

# SEABRIDGE

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The optimism that closed out 2017 spilled over into the new year with equity markets turning in a strong performance in January. The MSCI All Country World Index rose 5.7% in the month including reinvested dividends. This performance was all the more impressive given the nearly 25% the index returned in the calendar year of 2017. Markets were cheered by a number of factors including accelerating global economic growth, the enactment of U.S. tax cuts in December punctuating a year of pro-business initiatives on the part of the current U.S. administration, and the continuation of generally loose monetary policy world-wide.

In February, there were some developments that reversed market momentum. A thirty basis point move upward in the 10 year yield to 2.7% early in the year had been fairly well tolerated but the breach of 2.9% in February was a wake-up call that interest rates were really moving higher, and that consequently, world-wide debt, which increased considerably since the Great Recession of 2008, would become more burdensome to service. As discount rates rose and credit spreads widened, financial assets came under pressure. Additionally, higher yields now available in debt markets would naturally serve to position fixed income securities as a reasonable risk adjusted alternative to equities in the search for return on capital.

Rising interest rates perhaps combined with some ambiguous economic data created the low-pressure conditions that precipitated a short-lived market tempest. The employment numbers were strong and wages rose nicely but productivity, a necessary but long missing component to U.S. growth acceleration without inflation, lagged. Additionally, despite strong private sector performance, GDP growth in the U.S. was revised downward for the fourth quarter of last year. This was unhelpful to sentiment. With the U.S. leading the retreat, most markets were off in the 10% range. But even as we moved through this difficult period, a consensus view prevailed that the bull run in equities was not over. Reported earnings in the first quarter were good and economic activity was just too strong for the market to roll over. With no recession in sight the interest rate scare dissipated and upward momentum haltingly resumed, but noticeably lacking the vigor of the run up from last year. Our current thinking is that we had a run of the mill correction in February.

Normally, such a correction would not warrant comment in our quarterly letter. However, a decline of the magnitude of a 10% pullback from the market's high hasn't happened in about two years, an unusually long gap. In fact, the S&P hasn't had a decline of at least 3% from the market's high since Nov. 7, 2016 until the February retreat. That 316 trading-day period, which ended on February 8, broke the previous record that stretched from Jan. 26, 1995 to Jan. 9, 1996, which entailed only 241 trading days. The extraordinary calm and the abrupt about face in February call for some reflection.

The year 2017 was remarkable for the absence of the exogenous shock. No Brexit, no Trump election, no first claim by North Korea of a successful nuclear weapons test. Additionally, the Federal Reserve, the most hawkish of the world's central banks, had signaled a withdrawal of stimulus well in advance of the rate increases enacted.

This foreknowledge dampened market responses to actual central bank tightening. Furthermore, investors in the era of easy money had for years been conditioned to exploit the most minor of market selloffs and buy at lower price points. Finally, an earnings recovery accelerated during the year. Inflation seemed well contained. Optimism reigned. Hence, we had an extraordinary period of calm.

Clearly, with a second market downdraft in March, we believe that this prolonged period of low volatility is ending. The market may have come to the realization that the U.S. and, by extension because of its importance, the rest of the world, may be at the cross roads of great promise and great peril. Below is our short list of the most important issues, ex the yield curve, that will likely move markets, at times dramatically, for the rest of the year.

### **Trade**

When steel and aluminum tariffs were announced by President Trump in early March, the market reacted negatively. Investors were rightly less concerned about the new levies since they were imposed on a relatively small portion of U.S. imports. They were more alarmed that the tariffs perhaps were a harbinger of an all-out trade war. Those fears intensified with the announcement in March of additional tariffs on U.S. \$60 billion of Chinese products including shoes, clothing and consumer electronics. China has responded in kind, imposing U.S. \$3 billion in levies on certain agricultural products and steel pipes.

Some consider the new tariffs an opening gambit to a grand negotiation over reforming an outdated global trade system, that, though revised over time, contains the antiquated presuppositions of a Europe devastated by a world war and a China that was hollowed out by MaoTse Tung. How else to explain tariffs on U.S. autos into Europe or the tolerance of the theft of intellectual property in China. Germany, with its BMWs and Audis, does not need tariff help against Ford imports. Nor is China any longer in an early state of emergence requiring developed country largesse in the form of uneven application of import duties, the turning of a blind eye to illicit technology acquisition or the rationing of market access inside China to Western goods and services. Although the ride will undoubtedly be bumpy, we think eventually cooler heads will prevail and that trade flows will ultimately be freer and stronger.

### **North Korea**

At the time of the writing of this letter, President Trump was still expected to meet with President Kim Jong-un of North Korea on the subject of the North's nuclear weapons program. To call this a high stakes encounter would be an understatement. The outcome of the meeting, should it be held, will likely either be more economic sanctions and the not insubstantial probability of some kind of military intervention by the U.S. or the denuclearization of the Korean peninsula. If we could dream for a moment, the latter outcome could occur in the context of a withdrawal from north Asia of U.S. military personnel, whose presence there reflects the inconclusiveness of a war waged in the 1950's. Such a move would be warmly greeted by China and perhaps could be part of a grand bargain on trade and other cooperative arrangements. In any case, the market will closely follow progress leading to either a very good or very bad outcome and react accordingly.

### **The Mueller Investigation**

Although often in the background, the Special Counsel's investigation into possible collusion between the Trump administration and Russia could produce outcomes that range from a complete exoneration involving the more serious charges or a bombshell indictment that could be directed at the President himself. The investigation has now been in place for 15 months. The market has for the most part tolerated well the slow drip of damaging information and the occasional peripheral indictment. As we enter full bore into mid-term election season, the political ramifications of the committee's work, and the market's reaction thereof, will become more pronounced.

### **The November Mid Terms**

If the Mid Term elections were only a vote on the Trump agenda, the odds that Republican retain the House and Senate would be significantly higher than what generic balloting currently suggests. As it is, the election will likely be a referendum on Trump himself which will have a profound effect on voter psychology. If Republicans lose either or both the House and Senate, the market would likely view this outcome as unhelpful to the pro business agenda that Trump has promoted and react negatively. The obverse would likely be true.

The issues mentioned above are political in nature and have a decidedly U.S. tilt to them. There are other political narratives outside our borders that also bear watching. Italy has veered decidedly right in its recent election results and is now somewhat out of step with the more centrist governments of Germany and France. The rise of the right and the tapering of the BOE's bond purchase program may, as was the case during the Greece crisis of 2015, call into question the durability of the European Union. Also in Europe, the terms of Brexit have yet to be announced. Those terms could signify an amicable parting of ways or a post Brexit relationship between the two regions that damages one or both entities. On the economic front, the elephant in the room is still central bank policy and the withdrawal of excessive liquidity in the system. The market will be on alert for any sign that central banks including the Fed have gotten behind the curve.

We would like to end on an optimistic note. We believe that the U.S. will continue to lead a world of accelerating growth and improving earnings, conditions which should be supportive of equities in the near term. We take issue with strategists who proclaim that we are near the end of the business cycle. They obsess over the calendar and note that the 10-year expansion represents the longest period of growth in U.S. history and that synchronized global growth is a rare and short-lived anomaly. Our view is that this period of growth cannot simply be categorized in historical terms. The extraordinary surge of money supply in the decade post the Great Recession was unprecedented and the single biggest reason for the stock market's resurgence and the economic recovery, meager though it has been, experienced thus far. It also provided cover to politicians reluctant to enact true fiscal stimulus and de-bottleneck the private economy through regulatory reform. The U.S. has made a good start in the past year on both fronts. If we don't screw up on trade, we see no reason why the current economic expansion cannot defy a conventional view of its life expectancy. Two key elements of a normal business cycle have been missing over the past decade: capital investment and housing. With 100% depreciation in place for capital equipment investment because of the new tax law, we expect capital expenditures to contribute more meaningfully to growth. Rising wages, fuller employment, easier access to credit and demographics that are spring loading demand for housing, should be tailwinds for the housing market. The added benefit to cap ex is that it is inherently disinflationary and may counter the stimulative effect on pricing of goods and services that tax cuts entail. Both cap ex and the risks that follow from the muddled geopolitical conditions mentioned above may help bend the fed funds forward curve downward which would be supportive of the markets. In summary, our base case is that the market advance continues, but with noticeably more volatility.

We have included in this package commentaries on the major investment strategies that SeaBridge manages. If you would like to discuss any of them, please call or email us. See below for email addresses.

Looking forward to Spring,

*Your SeaBridge Team*

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