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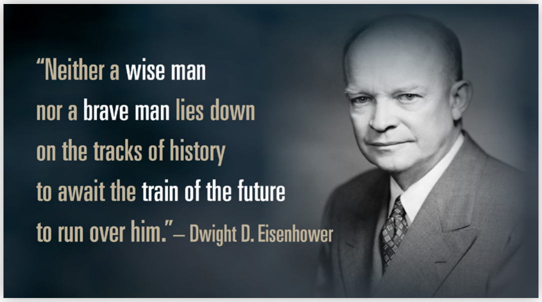
Charles W. Fish

Chairman and Chief Investment Officer

Letter from the Chairman…

July 3, 2018



The two areas of most concern to CFI at present are trade tariffs and the escalation of deficit spending. Two hundred years ago, the English economist David Ricardo warned that governments should not fund tax cuts with borrowed money. Borrowing for capital projects in pursuit of future prosperity is laudable. Borrowing simply to cover spiraling expenses isn't. We understand the need to go into debt in times of national emergencies such as WWII, but not for political gamesmanship.

Here's the thing. U.S. debt, as a percentage of GDP, is poised to eclipse where it was during WWII. According to the Congressional Budget Office, our expenditures will put us a whopping $1 trillion further into debt by 2020, two years ahead of projections.

When it comes to trade wars, real or threatened, history should be our guide. William McKinley (then Chairman of the House Ways and Means Committee and later to become our 25th president) was his era's foremost advocate of trade tariffs. He engineered the passage of protectionist legislation covering no less than 4,000 items. Then he saw the light. America's industrial and agricultural productivity, having surpassed domestic demand, required access to foreign markets. Dubbed "reciprocity," bilateral tariff reductions became strategic objectives. That was too wise to last and we soon reverted to more protectionism and, especially after WWI, isolationism. In 1922 Congress passed the Forоncy-McCumber Act and then doubled down with the infamous Smoot-Hawley Tariff Act in 1930. This led to a 66% decline in international trade, deepening and prolonging the Great Depression. The profound influence tariffs have had on all of America's wars (especially our Civil War) is fascinating, but that's a tale for another time.

What concerns us now is how rising deficits and the threat of trade wars, absent any semblance of statecraft, will impact interest rates. Trade conflicts can increase costs, starting with commodities, inflating prices pretty much across the board in time. This is usually a short term phenomenon, however. Reductions in the velocity of money, dislocations, jobs losses, and shrinking trade inevitably produce a recession. Downward pressure on interest rates results followed by fears of deflation that can push rates even lower.

Central banks have infused an ocean of liquidity into the global markets in the last several years in hopes of stimulating recovery from the most recent recession. This continues to be sufficient ammo to digest, at least for now, all the new debt being issued. As a result, rates have stayed low by historical standards.* The exception to this is the short end of the curve, where the Fed is expected to continue pushing short rates up. Long term rates seem unwilling to budge until the threat of inflation comes out of the shadows. Acknowledging that not all swans are white, this is unlikely to occur anytime soon.

If you would like to learn more about the disconnect between economists and politicians, I recommend Princeton Professor Alan S. Blinder's (former Vice-Chair of the Fed) new book: *Advise and Dissent*. It is very readable and enlightening. Chapter 8, which deals with trade, tariffs, and the myths surrounding them is particularly engaging.

Housekeeping:

This is just a reminder that CFI continues to conduct "Municipal Bond School" in a variety of iterations. These are complimentary (you just need to get yourself here) and can be as brief as one day or last for several days depending on the depth of exposure pupils are after. What we request is some advance notice of availability so we can group like requests efficiently. If you know anyone that might be interested (they needn't be related to a CFI client), please encourage them to call us or you can call on their behalf.

**This is particularly true of the California municipal market. Demand has pushed rates well below national counterparts. Most maturities on new issues in California are many times oversubscribed.*