



November 2009

Dear Investor,

In October the stock market's rally stalled, with the S&P 500 recording its first monthly loss since the March low. It was a small decline, in which the market ended at its lows after being higher early in the month. By early November, stocks had recouped most of their October losses.

The US dollar fell last month as well, by 0.5%. Although the dollar has continued to decline over the past several months, the fear of an outright collapse in the dollar has seemingly reached a fever pitch. However, the actual market data is not that scary. In the three months following early March, the dollar fell more than 10% from its peak as stocks rallied from their low. In the *five months* since then, the dollar has fallen less than 4%. In other words, fears over the dollar have reached a heightened state even as the decline in the dollar against other currencies has slowed dramatically.

This fear of the dollar's fate has helped buoy commodities and stocks, although not as dramatically as most news coverage seems to suggest. Gold has certainly entered the next phase of its bull market, as we mentioned last month. However, more economically sensitive commodities have stalled recently.

For instance, although copper has rallied more than 140% from its low last December, it has managed to gain only 5% over the past three months. Oil reached \$73/bl in June from a low near \$35, but is now trading only slightly above that level near \$78/bl—a 7% gain. And during the last several months, the S&P 500 has made new highs by only a couple percent at a time after initially rising more than 50% from its March low.

These modest gains have taken place during an incredible surge of bullish sentiment and almost universal certainty that the housing bust is over and the world's economies are on the road to recovery. It goes to show that markets don't often make tremendous progress when everyone is bullish. In fact, it's often at times like this when markets contain the least potential return and the most risk.

The US economy has indeed pulled back from the brink this year, as the positive Gross Domestic Product for the third quarter attests. However, the question now is whether we have truly turned the corner, or whether this rebound has been just a lull in the storm. Since it has been quite a while since we have looked at data from the center of the storm, this month we'll take a look at some charts from the housing market that may offer a preview of what could be in store for real estate in the next few years. As always, we'll then turn our attention to the markets.

<u>Stock Indexes</u>	<u>October</u>	<u>2009</u>	<u>Market Indexes</u>	<u>October</u>	<u>2009</u>
S&P 500 Index	-2.0%	+14.7%	HFRX Global Hedge Fund Index	-0.1%	+10.9%
MSCI World (ex USA) Index	-1.7%	+25.0%	US Dollar Index	-0.5%	-6.0%
Amex Oil Index	+2.8%	+7.5%	CRB Commodities Index	+4.2%	+17.8%
Gold and Silver Index	-5.3%	+26.5%	Gold (Continuous Contract)	+3.8%	+18.3%

Over the past several months, hard data has confirmed that home prices are not falling as fast as they were before. Earlier this year, the Case-Shiller home price indexes were showing nearly 20% average annual declines from the equivalent point in 2008. As of the most recent release, the same indexes are now showing a 10%–11% decline from a year ago.

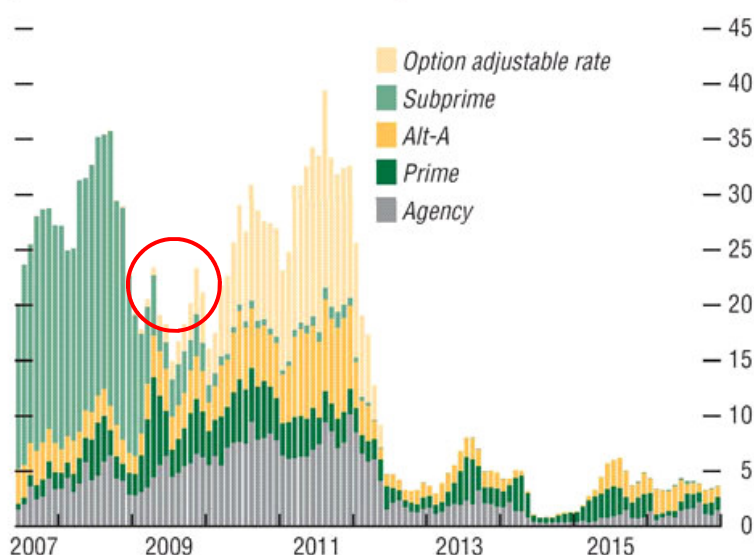
There has been a tremendous amount of government effort, including trillions of dollars, that has gone into arresting the housing decline. The government has given a tax credit to first-time homebuyers, in an effort to get more people buying homes. The Federal Reserve has purchased nearly \$800 billion in mortgage-backed securities since February, in a effort to keep mortgage rates low. And the Fed and Treasury department have given hundreds of billions of dollars to financial firms so that lending doesn't dry up completely.

That kind of stimulus on its own was bound to produce some positive effect on home prices. However, those efforts happened to coincide with a release of pressure from the mortgage market.

This chart to the right has been widely circulated over the past few weeks because it so clearly illustrates some critical factors influencing the housing market. It shows, in billions of dollars, the monthly amounts of various types of mortgages whose interest rates will begin resetting.

The red circle in the chart highlights that 2009 saw a dramatic drop-off in the amount of total mortgage debt that reset. This eased the pressure on the housing market and the economy as fewer homeowners felt the pinch of higher mortgage payments.

Figure 1.7. Monthly Mortgage Rate Resets
(First reset in billions of U.S. dollars)



Source: Credit Suisse.

Unfortunately, the drop-off in mortgage resets seen in 2009 is only a temporary respite. As you can see on the chart, the dollar value of mortgages scheduled to reset in 2010 and 2011 is going right back up again, until finally dropping off in 2012. Seen from this perspective, the conditions in 2009 appear to be more like the eye of the hurricane, not the end of it.

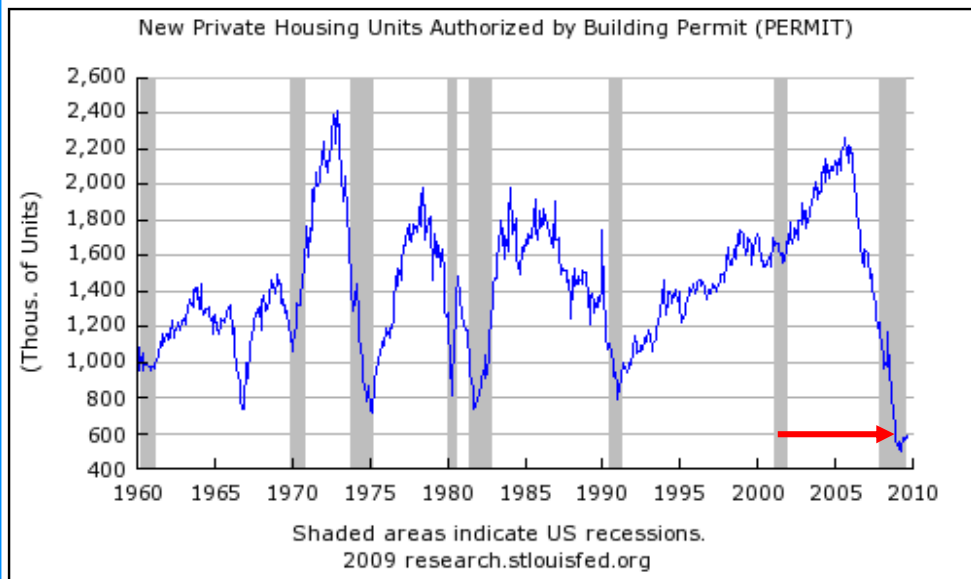
In fact, we are already starting to see some effects of the first bump-up in resets that is currently underway. In its 3rd quarter earnings release, bond insurer MBIA Inc. posted a loss after two consecutive quarters of positive results. The culprits: losses on credit derivatives and mortgage loans.

In the words of MBIA's CFO, "... losses in our insurance business were above expectations and the same housing-related performance trends drove our asset losses and impairments." With such a surprise coming so early in this next wave of resets, it's clear that there are more losses to come from financial assets linked to housing.

The entire financial meltdown in 2008 was triggered by sub-prime mortgage borrowers who suddenly faced higher payments they couldn't afford, but couldn't refinance because they were locked out of the

market. In the wake of the housing collapse, lending standards continue to become more restrictive and unemployment continues to rise. The next wave of mortgage resets will leave those homeowners with few good options other than to make the higher payments or face foreclosure.

This 2nd wave of mortgage resets is one of the reasons why there isn't much hope for a sustained increase in home prices over the next few years. It's unlikely we'll see the type of crash conditions we saw in 2007 and 2008, but the outlook for a sustained recovery appears to be dim.



In fact, the homebuilding industry itself is in agreement with this assessment.

Historically, a recovery in building permits has come before a rise in home prices, usually by a year or more.

The fact that the number of building permits being issued remains near the lowest level in more than 50 years of data suggests that homebuilders see no significant recovery on the horizon.

If we were on the cusp of a real recovery in housing, one that promised to overcome the weight of other negative market forces (e.g., mortgage resets) in the coming years, we would have seen the number of building permits rising strongly throughout this past year. That just isn't happening.

There has been a lot of talk recently about how the Fed is going to withdraw some of the stimulus it has created over the past year, since the crisis seems to have blown over. However, considering all that will hit the housing market over the next few years, it seems more likely that it won't be able to withdraw the stimulus it has put in place anytime soon.

In fact, it seems likely that the Fed will again have to put the monetary pedal to the metal in the coming years to contain the continued fallout from residential real estate, and the looming losses in commercial real estate.

It hasn't had much time in the limelight, but commercial property prices have fallen by an average of 30%–50% from their peaks. Estimates suggest up to \$750 billion of mortgage debt on commercial real estate will be defaulted on over the next few years, as owners struggle with the same forces that are sinking residential homeowners: falling incomes and the inability to refinance their debt.

Thus, it appears we haven't yet turned the corner in real estate. While we are unlikely to see another crash like we saw in 2008 and 2009, both residential and commercial real estate likely have years of falling prices ahead before any sustainable and significant recovery takes hold.

However, we are not real estate investors, so the relevant question is how this ongoing adjustment process will translate into the financial markets going forward.

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Although it appears we are about to head into the next phase in the ongoing real estate downturn, it would be a mistake to assume the reaction in the financial markets will be the same as in 2008 and early 2009. In 2007, alarm bells were ringing all around warning of the impending housing bust, but investors largely ignored the risks. The cliché often repeated at the time was “nationally, home prices have never before declined, so there is nothing to worry about.”

It also didn't help that the Fed chairman and government officials often repeated that sentiment, saying that any fallout from the housing market would be “well contained.” As the situation worsened, it became increasingly clear that the Fed and the government didn't have a firm grasp on what was unfolding. The result of these messages of denial was that the market really didn't know what it would do in response to a clearly deteriorating situation – or even if there would be a response.

After Lehman Brothers was allowed to fail and the financial crisis erupted in full force, we got our first taste of the government's coordinated efforts to address the downturn. The Fed started printing like there was no tomorrow, and the government went into huge deficit to give the Treasury department money to hand out to the banks alongside an economic stimulus bill. Since that meltdown, the Fed has made it clear again and again that it will do whatever it takes to keep the financial system from seizing up again.

So as we enter this next phase of the housing bust, the markets have a clearer sense of both the underlying problems and the policy responses we're likely to see to address those problems. This is a very different investment climate from the denial and uncertainty that was found in 2008.

For instance, investors now know that the Fed will keep interest rates near zero and print as much money as is needed in order to keep the markets functioning. All the discussion of limited intervention and morale hazards have gone the way of the dodo.

It is in this context that gold is now rising again. After spending a year and a half consolidating below \$1000, gold has broken out and is currently trading at over \$1100. Of all the major asset classes, gold is the only one making new highs.

The most cited reasons for gold's rise have been the falling dollar and the imminent arrival of inflation from the Fed's money printing. However, as previously noted, the dollar hasn't been falling very much against other currencies over the past several months.

In addition, since credit continues to contract more than the Fed has been printing, there is no real inflation in sight. In all likelihood, this will remain the case for some time to come.

Rather than signifying fears about the dollar's fate or fears of a significant bout of inflation, gold appears to be fueled by a growing distrust of fiat currencies in general. That's because gold is now rising against *all* major currencies, not just the US dollar. Even the Australian dollar, which has been strong over the past year, is now declining against gold.



However, as the chart on the previous page notes, gold mining stocks have not yet followed gold to a new high. As a group, they remain below the high set in early 2008, and it is a little surprising to see them having this much difficulty, given the strong rise in gold. Although gold miners could certainly play catch-up in the coming months and follow gold higher, their relative weakness is notable.

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Currently, most stock indexes have risen to a point of significant resistance – which is the main reason why there has been only modest net progress over the past few months. The Nasdaq Composite is just below where it was prior to the crash last September and October; it would take a rise beyond 2250 to take the index above this resistance. The NYSE Composite and the S&P 500 have retraced 50% of their bear market losses – a common occurrence within a larger downtrend. It would take a rise above 1120 on the S&P 500 to take the index beyond that resistance.

In the chart below of the Russell 2000, you can see that the index has risen to the top of a large trading range that has been in force over the past 10 years. The index broke out of this trading range during the 2002–2007 bull market, but fell back into it during the bear market last year. The low in March occurred at the low end of this range, and since August it has been struggling with the resistance at the high end of this range between 600–620.

The Russell 2000 is a good illustration of where the stock market stands. Although it has rallied dramatically since March, it has recouped only around 50% of its bear market losses, and remains below the resistance defined by last year’s crash. From a technical analysis standpoint, it remains in the range of a typical rebound within an ongoing bear market.

It is always possible that stocks will rally further in the short-term. In fact, if the S&P 500 were to rise beyond 1120, it could quickly move another 10% higher to the next significant level of resistance near 1230. However, after this rally it’s very important to keep these short-term moves in a longer-term perspective.

Internally, the market has weakened substantially over the past couple months, as breadth and volume have fallen off dramatically. Most indexes are at or within 10% of formidable resistance that will likely prove to be a lid on this rally, if stocks are still in a long-term bear market. If this rally since March has been the start of a new bull market, it will likely move through these nearby resistance areas with ease.



Whereas in March the market was in a very good risk/reward position, the current situation is just about the exact opposite. It appears quite unlikely that stocks will be able to climb much further from where they are today, and downside risk from here is substantial. This is why we remain largely hedged.

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All things considered, it appears we are now heading into the second wave of this housing bust. If so, it seems likely that we'll see a resurgence of deflationary fears as the hope of recovery fades.

This may be the reason gold mining stocks remain below their 2008 highs, even as gold heads higher. Gold mining stocks usually lead gold higher during significant advances, and the fact that they have held back suggests the market is still uncertain whether or not we are truly out of the deflationary swamp.

The stocks in the Dow Industrial Average have rallied to a new high over the past month, even while other areas of the market, such as small-cap stocks, have stalled. Part of this is a result of the lower dollar, which boosts earnings in larger companies with more international exposure.

However, it also appears to be part of a strong flow into high quality yield-producing investments, a trend which has also kept the 10-year Treasury bond yield at a low 3.3% despite record issuance over the past six months. The continued demand for relatively secure yields is part of a deflationary undercurrent that remains strong.

Although there are a number of inflationary/deflationary cross-currents in play at the moment, these muddy waters won't last indefinitely. At some point we'll either see stocks reinvigorate themselves and move through nearby bear market resistance levels, or they will turn down and retrace a good portion of the rally over the past seven months. Although the latter appears more likely, we will align ourselves with whatever trend emerges.

If you have any questions about this letter or your account, feel free to give us a call or send us an email—we would be happy to hear from you. We hope you have a very nice Thanksgiving.

Sincerely,

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