The Lychak Letter

"A Quarterly Analysis of Bond and Stock Market Trends Worldwide" **March 2003**

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Term	*Cdn Govt Yield*	*US Govt. Yield*	*Cdn Rates* Prime 4.75 % Bank 3 %
3 mo	3.14 %	1.18 %	
6 mo	3.3 %	1.19 %	*US Rates*
1 yr	3.5 %	1.4 %	Prime 4.25 %
5 yr	4.24 %	2.6 %	Fed. 1.25 %
10 yr	4.93 %	3.64 %	
30 yr	5.44 %	4.67 %	$CDN = 0.67

Government Yields / Currency

On March 4th the Bank of Canada raised the bank rate a quarter of a point to 3% to rein in the fastest inflation in more than a decade. Canada's economy (the smallest in the G7) expanded at 3.4% in January and is expected to have the strongest economy this year out of it's G7 peers. The main reason is rising commodity prices have boosted the revenue from exports which accounts for 45% of Canada's economy. Because of expectations that Canada's economy should do well this year, the Bank of Canada has been stating that rates are likely to rise more (next meeting is April 15, 2003). Canada's stronger economy and higher interest rates have resulted in the Canadian dollar rising to a high of 67.5 cents recently. Funny, you do not hear those "experts" mentioning we should convert to the US dollar anymore when they thought it was a great idea when the loonie was 62 cents? My outlook is that interest rates are likely to rise a little more in the coming months but I do not expect large increases. The main reason is I feel the stock market and the world economies will have a very tough year (again) and this will cause most central banks to keep rates low. As a result we may see slightly higher rates and a stronger Canadian dollar near 70 cents later this year.

In the US rates have remained at record low levels (bank rate of 1.25% vs. Canada's 3%) resulting in US residents to bid up real estate to record highs. The main reason is the low deposit rate for investments vs. the affordability of a mortgage. The reason the US government has dropped interest rates to such low levels is to try to revive and maintain the US economy as well as US stock market valuations. Well, I do not believe the government will be successful and I feel that ultimately US stock market valuations will drop considerably, the US dollar will continue declining, and the US trade deficit will continue to get worse. Eventually the US government will have to raise rates in order to get investors to buy US Government debt. The reason rates will eventually rise is the US government has a growing budget deficit, growing total debt, and consumer debt is at high levels as well. Basically, this is just a cycle and while the government would like the economy to always be strong eventually corrections occur and trying to avoid one often prolongs the weakness till eventually the bottom is reached anyways. Because the government has intervened by lowering rates dramatically they are likely just prolonging the inevitable as rates cannot be lowered any more and eventually they will rise. I do not expect rates in the US to rise soon though, it will happen after investors become concerned about the growing deficit or the US economy recovers and rates need to rise to prevent inflation. Overall I expect rates to remain low in the coming months along with a weak economic environment and a declining US dollar.

North America Stock Markets

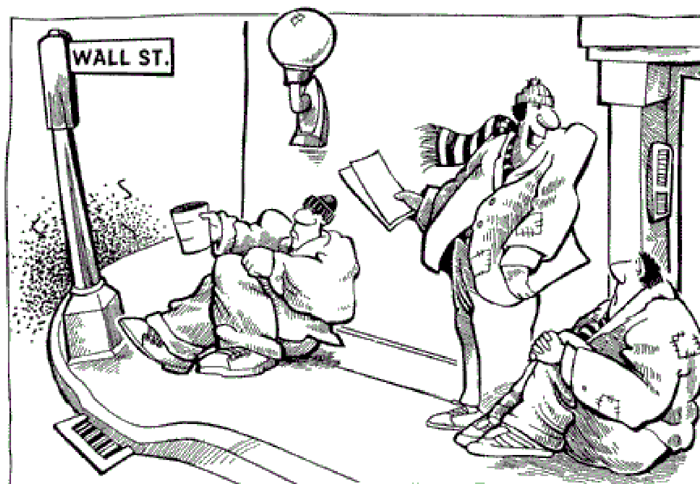
Index (March 5, 2003)	Value	%chg/6mo	%chg/1yr
TSE 300 Index	6422	- 14 %	-19 %
S&P 500 Index	821	- 2 %	- 28 %
Dow Jones Industrial Avg.	7704	- 9 %	- 28 %
NASDAQ Composite Index	1307	+ 1 %	- 30 %

What do the experts think about the markets? Well, this is what billionaire investor Warren Buffett stated on March 3rd. He said, "We continue to do very little in equities. Despite three years of falling prices, which have significantly improved the attractiveness of common stocks, we still find very few that even mildly interest us."

My opinions of the markets is that yes, overall they still are very expensive. I have noticed though that some countries have declined more than others. I will compare these differences in more detail in the World Markets section. Comparing Canadian equity valuations vs. the US I have found that US valuations are considerably higher. This indicates that the US market has far greater downside than Canadian equities. If you were to also factor in the fact that the Canadian dollar has been rising lately and is expected to continue rising, your downside in Foreign denominated assets (like US stocks) is even greater. This leads me to continue avoiding US equity investments. Now I know most people think that the reason for the weak equity markets and economy is because of the potential war with Iraq, right? Well, that is the message that the newspapers and media seem to say. But, I do not feel this is the case at all and the real problems with the economy are not really being stated. The potential war with

Iraq is only having one major impact. It is causing short-term (meaning duration of less than a year) prices of oil to rise to record high levels. The last time there was a war in Iraq (Gulf War), as soon as the war started prices plummeted and in 4 months oil had dropped from $40/barrel to $17. And this was despite the fact Iraq blew up most of their oil wells and it took 6 months to put out all of the fires. The impact that higher oil prices are having is to increase expenses for consumers (transportation & heating) thus reducing disposable income. While this is having a short-term negative impact on the economy it is not expected to last.

The real problem with the economy is over-capacity. Industry has too much capacity built up over the previous 10-year expansion when companies expected that growth would continue indefinitely. Now faced with a recession this over-capacity is resulting in under-utilization of assets. The only solutions are to either shut down factories and fire employees now, or wait several years till the economy and demand grows to meet this capacity (this often takes many years). The layoffs that have been announced over the recent months indicate this is being addressed by many businesses (e.g. Bombardier announcing they will layoff 3000 employees on March 5th). But some businesses do not have a flexible labor force to do this and as a result are headed for a dramatic climax (e.g. United Airlines in bankruptcy protection). One area that I feel is very vulnerable is the auto industry. These companies have high labor costs and have balance sheets burdened with lots of debt. When these companies are faced with an economic slowdown it is often too expensive to reduce their workforce due to inflexible union arrangements. Thus the easiest way they will initially try to survive is to somehow keep selling as many vehicles as before thus keeping production at high levels and hope that the demand picks up again. They have been able to do this up till now by offering many rebates on vehicles. But the problem is this has resulted in many buyers entering the market sooner and now demand is likely to soften. Add to this problem their massive pension liabilities and you have something that can get much worse and will require eventual downsizing.



"Just be careful. Last week somebody gave me their entire foreign investment portfolio and I ended up owing 10 million bucks."

What is a pension liability? Well, companies have pension plans for their workers that pay them a set amount when they retire. These accounts are funded by taking part of an employee's pay now and investing it in investments (stock and bonds) to grow the principal and eventually pay out the benefit. Well, investment returns have resulted in losses recently and now many companies are a few billion dollars short of being able to pay out retirement benefits. The only solutions are to reduce the benefits to retired workers, or have all the company's profits go to making up pension shortfalls for many years (this would result in the company not being profitable for a while). And if the stock market declines further the shortfall will get worse.

Another big problem with the US economy is that the economic downturn has been insulated dramatically by a home-refinancing boom. With the large drop in interest rates, people have refinanced their mortgages resulting in lower mortgage payments and more disposable income. While this has resulted in real estate prices rising dramatically and many people opting for a variable mortgage, this boom is already ending as rates are likely to only go higher. Thus it is anticipated that house prices will flatten, potentially decline, and consumer spending will start weakening as mortgage payments rise. This will likely make an economic recovery harder in the future.

Overall I expect this year to be quite weak and the markets may exceed previous lows. I really would like to see the markets fall apart and bottom that way we could get this period over with, but this is unlikely to happen as so far everything has progressed quite slowly. This is just a corrective cycle that needs to run it's course and in the end the markets will go up once they represent a good value again

World Markets

Index (March 3, 2003)	Value	chg/6mo	chg/1yr
London FTSE 100 Index	3625	- 10 %	- 31 %
German DAX Index	2501	- 27 %	- 52 %
France CAC 40	2676	- 16 %	- 42 %
Brazil Stock Index	10280	+ 1 %	- 29 %
Mexico Bolsa Index	5911	- 3 %	- 16 %
Australia ASX Index	2787	- 10 %	- 19 %
Japan Nikkei 225 Index	8451	- 8 %	- 26 %
Hong Kong Hang Seng Index	9181	- 5 %	- 17 %

If you think the stock markets have dropped dramatically here in Canada, well things have been much worse in other parts of the world. In the last year the TSE300 index declined 19%, while most European markets declined on average 40% and Asian markets declined 20%. Some of the worst performing stock markets in the world last year were; Germany (-52%), Amsterdam (-49%), France (-42%) and Switzerland (-38%). If you consider how these markets have done in the last 3 years it gets even worse; Germany (-70%), Amsterdam (-62%), France (-59%) and Switzerland (-45%). This is without factoring in the impact of the rising Canadian dollar. When examining US investments, because the Canadian dollar has been rising against the US dollar losses in US Equity funds are increased. This does not present a strong case for investing internationally when most international markets have performed worse than Canada (especially Germany –70%). That means if you invested $100,000 in German stocks, your portfolio would now be worth $30,000. This decline in Germany may cause some of you to think that now is a good time to buy. And it is also quite likely that those who are thinking now is a good time to buy in Germany are also the same people thinking now is a good time to buy in the US. Well, if the US market had the equivalent drop as the German markets, that would give the S&P500 and Dow Jones Industrial

Average indexes respective values of 450 and 3360 compared to their current values of 821 and 7704. This indicates that they would have to decline another 50% in value to match the drop in the German market!

The best way to compare valuation levels of various countries is to look at the stock market indexes of each country and compare the price/book value and price/sales value against one another. If you look at the chart on the right you will see that the US market is more than twice as expensive as German stocks and Canada is very similarly valued as Japan. Overall, my conclusion and opinion is that European stocks now have the least downside and represent good value while the US market still remains the most overvalued. The reason why the US market has remained so expensive is that in the last bull market the US stock market was the leader. Usually the leaders tend to drop last as it often takes people a while to change their strategy from what worked in the most recent years. While I am now interested in investing in the European markets I still am cautious. The reason is that these markets are still likely to follow the lead of the US market. As long as I feel the US market will go lower it is quite likely most other markets will do the same or have limited upside. The opportunity to invest will be once the US markets have declined some more. At that point it would be best to analyze all markets and determine which represents the most opportunity. I am hoping this will coincide with a higher Canadian dollar later this year.

Index	Price/Book	Price/Sales
DAX (Germany)	1.02	0.33
S&P 500 (US)	2.52	1.18
TSE 300 (Canada)	1.76	0.89
NIKKEI (Japan)	1.53	0.83

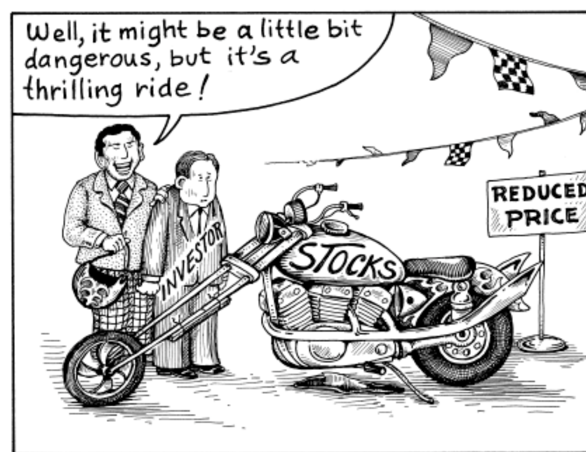
Commodity Markets

I guess one of the current issues on everyone's mind is how the potential war with Iraq is causing high oil prices. But it has been a combination of factors that have caused prices to go where they are today. A two month strike in Venezuela (world's 5th biggest oil exporter) initially disrupted supply dramatically. This in combination with uncertainty over the oil in Iraq accounts for 7% of the world's oil supply. The strike in Venezuela is now over and countries like Russia are dramatically increasing their oil production. This in combination with the fact that actual demand for oil is lower due to the global economic slowdown leads me to believe what happened in 1990 will likely repeat itself. What happened in 1990? Well, the Gulf War (or the first time the US attacked Iraq). Now I am not saying I feel the US will attack Iraq, but I do feel the price of oil will drop (for similar reasons as in 1990). The actual war started on January 17th, 1991 and lasted until February 28th (about 5 weeks). However the price of crude oil was at its highest ($37/barrel) in September to October of 1990. It then began dropping all the way to $17/barrel at the end of February 1991 (end of the war). The chronology of events is as follows: On August 2, 1990 Iraq invaded Kuwait. This disrupted oil supplies and caused oil prices to peak in September 1990. From September 1990 on, the US began planning and arranging the counterattack that was launched on January 17th 1991. But the price of oil had already fallen dramatically leading up to the counterattack and remained low even after the war was over, even in spite of the fact that Iraq had blown up most of their oilfields and sabotaged their capacity to produce oil. This illustrates the fact that during periods of uncertainty prices are often at their worst and once it was clear the war would begin the price of oil began dropping. This same scenario is likely to repeat itself here. The price of oil is likely not sustainable at current levels as the demand for oil is lower than the supply. But because of the potential disruption, oil prices are remaining at high levels. The moment it is clear that a war will either begin or not begin it is likely oil prices will decline. And if this drags on any longer the price of oil may drop anyways as the uncertainty will gradually be discounted.

Commodity	Price US$
Crude Oil	$37
Gold	$350

The price of natural gas has also risen dramatically as well but for different reasons. This winter has been far colder than normal and as a result the gas in storage is down 47 percent from a year ago. In seasons where the Winter is colder than normal, gas prices tend to peak in February. Prices should decline from now till Summer as the weather will only get warmer and storage levels are gradually replenished. Thus it is expected that natural gas prices will soften from now till Summer (this tends to be a normal cycle).

Gold has risen as well recently hitting highs of $380 on February 4, 2003. The reasons have been decreasing production, a declining US dollar, and global uncertainty. I mentioned in the last newsletter I expected gold to have another rally and this rally that peaked so far in early 2003 is likely to be it for a while until a period of consolidation passes. The funny thing though is that the senior producers (Barrick and Placer Dome) did not really rise in price even though the junior producer share prices advanced substantially. I feel the reason for this is the senior producers were penalized because they have larger hedged positions and did not benefit as much from the rally in the price of gold. Now this sets the stage for interesting events in the future. What may happen now is because the senior producers are under a lot of pressure to reduce their hedge positions, they likely will do so (but it will take time to do this in a normal fashion). This may bring about the ingredients necessary for a higher gold price a couple years in the future (meaning another buying opportunity to buy gold producers will likely present itself). I am not buying senior gold producers now but am watching and likely later this year we may see opportunities present themselves in the gold sector.



Fixed Income

For the last several months the Bank of Canada has been stating they will raise the bank rate (interest rates). On March 4th the Bank of Canada followed through with it's public statements and raised rates a quarter point to 3%. It is expected that rates will rise more later this year potentially by as much as another 1% to 4%. While short-term rates have been rising long-term rates have not. The reason is that the stock market and the global economies currently are performing poorly and the outlook is weak. As a result I anticipate long-term rates to remain low for the next few years until the global economies gradually recover. As a result I would suggest buying bonds with short-term maturities till later this year (when it is expected rates will be higher than current levels). Then later this year buy bond maturities from 1 to 3 years duration for an optimum overall return.

Following is a list of bonds and debentures that I feel offer a good yield and reasonable quality.

- Hudson's Bay, Dec. 1/03, BB+, 5%
- Poco Petroleum, Dec. 3/03, BBB+, 3.26%
- Alberta, Dec 10/03, AA, 3.15%
- Trans Alta Util., Oct.13/04, BBB+, 4.27%
- Manitoba, Nov. 15/04, A, 3.4%
- Telus, June 1/2006, BBB, 7%

Hudson's Bay is rated BB (non-investment grade), but because of the short maturity the default risk is lower and the yield of 5% is attractive. Telus has reduced expenses and while it has a high debt burden it will carry for many years, the default risk has decreased making the 7% yield attractive. Bombardier is mentioned below because it's bonds have dropped dramatically in price recently. While the bonds are rated BBB it is known that they will have their ratings cut soon to BB+ or BBB-. However it is anticipated they will be issuing stock very soon to reduce their debt. If this happens these bonds will strengthen in price once the offering is done and Bombardier's credit risk improves. While these bonds are rated investment grade I feel they are not suitable for low risk investors, and should only be considered for more risk tolerant investors.

- Bombardier, Nov. 29/04, BBB+, 13.5%
- Bombardier, Jul. 19/06, BBB+, 14%

Focus Stocks

I have decided to change this section to mention stocks or investments to consider. I will not be tracking investment performance any more as I have found that I buy/sell in between newsletter issues and it is not fair to post results after-the-fact. I am currently monitoring many investments and will include them in the next issue.

"I retire on Friday and I haven't saved a dime. Here's your chance to become a legend!"

"I predict most brokers will come to work today in suits. Most will buy and sell stuff."

Please note the website where I post past issues of the Lychak Letter has been changed to!
www.wolverton.ca/patrick

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