CFI

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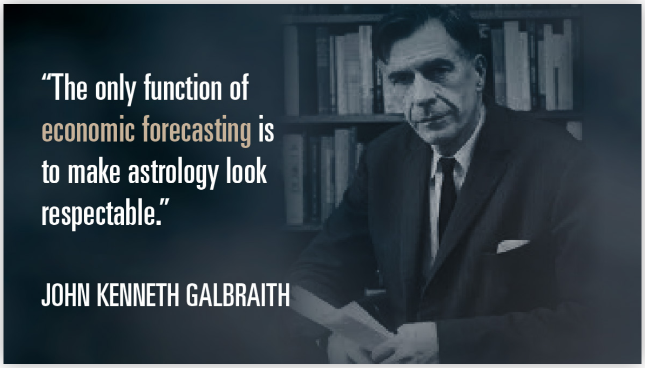
Charles W. Fish
Chairman and Chief Investment Officer

Letter from the Chairman…

October 2, 2018



It's official. The economy is strong. The Fed says so. According to their projections, our GDP will exceed 3% this year, making an additional bump in the fed funds rate this December all but certain. That will bring the overnight target lending rate range to 2.25% to 2.50%. If the predictions for 2019 are correct, three additional increases will close next year with a range of 3% to 3.25%

The Fed is not so sanguine about economic performance in 2019 and 2020, which they project will only return 2.5% and 2%, respectively. This may be an acknowledgement of global deceleration's drag on the U.S. economy compounded by serious trade disputes. The stimulative effect of the massive cut in the corporate tax rate at the end of last year seems to be dwindling as well. Regardless of whether or not their projections are correct, with a Fed funds rate around 3% by the end of next year, they will be in position to be more or less accommodative.

As logical and well-reasoned as the Fed sounds however, we must temper our judgement in recognition of the Fed's dismal forecasting record. If we are all wrong and the economy surges ahead at an unsustainable, highly inflationary pace, this Fed has a tool (more like a sledgehammer) that Paul Volcker didn't. They can accelerate the liquidation of their gigantic portfolio* of securities.

With record inflows pushing the stock market to new highs and the Fed's march to higher rates, shouldn't bond holders be alarmed? The answer is no, but they shouldn't just sit idle either. CFI has been aggressively building defenses for over a year now. Our primary weapon is to employ large coupon (5% or higher) bonds with relatively short call features. If the call is likely to be executed, these bonds, which offer much higher yields to the call date than comparable bonds with that maturity date, can serve as superior short-term instruments. If the call is unlikely to be executed, they can substitute for long positions. As they pass the call date, their yields will gap up to substantially higher returns than those available on comparable credits of the same maturity with current (prices that are near 100) coupons.

If rates do continue to rise, they should be exploited. If the Fed is correct and the growth of the economy slows in 2019 and further slows in 2020, yields will most likely retreat as well. One would be squandering the chance to increase the yield on their portfolio if no action is taken.

Housekeeping:

We urge all our clients to talk with their accountants/CPAs now about their 2018 tax liability. CFI is concerned that many are underestimating the funds required to meet this year's obligation. This new restriction on SALT (State and Local Taxes) deductions of $10,000 per year is the culprit. Planning now for the liquidity needed will give us all peace of mind and perhaps the opportunity to take advantage of the stampede to raise cash in April by those who didn't plan ahead.

**According to the federal reserve, their securities portfolio, which stood at only $869 billion on 8/8/07, has ballooned to $4.2 trillion as of 9/26/18.*
