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Edited copy of letter sent to individual clients of SeaBridge Investment Advisors for the First Quarter 2012

In our letter of last November, I quoted Dr. Woody Brock, who had observed, "We have now moved out of the realm of economics and into the realm of social philosophy." We are still there, and fortunately a warm social wind of European Central Bank money printing blew good tidings on the U.S. market during the first quarter of 2012.

To me, the most succinct summary of the last year was made by the head of a major university endowment. At the end of February 2012, she noted, ""In late summer and fall, last year, the investing public observed political paralysis, first in the US and then in Europe. With the 2008 collapse fresh in memories, the public panicked. Investments which were simple and safe became very dear, and investments which were complex or somewhat risky became very cheap. We are now beginning to unwind that panic."

We are enormously pleased and relieved to see the U.S. market turn in the best quarter since 1998. On price appreciation alone, the S&P 500 was up 11 per cent for the quarter and the NASDAQ, fueled by Apple, rose 18%. In the U.S., the market's rise was supported by slow but consistent economic growth, with a reassuring pick up in job creation. For total returns on the world market indices we report to you each quarter, this year-to-date: the S&P 500 rose 12.58%, the Russell 3000® Index was up 12.87%, the MSCI World Index gained 12.02% and the MSCI World Index ex the USA was up 11.34%.[1]

Abroad, the economic news was not so good. The European Central Bank pumped more than $1 trillion into the region's banks. This relieved a liquidity crisis and provided funds to let Italy, Spain, and France refinance maturing debt. It also eased the tone of financial markets around the world, the same way our Quantitative Easing programs had eased world markets in 2009 and 2010. In spite of riots and protests, the Greek bailout was achieved, with an additional 130 billion Euros of loans advanced. Now the riots have moved to Spain, where increased austerity measures are being invoked on a country with 26% unemployment. The very large question of how massive amounts of European sovereign debt will be repaid is now moved out to the three year maturity of the ECB loans. Someone quipped, "Der wolf is no longer a la port de les trois petit cochons, but he is still in the front yard and he is still hungry."

China is going through both an economic slowdown and a tense political transition. After two years of tightening credit, both inflation and real estate prices are falling. With a recession in Europe, China's

[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.

exports are slowing. Equally important, a political succession crisis is brewing. The political transition in China is extremely important, because the political views of the nine members of the Standing Committee of the Politburo, to be elected next October, will likely set the tone for U.S./China relations for the next decade. The retiring hard-liner on the existing Standing Committee, Zhou Yongkang, had been expected to be replaced by Bo Xilai, the party secretary of Chongqing. However, Bo has just been removed from office for heavy-handed Maoist programs. Chalk up one for the liberals: Premier Wen, PBOC Chairman Zhou, and the incoming President Xi. This eliminates Bo as a candidate for the new Standing Committee, which removes a potential Maoist, militarist, populist influence. If a military lash-back is avoided, the chances for political reforms in China improve significantly. This sets the stage for better U.S./China relations in the next decade and a smoother integration of China's growth into the world economy.

The Fed has kept money easy and continues to forecast very low interest rates through 2014. The rising stock market, improving job statistics, strong auto sales, and rising consumer confidence are nurturing hopes that we are returning to better times like 2003 to 2006. Things are getting better, but growth in inflation adjusted terms is still barely above two percent, and we still have massive debts to repay. Consumer debt reduction over the last two years has come more from defaults on mortgages and credit cards than actual repayments. In addition, no matter who wins the Presidential election, the ballooning Federal debt will need to be addressed shortly after the November election. So the outlook is better than eight months ago, but we are not yet back to a "happy days are here again" scenario.

Corporations will be reporting their first quarter results shortly. We expect those to be solid. Management guidance for the remainder of the year will probably look for slowing growth – based on expected weaker profits overseas somewhat offsetting continuing profit growth in the U.S. However, we expect large companies to continue their rapid investment in emerging markets, as the five year growth outlook there remains much stronger than for the U.S. and Europe.

The movement of money within the markets is worth noting. Money continues to flow out of equity mutual funds and into bond funds and exchange traded funds, both debt and equities. Exchange traded funds buy stocks by economic sectors or geographic regions, generally without regard to individual company valuations. Their growing influence in the market increases volatility which should make it easier for us to find attractive companies at good prices. With money market funds paying practically nothing, investors have a strong yield hunger. The discounts to net asset value on the closed end funds we use in some of our investment strategies for cash investment narrowed a bit during the first quarter, providing an appreciation element to the better yields we are getting.

Perhaps a way to summarize current markets is: the opportunity to buy stocks very cheap, which arose during the extreme political uncertainty last fall, has been significantly reduced by the rally in 1Q12. However, we are still able to find what we think are good companies trading at reasonable prices relative to their growth outlook. Unless the market is hit with another big political shock, we look for a gradually rising U.S. market for the next few months. As confidence rebuilds, we expect complex or slightly risky stocks to perform better than simple and safe securities. Our outlook for Treasury bonds – the simplest and safest of securities - is not positive.

This sounds very reassuring which, given the problems all around the world, seems naïve. However, one thing seems increasingly clear. Even if nominally independent, Central Banks around the world are political and they move aggressively to minimize the under-utilization of resources (people as well as plant and equipment) in a recession. They will likely invoke extreme measures to avoid a cumulative credit collapse growing out of a recession. Twice recently, the Fed has printed money to stimulate the U.S economy; the ECB, the most conservative of central banks, has outdone the Fed in money printing in the past four months; Britain and Japan are now printing money to stimulate their economies; China will likely expand credit sharply if exports and real estate prices fall too fast. So while the huge global debt load is deflationary, the money printing to ease the burden is widespread and continuing. While inflation is not an immediate concern anywhere, this whole debt unwinding drama is more likely to end in inflation than a depression. One needs to be watchful and careful, but the evidence continues to build toward that conclusion.

Overseas, the political uncertainties are much higher. However, stocks are cheaper and value hunting should be rewarding. Foreign stocks could rally strongly if and as the political uncertainties are eliminated.

This is our current outlook. However, as always, things can change and markets, and your portfolios, could decline. We hope for a positive outcome and are working hard to keep your portfolio positioned for positive results. Please let us know if you have questions on your portfolios and how we are managing them.

Best wishes,

Garnett L. Keith, Jr.

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. This does not represent an offer to buy or sell securities or interests in any fund.

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