DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter
Q1 2019
Fixed Income Strategy
Doucet Value Momentum Portfolio
Doucet Value Income Portfolio
Mutual Fund Strategy

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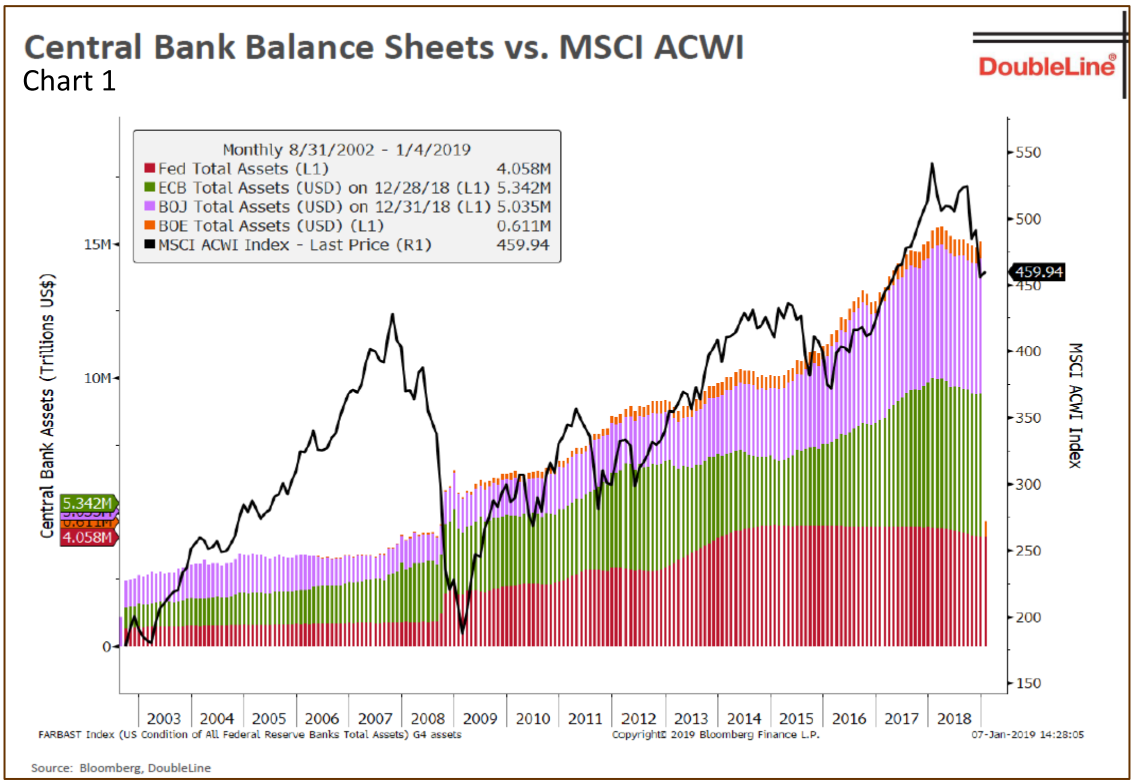
The Old Union Playbook and the Quest for Silver Bullets

"Wars are fought with silver bullets."
-Chinese Proverb

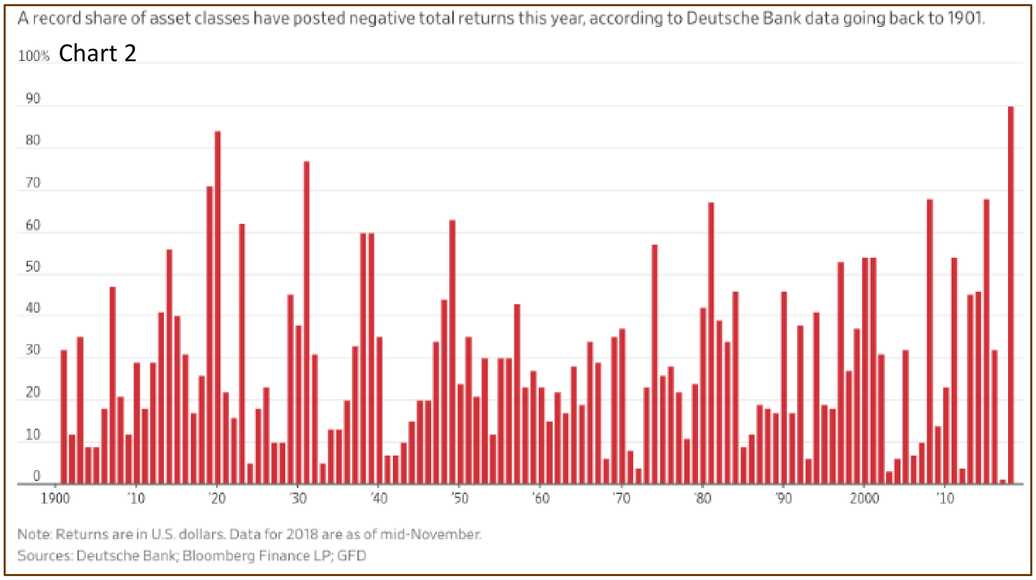
During the Civil War, the Union passed two pieces of legislation known collectively as the *National Banking Act*. New regulations associated with these laws drove state bank notes into extinction (the main source of paper currency at the time), forced banks to acquire a national charter, and required them to collateralize their notes, dollar-for-dollar, with US Government securities. The Act resulted in massive demand (and corresponding issuance) for US Government securities. By the time the war ended, inflation had risen by a cumulative 80%. However, thanks to the Act, inflation moderated the last couple of years of the war. In stark contrast, inflation in the South grew a whopping 5,725%. The Union had decisively won the war of 'silver bullets.'



At the beginning of the Great Recession, Congress and the Federal Reserve adopted a plan similar to the old Union playbook to combat the new enemy, deflation. Congress quietly passed legislation to allow the Fed to pay interest on reserves they held in the system. This small legal change would have an enormous impact on markets over the next ten years. It made it easier for the Fed to borrow aggressively from the commercial banking system. This 'free money' was used, in turn, to create asset inflation and significantly bolster bank reserves with the purchase of massive amounts of both mortgage-backed and Treasury securities. Not coincidently, as Chart 1 suggests, there has been a direct correlation between growth in Central Bank balance sheets and world stock markets. The Fed's balance sheet ballooned from $900 billion to $4.5 trillion, US Government debt more than doubled to over $21 billion, and the Dow was up over 300% from the March, 2009 lows. Deflation was defeated and the interest rate on US debt was actually cut in half.

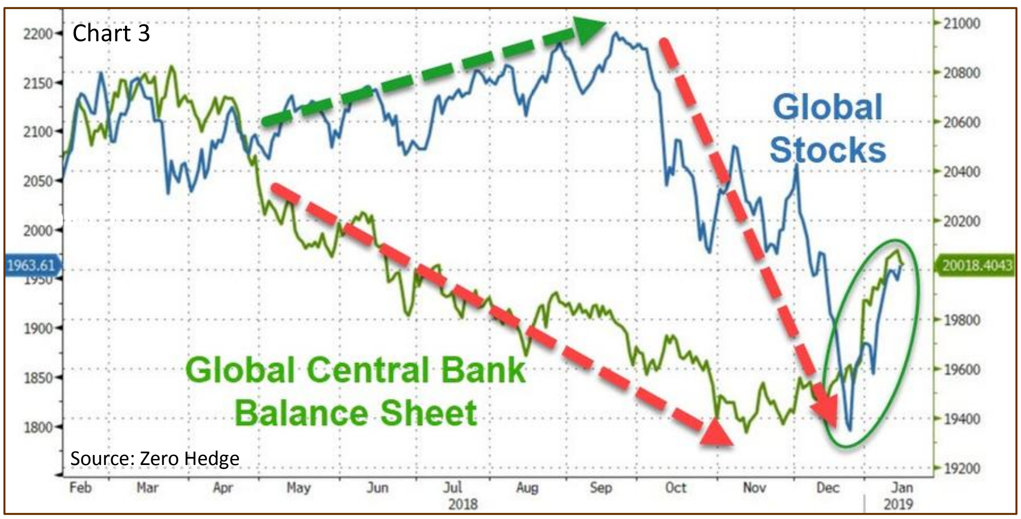
Unwinding is Hard to Do

Congress and the Fed realized very quickly how difficult the implementation of the Union plan would be, but now they are probably asking themselves if unwinding the same playbook is even possible. Between 1865 and 1900, GNP in the US increased 600% or over 6% compounded annualized, the population doubled, and the US managed to cut their debt by two-thirds thirty years later[1]. Today the Fed has a stated goal of 2% inflation, the US population is growing at less than 1% per annum over the past 10 years according to the US Census Bureau, and budget deficits in the US are…out of control. In the incipient stages of the Fed's attempt to unwind its balance sheet, investors were greeted with elevated market volatility and the worst performance for stocks in the month of December since 1931. By November 15th of last year, world financial markets had performed so poorly, across all asset classes, Deutsche Bank declared 2018 the year "no one made money." The Bank published chart 2 that suggested 90% of the 70 asset classes they tracked posted negative returns in US Dollar terms for the year, the highest share since 1901.



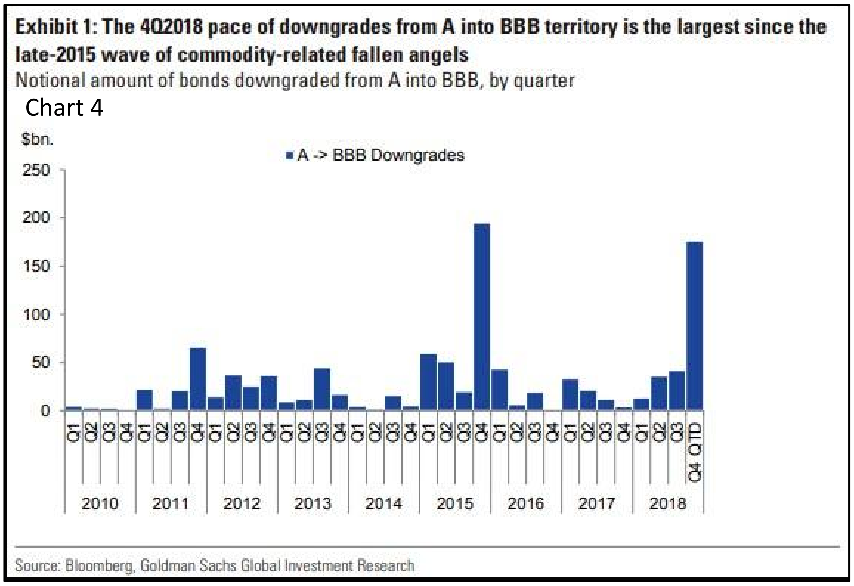
Here Comes the Cavalry

But something happened that caused December's market meltdown to abruptly stop. It was as if a sudden force began "dragging stocks higher, squeezing shorts at an unprecedented pace, and economically irrationally levitating P/Es despite a wall of uncertainty ahead."[2] As it turns out, central banks around the world reversed course. In the past 30 days, they have actually *increased* the assets on their balance sheets by over $500 billion. (See Chart 3) Additionally, Fed Chairman Powell, in a January *kumbaya* panel discussion with former Chairs Yellen and Bernanke, also did a monetary about face. He suggested the Fed is "listening very carefully" to the market and they would be "patient" in their approach to monetary policy, which is Fed speak for temporarily throwing in the normalization towel. Since Christmas Eve, this combination of a dovish Fed and $500 billion in stimulus from central banks around the world helped propel the S&P 500 up about 13% from its December lows and spreads on high yield corporate bonds are now down a whopping 100 basis points from their recent highs according to Bloomberg.



The Ghosts of Recessions Past

December, 2018 gave investors a glimpse of how dependent markets are on central banks machinations and what a herculean task it will be for these institutions to unwind their balance sheets and normalize interest rates. Investors should have also seen this as a cautionary reminder that before the Great Recession, the world economy already had too much debt. Then debt around the world imploded and credit markets froze. And yet today, governments and corporations are much more leveraged in both absolute terms and as a percentage of GDP than they were pre-crisis, which makes the system more fragile today than it was in 2008.



While some investors may be ignoring troubling signals from the debt markets, rating agencies are not. As Chart 4 illustrates, last quarter, the US experienced the largest wave of corporate credit downgrades from an A to a BBB rating since the oil bust in late 2015. If corporate profits continue to soften and US Government debt continues to grow, this downgrade trend will spread across the entire credit spectrum. Few borrowers will be immune. Even the credit rating on US Government debt may be in jeopardy, the Fitch Rating Service suggested recently.

More BBB Formula

At the beginning of the last quarter, we attempted to point out what we believe to be the most glaring example of potentially dangerous financial engineering that has resulted from this historically easy central bank-fueled credit environment. In our Doucet Asset Management Fixed Income Quarterly we coined the phrase 'Triple B Formula.' We describe how corporate America has taken advantage of low interest rates by levering up their balance sheets and engaging in stock buybacks to support their stock prices, even at historically high multiples. This strategy creates a myriad of long-term problems, but as long as profits are sufficient to adequately cover debt service on their bonds this behavior will go largely unnoticed.

The good news for purveyors of the BBB Formula is corporate earnings are still growing. Chart 5 clearly shows that Leading Economic Indicators are comfortably positive even though the rate of growth is clearly softening recently. Additionally, central banks around the world are doing their collective version of a monetary Rebel yell, injecting billions in liquidity in the system and calming nervous markets. Central banks have proven that they stand ready, willing and able to ease monetary policy at a moment's notice, including the Fed. As a matter of fact, Bloomberg's World Interest Rate Probability chart suggests economists surveyed now believe that Fed will not hike rates at all in 2019. More 'free money' could help prolong any significant downturn in the short-term.

The Doucet Asset Management Playbook

From a portfolio perspective, investors are in a tight box. Central banks will attempt to put a floor in on asset prices any time there is market turmoil; however, if markets are strong, they will attempt to normalize monetary policy to attempt to replenish their arsenal of silver bullets. The *slowing* of growth in both corporate earnings and leading economic indicators to continue coupled with rising world debt levels complicate the investment equation and simply create a more risky investment environment. As a result, we expect to exit securities most susceptible to price declines in coming market run-ups. But we would also anticipate keeping a healthy level of liquidity in portfolios in order to take advantage of future opportunities like we saw last month.

It took the United States 219 years to put $10 trillion on its balance sheet and only 10 additional years to add another $10 trillion. This confirms our belief that unwinding the Union playbook will take time. If Congress and the Fed cannot figure out an expedient way to improve the three Ds (debt, demographics and deficit spending), deflation will be the least of their enemies and they may be wanting of silver bullets much like the Confederacy.

Sincerely,

Chris L. Doucet, CEO

Footnotes

[1] *"Business & Industry in the Late 19th Century," February 2010, Northern University*

[2] *Zero Hedge, January 21, 2019, "Is This the Real Reason Why Stocks Are Surging?"*

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.