



Sitka Pacific  
Capital Management

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Dear Investor,

Over the past month the stock market has recovered from the sharp decline in February and March and has gone on to make marginal new highs for the year. And while the Nasdaq had been badly lagging the Dow Industrials and S&P 500 in a sideways trading range since November, it has also shown signs of life lately. So, despite the economic headwinds, stocks seem to be in a positive mood at the moment.

Treasury bonds hit a low mid-month after correcting from a high in late February and appear ready to continue their advance that began last year. The Treasury yield curve remains strongly inverted below the Fed Funds rate, and just last week the preliminary report on first quarter GDP came in at a tepid 1.3%. Consumer spending was strong during the quarter, but housing, business investment and exports were weak. The decline in housing alone shaved 1% of Q1 GDP growth. Since the yield curve inverted last summer, GDP growth has weakened from above 3% to last quarter's estimate of 1.3%.

If you have viewed the holdings of your account in the past month, you may have noticed that in addition to our core portfolios we've taken on a significant exposure to a few specific sectors, mostly related to energy. Given that this allocation could create somewhat more volatility in your account in the coming months, I would like to use this month's update to outline the important emerging (and continuing) investment themes this exposure is meant to address. In many ways these have been *the* dominant investment themes since the turn of the century, and after a pause in 2006 and early 2007 it looks like they are primed to resume.

We'll begin by taking a step back with a look at commodities in general in the context of past 40 years, and then touch on recent developments in energy and other commodity sectors that have prompted our recent allocation.

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It is hard to overstate the significance of the changes to our investment landscape that took place at the stock market peak in 1998-2000. As market breadth began to turn down in 1998 (from 1998 on, fewer and fewer individual stocks made new highs with the major indexes) and technology indexes went to parabolic heights, some sectors that had remained dormant for close to 20 years began to wake up.

Back in the early 1980's, stocks and bonds had been mired in a severe bear market for over a decade. The Dow Industrials peaked near 1000 in 1965, and 17 years later in 1982 it remained near 1000. On an inflation adjusted basis stocks had lost over 80% of their value, a loss similar to the bear market during Great depression. Treasury bond yields had gone from the levels similar to what we are seeing today to over 14% in 1981 – also representing a huge inflation-adjusted loss. Looking back, the 1965-1982 period was not a good environment for stocks or bonds and other 'paper' assets, but there were other sectors that did quite well.

While paper assets struggled, commodities did quite well during the 1970's and early 1980's. The most visible part of this trend to the average American was the price of oil. Less visible was the price of precious metals, including gold and silver. The price of gold went from \$35/oz to a high in early 1980 above \$800/oz. The stocks of companies that profited from the rise in gold and other metals and commodities did very well as the Dow languished, and investors who recognized early on that real assets had entered a period of out-performance had a very good decade.

However, just as gold and precious metals were going parabolic in 1980 (just like the Nasdaq would in 1999), the reign of commodities and other real assets ended. In the intervening years investor sentiment had completely reversed from the late 1960's and early 1970's. By 1982 no one wanted to own stocks and bonds anymore as commodities had come to rule the investment landscape, and that positive sentiment for real assets would stay on long after the bull market was over. Even as gold and silver quickly sank 50% from their highs in 1980 and then failed to recover, most investors were convinced a roaring comeback was just ahead.

However, despite numerous fits and starts during the following years, the reality was that in the early 1980's the dominant investment theme had moved away from real assets like commodities and back to paper assets. Just as those who recognized the shift away from paper assets in the early 1970's were able to prosper, those who recognized the shift back to paper assets in the early 1980's profited from the longest bull market in our history.

If we fast forward to 1999, at the same time technology stocks were hitting parabolic heights the investment landscape began to shift again - away from paper assets. This chart below gives us a way to visualize that shift. It shows the Goldman Sachs Commodity Index (GSCI) divided by the S&P 500 from 1998 to today.

The low in 1999 ended up being *the* low commodities reached as valued against the general stock market from their peak in the early 1980's. Since that time, you can see the solid uptrend commodities have established against stocks as the value of the GSCI has almost tripled relative to the S&P 500.



Even though we now have the Dow Industrials at a new all time high and we have the S&P 500 approaching its 2000 high, the gains in recent years by stocks merely recovered losses from the 2000 peak on a nominal basis – which still represents a big inflation-adjusted loss over the past 7 years. The only major sectors that have kept pace with inflation since the 2000 high in the stock market have been commodity-related. In other words, the 1998-2000 stock market top marked the end of almost two decades of dominance by paper assets and ushered in a new era dominated by real assets.

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We are now 7 years into this investment landscape dominated by real assets and there are few indications we are close to an end to this trend. The main focus of the media and the general investing public (judging by fund flows) remains firmly on paper assets, and stocks are still embraced as the best long-term investment – even though they have severely underperformed real assets over the past 7 years. From a long-term perspective, these are hints that we still have a long way to go before we reach an end to real asset out-performance.

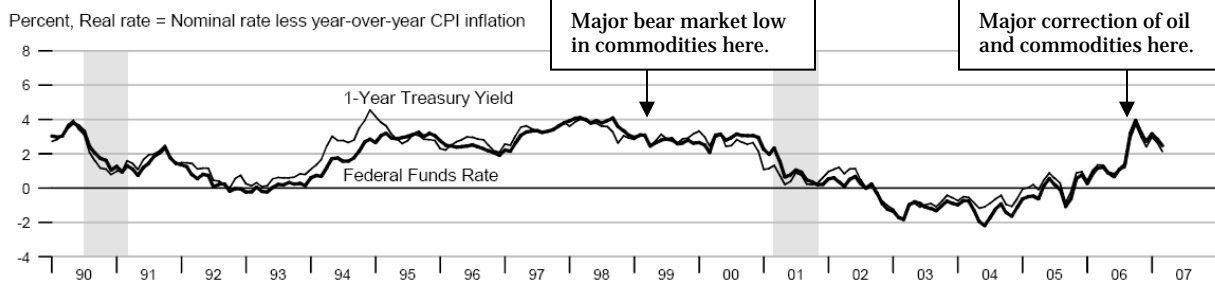
In the short-term, we remained quite cautious toward metals and energy in 2006 as it was clear a lot of new 'hot' money was flowing in. The action of many energy and mining stocks began to act as if the smart money was exiting and being replaced with money controlled by less experienced investors – which is always a sign that a significant

correction could be approaching. In fact, in early 2006 natural gas had already declined dramatically from a peak in December 2005. Gold and silver topped in May 2006, which was followed in July by oil.

This roll-over in energy and precious metals prices did not occur in an economic vacuum. One aspect of real asset bull markets is that they tend to out-perform when returns on paper assets do not adequately compensate for inflation – which was definitely the case in the 1970's. The chart below shows *real* short-term interest rates since 1990, in this case the Fed Funds rate and the 1-year Treasury yield minus Consumer Price Index inflation (we'll leave the debate over the accuracy of the CPI for another day).

Between 2002 and 2005, real interest rates were clearly negative versus inflation and it was during this time that we saw the most dramatic rise in oil and precious metals – exactly what we would expect. As the Fed raised rates through 2005 and into 2006, real rates climbed into positive territory and it was then when we started to see a cascade of trend failures from natural gas, to gold and silver, and then to oil and other metals such as copper.

### Real Interest Rates



From a purely technical perspective, the highs many commodities set in 2005-2006 and the subsequent declines could have easily been major tops from which there would be no recovery. But a funny thing happened on the way to the bear market: instead of collapsing along with their respective commodity, many of the stocks – particularly in energy – instead remained relatively strong in sideways consolidations. By early this year it became clear that they had weathered the storm of late 2006 better than they should have if in fact 2006 had been a major top.

Back in 1999, negative interest rates, the poor returns in the stock market and the severe decline in the exchange rate of the dollar were still several years away. But the market anticipated those conditions well in advance as commodities began to rally from their lows in 1999. With the continued strength of many energy, mining and materials stocks it is very possible they are anticipating similar conditions again.



It's no big secret that a decline in the value of the dollar adds a tailwind to real assets priced in dollars, and over the past year the dollar's exchange rate with other currencies has been falling. This decline has occurred at a time when short-term interest rates have been relatively high and rising. You can see on the chart to the left that over the past 10 years the dollar has followed the direction on short-term interest rate changes rather closely (with a lag) until 2006.

Although there is always the chance the dollar could strengthen this year and re-establish its relationship with short-term rates, it also possible that the dollar has begun to anticipate lower interest rates here in the US – perhaps in response to the weak housing market and a slowing economy (which we are already seeing). Given that inflation is already at the high end of the Fed's comfort zone, this puts them in a tough position – whether to keep rates high and focus on bringing inflation down, or whether to come to the rescue of the economy.

The weakness in the dollar and the relative strength of energy and metal stocks after their peaks last year in light of the declines in commodities suggest that the current environment of positive real short-term interest rates may prove to be temporary. If the Fed is forced to lower interest rates in response to a weak economy before they have effectively dealt with current inflation, the dollar will drop and we'll quickly be in another period of negative real interest rates. That would certainly be enough for another round of significant out-performance by real assets.

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As you know, it is not without serious consideration that I allocate a significant portion of your account to a specific sector, unhedged. Our investment goals remain preservation of capital and a positive absolute return, and at times preserving your investment capital means taking on broad exposure to well defined trends – even if that raises risk and volatility over the short-term to some extent.

Your account now has an allocation to a diverse basket of stocks from the energy sector, and a few more will likely be added as the sector continues higher. We have kept a limited exposure to precious metals since February, but that may change in the next few months. Our continuing interest in commodities reflects the long-term bull market in real assets, especially relative to stocks and bonds. If the Fed reacts to the slowing economy by lowering rates and the dollar embarks on another severe slide, we can expect many assets to be 'revalued' by the weaker dollar. This revaluation may or may not prove to be a support for stocks but it will directly benefit commodities.

And finally, you probably know by now that we tend exit allocations such as this quickly when even the best laid plans fail to materialize. So while this represents current thinking on energy and commodities, there are certainly a number of risks to this positive outlook. For instance, if the US economy was to weaken substantially over a short time and/or the global economy was to slowdown significantly, real assets could decline along with stocks (even while maintaining their out-performance). Demand from countries like China is certainly playing a key role in this bull market, and a slowdown there could significantly impact commodity prices. Signs of any of these outcomes would move us to a more defensive position, which would not include unhedged allocations to commodity stocks.

That's all for this month's update. As always, if you have any questions about your account feel free to contact me anytime.

Sincerely,  
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