DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter

Q3 2021

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Will The Fed WIN?

Regarding the Fed's magic act:
"Give a man a gun and he can rob a bank, but give a man a bank, and he can rob the world."
~Tyrell Wellick

Fifty years ago, the pipe-smoking, autocratic Chairman of the Federal Reserve, Arthur Burns, ruled with an iron fist. When an OPEC oil embargo drove prices up four-fold in the aftermath of the Yom Kippur War in 1973, the Chairman argued the increase had nothing to do with monetary policy. As a result, he did what any other leader might do who was not concerned over something as trivial as facts-he had energy (which represented 11% of the consumer price index or CPI), excluded from the Fed's inflation calculation. Later that year, food prices spiked due to an El Niño weather event. Burns argued that food, which represented 25% of the CPI, should also be removed from the equation. By the time he was done using his economic scalpel, 65% of the items in the Index had disappeared due to their "transitory" nature. Today, economists refer to this idea as "core inflation," or inflation ex-food and energy.

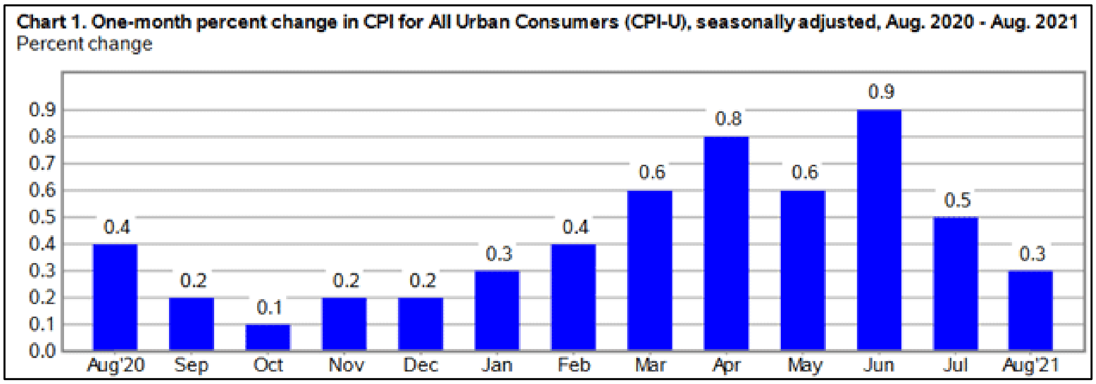
By the mid-70s, the "transitory" argument did very little in the way of calming both consumers and investors alike. When it was evident to all that inflation was not going away any times soon, the Fed campaign of "inflation is transitory" was finally replaced with the new official mantra, "Whip Inflation Now" or "WIN." The Great Inflation Era had begun.

Since the early summer of 2020, the current Fed Chairman, Jay Powell, has taken a page out of the early Arthur Burns playbook: convince the public the rise in commodity prices, supply-chain disruptions, and historic fiscal and monetary stimulus are temporary in nature and hope like hell inflation normalizes. All of this is a ghost of inflation past. But is Powell going to stay on the current emergency liquidity track? Will the Fed begin the easing process soon and, if so, what are the implications for the markets?

"I Told You So" or The Final Countdown?

The resurgence in Covid infections, thanks to the Delta variant, helped Chair Powell and his transient inflation cause. While the economic data did show inflation was alive and well in August, there was a noticeable slowing in some numbers last month.

Chart 1. One-month percent change in CPI for All Urban Consumers (CPI-U), seasonally adjusted, Aug. 2020 - Aug. 2021



Source: John Mauldin, Thoughts from the Frontline, September 18, 2021

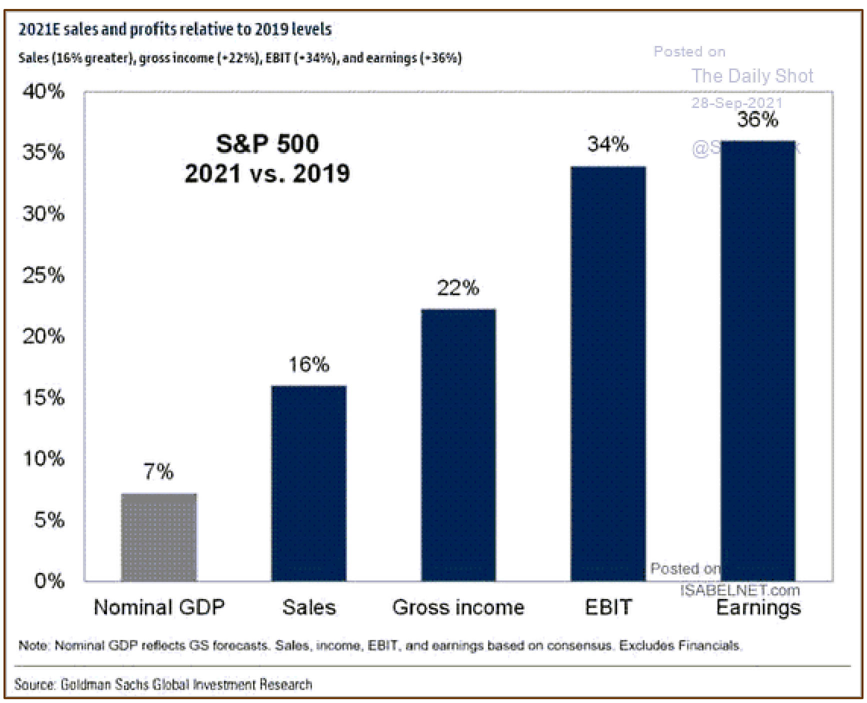
Headline inflation rose at a rate of 5.3% over the past year, while core inflation (Chairman Burns' inflation yardstick) increased 3.7%. Fed Chairman Jay Powell's response to the numbers continues to be that they are "transitory" due to temporary factors. But there was a notable shift in his tone after the recent Fed meeting. He suggested that most of the requirements have been met to begin tapering later this year, including the all-important Fed mandate of full employment. However, the expectation is that a large swath of the labor market will return to the work place as extended unemployment benefits expire, and schools reopen, allowing primary caregivers to go back to work.

1970s Inflation Déjà Vu?

Stephen Roach of the *Project Syndicate* suggests the similarities between the Powell and Burns Feds evoke "an eerie sense of déjà vu" and believes emergency measures on the part of the Fed should have been lifted long ago. The modern Fed "is insisting that recent increases in the prices of food, construction materials, used cars, personal health products, gasoline, car rentals, and appliances reflect transitory factors that will quickly fade with post-pandemic normalization. Scattered labor shortages and surging home prices are supposedly also transitory. Sound familiar?"

While official CPI numbers suggest inflation has only grown about 2% annualized since the Great Recession, consumers would argue that this is ridiculous. According to Bloomberg, housing prices have increased 46% since the Great Recession or about 4.9% annualized; autos have shot up over 54% or about 6.25% annualized; unleaded gasoline has soared over 83% or 14.45% annualized; and items like computers or televisions have only increased 4.7% over the same time period or .38%. Perhaps the only thing that has had less inflation than electronics since the Great Recession is the Federally mandated minimum wage which was $7.25 in 2009 and is still $7.25 today.

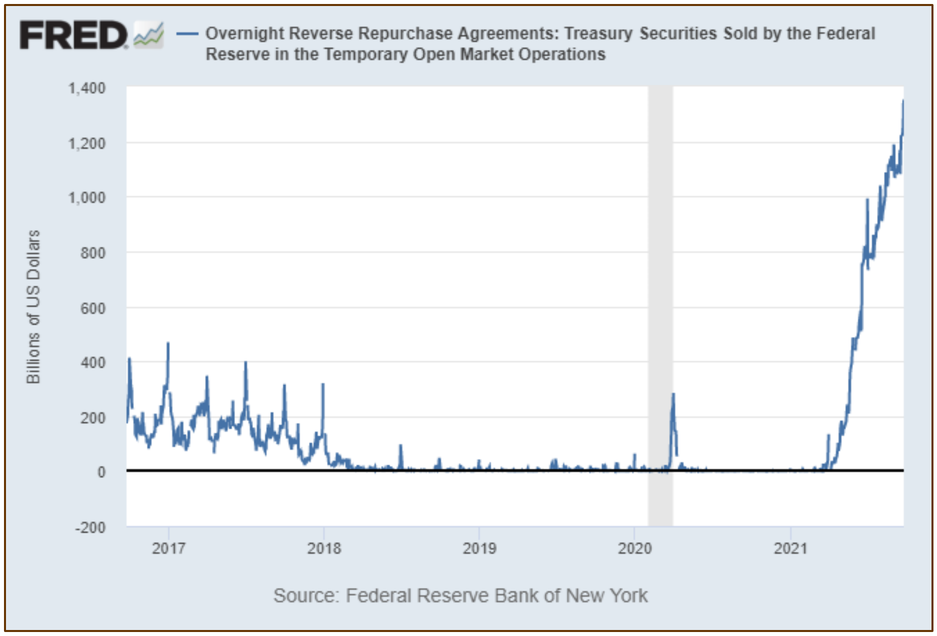
Roach believes the most interesting parallel though, is both Feds allowed negative *real* interest rates (prevailing interest rates minus the rate of inflation) to persist over an elongated period of time, much to the long-term detriment of both the market and the economy. As you can imagine, this phenomenon discourages savings on the part of investors and encourages risk taking, not to mention unintended policy mistakes. In the 1970s, *real* interest rates got down to *negative* 250 basis points. **Today, real rates are negative by more than 500 basis points!**



In the 1970s, negative real rates had the effect of pouring gasoline on the Great Inflation fire. Today, real rates are *twice* the size of negative rates in the 70s and yet the U.S. continues to inject $120 billion a month in the form of additional quantitative easing (QE). At the same time, current Treasury spending rivals that of fiscal outlays during World War II even though the post Covid economy seems to be absorbing any excess slack. Corporate earnings are echoing the same refrain as Goldman Sachs recently reported that financial metrics of S&P 500 companies have not only surpassed the artificially depressed 2020 numbers, but now have significantly improved upon 2019 pre-Covid numbers. Combined with the added ingredient of inflated financial asset prices, Wall Street is saying the time for emergency stimulus measures is past due.

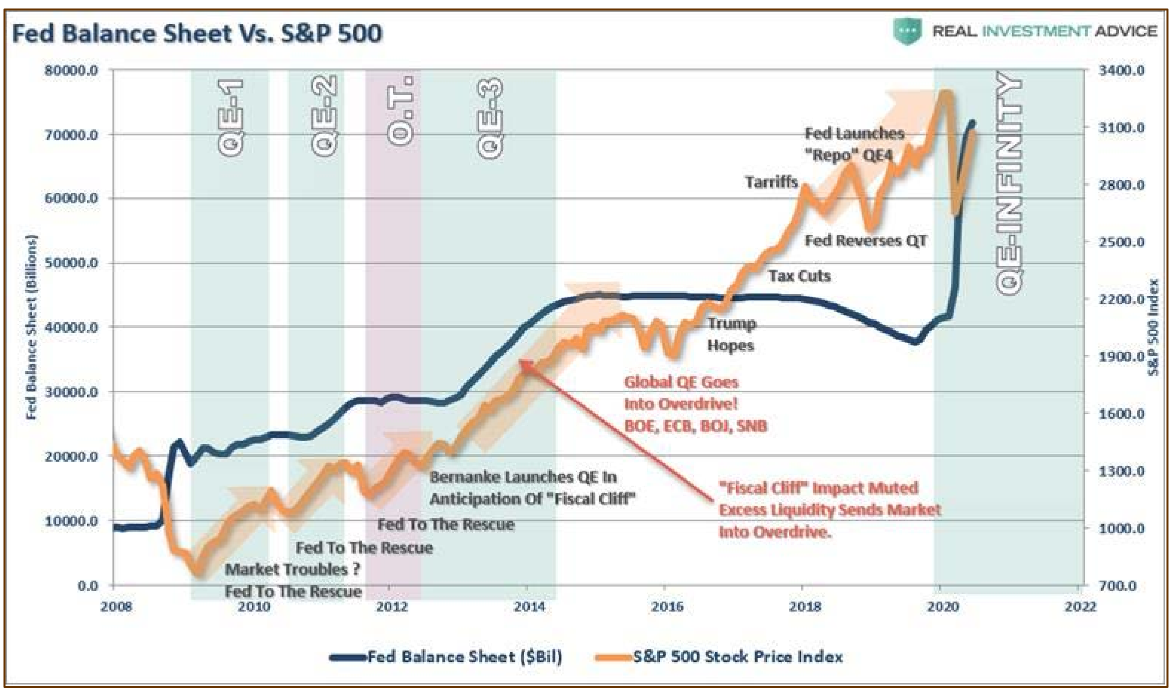
Changing Course?

The Fed has given the market two pieces of evidence that historic monetary stimulus is about to reverse course. Recently, Chairman Powell stated the Fed would begin tapering asset purchases from their current $120 billion per month later this year. The goal is to have net new monthly purchases down to zero by next summer. He was certain to keep the markets calm by insisting the Fed would not raise interest rates until after the taper process had concluded. But there is an old saying: "Don't listen to what people say, watch what they do." Just last week, there was a loud and clear signal from the Fed that they were draining cash from the economy through reverse repurchase agreements.



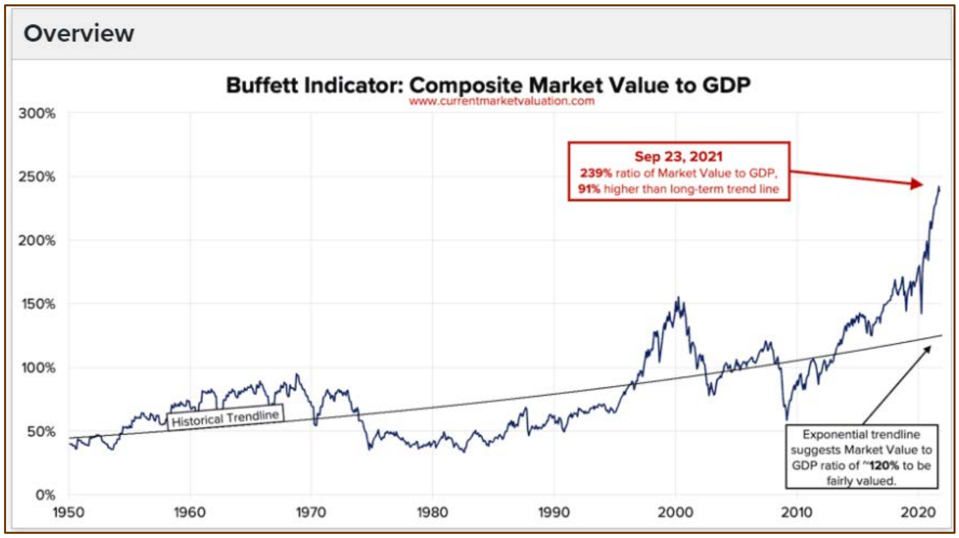
Back Door Tightening

A Reverse Repo (RRP) is used when an institution has too much cash and needs a place to park it and receive a decent rate of return. Recently, the volume in the RRP market set a record of $1.35 trillion (with a T) when the Fed began temporarily draining bank reserves. The markets reacted slowly at first, then violently, as the yield on the 10-year U.S. Treasury rose from 1.3% to 1.55% in less than a week. Likewise, the equity market swooned as it experienced its worst single day decline since last spring.



The significance of this action in the RRP market is high volumes are indicative of cash being drained from the system and the financial markets are addicted to liquidity. It also helps prove that there is more than a little truth to the saying, "Don't fight the Fed." If the Fed is truly in the incipient stages of pulling liquidity from the system that has helped propel markets to historic heights, then when the exact opposite occurs, the market is likely to soften.

Unwinding Is Hard to Do



The lesson learned after the Great Recession was unwinding both monetary and fiscal stimulus is hard to do without a certain amount of pain to financial markets. Complicating the equation this time around is most asset classes are elevated in price. Housing prices are now more expensive than they were before the housing boom burst preceding the Great Recession. According to gauges like the Buffet Indicator, stock prices are now more expensive than any time in history, including 1929. And while bond yields have risen steadily since this summer, they are still trading near 5000-year lows. There is one thing that investors can take to the bank-the current Fed is perhaps the most dovish one in history and unwinding the fiscal stimulus of the past will be slow, long and measured. Let's hope this is enough to keep the ghosts of inflation past at bay.

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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