SeaBridge Investment Advisors, LLC

SeaBridge Core Strategy

Third Quarter 2016

Commentary

We began 2016 in the wake of a ¼ of 1% increase in the Fed Funds rate engineered by the Federal Open Market Committee (FOMC). Furthermore, the FOMC told financial markets in December 2015 that they expected to raise interest rates by ¼ of 1% four times during 2016. The FOMCs forecast was, however, qualified as being data dependent. Despite continued tightening in the labor market throughout 2016 and an inflation rate approaching the FOMCs 2% target, economic data have sent inconsistent clues about the strength of the U.S. economy. Indeed, most of the economic data through August have been disappointing. Hence, the FOMC has not raised short-term interest rates thus far in 2016. While they may find an opportunity to raise interest rates by ¼ of 1% before the end of the year, the economic data will have to show some improvement in the coming months for the FOMC to take any further action.

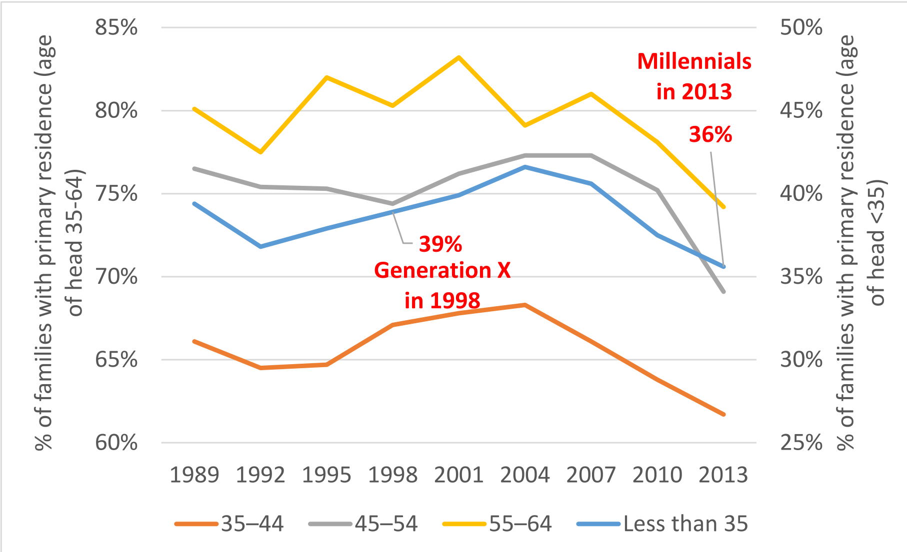
In the first half of 2016, the economy grew at a rate below the post-recession trend line growth rate of 2.17%. For the remainder of the year, we expect the U.S. economy to accelerate to a rate above the post-recession trend. As noted in previous commentaries, we believe the incremental growth drivers will be the government sector (mostly state and local government) and residential housing. Our case for increased state and local government spending is based on a recoupment of the lack of spending by local governments post the last recession. The case for continued acceleration in residential real estate investment is based on demographics. In particular, the children of the baby boom, which are a large demographic cohort and are moving into the age group in which people have historically formed households, had children and, therefore, needed their own homes.

The echo boomers (birth years from 1980 to 2000), also known as Millennials or Generation Y, are the children of baby boomers and are the demographic cohort that followed Generation X (birth year from 1965 to 1979). According to Pew Research Center, in 2015, Millennials surpassed Generation X in size and now comprise the largest share of the U.S. labor force. Millennials are expected to shape the economy for years to come as more graduates join the labor force. However, many observers have cast doubts on the financial wellbeing of Millennials because of soaring student loans resulting from higher college enrollment and a decade-long growth rate of college tuition above the rate of inflation. In addition, they faced substantial challenges entering the workforce during the most pronounced recession in the post WW II period. The common perception that Millennials are less financially secure than previous generations of young adults raises concerns about potential adverse effects on overall consumer spending and economic growth. In contrast to this perception, our research, using data from the Federal Reserve's Survey of Consumer Finances (SCF), suggests Millennials weathered the Great Recession relatively well compared with Generation X.

SCF is a triennial cross-sectional survey of U.S. families. The last survey was conducted for 2013 and provided good insights into the balance sheet of Millennial households post-recession. SCF is designed to study the portion of the population that is living independently and is, therefore, not representative of the entire population. Independent living means living alone or with spouse/partner and excludes those living with parents, relatives, or nonrelatives. Indeed, the percentage of the 25-34 years old cohort living independently declined, but by a moderate 3 percentage points from 70% prior to the recession to 67% as of 2015 based on the U.S. Census Bureau's data on living arrangements of adults 18 years of age and older. Our observations from a review of the SCF data are based on a comparison of the Millennial generation to Generation X when they were the same age as the Millennials are at present and are as follows:

1) Relative to Generation X, Millennials are not less likely to own a home, which is contrary to the popular perception that Millennials are a generation of renters. Chart 1 depicts the percentage of home owners among families by age group. The blue line represents the age group under 35. In 1998, about 39% of Generation X were home owners. In 2013, Millennials' ownership of their primary residence was 36%. Despite a 3% drop in the home ownership rate for the under 35 cohort, other age cohorts experienced declines of more than 5%. This suggests that cyclical rather than structural changes are influencing home ownership. We believe continuing improvement in labor market conditions should drive further growth in residential investment, and possibly a rebound in the rate of home ownership.

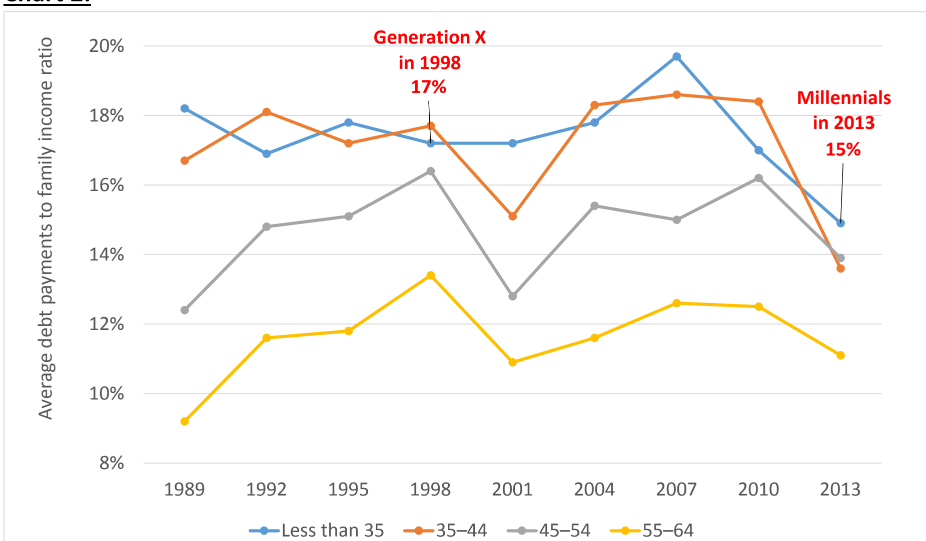
Chart 1:



Source: Federal Reserve

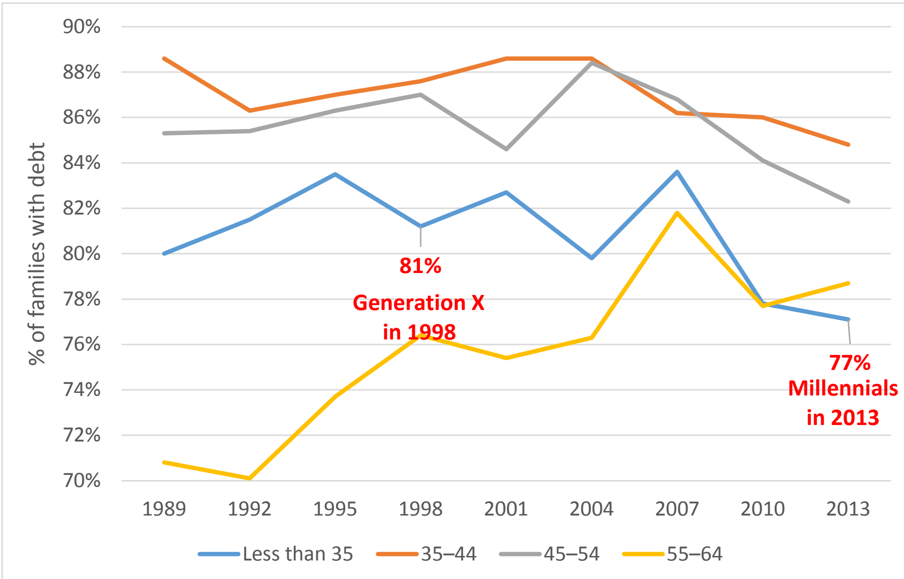
2) The debt payment burden of Millennials is lower than Generation X when they were at the same age as Millennials are now. Chart 2 depicts the average debt payments to family income ratio by age group. Similar to our previous point, we observe from the blue line (under 35 cohort), that Millennials in 2013 had an average debt payments to family income ratio of 15% compared with 17% for Generation X in 1998. Perhaps low interest rates are making debt more affordable for today's young adults than for prior generations. Furthermore, 77% of Millennial families had debt, which compared favorably with Generation X, of which 81% had debt in 1998 (Chart 3).

Chart 2:



Source: Federal Reserve

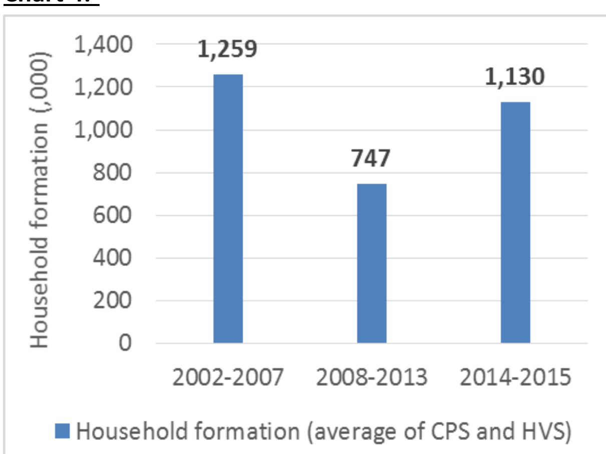
Chart 3:



Source: Federal Reserve

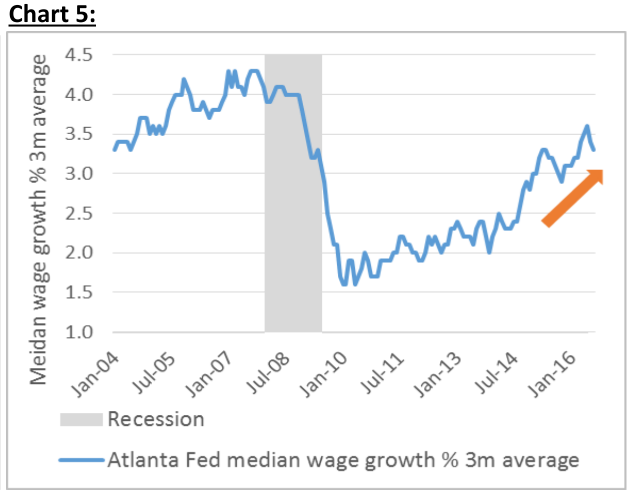
The 2016 Survey of Consumer Finances has just started and will be published in late 2017. With solid job gains since 2013, we expect further strengthening of household financial well-being across age groups. One further detail from the SCF suggests that baby boomers, parents of Millennials, are taking on education loans for their children. From 1998 to 2013, the percentage of families with education loans increased across age groups by 18%, 16%, 8% and 6% for the under 35, 35-44, 45-54 and 55-64 age cohorts, respectively. With parents shouldering some of their children's debt burden, Millennials perhaps have more freedom to take risks in their careers and investments.

Chart 4:



Source: U.S. Census

Chart 5:



Source: Bureau of Labor Statistics

Encouragingly, recent data on household formation indicate that more Millennials are moving out of their parents' homes or shared rental arrangements. Averaging two prominent data sources (Chart 4), the Current Population Survey and the Housing Vacancy Survey, household formation improved significantly in 2014 – 2015 to 1.1 million from 0.75 million from 2008 – 2013. Moreover, despite sluggish growth of the Average Hourly Earnings Index (AHE) and the Employment Cost Index (ECI), two commonly used wage measures, an alternative indicator, the Atlanta Fed's wage tracker has been strengthening consistent with job gains since late 2014. The Atlanta Federal Reserve's Wage Growth Tracker (Chart 5) features the median of the distribution of individual 12-month wage changes for each month by matching the hourly earnings of individuals observed in both the current month and 12 months earlier. In contrast to the AHE and ECI, this measure should capture wage growth associated with experience level changes and promotions. Consequently, shifts in job composition during business upswings perhaps render the AHE and ECI less useful indicators of current labor market conditions.

In conclusion, the data do not support the popular claim that Millennials came out of the recession poorly and are largely financially dependent. As cyclical factors wane, we expect Millennials, the largest portion of the U.S. workforce, to contribute meaningfully to domestic consumption and investment in the coming years. Historically, housing has represented a significant share of GDP, roughly 18%, of which residential investment and housing services averaged about 5% and 13%, respectively. In our view, a continued housing recovery backed by the demographic tailwind of the Millennial generation moving into a higher consumption phase of life should provide support to economic growth and, possibly, further moderate equity market returns.

The companies in our portfolios that could benefit from a continued recovery in residential real estate are: Simpson Manufacturing (SSD, wood connectors), Weyerhaeuser (WY, lumber), The Howard Hughes Corporation (HHC, real estate development), Alexander & Baldwin (ALEX, real estate development), Hubbell (HUBB, electrical fixtures), RPM International (RPM, coatings and sealants), CoreLogic (CLGX, real estate data), Pentair (PNR, swimming pool equipment), Bed, Bath & Beyond (BBBY, home furnishings), and SPX Corp (SPXC, heating boilers).

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10/2/16

Disclosures

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