while the "natural rate" on the 10-year treasury is closer to 4% than 3% based on the current rate of inflation, the markets would not be able to withstand this dramatic of a shock if rates were to rise quickly. However, as the proverbial "punch bowl" is taken away from the markets, yields will rise and asset prices will have to adjust to the new reality. It is at this point that investors will start to focus on larger issues which will negatively impact economic growth in the future. According to Trading Economics.com, the US Gross Federal Debt to GDP now stands at 106.1%, its highest level since immediately following World War II. This level represents a 75% increase since the beginning of the Great Recession. Two questions which will be asked frequently when rates do finally break out of their current trading pattern are how much permanent damage will result from the Fed's easy money policies of the past decade and how much ammo will the Fed have to combat the next economic crisis?

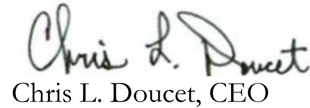


Former senior US Treasury Department official, Larry Summers, produced an interesting chart recently when he suggested the Fed has reduced interest rates by about 500 basis points or more during the past 5 recessions. At an effective Fed Funds rate of about 1.4% and short terms rates in both Japan and Europe firmly negative, it is questionable how effective monetary policy can be

in the future to say the least.

Even small increases in interest rates will cause a market trading at 22 times trailing-twelve-earnings to become much more volatile. The upside is buying opportunities, that do not exist today, will appear. Some experts suggest the psychological level where fear grips the market and panic ensues is 3% on the 10-year Treasury. Whatever that level is, the forces that gave the markets their strength in the past are the same powers that will prove to be their *Achilles Heel* in the future.

Sincerely,



Chris L. Doucet, CEO

Footnotes

[1] *Bloomberg, US Inflation Adjusted Yield Curve*

[2] *Zero Hedge, "Citi Reveals The Reason Behind the Market's Melt up", January 14, 2018*

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- 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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