DOUCET ASSET MANAGEMENT, LLC

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Modern Fed's Third Crossing of the Rubicon

"Inflation is always and everywhere a monetary phenomenon."
-Milton Friedman, American Economist, 1912-2006

The Rubicon stands as one of the world's most famous rivers ever since Julius Caesar made his fateful crossing on January 10th in 49 BC. As a waterway, the river was so unimpressive that experts debate to this day which one of three minor streams the Rubicon might have been. But brazenly traversing it over 2000 years ago made armed conflict inevitable and gave centuries of writers an apt metaphor for an act committed from which there is no return.

There perhaps has never been a more fitting literary trope to describe the three distinctive *advancements* in monetary policy of the modern-day Fed. The first crossing of the Rubicon by the modern-day Federal was sighted shortly after the 1987 Stock Market Crash, as they helped buoy foundering stocks by reducing the Fed Funds rate or short-term interest rates. In the successive two decades, they would repeatedly pluck this blunt instrument from their sword sheath to help supercharge financial markets. The second crossing featured the policy of Quantitative Easing (QE) in the aftermath of the Great Financial Crisis which allowed the Fed to buy longer term bonds. This had the effect of artificially *deflating* interest rates and *inflating* financial asset prices while only modestly increasing the money supply. But the truly extraordinary anomalies did not occur until the *third* Fed crossing in response to the Great Lockdown. During this period, M2 money supply surged 25%, stocks hit new record highs, Treasury bond yields plummeted, U.S. household income rose … amidst a pandemic-fueled economy and high unemployment. But perhaps the oddest occurrence of all of these is debates are now sprouting up about … inflation!?

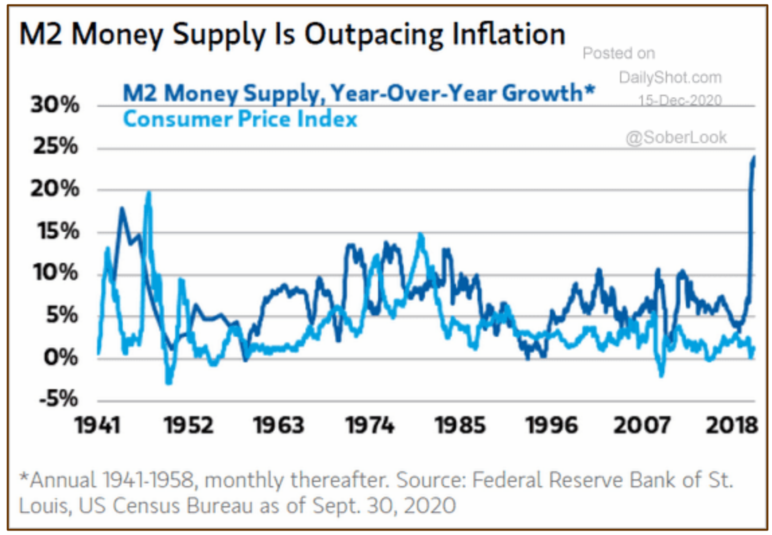
The Rip Van Winkle of all financial statistics is inflation -- it has laid relatively dormant in the U.S. economy for almost 40 years. But the recent no-expense-spared responses to Covid-19 by the government (and supported by the Fed), has sparked debates between the inflationary and deflationary camps rarely heard since the days of Chairman Volcker. An overabundance of monetary and fiscal stimulus makes it hard to know if the recent triggering of inflation alarms is charting a new course for the economy; or if the pandemic will exacerbate deflationary fears which have loomed since the Great Recession. Divining the right answer to this puzzle is imperative as a surge in inflation would significantly derail government efforts to provide more stimulus to support the continued V(accine)-shaped economic recovery; and disrupt financial markets whose value is based on future discounted cash flows ostensibly based on near-zero interest rates. So here are just a few of the arguments, pro and con, on the resurging inflation debate.

Pro Inflation: M2 & Third Fed Crossing

Source:

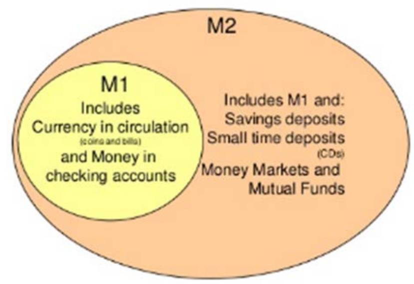
22% of all U.S. Dollars (USD) in circulation today were printed by the Federal Reserve in 2020! (source: 10/1/20, Pam & Russ Martens, *Wall Street Parade*). To put it differently, the USD has been in existence for 228 years and over 20% of that money was created last year which was a by-product of the Fed's third crossing of the Rubicon. According to Bloomberg, M2 increased from $15.2 trillion to $19.2 trillion during 2020. This rapid rise in the money supply is the result of the Federal Reserve indirectly funding the deficit spending of the U.S. Treasury, in part, to help support its Covid-19 relief programs.

Chart 1: M2 vs Inflation



Argument:

As evidenced in Chart 1, M2 increases in the past were followed by a corresponding pickup in consumer prices. When there is too much money chasing too few good services, it will sooner or later wash through the economy and result in higher consumer prices. From supply disruptions causing product shortages to increased retails in 2020 versus 2019, there are plenty of signs cash is making its way into the real economy and driving up prices.



Pro Inflation: Federal Reserve Bank

Source:

Chart 2: Federal Reserve Balance Sheet

The Fed balance sheet has increased $3.25 trillion in the past year in response to the Covid crisis from around $4.15 trillion to $7.4 trillion. The first two Rubicon crossings of the modern-day Fed before the Great Lockdown did not cause massive amounts inflation because what was occurring were simply asset swaps - the Fed creates borrowing power out of thin air, and transfers a credit to the Treasury; while the Treasury sends back freshly minted bonds for Fed member banks to hold on their balance sheets. Very little money enters the real economy except indirectly through increased lending capacity and the wealth effect.

Argument:

This third Rubicon crossing has resulted in massive amounts of real money entering the real economy as evidenced by the historic increase in M2 last year. In August, the Fed stated they would allow inflation to run hotter during the economic recovery which suggests the Fed might be willing to relinquish their decade-long rein on price controls.

Con: Labor Markets

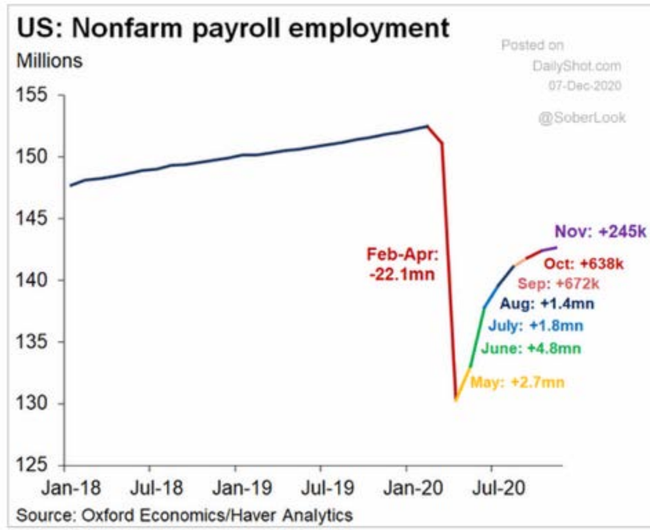
Source:

According to Oxford Economics in Chart 3, only about 12.25 million of the 22.1 million jobs that were lost from the Covid crisis have been replaced to date suggesting there is still a huge amount of slack in the labor market.

Argument:

As one of its primary metrics of measuring inflation, the Fed uses an economic concept known as the Phillips Curve. The theory suggests that prices can only face sustained upward pressure when an economy is using all of its resources - especially labor. Simply put, continued pricing pressure is capped on goods and services if people do not have wage-producing jobs.

Chart 3: Rise & Fall of Unemployment



Source: Oxford Economics, @GregDaco

Neutral: Household Income

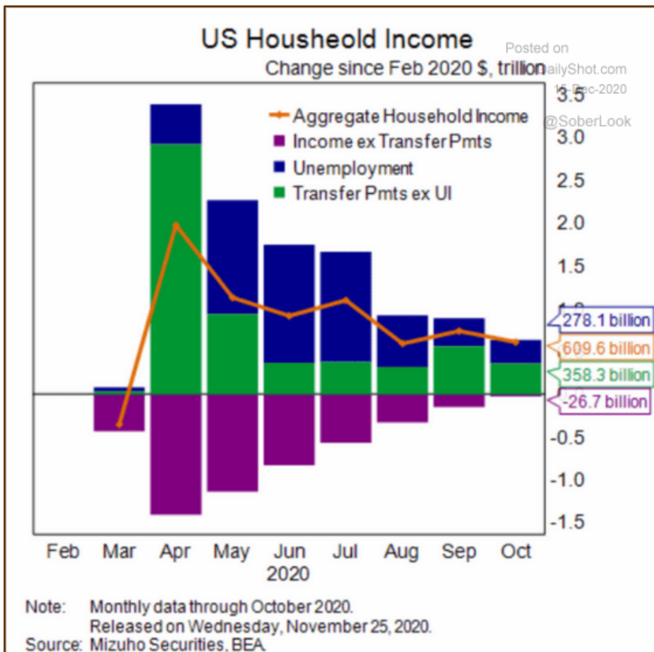
Source:

2020 represents the only year in history in which household incomes actually *rose* during a recession. As a result of the huge rise in the U.S. unemployment rate last year, incomes in the U.S. were down $26.7 billion for the first 10 months of 2020, according to a recent report put out by Mizuho Securities. However, overall household income actually rose $609 billion thanks to unemployment benefits and government transfer payments.

Argument:

While large increases in household income would typically be considered inflationary, many economists discount last year's increase suggesting this level of government support is not sustainable and, therefore, will not be inflationary. Bloomberg Economics believes "as the remains of stimulus checks are spent and extended unemployment benefits expire, overall personal income growth will 'catch-down' with the wage and salary trend, which is growing at less than half of the headline pace [of overall income growth.]"

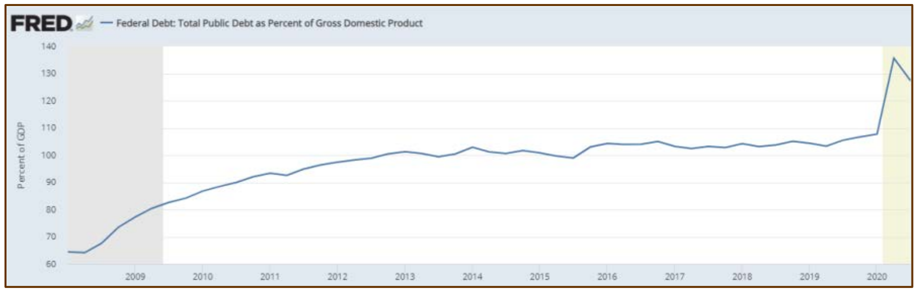
Chart 4: U.S. Household Income



Pro: Increases in U.S. Government Debt

Source:

Chart 5: Total U.S. Government Debt to GDP



The Federal Reserve Bank of St. Louis recently reported that total U.S. public debt outstanding as a percentage of GDP currently stands at 128.3%, roughly doubling the same ratio before the Great Recession and easily eclipsing the post-World War II high. But while the ratio has doubled since the beginning of the Great Recession, debt has risen by 177% in the same time frame or an increase from $10 trillion to $27.7 trillion, suggesting that debt is growing significantly faster than the economy.

Argument:

Investors will eventually tire of buying bonds issued to fund intractable twin deficits with printed money. With continued rounds of money printing, and the unsustainable trajectory of debt growing faster than GDP, U.S. dollars will command less value in the future; and the prices of goods, services and future wages will have to increase to meet new realities.

Pro: Falling U.S. Dollar

Source:

Chart 6: U.S. Dollar Down 15%

According to R. W. Hafer, formerly of the St. Louis Federal Reserve Bank, a falling U.S. dollar is inflationary. Since the beginning of the Great Lockdown, the U.S. Dollar Spot Index is down 15%. Louis Gave, CEO of GaveKal Research, declared in a recent interview that the dollar has entered a prolonged bear market. He argues the dollar has been strong over the past 10 years because the shale revolution and the move towards U.S. energy independence helped shrink the U.S. foreign trade deficit. "The shale revolution meant the U.S. was no longer exporting money." This trend has reversed dramatically and "the U.S. will be back to exporting $100 to $120 billion to the rest of the world…who will turn around and sell those dollars for euros."

Argument:

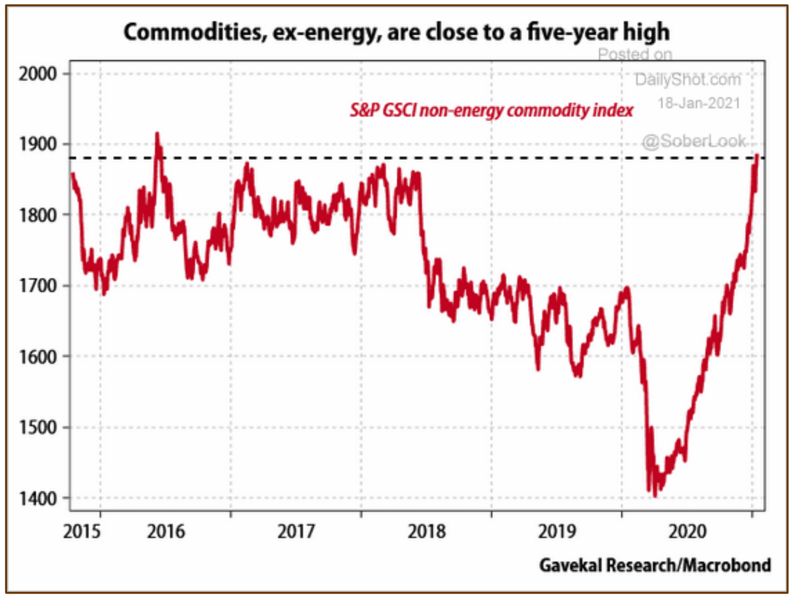
The balance of trade will likely deteriorate in the near term. Additionally, the U.S. is expected to increase Covid relief funding versus other nations, on both an absolute and relative basis, which is likely to put additional pressure on both U.S. interest rates and the dollar. The decline in the value of the dollar raises the price of imported goods and, therefore, the prices paid by U.S. citizens as well.

Pro: Rise in Commodity Prices

Source:

The S&P GSCI Spot non-energy commodity index in Chart 7, which measures a diversified basket of commodities, is trading at a five-year high. In the past year, the index is up about 20%, and about 42% since the beginning of the Covid crisis. "Goldman Sachs … is predicting a new commodity bull market to rival the China-driven boom of the 2000s and the oil price spikes of the 1970s." (source: Bloomberg, Jack Frachy & Nishant Kumar, 12/19/20).

Chart 7: Commodities at Five-Year High



Argument:

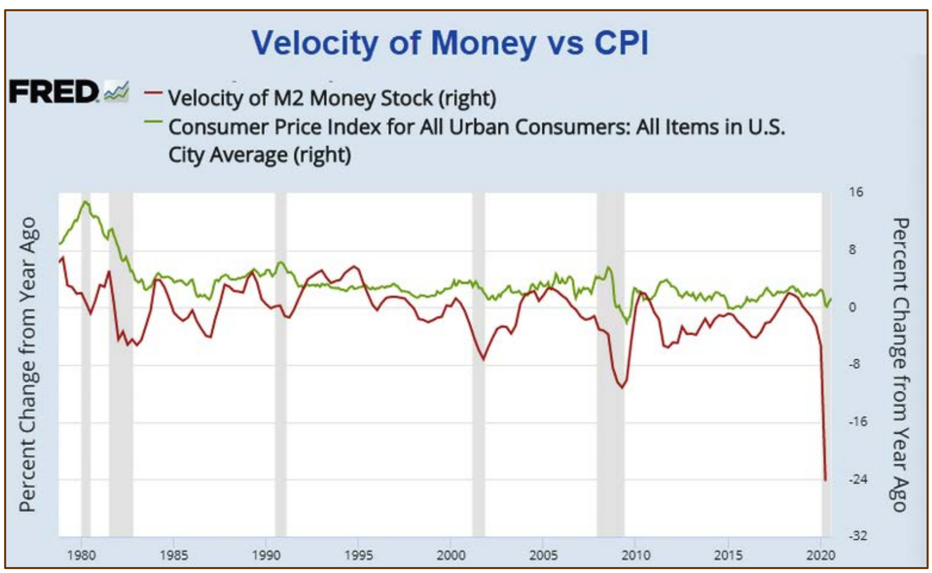
Commodity prices are generally a leading indicator of inflation. The significance of rising commodity prices, from an inflation standpoint, is higher input costs mean higher end product prices down the road. While commodities have been out of vogue for many years, the consensus is they will continue to rise and bring more inflation to the economy as demand returns and the dollar weakens.

Con: Velocity of Money

Source:

Bloomberg's Quick Take Magazine recently reported that the velocity of money fell off of a cliff following the Great Recession, and has declined to "about half of the level seen in the prior decade."

Chart 8: Weak Velocity of Money



Argument:

Prices are impacted by how often money changes hands, referred to as the 'velocity' of money, not just by the gross amount of cash in an economy. If money is changing hands less often, even though the amount of money in circulation in the economy has increased, the economy cannot expand and prices of goods and services cannot go up. Chart 8 from the St. Louis Federal Reserve Bank suggests that consumer prices should be significantly lower than they are now, not higher.

Conclusion

Doucet Asset Management FI Strategy Composite Performance							
As of 2/3/2021	YTD 2021	2020	2019	2018	2017	2016	2015
Doucet Fixed Income Composite	**0.66%**	**2.16%**	**9.21%**	**1.82%**	**3.89%**	**10.64%**	**0.73%**
Barclays US Aggregate Bond	-0.81%	7.51%	8.72%	0.01%	3.54%	2.65%	0.55%
ICE B of A 1-3 Year Muni	0.20%	2.16%	2.88%	1.76%	0.99%	0.33%	-0.45%
+/- Benchmark (Barclays Agg)	1.47%	-5.35%	0.49%	1.81%	0.35%	7.99%	0.18%
+/- Benchmark (ICE B of A 1-3)	0.46%	0.00%	6.33%	0.06%	2.90%	10.31%	1.18%
*Performance calculated by Morningstar Office, periods over 1 year are annualized							

Prior to Covid, the Fed was already in the process of reflating its balance sheet from the 'repo-calypse' from the previous Fall when short-term rates shot up to 10% overnight. As a result, we continued to maintain our portfolio positioning to be benefit from a rising interest rate environment relative to the index. We continued to purchase callable bonds, higher coupon/shorter duration paper, invested in industries on the corporate side that we believed would serve as a hedge for inflation, and, with few exceptions, higher grade issues. Unfortunately, the bond prices of many inflationary-protective credits were hammered by Covid, including REIT bonds in the portfolio, and, of course, overall interest rates plummeted benefitting portfolios with long duration. We were early on all fronts and underperformed the Barclays Intermediate Term Bond Index for the first time since we began recording performance on our fixed income model many years ago. However, our model's performance and metrics did match the Bank of America 1-3 year Muni Index in 2020 so our performance was in line with how we structured the model for the year.

Doucet Asset Management Fixed Income Composite Characteristics					
As of January 2021	Portfolio	Benchmark	+/-	% of Benchmark	Target
Maturity (Years)	4.67	8.18	*-3.51*	57%	65%
Modified Duration	3.22	6.29	*-3.07*	51%	65%
Coupon Rate	5.71	27.76	*-22.05*	21%	>100%
Yield to Worst	7.78	1.16	*6.62*	671%	>125%
Yield to Maturity	8.38	1.17	*7.21*	716%	>150%
Current Yield	6.95	2.54	*4.41*	274%	>150%
Convexity	0.43	0.09	*0.34*	473%	50%
OAS	568.05	36.37	*531.68*	1562%	>200%
Rating	AA-	AA-			
Note: Stated Benchmark is Barclays Agg					
Source: All characteristics calculated using Bloomberg Portfolio & Risk Analytics					

So far in 2021, the market has begun to shift. Rates have risen from about 75 basis points on the 10-year Treasury before the election in November, to about 1.13% today. Evidence suggests our portfolios are benefitting from this as the early results show our model outperforming the Index by 100 basis points after only a few weeks into 2021. As evidenced by Charts 9 and 10, historical ratios showing the 10-year Treasury compared to PMI and commodity prices and the 10-year U.S. Treasury should currently yield between 2% to 3.5% based on current economic indicators. The result of the lid the Fed has put on rates has given us the lowest real interest rates in the developed world. We expect heightened levels of fiscal and monetary stimulus to persist, the dollar to weaken, and rates on fixed income securities will gradually grind higher over the coming months.

Chart 9: 10-Year Treasury to PMI

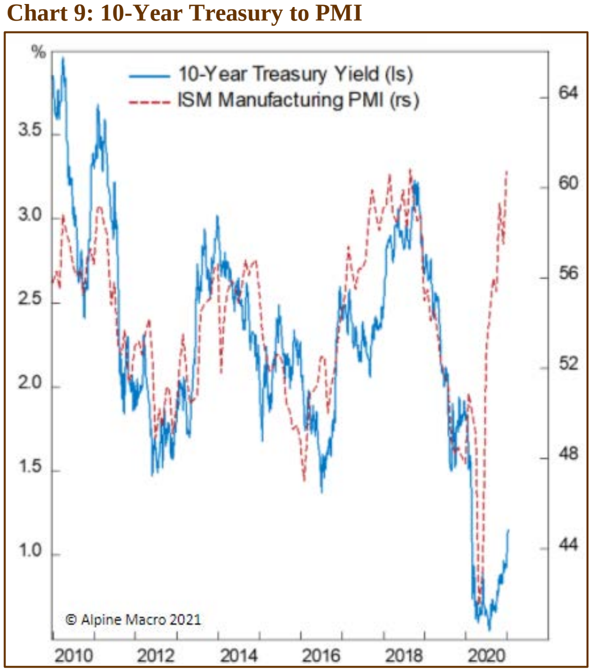
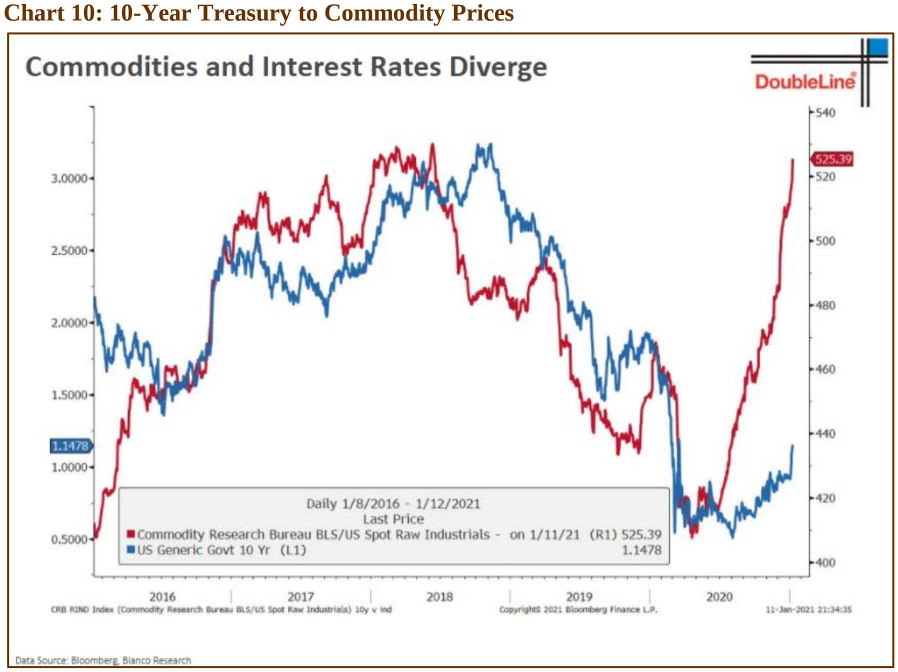


Chart 10: 10-Year Treasury to Commodity Prices



“Following the 2007-09 recession, critics of the Fed’s quantitative easing programs sounded the alarm about unbridled inflation that never materialized” according to Bloomberg Economics. What the decade after the Great Recession proved was growing public and private debt suppressed economic growth, low growth reduced velocity of money and both worked in concert to keep a lid on inflation and yields on bonds For years, the Fed has *monetized* debt converting Treasury securities into a credit on member banks’ balance sheets. Economic inflation never materialized because these machinations were nothing more than an asset swap where real money never made its way to the real economy. Understand, if the Fed were truly *printing* money with its first two Rubicon crossings, and declaring its liabilities “legal tender,” Jeffrey Gundlach of Doubleline Funds believes, it would have led “to not just to inflation but hyperinflation.” What makes the third crossing of the modern Fed different from the previous two is that over $3 trillion made its way into the hands of consumers in the form of PPP loans and government transfer payments, while the money supply surged to its biggest increase on both a percentage and absolute basis in the U.S. since the Civil War.

For now, inflation is relatively tame as Americans have used their stimulus money to pay down credit card balances at a 14% annual rate over the past six months, according to David Rosenberg, proprietor of Rosenberg Research. Additionally, deflationary events of 2020 will make for easy inflation comparisons beginning in the second quarter of 2021. Most economists will agree this is an anomaly stemming from Covid. However, the math becomes more problematic for the Treasury to keep higher interest rates at bay as 25% of all Treasuries mature in the next year and new bailout initiatives are funded. All of this comes at a time when the investment appetite for Treasuries from foreign buyers and pensions is waning. The hope is there is a light at the end of the proverbial tunnel in the fight against Covid and the V(accine)-shaped economy will soon resemble the V-shaped recovery in financial assets. But if inflation returns, the “die may be cast” and the Fed will most certainly attempt its fourth crossing of the Rubicon…whatever that might look like.

Sincerely,

Chris L. Doucet

Chris L. Doucet, CEO

Firm News

After years of exhaustive research on clearing alternatives to our current clearing firm, Hilltop Securities, Doucet Asset Management and its Broker Deal Institutional Securities Corp, have made the decision to move our clearing services to RBC Clearing, a subsidiary of Royal Bank of Canada (RBC). RBC is among the largest, best capitalized banks in the world, and we found RBC to be head and shoulders above the other options available. We are excited about this new relationship and we are confident that our clients will be pleased with the exceptional level of service and functionality the RBC platform provides.

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.

"project," "estimate," "intend," "continue" or "believe," or the negatives thereof or other variations thereon or comparable terminology. Due to various risks and uncertainties, actual events or results or the actual performance of any of the investments discussed herein may differ materially from the events, results or performance contemplated by such forward-looking statements. Although Doucet Asset Management, LLC believes that the expectations reflected in such forward-looking statements are based upon reasonable assumptions at the time made, it can give no assurance that its expectations will be achieved.