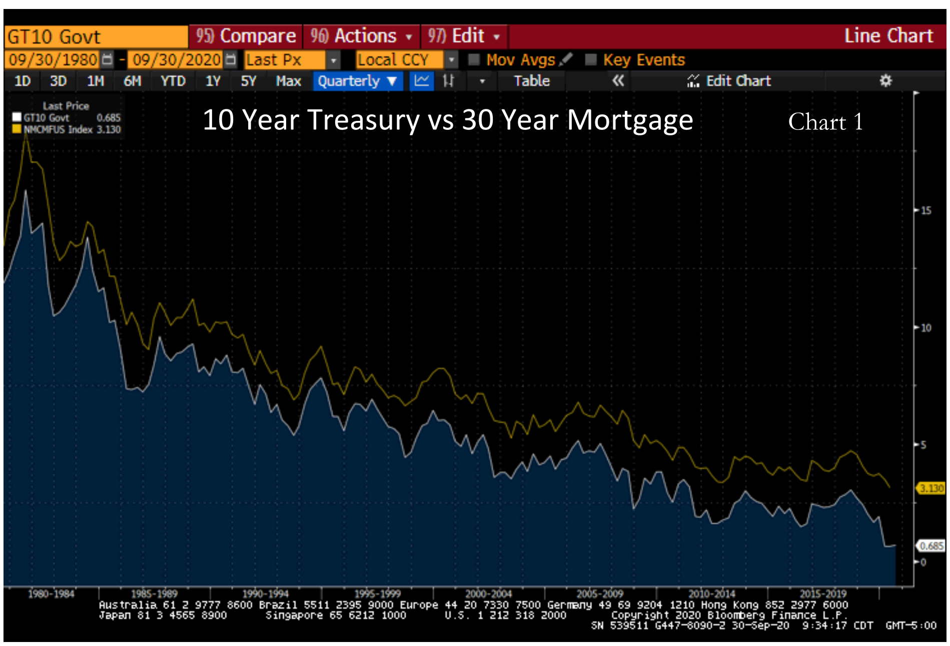
October 2020

The Parable of the Boiling Frog *Market*

"If something cannot go on forever, it will stop."

- Herbert Stien

Urban legend has it that if a frog is placed in a pot of boiling water, he will immediately jump out. However, if a frog is put into a pot filled with water at room temperature and the heat gradually increases, the frog will fail to notice the creeping change in its circumstance until it is too late. Since the 1980s, the thermal reading of the proverbial investment waters has steadily risen over time as interest rates have declined. 2020 began with elevated valuation metrics across most asset classes, muted return expectations and sky high government and corporate debt levels. But since the start of the pandemic, mercury levels have spiked even further and investors now find themselves in a similar situation as their fabled amphibious friends. All of this begs the question "are investors trapped in a future low-return kettle of water with high levels of heat?"



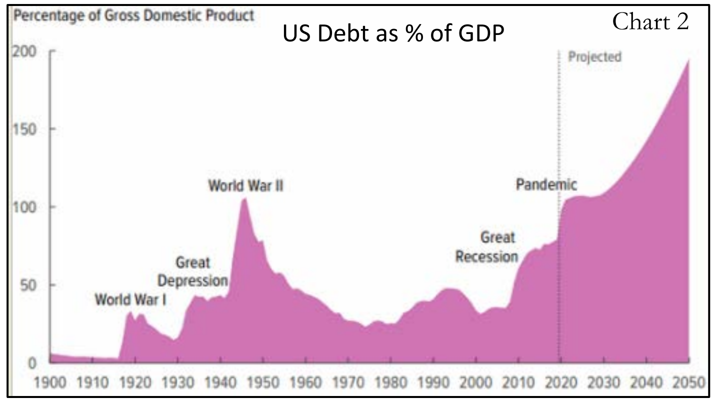
The Flame Fueling Higher Asset Prices

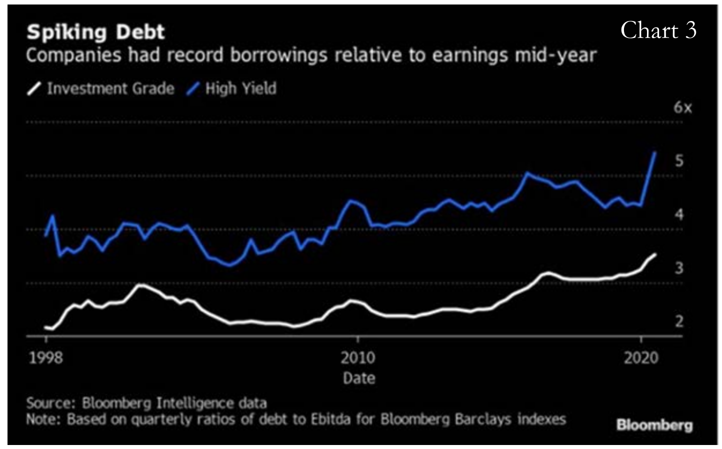
The financial instrument at the center of this low return/high risk reality is the 10-year U.S. Treasury note. The10-year is the foundation upon which most financial instruments are priced, either directly or indirectly. Since the beginning of the year, the yield on the 10-year has fallen from 1.919% to .696%. This set off a chain reaction of repricing of financial instruments ranging from mortgages to corporate bonds to common stocks.

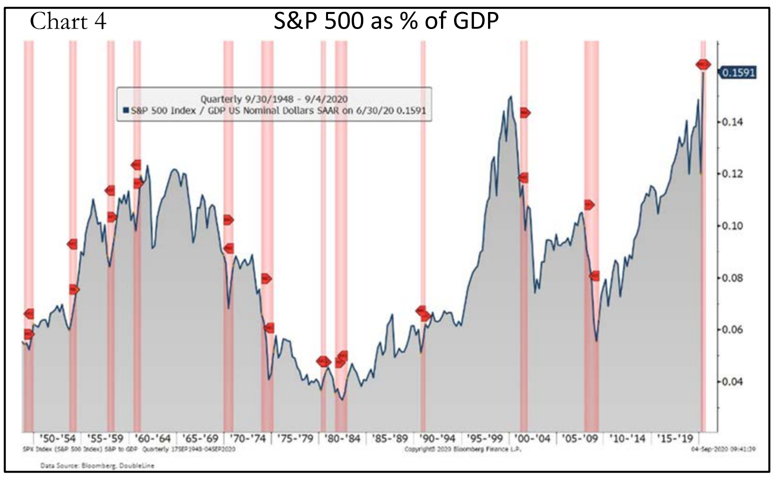
As evidenced in Chart 1, the 10-year Treasury and 30-year mortgage rates historically have a high degree of correlation and tend to move in the same direction. So far this year, mortgage rates have fallen from 3.72% to a record low of around 2.9%, but the drop has not been as precipitous as the decline in the 10-year. Obviously, these lower mortgage rates have the effect of reducing monthly interest payments which has helped single family home prices rise in most markets. Likewise, the drop in rates has also impacted the yield on high-grade corporate bonds, but the decline has not been as significant as the decline in Treasury yields due to general credit risk concerns. In the institutional investment world, prices are generally quoted based on their yield spread over Treasuries or how much additional yield is required over the 'risk-free' Treasury rate to attract a willing buyer. Thanks to a drop in interest rates, the average yield on this grade of paper has jumped from a spread of 112 basis points over Treasuries to 169 basis points today, but the absolute yield has declined from 3.04% to 2.39%. Even stock multiples tend to fall when interest rates rise and rise when interest rates fall. So far this year, the price-to-earnings multiple of the S&P 500 increased from 17.8 times at the beginning of the year to 26.24 times today as a result of the combination of soft corporate earnings coupled with lower rates.

The New Green is Red

While historically low interest rates and near record asset multiples receive most of the financial headlines these days, the amount of risk inherent in the financial system has been relegated to the back pages. It is expected that the Treasury will collect approximately $3.71 trillion in various taxes and income for fiscal 2020. U.S. government debt rose by about $3.3 trillion in just the past six months, rising from $23.5 trillion to $26.8 trillion. This amount now represents about 125% of U.S. GDP, a number not seen in the U.S. since the conclusion of World War II (see Chart 2). Equally troubling is the debt-to-GDP ratios of both high-grade and junk bonds have risen to all-time records as corporate borrowers have taken advantage of ultra-low interest rates (see Chart 3). Even though P/E multiples were higher in 1999 dot com era, Chart 4 suggests the value of the S&P 500 today has never represented such a large percentage of GDP.



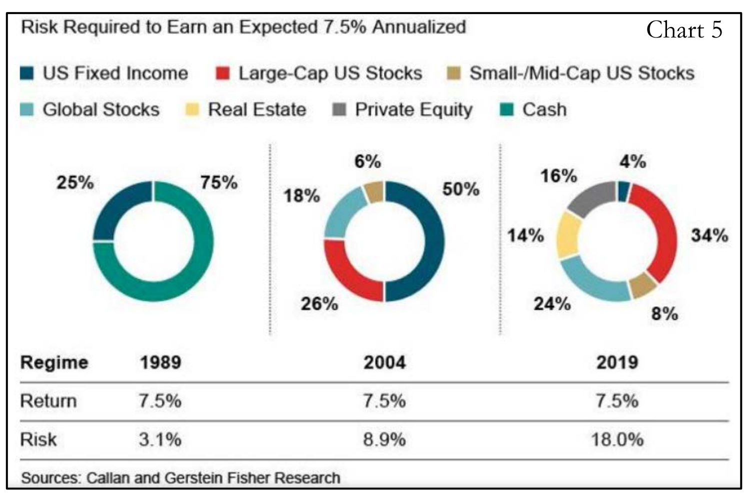




The Fed Triple Jump

The trifecta of lower interest rates, excessive corporate and government debt, and high asset valuations would not be possible without the machinations of the Federal Reserve. Simply put, the Fed is funding the majority of the Treasury's deficit spending. Since the beginning of the pandemic alone, the Fed balance sheet has increased by almost $2.5 trillion. It is this continual willingness on the part of the Fed to intercede when financial markets show any weakness that evokes the Pavlovian response on the part of investors to assume more risk in their portfolios than they otherwise would and others to simply be oblivious to how much risk they are actually taking in their portfolios.

Two studies can actually help ascertain just how much risk investors are assuming and how little return they are receiving in their portfolios versus years past. The research firm of Gerstein Fisher sought to determine the optimal asset allocation to produce a 7.5% return in three different periods. In 1989, a portfolio with a combination of 25% high-grade US fixed income and 75% cash was sufficient to provide a 7.5% return with little to no risk. By 2004, it took a portfolio of 50% bonds and 50% cash to produce the same number with an increase in risk of about 200%. But by 2019, the bond allocation was reduced to 4%, stocks increased to 66% and real estate and private equity combined to represent the final 30% of the pie. However, the risk level to the investor increased by 100% in 15 years and by a whopping 500% over 30 years.



A similar study was done by Real Investment Advice in which they sought to determine just how much decreasing interest rates have affected investors' ability to produce income in their bond portfolios while maintaining the same level of risk. According to Chart 6, a fixed income buyer needed to invest slightly less than $900,000 in relatively conservative investments in 1998 to produce an annual income of $50,000. Today, one would have to invest $8.3 million to produce the same number.

Chart 6

The Gerstein Fisher and Real Investment Advice studies simply highlight how much "financial repression" the Federal Reserve has helped usher into the financial system over the past three decades. One obvious side effect has been a massive transfer of wealth from savers to borrowers. The Covid-19 Recession has only stood to heighten the low yield/high risk circumstance of the markets which already existed. From real estate to cash instruments, financial assets simply have a higher risk and lower return profile than they did even a few years ago.

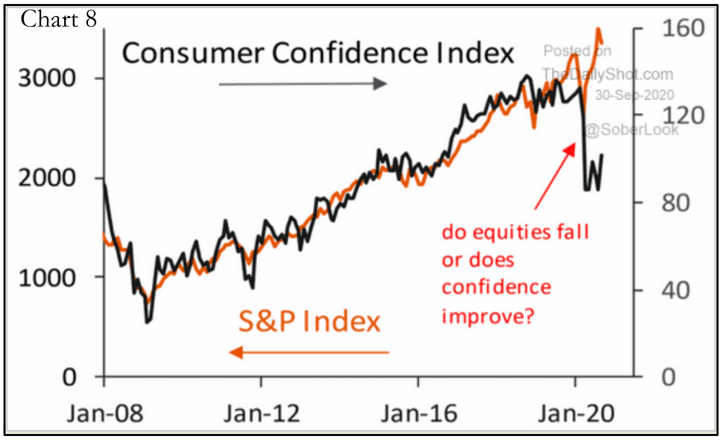
Growth Leapfrogs Value

One of the biggest risks facing investors today is many indexes are concentrated in a few large stocks or bonds. The six largest stocks in the S&P 500 now represent a quarter of the total value of the index. This raises serious questions about just how much diversification an index actually provides and how true a barometer it is for the overall economy. If one excludes Facebook, Amazon, Apple, Netflix, Google and Microsoft from the S&P 500, the return of the index is lower by about 725 basis points or the return is reduced from a positive 4.35% to a negative 3.1% year-to-date. The numbers are more jarring when value stocks are compared to growth stocks. The S&P 500 Spider Value ETF is down over 10% so far this year, while the same Growth ETF is up over 20% (see Chart 7).

Chart 7

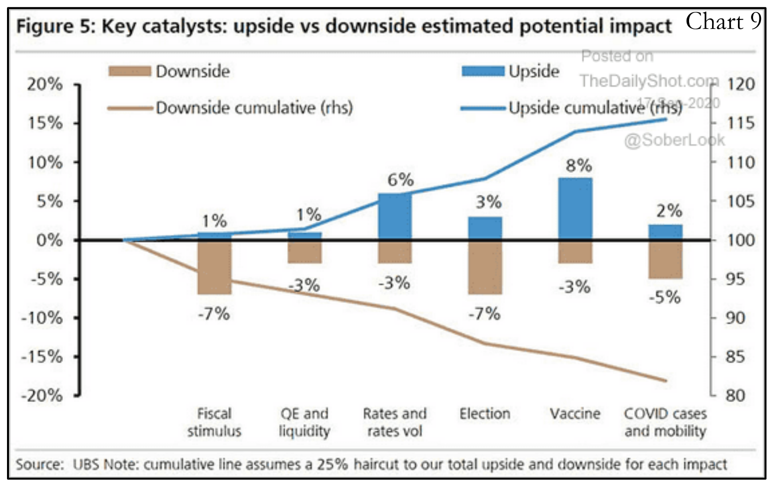
This disparity between growth and value is one of the many reasons why professional money managers are so anxious when it comes to putting money to work these days. Former Duquesne Capital founder and famed money manager, Stanley Druckenmiller said recently, "I have no clue where the markets are going to go in the near term. But I just want to remind people that there is no valuation support because we drop 10%. That hasn't mattered, because we're so far out the valuation realm with the Fed doing what they're doing." It is impossible to predict what the markets will do in the short term, however, Druckenmiller goes on to say that "Fed Chairman Powell is out lobbying Congress to do more spending and guaranteeing those of us on Wall Street that he'll underwrite it" even though the 2020 fiscal deficit exceeded $3 trillion in fiscal 2020.

The Heat is On, On…Main Street



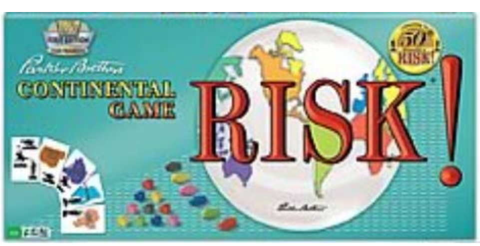
Main Street is equally cautious on the markets. While the Consumer Confidence Index has bounced off of its bottom, it clearly illustrates the juxtaposition in thought between nervous Main Street and complacent Wall Street. It is also interesting to note that the S&P 500 and the Consumer Confidence Index have been more or less in sync since 2008. However, as seen in Chart 8, the two diverged in March which suggests an increase in consumer confidence or a market downturn is in the offing.

Several key factors will certainly help determine which direction rates, the markets and consumer confidence will meander over the next several weeks and months. UBS conducted a recent client survey and asked them what they believed were the most significant market influencers were in the near term (see Chart 9). What the survey concluded was a further reduction in interest rates and a vaccine for Covid would be the most beneficial influences over the markets. What the survey also determined was a failure on the part of Congress to pass an additional stimulus package, election associated turmoil, or a significant increase in Covid cases and deaths would do the most damage to the markets and dampen consumer spirits.



Conclusion-The Boiling Frog Market

While we believe an additional stimulus package will ultimately be passed by Congress no matter who wins the election, it will drive up Treasury yields and weaken the US Dollar (USD). Hard assets like gold will strengthen in USD terms, but not necessarily in euro or yen terms. As hospitals continue to become less overwhelmed, cities and states will be more willing to open up their economies. The result will be a shift in sentiment from the Covid-19 darling stocks, or 'couch stocks' as we like to call them, to value stocks and others that have suffered due to lack of economic activity over the past several months. Mind you, this forced economic shut down has caused permanent damage in multiple sectors that will be felt for many years; there are some survivors that will be generational-type buys once the Covid air clears. In the short term, the plethora of headwinds facing investors today should only heighten the belief that the current investment landscape provides a less than optimal risk/reward scenario for investment capital. This combination of low-yield, high-risk, and elevated multiples in the broader markets merit caution on the part of investors. Values will surface soon enough for those who are patient. However, impatience could result in one's frog being cooked.



Sincerely,

Chris L. Doucet

Chris L. Doucet, CEO

Footnotes

- 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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