SeaBridge Investment Advisors, LLC

SeaBridge Core Strategy

Second Quarter 2019
Commentary

We entered 2019 with a portfolio that was positioned for continued economic growth. Our base case scenario for the U.S. economy this year was an assumption that growth would be slower than 2018 but above the average rate for the current economic cycle, which was slightly above 2%. We noted in our last commentary that a rate of growth in the range of 2.2% to 2.5% seemed reasonable. With six months of data behind us, we still believe our assumption is reasonable for the full year, but the cadence is a bit different than assumed at the beginning of the year. We had previously assumed the first quarter would be the weakest and that growth would accelerate throughout the year. Of course, we now know that the first quarter was much stronger than anticipated at 3.1%. The composition of growth, however, was not normal and likely overstated the underlying strength of the economy. In particular, net exports and inventory accumulation comprised nearly half of the growth in the first quarter.

The second quarter likely slowed markedly based on the data already published. Some of the weakness in the past quarter was likely attributable to a reversal of the outsized contribution from inventories and trade, but several other factors also conspired to soften the economy in the second quarter. In particular, we believe the abnormally wet weather, tariff fears and Boeing contributed to the recent economic soft patch. All three of these factors are likely to prove to have been transitory.

While poor weather also likely affected growth in the first quarter, the persistent, heavy rain and serious flooding through the second quarter clearly slowed the mid-West farm economy and shipping on the Mississippi River. In addition, retail sales throughout the nation were likely affected by the harsh spring season. In the wake of the flooding in the farm belt, corn crops were planted late and are of a poor quality. Moreover, a lot of wheat in storage bins was destroyed. Consequently, some farmers were able to make insurance claims for lost assets and income, and the expected poor yield from the corn that farmers were able to plant in time for the growing season led to a sharp increase in the price of corn. Ironically, the persistent, heavy rain may have been just what the farm economy needed to see a rebound to prosperity in 2020.

The tariff overhang just won’t go away. A few short months ago, White House officials were hinting that we were close to a trade deal with China. At the last minute, however, hopes were dashed and Trump threatened higher and broader tariffs. Even worse, Trump summarily slapped escalating tariffs on Mexico to coerce our neighbors into helping contain the flow of immigrants across the Southern border. The Mexican threat, of course, proved to be short lived and we are now back in negotiations with China. Nonetheless, these kerfuffles left their scars on the world economy in the second quarter. Indeed, even the mighty U.S. economy was not impervious to the assault on confidence coming from the ongoing trade war with our trading partners. Businesses and consumers alike seemed to rein-in their horns in response to tariff related angst. Capital spending and retail sales suffered accordingly.

Although Boeing is just one company, it is a measurable part of the U.S. manufacturing economy. With the 737 Max grounded, Boeing has reduced production of its most profitable product by 20%. Many economists have projected that the reduced rate of production of the Max in and of itself trims 0.2 percentage points off of GDP growth.

We believe each of the factors enumerated above are transient and will dissipate as the year progresses. Moreover, the sharp decline in mortgage rates that occurred in recent months should spark another growth spurt in the housing segment of the economy. That is, when as or if the weather decides to cooperate. Notwithstanding a likely re-acceleration of the economy in the third and fourth quarters of 2019, the second quarter was very soft. Our best guess is that the U.S. economy grew at a rate of 1% plus/minus ½ % in the quarter. If this proves to have been the case, then growth in the first half would have averaged a little more than 2%. Based on a reversal of the factors cited above plus a recovery in housing, second half growth has the potential to be considerably better, and consistent with our assumption coming into the year.

The economic swoon in the second quarter caused a sharp rotation into defensive stocks. Utilities and consumer non-durables led the market to new highs in recent months. Our Core Global portfolios do not hold utility or consumer non-durables because of the excessive valuation of stocks in those sectors, hence we lagged the broader market. As noted in previous commentaries, our portfolios feature economically sensitive stocks as they seem to be the best value in an expensive market. The Core Global portfolios also have a fair representation in special situations, which we discussed in our previous commentary. A third area of concentration for our portfolios is our deep-value, hidden asset companies. These include: **The Howard Hughes Corporation (HHC), Senior Housing REIT (SNH), Alexander and Baldwin (ALEX), Weyerhaeuser (WY), Pioneer Natural Resources (PXD), and WPX Energy (WPX).**

CNBC recently published an article that referenced a report by JP Morgan (JPM) which indicated that 80% of the stock market is on auto-pilot. According to JPM research, 60% of equity assets are in index funds and exchange traded funds. Another 20% is controlled by trend-following, computer algorithms. This implies that only 20% of equity assets are in the hands of people who actually do research. Since computers get their data from published financial information and news headlines, the market gets whipped around based on superficial information. As a consequence, momentum develops in the market and stocks that fit the superficial model are driven to excess. Stocks that don't fit the computer algorithms are left behind. Our asset-rich companies have languished in recent years as the quant funds have gained in popularity because their published financial statements are too hard for simple trend following algorithms to process. The Howard Hughes Corporation is a great example.

HHC is a real estate developer. We discussed Howard Hughes in our commentary published after the second quarter of 2018. From our perspective, HHC is a cornucopia of value with a unique management incentive structure. The latter point is extremely important in a market that is driven by simple computer algorithms because the market has a limited capability to identify the hidden value if it is not expressed in the financial statements as is the case with HHC. Over time, while the financial statements should catch-up with the value accretion that management has created through the development of their Master Planned Communities and other real estate development projects, the time line for this to occur is very long, and the share price has languished in recent years. This is where the incentive structure for the management team comes into play.

As described in our Q2 2018 commentary, David Weinreb joined HHC as CEO in 2010. At the time, he purchased warrants for $17 million that gave him the right to buy 2,367,985 shares at a price of $42.23, which was the price of HHC at the time the warrant was purchased. When the warrants expired in 2017

Mr. Weinreb exercised the warrants, paid the tax on his substantial gain and was granted the right to purchase warrants to buy 1,965,489 shares at $117.01 per share until June of 2022. Weinreb paid $50 million for the warrants. The key point in this incentive system is that the CEO paid $50 million for the warrants, they were not given to him. If the price of HHC does not rise above $117.01, Weinreb loses his entire investment. He gets his money back if the price of HHC rises to $142.45. Weinreb reaps profits above $142.45. (The price of HHC is $130 at present).

Despite making substantial progress in the development of their properties in Hawaii, Texas, Nevada, Maryland, and New York, the share price of HHC declined since our commentary in 2018. In late June 2019, however, Weinreb and the Board decided to find a way to bring the hidden value to the surface and announced that they hired an advisor to "explore strategic alternatives." This term is often a euphemism that implies that the company is up for sale. The process will take several months and may or may not result in the sale of the whole Company. More likely, we believe, HHC may sell its properties in Columbia, MD, or bring in a joint venture partner for The South Street Seaport in Manhattan. The goal of such actions could be to raise enough cash to re-purchase enough shares to close the gap between the public and private market value of The Howard Hughes Corporation. Although the sale of the entire company would result in a higher price in the short-run, we believe a substantially greater value would be realized if HHC sold a few properties and re-purchased shares. In any event, the announcement that HHC was exploring strategic alternatives caused a 40% single day pop in the share price.

Although none of the other asset rich companies cited above are taking the dramatic step of exploring strategic alternatives at this time, they are all taking steps to bring their hidden value to the surface. **Senior Housing REIT**, for example, is in the process of selling properties that should produce $900 million in proceeds. The funds are intended to be used to pay-down debt and possibly re-purchase shares. With an equity market capitalization less than $2 billion, their asset disposition program is relatively large and has the potential to lift the share price substantially by the end of 2019, which is the time frame for their property sale program.

Alexander and Baldwin, Weyerhaeuser, Pioneer Natural and WPX are all selling assets to help close the gap between the public and private value of the respective enterprise. Although continued patience will be required, we believe asset rich companies with properly incentivized managers should ultimately prove to be rewarding investments, albeit with performance coming in fits and starts.

Before we close, we offer two brief concluding thoughts: one regarding our currently elevated level of cash reserves, and the other regarding tax loss harvesting. Earlier in the year, we trimmed some investments in stocks that approached our estimate of fair value. We also exited most of our foreign investments because we prefer to be closer to the information flow during volatile economic environments such as the current tariff-afflicted period of time. This has resulted in an increase in our cash reserve to levels above our normal 10% target. Within our client base, tax exempt portfolios typically hold more cash than taxable portfolios because we have avoided realizing some current year gains in taxable portfolios. We have been slow to reinvest our reserves into other equities because we believe the economic swoon is likely to lead to a sloppy second quarter earnings reporting season. If so, we may see some, or all, stocks go on sale. If the bargains are great enough, we hope to put some cash to work on favorable terms.

Our stock sales earlier in the year produced substantial gains for our taxable portfolios. We have, and will continue to, look for opportunities to reduce the tax liability. This may take the form of adding to an existing investment, waiting 30 days, as required by the IRS, and then looking for an opportunity to sell the shares purchased earlier. This enables us to book tax losses while maintaining exposure to the investment. As we approach the end of the year, we may reverse the process to book losses. This would result in the sale or elimination of a position and re-establishing the investment late in the year when others are depressing stock prices as they book losses in the 11^{th} hour.

John Conti
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