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Sound Investments Inc.

Fourth Quarter 2018

DJIA - 22246 S&P 500 - 2510 Nasdaq - 6665

Summary

Stocks Rise as Fear Subsides

With the December decrease in stock prices the the new P/E ratio is about 14.4 times which is below the 25 year average of 16.1 times. Hence stocks look inexpensive.

Dividend yields and cash flow per share are in line with the past 25 year averages. With 10 year bonds yielding 2.8% and inflation at 2% a lot of the concerns noted above seem to have been discounted. Economist expect the economy to grow but at a slower pace. To be sure some economic data remains uneven reflecting lower consumer confidence.

This investment letter is mailed quarterly to our clients and friends

Worst December Since 1931

2018 turned out to be a particularly difficult year to make money. Stocks around the world limped into the end of a dismal fourth quarter that saw bear markets in equities from Japan to Germany. Foreign markets had a particularly bad year with the main European index down 14.7% and the Emerging Market Index sliding 15.3%.

At the end of the Third Quarter, the S&P 500 was up over 8% and the Dow-Jones was up over 7%. However, in the 4th Quarter the averages dropped approximately 14% which produced a loss in the S&P 500 of -4.6% and -3.7% in the Dow-Jones.

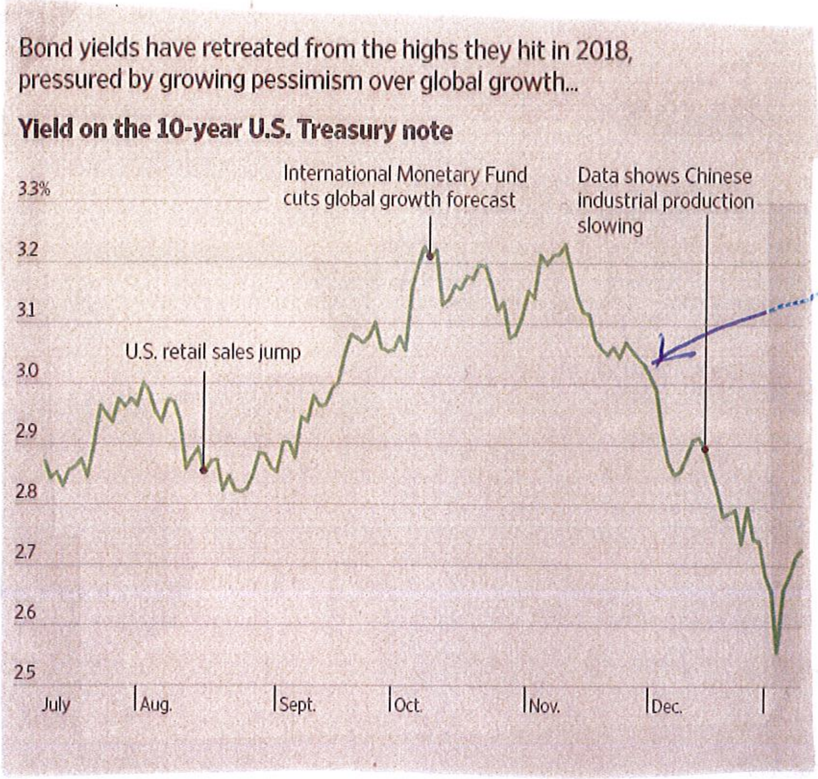
Up to the end of the third quarter, U.S. stock gains had been strong for nearly a decade. There was no asset class except (cash) with gains in 2018. The plunge pushed technology stocks down 24% from early Sept to Dec 24th, their worst performance in a decade. Nearly 90% of all equity lost money in 2018.

It can feel discouraging to have losses in your account but you have to look at the long term and if you look back 5 years or so, we had some great gains. Over the last 30 years the S&P 500 has averaged a rate of over 8% a year. Perseverance is a great blessing.

Why the 14%+ Drop Off in the 4th Quarter

Last summer, there was a feeling that trade with China, interest rates and immigration could be solved and we would continue on our merry way. Additionally, the global economy was slowing but it wasn't until November that global supply chains for auto parts, computer chips etc. noticeable started to slow here as well. I comment further on these issues below:

1. I believe we reach a trade deal with China in the next 6 months. However, we are on a new strategic plane and our relationship with be chiller.



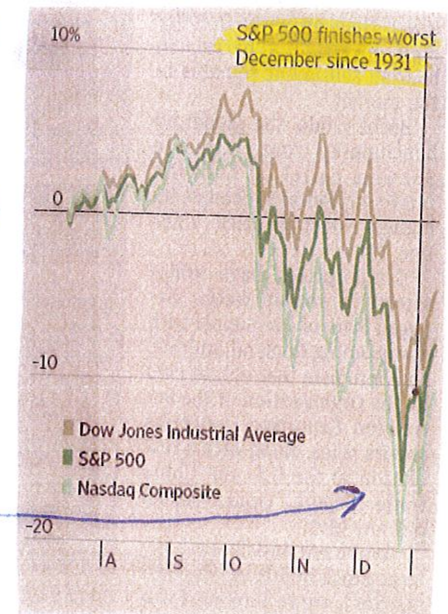
10 year Bonds declined as the Federal Reserve Bank wanted to Raise interest Rates 4 times, since Reduced To 2 Times

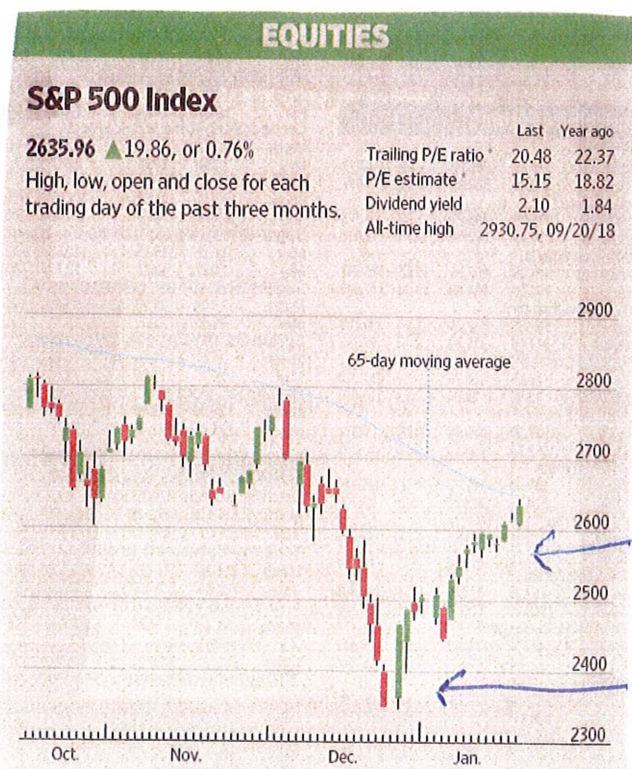
+10

0

Markets decreased approx. 14% in December
24% in the Quarter.

-10





High was on Aug 30 @ 2900

Recovered 8% since hitting bottom on Dec. 24th

2. At the same time, in Nov, the new Federal Reserve Chairman Powell, wanted to increase interest rates in Dec., which he did, and 4 more times in 2019. This slowed housing. (Home depot dropped from $200 a share in late Oct to $164 in mid Dec. Lumber prices decreased from $600 per thousand board feet in May to $329 in December). Since then, Powell has moderated his position, stating he wants to see the data but 2 more rate hikes are likely now.
3. The partial government shutdown added more uncertainty to the mix.

The above issues came together in Dec. and the traders brought the market down on Dec. 24 before they left for Christmas. Data showing a heathy labor market, signs of easing trade tensions with China and scripted comments from Fed Chairman Powell stating they will be more flexible resulted in a broad rebound, lifting markets by 13% by Jan 11th. In essence, we have a **'do-over' at lower prices.**

Stocks Rise as Fear Subsides

Lets Look at the chart on page 4. It shows the price earnings ratio (P/E) of the S&P 500. This is the price of the stock divided by it's earnings. To give you an example, suppose a stock was trading at $24 and made $2 a share in earnings; the price earning ratio would be 12 (24 divided by 2 = 12). It is a broad measure of how expensive stocks are. A lower value indicates indicates a better value whereas a higher value indicates an expensive stock. As per the chart on the back of this page, the the P/E ratio peaked at over 24 times, on the year 2000, at the height of the dot com bubble. Next, it dropped to 10 times in the great recession of 2008 and slowly recover to approximately 18 times in 2018. With the December decrease in stock prices the the new P/E ratio is about 14.4 times which is below the 25 year average of 16.1 times. Hence stocks look inexpensive.

Other measures that confirm positive stock prices are dividend yields, which are currently at 2.3% compared to the 25 year average of 2.0% and cash flow per share, now at 10.6 compared to the 25 year average of 10.7. With 10 year bonds yielding 2.8% and inflation at 2%, a lot of the concerns noted above seem to have been discounted. Economist expect the economy to grow but at a slower pace. To be sure, some economic data remains uneven, reflecting lower consumer confidence.

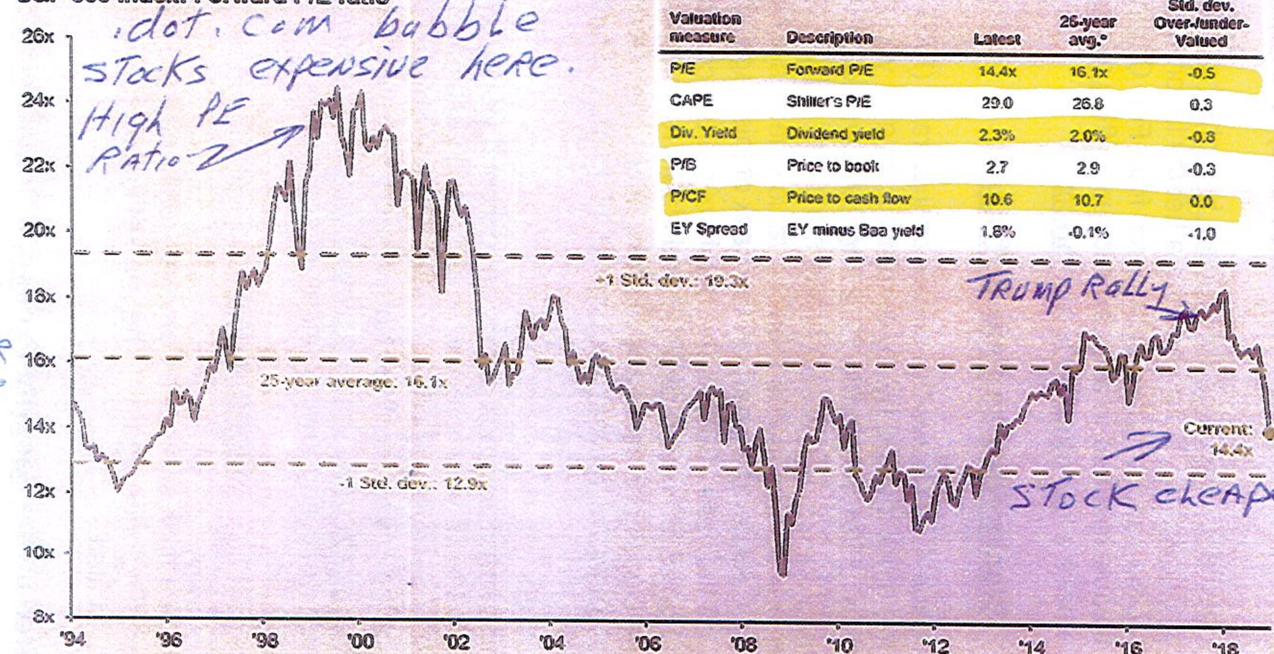
Conclusion

As I write this on Jan 11th, we think sufficient froth was removed from the market in late-2018 for stocks to be appealing once again. The market looks promising based on it's fundamentals but remain on alert.

Once a year, I am required by the Security Exchange Commission to offer to send out to my clients a copy of my ADV part 2, which outlines my companies policies and procedures. I am happy to send it or, even better, come in and will explain it to you.

S&P 500 valuation measures

S&P 500 Index: Forward P/E ratio



Valuation measure	Description	Latest	25-year avg.*	Std. dev. Over-/under-Valued
P/E	Forward P/E	14.4x	16.1x	-0.5
CAPE	Shiller's P/E	29.0	26.8	0.3
Div. Yield	Dividend yield	2.3%	2.0%	-0.8
P/B	Price to book	2.7	2.9	-0.3
P/CF	Price to cash flow	10.6	10.7	0.0
EY Spread	EY minus Baa yield	1.8%	-0.1%	-1.0

25year
Average

Lower
P/E
Ratio

Source: FactSet, FRB, Robert Shiller, Standard & Poor's, Thomson Reuters, J.P. Morgan Asset Management.
Price to earnings is price divided by consensus analyst estimates of earnings per share for the next 12 months as provided by IBES since December 1993, and FactSet for December 31, 2018. Average P/E and standard deviations are calculated using 25 years of IBES history. Shiller's P/E uses trailing 10-years of inflation-adjusted earnings as reported by companies. Dividend yield is calculated as the next 12-month consensus dividend divided by most recent price. Price to book ratio is the price divided by book value per share. Price to cash flow is price divided by NTM cash flow. EY minus Baa yield is the forward earnings yield (consensus analyst estimates of EPS over the next 12 months divided by price) minus the Moody's Baa seasoned corporate bond yield. Std. dev. over-/under-valued is calculated using the average and standard deviation over 25 years for each measure.
*P/CF is a 20-year average due to cash flow data availability.
Guide to the Markets – U.S. Data are as of December 31, 2018.

J.P.Morgan
Asset Management