

The Lychak Letter

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

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Government Yields / Currency

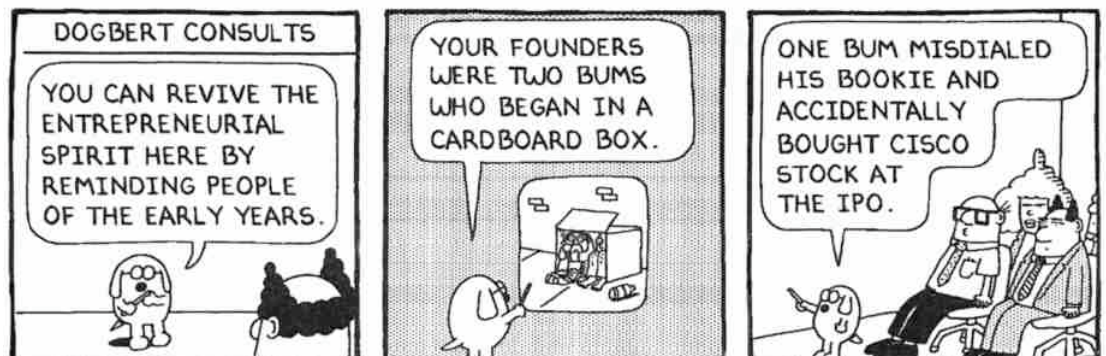
Term	Cdn Govt Yield	US Govt. Yield	Cdn Rates Prime 7.5 % Bank 6.0 %
3 mo	5.51 %	6.05 %	US Rates Prime 9.5 % Fed. 6.5 %
6 mo	5.57 %	6.01 %	
1 yr	5.57 %	5.72 %	\$CDN = 0.66
5 yr	5.43 %	5.25 %	
10 yr	5.41 %	5.30 %	
30 yr	5.51 %	5.50 %	

Overall interest rates have remained the same which is what I suggested in the last newsletter. I still expect this to be the case for the next quarter as well. Currently people are divided on whether rates will rise or fall. On one hand investors are hoping interest rates in the US will drop because the stock market and the economy is beginning to show signs of softening. On the other hand, large increases in wages and the higher prices for commodities (notably oil and gas) may have an eventual effect of increasing inflation causing rates to rise. My expectations are that the two in combination will mute each other out and rates will remain more or less where they are. I am expecting next year to be a difficult year for the stock markets and as a result I do not expect interest rates to rise that much as inflation cools with the economy. Thus I am overall expecting relatively stable rates for this year. The Canadian dollar long-term has good upside as the US economy gradually slows down and the US dollar weakens as a result.

North America Stock Markets

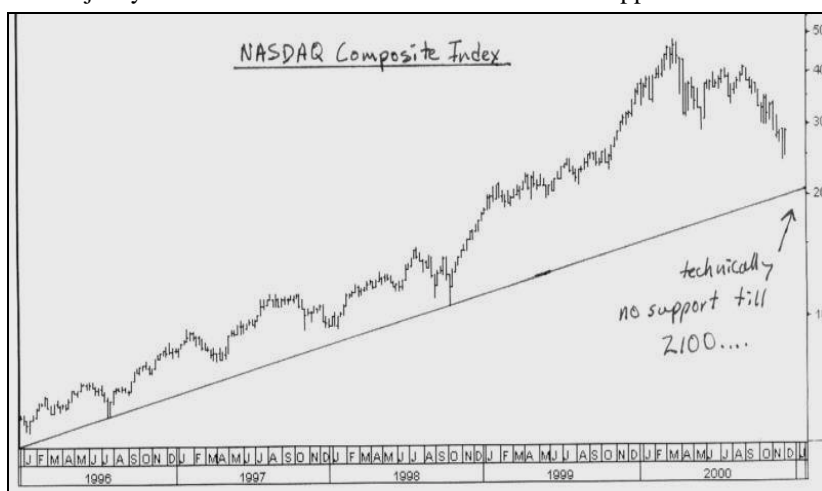
For the majority of people the markets have been very ugly in the last few months. The biggest losses have happened in the high technology sector with the NASDAQ off 51% from its March high and down 38% from the time of my last newsletter. In my last newsletter I warned of the danger in the technology sector when I said, “this rally is close to peaking again”, “it is likely to go lower than the lows reached in May”, and “I have reduced all technology holdings”. I also went to great lengths to warn about the danger of owning Nortel at \$122 and compared it to a “house of cards”. I imagine many people never would have thought that it would drop to as low as \$49 in two and a half months (a drop of 60%). Nortel may have been the most expensive company in Canada but the fate of the most expensive company in the US was even worse. Lucent dropped from a high of \$84 in Dec 99 to its current price of \$15, a drop of 82%, (needless to say it no longer is the most expensive company in the US). I initially felt the markets had the potential to bottom in late October but none of my downside targets were reached. I then came to the conclusion that the markets would bottom in the first week of December. However I am getting many crossed signals at the moment which is making me form the opinion that only a few sectors will rally through the first quarter and that the overall market still has lots of downside. The reason why I am still leery of the overall markets is that some things I wanted to happen have (most of the technology stocks have had large declines as evident by the drop in the NASDAQ (except for a few like Cisco, America Online, Research in Motion and others that I still think have no justification for their current prices)). However while the technology stocks have dropped utilities, financial services, manufacturing, pipelines, biotechnology, communication and merchandizing stocks have risen or remain high and are currently trading at historically very expensive prices. In addition I have yet not witnessed a final panic selling frenzy which is usually indicative of a market bottom. If this does not occur any rally that ensues will be very

Index (December 9, 2000)	Value	%chg/3mo	%chg/1yr
TSE 300 Index	9548	- 11 %	+ 20 %
S&P 500 Index	1369	- 8 %	- 3 %
Dow Jones Industrial Avg.	10712	- 4 %	- 5 %
NASDAQ Composite Index	2917	- 25 %	- 20 %



weak and not last longer than a couple months. So I am in a conundrum as a result (on one hand I feel the technology sector is due for a "dead cat bounce" and on the other hand I feel the other sectors have little upside and substantial downside). I am overall quite bearish on financial services (banks), life insurance companies, utilities, and biotech stocks. Because of these mixed feelings I feel that three scenarios may unfold 2001. One is that the technology sector will have a brief recovery rally for the first 2.5 months of 2001 and lead the overall markets slightly higher followed by a continued deterioration the remainder of the year in the overall markets. The second choice is that the technology sector will post a weak rally in the first quarter followed by declines in many of the other sectors resulting in overall flat performance in the markets for the first quarter followed by declines in the markets the remainder of the year. The third scenario is that the markets will continue to decline until a final selling panic results. Currently I am waiting for some direction to see which way things will go and should make up my mind soon. I feel that the technology sector is getting close to bottoming soon and may be ready for a brief recovery rally by the end of December. I can't really predict the date but I do have a target of 2300 for the NASDAQ (this should be the point from which a little rally could result from). I guess overall I am expecting a very difficult year in the markets next year and investors will have to be very careful or they could face more losses in their portfolio by the end of 2001. I continue to stress to investors that they must pay attention to the price multiples they are paying for stocks.

I was asked lots last year why don't I follow US stocks? Well, I do actually follow the US markets just as close as the Canadian markets. However I found the US stocks last year to be way overvalued and as a result preferred to avoid them. Just look at the 1-year performance of the S&P500, Dow Jones, or NASDAQ indexes and you will see why I felt that way. Also, I still feel the same way now so I guess I really won't be following many US stocks this year either. I know General Electric, Cisco, Pfizer, Disney, etc. are great companies, it is just that I will never pay 40 to 50+ times earnings for a large cap company (growing at 12% a year) no matter how popular it is with the majority of people. If I can buy the same caliber company here in Canada (ATCO, Canadian Utilities, etc.) but instead pay 9 to 12 times earnings why not pay 3 to 4 times less? I guess what I am trying to spell out is the significant downside I see in the majority of US stocks. No one thinks that it could happen to GE or Disney until a Cisco equivalent bomb explodes.



I have included a chart of the NASDAQ composite index (see left) to indicate where technically the bottom in the market should be. Unfortunately, if this chart I selected turns out to be right, it indicates the NASDAQ is likely to continue dropping to as low as 2300 and could trade even lower to 2100. If this scenario were to unfold it would indicate the strong chance of a rally back to 3000 as another likely scenario.

I think that after this coming year there will be many disillusioned novice investors who bought equity mutual funds with the idea that they always go up in value. I feel there will be more and more redemptions of mutual funds in the coming year and overall a consolidation and reduction in the number of mutual funds in the industry when this begins to happen.

World Markets

Last newsletter I said that I did not find any of the global markets attractive. A look at the chart to the right indicates that overall the majority of markets have lost ground since then. As I recently looked at the charts of most of the world market indexes I noticed a similar recurring pattern. Most of the markets have risen sharply from 1998 and have been barely holding the high levels currently at. What I see potentially happening is that if the markets go any lower and there becomes panic in the markets we could see the majority of them fall off substantially. Because of this risk I continue to suggest avoiding these markets. The one market that is worth looking at is Japan. It has continued declining and I feel is getting close to a strong level of support. Support exists at 13,000 to 12,000 on the Nikkei Index (currently 14,700, off from a high of 21,000 in March 2000). What happens in the US market is the main factor in determining where these markets will go.

<u>Index</u>	<u>Value</u>	<u>chg/3mo</u>	<u>chg/1yr</u>
London FTSE 100 Index	6288	- 5 %	- 14 %
German DAX Index	6691	- 4 %	- 1 %
France CAC 40	5939	- 8 %	- 3 %
Brazil Stock Index	14982	- 18 %	- 2 %
Mexico Bolsa Index	5795	- 15 %	- 13 %
Australia ASX Index	3232	- 1 %	- 6 %
Japan Nikkei 225 Index	14696	- 9 %	- 24 %
Hong Kong Hang Seng Index	15189	- 8 %	- 5 %

Commodity Markets

What I alluded to last newsletter was the fact that storage levels of oil in the US were low and that if we had a cold winter this would cause the price of oil to remain strong. Well, oil has dropped a bit in price as OPEC has continued to increase production but overall has remained strong as heating oil

<u>Commodity</u>	<u>Price US\$</u>
Crude Oil	\$27.5
Gold	\$270
CRB Index	232

reserves are still at low levels in North America. I feel that oil will remain strong in price over winter and may weaken come March. However OPEC is already talking about production cuts early in the new year to ensure the price of oil remains in the \$20 to \$28 dollar range (something I feel they will try to attain). Natural gas on the other hand has increased dramatically in price! Normally around \$3 to \$4, it has surged to \$12 in the last 8 months! Let me repeat this, gas prices have quadrupled in the last year (I am trying to emphasize how expensive natural gas is at the moment). What is causing the price to rise so high? Well, demand from the US has risen as power companies have built natural gas fueled power plants and as more residences have moved to natural gas heating. However, supply has not kept up with increasing demand and because reserves were at low levels prior to winter, and now the weather is already colder than normal, demand has increased even more causing a bit of a buying panic in the markets. Prices I feel are not going to remain at these levels for long and are likely to soften come Spring, however the long term scenario for natural gas are overall strong prices until supply surpasses demand. This should be a huge boom for Alberta, BC and the NWT these next few years as drilling for these reserves are likely to remain at a high level of activity to keep up with demand. Gas producing companies should have another good year as they make lots of money at current and expected future prices. You will notice that your home heating bill will be up substantially this winter as the consumer eventually pays for these rising costs. The power companies are also in a bit of a pinch cause they are now paying more for gas and still receiving the same for the electricity they sell. Long term you may see electricity prices rise as well! Gold has been increasing in price these last two months but overall still has not indicated any major moves. With continued inflation gradually raising its head, a weakening US economy and dollar the case for stronger gold prices is a more and more likely scenario.

Fixed Income

Following is a list of bonds and debentures that I feel offer a high 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, July 2001, 5.6%
- Westcoast Energy, Feb 2002, 5.7%
- Coca-Cola, Oct. 2002, 5.84%
- Bell Canada, Dec. 2003, 5.9%
- Molson, April 2004, 5.92%
- Bank of Nova Scotia, Feb. 2006, 5.97%

Tax, Estate & Investing Information

Update on Capital Gains Inclusion Rate

In the October 18 federal budget update, the government again lowered the capital gains inclusion rate, this time to 50 % from the previous rate of 66.67 %, for capital gains realized after October 17, 2000. This change makes capital gains the lowest taxed form of income in Canada. It even makes Canada's capital gains tax rates generally lower than those of the United States for all capital gains, regardless of the holding period.

However, because this rate is effective only for capital gains realized after October 17, 2000, and the actual Federal Budget in February had lowered the inclusion rate from 75 per cent to 66.67 per cent, three different inclusion rates apply for the 2000 taxation year as follows:

- From January 1 - February 27: 75 % inclusion rate
- From February 28 - October 17: 66.67 % inclusion rate
- From October 18 - December 31: 50 % inclusion rate

An investor's effective capital gains inclusion rate for the 2000 taxation year will depend on which period, or combination of periods, he or she has realized net gains or net losses.

Interest deductibility: When borrowing to invest

Even though I only suggest investing what you have, more and more people are borrowing to invest these days. With tax season fast approaching, it's important to know when interest payments are and aren't deductible.

Deductible interest

As long as your client is borrowing money in order to earn income from an investment, business or property, most interest expense is deductible. Earning income does not mean that the investment must make an immediate profit, but that it is expected to earn income or a return on the investment. Although the Income Tax Act states that "income from property" does not include capital gains from the disposition or sale of the property, in the case of mutual funds or other investment products that generate interest and dividend income in addition to capital gains, interest is generally deductible.

The deciding factor according to the Income Tax Act is if the investment has the potential to earn income. As long as the investment has the potential to generate income (without considering the capital gains), then the interest on the borrowed funds will be fully deductible.

Borrowing to finance an RRSP

Interest on money borrowed for any sheltered or tax-assisted retirement savings plan (including in-trust, RRSP and RESP accounts), is not a deductible expense for tax purposes. If your client has a choice, borrowing for the non-registered investment is the better strategy.

There can be other benefits of borrowing to invest in an RRSP that could outweigh the fact that the interest is not tax-deductible. The benefits of tax deduction and tax-deferred income accumulation may be better reasons for borrowing to invest for some clients. In some cases it can make sense for your client to borrow for a few months and pay off the loan with the tax refund.

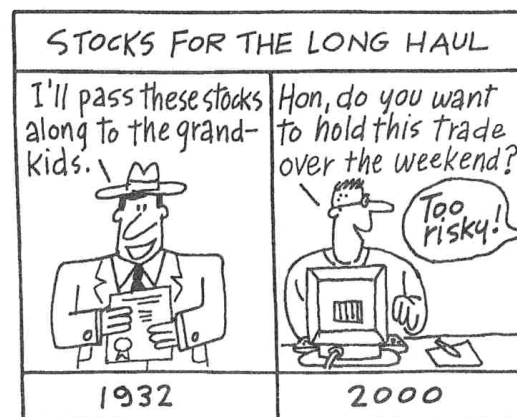
Student loans

Clients repaying a student loan under the Canada Student Loans Program and provincial post-secondary loan programs can apply for a non-refundable tax credit of 17 per cent in 2000 and 16 per cent in 2001 on the interest portion of the repayment made in the taxation year. If in any given years there isn't enough income to use against the credit, the unused credit may be carried forward for up to five years.

Focus Stocks

Previous mentions:

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



On a separate note, I would like to wish everyone a Merry Christmas and best wishes for the New Year!!

Patrick Lychak



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