



# Sitka Pacific

Capital Management LLC

## May 2010

Dear Investor,

April saw stocks continue modestly higher, with the S&P 500 gaining 1.5% for the month. However, the gain came amid a notable increase in volatility in the latter half of the month, along with a decline in many markets outside the US. The MSCI World (ex USA) index declined 1.8% in April, with China's market leading the way with an 8% loss.

As you probably know, a 4-day decline during the first week of May included a brief 1000-point decline in the Dow Industrials. While the causes of that decline are probably technical in nature, it was not entirely surprising to see such a decline, given the extreme sentiment in recent months (see last month's letter).

Fears of a spreading debt crisis in Europe, primarily in Greece and Spain, created some of the same market dislocations as the sub-prime crisis did in 2007. In response, governments in Europe have cobbled together a \$1 trillion bailout plan to help indebted euro-zone countries refinance their debt. However, despite the bailout plan, the euro continued to fall against the dollar and most other major currencies. This buoyed the US dollar index by 5% through April.

Moreover, the rising dollar did not halt gold's advance. Gold gained nearly 6% in April, and in early May gold rose to a new all-time high above \$1240/oz.

The flight to safety out of the euro area into the US dollar benefited both US Treasuries and precious metals. Yields on Treasury bonds and notes peaked in early April before declining precipitously. The 10-year Treasury note yield rose to 4.013% on April 5, and then declined to end the month at 3.663%. This move down in US government yields coincided with a sharp rise in sovereign yields in some parts of Europe.

During the financial reform hearings in Washington, the debt crisis in Europe reached a boiling point. Essentially, the markets moved forward, focusing on new economic trends and concerns, even as the political gaze remained fixed on the rear-view mirror of the housing bubble that has long since popped. This awareness is showing up in the performance of various asset classes, especially Treasury bonds and precious metals. With those thoughts in mind, this month we will take a closer look at gold's long-term bull market.

<u>Stock Indexes</u>	<u>April</u>	<u>2010</u>	<u>Market Indexes</u>	<u>April</u>	<u>2010</u>
S&P 500 Index	+1.5%	+6.4%	HFRX Global Hedge Fund Index	+0.8%	+2.5%
MSCI World (ex USA) Index	-1.8%	-1.1%	US Dollar Index	+0.9%	+5.0%
Amex Oil Index	+1.4%	+2.3%	CRB Commodities Index	+1.6%	-2.0%
Gold and Silver Index	+8.3%	+6.4%	Gold (Continuous Contract)	+5.9%	+7.5%

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One of the most frequently heard criticisms about gold is “Gold has no dividend and no earnings, and therefore there is no way to value gold, nor is there any reason to invest in it.” While from a certain point of view this assessment is true, it misses the main reasons for holding gold in the first place.

Gold is not an investment in the traditional sense. It is not a share of a business, such as a share of stock. It also isn't a debt certificate, such as a bond or a CD, which formalizes a loan between two parties. Gold is best thought of as a way to store value, the way currencies do—or rather, the way currencies are *supposed* to do. Thus, attempts to value gold with methods usually used for investments will always give the wrong results.

Until recently the world's currencies were all backed by gold to varying degrees. Indeed, it was not so long ago that you could directly exchange US dollars for gold. Since that time, most citizens and investors have forgotten that the past few decades have been a grand experiment in currencies backed only by government decree—by fiat.

Although fiat currencies can be created at will, diluting the value of the existing notes in circulation, gold has to be mined at significant expense. Since the amount of new gold mined each year is very small, gold is often viewed historically as a source of stable value.

During periods of turmoil when currency was backed by gold, people would often exchange their currency notes for gold at the official exchange rates because of the risk that the currency would be devalued.

For example, in times of war, governments would often print currency to fund the military. That increase in the amount of currency in circulation represented new claims on the country's existing gold reserve.

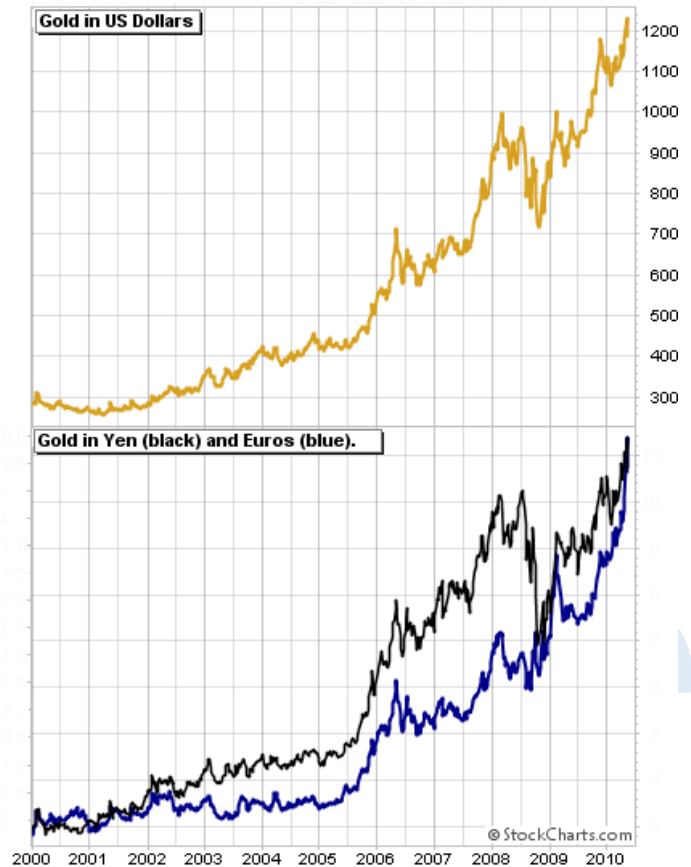
When the war ended, an official devaluation of the currency against gold brought a new equilibrium.

During the Great Depression, most countries devalued their currencies or left the gold standard entirely. In the US, the gold exchange rate changed from \$20.67 to \$35 in 1933. This increase in the exchange rate of gold effectively devalued the US dollar by 41%.

In 1971, the US dollar was officially made un-convertible to gold. This officially “unmoored” the dollar from any value relative to gold. Since 1971, the dollar has been backed only by the full faith and credit of the US government.

Since then, the value of the US dollar in gold has floated freely. From 1971 to 1980, gold rose from \$35 to a peak near \$850. This 96% decline in the value of the dollar in gold was partially a pent-up response to all the currency that had been printed in the decades since the last devaluation during the Great Depression. It

Gold in Dollars, Yen & Euros, 2000-2010



was also partially a speculative rise, as the newly free-floating price of gold was subjected to all the forces that influence asset prices in financial markets.

As happens in almost all speculative rallies, the subsequent decline in the price of gold during the 1980s and 1990s took back the portion of gains that were part of the final “bubble” phase of the rise to \$850. By 2000, gold was trading near \$250, which still represented an 86% devaluation of the dollar versus the official exchange rate of \$35 established in 1933.

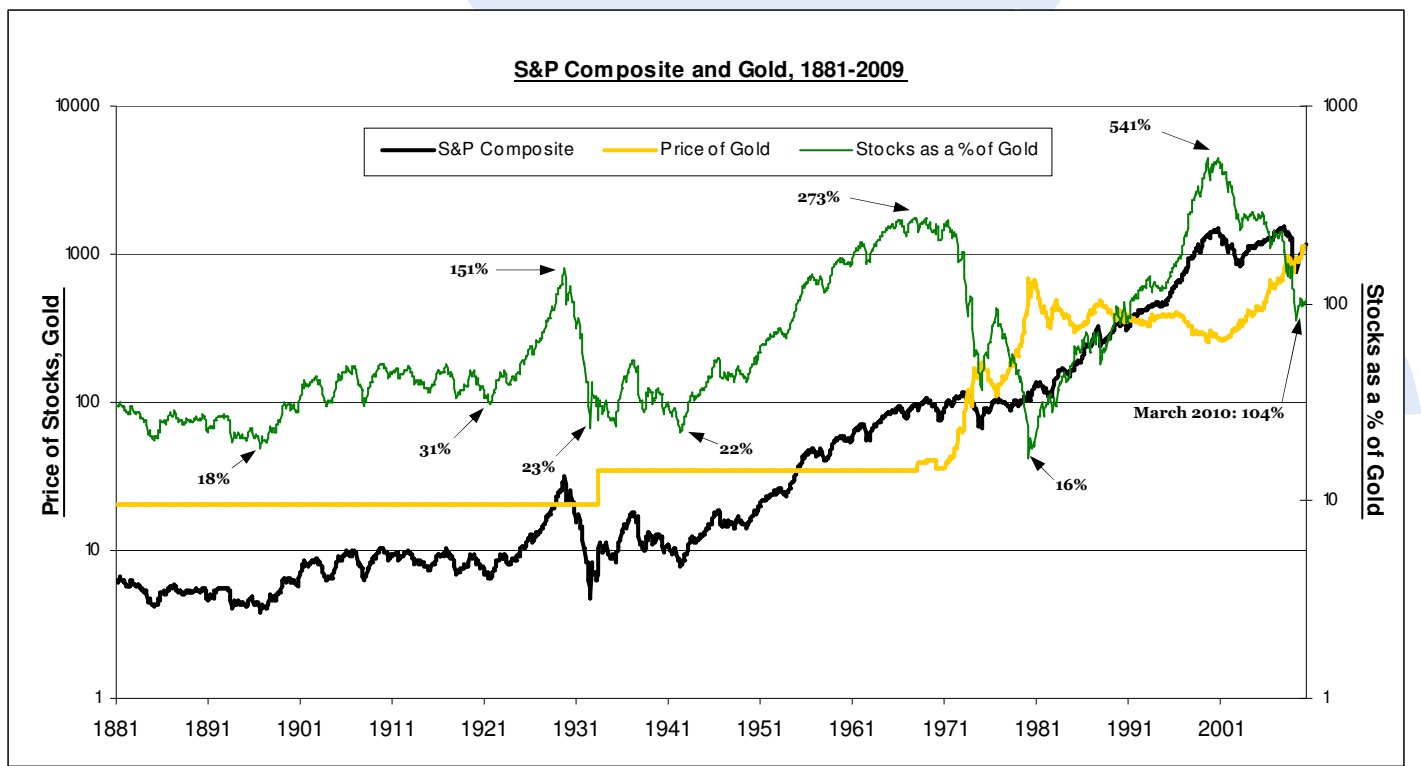
Now that the exchange rate of dollars into gold is set in the marketplace, we see the change in value of the dollar in real time. Over the very short-term the price of gold will be influenced by the ebb and flow of sentiment and other factors that influence the price of any asset traded in financial markets. However, over the long-term, the price of gold in any currency is a function of how much that currency is devalued by the government that prints it.

Since the value of a dollar is always changing, the real price of a stock index like the S&P 500—which is quoted in dollars—is a moving target. We can get a much better sense of whether stocks are undervalued or overvalued if we compare stocks to long-term earnings averages (like the 10-year P/E Ratio) and to gold, since both of these will remove the effects of a devaluing currency.

The chart below shows the price of the S&P Composite, the price of gold and the ratio of the S&P Composite to gold (the green line) from 1881 through March 2010. Over the past 130 years, the S&P Composite has traded as high as 541% of the price of gold in the year 2000, and as low as 16% of the price of gold in 1982. As with valuations, stocks have gone through long-term cycles of rising and falling against gold.

The S&P Composite is currently trading near the price of gold—104% of gold at the end of March. Stocks have lost roughly 80% of their value relative to gold since 2000, but that doesn’t necessarily make stocks cheap. In the past, durable lows have been made between 16%-31% of the price of gold.

The main message of the chart below is that throughout various currency regimes, periods of inflation and deflation, and economic boom and bust, the price of stocks relative to gold has fluctuated between a range



of highs and lows. This is exactly what we would expect to see when we strip out the effects of currency depreciation. While the peaks have been increasing (151% in 1929, 273% in 1967, and 541% in 2000), the level at which significant lows have been made has remained more or less constant.

The implication is that while stocks have already lost ~80% against gold, they will most likely lose another 70%-80% against gold before this long-term bear market is over. That may sound like a fantastic claim, but it would simply be another repeat of history that so far has no exceptions. The real challenge in the coming years will be to discern *how* that devaluation will happen.

Adamant inflationists argue that the US and other governments will print currency in the coming years to overcome structural debt problems, and that will result in an inflationary outcome similar to the 1970s—which resulted in a meteoric rise in the price of gold.

For example, in 1976 gold traded around \$120, which was nearly 250% higher than its fixed price before 1971. However, over the next 4 years, gold rose another 7-fold to near \$850 as inflation drove stocks down towards their valuation lows.

With gold currently near \$1200, the inflation argument suggests gold could trade higher toward \$8000 in the coming years. If stocks were to remain near their current level while this happened, that would bring the S&P/gold ratio down in the range of past lows.

Adamant deflationists essentially argue that the ongoing destruction of credit will overwhelm any currency printing by the government, and that will result in an overall reduction in money supply that keeps prices on a downward path. This is certainly what we have seen over the past 3 years.

The market implication of the deflation argument is that stocks will likely decline much more than gold will rise and it will primarily be a decline in stocks that will bring the S&P/gold ratio down within range of past long-term lows. Following the deflationists' argument, with gold remaining near \$1200, the S&P Composite would have to decline more than 75% to below 360 to be in range of past lows of the S&P/gold ratio.

Those are both relatively extreme potential outcomes, promoted by relatively extreme viewpoints. The flaw in the inflationists' argument is that we are in a very different economic environment than the 1970s. The credit and housing bubbles have burst, and along with demographic issues this points to a continued *deflationary* period ahead.

However, the flaw in a purely deflationary argument is that, unlike during the 1930s when most countries were on the gold standard, governments can and will print currency in the coming years to address the problems in the economy. We have seen the latest iteration of this in Europe's \$1 trillion bailout of Greece and other heavily indebted euro-zone countries.

Stepping away from those extreme potential outcomes, the most likely potential outcome is a continuation of the trends that have already been in place since 2000. Over the past decade, gold has risen 380% and nominal stock prices have fallen roughly 30%.

This combination of rising gold and falling stocks has resulted in the 80% decline in stocks relative to gold that we have seen over the past 10 years. It appears most likely that a continued trend higher in gold along with additional declines in the stock market is what will bring us to the end of this bear market in the years ahead.

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The expectation that we will see a continued rise in gold accompanied by a continued decline in stocks in the coming years is one of the reasons we generally suggest clients spread their investment with us among different portfolios, if they can. This makes it more likely that you will come out ahead, regardless of the exact path the markets take.

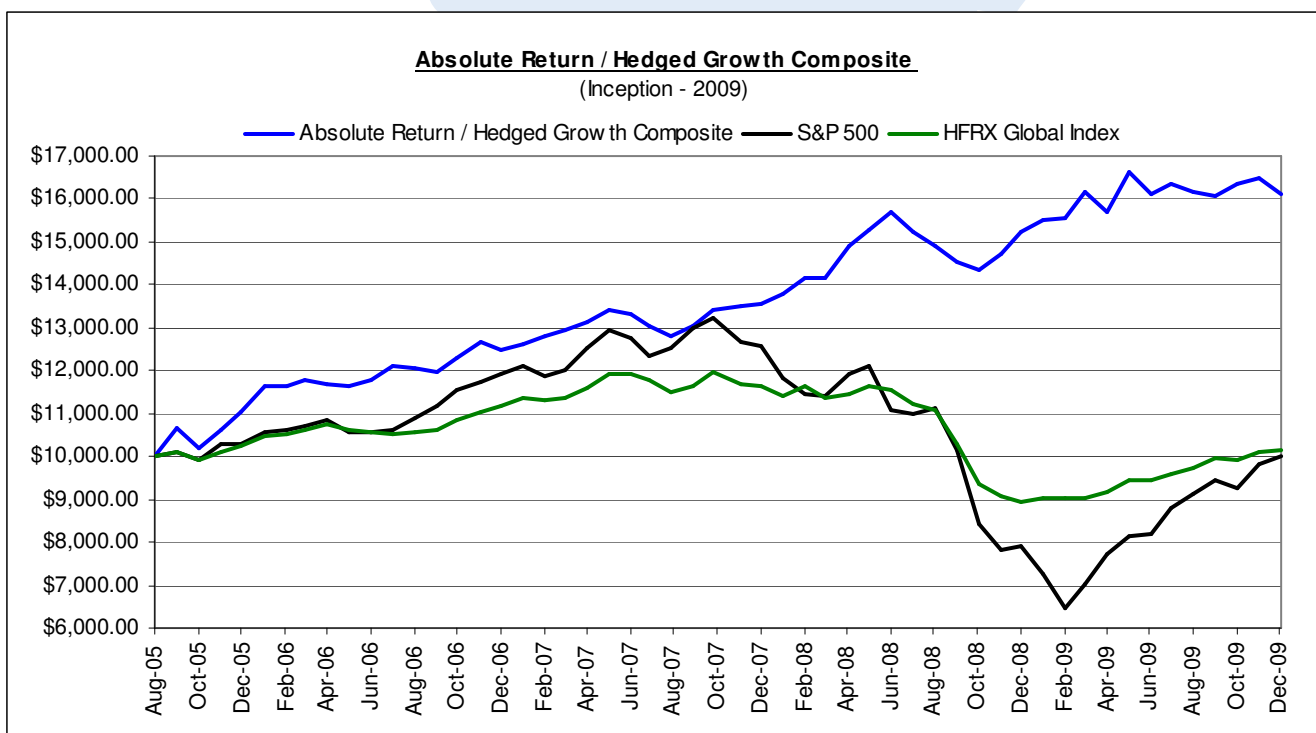
A typical suggestion we make is for clients to split their assets between the Absolute Return portfolio and the Hedged Growth portfolio. Absolute Return is a actively managed portfolio that invests in a broad array of asset classes, including commodities, bonds and stocks. Hedged Growth is a long/short equity portfolio that buys stocks and sells other stocks short.

A prudent approach to the market in the years ahead is not to “guess” the exact path the markets will take and then wager everything on that one outcome, although there are many investment advisors who are doing exactly that. Instead, our goal is to take a hedged approach: we position ourselves for the most likely outcome, while protecting ourselves in case one of the more extreme outcomes comes to pass.

Over the past few years, there have been market environments which strongly favored Absolute Return (e.g., 2009), and other times that strongly favored Hedged Growth (e.g., 2008). This is part of the “mixed” inflationary/deflationary trend over the past decade that alternately favors different investment approaches, and we expect to see that continue in the years ahead.

While it is tempting to try and guess which market environment we’ll see in the coming years, the guesswork is taken out of the equation by having part of your investment with us in each portfolio. This chart shows the returns of an investment 60% in Absolute Return and 40% in Hedged Growth, which is a typical split we recommend. Since we expect this bear market to be resolved by both a rise in gold and a decline in stocks, both Absolute Return and Hedged Growth will likely have their opportunities in the coming years.

We realize that it may not be possible for you to allocate among different portfolios, especially if you have an IRA or trust that does not allow shorting. We compensate for this by actively managing all of our portfolios for risk—stepping to the sidelines when appropriate, while waiting for the inevitable opportunities that present themselves for each portfolio.



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With all that is currently going on in the markets, from the debt troubles in Europe to the market failure behind the recent 1000 point drop in the Dow Industrials, it may seem odd to have lengthy discussions in recent letters about long-term trends in gold and stocks. However, just like in 2007, the past 6 months have been *the* time to have these long-term discussions, so that investors are not caught flat-footed when the trends change.

Although stocks, commodities, and gold have risen over the past year, we are currently positioned defensively in anticipation of a pullback. We have been anticipating this pullback for some time, and until recently the markets have continued modestly higher. However, because each advance has been technically weaker than the last, the risks have only risen as the markets moved higher.

There is a wide range of potential paths the markets could take over the next two years, and in the coming months we'll discuss those in more detail. For now, it does in fact appear that the trend in the stock market has turned down. The market action in the next six months will tell us a lot about the nature of this rally from the low in March 2009; specifically, whether it is part of a new larger trend higher that will last several years, or whether it is a technical rebound from the 2008 crash that will ultimately be given back.

In the short run, a significant decline in the stock market could pull down gold and other precious metals, as it did in 2008. However, this would likely have little impact on the long-term trends we've discussed. We reduced our exposure to gold mining stocks near the end of 2009, because they are most vulnerable to a decline in the stock market. When the market risk associated with mining stocks is reduced, we will increase our allocation again. With any luck, it will be at lower prices than today.

If you have any questions about your account or issues raised in this letter, just send us an email or give us a call. We would enjoy hearing from you.

Sincerely,  
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