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*Edited copy of letter sent to individual clients of SeaBridge Investment Advisors for the Second Quarter 2015*

**"So, is this where the excitement begins?"**

Fifteen months ago, I started the letter with the riverboat leadsman's call to the helmsman, **"Steady as she goes."** That was slightly less than the most favorable historical call, which was "**No bottom,**" meaning my lead line cannot reach the bottom and we do not have to worry about running aground. Neither of those calls would be right now - today we are out of the known channel and trying to assess the risks of various courses, speeds and economic sandbars.

Before I get into the details of the economic and market outlook, let us report on what happened in the markets:

Returns were modest in the quarter. The S&P 500 rose only 0.3% and the Russell 3000® Index 0.1%, while the MSCI All Country World Index gained 0.5%, the MSCI World Index ex the U.S. was up 0.7% and the MSCI AC Far East ex Japan Index was up 1%. For the six month period, the S&P 500 was up 1.2% and the Russell 3000® Index gained 1.9%. The MSCI All Country World Index returned 3.0%, the MSCI World Index ex the U.S. was up 4.3% and the MSCI AC Far East ex Japan Index gained 6.0%[1]

Three unknowns loom in the remainder of the year:

1. On Sunday, the Greek people voted NO on a question seen differently in Athens and Brussels. In Athens, the question was whether to agree to more reforms (austerity) without getting forgiveness of some of their outstanding debt. In Brussels and especially Berlin, the referendum was about whether the Greek people wanted to stay within the Eurozone and make yet another effort to achieve the reforms necessary to stay within the currency block. The vote was not close - the NO's had a 61% following. The Greeks are clearly exhausted by five years of austerity which has not worked. This has left an economy shrunken by 25% with 49% youth unemployment and 26% unemployment overall.

   As Monday dawns, it is unknown what happens next. The jubilant Syriza Party is ready to start negotiating again in Brussels, but this time on the terms of their democratic mandate. However, many Europeans (especially Germans) feel the Eurozone will be stronger without Greece and are in no mood to resume negotiations. If the Greeks do not want EU help, let them live with their closed banking system.

[1] Results for these indices (S&P 500, Russell 3000®, Morgan Stanley Capital International All Country (MSCI AC) World Index, MSCI AC World Index ex USA and the MSCI AC Far East ex Japan Index) are quoted as being somewhat representative of the broader equity markets for comparison to SeaBridge U.S., global, foreign and Asian 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.

At the top of the list of questions:

- Will Europe send emergency funding to get the Greek banks reopened - on top of the €9 billion the ECB pumped in to keep Greek banks open during the recent negotiations?
- The IMF says Greece needs €50 billion to keep it afloat until its economy can be restored (assuming the needed reforms are finally put in place), plus at least half its debt forgiven (that would be roughly €120-160 billion.) Where will €50 billion come from if they reject the EU terms offer?
- While solutions are sought, Europe will be pounded with daily installments of news on how financially off course their "United Europe" project has been going. Could this cause reconsideration of the entire move toward using a currency lock as the means to drive European integration?

Markets will almost certainly be volatile while European politicians grope to find a plan to restore order and cut humanitarian distress in Greece. Relative to Europe, Greece is so small - an economy about the size of the state of Oregon - that its seize-up is unlikely to tip Europe back into a recession. But all the uncertainty will likely be a depressant on confidence and growth.

2. China is slowing faster than expected or desired by anyone. In 1Q15 China reported GDP growth of 7% down from a 7.4% growth rate last year. But of the 7% reported, 1.3% came from net exports, and that mostly from the impact of falling commodity prices reducing imports rather than an increase in exports. In the prior year net exports had contributed 0.1%. So excluding the impact of commodity prices, domestic growth in China tallied something like 5.7% in 1Q15. The second quarter GDP number comes out in about three weeks. All eyes are on whether domestic growth in China turns up or down.

   At the same time, the stock market bubbles in Shanghai and Shenzhen are deflating in spite of official efforts to reverse the slide. We have felt that a hard landing in China is unlikely because of Beijing's enormous financial strength. But could a slowing economy and falling stock market strain Beijing's ability to maintain control?

3. The world expects our Federal Reserve Bank to start lifting interest rates this fall which will end seven years of easing rates and pumping liquidity into the U.S. and world economies. The "when will they start" drama has been playing for a year, with Fed Chair Janet Yellen saying tightening will start when the labor market recovers further and inflation is solidly headed back above two per cent. These conditions will signal that our economy is doing well and a sustainable recovery still has years to run. The problem is we do not know what evils have been hidden by this protracted period of unprecedented easing. The problems may be small, or as discussed below, they may be larger than we now foresee.

So let me ignore ISIS and Vladimir Putin and conjecture what the leadsman should call to the helmsman in light of these three unknowns.

Regarding Europe, we received a sneak preview of the late June turbulence when in early May Hans-Werner Sinn's book (<u>The Europe Trap, Bursting Bubbles, Budgets and Beliefs</u>) came to our attention. Sinn is President of the Ifo Institute, one of Germany's top research institutes, and a co-spirit of the economic staff at the Bundesbank. Thanks to Amazon, we got a copy immediately and spent May plowing through the dreadful story of how the EU project got so far off course between 1999 and 2015. As the parade of political "cop-outs" mounted, our conclusion was that the magnitude of the bad news is not widely known, and the end of the Greek reform period on June 30 would likely surface considerable ill-will on both sides. (In early June, you probably noticed a number of sales in our Yield Growth, Inflation Fighter, and International styles as we cut back European exposure.) The magnitude of the problems are coming to light in the difficulty of the Greek negotiations. Even after five years of austerity, Greek labor costs per hour are still almost twice those in Poland, and strong unions make further cuts unlikely. If advances to the troubled European GIPSIC economies (Greece, Italy, Portugal, Spain, Ireland, and Cyprus) stopped now, the tax hit would approach €6000 for each person in Germany, Holland, Finland and Luxembourg. How this all comes out is not clear, but two things are fairly certain: (1) The northern European politicians have not wanted to give their voters the full story on the bill they have coming their way. Hence, a great resistance to Greek debt write-offs that would make the accounting clear. (2) In 3Q15, Mario Draghi will be running the European Central Banking System money printing presses overtime to dampen market volatility. Since money printing lifts stock prices, we are not negative on better quality companies in Europe once a forward path is clear. But we are concerned about turbulence in July as quarrels rage over who pays for the uncollectable debts, plus the small possibility that some totally unforeseen turn is taken.

The unknowns of stresses in China's economy have seldom been greater. Last Wednesday the World Bank released their Economic Update on China. This included a section which was quite critical of China's economic management, saying that Beijing was moving too slowly to address growing debt problems and was still favoring their State Owned Enterprises to the extent that smaller private companies are being starved for credit. Who knows what pressures went on behind the scenes, but on Friday the World Bank "redacted" their report - pulled it from the internet and reissued it with the section elaborating on China's economic mismanagement deleted. Their reason was that the report "did not meet our standards of discourse with member governments." (That plus probable fear of a Beijing cyber attack on their computer system.)

Apartment prices, which had been falling in almost all Chinese cities, stabilized somewhat in the last quarter, with 15 of 70 cities showing stable or rising prices. This helps the public mood in a country where real estate is the primary savings vehicle. However, in the past three weeks, stock prices in Shanghai and Shenzhen plummeted in spite of credit easing and powerful administrative guidance to investors to stop selling. Although off 30% from the June 12 peak, the market is still up over 70% since last November. So investors are frantically selling futures to protect their profits, and the futures providers are selling the underlying stocks to keep their positions balanced. Margin borrowing by retail punters is huge in the Chinese markets so the slide is also being forced by margin calls as prices retreat. Where this ends is uncertain, but bad surprises can come out of such turbulence, and we are being very careful with our China H share exposures via Hong Kong, and we have no A Share exposure in stocks trading solely in the Shanghai or Shenzhen markets. Nonetheless, the pressure on Chinese markets will likely depress Chinese stocks wherever they trade.

Meanwhile, here at home the economic recovery continues. Unemployment falls, consumer confidence and auto sales hit records, while housing sales surpass recent highs. I was feeling good about things when I heard a comment by Bill Gross, the bond czar, that the most important thinking he had seen recently was the criticism of U.S. monetary policy in the Annual Report of the Bank for International Settlements (BIS). BIS is the Central Bank for the World's Central Banks, and has a highly regarded research staff in Basle, Switzerland. So I pulled the report off the internet and got chapter and verse of what has been bothering recently departed hawkish Fed Governor and Regional Presidents Jeremy Stein, Charles Plosser, and Richard Fisher.

The essence of the report is "When the Unthinkable becomes Routine, you probably have a Problem of which You are Unaware." The BIS complaint is that Central Banks, and especially the U.S. Fed, are too fixated on inflation as the measure of when to tighten credit. Note well that globalization creates new inputs and flows which increase supply and dampen reported inflation. Hence apparent inflation may be dormant while other problems are increased by monetary policy that is too stimulative for too long. Allen Greenspan's failure to see the U.S. housing bubble in 2003-07 because overall inflation figures were OK is Exhibit A. In 2015, the speculation in Silicon Valley private companies, the forcing of pension plans, insurance companies, and retiring savers into risky debt to get any yield, the boom in corporate borrowing to finance stock repurchases, a growing number of emerging market companies borrowing in dollar denominated debt all say that matters may not be going as well in our economy as we think. It would be wise to get interest rates up from zero quickly to see what unknown problems are being obscured by our excessively easy money solution to combat slow growth.

My reaction to the BIS report is "message received." The riverboat leadsman inside me is telling the helmsman to slow down and be careful because we do not know how to read the current soundings. We may have excitement in the markets between now and yearend. The Fed should probably raise rates to 0.25% in September, and if our economy is growing at a 2.5+% rate in the second half of the year they should probably increase rates to 0.5% in December. That would be consistent with Europe getting a plan together, China stabilizing its growth and markets, and no unexpected problems arising as the Fed begins to tighten. We believe the earnings outlook is solid for the companies we own and that their stock prices should be higher in 2016. However, the problems in China and Europe and the BIS warnings about unknown consequences are sobering. We are holding more cash than usual right now should known and unknown problems surface during the rest of the summer.

Happy 4th of July to you and your families,

*Garnett L. Keith, Jr.*