DOUCET ASSET MANAGEMENT, LLC

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The Great Unwind: *Navigating the Rocky Road to the Emerald City*

Inflation is always and everywhere a lagging indicator.
-David Rosenberg

In the late 19th Century, populist thinking wanted to add silver to the gold standard. It proved to be a polarizing argument. Proponents claimed it would expand the amount of money in circulation. Opponents had myriad of reasons showing it a poor option. At the Democratic presidential nominating convention, William Jennings Bryan opportunistically delivered one of the most famous speeches in American history. He glared at the "Golden Democrats" who did not want two metals and bellowed:

"You shall not crucify mankind upon a cross of gold!"

He went on to lose the election and also alienated about half of his party, including newspaperman L. Frank Baum.

After the convention, Baum created an allegory featuring an innocent girl by the name of Dorothy who hailed from middle America (the American economy). She was cast into a tornado (financial panic) and struggled against witches (corporate barons) and flying monkeys (wedge issues).

Dorothy's allies were a scarecrow - good hearted but no brain (agricultural America), a tin man - strong but no heart (industrial America) and the cowardly lion (rhymes with "Bryan"). This pack has to follow a path of gold (yellow brick road) to the Emerald City (the color of money) aided by Dorothy's silver slippers (the movie studio changed it for the film because ruby looked better). Baum named this land for the symbol for 'ounce' - The Wizard of Oz.

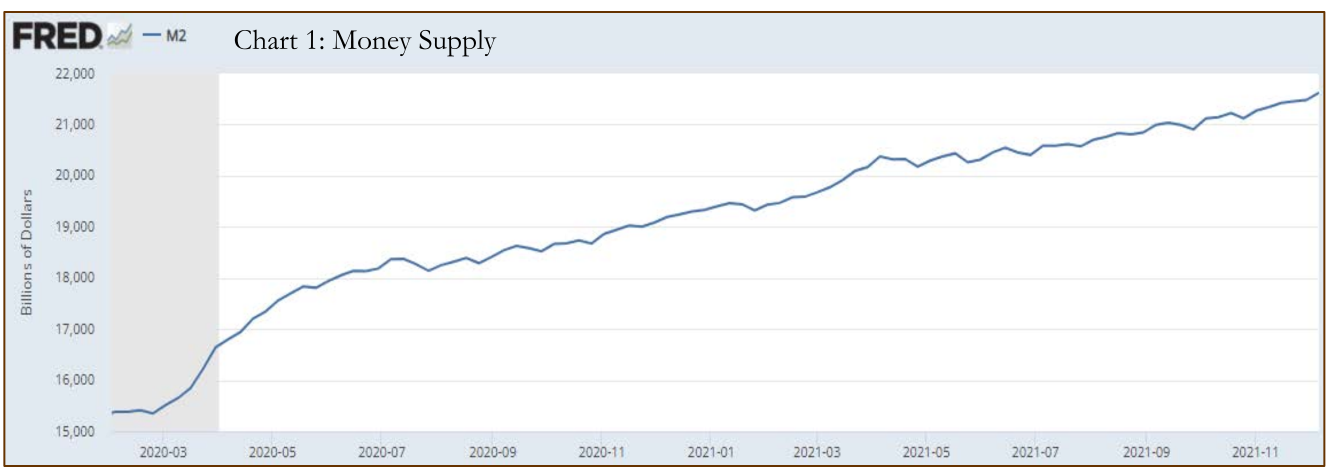


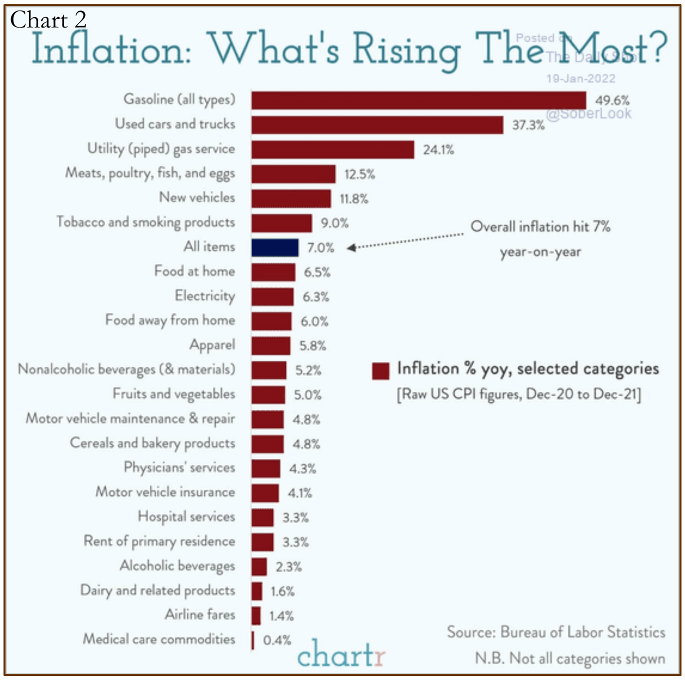
Chart 1: Money Supply

At the time, the dollars in circulation were equivalent to the amount of gold in the government's vault. This was further complicated by the fact that gold prices had been fixed at roughly $20.70 an ounce since 1834. But if

President McKinley and Washington could simply add an element of silver to the existing gold standard, the new system of *bimetallism* would help the U.S. avoid financial turmoil and promote economic growth.

Toto, We're Not in Kansas Anymore!

Chart 2



Well, if the goal of Dorothy's trip to the Emerald City was to lobby for an increase in the money supply, she certainly got her wish..and then some! Shortly after the book's publication, the Federal Reserve was established. It did not take long for the country to wean itself off of the gold standard, bypass bimetallism altogether, and fast forward to the current fiat monetary system. Things really sped up with the Covid Crisis when both monetary and fiscal stimulus spigots were turned on full blast and the money supply increased by an amount that would make even Auntie Em uncomfortable-an eye-popping 40%. The massive money printing helped fuel rip-roaring corporate profits and outsized stock market gains in 2021, but there was one side-effect that somehow caught the Federal Reserve off guard-***inflation***.

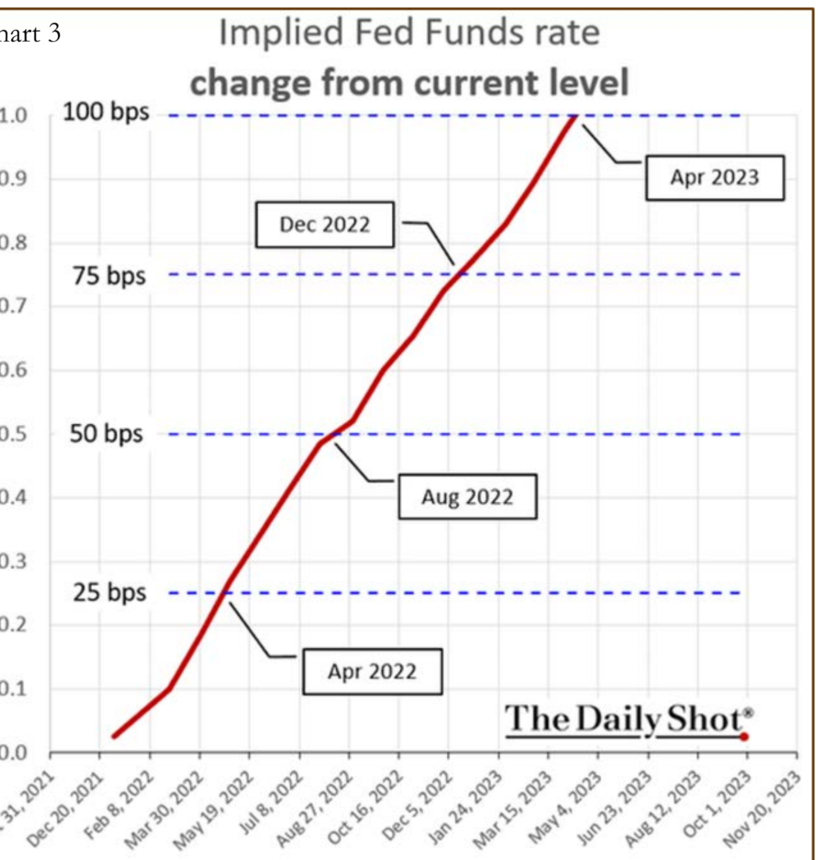
The Consumer Price Index (CPI) rose 7% in December, its largest increase in 40 years! This *unexpected* rise in the CPI prompted the Fed to state their intent to unwind the historic monetary accommodation much faster than originally planned. Now investors are asking how much the Fed will be able to chip away at key stimulus (which has been the key support of the market over the past 22 months) and just how this pivot in policy will impact the performance of financial assets in 2022?

Inflation 1970s Style

Economist Milton Friedman famously warned the Fed in 1970 that "inflation is always and everywhere a monetary phenomenon." His statement fell on deaf ears as the money supply would be increased by 12% (two separate times) during the 70s. This served as the foundation for the soaring inflation and interest rates that followed. Even though the Fed is directly responsible for increasing the money supply, former Federal Reserve Chairman Arthur Burns attributed the price increases mainly to "wage pressures, monopoly power, and the oil shock of the 1970s."[1]

U.S. government debt-to-GDP ratio has ballooned to a record 136%. The current money supply has "skyrocketed from $15 trillion in January 2020 to $21 trillion in November 2021" or 40%. Sound familiar?[1] Apparently not to Jerome Powell as his comments on November 30th to Congress about inflation were eerily reminiscent of comments attributed to Burns four decades ago. "Supply and demand imbalances have contributed to notable price increases … as supply

Chart 3



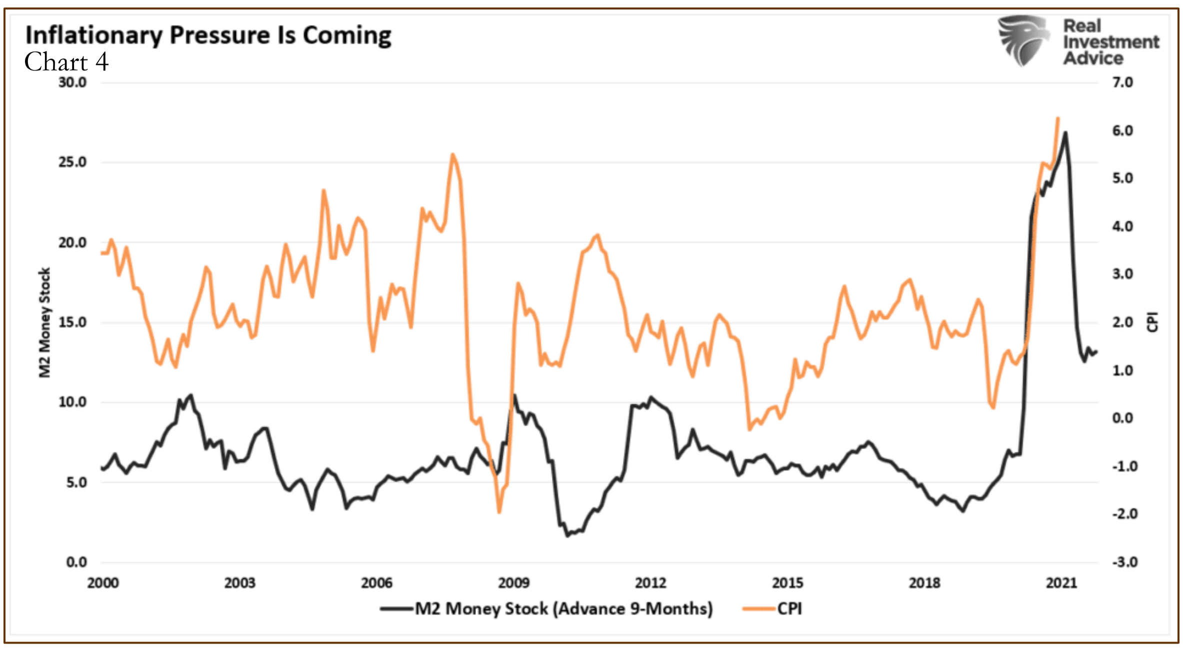
chain problems have made it difficult for producers to meet strong demand..for goods..and increases in energy prices and rents are also pushing inflation upward."

Fed Levers Behind the Curtain

The dual mandate of the Fed is to provide price stability and full employment to the economy. It attempts to accomplish these directives through the use of two primary monetary levers. The Fed endeavors to impact short-term rates by raising/lowering the Fed Funds Rate. It tries to effect longer term interest rates by buying/selling Treasuries and mortgage-backed securities (MBS) through a process known as Quantitative Easing (QE). Initially, the Fed's plan was to slowly taper their $120 billion a month in bond purchases, conclude *net* purchases in June, and begin raising the Fed Funds rate later in the year. But the recent flurry of inflation news has caused Chairman Powell to abandon his rhetoric about the "transitory" nature of inflation and turn up the clock on the unwinding of past stimulus by at least three months.

Somehow, the idea that inflation is a 'lagging' economic indicator has been lost on the Powell Fed. Commodity prices go up and goods rise in price down the road. Unemployment improves and labor costs rise in the future. It is this inability to see inflation's lag that helps explain why the Fed is so notoriously *reactive* to the business cycle. Investors and consumers alike were able to see the *deflationary* impact of Covid two years ago and the subsequent *inflationary* pressures which followed.

Today, most commodity prices are beginning to level out providing a higher base by which to measure inflation. Monetary and fiscal stimulus created a huge increase in the money supply which fostered the current inflationary environment. As the Fed begins to drain liquidity from the system, there will be a significant decline in the money supply which suggests 'disinflation' may be more likely towards the back half of 2022. As evidenced by Chart 4, Real Investment Advice believes the money supply will drop significantly as the year progresses and that inflation will follow. Bloomberg Economics concurs. They suggest inflation in the first quarter of 2022 will mirror the 6.7% average rate in the fourth quarter of 2021, but "then likely drop steeply in the second quarter of 2022 as adverse base effects reverse, and ultimately fall to 2.8% by the end of the year." How ironic would it be if the Fed abandoned the word "transitory" when referring to inflation if inflation was, in fact, well on its way to becoming..transitory?



Fed-Arsonist or Fireman?

In response to the Great Recession, the Fed ballooned its balance sheet from about $900 billion to $4.5 trillion and reduced the Feds Fund rate to 0%. Almost a decade later, it attempted to unwind this stimulus, but was only able to reduce its balance sheet by $700 billion and increase short-term rates to the range of 2.25% to 2.5%. In December of 2018, the financial markets cried 'Uncle!' The Fed's attempt at policy normalization incited the stock market's worst December performance that year since 1931. All of this gave the appearance that the Fed's *functional* mandate is to actually put out the fires they in fact start. Now, the Fed approach to unwinding the Covid-induced policies of the past two years sounds much like a redo of their 2018 tightening playbook.

The Fed kicked their dovish policies into overdrive in the Spring of 2020 with the onset of the Covid Crisis. When the new hawkish phase of monetary policy begins this March, the Fed will be starting with a zero Fed Funds rate and a whopping $9 trillion balance sheet.

Conclusion

Monetary stimulus has been an instrumental force in the market's meteoric rise since the crisis began as evidenced by Chart 5. Aided by low interest rates and record corporate profits, the equity markets are as expensive as they have ever been on practically every fundamental metric. The largest 10 stocks in the S&P 500 now represent about 33% of the market cap of the S&P 500 and were trading at an average multiple of over 40 times earnings at the beginning of the year. As rates continue to rise, value stocks will likely outperform high beta growth stocks.

Chart 5

We argued at the beginning of last year that interest rates would grind higher creating a very narrow path to successful fixed income investing in 2021. The strategy suggested we keep the duration in bond portfolios short and invest in fixed income securities that would benefit from the reopening of the economy as the effects of the Covid Crisis began to wane. In contrast to the vertical rise in stock prices in 2021, the return of the Bloomberg Aggregate Bond Index was *down* 1.54% in 2021 as yield on the 10-year Treasury increased by about 50% in 2021. Fortunately, despite the draconian backdrop for bond investing, our strategy proved prudent and the Doucet Asset Management Fixed Income Composite was up 12.77% in 2021 or a 1431 basis point outperformance of the Index.

Doucet Asset Management FI Strategy Composite Performance	2021	1 Year	3 Year	5 Year
As of 12/31/2021				
Doucet Fixed Income Composite	**12.77%**	**12.77%**	**7.52%**	**5.20%**
Bloomberg US Aggregate Bond	-1.54%	-1.54%	4.79%	3.57%
Bloomberg 1-3 Year Muni	0.32%	0.32%	1.77%	1.64%
+/- Benchmark (Bloomberg Agg)	14.31%	14.31%	2.73%	1.63%
+/- Benchmark (Bloomberg Muni 1-3)	12.45%	12.45%	5.75%	3.56%
Performance calculated by Morningstar Office				
Periods greater than 1 year are annualized				

As the Fed attempts to get back to the Yellow Brick Road and dampen inflation's rise, interest rates will likely creep higher, stock multiples will soften and corporate margins will normalize. Currently, the Fed is sending signals that they plan to unwind the stimulus of the past 22 months in a 'fast and furious' manner. Based on the 2018 reversal experience, if the Fed moves too quickly, they run the risk of causing severe market dislocations before they are able to make much of a dent in normalizing

Doucet Asset Management Fixed Income Composite Characteristics					
As of 12/31/2021	**Portfolio**	**Benchmark**	**+/-**	**% of Benchmark**	**Target**
Maturity (Years)	4.40	8.78	*-4.38*	50%	65%
Coupon Rate	3.67	2.44	*1.23*	150%	>100%
Yield to Maturity	5.47	1.86	*3.61*	294%	>150%
Rating	AA-	AA-			
Notes: Stated Benchmark is Bloomberg Agg					
Portfolio data from account 10831 included in the Doucet Fixed Income Composite					
Source: All characteristics calculated using Bloomberg Portfolio & Risk Analyitics					

monetary policy. However, the combination of a low base effect, moderating energy prices, and the unsnarling of logistics should help inflation moderate on its own and allow the Fed to opt for a more gradual tightening approach. If so, perhaps they can run with Dorothy and friends to Emerald City of financial health and sing a refrain of 'You're out of the woods, you're out of the dark, step into the light!'

Sincerely,

Chris L. Doucet, CEO

Footnotes

[1] Barron's "A Grim History Repeats at the Fed" January 23, 2022

- 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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