Loudon Investment Management, LLC
24 Airport Road
West Lebanon, New Hampshire 03784
Phone: 603-298-7370
FAX: 603-298-7375
Email: LIM@loudoninv.com

Douglas M. Loudon, CFA | Emily L. Sands, CFA | John J. Sands, CPA | Lynn O'Mealia

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Dear Clients and Friends:

Re: Quarterly Update

Another quarter is on the books and the markets continue to mystify the critics. Tech and internet stocks continue to dominate equity indexes while value continues to lag. The S&P was the only broad-based equity index up year to date while bonds produced negative returns and have been the losers. This is due to interest rates having edged higher in response to actions from the Federal Reserve Bank and the growth in the economy. The economy is strong but, as with the stock market, viewed with much skepticism. We think the skeptical outlook, at least for the economy, is overdone as described below.

As has been the case for some time now, our performance year to date has generally been better than the Russell Value Index but lagged the S&P 500 as have most stocks paying reasonable dividends. We are doing well as far as value and yield investments go but can't keep up with the performance of internet stocks that pay no dividends.

Benchmark Index Returns	6 Months Ending 6/30/2018
Lipper Balanced Fund Index	0.00%
S&P 500 Stock Index	2.65%
Russell 1000 Value Index	-1.70%
High Yield Div. Aristocrats	-0.45%
Money Fund Average (Current Rate)	0.52%
S&P-7-10-Year-US Treas. Bond Index	-1.98%
S&P- Twenty Year+ US Treas. Bond Index	-3.05%

We recently looked at a growth manager's portfolio which has done very well over the past several years. But to produce those returns, the manager was invested over 50% in technology related stocks. And we know that five years ago this same, well respected firm, was at the bottom of all the performance lists. They didn't change but the market did. We fully expect the performance pendulum to swing back in our direction over time just as it recently has benefitted growth managers whose performance will eventually fade. In the meantime, we continue to pursue a more balanced approach to selection which has always paid off for our clients over time.

The Economy

As mentioned above, the economy remains in excellent shape as the growth that began with the recovery way back in 2009 is now in its tenth year. Like the stock market, the longevity of the recovery doesn't necessarily mean that growth will end any time soon.

The broadest measure of economic progress remains growth in Gross Domestic Product and recent numbers indicate that we remain in good shape, most recently reporting about 2% growth after adjusting for inflation. Forecasts for 2018 as a whole seem to point to an aggregate number of between 2 and 3%, an amazingly high rate of growth given how long the expansion has been going on. By now bottlenecks to further progress have usually begun to appear but none are apparent so far.

The most recent upside surprise was the report that employment grew by over 213,000 new jobs in the month of June, well above the expected number of 191,000. More people working means more money being earned and therefore more money being spent, which leads to more growth in the economy creating a "virtuous circle".

While the unemployment rate ticked upward to 4% we are still at what is generally thought of as "full" employment as there is always some percentage of the population in transition between jobs or temporarily unemployed. Last month it is thought that the main reason for the upward movement was more people coming out to actively look for jobs – another sign of strength. It answers part of the question as to why, if unemployment is now so low, we are not seeing more upward pressure on labor costs and hourly wages.

A concept we don't hear much about anymore is Quantitative Easing. This was the mechanism by which the Federal Reserve Bank tried to pump more money into the economy whether it needed it or not. As apparently the economy did not need it, it ended up in the financial markets instead and is one of the reasons the stock market has done so well for so long.

The good news for the stock market is that although this activity was halted last year, there is no sign that this policy has been reversed. Money drained from the economy by the Fed always comes first from the financial markets and that would be a difficult barrier for the continuing market advance to overcome. It is also why the stock market often corrects before any visible change in the economy. So far, however, the Fed has maintained a steady as she goes approach with only moderate upward pressure on interest rates.

Today no discussion of the economy would be complete without some review of the ongoing trade disputes the current administration is having with the rest of the world. This is the kind of activity that typically dulls enthusiasm for future opportunity. Like everyone, we have no idea how all of this will turn out, but it is one additional "risk" (in the same category as tensions with NATO and North Korea) to be considered when looking at both the economy and the stock market.

As the stock market in aggregate has made little progress since the beginning of the year, it may be that the psychological burden of these activities, along with continued moderate increases in interest rates is finally beginning to have some impact on the upward trajectory the market has been on for some time.

Equity Changes

This quarter saw increased movement in our top twenty stocks as market volatility picked up and we added a few new positions to portfolios, as well as a few sales. Normal price changes account for the movement of Fastenal, H&R Block, and Caterpillar out of the top 20. They were replaced as a result of above average performance from Pfizer, Kohls and Qualcomm (we also added some shares in Qualcomm over the period as we believe it remains quite undervalued).

As we have often reminded clients, we always reserve the right to change our minds. This was the case for CVS which we began purchasing around the end of last year but was largely sold out of portfolios in recent months. Our decision to sell CVS is tied with our decision to sell and trim back drug distributor Cardinal Health, which also dropped out of our top twenty holdings though it is still held in some accounts. Though down in price recently, Cardinal Health has generally been a successful stock for us, and we have trimmed it and sold it where we are able to and the tax consequences are reasonable. We will continue to evaluate it over time for additional profit taking.

Despite very favorable demographics, health care stocks in general face a great deal of uncertainty in upcoming months and years. Amazon recently announced the acquisition of online pharmacy PillPack, which represents the behemoth's first significant move into the drug space. While we do not know how big the "Amazon Effect" might be, it is a difficult move to ignore as Amazon has proven to be a disruptor in many industries. CVS derives 75% of its sales from pharmaceuticals accounting for our concern there. Meanwhile all of the drug companies are facing more pushback on raising drug prices. We saw evidence of this last week as Pfizer rolled back announced drug price increases after its CEO had a "heart to heart" with President Trump. Fewer price increases mean narrower margins for both sellers and wholesale distributors of drugs.

Because of the rising cost of health care, these pressures are likely to continue, and we believe the distributors and pharmacies will largely be the ones getting most squeezed over time. As a result, we have decided to exit the pharmacy business for the time being. We do continue to hold onto the drug companies which historically remain very reasonably priced and many including Amgen and Pfizer have a good combination of products already in the market and new ones in the pipeline which should add to revenues going forward as other drug offerings come off patent.

These sales provided the cash for new purchases in Starbucks and Kraft Heinz Co, both well-known household names:

Starbucks appeared on our radar because it has raised the dividend an average of 28% per year over the last five years, while the stock price remained relatively flat. As we looked closer we liked what we saw – earnings and cash flow were both up more than 15% annually over that period. The company is in excellent financial shape, and despite a recent hiccup in which the company announced it will be closing a few stores, the outlook for growth over the next several years also looks quite good. A recent deal inked with Nestle to bring more Starbucks branded products to grocery store shelves should provide more revenue gains. Trading around 19 times next year's expected earnings (versus 30 times four years ago), we believe Starbucks provides us with an opportunity to buy a high quality "growth" stock at a "value" price.

Kraft Heinz was caught up in a downturn earlier this year along with many other consumer staple stocks like Proctor and Gamble, General Mills, Kimberly Clark, and Pepsi. Their only sin seemed to be that they lacked excitement. Just a few months ago many of these stocks qualified as grossly overvalued by many of our metrics. In the case of Kraft Heinz, a correction of 40% from its high and a current income yield of over 4% brought it easily within our buy range.

All packaged food companies have been battling changes in consumer tastes as consumers are passing over many packaged foods for fruits, vegetables, and other healthier alternatives and grocery shelves are becoming more saturated with new options. Kraft Heinz is addressing these issues head on as it has reformulated some of its more popular brands, for example removing all artificial colors and flavors from its popular mac 'n cheese. It is also introducing new products such as the Devour line of frozen meals which have been rolled out to solid reviews. It also owns the leading brand in a number of categories such as Ketchup, providing some pricing flexibility. All of this, along with some prudent cost cutting means that earnings growth over at least the next several years should be pretty good. Overall, Kraft Heinz has a popular lineup of products, the company is financially strong and more profitable than its average peer and seems to be selling at a depressed valuation. Any time we can pick up a "boring" stock like Kraft at such a discounted price it catches our attention, as it is truly a sleep well at night kind of stock.

Summary

Given all of the above, the watchword going forward will be continued balance in our portfolios. In some ways the stock market has become increasingly unbalanced as tech has not only provided some extraordinary gains but has pushed an increasing proportion of the market into fewer and fewer names. There have been some reclassifications of stocks within each named sector of the S&P but we estimate without those changes more than 30% of the entire market by aggregate market value can now be classified as technology. This has happened before and forward performance from this position has generally not been very good. It happened to technology in 2000-2001 and more recently it happened to energy stocks in 2014. This doesn't mean that the companies (tech in particular) necessarily do a poor job growing earnings but that eventually valuations become so top heavy that they collapse under their own weight.

We are not predicting this, but if it happens it can be very painful. We would rather keep risk in check and avoid the pain that occurs if a correction does happen than reach for the last dollar.

But even with our word of caution for the present, we do want to reemphasize our firm belief that on a longer-term basis the U.S. stock market remains the best place in the world to invest your money for the long term. Our economy remains healthy and highly resilient in spite of all that has been thrown at it over the past several years. It is, after all, this economy that has produced all the returns we have enjoyed from the stock market over the past ten years. For an investor with a time horizon of five years or more, there is no time better than now to buy stocks for the long-term.

We welcome your thoughts and comments.

Sincerely,

Loudon Investment Management LLC

DML/ELS/LO/JJS