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Sound Investments Inc.

Fourth Quarter 2017

DJIA - 24719.2   S&P 500 - 2673.6

Markets: A Banner Year!

Markets over the past year have persistently rewarded investors and defied the skeptics who pointed to political dysfunction, monetary policy uncertainty, and geopolitical crises as reasons for woe. Even experts got many big forecasts wrong, including global growth, inflation and geopolitical power. A year ago forecasters thought 2017 would look like 2016; instead, the world economy had its best year since the financial crisis. Once again, assuming one year will be like the last was a bad idea.

In the US, large-cap stocks led. The Dow was up 28%, and the S&P 500 gained nearly 22%. Small caps rose about 14%. Foreign stocks outpaced those in the U.S. with Europe up almost 25%, and emerging markets gained 37%. (Note we loaded up on international funds at the beginning of the year.)

Gains were both strong and steady. The S&P 500 was positive every month in 2017, a feat not seen since 1970, according to the Wall Street Journal. After eight consecutive years of gains, many predicted 2017 would bring a correction, when in fact, 2017 was among the least volatile in modern history. The S&P 500 dropped just 3% during the year, despite talk of conflict with North Korea, catastrophic hurricanes, a remarkably unpopular president, and interest rate hikes. Earnings were strong, but markets were stronger, leaving earnings multiples at levels higher than the peak in 2007. Most expect the corporate tax cuts to boost earnings, yet how much is already priced in is unknown.

Looking Ahead to 2018

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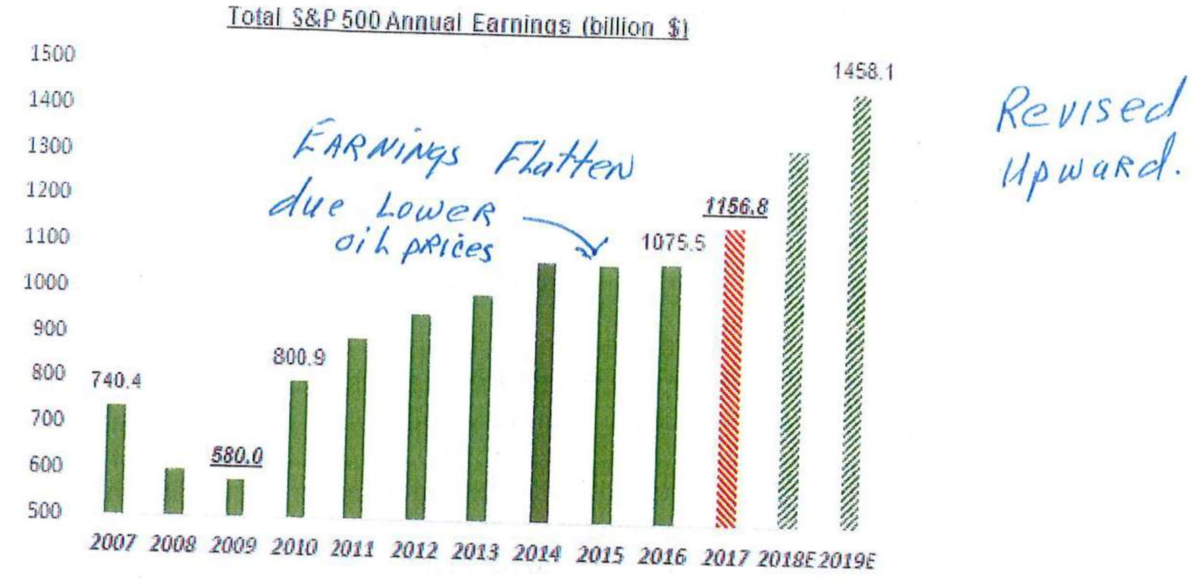
Summary

William Dudley (President of the New York Federal Reserve Bank) recently commented "Not only, do I think the economy is in good shape today, I think the economic expansion is going to continue for some time." We heartily agree with him. This reminds me of the 1980's when I was a Stockbroker! This continues to be <u>a bull market</u>. With consumer confidence at all time highs it is describe <u>as a feel good era</u>. Zach's Investment Research on Jan 17th stated, "Sales and earnings growth looked as best as it been in years" (see chart on back of this page).

Things to Look Out For

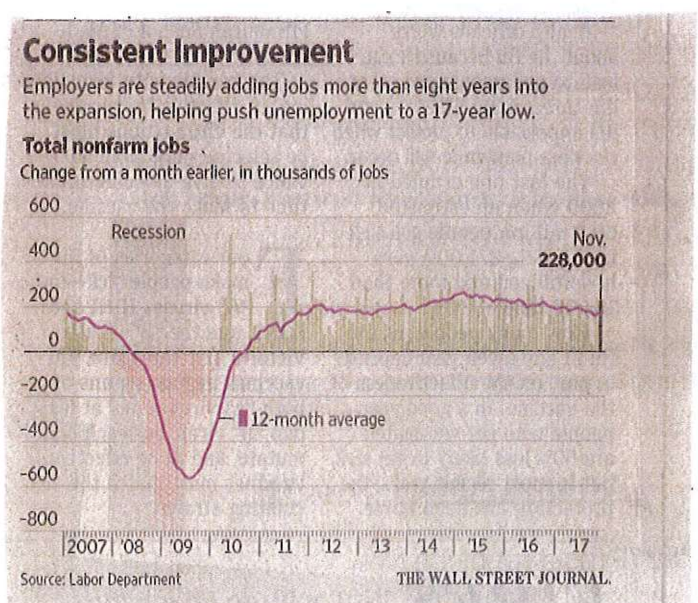
- Our sense is Wall Street will be tested at some point. When a new president is elected, the first mid-term election usually results in a sell-off of 7.5% or more. This may happen between now and Nov 2018.
- An expensive market tends to ignore the good news and focus or over reacts to bad news. For instance, Greece a small country of 10 million people caused a major stir 6 years ago when it threatened bankruptcy way out of proportion to its size.

This investment letter is mailed quarterly to our clients and friends



Source: Zacks Investment Research, Inc.

ZACK's are well know for forecasting earnings and the markets. On JAN. 17th they projected the S&P 500 to increase from 2800 to 3000 by the end of the year!



The question is Are we going to Run out of workers! A shortage of workers will lead to wage increases and possible inflation agree with him. This reminds me of the 1980's when I was a Stockbroker! This continues to be a bull market. With consumer confidence at all time highs, it is described as a feel good era. Zach's Investment Research on Jan 17th stated, "Sales and earnings growth looked as best as it's been in years" (see chart on page 2.) The new tax bill will especially help people who are self employed. The latest positive information is that new unemployment claims are at a 45 year low. In past client letters we discussed increases in job growth, profits and the general recovery of the economy. I could fill a whole page with convincing statistics, but thought it worth while to spend some time going over some things I am mulling over.

Things to Look Out For

As we start the new year, I made a list of things that may affect the investment climate as we go forward:

- Europe will continue to do well although there may be some issues as England leaves the common market. If oil and natural resources just stay where they are, less developed countries should continue to perform well.
- Our sense is Wall Street will be tested at some point. When a new president is elected, the first mid-term election usually results in a sell-off of 7.5% or more. This may happen between now and Nov 2018.
- Inflation by any broad measure has been subdued over the past 10 years. But with unemployment at record lows and a booming economy the inflation rate is now at 1.9%. The Federal Reserve Board goal is 2%. It is easy to see how a spike in oil or food or labor could cause an increase. Just the thought of higher inflation could cause a correction.
- Heightened tensions throughout the world. We see it in North Korea, China and Iran. Could we shug off a Chinese recession? Even Saudi Arabia's economic restructuring could sow civil unrest.
- An expensive market tends to ignore the good news and focus or over reacts to bad news. For instance, Greece a small country of 10 million people caused a major stir 6 years ago when it threatened bankruptcy way out of proportion to its size.
- Oil inflation could cause all commodity prices to soar.

Conclusion

The first five trading days of January set record highs and bodes well for the year. However, the market is clearly pricey; but markets can remain extended over long stretches. Indeed, stock market reversals rarely begin due to advanced age or high Price / Earnings ratios. Rather bull markets end due to eroding economic fundamentals (often rising inflation leads to a material jump in interest rates) or faltering earnings -------neither of which is an issue at this juncture.

We have generally remained fully invested over the past 8 years and have been well rewarded. Nobody knows but we do not see a major bear market coming but corrections of 10% are normal. We watch the market daily and welcome your phone calls.

Profits Are Forecast To Remain Elevated

By Ben Eisen

Wall Street expects another banner quarter for corporate earnings, but it may come with some caveats.

Earnings season starts at the end of the week, with financial firms leading the charge. S&P 500 companies are forecast to report that profits increased nearly 11% in the final three months of the year from a year earlier, according to FactSet.

On top of that, companies usually beat those forecasts by 3.4 percentage points on average, per Deutsche Bank AG data. This is poised to be the third quarter in four in which profits have risen at least 10%.

Expectations are high in part because analysts never really dropped them much. Typically, analysts start with high forecasts for the companies they cover and revise them down throughout a given quarter. Over the past 40 quarters, the average decline has been 6% for S&P 500 companies. But in the October-to-December quarter, the decline throughout that period was just 0.3%, the least in seven years, according to FactSet.

Economic growth has picked up in the U.S. and globally, helping boost sales, which **Goldman Sachs Group** Inc. analysts expect to expand at the fastest pace since 2011. A weak U.S. dollar has also been a boon to companies with large international operations.

But there could be some unexpected twists this season, particularly as it relates to the tax overhaul signed into law last month. Companies are expected to take one-time hits tied to newly taxed cash held overseas as well as write-downs of deferred tax liabilities or declines in the value of deferred tax assets, according to Bank of America Merrill Lynch analysts. Indeed, some firms have already warned that such charges are coming.

While these wouldn't necessarily show up in adjusted earnings numbers due to their one-time nature, they would show up in earnings reported through generally accepted accounting principles.

"For companies only reporting GAAP EPS, the headline impact could be substantial," the Goldman analysts said in a note to clients.

Count Goldman and **Bank of America** Corp. among the companies that will take a hit. Goldman said it would take a $5 billion earnings charge, two-thirds of which is tied to the new tax on overseas earnings. Bank of America said it would take a $3 billion hit.

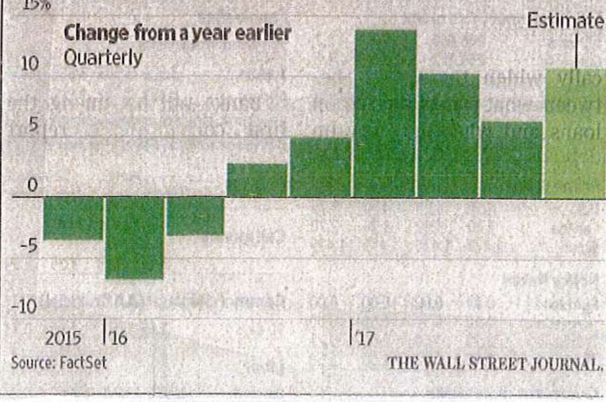
Banks and other financial-services companies are likely to eventually see a boost to profits because of the lower corporate tax rate. Many believe the one-time tax hits won't drag much on the market. "We expect investors to look through a noisy 4Q and focus on the effects of tax reform," Goldman analysts said.

11%

Expected rise in fourth-quarter earnings from a year earlier

Powering Up

S&P 500 earnings are expected to have continued increasing in the final three months of 2017.



Source: FactSet

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