LOUDON
INVESTMENT MANAGEMENT

July 9, 2021

Memo to our Clients and Friends:

Re: Q2 Report

The financial markets seem to be at it again. During the second quarter the S&P 500 was up more than 8%, meaning that year to date stocks have returned over 15%. Growth returned to favor, so after a good first quarter our stocks in aggregate lagged the S&P. However, ups and downs are to be expected. Year to date, our selections remain modestly ahead of the S&P. Total account performance has been comfortably ahead of the Lipper Balanced Fund Index. As always, your individual total account performance may be found in the attached file.

Benchmark Index Total Returns	Quarter Ending 6/30/2021	Year to Date 6/30/2021
Lipper Balanced Fund Index	5.1%	12.9%
S&P Dividend Aristocrats	5.8%	14.8%
S&P 500 Stock Index	8.6%	15.3%
Russell 1000 Value Index	16.3%	17.1%
3-month US Treas. Bill	0.0%	0.03%
S&P 7-10-Year-US Treasury Bond Index	2.5%	-3.3%
S&P U.S. Gov & Corporate 30 Year Bond Index	7.8%	-9.1%

Equities, after a breather in the first quarter, were again led by high growth, low or no yield stocks. Valuation wise, we continue to believe these stocks carry high price risk. Interest rates fell in the second quarter producing positive returns for most bonds, but it was not enough to make up for a poor first quarter for fixed income securities. Year to date, bond returns remain in negative territory. Our balanced portfolios hold virtually no long-term bonds.

The underlying economic fundamentals have not yet changed very much since our letter written at the end of the first quarter of the year, though there is increasing talk of higher interest rates to come. Based on action in the stock market there does not seem to be much in the way of actual portfolio repositioning to indicate that anyone is listening to what the pundits have to say.

The business reports have been strong in keeping with earlier opinions as recovery from the pandemic seems on track. If anything, the recovery has been too fast as the supply of everything now seems to be

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short of demand. This has been especially true of the labor supply. Actually, there are plenty of workers around, but many seem to be reluctant to return to the job given the currently pandemic inflated special unemployment benefits. Those at the low end of the wage scale can often earn more by not working rather than by going back.

Over the past year the price of gas has gone up about a dollar per gallon. Food prices are also on the rise and obvious to anyone who goes to the grocery store. Higher labor costs are expected, given the current number of unfilled job openings, and in general we are paying more for most items.

The inflation numbers are now being noticed, as the year over year Consumer Price Index has recently been reported as up 5% with "Core Inflation" (excludes volatile oil and food prices) also up 3.5%. Yet the current income yield on a ten-year US Treasury Bond is now below 1.3%. Something has to give. These bonds usually sell at a premium to the inflation rate and money market rates are usually in line with core inflation. As you can see from your own portfolios, they are now less than 0.5%.

Inflation is also driven by an expansive monetary policy along with the huge Federal spending programs that were (mostly appropriately) enacted over the past year. By at least one measure (M2), the money supply has grown over 33% in the last twelve months. Under most circumstances, all of these factors provide the perfect set up for inflation and suggests it will be more than just transitory.

Part of this is due to the Fed finding itself in a bind. It has dual objectives assigned by Congress that state its job is to keep inflation under control, typically by loosening or tightening the money supply. But at the same time, it is required to support full employment generally by lowering interest rates. These objectives are often in conflict. On one side is the Federal Reserve Board, a majority of which seem to be staying with their belief that the spike in inflation is mostly temporary and related to the labor shortages and surging demand as the economy recovers. But many others outside the Fed are not so sanguine and believe we should be starting to raise interest rates now.

Gray Cardiff, editor of a publication called Sound Advice, and one of the people we listen to carefully, recently said "Nothing is more dangerous than to assume a current trend is transitory," a sentiment with which we agree. With high stock valuations being supported by very low interest rates, any uplift in rates will likely reduce valuations and stock prices with them. The risk of higher rates will increase at the same time that year over year earnings numbers slow from recent recovery levels.

As always, it is much easier to identify risk than it is to tell when the financial markets will start to act on it. We do take some comfort that our holdings, in general, are less volatile than the overall market, not to mention much less so than high growth stocks that are and will be particularly vulnerable in a market decline.

Although we are conservative in our equity selections it is not without reason and, except for the recent market focus on high growth, has served us and our clients well over the years. Transactions over the past several years have focused on high quality along with income yield and total return potential. Quality, in particular, should fundamentally serve us well when the economy slows and the next bear market begins.

Negative returns, though never welcome are particularly painful when stocks held go down faster than the general market. This is what we most try to avoid even if we give up some return when the market surges. It is accepted theory that we all find losing money far more painful than the pleasure provided when the market is moving higher and we are at least making money.

Top 20 Holdings

This last quarter saw no major change in our top 20 list. But we have been actively trimming back some of our biggest winners that had grown too large relative to the total size of some portfolios. Broad diversification is always a factor in our thinking and another way to reduce risk. We have mostly been adding to some of our existing holdings in recent months. Our current Top 20 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	Qualcomm Inc.
Cardinal Health	Starbucks Corporation
Caterpillar Inc.	Technology Sector SPDR Fund
Cisco Systems Inc.	United Parcel Service

One company worth special mention is long-term holding AT&T. The company shocked investors in May with its announcement of some significant structural changes. AT&T's WarnerMedia business will combine with Discovery Inc. (DISCA) in an all-stock deal. The combined entity will be spun off into a separate company with current AT&T shareholders owning about 71% and Discovery shareholders owning the rest. The deal will bring together many well-known names including HBO, Warner Bros, Discovery, CNN, HGTV, Food Network and others. But the spin-off was surprising. AT&T purchased the assets of Time Warner not too long ago in 2018 and added to its significant debt load to do so. AT&T has also been bogged down by its extremely overpriced purchase of DirecTV in 2015, with a spin-off of those assets expected to be completed in the second half of this year. After these previous purchases are unwound, the remaining AT&T company will be focused on telephone and broadband internet.

For a long time, AT&T has been a reliable dividend growth holding for investors. The company has generally provided an income yield well above that of a typical stock with a current yield over 7%. Additionally, the company had raised its dividend every year for over 30 years, earning its place as a Dividend Aristocrat (an S&P 500 Index stock that has raised its dividend every year for 25+ years). But now AT&T has not increased its dividend in over a year, mainly due to the increased debt load from its previous acquisitions of DirecTV and WarnerMedia, as well as the recent large purchase of band width during the FCC's last 5G spectrum auction. It was becoming clear that AT&T would struggle to continue raising the dividend given the capital expenses required to maintain a strong position in the wireless world and service its sizable debt load. As part of the recent announcement, AT&T also noted that the dividend will be cut once the spin-off is complete, making it less appealing for us as dividend growth investors.

What does this mean for us and our holdings? Many investors are excited about the spin-off while many dividend investors are disappointed at the upcoming dividend cut. While AT&T's stock price did fall a bit on the news, the impact on the stock price has not been that significant one way or the other. Our average client holdings remain around their cost basis, meaning that the current price is about in line with what we originally paid for the stock. Meanwhile we have been earning a 7%+ dividend along the way. While the total performance lags the market in recent years, the steady cash flow provided by the dividend since we have owned it and the resilience of the stock price has helped us out quite a bit. While AT&T stock has not worked out as well as we had hoped, the result has been far from a disaster for shareholders.

Now that we have had some time to digest the news and review the facts, we find that we are not particularly excited or upset about it. Rather, we find our confidence in AT&T is fading as the company seems to lack a clear direction for the future after its media assets are spun off. A dividend cut, even one that is announced a full year in advance, is always disappointing. In the case of AT&T it will be nearly impossible to replace the 7%+ income yield that our clients have been earning from the holding, as the S&P 500 now yields less than 1.5%. Putting it all together we have difficulty believing that there will be any great catalyst for AT&T stock for the next year or so until the spin-off is complete. It seems quite possible that AT&T stock may trade in its own narrow bubble around the current price without too much influence from the rest of the stock market. We have begun unwinding our holdings in AT&T as we are able to find new opportunities to buy. Recent purchases have included defense contractors Lockheed Martin and General Dynamics as well as pharmaceutical company Merck. All have promising fundamentals but, like AT&T have not performed well over the past year. Even in the current hot market we are still able to find a few reasonable values out there that we believe will perform over the next several years. These stocks have not yet made it onto our top twenty list, though they may get there in coming months.

Summary and Conclusion:

There are many crosswinds at work today in both the economy and the financial markets. Most of these are the result of reactions to the pandemic caused by the corona virus.

With the shutdown of the economy last year, unprecedented action was undertaken including the extraordinary economic recovery packages and actions by the Federal Reserve to be sure that the deficit spending incurred could be financed with as little disruption as possible. Aggregate growth in the U.S. money supply was very high.

We are now in recovery mode which generally calls for different actions but not much has changed. The current administration in Washington is continuing with proposals for ongoing large deficits, which are stimulative but normally tapering off at this point in the cycle while at the same time they are discussing higher personal and business taxes. If enacted, tax hikes would be a drag on strong growth at a time when we will probably want more of it.

While all this has been happening, the stock and bond markets have apparently been oblivious to the challenges all this poses to future growth and stability. Low bond yields have not only made financing the deficits in Federal spending relatively inexpensive but have also been one of the main props under the stock market and its high valuations.

Given all of this, the future is even more difficult to predict than usual. However, we do believe that adjustments in the financial markets will happen and probably be beyond the control of the Federal Reserve Bank.

Our conclusion from all of the above is not much changed from the first quarter. We are further advanced in our recovery from the pandemic induced slow down but both the stock and bond markets have moved higher.

Higher inflation and its ongoing threat to the high valuations that seem to be the norm today have apparently been offset by very robust earnings reports, at least so far. The big challenges will come when earnings growth slows and inflation begins to have a larger impact psychologically as well as physically. Nevertheless, and despite all the issues faced over the past year, 2021 would be a substantial winner for the stock market if the books were closed out today.

Sincerely,

Loudon Investment Management LLC

DML,ELS,JJS,LRO