SeaBridge Investment Advisors, LLC
450 Springfield Avenue, Suite 301
Summit, NJ 07901-2610

Copy of the second quarter 2022 letter mailed to clients.

July 13, 2022

Markets have been challenging in the first half of 2022. From its high in early January, large cap U.S. stocks had fallen 23% by mid-June, before recovering modestly at quarter end. Other markets have had similar declines, including U.S. small companies, the MSCI developed market indices, and most of the MSCI emerging market indices. These drops meet the traditional definition of a "bear market." The fixed income markets have also suffered appreciable losses. For most of the quarter, oil and gas prices were strong, but industrial commodities suffered from the lock-down of China. With the Ukraine War, commodity prices are volatile and the outlook uncertain.

The easy money regimen of the pre-Covid years turbo-charged Americans' legendary propensity to consume. The government transfers during Covid enabled a surge in consumption that strained the damaged global supply chain. The Federal Reserve now seeks to tame the resulting inflation by raising interest rates and withdrawing liquidity, resulting in price erosion of financial assets. The consensus view now is that the U.S. economy will slow and enter a recession. We agree. The relevant questions are: "How deep will it be; how long will it last; and when will markets begin to price in a recovery?"

Recessions and Bear Markets

The U.S. economy has entered into recession a total of 13 times since the 1933 Great Depression. The average duration of each downturn has been 11 months, with GDP declining 3.5%, on average. Bear markets accompanied these recessions about 80% of the time, with the S&P 500 losing about 33%, on average. Market pain has, therefore, been a reliable consequence of recessions. Recessions normally occur when there has been a rapid expansion of credit, often coinciding with inflation of asset prices and an outsized accumulation of debt. As corporations and households get over-extended and face difficulties in meeting their debt obligations, they reduce investment and consumption, which in turn leads to a decrease in economic activity.

Slowdown Looming?

There are signs that the U.S. economy is rapidly slowing. The Fed Funds rate has been raised twice in the quarter and now stands at 1.75%, which is still inconsistent with the inflation facts on the ground. But the rate increases reflect the Fed's seriousness in reining in the excess demand, which is causing inflation. The rising cost of capital has been felt, and most of the market decline so far is consistent with the expected rise in interest rates. We believe weakness in corporate earnings has not yet been reflected in market prices.

Capital formation, generally, has taken a serious hit. Housing is coming off the boil as mortgage rates rise and affordability declines. Consumer and corporate confidence have waned significantly according to the most recent surveys. Consumers have begun to ration their expenditures and ratchet back on discretionary purchases in favor of putting fuel in their gas tanks and food on their tables. Suddenly, once bare shelves at the nation's largest retailers are now over-stocked with unsold inventory. Corporations seem more intent on rationalizing their workforce after a period of taking on any warm body to fill a staffing need. For example, last month Microsoft said it would slow hiring in its software group. Meta declared a hiring freeze; Netflix, Wells Fargo and several other retailers have recently announced job cuts. We expect more such announcements over the course of the remainder of the year.

But just as Tolstoy's families are unhappy in their own way, each recession is different. The one we may experience will have causality without precedent with some believing that the extraordinary conditions of the pandemic and a wildly accommodative Fed will make for a severe recession. And this may be so. The economic downturn that we may be about to experience may be deep and long-lasting.

Looking Backward

Or perhaps not. The obvious similarity to our current situation is the role the government has played in the downturns. The Fed often plays catch up to the inflation facts on the ground. This was the case in the antecedent recessions, and it seems to be the case now. In our view, the difference between now and then is the behavior of the private economy. In the seventies, as today, elevated energy prices were certainly an important factor behind the seemingly intractable inflation of that decade. But perhaps more importantly, there was a structural dimension to the labor market, i.e., automatic cost of living adjustments in labor contracts promoted an inflationary wage price spiral. In addition, U.S. companies were generally inefficient and in need of reinventing themselves. Companies themselves were a supply-side impediment.

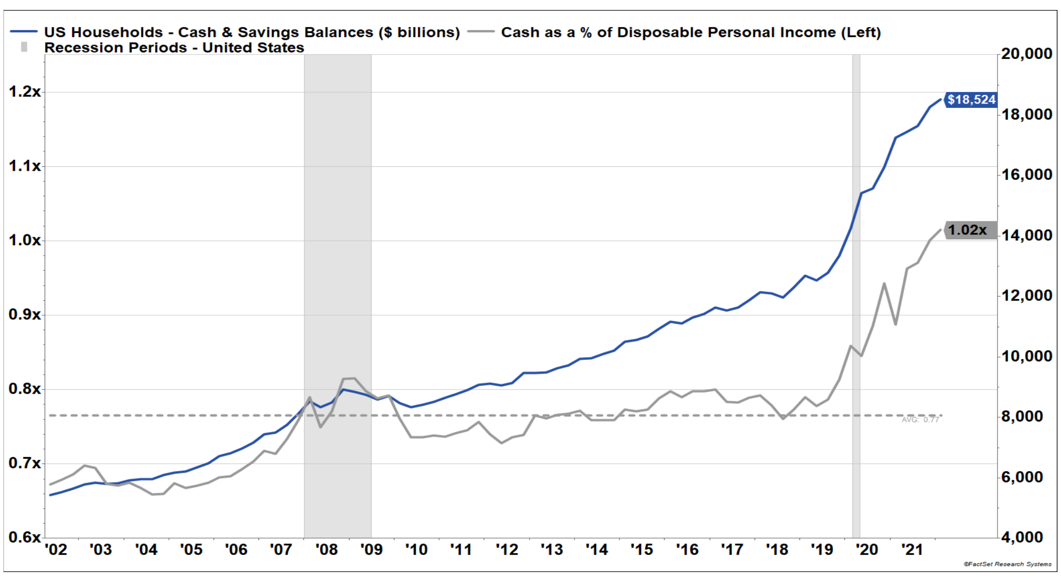
The genesis of the Great Recession could be traced to politically induced bad mortgage underwriting, plus an overextended consumer who treated his home equity like an ATM machine. This led to excessive leverage in the financial systems, and ultimately, liquidity crises necessitating Congressional and Fed bailouts.

Of course, these summary statements are simplistic, but highlight important past differences from our situation today. We would note that in our opinion, none of these conditions listed above, except for the cost of energy, now applies.

The Consumer

The private economy today is unlike those of these prior periods. The consumer and the corporation are currently in remarkably good shape. Unemployment is at a record low; household net worth is at a historically high level, elevated by significant house appreciation and sizable liquid assets; the savings rate is still solidly positive. Wage gains, though lagging a high inflation rate, are still impressive by U.S. standards.

Health of the U.S. Consumer:



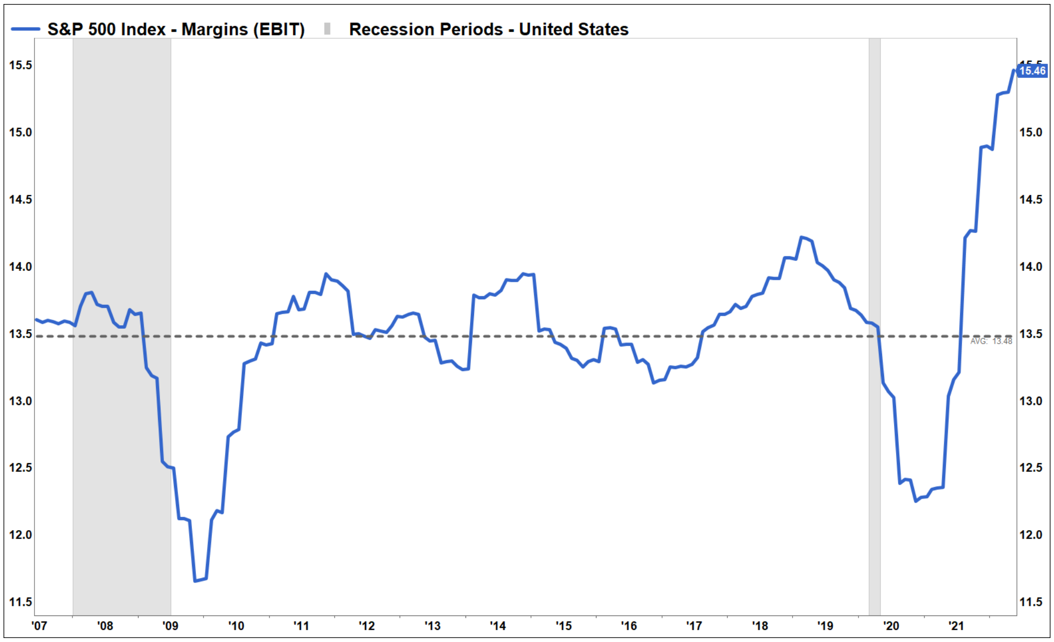
Source: FactSet

While labor is in a strong position today as job openings far outstrip available workers, there are signs, noted above, that this is changing. The balance of power in the employment market should continue to tilt more in favor of the employer. This may help to reduce the pressure on cost push inflation. Unlike in the seventies, there are few structural barriers preventing this.

Corporations

On the corporate side, companies have expanded margins in an inflationary period indicating pricing power and an ability to manage costs in a very difficult environment. Balance sheets are generally in good shape. While companies took on record debt during the Covid years, they have been circumspect about spending it. Companies are refinancing debt, pushing out maturities, and reviewing cash-management strategies. U.S. corporations held $3.83 trillion in cash during the first quarter, according to the Fed. That was $120 billion lower than during the final quarter of 2021 but more than $1 trillion higher than before the pandemic. Banks are strong; this year's stress test measured the 34 biggest banks' ability to withstand a hypothetical recession– they all passed. If the economy slows, and we think it must, the private sector should be well positioned to weather the storm.

Health of the Corporate Sector:

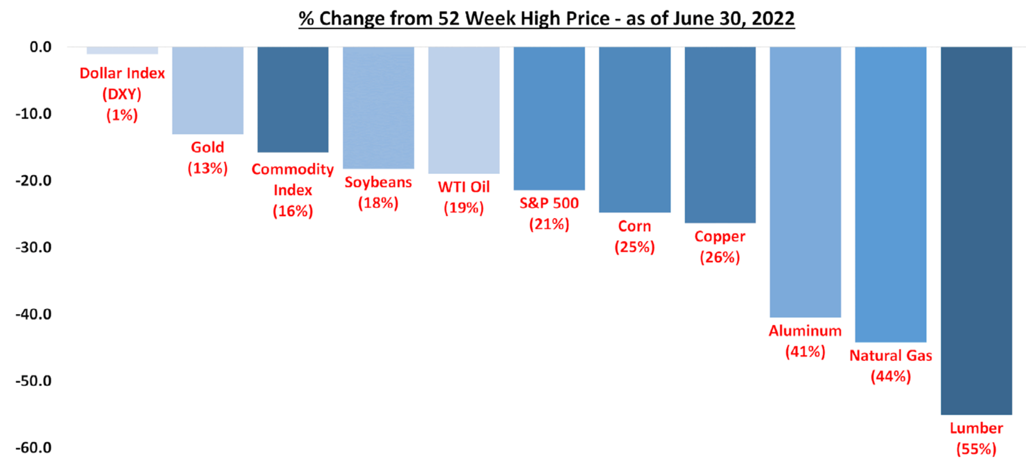


Source: FactSet

Our conclusion is that the private sector is generally healthy. We may also get some help on the inflation front from overseas. They include further healing of the supply chain, a strong U.S. dollar, and a China that is still struggling to manage itself out of the pandemic and deflate a property bubble lest it burst. These are factors that should help lower inflation expectations. Indeed, the commodity complex, perhaps with a sub-par China as the main driver, is signaling softness ahead.

Commodity Returns

The Ukraine/Russia war has been a catastrophe in terms of the human toll exacted. Discussing its effect on commodities markets seems irreverently superficial. Still, we must note that the war's damage extends to the commodities markets. Both countries are significant producers of oil and gas, wheat, corn, sunflower oil, and certain metals. Prices for these commodities spiked at the war's onset. Of late, prices have fallen indicating it could be that the market sees some kind of armistice, with the Russians controlling the eastern region of Ukraine and allowing for a freeing up of supply. Or it could be that the market expects additional supply coming from other areas of the globe. Most likely, the market is anticipating an imminent economic downturn and falling demand for most commodities. We would exclude oil and gas from this assessment. The supply-demand imbalance for fossil fuels, and the resulting inflation in the space, seems a long term, secular proposition to us.



Source: FactSet

Readers may detect a more optimistic tone than in prior letters. We are beginning to see how this can work out, but we remain cautious. Our openness to increasing equity exposure is a function of the meaningfully lower valuations the equity markets now offer. Yet we recognize that earnings reductions usually happen during a recession, and they have not yet occurred. There may be more pain ahead, but, that said, we believe that beyond the short term, better times lie ahead.

We know that this has been a difficult period for all market participants. We encourage you to reach out to us to discuss the outlook and how you are positioned for it in your SeaBridge accounts.

The SeaBridge Team

If you'd like to discuss any of the strategy commentaries, or your individual portfolio, please let us know. Also, as always, we encourage you to contact us if there are any changes in your circumstances or goals that might suggest a change in the level of risk in your portfolio or in the investment strategy we are managing for you. You can call 908-273-5085 or email SeaBridgeTeam@SeaBridge.com.

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