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

October 9, 2018

Dear Clients and Friends:

Re: Quarterly Update

As can be seen below, the last quarter was the strongest this year for equity performance. Looking at the year to date numbers, our equity and balanced account returns were competitive with all the indexes other than the S&P 500.

Bonds, on the other hand, continued their negative return string as the Federal Reserve Bank continued to modestly push rates higher on a very gradual basis. At some point, the higher rates will start to limit equity performance, but there is no sign of that yet.

<u>Benchmark Index Returns</u>	9 Months Ending 9/30/2018	3 Months Ending 9/30/2018
Lipper Balanced Fund Index	3.42%	3.3%
S&P 500 Stock Index	10.56%	7.7%
Russell 1000 Value Index	3.92%	5.7%
High Yield Div. Aristocrats	3.77%	5.7%
Money Fund (Vanguard Prime)	1.30%	0.5%
S&P-7-10-Year-US Treas. Bond Index	-2.69%	-0.7%
S&P- Twenty Year+ US Treas. Bond Index	-5.90%	-2.9%

Goldilocks Lives

All the economic numbers seem to be moving from strength to strength. This is not surprising (at least for a while) as employment has continued to grow and the newly employed have been spending their money. This leads to more demand for goods and the need for more manufacturing and capital spending to meet the demand. And all this is happening while visible inflation remains relatively benign. This is truly an economy that Goldilocks would love.

Spending is growing but so is the savings rate, an underestimated but very important factor to future growth and financial market returns. Gross Domestic Product, the most broadly-based measure of economic activity, is up more than 5% over the past year and the positive growth continues. A number of measures of economic activity are at twenty-year highs. How come?

Economies don't just gain strength without a reason and the expansion didn't just begin randomly several years ago. In fact, we have been in general recovery mode since coming out of the financial crises way back in 2009. But there are several reasons strength has grown recently and they shouldn't be a surprise:

1. Tax Cuts - All things equal, more money in personal and corporate pockets equals more spending and saving and that means a higher level of economic activity. The corporate cuts were both unusual and needed to make U.S. exporters and manufacturers competitive on a cost basis with the rest of the world. Taxes are an expense and they were too high and contributing to our loss of manufacturing capacity to lower tax (and wage) countries. Now we are more in line with global tax rates and in a much better position to compete on an equal footing. Another benefit of the new law is that money "trapped" overseas is also much better able to come back to the U.S. with less of a penalty. That provides more capital for investment in the U.S. rather than overseas. And the personal cuts put more money in everyone's pocket regardless of the nitpicking that went on over who was most favored. A small amount in many many pockets equals a big increase in spending capacity in total.

2. The second (and partially related) reason for economic strength is that intangible often referred to as "confidence". Increased confidence in the future convinces both individuals and businesses that it is OK to spend now and invest for the future rather than hang on to what you have for the present. Whatever the reason, five (or ten or fifteen) years ago we didn't have it and now we do. When it is around, longer term financial planning and projects just seem easier to get done and investors loosen their purse strings. It is the main factor leading economic growth from strength to strength.

So here we are. What comes next? At the moment, it appears as though growth will continue for some time as momentum and confidence remain high.

What could change that? Usually at some point in the economic cycle (yes, we still have an economic cycle), demand for goods outgrows the ability of the economy to supply them. This can happen for a variety of reasons but usually it is fueled by either or both of higher financing costs, making it more expensive to fund demand satisfying projects or inventory, or an increase in the cost and availability of people to fill the growing number of jobs created by growth.

Though wage increases have been sticky, Amazon just announced that all their workers, part and full time, will earn a minimum of $15 per hour (though it was later learned that there would also be a cutback in some noncash benefits). The increase is a good thing for those who receive it but it could be the beginning of wage competition for labor. Should the $15 minimum catch on, or other retailers be forced to match it to meet growing personnel needs, it would increase cost pressures and the pass through of at least some of the increased costs means prices will rise at a higher clip. There have already been bottlenecks relating to an inability to find skilled workers in particular and the result is the lowest unemployment rate seen in the last fifty years.

Why is this happening now? Because of the strength of the economy. More workers are demanded to meet growing demand. Workers who dropped out of the labor force because of low demand for labor in the aftermath of 2009 have now been coming back in. Those not looking for work are not considered unemployed and the non-counting of those people is one of the major shortcomings of the headline unemployment statistic. The formerly uncounted have been the source of an ongoing supply of workers. Since 2009 that has depressed the “real” unemployment rate. But now it appears that this source of labor is drying up and real wage pressures may take hold leading to higher inflation.

In response and to control the inflation potential, the Federal Reserve will further increase interest rates creating increased friction in the wheels of the economy and eventually all of this leads to a slowdown and, usually, recession. Looking toward this is what gives Goldilocks (and us too) a headache.

The Stock Market

Obviously, the stock market has so far greatly enjoyed the economy. But there was a further boost to the stock market beyond economic growth and technology-based innovation. This was provided by an excess of money which, until last year, had persisted since the Fed opened the monetary spigot way back in 2009 when things really looked bad. A significant portion of this money eventually ended up in the stock market which is one of the reasons returns have been so strong and well above long term market averages.

But that spigot was turned off late last year. And since then, the Federal Reserve has been gradually increasing interest rates with every indication that they will continue to do so. Today the ten-year maturity U.S. Treasury sold at price to yield above 3.25% for the first time in seven years.

So for now, everything looks fine but we should anticipate a less ebullient market going forward. Most economists (acknowledging that they are usually more wrong than right) anticipate a pullback in the economy in 2020. But the stock market usually anticipates so, if true, this would likely bring pressure on the stock market next year even as the economy continues to expand. This is consistent with history.

Top Twenty Stock Activity

This quarter saw ongoing but limited trading activity as we trimmed back some of our winners in order to purchase some new stocks and add to existing positions. However, the movement within our top twenty list rankings was largely due to performance rather than trading. Kohls is the only stock that came off the list due to selling activity, while National Grid fell out of our list due to lackluster performance with the stock down about 7% for the quarter. Meanwhile Pfizer and Fastenal were both up over 20% for the quarter which jumped them into our top twenty holdings.

Kohls met all our usual criteria when we first purchased it about five years ago. It was and remains a best in class retail stock with a solid bottom line, strong financials, and a well-supported dividend. Trading around a very reasonable 10 times earnings at the time, the future looked bright for Kohls in 2013 despite a slow growing economy and Amazon related worries about retail in general. We believed at the time that Kohls was in better shape than other department stores because it was (and is) not dependent on malls for its survival. And unlike most department stores at the time was already pursuing a multi-channel approach to marketing. And while retail stocks can often be volatile, caught near the bottom of a cycle they can provide outsized returns. So, the opportunity from a high quality cheap stock seemed to outweigh the risks.

Fast forward several years and the stock has performed well, the dividend has increased about 20% annually, and the financial strength remains strong for Kohls. However, we know that Mr. Market can often be fickle, and Kohls is no exception. The stock has provided us with a five-year roller-coaster ride since its initial purchase. The most recent downdraft occurred in early 2017 when investors became increasingly worried about the Amazon effect on all retailers across the board. As it tends to over time, value has now won out and the price has more doubled since then.

At least so far, the Amazon fears have not been realized. In fact, Kohls has partnered with Amazon for a “store within the store” concept in several locations and so far, the results have been promising. Nevertheless, when Kohls reached new highs this past quarter and the business began to look frothy, we took the opportunity to sell the stock or trim it back where we could and where the tax burden of selling was not too great. We will likely aim to clear out remaining positions early next year when the tax clock resets.

The only utility in our portfolio, National Grid is a stock we have been watching closely since it sold off its gas distribution business last year and returned a significant portion of the cash to shareholders in the form of a special dividend. This accounts for some of the decline in price as that asset was distributed and is now owned by shareholders. The company originally appealed to us because it owns the electricity transmission network in England and Wales (literally the British grid), while also operating as a traditional electricity and natural gas delivery company in both the U.S. and U.K. Rising interest rates, as we are seeing now, do tend to put pressure on utilities because investors are able to find a safe return on their investment elsewhere and utilities tend to be heavily financed by debt. Additionally, the company has been under some pressure in the U.K. and recently agreed to spin off its electricity operator there into a separately run subsidiary. However, with about 90% of its operations regulated, we would be hard pressed to find a more stable business than National Grid. The stock provides a generous 5.9% yield with reasonable upside, and it should provide a good hedge if the market should turn down at some point.

Looking over to the winner category, Fastenal and Pfizer are two very different companies, though both show that you don't necessarily need to take on a lot of excess risk in order to make a decent return. Pfizer is a global pharmaceutical company that produces many successful drugs such as Xeljanz (Rheumatoid arthritis), Prevnar (pneumonia vaccine), Lyrica (fibromyalgia), Eliquis (blood thinner) and Viagra (erectile dysfunction) and also has a reasonable pipeline of new products that should be able to support operations as other drugs come off patent.

Fastenal is an industrial supply company that sells threaded fasteners as well as a variety of other industrial products. Sales are mostly to contractors but despite the cyclicality of the building industry FAST has compiled a consistent record of growth. In recent years they developed an unusual process to deliver their product by leaving "vending machines" at major building sites.

Both stocks are up on generally positive earnings surprises. We would rate both companies as "best in class". Exceeding market expectations is always a good recipe for performance.

While they have not yet made it onto our top twenty list, we have been using the proceeds from some of our sales to buy small positions in a few new names that you may hear more about in the future or see in your portfolio: industrial company Illinois Toolworks, appliance manufacturer Whirlpool, and mutual fund company Franklin Resources. All meet our criteria with strong balance sheets and the ability to generate cash flow beyond their immediate need for dividend payments and capital spending – these too are candidates for "best in class". As with most the stocks we buy and often for mysterious reasons their stock prices that have not kept up with recent market increases. We expect you will hear more about these companies in future letters but would be happy to provide more information to anyone who is interested.

<u>Portfolio Structure</u>

The most important question that we ask early in each client relationship is "What do you want your money to do for you"? Implied in this question is the implication that we are not here just to "beat" a particular market benchmark but rather to find a level of return, risk and volatility that clients are comfortable with. Everyone wants to make more money but they may not realize the amount of risk that must be assumed to do it, and with higher risk comes an increased chance of failure.

When the stock market has been strong for an extended period, as in the last five years, risk is often forgotten and some seem to think that it has disappeared entirely. But it is always present whether it rears its ugly head or not.

By way of example, we have suggested above that the risk of a market decline is growing. This does not mean that the market is in danger of imminent substantive decline but it does mean that a decline could happen at any time. The most difficult part of deciding how much money to place on the opportunity side of the ledger (own stocks rather than more stable alternatives) is that the biggest declines occur without warning. For instance, the warnings about the 2008 financial debacle were there relatively early and there was even a fair amount of discussion about the increase in risks surrounding multiple tranche mortgage securities. But no one had a hint of how bad it could get.

These "exogenous" events seem to happen about every decade or so. Examples include the early seventies with the valuation crises of the "nifty fifty" along with the oil embargo; the early eighties with interest rates rising to 14%+ on five-year U.S. Treasury Notes; the nineties with the Savings and Loan debacle; the early 2000s with the tech bubble and the aftermath (many overvalued tech stocks went nowhere for five years or more) and most recently in 2008.

The only way to plan for these events is to prepare in advance. Even when a market decline begins or an economic problem appears, we have no idea how large the impact on the market or the economy will be. And neither does anyone else.

This is why we have no portfolios that we manage that are 100% in stocks even though it was clearly the place to be for the past nine years. And this is in spite of the fact that we are always long-term optimists on both the stock market and the economy. The capacity of the market to surprise should never be underestimated. At a minimum we like at least two years of expected withdrawals to be held in reserves. That was about the duration of the 2008-2009 decline and the reason is so we will never be forced to sell stocks for normal purposes in the midst of a major downturn. Money removed from the market at a low point will never be earned back.

How much more limited stock exposure should be relates to a number of factors, both psychological and absolute. For instance, a nonprofit operating at breakeven may have a greater need to call on reserves without warning. Or an individual operating in a high paying but high turnover business (like much of Wall Street) may need more security for their savings because of the risks of their continuing employment.

Psychologically some people are also just not equipped to handle a major decline or large interim volatility. Sell down to the sleeping point has real peace of mind validity. But in spite of the many multi colored and slick presentations that are made by many claiming to be financial advisors, there is no formula we can execute to figure out just what the asset allocation should be. In the end it really comes down to interpreting what the client is really saying and looking for and how we can best provide it.

This is why the performance numbers we provide, though statistically correct, are generally incomplete. And we have not covered as part of this discussion how our stock selection process relates to overall asset allocation. More on this in our December letter.

Summary

So, both the stock market and the economy have continued to perform well. This has boosted asset values but some strain from the Federal Reserve tightening effort is beginning to become evident. This initially shows up in the negative returns produced by the bond market. We feel a lot better when both markets are performing in sync.

We are not predicting an imminent decline but cyclical risks to the stock market in particular are beginning to show and our tendency is now to accumulate net income rather than reinvest it in equities.

We believe that returns for the balance of this year and next are likely to be more muted than they have been recently. Because of all of the above it may be appropriate for all clients to review their equity exposure to assure themselves that it is aligned with their evolving long-term interests. We welcome conversation on this subject or any other that may be of interest.

Sincerely,

Loudon Investment Management LLC