



Registered Investment Adviser

November 26, 2009 Commentary
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S&P 500: 1110
NASDAQ: 2176
Gold: 1180

“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 Thanksgiving!!!

General Market Overview
Relative Performance of Financial Sectors
Gold vs. S&P 500
Conclusion

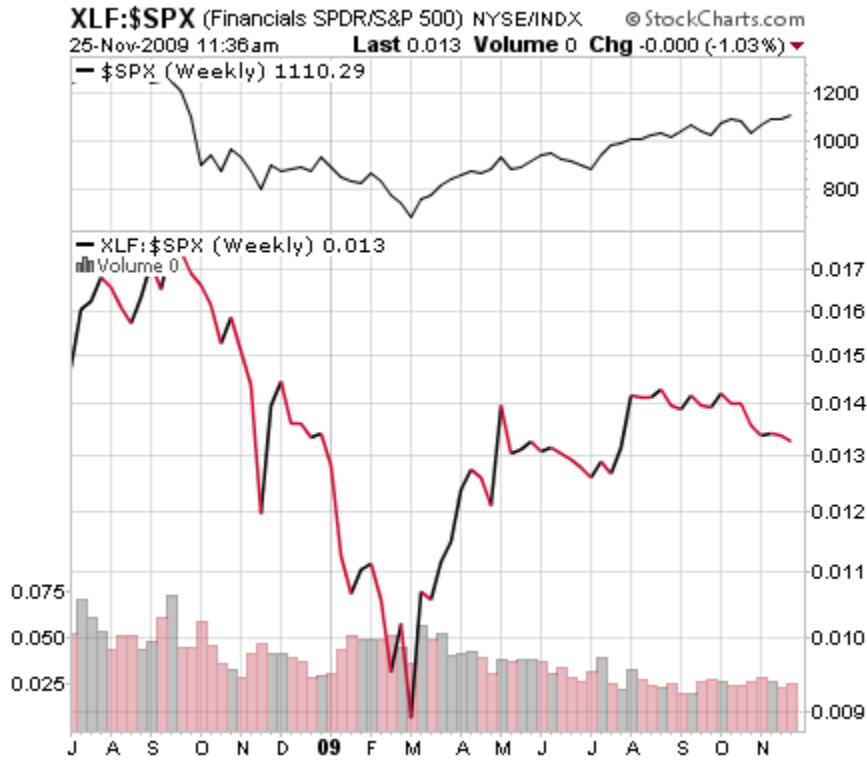
General Market Overview

The markets continue to rise, but only slightly as internals remain weak and the some crucial sectors raise red flags. This huge bear market rally has been led by extraordinary strength in financials, real estate, and commodities. The major driving force has been a weak dollar and artificially low interest rates. A weak dollar and artificially low interest rates around zero percent force investors to take unnecessary risk to buy stocks and corporate bonds in order to maintain their standard of living. A stock market can only go so far on a weak currency and zero interest rates. And lately, the leaders, financials and real estate, have waned. I don't think we can have a sustained rally in the market without Financials and Real Estate, the backbones of our economy. Let's take a look at the relative performance of Financials (in terms of XLF, a financial stock Fund) and Real Estate (in terms of IYR, a real estate stock fund) compare to the S&P 500 over the past year. As a precursor to these charts, generally speaking, in real bull markets, financials outperform, and in bear markets, financials underperform. This is called "leading the market". What is interesting, and concerning now, is the latest market rise has not been led by financials.

Relative Performance of Financial Sectors

Here is the a weekly chart of Financials as represented by XLF, a Financial Sector Fund, compared to the S&P 500: (top panel is the S&P 500 by itself and bottom panel shows

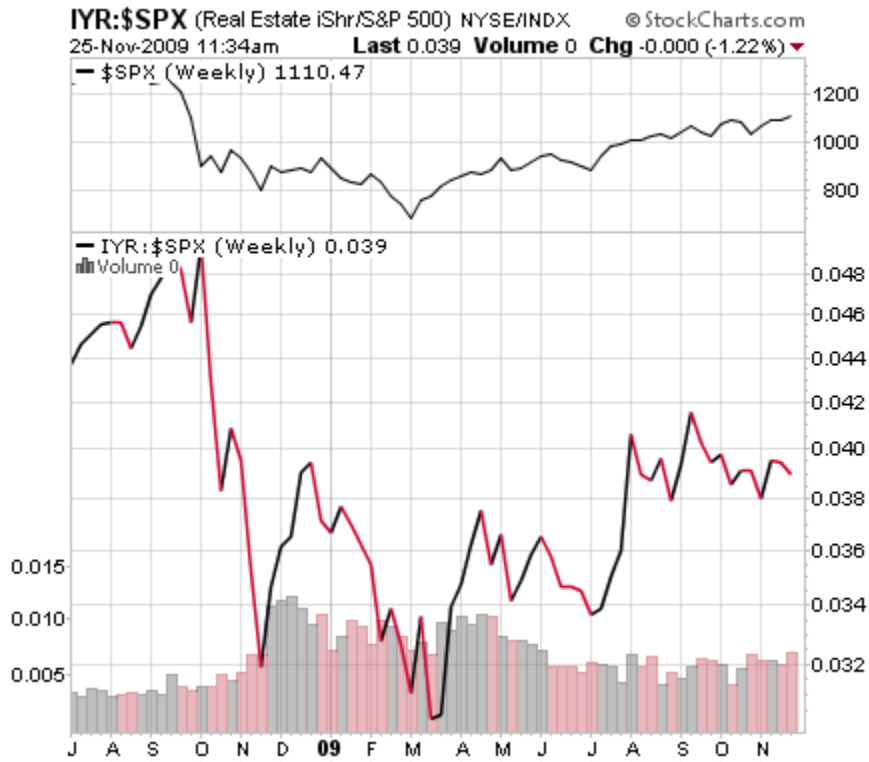
relative performance of Financials to S&P 500). If the line in the bottom panel is rising it implies that Financials are outperforming the S&P 500 and "leading up"; if declining it implies that the Financials are underperforming the S&P and "leading down".



Here is a close-up of the very recent past showing you the underperformance of late...

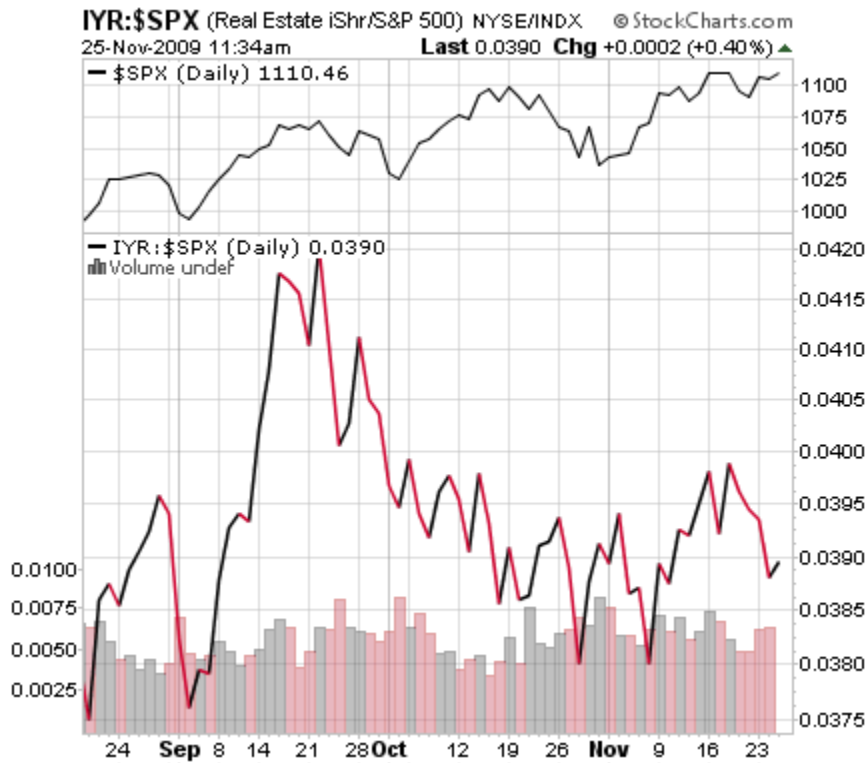


Now let's look at Real Estate, as represented by IYR, a Real Estate stock sector Fund compared to the S&P 500:



As you can see here, Real Estate has been underperforming badly since mid-September.

Here is the close-up of recent action:



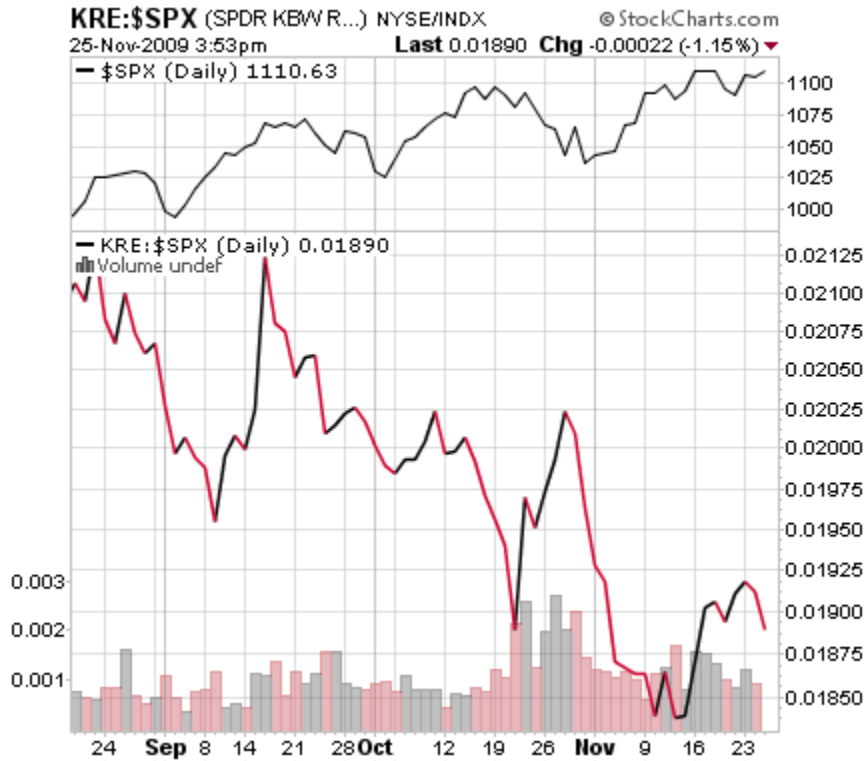
As you can imagine this is not good for the health of the market and probably speaks to the health of the economy going forward. But, unfortunately, it gets worse. XLF is mostly filled with Big Banks, that is, Wall Street Banks. Let's see how smaller banks are faring, that is, "Main Street" banks where the money is moving (or not) on the front (consumer-centric) lines.

A weekly chart of Regional Banks, represented by KRE, a regional bank stock fund, compared to the S&P 500:



As you can see, these stocks did not come close to keeping up with this rally from March 2009 to present.

Here is the close-up of recent action:



It is absolutely essential, in my mind, for "Main Street" to be doing well, and better than the overall market, in order for the stock market to continue to rally. In fact, it appears to me as if not only are they underperforming, but they are also signaling that this rally is truly not to be trusted.

Gold vs. S&P 500

Let's look at the Gold, widely considered a safe haven, versus the S&P. It stands to reason that if markets are rallying, the need for Gold should whither as fear exits the marketplace in favor of risk tolerance.



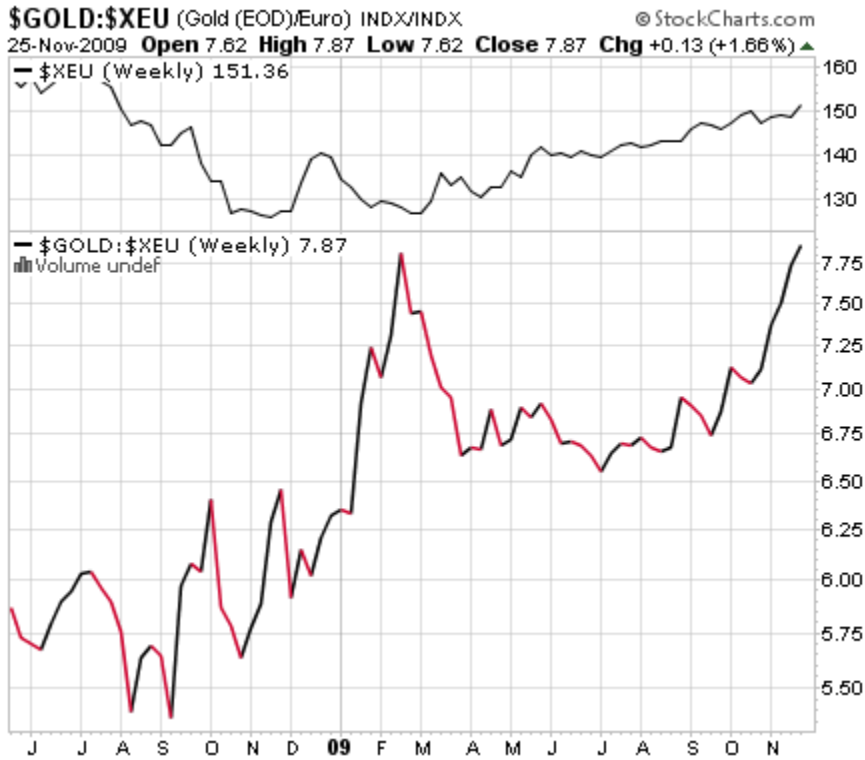
As you can see, the Gold naturally outperformed the S&P in the fear phase leading to the bottom in March. When the S&P's initial knee-jerk reaction took place in March, it did outperform Gold. But amazingly, from April to now, despite a 28% rise in the stock market from late April to present, investors have been equally interested in Gold on a point-to-point basis. What does this tell us?

Here is the close-up of recent action:



Gold has been achieving dramatically higher highs than the waning stock market these past few months. I say waning, because the rallies have been progressively weaker. Look at the flattening of the tops in the top panel. Now look again at the bottom panel: Is Gold telling us something that we should be paying attention to?

And this is not just a weak dollar story. Take a look at the chart of Gold in Euros, that is, if you had your money in Euros and used that currency to invest in Gold, how well would you have done?



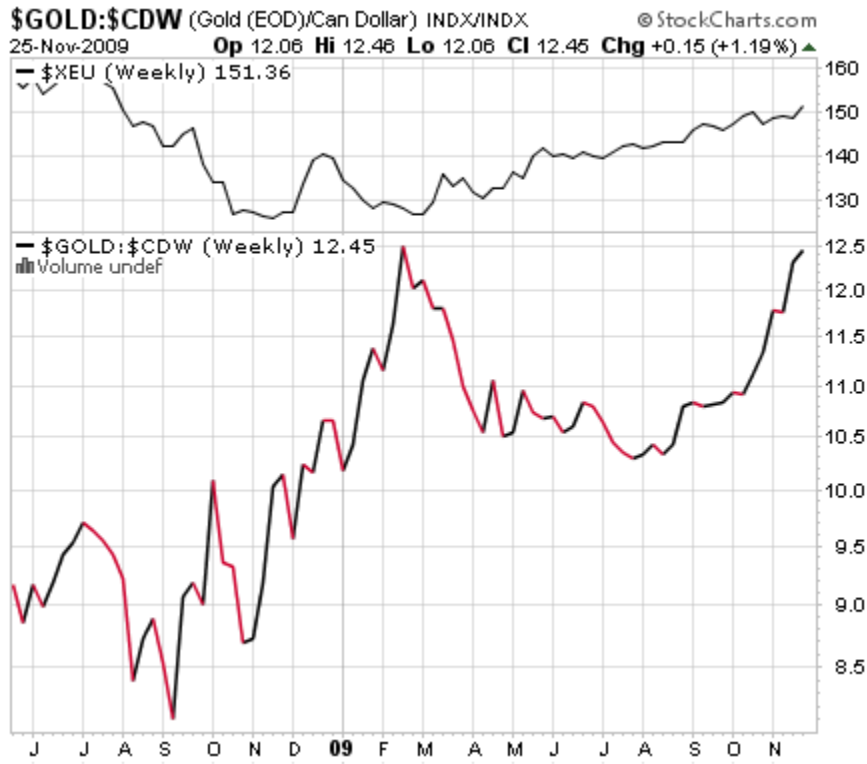
Up over 40% since September of last year (€550 to €775 in bottom panel)...

Close-up of most recent action...



As you can see, while the Euro has strengthened considerably against the Dollar (top panel), and yet Gold continues to outperform even the Euro!

How about "commodity currencies" which should do well vs. Gold, like our big trading partner to the North, the Canadian Dollar?



Up over 50% in Canadian Dollars since September 2008...

And the Japanese Yen...



Up nearly 50% in Japanese Yen...

Gold is clearly telling us that paper currencies around the globe are increasingly dubious. Let's face it: Humans cannot manage paper money. The inevitable result of every attempt in history is to succumb to near term goals dictated by political pressure. The only action they know is to infuse more and more paper money (read: PRINT MONEY) into the system to stimulate "growth". Historically, empire after empire has repeated this process whenever attempting to manage un-backed money. What they are really doing is artificially stimulating stock and other asset values in each respective paper currency in order to prevail a perception of growth upon the public. As far as Gold price action is concerned, it is hard for even me, a gold bull since 2003, to believe the powerful advance that gold has undertaken since I last wrote here a few weeks ago. Gold has gone from \$1050ish to \$1180+/- . It could correct soon. When, how much, and for how long is anybody's guess. For now, we are holding our winner.

Conclusion

In conclusion, the credible risk of a meaningful decline far out-weighs any potential reward in broad U.S. stock markets. I don't think the market can make meaningful new highs without the health of banks, especially "Main Street" banks, and housing/real estate values. Indeed, I think the preceding charts argue for a meaningful, if not horrible, correction of this "artificially" stimulated rally. As I stated earlier, investors have been forced to take unnecessary risk in order to maintain their standard of living. I can only

imagine how fast investors will evacuate when the plug begins to leak water and markets show their true, underlying weakness. When? Well, the holidays usually bring about seasonal strength so we might not get any meaningful declines until early next year but it could easily start sooner. For now we are holding funds that go in the opposite direction of the U.S. stock market as well as funds that go in the opposite direction of the Financial and Real Estate sectors.

Gold, while extended in the short term, is certainly causing many around the world who have not bought in yet to consider protecting themselves. Meanwhile, the global allocation of the typical investor is infinitesimal. So any minor uptick in the each investor's asset allocation to Gold and precious metals will continue to support this bull run, if not cause a meteoric climb. Central banks are doing this as I mentioned earlier this month that India, and now Sri Lanka, are adding to their Gold reserves. Many are talking of a bubble in Gold *right now* and some calling for a crash. While I think this is possible, I think the bubble (and subsequent "crash") is a long way off, price-wise. To be sure, a correction may be due but my bull-cycle targets remain: A bubble-like peak north of \$3500 with prices "crashing"/settling down around the inflation-adjusted 1980's high of around \$2300. When? No idea, but we are about 8 years into what is historically a 15 year cycle. The fundamentals of our economy support this trend as well. By every metric, we are over-extended with debt as a result of the lack of central planning discipline. The only way out is to print more money to re-pay this debt.

"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.*

While I talk very pessimistically about the U.S. situation, I am merely being a realist. Jefferson was right, and to deny what we are doing right now is harmful to our financial health. I am very optimistic about our approach to this situation, both in terms of keeping you up with any potential inflation that occurs as well as helping you retain your capital base during declines. We do this by maintaining bullish positions in Gold-related securities and bearish positions in U.S. stocks. At the moment, in order to avoid a 2008-like decline, we are in the process of taking profits (sometimes in excess of 100%) on Gold stock fund trades we have placed during the past year. This is to help protect us in the event Gold stocks decline along with the market as they did last year. Hopefully they will prove stable and we can re-enter. We continue to hold securities directly tied to the price of Gold, and will consider taking short term profits at any time upon "due" corrections in order to attempt to obtain a better re-entry point.

Again, Happy Thanksgiving, and *Thank You* for your business.

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