DOUCET ASSET MANAGEMENT, LLC

Quarterly Newsletter

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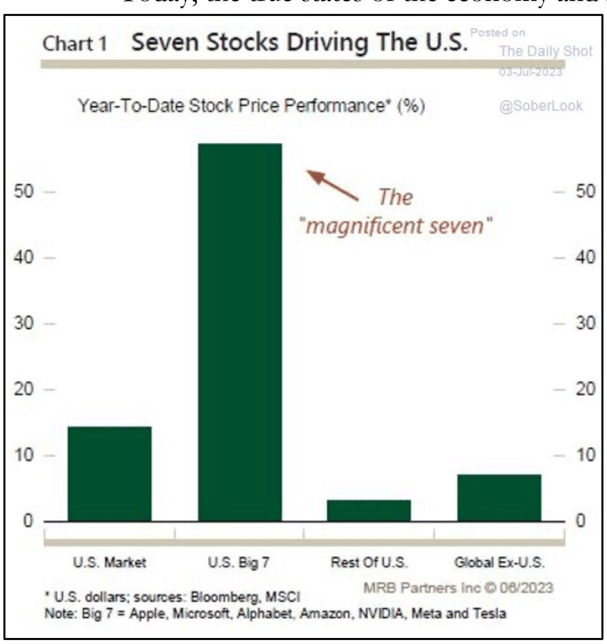
Ghost Army Economics-*A travelling roadshow of deception*

"All warfare is based on deception" Sun-Tzu (c.544-496 BC) The Art of War

During World War II, a top-secret division of the U.S. Army fought battles not with bullets or aircraft, but with "stagecraft." According to the New Orleans World War II Museum, they used "inflatable tanks, phony soundscapes and fake radio transmissions to fool Nazi soldiers." This unit consisted of 82 officers and 1,023 men and could mimic two whole divisions, or 30,000 soldiers. The troops took part in 22 large scale deceptions in Europe from Normandy to the Rhine River and aided the Allied forces in multiple strategic military victories late in the war, leading up to D-Day. To complete the charade, actual soldiers would go into local bistros and bars declaring themselves part of the 'huge' phantom force to increase the believability of the enterprise. The official name of the group was the 23rd Headquarters Special Troops, but they were commonly known by their code name, 'Ghost Army.'

Today, the true states of the economy and market are being masked by "ghost armies" of their own. Their appearance has helped the US avoid one of the most anticipated recessions in US history. But they have also had a presence in the stock market as a highly concentrated group of stocks have managed to significantly distort the true health of the S&P 500 so far this year. They have created elements that have combined to conceal the risks imbedded in both the stock market and the economy and have made the investment landscape more difficult to maneuver. So, what are some of these potential smoke screens and how should investors have their portfolios positioned once the air clears?

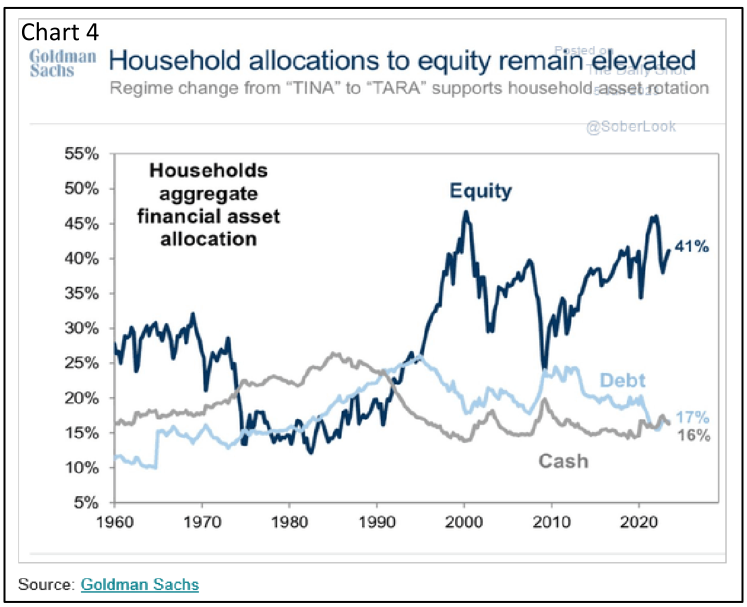


Narrowing Market Breadth: The Magnificent 7

Perhaps the most obvious example of ghost armies at work can be seen in the performance of the S&P 500 this year. Despite flat corporate earnings, the Index is up a whopping 15.9%, all of which can be explained by expanding multiples. But according to MRB Partners, the 'Magnificent 7,' a handful of large company technology stocks, drove most of the performance of the S&P 500 and the same stocks helped the NASDAQ experience its best performance in the same period in over 40 years. In sharp contrast, the Dow was up about 3.8% since the Magnificent 7 is underrepresented in the Index.

Weighing Risk vs Reward

For years, the mantra of the stock market has been 'TINA,' *there is no alternative*. But while stocks have gotten more expensive this year, bond prices have gotten cheaper as yields have risen across the board. Stocks have not been this expensive on a fundamental basis since 2000 with the exception of the Covid era. Currently, the yield on the two-year Treasury is trading near its highest level in 16 years. Other fixed income securities are trading at relatively elevated levels as well. Chart 3 shows BBB-rated corporate bond yields compared to the earnings yield of the S&P 500. Despite a significant mismatch in the risk profiles, the chart clearly illustrates stocks have not been this expensive versus bonds since the summer of 2008, just prior to the Great Financial Crisis.

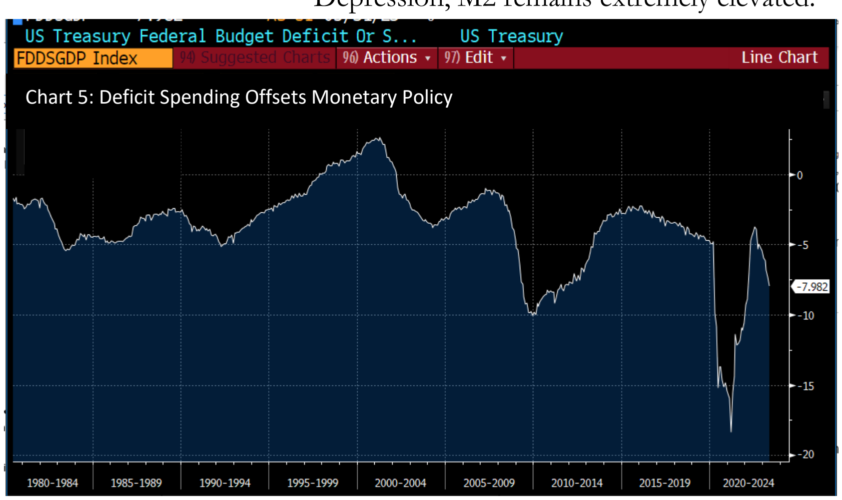


All-Out Equity Offensive

Higher stock valuations and lofty bond yields have not yet compelled investors to opt for bonds over stocks. Equity positioning in portfolios is near an all-time high, despite the *relative value* cash and bonds currently provide over stocks. Further, equity positioning in institutional accounts is also extremely bullish as sentiment in the stock market has made a complete 180 degree turn from where it has been over the past 18 months.

What is driving risk appetite in the markets? Certainly, one factor is the money supply (M2) increased by nearly 40% during the Covid Crisis. And while the money supply is currently falling faster than any time since the Great Depression, M2 remains extremely elevated.

Perhaps more significant is the recent Fed 'pause' on interest hikes. This is being viewed as a bullish sign for risk assets. Additionally, the Fed's $700 billion reduction of its balance sheet over the past year has been more than offset by $2 trillion in deficit government spending. As evidenced by Chart 5, the Treasury is running at an 8% of GDP fiscal deficit which is the highest level of government spending in an expansionary economic period in US history.



Treasury Running Low on Ammo

The US economy has become overly reliant on government stimulus in recent years. According to Haver Analytics, government spending was 68% of real GDP in the first quarter. This suggests the private sector may be weaker than the markets would otherwise indicate. The current level of fiscal outflows is complicated by the fact that the Treasury is now being forced to refinance maturing debt and issue new bonds to finance cash shortfalls at much higher yields. And while it may take some time before higher funding costs become problematic for the stock market, it will certainly put downward pressure on GDP as Congress attempts to get its fiscal house in order.

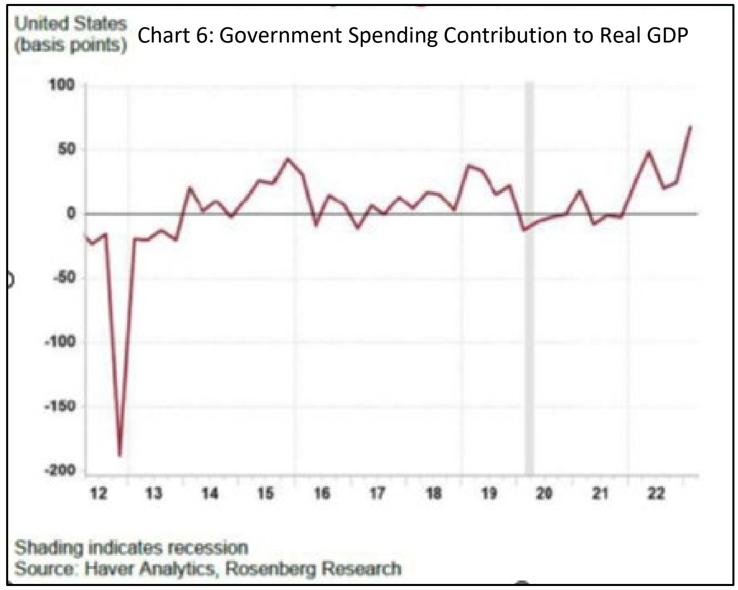


Chart 6: Government Spending Contribution to Real GDP

Conclusion: Ghost Armies Will Retreat

Liquidity has been the ammunition that has helped drive the equity markets higher since the Great Recession. Government deficit spending, more restrictive bank lending, and the massive expansion of the Federal Reserve balance sheet, have all contributed to the market's deceptive strength. The Federal Reserve seems determined to significantly reduce their balance sheet over the next several months and provide diminished cover for the market. GLJ Research attempted to illustrate just how important central bank balance sheets are to the performance of the S&P 500 Index. According to their research, there is a 98.4% correlation between central bank liquidity and the performance of the S&P 500 Index, dating back to January of 2009.

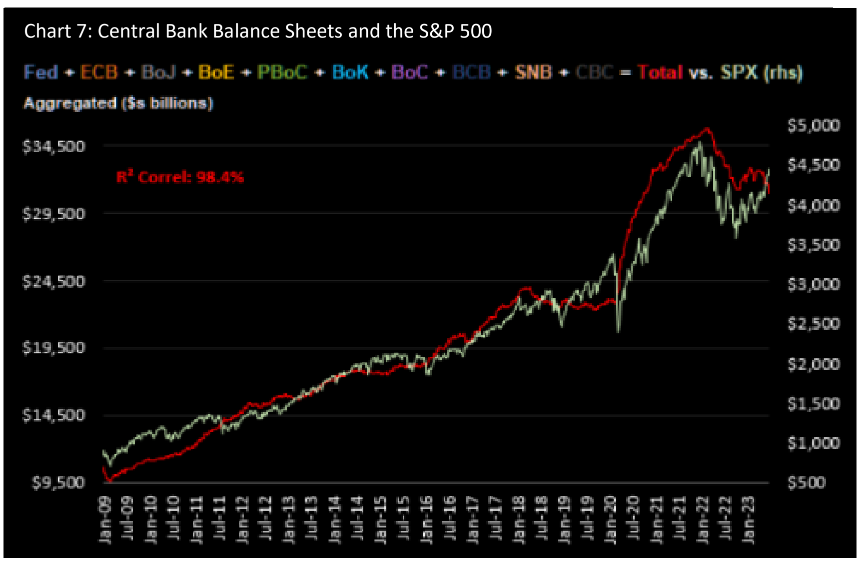


Chart 7: Central Bank Balance Sheets and the S&P 500

Source: GLJ

So, with the expectation of waning reinforcement liquidity, continued fiscal deficit spending and a retreating Fed floating like balloon tanks, jeeps and cannons along the Market battlefield, it will be as important as ever to ensure portfolios are positioned with this new reality in mind. After all, wars are won by the most prepared, the ones not taken in by "a traveling roadshow of deception."

Sincerely,

Chris L. Doucet

Chris Doucet

Amin 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.

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