



Registered Investment Adviser

April 2008 Commentary
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S&P 500: 1365

NASDAQ: 2348

Gold: 919

Dow Jones Industrial Average = 13.6 ounces of Gold (Dow 12576/Gold 920)

“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*

What a Quarter????!!

Wow, what an incredibly volatile quarter!! All kinds of records were set in terms of volatility. The S&P 500 was down over 9%-the worst quarter since 3Q 2002 when the last bear market was bottoming. Times like this beg for a rally and we seem to be amidst one right now. It may turn out to be the beginning of a new bull market-see more below. Fortunately, our bets are in the right place, as demonstrated by our average client suffering a mere 1.34% loss after fees. Since the market was down over 9% we only captured 14% of this down-move (1.34% divided by 9.45%). Considering that in both 2006 and 2007 when the market was up 15.81% and 5.49%, respectively, and our average client captured 84% of each of those up-moves our capture ratio is tracking very well: a lot of the upside and not much downside.

The Incredibly Emotional Investing Public

Back to the volatility, the most amazing things happen when people panic. Gold steadily rose from \$838 to over \$1000 per ounce during the first quarter. It began to waiver and despite no signs of euphoria it exhibited a “blow-off” top and absolutely tanked to below \$900. No euphoria and I’ve yet to read a prominently placed article in mainstream media mentioning the benefits of buying and holding gold or gold mining companies. Meanwhile, as it tanked many of the smaller explorers and miners we own did not shed nearly as much value as they should have. This tells me the selling is done or near done in these stocks (assuming gold holds \$850 or so). Gold collapsing so rapidly tells me there is way too much fear in this market for it to be near the end of its bull run. Despite the fact that it is up over 7% this year one would think it is the worst investment to own if you only read the main stream media. Sentiment is down-right lukewarm at best which inclines me to believe this market is relatively under-invested. This is best reflected in the prices of mining shares. While they have held up well during this correction, many of the small mining companies that stand to benefit most from this are unchanged or down

on the year while gold is up!!! Let me be a little more specific about the huge impact that higher gold prices have on these companies' earnings: The average price of gold in 4Q 2007 was about \$750 per ounce. For the first quarter of 2008 it averaged about \$900 per ounce. Here is how it impacts profit margins at mining companies, assuming costs of \$400 per ounce:

	<u>4Q-2007</u>	<u>1Q-2008</u>	<u>Change</u>
Proceeds from sale:	\$789	\$924	17%
Cost:	\$400	\$400	0%
Profit	\$389	\$524	35%

Logic, not emotion tells me that once we get through this emotional period and these companies report 1Q 2008 earnings over the next couple of months, we should see some very nice results. This will lead the stocks to be bid higher by merger propositions or simply the public recognizing good values.

Back to the General U.S. Markets

Speaking of the public, in the olden days of stock investing one could always see a top coming when the big investment banks (smart money) distribute as much product as possible into the market, mostly in the form of Initial Public Offerings (IPO-this a private company selling itself to the public) much like we saw in 1999-2000. The best current example is the famed Private Equity Firm Blackstone selling itself to the public at \$25/share in July 2007-just about the peak of the Private Equity Boom (Are these guys smart or what?!!!) Not coincidentally, June was the month we saw the rapid year-over-year change in margin debt (discussed in the January Commentary) which can portend a market top. In addition as you can see below, most global stock markets began topping around then (Did I say these guys are smart?) Currently its stock is around \$18/share, down almost 30% from when they sold it to the public.

GLOBAL STOCK MARKETS: INDEX MOVEMENTS					
(All indexes in local currency terms)					
Index	High		Current Index value		
	Index value	Date	(March 20, 2008)	% change	
MSCI World Index	1682.4	Oct 31, 2007	1400.4	-16.8%	
MSCI Emerging Markets Index	1338.5	Oct 29, 2007	1065.9	-20.4%	
DJ Industrial Index	14164.5	Oct 9, 2007	12361.3	-12.7%	
S&P500 Composite Index	1565.2	Oct 9, 2007	1329.5	-15.1%	
Nasdaq Composite Index	2859.1	Nov 1, 2007	2258.1	-21.0%	
Russell 2000 Index	855.8	Jul 13, 2007	681.4	-20.4%	
Composite DAX Index	8105.7	Jul 16, 2007	6320.0	-22.0%	
Paris CAC40 Index	6168.2	Jun 1, 2007	4533.7	-26.5%	
UK FTSE 100 Index	6732.4	Jun 15, 2007	5495.2	-18.4%	
Aus ASX All Ordinaries Index	6853.6	Nov 1, 2007	5182.4	-24.4%	
Nikkei 225 Index	18262.0	Jul 9, 2007	12482.6	-31.6%	
Hang Seng Index	31638.2	Oct 30, 2007	21108.2	-33.3%	
Shanghai Composite Index	6092.1	Oct 16, 2007	3761.6	-38.3%	
Bombay Sensex Index	20873.3	Jan 8, 2008	14994.8	-28.2%	
FTSE/JSE All Share Index	31531.1	Oct 11, 2007	28418.7	-9.9%	

(courtesy of Plexus Asset Management based on data from I-Net Bridge)

Not to be left out, Visa’s advisors hastened its IPO last month and had to let it go at a low valuation in order to allow for the market to absorb \$17 billion of supply in new stock. Given the sub-prime woes suffered by these huge investment banks this was an absolute coup in terms of helping to replenish losses. But it begs the question: By not putting the IPO off to better times at which they could raise more money (Visa) and earn higher investment banking fees (bankers) **what do you think they see coming down the road?** Or is the Visa “give away” (the stock still trades about 50% higher than sale price) and the Bear Stearns bailout the signs of the bottom we’ve been looking for?

Is the Bottom In?

Given that fear has struck fear in whom I consider some of the smartest investors in the world, one has to consider the possibility that, in the short term, the market has made a bottom. The sentiment just got so bad in March that I have to assume that everyone who wanted out got out-for now. The chart below is another good Greed/Fear barometer as it tracks the ratio of stocks to bonds and sheds light on shorter term shifts in this sentiment. It is the S&P 500 (SPX) divided by the Lehman Aggregate Bond Index I-Share (AGG)-here it is indexed at a multiple of 100.



chart courtesy of www.Stockcharts.com

As you can see, the relationship seems to have carved a significant bottom and has violated the red long term down-trend line. This chart is indicating a renewed tolerance for risk. In addition, our major intermediate term indicator is telling us we are in a position to see further gains in the stock market. The NYSE Bullish Percent-the percentage of stocks listed on the New York Stock Exchange on buy signals-has reversed from oversold levels and broken a previous top at the highs of the February rallies.

It is interesting that while the market has not bettered those highs our internal indicator tells us it has a decent potential to do so. The collective force of that many stocks giving buys signals (buyers winning over sellers) and for the group of stocks as a whole to reflect stronger buyer/seller strength than the peak in February, given the Bear Stearns “bail-out” and all else that has come to pass since then, indicates enough strength to pay attention. I must note that this indicator, in such volatile markets can be too much of a lagging indicator. It gave a similar signal in November 2002, the last bear market bottom, but at that point the market had already rallied 20% off its bottom and then proceeded to re-test again *after* this signal was given. The signal proved itself valid but not until March of 2003. So this could be the early signs of recovery but we’d have to see the Dow close above its February 1st closing high of 12,743 to confirm this. If that happens, we will probably throw long the Dow with a stop loss in place to see how far it will go. Until then, there is good chance we will re-test the early March lows of 11700 or so-that also may be a good time to throw long with a close stop loss.

In the Context of the Long Term Valuation Cycle

The best we can do is position ourselves to protect our capital and find the path of least resistance to profits. I’ve repeatedly called this maximizing the reward/risk ratio. You best maximize this ratio when fear is at its height. It seems we are close to that now, or were in early March. This gets very tricky because we have to keep in mind that valuations in the market still indicate we are amidst a long term bear market as you can see in following “regular” chart in the *Commentary*. It tells me the U.S. markets are still in a long-term corrective mode, washing away excessive valuations on our way back to extreme fear accompanied by excessively cheap valuations.

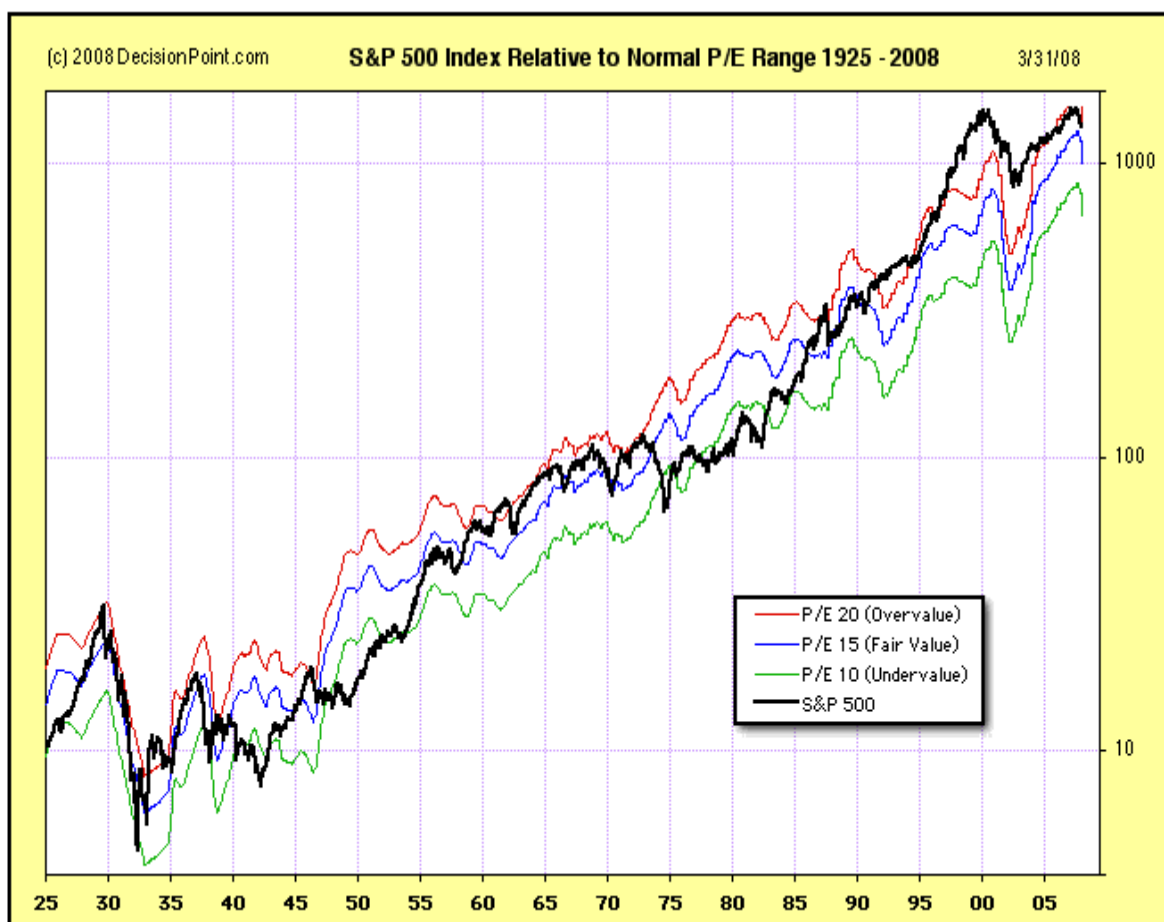


Chart courtesy of www.decisionpoint.com

The chart above illustrates the 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.

All long term bear markets have mini-bulls like the 2003-2007 market within the long term bear. This bull could very well lead to nominal new highs just like the last bull. But in real terms, compared to oil, gold, and other tangibles that we need I don't think we'll see new highs for a decade or more. A reminder of this is the chart which tracks the ratio of the Dow Jones Industrial Average to Gold-another regular in this *Commentary*. How many ounces of gold does the Dow buy you? The answer to this question is my measure of how well the stock market is really doing. Nominal new highs are new highs in the price on an absolute basis; relative new highs are new highs of the market compared to other items. For example we know the Dow set an all time high over 14,000 in October 2007 but in viewing the chart we can see that it peaked long ago at about 44 ounces of gold. Likewise it peaked in early 2007 at 230 barrels of oil and now buys 115 barrels of oil. Comparing the Dow Jones Industrial Average which is representative of paper money and financial assets to Gold which has been real, tangible money for centuries-is the best way to measure the relationship between greed and fear over the decades. You might call it financial assets to real assets, faith versus reality-whatever.



Courtesy of Fred's Intelligent Bear Site: <http://home.earthlink.net/~intelligentbear/com-dow-au.htm>

As you can see, over the very long term we have become more risk tolerant and put more faith in financial assets. However, it appears as if we are experiencing a 'reality-check'. At the bottom of this cycle, the Dow will probably only buy you 5 ounces of gold. To happen instantly, the Dow would have to go to 5000 or gold up to \$2500 or somewhere in the middle for each. The reason I bring this up is that it has always been my goal to create growth in real terms. The impact of inflation deceives us into thinking we are growing our net worth every year if the \$ amount is going up. Meanwhile, the items we need require more dollars to acquire. This is the result of the new "Fed", one which is less and less concerned with its original purpose- keeping the currency stable. (see "Parting Shot" after "Indicators")

Conclusion

To be sure, we enjoy playing temporary moves in the event they become more permanent, controlling risk with tight stops. But, by combining these long term PE and DOW/gold charts and analyzing the historical precedent of reversion to the mean (and beyond), the path of least resistance is to invest in under-valued, tangible items and the companies that prospect for and produce them as well as low PE and nice yielding stocks elsewhere. When the S&P 500 gets back to a PE under 10, its dividend yield above 7%, and the Dow/Gold ratio is around 5, then we will have to seriously start looking at a buy and hold scenario for U.S. markets. But not until then should we be so careless with our

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.

AII 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.

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.

Parting Shot

The latest recommendation of new regulation and reform involves giving more power to an already secretive organization called the Federal Reserve Bank. We continue to stray from operating free markets which hold people accountable for taking risk and move toward some kind of quasi-socialist-nationalist system where everyone asks for and gets what they want. (And to think these proposals are supported by both sides of the aisle!) Because it is impossible for everyone to get what they want, that is, to experience the prospect of upside potential for gain with no downside risk (vis a vis the bailout du jour), this will only lead to our country's financial failure. By bailing out reckless borrowers and forcing shotgun weddings between investment banks (J.P. Morgan buy of Bear Stearns) we are enabling an irresponsible society. Fortunately, it (the country's failure) will not happen before some kind of accountability revolution takes place to prevent it-at least that is what I am confident of and hoping for. Alas hope does not buy anything. In the mean time, we invest accordingly.

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