DOUCET ASSET MANAGEMENT, LLC
Fixed Income Quarterly
May 2019

The Good, the Bad & the Ugly of the Duct Tape Economy

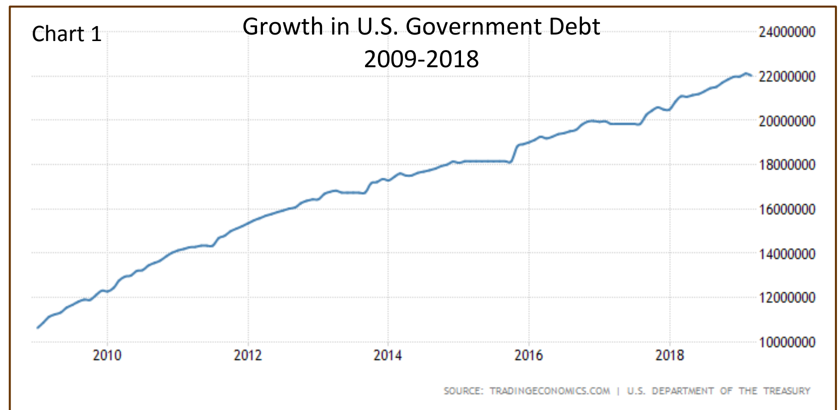
*Fulfilling the responsibility as lender of last resort is what the Fed was created to do.
This is what central banks have been doing for 300 years.*
-Ben Bernanke, 2002

In the early 1940s, a mother of two U.S. Navy sailors wrote a letter to President Roosevelt to provide a solution to a particular military problem her sons had described in correspondence with her. Apparently, water and humidity were damaging explosives in ammunition boxes. The mother argued the key to fixing this challenge was simply sealing the metal boxes with an adhesive fabric made from cotton duck cloth. FDR forwarded the correspondence to a division of Johnson and Johnson, and within weeks, what we now refer to as 'Duct Tape' was born.

Since the beginning of the Great Recession, the Federal Reserve has been using its own version of Duct Tape - monetary policy. And like Duct Tape, monetary policy can be an effective short-term answer to a particular problem; however, using it as a permanent solution can prove disastrous. For the first 95 years of the Fed's existence, it can be argued that its arsenal of monetary tools were used as temporary measures of last resort. However, over the past decade, they have utilized them any time the markets hiccup. The **good** is domestic stocks are hitting new record highs almost daily and bond yields are hovering near their 5,000-year lows. The **bad** is government debt is at unsustainable levels around the world and most question whether there is even the ***ability*** to pay it back at this juncture. The **ugly** is this '*buyer of first resort*' status the Fed has adopted. This has helped foster a groundswell of support for the proponents of the modern monetary theory (MMT) who seem void of all ***desire*** to ever satisfy government obligations as they believe debts and deficits don't matter as long as a country has the power of a currency printing press.

What is monetary policy?
Monetary policy is how central banks regulate how much money is in the financial system in an attempt to control inflation and to help maintain low rates of unemployment. The traditional lever the Federal Reserve uses to control the flow of money is known as 'open market operations.' The Fed simply buys/sells short-term Treasury securities to reduce/increase the Federal Funds Rate. Beginning in 2008, The Fed began Quantitative Easing (QE) which allowed them to purchase Treasuries with longer maturities and included agency debt and mortgage-backed securities in the mix.

Old Math vs New Math

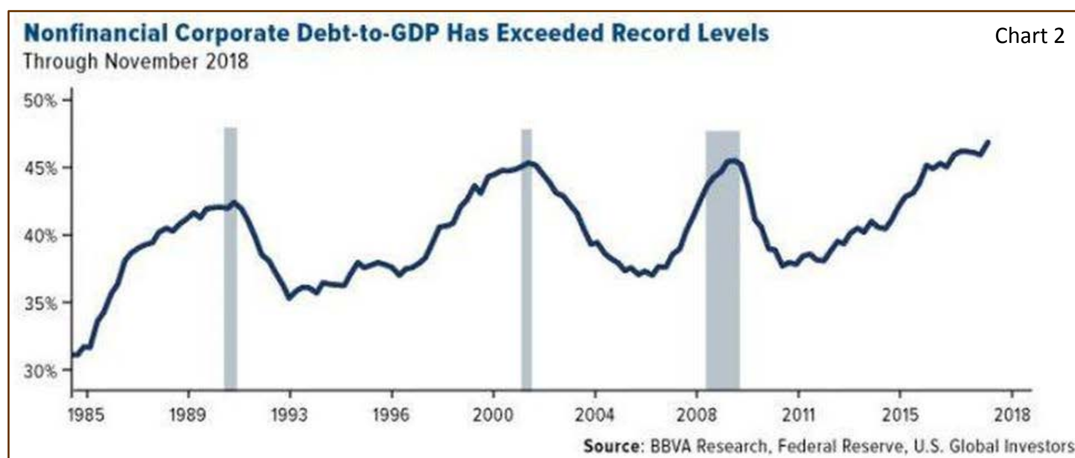


It is easy to see why MMT is all the rage in Washington. The limits of debt have been tested. The U.S. may have already reached a tipping point in its ability to pay off its $22 trillion in government debt and yet interest rates are down…a lot. According to its own statistics, U.S. government debt has grown by a whopping 120% since 2008 versus a mere 40% rise in GDP in the same period. It is counterintuitive to think that rates can remain this low in a financial system that requires debt levels to grow at a much faster pace than the overall economy, just to maintain itself. ***Old*** math clearly illustrates that the U.S would have to run a 10% surplus for 55 straight years, and use 100% of that surplus for debt reduction, just to pay back the debt they currently have on the books. Since the bond market has failed to

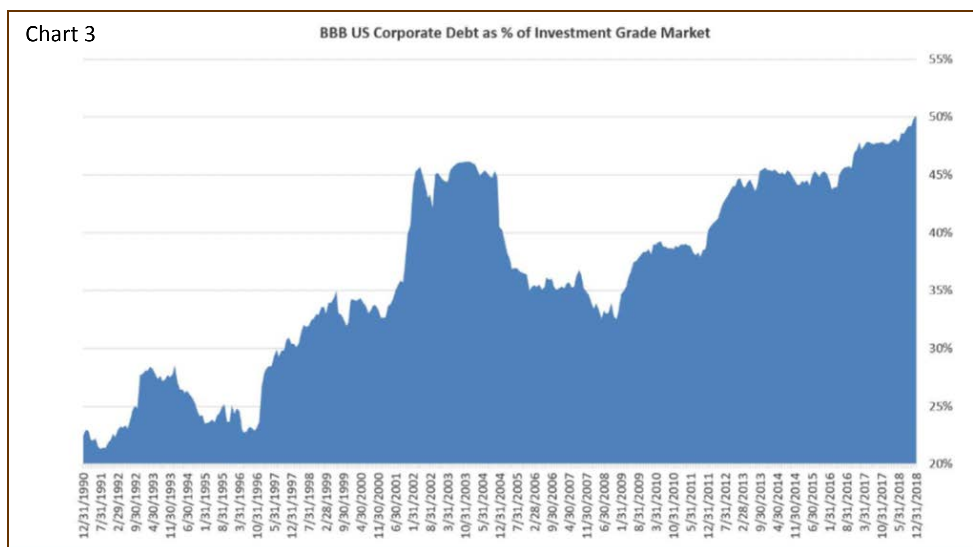
buckle thus far, the MMT crowd would argue the limits of excess could be pushed out farther. One politician believes the U.S. should excuse 95% of all student loans; another believes in free Medicare and Medicaid for all; and all seem to believe that annual trillion-dollar deficits make perfect sense. A high profile bond manager likens the attitude of the Fed and the MMT movement to a guy who jumps off the 102-story Empire State Building. When he reaches the 90th floor he somehow has the confidence to say to himself, "so far so good." Unfortunately, he may not realize this ***new*** math does not work until he reaches the ground.

Debt Bubble - Sowing the Seeds of the Next Financial Crisis

The U.S. has two significant advantages over most other sovereigns-it possesses a massive currency printing press and it is the world reserve currency. These benefits give domestic government debt the luxury of time before something truly catastrophic occurs. However, the $9 trillion U.S. corporate debt may not be so lucky and the day of reckoning may appear sooner than later. Like governments, corporations have taken advantage of low interest rates, but with a slight twist. They issue as much debt as possible while still maintaining a bank investment grade rating. Then they use the proceeds of these issues to fund massive stock buybacks. The result is they have created the *junk*iest investment grade corporate bond market in history. In our most recent Fixed Income Quarterly, entitled "The 'Crazy Loco' Fed and the BBB-Formula," we coined the phrase, the 'BBB-Formula,' to describe this phenomenon.

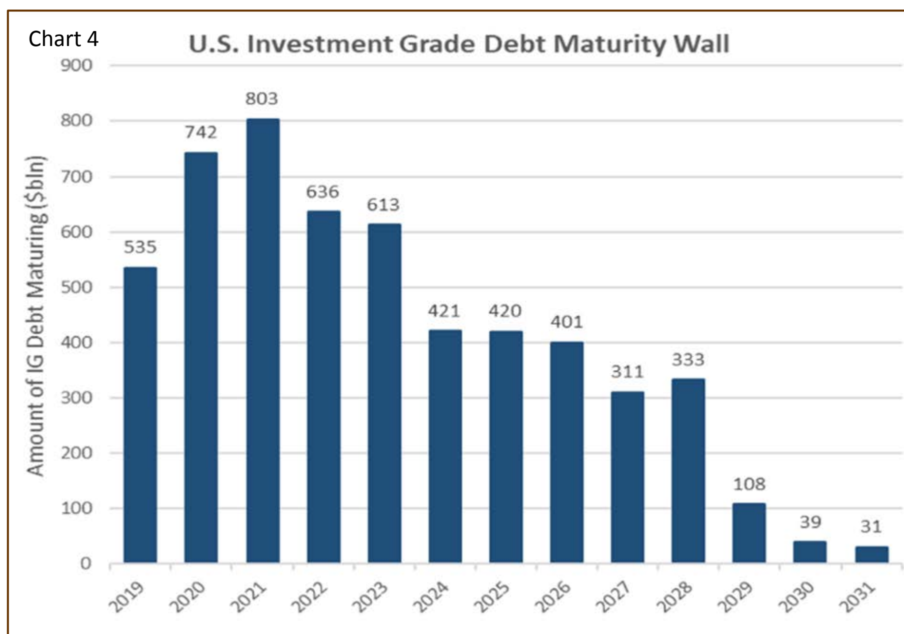


Corporate bond debt is at an all-time high as a percentage of GDP at 45%. This is noteworthy because this ratio has risen above 40% in each of the last three financial recessions. But "this time *is* different." Not only is this debt bubble bigger than in past recessions, but "risky corporate debt has been growing faster than any other category."[1] Corporate bonds rated BBB, one notch above junk, now represent 50% of the bank investment grade market. This is a frightening statistic considering the last economic downturn was caused by too much debt when BBB-rated bonds only accounted for 30% of the bank investment grade market. To make matters worse, Morgan Stanley recently published a report in which they suggested that 55% of the investment grade corporate market, or about $4.25 trillion worth of bonds, would actually be rated 'junk' if their current ratings were based on leverage alone.



Just North of the Border of Junk

For now, healthy corporate earnings provide the last bastion of defense for credits hovering just north of the borderline of BBB and junk. But it important to remember that the high yield bonds acts very differently than investment grade credits. It might be more accurate to look at these securities more as stocks with high dividends rather than bonds with high yields to understand better how they might perform in good and bad markets. The December downturn gave investors a glimpse of just how esoteric and illiquid the junk bond market can be and how highly correlated it is with stocks. According to Dealogic, December high yield markets simply froze and new issuance hit its lowest level since August, 2008. Danielle Di Martino-Booth of Bloomberg says that the high yield market is a relatively small market-only about a $1.25 trillion. For perspective purposes, this is roughly the size of the subprime market at its peak before the Great Recession. When markets really started to unravel 10 ½ years ago, the then Fed Chairman, Ben Bernanke, said subprime was "contained' and did not believe it would spread to other financial markets. No more foolish words were ever spoken. What he missed was the number of homebuyers who would become 'subprime' as a result of the economic downturn, the failure of the rating agencies to reflect this unfortunate set of circumstances in a timely manner, and the swiftness and magnitude in which markets reacted. If an additional $4.25 trillion worth of paper hits the junk bond market, it does not take a significant leap of faith to conclude a prolonged decline in corporate earnings could make the subprime crisis of a decade ago look like a walk in the park in comparison.



The timing of the next economic downturn could be determined by the ease or difficulty in which corporate debt can be paid off or extended when bonds mature. The good news is the test has already begun and so far, so good. But 43% of all bank investment grade corporate bonds are scheduled to mature by the end of 2023. The term 'Wall of worry' is one used in Wall Street parlance to describe an ascending market in the face of negative factors. The success of the markets to continue to climb will certainly be dependent upon the ability of corporations to navigate this 'wall of maturities.'

Navigating the Good, the Bad and the Ugly

In our 4th quarter fixed income report, we described our 'wall of worry.' We suggested the Fed would raise once more, the Fed's tone would then turn from hawkish to dovish, and corporate earnings would decline in 1Q19 year-over-year. While we were right on all three counts, we neither expected the markets to dive so dramatically on the news of the last rate hike nor rise so euphorically on the Fed's *expected* changed in tone. Fortunately, we were able to significantly increase our muni exposure before yields plummeted and do some end of the year corporate bond bargain hunting. However, these windows of opportunity closed just as quickly as they opened.

Doucet Asset Management FI Strategy Composite Performance						
	YTD	2018	2017	2016	2015	Since Inception
Doucet Fixed Income Composite	2.80%	1.82%	3.89%	10.64%	0.73%	5.37%
Barclays US Aggregate Bond	2.94%	0.01%	3.54%	2.65%	0.55%	2.28%
+/- Benchmark	-0.14%	1.81%	0.35%	7.99%	0.18%	3.09%
*Performance calculated by Morningstar Office, periods over 1 year are annualized						

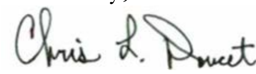
Our macro views during the 4th quarter of 2018 and the first quarter of 2019, guided our conservative stances on both modified duration and credit quality in our Fixed Income Model. Our modified duration remained steady at about 35% of that of the taxable Barclays U.S. Aggregate Bond Index and an average credit rating of an A. We were pleased that our muni-centric Model was able to outperform the taxable Index by 181 basis points for the year in 2018, and we only lagged the Index by a mere 14 basis points in the 1st quarter with a healthy 2.8% return.

Doucet Asset Management Fixed Income Composite Characteristics					
	Portfolio	Benchmark	+/-	% of Benchmark	Target
Coupon Rate	5.24	3.22	2.02	163%	>100%
Modified Duration	2.17	6.09	-3.92	36%	65%
Yield to Worst	7.09	2.99	4.10	237%	>125%
Yield to Maturity	8.04	3.00	5.04	268%	>150%
Current Yield	7.22	3.16	4.06	228%	>150%
Convexity	0.26	0.79	-0.53	33%	50%
OAS	253.51	44.84	208.67	565%	>200%
Rating	A	AA			
Note: Stated Benchmark is Barclays Agg					
Source: All characteristics calculated using Bloomberg Portfolio & Risk Analytics					

As we begin the 2nd quarter of 2019, we believe there is more risk imbedded in the markets currently than at any other time in history. We do not make this statement lightly. While good records are being broken almost daily, bad records are too-record stock buybacks, record world debt, and the list goes on and on. There was even a Bloomberg Opinion out recently that stated they expect 2019 to set the record for the highest value of IPOs brought to market. Coincidentally, they also expect a record in the most unprofitable IPOs of all time.

While we believe that most securities are overpriced based on current fundamentals, it is our opinion that securities furthest out on the risk curve are the most mispriced. As a result, we expect the overall credit rating in our Fixed Income Model to rise slightly and the modified duration to be reduced. In other words, our plan is to take this era of complacency in the fixed income markets to de-risk portfolios even more than they already are. We liken the current investment environment for all securities to the 2008 market on steroids-more debt, more leverage, less Fed tools to fight market dislocating events when they occur, and the new addition of the MMT movement who will likely exacerbate current conditions. Given the flexibility of our bond trading desk coupled with our low fee regime, we believe we will be able to continue to keep pace or outperform in a positively sloping fixed income market. However, we feel confident we will significantly outperform overall credit markets if investment sentiment turns south. It will take a herculean effort simply for markets to avoid some disruption in pricing given the 'wall of maturities' that begins this year. Even an industrialized roll of accommodative policy may not be enough to smooth out all of the rough patches ahead. And when that Duct Tape ceases to hold these markets together any longer, we believe our cautious portfolio positioning will provide us with ample opportunities to redeploy cash with a much healthier return profile. In short, there will be some good that will come from the bad and the ugly.

Sincerely,



Chris Doucet

Footnotes:

[1] Zero Hedge, April 16, 2019

[2] Morgan Stanley Research, *The Nature of the BBBeast*, October 25, 2018

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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