

# The Lychak Letter



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

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Term	Cdn Govt Yield	US Govt. Yield	Cdn Rates
			Prime 4.75 % Bank 2.75 %
3 mo	2.6 %	0.98 %	
6 mo	2.56 %	1.05 %	US Rates
1 yr	2.6 %	%	Prime 4.0 %
5 yr	3.88 %	3.46 %	Fed. 1.0 %
10 yr	4.90 %	4.48 %	
30 yr	5.38 %	5.26 %	\$CDN = 0.71

## Government Yields / Currency

The battle going on amongst most countries now is who can achieve the lower currency. The reason for the battle is the global economic weakness. Countries are trying to weaken their currency in order to stimulate more trade and economic activity. The weapon of choice is the central bank rate. By lowering the central bank rate countries can make their currency less attractive to foreign investors thus weakening it. The countries that are most aggressive at maintaining a low bank rate are currently Japan with a bank rate of 0.15% and Switzerland with a bank rate of 0.75%. This is no surprise as Japan is desperately trying to get out of a 14-year bear market and Switzerland has found their high currency has resulted in Swiss goods and services being far too expensive relative to the rest of Europe. The award for the highest rates goes out to Turkey (32%), Brazil (22%) and Russia (16%). The instability and higher political risk of these countries pretty well sums up why they have higher bank rates. The average central bank rate among G7 members currently is 2%. Canada recently found that raising rates too aggressively earlier in the year caused the Canadian dollar to soar and weakened the economy. The central bank promptly cut rates twice since then to 2.75% erasing previous increases.

The country that appears to be leading the cuts in the central bank rate is (no surprise) the country that led the previous stock market rally, the United States. The United States has lowered rates dramatically in the last 3 years in order to stabilize/revive the US economy. This resulted in the 3-month US Treasury Bill yield to decline from 6.5% (2000) to 1% where it currently is today. In addition to lowering rates the US government also reduced taxes and increased military spending. This has resulted in what I feel is a short-term solution that will result in longer-term problems. The main problem that I see is the growing US government debt. The deficit projected for this year is estimated at \$455 billion and \$500 to \$600 billion next year. Increasing federal debt may weaken the economy due to the potential for rising interest rates as federal debt competes with corporate debt. As the US government increases the issuance of government debt securities investors will start demanding higher yields. This will likely push up interest rates and eventually be beyond the government's control. Signs of this are appearing now as the 30-year US Government Bond rose from 4.25% to 5.25% over the last 2 months. As the US government debt continues to grow interest rates will start climbing. This will weaken the appeal of the stock market and increase the cost of real estate potentially further weakening the economy. In addition the higher rates will make funding the federal debt more expensive. Eventually the government will have to increase taxes and cut spending in order to



balance the budget. But this will further weaken the economy and not make many people happy. It will be a very tough pill to swallow, however it is what should have been done all along. But then again, which President would want to knowingly initiate a policy that would cause the stock market to plummet dramatically in the short term even if it had better long-term results? Presidents will naturally try to make their term be remembered as a good one, even if their policies result in following years being far, far worse. Because at that point when things go really bad, the public will then accept their fate and will elect a President who they know will make many hard cuts. But that is what I believe the future has in store for the US and it will be felt on a global scale.

I actually am quite optimistic about Canada's long-term future. Our country has a high deficit but most of the public is still in favor of reducing it so this will benefit our economy in the long term. Our currency pricing makes global trade adequate and our educated work force and abundance of commodities is also favorable. The best thing the next government could do is to bring renewed focus to reducing the governments debt. This would result in long-term benefits of reduced taxes and increased spending on health and education. While I expect interest rates to remain low in the coming 6 months I also expect a long-term trend of rising rates to begin after the first quarter of 2004. This will be the result of Canada having to follow the US government as they are forced to raise rates due to their growing federal deficit. I also feel the Canadian dollar will continue rising and this eventually will hurt Canada's trade with the US. Do not be surprised if in 3 years the Canadian dollar is > 80 cents.

## North America Stock Markets

Back in March Warren Buffet stated that he felt there was little value in the markets. Knowing the markets have rallied since March, I imagine he sees even less value now. I know the media is pumping the story that the economy is recovering but the reality is that the methods being employed currently are unlikely to be maintained.

<u>Index (August 24, 2003)</u>	<u>Value</u>	<u>%chg/6mo</u>	<u>%chg/1yr</u>
TSE 300 Index	6422	+ 15 %	+ 13 %
S&P 500 Index	821	+ 18 %	+ 5 %
Dow Jones Industrial Avg.	7704	+ 18 %	+ 5 %
NASDAQ Composite Index	1307	+ 32 %	+ 28 %



The US government is pouring gasoline on a weak fire in order to keep the fire going. The fire is the economy and the gasoline is the income tax cuts and increased government and military spending. However the government only has so much gasoline and when it runs out the tax cuts will be reversed and the government will decrease military and government spending. This is not too far away and at that point the true strength of the economy (or weakness) will be revealed. As a result I believe the economy will have an even more difficult period in the coming years as the US government eventually has to increase taxes and reduce government spending.

I recently completed a review of all stocks composing the TSE 300 index and found few that were really attractive. I believe we are in period where the equity markets are going to be stuck in the mud for a few years and performance likely will be flat. This is likely to be characterized by stock market indexes rallying and then declining over the course of the year. This will be repeated until either the stock market indexes decline and become valued attractively or time passes and companies grow to eventually be worth the current pricey valuations. The future I feel will be similar to the period from 1964 – 1974 where the North American stock markets had little growth. This period was characterized by stock market rallies followed by declines that erased all gains. During this period the TSE 300 Index had a 10-year return of 3.3%. If the stock market has this extended period of weakness it is likely investors will finally become more focussed on how much they are paying for a company. I feel the best strategy to use if this scenario unfolds is to take advantage of the rallies and to switch asset allocation from stocks to money market securities and then wait out the decline and then buy back in again. This market timing strategy though is very hard to implement and is not suggested for novice investors.

## World Markets

I feel the world markets are still following the lead of the US markets so the recovery we have had in most of the International markets is to a large extent just a rally and not a new bull market. As a result I expect any weakness expressed in the North American markets to be duplicated internationally. I still do not see the prerequisites for a foreign country to have a long-term bull market. An interesting point is that the German stock market performed the best in the last 6 months and I noted in my last newsletter that Germany had the lowest multiples of the G7 countries!

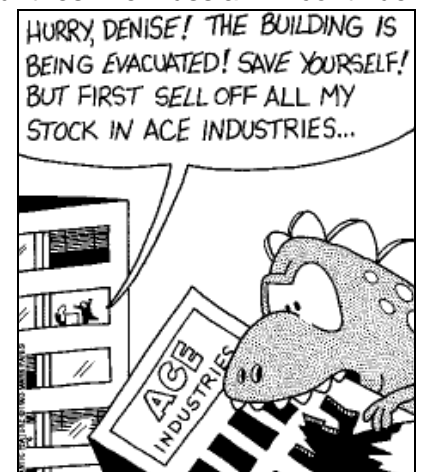
Index (August 24, 2003)	Value	chg/6mo	chg/1yr
London FTSE 100 Index	3625	+ 17 %	- 4 %
German DAX Index	2501	+ 43 %	- 7 %
France CAC 40	2676	+ 24 %	- 6 %
Brazil Stock Index	10280	+ 43 %	+ 51 %
Mexico Bolsa Index	5911	+ 27 %	+ 22 %
Australia ASX Index	2787	+ 13 %	+ 1 %
Japan Nikkei 225 Index	8451	+ 23 %	+ 4 %
Hong Kong Hang Seng Index	9181	+ 17%	+ 5 %

## Commodity Markets

The price of oil has dropped from the highs reached during the Iraq conflict but are within the range that OPEC desires of \$22 - \$28 a barrel. The period of high prices that has endured over the last few years has resulted in supply from sources other than OPEC to rise dramatically. As a result it is likely that we may be heading for a period where the price of oil may go much lower than OPEC may want in the future. Because even if OPEC decides to reduce supply if the price of oil declines below \$22/barrel, countries like Russia will continue their exports thus reducing the effectiveness of OPEC. And because of the weak global economic environment most countries are facing it is unlikely they will want to reduce production that much. I am expecting lower oil prices in the coming months and lower oil prices for 2004.

Commodity	Price US\$
Crude Oil	\$27
Gold	\$376

Natural gas prices have remained strong these last few years and the main reason is the increase in demand. In the last few years the rise in homes being constructed that require gas for both heating and cooling and more natural gas fired co-generation plants constructed has increased the demand for natural gas considerably. This increased demand has not been met adequately with the current supply and with declining reserves in the US the search for natural gas is now taking producers further and further north. The high prices have resulted in more discoveries in Canada and now it seems supply is exceeding demand but not by much. As a result prices are expected to remain high over Winter with estimates of \$4.75 per million Btu. However prices for natural gas are likely to remain high until pipelines accessing the gas up North are constructed.



The price of Gold seems to be hitting new highs as the outlook for a weak US dollar makes the metal cheaper to buy. This plus the weak economic and equity environment makes gold a good alternative. However, I am not likely to recommend gold stocks as investments at the moment. Most have already advanced so much in price that they do not seem like a good investment but more of a source of insurance. I do expect the price of gold to remain near current levels but it is quite possible for gold stocks to have a pullback.

## Fixed Income

If your asset allocation dictates that you should hold certain a certain percentage of income in your portfolio or if you have a requirement to buy bonds, then you will be disappointed with the yields in the current market as they are very low. The Bank of Canada initially started raising rates early in the year, but when this caused the dollar to strengthen (and the economy to weaken) the central bank then decided raising rates was really not that good an idea yet. As a result it is following the US's lead and is more or less matching their low level of interest rates. Thus Canadian yields in the bond market are quite low for investment grade bonds.

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

- Hudson's Bay, May 13/04, BB+, 4.4%
- Bombardier, Nov. 29/04, BBB-, 4.4%
- CDN Tire, Dec 1/04, BBB+, 2.6%

Hudson's Bay is rated BB (non-investment grade), but because of the short maturity the default risk is lower and the yield of 4.4% is attractive. If you would like a higher yield and a little more risk then you may want to consider Magellan Aerospace Debentures. They have a coupon of 8.5% and a maturity of January 31, 2008. However, because these debentures trade at a discount to par the actual yield is closer to 11%. A convertible feature into common stock also gives added upside potential. Because the company is involved in the airline sector it is currently in a weak environment and has considerable risk until this sector improves.

**Please note the website where I post past issues of the Lychak Letter has been changed!**

The new address is:

[www.wolverton.ca/patrick](http://www.wolverton.ca/patrick)



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