CAIRN INVESTMENT GROUP

Newsletter and Quarterly Update — **December 2013**

Inside This Edition:

- SEC's Social Media Rules
- What If?
- Fed Begins Tapering
- Economic Expansion
- Your Household Summary
- Individual Account Reports

Important Reminders:

- Cairn Will Be Closed January 20 for MLK Day
- CPA Authorizations In Your Mail Soon

Tax Forms and Dates:

- Two Mailing Dates for Form 1099– End of January and Mid-February
- April 15 IRA Contribution Deadline

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Greetings from the Northwest.

2014 is bound to be an exciting year, and, like so many things that are growing and changing, one of the quickly changing areas is the use of social media. As much as we appreciate any and all positive acclamation from our clients and colleagues, Tim and I, as Registered Investment Advisors, fall under SEC Rules and Regulations that prohibit the use of testimonials via all social media. In plain talk, thanks for the props but we have to take them down. Yes, this includes the simple "like" button or the LinkedIn button that "endorses" us.

2013 has been a success, and with the exception of a few sectors of the economy, investors, for the most part, had a wonderful experience over the past year. As I was reviewing information from the last quarter, I stumbled upon a quotation from G.K. Chesterton. Mr. Chesterton said, "Wisdom should reckon on the unforeseen." Wow, does that hit home? "Wisdom should reckon on the unforeseen," and the future is unforeseeable. This is the time of year when investors ask the "what if" questions, if what's happened, has happened, then what will happen next? Forecasting and trying to predict the future, in particular the short term, has never been my interest, but I think Jason Zweig, author of The Intelligent Investor, has some wise words: "Many investors believe that financial markets exist to facilitate the efficient allocation of capital. That's a myth. The purpose of financial markets is to humiliate anyone who thinks he can predict how they will perform in the short run. And those who are most certain that they know how the markets will perform will generally get the biggest surprise.

Goat Rocks Wilderness — *Photo by: Bonnie W.*

"The consensus emerging on Wall Street is that U.S. stocks will have a decent year in 2014, perhaps returning 8% or 10%. That sounds plausible; since 1926, when modern data on the U.S. stock market began, stocks have averaged a gain of 10.1% annually. But in how many of those years did stocks return between 8% and 10%? In 88 years, it has never happened once. Stocks almost always perform either much better, or much worse, than investors expect them to. That's why relying on the comfort of a consensus forecast is so dangerous. As G.K. Chesterton wrote, 'Wisdom should reckon on the unforeseen.' So should investors."

Most recently, the largest conversation on Wall Street has been around Quantitative Easing, and tapering the Fed's bond buying program in a way that would not destroy the slow economic growth that is beginning to take hold. In the middle of 2013, the conversation about the potential tapering was enough to send a shudder through the markets. As time went on, it became clear that at some point the Fed would begin to taper the amazing amount of money that's been spent each month buying bonds. I believe the number is $85 billion per month. Ben Bernanke, outgoing Fed Chairman, made the declaration towards the end of the year that the Fed would begin the taper by reducing the number of bonds purchased by $10 billion per month. That drops it down to $75 billion per month in stimulus. As I mentioned earlier, Wall Street shuddered, and I wasn't sure why. Wouldn't it make sense that the Fed would taper? Wouldn't it make sense that the Fed would stop buying these bonds? Wouldn't it make sense that our Government would stop propping up the economy in that particular way, because the economy had strengthened on its own? Well, it would appear that's exactly what's happening. The economy is strengthening, which is a very good thing for equity investors, and the QE or Quantitative Easing tapering process has begun. I look forward to a time when the Fed is not involved with Quantitative Easing, but is completely out of the business, and the economy will move forward on its own. At the core of the Fed's tapering, I believe, is a 5 year low in unemployment, and this boost in job hiring helped the Fed feel comfortable with their move.

The economy is continuing to strengthen, and I have seen a modest acceleration in consumer spending. I expect consumer spending will increase at an annual rate of between 2% and 3% during 2014. However, the typical American, if there is a typical American, is still in the struggle. The income of the median household, statistically the one in the middle, was hardly higher in the fall of 2013, compared to a year earlier. But those Americans with money, and those with credit, are buying. Even the October government shutdown didn't discourage them from spending. Reports show solid increases in consumer spending right through the end of the year.

The economic expansion is going to happen in a variety of different ways. Consumer confidence and overall optimism in the economy are already evident in higher vehicle sales. U.S. auto sales at the end of the year climbed at the strongest pace in more than 6 years. The U.S. automotive industry is also hiring. Housing prices have continued to rise notably, in spite of home building indicators softening over the last few months. I believe that in 2014, housing starts and new home sales will move up into an area unseen for the last few years. Home builders started work on 20% more single family houses in the first 11 months of 2013 than in the whole 12 months of 2012. I expect that home loan rates will remain relatively steady and very attractive compared to historic levels. Whirlpool, Maytag, Kitchen Aid and Jenn-Air appliances, all owned by the same company, predicted their U.S. sales would end up 9% ahead of last year. The economy is creating jobs and household wealth. Energy costs are dropping and credit is available and affordable. All of this points to solid growth for the future.

I expect to see an expansion of industrial activity. The Unites States continues to be a country of increasing industrial activity, and we're moving more manufacturing jobs back to the United States than had moved off-shore in the last few years. These new manufacturing jobs and the expansion of industrial capacity in this country, I believe, will be meaningful and will add to the acceleration of gross domestic product (GDP) growth. It's very likely that we'll have a 3% to even 3.5% GDP growth for 2014.

Probably the biggest thing that is happening in our world as we reflect upon this dramatic change, or possible change, is in the direction of interest rates. In 1981, the 10-year Treasury yield peaked at 15.8%. In 2012, there were times when the Treasury yields for short-term securities were actually negative. Right now the 10-year Treasury is hovering at about 3%. If in fact we have entered a new environment of rising interest rates, then the question that we have for ourselves as managers is: How do we invest as interest rates rise? We're excited about this. This is the type of environment where we believe that the type of investing that we do, which is to focus on a company's manufacturing process and their ability to invent new products and for those new items to garner high profit margins, puts us right where we want to be.

Higher interest rates normally lead to higher returns on stocks…and so a new era begins. It's possible that interest rates won't rise much further than they have already have for a while. At the current economic growth levels, they would suggest that a natural rate for Treasuries would be somewhere between 3% and 3.5%, not much higher than where we are right now. Additionally, there's no rule that says that bond rates can't stay low for a long time. Japanese 10-year government bonds have had a yield of less than 3% for well over a decade. We will remain focused on companies that are innovative, companies that are watching costs, companies that are growing in spite of doubts, as we go forward.

There are many hopeful signs for the U.S. economy. Each of the past few years has ended with optimism that in the coming year the economy would finally pull itself out of the mud. Each year that we felt that optimism, it's been proven wrong. This year, 2014, might just be the one that doesn't disappoint. Stock market prices are a leading indicator, and clearly share prices that have been bid up in 2013 are expecting a continuation of economic expansion into 2014.

I chuckled as I read the caption: "2013 may be remembered as the year coal died." Clearly, coal was not the thing to be invested in recently…and we don't, and we probably won't, and maybe we shouldn't. But, all things are cyclical and here's what's really happened: As new oil reserves have been found in North America, regulators and communities have discouraged more coal emissions. We have shunned coal; makes sense. But the coal is still being mined. Maybe not as vigorously, and certainly not with a market that is close at hand. Here in the Northwest, we have seen an enormous increase in coal trains heading to seaports, as we've also seen an enormous increase in oil trains heading to seaports. Some of the oil is destined for domestic refining, some of it is heading elsewhere. All of these things are cyclical. Natural gas will certainly be a significant player; maybe it's going to be the top producer of energy, but it still has substantial emissions issues.

Another large and exciting component to investing is the value of the U.S. dollar. More often than not, we enjoy bringing the efforts of companies that operate internationally back to the U.S., through the process of Generally Accepted Accounting Principles, or GAAP. Those accounting principles applied to a U.S. based mother company with overseas operations, in combination with a leveling U.S. dollar, could in fact find themselves in a spot


Timber Butte Lookout Cabin

Photo by: Jim P.

where returns for investors will be better.

As most people who have lived in the Northwest know, we can be challenged by the weather from time to time. On occasion the weather and a special location line up to create an unforgettable experience. In November, taking a page from my Dad's playbook, we rented a remote USFS Fire Lookout cabin in the Willamette National Forest, sent an invitation to the kids and said "show up, the tube steaks are on us." All three kids showed. So did the weather. Amazing!

At Cairn Investment Group, we are excited about the business that we're in, and the businesses that we're investing in. Thank you so much. I look forward to an exciting 2014!

Happy Trails,

Jim

Jim Parr, Principal