

Sound Investments Inc.

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Second Quarter 2010

DJIA 9744

S&P 500 1030

NASDAQ 2109

Summary

While the economic picture isn't all that rosy (unemployment remains uncomfortably high and credit to small business is tight), we are certainly not facing the dire fundamentals of two years ago. With the recent 15% pullback, we now rate the stock market attractive to purchase. On a risk reward basis, we believe there is substantial upside potential for the stock market into the next year.

At the same time, we view the level of risk at this price level as reasonable for those willing to accept a businessperson's risk. In other words, this means the level of risk is reasonable for those willing to accept stock market risk. Any further backing and filling (this means the daily to and fro of the market averages) that occurs at this price level is viewed as normal activity viewed in the context of the mid-term election bottoming processes. We are moving to a more fully invested posture.

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.

Mid-Year Stall

Now, half-way through 2010, stock investors around the globe are mostly looking at losses. The S&P 500 and DJIA are down 7% and the Russell 2000 is off 3% for the year. Since late April when the market reached its high for the year, the S&P 500 has lost 14.5%. For the most part we avoid losses by staying in cash and investing in bonds and balanced funds. In our last quarterly report, it was stated, "we could easily see a correction of 5 to 10%." Below, I sketch a few of the major issues of the day and offer some projection on page two.

We can check off a laundry list of potential worries: the economic crisis in Greece and Europe, tighter money in the emerging markets, the tragic oil spill in the Gulf, jobless recovery, to name a few.

We believe the 2nd quarter profits coming out over the next several weeks will be positive, reflecting a stronger economic pace over the last 6 months. In fact, corporate profits are rising – up 52% in the 1st quarter, with analyst forecasting a 34% increase this quarter. However, economists and investors are growing ever more anxious about unemployment, housing, and stock market volatility. Data showing a sharp drop in consumer confidence only adds to the current uneasiness. (Retail sales have declined 0.5% following a 1.1% fall in May.) The Federal Reserve Bank recently offered a subdued assessment of the economic recovery.

Lower growth estimates are due to the European Debt crisis that started in Greece and threatens to spread to other countries. This could reduce exports and lower new job prospects. This implies the Federal Reserve Bank will keep short-term interest rates at close to zero into 2011.

Growth will Likely be Slower in the Second Half

In the first months of the year, U.S. gross domestic product increased by 3 to 4% and may slow down to a more pedestrian 2-2.5% in the next six months for the following reasons.

- Housing continues to be weak
- Declining consumer confidence will slow consumer spending as employment recovers slowly
- The high level of public debt and national deficit continues to weigh down growth prospects.

- Lessening contribution from the government's fiscal stimulus efforts.

Although new job growth looked impressive for May, on the surface, the exclusion of short-term census jobs brought private sector new job growth to only 41,000 for the month. This figure is below the 100,000 to 150,000 new jobs figure needed on an average monthly basis to absorb new workers and to gradually reduce the unemployment rate. This is needed in order to support consumer spending. On a positive note, the average workweek increased for the third straight month and now stands at 34.2 hours, the best figure since Jan 2009.

Other Items

- Capacity utilization rates improved again in May to 74%. This is the highest reading since October 2008. The utilization rates have increased 6.2% over the past year, but is below the 40-year average of 81%. Since the capacity utilization measures the factory space in use, the current reading of 74% leaves an output gap between the level of current production and total available capacity. This output gap combined with a very high level of labor slack continues to work as a powerful restraint against inflation. This is the primary reason why inflation remains benign The consumer price index for May was .2% and year over year is 2.0%.
- With mid-term elections coming in November, it is not unusual for the market to fall before the election and then rise significantly for the next 2-3 years. (see chart in the March 2010 client letter)
- We estimate or project earnings for the S&P 500 group of companies to be \$80. Based on a current value of the index at 1030 on June 30th this works out to a price – earnings ratio of 12.9 (i.e. 1030 divided by 80 = 12.9). With the current low inflation and low interest rates, we think a price earnings ratio of 16 to 16.5 is reasonable which would produce a range of 1280 to 1320 on the S&P 500. We continue to believe that gains beyond this level will be a function of durability of the economic cycle and the Federal Reserve policy.
- As noted in our last report, in March, Corporate America is sitting on a cash trove with over 15% of assets in cash, the highest in 23 years.

Chances of a Double Dip

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Conclusion

This has been a harder letter to write since we had some first-rate earnings reports, but the immediate future is clouded. It takes courage to be a bull when the market is down, but that is often what it takes to realize major rewards in stocks over time.