SeaBridge Investment Advisors LLC

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August 5, 2011

This is a copy of a letter sent to clients of SeaBridge Investment Advisors LLC.

The ink was not dry on our second quarter letter to you before more discouraging economic data came in: Manufacturing PMIs (Purchasing Managers Index) dropped further, job creation dropped to alarming levels, and consumer confidence took a dive. Political posturing as Congress addressed the debt ceiling increase alarmed all viewers – and the proceedings in Washington played on television about 20 hours a day. As a result, confidence in Congress willingness to pass the needed cuts in mandatory spending (Medicare and Social Security) disappeared.

The bill which was finally passed calls for $2.1 trillion of spending cuts over ten years. The cuts are very back-loaded, and $1.5 trillion of cuts in mandatory spending (Medicare and Social Security) have been pushed off to a Special Committee (SC) which must come back to Congress with recommendations by November 23rd. With luck, normal Congressional procedure will be truncated and the SC proposal will be subject to a single 51% majority vote in both houses of Congress. This gives Congressmen some political cover in avoiding a vote on cuts in specific social programs which are very popular – particularly popular with older voters who benefit most from the programs being cut.

That may be small progress in the short run, but it highlights how hard it will be to make the massive health benefit cuts required to avoid fiscal disaster as baby boomers start to retire in 2015. No wonder the stock market took a dive as everyone reflected on what they had seen.

There are a few positive signs. The frightening restatement of 1H11 GDP growth (to a less than 1% annual rate of GDP growth) has some statistical gremlins in it as the GDP data does not match PMI and other data. But the weakness does partly explain why job growth has been so poor. Moreover, weak data from all over the world implies slowing growth and less stimulus from exports. With fiscal support fading, the Fed is no doubt considering what they will do if data trends continue down from here. Some version of asset buying is likely to be the answer, but the data will have to be terrible for the Fed to address something like QE3 before the Fall. The upcoming Fed retreat at Jackson Hole, WY will be buzzing with ideas about what comes next.

There is a complex of ideas which comes up as one tries to anticipate what the Fed will do. The last thing the Fed wants is equity markets falling as they did in 2008. That has several feed-back loops into the real economy. With quality stocks yielding 3% and the Fed's borrowing cost at a fraction of 1%, the yield arbitrage is clear. Plus there is some growth in corporate earnings in all but the deepest recessions. In addition, corporate balance sheets are in excellent condition – unlike the residential real estate sector which the Fed has ceased supporting. So how does the Fed orchestrate liquidity support for the large corporate equity sector? It is self serving, therefore suspect, for Wall Street to be thinking this way. But if one reads the 2008-09 dialog of Paulson/Geithner/Bernanke coming out in the many books chronicling the Great Financial Crisis, this sort of thinking was very much on regulators' minds. Perhaps that is too hopeful at this early juncture, but the disparity of 75% of corporate earnings exceeding guidance and the dismal reports from the job/consumer fronts leads minds to try to figure out how government can get the former to support the latter.

The negative view of this dichotomy is that corporate earnings cannot continue to be favorable if the world economy starts falling. This view has been given by some corporate CEOs (e.g. Emerson Electric) who say current earnings are good, but are unwilling to forecast the future in the face of such political uncertainty except to say that growth will likely be slower. In the meantime, corporations will probably keep high levels of cash and increase stock repurchases as markets fall.

In the past, slower growth in the West has been a red flag signal for **Asian** economies, where growth has long been largely dependent on a vibrant export sector. The biggest issue facing Asia today is inflation. Most countries in the region have been raising interest rates and curtailing the growth of the money supply to try to get inflation under control. While Asia would not welcome a global slowdown, demand destruction in the West would perversely have the salutary effect of allowing Asian banks to loosen monetary policy and become accommodative to economic growth. This would be positive for fixed asset investment and regional stock markets. If one is looking for a silver lining in the current chaos, it is here.

Attached is an update by John Conti on the **Core Global Equity strategy**. It includes more details on the economic data as well as comments on some of the companies in those portfolios.

With regard to the **International**, **Yield Growth, Inflation Fighter, Cautious Core and Global Trust strategies**, we are continuing to shift our equity holdings in the direction of less cyclicality. Current trends for weaker growth will almost certainly cause downgrades in the earnings forecasts for cyclical companies. But more than the equity component, we are reassured by the large portfolio positions in what we consider to be "reliable claims." These are holdings like Cash, Gold, MLP's, Fixed Income, and REIT's holding government guaranteed mortgages. These "reliable claims" represent significant proportions of total portfolios values (generally between 30% in the higher risk International and Inflation Fighter accounts to 60% in many Cautious Core portfolios).

We think these holdings should provide good current income, dampen the fall of declining portfolios values somewhat, and also give us cash to invest as high quality growth equities as markets stabilize.

In summary, while we acknowledge concerns with the economy and markets and political environment and have scaled back a bit on our estimates of growth in the near term, we remain generally constructive on the markets and view the downturn as an opportunity. A lot of our optimism comes from the reports of the individual companies in your portfolios. While some have fallen short of expectations, we have not seen any overwhelming negatives and many companies continue to report strong results. However, there is still a lot of uncertainty in the world which can cause unforeseen problems. For example, in Europe, if the ECB or European governments cannot resolve issues in Italy and Spain, the impact on world markets could be severe.

With best wishes,

Garnett Keith

SeaBridge Investment Advisors LLC

SeaBridge Core Global Strategy

August 2011

Supplement

There is a lot of new information to consider since our quarterly commentary. Starting with the negatives: the price of oil/gasoline increased; GDP for the first quarter of 2011 was revised substantially lower; the preliminary estimate of second quarter GDP was also very soft; the ISM Manufacturing Index declined sharply in July; and perhaps most important, political histrionics in Washington reduced consumer and business confidence. On the positive side of the ledger, the Japanese supply chain is normalizing; the weather is no longer disrupting the economy; second quarter corporate earnings were, on balance, very positive; the U.S. debt ceiling was raised, and a process for reducing the deficit in future years was put in place. In consideration of the aforementioned factors, we continue to expect the U.S. economy to grow at an accelerating rate in the second half of 2011, but at a rate that is lower than we would have expected just one month ago. We believe GDP growth of 2.5% is a reasonable assumption.

The Bureau of Economic Analysis (BEA) revised the first quarter GDP growth rate from 1.9% to .4%. This revision was largely the result of their three year benchmark revision, which is ostensibly based on more accurate information regarding historical levels of inventories and trade. Essentially, the refined historical information affects the seasonal adjustment factor, which causes a revision to the current year data. Most of the revision to GDP can be attributed to a reduction in the contribution from inventory accumulation, which went from 1.31 percentage points to .32 percentage points. The exceptional volatility in GDP over the 2008-2009 time frame has distorted the seasonal adjustment factors. (Re-basing of the seasonal adjustment factor will also produce substantial revisions to the non-farm payroll data series). It's not clear whether the pre or post revised number is a better proxy for reality. It is interesting to note, however, that the BEA's .4% GDP figure for the first quarter occurred concurrent with the ISM indices hitting ten year highs.

The ISM Manufacturing Index declined from 55.3 to 50.9 in July. The ISM Non-Manufacturing Index also declined, but less dramatically, with a drop from 53.3 to 52.7. While the decline in these indices is disturbing, in our opinion, it may be the result of a deterioration in confidence among corporate executives that is the direct result of the political drama in Washington around the debt limit legislation. It was unfortunate to have witnessed the pathetic display of self-interest among our leaders in Washington at the expense of the best interest of the American economy. Importantly, while we were disappointed with the process, the product seems reasonable to us. For the first time in modern history, a mechanism may now be in place to contain Government spending.

The preliminary estimate of second quarter GDP growth was disappointing at 1.3%. As we mentioned last month, the supply chain disruption from the Japanese earthquake/tsunami, harsh weather in the U.S., and a sharp increase in the price of oil/gasoline likely constrained second quarter growth. The supply chain disruption and inclement weather have abated, but oil/gasoline remain near the upper end of the danger zone. The combination of a continuing headwind from oil/gasoline, and the reduction in consumer confidence resulting from the political theatre in Washington will likely dampen economic activity into the third quarter. If the price of oil/gasoline declines in coming months as the summer driving season comes to an end, and the debt ceiling debate fades from the headlines, hopefully, we can enter the fourth quarter under more normal growth circumstances.

Adding to our optimism, second quarter corporate earnings reports were, in general, at or above expectations. Within Core Global portfolios, most of our companies reported solid earnings and gave encouraging appraisals of current business conditions. Some of the companies that reported earnings below expectations were Sherwin Williams (SHW), Life Technologies (LIFE), and Compass Minerals (CMP). SHW reported earnings below expectations because of a rapid increase in the price of commodities, such as titanium dioxide. The Company expects to raise prices at a high single digit rate in the second half of the year to recoup their gross margin. LIFE generated earnings a bit shy of expectations because of a continued supply chain disruption from Japan, and a reduction of sales to government funded research organizations. CMP fell short because they couldn't ship adequate quantities of salt up the Mississippi River due to flooding. In addition, their production of fertilizer was impaired due to an excessive number of rainy days, which affected their solar evaporation manufacturing facility.

Some of the more positive earnings reports came from our banks. Citigroup (C) and Regions Financial (RF) both reported earnings ahead of expectations. More importantly, credit quality trends continue to improve. In addition, Regions continues to report an increase in lending activity. In particular, Commercial and Industrial (C&I) loan demand is growing. This is consistent with data released by the Federal Reserve Bank of St. Louis, which shows C&I loan growth accelerating to 3.9%. Finally, Simpson Manufacturing (SSD) reported earnings ahead of expectations, and indicated that business is improving across most regions of the U.S. This is particularly noteworthy in that Simpson manufactures metal connectors that are sold primarily into the residential construction market.

John Conti

8/4/11