



Registered Investment Adviser

January 5, 2010 Commentary
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S&P 500: 1113
NASDAQ: 2308
Gold: 1120

“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*

Happy New Year, Investors!!

From September 2008 to December 2009 our typical client outperformed the S&P 500 while underperforming during this March 2009-to-present rally. This despite the huge bear market rally in U.S. stocks since March 2009. Our accounts bottomed in 4Q-2008, and have retained most of their gains, rallying some 50% from the bottom which occurred November 20, 2008. Since mid-2009 we have shifted to a more balanced approach, keeping in mind that we are still amidst a long term bear market and we must be cautious and wary of bear market rallies, especially those that proceed with no meaningful corrections.

This correction-less gain is a warning of excessive complacency. It seems the attitude is that the government will intervene should any major correction begin, thus creating the delusion of reduced risk when investing. Combine this with zero interest rates which practically force individuals to buy stocks and you have a very dangerous concoction. Yet another boom and bust cycle created by the FED and the government as opposed to being created naturally and organically through the free market mechanism. As a result, our strategy is shifting again from the balanced approach (long Gold, short stocks) to a strategy a little more weighted toward declining stocks. What this implies is that we are more bearish about the stock market than we are bullish on Gold at current levels. This may change very soon as Gold declines to a level at which we are comfortable adding to bring us back into balance. From all indicators - clients in business who provide me feedback of the business climate, global financial imbalances, and technical indicators - the signal is to not trust this stock market rally. It seems to be completely government driven with little private sector traction.

Despite the liquidity crisis taking our stocks to the woodshed in 2008, I have actually been pretty good in calling broad market tops and bottoms. In September 2007 we advised clients with assets outside of Schwab (Annuities, 401k's, etc.) to move these

assets to cash. At that time the DOW was at 13,766 and the S&P at 1525. We moved back in, albeit early, in October 2008 at S&P = 900. During October and November 2009 we recently switched these assets back to cash at an average level on the S&P 500 of 1075. This has also been an early call. The point is we expect the decline to begin at any time and the reward to trying for more gains is puny compared to the damage we expect.

There is no doubt in my mind we are in strange times. Following the initial crash in 1929, markets rallied some 48%+ which belied reality as markets then declined another 86%, taking markets down a total of 80% from their peak. I don't like being a party pooper but let's be realistic: At that time U.S. total national government debt was infinitesimal compared to GDP (20%) whereas right now it very nearly equals it at almost 100% of GDP; At that time the country was actually running a surplus going into the initial crash whereas now it is running a deficit of about 10% of GDP - a ratio that would put most country's debt at lower than the current "AAA" ratings; Total debt (National debt+Household Debt+Corporate Debt) is nearly 4 times that of GDP - so you've got to wonder in an economy that is 70% consumer driven, "How is the American household going to lead us out of this?" Below you'll see a chart in percentage terms the amount of debt in the U.S. that total production is having to support on a timeline. >100% (vertical axis) means that debt exceeds total production.

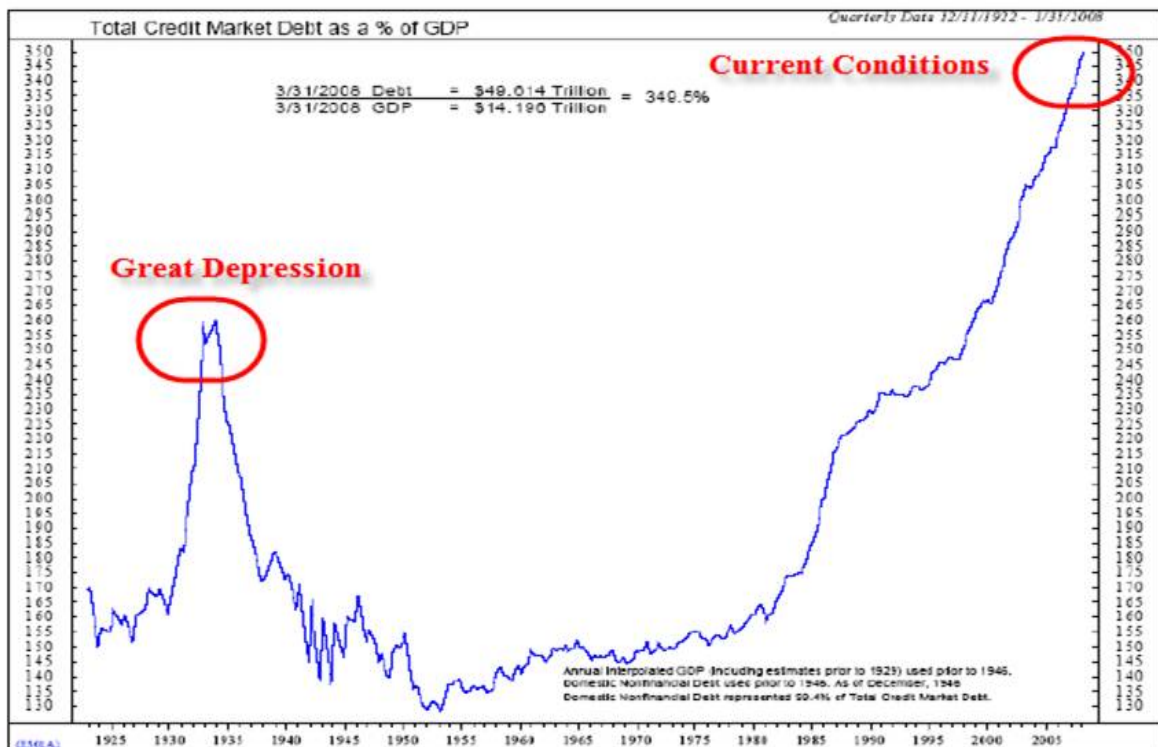


Chart from www.usgovernmentspending.com , a pretty neat site, actually. Total Debt (household, corporate, government debt) divided by Total Gross Domestic Product (GDP). It is represented as a percentage along the vertical axis and the horizontal axis along bottom tracks time.

During the Great Depression, stock markets did not put in a real bottom until 1940 or so when, as you can see, rapid pay-down of debt (as a percent of GDP) had occurred as represented by the sharp decline in graph from circled portion in 1930's. This chart only goes to 2008. In 2009 the figure stood at 370% of GDP. Thus, I don't think we will have an investable bull market until we observe a marked decline in debt as a % of GDP. Again, I don't enjoy proclaiming that bad times lay ahead. Surely my and my children's assets and future income streams are vulnerable to the inevitable shake out. So the only way to become optimistic is to be realistic and ask "Where is our capital best put to use.....NOW?"

It's not fun but we are sticking with cash, gold and funds that benefit from stock market declines. **This overall approach should provide the balance we need to not only survive, but prosper.** We are not, as we did in 2008, going to speculate much on individual stocks somehow doing well in a bear market. We are keeping it simple with maybe a defensive stock or two, and play market swings with broad, low cost funds. This may be a frustrating approach as there may be times when we under-perform the market as we did from March 2009 to present. However, similar to the aforementioned September 2008 to December 2009 time frame, the long term reward should be there for those who are prudent.

Thank you for letting me into your day. Make it a good one!

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