

The Lychak Letter



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

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**Patrick Lychak, Investment Advisor
B. Ed., CSC, PFPC, CPH, Options Licensed**

Wolverton Securities Ltd.
17th Floor, 777 Dunsmuir St.
Box 10115 Pacific Center
Vancouver, BC, V7Y 1J5

Tel: (604) 662-5287
E-Mail: PatrickL@wolverton.ca
Website: www.avaluinvestor.com

Term	Cdn Govt Yield	US Govt. Yield	Cdn Rates
			Prime 4.5 % Bank 3.0 %
3 mo	2.9 %	1.64 %	US Rates Prime 4.75 % Fed. 1.7 % \$CDN = 0.64
6 mo	3.0 %	1.66 %	
1 yr	3.2 %	1.9 %	
5 yr	4.52 %	3.3 %	
10 yr	5.15 %	4.2 %	
30 yr	5.57 %	5.04 %	

Government Yields / Currency

I still have the opinion that overall rates will remain low for the next 6 months and should start rising in 2003. The reason why I feel rates will remain low is that the US economy and the stock market will continue to have weak performance over the next several months. The US government will thus not be inclined to raise rates as this would make the economic recovery take even longer. The US government also has the option of cutting rates further. But I believe this strategy would be very foolish as it would cause inflation to occur and real estate prices to escalate to bubble proportions. In the end would kill the US economy for many years instead of potentially far less which is why it is unlikely to happen. The only issue that could cause rates to rise sooner than a healthy economy is if the growing US government deficit causes foreigners to stop buying the low yielding US Government bonds and the US\$ declines substantially. The US government would then be forced to raise rates causing the yields on US bonds to rise resulting in foreigners resuming purchases of US government bonds. I believe the US\$ will decline gradually over the next few years but do not anticipate anything precipitous enough to cause rates to rise quickly. The end result is that rates should remain where they are for the rest of this year which will be good for many people with variable mortgages.

I still feel the Canadian dollar is beginning a long-term trend of rising in price. Canada's economy is healthier than most developed countries and consumer debt levels are not as excessive. Thus Canadians should feel a slowing in the economy but not as much as other developed countries. I am concerned that the federal government will have a tough time delivering a balanced budget this year and next as taxation revenue will decline. But if the federal government continues to deliver a surplus budget and continues to pay down Canada's federal debt our Country will have even better times ahead years in the future as eventually taxes will have the potential to decline. I can only dream this will be the case.

North America Stock Markets

Last newsletter I rambled quite a bit that I was very bearish on the markets, I thought US stocks were a bad investment, and that the economy was really not that healthy even though the newspapers were saying it was. Well, turns out I was right as evidence in the recent and continued weakness in the equity markets. And what is interesting is that now the economists actually are admitting that the economy is not that strong. Even worse is that now it is becoming apparent that many US companies were using creative accounting to show profits in order to justify their high share prices. Well I do feel that all of this will be positive in the end, but for now many investors are uncertain. Some investors are even giving up and selling their equity mutual funds. Now the papers are saying that we have hit bottom! Is this the case?

My experience tells me that when people are still brave enough to say that the markets have bottomed, they really just need to lose some more money. For example, what proof do I use to know when the markets are very expensive. Well, five months ago I sold all of my gold equity holdings. The reason was my mom asked me about buying gold stocks cause she heard someone mentioning it on the radio. Well, my mom is not that knowledgeable about the stock market, so when I hear someone wanting to do something that they really should not do it tells me that things are a little overvalued. Now I just as easily could have used a barber, or a taxi driver or someone else instead of my mom (sorry mom, I meant no disrespect) but the reality is that when everyone is buying something odds are prices will not be cheap. Since then gold stocks have actually dropped quite a bit and my mom did not end up buying any gold stocks (although I do feel soon will be a good time to buy gold stocks again). Using the above analogy to the current market situation tells me that because people still feel they can pick the bottom in the markets, the reality is that this will not be the bottom. You see, when a bear market

<u>Index (Aug 23, 2002)</u>	<u>Value</u>	<u>%chg/3mo</u>	<u>%chg/1yr</u>
TSE 300 Index	6629	- 14 %	-12 %
S&P 500 Index	939	- 14%	- 19 %
Dow Jones Industrial Avg.	8848	- 13 %	- 13%
NASDAQ Composite Index	1380	- 19 %	- 25 %

begins (and we are in a bear market) it can only end in a capitulation. Capitulation refers to everyone giving up. So evidence of a market bottom will be when everyone has lost hope and no-one is willing to buy no matter how cheap stock prices are. This situation will exist when everyone who holds equity mutual funds but really does not realize that they are not a guaranteed investment sells them, no one buys on the dips, mutual funds are in net redemptions for an extended period of time, and people have given up hope on their stocks for ever coming back in price. This situation does not exist yet as people (unsophisticated investors including) still have hope. When the majority of people do not have hope and have written off their investments then I will know the markets are a great time to buy. This may sound a little simplistic but those who have experience in the markets (whether it be stocks, cattle, grain, currencies, or real estate) know that this is the way markets and people behave.

I recently completed a review of all 300 companies composing the TSE300 Index. Financial data analyzed involved market capitalization, earnings, revenue, assets, liabilities, price/debt, price/book, price/sales, price/earnings and other data. My conclusion was that from a fundamental standpoint the markets were still considerably overvalued even today. On a scale of 1 to 10, with 1 representing the lowest that stock prices will ever go and the best time to buy and 10 representing the highest that stock prices will go and the worst time to buy the following numbers I would assign for the North American markets; Canada – 7, USA – 9. At 5 the markets would be trading at a fair price (not too expensive not too cheap). Ideally 3 or 4 would be perfect, but it takes a prolonged bear market of a few years to get prices this cheap. If prices in Canada declined by another 20% from current levels then we would be very close to a 5, but still not at the bottom.

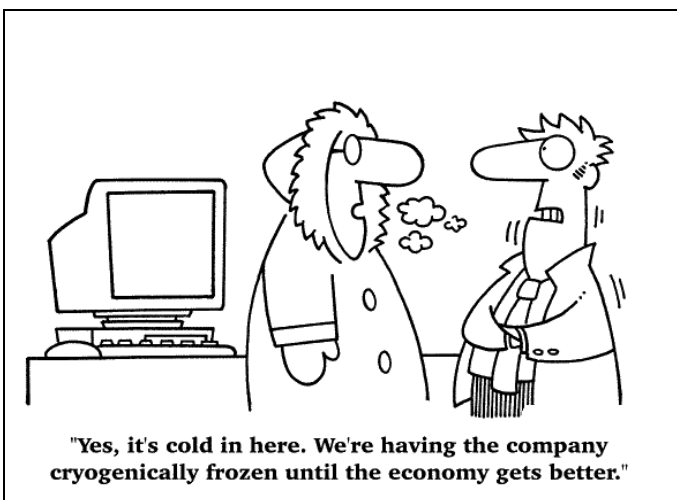
My feelings on the market is that this current rally will be short-lived and there will be another drop in the markets exceeding previous lows soon. I am hoping for this so that a mid term bottom will occur and a longer rally will have the potential to commence through the first quarter of 2003. I do expect that for the next few years the stock markets will be very tough. This tough period often follows bull markets and are healthy in the end. How long will this tough period last till a permanent bottom occurs and the markets are bullish again? Well I am waiting for my mom to tell me to sell all of her mutual funds. No seriously, I feel it will happen when stocks are trading at attractive prices again that are just too good to pass up (unlike the current environment).



World Markets

And if you think things are bad here in Canada and the US, well just go a little further South, say South America. In Brazil the currency, bonds, and the stock market have all dropped by 25% so far this year. Venezuela and Argentina have seen their currencies decline by 45% and stock markets have dropped as well. But the worst country has been Argentina where the currency has declined by 72% in the last 9 months. Now if you want to get a slightly higher yield on your GICs and do not like the rates here in Canada and the US of 3% and 2% respectively, the South American countries do have higher yields. Brazil's 10 year bond

<u>Index (Aug 23, 2002)</u>	<u>Value</u>	<u>chg/3mo</u>	<u>chg/1yr</u>
London FTSE 100 Index	4389	- 17 %	- 20 %
German DAX Index	3828	- 22 %	- 29 %
France CAC 40	3526	- 19 %	- 28 %
Brazil Stock Index	9694	- 23 %	- 24 %
Mexico Bolsa Index	6147	- 17 %	- 2 %
Australia ASX Index	3184	- 6 %	- 5 %
Japan Nikkei 225 Index	9867	- 18 %	- 12 %
Hong Kong Hang Seng Index	10245	- 12 %	- 8 %



has a yield of 24% and Argentina 72%. No that is not a typo, in Argentina you will get a return of 72% on your money, the only problem is the currency may decline even further eroding gains made in the bonds. And who knows the government may even default on the debt meaning you do not get your interest or principal back. As a result of these really high rates in South America people who borrowed money there are now in a lot of trouble as their debt servicing costs have gone through the roof. All of this happened because these governments developed very large government debts and the foreign countries stopped buying their bonds and unloaded them instead causing the currencies to plunge. This tells the story of what happens when governments run up large deficits and huge federal debts.

In regards to the global stock markets they have witnessed similar declines as the North American markets and I feel that the worst is still not over yet. I still am on the sidelines waiting for the time to invest in equities.

Commodity Markets

Oil prices are at historically high prices as fears of a disruption in oil supplies will result if the US attacks Iraq to oust Saddam Hussein. However it is unclear if there is enough support for this action to happen so prices are currently ahead of themselves. Especially since it appears the other Arab countries are reluctant to support the US. It would have to take some major terrorist action directly linked to Saddam to justify attacking Iraq. Barring this from happening, oil prices are unsustainable at these levels based on demand.

Commodity	Price US\$
Crude Oil	\$29
Gold	\$312

The price of gold has softened a bit in the last few months, however the share prices of gold producers have declined far more substantially. Why is it that the gold stocks have dropped so much? Well, quite simply became too popular and the share prices overvalued. A few months ago everyone wanted to buy gold stocks and the result was prices became extended. Prices will naturally correct in order to prepare for the next leg up. This correction is what is happening now, and will likely be followed by another rally in gold stocks potentially next year. While I have not yet started buying gold stocks again I do feel a good opportunity to buy will present itself very shortly as long term the fundamentals for a stronger price of gold are positive.

Fixed Income

Following is a list of bonds and debentures that I feel offer a good yield and reasonable quality. Yields have dropped a little since the last quarter and I still am suggesting terms of 1 to 3 years as I expect rates will gradually rise. Please note that the rating BBB or higher is investment grade and very good quality. Ratings below this are poorer quality which is why I cannot recommend them but I wanted to illustrate how the yields of these bonds are much higher.

- Chrysler, June 2003, BBB+ 4%
- Bombardier, July 2003, A- 5%
- Hudson's Bay, Dec. 2003, BB+ 9.3%
- GMAC, June 2004, BBB+ 4.8%
- Telus, August 2004, BB+ 10%
- Shaw Com., April 2005, BBB 9.3%



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Focus Stocks

Results of previous stocks recommended in the newsletter 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%, Aberdeen Asia Pacific (First Australia Prime) (August 2001) +40%

Previous mentions:

Taylor Gas, \$4.6 HOLD – Recommended at \$4.25 (Aug. 2000). Paid out 94 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, \$0.2, HOLD – Recommended at \$1.15 (Dec. 2000). Company is facing a very weak environment and the future is uncertain. Will likely take a year before the profitability of the company improves.

Wajax, \$4.75, BUY – Recommended at \$5.2 (April 2001). The stock is trading at low valuations and has good potential from these levels.

Aberdeen Asia-Pacific Fund – SOLD at \$8.7 - \$8.8 as price target was achieved and future potential was limited.

Rogers Sugar Income, \$4.6, HOLD/SELL – Recommended at \$4 (August 2001). Paid \$0.40 in cash distributions to date. Do not like management's insider motivated actions and would sell at \$4.8.

Agricore United, \$6.15 BUY – Agricore United is an agribusiness that sells crop inputs to farmers and transports grain to the port facilities. I previously recommended this stock at \$9.15 in May and later suggested in an email to sell at \$9.6 as the prairies were facing a drought. With the drought now a reality the price has dropped substantially and trades at very low multiples. The company has excellent long-term potential and while the share price should remain weak these next few months by January investors will already



"Did you just say that anyone who asks another question will be fired?"

start forgetting last years poor crops and will begin focussing on next year. By April, the stock price should recover far more and if next year turns out to be a normal year the stock price should reflect the positive cash flow and an even high share price. I feel the stock could trade at previous valuations of \$10 - \$12 by January 2004 barring any further droughts.

New ideas:

With the current markets I still am finding it very difficult to find any good buys. As a result I prefer to wait until I feel there are cheaper prices. 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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