

January 2006 Commentary and Outlook  
 Justin B. Friedrichs, CFP®  
 Friedrichs Asset Management LLC  
 Registered Investment Adviser

S&P 500: 1287  
 NASDAQ: 2316

**A Quick Personal Note**

Thank you for a great year. Assets under management have grown dramatically since the founding of Friedrichs Asset Management and 2005 was no exception, with assets growing by almost 20%. This could not have been possible without the loyal and heartfelt support of you, my friends and clients. The power of the combination of goodness and loyalty is unbelievable. For our part, managed account performance averaged 5.8%, handily beating every major stock and bond index. Combine that with an 8.7% average return for 2004, and we have averaged just over 7% per year since the end of 2003. What is most exciting about this is that we've accomplished this performance while maintaining, on average, 40% of assets in capital preservation investments like corporate, government and municipal bonds and cash. As clients know, with the bond market bottoming in the October-November time frame, we took advantage of the long awaited opportunity to add to bond positions at relatively nice yields. Most of these bonds are already showing nice gains on top of the interest they are paying.

**The Indicators**

Let's look at the indicators introduced in the *January 2004 Commentary and Outlook*, which can be viewed along with other *Commentaries* by accessing the "Archived Commentary" section of the website: [www.FriedrichsAssetManagementLLC.com](http://www.FriedrichsAssetManagementLLC.com)) Following the readings of the indicators you will find the rationale for all of them.

**Contrarian**

<b><u>Indicator</u></b>	<b><u>Greed</u></b>	<b><u>Fear</u></b>	<b><u>Current</u></b>	<b><u>Indication</u></b>
NYSE Bullish Percent	>70%	<30%	<b>67.13*</b>	<b>Bearish</b>
AII Sentiment				
Bull/Bear ratio	>2.5	<1	<b>3.11**</b>	<b>Bearish</b>
NYSE+NASD				
Margin debit balances	>160B	<100B	<b>\$240B/Last here 11/2000!!</b>	<b>Bearish</b>
Savings Rates	<5%	>12%	<b>-0.8%</b>	<b>Bearish</b>
Mutual Fund Cash	<7%	>12%	<b>4.4%</b>	<b>Bearish</b>

\*Declining from a peak of >86%

\*\*Recently we have seen readings not seen since 1987, the year of the last stock market crash, which like 2004, also followed 2+ years of >10% \$US Index declines each year.

<u>Valuation Indicator</u>	<u>Greed</u>	<u>Fear</u>	<u>Current/Last here</u>	<u>Indication</u>
Price/Earnings Ratio	>20	<10	20.10/>20 since 1997	<b>Bearish</b>
Dividend Yield	<3.5%	>6%	1.73%	<b>Bearish</b>

<u>Monetary Indicator</u>	<u>Bullish</u>	<u>Bearish</u>	<u>Current</u>	<u>Indication</u>
Yield Curve Spread	>3.5%	<0	0.73	<b>Neutral</b>

In summary, it is useful to note that we are having to go further and further back toward the bubble years of 1999-2000 to see examples of some of these indicator levels in the past. Margin Debt is at very high levels indicating a general perception of risk-free conditions.

### **Explanation of 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. The best actionable points are when most or all of the indicators are in line, as they are now.

**NYSE Bullish Percent:** This great indicator is from Dorsey Wright and Associates 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.

**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 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%.

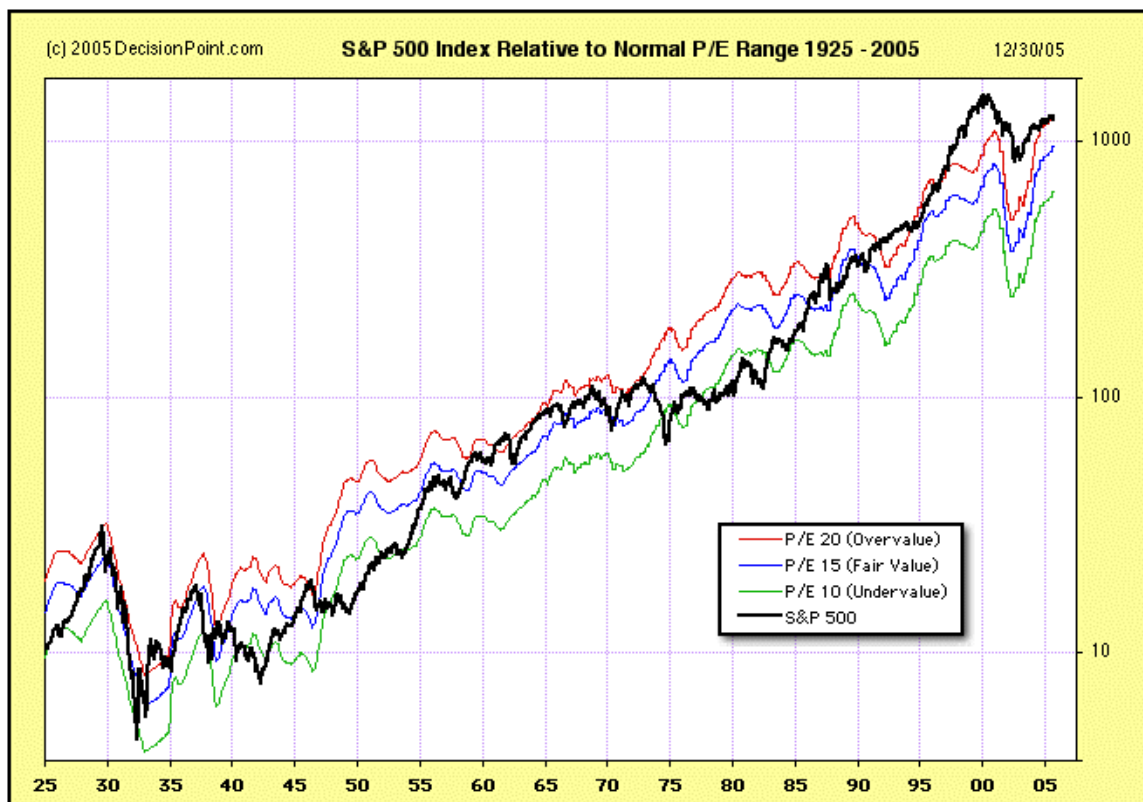
#### **Yield Curve Spread:**

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.

#### **What We Believe**

**We believe in Cycles.** Everything travels in cycles, from hemlines to business valuations. Using a simple business valuation tool known as the Price to Earnings Multiple (P/E), we can track such behavior. 200 years of stock market history tell us that

P/E's run roughly from 8 to 20 to 8 and back up again. If you really want to buy and hold the market and have the best chance of achieving strong future returns, you buy when P/E's are around 8, which is typically the bottom of a bear market and the peak of FEAR. If you want to invest into a stiff 15-year headwind, you buy when market multiples are around 20 or higher. The reason you are facing a headwind is the simple movement of the valuation cycle. Eventually, the P/E will revert to the other extreme in order to maintain the mean of 15. Yes, earnings could grow, which would support high multiples, but with the multiple of earnings actually declining, it becomes very difficult to succeed without active portfolio management. And, indeed, that is usually how the P/E corrects - a gradual decline in the earnings multiple is offset by earnings growth over time. What we are saying is that we don't think the major market indices will be much higher in 2015 (15 years from the bull market top in 2000) than where they are now. There will be a lot of ups and downs from year to year but not much progress will be made from point to point over a multi-year period (like the next 10 years). A good illustration is the chart below. Notice how the actual value of the market (black line) continually oscillates from "Overvalued" (Red - where the market would be at a P/E of 20) to "Undervalued" (Green - where the market would be at a P/E of 10). Rarely does the market spend much time at the mean P/E of 15.



(chart courtesy of www.decisionpoint.com)

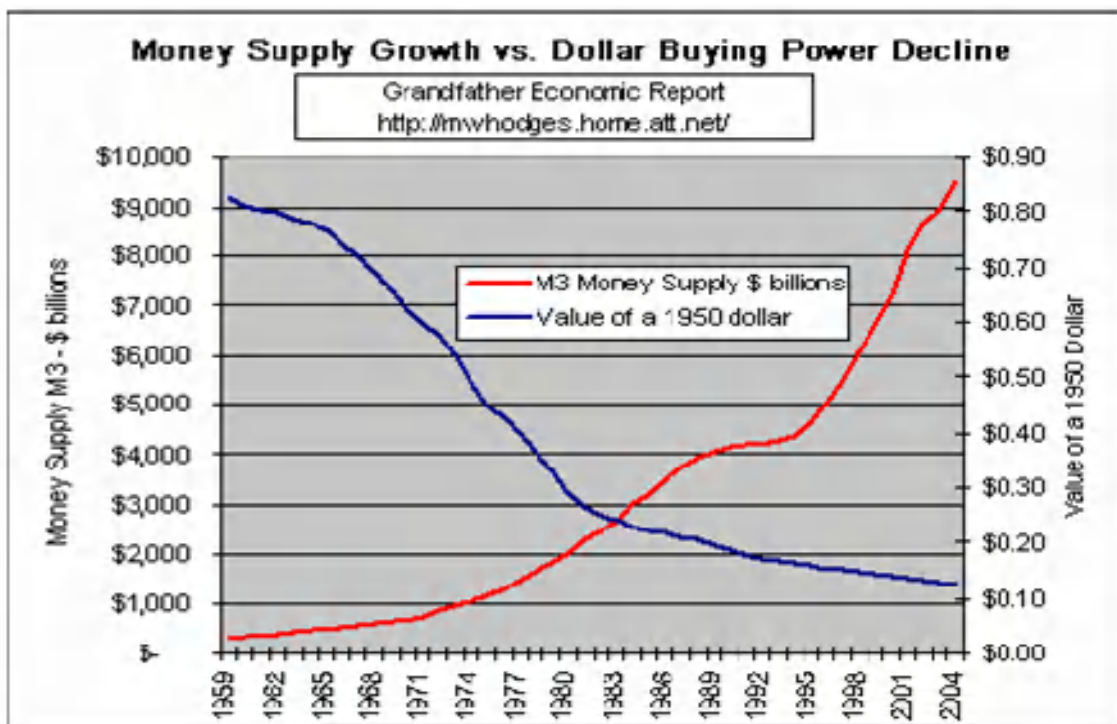
**Therefore, we believe we are in the midst of a long term bear market, particularly for large cap U.S. stocks, which won't be attractive buys for the long term until their P/E, collectively, is under 10.** In the 1920's, hemlines were rising as business valuations rose to levels approaching a P/E of 20. Well, P/E's have been above 20 since 1997, so it makes sense that hemlines are GONE!! Funny, and not funny. We believe attitudes transcend behaviors in all areas of life. Generally, folks that spend aggressively

will probably dress aggressively and vice versa. Well, given a P/E that is still above 20, people are obviously not discounting the risk of investing in stocks. This leaves us no other choices but to reasonably anticipate either a rapid and unexpected market decline or about 10 years of choppy markets with no real return point to point over the next 10 years. This type of market environment occurred most recently from 1966-1982 - prior to the historic bull market run from 1982-2000.

**We believe that central banks should not attempt to manipulate currencies.** For thousands of years, from the barter system to the arrival of paper money, there has been something of tangible value backing what someone received for what they gave in trade. In other words, in the world of barter, a farmer might have exchanged five chickens for some dental work. The dentist got five chickens - something that took the farmer time, tools, chicken feed and labor to raise. The farmer received quality dental work in exchange, which took time, labor, training and internship work in order for the dentist to acquire that skill.

Barter became impractical for obvious reasons, which led to the creation and circulation of gold and silver coins of inherent value. They have inherent value because they are made of a scarce material, which requires labor to produce. These coins were advantageous for the following characteristics: 1) divisibility; 2) portability; and 3) durability. It is much easier to carry around a gold coin than five chickens. And the chickens could get sick and die, while the coins will last for centuries. From coins of inherent value came paper money backed by metals such as gold, silver and platinum. The backing was important because it allowed an increase in portability (paper made it easy to increase denomination without increasing bulk) while still providing for the “guarantee” that the paper was worth something. You could walk into a bank and “redeem” your note for the equivalent value of gold or silver, depending on the type of note.

**Both gold and silver possess inherent value coming from two factors: Scarcity and Labor.** It seems like a law of nature that when something is scarce, relative to demand, or if it requires labor to produce, then we place a higher value on that something. An oak tree may fetch one value as an entire tree while several boards of carved oak that represent a fraction of that same tree will fetch a much higher value. Dirt is cheap because all you have to do is reach down and pick it up; gold is expensive because you have to hire and employ engineers, equipment and labor to pull it out of the ground. When the Founding Fathers of the United States of America established our nation, they specifically suggested that paper money, if employed, must ALWAYS be backed by gold or silver. Why is this important? Because if you don't back paper money, or at least restrain the growth of its supply, it is destined to lose value over time as more of it is created by central banks. The chart below demonstrates how we have increased the supply of money, and have decreased the purchasing power of that money proportionately. This is also known as “inflation”.



(Courtesy of The Grandfather Economic Report)

In 1971, President Nixon terminated the exchangeability of dollars for gold by closing the “gold window”. From then on, the U.S. Federal Reserve would no longer deliver gold to foreign central banks in return for dollar deposits. The dollar’s value (that is what you can buy with it) since the closing of the “gold window” has been based solely on perception, or, as some may say “faith”. It is the perception of those who hold dollars that their dollars will be exchangeable for some unit of value. Naturally, since the dollar’s value is based on perception, goods and services priced in dollars will require more dollars to be acquired when the perception of a dollar’s store of value is tarnished. Likewise, gold (which does not tarnish!) will act the same way: A weak dollar yields rising gold in dollar terms.

**That is why we believe gold, and other scarce, tangible commodities like silver, copper, oil, etc. are in a long term bull market.** Last year’s Outlook and Commentary called for a reversal of what seemed to be the irreversible decline of the U.S. Dollar on a trade-weighted basis. I wrote that Commentary soon after the ultimate contrarian indicator, the mainstream financial press, couldn’t get enough of the story of the declining dollar. Well, the “mainstream press” indicator worked and the U.S. dollar staged a 13%+ rally in 2005, ending the year up about 11% against a trade-weighted basket of foreign currencies. Normally, as indicated above, this would imply a weaker price of gold. Impressively, the price of gold did not weaken relative to the strengthening U.S. dollar.

The U.S. Dollar Index is a measure of the dollar’s value against several other national currencies of our major trading partners. It follows that since gold is actually rising at the same time the dollar is rising, then the market’s perception of the weak paper dollar now includes other paper currencies (like the Euro). The paper currencies that are the

exception to this market occurrence are those currencies that remain backed by tangible deposits of gold or those currencies of countries who hold massive inventories of these tangible, scarce commodities under ground (like Canada and Australia).

Why is the paper dollar system breaking down? Because man is in control man has his finger on the button of the electronic printing press that controls the money supply. Man (Republicans and Democrats) can run huge deficits without being held accountable by the gold standard. And, since the backing of the U.S. dollar has not been required by our trading partners, man (think Federal Reserve) has created more dollars to pay for our “twin” deficits. It used to be long ago that when a country ran a trade deficit with another trading partner, the gap would be filled by the payment of gold. Now, it is filled by the payment of electronic dollars created “out of thin air”. Because of the United States’ ability to issue bonds and borrow from other trading partners (who only lend to us out of necessity to keep their currencies weak against the dollar - see July 2005 Commentary at our web site), we have also gotten away with running budget deficits at home. It reminds me of a scene from the movie, “A River Runs through It”, where the boy does not want to eat his oatmeal. The father proclaims, “Man has been eating God’s oats for a thousand years; it is not the place of an 8 year old boy to change that.” It is truly childish and immoral behavior to expect more from others than you give of yourself, which is directly reflected by the huge trade deficit. It is just a matter of time before un-backed paper money (or our debt denominated in un-backed paper dollars) becomes unacceptable tender to our foreign trading partners. Every now and then, such as occurred in November 2005, when the U.S. Treasury auctioned 5 year notes, we see indications of foreign central banks’ unwillingness to continue to lend us money at current interest rates. In November, half as many 5 year notes were sold when compared to the previous month’s auction. **For thousands of years, currencies have been backed by gold and it is not the place of a 230-year-old country to change that.**

**“No generation can contract debts greater than  
may be paid during the course of its own existence.”**

*-Thomas Jefferson, 1789, in a letter to James Madison*

### **The Result of Human Intervention: An Inflationist FED**

We come by our convictions honestly by studying economic history. The newly appointed FED Chairman, Ben Bernanke, has spoken on multiple occasions about the strong desire of the FED to avoid deflation at all costs by inflating the money supply using just about any means necessary. These “means” include the obvious tools such as the reduction of the FED Funds target rate and the purchase of short-term government bonds. Mr. Bernanke, defining himself as an inflationist in my mind, added some other tidbits in recent speeches like the following comment: “The U.S. government has a technology, called a printing press, that allows it to produce as many dollars as it wishes at essentially no cost.” What he is saying, for better or for worse, is that the FED will avoid deflation at all costs, including, destroying the purchasing power of the dollar by dramatically increasing the supply of dollars available. And, to really top things off, the government has decided to limit the disclosure of the money supply by ceasing the publication of the M3 money supply measurement beginning March 23, 2006. Despite

my fear of sounding like a conspiracy theorist, I have to say that I don't like the idea of an independent government institution not only controlling the level of inflation of our currency but also limiting our ability to gauge how bad the inflation is actually getting. We may be a bit conservative in our investment strategies, but I think our clients will be rewarded over the next 10 years or so.

## **Gold**

We've spoken quite a bit about gold as an investment for the long term. In 2005, its price was up over 18%. Last year around this time the dollar had dropped dramatically, so, naturally, that investment story made the cover of several periodicals in the financial press. We took that as a contrarian indicator and one reason to NOT bet against the dollar in 2005. That was an accurate reading and investment decision. Well, now gold is getting all the mainstream attention and my thought is that it is still due for a deeper pullback or correction. Gold rose to 540 or so in December and then pulled back to 490 or so not long after Fortune put gold stock investing ideas as its cover. Gold has rallied strongly since the last mini-correction, but I think one more leg down is due to shake out the excessive bullishness. We like the precious metals sector but think caution is warranted at present price levels. Besides, January to June is seasonally bearish for gold, so seeing it surge through the 540 high in the near term would be quite a feat. Fortunately, we remain exposed to gold in our portfolio but on a reduced scale at present. We look forward to scaling back in to gold mining stock positions soon...

## **Outlook**

We are excited about the bull markets we have discovered with the help of some great minds. Indeed, I feel very fortunate to have been introduced to all the thinking that leads to these conclusions. The best part is that with our individual investments, we have disciplines in place that keep us from becoming emotionally attached to any one position, thus limiting our downside risk. This strategy contrasts with the "buy and hold" approach where one does not have a bottom (or stop loss) to each position value.

2006 will be an exciting year. Many of our investments should perform well, and it looks like we will have a terrific buying opportunity in some of our favorite sectors between now and mid-year. I think by the mid to end of 2006 the bond market will anticipate interest rate cuts by the FED, and we will get one last surge in home buying. Suffice it to say, with the affordability of homes at all time lows, I think the cycle will turn over the next year or two. Now does not appear to be the optimum time for making long term real estate investments. The direction of interest rates, which plays a major role in the housing market, will largely depend on foreign central bank demand for our bonds. If we enter a recession in early-to mid 2007, I think you will see these bond buyers back away from the table causing long term rates to rise.

Capital preservation is a priority for us, and we continue to underweight large cap, mainstream U.S. stocks and broad market indices. Since our selectively chosen investment portfolio is off to an incredible start this year we've been adding equities to it with immediate success on the new investments, I am very excited about our prospects in 2006!!!

Successful Investing and Planning to All!!

Justin

Justin B. Friedrichs, CFP®  
Friedrichs Asset Management LLC  
Registered Investment Adviser  
6767 Forest Hill Avenue Suite 305  
Richmond, Virginia 23225  
(804) 272-6070

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