

# The Lychak Letter



*"An Analysis of the Investment Markets in Canada"*

February 2008

## Government Rates / Currency

Country	Rate (%)	3 mo ago	1 yr ago
US Fed Target Rate	3.0	4.75	5.25
US Prime Rate	6.0	7.75	8.25
Canada Overnight Rate	4.0	4.5	4.25
Canada Prime Rate	5.75	6.25	6.0



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On January 22, 2008 the Fed announced an emergency unscheduled interest rate cut of  $\frac{3}{4}$  a point to the Fed target rate from 4.75% to 3.5%. The Fed announced a second cut of  $\frac{1}{2}$  a point on the scheduled Jan 30<sup>th</sup> meeting to send a signal to the markets that it was taking aggressive action. The markets have been very weak lately as recent economic data is indicating the US is potentially heading for a recession if not already in one already. The Fed wishes to minimise the impact or duration of a recession by making borrowing more affordable for consumers and prevent more defaults on sub prime loans issued by banks. This has been brought on by the eventual correction in the US housing market and financial problems associated with subprime loans issued during the Greenspan era of "free" money. The Fed is resorting to low interest rates again to bail out the banks and and try to revive the US economy. Last time it worked as consumers found money to spend with the increasing value of their properties. This time it will not be as effective as house prices have already peaked and presently are decreasing along with the home equity that previously consumers had used to stimulate the economy. This leads me to believe it will take a much longer time to revive the economy as interest on motrgages will be the primary source of relief. In addition there are still many teaser mortgages coming due over the next two years and the increased rates higher-risk borrowers will be forced to pay will only result in further delinquencies and pressure on the entire sector. It is also likely US banks will report further deterioration in mortgaged backed assets over the course of 2008 as the housing sector is repriced. This continual bad news will not be good for investor confidence and lead to a year of swings in the equity markets. With the Fed making money very cheap again with low interest rates this should offset this weakness but the ongoing weak economic news will likely lead to lower valuations in the market as corporate profits decrease and investors are more cautious.

By cutting rates like it has the Fed is abandoning the US dollar (for now) and opening the door to ever increasing inflation. This rate cut will weaken the US dollar further and likely lead to increased inflation. In 2007 inflation hit a 17 year high of 4.1% pushed up by rising costs for energy and food. While the Fed is concerned with inflation a recession is the worse of the two evils. Knowing the Fed is likely to cut rates more this will lead to further inflationary risk. The Fed is hoping the weaker economy will lead to less inflationary pressure as consumers cut back on purchases. But the weaker US dollar will force the Fed to raise rates to deal with inflation (once the housing crisis eases somewhat sometime in 2009). The next Fed meeting is March 18<sup>th</sup> and Fed fund futures indicate a 76% chance the Fed will lower rates to 2.5%.

The Bank of Canada also cut rates recently (though only by a quarter point) down to 4% and also signalled more cuts were in the future (and likely in quarter point increments). Expectations are that rates will be closer to 3.5% or lower by mid-year (next Bank of Canda announcement is March 4<sup>th</sup>). The Bank of Canada wants to follow the Feds moves down so it can stimulate the Canadian economy and weaken the Canadian dollar to allow the manufacturing sector in Canada to improve. The Bank of Canada expects a Canadian dollar around \$1.02 US for 2008. While 2008 will be a slower growth year for Canada's economy as it will ultimately be affected by a weak neighbor 2009 is expected to be stronger. The Bank of Canada has stated the following about the US, "While the United States will narrowly skirt a recession in the first half of 2008, its economic recovery will be slow, and will not really take hold until 2009" (A recession is generally understood to be two straight quarters of contraction.)

In summary, the Canadian dollar is likely to trade at present levels for 2008 (near parity) while interest rates are likely to continue heading lower. As a stronger economy is expected for 2009, it is likely rates will bottom over the course of 2008 before reversing, as inflationary concerns will become more important.

## North America Stock Markets

Due to the fact the US housing market is expected to remain weak throughout 2008 and the central banks will be creating massive monetary stimuli with low interest rates the equity markets are likely to be in a tug-of-war and be quite volatile. US Banks and financial institutions are witnessing their mortgage portfolios deteriorate with each day as foreclosures continue to increase.

These mortgage defaults are further being spread to deteriorating asset backed paper and hedge position insurers who are being downgraded by the ratings agencies. This will likely lead to more financial institutions announcing more sub-prime related writedowns. This continued negative news would have a negative impact on the economy, decrease investor confidence and likely result in lower valuations in the marketplace. I expect the markets to drop over the course of 2008 with recovery rallies in between. I have added a chart below of the TSX index to indicate a potential scenario for 2008.

Index (Feb 2008)	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



Bad news always results in buying opportunities as long term the markets historically have gone up. This will present an excellent opportunity to increase one's equity exposure. The trick is determining how severe the economic weakness lasts in the US. It can be weak throughout 2008 and recover in 2009 (which the central banks currently are predicting) or it will last longer through 2009. The markets tend to reflect future potential in the present so they will bottom while the economy is at it's worst. This means the buying opportunity will likely be best either in mid 2008 or later in 2008 or early 2009. Regardless if you are considering a large broad equity fund investment it is better to wait till midyear for another potential drop. Certain sectors and companies of the market will provide positive returns in spite of this trend as money flows to where it is rewarded. I am optimistic growth will resume (although slowly) as the growing economies of India, China and South America will create more consumer demand due to their large populations and increasing wealth. As these populous regions develop they will create new consumers for global economic growth.

The world's second richest man (Warren Buffet) is one to listen to when it comes to predicting the future. He was recently quoted as saying that Equity markets are not yet bargain-priced (though they may never be to the extent he likes) and there's more pain to come on Wall Street because of the debacle in US mortgages. He also felt the US housing bust was going to take a while to work it's way through the financial system due to secondary and tertiary effects, "It isn't just subprime. When housing prices go down, it affects the prime stuff." While he conceded the problems in the credit markets, particularly in the US, have "rippled across the globe," he said he didn't consider it a credit crunch, but a repricing of risk. For creditworthy borrowers, "money is available and it's really quite cheap." On the U.S. dollar, Buffet suggested there was no reason it wouldn't continue to fall over "the next five to 10 years" unless the U.S. government changed policies that have led to a massive trade deficit. "Force-feeding a couple of billion a day to the rest of the world is inconsistent with a stable dollar." It's only natural, he said, that sovereign wealth funds from the Middle East and Asia that have funded that deficit would spend some of their U.S. currency reserves on large equity stakes in U.S. banks like Citigroup. "The truth is we're selling America to the rest of the world. It's just a question of what form we sell it to them. They're going to invest their money if we send them \$2-billion a day. I don't blame them at all for investing the money that we're forcing them to invest." On the response to recession fears, he noted that it's hard for the US Federal Reserve to fight inflation and deal with slowing growth at the same time. "I wouldn't be at all surprised to see inflation become more of a factor."

While the overall markets are likely to be lower mid way through 2008 there still will be buying opportunities over the course of the year in sectors that will be in favor and from profiting from the rallies following fear driven corrections. The sectors that I feel will do well over 2008 are predominantly defensive in nature (consumer staples, healthcare, utilities, and gold). I also feel that oil producers will do well as global supplies are still tight and long term the demand will continue to grow as emerging economies increase consumption. Below are certain stocks I have selected that I feel are worth investing in.

### Banks/Financials, Bank Montreal, BMO

The last few months have not been pretty for the banks. The biggest factor seems to be the fact that they tell everyone everything is all right and then stun everyone with incredible losses. For example: CIBC took a charge of \$2.5 billion due to unhedged US subprime mortgages and still has a further \$6.5 billion at risk: Citigroup claimed \$10 billion in losses due to sub-prime mortgage exposure, and just recently Societe Generale (one of France's largest banks announced losses of \$7.14 billion due to a trader conducting fraudulent hedge trades (unrelated to subprime). First let me say a billion is a very, very large number and these 3 banks have had to issue shares to shore up their capital reserves these losses were so severe. Because many financial institutions exposure to US subprime mortgages continues to deteriorate as home prices drop and foreclosures increase more charges/surprises are likely in this sector making it volatile over the coming months. For this reason it is necessary to be patient and wait for lower share prices associated with market weakness when buying for investment or for a trading opportunity when the stocks are likely to rebound. Long term I feel the financial sector will recover and this will present a nice opportunity to add financial stocks to ones portfolio for their high yields and long-term growth. I like Bank of Montreal for its smaller exposure to the US housing market and high yield (5.1% dividend) though there are other Canadian banks that have small exposure to the US housing issue. From the chart to the right you can tell it is presently in a downtrend with long-term support at around \$47. At present it will trade in a channel as indicated by the blue lines. Buying at the lower ends of the blue channel would be a strategy to apply. It presently trades at 11 times next years estimated earnings and 1.7 times book value.



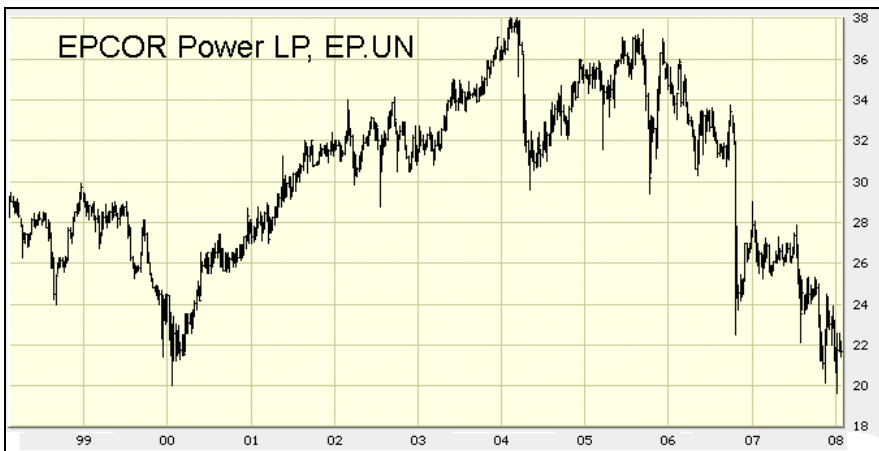
### Oil/Gas Producers, Petro-Canada, PCA

The senior oil producers have really corrected in the last few weeks on concern a US recession will substantially reduce oil consumption and subsequent oil prices. Whether or not this will happen is debatable but long term the increasing demand from China and India as well as other developing countries is more certain as is the decreasing production from mature oil fields. This provides a much lower entry point to acquire a position in senior oil producers with good long-term growth fundamentals. The chart for Petro-Canada indicates that it has strong support at \$43 where it is trading at 8 times earnings (a historical low valuation) and where it is at presently with resistance or an upside target of \$62.



### Utilities, EPCOR Power LP, EP.UN

The utility sector is typically a safe place to invest for conservative growth and high yields. EPCOR Power LP is an income trust that has had difficult times lately a result of the income trust ruling, integrating a US acquisition and the higher Canadian dollar's impact on earnings. It owns 20 power plants in Canada and the United States in many different markets. It trades at lower valuations than it peers and has a high current yield of 11.4%. I do not feel the stock has lots of upside and the high yield is its main attraction. The present yield should be safe till 2011 and 2012 when the income trust ruling and hedges to the US\$ expire likely leading to reduced cash available for distribution. At that point the yield will likely decrease to as low as 8% and the share price may



weaken reflecting this. Overall though the current price reflects this and the high yield is still attractive. This explains the current share price weakness and the discount you are able to buy the stock at as reflected in the chart.

### Food Retailing, George Weston, WN

Food wholesaling has come under lots of pressure lately due to the entry of Wal-Mart to Canada and the resulting increased competition. Weston owns Loblaw who has had their earnings hurt due to this competition and resulting restructuring they are undergoing to compete. This has resulted in share prices that have dropped substantially in the last few years. Long term though I feel that Weston owns some very good brand names that should provide nice growth in profits as restructuring begins to show results (expected in later 2008). Weston owns PC Financial, Joe Fresh Clothing, Superstore, Presidents Choice, Extra Foods, and Superstore (all Canadian companies).

At present it trades at 11 times estimated earnings, 1.3 times book value and has a dividend of 3% making this an attractive investment in a company with significant real estate across Canada. Current analysts have targets of near \$70 if a recovery can be initiated in earnings at its Loblaw subsidiary.



### Fixed Income Strategy

Central banks are lowering interest rates to deal with subprime mortgage problems and weak consumer in the US. This should be bullish for bond funds as lower rates are still expected in the coming months. The only issue yet to be addressed is the increased inflation Americans will likely be facing and the fact the US government will need to raise rates eventually to reduce the impact. This leads me to believe that while short-term rates are currently heading lower it is likely that later this year or early in 2009 rates will stabilize and begin to show a rising pattern to combat inflation. I feel for now the Fed is willing to tolerate the risk of higher inflation in order to stabilize the economy and once the mortgage mess improves will begin raising rates to address inflation. Thus, at some point late this year or early in 2009 it may be a good opportunity to sell bond funds before rates begin rising. For now they are still a good investment as opposed to short-term bonds.

### Editors Note:

I will be reviewing the latest data on valuations and will make a list of companies trading at lower historical valuations for RSP investments in 2008. I hope to have this done in the next month.

*Patrick Lychak*

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