



January 2016

Say Adios to the Zihuatanejo Market

“The fate of the world economy is now totally dependent on the U.S. economy, which is dependent on the stock market, whose growth is dependent on about 50 stocks, half of which never reported any earnings...”

-Paul Volker, August, 1999

In the movie *Shawshank Redemption*, Tim Robbins plays a character by the name of Andy Dufresne who is serving two life prison terms for a double-murder which he did not commit. While in prison, he dreams of a warm place with “no memory” to where he might escape - the Pacific Coast Mexican Village of Zihuatanejo. Having just experienced its warmest winter in 135 years, perhaps the U.S. hoped that it had found its own warm place with no memory, as P/E multiples for the S&P 500 were comfortably over 20x, even as earnings were beginning to slow. But then a metaphorical blizzard hit the market with a series of icy jabs.

The Fed turned off their monetary spigots and raised interest rates for the first time since the recovery began; oil plummeted to a fresh 12-year low; and overall commodity prices declined to their lowest levels since 1991. The majority of major market indices are now in correction mode (down 10% or more from their highs), and more than half of stocks are firmly in bear territory (down 20% or more from recent highs). For those whose memories have returned, their thoughts may harken back to 1999, when: value investing was dead, commodity prices were weak, unemployment was at a generational low, and value stocks were in bear territory while the S&P 500 was trading at roughly a 29x multiple. Sound familiar? Say goodbye to the Zihuatanejo market and welcome back to 1999.

Value in the Land of the Misfit Toys

Some readers may remember an article I wrote back in 1999, entitled *The Tail That Wags the Dog*. In this piece, I argued that multiples were not sustainable for growth stocks on the upside, and for value stocks on the downside. Much like today, bubbles had formed on both sides. On the one hand, indices were awash with stocks that had little to no earnings, but exciting

growth prospects. Think Tesla. At the other end of the spectrum were dented value stocks, trading at salvage value, that had essentially been banished to the “island of misfit toys”. Ryan Thibodeaux of Goodwood Capital does an excellent job of illustrating some of the similarities between 2000 and 2016 in Chart 1 as he attempts to draw conclusions about future stock action. Could we be witnessing history repeat itself?

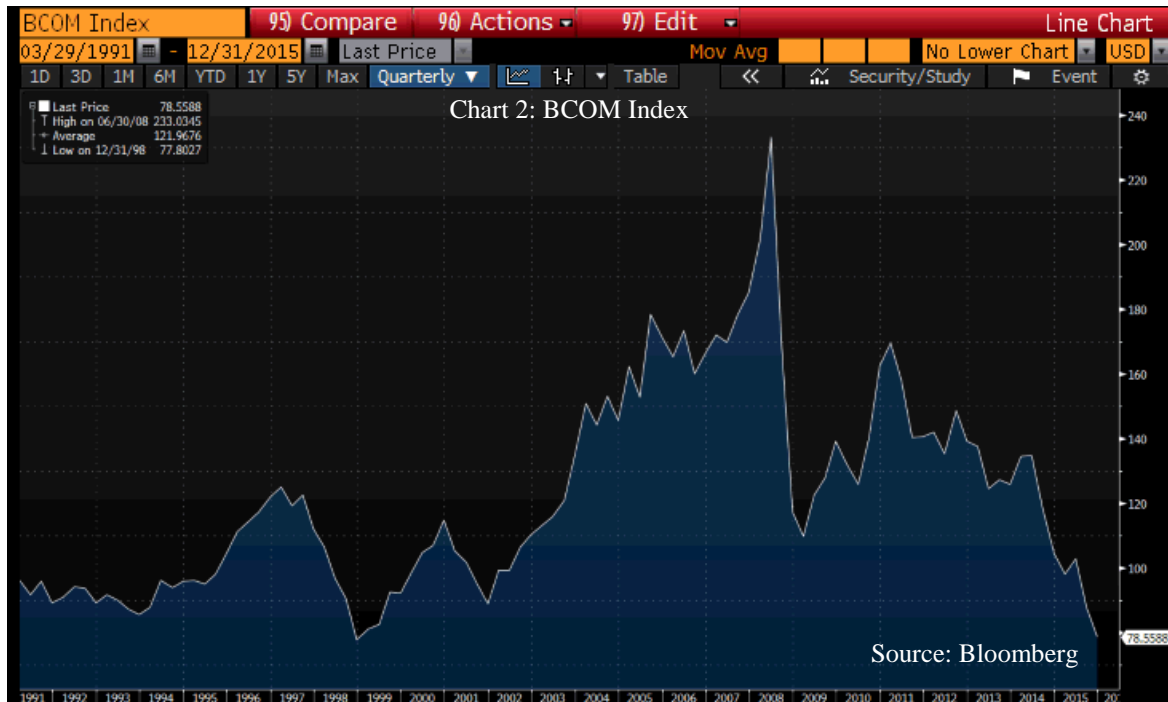
Chart 1

Observations of Interest	Aug 2000	Jan 2016
US Trade Weighted Dollar Index	\$105.74	\$106.57
High Yield CCC or Below Spreads	16.4%	17.5%
High Yield Master II Index Spreads	6.4%	7.5%
10-2 Year Treasury Spread	-0.5%	1.2%
WTI Crude Oil	\$30.00	\$29.65
Wilshire Large Cap Growth - 2 Yr Trailing Return	47.3%	7.09%
Wilshire Small Cap Value - 2 Yr Trailing Return	4.1%	-8.6%
Wilshire Large Cap Growth - 1 Yr Forward Return	-36.3%	??
Wilshire Small Cap Value - 1 Yr Forward Return	17.8%	??

Source: Ryan Thibodeaux, Goodwood Capital

The Big Short in the Commodities Market

Of all the so-called misfit toys, commodity stocks are certainly the most ragged and unloved. Just last week, the Bloomberg Commodity Index hit its lowest level in 25 years. Going back and adjusting the numbers for the impact of inflation paints even a bleaker picture still. In the case of oil, in particular, sentiment has become so negative that some of the very same experts who claimed \$140 oil was sustainable, because of 'peak oil' and the ascendance of the Chinese middle class,



are now saying it is a limitless resource, and that prices will fall to \$15. Both are equally absurd statements.

To truly understand why prices at these levels are not sustainable, it is imperative to understand how prices reached such extremes in the first place. Sure, OPEC played a heavy hand in setting the price of oil, the *commodity*, by controlling supply. There was also, however, a less-visible supply/demand dynamic at play: that for oil the *asset class*.

Some years back, wealthy foundations, such as the Harvard Endowment, began to argue that oil, and commodities in general, should play a role in portfolio asset allocation, a natural hedge against inflation. Ever accommodative, Wall Street stepped into action and created new instruments to capitalize on this demand. If one has seen the movie *The Big Short*, basically just substitute oil for houses and you have the general idea of what happened next; the financial industry more-or-less 'sub-primed' the oil market. Even as the price of the commodity became artificially inflated, demand for the asset class continued to swell, as institutional money managers attempted to replicate the success of the Harvard Endowment, and others. This double-barreled increase in demand for oil, both as a commodity and an asset class, ultimately led to an increase in the supply of both. Technological advancements, such as fracking and horizontal drilling, helped U.S. production to increase from 3.8 million barrels a day in September 2009 to 9.6 million barrels in June 2015².

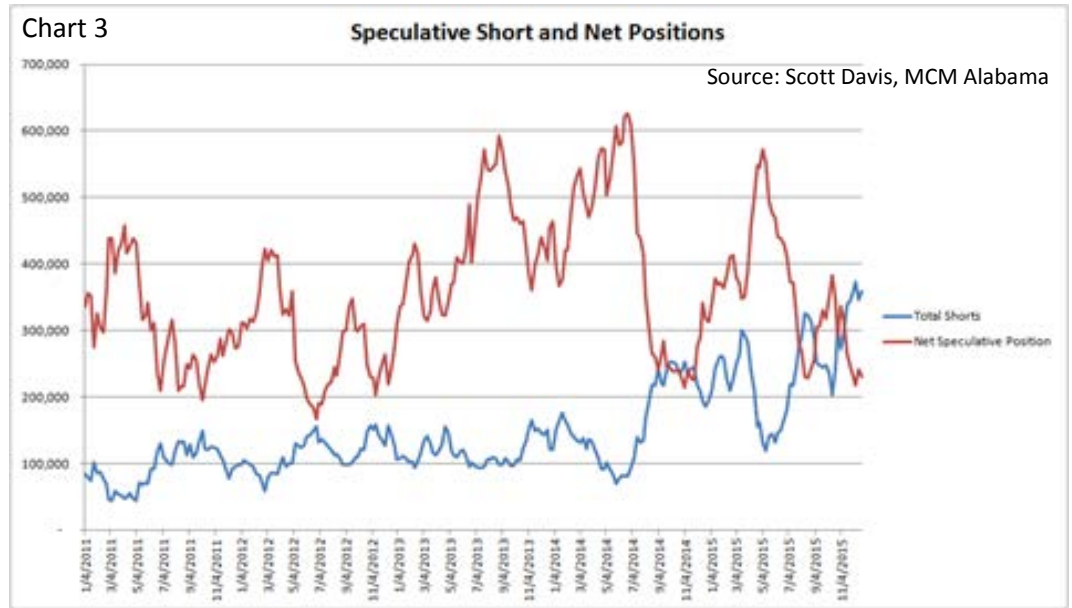
Wall Street to the Rescue?

Just as Wall Street speculators and leveraged financial instruments fueled oil's meteoric rise on the upside, these same forces magnified its decline on the way down. All that was needed was a slight shift in sentiment and a change in the supply/demand equation to set things in motion. Demand stabilized as China slowed; the Saudis and OPEC felt their market share threatened and started pumping full-speed ahead; and the U.S. reached a nuclear deal with Iran that would lift sanctions and bring more Iranian oil supply into the equation. The net effect of it all was an imbalance in the world supply/demand formula, and oil began a freefall from \$100 to \$30 per barrel.

There have only been four times since 1986 that oil prices fell 50% or more. Each time, OPEC responded by making significant production cuts, and shortly afterwards, oil prices recovered. This time has been very different; OPEC has actually increased their production from 26.6 million barrels per day in March, 2009 to a record 32.9 million barrels today. Even as the industry has attempted to adapt to this new reality by slashing cap-ex budgets and shuttering rigs, investors have continued to flee the sector in droves. On top of this, there has been a pile-on effect, as a very large, high-profile oil bull has been forced

to liquidate, causing prices to plummet even more. If that were not enough, speculators seem to smell blood and are actually increasing their short positions at a shocking pace.

Chart 2 illustrates the speculative short and net positions in oil. The blue line is the total speculative short position, which is nearly 360 million barrels of oil. This suggests there are more people betting oil goes lower than those who think it will go higher. Net of the speculative longs are represented by the red line. According to Scott Davis of MCM, a commodities and FX trading firm, “the market is always net long for various reasons, such as ETFs, indices, and then certain investors are always long by rule.” What would happen if the speculative shorts tried to cover a net 360 million barrels? Davis went on to say, “360 million in shorts cannot be covered in any sensible way, especially with the net this low.” Already in the first weeks of 2016, we have witnessed some of the largest oil volume days on record, so much so that it has even been difficult to calculate its closing price in a timely manner!



Whether we see a v-shaped recovery or not (consensus opinion is that we will not), one thing that is for sure is that the exit door is too small for everyone to fit through at one time, should all speculators attempt to cover their shorts simultaneously.

Will History Repeat Itself?

It is important to take a step back and put things in perspective. Any portfolio manager who manages stocks and bonds based on fundamentals will tell you that the past three years have been three of the most frustrating years they have ever witnessed, and that recent market actions actually make a lot more sense. In managing money, one must: look at the events of the day, study the events and outcomes of yesterday, attempt to draw logical conclusions, and allocate accordingly. If history does, in fact, repeat itself again, and we are on the precipice of a 1999-2000 type of market, the following conclusions might be drawn:

- **Oil** - Due to the significant reduction in the rig count and Draconian cuts by oil-and-gas companies, production will likely decline everywhere *except* in the Middle East. However, due to the fact that many Middle Eastern nations fund their extensive social programs through oil revenues, there is a finite degree to which they can play this game of chicken without risking real political unrest. The seeds for a significant reduction in worldwide supply have already been sewn, but certain geopolitical events could speed up this process or slow it down. While trying to pick the bottom in oil is a fool’s errand and tantamount to picking the bottom in financial stocks in 2009, there are certainly many investment professionals getting cash ready to redeploy into the asset class. The bottom will be likely occur when the shorts in oil finally begin to cover.
- **Interest Rates** - The Fed likely waited too long to begin raising interest rates, and may even regret its December decision to increase rates at this point. As a result of the Dollar strength and weakness in oil, corporate profits are expected to be 4.5% lower in 2015 than they were in 2014, when all is said and done. The Fed expects to raise interest rates four times in 2016, and Wall Street expects them to raise twice. However, we would not be surprised to see the Fed reverse course and go so far as to undo the December rate hike.
- **Multiple Normalization** - Logic would dictate that you should not have a 20-plus P/E multiple on the broader market when S&P 500 earnings are falling, but that is exactly what happened. As the market attempts to

normalize multiples, the leaders in 2015 will likely be the market laggards in 2016, just as we experienced in 2000. Large-cap growth stocks will likely come down in value more than the broader market, making index investing more problematic than it has been in the past. Managers will begin to shift allocations away from their expensive assets towards those that are trading as cheaply as they have since 1991, in some cases. With that said, it would be surprising if the market did not shift from a growth-bias to a value-bias once we begin to see stabilization in commodity prices.

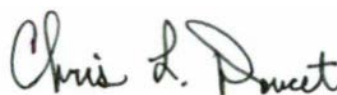
- **Fiscal Stimulus** - Countries, frustrated by the lack of growth emanating from monetary stimulus, will turn to fiscal stimulus in order to help spur growth in their respective economies. It would be easy to conclude that part of their spending will come from infrastructure build, which would benefit commodity-related stocks, and the companies that service those sectors. If this proves true, it is reasonable to expect that value stocks will outperform growth stocks by a fairly substantial margin in the coming months, much like we witnessed in 2000.
- **Economic Slowing** - Domestic troubles right now are financial in nature rather than economic. But, what we have learned over the past year is that lower oil prices can have a stimulative effect on the economy up until a certain point. Once that point is breached and prices go too low for too long, the impact on the overall economy turns negative. If this goes unchecked, financial woes have the potential to turn into deep-seated, economic ones. The world will try to get this under control, if for no other reason, because the decline in oil is having a destructive impact on growth rates around the world. Domestically, the U.S. manufacturing sector is already in a recession, as evidenced by the NY Empire manufacturing numbers which just printed their lowest read since 4Q08³, and the high-yield bond market just experienced its fifth negative year in 2015 since 1980, and each one of those previous negative years corresponded with a recession.

Re-runs Usually End the Same

We have seen this movie before and there is a high likelihood it plays out the same way this time around. There are a plethora of similarities between 2000 and 2016. If they are anything alike, you will find there will be a massive leadership change that will last for a time until market leadership changes once more. The current selling will end once the market feels the excesses in growth stocks have been corrected and the market is priced at a more normalized P/E multiple.

This is both good news and bad, depending on who you ask. On the bad side, it is abundantly clear that the gravy train for high growth stocks without much in the way of earnings has finally run out of track. One can no longer simply lock and load with the broader market indices while the Fed does all the work. In other words, easy money is dead for the time-being. The silver lining is that fundamentals and value investing may soon be back. We think this is a good thing, and have positioned client portfolios for this. Volatility is likely to remain heightened for the time-being as this change in market leadership occurs because the 'Fed put,' which has done a good job snuffing out market volatility over the past few years, is now gone. As a result, this new road will be bumpy at times. We believe commodity-related companies (oil-and-gas companies in particular) will likely see a downgrade cycle by the credit rating agencies in the months to come, but we feel that a lot of this (maybe too much) is already 'in the price'. Commodity company bankruptcies are likely to rise in the short-term, much like banks in the wake of the financial crisis, so investors should keep individual company positions relatively small and portfolios diversified. Even so, while it may sometimes be easier to retreat into one's own warm place with no memory than to relive the days of the Great Recession, one would be wise to remember that investors who bought the banking sector in 2009 have since seen handsome returns. It is just a matter of time before investors finally say goodbye to the Zihuatanejo market of 2015 and say hello to 2000 all over again.

Sincerely,



Chris L. Doucet, CEO

Firm News

As we reach the one year anniversary of Roland's passing, we sincerely thank all of you that have been in touch to let us know he has been in your thoughts.

We are proud to announce the arrival of another Doucet Asset Management team member; Molly Claire Vaughn was born on December 1, 2015. Laura and her family are doing well and we wish them all the best.

Please help me congratulate our own Will Aycock for being elected as Treasurer of the CFA society of Alabama.

Footnotes

- 1 CNBC News Channel Interview with Carter Worth, Cornerstone Macro
- 2 Bloomberg Terminal
- 3 Zacks Research
- 4 Empire State Manufacturing Survey, Federal Reserve Bank of New York

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.
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