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*Abbreviated copy of letter sent to individual clients of SeaBridge Investment Advisors for the Fourth Quarter 2009*

The good news is that the U.S. economy is recovering and we think, as that growth momentum feeds on itself, the next two quarters are likely to feel much better than the last 18 months. The bad news is that many of the imbalances which caused the 2008-09 cataclysm remain, and it will take several years to find a new balance in the world economy which is sustainable for the long term without Government support.

Let me list four of the major imbalances:

**The changing location of world manufacturing.** This starts with the introduction of roughly a billion workers in China and India to the world economy in the past 20, but especially the past 10 years. The number of new workers is huge relative to the number of workers in the U.S., Europe, and Japan, and the wage differentials are similarly huge. Something like:

Germany	\$ 50 per hour
U.S.	\$ 30 per hour
Japan	\$ 23 per hour
Brazil	\$ 8 per hour
China	\$ 2 per hour

(These labor rates are an approximated update of 2007 Bureau of Labor Statistics data. Even if our updates are slightly inaccurate, they are close enough to illustrate that, when world businesses start putting the latest manufacturing equipment into China and Brazil, it is very hard for U.S. manufacturing plants to compete.)

**The collapse of the colonial model of trade.** From colonial days, money centers in colonial empires dominated financing for their developing hinterlands. In addition to financial profits, the leading countries also tried to keep the terms of trade very favorable for themselves, making their exports expensive and their imports cheap. The 1997 Asian Crisis changed all that. The developing countries, led by China, decided to reduce their citizens' immediate incomes by setting their currencies cheap relative to the U.S. Dollar and keep it cheap by using the resulting trade surplus inflows of Dollars to buy Dollar investments, keeping the U.S. currency expensive. This encouraged more manufacturing to shift to their countries, which created more manufacturing jobs. Their purchase of Dollars to keep the U.S. currency dear also reduced U.S. interest rates and encouraged us to borrow and import more and more of the "bargain priced" goods. There was a stark change in the trade accounts of the emerging countries post 1997. Asian emerging countries swung from trade deficits of 1 to 2% of GDP before 1997 to an annual trade surplus of 3 to 5% of GDP after 1997. The result of this has been to shift financial power away from New York and London and into the hands of the major exporting countries.

**The rise in domestic purchasing power in the emerging economies.** As the laborers in China, India and other emerging nations find jobs which are an integral part of the world economy, their incomes soar.

It has been estimated that 100,000 people cross the threshold of \$5,000 per year of income **every day!** It works up and down the pay scale. A greater number each day pass through a \$4,000 per year income gate, and a smaller number pass the \$6,000 per year income level. These numbers seem incomprehensible, but when you realize that they come from a labor force of something like 2 billion people working hard to move into and up in the world economy, you realize that it is the size of the denominator which is hard for us to comprehend. The 36.5 million workers who pass the \$5,000 gate each year represent only about 1.8% of the aspiring base. The related surge in emerging market incomes means that **growth** in aggregate consumption in emerging markets exceeds **growth** in consumption in developed markets – certainly for as long as the U.S. consumer is reducing spending in order to pay off our debts. This has set in motion a drastic shift in the composition of world consumption. According to a Credit Suisse forecast, China will likely move from 8% of global consumption in 2009 to 21% in 2020. By contrast, the U.S. will probably move from 28% of global consumption to 21% in that same period.

**The growing indebtedness of the developed world.** In the U.S. we have witnessed a huge build up of debt in the system. Banks and hedge funds took on more and more leverage, and consumers took advantage of the very cheap interest rates in the last decade to spend more than they earned. Government has incurred a stealth debt increase of massive proportions in the form of public commitments to health care. Medical technology can produce more “health interventions” than we can afford to pay for as a nation. The political process is determined to make more health care available to more people, but we have not figured out how to tax ourselves to pay for that. As a result we have both public and private and both past and future obligations with no visible means of repayment. This, in turn, creates credit crises, and the capital markets seize up.

Historically, economists have felt that when debt exceeds 150% of GDP an economy has entered a danger zone for a debt “death spiral.” If interest rates rise, the debt cannot be serviced. The present value of future obligations, including the likely unfunded costs of our social security and healthcare, is now approaching 1000% of GDP. We need to make more to sell to the rest of the world or limit our foreign purchases and borrow less money from abroad. In the short run, we are likely to have trouble, politically, with the unemployment implications of the shift of manufacturing and consumption to the emerging world. In the slightly longer run, we have to agree on a triage system for who gets what health care at whose expense. In both time frames, we can agree on the goals, but we cannot agree on the allocations of related costs.

So what does all this have to do with our investments? How our leaders try to solve these problems, or the extent to which we fail to address them realistically, will have a big influence on the emotions of the financial markets and on the strength of the Dollar relative to other world currencies. So far, progress on the international imbalances has been disappointing. Hence we are cautious about the market’s potential reaction to political developments in 2010 and specifically to the risk of currency upheavals. The U.S. is not alone – Japan, Ireland, Portugal, Spain, Italy, Greece, and the Baltic States all have currency issues which could destabilize markets.

But, lest we seem ungrateful, we are very thankful that markets which started 2009 on a disastrous track turned in an excellent recovery by year-end. The credit goes to the Fed for flooding the markets with liquidity. We do not see how the Fed can remove this liquidity from the markets without risking a relapse. However, there is much speculation that they will try – in fact must try - to avoid inflation. We doubt that liquidity can be removed, but are trying to position the portfolios so that they will not be seriously damaged if we are wrong about when the Fed will begin to remove the monetary stimulus.

The markets rose around the world in 2009. For the fourth quarter, the S&P 500 was up 6%, the broad U.S. market Russell 3000® Index rose 5.9%, the global MSCI World Index returned 4.7% and the MSCI World Index ex USA was up 3.8%. For the full year, the S&P 500 index had a positive 26.4% return, the Russell 3000® Index was up 28.3%, the MSCI World Index returned 35.4% and the MSCI World Index ex the USA was up 42.1%.<sup>1</sup>

My **guess** is 2010 will be another good year in the markets. Until we can begin to see how the imbalances recited above can be reconciled, whether banking reform can be passed, and whether the Fed will try to withdraw liquidity, we favor investments benefitting from the less indebted and more rapidly growing foreign economies. This does not exclude interest in companies in the U.S. Many U.S. companies have large foreign operations. The employment rolls of U.S. companies are very lean, and companies have good operating and financial leverage. So, with an economic rebound, corporate profits should be able to recover, perhaps strongly. However, over time, affairs should go better in economies growing at six percent a year than in economies growing at three percent a year. So exposure to growth which is not dependent on Government stimulus packages is a significant factor we consider as we examine new investment ideas.

2009 was a good year for our clients. We appreciate your confidence in SeaBridge, and we will try to make 2010 another good year.

Yours very truly,

*Garnett L. Keith, Jr.*

*Note: this is an edited 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, 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](http://www.SeaBridge.com)) for a complete fee schedule. The views presented here represent the opinion of Garnett Keith, Dave Descalzi, John Conti and Susan Boyd of SeaBridge Investment Advisors based on their 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.*

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<sup>1</sup> 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.

NOTE: certain statistics were quoted in this letter. While we believe the data to be accurate, there may be errors or inconsistencies in the data presented. The conclusions drawn from the historical data and/or the implications for the future may not be accurate. Our expectations about the future may not be realized.