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Dear Clients and Friends:

The past quarter was relatively benign in terms of performance with all of the common stock indexes returning modestly positive returns while the year-to-date returns exceeded 20% for the S&P 500 mostly on the back of a very strong first quarter. Other equity indexes lagged behind the S&P.

Bonds also continued their pattern of positive returns as the Federal Reserve began lowering the target rate for excess bank reserves after several increases. As shown below, YTD returns for long-term bonds actually outperformed the S&P 500 through September 30.

Benchmark Index Returns	3 Months Ending 9/302019	YTD Ending 9/302019
Lipper Balanced Fund Index	1.30%	13.62%
S&P 500 Stock Index	1.70%	20.55%
Russell 1000 Value Index	1.40%	17.80%
Bloomberg Barclays 1-3 Month T-Bill	5.16%	2.23%
S&P-7-10-Year-US Treas. Bond Index	2.79%	9.82%
S&P U.S. Gov & Corporate 20+ Year Bond Index	7.38%	21.34%

The strong bond returns, of course, are the result of lower interest rates from an easing in monetary policy, not just recently, but going all the way back to the quantitative easing policy following the Great Recession of 2008-2009. But, even before that, interest rates actually peaked way back in the early eighties (with five-year Treasury rates over 14%!) as then Fed Chair Volker forced a recession to break the back of inflation. The huge inflation was the result of the ratcheting up of the price of oil in the seventies. Both interest rates and inflation have generally both been working lower for a long time. Lower interest rates provide oil for the wheels of economic expansion. Higher rates act as friction for the economy. Thus, a decline in rates is often associated with rising stock prices.

But rates this low are not always good as they can also be the result of a lack of demand, economic lethargy or recession. But all other things being equal, they do provide a favorable environment for growth. When product demand is growing, they lower the cost of capital to fund investment projects. They also lower the cost of consumer borrowing. Investment projects are undertaken to meet the increased demand resulting from higher employment and the other benefits that come from expansion. On the consumer side, the price of home mortgages eventually also moves lower. All of this drives corporate earnings higher and the combination of low interest rates and higher corporate profits produce higher stock prices. Higher stock prices also lead to a sense of optimism further reinforcing an even higher market. Over optimism eventually leads to an overvalued stock market in spite of all the economic good news. As noted below, we were well overvalued in January of 2018 when stocks hit their first peak but less so now.

How low can rates go in the midst of an economic expansion?

This is the quandary. Usually rapid expansion and a strong economy lead to inflation and higher interest rates. But we haven't seen rising inflation for a long time. In one way, this shows how bad the economy was in 2008 – 2009 as it led to very depressed demand as well as lots of slack in our production capacity, and it took a long time to recover from that. Then more recently, the technology revolution accelerated with greater productivity offsetting many inflationary forces. The trade war with China is a separate factor creating a drag on growth, though the impact beyond psychological has so far not had a major influence on U.S. growth. However, all of this may now be changing.

Both wages and employment are rising. In fact, the most recent employment report recorded that the unemployment rate had hit a fifty-year low! Further, the number of job seekers actually exceeded the number of jobs posted. The good news is that almost anyone who wants a job today can find one (though not always the one they want). The bad news is that higher inflation often follows high demand for labor as wages go up. Higher inflation usually means higher interest rates and that can lead to a slowdown in economic activity – the self-reinforcing expansion turns the corner to slower growth and possibly recession.

What about the international economy?

Unlike much of our history, we now also have much greater exposure to events that occur overseas as the world and the financial markets have become increasingly linked economically. For instance, our interest rates today are generally higher than they are in Europe. In fact, there are some places in Europe where rates are effectively zero. Unlike the U.S., the Eurozone has had difficulty producing sufficient growth to support both social programs and job growth. The possible impact of the British exit (Brexit) from the European Union has been a further factor creating uncertainty and impeding growth.

As the dollar is also seen as a safe haven currency, this means there is a steady demand for dollars to both earn a higher rate of return and to escape the turmoil found in much of the rest of the world. Higher demand for dollars means the value of the dollar versus other currencies is relatively high. The positive in this is that a strong dollar means foreign goods are cheaper to buy as a dollar will buy more of a foreign currency and goods than it would otherwise. The negative is that our goods become more expensive to sell overseas and hence, become less price competitive. The combination of these two factors is one of the reasons we have a chronic problem with our trade deficit.

The trade war with China and others is another major factor. Demand from China for agricultural products in particular has declined due to tariffs. In addition, the technology competition coupled with the ongoing theft of Western intellectual property is ongoing. China is what the markets seem to be reacting to most strongly to today.

So where are we today?

In terms of the economy, so far so good. While there are always issues to deal with as noted above and growth has slowed somewhat, there is no sign of a recession on the immediate horizon. Strong economies often develop a momentum of their own and barring significantly higher interest rates, can go on growing for some time well beyond their peak in activity. And it is also unlikely with an election year coming up that there will be any recession next year either. The Fed does its best to try to avoid politics so steady as she goes with continued modest easing in monetary policy will probably be the policy for the next 18 months.

What about the stock market?

Despite all the good news on the economic front (low unemployment, low inflation and low interest rates) and the many ups and downs, the stock market has been pretty much flat since the beginning of 2018, over a year and a half ago. This is actually a good thing as it has allowed earnings to catch up with stock prices that looked to be well ahead of themselves. Valuations have now moved closer with historic levels. So, valuations today, though still elevated, are no longer as much of a concern as they were a year ago.

These are rational conclusions. But, of course, the market is not always (ever?) really rational. It's not what you can see that usually shakes things up but more likely what you don't see coming. Resolution of the trade war with China may or may not happen but its settlement would ease that particular worry and lead to a market rally. However, there is no doubt that a continued trade war will be a drag on growth. How can anyone factor properly factor that into decisions on how much should be invested in stocks? Larger concerns of ours longer term relate more to internal stock market workings in the era of "fast trading" and index funds in a declining market rather than visible economic or political events. These represent risk factors that we do not believe the market will see coming or is currently considering.

<u>Schwab Announcement</u>

Last week Charles Schwab announced that they will no longer be charging any commission on trades and they were quickly followed by most of the other discount brokers. As you probably know, commissions have been declining for a long time (all the way back to the seventies) and had previously been only about $5 per trade. But don't feel sorry for them as Schwab can make money from your account in a variety of ways. These range from their investment of your excess cash reserves to margin loans and referrals to Schwab bank. It will be interesting to see what impact this has on full service brokers where commissions can still be significant.

<u>Top Holdings</u>

We had some turnover in our top twenty holdings this quarter. Caterpillar, PepsiCo, and VF Corp fell off the list, while Archer Daniels Midland, Leggett and Platt, and Whirlpool made it on. Interestingly, all but one of these names (Whirlpool) qualify as Dividend Aristocrats, a list which includes all stocks in the S&P 500 that have increased the dividend for the last twenty-five years or more. This is not too surprising, as we have continued to focus on the highest quality companies as the market has generally continued higher and the chances of an economic slowdown, while still low, certainly seem greater than they did a few years ago.

The main purpose of our trades over the quarter was to trim back or sell some of our long-term winners in favor of companies with better value / more upside going forward. VF Corp is a great example of a company that we trimmed during the quarter. While you may not be familiar with the name VF Corp, you are likely familiar with many of the brands owned and managed by this lifestyle apparel company, including North Face, Timberland, Smartwool, Vans, and Rock & Republic to name just a few. We first purchased the stock in early 2017 when it was trading in the mid-$40's (this is adjusted for the spin-off of its jeans brands including Wrangler and Lee earlier this year). At the time the stock had taken a deep dive largely due to worries about the coming "retail apocalypse" to be caused by Amazon. Upon taking a closer look at the stock we were impressed with its solid and consistent cash flow as well as its dividend record. While we are generally cautious about retailers, we liked the idea of buying this collection of brands rather than a physical store dependent on foot traffic. For the most part VF Corp's products can be sold through multiple stores and multiple channels, including Amazon. With a diverse list of solid brand names, we liked the company more and more as we took a closer look and made the purchase.

Fast forward to today, and VF Corp has met all of our expectations in a relatively short period of time. We readily admit this is not always the case with our purchases, but VF Corp is one that has worked out extremely well. Today the investment has roughly doubled including the dividends paid along the way. Because the stock price has risen faster than the dividend or earnings, the stock now looks overvalued and so we have sold many shares along the way although we also continue to hold a reduced position in many accounts.

Similarly, long time holding PepsiCo is trading at all-time highs and is well ahead of the S&P 500 this year. While PepsiCo is an extremely stable blue-chip company, we have made some effort to lock in some of the gains at current prices, particularly in accounts where the holding grew to be very large due to the company's success. This is a stock we feel comfortable continuing to hold for the long term, though we would not buy it at today's prices. Similarly, there are many other stocks we have trimmed back this year, but that remain firmly in our top twenty holdings – Microsoft, Cisco, Intel, Aflac, Qualcomm and Starbucks are all stocks that we have looked at on an account by account basis.

Caterpillar is the one stock that has fallen off our top twenty list due to poor performance last quarter, largely due to disappointing second quarter earnings. We did not buy or sell any shares over the quarter, but it is one we might consider adding to down the road as the long-term prospects look excellent for this "best in class" company.

Looking at the new names on our list, Archer Daniels-Midland transports, stores, processes and merchandises agricultural commodities. It is not a particularly exciting company, but it does pay a very safe 3.5% yield at current prices, which is significantly higher than what the company has paid out historically. This is not likely to be a stock that will shoot the moon, but it is a very stable company in a cyclical industry with the potential to perform quite well from current levels assuming the trade wars are eventually resolved. We began purchasing shares about two years ago, and have added more over time including over the last quarter.

Although an entirely different industry, the story is similar with furniture component maker Leggett and Platt, which we began purchasing around the end of 2018. Leggett manufacturers, among other things, the innersprings and wire used in the construction of furniture, probably the highest value-added parts of sofas and mattresses. We were surprised to find this one on the dividend aristocrat list as it first hit our radar screens last year when the dividend yield crept over 4%. It is rare for such a company in such a cyclical business to pay out such a stable dividend year in and year out. The more we looked at the company the more we liked what we saw. While there is a large potential upside in this holding, the stock can be quite volatile at times. We generally manage this risk by purchasing less than a full position in a company such as LEG.

Home appliance maker Whirlpool is another company we initially purchased about a year ago after the stock was nearly cut in half from its all-time highs. Like LEG, Whirlpool stock can be volatile, so it is generally a smaller holding in the accounts where it is held. In the case of Whirlpool, we have not added any shares recently. However, the stock has been one of our best performers year to date, up over 45% despite some major tariff whirlwinds, with much of that movement in the last quarter. It was this movement in price rather than the purchase of more shares that landed it on our top twenty list. While the stock looks like it has some room to run from here, we are not looking to add more shares at this time, and we may look to sell and lock in the gains in the coming months.

Conclusion

Like the economy, steady as she goes seems to be the best course forward for the time being. In taxable accounts with gains (most accounts) we will be looking for offsetting losses where they are available. However, a limiting factor in selecting new securities at the moment, is that there don't seem to be a large number of outstanding values. One offshoot of volatile markets though, is that we never know when one will appear so we keep looking.

Sincerely,

Loudon Investment LLC

DML/EJS/JJS/LO