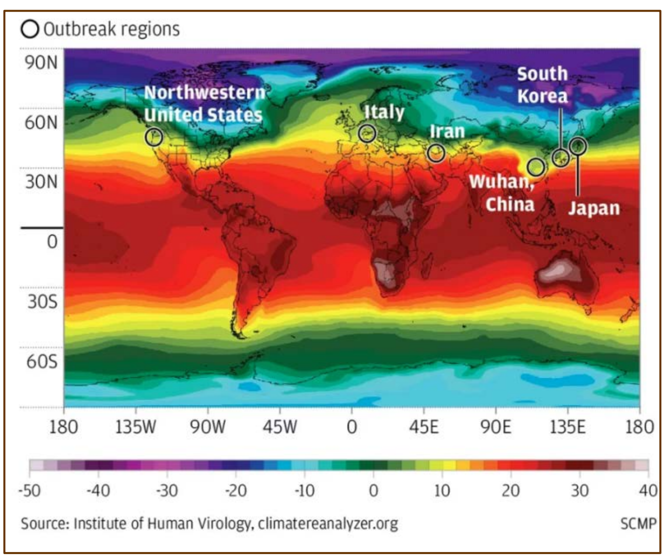
DOUCET ASSET MANAGEMENT, LLC
Fixed Income Quarterly
March 2020

Bond Investing in the Age of the Coronavirus

In 1918, an influenza pandemic known as the 'Spanish Flu' began its march from the front lines of World War I to Main Streets across the globe. An estimated 500 million people or about 27% of the world's total population were infected by the virus and approximately 40-50 million died. A 2007 study stated "the viral infection was no more aggressive than previous influenza strains," but the high death toll was, in part, a direct result of a perfect storm. "Malnourishment, overcrowded medical camps and hospitals, and poor hygiene promoted bacterial superinfection." They were all factors in making the virus deadlier than it should have been.[1] The death rate peaked in October of that year, but something miraculous happened the very next month. The war ended and the number of people getting the virus dropped precipitously…almost overnight. The pandemic had run its course.

Fed Cure All-Emergency Rate Cut

Much like the Spanish Flu 100 years ago, Covid-19 (the coronavirus) is making its presence known across the globe. Secretary of Health and Human Services, Alex Azar II, told a Senate committee recently that "this is an unprecedented, potentially severe health challenge globally." As was the case with Spanish Flu a century ago, the data set coming out of various countries impacted by Covid-19, including the U.S., is imperfect. Goldman Sachs estimates that 50% of Americans will contract the virus and the mortality rate could be as high as 2%. One statistic shows that most of those infected are concentrated in a band between 30 and 50 degrees North latitude which suggests the virus is seasonal, much like the common flu. Some experts use this evidence to suggest the economy will begin seeing green shoots again when temperatures rise. Others contend the effects of the virus will continue through the next several quarters. No matter who is correct, until this virus peaks and then begins to subside, most of the world economy will find itself in a simultaneous state of supply and demand shock as trade is disrupted, factories are closed, travel is restricted and people are voluntarily or involuntarily quarantined.



Source: Institute of Human Virology, climatereanalyzer.org

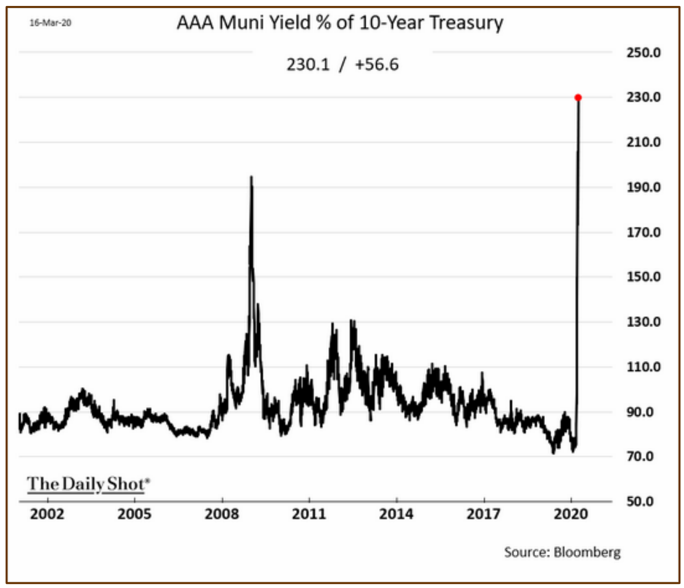
From Good To Bad In Record Time

Just a few short weeks ago, Federal Reserve Chairman, Jerome Powell, emphatically stated that the U.S. economy "is in a very good place" and shrugged off concerns about the coronavirus and the potential for an economic slowdown. Well, the world has changed. The S&P 500 has now fallen by as much as 30% from its recent peak with alarming speed making this the first bear market since the Great Recession. The 10-year Treasury plummeted from a 1.9% yield at the beginning of the year to its lowest yield in history when it hit 1.32%…and then it dropped almost 75%

further to as low as .318% recently. Governments around the world have responded to the Covid-19 crisis by virtually shutting down multiple industries including restaurant, retail, travel, hotel, airline, and cruise line…just to name a few. The Fed has reacted to these market dislocations, thus far, by implementing its first emergency 50 basis point rate cut since the Lehman crisis, a follow-on rate cut of another 100 basis points a week later, along with a $700 billion restart of Quantitative Easing (QE), and a commercial paper fund similar to the one implemented during the 2008 financial meltdown. Congress will respond with multiple bailout packages for the individuals they temporarily put out of work and for the industries they forced to shut down.

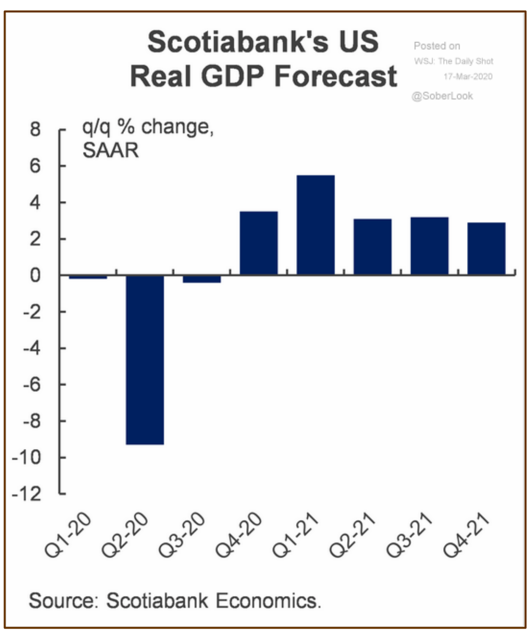
Something's Broken

The current drop in business activity has helped force investors out of stock and credit markets and into safe-haven investments like U.S. Treasuries. The *Wall Street Journal* stated this move is also being fueled "by commercial banks hedging against balance-sheet risks in anticipation that more consumers will look to refinance mortgages in a low-rate environment."[2] (March 7th, page 1, WSJ). "Banks need to buy around $1.2 trillion of 10-year Treasuries to offset risks on mortgages and bank deposits" on top of the $3 trillion of U.S. Treasuries and government-agency securities they already own. But while there are multiple reasons why interest rates go down, there is only one reason rates go down this much, this quickly-something is broken. Jeffrey Gundlach of Doubleline Capital said in a recent interview that "things have to get worse-you don't have a move like this end without disorder. It just never happens."



Disorder-Widening Credit Spreads

The 'disorder' Mr. Gundlach spoke about is occurring in real time in the fixed income markets. The rapid spread of Covid-19 and the various government responses has struck fear in the hearts of fixed income investors and created an unusually high demand for liquidity. The results have been eye-popping. While yields on Treasury bonds have plummeted since the beginning of the year, yields in credit markets have spiked in record speed. Credit spreads have widened to levels not seen since the collapse in oil prices in the first quarter of 2016. Yields on high yield bonds have gone from 325 basis points over Treasuries at the beginning of the year to 893 basis points today. Investment grade corporate bond spreads have risen from 95 to 287 basis points in the same time frame. Even spreads in the sleepy muni bond market have gone from a negative 75 basis points to positive 47 basis points as economic conditions have worsened and investors have decided to sell first and ask questions later. This has created massive dislocations in the fixed income markets as buyers have been swamped by the massive wave of selling.



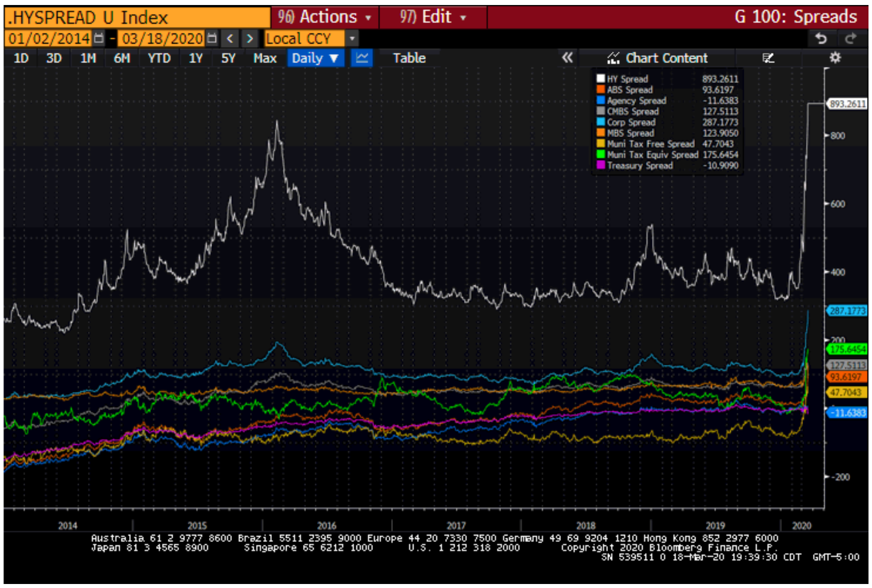
Economic Prognosis-Lethargy

Economic analysts are acting swiftly to adjust their GDP and corporate earnings estimates in response to the sudden slowdown in business activity. At the beginning of the year, the average forecasts for S&P 500 earnings growth in 2020 were just shy of 10%. Goldman Sachs now believes the S&P 500 will experience an earnings growth rate of between -15% to -20% in 2020. Likewise, Scotiabank now expects GDP growth in the U.S. to be down for first three quarters of 2020 implying that a recession is all but certain this year.

The Right Formula

In the past five years, when volatility surfaced in the fixed income markets, it was typically a good time to deploy capital. The Doucet Asset Management Fixed Income Composite took advantage of these short bursts in price drops with the help of models such as credit spread chart below.

Doucet Asset Management FI Strategy Composite Performance					
	2019	2018	2017	2016	2015
Doucet Fixed Income Composite	9.21%	1.82%	3.89%	10.64%	0.73%
Barclays US Aggregate Bond	8.72%	0.01%	3.54%	2.65%	0.55%
+/- Benchmark	0.49%	1.81%	0.35%	7.99%	0.18%
*Performance calculated by Morningstar Office, periods over 1 year are annualized					



Having the ability to put cash to work during these rare moments is, in part, the reason our Composite outperformed the Index five out of five years. But there are major differences between then and now. Today, markets are falling because of a public health issue and a government response which cannot be easily resolved with a liquidity injection or a tax cut. However, in this case, there is nothing in the old central bank playbook that can stop the virus from spreading.

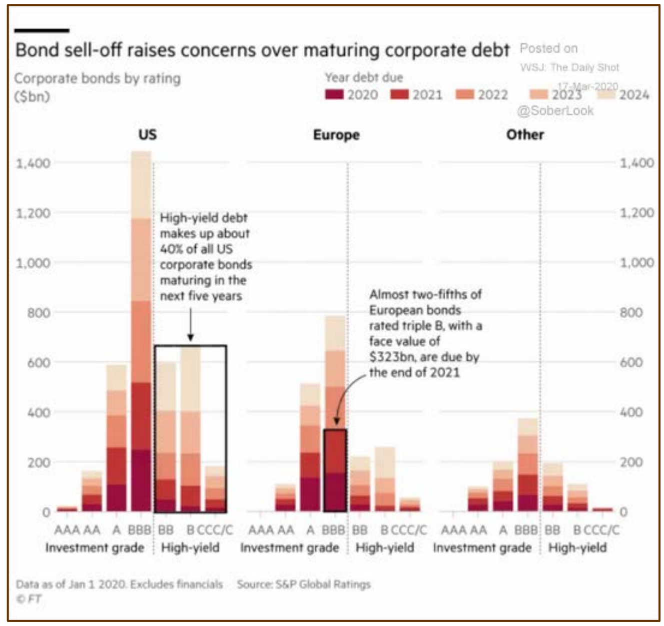
The majority of the Doucet Fixed Income Composite is composed of higher quality bonds with shorter maturities. The current credit rating is about an A. The modified duration of the portfolio at the beginning of the year was 1.19 and the workout date was about 2.27 years or only 29% of the Benchmark. This inherent liquidity should give us the flexibility to take advantage of weakness in the markets when very few investors want to step up and put capital to work.

Doucet Asset Management Fixed Income Composite Characteristics					
	Portfolio	Benchmark	+/-	% of Benchmark	Target
Workout Date (Years)	2.27	7.96	*-5.69*	29%	65%
Modified Duration	1.19	6.10	*-4.91*	20%	65%
Coupon Rate	4.79	3.17	*1.63*	151%	>100%
Yield to Worst	3.89	2.25	*1.64*	173%	>125%
Yield to Maturity	5.80	2.26	*3.54*	257%	>150%
Current Yield	5.83	2.99	*2.84*	195%	>150%
Convexity	0.11	0.83	*-0.72*	13%	50%
OAS	153.33	46.44	*106.89*	330%	>200%
Rating	A	AA			
Note: Stated Benchmark is Barclays Agg					
Source: All characteristics calculated using Bloomberg Portfolio & Risk Analytics					

The Fever Will Break

The combination of an unprecedented wall of debt scheduled to mature over the next several years and deteriorating corporate earnings will complicate the investment landscape for traditional fixed income and equity investors alike. It has been our belief for quite some time that markets have been much more vulnerable to an economic shock simply because the U.S. Government and corporations have too much debt on their balance sheets. In fact, in our February Newsletter entitled, ***When the Fed Was King***, we stated "*the level of corporate debt has risen in the last 11 years by roughly 90% to a new record high of 47% of GDP, while U.S. government debt has increase over 150% in the same time* *frame."* We went on to say high debt levels and relatively expensive financial assets *"make the markets more vulnerable to exogenous shocks like a virus."*

If the Spanish Flu of 1918 is any indication of how this crisis will play out, the coronavirus will continue to spread at a rapid pace. But ultimately, the curve will flatten. When this occurs, fixed income markets will begin to normalize. For now, we are closely monitoring our existing portfolios, taking advantage of the dislocation in high-quality short-duration munis, and making a wish list of other bonds to own in the near future. Our advice to investors is to buckle up. The ride will be bumpy for a little while longer.



Sincerely,

Chris L. Doucet

Chris Doucet

Footnotes:

1 Wikipedia, Spanish Flu of 1918

2 Wallstreet Journal, March 7th, 2020 page 1.

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.