July 2006 Outlook and Commentary

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S&P 500:	1270
NASDAQ:	2172
Gold (August):	616

"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*

Outlook

As I write this, despite terrible bond markets as a result of rising rates, even our most conservative portfolios (heavier in bonds) are up 2% half-way through the year nearly matching the S&P 500!! Our most aggressive investors are up nearly 9% year-to-date, with the average of all of our investors up 5.4%. All numbers are after expenses, except the S&P 500 data. Our strategy of narrowing on sectors with good long term values and bullish patterns is paying off and we have been adding significantly to some of these sectors recently as we have gotten long-awaited buying opportunities. Our more concentrated strategy will probably add to volatility so we will see a lot of interim fluctuation but this window of opportunity could open us up to strong relative performance over the next several years. If you have any questions about our specific strategies, or know someone we can help, feel free to call me to set up an appointment.

We are still bearish on broad U.S. equity markets as valuations don't warrant long term investments at this time. The FED just raised rates to 5.25%. The two year note is at 5.13% and the 10 year bond is at 5.14. This appetite for similar long term yields to short term yields reflects the possibility of generally lower performing alternatives (like stocks) and the recent tightening of short term rates by the FED. Relying on the general market to "bail you out" will not work over the next 5-10 years as PE ratios remain at historically "over-valued" levels and have yet to come down to earth, much less down to levels that represent a good long term buying (and holding) opportunity.

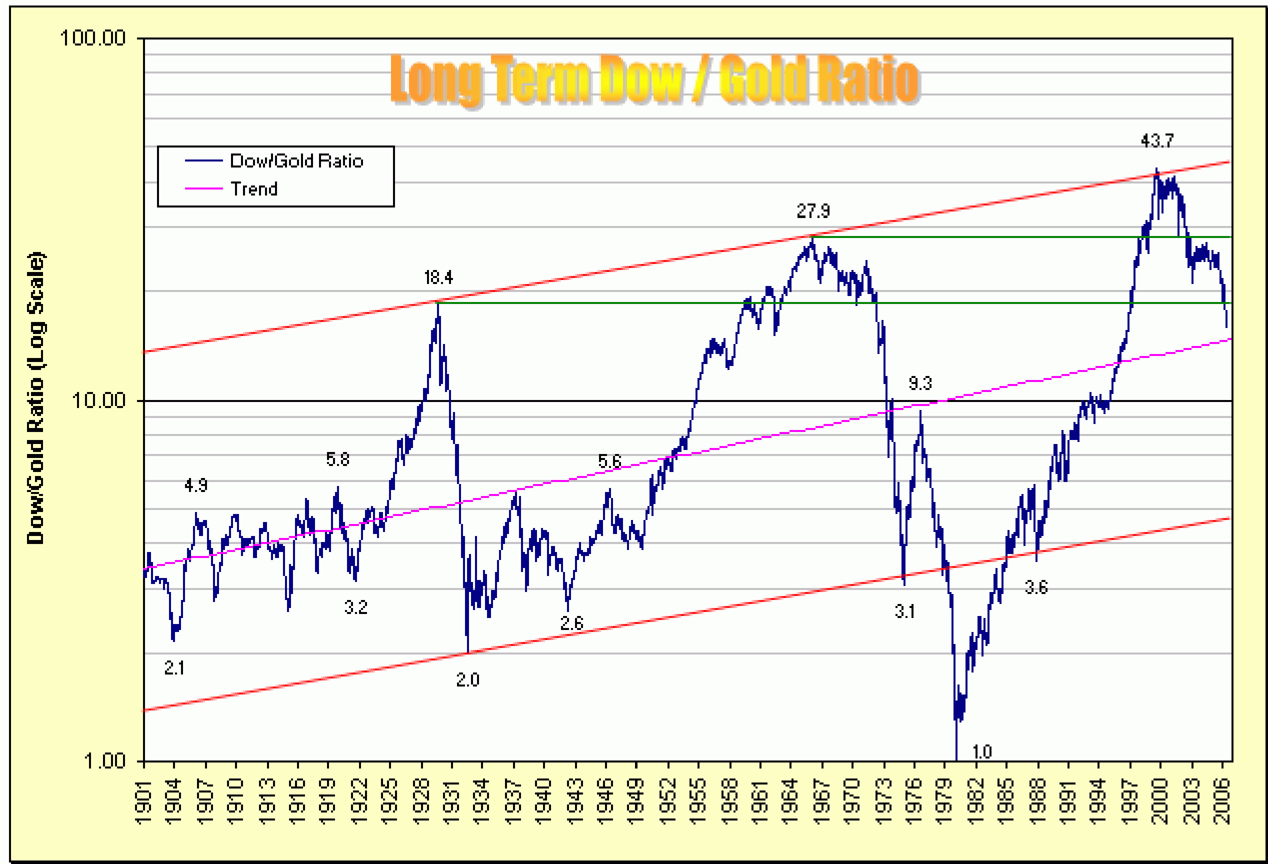

Chart courtesy of Fred's Intelligent Bear Site http://home.earthlink.net/~intelligentbear/

The Dow/Gold Ratio

Have you ever seen a chart like this? It's a chart tracking the ratio of the price of the Dow Jones Industrial Average to the Price of Gold. Seen another way it is the number of ounces of gold required to buy the Dow Jones Industrials Index. What drives this ratio? This is a tough question, and I don't know if there is any definitive answer. By looking at the chart we can see that it has peaked (DOW outperforming gold) during periods of excessive accommodation to risk and has bottomed (Gold outperforming the DOW) when markets have become excessively cautious. Bottoms are marked by low productivity, rising taxes and dramatic inflation. As you can see, just like many other items we study, it moves in broad cycles. Critical to note, it usually bottoms below a ratio of 5 where you could trade 5 ounces of gold for the DOW. This would imply that sometime between now and the bottom of this cycle, the DOW will come down to 616, gold will rise to $11,150 per ounce, or there will be some "meeting in the middle". Obviously there are other variations on which one could speculate, such as both going higher than $11,150 or lower than $616 but I suspect the "meeting in the middle" is more reasonable.

Human behavior has marked peaks in the past with racier fashion trends and higher luxury consumption as occurred during the 1920's, the 1960's, and the 2000's. It is interesting to note that the ratio seems to be on 40 year cycles. This tells us the time it

takes for broad investment perceptions to change and it is not a coincidence that it is approximately equal to the (active) investment life-cycle of humans. Regardless of where the bottom is, the trend is in place and I'd rather bet on gold than the DOW because I have yet to see fear in anyone's eyes when it comes to activities such as borrowing money or planning for more than 5 year out in their lives. Looking at the big picture it is useful to remember that as individuals we vote for leaders to represent us in our government and it seems this is the same attitude in Washington.

The Budget

Talking about our Federal Budget is tricky. On one hand there is a good argument to be made that deficit spending can provide a near term stimulant to the economy. However, the folks that advertise this could just as easily say "more spending" is good for the economy rather than tie in specifically "deficit" spending as a good thing. It is the proverbial lipstick on the pig. If we are taking on more debt, let's show how good for the economy increased spending is. On the other hand, sustained deficits cause us to constantly accumulate a total debt that must be repaid sometime in the future. Below is a table that no one wants to show you if they support increased government spending.

US GDP And Total Credit Market Debt ($Billions)			
Decade	Increase In GDP	Increase In Total Credit Market Debt Outstanding	Dollars Of Credit Market Debt Growth For Each New Dollar Of GDP Growth
1950's	$161.9	$286.5	$1.77
1960's	491.4	752.2	1.53
1970's	1,655.9	2,791.4	1.69
1980's	2,923.8	8,544.1	2.92
1990's	3,935.2	12,379.0	3.15
2000's	3,081.5	13,623.5	4.42

Table courtesy of ContraryInvestor.com

This table reflects how much debt we have had to take on in order to create $1 of GDP growth. The less borrowing necessary to create growth implies that we are using the borrowed funds efficiently to stimulate growth. Likewise, more dollars necessary to achieve GDP growth implies that deficit spending has less and less of an impact on economic growth. As you can easily see, this latest binge has been the least productive of any decade since before the 1950's. Like many individuals who, every few years refinance their home for another 30 years and pull out cash to spend rather than invest, so does our government.

Does it really count as paying it back when you are borrowing the money to pay down old debts? I think you know the answer to that one. Until we as individuals--and collectively our government which represents us and our money--say "enough is enough" and actually live within our means, we are doomed to be obligated. We are obligated to whoever is buying our bonds. These lenders are individuals seeking a "safe" return, pension plans balancing their portfolios or foreign countries looking for some way to get a return on the dollars they accumulate as a result of our trade deficits. If we owe over 10 Trillion dollars and we can't even run a profit as a government, how will we ever repay this debt?

Inflation versus Deflation

This is tricky, too. Lately all the talk is about inflation. Four to five years ago all the talk was deflation. Let's look at the contributors of each and see if we can simplify this.

Deflation, generally, is declining prices. China and India, among others, produce goods and services in exchange for fewer and fewer U.S. dollars. Computers, Household Goods, Electronics, metals and metal products, Apparel, Jewelry, and even services like customer support centers and accounting and architectural services come to mind. These two countries, among others are producing these items cheaper than we can and sometimes cheaper each year. Why would deflation, then, be bad? Two reasons: the first is the obvious competition which forces us to lower our wage rates in these areas or shut down factories and businesses all together. This has a reverberating effect in our economy leading to decreased consumption of people laid off (and the multiplier effect thereof) which results in lower tax revenue. Second, if deflation is all over the place and in every sector, then people start to figure this out and put off purchases while holding out for better prices in the future--having the same effects as the first reason--and ultimately causing the economy to slow and unemployment to rise. Also, when one borrows money in this environment you pay back the money with "more valuable" dollars, reflecting the fact that you have to be more productive to pay off their debts. It seems that even though we've been experiencing deflationary symptoms in some areas, like any supply demand analysis, we have increased the consumption of these items, even if we don't really need them, rather than holding out for cheaper prices. This brings me to inflation.

Inflation is steady or rising prices caused by either natural supply/demand imbalances or unnatural monetary imbalances. A strong economy where there is more demand than supply of various goods and services and thus driving prices up is natural whereas a temporarily "juiced" economy fueled by artificially cheap money and excessive government spending is inherently inflationary and unnatural. When money is easy to access via lower lending standards or lower rates (both of which have been prevalent the past 5 years) it causes things that we borrow in order to buy to go up in price, no matter what they are. If at a sustainable level, we see this ultimately result in higher wages and lower unemployment as a result of factories and business requiring more labor. The higher paid people spend more which helps the economy. When one borrows under this

environment, one pays back the loan with cheaper dollars than the ones they borrowed. Sound familiar? It is the American way. So why is inflation a problem *now*? The inflation we have been experiencing and will continue to see has been brought on by a FED that has just intervened too darn much in the free market system.

Rates have been artificially low for a long time and Americans have gotten used to never hearing a "no" when they go to the bank to get a loan. Do you remember the days when a friend was going to get a car or home loan and it was a nail-biter? What a joke that would seem today. Every institution is willing to lend everyone money-and cheap money. The problem is that no matter how cheap our money is, we can't compete with cheap labor. As a result, for the past few years prices have been rising but due to the competitive deflationary effects of low cost labor oversees hourly wages in America have not been keeping up with the price increases. And since Americans *must* have what they want *now* rather than cut back, they have preferred to borrow to keep up the lifestyle while not experiencing commensurate increases in earnings. This does not have to be a problem so long as someone is continuing to lend us money at affordable rates that allow the debt to be carried. This is why inflation (increasing the money supply) is the only solution to our current debt problems.

So Who is Lending Us the Money?

We rely more and more on foreigners, specifically, foreign central banks. Yes, the FED can lower short term rates if we get into trouble, we can all then refinance at lower rates, thus cutting back in at least one area, debt coverage. But the FED has less control over long term lending rates. The control lies with those buying our longer term bonds who are increasingly foreigners. Naturally, once these foreigners decide we have too much debt or they don't need U.S. consumption to support their own economies they won't mind converting their excess dollars into other assets like Euros, Yen, Gold, Oil, U.S. real estate and U.S. businesses that they buy with dollars (sound familiar?-the Chinese are on a dollar denominated buying spree just to get the money out of dollars and into something more productive). Maybe that 30 year bond at 5% denominated in dollars declining at 3-4% per year over a long term period just does not seem like such a good deal. You may then suggest that the dollar has been rallying this year so why all the worry about foreigners not buying our bonds? This brings us to the headline stories you've been reading about regarding the new FED Chairman Ben Bernanke jawboning the markets.

Mess with the Kitty Cat and Eventually You Get the Claws

Ben Bernanke, prior to being appointed Chairman of the FED, was practically abused by the media for making so many 'easy money' comments. Speeches he gave, which have been widely quoted and publicized, including in this letter, in which he refers to going to any effort to avoid deflation such as using the printing press to print our way out of deflation or dropping money out of helicopters painted him as a kitty cat when it comes to inflation. Now that he is chairman, I liken him to having somewhat of an inferiority complex for which he is over-compensating. This is his opportunity to prove whatever he wants us to think he is-at the moment that is hawkish on inflation. This is the ultimate

"scratch in the face" that has bond holders and inflation hedging traders crying in their hands. He will talk this talk while making only minor adjustments in monetary policy so the markets will do the work for him. As a result of his talk, the dollar is rallying which makes foreigners more comfortable holding them. That is why gold is correcting.

Gold pays no income and is denominated in dollars when purchased so therefore it follows that when the dollar is stronger it would require fewer dollars to buy gold and other materials in relatively limited supply. (For more on the subject of gold, see the *January 2006 Outlook and Commentary* at the web site) We believe this is a short term and rather opportunistic phenomenon for those who believe the reality that in the long term there is no other way to pay off these trillions in debt other than to print dollars and return to an easy money policy. In fact, whilst interest rates have been rising the past few years, gold has proven its metal, if you'll pardon the pun derived from this very metal, as it has risen rapidly *in the face of rising rates*. The more dollars are put into the system through electronically created loans and increased liquidity it stands to reason that items in more limited supply will require more of these dollars to purchase them. This is what I call monetary inflation and is much more important than the inflation individuals are told about through the CPI. After all, the actual supply of money grew at a 13% annual rate last year-no wonder gold and oil were up so much. Incidentally, the money supply number I am quoting, the M3, is no longer disclosed to us by our government…hmmmm.

Why Do We Even Have a FED?

Are you sick and tired of hearing all about what the FED will do next? Does it ever seem to you like, in the short term anyway, free markets don't exist? As I've said in the past, the entire FED system flies directly in the face of Adam Smith's "Invisible Hand" theory-that free markets ebb and flow and that individuals serving their own needs, collectively create a consensus for supply/demand relationships. Nobody seems to care about this massive intervention by the FED. Yet the FED was created to preserve the purchasing power of the dollar. However, since the FED's creation the dollar has lost 97% of its purchasing power. Until recently, only independent observers like me and other newsletter writers have spoken up. However, it seems sentiment is changing. No, it's not people upset with the actual choices the FED makes-it's people like me, only with bigger loudspeakers, that are questioning the very purpose of the FED. Jeffrey Saut of Raymond James quoted Richard Russell at length on the front page of his June 26th Market Strategy report as acknowledging these very weaknesses. It is one thing for me to quote Richard Russell's criticism of the FED but to see a large firm approve this kind of tough talk is practically revolutionary and I applaud mainstream firms like Raymond James for allowing this freedom to their analysts. While I would not call this public outcry a trend yet, if others begin to follow suit, my prediction for an evaluation of the un-backed dollar system, and the existence of the FED, may come true, as bizarre as it may sound.

The More Things Stay the Same, The More They Eventually Change

As I've mentioned in previous *Commentaries*, Friedrichs Asset Management studies behavior and psychology as much as anything else. And there are two certainties regarding human behavior: 1) The longer things stay the same, the more individuals believe that to be the norm or "the way things have always been"; 2) Behavior patterns run in cycles which ultimately correct the first certainty! As an example, by 1999 everyone thought markets could go nowhere but up. The corresponding example today is, it seems, everyone is interested or actually invested in real estate that they are certain has nowhere to go but up and interest rates will never over 10% again. Reflecting this attitude a higher percentage of home loans then ever before have adjustable interest rates, otherwise known as Adjustable Rate Mortgages. During the next 2 years approximately $2.7 Trillion dollars worth of these mortgages' rates will ratchet up as loans taken out in 2001 and 2002 hit their respective 5 year anniversaries. Believe it or not--and I am certain those involved in these mortgages will be shocked--but this will lead to *payment increases of 25-60%.* Do you think these consumers have been leaving room in their budget for this? Just as investors thought they were geniuses because every stock they bought went up, speculators in the real estate market will have a rude awakening as all they have been focused on is reward, not risk. For every time things went wrong with our economy or our stock market, the FED lowered rates and bailed folks out-what's to stop them from bailing out these risk-prone real estate investors?

What is the unseen risk to leveraging your house and buying more property? What was the unseen risk to investing in the 90's? Valuations move in cycles. That is the risk. In the 90's valuations became historically over-valued in 1997 and are still over-valued today. Today, housing prices as a multiple of rents are at an all time high of 30 times rents-that's the P-E multiple of investment property. This multiple will correct over an extended period of time just as the PE multiple on the S&P 500 is doing now. How it manifests itself is anybody's guess. My guess is the direct impact of rising rates will squeeze people out of their mortgage payments and cause sales and/or foreclosures which cause downward revisions in appraisals. Indirectly, rising rates could affect corporate profits and cause layoffs which will cause foreclosures and rent failures. For those of you that like to keep up, here is the chart I include in every *Commentary* demonstrating the importance of keeping track of where we are in the valuation cycle.

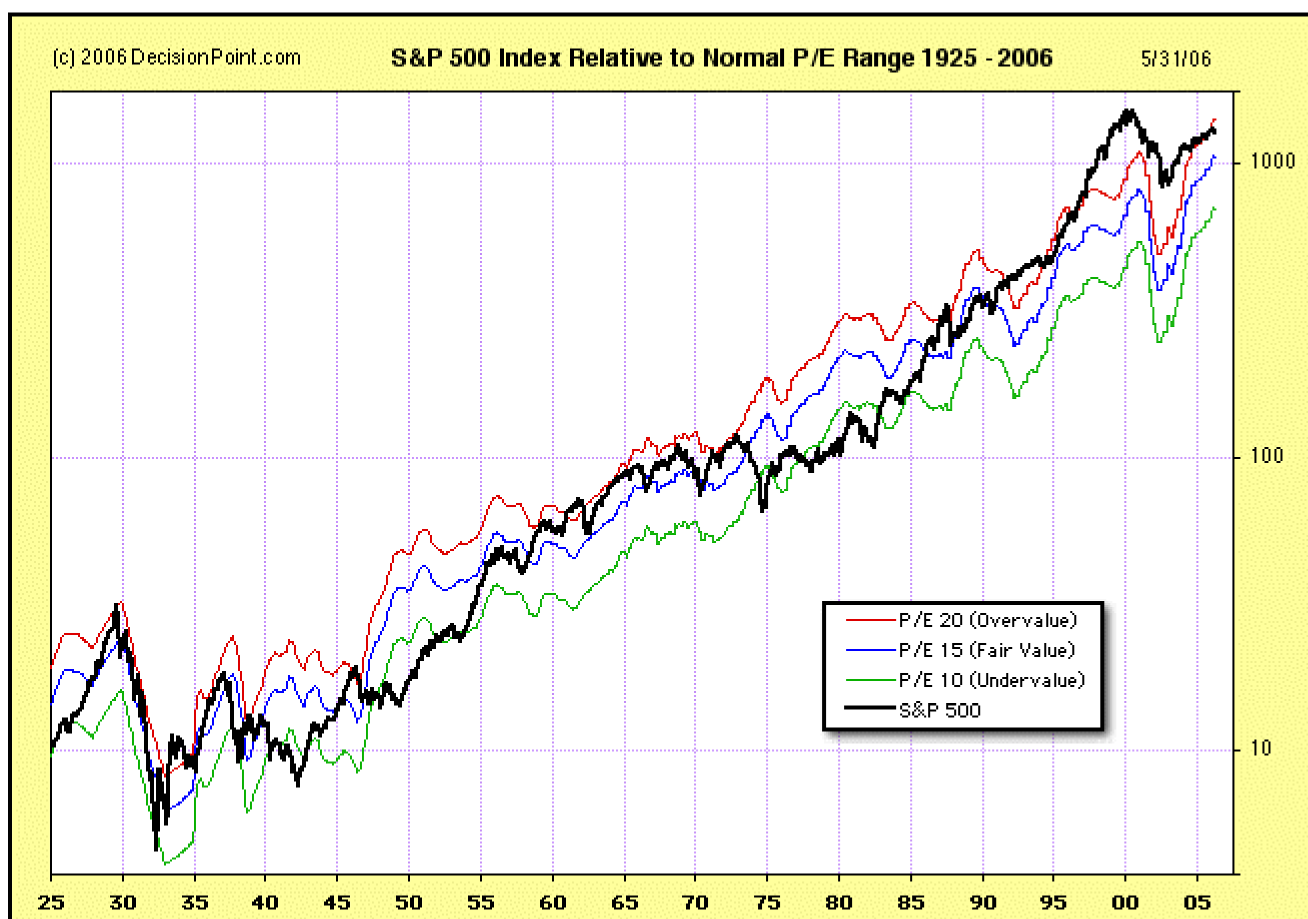

Chart courtesy of DecisionPoint.com

The 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 and we simply balance them out to assess the current market environment. The best actionable points are when most or all of the indicators are in line, as they nearly are now.

Let's look at the indicators explained in the *January 2006 Outlook and Commentary*, 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%	**46.19***	**Bearish**
AAII Sentiment Bull/Bear ratio	>2.5	<1	**.98**	**Bullish**
NYSE+NASD				

Margin debit balances	>160B	<100B	**$256B/Last here 9/2000!!**	**Bearish**
Savings Rates	<5%	>12%	**-1.9%**	**Bearish**
Mutual Fund Cash	<7%	>12%	**4.5%**	**Bearish**

*Declining from a peak of >86%

Valuation Indicator	**Greed**	**Fear**	**Current/Last here**	**Indication**
Price/Earnings Ratio	>20	<10	**17.37**	**Bearish**
Dividend Yield	<3.5%	>6%	**1.9%**	**Bearish**

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

Again, if you have any questions, or know someone you think we can help, please do not hesitate to contact me.

Successful Investing To All!

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