Sound Investments Inc.

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Summary

The market is responding to an economic slowdown and the continuation of the housing slump. Also, banks continue to face large write offs of bad loans. High energy prices and commodity prices continue to boost inflation concerns and the employment data is weakening.

When the major concerns are considered, **<u>the financial markets have performed reasonably well.</u>** That said, it will be important for the market to find a base near recent lows. Looking ahead, the most recent action by the Fed and the restoration of liquidity in the bond and mortgage market should act to stabilize and provide a base for the markets. This should help a sustainable rally in the months ahead.

We think there is a good case for reinvesting and staying the course based on lower stock prices, low interest rates, insiders are buying, investor sentiment is pessimistic and the federal reserve is doing all it can to ease the ongoing credit crunch.

Agricultural and Materials sectors continue to lead as global demand remains strong. Conversely, Financials and Consumer Discretionary groups were in negative territory … obvious victims of the mounting housing and credit troubles. Overall this market favors stocks that thrive in the late–stages of the economic expansion.

The Investment Letter is mailed quarterly to our clients and friends. The intent of this publication is to share some of our more interesting views and research with our clients.

<u>Quarterly Report … Looking for a Rally</u>

After a dreary winter and the worst first quarter in six years we are all eager for signs of life from the markets. I am not sure I want to recap it, but here are the results:

	3 months	1 year	3 years
Dow Jones Industrials	-7.6%	-1.5%	7.8%
S&P 500	-9.47%	-5.15%	10.8%
Nasdaq	-14.0%	-6.5%	7.1%

The average diversified U.S. Stock fund ended the quarter down 10%. For the most part we have done considerably better either by going to cash or by upgrading to better investments.

There will be more reports of:

- Foreclosures and personal bankruptcies
- Corporate write downs
- Layoffs and declining house prices
- Companies will be unable to roll over their short term debt and either fail or merge.
- Consumer spending will fall further
- Consumer confidence currently at a 35 year low and isn't likely to recover soon.

For most economists and investors, recession is no longer a question of when, but how long. We think it will be a shallow recession, but with a longer period of recovery.

We come to this view of a <u>shallow, but longer recovery period</u> for the following reasons:

1. Interest rates: The Fed has cut rates to 2.25% which is widely seen as necessary to support the broader economy, but they also made life tougher for the dollar. The U.S. dollar fell yet again in the first quarter, down 7.5% against the Euro and 10.5% against the Yen. In a strange way this will help stabilize the markets. Let me explain, in 2000 the dollar and Euro were equal in value but now the Euro is worth 50% more. This means it cost an European 50% less to invest in the U.S. This tends to support stock prices here since an European Company can buy an American Company at a lower price in their currency.
2. Accommodating Central Bank: The Federal Reserve Bank appears willing to do whatever it can do to stabilize the credit and financial markets and so far seems to be succeeding.

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The new chairman, Ben Bernanke, recognizes the problem and has found ways to handle a major bank failure (Bear Sterns). The Treasure Secretary, Paulson, has changed bank regulations so that stock brokerage companies, like Merrill Lynch and Morgan Stanley, have similar accounting rules of when and how to account for a bad debt. Time will tell but they appear to be on top of the problem.

3. Little manufacturing overhang: Excess inventory has been a major factor in past recessions as businesses are caught off guard and have to reduce production even more to get rid the old inventory.
4. Limited overhang elsewhere: Parallel to inventories, there isn't an overhang with excess labor as there usually is at the peak.
5. <u>Split economy: As I write this, 1st quarter earnings are beginning to roll in, and a stark picture of an economy on two tracks is emeraging. Banks and Companies that sell directly to the public are having a tough time as consumers grapple with a slowing econmy and falling house prices. However, many big companies that sell to other companies or to customers abroad are proving to be resilient. Earnings, excluding financial companies are up 8.2% so far, which is great news</u>.
6. With exception of banks, many businesses have strong balance sheets with lots of cash to invest and to weather this storm
7. Exports: Due to the lower dollar, exports have grown at a steady pace of 8% for 3 years now while import growth has begun to contract.

The market leads the economy. It is an anticipatory mechanism. It is less concerned with what is happening today than what will happen in 6 months or more from now what this means is the market will turn before there is solid evidence that the economy is recovering or before we are free from worry about problems in the financial sector. Most likely the recession will end <u>after the election</u>, but by then the market will have turned.

When the market does turn it usually records the biggest gains early on.

I think we have to look at the long view we have seen all this before, whether its bubbles, panics or collapses. And yet, somehow the world adapts. It also shows that whatever we are seeing today is not going to be the same in 10 years. For instance in the late 1990's we had the technology bubble. Change is inevitable and we have to adapt with it.

There is an old saying," you should be fearful, when others are greedy and greedy when others are fearful." Clearly folks are fearful now so should we be greedy now? The downward trend is still intact, but there are distressed assets for sale that make sense.

When the major concerns are considered, the financial markets have performed reasonably well. That said, it will be important for the market to find a base near recent lows. Looking ahead the most recent action by the Fed and the restoration of liquidity in the bond and mortgage market should act to stabilize and provide a base for the markets. This should help a sustainable rally in the months ahead.

Areas we think can do well are Agricultural, Energy and Materials. There will be a real case for buying distressed assets in such as corporate high yield bonds, retailers, banks and other beaten down sectors over the next several months.

<u>Conclusion</u>

It will take some time to recover from one of the worst credit excesses in U.S. History. We think there is a good case for reinvesting and staying the course based on lower stock prices, low interest rates, insiders are buying, investor sentiment is pessimistic and the federal reserve is doing all it can to ease the ongoing credit crunch.

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