



# Sitka Pacific

Capital Management LLC

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Dear Investor,

Over the past month, stocks in the US have continued higher, with most major US market indexes reaching a new high for this rally that began last March. The S&P 500 has moved beyond its early January high by nearly 5%. Outside the US, it has been a mixed bag—some markets are at new highs, but others remain below their previous highs made in January. Thus, the MSCI World Index ended March near even for 2010 year-to-date.

In the bond market, yields on long-term Treasuries have risen to re-test the upper end of the trading ranges established over the past 9 months. The yield on the 10-year Treasury note rose briefly to 4% early in April, before declining again recently. On the one hand, yields on Treasuries have been testing their highs as if they are preparing to break higher. However, given the rally in stocks and other risk assets over the past 9 months, it is notable that Treasury yields so far remain below the highs they made last summer.

As of the end of March, both the US dollar and gold were higher year-to-date. While few seem to have anticipated the recent strength of the dollar, fewer still would have predicted that gold would have remained this strong while the dollar rose.

The euro has been dragged down due to fears of government defaults and a lack of political cohesion around the appropriate response, causing the dollar index to rise. However, the rise of the dollar against other currencies has not been universal. The bottom line is that the gold market appears to understand that this rise in the dollar has mostly been due to euro weakness, not dollar strength. Accordingly, there have been no new reasons to sell gold for dollars, or any other currency.

Aside from gold, commodities have risen somewhat over the past few weeks, but not enough to bring the CRB index into positive territory for the year. The price of oil has recently made a new high for the year, but oil stocks, like most commodities stocks, have not followed their underlying commodity to a new high.

In this month's letter, we'll continue our discussion of long-term valuation contractions with a comparison of this bear market since 2000 with previous bear market cycles. In case you have been wondering why we have not opened our portfolios to the stock market despite the advance over the past few months, the following pages will likely provide an answer.

<u>Stock Indexes</u>	<u>March</u>	<u>2010</u>	<u>Market Indexes</u>	<u>March</u>	<u>2010</u>
S&P 500 Index	+6.0%	+5.4%	HFRX Global Hedge Fund Index	+1.4%	+1.6%
MSCI World (ex USA) Index	+6.0%	+0.1%	US Dollar Index	+0.9%	+4.0%
Amex Oil Index	+5.9%	+1.2%	CRB Commodities Index	-0.5%	-3.5%
Gold and Silver Index	+2.4%	-1.8%	Gold (Continuous Contract)	-0.4%	+1.5%

\* \* \*

In the spring and summer of 2007, the US and global stock markets went through two dramatic declines. The first, in February, was in response to a sudden dive in the Chinese stock market. The second, in July, was in response to the sudden implosion of two mortgage-related hedge funds here in the US. During those declines the first headlines about losses in sub-prime mortgages were made, although the financial crisis in the fall of 2008 was still more than a year away.

It didn't take long for the markets to recover following both of those declines, and on the surface everything appeared to be back to normal as new highs were made. In fact, as the market recovered a second time, investors were clearly emboldened. China's stock market shot up more than 70% between July and October, and the rest of the world's markets followed China higher.

As we now know, those enthusiastic months in late summer and early fall of 2007 marked the end of the rally from the lows in 2002 and 2003. The bear market that followed not only took back all the gains of the previous four years, but in many markets, it took back more.

We largely sat on the sidelines during that final rise, for some of the same reasons we are on the sidelines now. Not only had the underlying strength of the market badly deteriorated in 2007, there were a number of signs that the rally from the lows in 2002 and 2003 had not been a robust bull market as most investors assumed, but a rally within a long-term bear market. That fact, whether a rally is part of a bull or bear market, should change the calculus an investor uses when deciding to be in the market or not.

At every major turning point in the market it is always a guessing game, in the short run, as to when the trend will end. That's because at the end of long market trends, prices are being driven more by primal emotions than rational thinking.

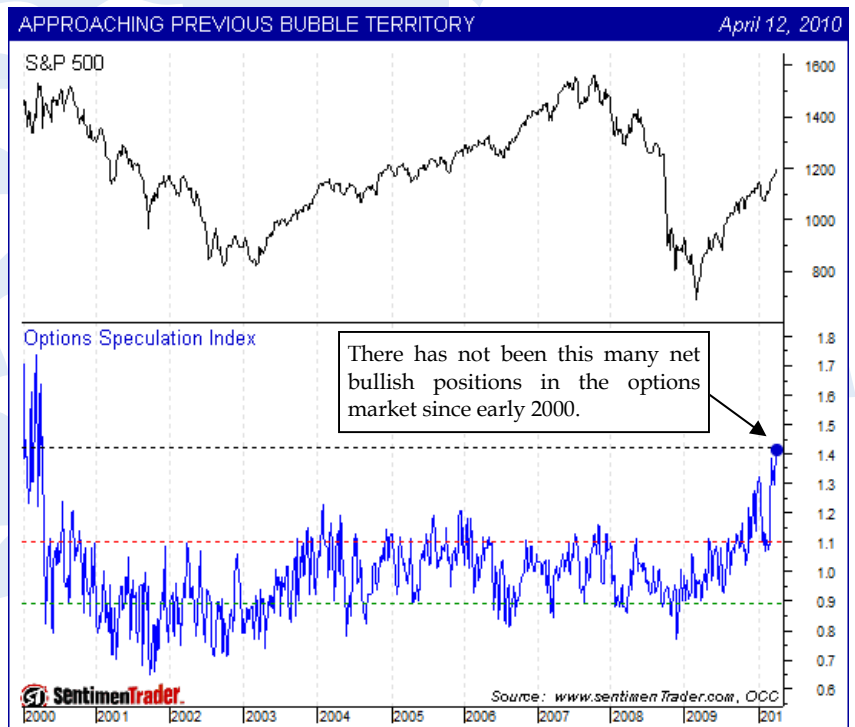
The end of large advances is usually marked by intense speculation, and the end of large declines is usually marked by intense liquidation and fear. The uncertainty of predicting exactly how intense those emotions will grow is a large part of the uncertainty of predicting the end of major declines and advances.

At the beginning of this year, some of the sentiment measures we follow were at extremes. That suggested risk in the market at that time was quite high.

However, the rally over the past few months has pushed many of those measures to levels that haven't been seen since the peak of the stock market bubble ten years ago.

The options index shown on the chart to the right is one example. It shows that the last time there were this many net bullish options positions was at the end of the Internet bubble in early 2000.

While sentiment can always carry on to further extremes, as it has over the past few months, that only increases the risk in the market.



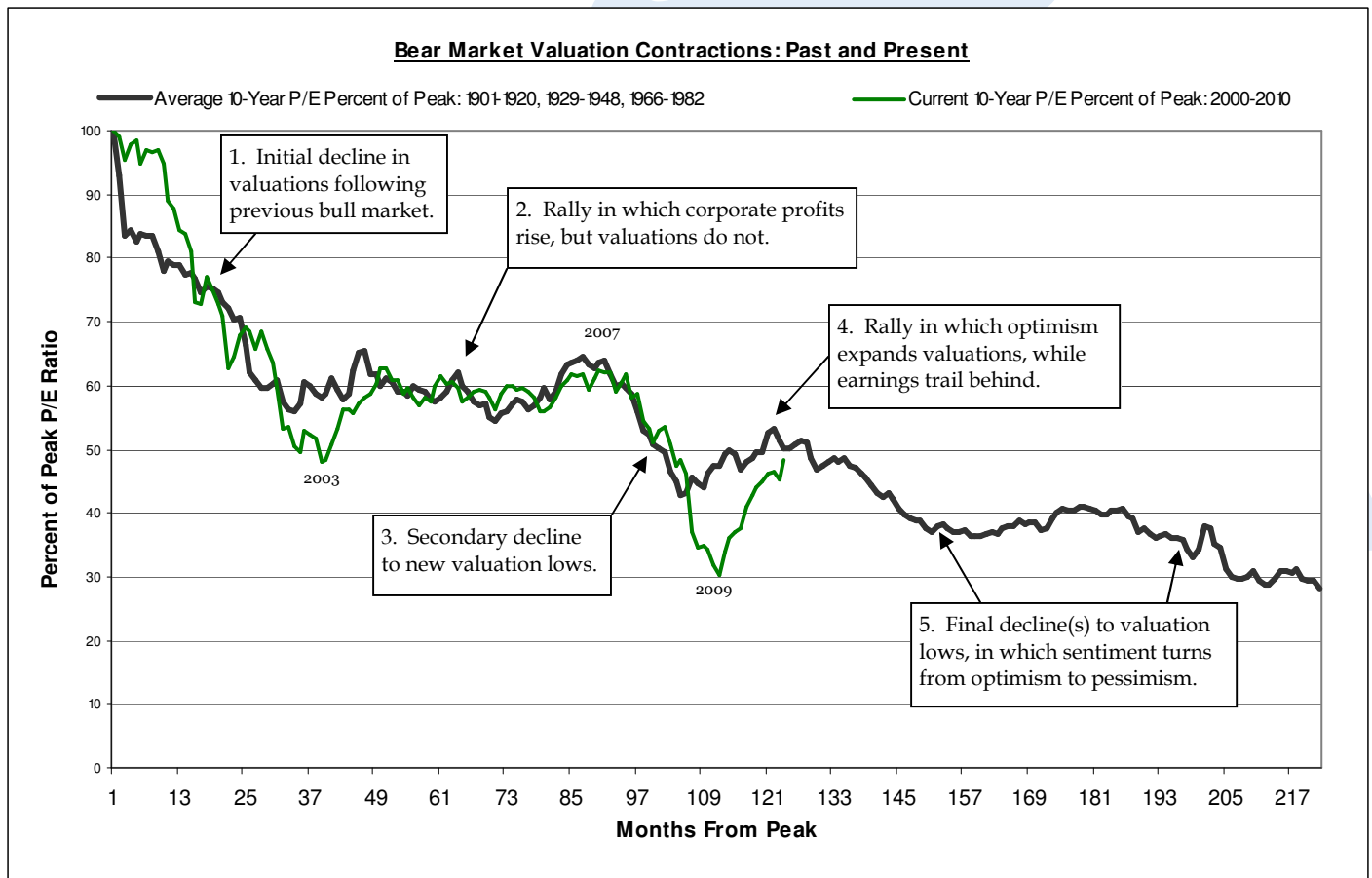
As in 2007, the current extremes in sentiment have been reached with many indicators of the market's internal strength continuing to deteriorate. This suggests that the risk that the market could quickly take back recent gains (and more) is high.

Unlike 2007, it isn't just *suspected* that the market has entered a long-term valuation contraction—it is quite certain. The red flags from technical and sentiment indicators are significant in and of themselves, and suggest investors should be cautious here. However, when we compare the current valuation contraction to past periods, we find that these caution signs are coming right at what may be the last bout of optimism before sentiment on stocks really turns negative.

On page 7 of our 2009 Annual Review, we looked at a long-term chart of the S&P Composite, which highlighted the long-term cycles of the 10-year price-to-earnings ratio. It showed that the market goes through long-term cycles of rising and falling valuations, and that we are currently in the middle of a period of falling valuations that began 10 years ago.

The chart below shows those periods of contracting valuations (a declining P/E ratio) in another way. Scaled to the peak valuation of the preceding bull market, the chart shows the decline in the 10-year P/E ratio as a percentage of the prior peak, all the way down to its final valuation low. The black line is an average of previous cycles, and the green line is the current cycle from the high in 2000.

Despite the unique events that have shaped the last 10 years, this valuation contraction is proceeding right along the path of the average long-term bear market in past cycles—the timing of the declines and rises in valuations on the way down have been more or less the same. The only major difference is that the green line in the chart below has been declining more than the average at major lows. This is a reflection of how high the peak was in 2000: the P/E in 2000 was 67% higher than the average of past peaks, so the market has had further to fall in each successive decline.



The most important messages given by the chart on the previous page is that valuation contractions appear to proceed in a specific series of phases, and the market today is closely following the path of past bear markets. In addition, despite the rally over the past year, stocks have gained very little against gold. These are strong indications that the long-term devaluation of stocks is ongoing, and that the rally over the past year is part of an ongoing long-term bear market.

At this point, the valuation of the market is probably on the cusp of a long decline. This is one of the primary reasons we have remained cautious in recent months. Going forward from here, that path involves a large shift in sentiment from the relative optimism of today toward a deeply entrenched pessimism.

The transformation of sentiment from the frenzy at the bull market peak toward a general repudiation of stocks is the shift which ultimately drives valuations toward their lows during the second half of long-term bear markets. Ten years ago it was not possible to know exactly what events would transpire to get the markets to this point, and its not possible to know exactly what will happen in the coming years to drive valuations to their final lows. However, in all likelihood it will be driven by events linked to the fallout from the bubbles in stocks and real estate, as well as the demographic transition that has been influencing all these trends.

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We have spent a lot of time talking about stocks over the past few months, mostly because with the continued rise over the past 6 months there has been a lot of debate about the market's prospects going forward. We want you to be clear and informed about our views, so that you fully understand why your accounts are positioned the way they are.

In other markets, there has not been a whole lot going on in the past few months. Treasury yields have been rising ever so slightly with the stock market, but not enough to push the yield on the 10-year note above 4%. Yields on both 10-year and 30-year Treasuries remain below their highs made last summer.

Gold (above) and Dow/Gold (below), 2003-2010



Gold made a high near \$1226 in December, and since then it has been consolidating in a range between \$1170 and \$1044. This range is above the significant resistance (now support) near \$1000 that gold broke through last fall on its way to its December high.

It would be completely normal for gold to decline and test this support area before the next advance begins. Such a test could take gold below \$1000 for a short time, but as long as gold stayed above that level on a monthly closing basis there would be no threat to gold's ongoing bull market.

The blue line on the bottom of the chart to the left shows the ratio of the Dow Industrial Average and gold. Despite the rally over the past year, stocks have traded sideways against gold. This is similar to what happened between 2003 and 2005, and it suggests gold will eventually make new highs against stocks.

Even though both have risen over the past year, the contrast between the long-term outlook of gold and stocks could not be greater. One (gold) is in a long-term bull market that shows few signs of ending, and the other (stocks) are in a long-term bear market that most likely has a long way to go. The distinction between those assets in bull markets and those assets in bear markets proved critical in the past decade, and it will likely prove critical again in the coming years until stocks reach their valuation low.

With all the fast-moving action over the past several years, it's tempting to try and take advantage of every twist and turn in the market. However, not all market moves are the same—some are low risk, and some are high risk. With gold there is every reason to stay invested *except* when the market reaches a point of high risk, because the long-term trend is up. With stocks, there is every reason to remain out of the market except in periods of low to moderate risk, because over the course of the bear market, high risk periods will result in more losses than gains.

Those holding stocks here are doing so with short-term indicators signaling that the market is in a state of high risk, a market environment that should be avoided in a long-term bear market. In addition, the long-term outlook suggests that market valuations are about to begin a contraction which could result in a significant headwind in the coming years. Between the high short-term risk and the unfavorable long-term outlook, there are few good reasons to be committed to stocks here.

The most bullish outcome for stocks at this point would be for the market to go through a period of consolidation, similar to what happened in 2004, in which sentiment and technical indicators worked their way down to oversold levels while prices held on to most of the gains made over the past year. This would reduce risk tremendously and also signal that the market was preparing to move higher as part of a much larger bear market rally.

Such an outcome would leave us plenty of room to open up our portfolios to stocks and other assets that have become extremely stretched. However, until we see the market reach a better risk/reward profile, our portfolios will remain positioned in line with long-term trends.

If you have any questions about your account or issues raised in this letter, just send us an email or give us a call. We would enjoy hearing from you.

Sincerely,  
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