



December 2009

Dear Investor,

US and global equity markets were generally range-bound throughout most of November and early December. After an early November rally recouped the losses from a decline in late October, the S&P 500 has since remained within a narrow 3% range between 1085 and 1120. The MSCI World (ex USA) Index has remained in a 3.5% range between 1570 and 1625.

While the broader stock market has moved very little in recent weeks, there have been wider swings in currencies and precious metals. Gold rallied approximately \$275 since breaking out in early September to its recent high and there was bound to be a correction at some point—and it appears we have reached that point. Gold rose to above \$1226/oz in early December, but then fell back to where it traded in mid-November. Both gold and silver have already fallen more than 10% from their early December peaks.

The US dollar fell to a new low in late November, but so far in December the dollar has rallied. A stronger than expected jobs report for November, coupled with news that Greece may be teetering on the edge of default, has contributed to the dollar's recent strength against the Euro. However, as we have mentioned in recent letters, the dollar has been poised to rally for some time and these recent events have merely provided the spark. We'll discuss the dollar in more detail in the following pages.

Since hitting a high of 4.014% in June, the yield on the 10-year Treasury bond has trended lower within a range between 3.1% and 4.0%. This has occurred against the backdrop of the 3-month T-Bill rate dropping to 0.005% in November, down from 0.18% in August. It's clear from the action in T-Bills that there is still an enormous amount of money willing to accept practically no yield in exchange for safety.

The recent default of Dubai World, Dubai's state-run investment company, showed us one reason why there is still such a large demand for safe assets. Although equity markets quickly recovered when it became clear Dubai World would be bailed out by neighboring Abu Dhabi, the entire episode seemed strikingly similar to events during the summer of 2007. At that time, the first sub-prime-focused hedge funds blew up in the first serious tremors of the mortgage crisis. Dubai is an emblem of over-building during the boom, and the markets are just now starting to feel the financial the effects of the hangover.

This month we'll take a brief look at the dollar and commodities. Our next letter will present a summary of the markets in 2009, and detail our expectations for 2010. It will be in your inbox in early January.

| <u>Stock Indexes</u> | <u>November</u> | <u>2009</u> | <u>Market Indexes</u> | <u>November</u> | <u>2009</u> |
|---------------------------|-----------------|-------------|------------------------------|-----------------|-------------|
| S&P 500 Index | +5.7% | +21.3% | HFRX Global Hedge Fund Index | +1.66% | +12.8% |
| MSCI World (ex USA) Index | +1.8% | +27.2% | US Dollar Index | -2.0% | -7.9% |
| Amex Oil Index | +1.5% | +9.1% | CRB Commodities Index | +2.6% | +20.9% |
| Gold and Silver Index | +17.3% | +48.3% | Gold (Continuous Contract) | +12.8% | +33.4% |

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From its peak in early March, the US Dollar Index declined roughly 16% as equity markets around the world rallied and conditions in the financial markets eased. The dollar index had risen over 26% from its low as the financial crisis erupted in 2008. It rose because of its status as a safe haven currency, but also because of technical reasons.

For instance, when US debt markets were shut down last fall, there was an intense demand for dollars to pay back maturing dollar-denominated debt. There was a rush to convert into dollars to meet this demand, and the dollar's exchange rate rose.

As financial conditions eased, the dollar initially fell rapidly as the demand to exchange other currencies into dollars for debt repayment collapsed. The decline continued as money began flowing out of dollars into economies with higher interest rates and better growth prospects.

With asset prices rising and the Fed repeating its commitment to leave interest rates near zero, the decline in the dollar stoked fears of inflation. Many even became convinced of the real possibility of an outright dollar collapse.

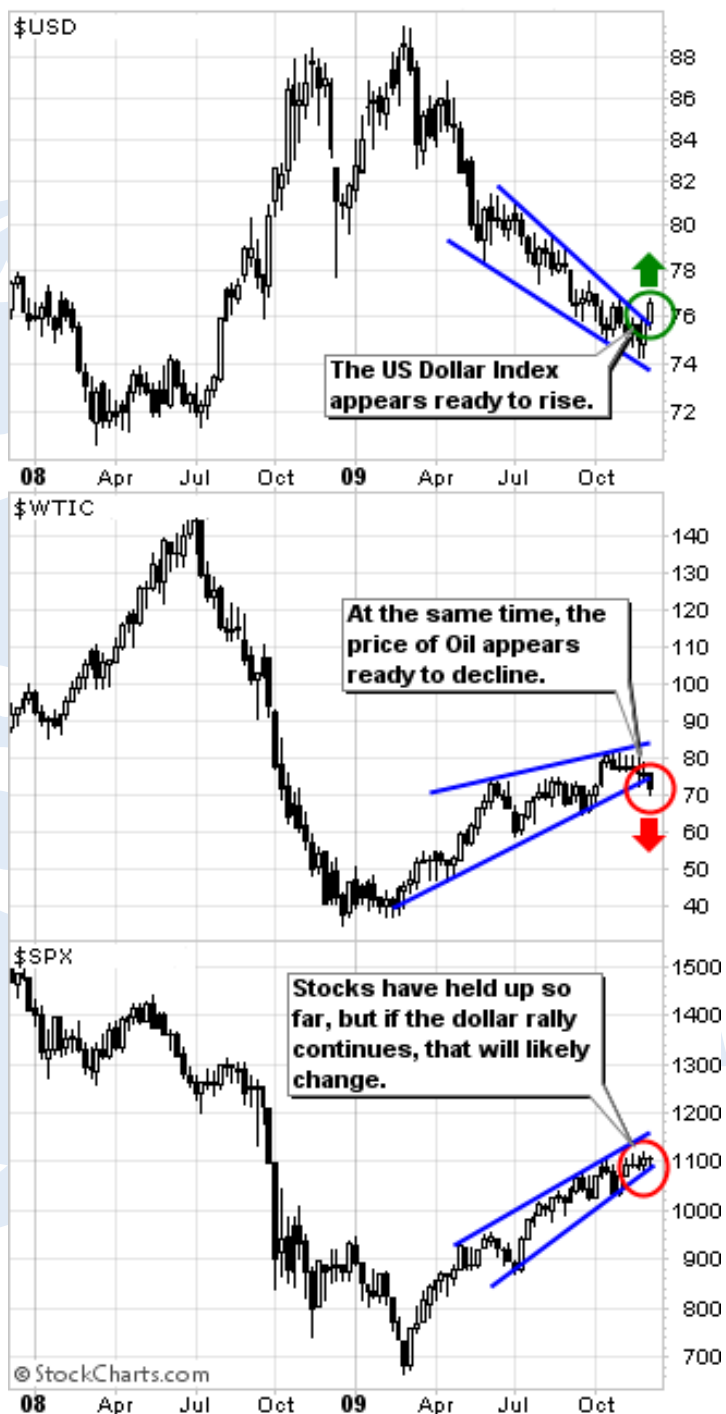
However, despite the extremely negative sentiment (one recent poll showed only 3% of traders were bullish), the dollar has remained above the low level it reached in 2008. Moreover, from a technical standpoint, there were strong hints that the trend higher that began in 2008 was not over.

Over the past several weeks, the dollar has broken its downtrend and climbed higher. At the same time, commodities, particularly oil, have declined and broken their positive trends that began earlier this year.

As we have discussed at length in recent letters, except for gold (which has reached new all-time highs) the gains in most markets this year have appeared less like new bull markets and more like typical, temporary rebounds following a crash.

These rebounds have been aided by the conditions that allowed the dollar to fall (thawing credit markets), and by the falling dollar itself—which has amplified gains in many markets. The rebound in oil and energy-related stocks, for instance, has moved in lock-step with the dollar's decline. And as the dollar has risen over the past few weeks, both oil and energy stocks have fallen.

US Dollar Index (top), Oil (middle), and S&P 500 (bottom)



With the benefit of hindsight, it's easy to see the relatively orderly sequence of events that preceded the dramatic fall in stock prices in the fall of 2008. A key step in that sequence was that the dollar began to rally and commodities began to decline in July, a number of weeks prior to the failure of Lehman Brothers and the stock market crash. It was an advanced warning that financial conditions were beginning to tighten.

This is one reason why we take special notice of the dollar's recent rally. As we enter into what appears to be the second phase of this real estate bust, a rising dollar could be a signal that conditions in the financial markets are beginning to tighten once again. It could also be a more benign sign that the dollar was simply oversold and ready to rally in a modest technical correction. However, with the issues we face as we head into 2010, it's important to pay close attention to the more serious signals the dollar rally may be sending.

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While we are seeing some of the same trends emerge that preceded the downturn in 2008, we are under no illusions that the markets will react in the same way. For example, while the dollar may rise and commodities and stocks may ultimately fall, it's possible that Treasury bonds will not provide the safe haven they did in 2008.

In fact, there is the distinct possibility that Treasury bond yields could rise (and prices fall) during another bear market in stocks—just the opposite of what happened in 2008. This could happen if fears of sovereign defaults started to grow, perhaps triggered by events like we are currently seeing in Dubai and Greece. This potential outcome is one of the reasons we continue to hold gold, even though the dollar is currently strengthening.

The bottom line is that the current investment landscape is quite different from what it was in 2007 and early 2008, and in many ways it is far more complex. We will have a more in-depth discussion of the markets in next month's letter, including a review of 2009 and the risks and opportunities ahead in 2010. We'll also discuss each portfolio in detail, so that you have a good sense of how your account is invested.

Until then, we hope you have a wonderful holiday season and a happy new year. If you have any questions about your account or topics discussed in this letter, please feel free to contact us.

Sincerely,
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