CAIRN INVESTMENT GROUP

Newsletter and Quarterly Update

March 2015

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- **April 15 IRA Deadline**
- **May 25 NYSE and Cairn Closed for Memorial Day**
- **ADV Firm Brochure Available Online or By Request**

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Greetings from the Northwest.

We have been experiencing a particularly newsy period of time. During the first quarter of 2015 we have had news of things accelerating economically, contracting economically, going forward, going backward, and we have seen political uncertainties and global uncertainties, but we continued to see a strengthening of the U.S. economy. In general, I believe it can be said that U.S. equities are hitting all-time highs, and doesn't that feel good? It's been quite a few years since those icy days of 2008 and 2009 when the market was falling away and banks were collapsing, but since February 2009, that memory has been pushed into the rear view mirror and investors have enjoyed themselves. We've had a lot of great investment returns, and now people are beginning to ask: "Is this sustainable?" I'm not sure that anything in a straight linear path is particularly sustainable. But there are certainly new things happening, being invented, created, and launched for us to invest in, ways for us to continue to make money as investors.

So I know it's commonly thought that all past market crashes are viewed as opportunities, but all future market crashes are viewed as risk. Well, Hmm. I guess I'd say that is kind of the opposite. Most bubbles begin with a rational idea that gets taken to an irrational extreme. I don't see too much irrationality currently in the market, with the exception of maybe fixed income, and in particular the high prices that people are paying for U.S. government bonds. It may be that the next big bubble and slide in valuation will be in U.S. Treasurys. It's been almost a decade during which the Federal Reserve has been very accommodating with low interest rates. It would appear there are some who fear we will experience

Near Lake Billy Chinook *Photo by: Ron U.*

some sort of disaster as the Fed begins to tighten and interest rates are increased. I don't think it's a disaster at all. I think it's a reflection of our economy doing well, and with our economy doing well it does not need to be propped up by the Fed artificially working to keep interest rates low. I have a longer term philosophy. I'm trying to look over the horizon and I'm thinking more in a five-year time range. I believe at the root of most investing problems is short-term thinking. Historically, a couple of times per decade, investors forget that recessions happen a couple of times per decade . . . As we look forward over the horizon, we need to be mindful that when change comes, it is time to change our minds and we need to move accordingly. There is no such thing as a normal economy or a normal stock market. Investors have a tendency to want to wait for things to get back to normal. But markets and economies are almost constantly in some state of booming or busting.

Gross domestic product (GDP) is improving, having accelerated from about 2.4% in 2014 to a rate that looks like maybe 3.3% in 2015. This is coupled with interest rate change speculation increasing, and I suspect we may see our first increase in 2015. I view this as positive. As I said earlier, it's a reflection of our improving economy that doesn't need to be propped up. With growth rates up and interest rates up, inflation would also be up. Inflation at a high rate can be quite scary, but an inflation rate at maybe 2% would be quite acceptable, and in fact important for an economy and population to continue expanding. It would appear, so far, maybe inflation rates will climb to about 1 ½% for 2015. Unemployment is down, a good indicator that our economy is getting stronger. It is true that many people who are returning to work are finding that their new job doesn't pay them as much as their old. This is unfortunate; it means many households across the country, even though they're getting back to work, are experiencing a lower overall income. At the same time other businesses are beginning to pay higher wages. In fact, across the country we're seeing wages being pushed up. The classic economic structure of wage-push inflation. With wages increasing, inflation growing, interest rates beginning to actually appear and the GDP growth rate increasing, these all add up to a solid focus for our economy.

A contrary condition is the surprisingly abrupt fall in crude oil prices. Last year crude hit a peak of about $120.00 a barrel. It has continued to sink and adjust, sink and adjust, down to nearly $40.00 a barrel. There is certainly a phase when reducing oil costs or reducing the amount of input cost for a lot of businesses is a positive. But oil has fallen so precipitously that oil is now causing certain economic slowdowns and certain amounts of unemployment in high paying wage jobs. I believe as we go forward we're going to see a balancing of oil prices somewhere in the $65.00 - $70.00 per barrel range. There are a lot of variables in the oil supply right now. Not only the U.S. supply chain, but also the supply coming from multiple different sources around the globe. We will see an upward change and a solidifying number higher than where it is currently, but lower than its peak. And that should turn out to be just about right for a while. One of the folks who have followed oil prices longer than I can remember is T. Boone Pickens. Recently Mr. Pickens was asked about his ideas and views on where oil prices are going. Mr. Pickens said, "You know why you have $50.00 oil? Because the industry in the U.S. actually found too much oil. We are in a period of surplus. It started with natural gas. Seven years ago, we had 1,400 rigs drilling for natural gas. And we oversupplied the country. I mean, we really oversupplied. Today you have 250 rigs."

Mr. Pickens continued: "'The rig count is extremely important. On December 23, I said, 'There are 1,509 rigs drilling in the U.S. for oil.' We have been up to as high as 1,600, but with 1,509 you're pretty well at the top for oil. Today, there are 822. We can't replace our production with 822 rigs. You will go into a decline probably in June. Then, oil will go back up. We'll be at $70 a barrel by the end of 2015. By the year of 2016, you'll be up to $90 to $100."

From time to time I get a question about "Jim, are we heading into a bear market?" Well. . . wouldn't we all like to know the answer to that question? One of the things I endeavor to do is be prepared for a bear market all the time. I try to be looking out in advance, over the horizon; I try to be looking out about five years. I'm hoping that if I keep looking out I won't find the bear, because I will have moved in a direction where the bear is not. As someone once said to me, "What's the worst thing you can do in the forest when you come upon a bear? Well, that's run – don't run from a bear." Trying to predict a bear market is like trying to predict the market itself or interest rates. It's one of the biggest mistakes that investors make. I know that it's an overused concept, but trying to build some type of all-weather portfolio is a much more reasonable thing to do. To be aware of a company's earnings growth, to be aware of a company's spot in the economy and how it fits, is a much more reasonable approach. We don't necessarily change our portfolio holdings because of a bear market. We change our portfolio holdings when there is a change to the company or a change that we see on the horizon.

Our investors have heard me say it many times: "Earnings are the most important component to stock advancement." So, that being said, I'm also getting prepared for a period of time where we will have a short disruption in earnings advancement. And I believe that this is going to be driven by this rapid fall off in oil prices. At Cairn, we regularly follow earnings announcements. We run a percentage of how many of our companies are reporting above expectations or behind expectations. I suspect for the next two quarters we will be surprised to see quite a few companies report below expectations. The biggest driver behind this slide is going to be the plunge in oil prices; energy sector earnings are expected to fall off by almost two-thirds. I believe that this will cause a fair amount of volatility and a lot of opportunity for us to pick up companies that are affected by this short-term oil price swing. So the news to be listening for is news regarding oil prices going up, and output capacity or the pace of drilling going down.

An industry that I would be remiss if I did not write about is construction. Have you noticed how construction is booming? As Tim and I look out of our 10th floor office window, we see a good section of downtown Portland and there are 11 construction tower cranes. These cranes represent a tremendous change from 2009 when we could count – zero. The construction isn't limited to just downtown. It's in the suburbs, and it's in the residential areas, agriculture, industry, from the East coast to the left coast. We have seen a tremendous surge in companies connected to construction, engineering and material supply. According to a late February analysis in the WSJ, home builders are reporting that sales of newly built homes so far this year are going gang busters.

Another event that has happened this quarter, that is different from the last few years, is that a couple of companies that we own were acquired. Some of these acquirers have been public companies but have chosen to cash out our investors; some of them have been acquired by private sector companies and are no longer part of the public company universe. This has been terrific, as the investment returns have been wonderful, and a little bit frustrating in that we often would prefer to continue to own the investment and have these transactions take place as a stock transaction, not a cash transaction. Folks have been a bit surprised by having to pay taxes this April 15. Yes, the gloomy days of 2008 and 2009 have gone by. Any tax loss harvesting we were able to accumulate has been used up and we're back to paying good old capital gains. Isn't it nice to make an investment and have it work out so well?

We have a new and yet very experienced voice and face at Cairn. Brie Valant has joined us as Investor Services Manager. Brie, an East Coast transplant, brings over a decade of experience in the financial services industry. She began her career in 2003 with an RIA in Boston and has continued her career focused on servicing individual investors. Brie enjoys the Portland Farmers Market, knitting, and traveling back east to visit family with her four year old daughter.

Wishing you all a very happy spring. I look forward to seeing as many of you as is possible. If you're in the neighborhood stop on by; we have a new Nespresso coffee machine.

Happy Trails,

Jim

Jim Parr, Principal
Cairn Investment Group, Inc.

Stopping Line Drives and Foul Balls