DOUCET ASSET MANAGEMENT, LLC
Fixed Income Quarterly
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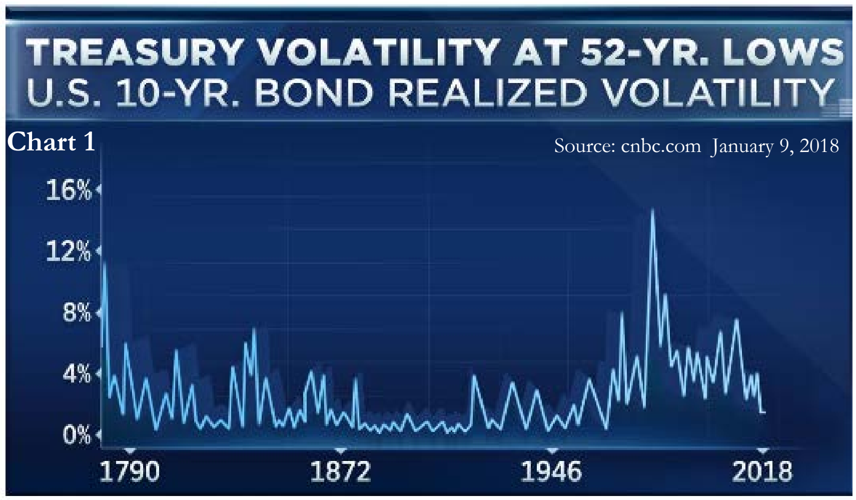
The Year Fear Died (in Bonds)

"History does not repeat itself, but it rhymes"

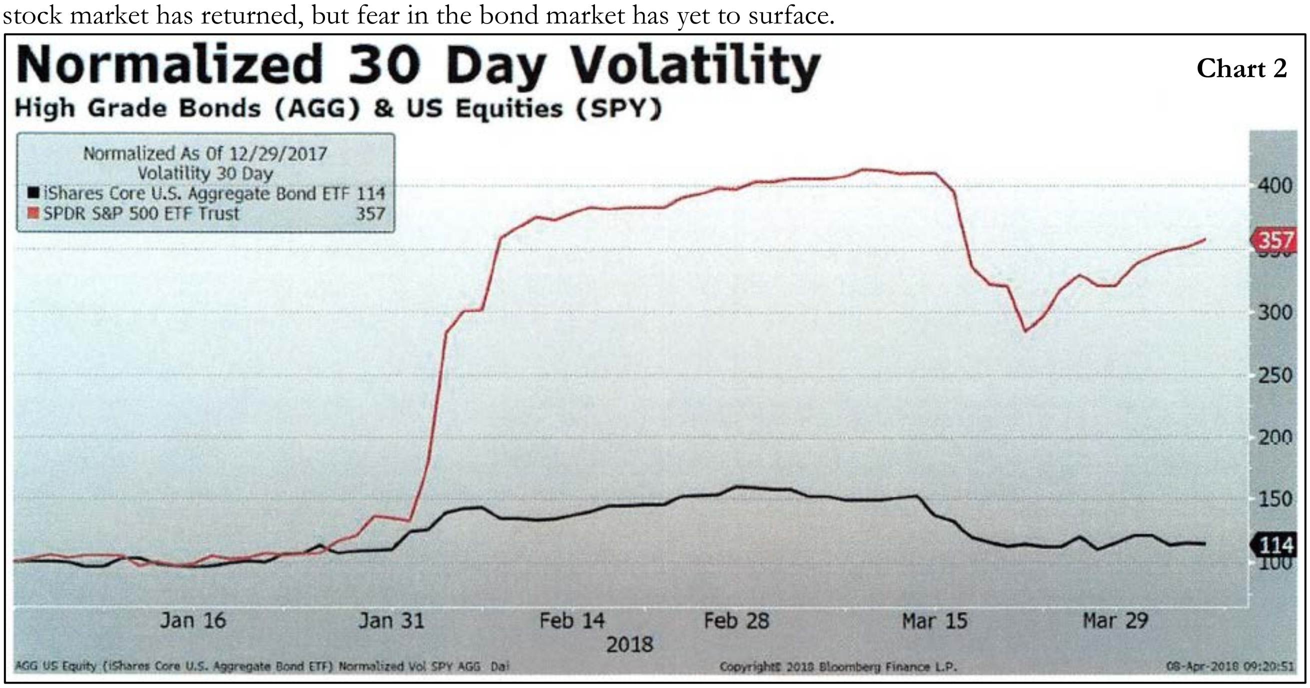
- Mark Twain

The year 1966 is most remembered for events and movements like the Vietnam War, Lyndon Johnson's 'Great Society' initiatives, the start of the Star Trek series and miniskirts. From an economic perspective, 1966 began much like 2018. The stock market performed well the previous year, unemployment was low yet wage growth was tepid, and volatility in the bond market was virtually non-existent. However, what economic historians remember about 1966 is not what happened in 1966, but what happened in the 15-years that *followed.* Inflation in the US rose to heights only matched by the hyper-inflationary days of the post-Revolutionary War era, unemployment soared, and stock returns for the Dow were flat for the period. Could 2018 be the next 1966?

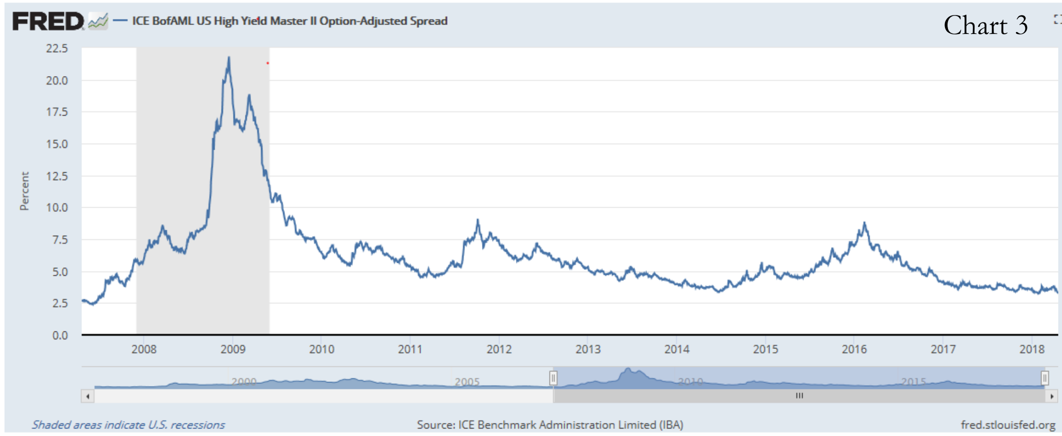


One Of These Things Is Not Like the Other

According to CNBC, volatility or the "fear gauge" in the 10-year Treasury market recently fell to complacency levels not seen since 1966[1]. Volatility in the equity markets, as measured by the VIX, hit an all-time low in November[2], however, heated trade talks and rising interest rates helped propel the VIX to a 2 ½ year high[3]. As a general rule, when fear is high in the stock market, both stocks and other risk assets decline in value. As seen in Chart 2, volatility in the stock market has returned, but fear in the bond market has yet to surface.



One Man's Junk Is Another Man's Gold



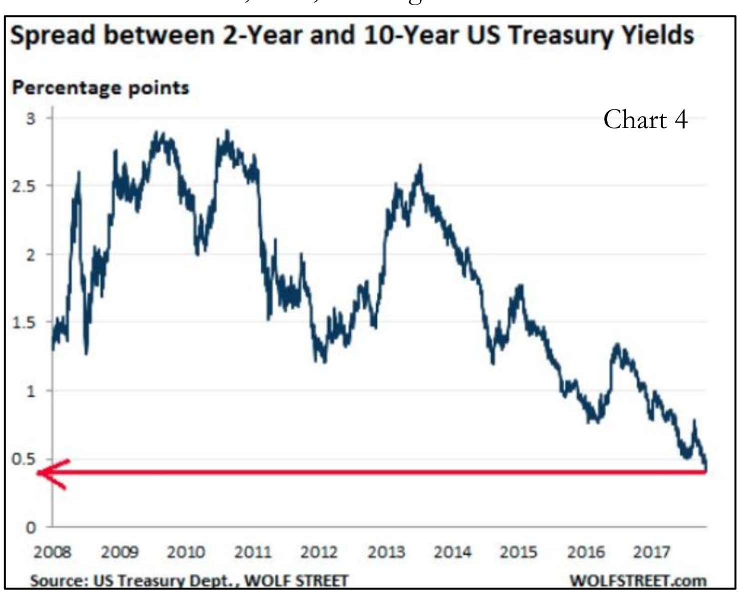
The disconnect in the level of volatility between the stock and bond markets is perhaps most clearly evident in high-yield or junk bonds. Junk bonds are viewed by most investment professionals as stocks with high dividends versus bonds with healthy coupons. So it stands to reason that when there is volatility in the stock market, high-yield bonds will fall in price more than other fixed income asset classes. But that is just not happening. Junk outperformed both Treasuries and high-grade corporates in the first quarter. As a matter of fact, according to Chart 3 produced by the St. Louis Federal Reserve, high-yield bonds have not been this strong versus the U.S. Treasury market since before the Great Recession.

Credit Spreads Are The New Skinny Jeans

The narrowing of spreads across all credit markets and record levels of complacency are signs of confidence in the economy. This, in part, has been aided by the belief that the Fed would come to the rescue of the markets at the first sign of trouble. However, one negative side effect of keeping rates too low for too long is government debt has continued to grow on both an absolute basis and as a percentage of GDP when historically it should be shrinking at this point in the economic cycle. As was mentioned in the Q12018 edition of the Doucet Asset Management Quarterly Newsletter, U.S. government debt as a percentage of GDP is now the highest it has been since the immediate aftermath of World War II. Unfortunately, this coincides with the Federal Reserves' desire to now normalize interest rates and reduce its massive balance sheet. All of these ingredients have combined to make the credit markets more susceptible to shocks in the future.

Fed Up On The Tight Wire

The Fed is attempting a nearly impossible balancing act. They have now raised short-term interest rates six times since December, 2015, and its goal is to raise the Federal Funds Target rate several more times over the next two years. However, the economy has not produced an adequate amount of inflation to ensure long bonds would rise at the same pace as short bonds. As a result, the yield curve is flattening. The flattening of the yield curve is generally measured by monitoring the yield differential between the 2 and 10-year Treasury bond. In Wall Street parlance, this variance is referred to as the '2/10 spread.' According to Bloomberg, the bond market recently hit a post Great Recession low spread of 41 basis points and currently stands at about 50 basis points as illustrated in Chart 4. And as the Fed continues to raise interest rates, short-term yields will likely continue to rise faster than long-term rates.



Why does this matter? A flattening yield curve suggests to economists that there is a slowing of economic activity or a reduction of inflation on the horizon. A flatter yield curve is not unusual at this stage of a rate hike cycle and, currently, corporate earnings and other economic indicators do not suggest an economic slowdown or recession is imminent.

Conclusion: What Comes Down Must Go Up

The 10-year Treasury rose 40 basis points in Q12018. This caused most major fixed income indexes to be negative in the first quarter. Fortunately, the Doucet Fixed Income Composite was positive in Q1 and outpaced the Index by 158 basis points. In part, we attribute this outperformance to fact that the modified duration in the composite was only 28% of that of the Index. Likewise, this short average life positioning also help the composite outperform the Index by 0.43 basis points.

Doucet Asset Management FI Strategy Composite Performance					
	YTD	2017	2016	2015	Since Inception
Doucet Fixed Income Composite	0.12%	3.89%	10.64%	0.73%	3.77%
Barclays US Aggregate Bond	-1.46%	3.54%	2.65%	0.55%	2.24%
+/- Benchmark	1.58%	0.35%	7.99%	0.18%	1.53%
*Performance calculated by Morningstar Office, periods over 1 year are annualized					

So what does all of this mean?

The next 10 years in the bond market will probably not resemble the past 10 years. Think about what has happened in the fixed income markets since the beginning of Quantitative Easing (QE) and expect the mirror opposite in the era of Quantitative Tightening (QT). While U.S. Treasury yields currently have an upward momentum bias (a rise in yields equals a decline in price), a flattening yield curve combined with a moderate level of inflation should help keep Treasury yields range bound. However, when a more normalized level of volatility returns to the credit market more attractive opportunities in risk assets should emerge.

So how are we investing fixed income dollars in this environment?

The short answer is cautiously! Our approach to managing fixed income assets over the past 2 ½ years has been much like it was in periods such as the 1993 to 1996 and the 2015 to 2016 markets, and to a lesser extent, much like in the 2007-2009 timeframe. Bond market machinations guide our investment decisions. Recently, they have forced us to weight portfolios heavily to the short end of the curve and into higher grade paper. Similar to late 2015, the lack of volatility in the bond market coupled with the narrowing of credit spreads have dictated what we have had to do to keep portfolios safe. This defensive posture helped keep portfolios fairly stable when volatility spiked in credit in the early part of 2016. As a result of the high level of liquidity in our portfolios, we were able to take advantage of numerous dislocations in the market which ultimately helped us outperform the Index that year. We believe we are witnessing a similar setup in the fixed income market today. Our hope is we will reap the benefits of having a 1.76 year average duration in our portfolios when volatility returns and the negative repercussions of Quantitative Tightening become more evident.

Doucet Asset Management Fixed Income Composite Characteristics					
	Portfolio	Benchmark	+/-	% of Benchmark	Target
Workout Date	10.30	8.28	*2.02*	124%	65%
Coupon Rate	4.93	3.08	*1.85*	160%	>100%
Modified Duration	1.76	6.20	*-4.44*	28%	65%
Yield to Worst	5.14	3.28	*1.86*	157%	>125%
Yield to Maturity	5.77	3.28	*2.49*	176%	>150%
Current Yield	5.99	3.07	*2.92*	195%	>150%
Convexity	0.23	0.80	*-0.57*	29%	50%
OAS	136.26	31.76	*104.50*	429%	>200%
Rating	A+	AA			
Corporate Debt	10.84%	26.87%	*-16.03%*		25.0%
Government Debt	0.00%	41.93%	*-41.93%*		0.0%
Preferred Shares	14.36%	0.00%	*14.36%*		5.0%
Securitized Debt	6.16%	30.55%	*-24.39%*		10.0%
U.S. Municipal Debt	66.51%	0.66%	*65.85%*		60.0%
Note: Stated Benchmark is Barclays U.S. Agg Bond TR					
Source: All characteristics calculated using Bloomberg Portfolio & Risk Analyitics					

Final Thoughts

It is important to remember that the modern economic world has neither experienced the level of artificial stimulus pumped into the market over the past 10 years nor has it had the burden of this amount of absolute debt so it is hard to know exactly how this chapter in our economic history will end. In 2019, the Treasury will have to fund over a $1 trillion deficit and there are over $600 billion worth of bonds the Fed will not be replacing in its portfolio over the next two years. At some point, the simple laws of supply and demand will take over and this could prove to be a challenging period for all financial assets much like it was in the 15-year period following 1966. To quote the great American writer and humorist, Mark Twain, "History does not repeat itself, but it rhymes." There is nothing new under the sun-the names and events have simply changed. Vietnam has been replaced with skirmishes all throughout the Middle East, Johnson's Great Society has been eclipsed by Trumps "America First" initiatives, Marvel Movies have a similar attraction to video fans as the old Star Trek series, and I am told skinny jeans are as popular now as miniskirts were in the 1960s. Likewise, if the old saying 'don't fight the Fed' holds true, bond yields will rise, credit spreads will widen and an old pattern of Wall Street past will re-emerge.

Sincerely,

Chris Doucet

Footnotes:

[1] cnbc.com *The Bond Market is doing Something it hasn't done in 52 Years*, Bill Baruch, January 9, 2018

[2] Bloomberg terminal

[3] Thompson Reuters, "U.S. stock volatility spikes; short volatility ETPs implode," February 6, 2018

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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