



Sitka Pacific

Capital Management LLC

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Dear Investor,

After recovering from a decline in March, the S&P 500 reached a marginal new high for the year in late April, before declining again in early May. As of this writing, the S&P 500 now sits near 1330, a level it first reached in February. The MSCI World (ex USA) Index and the MSCI Emerging Markets Index are in similar positions – they are currently in positive territory for the year, but have had trouble maintaining advances to new highs.

From a technical perspective, the U.S. stock market remains, at least in our view, in a very vulnerable state. Although the Fed’s current quantitative program has succeeded in boosting asset prices, the advance in stocks over the past 6 months has been made on a particularly weak foundation. In fact, the deterioration in the market’s technical condition has accelerated in recent months, most likely as risk assets are being distributed in advance of the end of QEII in June.

The most notable market action over the past month was the parabolic rise, and then collapse, of the price of silver. Silver reached a high of \$49 in late April, and then fell back down to \$33 within a week (a 33% decline over 5 trading days). This undoubtedly marks a top of some significance for silver, but just how significant is not yet clear.

While some economically sensitive commodities have declined in recent weeks (oil declined 17% over 4 trading days in early May), gold has so far declined just over 5% from its recent high in April at \$1575. The outperformance of gold versus other, more economically sensitive commodities is typical during an economic downturn. If we continue to see gold outperform silver and oil while maintaining the bulk of the gains made over the past two years, it’s likely the recent high in silver will be recorded as a significant intermediate-term peak within its larger bull market (not unlike gold’s top at \$730 in 2006). In fact, this is our expectation.

While the Fed’s second quantitative easing program successfully put the sovereign debt issue on the back burner for most of the past 6 months, in recent weeks the markets have again begun to focus on potential debt problems on the horizon. Greece has been making headlines again, as it has become clear its government debt is unsustainable; 2-year Greek government notes now yield 26%, signaling that a default is all but inevitable. In the following pages we’ll continue the discussion from February’s client letter and the *2010 Annual Review* on U.S. government debt, and look at our debt relative to our private economy.

| <u>Equity Indexes</u> | <u>April</u> | <u>2011</u> | <u>Market Indexes</u> | <u>April</u> | <u>2011</u> |
|---------------------------|--------------|-------------|------------------------------|--------------|-------------|
| S&P 500 Index | +3.0% | +9.1% | HFRX Global Hedge Fund Index | +0.5% | +0.9% |
| MSCI World (ex USA) Index | +5.1% | +8.4% | US Dollar Index | -3.7% | -7.5% |
| Amex Oil Index | +1.8% | +15.6% | CRB Commodities Index | +3.1% | +11.3% |
| Gold and Silver Index | +2.5% | -1.9% | Gold (Continuous Contract) | +9.1% | +10.0% |

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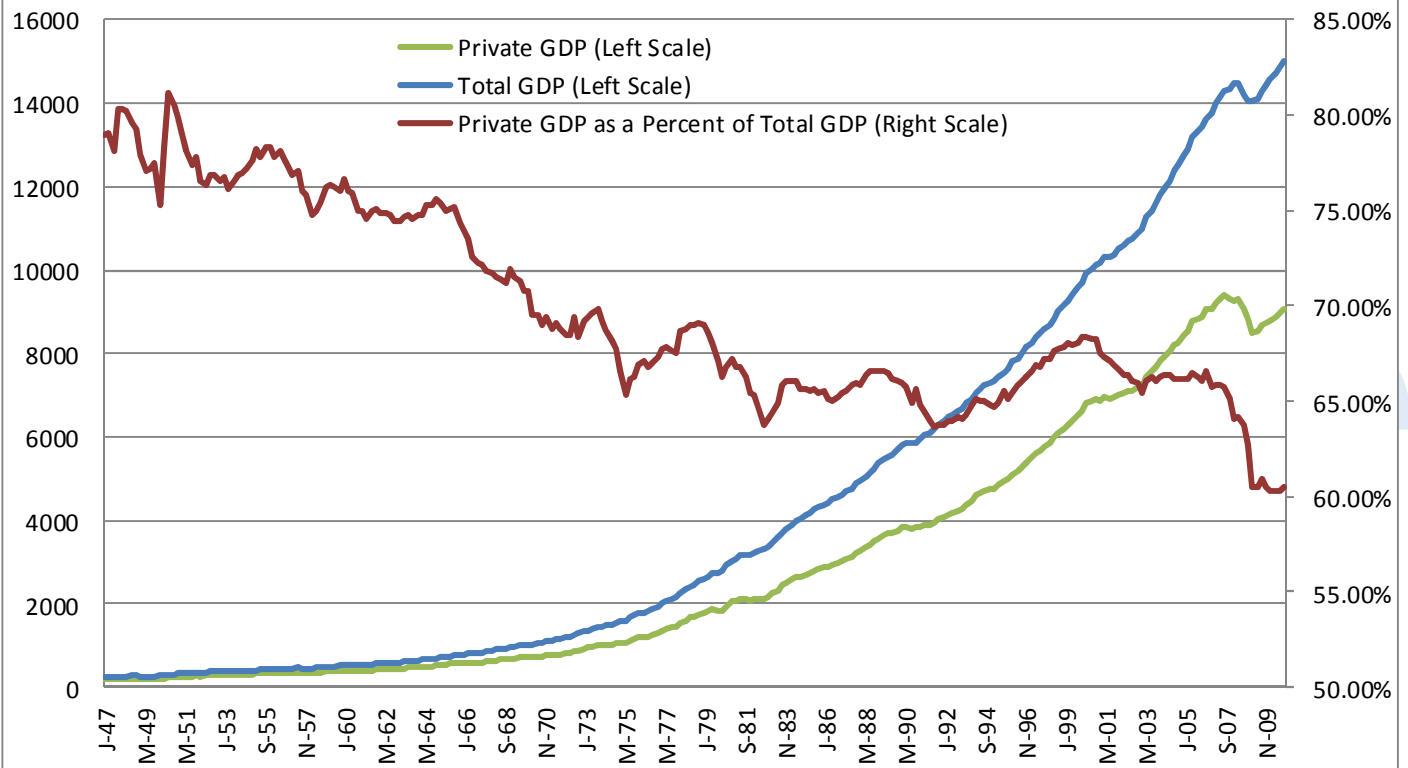
The growth of the federal government debt has been given a lot of national attention over the past year, and with the attention has come a vast array of various statistics and numbers—many of which serve to confuse the issues we face. However, when we boil them down to their essence, the issues are quite simple.

In a recent interview on Bloomberg, Mohamed El-Erian, the co-CEO of PIMCO, very succinctly laid out the limited options a country has when it has accumulated too much debt. The economy can grow its way out, which increases revenues to the government and thereby increases its ability to service its debt. The government can impose austerity to reduce spending to decrease deficits and debt growth to sustainable levels. The government can default, in which debt levels are reduced as bondholders are forced to accept less than they are owed. And last, but certainly not least, the government can inflate (or devalue) its currency, which reduces the burden of a fixed amount of debt.

Over the entire post-WWI period, we in the U.S. have depended on our economy to grow its way out of the government’s debt, and all while we have more or less constantly devalued the dollar. On the surface this combination of growth and inflation has been enough to keep government debt at moderate levels compared to the size of our economy. However, the comparison of debt to the size of our entire economy masks some important trends that suggest growing our way out of our current debt will be far more difficult than in the past.

The task of a country growing its way out of a large government debt burden falls squarely on the country’s *private economy*. Official GDP statistics include all activity within an economy, including private sector business activity as well as local, state and federal government activity. But it is only the part of the economy *outside* government activity, i.e., the private economy, that represents the true potential of the economy to grow its way out of government debt, because it is only this part of the economy that will increase the government’s revenue.

Private GDP as a Percent of Total GDP, 1947-2010

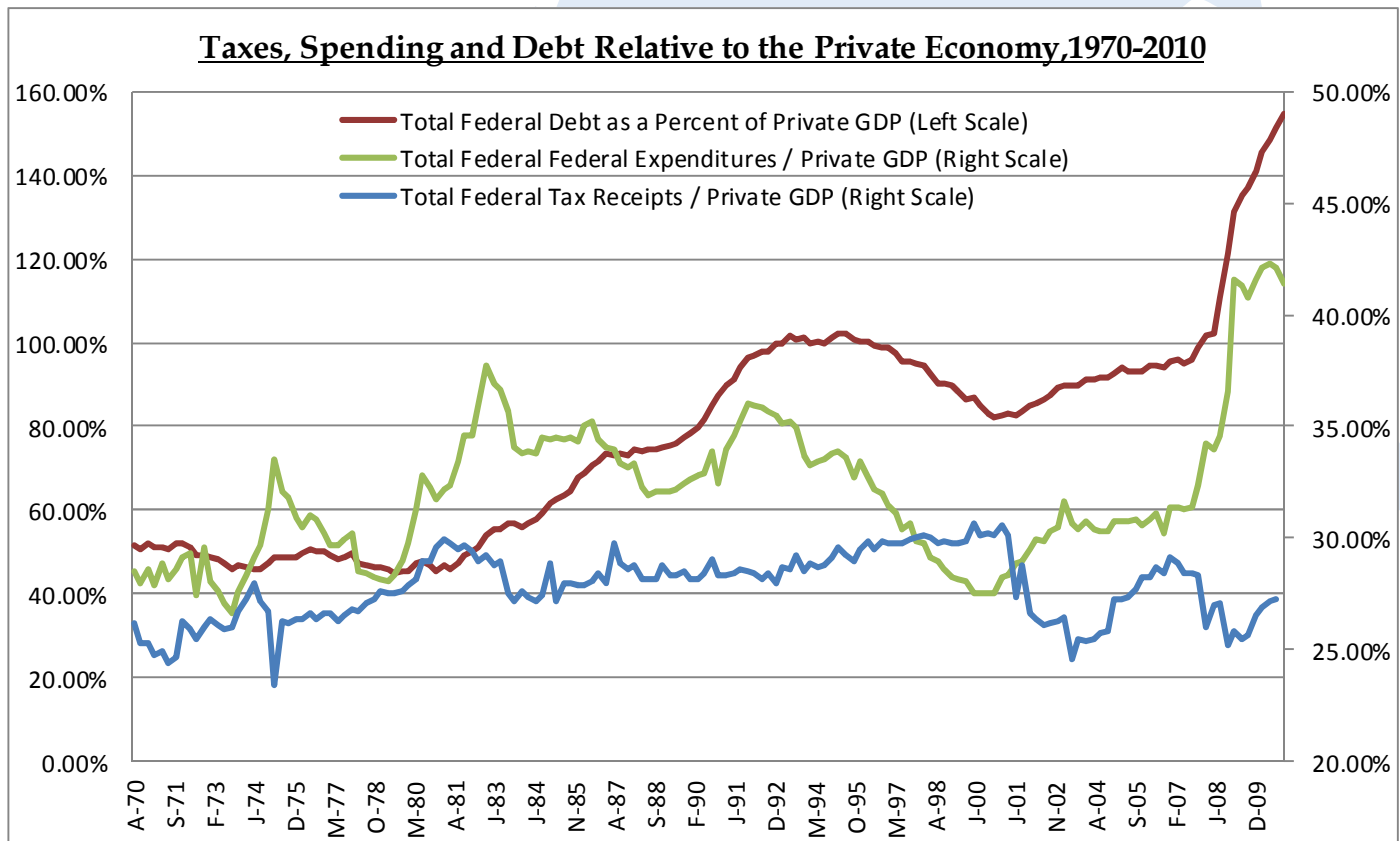


The share of the U.S. economy outside of government spending has been falling for most of the post-WWII period. Total local, state and federal government spending accounted for just over 20% of GDP in the late 1940s, with the private economy accounting for the remaining ~78+%. By early 1980, the private economy's share had fallen to 65% of GDP, and it has taken another dip with the recent recession. All told, at the end of 2010 government spending accounted for 39.49% of economic activity—twice the share of GDP accounted for by government spending in 1950.

As the effects of the housing/credit bust linger on, the private economy remains sluggish (green line on the previous chart) while overall GDP (blue line) has surpassed its previous peak. This divergence between private GDP and overall GDP has been due to the huge deficits the federal government has been running while the private sector continues to deleverage. In effect, the federal government has borrowed and spent huge sums over the past 4 years to offset the impact of a shrinking private economy – and, as far as overall GDP is concerned, it has worked.

The cost of that effort has been \$5.3 trillion in new debt. By the end 2010, the federal government debt-to-GDP ratio had risen to 93.46%, up from 62.92% at the beginning of 2007. However, since there has been such a large *structural* reduction in the private economy over the past 60 years, the current debt situation is worse than many of these traditional measures would suggest. If we scale the federal government's debt to private GDP, we get to the core reason why the current rise in debt is alarming.

The red line on the chart below shows the federal-debt-to-private-GDP ratio. At the end of 2010, the level of federal government debt was 154.54% of the private GDP, up from 95.72% at the start of 2007. You can also see that while tax receipts as a percent of the private economy (blue line) have held fairly steadily near the average over the past 40 years, total federal expenditure as a percentage of the private economy (green line) has exploded to over 40% during the current recession. This difference between tax receipts and expenditures is the source of the federal government's deficit, and the federal debt will continue to increase until that gap closes.



As we discussed back in February, the going assumption is that the growth of the private economy will be significant enough to reduce the government's deficit to a manageable level in the coming years. This growth assumption is *the key* assumption that underpins the market's acceptance of the current deficit spending by the government, because it means that the large deficits of today, which remain near 10% of total GDP and 16% of private GDP, are only *temporary*. When the economy does finally fully recover, the thinking goes, the deficits will shrink and the growth in debt will slow down to a management rate.

Unfortunately, there are two issues that will likely prevent the private economy from growing enough to rein in government debt growth over the next 5 years: the housing bust and demographics. These two forces, which we have talked about many times over the past few years, will continue to exert a powerful undertow over the next 3-5 years. As a result, economic growth will be restrained, the economy will likely continue to underperform versus past post-war recoveries, and the deficit will likely not decrease as expected.

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The debt problems some European countries face today are similar to what we face here in the U.S., but because we have full control over our own currency we are unlikely to ever default on our debt. In short, we can print new money to continue our borrowing, as the Fed has done with QEII (the amount of Treasuries the Fed has purchased equates to most of the new debt issued by the government over the past 7 months). However, for those highly indebted countries that do not have control of their own currency, default is far more likely.

Based on current yields on Greek government bonds, the market is assuming that Greece—which does not control its currency, the euro—will have to default on its outstanding debt in order to keep its budget from spiraling out of control. This is nothing new for Greece; over the past 200 years, Greece has spent about as much time in default as not in default.

Greece is the first country to have gone through all the bailouts and required austerity cuts following the 2008 recession, and it has still failed to resolve its deficit and related debt issues. The outcome in Greece is therefore being widely watched to ascertain what is possible in dealing with these debt issues. A default could lead to a shift in how markets assess the risk inherent in sovereign debt in many highly indebted countries.

While the likelihood of an outright default here in the U.S. is remote, the long-term risk of inflation eroding the real value of our national debt is real. In fact, the only difference between the two is *how* the real value of debt is reduced—all at once, or over time.

If we think back to Mohamed El-Erian's comments, the most likely outcome for our debt problem here in the U.S. is a combination of austerity and continued devaluation of the dollar. With the ongoing real estate bust and the retirement of the baby boom generation, there is little chance the private economy will be able to grow enough in the next 5 years to compensate for the increase in government debt. There is also little chance of a real default here in the U.S., i.e., one in which the principle value of outstanding bonds is reduced. There is, however, a significant chance the government will have to reduce the deficit, either by spending cuts, tax increases or both, before the private economy is able to reduce the deficit through sustainable growth. This will contribute to the economy's below-trend growth in the coming years.

While the Fed's actions have worked to lower interest rates throughout the financial system by encouraging money to flow into risk assets of all stripes, it has been a "sweet spot" for the economy and markets, as yields have stayed low while asset prices have risen. However, it would be a mistake to think that the markets will continue to react in this way if the Fed continues more quantitative easing, especially if that continued monetary easing is accompanied by a realization that the economy will not be able to

grow its way out of the government's debt.

Without a voluntary reduction of the deficit, there is a significant risk that we will see some sort of market revolt over our deficits and debt growth before the effects of the housing bust and demographics have abated. The modest job growth and GDP growth we have seen over the past year has been entirely dependent on the government's ability to borrow ~\$1.5 trillion a year *at low interest rates*. The markets are currently rather sanguine about the prospects for all this borrowing, but this appears to be largely due to the assumption that growth in the private economy will continue to improve. If any news or event pokes a hole in that assumption, we could see markets rapidly change their assessment.

We think just such a change is likely to occur at some point, though the timing could not be more uncertain. With so much in the hands of politics in Washington and the Fed, instead of a normal economic cycle, it's impossible to say when events will take us further down the path toward a more sustainable economy and debt situation. We can say with some certainty that once the markets begin to price in the real cost of overcoming these issues, we'll see a far different market environment than we have seen over the past year.

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Thinking about all these debt issues isn't something that is necessarily enjoyable, but it also isn't something we can ignore in good conscience. Like the fallout from the housing bubble, the fallout from our ongoing deficits and money printing by the Federal Reserve will likely have far-reaching consequences. These are issues that should be factored into every investment decision made today, because they will have a significant influence in the coming years.

As we have seen in Greece, and other European countries such as Spain and Ireland, the markets often begin to anticipate debt problems far in advance of the situation becoming critical. This also was the case during the housing bust, as mortgage-related bonds began to fall in 2007—more than a year before the financial crisis of 2008. The stock market continued to make new highs in 2007, even though there were already large cracks in the mortgage bond market that were causing the most vulnerable hedge funds to collapse. Similarly, we are currently seeing large cracks in the sovereign bond markets in some parts of the world that are causing the most vulnerable countries to collapse.

One of the least visible things an investment advisor can do is to think about risk. However, it is also one of the most important (and neglected) things an investment advisor can do—if not *the* most important.

We have positioned all our portfolios to benefit modestly from what appears to be the most likely market relationships we'll see over next year or two, while at the same time not betting on any one particular part of the market rising or falling. Because of the high degree of uncertainty in how the markets and the economy will react to the end of QEII next month, another round of QE at some point in the future (which appears quite likely), changes in the deficits caused either by political or market forces, slowing emerging market economies, etc., the absolute price of stocks, bonds, commodities and gold could go any number of different directions from this point. However, within all those various possible market reactions are a number of relationships that offer far better odds.

For instance, in Absolute Return, Hedged Growth and Dividend Growth we are positioned to benefit from gold rising versus other commodities and the broader stock market. Yet we are not depending on gold continuing to rise and/or stocks and other commodities falling—we are only depending on gold ending its 2-year long trading range versus those other markets and starting another phase of outperformance.

Under certain circumstances it is certainly possible that gold could fall in the year ahead, as it did in 2008. This would become far more likely if the Fed took its foot off the monetary gas pedal just as the global

economy slowed down (recent manufacturing reports suggest this is possible). It is also possible that stocks and other commodities could continue to rise in the year ahead, especially if the Fed introduced QEIII sooner rather than later, for any number of reasons.

In both of those circumstances, however, gold would probably outperform stocks and more economically sensitive commodities. By positioning ourselves to benefit from this likely *relative* market relationship, we effectively remove much of the economic and political uncertainty over the next 6–12 months. As a result, this approach offers a good chance for generating a modest return, and at the same time it addresses a number of significant risks on the horizon.

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As a final note, while we spend a lot of time (and a lot of pages in these letters) talking about risks and the potential for negative outcomes in the markets, the positive side is that we are starting to see how we may reach a level of real long-term value at some point in the next few years.

We already have set our sights on a number of sectors and individual stocks here in the U.S. that could conceivably reach very attractive long-term valuations under the right circumstances. Also, there are a number of markets outside the U.S. that could become quite attractive following the current debt problems and a resolution of China's property bubble (with its likely effect on commodities).

For now we remain primarily focused on protecting capital, but once these imbalances are priced into the markets our investment approach will necessarily shift gears. In all of our portfolios, we are already anticipating that shift.

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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