

The Lychak Letter



"A Review of the Investment Markets in Canada"

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Government Rates / Currency

<u>Country</u>	<u>Rate (%)</u>
US Fed Target Rate	.25
US Prime Rate	3.25
Canada Overnight Rate	1.5
Canada Prime Rate	3.5

The year 2008 will be known as the year of disastrous financial markets as problems in the US had a global impact. The US government bailed out many public companies, US real estate values plunged, the Fed lowered rates to almost zero and several multinational US companies went bankrupt. Yes, it likely will be known as the year the US housing bubble and Wall Street sub prime debt and derivatives caused the severe downward spiral of the financial markets and the economy. I will discuss what I feel the central banks are likely to focus on in the coming months.

The Fed's main concern at present is propping up the weak economy. It is primarily attempting this by lowering the Fed Fund rate to almost zero making debt more affordable. It also is taking over certain weak financial related companies and bailing out others in an attempt to improve the ability of financial institutions to loan again. Real estate is expected to weaken further in 2009 and it is expected financial firms will face more losses as foreclosures increase. Due to mortgage related losses and the billions of dollars in debt the US government is creating with bailouts and stimulus packages I see the possibility of two dominant themes in the coming years. One is a weakening US dollar as the world gradually realizes how much debt America has and is creating and its status as a world currency will be at risk. Second, a prolonged period of low interest rates is likely as the government tries to make paying off this debt as affordable as possible. Eventually these low interest rates and the resulting weak currency may begin to create substantial inflation for the US as foreign countries stop funding the US's debt. This may ultimately force US rates higher as the US tries to make its debt more appealing. Thus I expect a prolonged period of low interest rates followed eventually by higher rates to ward off inflation.

The Canadian government appears to be in fairly good financial shape and has among the lowest debt loads of many of the industrialized countries. However, the recent weaker commodity prices coupled with the weak US economy and Canada's own housing related problems (which while lagging the US are starting to show an impact) could potentially result in numerous job losses and a deficit budget. This weak economy will allow the government to follow the US in lowering rates without triggering any inflation. The long-term outlook for Canada seems quite favorable as commodities are likely to strengthen in the long term. This could put pressure on the Canadian currency to trade closer to parity late in the year when commodity prices start recovering. I expect our central bank though will respond by lowering rates further to enable a weaker currency thus helping Canadian manufactures. Our overall good financial shape should allow us the ability to have a sustained period of low rates as needed till inflation becomes a concern.

Not everyone will get the benefit of low interest rates. Those that have good credit and substantial equity in their home will be able to take advantage of low mortgage rates. But for people with a large mortgage relative to their equity as house prices deteriorate and home equity erodes further the banks will view them as a higher loan risk and they will not be offered these low rates. They may have no choice but to accept a higher mortgage rate or be forced out of the market. This could create further price declines in some of the more pricey real estate markets in Canada. I expect the recent correction to continue its trend for a few years, as the excesses will painfully work their way out of the system. If the stock market can correct 40% in one year then real estate will likely do the same but over a longer time frame.

North America Stock Markets

The last week has already seen an advance in the equity markets, which often is typical after the tax loss-selling period ends in late December. I do not believe this rally is a sign of the markets beginning to recover but more of money sitting on the side rushing to get back in before bargains in certain sectors disappear. With bank GICs offering low yields (presently 3%), and likely to be lower in the future as Canada's central bank has already hinted at further cuts, what other choices do investors have? Getting ahead on 3% interest from bank savings accounts is difficult and the high dividend yields offered by many companies will become a more appealing alternative in spite of the risk. This sector rotation to high dividend yielding companies could drive a specific rally though I expect weak economic news and more problems will take the markets back down to lows before having the potential for the beginning for a true recovery late in the year. I do feel profits can be made on this rally though timing is important. I also feel that the high yields offered by some companies are very attractive long term, as low GIC rates will force people into finding sustainable alternatives for yield. I believe the high yielding utility sector will benefit the most from investors seeking reliable yield although I am optimistic on various other sectors as well.

Financials

I believe the banks are due for a brief recovery rally. With dividend yields close to 9% and their GICs offering less than 3% this variance in yield alone merits consideration? I am expecting more writedowns in 2009 and a retest of lows but for now a rally is likely. I expect it to be brief and peak prior to the next quarterly results where more issues the banks have previously not disclosed may surface. I feel, if timed correctly, you can buy on the lows, receive the dividend (if held over the dividend period) and potentially a decent return on the rallies. Mutual fund companies should also rally as NAVs rise along with the markets. It likely will be of similar duration as the banks. Overall, I expect the financials to trade sideways in a narrow range this year.

National Bank, NA, \$34, 7.5% dividend

Bank Montreal, BMO, \$33, 8.4% dividend

AGF, AGF.B, \$9.3, 10.7% dividend

Gold Producers

The rally in financials is likely to be met with a softening in the price of gold. People seem to be using gold as a protection against currencies more than inflation in this case so rising financials will likely work against gold. For this reason I would suggest selling gold holdings now as the recent rally leaves less upside and a chance lows may be retested.

Oil Producers

Crude oil (long term) is likely to begin strengthening in price. It is expected to remain weak for most of this year as demand issues will have greater significance than supply. Production cuts from OPEC and focus on the stimulus package from Obama should temporarily strengthen the price of oil. But a worsening international economy over 2009 should keep the price low. Eventually, decreased drilling from producers with less cash due to current prices will lead to production declines. In turn when the economy rebounds there could be a potential shortfall leading to higher prices long term. I expect oil to trade in a volatile range of \$30 to \$60 this year with senior producer benefiting the most from these swings due to their liquidity.

A strengthening price of crude oil will eventually be met with a rising Canadian dollar. I would thus encourage selling foreign denominated securities, as gains could be offset with currency related losses. The Canadian dollar trading closer to parity with the US dollar is possible in the coming months though our government will try to weaken the currency by lowering rates to help the Ontario manufacturing sector.

Talisman, TLM, \$12.3, 1.5% dividend, 2.4x historical cash flow

Petro Canada, PCA, \$30, 2.2% dividend, 3.2x historical cash flow

Utilities

Low yields on GICs offered by banks will result in investors focusing on yield when buying securities. I believe these high yields offered by many companies are a good choice for long term yield and growth. I feel the utility sectors (pipelines and power companies) may not only rally but remain strong even if the market weakens again as investors look for a sustainable solution to low yields from bonds and GICs. In my opinion this sector has the best potential for gains in the coming year.

Pacific Northern Gas, PNG, \$13.5, 6.5% dividend, 5.6x historical cash flow

Algonquin Power, APF.UN, \$2.5, 9.6% yield, 4.5x historical cash flow

EPCOR Power, EP.UN, \$17.3, 14.5% yield, 6.6x historical cash flow

Emera, EMA, \$22.5, 4.3% dividend, 5.5x historical cash flow

Inter Pipeline, IPL.UN, \$7.8, 11% yield, 5.3x historical cash flow

Fort Chicago Energy, FCE.UN, \$7.5, 13.6% yield, 3.7x historical cash flow

Boralex Power Income Fund, BPT.UN, \$3.5, 19.6% yield, 3x historical cash flow

Communications

Companies involved in wireless, phone, and cable/satellite distribution should have fairly reliable profitability over the current economic weakness. For this reason the attractive dividends are worth considering.

Manitoba Telecom, MBT, \$35, 7.4% dividend, 4.3x historical cash flow

Commercial REITs

With the weak economy many companies will be cutting costs and downsizing in the coming year. This will likely impact many commercial REITs as keeping properties full may get more difficult. However, many REITs have dropped so much in price they have already factored in this weakness and the yields being offered are too attractive to ignore.

Scott REIT, SRQ.UN, \$4.45, 19% yield, 4.1x historical cash flow

In summary you will have to be patient when buying many companies and be prepared to take smaller profits on rallies. Some sectors will likely remain strong while others have the potential to deteriorate further. The economy is likely to get worse over 2009 but eventually the housing sector will start to bottom and the slow recovery will begin. The stock market is likely to perform weak over this year but there are always areas profits can be made. Being patient and picking the right sectors will be important.

To reiterate, at present prices I feel the following stocks offer good value and attractive yield; Bank Montreal, AGF, Pacific Northern Gas, Algonquin Power, Boralex Power Income Fund, Manitoba Telecom and Scott REIT. With the present high market volatility, prices can change rapidly so please contact me to determine present opportunities and suitability for your personal situation.

Patrick Lychak currently has a position in the following companies: Petro Canada, Talisman, Scott REIT, Bank Montreal, and AGF Ltd.

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