Balancing Murphy's Law and Newton's Law

April, 2011

> ***"Every body persists in its state of being at rest or moving uniformly straight forward, except insofar as it is compelled to change its state by force impressed."***
> **- Newton's Law of Inertia**
>
> ***"Anything that can go wrong, will go wrong."***
> **- Murphy's Law**

The first quarter of 2011 seemed to be a conglomeration of events where Newton's "Law of Inertia" actually took precedence over Murphy's Law. Everything that could have gone wrong in Q1 did. There were riots and regime changes in the Middle East, a U.S. supported "No-Fly Zone" over Libya, oil over $100 a barrel, one of the most powerful earthquakes on record resulting in a nuclear disaster in the world's third largest economy and a near government shutdown here at home. And none of these external forces could knock the market off of its bullish course as the S&P 500 finished up 5.4% in the quarter, marking its best first quarter seen since 1998. Despite these calamitous events, market volatility (as measured by the Volatility Index) registered its second largest drop in history.[1] Even the percentage of newsletter writers who are now bearish on the markets has fallen to the lowest level in the past 20 years, only 0.1% from its record low (December 24, 2009), as measured by Investor Intelligence.

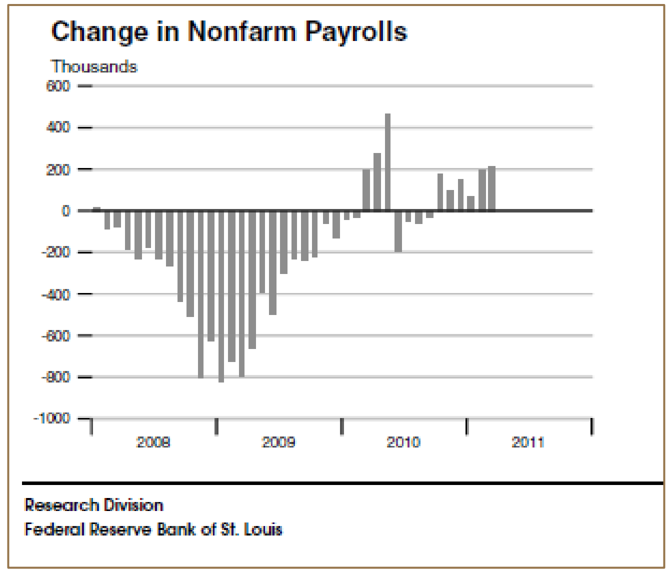
Equally surprising are investors' valium-induced reactions to the all night charade performed by our political leaders to cut spending by a rounding error, comments from Fed Chairman Ben "*He Who Sees No Inflation*" Bernanke and the rerun of the horror show about Washington kicking the cans of entitlements, taxes and fiscal reform down the road. If America has a superpower right now, it is the ability to convince itself that it has a star-spangled banner cocoon protecting it from the economic and societal ills that, if left unchecked, will ultimately ravage the domestic economy. Is this complacency well-founded or will the positive inertia of corporate profits and an expanding economy be thrown off course by the forces of rising oil prices, the conclusion of QE2, and budget and deficit talks in Washington? One certainty is investors will have to be mindful of both Murphy's and Newton's Law of Inertia to successfully traverse the investment landscape in the coming months.

Positive Inertia

The equity markets are up, in part, because of fundamental reasons such as strong productivity growth which has resulted in a surge in corporate profits. US corporate profits rose to a record $1.678 trillion annualized rate in Q4 2010, an eighth straight quarterly gain, according to the Commerce Department, and by 18.3% versus 2009. Near record levels of cash on corporate balance sheets combined with a 100% federal tax deduction on capital expenditures have proven to be a powerful engine which have helped drive hiring and business investment in the first quarter. And despite encountering a plethora of potholes, positive economic signs are arguably visible everywhere:

- 74% of S&P 500 companies which have reported first quarter earnings have exceeded analysts' expectations so far and, of the companies who exceeded estimates, 62% of those surpassed expectations by more than 20%.[2]
- The economy has expanded by almost every metric, outside of housing. Even within the gray clouds of housing, there are "silver linings." March new home sales data, available from the Commerce Department, show inventory of new homes in the United States has dropped to 183,000, the lowest total since August 1967.
- The Conference Board [3] stated that its index of leading economic indicators rose 0.4 percent in March. The index, which is a measure of future economic activity, has increased for nine straight months.

- The private sector has added more than 200,000 jobs (not including temporary census workers) in back to back months (February and March) for first time in four years.
- The manufacturing sector continues to expand, recording six consecutive quarters of expansion. According to the Wall Street Journal,[4] the U.S. manufacturing sector expanded four times as fast as the overall economy in the first quarter.



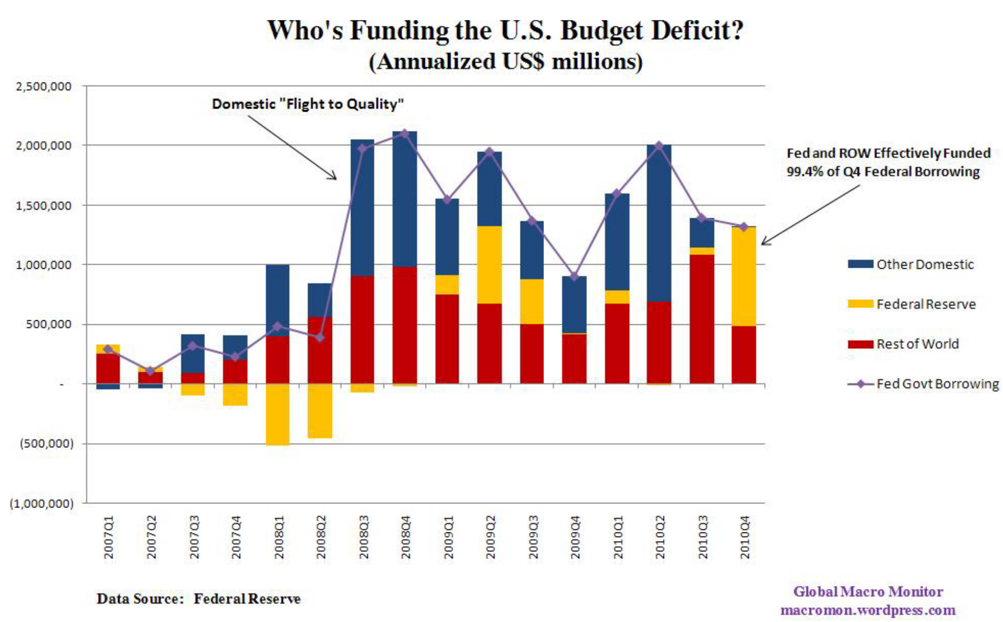
External Forces Against Inertia

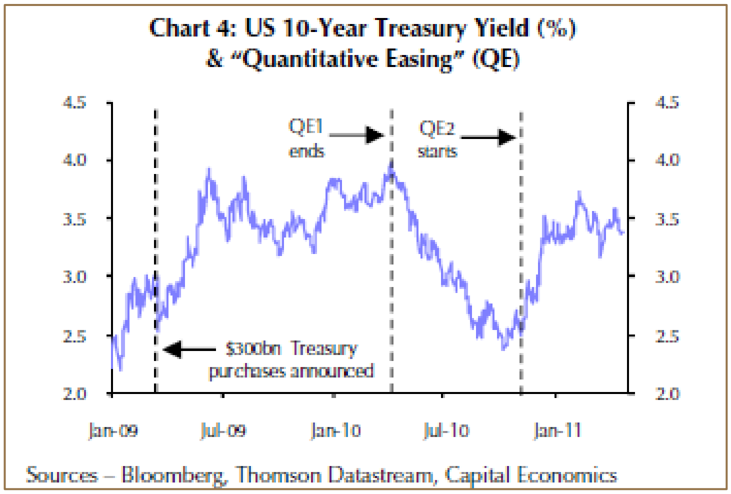
While both the market and the economy continue to see improvement, near term forces are certain to have a negative impact on the economic recovery. Fed Chairman Bernanke claims inflation is not a near term threat to the economy, yet prices of food prices have risen 37% over the past year according to the United Nations.[5] Changes in oil prices have an almost immediate impact on consumer confidence, positive and negative, and oil has risen to $113, more than 25% higher than at the beginning of the year. At a minimum, the "easy money" policies undertaken by the Fed and the resulting weak dollar have contributed to high commodity prices globally, hastening Murphy's Law in becoming reality in many parts of the world.

The proverbial "straw that broke the camel's back" in many Middle Eastern and North African countries was escalating food prices. Last month, the World Bank estimated that higher prices for corn, wheat and oil have pushed 44 million people into extreme poverty since last June. The U.S. has been mostly insulated from the devastating impact of higher food prices around the globe. Americans spend a much smaller portion of their budgets on food — about 14%— compared with 40% to 50% in developing countries.

While Americans have not felt the effect of higher food prices like many other countries, they have felt the impact of rising gas prices. A $10 increase in the price of a barrel of oil equates to roughly a $0.25 increase in a gallon of gasoline.[6] Higher gas prices weigh on consumer confidence and take a bite out of discretionary spending, neither of which is positive for equity markets. Increased demand due to a worldwide economic recovery, a weaker dollar and instability in the Middle East promise to help keep oil prices at an elevated level for the foreseeable future.

The Fed has kept interest rates artificially low through gimmicks like quantitative easing – printing money and then buying mortgage or Treasury securities on the open market with that money – which has had the consequence of exporting inflation and currency instability to the rest of the world. The Federal Reserve has indicated that it will end its purchases of U.S. Treasuries, or QE 2, as of June 30, 2011. At this point, the markets will have the opportunity to adapt and adjust to the absence of the Fed as a buyer. Until the Fed stops buying government securities, no one will know if quantitative easing has worked and at what levels the market steps in to fill the large gap left by the Fed.





Sources – Bloomberg, Thomson Datastream, Capital Economics

Much has been written about the possible drastic consequences stemming from the Fed's exit in June. As evidenced by the chart to the left, the conclusion of QE 1 had the opposite effect one might have deduced. The yield on the 10 year U.S. Treasury actually *fell* approximately 150 basis points after QE 1 ended. Likewise, as the Fed began buying in November (beginning of QE 2), Treasury yields *rose* by 100 basis points. While it is logical to assume that it may take higher interest rates to induce investors to buy in the place of the Fed, history suggests investors may be more focused on what impact political leaders in Washington have on reducing spending and deficit levels and what Fed policy might be in the future.

How To Invest in this Environment

The reality is everyone wants to cut spending…..of course unless they will be directly affected. A Pew poll [7] released in early April asked Americans whether they wanted to increase or decrease spending in 13 areas. In all but two, Americans wanted to see spending go up, not down. Politicians, in their defense, are getting mixed signals from their electorates. A country cannot wage multiple wars and make no increase in taxes to pay as you go. There is little hope of curbing government spending and reducing the deficit if it is more politically expedient to inflate the debt away and leave the fiscal problems of today for the leaders of tomorrow. Continuing on the current path of fiscal irresponsibility ends badly, not just for America, but for the global economy. Fortunately, it is always a mistake to take today's exact circumstances and project them out linearly into perpetuity.

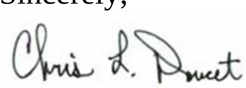
It is a natural imperative that investors play the hand in front of them. This simple maxim helped Doucet Asset Management maneuver through the recent markets and made Doucet the #1 performing manager in the U.S. for the 12 month period ending February 28, 2011 of the 167 managers whose performance numbers are compiled by Orion Advisors, LLC.[8] There have been several clear paths that we have seen for the market over the past couple of years that we have discussed in our newsletters: Dramatic earnings growth as the economy recovered as companies right sized their businesses to their new economic realities, and small cap stocks outperforming large cap stocks as the economy improved just to name two. S&P 500 earnings are expected to rise by 15% this year, the economy is expected to continue to grow for the remainder of 2011, albeit at a tepid pace, and merger mania is now in full force. However, we see high energy prices beginning to slow growth while weighing on consumer confidence, and QE2 will end soon. Instead of playing "chicken" with these potentially damaging events in our stock and bond portfolios, we will be less likely to raise short term price targets for stocks and bonds and will be more likely to sell when our targets are hit. If we are right about what is going to happen around the conclusion of QE2, the market's pause will give us an opportunity to see a slightly improving dollar, a decline in commodity prices and an increase in US interest rates, all of which would provide attractive openings to redeploy cash in the near future. But if we are wrong, and high energy prices and the conclusion of QE2 are non events, we believe the opportunity lost is minimal. While we still expect 2011 to be a good year in certain parts of the equity markets as well as campaign stimulus to magically appear in the second half of the year, we fully expect the battle between Murphy's Law and Newton's Law of Inertia will continue to be alive and well this Summer.

Fu Man Chu Decides The Real Debt Ceiling

Earlier this month, our elected representatives in Washington put on a reality show, working until the eleventh hour to show us how hard they are fighting to cut spending…a colossal 2% of the expected *overspending*! Now, Congress is scheduled to vote to raise the debt ceiling (May 16th) which they have voted to raise 10 times already since 2001. Despite posturing, Congress almost assuredly will raise the debt ceiling, ensuring that history's greatest Ponzi scheme, the U.S. Treasury market, is perpetuated.

The simple fact that most investors realize, whether politicians do or not, is the real debt ceiling is the one that will be eventually imposed by its creditors, namely the Chinese. At some point, creditors say no more. The message to Washington is simple: Rein in spending, benefits and the size of government to our new economic reality or the only entity who will loan U.S. money is a loan shark from China.

Sincerely,



Chris L. Doucet
Chief Executive Officer

Footnotes

[1] Volatility Index (VIX) March 16 – 25, 2011. Only larger weekly VIX drop during week of November 4, 2008 (when the VIX dropped from 80 to 47.7).
[2] Bloomberg Data, April 20, 2011
[3] The Conference Board Leading Indicators Economic Activity Index
[4] Wall Street Journal, "World Revs Up U.S. Profits." April 21, 2010
[5] United Nations Food and Agriculture Organization (FAO), "Rising Food Prices: 10 Questions Answered." April 12, 2011
[6] Federal Reserve data
[7] Pew Research Center for States, "The Deficit Debate: Where the Public Stands." April 12, 2011
[8] Doucet Asset Management ranked first in performance as compared to the 167 Advisors utilizing Orion Advisors Services to compile performance data for the 12 months ending 2/28/2011.

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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