

Kenneth A. Gilpin CFP

Sound Investments Inc.

Second Quarter 2013

DJIA 14,909

S&P 500 1,606

NASDAQ 3403

Summary

One of the major news themes of the day is the increase in interest rates from 1.7 to 2.5% on the 10 year bond. This marks the end of the biggest bull market in bonds in 30 years. When I was a stockbroker in the early 1980's interest rates were 16%. We have held Vanguard High Yield Corporate (VWEAX) and Eaton Vance of Boston (EVIBX) high yield bond funds for over 10 years in some accounts. Returns over the 10 year period were in the 7 to 8% range – Higher than stocks. In recent client letters we discussed reducing the length or term of the bonds terms and reduced the holdings over the past year.

Our sense is this bull market is mature but still growing. To put in baseball terms this market is somewhere between the 5th and 7th inning. I think the advance will be erratic, uneven and even at times scary but never the less move ahead. Usually there will be pull backs of 5% approximately 3 times a year and 10% about once every 18 months. We had a correction in June. I do not see an internet bubble like 2000 to 2002 or a mortgage and banking crisis like we had in 2008/2009. Stock market volatility and corrections are normal and reflects the to and fro of financial data and human nature.

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.

Overdue Correction --- Stocks Still Lead

In our last quarterly report we discussed the possibility of a market correction of 5 to 10%. This correction happened at the end of June. The market slumped 3% overall in June but is up 13% since the beginning of the year. The culprit was interest rates. The rate spiked sharply when the Fed chairman, Ben Bernanke, stated he intends to taper or reduce the stimulus so long as the US economy continues to improve. I included a well written Article by Brenda Cronin which does a great job outlining the current state of the economy.

The Wall Street Journal often has small graphs, called Vital Signs which show key economic indicators, that illustrate the trends in the economy. Below is a listing of some the results. The actual graph appear on the back of this page.

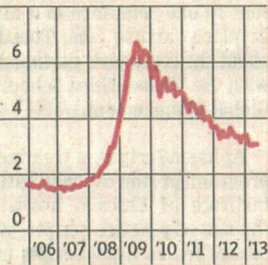
- Number of job seekers per opening – For every job opening, there were 3.07 people looking for work. Back in 2009, there were over 6 job seekers for every opening
- Initial jobless claims have returned to prerecession levels.
- Consumer confidence index has risen over the past 3 years but is still below the prerecession levels.
- Retail boat sales show a huge 30% improvement which points again to an increased level of confidence.

These graphs show a slow but gradual recovery. House construction is helping. The Wells Fargo Housing index surged 8 points in June to 52. Any reading above 50 is positive and it is the first time since 2006 it has risen above 50. The gauge of future sales jumped 9 points to 61, its highest reading since March 2006. All indications currently point to a continuation of the housing recovery.

Another positive is inflation; which remains low along with the consumer price index of 1.1% for the year. This is below the 2.5% average annual increase since 1991.

Vital Signs

Number of job seekers per opening



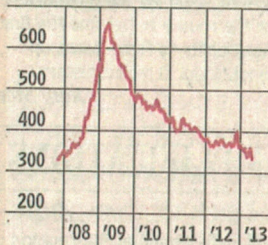
Source: Labor Department

◆ **Competition for jobs** has eased noticeably since the recession. For every job opening in May, there were slightly more than three people—3.07—looking for work. That is up from the previous month, but well below the 3.37 level seen in May 2012. Back in July 2009, when the recovery began, there were more than six job seekers for every job opening.

Follow the news all day at WSJ.com

Vital Signs

Initial jobless claims, four-week moving average, in thousands

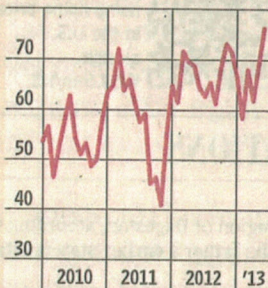


Source: Labor Department

◆ **Jobless claims** have returned to prerecession levels. The four-week moving average of first-time claims for unemployment insurance, a metric that smooths out distortions, fell last week to 336,750, the lowest since November 2007. Layoffs have normalized in recent months, reducing claims, but hiring remains spotty amid fears of further economic turmoil and higher health-care costs.

Vital Signs

Consumer Confidence Index

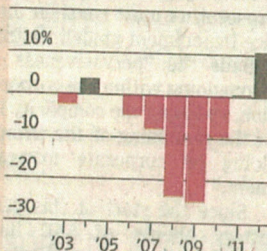


Source: Conference Board

◆ **Americans are gaining confidence in the economy.** The Conference Board's consumer index rose 7 points this month to a five-year high of 76.2. Rising stock prices, improving home values and steady job gains are lifting consumer expectations about the economy. Yet many Americans don't expect incomes to rise and overall confidence remains below the prerecession average of 105.

Vital Signs

Boat retail sales, year-over-year change



Source: National Marine Manufacturers Association

◆ **For many Americans, the Fourth of July** kicked off a long weekend that includes time on the water. Retail sales of new powerboats and sailboats in the U.S. surged 10.7% in the past year. The industry was hard hit during the recession but is climbing back. While powerboats remain far more in demand, sailboats are riding a wave of popularity, with sales rising almost 30% in 2012.

We project earnings for the S&P average of 108, with price / earnings ratio estimate of 15.5 to 16, which brings the index to the low mid 1700's. Our current 2014 operating earnings estimate is \$114 which could allow future progress to the 1800 level on the S&P 500.

One of the major news themes of the day is the increase in interest rates, from 1.7 to 2.5% on the 10 year bond. This marks the end of the biggest bull market in bonds in 30 years. When I was a stockbroker in the early 1980's, interest rates were 16%. We have held Vanguard High Yield Corporate (VWEAX) and Eaton Vance of Boston (EVIBX) high yield bond funds for over 10 years in some accounts. Returns, over the 10 year period, were in the 7 to 8% range – higher than stocks. In recent client letters, we discussed reducing the length or term of the bond terms and we reduced these holdings over the past year.

So What can We Expect Over the Next 10 years ... The Long View

I subscribe to a newsletter called No-Load Fund X and here is how they responded to the above question. Since 1925, Stocks averaged a return of 8.5%, handily outperforming bonds, which returned 6%. But the problem is that returns are rarely average, even for periods of a decade or longer. Over the last 10 years, for example, stock returns have been far lower, at 4.6% than their historic average, while bond returns have been much higher than average at 7.7%. When we look at stocks and bonds today, we find that stock valuations are still in line with their long-term historical average. Earnings continue to grow and there is very limited competition from other asset classes like bonds. Given this, we believe it is reasonable to assume that stocks can return, at or near their long-term average, over the next decade. This also implies more volatility as investors tilt their portfolios towards equities. Stocks have shown, on average, three 5% pullbacks per year, one 10% correction per year and one bear market decline of 15-30% every 3-5 years. Of course, this compares favorably to the rather extreme volatility of the trailing decade when valuations were much richer. We believe bond investors may have a hard time doing better than their current coupon yield over the next decade. For investors in a bond index, this implies returns as low as 1 to 2%. More diversified bond portfolios yield closer to 3%.

The benefit to bonds is that they remain less volatile than stocks. An allocation to bonds buffers one's portfolio during stock market dips. Rebalancing helps improve participation in recoveries. Bonds also allow investors to reap the benefits of stocks by helping investors remaining invested through full market cycles. This implies that investors either need to expect relatively lower returns or consider accepting greater volatility in their portfolios.

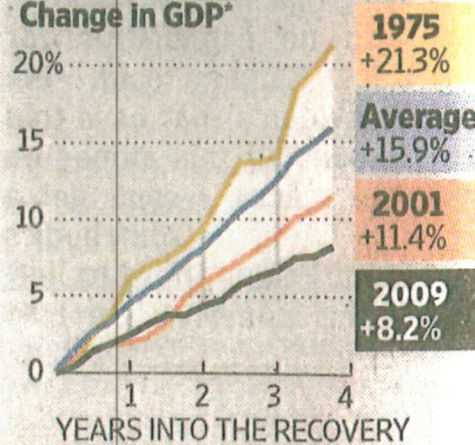
Conclusion

The 30 year decline in interest rates was an amazing phenomena, not soon to be forgotten! Generally we remain fully invested but are cognizant that stock market corrections are normal and are to be expected now that it is at higher levels. Investing is a marathon, not a sprint and the key is to maintain discipline.

Slow Climb

The economic rebound has been slower than the average between 1970 and 2008.

Change in GDP*



*GDP is annualized and adjusted for inflation and the seasons. Source: Commerce Dept.

The Wall Street Journal

The above chart is from the attached article entitled "slow motion recovery searches for second gear."

Our sense is that even though this is a recovery and there will be twist and turns we are making progress.

Slow Motion Recovery Searches for Second Gear

By Brenda Cronin, Wall Street Journal, June 13 2013

After four bumpy years, the U.S. recovery finally appears to be on a smoother road.

Many economists now predict 2014 will be the best year for growth since 2005, while joblessness is expected to click below 7% next year for the first time since 2008. Houses are selling again, the energy sector is booming and jobs, while not plentiful, are being created at a steady pace. On Wednesday, the Federal Reserve upped its estimate for next year's expansion as well.

There have been earlier waves of optimism that the economy was poised for better growth, and the past week's financial-market turmoil is a reminder that a lot still could go wrong.

News that the Fed could start dialing back stimulus later this year sent the Dow Jones Industrial Average down 2.34% on Thursday. The average closed at 14799.40 Friday, down 1.80% for the week. A persistent decline in stock prices or faster-than-expected increases in mortgage and other long-term interest rates could slow the recovery.

It has been a long haul. The recovery that began in June 2009 has been painfully slow. Jobs, median household income, industrial production and home prices still haven't returned to the levels they were at before the recession.

But despite the weak pace of overall growth, the recovery has proved surprisingly resilient. The economy has absorbed a series of shocks, from tax hikes to a tsunami in Japan, without getting knocked off course or falling back into recession. And crucially, inflation remains low.

"The good news is if [the recovery] continues to ratchet up gradually," the economy could see growth persist and strengthen, says Nariman Behraves, chief economist at IHS Global Insight.

It will take a prolonged upturn to make up ground lost during the recession, which stretched from December 2007 through June 2009. Long-term unemployment, a hallmark of the recession's toll, remains at historically high levels. The economy has been expanding, but at a 2.2% annual pace, below the average 3.3% rate of recent decades. The federal government's belt-tightening has weighed on the recovery, but that impact is now dissipating.

Economists in the latest Wall Street Journal monthly survey expect gross domestic product to expand at a 2.3% annual pace this year and 2.8% next year. The Federal Reserve edged up 2014 growth forecasts to between 3% and 3.5%, from a March estimate of 2.9% to 3.4%.

After the central bank's policy-making committee met last week, Fed Chairman Ben Bernanke explained the panel's recent optimism by saying the economy's "fundamentals look a little better to us."

Such optimism about the recovery looks justified, thanks in part to the energy boom and the real-estate sector's patchy comeback. The property market's expected contribution to the economy during the se-

cond half of this year is the critical engine, says Joseph LaVorgna, chief U.S. economist at Deutsche Bank, noting that housing gains benefit many other areas, from furniture sales to landscaping.

Earlier in the recovery, similar bouts of optimism flared, only to be snuffed out by events such as the tsunami in Japan, euro-zone turmoil and budget strife in Washington. While such shocks undercut the momentum, they didn't tip the economy back into recession. But each disappointment renewed skittishness among consumers and businesses scarred by the financial crisis.

"We're extremely cautious and not seeing dramatic growth," says Mike DePasquale, chief executive of BIO-key International, Inc. The Wall, N.J., company makes security software that recognizes biometric markers, such as fingerprints. In recent months, BIO-key added three employees, bringing its full-time staff to 19.

Although demand at home and abroad remains brisk, the ordeal of the recession, when BIO-key laid off workers and streamlined operations, is still vivid. "We all sense that things are beginning to get better, but we don't innately feel it," Mr. DePasquale says. "There are still so many people that each of us know who are out of work or struggling in positions that are below where they were five years ago."

Such doubts are inevitable amid a recovery that has defied the contours and pace of previous comebacks. The labor market remains strained, even as the unemployment rate has dropped to 7.6%, from double-digit levels. The U.S. has 2.4 million fewer jobs today than when the recession began. Adjusting for population growth, it will take more than nine years at the current rate of hiring to return to prerecession employment levels, according to estimates from the Brookings Institution.

Slow hiring and scant wage growth have made the recovery feel no different from the recession for some. According to the latest WSJ/NBC News poll, 58% of Americans believe the country is in a recession. That isn't surprising after a financial crisis that put households through their "worst losses of wealth in 80 years," says Robert Shapiro, chairman of Sonecon LLC, an advisory firm.

And yet, consumer confidence now stands at a five-year high. Households that borrowed extensively before the recession have pared their debt. After years of cutting back, they are spending again, moving beyond absolute essentials to big-ticket purchases that were postponed in leaner times. Economists see consumers now carrying this recovery forward, as a combination of slow gains in the job market and a snapback in housing improves their od.

Household balance sheets have shown "pretty good improvement," but about 20% of mortgage borrowers are still underwater on their loans, says Paul Ashworth, chief U.S. economist at research firm Capital Economics. Businesses have reined in borrowing and strengthened their books, he says, but remain gunshy about spending to expand.

"What we really want is business investment to rise well above just replacing worn-out stuff, and into getting new stuff," he says, "because when you get extra new stuff, you need new staff. When you buy two new vehicles, you need two new drivers." Many businesses say they don't want to commit to new investment until they are sure that demand is there. Some continue to cut back in the face of wavering demand.

Weakness overseas remains a wild card for the recovery. If the euro-zone recession gets worse and softness in China and elsewhere persists, that could stall momentum in the U.S. There also are risks closer to home. Fiscal clashes in Washington could further strain consumers and businesses. Already, the federal government has cut spending 4.5% since June 2009, compared with an average 6.3% increase in recoveries since 1970.