SeaBridge Core Strategy

First Quarter 2019

Commentary

In the wake of the disquieting market swoon in the fourth quarter of 2018, we cited a pearl of wisdom from revered economist Paul Samuelson in our year-end commentary. The gist of Samuelson's quote was that the stock market certainly has some ability to forecast pending economic recessions, but that it can be wrong nearly as frequently as it is correct. Moreover, Samuelson noted that "its mistakes were beauties." We saw no evidence of an imminent recession in the U.S. in 2018. We, therefore, chose to invest some of our cash reserves into the market weakness. Indeed, Samuelson was correct. The stock market rebounded smartly off of the panic bottom in December, and our Core Global portfolios recovered much of the losses incurred late in 2018 by the end of the first quarter of 2019.

Reflecting back on the economic and political environment that caused the stock market to panic last year, the market was likely wrong about an imminent recession, but it was clearly spooked by something. The first leg down in the market was a reaction to the Federal Open Market Committee's (FOMC) plan to increase interest rates in three one quarter point increments in 2019. While the FOMCs plan may have been reasonable given the strength in the U.S. economy, their plan ignored the slowing economic activity in the key economies outside of the U.S. Indeed, China has slowed materially and Europe and Japan are flirting with recession. While economic weakness outside of the U.S. is not the responsibility of the Federal Reserve, an FOMC policy to foster higher interest rates in the U.S. while all of the other major central banks in the world are easing monetary policy has the effect of attracting capital and increasing the value of the dollar. This, in turn, dampens inflation and reduces the FOMCs need to raise interest rates. It also makes U.S. exports more costly, which slows GDP growth.

In addition to the already deteriorating economic activity around the globe, President Trump's strategy in negotiating a new trade agreement with China fed fears that tariffs would impede global trade and lead to a further diminution in global economic activity. It's clear by now that our President likes to rattle his sabre at the precise moment trade discussions appear to be making progress. Markets were unfazed when he employed this negotiating technique with Mexico, but China is a more formidable negotiator and the stock market panicked as Trump demonstrated his "art of negotiation."

The combination of rising interest rates in the U.S. and a tariff induced slowing of global growth roiled the stock market in 2018. As this drama played-out late in a year in which investors were rewarded with gains earlier in the year, tax-loss harvesting compounded the losses and 2018 was horrendous for equity investors. We took advantage of depressed equity valuations and deployed a substantial portion of our cash reserves. As the stock market recovered into the New Year, we trimmed some of our investments to restore our cash reserves. Maintaining cash reserves to invest into market panic is a defining attribute of the SeaBridge Core Global strategy; we buy stocks when they're cheap and sell them when they are not cheap.

As we think about the remainder of 2019, we expect the U.S. economy to start the year growing below the trend rate of the current recovery, but accelerate to an above trend rate as the year progresses. The first quarter appears to have been depressed by a hangover of events in late 2018 as well as some horrendous weather throughout the nation. Three situations, in particular, slowed the economy, but are all now dissipating. They are: the Government shut-down, rising interest rates and lingering trade negotiations.

The Government shut-down impeded economic activity, but is now solidly in the rear-view mirror. Although some of the economic activity that is lost from a shut-down is re-captured when the Government re-opens for business, some business is permanently lost. There is also a negative psychological effect on business and consumer spending. The first quarter experienced the negative economic effect of the shut-down, but that shouldn't linger into the second quarter.

When the stock market correction began last October, the FOMC was signaling to market participants that they expected to raise interest rates in three one quarter point increments during 2019. In a stunning reversal of policy, the FOMC has signaled that no further interest rate increases are needed at the present time. Indeed, it appears as though the Fed cowed in the face of the fourth quarter market swoon and the prospect of slowing global growth. As a consequence, the forward interest rate curve now suggests that the next move by the FOMC will be to lower interest rates, rather than raise them three times. This should prove to be stimulative to the economy as the year progresses.

The trade negotiations with China are still lingering. Officials from both the U.S. and China have signaled that they are making good progress and expect to come to terms, but as yet we have no agreement. Given that Trump has often cited the stock market as a barometer of the efficacy of his policy initiatives, it is reasonable to expect him to find a way to come to terms with China. Similarly, the pace at which the Chinese economy appears to be slowing supports the notion that they too want to find an amicable solution to the trade problem.

With Monetary Policy now on hold, the Government shut-down a distant memory, and the prospect of a trade deal with China on the horizon, we believe the backdrop for equities will be favorable for the remainder of 2019. Despite the favorable environment, however, finding reasonably priced stocks is challenging 10 years into an economic recovery. Aside from stocks going on sale in market panics as we experienced in late 2018, the market is fairly well picked-over. We believe the investments in our portfolio represent good value, but finding incremental investments in companies that are different from our existing holdings is a challenge. In this environment, we find the best value to be in "special situations."

In recent years, some of the special situations we have added to the portfolio are IBM (IBM), Hanesbrands (HBI), Newell (NWL), Steelcase (SCS) and Harley-Davidson (HOG). We view these investments as special situations because they are all good businesses that have been temporarily impaired either due to internal or external factors. In our judgment, in all of these cases management has a reasonable plan to overcome their temporary affliction and grow value for shareholders.

While all of these stocks are inexpensive, special situations always take longer to resolve than anticipated. **IBM**, for example, has been repositioning the Company for several years, and is only recently showing signs that their renaissance is taking hold. The shares have languished since we initiated the position, but now seem poised to appreciate. It is worth noting that while we were waiting patiently for IBMs strategic turn-around to produce results, we have been collecting a 4.5% dividend. From here, we expect IBM to capitalize on their substantial investments in hybrid cloud computing, multi-cloud computing, artificial intelligence, blockchain software architecture, data security and quantum computing.

Steelcase needed to reinvent its product line to take advantage of the changing trends in office furniture. We all know the millennial generation is different in many ways. One way in which millennial preferences are different from that of previous generations is in the means of interacting with one another. Clearly, this is true socially but, more subtly, in the office as well. Steelcase recognized this difference and revamped its office furniture offering to facilitate an open, interactive work space. This was much less of a challenge than IBM faced in revamping its product offering and took considerably less time to implement. Steelcase is now hitting its stride and the shares have performed accordingly. Steelcase also offers a good dividend that presently yields 3.2%. The shares trade at a mere 11X earnings.

Hanesbrands enjoys the leading position in underwear in many markets around the world. In the U.S, however, the business needed to adjust its distribution channels as many of the traditional distributors of Hanes underwear closed their doors. Department stores have closed many stores and Sears is nearly out of business. Despite the disruption to distribution, the demand for underwear still grows in line with population growth. The challenge for Hanesbrands was simply to grow their e-commerce capability to deliver the product to consumers on their own terms. While this will be an ongoing endeavor, Hanesbrands has completed the heavy lifting and their U.S business has stabilized. Meanwhile, throughout the disruption to earnings caused by the shift in distribution channels, investors, apparently, failed to focus on the Champion athletic brand that represents approximately 20% of Hanesbrands' sales and is growing at a rate of 30% largely driven by international expansion. HBI has performed well in 2019 after a disastrous performance in 2018. We think the shares are still inexpensive, however, trading at 10X earnings and offering a dividend yield of 3.4%.

Newell has a very broad collection of consumer products including Graco baby products, Yankee Candle, Mr. Coffee, Crockpot, Coleman, First Alert, and many more. After a very long period of outstanding performance driven by acquisitions, Newell management took a step too far and acquired Jarden, which caused the Company to lose its focus. Activist investors Starboard Value and Carl Icahn forced a change in control of the Board and urged Newell management to put a plan in place to rationalize its business. The plan included the divestiture of business lines that should generate proceeds of $9 billion by the end of 2019. The proceeds from the divestitures are being deployed into debt repayment and share repurchase. Newell is already nearly $6 billion into the redeployment. As the remaining businesses are sold, Newell should continue to repay debt and repurchase shares that could amount to 25% of the shares outstanding in the next 12 to 18 months. The stock trades at 10X earnings and has a 5.9% dividend yield.

Harley Davidson is the market leading manufacturer of motorcycles in the U.S. It is also expanding abroad where its market share is much lower and the opportunity to take share is greater than in the U.S. The company has been facing a major headwind as the baby boom generation ages and, ultimately, stops buying motorcycles. Moreover, when people stop riding motorcycles, they often sell their bikes, which puts additional inventory on the market. Harley Davidson has managed this challenge remarkably well. They have reduced costs to maintain profitability in a lower volume environment, and broadened their product line to introduce bikes that would be more appealing to younger riders. Importantly, Harley Davidson plans to introduce a line of electric bikes later this year. Despite being in the trough of its cycle, Harley Davidson generates a 12% free cash flow yield, which comes back to shareholders in the form of a 4.4% dividend yield and persistent share repurchase program. Harley Davidson trades at less than 10X depressed earnings.

Beyond our special situation investments that will coalesce on their own timetable, if the U.S. economy were to improve throughout the year as we expect, the valuation of the economically sensitive investments in our portfolio should also improve. If so, we expect to trim some of these investments as we have already begun to do in the first few months of 2019 with small trims of **SPX Corp (SPXC), Pentair (PNR), TE Connectivity (TEL), and ITT (ITT)** as they have approached our price targets.

We also eliminated our small position in **FedEx (FDX**) after initiating the investment at a depressed price in late December. While the short holding period is uncharacteristic of our investment style, the challenge for the company of integrating a recent acquisition in Europe seems as though it will be more daunting than anticipated given the weak European economy. Similarly, we eliminated our position in **Qualcomm (QCOM)** because we were not comfortable with the Judge's body language in an anti-trust trial that ended in January. We concluded that, in the short-run, the risk/reward ratio of this investment could not be determined. We hope to re-establish our investment in Qualcomm after the Judge renders her decision if we can do so on favorable terms. Qualcomm owns most of the essential patents that enable 5G cellular technology, which we view as one of the more interesting opportunities in the coming years.

We will continue to look for special situations such as those described in this note; good companies that are temporarily impaired and available at a reasonable price.

John Conti
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