The Lychak Letter

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

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Government Rates / Currency

Term	CAN Gov. Yield	US Gov. Yield	
3 mo	3.2%	3.9%	**CAN Rates** Prime 4.75% Overnight 3.0%
6 mo	3.4%	4.2%	**US Rates**
1 yr	3.7%	4.3%	Prime 7.0%
5 yr	3.9%	4.5%	Fed Fund 4.0%
10 yr	4.2%	4.6%	
30 yr	4.3%	4.8%	$CDN = 0.84

Allan Greenspan, Chairman of the US Federal Reserve, will be retiring on January 31st. He has boosted the overnight lending rate to 4% and indicated the likelihood of two more quarter point increases on December 13th and January 31st. He also has indicated that the new chairman Ben Bernanke will likely continue on with further rate increases until it has an impact on the economy. I feel the likely scenario is for the overnight rate to reach as high as 5% over the next 6 months before the Fed eases on raising rates. The Fed is very concerned about the housing bubble in the US, rising consumer debt levels, and the threat of inflation. The Fed has indicated it will raise rates above a level deemed neutral in order to get consumers to stop borrowing. It is anticipated rate increases will have just that effect, however many are saying it is already too late. Many of the world's top economists have publicly criticized the Federal Reserve for sending consumers off the deep end with years of historically low rates. The Fed has allowed Americans to believe low rates will last forever and has allowed many to load up with unprecedented levels of personal debt to purchase real estate and other consumables. Now it is too late and any increases in interest rates will make it impossible for many Americans to survive the coming debt crisis where many will be unable to service their debt. If however, the Fed does not raise rates, then the US currency will have little support and its decline will result in increasing inflation for Americans. If they do continue to raise rates, the consumer may stop spending and the economy will have the potential to weaken as many Americans have a difficult time servicing their debt. Either way many are saying that Ben Bernanke will inherit a difficult situation.

David Dodge (Canada's central bank governor), raised Canada's benchmark rate to 3% on October 18 and indicated additional rate increases will be coming. Canada's central bank will likely raise rates a quarter a point on December 6th and January 24th at its next meetings. Canada's central bank has noticed that personal debt rose by 10% in the last year and feels this needs to be curtailed. It also indicated that inflation must be controlled as companies work at full capacity and consumers face record energy costs. Canada's central bank will likely raises rates in conjunction with the US to ensure the Canadian dollar does not strengthen too much. I feel the Canadian dollar is in a brief lull as the rising US interest rates take steam away from the Canadian dollar. However, knowing that Dodge will likely raise rates further in the next two months it is highly likely the currency will resume strengthening as we approach the next rate announcement. Long-term I feel the US dollar has many reasons to decline. It is no wonder Warren Buffet (the United States most successful investor) is short $16 billion worth of US currency contracts. The US dollars decline will likely result in our dollar strengthening further towards $0.90 in 2006.

North America Stock Markets

Index (Nov. 9, 2005)	Value	%chg 6mo*	%chg 1yr*
S&P TSX Index	10645	+ 11 %	+ 15 %
S&P 500 Index	1222	- 0.7 %	- 0.6 %
Dow Jones Industrial Avg.	10567	- 2.6 %	- 3.5 %

** returns are expressed in Canadian dollars*

Where are all those people loudly trumpeting the merit of investing in US equities? It seems the fashion of 2000 no longer seems to be in style any more. Even though now you are allowed unlimited foreign content in one's RSP (to invest in US equities), people are gradually waking up and realizing that investing in foreign equities is not always the right thing to do. The reason why Canadian stocks have outperformed US stocks is really quite simple. You see they were cheaper before (or US stocks were far more expensive). Also the Canadian index has a far higher percentage of commodity/resource based businesses which have posted excellent profits with the rising commodity prices of late. Knowing that Canadian valuations are now approaching US valuations and that certain commodity prices are likely to decline it is unlikely that the Canadian market will outperform the US market much longer. The end result is neither market will offer much more upside soon and the best we can expect is either mediocre returns or a substantial decline at some point in the future. It is no wonder why top analysts are now increasing cash weightings in model portfolios. They want to have money set aside in case of a correction. I feel that this is a prudent move but I do feel that this bull market run will go a bit further before it

peaks. It may last another 6 months but I feel it will end sooner. The sectors to still offer upside are oil/gas and potentially gold producers. Gold stocks defy all logic according to my investment criteria. They trade at unbelievable multiples of earnings, cash flow, or net asset value. So why am I mentioning them? Well I do feel that the price of gold does have many strong reasons to potentially go substantially higher in the coming years. Buying a senior producer will offer good leverage in case this were to happen. Another area which recently has produced some buying opportunities is the income trust sector. With the big sell off in the last couple months some individual companies are actually appearing attractive. Lastly I would avoid manufacturing, companies with substantial exports to the US, or companies in the auto sector. The areas to look at in the future are businesses' with recession proof earnings as the future is likely to involve some degree of a correction.

Top Stories

The United States – A Bad Investment!

First, let me state that I am referring to the overall US stock market and the US currency. There are always individual securities/companies that can do well but this is purely a commentary on the overall market. Second, I am not being anti-American nor am I like the Europeans who currently believe it is fashionable to bash the Americans for their ways. I like Americans and am purely writing this article from an objective standpoint about what I feel is seriously wrong in their country. Many of them already know all of this, I just feel that many are not aware of how serious the repercussions can be…

You see, I learnt a very hard lesson several years ago when I was investing in stocks. It was to never invest in companies that have high debt levels. I found that stocks with high debt often can have things seem manageable and the company can exist with high debt levels for many years. The problem I found was that all of a sudden something can give and in one day, or in one week, the share price plummets to less than 90% of its value as the company suddenly heads towards bankruptcy protection. From out of nowhere you now have a stock where you have lost most of your money and the future of it is over (at least until it is restructured and is now no longer the same company). Well this is what I feel of the United States now. They have too much debt, and while they have been able to keep it all together, the potential for it all unraveling is getting more and more likely.

Debt is pervasive in all aspects of US society. Americans have higher levels of personal debt then they have ever had before. Many states and municipalities have crushing debt loads (California, New York, etc.). Many American corporations have debt levels at high historical levels. Many corporations have pension funds that are grossly under funded and the future pensions of many Americans soon to retire are likely to be eroded dramatically in value. Several of the airlines are already in bankruptcy protection and the auto parts and manufacturing sector is now starting to unravel also. Government institutions like Freddie/Fanny Mae have very dubious accounting and exposure to many mortgages soon to go bad. And the federal government is on track to rack up another massive budget deficit and a federal debt spiraling out of control. Add to this rising health care costs, a weakening currency, and rising inflation and I simply to not see a pretty picture emerging for the American consumer. The case for things to change dramatically has never been so strong. As a result I feel there are likely two potential outcomes. One is that the US will begin on a long and slow painful recession as debt is gradually written off and Americans gradually reduce debt levels. This would likely occur over a period of 6 to 10 years and would be similar in some aspects to what happened in Japan from 1989 to now. The second scenario is for Americans to start panicking and the entire system to go into shock. This would involve dramatic increase in interest rates, many bankruptcies, and substantial declines in stock and real estate valuations. I feel that scenario one is the likely outcome as governments continue to not admit wrong and the public remain in denial. As years pass and the economy show no signs of improving Americans will be more and more willing to correct the things that went wrong. The end result in both cases is lots of downside in the overall American stock market, real estate, and the currency. For me, a Canadian, why should I seem to care? Well, they are our largest trading partner. And if things go wrong down South expect Canada to suffer as well. I do believe we will be somewhat insulated with our commodities, but as a global downturn unfolds we will not be insulated in the end. In addition, do not expect Americans to come to Canada for holidays or to go shopping. With a rising Canadian dollar expect Canadians to start heading South for some 1 day trips of the scenery (the closest factory outlet mall that is). This is not going to be good for retailers in Canadian cities close to the border. It will not be good for the film industry in Canada either. Interesting times are before us and in the coming months it is advisable to take a more conservative approach to one's portfolio to weather the potential storm.

Income Trusts Under Review

On September 21, Canadian Finance Minister Ralph Goodale said he asked Canada Revenue Agency to stop issuing advance tax rulings for companies converting to income trusts. He also stated the Finance Department would be conducting a review of income trusts and invited companies and investors to make submissions by December 31 on potential tax changes. The Finance Department began a review after reporting they lost $255 million in taxation revenue last year because income trusts don't pay income taxes. He was concerned the proliferation of trusts may make the economy less competitive, because money is paid out to investors, rather than being reinvested in the business. As part of the review, the government said it will consider limits on the deduction of interest payments by trusts, or taxing trusts in the same way as companies. Another option would be to ease the practice of taxing profit twice (at the corporate level and then on dividends). Goodale said he would make a decision on potential tax changes on income trusts "as rapidly as possible", but was unsure if it would be ready in time for the budget due in February or March. However, knowing that their may be an election early in 2006 I expect this review may not only not be completed but may also potentially be passed on to another political party. If so it has the potential to drag on much longer before being dealt with, placing the entire sector in limbo.

In my opinion I feel that income trusts have an unfair tax advantage and the government is correct in remedying the situation. I feel that the most appropriate action is to limit the amount of interest paid out to shareholders and tax the remainder in the income trusts hands. This would place more tax on the income trust company and make it comparable to a regular company. This would also reduce the amount of cash available for distribution (resulting in a lower yield) and a significant amount of valuation of most income trusts would be reduced. The other option is to reduce taxes at a corporate or individual level for companies that pay dividends. While this would preserve valuations for income trusts it would also increase valuations for dividend paying companies but more significantly would further erode corporate taxes received. I find that a government that is already complaining about lost taxation revenue would adopt a solution that involves further losses in taxation revenue. I feel that the taxation changes I am expecting would have a net result of a maximum of a 20% reduction in distributions. So I guess investors should be warned that income trusts may lose some of their taxation benefits in the coming 6 months and reducing your exposure to this sector is prudent (until the review and proposals are revealed).

Can The Price of Gold Go Higher?

Many analysts are starting to warm up to forecasts for a higher gold price in the coming years. The reasons why gold can go higher are:

- A supply/demand imbalance. Mining gold has gotten more expensive in the last few years but the price gold producers are getting for the metal is often at a slim profit. As a result there are few new mines starting up and many mines' production is actually declining. This has resulted in the supply of gold being produced to be stagnant for many years with little significant increases in production for the future. Demand however has been rising as India, China and other emerging markets that buy gold have enjoyed increasing wealth in the last few years and the future looks promising as their economies grow. The extra supply though that has met this rising demand has come from central bank sales as they have been gradually reducing their gold reserves over the years and moving the proceeds into other interest bearing government bonds. The central banks are a wildcard as they can significantly add to supply and depress the price. However, I expect they will continue to sell gold at the current measured pace of the last few years in order to get better prices.
- A bearish outlook for the US economy. It is anticipated that US consumer spending will grow at an anemic 1% next year (the slowest pace in 15 years) largely because Americans are burdened by debt and struggling with higher energy prices. If US consumers hunker down it would force the Federal Reserve to stop raising rates. This would cause the US dollar to plummet and lift the price of gold. If you are nervous on the US economy, the US consumer, and US real estate, gold is an interesting hedge or insurance policy.

While the price of gold has good potential to rise from the current level of $467 US/ounce you can profit by either buying the actual commodity or buying a gold producer. Normally buying the gold producer has the greatest potential for profit, however most gold producers are currently trading at valuations that I feel are excessive so the profit potential now is not as great as one would expect. At present most gold producers are trading at the following valuations on average: 1 to 3 times Net Asset Value (NAV) with the average being 2 times NAV; 20 times 2005 cash flow on average (this would drop to 13 times cash flow in 2006 with a gold price of $525). The producers with the most leverage are ones with a high cost pf production as they will benefit the most from a rising price. However these same producers will also have the most risk if the price of gold does not rise as they are likely losing money at present and their financial situation will deteriorate if the price of gold declines. I do feel the gold sector does offer some potential in the unique global economic environment we are in today. However with the present high valuations one must be cautious. It is worth having a portion of one's portfolio in this sector and knowing the risk is important. Determining which company has the most potential relative to risk is important for future potential gains.

Fixed Income Strategy

Expectations are for a rate increase of 0.75 in the next 9 months in Canada. While short term rates are rising long term bond yields are not. As a result I would suggest buying terms of 1 to 3 years to get the best yields relative to time frame. I would continue to avoid bond mutual funds, as they have maturities of up to 30 years which may perform poorer in a rising interest rate environment. One bond fund though that is a new variety being marketed is a mid-term bond fund. Mid-term bond funds often have a maximum maturity of 5 years so they are actually one to consider in the current environment. Sample investment grade bonds with maturities of 1 to 3 years are:

- Laurentian Bank, October 2/06, 3.65%
- Merrill Lynch Canada, November 19/07, 3.65%
- Transalta, June 02/08, 4.02%
- Greater Toronto Airport, February 4/09, 3.96%

On a side note I wish to caution anyone buying either GM, GMAC or Ford bonds. They have currently been downgraded to junk bond status and with the looming bankruptcy of Delphi approaching it is likely in the next 3 years these bonds may become substantially devalued. I would suggest selling now while prices are still attractive.

Stock Ideas

Blue Mountain Energy (GAS), $5.2
Blue Mountain is a junior oil/gas producer (primarily gas) that trades on the TSE. They are a full cycle exploration and development company, primarily focused on exploring for natural gas in the Peace River Arch and west-central Alberta. The attraction I have for this company is based on their experienced management (who are concerned with not diluting the shareholders), large land position of 139,000 net acres, and low valuation parameters. It is very hard to find deals in the oil/gas sector in the current times but this I feel is an exception. The share price of Blue Mountain previously traded as high as $9 in early 2005 before one well with a high production encountered problems. The resulting lost production created a market sell off that took the share price down. However, the company has since replaced most of this production and will likely exceed previous production highs in the coming months. The stock I feel has not recovered as tax loss selling continues to weigh on it. Knowing this will end in the next month and the company will likely be reporting further production gains it is likely the share price may strengthen. Add to this excellent cash flow and many drillable prospects for the next couple years and you have a very promising growth story. The main risk with Blue Mountain is fluctuations in the price of natural gas. You can access more information on Blue Mountain by visiting the company's web site at the following link, www.bme.ca.

Editors Note

At present the overall markets are quite expensive. However, with the correction taking place in the income trust sector and with tax loss selling occurring, there may soon be some opportunities. I will be trying to prepare a research report on investments for 2006 following this newsletter that I will be forwarding to clients. Tks, Patrick Lychak

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