CAIRN INVESTMENT GROUP

Newsletter and Quarterly Update — December 2018

Inside This Edition:

- **The Fed Changes Direction**
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- **Corporate Credit Markets**
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Important Reminders:

NYSE Closed—No Checks, Deposits or Settlement on:

- **1-21-19—MLK Day**
  2-18-19—President's Day

Tax Forms and Dates: Expect:

- **1099 Forms Mid Feb**
  1099R Forms Late Jan
- **Schedule K-1 Various**
- **April 15, 2019 IRA Contribution Deadline**

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Greetings from the Northwest.

The News:

Lower inflation has reduced the Fed's sense of urgency to prevent economic overheating.

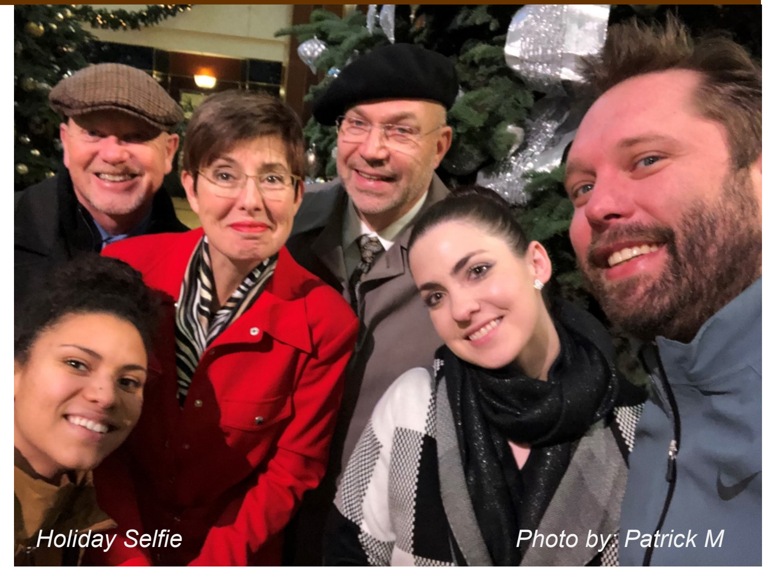
The Result:

The Fed may slow the rate increase pace . . . I think.

The news, and yes, the fake news, is flying through the airwaves at an amazing pace. As someone who attempts to keep track of the investment world, I would vote for a breather so we can look objectively at both the good and the bad economic news.

The current U.S. economic expansion has already had a long life. That doesn't mean it will end now. Periods of growth don't end just because of old age; they generally end when something goes wrong, such as unchecked inflation, or a bubble in housing prices, or a central bank pushes interest rates up too fast. Patrick is going to cover more of the economics of today in his comments.

In general, but not always, our investors' portfolios performed quite well. Relative returns versus the market can be measured in many different ways; volatility, income flow, relative expensiveness, liquidity, and environmental and social objectives are just some variables. The 4th quarter of 2018 has been tough. But our portfolios are up to the task. Generally, we hold a group of companies that have lower price/earnings, lower price/sales, lower price/cash flows and higher dividends than the S&P 500. Patrick touched on this in our September letter. Please give your reports a good read, and then give us a call. Tim, Patrick and I are available.

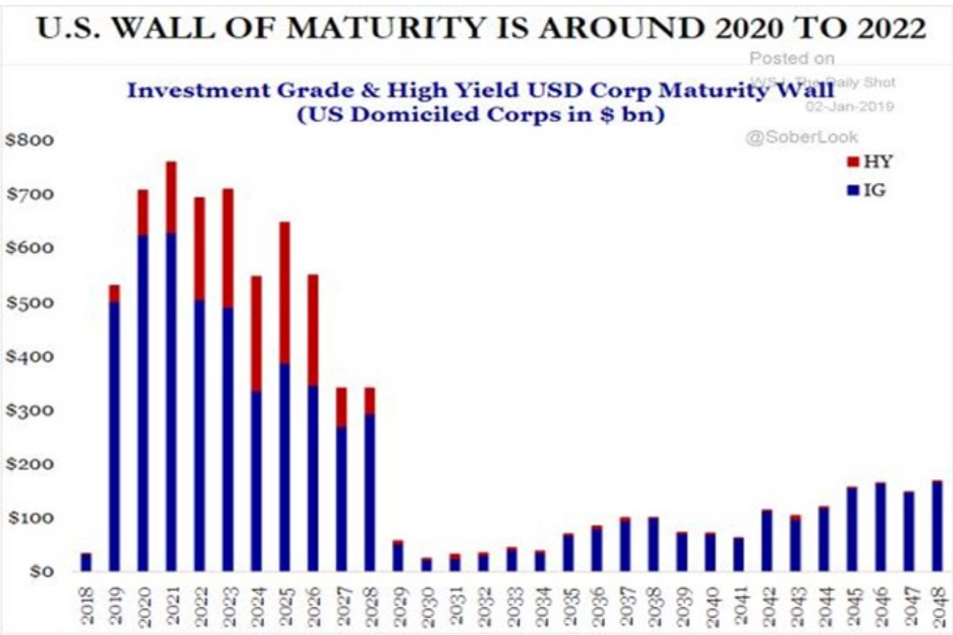


Holiday Selfie — Photo by: Patrick M

Patrick's Part

Optimism about the economy, and more specifically about equities, clearly faded during the 4th quarter as stocks experienced a U-turn from the exuberance that they had felt during most of the year. The S&P 500 Index closed down -13.52% for the quarter and -4.38% for the year, after posting impressive gains through the first nine months. International stocks fared slightly better during the quarter, only retreating -12.86% for developed stocks and -7.63% for emerging market stocks. High quality bonds and cash were safe havens during the quarter as investors flocked to safety during December. We have spent many quarters talking about the risks in equity markets and how we manage those risks through patience, not paying a premium for growth, and waiting for compelling value investments to come to us. As volatility increased during the quarter, we sent out an email in December describing our investment process. Our viewpoint and process have not changed over the last few weeks.

One of the primary areas of financial markets that we feel need to improve, in order for investors to feel comfortable taking increased risk again, are the credit markets (i.e., corporate bonds). During this current market cycle, many companies used the low interest rate environment to issue billions of dollars in debt (bonds) to fund share (stock) repurchases and dividends. In essence this was a large, debt for equity swap, and that changed the dynamics of how companies are now capitalized. This generally has no effect on the financial markets, as long as interest rates remain low and profitability for companies remains high so the debt can be serviced. Concerns over the level of corporate debt start to arise when the interest rate environment and maturity schedule start to change. The Federal Reserve has continued down the path of raising short-term rates, which sends a ripple effect through the rest of the bond market as rates across all risk spectrums adjust accordingly. When rising interest rates combine with slowing corporate profits, which we are witnessing due to higher wage and input costs, and large volumes of maturities need to be rolled over at higher rates, the bond market starts to become more volatile. The chart below shows the upcoming maturity schedule for U.S. corporate bonds (both investment-grade and high-yield).



As the chart illustrates, there are large amounts of corporate debt that will need to be refinanced in the coming years at potentially higher interest rates than when the original debt was issued. This should not have a heightened effect for companies that have low leverage and high profits, but will be much more worrisome for companies that already have bloated balance sheets and a lower ability to fund operations internally. When you have excessive valuations in broad U.S. stocks, combined with rising interest rates and economic growth that is showing signs of slowing down, markets can become skittish. Needless to say, highly indebted companies will have some big decisions to make as a large volume of maturities start to take place.

Another reason we bring up the corporate debt topic is that the amount of debt and financial leverage a company has is an important part of our analysis when considering an investment. It's not just the amount of debt that is important; it's the ability to service the debt with consistency of cash flows and profits while also having the ability to repay that debt without having to issue additional stock. The low interest rate environment of the previous ten years has truly created some interesting times for corporate America as senior management make decisions on how to navigate the next market cycle.

Please feel free to drop me a line if you have any follow-up questions or concerns as we navigate through this choppy market environment.

—Patrick Mason

Thank you, Patrick.

The coffee pot is stocked with a new grind of Nossa Familia Coffee medium roast. Seven scoops in a #4 filter make a great 12-cup pot. We are always excited to have investors stop by for a visit at our world headquarters.

Happy Trails,

Jim

Jim Parr, Principal
Cairn Investment Group, Inc.

Chart source: Wall Street Journal Daily Shot: @soberlook