Sitka Pacific
Capital Management

November 2007

Dear Investor,

In the first week of January you'll receive our *2007 Review*, where we'll look back at the markets and economy this past year and give our outlook heading into 2008. It will also contain information about the portfolios and what is expected in the coming year for each. This will be a full summary of our outlook and portfolio positioning, so with that on its way this month's discussion will be brief.

Over the past month we've seen the markets continue to react to the rapidly changing prospects for the economy and the continued deterioration of the credit markets. Treasury bonds continued significantly higher, with the yield on the 10-year bond falling below 4% for its lowest close since 2004. The Fed Funds rate remains at 4.5%, but the entire Treasury yield curve out to 30-year bond is now firmly below that level. The 2-year Treasury yield has been hovering near 3% and the 3-month Treasury bill yield closed below 2.9% just this week.

However, despite a yield below 3% on short-term risk-free Treasuries, the rate which banks are demanding for short-term loans to other banks (the LIBOR rate, which is not default risk-free) remains near 5.2%. There have been only a few times in the last decade when the spread between the LIBOR rate and the Treasury rate has been this high, and it is a clear sign of continued stress in the financial system. Given the continued strain the credit markets and the action in short-term Treasuries, it's clear the market is expecting the Fed to continue to lower the Fed Funds rate in the immediate future.

Stocks fell dramatically over the past month and then managed to recover roughly half of those losses over the past week. The S&P 500 ended down 4.4% in November, and the Nasdaq fell 6.9%. In the parlance of Wall Street, this is now an official "correction" since the major indexes at their low closed more than 10% below their October high. The more economically sensitive indexes such as the Russell 2000 small cap index and the Dow Transportation index have continued to underperform, and the rest of the market appears to be coming to grips with the possibility of a significant downturn in the economy.

Although stocks have come down a long way from their October high we are anticipating further declines into 2008 before this adjustment is over. There will certainly be short-term rallies that emerge when the market gets too oversold, but unless they exhibit staying power it is important to see them for what they are and remain focused on the overall picture. It's also important to remember that there will be a tremendous opportunity for growth for years to come once the housing market finds a bottom and the market fully discounts the upcoming weakness in the economy. The best we can do in the mean time is to remain focused on preserving capital until that time has arrived. So as of the end of this month we remain in a defensive position relative to stocks.

However, having said that, we are currently looking at a number of foreign markets in the Absolute Return portfolio. Most foreign and emerging markets have declined recently alongside the US market, with some markets like China closing more than 20% off their October highs. That close correlation between the majority of global markets and the US market will likely remain strong, but over the past month we are seeing some markets buck that trend.

320 Dayton St. Suite 220 P.O. Box 7 Edmonds, Washington 98020
ph: 425.774.1425 fax: 425.774.1486 www.sitkapacific.com

Now that the US market is responding to the deteriorating domestic economy we are getting a chance to separate the "wheat from the chaff" in the global marketplace – in other words, find the markets that will remain strong independently of weakness in the US. What we have seen so far are encouraging signs from some markets that have spent the past couple years building value while most other global markets have rallied to extremes. These markets are showing signs that they will be able to strike out on their own, and if they continue to do so we will likely add exposure in the coming months.

Precious metals were volatile in November, and the dollar hit new lows against most other major currencies. Gold hit a rally-high near $848 early in the month, then declined to as low as $773. Silver traded higher in what appears to be the end of its consolidation from the May 2006 high. Although gold and silver may be vulnerable in the next month or so to more short-term declines, there are already signs that the current volatility is only a healthy correction within the larger uptrend. As long as that remains the case we will continue to be invested in precious metals.

Oil traded below $90/bl early in the month and then rallied to a new high of $99/bl before falling back below $90/bl again. Many energy stocks (including some of those held in the *Commodities Focus I* portfolio) failed to buck the trend of the general market in November and declined. This is likely a sign that oil has reached a short-term or even a medium-term high. Oil has rallied from a low near $55/bl to its recent high at $99/bl and there is bound to be a correction of that advance at some point. However, beyond the potential for any short-term decline, there has been no change in the long-term bullish case for energy and in fact many energy stocks continue to look very healthy despite the pull back.

On the economic front, the credit markets again took center stage in November with the over-arching theme being that credit continues to become more restricted. Up to now this has been largely a theoretical problem for most Americans, but we are now seeing that the deteriorating credit market and the housing market are taking their toll on consumers. Consumer sentiment surveys have declined significantly over the past few months, and a number of retailers from Starbucks to Sears to Winnebago have been lowering their forecasts. It is quite clear that the economy is slowing significantly. We'll have a thorough discussion on recent developments in the economy in the upcoming *2007 Review*, but we'll leave it here for this month.

If you have any questions about your account or would like to discuss issues raised in this letter, feel free to give us a call or send an email to the address below. We hope you had a nice Thanksgiving last week, and we wish you Happy Holidays in the coming weeks.

Sincerely,
Brian McAuley

Brian McAuley
Investment Advisor
Sitka Pacific Capital Management, LLC
investing@sitkapacific.com

320 Dayton St. ♣ Suite 220 ♣ P.O. Box 7 ♣ Edmonds, Washington 98020
ph: 425.774.1425 ♣ fax: 425.774.1486 ♣ www.sitkapacific.com