Sitka Pacific
Capital Management LLC

August 2009

Dear Investor,

In July, stocks rallied from their low early in the month, as corporate earnings came in a little better than expected (as a result of cost cutting) and investor optimism for an economic recovery increased. The S&P 500 rose to a new high from its low in March, to where it was in early November 2008—during the peak of the credit crisis.

While the S&P 500 ended July up 9.3% year-to-date in 2009, it would still take a 28% gain from here to return to its level last summer, and it would take a 59% gain to recover all its bear market losses. The need for almost a 60% rise for a full recovery, even after such a large rally from the low, shows how much investors suffered during the decline from 2007 through this past March.

In other markets, Treasury bonds dropped modestly as stocks rallied, as did the US dollar. At the same time, gold, oil and other commodities rose in synch with stocks. This strong correlation between stocks, commodities and various foreign currencies on the one side, and Treasuries and the dollar on the other side, continued in July. This shows there are largely two bets in town at the moment: either you are investing for a recovery, or not.

However, there are signs these bifurcated market trends may be set to reverse or decouple, at least temporarily. The dollar appears primed to rise versus the Euro and other major currencies, and Treasury yields have risen up to significant resistance, from which they could turn down. If the recent correlations between markets persist, this could mean the move into higher risk assets (stocks, commodities, foreign currencies, etc.) may be about to reverse.

The coincident rally in nearly all risk asset classes over the past few months has apparently convinced the majority of investors that now is the time to be aggressively positioned, in the hope of recapturing losses suffered last year. While that could end up being the correct call, we believe it is a high risk bet that isn't yet the most likely outcome.

It is still more likely that this rally has been a rebound from last year's decline that will give back a large portion (or all) of its gains when completed. Fundamentally, the market is pricing in a recovery in earnings and employment that is unlikely to be met. This cautious outlook is probably not what many investors would like to hear after such a difficult year last year, but it does reflect the state of the markets as we see it.

Stock Indexes	July	2009	Market Indexes	July	2009
S&P 500 Index	+7.4%	+9.3%	HFRX Global Hedge Fund Index	+1.6%	+7.3%
MSCI World (ex USA) Index	+9.3%	+17.0%	US Dollar Index	-2.4%	-3.6%
Amex Oil Index	+4.6%	-1.9%	CRB Commodities Index	+3.0%	+12.2%
Gold and Silver Index	+6.9%	+20.0%	Gold (Continuous Contract)	+3.0%	+7.9%

*   *   *

As mentioned previously, it appears many investors have seen the rally from the March low as an opportunity to get back some of the money they lost during 2008. They are eager to be fully invested, because they are convinced that after the losses last year and the early part of this year, to worse surely must be over. This is seen in investor sentiment surveys, which are showing the most optimism since 2007.

It may very well be that we won't see another crash like we saw last year for a very long time. The credit crunch that nearly took the financial system down the drain probably won't happen again, and the markets are very aware of the underlying issues that have caused this recession: a housing bubble that burst, an over-leveraged consumer, and an over-leveraged financial system. That awareness alone will likely prevent a repeat of last year's crash.

However, just because we likely won't see those crash conditions again doesn't mean the only way for the markets to go from here is up. Over the past few months, we have discussed a number of potential paths the market could take to reach its final valuation low in the valuation contraction that began in 2000, which has not yet been reached. In fact, after this rally, stocks are again richly priced: the S&P 500 is now trading with a P/E ratio near 18 against earnings over the past year, which is at the high end of its average historical range. These remain the two most likely long-term scenarios going forward:

1. A Japan-style deflation, in which a general deleveraging of the financial markets and the economy, coupled with a demographic shift of baby boomers from work to retirement, creates a long-term bear market in stocks. This would mean that stocks would periodically rise and fall, but the overall trend would remain sideways or down until valuations reached a final low.
2. An inflation-fueled rise in which we see asset prices rise nominally, but decline in real (inflation-adjusted) terms. This would mean that stocks could continue to rise, on average, in the coming years, but inflation would outpace the gains in stocks and other asset classes would substantially outperform.

So far, nothing we have seen suggests we are headed for an inflationary outcome. Instead, it appears a Japan-style deflation is taking hold. Unemployment is rising and is likely to remain high for some time, based on recent jobless recovery patterns. This will continue to directly impact the housing market, where prices are still falling, albeit at a slightly less rate than they were a few months ago. However, some of the recent improvement is largely the effect of temporary factors, such as the government moratorium on foreclosures that has (for now) held back the flood of foreclosed waiting to come onto the market.

In short, the massive stimulus and support provided by various government agencies and programs have made things "less bad," but there has been no real change in the underlying trends driving this downturn. Since his has been the largest government intervention in the economy and financial markets since the Great Depression, achieving "less bad" is not a screaming success. Markets such as the asset-backed bond market have remained moribund largely because the prospect for recovery in the housing market remains grim.

Although stocks have rallied, it has been a poor quality rally lead by the stocks with the worse economic fundamentals. That has powered a rally in which major indexes have recovered 38%-50% of their bear market losses, depending on the index. This is in the range of what we would expect of a rebound from the steep bear market over the past 2 years if stocks were *not* destined to recover to new highs any time soon. It would take a strong, broad-based rally with convincing leadership that recovered more than just a fraction of last year's decline to make a convincing case that the long-term trend had turned higher.

Since the March low, assets that we would expect to significantly outperform during an inflationary recovery have lagged behind the general market: oil prices and energy stocks have recovered less than

stocks, and gold remains below its high made in 2008. And despite the rise in Treasury bond yields over the past 5 months, they remain below where they were just before the credit crunch began last summer. If we truly were heading into a significant inflation, these markets—commodities, gold and bond yields—would probably have risen much more than they have at this point.

When we take a step back and consider the reaction of the markets during the past 5 months, what we see is a rebound from a very steep bear market that continues to betray signs of underlying deflationary forces at work in the markets and the economy. This outlook will change if we see signs that inflation is taking hold, but until we do we should remain cautious with our exposure to risk assets, especially when we see so many markets as correlated as they are today.

* * *

In some ways, the current environment is reminiscent of 2007. At that time, we became cautious early when the first visible cracks began to appear in the markets: home prices were falling in most areas of the country; China's stock market suffered it first big exodus after a record run; the first mortgage-related hedge funds blew up; and some of the carry-trade currencies suffered huge declines. Although these we signs that the global equities rally was rising on increasingly thin air, stocks continued to rally into the fall with vigor as if everything was fine.

Today, the market is cheering the recovery from depression-like conditions to merely recession-like conditions, but it is again ignoring the significant issues on the horizon beyond the very short-term. That may not matter this month or next month, but it will matter eventually.

We let the autumn 2007 rally go without taking on any significant market exposure, and from the sidelines we watched the market gain another 10% before it made its high in October. At that time, the market was in a phase that contained both high risk and low potential return, which is appealing only to those investors with the highest risk tolerance. We are in that same type of market environment today.

We are watching for any signs that this move up in stocks is more than just a rebound from last year's crash, but so far there is little real evidence of a new bull market. That could change, but in the mean time we will continue to be cautious about our exposure to stocks and other risk assets. At this point, after the rally we have seen from the March low, the potential for significant losses outweighs the potential for substantial gains.

If you have any questions about your account or this letter, just give us a call or email. We'd be happy to talk with you.

Sincerely,

Brian McAuley

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

The content of this letter is provided as general information only and is not intended to provide investment or other advice. This material is not to be construed as a recommendation or solicitation to buy or sell any security, financial product, instrument or to participate in any particular trading strategy. Sitka Pacific Capital Management provides investment advice solely through the management of its client accounts.