



July 2010

The Old Normal?

It was the best of times, it was the worst of times...it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair...

- Charles Dickens, "Tale of Two Cities"

...And it was the age of the "New Normal," it was the age of the "Old Normal." Much attention has been given to the idea the world is entering a period in which investors should expect lower growth, and ergo, anemic returns on their investments. One obvious premise behind this assumption is our economic ship has entered into completely uncharted waters. But this assertion is flawed as history is replete with examples strikingly similar to those headwinds which appear on the current investment horizon. The 1994 mid-term election, the "double-dip recession" of 1938 and the "depression that never was" in 1946 bear direct parallels to challenges the economy faces today. In all three cases, history provides several valuable lessons: An economic recovery can occur without government spending (and further, even massive government cuts in spending); governments are inefficient in creating long-term sustainable economic growth; and there is an opportunity cost for those too fearful to invest during the markets' recoveries.

"Growth Scores"

The question on the minds of many investors has been is the U.S. heading into a double-dip recession? The recent economic data pointing to slowing growth and disappointing jobs data, combined with debt woes in Europe and here at home, were the perfect formula for a decline of 16.0% in the S&P 500 Index from April 23rd to July 2nd. J.P. Morgan, in a June 17th research report, refers to this phenomenon as a "growth scare."¹ Growth scares have been "common early into" every economic expansion since 1945. Investors wonder if the recovery is real, the markets sell off "fast and deep," "decline on average 16%," but only last about "1.8 months." During these times, jobless claims increase, confidence and ISM manufacturing decline. Yet, the report showed that subsequently, the market usually gains 16% and 20% after 3 and 6 months, respectively.¹

It's Starting to Feel Like 1994

The "growth scares" seen in the markets recently have been trumped, however, by the "Nightmare on Pennsylvania Avenue." However, change may be on the horizon. The Declaration of Independence states, "Governments are instituted among men, deriving their just powers from the consent of the governed, that whenever any form of government becomes destructive of these ends, it is the right of the people to alter or abolish it, and to institute new government." A recent ABC News/Washington Post poll² showed a

Figure 5: Precedent Growth Scores: Duration and Subsequent Bounce

S&P 500							S&P 500 Fed Perf	
Start of Correction	End of Correction	Delta (mos)	Level at Start of Correction	Level at End of Correction	%chg	3 months after correction	6 months after correction	
2/5/46	2/26/46	0.7	18.7	16.8	-10%	12%	4%	
6/12/50	7/17/50	1.2	19.4	16.7	-14%	19%	29%	
9/23/55	10/11/55	0.6	45.6	40.8	-11%	9%	18%	
8/22/62	10/23/62	2.0	59.8	53.5	-11%	23%	30%	
7/15/75	9/16/75	2.1	95.6	82.1	-14%	8%	23%	
8/25/87	12/4/87	3.3	336.8	223.9	-34%	19%	19%	
7/17/88	8/8/88	1.5	1,186.8	957.3	-19%	22%	29%	
7/16/89	10/15/89	3.0	1,418.8	1,247.4	-12%	17%	9%	
Mean		1.8			-16%	16%	20%	
Median		1.8			-13%	18%	21%	
4/23/10	6/7/10	1.5	1,217.3	1,050.5	-14%			

Source: J.P. Morgan and Bloomberg.

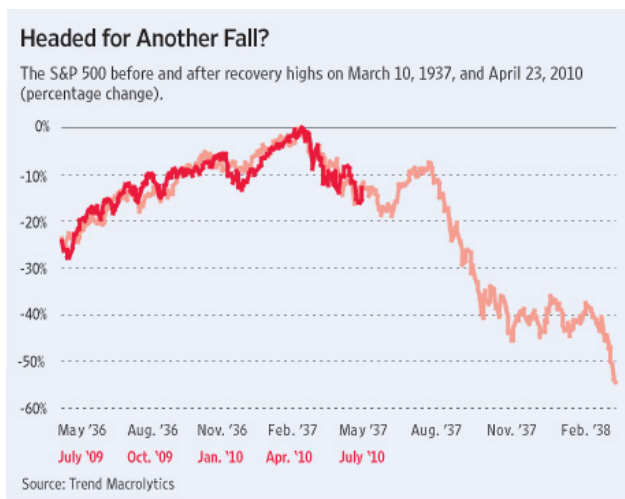
majority of Americans desire improved checks and balances in Washington. To date, voting leading up to the mid-term elections have witnessed incumbents failing to win primaries for their respective parties.

Similarly, leading up to the mid-term elections in 1994, public confidence in government had reached new lows. Unemployment had been stubbornly high. The Savings & Loan crisis of the late 1980's had resulted in the worst real estate crisis since the Great Depression, and the slowdown in the finance industry and the real estate market were a contributing cause of the 1990–1991 economic recession. Republicans ran for office in the 1994 mid-term elections with the slogan of “Contract with America,” a pledge that their policies would be “designed to enhance private property rights and economic liberty and make government more accountable.” The campaign worked. The Republicans took control of the House of Representatives for the first time in 40 years. By December 1995, the Dow Jones Industrials had gained 45.2% from its April 1994 low. Fiscal restraint imposed by Congress helped lead to budget surpluses later in the decade. By December 1999, the Dow had more than doubled its 1995 peak level.

“Double-Dip Recession” of 1938

Now contrast 1994's Republican platform of enhancing private property rights and limiting government with those of the Great Depression. It was an era chock-full of the “duality” expressed in Charles Dickens' 19th century novel, “Tale of Two Cities.” In the years following the stock market crash of 1929, government policies were implemented that facilitated the destroying of crops and livestock while millions of Americans were starving; price-fixing on milk and other staples while people needed Wal-Mart-like bargains; the harassment of employers and the discouragement of investment when the former needed incentives and the latter needed encouragement. While a select few benefitted from these policies, the country as a whole suffered.

By late 1936, the economy was in a recovery mode from the depths it had reached in 1932 and there was a sense of exuberance that the worst was over. Unemployment had fallen to 14.3% by 1937 from a high of 24.9% in 1933, and the Dow Jones Industrial Average was up over 370% from its low in July 1932. Gross National Product (GNP) grew by a record 14.1% in 1936! And then came more government regulations: The Federal Reserve Board voted to increase the reserve requirement for banks....twice; the government began deducting Social Security payroll taxes in 1937 even though benefits were not expected to be distributed until 1940; Congress passed several measures which kept wages artificially high, including the Fair Labor Standards Act (minimum wage, especially devastating to the Southern economy); FDR's New Deal tax increases reduced “the incentives for personal effort, investment and risk taking.”³ Subsequently, the market fell about 50% from February 1937 to March 1938. Despite the more than 3 million New Deal jobs that were created by the government during the era, unemployment never dipped below 14% during the Great Depression.⁴



Fast forward to today, the Wall Street Journal recently suggested employers have not begun to replace their shrunken employee ranks – despite having the highest cash levels in 50 years – due to the “destructive impact that higher taxes, trade restrictions, and more regulation” could potentially have on business activity. Several months ago, the Healthcare Bill was passed despite being extremely unpopular among voters and with no obvious source of funding. More recently, the 2,400 page Frank-Dodd Financial Reform Bill effectively raises bank reserve requirements when commercial and industrial (C&I) lending has declined 17.9% in the last 12 months and overall lending has declined 3.5%.⁵ Similar to the healthcare bill, “the main problem with the (financial reform) bill is that it is based on a misdiagnosis of the causes” of the recent financial crisis according to John Taylor, Professor of Economics, Stanford University, leading many Americans to believe this is nothing more than another Washington pork-barrel bill.

1946 - The Depression That Never Was

“The ‘Depression of 1946’ may be one of the most widely predicted events that never happened in history.”⁶ Immediately after V-J Day, the government began to disband military personnel, closed down armament manufacturing plants, cancelled war contracts and, in total, reduced government spending from “\$84 billion in 1945 to under \$30 billion in 1946.”⁶ Consensus among economists, since many believed wartime stimulus had ended the Great Depression, was removal of this government spending would certainly lead to chronically high unemployment and another prolonged severe economic downturn. The direst predictions forecast unemployment to rise as high as 35% in 1946!

Yet, by 1947, the government was paying back its massive wartime debts by running a budget surplus of close to 6%.” While more than 10 million military personnel were returned to civilian life after WWII, unemployment remained under 4.5% in the first three postwar years.⁶ Civilian employment expanded by over 4 million between 1945 and 1947. How could this happen when so many were predicting economic Armageddon? The fact of the matter is government pay outs come directly or indirectly from taxation, resulting in less money for both people and businesses to spend or invest. This example of “spending restraint” following the end of WWII clearly illustrates what can happen if government expenditures do not "crowd out" private sector spending and how the economy can thrive when the government’s shadow is dramatically reduced.

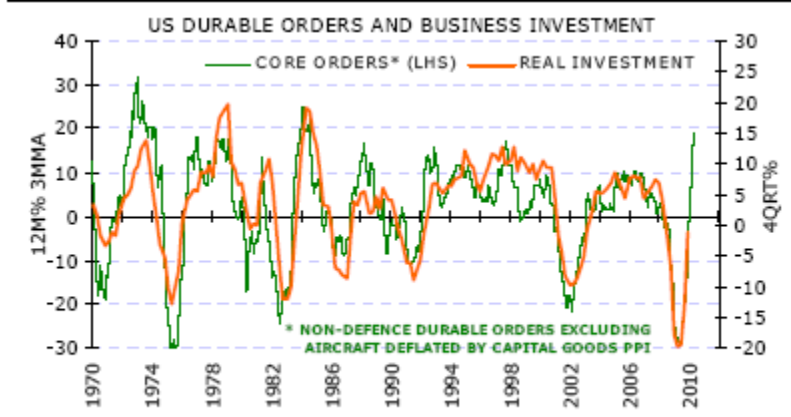
It is All About Creating Jobs

Few would argue that the private sector, not government, transformed the United States from a fledgling economy to the economic powerhouse it is today. If government jobs were the secret to an economy’s success, Cold War Soviet Union and Argentina would certainly have been roaring successes. Private sector job expansion is important to the government because of the taxes they produce.

Ask any private sector employer and he or she will tell you that some or all of the following ingredients are necessary for them to be compelled to hire additional employees, i.e., create jobs:

- **Predictable rules** – What are the implications of Frank-Dodd “financial reform” legislation or “Obamacare” to the private sector? No one will be able to answer these questions for years to come, making planning for long-term commitments of capital difficult and risky for companies of all sizes.
- **Sound money** – U.S. fiscal policy is clearly deteriorating the U.S. Dollar. Additionally, tax payers and corporations alike need to see that the Government (Federal, State and Municipal) is rightsizing salaries, benefits and size to correspond with global realities.
- **Fair and predictable tax policy** - Targeted programs like “cash for clunkers” will not help create long-term sustainable jobs but rather provide merely a temporary sugar high for the parts of the economy. Likewise, efforts to soak “the rich” will backfire because “the rich” are needed to create private sector jobs.
- **Protection of private property** - The President’s decision to coerce (read extortion) Chrysler senior bondholders in late 2008 to take a back seat to the unions during bankruptcy proceedings went a long way to destroying the view of the safety of private property in America, further curtailing willingness to make long-term investments needed to spur job growth.

Corporations in America are doing what they should – accumulating as much cash as they can and “hunkering down” until they know long term demand has returned. Non financial companies have amassed \$1.8 trillion in cash, approximately 25% more than was on corporate balance sheets prior to the current recession.⁷ Dr. Mohamed El Erian, CEO of bond behemoth PIMCO, refers to the cash-building as “self-insuring.” Likewise, profit margins for S&P 500 companies in the first quarter were the best on record. Large corporations are the healthiest part of the U.S. economy, far healthier than the deleveraging consumer and the levering Federal Government. With cash and profits, they have the options to increase stock buybacks, to make acquisitions, pay out dividends, augment capital spending and begin hiring. In the following chart, you can note that durable goods orders have been a solid, accurate predictor of capital spending (real



Source: BEA, Census Bureau, Morgan Stanley Research

way. Business recovery, like prosperity, comes from the ground up, not from the top down.” While economic data as of late has not been robust, the signals are still consistent with an economy on the mend. There will be “growth scares” in every economic recovery, and this one is not likely to be an exception. If this time proves to be another of the “old normals” in U.S. history, it will be a time marked by a 1994-like pushback on government spending, money flows in mutual funds beginning to trickle from bond funds to stock funds and an uncoiling of the “fear trade” that has existed for the past couple of years. Investors see the risk everywhere, and rightfully so, but those who fail to see the opportunity will miss the reward – just like during the other “Old Normals.”

Sincerely,

Chris L. Doucet
Chief Executive Officer

End Notes

1. Lee, T. JP Morgan U.S. Equity Strategy Flash, Jun 17, 2010
2. Politics of Discontent, ABC News/Washington Post Poll, July 13, 2010
3. Powell, J. *FDR's Folly*. New York: Three Rivers, 2003
4. Bureau of Labor Statistics data
5. Federal Reserve data
6. Taylor, J. “Stimulus by Spending Cuts.” Cato Policy Report, May/June 2010
7. Yang, Jia. “Companies Pile Up Cash,” Washington Post, July 15th 2010

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