DOUCET ASSET MANAGEMENT, LLC
Fixed Income Quarterly
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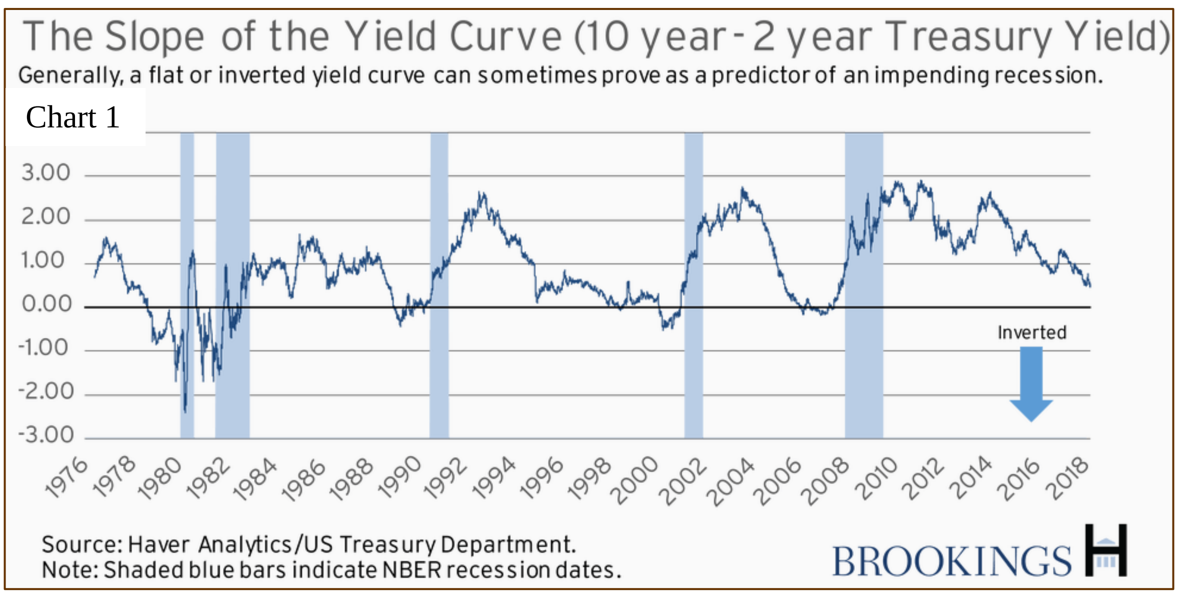
Flat Yield Curve & End of the Fed Funhouse

The "funhouse" first became a popular U.S. amusement park attraction at Coney Island in the early 1900s. A funhouse was a building equipped with attractions like shifting floors, enormous wooden slides, a spinning disk ride, and many other mechanical devices used to entertain, amuse and sometimes even frighten guests. But perhaps the most popular funhouse attraction of all was the 'hall of mirrors' where patrons were able to see distorted views of themselves through the use of curved mirrors. Much like the funhouses of old, the modern Federal Reserve has used its own version of the hall of mirrors since the beginning of the Great Recession to help create a financial alchemy for beleaguered markets.

The Fed's Hall of Mirrors

QE, ZIRP, and Operation Twist were just some of the tools used by the Fed to make the lens of the market more concave or convex, depending on what they need, to help bolster asset prices. This alphabet soup of policy initiatives resulted in a whopping 365% increase in the Fed balance sheet from the early days of Quantitative Easing to today. In the process, they "have distorted the markets, have muddled the calculations, have surgically removed 'fundamentals' as a consideration for the markets, and have brainwashed the markets into believing that the Fed will always bail them out of the smallest dip."[1] But now that the Fed has begun the process of closing down its monetary funhouse by raising interest rates and reducing its massive balance sheet, a warning sign from past recessions has surfaced-the flattening of the yield curve. Should investors be concerned?



9 Out of 9 Ain't Bad

Typically, no one pays much attention to Treasury yield curves except for maybe newspaper writers and bond traders. But today, as the spread between long and short Treasuries narrow (as depicted in Chart 1), the yield curve is getting almost as much press as tariff talks and world cup soccer. Why? According to Bloomberg Markets, "a negative curve has predicted all nine recessions since 1955, with a lag of six to 24 months."[2]. It is important to be mindful that Fed tightening is the usual suspect for a flatter yield curve historically. The Fed has a great deal of control over the shorter end of the yield curve, but only nominal influence over the longer end. This time is not different. The day before the Fed began raising interest rates on December 17, 2015, the spread between the 2-year Treasury and the 10-year Treasury or the 2/10 spread was 128 basis points; today, it is 25. This spread

A yield curve is considered *normal* or *positive* when longer maturity bonds yield *more* than shorter maturity bonds, flat when both yield about the same and *negative* or *inverted* when long rates yield *less* than short rates.

narrowed as the 2-year Treasury rose 159 basis points during this period from 1.02% to 2.61%, while the 10-year only increased by 56 basis points from 2.3% to 2.86%.

Why the Fed Fosters Negative Yield Curves

In the first 40 years of the Federal Reserve, most recessions in the U.S. were *not* preceded by an inverted yield curve. It was common knowledge back then that the Federal Reserve was created only to intervene in cases of a severe financial stress….and then get out and let the free markets take over as quickly as possible. There were never massive balance sheet buildups and unwinds and yield curve inversions were rare.

Times have changed. Since the appointment of William McChesney Martin Jr. as Federal Reserve Chairman by President Truman in 1951, each successive Federal Reserve has become increasing active in their attempt to influence the economy through monetary policy. As the Federal Reserve has transitioned from a passive to an active institution, yield curve inversions have become commonplace. And investors now understand inverted yield curves augur economic trouble ahead for multiple reasons. The obvious is banks usually borrow on the short end and lend out on the long end of the curve, creating a positive spread. An inverted yield curve creates a negative spread for a lending institution. Second, over 70% of the U.S. economy is driven by consumer spending. While some spending is fixed, a large portion is driven by banks desire to lend and customers' desire to borrow especially on big ticket items like cars and homes. Third, the Fed usually continues to raise rates (and flatten or invert the yield curve) as long as the economy is healthy and there is a threat of inflation (see chart 2) Historically, Fed tightening cycles end once there is a significant crisis which could lead to a recession.

Source: BofA Merrill Lynch Global Research

Throw The Bum Out!

Business Insider recently reported the Fed now believes, based on comments made in the June 12-13th Federal Reserve Minutes, factors other than their own actions "cause the yield curve to flatten." And while investors are wringing their hands over the flattening of the curve, the Fed is considering throwing it out of their decision-making process altogether. What is most remarkable is one of the reasons they give for abandoning this age-old indicator is their very own monetary machinations "might be distorting investors thinking and this distorted thinking causes investors to pile into long-term Treasuries at these low yields, and thus push down yields further."[3] In other words, the majority of the Fed now believes it has manipulated markets and rates so much that this time may actually be different.

While the yield curve has proven to be an excellent economic predictive tool in the U.S., AQR Capital Management, the world's second largest hedge fund, suggests "internationally, the yield curve's predictive power has been mixed." Australia's yield curve has inverted four times since 1990 and only once was there a recession; Japan has had five recessions since 1994 without an inverted yield curve; and the German curve came the closest to mimicking the U.S. curve with recessions following yield curve inversions in 2000 and 2009. So not all yield curves and central banks are created equal.

Conclusion-What Reality Looks Like

In our May, 2018 Fixed Income Quarterly, we stated that there was a higher interest rate bias to the fixed income markets, but that the flattening yield curve would help keep a lid on long rates. Our words proved prescient as the two-year Treasury rose by the same 25 basis points as the Fed Funds rate during the quarter while the 10-year only rose 11 basis points. Our composite managed to remain positive the past three quarters, while the index was negative, only because we continue to reduce the modified duration and credit exposure in our portfolios.

Doucet Asset Management FI Strategy Composite Performance					
	YTD	2017	2016	2015	Since Inception
Doucet Fixed Income Composite	0.38%	3.89%	10.64%	0.73%	4.47%
Barclays US Aggregate Bond	-1.62%	3.54%	2.65%	0.55%	1.59%
+/- Benchmark	2.00%	0.35%	7.99%	0.18%	2.88%
*Performance calculated by Morningstar Office, periods over 1 year are annualized					

While the Fed is trying to convince the public that this time is different, our message is this time is very much the same as past tightening cycles. The Federal Reserve drags the short end of the curve lower during periods of recession and pumps rates up during periods of economic expansion. Corporate earnings have been solid as of late thanks to reduced regulations, tax cuts, and low cost of capital, both human and monetary, which have kept this economic expansion intact. But unfortunately for the Fed, there are factors like tariff talks, the softening of inflation fears, their own self-admitted manipulation of markets, and low European rates which have all helped to keep a lid on long-term rates. As a result, the yield curve is flattening much sooner than the Fed had hoped or anticipated.

Doucet Asset Management Fixed Income Composite Characteristics					
	Portfolio	**Benchmark**	**+/-**	**% of Benchmark**	**Target**
Workout Date	1.36	7.88	*-6.52*	17%	65%
Coupon Rate	5.85	3.18	*2.67*	184%	>100%
Modified Duration	1.10	6.23	*-5.13*	18%	65%
Yield to Worst	3.69	3.41	*0.28*	108%	>125%
Yield to Maturity	5.45	3.41	*2.04*	160%	>150%
Current Yield	6.20	3.27	*2.93*	190%	>150%
Convexity	0.05	0.80	*-0.75*	6%	50%
OAS	138.45	31.77	*106.68*	436%	>200%
Rating	A+	AA			
Note: Stated Benchmark is iShares Agg Bond ETF					
Source: All characteristics calculated using Bloomberg Portfolio & Risk Analyitics					

Our internal research suggests in the past 7 recessions, every time the 2/10 Treasury yield spread fell below .5% and the 3 month/10-year spread fell below 1%, the spread did not come back and a recession eventually occurred. As we mentioned earlier, the 2/10 spread is now 25 basis points and we have no reason to believe that history will not repeat itself. As the Fed unwinds all of the trappings of its monetary funhouse, the yield curve will invert and the distorted reflection of the markets will begin to mirror something closer to reality. Until then, caution is advised.

Sincerely,

Chris L. Doucet

Footnotes:

[1] Wolf Richter, Business Insider, 'The Fed is Thinking About Throwing Away a Key Recession Indicator,' July, 2018

[2] Alister Bull, 'Fed Study Finds Inverted Yield Curve Still Good Recession Alerts" Bloomberg Markets, March 5, 2018

[3] Business Insider Article.

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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