SEABRIDGE
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2017 has been an extraordinary year for investors. Challenges such as North Korea, the risk of a populist shock in a European election, and the fear of rising protectionism have failed to unsettle markets. The equity markets absorbed all those challenges, supported by accommodative monetary policies from Central banks, benign inflation, and improving global growth prospects. After a two-year earnings recession, corporate earnings were robust and were led by improving top line prospects. Equities significantly outperformed the credit markets by a wide margin. S&P delivered a total return of 21.8%. Non U.S. market exposure was rewarded as illustrated by the MSCI All World return of 24.6%. Asia generated a very strong year fueled by a stable environment in China. The technology sector was a big driver of returns in both the U.S. and Asia markets. Investment grade (LQD ETF) and high yield credit (HYG ETF) returned 7.1% and 6.1%, respectively.

The global economy is in a rare goldilocks period, where nearly all industrial economies are experiencing positive growth in real economic activity. For the second quarter in a row, all 45 countries tracked by the OECD demonstrated year-year growth in GDP in the 3rd quarter. Despite President Trump threatening to renegotiate trade deals and increase tariffs, global trade is on solid footing. According to JP Morgan, the global manufacturing activity index increased to 54.5 in December, a seven-year high, with faster rates recorded in exports, new orders, employment, and input prices. The U.S., Europe, and China's economies, representing approximately 55%-60% of the global economy, are igniting the rest of the world. The Eurozone Purchasing Manager's Index (PMI) rose to 60.6 in December, a series record high, and China's forecasted GDP growth of 6.2% is very constructive for world economic growth in 2018. Overall, world GDP is expected to grow 3.5% in 2017, the best year since 2011, and is expected to advance 3.7%-4% in 2018. Of course, these expectations may not be realized.

In the U.S., unemployment has dropped to 4.1%, down from the crisis-era peak of 10%. With 4th quarter GDP expected to be above 3%, the growth trend of the last two quarters is predicted to continue. Earlier in the year, hard data (economic data) was not growing as strong as the soft data (i.e. consumer and business surveys), but the hard data is closing the year out stronger than expected. Animal spirits appear to be vibrant among small businesses, all thanks to deregulation and to Congress for the tax cut package. According to the National Federation of Independent Business (NFIB), small business optimism is at record high (2nd highest in 44 year history) and is close to eclipsing the highs of the Reagan economy. The hiring plans survey of small businesses increased to a record high with 24% of companies planning to hire more workers on expectation of greater economic activity. Homeowners are also better able to support the U.S. economy as homeowners' equity, according to JP Morgan, is back at pre-housing crisis levels, 58.6% versus 36.1% of 8.5 years ago.

The recently passed tax cuts should boost corporate earnings and could cause a feedback loop of spending and hiring, leading to stronger-than-expected GDP in 2018. Business capital spending has been very sluggish in the last 5 years. However, we think that capital investment is set to accelerate and possibly outpace the broader economy due to an earnings resurgence, strengthening business confidence, and a business friendlier attitude in Washington. The tax plan allows for the full and immediate expensing of investments in equipment over the next five years, an incentive for companies to invest in new equipment and upgrade technology infrastructure.

Prior to 2017, the total return on the S&P in the last few years was not due to earnings growth, but more from low interest rates driving up the price/earnings multiple. Historically, earnings growth and dividends are the key drivers of returns. As interest rates normalize and the Fed reduces its balance sheet, we should return to a more normal return distribution and a more favorable environment for stock picking. In fact, earnings growth of 10.3% made up approximately 47% of the total S&P returns in 2017 versus only a 12% earnings contribution to total returns in 2016.

What was encouraging in 2017 was that we saw a nice pick up of S&P 500 sales growth of 6% (FactSet) vs. little sales growth for 2015-2016. From 2012-2016, earnings were primarily driven by margin improvements, debt refinancing to lower interest rates, and share repurchases. Many of the companies in the SeaBridge portfolios reported solid organic growth in the 3rd quarter of 2017 and also revised upward future sales growth projections. Now that the tax package has been passed, we continue to expect a flurry of upward sales and earnings revisions in our companies in the next two quarters. According to Factset, S&P 500 earnings growth is expected to increase 11.8% in 2018.

We are on the lookout for inflationary pressures in 2018. Inflation has remained low in the face of a tightening labor market and has been one of the biggest obstacles to a prolonged rise in the 10 year treasury yield, but that may be changing. Structural factors (the "Amazon" effect, globalization/technology, and low productivity growth) may be weighing down prices temporarily, but cyclical inflation pressures are rising given the tax cut stimulus, synchronous nature of the global expansion, accommodative financial conditions, and recent increases in commodity prices. With the unemployment rate already at a decade low at 4.1%, wage pressures are expected to increase and inflation should rise more, possibly leading the Fed to raise rates faster than expected. This could potentially unsettle both the bond and equity markets.

Global central banks should be more willing to normalize their balance sheets as global growth picks up. The U.S. Fed has taken the lead on this as it has hiked interest rates five times and has implemented a plan for the gradual reduction of its balance sheet. The hope is that the Fed would be able to restore greater policy flexibility to counter the risk of a possible recession down the road. Other central banks are not tightening policy, but are injecting less liquidity. The ECB is cutting its monthly purchases by half until 3Q2018. The Bank of Japan has been reducing its purchases of government bonds. So far, actions by the Fed have not been disruptive to either financial stability or economic growth, but that may change. The Fed plans to ramp up the amount it rolls off and the ECB is expected to announce its balance sheet reduction program as well as plans to gradually raise interest rates back toward neutral, setting up for a more serious acceleration in global monetary policy tightening for 2019.

Heading into 2018, corporate earnings in the U.S., Europe, and Japan appear to be on an upswing as the global economy converges into a synchronized pace of modest and steady growth. However, we expect market volatility to increase as interest rates trickle upward and quantitative easing is withdrawn. This is problematic given market complacency and fairly rich valuations for many asset classes. Liquidity dislocations are more likely going forward as the increased adoption of algorithmic/quantitative strategies and the recent inflows from active to exchange traded funds can lead to indiscriminate selling. On the other hand, we have observed that price correlation among stocks within sectors and markets has declined, suggesting that company fundamentals are driving stocks and should be favorable for SeaBridge to find and harvest opportunities.

Thank you for continued confidence in SeaBridge. We wish you and your family a happy, healthy, prosperous and meaningful 2018.

Best Wishes,
Your SeaBridge Team

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