



Sitka Pacific
Capital Management

September 2007

Dear Investor,

The top news of the past month was the Fed's decision to cut the Fed Funds rate by 0.5% to 4.75%. The aggressiveness of the move was a surprise to many, especially given the stoic stance the Fed maintained up to now. It's clear they are seeing evidence that the events in the credit and housing markets pose a risk to the broader economy, as is seen by their statement released with the news of the rate cut:

Economic growth was moderate during the first half of the year, but the tightening of credit conditions has the potential to intensify the housing correction and to restrain economic growth more generally. Today's action is intended to help forestall some of the adverse effects on the broader economy that might otherwise arise from the disruptions in financial markets and to promote moderate growth over time.

- FOMC, September 18, 2007

As recently as their August meeting, the Fed maintained their stance that despite the housing downturn the economy was poised to do well and inflation remained their primary concern. This was in stark contrast to what the market was saying at the time, as Treasury bond yields were moving decisively lower – hinting the economy was about to weaken. Ironically, the Fed now seems comparatively unconcerned with inflation while the markets have sent gold and other commodities to record highs in apparent anticipation of higher inflation.

As of this writing, the markets are still sorting out what to do next. Stocks gained immediately after the Fed's decision, but have since stalled. Treasury bonds moved lower (yields higher) after the decision, but they have since stabilized and remain well below their summer peak. Gold rallied to a new 27-year high this past month, as did Oil – both benefiting from a new all time low in the dollar.

With the Fed lowering rates this aggressively after steadfastly maintaining their concern for inflation over the past year, the current situation may seem confusing, to say the least. However, if we broaden our view a little we may get a better understanding of the short-term issues the Fed is responding to and also what they hope to accomplish in the long-run. Whether or not we agree with their goals and their methods of achieving those goals, understanding how they intend to address the short-term risks to growth and long-term imbalances in the US economy will be essential in the coming years – because they hold the keys to the bank.

Bernanke's Plan?

The most surprising aspect of the Fed's decision to cut the Fed Funds rate by 0.5%, instead of the widely anticipated 0.25%, was their apparent abandonment of the dollar. They had maintained their stance of “we don't expect problems in the housing market to spill over into the broader economy” for a long time, even though the housing downturn was gaining momentum. It became clear that the Fed was stuck between the growing risks to the economy and the fact that commodity prices were continuing higher and the dollar was continuing lower.

As we discussed last month, the recent credit market events changed the landscape for housing. Up to that point home prices had been slowly declining but mortgages remained available to almost anyone who wanted one. Since then some segments of the home buying population have been shut out of the market, and many who were counting on refinancing their adjustable-rate mortgage are suddenly left without options. These changes by no means affected the *majority* of those seeking mortgages, but it will certainly lead to another reduction in demand in the housing market in addition to what we've seen so far.

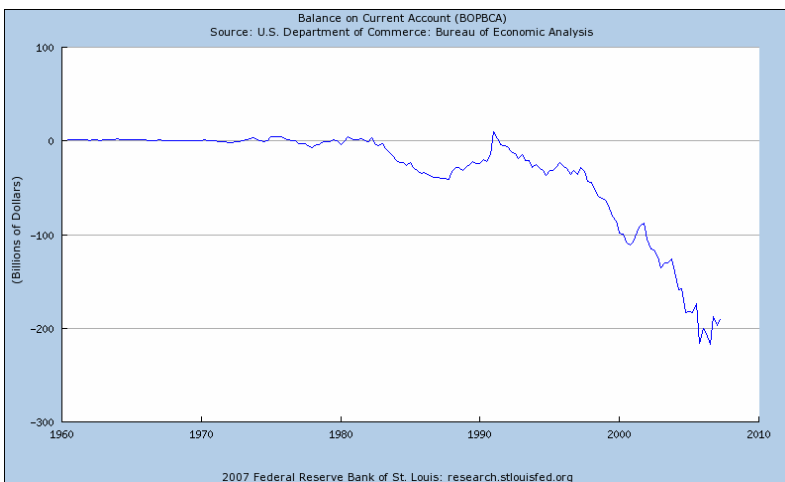
The Fed apparently judges these events as significant enough to abandon their campaign of “fighting inflation” in favor of stimulating the broader economy, starting with a 0.5% rate cut. As a consequence of that dramatic shift, we have seen an immediate response by the market. The exchange rate of the dollar declined to a new low against a basket of major foreign currencies and at the same time gold broke out of a 16-month trading range - a sign that the market is expecting the decline in the dollar to continue.

While a continued decline in the value of the dollar may seem like an unavoidable consequence of the Fed's response to the housing market, it may be the case that the Fed actually welcomes it as part of the solution for some of the long-term imbalances in our economy. Even though they could never admit as much publicly, evidence of this comes from the Fed's own public comments on our trade deficit with the rest of the world.

On September 11, 2007, the Fed chairman Ben Bernanke gave a speech in Germany entitled *Global Imbalances: Recent Developments and Prospects* that focused on the origins of our current account deficit with the rest of the world and possible policy remedies. If words like “current account deficit” make you tense up, please try to relax – I assure you we're not going *too* deep into the economic abyss.

Since the late 1990's, we have been buying more “stuff” from the rest of the world than they have been buying from us. As those countries sell us more stuff than we sell to them, it results in those countries accumulating more of our money than we accumulate of theirs. That resulting surplus of money is the major component of what is referred to as the current account surplus we have with that country.

If we sum up the current account surpluses we have with the rest of the world, we find that we are now buying close to \$800 billion of more stuff than the world has been buying from us. This trend can be seen in the chart to the right, which shows our quarterly current account surplus with the rest of the world since 1960. You can see that since the mid-1990's the surplus has continued to grow.



According to Bernanke, there are several reasons why we in the US buy a lot more stuff from the rest of the world than they

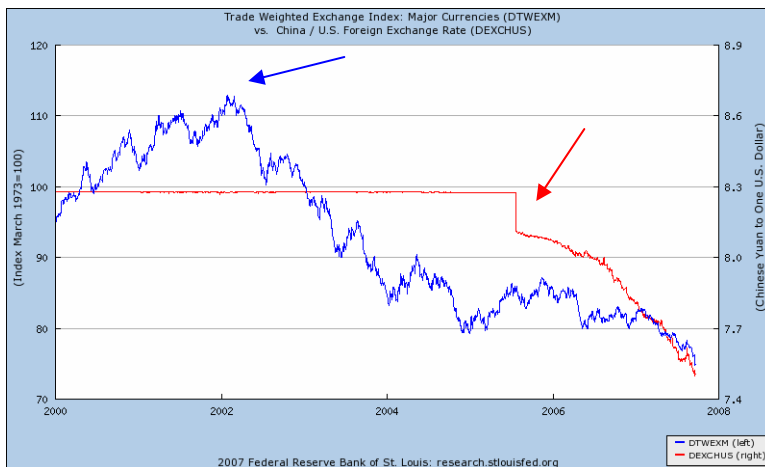
buy from us. One reason is that after the Asian financial crisis in the 1990's, investment in those countries declined significantly and people began to save more - which resulted in higher national savings rates in Asia (excluding China and Japan). Another reason is that with boom in oil prices, oil exporting countries have found themselves with more income than they anticipated – which resulted in a higher national savings rates in the Middle East and Russia. And third, income levels in China have grown much faster than spending as the economy there has boomed – which resulted in a high savings rate. As a result, these countries began to save more of their income and this translated into them began buying less of our stuff than we were buying of theirs.

Of course, our current account surplus is not entirely the result of other countries' unwillingness to spend – it is also the result of our propensity to overspend. In this country we save very little of our income, and in fact over the past several years our national savings rate has been negative for the first time since the 1930's. This combination of over-spending on our part along with over-saving on the part of our trading partners has created the record current account surplus we have today.

These imbalances can not and will not last forever, and someday we will have to return to a state of equilibrium where the world is buying from us the same as we are buying from them – and the sooner this balance is restored the less pain the transition will cause. In Bernanke's view, two things need to happen in order to bring this about: the US needs to start saving more (and buying less), and our trading partners need to start spending more (preferably buying more stuff from us).

On the saving side, Bernanke makes it clear that he thinks *a major effort to increase public and private saving is needed*. He notes that as the baby boom generation begins to retire, this will prove more difficult than it is today as the workforce grows more slowly and government outlays for programs like Social Security increase. Nevertheless, it is clear to him that as a society we will have to at some point begin saving a lot more than we do today.

On the spending side, Bernanke thinks our trading partners need to begin spending more domestically. He also makes it clear – and this is the point most relevant to the dollar - that the US and the goods we manufacture will have to become more competitive in the global market place. In other words, we will have to produce more goods that other countries want to buy at prices they want to buy them at.



A decline in the exchange rate of our currency part of the solution to make our products priced more competitively in the global marketplace. The Fed knows it, the Treasury Secretary knows it, and the markets know it. They have remained relatively quiet as our dollar has lost one-third of its value since 2002 against currencies in the Dollar Index, so that this adjustment can progress in an orderly fashion. This chart shows the Dollar Index (in blue) since 2000, and you can see that after reaching a high 2002 (marked by the blue arrow) the index has fallen to fall to a new all-time low.

However, some of our largest trade deficits are with countries that have maintained a fixed exchange rate (or “peg”) to our dollar, and this has impeded the dollar's decline against the currencies it needs to fall the most. In a point of progress on this front, the Chinese recently allowed the Yuan (in red) to float against the dollar on a limited basis (marked by the red arrow) for the first time since the mid-1990's, and the dollar has been depreciating against the Yuan ever since. It likely has a long way to go, and other countries with a dollar peg and a large trade surplus with the US will likely follow suit in the coming years.

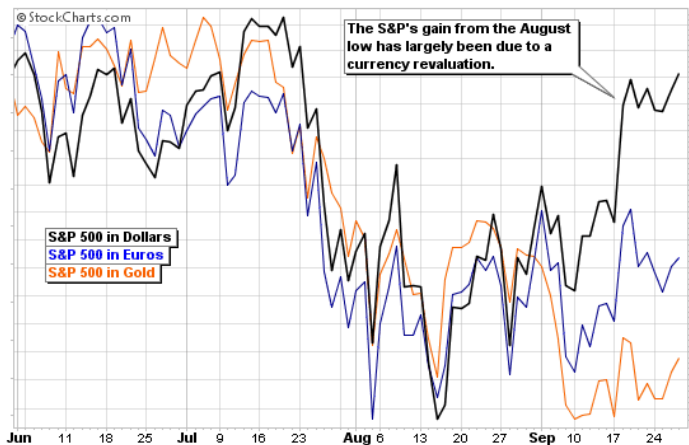
The decision by the Fed to lower the Fed Funds rate by 0.5% this past month was surprising because they so quickly left their public “strong dollar/inflation fighting policy” behind. If they had really wanted to maintain credibility on their desire for a strong dollar, they would have reduced rates more gradually. In retrospect this may be the point at which a broader portion of the market realizes the Fed is going to freely let the dollar fall, and that it was their intention to do so all along to address our current account deficit. This certainly fits what Bernanke thinks needs to happen in order to correct our large trade imbalances. This may benefit the US in the long run, but it will certainly require investors to protect their assets during the adjustment period.

A Falling Dollar and Stocks

This week we got the first glimpse of how the housing market is handling the new credit landscape. Economists had forecast sales of existing homes in August would be around 825,000, a drop of 5.2% from July's level of 870,000. Instead, existing homes sales fell to 795,000 in August, a drop of 8.3% over one month and 21% lower than one year ago. This was the largest one month drop since 1970. According to the Case-Shiller housing index, home prices in the 20 largest metro regions are now 3.9% below a year ago. So it appears the credit events in July and August have propelled the residential housing market into the next phase of this ongoing downturn.

Despite the news on the housing front, the S&P 500 has recovered most of its losses from the July-August decline. With the housing market continuing to deteriorate and the Fed signaling they see a real risk of a downturn in the economy, the stock market sure doesn't seem to be suggesting any weakness ahead. But with the dollar changing value as fast as it is, we need to scale the S&P 500 properly to get an accurate sense of value.

As you can see on this chart, the S&P 500 has recovered most of its recent decline in dollars, but when the S&P is priced in Euros or in Gold (shown by the blue and orange lines) the S&P hasn't recovered much at all. We looked at a long-term chart similar to this one back in July, and I mentioned then that as long as the decline in the dollar remained gradual it could be a benefit to stocks. It's clear the dollar's decline of 4.5% since mid-August has certainly helped the S&P over the past month.



While stocks have so far managed to provide a reasonable hedge against the dollar's decline, if the Fed is right and there is now a significant risk that the economy could slow or enter recession, stocks are certainly a high-risk dollar hedge at this point. There are far more risk-appropriate ways to hedge the effects of a falling dollar, including commodities (real assets) and stocks that benefit from a rise in commodity prices.

The Dow Transports and the small-cap indexes, which are the "first responders" to a weakening economy, have recovered little from their August low and remain far below their July highs. The relative weakness of sectors such as these is keeping us on a cautious footing with respect to the stocks. However, given the positive outlook for commodities, treasury bonds and select sectors, I am comfortable with our positioning and optimistic about the potential for gains heading into 2008.

That's all for this month. If you have any questions about your account, please don't hesitate to contact me.

Sincerely,
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