



Sitka Pacific

Capital Management LLC

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Dear Investor,

Since our last letter, the US stock market recovered from its March losses and closed even for the month. US and global markets finished the first quarter of 2011 with gains of 5.9% and 3.2% respectively, as the overall economy continued to grow modestly with tremendous support from the Fed's purchases of Treasuries and the Federal government's budget deficit.

Commodities fared better in the first quarter than stocks, with the CRB index rising 8%. The CRB Index is heavily weighted towards oil, which rose over 16% from the end of 2010 to \$106/bl. While events in the Middle East had a large influence on the price of oil over the past several months, commodity prices have been rising since the market began to anticipate the Fed's second round of quantitative easing last summer. From last August to the end of March most commodities have risen substantially.

Gold and silver have also risen substantially over the last 9 months, although the performance during the first quarter was mixed. Silver has continued higher since the start of the year, while gold was flat and precious metals mining stocks were collectively down 4%.

This mixed performance of precious metals and mining stocks, especially relative to other commodities, was largely responsible for the slight declines in some of our portfolios early this year. However, this underperformance of gold-related positions does not appear to be anything other than a short-term phenomenon.

The main driver of the markets over the past few months appears has been the continued purchase of Treasury securities by the Fed. The Fed has expanded the Monetary Base from \$2 Trillion to nearly \$2.5 Trillion since last September, and their bond portfolio has expanded by a similar amount. However, the current quantitative easing program has almost run its course, and at the moment there does not appear to be support within the Fed for additional stimulus.

Outside of the US in the last month, the European central bank raised its short-term interest rate for the first time since the financial crisis, and the Chinese government has also continued to tighten monetary policy. Combined with the tightening effect of the passing of the Fed's current QE program, it's possible the market environment for the balance of 2011 may be markedly different from what we have seen over the past two quarters.

<u>Equity Indexes</u>	<u>March</u>	<u>2011</u>	<u>Market Indexes</u>	<u>March</u>	<u>2011</u>
S&P 500 Index	+0.0%	+5.9%	HFRX Global Hedge Fund Index	-0.9%	+0.4%
MSCI World (ex USA) Index	-2.4%	+3.2%	US Dollar Index	-1.3%	-3.9%
Amex Oil Index	+1.0%	+13.7%	CRB Commodities Index	+1.9%	+8.0%
Gold and Silver Index	+0.7%	-4.3%	Gold (Continuous Contract)	+1.5%	+0.8%

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Over the past few months, it has become abundantly clear that the housing market did not “turn the corner” in 2009. Although nationwide averages for home prices did in fact stabilize in 2009 and move slightly higher into 2010 as various stimulus programs took effect, those modest gains have been given back following the expiration of those programs. The most recent release of the Case-Shiller 20-city home price index showed a 3% decline from January 2010 to January 2011, and it now sits only 1.1% above its April 2009 low.

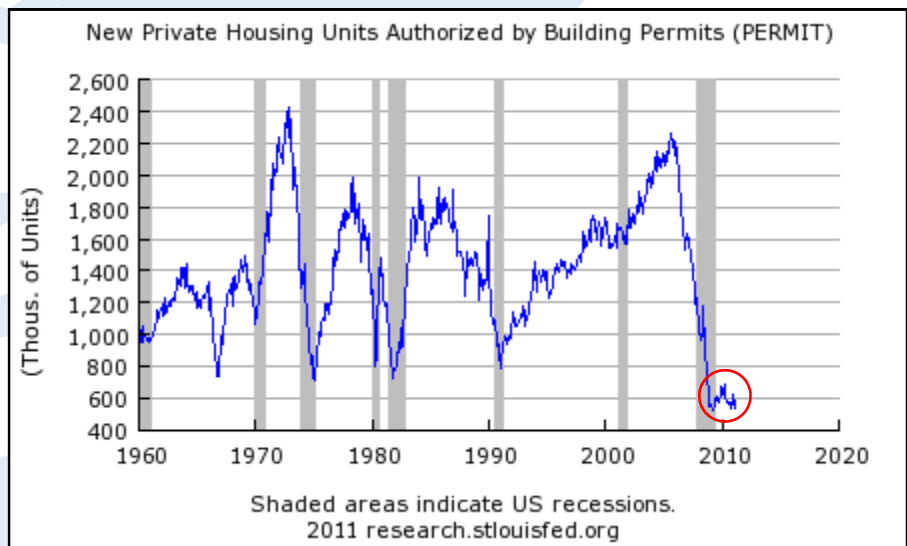
For those watching data that have traditionally been leading indicators of home prices, this renewed decline over the past year hasn’t been much of a surprise. Rising or falling levels of Building Permits have in the past lead changes in home prices by a year or two, and over the past two years the level of building permits being issued has remained near its lows despite the end of the recession (see chart below). This is an indication that professional builders, including large public homebuilding companies, see little chance of a significant housing recovery ahead.

The lack of a durable housing recovery also isn’t a surprise to those who are familiar with how markets usually behave after the collapse of a bubble. The aftermath of market bubbles are always long, drawn out affairs which, from a sentiment perspective, closely resemble stages of a grieving process. The housing market’s fall from its peak 5 years ago has all the classic post-bubble signs, such as continuing falling prices, a complete lack of enthusiasm by professional builders, as evidenced by the low level of building permits, and a lack of enthusiasm by home buyers despite increased affordability.

If the real estate market continues to follow the typical path of post-bubble markets, nominal prices will likely stagnate or decline for most of the coming decade and real (inflation adjusted) prices will continue to fall throughout, just as happened in previous bubbles such as with stocks after the 1929 and 2000 peaks, and gold after its 1980 peak. During these times, markets go through the painful, but necessary work to rebalance and heal from the bubble’s excesses.

However, because housing is such a significant part of our economy in so many important ways, including its effect on consumer’s net worth and on state and local budgets, the Federal Reserve and the Federal government have been extremely active in trying to counter the lingering effects of the housing bust.

In their most recent efforts, The Fed has pumped up nearly all markets since last year with their second quantitative easing program (QE2), and the Federal government passed new tax breaks and extended others last year.



These actions have benefited the stock market and the economy in the short term, but they also have had consequences. For instance, over the past 6 months commodity prices have risen faster than stock prices. And despite the Fed’s purchases, Treasury bond yields have also increased.

In fact, the Fed's actions and the continued record budget deficits have caused a significant negative shift in sentiment toward Treasury notes and bonds in recent months. Investors are now wondering who will buy the Treasury's huge monthly issuance once the Fed stops buying in a few months, since it has been the Fed who has been buying the vast majority of Treasury's new debt. They are also wondering about the implication for inflation expectations (and therefore Treasury yields) if the Fed comes in with yet another round of quantitative easing if the markets and economy weaken with the expiration of the current program.

All told, there is a growing risk that the efforts to prop up the markets and the economy through Fed-financed deficit spending will result in a bond market that refuses to lend money to the Treasury at the low rates we have seen over the past few years. The continued rise in the price of gold and the continued buoyancy of both the 10-year and 30-year Treasury yields suggests the markets may already be anticipating even higher yields on the horizon.

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The steady rise in gold had us thinking recently about the inevitable end of its bull market. Gold has been rising almost non-stop over the past 11 years, and it has doubled since the low in 2008 during the financial crisis. Yet, its steady rise over the past 2 years shows very few signs of the speculative fervor that will almost certainly show up near the end of its bull market - which implies that its bull market has farther to go from here.

We have talked many times before about the Dow/Gold ratio, which currently sits near 8 after falling from a high of 44 in 1999. In the past this ratio has declined close to 1 near the end of real asset bull markets and/or equity bear markets. That may seem like a good distance away from current prices, but with the right combination of events over the next several years the Dow/Gold ratio could conceivably decline to levels that would prompt us to begin shifting our long-term focus from gold back to stocks.

As a hypothetical example, if the Dow were to decline to 8000 and Gold doubled again to \$3000 over the next 3 years, the Dow/Gold ratio would decline to 2.7. This would represent a 94% decline from its peak in 1999, and would likely be quite close to the lows for this cycle. Given the sovereign debt issues that the markets will face over the next 3 years, a market response such as this example appears possible.

However, while it seems highly likely we'll see another significant decline the ratio of stocks to gold in the coming years, exactly how that will be achieved is heavily dependent on Fed and government policies going forward, and also on how other markets - such as the Treasury market - respond to those policies.

If the Fed keeps on pumping money into the financial system in the years ahead in successive quantitative easing programs, we could see stocks remain buoyant and gold rise much further than expected. However, if the Fed winds down its QE activities or the federal government significantly cuts spending or raising taxes to narrow the budget deficit, we could see a very different market response.

In the end, there really isn't a way around the economy rebalancing itself after a bubble, just as there isn't a way to prevent markets from cycling back and forth between real assets like gold and paper assets like stocks. The only thing the Fed and the government can do is try to break the rebalancing process into smaller chunks, so that they don't all hit the economy and markets at once. However, those efforts to manage the fallout will also have their own consequences.

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As we have discussed in recent client letters, the likelihood of higher yields appears to be increasing. Although we could see another modest swing lower in the coming months, the longer the yield on the 10-year note consolidates above 3% the more likely it will eventually break significantly higher. The consequences of a significant move higher in Treasury yields would likely be a severe negative for the economy, the housing market, the stock market and the outlook for interest expenses on the Federal debt.

Meanwhile, investor sentiment has shifted back to a strong preference for squeezing out incremental gains just when it appears the markets are facing large risks from a significant outside event, as they were in 2006 and 2007. As was the case back then, investors are currently looking the other way and bidding up the prices of stocks and economically sensitive commodities to levels that leave little room for disappointment.

These trends can continue for longer than most skeptics think possible. However, in the end, trends that are unsustainable – such as running a government deficit over 10% of GDP and buying most of the debt with newly printed money from the Fed – eventually bring about consequences that shift the system back within sustainable bounds.

Our continued cautious stance in our portfolios is a reflection of the fact that we neither can nor will attempt to time when these issues might matter to currently over-valued markets. We continue to invest in long-term trends that are well established and appear to have a good distance more to travel, and also in areas of the US and other markets that present us with good value. However, we remain wary of broadly committing funds to markets that are over-valued and are showing technical signs that indicate they are vulnerable.

Given the current state of the markets, we are left with an increasing portion of our portfolios in cash and cash equivalents, as we have continued to cull positions whose potential returns appear low relative to the risk inherent at current prices. This necessarily limits our short-term potential return going forward, but it also leaves us in a very low-risk position with the flexibility to buy when prices become attractive again. Given the potential issues our markets face over the next two years, I have little doubt we will be faced with another good buying opportunity before long.

As always, if you have any questions about your account or issues discussed in this letter, feel free to contact us.

Sincerely,
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