The **Lychak Letter**

"A Quarterly Analysis of Bond and Stock Market Trends Worldwide" **January 2005**

Patrick Lychak, Investment Advisor
B. Ed., CIM, FMA, FCSI
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.i-invest.ca

Government Rates / Currency

Term	CAN Gov. Yield	US Gov. Yield
3 mo	2.52%	2.24%
6 mo	2.68%	2.57%
1 yr	2.92%	2.9%
5 yr	3.67%	3.6%
10 yr	4.3%	4.21%
30 yr	4.84%	4.81%

CAN Rates
Prime 4.25%
Bank Rate 2.75%

US Rates
Prime 5.25%
Fed Fund 2.3%

$CDN = 0.827

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First let me say something not related to this section, "Happy New Year! May you have a healthy, happy and prosperous year!"

Back on track, the top story of 2004 was the strengthening Canadian dollar. However, it's rise has caused many to wonder "where to from here?" The top banks in Canada are predicting a currency in the range of $0.80 to $0.90 by the end of 2005. With the Canadian dollar currently at about $0.83 you can see that overall the one thing in common is they expect the currency to remain near current levels. I feel that the Canadian dollar will remain in a range of $0.80 - $0.84 this year. Our government has already sent out a signal that it does not want too strong a currency, as it will hurt exports. And while the US dollar has far more negatives than positives, our rising currency will hurt trade with our largest trading partner. So there is a natural resistance built into our currency. It cannot go too high or our countries trade will suffer, leading to a weakening currency. Thus it will trade at a point where it is more neutral. I expect it to trade near $0.80 in the coming quarter as rising US interest rates gain on neutral CDN rates. However, later in the year I expect it to rise towards $0.84 as the CDN government increases rates and the US currency declines further.

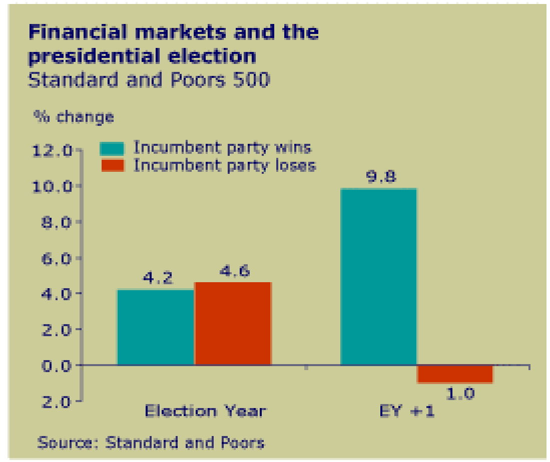
I feel the story for 2005 and 2006 will no longer be about the Canadian currency; it will be about rising interest rates. Alan Greenspan stated on Nov. 19, 2004, "Rising interest rates have been advertised for so long and in so many places that anyone who has not appropriately hedged this position by now is desirous of losing money". He also stated that, "foreign investors may tire of financing the US deficit and demand higher interest rates, elevating the cost of the financing the US deficit and rendering it less tenable". This scenario is what I feel will gradually become a reality as 2005 progresses and will be more evident in 2006. To date Japan and China have been the biggest purchasers of US debt over the years. If they stop buying US debt, lack of demand at future US debt auctions will force US interest rates up considerably higher to make the debt more attractive. The rising debt servicing costs will put further strain on the US budget and will force the government to address the issue of getting the deficit under control or face it spiraling out of control. I feel this process will evolve over the course of 2005 and 2006. In 2005 you will see gradual interest rate increases in the US but later in the year you will see more and more mention of the US's growing debt. This will lead to higher rates as foreigners stop buying the US debt. In 2006 the rising rates will be a greater issue and will impact the economy to the point where the government will need to address the deficit. Interest rates in Canada should rise along with the US but will not go as high due to our government's far better balance sheet. In the coming quarter I expect a couple more quarter point increase in rates from the US and Canada to hold rates at current levels till the CDN currency stabilizes. The CDN central bank has stated they wish to raise rates to a non-inflationary level so it is likely rates will go a bit higher but it will be dependant on how much US rates rise.

North America Stock Markets

Index (Jan 4, 2005)	Value	%chg 6mo*	%chg 1yr*
TSE 300 Index	9246	+ 4 %	+ 11 %
S&P 500 Index	1200	- 3 %	+ 1 %
Dow Jones Industrial Avg.	10718	- 5 %	- 3.6 %

** returns are expressed in Canadian dollars*

The chart to the right indicates the impact the Canadian dollar is having on investment returns. Having your money invested in US stocks was not a good idea last year. Last newsletter I stated the potential for the markets to rally till the end of 2004 and early 2005. This scenario seems to be occurring as markets continue to creep higher with the lower than normal interest rate environment. Valuations seem to be heading from higher to even higher still. This leads me to believe that a correction will commence at some point later in the first quarter and progress through 2005. How severe of a correction will depend on the timing of the rising interest rate environment as the two should go hand-in-hand. I feel the drop will be significant over time but could get worse if US interest rates were to get out of control in late 2005/2006. The coming months should be an important time to check the valuations of the positions you hold and to increase weightings in short term bonds to prepare for future opportunities.



On the flip side of the coin, two statistical anomalies are indicating that 2005 will be a good year. One of them is that years ending in a 5 will result in a positive equity market return (since 1885 all years ending in a 5 were positive returns for the DJIA, prior to 1885 results were mixed). The other is that years following an election in the US are normally bad for the markets. The best year for the financial markets as measured by growth in the S&P 500 is the year before the election. Since 1948 the S&P 500 has tacked on an impressive average gain of 18.1% in the year before the election. Election year gains are a much more modest 4.4%. In the year after the election the stock market on average has managed to gain a modest 3.7%. However, there is a significant difference in stock market performance depending on whether or not the incumbents are re-elected. In years when the incumbent party manages to get re-elected the stock market has risen 9.8%. When the challengers win the market has dropped an average of 1%. Since Bush won the re-election, previous statistics are betting for a decent return.

My rational for being less optimistic about 2005 deal with the following issues. China had a huge impact on commodities as massive investment took place in this country. Signs are now emerging that this boom is in decline and may result in lower commodity prices. The US government and people have a huge debt and current deficit. The government will need to balance the budget by either cutting spending or raising taxes. US interest rates are on the rise to bring them back to a normalized level (this will slow the economy). Rising interest rates will erode wealth created in real estate that has further propelled the economy. Current market valuations are very high relative to historical levels. These negative issues I feel outweigh the positives for 2005 and the overall markets will suffer. I feel the stock markets will be in a long-term sideways channel with rallies in some years and declines in others taking the market back down again. This pattern may go on for several years till the excesses in the markets are adjusted. Picking individual stocks that can beat the broad market and timing of asset allocation will be very important in the coming years in order to obtain decent returns!

International Stock Markets

We are lucky to not live in the modern European countries (Germany, France, Switzerland, Italy, etc.). They have had to deal with increased competition for jobs from neighboring countries that now have more democratic governments (with less corruption) and increased free trade. In addition, these neighboring countries have far cheaper wages and cost to manufacture. As a result many jobs are moving to these countries as factories are relocated. This is resulting in high unemployment in the modern Euro region and will distress these economies even more in the next couple years. This distress will continue until wages in the emerging Euro countries rises and wages in the modern Euro region declines or is stagnant till both are more normalized. This situation is evident with current unemployment rates of 10.8%, 9.9% and 8.5% for Germany, France and Italy. Their struggling economies are further being jeopardized by the huge budget deficits these countries are incurring. I expect things to get worse for these countries in the coming years until labor costs are more competitive with neighboring countries and the global marketplace. I feel this change that is happening in Europe will eventually be resolved and the markets will recover. As neighboring countries benefit from free trade with the Euro zone, people in the neighboring countries will see higher wages and increased purchasing power that will eventually benefit all countries. The countries that I feel will offer above average growth in the next 10 years are all of the neighboring countries to the modern European ones. This is evident when you look at the GDP growth of the modern Euro countries vs. neighboring developing countries as of January 2005.

Modern Euro Countries GDP Growth: Germany - 1.3%, France - 2%, Switzerland - 0%, Italy - 1.3%, Denmark - 1.9%, Netherlands - 1.5%, Norway - 1.8%

Neighboring Countries GDP Growth: Czech Republic - 3.6%, Estonia - 6.1%, Latvia - 9.1%, Lithuania - 5.8%, Poland - 4.8%, Slovak Republic - 5.3%, Romania - 6.6%

It's kind of obvious who is growing and who is not (expect this trend to continue over the next few years).

Commodity Markets

Commodity	Price US$
Crude Oil	$45
Natural Gas	$5.98
Gold	$419

Commodity prices overall are substantially higher than they were a year ago. The main reason is the weak US dollar (as all commodities are priced in US dollars) and the insatiable demand from China. Both of these factors should also exist in 2005 leading me to believe commodity prices overall will remain at higher than normal levels. With a slowdown in the global economy commencing through 2005 it is possible that oil may drop from current levels closer to $28 later this year. OPEC has already indicated they are cutting production in order to prevent a surplus from developing. Current world oil production exceeds demand by 700,000 – 800,000 barrels a day. However, if the US dollar continues to weaken oil may not drop as much, as the reduced buying power of the US dollar will be factored in.

Gold has remained high but recently has dropped from 458 to 419 in the last few weeks. The main reason for the strength in the price of gold is the continued weakness in the US dollar and the strength in most other commodity prices. A weaker US dollar makes gold more affordable and rising commodity prices leads to inflation which also is a boost for gold. The outlook for the US dollar is continued weakness though it is unlikely to drop as much due to the decline to date. Commodity prices may drop as the commodity cycle is very short in nature and the boom/bust mentality of the Asia region is likely to repeat itself again (when was the last Asian crisis?). With positive and negative forces at work I feel gold will trade in a range near $400 this year.

Fixed Income

The Fed has indicated that rates will continue to rise in the coming months. I expect the Bank of Canada to continue to pause with rate increases until it can be done without impacting the Canadian dollar beyond $0.84. Rates should rise over the course of 2005 with an increase of about .5 - .75 expected in the US and .25 in Canada. The best deal appears to be 1 – 2 year bonds with yields of 2.8% and 3.25% respectively. Long-term rates, in my opinion, are just not worth the yields.

Investing in bond mutual funds also may be a good strategy move this year as they offer higher potential yields than short-term bonds. They perform well in periods where interest rates are stable (which is the outlook for Canada for the next year). They also may outperform equities if the stock market corrects. This investment choice is something I will be recommending for the coming year.

Wolverton now has access to the Merrill Lynch bond inventory meaning better yields, new issues and more fixed-income product is now available. Sample bonds are:

- Canadian Tire Corp, January 16/06, 2.8%
- Westcoast Energy, Dec 18/06, 3.28%
- MBNA Canada, August 24/06, 3.3%
- Dundee Bancorp, September 24/07, 5.15%

Stock Ideas

Choice Resources (CZE), $0.61

Choice is a small-cap natural gas producer with properties in Alberta. Current production is around 1350 boed that has a long reserve life of ~12 years. The company has experienced management, good cash flow and a decent balance sheet. The company has acquired more land recently to enable the drilling of 12 wells in the coming 3 months that could add to current production. I have been recommending this company for a while now and feel it trades at very low multiples relative to the growth potential it has. The risk in Choice is the fact it is a very small company ($20 million in revenues) and if the price of natural gas were to decline substantially.

Wolverton has recently released a research report on Choice with a $0.80 price target. Please phone or email me for a copy of Wolverton's research report that can be provided to those from authorized provinces or states

Microsoft Corporation 1978

Would you have invested?

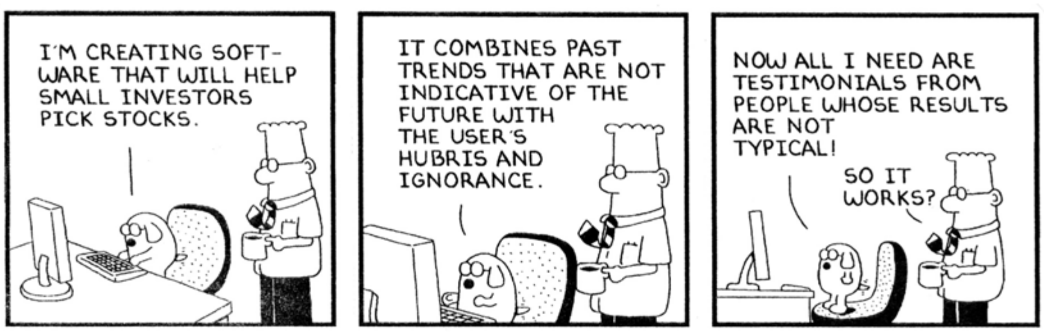
QUOTE:

"A bank is a place that will lend you money if you can prove that you don't need it."

- The following article was taken from the National Post (Jan 13/05). The Author is a fairly respected business journalist and the points she makes are fairly accurate. It is included in this issue as the US policy will have a big impact in the coming year.

Trade at Core of America's dollar policy – Diane Francis

How low will the U.S. dollar fall this year? It's a critical question for Canada's policy-makers, investors, exporters, tourists and workers. The answer is the dollar will go much lower because this has been the unspoken policy in Washington since July 2001, for a variety of trade and other reasons. The purposeful re-evaluation of the dollar by the Republican administration is why the market drove the dollar down to its record low immediately after George W. Bush's re-election. Like everything else the Bush administration does, this dollar policy has caused consternation around the world, including Canada where the Canadian dollar has jumped 30% as a result since 2002 to around US$0.84. The Bank of Nova Scotia estimates the Canadian dollar will hit US$0.90 this year and possibly par value in 2006. The bank, a contrarian on this target, probably has it right. While the rest of the world whinges, the Bush administration pays no attention and will not change its mind. That's because the policy is demonstrably beneficial to the U.S. because it reverses years, even decades, of artificially low values in the currencies of trading partners. To Washington, the sinking U.S. dollar enhances exports, makes imports more expensive and has given the Asian economies, which have played currency games for years, a major haircut in terms of the value of their U.S. denominated debts. This means that Canada's currency will finally reflect the country's Taiwanese-scale trade surpluses and record commodity prices. Canada's manufacturers, exporters and tourism sectors have no choice but to adjust accordingly. Same with governments. Americans are merely amused, and should be, at the latest scare tactics by the Europeans, and anti-Bush Democrats, that somehow the continuation of the U.S. dollar's decline will lead the Chinese, Japanese and other Asians to dump all their U.S.-denominated bonds, thus bringing about a free-fall and international currency crisis. But that's unlikely even though foreigners hold 52% of all U.S.-denominated government debt, compared with 20% of Canada's debt held by foreigners. Asia alone holds *85%* of its massive foreign exchange reserves in U.S. dollars and last year Japan continued to be the largest buyer of U.S. treasuries. Why? They have to. By keeping their massive savings in U.S. dollars, they avoid converting their export earnings into their own currencies, thus increasing their value dramatically and making their exports less competitive in price. They also hold huge amounts of debt to help keep U.S. interest rates low so that Americans buy their goods. Now, having such significant holdings, they are stuck. They cannot dump large amounts of dollars without shooting themselves in the proverbial foot by driving down the value of their dollars and causing higher interest rates in the U.S. The Americans, on the other hand, are winners all the way. Not only have their exports been buoyed by the declining dollar, but their consumers have enjoyed a huge transfer of wealth from Asia in the form of lower interest rates and subsidized goods, notably from China. The Chinese are playing a slightly different game because their currency is pegged to the U.S. dollar, which insulates it from local currency spikes hurting their competitiveness. The problem is the system is unsustainable and China will eventually have to re-peg its currency in order to sustain this game. There are indications this is imminent. There are also indications that American pressure on China to stimulate domestic spending is also working its way into policy there. As for those in Europe (mostly) who bleat about America's dollar recklessness, and its soaring deficits, there are a couple of economic facts to keep in mind. First, the American economy is so gigantic, wealthy and under-taxed compared with other developed nations that it could erase its budget deficit overnight by adding a relatively small tax on gasoline. It could also, with complete impunity, extend its policy of unfair trade rules - such as duties on Canada's softwood lumber or quotas on steel - to imports from Japan, China, India and others with undervalued currencies. Naturally, the Euros cry this will mean an end to trade as we know it. But that is precisely the point. Trade as the world has known it is no longer acceptable to the American government. They have finally had enough and everyone had better get used to it.



Editors Note:

The Lychak Letter is no longer going to be emailed due to problems associated with spam. Instead it will be mailed to all clients and subscribers and will also be posted at the www.i-invest.ca link. Please visit the website if you wish to subscribe with your mailing address.

I am currently in the process of researching several companies for an article I will be writing, "Investment Ideas for 2005". I will be mailing the results of this analysis to my clients in the coming weeks once it is complete.

Patrick Lychak