Kenneth A. Gilpin CFP

Sound Investments Inc.

Third Quarter 2013

DJIA 15,129 S&P 500 1,681 NASDAQ 3,818

Summary

The third quarter was a decent one for the stock market; however the gains were anything but routine. The indexes moved higher in July; then backtracked in August, on interest rate concerns. They rallied for much of September, before paring those gains late in the month on concerns of the contentious budget battle in Washington. For the quarter, the Dow Jones rose 1.5% and the S&P 500 index rose 4.7%. The NASDAQ led the way, up 10.8%, buoyed by Apple and Face Book. For over 5 years, international equities have laggard behind but are perking up, as we expect to invest in them soon

There are a number of issues that could throw the market off its stride, as we look out to end of 2013. That however, is not unusual. For instance, we have already experienced a government shutdown and face a default if the debt ceiling is not raised; a renewed raise in interest rates could derail the housing recovery or a miscalculation by the new federal board chairperson. Of course, threats to any long term bull market are not unique. <u>Our sense is that the modest pullback the market suffered in late Sept may go on a bit longer</u>. <u>Overall, we sense the averages will stay in a range for the time being for the next several months</u>.

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.

What a Difference Five Years Makes

This quarter marks the five year anniversary of the financial markets collapse, beginning in Sept 2008. We have come a long way since the market low of Mar 2009.

Generally, we have remained fully invested over the last 5 years, primarily in U.S. mutual funds and stocks.

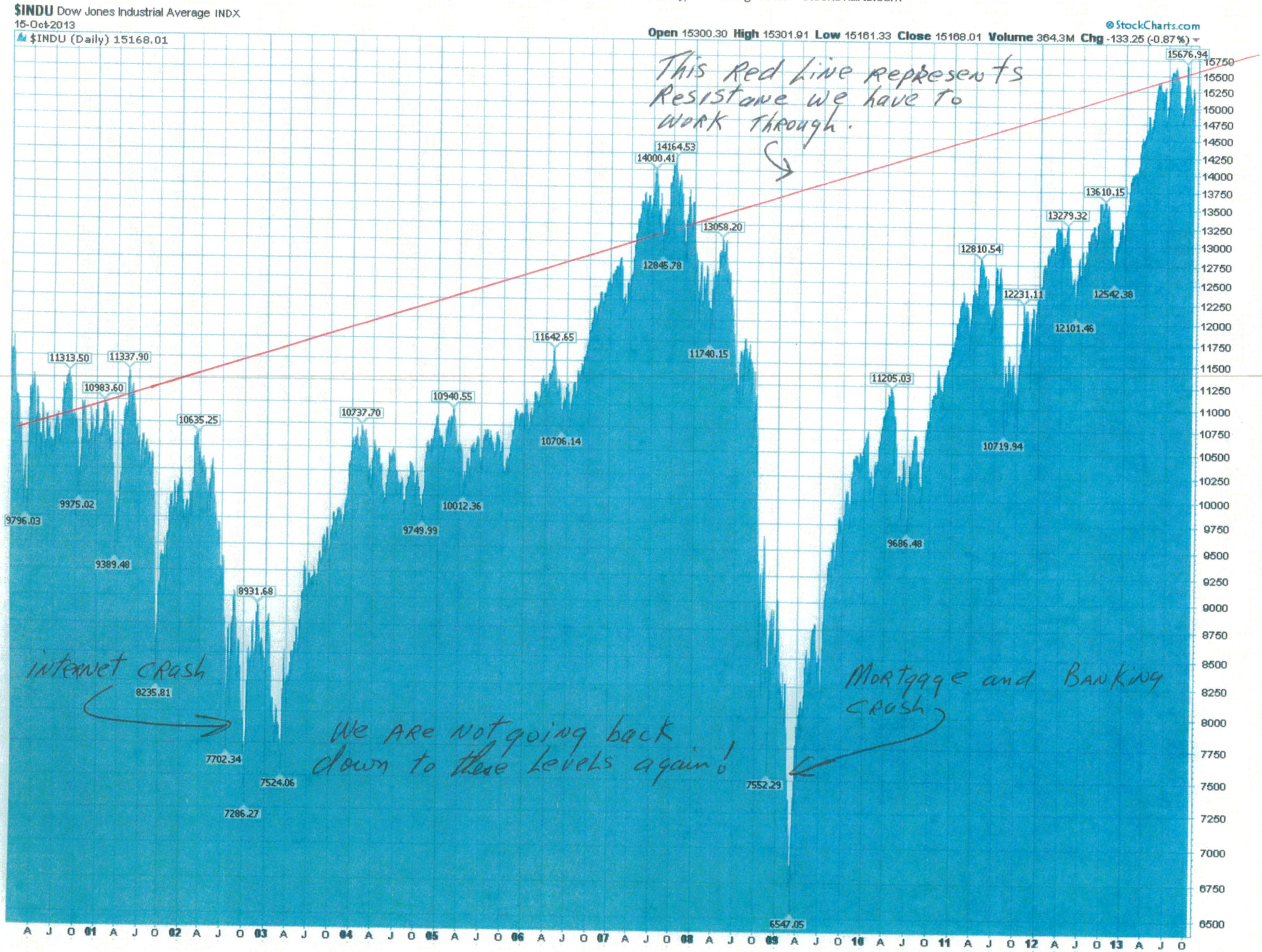
Over the past few years, the market has been impacted, by everything from housing crashes to bank bailouts. In every circumstance, it has proved resilient. The latest concern is the Congressional drama over government funding, which has caused a partial shutdown. The debt ceiling issue will be the next topic of concern. These are important debates and they will have a positive impact on our lives if we can get our economic house in order. The debt level is a big issue and it's going to take more than a few months or several election cycles to get it resolved.

The 3rd Quarter – Anything but Routine

The third quarter was a decent one for the stock market; however the gains were anything but routine. The indexes moved higher in July; then backtracked in August, on interest rate concerns. They rallied for much of September, before paring those gains late in the month on concerns of the contentious budget battle in Washington. For the quarter, the Dow Jones rose 1.5% and the S&P 500 index rose 4.7%. The NASDAQ led the way, up 10.8%, buoyed by Apple and Facebook. For over 5 years, international equities have laggard behind but are perking up, as we expect to invest in them soon.

Two things are causing the market to gyrate. 1.) The ending of easy money (what is known as quantitative easing.) Interest rates could increase from 2.7% on the 10 year bond, to 4%. 2.) The attempt to come to grips with lower growth rates and the impact it will have on employment and corporate earnings.

On the back of this page, you will find a Dow Jones Chart. The market peaked in 2002 and 2007, and is just now breaking through to new highs. You will notice a line connecting the peaks. I think it will move higher but it will take some time moving through this resistance. As mentioned in our last report, I do not see an internet bubble like that of 2000 to 2002 or a mortgage and banking crisis like we had in 2008.


$INDU Dow Jones Industrial Average INDX
15-Oct-2013
$INDU (Daily) 15168.01
Open 15300.30 High 15301.91 Low 15161.33 Close 15168.01 Volume 364.3M Chg -133.25 (-0.87%)
©StockCharts.com
This Red Line represents Resistance we have to work through.
Internet crash
We are not going back down to these levels again!
Mortgage and Banking crash
15676.94
14164.53
14000.41
13610.15
13279.32
13058.20
12845.78
12810.54
12542.38
12231.11
12101.46
11740.15
11642.65
11337.90
11313.50
11205.03
10983.60
10940.55
10737.70
10719.94
10706.14
10635.25
10012.36
9975.02
9796.03
9749.99
9686.48
9389.48
8931.68
8235.81
7702.34
7552.29
7524.06
7286.27
6547.05
A J O 01 A J O 02 A J O 03 A J O 04 A J O 05 A J O 06 A J O 07 A J O 08 A J O 09 A J O 10 A J O 11 A J O 12 A J O 13 A J O

More Statistics and Predictions

We continue to hold a fairly positive view of the economy (which can be different from the Stock Market). This is supported by the numbers outlined as follows:

- Economy Industrial production increased 4/10 of 1% in August, the best reading in six months. The rate of growth is accelerating and points to an increase in economic growth in the second half of the year. Motor vehicle production improved 5.2% to an annual rate of 11.2 million units. On a year over year basis, industrial production is up 2.7%, which is indicative of a moderate growing economy.
- Capacity utilization edged up 0.2% to 77.8%, which is up 0.6% from a year ago.
- Single family permits rose 3%, to a 627,000 annual rate, the highest level since May 2008.
- U.S exports have grown seven times faster than the overall economy since 2005. We have a growing cost advantage over Europe and Japan and exports are now at their highest level in 50 years.

It's hard to predict but we are holding our 2013 operating earnings estimate at $108 and our 2014 estimate at $114. Based on our price earnings ratio estimate of 15.5 to 16 times earnings, which is close to the 50 year average, P/E multiple of 16. Using these multiples, the S&P 500 has the potential to trade into the upper 1700 range.

Ms. Yellson has been nominated to replace Ben Bernanke as chairman of the Federal Reserve Bank and we expect her to be confirmed. The Wall Street Journal ran a chart of what previous Fed Chairpersons had to face. On the back of this page, the graphs show interest rates, inflation, jobless rate and the Fed's balance sheet, for the past 53 years. What stands out is the low interest rate for Federal Funds and the ballooning Fed balance sheet. Along with the budget deficit, these are some of the financial issues of the day.

As outlined above, there are a number of issues that could throw the market off its stride, as we look out to end of 2013. That however, is not unusual. For instance, we have already experienced a government shutdown and face a default if the debt ceiling is not raised; a renewed raise in interest rates could derail the housing recovery or a miscalculation by the new federal board chairperson. Of course, threats to any long term bull market are not unique. <u>Our sense is that the modest pullback the market suffered in late Sept may go on a bit longer</u>. Even if it doesn't, the pullback thus far has been constructive in taking out a little of the markets froth. <u>Overall, we sense the averages will stay in a range for the time being for the next several months</u>. As if to confirm this, Warren Buffett has trouble finding things to buy but it should be noted that he's not selling either.

Conclusion

The stock market has risen mightily, to almost 1700, since the S& P 500 index traded in the 1300 range last November. Short-term correction activity should come as no surprise as the market has shown such hefty gains. So far, pull backs have been limited to minor rounds of profit taking. This no time to be complacent about the market and we remain vigilant for changes in our outlook.

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