DOUCET ASSET MANAGEMENT, LLC

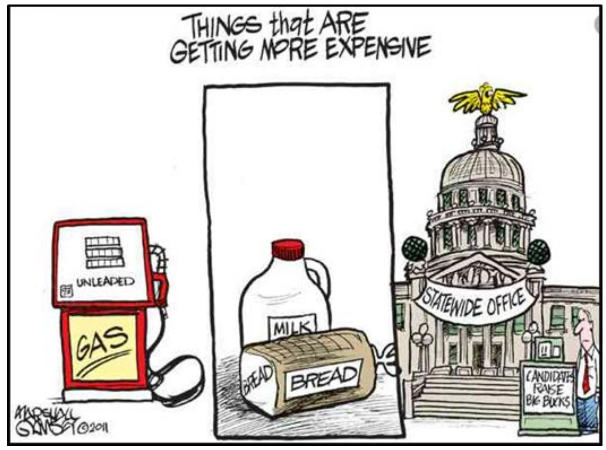
Fixed Income Quarterly

June 2021

Fed Up, Value Down:

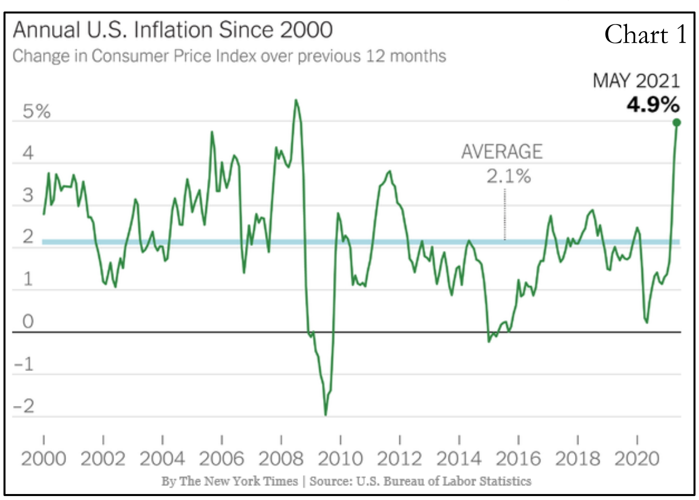
Fixed Income Investing in the Era of Transitory Inflation

Inflation alarms are ringing across America. The money supply is up 30%, commodity prices have risen 55%, and the median home price has shot up by 16% since the beginning of the pandemic. Even the cost of a political office is more expensive these days! The response to the rapid rise in prices from the Powell Fed has been to add more fuel to the fire. The Fed followed up a record amount of monetary accommodation with a successful public relations campaign whose motto is "inflation is *transient*." It has been hugely successful as the narrative has been widely adopted and calmed the financial markets. However, there is a minority opinion that the Fed is falling behind the curve, losing control of the inflation story line and allowing inflation expectations to become embedded in the minds of consumers. All of this begs the questions, who is right and what is the appropriate fixed income strategy given the current economic backdrop?



Will Inflation Eat Bonds Alive?[1]

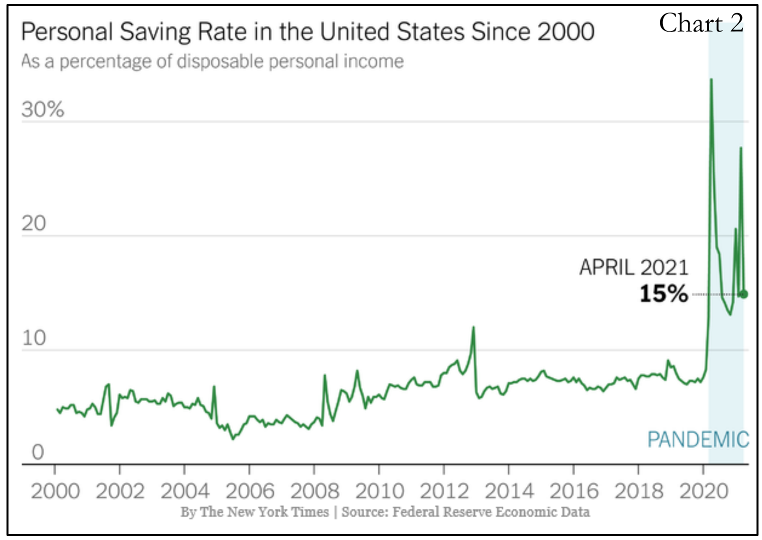
Many inflationary pressures have not made their way through the economy, however, "U.S. inflation is the highest in 13 years" as the Consumer Price Index (CPI) surged almost 5% year-over-year (see Chart 1). This number represents the largest monthly increase since August 2008 when oil rose to $140 a barrel. For those who do not consume food or drive a car, prices rose less. According to the *Wall Street Journal.*, the core-price index, which excludes the often-volatile categories of food and energy, jumped 3.8%" which was "the largest increase for that reading since June 1992." It is worth noting that bond yields typically go up and down in anticipation of the rise or fall of inflation. The 10-year Treasury has never traded below a 6% yield-to-maturity when the core inflation rate was this high and today the 10-year yields about 1.50%. While these data points suggest the bond market agrees with the Fed, they highlight just how vulnerable the financial markets could be if it turns out inflation it *not* transitory.



There is little doubt that the lion-share of price increases in goods is being driven by a Covid-induced low starting point, transportation disruptions, continued shut down of some manufacturing, pent-up demand, a labor shortage, and an artificially high domestic savings rate..among many other factors which may prove temporary. A plethora of these issues should get ironed out in the coming months when consumers will likely get a more accurate view of where inflation really is. Supply shortages will certainly self-correct. Supply chain issues, which have slowed to 70-year highs, will improve. Hoarding of supplies like commodities will subside. In the interim term, most prices for goods are now higher than pre-pandemic levels. Few would agree the Federal Reserve is accomplishing its mandate of stable prices. But few believe that the growth rate of inflation will begin to slow. If this view is correct, perhaps the correct strategy would be to invest in long maturity bonds?

Is Inflation a Monetary or Psychological Phenomena?

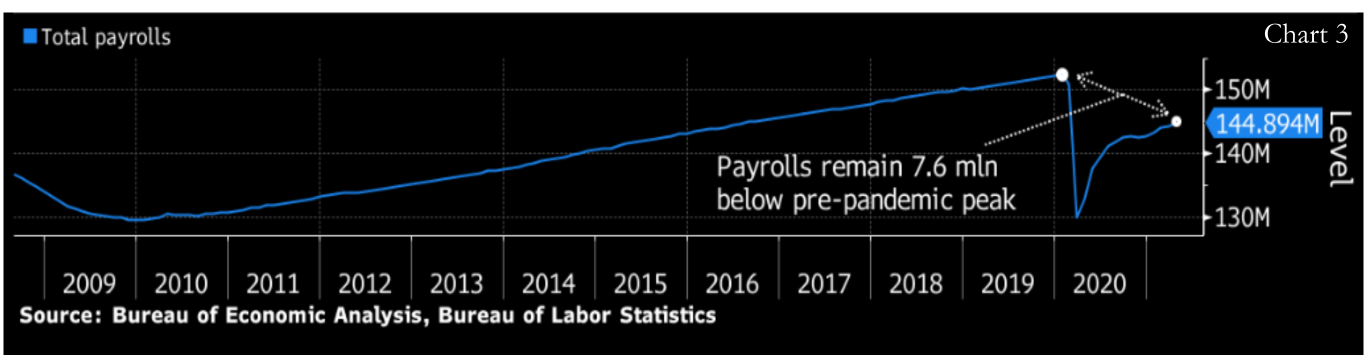
Most consumers and investors have a deflationary mindset and have no memory or knowledge of the inflationary psychology of the 1970s. Even fewer remember a time during the Carter Administration when the dollar was so weak and inflation was so bad in the U.S. that the government could not issue bonds in U.S. Dollars for a time and was forced to pay principal and interest in Swiss francs and German marks on new issue bonds. The famed economist Milton Friedman once said, "Inflation is always and everywhere a monetary phenomenon." But from a psychology standpoint, it is really difficult to go from an investor and consumer mindset of "deflation to inflation, from depression to economic boom, and from Bubonic Plague to the Roaring Twenties" - in just 16 months since the pandemic began, according to economist David Rosenberg. It will take more time and evidence to change the current deflationary psychology that has been so pervasive over the past 40 years. So what would it take to change the psychology of the masses?



Sticky Inflation

While consumer psychology may not have changed yet, there is certainly a current mismatch between supply and demand. On the demand side, Americans have money to spend, thanks partly to the stimulus that the government has pumped into the economy. As evidenced by Chart 2, savings rates have skyrocketed, but, more importantly from an inflationary standpoint, *excess* savings rates have increased. This gives consumers the ability to afford more of everything suggesting inflation could prove stickier than the Fed thinks if consumers begin to open their pocketbooks.

Another potential wrench in Mr. Powell's transitory PR mantra is the recent increase in demand for goods and services continues to increase competition for workers. Chart 3 illustrates that U.S. payrolls still remain 7.6 million jobs below pre-pandemic levels. Some employees remain homebound due to Covid concerns. However, an estimated 42% of unemployed are staying unemployed because they are making more money collecting heightened unemployment



benefits rather than going back to work. Employers are finding they are forced to pay higher wages to get the help they need to run their businesses. Historically, higher wages are sticky. While many of the other inputs in the production cycle will likely be ironed out, once a wage is given to an employee, it is hard to impossible to roll back. This could help inflation stay elevated for much longer than the Fed has suggested.

SAT Question: When & Why Does the Fed Change Course?

It is imminently clear prices are currently elevated, the economy is nowhere near full employment, and the Fed is allowing the economy to "run hot." Chart 4 is a tongue-in-cheek approach to presenting the Fed dilemma taken from the *Wall Street Journal*. It does it in the form of an SAT question.

Chart 4

Let's try one of those multiple-choice questions we all hated on SAT tests. Question: Which of the following doesn't fit with the others?

A) 7% GDP growth in 2021

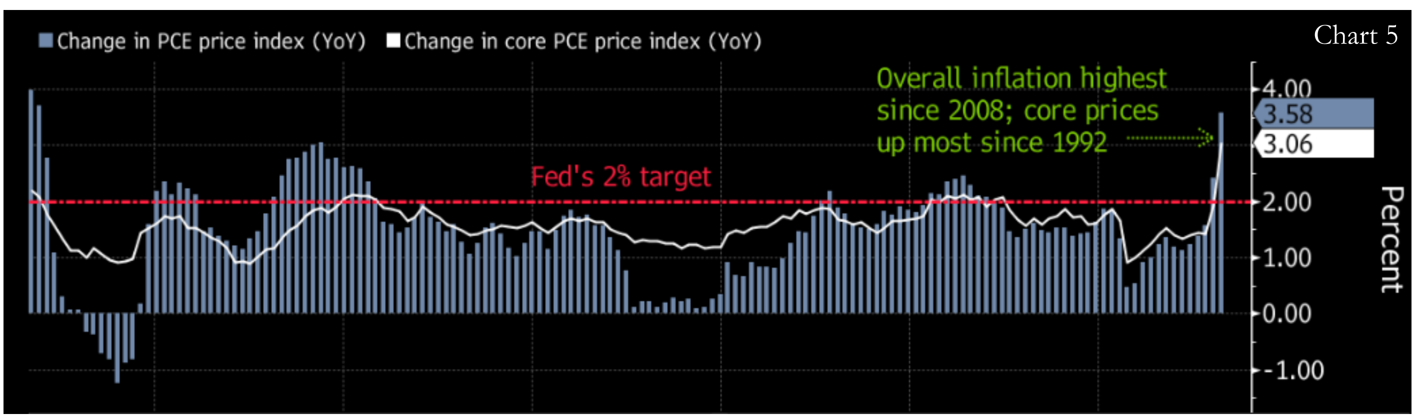
B) A 5% increase in the consumer price index from a year earlier, and 3.8% in core prices excluding food and energy

C) A 4.5% unemployment rate by the end of this year, heading toward 3.8% next year

D) A federal funds interest rate of near-zero for another two years

If you answered D, you aren't a member of the Federal Open Market Committee (FOMC), which on June 16th reaffirmed its pedal-to-the-metal monetary policy despite a booming economy and rising inflation that even the Fed anticipates will be 3% this year.

If one were to just view the first three choices in a vacuum, investors would assume interest rates were about to sky rocket. In this scenario, one would want to be short stocks and hold as much cash as possible in money markets in preparation for the massive amount of inflation just around the corner. But Chart 5 illustrates just how elusive inflation has been for the Fed since the start of the Great Recession. It only peaked above 2%, the Fed's current target rate, a couple of times before retreating back to sub-trend growth. Given the uncertainty of *when* employment might return to a more normalized level, the Fed has decided to risk



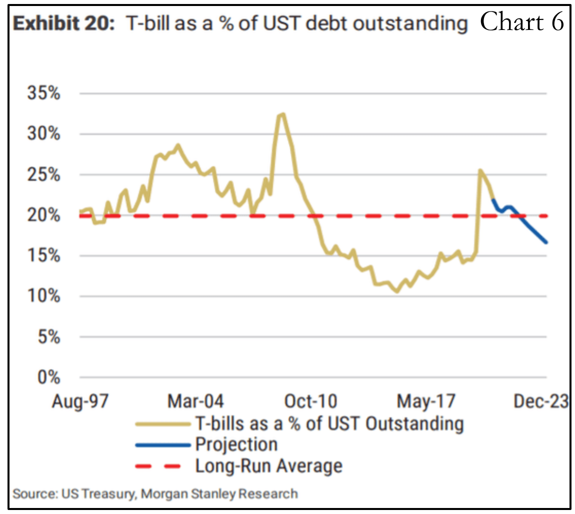
allowing the economy to overheat. At least in the short-term, full employment trumps stable prices in the Fed's playbook, especially since Mr. Powell believes rising prices will remain elevated only on a temporary basis.

Treasury Bond Maturities Are Also *Transient*

At its June 16th meeting, the Fed telegraphed that it has become less sanguine about rising inflation. They are now *"talking about talking about"* (not a typo) "tapering" their monthly bond purchases from their current $120 billion per month bond. In all likelihood, they will attempt to acclimate investors to the idea of reducing asset purchases during the summer months. The Fed has already announced its intent to sell the corporate and junk bonds on its balance sheet in the last several weeks. Additionally, the pace of growth in the economy and inflation caught the Fed by surprise and its members moved up the dates they expect to begin raising rates. But the heavy hand of the Fed will likely keep interest rates relatively in check over the next several months.

Peter Schiff of Euro Pacific Funds stated in a recent interview, "Through the first 7 months of fiscal 2021 (US Government calendar year ends on October 30th), the US government collected about $2.1 trillion in taxes, but spent about $4.1 trillion, which is higher than the first months of 2020, which included the depth of the COVID recession." Not including the expenses associated with a potential infrastructure bill, he believes government deficit spending may rival the 20% of GDP record set by the U.S. in the period of 1943-1945 to fund the Allied effort during World War II.

To compound the problem of having to fund many more bonds to finance Covid recovery costs, over 20% of outstanding Treasuries mature in less than one year, according to Chart 6. If the bond market becomes convinced inflation is "sticky" and not "transitory," bondholders may demand higher yields to fund future deficits.



Bond Investing Strategy-*Transitory* Barbell

Given the diverse backdrop of possible outcomes, it is challenging to predict just where interest rates and inflation are heading. However, it is probably fair to say the rate of growth of inflation will slow and bonds will remain range bound until the Fed begins to taper asset purchases later this year. When asked how we have positioned assets for our clients, our knee jerk reaction is to say the *fetal* position. But seriously, it is not hyperbole to say there have been no time in modern history where it has been more challenging to ***maximize yield*** and ***minimize risk*** than today.

We believe the combination of today's economic and financial landscape gives a very clear and narrow picture of how assets *should* be allocated in fixed income portfolios. Doucet Asset Management adopted a variation of the bond 'barbell investment strategy' several months ago. A traditional barbell strategy invests a portion of a fixed income portfolio in long-duration bonds and the remaining piece at the short end of the maturity scale, ignoring the belly or intermediate part of the curve. This strategy is useful when interest rates are rising as the short-term maturity bonds maintain stability of price and can be redeployed easily if the investor becomes comfortable with long rates. Our variation of this strategy assumes we invest heavily in highly-rated bonds (mostly munis) with ultra-short maturities to ensure the portfolio has plenty of safety and liquidity built into it. But in lieu of investing in long-maturity bonds, we have been investing in bonds with shorter to intermediate-term maturities in credits we believe have the best chance of creating high relative total return for portfolios in a recovering economy. We have eschewed the high- yield market, for the most part, for lower bank investment grade rated bonds whose earnings, we believe, will improve over the next couple of quarters as the economy reopens and expands.

Doucet Asset Management Fixed Income Composite Characteristics					
As of June 22, 2021	**Portfolio**	**Benchmark**	**+/-**	**% of Benchmark**	**Target**
Maturity (Years)	2.42	8.54	*-6.12*	28%	65%
Modified Duration	2.96	6.55	*-3.59*	45%	65%
Coupon Rate	4.16	2.57	*1.59*	162%	>100%
Yield to Maturity	4.10	1.50	*2.60*	273%	>150%
Rating	AA-	AA-			
Notes: Stated Benchmark is Barclays Agg					
Portfolio data from account 0864 included in the Doucet Fixed Income Composite					
Source: All characteristics calculated using Bloomberg Portfolio & Risk Analyitics					

The strategy has helped the Doucet Fixed Income Composite outperform the Barclays U.S. Aggregate Bond index by 713 basis points so far in 2021. At a 5.21% return year-to-date, the model has outperformed every long-only and bank investment grade rated fixed income mutual fund or manager who benchmark against the Barclay's Index, according to Morningstar. Given our belief that rates will stay within a very modest trading range until the economy gets closer to full employment, we believe the strategy will continue to show similar positive results.

As of 6/15/2021	YTD 2021	2020	2019	2018	2017	2016	2015
Doucet Fixed Income Composite	**5.21%**	**2.16%**	**9.21%**	**1.82%**	**3.89%**	**10.64%**	**0.73%**
Barclays US Aggregate Bond	-1.92%	7.51%	8.72%	0.01%	3.54%	2.65%	0.55%
ICE B of A 1-3 Year Muni	0.47%	2.16%	2.88%	1.76%	0.99%	0.33%	-0.45%
+/- Benchmark (Barclays Agg)	7.13%	-5.35%	0.49%	1.81%	0.35%	7.99%	0.18%
+/- Benchmark (ICE B of A 1-3)	4.74%	0.00%	6.33%	0.06%	2.90%	10.31%	1.18%
*Performance calculated by Morningstar Office, periods over 1 year are annualized							

Conclusion: Alarm Bells Real, Approach with Caution

The Federal Reserve is caught in a trap from which it will be difficult to extricate itself. The Fed claims it has the tools it needs to resolve the inflation issues in front of them. Of course, they had more tools at their disposal 40 years ago and that did not work out so well for them. At the same time, the past four decades of history has created a deflationary mindset for most people in this world which will be hard to break. On the other hand, the current Fed (and Feds of the past) have been unwilling to use their powers to pull away the monetary punch bowl in a timely fashion. Today, as a result, financial bubbles have formed, speculative excesses have been allowed to thrive, investor complacency has risen, but bond yields are still extremely low. All of this helps to reinforce our belief that we have adopted the best strategy to continue to outperform the Index for the months to come. Plenty of liquidity is embedded in our portfolios and we see the improvements on the credit side of the portfolios almost daily. However, we also see Powell as the most accommodative Chairman of the Fed in history. We just hope that the Fed's public relations campaign is accurate and they have not misread the current inflation alarm bells.

Sincerely,

Chris L. Doucet

Chris Doucet

Footnotes:

[1] Forbes Magazine, February 25, 2021 Dan Runkevicius

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.