DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter

Q2 2021

May 2021

10 Cent Beer Night at the Fed

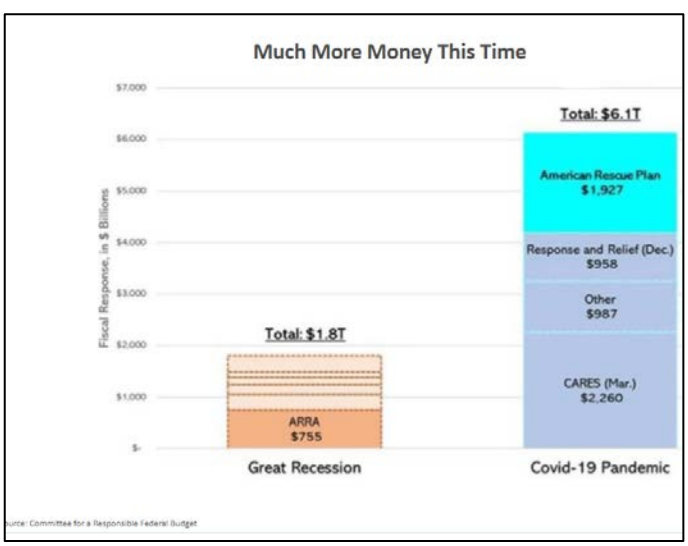
"You have a market with a tremendous amount of excess liquidity and that excess liquidity is going to manifest itself in a lot of unintended ways"

~ Ian Pollack, Global Head, FICC Strategy, CIBC Capital Markets

By June of 1974, the Cleveland Indians were so bad, there were rumors they were going to be bought and moved to New Orleans. No one was going to the games - in the last two seasons they had drawn under two million fans total. The NFL Cleveland Browns outdrew them for last season - and they only played seven home games then versus baseball's 81! Fans were enduring a sixth losing season in a row. Cleveland Municipal Stadium only averaged about 5,000 Indian faithful in attendance per home game so far that season. A frustrated front office determined they needed a gimmick to help fill the stands. They decided a sure-fire way to encourage gate sales for their June 4th contest against league rival Texas Rangers was "10¢ Beer Night."

What could possibly go wrong?

The initial results could not have been more promising. There were over 25,000 fans in attendance that night. By the start of the game, the stands were already loaded. Literally. The game began and, as usual, Indian fans had little to cheer about - the Rangers jumped out to an early 5-1 lead. But then the real excitement began. In the second inning, a middle-aged woman ran onto the field and flashed the crowd. By the end of the 4th inning, an estimated 60,000 12-ounce cups of Stroh's Beer had already been sold and the first streaker of the evening ran across the field and slid into second base (ouch). The Cleveland faithful became more raucous in the 5th inning as they overwhelmed the two scantily clad young women serving the cold beverages, in essence, making it "Free Beer Night." Later that inning, a father and son tag team jumped over a fence and mooned the Ranger outfielders. Cherry bombs started raining down in the visitors' dugout in the 8th inning. Finally, in the 9th, a drunken teenager ran onto the field attempting to steal outfielder Jeff Burroughs' cap. This turned out to be the straw that broke the camel's back, as both the Ranger and Indian players armed themselves with baseball bats, and took to the field to protect themselves from unruly inebriates who poured out of the stands and onto the field. Before the game ended, there were 19 reported streakers, 9 arrests, and 17 injuries that merited emergency room visits. One might say, the cheap *stimulus* provided helped achieve its primary goal, but resulted in several unintended negative consequences.



In the past 15 months, the Federal Reserve has been engaged in a version of 10¢ Beer Night of its own. The Fed balance sheet has increased from $4.24 trillion to $7.82 trillion or about $3.6 trillion since last March. This in turn has helped make it possible for the Treasury to fund the $6.1 trillion in approved Covid-related bailout initiatives at a very low cost in terms of interest to taxpayers. As evidenced by Chart 1, government spending for the *Great Shutdown* bailout has dwarfed that of the entirety of the *Great Recession* by a whopping 275%. So far. What truly defies logic is the fact that the Treasury spent almost $6.8 trillion in 2020, only brought in $3.7 trillion in revenues, expects a repeat performance in 2021, and interest rates have managed to remain very near 5,000-year lows. The good news is this grand slam of liquidity accomplished its initial goals of providing a short-term economic lifeline for businesses and individuals, and replaced a big swath of lost GDP. And when the *hopium* emanating from the successful rollout of the Covid-19 vaccine was added to the lineup, economic activity began to explode to the upside and risk asset prices skyrocketed. Today, excess liquidity is showing up everywhere and distorting both economic and investing landscapes alike. Now the questions on the minds of many are whether *bubbles have formed in financial markets and, if so, does this game have more innings still to be played before they burst?*

Game Over or Extra Innings?

So many clients of Goldman Sachs apparently called or emailed with these very questions that the Company felt compelled to answer with a formal reply. Chief Global strategist, Peter Oppenheimer, who must have drawn the short straw, was called out of the bullpen to compose a 42-page work entitled "A Guide to Bubbles and Why We Are Not in One." He

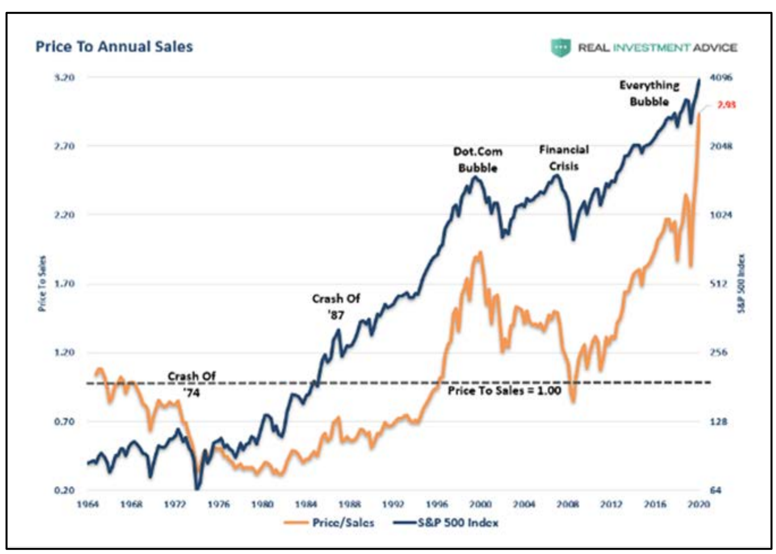
Assessment of Bubble Characteristics and Risks

	Common Characteristics	Any signs?	Risks
1.	Excessive price appreciation & extreme valuations	Yes/Selective	Moderate
2.	New valuation approaches justified	Yes/Selective	Limited/Moderate
3.	Increased market concentration	Yes	Moderate/High
4.	Frantic speculation and investor flows	Yes	Moderate/From low base
5.	Easy credit, low rates & rising leverage	Yes	Limited in private sector
6.	Booming corporate activity	Yes	Moderate/From low base
7.	New Era narrative and technology innovations	Yes	Moderate/High
8.	Late Cycle economic boom	No	Limited
9.	The emergence of accounting scandals and irregularities	No	Limited

Source: Goldman Sachs Global Investment Research

defines a bubble as one in which rapid price appreciation and "valuation make unrealistic claims on future growth and returns." Chart 2 is a summary of the 9 characteristics common in most financial bubbles. Based on his criteria for a bubble, there is good news and bad news. The bad news is that the current market fulfills 7 out of 9 these characteristics based on his research or an impressive .777 bubble batting average. However, the good news is Mr. Oppenheimer believes the bursting of any bubble, along with any subsequent systemic risk to the markets and economy, are events far off into the future. *He bases all of this on his belief that the economy is still in the very early stages of the current cycle, and the financial system is absent of significant leverage.*

1st Inning: Excessive Price Appreciation & Extreme Valuations

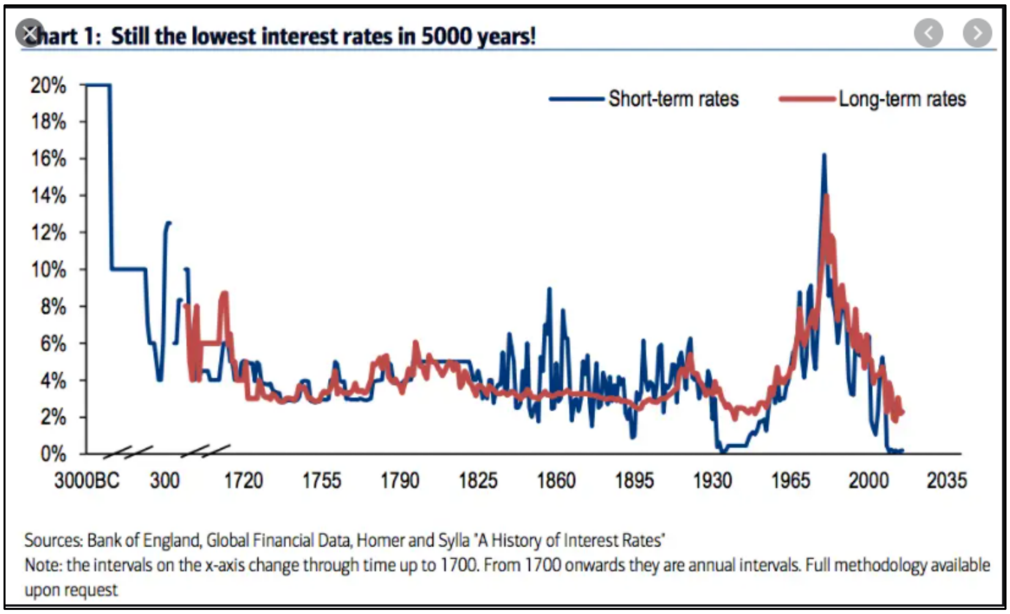


There are few who would dispute the S&P 500 Index is expensive from a historical standpoint. According to Bloomberg, the market currently stands at a 31.79 P/E multiple. But if one takes out the companies from the calculation that had negative earnings in 2020, the Index is still a lofty 27.77 times trailing 12-month earnings. The price-to-sales ratio for the S&P 500 is the highest ever along with many other traditional ways of valuing stocks. Pick a valuation metric - any valuation metric - and stocks prices are at nose bleed levels. Housing, commodities, bonds - the list even includes meme stocks and cryptocurrencies - are all benefiting from the enormous amount of cash looking for a home, and an economy that is opening back up after a long slumber.

2nd Inning: New Valuation Approaches Justified

When old ways of valuing assets do not make sense, Wall Street comes up with ways that do. Since the Great Recession, there have been multiple fundamental changes which have helped shape this new era mindset. The Federal Reserve is the alpha and omega of the tectonic shift the world has seen in valuation of securities. They are the buyer of *first* resort in the bond market. This has resulted in artificially lower rates which now stand as a reasonable justification for higher stock valuations and their presence has ushered in the new era dominance of index and target date funds in the market.

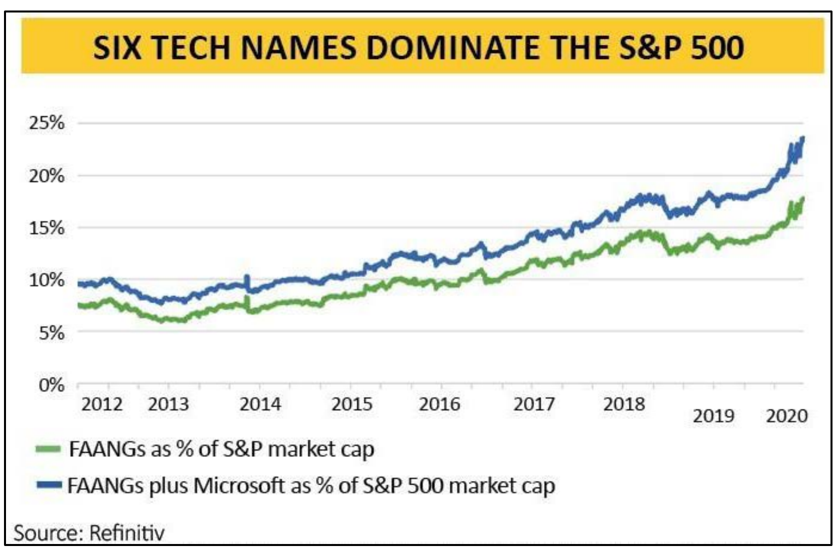
From an asset valuation standpoint, the most consequential and important price in all of capitalism is the yield on the US 10-year Treasury bond. The 10-year is the foundation upon which most financial assets are priced. Its yield has remained suppressed thanks, in part, to the Fed's unofficial third policy mandate to support the financial markets at all costs. These same tools have driven interest rates to near 5000-year lows.



The constant Fed 'put' has also significantly reduced market volatility, and made it easy for passive investment vehicles to proliferate. According to Mike Green of Logica Capital Advisors, before the Great Recession, various forms of passive investment vehicles represented only about 10% of the volume on the broader market and the other 90% was fundamental investing. Now Green suggests this relationship has been reversed and 90% of the market is based on passive investing and only 10% on fundamental investing. According to *The Wealth Advisor*, the dominance of passive investing has not only resulted in an overpriced market, but it has also "led to all sorts of deleterious downstream effects: suppressing workers' wages, raising consumer prices, stifling innovation, stoking inequality, and suffocating business creation."

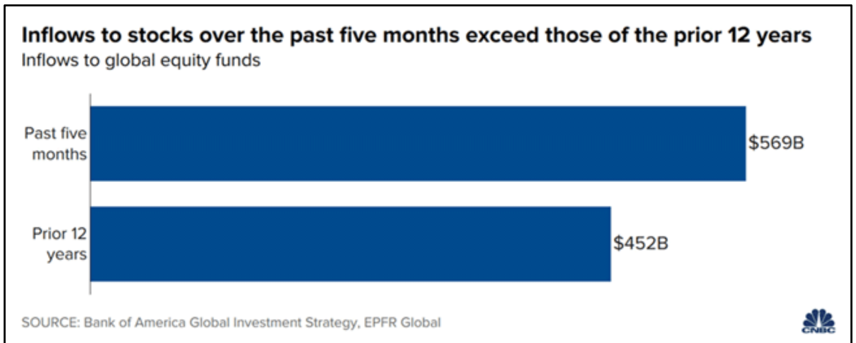
3rd Inning: Increased Market Concentration

Thanks, in part, to indexing and new valuation metrics, six technology stocks now represent about 24% of the S&P 500 Index. However, in a recent Fortune Magazine article, JP Morgan suggests "the true weighting in the market for tech stocks is closer to 40%." The article goes on to say that these "companies account for 6% of nominal GDP and employ just 2% of the country's workers. This is a pattern that was consistent with other extended periods in stocks including radio stocks in 1929, the "Nifty 50" stocks in 1973, tech stocks in 2000, and bank stocks in 2008, and many others.



4th Inning: Frantic Speculation & Investor Flows

One curveball thrown at the market since the beginning of the Covid recovery is the preponderance of retail volume in stocks. Historically, this has been a tell-tale sign of a market top. Joe Kennedy began selling stocks before the Crash in 1929 because he felt "If shoe shine boys are giving stock tips, then it's time to get out of the market." According to CNBC, **the inflows in stocks globally in the past five months have exceeded those of the past 12 years!** Where is the money coming from? Credit Suisse believes much of the increase in volume is emanating from retail investors and monies received from stimulus checks. Based on a recent poll of their clients, they believe 35% of stimulus money will make its way into the stock market. Many have opted for sites like Stockwits, E-Trade, Robinhood and online brokerages who sell their volume to third parties and create so-called "no commission" platforms on which investors and day traders alike can traffic in stock.

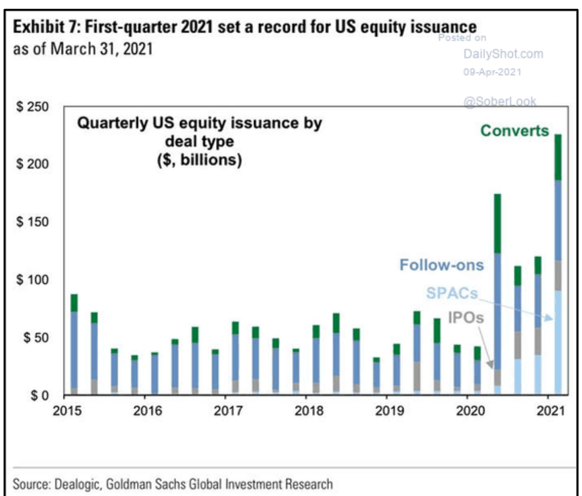


Source: CNBC

5th Inning: Easy Credit, Low Rates & Rising Leverage

Credit is easy. Rates are among the lowest in history despite the fact that the Treasury is up 110 basis points since last August. Even junk bond yields recently hit record lows on both a relative and absolute basis. However, this combination of low rates and easy credit has created the perfect environment for both government and corporate debt to reach their highest debt to GDP levels since World War II. The one silver lining on the debt side is, while margin debt has skyrocketed along with the market, individuals have taken their stimulus checks and used some of the cash as an opportunity to de-lever their own personal balance sheets.

Source: Deutsche Bank Research



6th Inning: Booming Corporate Activity

Corporate activity of all types is hitting it all over the park. In the first quarter of 2021, both IPO and SPAC offerings have set volume records. Historically, significant increases in corporate activity hints that markets are nearing a top. A SPAC is simply a corporation that raises money through a public offering to pursue a future acquisition. This is why they are typically referred to as "blank check" companies. Famed value investor Jeremy Grantham believes they "should be illegal." In a recent report, Michael Ohlrogge of NYU Law School suggested SPACs are a "get-rich-scheme when compared to traditional IPOs" and they provide a "gross misalignment of incentives between the sponsor and the non-redeeming investor."

7th Inning: New Era Narrative & Technology Innovations

Today, there is a new narrative about what technology can do for economies and societies in general. With Zoom, Netflix, food delivery services, and Amazon, there is little need to ever leave the house. Prominent tech breakthroughs and mass adoption of digital technologies has caused a boom in investment, and has raised the hope of a new era of progress from healthcare to raising the average standard of living. Electric and self-driving vehicles hope to better the environment, and more efficiently get people and goods from one place to another. Certainly, this period of innovation resembles the optimism associated with past periods including railroads in the early to mid-1840s, radio in the late 1920s, and the internet in the late 1990s. Certainly, Goldman Sachs agrees as they rank this period medium to high, historically based on what these innovations can mean to society in the future. However, sometimes excess in asset valuation can accompany excess optimism.

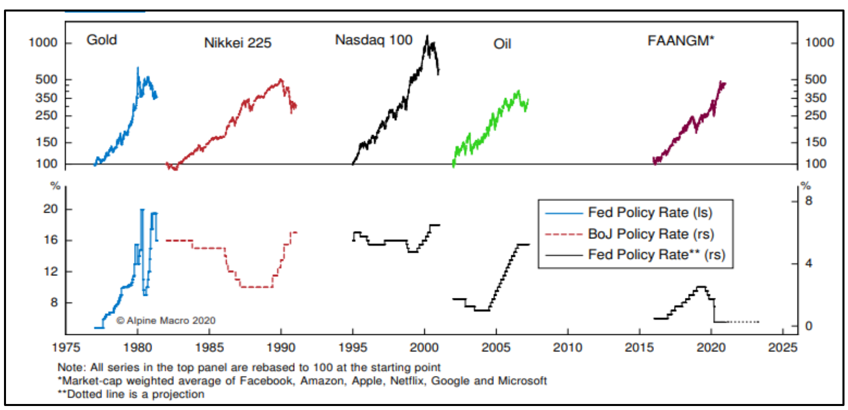
8th Inning: Late Cycle Economic Boom

Is the current economic cycle a continuation of the cycle that began in March, 2009 after the financial crisis, or a new cycle which began last year? Peter Oppenheimer argues that there was a reset button hit when the self-imposed shut down a year ago caused the market and economic downturns, and the world is still in the very early innings of recovery. There are others who claim both the market and the economy were exhibiting late-cycle behavior before the pandemic crisis arose. Whatever the case, it is hard to argue against the fact that there has been a meteoric rise in the balance sheet of the Fed, which has accelerated since the start of the Great Shutdown. It is also hard to fathom that fiscal policy can provide much more relief than it has without dire consequences. What do the Fed and Congress do for an encore?

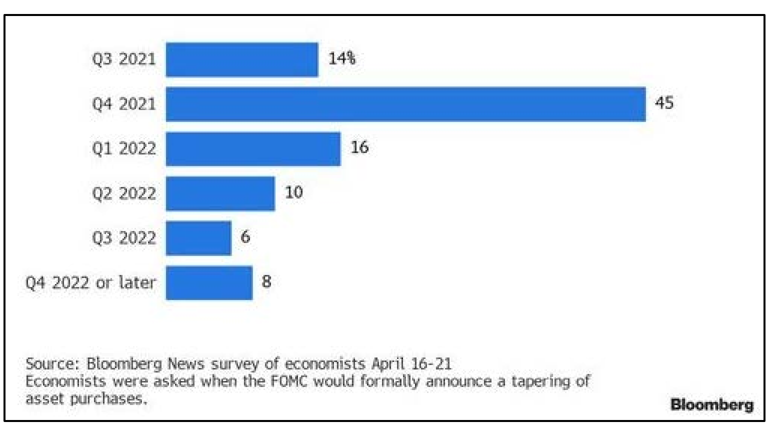
9th Inning: The Emergence of Accounting Scandals & Irregularities

While there have not been many scandals and irregularities which have broken out recently in the financial world, there certainly have been 'big ticket' items which have hit the newswires. Archegos, the family office of Bill Hwang, made multiple leveraged bets, and the investment banks which loaned him the money to leverage his assets, lost an estimated $10 billion. Of course, then there was the recent 1Malaysia Development Berhad scandal (1MDN scandal) wherein the Malaysian Prime Minister funneled $700 million from the 1MDM. Goldman Sachs was charged with bribery and fined $2.9 billion for their part of the scandal. So, while there have not been a significant number of scandals associated with financial markets in the recent past, the dollar amounts have been large.

Extra Innings: Conclusion



While stock prices are expensive today, Covid makes it difficult to know just how expensive they are and where we are in both the economic and market cycle. A change in accommodative central bank policy was evident when some bubbles of the past burst. Past examples include the bursting of the gold bubble in the early 1980s, the Japanese stock and real estate markets in the late 1980s/early 1990s, the NASDAQ bubble in 2000 and the oil bubble in the summer of 2008. The flooding of markets and the economy with stimulus will certainly add to heightened economic activity, inflation and elevated asset prices. But it is not likely Congress and the Fed will reduce the amounts coming out of monetary and fiscal faucets any time soon. Ultimately, the market will dictate to the Fed when they can begin tightening policy. In a recent Bloomberg poll of economists, 45% believe the Federal Reserve will begin



tapering asset purchases in the 4th quarter of this year with tightening of credit not expected until much later.

If one of the world's largest investment banking firms feels compelled to write a 42-page novella on why the current market is not in a bubble, it is safe to say there are at least elements of a bubble present and the market is suffering from an acute case of *stockflation*. The monetary and fiscal grand slams of liquidity provided the fuel to help propel the stock market to record highs, but this stimulus also helped dampen junk bond yields to all-time lows, 'moon shot' some meme stocks into the stratosphere, proliferate historic levels of SPAC and IPO issuances, catapult prices of crypto currencies, change market structures and valuation metrics, and supercharge housing prices. It is also imminently apparent that GDP growth over the next several quarters could be among the best in US history compared to a year ago. Hopefully, financial assets can at least partially grow into their elevated multiples. This herculean task will be made more difficult thanks to the coming headwinds of higher corporate and capital gains taxes along with interest rates which are expected to continue to grind higher. With all of the questions Covid has brought, the one thing that investors can depend on with certainty is the Fed will bring back their version of 10¢ Beer Night any time the market stumbles and asks for it.

Sincerely,

Chris L. Doucet, CEO

Firm News

We have completed our transition to RBC Clearing. If you have not registered for online access and would like to, please call our office or send us an email. Once registered online you will also have the option to download the RBC App on your phone or mobile devices.

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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