LOUDON
INVESTMENT MANAGEMENT

October 13, 2021

Memo to Clients and Friends:

Re: Q3 Review

Over the month of September, the stock market declined more than 3%. Given all that's been happening, both politically and economically, we were lucky it wasn't more. In spite of this, the stock market was relatively flat for the quarter and continues to show above average returns for the year to date.

Benchmark Index Total Returns	Quarter Ending 9/30/2021	Year to Date 9/30/2021
Lipper Balanced Fund Index	-0.4%	8.3%
S&P Dividend Aristocrats	-1.8%	12.8%
S&P 500 Stock Index	0.6%	15.9%
Russell 1000 Value Index	-0.8%	16.1%
3-month US Treas. Bill Index	0.0%	0.04%
S&P 7-10-Year-US Treas. Bond Index	0.0%	-3.4%
S&P U.S. Gov & Corporate 30 Year Bond Index	0.4%	-8.8%

Overall, looking at the numbers above, the quarter appears to have been quite benign following a strong first half. But, of course, there was a lot going on.

The Debt Limit, Reconciliation, The Price of Oil, Covid, Inflation, Etc.

And the above doesn't mention Afghanistan or China. But mixing in foreign policy with politics and economics produces a level of confusion about almost everything that hasn't existed for some time. It is difficult to tell which started it all. No wonder the market moved lower in the second half of the quarter, and September in particular.

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Historically, September has been the worst month of the year for the stock market so we shouldn't have been surprised.

Covid, of course, seems to have been the source of all evil but the Afghanistan withdrawal seems to have kicked off the most recent round of dissatisfaction, and it also played a large role in reducing President Biden's approval ratings which, fair or not, makes getting anything done more difficult. The honeymoon period following the election clearly ended several months ago, though the quarter started well enough with the senate approval of the bi-partisan infrastructure bill.

Though massive in historic terms at $1.5 Trillion, it seems small relative to the $3.5 Trillion "human" infrastructure bill subsequently pushed by the House. And according to Bernie Sanders, now Chair of the Senate Budget Committee, this itself was a compromise as they really were shooting for $6 Trillion.

While all of this was going on, the Federal Reserve began to mumble that its talk on "temporary" inflation may have been somewhat premature as some of it was proving to be somewhat stickier than originally anticipated due to a number of factors. The previously smooth working global supply chain that was disrupted to due to the Covid virus was proving more difficult than anticipated to get working again resulting in a number of disruptions in getting goods to market. And with a less friendly attitude toward drilling and transport in the U.S., crude oil was moving toward tightness at the same time OPEC decided not to increase supply to offset higher energy prices. Finally, not all workers who were on higher-than-normal unemployment benefits during the Covid crisis and not working were anxious to immediately start working again, at least without higher wages as an incentive and some relaxation of Covid restrictions.

Finally, on top of all of the above, there was the question of increasing the aggregate amount of debt that the U.S. can borrow to pay its ever-growing and aggregating deficits. This is a dance that is initiated periodically, typically by the party out of power to create discomfort for the opposition.

As the Democrats are trying to pass very large and expansive pieces of legislation, the Republicans are using the debt limit to put a brake on these plans. The problem is that the Dems need to do two things at once: pass their legislative agenda while also bumping up against the debt limit. Aside from disagreements within the Democratic party, either of these can be done but probably not both given their narrow legislative majority.

Once a year (but only once a year) spending bills can be passed through a process called reconciliation. Reconciliation bypasses the normal legislative process by disallowing the filibuster, so fiscally related bills can pass by a simple majority vote. Originally Democrats had hoped to tie all of these matters into one bill that could be passed to resolve all these issues. But that proved not to be possible according to the rules. So now they are stuck with two items they would like to reconcile but only one opportunity to do it this fiscal year. This has given the Republicans an unusual amount of legislative power and, of course, the Democrats don't like it.

Republicans have agreed to temporarily postpone the debt crises by extending government funding, but only by two months, so this will all come up again before the end of the year. And with several Senate

Democrats in addition to all the Republicans objecting to the size of the Human Infrastructure Bill, it remains to be seen what will happen on that front.

Meanwhile, in the background, the Federal Reserve Bank continues to watch inflation and may shortly start to become less generous with the funds they have been pumping into the economy. Stay tuned as the fourth quarter could become even more exciting than the last before the year is up.

If all of the above seems pessimistic in terms of probable resolution, it shouldn't. Legislative impasses have happened before and are not unusual. The debt limit, however uncomfortable currently, will be resolved prior to year-end as it must and looking back six months from now, all of this will probably seem a distant memory.

A slimmed down human infrastructure bill will probably pass, and the government will continue to function. What will happen on the tax front will likely have a lot more impact than the programs that remain in the bill. As always, the financial markets will also continue to function though at what level is difficult to tell at this point as so much is in flux. However, it is important to remember that this is just one short period in a continuum. Eventually this will all work itself out and we continue to believe that the U.S. will continue to be the best place in the world to live and invest.

Top Holdings

The third quarter saw greater than usual turnover on our top twenty list, as AT&T, Aflac and Cardinal Health were replaced by newcomers Merck, Lockheed Martin, and Bank of New York Mellon. Our current twenty largest holdings list is as follows:

3M Company	Illinois Tool Works Inc.
AbbVie Inc.	Lockheed Martin Corp
Ameriprise Financial	Lowe's Companies, Inc.
Amgen Inc.	Merck & Company, Inc.
Archer Daniels Midland	Microsoft Corporation
Bank of New York Mellon Corp	Polaris Industries Inc.
Caterpillar, Inc.	Qualcomm Inc.
Cisco Systems, Inc.	SPDR Technology Sector ETF
Enterprise Products Partners L.P.	Starbucks Corporation
Fastenal Company	United Parcel Service, Inc.

The additions are all new holdings we have been actively buying in 2021. All represent high quality companies and industries that, at time of purchase, had lagged behind the stock market over the previous year, including the Covid recovery.

Perhaps the most interesting of our new holdings is Merck. Pharmaceutical companies have lagged the market over the past year, and Merck with its focus on oncology and diabetes drugs was no exception. While drug companies do generally come with some added risk due to the somewhat constant threat of regulation, we believe there are some great opportunities in the sector right now. Merck stock has been up very recently on the news that its new oral antiviral medicine, Molnupiravir, greatly reduced the risk of hospitalization or death in a Phase 3 study of Covid patients with mild to moderate symptoms, and no patient receiving the drug died compared with eight in the placebo group. This is a great piece of news for the company as well as the general ongoing fight against covid, though it did not play a major role in our logic for purchasing the stock. Merck's dividend yield of around 3.5% at the time of purchase provides a solid income stream that is well above its historical average, and the company's financial strength is one of the best in the industry. We aren't sure what the immediate future holds, but it looks a little brighter with a possible Covid treatment on the horizon. Looking out over the next 5-10 years and considering the aging population in the U.S., this is a company we will gladly hold for the foreseeable future.

Next up, Bank of New York Mellon is the largest custody bank in the world, offering investment management and services in over 35 countries. BNY Mellon is an extremely high-quality bank trading at below average prices with a solid dividend yield of around 2.5% that was recently increased 10%. Expectations for the company are relatively modest, giving it a very reasonable hurdle to reaching above market returns. Also, BNY Mellon is in a good position to benefit from a potential rise in interest rates (and, perhaps, inflation), which could help to boost returns over the next several years. Higher inflation and interest rates would very likely be a drag on the average stock, but banks are generally able to increase their revenues as interest rates rise. This gives them a cushion compared with other industries. While this fact is already reflected in the prices of most of the highest quality banks, BNY Mellon is trading at a reasonable price and we have continued adding to the stock since our initial purchases in February.

Lockheed Martin is the largest defense contractor in the world, and we believe it is also the highest quality company of the group. The company has dominated the Western market for fighter aircraft for decades since winning the F-35 program in 2001. While the industry is inherently political, there is a great amount of stability in Lockheed's business. While the stock has lagged the market at least partly due to concerns about threats to the U.S. defense budget, the company historically has been able to deliver solid and stable returns no matter whether the Democrats or Republicans are in power, and it is well seasoned in the political challenges that lie ahead. Meanwhile, the F-35 program, which comprises nearly a third of its revenues, is under contract through 2070. With a 3.2% dividend yield and trading at a very reasonable 12 times earnings, Lockheed Martin is a rare bargain in a heated market.

Moving to the companies that have dropped from our top twenty list, as noted in our June letter, we have continued to trim AT&T after the news of its media combination with Discovery Inc. and subsequent spin-off. We don't expect there to be much of any catalyst for the stock until the deal is complete. Meanwhile, as we discussed in our last letter, we continue to unwind the position as opportunities arise in other areas.

Aflac is a company we have purchased and trimmed several times over the past ten years, and by all measures it has been an extremely successful holding, including outpacing the market year to date. Though best known in the U.S. for the Aflac duck in TV ads selling their disability insurance, their largest business is specialized cancer insurance sold in Japan.

This unusual mix of business ebbs and flows and is also subject to the vagaries of the yen/dollar currency relationship. As a result, the stock price, along with earnings often makes large moves, not always related to each other. Earnings were strong last year but are expected to slow considerably next year

and as a result, we took advantage of a strong performance by the stock to move some of the invested funds elsewhere.

Because Aflac remains fundamentally a very strong company with an excellent record of dividend growth, we were in no hurry to clear it from all accounts. But it is a company we periodically consider for sale to make room for some newer names with greater potential.

Last, pharmaceutical and medical product distributor Cardinal Health has dropped from our top twenty based on poor stock performance over the past quarter. The stock fell in August after it severely missed earnings expectations, and it has yet to recover. The earnings miss was largely due to an accounting adjustment due to the pandemic (as well as some pre-pandemic issues) rather than fundamental issues, while revenues continued to grow as expected.

Still, investors generally do not like surprises, and this one was disappointing as Cardinal Health didn't provide much guidance to prepare investors for the miss. In addition, along with other drug distributors, they continue to deal with lawsuits related to opioid distribution. Nevertheless, Cardinal Health remains a solid company and we believe the stock price was overly punished for its disappointing results. We're willing to have a little patience for the time being though it is a company we continue to watch closely.

Conclusion

A correction in the stock market has now been predicted for probably three years running, but so far nothing has happened since the brief downturn due to Covid last fall was quickly erased. While we can't say with any certainty if or when a correction will occur, there are several indications that we may be closer to this happening.

If the strong growth in the economy continues as Covid diminishes, and especially if that growth leads to continued inflation, some tightening by the Fed resulting in higher interest rates is virtually certain. As the stock market is priced for low interest rates, higher interest rates should be expected to put negative pressure on the stock market, and we would fully expect the stock market to retreat to some extent if rates increase. This is particularly true for higher growth stocks which are more dependent on future earnings, as those future earnings would then be worth less.

Additionally, this year's recovery in earnings following last year's Covid forced debacle has led to some very good year over year earnings growth in percentage terms. These percentage increases are unlikely to be matched in 2022. Meanwhile, increasing raw material prices for manufacturers and continuing disruptions in the supply chain could put additional pressure on earnings for many companies going forward, and there are indications that there may be a shortage of at least some goods for the Christmas season which could lead to lost sales that can't be recovered.

The best-case scenario would be an economy that continues to grow, but not too fast, with current supply chain issues able work themselves out over time. Future price increases (i.e., inflation) would calm down as the imbalance between supply and demand works its way through the system in industries like energy and real estate, and the backup of container ships stuck off the coast of California and elsewhere would slowly unwind. Those who have been sidelined from work for one reason or another due to Covid would return, especially in industries where they are sorely needed – driving trucks or working in restaurants, retail, and construction.

Like the legislative issues mentioned at the end of the first section of this review, it is important to remember that one way or another all of this will eventually pass. The major advantage of the U.S. system is its ability to adjust to change and come out the other side even stronger than it entered a period such as we are now experiencing.

On the good news front, as noted in our largest holdings, we do continue to find attractive holdings to add to our portfolios. Though as longer-term investors, we fully expect to hold on to these for a much longer time than the next three months.

At a minimum, this quarter should be interesting. But while we may be skeptical in the short run there is no reason not to continue to be optimistic within those portfolios that are properly positioned for the longer term.

Sincerely,

Loudon Investment Management LLC.

DML/ELS/JJS/LRO