



Sitka Pacific

Capital Management LLC

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Dear Investor,

In case you missed our note in this month's email, we will be moving our office from Edmonds, Washington down to Sonoma, California later this quarter. The Sonoma office will be open in October, and we will include information for that office in the September client letter and in future announcements. If you have any questions about this move, just send us an email or give us a call.

Last month we mentioned that the market had been trading on an 'inflation' theme, with bond yields and commodities and stocks rising in anticipation of a recovering economy. However, that came to an abrupt halt in June, as it became increasingly clear that the assumption of a recovering economy was premature.

Stocks moved higher in early June, but then fell in the later half of the month. The early June advance was particularly weak, from a technically standpoint, and it likely marked an end to the rally from the March low for now. Since their high, stocks have been in a modest downtrend, and we are watching from the sidelines to see how this decline progresses. What happens next will likely tell us a lot about what we can expect heading into the end of the year.

The yield on the 10-year Treasury bond peaked at 4% in June before declining to end the month near 3.5%. The rise to 4% from a low near 2.5% in March was swift, and it stoked a fear of run-away inflation taking bond yields higher. However, a significant part of that move was probably related to the huge surge in mortgage refinancing we saw in March and April, and the selling of Treasury bonds by those seeking to adjust to the changing duration of their mortgage portfolios in response. In the coming months, we will be able to see if this rise in yields is part of a new, larger higher in trend in bond yields.

Commodity related stocks also fell after peaking in June, as did many global stock markets. This synchronized action among various markets continues to command our attention, because it suggests the key drivers remain firmly linked to the massive deleveraging of the financial system. Until the fundamentals of each individual market begin to play a more dominant roll, the potential remains for a repeat of another market downturn that takes the majority of asset classes with it.

This month we'll assess where the stock market stands after the rally from the March low, and what we will be looking for over the next few months. We'll also comment on the some of the problems with trying to diversify your way out of market risk in a market in which everything is highly correlated.

<u>Stock Indexes</u>	<u>June</u>	<u>2009</u>	<u>Market Indexes</u>	<u>June</u>	<u>2009</u>
S&P 500 Index	+0.0%	+1.8%	HFRX Global Hedge Fund Index	+0.0%	+5.6%
MSCI World (ex USA) Index	-1.2%	+7.1%	US Dollar Index	-1.0%	-1.3%
Amex Oil Index	-6.9%	-6.2%	CRB Commodities Index	-1.2%	+8.9%
Gold and Silver Index	-13.2%	+12.2%	Gold (Continuous Contract)	-5.4%	+4.8%

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As the stock market began to rise off its low in March, there was reason for cautious optimism. While the hard data on the economy and the financial markets still painted a grim picture, stocks had declined close to 60% from their high in 2007, and there was a noticeable tone of capitulation among investors. Regardless of the economic context in which the market finds itself, the conditions in March were those that might have made for a durable market bottom.

However, after strong start in March, the rally quickly weakened in April and continued to weaken further in May. It soon became clear that we were probably not in the early stages of a strong advance that could carry stocks higher for good: the weakest areas of the market were leading the advance (powered mostly by short-covering), and the rest of the market was failing to attract the buying interest we would expect from a new bull market.

As an example, money-losing companies with the most debt in the MSCI World Value Index rallied 38 percent in the second quarter, compared to a 20 percent gain in the MSCI World Index over the same time. That means that stocks with the poorest earnings and the most debt rose almost twice as much as the rest of the market between April and July. This out-performance by low quality stocks is the main reason why our Hedged Growth portfolio had such a poor quarter. However, since we are still most likely in the *middle*, not the end, of a giant de-leveraging process in the financial markets, the out-performance of these debt-laden stocks will likely prove temporary.

At the same time as market internals deteriorated, market sentiment changed dramatically as stocks rose. From the hopelessness we saw in February and March, the vast majority of investors suddenly became convinced that the bear market was over that the economy was moving towards recovery. Such rapid sentiment shifts from pessimism to optimism almost never occur at significant market bottoms, and so we were left with what increasingly looked like a standard (but large) bear market rally in its later stages.

It appears we saw the end of that rally in June, and that was the case for most global stock markets as well. And not only stock markets, but many commodities reached a high in June and then turned down, as did many other asset classes. To say all these markets have been correlated is an understatement—moving in lock-step is a more accurate description.

The two charts below are but two examples of these correlations. On the left is the MSCI Emerging Markets index, and on the right is the Nasdaq Composite. Although there are minor differences in how these two indexes have tracked over the past two years, it is notable that both rebounded to similar technical levels in June and have since turned lower at precisely the same time.

Correlated Markets: The MSCI Emerging Markets Index (left), and the Nasdaq Composite (right)



The fact that these and other stock markets rallied to the Fibonacci resistance and then turned down is another strong hint that we remain in an ongoing bear market. Market corrections that move back to the range of these Fibonacci retrace levels and then turn down are usually destined to make new lows, *eventually*.

That move to new lows can happen right away, or it can take many years with many ups and downs along the way. Despite that uncertainty, from our point of view there are several important investment themes that will continue to be important if the current deflationary environment continues:

1. Since a new bull market is not in sight, it's important to continue to view stocks as vehicles for trading, not for investment. There will likely be many ups and downs, and stocks could remain relatively range bound for an extended time. We will attempt to stay hedged during most of the declines and open to market fluctuations during most of the advances. However, the key will be to remain uncorrelated to the markets overall.
2. The correlation among markets over the past two years largely reflects the ongoing deleveraging process. Until this dynamic changes, the Modern Portfolio Theory method of managing risk by diversifying among many asset classes and geographic regions will remain prone to the kind of severe draw downs seen in these strategies in 2008.
3. With the US government running up \$1 Trillion in deficit through the first 9 months of this fiscal year, the potential for "unintended consequences" of all the bailouts and government spending remains high. The chart of the 30-year Treasury bond yield at the bottom of the page is a potential example of this. Although markets are relatively calm at the moment, that could change if confidence in the economy sours again.

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In March, we were open to more positive potential outcomes. If the government's efforts to counter the deflationary forces succeeded, we could have found ourselves in a market environment that resembled the late 1970's, in which stocks declined in real (inflation adjusted) terms, but still rose in nominal terms. That would have enabled us to focus on investing in areas most likely to benefit under those conditions, on the premise that the broader market had seen its lowest point and the risk if a severe drawdown was low.

A Potential Unintended Consequence: 30-Year Treasury Bond Yields



So far, however, the continued destruction of credit appears to be overwhelming the government's response, and the markets are acting in a way that suggests the lows have not yet been seen. Under these circumstances, the best we may be able to hope for is a trading range similar to how Japan's stock market traded in the later half of the 1990's, before a final move down to a bear market low.

In these post-crash corrections, the movements of stocks and other markets may have little to do with fundamental factors such as economic performance or earnings, and more to do with correcting systematic imbalances and the effects of continued deleveraging. That means that markets can rise and they can fall, but it doesn't necessarily mean that conditions in the real economy are improving or getting dramatically worse. It may just mean that, for a variety of technical reasons, there happen to be more buyers or more sellers at that time.

In an environment where there are no reliable growth trends and the broader market remains range-bound and prone to severe draw downs, certain factors will likely begin to have a greater influence than others. For example, if the stock market settles into a trading range, it's likely that stocks that have stable businesses and pay *reliable* dividends will gain favor over those that don't. In fact, we have already begun putting a greater emphasis on these stocks in our portfolios in anticipation of this trend.

In the very short-term, stocks could continue to fall in the coming months, potentially erasing up to 100% of the rally from the March low. They could also go through a shallow correction and then move modestly higher through the summer. This range of possibilities says little about future economic prospects, which remain depressed—it says more about the range of potential for large swings in investor sentiment in the coming months.

For now we are defensively positioned in case the market takes the path of a deeper correction, but we will open ourselves up to market fluctuations if conditions improve. However, given that the S&P 500 is much closer to the top end of its likely range than to the bottom, any market exposure we take on will likely be modest.

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We will be focused on the markets and preparing for our move in August, so next month's client letter will be brief. As always, if you have any questions about your account or topics in this letter, don't hesitate to contact us.

Sincerely,
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