



Sitka Pacific

Capital Management LLC

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Dear Investor,

In September, stocks continued modestly higher, both in the US and globally. There have been a few notable exceptions to the gains, as stock indexes in China and Japan (among a few others) have declined from peaks in August and September. A few domestic indexes have diverged from the rest of the market as well, such as the Dow Transports. In general, the uptrend remains intact although it appears more tenuous by the week.

The most significant event in September, and early October, has been the move in gold to a new all-time high. While gold remains less than half of its high in 1980 on an inflation-adjusted basis, it has again confirmed its long-term bull market by rising to a new nominal high above \$1033, the previous high set in March 2008. Other metals, including silver and copper, have also rallied over the past 6 months, but they remain below their 2008 highs. Gold is the first to make a new high since the credit crisis last year.

Treasury bond yields and the dollar have moved lower over the past few months. Both markets appear to be responding to the likelihood that the Fed will be keeping short-term interest rates near zero for a very long time, despite all the talk about economic recovery. The drop in the dollar has helped power gold and stocks higher recently. However, the dollar's decline is quite extended so it would not be surprising to see a rebound at some point. Short, sharp rebounds tend to happen with all carry-trade currencies, from time to time.

Since gold has moved to a new high while stocks remain more than 50% below their 2007 peak, we're going to spend some time this month reviewing some long-term valuation cycles of gold and stocks. It has been quite a while since we looked at these charts, and there is no real news to report—only that trends we have highlighted in the past remain firmly in force today.

We'll also take a look at a technical measure of the Nasdaq as an example of how tenuous the current rally in stocks appears to be. Although markets can always continue to trend higher as they weaken, they also build up more risk in the process.

Our new office in Sonoma is open, and we will be back to our normal capacity for communication this month. We very much appreciate your patience during this move.

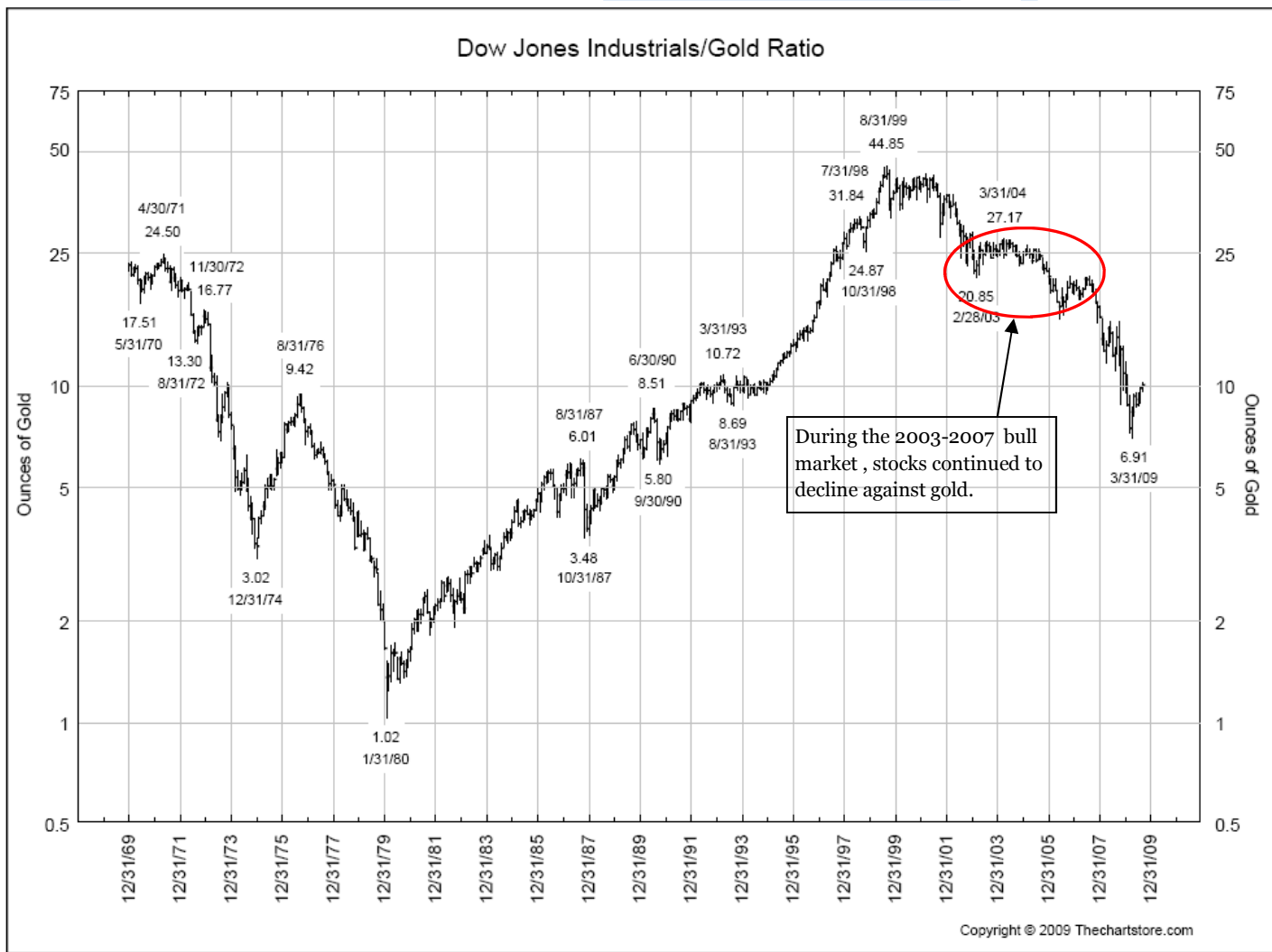
<u>Stock Indexes</u>	<u>September</u>	<u>2009</u>	<u>Market Indexes</u>	<u>September</u>	<u>2009</u>
S&P 500 Index	+3.6%	+17.0%	HFRX Global Hedge Fund Index	+2.2%	+11.0%
MSCI World (ex USA) Index	+3.9%	+27.0%	US Dollar Index	-1.8%	-5.5%
Amex Oil Index	+4.7%	+4.6%	CRB Commodities Index	+2.3%	+13.0%
Gold and Silver Index	+12.5%	+33.6%	Gold (Continuous Contract)	+5.9%	+14.0%

As the stock market began to rally in 2003, after the historic bust in technology stocks, there was a notable difference in how various areas of the market were relating to each other. Although on the surface things appeared more or less the same as they had been, there were subtle indications that the peak in 2000 had been a significant threshold, beyond which the investment landscape altered significantly.

Throughout 2004, 2005 and 2006, those initial indications grew into clear signals that the peak in 2000 had been a seismic shift between what we have in the past referred to as 'real' and 'paper' assets. Although stocks continued to rally higher in those years, *they gained ground only when nominally priced in dollars.* When stocks were priced in other real assets, they were making little headway – and in some cases were continuing their decline unabated. One such case was stocks priced in gold.

During the 20 years from 1980 to late 1999, stocks in the Dow Jones Industrial Average had increased close to 45 times in value versus gold, as can be seen in the chart below of the Dow/Gold ratio. During the 2000-2003 bear market, stocks lost over half their value in value relative to gold – a performance that is not out of character for a cyclical bear market.

However, as you can see in the red circle on the chart, as stocks rose from their lows in 2003 they only managed to tread water against gold. Moreover, while the rally continued through 2006 and 2007, stocks were declining to new lows against gold.



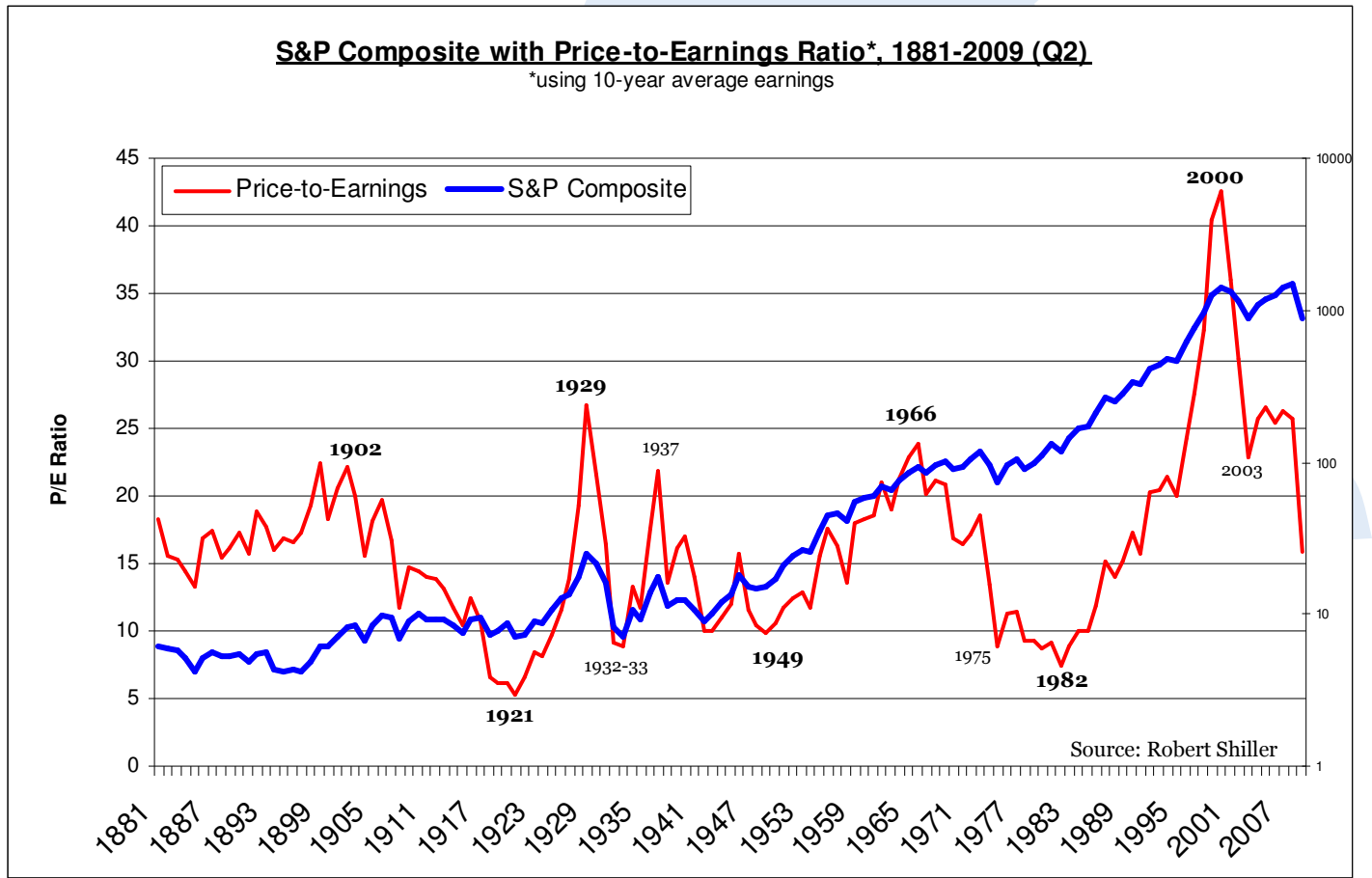
For those of us watching this new behavior of stocks against gold and other real assets, it became clear that the rally from the 2002-2003 lows not a bull market in the same category as the advance during in the 1980's and 1990's. During those bull market years, stocks rose in value against almost all other assets. They also rose in value by other standard methods of valuation, such as the price-to-earnings ratio.

Of course, stocks also benefited from beginning their advance in the 80's and 90's from a once-in-a-generation valuation low. As you can see on the chart on the previous page, the Dow/Gold ratio reached 1 in early 1980 – a level last seen 50 years before during the great depression.

In addition, stocks were also very cheap by most internal valuation measures. The price-to-earnings ratio, using the rolling 10-year average of earnings to weed out short-term fluctuations in earnings, was at low levels not seen since after World War I. The chart below shows the history of this price-to-earnings ratio, back to 1881. From this long-term view you can see the relatively orderly cycles of rising and falling valuations through the decades; the years in **bold** highlight cycle lows and highs.

In 1929, stock valuations reached a high above a P/E of 25. They then spent the next 20 years in a period of generally falling valuations until 1949, when the next long-term bull market began. Valuations peaked again in 1966, which ushered in a 16-year period in which stocks lost as much value as they did during the great depression, on an inflation-adjusted basis. By the time 1982 came along, stocks were again at bargain-basement prices.

From the fertile ground of the early 1980's, stocks entered another long-term bull market phase that ended with the bursting of the technology bubble in 2000. It was indeed a bubble, as the 10-year P/E of the S&P Composite reached above 40 – far higher than in 1929. As we can now see, the peak in 2000 marked the beginning of another long-term valuation contraction, which based on past experience (1902-1921, 1929-1949, and 1966-1982) can be expected to last 15-20 years.



When we think about *investing*, as opposed to *trading*, one of the most important things to determine beforehand is whether what we are investing in is in a bull market or a bear market. It makes little sense to bring a buy-and-hold approach into a long-term bear market, but that's just what many did during the rally of 2003-2007.

In our March client letter, we discussed the one scenario in which stocks could be reaching a nominal low that would last. However, even in this most optimistic scenario in which stocks may have already seen their lowest nominal price, they remain *in the middle* of a long-term valuation contraction. They will likely be "paddling upriver" for some time as they continue to be devalued by inflation and the rising prices of commodities and other real assets.

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The above overview of where we find ourselves within those long-term cycles is meant to give some context to our discussions of our short-term outlook, as well as our positioning in our portfolios. The main reason why we remain cautious is because stocks are not in a long-term bull market, and therefore we must continue to approach stocks in terms of their value as a *trading* opportunity. And as with any trade, you have to carefully weigh the opportunity for gains against the potential for loss.

The Nasdaq Composite, 2008-2009



Since July, stocks have continued their advance. The Nasdaq, shown at the top of the chart on the right, has now rallied over 70% from its low in March.

However, it has done so in a way that suggests a good portion of this rally will likely be given back in the end. At this point, there appears to be a lot of risk and little potential return—which is not a foundation of a good trading opportunity.

Below the Nasdaq is an example of what we find when we look 'under the hood' of this rally. This black line is a measure of breadth that shows the portion of stocks rising along with the index.

In a healthy advance, this measure usually rises with the market, as more stocks participate in the advance. In an unhealthy or weakening advance, this measure will stagnate or decline as the market rises, as the number of stocks rising with the market falls.

In March, there were a number of indications that stocks were preparing for a significant advance. One of these indications was fewer stocks falling

with the market. In the chart on the previous page, the green number 2 marks where this measure of breadth made a higher low versus the low it made during the crash in October and November. This told us that although stock indexes were declining to new lows, there was underlying strength building that allowed fewer and fewer stocks to follow the indexes down. This is one sign you tend to see before the market makes a significant low.

When we look at the market today, we find that although the Nasdaq has continued to rally since July, this measure of breadth has been unable to climb beyond the level seen in early May—as shown by the red number 2 on the chart compared to the red number 1. In a real bull market, we would have seen this measure of breadth rise well beyond that high in May, as the market shifted into high gear. However, that is not what has happened. And as the market has rallied again in early October, it has done so with measures of breadth in an outright decline.

At various times in the past, the market has been able continue rising while technical indicators such as this breadth indicator continue to weaken. However, such weak rebounds from market crashes are at times swiftly taken back by a subsequent decline, in a way that is very difficult to avoid losses—unless you were prepared ahead of time. This is what happened in early 1938 in the US, and also in Japan in 1993.

From our vantage point, stocks appear to be in a high-risk, low-potential-return position after the steep rally from the March low. This is why we have remained hedged over the past few months, despite the continued advance. Although there is the possibility that stocks could find renewed strength and prove us to have been too cautious, we would rather see the market offer more real evidence of underlying strength in light of the long-term and short-term risks.

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In September, while everyone's attention seemed to be fixated on stocks, gold embarked on the next leg of its long-term bull market. After spending the past year and a half consolidating its gains after its rise to \$1033/oz in March 2008, gold began moving higher in late August, and in early October traded above \$1060/oz. At the same time, as shown in the chart below, the Dow/Gold ratio turned down again in an apparent signal that the next round of devaluation of stocks against gold has begun.

During the 2003-2007 bull market, one of the signs that it was a cyclical bull market within a long-term bear market was that although stocks rallied, they did so *only* nominally priced in dollars. Against gold and other real assets, they declined.

Stocks have risen modestly in value against gold since March. However, it has not been enough to signal that there has been a major trend change—stocks are still in the process of devaluing against gold.

This means that the advance from the March low in stocks is likely another cyclical recovery within a long-term bear market, which will ultimately give away its gains. The big question is: will stocks devalue just against gold (as in the 1970's), or will they also decline nominally?

The Dow Jones Industrials/Gold Ratio, 2007-2009



While we don't know the answer to that question yet, we do know that we remain *in the middle* of a long-term cycle of contracting valuations in stocks. At the same time, we are *in the middle* of a long-term bull market in real assets, gold included. While stocks have already declined 80% against gold since 2000, if history were to repeat they could conceivably decline *another* 80% against gold before the next long-term bull market arrives. This is what happened in both the 1970's and the 1930's bear markets.

These are some of the reasons why we have remained on the cautious side when making trading decisions in stocks, while we have adopted more of a buy-and-hold approach with gold and related positions. Such an approach is prone to periods of underperformance, especially when the stock market stretches a rally far beyond what is acceptable from a risk/reward standpoint. However, our first priority is to stay aligned with these prevailing long-term trends, and only take positions against them when there are good, well defined trading opportunities.

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The S&P 500 is now close to recouping 50% of its bear market losses. This is an area that has repeatedly contained past bear market rallies in deflationary periods. Many other areas of the market are also within a few percent of significant resistance. The comment on the chart on page 4 highlights this resistance area for the Nasdaq. The chart we looked at last month of energy stocks showed that they remained at the high end of the consolidation range that began a year ago, and that is still the case. These are all significant hurdles that need to be overcome if stocks are to continue higher from here.

If we see the market begin move higher above these resistance areas, we will be looking for other signs that the market is beginning to price in a future that includes significant inflation. The breakout in gold over the past month is one step in that direction. However, Treasury bond yields have been declining since June, and consumer credit and other credit measures continue to decline dramatically. These deflationary forces continue unabated.

We are waiting to see how the markets react to all these crosscurrents, and we will adjust our allocation and hedges to reflect the market environment if it changes. For now we remain defensive because the risk of loss from this point appears far greater here than the potential gain. That could change if we see the market strengthen convincingly, but so far in October the market has only continued exhibit further internal weakness with each successive rally.

If you have any questions about your account, just give us a call or email. We are settled in our new office in Sonoma, and would enjoy hearing from you.

Sincerely,
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