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NASDAQ: 1915.3

Dollar Renews Weakness
Can Anybody See Their Hand?
What Can We Realistically Expect?
It's a Win-Win-Win!

Dollar Renews Weakness

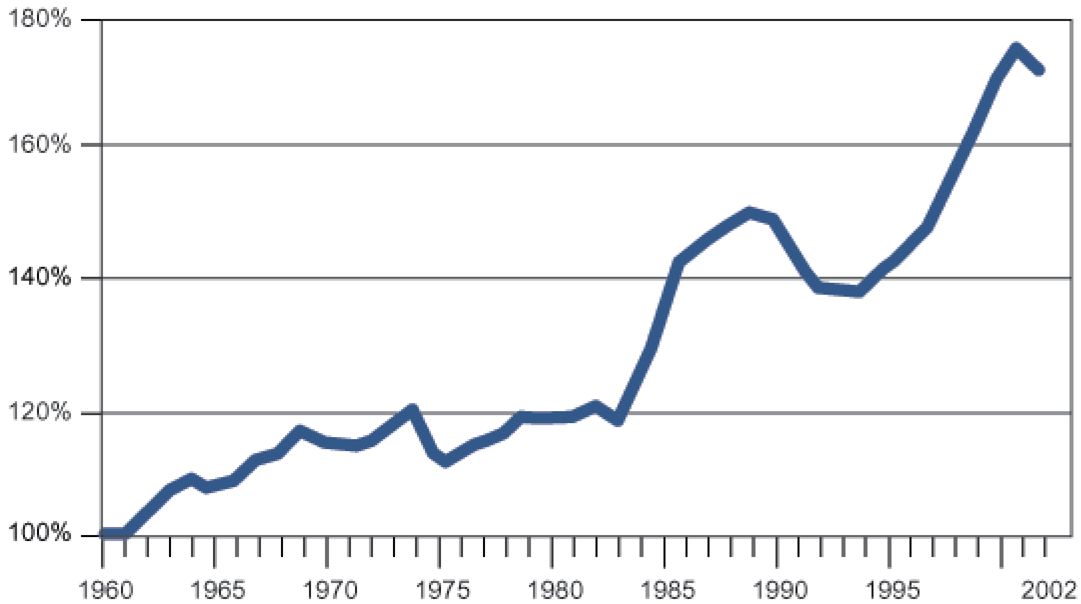
The U.S. Dollar's decline resumed last month spurred by the same issues that I have been raising in this space about our nation's trade and budget deficits. The stock market took a couple of shots as well and then proceeded to make a new one year high in early October on better than expected jobs data. The stock market declines were attributed to sympathy for the dollar (sounds like a song), OPEC announcing a production cut which sent oil prices higher and…hold your breath…concerns about stock valuations. (Veterans of this commentary should not be surprised.) Look for that guy in the future. The U.S. Dollar decline versus other currencies was accompanied by a surge in the price of precious metals, which some, including me, consider an alternative currency.

Everywhere I look there is a politico criticizing China for keeping the exchange rate of their currency pegged at 8.276-8.28 Renminbi to each U.S. dollar. When in doubt, become a nationalist and bash the foreigners-who will stand against you in that? One by one, representatives of countries dealing with China including Treasury Secretary Snow have taken the opportunity to repudiate China's pegging of its currency to the dollar. The purpose of the peg, obviously, is to keep Chinese goods at a consistent affordability level to U.S. consumers. (According to Everbank's Chuck Butler www.everbank.com, this practice was established back in 1995). Why all the fuss *now*? It is inconvenient, it appears to be causing job losses in the U.S. and its election time. As a result, China maintains a trade surplus with the U.S., causing it to build up a store of dollars. China and many other countries that run a trade surplus with the U.S. use the surplus of dollars to buy U.S. Treasuries. Ironically, while the current political fad is to publicly criticize China for the peg, this constant demand for our Treasuries helps keep interest rates down-a welcome side effect. Meanwhile, we print U.S. dollars to pay back the debt of these Treasuries. The net effect is a huge supply of currencies coming into circulation. It is cycle that won't end nicely and "Sympathy for the Dollar" will have mixed meaning.

While removing the peg will be good for U.S. exports as our goods will become relatively cheaper, big importers like Wal-Mart and major U.S. Auto companies which mandate Chinese made parts for their cars will see margins get squeezed. A stronger Renminbi may also inhibit the use of the U.S. dollar as a reserve currency which would necessitate higher interest rates in order to finance our deficits. If you would like to read

further on this subject, go the following link and read the last couple of months' commentary from Bill Gross, Chief Investment Officer of PIMCO Funds. http://www.pimco.com/bonds_generic_frms.asp?cont=/ca/bonds_public_arch.htm
In any case, here are a couple of charts featured in those commentaries:

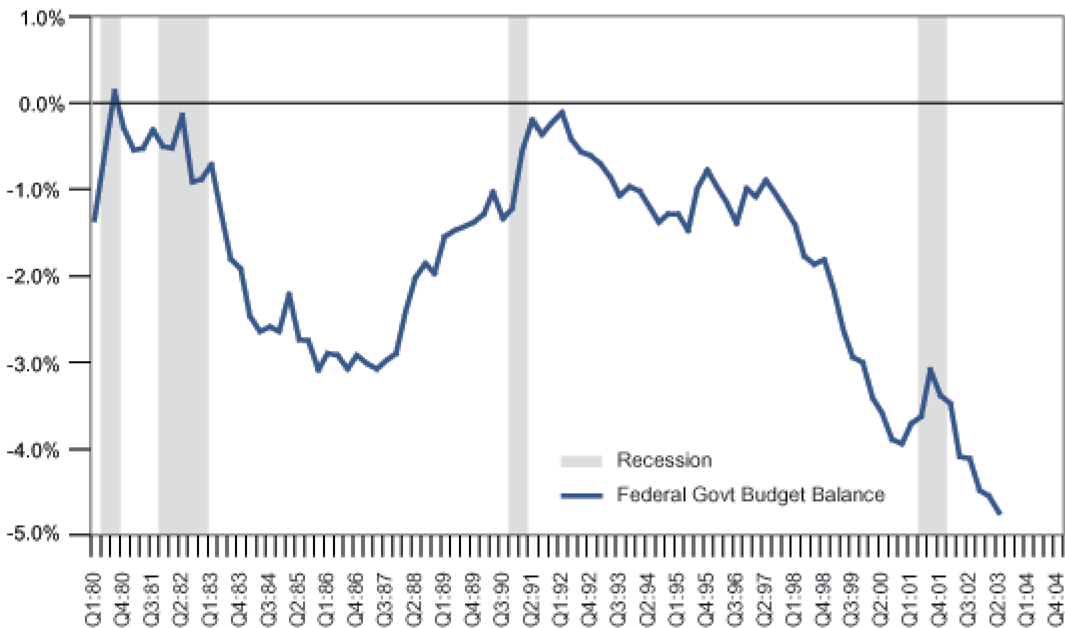
U.S. Private-Sector Debt as % of Disposable Income



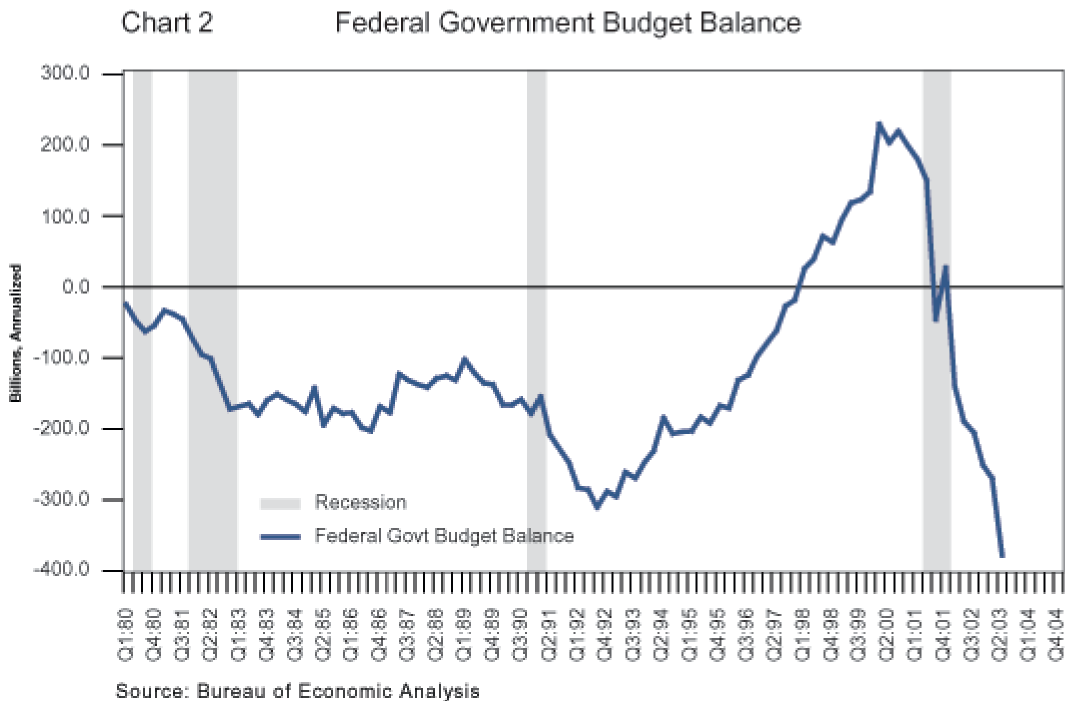
Source: Godley & Izurieta, Levy Institute
The Economist, September 28, 2002

During the bull market of the 80's and 90's, debt creation outpaced disposable income by nearly 50%. To me this reflects a stronger passion for consumption than saving. The charts below illustrate this behavior as a nation.

Chart 1 Trade Deficit as a % of GDP (Nominal)



Source: Bureau of Economic Analysis



We consume more than we produce and spend more than we earn as a nation-now at a GDP-relative deficit rate of about 5% *each.* Coincidentally, I noticed that during the month of August Personal Spending rose by .8% while Personal Income only rose .2%- How does that work? Answer: more debt. A week later it was announced that Consumer Credit for the same month increased a whopping $8.2 Billion.

Can Anybody See Their Hand?

I was fortunate enough to be out of town when Isabel wreaked havoc on the Mid-Atlantic. (Yes, for you, I fled to the woefully inadequate hospitality of New Orleans (right!) so I could access your accounts and stay on top of things.) My planned trip was extended by the indication that power at home and office had not been restored. Upon return Friday night to my dark home in the very dark suburbs, I held my hand in front of my face and BEHOLD, I saw nothing. It was as if I was blind. Something dramatic and business-related dawned on me: This is what it must feel like to own 30 PE stocks in a business not based on something tangible. Ugh!! "How can people live like this?" I thought, "Investing in a black hole of totally uncertain outcome." I note that the PE's on the DOW, NASDAQ and S&P 500 are all at or above 25. That is 78% above the 200 year historical average. How can this be? Did you know that 29 of the NASDAQ 100 have no earnings? These are supposed to be the "blue chips" of the NASDAQ. My only thoughts are that not only can investors not see their hand in front of their face, but also that they are swimming in an ocean of liquidity much like the storm surge which plagued the Outer Banks and the Chesapeake Bay area.

This insatiable appetite for risk has caused borrowing for stock purchases (margin debt) to return to early 2000 levels. In fact, in the month of July, margin debt balances in accounts actually exceeded the peak hit in March of 2000 by almost $5 Billion, according to the NASD. Dramatic surges like this are indicative of highly speculative behavior. Likewise, when you observe long term charts of PE fluctuation, it is apparent that whenever the PE deviates widely from the mean it not only returns to the mean but most of the time also declines to levels below it. It is going to happen; it is just a matter of when. I talk so much about valuation I am sure you are tired of it so I'll leave you with another's perspective:
"As the current bull market nears its first birthday, its defining characteristic is the great performance of otherwise poor stocks," notes the New York Times' Floyd Norris. "A money manager with the foresight a year ago to buy only companies of dubious financial standing would now be a star. Consider the Standard & Poor's stock ratings, based on 10-year records of earnings and dividends. So far this year, stocks with a rating of A have risen about half as much has stocks rated B. And stocks rated C - a category that indicates shaky financial condition but excludes companies that have defaulted on their obligations - have done twice as well as the B companies." (Daily Reckoning)

What Can We Realistically Expect?

I have mused in this space before that there is a causal relationship between casual behavior in every day life and speculation in the markets. Casual attitudes, dress codes, television, etc. breed casual behavior in all areas of our lives and, it would seem, national endeavors (See May, 2003 Commentary). For example, when Congress draws up the budget for the President to approve, one would think the purpose is to balance outflows with inflows. That never seems to be the case-and it is only getting worse. It is not surprising to me that our government behaves this way when you look at the chart of debt to disposable income. The priorities have been established and the electorate has spoken. Or maybe government's action sets the example.

Whether the chicken or the egg came first is not for me to decide. What is for me to decide is where the best place is to invest your money for both the short and long term. At the beginning of this letter I cited some reasons for short term market strength and some reasons for short term weakness. The causes of stock market strength have been economic growth through the increasing productivity of labor. The good news is that in the near term companies will be more efficient. The bad news is that eventually, while running more efficiently, sales are not picking up and won't as long as the jobless recovery continues to produce more cash-poor consumers. So the good news, I hate to say, is temporary. This is not to say things will never get better. In America we have made it through many periods where increasing productivity lead to joblessness. To survive, one invests using the methods that sustain through time rather than the previous, outgoing fad. The previous system, which I put in the "casual" category is, "Buy before it goes up even more!" and the old system that sustains is "Buy when it's cheap. Period."

With the bubble never having gone away (the lowest PE's got on the S&P was 21.7 in April of 2001) I submit that the only way investing is to become attractive to serious

participants is for valuations to become cheap. Indeed, why else would I want to buy stocks for the long run? I want cheap stocks. And the market, in general, is not cheap. Historically, at the bottom of bear markets stocks become "dirt cheap" and I don't think this time will be different.

Prudence is the action. It may take time to be rewarded for prudence but when has it not? Besides, does it make you feel better to pay for 33 years of unpredictable earnings in advance? Records are being set in high valuations, extreme bullishness and complacency, debt to disposable income, margin debt levels, trade deficits, budget deficits and money supply. *Don't* take unnecessary risk. *Do* take action. Develop a plan that will preserve and grow your REAL net worth by investing in securities that will hold up well in these tough environments. We are doing this for our investment accounts-that is evidenced by the fact that our managed account program has 33% cash still outperformed the S&P and in some cases doubled the S&P's performance last quarter.

It's a Win-Win!!!

I want to thank you for your ongoing enthusiasm in sharing my business concept with friends, family and co-workers. I have prepared many financial plans and have been serving families well this year using my conservative investment style. When you share two things happen: 1) I spend more time managing your assets because I spend less time prospecting for new business and 2) Your friend or family member sleeps better knowing they have an advisor you trust. It's a win-win!!! The easiest way to refer someone to me is to call or email them and **tell them about the web site**. You should go there yourself if you haven't yet. It is loaded with useful articles and information. **Tap the "Tell A Friend" button** and it does the rest for you, including alerting me. Again, thank you.

Now that I am back in town for a while, I am looking forward to meeting with you and going over quarterly reports. On a personal note, Erica and I have rented a piano and are taking lessons. It is one of those things we each have always wanted to do and never got around to it. So far, the experience can best be described as a "somewhat frustrating THRILL". My only regret is not having more time to practice. I strongly recommend that you start today whatever you've always wanted to do.

Successful Planning to All!

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