



Sitka Pacific

Capital Management LLC

August 2011

Dear Investor,

Stock prices in the US and around the world bounced higher and lower in July, before ending the month down modestly. The S&P 500 declined 2%, while the MSCI World (ex USA) Index decline slightly less than 2%. However, as you probably are aware, stock prices began to fall precipitously as the calendar turned to August. As of this writing, the S&P 500 has declined into negative territory, year-to-date, and has taken back most of the gains made during QEII.

Meanwhile, the price of gold has continued to climb to record highs. At the end of June gold traded near \$1500, up from \$1421 at the end of last year. Here in early August, gold has traded over \$1800, up over \$300 in 6 weeks.

Markets rarely go straight up without resting periodically, so gold could enter a significant correction at any time. However, the continued strength of gold's trend higher is a strong indication that this bull market is well beyond its early stages when frequent corrections offered many opportunities to buy gold on the cheap. The gold market is now acting much more like a late stage bull market, in which there are more and more buyers and fewer sellers. In this type of market environment, significant corrections often become few and far between.

The recent decline in stock prices and the concurrent rise in gold have brought the price of stocks relative to gold down to new bear market lows. The Dow/Gold ratio hit an intra-day low of 5.94 here in early August, which is below its lowest level (6.86) recorded as stock prices bottomed in March 2009. This new low in the Dow/Gold ratio strongly suggests the stock market rally which began in 2009 has been a large advance within a long-term bear market, because stocks do not make new lows relative to gold when they are in a long-term bull market.

Like the Dow/gold ratio, yields on Treasury securities have also fallen to new bear market lows in early August. The yield on the two-year Treasury recently declined to a new low of 0.18%, and the yield on the 10-year note recently declined to 2.09% - just above the lowest yield during the peak of credit crisis. These low yields come despite Treasury debt having been downgraded from its AAA rating by Standard & Poor's. While there is certainly merit to S&P's long-term concern about U.S. government debt, the bond market is currently dealing with far more pressing short-term issues - such as continued underlying deflation, and the likelihood that the economy has entered another recession.

<u>Equity Indexes</u>	<u>July</u>	<u>2011</u>	<u>Market Indexes</u>	<u>July</u>	<u>2011</u>
S&P 500 Index	-2.0%	+3.9%	HFRX Global Hedge Fund Index	-0.1%	-2.2%
MSCI World (ex USA) Index	-1.7%	+1.1%	US Dollar Index	-0.5%	-6.5%
Amex Oil Index	-1.5%	+5.9%	CRB Commodities Index	+1.2%	+3.0%
Gold and Silver Index	+2.3%	-9.2%	Gold (Continuous Contract)	+8.4%	+14.6%

* * *

If you have been following the news over the past month or so, you're probably aware most of the significant events which have coincided with the dramatic moves in the markets in recent weeks. However, part of our job is to follow these events so you do not have to. We'll recap some of the events in the following few pages.

The US narrowly averted a potential crisis in early August by passing legislation to avoid hitting the statutory debt ceiling. While there was no risk of a real default on existing Treasury debt had the government be unable to borrow additional money, there was a real risk that spending on entitlements and other programs could have been curtailed for a short time had there been no agreement on raising the debt ceiling - and this may have had significant economic consequences. In the end, a deal was reached to raise the debt ceiling and modestly trim projected spending increases over the next 10 years, and this avoided the government having to make some difficult short-term choices on spending.

Unfortunately, although a deal was struck in time to avert a government spending hiccup, the path to that deal was so politically contentious that it raised serious questions about whether the political process will be capable of tackling far more serious financial problems that are now visible on the horizon. It took a near crisis to get politicians to agree to close the projected deficit by just \$400 billion over 10 years. However, under any but the most optimistic growth assumptions, this will likely represent only a tiny fraction of the cumulative deficits in the coming decade. For these reasons, and others, on August 6th Standard & Poor's downgraded the credit rating on US debt from the triple-A rating it had held since 1917.

The credit rating downgrade garnered a lot of news coverage, but it actually had relatively little impact on the markets. Yields on short-term and medium-term Treasury securities hit record lows this past month, which is not what would be expected from a recently downgraded debt market.

Since we have full control of our currency, and can print more if we need to, we will always be able to pay interest and principal on our existing debt. Thus, there is no risk of an actual default on our debt. However, while current holders of Treasury bills, notes and bonds do not have to worry about receiving their due interest and a return of their principal, they do have to worry about the value of those dollars that will be paid back to them. The risk that current Treasury debt holders will receive significantly *devalued* dollars by the time their notes and bonds come due is the primary risk that S&P addressed with their downgrade.

The devaluation of the dollar is certainly a long-term risk, given the economic circumstances we find ourselves in. But in the short-term, there have been far more pressing issues driving yields on Treasuries lower.

At the top of the list, the early signs of a possible economic slowdown we began to see in the spring have recently taken a more serious turn. The most recent manufacturing reports have mirrored the decline in consumer confidence over the past month, and the magnitudes of the declines in these reports have only rarely occurred without the economy already being in recession.

We have mentioned in past client letters that it would not be surprising for the economy to drift in and out of mild expansions and recessions in the coming years, as the economy and financial system continue working through the imbalances created during the housing and credit bubbles. This is precisely what has happened in Japan over the past 15 years or so. In that context, the mild expansion we had from 2009 appears to have followed the post-financial-crisis template quite closely.

That mild expansion appears to have now given way to a new recession, which could prove to be significant if it is accompanied by another financial/debt crisis (most likely to emanate from Europe, this time). Or, it could prove to be just a mild contraction that does not even satisfy the standard definitions of a recession.

Another major factor driving Treasury yields lower was the Federal Reserve's announcement that they would maintain short-term interest rates between 0% and 0.25% until at least mid-2013. This announcement of a 2-year pledge to maintain near zero interest rates replaced their previous language of keeping rates low for "an extended period," and it effectively marks the start of another effort by the Fed to lower interest rates throughout the financial system.

After the announcement, yields throughout the Treasury yield curve fell. The 2-year note fell to a record low below 0.2%, and the yield on the 5-year note fell below 1%. The yield on the 10-year note, which is the benchmark for mortgage rates, fell slightly below 2% - just below the lowest level it reached during the peak on the financial crisis in 2008, and the lowest level since 1950. Along with the economy following a post-bubble track similar to the path Japan has travelled, yields on Treasuries now have a distinctly Japan-like appearance.

However, while the Fed's first hint of QEII last year sparked a rally in the stock market and most other risk-assets, their most recent announcement hasn't had the same effect. In fact, the S&P 500 has now declined back to the level it was just prior to QEII, taking back eight months of price gains in just a few short weeks.

The stock market is constantly reacting to innumerable current events and also discounting potential future events and trends, and so it is always with a large grain of salt that we attempt to assign "causes" for a stock market decline or rally based on what we know today.

With that in mind, however, the decline in recent weeks appears to be due, at least in part, to the realization that the Fed's zero interest rates and recent QEII purchases did not succeed in sparking a durable, robust recovery in the economy. The gains in stock prices since last summer were made under a number of assumptions about how the Fed's action would positively affect economic growth, and when it became clear that the economy was slipping back into recession instead of accelerating, those gains in stock prices were quickly given back.

NYSE Composite, 2007-Present



Where the market will go from here is hard to say, as it will depend largely on how this recession evolves and how the markets react to further stimulus. We have in mind a number of potential paths, but at this point there is no reason to speculate on the likelihood of all these scenarios. However, it is important to stress that the recent decline in the market from its consolidation over the first seven months of 2011 has all the characteristics of a major market top that could remain as a high water mark for some time.

Following a trend change of this magnitude, patient, disciplined investors need only to wait for the market to begin giving off signs of accumulation and a general weakening of the downtrend before starting to accumulate stocks. At the end of the two prior declines within this long-term bear market, in 2003 and 2009, the market spent 6-9 months building a durable bottom before advancing strongly in a new cyclical bull market. During those periods, the market made lower lows while showing many signs of underlying strength.

This current downtrend will most likely end only after a similar bottoming process. Between now and then there will certainly be a lot of volatility, but until we see signs that the market is building a base for another durable advance, we will continue to watch that volatility mostly from the sidelines.

* * *

Aside from the moves in Treasuries and stocks, gold has started to show some signs that its bull market is moving into its later stages. The rise over the past few months has taken on a somewhat more urgent feel from the slower, steadier climb we have seen up to this point from the low in 2008. Also, the Dow/Gold ratio, which we have discussed a number of times in the past few years, has declined ~30% over the past two months from 8.5 to below 6. If recent trends were to continue, it's possible we would reach end-of-bull-market valuations for gold versus stocks within a relatively short period of time.

Under the right conditions, its possible gold could trade much higher than its current price near \$1800 before its bull markets ends. However, it's important to realize that the price of gold has *already* risen over 600% from its low in 1999. Gold's bull market began when investors were crazy about stocks, and it will likely end when investors have thrown in the towel on stocks and are afraid of a crash in the value of the dollar. While it could take a number or years to get to that point, if we see gold begin to rise in an end-of-bull-market fashion in the coming year while ratios such as the Dow/Gold ratio fall down to previous historic lows, we will be ready to shift our focus away from gold.

During such shifts, it is far more important to recognize the end of the current cycle for what it is and make that transition than to try to time the precise top in the gold bull market. While most investors were falling over themselves to grab the last dramatic gains from stocks in the late 1990's, gains that would evaporate soon thereafter, disciplined investors who have done well over the past decade were already transitioning their portfolios and accumulating assets that would provide better returns when the bull market in stocks ended. Ten years from now, the same will undoubtedly be said about gold investors who made the transition out of gold as its bull market approached an end.

We mention all of this because while it may be years before gold ends its long-term bull market, sometimes markets move a lot quicker than most investors expect - especially during the speculative frenzy that usually comes in the last phase of a bull market. The economic adjustment we are currently going through also has many years to go, but markets often anticipate economic and financial trends well in advance.

The decline in stocks over the past month has been unusually strong for an *initial* decline from a cyclical market top, and the recent rise in gold has been very strong. This has us wondering whether this momentum will continue - and if it does, how we could see a number of long-term valuation targets hit within a short amount of time.

We will have a lot more to say about these long-term targets as this new downtrend continues to evolve. For now, the dividend yield of the S&P 500 is now greater than the yield on the 10-year Treasury for the first time in 50+ years, and the Dow/Gold ratio has fallen 86% since 1999. These are signs that suggest, from a price perspective at least, we are probably closer to the end of the long-term bear market in stocks than the beginning, and the same can be said for the long-term bull market in gold.

In light of recent market conditions, we remain largely defensively positioned in our portfolios. Now that the US and global equity markets have entered a clear downtrend, we will likely remain defensive for the time being.

One of the reasons we have been cautious in our allocations over the past year has been because of the potential for the next decline, when it came, to exhibit some end-of-bear-market extremes in sentiment, valuation and various inter-market ratios. The approach to such extremes never comes to pass in a calm, orderly fashion – there is always tremendous volatility. During the rapid decline in stocks over the past month, there was very little time to sell before prices had moved substantially lower.

In Absolute Return, we have held over 40% of the portfolio in cash and cash equivalents for a number of months. In addition, most of our net market exposure outside of gold has been completely hedged. This has been a low-risk, low-potential-return allocation, and it has been designed to weather the type of market storm we have now entered. Although we will likely see modest gains if the ratio of stocks to gold continues to fall, the opportunity for greater returns will come once US and global equity markets are ready to embark on another sustainable uptrend. This may take some time or it may come quickly, but until then we will continue to focus on preserving our capital in anticipation of better opportunities.

In Hedged Growth, the shift back towards value and away from risk has benefited the portfolio in recent months. The two year period between April 2009 and March 2011 saw a record underperformance of high quality versus low quality stocks, and that was a large drag on the performance of Hedged Growth. However, that trend appears to have ended in March.

In all of our portfolios we have been quite conservative in our market exposure over the past year and a half. This has been for both technical and fundamental reasons, many of which we have discussed in client letters. Fortunately, the markets now appear to have started the process of pricing in some of the current risks, and when those risks are more fully priced in we will be left with a lot more opportunity for generating returns than we have today.

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

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.