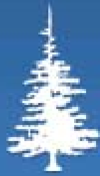

Sitka Pacific
Capital Management

May 2007

Dear Investor,

The broader stock market maintained its strength this past month, with the S&P 500 reaching its all time high set in March of 2000. The Nasdaq and the Russell 2000 small cap index lagged the large-cap indexes somewhat and posted modest gains for the month. The market is now leaving its strong seasonal period, and even if the bull trend remains intact over the summer gains will likely moderate in the coming months. Although our core portfolios are now hedged against market fluctuations, we remain openly invested in a few key sectors that represent significant long-term opportunities. These include the allocation to energy we discussed last month, as well as a re-entry into precious metals shares during the recent sell-off.

Treasury bond yields headed higher in May. The 10-year Treasury bond has broken through 4.75%, a medium-term resistance level, and there is a risk bond yields could head significantly higher from here (we'll talk more about this below). That risk prompted us to sell our Treasury bond ETFs this past month in Absolute Return accounts, and as a result cash levels have been higher than normal. The current interest rate on cash is slightly above 5% for balances above $100,000, and slightly below 5% for balances below $100,000 – which is a higher yield than the vast majority of stocks and available funds. With Treasury bond rates rising and the stock market looking extended, having part of our portfolios in a money market fund that yields 5% with very little risk is a good place to be until better opportunities arrive.

In April we talked about the alternating dominance of paper assets vs. real assets over the past 43 years, and this month I'd like to continue that theme with an excerpt from a speech Warren Buffet gave in July 2001, which was reprinted by Fortune Magazine in December 2001. Leaving out the behavior of commodities, he discusses past periods of stock market stagnation in terms of interest rates and investor sentiment. I've underlined a few lines that I consider particularly significant, and we'll continue our discussion in more detail at the end of this letter.

* * *

Warren Buffett (July 2001):

The last time I tackled this subject, in 1999, I broke down the previous 34 years into two 17-year periods, which in the sense of lean years and fat were astonishingly symmetrical. Here's the first period. As you can see, over 17 years the Dow gained exactly one-tenth of one percent.

Dow Jones Industrial Average
Dec. 31, 1964: **874.12**
Dec. 31, 1981: **875.00**

And here's the second, marked by an incredible bull market that, as I laid out my thoughts, was about to end (though I didn't know that).

Dow Jones Industrial Average
Dec. 31, 1981: **875.00**
Dec. 31, 1998: **9181.43**

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Now, you couldn't explain this remarkable divergence in markets by, say, differences in the growth of gross national product. In the first period--that dismal time for the market--GNP actually grew more than twice as fast as it did in the second period.

Gain in Gross National Product
1964-1981: **373%**
1981-1998: **177%**

So what was the explanation? I concluded that the market's contrasting moves were caused by extraordinary changes in two critical economic variables--and by a related psychological force that eventually came into play.

Here I need to remind you about the definition of "investing," which though simple is often forgotten. Investing is laying out money today to receive more money tomorrow.

That gets to the first of the economic variables that affected stock prices in the two periods--interest rates. In economics, interest rates act as gravity behaves in the physical world. At all times, in all markets, in all parts of the world, the tiniest change in rates changes the value of every financial asset. You see that clearly with the fluctuating prices of bonds. But the rule applies as well to farmland, oil reserves, stocks, and every other financial asset. And the effects can be huge on values. If interest rates are, say, 13%, the present value of a dollar that you're going to receive in the future from an investment is not nearly as high as the present value of a dollar if rates are 4%.

So here's the record on interest rates at key dates in our 34-year span. They moved dramatically up--that was bad for investors--in the first half of that period and dramatically down--a boon for investors--in the second half.

Interest Rates, Long-Term Government Bonds
Dec. 31, 1964: **4.20%**
Dec. 31, 1981: **13.65%**
Dec. 31, 1998: **5.09%**

The other critical variable here is how many dollars investors expected to get from the companies in which they invested. During the first period expectations fell significantly because corporate profits weren't looking good. By the early 1980s Fed Chairman Paul Volcker's economic sledgehammer had, in fact, driven corporate profitability to a level that people hadn't seen since the 1930s.

The upshot is that investors lost their confidence in the American economy: They were looking at a future they believed would be plagued by two negatives. First, they didn't see much good coming in the way of corporate profits. Second, the sky-high interest rates prevailing caused them to discount those meager profits further. These two factors, working together, caused stagnation in the stock market from 1964 to 1981, even though those years featured huge improvements in GNP. The business of the country grew while investors' valuation of that business shrank!

And then the reversal of those factors created a period during which much lower GNP gains were accompanied by a bonanza for the market. First, you got a major increase in the rate of profitability. Second, you got an enormous drop in interest rates, which made a dollar of future profit that much more valuable. Both phenomena were real and powerful fuels for a major bull market. And in time the psychological factor I mentioned was added to the equation: Speculative trading exploded, simply because of the market action that people had seen.

Two years ago I believed the favorable fundamental trends had largely run their course. For the market to go dramatically up from where it was then would have required long-term interest rates to drop much further (which is always possible) or for there to be a major improvement in corporate profitability (which seemed, at the time, considerably less possible). If you take a look at a 50-year chart of after-tax profits as a percent of gross domestic product, you find that the rate normally falls between 4%--that was its neighborhood in the bad year of 1981, for example--and 6.5%. For the rate to go above 6.5% is rare. In the very good profit years of 1999 and 2000, the rate was under 6% and this year it may well fall below 5%.

So there you have my explanation of those two wildly different 17-year periods. The question is, how much do those periods of the past for the market say about its future?

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To suggest an answer, I'd like to look back over the 20th century. As you know, this was really the American century. We had the advent of autos, we had aircraft, we had radio, TV, and computers. It was an incredible period. Indeed, the per capita growth in U.S. output, measured in real dollars (that is, with no impact from inflation), was a breathtaking 702%.

The century included some very tough years, of course--like the Depression years of 1929 to 1933. But a decade-by-decade look at per capita GNP shows something remarkable: As a nation, we made relatively consistent progress throughout the century. So you might think that the economic value of the U.S.--at least as measured by its securities markets--would have grown at a reasonably consistent pace as well.

The U.S. Never Stopped Growing

Per capita GNP gains crept in the 20th century's early years.
But if you think of the U.S. as a stock, it was overall one helluva mover.

Year	20th-Century growth in per capita GNP (constant dollars)
1900-10	29%
1910-20	1%
1920-30	13%
1930-40	21%
1940-50	50%
1950-60	18%
1960-70	33%
1970-80	24%
1980-90	24%
1990-2000	24%

That's not what happened. We know from our earlier examination of the 1964-98 period that parallelism broke down completely in that era. But the whole century makes this point as well. At its beginning, for example, between 1900 and 1920, the country was chugging ahead, explosively expanding its use of electricity, autos, and the telephone. Yet the market barely moved, recording a 0.4% annual increase that was roughly analogous to the slim pickings between 1964 and 1981.

Dow Jones Industrial Average

Dec. 31, 1899: **66.08**
Dec. 31, 1920: **71.95**

In the next period, we had the market boom of the '20s, when the Dow jumped 430% to 381 in September 1929. Then we go 19 years--19 years--and there is the Dow at 177, half the level where it began. That's true even though the 1940s displayed by far the largest gain in per capita GDP (50%) of any 20th-century decade. Following that came a 17-year period when stocks finally took off-- making a great five-to-one gain. And then the two periods discussed at the start: stagnation until 1981, and the roaring boom that wrapped up this amazing century.

To break things down another way, we had three huge, secular bull markets that covered about 44 years, during which the Dow gained more than 11,000 points. And we had three periods of stagnation, covering some 56 years. During those 56 years the country made major economic progress and yet the Dow actually lost 292 points.

How could this have happened? In a flourishing country in which people are focused on making money, how could you have had three extended and anguishing periods of stagnation that in aggregate--leaving aside dividends--would have lost you money? The answer lies in the mistake that investors repeatedly make--that psychological force I mentioned above: People are habitually guided by the rear-view mirror and, for the most part, by the vistas immediately behind them.

* * *

In Buffett's speech above we are reminded that throughout the last century the US economy grew at a relatively constant pace decade-to-decade. This is in stark contrast to the growth of the stock market, which periodically went through extended periods of stagnation even while the economy continued to grow. The main culprit behind the

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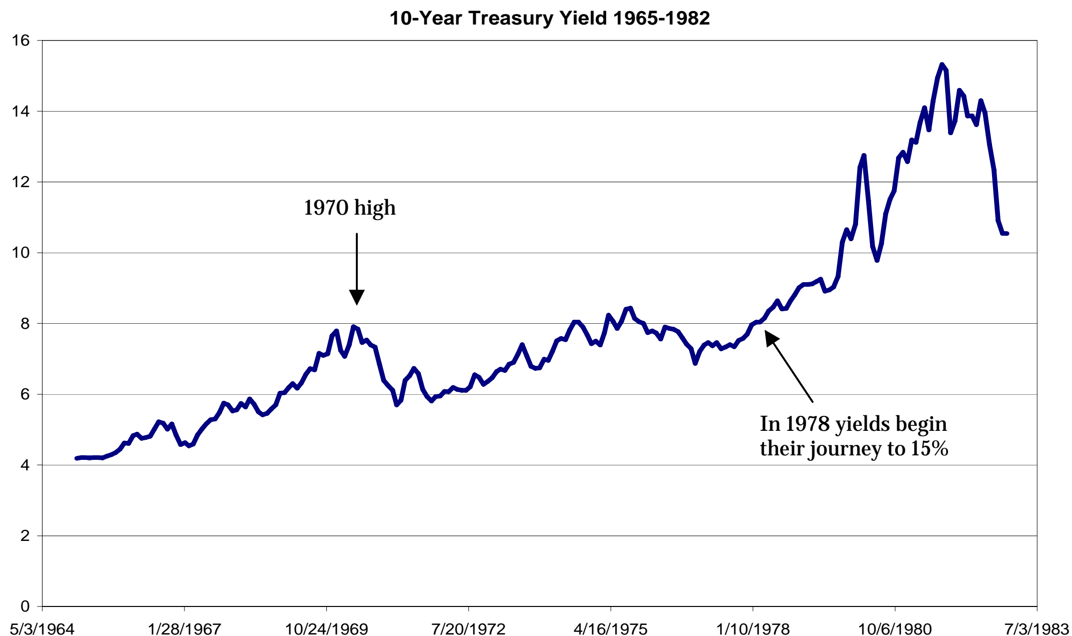
market's long-term cycle of stagnation and raging bull is how investors value the businesses behind the stocks in light of changes in interest rates (along with many other factors).

When we talk about these very long term trends, it's important to keep in mind that over a short period of a few months to a few years anything can and does happen. During the 1970's the Dow Industrials did not sit tight around 875 the entire decade - there were tremendous swings up and down. After bottoming in 1970 near 660, the Dow Industrials closed at a new all-time high at 1051 in January 1973, a near 60% rally over the preceding 3 years and 20% above the close of 874.12 on December 31, 1964 cited by Buffett. However, after that January 1973 high the Industrials declined throughout 1973 and 1974 to a low near 584, a 45% loss in just under 2 years.

Those swings highlight the fact that even though they certainly didn't make any meaningful long term progress, stocks did not spend the entire 1994-1982 period standing motionless. As an aside, near the 1973 peak Barron's ran an article entitled *Not a Bear Among Them* which detailed the bullish consensus on Wall Street at the time. Given the Dow's 45% decline over following 22 months we can see how dangerous Wall Street bullishness can be – *especially* during these long-term re-valuation cycles. As we are probably about halfway through the current cycle of contracting valuation, I find the current bullish sentiment bears a striking resemblance to 1973.

Just as the Dow did not hang around 875 throughout the 1964-1982 period, Treasury yields did not move in a straight line from low to high either. As seen on the chart below, the yield on the 10-year Treasury bond rose from near 4% in 1965 to near 8% in 1970, then spent the next 8 years fluctuating between 8% and 6%. It was only in 1978 that yields began their record tear higher into 1981.



In 2000, after a 20-year expansion of valuations from the lows in the early 1980's, the stock market was valuing businesses higher than at any other point in the previous 100 years. As Buffett notes, this was accompanied by a decline in interest rates from the highs seen on the right side of the above chart back down to levels last seen in the 1950's. This helped the valuation of the market – represented by its P/E ratio – to reach a high near 35 in 2000 before soaring to above 44 during the 2001 recession. Since then it has declined to near 16 today as earnings have rebounded over the past 5 years, which is low versus recent history but now where near the lows in valuation recorded in past; in the early 1980's and at other valuation lows over the past 100 years, the market's P/E has consistently fallen below 8 before another period of P/E expansion emerges.

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It's clear that the peak in 2000 not only marked the beginning of a period of real asset outperformance, it also marked the start of a phase of reducing the valuations the market gives to businesses. During the last phase of valuation contraction from 1960 through to 1980, the P/E fluctuated around 16 until the market started to "sense" that interest rates – including Treasury bond yields – were moving significantly higher. This provided the spark that carried stocks to their long-term valuation cycle low: the P/E of the market dropped quickly as investors discounted future earnings with higher interest rates. The notable thing about the market since 2000 is that long-term interest rates have *declined* modestly while the P/E of the stock market has come down. The yield on the 10-year Treasury bond was 6.4% at the end of May 2000, and stands near 4.9% today. This has provided a significant cushion to the market because if yields had risen during the last 7 years the market's P/E would probably have dropped much further.

As I mentioned at the start of this letter, we exited a significant allocation to Treasury bond ETFs in Absolute Growth accounts this past month. This was done not only because of the recent rise in bond yields (which depresses the prices of these ETFs), but also because 10 and 30 year Treasury yields are now threatening to break out of their long-term downtrend in place since 1982. In the *2006 Review* I mentioned that the high in bond yields last summer presented a great buying opportunity, and we looked at a long-term chart of the 30 year Treasury bond yield showing the decline from the early 1980's. At the time I was encouraged by the bounce off the upper end of the channel and the subsequent rally into the end of 2006 – it appeared another rally in bonds would eventually take yields down to another new low.

However, bond yields have now revisited the top of their channel, and it appears yields could potentially break higher and end their 25-year downtrends. If bond yields do break higher this year, we can expect the market to begin re-valuing stocks in light of the new trend in interest rates; even if the level of interest rates themselves do not rise significantly at first, the market will likely begin to anticipate higher rates down the road, as it did in the late 1960's and early 1970's. This could completely change the character of the current decline in the market's P/E from the 2000 peak, which has up to now benefited from lower long-term interest rates. Up to this point the market's P/E has been able to come down even while the price of the market has remained buoyant, but that would likely change for the worse under a new trend of rising long-term interest rates.

In laying all this information and comparisons out over the past 2 months, in no way do I want to imply that we are heading for a direct *repeat* of the 1970's experience. I only mean to suggest that some of the themes that played out during the last cycle of contracting valuations may play out again during this cycle: such as the continued decline of valuations given to stocks, and the outperformance of real assets vs. paper assets. The potential breakout of Treasury bond yields and a new long-term trend of rising interest rates is certainly a key event that would heavily influence the market and economy in ways we haven't seen in more than 30 years, and we are prepared for that shift if it happens.

Stocks and investment trusts that derive their earnings from real assets have been in very strong uptrends over the past 7 years, and theme that will likely continue or even accelerate as the long-term cycle of declining stock valuations continues. Hopefully you have a clearer understanding behind many of the positions and changes in your accounts, and if not feel free to send a quick email and we'll get back to you as soon as possible.

Sincerely,
Brian McAuley

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