



# Sitka Pacific

Capital Management LLC

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Dear Investor,

Global stock markets continued their recovery in May and early June, and most now have recouped all of their losses from the start of the year. The S&P 500 gained 5.2% in the May, which left the index up 1.8% year-to-date. However, those recent gains came in an increasingly fragile advance, and in response we removed most of our exposure to stocks.

As you can see by the gains in gold and commodities at the bottom of the page, the inflation trade was in full force in May. Treasury bond yields rose, and with all the talk about “green shoots” in the economy, the markets rapidly priced in an inflation-filled economic recovery. The rapid sentiment change from complete despair at the March low to the consensus that “we are in a new bull market” appears to be way ahead of itself, and is more evidence that we have yet to see the end to this bear market.

From our perspective, the move higher in oil prices and other markets deemed to be harbingers of inflation have merely been typical rebounds from last year’s historic collapse. In fact, even with its move back to \$70/bl, oil has not yet recouped 1/3 of its decline from last year’s high near \$150/bl. With markets as volatile as they have been over the past year, it is very easy to read too much into these short-term moves.

At this stage, with the economy still losing hundreds of thousands of jobs a month, and another peak in mortgage resets approaching in 2010, the likelihood of a significant rebound in the economy or the housing market over the next year appears remote.

Of course the markets might swing into greater optimism over the prospect of a recovery, and/or inflation *fears* might grow even more intense. However, should that happen, history suggests there will be an unwinding of that premature optimism once reality sets in.

That reality has less to do with cyclical recoveries, or with recessions that improve from dire to just *bad*. It has more to do with the ongoing deleveraging of our economy and our financial system, which is still in its early stages (more on this to follow).

In that context, the markets seem to have moved to yet another sentiment extreme that is assuming an economic recovery and a new bull market in stocks. We don’t see either of those outcomes as likely, and the next decline will likely take back a significant portion of the recent rally.

<u>Stock Indexes</u>	<u>May</u>	<u>2009</u>	<u>Market Indexes</u>	<u>May</u>	<u>2009</u>
S&P 500 Stock Index	+5.2%	+1.8%	HFRX Global Hedge Fund Index	+3.2%	+5.5%
MSCI World (ex USA) Stock Index	+11.9%	+8.4%	US Dollar Index	-6.4%	-2.3%
Amex Oil Index	+12.6%	+0.8%	CRB Commodities Index	+13.8%	+10.2%
Gold and Silver Index	+33.4%	+29.3%	Gold (Continuous Contract)	+10.2%	+10.7%

\* \* \*

Just about 3 months ago in March, the Federal Reserve announced that they were going to begin buying Treasury bonds and mortgage bonds in an effort to keep interest rates low. That day, the yield on the 10-year Treasury bond had one of its largest one-day drops on record to 2.46% from over 3% the day before.

However, that proved to be a low point in Treasury bond yields. From that day through early June, the yield on the 10-year rose from 2.46% to over 4% - despite the Fed's purchases. Rates on mortgage bonds stayed low for a time, but in May they too began to rise. Even though Fed officials say that their efforts have had an impact, and that rates would be even higher had they not been purchasing these bonds in the open market, it's clear that their actions have not been a *decisive* factor in determining the trend in long-term bond rates.

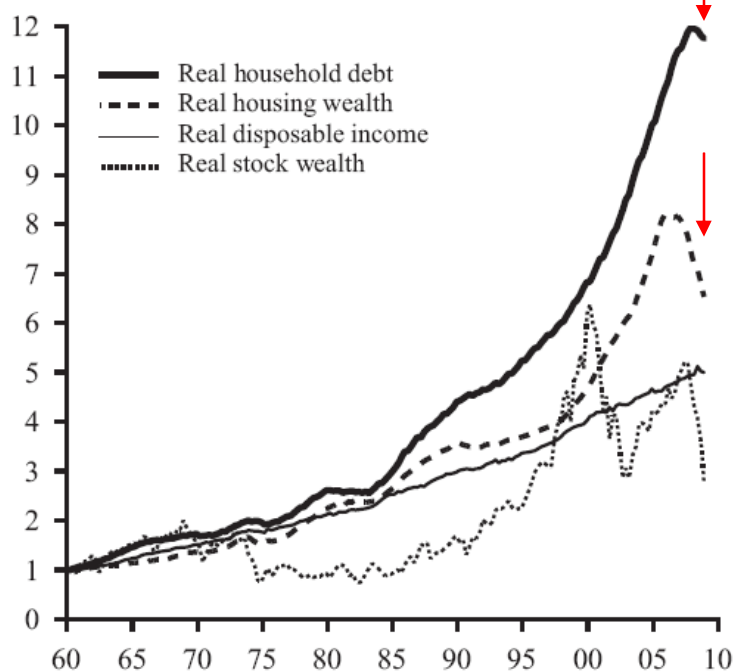
Many people seem to think that the Fed has enough power to get what it wants, all the time. Hence the saying "don't fight the Fed," which is meant to imply that as investors we should all pay close attention to what the Fed is trying to do, and make sure we are not investing in a way that runs contrary to their actions.

We believe differently. Indeed, the action in the bond market over the past few months is just one example among many of the Fed *not* getting what it wants. And if you take a step back and consider this entire downturn since 2007, you'll see that the markets have more or less moved on their own volition the entire time. The Fed's actions have certainly had a marginal impact, but they have not changed the deeper underlying economic trends driving this downturn, nor have they had any lasting impact on market trends.

These are things to keep in mind when listening to statements from the Fed. They are certainly going to try to achieve certain responses in the markets, but so far over the past year the effects of have been very short-term—if there was any response at all. In the case of the bond market, it's clear the \$3.25 Trillion the federal government is borrowing this year is overwhelming any efforts to keep long-term bond rates low.

### Real household debt, wealth, and income

All series normalized to 1 in 1960:Q1



If the Fed's lack of success in the bond market is any indication, their chances of having any lasting impact on the debt de-leveraging that has begun is minimal, at best. This is the heart of the argument for continued deflation in the coming years, and so far there isn't much evidence that the current deflationary trend is coming to an end.

The chart to the left is from a recent Federal Reserve Bank of San Francisco article called *U.S. Household Deleveraging and Future Consumption Growth*, and it shows trends in real income, wealth and debt over the past 50 years.

You can see from the thick line at the top that debt growth has simply been off the charts relative to incomes since the mid-1980's. You can also see that the economic pain over the past year had just barely dented the level of household debt relative to income.

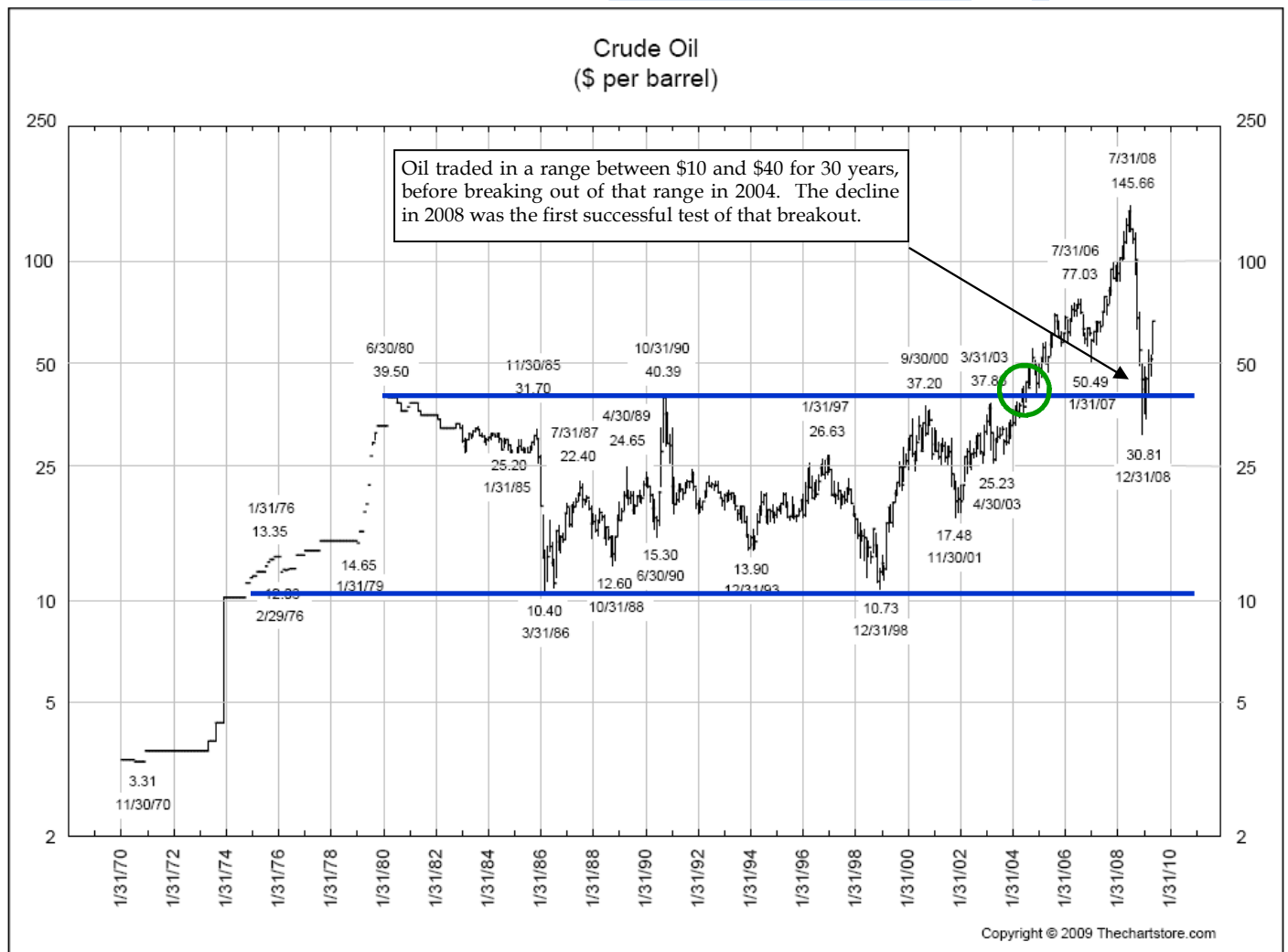
In a refreshing conclusion (given that this is coming from Fed economists), the authors state:

*Going forward, it seems probable that many U.S. households will reduce their debt. If accomplished through increased saving, the deleveraging process could result in a substantial and prolonged slowdown in consumer spending relative to pre-recession growth rates. Alternatively, if accomplished through some form of default on existing debt, such as real estate short sales, foreclosures, or bankruptcy, deleveraging could involve significant costs for consumers, including tax liabilities on forgiven debt, legal fees, and lower credit scores. Moreover, this form of deleveraging would simply shift the problem onto banks that hold these loans as assets on their balance sheets. Either way, the process of household deleveraging will not be painless.*

Of course, the bear market of the past 18 months has been all about the deleveraging of the consumer and the financial markets. And despite the efforts of the Fed and government over the past year, that process continues unabated. In fact, from the perspective of the chart on the previous page, it's probable that this process is still in its early stages.

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Although we see the continued deleveraging of our economy as the dominant theme going forward, we believe there will be many investment opportunities outside of the traditional deflationary trades. For example, the chart below of the price of oil is an example of a new trend of increasing prices that will likely run counter to falling prices elsewhere in the economy.



Inflationary forces can work to drive commodity prices higher, but that is certainly not the only reason why the price of oil broke out of its 30-year trading range between \$10 and \$40. There are supply issues connected with peak oil and demand issues connect to the 1+ billion people who are in the process of entering the global economy, mostly in emerging markets. These are some of the reasons the price of oil today remains near \$70 in the depths of the most severe global economic contraction in 75 years.

The long-term trend in energy is driven primarily by long-term demographic and supply/demand issues specific to that market, as opposed to pure inflation dynamics. Therefore, those who look at the rise in oil prices and conclude that a massive 1970's-style inflation is just around the corner have likely come to some incorrect conclusions about the state of our economy and markets.

Investing in a world dominated by deflationary forces with some key markets like energy bucking that trend is a very different investment landscape than investing in a market dominated by broad inflation concerns, where the price of goods and services, wages, interest rates all increase in unison. Going forward, that distinction will likely prove paramount .

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The next move down in the stock market will probably tell us a lot about the relative merits of the deflationary vs. inflationary scenarios playing out. Until we have a better idea of these long-term trends, we remain wary of taking on too much market risk.

While the markets continued to rally in May and early June, they have done so in a deteriorating technical fashion. That has left us in a largely defensive stance in June, as we expect the market to eventually decline and retrace a good portion of the rally from the March low. This could happen sooner or it could happen after another short-term advance, but at this point there is no reason to take on market significant risk until conditions improve.

As always, if you have questions about your account, don't hesitate to contact us. We would be happy to hear from you.

Sincerely,  
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