April 13, 2021

Dear Clients and Friends:

Re: 2021 Q1 Report

Last year was unexpectedly good for the stock market in spite of Covid shutting down much of the economy. Now that we are entering an economic rebound, what comes next? So far so good as positive returns continued through the first quarter. However, leadership seems to have changed direction.

Benchmark Index Total Returns	Quarter Ending 3/31/2021
Lipper Balanced Fund Index	3.30%
S&P Dividend Aristocrats	8.50%
S&P 500 Stock Index	6.20%
Russell 1000 Value Index	11.30%
3 Month US Treasury Bill (Current yield)	0.20%
S&P-7-10-Year-US Treas. Bond Index	-5.70%
S&P 30-year US Treas. Bond Index	-15.74%

As can be seen above for the first quarter of 2021, the stock indexes have just about reversed last year's order of returns, and bonds have declined in response to rising interest rates. For some time, we have been saying that an unbalanced market does not last forever, and growth has led the market in a big way for over five years. The above suggests a reversal of market preferences seems to have begun with value stocks leading growth by a substantial margin. If this is what is actually happening, it needs to be remembered that before high growth took over the market, there have been long periods of time when cyclical and "value" stocks have led the market higher. If a reversal is occurring, this should work in our favor as our high-quality dividend paying stocks also lean toward value.

This fits in with what is happening in both the economy and interest rates. The negative bond returns above suggest that interest rates have started to rise in anticipation of higher projected growth and increased corporate demand for funds to finance it. Corporate demand will come on top of the

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huge bond offerings the Treasury will need to fund if anything like the currently contemplated legislative programs pass Congress and are signed into law.

The Federal Reserve has said it is going to keep interest rates low, but we do not think this can last in view of the growing need for money. Consumer demand for all sorts of products will also grow given high savings rates over the last twelve months and rapidly increasing employment this year. Some shortages have already started to appear with ketchup apparently leading the list as restaurants prepare to reopen. Ironically, at the same time, restaurants are also having trouble finding enough people to hire. There is anecdotal evidence that this is starting to happen in many economic sectors, and shortages always lead to one thing - higher inflation.

We hope not, but we may be moving away from the virtuous circle that we have been in for many years (all the way back to 1981) with declining interest rates leading to a greater ability for corporations to finance expansion through cheap money leading to more employment and growing consumer demand from the wages earned. Instead, we may be entering a period of rising interest rates that will last for some time. Certainly, the money has been created to fund it.

While we have great confidence that the economy will boom this year, there are so many unknown forces (particularly financial) that have been put in place over the last year and longer, that everything else is open to interpretation. For instance, the rapid and huge increase in government debt. In the year 2000 total national debt totaled $5 trillion while today it is over $27 trillion and growing rapidly. Probably more importantly, U.S. debt is now 127% of Gross Domestic Product up from 55% in the year 2000. New theories abound as to why this is not so bad, and a "New Monetary Theory" has emerged to justify what has happened and how inflation and interest rates will remain in check. The inferred suggestion is that it is "different this time". We are highly skeptical. The best historic evidence we have is what has actually happened to countries whose national debt has exceeded GDP. Their economic experience has not been good.

That is a longer-term view, but the next twelve months things look fine with the consensus GDP growth rate at about 6%. We think it could be higher. As the cyclical recovery moves forward, many raw material and industrial prices will also move higher and that should lead to exceptional earnings for these kinds of companies. Fortunately, our portfolios are laced with many high-quality industrial companies. By comparison, a number of high growth companies may see their valuations decline in spite of ongoing growth. Part of this will depend on interest rates, but the more they move higher the less attractive growth will appear. Many are still valued for perfection, and the "bird in the hand" becomes more important to investors. Periodic changes in market leadership are the norm, not the exception.

Financials, and banks in particular, have recovered somewhat from very depressed levels. They are generally in strong financial condition. They will benefit from both higher interest rates and greater demand for corporate financing as the economy becomes stronger.

Bonds have been up and down recently (down last quarter) but we believe that a long secular increase in interest rates has begun. Simply put, higher inflation means higher interest rates as

from inflation. This will be caused by continued high monetary policy to finance all of the government spending programs that have already begun.

Finally, also on the negative side of the ledger, are the planned increases in both corporate and personal income taxes. Lower taxes stimulate economic growth while higher taxes act as a drag. This is particularly true for corporations. Lower taxes played a dominant role in the booming economy we had in 2019. Higher taxes will slow things both before (due to anticipation) and after they are passed though they are unlikely to get back to the old, much higher rates before the tax cuts were implemented by the last administration. And, unfortunately, the anticipated increases will not even pay for the current so called "infrastructure" bill now being debated. We have seen estimates that the higher taxes contemplated will take fifteen years to provide the revenue to pay for the next eight years of planned infrastructure spending. Some economists have even said "Why bother?" when the impact will be so small relative to the amount of financing already done and that yet to be formally proposed.

Nonetheless, we have learned to never underestimate the strength and resiliency of the U.S. economic/political system. Earnings will move considerably higher this year as will consumer spending power and employment. Hopefully, that will also lead to a more content public reducing some of the social tensions we have seen in recent years.

Top 20 Holdings

Over the first quarter Intel and Pfizer dropped off our top twenty holdings list, replaced by Aflac and Caterpillar. Our current top twenty list is as follows:

3M Company	Enterprise Products Partners L.P.
AbbVie Inc.	Fastenal Company
Aflac Inc.	Illinois Tool Works Inc.
Ameriprise Financial	Lowes Companies Inc.
Amgen Inc.	Microsoft Corporation
Archer Daniels Midland	Polaris
AT&T Inc.	Qualcomm Inc.
Cardinal Health	Starbucks Corporation
Caterpillar Inc.	Technology Sector SPDR Fund
Cisco Systems Inc.	United Parcel Service

In our last letter we mentioned that we had begun trimming Intel based on some fundamental concerns

about its ability to remain competitive going forward. Since then, Intel stock has continued its rebound from previous lows. The stock is now approaching its all-time high which was reached in 2000 at the peak of the tech bubble. We are pleased with the gains, but the story for Intel has changed quite a bit since our original purchases. When we first bought Intel its only major competitor in the market was a much smaller company called Advanced Micro Devices (AMD). Nearly every computer had either an Intel or an AMD processor, with Intel generally outpacing AMD by a wide margin. Since then, AMD has gained some additional footing, but more importantly the competition is much stronger with companies like Apple entering the mix. We expect to continue taking profits and trimming Intel as the year goes on though we are happy to ride it higher as we do this.

Well-known pharmaceutical company Pfizer also dropped out of our top twenty. We sold a few shares along the way, but mainly it dropped off the list based on relatively lackluster performance (a slightly negative return for the quarter) compared with stellar returns from Caterpillar and Aflac that were added. We have mixed feelings about Pfizer. The stock is up modestly in price since our original purchase, and as a result the stock remains historically cheap with a generous dividend around 4.3%. Meanwhile Pfizer's results have been generally good as the company expects about $15 billion in revenues from its Covid vaccine in 2021 and has goals to deliver 200 million doses to the U.S. by May and 2 billion worldwide by the end of the year. Earnings forecasts have increased, and yet the stock has not moved much to reflect the generally positive news. Looking further into the future there are some concerns regarding the sustainability of the Covid vaccine (will it require regular boosters as does the flu shot?) as well as the company's pipeline of products which is always a concern with the major drug companies. Also, though the dividend is well covered, dividend growth slowed this year as the company only raised the quarterly dividend by a penny. Although the long-term prospects look good, Pfizer remains on our watch list for the time being and we consider it about fairly valued. If something better shows up, we will probably replace it.

Meanwhile, longtime holdings Aflac and Caterpillar were up 15% and 28% respectively, jumping them back onto our top twenty list based on performance. Both companies are Dividend Aristocrats, meaning they are S&P 500 companies that have raised their dividends each year over the last 25+ years.

Insurer Aflac remains reasonably priced, and we would rate it a hold as there is a lot to like about the company's consistency. Meanwhile Caterpillar, the world's largest maker of earthmoving equipment, is beginning to look a bit frothy as the stock currently sits at all-time highs. Some of our holdings in CAT date back to near the low point of 2009, with those purchases returning between 600-800%. Along the way we have added to and trimmed the position several times in accounts depending on how the company was doing. Caterpillar is a cyclical company, and as a result the stock price tends to be more volatile than our typical holding. At current prices CAT could have some room to continue to run if the worldwide economy continues to pick up steam through the rest of 2021 and commodity prices remain stable or continue to rise. However, it is another company we continue to watch closely. This is the kind of stock we try to buy cheap, but we know that we should sell it at some point to avoid the next cyclical downturn that will inevitably appear at some point. At the moment though, it fits very well with our belief that the market is looking more toward the cyclical side of the economy.

Conclusion

We approach forecasting with a huge sense of humility. As Yogi Berra once said, “It's tough to make predictions, especially about the future.” To begin with, while we often get it right eventually, we have to be careful that our patience is not dramatically longer than that of our clients. It may very well be that we will eventually be right about our suggestions on where the economy will be headed in the future, but not yet.

While we have a fair amount of confidence about future inflation and interest rates, we do not know when the stock market will recognize what we believe we can see. It has often been said that bear markets end in a crisis but bull markets give up ground only with great reluctance. And with corporate profits headed higher this year, there is no immediate reason to think that the market is ready to crash as it did a year ago.

It is also important to remember that economic and stock market cycles last a long time. But it is also well remembered that they have not gone away in spite of the upward durability of the last seven or eight years. Our current policy calls for 10% cash even in all equity accounts and that is our main hedge against decline. That and our conservative selection process with a yield overlay will serve us well if risk does raise its ugly head. At the same time, we do believe our current equity holdings are well positioned over the rest of the year to do well in terms of market participation.

We welcome your questions and comments.

With best personal regards,

Loudon Investment Management, LLC

DML/ELS/JSS/LRO