# Sound Investments Inc.

Kenneth A. Gilpin CFP

2nd Quarter 2008

**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.

Overall the 2nd half may not differ too much from the first six months with possible faster growth in the 3rd quarter then slowing from Oct. to Dec. period, as the stimulus effect wears off. We see a moderate fall off in housing, and continuing but somewhat less turmoil in the credit markets.

In summary, our stock market forecast is based on the stabilization or decline of oil prices. If oil prices stop rising or decline low short term interest rates have the potential to provide the stimulus for improved economic growth next year. In the event oil prices continue to rise, the economic recovery process will be delayed and the stock market will continue to struggle due to the impact of rising energy prices have on consumer spending and corporate profits.

.

*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.*

## Quarterly Report … June Swoon

As we stated in our 1st quarter report, there will be a great deal of news on foreclosures, declining house prices and Banks unable to roll over their short term debt and fall or merge. As I write this, IndyMac Bancorp was just taken over by the FDIC and the future of 2 large mortgage giants Fannie Mae and Freddie Mac are being actively debated in congress. To top it all off, The Federal Reserve Chairman, Ben Bernanke, told Congress the economy is facing "numerous difficulties" including persistent strains in the financial markets, rising unemployment and housing problems – despite the Fed's aggressive interest rate reduction.

The average diversified U.S. Stock fund is down over 11% since the beginning of the year. For the most part we have done considerably better either by going to cash or by upgrading to better investments.

Jim Dimon, the head of J.P. Morgan, said the future of the U.S. economy is bright but more short-term suffering is ahead. He said commercial banks, regional banks and jobs for the average American will be the next areas to experience significant stress.

## Where We are Now: Just the Facts!

May's industrial production declined .2%. Capacity utilization continues to recede with the latest figures at 79.4%, close to a 3 year low. Housing starts at 975,000 per year is close to the area of housing recession's bottoms over the past 4 decades.

New job figures are expected to remain soft for the balance of the year. Although the number of jobs losses has been less when compared to past periods of weakness, employers are reluctant to add to payrolls until they see meaningful improvement in the economy. Declining capacity utilization does not argue well for additional hiring. The index of leading economic indicators has risen by .1% in each of the past 3 months suggesting that signs of a meaningful recovery have yet to appear.

Exports, fueled by a low dollar, continue to be the one bright spot. Strong export sales provide jobs which serves to partially offset weakness in the housing and auto sectors.

The Federal Funds rate is expected to remain at 2% or they may increase it by a token amount of ¼ just to show the world they are

serious about fighting inflation. Lower short term rates can help the economy in a high cost energy environment.

The price of oil is the wild card in our stock market forecast. Iran's nuclear ambitions pose a potential risk to Middle East oil production. Continued oil price escalation would bring consumer spending power under increased pressure. High energy prices act as a tax on the consumers, and this taxing effect reduces economic growth potential. In the event oil prices continue to rise consumers and the stock market will be held hostage to the price to the cost of energy. This would provide a strong headwind against the economic recovery process. If oil prices stabilize or decline from current levels, we believe the stock prices can make progress into 2009.

The June 30th closing of he S&P 500 index price of 1280 represents a price / earnings ratio of 14.7 times the earnings estimate of $87. Normally these earnings would be valued at 16.5 to 17 times bringing the S&P 500 Index into the 1400 range. In order to get there it will require stabilization or declining oil prices. Favorable news on reducing tariffs on world trade would also help.

## Closer to a Bottom than a Top

Market declines are normal. Over the long term Stocks have provided excellent returns. Equities have managed to keep pace with inflation over time, where as bonds for all their ability to buffer a portfolio, have not offered much protection against eroding purchasing power. However, the price we pay for strong long term performance is market volatility. Stock prices simply do not move in a straight line.

Based on historical stock market action, investors should expect to see declines of 5-10% quite regularly and should expect severe declines every few years. The S&P 500 index has suffered falls of at least 20% on 9 separate occasions in the last 50 years. Since 1900 the Dow has declined 20%, entering the "bear territory" 31 times or about once every 3 years. Is it pleasant? No, but smart investors stay put and maintain a long term focus.

Equity investors typically get paid high returns after periods of sharp losses. The sellers of stocks feel anxious and this how prices get depressed. The worst time to abandon investment discipline is often when sentiment is at the lowest and media reports are most pessimistic.

## Breaking News

As I write this the market broke below 11,000 on the Dow Jones index and appeared to want to test a major support level of 10,700 however, we finally had a break in the oil price and had some good earnings from Wells Fargo on Tuesday morning. It resulted in a strong rally with the Dow up 396 points for the week to close at 11,497. It was a spirit change of character spurred on by a very oversold condition of the market. Nobody knows the future, but based slower earnings, and rising inflation and interest rates we believe this is a bear market rally which in the 2002 recession rallies lasted on average 22 days.

# Conclusion

In summary, our stock market forecast is based on the stabilization or decline of oil prices. If oil prices stop rising or decline low short term interest rates have the potential to provide the stimulus for improved economic growth next year. In the event oil prices continue to rise, the economic recovery process will be delayed and the stock market will continue to struggle due to the impact of rising energy prices have on consumer spending and corporate profits.