Sound Investments Inc.

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Summary

It's tough to say when markets will bottom but unless the world is entering an economic depression, history suggest that stocks don't have too much further to fall. Save for the 1929-1932 crash, no down turn in the 20th century exceeded 50%. One of the many ironies about this years set back is the way that it was largely unanticipated because the major stock market averges began 2008 selling for a seemingly modest 16 to 17 projected earnings.

So far, there have been four days when the S&P 500 closed below 845; Nov 19th (806), Nov 20th (752), Nov 21st (800) and Dec 1st (816). We wonder if the 750 to 850 range is the final bottom for this bear market. Nobody knows but a test of this 750 to 850 range on **reduce volume would be a positive development**

The worst of the business reversal may be over. We may see a further 2 to 4% contraction in the opening half and then edge forward very tepidly in the 2nd half of 2009. Assuming Wall Street follows it''s usual pattern of anticipating turns by 6 months the market could be near a low. That said, one year ago in our quarterly report, we said "In a nutshell, I don't think 2008 is going to be all that great for stock prices." We feel a touch more optimistic entering this New Year.

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.

A Short Review of 2008

There was almost no place to hide from the crash of 2008. Nearly every invesment class declined dramatically as markets around the globe suffered historic losses and for a time segments of the bond markets simply stopped functioning. Although the DJ Industrial Average held up best, losing 32% for the year. It had its worst showing since 1931. The S&P 500 Index lost 37%, and NASDAQ 41%, while the International Index lost 45%.

The average U.S. diversified stock fund tumbled 40% for the year, suffering an average decline of 25% in the fourth quarter alone. The financial sector led the way down. Health care funds held up best, averaging losses of only 25% for the year. Value oriented funds mitigated losses slightly better than growth funds, and large-cap funds lost a bit less than small-cap on average.

Not to be labor the negative but there was little to celebrate at the passing of 2008. This year saw the loss of over two million jobs, futher erosion in home values, the carmakers, banks and brokers lose their way and the stock market suffers its worst debacle since the 1930s. It was a dismal year.

What's Ahead

The good news is based on current stock prices, long term propects appear to be above average. I have attached a scholarly article from the January issue of the American Assoction of Individual Investors journal. It is worth a read and the graphs are interesting, however look at the 5 to 10 year return.

Perhaps more to the point, It's tough to say, when markets will bottom but unless the world is entering an economic depression history suggest that stocks don't have too much further to fall. Save for the 1929-1932 crash no down turn in the 20th century exceeded 50%. One of the many ironies about this years set back is that it was largely unanticipated because the major stock market averages began 2008 selling for a seemingly modest 16 to 17 projected earnings.

We face serveral difficult quarters ahead. Our sense is the first and second quarters of 2009 will see declines in business activity of 2 to 3%, as the broad contractions in the economy drones on for a possible 6 to 9 months more. At this point, none of the consumer and industrial markets that we view as critical to a substaned revivival in economic activity (such as housing, retail, auto and manufacturing sectors) appears even close to bottoming.

Any business recovery in 2009 may arrive late and be selective. The announced stimulus plans by the Bush and Obama administrations will lesson the severity and duration of the recession in selected areas such as infrastructure and housing. However, the hoped for second-half recovery is a bit conjectural at this time. Indeed, even if all goes well, any second half growth maybe capped at 1 or 2%.

Where We are Now? Is There a Bottom?

We think the current bear market bottom began with the Nov market decline that carried the S&P 500 index down to 754 on Nov 20th. This was also the day when that the gap between the Dow Jones Industrial Average and the 200 day moving average regisitered it's highest level in 35 years with a reading of 34%. We believe this decline was aggravated bywaves of forced selling by hedge funds and leveraged investors unable to meet margin calls.

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The economy still has a long way to go before it can purge itself of a generation of overindulgence. This is one of the big reasons we're not convinced that the bear market is itching to go into hibernation. There is no question that equities have been beaten down with a vengeance. The market is probing for a sustainable low. The stock market has a history of developing major bear market bottoms over an extended period of time which can last as long as serveral months.

Just as there is more risk in the market when everyone is optimistic and valuations are stretched, it is less risky for long term investors to buy stocks when fear is high and valuations are depressed. Opportunity arises when investors dump both bad and good companies in fear or panic. In the 5 years after the 1931 loss, the S&P 500 gained 176% or an average gain of 22.5% per year. So far, we have been able to keep our losses to a minium by being in cash.

Conclusion

We think the markets tug of war will be eventually be won by the bulls, assuming steps to counter the recesion are effective and efforts to calm a more jittery world bears fruit. Now however vollattillity in the stock market is likely to remain high as the recession traverses a painfull path.

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