Sound Investments Inc.

Kenneth A. Gilpin CFP Seond Quarter 2007

The last Quarter Ending June 30th

We think there are a number of unresolved issues related to the fourth quarter earnings forecast that will make it have to be worked out over the next 2-3 months. New purchases are being put on hold.

Upgrading is based upon the observation, that few, if any money managers consistently excel. Instead we observe a wide range of performance returns, with only a small percentage of professional money managers investing in the right sectors of the equity markets at any given time.

This is because each money manager has a particular style that works well in some, but not all market environments. Market leadership rotates between large-caps and small-caps, growth and value styles, and international and domestic areas. Leadership changes because economic conditions change. However, most fund managers do not change their particular styles when the market leadership changes.

Since market leadership is forever changing we move incrementally towards the top ranked funds by progressively selling the lower ranked funds and investing in the new leaders. **This continuous process provides an effective way to invest in a broad range of investment opportunities as they develop.**

We use no load funds as they provide access to the talents and research of the country's leading money managers while they are at the top of their game.

Despite a rocky June, U.S. stocks enjoyed a robust second quarter due to a strong performance in April and May. For the three months ending June 30th quarterly returns were solid: the Dow-Jones advanced 9.15%, the S&P 6.3% and the NASDAQ 7.5%.

However, once again the strongest areas were outside the U.S. particularly in Asia and the emerging economies. Our portfolios remain heavily invested overseas as international funds continue to outperform most domestic funds.

June was a tougher month for a number of reasons. Investors were hoping for a "Goldilocks" scenario – an economy not too hot and not too cold – the hope was the Federal Reserve Board raised rates enough to stave off inflation, but not so much to caused a recession. Interest rate futures are not predicating a cut anytime soon. The culprits: a booming worldwide economy that has raised the specter of inflation and a sagging U.S. housing market.

The risk, if interest rates pop up higher, is that the summer could become a rocky period. The yield on the 10 year treasure note at 4.63% in early May surging to 5.33% on June 13th and then pulling back to 5.03% on July 1st. (the drop in interest rates fueled an over than 100 point gain in the Dow) With rare exceptions the yield on 10 year note has stayed below 5% since mid-2002. The low rate, low inflation environment is one of the main pillars of the bull market. That helps explain why investors are so nervous to see the rates push higher.

A Tougher Market

Many believe stocks remain reasonably priced measured up against corporate profit gains. For example, the price of the S&P 500 is about 17 times earnings over the past 12 months which is slightly above the average of 16 times over the last decade. During the technology stock bubble of 1999 the price/earnings ratio was close to 40.

Every now and then it is a good idea to stand back and take a good hard look as to what is really driving this truly remarkable market. Indeed it's being climbing the proverbial wall of worry and we need to know whether it has gone too far.

As recorded above, in Mid June, it was interest rates moving over 5.5% that drove the market lower. Then we heard losses from

sub prime mortgage loans made money manager sell these loans and switch back into U.S. government bonds higher and therefore rates went lower. The pressure was off and the market merrily went ahead for the next 2 weeks. As I write this on July 20th the second quarter earnings are just coming out. Two large companies, Caterpillar and Google announced their earnings had missed forecast and the market retreated 149 points on the Dow-Jones. The markets are now saying it wants earning growth – that's the key.

Slower Earnings Growth Ahead

In 2006 earnings grew at 14% a good increase. For 2007 earnings are projected to grow only 7% here is how the projections break down on quarterly basis:

Growth in Earnings Forecast

	Actual	**Estimated**	**Estimated**	**Estimated**	**Total**
	1st Quarter	2nd Quarter	3rd Quarter	4th Quarter	
S & P 1500 Composite	8	5	3	14	7.4
S & P 500 Large-Cap	8	5	2	13	7.1
S & P 400 Mid –Cap	7	10	11	14	10.5
S & P 600 Small-Cap	0	-5	8	31	7.9

Looking at the above chart, the markets are banking on great 4th quarter earnings, which we won't know for sure until Jan 2008. This is a long time to go without a reality check. We think this will provide a lot of volatility as the market responds to news. Lately the market is reacting to the downgrading of 6.4 billion in sub prime loans, dampening any hope of a swift end to the housing prices decline.

Analysts estimate that 60% of the earnings growth is from favorable foreign currency transactions and stock buybacks so real growth in earnings is slim. While hope springs eternal we feel earnings outlook may have to be ratchet down. Without an interest rate cut or lower oil prices reliance on the 4th quarter raises questions whether 2007 earnings growth expectations can be met.

Since we won't know until Jan 2008 whether this earnings forecast is correct this is too much time for the market to sit on it hands and wait. We suspect there could be some volatility ahead as it reacts to news. At this time we are delaying new purchases, but continue to hold our international positions.

We are living in an era in which the world economy is not totally dependent on the USA. Remember the industrial revolution of the 19th century? Well, we are living in a modern version of that revolution the economies of China, India and Brazil have a scope and energy that has never been seen before. Their demand for goods and services are stimulating economies around the world, including ours.

It is estimated that 44.2% of all sales in 2006 of the top 500 U.S. companies were export related, this is up from 32.2% in 2001. There is little doubt that U.S. companies have evolved into global players. They manufacture and produce goods worldwide. Our lower dollar makes makes our products cheaper and hence more competitive. Exports hit an all time high of 132 billion in May. This is great news, but it will take time for the lower dollar to help penetrate new markets and can the rest of the world shoulder market leadership? Time will only tell. We think the next 2-3 months will be tough until the earnings news becomes clearer.

Conclusion

We are concerned whether the earnings forecast for 2007 can be met. New purchases are being put on hold.