

January 2004 Commentary and Outlook

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Tracking Greed and Fear

“Greed” and “Fear” are what drives markets. You’ve heard many catch all phrases about how to invest such as “Buy Low, Sell High”, but I’ve got the best one yet. I learned it from my father, and I am sure it is not a novel approach to some of you, but it works. “When Greed is at its height, sell; when Fear is at its height, buy.” Pretty good stuff. And just like “Buy Low, Sell High”, sticking to it is the toughest part! What I like about “Greed-Sell, Fear-Buy” is that it is more tangible and easier for me to understand. Heck, maybe it is just a different way of saying it - and it works for me!

Let’s look into how we track levels of Greed and Fear in the marketplace. I use several indicators, most of which are either contrarian indicators typically telling us about market sentiment or straight valuation indicators, which simply tell us the value currently being placed on earnings and cash flows. Using history as a reference, we track the zone indicators typically read just prior to a turn in the market; thus, exploiting the extreme measurements to watch for in the future. As always, these Greed and Fear zones are simply guidelines. What makes the market so challenging is that history never exactly repeats itself, but it occasionally rhymes. Indeed, the market takes its sweet time working out bulls and bears. In bull markets you see corrections and pullbacks designed to “shake out” the squeamish. Those that hang in there and maintain discipline are rewarded. Likewise, in bear markets, corrections to the upside occur which serve to bring in more money from the “perpetual bulls” as they perceive (falsely) the start of the next long-term bull. These indicators help “sort through all the bull”, if you’ll pardon the pun.

Contrarian Indicators

Contrarians hold the belief that the crowd is nearly always wrong, and so, contrarians seek better ways of investing accordingly. In summary, each of the indicators may reflect

one sentiment from the “crowd”, but since it is giving us such an extreme emotional reading of the “crowd”, the opposite indication is warranted. Independent thought is crucial to investment success.

Indicator	Greed	Fear	Current	Indication
AII Sentiment				
Bull/Bear ratio	>2.5	<1	3.7/Last here in 1987*	Bearish
NYSE+NASD				
Margin debt balances	>160B	<100B	175B/Last here 6/2001	Bearish
Savings Rates	<5%	>12%	2%	Bearish
Mutual Fund Cash	<7%	>12%	4.69%	Bearish

*1987, like 2004, also followed 2+ years of >10% \$US decline each year.

For example, I have mentioned sentiment indicators in the *Commentary* before as contrarian indicators. When the majority of Investment Advisors are bullish, this phenomenon is not necessarily a bullish omen. There are a few reasons behind why it is not necessarily bullish: 1) if everyone is bullish, it follows that they are already in the market, so who’s left to invest and fuel the bull? 2) from www.contraryinvestor.com, “When everyone thinks alike, there isn’t much thinking taking place” and 3) individuals can analyze very well what is in their best interest. But when thrown into the crowd - that is the market pit - it is very difficult to maintain your disciplines. Margin debt balances reflect a greater risk tolerance indicating that these borrowing investors think the stock market is sure to rise. Certain levels are reasonable, but total debt held in these accounts of \$175 Billion is an extreme level that concerns me. Again, how much more can they borrow to fuel the bull? This same question applies to Savings Rates and Mutual Fund Cash levels except instead of borrowing, these indicators are simply measurements of how fully invested the respective parties are. The low Savings Rate implies the public is not investing in itself. Rather, it is consuming; thereby expressing confidence that the future will somehow save for them. This could be interpreted as desperation or excessive optimism about the future - either way it has bearish implications for the profits of publicly traded companies in the long-term. Similarly, Mutual Funds are “fully invested” with only 4.69% cash. The only way they can help fuel the bull is with new inflows.

Valuation Indicators

Below are valuation indicators. The parameters set forth in these indicators take into account 200 years of stock market history - not just the past 20. Recent history tends to bend our minds. I wouldn’t be surprised, for example, if a survey was done on home appreciation that most thought their home would appreciate at 7-10% per year for the rest of their lives. This is indeed what the past 2 years have told people. Likewise, we as market participants have gotten so accustomed to P/E’s above 20 that it is habit forming. I continue to read analysts’ reports characterizing a stock as “not that expensive” at only 20 times next years’ earnings. The bottom line is we need to look at all of the applicable

historical data in order to make judgments as to what is “acceptable” - not give into our recently acquired habits.

Indicator	Greed	Fear	Current/Last here	Indication
Price/Earnings Ratio	>20	<10	27/over 20 since 1997	Bearish
Dividend Yield	<3.5%	>6%	1.6%	Bearish

According to the Wall Street Journal, the Nasdaq 100 trades at about 38 times estimated 2004 earnings (PE=38). And, “out of a universe of 600 tech companies, 55% are trading at more than twice the overall market multiple on 2004 estimates. (That figure includes profitless companies). In March 2000, the figure was 49%.” So, by that measurement, market participants are now more enthusiastic about what they are willing to pay for earnings than they were at the peak. In fact, 30 of the Nasdaq 100 stocks earn nothing.

Other Indicators to watch in 2004

Following Insiders can be helpful, as well, although some insiders are more adept than others. In all honesty, I am not sure most insiders really have a clue as to the near term future any more than you and I, so I follow insider activity like most others - as a guide but certainly not as a contrarian indicator - as insiders are more often right than wrong. Other issues may be affecting the decisions, as well, such as the insider’s personal financial situation. But when insider activity is at extreme levels, I pay attention. The Insider Selling/Buying ratio in transaction value is simply the dollar amount of sales by insiders divided by the dollar amount of purchases by insiders during a given period. We know that generally insiders do more selling than buying since much of the stock they have acquired was granted, either directly or through options. Typically a ratio of 3:1 selling/buying is normal in the process of exercising stock options (and immediately selling the newly acquired stock - called a cashless exercise) and diversifying out of grants. Currently, the sell/buy ratio is 20 implying that insiders are selling 20 times more stock than they are buying. This concerns me considering that the crowd is under the impression (and indeed told by the “experts”) that they ought to be getting into these same stocks right now.

In tracking the health of the consumer, observe that along with a mere 2% savings rate, consumer debt (excluding mortgage debt) hit a record \$1.977 Trillion in October 2003. Given approximately 106 million households, that equates to about \$18,700 of consumer debt for each U.S. household. We need the jobs market to get going...NOW!!!

Fiscal Discipline: the Dollar, Gold and Oil

I have written much about our government’s trade and budget deficits, so I don’t need to go into that. Needless to say, along with better interest rates abroad, the two deficits which are approaching a total of \$1 Trillion per year are the main factors driving more than two years of 10%+ declines in the dollar against an index of foreign currencies. Gold and oil, which are priced in dollars, continue to climb because sellers around the world, who must accept dollars, naturally demand more dollars in return since those

dollars are worth less in their local currency. The declining dollar, to be sure, will help exporters as their goods become cheaper to foreign buyers. However, the trend of the declining dollar scares foreign investors because their dollar-based investments are declining in value. That is why one of three things must happen for the dollar decline to stop: 1) interest rates must rise in order to attract the foreign capital; 2) fiscal discipline must be restored so that foreigners will regain confidence; 3) more dollars will need to be printed to pay our debts. Currently, the treasury is taking the lattermost approach, hoping it will provide the “band-aid of liquidity” the economy needs during the healing period in the jobs market. In order to protect clients from their declining purchasing power, we are invested heavily in gold and oil stocks. After all, despite the miraculous returns in the stock market this year, in terms of Gold or Euros, the S&P was only up only about 5-7%. For the risk, which would you rather own?

What the Consensus is saying...

The consensus says interest rates will have to be raised around mid-year. It also says the market will get tricky during the second half because the earnings growth won't be as easy to come by since companies will be comparing 3Q 2004 to 3Q 2003, which is a much tougher comparison than the 3Q 2003 to the abysmal 3Q 2002. The consensus also believes the dollar will continue to decline “steadily” and that the stock market will return 5-15% in 2004.

What I see...

This is what I see. Right now, the stock market is in a short-term uptrend within the long-term downtrend. How long this uptrend will last is anybody's guess, but I think the highs will be seen within the next year before the secular bear market resumes. I have a feeling our FED leaves rates alone all year. I think there is even an outside chance that as the job market recovery does not materialize, our FED will have to reduce rates toward the end of the year in order to give Bush any boost he can get. Yes, that is way out there, but I don't rule it out. Currently, the futures market is pricing in a quarter point raise in June, giving us a slight accumulation opportunity in bonds. I believe bonds will rally once more before the re-inflation efforts of our FED go into high gear. I also see gold, which is in the middle of a huge bullish uptrend, correcting within the framework of the big bull market. Since this is a long-term bull market, we will use dips as buying opportunities. Likewise, I see a sharp dollar rally within the downtrend, which will temporarily support the stock market. Interestingly, traders perversely credit the *slowly* declining dollar for stocks rising (as it helps exporters), and they will credit a dollar rally as an excuse to buy more stocks (after all that's an indication of strength). Meanwhile, gold just set a 14-year high! Anything making a 14 year high has truly been through a bear market and is worth a strong look! Fortunately, clients have participated nicely since I started this firm.

Getting in on the Ground Floor of a Major Bull Market

Why have we had exposure to gold? - 1) gold is priced in dollars and is now half the value of its peak in 1980 - meanwhile the supply of dollars (M3 money supply) has doubled since 1995 alone - "Gold is "cheap at twice the price."; 2) gold, like many hard assets, will appreciate in dollars while the dollar becomes worth less; 3) gold has no enemies and no debts, unlike all other currencies; 4) everyone around the world loves gold and demand for gold jewelry is on the rise, especially in China. Like most other commodities and raw materials, gold will benefit from the booms in China and India; 5) Most importantly, gold requires labor to pull it out of the ground; therefore, it cannot be controlled by men. **The main reason our founding fathers wrote into the U.S. Constitution that money is to be backed by either silver or gold is that they were fully aware of the temptation of men to manipulate the currency, if they could manage it.** We now see that happening as dollars are printed daily and \$1.5Billion of them per day (the daily trade deficit) are going over seas with an IOU attached to them. In the old days, when a country ran a trade deficit, they had to make good on the debt with gold reserves. As a result, fiscal discipline was enforced. The last thing a country wanted was to allow their gold reserves to be depleted. With Congress giving voters everything they ask for without having to pay for it today, you can see the lack of discipline that managed currencies engender. You can get something for nothing for only so long.

The most crucial element to successful investing is to capture gains while no one else is looking. That is because once they catch notice and jump in, that's when the easiest money is made. Currently, relatively very few investors are even thinking about gold or gold stocks - much less owning anything related to gold. As a matter of fact, if you ask five people on the street what they think about gold, they will probably think you are crazy. Ever since Nixon closed the gold window to foreign central banks in August 1971, we have been trained to think of gold as a commodity. On Monday, gold hit a 14-year high, and I could find nary a word about it in the Wall Street Journal. Again, our recent memory provides a disservice as it tells us to stay away from something which has been recognized for 5,000 years as money - that is up until 32 years ago. This is all going to change...very slowly, though. Meanwhile, now that the stock market has risen 25%, market participants are eager to pay 30 times earnings for stocks whose futures are far from certain. In my view, math works. The 200 year average PE of 14 exists for a reason. Eventually the PE will fall far below that level in order to counter balance the positive differential we are experiencing. Meanwhile our FED, by keeping interest rates as low as possible, will continue to force the average person to buy stocks because of the low yielding alternatives. Whenever you are "forced" to do anything, it can't be good. This also applies to printing dollars and expecting others to assume they are worth something "because you say so". Forcing people to accept your currency and way of life is a recipe for disaster. Our founding fathers knew that all too well.

Possible Solutions

I suggested last month that if our Federal Government would cut back on spending by 5% per year for the next five years that (based on my albeit rudimentary calculation) the budget would be balanced at the end of that term. I submit that this will eventually have to happen, but it won't occur until we are forced to do it by our trading partners. By cutting back, it would harm the economy and cause some shrinkage, but I posit this shrinkage is much needed and better now than when we are "forced to". Remember, whenever you are forced to do anything, it can't be good. How will they force us? By demanding higher interest rates. Two years ago the economy was not allowed to go into any kind of meaningful recession, which, as sadistic as this may sound, is necessary in order to "purge" the excess capacity required in order to begin a sustainable uptrend. Rather, our FED is keeping rates low and our government is borrowing and spending OUR money and effectively diluting the return on our tax dollar investment. I read that the recent economic growth spurt cost taxpayers \$8 OF BORROWING for every \$1 OF GROWTH realized. Shouldn't it be the other way around?

Our leaders react more to polls, which represent near term desires rather than prudent judgment of what is best for the NATION in the long-term. As I've implied before, they come by their voting behavior honestly. Since the 1970's when consumer loans became more readily available, their constituents have become accustomed to the instant gratification that somehow justifies "borrow to have" over the depression-era generation's "save to own". It doesn't help that they are spending other people's money, either. Our elected leaders obviously don't vote on spending and tax bills as if it were money coming out of their own pockets.

Another benefit of reducing government spending is that it forces Americans to be more independent, stand up for themselves, and take on new ventures. Since our government spending, which currently comprises over 30% of GDP, will be spending less, inflationary pressures will be kept at bay as well. Easy money (low interest rates and lots of FED-induced liquidity) can be good, but not without any fiscal discipline. Otherwise, all that is created is more debt. Easy money and fiscal discipline can work together to counter inflation, balance budgets, and get America back to work.

Time to Back Away from the Table

Fortunately, we live in America where you can invest in just about anything you want. The investment accounts under my care have been exercising that right with gusto!! And you have the right, believe it or not, to back away from the table whenever you want. In fact, accounts under my care have recently taken profits on most of the "low PE" stocks we bought over the past couple of years as they ventured into overpriced zones. I am excited about 2004 and what it holds for the disciplined investor.

Successful Planning to All!

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