

The Lychak Letter



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

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Government Yields / Currency

Term	Cdn Govt Yield	US Govt. Yield	Cdn Rates	
			Prime 6.75 %	Bank 5.25 %
3 mo	4.52 %	4.13 %	US Rates	
6 mo	4.56 %	4.19 %		
1 yr	4.60 %	4.20 %	Prime 8.0 %	Fed. 5.0 %
5 yr	5.25 %	4.84 %		
10 yr	5.62 %	5.23 %		
30 yr	5.94 %	5.68 %	\$CDN = 0.64	

Well it has been kind of interesting what has happened in the last few months. The Fed has cut rates some more and the Bank of Canada has done the same. However, while short-term rates (1 year or less) have dropped by about 1 percentage point, long-term rates (more than 10 years) have actually risen by a quarter point! What does this mean? Well it implies that the market feels that short-term rates may go lower or can remain at current levels for at least a year. However while for the next year rates may remain low the market feels that eventually they are going to rise again. The increase of a quarter point in the 10 year bond to the current yield of 5.94% implies that long-term rates are unwilling to go much lower as the risk of substantially higher rates in a few years is not worth it. As the stock market is currently weak and there is uncertainty in the economy it is unlikely that rates will change much in the near future and will remain low where they currently are. The Canadian dollar is at a year low of 64 cents US and does not have the potential for strengthening until the world ends it's fascination with the US dollar. If you think things are bad here in Canada, well then you should travel to Australia. The Australian dollar has dropped even more than ours and currently is at 50 cents US! The main reason is the world has this funny perception that the US economy is a powerhouse and the US dollar is supreme and invincible. However, I feel they have let their economy surge for too long and now will be paying the price. The price is that things will get much worse than people expect and it will take a while for things to get better. What does this spell for the Canadian and Australian dollar? Well, I feel that both these currencies long-term will actually strengthen. It may take a couple years for this to happen but the current prices of these currencies may be close to the bottom...

North America Stock Markets

Last newsletter I warned that, “the overall market still has lots of downside”, and that I felt, “Cisco, America Online, and Research in Motion had no justification for their current prices”. Well not only has the market gone lower but these three stocks have now declined 69%, 16%, and 69% respectively so it looks like I was right. I now hear this question a lot, “Is Nortel a buy?” The reason for this is that Nortel was one of the high tech leaders that made and lost lots of money for many people last year. Now that it is cheaper it is natural to assume that, “hey it should recover a little in price”. Well, depending on where you buy it yes this scenario can easily happen. However, the potential reality for most high tech stocks is that they are likely to be weak performers for the next several months (unless you are good at trading minor rallies). Some high tech stocks may never recover back to the price they once traded at in early 2000. Some high tech companies are even going to go bankrupt! Why is this the case? Well in short, when a bubble bursts you have prices declining twice as fast as they previously rallied. This results in buyers who bought on dips (thinking that prices will recover back to mania valuations), being trapped and owning a stock they really believed they could sell and make

<u>Index (April 17, 2001)</u>	<u>Value</u>	<u>%chg/3mo</u>	<u>%chg/1yr</u>
TSE 300 Index	7819	- 12 %	- 14 %
S&P 500 Index	1191	- 12%	- 17 %
Dow Jones Industrial Avg.	10216	- 4 %	- 5%
NASDAQ Composite Index	1923	- 31 %	- 50 %



a quick buck. Well, unfortunately the stock market is not an easy place to make money (even though discount brokers may try to make you believe otherwise). And all of those people who bought on dips in the technology sector are now trapped. Right about now they really do not want to admit to themselves that they have made a mistake (this is normal for almost any human, me included). The more experienced investors will take a quick loss, sell on any rally, and not buy back (at least until the dust has settled). The others... well they tend to hold on and watch as things get worse, and worse, and worse. In fact they basically end up saying, "well it is worthless now, so there is no point in selling". When a rally results and a good opportunity for selling occurs, they often think that things are better now and suddenly become optimistic again. They usually end up missing the chance to sell at a much better price as the rally dies and things head even lower again. After several months go by and things still do not recover they then question themselves and ask, "why am I still holding on to this loser stock". Well over this time period many gradually give up and sell. Which is why any rally that occurs is met with fierce selling from other holders who are tired of waiting. So you see what may lay ahead is a period of time where the future holds further selling pressure. After a good consolidation period (when all of this selling dries up) yes the technology sector will again be something to consider as an investment, but I feel that it is going to take a period of time for this to occur. So I guess that while I feel that the technology sector has less downside now it is still likely to be a weak investment choice for the next little while. Trying to pick the bottom is a tough game to play and you are better off doing this once the stock has demonstrated that it is not going lower even if it means you are paying a slightly higher price.

What really scares me is the DOW or all those great US companies trading at 30, 40 and 50 times earnings. You know the ones (Coke, General Electric, America Online, Pfizer, etc.). Why would anyone pay so much for companies that normally have a valuation of 12 times earnings equivalent to their historical growth rate? Well I guess the technology stocks over the last few years have caused people to believe in fairy tales. Only problem is that people now are realizing the painful reality of investing in fairy tales. Which is why I believe that investing in these large cap stocks (that everyone has heard of) is another correction waiting to occur. I do not think that a devaluation equivalent to the NASDAQ index is about to occur. But I do believe that a drop of 25% from current levels for most of these stocks is a potential scenario. I feel this same scenario can likely be repeated here in Canada as well. The stocks I feel are most vulnerable are banks, life insurance companies, utilities, mutual fund companies, and stocks like Bombardier (which may be a little overextended at 30+ times earnings). Why have I put banks at the front of my list? Well they may appear to be trading at low valuations relative to last year's earnings, but last year is history. Last year the banks may have made a killing from their brokerage, stock trading, and mutual fund divisions but go to their offices now (things are a little slower...). This year's numbers may be substantially worse than last years and that is what the future stock price will be based on (so just wait a little while). Also I feel that the banks are sitting on lots of bad loans and they are not revealing the extent of their current situation which could add to the weakness.

Well enough of the doom and gloom because things are not always bad. There are always stocks to buy that go up even in a down market! I have been buying several stocks over the last few months that I feel are good investments. They may not be companies that everyone has heard of (even though they have over 1 billion in revenue) but from my research they appear to be trading at low valuations. This is where I feel the opportunity exists now. I feel that stocks trading at low valuations will outperform large capitalization growth companies in the year to come. Currently it looks like the overall market is having another recovery rally which typically is another good opportunity to sell positions you are unhappy with. This rally is likely to hit resistance at 2200 for the NASDAQ and at 8300 for the TSE300 which it looks like has just happened. After that the market is likely to go lower.

World Markets

I looked at some of the recent charts and many of them do not look that good. The Hang Seng Index (Hong Kong) has started a disturbing pattern of now hitting lower lows and highs after breaking down in February. If this pattern behaves typically then we may get a brief rally (close to 14000) ending soon, followed by an even more rapid deterioration. This market I would avoid entirely and sell into this rally. However, I can't really say much for the rest of the world markets either. Many of them look like they are on life support and have the potential to decline further later this year. I feel the key to all of this is the Dow Jones Industrial Average. If the New York Stock Exchange is able to

<u>Index</u>	<u>Value</u>	<u>chg/3mo</u>	<u>chg/1yr</u>
London FTSE 100 Index	5890	- 5 %	- 5 %
German DAX Index	6164	- 8 %	- 15 %
France CAC 40	5505	- 7 %	- 11 %
Brazil Stock Index	14955	- 18 %	- 1 %
Mexico Bolsa Index	6143	+ 8 %	+ 3 %
Australia ASX Index	3325	+ 1 %	+ 8 %
Japan Nikkei 225 Index	14053	+ 1 %	- 26 %
Hong Kong Hang Seng Index	12972	- 18 %	- 16 %

hold it's head above water (above 10,500) then lots of what I fear may not happen. However because of my negative sentiment towards the Dow, my belief is that it will unravel soon and thus may cause the rest of the world markets even more pain. I guess globally I am a very upbeat person when it comes



to the stock market, haha. Oh well, my predictions may not turn out. But if they do I will be very happy because then I am quite sure I will be coming out with lots of buy recommendations. Unlike now where I am finding that there are few companies I would buy at current prices.

Commodity Markets

Three months ago natural gas was trading at around \$12/Gigajoule and since has softened to \$7. While I feel that it still has more price weakness ahead of it, for the next few years I feel that natural gas prices will remain at historically high levels (anywhere from \$3 to \$8). The reason for my bullish predictions is that demand for natural gas in North America is growing at escalating rates. With shortages of power in parts of the US it is likely that more natural gas co-generation plants will be built in the coming years and this will continue to keep natural gas prices strong. Oil on the other hand is likely to soften later this year. I still expect it to remain above \$20 but do not expect more strength from current prices as a potential weakening global economies may reduce demand. Gold is almost back at a low reached in August 1999 as the current downtrend continues. What is interesting is that the producers are actually strengthening in price. Well this divergent pattern is not likely to continue for long as either gold prices will also have to begin strengthening or else the producers will go down as well.

<u>Commodity</u>	<u>Price US\$</u>
Crude Oil	\$27.3
Gold	\$261
CRB Index	214

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, Jan 2002, 4.6%
- Molson, April 2002, 4.5%
- Royal Bank, April 2003, 4.78%
- National Bank, Dec. 2003, 5.15%
- Westcoast, Dec. 2006, 5.82%
- Enbridge, Oct. 2009, 6.35%

Tax, Estate & Investing Information

Transfer investments between spouses to save tax

You can benefit from selling an investment to your spouse or partner. For example, if you have a mutual fund that is currently worth \$5,000, an increase from your original \$1,000 investment. If you transfer (either by sale or gift) the mutual fund to your spouse or partner, you can transfer it at the adjusted cost base (ACB) of \$1,000 or file a special election on your tax return to request the transfer be made at the fair market value (FMV) of \$5,000. If your spouse or partner later sells the mutual fund for an FMV of \$6,000, the capital gains may be taxed in the presumably lower-income spouse or partner's hands, assuming the transfer was done at FMV and the election was made.

There are tax consequences either way, but a transfer can be made to benefit both spouses or partners.

SCENARIO 1 - Transfer at ACB

Capital gain to transferor:	Nil
Capital gain on later sale in hands of transferor (see note below):	\$5,000

SCENARIO 2 - Transfer at FMV

Capital gain to transferor:	\$4,000
Capital gain to transferor on later sale:	Nil
Capital gain to transferee upon sale:	\$1,000

Note: If you make the election, but your spouse or partner didn't pay fair market value for the shares, then the capital gain is still taxable in your hands.

Income-split with heirs through testamentary trusts

If you are planning to leave money to a spouse or other family member who is already earning an income, you can take advantage of an extra set of graduated tax rates to accomplish post-mortem income splitting.

SCENARIO 1 - Outright inheritance

In 1999 Jack inherited his father's \$750,000 investment portfolio. Last year the portfolio had an 8 per cent return. Jack's marginal tax rate is 50 per cent. Looking only at the investment income from the inherited portfolio, Jack received an income of \$60,000 (\$750,000 x 8%). At his 50 per cent tax rate, his tax bill is approximately \$30,000.

SCENARIO 2 - Inheritance placed in a testamentary trust

Tom also inherited his father's \$750,000 investment portfolio. Under the terms of his will, Tom's father set up a trust and instructed that the portfolio be placed in it. Tom is also at a 50 per cent marginal tax rate, but the tax payable on the annual income of \$60,000

(\$750,000 x 8%) can be taxed in the trust, using the graduated taxation rates used by individual taxpayers in their personal income tax returns. This results in tax payable by the trust of approximately \$20,000.

The savings in tax dollars between the two scenarios is approximately \$10,000 each year.

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

Focus Stocks

Previous mentions:

LIVE FROM THE TRADING FLOOR!



Stock ideas are omitted on web site version....

Request newsletter via email in order to receive full version...

Note from Editor:

Part of the reason for the delay in getting this issue out was the work I did myself in designing and creating my own web site. Well, it is now complete and can be viewed at the following domain name.
www.avaluinvestor.com

The reason for "a value investor" is because of my investment philosophy of paying close attention to the multiple a company is trading at when considering investments.

My web site also has links and past issues of newsletters (though certain sections of the newsletter have been edited due to regulatory issues).

Please check it out and I appreciate any feedback!

Patrick Lychak

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