DOUCET ASSET MANAGEMENT, LLC

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Q1 2020

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When the Fed Was King

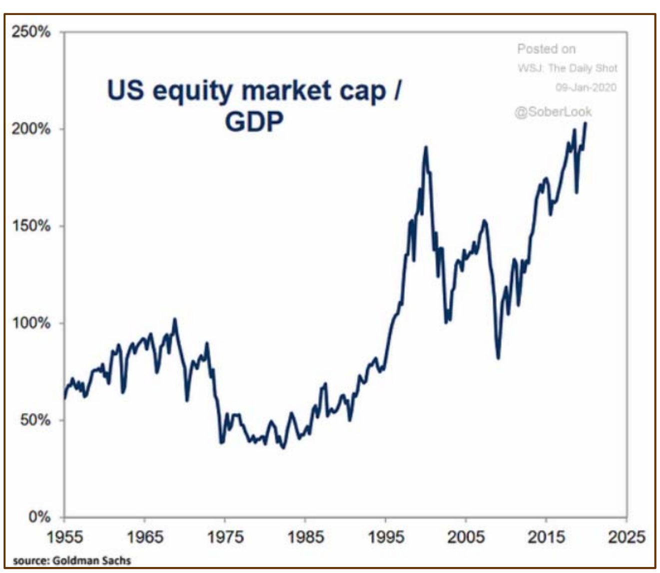
"The bold effort the present (central) bank had made to control the government ... are but premonitions of the fate that await the American people should they be deluded into a perpetuation of this institution or the establishment of another like it."

~ Andrew Jackson, (1767-1845)
7th US President

In 1830s America, 'cotton was king.' Cotton helped fuel an economic renaissance, a meteoric rise in asset prices, and major technological changes in the era. The unicorns of the day in the telegraph and rail industries were helping to make the world a smaller place to live in and commerce easier to transact, but cotton was the fabric that connected the fortunes of southern plantation owners, the northern banking industry, textile factories in New England and a huge portion of the economy in Great Britain. And it was all funded by debt…and lots of it!

"Cotton, the Fabric of Our Lives"

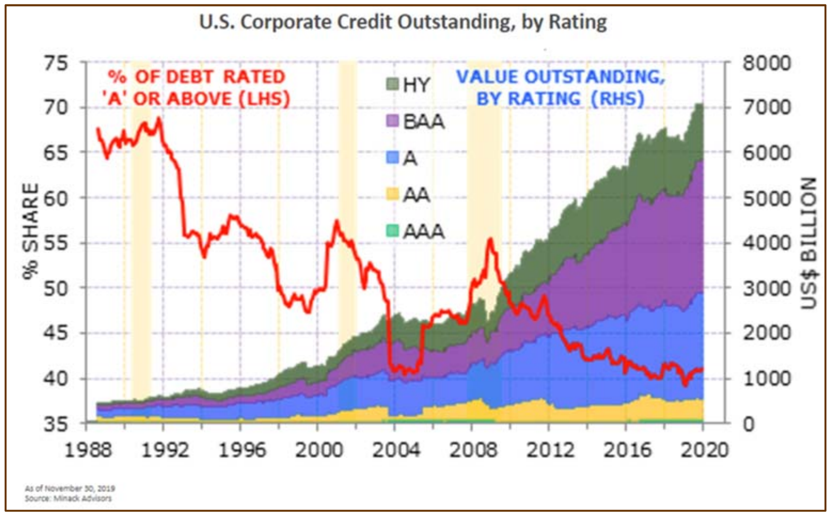
In the South, a plantation owner would solicit the help of a cotton factor who could broker crops, buy and sell slaves, and finance equipment. No cotton factor was more successful during the era or employed the use of financial engineering more effectively than Samuel Hermann of New Orleans. It is estimated that as much as 20% of Louisiana's entire banking capital in 1837 was on loan to Hermann[1] which he in turn doled out to wealthy planters to help them juice their returns on investment. As long as cotton prices remained healthy, cash flow could support the debt, banks would continue to extend credit, and profits could grow. In the summer of 1836, cotton prices began to soften. By early 1837, they were down another 25%. As a result, Hermann's cash flow declined to a point that neither he nor most of his clients could continue to service their loans. In March of that year, his company declared 'failure.' Word of the fall of the House of Hermann spread quickly and the Panic of 1837 had begun. Over the next several years, financial sectors shut down, asset prices across the globe plummeted, 90% of all northeastern factories closed, over 600 banks failed, and unemployment rose to 25% in some places. America had entered its first economic Depression.



Depression That Never Was

171 years later, the U.S. faced a similar fate with the Subprime debt crisis. This time, the foundation of the boom and bust was the real estate market instead of cotton, but otherwise the stories were essentially the same-prices rose, borrowers became over-levered, prices fell, borrowers defaulted on loans, and panicked selling ensued. A key difference was the Federal Reserve was mobilized into action in 2008 to help the U.S. avoid another 1837-style Depression. They reduced rates to unnaturally low levels and initiated their Quantitative Easing (QE) programs where they bought trillions of dollars-worth of assets. These two moves had the intended effect of compelling individuals, governments and companies to assume greater levels of risk than they would ordinarily take just to achieve the same rates of return on their invested capital.

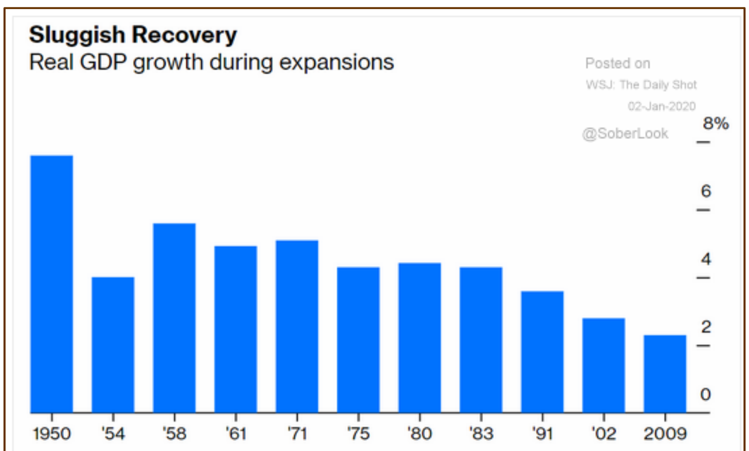
All the Wrong Moves



11 years and $3 trillion later, the Fed is still going strong! The stock market is elated as it hits record highs seemingly daily. But stocks are also near their most expensive levels *ever* based on just about every fundamental metric. Instead of taking this as an opportunity to raise cash for a rainy day by doing a secondary offering or using proceeds from asset sales to pay off debt, corporations are spending trillions of dollars to repurchase their own shares at exorbitant prices. Additionally, the level of U.S. corporate debt has actually *risen* during this time period by roughly 90% to a new record high of 47% of GDP[2]. Simultaneously, the credit quality of the associated debt outstanding has gradually deteriorated according to Manack Advisors. The same bad behavior has been exhibited by the U.S. government as its debt has increased by over 150% in the same timeframe and the rate of growth of its debt has actually exceeded that of GDP in each of the past six years. All of this suggests the U.S. and its major corporations exited the worst financial crisis since the Great Depression by perhaps creating an even bigger problem to deal with in the future. But as was the case in 1837, as long as cash flows can support debt service and profits continue to grow, the economy and markets can move forward.

New Math: 0% EPS Growth + Fed =30%

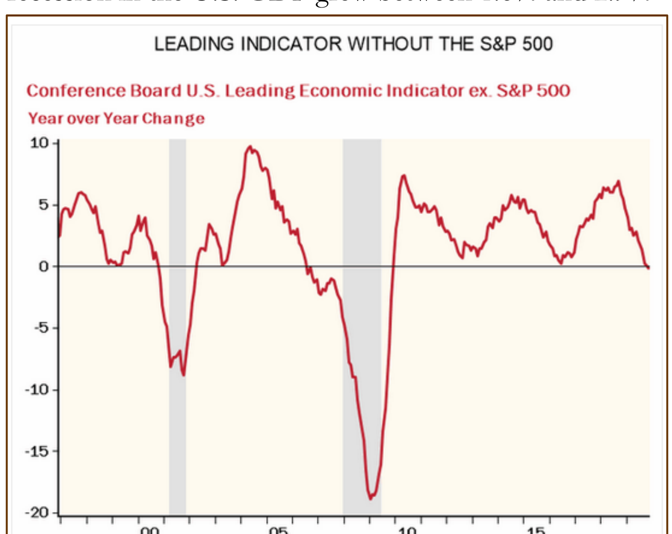
While S&P 500 earnings were flat year-over-year and economic performance was tepid, the market still managed to surge 30% in 2019 thanks to a huge multiple expansion and help from the Fed. Just call it the new math. According to the U.S. Bureau of Economic Analysis and the National Bureau of Economic Research, the current economic expansion represents the most sluggish recovery in the post-World War II era[3]. But the 2010s was a decade where Mr. Market got to 'eat his fill' without much indigestion. The economy has now expanded 129 months in a row. A record was set for the least amount of volatility in a host of markets over the past decade. There were no bear markets and only six corrections in the period and it was the only decade in at least 170 years where there was not a single day of recession in the U.S. GDP grew between 1.6% and 2.9% during the decade, which represented its smallest fluctuation since at least the 1920s. Unemployment rates declined to a 50-year low. What's not to like?



Sources: U.S. Bureau of Economic Analysis; National Bureau of Economic Research
Note: Annualized rates of expansion from trough to peak. Data are through third quarter 2019.

Can We Have an Encore?

According to Haver Analytics, if stock market performance is stripped from the Conference Board of U.S. Leading Indicators Index, economic growth is actually beginning to *decelerate*. What is disconcerting is all of the stops have been

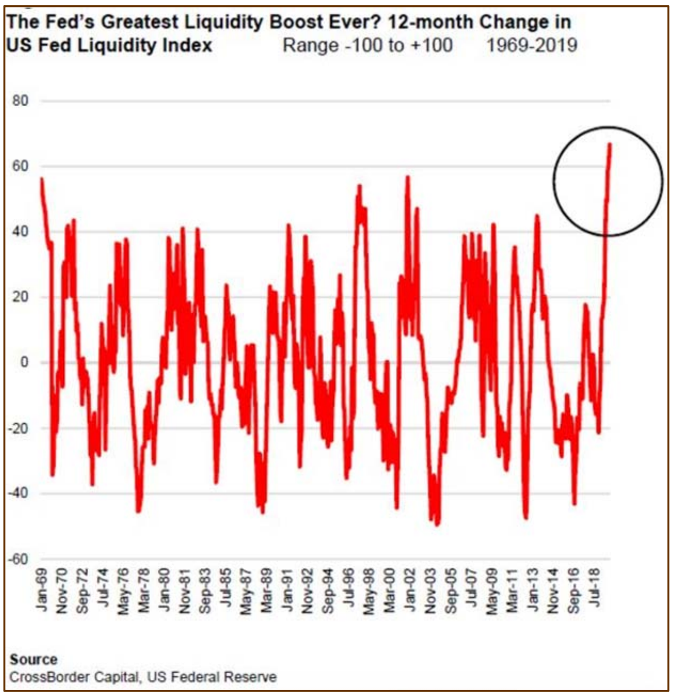


Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Rosenberg Research

pulled out to get both the markets and the economy to these levels. Corporations have executed trillions of dollars in stock buybacks, record amounts of corporate debt are currently outstanding, equity multiples are uncomfortably high, and the Fed accommodations exceeds even the support they showed the markets at the height of the Great Recession. What can the market possibly do for an encore?

2020 is slated to be a year where corporate profits finally begin to accelerate again after a long hiatus and the Fed continues its 'whatever it takes' approach to keeping the financial markets buoyed. According to Factset, S&P 500 earnings are expected to increase by a healthy 9.5% in 2020. While most of the gain in earnings is expected to come from the energy sector, oil prices are already down 20% from their high this year, partly due to the fallout from the coronavirus. Oxford Economics suggested in a recent report that the virus could impact China GDP by 2% in the 1st quarter, but it is expected to have a lesser impact on the rest of the world.

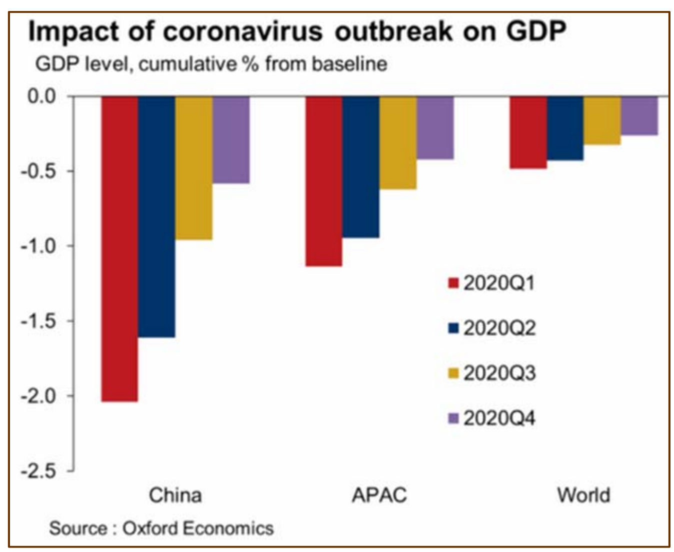
Fed's Third Mandate



The market is also comforted by the knowledge that the Fed plans to remain supportive for the foreseeable future. At this point, the Federal Reserve has left little doubt in the minds of most investors that their unspoken *third mandate* is supporting the financial markets at all cost. Unfortunately, the Fed attempted to unwind its expansive policies in 2013 which resulted in the "taper tantrum" and again in 2018 when investors experienced the historic market meltdown that December. Since this most recent episode, Chair Powell has done a complete about face in regards to Fed policy. The Fed has increased its balance sheet by $400 billion since last summer and reduced interest rates three times in 2019. While it is alarming on several different levels that the Fed would still feel the need to provide historic levels of accommodation when the stock market is hitting all-time highs and yields are near 5000-year lows, a recent survey of economists by Bloomberg suggested there is an 84% chance that at least one rate cut will occur in 2020. This move would be highly supportive of continued asset inflation.

Conclusion

While the Fed has been successful in supporting the financial markets thus far, they have fallen short of creating desired inflation in the real economy. Given the extraordinarily high levels of debt, it makes it increasingly more difficult to marry the momentum of this market with current valuation metrics. This toxic combination in financial assets makes the markets more vulnerable to exogenous shocks like a virus or a 'no trade deal.' The current environment compels investors to take profits and wait for a better opportunity. For the time being, the Fed is King. But if 1837 was the 'cotton bubble,' if 2008 was the 'housing bubble,' this market will certainly be known as the '*central bank bubble*' if earnings do not return soon to justify current multiples.



Sincerely,

Chris L. Doucet, CEO

Footnotes

1 The Many Panics of 1837, People, Politics, and the Creation of Transatlantic Financial Crisis, Jessica Lepler, 2013

2 Goldman Sachs Global Market Research

3 U.S. Bureau of Economic Analysis, National Bureau of Economic Research

- 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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