

Sound Investments Inc.

Fourth Quarter 2014

DJIA 16576.66

S&P 500 1,848.3

NASDAQ 4183.9

Summary

In our Dec quarterly news letter we wrote "One of the hardest things about market predictions is that there is only a very loose correlation between economic growth and the stock market, in the short run. Warren Buffet said it better and I quote "In the short term the market is a voting machine but in the long term it is a weighing machine."

In 2013 investors were willing to pay up for growth even if it is highly uncertain or lies in the distant future. As I write this in Mid April high flying momentum stocks were hammered in the past two weeks – for no identifiable reason, other than investor enthusiasm reached its limits.

Corrections are a normal part of the flow of stock markets. It's about investors testing and looking for conformation on their thoughts and feelings. We've gone 30 months without a correction of 10% or more. The average is 18 have averaged 12%. Statistics also show there is an average return of 10% in years after a 20% gain in the S&P 500.

Will this rally end in ruin like the tech and credit bubble before it? Not likely

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 and friends.

After the Thaw

After strong gains in 2013, expectations for the first quarter of 2014 were high but most markets were barely positive over the last 3 months. The S&P 500 which tracks large-cap stocks was up approx ¾ of 1 percent while the Russell 2000 Index which tracks U.S. small-cap stocks fell approx. 7/10 of 1%. Meanwhile foreign developed markets were slightly down as well, being off 6/10 of 1%. Bonds also were down slightly with only high yield bonds posting a small gain of ¼ of 1%.

The first quarter was fairly tepid from an economic standpoint. Job numbers came in soft, retail sales and confidence readings sagged, and business seemed no more enthusiastic about capital spending than before. But it was very cold and awfully snowy across much of the country – miserable, really and I from Canada! No doubt this weighed on demand and overall activity.

So, after the thaw where are we? We'll probably find that the economy, despite underwhelming recent data, is continuing to gather strength. That is, the labor market is still healing; consumers are feeling better about their lot in life; small businesses are willing to invest; banks are more willing to lend; residential investors are increasing eager to buy or build. We expect to see a continuation of the trend that was taking place before the deep freeze set in.

This last paragraph seems pretty calming but it is back up by some hard numbers outlined as follows:

- * The Federal Reserve's Beige Book which is a survey of different regions across the country reports improved levels of economic activity.
- * The Conference Board of Leading Economic indicators was up ½ of 1% in Feb after going sideways in the previous 2 months.
- * Even the Federal Governments DEBT was down 24%. Federal revenue was up 11.8% while government outlays declined 3.8% due to Lower defense spending.
- * Industrial production increased 6/10 of 1 % in Feb following 2 months of no progress.
- * Building permits, which provide a window into future activity, rose 7.7% in Feb. the best gain in 10 months.

We think current trends auger well for a 2nd quarter pickup in business activity. Our sense is growth will average 2 ½ to 3% or better in 2014 or early 2015.

Figure 1

S&P 500 Index

Characteristic	Mar-2000	Oct-2007	Mar-2014
Index level	1,527	1,565	1,872
P/E ratio (fwd.)	25.6x	15.2x	15.2x
Dividend yield	1.1%	1.8%	2.0%
10-yr. Treasury	6.2%	4.7%	2.7%

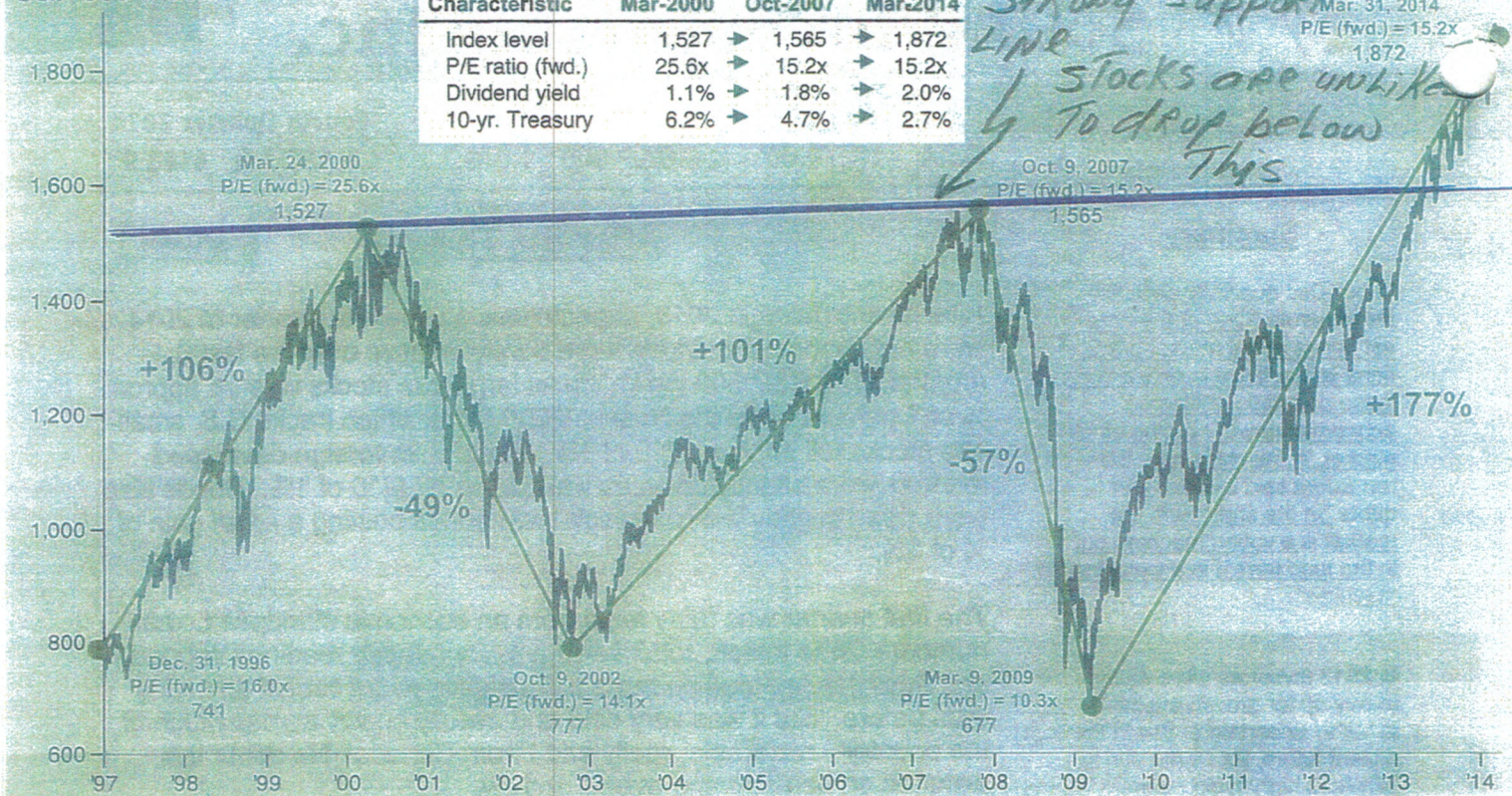
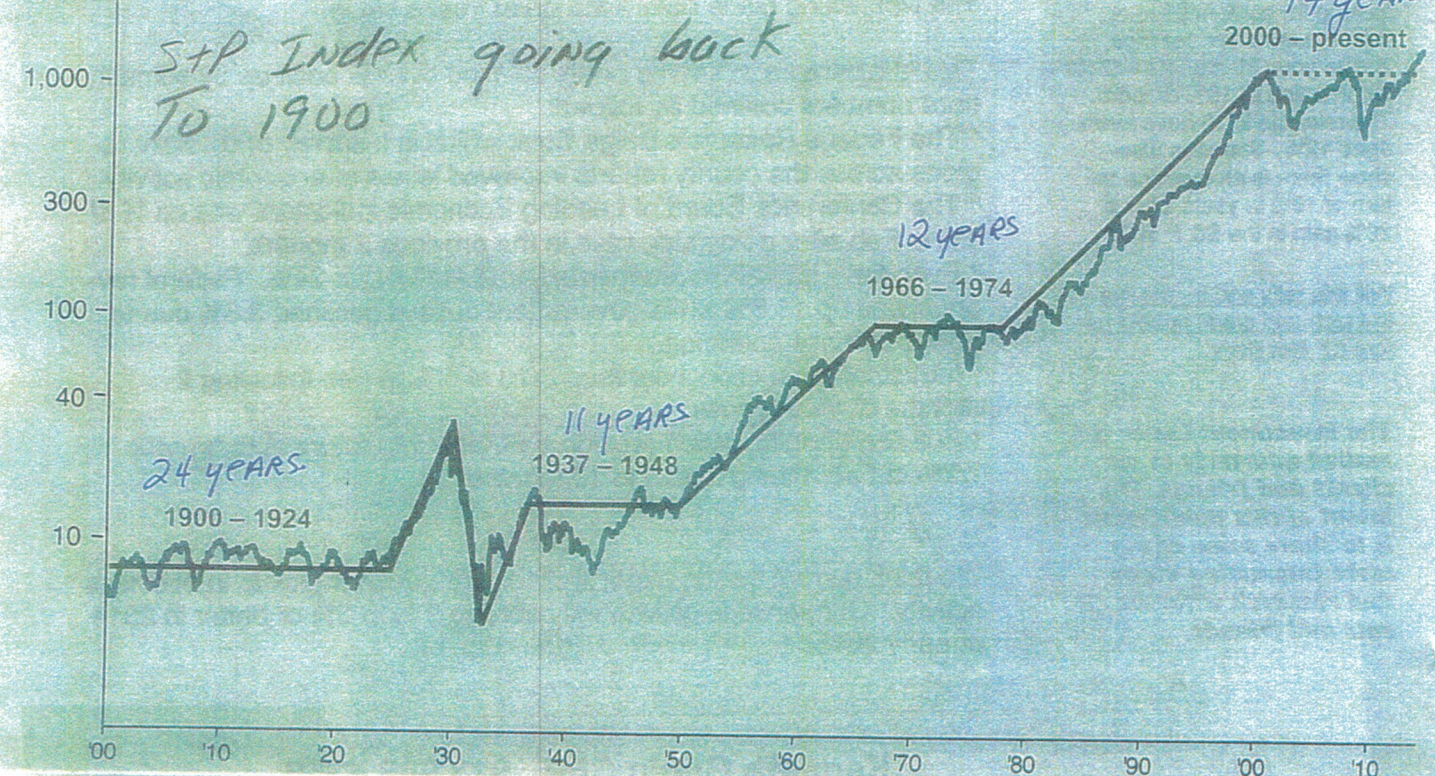


Figure 2

S&P Composite Index

Log Scale



Is a Correction in Store?

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Corrections are a normal part of the flow of stock markets. It's about investors testing and looking for conformation on their thoughts and feelings. We've gone 30 months without a correction of 10% or more. The average is 18 months. Historically, corrections are likely to occur during mid term elections when declines have averaged 12%. Statistics also show there is an average return of 10% in years after a 20% gain in the S& P 500.

Will this rally end in ruin like the tech and credit bubble before it? Not likely. But it behooves us to spread our assets out widely, be picky about what we own within each asset class and even let a little bit of cash build up when opportunities are fewer. A picture is worth a thousand words and I have included some charts out lined as follows:

Figure 1 This 15 year chart of the S&P 500 shows the double top in 2002 and 2007 where the averages reached 1527 and 1565. I drew a line here that forms support for the market and I doubt that the market which is now at 1864 on Apr 19th will go below this level. If the economy and earnings continue to improve there is a good chance it might not go this low.

Figure 2 This chart shows the S&P 500 since 1900. It is interesting in that the market will stay flat for a number of years then head higher.

Figures 3 & 4 These charts show corporate balance sheets have improved tremendously with high cash levels and significantly lower debts.

Figure 5 This chart shows the average price / earnings ratio since 1986. It is currently at 15.2 which are slightly above the long term average of 14.9. These earnings multiples can only be justified by the expectation of strong earnings and revenue growth.

Conclusion

Stock Market volatility is on the rise. We see relatively generous valuations and stresses on the international front. The latter concerns included a soft economy in Europe, a listless growth outlook for China and a return to the cold war tensions between United States and Russia. After a selloff in Feb we've had a solid rebound as we go to press. It's hard to bet against equities. For now the market is focused on the improving economy. We think a possible downturn is limited to approx. 8% and equities are good bet for a 10% gain this year. As always we remain vigilant in protecting our client's investments.

I have included an article from the Wall Street Journal entitled "Retirees face High Stock Prices and Low Bond Yields" that discusses how hard it is for retirees to get a return on their money.

Figure 3

Corporate Cash as a % of Current Assets

S&P 500 companies – cash and cash equivalents, quarterly

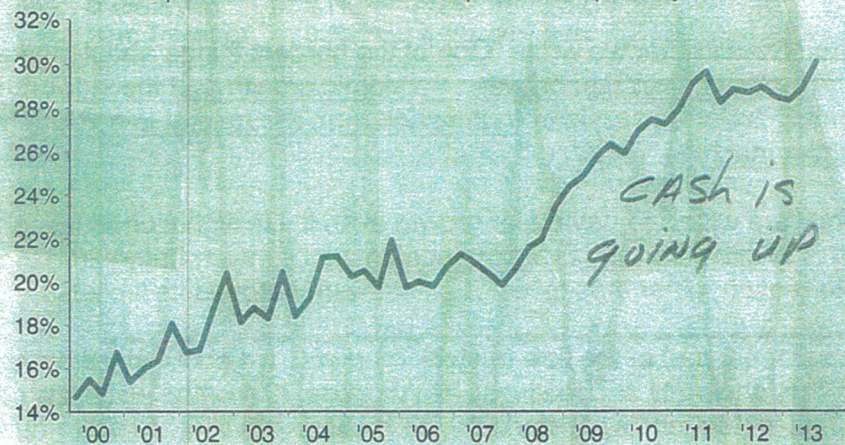


Figure 4

Total Leverage

S&P 500, ratio of total debt to total equity, quarterly

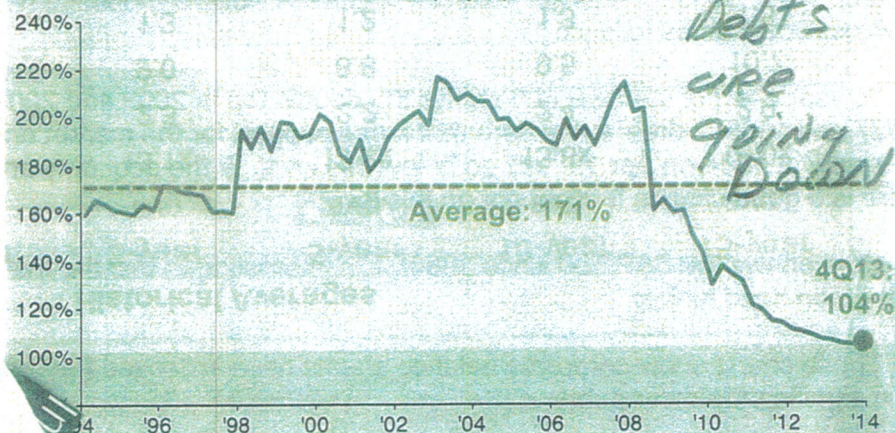


Figure 5

S&P 500 Index: Forward P/E Ratio

