

# 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 6.0 % Bank 4.5 %
3 mo	4.08 %	3.51 %	US Rates Prime 6.75 % Fed. 3.75 % \$CDN = 0.68
6 mo	4.14 %	3.51 %	
1 yr	4.32 %	3.43 %	
5 yr	5.35 %	4.66 %	
10 yr	5.73 %	5.13 %	
30 yr	5.91 %	5.55 %	

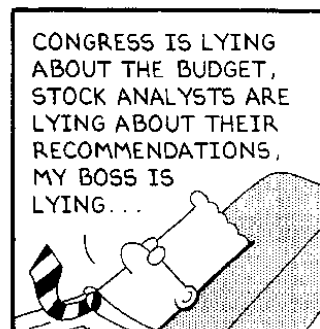
In the last 6 months the US Federal Reserve has lowered rates six times to the current level of 3.75% (a 7 year low). They also have hinted that the central bank would lower rates further in the coming months if the economy didn't rebound. The Bank of Canada has matched the US moves as it wants to keep the economy healthy as well. I feel that all along the US knew their stock market was way overvalued and that eventually things would deteriorate. The only medicine they could use was cutting interest rates. Initially this had a positive impact as investors cheered the cuts when they first started happening and minor rallies resulted. However, you know what happens when too much medicine is given to the body. Eventually the body gets used to it and needs stronger and stronger doses as the medicine has less and less of an impact. Well, from what I see, this is already what I see happening in the US. The Fed has dramatically cut interest rates and so far has prevented a collapse in the US equity markets, as the Dow Jones has relatively been stable. However, the Fed is running out of medicine as interest rates can only be cut down to zero and then there is nothing left. So it will be interesting if a downturn in the US markets can be held off while interest rates get cut further. My viewpoint is still unchanged as I see no upside in the US markets and further deterioration till later this year.

Another point to make is that while short-term rates have dropped (and people find that 1 year yields and money market returns are very low), longer-term yields have actually risen. This indicates that longer term, or 2 – 5 years from now, short-term rates will be higher than current levels. I still see a low interest rate environment till mid next year before yields begin improving.

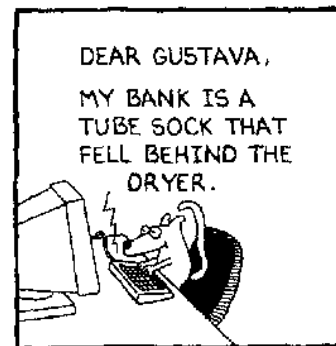
## North America Stock Markets

Last newsletter I mentioned that the DOW (New York Stock Exchange) scared me. I felt that a drop of 25% was a potential scenario this year. Well that has not happened yet, and so far it still remains at previous levels. Based on my current research I still am scared of the DOW (and would not remotely consider investing in any large cap US stock), but for now let's talk about what has happened this last quarter. If I were to describe to you the current state of the market the following words would come to mind: boring, disenchanted, and imaginary. “Boring”, describes the lower trading volumes, and the more flat trading patterns of stocks. Stocks no longer are surging higher and most are trending lower. Many investors have bought stocks at higher prices over the last few months and now find that they have made no money and if anything have lost money. “Disenchanted”, refers to the investors who previously eagerly listened to CNN / ROB TV, and who were reassured with positive analyst forecasts on stocks they were buying only to find out that these opinions were wrong. Now they find that they do not know who to listen to or how things could have gone wrong as they look at their losses. “Imaginary”, refers to those investors who are looking at their portfolios of stocks and have not accepted that in some cases they have permanently lost their capital. They currently try to live in a world where they believe the stocks they own will recover, and have not yet accepted the present world where the losses are real and will take considerable time to reverse.

Index (July 22, 2001)	Value	%chg/3mo	%chg/1yr
TSE 300 Index	7647	- 4 %	- 29 %
S&P 500 Index	1210	- 1%	- 18 %
Dow Jones Industrial Avg.	10576	+ 1 %	- 2%
NASDAQ Composite Index	2029	- 2 %	- 50 %



The reality of investing in the stock market is that, “the stock market does not go up each year, sometimes it is bad to buy on dips (as the dip turns out to become the beginning of a precipitous decline), and sometimes it is smart to not buy stocks and to patiently wait with cash”. Why is it then that analysts and the media always seem to have nothing but praise for the stock market? Why is it that analysts always seem to say, “buy, strong buy, or hold” and rarely say, “sell”? Well, I refuse to listen to the media, or most analysts cause I know the reality of what they do and all the



inside reasons they have. It would take me too long to explain all this but it is the reason why I do my own research and trust myself. Even the Governments cannot be trusted as they will often try to talk up the market by lowering interest rates or by saying things like, “we already see signs the economy is beginning to recover”. They simply are trying to talk up the market, when the reality is that they are quite worried. You see the stock market has had a good run these last few years. Normally the market has 5 years of expansion and 1 to 2 years of contraction. However the US stock market got far too excited and the run lasted for more than 7 years. Now the inevitable decline has begun and it likely will be much more painful than most people expect. It already has happened for the NASDAQ and the declines from current levels will not be as bad now. But the DOW has so far remained unscathed. I feel that in the current environment it is wise to have a portion of one’s portfolio in money market securities with the only equities I would buy being value-oriented stocks. I do not feel a Summer rally will happen this year (as is typical), but instead a flat market with more declines thorough till late Fall. In fact I expect a weak market through till late November. My reasons are that most stocks are still overvalued, and there is little upside. Now I do not feel this applies to all stocks (as I have previously given support to value stocks), as certain sectors can rally in a declining market.

### World Markets

Last newsletter I mentioned that the Hang Seng stock index looked very negative. I predicted, “a brief rally (close to 14000) ending soon, followed by an even more rapid deterioration”. Well, this is exactly what has happened so far and I expect things to get much worse. As a result I would avoid this stock market. I still feel that the rest of the world markets will also have negative performance. It is because of my negative sentiment towards the US markets and the worldwide economic slowdown that I believe will impact global equity markets.

Index (July 22, 2001)	Value	chg/3mo	chg/1yr
London FTSE 100 Index	5387	- 10 %	- 20 %
German DAX Index	5764	- 7 %	- 27 %
France CAC 40	4880	- 12 %	- 30 %
Brazil Stock Index	14092	- 7 %	- 30 %
Mexico Bolsa Index	6389	+ 11 %	- 3 %
Australia ASX Index	3384	+ 2 %	- 2 %
Japan Nikkei 225 Index	11908	- 15 %	- 30 %
Hong Kong Hang Seng Index	12301	- 8 %	- 31 %

### Commodity Markets

What has surprised many people is how much natural gas prices have dropped recently. They are now back down to historic levels of \$3-\$4/Gigajoule. I anticipate that with the dramatic growth in natural gas production that this winter prices should be on the low end of historical levels until demand catches up to supply. As a result I anticipate much lower heating costs this year as compared to last. Oil on the other hand has managed to remain in OPECs target price range of \$22-\$28/barrel. OPEC has recently decided to cut production by 4% in order to keep prices firm in spite of a slowing global economy. However, I see a trend emerging which indicates that if Oil breaks \$25/ barrel on a weekly basis it is quite likely it will drop to \$18/barrel quite quickly. My opinion is that oil prices will weaken further due to the slowing demand (as a result of a slowing global economy), and have the potential to decline lower than \$20. The price of gold has remained at current levels and with inflation starting to ease seems to have little reason to rise in price. However, I feel that long term the US dollar is likely to weaken in price as are the US equity markets. This has the potential to cause investors to seek out gold as a safe haven in the weak global equity markets. I would not be surprised if senior gold producers rallied in the latter half of this year.

Commodity	Price US\$
Crude Oil	\$25.6
Gold	\$268
CRB Index	200

### 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, Feb. 2002, 4.01%
- Thomson, Sept. 2002, 4.4%
- Bank of Montreal, June 2003, 4.76%
- GMAC, July 2003, 5.12%
- Molson, April 2004, 5.35%
- Canadian Tire, Jan. 2006, 6.5%

## **Tax & Investing Information**

### **Registered Education Savings Plans (RESP) vs. In Trust For (ITF) accounts**

Registered Education Savings Plans (RESPs) and In-Trust For (ITF) accounts are both tax-effective ways to defer, or even eliminate taxes when saving for a child's post-secondary education. It is important to understand the merits of each type of account as they have different flexibility and tax-deferral benefits.

### **RESPs**

Before investing in an RESP the most important factor to consider is what will happen to the funds invested if the child (the beneficiary of the plan) does not attend a qualifying education program.

### **Refund of contributions**

The subscriber (the individual who funds the plan) can always take back his or her contributions to the plan as a refund of original contributions, tax-free.

### **Accumulated income payments**

If the plan has been in existence for at least 10 years and the beneficiary is at least 21 years old, the subscriber may receive an accumulated income payment (AIP). An AIP is any income and other growth earned on both the subscriber's contributions and the Canada Education Savings Grants (discussed below). The subscriber can transfer AIPs to his or her RRSP (or a spousal RRSP) up to a maximum of \$50,000, if he or she has the available contribution room. If the subscriber is over the age of 69 and no longer holds an RRSP, or is under 70 but has no contribution room available, the AIP would be included in income and taxed at the subscriber's tax rate, plus an additional 20 per cent penalty tax. Adding the AIP to income could result in unwanted income tax consequences such as old age security (OAS) clawbacks.

### **Canada Education Savings Grants**

RESPs are eligible to receive a Canada Education Savings Grant (CESG) of 20 per cent of the first \$2,000 of contributions made to the plan each year to a maximum of \$400 per beneficiary annually. All CESG money has to be repaid if the beneficiary (or a replacement beneficiary) of the plan does not enter into a qualifying education program. The maximum potential amount that would have to be repaid is \$7,200 (18 years x \$400 per year).

### **Funding limits**

Although there are no restrictions on the number of RESPs that can be established for a particular beneficiary there are limits on the total amount of contributions (\$4,000 per year up to a lifetime maximum of \$42,000 per beneficiary) and CESGs (\$7,200 per beneficiary) that can be received. Exceeding these limits may result in penalties.

### **In-Trust For (ITF) accounts**

An alternative to an RESP is an ITF account for the child. The account is an informal trust and rules regarding the taxation of investment income as well as attribution must be carefully considered. Capital gains are generally taxed to the child while any interest and/or dividend income may be taxable to the donor. When the child reaches the age of 18 these attribution rules no longer apply and all income and capital gains are taxed in the hands of the child. The account can be transferred to the name of the child at that time, and can be used for education or any other purpose.

The ITF account has no specified maximum contributions or any possible loss of income if the child does not pursue post-secondary education. The drawbacks include the possible annual attribution of interest and/or dividend income and the fact that ITF accounts don't qualify for the CESG, and the possibility that the child, upon reaching the age of majority may legally claim ownership of the account.

### **Funding limits**

There are no limits as to the number of ITF accounts that may be set up for a beneficiary or the amount of funds that may be deposited in them.

*It's a good idea to thoroughly review the features of both RESPs and In-Trust For accounts when considering a savings plan for a child. The above material is general tax information. One should*



*seek individual tax advice specific to their needs, as individual circumstances may vary.*

## **Focus Stocks**

**Results of previous stocks recommended that have been sold:**

**Previous mentions:**

**Stock ideas are omitted on web site version....  
Request newsletter via email in order to receive full version...**

### **New ideas:**

*With the current markets I am finding it very difficult to find many good buys out there. As a result I prefer to wait until Fall when I think there will be more good deals for me to mention. These are some companies that I feel still deserve mention.*

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