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Edited copy of letter sent to individual clients of SeaBridge Investment Advisors for the Third Quarter 2016.

"We are being offered a seat in a room filled with one-legged stools."

Since the June Brexit vote the markets have floated up on a sea of central bank money printing. The U.S. political conventions created some excitement, and bad news from the Middle East and our inner cities reminded us that all is not well. But the markets have generally been tranquil and announcements of new highs for stocks and bonds give a sense of reassurance. Job creation, a high priority for the Fed, continued strong, led by more jobs in health care, retail trade, food services and local governments. Housing continued to recover. Auto sales plateaued at a high level. However, news from the rest of the manufacturing economy was weaker than expected – especially in August. A slowdown in the usually steady service economy raised eyebrows.

Corporate earnings have been weaker than hoped, if not alarming. Forward guidance – the forecasts of future sales and earnings - was reduced in many cases. Securities prices – both stocks and bonds - made new highs during the third quarter. But with the rate of growth slowing – now well below the growth rate of 2014 – one wonders how long stock valuations can continue to go up faster than the underlying corporate earnings? The "one-legged stool" quip came to mind as I reviewed a Deutsche Bank 4Q outlook which observes the following:

- Global growth remains disappointingly sluggish with forecasts downgraded repeatedly. Global growth forecasts for this year have now fallen below 3% for the first time in a long time.
- The U.S. labor market is firm, but capital spending is largely absent, and productivity growth has turned negative.
- The Eurozone is "cyclically challenged, structurally vulnerable, and packed with political event risk."
- In Japan, the negative interest policy is destroying the financial sector, and the Bank of Japan is groping for a new policy regime. The unwelcome strong Yen is eroding corporate earnings at an accelerating rate.
- China is slowing, but the rate of slowdown seems to be under control. The huge fiscal jolt in Q1 is flowing through the economy and an immediate "hard landing" has been avoided.
- Central bank liquidity has pushed interest rates to very low levels (negative rates in over 30% of the developed markets) and investors' search for income and growth has pushed bond and stock prices to very high levels.
- So we have the liquidity, momentum and high securities prices driven by central bank action, but the economic growth, wage gains, growing corporate earnings, and investment for the future that would give our stool a solid base are worryingly absent.

That sounds dire, and it might be, if a shock, economic or political, caused a loss of confidence and a flight to cash. But things are very much better than they were eight years ago and a series of policy choices could make things look much better a year from now. What might those choices be?

- Government programs to restore our infrastructure – giving the economy a positive spending shot and building a sense that better times are ahead.
- A reform of our tax codes – simplifying them, killing loopholes, inducing corporations to return money sequestered overseas.
- Simplifying government rules, which are strangling smaller businesses.
- A "Minsky education** initiative."

We are sure you can add to the list. But all parties seem to agree that our divided politics put compromise solutions beyond reach and we remain stalemated at a significantly sub-optimal level.

The Minsky education** comes from some of Garnett's plane reading this summer. He had a Kindle version of "Why Minsky Matters." Hyman Minsky (1919-1996) was a conservative financial markets economist, but a radical social liberal. Minsky taught at Chicago, Harvard, Berkeley, Washington University (St. Louis) and the Levy Institute at Bard College in retirement. He has become a cult figure since 1999 for his "Financial Instability Hypothesis." Essentially, this says that if the Central Bank smooths the economy too much, ambitious business operators will get excessively aggressive, over-leverage, and when something changes, they will cause a big crash. (Better small forest fires every 2 years than no fires for 10 years, but when one comes it wipes out the forest.) The dotcom crash in 2000 following the benign 1990's and the 2009 financial crisis following the Fed-made tranquility from 2002 to 2008 have lots of economists reading Minsky.

What struck Garnett most about the Minsky Matters book was the second half on his social theories. He was violently opposed to the "let macro demand trickle down to the unskilled" approach. His point was that the demand may be there, but if the unskilled do not have the tools-of-mind and work habits, they are unemployable and you will have ghettos of growing violence. He advocated a "jobs program" like compulsory military service. You take the unskilled where their skills are, into WPA type projects. Feed them, work them, teach them, and gradually give them the skills to participate in society. Garnett was reminded of his division of stewards on the USS Boston. Several of them could barely read and two had to sign their pay chits with an "X". However, they were doing menial but useful work and learning ever so slowly, but learning.

As you will see from the commentaries on our various investment styles sent by e-mail, we benefitted from some corporate take overs during the quarter. Core Global, Global Trusts, and Asia were our top performing styles. In Yield Growth and Cautious Core, we have concluded that the global weakness will restrain rate increases by the Fed (probably a ¼% increase in December and little thereafter for awhile.) Hence, we are tilting toward less growth and higher yields in those portfolios.

We continue to hold more than transactional cash in our portfolios, reflecting our views that securities prices are very high and individual companies' stock prices may drop sharply with disappointments. We want to have cash to step forward and take new starter positions in good companies when this happens.

With best wishes for the fall,

Your SeaBridge Team