

The Lychak Letter



“A Quarterly Analysis of Bond and Stock Market Trends Worldwide”

December 2001



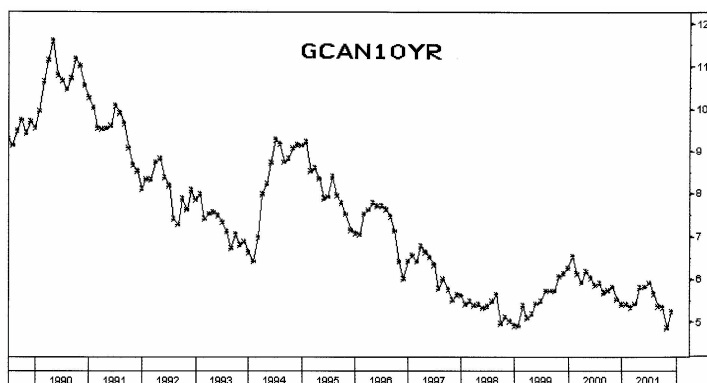
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Government Yields / Currency

Term	Cdn Govt	US Govt.	Cdn Rates
	Yield	Yield	
			Prime 4.0 %
			Bank 2.5 %
3 mo	2.05 %	1.69 %	US Rates
6 mo	2.09 %	1.81 %	
1 yr	2.44 %	2.3 %	
5 yr	4.83 %	4.48 %	
10 yr	5.53 %	5.16 %	
30 yr	5.76 %	5.58 %	Fed. 2.0 %
			\$CDN = 0.635

The last few months have resulted in the Federal Reserve cutting rates further in an attempt to rescue the US economy from a recession. Canada has followed suit and the end result is some of the lowest interest rates seen in many years. By dramatically reducing borrowing costs the central banks are hoping that people will resume spending and the North American economies will recover. This same scenario is also happening around the world as well in all other developed countries. I do believe that the lower rates will eventually help the economies recover, but I do believe it will take some time. As a result I expect short-term rates to remain low for the next few months and do not see the potential for higher short-term rates till later in 2002. Long-term rates, on the other hand, have only dropped a little indicating that they are unlikely to go much lower. Recently many people have been canceling mortgages and opting for variable terms in an attempt to reduce the amount of their mortgage payment. While in the short-term this strategy will reduce borrowing costs, short-term rates will not remain low forever. And long-term rates move higher well before short-term rates do. So I would urge caution and encourage people to lock in a longer-term mortgage while rates are low. Once short-term rates begin rising the longer-term rates will already have risen. I have enclosed a chart indicating the yield of 10 year Canadian Government securities to show how long-term rates have fluctuated over the last 10 years.



Another thing that has been in the papers lately is that Canada should adopt the US dollar. Well the only reason that this topic has been created is due to the weakness in the Canadian dollar lately. However, the Canadian dollar is only weak due to the dominant role the US economy has played in the equity markets in the last 10 years and the fact the Canadian central bank has been aggressive in lowering rates to stimulate the economy and rollover Canada's federal debt at lower rates (thus reducing debt servicing costs). Anyone who thinks that converting the CDN\$ to US\$ (when the exchange is at it's worst ever) is a good idea, is not someone I would listen to. I feel that this topic will disappear and not be heard from again in the future and is likely the indication that the CDN\$ is almost at the bottom.

North America Stock Markets

The terrorist attack in September resulted in the stock market dropping substantially soon after. However, to a large extent that drop was not a result of the attack but was more a reflection of the overvaluation of US stocks. I feel that it would have happened anyways and that the terrorist attack simply speeded things up. The real impact of the terrorist attack was temporarily reduced travel and a slowdown in all industries that rely on that sector of the economy. To a large extent travel was declining substantially anyways as the slowdown in the economy forced companies to cut travel expenses. So the reality is that the decline in the market was more a result of the deteriorating economy (which was already a known fact prior to September), but people like pointing the blame at something else. Now the last couple months has seen the stock market recover back up to levels prior to the terrorist attack and it seems like everything is back to normal. People who previously were scared of their equity mutual funds now are feeling better. But is this really the case and is peoples returning sense of calm going to last?

<u>Index (Dec. 8, 2001)</u>	<u>Value</u>	<u>%chg/3mo</u>	<u>%chg/1yr</u>
TSE 300 Index	7616	+ 4 %	- 20 %
S&P 500 Index	1158	+ 6%	- 15 %
Dow Jones Industrial Avg.	10049	+ 5 %	- 6%
NASDAQ Composite Index	2021	+ 20 %	- 30 %

I do not believe so and I feel that this rally is really just a brief correction of the overall long-term downtrend. It is often quite normal for the market to recover back up to previous levels after dropping substantially. It is usually at this point when it is the ideal time to sell that the inexperienced actually do not want to sell but actually want to buy again. I still am negative on the overall market for the following two reasons: 1) Unemployment is still rising. This results initially in the unemployed relying on unemployment insurance and on their severance packages. However eventually they cut spending dramatically as debt rises and the need for money increases. Thus as people become unemployed they gradually reduce spending as the length of their unemployment increases. This further weakens the economy and results in higher unemployment in the future. Thus, I feel until the unemployment numbers stop rising the economy is only going to get worse.



2) Stock market valuations are still at levels of a very healthy, expanding economy. But this is not the case for the current economy. Because I feel that the economy is likely to remain weak and not begin to recover till later in 2002, the market presently should be trading at lower valuations. At current valuations there is little upside even if the economy were healthy. Because of my beliefs I am finding that as I research the markets trying to discover good stocks to buy I am not having much success at the current prices. I feel that the large cap stocks are overvalued the most as compared to smaller companies. And because interest rates have dropped substantially this year, dividend paying stocks have risen dramatically as investors try to find alternative sources of income. These income oriented stocks presently are trading at very high valuations and will have substantial downside once interest rates start rising again. For this reason I would avoid dividend mutual funds or other income oriented equity funds even though they have had good returns in the last few years. I still feel that the markets are going to have another leg down either soon or in the first half of 2002 before the market truly can bottom. As a result I am going to wait till then and see what the future will bring.

World Markets

To a large extent you can pretty well take a look at a chart of the S&P 500 Index (US stock market) and it will look the same as the charts of all other market indexes around the world (with few exceptions). This indicates the role the US economy has had in leading the world economy in the last few years. It also indicates that while the US economy has lead the world markets up, it is also likely to lead the world markets back down again as well. Because I am bearish on the US stock market I overall am still bearish on the world markets as well. There are some exceptions like Australia and Japan, which seem to be existing in another world as their stock markets have not exactly followed what has happened around the world. But it seems that Japan is the one market that seems to be trading at the lowest levels historically and still has not had a recovery in years. Well, from my research Japan may be trading at low levels but not low valuations. As a result I would prefer to wait on the sidelines the next few months and see how things unfold.

Index (Dec. 8, 2001)	Value	chg/3mo	chg/1yr
London FTSE 100 Index	5264	+ 4 %	- 16 %
German DAX Index	5199	+ 11 %	- 22 %
France CAC 40	4642	+ 6 %	- 21 %
Brazil Stock Index	13298	+ 11 %	- 11 %
Mexico Bolsa Index	6141	+ 5 %	+ 6 %
Australia ASX Index	3371	+ 4 %	+ 2 %
Japan Nikkei 225 Index	10796	+ 6 %	- 26 %
Hong Kong Hang Seng Index	11832	+ 14 %	- 22 %

As a result I would prefer to wait on the sidelines the next few months and see how things unfold.

Commodity Markets

Well, natural gas prices dropped substantially over the Summer and now it seem that oil prices are now dropping. OPEC previously stated they would keep oil in the \$24 - \$28 price range. However with the slowing global economy, resulting decreased demand, and current overproduction it is obvious which direction oil prices are heading. OPEC is trying desperately to get other countries to cut production but when everyone needs the money it is very hard to get countries not to cheat on production. As a result I expect oil prices to continue dropping until the global economy begins to show signs of stabilizing. Knowing that I do

Commodity	Price US\$
Crude Oil	\$19
Gold	\$274
CRB Index	180



not expect this to happen till later in 2002, oil prices I expect may get a lot cheaper. I have already been asked if now is a good time to buy oil producers? Well, I have found that the producers are still trading at high valuations based on when they were making lots of money at the previously higher oil prices. As producers cash flow begins deteriorating so will their share prices. So in the coming months, as cash flow deteriorates, share prices of oil producers may continue to decline. This is why I feel there is still substantial downside in oil and gas producers and do not plan on buying these stocks till mid to later 2002.

To a large extent most commodity prices are soft as the weak global economy has resulted in decreased demand. It will not be until things start recovering that prices will begin to firm up again. Gold however is a commodity that I am getting interested in again. Not only do I feel that gold producers are likely to do well in the short-term if the market resumes going down, but I now feel that long-term there is very good upside potential. My reasons for this are as follows; 1) Several of the large producers are merging which is resulting in even larger producers that will be able to more significantly manipulate the supply of gold and impact the price of gold. 2) Gold hedging positions are being unwound which will result in less supply. 3) The US dollar is likely to drop in value resulting in gold being cheaper to buy. 4) Mine production is in decline and supply is decreasing as reserves are being depleted. I feel that these ingredients give the potential for gold to rise in price at some point in the future. Add in the potential of a volatile stock market and you have some very good reasons for owning some of the senior producers.

Fixed Income

Following is a list of bonds and debentures that I feel offer a good yield and are "A" rated quality. Yields have dropped a little since the last quarter and I still am suggesting terms of 1 to 3 years.

- | | | |
|--------------------------|----------------------------------|--|
| - GMAC, Nov. 2002, 3.17% | - GMAC, April 2003, 4.07% | - CIBC, March 2004, 3.81% |
| - GMAC, June 2004, 5.14% | - Enbridge, November 2005, 4.96% | - TransCanada Pipeline, Oct. 2007, 5.76% |

Tax & Investing Information

Capital Gains and Losses

Did you sell any mutual funds that were not inside your RRSP last year? If you did, you either had a capital gain or a capital loss. Capital gains result when you sell something above its adjusted cost base (ACB). Conversely, a capital loss occurs when you sell something for less than its ACB. Mutual fund companies report your capital gains and losses due to dispositions on your December 31 statements. They accurately keep track of your ACB, which can be complicated with multiple buys and sells. When you do your income tax, you are able to deduct capital losses from capital gains. The government then wants a portion of your net capital gains for themselves. Fortunately, capital gains are not taxed nearly as hard as regular income from your job or from interest. The net income from your job or your bank account is 100% taxable (i.e. if you make \$100 from either, you have to add \$100 to your income). If you sell a mutual fund for \$100 more than you paid for it, you only have to add \$50 to your income because the inclusion rate for capital gains is now 50%. Keep in mind that, while capital gains have to be claimed in the year in which they arise, capital losses can be carried back for three years or carried forward indefinitely. By spotting investments in your portfolio that have declined in value, you may be able to reduce your capital gains with capital losses. Remember that if you are going to take a loss on an investment, you cannot re-invest into that investment within 30 days. As well, if you choose to make an in-kind contribution to your RRSP with an investment that is in a loss position, you would be better off to sell it and then contribute the cash to the RRSP. That way you can claim a capital loss and an RRSP deduction. You can't claim a capital loss and an RRSP deduction from transferring a losing investment.

Mutual Fund Distributions

So now you are thinking "Thankfully, I didn't sell anything last year, so I don't have to worry about all that." Not so fast mutual fund investor. Did you receive a T3 or a T5 indicating a distribution from any of your funds? If so, you might have capital gains in addition to dividends and interest to add to your income. Distributions arise from the fund managers' activities as well as the nature of the fund. Money market funds and bond funds distribute interest income, dividend funds distribute dividends which are eligible for the dividend tax credit and equity funds typically distribute capital gains, though there may be some excess interest and dividend income that was not able to be written off against the management fees. The interest distributions are treated just like bank interest. Dividend distributions that are eligible for the dividend tax credit are grossed up by 25% on the T3 so that you can claim a dividend tax credit of 13.33% on your T1 return. T3's indicating capital gains distributions break down the distributions this year, so that you know which reporting period to allot them to. If you have segregated funds from the insurance industry, you might also receive a capital loss distribution. Mutual funds only report net capital gains, having already considered capital losses.

Distributions are interesting things. You may receive distributions (and therefore have



to add to your income) from your mutual funds, which may have even dropped in value (potential capital loss?). Typically, mutual funds make their distributions in December, so it is wise to check with your advisor in the last quarter of the year to see which will be greater, the attained capital gains in the fund or the potential distribution. Sometimes it can be cheaper to cash out of the fund just before the distribution is made and take a capital gain or loss than to accept the distribution from the fund. Even if you do not physically receive the distribution you are responsible for the tax on it. If you do accept a reinvested distribution, it is added to your ACB so that you are not taxed on it again when you eventually sell.

The above material is general tax information. One should seek individual tax advice specific to their needs, as individual circumstances may vary.

Focus Stocks

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New ideas:

With the current markets I am finding it very difficult to find many good buys out there (especially large-cap and dividend oriented stocks). As a result I prefer to wait until Mid 2002 when I feel there may be better deals. There are several companies I am following that I may be mentioning soon but due to the fact I feel upside may be limited the next few months I am opting to wait.

Check out my web-site where I post past issues of the Lychak Letter!

www.avalueinvestor.com

Patrick Lychak

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