SeaBridge
Investment Advisors, LLC

SeaBridge Core Strategy

Third Quarter 2020
Commentary

To every thing there is a season, and a time to every purpose under the heaven

Ecclesiastes 3:1, (KJV).

The instant recession induced by COVID-19 back in March prompted the Federal Reserve to flood the economy with more liquidity than they have ever provided in the past. The United States Congress similarly responded with uncharacteristic agility and provided an abundance of fiscal stimulus. As a result of the extraordinary actions by the Fed and Congress, the money supply is now growing at an unprecedented rate of about 24%! Nobel prize winning economist, Milton Friedman, once said that "inflation is everywhere and always a monetary phenomenon." If Friedman was even a little correct in his statement, perhaps the economy will finally be able to generate the inflation that the Fed has been dreaming about since the Great Recession.

The Fed conducts monetary policy within the context of dual Congressional mandates—price stability and maximum sustainable employment. Although one might reasonably conclude that price stability should be defined as prices neither rising nor declining, the Fed sees the definition a bit differently. If the Fed were to adopt a target rate of zero inflation, then it seems likely that, over the course of a full business cycle, prices could both rise at a rate above zero but also decline during the downcycle. Given the enormous debt burden in the modern economy, a period of declining prices could be extremely dangerous.

Assume, for example, a consumer or corporation borrowed money at an interest rate that assumed the loan would be repaid after a multi-year period of perhaps 2% inflation per annum. The interest rate paid by the borrower would be comprised of a portion designed to give the lender a return on their investment and a portion intended to compensate the lender for having the loan re-paid with inflated dollars. If, however, inflation were to decline by 2% per year rather than increasing as the borrower had assumed, the borrower would have to re-pay the loan with dollars that are more valuable than expected. The debt burden would, therefore, feel heavier than the borrower had expected. Moreover, in a deflationary environment, such as described above, consumers and businesses would assume that goods and services would cost less in the future and defer purchases. In such an environment, a heavily indebted economy could slip into a debt collapse, more commonly known as a depression.

To ensure that the U.S. economy would be able to avoid a depression and grow fast enough to allow the Fed to achieve its congressional directive of maximum sustainable employment, in 2012 the Fed adopted an official inflation target of 2%. Although 2% inflation certainly doesn't represent price stability, it should allow the economy to sustain a positive rate of inflation during the recession phase of a business cycle, thus reducing the likelihood of a deflationary mindset. Unfortunately, over the ten-year period since the Great Recession, inflation, as defined by the Fed's favored measure of inflation, the PCE (Personal Consumption Expenditures), has averaged just 1.5%, well short of the Fed's 2% target.

The Jackson Hole conclave of the world's central bankers and notable economists is an important annual event. Great minds gather in Jackson Hole, Wyoming, think great thoughts and deliver papers to their esteemed peers. Importantly, the U.S. Federal Reserve has, from time-to-time, used this forum to signal extremely important changes in monetary policy. This year, at the virtual conclave on August 27th, Chairman Powell used the occasion to formalize the notion of an average inflation rate target over time. This is a radical change from the Fed's 2% single point target. Essentially, the Fed is telling the markets that it is concerned that the economy has not been able to sustain a level of 2% inflation since the Great Recession. It further implies that our economy carries a lot of debt and without higher inflation, the debt burden could get too heavy to bear. Hence, the Fed now intends to foster a rate of inflation that goes above 2% and stays above 2% for a period of time that offsets the period during which inflation was below 2%. The Fed has not yet articulated a specific desired inflation on a per annum basis to recoup the inflation deficit, but we suspect something like 2.5% per year for 10 years would be tolerable for financial markets. If the economy were to run hotter than 2.5% inflation, perhaps markets would get spooked that inflation is out of control and the Fed would need to engineer a recession to cool things down a bit.

Right about now, you are likely thinking that this is all very interesting (or, boring), but what does it have to do with the outlook for stocks? More specifically, what does it have to do with the SeaBridge Core Global strategy? Over the years, we have gone to great pains to depict the Core Global strategy as one of extremely disciplined value investing. We have noted from time-to-time that many of the stocks that have led the market in recent years are those of high growth, high valuation companies. As a disciplined value strategy, high growth companies are usually outside of our valuation parameters, so we have lagged the broader market's returns. We have also represented that the most likely cause of high valuation equities besting more moderately priced equities is the result of absurdly low interest rates. Of course, with short-term rates near zero and the rate for Treasuries with a maturity of 10 years below 1%, cash flows expected many years into the future have a higher present value than if interest rates were higher. Hence, investors pay higher prices for growth stocks irrespective of valuation.

Subsequent to the Jackson Hole speech, Fed Chairman Powell implied that the Fed's new inflation target of 2% average inflation may necessitate keeping interest rates low for three years, and possibly longer. Painfully, we need to embrace the notion that low interest rates for at least three more years would likely continue to present a strong head wind for value investors such as myself. Therefore, after a lot of deliberation and consternation, I have decided to broaden the valuation parameters for the SeaBridge Core Global strategy. I also realize that I am a dyed-in-the wool value investor and that is not going to change. Therefore, I have asked my partners, Dave Descalzi and Adrian Morffi, to join the Core Global team to assist in this expansion of candidates for investment in the strategy. Both Dave and Adrian have broader valuation parameters in other strategies that they manage and, therefore, have experience in growth stock investing. If you have any questions or would like to discuss how this might impact your Core Global investment strategy portfolio, please contact Matt Falkowski (MFalkowski@SeaBridge.com) or me at JConti@SeaBridge.com.

We began this note with a quote from Ecclesiastes that serves as a tidy metaphor for investing over time. "To every thing there is a season, and a time to every purpose under the heaven." Of course, there have been seasons during which value investing produced the best results, as well as seasons in which investing in growth stocks prevailed. The enduring low interest rate environment in which we will likely exist as the Fed pursues its new inflation target seems likely to be a season that continues to favor growth-stock investors. This brings us to our closing quote, which is from a song called *The Gambler*, written by Don Schlitz and most famously performed by Kenny Rogers: "you've got to know when to hold `em, know when to fold `em." The wisdom in this quote is the virtue of keeping one's stake intact to play another day.

John Conti
10/2/20

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