Sitka Pacific
Capital Management LLC

September 2009

Dear Investor,

Before we begin our discussion of the markets, we wanted to let you know that this month we are completing our move from Edmonds, Washington down to Sonoma, California. By the end of September, all of our books and records will have been transferred from our Edmonds office down to our Sonoma office. Our new address, phone and fax numbers are listed below.

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In case you are wondering, this move has been planned for some time and is being done mostly for personal reasons. My wife is originally from the area, and we have enjoyed visiting the town of Sonoma periodically for the past 12 years or so. We're looking forward to being closer to family, and also being closer to the mountains in the Sierras and the coast north of San Francisco. Despite the enormous financial difficulties in California, the mountains and the rugged coastline are as beautiful as ever.

It has been a few months since we have had an discussion about the state of the stock market, so this month we'll provide detailed review of where we stand. Stocks have continued to rally modestly over the past few months, but the market has reached a point where it will have to make some important decisions in the near future.

Treasury bond yields have trending down over the past few months, and yield spreads with riskier bonds have begun to widen. Although the stock market has a reputation of anticipating changes in the economy, it is often the *last* market to do so. Other markets tend to provide earlier and more reliable signals, and our continued focus on all of these inter-market relationship is part of the reason we have remained cautious while stocks have drifted higher.

We'll go into more detail in the pages ahead. However, we'll start with a brief look at our current employment and debt situation, viewed from a long-term perspective. Taking a few steps back to look at these trends provides vital context in which to view today's markets.

Stock Indexes	August	2009	Market Indexes	August	2009
S&P 500 Index	+3.4%	+13.0%	HFRX Global Hedge Fund Index	+1.3%	+8.6%
MSCI World (ex USA) Index	+4.5%	+22.3%	US Dollar Index	-0.2%	-3.8%
Amex Oil Index	+1.8%	-0.0%	CRB Commodities Index	-1.5%	+10.5%
Gold and Silver Index	-1.1%	+18.7%	Gold (Continuous Contract)	-0.3%	+7.6%

*   *   *

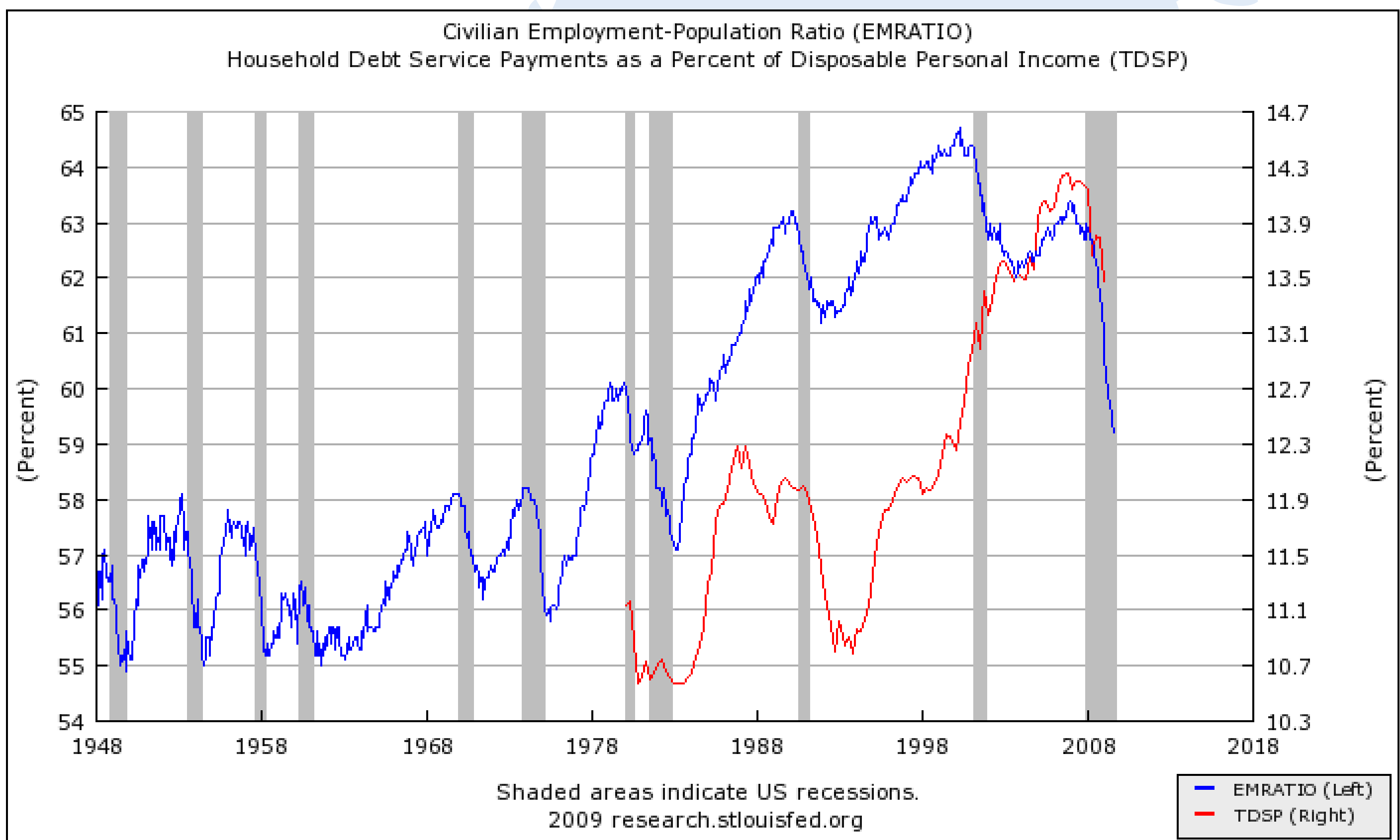
Earlier this month, a report by the Federal Reserve showed that consumer credit fell by $21.6 Billion in June to $2.5 Trillion—a 10% annualized rate of decline This number includes revolving credit like credit cards, as well as non-revolving debt such as auto loans. It was the sixth straight month of decline, which suggests that the contraction in consumer credit is not just a short-term phenomenon.

In fact, there is every reason to suspect that the recent decline in consumer credit may be the start of a significant trend. That's because not only are US consumers dealing with nearly seven million jobs lost and a record decline in wealth from declines in stock and home prices, they came into this recession saddled with a large amount of debt.   When we look deeper into the numbers, it's clear that this time around we may see a decline in consumer credit that both follows the normal path of past recessions *and* corrects the excess of debt that was accumulated over the past decade.

The recession that followed the tech bust in 2001 was very unusual, and we can see one of the ways it was unusual in the chart below. In recessions past, consumers generally reduced spending and debt—a straightforward response to job losses and wages that stagnated. But in the recession in 2001, consumers did just the opposite, taking on more and more debt even as fewer people worked and incomes stagnated.

The 2001 recession is marked on the chart by the thin vertical grey bar second from the right. You can see that as employment (the blue line) peaked in 2000, debt payments as a percent of income (the red line) didn't decline—it rose dramatically. In other words, instead of reining in spending and debt accumulation, consumers took on more debt relative to their income and kept on spending right through recession.

When the 2001 recession ended and employment began to modestly grow again, consumers took on even more debt until debt payments were taking up over 14% of disposable income in 2007, a much higher level than seen prior to past recessions.



As employment began dropping again in 2007, consumers carried a higher debt burden relative to their income than they had for decades. As you can see by the blue line on the chart, employment has dropped precipitously since then, and that has made that debt all the more difficult to service. This is one reason why outstanding consumer credit is now falling, because people have realized that the debt they took on over the past 10 years is much more than they can handle.

Of course, consumers have a long way to go. Debt levels are still far above past historic norms, and with employment and incomes falling it means debt repayment will continue to take a large chunk out of consumption. This process will likely take a long time, and it's one reason why there is little hope for any significant rebound in consumer spending in the years ahead.

The take-home message is that this recession is not just correcting imbalances of the last business cycle—it is correcting imbalances built up over the past several business cycles. It retrospect, it appears the year 2000 was not only the end of the 1990's stock market bubble, it was the end of a 40-year expansion in the percent of the US population that is employed.

During the last nine years, people spent and took on debt as if the previous trends of increasing employment and increasing wages were going to come right back. However, employment and wage growth never did come back, and instead took a dramatic turn for the worse. The US now are back to early 1980's level of employment, but consumers have 30% more debt to carry.

We are already seeing the social changes towards frugality that have swept through as people have become more aware of this "new reality." We are not in a depression like the Great Depression, but its possible that the experiences of this decade (and those to come) will have a similar *generational* impact on people's spending habits and attitudes towards debt. In other words, even after debt levels decline back to previous ranges, which will take a number of years, it may take much longer before consumers are willing to spend the way they did before this recession.

Given that, we should approach the markets not with the expectation for a typical recession followed by a typical recovery, because such expectations will almost certainly lead to disappointment. The excesses that are now unwinding were several decades in the making, and it will likely take many years to unwind.

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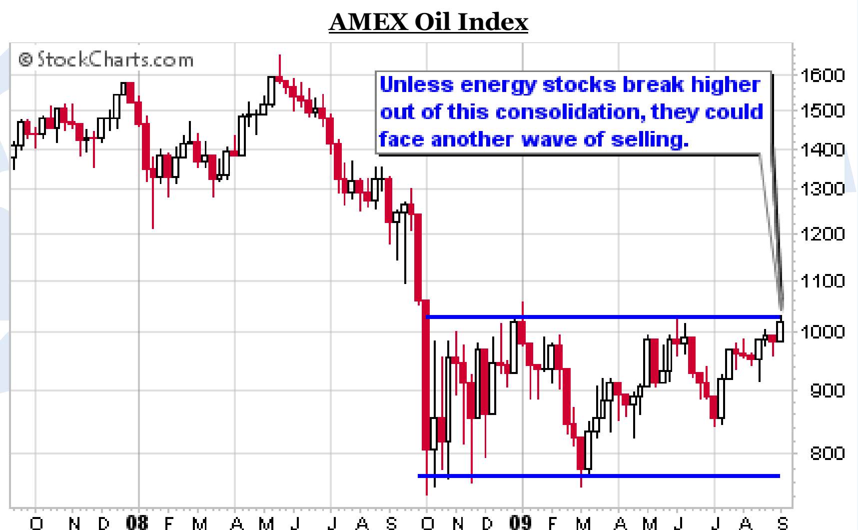
Back in our March client letter, we were open to the possibility that stocks could have put in a significant low that would be followed by decent bull market. While stock averages have rallied more than 50% from their low, from early on it showed little resemblance to a new bull market.

The gains were primarily driven by a rebound in the very stocks that were at the center of the bear market. Some bank stocks, for instance, gained over 100% in the first month, and a few have gone on to gain over 500% from their lows. Meanwhile, most other areas of the market gained only modestly.

Energy is one of those sectors that has only enjoyed modest gains since March. Although the price of oil has rebounded

AMEX Oil Index



up to $70/bl from a low below $40/bl, energy stocks have up to now failed to break out of a broad trading range that traces its roots back to last October's crash.

If energy stocks were to break higher out of the range shown on the chart on the previous page, it could be bullish sign for this sector, and the market in general. However, these types of consolidations *usually* foreshadow further declines, and at this point investors need to be prepared for that outcome.

There are many sectors have done better than energy, but most corners of the stock market are showing similar themes: either it looks as if a sector has gone through a standard rebound from a catastrophic decline in 2008 (like financials) , or it looks as if there has no significant rebound at all (like energy) .

There is always room for improvement, and it is certainly possible that things could improve in the coming months. However, it's important to emphasize that this mild rebound, lead by financials, is not what should have happened if stocks had ended their bear market in March. We would have seen much more vigorous buying in nearly all sectors, powered higher by increasing volume and breadth. In fact, we've seen just the opposite.

The S&P 500's heavy rise from its low is March reflects the relative lack of participation of some sectors, as well as the heavy resistance put up by the post-crash trading in October, November and December of 2008. For those familiar with Elliott Wave labeling, the decline from the high in 2007 took the form of 5 clear waves down, and so far the rise from the March low (Wave 5) has been a corrective-looking advance that has taken on the form of a rising wedge.

These wedges usually end with a move that retraces 50%-100% of the preceding rally. That outcome would be in line with what a number of other markets are suggesting. Treasury bond yields have broken their rising trend from their December 2008 low, which suggests the Treasury market is already beginning to price in weakness. The rebound in commodities, including oil, appears to be a normal correction of last year's dramatic decline. The lack of conviction of energy and other commodities stocks suggests the market is anticipating weakness in those areas as well.

However, in rare circumstances these types of wedges break higher, instead of lower. If the S&P 500 were to break higher out of this wedge, it would clear major resistance from last year's post-crash consolidation, and it would also likely be accompanied by significant breakouts in specific sectors, such as energy.

Likely S&P 500 Elliot Wave Count

From a strictly technical perspective, the odds of such a bullish outcome are probably less than 1 in 5. If we take into account what other markets are suggesting, the odds are probably lower than that. Which means that being highly exposed to the stock market carries far lower odds from this point than betting at the craps tables in Las Vegas.

We have to remember that times like this are periods of "wealth destruction," not "wealth creation." This is why our underlying stance remains cautious, even though stocks have managed to drift higher over the past few months. Even in a casino it is possible to win the long-odds bet sometimes, but over time these gamblers will lose it back to the house because the odds are generally against them. The same holds true of bear markets, especially this one. Until a long-term bull market begins again, and the odds shift back to favor wealth creation, the winners will be those who continue to tread lightly in stocks.

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Now that stocks have rallied over 50% from their March low, they are again valued at near 20 times earnings. Viewed another way, the market is expensive and the only way it represents any value is if you believe earnings will increase significantly over the next year.

Although many stock analysts seem to think that is just what's going to happen, corporate insiders are now selling their own shares at a rate not seen since 2007, just before the bear market began. Given that these insiders were also net buyers in March, they have fairly good track record of knowing when their stocks are under or overvalued. They also know more than most about their future business prospects.

If the market does break down, many of the financials and other low quality stocks that have rallied two, three and four hundred percent from their lows would likely lose support rather quickly. Hedged Growth has had a difficult stretch as the market has continued to grind higher, but we are now in a position to benefit from a positive spread between our long and short positions if the market breaks lower.

In Absolute Return, Dividend Growth and Commodities Focus I, we are in a defensive position. If the market gives us reason to believe there are sustainable gains ahead, we will increase our market exposure. However, as we discussed, that appears to be the lower probability outcome, and at this point it is prudent to be hedged.

If you have any questions about your account or this letter, just give us an email. We will be fully up and running at our new office in Sonoma in a few weeks, and we thank you for your patience during this transition.

Sincerely,

Brian McAuley

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