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Sound Investments Inc.

Fourth Quarter 2016

DJIA 19762 S&P 500 2238 NASDAQ 5383

Year in Review - Unpredictably Rewarding

2016 was a year of surprises that kept long term investors guessing what would happen next. How did the markets perform in 2016? The S&P 500 Index gained 3.8% in the first half and 7.6% in the 2nd half, combining for a full years return of nearly 11.8%.

Stocks tumbled to start the year, with investors bracing for a global-growth slowdown to tip the U.S. into recession. By mid Feb, stocks dropped 10% and then rallied to close up 1% for the first quarter. In June we had the suprise vote that Britain would leave the European Union. The markets fell 5% on this news then rebounded to new highs. Finally, we had the post election rally which boosted stocks 5% as markets embraced the notion that a Trump presidency may boost growth.

For the most part, we were 80% invested in 2016 and were rewarded.

The Trump Rally, Is It For Real?

I think so. The S&P 500 Index jumped 5%, with Banks and smaller to mid size taxable companies leading the way. So why the immediate jump, in stock prices? Donald Trump revved up investor's hopes for business friendly policies, corporate tax cuts and looser regulation.

The republican control of both the congress and senate makes it likely that Corporate Tax rates will be lowered in 2017, from 35% to the 22% range. Due to the current high tax rate, there are a lot of profits parked overseas. We expect a repatriation of overseas profits to be encouraged, through a special repatriation tax rate, so cash can be brought back to the U.S. This additional cash will support dividends, stock buybacks, acquisitions and other forms of capital investments.

Summary

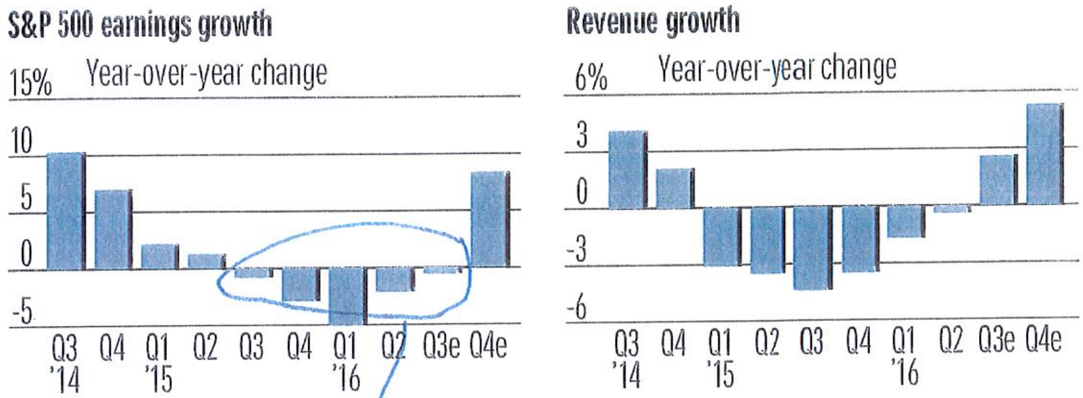
Finally, U.S. Corporate earnings broke a string of five consecutive quarters of decline for the S&P 500 by delivering growth in the 3rd quarter. So what happen? Basically, oil prices fell from over $100 a barrel in 2014 to $26 a barrel. Energy companies not only produced losses but wrote off their investments and this pulled down the average earnings of the companies in the S&P index. The charts on the back of this page indicate the that earnings will start to improve as the overhang from the oil bust fades.

Right now, 4th quarter results are being announced and the early expectations are that profits, overall, should rise 4.4%. It is a long awaited improvement in earnings. Stock valuations are high and the market needs these increases in profits to justify the stock prices.

This investment letter is mailed quarterly to our clients and friends.

Earnings Light At End Of Tunnel

S&P 500 companies likely saw their last quarter of earnings declines in Q3 as the overhang from the oil bust fades

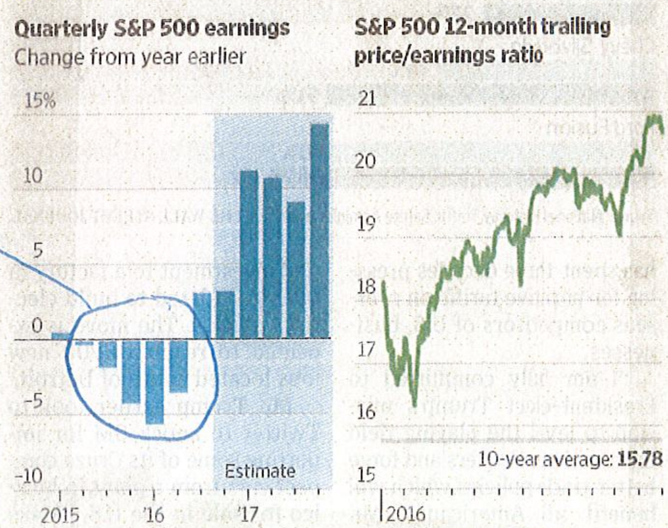


Source: Thomson Reuters

Five quarterly Declines caused by write-offs in the Oil and Gas Sectors

Bouncing Back

S&P 500 earnings are set for another gain after five quarters of declines, easing pressure on valuations.



Source: FactSet

THE WALL STREET JOURNAL.

Price / Earning Ratio go up in Anticipation of higher sales and Profits

Profit Rebound Emboldens Stock Bulls

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After a difficult 7 years, even the Banking Sector is also showing robust growth with a promise of more to come as rates head slightly higher and potentially faces less regulation. Right now, 4th quarter results are being announced and the early expectations are that profits, overall, should rise 4.4%. It is a long awaited improvement in earnings. Stock valuations are high and the market needs these increases in profits to justify the stock prices.

Outlook

The last year was the longest earnings slump since the financial crisis of 2009. It comes against a backdrop of improving economic data, which I outline below in point form.

1. Interest rates - The top chart on the back of this page looks at stock market performance when interest rates start to rise. When interest rates rise from a low level, like today, it is usually a sign of economic strength. When the 10 year rates continue higher, (i.e. over 5%) it can be disruptive for stock market performance. Currently, the 10 year bond yield only 2.5% so this shouldn't be a problem.
2. Employment. - Jobs have been steadily added, although, at a slow rate. Lately, wages have increased which is a very positive sign.
3. US. Dollar. - This a tough one. The dollar has surged 20% since 2014 and hit a 14 year high in December. It has dragged down U.S. corporate profits as the higher currency makes U.S. products less competitive throughout the world. Also, it hurts less developed countries as it drives down commodity prices and makes repayment of debt expensive. The dollar will likely remain in limbo until there is more clarity on Trump policies.

Asset Allocation

In my last letter, I reprinted the lower chart on the back of this page, "Diversification and the Average Investor," and had a lot of comments on it. It is interesting to note that the 50/50 and 60/40 portfolios did almost as well as the S&P 500, yet they didn't go down nearly as far and their recovery was significantly faster.

Conclusion

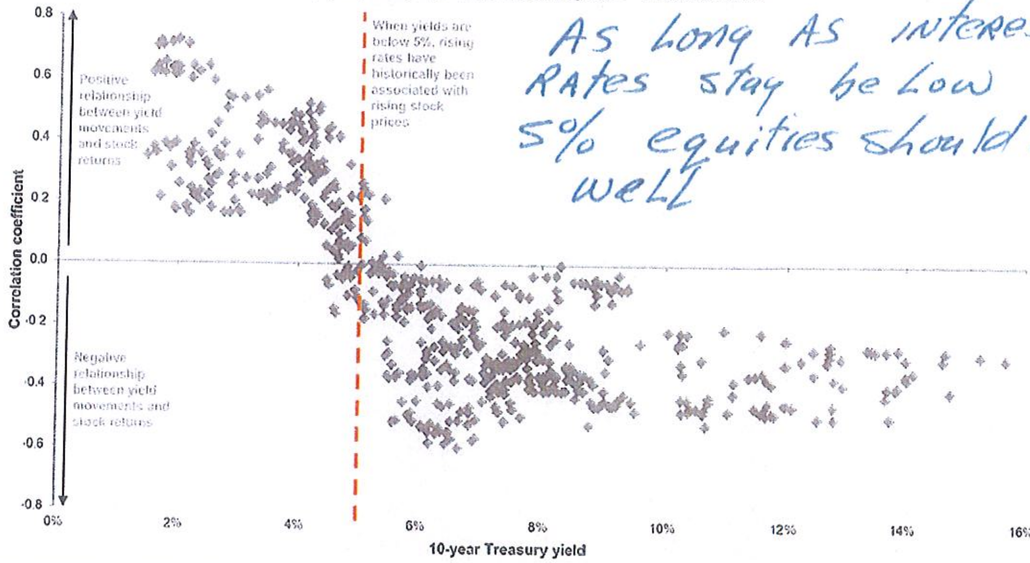
The stock market has come a long way in recent years and we are always vigilant in the event our market outlook changes. I wrote a reassuring letter but there is a lot that could go wrong. I believe the markets will 'muddle through' and will be higher a year from now.

We continue to watch and monitor the portfolios. Please call anytime.

Correlations between weekly stock returns and interest rate movements

Weekly S&P 500 returns, 10-year Treasury yield, rolling 2-year correlation, May 1963 – December 2016

X-Axis shows changes To the 10 yR. Bond.



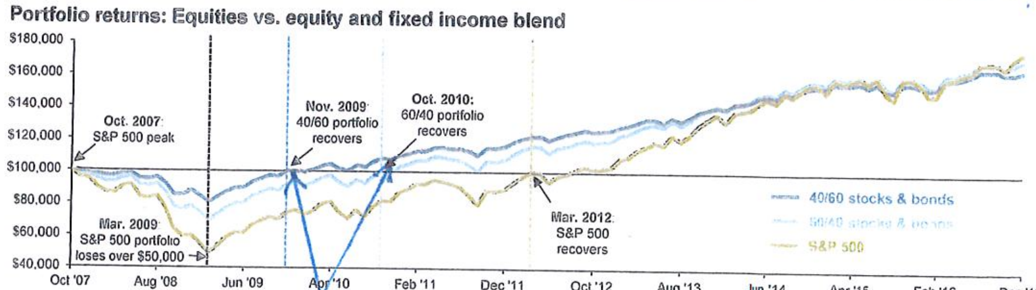
As Long As interest Rates stay below 5% equities should do well

Source: FactSet, Standard & Poor's, FRB, J.P. Morgan Asset Management.
Returns are based on price index only and do not include dividends. Markers represent monthly 2-year correlations only.
Guide to the Markets – U.S. Data are as of December 31, 2016.

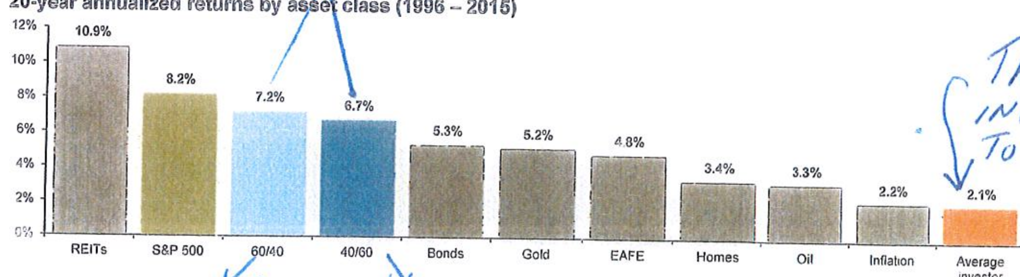
Y-Axis shows the Relationship between the S+P500 and the 10 year Bond.

J.P.Morgan
Asset Management

Portfolio returns: Equities vs. equity and fixed income blend



20-year annualized returns by asset class (1996 – 2015)



The Average investor Tends To buy at the Top and sell at the bottom!

60% Stocks
40% Bonds

40% Stock
60% Bonds