



**Investment Outlook  
May 2002**

**No “Double Dipping”**

The US and Canadian economies seem to have shaken the recession blues, and even the fear of a “double dip”. As we progressed through the first quarter of 2002 many economists were concerned that the North American economies would again fall into a contraction mode and experience negative economic growth, as we saw in the third quarter of 2001. Data released during the first quarter of fiscal 2002 indicated that while inflation was muted, growth in industrial inventories and resilient consumer demand helped boost growth in the US Gross Domestic Product (GDP). By the time we finished the first quarter, the economy seemed to be truly humming along.

For the first quarter of 2002, the US economy grew at a surprisingly robust 5.8% annual rate, the fastest rate since the fourth quarter of 1999. Domestically, when the Canadian GDP figures for the first quarter are released at the end of next month, **we anticipate that the Canadian economy will be at least as strong, and perhaps even stronger than the US.** The Canuck economy can still be viewed as one of primary and secondary industries, which tends to lead an economic expansion. When US-based industries and consumers fuel an increasing demand for products, inputs are needed to create those products, and where better to get cheap inputs than their next door neighbour Canada and our 63¢ dollar?

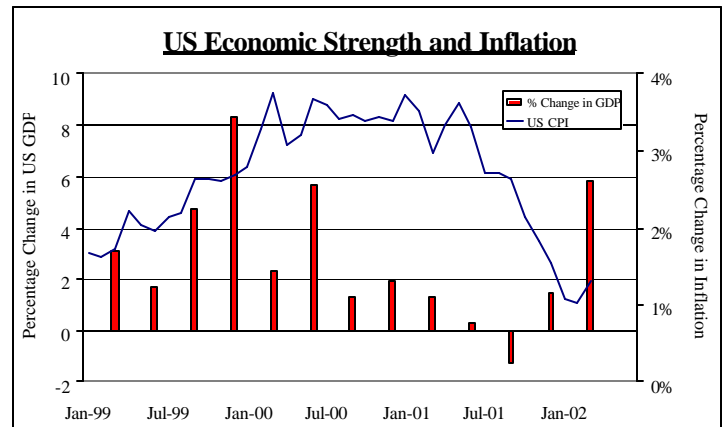


Chart 1 – Source: US Federal Reserve

With still a month to go until Canadian Q1 GDP figures are available, **we are expecting that the Canadian economy will grow by over 6%**, beating our American counterparts, **with muted inflation in the range of 1.5-2%**. However, although both of the North American economies have experienced substantial growth in the second quarter, we feel that the recent drops in the equity markets are finally correcting the over-bought position in which they have been since November.

Since September 11<sup>th</sup>, 2001, the North American Equity Indices have had a dramatic run from their lows on September 21<sup>st</sup>, 2001, to highs reached in January of this year. Investors were feeling good about the “War on Terrorism”, the economy was picking up and President Bush had record high approval levels. Indications were that the economic turnaround was not going to be delayed by the events of 9-11, and that Q1-02 was going to be the first of the next wave of economic expansion. Then reality hit, at least for awhile:

- Perhaps economic expansion was not going to occur immediately as previously thought.
- The Telecom and other High Technology industries have had several high profile failures (and pending failures): Enron, WorldCom, Nortel.

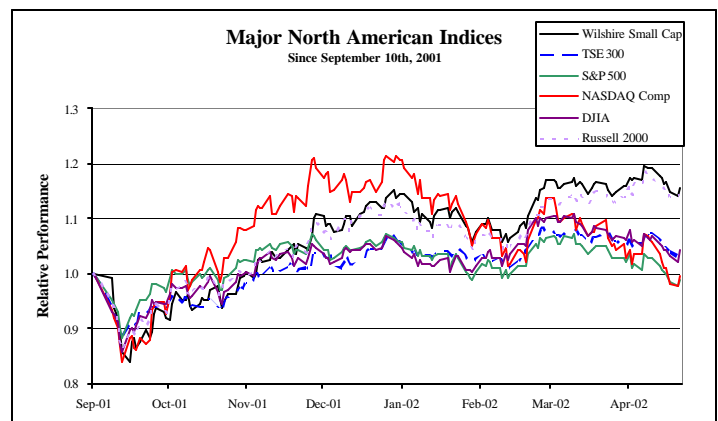


Chart 2 – Source: Bridge

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- Auto sales were excellent, but on the backs of low financing rates and high incentives. Once those incentives were removed, sales returned to more normal levels.
- Unemployment rates continue to climb, and if history is a good indicator (which it often not), rates could continue to rise until June or July of this year, before they start to decrease.

Equity markets hit near-term peaks in January, but the equity indices have retraced much of their gains since the New Year. In the final days of April the US key indices have broken below near term support levels and could trend even lower. The Dow has fallen below the 10,000 level, the S&P500 dropped beneath 1,100 and the NASDAQ Composite Index is below the 1,700 mark. While these may not mean much on a valuation based purely fundamentals, investor psychology can make these levels important for those wishing to trade on the equity markets. The standouts at this point are the Small Cap markets, represented on Chart 2 (above) by the Wilshire Small Cap and the Russell 2000 indices, which are both up by approximately 15% since September 10<sup>th</sup>.

If we take the S&P 500 as a reasonable proxy for the US economy (it does represent a significant portion of the American Economy) and compare it against the change in the US GDP we can see the logical similarity between the two data sets. When the economy is growing strongly the S&P is, or has, increased. Conversely, when the economy contracts, there is a dip in the equity markets within close proximity of the recession.

The usefulness of this relationship for forecasting market movements is not particularly great as the economic data comes out two months after the end of the quarter; not exactly timely. However, as we have mentioned in previous Investment Outlooks, there are a couple of *leading* indicators which seem to have a predictive effect to the equity markets.

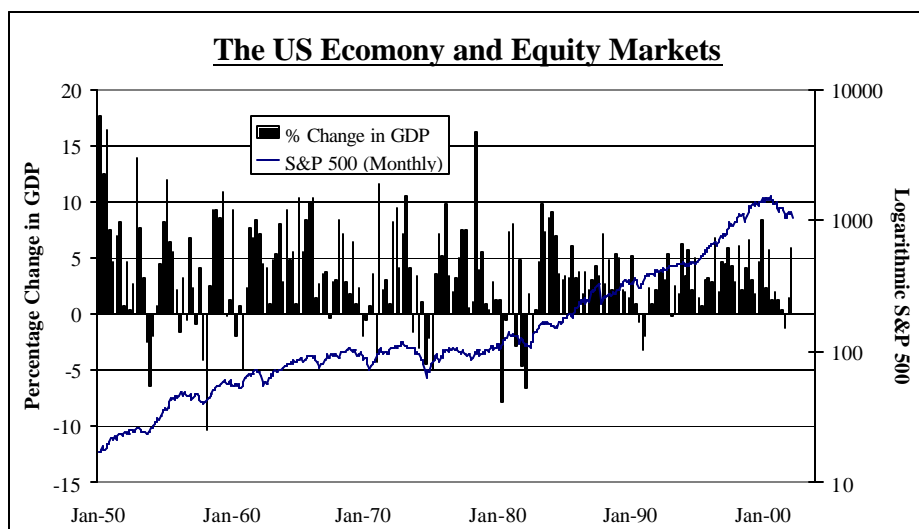


Chart 3 – Source: US Federal Reserve and Bridge

### Leading the Charge: Economic Indicators

In our December of 2001 Investment Outlook, we brought to the attention of our readers three leading economic indicators that we felt would give reasonably accurate indications on market direction *in advance* of the movement, rather than from the “rear view mirror of economics”, as most economic figures tend to show.

**Consumer Confidence** was one of our choices in December and since then we have refined our predictive model. When we lagged the performance of the S&P500 against Consumer Confidence by three months, there appears to be a negative relationship, at least visibly. When consumer confidence rises, the performance of the S&P500 over the next three months tends to move down; another contrarian indicator. And empirically it makes sense, if everyone expects the future to be wonderful, there is a greater chance for them to be disappointed, therefore making it easier for the equity markets to drop.

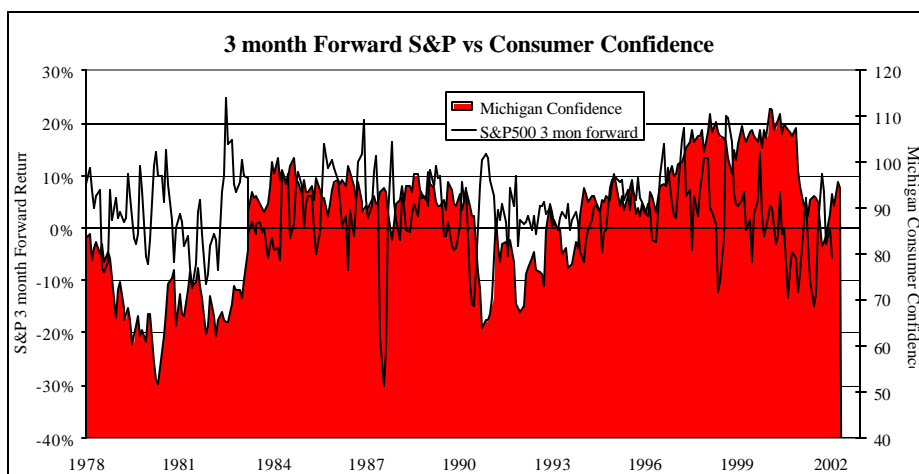


Chart 4 – Source: University of Michigan and Bridge

That said, the statistical correlation between the S&P500 and Consumer confidence is actually quite low, so although it “looks” good, the science behind it just isn’t there. But, if we assume just for now that it does work, Consumer Confidence in

January through March has been fairly high indicating that we could expect the performance of the S&P500 to decline over the next three months, which seems to have occurred so far. Looking forward, if investors start to see two or three months of negative sentiment, then the future performance of the equity markets might be higher. April was negative, here's hoping that May will be too.

The **Yield Curve**, we decided, was a good indicator of negative market movements, but not necessarily bull markets. The current US Yield Curve is steep on the short end, but flatter on longer maturities. Since April of last year, rates have dropped across the maturity range, but in the last six months since October, rates have started to increase again, particularly at the shorter end of the curve (for maturities under five years).

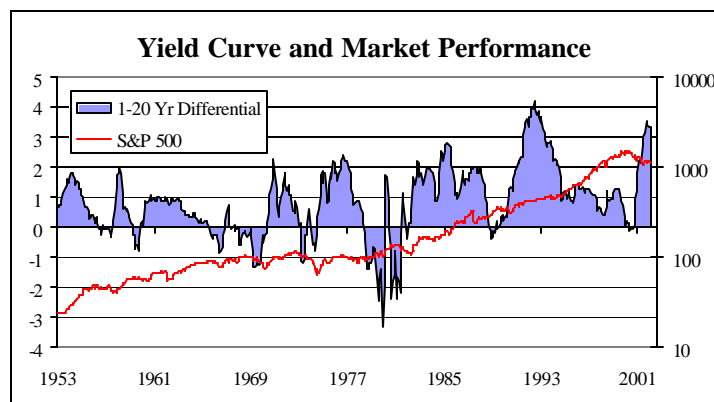
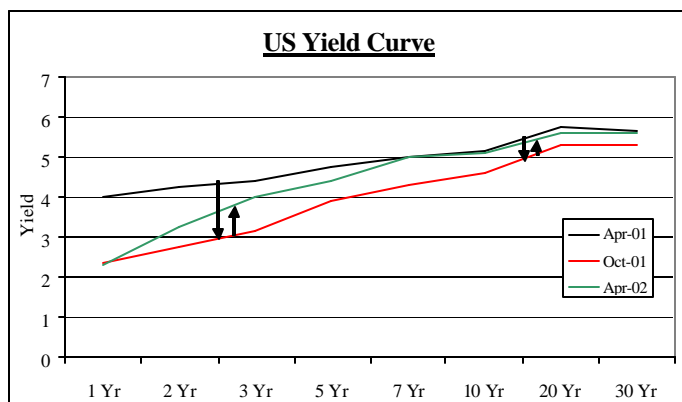


Chart s 5&6 – Source: US Federal Reserve and Bridge

This movement upwards *combined* with a steepening of the yield curve indicates that the bond markets anticipate an economic recovery, but unfortunately not much more information can be gleaned. As an economic indicator, we will keep the yield curve in our back pocket until it again turns negative – indicating that a recession is near.

The third and final leading indicator that we analysed in December was **Housing Permits** and their predictive ability on the US GDP. At the time we felt that Housing Starts (smoothed 12 months) were a good indicator of the future direction of the economy, however, as we have discussed, it is not necessarily the economy in which we are immediately concerned, but rather the performance of the equity markets. When we compare the forward three month performance of the S&P500, there is no discernable pattern. In fact, the level of correlation between the two sets of data is only -0.04, or fundamentally none. Therefore, although US Housing Permits and Starts do have some correlation with US GDP, there is really no relationship with the North American Equity Markets.

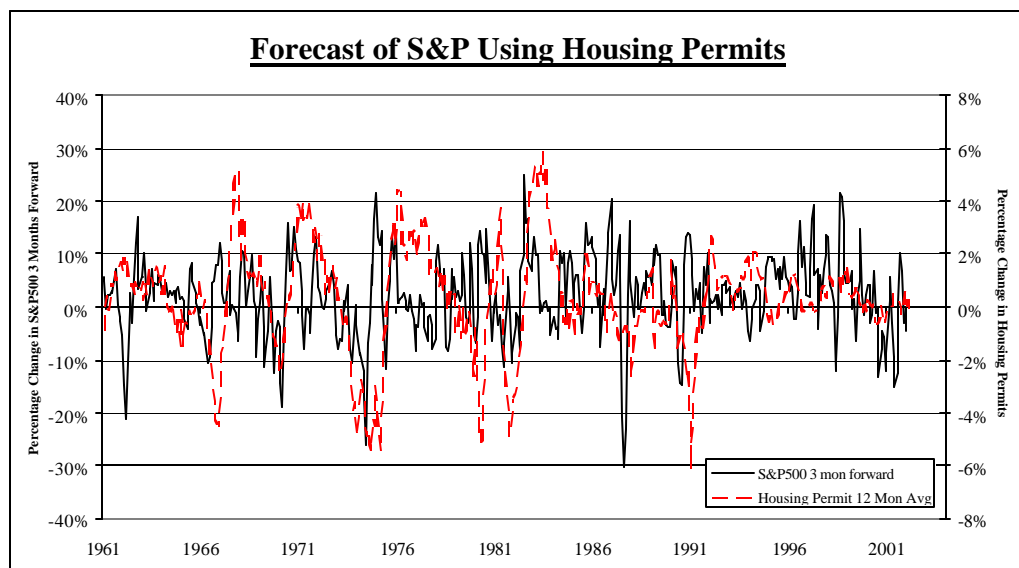


Chart 7 – Source: US Federal Reserve

### **Leading the Charge: Market Indicators**

Over the last several months we have been watching two market based indicators: investor sentiment and market volatility, which is itself a form of investor sentiment. As a gauge of market sentiment, **the Put-Call ratio** is the volume of put options being compared to the volume of calls. When sentiment is negative, the volume of puts will increase as investors expect that the equity markets will drop, and when sentiment is positive one would see a higher volume of calls as people expect the markets to increase. However, if the number of calls being written becomes too great, it indicates that too many people think that the market is going up and it can become a “contrarian indicator” (if everyone thinks its going up, it must actually be about to go down).

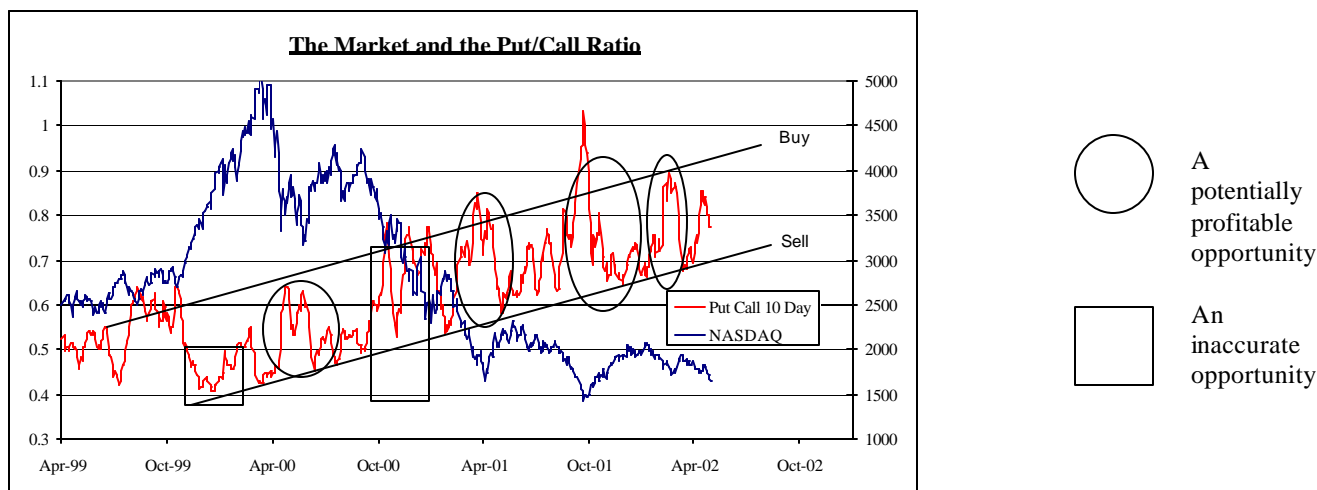


Chart 8 – Source: CBOE and Bridge

By using the ten-day moving average of the Put-Call ratio to smooth out the daily fluctuations, we can see a discernable pattern forming. If we look at the relationship historically, there were several instances over the last 3 years during which investors could have anticipated the direction of the equity markets based on a contrarian action. In the chart above the circles represent potentially profitable opportunities, while the squares represent inaccurate ones.

As of the end of April 2002, the indicator appeared to be right in the middle of the range, with no clear signal. However, we will be watching it closely in case investor sentiment turns excessively positive or negative. If the moving average reaches 0.7 or less, this would indicate that the markets may be headed lower. Conversely, if the average hits 0.9 or higher, a buying opportunity may be presenting itself as too many puts are being written.

The other market indicator is our old friend, **the Volatility Index**, or VIX. As mentioned above, it measures the implied volatility on index options, and is in a way an indicator of investor sentiment. When investors are unsure as to the direction of the overall market (and particularly in a down market), the volatility in the equity markets rises. It is during these periods of uncertainty that opportunities for short term trading profits can arise.

We have noticed that VIX levels in excess of 30-35 tend to be excellent buy signs, while values below 20-22 indicate a complacent market and tend to be good time to sell. Again, while not a perfect signal, over the past five years, it has given excellent signals for both purchases and sells. Currently, the VIX has started to climb as a result of the recent softness in the equity markets, this may give a signal that a buying opportunity is approaching.

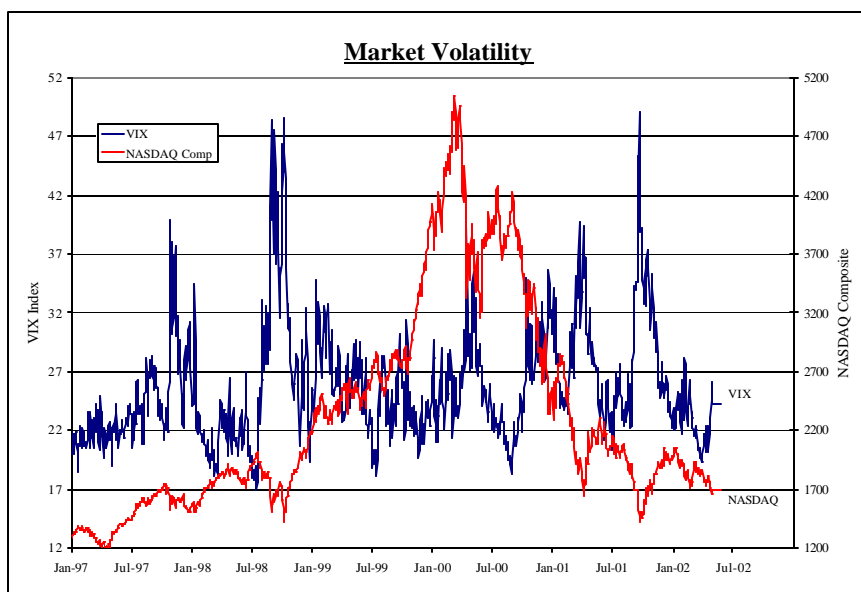


Chart 9 – Source: CBOE and Bridge

## Is Debt Good?

This is a really good question and it principally depends on the way it is being used. For many companies, debt, whether in the form of bonds, convertible debt or mortgages, is a way for them to leverage their balance sheet and improve overall returns to their equity holders. The idea being that if you can earn 10¢ for every dollar you invest in your business; if you had two dollars, you could earn 20¢. The benefit comes in the amount of return that an investor requires depending on the form of their investment.

A bond investor will normally accept a lower rate of return than an equity holder because 1) they are promised a certain yield on their investment, 2) there are sometimes hard assets being pledged against the debt (a building, inventory, etc.) and 3)

bond holders usually rank above all equity holders, therefore if something does go awry bondholders will get their money back first (if anything is left over). By accepting this lower rate of return, investors can offer “cheaper” money to Companies than equity holders are willing to accept. For example, in the case above, if a Company could earn 10¢ on every dollar invested, but a bondholder only required 8¢ for the use of their money, then shareholders would have 12¢ at their disposal. The power of leverage.

So one might ask, “If that were the case, why not have \$1 in equity and \$10 in debt, which would yield equity holders 30¢ in returns (10¢ from the equity dollar and 2¢ from each debt dollar). One would be absolutely correct if that Company:

- Had a predictable and non-cyclical or seasonal business
- Could generate 10% returns on every dollar invested, there could be no diminishing returns as the Company grew.
- Never had anything unexpected happen.

Therefore, like most things in life, a balance is required and that magic proportion of debt to equity depends on the Management, Company, Industry and Investors.

In the real world, there has been great hand-wringing recently with respect to several high profile companies that may experience financial difficulty due to their debt levels. WorldCom (WCOM-NADAQ) has been a central character in this latest round of worry, and although the Company has tried repeatedly to reassure investors (both debt and equity) that the Company is a going concern, bond ratings agencies have downgraded the Company’s debt to near-junk status, and equity shareholders have fled the stock, from an average of \$14.50 at the end of last year to close at \$2.48 as of April 30<sup>th</sup>.

However, if potential investors were to look solely at the balance sheet and income statements, there does not appear to be anything significantly wrong with the Company, and it seems to be in a position that is quite typical of the industry:

- Revenue Growth is down about 10% and expected to be down again in fiscal 2002,
- The Company is profitable on an operating basis (before depreciation, interest and taxes),
- Interest expenses are covered several times over, and
- Leverage is substantially lower than General Electric (GE-NYSE), which should allow more financial flexibility.

	General Electric 2001	Nextel 2001	WorldCom 2001	Telecom Industry Average
Revenue	\$125.9 B	\$7.7 B	\$35.2 B	
EBITDA (margin%)	\$30.7 (24%)	\$1.8 (23%)	\$9.4 (26%)	
Interest Expense	\$11.1	\$1.4	\$1.53	
<b>Interest Coverage</b>	<b>2.76 Times</b>	<b>1.29 times</b>	<b>6.14 Times</b>	<b>6.66 Times</b>
Total S/H Equity	\$54.8 B	\$10.99 B	\$56.3 B	
Total Debt	\$232.9 B	\$13.8 B	\$30.8 B	
<b>Debt to Equity</b>	<b>4.25</b>	<b>1.25</b>	<b>0.55</b>	<b>1.07</b>

That said, much of the Company’s current problems are not in the immediate, but what investors see looming on the horizon. In fiscal 2002, WorldCom has only \$60 million in long term debt coming due, but in the following three years WCOM has \$2.5 billion due in 2003, \$2.5 billion in 2004 and \$2.3 billion in 2005, totalling \$7.3 billion dollars coming due in the next three years. Plus, WCOM’s management expects revenues to drop to approximately \$21 billion in 2002, and EBITDA earnings to \$7.5 billion, thus compressing the interest coverage 4.6 times.

If we compare WorldCom to General Electric, the Companies’ EBITDA margins are similar at approximately 25% and shareholder equity is basically the same as well. The real difference is in the level of leverage that each Company uses. GE’s debt to equity ratio is 4.25, meaning that for every dollar of Shareholder’s Equity, there is \$4.25 in debt. Even though this is considered a very high leverage level, the Company can still cover their interest payments by almost three times over, and therefore generating significant returns for its shareholders.

Therefore, is WorldCom a Buy at \$2.48? If the Company is able to weather the storm and still remain profitable on an operational basis on revenues of \$20 Billion, reduce capital expenditures to reflect the industry slowdown and reduce their debt, they might be able to turn it around. Plus, at its current price level, the Company is trading at \$8.2 billion in Market Cap (when MCI (MCIT-NASDAQ) is added) which is only 0.4 times 2002 forecast revenue, 1.1 times 2002 EBITDA and 8 times Free Cash Flow. Most investors (debt and equity) are betting the Company cannot make the changes, could this be a contrarian opportunity?

## Canadian Dollar: A Technical Call

Our Technical Gurus have changed their longstanding position on the Canadian Dollar. As perennial Bear on the Loonie, our Technicians have eased their stance and stated, “We are no longer bearish on the Canadian Dollar. Instead, we are cautiously bullish.” This represents a huge departure for these technical analysts.

If we look at chart 10, to the right, the exchange rate of Canadian Dollar to US Dollar have broken through several moving averages and is currently headed towards the 150 week average (the smooth red line, heading down).



Chart 10 – Source: CQG

Fundamental analysis may even support the technical, as a report from the G7 recently indicated that the Canadian Economy was expected to grow at a faster rate than the US, resulting in strong internal demand for the Canadian dollar. Additionally, as mentioned above, as the US economy expands, there will be a demand for Canadian primary and secondary resources. US Manufacturers looking for inputs will buy Canadian goods, requiring them to sell US Dollars and buy Canadian, improving the demand for our dollar and thus the exchange rate.

While a return to the US/Canadian dollars on par is still nowhere in sight (expect for some hotels in Reno and Seattle), a stronger Canadian dollar may be in the cards. However, with this forecast we issue a caveat. For the last several years the Canadian economy has been largely an export driven one, one which has relied on our low dollar to make the price of our goods and services competitive. A rising Canadian dollar vis-à-vis the US will make our goods and services relatively more expensive, and thus less competitive. A decrease in the level of exports could be a detriment to the economy, and it is because of this that the Bank of Canada and the Federal Government have let the dollar drop as low as it has. Therefore, while Canadian Consumers might find imported items cheaper, they may have less money to spend on them.

Until next month.

## Our Favourites

Our Canadian Portfolio is still staggering from the weakness in the technology industry, particularly Nortel and AimGlobal. The indices are down for the year-to-date period as well, but definitely not to the extent to which our portfolio is. The one bright spot is Toronto Dominion Bank, which is down only one percent. If only we had had some gold stocks.

Name	Close	Recommended		% Return
	Mar 28, 2002	Month	Price	
AimGlobal Technologies Company I	\$0.61	January	\$1.30	-54%
Bombardier Inc	\$13.33	January	\$17.09	-21%
Celestica Inc	\$43.07	January	\$70.81	-38%
Nortel Networks Corporation	\$5.40	January	\$13.78	-60%
Toronto Dominion Bank	\$41.67	January	\$42.40	-1%
<b>Golden Capital Portfolio</b>				<b>-35%</b>
S&P/TSE 60 Index	428.59	January	454.79	-5%
TSE 300 Composite Index	7,582.45	January	7,870.30	-3%

A real mixed bag with our US Favourites portfolio. Similarly to our Canadian Portfolio, technology in the form of IBM and Corning have dragged down the performance. It is only Johnson & Johnson that is up. The performance of the US Portfolio did match the return on the NASDAQ Composite, but a 20% loss in four months does not give us bragging rights.

Name	Close	Recommended		% Return	Sold	
	Feb 28, 2002	Month	Price		Month	Price
ChevronTexaco Corp	\$85.86	January	\$89.72	-4%		
Corning Inc	\$6.67	January	\$10.51	-37%		
Du Pont El de Nemours	\$43.27	January	\$44.65	-3%		
Entrust Inc	\$4.00	January	\$12.10	-40%	January	\$7.25
Johnson and Johnson	\$62.91	January	\$59.28	6%		
International Business Machines	\$83.89	January	\$124.05	-32%		
Wal-Mart Stores Inc	\$56.20	January	\$57.39	-2%		
<b>Golden Capital Portfolio</b>				<b>-19%</b>		
S&P 500 Index	800 to 895	January	1,164.89	-9%		
NASDAQ Composite Index	1,656.93	January	2,037.14	-19%		

Thank you,

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