SeaBridge Core Strategy

Third Quarter 2018
Commentary

In the second quarter SeaBridge letter, we highlighted five layers in the metaphorical wall of worry that have dogged markets in 2018. The five areas of concern are as follows:

- The currencies of several emerging economies have plummeted
- America's relationship with North Korea is unstable
- Donald Trump's trade war is lingering
- A new, populist government in Italy may spend too much
- Inflation in the U.S. is accelerating

In this note, we briefly update our thoughts on these five layers in the wall of worry, add a new layer to the wall, make some observations regarding the U.S. economy, and highlight a few investments.

Emerging Market Currencies

When emerging economies borrow through loans denominated in dollars, their debt burden becomes untenable if the dollar rises in value as it has in 2018. Several emerging economies, such as Argentina, South Africa, Turkey, Brazil and Indonesia have experienced currency devaluation as a result of rising interest rates in the U.S., which have caused the dollar to strengthen. In the past, there have been periods in which emerging market currency weakness has roiled global equity markets as investors feared contagion. Although contagion risk is real, at present, we believe the currency problems being experienced by the countries noted above are related to issues internal to those nations and do not immediately appear to be contagious. As the Fed continues to foster higher interest rates in the U.S., the dollar could continue to strengthen, which could put further pressure on countries that have not managed their budgets as prudently as they should have. For now, the emerging market currency problem has been fairly contained, and has not yet proven to be a material factor in impeding world economic activity. Importantly, the stock market doesn't seem to be too bothered by currency contagion at the present time.

North Korea

Not much has happened since the historic summit between the United States and North Korea. Initially, the status quo appeared to have deteriorated as there were some press reports that North Korea was proceeding with its nuclear program despite the public message they fostered post summit. More recently, however, we may be back on track towards a more stable Korean Peninsula as North and South Korea seem to be having ongoing talks and may be taking baby steps towards a more stable relationship. Most importantly, the North has not tested any missiles or detonated any nuclear bombs. Therefore, the stock market isn't concerned about North Korea at the moment.

Trade

The U.S. has, apparently, reached a trade agreement with Mexico, but Canada has yet to sign onto a new NAFTA and progress seems stalled at best. Outside of North America, South Korea and the U.S. have forged a new trade agreement. The EU seems to want to come to terms, but there have not been any meaningful developments in recent months. China has dug in its heels and appears to be waiting until after the U.S. mid-term elections to come back to the table. Moreover, China appears to be backed into a corner and does not want to negotiate from that vantage point. The ultimate outcome of the negotiations between the U.S. and Canada, the EU, and China is anyone's guess. From a stock market perspective, however, the potential for a protracted trade war with China, in particular, appears to be impeding many sectors of the stock market. Industrial stocks, such as ITT (ITT), Hubbell (HUBB), TE Connectivity (TEL) and Deere (DE), are important to our Core Global strategy and have been held in check by the looming trade war. Similarly, some consumer goods producers, such as Newell (NWL) and Hanesbrands (HB), also seem to be moving to the beat of the trade war drums. At a minimum, we would like to see some progress with Canada and the EU to enable the trade war prisoners in our portfolio to capitalize on the exceptional earnings growth that many of these companies are capable of producing.

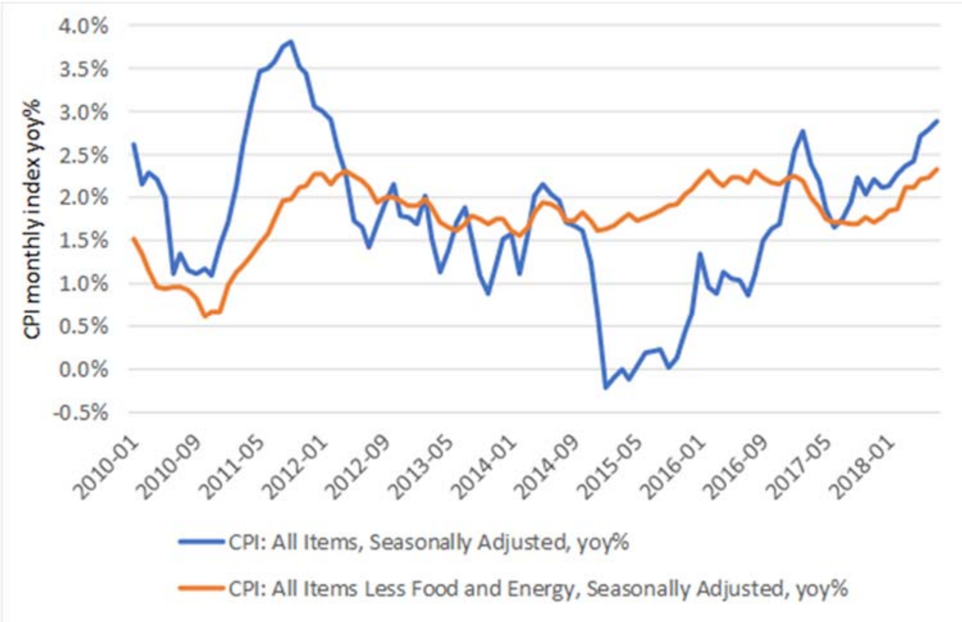
Populism in Europe

Beginning with the election of Donald Trump, an anti-globalist, anti-immigration populist wave has swept through western economies. Without sifting through the investment implications of the populist wave in every country, the new government in Italy needs to be monitored closely. In Italy, the NEET rate (neither in employment nor in education or training) among Italians age 20 through 34 is 30%. Normally, a country would deal with chronic unemployment by devaluing its currency. As Italy is a member of the European Monetary Union, it cannot devalue its currency to become more competitive on the world market. The European Central Bank has been implementing a massive quantitative easing (QE) program since 2015 to devalue the euro, but that program is nearing its end in the coming months. Recently, the euro has strengthened vs. the dollar as the market contemplates rising interest rates in Europe as the end of QE comes into the investment horizon. A strengthening euro could put pressure on Italy's populist government to stimulate the Italian economy by increasing fiscal spending. More government spending would likely put Italy outside of the EUs deficit limits. If a rising deficit were to put Italy at odds with the EU government in Brussels, markets may fear a move by Italy to exit the EU. This would likely be very bad for stocks.

Inflation

As can be seen in Chart 1, inflation is running above the Fed's target rate of 2%. The Fed has told us on many occasions that it is likely to allow inflation to run above their target for some undefined period of time to offset the extended period of time over which inflation was below its target. For more than two years, the Fed has been raising short-term interest rates at a very measured pace with a goal of allowing rates to find their normal level. The normal level of interest rates is both subjective and a moving target so we don't know with certainty how high interest rates may go. Importantly, the Federal Open Market Committee (FOMC), which sets monetary policy for the Federal Reserve, has removed the word accommodative from its current description of monetary policy. This means that the Fed believes short-term interest rates are no longer fostering economic growth. This does not mean, however, that the Fed is impeding economic activity. In our opinion, if the Fed maintains its current pace of increasing interest rates, the Fed will not reach a restrictive monetary policy until the second half of 2019 with a goal of bringing the U.S. economy off the boil in 2020.

Chart 1: Inflation Has Passed the Fed's Target Rate of 2%



Source: Bureau of Labor Statistics

Constitutional crisis

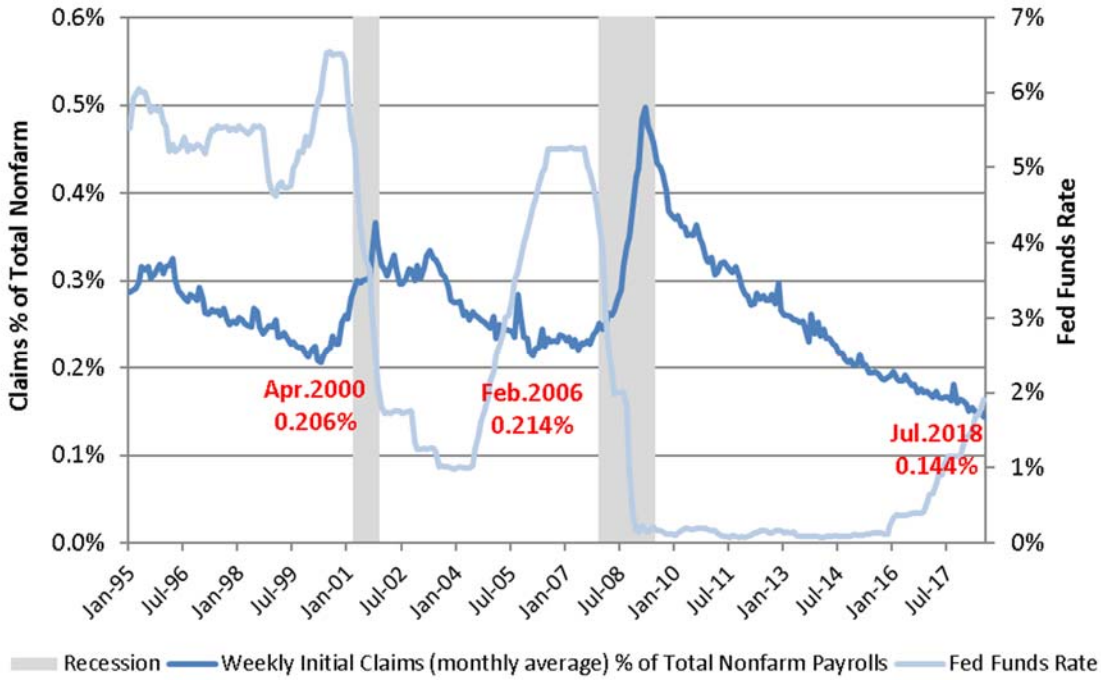
Political pundits are increasingly throwing around the term "constitutional crisis". We're not exactly sure how to define the term constitutional crisis but, whatever it may be, the odds of one have likely increased since our last commentary, and added a sixth layer to our wall of worry. Now that Paul Manafort and Michael Cohen, two of President Trump's former colleagues, have taken plea agreements with the Department of Justice, it seems reasonable to assume that the odds of a legal action against the President have increased. It is also possible that the Democrats will take the majority in the House of Representatives. If so, an impeachment action would likely ensue. Although we view it as unlikely that Trump would be removed from office by impeachment, the stock market doesn't like uncertainty and the unstable nature of the current administration will likely continue to incite market volatility.

With six layers in the wall of worry, why equities?

In a nut shell, the U.S. economy is strong and getting stronger. This, in turn, is leading to accelerating earnings growth. In the final analysis, we buy stocks for the profits that can be earned by the companies in which we are invested, and those profits are increasing. In our judgment, the valuation of the equities in our portfolios does not reflect the earnings power of the underlying companies.

We are mindful, however, that all that glitters is not gold, and that the inflation outlook complicates the rosy scenario of an accelerating economy. The tariffs associated with the aforementioned trade war are lifting input costs, which corporations are passing along to consumers. Although one could rightfully make the case that inflation associated with tariffs would likely be transitory, we can't ignore the extreme tightness in the labor market, which has the potential to produce a sustainable increase in inflation. Chart #2 below depicts the level of initial unemployment claims as a percentage of the total number of jobs in the economy. The key point to take away from this chart is that initial unemployment claims are at the lowest level on record. This comports with record high levels of both consumer confidence and small business confidence. It also leads us to conclude that the U.S. economy is roaring into the end of 2018 and may to continue to do so into 2019.

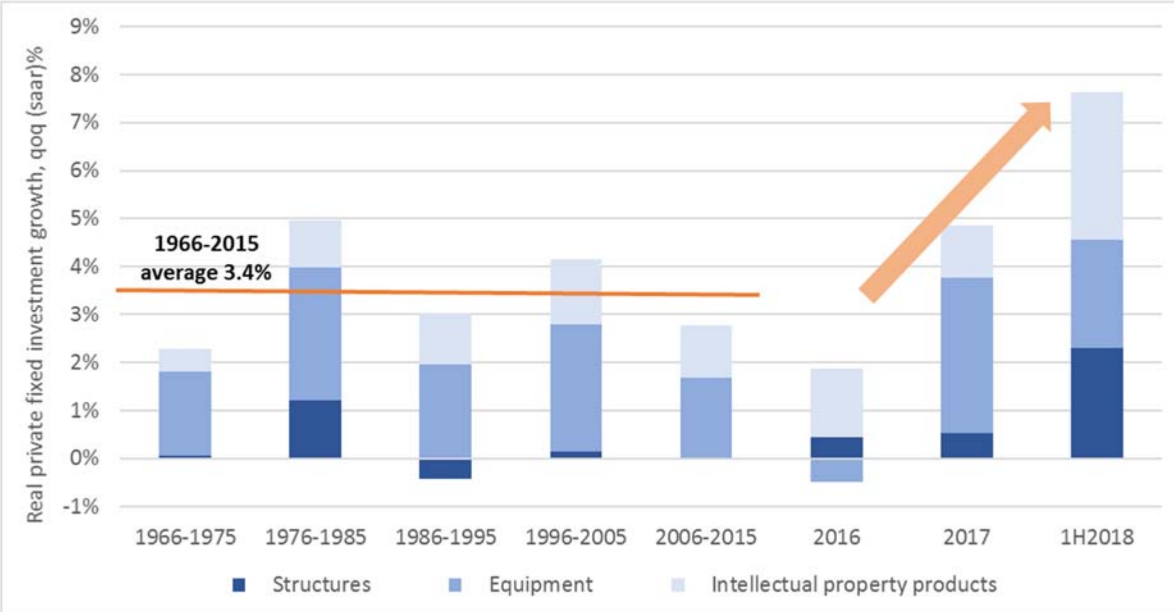
Chart #2: Record Job Market Strength



Source: St. Louis Federal Reserve

Given the tightness in the job market, continued economic growth through 2019 has the potential to foster a level of inflation that prods the FOMC to bring Monetary Policy to a restrictive posture and induce a recession. As we noted in our last commentary, the key to growth in 2020 and beyond is productivity. If productivity were to increase enough to offset the lack of labor available to foster growth, then the U.S. economic expansion has the potential to maintain growth beyond our investment horizon. Although this story is yet to be told, there is some evidence that the Tax Act of 2017 may have been successful in inducing corporations to increase capital spending, which should lead to an increase in the rate of growth in productivity. (See chart #3).

Chart #3: Business Capital Investment Poised to Improve Productivity



Source: Bureau of Economic Analysis

From a portfolio perspective, we are excited about the stocks in our portfolio that benefit from rising productivity and a strong economy. Simpson Manufacturing (SSD), for example, sells metal connectors that are used in residential construction. They control 70% to 75% of the market for their product. The shares have performed well thus far in 2018 on the back of strong unit growth and improving margins. We expect the fundamentals at Simpson to continue to improve as the Company implements a radical efficiency enhancement program, which is designed to further improve margins, pull capital out of the balance sheet and return it to shareholders. Earnings growth should also be aided by a recently implemented 11% price increase for their connectors. Given the strong performance of Simpson shares, we have already trimmed our position once and will likely trim the shares into third quarter earnings in order to maintain portfolio diversification.

We also continue to be excited about the prospects for Compass Minerals (CMP), which sells road salt and specialty fertilizers. You may recall from our last commentary that road salt is one of the few products that correlates well with inflation. In fact, since we highlighted the exceptional pricing power of road salt, CMP raised the price for the upcoming winter season by 15%. Let it snow, let it snow, let it snow!

We also suggested in our last note that fly ash may have many of the attributes of road salt and timber that enable these commodities to provide a hedge against rising inflation. Since our last note, Boral (BLD-AU), which controls 50% of the fly ash supply in the U.S., raised its price by 9%. Please note, while we are favorably disposed to Boral over the long-term, we recently trimmed our position in taxable portfolios to book a small tax loss. We will look for an opportunity to replace those shares with cheaper shares after the requisite 30 day IRS-imposed waiting period.

In general, we believe a strong economy with both inflation and interest rates rising at a moderate pace bodes well for our value style portfolio. Nonetheless, growth/momentum stocks have behaved remarkably well in 2018 despite the increase in interest rates and have bested our results this year. We remain patient and disciplined in our quest for value. Nonetheless, the anticipated rotation from growth/momentum to value remains elusive. Progress on the trade war will likely be needed to serve as a catalyst for a market rotation in our favor.

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9/28/18