Sitka Pacific
Capital Management LLC

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Dear Investor,

So far in 2011, stock prices in the US, Europe and most other major western markets have continued their trend from late 2010 by climbing modestly higher. The S&P 500 and the MSCI World Index both ended January higher by more than 2%.

This continued climb in stock prices has brought long-term valuations officially back into "bubble" territory. Valuations have in the past only been this high at the very end of the bull markets, and additional price gains made from these valuations have never been durable—in other words, the gains have always eventually been given back. Valuations tell us nothing about the likely path of the markets in the near term (in fact, overvalued markets often become even more overvalued in the short run), but they do tell us whether holding stocks for the long-term will likely pay off better than trading in and out of the market. From these lofty valuations, the data is clear that "renters" of stocks will likely fare better in the coming years than those who "own" them.

While many western markets continued to rise, most emerging stock markets have been declining since the beginning of the year. The MSCI Emerging Markets Index lost more than 2% in January. Some of the best performing equity markets in 2010 were emerging markets, and the reversal in relative performance so far in 2011 is notable. This underperformance may mark a significant turning point, as many of these countries have begun to tighten monetary policy to address increasing inflation. In contrast, inflation in most western economies remains muted, even with central banks keeping monetary policy loose.

Gold and gold related stocks declined significantly in January, while energy and other commodities either held firm or advanced. However, gold prices have been recovering so far in February, and this recovery has made a more significant decline in gold in 2011 less likely than it was a month ago. It now appears that gold is going through a standard intermediate-term correction, which has happened almost annually since the gold bull market began 12 years ago.

Treasury yields have continued modestly higher in 2011 as well, with the 10-year Treasury yield climbing from near 3.3% at the end of 2010 to above 3.6% in early February. Yields throughout the Treasury curve remain below their peak levels in 2010, but not by much. The yield on the 30-year Treasury bond is just below the critical resistance we discussed in the *2010 Annual Review*, and a move above 4.8% in the coming months could provide the first firm evidence that the long bull market in bonds is over.

Stock Indexes	January	2011	Market Indexes	January	2011
S&P 500 Index	+2.4%	+2.4%	HFRX Global Hedge Fund Index	+0.6%	+0.6%
MSCI World (ex USA) Index	+2.1%	+2.1%	US Dollar Index	-1.6%	-1.6%
Amex Oil Index	+6.6%	+6.6%	CRB Commodities Index	+2.6%	+2.6%
Gold and Silver Index	-11.8%	-11.8%	Gold (Continuous Contract)	-6.2%	-6.2%

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According to a report by Bloomberg this past month, Treasury department officials recently outlined their expectations for federal government borrowing in the coming years in a private presentation to bond dealers and investors. The going assumption in the presentation was that the government will have to borrow more than $4 trillion between now and 2015. This assumption includes this year's projected budget deficit of $1.6 trillion, combined with steadily declining annual deficits thereafter (which assumes the economy will continue to recover).

With all the large numbers being thrown around these days, it's useful to remember where debt levels were just a short time ago. At the end of 2008, the amount of federal debt held by the public was $6.4 trillion (this total does not include the $4.3 trillion in intra-governmental debt). By the end of this past January, just 25 months later, federal debt held by the public had grown to $9.5 trillion—a 48% increase. If the estimated need for $4 trillion in new borrowing holds true in the next 4 years, the amount of federal debt held by the public will jump by a similar percentage to ~$13.5 trillion in 2015.

In 2010, with short-term interest rates held near zero by the Federal Reserve and long-term rates relatively low, interest expense on the existing ~$9 trillion in public debt was relatively low. The Treasury paid out a total of $185 billion in interest on its bills, notes and bonds in 2010, which amounts to an average interest expense of just over 2%.

As the amount of public debt rises by leaps and bounds, the amount of interest that will be paid in the coming years will rise as well, even if rates stay low. However, as the Treasury acknowledged in its presentation, as the debt continues to increase it is likely the average interest rate paid on the debt will likely not stay near 2%—it will probably go up. In fact, Treasury officials estimate that interest expense could reach an all-time high of $554 billion by 2015 if the average interest rate increased to near 4%.

This estimate of $554 billion in interest expense by 2015 is entirely dependent on the prevailing market rates for Treasury debt over the next few years. If yields on short and long-term Treasuries trend higher, then the expected interest expenses will trend higher as well. And if the Fed keeps short-term rates near zero and long-term bond rates fall again in the coming years, expected interest expenses will trend lower.

In addition to the projected $4 trillion that will need to be borrowed to cover the annual deficits between now and 2015, nearly $4.5 trillion in existing Treasury debt will mature between now and 2016. This means the federal government will have to issue over $8.5 trillion in new debt over the next 5 years, making it vulnerable to a rise in interest rates.

So while officials can only guess at what the exact interest expenses will be by 2015, there's no escaping that total interest expense on the debt is heading higher in the years ahead as the amount of debt outstanding rises—and it could rise by a lot if yields on Treasury securities trend higher.

Whether the amount of interest on the national debt becomes a problem for the financial markets depends on 1) whether interest rates head higher and 2) whether tax revenues increase in the years ahead.

President Obama recently released his budget for fiscal year 2012, which includes $3.73 trillion in spending. In the most recent year for which we have data (2010), tax revenue totaled $2.165 trillion—up slightly from $2.105 trillion in 2009. While tax revenues from 2010 and 2009 are below the peak of $2.568 in 2007, the Treasury department's estimates for a shrinking deficit over the next four years depends on tax revenue jumping to $3.633 trillion in 2015—a 67% increase from 2010.

That is a huge assumption. In fact, there are only two times since WWII that there has been such a large jump in tax receipts over five years: the boom years of the early 1950s, and the inflationary years of the late 1970s and early 1980s.

If the projected 67% increase in tax revenue does not materialize and/or the economy does not recover as strongly as expected (which has been the case up to now), the Treasury will have to borrow far more than the $4 trillion it estimates over the next four years. This could cause interest expenses to climb higher than the Treasury's estimate of $554 billion by 2015. For example, if the Treasury has to borrow $6 trillion over the next four years instead of the estimated $4 trillion, and the average interest rate on the entire debt rose to 5%, instead of the 4% mentioned above, total interest expense would be $775 billion by 2015—40% more than the Treasury department's current estimate.

At this point, the basic problem is probably clear. If the economy recovers in the years ahead and tax revenues increase as the government expects, interest on the debt will likely remain manageable: if the government is taking in $3.6 trillion in tax receipts by 2015, interest expenses of $554 billion would be only 15% of tax revenue. This is a level of interest expense versus revenue that will likely be acceptable to the bond market.

However, if tax receipts fail to grow as much as expected in the years ahead, the Treasury will be forced to borrow more than the currently expected $4 trillion and interest expenses could reach critical levels in just a few short years. For instance, in the example above, $775 billion in interest expenses would be 26% of revenue if tax receipts totaled only $3 trillion in 2015, and it would be 31% of revenue if tax receipts only recovered to their 2007 high by 2015. These are levels of interest expense the bond market would likely find unacceptable.

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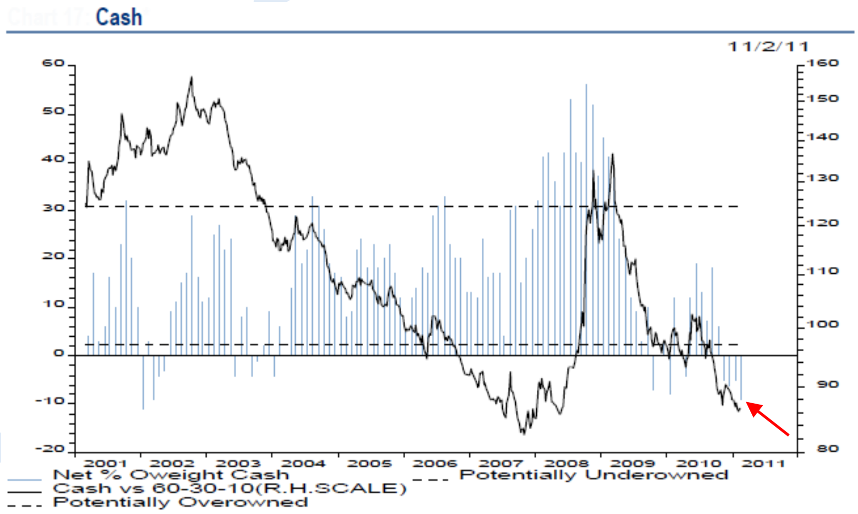
It is with the above thoughts in mind that we have been watching the bond market so closely in recent months. As we discussed in the *2010 Annual Review*, the yield on the 30-year Treasury bond has declined over the past 25 years in a well-defined channel. The upper trendline of that channel is near 4.7%–4.8%, and the 30-year yield has now risen up to that resistance level (see chart below). If the yield on the 30-year Treasury bond were to move higher above 4.8%, it could be the first sign that the bond market may be transitioning out of its 30-year trend of declining yields.

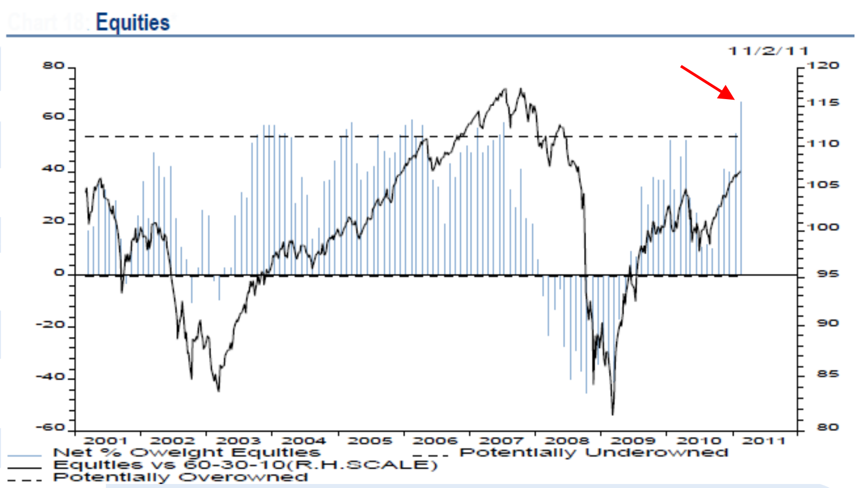
<u>30-Year Treasury Bond Yield, 1980—January 2011</u>

If that were to happen, we would look for other parts of the yield curve—especially the 10-year note yield—to follow suit and confirm the action in the 30-year by moving above long-term trend-defining resistance levels. The more parts of the yield curve that began to show signs of breaking out of their long declines from the highs of the early 1980s, the more likely it would be that the 30-year bull market in Treasuries was indeed over. And as we discussed above, higher yields would have significant ramifications for the expense of our rapidly increasing government debt.

As far as the equity market is concerned, the growing government debt problem is being treated just like the housing bubble before the bust: it is a potential problem to be dealt with at some point in the future. In the meantime, over the past two years sentiment has swung 180 degrees in favor of risk assets.

A recent survey of fund managers put out by Merrill Lynch shows how lopsided sentiment has become in favor of all risk assets.





These two charts show the performance of cash (top) and stocks (bottom) related to a standard 60-30-10 stocks/bonds/cash model portfolio. In addition, the blue vertical lines on each chart show the net percentage of managers who recommend being overweight that asset class.

At the market lows in late 2008 and 2009, cash had outperformed the standard 60-30-10 portfolio by a wide margin, and a net 50% of fund managers were overweight cash. At the same time, stocks had severely underperformed, and a net 50% of fund managers were underweight stocks. It was in this pessimistic context that stocks bottomed and began their current advance.

As of this month, the survey of fund managers has set multi-year records for the net number of managers that are underweight cash and overweight stocks—a complete reversal from 2 years ago.

A net 9% of managers are now underweight cash, the lowest reading since early 2002. In addition, a net 67% of managers are overweight stocks—which is the highest level in the survey's history.

Although the chart is not included here, the same extremely bullish sentiment is seen in commodities. While a net 30% of managers were underweight commodities in late 2008 (when most commodities reached their lows), a net 28% of managers are now overweight commodities. As with stocks, this level of bullishness on commodities is the highest in the survey's record.

As we discussed in the *2010 Annual Review*, the stock market has never before had a positive inflation-adjusted 20-year return when starting from 10-year P/E ratio above 22. We ended 2010 at 23, and the rise in stocks so far in 2011 has pushed it above 24 in February.

There have been only a few times in which valuations against long-term earnings have been this high, and as was mentioned earlier, additional price gains from these high valuations have in the past never proven to be durable—the gains have always, sooner or later, been given back. However, the gains haven't always been given back *immediately*. There have been times where the additional gains were given back within months, with the 2 years following that peak showing significant negative returns. There have also been other times, i.e., the late 1990s tech bubble, where the gains lasted for years before ultimately being given back.

As the stocks continue on their upward path, many market strategists now think the S&P 500 could be poised to rise all the way back to its 2007 high at 1576. That would represent another 22% gain from where the index ended in January, and such a gain would likely bring its 10-year P/E ratio up to near 30 from its level today.

While anything is always possible in the markets, not everything is equally probable. There have been only two times valuations reached such levels in the past: in the three months leading up to the peak in 1929, and in the three years leading up to the peak in 2000. These were the two largest stock market bubbles in our history, and the subsequent returns from those market peaks were (as you know) extremely poor. So while it is certainly possible that stocks manage to reach those valuations again over the next few years, the odds are stacked against it. Moreover, the potential returns following those gains would be very poor.

What is clear is that once the market reaches the high valuations seen today, there need to be compelling short-term reasons to hold stocks—because there are no compelling long-term reasons. In this environment, absent those compelling short-term reasons, there will be long stretches of time spent waiting on the sidelines for another attractive time to buy.

As we have discussed in prior client letters, it appears we are in somewhat of a calm period between debt-related storms. This calm period could continue for some time, or it could end abruptly if market conditions or risk appetite were to suddenly change for some reason. For example, if Treasury bond yields were to begin breaking out of their long-term downtrend, that could prompt a re-assessment of valuations in the stock market.

In light of current valuations, the current extremes in market sentiment, and the weak technical backdrop, we remain defensively positioned in February. Although the market's continued advance over the past few months may seem to fly in the face of our continued defensive stance, we are more concerned with the total return, risk and volatility of our portfolios over the course of this entire bear market than our short-term performance. In a long-term bear market, we believe this is the right focus.

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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