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Dear Clients and Friends:

Re: Q2 Investment Review

In the quarter just finished, the S&P 500 closed out with a return in excess of 4%. Coupled with the strong first quarter the stock market has now returned over 18% since the beginning of the year. As expected, the returns for balanced funds has been more modest. The more detailed numbers are below:

Benchmark Index Returns	3 Months Ending 6/302019	6 Months Ending 6/302019
Lipper Balanced Fund Index	3.40%	12.19%
S&P 500 Stock Index	4.30%	18.54%
Russell 1000 Value Index	3.85%	16.24%
Bloomberg Barclays 1-3 Month T-Bill	0.56%	1.14%
S&P-7-10-Year-US Treas. Bond Index	3.90%	6.71%
S&P U.S. Gov & Corporate 20+ Year Bond Index	6.20%	12.99%

The strong returns from long-term bonds should also be noted as interest rates have declined in spite of the strong economy.

So, if the stock market can return 18% in two quarters, does that mean 2019 in total could return 36%? We very much doubt it. As we have said before, the market cannot indefinitely outperform the underlying earnings and fundamental progress of the companies that make up the market. It did this in the first half of this year by a substantial margin while estimates now call for the S&P 500 aggregate earnings to be up by only 2-3% this year in comparison with aggregate growth of 37% over the previous two years – but the stock market doesn't seem to care.

There can be any number of reasons for the discrepancy between the market returns and earnings growth but they mostly fall under three categories – psychology, the state of the economy and valuation. In the short run psychology (optimism vs. pessimism) generally rules, but over three to five years growth is what matters.

Let's look at the psychology first. The first quarter was partially a reverse reaction to the overdone poor returns from the 4th quarter of 2018. The bad things predicted just didn't come to pass, and valuations in general became much more reasonable as a result of the decline that ended on December 24.

This partially carried into the second quarter as a strong market builds its own optimism and the stock price momentum from the first quarter continued. There was concern about job growth as the quarter began but the concerns proved unfounded - the most recent report estimated that 266,000 new jobs were added, and that puts us back on track so far this year. All of the unemployment numbers continue at or near record lows for the past 25 years or longer. And small business optimism in particular is at a high level. Finally, the futures markets tell us that a rate cut by the Federal Reserve this month is already priced into the stock market and that is another reason for the rebound in the market since its most recent low in early June. The trade war with China now seems to be old news with the consensus assuming that a solution will eventually be found while higher tariffs have now been delayed for the second time.

On a short-term basis, the market reacts very quickly to new news and often overreacts both up and down. But in the end, it is what is actually happening in both the economy and corporate earnings reports that really matters.

The economy remains in good shape. As noted above, strong job growth continues and this means more money in the pockets of more people which means more buying power in what for the moment seems to have become a virtuous circle upward. While the current expansion is very old by traditional measures, slow growth has its benefits as it prevents bottlenecks and inflation from occurring.   The economy did not really accelerate until the tax cuts went into effect. And, as yet, there is no sign of inflationary pressures which suggests that the path of least resistance for the economy remains upward. Barring something unforeseen (always a risk), we expect economic growth to continue at a reasonable rate.

Less positive is the fact that earnings in aggregate this year will be positive but sluggish, particularly by last year's standard. However, this has been expected for some time as the unusual boost to corporate profits resulting from lower tax rates can only happen once as the market revalues itself to reflect the higher profitability that results from the cuts. This, in turn, brings us to valuations in the stock market.

In the long-term, the market has sold at a price of about 15 times earnings. Today it is higher and this has been an ongoing cause for concern for some. But as noted above, the market is continuously reflecting new news as it happens. Taking the economic and corporate positives that have occurred over the past several years into account, where should the market sell today?

A major influence on valuations is the level of interest rates. Given the sustained growth of the economy since 2009 confidence is based on an expectation of continued growth. Over the times when the market has averaged 15 times earnings, interest rates were virtually always higher than they are today, which among other effects creates competition with stocks for income. This is not the case today.

With growth continuing and interest rates unusually low, the market should sell at an above average valuation. Low interest rates mean that money is both available and cheap and with below average funding costs for new capital projects and consumer spending, demand continues at a fairly high level. As long as this continues, the background for stock investing will remain positive.

The stock market in our minds is currently selling only a little above a "fair" value. With expected S&P earnings this year of about $165 per unit, it is nowhere near "gross overvaluation" that would suggest active selling. When the stock market first hit the level it is selling at today, the Price Earnings Ratio was about 23 times expected earnings. Today it sells at about 18 times expected 2019 earnings thanks to the growth we have experienced, and lower interest rates do justify an above average valuation. We are sitting tight with an expectation that we would be net buyers of equities if the market goes into another decline similar to that of last fall.

<u>Largest Holdings</u>

During the second quarter we had only minor turnover in our top 20 holdings. DowDupont dropped out of our top twenty holdings as it split itself into three separate companies. As a result of the split our overall holding in the combined DowDupont companies remains relatively unchanged, but the position is now held across three companies rather than one (Dow, DuPont de Nemours, and Corteva). DowDupont was replaced in our top holdings by long term holding Polaris, maker of snowmobiles, all-terrain vehicles, motorcycles and boats.

Polaris is a company we have bought and sold a few times over the years, and we have been a net buyer of the stock this quarter. For a long time, Polaris has been a leader in the power sports industry, and most recently it expanded into boats via an acquisition. The company has had problems with quality control in recent years, including several recalls which impacted both earnings and cash flow. With these issues largely behind the company and a stock price that has been generally stagnant over the last three years, we see a lot of upside potential for Polaris stock from current levels.

Additionally, Polaris is in excellent financial shape. In January Polaris announced its 24th consecutive annual dividend increase. This consistency in raising the dividend through good times and bad is always a great signal to us that the company is well managed, has competitive advantages within its industry and is financially strong. While the dividend of about 2.8% is not as high as many of our other holdings, it is very well covered and should continue to grow. Polaris has the potential to grow both earnings and cash flow well into the double digits over the next several years despite low expectations for the remainder of 2019.

Looking at the other end of the spectrum, the combination of Dow Chemical with Dupont last year and the subsequent split into three separate entities was about as complex as just about anything we have seen in our collective memories. Rather than immediately "unlocking value" as the spin-offs had promised, the reactions for all three stocks has been generally tepid, with investors taking plenty of time to digest the transaction. The first portion, the spin-off of Dow, was completed at the beginning of the quarter. Dow is a leading basic chemicals company with manufacturing facilities scattered around the world and it has now replaced the former DowDupont in the Dow Jones Industrial Average. With a strong dividend yield of over 5.5% the stock price is fairly compelling, but the company is facing some headwinds mostly due to a decline in prices for some of the products it sells.

The remaining separation was completed in early June. The largest piece, DuPont de Nemours, is a leading specialty chemicals company with products like Kevlar, Tyvek, Lycra and Teflon that command premium prices over other products. DuPont may be the most compelling company to hold post spin-off, but the projected income yield is only a little over 1.5%, well below our usual qualifying cutoff. In addition, the business is cyclical and will be impacted by changes in the automotive and construction markets. It also has substantial exposure to China that will likely be affected by ongoing trade negotiations. And increasingly we are growing concerned about potential legal environmental risks related to PFAS chemicals (per and polyfluoroalkyl substances including PFOA and PFOS) that they have sold in the past. While Dupont along with many other chemical companies have voluntarily phased out the production of certain PFAS, many questions remain, mostly because these chemicals remain persistent in the environment – like many plastics, they don't break down over time. Many states are now discussing tightening up drinking water and land fill standards (firefighter foams in particular are a major source of groundwater contamination) to levels that will be very expensive to meet.

Lastly, the smallest piece of the DowDupont spin-off is Corteva which specializes in Agribusiness, producing seeds (including corn and soy) and crop protection chemicals. The income yield of 2% is only slightly better than the general market and the business can be quite cyclical. Financials including its balance sheet are quite strong.

With 20/20 hindsight, we should have sold our original Dow (or the combined DowDupont) prior to the company's break up, as performance so far has been generally lackluster since the company's original announcements regarding restructuring activities. Like us, the market appears to be taking its time digesting the transaction. While we did trim our original Dow holding from time to time, we continued to hold on because the stock never quite reached major overvalued status which is one of our signals to sell. For the time being the individual pieces all look reasonably valued, so we are not in a great hurry to sell. However we are keeping a close watch on all three of these positions and it is likely that we will make some changes before year end.

<u>AbbVie</u>

After mentioning drug maker Abbvie in some detail in our last letter, specifically that we might consider adding to the stock at current prices, we found our opportunity. In news that came as a shock to investors, AbbVie announced a planned takeover of Allergan, resulting in the stock dropping 16% on June 25. The drop in the stock price was ostensibly due to concerns about the amount of debt needed to complete the $63.5 billion deal. Abbvie stock has since recovered a bit, though the total return for the quarter of -7% was not exactly impressive and it was one of our worst performers.

After digesting the news of the deal, we quickly decided to add AbbVie to accounts in which there were no shares or the position was very small, and where cash was available. While there are some definite risks inherent in the deal (as we believe there always are in mergers), there are also many positives. Abbvie should be able to use some of the cash flow from its blockbuster drug Humira and Allergen's Botox to quickly pay down the added debt from the deal as the combined companies will throw off substantial amounts of free cash. With the deal in place, the combined entity is not reliant on robust sales of Humira beyond 2023 when it goes off patent in the US. Allergan does come with its own unique set of risks including competitive threats to two blockbuster drugs in particular, Botox and eye treatment Restasis, used to treat Dry Eye. Nevertheless, the deal will be accretive immediately and is expected to add about 10% to earnings per share, with growth from Allergan in the high single digits expected over the next several years. Once the deal is completed AbbVie will be one of the largest drug makers in the world, with potential to grow revenues in the high single digits and a robust pipeline of potential new drugs. Trading at less than eight times forward earnings, the combination of the two companies looks stronger to us than the individual entities, and we were pleased to pick up some additional shares at such a cheap price.

<u>Qualcomm</u>

At the other end of the performance spectrum Qualcomm rocketed higher as on April 16 the company and Apple announced a settlement of the lawsuits between the two firms. Apple originally sued Qualcomm over what it suggested were unfair pricing practices and began withholding payments due the company. The settlement not only released more than $4 billion to Qualcomm but also resulted in Apple signing a six-year licensing agreement for the future delivery of Qualcomm communication chips for the next generation of iPhones. The stock immediately rocketed to $89 per share from $57 the day before the announcement.

Probably the most interesting part of the squabble was that while it was going on Apple announced that they were working with Intel to develop a chip that would compete with Qualcomm. It appears that the reason for the settlement was Intel's inability to move forward as fast as predicted, and Apple concluded that sticking with Intel would slow their introduction of 5th Generation phones. Intel recently announced that they were discontinuing their efforts in this area to concentrate on their core competency of computer chips. The result was that a potential competitor has left the business while confirming that Qualcomm still has the most advanced communication chips on the market. This is their competitive advantage and they have held this position for years.

Unfortunately, not too long after the announcement, there was a ruling by a U.S. District Court in favor of an FTC suit that stated that the company's pricing practices were, indeed, unfair and the stock then fell to $65 per share before working its way back to the mid-seventies today. It is generally believed that Qualcomm will win the case on appeal but it will, at least temporarily, upset their pricing model.

All in all, Qualcomm returned about 34% for the quarter with another demonstration of the interplay between psychology and the facts and the volatility they can cause. The stock price moved from depressed to euphoric to reasonable based on our relatively stable assessment of the fundamentals.

<u>Summary</u>

So where does all that leave investors? As we said earlier, the market is not much overvalued but the current prices may reflect a little too much optimism. On a scale of one to ten, we are probably at a six or seven, not bad but not a great value either. As a whole, the S&P 500 is up some 18% year to date, running well ahead of recent fundamental progress and that leads us to doubt that more outstanding returns are immediately ahead. Finishing the year right where we are now would be a very good result.

The one thing we have been doing with recent changes is to keep an especially close eye to see we are invested in companies with high quality businesses. At this stage of the cycle quality becomes paramount.   This will serve us well when the market eventually does go into decline.

Yet as the company examples above suggest, there are a large number of stocks experiencing high volatility. These are the ones we are looking for and as they move between over optimism and over pessimism based on short term events, opportunities to buy and sell will often appear.

We are happy to respond to any questions the above may raise.

Sincerely,

Loudon Investment Management, LLC

DML/ELS/JSS/LO