SeaBridge Investment Advisors, LLC

SeaBridge Core Strategy

First Quarter 2016

Commentary

Although we seldom discuss stock market activity in our commentaries, recent market behavior warrants special mention. The stock market as defined by the S&P 500 ended the first quarter of 2016 very close to where it began the quarter. This seemingly uneventful period of market activity was actually comprised of two diametrically opposed behavioral patterns. From the very first day of the New Year, stocks were in a death march straight down, nearly every day, until the 20th of January at which point the cumulative decline was 10%. After a short attempt to regain some ground, the market again fell back to the previous nadir on February 11th. Then, in a mirror image of the first half of the quarter, the stock market reversed and began its recovery, which was equally persistent to the upside as its previous descent was to the downside. This unusual market behavior begs at least two questions: What happened, and is it over?

The decline in stock values in the first half of the quarter seemed to be driven by three specific factors: 1) the ultra-low price of oil and the resulting implications for the value of bank loans to energy companies; 2) the adequacy of capital levels among some European banks; and, 3) the potential need for a substantial depreciation of the Chinese yuan. We won't go into our thoughts regarding each of these issues as they are beyond the intended scope of this note. We merely note these factors as apparent reasons for the breath-taking market decline during the first six weeks of the quarter.

Suddenly, as if following a well-scripted movie, four events occurred within a short period of time and changed market sentiment. On February 11th, Jamie Dimon, CEO of JP Morgan, announced that he had taken $26.6 million out of his pocket to buy shares in his bank. Reminiscent of the actions taken by John Pierpont Morgan during the stock market panic of 1907, Mr. Dimon's commitment of his own capital sent a strong signal to market participants that problem loans to oil companies were quite manageable.

Shortly following Mr. Dimon's show of confidence in his bank, Deutsche Bank announced that it would purchase $5.4 billion of its own debt. This action went a long way to dispel the rumor that the bank was undercapitalized and, similar to Mr. Dimon's share purchase, instilled confidence in a market that was running rife with thoughts reminiscent of the credit crunch of 2008.

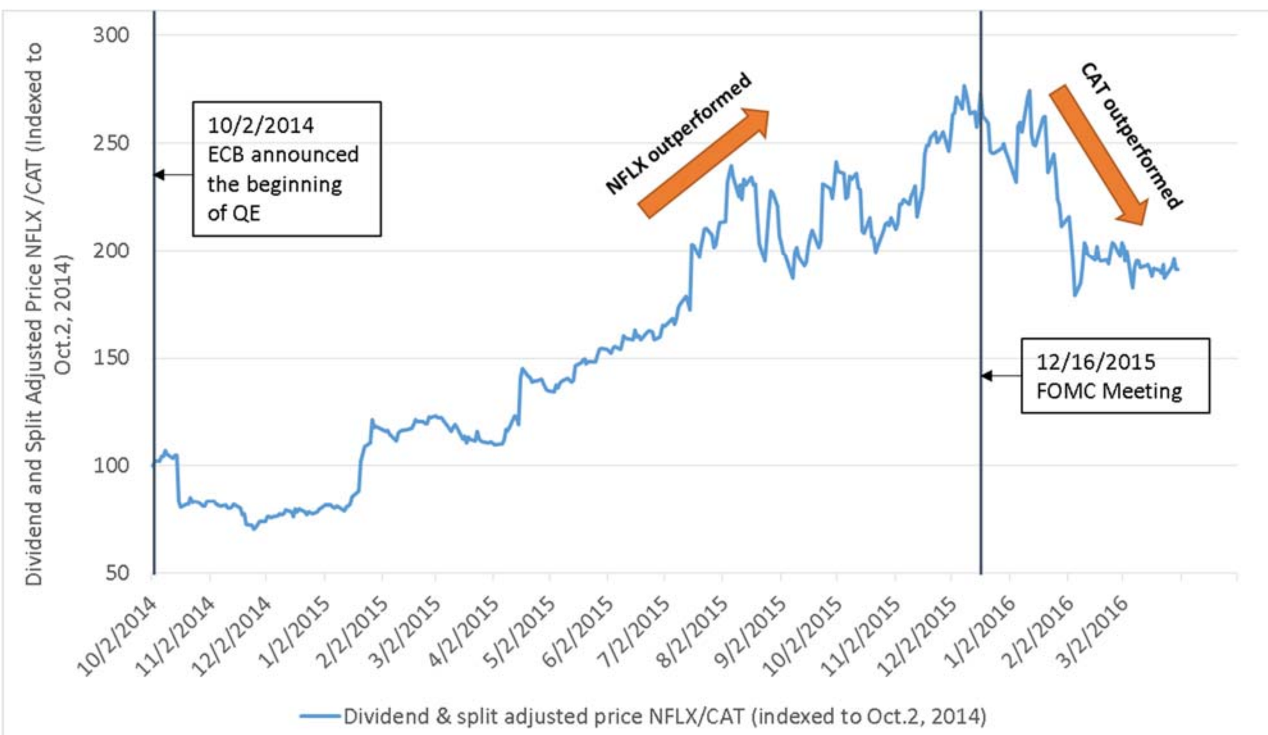
A third factor in the reversal of stock market sentiment came from OPEC. On the same day as the Deutsche Bank announcement, Suhail al-Mazrouei, oil minister from the UAE, said that he expected the oil market to stabilize and that OPEC was willing to talk with other oil producers to cap production. Mr. al-Mazrouei's comments reversed the free-fall in the price of oil. The price of oil has since rebounded from $26 per barrel on February 11th to near $40 at the end of March. At the current price of oil, some oil companies will default on their debt obligations, but problem loans will be much lower than if oil were to have stayed in $25 to $30 per barrel range, and are not likely to represent a problem for the banking system as a whole, in our opinion.

While the events noted above were transpiring, Chinese financial institutions were closed for the Chinese New Year celebration. When financial institutions returned to work on February 15th, the Chinese central bank (PBOC) seemed determined to break the backs of currency speculators and engineered a higher price for the yuan relative to the dollar. In the U.S., equites rejoiced the return to a stable yuan and began another leg up.

Although the stock market as a whole made little progress throughout the theatrics of the first calendar quarter of 2016, below the surface, a significant rotation was underway within the market. After an extended period of over-priced growth/momentum stocks leading the stock market at the expense of the performance of stocks that trade at reasonable valuations, more recently, the worm has turned.

Chart 1 below plots an index that we created to highlight the rotation from the growth/momentum style of investing to our more value oriented style that may have begun in February. The line depicts the performance of Netflix (NFLX) relative to the performance of Caterpillar (CAT). We've highlighted Netflix in past commentaries as being the poster-child of excessively priced growth stocks that have been powering market returns in recent years. We selected Caterpillar to represent our value-oriented approach. When the line is ascending NFLX is generating better relative performance than CAT. Conversely, when it is descending CAT is generating better performance than NFLX. The data series begins on October 2, 2014, when The European Central Bank (ECB) commenced their quantitative easing program. At the time, the U.S. Federal Reserve was on record expressing their desire to take the first steps towards allowing monetary policy in the U.S. to regress to something more appropriate for the strengthening U.S. economy. With U.S. monetary policy poised to tighten, the ECBs incremental policy easing measures had the effect of reducing long-term interest rates and strengthening the value of the dollar relative to the euro. As a result of the ECBs easy money policy forever approach, expensive growth/momentum stocks, such as NFLX, were launched into the stratosphere and only began the process of falling back to Earth from a valuation perspective after the Fed's monetary policy arm, the Federal Open Market Committee (FOMC), raised interest rates in December 2015. Higher interest rates, of course, means stocks that are valued using earnings projections way out into the future should incorporate a higher discount factor and, therefore, suffer a multiple contraction.

Chart 1:



Source: Yahoo Finance as of March 31, 2016

As noted on the chart, during the first quarter of 2016, CAT began to outperform NFLX after an extended period that dramatically favored NFLX. In fact, during the first quarter, CAT increased in price by nearly 14% while NFLX declined by more than 10%. After this price adjustment, NFLX still trades at a multiple of 87 times the consensus estimate of next year's earnings, whereas CAT trades at 21 times estimates, but only 12 times normalized earnings (the average of trailing peak and current trough earnings). As Caterpillar operates in cyclical end markets, we believe normalized earnings should be the operative valuation measure. It should also be noted that CAT is in the midst of an unprecedented fourth year of recession in its construction and mining equipment end markets while NFLX continues its global expansion apace. The management of CAT has spent the last four years of end market softness substantially reducing costs and aggressively repurchasing shares. CAT management has also indicated that the Company has increased its share of the construction machinery market every year of the downturn despite the fact that its main competitor is Komatsu, which hails from Japan, while the yen has depreciated by 40% against the dollar over the past four years! Given the reduction in costs, substantial share repurchase and market share increase, CATs shares should have a lot of leverage when its end markets finally improve. Moreover, the share price is likely to respond well in advance of an upturn in end market demand, and it is possible that the share price action is telling us just that right now.

So what does all of this mean for our portfolios? The issues that roiled the stock market in the first six weeks of 2016 have faded, for the time being, but they are by no means gone. In a heart-beat, the price of oil could plummet, thus reigniting fears of bad energy loans hampering the banking system. Similarly, capital could again seek flight from China, which could raise the specter of a precipitous devaluation of the yuan and the myriad of financial implications of such an event for global markets. More likely, the next world event that will take center stage as cause for concern will be the upcoming vote in Britain regarding continued inclusion in the European Union (EU). An event such as Britain leaving the EU is unprecedented and the financial ramifications are uncertain. If we know one thing with certainty it is that stocks don't like uncertainty.

Moreover, the U.S economy is still growing strongly enough to continue to tighten the labor market. This will likely stoke fears of rising inflation and push the FOMC to look for more opportunities to raise interest rates in an effort to continue the process of allowing monetary policy to regress to a normal level. The key word in the previous sentence is "opportunities." It is likely that, to a degree, the FOMC is in a pickle. The Chinese currency issue moved to center stage after the December 2015 FOMC meeting when U.S. short-term interest rates were increased by a mere 1/4%. The FOMC was, apparently, spooked by extreme volatility in the markets during the first quarter of 2016 and has subsequently backed-off their goal of raising interest rates four times in quarter point increments over the coming year. Their new forecast calls for only two increases. The FOMCs pickle is defined by the need to raise interest rates to get ahead of budding inflation in the U.S., but not being able to do so at a sufficient pace due to their concerns about potentially destabilizing global currency and stock markets. As we suggested in our last commentary, the third round of quantitative easing (QE) in the U.S. was likely a mistake, and the FOMC is now paying the price for that mistake.

As the FOMC attempts to normalize monetary policy, returns available in the stock market may be lower than investors have experienced, over time. In addition, potential dislocations stemming from currency markets and sudden changes in the price of oil have elevated the risks associated with equity investments. Despite our assessment that equities may provide lower returns at higher risk than in the past, the improving relative performance of our value style of investing exhibited in the first quarter is encouraging. After all, the essence of our style is to invest in companies that we believe are inherently undervalued and are managed by people who have a demonstrated history of realizing value for shareholders.

In consideration of the issues illuminated above, we added only one new position, American International Group (AIG), to our portfolios in the first quarter. AIG is a multi-line insurance company that trades at a price that is 35% below book value. Under the leadership of Peter Hancock, who assumed the role of CEO in September 2014, and the encouragement of activist investor, Carl Icahn, AIG recently announced a plan designed to "narrow its focus, improve its financial performance, and return capital to shareholders." Under the plan, AIG expects to return at least $25 billion of capital to shareholders over the next two years. The reallocation of capital is expected to be comprised of both dividends and share repurchase. Within the context of an equity market capitalization of $60 billion, AIGs plan to return $25 billion to shareholders in just two years should help the share price swim upstream in the challenging equity market that we may experience as the Fed attempts to raise interest rates and allow monetary policy to return to a posture more appropriate for the current U.S. economic environment.

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4/1/16

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