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Letter from the Chairman...

I was asked a perfectly legitimate question a couple weeks ago: “Why not sell into these ridiculously low interest rates and then reinvest at the end of the year when rates have gone back up?” Resisting the impulse to quote Rudy Guiliano’s 2008 statement, “. . . hope is not a strategy”, I simply said, “too risky” and let it go at that. I wasn’t asked why I felt that way, but in retrospect, I should have offered some of my reasoning. Well, better late than never.

To start with, interest rates don’t automatically rise simply because they have been low for a long time. They have the potential of going even lower (which they did just recently when the experts were proven wrong on the Brexit vote).

As this year started, the debate over further rate hikes by the Federal Reserve (after it’s December 2015 first increase), was whether 2016 would witness 2 or 4 more hikes. As of this writing, there is a growing chorus predicting no further rate increases until 2018. While very good at restricting economic activity, monetary policy is a weakling when it comes to stimulating growth. In the absence of credit demand, how affordable credit is doesn’t matter. The potential for fiscal policy (Congress) to invigorate the economy is huge, but sadly AWOL for now.

One of the problems with open-ending a municipal portfolio now is that, to a large extent, you would be converting a higher than prevailing stream of tax free income into a current capital gain tax liability unless you had comparable offsetting losses. Often people set the reinvestment bar too low. Besides the need to earn more to cover the IRS’s bite, you also must not ignore duration. Sell 8-year bonds yielding 2%, sit in cash (earning virtually 0%) for 4 years and reinvest when 8-year bonds go above 4% and you’ll succeed, right? Wrong. To break even, ignoring the effects of interest compounding, after 4 years the 4-year bond would have to yield 4%. That would require a more than 300 basis point rise in rates from current levels. An honest evaluation of the world’s economies suggests that a raise in rates of that magnitude will take a long, long time.

The dire predictions of the damage Brexit will reap may well be overblown, but I don’t think so. The Brexit decision and the potential for other EU countries to initiate similar efforts creates a huge cloud of uncertainty. Uncertainty puts plans on hold and further slows our already anemic growth. Protectionist movements rear their ugly heads and the contagion of doubt and fear spreads. The Federal Reserve knows full well it’s impotence at stemming deflation and that is why it should not risk removing accommodation prematurely by raising rates.

For now, I have to settle for saying that, although there are several encouraging factors favoring growth, they seem overwhelmed by those holding the economy back or actually pushing it down. One thing is irrefutable—for many very good reasons, the demand for municipals is very strong and growing. The supply of them isn’t.

“Facts do not cease to exist because they are ignored.”

—Aldous Huxley