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Dollar Rally Alive and….well…

The dollar rally is alive but may be approaching its last weeks. Ironically, the latest surge in the dollar has been caused by investors fleeing another currency--namely the Euro. Stop and think about this. Only a few months ago, right around the time we were calling for a continuing and surprising dollar rally, everyone was convinced the dollar was doomed. They had and still have good reasons to be convinced: 1) the U.S. runs massive, unsustainable trade deficits which we "cover" in an indirect way with IOU's in the form of treasury bonds; and 2) the U.S. runs massive, unsustainable current account deficits which are directly covered by issuing debt.) At the same time, these folks were convinced that interest rates had nowhere to go but up. NOW, these crowds are running FROM the Euro and are landing in dollars. One might ask, "Why are investors fleeing FROM currency to currency?" and "Is there any currency that folks are running TO?" This is where it gets interesting. 2003 and 2004 were years in which the Euro, gold and commodity-oriented currencies were the beneficiaries of flight from the U.S. Dollar. In early 2005, the dollar, and gold have been beneficiaries of flight from Euros while the commodity currencies have held their own. With mounting debts piling up around the world, the common "go-to" currency will increasingly be gold, as it has been for thousands of years. The common 'flee-from' currencies are those un-backed, or 'fiat' currencies includes, with the exception of the Swiss Franc which has partial backing, most major currencies. The crowds remain bullish on bonds as a result of interest rates defying their predictions and staying low around 4% on the 10 year Treasury; and the dollar, an inherently flawed currency (like all un-backed currencies) is rallying!!

Currencies Un-backed by Gold/Silver (Fiat Currencies) are Inherently Flawed

We say un-backed currencies are flawed because they lack the discipline of backed currencies as they do not require the delivery of goods (gold/silver) when a deficit is occurring. In the past, before the creation of the Federal Reserve in 1913 and the subsequent de-linking of the dollar from gold, when a country ran a deficit against a trading partner, it was required to make up the deficit in gold deliveries. This is how the U.S. became so wealthy after World War I. Europeans were taking delivery of American made weaponry at rates that outstripped their exports to the U.S. As a result, they were forced to deliver gold against these deficits. Now, we run deficits with other countries and our only charge is to deliver paper dollars.

These countries - and I've spoken about this before, so those familiar please excuse me - are either in dire straits themselves (Japan and Europe) or are undertaking massive development (China), so they can't afford to convert those dollars back into their own currencies. They know if they did convert, it would strengthen their currencies against the dollar, making the goods they produce less affordable to the consumption-addicted Americans. So, they keep the dollars and in order to get some kind of return, they buy our debt (treasury bills) that we issue because we are running budget deficits. It truly is a matter of time before these strangers' economies improve enough to where their domestic demand can absorb the production levels required to keep their domestic unemployment levels tolerable. When this happens they will probably require higher than 4% returns on investments denominated in a currency that, until recently, was losing 10% per year.

The Indicators

Let's look at the indicators explained in the *January 2005 Commentary and Outlook*, which can be viewed along with other *Commentaries* by accessing the "Archived Commentary" section of the website: www.FriedrichsAssetManagementLLC.com

Contrarian Indicator	**Greed**	**Fear**	**Current**	**Indication**
NYSE Bullish Percent	>70%	<30%	**65.13****	**Neutral**
AAII Sentiment Bull/Bear ratio	>2.5	<1	**1.59***	**Neutral**
NYSE+NASD Margin debit balances	>160B	<100B	**$219B/Last here 11/2000!!**	**Bearish**
Savings Rates	<5%	>12%	**.6%**	**Bearish**
Mutual Fund Cash	<7%	>12%	**5.6%**	**Bearish**

**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.

Valuation Indicator	**Greed**	**Fear**	**Current/Last here**	**Indication**
Price/Earnings Ratio	>20	<10	**20.4/>20 since 1997**	**Bearish**
Dividend Yield	<3.5%	>6%	**1.77%**	**Bearish**

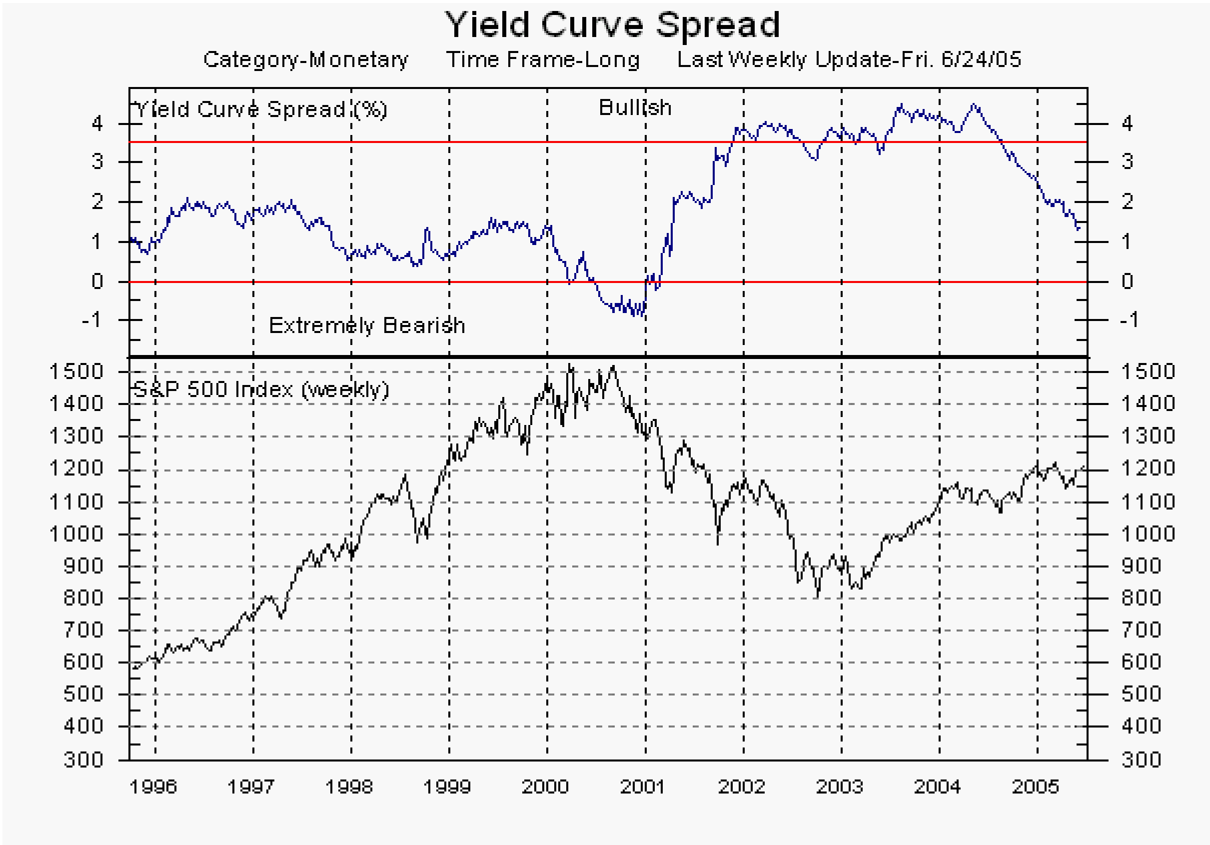
Monetary Indicator	Bullish	Bearish	Current	Indication
Yield Curve Spread	>3.5%	<0	**1.2**	**Neutral**

Looking at the indicators, 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 and Investor Sentiment are both at very high levels indicating a general perception of risk-free conditions. Watching these levels alone tell you where the peaks are in the cycles. The emotions run strong at the extremes. For example, at the bottom of the bear market around October 2003, margin levels were (not coincidentally) at their cycle lows of around $136 Billion. Today, nearly $100 Billion of confidence has built up and, while we are still $80 Billion from the peak of the risk-averse months of the year 2000, we are also in a different phase of the credit cycle. Back then, long term rates were declining and the fed was neutral; now the fed is tightening and, while long term rates have come down during the last month, they are effectively unchanged from two years ago. The convergence of these two yields—long term and short term—is the reason we established the new 'monetary' indicator discussed below.

Note that during the first half of the year the NYSE Bullish Percent reversed from a peak above 70%--generally a bearish omen. It recently reversed itself setting up a temporary bear rally situation, which we have witnessed, simultaneously setting itself up for a major sell signal upon reversing down again and breaking the recently set low.

The Yield Curve

As you have probably noticed, we added the Yield Curve Spread as a monetary indicator. 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. (See chart below)



(Chart courtesy of www.marketguage.com)

Above: Chart of yield curve spread (top) and S&P 500 (bottom) When the spread went negative in mid-2000, the market topped and both metrics properly forecasted the recession in 2001.

This can come about as a result of several factors: 1) Unusually high demand for short term funds, as would occur during near term liquidity crises in government or business; 2) a surge in short term inflationary pressures; or 3) a very restrictive monetary policy by the Federal Reserve (increasing short rates). Each of these factors--liquidity problems, inflation and tight monetary policy - is bearish for the economy and stocks. Indeed, an inverted yield curve invariably leads to a recession that begins within one year-most times within 6-9 months. John Mauldin's (author of Bull's Eye Investing) research suggests that the stock market falls, on average, 43% during a recession. Sounds a little high, huh? Consider this: In July 2000 the yield curve inverted with the S&P 500 at 1464. About 6-9 months later the recession started in February-March. By the time the recession "officially" ended at the end of 2001, the market had gotten as low as 965, a drop of 35%. The market continued to fall through 2002 to make a low of 776, or down a total of 47% for that recession.

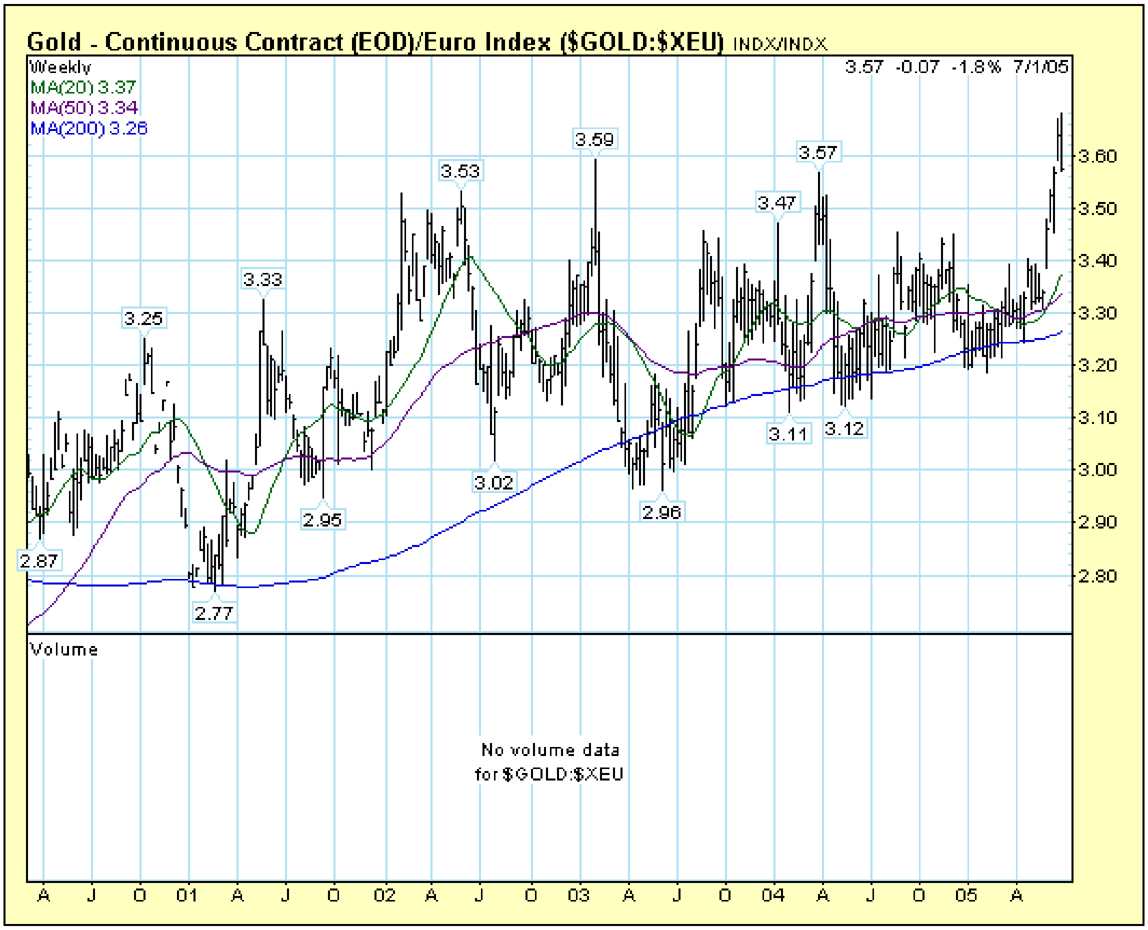
Our Outlook for the Next Decade or So…

We believe due to overvalued markets and reduced fiduciary responsibility among the U.S. government (unsustainably high current account and trade deficits and under-funded Social Security), its citizens (cash out refi's and otherwise excessive borrowing to fund consumptive behavior), and U.S. corporations (under-funded pension plans) that the U.S. stock markets are in a "secular bear" market – a bear market that probably won't bottom until the PE reverts back below 10. Since it probably won't happen overnight, there will be a higher frequency of recessions and thus continually corrective markets.

As you know, I've stated that the massive efforts of the FED to fend off the 2001 recession through the injection of liquidity and the use of artificially low rates resulted in a very painless, 'home-price-rising recession'. I call it the "non-recession". I say this because my feeling is that through the use of artificially low rates, the FED delayed the inevitable shrinkage that must take place in the economy, especially after "irrational exuberance" (a phrase that you are well aware was coined by Alan Greenspan, Chairman of the FED) that occurred in markets during the preceding growth period. So why call a market "irrationally exuberant" and then, when it begins to fall, try to bail it out with rates so low one was practically forced to borrow/spend rather than save. Your guess is as good as mine, but the reason this recovery is becoming known as the "non-recovery" reflects the fact that it has produced fewer real jobs, less real growth, and more personal debt than any other recovery before it. Tying things together, it is no coincidence that the non-recession marked the bottom in the gold market and the beginning of a long term gold bull.

How the FED's Actions Affect Real Assets' Dollar Values

When the FED inflates the currency (reduce its purchasing power), as it has been doing since its creation in 1913, and it becomes apparent that the FED will be required to continue to do so, real assets (like U.S. homes and gold) that can only be exchanged for dollars and cannot be produced out of thin air require more of those 'worth-less' dollars in order to acquire them. That being said, we discussed in the January Commentary the anticipation of an overdue dollar rally. The rally has indeed been strong but that is not the most interesting thing about this ever-changing market. As a result of the rally, gold stocks sold off even more dramatically than gold, thereby destroying gold sentiment. I mentioned in the last commentary that the rally in the dollar would be necessary to shake off and re-build a stronger gold base and an eventual continuation of the bull market in the metal itself. Amazingly, gold has stayed strong and, as you can see below, those fleeing the Euro are now not only going into dollars but also into gold.

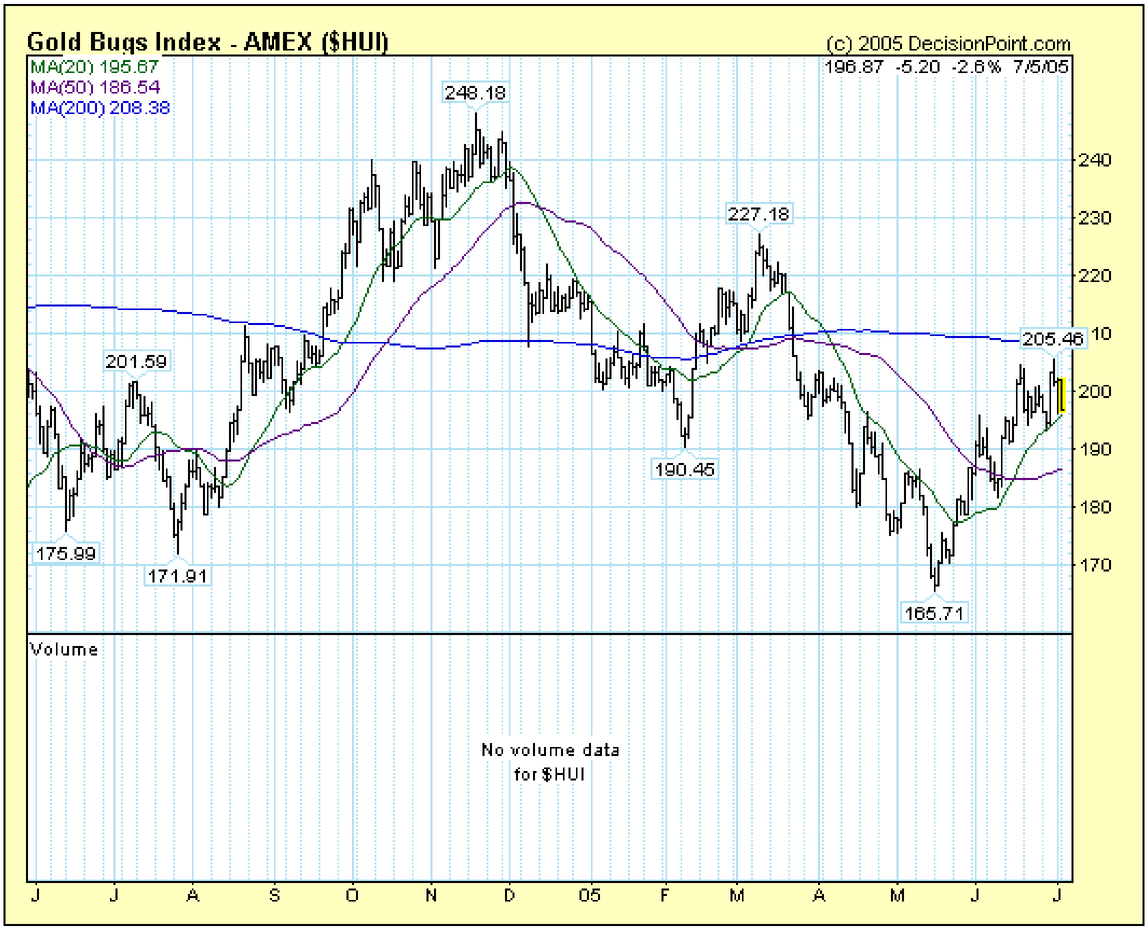


(Chart courtesy of www.decisionpiont.com)

Above: Gold to Euro ratio divided by 100; a reading of 3 would indicate a cost of 300 Euros per ounce of gold-the recent breakout above all previous tops will grab the attention of Euro-based investors…

Gold Bull Goes Beyond the U.S. Dollar

You see, the chart above tells us how many Euros an ounce of gold costs (divided by 100). So if gold costs $440 and the Euro costs $1.10, the ratio would read 4, or gold costs €400. Currently, an ounce of gold costs €357 so the chart reads 3.57. This ratio tells us if gold is rising or falling, in Euro terms. This is important because a gold bull market will really break out once gold demonstrates strength in more than one currency. To true gold bulls, a breakout to the upside is one step closer to gold being recognized as the currency of choice, as it has been throughout human history. The breakout is also heard around Europe as an announcement of investment potential. Usually, as we've discussed, crowds gravitate toward rising investments hoping the trend will continue. As you can see above, gold has done just that and until now has been stuck in a trading range with no appeal to Euro-based investors.



(Chart courtesy of www.decisionpoint.com)

Above: The Un-Hedged HUI Gold Stock Index: while we expect a pullback after testing resistance at the 200 day moving average (blue line), we have been averaging into positions since early May.

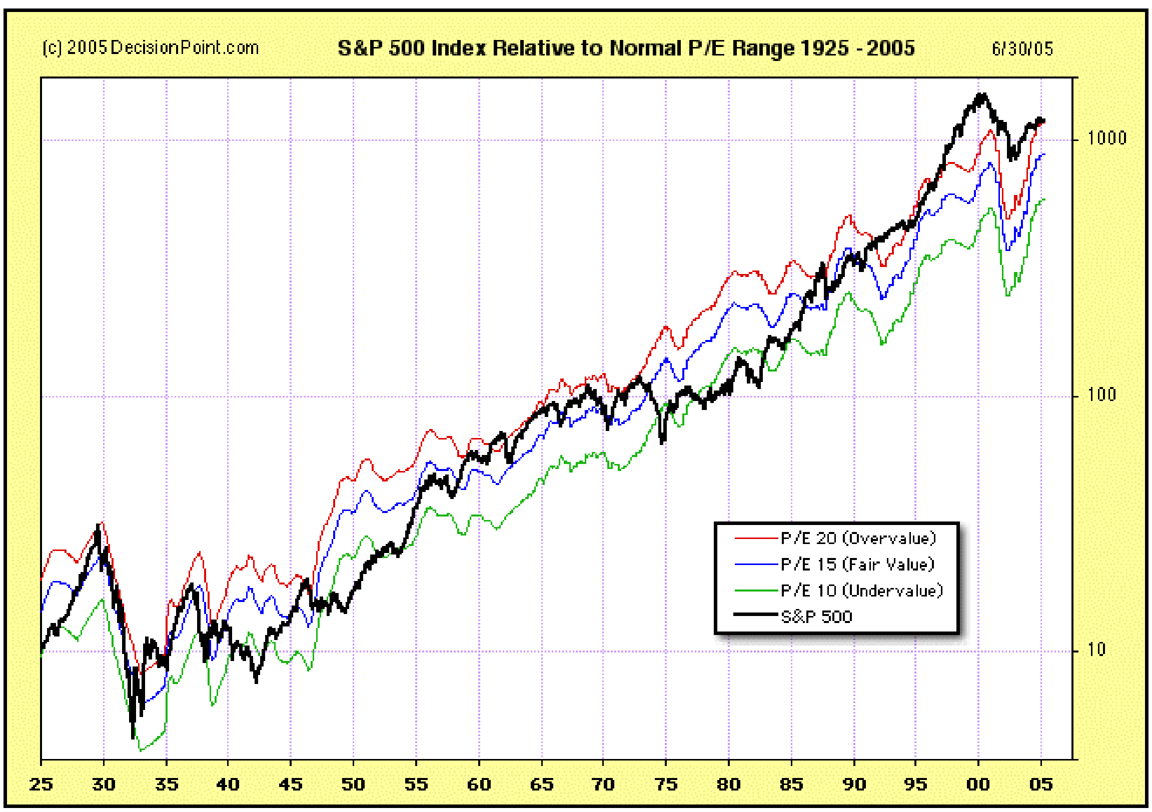
It remains to be seen whether this breakout holds, but our clients have been participating as we began re-deploying cash into gold stocks (see above chart of the un-hedged gold stock index) in May and anticipate further investments. We continue to have a buy-and-hold strategy (a strategy only appropriate in bull markets) with a few of the stronger gold stocks while trading the ups and downs with small to mid size companies.

Given Our Outlook, How Do We Invest…and Perform?

Because of the fears of inflation, rising rates, and excessive valuations on cash flows, we have been actively seeking real returns elsewhere. This includes the above-mentioned gold-oriented investments (a hedge against the gradually declining dollar) as well as investing in stocks overseas. By selecting high dividend-paying foreign stocks we are aided by the dividend when the dollar has bear market rallies, such as the one taking place now, and realize nice dollar-translated gains when the dollar returns to its bearish course against the currencies in which our stocks are denominated. Most of these foreign stocks are non-export dependent companies - meaning they don't rely on the U.S. consumer to drive their earnings. While some might ask if I am getting ready to vacate the country - what with my bearish view on U.S. markets and the dollar combined with my heavy foreign stock investing - I see it as helping our clients preserve their wealth during the inevitable standard of living adjustment so that we will have more capital to invest on the rebound. I contrast this with the opinion that we should always be bullish on America just for the sake of being patriotic. As Peter Schiff of Euro Pacific Capital wrote in a piece viewed on www.financialsense.com dated May 27, 2005:

"…it is important not to confuse a desire to go down with the ship with patriotism. Such "patriots" who stand on the deck saluting the flag as the ship sinks, will likely be of little assistance to other survivors left treading water. Only by safely positioning ourselves aboard sea-worthy lifeboats now, will we be able to participate in any future rescue efforts. Protecting our wealth today allows us to repatriate it tomorrow, to help rebuild a viable American economy."

With regard to mainstream U.S. stocks, we will remain long-term bearish and actively invest your money (as opposed to employing a passive buy-and-hold strategy) until the chart below indicates mainstream stocks are under-valued.



(Chart courtesy of www.decisionpoint.com)

Above: Black Line=S&P actual value; Green Line=S&P at PE of 10 (under-valued); Blue Line=S&P at PE of 15 (fair value); Red Line=S&P at PE of 20 (over-valued); Because of our belief in cycles over everything else, the market will always make its way from under-valued to over-valued back to under-valued which currently implies S&P=600. Looking closely, one can see the black line does just that.

Fortunately, there are many stocks "off the radar" that we find attractive. They usually fit three or more of the following characteristics: 1) Good value; 2) proprietary product or service offering; 3) Insiders find it attractive; 4) technically attractive. Everyone has their own way of assessing each of these characteristics and we are no exception. As always, our methods keep the best reward to risk ratio as the highest priority. Like everyone else, we sometimes make poor choices. What happens then? Unlike more emotional investors or managers that employ a passive, buy and hold strategy, we employ a sell discipline which immediately separates us from our poor choices and re-deploys the funds into better opportunities. The emotional investor tends to hold on and hope to be right rather than cut his losses early. Most do not want to be "wrong" and selling for a loss is an outward admission of being wrong. There is a reason we call them "realized" losses!! We are okay with being wrong, especially if it means losing less money. That being said, we rarely have had to do this because our entry point analysis serves us so well.

Thus far this year the strategy has served well. With accounts averaging about 27% cash and the DOW and S&P down, we are up roughly 4%, on average, half way through the year. That's after fees and excludes restricted accounts-those in which clients requested we hold or avoid specific investments.

Life, Business and Philanthropy

On a personal note, I want to thank everyone for their well wishes and congratulatory notes and gifts for the birth of our baby girl, Ruby Brown Friedrichs. She came into the world February 18th and life has not been the same since!!

In corporate news, we welcome Justin Harris, a UVA graduate with a background in real estate management and investment, who has joined us as an Investment Adviser Representative specializing in financial planning. Please welcome him by calling him at our main number or email him at JHarris@FriedrichsAssetManagementLLC.com.

Lastly, thanks to all who contributed to the success of our most recent charitable event, the Drive for Community Service to benefit Richmond Friends of the Homeless. We raised over $2000 and everyone really enjoyed themselves. It would not have been possible without the support of participants, contributors and our sponsors including Richmond BMW of Midlothian, Bottega Bistro, Switch Beverage Company and Arena Racing USA. Visit the "Related Topics" section of our web site for details and photos.

As always, please keep us in mind when friends, family, neighbors and co-workers are seeking professional financial advice and portfolio management.

Successful Investing to All!!

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