DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter

Q4 2022

October 2022

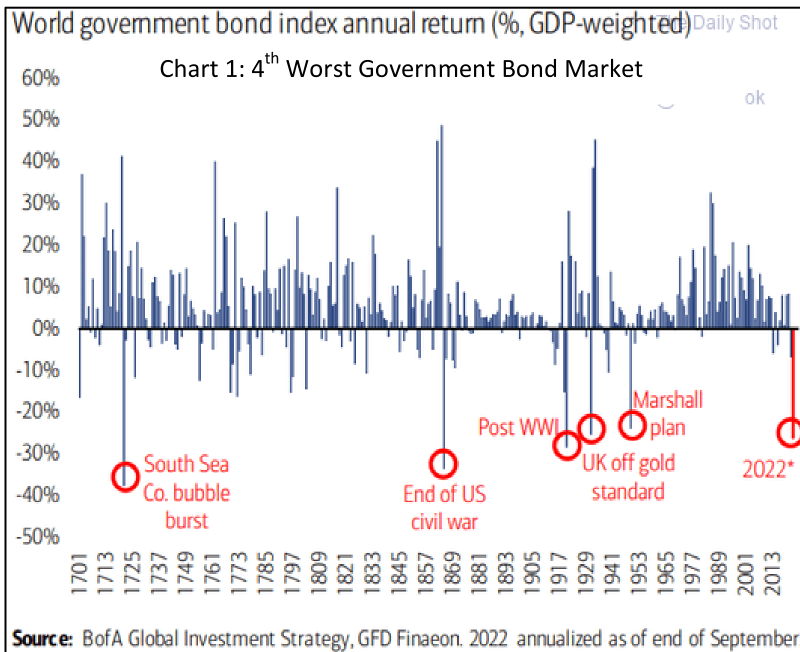
Fed Bowl

"Don't Fight the Fed" Marty Zweig 1970

With football season back, let's put the market on the playing field. Imagine financial securities - like stocks and bonds - are football players and the markets are the games. The contests are televised and millions of people around the world watch. But at the end of each game, all the commentators can talk about are a couple of players and a few ill-advised calls on the part of the referee which determined the outcome of each match. Well, of course, the players are typically whatever high-profile meme stock did well or tanked. But who is the referee in these games? Why our friends over at the Federal Reserve, of course. Much to the chagrin of market pundits everywhere, the Fed "has come to occupy the anomalous place of the referee who dominates, overshadows and is in utter control of the game that he or she is merely supervising."[1] Perhaps it might be more appropriate to refer to financial markets these days as the *Fed Bowl*.

Repeat of the 1970s Great Inflation?

The last time the Fed received this much commentary was about the same time it effectively began operating under a directive from Congress in the 1970s to promote the 'dual mandate' of ensuring maximum employment and stable prices. Two Fed Chairmen from the 'Me Decade,' Miller and then Burns, opted to err on the side of full employment over price stability when the economy showed signs of weakness. One might recall, their actions helped flame inflationary fires. Era highlights included oil price spikes, significant increases in the money supply, skyrocketing government spending and the Fed's complete inability to diagnose the severity of the problem. Finally, the G.O.A.T. Federal Reserve Chairmen, Paul Volcker, was appointed and took tough decisive action to put an end to the period known today as the *Great Inflation*.



Source: BofA Global Investment Strategy, GFD Finaeon. 2022 annualized as of end of September.

With the exception of the Chair Volcker reference, does this financial backdrop and melodrama sound familiar? Today, the economy finds itself firmly in the midst of the second coming of the Great Inflation, which has eerily resemblant features of the first one, including a significant misdiagnosis of reality by central bankers. The current Crew Chief of the Federal Reserve, Jerome Powell, initially tried

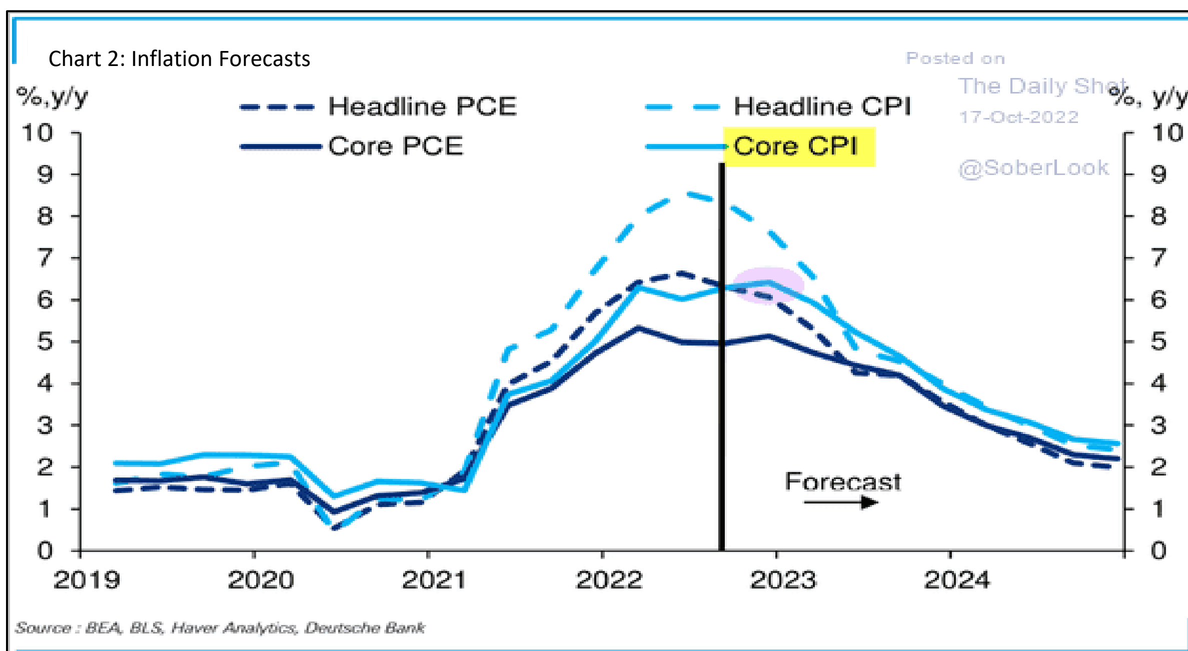
to do his best Burns and Miller imitations when he botched a critical call early in the inflation season referring to it as 'transient.' He subsequently picked up the errant flag and reversed his call when he finally saw inflation as fans had seen it for months-a more permanent fixture.

In his late August Jackson Hole speech, Powell must have reviewed old game film because he mirrored language used by the G.O.A.T. over 40 years ago. After Powell's speech, the markets swooned. The S&P 500 fell by almost 12.5% in just seven weeks. In the same timeframe, the 2 and 10-year Treasuries increased in yield by about 35% to 14-year highs. Many other central banks have problems of their own as they have taken queues from the Powell playbook. Their results have been similar. As a clear illustration of just how hard it has been to stay out of harm's way in the fixed income markets, the World Government Bond Index has experienced its fourth worst year since 1721 (see Chart 1)!

First Half Play – Fed Hikes Rates 300 Basis Points

Since the Fed began its fight against inflation in March, they have raised short term rates by 300 basis points. This series of moves has resulted in a bloody first half of highlights in the financial markets…with plenty of time remaining on the clock. This year, the yield on the 10-year Treasury is up about 170% from 1.51% to the current 4.1% rate; the 2-year Treasury is up in yield about 520%, from .732% to 4.53%.; and the S&P 500 is down 22.5%.

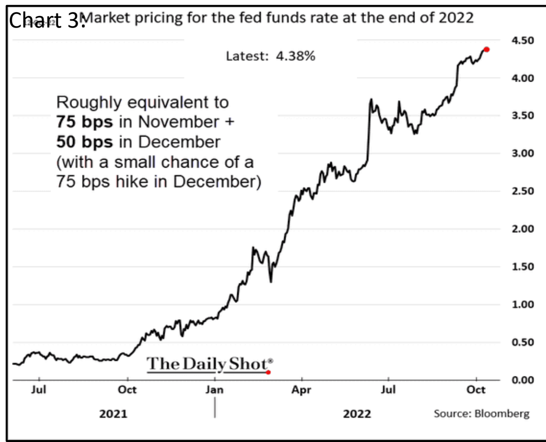
The Fed is expected to raise rates at least two more times in 2022, but there is a significant amount of data which suggests that inflation may begin to soften beginning early next year. We think this is important because we vehemently believe the level of inflation will decline beginning in the early part of 2023 simply because a perfect storm



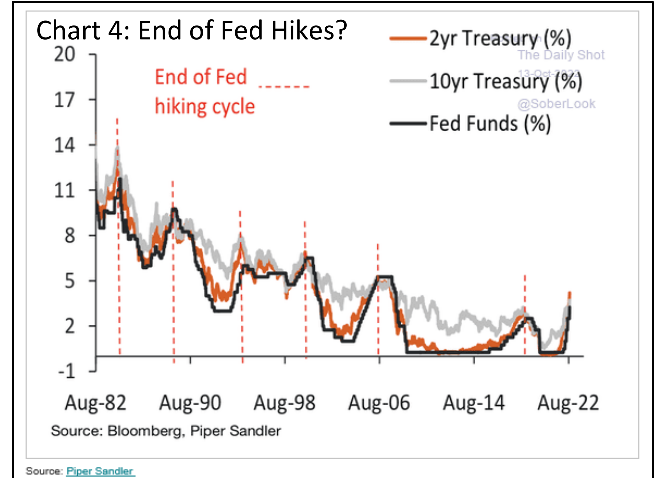
created unsustainable high prices in some categories. However, this does not mean that inflation will not prove to be stubborn and remain elevated for some time-it will. Prices should still remain much higher than 2020 and 2021 for the foreseeable future, but the rate of increases should start to subside beginning next year.

Halftime Commentary

Apparently, central banks overseas are having the same impact on European football. The Bank of England and other central banks are clearly showing the Fed how tightening actions may be sowing the seeds of destruction in financial markets. However, until the domestic market is convinced the Fed is truly nearing an end of its rate hikes, the bond market will continue to be soft (and worsen because of the spillover effects from foreign markets). The equity markets will continue to show weakness, with occasional fits of violent short covering.



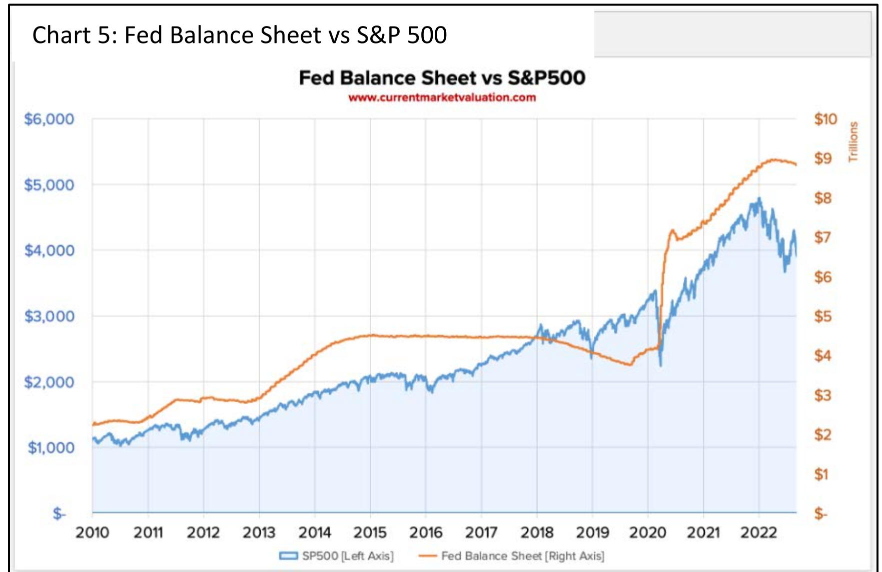
Any positive asset drive will likely be stalled as the Fed continues to strike a hawkish tone. There are signs which suggest the markets are oversold and are ready to rally. Equity bulls point to a plethora of positive indicators ranging from low consumer leverage to a 12-year high in bearish sentiment for equities. But perhaps the most bullish data point in their 'hopium' arsenal is bulls expect the Fed to pause interest rate hikes after their December 14th meeting. This would put the Fed Funds rate in the 4.38% range by year end, based on estimates compiled by Bloomberg (See Chart 3). IF this is true, it could be boon to financial markets. Piper Sandler points out just how significant ending rate hikes has been for financial markets in the past. They suggest Treasury yields historically have peaked when a Fed tightening cycle ends (see Chart 4).



Second Half Play-Quantitative Tightening (QT)

As the market is ever hopeful the first half of play (rate hikes) is coming to an inglorious end, what they forget is a football game is comprised of two halves. The second half of the Fed Covid Recovery Game Plan is yet to begin. Bulls are convinced the markets will receive an 'all clear' signal on the monetary policy front if/when the Fed pauses its rate hikes in December. But the second half of the Fed Bowl may prove more challenging than the first.

It is imperative to remember the Fed more than doubled its balance sheet from around $4 trillion to about $9 trillion as a result of its emergency asset-buying to prop up the U.S. economy during the Covid-19 pandemic. This helped fuel significant gains in asset prices across the board-housing, stocks, and bonds (See chart 5). Now their plan is to reduce their balance sheet by $1 trillion per annum over the next three years through a process call Quantitative Tightening or QT. Logic dictates that if QE inflated asset prices, QT will have the opposite effect.



It is difficult to believe QT will *not* have a continued adverse impact on risk assets. Stocks have already come down from over 30 times earnings to 18. But with expected upcoming challenges to corporate earnings in the next year, our focus has been on specific stocks we believe will perform well in a slowing economy.

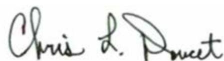
While stocks are down this year, bonds have experienced the equivalent of a 100-year storm. The performance in world government debt has not been this poor in over a century. And while we are convinced the Fed will raise overnight rates at least another 125 basis points this year, we think QT could have a more adverse impact on the market than the neutral effect the market currently expects.

A Playbook for Uncertain Times-Rates and Positioning

Higher interest rates are having a negative drag on most industries. There is a limit to how high interest rates can go without causing damage to the economy. The Fed is getting closer to reaching that level. Therefore, we have begun to put additional cash to work in limited high-grade municipal and government bonds with maturities ranging from 60 days to six years.

While there are many uncertainties in the markets, there is one certainty today-the Fed will attempt to control the outcome of the game months after the consequences of their actions are clear. Like the old saying goes, "Don't fight the Fed." When Fed was easing, stocks and bonds went up and everyone felt smart. This time, we will have the Fed to blame as they try to get through the second half of Fed Bowl.

Sincerely,



Chris Doucet

Footnotes:

[1] Jim Grant, "*Grant's Interest Rate Observer*, June, 2016

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.

The above views are those of Doucet Capital and Chris Doucet, and are not necessarily the views of Institutional Securities Corporation.
Doucet Asset Management, LLC is independent of and not affiliated with Institutional Securities Corporation (ISC).
Chris L. Doucet is a Registered Representative of ISC. Past performance does not guarantee future returns.

REGISTERED INVESTMENT ADVISORY SERVICES PROVIDED BY DOUCET ASSET MANAGEMENT, LLC. SECURITIES OFFERED THROUGH INSTITUTIONAL SECURITIES CORPORATION, DALLAS, TEXAS, MEMBER FINRA, SIPC (214)520-1115. THIS NEWSLETTER IS FOR INFORMATION PURPOSES ONLY. NOTHING IN THIS NEWSLETTER CONSTITUTES AN OFFER TO SELL OR A SOLICITATION OF AN OFFER TO BUY ANY INTEREST IN ANY SECURITY, OR IN ANY INVESTMENT VEHICLE MANAGED BY DOUCET CAPITAL, LLC OR DOUCET ASSET MANAGEMENT, LLC, OR ANY OF THEIR AFFILIATES. NOTHING IN THIS NEWSLETTER CONSTITUTES PROFESSIONAL OR FINANCIAL ADVICE, OR RECOMMENDATIONS TO PURCHASE OR SELL A PARTICULAR SECURITY. CERTAIN INFORMATION DISCUSSED IN THIS NEWSLETTER MAY CONSTITUTE FORWARD-LOOKING STATEMENTS WHICH CAN BE IDENTIFIED BY THE USE OF FORWARD-LOOKING TERMINOLOGY SUCH AS "MAY," "WILL," "SHOULD," "EXPECT," "ANTICIPATE," "TARGET," "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.