

# 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 6.75 % Bank 5.25 %
3 mo	5.11 %	5.86 %	US Rates Prime 8.75 % Fed. 5.80 %
6 mo	5.44 %	6.09 %	
1 yr	5.84 %	6.18 %	
5 yr	6.17 %	6.57 %	
10 yr	6.11 %	6.37 %	\$CDN = 1.46
30 yr	5.84 %	6.16 %	

Since December the US Federal Reserve has raised the Fed rate by another quarter point to 5.75%. The next meeting for Fed policy makers is March 21, and expectations are that the Fed will raise rates by another quarter point to 6%. The Fed has long been concerned the US economy is overheating and is recently also concerned with the high price of oil and potential resulting inflationary pressures. A sustained high oil price results in high gasoline prices. With crude oil currently at record highs of almost US\$34/barrel it is likely that prices for diesel and gasoline will continue to rise. So far this has not equated into inflation from recent numbers however it is only a matter of time. Most transportation companies (trucking and airlines) hedge a portion of their fuel costs so their expenses are fixed. However as these hedges expire, eventually they have to pass on these increased fuel costs to the consumer or company. In the end the consumer feels these increases as prices for any product that is transported rise. Recently truckers have staged protests over the high diesel prices. In the end truckers will either stop hauling or they will raise their rates considerably. This is the most serious inflationary threat that has raised it's head in the last few years. I expect inflationary pressures will increase as oil prices remain high and the world economy remains strong.

An interesting point is that Canadian yields are currently lower than US yields? Yes, it is true, if you look at the above Canadian government yields, they are almost a quarter point lower than US yields. Normally if Canadian yields are lower than US yields the Canadian dollar begins dropping. Why has this not happened? Well, Canada exports lots of oil and other commodities. As commodity prices have continued to rise, the economic outlook for Canada has improved leading to a stronger Canadian dollar! One thing to note though, if the Fed raises rates in the US to 6% Canada will likely follow suit, as Canada cannot have rates much different than the US. If you are debating about your mortgage, it is quite likely that rates will rise even more very soon!

## North America Stock Markets

I wanted to start by first mentioning some of the predictions I stated last newsletter. In December I stated; the current rally in the markets would “continue to a final high in the first quarter of 2000 and then something will have to give”, and “the Canadian market will continue to outperform the US market”. Well, the Canadian market has definitely outperformed the US market as the TSE 300 has risen substantially more than the S&P 500 (a broad measure of the overall market). Now, while the markets have rallied to new highs it is yet unknown whether they will peak by the first quarter. Lets analyze the current markets now to see if this may happen....

The indexes as we used to know them (TSE 300, S&P 500, Dow Jones Industrial Average) are no longer what they used to be and are not as representative of the overall market as they used to be. With the ever-expanding market capitalizations of technology stocks not only have these stocks been increasingly added to various indexes but their weightings have been increased as well. The S&P 500 is regarded as the benchmark index of the US market, and now technology represents 32% of the index (the largest concentration ever for one of the indexes economic sectors). Only energy came close, when it reached 28% of the index in 1980 (oil stocks subsequently dropped dramatically later). In Canada, Nortel and BCE compose almost 40% of the TSE 35 index. Why even have an index (which is supposed to be a broad measure of the market) if 2 stocks represent almost 40% of what the other 33 don't! This indicates two important points; 1) Technology stocks have been bought up almost as much as possible and now are highly represented in almost every equity fund, and 2) Even though the indexes have indicated the broad stock market is strong, it is being led by the technology and communication sector (a narrow group of stocks).

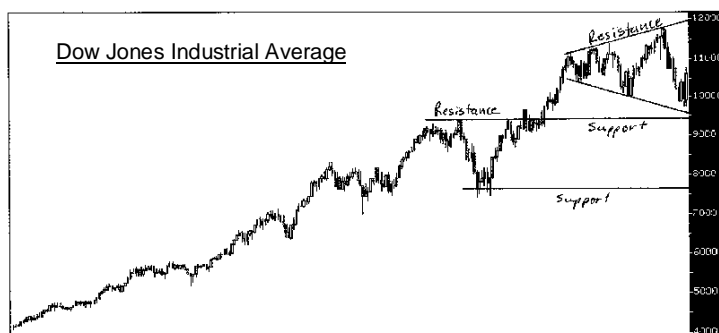
In Canada the TSE 300 has had an impressive performance, up 16% in the last 3 months. It only seems like yesterday (December) when everyone was pushing the merits of buying 100% RSP eligible US based mutual funds (as the performance of the US market up till

<u>Index</u>	<u>Value</u>	<u>%chg/3mo</u>	<u>%chg/1yr</u>
TSE 300 Index	9293	+ 16 %	+ 41 %
S&P 500 Index	1392	- 2 %	+ 6 %
Dow Jones Industrial Avg.	10131	- 10 %	+ 2 %
NASDAQ Composite Index	4582	+ 27 %	+ 89 %

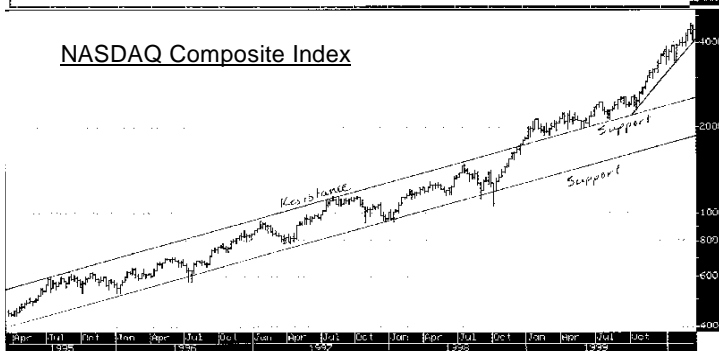
then had been stellar). This just goes to show that when things finally seem like you can't lose... you do, as the overall Canadian market has outperformed the US market. The stocks that have delivered the performance for the TSE belong to a narrow group that has also resulted in several world market indexes strong performance as well. These stocks belong in the biotechnology, technology, internet, and communication sector including anything with the word "wireless" in it. The rest of the stocks have had lackluster performance and now are considered bricks & mortar or "old economy", as they are not with the times (you see we are now in a new paradigm). Disregard that last sentence, as this is not how I feel, but indicative of the current market mentality.

The Canadian Venture Exchange (a merger of the Vancouver and Alberta Stock Exchange) has had an incredible and well-deserved rally in the last 3 months. This rally has not been the result of mining stocks but biotech and technology stocks. The exchange now has a huge backlog of companies to process that are switching from being classified as a mining company to high tech. Some even are just announcing that they are no longer mineral exploration and are now focussing on technology, which results in their share prices exploding. Why is it that these speculative and small-cap technology stocks are being sought by investors, I mean speculators, at such a frenzied pace? The answer lies in the fact that most large-cap technology companies have grown dramatically over the last few years. As an example, Cisco Systems is 27 times bigger than it was 5 years ago. It is now such a large company that it is almost impossible to find new customers to keep profits growing at the same rate. Once this growth rate slows for companies with high price/earnings (PE) multiples (like Cisco), investors flee the stocks. The prolonged buying of technology stocks has resulted in such extraordinary multiples that the large stocks are not going much higher now. The only other gains to be made are in the speculative stocks as they are the only low-priced technology stocks left. Once these speculative stocks peak the technology sector will be ripe for a large correction. It happened before with oil and gold stocks and will happen again. Currently I believe it is time to sell all large-capitalization technology stocks and the speculative ones as well. I am predicting that after a soon correction, the speculative stocks may have one more rally in the Summer as this is a typical occurrence. For now I will just say to expect a decline soon in the speculative high tech and biotech stocks.

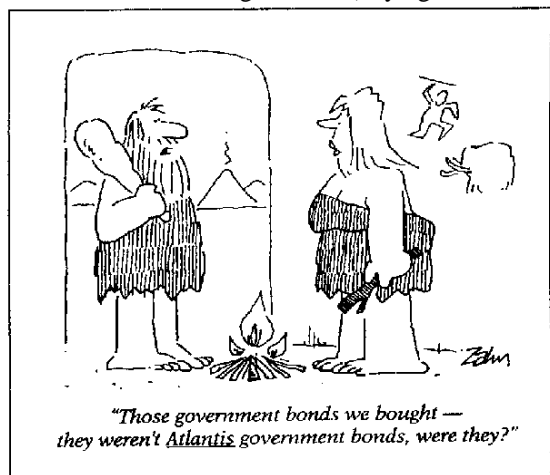
The chart to the right illustrates the weak performance of the Dow Jones Industrial Average. The current downtrend is approaching very strong support at 9500. This should hold, as it is support from both the current diverging consolidation, and the previous resistance now turned support. If it does hold the Dow should rally back to previous highs near 12,000. If it does not hold, and the odds are against this, expect a quick drop to 7500. The main point of this chart is to illustrate technical support levels.



The chart to the right of the NASDAQ composite index illustrates the amazing rally it has recently enjoyed as a result of it breaking out of its long-term channel. What is important to know is how these patterns typically end up. This pattern typically ends with the index dropping initially back to the top of the channel (2700) and eventually back to the bottom of the channel over the course of a year and a bit (~2300). I guess what I am forecasting is a drop of almost 30% within the time frame of a year (the top of the channel is the initial target (2700))! Knowing that 70% of the NASDAQ index is technology related companies, and the fact that I believe now is the time to sell this sector of the economy, I do believe this is likely.



I noticed even Warren Buffet (a renowned long-term value investor) has jumped on the technology bandwagon. He bought shares of Microsoft, but made no mention of it in his annual newsletter. I presume he did not want to rationalize the purchase, as it does not meet his investing criteria (buying stock at cheap valuations). His stock, Berkshire Hathaway, has dropped by 26% this year to \$41,000 as a result of poor performance from the insurance businesses (one of the insurance industries toughest years) and lagging large-cap stocks like Coca-Cola, etc. His company is not alone as several casualty and car insurers have had terrible years due to underwriting losses and low policy premiums. Fairfax Financial a company with an excellent long-term track record has seen its share price decline from \$600 to recently \$150 on the TSE. Management is excellent so when this stock bottoms it will be a great long-term buy as will other insurance companies.



To sum up I feel the technology sector is extremely vulnerable to a correction. What I anticipate to happen is sector rotation (money will flow out of the technology sector into other sectors that have lagged (interest rate sensitive, oil & gas, value stocks, utility, pipelines)). This will result in the overall market indexes not making much more headway thus it will be important now to pick the stocks which have little downside and good long-term potential. Now is a good time to

serious evaluate one's portfolio and ask exactly how many times earnings are the companies trading at?

**World Markets**

The trend of selling boring “old economy” companies and buying technology, internet, and communication related stocks that has been apparent in North America has also occurred globally. My expectations for the North American markets might as well be repeated here as well. Almost every country has had good returns in the equity markets in the last few months as economies recover. I am going to repeat what I mentioned last newsletter. If worldwide economic growth continues; 1) inflation will increase, or 2) interest rates will be raised to combat or prevent inflation. Either of these two scenarios will put the brakes on a booming stock market.

Index	Value	chg/3mo	chg/1yr
London FTSE 100 Index	6447	- 3 %	+ 4 %
German DAX Index	7414	+ 17 %	+ 45 %
France CAC 40	6819	+ 12 %	+ 48 %
Brazil Stock Index	17381	+ 21 %	+ 67 %
Mexico Bolsa Index	7987	+ 18 %	+ 67 %
Australia ASX Index	3163	+ 1 %	+ 6 %
Japan Nikkei 225 Index	19078	+ 5 %	+ 19 %
Hong Kong Hang Seng Index	16747	+ 8 %	+ 54 %

An interesting point is that I researched worldwide Price/Earnings (PE) ratios and discovered that the average PE ratio is close to 25 in North America, 35 in Europe, 87 in Japan, 25 in Hong Kong and 23 in Asia. Overall, these are very high PE multiples so I expect that at this point the high priced stocks will drop and the low priced stocks will be bought over the next little while. The indexes, as a result of this sector rotation, are unlikely to make much more significant gains from these levels.

**Commodity Markets**

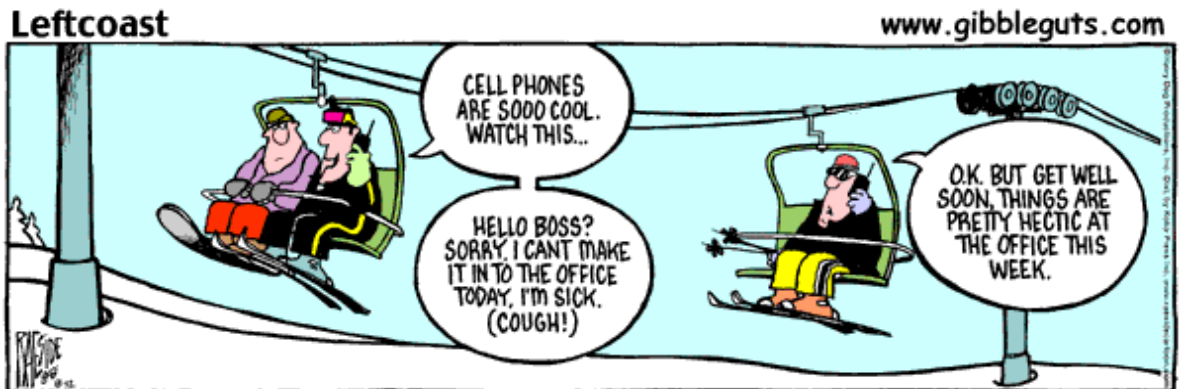
Commodity	Price US\$
Crude Oil	\$31.92
Gold	\$289
CRB Index	216

In the last newsletter I stated that the continuing worldwide economic strength would result in higher commodity prices. The CRB Index has climbed another 7% in the last 3 months to its current level of 216. Nowhere is this more apparent than with the current price of oil. Oil is currently at a 9 year high of \$32 due to a combination of OPEC's output cuts initiated last year and increased worldwide demand. The reason for the current high price of oil started initially with the meltdown in the emerging markets in late 1998. This caused worldwide oil consumption to decrease and resulted in oil hitting a low of \$10 in late 1998 and early 1999. The Organization of Petroleum Exporting Countries (OPEC) decided to cut production in order to strengthen the price of oil. Not only did all member countries maintain output cuts but as the worldwide economies recovered demand increased as well. This caused the price of oil to rise dramatically to \$25/barrel. With the sudden increase in the price of oil most countries held off of purchases of oil as they felt it would stabilize around \$17-\$20 and they did not want to buy at the price of \$25 which seemed high. However, with ever-increasing demand and still no production increases from OPEC the price of oil has risen even further while refineries oil reserves continued dropping. The US is now concerned that OPEC must increase production soon as their reserves are currently at a 23 year low, and they have even contemplated using their strategic petroleum reserve to meet demand. The high price of oil today is a direct result of the fact that most countries can no longer wait and are buying oil now rather than wait for better prices, whether or not they will occur in the future. OPEC's next meeting is March 27<sup>th</sup> and the likelihood is that they will increase production enough to match worldwide demand. This should cause oil prices to soon stabilize and potentially drop from current levels. How much of an impact depends on how much supply is increased as demand will remain strong (especially with the Summer driving season approaching when gasoline consumption is at a high). Overall, I expect oil prices will remain very strong for the remainder of this year (\$20+).

Where does this leave gold? Well the threat of inflation continues to grow so I would suspect that prices for gold should continue to strengthen. In the last 3 months gold has consolidated in price in a symmetrical triangle formation. This formation will come to a head in the next 3 months and gold will either rise or drop dramatically then! The current price range is from \$285 to \$317 on a weekly closing. Any price move beyond that range on a weekly closing will indicate the next move for gold. My expectations are for a price advance to begin within the next two months. A drop below \$285 would be a very negative signal!

**Fixed Income**

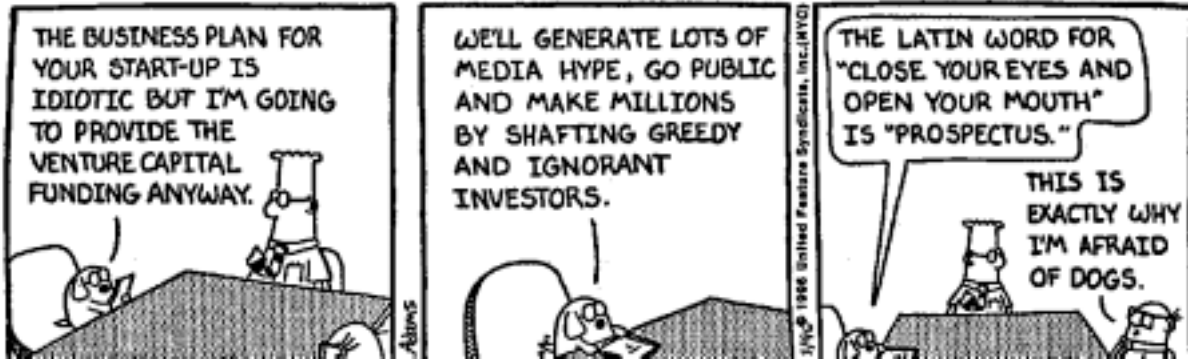
In the short-term it looks like interest rates will not rise that much more. For this reason it is a good time to buy 1-2 year bonds now. With a likely fed increase soon they may go a little higher but not that much more. Yields for corporate bonds with a term of 1-2 years will be from 6% to 6.5%. Long-term rates should continue rising so I would avoid buying bonds with maturities longer than 2 years. Avoid bond mutual funds and stick with short-term bonds. Check out some of the high yielding pipelines (Trans Canada Pipeline 7% dividend, and Pembina Pipeline 15.5% distribution) and power generation income trusts (TransAlta Power 12.5% distribution, Northland Power 12.5% distribution, and Drayton Valley Power 17% distribution).





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