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July 15, 2022

Letter from the Chairman…

"Even if you're on the right track, you'll get run over if you just sit there."
Will Rogers

By M. C. Escher - www.mcescher.com Official M. C. Escher website, Fair use

We couldn't agree more. Just "sitting there" now is throwing away the opportunity the current market provides to boost the yield on your portfolio and possibly improve its quality and distribution while you're at it. More on this in a minute.

The paradox illustrated in M.C. Escher's Waterfall resembles the Fed's current mission. They have made it crystal clear that halting inflation is their primary objective and they intend to do it by aggressively raising interest rates. They are hoping that it won't provoke a serious slowing of our economy. This is unlikely. There is mounting evidence that at least a mild recession will occur late this year or, more likely, in the first half of 2023. In many parts of the globe, it is here already. The Fed's arsenal is only aimed at reducing demand.[1] They have no tools to relieve supply problems that have been exasperated by the pandemic and the war in Ukraine; both events of unknowable duration.

The Fed has its work cut out for them. Despite the considerable anecdotal evidence that the economy is slowing, unemployment remains at 3.6%, a 50-year low, and hundreds of thousands of open positions remain unfilled despite salary and bonus incentives. Nonetheless, the Fed will prevail in time. Perhaps so well they will have to reverse themselves by the second half of next year.

It's first casualty will be housing,[2] followed by other big ticket items like cars and then tightening the screws on all discretionary spending. The just published CPI number of 9.1% confirms our current 40-year high inflation rate. Surprisingly, the labor participation rate actually declined slightly. Both the Treasury and the Fed erred in their "transitory" assumptions and it would appear that the supply side culprits will be with us for a considerable time to come.

Increases in yields on bonds since the first of the year have been dramatic. Ten year AAA bonds went from 1.03% on 12/31/21 to 2.66% on 7/1/22. Yields have subsided 15 basis points or so since then, but still look compelling. Although muni yields may well go higher, perhaps much higher, trying to time the peak in muni yields is a fool's errand. The preponderance of evidence leads us to conclude that yields on municipals will remain attractive for the balance of this year, becoming much less so beginning in the first quarter of '23. Therefore, we intend to gradually commit increased portions of unrestricted portfolios to suitable higher yielding assets of longer duration. We can do this because of the shorter, more liquid holdings already pre-positioned in portfolios for just this purpose. If we are wrong and rates continue to rise into 2023, further swaps may be executed.[3]

Just as the recent steep decline in interest rates elevated the market value of bond portfolios, the current dramatic rise in interest rates has caused most portfolios to significantly decline in market value. It <u>does not</u> change the income your portfolio generates as that is based on your cost yields. One can do nothing, wait for all bonds to mature and suffer no losses. We suggest that, like those who are still kicking themselves for freezing during the scary markets of the early 1980's,[4] you don't pass up the opportunity to elevate your portfolio's average cost yield while you can.

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[1] The FOMC is expected to raise the Fed Funds rate by at least an additional 75 basis points on July 27th.

[2] Most people think in terms of a 3% rise when mortgage rates climb to 6% from 3%, not realizing that on a fully amortized 30-year mortgage, that rise will increase a monthly payment by 42.2%.

[3] If losses are taken that don't offset gains, they can, unlike gains, be carried forward indefinitely.

[4] In the first quarter of 1980, Fed Funds reached 20%, 10-year U.S. Treasury 12.75% and 20-year high grade munis 9.44% (they finally peaked in January of 1982 at 13.44%).