SeaBridge Investment Advisors, LLC

SeaBridge Core Strategy

Fourth Quarter 2014

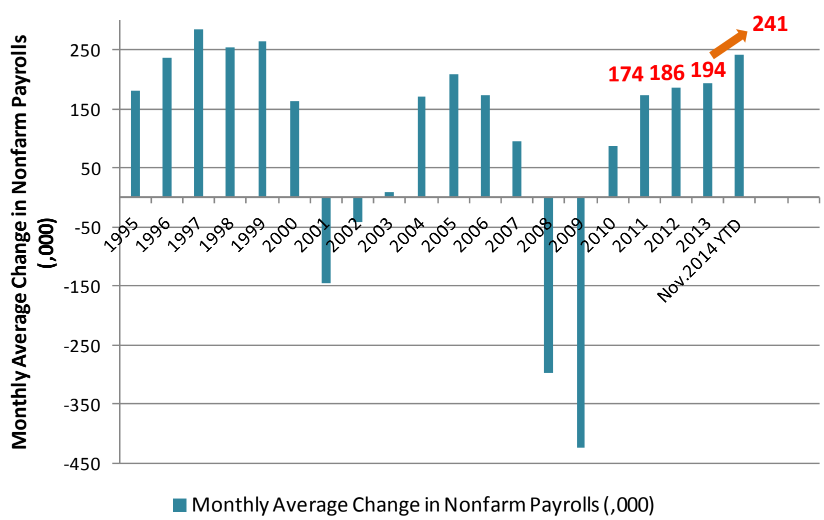
Commentary

"To a Mouse" is a Scots poem written by Robert Burns in 1785. Burns wrote the poem after disrupting the winter nest of a family of mice while ploughing a field. The poem is responsible for one of the more prophetic phrases in modern literature: "The best laid schemes o' mice an' men, Gang aft agley." In modern English, rather than old English and Scottish, we would say: "the best laid plans of mice and men often go awry." Indeed, 2014 was a year in which the plan for our portfolio, clearly, went awry!

Our investment approach begins with an assessment of risks and opportunities that we believe could occur within the context of our assessment of the current economic environment. Our macro economic outlook is not intended to serve as a forecast but, rather, as a framework from which we structure our portfolio. This approach has served us well over the long-term as it forces a discipline of making investment decisions based on data instead of emotion or current fashion. Unfortunately, in 2014 our data-based discipline worked against us by keeping us from investing in sectors/stocks that were charging ahead based on stock price momentum rather than value. A price momentum market is the bane of our existence. Although we had some investments that performed quite respectably in 2014, our portfolio as a whole languished.

As we see it, here's what happened in 2014. We began 2014 with a framework based on a persistently improving US economy. After a soft first quarter attributable to horrendous weather, the US economy, indeed, improved throughout the year. As expected, we believe the US economy is now growing broadly in line with its historical average rate of 3.4%. To be clear, the US economy is not growing exactly at a rate of 3.4% each quarter as that simply never happens. Instead, the economy appears to be growing quite comfortably at a rate that is consistent with its long-term potential as demonstrated over the period after WW II up to the Great Recession, during which GDP growth averaged 3.4% (1947 through 2007). We could offer many data series in support of our economic assessment, but we'll focus on just three for this commentary: the monthly net change in non-farm payroll, initial unemployment claims and the 6 month Index of Leading Economic Indicators.

<u>Chart 1:</u>

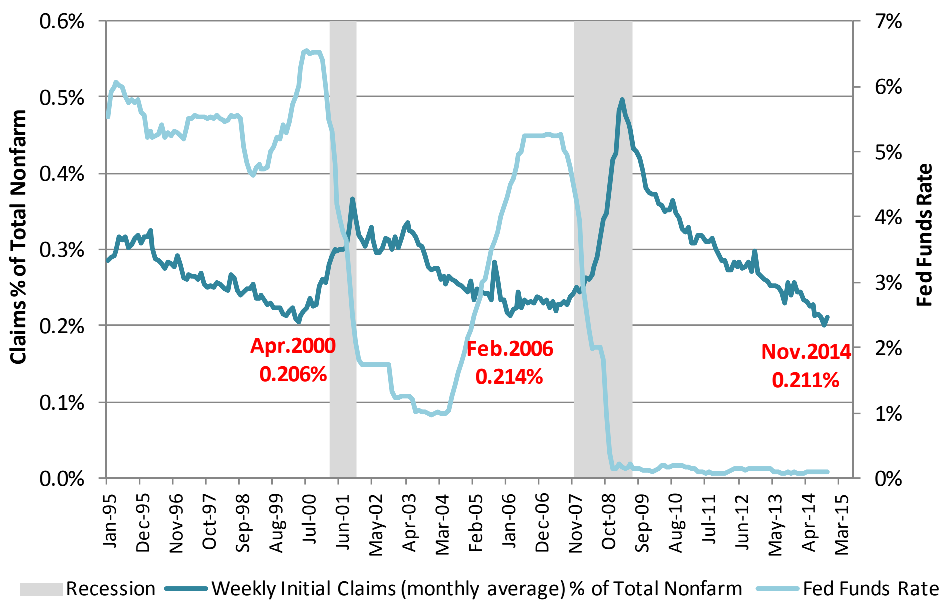


Source: St. Louis Federal Reserve

From our perspective, the labor market in the US is tightening rapidly and, possibly, approaching the point at which labor costs will become a concern for the Federal Open Market Committee (FOMC). Chart #1 displays the non-farm payroll series. As shown, the US economy created 174,000 net new jobs per month in 2011. The rate of job creation each year since then has slowly increased. In 2014, however, the monthly job creation rate made a step-function increase to 241,000 per month, thus supporting our assumption going into 2014 that the US economy was accelerating.

Chart 2 looks at the labor picture from another perspective and reaches the same conclusion. Here we display initial unemployment claims expressed as a percent of the total number of jobs. This is different from the data series released every Thursday, which just reveals the number of new unemployment claims. Our observation from this series is that the job market is getting much tighter than we believe is commonly perceived; initial unemployment claims as a percentage of total jobs are nearly as low as they have been in 20 years! As more people go back to work, wages should, at last, begin to rise; spending should increase; housing activity should improve; and a US economy that may already be growing in line with its historical average may be poised to accelerate to a level above trend.

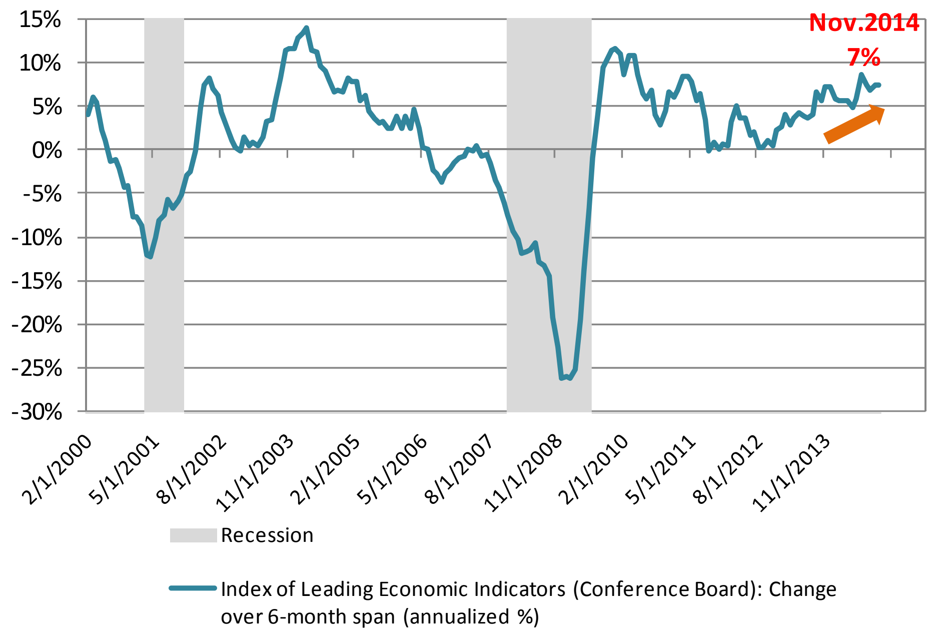
Chart 2:



Source: St. Louis Federal Reserve

The latter point is made more poignantly by looking at Chart #3, which shows the 6 month Index of Leading Economic Indicators expressed at an annual rate. The November figure shows a 7% rate of growth, which is very strong, indeed. Now, layer onto that rate of growth more workers, higher wages, and an enormous increase in disposable income resulting from the substantial decline in transportation and space heating fuel. From our perspective, the US economy was strong in 2014, and it is now poised to get very strong.

Chart 3:



Source: FactSet

So let's get back to what went wrong with our portfolio strategy in 2014. We structured the portfolio for an accelerating US economy with investments in five primary sectors: consumer discretionary, financial, real estate, industrial, and energy. The stock market, however, seemed to be responding to declining interest rates rather than strong economic activity that improved persistently throughout the year. Many of the sectors that drove equity returns in 2014 are defensive in nature, such as utilities, health care, and consumer non-durables. Technology and airlines also performed well. They are not defensive sectors, but they had price momentum, which was the common denominator of success in 2014. Investing in the "new high list" was a winning strategy. We simply don't do that as it is contrary to our value discipline.

As we hope to have demonstrated through the three charts presented above, the US economy is strong and getting stronger. Normally, an economic environment such as this would result in rising interest rates. In 2014, however, interest rates available in the US Treasury market declined. Despite the demonstrated strength in the US economy, most other economies around the world were either soft or softening. In particular, Europe, Japan, and China all seemed to have failed to do their part in sustaining global growth. Interest rates available to global investors were much lower outside the US than in the Treasury market. Consequently, US rates declined rather than rising as they should have given the strength of the US economy. In an environment in which the US economy is growing between 3% and 3.5%, and inflation is running in a range of between 1% and 1.5%, the yield on the 10 year Treasury bond should be between 4% and 5% based on historical relationships. Instead, the 10 year Treasury yield has been trading in a range of 2% to 2.25%, largely because the yield on 10 year German Bunds is around 0.6%. In a nut shell, this surprising interest rate environment caused the US stock market to favor both defensive sectors, and companies with very high revenue growth, many of which are speculative in nature and trade at risky valuations. Our portfolio favors companies that perform better in an environment based on economic growth rather than recessionary interest rates as we see in the market today.

In 1971, The Persuaders, a Rhythm and Blues group, had a big hit entitled "Thin line between love and hate." Similarly, in an investment context, there is a thin line between discipline and stubbornness. From our perspective, a disciplined investor is one who makes decisions based on a clinical evaluation of the data, whereas, a stubborn investor is one who succumbs to passion or other emotions and sticks with a losing hand in the absence of data to support the portfolio structure. As we enter 2015, there is an abundance of data to support the notion that the US economy is growing strongly. Moreover, the cost of gasoline has recently plunged by more than 30%, thus adding fuel to the economic fire. Let's also not forget that residential housing starts are still running at a level barely above 1 million units per year despite the clear demographic demand for at least 1.5 million units. We expect the recent decline in interest rates and improving employment picture to expedite housing activity in the intermediate-term. Furthermore, the non-residential construction sector is showing signs of acceleration as depicted in our November commentary. Accordingly, the US economic environment is one of visible growth, low inflation and low interest rates. This is likely a good backdrop for economically sensitive equities, such as financials, real estate, consumer discretionary, industrials, and energy. (Although, the energy investments may languish until after Saudi Arabia decides to stop cutting off its proverbial nose to spite its face, or when demand picks-up enough to sop-up the 1.5% excess supply present in today's oil market).

Let's not forget the risks, however, because they are substantial at present. The deflationary waft evidenced in global interest rates is ominous. It may very well be a harbinger of a painful world economic environment that potentially lies ahead. On the other hand, the accelerating US economy and recent global stimulus in the form of a massive cut in the price of oil may conspire to create a force great enough to lift economies outside of the US.

Another risk is that the world's growth engine, the US economy, may be getting close to overheating. We know the FOMC has its eyes focused squarely on the improving employment picture in the US, and is itching to allow monetary policy to return to normal from its exceptionally easy stance at present. At this point we refer readers back to chart #2. Although initial unemployment claims as a percentage of total jobs are at a level that is approaching a pre-recessionary condition, the Fed Funds rate is not flashing the same signal. Based on the current Fed Funds rate, and the FOMCs recent commitment to refrain from increasing short-term rates at the next several FOMC meetings, we believe the stock market bull has more room to run. Nonetheless, at some point, likely in 2015, the FOMC is going to find an opportunity to begin the process of normalizing monetary policy, which could incite extraordinary volatility. As the year progresses, we'll keep a sharp eye on the data, and make portfolio adjustments accordingly.

12/22/14
John Conti
Angell Xia
Adrian Morffi

See general disclosures at the end of the document.

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General Disclosures: