

The Lychak Letter



“A Quarterly Analysis of Bond and Stock Market Trends Worldwide”

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Government Yields / Currency

Term	Cdn Govt Yield	US Govt. Yield	Cdn Rates
			Prime 4.0 % Bank 2.5 %
3 mo	2.4 %	1.76 %	US Rates
6 mo	2.7 %	1.9 %	
1 yr	3.31 %	3.0 %	Prime 4.75 %
5 yr	5.02 %	4.41 %	Fed. 1.7 %
10 yr	5.61 %	5.09 %	
30 yr	5.89 %	5.59 %	\$CDN = 0.64

In my opinion I feel that short term interest rates have gone as low as they are going to go. The reason why the governments have adopted such a low rate policy is because of the high debt levels that both consumers and companies are in. This situation exists extensively throughout the United States and also in Canada as well (though not as bad). The US government knows that the only way to get out of this situation is to decrease the debt servicing costs for corporations and consumers by lowering interest rates until debt levels have been reduced. This debt reduction will take a while to be achieved so the likelihood is that overall rates will remain low. Normally a low interest rate environment would cause inflation to start increasing. But because I feel the US economy is quite weak and will take a while to truly be robust, I do not feel inflation will be present for the next few years. The one issue that I feel will truly cause rates to go up is something that is not being mentioned right now. That issue is the growing US government deficit and the likelihood the US dollar will drop substantially in the future. These two issues will force the US government to raise rates in order to attract investors into government debt. When will this happen? Well, the US dollar is already weakening as can be seen in the strength of the Canadian dollar. And the US government is already creating a growing deficit due to increased military spending and reduced taxes. This trend is likely to continue in the future and once it becomes apparent to foreign institutional investors, they will soon start investing less in US government securities and force the US government to raise rates in order to attract investment. Overall, I do expect rates to remain low but do expect them to gradually rise in 2003.

Another important point to make is that I feel the Canadian dollar is now going to begin a long-term trend of rising in price. The main two reasons why I feel the US dollar is going to decline in the future is due to the government's deficit spending and foreign investors gradually reducing their exposure to US government and US equity securities. Also, in Canada both federal and provincial governments have continued work at reducing debt levels which has recently resulted in Moody's granting Canada's federal debt their highest rating "Aaa". This will make the Canadian dollar more attractive to foreign investors over the US dollar. This brings me to the conclusion that now is not a good time to hold US dollars and I would suggest to convert to Canadian dollars from an investment standpoint as this currency I feel has more upside.



North America Stock Markets

It seems that the one dominant theme that is always in the papers and on tv is that the economy has recovered. Why is it that the government wants to make sure that this statement, "the economy has recovered" is heard by all? And, is this really the truth?

Well, the truth is that the government wants the general public to continue spending their money. This way the government can maximize the taxation dollars received from a buoyant economy. This will only happen if the general public is confident they will have a

Index (May 1, 2002)	Value	%chg/3mo	%chg/1yr
TSE 300 Index	7647	- 1 %	- 4 %
S&P 500 Index	1086	- 3%	- 14 %
Dow Jones Industrial Avg.	10059	+ 1 %	- 7%
NASDAQ Composite Index	1677	- 12 %	- 22 %

job, and that the economy is doing well, which also supports their belief that stock market valuations are justified. So, the reality is that the government will never say, “things are going to be tough for a while”, or that, “we will be in a protracted recession”. Because if they did say this, then you could expect the stock market to drop dramatically, consumer confidence to plunge, and the economy to tank, followed by the government receiving less taxation revenue. So I guess, you can expect much more rosy headlines in the future about the

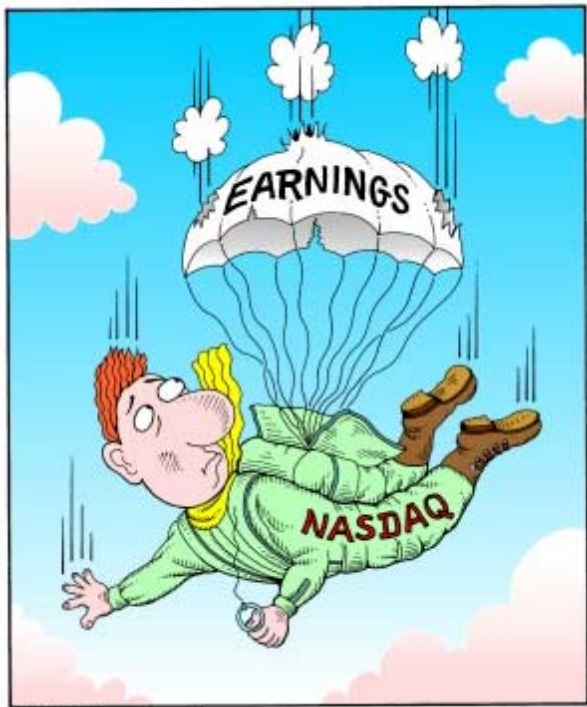
excellent times ahead. And I guess you can either be like some of the general public and subscribe to this...., or you can ask yourself, “what does the economic future really look like”. The reality is that companies are continuing to lay off workers, and unemployment is still rising (it recently hit an 8 year high of 6% this week). This does not indicate a healthy economy. While this is the current reality and likely to continue for a while, it is my belief that long-term things will improve. The economic cycle always has periods of expansion followed by periods of contraction. I just feel that things will not get better overnight and it will take many more months for this to be the case.

This leads me to the question, “Is it time to buy in the stock market”? Well, I guess if you are patient and can wait 100 years in the future, yes the market always is a good time to buy. But, if you are planning on making money over the course of the next year, well the odds may not be in your favor. Yes the stock markets have rallied since September, and now are trading at previous high levels (except the NASDAQ). But the problem is that the current prices of stocks are expensive and offer little upside and lots of downside. This is not a good equation for making profits from your investments. As a result I am still bearish on the overall equity markets and prefer to invest most money in liquid money market securities. I am especially negative on most US stocks which I feel are quite frankly a bad investment. And yes there are lots of great companies in the US, but no matter how great they are if they are too expensive they are a bad investment. The future for most US stocks is that they will likely continue dropping in price as foreign investors gradually reduce their exposure to the US equity markets. You see

the reason how US stocks got so expensive in the first place was that so many foreign institutional and retail investors bought US stocks while the US economy was hot. The technology stocks in the US further attracted this capital. In fact, today the average international equity mutual fund has a very high exposure to the US (~56%). The other respective weightings of other countries are; United Kingdom 10.5%, Japan 8%, France 4%, Germany 3%, Canada 3%, etc. And if country weightings were to return to historical levels the US would only be represented by 35% on average. This inevitable redistribution of equity capital will in the end result in much lower US stocks prices and a weaker US dollar. It is just a question of how long do we have to wait. Will Canada stand to gain when the international investment equity weightings increase? Yes most countries will gain when this redistribution occurs, but it does not mean these equity markets will rise. It means that they will just have less downside relative to the overall US equity markets. For now I am quite cautious and prefer to wait with higher cash positions until markets correct further. I still do see the potential for September lows to be revisited or exceeded but will wait to see how things look later this Summer.

World Markets

After reading about the North American markets you may think that anywhere else in the world is a better place. Well, the only International markets I like are Europe and Japan. Europe currently trades at lower valuations than both Canada and the US and with the introduction of the Euro currency has improved the potential for international markets. And while I do feel that Japan has almost bottomed, the problem is the country has unofficially adopted a policy of weakening the Yen. Well, it makes no sense to invest in Canadian dollars to buy a Japanese equity mutual fund until the Yen has stopped dropping. Because any gains made in the equities will be lost in the currency exchange. But I do feel



Index (May,1 2002)	Value	chg/3mo	chg/1yr
London FTSE 100 Index	5125	- 1 %	- 13 %
German DAX Index	5041	- 1 %	- 19 %
France CAC 40	4462	- 1 %	- 20 %
Brazil Stock Index	13085	+ 3 %	- 12 %
Mexico Bolsa Index	7480	+ 8 %	+ 25 %
Australia ASX Index	3360	- 2 %	+ 1 %
Japan Nikkei 225 Index	11552	+ 18 %	- 20 %
Hong Kong Hang Seng Index	11497	+ 7 %	- 17 %

that Japan will be one of the best performing markets in the future. People in Japan have endured a bear market that has gone on for 11 years. In 1989 the Nikkei index was ~35,000 and today is 11,500 a drop of 67%. That is like having the TSE300 index drop from the current level of 7,600 to 2,800 10 years from now. Back in 1989 people loved buying those wonderful Japanese companies, no matter how expensive they were (just like today how many people love buying US stocks). As a result people in Japan are quite cautious about investing in stocks and have been quite savers of money. Unlike the typical US consumer who loves buying stocks and is debt burdened. When the Japanese consumer starts spending again, the economy will have lots of saved capital for economic growth and stock market appreciation. While I do not feel it is time to invest now I am closely following these markets to see how things transpire.

Commodity Markets

Oil prices have risen in the last few months from \$19 to \$27 causing many producers stocks to rise as well but I fail to see any support or justification for this and would use this as an opportunity to sell oil producer holdings. I believe that oil rallied in response to the anti-terrorism campaign and the fighting going on in Israel/Palestine. It also received further support from the strike in Venezuela and Iraq temporarily reducing output in support of Palestine. While these short-term issues caused oil to rally, the reality is that oil output growth is growing faster than consumption. This will inevitably result in lower oil prices later this year I feel somewhere around \$15 - \$20 a barrel (barring any unforeseen event).

<u>Commodity</u>	<u>Price US\$</u>
Crude Oil	\$27
Gold	\$308

Natural Gas still remains at lower levels than last year but is where I feel is a normal trading range \$2-\$4. Producers have still not declined to attractive levels so I have not suggested investing yet but prefer to watch how the Summer unfolds. If gas producers decline further a buying opportunity may present itself.

I have been bullish on gold producers for quite a while and with the recent strength in the price of gold and gold stocks it now appears that I was correct in my assumptions. However, I have decided to take profits in my gold producer holdings (Placer Dome, etc.) because this rally I believe has now run it's course. I feel that while the price of gold has rallied, it is due for a correction as are so many of the gold producer stocks. I feel that later in the Fall will likely present another opportunity to buy back into gold producer holdings and I would suggest taking profits and patiently waiting for another entry point.

Fixed Income

Following is a list of bonds and debentures that I feel offer a good yield and are "investment grade" quality. Yields have risen a little since the last quarter and I still am suggesting terms of 1 to 3 years as I expect rates will gradually rise.

- GMAC, Nov. 2002, 2.83%
- Bombardier, July 2003, 3%
- CIBC, March 2004, 3.89%
- Weston, Feb. 2004, 3.8%
- GMAC, April 2005, 5.04%
- Telus, June 2006, 7.35%

Focus Stocks

Results of previous stocks recommended that have been sold:

Surrey Metro Savings (Sept. 2000) +40%, Sepps Gourmet Foods (Dec. 2000) +1%, Taiga Forest Products (April 2001) +40%, Placer Dome (email recommendation, Jan. 2002) + 20%, Versacold (August 2001) + 88%.

Previous mentions:

Taylor Gas, \$4.6 HOLD – Recommended at \$4.25 (Aug. 2000). Paid out 84 cents in distributions to date. Company is building an ethane refinery in Joffre, Alberta. Distributions should increase to 50 cents in 2003, with more upside if propane prices were to surge. I feel the stock has great long-term potential and would buy if it trades less than \$4.5.

Q-Media, \$0.81, HOLD – Recommended at \$1.15 (Dec. 2000). Q-Media is facing a very weak environment and is barely cash flow positive. Also the company has a high debt load that will make a recovery take longer. I do not anticipate the sector to improve till 2003 and as a result the stock may go lower till the outlook looks better. Because of this I would not suggest buying it and would hold while waiting for an exit.

Wajax, \$5.5, BUY – Recommended at \$5.2 (April 2001). The stock rallied to \$7 recently and has since settled back to \$5.5 after a weak quarterly report came out. I would continue suggesting a buy less than \$5.5 as long term the company is worth more.

Aberdeen Asia-Pacific Fund, \$8.4, HOLD – Recommended at \$7.2 (August 2001). Paid \$0.56 in cash distributions to date. I do not like the income trust sector any more as valuations are at high levels. This stock has a bond portfolio worth \$9.15/share. I would sell this holding near \$9 which is my target.

Rogers Sugar Income, \$4.6, HOLD/SELL – Recommended at \$4 (August 2001). Paid \$0.30 in cash distributions to date. Management approved the acquisition of Lantic Sugar which I feel favors management and insiders more than shareholders interests. As a result I have sold some of my position at \$4.85 and would get out in the future of the rest at these levels as I no longer like the long term potential of this company.

Versacold, \$8.5, SOLD – Recommended at \$4.25 (August 2001). Sold, at \$8 in January 2002. A return of + 88%.

Placer Dome, \$19, SOLD – Recommended at \$17 (January 2002). Sold at \$20.5 in February. A return of + 20%.

New ideas:

With the current markets I am finding it very difficult to find many good buys out there (especially large-cap, dividend oriented, and US stocks). As a result I prefer to wait until I feel there are better deals. There are several companies I am following that I may be mentioning soon but due to the fact I feel greater risk of downside I am opting to wait.

While it is good to invest long-term and to always be fully invested, it does not mean to always be fully invested in stocks. Sometimes it is good to be fully invested in guaranteed money-market securities...

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I feel it is only fair that they know I appreciate it.

**As a result I have initiated a policy where all client referrals receive gift
Certificates of \$50 / referral. Gift certificates for either Future Shop or
Earls Restaurants will be mailed out. I really appreciate
all of my clients and will work hard to do my best for them.**

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