Sitka Pacific
Capital Management LLC

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Dear Investor,

In May, U.S. and global equity markets continued their downtrend from the highs reached in April. The S&P 500 Index lost over 6% for the month, leaving it with a 4% gain from the beginning of the year. The MSCI World (ex-USA) Index lost more than 11% for the month, a drop which carried the index into negative territory for 2012 by 3%.

Along with global stock markets, commodity prices fell substantially in May. The CRB Commodities Index declined nearly 11%, and ended May lower by 10% year to date. The downdraft was widespread among economically sensitive commodities, with oil and copper prices falling 17% and 12%, respectively. Precious metals were also swept lower, as gold fell 6% and silver fell nearly 11%. However, while both the price of oil and the broader CRB Commodities Index ended May down more than 10% for the year, gold ended May just where it began 2012.

Over in the Treasury market, the rate on the 10-year note has fallen precipitously since its peak near 2.4% mid-March. On the first trading day in June, the 10-year yield declined to 1.44%. This was the lowest yield in decades, and far below the lowest point it reached during the peak of the crisis in 2008. On the same trading day, the yield on the German 10-year bund also fell to record lows, while the yields on some short-term German government securities traded in negative territory—meaning some investors were willing to lock in a small loss in exchange for the privilege of owning German government debt.

As we mentioned in last month's letter, falling prices for stocks and commodities, along with collapsing yields on perceived safe havens like U.S. and German government securities, indicate the markets have started to price in a less-than-ideal economic outlook. Although the markets have stabilized somewhat in early June, we haven't seen any evidence to suggest a durable turnaround is on the horizon.

If anything *is* likely on the horizon, it is some kind of policy announcement by the Fed and other major central banks in response to economic data which has continued to deteriorate. The most recent forward-looking data for the Eurozone economies continues to point towards recession, and U.S. economic data has softened lately.

However, whether equity and commodities markets would react positively to any central bank announcements of additional monetary stimulus this time around is difficult to say. While central bank actions over the past two years clearly boosted the markets in the short term, those gains

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turned out to be temporary and were given back in subsequent declines—just as has happened again over the past two months. All the while, economic growth in major western economies, including the U.S., has continued to be sluggish, and governments have continued to rack up additional debt at an unsustainable pace. A positive reaction would require the markets to believe the temporary effects of more Fed stimulus outweighed the implications of another economic downturn on the government's deficit and debt trajectory. While anything is possible in the short term, a positive market response that proves durable seems quite unlikely at this point.

While the relatively stagnant outlook for the economy may sound rather dire to some, to us it is merely in line with what history suggests should be occurring at this point. In the past there have been many periods of post-boom malaise, and as it turns out, the rapidly evolving situations in Europe and China, as well as our own looming debt problem, are not too dissimilar from many of those past episodes—as we'll discuss below.

Debt, Cycles and Investment Returns

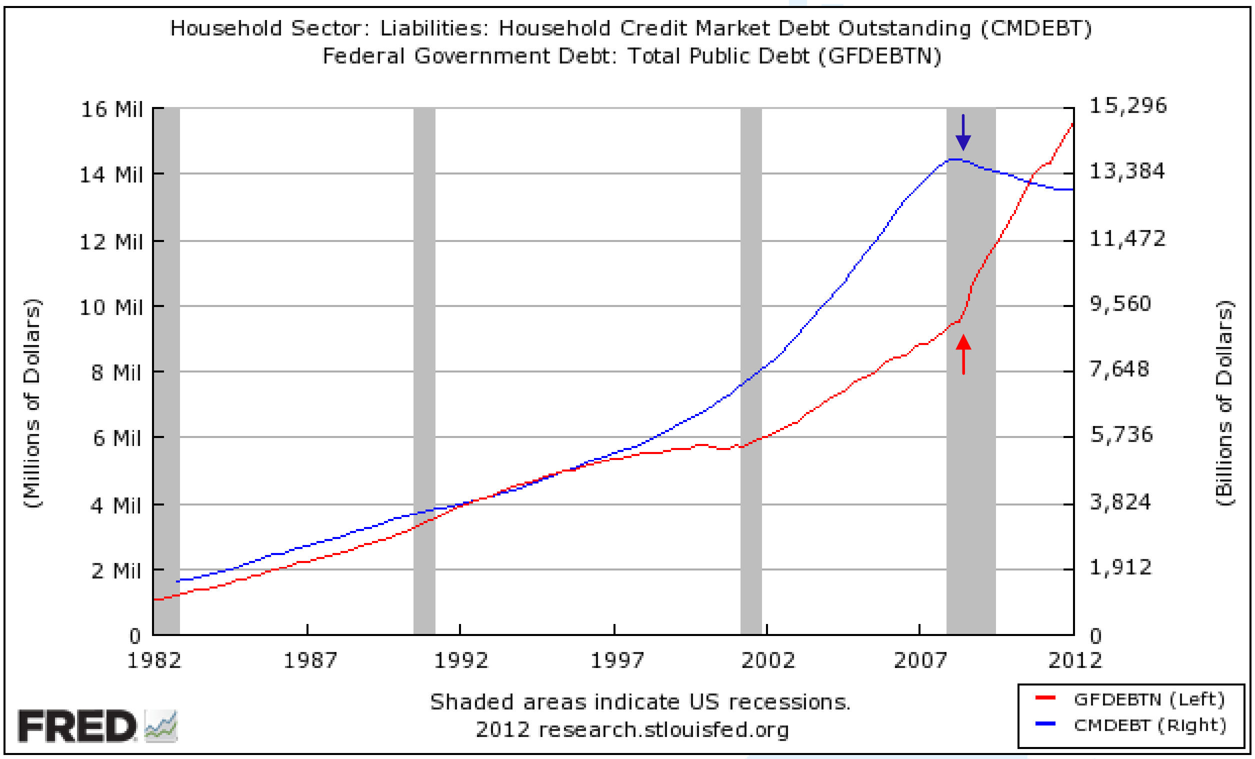
A couple months ago, the authors of one the most influential books in finance in recent years, namely *This Time is Different: Eight Centuries of Financial Folly*, put out a new paper through the National Bureau of Economic Research entitled *Debt Overhangs, Past and Present*. In this paper, they highlight some key points about periods of debt deleveraging that few people want to hear. However, these are points that are critical for anyone hoping to understand the process many economies and financial markets around the world (including ours) are currently going through, and as such they are points that will likely prove critical for investors hoping to protect and grow their wealth in the coming years.

While anyone who finds excitement in looking through tables of economic data should download the entire paper, a few select passages from the conclusion highlight the important take-home messages (with our emphasis):

> The advanced world has entered an era characterized by massive overhang of public and private debt. Public debt to GDP levels in advanced countries as a whole already exceed our critical 90% threshold. Private debt … remains near pre-crisis levels.
>
> We identify 26 episodes of public debt overhang—where debt to GDP ratios exceed 90% of GDP—since 1800. We find that in 23 of these 26 episodes, individual countries experienced lower growth than the average of other years. Across all 26 episodes, <u>growth is lower by an average of 1.2%</u>. If this effect sounds modest, consider that <u>the average duration of debt overhang episodes was 23 years</u>.
>
> In 11 of the 26 high debt overhang episodes, real interest rates were the same or lower than in other periods. Yet growth was similarly impaired.…

Here in the U.S., politicians and central bankers are feeling the pressure from a public upset about the weak recovery from the Great Recession; by any measure, it has been the weakest recovery since the Great Depression. However, what these policy makers don't know, or won't publically acknowledge, is that this lower rate of growth is what we should expect after a multi-decade buildup of debt.

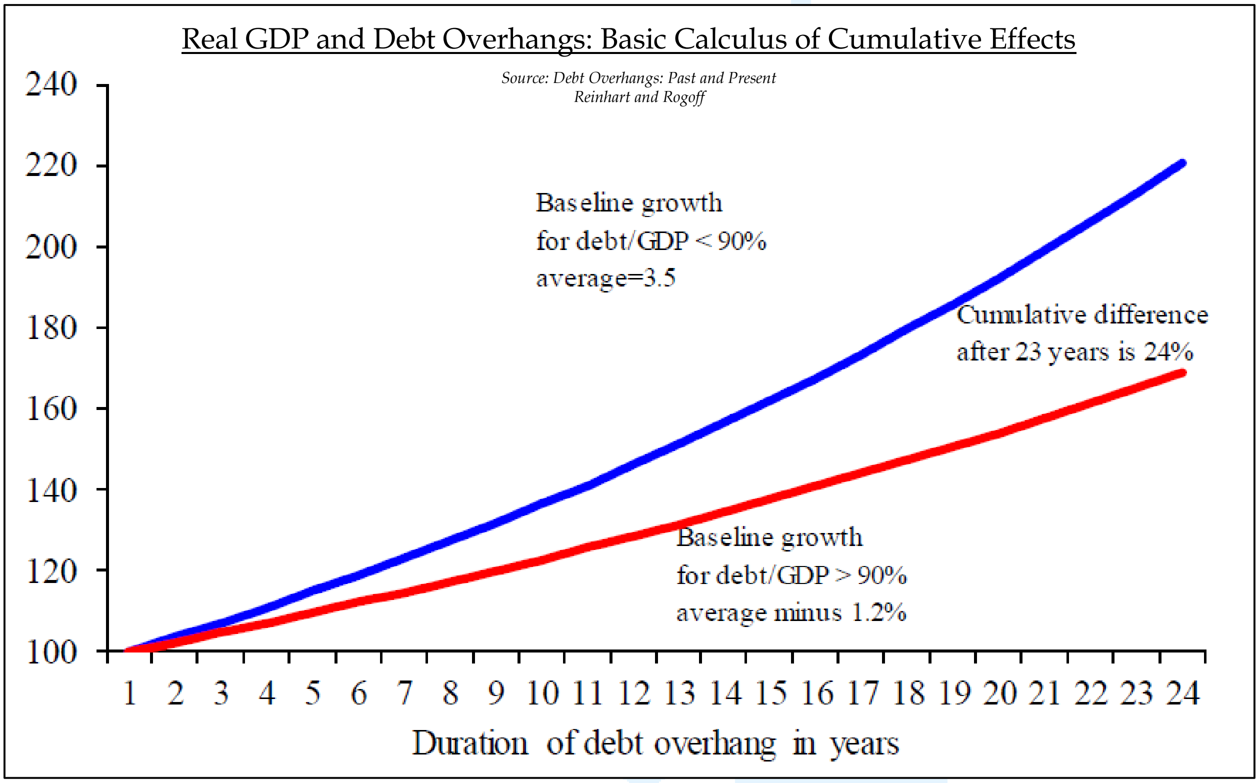
The housing bust and the recession in 2008 marked the *beginning* of the private economy's deleveraging process following that buildup of debt. This trend can be seen in a number of economic data series, and the chart below shows one example. After an uninterrupted 25-year rise, Household Credit Market Debt Outstanding has been steadily falling since 2007 (blue line, right scale). However, most of the economic effects from this deleveraging in the private economy have been cushioned by a large increase in government debt (red line, left scale). In other words, the government borrowed more to fill the hole left by households' reduced borrowing.



While this large increase in government debt has clearly resulted in a stronger economy that would have been otherwise over the last four years, it has come at an enormous long-term cost. As stated earlier, private debt remains near pre-crisis levels, which can be seen in the above chart (i.e., the blue line hasn't declined *that* much from its high in 2007). And with the large increase in government debt over the past four years, both the public and private sectors are now in an over-leveraged state.

As data from the study cited above make clear, past periods of over-indebtedness have almost always resulted in lower economic growth over the long term. In fact, once an economy reaches the level of indebtedness we have reached in the U.S., economic growth averages about a third less over time. While "a third less over time" may not sound like much of a difference, the cumulative impact of lower growth rates throughout a period of deleveraging can have an enormous impact.

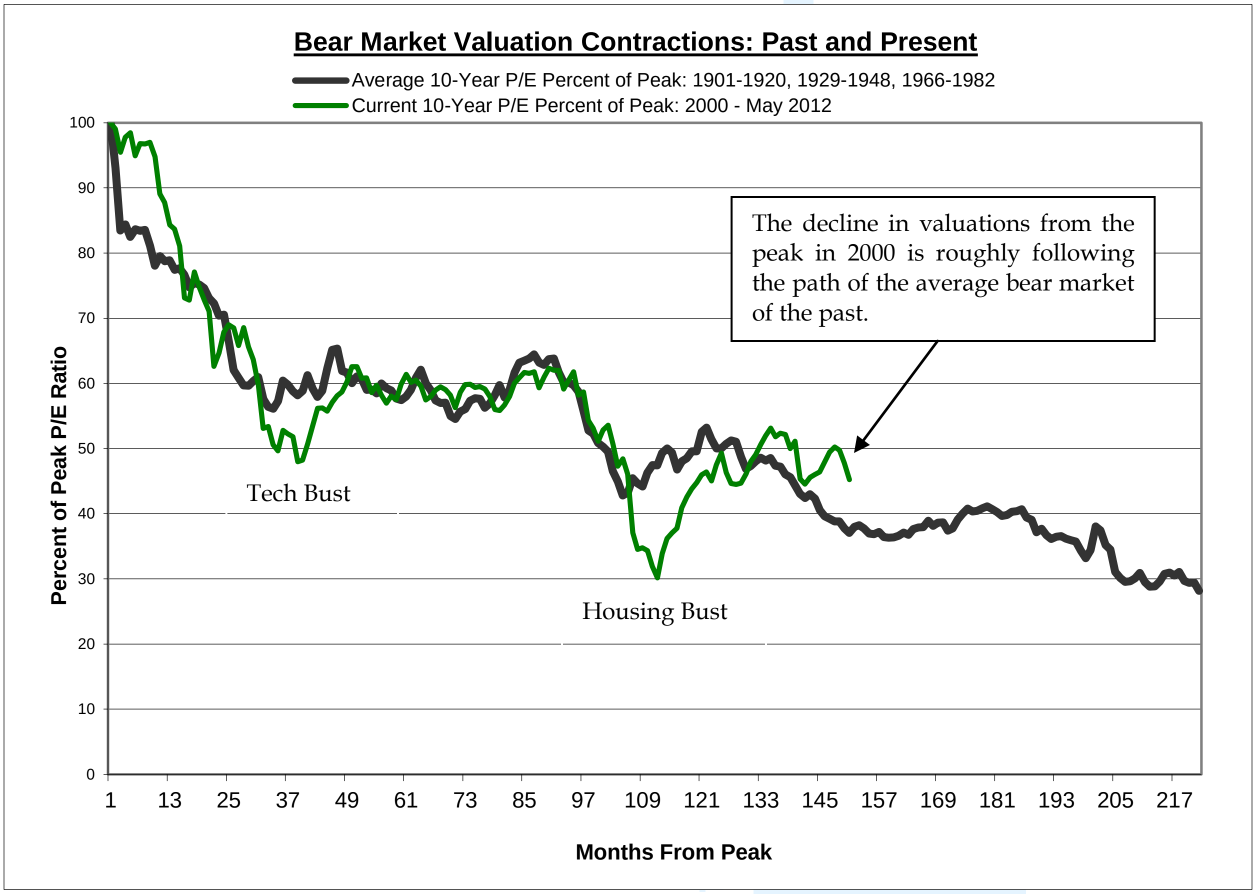
As Reinhart et al. demonstrate in their paper with the chart below, since past deleveraging periods have lasted 23 years on average, the lower average growth rate results in an economy nearly ¾ the size it would have been after 23 years without the growth drag from excessive debt. This large gap between the future size of the economy growing with and without a large debt burden weighing it down highlights some of the real long-term costs of accumulating public debt today in order to cushion the effects of private sector deleveraging.



With the U.S. economy now five years into its private sector deleveraging, the impact on growth has been plainly visible. While the real, inflation-adjusted growth rate of the U.S. economy averaged 3.29% from 1982 to 2007, it has averaged just 0.37% since 2007. And since the official end of the recession in the second quarter of 2009, real growth has averaged only 2.39%—and that was achieved with the help of an unsustainable rate of increase in government debt. These lower rates of economic growth are right in line with results seen from previous episodes of over-indebtedness, and they put the U.S. economy firmly on a track of slower growth, comparable to the red line in the above chart.

These lower economic growth rates are also are right in line with some aspects of the markets that seem to puzzle many, such as the ultra-low rates on Treasury notes and bonds, and the continued decline in valuations in the stock market. While many strategists seem to be waiting for the markets to "wake up" and revert to their post-WWII average valuations, it's quite likely these markets are simply (and correctly) discounting a much slower rate of economic growth going forward.

The U.S. stock market is currently in the 13th year of a long-term bear market, the 4th such long-term bear market since 1900. Each one of these bear markets has been defined as a transition from high valuations at the end of a long bull market, back to low valuations. Although valuations today are quite a bit lower than in 2000, the market is still in the middle of a process of becoming cheaper relative to earnings. Just as the valuation of an individual stock goes down when its growth prospects dim, the valuation of the entire market has declined as the economy's growth prospects have dimmed.



At some point, the market's valuation will be low enough that we'll be able to confidently invest in stocks knowing the market has already priced in most or all of the effects of our high debt, slow growth predicament, and all the money printing we'll likely see from the Federal Reserve in the coming years. At some point the market's price and valuation will have factored in all these issues, and from that point we'll be able to invest in stocks for the long run. However, in all previous bear markets, that point came at a valuation less than ½ of what we find today, 16–20 years after the start of the bear market—so our market likely has some ways to go.

As with an economy going through a deleveraging process, these bear market cycles take a long time to complete. Fortunately, the benefits for those who wait for end-of-bear-market valuations are great enough to inspire our patience. Until then, we continue to view stocks as an asset to be rented, and only when they are in a very favorable position.

Over the past two years, there have been several opportunities for stocks to decline to levels that would have represented value in light of our current circumstances, but each opportunity was snuffed out by the Fed's quantitative easing programs. During each of these programs the market rose for a while, only to give back most of the gains later. However, as the market didn't fall substantially during this time, it is almost certainly viewed as a success within the Fed.

Unfortunately, the Fed's success in keeping stock prices aloft has meant a longer wait for investors like us who look for value, a margin of safety and a supportive technical outlook before making large, temporary allocations to stocks within a long-term bear market. But we are confident the wait will have been worth it when the next opportunity arrives.

In the meantime, we have been given a good opportunity over the past few months to add to our holdings of gold mining companies, and it appears we may be given an equally good opportunity to buy back into stocks in other commodity sectors over the next year. We have been out of energy and other economically sensitive commodities for more than a year now, and we are constantly on the lookout for the market conditions that would allow us to start buying back in.

Treasury notes and bonds could remain an asset class that provides capital preservation and a modest yield for some time ahead, especially if the Fed (as we expect) continues to expand its balance sheet in the coming years and uses that expansion to buy Treasury bonds and keep yields low. However, as an investment, treasuries are now almost certain to deliver a negative real return over longer time frames, and they are not attractive relative to some of the opportunities we will likely be presented with. Within the next few years we will likely again be given the opportunity to buy undervalued stocks and commodities, which will be poised to deliver significantly positive real returns—even when we factor in the low return on cash we get while waiting.

In the end, one of the primary goals in all of our portfolios is maximizing long-term annualized returns, and during a long bear market sometimes that means investing and other times that means holding cash. While the last couple years have called for more of the latter, we're eagerly awaiting more favorable market conditions. 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