



Registered Investment Adviser

April 2007 Commentary
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S&P 500: 1439
NASDAQ: 2458
Gold: 674

“No generation can contract debts greater than may be paid during the course of its own existence.” –*Thomas Jefferson, in a letter to James Madison in 1789*

Liquidity, Liquidity, Liquidity

If I were to pick three reasons the market is up, these are the three. Liquidity is provided by near record margin borrowing, the war chests of private equity funds and hedge funds, and lenders of all stripes. While the indexes did well in 2006, including the large company indexes, the small cap out-performance trend continues. This is mainly due to the fact that these companies are the primary beneficiaries of the 2000's version of the 1980's leverage buyout (LBO) boom. Their size is obtainable and they can show the growth needed to cover debt service. As valuations get driven up these companies become less attractive (although it seems we haven't hit that limit yet) and eventually liquidity slows, capital markets ebb and these companies, and all others see earnings growth decline if not losses. Note: when I refer to valuations I'm talking about multiples of earnings, cash flows and sales, not the absolute price paid. And as I've alluded to before in this space, valuations cycle in lockstep with the fear and greed cycle investors experience. We got a small taste after the 10% drop in the Chinese market February 27th. The result was a brief panic for liquidity--and nothing was safe from that panic--as everything was sold off. I believe this could be the beginning of something serious. I don't need to tell you how the LBO boom of the 80's ended up--and for that matter how markets typically do after a few years of high Merger & Acquisition activity. They usually predicate important tops.

Previous Bull-Bear Cycles

The stock bull of 1982-2000 saw the S&P 500 go from 105 in July 1982 to a high of 1553 in March of 2000, an increase of 1478%, or about 15X. The PE ratio went from about 8 to 36--about a 4.5X increase. So without valuation changes the market climbed only 3X. In other words as the market grew, folks became willing to tolerate more risk by paying more times earnings than before rather than becoming more risk averse as prices soared. Just does not make sense, does it? Nothing begets higher prices like higher prices. It's just human nature. The inverse is true as well. As profit growth

shrinks, so will PE's. An old stock valuation tool indicates that fair value exists when the item trades at a PE equal to its growth rate. It is known as the PEG ratio. Some will add in dividend yield to the growth rate. If the PE exceeds the growth rate plus the dividend yield then the item, all things equal, is deemed to be over-valued and vice versa. With the estimated earnings growth rate in 2007 and 2008 of 8% and 10.9%, respectively, and a paltry yield of 1.8% I can only justify a PE of maybe 10-13. Currently the PE is about 17 while the market is at about 1400. I believe we could experience further decline as the S&P PE comes into parity with its growth rate. That is how you get to a bear market bottom and that is why the PE on the market was only 8 in 1982. I'm not sure what profit expectations were then but the yield was 8%, justifying an 8 PE. I bet there was a positive growth rate expected but after 15 years of little growth (1967-1982) in the index there was also a little pessimism priced in. The chart below illustrates this PE cycle over the past 82 years. The market value is in black while the PE range is illustrated using green (where the market would be if the PE=10), blue (where the market would be at fair value, PE=15) and red (where the market would be at a PE=20). You can clearly see that over time whenever the PE exceeded 20, it always reverted back to a PE of 10 or below.

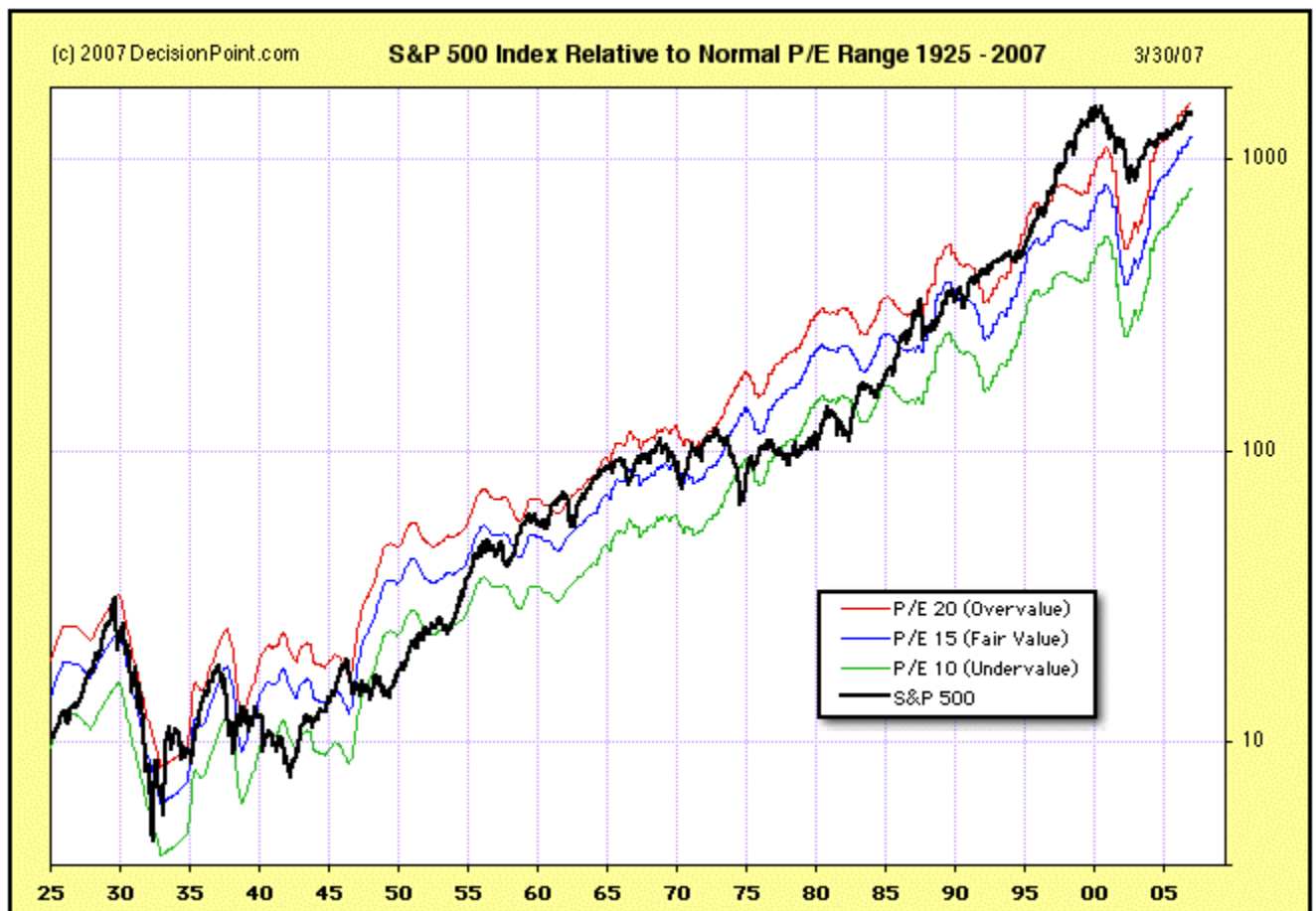


Chart compliments of www.decisionpoint.com

Buying into Pessimism

So it stands to reason the best time to buy and hold is when pessimism, or fear, is at its peak. Sounds easy, right? Well it's simple but not easy to do. Gold, like other investment items goes through similar cycles. While the great stock bull was in control, gold went through a terrible bear market taking it from a peak of over 800 in early 1980 to a bottom of 250 in early 2001. I've spoken often in this space about the relationship between the U.S. dollar and gold and how it has been affected by the U.S. decision to go off the gold standard. In brief, it stands to reason that since gold is priced in U.S. dollars, as the supply of dollars increases, the value of the dollar, in theory, should decline against items in fixed or slowly growing supply and thus those items would increase in U.S. dollars-this is called inflation. As gold prices declined over that 20 year period mines shut down due to inefficiency, taking out supply growth. Meanwhile the money supply has grown from roughly \$300 Billion to over \$10 Trillion, an increase of 33X. To be sure, global gold reserves have grown during this time period but studies suggest that with mine production growth peaking in 2001 it is unlikely that even with the increased technological developments and the sheer limits in the earth's gold content that the supply will keep up with money supply growth, much less, demand growth. With gold prices growing 2-3X during this initial phase and now gyrating around, pessimism is coming back which is ultimately good once prices turn. Many think gold is done with its bull market and I think it is preparing for the next phase of acceptance.

Demand Growth

We have very little supply coming on the market at a time when burgeoning middle classes of India and China (two countries with cultural roots with gold) are demanding more and more for investment purposes. Unlike U.S. citizens who have been convinced by politicians that the dollar is real money and will always be redeemable for goods, these folks believe paper currencies are nothing compared to real money-gold. You can't really blame U.S. citizens-we have no choice but to use dollars to acquire things we need. Few will barter-tax laws don't make it easy-and you will definitely get looked at funny if you present gold as payment. Then again, with the dollar buying 3% less, on average, each year, why hasn't anyone looked at the government funny? In all seriousness, would you buy a house this year if you knew each year it would decline in value every year by 3%? Even parking it in money funds at current rates you can only net about 2%.

Back to the gold bull: What I expect is the gold bull to do something similar to just about any other bull market. First, the item in a bull market starts sneaking up with many noticing but not taking it seriously. Then, many begin taking it seriously but few actually invest real money. Finally, all take notice, all take it seriously, and all get in. In between and among these different phases are corrections that serve to shake off the unconvinced. Those unconvinced who get off usually get back on and with more conviction at higher prices. This is why bull markets tend to accelerate as they go through these phases. Each group that is shaken off gets back on but with more money than before. Once everyone is in, a la 2000 for our stock bull, valuations have reached a level that no additional "sucker" is willing to bet on and it is time to get out. The stock bull grew 1478%. The

money supply since 1980 has grown 3233%. Using these figures gold has the possibility of growing maybe 15X from its bottom of 252. That puts the long term target at \$3780 per ounce with it settling down around \$3500 per ounce. Alternatively, if you took the \$800 peak in 1980 and put inflation of 4% on that, you would end up around \$2800 per ounce.

We can also track this relationship of the perception of the value of paper money vs. gold in the chart below which I have presented before, courtesy of Fred's Intelligent Bear website.

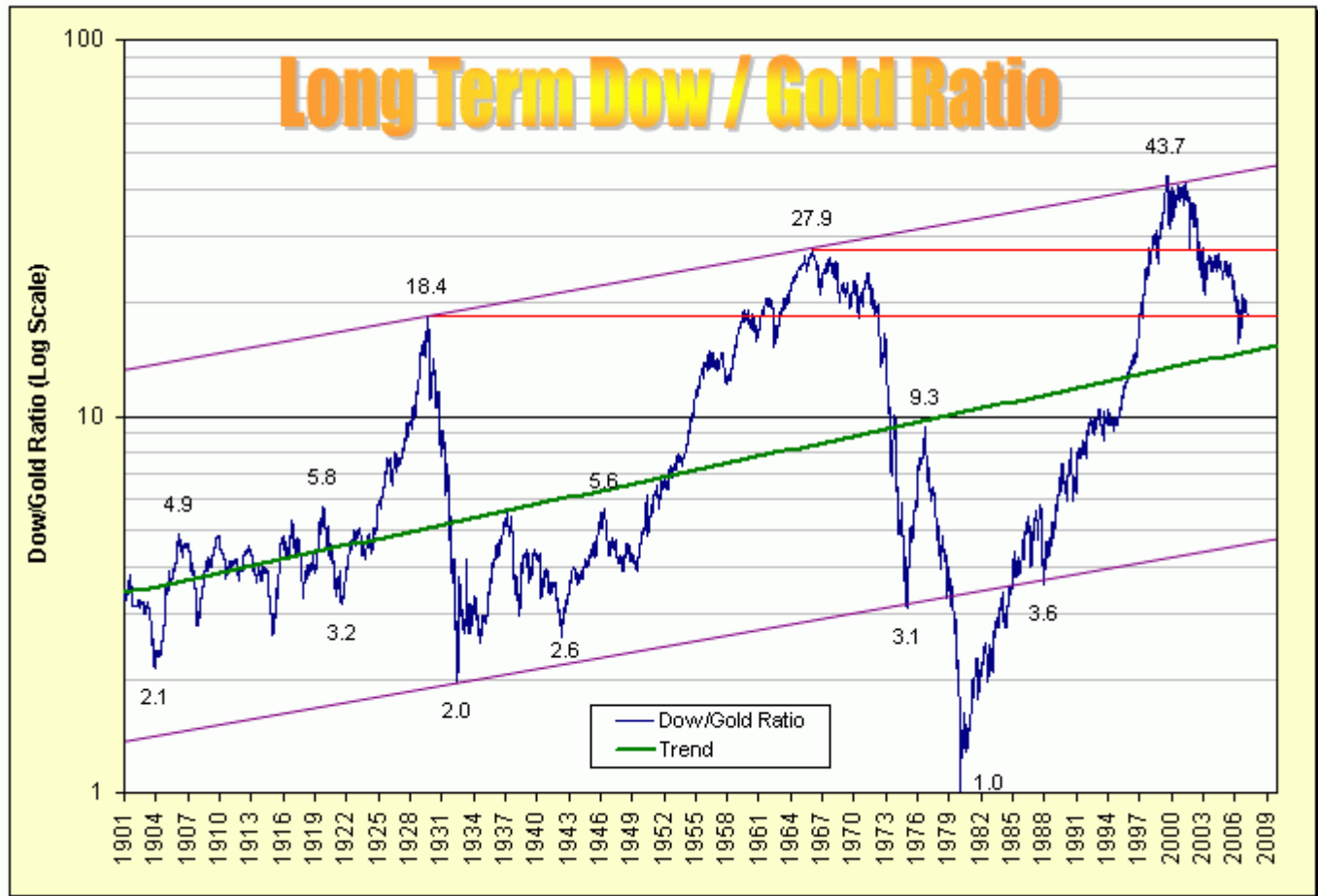


Chart courtesy of Fred's Intelligent Bear Site: <http://home.earthlink.net/~intelligentbear/>

This is the Dow Jones Industrial Average/Gold Price ratio. You can clearly see it goes in cycles as well. Not coincidentally, bottoms are made at similar times to bottoms in the S&P 500 PE cycle in the previous chart. When fear is at its height PE's can shrink and gold may shine. Based on the tendency of these cycles to fulfill their cyclical nature, I think we are far from the height of fear, which will be an incredible buying opportunity for stocks and possibly the time to lighten up on gold.

Balanced Approach to Investing

While I would love to tell investors to sell all stocks and put everything in gold, I don't think that is the prudent answer due to the volatility in both items and the unpredictability of the timing of these items. So we apply a balanced approach, investing in a range of stocks based on good values, good reward/risk entry points and most of all, based on stocks whose products' demand will greatly exceed supply. To be sure, we avoid diversification for the sake of diversification, a tendency that I feel plagues the typical individual investor's portfolio while using tight risk controls in our concentrated positions. My feeling is that the demand for the stocks we own will far exceed the supply by the time this is all said and done. This is what can cause PE's on mining stocks to soar out of control for a relatively brief period and those holding the right ones may experience some 'offset' to the relative mal-condition of the economy around us.

Needless to say, we had a good performance year in 2006 and the first quarter of 2007. While the stock indexes were extremely difficult to beat last year (a rare occurrence in a secular bear market) our 60% stock weighted model nearly matched the 100% stock weighted S&P 500. Our 2004-2006 three year average is 9.4% versus the price performance of the S&P at 9.2%, again with a limit of 60% stocks!!! We are experiencing quite a bit of volatility but the long term fundamentals favor investing in items where demand exceeds supply.

We'll finish with the "Indicators" report with explanations that follow. Please do not hesitate to contact me with any questions-and I really appreciate referrals.

Successful Investing to All!

Justin

The Indicators

"When Fear is at its height, Buy; When Greed is at its height, Sell" -my father, J.M. Gore Friedrichs. With these indicators, we try to assess the current levels of "greed" and "fear". At times, we have contradictory readings and we simply balance them out to assess the current market environment. The best actionable points are when most or all of the indicators are in line, as they nearly are now.

Let's look at the indicators explained below and other *Commentaries* by accessing the "Archived Commentary" section of the website: www.FriedrichsAssetManagement.com)

Contrarian Indicator	Greed	Fear	Current	Indication
NYSE Bullish Percent	>70%	<30%	67.36*	Bearish
AAII Sentiment				
Bull/Bear ratio	>2.5	<1	1.65	Neutral
NYSE+NASD				
Margin debit balances	>160B	<100B	\$321B-highest EVER!!	Bearish
Savings Rates	<5%	>12%	-1.2%	Bearish
Mutual Fund Cash	<7%	>12%	4.5%	Bearish

*Declining from a peak of >86%

Valuation Indicator	Greed	Fear	Current/Last here	Indication
Price/Earnings Ratio	>20	<10	17.28	Bearish
Dividend Yield	<3.5%	>6%	1.87%	Bearish

Monetary Indicator	Bullish	Bearish	Current	Indication
Yield Curve Spread	>3.5%	<0	-.20	Bearish

***The NYSE Bullish Percent is in Bear Alert Status which means it has been in overbought territory (above 70%) and reversed down.**

Why These Indicators?

Contrarian Indicators

NYSE Bullish Percent: This great indicator I get from Dorsey Wright and Associates www.DorseyWright.com headquartered here in Richmond. This indicator tracks the percentage of stocks on the New York Stock Exchange currently on buy signals. Generally, the higher the number, the more buying has been done prior to the point of measurement. This could be an indication that less and less buying power remains out there, so at readings above 70%, we become cautious as the inevitable cycle of cash flowing in and out of the markets progresses. At levels below 30%, we become aware that a very good buying opportunity may lie ahead as most investors have probably already sold and are holding cash to fuel the next run.

AAII Sentiment Bull/Bear Ratio: A weekly poll is conducted by the American Association of Individual Investors - what we call the individual public investors. This is a reliable indicator of the sentiment of individuals who are considered more emotional and less sophisticated than the “big money” investors. Since generally we don’t trust the emotions of the individual, this secondary indicator tells us when caution is warranted with high Bull/Bear ratio readings. Likewise, low readings can portend buying opportunities as markets tend to rally once the last little guy has bailed.

NYSE + NASD Margin Debit Balances: This is a monthly posting at the National Association of Securities Dealers' (NASD's) website telling us how much is currently being borrowed to own stocks. These are investors who actually borrow money to buy stocks and high readings generally indicate a frothy environment. The reason this is of particular value is that once the market turns, margin calls cause these borrowers to dump stock more rapidly in order to repay loans; thus, the risk in the market grows at something more like an exponential rate as these debit balances grow. Low debit balances indicate that these risk-averse investors have finally caved and now are flush with cash and fresh borrowing power, and thus, buying power.

Savings Rate: This is the national savings rate and is gleaned from the U.S. Personal Income and Spending monthly report. My view is that the lower the savings rate the less disposable income with which the emotional public can use to add to stocks. A higher rate, to me, indicates more reserves on tap to fuel a strong bull market. From a contrarian standpoint, this indicator also tells me how optimistic John and Jane Q. Public are about the future. Low savings rates indicate high levels of optimism and probably a correspondingly high level of risk tolerance. This can foster an inclination among investors to count on and indeed borrow against "future dollars", which tells me to be careful.

Mutual Fund Cash: This is the level of cash held in mutual funds. Generally, less than 8% is bearish and greater than 10% is bullish. I go a little further and like to reduce my risk by waiting for buying opportunities closer to 12% cash and for selling opportunities at less than 7% cash. This works the same way as the savings rate except that this cash is professionally managed money ready to be put to work. Generally, the more cash available, the better.

Valuation Indicators

Price to Earnings Ratio (P/E): The historical average is around 15. We also call this fair value. There are many justifications in certain periods of time to accommodate higher levels, but the key I focus on is the historical tendency over decades of market action for this ratio to gravitate toward its mean of 15. Specifically, greater than 20 represents extreme overvaluation (proceed with caution) and less than 10 represents extreme undervaluation (back up the truck because the next 15 years should be good!). I use the P/E of the S&P 500, which represents 500 companies across the economy. P/E's are available on The Dow and NASDAQ as well. Bear markets usually bottom with P/E's around 8.

Dividend Yield: Again, using the S&P 500, this represents the amount of real money being distributed to shareholders as a percentage of their investment (the stock price). The historical average is around 4-5%. The higher the market goes, assuming a fixed dividend stream, the lower the yield. The lower the market goes, the higher the yield. Bear markets usually bottom with yields around 8%.

Yield Curve Spread: This indicator tells us the difference, or “spread” between yields (compensation for risk) being paid on short-term funds (three-month Treasury Bills) and long-term funds (30-year Treasury Bond). Normally, the curve is upward sloping; meaning investors are expecting more compensation for the risk of inflation arising over the long term. This implies an inherent confidence in pricing power, generally speaking, which bodes well for the economy and stocks. An inverted yield curve (spread<0) is a condition that exists when short-term yields are greater than long-term yields.

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Investors should not rely solely on the information contained in this Commentary. Rather, investors should use the Commentary as a market analysis starting point. An investor should engage in additional in-depth research in order to develop an informed opinion regarding the merit of an investment opportunity.

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