

Sound Investments Inc.

Kenneth A. Gilpin CFP

Second Quarter 2009

Summary

Consumers confidence jumped as personal income unexpectedly increased. At the same time personal spending fell was less than predicted and business spending showed signs of increasing. Separately, construction showed signs of coming back and new data suggested the manufacturing sector was in better shape than expected.

The above all sounds good and is true, but the reality is we are not out of the woods yet! **It's going to be a much harder road to recovery than was anticipated.**

The pending recovery is likely to be slow and selective. In fact, we expect to see just incremental progress or none at all in the second half. However, since markets have declined to reflect this we continue to think the markets tug of war will be eventually be won by the bulls. Therefore, we continue to recommend buying on weakness for longer term investors.

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.

Recovery Rally

Markets around the world enjoyed the third consecutive month of gains, the longest winning streak since August 2007. While investors increasingly believe that the worst of the financial crisis may be over and the global recession may be nearing an end.

Since hitting a 12-year low, the in early March the Dow Jones average is up 30%, S&P up 36% and NASDAQ up 40%. Foreign market, especially in developing countries, have done better.

In economic news, consumers confidence jumped as personal income unexpectedly increased. At the same time, personal spending fell by less than predicted and business spending showed signs of increasing. Separately, construction showed signs of coming back and new data suggested the manufacturing sector was in better shape than expected.

The above all sounds good and is true, but the reality is we are not out of the woods yet! **It's going to be a much harder road to recovery than was anticipated.**

Second quarter real GNP will likely show a moderate decline for total goods and services. This would represent an improvement when compared to the large declines of the last two quarters. We expect to see an improvement in last half of 2009 and moderate growth in 2010.

A major near term challenge for investors will be 2nd quarter earnings reports which are set for release in the next several weeks. We think that earnings reflecting the uninspiring state of the economy will be lower for most companies. A significant profit recovery will take some time.

Slogging Towards Recovery

Despite signs that the economy is beginning to stabilize, investors remain uncertain about the future. Historically, stocks have tended to bottom about four months before the economy and earnings growth has bottomed about two months after the economic trough. However, as markets continue to teach us, stock prices are unpredictable and simply do not move in a straight line. Although market declines are normal, we have been through the most extreme drop of our lifetime and it has taken its toll. We all know that over the long term, stocks have provided the best returns. Money that will be invested for 5 years should be in stocks. Cash, for all its ability to buffer a portfolio, has not offered protection against eroding purchasing power

in the long term. the price we pay for higher long term returns is market volatility, and recent volatility has been extraordinarily high.

However, in line with our expectations that the economic news will gradually improve as we move through the 2nd half of 2009. The leading economic indicators registered a solid 1.2% increase in May. April increase was 1.1%. This suggests we are at least leveling off and in the next 3 to 5 months may see an economic recovery. Out of the 10 leading indicators 7 rose. The 7 positive factors were interest rate spreads, stock prices, vendor performance, real money supply, consumer expectations, building permits, and manufacturer orders for nondefense capital goods.

Those looking for an improvement in the employment market will have to wait. The jobless rate is a lagging indicator and an improvement is not expected until after the recession ends.

There is some good news on the Banking front. The risk of major Bank failure appears to have passed. Although, we will still hear in the news of smaller banks closing over the next year. By and large, the key Banks have raised significant sums to cover their losses. Nevertheless borrowing money is more difficult still very difficult than at any time in recent history. We are encouraged that the interest rates in investment grade bonds have declined from 9.5% to 8.2%, which indicates an improvement in the corporate credit market place.

Several analysts in Barons magazine were raising their earnings estimate on the S&P 500 from 66 to \$68. The increase is based on the improving visibility for an economic recovery in 2010, inflation in the 2.5% range, and a continued low interest rate environment. This leads us to estimate a price earnings ratio of 16 to 17 times the 2010 earnings estimates. Therefore, we could see a run up to $(16 \times 68 = 1088)$ on the S&P index. Currently, the index is at approximately 900.

We recommend using short-term weakness as buying opportunities to add to positions. We look for an upward bias in stock prices at least into 2010.

It is hard to see the recovery catching fire until housing prices start to recovery and that probably will not occur until late in 2010, or even in 2011. In fact, we may be six months or more, away from seeing the bottom in housing prices. As long as home prices are falling, consumers will feel less wealthy and may not spend the sums needed on cars and other consumer goods to put the economy back on a solid growth path.

What Does Look Positive

High yield corporate bonds are currently yielding over 9%. These bonds are still down 20% from last year. There are a number of money managers that have extensive experience running these assets and over time should do well. Investors with a longer time horizon investments in less developed countries or emerging markets will pay off. The stock market rewards growth and countries like India, China and most of the less developed countries are going to grow at a fast clip.

Conclusion

The pending recovery is likely to be slow and selective. In fact, we expect to see just incremental progress or none at all in the second half. However since markets have declined to reflect this we continue to think the markets tug of war will be eventually be won by the bulls. Therefore, we continue to recommend buying on weakness for longer term investors.