January 18, 2022

Memo to clients and friends:

Re: Q4 Review

The year 2021 was another boomer for the stock market. The S&P 500 returned about 29% while the Dow Jones Industrial Average was up 21% including income. As this was the third year in a row of 20% + returns for the S&P, a large number of commentators are wondering how much longer the bull market can go on. Count us among the skeptics.

Though they had positive returns in the last quarter, bonds did not fare well for the year and money market funds returned less than one half of one percent.

<u>Benchmark Index Total Returns</u>	Quarter Ending 12/31/2021	Year Ending 12/31/2021
Lipper Balanced Fund Index	4.5%	13.2%
S&P Dividend Aristocrats	11.7%	26.0%
S&P 500 Stock Index	11.0%	28.7%
Russell 1000 Value Index	7.8%	25.2%
3 month US Treas. Bill Index	0.0%	0.1%
S&P 7-10-Year-US Treas. Bond Index	0.2%	-3.2%
S&P U.S. Gov & Corporate 30 Year Bond Index	4.1%	-5.0%

Ultimately, the financial markets reflect what is going on in the U.S. and global economies. Over the past three years the S&P 500 has returned about 26% annually. But we know that neither the real economy nor corporate earnings have grown nearly as fast. This discrepancy between the real world and the stock market is what eventually leads to overvaluation and corrections to bring things back in line.

Another part of the equation is the level of interest rates. Interest rates today, like stocks, don't seem to fully reflect reality. With interest rates for five-year maturity U.S. Treasury bonds and notes now yielding about 1.5%, the expected interest and principal at maturity are losing ground against inflation – the purchasing power of the principal invested will buy less when it is redeemed than it will today. With interest rates so low, it is not surprising that a huge amount of money has fled to the stock market and, in fact, most of our equities provide more annual income than even twenty-year maturity U.S. Treasury securities.

But the stock market can be fickle and irrational in the short run as psychology also plays a role in where common stocks are selling. With last year's stock market up some 29%, logic suggests that people should become more cautious because of the higher prices. But in fact, they often become more optimistic as seeing the value of their investments rise feels so good that they want to buy more common stocks so they can feel even better.

To us, all of this suggests an increasing amount of risk has been built into financial markets versus what existed a year ago. A few of the most prominent risk factors are listed below:

Inflation: A year ago, inflation wasn't on anyone's mind, except as something to be concerned about somewhere out in the future. Inflation projections ranged around 2% for 2021. Now inflation is running at about a 7% rate, a huge increase from what was expected. Though some of inflation is related to supply shortages caused by Covid, attendant labor shortages and a resulting inability to move goods as quickly as we could a year ago, much of it has been building for some time. The combination of Covid related government stimulus and the willingness of the Federal Reserve to continue to pump money into the financial system has outrun our ability to get goods to the shelves for consumer buying. Higher prices (inflation) is the process by which a shortage of goods is rationed to buyers.

It will take an incredible job by the Fed and the Government to get out of this fix unscathed. Historically it is a rare event when they are able to do this. Generally, they overshoot and the result is a slowdown in economic activity if not a recession.

Stock Market: As mentioned above, the stock market is driven by both tangible items (earnings growth) and intangible forces (the psychological or how investors feel). The combination of these two factors has led to the stock market returning in excess of 16% annually over the past ten years. This is far more than the previous historic rate of about 10% and in some ways was justified. Earnings grew rapidly as internet related technological innovation accelerated and low-cost money provided lots of liquidity for financing. The result was a strong rise in the stock market further stimulated by a growing belief that this time things truly were "different" than they had been in the past. This along with declining or low interest rates led to a rapid rise in the stock market beyond that supported by higher earnings. Today, a dollar of earnings is being valued in the stock market over 50% higher than its historic rate before the current era began – Using the price earnings ratio as a measure of value, stocks today are valued at about 23 times earnings versus 15 times before all this began.

To maintain this level of valuation, we will have to have the next ten years prove similar to the past decade. We think this is unlikely. For one thing, the decline in interest rates, a primary factor in returns, is now behind us. In fact, with inflation where it is or even half what it is today, interest rates are likely to increase. If they rise too much, they will impact corporate profits and some portion of the gains of the past decade will start to be realized and moved back to much "safer" bonds. This is where some of the money came from to push the stock market higher in the first place. We believe there are a number of portfolios that are now "overinvested" in stocks as many investors decided higher yielding equities were a better value than more stable bonds and money funds. The downward volatility that happens when the economy slows down can become too painful and many will probably sell at the wrong time (after some price declines) pushing the market even lower.

Economic Growth: With a few minor interruptions, growth has been very strong over the last decade for the reasons discussed above. Innovation and corporate growth will continue but we are unlikely to find a new equivalent of the internet in the near future. And without that, it is likely that economic growth will revert to its previous pace going forward. If inflation continues at its current pace, it is likely that "real" economic growth could turn negative sometime this year even as reported numbers push higher (as we think they will). Should that happen, it would be another negative psychological factor raising questions for the stock market.

Labor shortages: With a push from Covid, the great demographic force of the baby boomers is leaving the work force at an accelerated rate, not likely to return. This cohort had a great economic and social impact as they entered the labor market after World War ll, and they will continue to be a force going forward as they leave. Covid has accelerated this movement and with a long-term decline in the birth rate continuing, the odds are likelier than ever that a chronic labor shortage will materialize. The $15 an hour minimum is here to stay as it continues to spread across the U.S. and Unions may regain more of their former political strength. At a minimum, labor shortages and continued supply chain disruptions will continue to be a drag on growth this year and next, and the price of labor will continue to rise.

Covid: Covid and the pandemic have been referred to in most of the above and it continues to have an impact on nearly everything. While we all hope that the Omicron variant is the last we will see, that is highly unlikely. It is entirely possible that future variants will continue to produce milder symptoms and become increasingly "manageable". But suppose that does not happen and the next variant (or another Delta variant) produces different or more serious symptoms? We are not predicting this, but it appears that the financial markets and economic growth projections aren't taking this into account at all.

You might draw a conclusion from all of the above that we are generally negative in our outlook - skeptical of the existing positive consensus is probably a better description of our outlook. It just seems to us that risks to a positive aggregate stock market outcome over the next year or two are high. Said differently, a very large number of factors need to tilt the right way for the bull market to continue.

The management of these risks as reflected in what we own is key to how we select our common stocks. Basically, we have long pushed our equity selections toward companies most able to withstand these risks – those with deep reservoirs of financial strength paying reasonable dividends purchased for the long term when we believe price risk is relatively low. The result is portfolios that may lag somewhat in ebullient times but hold up much better during market declines.

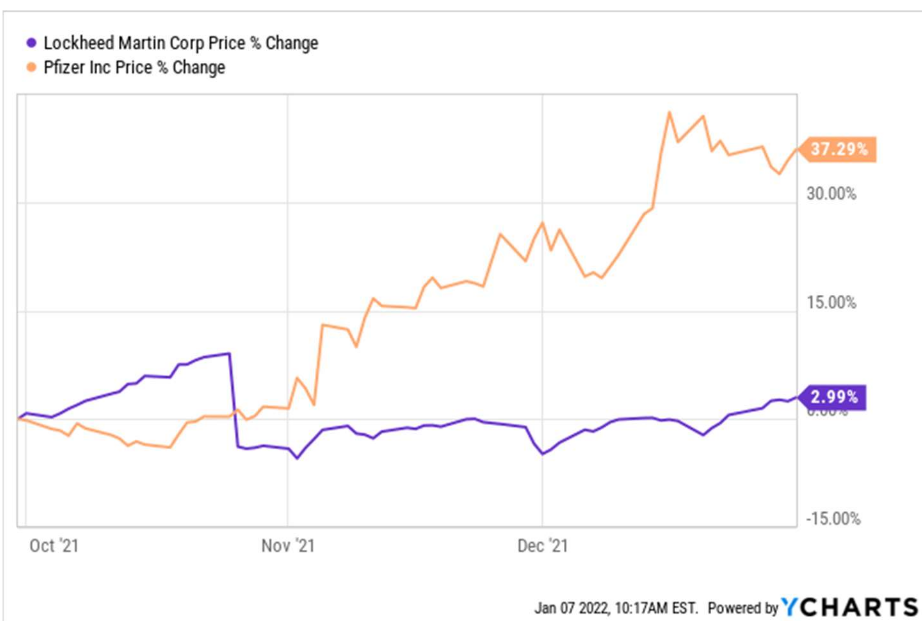
One thing your investments have in your favor is our emphasis on the long term. Whatever may happen this year or next, we retain our positive five-year outlook – at the end of that period, common stocks will continue to have been the best place to invest your money, whatever downs and ups we may experience along the way.

Top 20 Holdings

Our current Top 20 Client Holdings are 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 last quarter did not see much turnover in portfolios. However, recent newcomer Lockheed Martin was replaced by Pfizer because of relative performance. This can be seen very clearly from the chart below, as Pfizer (leader in Covid vaccinations and antiviral medications) was up over 35% for the quarter while Lockheed was relatively flat (probably reflecting a no growth defense budget even as earnings continue to rise):



Pfizer was up on the news that its Covid therapeutic drug, Paxlovid, appears to be more effective than Merck's therapeutic, with an even better safety profile. As was widely expected, the FDA authorized Paxlovid in late December. The good news is that it provides a treatment that can be taken at home for high-risk individuals before they get sick enough to be hospitalized, and at least so far, the pill appears to be highly effective against newer variants including Omicron. Pfizer's updated results indicated that

its five-day treatment plan cut the risk of hospitalization or death by nearly 90% if given within a few days of a patient's first symptoms. President Biden has pledged to secure enough supply for the American people so that the treatment is accessible and free, though it will take some time to build up supply. The Biden administration recently doubled its order to 20 million courses of treatment, with some 4 million treatment courses expected to be available by the end of January and 10 million by June, a few months sooner than expected though it will still take several months before demand can be satisfied. Still, this is great news as therapeutics could be the light at the end of the tunnel in providing a potential offramp for the pandemic in months to come.

The fourth quarter also saw a substantial turnaround in some sectors of the market. The FAANGs in particular, which have dominated the market in both size and performance for a number of years, lagged behind quite a bit. The FAANGs consist of Facebook (now Meta Platforms), Amazon, Apple, Netflix and Google (now Alphabet). While the S&P500 returned 11% for the quarter, only one of the FAANGs outperformed (Apple returned 26%) while three (Meta, Amazon, and Netflix) had negative returns. Rising interest rates nearly always have a large impact on the highest valued securities.

Meanwhile, many dividend-paying, value-oriented stocks like those we like to own have performed much better of late. Several of our top holdings including AbbVie, Fastenal, Lowes, Pfizer, and Qualcomm all returned over 20% in the fourth quarter, well ahead of the market, and only Polaris was negative (we continue to buy on weakness). In better news, the winners spanned a range of industries rather than being concentrated in just one or two (technology and finance last year). On average our top twenty holdings returned just over 15% for the quarter. We try not to read too much into short-term trends. But while growth has led the market for the last several years, dominated by the FAANGs in particular, it seems quite possible that a longer-term shift back towards value stocks could be on the horizon. This shift could be accelerated by interest rate increases that are expected in 2022, as rising rates tend to favor value stocks.

Conclusion

Over the next several years financial market volatility will return as there is likely to be friction between all of the factors discussed in this letter. Earnings growth will be strong in the first half of the year but the growth rate will decelerate in the 3rd and 4th quarters. Interest rates will likely rise as a result of both higher inflation itself and the Federal Reserve trying to bring it back under control through tighter money than has existed over the past ten years. The trick is for the Fed to get it just right without slowing growth so much that we tip into recession, a tough proposition.

Covid has obviously had a major impact over the past several years on most activities. The slowdown in general economic growth it created is probably why inflation has stayed under control for most of this period. We do not believe it is going away, so we need to find a way to live with it going forward. Most interesting will be to watch to see if the changes we have seen because of Covid will have a permanent impact on how we work and live our lives.

We wish everyone a satisfying and happy 2022 and want you to know that we very much appreciate your loyalty and your business. If you have friends that you believe would benefit from our lower risk approach to equity investing, we are always happy to talk to them. Let’s all hope for a return to some degree of normalcy this year as we learn to live with Covid.

Sincerely,

Loudon Investment Management LLC

DML/ELS/JJS/LRO