DOUCET ASSET MANAGEMENT, LLC

*Quarterly Newsletter*
*Q2 2015*
*Doucet Value Momentum Portfolio*
*Doucet Value Income Portfolio*
*Fixed Income Strategy*

**May 2015**

# Risqué Trade On!

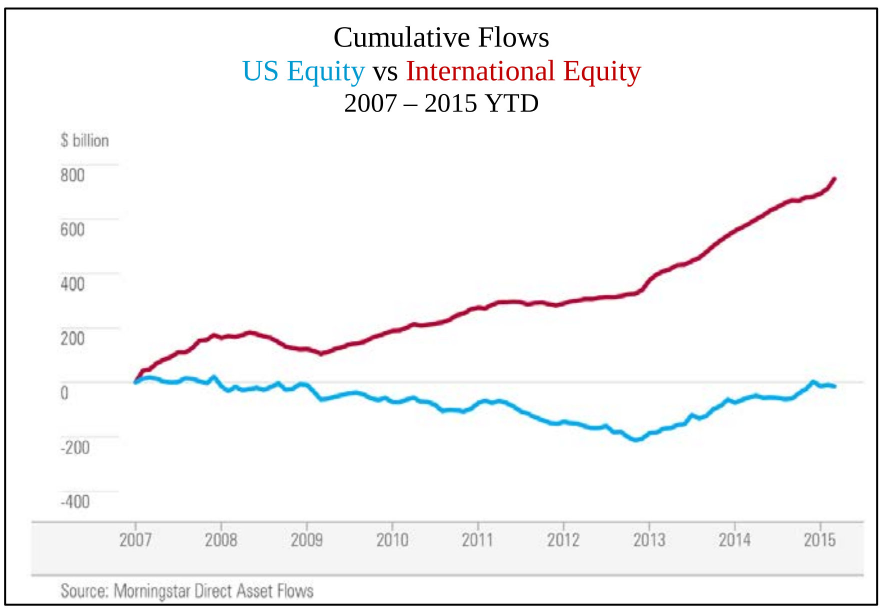
**"When you combine ignorance and leverage, you get some pretty interesting results."**
**-Warren Buffett**

The U.S. stock market has been both a seductive and frustrating affair to watch over the past six years. Despite an average economic growth rate of only 2.2% per annum, the S&P 500 is up over 160% since the start of 2009. Investors have witnessed a near perfect recipe for corporate profits, consisting of: historically high levels of stock buybacks, 275-year lows in interest rates, and the lowest level of labor costs as a percentage of GDP in history. It has been a wonderful thing to be long the market and a miserable thing to be short. Many question whether this 'Goldilocks' scenario for earnings is sustainable. Even so, there seems to be near unanimous agreement among financial commentators, market pundits, and people of all political persuasions that this may be the most unloved bull market in history!

New market highs are typically accompanied by feelings of euphoria and prosperity. Chock it up to recency bias, perhaps, but this bull run has been lacking of exhuberance of any kind, rational or irrational. Rather, this market has been characterized by investors climbing the proverbial *wall of worry*, combined with a healthy dose of skepticism. In a way, it is oddly reminiscent of an edict King George III of England passed in the 1700s which made it illegal for a woman to seduce a man into matrimony through the use of "make-up, holstered hips, and iron stays." If she did, she could be tried as a witch and, if found guilty, burned at the stake. While maybe not as scandalous as holstered hips or iron stays, the level and breadth of stimulus present in this market run up has at the very least been the lipstick on the pig, helping to create attractive returns, albeit slightly artificial at best.

## *Retail Me Not*

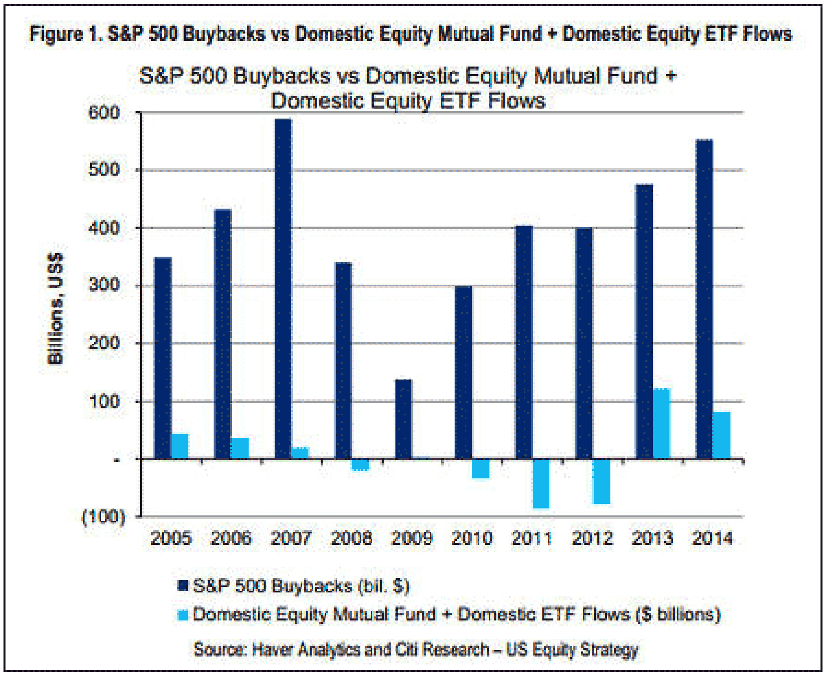
Somewhat surprisingly, retail investors have been reticent to take the long walk down the aisle, largely remaining on the sidelines. While markets are hitting all-time highs, there has been little-to-no trickle down effect in wages and wealth of the everyman. The wide gulf between Wall Street and Main Street has only added to the negative aura associated with the current market and has at least caused it to qualify as one of the most mistrusted rallies.




There was a strong sense among retail investors that the current rally was initially driven by a simple return to normalcy after the downturn. Somewhere along the ride up, however, this sentiment faded and was replaced with the belief that it was being powered as much by financial engineering as a reversion to the mean. A quick look at domestic equity mutual fund and ETF flows supports this notion, as inflows have been relatively neutral since the recovery began.

## *Baby Got Buyback?*

So if retail investors have been largely absent, where has all the money driving this rally come from? Ironically, a lot of the money that has driven the rise in share prices has come from the very corporations whose shares prices have risen, in the form of buybacks. While individuals have watched the market from afar, corporations have been buying their stock back at a record pace. Companies in the S&P 500 are expected to buy back and pay dividends to the tune of $1 trillion in 2015, up from $910



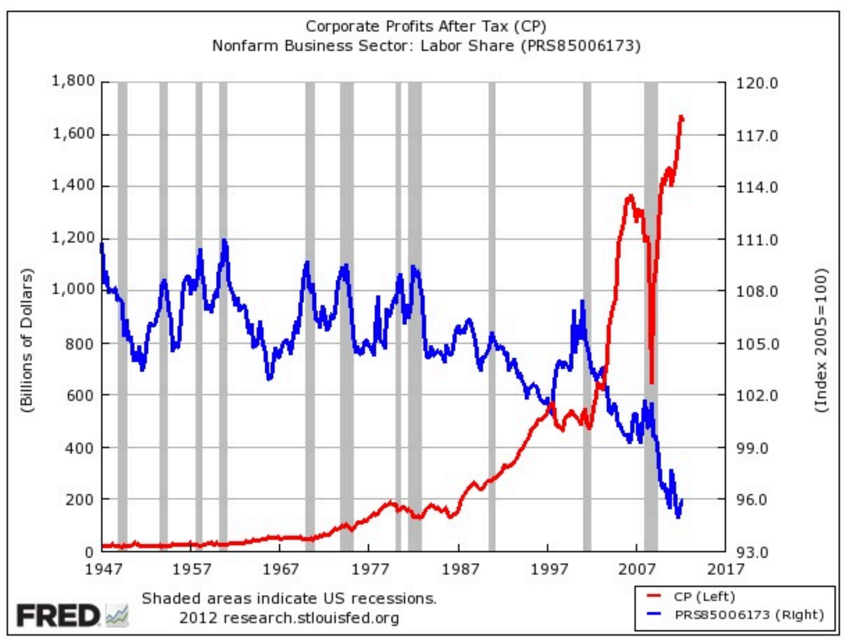

billion in 2014. According to Strategas' Investment Strategy Outlook, Aprl 2015, "Conventional wisdom has it that a surfeit of central bank liquidity and the ability of management to use it to manipulate earnings have had more to do with earnings gains than management skill."

Some economists believe as much as 60% of S&P 500 EPS over the past several years have been as a result of stock buybacks. Others disagree. According to Strategas Research, "share buybacks have had little to do with the rapid rebound in earnings." The truth of the matter is that buybacks are just a symptom of a greater issue. The one-two punch of lower interest rates and declining labor costs as a percentage of GDP have been the real catalysts.

It is thanks to these two forces that revenues for the S&P 500 are up a mere 11.6% since 12/31/08, while EPS are up 128% and operating margins are up 104% (Strategas). Further, corporate profits are at an all-time high as a percentage of GDP, but labor as a percentage of GDP is at an all-time low, again suggesting that many of the benefits of Quantitative Easing(s) are largely accruing to Wall Street and not the people for whom these stimulative measures were sold as being intended.

### *Make-up or Break-up*

So with the Fed contemplating raising rates in 2015 (and the potentiality of an even stronger US Dollar) combined with an improving employment picture (and potential upward pressure on wages), could the US be heading for an earnings recession in 2015? An earnings recession occurs when two consecutive quarters of year-over-year declines in S&P 500 quarterly earnings-per-share. Wall Street analysts were predicting a decline in earnings for the S&P 500 in the first quarter which never materialized. Now, they are forecasting a similar fate for the second quarter, according to Factset. The significance of this is there have been 12 earnings recessions since 1960 and 10 have resulted in stock market declines of 10% or more. (See chart: Earnings recessions and associated recessions and price declines on next page).




One reason investors should be cautious about the current domestic stock market in general is that the market will need a combination of earnings acceleration and multiple expansion to see the kinds of returns to which investors have become accustomed over the past several years. What should make investors even more nervous is just as margin debt levels have reached an all-time high, so has the market. According to the New York Stock Exchange, margin debt now stands at $476.4 billion. If sentiment in the market changes for any reason, losses on stocks may be exacerbated as investors are forced to sell stocks to cover margin calls.

### *Conclusion*

So what happens to the markets when the trappings that have made them such an object of seduction over the past several years disappear? What happens if rates rise, full employment causes labor costs to accelerate, corporate buybacks no longer make economic sense, and P/Es adjust downward due to slowing earnings? It is not a question of *if* these events will occur, but rather a question of *when.*

## Earnings Recessions & Associated Price Declines

**Earnings Recessions***

| EPS Recession Range | | EPS Recession Peak To Trough Dates | | EPS Change From Peak to Trough | | | Duration | |
|---|---|---|---|---|---|---|---|---|
| From | To | Peak | Trough | EPS Peak | EPS Trough | Percent Change | Qtrs | Days |
| Jan-61 | Jun-61 | December-60 | March-61 | 0.80 | 0.72 | -10.00% | 2 | 89 |
| Jan-67 | Sep-67 | December-66 | September-67 | 1.47 | 1.23 | -16.33% | 3 | 273 |
| Oct-69 | Dec-70 | December-69 | September-70 | 1.49 | 1.21 | -18.79% | 5 | 273 |
| Oct-74 | Sep-75 | September-74 | March-75 | 2.32 | 1.64 | -29.31% | 4 | 180 |
| Apr-80 | Sep-80 | March-80 | September-80 | 3.94 | 3.40 | -13.71% | 2 | 183 |
| Jan-82 | Mar-83 | December-81 | March-83 | 4.06 | 2.93 | -27.83% | 5 | 454 |
| Jan-85 | Mar-86 | December-84 | December-85 | 3.95 | 3.33 | -15.70% | 5 | 364 |
| Jul-89 | Dec-91 | June-89 | December-91 | 6.48 | 2.55 | -60.65% | 10 | 912 |
| Oct-97 | Dec-98 | March-98 | December-98 | 10.29 | 8.56 | -16.81% | 5 | 274 |
| Oct-00 | Dec-01 | September-00 | June-01 | 13.71 | 4.83 | -64.77% | 5 | 272 |
| Jul-07 | Mar-09 | June-07 | December-08 | 21.88 | -23.25 | -206.26% | 7 | 548 |
| Apr-12 | Sep-12 | March-12 | September-12 | 23.03 | 21.21 | -7.90% | 2 | 183 |
| Overall Median | | | | | | -17.80% | 5.00 | 273 |

*Note: An earnings recession is defined as two consecutive quarters of YoY decline in S&P 500 quarterly EPS.

**Maximum S&P 500 Index Declines That Coincide With EPS Recessions***

| S&P Index Decline: Peak To Trough Dates | | S&P Index Decline: Peak to Trough Change | | | Duration | Classification |
|---|---|---|---|---|---|---|
| Peak | Trough | S&P 500 Peak | S&P 500 Trough | Percent Change | Days | Correction or Bear? |
| 8/24/1960 | 10/25/1960 | 58.07 | 52.2 | -10.11% | 61 | Correction |
| 2/9/1966 | 10/7/1966 | 94.06 | 73.2 | -22.18% | 239 | Bear |
| 11/29/1968 | 5/26/1970 | 108.37 | 69.29 | -36.06% | 542 | Bear |
| 10/12/1973 | 10/3/1974 | 111.44 | 62.28 | -44.11% | 355 | Bear |
| 2/13/1980 | 3/27/1980 | 118.44 | 98.22 | -17.07% | 42 | Correction |
| 8/11/1981 | 8/12/1982 | 133.85 | 102.42 | -23.48% | 365 | Bear |
| 11/6/1984 | 12/13/1984 | 170.41 | 161.81 | -5.05% | 36 | Bull Continued |
| 7/16/1990 | 10/11/1990 | 368.95 | 295.46 | -19.92% | 86 | Correction |
| 10/7/1997 | 10/27/1997 | 983.12 | 876.99 | -10.80% | 19 | Correction |
| 9/1/2000 | 9/21/2001 | 1520.77 | 965.8 | -36.49% | 384 | Bear |
| 10/9/2007 | 3/9/2009 | 1565.15 | 676.53 | -56.78% | 516 | Bear |
| 4/2/2012 | 6/1/2012 | 1419.04 | 1278.04 | -9.94% | 59 | Bull Continued |
| Overall Median | | | | -21.05% | 225 | |

*Note: A price decline is considered to coincide with an earnings recession if it occurs within a period of 12 months before the start and 6 months after the end of an earnings recession.

As we have stated in previous newsletters, we continue to believe interest rates will stay 'lower for longer'. However, we are more concerned about deteriorating corporate credits. At some point in the near future, we expect spread widening events to occur in the bond markets. Coupled with recent changes in legislation and regulation, we expect liquidity in the bond markets to be negatively impacted, as too many investors try to hit the exits at one time when credits do begin to show signs of weakness. As a result, we have adopted a strategy of buying short callable bonds with excellent credit profiles and overloading portfolios in sectors of the market where we see significant reversion to the mean opportunities occuring.

Our startegy on the equity side has been very similar to that of bonds and the same rules of caution apply. Our portfolios will remain cash heavy as the market P/E of the market is near 20 times, values in the market are becoming harder to find, and earnings are slowing. At some point, the "make-up, holstered hips and iron stays" supporting the market are removed and we are convinced investors are not prepared for what they will see.

Sincerely,

Chris L. Doucet

Chris L. Doucet
Chief Executive Officer

**Footnotes**

[1] James A. Kostohyrz, Seeking Alpha, March 6, 2015

**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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