The Lychak Letter

"An Analysis of the Investment Markets in Canada"

October 2007

MEMBER CIPF

Wolverton Investment Services Since 1910

Government Rates / Currency

Country	Rate (%)	3 mo ago	1 yr ago
US Fed Target Rate	4.75	5.25	5.25
US Prime Rate	7.75	7.75	7.75
Canada Overnight Rate	4.5	4.5	4.25
Canada Prime Rate	6.25	6.25	6.0

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Fed Chairman Ben Bernanke might as well have put a for sale sign on the US dollar when he cut the target rate by half a point recently to 4.75%. Not only is the US dollar for sale but all of America will be in the future if left as is. The continued non-support of the US dollar will result in ever increasing Foreign companies buying US corporations. Just this month TD Bank announced it is buying a US bank and CP Rail is acquiring a large US rail company. This is the first of many more to come. Not only will US companies be subject to more takeovers, but Americans will start experiencing increasing inflation. Their dollar will have less purchasing power and most items will get more expensive. The only positive news is American exports should start increasing as the cost to buy US manufactured goods will be much cheaper for foreigners. I am sure you have heard many office stories of how much cheaper cars are to buy in the US and of co-workers who have or are planning on buying their vehicle from the US. Manufactures will eventually respond by lowering prices in Canada and raising them in the US to bring them closer to parity.

So why is the Fed willing to kill their currency? Well, it appears the Fed is more controlled by political pressure as opposed to economic fundamentals. And the current political pressure comes from all of the homeowners (with too large a mortgage) who are having their houses foreclosed and the resulting chaos. This chaos is mortgage lenders and banks that are going bankrupt or laying off staff (plus the negative consequences down the chain). This housing correction is the legacy of Greenspan who essentially created the US housing bubble with his ridiculously low interest rate policy to rescue the US stock market. The Fed has indicated that it is more concerned with helping the US housing market and mortgage industry because problems there are not only isolated to the homeowner who is being foreclosed. It spreads to the banks and lending institutions that are holding mortgages that are non-performing. And two of the biggest institutions are federal (Fannie Mae and Freddie Mac). The Fed likely can live with a few banks taking the fall but it does not want these two government organizations with huge liabilities. Thus it has to sacrifice its currency to protect itself from even more liabilities.

How long will the American Peso erode is related to how long will housing problems last. Indications are that most of the housing problems are related to teaser mortgages issued in prior years at very low rates that are now coming due at substantially higher rates. Homeowners apparently thought low rates are forever and now are unable to make payments. However, the number of these mortgages coming due in the first quarter of 2008 is double the number that came due in all of 2007. This indicates that the housing sector is going to be under pressure for all of 2008 and 2009 till things start getting better. In order to rescue this sector the Fed will be handcuffed and need to maintain low rates for a while as debt does not go away overnight. This tells me that the current weak US dollar is likely to get weaker till eventually the Fed is forced to address the massive inflation it is opening the doors to for the American consumer.

In Canada David Dodge has done a great job though he has the luxury of being able to follow economic fundamentals due to our government's fiscal surpluses. The only difficult issue he faces is the high inflation experienced in Western Canada (that requires higher rates) and the strong Canadian dollar

hurting Eastern Manufactures (that requires lower rates). In the end he has to choose a rate somewhere in between not as high as it should be for Western Canada and not as low as ideal for Eastern Canada.

The current data indicates that higher rates are necessary in Canada in order to address the most important issue of inflation. Recently Canada's unemployment rate dropped to 33 year low of 5.9% as wages increased 4.2% (far above the governments inflation target). With more retirees likely in the coming years (due to aging baby boomers) the employment sector is likely to remain tight for the next several years. The government will need to address inflation by raising rates in the future. However, with the US lowering rates it may cause our currency to go too high. While Canadian consumers will benefit from cheaper foreign goods Canadian exporters will be hurt even more. I expect the central bank to leave rates as is though ideally they will look for opportunities to raise in the future if things remain as they are. The Canadian dollar is now superior to the US and with current Fed policy it is only going to get stronger. I expect a currency range from $1US = $1.1 to $0.95 CDN for 2008.

North America Stock Markets

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*

Regardless of what is happening with asset-backed debt, US housing woes, mortgage defaults in the US, or weak US dollar, the real question is what will the economy do? Will there be economic growth or not in Canada and the US? Cause if there is growth than it is likely stocks markets will continue to have support. The Fed cutting interest rates indicates that the US is more concerned about keeping things going than what is necessarily correct. Knowing the US has a huge impact on the global economy, overall stock markets should continue to do well in the future. Growth of ~2% and ~2.3% is currently expected for 2008 for the US and Canada. However, because stock valuations are very high the growth may not be enough to cause significant improvement in share prices and the market is likely to be volatile in the coming year. It will trade up on economic outlook and low interest rates and down on profits not meeting expectations and worries of the US economy slipping into a recession and affecting the rest of the world. Buying on these dips will be a preferred strategy. The market is also likely to favor certain sectors in the coming year based on the current state of the markets. Stock selection will be crucial and I would suggest good quality companies with lower multiples for downside protection as opposed to growth, because in a market correction growth stocks will decline much more.

Gold producers have been excellent performers in the last quarter and are expected to continue to do well in the coming year as current Fed policy will likely lead to increased inflation. Because gold is seen as a hedge against inflation the price of gold has recently rallied from $670 to $745 and long-term (next couple years) prices for the gold are expected to continue higher. Because the price of gold is volatile any pullbacks in the producer stocks should be viewed as buying opportunities. At present it appears the rally in the producers is approaching overbought, thus if you own gold producers it will soon be time to sell as this sector will likely have an overbought correction. The most favored (large cap) stocks in this sector to consider are Barrick, Goldcorp, Kinross and Iamgold.

Because a weak US dollar will lead to higher commodity prices overall, energy is expected to be another sector posting good numbers. While oil producers are benefiting from this scenario the gas producers are doing terrible due to a supply glut from previous warm Winters and new supplies of gas to North America from LNG facilities entering the market. Long-term the fundamentals for gas are quite favorable as current wells have high decline rates (as the reserves are being depleted) and the oil sands expansions will have large gas requirements. The problem though is that the current gas supply is so large that gas prices are not likely to begin strengthening significantly (barring an incredibly cold Winter) till Fall 2008. The weak gas prices are not only devastating gas predominant producers but also drilling/service companies that have a high amount of gas related work. Adding to their problems was the Federal government's decision to tax income trusts last year which impaired the balance sheets of several producers giving them no money to spend on drilling and rebuilding balance sheets will take a few years. To make matters worse the Alberta government is now looking at changing the royalty tax structure that would further erode the attractiveness of drilling in Alberta. Because of all this I am inclined to invest in companies with a high weighting to oil production and ability to grow with properties outside of Alberta. Petro-Canada is the most diversified with production, refining and distribution. The producers I would consider (at current prices) are Talisman and Encana. Canadian Natural and Husky are also good just more expensive than the rest. Talisman has good growth potential outside of Canada and is estimated to be trading at 3 times 2008 cash flow making it one of the value plays. Encana is a good contrarian play with all of their gas exposure so it will post better profits when gas prices recover. On the service side of the industry the majority of service/drilling stocks have done poorly due to the weak gas environment and other industry associated woes. Stocks like Precision Drilling, Total Energy, Enerflex, Peak Energy, and Wellco have lost 50% to 80% of their market value in the last year. I see this as a long-term opportunity to buy in this sector as it will eventually recover. In addition there will likely be some industry consolidation as weaker players are acquired. However, I do not feel it has bottomed yet and with the Alberta royalty tax looming the stocks prices have only more bad news to digest. I would watch this sector and look at opportunities with an ideal entry point likely in the future.

With the chaos in the financial markets related to asset-backed debt and the US housing crises some of the Canadian banks have been hit harder than others. National Bank has dropped due to asset-backed debt it had to buy while Bank of Montreal has suffered due to commodity trading and US bank exposure. Long-term they represent good value at current prices with dividend yields of ~4.5% and should recover in price as people gradually forget about the current issues the market is focusing on.

Other stocks that should perform well include:

CP Rail – Look for a buying opportunity around $68. The company has good long-term growth prospects and is likely to grow by acquiring more rail operations from the United States with our strong Canadian dollar. At present prices (16 times estimated earnings and 1.25% dividend will likely match market performance but nothing amazing.

Emera and TransAlta Power LP – Both of these are power utilities so are quite conservative in operations. Transalta is likely to trade at current prices with little upside but has an 11% distribution. When the income trust ruling kicks in (2011) distributions likely will be 8 – 9%. Still is a decent return. Emera pays a 4.6% dividend and has moderate growth potential from expanding operations long term. Most utilities are presently trading at 20 times earnings giving Emera either 30% upside or considerably less downside in addition to the dividend.

Power Financial Corp – As a financial it would appear fairly priced at 14 times earnings. However this conglomerate owns interests in several utilities in Europe that are very stable in operations. With a dividend of 2.76% this stock should match market performance with better downside protection if markets were to get uncertain.

In summary I am favoring stocks with attractive dividends and lower multiples in stable businesses. The stocks I am interested in are Emera, Petro-Canada, Talisman, TransAlta Power LP, Bank of Montreal, National Bank and Power Financial.

***STOCKS vs. REAL ESTATE** - Over the last 5 calendar years (2002-06), the average annual rate of home price appreciation (up +9.2% per year) was greater than the annual return achieved by the S&P 500 stock index (up +6.2% per year). Over the last 30 calendar years (1977-2006), the average annual rate of home price appreciation (up +6.1% per year) was less than half the +12.5% annual return for the S&P 500 (source: Office of Federal Housing Enterprise Oversight, S&P).*

Fixed Income Strategy

Because of current Fed policy that abandons the US dollar in favor of low interest rates it is likely rates will remain low over the coming year. This does not make short-term bonds as attractive and it is likely a bond fund would be a better alternative over the coming year. I would suggest either bonds with duration of 1 year or else the TD bond Fund for ones fixed income portion of their portfolio. The Manulife Bank Investment Savings Account is also a good choice with a yield of 4.1% and no fixed term.

Editors Note:

In the future I am planning on issuing newsletters on a more frequent basis. Some will be quarterly reports on the market and some will be more specific to opportunities in specific stocks. Typically they will be emailed in bulk format so be sure to have your spam filters turned off or add me to the safe senders list or accept from my email always. Thanks!

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