

September 1, 2003 Commentary
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S&P 500: 1008
NASDAQ: 1810

**August “Laziness”
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To Sell (and pay all those taxes) or Not to Sell
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August “Laziness”

August has been an uneventful month, to say the least. The equity markets continued rising on a tide of increasing liquidity in August, finishing with a 1.8% advance. Mixed economic signals and light volume made for indecisive trading trends. (Note: The S&P has been stuck in this trading range of 960-1010 since early June.) Importantly, despite the weak volume, the Dow finally managed to break and close above its previous closing high of 9323 recorded in early June. Its closing high now stands at 9423.68 on 8/21/2003. This leads me to believe that there may be more wind left in the Dow’s sails, even though this new high has yet to be confirmed by the S&P. We are proceeding cautiously, however, for the reasons I continue to mention here. The S&P is trading at a PE of 29 and yields 1.7% (www.standardandpoors.com) and both of these figures deviate widely from historical averages. *A consistent procession of new highs in all relevant indices* is bullish whereas noted before with the Dow “finally” breaking a new high after two and a half months is not quite as strong an indicator and is more typical of slow topping action.

I was interested to see Randall Forsyth’s column in Barron’s August 25 edition which discussed the research of Bob Arnott, who runs a quantitative research firm. His research goes back to 1800, much like the research I have cited in this commentary and in my seminars, and tells us that the average PE is around 14 and that most of the returns on stocks come from dividends, not growth. In fact, 5.6% of the 6.8% total real return of the stock market over the last 200 years was attributed to dividends. (Stock Cycles by Michael Alexander) These continue to be the most important figures to me—PRICES and CASH distributed to investors.

Understanding Inflation versus Deflation

Another important figure to take into consideration is growth rate of the money supply. The growth rate of the money supply directly affects the level of inflation. Inflation is the increase in dollar terms of the cost of goods and services. The most common real life example of inflation is the \$4500 car in 1966 which now costs \$43,000 in 2003.

Inflation can be caused by one of two things: 1) an increase in the supply of money to the point where too much money is chasing the same number of goods or 2) a demand side shock where the supply of goods is declining as the amount of dollars chasing them is rising. This is the result of a strong economy in which individuals benefit by getting raises and are thus willing to pay more out of pocket for these goods and services. The strong demand leaves a shortage of workers and the cycle continues. The first scenario is where we are now with regards to home prices and stock prices. Let's take a look at this side of the inflation/deflation, split personality, economy that exists at the present:

Too many dollars chasing too few houses and stocks: Driven by lower interest rates (lower payments *create* demand) and greater access to easy term loans with low down payments (increasing supply of money) we see housing prices rising over the last several years. Similarly, declining interest rates have forced investors who require income to steer away from lower and lower yielding bonds into stocks in an attempt to maintain their standard of living. These investors are literally hoping and praying they will be able to sell their investments at higher prices.

During the month of July, the M3 money supply grew at a seasonally adjusted *annualized* rate of over 21% (From Barron's 8/18/2003: month ended July \$8919.5 Billion vs. previous month \$8760.3 Billion). In a perfect economic model, an increase in money supply should cause a chain reaction as follows-The money is available from the FED through banks and banks are eager to lend it to earn their spread over the amount charged by the FED. Banks lend it to businesses and individuals who are making capital investments, who borrow because they believe they will get a better rate of return on their investment than the interest rate at which they borrow. Investment creates demand for all the little stuff in the economy as well as demand for labor allows people to have more disposable income with which they can purchase big ticket items. The hope is that by recycling this money through the entire economy it creates a sustained cycle of demand. Unfortunately, the cost of borrowing has not been low enough to entice the larger investments necessary to get the economy back on solid footing.

As we all know there is hardly a perfect economic model. I referred to this a little last month when I described the confusion caused by the FED through its communications to the markets. The FED was trying to confuse and be vague-The FED, like all of us, does not have a model that acts as a panacea at any given time. Greenspan acknowledged as much in his latest speech given at Jackson Hole by stating in so many words that as much as we would like to rely on models to predict the economy, the only thing that doesn't change is change itself, making economic models less and less useful. <http://www.federalreserve.gov/boarddocs/speeches/2003/20030829/default.htm>

With regard to just about all goods and services other than houses and stocks, we are currently seeing the opposite of the second cause of inflation, creating the other half of the "split personality"-disinflation or deflation. Instead of a declining supply of goods being chased by increasing demand for the goods, we are seeing lots of dollars supplied by the FED chasing an even more rapidly *increasing supply* of goods.

Lots of dollars chasing an increasing supply of cheaper goods and services:

The world is producing so many goods that even the ever-increasing availability of capital is barely enough to cause inflation because of the ever increasing supply of cheaply produced goods. Supply continues to exceed demand. This is causing *disinflation* (a slowing in the rise of prices) and in some cases *deflation* (outright price decline).

For example, I have a Dell computer. When I called customer service I was helped by someone with an Indian accent so I asked if they were in the U.S. or in India. It turns out they were in India and they gave me great service as well. After doing more digging and rereading articles from the past, I have learned that folks in India are performing architectural services at one-fifth to *one-tenth* what a U.S. firm would charge in U.S. dollars. “U.S. companies are expected to send 3.3 million jobs overseas in the next 12 years, primarily to India, according to a study by Forrester Research... Financial-services companies in the U.S. are expected to move more than 500,000 jobs overseas in the next five years, according to a survey by management consultant A.T. Kearney, and India is by far the top destination.” (From a Time Magazine Article by Jyoti Thottam July 28, 2003-you can read the whole article here: <http://www.mindfully.org/WTO/2003/Jobs-Are-Going28jul03.htm>) These professionals perform services from accounting to stock analysis and are simply willing to work for less. The decline in prices for these services is the exact opposite of pricing power and inflation-it’s called **deflation**. The fascinating thing is that U.S. corporations are doing this hiring abroad in an effort to get their costs of production down so that they may better compete with foreign corporations already taking advantage. Right now, we are battling simple truths such as the fact that people are able to do more with the technology they have and in different countries for less money. Therefore, businesses haven’t felt the need to hire more people or invest in new equipment and technology in the U.S.....yet.

This tug of war between asset inflation AND disinflation/deflation in most goods and services is tenuous, at best. If prices begin to fall in the housing and stock markets, the two areas reflecting inflation, it is likely we will get closer to the deflation scenario. This would mean that money today, if saved, not spent, will buy you MORE goods and services in the future. Could you imagine that? No more “buy it now at these prices while they’re cheap”. No, I’ll wait, they’ll get cheaper. And that is my response to the temptation to buy at current prices in the stock market.

To Sell or Not to Sell

Many ask how they can possibly sell their longer term holdings in which they have gains on which they would have to pay taxes. This is a common burden for successful investors and one that literally keeps people up at night. On one hand they want to sell because either the company or its current valuation is flawed. On the other hand, they don’t want to have to pay the taxes. Paying the taxes makes them feel like they are taking one step back and ask themselves, “How am I going to make this up?” Recently,

one such individual proposed this dilemma with EMC Corp. after I mentioned how richly priced the market, in general, is now. Let's go through this discussion.

If you have a stock, let's say EMC Corp. which in 1996 you could have bought for \$3 per share. Currently the stock is at \$12.65, a nice gain over 7 years. If you sell now, you will have to pay 15% of the difference in capital gains taxes, or 15% of $9.65 = \$1.45$ per share. Currently this company is estimated to earn \$.16 for 2003 and \$.31 for 2004. Even though I don't like to use future estimates in such a questionable economy, let's be generous and say it will hit the 2004 target. Taking the price and dividing it by the 2004 earnings gives a PE of about 40. In order for you to break even on your sale and tax payment, the stock would have to decline to \$11.20 per share, or a PE of 36. With the historical average market PE around 14 and the current market PE around 29, how likely do you think that is? Put another way, a PE of 40 means that if earnings miss, the stock should adjust by declining an amount equal to 40 times the miss. So if earnings miss by \$.04 (and only earn \$.27) that should lead to a decline of \$1.60 per share ($$.04 \times 40$). In this scenario, the money could have been given to the government (oh joy) but it ends up simply disappearing (and I didn't think there was anything worse than giving money to the government!). Obviously the inverse could be theorized as well, although with a PE of 40, I would imagine that any "upside" would already be priced in. And of course, valuations could be sustained for a period of time whereby you actually could sell at higher prices and put more in your pocket after taxes. This bet, albeit risky, has paid off during this current rally. While we may have 10-15% more on the upside in this rally, I think we are seeing a topping process occur.

To be sure, my guess would be that if you sold, you would have an opportunity to buy it back for much less, have a higher basis and have saved money *after* taxes. Most importantly though, no matter where the stock is and no matter what your cost basis (above or below) no stock should be held if either the company fundamentals or the valuation given is flawed. In this case, when you get to these high PE levels, you are betting there will be someone else willing to pay you that much for it at a future date, or that the company REALLY grows its earnings. 200 years of history points to the fact that odds are much better of winning that bet when PE's are at or below the historical averages with any investment. Keep in mind that 2004 estimates we used for EMC are *double* over the \$.16 *estimate* for 2003. The fear of paying taxes (and the fear of taking a loss, for that matter) cause many to avoid selling stocks when the fundamentals of the company or its valuation are flawed. Traditional investment theory dictates that taxes are not a primary reason to own or not to own *any* investment. Of course, these are personal decisions which need to be well thought out and discussed with you tax advisor.

Conclusion

For sure, regarding the few stocks I still own for clients, I will not pick the top. So I am slowly selling them off and certainly putting in stop losses. There are still some sectors and stocks I find attractive which I continue to monitor closely. Stop losses are helpful because the last thing we want to do is another "round trip" where you are so elated by the paper profits you have achieved and thus become more loyal only to be swindled into

a panic sell when it gets below what you paid for it. There are also sectors that I see as extremely overvalued and I may seek to benefit on their decline. Again, I don't mention stocks or sectors here, not because I don't want to "give away the goose that lays the golden egg" (pun intended for those of you in the know), but because what may be good for the goose may not be good for the gander. Different people have different objectives and I don't want individuals to make assumptions about what may be right for them. I'll finish with interesting August data courtesy of Dennis Gartman via John Mauldin's August 22,2003 letter which can be found at <http://www.frontlinethoughts.com/>:

"While most people view the last 2 weeks of August as vacation weeks, over the last 16 yrs important turns have taken place then:

August 25,1987 - the exact top prior to the crash..
August 23,1988 - low has never been returned to..
August 24,1995 - low has never been returned to..
August 19,1998 - top preceding 18% plunge in 2 weeks..
August 31,1998 - important market bottom..
August 31,2000 - 2 days before all time high..
August 24,2001 - end of rally ,market drops 22% in under a month..
August 22,2002 - exact rally top, market drops 21% in under a month.
(Courtesy of Peter Eliades of Stock Market Cycles.) "

Let's see what September brings. Hopefully more profits than back to school traffic!

Successful Planning To All!

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