Sitka Pacific
Capital Management, LLC

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Dear Investor,

When we sent you our annual letter a month ago, the markets were in a state of exuberance. Risk asset prices began to climb when the Fed began expanding its balance sheet last October, but the general feeling was that the rising market was *doing what it always does* — i.e. anticipating a resumption of corporate profit growth in the year ahead. Yet by the first week of January, the Fed's repurchase agreements facility had expanded to $242 billion, from zero in September, and some of the behavior in the markets clearly reflected a monetary influence — including dizzying, parabolic rises in some of the riskiest stocks.

Without much fanfare, the Fed's repurchase agreements facility peaked that first week of January, and then began contracting — falling to $167 billion by the week of February 19th. Although stock prices had continued modestly higher during the first month and a half of the year while the amount of repurchase agreements fell and the Fed's balance sheet growth stagnated, the market advance noticeably weakened, and volatility began to increase. Then, the last week of February saw the entire four-month advance taken back in just six trading days.

It's not every week that you witness an 11% fall in the broader market, but the week that just ended was one of the most severe declines in history. On Thursday, the Dow Jones Industrial Average closed with its largest point drop in its 124-year history, down 1190.95 points. In fact, four of the five trading days of the week saw the Dow down more than a thousand points, on an intra-day basis. For daily market-watchers like us, sometimes it is clear that you are witnessing market action which will long be remembered, and the week just ended was one of those weeks.

Yet the volatile decline in the stock market during the last week of February was not the only important market event of the month. In our opinion, the message emanating from the bond market was far more significant. February saw a swift and dramatic shift in the bond market's expectation for monetary policy in the year ahead, and it also saw record low yields in the 10-Year and 30-Year Treasuries. The 30-Year Treasury bond ended February trading with a yield of just 1.67%, which is in the middle of the current 1.5%–1.75% range for the Fed Funds rate. The bond market is now sending a signal loud and clear that current monetary policy is far too tight, and we'll begin this letter by discussing the implication of this message.

In this month's letter:

- The Yield Curve Re-Inverts, and the Fed Is Suddenly Dramatically Behind the Curve
- A Few Words on Market Volatility and Precious Metals

The Yield Curve Re-Inverts, and the Fed Is Suddenly Dramatically Behind the Curve

> *Financial markets on Monday ratcheted up bets the U.S. Federal Reserve will be pressed to cut interest rates to cushion a feared hit to economic growth from the spread of the coronavirus.*
>
> *The federal funds futures contract tied to the Fed's July policy meeting reflected a roughly 85% probability the central bank's benchmark overnight lending rate would be at least a quarter percentage point lower after that meeting's conclusion, according to the CME FedWatch tool. A month ago that was seen as a roughly 50-50 prospect. Contracts expiring in early 2021 were priced for a Fed policy rate of around 1% or lower, compared with the current level of between 1.50% to 1.75%, where it sits after three rate cuts last year.*
>
> \- Reuters, Monday, February 24, 2020

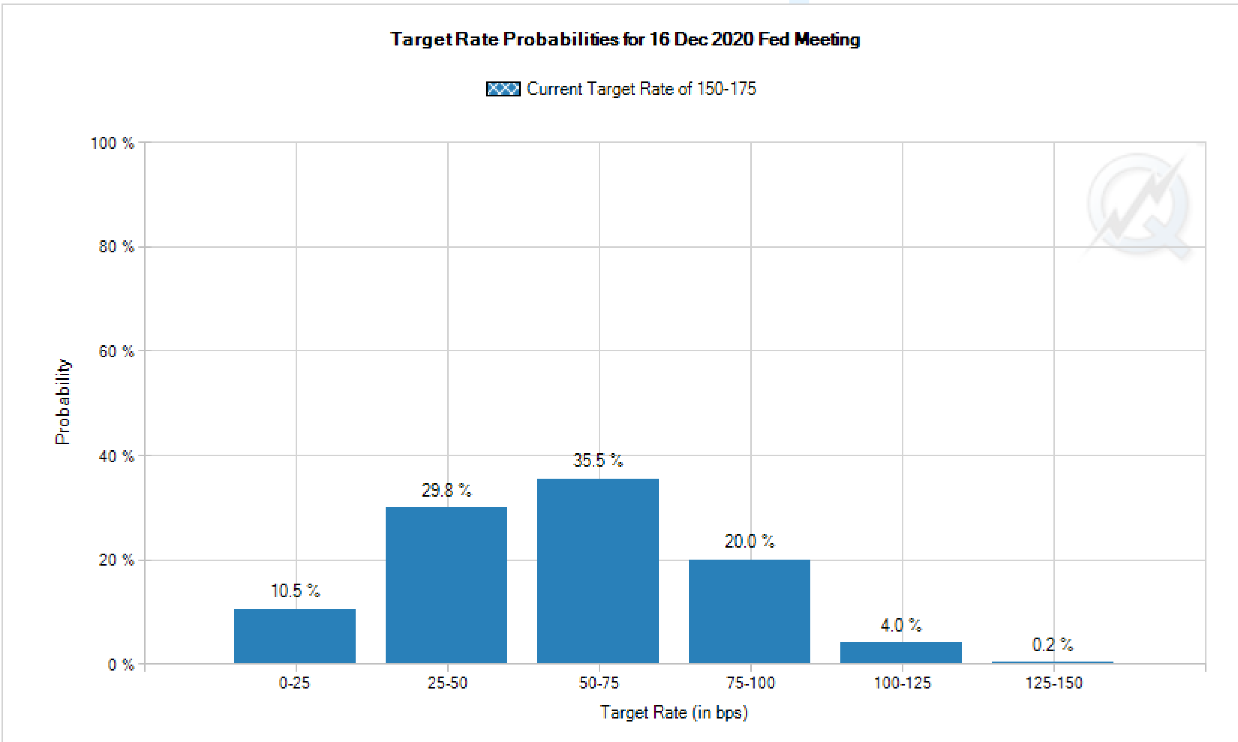
How quickly things can change. At the end of trading on Friday, February 21st, the markets ended the week in a state of optimism. The stock market had closed modestly lower on Thursday the 20th and Friday the 21st, but this had come after setting another new record high on Wednesday the 19th. In the bond market, corporate bonds of all grades traded at new highs during the week, as did proxies for junk bonds.

In the Treasury market, the yield on the 3-Month Treasury bill remained firmly in a trading range between 1.45% and 1.55%, which was where it had been since late October. This ongoing trading range indicated the market continued to anticipate that the Fed's main interest rate, the Fed Funds rate, would remain where it was — between 1.5% and 1.75% — for the time being. Fed officials had emphasized since last fall that after lowering interest rates three times in 2019, the campaign to lower interest rates was "on hold," and the market generally agreed. The Fed Funds futures market estimated there was an 89% chance the Fed would not change interest rates at its next meeting, scheduled for March 18th.

When the markets opened on the following Monday, the 24th, it was clear that things had dramatically changed over the weekend, in part because a wider economic impact from a global spread of the Covid-19 coronavirus was starting to be discounted. Risk assets of all stripes opened the day sharply lower, and the trading in the Treasuries showed the market was rapidly reassessing its view about monetary policy. In the Fed Futures market, the odds of the Fed Funds rate remaining at its 1.5%–1.75% range at the March meeting fell to 80%, and a day later, on Tuesday, they fell again to 67%. By Thursday the odds were 42%, and on Friday they fell all the way to 0%. In just one week's time, the market had concluded the Fed's period of being "on hold" was over.

And that was not all. Not only did the market completely reassess the odds that the Fed would begin lowering interest rates by its next meeting, it began estimating that the Fed would be forced to lower interest rates by more than its usual step of one quarter point. By Friday, the market was estimating there was a 95% chance the Fed Funds rate would be a *half* point lower by its March 18 meeting — which was less than three weeks away.

Beyond the market's estimate of where short-term interest rates would be after the Fed's meeting in March, estimates of the Fed Funds rate by the end of this year also plummeted during the last week of February. On February 21st, the Fed Funds futures market had estimated the Fed would probably lower short-term interest rates by one or two quarter-point cuts by the end of the year, but a week later that had changed to a 96% chance the Fed Funds rate would be below 1% by the end of the year (i.e. three quarter-point cuts), and a 76% chance it would be at a 0.5%–0.75% range, or below. In other words, the market ended February estimating the Fed would lower interest rates almost back down to zero by the end of the year, as shown in the chart below.



Outside of the financial crisis, we can't recall a time when the market, within the span of five trading days, went from expecting no change in the Fed Funds rate to expecting a half-point cut by the Fed's next scheduled meeting — but that is just what happened during this past week.

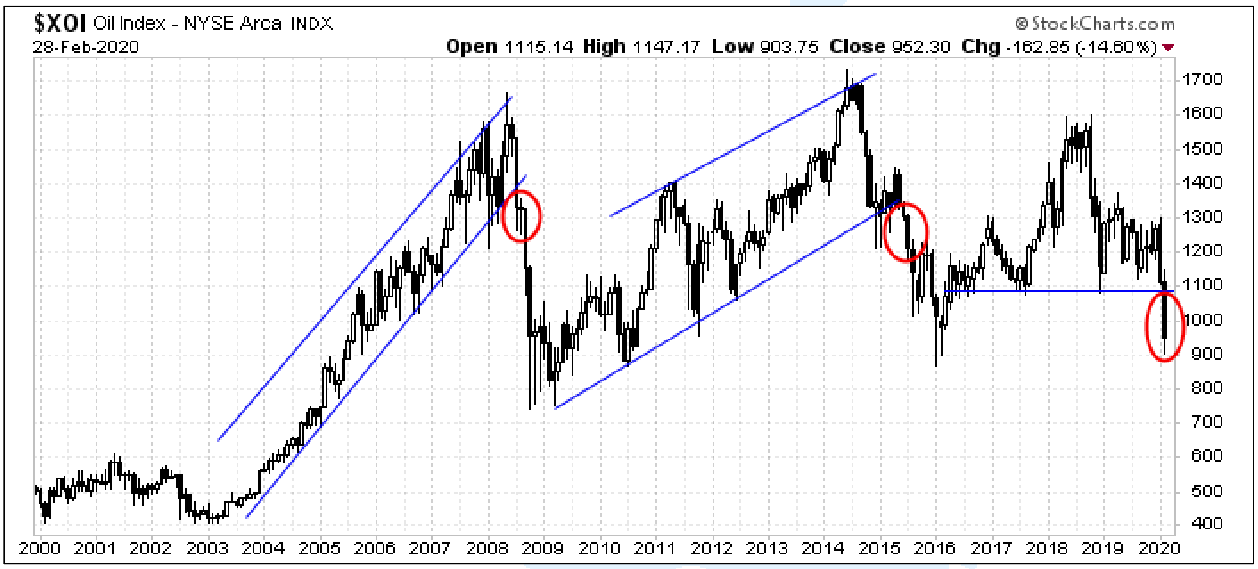
We have repeatedly emphasized that long-term Treasuries are a far more reliable indicator of future changes in monetary policy than what Fed officials say, and also a far more reliable barometer of the potential for a recession than the stock market — and the past year has been another clear example of this. Throughout 2019, falling yields on the 10-Year Treasury note and 30-Year Treasury bond signaled that the outlook for changes in short-term interest rates was pointed lower, and after a brief pause toward the end of the year, long-term yields began falling again on the first trading day of 2020. As the stock market continued to rise in January, the yield on the 10-Year Treasury note fell, and it ended the month at the bottom end of the Fed Funds rate range, nearly inverting the yield curve again. Then, on the day after the S&P 500 hit its highest level on Wednesday, February 19th, the 10-Year Treasury yield took the next step and declined below the Fed Funds rate range — which inverted the yield curve for the second time in the past year.

The decline in the 10-Year Treasury yield throughout 2019 and into 2020 can be seen in the chart below. Amid the headline-generating volatility in the stock market, the last week of February quietly saw the 10-Year Treasury yield do something extraordinary: as is highlighted on the chart, it fell to a new all-time low, below a shelf of support at 1.3% that had held all through the decade following the financial crisis. It ended the week at 1.127%, a quarter point below the current Fed Funds rate. The yield on the 30-Year Treasury bond also ended the week, and the month, at a record low — at just 1.671%. There is now no Treasury security available to investors with a yield above 2%.

Although the volatility in the stock market during the last week of February was dramatic, seeing long-term Treasury yields break through to new lows like this is a more significant signal. It suggests that current monetary policy, with short-term interest rates being held between 1.5% and 1.75%, and the Fed's balance sheet holding steady near $4.15 trillion, is far too tight for the economy to keep growing. This is a rather amazing assessment by the market, because it implies the Fed will soon ease monetary policy rather dramatically — beginning, perhaps, *before* its next policy meeting.

Undoubtedly the news of the spread of Covid-19 beyond the borders of China has had a dramatic impact on the market's outlook for the economy and corporate profits; major companies like Apple and Microsoft both gave profit warnings last month, and the widespread expectation for profit growth for the broader market appears to have evaporated. However, unlike the bankruptcy of Lehman Brothers in 2008, which was the last time we saw such a rapid shift in the market's outlook for monetary policy, the Covid-19 virus was known about for many weeks before the last week of February. Was the outlook so different on February 19th, when major equity indexes made new highs, than it was a week later, after the S&P 500 had fallen 11%? No, it wasn't, but in the context of a market having been inflated by a $242 billion monetary infusion during the last three months of 2019, it's impossible to know ahead of time when a more rational market sentiment would suddenly return. It's this unique uncertainty, endemic to a monetary-fueled bubble, that makes the market risk so difficult to gauge in times like this.

Yet, just as with the decline in long-term Treasury yields starting on the first trading day of 2020, there were hints within the equity market that the change was coming, even if those hints weren't taken by the broad indexes; you just had to know where to look. For example, amid the increased equity market volatility in January and February, the weakness in the price of oil and in energy stocks stood out. Energy is one of the most economically sensitive sectors in the equity market, and the price of oil fell from $61 to $49 in January, a 19% decline. Share prices of major integrated oil companies and service providers also fell in January. These declines were significant, but they didn't breech any attention-grabbing technical levels — that came in February, when the NYSE Oil Index of energy stocks suffered the third major breakdown since its bubble peak in 2008 (chart below). Although the major breakdown occurred in February, it's clear the energy sector began discounting a much weaker global economy in January.



Over the past year, there has been a heightened risk of recession since the Treasury yield curve first inverted in May of 2019. An inverted yield curve is a market signal that monetary policy will soon ease, most often because economic growth is slowing enough to warrant a monetary response. Because of how long it takes changes in monetary policy to filter through the economy, we have still yet to see the full effects of the Fed's increase in interest rates through December 2018, or the contraction of the Fed's balance sheet through September 2019. These changes were enough to induce the first yield curve inversion since 2006 last year, an event which indicated the economy was already poised to contract in 2020 or 2021.

It is in this context that the Covid-19 virus appeared, which has now weakened the economic outlook further enough to create yet another recessionary yield curve inversion here in early 2020.

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A Few Words on Market Volatility and Precious Metals

> *It's bloodshed. It first started with forced selling from equity investors who also sold their gold positions to cover their losses in equities and also to cover margin calls.*
>
> - Commerzbank analyst Carsten Fritsch, Friday, February 28, 2020

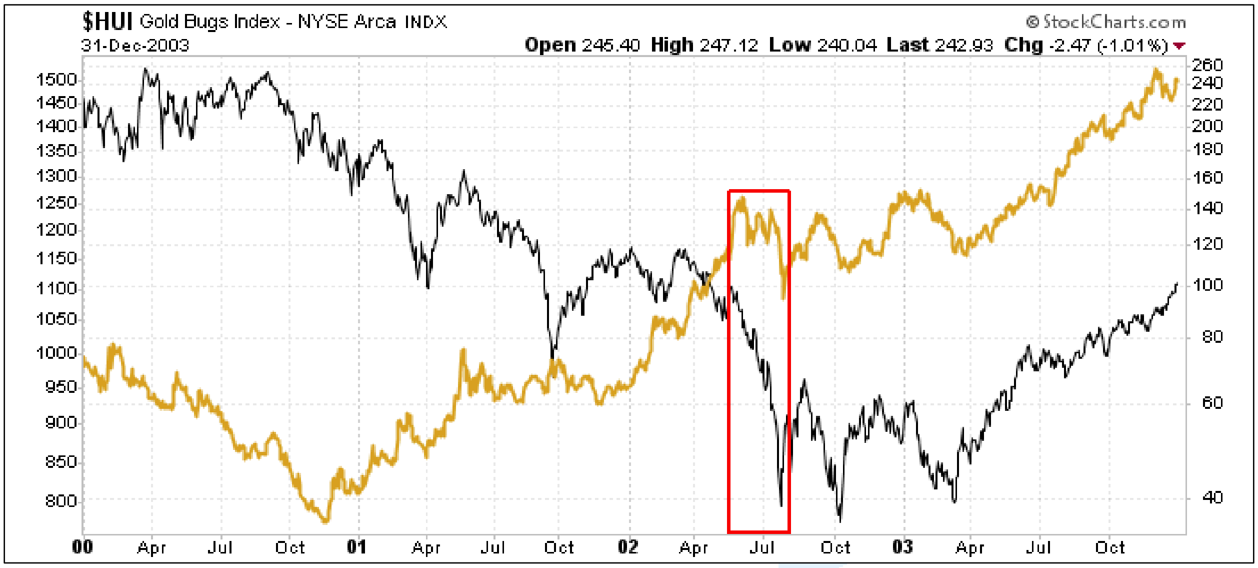
The paradox of a bubble is that in order to keep participating, you have to hold the most overvalued stocks at the worst possible time. Only five stocks accounted for half the S&P 500's year-to-date gain this year before prices started to fall, and this ultra-concentrated source of gains distorted indexes structured to exaggerate and amplify such a concentrated market dynamic. In order to track the performance of an index like the S&P 500 during a period like this, you have to hold these most popular stocks just when the odds of any long-term appreciation in the market is at its lowest — which is a very unattractive position to be in.

Although the advance last fall brought prices marginally above the market's peak in January 2018, February's decline brought the NYSE Composite back down below that peak. Overall, the broadly based NYSE Composite, which is more representative of the typical listed stock than the S&P 500, has seen a modest negative return over the past two years, and a whole lot of volatility. This is what is expected when an extremely overvalued market's valuation stops rising; the lack of sustainable upside potential is the hallmark of high valuations. What we have not yet seen over the past two years is a meaningful retreat in valuations, but the market volatility over the past month served as a reminder of what the beginning of such a retreat can feel like. And the last two days of February also served as a reminder of what can happen to safe-haven assets like gold during vigorous selloffs in the stock market; on the last day of February, gold suffered its largest daily drop since 2013.

Gold and gold mining stocks are not immune during periods of peak selling pressure in the stock market. As the quote above attests, gold is a liquid asset, and during steep selloffs in risk assets, investors are sometimes forced to sell whatever liquid asset they can in order to reconcile their portfolios.

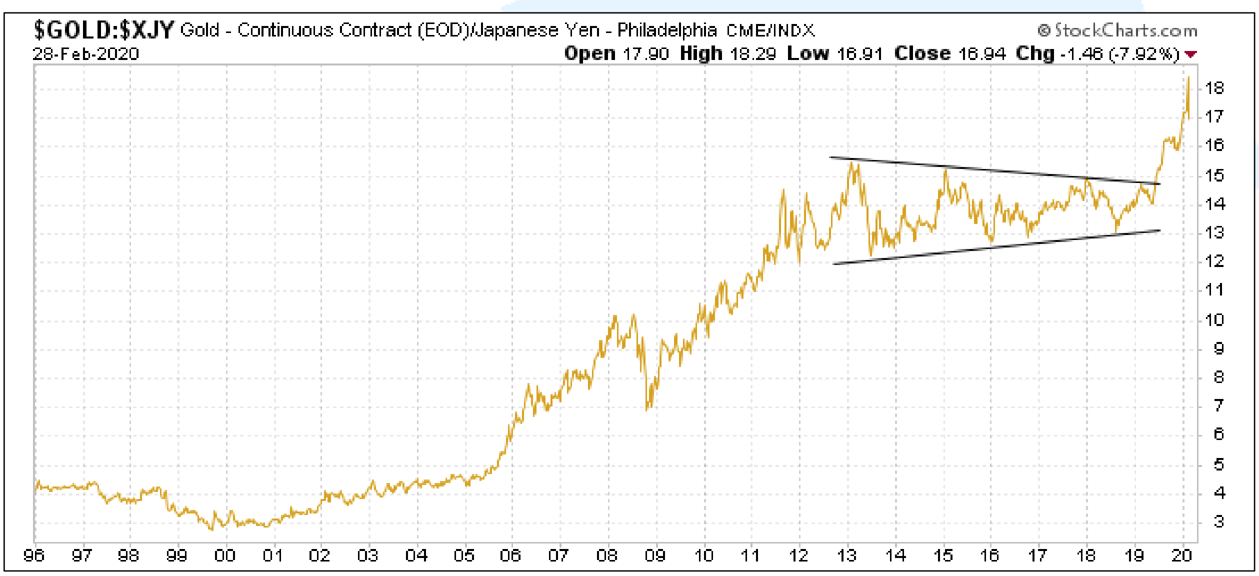
During the bear market following the tech bubble, gold and gold miners fell dramatically at times, but each time prices quickly bounced back once the peak selling pressure had abated. In one particularly memorable episode in the summer of 2002, highlighted in the chart below, miners fell 36% in less than two months as the S&P 500 cascaded down in a wave of selling. In early 2003, a similar decline unfolded as the stock market descended to its final low of the tech bust.

This degree of volatility is not easy to endure, but it is inevitably part of the investment landscape following a bubble. Beyond the short-term swings, however, you can also see in the chart below the dramatic difference in overall trend between gold mining stocks and the S&P 500 between 2000 and 2003. This difference in trend is what should matter most to investors who aren't looking to guess about what the next month may bring, but who are looking for assets which gain in value while a bubble deflates.



Holding onto any bull market is a marathon, not a sprint, and that particularly holds true for bull markets in gold. A steady pace can carry prices a long way over time, but sprinting too fast can quickly lead to exhaustion. Bull markets in precious metals are propelled primarily by monetary devaluation, but short-term spikes are usually driven by fear, which is a very different motivation than what drives bull markets in risk assets. Consequently, when prices quickly outpace themselves in a long bull market in gold, it is usually due to an intense bout of fear, which often fades just as quickly as it appeared. These fear-driven advances can result in high short-term volatility in precious metals, especially when they occur during a bear market in risk assets. It can be difficult to hold through those swings, but the reward for doing so over the course of a long-term bear market in risk assets is substantial.

The chart below shows the price of gold in Japanese yen, and it serves as a good illustration of how the market environment changed over the past year: after an eight-year consolidation, gold appears to be in the early stages of a new bull market. This is an ideal time for investors in real assets.



With interest rates on the entire Treasury yield curve now below the likely long-term rate of inflation, and with monetary policy on the brink of what will probably turn out to be another significant round of monetary stimulus, real assets like gold will likely be viewed as one of the few alternatives available to preserve one's purchasing power once risk assets begin delivering the negative returns that are forecast from today's high valuations.

However, it's also important to emphasize that the road will likely be volatile for all asset classes in the years ahead — intense waves of selling pressure and deleveraging in risk assets can bring all types of assets down for a time. Yet when the dust settles near the end of a cyclical bear market, there is a big difference between economically sensitive assets which were pulled down by a recession, and real assets that benefited from the monetary response. And at the end of a long-term bear market following a bubble peak, the short-term, month-to-month and year-to-year volatility in real assets like gold tends to be long forgotten.

February was a volatile month in the markets, and it's anyone's guess what March will bring. Going forward, however, we feel our portfolio allocations are aligned with the trends which will likely unfold in the years following the current bubble, while also enabling us to use a cyclical bear market to invest in undervalued assets as they appear. We've mentioned equity markets outside the U.S. as maturing opportunities, and it's also likely a cyclical bear market would place the energy sector in a very favorable position for long-term investment. It has been twelve years since the peak of oil prices in 2008, and over the past year we've already begun seeing the early signs of energy assets trading at below liquidation valuations. Every cyclical bear market creates long-term value in some corners of the market, but it's only available to those with buying power to take advantage of it.

We appreciate your taking the time to read this letter. As always, if you would like to discuss investments in your account, or topics discussed in this letter, feel free to contact us — we would be happy to talk with you.

Sincerely,

Brian McAuley
Chief Investment Officer
Sitka Pacific Capital Management, LLC