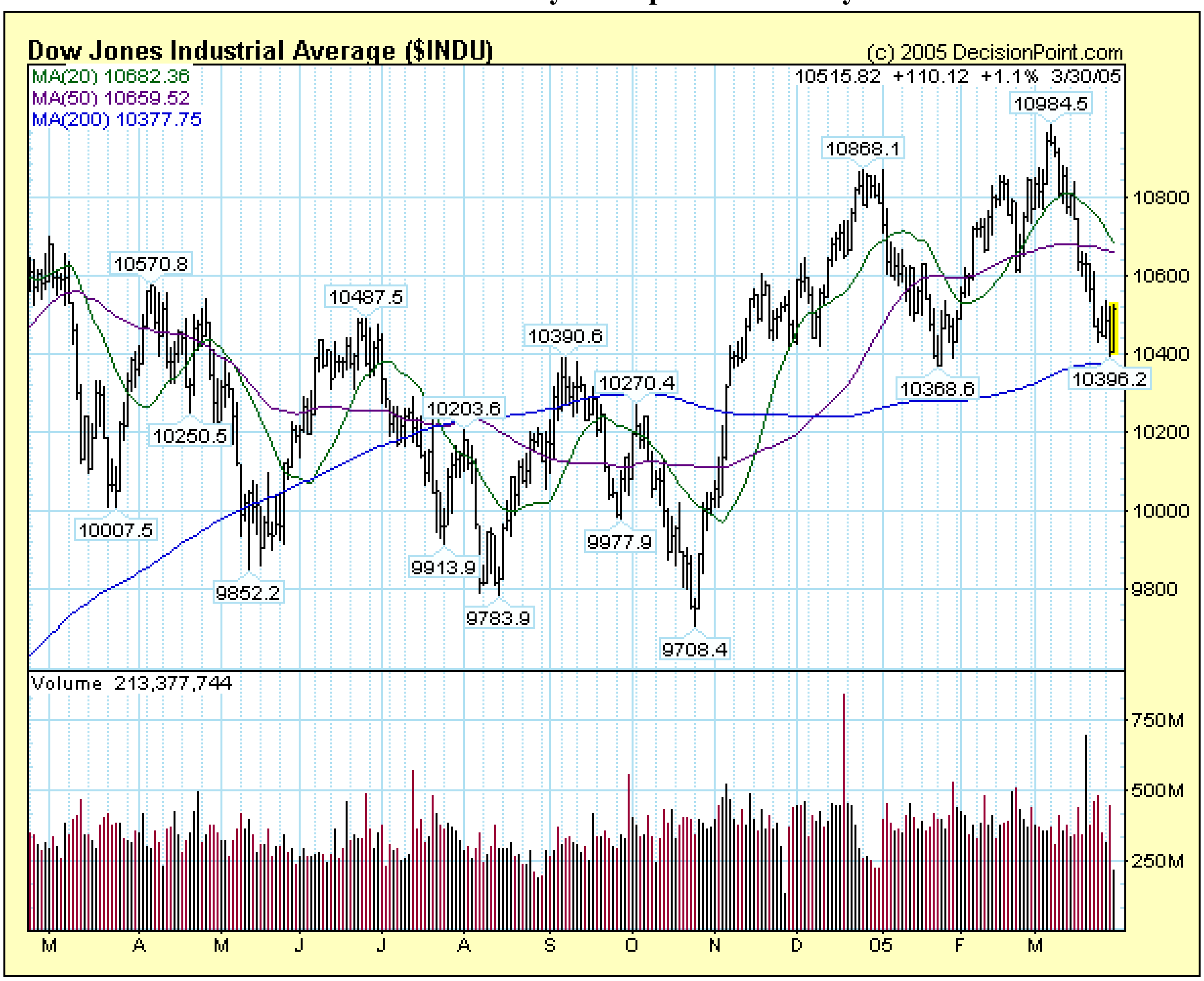
November 2, 2004 Commentary
Justin B. Friedrichs, CFP®
Friedrichs Asset Management LLC
Registered Investment Adviser

S&P 500: 1130.51
NASDAQ: 1979.9
10-YR Yield: 4.09%

Summary: As you can see below, although rallies (sometimes strong rallies) will briefly appear, particularly with a clear election outcome, the trend is still churning downward. The longer the Dow remains below its 200-day moving average (blue line), the more bearish this chart becomes. With the National Savings Rate below 1% and mutual funds holding only 4.7% cash, who in the heck is going to step up and buy? Sadly, the trend is developing so stealthily that although the AAII bullish sentiment ratio is low, the typical *advisor*, according to Investors Intelligence, is still bullish by a 2 to 1 ratio - encouraging readers to "Buy the Dip" once again!!

Does this look like another "buy the dip" scenario to you??????



This chart courtesy of www.decisionpoint.com

The Indicators

Let's start with 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%	**64.75****	**Bearish**
AAII Sentiment Bull/Bear ratio	>2.5	<1	**1.31***	**Neutral**
NYSE+NASD Margin debt balances	>160B	<100B	**$188B/Last here 2/2001**	**Bearish**
Savings Rates	<5%	>12%	**.5%**	**Bearish**
Mutual Fund Cash	<7%	>12%	**4.7%**	**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 decline each year.

Valuation Indicator	Greed	Fear	Current/Last here	Indication
Price/Earnings Ratio	>20	<10	**20.04/>20 since 1997**	**Bearish**
Dividend Yield	<3.5%	>6%	**1.70%**	**Bearish**

The Big "Behavior" Picture

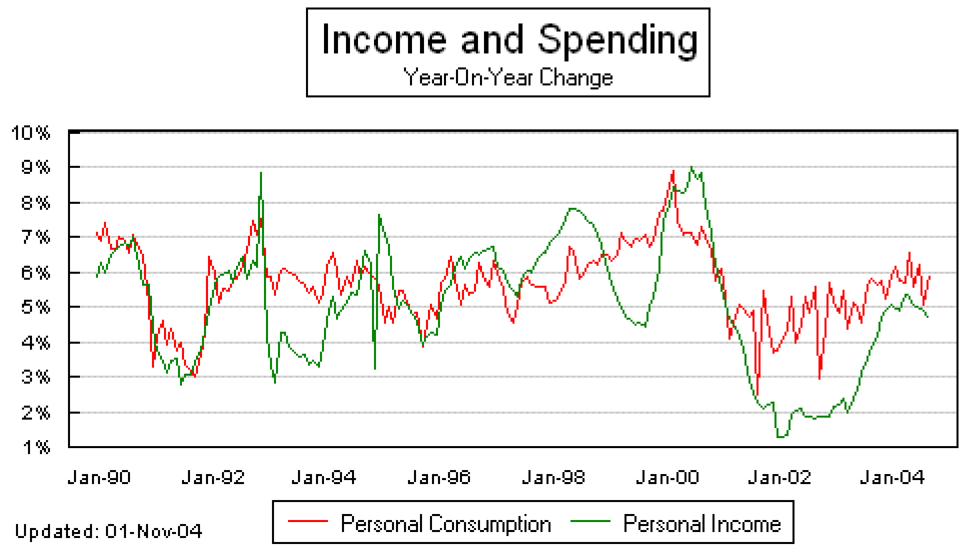
The big picture is best described by observing behavior. I have often suggested that behavior in one area of life transcends to all other areas of life, specifically the growing acceptance of what I call "casual" behavior. I have also suggested that almost all things run in cycles. So, if you observe behavior at one extreme, you cannot expect that behavior to continue indefinitely. Further, rotation toward the opposite extreme may not be far off. Take the Roaring Twenties, for example, it is the only time period in history that even comes close to exhibiting the wild swings that we have experienced over the past 10 years in attitudes, lifestyles, and business practices.

A PBS documentary was on the other night called "American Experience: The Crash of 1929", which focused on the Roaring Twenties and the subsequent Stock Market Crash in 1929. Clearly, this period was not only about rising stock prices. The underlying behavior of humans is uncanny in its ability to illustrate the temporary nature of the phenomenon. Women's fashions were becoming ever more racy; shoe-shines were getting into the stock market (a market which was not appropriate for those with very little to lose); and investors were not only buying any stock in sight, but were also using 10% margin borrowing requirements (that's 10% down) to buy, apparently ignoring the risk of owing money if the stock declined 10%. During the Roaring 20's and the great stock market bubble that accompanied it, Price to Earnings (PE) multiples hit record highs of around 21. From the standpoint of historical cycle analysis, this represented extreme over-valuation. The key human behavior or emotion most common during bubbles like this is DENIAL. How else do you rationalize putting 10% down to buy a stock trading at valuations that were *unheard of in history at that time?* The answer lies in the last part of the question and indeed was pointed out by one of the folks interviewed during this documentary. I didn't get it exactly, but he remarked to the effect that *the investment memory lasts about 20 years.* This is how these bubbles re-occur. They cannot happen unless the memory banks have been cleared of those prior periods of depressing declines. So, if we can find high denial readings, can we invest more intelligently?

"Denial" Indicators

The following behaviors are those that are extreme, and in my view, due to revert to more normal behavior levels. Surely, I will be viewed as a curmudgeon who needs to face the reality that some changes are here to stay. A few would probably say, "Hey, this is progress", but I differ. With all of these behavior patterns being exhibited concurrently, is it not an indication of a consuming public with its head in the sand? - a condition that usually precedes disaster. Accordingly, I call the following "Denial Indicators":

- Popular culture dictates that gangsters and prostitutes are to be emulated.
- "Pink is regarded in psychiatric literature as the color of denial. And we have been seeing a rise in the use of pink in clothing for the past few years," according to James Williams of the Williams Inference Center. – from John Mauldin (alright, this may be unusual for investment analysis but all behavior counts).
- Lottery sales post record quarter in Virginia.
- US Dollar is down 20% during the last two years against a broad spectrum of currencies, despite a massive wave of outsourcing that should slow down with a weakening dollar.
- Cost of higher education in Virginia to rise 10% this year but incomes for college-educated employees is barely moving.
- Healthcare costs are up 8% "but not as bad as before", Gas prices are up 25% in 18 months and yet we are told inflation is only running at an acceptable 2-3%.
- Total Government Debt is within $51 billion of the Statutory Debt Limit.
- Consumer and public debt is now 84% of GDP – higher by far than ever before.
- National Savings Rate (as a % of disposable income) breaks under 1%.
- Howard Stern will be paid $500 million by Sirius Satellite Radio from 2006-2011.
- P/E multiples are still, after 3 years of "healing and repairing the economy and bubble valuations", higher than what is considered "overvaluation".
- Dividend yields are 1.7% - lower than the rate of inflation - reflecting the popular view that dividends are not necessary to create wealth because stocks will provide 8% growth forever.



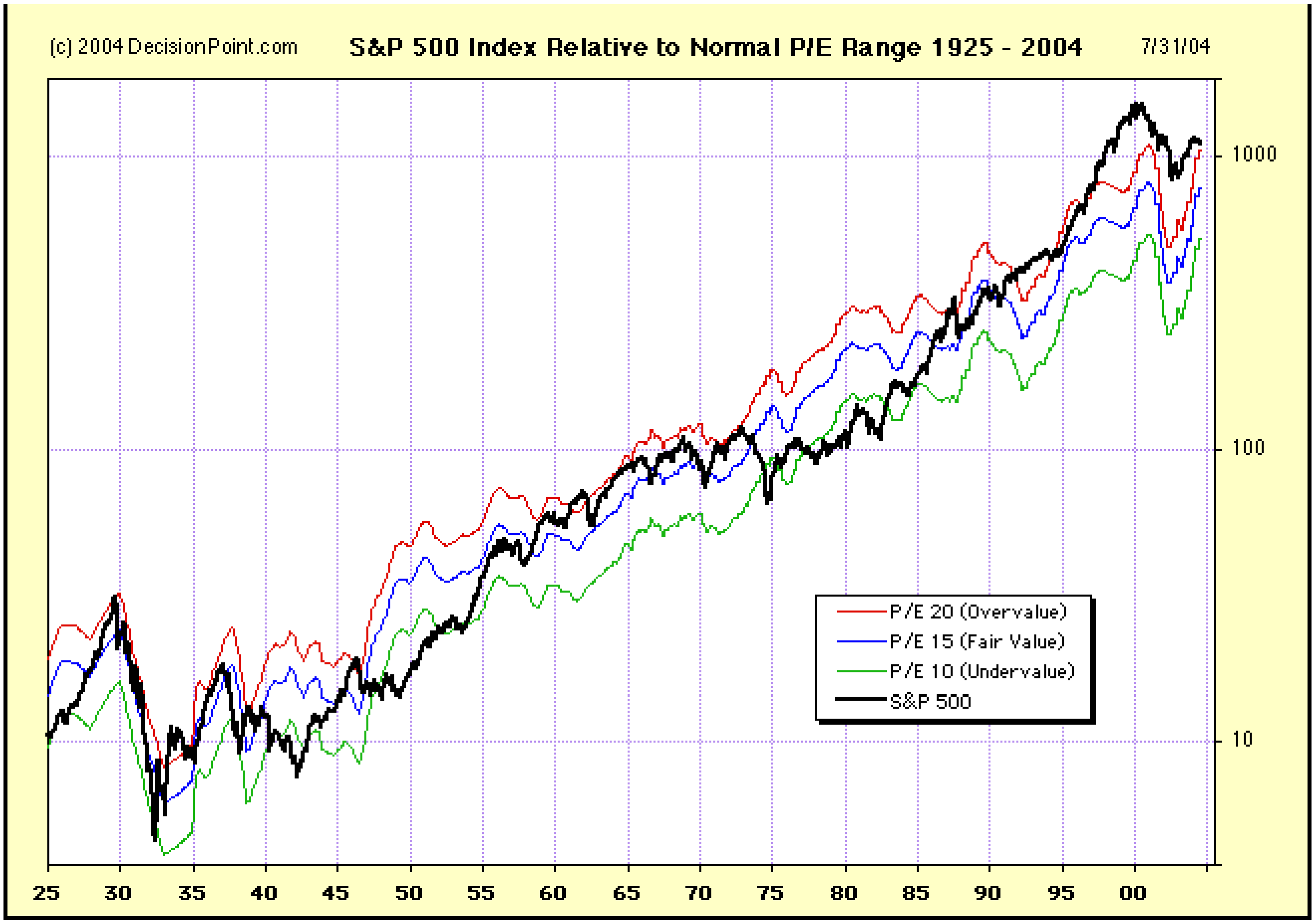
This Chart courtesy of www.Briefings.com

- Lastly, as you can see above, for over two years consumption growth has outpaced income growth. **The American consumer increases spending despite no commensurate increase in what he or she earns.**

After about 20 years, folks forget the lessons of the past. Incredibly, when observing stock market cycles, they indeed run in approximately 20-year cycles - the key word here being "cycles". Cycles of what, high prices moving to low prices and back up? Not necessarily. The cycle is undervaluation to overvaluation and back to undervaluation. The market may move up, down or sideways, while this valuation cycle manifests itself.

Revolving Around the Mean

For veteran readers, you've seen the chart on the following page, but as complacency and denial entrench themselves, it is important to remind yourself of where we are in the valuation cycle. The solid black line on the chart is the actual value of the S&P 500 Index. The red line represents where the index would be if it was at a P/E of 20, or what we call "overvalued". The green line represents where the index would be if it were at a P/E of 10, or what we call "undervalued". Check out the blue line in the chart. It represents where the index would be if it were at a P/E of 15, or what we call "fair value" - neither bargain basement nor overpriced. It is also close to the 200-year average P/E. This chart illustrates my point about trends always revolving around a mean (or an average). Notice the black line (current value) relative to the blue line (fair value/average PE). Current values seem to regularly revolve around historical averages. The fact that they are hardly ever at the same point demonstrates the true risk associated with investing in the market. Just like projected market returns, the average is rarely what you experience.



This chart courtesy of www.decisionpoint.com

Mr. Market, as some refer to the stock market, is not interested in making you feel secure. As such, he rarely hangs around comfort zones very long. This is partly why I find the market so fascinating. Not only can you find equally brilliant people disagreeing about the state of the economy and direction of the market, but you can also experience a market that, despite all the brilliant claims, is absolutely and without a doubt UNPREDICTABLE when it comes to price and timing. Now, let's go back to our analogy of behavior as it transcended all areas of life in the 1920's versus behavior today.

Recall, I alluded to the documentary and how it described sassier fashions, racier cars, and an apparent acceptance that "everything will be okay". I have to say that the behaviors described during the period leading up to the crash were remarkably similar to those exhibited during the past 5 years. I've mentioned above the many examples of denial, but you probably already know what I'm talking about. You wake up in the morning and at 6:30am you turn on VH1 or MTV and watch women in music videos barely dressed who are playing the roles of strippers and prostitutes. Young ladies see this behavior, think it is cool, and dress accordingly, not knowing the lack of self-respect they show by doing this. Is this how we respect women these days? Rewarding this kind of dress with attention? Does anyone think this lack of respect will last forever? Eventually, people learn the easier way through a gradual process of maturity or they learn the hard way when they get burned because of suggestive attire. It is only at this point that respect is restored. Now, change the channel to CNBC to learn that trade and budget deficits and consumer debt (each as a % of GDP) are not only at all time record levels, but are FAR in excess of all previous records. We are told by the talking heads on CNBC that "this time it is different because we are a service-based economy", "the FED won't let that happen", and "deficits really don't matter". I ask the same questions. Is this any way to demonstrate respect for 1) risk or 2) the serious implications of high levels of debt? Eventually, consumers and investors either gradually mature or they learn the hard way when interest rates rise and respect for debt and leverage is restored once again. However, 20 years of declining interest rates have many people convinced that "interest rates only affect me positively", and by the way, "deficits don't matter". To that I say, "SNAP OUT OF IT". One of the reasons it is so hard to "snap out of it" is that the government we put in place encourages our ignorance. In my opinion, **the reason denial is so entrenched today is that the Federal Reserve is constantly telling us everything is okay**.

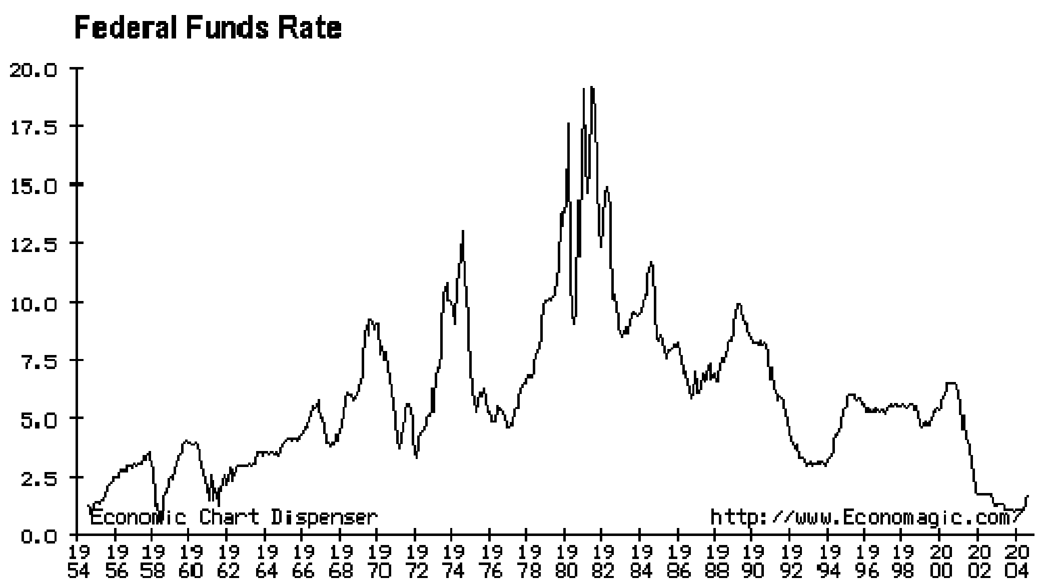
The FED's Role

In contrast to today's FED, the documentary of the Crash of 1929 interviewed individuals who had first hand knowledge of the activities of the FED at that time. As it turns out, it was an entirely different FED. As such, it was still a FED not overly concerned with price stability or micro-managing the swings of the economy. In fact, the FED was chided for not stepping in and providing liquidity during market corrections. Someone else got the credit for staving off the first panic, which occurred about a year before the actual crash. I think it was the then head of Citibank who stepped in and made $25 million worth of credit available to people in order to stem the vicious cycle of margin call panic selling. It was like a slap in the face of the FED, which was deemed wrong for not acting while this hero stepped up to the plate to "save the market". It seems that the FED, believe it or not, at one time was politically independent enough to stand by its tough decisions. Today, the tough decision that is reinforced is the decision to move off the gold standard made in 1971. Standing by that decision means that whenever deflation nears, the way to combat it is "inflate, inflate, inflate". This is what is happening right now. More money has been created since Greenspan became Chairman than was created during the entire period going back to the creation of the FED in 1913.

This printing of money, combined with steadily declining interest rates, caused what is now known as the bubble of the 1990's. That bubble wasn't enough for the FED. When the bubble burst, the FED came to our rescue with a cocktail of money creation and artificially low interest rates - rates that were truly lower than necessary - which forced decent savers into negative <u>real</u> returns, so that borrowing has become more advantageous than saving. This helped stave off the recession that never was or what some call the "half-recession". Do not forget that the constitution does not authorize the creation of un-backed, paper money.

Natural Cycles Prevail and My Election Prediction

When you don't allow the system to fix itself by going through the natural cycles of the economy, it will do so on its own (eventually). Take a look at the chart again. Now, look at the following chart of the FED Funds rate and compare it time-wise to the valuation chart above. It typically shows high P/E's in low interest rate environments and low P/E's during high interest rate environments. Is there any doubt in your mind that we are in wild mania land? The sharp reduction in interest rates has not only prevented us from self-correcting to an undervalued level but has also encouraged us to borrow and overpay for everything (including stocks) instead of saving money.



This chart courtesy of www.Economagic.com

Notice rising rates from the mid-60's to the early '80's, which coincided with a bear market in stocks when stocks moved sideways for over a decade. **I ask you, which is coming next, lower rates and higher valuations or higher interest rates and lower valuations?**

Pulling It All Together

It is my belief that not only will market valuations come back down to undervalued levels (P/E's around 10) but professional dress will also make a comeback over casual business attire. Our population will become more citizenship-oriented, while throwing out the lax standards of the hip-hop culture, and Sirius Satellite Radio will go out of business on this deal with Howard Stern - bringing him and his disrespectful style of entertainment down with them. **My election prediction** is that all of this will happen regardless of which candidate you vote for on Tuesday, November 2nd. By all means, vote for the one you like the most but know that presidents preside over the major trend changes rather than cause them.

Our Results

We have been investing based on the premise that these extremes will correct back to the mean. However, we don't know the exact bottom. We do know that by looking at the charts above this is probably not an ideal time to be engaging in stock investing unless the holdings are actively managed by someone who can use discretion and has the will and unique ability to go to cash in an effort to preserve your capital. We also know that at historical average valuation levels the market would be significantly lower - meaning that earnings must grow at a faster rate than we feel capable - or stock prices must come down. At Friedrichs Asset Management, we are aware of these concepts and are armed with a disciplined investment strategy. We manage your money with the goal of growing your REAL (after inflation) net worth. The average return through October for accounts managed since the beginning of the year is 6.64%, before fees, versus 1.64% for the S&P and 4.22% for the Lehman Aggregate Bond Index. We are currently sitting on 23% cash as dry powder. Once again, we are delivering a great risk to reward ratio and hope that you will pass this information along to your friends, family, and neighbors that you feel we could help.

Successful Investing to All!!

Justin

Justin B. Friedrichs, CFP®
Registered Investment Adviser
Friedrichs Asset Management LLC
6767 Forest Hill Avenue Suite 305
Richmond, Virginia 23225
(804) 272-6070

Information contained in this Commentary deemed but not guaranteed to be accurate.

Investors should not rely solely on the information contained in this Commentary. Rather, investors should use the Commentary as a market analysis starting point. An investor should engage in additional in-depth research in order to develop an informed opinion regarding the merit of an investment opportunity.

While this presentation provides a general overview of some aspects of your personal financial position, it is designed to provide education and/or general information and is not intended to provide specific legal, investment, accounting, tax, or other professional advice. For specific advice on these aspects of your overall financial plan, you should consult your professional advisors. Any asset or portfolio earnings and/or returns shown or used in the presentation are not intended to predict nor guarantee the actual results of an investment product.