

The Lychak Letter



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

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Government Rates / Currency

Term	CAN Gov. Yield	US Gov. Yield	CAN Rates
			Prime 4.25% Overnight 2.5%
3 mo	2.5%	2.8%	US Rates Prime 5.75% Fed Fund 2.75%
6 mo	2.6%	3.1%	
1 yr	2.8%	3.5%	\$CDN = 0.82
5 yr	3.7%	4.1%	
10 yr	4.3%	4.4%	
30 yr	4.7%	4.7%	

The Bank of Canada has left its target overnight lending rate unchanged at 2.5% since October. David Dodge has stated that, “eventually rates are going to have to be higher than they are today in order to keep inflation at the central bank’s 2% target”. Overall opinions are that the central bank will continue to leave rates at current levels in order to prevent further appreciation of the Canadian dollar. This is not desired as it will hurt Canadian exports. As the US Federal Reserve raises rates further this will weaken the Canadian dollar and give room for the Bank of Canada to raise rates later in the year. The central bank schedules eight interest rate announcements a year, and the next ones are April 12 and May 25. It is anticipated there will be no change to rates on these dates.

The US Federal Reserve has raised the federal funds rate 7 times since June 2004 from 1% to the current level of 2.75%. The Fed is trying to steer rates to a level that will keep the economy growing without speeding inflation. Recently the Fed has stated that, “pressures on inflation have picked up in recent months and pricing power is more evident.” The Federal Reserve is concerned because the string of interest rate hikes in the last several months has done little to long-term consumer borrowing rates (which currently are still very low). The Fed felt that the rate hikes would force up long-term rates and prevent inflationary pressure by slowing consumer spending. It is this consumer spending that is causing commodity prices to reach record levels and build inflationary pressure. The Fed is anticipated to raise the Federal Fund rate by a quarter point at the next 3 meetings with a long-term goal of 3% to 5%.

My concern is that the central banks have left interest rates too low for too long and the impending inflationary pressures will be more dramatic than anticipated. Rates will need to be hiked more aggressively than the neutral target of 3% to 5% in order to bring things back under control. This scenario unfolded back in the late 70s early 80s and was marked by crude oil reaching all time highs and dramatic interest rate increases as high as 20%. Back then the government waited far too long to raise rates and the consequences were very severe. I do not feel rates will move up that substantially as the situation is not the same yet, just that rates will move higher from current levels. The recent strength in the price of oil has the central bankers very nervous at the moment and they are all hoping that oil will go back down. The future price of oil in the coming years will have a big impact on what the central bankers will do next....

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North America Stock Markets

Strong commodity prices and the strengthening Canadian dollar have resulted in the Canadian stock markets to outperform the US. The top-performing sector has been energy with an increase of 42% in the last year and 26% in the last 6 months. This is the direct result of record profits due to the high price of oil. The other strong sectors in the last year

have been telecom (+15%), consumer staples (+13%), and financials (+9%). On the other hand technology and health care (biotech) stocks have been the worst performers with both losing 27% year to date. Telecom and utility stocks have done well as many people have been attracted to the dividend yields they offer in the current low interest rate environment we are in. Consumer staples have done well as many investors seek protection from a decline in the markets by buying defensive positions. Financials continue to do well due to the strong bank profits that have been typical with the declining interest rate environment we have seen for the last decade. Technology and health care stocks were the market darlings of the last bull market and their lofty valuations do not make them attractive. The past is easy to explain; it is the future we wish to know.

<u>Index (Apr 3, 2005)</u>	<u>Value</u>	<u>%chg 6mo*</u>	<u>%chg 1yr*</u>
TSE 300 Index	9638	+ 9 %	+ 9 %
S&P 500 Index	1172	- 1 %	- 5 %
Dow Jones Industrial Avg.	10404	- 2 %	- 8 %

* returns are expressed in Canadian dollars

Currently at 32% the financial sector makes up the bulk of the TSE index. This is the direct result of the profits banks have made in the declining interest rate environment we have been in the last decade and the higher than historic multiples bank stocks are now being awarded. However, we may be in the early stages of a potential rising interest rate environment. If this unfolds the banks will not be as profitable and will trade at lower multiples. I would tend to avoid this sector of the market. Dividend paying stocks will also suffer in a rising interest rate environment as their yields become less attractive to the current rates. The best performing sector will likely be oil and gas producers or the energy sector as they make record profits with the high price of the underlying commodity. This does result in one small problem though. It is a known fact that energy/resource stocks lead the final rally of a cyclical bull market. If energy stocks continue to perform then the resulting correction when it comes will end up being a bear market that potentially may exceed previous lows reached in 2002. Ron Meisels (a stock market veteran and technical analyst) has talked about this scenario unfolding already and I tend to agree with him. He writes a column and appears in the media often and his opinions are worth listening to. If interested I can forward some of his articles on this subject.

In summary I still like energy stocks even with the strength we have seen to date. The market appears to be undergoing a correction so buying opportunities may present themselves in the future as prices weaken. Stocks that can have consistent earnings in spite of rising commodity prices will also likely perform well. To be successful in this market environment individual stock picking will be more important than broad market investments.



Top Stories

Oil \$105 a barrel?

A few weeks ago I read an article about the oil crisis from 1979 to 1985 when the price of crude oil soared in price to \$34/barrel. In today's inflation adjusted dollars that is the equivalent of oil trading from \$70 to \$80 a barrel. With oil currently at \$57/barrel and many asking when will the price of oil go back down to normal levels, it is becoming apparent that the stage for a repeat of that scenario has been built. The high oil prices during the early 80s caused both inflation and interest rates to soar. It forced many oil producers (who were making record profits) to aggressively drill for increased production like never before. This had a dramatic result of increased global oil production. The high interest rates curbed people's spending and forced them to stop consuming and start paying down debt (if they had not gone bankrupt). The high inflation (most noticeably at the pumps) forced many to sell their gas guzzlers and buy economical, fuel-efficient vehicles. The result was that after a few years the consumption of oil decreased while the production of oil increased leading to the eventual collapse in the price of oil in 1986. The price of oil remained low for several years after and resulted in many oil producers going bankrupt soon after. Companies that had gambled to increase production by taking on debt (hoping to pay off the debt with the high profit margins during the boom years) now found the collapsed price of oil did not generate enough money to service their debt. The high profile collapse of many oil producers and giants caused many executives in the oil industry to grow production far more cautiously in the years following. This has been the environment we have been in for

the last 20 years and we have been fortunate to have relatively cheap gas for our vehicles. So cheap and for so long that people have become complacent and expect gas prices to always be cheap (just like they expect interest rates to always be low). Well the stage has been set and the low interest rate environment we have been in for so long has caused consumption to be the norm. People seem to be buying the biggest vehicles, everyone wants to own a house or many, and the result is manufacturing locally and abroad has fueled escalating commodity prices (metals and energy). However, even though gas is now almost \$1 a liter it doesn't appear to cause people any concern or convince them to buy a fuel-efficient car. The governments though are deeply concerned with the rising price of oil and want it to go down immediately before inflation gets worse. They can prevent it themselves by raising interest rates dramatically to stop consumption. Unfortunately, it has been the consumers that have been leading the economy



the last few years and to stop them would likely result in an immediate recession. Thus I feel the governments are going to do what they do best, too little, too late. They will likely continue to keep interest rates at far too accommodative levels and the price of oil will rise to the point where inflation becomes unbearable. Eventually they will have no choice but to raise interest rates and a recession will begin. The recession coupled with higher interest rates will make it difficult for people whom today have a high amount of debt. This will lower consumption, people will use more fuel-efficient vehicles (hybrids), and oil producers will have increased production. A new decade of somewhat low oil prices will return again. This scenario I have described is what I feel is happening now. Governments can stop it by dramatically raising interest rates, but will they? Knowing how much debt people have and the fact that high interest rates will hurt people with large mortgages it is likely that governments will defer this option until they do not have a choice.

Goldman Sachs* recently released a report that mentioned this new industry perspective and the potential for \$105 a barrel oil in the coming years. RBC Dominion also stated that the era of low interest rates and deflation is over and to avoid financial stocks and invest in metals and energy. For those people who are younger and did not experience the 80s it was a time when many people bought fuel efficient cars and many lost their houses due to interest rates as high as 20%. Be careful because history tends to repeat itself...

** for copies of a summary of the Goldman Sachs research report please contact me.*

Hedge Fund Portus Shut Down By Securities Regulators

On March 4, securities regulators shut down the operations of hedge fund Portus Alternative Asset Management due to concerns about the structure of its operations and the unusually high referral fees paid to advisors who recommended these investments to their clients. Hedge funds have grown in popularity dramatically in the last few years but the growth of assets with Portus was far above the norm. Why were advisors recommending Portus with such enthusiasm? Well, of the \$717 million that investors gave to Portus, \$87.6 million was paid to advisors as commissions, referral fees, and performance bonuses. Newspapers ran articles questioning this excessive level of fees paid out to advisors that composed 12% of the assets invested. They mentioned fees were above what is considered fair and left little room for this investment to earn returns that would justify it. When KPMG investigated Portus as receiver, they discovered that \$240 million had been wired to offshore bank accounts and that computer hard drives had been erased along with many other documents. It is important for clients that they know how an advisor is compensated when it comes to sophisticated investments like hedge funds or other structured products. If you do not understand how an investment works it is best to avoid it. We have not heard the last of what will become of Portus yet.

GM Debt the next Junk Bond?

General Motors, the world's biggest automaker, has its debt on the verge of non-investment grade status (BBB-) following the release of its largest quarterly loss since 1992. Rating agencies are all monitoring the situation and still have the company at the lowest rating for investment grade with negative implications. GM has almost as much debt as Canada but its problems are far worse. Its unionized employees have burdened the company with high wages and a health care benefit package that is costing the company far too much. GM has to provide escalating health care benefits to all of its retired employees whom far outnumber the current. Add to this rising debt servicing costs (due to higher interest rates) and declining sales of sport utility vehicles (which have been the most profitable) and you have a serious problem. But the biggest issue is that the Government is raising interest rates to combat inflation and dampen consumer spending. This will reduce auto sales even further in the future (further eroding profitability). However, all this bad news can still get worse. If the company has its debt cut to non-investment grade then many financial institutions will not be allowed to invest in GM debt instruments and the debt servicing costs will rise. It may lead the company towards bankruptcy. Currently you can buy GM debt with yields of 5% - 1 year, 6.3% - 2 years and 8% - 4 years. I would not invest in GM though as I feel it is not worth the risk and all this debt will eventually catch up with the company in the end. The United States has many GM's though in its future. Fanny Mae, one of the largest providers of mortgages, currently has a very dubious credit rating as do many other companies and states. It will be an issue.



Fixed Income Strategy

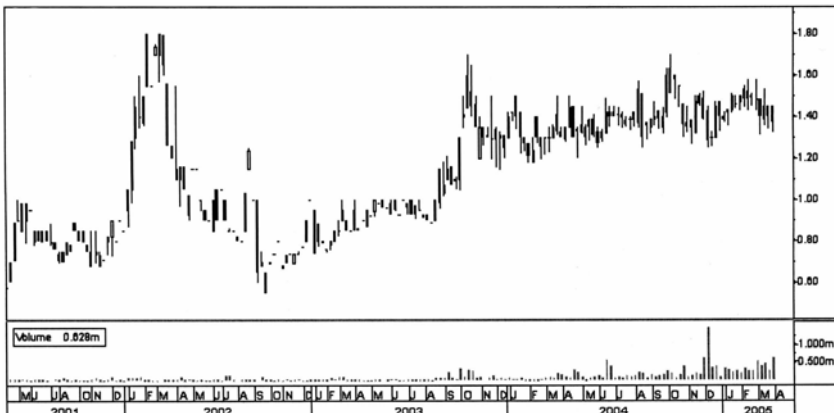
With the outlook for continued rising interest rates I would stick with short-term bonds only. Terms of 1 to 3 years are best. Avoid bond mutual funds as rising long-term rates may result in negative returns in the coming year. With inflation concerns it is likely the spreads for corporate debt will increase and make it more attractive in the future.

Stock Ideas

Geocan Energy (GCA), \$1.4

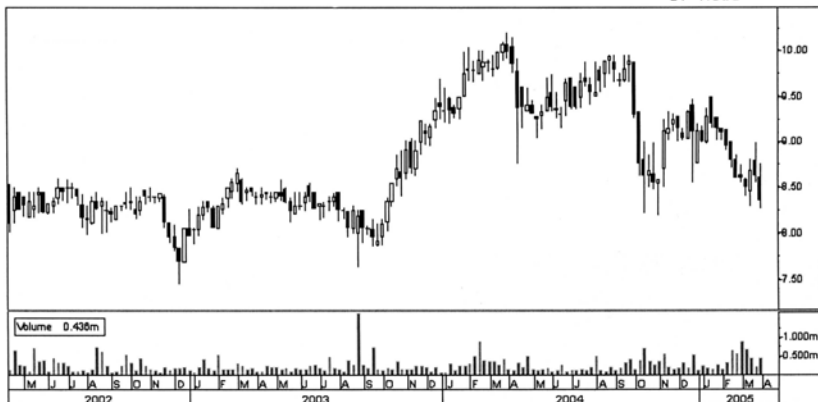
Geocan is a small-cap oil producer based in Alberta that has good future potential. The valuation that Geocan trades at currently ranks it among the lowest of all producers on the exchange. One reason for this is the fact that the majority of Geocan's production comes from heavy oil that traditionally has higher costs to recover. However, I feel the multiples it trades at are far too conservative for the future potential of this company. Geocan has acquired more land for drilling and has the money to drill many wells in the coming months. The majority of the targets are natural gas that will begin to diversify Geocan's production base as well as add to the company's production. Geocan's cash flow will get a further boost in April when an oil hedge expires and the company can begin selling its production at the current market prices. You can access more information on Geocan by visiting the company's web site at the following link:

www.geocan.com.



Versacold Income Trust Units (ICE.UN), \$8.35

Versacold is a mid-cap company founded in 1946 that operates 24 modern, temperature-controlled warehouses across Canada and the US. It offers custom freezing and food processing, as well as complete third party logistics and transportation services. The company is structured as an income trust and has been paying monthly distributions that total \$0.93 a year to yield 11%. The company's business is asset intensive with a low growth profile and has fairly consistent cash flow. This profile makes it ideal to pay consistent distributions. Versacold has been paying out 100% of its cash flow making it vulnerable to a cut in distributions if its business were negatively impacted. However, the company to date has demonstrated consistent cash flow that has been adequate for distributions for the last few years. Versacold is building 2 more warehouses in Alberta that should add to future distributions and provide additional distribution coverage. I do not feel the stock has much upside from current levels even though it is off from its high of \$10 but the yield is the primary long-term benefit. From an income standpoint the company offers good long-term potential for investors. For more information visit the companies web site at the following link: www.versacold.com.



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Patrick Lychak is an instructor of investing courses with the Vancouver School Board (VSB) through the Adult Continuing Education Program. Courses are offered in Winter (February to March), Spring (April to May) and Fall (October – November) sessions. A listing of future course dates can be obtained from the VSB website at this link: www.vsb-adult-ed.com by selecting in the second column, (Career and Personal Development (Arts to Languages)) the "Finance" category. For the rest of 2005 Patrick will offer a discount for courses to clients. Please contact him for more information.

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