Newsletter and Quarterly Update :: June 2022

CAIRN INVESTMENT GROUP

GREETINGS FROM THE NORTHWEST

It looks like this year's take on summer has arrived, and we're seeing a noticeable surge in the number of people mingling, dining out, shopping, and pursuing their outdoor passions, despite the higher costs that have been lightening wallets. The basic human need to live our lives and move beyond the virus is driving this burst of social activity. We'll see how long this can survive in the face of the higher prices we're experiencing. I'm sure glad I don't have air travel planned any time soon, as that appears to be an unpredictable and expensive mess.

So here we are, officially in a bear market, having just completed the worst first half experienced in our stock markets since the 1970s, with more clouds in the distance, as historically, the second half is the rougher. We're probably in a recession, but a strange one. The economy is trying to burst forth from our COVID-induced lull, while at the same time the Fed is dousing the flames of the stimulus bonfire; and there's a war and a lingering virus. The stock market has been overpriced for some time, so it's not surprising to see a pull back, and Patrick will point out that overall, it's still not cheap, despite some huge drawdowns in the more speculative asset classes. Housing is due for a correction of sorts, and it's probably in the early stages of one.

Depending on who you talk to and where you get your news, you could get the impression that the sky is falling and that we're in a complete and total market meltdown. To be sure, it has been tough to find shelter in this storm, but I find comfort in our process, imperfect as it may be, believing that we'll come out of this better than the broader markets, and well prepped for whatever's next. Your actual experiences will vary, but I believe that what you have seen so far with your investments is distinctly less frightening than the shrill alarms being heard on many media outlets.

On another, somewhat related note, I'm proud and excited to share with you that Cairn Investment Group was honored this last month as one of Oregon's fastest growing private companies by the Portland Business Journal, the result of much hard work by the entire team.

OF NOTE

:: Annual Privacy Notice Attached

IMPORTANT REMINDERS

:: Cairn and Stock Markets Closed Labor Day, September 5

Cairn Recognized as One of Oregon's Fastest Growing Companies

…I believe that what you have seen so far with your investments is distinctly less frightening than the shrill alarms being heard on many media outlets." **—Tim Mosier**

With that, on to Patrick and some specific and useful thoughts:

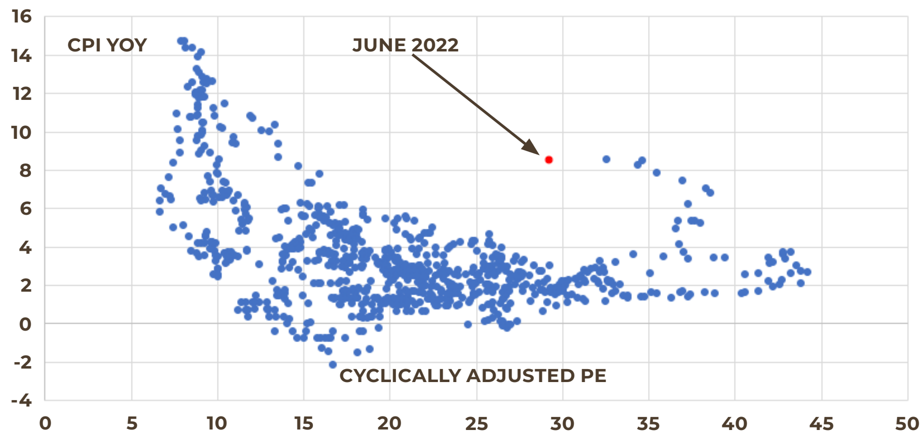
PATRICK'S PART

Equity and fixed income markets continued their march lower during the 2nd quarter, as investors continued to absorb rising inflation, tighter monetary policy, corporate profit margin pressures, and still high equity valuations. There were very few places for investors to hide during the first half of the year as large cap stocks, measured by the S&P 500, are down -19.96% and the Bloomberg US Aggregate Bond Index down -10.35%. I pointed to this as a risk in our Q1 2021 letter:

> *"If inflationary pressures and concerns become a reality, the tool kit used over that last cycle (investing in high revenue growth, low current earnings U.S. companies, combined with long dated bonds), will not have the same level of success that investors have become accustomed to."*

As we've discussed with many of you during meetings and reviews, stocks are not a very good inflation hedge when they are combined with high valuations. It's only after valuations return to a more reasonable level that stocks offer a good hedge against inflation. The actual best hedge (short-term) against inflation is cash, which is why we have been holding a higher-than-normal cash allocation in portfolios for the last 18 months. The chart below shows inflation (vertical scale) and valuations (horizontal scale). As it illustrates, generally when you have 8.5% inflation, valuations are much lower than where they currently stand. So even though valuations have fallen from their historical extremes that investors were witnessing to start the year, they are still well above normal given the current inflationary backdrop.

INFLATION AND VALUATIONS 1953-PRESENT

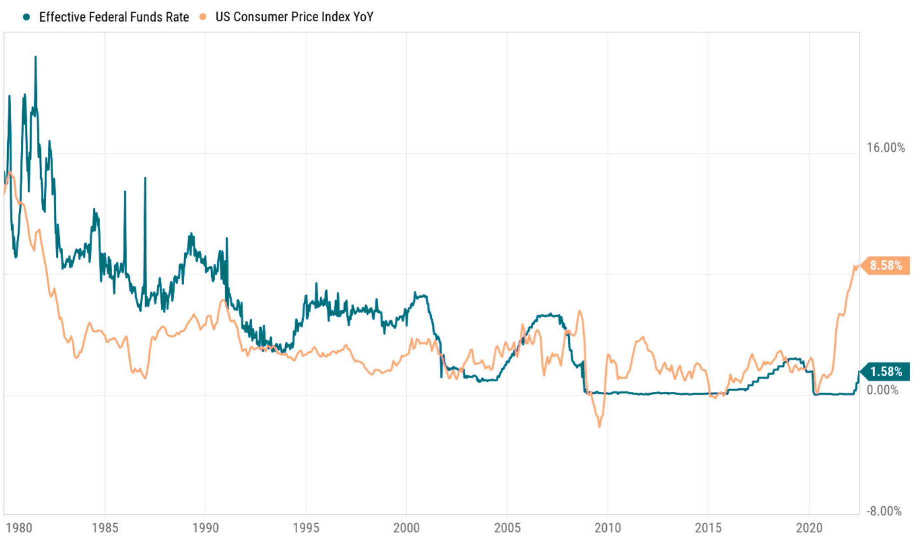


Source: Robert Shiller, BLS

We are not in the business of predicting recessions, but we do have to be aware of the environment we are in and manage through it appropriately." **—Patrick Mason**

To combat the steady rise in inflationary pressures the economy has been experiencing, the Fed has become more aggressive in raising interest rates and tightening financial conditions. During their June meeting they raised the fed funds rate by 0.75% and have been hinting that another 0.75% hike might take place in July. As the chart below indicates, historically, when inflation is over 8% the fed funds rate is higher, not lower, than the inflation rate. So, if inflation stays high, then the fed has a way to go in raising rates.

INFLATION VS. FED FUNDS RATE



Source: Federal Reserve, BLS

The biggest argument that we hear about why the Fed should slow their pace of interest rate hikes is the problem with the toolkit the Fed has to cool inflation. The options available are useful in decreasing the demand side of the inflation, not the supply side. Lyn Alden, of Alden Investment Strategy, said it best in her most recent monthly newsletter:

> *"The US Federal Reserve can't print more oil, refineries, pipelines, copper, fertilizer, ships, or manufacturing facilities, but they can reduce consumer demand for periods of time for some of those things, through very uncomfortable methods."*

By raising interest rates, the Fed is in essence trying to raise unemployment and cool consumer demand. These actions could slow inflation for a period of time but, unfortunately, the price paid might be an economy that goes into recession. We are not in the business of predicting recessions, but we do have to be aware of the environment we are in and manage through it appropriately. With that said, we have a hard time believing that if the Fed continues down its current path, a soft landing they are hoping for is the most likely outcome.

Through all the negativity there are some silver linings. Though the S&P 500 is down over 20% from its highs, many companies and asset classes have fared far worse. Many of the high-flying growth stocks that helped fuel the market bubble we were in, are now trading like beaten up value stocks. Overall, portfolios continue to hold higher than normal cash positions and are defensively positioned based on what the data is showing us. This provides us plenty of flexibility to change course when opportunities present themselves across the investment landscape. Combined with our cash allocation, we continue to hold a portfolio consisting of high quality, value-oriented stocks and bonds across asset classes that can weather market turbulence and provide the ability for capital appreciation, once the market environment eventually changes course. Thank you again for your continued trust and feel free to reach out to me to discuss any topics in greater detail. —Patrick Mason

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Thanks Patrick.

Here's a reminder that the office is open, the coffee is fresh and hot, so please, don't be shy about requesting an appointment or giving us a ring.

Happy Trails,

Tim Mosier, President,
Cairn Investment Group, Inc.