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Things have been getting more and more exciting in the U.S. market since our July letter. The market is going through what I call a “Minsky Moment.” (Hyman Minsky was a Keynes disciple who studied what happens if the Central Banks leave too much liquidity in the markets for too long. When the aggressive players realize they are over-committed and simultaneously try to sell back to a safer position, the markets have a “Minsky Moment.”)

Essentially, many banks and hedge funds own debt which is collateralized by sub-prime residential mortgages. As the papers have widely reported, there are growing doubts about whether that debt will be paid. Moreover, many of the funds which own this investment paper are leveraged, using borrowed money to carry part of their assets. So, for these funds, a loss on one holding wipes out an equal amount of capital and makes the fund more leveraged relative to its remaining holdings. In addition, the money center banks are caught with about \$200 billion of debt associated with leveraged buyouts. This is now trading far below the banks’ investment value, so bank capital is coming under stress as they come down to the September 30th reporting date.

The housing market continues to deteriorate, and many mortgage originators – the people who created all this sub-prime debt problem – are going out of business. So uncertainties about mortgage availability and sustained housing weakness are weighing on confidence about business in 2008.

In sum, some of the problems I have been ruminating about for 18 months are now on the minds of everyone, and global markets have been falling sharply. The ultimate question is, “Will this crisis in financial markets lead to a crisis in consumer confidence and a recession next year?” This concern is rising in spite of the fact that the economy is growing, unemployment is low, and profits just reported for the second quarter were generally good.

Our assessment is that strength in the global economy is sufficient to keep the U.S. growing while these mortgage and LBO problems are purged by the financial system. The Fed has been injecting more than usual liquidity into the system each day for over a week. Friday morning they cut the discount rate – the rate at which banks under stress can borrow from the Fed – by ½%. So, if events continue to create concern, the Fed will almost certainly cut interest rates, which will be very heartening to the market.

On the positive side, many of the investments in which we have an interest have fallen to very attractive prices for purchase. Even though we have been holding more cash than usual we have held off significant purchases because we wanted to see how events unfold a bit further before committing our reserves. Many of our purchase candidates show potential returns in excess of 30% if one assumes a return to normal markets. This is about 50% higher than we have been seeing for the past 18 months, so, when we get conviction that the Fed has the crisis in hand, the shopping should be attractive.

The upset in the market has hit all portfolios values but with somewhat differing effect. Companies with a significant yield component have been hit the hardest, because many funds holding bad mortgage paper also hold these securities and have been forced sellers to meet redemptions. Emerging markets have also been hit hard even though their economies remain robust. The weakness has spread to securities in general in the past week and bargain prices are cropping up everywhere as fear reappears in investors’ dictionary. On the other hand, the large global growth companies, which have been ignored for several years, are now the darlings of the market. Our purchases in that sector in the past year are finally being rewarded.

Garnett Keith

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