



Registered Investment Adviser

May 25, 2009 Commentary
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S&P 500: 887
NASDAQ: 1692
Gold: 956

“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*

Memorial Day

“Quantitative Easing” Doing Wonders for Uncle Sam’s Credit

State of the Market

Why the Long Term Bull Cannot be Here Quite Yet

The Ultimate Fear-Greed Indicator

Our Interests Aligned

The Indicators

Memorial Day

Happy Memorial Day. Thank you thousands of men and women who have died in battles for freedom. Only because of you are we able to wake up every day without fear of oppression or any kind of suppression of our thoughts, speech, and even actions. Thank you that we live in a free market economy where we can make choices that can change our future, should we be interested.

“Quantitative Easing” Doing Wonders for Uncle Sam’s Credit

Standard and Poors warned the UK that its AAA credit rating was on watch for a downgrade. As a result, a decline in the perception of the creditworthiness of the U.S. Government seems to be finally seeping in and rumor has it the U.S. may be next. The only reason treasury rates are as low as they are is because the FED is buying our government’s bonds and thus propping up the market (paying higher prices for bonds sends yields down). As you know they call this “quantitative easing”-the process of easing credit by creating money to buy un-desirable treasury bonds. Bidding up, or supporting treasury bonds keeps interest rates artificially low so more home buyers can afford to borrow more. I find it disturbing that the only solution our government comes up with to resolve a crisis created by excessive borrowing is to artificially incentivize increased borrowing among consumers. Nonetheless, the FED, technically an

independent and private organization, is using computer entries to create money from nothing in order to lend that funny money to the U.S. government by buying its treasury bonds. This does not seem to be an investable long term solution.

At the risk of sounding clueless, I am curious as to when the FED will have the opportunity to dispose of these bonds without causing interest rates to rise more than is acceptable. Remember, when an excess supply of anything is created by selling it off, prices decline. In the case of bonds, when prices decline, borrowing rates rise. I think the FED knows all well that it really does not matter because the money used to pay back these bonds in 10-30 years will be worth much less than the money it lent the government due to the inflationary impact of massive money creation. The FED knows by creating all this money and incurring all the obligations related to bailouts (currently this total is projected to be near \$10 Trillion, with a "T") no one will want our money anymore and the dollar will get pummeled. The sacrifice we will make is not going to be dramatically higher taxes or a reduction in spending toward living within our means. Rather, the sacrifice will be the Dollar and our purchasing power. So when the FED sells these bonds in 15-30 years, it will be much easier for the market to absorb. Or, I guess the FED could let the bonds mature and then just retire the currency just as it created it. The fact that a plan has not been created (or disclosed) is disturbing. I suspect many paper currencies around the world will suffer a similar fate before some kind of discipline is embraced by either balancing budgets or tying the currencies, in part or in whole, to a basket of real assets.

This coming week the U.S. Treasury will attempt to borrow over \$150 Billion through its auction process. With the negative news about the UK credit watch outlook, market rates for loans to the U.S. Treasury are already rising. A bit of this fear spilled over into the stock market last week as evidenced by a couple of failed intra-day rallies toward the end of the week. This fits well with the anticipation that a short term correction is needed to consolidate cash levels in order to fuel the last leg of this rally. Stock markets will probably correct over the next couple of weeks before continuing on. This mid-rally correction will serve the purpose of shaking off newly arrived bulls.

State of the Market

Short term (next 6 weeks): Bearish

Intermediate term (6weeks-6 months): Bullish

Long term (6 months and forward): Bearish.

The short term: It is my opinion that the lows struck in March have a high degree probability of being the lows for at least a few more months. Sadly though, it does not look like the 2002 bottom which resulted in a multi-year rally. (I'll expand on that later) I say the current rally will go farther because we simply have too much bearish sentiment to strike an intermediate term top. This rally has notched some 35% in gains so far and we still have a lot of bears out there. Bearish sentiment implies cash on the sidelines. After a 30% move this is now frustrated cash. Not until this group capitulates and pumps in their cash will we run out of buyers.

Why the Long Term Bull Cannot be Here Quite Yet

This rally will not be a long term bull, though, because there are too many things wrong with the economy and valuations in the market. While valuations at the 2002 low were extremely high and thus unlikely to produce a multi-year bull for a number of reasons: 1) The bottom struck in 2002 occurred during a much more encouraging unemployment level of around 6% and GDP was rising. In today's 2009 proclaimed bottom the economy is experiencing a rising 9% unemployment rate and a shrinking GDP. 2) Instead of ample credit markets for consumers to borrow and continue to leverage themselves, we have shrinking credit, tightening terms and massive deleveraging. Much more is needed in a consumer economy in order to drive corporate revenue, and the resulting earnings growth. 3) This rally has thus far has been marked more by short sellers covering their bets than by new money coming in. 4) Long term momentum indicators have confirmed the lower lows of 2009 versus 2002 rather than indicate that the lower lows of 2009 are an anomaly. 5) As I mentioned above and present graphically below, valuations are too high for a long term bottom to be in place.

As you know from previous writings, for long term, big picture perspective, I often look to the following 100 year chart of the S&P 500 Price-to-Earnings Ratio:

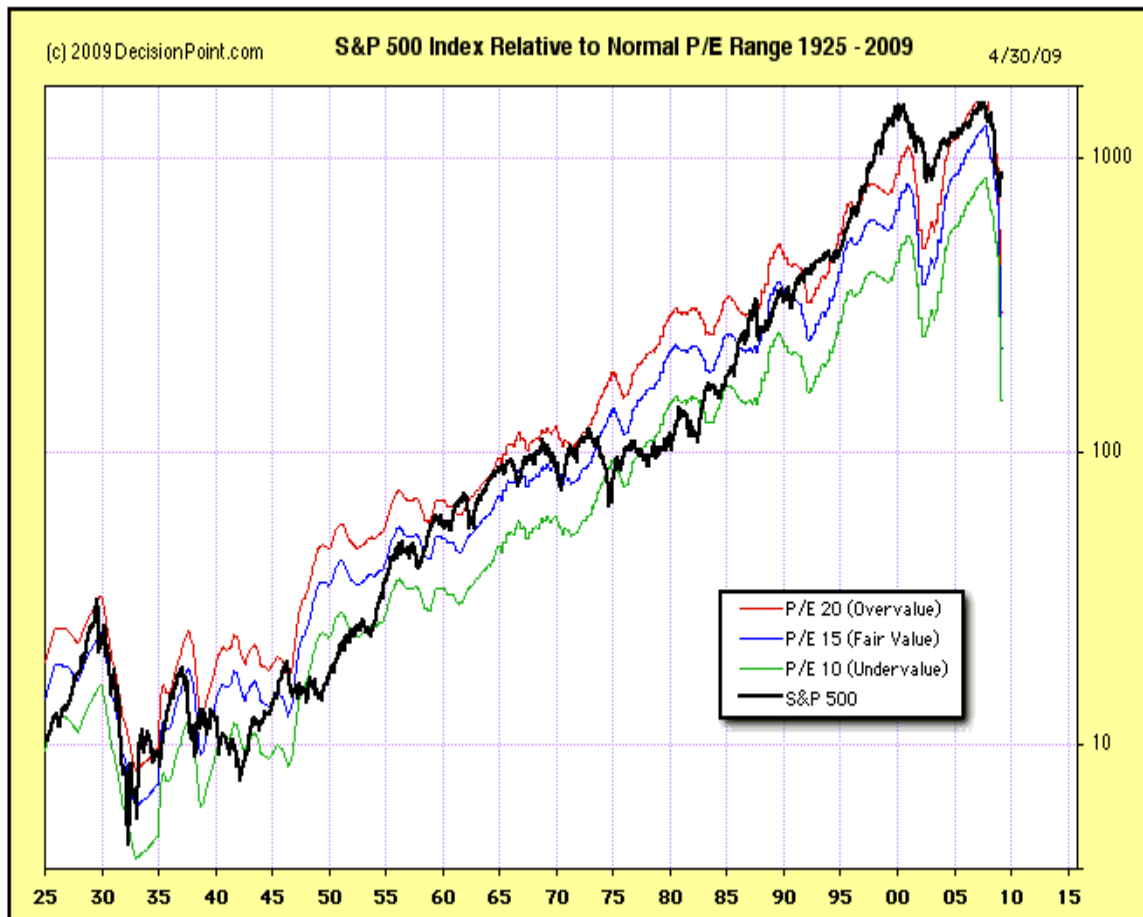


Chart courtesy of www.decisionpoint.com

The chart above illustrates the PE cycle over the past 84 years. The market value at any given time is in black while the PE range is illustrated using green (where the market would be if it was generally undervalued, PE=10), blue (where the market would be at fair value, PE=15) and red (where the market would be if it was generally overvalued at a PE=20). You can clearly see that over time whenever the PE exceeded 20, it always reverted back to a PE of 10 or below.

Read the text above then look at the chart and the relationship between the black line (where the S&P is now) and the bottom of the green line (where it is at market bottoms with a PE below 10). Yes, you are seeing this correctly: for the market to be undervalued it would have to be nearer 100 than 1000. That is because the PE on the S&P 500 is 123. That is not a typo: 123. Long term bulls come up with new reasons why you should ignore it despite what it is telling you: “Caution ahead”. One reason they might propose is that we should look at future earnings to judge valuations. There are two problems with this: 1) It ignores the chart which shows that while the market does not bottom until it reaches a PE under 10 on a *trailing basis*, it has yet to reach this level since the peak 9 years ago. Take a look at the chart again and note every time the black line crossed under the green line), and only when it did, were 15+ year bull market buying opportunities presented. 2) The average of the estimated PE’s for 2009 and 2010 are 29

for the S&P 500 and 18.5 for the DOW on an as reported basis. If the P/E is 18.5 then the E/P (earnings/price=your expected return) is 1/18.5 or 5.4%. With valuations high, the earnings yield not much higher than that of U.S. Treasuries, and plenty of risk to these estimates compared to the risk in treasuries, this does not appear to be an attractive long term buying opportunity.

The Ultimate Fear-Greed Indicator

When investors are most cheerful and optimistic they exhibit an incredible faith in everything under the sun. As this optimism grows, the demand for ownership of tangible assets like gold (money for thousands of years up until this century) declines and faith in paper assets *representing* ownership (like stocks) accelerates. When fear is at its height the opposite is true. Interestingly, while gold has moved up quite a bit and the Dow has dropped quite a bit, the ratio of the Dow to Gold has yet to decline to levels normally seen at points of extreme fear. This is another reason I believe the cycle is not complete yet. Folks are still holding on to their faith in paper assets that can disappear as quickly as the FED can print the dollars that are used to value these paper assets. See the chart below of the ratio of the Dow to Gold and you'll see what I am talking about.



Courtesy of Fred's Intelligent Bear Site: <http://home.earthlink.net/~intelligentbear/com-dow-au.htm>

As you can see, in order to mark a bottom the ratio has to go from its current level of 9 down to the 2-4 area. This would imply nearly two-thirds of the Dow getting wiped out, a tripling of gold, or some combination in the middle.

Bringing It All Together

In the short run we are probably due for a breather but this rally won't be done until all the buyers step back in. In the long run we have too much money chasing too few assets which equals an overvalued market or an overvalued dollar. Look at both charts above and observe the last major bottom in stocks-around 1980-82. On the S&P 500 chart the black line got below the green line and on the Dow/Gold chart the ratio got to 1.

I don't pretend to be able to explain the psychological factors that explain these 40 year cycles. But as you can see the peaks in both these charts occur every 40 years or so. They experience the bottoms around 20 years after the peaks. Maybe it takes a generation to forget the euphoria and faith surrounding a frothy, exciting bull market marked with the "it will always come back" mantra. Maybe it takes a generation to forget how hard it was when the market really tanked and *all you could do was lose* money over your investment horizon after inflation. All I know is this stuff is for real and in the LONG TERM, this is how we invest.

Our Interests Aligned

Most advisors really want to do well for their clients. I have a particularly keen interest in this because I am invested, with all of my liquid assets, in the 80/20 model I run for my clients. Lately, given the unprecedented nature of this economy and unprecedented and unpredictable government involvement it is my opinion that using fundamental analysis on a micro level is not the best-odds way of making money. If that is the case then we must learn the language of the market in order to protect and grow our accounts going forward. To this end, a few months ago I joined the Market Technician Association and began to pursue the Chartered Market Technician designation. It is a three level designation and I have completed the first level. The goal of this continuing education is for you and me to see more commas in our account balance. Indeed, your recent performance both absolute and relative to the S&P 500 has certainly not been hurt by developing this weapon in our arsenal. Despite the market not bottoming until March 2009, the average FAM client bottomed in November 2008 and has risen 60% after fees since then versus the S&P 500 up about 18%. Year to date the average FAM client is up 14% after fees versus -1%. Those with more conservative allocations experienced lower growth and those with more aggressive allocations experienced higher growth.

The remaining portion of this Commentary is a table of indicators. If you choose to skip it, thank you for reading, thank you for your business, and thank you again to those that died for our ability to choose different paths in life, should we be interested. As always, please provide me with real-time and real-world feed back so all of our observations are integrated into the strategy.

The Indicators

“When Fear is at its height, Buy; When Greed is at its height, Sell” –among others, 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.

Contrarian

<u>Indicator</u>	<u>Greed</u>	<u>Fear</u>	<u>Current/Direction</u>	<u>Indication</u>
NYSE Bullish Percent	>70%	<30%	67.13*/Down	Possible Bearish Reversal
AII Sentiment				
Bull/Bear ratio	>2.5	<1	.76/down	Short Term Bullish
NYSE+FINRA				
Margin debit balances	>160B	<100B	\$203B/Down	Mildly Bullish
Savings Rates	<5%	>12%	4.2%/Up	Mildly Bearish
Mutual Fund Cash	<7%	>12%	4.5%/Flat	Bearish

<u>Valuation Indicator</u>	<u>Greed</u>	<u>Fear</u>	<u>Current/Last here</u>	<u>Indication</u>
Price/Earnings Ratio	>20	<10	123/Up	Bearish
Dividend Yield	<3.5%	>6%	2.56%/Flat-Up	Bearish

<u>Monetary Indicator</u>	<u>Bullish</u>	<u>Bearish</u>	<u>Current</u>	<u>Indication</u>
Yield Curve Spread	>3.5%	<0	4/Up	Bullish

*** This indicator will likely indicate a chart reversal from overbought levels if we see a down week next week. Overbought markets are vulnerable markets and a reversal would be down right bearish.**

Why These Indicators?

NYSE Bullish Percent: This great indicator I get from Dorsey Wright and Associates www.DorseyWright.com 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.

AAII 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 generally 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 + FINRA Margin Debit Balances: This is a monthly posting at the Financial Industry Regulatory Authority (FINRA) 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.

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