

The Lychak Letter



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

September 2004



Patrick Lychak, Investment Advisor
CIM, FMA, B. Ed, Options Licensed
Wolverton Securities Ltd.
17th Floor, 777 Dunsmuir St.
Box 10115 Pacific Center
Vancouver, BC, V7Y 1J5

Tel: (604) 662-5287
E-Mail: PatrickL@wolverton.ca
Website: www.wolverton.ca/patrick

Government Rates / Currency

Term	CAN Gov. Yield	US Gov. Yield	CAN Rates
			Prime 3.75%
			Overnight 2%
3 mo	3.14%	1.6%	US Rates
6 mo	3.3%	1.79%	
1 yr	3.5%	1.4%	Prime 4.5%
5 yr	3.98%	3.3%	Fed Fund 1.5%
10 yr	4.6%	4.11%	
30 yr	5.11%	4.67%	\$CDN = 0.76

On September 8th the Bank of Canada is expected to announce that it will raise the overnight rate by a quarter point from 2% to 2.25%. Previously the central bank had been lowering rates to prevent the Canadian dollar from strengthening too much. The quick rise in the Canadian dollar was hurting exporters financially and reducing Canada's economic growth so the central bank lowered rates to stop the rise in the currency. After the Canadian dollar stabilized and exporters adapted to the new price of the currency the central bank left rates alone and economic growth returned. However, now the government feels that while the Canadian dollar is still high, the economy has posted decent growth this year to warrant concern over potential inflation. Thus the government has indicated the likelihood of a rate hike this week and that it may raise rates further on October 19th. While I feel this is a likely scenario and the current data indicates the economy is strong, I do not feel the strength will continue at the current pace later in 2005. As a result I feel interest rates will likely pause after October and remain in the range pending further data.

In the United States the Federal Reserve has already begun raising rates with quarter point increases in June and August to bring the current rate to 1.5%. It is expected the Fed will raise rates again this September 21 by another quarter point to 1.75%. This is based on Alan Greenspan saying, "the central bank will stick to a plan to raise rates at a measured pace". Even though recent economic data from the States indicates economic growth is slowing, the central bank feels this is temporary and that the economy will resume its growth. I feel that it is likely rates will rise this September, however I believe the US will have flat growth in 2005. The US government is amassing a large debt as a result of its current budget deficit and this issue will need to be addressed quite likely with a combination of a rise in taxes and a cut in services. The US's rising debt is a serious issue and has the potential to spiral out of control (potentially causing interest rates to rise dramatically). However, that situation would require the US government to ignore the deficit some more and let it grow even larger. 2005 will be a difficult year for the US president as he will face the tough task of facing the growing debt. I do not believe rates will rise much more in early 2005 as I do expect economic data to be weaker. However, while the US debt currently has no effect on US rates I feel it will begin exerting a greater and greater influence as we go further into 2005 and 2006.

What is interesting to note is that Canada is one of the few countries that is balancing their budget. All of the other G7 countries currently have deficit budgets with Japan at -8.2%GDP as the worst. Germany has the highest unemployment rate at 10.6% followed by France at 9.9%. The issues these countries are facing are not going to be solved quickly either. The reason why I feel this is worth noting is that it indicates the largest nations are struggling and this may lead to deterioration in the global economy in the coming year.

North America Stock Markets

The last year has been quite good to the markets with most indexes hitting higher levels again. However in the last 6 months the markets would be best described as quiet. The reason is that in the last 6 months the markets have gone down slightly and have been stuck in a sideways trading range for a few months now. Because no profits have been made investors are now sitting on the sidelines and beginning to wait and watch.

The markets currently are considered expensive based on valuation measures. However, they are at this level because the governments had previously reduced interest rates and created a lot of cheap money for consumers and corporations. This not only has stimulated the economy dramatically but has also given few options for one to invest their money as deposit rates and bonds have offered very low yields. This low interest rate environment has helped companies recover from the recession of 2000 but now that companies are trading at higher valuations again investors are getting cautious. The reason is that while company's earnings have improved the government at some point will have to raise interest rates to prevent

<u>Index (Sept 3, 2004)</u>	<u>Value</u>	<u>%chg/6mo</u>	<u>%chg/1yr</u>
TSE 300 Index	8344	- 5 %	+ 10 %
S&P 500 Index	1113	- 3 %	+ 8 %
Dow Jones Industrial Avg.	10260	- 3 %	+ 7 %
NASDAQ Composite Index	1844	- 9 %	- 0.5 %

inflation. The markets are thus in this tug of war where they are unlikely to go much higher from current levels but also have the potential to drop.

One other piece of the puzzle is that this is an election year in the United States. To most people this means nothing, but most sophisticated investors know that throughout history the market normally does well in an election year. Well, this is further reason for the markets to do well in the remaining months of 2004. While the markets have historically done well in an election year, they have also performed poorly in the following year. Which is why most market professionals expect 2004 to be okay and 2005 to be a poor year.

Where to we go from here? Well, with interest rates still very low, companies reporting decent earnings, and this being an election year, it is still possible for the markets to rally from here till the end of the year and into early 2005. I do not expect much of a rally but it could go about 10% higher from current levels. If this scenario were to unfold then this excessive high would likely be followed by a large drop (heading back to the lows reached in 2003) later on in 2005. Another option is that the markets continue going sideways leading up to the election and till the end of the year followed by a correction later in 2005 that takes the markets considerably lower from current levels. Either way you should not be too aggressive with your investment portfolio. The government is in a tough spot in the States as they will want to raise rates but yet will not want to hurt the economy. The other problem is that the government is currently in a big budget deficit that will need to be addressed. So far the government is putting things off and letting the debt grow considerably larger. But this can only be done for so long till increased taxes and reduced government spending must happen. It will be very interesting to see how things unfold in the coming year as the government has already indicated that measured increases in rates are quite likely to occur.

Commodity Markets

Oil futures reached \$49/barrel on August 20th, the highest level since these futures began trading in 1983. This is no surprise as many people found it getting more expensive to fuel up their vehicles. Oil seems to have valid economic reasons for a higher price level with the larger demand coming from China but most analysts feel that a price level of \$30 is justifiable. The reason prices are considerably higher is because of the continuing disruptions to Iraq oil production and the ongoing uncertainty over Yukos (Russia's largest oil producer). Until these two countries get things resolved there will remain a price premium in the price of oil. The other issue that could derail the price of oil is if the global economy faltered (something which I do not expect to be likely unless in later 2005). I feel oil will remain around \$36 - \$40 until we hear less about Iraqi oil disruptions and the Yukos issue is resolved.

Commodity	Price US\$
Crude Oil	\$44
Natural Gas	\$4.67
Gold	\$402

Natural Gas prices are starting to soften as it is becoming apparent that there will be plenty of gas in storage for this Winter (when demand for gas exceeds supply). US gas inventories are 7.3% higher than the previous 5-year average and 11% higher than this time last year. The reason for the large increases in gas storage is the cooler Summer weather has reduced the need for gas powered electricity and the record number of rigs drilling for the fuel this year has increased supply. This leads me to believe that this Winter will see a softening in the price of gas that will likely continue into 2005. I still believe though that longer term the price of gas has the potential to remain high as overall reserves of gas are declining and demand continues to grow. There is a pipeline in the works to connect NWT gas and many liquefied natural gas (LNG) ports in the planning phase, but they are unlikely to be completed and operational until 4 years from now. While this coming year looks like it will be softer for gas prices, I feel in the coming years stronger prices are more likely until the pipeline and LNG facilities are constructed. This may result in a buying opportunity in 2005 as natural gas producers report lower cash flows.



Gold has lost a bit of momentum in the last few months as it has corrected 7% from a high of \$433/ounce in April. The main reasons are a strengthening US dollar due to a belief in an improving US economy and the government stating they will raise interest rates in coming months. European central banks announcing they will be increasing sales of gold has not helped either but it is obvious they want to cash in on the higher prices for the metal. I still feel that long term there are reasons for a higher price of gold but I feel at current levels I would rather wait for the potential of a correction before buying gold producers.

Fixed Income

Based on central bank statements of coming interest rate hikes it is likely that short-term rates will be higher in the coming months. Long-term rates have risen a little but not as much as one would expect. Long-term rates are more dependant not on what the government says interest rates should be but based on how the market interprets the economy and government

debt levels are. The reason for long-term rates being lower is that the market is not as confident in the strength of the economy and feels rates will not go up that much. I feel that at some point in the future if the US government continues to run a deficit budget they will be punished with considerably higher interest rates. I still feel this is a couple of years from now but it can take anything to set off this ticking bomb. As a result I would be inclined to suggest investing in bonds with a maturity of 1 to 2 years for now as it is likely we are in a rising interest rate environment. The potential for a spike in the 3 – 5 year yield will be watched as opportunities may present themselves in the coming months.

Current yields for high quality 1-year bonds are about 2.8%.

Special Report – Oil & Gas Income Trusts

With the current majority of the public in love with income trusts I feel it is important for one to know the risks and how they are valued, as valuations for income trusts remain at high levels.

Oil & gas income trusts are quite similar to a standard oil and gas producing company except that a producer will use all cash flow generated from wells to fund future exploration and grow production levels while an income trust will pay out most cash flow generated to shareholders in the form of a distribution. As a result an income trust's reserves typically deteriorate or deplete unless more shares are issued to raise money to fund future reserve acquisitions to maintain cash flow levels. When oil and gas prices are rising both companies do very well as cash flow is up considerably. When oil and gas prices decline producers find themselves in a difficult position where they find it difficult to grow production and income trusts production declines considerably. The worst environment for an oil & gas income trust would be a long period of low commodity prices.

The key variable involved in determining how these companies are valued is essentially a multiple of how much cash flow they generate. Cash flow is how much cash is generated after paying all expenses. It reflects how much money a company has to spend to either drill more wells, pay down debt, or buy more land for drilling. Let's look at a sample company. Let's say it sells its oil at \$30/barrel but has royalty expenses of \$6/barrel, operating expenses of \$9/barrel, general and administration expenses of \$2/barrel, and interest expense of \$1/barrel. This company's approximate cash flow would be around \$12/barrel ($30-6-9-2-1=12$). It actually would be a little higher as the company can use the expenses to reduce taxes payable, but I want to keep things simple. Now what is important to note here is that a company's expenses are often relatively stable, though they do decrease as the company gets larger. However, the underlying price of the commodity can vary dramatically and this has a huge impact on how much cash flow this company generates. The above company has total expenses of \$18/barrel ($6+9+2+1=18$). If the price of oil were to decrease below \$18 this company would not generate any positive cash flow. Which explains why oil producers do poorly when the price of oil drops below \$18. In fact if the price of oil were to go to \$15/barrel for a couple years you would see many companies with financial problems. However, once the price of oil goes to \$22/barrel this company would generate \$4/barrel in cash flow. If the price went to \$26/barrel the cash flow would double to \$8/barrel. At the current price of oil \$44/barrel this company's cash flow would be far greater. The point I am trying to make is that when the price of oil is around \$24/barrel companies make money but if the commodity price rises substantially the profits and the cash flow increases dramatically. However while many companies today are making lots of money it is important to know that if the price of oil were to drop back to \$26/barrel the cash flow of many companies would drop dramatically.

The next important item is what type of oil is produced. Light oil is normally what is quoted in the newspaper. This oil attracts the higher prices. Heavy oil has more refining costs and thus obtains a lower price, typically about \$4 less. If light oil prices were to drop to \$22/barrel, heavy oil would likely be selling for \$18 and companies that produce this oil would be struggling. The same applies to gas producers though gas prices are typically converted to barrel of oil equivalent (boe) to make things simpler. However if the price of gas dropped it would have a big impact on cash flow generated.

The normal valuation parameters are that small companies will trade at multiples of 3 times cash flow, mid capitalization companies tend to trade at 6 times and large companies trade at 8 times cash flow. This is because a large company will have good economies of scale and will produce oil at a lower cost than smaller companies. Also it will be safer due to a larger production base. If you end up investing in a smaller company that grows its production you can benefit from the increasing

Subscribe to Martha Stewart Investing and save more than 50 percent off the cover price!

MARTHA STEWART Investing special issue

WHEN YOU SUBSCRIBE TO MARTHA STEWART INVESTING, YOU'LL GET THE INSIDE SCOOP ON EXCITING FINANCIAL SUCCESS STORIES... READ THE FINANCIAL SECRETS THE MARKET HAS TO OFFER... PREMIER DRUG, HELLARY EXPLAINS HOW SHE TURNED \$1.5M TO \$100,000 BY INVESTING IN EARLY PHARMS... WITH ABSOLUTELY NO EXPERIENCE

AVAILABLE 12 YEARS TO GO!

multiples it will be rewarded with as it gets larger. A smaller company trades at lower multiples due to the higher risk associated with it. If it went through a cycle of weaker oil prices it can drop far more in price.

The reason why oil & gas income trusts have been so popular lately is that because of the low interest rate environment investors would rather buy an investment that yields 8% or greater. The current multiple that oil & gas income trusts have been trading at is between 6 - 7 times cash flow (about the same level as a large producer). This is why so many smaller companies would rather convert to an income trust and be rewarded with higher multiples now than wait many years to grow in size. If a small oil & gas producer generated \$1/share in cash flow, then it would trade at 3 times cash flow or \$3 a share. However if they converted to an income trust they could instead pay out \$0.75 in distributions to shareholders. This works out to a 25% yield if the stock remained at \$3 ($.75/3 \times 100 = 25$). However, investors would keep buying the stock (due to the attractive yield) and as the price rose the yield would drop until the share price reached \$6 at which point the yield would be 12.5% ($.75/6 \times 100 = 12.5$). This 12.5% yield is the typical yield currently for most oil & gas income trusts. The stocks new share price of \$6 is now a multiple of 6 times cash flow ($6 \times 1 = 6$). So you can now see why so many smaller companies want to get bought out or convert to an income trust. The multiple goes from 3 times to 6 times quickly and is an excellent exit strategy for management.

It is not simply based on cash flow though. You also have to consider a company's debt, land base, production growth potential, management, and reserve life. This would take much longer to explain though. What I do want to point out though is that at the current prices for oil many income trusts are generating the highest cash flow levels they can. If oil were to drop in price, cash flow would drop considerably. This would have a negative impact on distributions and the resulting yield as they would drop as well. In some cases you are better off buying a producer trading at 3 times cash flow than an income trust that has a 12% yield as it is relatively a similar company but half the price. However the current popularity of income trusts has resulted in most investors being blinded by the yield and not aware of the risks.

Zargon Oil & Gas Income Trust, ZAR.UN – TSE, \$19

If I were to recommend an oil & gas income trust I would say take a look at Zargon Energy Trust. While most trusts pay out 80-90% of cash flow Zargon only pays out 50%. The reason why most trusts pay out almost all cash flow is that the investor thinks they are getting the highest yield (which would be true). The problem is that there would be very little cash flow left after distributions to grow or maintain a companies reserves or production. This is the problem that will be faced at some point in the coming years when the price of oil softens. Zargon pays out 50% so the yield will be lower (8.5% as opposed to 12% for most income trusts). However, the remaining cash flow will be used to reduce debt and increase production levels in the future. This would give this income trust the best potential to maintain distributions in a weaker oil price environment. Zargon currently trades at \$19 and has 2004 estimated cash flow of \$3.65 for a cash flow multiple of 5.2 times. For a research report on Zargon and comparison report on other income trusts feel free to contact me for more information.

Please note that past issues of the Lychak Letter can be downloaded at the following address:

www.wolverton.ca/patrick

The information contained in this newsletter is drawn from sources believed to be reliable, but the accuracy and completeness of the information is not guaranteed, nor in providing it do the author or Wolverton Securities assume any liability. Neither the author nor Wolverton Securities assume any obligation to update the information or advise on further developments relating to the information provided herein. This newsletter is intended for distribution in those jurisdictions where both the author and Wolverton Securities are registered to do business in securities. Any distribution or dissemination of this newsletter in any other jurisdiction is strictly prohibited. The holdings of the author, Wolverton Securities, and holdings of their respective directors, officers and employees, may from time to time, include the securities mentioned in this newsletter. The views and opinions expressed herein are of the writer only and are not necessarily representative of Wolverton Securities Ltd.

