DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter
Q2 2012
Doucet Value Momentum Portfolio
Doucet Value Income Portfolio
Bienville Model

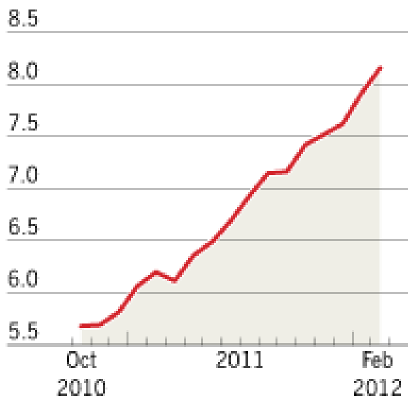
April 2012

Eye of the Storm

"When clouds are seen, wise men put on their cloaks." – William Shakespeare

An eerie calm of tepid economic recovery envelopes today's markets much like the eye of a storm. Violent winds of change can be seen looming on the economic horizon. Despite anemic economic statistics in the first quarter of 2012, the S&P 500 is up over 27% from its October lows.[1] The meteoric rise of Apple Inc.'s stock price and liquid courage served up by the Fed and EU have helped to fuel the rally and entice some investors to blindly wander out on the investment risk curve without the realization that the storm is not yet over. A fatal mistake made in hurricane-prone areas is to stray from safe shelter thinking the storm has passed only to be caught completely by surprise by gale force winds of the opposite eye wall. Lukewarm economic numbers, world balance sheets in crisis, a Congress that even makes FEMA look good and alarming geopolitical events serve as ample warning signs that investors should proceed with caution.

Dark Clouds Looming

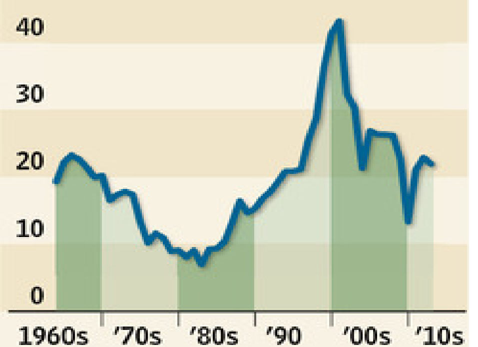


The European debt crisis, shenanigans in Washington and economic slowdowns in the EU and China that we referred to in our Q1 newsletter continue to dominate the economic climate. While the EU managed to escape economic collapse by orchestrating an orderly default of Greece's debt (the biggest sovereign default in history), we continue to see dark clouds looming over the EU. Just this week, eleven Spanish banks were downgraded,[2] and it was reported that almost one in four Spaniards is unemployed as the country's economy takes another turn for the worse.[3] The U.S. is dealing with problems of its own with over $15 trillion in debt, unemployment of 8.2% and a slowing economy.[4] Although corporate earnings have more than doubled off of their 2009 lows, it is important to note that accounting changes, lower debt service charges, a weaker U.S. dollar and tax benefits have all played a major role in bolstering earnings.[5] To make matters worse, China, the world's fastest growing major economy, has said it expects to see GDP growth of only 7.5% this year, a significant slowdown from the average growth rate of 10% since 1978.[6]

A Study in Contradictions

The markets and the economy recently have become studies in contradictions. While the S&P 500 gained 12% in the first three months of 2012, its best start to a year since 1998,[1] domestic GDP was only up a mere 2.2% annualized. Furthermore, trading volume on the NYSE has declined to its lowest level since 1999 according to Bloomberg.[7] Some market pundits claim the S&P 500 is "cheap," trading at a price to earnings ratio (P/E) of only 14 times trailing earnings, while others refer to its cyclically adjusted P/E (which uses an average of 10 years' worth of profits in its calculation) which is about 22 times, well above its long-term average of about 16 times.[1]

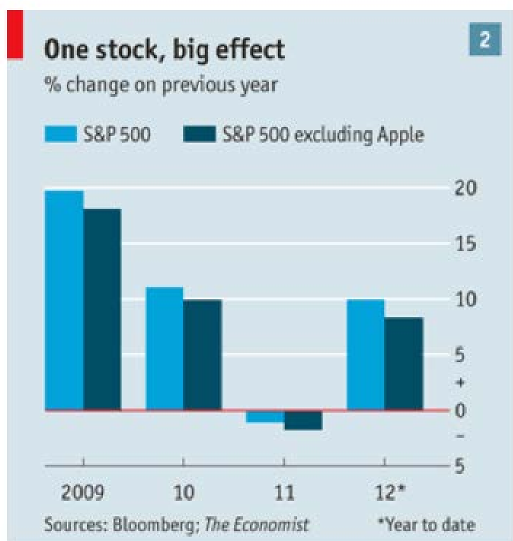
> "We are still in a meat grinder market. If not racked by volatility, as was the case in 2010 and again in 2011, then by eerily calm low-volume rallies in 2012."
> - *David Rosenberg* [5]



The data coming from companies themselves is equally indecisive. Company share buybacks hit $42 billion in February (the highest level since October); however, company insiders sold $6.8 billion worth of common stock, a ratio of $13 of selling for every $1 of buying.[8] So what is causing these drastic contradictions? Why are the markets responding positively to less than favorable economic statistics and endless doom and gloom headlines?

Apple of the Eye

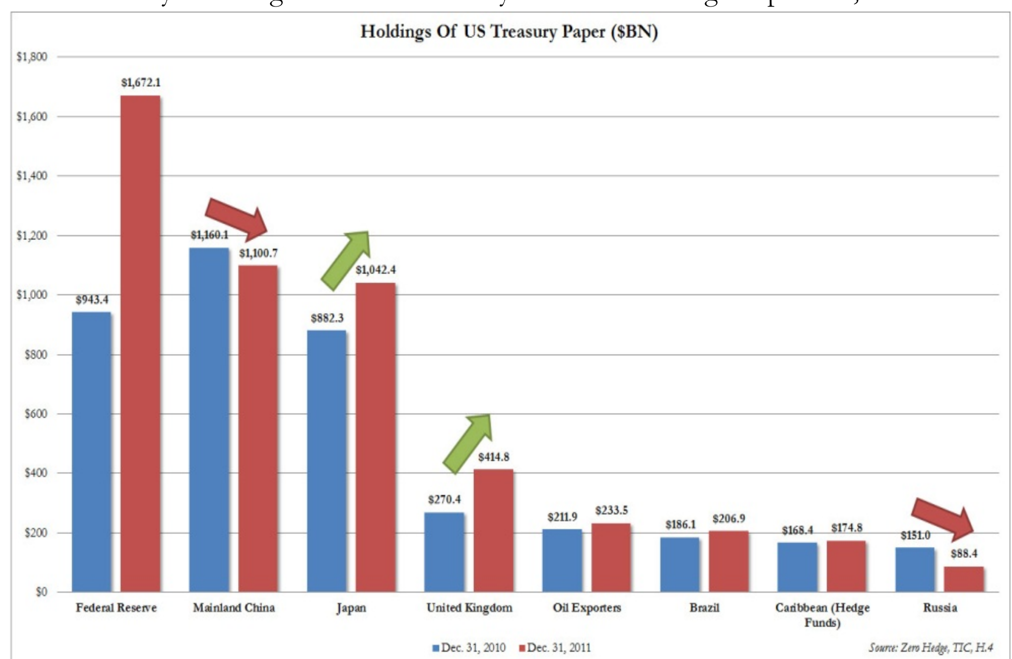
Amidst the current economic storm, Apple Inc. (AAPL), now the world's largest company by market capitalization has become the "apple of the eye" of both investors and money managers helping to avert their gaze from the slowing earnings growth throughout the rest of the market. The overall market is benefiting from the Apple factor. Apple surged 653% from 3/9/09 – 4/12/12, accounting for 8% of the S&P 500's climb according to data compiled by Bloomberg.[9] Including Apple, Q4 2011 S&P 500 earnings growth was 6.1% and only 3.0% without Apple. Additionally, Q1 2012 S&P 500 earnings growth rates are expected to be 2.2% with Apple and only 0.7% when Apple is excluded.[10] The effect Apple has on the S&P 500 and Nasdaq indices has become so drastic that several analysts have started a new fashion on the Street by publishing two versions of their quarterly forecasts: one with Apple and one without. On 4/25/12, the day after Apple released its Q1 2012 earnings, Apple's stock price jumped 8.9% which represented about 5 points of the 18.72 point gain in the S&P 500. This is the biggest contribution by any company in memory according to Howard Silverblatt, senior index analyst at Standard & Poors.[11] While it has been and continues to be a wild ride for Apple, this illustrates that, in the market, things aren't always as they seem.



> "By stripping away that one single company [Apple], it is like seeing light through a prism – you see things more clearly."
> - *Jonathan Golub* [12]

Liquid Courage from the Fed

Much of the market optimism has been a result of Fed and EU action. Market participants listen intently to determine if Chairman Bernanke will add extra liquidity to the market by printing more dollars and then buying more Treasuries. This has had a positive impact on the domestic stock market. The Fed has served up two rounds of "Quantitative Easing," QE1 ($2 trillion) and QE2 ($600 billion), where they printed trillions of dollars and bought securities with those dollars building their balance sheet to $6 trillion. "Operation Twist" ($400 billion), in which the Fed prints dollars and buys long Treasuries to keep longer yields low, ends June 30th. Who said money doesn't grow on trees? Every time the market gets spooked, Bernanke quells investors' anxiety by telling the public he is ready and willing to step in with another injection of cash. The liquidity bar is open but who is going to pay the tab?

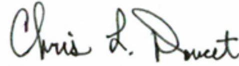


U.S. debt surpassed 100% of GDP in the first quarter of 2012 but what is truly frightening is who is buying U.S. debt now and who is not. (See Chart). Congress realizes it is easier to get re-elected when you print-and-spend versus tax-and-cut, so there is little impetus in Washington to stop. For now, the domestic markets are convinced they are immune to a recession even though the main trading partner of the U.S. is the EU which is currently in recession. Making matters worse is the fact that the European debt problem is not being resolved, but rather, the proverbial wheels are merely being greased to keep Europe's economic engine afloat. While the U.S. and the EU have come up with ways to solve their respective liquidity crises, they have yet to come up with ways to resolve the solvency issues which challenge both. Unless there is a domestic debt reduction plan put in place, increased private investment and structural reforms to increase growth prospects, it is only a matter of time before the backside eye of the storm reaches U.S. shores once more.

Conclusion

Doucet Asset Management has effectively managed the economic storms and outperformed the S&P 500 in each of the last three years despite high concentrations of cash at times and, even more notably, with no position in Apple in our managed portfolios. However, recently, we have begun taking advantage of this stage of the storm by evacuating to higher ground and seeking shelter for the next leg of the storm. There are some areas of the market still out of favor in which we are finding value including seasoned residential mortgage-backed securities (RMBS). (See our most recent *Window of Opportunity* located on our website.) However, from a macro perspective, the markets, in general, offer only mediocre risk/reward scenarios across most sectors. Additionally, during the past two years, every time the S&P reaches a 14 P/E multiple based on forward earnings (currently about 13.5 P/E), "some sort of crises-whether a growth scare in the U.S. or fears of a euro-area dissolution-has knocked it lower."[1] One thing history has taught us: sometimes the worst part of an economic storm is not the storm itself but man-made interventions to hastily plug the dikes.

Sincerely,



Chris L. Doucet
Chief Executive Officer

Footnotes

1 "Are Stocks Too Expensive or Just Right?", WSJ.com, April 12, 2012
2 "Spanish downgrade not seen hitting US debt market, yet", Reuters, May 1, 2012
3 "In the Picture: Roots of the Spanish crisis", Financial Times, May 1, 2012
4 U.S. Bureau of Labor Statistics
5 "The Stock Market Rally is Running on Empty", David Rosenberg, Financial Times, March 14, 2012
6 "China's Economic Growing Pains", CNNMoney, April 23, 2012
7 "The Bull Market Turns Three. Where's the Party?", Bloomberg Businessweek, March 8, 2012
8 "The Inside Track on the Market Rally", WSJ, March 5, 2012
9 "Broadest Bull Market Rally Since 1990 Masked by Apple", Bloomberg Businessweek, April 12, 2012
10 FactSet Research Systems, Inc, Earnings Insight, March 23, 2012 & April 20, 2012
11 "Apple's Stock Market Sway", WSJ, April 25, 2012
12 "The S&P 500 with and without Apple: Round 2", CNNMoney, March 25, 2012

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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