The Lychak Letter

"A newsletter on the Investment Markets in Canada"

MEMBER CIPF

WOLVERTON INVESTMENT SERVICES SINCE 1910

July 2008

Patrick Lychak, B Ed, CIM, FMA,
Investment Advisor

Direct: 604-662-5287 or 780-328-4594 or 1-877-390-7771
Website: www.i-invest.ca
E-Mail: *patrickl@wolverton.ca*

Fort Sask Address:
10104 – 108 Street
Fort Saskatchewan, AB
T8L 2J8

Head Office:
Wolverton Securities Ltd.
17th Floor, 777 Dunsmuir St.
Vancouver, BC, V7Y 1J5

Government Rates / Currency

Country	Rate (%)
US Fed Target Rate	2.00
US Prime Rate	5.00
Canada Overnight Rate	3.0
Canada Prime Rate	4.75

A key development lately is that both Canada and the US's central bank have both halted interest rate cuts at the last meeting. The main reason is concern over inflation (or increasing inflation brought on by higher oil prices). This has led to the new catch phrase being used more frequently to describe the state of the economy as "stagflation". The term stagflation became common in the late 1970s and early 1980s, as many countries strained to deal with simultaneous stagnation of growth and rising inflation prompted by soaring fuel prices. It's thought that stagflation is one of the trickiest economic problems for policy makers to deal with, since efforts to reignite growth often exacerbate inflation, and efforts to stifle inflation often also stifle growth. The conventional wisdom now among central bankers is that it is more important to fight inflation - by not cutting interest rates, or perhaps raising them - even if it hurts growth prospects in the short term. That's because a short-term sag in growth can be fairly easily fixed, but rising inflation tends to be more intractable.

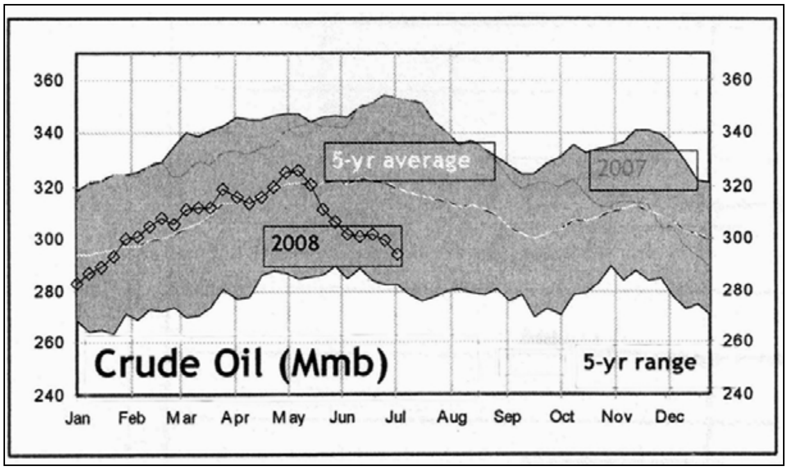
The US Fed is in a difficult situation. Chairman Bernanke pulled a "Greenspan maneuver", and cut rates aggressively to bail out many Americans who were loaded up with debt and overpriced real estate in the hope of making their maturing debt more affordable. But with bank's access to capital constricted and nervousness on the economy not everyone is getting lower rates. The problem of helping out the consumer by lowering rates has gotten worse because it has further devalued the US dollar and has contributed to rising commodity prices (most noticeably with oil). Now the American consumer is paying more when he/she fills up with gas or buys anything at Wal-Mart leading to less disposable income for that mortgage payment. Bernanke will have to make a choice by either raising interest rates to fight inflation and defend the purchasing power of retirees or put his head in the sand and hope rising fuel prices will eventually slow the global economy such that demand eases and inflation softens.

The Bank of Canada also halted interest rate cuts; while they mentioned inflation as of concern, I feel they are more interested in manipulating the currency in order to help out the Eastern provinces whose manufacturing and exports are hurting. I feel the Bank of Canada has revealed it's hand and that they will only follow the US's lead as they raise interest rates but not before. It appears the Bank of Canada wants to adopt a political as opposed to an economic monetary policy and wishes to have the Canadian dollar at less than par if possible. With a strong outlook for commodities in Canada and the US government's growing debt I am expecting the Canadian dollar to range $0.95 to $1.10 for the next year.

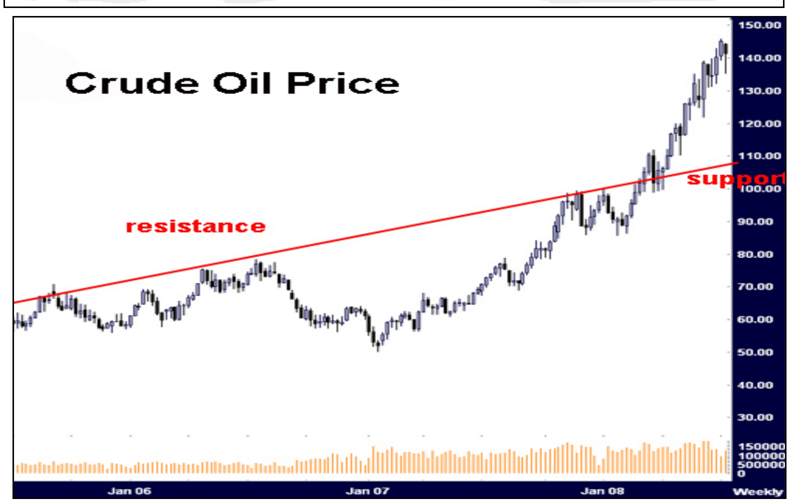
Interest rates went from being cut, to staying the same and the next step is likely to go back up again. I feel we are likely in a period similar to the 70s when oil prices rose to record highs and interest rates followed in an attempt to stop inflation. While high oil/commodity prices are now getting quite similar to this period interest rates still are not. I do believe we are likely to see interest rates start creeping up later this year, though the pace is likely to be slow unless oil goes substantially higher. This would light a fire under the central bankers as high oil prices will eventually work their way into affecting rising prices throughout the economy.

North America Stock Markets

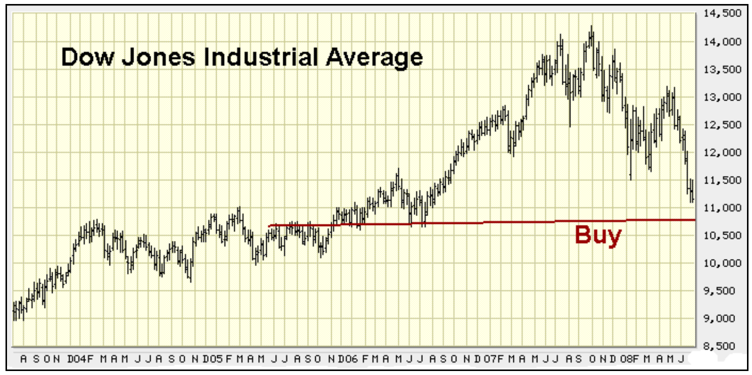
The focus of the markets lately has been oil or oil producers. It has been the dominant sector that has led the TSX to new highs. However the problem with having one sector drag the markets higher is that when only one sector is doing well (as opposed to a broad market rally) it does not often last. In addition I have noticed many short-term market players enter the market. This has led to the present fast correction in which the senior oil producers are bringing the market back down again. So where to from here? Well economists are talking anywhere from $90 to $200 oil by 2010. What I feel you should focus on is - what is the actual outlook for the commodity? If you visit the EIA website (http://www.eia.doe.gov/), which is a US government agency, they will actually tell you what the outlook is based on their constant research. Their latest report which you can view at their website indicates the following: "Despite 7 years of rising prices the global oil market is still tight. While oil consumption in the OECD (mainly US) is down slightly, the rest of the world continues to consume more (mainly emerging markets). In 2009 world oil demand is expected to grow by 1.4mmb in while supply increases by only .83 mmb. There also is little surplus oil production capacity. Gasoline/diesel prices are forecast to rise higher by about 20% in 2009." In summary they are expecting oil prices to remain high based on supply/demand. The chart to the right indicates that US oil inventories have been trending to the lower end of the 5-year trading range indicating tight supplies. My thoughts are that the emerging markets of China, India, Brazil and Russia all have large numbers of people that are slowly getting wealthier, thus they will likely consume more oil in the future. Production is not increasing like it has been in the past (there are less and smaller oil discoveries). In addition governments around the world have been increasing taxation on oil producers while wages have gone up as well so the producers have been unable to drill as many wells that are needed to increase production (not even factoring in that mature fields are declining). Bottom line, I expect oil prices to remain high for a few years (with a range of $120 to $170) until eventually it is so expensive that people change their consumption habits (just like in the late 70s and early 80s), but more importantly the central banks will eventually raise rates likely leading to a weakened oil price. The only dark side to this scenario is that the last time this happened interest rates skyrocketed and people who were loaded up with mortgage debt lost everything. While I do see significantly higher interest rates in the next 2 years than people expect, rather than tell you to consider locking in a long-term mortgage now, I will be focusing on what opportunities there are in the market.



The oil producers have dropped significantly in the last few weeks as indicated by the chart to the right of the TSX Energy Index. The red line indicates where support should be found for the currently dropping share prices. As you can see - it is not too far away. The next chart indicates the price of oil in the same time frame. While the price of oil is at all time highs and is up over 120% from the lows of Jan '07 the producers are up only 30%. This tells me that the producers are already pricing in a drop of oil from current levels to $110. If the price of oil goes higher, then the producers will have to play catch and the share prices will rise. Since I feel oil prices long term will remain strong, the producers eventually will resume their upward rally and catch up to current oil valuations. For some investors, I feel owning the senior oil producers is a good way to insulate your portfolio from potential rising inflation. I would use this market weakness to establish a position in some of the senior producers as their profits are likely to continue rising. I feel the current downward trend in the markets will likely bottom this month.



In terms of the overall markets both Canada and the US are down, though the US markets have been much worse. The housing related problems will likely take many years to fix in addition to write-offs by financial institutions. I expect the US market to trade in a sideways pattern with rallies focusing on the earnings of US based global companies and drops caused by concern over financials and mortgage related issues. Canada should continue to do well as our resource-based economy should post nice profits from our many energy and commodity based producers. I do expect a trading, range bound market with rallies and corrections for the next few years as the issues in the US will take time to resolve. The current correction underway can be seen in the charts on the next page and I feel it will be short term in nature. I view it as a buying opportunity for many companies and a good time to build a portfolio focusing on high dividend yields. The markets are not in shape to begin a long-term bull market but rather whipsaw back and forth over the next few years. Taking advantage of the market lows will enable you to own companies at attractive valuations.



In addition to oil producers I like the utilities, consumer staples, and financial sectors. Utilities are easy to understand as they tend to have very predictable profits from pipelines, power plants and services to homes. Consumers cannot really say no to these services and will also continue to eat resulting in steady earnings for certain consumer stocks. Financials though are more difficult to understand. I do feel that this sector's problems are likely to last for a few years but overall they have a history of finding ways to make money. The current pessimism towards this sector is resulting in share price valuations that now are entering "value" territory. With dividend yields approaching 7%, the banks are worth considering, as eventually they will fix their problems. In summary, most of the companies I will be mentioning have high dividend yields. Since I feel we are likely to be in a sideways market for a few years - making sure you get paid to ride out the volatility is an important consideration!

Stocks to Consider

These companies should be considered for various reasons – valuation, industry, dividend yield, recent share performance. With consultation, I can assist you in determining the appropriate stocks for your portfolio.

Johnson and Johnson, JNJ, $66, dividend 2.8%
Good company that is expected to post higher earnings in the coming years as well as increases in dividends. Long-term outlook very favorable and sector should do well with aging population. Currently in a holding pattern with high of $68 and low of $63. If trades to $63, it would have a yield of 3% and trade at 13.5 times 2009 estimated earnings. At $63 this quality company would be priced at an attractive multiple.

Pfizer, PFE, $17.5, dividend 7%
Pharmaceuticals are a sector that is completely out of favor currently. Drug pipeline issues, US government changing Medicare, lawsuits all are the negative news used to criticize this sector. Does anyone realize the company is trading at 8 times estimated earnings for 2008 or that the dividend is 7%? Don't get me wrong, long term this company will be losing patent protection on key drugs so earnings will eventually deteriorate before later recovering on eventual new drugs. However I feel the recent drop from $27 to $18 is too much and a recover back to $22 or $24 is possible. Plus you get a nice dividend while you wait. I feel it has good value < $18.

Bank of Montreal, BMO, $39, dividend 7%
The banks do not deserve any respect due to the way they "misled" the public about their US debt exposure. This has caused investors to loose faith in them and the shares are now much cheaper. I still feel their problems will take a while to resolve, but the one thing banks are good at is doing whatever they can to make money. Long term, as these issues resolve themselves profits and valuations will return. BMO has an attractive dividend as a result of the share price drop and is worth owning. You will then get an attractive dividend while you wait for the sector to recover.

Weston, WN, $42, dividend 3.3%
Weston owns Loblaw, which owns Real Canadian Superstore, Extra Foods, Joe Fresh, PC foods and PC Financial in addition to the Weston family of baked goods. All are great brand names and their stores offer what I feel are some of the best prices for consumers. The threat of Wal-Mart and the restructuring of Loblaw has been a big drag on the stock, taking it down from $115 to the present $44. However at current prices you buy a company with great brand names, a 3% dividend, trading at12 times earnings and 3.5 times cash flow. In addition they own prime real estate in major centers across Canada. While it is in a more boring sector it has delivered consistent profits!

Manitoba Telecom, MBT, $38.2, dividend 6.5%
While Manitoba Telecom is mainly focused in Manitoba they have a very good customer base with reliable cash flow. I know it gets beat up for having land line phones but they also have internet, wireless and TV - all growth areas. This company has low debt and very consistent cash flow trading at 4.5 times cash flow. Presently it is trading near the 5 year low indicating less downside. When BCE is taken out it is possible that a large part of that money will need to be reallocated in the remaining telecom companies. Telus, T (another one to consider) has a smaller dividend of 4.5% but better growth prospects.

Petro Canada, PCA, $50, dividend 1%
After mentioning companies with dividends of 3 to 7%, you wonder how this one made the list with a yield of less than 1%? Well the growth potential is what I like about Petro Canada. PCA owns gas stations, refineries, and oil/gas production around the world. The refineries and production are what I really like. It trades at lower multiples than typical producers due to it's huge refining operations but I feel if it were to split up would be worth more than the present price (though this is unlikely to happen). In a period of high oil prices this is a good company to own. At present valuations it is trading at 6 times estimated earnings! Talisman, TLM is also another good producer to consider.

Scotts REIT, SRQ.UN, $6, distribution 14%
Scotts currently has a yield of 14% of which 70% is non-taxable as it is structured as a REIT and will not be impacted by the income trust decision in 2011 as REITs are grandfathered. Scotts owns 204 retail properties across Canada with the majority in Ontario and Quebec. Their tenants include KFC, Taco Bell, Pizza Hut, Rexall Pharmacy, Laurentian Bank, Staples, and Subway. It has dropped from a high of $12 to $5.75 likely due to its association with Priszm (a trust) that owns KFC and has struggled lately. I feel this is not an issue as Scott owns the properties and will still receive the rent and worst-case scenario will obtain another tenant. Scotts has a high yield and currently has a manageable payout ratio of 93%. As the negatives associated with Priszm are forgotten the stock has decent capital gain potential. In addition you will have capital appreciation associated with rent escalation clauses over time. It is a property play that you can buy at a discounted valuations to obtain high yields.

Yellow Pages Income Fund, YLO.UN, $8.3, 13.5% distribution
Yellow pages owns the print directory as well as online directory business in which they are the dominant player. The stock has dropped a fair bit in the last few months and now I feel represents good value. Previously it traded as high as $17 but now can be had for $8.5. It has been previously called a “market darling” as analysts touted it as one to own. This resulted in a high share price and expensive valuations. Now that sentiment has changed the opposite has happened and the price is more attractive. The red flags the company has are the threat of it losing business as more people do searches online instead of using the yellow pages and the eventual higher taxation in 2011 due to the income trust decision. Yellow pages does have an online presence and it still is useful to use as a business directory so I feel it’s long term outlook still is favorable. With regards to the income trust ruling it is in 2011 and the distributions will be impacted by 22% but at current prices a present yield of 13% will result in a yield of 9% then (still very attractive). Thus I feel it has good value at present valuations for income and growth.