

# Sound Investments Inc.

Fourth Quarter 2013

DJIA 16576.66

S&P 500 1,848.3

NASDAQ 4169.2

## Summary

It was a stellar 2013 on Wall Street with the Stock market putting together a wire to wire win. In all, the averages advanced from the opening bell and rarely looked back, rising on a better economic outlook, sustained earnings growth and fully supportive Federal Reserve policies. As we look back at the previous year, we find the Dow's annual increase at 23.4% including a series of all time highs, not to be outdone; the S&P 500 was up 27%. The tech-laden NASDAQ retained a more imposing 34.8% advance.

On page 4, (the back of this page) there is a chart showing the price-to-earnings ratio for the last 100 hundred years of the S&P 500. Currently, the price of the average stock is at 19.5 times its earnings. Based on our S&P index, operating forecasted earnings are \$116 for 2014. This indicates the average stock is trading at 16 times next year's earnings. Looking at the chart, the market is fairly valued and could move up to the upper 1800 to low 1900 range.

Valuations are now stretched, and that tends to make stocks vulnerable to even modest disappointments. We think a total return of 6 to 8% is a reasonable expectation and maybe more for internationals once they get going again

*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.*

## 2013 Best Results Since 1997!

It was a stellar 2013 on Wall Street with the Stock market putting together a wire to wire win. In all, the averages advanced from the opening bell and rarely looked back, rising on a better economic outlook, sustained earnings growth and fully supportive Federal Reserve policies. As we look back at the previous year, we find the Dow's annual increase at 23.4% including a series of all time highs, not to be outdone; the S&P 500 was up 27%. The tech-laden NASDAQ retained a more imposing 34.8% advance.

Essentially, what happened was that profits were afforded a more generous price /earnings multiple in 2013 reflecting low interest rates and an improving economy. Recent news was encouraging with third quarter consumer spending and business investments far greater than initially estimated. This pushed growth to an encouraging 4.1% annual rate which fueled a continued stock rally.

## Hopeful Signs for the U.S. Economy

Each of the last 4 years has ended with optimism that next year the U.S. economy will finally pull itself out of the mud. Charles Evans of the Federal Reserve Bank of Chicago, predicted that growth would finally get back to normal each year for the last 4 years. Undaunted, Mr. Evans, predicts a 3.2% growth in 2014. (See chart of U.S. Growth on the back of this Page) He may be right this time as the ingredients for a faster growing economy may finally be at hand. Here are four building blocks of optimism for 2014:

1. Balance Sheets are Better. Businesses have cut costs, built up cash and enjoy high profit margins. Banks have bolstered their capital and profit levels have returned. Many consumers have locked in low interest rates and home prices are near 2007 levels.
2. Some Consumers are Buying. The typical consumer isn't doing all that well. But, those with money and credit are buying. Statistics show an increase from June to Dec, with housing starts on single family homes up over 20% from 2011. Auto sales are at a 6 year high.
3. Businesses Poised to Spend. December's manufacturing reports showed strength with new orders and hiring. Exports are at an all time high. Spending on new plant & equipment should move forward. (see chart on Page 2)
4. Government Headwinds Subside. This means, the spending deal approved by congress last month, reduces the amount of



## Building Momentum | Many indicators showed the U.S. economy strengthening in 2013, boding well for 2014.

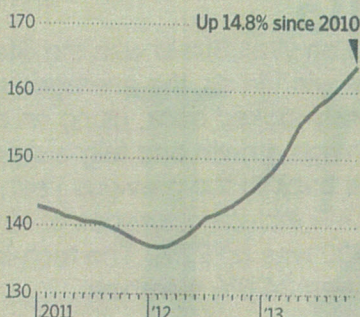
### Unemployment fell.

Monthly civilian rate, age 16 and older



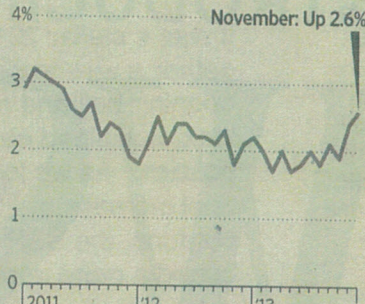
### Home prices rose.

S&P/Case-Shiller 20-city composite index



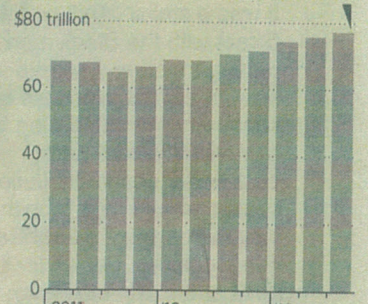
### Consumer spending started growing faster.

Change from a year earlier in inflation-adjusted consumer spending



### And household wealth rebounded.

Household net worth, quarterly, adjusted for inflation



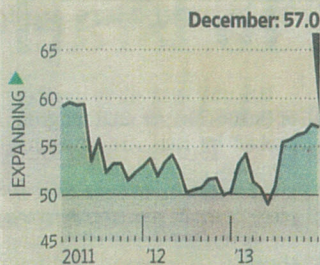
Notes: Data other than net worth are seasonally adjusted; household sector includes nonprofit organizations and is adjusted for inflation using the personal-consumption-expenditures price index.  
Sources: Labor Department (unemployment); S&P/Dow Jones Indices and CoreLogic (home prices); Commerce Department (spending); Federal Reserve (net worth)

The Wall Street Journal

## Manufacturing Momentum

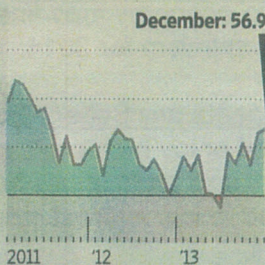
### PMI (manufacturing activity)

Expanded, but at a slower pace than in November



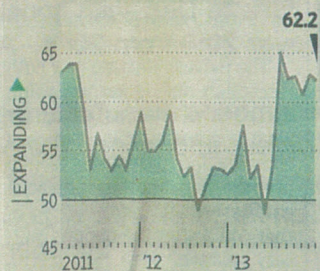
### EMPLOYMENT

Grew faster than in November



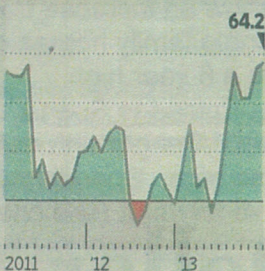
### PRODUCTION

Grew more slowly



### NEW ORDERS

Grew faster



Source: Institute for Supply Management via Markit

The Wall Street Journal

The numbers  
are looking  
better!



belt tightening (call sequestration) and increases spending for the next two years. It also reduced the chance of another government shutdown to nil.

5. Growth Seen Picking Up Overseas. Leading economic indicators from the OECD's 34 member countries show the global economy improved, as 2013 drew to a close. This makes for better conditions for our exports, as our trading partners economies continue to heal.

As noted above, the expansion appears to be on solid ground, as we peer into 2014. So, the stock market should move ahead; right? 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. How much of the good news is already in the market? In the rest of the letter, we will explore whether the market is overvalued by historical standards.

## **Not a Time to Time the Markey**

On page 4, (the back of this page) there is a chart showing the price-to-earnings ratio for the last 100 hundred years of the S&P 500. Currently, the price of the average stock is at 19.5 times its earnings. Based on our S&P index, operating forecasted earnings are \$116 for 2014. This indicates the average stock is trading at 16 times next year's earnings. Looking at the chart, the market is fairly valued and could move up to the upper 1800 to low 1900 range.

Perhaps the most interesting chart is on page 4 (back of this page). It shows the monthly returns of the S&P 500 index, from 1998 to 2013. Please note the support / resistance line at 1550. This is the old high's it achieved in 2000 and 2007. It broke through pretty convincingly in 2013 and I believe the old resistance now becomes the new support level. If the economy begins to falter or slow down, we could see a retest of the 1550 level. It is challenging at best, to time the market. At the present time we are in an uptrend but that could change, causing a retest, down to the new support new line of 1550. The markets course looks less defined. Valuations are now stretched, and that tends to make stocks vulnerable to even modest disappointments. We think a total return of 6 to 8% is a reasonable expectation and maybe more for internationals once they get going again.

Talking about trends, as I was writing this letter, I found a remarkable article in the Wall Street Journal that describes the impact of the baby boomers on the demographics of our country. We are going to be spending more on health care and we will be investing more in this area.

I'm often asked whether a crash in the market, like the Internet Bubble of 2002 or the Banking / Mortgage crisis of 2008, could happen again. It could happen again, however I don't see anything imminent on the horizon. China may represent biggest threat, because it's a dictatorship, and we don't know whether or not they are allocating their resources correctly or how accurate their financial reports are. Corrections are a regular part of the stock market. Normally, there are three downward 5% corrections every 12 months and one 10% correction or decline every 18 months, with the market climbing in between.

## **Conclusion**

Market momentum is clearly with the bulls and history teaches us its hard to fight the tape. Still, Wall Streets sights are high, and, in the end, something may have to give. It appears there will be another year of stable economic growth and further low inflation. Still future gains figure to be hard won.



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# Youngest Boomers Turning 50

Baby boomers, a generation that because of its sheer size has dominated the country's economy and politics for decades, continue steadily marching toward retirement. In 2014, the youngest boomers—those born in 1964—will turn 50, while many of the oldest—born in 1946—have already left the workforce. Boomers make up roughly a quarter of the U.S. population, so their decisions and actions are closely tied to the state of the nation as a whole.

**Born 1946** at the beginning of the baby boom

**Born 1964** at the end of the boom



**12,500**  
Number of Americans turning 50 every day

**9.2 million**  
Estimated number of veterans 65 and older

**\$170,000**  
Median net worth of householders 65 and older in 2010

**1.39**  
Average hours per day spent working by people ages 65 to 74

**53,364**  
Number of centenarians counted by the 2010 Census



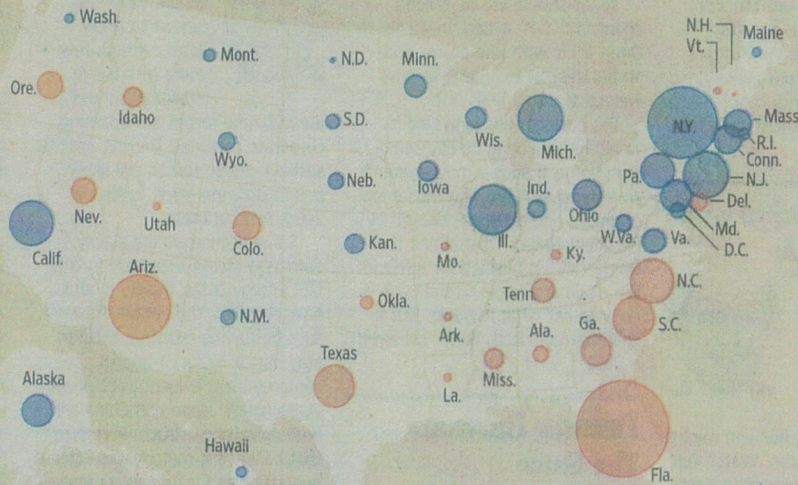
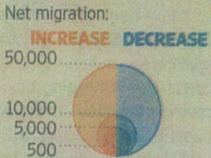
Clockwise:  
Actress Diane Keaton,  
economist Robert  
Shiller, President  
George W. Bush,  
biologist Craig Venter,  
President Bill Clinton

Clockwise:  
First lady Michelle Obama,  
philanthropist Melinda  
Gates, actress Sandra  
Bullock, Amazon CEO Jeff  
Bezos, author Dan Brown

## Senior migration

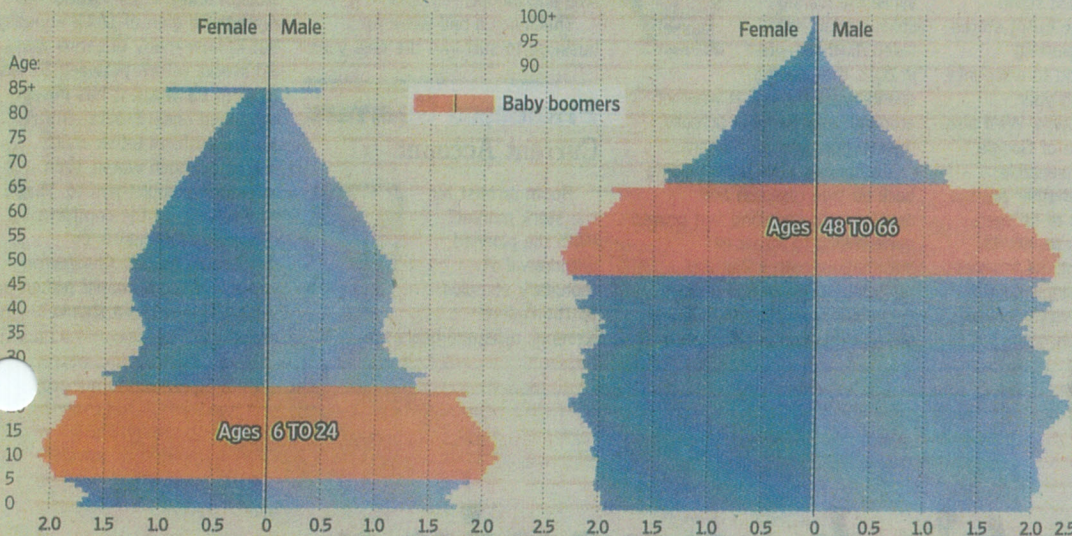
Census data show that in recent years, older Americans have been moving from pricier areas in the Northeast and California to cheaper climes, such as Florida, Arizona and the Carolinas.

Average annual net migration among those age 55 and over in 2009-2012:



## U.S. age distribution in 1970, in millions

**In 2012** latest data available



Photos: Associated Press (Keaton, Obama); Agence France-Presse/Getty Images (Shiller, Bush, Gates, Bezos); Reuters (Venter); Getty Images (Clinton); European Pressphoto Agency (Brown); WireImage (Bullock)

Sources: U.S. Census Bureau and William H. Frey analysis of Census Bureau data; Bureau of Labor Statistics (hours worked)

*We ARE moving south!*

*We ARE going To be spending MORE on HEALTH CARE.*