Doucet Asset Management, LLC Quarterly Newsletter

April 2024
2Q2024

Law & *Dis*order

*“**Whatever can go wrong will go wrong**.”*
~Murphy’s Law.Lietenant Edward A. Murphy 1918-1990
“Anything that can work, will work”
~Yhprum’s Law-Alan Abelson, Forbes Magazine Editor & Chief, 1925-2013

Tale of Two Laws

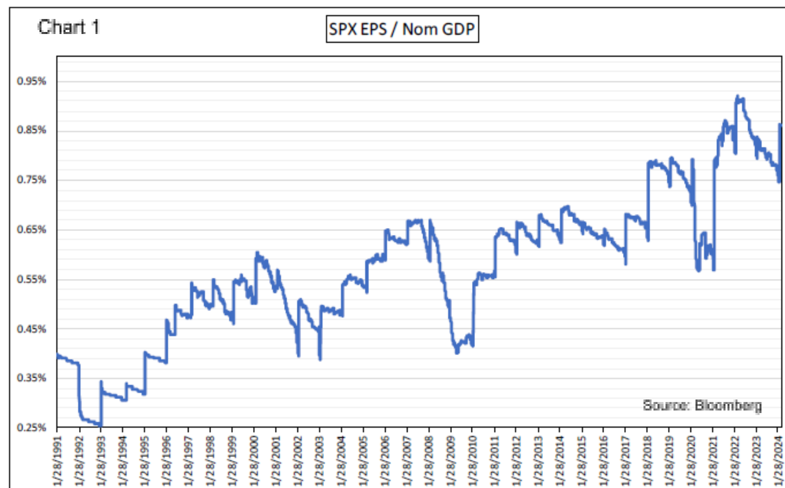
In the 1940s, the era of jet engines had begun. As aircraft speeds increased, a group of scientists from Edwards Air Force Base sought to determine how this might impact pilots. After a series of calamities, they tried an important experiment. They installed 16 sensors to a jet-propelled sled to measure the effects of rapid increases and decreases in acceleration on the human body. Exactly zero data was recorded. All the sensors had been mounted backwards. After this particular failed experiment, the frustrated commander, Lieutenant Edward Murphy, quipped “anything that can go wrong, will go wrong.” His staff began quoting that mantra, and “Murphy’s Law” was born.

In the December 1974 issue of ***Barrons Magazine’s,*** editor-in-chief, Alan Abelson attempted to apply a formulation of Murphy’s Law to economics. He coined the term Yhprum’s Law (Murphy spelled backwards) which went “ anything that can work, will work.” It was supposed to be a corollary to Murphy’s Law, but actually, it’s the complete opposite. It is this literal translation of Yhprum’s Law that describes the current state of the stock market today. Perhaps Jeremey Grantham, founder of GMO, put it best when he recently stated, “prices of US stocks reflect near perfection,” and yet “today’s world is particularly imperfect and dangerous.”

So investors find themselves in the loosening grip of Yhprum’s Law with a distant eye on Murphy’s Law in the midst of an imperfect and dangerous landscape. However, there are some lesser known *laws* that might prove helpful to successfully navigate today’s market landscape.

Law: Stocks are Expensive

By almost every fundamental measurement the S&P 500 is as expensive as it has ever been. Stocks in the Index are trading at a whopping 21.3 times forward earnings, CAPE Schiller price-earnings-ratio currently sits at a lofty 34 times earnings and S&P 500 earnings are trading near their highest level versus nominal GDP in history (see Chart 1). Financial markets have been on a tear most of this year, buoyed by moderating inflation and the hopes of forthcoming rate cuts by the Fed.

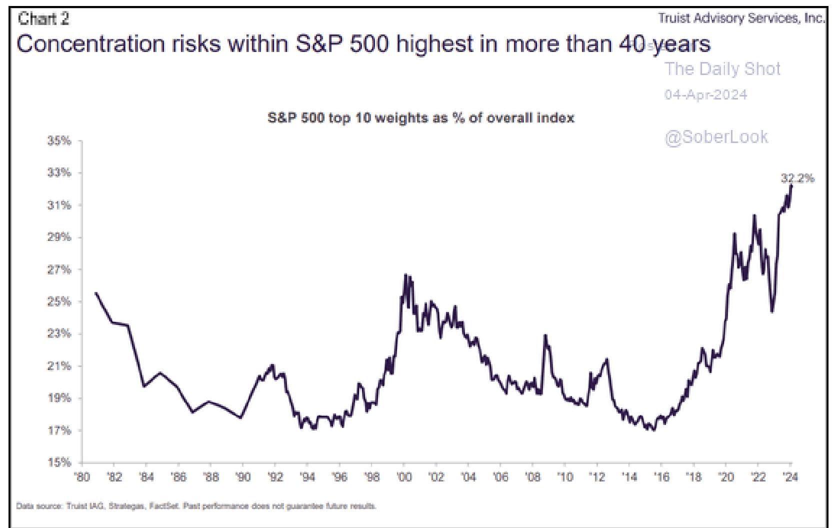


Until the last few days, the market has been immune to multiple pitfalls which could affect its ebullience. But a market with such stretched valuations and elevated optimism can become very vulnerable to potential negative shocks and corresponding readjustments in stock prices. Stubborn inflation continues to be a slowing headwind for consumers, the United States is fighting two and a half proxy wars, two very divisive candidates are vying for the Presidency, bonds continue to hover near the highest yields in decades, and out-of-control US debt and deficit spending are now beginning to send real danger signals to the market…just to name a few. Despite these mounting risk factors, this market has followed Yhprum's Law for most of the past year. But with stocks near new all-time highs and danger lurking just around seemingly every corner, should investors look to other lesser-known financial and economic laws to provide guidance?

Law: You Can't Squeeze Blood Out of a Stone

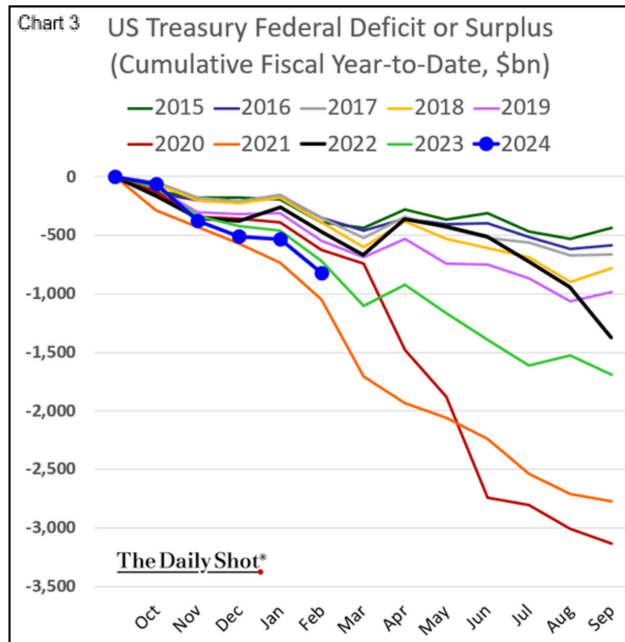
While not a law found in the annals of financial history, there is an old saying worth noting when it comes to today's market, "you can't squeeze blood out of a stone." Markets do not fall simply because they are "expensive," nor do they rise simply because prices are "cheap." However, sometimes a market's elevated valuations can put a ceiling on how high stocks can rise. It is beginning to make sense to apply this saying to current equity markets. Grantham believes market upside from these levels is extremely limited and the current bull market may be testing Father Time. He states "the longest sustained stock market rally from these lofty multiple heights in history was about 18 months. And it only happened twice - once in Japan until 1989; and the other in the United States during the US tech bubble of 1988 and 1999." Neither ended well.

Flashing red lights also usually accompany markets that have become top-heavy. Chart 2 suggests the 10 largest stocks make up over 32% of the S&P 500. According to Bloomberg, the top four names in the S&P 500 produced 43% of the return for the Index last year and 72% of the return for the Index so far this year. This level of concentration of stocks in the broader market has only come close to current levels twice in history – 1929 and 2000. Both the 1929 and 2000 markets were propelled by the tech darlings of the day. And the most recent rally to record Index levels has also been powered mostly by technology stocks.



Law: What We Do, Not What We Say

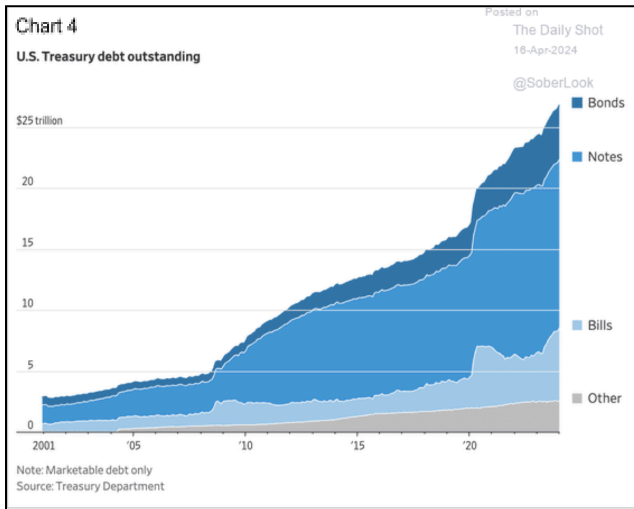
Why are markets hitting records in the face of high interest rates? One certainty is the stock market performs better when the economy is flush with liquidity and falters when liquidity is taken out of the economy. The Federal Reserve claims that monetary policy is currently 'tight' or restrictive. In other words, they have attempted to make conditions tough for borrowers by raising interest rates in the hope that the economy will slow. But it is important to see what is actually happening versus what political and Fed officials say.



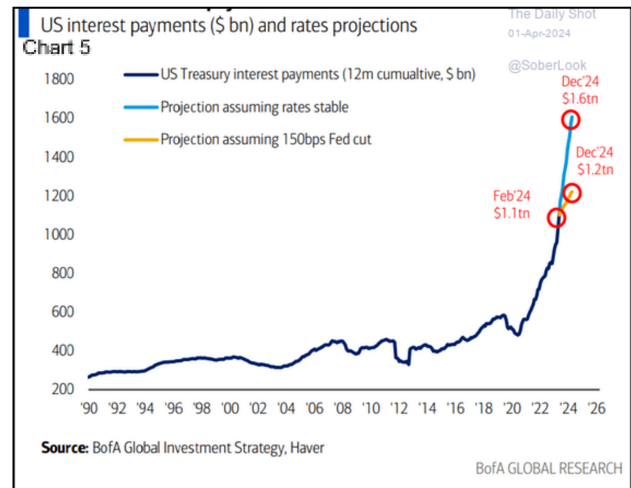
Contrary to popular belief, liquidity in the economy is actually *rising*, not *falling* which has helped support risk markets. While most investors believe the Federal Reserve when they say they have adopted a tight monetary policy, their actions show just the opposite. The Fed stopped raising short term interest rates 10 months ago although Chairman Powell has been hinting since last Fall that rate cuts are coming soon. However, beginning a year ago, the Fed pumped hundreds of millions of dollars to provide relief for troubled banks. And the decline in the Fed's Reverse Repo Window has dwarfed the reductions the Fed has made on their balance sheet over the past year.

Not to be outdone, the US Treasury has also provided ample liquidity to stimulate the economy and whet risk appetites. Since Covid began, record peacetime deficit spending has been the norm as evidenced in Chart 3. Last year alone, the US Treasury spent $1.7 trillion more than the $4.9 trillion in revenues they took in.

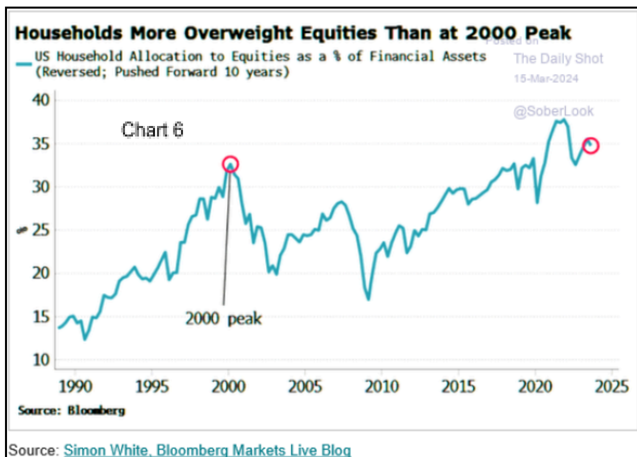
While a dovish-leaning Federal Reserve and record government peacetime deficit spending are bullish for equity markets in the short-term, markets may experience hiccups if fiscal and monetary policy diminish liquidity any time soon. On the monetary side, the Fed was expected to reduce short-term interest rates by more than six times in 2024 just a few short weeks ago; today, the expectation is down to less than two. From a fiscal standpoint, government spending is always elevated in an election year and tends to moderate once politicians are elected and take office.



Fiscal and monetary policy may change in the next several months because the bond market forces them to change. According to Jeffrey Gundlach of Doubleline Funds, about 50% of all government debt or roughly $17 trillion matures in the next 36 months. Much of this debt was issued when interest rates were at all-time lows. When these bonds mature, the government is forced to reinvest at prevailing rates which are much higher. Chart 4 helps illustrate the problem today and shows just how draconian this issue may become. At the very least, this combination of maturing debt and the funding of deficit spending will help ensure inflation remains stubbornly high and interest rates elevated.

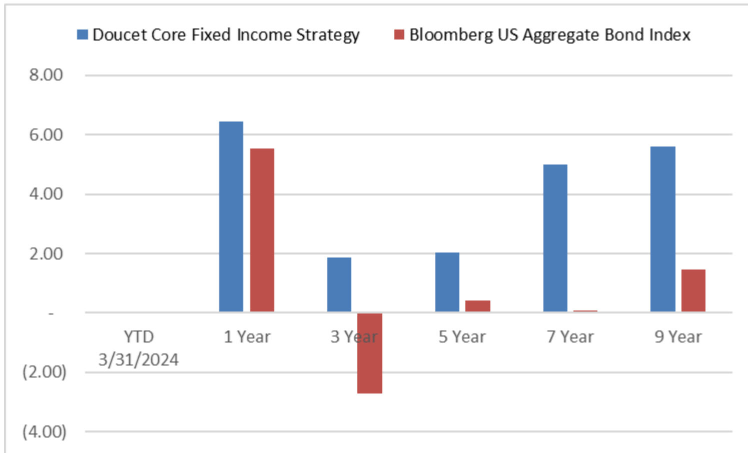


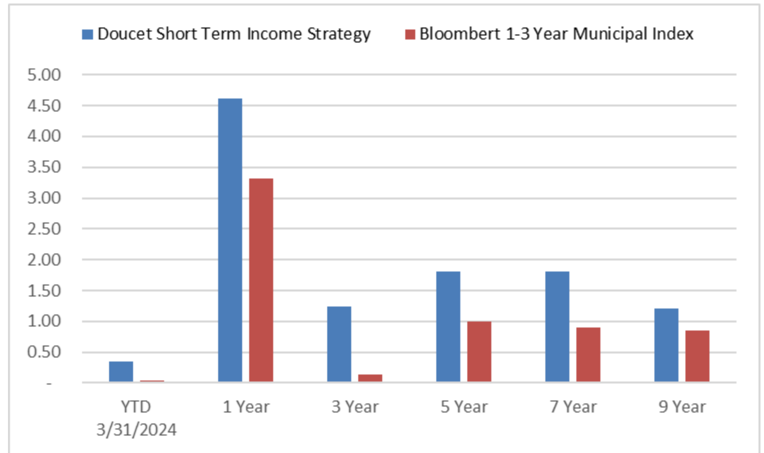
Law: Summary Judgement-Easier Said Than Done



While stocks have gotten more expensive recently, bonds are the cheapest relative to stocks since 1999, according to Eric Johnston of Cantor Fitzgerald. From a portfolio allocation standpoint, the logical reaction to higher-priced stocks and lower-priced bonds is to simply swap out of 'expensive' stocks into 'cheap' bonds. Besides, individual investors are more overweight stocks in their portfolios now than ever (see Chart 6).

We believe it is important to adjust portfolios to take advantage of today's market realities. It is equally important in these markets to manage downside risks. Bonds represent a value over stocks today, however, fixed income investing is not without risks. Investors have witnessed severe volatility in the bond market with precipitous rises and falls in interest rates and significant deterioration and strengthening in credit markets over the past few years. Despite these challenges, as evidenced by the charts below, our team has been able to outperform the pertinent indexes for each of our fixed income strategies in both good and bad markets and across every time frame over the past nine years-1,3,5,7,9-year periods and year-to-date. Of course, there is a very





important rule in the financial services business that suggests past performance does not guarantee future results. But while we believe it is prudent to begin pruning portfolios of equities and de-risking portfolios, it is equally important to be mindful to consider that financing challenges for the Federal Government will be the most pronounced in generations. Deteriorating political and geo-political events in coming months may add fuel to the fire. This combination will likely add to the complexity in fixed income investing in the future.

In order to successfully navigate the investment landscape in the near future, it will be incumbent upon us to filter out what Fed officials and politicians say and focus on what they do. Our portfolio strategy will continue to focus on some lesser known financial laws. We believe this will prove more prudent at this juncture. And while Yhprum's Law may continue to prevail in the near future, Murphy's Law is lurking right around the corner.

Sincerely,

Chris L. 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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