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Copy of the letter sent to individual clients of SeaBridge Investment Advisors for the Fourth Quarter of 2006

The fourth quarter of 2006 was the type of quarter investors dream about. In the pleasant afterglow, we try to find reasons to extrapolate powerful increases in market value into the future. While current conditions may continue, the excesses - or at least deviations from historical norms - are extreme enough to make one skeptical about such reasons for the long term. The key question for investing in 2007 is: *will the conditions which led to strong markets in 2006 continue, or will the world change in an adverse way as the new year goes forward?*

To answer this question, it is necessary to understand the causes for strength in 2006, admitting that the world is extremely complex and full of surprises and that cause and effect are usually a twisted skein of several reinforcing threads. Why did the markets surge from July to December? The answer to that does not seem to be only in good corporate profits or the beginnings of a floor under the housing collapse. There are some bigger drivers at work and we need to try to understand those forces.

Most of these have to do with nations' economic policies, international money flows, and inflation assumptions at the Central Banks. To restate the obvious, the basic building blocks are:

- The U.S. has cut taxes while fighting a war – historically, a formula for problems.
- China wants jobs and keeps its currency cheap to sustain its export advantage.
- Japan has aging demographics and an inefficient domestic economy. To exit deflation, Japan must keep the Yen cheap to sustain exports and keep interest rates very cheap to sustain domestic spending.
- In Europe, the monetary union is a mixed success. Countries on the periphery are growing well but, to keep Germany and France out of a recession, the Central Bank has had to keep interest rates cheap and money plentiful.
- Emerging markets have become self-financing on the back of strong prices of commodity exports.
- With China and India engaging in world trade, the global work force has gone from one to two billion workers. The wages of the new entrants are very low and this is driving down the prices of traded goods. Also, the job displacement gives developed economies a deflationary bias.

The structure built out of those blocks, which supports the financial market boom, is:

- Western companies put their new factories into China and export to their home markets. This increases corporate profits but blue collar wages fall in home countries.
- Instead of letting its currency rise to reflect its wage advantage, China pegs its RMB/Dollar exchange rate by buying U.S. government bonds.
- To finance the bond purchase, China prints RMB and these flood into the local economy and indirectly into global money supply.

- Global money supply migrates to the major financial centers, driving up the prices of financial assets. The purchase of U.S. bonds by China finances our fiscal and trade deficits and keeps long term interest rates lower than they would otherwise be.
- However, the printing of RMB stimulates the Chinese economy and, in the absence of exchange rate adjustments, interest rates need to rise and/or inflation will erupt.

This, of course, is just one logic track. There are similar ones for what happens when the Japanese peg their currency, when Middle Eastern petro-dollars purchase U.S. assets, or when Russian oil money flows into the European markets.

A very important side effect of all this liquidity sloshing around the global markets is that the demand for financial assets tends to dampen the volatility of asset prices – there is always a buyer around – and tends to give asset prices an upward bias. The assumption that one can depend on prices going up leads to bubbles – housing (as we have seen in the past five years) and LBO transactions right now.

Ironically, hedge funds, which present themselves as risk control vehicles, are investing in the riskier underlying assets in an effort to provide superior returns. They are also major transmitters of the liquidity by borrowing in the cheap currency countries (Japan) to invest in riskier assets in the major financial centers. They also speculate in commodities, which drives commodity prices up and stimulates emerging market economies.

It is the full bloom of these liquidity factors that created the stock boom in the Fall of 2006. What is important is that this prevailing equilibrium is not a minor influence – the excess liquidity allows the associated money flows to become huge and they are the dominant influence in the markets for the current moment. Can we count on them for the future?

In the short run, everyone is supporting the system. The displaced workers in developed countries have not found a political voice. The rising costs of domestic goods, like a college education for your children, has been accepted along with the rising home and stock prices. So, in the short run, there is no one fighting the system.

However, distortions of historical relationships are huge. The keys to watch are:

1. Inflation pressures will mount in China as more and more liquidity from its trade surplus and currency peg goes into its system.
2. The cost of domestic services in the U.S. is rising as the liquidity stimulates spending on goods and services which cannot be imported from low cost countries.
3. The U.S. debt to foreigners is soaring, and the cost of servicing this will eventually come home to the U.S. tax payer.
4. Foreign central banks own ever-growing amounts of Dollar debt. If they become nervous about the Dollar, they could slow the purchases, breaking the current equilibrium. Avoid the thought of what happens if they see the Dollar sinking and try to sell.
5. With so much liquidity around, more and more financial risk is being carried with ever diminishing rewards. Yield spreads on low quality bonds are at fifty-year lows.
6. As hedge funds borrow and sell the Yen to buy dollar assets, the short position in the Yen becomes massive. If China shifts part of its reserve buying from Dollars to Yen, driving up the Yen, the financial disruptions will be huge. Hedge funds will be forced sell risky assets to cover their short Yen positions.
7. The boom in financial derivatives has increased the leverage in the financial system enormously. It has spread the risk around among more non-bank holders, which is good. However, with the low volatility, we have not tested the risk-bearing capabilities of the financial system since 1998.

On the back of this structure, markets* did well, in the U.S. and abroad. For the fourth quarter, **representing the U.S.**, the S&P500 Index was up 6.7% and the broader Russell 3000 Index was up 7.1%; **representing foreign markets**, the MSCI All Country World Index ex USA was up 11.2%; and**, putting the US and foreign markets together,** the global MSCI All Country World Index was up 9.1%. For 2006, the S&P 500 returned 15.8%; the Russell 3000 15.7%; the MSCI AC World Index ex USA 27.2%; the MSCI AC World Index 21.5%.

The quarter and 2006 were good for most of our portfolios. The higher risk emerging market holdings were particularly strong and the less risky international holdings in Europe benefited from a weak dollar. Our Yield Growth style benefited from the appetite of inflowing money for higher yielding assets. We hold "Yield Growth" securities in most portfolios, so the benefit from this influence was broad. Fortunately, we reduced the oil and metals exposure in our portfolios as 2006 progressed, so that we were somewhat protected from the downdraft in these sectors late in the year.

So thank you Mr. Market for good fortune in 2006! What to do in 2007?

We do not see an immediate change in the current equilibrium, but we are aware that, if it changes, the price swings in risky assets could be abrupt and large. Therefore, we want to bias our portfolio purchases in the direction of higher quality bond-like securities and non-cyclical growth stocks in the U.S. We prefer to take risk overseas, where growth is likely to be higher than it is in the U.S. for the next couple of years.

You received my letter in November in which I said we are starting a new category of portfolios called "Cautious Core" for clients who want to reduce their exposure to the equity markets and particularly to the possible unwinding of the equilibrium described above. For myself, I thought it was wise to take a step in a cautious direction, so I started a "Cautious Core" portfolio last quarter to supplement my equity portfolios.

For money committed to the equity markets, we have the following beliefs and biases:

- We believe that world growth will continue but will be moderate, especially in the U.S., in 2007. The outlook for inflation is less clear. Declining productivity in the U.S. and tighter labor markets will keep inflation a concern. At the same time, the deflationary forces in traded goods will continue to keep the prices of traded goods under control. Housing weakness will continue even if building permits have bottomed. Building will be weaker and layoffs will continue. So housing will dampen income and growth. Some commodity prices appear to have crested, so inflation will probably be helped.
- With U.S. growth slowing, we think companies with non-cyclical growth at reasonable prices will probably go up in value.
- We want to see evidence of an upturn before we go back to housing and related sectors.
- Lower income participants in the U.S. economy are being stressed by blue collar job displacements and the high price of gasoline. Therefore, we will focus on companies selling to businesses and to the upper income segments.
- We are bulls on longer-term energy prices but, in the short term, the unwinding of speculative positions is a risk.
- Some raw materials (iron ore) and agricultural commodities (grains) appear to have favorable price prospects. However, the outlook for semi-finished raw materials like copper and steel is less clear.

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* 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.

- We like some particular “green” themes – food supply, water, and clean energy. We also like infrastructure: transportation, power, and energy.
- While we like the growing demand for health care, we are concerned about changes for reimbursement coming out of Congress. So we will go light on this area until visibility improves.
- We believe the growth in Asia will continue, and we are seeking good Asian companies for our portfolios.

Garnett Keith

Note: this is a copy of a quarterly letter 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.

This letter discusses, in general, results for client portfolios. SeaBridge manages portfolios for clients in several different styles. Results for individual clients may differ. Results in the future are likely to be different. Please contact Susan Boyd if you wish to see more details on the after-fee returns for any of our investment styles. Please refer to the Form ADV Part II for SeaBridge Advisors LLC (or our website www.SeaBridge.com) for a complete fee schedule. The views presented here represent the opinion of Garnett Keith of SeaBridge Investment Advisors based on his analysis of publicly available information. The opinions of other analysts based on these data may differ. There are no guarantees that the expectations expressed here will be realized in the future.