



March 2011

Dear Investor,

Most equity markets in the U.S. and around the world rose modestly in February, with the S&P 500 and the MSCI World (ex-USA) Index both ending the month with a gain of more than 3%. Emerging markets continued to lag behind by declining 1% in February. However, the market's returns don't tell nearly the whole story of what has happened since our last client letter. As you may know, there has been a decidedly different tone in the markets since mid-February, which has partially been due to events in the Middle East and Japan.

The most significant change has been a spike in the price of oil. In January, West Texas Intermediate Crude (WTIC) reached a high of \$93/bl. However, as the protests in Egypt and Libya gained traction, the price of WTIC spiked as high as \$107/bl in mid-February, and it remains above \$100 as of this writing. This is more than 25% higher than the average price in 2010.

Since the spike higher in oil, stocks and Treasury yields have moved lower. After hitting a high of 1344 in mid-February, the S&P 500 has recently taken back most of the year's gains. The 10-year Treasury yield reached as high at 3.7% as stocks peaked, but has since declined below 3.4%. This market reaction suggests that the price of oil has now risen high enough to have a negative impact on economic growth. The tragic earthquake in Japan, and the problems at the Fukushima Dai-Ichi nuclear power plant, has added to the market's emerging anxiety.

None of these events would have a significant impact on the markets if they were not already vulnerable to a decline. If valuations were low and stocks were in "strong hands," which would be reflected by a supportive technical and sentiment backdrop, the risk of a significant decline sparked by these recent events would be low. However, as we have discussed in recent months, valuations are currently stretched and the rally since last summer has been particularly weak from a technical perspective. These are conditions similar to a drought-plagued forest with a lot of dead, dry fuel on the ground - all it takes it a minor lightning strike to ignite a large fire.

In this month's letter discuss Japan's market and check in with a few charts we highlighted in the *2010 Annual Review*, including a few market-based ratios that have proved to be valuable indicators of long-term trends in the past. All of these continue to suggest that stocks remain in a long-term bear market versus real assets, with the possibility that stocks could be set to embark on another leg down after a two-year consolidation.

<u>Equity Indexes</u>	<u>February</u>	<u>2011</u>	<u>Market Indexes</u>	<u>February</u>	<u>2011</u>
S&P 500 Index	+3.4%	+5.9%	HFRX Global Hedge Fund Index	+0.7%	+1.3%
MSCI World (ex USA) Index	+3.5%	+5.7%	US Dollar Index	-1.1%	-2.6%
Amex Oil Index	+5.5%	+12.5%	CRB Commodities Index	+3.3%	+5.9%
Gold and Silver Index	+7.7%	-5.0%	Gold (Continuous Contract)	+5.9%	-0.1%

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At the beginning of 2011, the market's uptrend from its low in mid-2010 remained intact, but there was very little evidence that the market was rising due to strong buying. Instead, stocks continued to 'drift' higher as volume remained relatively low and breadth remained weak. These conditions have kept us in a more conservative stance in all of our portfolios, because such conditions usually produce limited gains while being vulnerable to significant declines.

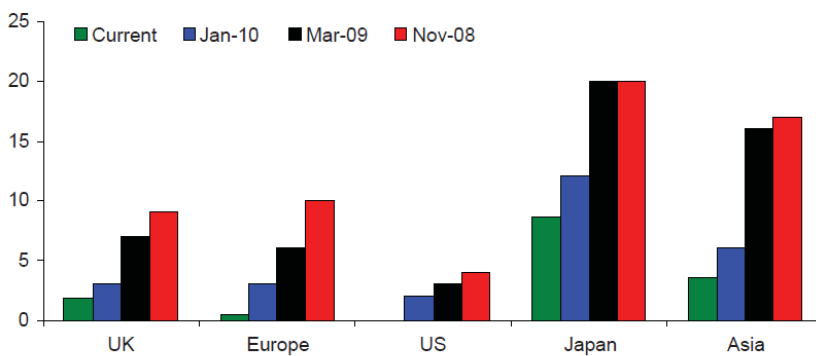
If we look back historically, market gains that are made with underlying strength in terms of volume and breadth usually prove to be durable. In a bull market, these gains are often never given back, and in a bear market, they are not usually given back for some length of time.

However, gains that are made with weak volume and breadth often prove to be far more susceptible to being taken back sooner rather than later. In a bull market these weak market conditions usually appear at the tail end of a long advance, and gains made are usually given back in a subsequent correction (or cyclical bear market). In a long-term bear market, these weak market conditions have usually been an indication that prices were about to decline significantly.

Coming off the March 2009 low, the market gained quickly and the gains were powered by strong volume and breadth. Since late 2009, however, the market has gained modestly under weak conditions in a way very similar to how late gains have been made in large corrective rallies during previous long-term bear markets. The most striking similarity is with the rally from April 1938 to January 1940.

During that time the market recovered from a severe decline that began in 1937, in which the S&P Composite declined 56% in a little over a year. This decline was partially precipitated by a collapse in the economic stimulus put in place during the Great Depression (the recent decline in 2007-2009 occurred ostensibly for the same reason). Following the low in April 1938, the S&P Composite rose over the following two years for a peak gain of 65%.

% of Stocks Passing Graham's Deep Value Screen*



* With additional criterion that stocks have a Graham and Dodd P/E of less than 16.5x.

Source: GMO

However, the market never fully recovered its losses from the previous decline, and the gains were made with low volume and generally weak technical conditions—similar to what we have seen over the past year and a half.

During the following two years, between 1940 and 1942, the market began to decline again. By the end, the market had fallen to a new marginal low, having taken back all the gains made during that weak recovery.

The same thing happened repeatedly to Japan's Nikkei average with the declines in 1994-1995, 1996-1998 and after the peak in early 2000. Each of these declines followed what appeared on the surface to be a reasonably strong advance. The peak in 1994 ended a 52% rally; the peak in 1996 ended a 59% rally; and the peak in 2000 ended a 63% rally. The more recent peak in 2007 followed a 141% rally over the previous 4 years, but the Nikkei then took back all those gains, and a little more, as it declined to a new low in 2008. All of these rallies could have been characterized as "new bull markets" at the time, but they were eventually given back because the Nikkei was in the middle a long-term bear market.

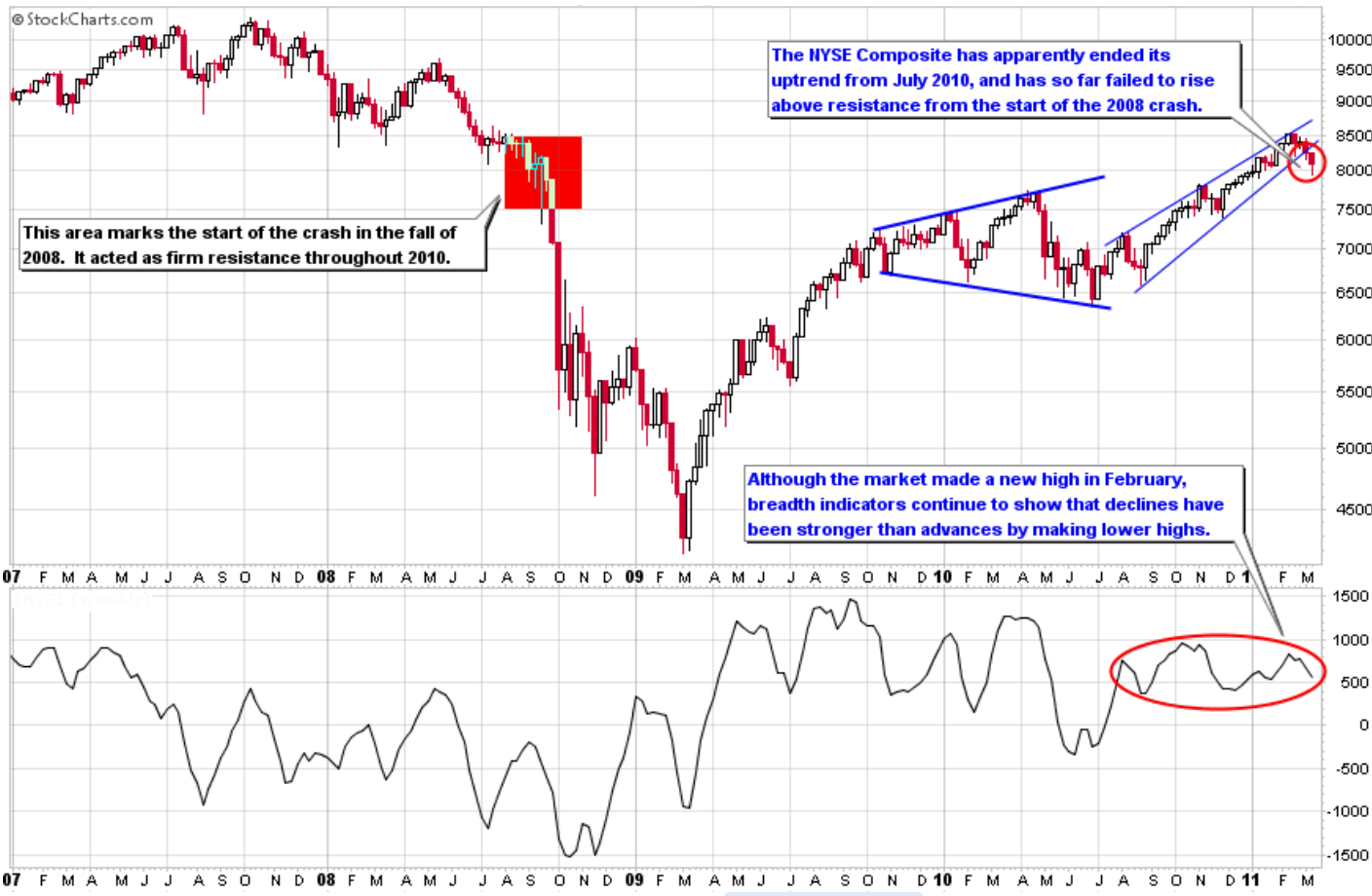
What we see over and over again during long-term bear markets is a willingness by the market to dramatically zigzag its way down to final valuation lows. Along the way, investors are thrown out of the market during severe declines, and then sucked back into the market during dramatic rallies. At the end of a long-term bear market, the public is so fed up with stocks that the market is left at truly low valuations – because no one is interested in owning stocks any longer. The U.S. stock market is still a long ways away from that end; valuations are high again, which reflects a strong willingness by investors to own stocks.

In contrast, Japan’s stock market is near or at the end of its long bear market, and valuations and sentiment reflect it. Japan’s market suffers from deeply entrenched neglect, both by the Japanese public and by professional investment managers. Japanese citizens only have roughly 3% of their assets in stocks, and the vast majority of global investment managers avoid exposure to Japan entirely in their allocations. Valuations reflect this reality, as Japan has a higher percentage of stocks meeting Benjamin Graham’s value criteria than any other major economy in the world (see chart on previous page).

We currently have positions in Japan in our Absolute Return portfolio, the first of which were purchased in 2008. We have been adding to our Japan exposure over the past year not because it represents the likely source of immediate gains, but because it represents the value one is able to buy near the end of a long-term bear market. The recent earthquake has lowered already depressed valuations in Japan, as the Nikkei has fallen more than 20% from its pre-earthquake level. For long-term value investors, this only makes Japan more attractive.

It usually takes many, many years for prices and valuations to recover from a long-term bear market, and it will almost certainly take a long time in Japan. Between now and then, there will likely be a debt crisis in Japan, which will likely weigh heavily on the value of the Yen. However, our guess is that it will spark a

NYSE Composite, 2007-Present



shift by the Japanese public and domestic institutions - which own ~95% of Japanese government debt - from bonds back into equities. Long-term investors in Japan today not only have valuations on their side, but they will be the likely beneficiaries of a large-scale shift back into stocks by the Japanese public at some point in the future. These are the favorable conditions usually present only near the end of a long-term bear market.

Since the beginning of this year, there have not been any developments in the U.S. market that would offer a more encouraging short-term outlook, and in fact the situation has deteriorated over the past few weeks. The uptrend that remained intact at the start of the year has recently broken down, which puts the market in a vulnerable position (see chart on previous page).

Given that prices have risen from last summer's low on such a weak technical foundation, there now is a risk that the gains made over the past 8 months could be given back rather quickly. Whether the market will actually realize that risk is impossible to know, but history teaches us that it is likely enough to prepare for.

As we have seen the major equity indexes break down over the past few weeks, we have also seen stock prices move lower against real assets such as oil and gold.

Over the past 2 years stocks have been keeping pace with the rise in real assets, but that has occurred within a larger downtrend which has been firmly in place since 1999.

Most investors would probably be surprised to learn that despite the rally over the past 2 years, stocks in the US and around the world remain near their lows versus gold.

Since 2009 both the Dow Industrials and Oil have been trending higher together following the turbulent swings in 2008. However, the recent spike in the price of oil has been enough to end that 1½ year consolidation in the Dow/Oil ratio.

This leaves open the possibility that stocks (including energy stocks) could be about to decline significantly versus oil. This could occur by a continued rise in the price of oil, a decline in the price of stocks, or some combination where stocks decline relative to oil.

At the same time, the current consolidation in the Dow/Gold ratio - the 4th such consolidation since 1999 - is now 2 years old. The longest consolidation prior to this one lasted 2½ years between 2003 and 2005, and it ended as gold advanced from the low \$400s to \$730 in 2006.

Dow/Oil Ratio (top), Dow/Gold Ratio (bottom)



While in 2005 and 2006 it was gold advancing more than stocks that resulted in a declining Dow/Gold ratio, it seems possible this time around that it may be gold remaining steady or falling less than stocks that results in a declining Dow/Gold ratio, as happened in 2008. After such a strong advance in commodities and stocks over the past 2 years, there is no reason why we could not see a period where both decline for some time – even as gold and oil continued to outperform.

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One of the clear lessons from market history is that declines usually happen far faster than advances, and that is doubly true in long-term bear markets. It is also an investing truism that timing all the market's zigzags during a long-term bear market is especially difficult. For many investment managers, the pressure to perform often results in going along with the market just as valuation and technical arguments suggest one should be stepping away, because it is during those times when the public is most enthusiastic about the market.

One of the benefits of being based in a small town 2500 miles away from Wall Street is that we can keep our focus entirely where it should be – on investing our portfolios in a manner that is consistent the market environment. That focus currently has our portfolios in a mostly defensive stance because the risk of a significant decline in a number of markets has left worthwhile opportunities few and far between.

However, even though we are defensively positioned, we stand to gain when some long-term trends re-assert themselves. For instance, when stocks begin another move lower relative to gold, we will likely gain regardless of which direction stocks and gold move on their own.

Positioning our portfolios in alignment with these firmly established trends will not necessarily produce immediate gains, especially if the market conditions we have seen over the past 2 years continue in the months ahead. However, it is a relatively low risk approach to investing in a market that is over-valued and technically stretched very thin. By the time we reach the next real buying opportunity in the stock market, our current approach will likely have proved worthwhile.

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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