SeaBridge Investment Advisors, LLC

Garnett Keith, John Conti, David Descalzi, Susan Boyd
450 Springfield Avenue, Suite 301 • Summit, NJ 07901-2610
Tel: (908) 273-5085 • Fax: (908) 273-6297

October 7, 2014

Edited copy of letter sent to individual clients of SeaBridge Investment Advisors for the Third Quarter 2014

"Passengers please return to your seats and fasten your seatbelts"

On a recent flight from Newark to Seattle, we got that announcement repeatedly between the Mississippi River and the Rocky Mountains. It never got really bad, but the pilot was getting reports from planes ahead that they were encountering substantial turbulence. The U.S. economic expansion is proceeding - auto sales are strong, and oil finds are reducing gasoline prices. Housing and retail spending are a bit slower than we had hoped but continuing to move in the right direction. However, economies outside the U.S. are struggling and their passengers are beginning to ask the attendants for more air-sick bags.

Stock market returns around the world were negative in August, bringing down the returns for the third quarter and first nine months of 2014. For the third quarter, the S&P 500 index returned 1.1%, the Russell 3000® Index was up only 0.01%, the MSCI World Index was down 2.2%, and the MSCI World Index ex the USA lost 5.2%. For the nine month period, the S&P 500 index returned a positive 8.3%, the Russell 3000® Index gained 6.95%, the MSCI World Index was up 4.2%, and the MSCI World Index ex the USA was up only 0.4%.[1]

The U.S. is a $17 trillion economy with real growth at about 2.2% for 2014. The 28 E.U. countries are about an $18 trillion economy, growing at about 0.8% in 2014. China is a $10 trillion economy growing about 7.3%. Japan is a $5 trillion economy growing about 1.2%. Those growth figures plus growth on $25 trillion of GDP from all the other economies not mentioned, adds up to world growth of about 2.7% on a on a $75 trillion world economy. The sum is an absolute annual global product expansion of about $2 trillion.[2]

That represents a lot of work by a lot of people, and lives should be better. But from the stock markets' viewpoint, several other questions intrude:

1. Is that more or less than we were expecting?

---

[1] 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.

2 Wells Fargo, “Monthly Economic Outlook”, Oct. 8, 2014.

2. Is the direction and momentum getting better or less good?
3. At what rate do I discount earnings growth beyond this year?
4. And most importantly, am I feeling confident or more frightened about the future?

For the U.S.:

1. Reality turned out to be roughly in line with what we were expecting, with the first six months disappointing, and the start of the second half better and more or less on target.
2. Direction is right, but momentum was spotty - very weak, a rebound, and then steady expansion in the second half. Looking ahead, the U.S., standing alone, should grow faster next year. But with the rest of the world fading, there is a risk that trade and psychological effects from overseas could slow the improvement of the expansion at home.
3. Lower discount rates are better. It is unlikely that rates will be lower in the future than today, as the Fed's rate repression will end with time. This is probably as good as it gets for monetary support for the U.S. economy. But, with the world economy weak, we do not expect much of a rate increase either here or abroad for 2015. Hence the monetary framework remains supportive.
4. Psychology is the wild card. As U.S. unemployment falls and job assurance rises, U.S. citizens should feel better. But low wages for unskilled workers at home or any economic or geopolitical shock abroad could rattle the post-2009 confidence recovery.

Outside the U.S. the answers are more discouraging:

1. In Europe, China, and Japan, the outlook as we enter the fourth quarter of 2014 is less promising than it was as we entered the year. Europe is rolling over into another recession. Retaliatory sanctions following the Russian intervention in the Ukraine are making a weak situation worse. China is proceeding with its reform agenda, but growth has fallen below the expected range and Beijing has said they will accept lower growth rather than add building projects to support the economy. (This is probably wise in the intermediate term as GDP growth still exceeds 6% per year. However, the limited response is disappointing to outsiders who want fast Chinese growth to pull the world economy forward.) Japan is trying to break out from a 20-year deflation, but the most recent numbers on both production and retail spending are below hopes.
2. The direction and momentum of growth abroad are both lower than hoped, and governments will not or cannot fix the shortfall. Europe remains locked in a common currency at rates that over-stimulate Germany and depress all their E.U. partners. This looks more problematic with every passing quarter. At the moment, the pain of breaking the currency lock appears greater than the pain of maintaining the union. However, the united E.U. economy is going in the wrong direction and there is no agreement on the policy changes needed to fix it. China could stimulate with more infrastructure building, but part of their current problem grows out of their ill-considered 2009 building program, some of which did not turn out well. Understandably, they are hesitant to do more. Japan has a shrinking population, massive government debt, and an aging society, which is more inclined to save than spend. The Abe government has broken with tradition to provide a massive stimulation program, but government spending to offset the excess savings makes the debt problem worse and the weakened currency has not accelerated exports as much as hoped.

So, Japan needs an immigration stimulus of younger, high spending workers (unlikely in Japan) or a confidence miracle to get the existing population spending more.

3. The interest rate outlook abroad is positive - there is little risk that foreign rates will rise, and a good possibility that foreign governments will be printing money at a faster rate as the Fed ceases to print. This should help world security prices.
4. There is the potential for world psychology to get better, since, given all the problems, psychology is not euphoric anywhere. However, with no immediate solutions to the problems, and with ISIS in the Middle East and the Russian face-off in the Ukraine, it is hard to predict much confidence improvement either.

So what does that all add up to? Left to itself, the U.S. expansion should continue and corporate earnings should increase enough to support higher stock prices in the future. However, we live in a global economy, and many large American companies have significant exports or foreign operating divisions where the outlook is not as good. We're keeping an eye on these developments as we manage each of our investment strategies.

Our **Asia Strategies** are being conservative in stock selection and focusing on growing consumer spending in China - the goal of many of China's current reforms. Asia portfolios hold about 5-10% cash for buying opportunities if the market gets frightened.

Our **International and Inflation Fighter Strategies** have reduced high P/E multiple holdings and are in the process of shifting portfolio holdings somewhat, replacing some cyclical stocks with non-cyclical stocks. This process has current cash levels of 19-24% available for new purchases as foreign stocks, or U.S. companies with substantial foreign operations, weaken.

Our **Core Global Strategy** is holding about 9-14% cash for buying opportunities and is maintaining its focus on companies that will do well as the U.S. recovery continues. Some portfolios have less cash due to withdrawals or special circumstances.

Our **Yield Growth Strategy** has significantly reduced cyclical holdings and increased non-cyclical holdings. These portfolios generally hold 6-10% cash, although cash levels vary based on specific factors, such as large MLP holdings with taxable gains or recent inflows.

Our **Cautious Core Strategy** has severely limited both cyclical and foreign holdings and is generally holding cash in the 15-25% range. Some portfolios hold less cash (because of extra holdings in MLP's or other securities or withdrawals) and portfolios in the process of investment may hold more.

The hammering of daily market declines is unsettling but, with ample cash reserves, the opportunity presented by seeing the stocks of good companies fall back to levels where they seem like good buys is encouraging. We do not know whether the current adjustment is a short or intermediate term affair. With the psychological support of Fed money printing ending, and since the market has been so strong for the past five years, we think it might be an intermediate term adjustment. However, some piece of unexpected good news could convert heavy hedge fund selling to buying and the market could rally strongly.

We hope we have struck the right balance of conservatism for our various strategies. Please contact us if you have questions about your portfolio or would like to discuss changes in how we should manage it.

Best regards,

Garnett

Attached are separate commentaries by John Conti on the Core Global Equity strategy and David Descalzi on the Asia strategy.

See general disclosures at the end of the document.

****

General Disclosures:

Note: this is a copy of a quarterly commentary sent to clients of SeaBridge Investment Advisors. It is presented in order to illustrate the current thinking of the investment manager and is for information only. It should not be treated as investment advice with respect to any potential investment.

The opinions contained in this letter and commentaries on investment strategies are the opinions of SeaBridge Investment Advisors LLC based on analysis of publicly available information. The opinions of other analysts based on these data may differ. There are no guarantees as to the accuracy of the interpretations of current events or future prospects. There may be other factors which have more influence on future growth, economic recovery and market performance than those presented here. There may be errors in the data referenced in this analysis.

This does not represent an offer to sell or the solicitation of an offer to buy any securities or fund. Some types of companies are highlighted in this commentary. This is not a recommendation to buy or sell any stocks. Our opinion of the companies' execution and prospects may change in the future. Our opinion of the economic and market prospects may change in the future and the actions we expect to take in the portfolios may change as our interpretation of events evolves. Any expressed "targets" for portfolios may not be realized in the future.

SeaBridge manages portfolios in a number of different styles. Not all portfolios hold the same securities. Returns realized by our clients may differ depending on the style and objectives of the individual portfolios as well as client-specific factors. Investment involves risk and past performance is not indicative of future performance.