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Copy of letter sent to individual clients of SeaBridge Investment Advisors for the Fourth Quarter 2012

The fiscal cliff came and was hurdled courtesy of a deal hammered out between Senate Minority Leader McConnell and Vice-President Biden: two old “Washington hands” accustomed to compromise. It was certainly not what either side would have written unconstrained. The “tea party” Republicans in the House were not happy, but had no constructive rejoinder at the 11^{th} hour, 59^{th} minute. The Democrats got the tax rate increases they wanted on the wealthy and no entitlement cuts. The Republicans got the threshold for the top rate increased to $450,000 of annual family income, and the estate tax exclusion remains at $5 million with an estate tax rate of 40%.

The fiscal drag on the economy will be significant, mostly due to the re-imposition of payroll tax withholding, now back to 6.2% after the temporary reduction to 4.2% in 2011. This has forecasters looking for very slow growth in the first quarter as the higher withholding takes effect, followed by potentially faster growth as the year goes on. However the strong fiscal drag now helps the overall deficit position.

The big question is whether the January 1 action provides enough future tax clarity to get businesses spending again? Negotiations over entitlement cuts are left to the Debt Ceiling debate and the two month extension of the Sequester provisions. The Republicans are saying the debt ceiling increase must be matched by entitlement cuts, and the President is saying “No Way!” Certainly, the Sequester negotiations will require entitlement reductions, but the quid pro quo will be hard fought. We need longer term entitlement containment for fiscal solvency, but our political representatives on both sides need to work together to accomplish that. The month of February could be another ugly month in the markets as each side threatens the nation with default.

Elsewhere, changes swirl, but with no immediate crises. Mario Draghi’s proposals have brought some peace to the troubled European financial markets. Economies remain in or near recessions, and unemployment in the Southern countries is unbearable for the longer term. But the risk of an imminent blow-up has likely receded, markets have recovered sharply, and that seems like progress. No one is sure how to get Europe growing again.

Japan has re-elected Shinzo Abe as Prime Minister, on a “Get Japan Growing Again” mandate. No one is sure how to do that, given Japan’s horrible demographics. A weaker Yen appears to be the primary measure. Growth will not be helped by the fact that Abe-san is viewed as a Japan “Nationalist” with unapologetic views on WWII. Since China is Japan’s largest customer, the issues could get very tense, with the current quarrel over the Senkaku Islands being only the first of issues. Japanese auto companies are having to reimburse Chinese owners of their brands for damage to their cars in anti-Japanese riots. This is not a warranty you want to have to design a marketing program around!!

China is surprising everyone positively right now – and the world needs the good news. Newly-appointed President Xi Jinping and Premier Li Keqiang are off to a fast start with both economic reforms and plans which are stronger than expected, and also a number of reforms and corruption control measures which are welcomed by the people. The economic data coming in from China suggest that the slowdown bottomed during the summer and growth would accelerate during 2013.

In our U.S. economy, there are several bright spots: corporate balance sheets appear to be in robust health; housing has turned the corner and will likely contribute to growth in 2013; oil and gas drilling is surging and lower energy prices are supporting growth; mobile data technology continues to expand, improving connectivity and electronic retailing; medical technology progresses with a number of breakthrough drugs in late stage clinical trials. So if Washington can get our long-term fiscal balance under control, there is much to be positive about.

The big financial issues on the horizon are the Federal deficit, the Fed's repression of interest rates, and the related excess liquidity in Treasury bonds relative to equities, real estate and other productive risk-taking investments. If Congress can find the balance to contain the growth of entitlements in the out years, and reduce current fiscal deficits at the rate of 1.0-1.5% per year, then within five years we should be able to be back into pretty good shape on a national fiscal basis. We will know more about our ability to follow this script as the winter goes on.

Assuming the economy absorbs the payroll tax drag and continues to grow, the focus will shift to when the Fed begins to withdraw its extraordinary monetary support. This foresees rising interest rates and falling prices for Government Bonds. The Fed has the mechanical tools to withdraw the liquidity it has injected, but even the first whiff of this will roil the markets as money rushes away from bonds toward other vehicles. In anticipation of this move, we have been reducing our debt holdings in a number of styles in the fourth quarter, and that will likely continue during 1Q13.

We attached some additional details on these and other economic and demographic trends and their implications in a separate commentary focused on SeaBridge's Core Global Equity strategy.

With regard to market performance in the past year, during the fourth quarter, the S&P 500 dropped 0.38%, the Russell 3000® Index advanced 0.25%, the MSCI World Index was up 3%, and the MSCI World Index ex the USA rose 5.9%. For the year: the S&P 500 rose 16%, the Russell 3000® Index was up 16.4%, the MSCI World Index gained 16.8%, and the MSCI World Index ex the USA was up 17.4%.[1]

A Happy 2013 to you from your friends at SeaBridge,

Garnett Keith

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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[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.