DOUCET ASSET MANAGEMENT, LLC
Fixed Income Quarterly
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The 'Crazy Loco' Fed and the BBB Formula

"The Federal Reserve is in the position of the chaperone who has ordered the punch bowl removed just when the party was really warming up."

- William McChesney Martin, Chairman of the Federal Reserve, 1951-1970

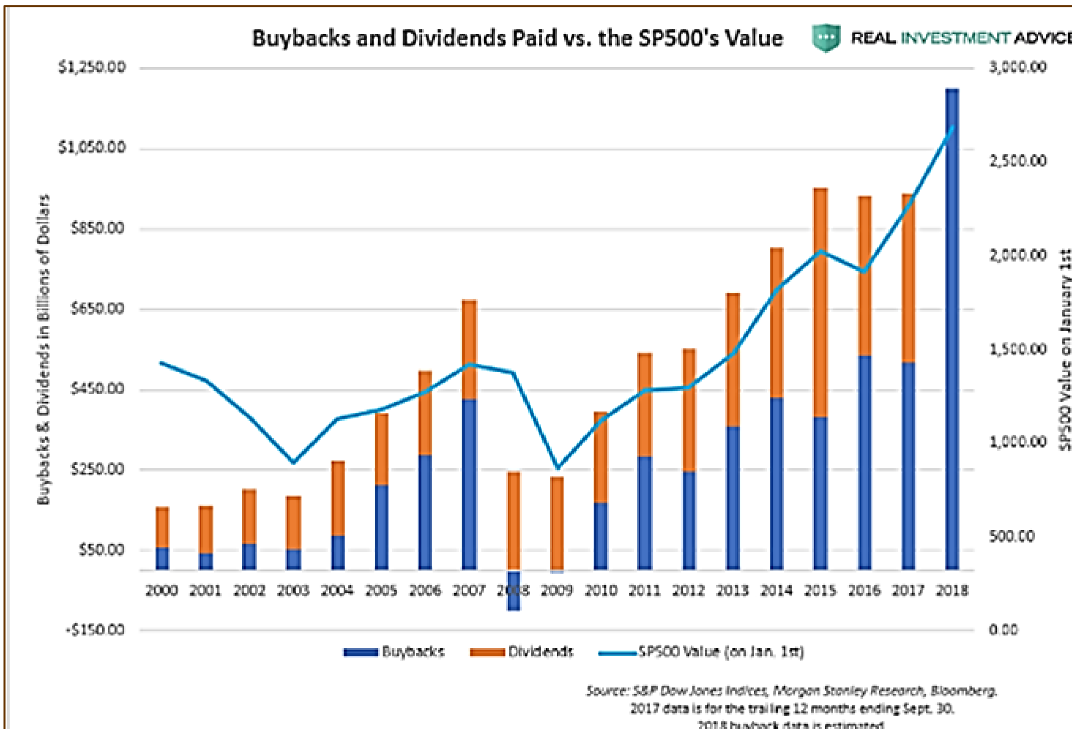
Since the Federal Reserve was created in 1913, some Presidents and their Fed chairmen have had uneasy relationships. Legend has it that Lyndon Johnson physically accosted his Fed Chairman, William McChesney Martin, one December day in 1965 at the LBJ ranch. Nixon kicked out a hawkish Fed chairman for a more dovish one...and got it all on tape. In the summer of 1984, Reagan's Chief of Staff called a meeting with Chairman Paul Volcker and ordered him not to raise rates prior to the Fall election as the President sat quietly next to them. Donald Trump is the latest in a long line of Presidents who displayed disfavor with his Fed chairman as he referred to Jay Powell as "crazy loco" and stated the Fed is *his* "biggest threat."

Sitting Presidents, talk show hosts and CEOs of publicly-traded companies alike are ardent supporters of an accommodative Fed (a Fed that keeps a lid on interest rates). Raise rates or unwind the Fed balance sheet and these same Fed fans become vocal critics. But when the Federal Reserve succumbs to pressure and keeps rates too low for too long, certain negative market behaviors will likely emerge. At least in this respect, this time is *not* different.

The average corporate credit rating of S&P 500 companies has declined from an A to BBB; the complacency level in the bond market recently hit a 52-year high; just two years ago, interest rates fell to a 5,000-year low; and, despite elevated equity valuations, stock buybacks are at their historical apex. These elements have combined to create many new forms of financial engineering including one we call the ***BBB Formula***.

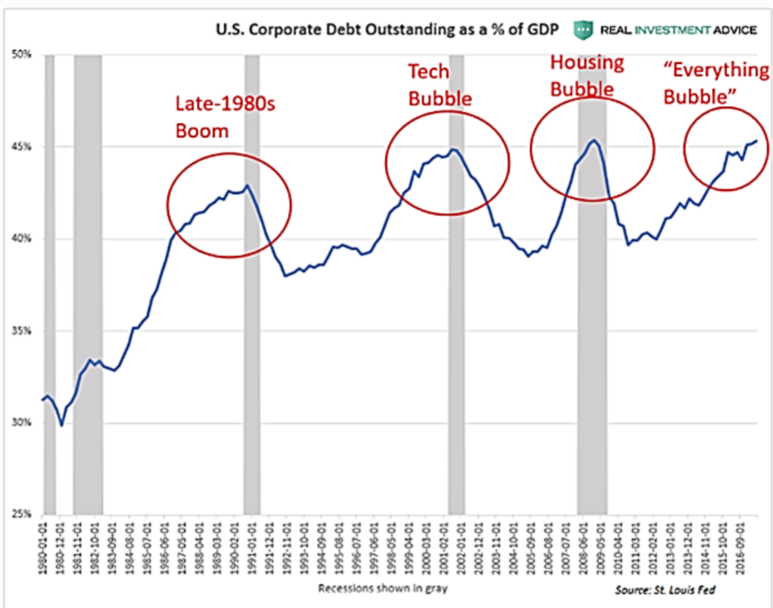
BBB is the New A

The BBB Formula has been employed en masse among large, publicly-traded companies. They simply borrow as much money as they can while maintaining a BBB or better credit rating. Then use these borrowed proceeds, along with corporate profits, to buy back record amounts of



Stock Buybacks REALINVESTMENTADVICE.COM

stock (helping to pump up stock prices and stock options for corporate executives) and pay out record dividends to shareholders. But until corporate profits slump, the widespread use of the BBB Formula will continue.



Corporate Debt As A % of GDP REALINVESTMENTADVICE.COM

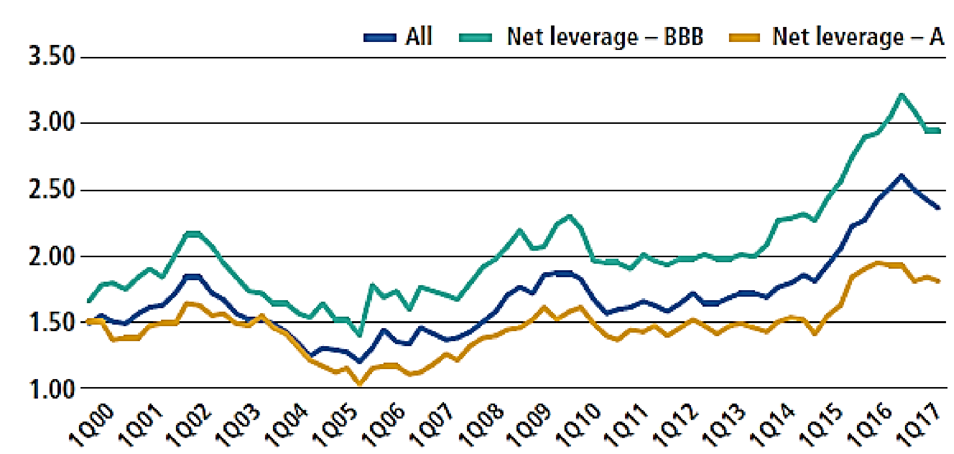
Before the Great Recession, the goal of most S&P 500 companies was to maintain at least an A corporate credit rating to ensure low borrowing costs. But 'zero' interest rates changed the way companies think about debt. Today, companies with BBB credit ratings can borrow at rates well below those A-rated credit yields only 10 years ago. And these ultra-low interest rates have encouraged significantly increased corporate borrowing versus years past. U.S. corporate debt levels have increased 40% from their 2008 peak and are now at an all-time high of 45% of GDP. [1] Both numbers are expected to rise in 2019.

Not Your Dad's BBB Rating

One of the most frightening aspects of this wide acceptance and implementation of the BBB Formula is today's version of a BBB credit is simply not as good as it used to be. According to PIMCO, "back in 2000, net leverage of BBB rated nonfinancial corporates was 1.7x on average; in 2017, net leverage for these companies was 2.9x (net leverage is defined as (total debt-cash-short term investment)/EBITDA). This suggests a greater tolerance from the credit rating agencies for higher leverage."[2]

Some investors might say, "So what?!" As long as cash flows are there to service increased debt levels, investors need not be concerned. Default rates on bonds are currently at among the lowest levels in the past 30 years. However, watch out below if corporate earnings slow, interest rates spike, or there is a sudden rash of credit downgrades. It is also important to note that many pension funds, trusts and mutual funds are *required* to exit positions if a credit rating falls below bank investment grade or BBB. Even a slight *earnings* recession could precipitate a significant liquidity crisis in the future. "In 2016, 18% of low BBB rated companies were downgraded below investment grade and became part of the high yield sector, mainly due to lower commodity prices."[2] You did not have to be a bond trader to understand how illiquid bond markets became in the first two quarters of 2016 because of this small segment of the corporate bond market.

Net leverage in U.S. investment grade credit markets remains high



Source: J.P. Morgan calculations as of 2Q 2017. Net leverage is defined as (total debt – cash – short term investment) / EBITDA.

Meet the New Quarter-Same as the Old Quarter

The third quarter of 2018 was highly supportive of BBB Formula-type behavior and a continuation of the second quarter performance metrics in many respects. The Federal Reserve raised the fed funds rate by another 25 basis points to a range of 2% to 2.25% in September despite angst over an aging bull market and contentious trade negotiations. The yield curve remained flattish at a spread of roughly 25 basis points in yield differential between the 2 and 10-year Treasury bonds. Despite all of these things, credit spreads (the yield differential between Treasuries and other fixed income investments) remained relatively tight. As a general rule, in the second quarter, portfolios with a basket of riskier assets along with shorter maturity profiles produced better returns. The same can be said for the third quarter. The Bloomberg Barclays U.S. Aggregate Bond Index delivered a meager. 0.02% and higher quality bonds (like Treasuries) posted negative returns for the quarter, while junk bonds turned in another stellar quarter.

"Crazy Loco" Changes

We increased the modified duration in the Doucet Fixed Income composite from 1.1 to 2.1 while maintaining the same A+ average credit rating to take advantage of higher interest rates. We expect to incrementally extend out on the yield curve as yields continue to rise, the Fed gets closer to the end of its tightening cycle and credit spread opportunities present themselves when earnings slow (much like we saw in 2016).

Doucet Asset Management Fixed Income Composite Characteristics					
	Portfolio	Benchmark	+/-	% of Benchmark	Target
Maturity (Years)	2.27	8.44	*-6.17*	27%	65%
Coupon Rate	5.10	3.16	*1.95*	162%	>100%
Modified Duration	2.10	6.23	*-4.13*	34%	65%
Yield to Worst	6.41	3.59	*2.82*	179%	>125%
Yield to Maturity	7.11	3.59	*3.52*	198%	>150%
Current Yield	6.50	3.22	*3.28*	202%	>150%
Convexity	0.29	0.79	*-0.50*	37%	50%
OAS	170.74	32.94	*137.80*	518%	>200%
Rating	A	AA			
Note: Stated Benchmark is Bloomberg Barclays Agg Total Return					
Source: All characteristics calculated using Bloomberg Portfolio & Risk Analytics					

Unfortunately, we still find several reasons to be cautious on the markets. But what alarms us the most is the fact that the U.S. has nine years of an economic expansion under its belt and both deficit spending and the national debt continue to *accelerate*. Historically, this is the point in the economic cycle where both should be *declining*. According to the Congressional Budget Office (CBO), the U.S. had deficit government spending of $833 billion in fiscal year 2018 (ends September 30th) or an increase of 18% over last year. Perhaps more problematic is U.S. debt has risen over 100% since the beginning of the Great Recession. Both are expected to continue their precipitous rise in 2019.

The Federal Reserve minutes suggest there will be one more rate hike in 2018 and perhaps three in 2019. We believe the current Fed tightening cycle is nearing its end. We expect corporate earnings to soften a bit in the early part of 2019 and the Fed to take a more dovish stance on interest rates as a result. Given this scenario, we like how our model is positioned from both a credit and a modified duration perspective. This positioning should give us both the opportunity to capture yield through a slight rise in rates and future credit widening events. Mid-term elections, an expected rate hike in December, and the potential of an escalating

Doucet Asset Management FI Strategy Composite Performance					
	YTD	2017	2016	2015	Since Inception
Doucet Fixed Income Composite	2.71%	3.89%	10.64%	0.73%	4.47%
Barclays US Aggregate Bond	-1.60%	3.54%	2.65%	0.55%	1.59%
+/- Benchmark	4.31%	0.35%	7.99%	0.18%	2.88%
*Performance calculated by Morningstar Office, periods over 1 year are annualized					

trade war between the U.S. and China should keep volatility in the market elevated and hopefully create near-term opportunities along the way. In the interim, if the economy hiccups and the BBB Formula begins to unravel, we feel certain we will see the ghost of LBJ channeled through negative tweets from President Trump.

Sincerely,

Chris L. Doucet

Footnotes:

[1] Jesse Colombo, *The U.S. Is Experiencing A Dangerous Corporate Debt Bubble,* Forbes, August 29, 2018

[2] Jelle Brons, Lillian Lin, *Investment Grade Credit: Be Actively Aware of BBB Bonds*, PIMCO Insights, January 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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