Kenneth A. Gilpin CFP

Sound Investments Inc.

Third Quarter 2018

DJIA - 26458 S&P 500 - 2913 Nasdaq - 8046

Summary

It is always hard to predict a top in the stock market: there are so many variables. See charts on the back of this page.

There are a lot of things going right in the economy from job growth, controlled inflation and strong earnings.

We are experiencing a stock market propelled by a strong economy, massive corporate tax cuts, and fading memories of crises past. However, we are observant and watchful for the future.

This investment letter is mailed quarterly to our clients and friends

A Turn of Events

In our last quarterly letter we started off with a quote, "A picture is worth a 1000 words." -- On the last page of this newsletter, I've included a chart of 7,000 stocks. The chart is an index of their performance over the past year. You will note, it reached a high on Jan 26th and again on Aug 30th of this year. Then, in early October it fell 8% back down to the lower end of the trading range. So far, the story for 2018 has been a sideways trek as the market tries to make up it's mind. It is processing information on interest rates, earnings reports, taxes, employment growth, election results, etc. This is not unusual and it may go on for some time.

Outside the United States, both the developed and emerging markets struggled as talk of trade wars and falling local currencies took their toll.

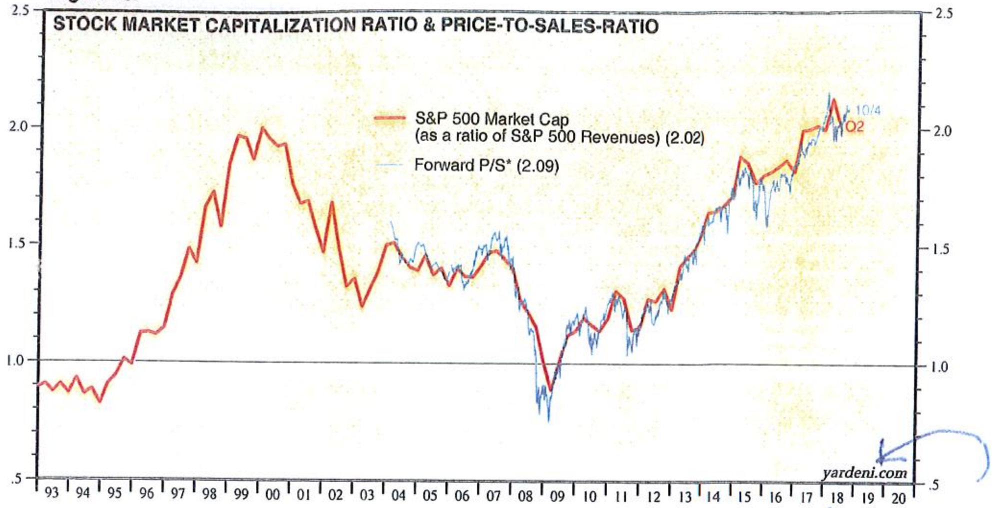
Spotting a Recession

It is always hard to predict a top in the stock market: there are so many variables. The recession of 2002 started during the dot.com era. Expectations were extremely high and this resulted in some of the highest valuation ever. Investors saw the potential of the internet and threw caution to the wind. It would be 10 to 15 years later before earnings could come close to justifying their stock prices. It took the tech heavy NASDAQ index 12 years to recovery.

The next recession was the mortgage crisis of 2008/2009. Housing prices peaked in 2006 but even the leading experts did not see the culprit -- bad loans -- which brought down the banks and led to the great recession.

On the back of this page, see two charts, which indicate the economy is similar to where it was in 2007 just prior to the last recession. <u>We do not think a recession is imminent at this time</u> but we present these charts to show that the economy has fully recovered.

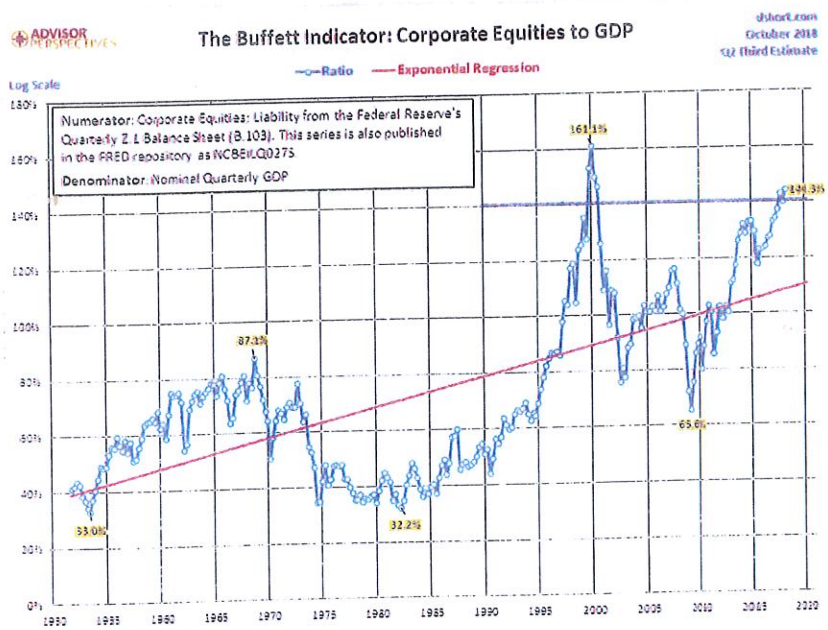
Figure 10.



* S&P 500 index divided by forward consensus expected revenues per share for S&P 500. Monthly through 2005, then weekly.
Source: Federal Reserve Board, Flow of Funds Accounts, Bureau of Economic Analysis, and Standard & Poor's.

YEARS

The price-to-sales ratio is a valuation measure that compares a company stock price to it's sales or revenue. The higher it goes, theoretically, the more expensive the stocks are. Currently, the ratio is around 2.2 near the highest last seen since early 2000.



Near high end of Range.

Market-Cap to GNP (Gross National Product) is a long term indicator that has become popular in recent years, thanks to Warren Buffett. Back in 2001, he remarked in Fortune Magazine, that it is probability the best single indicator of where valuations stand at any given moment. As you can see, we are near the upper end of the range.

Trade and Interest Rates

On Jan 1st, Trump will probably slap Chinese goods with an across the board 25% tariff. This will affect many things from clothing, shoes, purses, auto parts, etc. Barrons Magazine estimates it will trim earnings estimates by 4% and could cause some ripples in the equity markets. As discussed later in the newsletter, we don't think this escalating trade war with China will be the event that ends the bull market in the U.S. However, it will affect China, which is in the beginning of a slowdown, as production may move to other countries.

Interest rates are finally on the rise. In the past 3 weeks, the yield on the 10-year government bonds jumped from 2.99 to 3.23%, the highest since 2011. Ordinarily, this wouldn't turn heads - but rates are still low. Another increase is expected in December and 2 to 3 more increases are set for 2019. Stock markets are usually stable with higher interest rates until they reach the point where they start cutting into economic growth, which is normally around 5%. Interest rates can sting when short-term interest rates are higher than long-term rates -- This is called an **inverted yield curve** and we are not near to that currently.

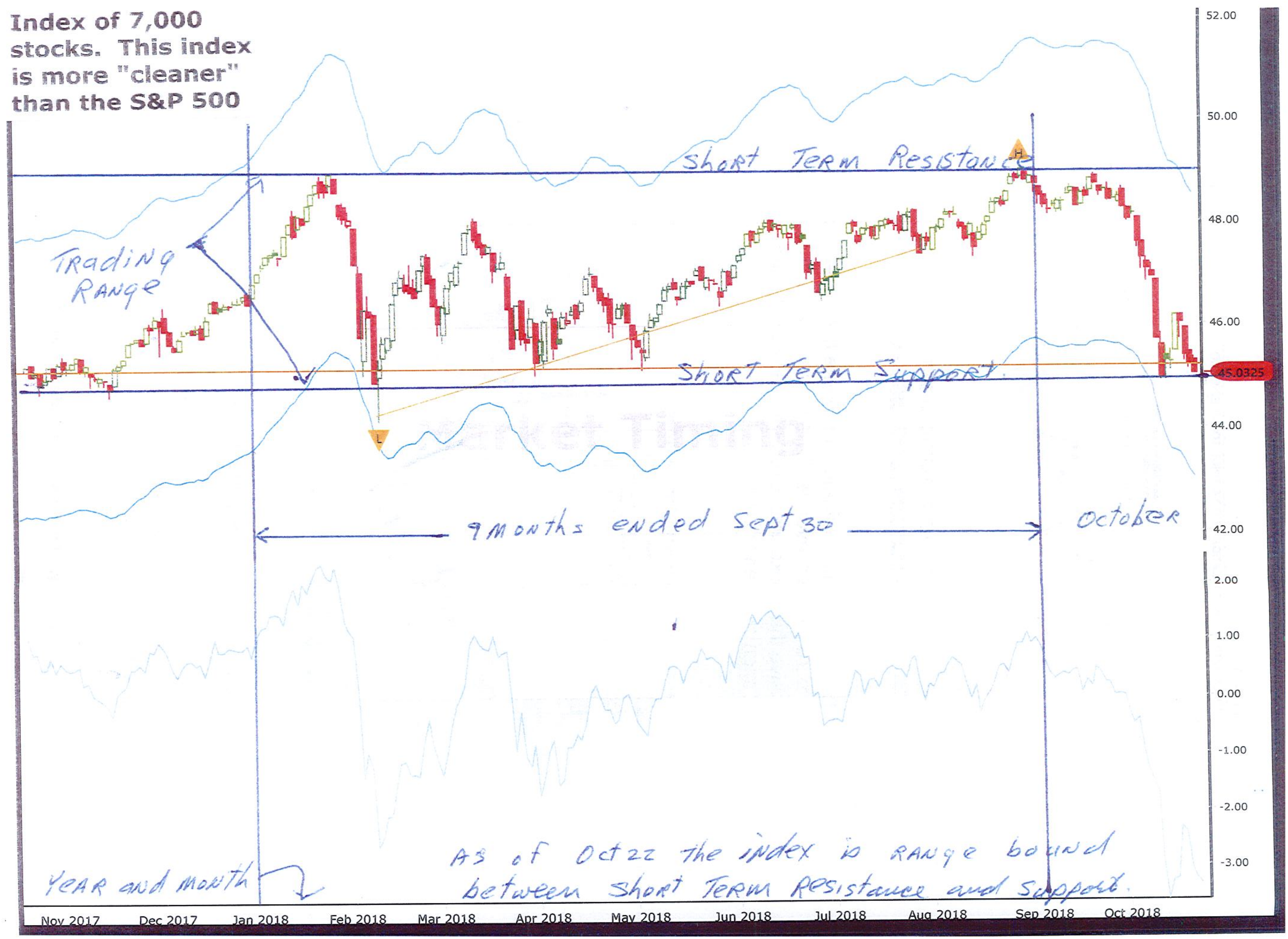
A List of What is Going Right in the Economy

- Payroll Growth is good with the unemployment rate at a very low 3.9%. Again, job openings exceed the number of unemployed.
- Massive corporate tax cuts.
- Low number of unemployment claims. Currently at a 49-year low.
- Inflation remains controlled. The consumer price index, over the last year, was 2.7% but over the last 6 months, dropped to 1.6%. We expected it to stay around 2% at least through the winter season.
- Positive Yield Curve exists today. Over the past 50 years each recession was preceded by a negative yield curve.
- Earnings continue to increase with an estimated growth of approx. 25%.
- 7 of the 10 Leading Economic Indicators (LEI) rose last month. Every recession since 1970 has been preceded by a negative reading from the LEI.

To put it another way, we are experiencing a stock market propelled by a strong economy, massive corporate tax cuts, and fading memories of crises past. However, we are observant and watchful for the future.

Conclusion

In our last client letter, we stated that we thought we're in a range bound market, that rises and falls based on the news cycle. We think a good motto for the times is, Keep Calm and Carry On! The market is richly valued and replete with uncertainty, yet still promising, based on fundamentals. For now, I don't see this leading to a financial crisis or a recession. We, remain on alert.


Index of 7,000
stocks. This index
is more "cleaner"
than the S&P 500
Trading Range
Short Term Resistance
Short Term Support
9 months ended Sept 30
October
As of Oct 22 the index is range bound
between Short Term Resistance and Support.
Year and month
52.00
50.00
48.00
46.00
45.0325
44.00
42.00
2.00
1.00
0.00
-1.00
-2.00
-3.00
Nov 2017
Dec 2017
Jan 2018
Feb 2018
Mar 2018
Apr 2018
May 2018
Jun 2018
Jul 2018
Aug 2018
Sep 2018
Oct 2018