SEABRIDGE
INVESTMENT ADVISORS, LLC

SeaBridge Core Strategy

Third Quarter 2019
Commentary

We began the third quarter with our cash reserves higher than normal. We had hoped to put some cash to work in stocks at bargain prices based on an expectation of soft second quarter earnings reports. Our hopes were dashed, however, as earnings were generally stronger than expected and, in our opinion, the likelihood of an economic recession in 2020 increased during the quarter. Based on our diminished confidence in continued growth, we reduced our risk exposure by exiting a few investments and trimming others. Consequently, rather than reducing cash reserves during the quarter as we had hoped, our reserves increased and now reflect our concern about continued economic growth in the U.S. and, to a greater extent, Europe.

Whenever we write about our expectations about the future, we always note that no one, including us, can predict the future. Nonetheless, we need to be mindful of the obstacles that we may face in the investment horizon and adjust our risk tolerance accordingly. Given our rising concern about the economic backdrop in 2020 we, therefore, eliminated our investment in Pioneer Natural Resources (PXD), WPX Energy (WPX) and Brunswick Corp (BC). Although we still believe that the stock of each of these companies is substantially undervalued in the marketplace, we also believe that they would decline in price in a recessionary environment. Indeed, most equities would decline in a recession, but these companies are particularly economically sensitive. Please note, although other companies in our portfolio are also economically sensitive, they have been kept for the time being as we gather more information that will further inform our assessment of the risk of a recession in 2020. If the leading indicators of growth were to improve, the remaining economically sensitive stocks in our portfolios should serve us well. Our high cash reserves would help to balance the risk if the leading indicators don't improve.

So, exactly what has caused us to temper our expectations? In a nut shell, inconsistent public policy has reached a tipping point. Two issues, in particular, seem to be vexing corporate executives and causing capital investment to slow, thus posing a drag on the economy. The more important of the two are the **trade negotiations** primarily with China but also, to a lesser extent, the potential for Trump to turn his trade ire towards the European Union (EU) later in 2019. The second issue is the drama and uncertainty surrounding **Brexit**. After ebbing and flowing throughout the year, in August the trade discussions with China seemed to have reached an impasse. Around the same time, Boris Johnson unseated Theresa May as Prime Minister of Great Britain and the fear of a so-called hard Brexit increased. The response was swiftly felt in the bond market when German government bond yields plummeted. The German economy is heavily exposed to both trade and manufacturing. It is, therefore, a good barometer of the sentiment regarding the trade war and Brexit. Earlier in the year, German sovereign debt (Bund) was trading with negative yields out to maturities of seven years. As the events noted above unfolded, negative interest rates on German debt blew-out to maturities of thirty years. From our perspective, negative interest rates on all outstanding German sovereign debt represents a warning signal that should not be ignored.

Investors have been living with negative yields on sovereign debt for several years. Negative yields on short-term debt are one thing, but negative yields on thirty-year debt is quite another. This event prompts us to stop and ponder the question: Why would an investor give the German government their money and expect to get back less than they loaned the government when their bonds mature in thirty years? This is a very complex question and we suspect the answer will be very clear years from now after many economists have earned their PhD with answers that may seem quite logical with hindsight. In the here and now, however, we should be concerned that investors in German sovereign debt apparently expect the future buying power of their diminished principal to be greater than today even though the nominal value of the investment may appear greater at present. This is the definition of deflation and is something to be feared by investors as the economic consequences of deflation can be devastating to economic prosperity. To be clear, we do not believe all investors who invest in bonds with negative interest rates expect to lose money on their investment. In fact, the most likely buyers of negative yielding debt, central banks and short-term traders, have very different expectations, indeed.

In many past commentaries, we have discussed quantitative easing (QE). It is a form of monetary policy that results in central banks expanding their balance sheets typically by buying long-term bonds. The Japanese Central Bank (JGB) has been easing monetary policy through QE for many years. In 2015, the European Central Bank (ECB) implemented its QE program to fend-off deflation. As the result of QE, about $15 trillion of Japanese and European debt is now trading with negative interest rates.

Although we have previously not been bothered by short-term debt trading at negative interest rates, when German rates suddenly went negative out to maturities of thirty years, something changed. As we live in a world of interconnected global financial markets, when German interest rates plummeted, U.S. rates followed. During the heightened trade woes in August, the rate on ten-year Treasury bonds declined from 2.07% to 1.46% as investors, such as European life insurance companies and pension funds that need to match long-term assets with long-term liabilities, scrambled to find sovereign debt with positive interest rates. This had the effect of inverting the U.S. yield curve (i.e., short-term interest rates are higher than long-term rates). Historically, this has been a reliable harbinger of a pending recession in economic activity within one to two years.

It is important to underscore that the time horizon of the inverted yield curve indicator is one to two years. As present, the U.S. economy is on solid ground. Moreover, we still believe it is reasonable to assume that in 2019 U.S. GDP growth will be on average greater than the rate of growth experienced since the end of the Great Recession. Although tariffs and Brexit anxiety have likely led to a reduction in corporate investment, U.S. consumers are in great shape. Unemployment is low, incomes are rising, and personal balance sheets are the strongest they have been in many years. In addition to a strong consumer sector, state and local government spending is also strong and likely to be additive to GDP growth for the foreseeable future. Together, consumer and local government spending should be enough to drive growth and offset the drag resulting from softening capital spending. Longer-term, if the yield curve were to remain inverted, banks would, ultimately, lose their appetite for lending as profit margins would diminish. If bank credit were to tighten materially, the U.S. would find itself in a recession.

All is not lost just yet, however. Although we began this note by saying that the probability of a recession in 2020 has increased, we still believe it is below 50% and a recession can be avoided. We reach this conclusion for two reasons: First, the Federal Open Market Committee (FOMC) has some ability to ease monetary policy and put a positive slope back in the yield curve. Second, the slowing growth outside of the United States that has caused the inverted yield curve is the result of man-made factors and could be easily reversed if cooler heads can prevail.

Normally, the yield curve inverts because the FOMC wants to cool the economy to contain inflation. They, therefore, force short-term rates above long-term rates and credit availability tightens. At present, however, the yield curve inversion seems to be the result of anxiety over uncertain public policy, which seems to have slowed growth in China. The German economy is heavily dependent on world trade. As the trade war slowed growth in China, the German economy also slowed. Brexit is also fueling anxiety in Europe, thus adding to the slowing of growth in Germany. Taken together, tariffs and Brexit have brought Germany to the brink of recession. The ECB has tried to combat the deflation that would likely ensue if Europe’s largest economy were to slip into recession by buying Bunds and other European debt (more QE), thus pushing interest rates further below zero and, indirectly, causing the U.S. yield curve to invert. Traders have capitalized on the ECBs endless appetite for European debt and bought Bunds themselves with an expectation of generating capital gains as the ECB shrinks the available supply. As previously noted, the sharp decline in German interest rates from the actions cited above set off a scramble for yield, which forced long-term interest rates lower in the U.S. and inverted the yield curve. Therein lies the origin of the much-feared recession indicator—the inverted yield curve.

Thankfully, the FOMC is on record saying that they intend to implement monetary policy in a manner that is supportive of continued economic expansion as inflation is presently below their 2% target rate. Consequently, the FOMC has eased monetary policy by reducing short-term rates in two quarter point increments. Moreover, they have more room to ease monetary policy if the yield curve does not take its normal positively sloped shape in due course. This should encourage banks to lend and keep the U.S. out of recession in 2020.

Furthermore, Trump holds the trump card. As we approach the election in November 2020, Trump's interest would be best served if the U.S. economy remains strong. If waning world growth were to pose too strong of a restraint on U.S. growth, Trump could reach some form of a trade agreement with China, thus easing the corporate anxiety that is presently impeding capital spending. The combination of the Fed's desire to keep the U.S. economy growing as well as Trump's ability to end the trade war with a single tweet represent a lot of fire power to fend-off a recession in 2020.

From a portfolio perspective, the economic issues discussed above present an interesting challenge as we now face the dreaded binary outcome: a visible future event will result in one outcome or another. If the trade war were to persist and easing monetary policy proves to be ineffective in stimulating the economy, the U.S. could be in recession by the second half of 2020. This would be bad for stocks well in advance of the actual recession as stock prices anticipate the future. Alternatively, Trump could serve his best interest and come to terms with China in a heartbeat. Global growth would likely accelerate, capital spending should increase and stock market investors may cheer. Hence, we have constructed the portfolio with a lot of cash to cushion the impact of a recession if one were to occur in 2020 and yet give us ample dry powder to buy stocks if prices were to fall in anticipation of a recession. At the same time, the remaining stocks in the portfolio have enough economic sensitivity to respond very favorably if the tweeter-in-chief ends the trade war to improve his chances of re-election. While we can't predict the future, we can certainly prepare for visible, likely scenarios.

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