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January 17, 2017

Dear Clients and Friends:

Once again the stock market did its best to fool all the professional pundits over the last quarter – declining about 4% up until about a week before the election and then after the Republican victory, rising over 7% through the end of the year. It was just one more footnote in our memory banks reinforcing the futility of trying to outguess the stock market, particularly on a short term basis.

	12 Months Ending 12/31/2016	3 Months Ending 12/31/2016
Benchmark Index Returns		
Lipper Balanced Fund Index	7.3%	1.2%
S&P 500 Stock Index	12.0%	3.8%
Russell 1000 Value Index	17.3%	6.7%
Money Fund Average	0.1%	0.2%
S&P-BGCantor-7-10-Year-US Treas. Bond Index	0.9%	-5.7%
S&P-BGCantor Twenty Year+ US Treas. Bond Index	1.5%	-10.3%

As can be seen above, it was a good year for stocks though somewhat wild and wooly along the way. Stocks started the year by declining sharply and it looked as though the long awaited correction was under way. But the January rule (as goes January so goes the year) was thwarted as the market took off after the low reached on February 11 rising some 24% from that point through the end of the year resulting in an S&P annual return of 12% including income.

Bonds were a different story and nearly the reverse of equities. Bonds rose through the end of September returning about 13% through that date. But then the election dynamics seemed to cut in as well as the realization that the Federal Reserve really would start to raise interest rates. This produced a turnaround in returns with long term Treasury Bonds declining over 11% through the end of the year – and bonds are supposed to be the stable higher income part of a balanced portfolio, but not today.

Therein lies our quandary. We have what by historical measures is a very highly valued stock market - 21 times earnings versus a long term norm of about 15. Earnings growth has lagged the increase in stock prices for some time and bond yields are now rising and likely to continue to slowly do so. So why did the market continue to go up?

There are two possibilities – the most likely cause is that foreign money continues to be desperate to leave home and find a safer haven. While the U.S. market is high, to someone in, for instance, Italy watching the banking system in decline and the possibility that the Eurozone will come apart, the U.S. may still look pretty attractive. While much of this money probably went into fixed income securities, some always leaks over into stocks. Our experience over time has been that the foreigners are usually the last pulled into a bull market but the current situation is not normal given that money is also being pushed out of Europe and other countries by the global economic/geopolitical situation.

The other possibility is purely psychological – no one wants to miss out on the action in the stock market while it is going up. And the desire to participate grows as the market moves higher. Amateurs and professionals alike often invest by looking over their shoulders.

Whether or not either of these reasons for the advance is correct, it is difficult to see the market moving substantially higher from its current level even if the economy and corporate earnings pick up. As in the past we continue to warn that none of these factors is a "sell" signal. If the market is irrational, rational analysis just doesn't work, at least in the short term. However we do believe that the risks of a correction have increased substantially over the past quarter and as a result we have changed our green light on stocks to a cautionary yellow.

The Economy and Financial Markets

In our 2015 year end letter we offered a number of our thoughts relative to the economy and financial markets going forward. With hindsight we were too conservative, but it is a fact that risk is always present whether or not it manifests itself in the financial markets and the economy.

Below are our comments at the beginning of 2016 and in the paragraph following, our response on how we did and whether or not our view has changed.

1. We have not had a major across the board correction since 2008. The market appears to be highly valued in the face of potentially rising interest rates and several sectors are valued at speculative levels. As the speculative valuations are found in a number of today's market leaders, any return to reality for these stocks could have a negative across the board impact on other prices.

Response: Last year the stock market's continued advance proved once again that speculative valuations are not a reason to sell in and of themselves. When sentiment and low interest rates are running in favor of higher stock prices it is best to stay engaged. With hindsight we carried too much cash last year (as a risk control should the market decline) but in our favor is the fact that we did maintain our green light for stocks in general.

2. About 80% of the time the market is lower three months after the Fed first raises interest rates. While the recent increase was small and well known in advance, three months from now the market will be looking at the second rate increase, possibly in June.

Response: This proved true last year but no one saw the recovery that followed the decline. The recovery was driven by both a desire to stay fully invested and the delay in the Federal Reserve Bank's second increase in interest rates until last month. As noted in the first part of this letter we have now changed the stock market light from green to yellow. Risks remain high on the fear and greed scale but at the moment, greed has clearly gained relative to the fear of loss.

3. There was really no apparent year-end tax selling in the market. However, there did seem to be changes in the character of the market, particularly following several third quarter mini corrections as a more limited number of stocks were pushing the market up. A narrowing market is usually a sign of increasing risk.

Response: The market did broaden out during the recovery from last year's mid-February low, effectively rebalancing itself internally.

4. The aggregate S&P is likely to report lower earnings this year than was the case in 2015 though this will be heavily influenced by energy and other asset oriented stocks.

Response: Asset oriented stocks, including energy, did better than expected last year. The result was modestly higher earnings for the S&P 500. Looking ahead, unless the Fed really slams on the monetary brakes (unlikely) the economy and S&P earnings will likely be up. Our traffic light on the economy remains green.

5. The stock market has had several "flash" crashes over the past year (including this week) and in no case has the market been able to move to new highs on the recovery.

Response: This is no longer true as the market moved on to new highs in early July of last year. Flash crashes for the market seem to have been converted to flash moves higher or lower in individual stocks despite minimal new news. Those who argue, based on volume numbers, that stock market liquidity has improved are, by our observation, just wrong.

6. The Middle East is always a wild card, but seems more so today than has been the case over the past several years. Europe is struggling with slow growth and immigrant issues and recent problems in the Chinese economy and markets just add to general angst.

Response: The Russian move to support the Assad regime in Syria and the carnage that followed was totally ignored by the stock market. Europe's problems continued, exacerbated by more banking issues in Italy, immigration overload in Germany and Britain's vote to exit the European Union. The Chinese continue to create mischief in the South China seas. But the Middle East could calm down somewhat going forward if Trump gets on better with Putin than his predecessor.

Sooner or later there will be a negative year for stocks. But no one knows when. Much will depend on how aggressive the Fed becomes with respect to increasing interest rates. If economic activity does pick up next year this could lead to a more aggressive Fed stance relative to what many now anticipate. Higher interest rates typically challenge the valuation of common stocks. This is particularly true today as valuations are historically very high. In general we like the direction of the economy but worry about increased inflation pressures bringing higher interest rates challenging the high level of the stock market.

Equity Selection

There was very little turnover in our top 20 holdings over the last quarter.

One of our newest holdings, Viacom, was bumped out of the number twenty spot due to poor performance in the month of December. The news on Viacom continued to be fairly dramatic, as talks of a potential merger with CBS broke down and controlling shareholder Sumner Redstone, age 93, announced he will soon step down as a voting member of the company's board of directors. The news did not have much of an impact on our belief that Viacom's stock is grossly undervalued based on the breakup value of its underlying assets. So we have continued to hold pat with the exception of some tax loss selling in some accounts. Interestingly, Viacom is our top performer year to date as we are writing this, up over 10% since January 1. Volatility continues.

Viacom was replaced by IBM in our top twenty holdings. It made the list due to strong performance rather than any active buying on our part. IBM reminds us a bit of the tortoise in the story of the tortoise and the hare. After many long years of struggling to reinvent itself, IBM is finally making some visible progress. It is no longer a hardware company – hardware now makes up less than 10% of sales. Rather, IBM is focusing on recurring revenue streams such as those that come from cloud computing, software and services. Cloud computing is leading the way – year over year revenues were up 42% as of the most recent quarter, and the cloud now makes up a substantial portion of the business, particularly when compared with a couple of years ago. While it is not a particularly exciting company, IBM stock was a solid performer in 2016 and unlike many of its peers that now look quite overvalued, IBM still trades at a very reasonable valuation (just 12 times forward earnings), so there may still be some room for it to run.

Lastly, Omega Healthcare Investors dropped out of our top twenty holdings and was replaced by Ventas. Both are high quality real estate investment trusts (REITs) that invest in healthcare properties. Ventas owns about 1300 properties in the US and Canada, consisting of senior housing communities, skilled nursing facilities, hospitals and medical office buildings. The change in positions was a result of some tax loss swaps between the two holdings in taxable accounts. The two businesses are fairly similar and we would have been equally comfortable swapping from Ventas into Omega Healthcare, as we feel equally comfortable holding either company today and the performance of the two stocks was almost identical last year. Nearly all healthcare related stocks were down substantially in the fourth quarter of the year. For biotechs Amgen and Biogen, device maker Abbott Labs, and drug makers Teva and Pfizer, among many others, the last quarter was not a friendly one. Investors are generally worried about downward pressure on the cost of drugs and medical devices, which could have an impact on all of these companies. It was somewhat surprising to us that the REITs went along for the ride down, although they also faced the headwinds of an interest rate hike. Although the risk is real, we believe many of these stocks have overreacted, as so often is the case. We are left with a number of high quality healthcare companies that are now extremely buyable at their current prices – several satisfy our criteria for "grossly undervalued". Looking ahead we are likely to continue purchasing at least a few of these names, particularly as we trim back some of our winners from last year in the industrial sector, particularly Caterpillar, Cummins, and Deere.

The Election

It is impossible to think about the future of the economy or the stock market or for that matter, the country, without taking into consideration the shocking win by Donald Trump on November 8. However, he is now our president and he and the Republican Congress will, for better or worse, have a major impact on almost everything that happens over at least the next four years.

Mr. Trump represents not just a change in party for the presidency but has an entirely different viewpoint of how government should be managed. Since the end of World War II there has never been such a successful businessman who became President. While this, along with his personality, has led to lots of controversy and questions that never needed to be asked before, the change goes much deeper than just conflict of interest issues.

As a businessman, he has a fundamentally different point of view from that of the typical successful politician. A good politician is always looking for a "compromise" to get his or her supported programs passed, and that almost always involves spending more money. And since government money is not the same as personal money the inclination is to just not worry about it. Getting reelected is far more important than a little money. Over the past ten years or so we have seen Congress pass huge "budget reconciliation" bills in which spending for the entire government is voted up or down without debate. It does incorporate the recommendations of the various committees but in the end, no one individual can really be held accountable.

Private projects, of course are much different, always involving limited financial and often physical resources. And Mr. Trump has been involved in many "deals". He also has been personally involved in most. So it should not be surprising when he calls U.S. corporations to account when they announce plants are being moved to Mexico to produce products that will then be sold back to the U.S. - or when he holds private defense contractors accountable for cost overruns. These are things he has been doing his entire business life.

He has always tried to hire the best people in keeping with his own objectives. So it should not be surprising that he has paid little or no attention to the political fallout from his cabinet appointees though we do not agree with them all. But generally it is a highly competent and accomplished group who share many of his views. Where they differ it can be most useful to the President to have the opposite view represented by people who are not afraid to have them known. He is clearly not afraid to pick strong personalities.

We, along with you, will watch our newly minted President with curiosity. He will be a President/politician who actually tells the public what he thinks; the negative as well as the positive and, unfortunately, the personal as well as the political. Time will tell if his temperament and personal sensitivities prove to be his downfall. Overall we would describe Donald Trump as a high risk, but also, a high opportunity President. For better or worse he will likely be consequential. And partly as a result, the financial markets are likely to continue to be volatile. We shall see.

Conclusions

Summing up all of the above, the overall picture is, as often happens, unclear. This is due to the conflict between high valuations and rising interest rates accompanied by moderate growth. Risks to the stock market have increased but they could be offset, for instance, by growth higher than anticipated (in response to stimulative spending) or a less aggressive Federal Reserve interest rate policy. The volatility and lack of liquidity in individual stocks remains a concern. It is difficult to do rational analysis on stock prices if there are irrational moves in the companies being reviewed. Longer term bonds may be the riskiest asset class at the moment as they are most directly exposed to the risk of rising interest rates.

Don't hesitate to give us a call if you have questions.

With kind regards,

Loudon Investment Management, LLC

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