

May 18, 2004 Commentary
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Summary-Correction in the Metals and Stock Market Action

At the beginning of the year I alluded to a pull back in the precious metals that was due and we certainly got it this past month. I see this as a correction within a long term bull market in the precious metals, commodities and other currencies versus the U.S. Dollar. The intermediate term impetus has been the perception that the FED raising interest rates will help encourage foreigners to keep their money parked in U.S. Dollars, thus weakening precious metals which have been performing inversely to the U.S. Dollar. While this perception has near term validity, I place more weight on the long term consequences rising rates will have on our economy-an economy that is currently benefiting from short term stimuli that will soon run its course. There was also an immediate impetus for this pullback and that was the indication by Chinese authorities that they are intent on slowing that economy's growth. I view this just as it is-a slow down in growth, but not a contraction. China is a vast nation with a growing economy that will continue to demand more of the earth's resources than supply can handle, including oil and gold and other commodities. In short, I think the reaction is overdone. As an aside, I will say that some of our oil stocks are looking 'toppy' so you may see some profit-taking in these issues.

We should be very close to a bottom in this commodities pullback and once the uptrend renews we will be well positioned for the next 10 years. THIS IS TYPICAL of long term bull markets and the long term bull market in gold is no exception. If you think of long term bull markets in stocks you know that they have usually lasted about 20 years but have significant corrections within the uptrend. No one knows how long this bull market in gold will last but it won't end until the dollar is properly valued in the context of both global economic competition (trade deficits) and fiscal profligacy (budget deficits). In the mean time, there will be corrections along the way. If a correction leads me to believe broad asset deflation is in the cards (more on deflation below), we will reduce or exit these positions.



Courtesy of www.decisionpoint.com

On the stock market in general, we keep experiencing weaker rally peaks and lower corrective lows (see chart above). This, along with the apparent “double top” formation (looks like an ‘M’) is very bearish. In addition, the market narrowed into a triangle pattern and usually the direction it chooses out of these patterns is an indication of things to come. The one bullish thing about this chart is the S&P’s ability to maintain support at its 200 day moving average-bouncing off it more than once. With the DOW and NASDAQ already having broken their respective 200 day moving averages, I suspect it is only a matter of time for the S&P. Keeping this in mind, we may invest or add to securities designed to perform inversely to the S&P 500.

Look Around You

Do your own reading. Take in and think about your own experiences and how they apply to this changing global environment. Does the job market seem much better off these days as recent government-produced data indicate? Are job hunters you know having an easy time finding it? By all means, please share your observations with me-your stories are the starting point for many of my investment thought trains. Tell me where you see

falling prices...where you see rising prices...experiences of neighbors and friends. I also encourage you to take a look at the Archived Commentary section at www.FriedrichsAssetManagementLLC.com and (re) read the *January 2004 Commentary and Outlook* as well as the *April 2004 Commentary*. Previous commentaries also posted discuss the origins of the FED, my theory on the “Casual Cycle” and indicators I use to analyze the markets. I have also discussed the basics of deflation and inflation. Whether we experience deflation (broad price declines) or inflation (broad price increases), the investments we are in today will help.

Implications of Deflation

Under a deflationary environment, any combination of weak demand and/or low raw material prices causes broad price declines—a phenomenon we as Americans haven’t experienced in decades. In this scenario, companies and individuals lose pricing power (for individuals it shows up as reduced wage levels). As a result of the inevitable profit squeeze caused by prices coming down, they have trouble paying off debts. This is why the worst place you can be during deflation is in debt. The debt you owe does not change but its value in terms of real goods goes up. Thus, you have to pay back your debt with *more valuable dollars* in the future. Under this scenario, gold will decline as it has been along with most tangibles but will eventually turn around for two reasons: 1) The realization that under this scenario the only way our national debts will be paid off is through the FED’s inflation of the dollar vis-à-vis mass printing and foreign currency adjustment; and/or 2) The fear, although unlikely to actually happen, that the days of the dollar standard are over and we will have to return to a standard currency backed partially or fully by something tangible, that is, gold.

Love Affair with Inflation

This is why the FED and America in general have a love affair with *inflation*. Yes you read that right. After all the seminars you have been to about how bad inflation is I am telling you that in highly leveraged economies inflation is good. This is because the dollars you borrow now are worth less when you pay them back. For example, say you have a ten year balloon payment loan and we have 5% inflation per year. By the time you pay back that loan you are paying back that loan in ten years at a rate of 60 cents on the dollar in terms of real goods. So you get to pay it back with “cheaper” dollars than the ones you borrowed. That is why those same seminars told you bonds were bad; during an inflationary period, a bond holder lends money by buying the bond and the principal returned is worth less than when it was lent. Put in practical terms, the items you could buy with the original dollar have gone up in price 5% per year for 10 years thereby reducing the purchasing power of the dollars you get back.

Let’s look at an example that is very real to us—our home. Remember, inflation can be caused by raw demand shocks (not what we have been experiencing) or by weakened dollar. Our nation’s trade deficits and the FED’s forced lid on interest rates, for example, is weakening of the value of the dollar causing things real, such as a home to require more dollars to purchase. I can speak from personal experience. Does anyone think for

one minute that I am some kind of real estate genius for buying my home 3 years ago and now it is up 25% in value? The economy did not produce any more jobs and, all “South Side” jokes aside, Midlothian hasn’t become some kind of real estate buyers’ magnet. The forced weakening of the dollar caused the value of my house, in U.S. Dollars to go up. It also drove foreign currencies and gold higher. Not surprisingly, my house is worth the same in Euros and gold because these currencies rose about as much as the dollar declined. So the Eurozone citizen whose house rose in value by 4% per year for three years has now gained 12% on me in terms of *real net worth*. This is but an illustration of words better said by another:

“...our trade deficit has greatly worsened, to the point that our country’s “net worth”, so to speak, is now being transferred abroad at an alarming rate.”

-Warren Buffett, November 10, 2003, when explaining his decision to invest in foreign currencies for the first time in his 72 year life.

In the near future gold will diverge from stocks, and possible even real estate as inflation and the accompanying higher interest rates squeeze profit margins causing the our economy, and eventually the dollar, to come back into question.

The Long Term Fundamentals

Many around the world will ask these questions about the dollar very soon. I’ve been reading a book called “The Coming Generational Storm” by Laurence J. Kotlikoff and Scott Burns. The authors have explained in detail the future obligations of our Social Security and Medicare Systems. First, let me assure you this is not just some “gloom and doom” report to be brushed aside. They have done extensive fertility rate studies and used government numbers and assumptions for much of the financial research. The beginning of a Fortune Magazine article by Anna Bernasek dated November 10, 2003 starts like this:

“Last fall (fall of 2002) Paul O’Neill, then Secretary of the Treasury, wanted a simple answer to a thorny question: How prepared was the nation today to pay all its future bills? Two government experts worked for months to calculate the answer. Their findings, which shocked even them, were never published—the Bush administration made sure of that. The reason for the silence was that by the time the two researchers had completed their study, O’Neill had been thrown out of the Treasury and replaced by the more politically astute John Snow. No savvy administration power player would dare point out, right in the middle of tax-cut season, that there was a huge hole in the country’s finances—a \$44 trillion hole.”

Kotlikoff now has that number at \$51 Trillion. According to him, every year we delay acting on the imbalances in the Social Security and Medicare programs the amount goes up \$1.6 Trillion. It is just a matter of time before the world begins to catch on and demands higher rates of interest from our government debt. They will look at our government’s balance sheet and schedule of cash flows, the American taxpayers’ balance sheet and schedule of cash flows and the ability of both to meet future rising obligations. They will realize that in order to meet these obligations, we will have to print more

money, raise taxes or cut government spending. The easiest (politically) is printing money because no one notices it. They notice their house “going up” in value but don’t realize the reason is the paper they are holding is worth...less. Raising taxes is tougher but you can always couch it in terms of a nice redistribution of wealth-“the rich don’t need it anyway”. This strategy will weaken the economy and weaken the dollar as well. And cutting spending will never happen unless we get someone in office who runs on the opposite platform and has no desire to be re-elected. Needless to say, but I will anyway, printing money is what has been going on thus far and it’s a tough habit to break. Oh, and by the way, it eventually will be highly inflationary.

The “Insurance Policy”

The bottom line is that I believe the only way for our nation to meet our fiscal obligations will be to weaken the dollar. This will lead to stronger precious metals prices. Precious metals stocks, and to a lesser extent, oil stocks will serve in the mean time as our “insurance policy”, to borrow a phrase from Richard Russell of Dow Theory Letters when referring to the gold. This insurance policy helped us keep up last year due to the dramatic asset inflation which took place and it will protect us in the future as we shift more toward monetary inflation. As always, timing is very difficult. Suffice to say, I don’t think that 10 years from now you will regret having been exposed to these investments.

“Optimistically Realistic”

We don’t want bad things to happen-we just want to be prepared for the future. Don’t feel guilty hoping for a weak dollar. Just know that a weak dollar will eventually narrow the wage gap and put people to work in America. In the mean time, position your assets accordingly. Be “Optimistically Realistic”: *optimistic* about that in which we are invested because we are *realistic* about the future. We continue to look for cheap stocks. When mainstream stocks become cheap, we will own them but I am also here to protect you from the mainstream way of thinking. With a PE on the S&P 500 of 23 and a paltry dividend yield of 1.8% the mainstream investment community is pretty far out on a limb. Our mission is to protect and grow your **real net worth** in what over the next 5-10 years is going to be a very challenging environment. The way to do this is with a carefully selected portfolio of reasonable priced stocks in terms of valuation (Price to Earnings, Price to Cash Flow and Price to Book Value), cash payout (decent and growing Dividend yields) and/or long term fundamentals (sectors emphasis).

Successful Planning to All!!! As always, if you have any questions, please feel free to contact me.

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