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

Is the market predicting an economic recovery in 2013? Because the stock market is one of the most leading indicators of the economy, and because it is very hard to find other data series which reliably lead the stock market, it is hard to find "cross checks" to give confidence to any interpretation of the third quarter's market rally. Whatever the reason, we are grateful to be going into the fourth quarter with the market higher than most observers thought likely for year-end.

During the third quarter, the S&P 500 rose 6.4%, the Russell 3000® Index advanced 6.2%, the MSCI World Index was up 7%, and the MSCI World Index ex the USA rose 7.5%. For the first nine months of 2012: the S&P 500 rose 16.4%, the Russell 3000® Index was up 16.1%, the MSCI World Index gained 13.4%, and the MSCI World Index ex the USA was up 10.9%.[1]

I will get back to stirring the evidence in a moment. But first, I want to share an observation from Daniel Kahneman, the Nobel Prize winning psychologist, whose work has had a major impact on how people think about investing in the last decade. Kahneman observes that the mind can hold only so much complicated data, and our survival instincts try to simplify and make sense of data which is too complex and contradictory to be fully absorbed.[2] We select a few salient facts and then develop a narrative about what is going on. We are heavily influenced by this narrative, far more than can be justified by the multitude of data we have left out in getting to our simplified interpretation. We stick with our narrative until omitted facts intrude and cause us to observe that we have veered far off the course our narrative predicted. We then go back to developing a new narrative based on a new set of highly selective facts. Good investors keep their data set as large as possible and are continually updating their narratives based on new data – as Lord Keynes said in his famous quote about inconsistency, "When the facts change I change my mind."

Why am I sharing this academic diversion? Because several narratives changed substantially in the third quarter, and we are still scrambling to get enough new data to see whether the change is reliable and sustainable, or whether another flip will intrude in the next four months.

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[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] Kahneman's current book, <u>Thinking; Fast and Slow</u>, seems destined to be one of the classics among current books on human nature – both for investing and for life.

What changed?

1. The Euro mess looked hopeless, but Mario Draghi, ECB Chairman, said the EU leadership would do all things necessary to hold the EU together. His plan, released subsequently, would have Spain and Italy apply for aid, which would take the form of the EU jointly (including Germany) buying their sovereign debt while they struggle to regain competitiveness. In seeking this aid, the supplicant country would agree to very painful reforms of its spending and labor markets. The Draghi Plan implies a major increase in exposure for the German taxpayers to credit risk from Southern Europe. This was heretofore thought to be highly unlikely. Apparently, German Chancellor Merkel backs the Draghi Plan.
2. The fundamental economic data for Europe has come in worse than forecast. France has now joined the southern tier of countries likely facing a severe recession in 2013.
3. China's economy is slowing more rapidly than forecast, based in part on falling exports to Europe. Observers had thought the growth rate would fall from 9% to 7.5%. It now appears that the growth rate may fall below 7.0%; although, with a leadership change in process, the official figures are unlikely to show anything which could be interpreted as an unfavorable surprise for government officials.
4. The Yen has strengthened further and has pitched the Japanese export sector into a very difficult posture, and Japan is fighting to keep an incipient recession at bay.
5. In the U.S., three significant observations:
    a. Housing data has turned favorable, and home prices are now rising – not a lot, but rising – in a majority of the top 20 metropolitan areas in the U.S.
    b. Manufacturing data has turned weak and capital spending by major corporations is falling. The conventional wisdom is that with weak demand, weaker exports, and so much tax uncertainty, companies will sit on their hands rather than expand.
    c. Near quarter end, the Fed announced a major program of asset purchases (QE3) which will buy $40 billion a month in mortgage bonds and continue indefinitely until employment data improves. This is highly controversial because the impact of easing money in an economy already flooded with liquidity may help business conditions only a little, and potentially increase inflation quite a lot.

With all this swirling around, in September Robert Woodward released his book, *The Price of Politics.* It is an hour by hour review of the battle over raising the debt ceiling in July 2011. It covers the fracas not only in detail, but from the points of view of seven key players: President Obama and the White House staff; Speaker Boehner and his staff; Whip Cantor and his staff and the Tea Party Republicans in the House; Senate Majority Leader Reid; Senate Minority leader McConnell; and Minority Leader Pelosi in the House. To me, the book makes clear that we have two party religions (R=no more taxes and D=no entitlement cuts for the disadvantaged); but we also have battles of multiple viewpoints and career interests, for which tax policy is the chosen battlefield. I hope I am wrong, but I do not expect any post-election solutions to come easily. While I do not put a high probability on it, the fiscal debate in November2012 –January 2013 could frighten the markets, as the fracas in 2011 did.

So, we have a deteriorating world situation. A fiscal solution in the U.S. and political and solvency solutions in Europe are not near at hand**.** China is trying to contain a slowdown while it changes leadership. Japan is facing a large export downdraft and trying to stave off a recession. **However, and it is a big however, with problems in every domain, the Worlds' Major Central banks, without exception, are printing money at a rate unprecedented since World War II.**

So, in 3Q12, a diverse range of narratives about how we get through the troubles, changed to "Money printing is accelerating and do not fight the Fed, the BOE, the ECB, the BOJ and the PBOC."

Exactly where this leads is unclear. With housing recovering, the U.S. economy may accelerate – not a lot, but perhaps up to a growth rate of 2.5%. With growth scarce and Treasury bonds yielding 0-2%, investments providing a yield above 2.5% and reliable growth will likely be valued more highly. Whether investors value Treasury bonds more for their safety, or fear them more because their prices are inflated by Fed buying, is unclear.

There are several global themes which are very encouraging in an overall gloomy world picture:

- The beginnings of a recovery in U.S. housing
- The impact of low cost natural gas on the U.S. economy
- The rapid growth of mobile data with its productivity increasing aspects
- The shift to cloud computing and big data storage needs as mobile data grows
- Increases in healthcare and potential breakthroughs on major diseases
- The rise of a middle class in emerging market countries and the business opportunities of meeting their ambitions for better lives.

Our response is to trim investments which have risen more than the long term facts seem to call for and try to find investments, often powered by one of the six themes above, with a good yield and good growth prospects in spite of a weak global environment.

If you would like to discuss any of this, please give us a call. Meanwhile, stay tuned for the fourth quarter as our political drama goes into its next act.

Garnett Keith