



The 2nd quarter was a very good one for the Doucet Asset Management Fixed Income Strategy Composite, which returned 5.44% and bested both its benchmark (the Barclays Agg) by 323 bp and the S&P 500 by 298 bp. Thanks in large part to an overweight in energy corporates and a non-traditional allocation to preferreds and REIT private-placements, the Composite significantly outpaced the Barclays Agg despite the fact that its modified duration was only 32% of the benchmark and it had a 0% allocation to government debt. This is especially noteworthy considering that the two best performing Morningstar fixed income categories were the Long-Term Bond and Long-Government Bond categories, each gaining nearly 6%¹. To be fair, our strategy did substitute some credit and illiquidity risk for interest rate and macroeconomic risk relative to the Agg; however, with an option-adjusted spread (OAS) of more than 5.5x the benchmark and a still-solid investment-grade rating of BBB+, this was a metered approach. Of course, a single quarter is a small sample size and performance cannot be extrapolated forward; nonetheless, this brings our year-to-date performance to 7.52% compared to 5.31% for the Agg and sets the Composite up well going into the second half of the year.

Figure 1: Doucet Asset Management FI Strategy Composite Performance

	YTD	2Q16	1Q16	2015	Since Inception
Doucet Fixed Income Composite	7.52%	5.44%	2.18%	0.79%	4.70%
<u>Barclays US Aggregate Bond</u>	<u>5.31%</u>	<u>2.21%</u>	<u>3.03%</u>	<u>0.55%</u>	<u>3.90%</u>
+/- Benchmark	2.21%	3.23%	-0.85%	0.24%	0.80%

*Performance calculated by Morningstar Office, periods over 1 year are annualized

Do not for a second let the green across indices and our Composite deceive you into believing that it was all smooth sailing. If anything,

the 2nd quarter of 2016 will be remembered for rampant volatility and a series of macroeconomic shocks. Amazingly, in a mere three month period, oil was up 21%, the municipal market witnessed its largest default in history with Puerto Rico, Labor Department payrolls data soured, and Federal Reserve expectations for the remainder of the year went from conviction about multiple hikes to fear of cuts. And then there was Brexit.

In many ways, Brexit was the perfect storm of a macroeconomic shock. It was one part Lehman and another part Y2K. It was in the news for months with the ‘Leave’ and ‘Remain’ camps polling neck-and-neck, yet it caught markets completely by surprise. Its ramifications were global, affecting: currencies, interest rates, equity markets, commodities, central bank policy, and even ruling parties and upcoming elections. It spurred a flight-to-safety that left more than \$10 trillion of sovereign debt in negative territory, according to the *Financial Times*, and pushed longer-dated U.S. Treasury yields to new all-time lows.

Systemically speaking, Brexit was and is a big deal. Such a big deal, in fact, that in its wake, Morgan Stanley economists upped their probability of a global recession over the next 12 months to 40%² and all three of the major ratings agencies took action against the U.K.’s credit rating and/or outlook. Under a best case scenario, the referendum result would likely knock a point or so off of growth within the U.K. and European Union, causing a massive headache for member countries and markets, alike. If this were not bad enough, the real fear is that it could spell the beginning of the end for the EU as we know it.

While we have been down this road before to a certain extent with the *PIGS* (especially with Greece), the threat of an EU break-up led by the stronger countries is a scarier prospect. In a June 30th publication titled *It’s not me, it’s EU*, Morningstar summarized this event risk well by stating: “A break up of the EU, including the common currency, would be catastrophic for the weaker member states in particular. This is due to the increased risk of debt defaults that would likely play out – particularly without the support of the stronger countries and the European Central Bank. Should this scenario eventuate, we would likely have another financial crisis on our hands.”³

To be clear, this is a worst case scenario and far from being a certainty. Still, with a global wave of nationalism that has not been seen in generations and Dutch, French, and German elections coming up within the next year, one must at least acknowledge that it is a possibility. As a parting thought on the matter, consider this statement from the same Morningstar publication referenced above, “A recent survey for Pew Research found that in France, a founding member and long-time supporter of the EU, only 38% of people still hold a favourable view of the organisation, six points lower than in the U.K.”⁴

Bond Markets At-a-Glance

Figure 3: Index Returns

	2Q16	YTD
Broad Market Equity Indexes		
DJIA	2.07%	4.31%
S&P 500	2.46%	3.84%
Broad Market Bond Indexes		
Barclays US Aggregate Bond	2.21%	5.31%
Bank of America Merrill High Yield	5.88%	9.32%
Morningstar Core Bond	2.20%	5.33%
Morningstar Short-Term Core Bond	0.82%	2.12%
Morningstar Intermediate Core Bond	1.48%	4.12%
Morningstar Long-Term Core Bond	5.21%	11.73%
Bond Indexes by Sector		
Morningstar Corporate Bond	3.40%	7.41%
Morningstar US Govt Bond	2.10%	5.31%
Morningstar Mortgage Bond	1.19%	3.43%
Morningstar TIPS	1.72%	6.31%
Barclays Municipal	2.61%	4.33%

*Source: Morningstar

Similar to the 1st quarter, the 2nd quarter was a good one for bonds, with most domestic sectors and spots on the curve experiencing healthy returns. Once again, the curve flattened (to the tune of 17 bp for the 2-30 Treasury curve) and the long-end significantly outperformed both the short-and-intermediate parts of the curve. The Morningstar Long-Term Core Bond, Intermediate Core Bond, and Short-Term Core Bond indices returned 5.21%, 1.48%, and .82%, respectively. Credit (investment-grade and high-yield) was a bright spot, with both the Morningstar Corporate Bond and Bank of America Merrill High Yield Master II indices beating the Barclays Agg and returning 3.40% and 5.88%, respectively. Municipals also outperformed the broader fixed income market, as the Barclays Municipal index returned 2.61%. Broadly speaking, it was a fairly tepid quarter for MBS and structured product. The Morningstar Mortgage Bond index lagged the Agg, but still posted a positive 1.19% return for the quarter.

In credit, high-yield was the market leader thanks to a continued rally in commodity-sensitive names. Within the high-yield space, the price of oil, in particular, continues to be major factor and runs at an uncanny correlation to the sector as a whole. So strong has the correlation been, that according to Morningstar, “Not so coincidentally, the widest credit spreads reached in the index earlier this year is exactly the same date that West Texas Intermediate (WTI) bottomed at \$26.16 per barrel.”⁵ We could see this relationship dissipating somewhat if oil was to break out on the upside from here; however, we anticipate this phenomenon holding as long as oil remains range-bound or depressed.

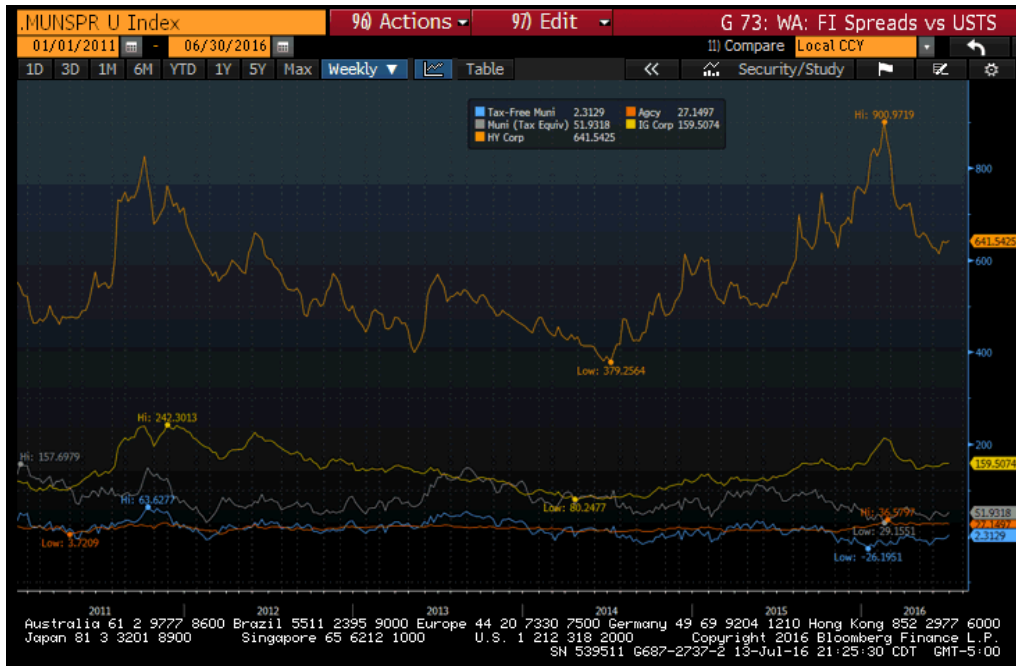
Both high-yield and investment-grade spreads narrowed on the quarter. High-yield spreads came in 76 bp to finish at 642 bp, while investment-grade spreads narrowed 5 bp to finish at 159 bp. According to Morningstar, the three best performing corporate sectors on an OAS basis year-to-date have been: Basic Industries (-134.1 bp), Gas Pipelines (-98.3 bp), and Energy (-40.2 bp). The worst performers have been: Banks (+17 bp), Insurance (+12.3 bp), and REITs (+8.7 bp). As of quarter-end, the three cheapest sectors are: Gas Pipelines (283.9 bp), Basic

Figure 3: High-Yield Correlation with Oil



Industries (236.4 bp), and Energy (208.4 bp).⁵

Figure 4: Fixed Income Spreads by Sector



As with pretty much all sectors of the U.S. bond market, municipals, too, saw money flow in from overseas due to their relative yield advantage and safety. According to Lipper, the closing of the quarter marked the 39th consecutive week of inflows into the municipal market. While technically a 3rd quarter event since it happened on July 1st, Puerto Rico defaulting was the big story. Despite being the largest ever default in the municipal market, it

barely moved the needle given that, unlike Brexit, it had been so widely anticipated. Puerto Rican bonds actually rallied a little after the fact, due in large part to U.S. Congress passing legislation that is viewed as being likely to set the stage for a more orderly re-structuring.

In mortgages and other structured products, there were not a lot of mention-worthy developments. On the quality side, bonds have been rich for some time, in our opinion, and are often looked at as Treasury surrogates. On the non-agency side of things, gone are the days of being a dislocated sector with outsized excess returns; the story is more about incremental loan quality improvement and carry now.

Final Re-cap and Look Ahead

Going forward, we are only making one small tweak to our asset allocation targets, reducing preferred exposure to 5% and increasing securitized debt exposure to 10%. As we have stated for a couple of consecutive quarters now, we would still like to be a little more neutral in duration. We just have not seen compelling enough opportunities to merit extending. If anything, we could see underlying accounts organically becoming shorter, as re-financings have ticked up and more bonds are being called or are prepaying.

Figure 5: Doucet Asset Management Fixed Income Composite Characteristics

	Portfolio	Benchmark	+/-	% of Benchmark	Target
Workout Date	3.41	7.59	-4.18	45%	65%
Coupon Rate	5.20	3.57	1.63	146%	>100%
Modified Duration	2.07	6.49	-4.42	32%	65%
Yield to Worst	4.66	2.06	2.60	226%	>125%
Yield to Maturity	5.60	2.06	3.54	272%	>200%
Current Yield	5.62	3.29	2.33	171%	>100%
Convexity	0.18	0.81	-0.63	22%	50%
OAS	381.89	68.39	313.50	558%	>200%
Rating	BBB+	AA			
Corporate Debt	42.33%	26.72%	15.61%		40.0%
Government Debt	0.09%	43.80%	-43.71%		0.0%
Preferred Shares	4.83%	0.00%	4.83%		5.0%
Securitized Debt	8.20%	28.80%	-20.60%		10.0%
U.S. Municipal Debt	44.54%	0.80%	43.74%		45.0%

Note: Stated Benchmark is Barclays U.S. Agg Bond TR

Source: All characteristics calculated using Bloomberg Portfolio & Risk Analytics

We did end up selling a big portion of our energy-related corporates over the course of the quarter. By no means did we bottom-tick the trade, but we have captured nice total returns for the holding period so far. While it feels as if the bond market really dodged a bullet with oil, according to BTU Analytics and Haynes & Boone data, there has actually been more than \$50 billion in North American Exploration and Production debt entering bankruptcy since the beginning of 2015.⁶ We will likely see more to come, which could be a catalyst for high-yield spreads to widen, potentially creating some opportunities. In fact, we would not be surprised to get another bite of the apple on some of the very names we sold or others, as an increase in bankruptcies, a strengthening U.S. dollar due to Brexit (or a weakening China), and widespread hedging around \$50 a barrel are all strong downward pressures on the price of oil. We will be monitoring this situation closely.

We will also be monitoring Financials, as we believe there is real potential for the sector (in both the U.S. and Europe) to become dislocated as the Brexit saga unfolds. In the equity market, bank stock valuations are already starting to look attractive, although bond yields have a long way to go in order to bring us off the sidelines.

As long as money continues to flow into the U.S. fixed income market indiscriminately, longer duration securities and riskier credits are likely to continue their good run. However, in our eyes, the return if this does play out is much less than the risk we would have to take. The bond market is a potentially dangerous place right now, and we urge caution. We would rather be pickers and buy dislocated stories than to buy the market as a whole. Either way, we intend to maintain a defensive stance and not blatantly chase yield by extending or dipping deep into junk.

Footnotes:

- ¹ Our Take on the Second Quarter, Karen Wallace, Morningstar.com 7-1-2016.
- ² Cross-Asset Playbook, Morgan Stanley, 6-29-2016.
- ³ It's Not Me, It's EU, John Likos and Michael Murphy, Morningstar.com 6-30-2016.
- ⁴ Credit Markets: Snap-Back Rally Stalled, Market Outlook Q3 2016 6-28-2016.
- ⁵ Morningstar Credit Research Highlights, Morningstar, 6-27-2016.
- ⁶ Energy Market Commentary, BTU Analytics, 7-6-2016

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.

The above views are those of Doucet Capital and Chris Doucet, and are not necessarily the views of Institutional Securities Corporation.

Doucet Asset Management, LLC is independent of Institutional Securities Corporation (ISC).

Chris L. Doucet is a Registered Representative of ISC. Past performance does not guarantee future returns.

REGISTERED INVESTMENT ADVISORY SERVICES PROVIDED BY DOUCET ASSET MANAGEMENT, LLC. SECURITIES OFFERED THROUGH INSTITUTIONAL SECURITIES CORPORATION, DALLAS, TEXAS, MEMBER FINRA, SIPC (214)520-1115. THIS NEWSLETTER IS FOR INFORMATION PURPOSES ONLY. NOTHING IN THIS NEWSLETTER CONSTITUTES AN OFFER TO SELL OR A SOLICITATION OF AN OFFER TO BUY ANY INTEREST IN ANY SECURITY, OR IN ANY INVESTMENT VEHICLE MANAGED BY DOUCET CAPITAL, LLC OR DOUCET ASSET MANAGEMENT, LLC, OR ANY OF THEIR AFFILIATES. NOTHING IN THIS NEWSLETTER CONSTITUTES PROFESSIONAL OR FINANCIAL ADVICE, OR RECOMMENDATIONS TO PURCHASE OR SELL A PARTICULAR SECURITY. CERTAIN INFORMATION DISCUSSED IN THIS NEWSLETTER MAY CONSTITUTE FORWARD-LOOKING STATEMENTS WHICH CAN BE IDENTIFIED BY THE USE OF FORWARD-LOOKING TERMINOLOGY SUCH AS "MAY," "WILL," "SHOULD," "EXPECT," "ANTICIPATE," "TARGET," "PROJECT," "ESTIMATE," "INTEND," "CONTINUE" OR "BELIEVE," OR THE NEGATIVES THEREOF OR OTHER VARIATIONS THEREON OR COMPARABLE TERMINOLOGY. DUE TO VARIOUS RISKS AND UNCERTAINTIES, ACTUAL EVENTS OR RESULTS OR THE ACTUAL PERFORMANCE OF ANY OF THE INVESTMENTS DISCUSSED HEREIN MAY DIFFER MATERIALLY FROM THE EVENTS, RESULTS OR PERFORMANCE CONTEMPLATED BY SUCH FORWARD-LOOKING STATEMENTS. ALTHOUGH DOUCET ASSET MANAGEMENT, LLC BELIEVES THAT THE EXPECTATIONS REFLECTED IN SUCH FORWARD-LOOKING STATEMENTS ARE BASED UPON REASONABLE ASSUMPTIONS AT THE TIME MADE, IT CAN GIVE NO ASSURANCE THAT ITS EXPECTATIONS WILL BE ACHIEVED.



DOUCET ASSET MANAGEMENT, LLC

