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INVESTMENT ADVISORS, LLC

John Conti, David Descalzi, Susan Boyd
Howard Chin, RoseAnn DeHaven, Nicole Goberman, Adrian Morffi, Angell Xia
450 Springfield Avenue, Suite 301 • Summit, NJ 07901-2610
Tel: (908) 273-5085 • Fax: (908) 273-6297

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Equity markets were strong in the second quarter led by the European bourses, each of which, in U.S. dollar terms, outperformed the S&P 500, which itself advanced 3% during the quarter. The Nikkei participated in the rally, returning 5% in U.S. dollar terms; the emerging markets benchmark index was up over 6%.

Undoubtedly, market performance was driven by the solid earnings performance of companies in the first quarter. Additionally, according to the IMF's most recent forecast, global growth is set to reach 3.5% this year and 3.6% in 2018, which is higher than that in their last published forecast of October of last year. Does all this good news mean that the "all clear" for markets is finally being sounded post the Great Recession of 2009?

Maybe, but we'll start with a list of things that bother us:

1. **A U.S. economic expansion, unprecedented for both its duration and the anemic growth rates posted since the recession of 2008**. The pace of economic growth in the United States since the end of the recession in 2009 has been slower than the previous 10 expansions, with the worst rate since at least 1949, according to a report from the Congressional Research Service. The report finds that real GDP, the value of the goods and services produced by the nation's economy, has grown at an average rate of 2 percent per year during the recent recovery. In the previous 10 expansions, real GDP grew by 4.3 percent on average.
2. **Unprecedented expansion of the central banks' balance sheets with mostly long duration assets**. As of April, this year, the Federal Reserve's balance sheet has roughly quintupled to $4.5 trillion, or around a quarter of U.S. gross domestic product, from about 6% before the crisis of 2008. The Bank of England's balance sheet has undergone a similar expansion. The value of assets held by the European Central Bank has more than doubled to around 36% of GDP. For the Bank of Japan, the balance sheet and the size of the nation's economy are roughly equal.
3. **Negative interest rates**. Over the last few years, we have witnessed the emergence of a strange, unprecedented phenomenon in much of the developed world outside the U.S., namely the charging of negative interest rates. The European Central Bank reduced its deposit rate to -0.1 percent in June 2014, and since then it has reduced this rate further, to-0.2 percent in September 2014, -0.3 percent in December 2015, and to -0.4 percent in March 2016. And apart from the ECB, four other national central banks, those of Switzerland, Japan, Denmark, and Sweden, have also reduced interest rates on certain parts of their deposits to negative levels. The negative interest rate phenomenon is not limited to the short end of the curve. As of this writing, six countries have five year sovereign yields in negative territory, four have seven year yields of less than 0% and one, Japan, has a ten year yield in the same category. Anyone holding these bonds is losing money; strange indeed.
4. **A deflationary trend that defies the Milton Friedman maxim that inflation is always and everywhere a monetary phenomenon**. Where is the inflation that accompanies too much money chasing too few assets? When quantitative easing was introduced following the financial collapse that gave way to the Great Recession, many people feared hyperinflation would result. Prices have risen modestly, but by historical measures, inflation has been subdued and there certainly has been no hyperinflation in any country other than those that are suffering through political upheaval.

5. **A dearth of U.S. labor productivity**. Productivity has increased at an annual rate of less than 1.0 percent in each of the last six years. Productivity growth averaged 1.2 percent from 2007 to 2016, well below the long-term rate of 2.1 percent from 1947 to 2016.
6. **A stock market advance driven by a handful of stocks**. Approximately a fifth of the stock market's gains this year have come from just five stocks as of last week: Apple, Amazon, Facebook, Microsoft and Alphabet Class A shares.
7. **A historic gap that is the mismatch between job openings and a labor force that lacks the education and skills necessary to fill those jobs**. A recent report from the National Federation of Independent Business showed that the share of small business owners reporting job openings they could not fill in May was the highest since November of 2000.

It's a long list and probably an incomplete one. On the other hand, here is a list of conditions that may help explain the recent bull run in equities:

1. **Earnings**. As of June 19, according to Thompson Reuters, first quarter earnings are expected to increase 15.5% from Q1 2016. Of the 500 companies in the S&P 500 that have reported earnings for Q1 2017, 75.6% have reported earnings above analyst expectations. This is above the long-term average of 64% and above the prior four quarter average of 71%. The first quarter 2017 blended revenue growth estimate is 7.3%. Excluding the energy sector, the revenue growth estimate declines to 5.3%. 63.1% of companies have reported Q1 2017 revenue above analyst expectations. This is above the long-term average of 59% and above the prior four quarter average of 53%. Companies seem to be adapting nicely to deflationary pressures that have set in post the 2009 recession.
2. **No US recession near term**. Employment is too strong. Unemployment claims are at their lowest level since the last recession and wages are rising at the fastest clip in eight years. The Leading Economic Indicators are up nicely and all reputable business and consumer confidence surveys have spiked to levels not often seen since 2009.
3. **Low interest rates**. Despite the recent rate increase and hawkish rhetoric coming out of the Fed, US interest rates seem poised to remain low and thus be supportive, for the time being, of financial assets.
4. **Chronically challenged international economies are doing better**, supported, for the time being, by an ultra loose money policy of their home central banks.
5. **No bubbles**. Unlike the crises of Asia in the nineties and housing in the last decade, we see no real bubble whose bursting would cause a similar widespread panic. Certain credit excesses are evident in the current level of China's total private and public debt outstanding, commonly referred to as total social financing. On the home front, student loans, auto credit and private equity are three areas where credit expansion has been notable. While China is a concern, the most recent data suggests that credit growth is now commensurate with economic growth, a sign that China is finally becoming serious in its efforts to curb credit growth. None of the other items mentioned is of a size that we think would create the financial system chain reaction that triggers a wholesale abandonment of risk assets and, consequently, a severe hit to the real economy like that experienced in 2008. As a result of stress testing and the imposition of more demanding capital standards and other regulations, we now know from the release of the Fed's Stress Test results that U.S. banks and the major foreign banks that do business in the U.S. are in much better financial position to withstand the strains on their balance sheets that inevitably develop in a downturn.

While we take some comfort in these positive signals for markets, the internet continues to roil our sense of continuity about things that worked in the past. Hasn't the value of incumbency been diminished as a result of the internet? Haven't companies that have been protected by barriers to competitor entry been reduced in number because of the net? What effect has the internet and the proliferation of social media had on the behavioral patterns of the customers of these businesses? Amazon deliveries are just the tip of the iceberg. Disruption and demographic shifts are happening with increased rapidity. Artificial intelligence and its proliferation through the democratizing venue of cloud computing will undoubtedly have a profound effect on the way companies deliver goods and services. It is too early in this epoch of demographic change and AI to know the extent and depth of those changes. There will be winners and losers among the companies we follow in this fast-changing world. It is our job to try to figure it out.

Finally, there is the wild card of politics. We do not believe that, because we are living in a time of hyper-partisanship, markets are more at risk. In fact, it may be the case that some of President's Trump's pro-growth agenda makes its way into legislation if only for the reason that Republicans need something to present to their constituents in time for the 2018 mid-term elections. Any lowering of the corporate tax rate or passage of an infrastructure bill would likely be cheered by the markets. Obviously, should the special prosecutor investigating the president produce evidence of Trump campaign collusion with Russia in the election or the obstruction of justice by the president, all bets would be off the table.

Perhaps our biggest concern is market complacency.   Equity market volatility is running now at half its historical average. We are wary of the calm. We are skewing towards risk aversion in all strategies. This means more cash than usual in our portfolios and a general avoidance of high priced growth stocks.

As you may know, SeaBridge manages portfolios across the risk asset spectrum and geographies. Attached to this letter is a depiction of this. This breadth of capability can be very helpful in achieving the benefits of diversification, especially in times of uncertainty. We will be sending you information soon that may be helpful to you in assessing whether you should broaden your investments beyond a single style. We are happy to have those discussions with you at any time.

Wishing you a happy summer,

Your SeaBridge Team