

April 2004 Commentary
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S&P 500: 1132
NASDAQ: 2015
10 Yr. Yield: 3.89%

Chicken Feet for Mudbugs
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Chicken Feet for Mudbugs

Let's start by talking about what we know. We are being swallowed up by the deflating prices of labor-intensive goods and services as China produces and India services. For example, I was at Wal-Mart recently (forced to go because no locally owned stores had what I was looking for) and was pleasantly surprised to see they had crawfish. Having grown up in Louisiana I was thrilled and immediately asked if they were Louisiana crawfish. Guess where they came from. Where does everything else from Wal-Mart come from? You guessed: China. Then I read a great story about an item that is helping offset our \$120 Billion trade deficit with China. Apparently, the Chinese get a lot more use out of Chicken feet than us Americans. According the Wall Street Journal, they are importing them by the tanker load! Chicken Feet for Mud Bugs!! Talk about free trade... It saddens me to think about all the poverty in Louisiana and it can't even export Crawfish more efficiently to Wal-Mart's in Virginia than the Chinese. A client told me the other day that they bought shrimp at a market off a Virginia highway and it turned out the shrimp were from Bangladesh!! This is extremely frustrating to me. The outcome of this unsustainable labor cost differential (35 cent per hour versus \$6 per hour) will be an improvement in the Chinese standard of living reciprocated by a decline in our standard of living. Combine that with the fact that just about every customer service call center these days is outsourced to India and you have *labor oriented deflation*.

On the other hand we have FED-induced low short-term interest rates causing higher home prices. This happens because people are able to take on more debt. That debt is piling up both on private ledgers and government ledgers and is going to be the straw that breaks the dollar's back. In addition, rising price pressure exists in basic commodities like oil, metals and food items because all this production in China comes from basic stuff. The demand for the basics is inflationary. I have mentioned before that since the dollar is worth less and less to foreigners, they must obtain more of these dollars from Americans in order to compensate them for the same goods and services. This is inflationary as well. Oil going up is adding a tax on everything that requires oil for its production or consumption. Let me make one thing clear: oil going up despite the lack of

job growth is not good at all. Usually oil rises because intrinsic demand for U.S. made goods increases to the point where it outstrips supply as a result of increased production which requires new hiring. In this case it is rising due to increased demand for *Chinese* made goods as well as the weakened value of the dollar. This is leading to *commodity oriented inflation*.

Debt Does Not Go Away, Stock Valuation Bubble Will

Here is something else we know and it addresses a question I get often about whether it is better to have a bigger mortgage and invest the extra money or just pay off the loan: What we know is that debt does not go away unless you pay it off. The other thing we know is that the alternative you are investing in, i.e. the stock market, is commanding the highest prices for earnings in almost a hundred years. The Price to Earnings multiple didn't even get this high during the Roaring 20's. With low interest rates and high valuations, people are wondering why the heck not be in the market given the low paying alternatives. Two answers: 1) whenever you are forced to take on more risk strictly for the sake of obtaining some kind of short term return, it can't be the right thing to do. When have you ever been hurt walking away from added risk? Have you ever heard of an experienced poker player playing the bad hand he is dealt (with the exception of the bluff)? As Kenny Rogers sings, "You got to know when to hold 'em, know when to fold 'em, know when to walk away, know when to run". This is a case of sitting at the table, counting your last dollars and the cards are just not dealt in your favor. Wise, experienced investors like Warren Buffett are sitting on piles of cash because despite how painful it is, he'd rather not "do something stupid". I know; Buffett has plenty of money so he can more "afford" to stay away whereas the average Joe "needs" the return. Shouldn't we all invest as if we could afford to stay out? Ironically, the rest of us are the ones who can least afford the risk and yet we take it. So avoid the "I've got to get back to even" syndrome. Rather, be the wise and prudent investor and "walk away from the table"...maybe even "run" until that which you are investing in is CHEAP!!

Why do high valuations imply greater risk? Because valuations operate in cycles just as sure as seasons change. The only problem is, unlike the seasons, we never know when the cycle will change; we just know it will. Not surprisingly, valuation cycles are highly correlated to interest rate cycles. Low interest rates beget high valuations and vice versa. Thus it follows that if interest rates are about as low as they can go, odds are valuations are readying to decline. Many studies have been conducted which ironically conclude that interest rate bottoms are NOT the time to be pouring money into any stock you can get your hands on. The odds of succeeding over the next five years are just not as good. This is why I stick firmly to a strict diet of CHEAP stocks with my valuation method.

Impact of Government Spending on Valuations

Valuations can also be inversely correlated to tax rates. If tax rates climb, corporations have lower after-tax profitability which leads to investors paying less for their earnings. As I have quoted in this space before, "Bush has yet to see a spending bill he didn't like". The most inefficient means for stimulating the economy, in my opinion, is government

spending. Besides the stories we've heard of overpriced toilets, just compare the dollar the government spends versus the dollar you or I get in our pocket and spend. After all, it is *our* money the government is spending. That is why I like tax cuts-it lets *us* directly inject the undiluted money. When our government spends more than it takes in, borrowing is necessary to spend. Our national debt is now \$7,118,813,594,044.39. That is up about \$1 Trillion from one year ago. And just as we take pride, as citizens, in our national landmarks and our military this debt is all *OURS*. Most people don't seem interested in facing this fact. We owe over \$7 Trillion. And unlike the past where we owed it to ourselves because we were the ones buying the bonds, we owe much of this debt to foreigners. How likely are they to bail us out? By the way, the total debt works out to \$24,000 per man, woman and child. Even the FED is becoming concerned:

From the January FED minutes:

"Some members expressed concern about the longer-run prospects for large federal deficits and their implications for the future performance of the economy."

"Some members indicated that they were concerned about the implications of the nation's rapidly growing external debt for domestic financial markets and the economy over time."

Interesting Ethical Question

One cannot blame credit card companies and similar lenders for this consumer "debt bubble". I am a big anti-regulation guy so it'd be tough for me to build a case for regulating how much one is allowed to lend individuals for revolving credit and car loans. BUT, I will say the most recent proposals and enticements really scare me. Two examples come to mind: 1) a proposal allowing low income individuals to buy a house with 0% down. This is actually being discussed and for all I know has passed. Why does this bother me? I have heard actual stories of people being forced to sell and *OWING the lender money* at closing after taking a haircut on a recently purchased home and paying realtor fees. Up to \$15,000, I've heard. It is not unheard of to find yourself owing the bank \$15,000 selling a house after one year after buying it with zero down. Again, I want people to make decisions for themselves so it is hard for me to argue with giving everyone the opportunity to own a home and contribute to our consumption based economy by stocking it with stuff. 2) Recently in Richmond an advertisement on television for a car dealership began: "Under water on your current car loan? No Problem!" The ad goes on to demonstrate on a chalk board the following:

Trade in value	\$7000
Current Loan balance:	\$-10000
Equity:	\$-3000
Rebate on new car:	\$4000
Equity in new car:	\$1000

If you didn't see this ad you are probably saying "I can't believe this!" So am I. Get out of debt at your earliest convenience. I am currently encouraging those who can afford it to refinance from 30 year mortgages to 15 year mortgages.

The Indicators

Let's now go through the indicators introduced in the January Outlook and Commentary where explanations for their interpretation can be found. (See the "Archived Commentary" section of the website: www.FriedrichsAssetManagementLLC.com)

Contrarian

Indicator	Greed	Fear	Current	Indication	
NYSE Bullish Percent	>70%	<30%	77.62--Peaked	>86%	Bearish
AAII Sentiment					
Bull/Bear ratio	>2.5	<1	2.5*		Bearish
NYSE+NASD					
Margin debt balances	>160B	<100B	190B/Last here	2/2001	Bearish
Savings Rates	<5%	>12%	1.8%		Bearish
Mutual Fund Cash	<7%	>12%	4.0%		Bearish

*Recently we have seen readings not seen since 1987, which like 2004, also followed 2+ years of >10% \$US decline each year.

From my January report, margin debt has increased, savings rates have declined and mutual fund cash positions have declined. This means less available to fuel the market.

Valuation Indicator	Greed	Fear	Current/Last here	Indication
Price/Earnings Ratio	>20	<10	23/over 20 since 1997	Bearish
Dividend Yield	<3.5%	>6%	1.6%	Bearish

One indicator has been added that should have been included in January as I've followed it for years is the New York Stock Exchange Bullish Percent (NYSE BP). What it represents is the percentage of stocks listed on the NYSE that are currently on Buy signals. When it reads 70%, this means that 70% of all the listed stocks are currently on buy signals. Likewise at 30% only 30% of the listed stocks are on buy signals and the rest are on sell signals. This is a contrarian indicator because while one would think that a large percentage of stocks on buy signals would be bullish, it is very similar to the bullish sentiment surveys in that it implies that most of the demand sitting on the sidelines has come in and bid the stocks up. In fact, readings above 70% indicate an "overbought" market while readings below 30% indicate an oversold market. Of course, markets can remain overbought indefinitely as well as remain oversold indefinitely. Just being above 70% does not give us the timing we desire. However, when this indicator goes above 70% and then reverses from above 70%, we know we are closer to the markets breaking down from a vulnerable area. This market has been overbought (above 70%) since June and finally reversed during the March pull back. It is important to note

that usually the highest this indicator climbs is 75-80% of stocks on buy signals before reversing. This violent rally (usually the most violent rallies occur amid bear markets) had taken the market to 86% of stocks on buy signals—a historically significant overbought level.

Most everything I follow has been telling me the market is feeling “toppy” and running out of steam. This reversal leads me to believe the top is in. If it is not in, I don’t think a rally from here will make any significant headway above the DOW peak of 10753 back in February. I say this for all of the other indicators presented above.

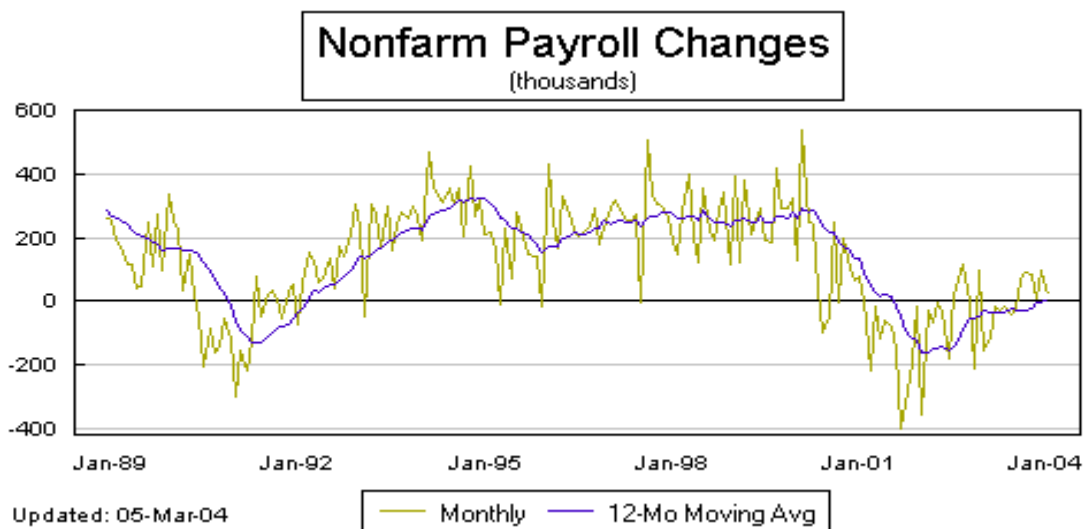
Insider activity is important to me as well. In January’s report I explained the merits and pitfalls of following the investment decisions of those closest to the action. However, I have since read one of the simplest explanations of the worthiness of this endeavor presented by Alan Abelson of Barron’s:

“Insiders, no question may be motivated by any number of reasons to sell their stock, but belief that the stock market is going higher is not prominent among them”

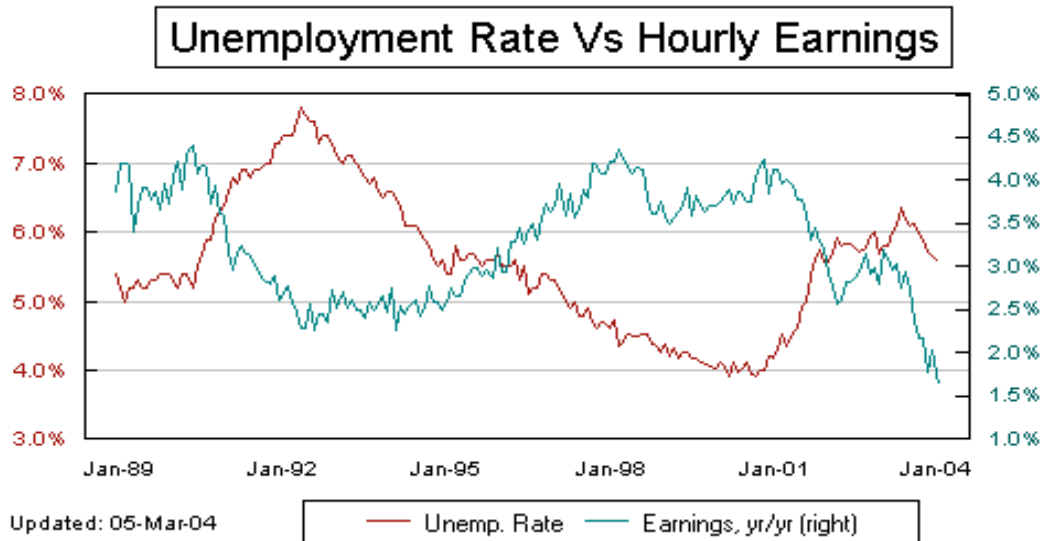
With the ratio of selling to buying usually way below 20 it is important to note some recent weekly figures: Week of January 28th: **42...**Week of February 11th: **30...** If the very people running these companies are selling into the January rally, much less selling up to 42 times what they are buying, why would I want to buy more than I sell? When reviewing a stock to invest for my clients, insider activity is among the top 10 characteristics reviewed.

The Job Market...

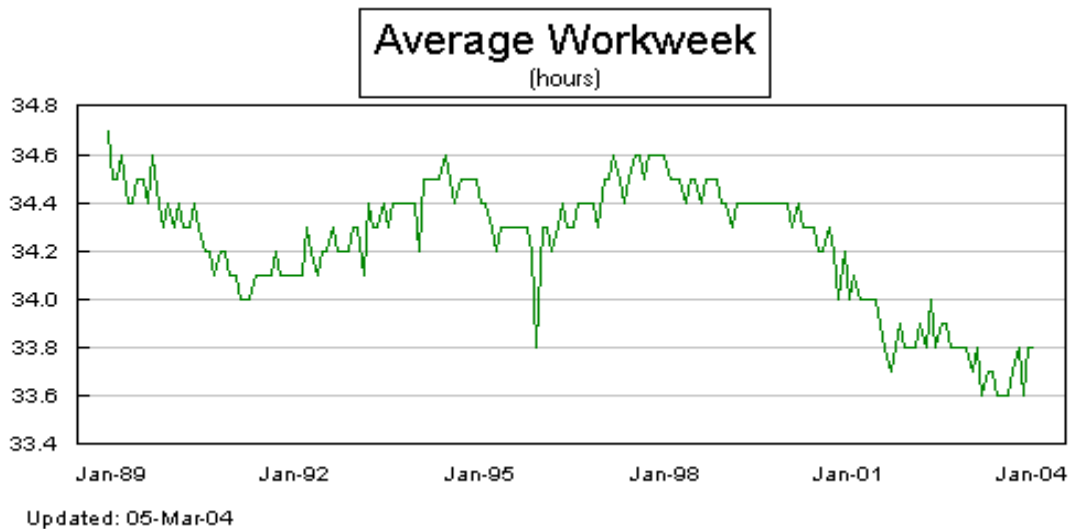
Mortgages are supported by jobs so let’s look at the Job Market. When jobs are being added, people (borrow to) buy houses and vice versa. The graphs here show inadequate, inconsistent U.S. hiring; declining wage growth rates; and shortening work weeks.



Lack of hiring; 150-200,000 per month needed to SUSTAIN our economy.



Wage growth rate (blue) shrinking dramatically as we outsource overseas.



Outsourcing and productivity means people paid for fewer hours.

Just today the government produced employment report surprised on the upside saying 306,000 jobs were added to the economy while unemployment *increased*. If you find these numbers confusing, you are not alone. The business survey gave us the payroll number while the household survey tells us that *total employment actually fell by 3000*.

Not Playing a Bad Hand...

Hopefully, the rosier payroll number is a harbinger of things to come. We currently hold about 19% cash while continuing to perform favorably. I'll feel better about deploying the remaining cash when Wal-Mart has Louisiana crawfish. Until then, I'm not going to put more into the pot.

Successful Planning to All!

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