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Dow 17,000+; Happy 4th of July!

And, that happy fact duo is not all the good news. In June, the U.S. economy created 288,000 jobs which with the prior four months was the first time since 2000 that we have created more than 200,000 jobs five months in a row[1]. Unemployment fell to 6.1% in June, the lowest reading since September 2008[2]. Auto sales are heading for the first 17 million year since 2006[3]. New home sales in May rose 18.6%, the biggest one month gain since 1992[4]. The median new home price was up 6.9% from a year ago[5]. Commentators have been saying that, to lift confidence, we desperately need better news on employment, wages and housing. Confidence (Michigan) rose from 81.9 to 82.5 - May to June[6]. So we are getting the lift! James Bullard, President of the Saint Louis Fed, predicted that interest rates will start rising early next year - three to six months earlier than the latest guesses of most FOMC voting members. That is good news regarding the economy, but perhaps not for the stock market.

In the second quarter, the S&P 500 index returned 5.22%, the Russell 3000® Index had a positive 4.86% return, the MSCI World Index was up 5.23%, and the MSCI World Index ex the USA returned 5.25%. For the six month period, the S&P 500 index gained 7.12%, the Russell 3000® Index was up 6.93%, the MSCI World Index was up 6.50%, and the MSCI World Index ex the USA gained 5.90%.[7]

George Akerlof (Janet Yellen's Nobel laureate husband) and Robert Shiller (the Yale economist and housing Guru) wrote a book in 2009 titled *Animal Spirits.* One of its several excellent points was that emotions and confidence determine economic outcomes as much as the starting fact circumstances.

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[1] Bureau of Labor Statistics

[2] Bureau of Labor Statistics

[3] Bureau of Economic Analysis

[4] US Census Bureau

[5] US Census Bureau

[6] University of Michigan

[7] Results for these indices (S&P 500, Russell 3000®, Morgan Stanley Capital International All Country (MSCI) World Index and MSCI World Index ex USA) are quoted as being somewhat representative of the broader equity markets for comparison to SeaBridge U.S., global, and foreign portfolios. The SeaBridge portfolios differ from these indices (in number of securities held, industry, sector and country weightings, etc). Therefore, in any given period, results for SeaBridge portfolios are likely to differ from the results for these market indices.

If we could work together and compromise for progress, the U.S. economy has all the resources needed to recover fast. It is possible that we are at an inflection point from which the acceleration in growth, frequently predicted, but yet to appear, will emerge.

However, not all the news is good. First quarter GDP data was revised down sharply, with consumer spending up only 1% - the weakest in almost five years - allowing big falls in exports and healthcare spending to send the economy down 2.9% in 1Q14[8]. Real consumer spending fell 0.2% in April and 0.1% in May, so it will take robust spending when the June report comes in to make the second quarter strong enough to offset the poor first quarter[9].

And, the third item in the "we need" trio above - wages - remains a problem. The background facts behind weak retail spending are shrinking median real earnings plus the income divide. U.S real (inflation adjusted) median household income fell from $56,000 in 1999 to $51,000 in 2012, and is still drifting down[10].

This is not mainly from a transfer of manufacturing jobs to China, but rather the astounding impact of productivity. It comes from the impact of greater automation on the number of manufacturing workers and the impact of computer software on layers of middle management. "Progress" has been relentless and huge in total. Since 2000, productivity is up about 30%, and wages have stagnated, meaning fallen in purchasing power[11]. The fruits of this have gone to corporate profits and stockholders, but the workers have, in many cases, been laid off and then rehired in lower paying jobs. The educated and wealthy -the top 20%- are doing well - their greater skills are more valuable, and the rise in the market has restored their wealth. But for the total public, times are not good, and it is not surprising that retail sales are under pressure.

So, our hope for the U.S. as we enter the second half of 2014 is a rise in confidence, an increase capital spending, a rise in wages, and better times ahead. But the "real wages reality" plus the impact of retiring baby boomers, says that progress will be slower than we would like, and slower than our post WWII experience has led us to expect.

In a July 1st interview, David "Danny" Branchflower, Dartmouth professor and former member of the Bank of England Monetary Policy Committee, called the recent U.S. data a "point of light" in a worrisome world. The overseas world is not doing badly, but has less forward momentum than the U.S. Europe, ex France, has broken free of its recession and the hope is that banks will start lending again once their Asset Quality Review is completed this fall. The European market has recovered - lifted by multiple expansions on political relief, rather than earnings increases. With returning growth, European companies could do significantly better. We are moving in that direction in our international portfolios.

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[8] Bureau of Economic Analysis

[9] Bureau of Economic Analysis

[10] US Census Bureau

[11] Bureau of Labor Statistics

China looks better than it did a quarter ago. Housing is still slowing, but the risk of a real estate meltdown appears low; Beijing has the resources to deal with problems and appears to have the adjustment under control. Recent moves by the Peoples Bank of China have eased monetary strains and the infrastructure building taps have been opened to keep growth around 7%. The Chinese market seems cheap, and several longer term prognosticators see Chinese stocks recovering as the "reform strains" are passed.

Japan remains a riddle - will PM Abe's reforms allow Japan to break out of deflation and grow in spite of the world's worst demographic profile? Abe must "thread the needle" of enough stimulation to get aging savers spending again, while not so much stimulation to raise inflation fears. That latter risk leads to rising interest rates, which Japan cannot afford with its 220% government debt to GDP ratio[12]. What is not a riddle is that Abe's foreign policy is annoying his neighbors in the extreme. Both China and Korea are angry about Japan's attempt to rewrite WWII history and rationalize its behavior as an occupier. Stay tuned but, in the meantime, we have limited exposure to Japanese equities.

Latin America? Well Mexico is doing better, Brazil is hosting the World Cup successfully, and Argentina is once again trying to shed its debt without paying the bill. We will see how it appears in the fall.

Finally, the Middle East. I am reminded of my years on the USS Boston, standing on the ship's fantail, and watching how rapidly the water returns to its undisturbed state after the ship passes through. We spent over a decade trying to "solve the Middle East" and we are now back to the intractable Sunni-Shia and Israeli-Palestinian conflicts which have no end in sight. The one plus is that Iran does not like what is happening in Iraq any more than we do, and a rapprochement with Iran seems more likely now than before. The portfolio implication of this is that we want North American hydrocarbons in our portfolios - one thing which could tip the world back onto a recession is an oil price spike above $125/barrel.

Last quarter we opened with "Steady as she goes." That was right in market terms as the second quarter was good for equity prices. Our outlook is still "Steady as she goes" but, as the end of the Fed's bond buying comes into sight in the fall, volatility is likely to increase - perhaps substantially.

Garnett Keith

Attached to this letter is a copy of John Conti's interesting analysis of the potential for productivity growth as well as David Descalzi's insightful comments on Asia.

See general disclosures at the end of the document.

[12] Factset

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General Disclosures:

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