DOUCET ASSET MANAGEMENT, LLC

Fixed Income Quarterly

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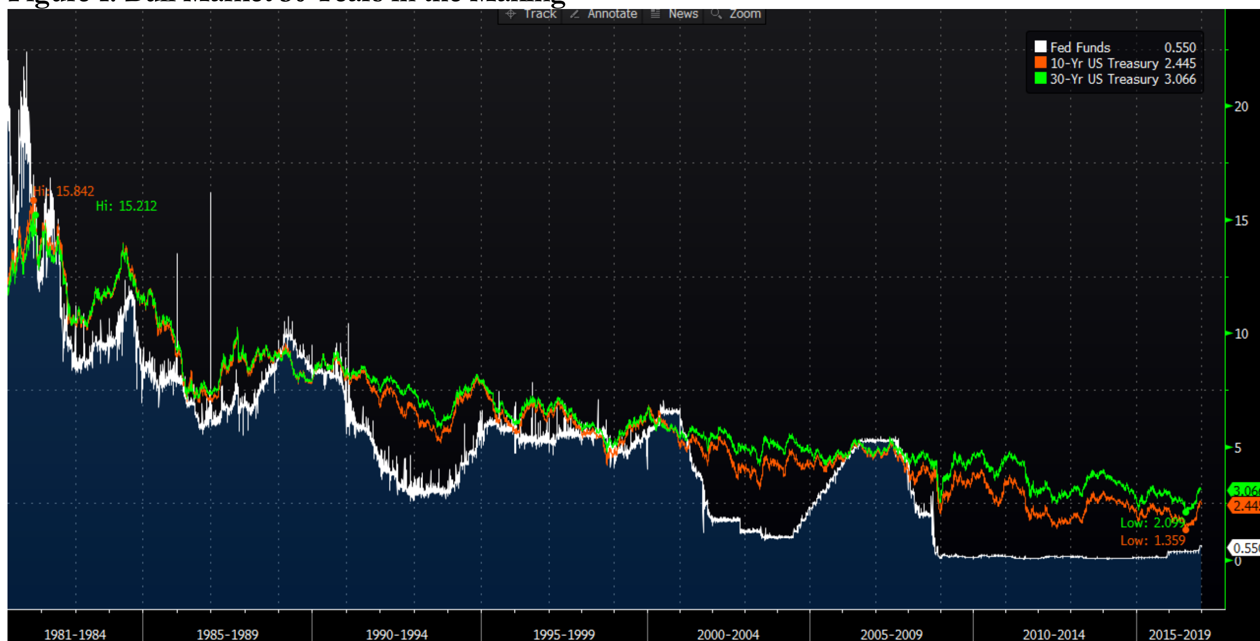
Is *lower for longer* dead already? As a refresher, *lower for longer* is an investment thesis premised on the fact that, while interest rates are significantly below their long-term mean, a reversion to the mean is unlikely in the foreseeable future due to a variety of factors, such as: even lower (or negative) interest rates abroad, sensitivity of a fragile domestic economy, and interest cost impact of an over-levered government following years of balance sheet expansion. This thesis began to circulate a couple of years back as an outlying opinion, and quickly morphed into what seemed like a consensus view by mid-year 2016. After a brief 15 minutes of fame, however, investors started backing away from this conviction over the course of the 4th quarter, thanks in large part to an upcoming Trump administration that has signaled a shift from monetary to fiscal policy.

Increasingly, the new market expectation is for inflation to increase and bond yields to rise. Should this scenario play out, 2016 could have been the year when a bond market bull-run 35-years in the making finally ran out of steam. Bull markets may not die of old age on the equity side, as the saying goes, but that is exactly how they die on the bond side. If we did just witness this metaphorical passing in 2016, then the full adoption of *lower for longer* will have coincided almost perfectly with all-time lows in both 10-year and 30-year US Treasury yields (1.36% and 2.10%, respectively) and will have been the mother of all contrarian indicators.

Figure 1: Bull Market 30 Years in the Making



Source: Bloomberg

While we are not ready to abandon *lower for longer* altogether, we do believe that yields are biased higher going forward and that bond market returns will not likely have the benefit of as friendly a secular tailwind as they have enjoyed in the past. With that said, 2016 returns could have been one last hurrah before the landscape becomes more secularly challenging. Overall bond market performance was modest, with the Bloomberg Barclays Aggregate Bond index (the Agg) returning 2.65%. Credit, however, knocked it out of the park, with the Morningstar Corporate Bond and BofA Merrill High Yield Master II indices returning 5.81% and 17.49%, respectively. **It was a similarly excellent year for the Doucet Asset Management Fixed Income Strategy Composite (the Composite), which returned 10.64%, outperforming the Agg by 799 bp. This brings its 2 year annualized since inception outperformance to 398 bp.**

Figure 2: Doucet Asset Management FI Strategy Composite Performance

	4Q16	2016	2015	Since Inception
Doucet Fixed Income Composite	0.73%	10.64%	0.74%	5.57%
Barclays US Aggregate Bond	-2.98%	2.65%	0.55%	1.59%
+/- Benchmark	3.71%	7.99%	0.19%	3.98%
*Performance calculated by Morningstar Office, periods over 1 year are annualized				

Bond Market At-a-Glance

Overall, yields generally rose on the year, with lower quality besting higher quality and the long-end outperforming 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 5.10%, 2.22%, and 1.46%, respectively. In addition to credit, it was a good year for TIPS, as inflation expectations reset higher, and bank loans, as demand for floating rate coupons and short duration assets picked up. After wild swings, Governments and mortgages finished largely flat. And while the Bloomberg Barclays Municipal index managed to eek out a positive 0.25% return, municipals lagged as concerns surfaced over what tax reform might mean for the sector.

Figure 3: Index Returns		
	4Q16	YTD
Broad Market Equity Indexes		
DJIA	8.66%	16.50%
S&P 500	3.82%	11.96%
Broad Market Bond Indexes		
Barclays US Aggregate Bond	-2.98%	2.65%
Bank of America Merrill High Yield	1.88%	17.49%
Morningstar Core Bond	-3.06%	2.64%
Morningstar Short-Term Core Bond	-0.69%	1.46%
Morningstar Intermediate Core Bond	-2.32%	2.22%
Morningstar Long-Term Core Bond	-6.89%	5.10%
Bond Indexes by Sector		
Morningstar Corporate Bond	-2.93%	5.81%
Morningstar US Govt Bond	-3.90%	0.97%
Morningstar Mortgage Bond	-1.97%	2.08%
Morningstar TIPS	-2.53%	4.68%
Barclays Municipal	-3.62%	0.25%
*Source: Morningstar		

In the Treasury market, the 2-Yr, 5-Yr, 10-Yr, and 30-Yr finished at 1.19% (+14 bp), 1.93% (+17 bp), 2.44% (+18 bp), and 3.07% (+5 bp), respectively, for a 2s-30s steepness of 188 bp. The 2-Yr, 5-Yr, 10-Yr, and 30-Yr AAA benchmark municipal finished at 1.23% (+49 bp), 1.80% (+48 bp), 2.35% (+35 bp), and 3.08% (+18 bp), respectively, for a 2s-30s steepness of 185 bp. Thanks in part to another Fed hike in December and an overall shift in tone post-election, 2-Yr yields on both curves are the highest they have been since 2009 and both curves are the flattest they have been heading into a calendar year post-crisis.

Figure 4: U.S. Treasury Market Snapshot

	US Treasury Actives							AAA Benchmark Muni		
	4Q16	*3Q16*	*4Q15*	*Qtr Δ (bp)*	*Qtr Δ (%)*	*Yr Δ (%)*	*Yr Δ (bp)*	*4Q16*	*%UST*	Tax Equiv*
2-Yr	**1.19%**	**0.76%**	1.05%	43	56.58%	14	13.33%	**1.23%**	*104.00%*	2.17%
5-Yr	**1.93%**	**1.15%**	1.76%	78	67.83%	17	9.66%	**1.80%**	*93.00%*	3.18%
10-Yr	**2.44%**	**1.59%**	2.27%	85	53.46%	18	7.05%	**2.35%**	*96.00%*	4.15%
30-Yr	**3.07%**	**2.32%**	3.02%	75	32.33%	5	1.66%	**3.08%**	*100.00%*	5.44%

Source: Bloomberg

*TE assumes current top 43.4% Fed tax rate

Within credit, investment grade spreads narrowed 45 bp and high yield spreads narrowed 283 bp to finish at 111 bp and 461 bp, respectively. According to Morgan Stanley Research, "Within IG, Gas-Pipelines (+20.1%) and Metals/Mining (+19.3%) had the best excess returns and Textile/Apparel (+2.2%) and Banking (+2.5%) were the laggards. Unsurprisingly in HY, Metals/Mining (+50.64%) and Energy (+35.81) outperformed in total return, whereas Lodging (+5.40%) and Healthcare (+6.68%) performed worst."

Figure 5: Fixed Income Spreads by Sector

Source: Bloomberg

Final Re-cap and Look Ahead

Over the course of 2016, the Composite moved up in credit quality and shed duration, both in absolute terms and relative to the benchmark. As we have stated time and again, our very short duration is less an expression of a deep-seated conviction that interest rates are going to immediately and severely rise, and is more a by-product of the fact that we just are not seeing compelling enough opportunities in the market to extend, as: absolute yields are low, the curve is flat, and risk product is generally tight. Should opportunities arise in the coming year, we would love to extend our duration to be closer to that of the benchmark, although we certainly would not want to be long.

Furthermore, we substantially reduced our allocation to credit as the year went on and our corporate bond holdings rallied substantially. It was this credit allocation that was the real driver of our outperformance in 2016, especially from those bonds of commodity-sensitive issuers such as: Hecla Mining, Freeport McMoran, Chesapeake Energy, Callon Petroleum, and Murphy Oil, et cetera. By mid-to-late year, however, spreads had tightened considerably, and the commodity backdrop had stabilized to the point where names that we purchased at distressed levels had largely returned to par pricing. Simply stated, the risk/return proposition changed to the point where we could no longer rationalize maintaining such an overweight to the sector. The majority of the proceeds from corporate sells were reinvested into municipal bonds, and the Composite finished with a 27.52%, 0.04%, 5.56%, 4.88%, 61.92% allocation to credit, Governments, preferreds, securitized debt, and municipals, respectively.

Figure 6: Doucet Asset Management Fixed Income Composite Characteristics

	Composite Characteristics			% of Benchmark			Targets
	YE2016	YE2015	*YoY* Δ	YE2016	YE2015	*YoY* Δ	New
Workout Date	2.88	4.38	*-1.50*	36%	58%	*-22%*	65%
Coupon Rate	5.08	5.57	*-0.49*	165%	172%	*-7%*	>100%
Modified Duration	1.70	2.34	*-0.64*	28%	41%	*-13%*	65%
Yield to Worst	3.71	5.96	*-2.25*	142%	236%	*-94%*	>125%
Yield to Maturity	4.54	6.64	*-2.10*	173%	262%	*-89%*	>150%
Current Yield	5.24	6.32	*-1.08*	174%	202%	*-28%*	>150%
Convexity	0.16	0.19	*-0.03*	21%	26%	*-5%*	50%
OAS	207.68	461.09	*-253.41*	417%	696%	*-279%*	>200%
Rating	A	A-					
Corporate Debt	27.52%	43.16%	*-15.64%*				25.0%
Government Debt	0.04%	0.16%	*-0.12%*				0.0%
Preferred Shares	5.65%	10.22%	*-4.57%*				5.0%
Securitized Debt	4.88%	4.23%	*0.65%*				10.0%
U.S. Municipal Debt	61.92%	42.26%	*19.66%*				60.0%

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

Source: All characteristics calculated using Bloomberg Portfolio & Risk Analytics

It is important to make a couple of qualifying statements here regarding our asset allocation, as well. For one, the Composite looks nothing like its benchmark. The benchmark, being the Agg, is simply the best, most-widely accepted approximation of the taxable bond market as a whole. We, however, are not trying to *be* the market, but rather are trying to *beat* the market by employing our own value-driven, total return strategy. Also, we have the ability to buy tax-free municipals when either absolute or taxable equivalent yields make sense. Secondly, taking the benchmark out of the equation for a second, our 61.92% allocation to municipals is not necessarily a conviction call that municipals are the best place to be or that they are exceedingly cheap relative to other sectors. Instead, short municipal bonds are typically our default stance when we are not seeing a lot of value elsewhere in the market. Because of the inherent inefficiencies within the sector, we find municipals to be a more effective way to express the core in our *core*-plus strategy, while generating incremental yield pick-up at the same time.

As a result of the changes made in 2016, the positioning of the Composite is the most conservative it has been in its two year history as we head into 2017. The way it is structured, it will be difficult (if not impossible) to generate the type of performance we had last year. Consider, however, that while our 4th quarter return of 0.73% was our lowest of the year, it was by far our best outperformance (+371 bp) quarter relative to the benchmark since the Composite's inception. This demonstrates the power of a conservatively built portfolio with a short duration in a period where rates are rising and bond market returns are negative, which they were in the 4th quarter.

Lastly, and perhaps more importantly, by being short duration and high quality, we have a lot of flexibility and liquidity built in that should enable us to jump on any dislocations that may arise. There are many question marks heading into 2017, and there are bound to be some opportunities along the way. Setting aside rising rates and macro, geopolitical shocks for a minute; there are a number of more micro, market specific situations worth keeping an eye on. In credit, for example, fundamentals have weakened with defaults having risen, while interest coverage and recoveries have

declined. Should spreads adjust to this reality, there could be a buying opportunity there. In municipals, the prospect of tax reform continues to loom large. At a minimum, lower personal tax rates would reduce the value of their tax-exemption and yields would theoretically have to adjust higher to compensate. Municipal spreads have already widened out some in anticipation of this, but could widen further should reforms come in more aggressively or momentum build behind the idea of limiting (or even eliminating) the tax exemption, altogether. With a new administration and a seemingly tectonic shift in policy on the horizon, there are many scenarios like these that could potentially play out in the months to come, far too many to name here. If 2016 taught us anything, however, it was to expect the unexpected and to be skeptical of consensus opinion when it becomes too loud.

Sincerely,

Will Aycock, CFA

Footnotes:

[1] Morgan Stanley, *US Credit Strategy 2016 Performance Recap,* January 3, 2017

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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