# Sound Investments Inc.

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**Fourth Quarter 2011**

DJIA 12217.56 S&P 500 1257.60 NSDAQ 2605.15

## Summary

Overall the market looks cheap. It is selling for 13.2 last years expected earnings of $97.05. Using a conservative earnings estimate of $103.00 and a 14 times price / earnings ratio produces a 1440 level on the S& P 500, a 9% return. As mention in previous reports corporate balances are strong with cash at all time high levels

Warren Buffet is famous for saying the market is like a weighing machine. There was an article in Barons magazine in late December that discussed how the new year would reconcile the opposing trends of a weak but growing recovery in the U. S. with the anxieties in Europe - and the persistent weakness in commodities and in Chinese stocks. No doubt we will continue to experience volatility in the coming year.

We remain generally constructive on propects in the year ahead, despite the slowdown in Europe and China. Our sense is that the U.S. economy will prove sufficiently resilient to lumber on at a modest gait of 2 – 2 1/2%, or so in 2012. That will translate into additional earnings growth in the year ahead. We think that within such a benign setting stocks should head **irregularly higher**.

***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

2011 was a volatile and difficult year in which most forecasts proved wrong. Despite ending the year where it started, the market changed direction often. Most stock markets experienced bear market declines of 15% to 25% between July and Oct. before a powerful rally masked much of the damage. Domestic or U.S. funds ended down about 2% and the European index was down 15%, Asian stocks did worse and emerging markets (i.e. China, India) were the weakest.

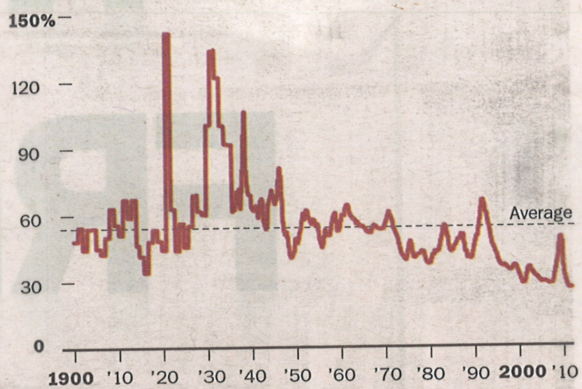
As you are aware, I write these client letters every quarter and the last one in Sept of 2011 was one of the most difficult. I had sold out of most of the international positions last year and moved into the U.S. markets. In July the market started to sell off but I did not think this was another 2008 meltdown where I went to cash but stayed in as earnings growth and dividends were very strong. In the Sept report, I outlined how recent data from Oct brighten the outlook. Since then, there have been a series of reports outlined as follows showing a better picture:

1. Manufacturing sales for 2011 were up 14%. First time claims for unemployment insurance are trending down
2. Freight prices are up. Trucking companies are healthy. Used truck prices – an indicator for the demand for trucks are up. Another positive indicator.
3. Even though cash rich American companies have been raising their dividends, payout ratio (see chart on the back of page 1) is at an all time low indicating that dividends could be raised which generally increase equity prices..
4. Domestic auto sales rose by more than 10 percent for two years in a row, the first time since 1983 and 1984, and analysts estimate they will grow this year to the highest level since 2007. GM, Ford and Chrysler all gained market share last year and all project a full-year profit.
5. Even though cash rich American companies have been raising their dividends, payout ratio (see chart on the back of page 1) is at an all time low indicating that dividends could be raised which generally increase equity prices
6. The spread between the S&P 500 earnings yield and the treasury yield is near levels that in the past preceded big rallies for equities. (see chart on the back of page 1)
7. Historically, January has been viewed as an optimistic month for the equity markets. Living up to the benchmark S&P500 has gotten off to its strongest start in 25 years. Many companies

## Where's My Money?

Although cash-rich U.S. companies have been boosting their dividends, the dividend-payout ratio, or the percentage of profits disbursed to shareholders, is at a historic low. It could rise in 2012.

**S&P 500 Dividend Payout Ratio**

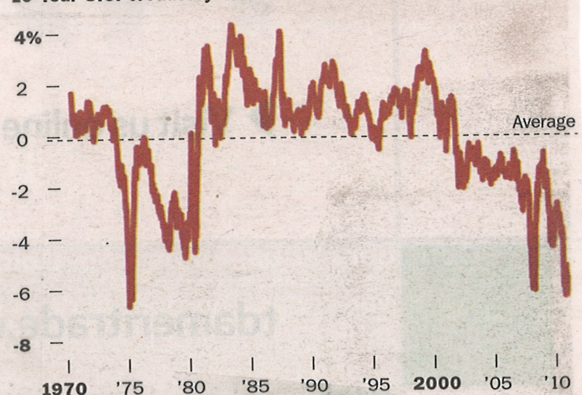



Source: BofA Merrill Lynch U.S. Equity & U.S. Quant Stategy

## An Auspicious Relationship

The spread between the S&P 500 earnings yield (8.6%) and the 10-year Treasury yield (1.91%) is at a level that preceded big stock-market rallies in the past. It is hard to see much upside for bonds.

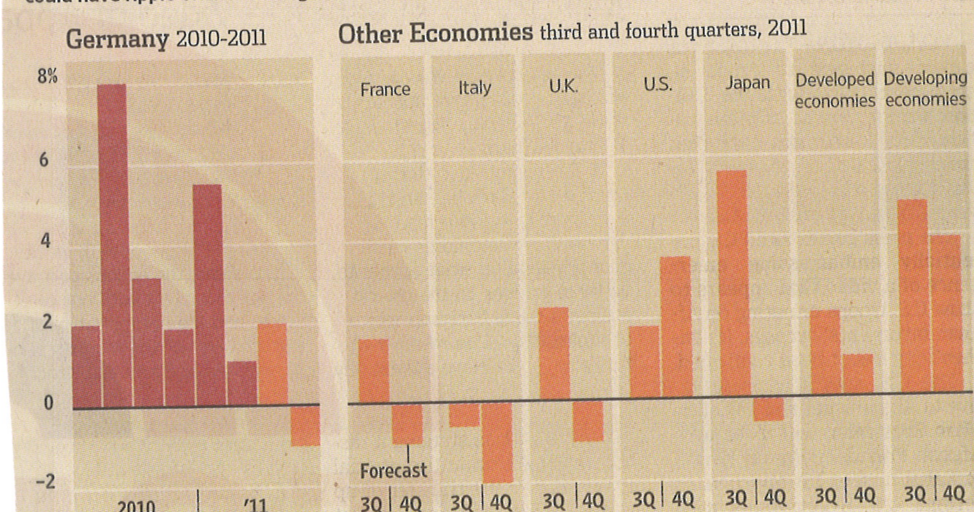
**10-Year U.S. Treausury Yield vs. S&P 500 Earnings Yield**




Source: Citi Investment Research

## Bad Augur?

Germany's economy contracted slightly in the fourth quarter, raising fears that a continued downturn could have ripple effects throughout the region. Quarterly change at an annualized rate in GDP*:




Source: J.P. Morgan Chase

*Seasonally adjusted

are spitting in two to increase their stock price. Two stocks we hold Pfizer and Abbott Laboratories have announced plans to split up and it has enhanced their value.

We expect industrial production to resume an expansionary this expectation, path going forward. At the same time, business sentiment remains cautious and cognizant of the value of keeping the inventory to sales ratio steady. On a year to year basis, industrial production has risen 3.7% and this figure is consistent with moderate growth. We expect 2012 gross domestic product (GDP) to grow within the range of 1.5% to 2.5%. During the 4$^{rd}$ quarter GNP grew at over 3%.

Overall the market looks cheap. It is selling for 13.2 last year's expected earnings of $97.05. Using a conservative earnings estimate of $103.00 and a 14 times price / earnings ratio produces a 1440 level on the S& P 500, a 9% return. As mentioned in previous reports corporate balances are strong with cash at all time high levels.

## Everything Looks Rosy, But What Could Go Wrong?

The global economy will have a rough year. The European recession probably will get worse. The Euro land is fraught with uncertainty and will continue to be a messy picture. In some countries people see it as a right to work 35 hours a week and retire at 55 so it may take some time to change attitudes. As Margaret Thatcher said "Socialism is great until you run out of other people's money."

China is slowing and manufacturing, housing and land sales are falling there. Japan's exports to China and Europe have weakened. The governments of Japan, India, and Korea all lowered their economic forecasts. Brazil's financial system is in contraction. Emerging market stocks indexes were down 15 to 30% with some down over 50%. In the long run these countries offer good rates of return and sometime in the next year or two may be compelling investments. The U. S. is the only place that is holding up and that might not be sustainable. Nearly 40% of the sales of the S&P 500 companies are generated outside the U.S. so this will affect the earnings. Another factor is Federal stimulus spending is over. State and local governments are still in the process of tightening budgets. The good news with a slowdown interest and inflation rates are expected to stay low for the next 18 months.

## Forecast & Conclusion

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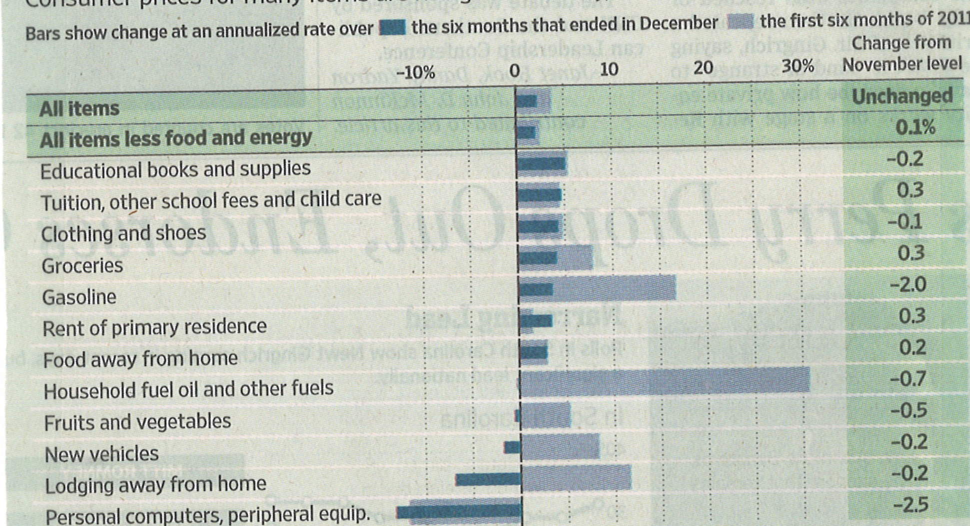
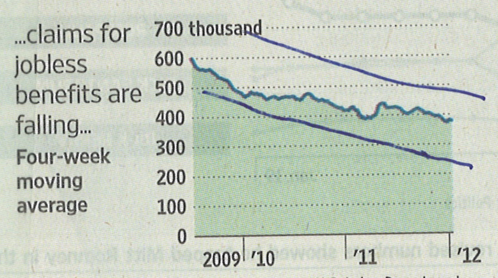
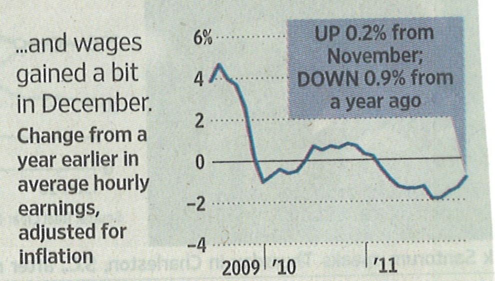
# Inflation Fears Ease, Jobs Picture Brightens

Consumer prices for many items are rising more slowly, or declining...




Note: Data are seasonally adjusted Source: U.S. Labor Department

The Wall Street Journal