

July 14, 2004 Commentary
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S&P 500: 1111
NASDAQ: 1914
10 Yr Yield: 4.48%

Summary - S&P holds 200-day moving average but is trapped in a downward trend channel, Gold rebounds and is looking better than S&P, Economy showing signs of trouble, and if everything is going so well, why can't the S&P make fresh highs?



The last report in May had the S&P at 1092, Gold at around 380 and the economic reports gangbusters, but the S&P was having trouble breaking out to the upside despite all the good news. In fact, I told you that the S&P was threatening breakdown (along with the already broken down NASDAQ and DOW), Gold looked ready for a rally, and I suspected economic stimulus was close to running its course. Well, the S&P rallied, failed to better its previous top (see declining trend channel in the chart above) and is

desperately holding on to a 1.7% gain from the May report and a breakeven year. Gold rallied and is holding on to a 6.5% gain since the May report and a 2.5% loss on the year. Gold and gold stocks have been underperforming year-to-date, but it looks as if that is about to change. The latest jobs report, Chicago PMI, and Retail Sales numbers are taking on a negative bias. Job growth came in at half what was expected and below the necessary growth to maintain our economy. The Chicago PMI indicated manufacturing growth slowed dramatically, although still above the 50% “expansion” level. And Retail Sales were expected down and ended up down almost twice as much. I don’t have enough room here, but the chart on Walmart tells the whole story on the Retail Sector...UGLY. The good news regarding the economy continues to be the number of housing starts and the still-above-average growth in median new home sale prices. We will initiate a discussion comparing the Japan stock market collapse and ensuing housing bubble with ours, since both housing booms accelerated following artificially lowered rates brought on by stock market and economic corrections (the real estate discussion was greatly enhanced by the experiences of my readers - thank you!). We will also take our quarterly look at the Indicators, a graphic look at the debt problem building up in the U.S., the effect on the dollar many issues are having, and a graph which is developing into a strong case for our investment strategy. Somewhere in the middle we will address the bind the FED is in that no one wants to talk. Let’s get on with it!

The Indicators

Let’s now go through the indicators introduced in the January Outlook and Commentary where explanations for their interpretation can be found. (See the “Archived Commentary” section of the website: www.FriedrichsAssetManagementLLC.com)

Contrarian

Indicator	Greed	Fear	Current	Indication
NYSE Bullish Percent	>70%	<30%	66.05**	Bearish
AAII Sentiment				
Bull/Bear ratio	>2.5	<1	3.6*	Bearish
NYSE+NASD				
Margin debt balances	>160B	<100B	193B/Last here 2/2001	Bearish
Savings Rates	<5%	>12%	2.2%	Bearish
Mutual Fund Cash	<7%	>12%	4.0%	Bearish

**Declining from a peak of >86%

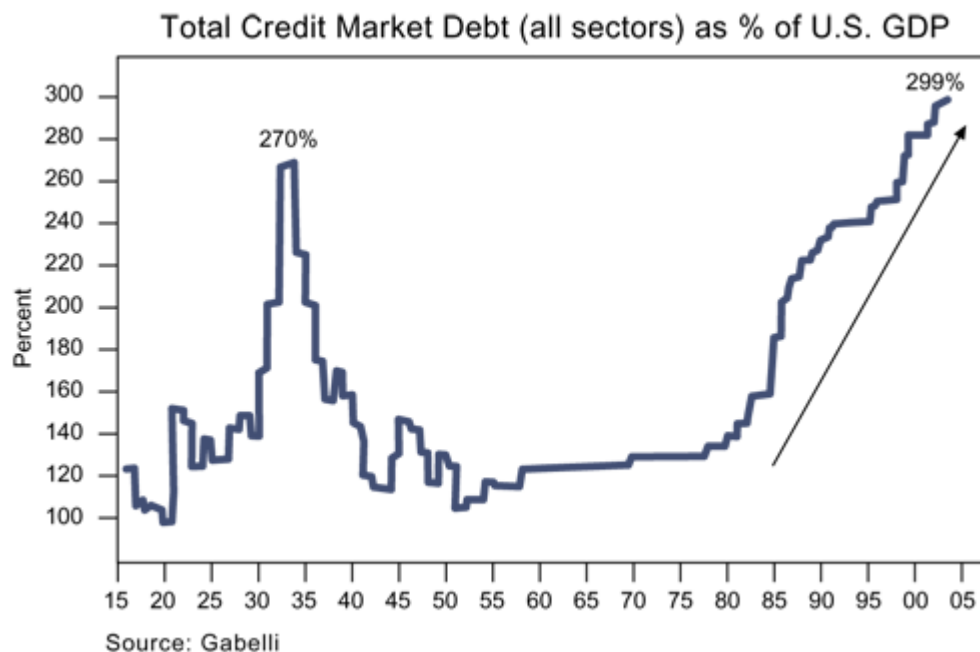
*Recently we have seen readings not seen since 1987, which like 2004, also followed 2+ years of >10% \$US decline each year.

Valuation Indicator	Greed	Fear	Current/Last here	Indication
Price/Earnings Ratio	>20	<10	21.36/>20 since 1997	Bearish
Dividend Yield	<3.5%	>6%	1.67%	Bearish

Since the April Indicator run, the NYSE Bullish Percent proved its usefulness by anticipating the decline in the S&P from April's 1132 to today's 1114. Interestingly, the bullish/bearish ratio has risen as the bulls continue to stubbornly pound the table. This is also reflected rise in margin debt levels, indicating further speculation. Savings rates blipped upward (they were even higher in May before pulling back again) and PE ratios and yields adjusted with the market decline. I am glad to report that it looks as if those that are not contributing to the retail growth just may be saving money. What does that tell us about the real mindset of the consumer? The next section shows why the consumer may be freaking out a bit.

Floating Rate Debt

Who is floating rate debt good for? On the surface, it would appear that because the interest rate is so low that it is good for the consumer. This may be the case for some. What we know for sure is that anything that is marketed as heavily as Adjustable Rate Mortgages (ARM's) and credit cards is probably pretty good for those investing in the marketing. According to Dr. Irwin Kellner, cbsmarketwatch.com's Chief Economist, roughly 40% of consumer debt is based on adjustable rates. It is obvious, then, why the FED has been so eager to lower rates and keep them down. The hope was that the low rates would present the opportunity to pare debt. While corporate debt ratios have been coming down, you can see from this chart from Bill Gross's website at Pimco, the overall ratio of debt to GDP has risen to fresh 90-year highs (as long as it has been tracked!!).



In the beginning of the year, I said I would not be surprised if the consensus was all wrong and the Fed not only would not raise rates mid-year, but that it might wait until the end of the year or after the election. The reason I made that statement is I did not feel that the debt-laden consumer and economy would be ready that soon. I also thought that

the deflation being exported from China and India would have a dampening effect on our Consumer Price Index. I talked about asset inflation (stocks, houses) being offset by labor deflation (China and India forcing Americans to work for less or forced out of work all together). Raising rates, I thought, would damage the recovery. Well, I was wrong about the FED raising rates. As you probably know, they bumped up rates .25% at the June meeting. The FED is going to have to tread very carefully going forward, and it knows it. It must raise rates to head off asset inflation but must be careful not to raise too much or too fast and fail at its political goal of avoiding another recession.

The FED is in a tight spot, which it created. It has created a debt fueled asset bubble while not producing any kind of long-term job growth. Last quarter, household sector debt increased at a 10%+ annual rate!! Are incomes growing that quickly? Personal Income is growing at about 2-3%. In fact, the most recent figure shows a persistent and bothersome pattern: Consumer Spending up 1% while the savings rate declined from 2.6% to 2.2%. Sure, the last few months have shown the government statistics reporting job creation, but many, if not most, of these jobs are temporary and low-skilled jobs. *My position is that most of our economic growth has been temporary in nature and caused by low rates, which enticed borrowers and sent housing demand up, which sent prices up, which lead to more borrowing to afford higher prices.* I say “temporary” because jobs drive the economy, and in the months when we’ve had more than 150,000 jobs created (the threshold number experts say are required just to keep us at flatline), the preponderance of evidence indicates these jobs are low wage service jobs or temporary jobs. Nonetheless, the FED raised rates, in my view, to head off the asset inflation it created. The bottom line is that when you lower the rate to borrow and consume and you don’t add decent jobs, the net creation is a lot of debt.

Borrowers love inflation because they get to pay off debt down the road in dollars worth less. My simple definition of inflation is the decline in purchasing power of the dollar. If housing prices increasing at 10% per year while personal income grows at 2-3% annually is not a decline in dollar purchasing power, I don’t know what is!!! I was pleased to see an article in Barron’s last week that addressed the real cause of inflation, which is the decline in the U.S. Dollar on foreign exchange markets. I’ve talked about this before and a little later in this letter.

So, I laud the FED’s efforts to fix the nightmare it created, but once again, it is delaying the inevitable thus making the inevitable worse. Although the FED has little control over fiscal policy, it has enabled the Bush Administration, and every administration before it, to pile on racks and racks of debt by artificially pushing rates down whenever it smelled trouble. This allowed every administration to borrow more, just as it is allowing every consumer to borrow more. Our national debt is increasing daily by \$1.69 Billion and is now \$7.274 Trillion as you can see below from the Treasury Departments site: <http://www.publicdebt.treas.gov/opd/opds062004.htm>. At the rate we are going we are only 100 days from having to increase the National Statutory Debt Limit **AGAIN**.

I have included this table for three reasons: 1) to let you know it is available for you to view any time, which hopefully serves as a remarkable shock to you to see exactly how

deep in debt we are; 2) to direct your attention to the bottom three lines, which show you, the voting taxpayer, the debt limit and how close we are to having to increase it and; 3) nobody else seems to want to talk about what everyone after them will owe. You heard it here first!! **Before the election, the Statutory Debt Limit must be raised!** What can you do about it other than invest all your money with Friedrichs Asset Management? If you want to stop this madness, go to <http://www.eff.org/congress/> and tell them what you think. To put this into perspective, according to the National Debt Clock web site at http://www.brillig.com/debt_clock/ this debt represents \$24,686.81 of debt for every man, woman and child in our great nation. Privately held consumer credit as of the end of April now stands at \$2.031 trillion (NOT including debt backed by real estate) – when added to the \$7 Trillion of public debt - makes the total debt which WE are financing equal to \$9.305 Trillion, or **\$31,588.48 per man, woman and child of DEBT (not per household, PER PERSON)**. The expression “up to our eyeballs in debt” does not do this situation justice.

**TABLE II -- STATUTORY DEBT LIMIT,
JUNE 30, 2004**
(Millions of dollars)

Title	Amount Outstanding		Totals
	Debt Held by the Public	Intragovernmental Holdings	
Debt Subject to Limit:			
Public Debt Outstanding	4,218,910	3,055,425	7,274,335
Less Amounts Not Subject to Limit:			
Other Debt Not Subject to Limit	513	0	513
Unamortized Discount	29,210	15,438	44,648
Total Public Debt Subject to Limit	4,189,187	3,039,987	7,229,174
Other Debt Subject to Limit:			
Guaranteed Debt of Government Agencies	147	0	147
Total Debt Subject to Limit:	4,189,334	3,039,987	7,229,320
Statutory Debt Limit			7,384,000
Balance of Statutory Debt Limit			154,680

What is a Conservative?

Last month we witnessed the passing of Ronald Reagan, president from 1981 to 1988. Analyzing his views and actions on fiscal and monetary policy can be a double-edged sword. On the one hand, he asked Congress to increase the aforementioned Statutory Debt Limit. On the other hand, he deftly kept non-military government spending growing at the slowest growth rates in recent history, even if it meant going through a necessary recession. “As far as inflation under Reagan goes, from 1980 to 1988, it dropped from an annual rate of 10.4 percent to 4.2 percent, and unemployment dropped from 7 percent to 5.4 percent. (Friedrichs Comment: And we’re fretting now over a 5.6% unemployment rate...?) When Reagan made clear that he was willing to support a tightening of the money supply to fight inflation, some advisers warned that such a policy might bring on a recession. Reagan responded by using the prophet, Hillel’s words: “If not now, when? If not us, who?” Says George Schultz, who was Reagan’s Secretary of State: “So he did the right thing, and we did have a recession. But also, inflation dropped like a stone.””-*cbsmarketwatch.com*

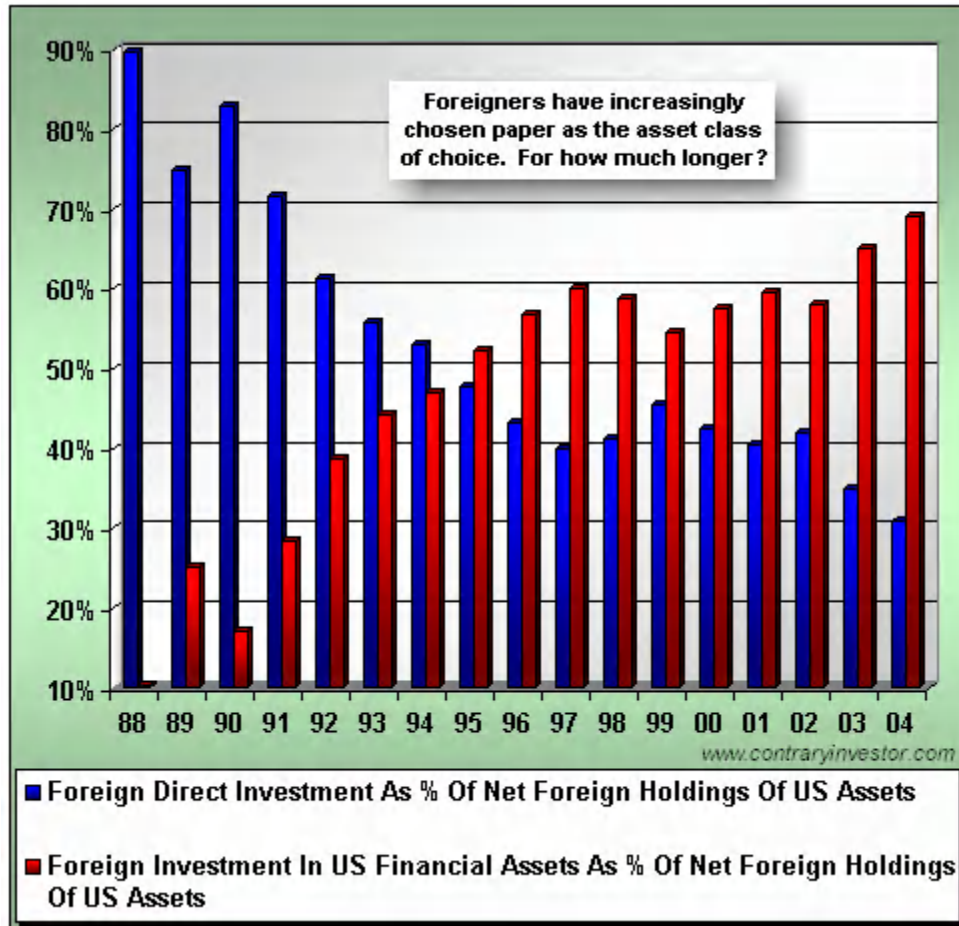
Is There an Easy Way Out?

Sometimes, there is no easy way out. It seems that Greenspan and Bush refuse to see this. By not acting now, and acting aggressively, to curb government and consumption-driven debt bubbles (which are fueling asset bubbles) they are only prolonging - and by prolonging - *increasing* the inevitable burden. To be sure, **the pain that would result in the policies I support would be felt by many and maybe for quite a spell.** But allowing us to continue at low rates and high levels of government spending is a short-term fix and does not teach anyone a lesson about taking on too much debt. Rather, this lesson is passed on to the next generation. **And the pain then will be unbearable.** In 1789, in a letter to James Madison, Thomas Jefferson wondered whether 'one generation of men has a right to bind another.' His answer was “no”. Jefferson concluded, “No generation can contract debts greater than may be paid during the course of its own existence.” - *Dailyreckoning.com*

As I have written before, in a democracy, the participants get what they ask for. Elected officials can’t be blamed when they are only doing exactly what the electorate asks. It is no wonder the dollar is losing value. And we have no choice but to invest accordingly to protect your interests.

Flow of Global Funds

The following charts below help shed light on foreigners’ ability to see and acknowledge what we refuse to. This information is what we use to develop an investment strategy for this environment. The valuation data from the *Indicators* above alone are enough to keep money from plowing into the market. Using the chart below, we can see the principal target of money inflows from abroad were these financial or “paper” assets. So if paper assets remain overvalued, money flows will slow.



The more compelling story behind the chart, and the reason [contraryinvestor.com](http://www.contraryinvestor.com) produced it, was to demonstrate how less and less of the inflows are being committed to long-term, illiquid projects. This is foreign money clearly exhibiting a reduced risk tolerance in U.S. investments. In other words, an increasingly higher percentage of Foreign Direct Investment is going to investments foreigners can immediately vacate once they see trouble around the corner. This fear can be attributed, in my opinion, to the rising debt levels and resulting decline in the dollar. If the dollar resumes its decline in a more rapid or regular fashion, expect to see liquidation of these paper assets. Think about it: Would you continue to hold stocks yielding 1.7% or bonds yielding 4-5% when the country is running 3-5% inflation and the currency in which your investments are denominated is declining 5% per year against your currency???

How To Succeed

How do we react? We invest your money accordingly. We invest to protect you from the structural changes going on in the U.S. as a result of an all-inclusive global community, which will serve to level the standards of living around the world over time.

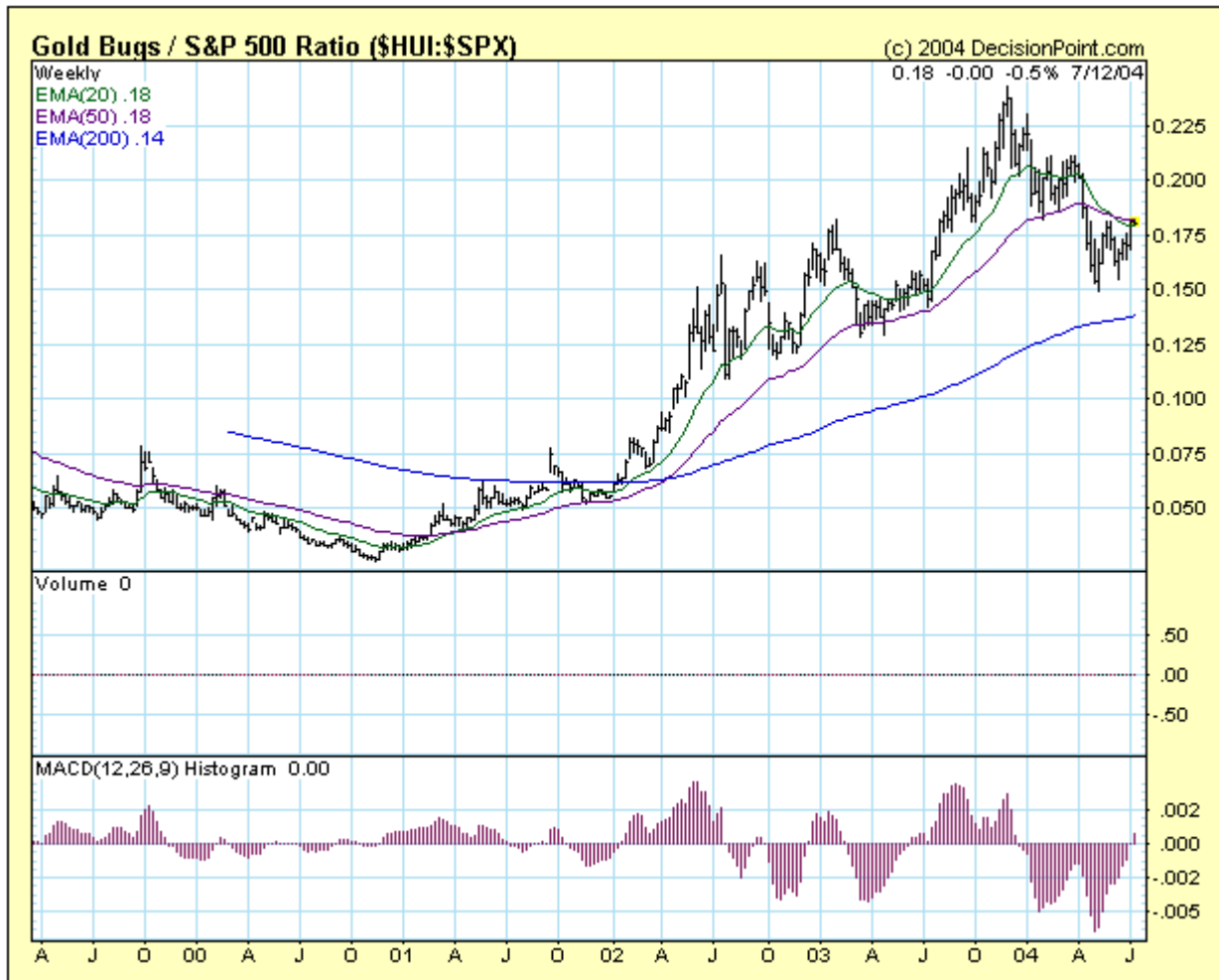


(courtesy of www.decisionpoint.com)

The U.S. Dollar Chart above is what we are protecting you against. You can see in the above chart the beginning (around the end of 2001) of what I believe to be a long-term affair. This is a weekly chart of the U.S. Dollar Index which, rather than a measure of the dollar versus any one currency, is a measure of the dollar's value versus a basket of currencies. Notice the purple lines have gone to below zero. These lines are sophisticated measurements comparing moving averages. By analyzing the chart, you can see the price action that typically develops as the purple lines revolve around the Zero Line. At this point, while not guaranteed, it appears as if the dollar will have a weak bias for the short-intermediate term.

The next chart is a relative performance chart of the Amex Gold Bugs Index (HUI) versus the S&P 500 (SPX). The HUI is an index of un-hedged precious metals mining and related stocks. I show this chart immediately after the U.S. Dollar chart because, as explained in previous *Commentaries*, since the gold is priced in U.S. Dollars and the U.S. dollar is weakening, it follows that gold should rise. In addition, the number of U.S. Dollars being created each year is far greater than the value, in U.S. dollars, of gold mined each year. Lastly, gold popularity is on the rise and new consumption and

investment-oriented markets are being created for gold. The Chinese have always loved gold, and now they can own it themselves through the Shanghai Gold Exchange!! It's all about the old supply-demand thing.

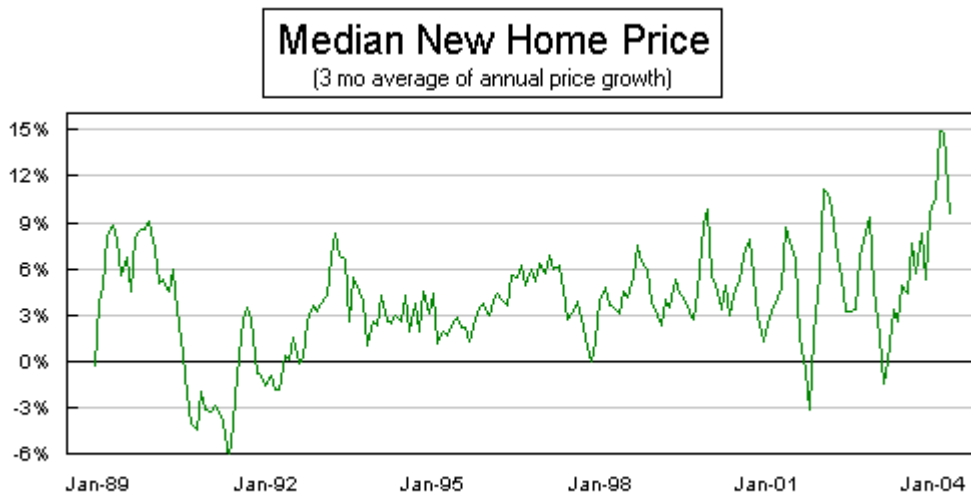


Note the purple lines have flipped to positive. While not a guarantee of positive relative performance, this chart is encouraging. (courtesy of www.decisionpoint.com)

Back to the chart: As you can see, while the HUI underperformed relative to the S&P during the first half of the year, it appears as if the tide is getting ready to turn for the second half - a half-year rife with potential uncertainty: the Olympics, handover of Iraq, and the U.S. election are some overhanging events. As you have read before, the markets can be perfect discounting mechanisms, and I think this chart tells an interesting story. My focus is not on terrorist attacks, although I feel asset managers should discount these possibilities in the form of specific investment strategies. My focus, as always, is on the health of the U.S. Dollar, which currently is deteriorating, and how that deterioration will impact our investments.

Real Estate

I am constantly confronting the real estate issues in the development of financial plans, so I will attempt to address this issue. Not to mention that it is a bull market to be reckoned with!! First, I have to admit I don't know much about investing in real estate. I thought about buying some rental property on the Outer Banks a few years ago but thought at that time I was "buying at the top". I also remember having thoughts along the lines of "what do I know about running a rental property?" and not wanting to invest the time to truly understand that concept and corresponding cost/benefit analyses associated with it. What a laugh that "top" is now, though?! You need binoculars to look that far down at the prices in the Outer Banks three years ago. As a matter of fact, I fully admit to not buying at the absolute bottom or selling at the absolute top in anything. (Thank you, but I'll pass on reader feed back in this area!) If I ever do, it will be pure luck. **My best is to pick up on major trends after they form and do my best to ride them until they change direction.** Alright, back to real estate, but that last sentence leads me to a truism in investing. I got this from Richard Russell of Dow Theory Letters, and it goes well with my father's advice "**When fear is at its height, buy...When greed is at its height, sell**". Russell says that items of value go through cycles, whether you like it or not, from extreme optimism and overvaluation to extreme pessimism and undervaluation and back again. Usually, periods of overvaluation create the perception of never ending increases in value due to an extended period of above average returns; hence the expressions "stocks always go up" or "real estate always goes up". Likewise, the inverse is true during periods of undervaluation, or decline. It is no wonder everyone is piling into real estate. With recent growth rates trending at double and triple the average of 3-5% per year, the growth we have been experiencing is intoxicating!



Updated: 24-Jun-04

(courtesy of Briefing.com)

However, the chart above coincides with a period of gradually looser monetary policy and lower rates. You can see the general trend toward higher growth rate ranges. More importantly, the process of overvaluation to undervaluation and back cycles endlessly, and to deny it, is to invest in an uninformed manner. It appears to me that the real estate

market, that is, residential property, is experiencing an inordinate surge in optimism and greed. But does that necessarily mean prices must come down? Is it overvalued? Russell says, "I was brought up by a real estate man, and his formula was that when you buy a house it's going to cost you 10% a year any way you cut it. That's figuring in mortgage, loss of income on your investment and annual taxes and repairs." (12/16/2003) Based on this application, if you can rent it for more than 10% of the purchase price, then you should be okay. Other factors are your basic supply and demand considerations like interest rates, job growth, the aging population (I still haven't figured out if that will be good, bad or indifferent), rentals and their rental histories (if you are looking at rental property), potential for new construction in the local area, and your holding period.

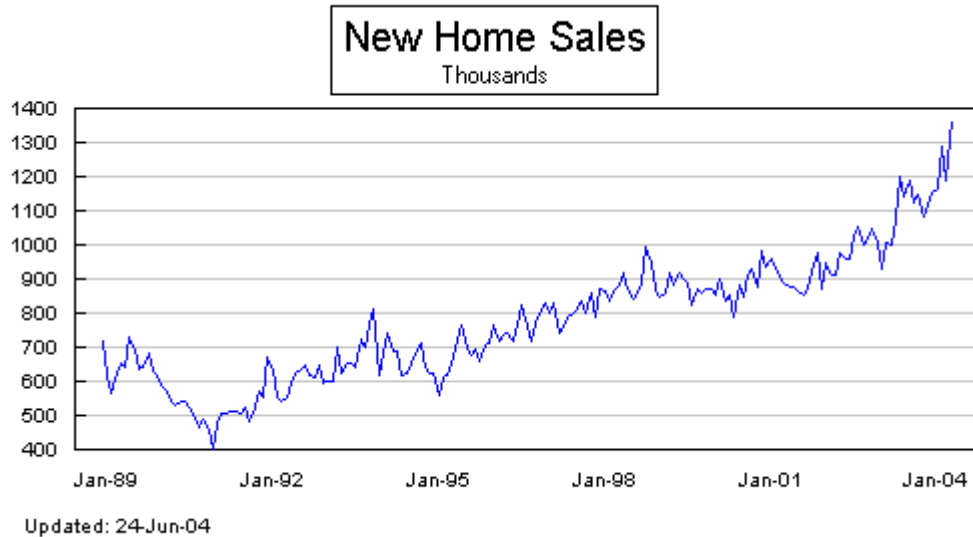
The Speculative Stage

Last month I referred to Warren Buffet's comment with regard to our trade and budget deficit - how our net worth (as a nation) is being exported abroad at an alarming rate. Every now and then mini-counter trends occur within the long-term trend as others take advantage of the weakening dollar. A reader wrote in about exactly that issue with regard to real estate. I have always talked about the trade deficit and thought of it in terms of goods and services. As you know from the chart above, foreign investment can be in plants and equipment and in paper assets. Based on my reader's observations, it seems the international investing public wants in on the U.S. housing mania. Apparently, the British, riding the wave of a strong pound-sterling to the U.S. Dollar, are taking their stronger currency and buying up real estate in Florida and driving up prices while at it. He writes:

"Last week, a broker we do commercial deals with had a call from a British couple wanting to see real estate in Orlando. He was reluctant as he was busy, but agreed to meet. When he met them, he thought he was wasting his time. They both were tattooed and pierced. However, at the end of the day, they had written over a million dollars of contracts for houses and lots."

This is not only an excellent example of the speculative stage of a cycle taking hold (you've got previously uninterested parties jumping in with froth in tow!) but also an example of inflation affecting our ability to house ourselves. If prices are bid too high, we'll be forced to reduce our standard of living. No, *you* may not *have* to sell your house today, but every 3-7 years on average, you will. In a declining interest rate environment, you can live larger and larger. This is not necessarily so in a rising interest rate environment. This is why your holding period is crucial, just as it is when you buy stocks. Real estate is less liquid, and you don't want to be selling it out of need. In fact, you probably shouldn't invest if you can't handle the payments without the offset of rental income - not at this "toppy" stage of the game anyway.

Is it Possible, or Even Important, to Exploit the Possibility of a Top?



It was also about a year ago that people started asking “How much farther will the housing boom go?” which in extreme boom scenarios is usually followed by a “last gas”, which blows away even the bulls and serves to convert the critics into believers. You can see an example of this in the 1998-2000 stock market. The Asian currency crisis brought on conviction that a top was in and yet it was followed by such a strong move that it managed to convert most naysayers back into the bullish camp. Separately, comparing the Japanese stock boom to bust followed by their real estate boom to bust to our existence, is important.

The Japanese stock market, as measured by the NIKKEI average, peaked at around 38,000 at the end of 1989. Within one year it declined to 25,000. However, because the Japanese Central Bank reacted by bring short-term rates to their knees, the housing market accelerated and turned into a veritable bubble, which peaked about 4 years after the NIKKEI peaked. Not only did housing growth slow but new home prices declined for years. This deflationary cycle is the nightmare our FED wants desperately to avoid, which is why the “measured” interest rate increases are so widely publicized.

While Japan has been through one recession after another over the past decade, one thing that has helped the Japanese maintain a standard of living is their savings rate that runs above 10%. When bad times occur, they not only are less addicted to consumption but are prepared due to their savings. We happened to be nearing the end of our fourth year, as well, but instead of using low rates to pair down debt and boost savings, we are still running a 2% savings rate - less than the rate of inflation. In Japan, after the liquidity-driven housing bubble burst, the stock market went from 20,000 in early 1994 to around 8,000 in 2003, and sits at around 11,000 today. I read an article a couple of years ago that indicated people were holding off making major purchases such as cars in Japan because they thought the next year it would be cheaper. This included houses, as well,

which at the time was quoted as declining 7% year-over-year. That said, people think you are crazy if you say house prices could decline in value in the U.S. because it has “always” been such a good investment and because “this time it is different”. Despite the possible validity of that near term thinking, maybe it is best to consider the big picture and decide whether, historically speaking, the odds are with you or against you. You can’t go wrong simply considering it a consumption item (not only money but a major time commitment) that may turn out to be a great investment. Maybe it is part of your retirement plan. Buy rental property on the water, make sure you can make the payments all year long, and you could quite possibly have others pay for your future retirement home. Would you be better off in low-maintenance investments like stocks and bonds, just paying the rent when you visit the waterfront, and then making the decision at retirement? Maybe in the next report we’ll try, with your input, to do a side-by-side comparison of the investments and let you decide.

To Be Continued...

I have no idea if we will have a highly inflationary scenario, which could help or hurt home values, or a deflationary scenario that could really hurt values. What I do know is there is quite a bit of optimism and speculation going on right now, which is usually experienced around a market top. So, treat a second home purchase as a luxurious consumption item, making sure you won’t need the funds that you spend and that you have good job security. One reader wrote in about buying frenzies in Florida. Another wrote in explaining how he knew someone in the 80’s who had to move, and because interest rates rose so dramatically to combat inflation, that he owed the bank money after the sale. Some in the business have told me about softening demand across the board in residential property. This is why I stress the holding period so much. Again, I am not a real estate expert, and again, I would love to hear from those experts or those with direct personal experience. Thanks to those that contributed.

In the mean time, at Friedrichs Asset Management we invest and recommend investment, in reasonably priced assets in sectors in where the long-term trend is up and in line with the global economy and flow of funds.

If you have any questions or comments, please call or write to me. I find your experiences invaluable.

Successful Planning to All!

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