

The Lychak Letter



“An Analysis of the Investment Markets in Canada”

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Government Rates / Currency

Term	CAN Gov. Yield	US Gov. Yield	CAN Rates
			Prime 6.0% Overnight 4.25%
3 mo	4.3%	5.1%	US Rates Prime 8.25% Fed Fund 5.25%
6 mo	4.3%	5.2%	
1 yr	4.3%	4.8%	\$CDN = 0.89
5 yr	4.0%	4.7%	
10 yr	4.1%	4.7%	
30 yr	4.2%	4.8%	

The Bank of Canada Governor, David Dodge, has kept the main lending rate at 4.25% for the last few meetings and so far has not indicated specifically whether he will raise or lower rates in the future. At present he has stated that the Canadian economy (currently operating at full capacity) will be in balance next year as slowing US growth will crimp demand for Canadian exports. The current level of interest rates is consistent with achieving the inflation target over the medium term. He also stated that risks to its outlook are roughly balanced, which means they plan on keeping rates as is for the next few months. The biggest unknown variable is how bad and how long will the US housing slump be, as this will have an impact on US consumer spending and ultimately the US economy. If this slump is prolonged, both Canada and the US will have room to cut rates in the future which I believe has the greater odds of occurring.

The Canadian dollar has two issues that will likely counter one another moving forward. On the upside there is the known issue of the overvalued US dollar. As the US economy slows they may eventually bring in tariffs to deal with the massive trade imbalance they have with China and Japan. This will cause the US dollar to decline and strengthen the Canadian currency. On the downside it is generally felt that the bull market in commodities is soon to be over and weakening commodity prices for metals, oil and gas will affect Canada significantly. Canada's currency tends to follow the price of commodities since they account for 54% of the nation's exports and 12% of the economy. Weakening commodity prices will result in a weaker Canadian currency. Both of these opposite forces will likely result in a currency that remains at a level near where it currently is. Moves on the upside or downside will likely be a result of which issue presents itself first. I feel that the Canadian currency will likely soften in the coming year and trade closer to \$0.85 a year from now, barring a rapid deterioration in the US.

North America Stock Markets

Stock markets in North America are currently fairly expensive. The economy in the US has proven resilient to the interest rate increases and Canada has been booming due to the windfall profits from commodity prices. The future direction of the stock markets will depend predominantly on United States consumer spending which has driven the global economic expansion and resultant boom in commodities. It will be important to keep an eye on the US housing market. If house prices decline further a recession may emerge as consumers struggle with debt. I expect this to be the likely scenario and the Fed may be forced to cut interest rates. This will result in commodity prices softening and exports to the US slowing as Canada's economy weakens.

Index (Nov. 9, 2006)	Value	%chg 6mo*	%chg 1yr*
S&P TSX Index	12433	+ 1 %	+ 10 %
S&P 500 Index	1378	+ 7 %	+ 7 %
Dow Jones Industrial Avg.	12099	+ 6 %	+ 10 %

* Returns are expressed in Canadian dollars

The sectors in the market to consider should be defensive positions that will be less affected by consumer spending. Commodity based stocks will likely deteriorate in the coming year as economies weaken. Oil prices have already begun to weaken and though they may be strong over Winter, trends indicate that they may go lower in the coming year. The one commodity sector that I feel has the most risk are mining stocks (gold, copper, uranium, etc.). The valuations they trade at are more in line with tech stocks during the dot com boom. With the change in income trust taxation, it is likely to put a chill on the markets as the tax implications are considered and the markets will take some time to adjust.

Top Stories

Income Trust Bombshell

In the previous issue written the Fall of 2005, I warned that the government was reviewing income trusts and that the way they were taxed was likely to change. I went so far as to warn people to reduce their exposure to this sector due to the potential reduction in distributions. The government finished the review and made changes last year and stated that they were now done. In the following election the campaigning political parties all stated they would not make any more changes to income trusts. While I was cautious on them all along I believed that the issue was resolved and the risk of change in government policy was reduced. Well, it turns out the government reserves the right to change their mind and do the opposite of what they promised. On October 31, 2006 the government announced surprising sweeping changes to the way income trusts will be taxed in the future. Income trust market valuations immediately dropped the next day.

Before I comment on the changes, I wish to state that they are proposed, meaning they may be changed or may be later rescinded. I do feel though that these changes will likely get passed by the minority government. This is likely, regardless of the carrots they throw out before the election (gst cut, reduced taxes, etc.) and allow the Liberals to get back in power. The proposed income tax changes to the income trusts will impact Alberta the most as oil and gas trusts as well as producers will find valuations will be reduced substantially. I suspect that the Albertans will send a message to the previous Western dominant Conservative party at the next election as Alberta's residents realize the consequences.

What the government has proposed is to tax income trusts just like normal corporations by imposing taxes of approximately 32% by 2011 (19% federal and 13% provincial). These taxes will have the ultimate effect of reducing income trusts cash flow by as much as this corresponding amount. The government has stated all future trust conversions will pay the new tax immediately and all existing trusts will be exempt for 4 years till 2011. The distributions from income trusts will also be taxable for investors as if it were dividend income. This will allow the government to not only recoup lost taxation from income trusts but to effectively double tax investors on their dividend income! The government has indicated that this regained taxation will be compensated by lowering the tax rate for corporations from 21% current to the proposed 18.5% in 2011.

The winners of the new changes will be existing corporations as they see their federal tax rate decrease by 3% over the next 4 years. Income trusts will lose as they face taxation of approximately 32% commencing in 2011. This will eliminate the tax advantage they currently have and force many of them to consider converting back into a regular corporation in 2011. Investors will lose as they find stock market valuations will ultimately decrease by as much as 32% to reflect the lost distributable cash. Investors will also lose as they find the income they are receiving from distributions reduced by the companies and reduced further from the dividend "double" taxation.

The proposed taxation measures will affect income trusts differently. As the tax will be applied to a companies earnings, if the income trust has considerable assets (that can be amortized) then the reduction in distributions will not be the maximum of 32% but less. For example a company that makes 50% of it's distributions as return of capital will find the yield will decrease by approximately 16%. Companies with lots of machinery, plants and equipment will be affected less from the new proposal. As there is only a current 4-year window on the current taxation of income trusts the 32% drop in income will ultimately be reflected in a corresponding drop in valuations. I expect to see a decrease in value of income trusts of approximately 20% in the immediate future to reflect the long term potential followed by further decreases of another 7% in the next 3 years. As an investor you will need to consider the expected yield of approximately 10% that most income trusts pay out over the next 4 years vs. the drop in value that will result when they ultimately are taxable. Knowing that investor sentiment will sour in this area for the foreseeable future it is likely valuations will erode further as time goes on. In addition there are many mutual funds that have extensive income trust holdings. These funds have names like: monthly income, high income, income and growth, etc. The returns these funds will post in the coming months will indicate substantial decreases in value. This alone will cause many investors to reduce holdings and result in funds having to sell more of their income trust holdings. To make matters worse it will be difficult for advisors to be able to recommend income trusts as an investment regardless of the yield. This leads me to believe that income trusts will likely face selling pressure for the next 3 to 4 months as this selling takes its



course. Investors tend to be either overly bullish or overly bearish and in this case it likely will be overly bearish in the end. Eventually the merit of the companies and the high yield offered will result in a recovery. This recovery I suspect will commence in early 2007 as investors focus on the high yield offered and the fact that other investments of comparable yield do not exist.

Overall I am deeply disappointed with the fact that the government lied to the voting public. If the current government would have simply said that changing the taxation of income trusts was part of their election mandate I would have voted for the party knowing what they were all about. But to publicly state that you will not make any changes and then to do the opposite is untenable. The second issue that really irks me is the process they went through. There was no advance warning of the potential changes nor was it even mentioned what they were considering. The changes themselves I feel are horrible. I am not upset with the rate of taxation imposed as it places companies on equal footing. It is the fact there is only a 4-year grandfather clause for existing income trusts. The amount of taxation imposed (32%) will reduce valuations by a corresponding amount. In order to prevent loss of capital for the vulnerable investor the changes need to be implemented after a minimum of 15 years. If this were the case then the reduction in income trust valuations would be at most 10% in the first year and the remainder spread out over the remaining 14 years. Instead the government radically altered the taxation environment and immediately caused investors (mainly elderly retirees) to lose over \$40 billion dollars in market capitalization. If you thought the Liberals were bad for spending a few million of taxation dollars on advertising, the Conservatives will make that amount seem like pennies. The government needs to protect investors, as this was a policy they endorsed and now have taken away. With the proposed changes many retirees will now face losses on this portion of their portfolio due to a sudden change in tax policy. This alone will cause investors to have a bad taste in their mouths as they now become uncertain of future investment strategies. The government will rightfully not likely survive the next election but the new party will also not likely change the current measures proposed as they will not wish to be associated with it.

I feel that the best strategy at this point is to understand the type of business that the income trust is involved in. If it has lots of buildings, vehicles and equipment that it can amortize then the reduction in yield will not be as bad. Most companies will ultimately restructure back to a corporation but some I feel will remain as present and just pay out a lower yield. Selling at some point over the next 4 years while keeping the current flow of income may result in you being further ahead than taking an immediate loss now. Plus there is also the consideration that the government may not be able to pass this proposal or they may extend the exemption period at some point in the future. In some cases it may be worthwhile to take a small loss now and in others it is worthwhile to collect the current cash distribution yield over the next several months and wait for a better exit price as the alternatives for this high yield do not exist.

A summary of the income trust changes can be viewed at the AIM Trimark website at this link:

<http://www.brainshark.com/brainshark/vu/view.asp?pi=320436642>

or at the Government of Canada website:

<http://www.fin.gc.ca/news06/06-061e.html>

Fixed Income Strategy

Expectations are for rates to remain at present levels for the next few months though I expect an eventual weakening in US consumer spending (due to a housing correction) that will lead to rate cuts. Bonds to consider are likely terms of around 2 years in order to get the benefit of higher yields for a potential longer time frame. Corporate yields are very low in the present environment so it is preferable to invest in provincial bonds. Sample investment grade bonds with maturities of 1 to 3 years are:

- Shoppers Drug Mart, October 24/08, 4%
- Province of Ontario, November 19/08, 3.85%

Stock Ideas

The government's proposed changes to income trusts will not only affect valuations for income trusts but also for many stocks that were anticipated on becoming trusts. It will result in market valuations deteriorating or the upside reduced for many companies. In addition many income trusts will drop to lower valuations than deserved as the selling pressure runs its course and stocks become oversold. This will ultimately result in many opportunities to invest in this sector or in associated sectors like real estate income trusts (REIT) that under the current proposal are not even impacted. Unfortunately I feel now is not a time to rush in and invest but rather to wait until the selling runs its course. I feel opportunities will result in this sector or in associated sectors in the near future

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