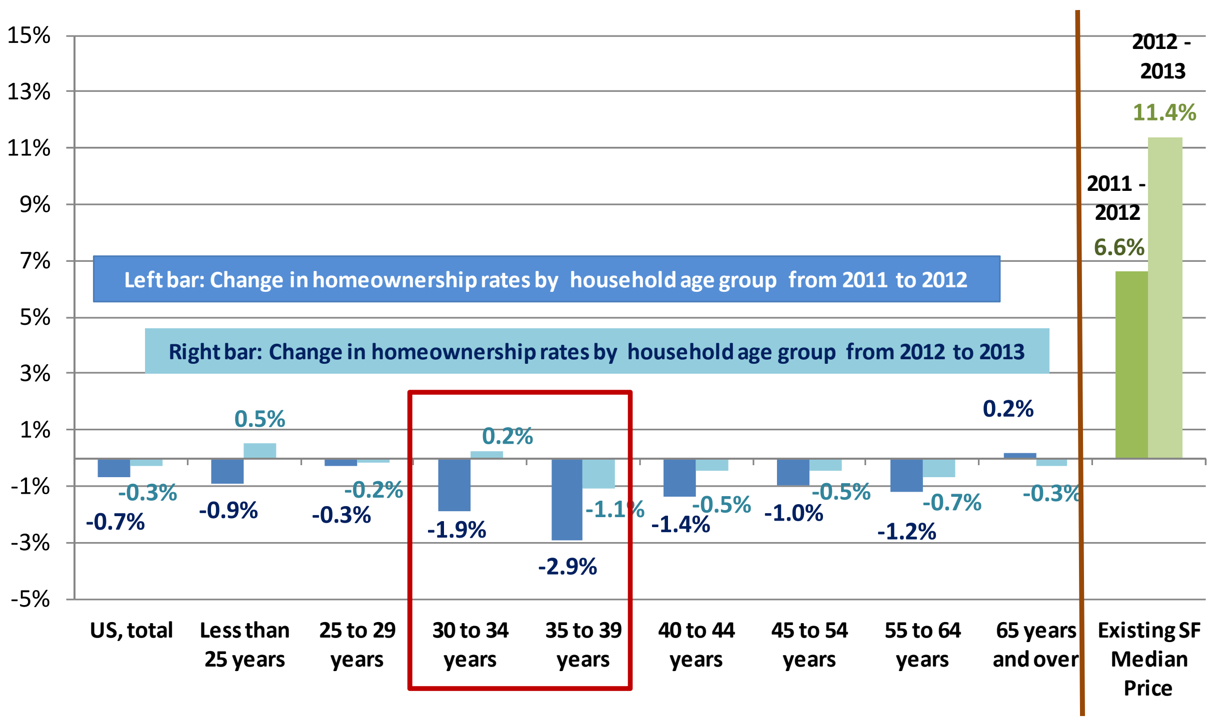
SeaBridge Core Global Strategy

First Quarter 2014
Commentary

The U.S. housing market mounted an impressive recovery in 2012 after declining for the prior five years. Following the 6.6% home price gain in 2012, the recovery continued to strengthen in 2013 with another widespread jump of 11.4%. Rising home prices benefit homeowners by enhancing their employment mobility, wealth and spending power. Corelogic, a provider of data and analytics for mortgage originators, reported that the number of negative equity properties was reduced to 6.5 million (13.3% of 49 million properties with a mortgage) from 12.1 million (25.2% of mortgaged properties) during the period from 1Q12 to 4Q13. At the same time, Federal Reserve data showed a significant improvement in household balance sheets with the addition of $3.8 trillion (+60%) in owners' equity in housing.

Despite solid improvement in the housing market, the homeownership rate continued to decline in 2012 and 2013. Homeownership fell to 65% of households in 2013 from its peak of 69% in 2004. The severity of decline in homeownership was pronounced in two household age groups: 30 to 34 years old and 35 to 39 years old. Encouragingly, the 30 to 34 years old cohort, the typical first-time home buyer, recovered a bit in 2013. Homeownership among the 35 to 39 years old cohort continued to decline in 2013, but at a slower pace than in 2012 (see chart below).



Source: U.S. Census and National Association of Realtors

The apparent disconnect between the decline in homeownership and gain in home prices could be attributed to a number of factors including the return of household formation following a pause during the recession, a shortage of inventory available for sale, and, possibly, the participation of private and institutional investors in the housing market. In our prior commentaries, we have highlighted the strong demand for housing that we expect to come from the children of the baby-boomers (echo boom) and inventory shortages due to a lack of land entitled for development, two factors powering the home price recovery thus far. The third element, investors, also aided the recovery particularly in certain markets that suffered the most from the credit-crunch, such as Atlanta, Phoenix and Las Vegas, driving a dramatic price turnaround. The influence of investors is evident in the different rates of price appreciation across different price segments. The Corelogic Home Price Index (HPI) showed that the lower price segment led home price appreciation during 2012 (http://www.corelogic.com/research/the-market-pulse/marketpulse_2014-march.pdf, page 9, HPI by Price Segment). Traditionally, the lower price segment is the niche market for first-time home buyers. With homeownership rates declining among the typical first-time buyers, investors are filling the void to accommodate more renters. However, rising home prices and higher bond yields should reduce the attractiveness of rental property as investments over time. In fact, Corelogic's analysis of several metropolitan markets suggests that overall price growth could be markedly slower heading into 2014. (http://www.corelogic.com/research/the-market-pulse/marketpulse_2013-december.pdf).

In 2013 and 2012, the consumer price index for rent of primary residence rose by 2.8% and 2.7% respectively, outpacing overall inflation of 2.1% and 1.5%. As the homeownership market recovers, rent growth should also slow, providing investors an incentive to switch rental properties to the for-sale market, thus increasing the supply of houses on the market. Homes should remain relatively affordable as home price appreciation normalizes and interest rates rise modestly. If we assume a 5% 30-year mortgage rate, 5% price appreciation and no wage growth, a family earning the median income still has 157% of the income necessary to qualify for a conventional loan covering 80% of a median-priced existing single-family home (based on January 2014 data).

We believe the continued recovery in housing will be an important element of the US economy's increase in growth from the mid 2% rate that has characterized the recovery thus far to a rate that approaches economic potential, perhaps in the range of 3% to 3.5%. From a demographic perspective, the first-time home buyer (cohort age 30 to 34) should represent the driving force behind the continued recovery in housing. Thus far in the current housing recovery, investors have primarily powered the recovery as first-time home buyers have not been participating at the rate in which they have in the past. As the chart above depicts, the rate of decline in home ownership among our target demographic cohort is beginning to moderate. We'll monitor this closely as it may very well signify the transition in this recovery from investors to the young and the restless. Leading indicators of the transition from investors to first-time home buyers are likely to be a continuing improvement in job creation, income growth, and confidence.

Angell Xia
John Conti
March 28, 2014

See general disclosures at the end of the document.

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