



November 2010

Dear Investor,

Equity markets in the US and around the world continued their rally in October with a modest rise after September's rally. Both the S&P 500 and the MSCI World Index gained over 3%, bringing both indexes into positive territory for the year to date.

Stocks, commodities and most risk-assets rallied in October and early November in anticipation of the Federal Reserve's widely telegraphed announcement of a resumption of quantitative easing. On November 3rd, the Fed announced that they would start buying \$600 Billion of Treasury bills and notes over the next 8 months. Along with the recycling of funds from maturing securities in their existing portfolio, they will buy roughly \$110 Billion of Treasuries a month - roughly the size the Federal Government's monthly budget deficit.

As a result of the Fed commitment to buy Treasury bonds in hopes of lowering interest rates, boosting economic growth and raising inflation expectations, the equity markets have temporarily priced out the possibility of any serious economic setback. The consensus appears to be that the Fed will be successful in creating inflation, and this will benefit all asset classes, from stocks to commodities to corporate bonds.

However, this market action is in spite of the fact that the Fed's actions are unlikely to provide any boost the real US economy. So far, most of corporate bond issuance by businesses in recent months has gone to higher growth areas outside the US, or to simply refinance existing debt at a lower rate. Little if any corporate debt issuance went into business expansion in the US. And with US consumers still *reducing* their debt loads, it's pretty clear consumers will not propel the US economy much further. Without investment by businesses and borrowing by consumers, inflation and growth will likely remain subdued.

Despite these issues, the Fed is proceeding with another round of QE, most likely because with short-term rates already near zero, it is their best remaining hope. Although markets may react in the short-term by these direct government interventions, beyond the short-term they have almost no lasting effect. In the end, the underlying trends in the economy and markets determine where asset prices trend.

This will be our last monthly letter for 2010. In the next few pages we'll briefly discuss some aspects of how our portfolios are positioned heading into the end of the year, and why. There will be a more thorough assessment of the economic backdrop, the markets and our portfolios in our *2010 Annual Review*, which will be in your inbox in early January.

<u>Stock Indexes</u>	<u>October</u>	<u>2010</u>	<u>Market Indexes</u>	<u>October</u>	<u>2010</u>
S&P 500 Index	+3.8%	+7.8%	HFRX Global Hedge Fund Index	+1.1%	+3.1%
MSCI World (ex USA) Index	+3.5%	+2.9%	US Dollar Index	-2.1%	-1.2%
Amex Oil Index	+4.5%	+1.1%	CRB Commodities Index	+4.8%	+6.1%
Gold and Silver Index	+3.7%	+21.4%	Gold (Continuous Contract)	+3.8%	+23.6%

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With the reaction of various markets to the Fed's resumption of quantitative easing, it may be a little difficult to see what is really going on beneath all the volatility. After all, the *price* of 10-year Treasury notes, which will be the subject of a lot of Fed buying in the coming months, began to *fall* just after the announcement - the 10-year *yield* rose from 2.5% to a recent high near 2.9%. There is, of course, a possible fundamental reason for this: if the Fed's actions are meant to spur inflation, and they are successful, then prices on Treasury notes and bonds should begin to fall and yields rise even as they buy them.

For now, speculation on possible future inflation remains just that—speculation. Overall credit is still contracting, and it's not likely the Fed's \$600B will be enough to counter that contraction. The most recent release of the Core Consumer Price Index, which excludes food and energy, rose just 0.6% year over year.

The Dow Priced in Dollars (top), Gold and Silver



This is down from a year-over-year core-CPI rate of nearly 3% in 2006. Not coincidentally, our Core-CPI decline in the 4 years since our real-estate peak mirrors Japan's Core-CPI decline in the years after their real-estate peak in the early 1990's. (Japan's core-CPI did not dip into negative territory until 7 years after their real-estate peak.)

The more likely explanation of the reaction for the move in Treasuries, along with a number of commodities and other markets over the past few months, is a normal *buy the rumor, sell the news* reaction. For those of us who watch the tape everyday, a lot of the market movements over the past year can best be explained as the result of herds of traders all trying to front-run each other.

Hedge funds and other investors have bought positions on Treasuries, stocks and commodities in anticipation of QE II handing them all big gains. One manager recently declared on television that it was a "sure thing" that stocks would gain in the months ahead - either from the economy improving, or from the effects of QE II.

Such sentiment is reflected in a number of recent surveys. For example, the Options Speculation Index, a chart of which was shown in the April client letter, is now above where it was when the market peaked that month. It is also near the highest it has been since the year 2000. This indicates that just about everyone is now speculating on higher stock prices, and very few are hedging against a decline - conditions that are usually seen at market tops.

As you can see on the chart to the left, while QE II has given investors reason to bid up prices over the past few months, stocks have only recovered when

measured in dollars (black arrow). Less well known is that when measured in gold, stocks are currently down ~20% from their April high (orange arrow). And when measured in silver, stocks are currently making new bear market lows (red arrow).

In short, despite the price gains over the past few months, stocks are falling in comparison to real assets. This is a bear market phenomenon. While it is certainly possible that prices may rally further (in dollars) for a while, they have already rolled over against real assets like gold and silver.

At the peak of the housing bubble in 2005, stocks resumed their decline against gold even though stock prices continued to rise in dollars for another 2 years before they reached a peak in October 2007. Such a long interval between the peak of stocks in gold and the peak in dollars seems unlikely to repeat, although it is certainly possible. However, in light of these and other factors, including the unfavorable technical and sentiment backdrop, we continue to remain cautious here on stocks.

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We will have more to say about the markets in the upcoming *2010 Annual Review*. However, it is probably fairly clear from our recent letters that we are expecting another decline in stock prices to begin at some point in the not too distant future, and it seems likely that such a decline will probably take prices below where they are today. This is the reason we remain defensive in Absolute Return as well as in Hedged Growth and Dividend Growth, with the “Growth” portion of the latter two portfolios in cash.

The growth stocks that usually make up ~50% of Dividend Growth and ~33% of Hedged Growth are usually economically sensitive stocks that tend to be quite volatile. They are just the kinds of stocks we want to hold during a healthy economic expansion, but they are not the types of stocks we want to hold when there is a significant risk of a recession and/or bear market. For example, had we remained fully invested in growth stocks during 2008, our estimates suggest Hedged Growth would have ended the year with a loss instead of gaining 13%. Dividend Growth, having a greater portion of its portfolio dedicated to growth stocks, would have ended the year with a much larger loss than it did.

Both Hedged Growth and Dividend Growth have underperformed the market for the last year, but it’s important to remember our primary objective of those strategies (and Absolute Return as well) is to avoid catastrophic losses, patiently waiting for the right opportunities in accordance with the stated investment strategies of each portfolio. In a long-term bear market, like the one we find ourselves in today, this emphasis on capital preservation is paramount.

The decision to stay out of growth stocks is based on how much we estimate we would likely gain by being fully invested versus how much we could lose if we stay fully invested too long into a new downtrend.

During a transition from a normal bullish trend to a bearish trend, there are usually a number of technical and fundamental signs that show the bull market has matured and the risk of a bear market has increased. We have seen a number of those signs over the past year, just as we did throughout 2007. This prompted us to shift to a more defensive stance, because under those technical conditions the potential for gains is far less than the risk of losses. The limited gain of the market over the past year is a reflection of that weak underlying technical condition.

Furthermore, the equation of potential gains versus potential losses is unfavorably skewed this time around because the economic recovery which began in 2009 was not a normal, healthy recovery; it was fueled primarily by government stimulus. As a result, it did not fuel a normal, healthy bull market in which growth oriented stocks—at least those defined by metrics relevant to the past 40+ years prior to

2009—do well. As a result, the risk/reward for this group of growth stocks has been even less attractive than usual. The potential gains have been limited more than in past cycles, while it appears the potential losses during the early phases of another downturn are significant.

Although, as a group, growth stocks remain unattractive, there are some exceptions. Several gold mining stocks have recently met our growth criteria. This comes just as gold mining stocks, as a group, have moved above resistance from highs in 2008 and 2009 (as shown on the chart to the right).

Gold mining stocks have come a long way since the depths of the financial crisis in 2008. Yet, compared to how far gold and silver have rallied since they first traded at these levels in 2008, they could have a lot further to go.



Now that we are seeing some of these stocks meet our growth criteria, we have been adding them to Dividend Growth and Hedged Growth accounts. We have not held these types of stocks in Hedged Growth since 2006, when they began to fall outside of our investing criteria. Since that time, there has been a wide divergence in this sector, with some miners continuing to rally along with the price of gold and silver, and others falling along with the broader market. However, these stocks now appear to be one of the few sectors of the equity market that are collectively moving into a new bullish phase.

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As it has been over the past year, the main question for investors is how risk assets will continue to be devalued in the coming years. It is clear is that stocks and other paper assets are again being devalued by real assets, especially precious metals. This process, which began in 2000, has continued through the tech bust, the housing boom, the housing bust, the credit crisis, government stimulus, zero percent interest rates and now multiple rounds of quantitative easing by the Fed.

It appears most investors today are looking for ways to capture increasingly hard to find returns at a time when the markets are sending strong signals that it is time to focus on capital preservation. As we have discussed in recent letters, it is possible that stocks could lose another 60%-80% against gold in the coming years. The next phase of this devaluation appears to already be underway, and it seems unlikely that the entire devaluation against gold will come solely from a rise in the price of gold – it will most likely involve one or more significant declines in stock prices in the year ahead.

Overall as we head into the end of 2010, we are invested precious metals and a few other commodities, moderately invested in Treasury bonds and the dollar, and defensively positioned with respect to stocks. Most of our modest stock holdings are conservative dividend paying stocks that will benefit from a continued low interest-rate environment.

Dividend Growth and Hedged Growth are both fully defensive with respect to net market exposure, and we will likely stay positioned defensively unless we see the stock market show signs that a more durable advance has begun. Over the past year the declines in the market have had stronger volume and breadth than the advances, including the recent advance over the past few months. As long as this pattern of distribution continues, potential returns are limited and the risk of a decline is significant. We have added a few gold mining stocks recently in light of the some miners meeting our investment criteria, and if the gold mining sector continues to improve its likely we'll add more as more companies meet our growth criteria.

In Absolute Return, we sold half of our Treasury bond exposure in October, and now hold a higher portion of the portfolio in cash. We have held even larger cash positions in the past, when conditions were unfavorable for a range of asset classes. Our current cash position could increase or decrease in the coming months, depending on how conditions in various markets evolve.

However, we expect to remain invested in precious metals, and have recently increased our metals allocation in September by adding silver and a few silver mining stocks at prices that now look attractive. In early November silver broke above significant resistance at \$25/oz, and now trades at the highest price ever except for the brief period in 1979-1980 when the Hunt brothers attempted to corner the silver market. Although an intermediate-term correction may come at any time, the long-term trend in both gold and silver appears strong.

Commodities Focus I remains heavily over-weighted towards precious metals and a few other commodities, such as agriculture. Energy stocks appear to be the most vulnerable to another decline over the next year, and so we have hedged our long-term investments with a short position on energy stocks. This should partially compensate for any significant downturn in commodities and/or the broader stock market in the coming months.

As was mentioned before, we will be sending you our *2010 Annual Review* in early January. Between now and then, we hope you have a wonderful Thanksgiving and a happy holiday season. As always, if you have any questions about your account or this letter, feel free to contact us.

Sincerely,  
Brian McAuley

Brian McAuley  
Chief Investment Officer  
Sitka Pacific Capital Management, LLC  
[investing@sitkapacific.com](mailto:investing@sitkapacific.com)

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