SEABRIDGE
INVESTMENT ADVISORS, LLC

SeaBridge Core Strategy

Second Quarter 2016
Commentary

The British vote to leave the European Union (EU) appears to have taken global investors by surprise. Despite public opinion polls leading up to the referendum indicating that sentiment was statistically tied, global stock markets and the British pound seemingly ignored the possibility of an outcome in favor of leaving the EU and rallied into the vote. Consequently, both the pound and stocks got pummeled when the vote was tallied and the people of Great Britain delivered their non-binding notice to their Parliament to begin the multi-year process of disentangling their future from the EU.

During times of extreme volatility in the stock market, we take stock of the investment principles that underpin our investment decisions and have served us well through turbulent markets in the past. The single goal of our process is to help us make clinical, rather than emotional, decisions during periods of extreme market stress. While we won't recount all of the elements of our investment process, we'll highlight just a few that seem particularly appropriate under current circumstances.

Rule number one: separate all information into that which is knowable with certainty and that which is not. While it is human nature to formulate opinions, we need to understand that opinions are not facts, and that even the most well considered opinions may prove to be incorrect as future events transpire. Consequently, applying opinions to investment decisions produces results that are no different from gambling. Indeed, a gamble can have an outsized payoff if it proves to be correct. Sooner or later, however, the odds catch up with those who treat their investments as mere wagers based on opinions, rather than facts. This can lead to an emotional pattern of investing that results in buying when stocks are expensive and the risk is greater than the reward potential, and selling when stocks are "on sale" and investors are being adequately compensated for the risks that they are taking.

So what are the facts? So far, all we know is that the British people have instructed their Parliament to begin discussions with the EU regarding the potential exit of Great Britain from the European Union. Arm chair experts are now full of opinions about the future course of events. The range of opinions goes from a rather benign future in which Britain negotiates a painless extraction from the EU with all trade agreements remaining much as they are today to a more dramatic future in which the British referendum is the opening salvo and other EU member countries follow Britain out of the EU.

While we are not oblivious to the range of potential scenarios that could represent the future, we are careful to avoid decisions that rely on one depiction of the future having a greater probability of occurring than the other scenarios. Instead, we contemplate the range of potential scenarios and identify the sign posts of change along the way. As events unfold, we will adjust our expected return hurdles for incremental investment decisions and deploy capital accordingly.

This brings us to rule number two: keep cash reserves available to deploy into equities when the reward potential available in equities is attractive relative to the perceived risk. This tenet of our investment philosophy comes from our observation and belief that during times of smooth sailing in the world economy, stock valuations incorporate a lesser perceived risk and valuations are dear. When the waters get rough, investors panic and stock valuations become more attractive to reflect the perceived increase in risk. In our experience, most of the excess return available in the stock market comes from investing into periods of distress, rather than periods of calm. In order to capture the excess return for investors, we typically maintain cash reserves. We then deploy cash reserves in a measured pace during periods of market dislocation.

This brings us to the third and final rule that we discuss in this note. We'll use a sports metaphor to illuminate this rule: during challenging times in sporting events, the wise coach will give the ball to the best player. Within the context of equity investing, the best player is the company or management that has the best chance of turning current adversity into opportunity.

Our first investment decision in the wake of the British vote was to use the steep decline in the price of American International Group (AIG) to increase our investment. AIG is a well capitalized, global insurance company with interests in both personal and commercial lines of insurance. It trades at a 40% discount to book value. We initiated a position in AIG earlier in 2016 after reviewing the Company's plan to reduce costs and narrow its business focus. The plan is designed to produce $25 billion in excess capital that AIG intends to return to shareholders through share re-purchase. To put this into perspective, $25 billion represents 37% of AIGs current equity market capitalization. Re-purchasing 37% of the market capitalization at a 40% discount to book value represents a substantial enhancement to shareholder value per share. Moreover, the current market turbulence enables the Company to re-purchase more of its shares with $25 billion than if the share price were rising. Therefore, long-term investors are reaping a permanent benefit from the short-term reduction in the price of AIGs shares. In terms of our sports metaphor, AIG can convert current market adversity into a substantial opportunity.

As previously noted, the post-Brexit world order could unfold in a manner that ranges from totally benign for the global economy to one that has the potential to be quite destructive. We will monitor economic conditions through a number of metrics to help us understand the impact of the British decision to leave the EU as it plays-out over time. Importantly, if the facts change, we will need to make some adjustments to our portfolio.

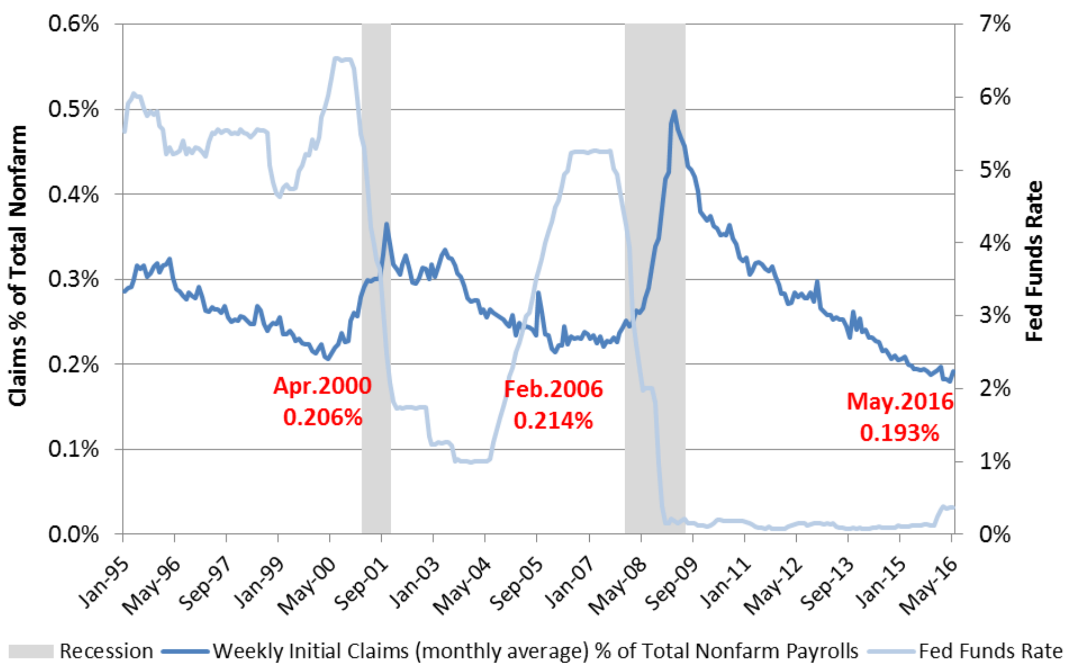
The most important tenet underlying our general approach of investing into market stress is the strength of the U.S. economy. Subsequent to the 2009 recession, the U.S. economy has grown at a rate of 2.1% per year. This is painfully below the historical rate of growth, which averaged 3.4% from 1947 to 2007 (the year before the recession). More encouragingly, however, housing is growing well below its potential as implied by demographics and, therefore, has the potential to add to GDP growth over time. Also, the savings rate is currently 5.7%, which is high compared with the 4.7% rate of the past 25 years. As the employment market continues to improve, wages should also improve. The high savings rate combined with rising income should result in more people having the confidence to buy homes, thus potentially causing GDP growth to accelerate.

The government sector is also a latent force for GDP growth to accelerate. As we've noted in past commentaries, the government sector contributed more than ½ of 1% to GDP growth from 1947 to 2007. In the economic recovery period from 2010 through 2015, the government impeded growth by ¼ of 1%. With government spending at the state and local level now regressing to the mean, the government sector also has the potential to augment GDP growth in the coming years. A full regression to the past mean for federal, state and local spending would contribute ¾ of 1% to GDP growth.

As mentioned earlier in this note, neither we nor anyone else can know the future. During times of market distress, we rely on our discipline to help us navigate the turbulent markets. Our goal is to do our best to avoid making emotional decisions. Nonetheless, we need to be aware that sometimes the facts and circumstances have changed enough to warrant a new course of action. The cornerstone of our analysis leading to the decision to slowly invest cash reserves into market volatility is the growing strength of U.S. consumers. Chart #1 carries a lot of weight in our analysis. It depicts initial unemployment claims as a percent of the overall job market. As can be observed, by this measure the job market is about as strong as it gets. In an environment such as this, employers are loath to release employees as they know they will have a difficult time finding replacements. Also, employees are more confident in a tight job market and, therefore, more likely to leave their job for one that pays better. Hence, our assumption that wages will grow and fuel consumer spending.

Another observation from Chart 1 is that the Fed Funds rate is very low at present given the tight job market. As we've noted in past commentaries, the Federal Open Market Committee (FOMC) has been slow to respond to the tightening labor market largely owing to repeated traumatic economic events outside of the U.S. The British vote to leave the EU likely represents yet another external event that will slow the FOMCs desire to address the tightening U.S. labor market. As can be seen in Chart 1, the FOMC was already well into its interest rate tightening cycle before the last two recessions. Therefore, with the FOMC sidelined out of concern for the global economy, the U.S. economy may enjoy a very long period of expansion before the next recession.

Chart 1:



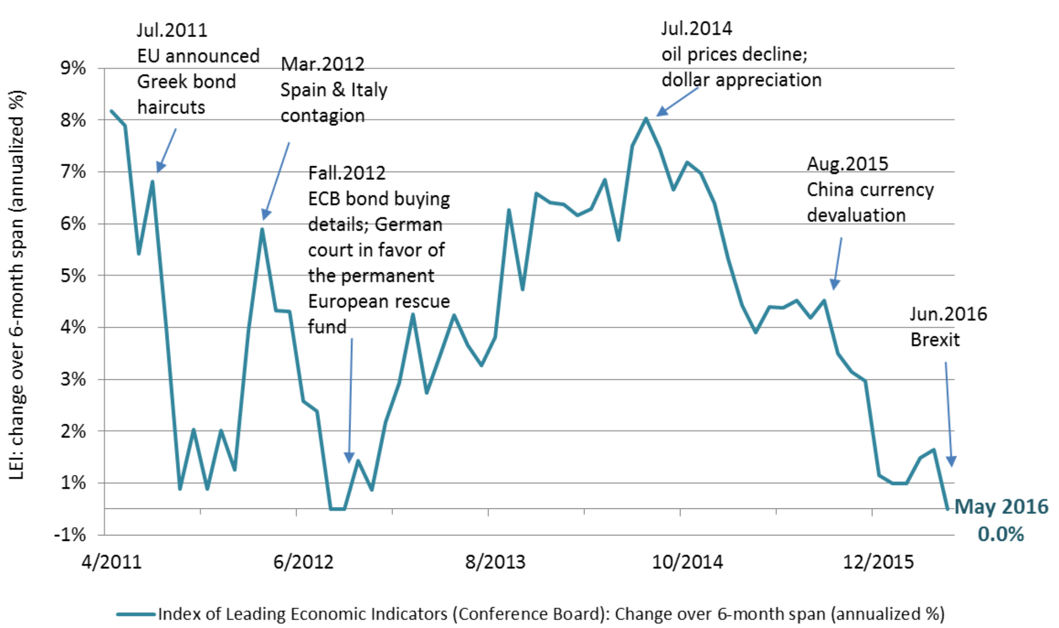
Source: Federal Reserve Bank of St. Louis

With consumers strong and getting stronger, and the government sector poised to serve as a tail wind to this recovery, we believe we are on solid ground to invest cash reserves into stock market turmoil. Nonetheless, there is one issue that gives us pause and warrants close scrutiny. In past commentaries, we have lamented that the FOMC was wise to undertake the first round of its quantitative easing (QE) campaign in March 2009 because the banking system was impaired at the time, and the U.S. economy needed liquidity to recover. We have further noted that QE2 was probably unnecessary, but that it did no economic harm. Our third observation has been that QE3 was not only unnecessary, but it likely impeded economic activity. In our opinion, QE3 diminished bank margins and, therefore, reduced lending activity from what might have been if margins were normal. More recently, we have formulated a hypothesis that QE3 not only reduced the supply of capital as described above, but it also may have diminished the demand for capital.

By substantially reducing interest rates in the initial years following the last recession, the FOMC induced a wealth effect. As interest rates declined, the value of assets rose, thus increasing consumer confidence and spending. Although short-term rates were very low and ultimately approached the zero lower bound, until QE3 savers could lengthen investment maturities and earn something on their cash reserves. After QE3, savers have been forced to move savings from debt instruments to more risky equity investments in search of income through stock dividends. With the unsettled global markets apparently shackling the FOMC into keeping interest rates abnormally low despite the tightening labor market, savers appear to have an uncomfortable amount of risk in their portfolios. There is some evidence that this uncomfortable risk posture has produced a hyper-sensitive wealth effect reaction function.

Chart #2 shows the Conference Board's Index of Leading Economic Indicators (LEI) expressed as a percentage using six month annualized data. Although we look at the monthly data series as well, the six month series smooths-out the short-term noise and has generally served as a good leading indicator of a pending recession. We have annotated the chart to show several major events that may have caused the LEI to turn down (or up) over the past five years. Our hypothesis, simply stated, is that since consumers are excessively exposed to stocks to generate income, they get cautious every time global events get scary, and the economy responds immediately. Please note, the LEI is not a perfect indicator to measure this phenomenon because one of the ten leading indicators is the stock market itself. Nonetheless, there are nine other components that comprise the LEI and seem to be responsive to headline risk. Therefore, it seems to fairly display a relationship between news that affects the stock market and then flows through to immediately affect economic activity.

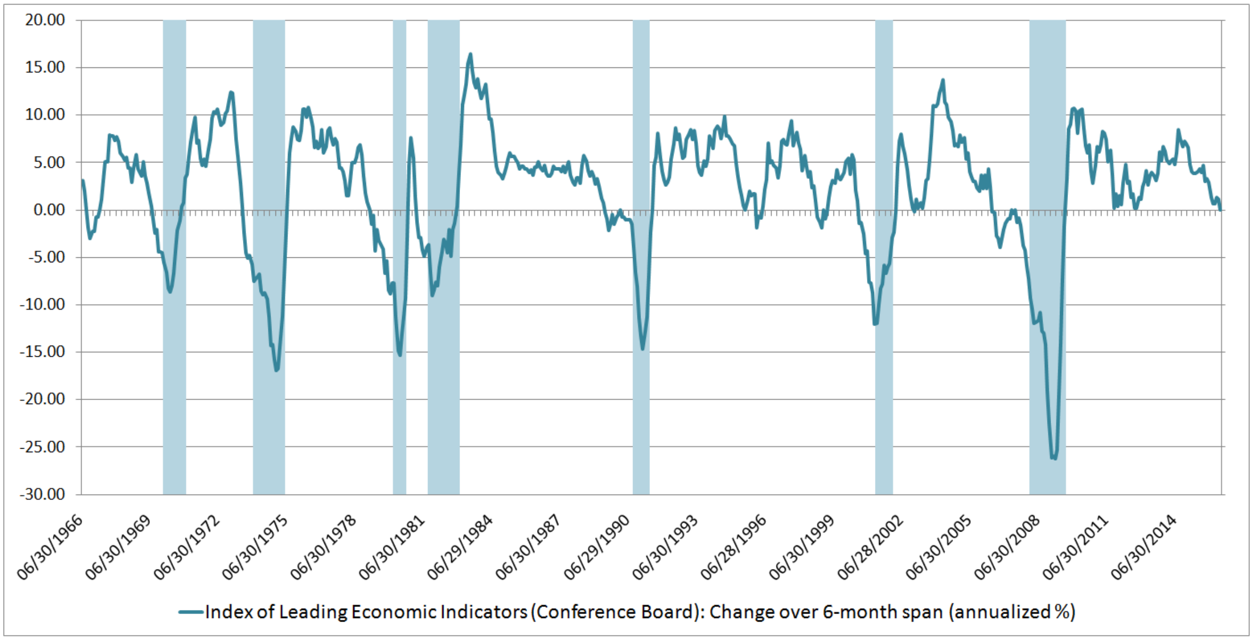
Chart 2:



Source: The Conference Board

Astute observers will note that the six month LEI has been declining and, most recently, showed an annualized growth rate of 0%, which indicates the U.S. economy has slowed. This begs the question: Is the U.S. headed into a recession? Our answer is probably not. As long as the employment market continues to improve and, along with it, wages are growing; consumer finances aren't deteriorating; housing is well below normal and improving; and, state and local government spending is rising, growth should accelerate as it has after bouncing off of a 0% growth rate twice before in the past five years. As can be seen in Chart #3, the six month LEI has gone decisively negative preceding past recessions.

Chart 3:



Source: The Conference Board& Factset

Nonetheless, until we get some confirmation that the drivers of economic growth that we have previously articulated are still in place, we expect to move at a very measured pace to invest our cash reserves into market turbulence. In addition, corporate earnings reporting season commences shortly and should provide us with incremental information regarding the health of the U.S. economy, thus helping inform our decisions.

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