

# Sound Investments Inc.

Second Quarter 2014

DJIA 16826.6

S&P 500 1960.2

NASDAQ 4408.1

## Summary

No doubt, the 2014 additions to the Wall of Worry ---- the slowdown in economic growth in China, the near recession in Europe, the drama in the Ukraine, the 2.9% decline in first quarter GDP caused by winter weather and the heightened hostilities in Iraq ---have provided new fodder for the gloom and doom crowd to stay on the sidelines. We remain opportunistic on the balance of 2014 and beyond. Even if there is no resurgence of investor interest in equities, we think valuations **are reasonable for our type of stocks (mostly large well established companies)** in the context of near record low interest rates, strong corporate balance sheets and income statements. *It is not too hot, not too cold, economic climate and a friendly Federal Reserve, keeping interest rates low that supports the market.*

A short term correction would not be surprising in a market that has seen the S&P Index rise 600 points since November 2012. If, a correction develops, we will work to identify a buying opportunity. We are generally 85 to/ 90% invested in our portfolios and view a **correction as a health restoring event and a precursor to further gains.**

*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.*

## Healthy at the Half

Slumbering, grinding and even boring are three adjectives used to describe the U.S. equity markets in recent weeks. That's been just fine with us, as we like the way stocks have been behaving. We made good money in 2012 and 2013, and we look for decent returns in 2014. Our benchmark S&P 500 index gained 7.1% over the last 6 months. The NASDAQ was close behind with a 5.3% return over the past 6 months. Both numbers (when annualized) exceed the 10.1% figure that Morningstar calculates as the average return, per year, for mid to larger stocks.

To be sure, it wasn't clear sailing, as the widely followed Dow Jones Industrial Average only showed a 6 month return of 2.7% and the Russell 2000 index fell 1%.

## Continued Strength In the Economy

The economic news continues to be positive which is outlined as follows:

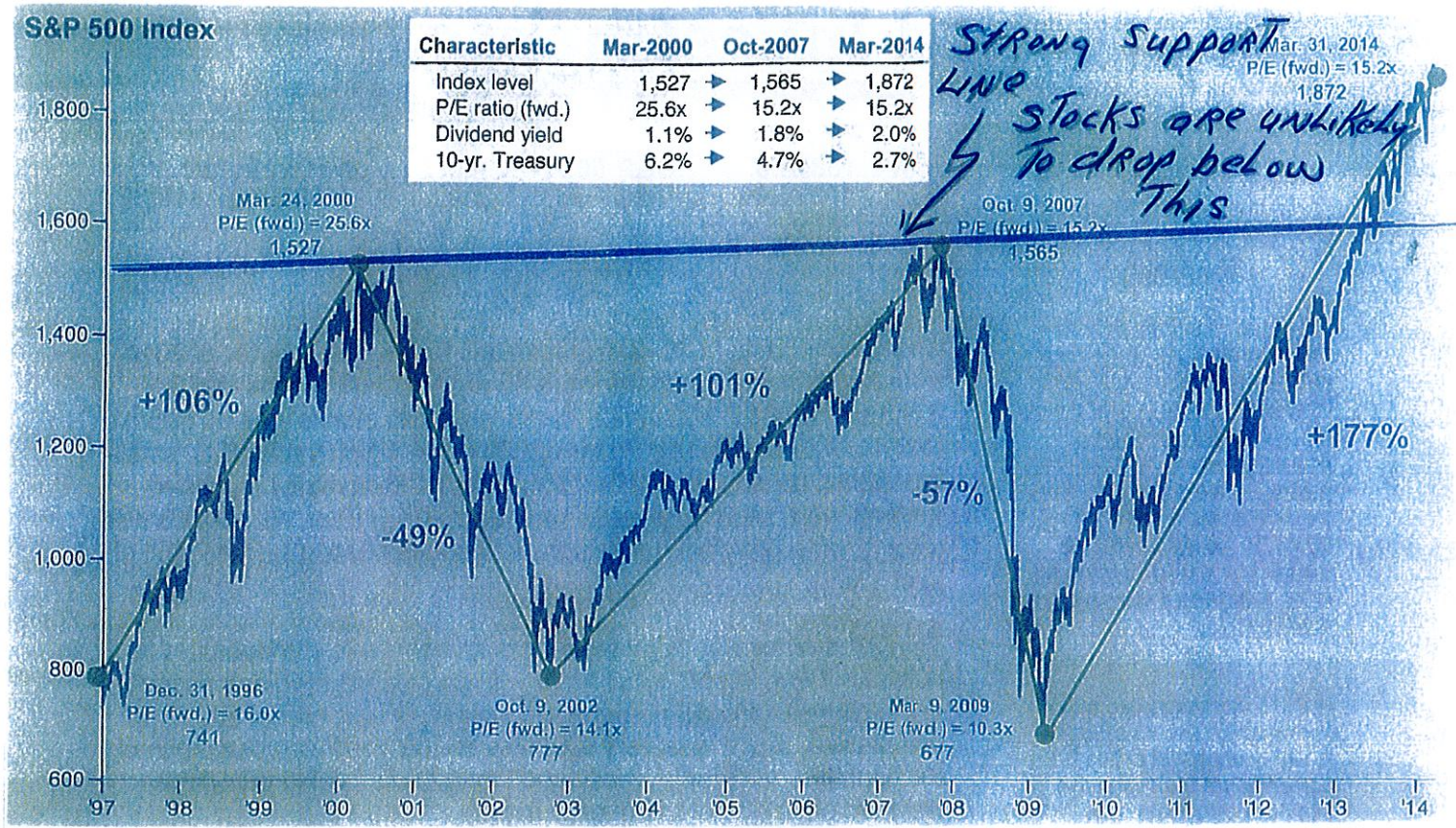
- Industrial production edged up 0.2% in June -- the second monthly gain in a row and the fourth in the past 5 months. Also, factory usage held at just under 80% thereby matching its best level of the year.
- Americans are cautiously stepping up their spending, with data on retail sales for June showing a 0.2% uptick, following a 0.5% rise the month before. Meanwhile if we back out auto sales to get to a core rate of sales growth, we find spending was up a more appreciable 0.4%, as sales climbed throughout the economy.
- The Conference Board of Leading Economic Indicators increased 0.05% in May. Seven of the ten index components advanced, two held steady and one declined again indicating a broad advance in the economy.

## Is the Market High Now?

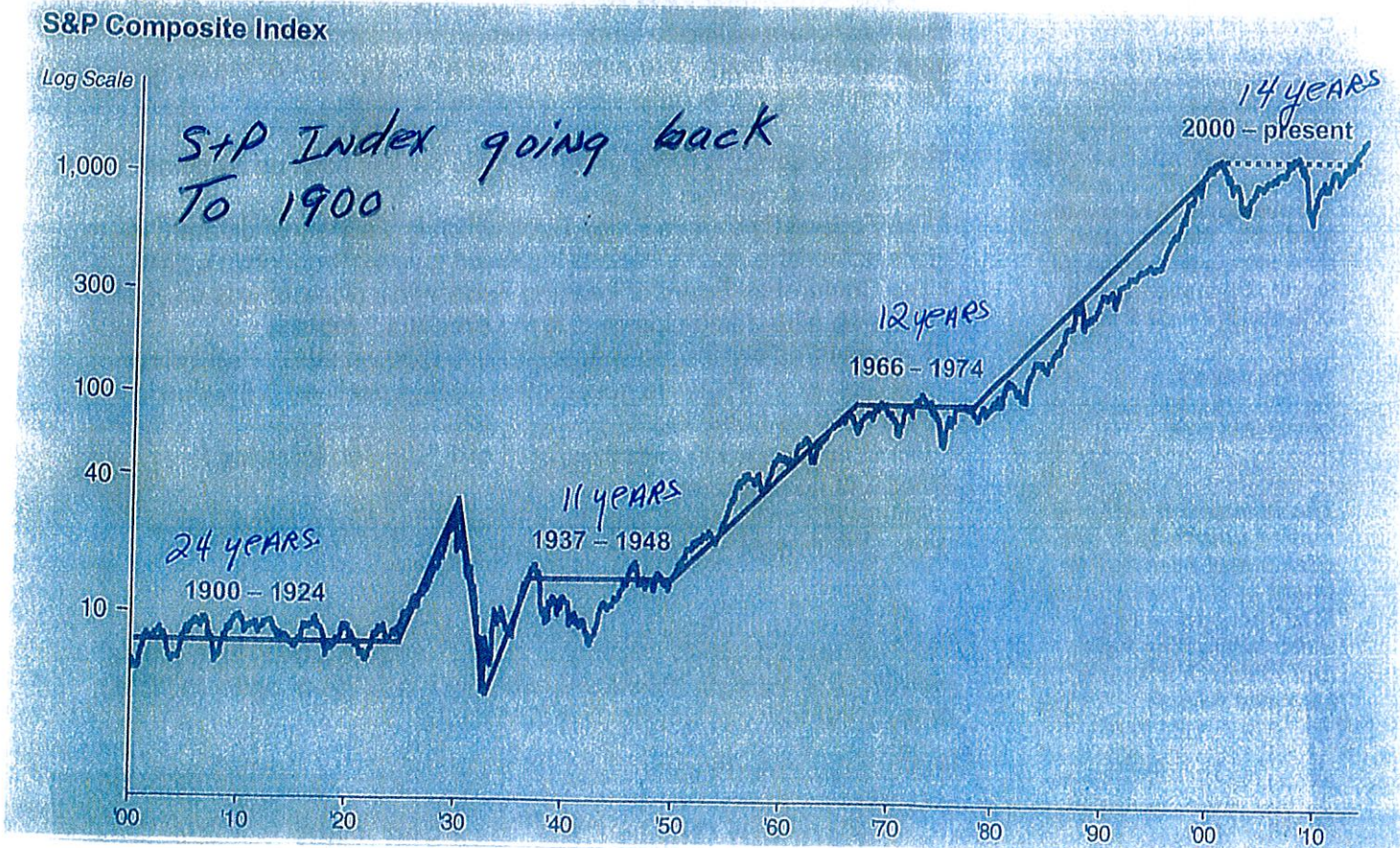
I attached an article from Barrons Magazine entitled "A Case of Salmonella" which proposes small cap stocks are high and funds might migrate to large cap stocks that are trading signifi-



# Figure 1



# Figure 2





cantly lower. Also, there is a short article from Goldman Sacks with the heading "Goldman Goes from a Bear to a Bull on U.S. Stocks." I sketched out my opinion in the next several paragraphs.

The S&P 500 index has traded at an average price earning ratio of 16 to 16.5 operating earnings, over the past 50 years. Given the low inflationary environment, we expect this price / earnings ratio to prevail over the next year or so. We estimate S&P 500 earning at \$130, so we estimate the index has the potential to trade at the 2100 level. (I.e.  $16 \times 130 = 2080$  or  $16.5 \times 130 = 2145$ )

There is a good chance of a midterm, off –presidential year stock market correction where the market goes down 8%. In every midterm election year since 1962, there has been a correction of at least 8%. We also note market sentiment has become complacent with a high percentage of investment advisors being very bullish. Investment complacency often met a period of profit taking where the market goes down. A short term correction would not be surprising in a market that has seen the S&P Index rise 600 points since November 2012. If, a correction develops, we will work to identify a buying opportunity. We are generally 85 to 90% invested in our portfolios and view a correction as a health restoring event and a precursor to further gains.

### **Wall of Worry or How Wall Street is Thinking Today**

The stock market loves patterns and formations. A good example, is that it takes 5 years of back and forth activity for a market to climb higher eventually reaching a peak. It then takes 6 months for it to decline 50%. As the market climbs higher, it anxiously considers each new tid bit of information and moves back and forth, heading higher and looking for confirmation that that everything is OK. This is the wall of worry. When markets discern that we are going into a recession, only then we have the fall or a bear market. Bear markets happen when we have a recession. On the back of page one there are two charts showing the support levels and history of the index

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### **Conclusion**

The case for mid and large equities remains in place, notwithstanding our concern over a correction. Investing is a marathon not a sprint. We feel stocks will be higher one year from now.





Client Event

Culinary Kitchen

June 3, 2014

*Thanks for coming,  
we all had a great time!*

