SEABRIDGE
INVESTMENT ADVISORS, LLC

# SeaBridge Core Strategy

Fourth Quarter 2015
Commentary

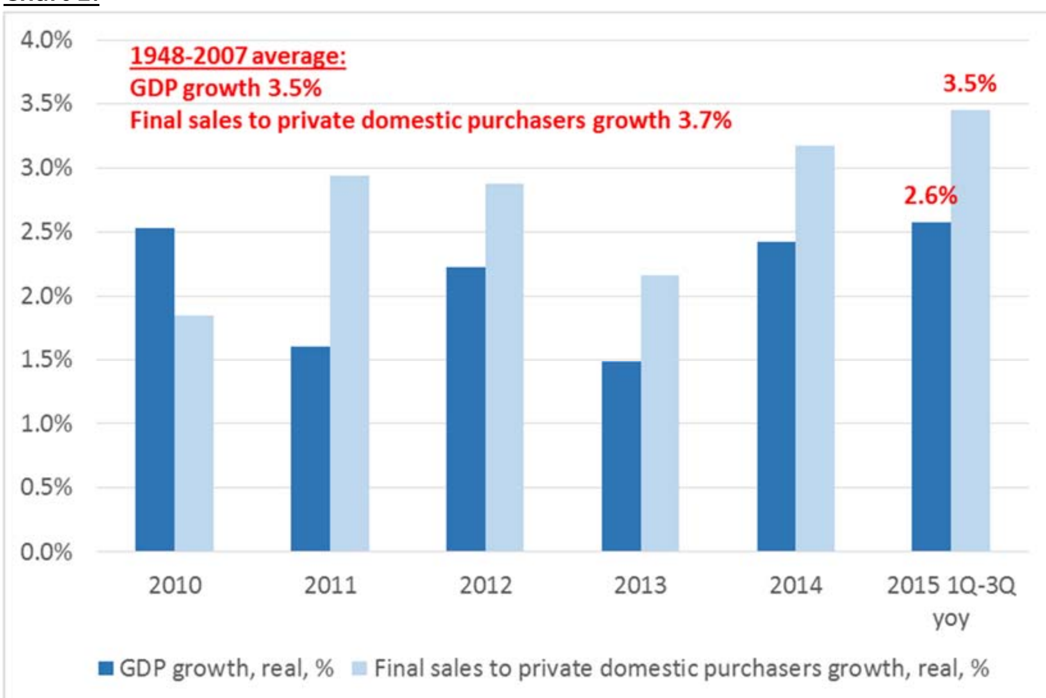
As we have noted in several of our previous commentaries (which are available on our website www.seabridge.com) , the extended period of extremely low interest rates caused by extraordinarily easy monetary policy has narrowed stock market appreciation to a handful of companies that are generating high revenue growth. Valuations for high growth equities have been and continue to be well beyond our investment parameters. At the same time, cheap stocks have become cheaper. Essentially, our value style of investing is out-of-favor. We pride ourselves in our disciplined approach to investing. Drifting from one's core competency as an investor is an extremely dangerous practice, so we stay the course.

While our disciplined approach has been painful for our clients in 2014 and 2015, there are recent signs that the stock market may be rotating back towards value. With the FOMC finally beginning the process of regressing towards a monetary policy more appropriate for the current economic environment rather than one of financial crisis, investors may be forced to sharpen the pencil in determining what to pay for equities. In the final analysis, we believe the companies in our portfolios are worth more than they are currently valued by the stock market, while many of the stocks that have been pacing the market in recent years are worth considerably less. In our investment selection process, we place a great deal of emphasis on companies with management teams that take actions to realize value for shareholders. Two recent examples of our value discipline rewarding our patience are AirGas (ARG) and Plum Creek Timber (PCL). During the last few months of 2015, both companies agreed to be acquired (by Air Liquide and Weyerhaeuser, respectively) at substantial premiums to the prices at which they were trading in the stock market. Value investing may fall out of favor for an extended period of time, but sooner or later rationality prevails and business value surfaces either through the actions of competitors, shareholder oriented management teams, or at the instigation of activist investors. In any case, the intrinsic value of a business enterprise should prevail over time. Our strategy is to wait patiently and avoid being seduced by fads wafting through the market at any given point in time.

As we reflect back on 2015, we can't help but notice that the theme of our commentaries published throughout the year was very similar to the sentiments expressed in the notes we published in 2014. The main message that we've articulated is one of a U.S. economy that powers forward at a slowly accelerating rate despite numerous obstacles that included: extraordinarily erratic weather, a port strike on the West Coast, the federal budget sequester, potential Greek default, currency volatility, anxiety over the viability of the Euro, and global economic instability. In addition, the economy has found a way to grow despite a particularly challenging and distracting domestic political environment that has produced many tax policies that are hostile to business interests. Through the sundry obstacles that have impeded economic progress in recent years the U.S economy appears to be on solid ground six years into the recovery from the Great Recession. Nonetheless, several economic questions have developed in recent months and they have not gone unnoticed by the stock market, which has experienced extreme volatility since August.

In the notes that we published early in 2015, we expressed our expectation that the U.S. economy would rebound from a severely weather-affected first quarter to reach its 3.4% historical average rate of growth by the end of the year. In fact, while the fourth quarter has yet to be reported, the average rate of growth in the second and third quarters was nearly 3%. Although GDP growth fell a bit short of the target on an "as reported" basis, as noted in our November commentary, the year over year rate of growth in final sales to private, domestic purchasers (i.e., private sector final demand) was 3.5% in the first three quarters of 2015, which is very close to the post war average of 3.7% (chart 1). Moreover, the three incremental drivers of growth that we have highlighted in the past, residential construction, non-residential construction, and state and local spending, still seem to have the potential to continue to drive incremental growth. In addition, the substantial spending bill recently passed by Congress will likely add the federal government to the list of incremental economic drivers for the next few years after materially impeding GDP growth from 2011 through 2014, and adding very little thus far in 2015 (table 1).

**Chart 1:**




*Source: Bureau of Economic Analysis*

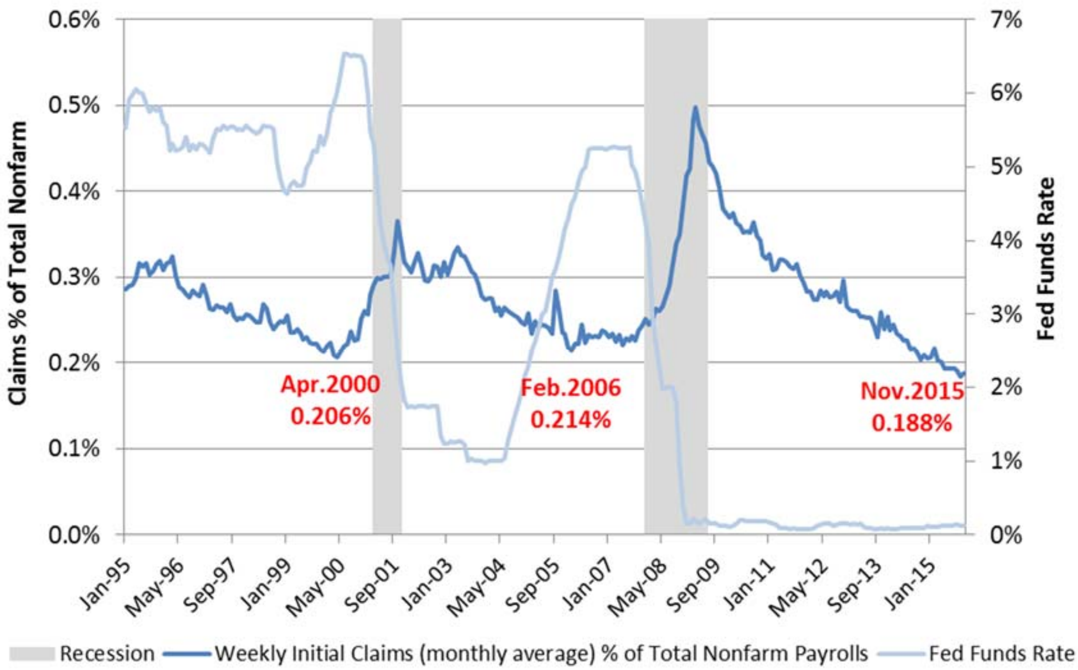
**Table 1**

| % Contribution to GDP | 2011 | 2012 | 2013 | 2014 | 1Q2015 | 2Q2015 | 3Q2015 |
|---|---|---|---|---|---|---|---|
| Federal Government | -0.24 | -0.15 | -0.46 | -0.18 | 0.08 | 0.00 | 0.02 |

*Source: Bureau of Economic Analysis*

With demand running near its historical average and productivity running low by historical standards, the job market has been very strong. As we noted several times throughout 2015, initial unemployment claims as a percentage of the total jobs in the economy remain very low (chart 2). Based on this measure, in past cycles the Federal Open Market Committee (FOMC) would already have been well into the process of raising interest rates to pre-empt inflation. In this cycle, however, the FOMC has been slow to allow interest rates to seek a normal level given current economic conditions for fear of sending shock waves through a fragile world economy. Indeed, the European Central Bank (ECB) is still trying to stimulate the European economy through incremental quantitative easing (QE). Nonetheless, in December, the FOMC took its first step on the path towards normal monetary policy by raising the target Fed Funds rate by ¼ of 1%. The FOMC also implied that they intend to raise the target rate by an incremental ¼ of 1% each quarter throughout the coming year. Although the increase in rates was widely anticipated, the FOMCs announcement incited extra volatility in the stock market because many market observers were hoping for an indication from the FOMC that the future path of interest rates would have a lower slope.

**Chart 2:**

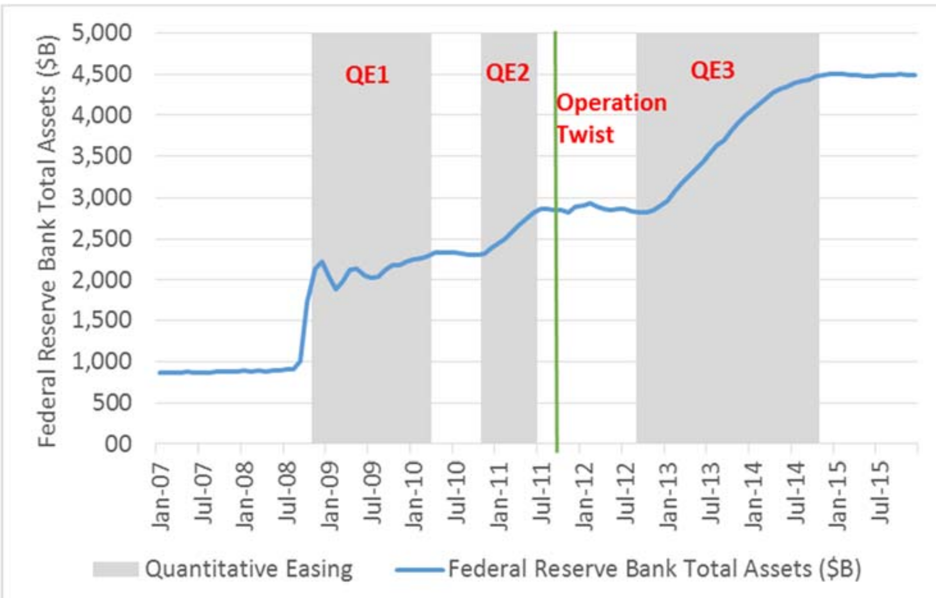



*Source: Bureau of Labor Statistics*

Despite the stock market's recently exhibited angst, we are encouraged by the monetary policy direction implied by the FOMC. Chart 3 depicts the Fed's balance sheet since 2007. Normally, the Fed maintains a balance sheet just under $1 trillion. After three rounds of quantitative easing, the Fed's balance sheet is currently $4.5 trillion. From our perspective, QE1 was necessary because the banking system was severely impaired in the wake of the 2008 credit crunch and ensuing recession. QE1 was intended to bypass the banking system and provide liquidity directly to the asset backed security market. That worked well and the economy began to recover shortly after the program went into effect. By the time the FOMC began to implement QE2 in November 2010, the U.S. economy had just printed two quarters that averaged 3.3%  GDP growth. Nonetheless, the FOMC was concerned that the recovery was fragile and decided to add incremental monetary stimulus. We don't believe QE2 was necessary, but it likely served as a palliative for corporate decision-makers and stock market investors. In September 2011 the FOMC again attempted to stimulate the economy through operation twist, which increased the duration of the Treasury securities they were buying and was intended to reduce longer-term interest rates. QE3 began in September 2012. This program ballooned the Fed's balance sheet from $3 trillion to $4.5

trillion. From our perspective, both the twist and QE3 were not only unnecessary, but they may have actually impeded the economy. By reducing long-term interest rates, the FOMC also reduced the profit margin on bank loans. In addition, the witch-hunt political environment that followed the Great Recession resulted in the promulgation of new, onerous banking regulations and substantially increased bank capital requirements. The combination of reduced lending margins and higher capital requirements likely resulted in lower loan growth than we may have experienced if the FOMC and the sundry regulators had not tried to micro manage the banking system.

**Chart 3:**



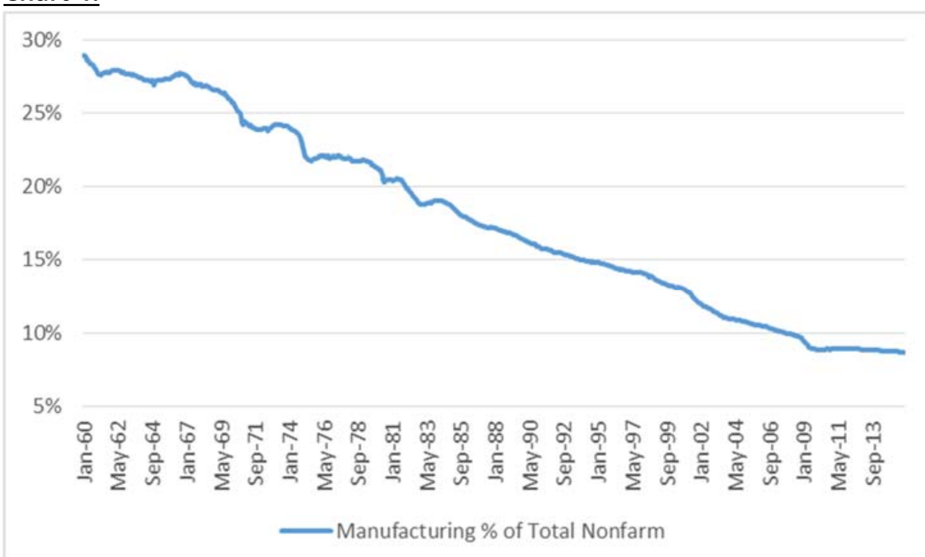

*Source: St. Louis Federal Reserve*

We mentioned at the beginning of this note that, despite the generally strong economic environment in the U.S., several concerns have developed that cloud the outlook. We'll address three of those issues: the change in monetary policy, the weakness apparent in the manufacturing sector, and illiquidity in the high-yield bond market.

If we're correct in our previously stated assertion that the FOMC over-played its hand by implementing extraordinary monetary measures too long into the economic recovery, then perhaps a normalization of monetary policy may actually stimulate the economy rather than inhibit growth. If interest rates rise at a gradual rate as the FOMC has suggested, then bank lending margins should improve as loan pricing rises. U.S. banks are extremely well capitalized at present and have ample capacity to increase lending activity as margins improve. If the job market continues to improve, consumers should become more confident in their fiscal circumstances and, therefore, may increase spending rather than savings as they have done thus far in the economic recovery. As demand for goods and services increases from more confident consumers armed with increasing borrowing capacity, businesses should have increased comfort in making capital investment decisions that, heretofore, have also been slow to rebound in the wake of the 2008/09 recession. This potentially emerging virtuous cycle and the resulting implications for productivity are described in greater detail in our November 2015 note.

Despite the generally favorable economic environment in the U.S., in November, the ISM Manufacturing Index dipped below 50, suggesting a contraction in the manufacturing sector. We believe this is a case of the statistics catching up with reality. As we have heard from many of our industrial portfolio companies, the manufacturing sector has been deteriorating throughout 2015. A major driver of the industrial softness is a dramatic reduction in capital spending for equipment related to oil & gas exploration. In addition, U.S. industrial companies are adjusting their spending levels to offset profitability deterioration related to the strength of the dollar. Importantly, we do not view the dip in the ISM Manufacturing index as a harbinger of an impending economic recession. As can be seen in chart 4, the percentage of jobs related to manufacturing in the U.S. has declined to merely 9% of the total jobs in the economy. This stands in sharp contrast to the 1960s when manufacturing jobs accounted for nearly 30% of the total. Once the service sector gets a head of steam as it has at present, it is unlikely that the manufacturing sector alone can precipitate a general recession, in our opinion. If we're correct about bank lending increasing into a modestly rising interest rate environment as noted above, and the service sector job market continues to strengthen, then we'll assume that the softness observed in the manufacturing sector is manageable and represents a source of future growth when the value of the dollar and the price of oil and natural gas stabilize.

**<u>Chart 4:</u>**




*Source: Bureau of Labor Statistics*

Another caution sign that appeared late in 2015 came from the high-yield (junk) bond market. In the first half of December, the high-yield bond market became illiquid. By illiquid we mean to say that bids simply disappeared. This condition was, apparently, caused by redemption requests from mutual funds that invest in the highest risk segment of the high-yield bond market. The redemptions were likely caused by investors looking to harvest tax losses in bonds that substantially declined in value during the tax year. The loss of value was mostly attributable to the sharp decline in the price of oil in recent months. After a short period of illiquidity, the high-yield bond market seemed to find vulture buyers as prices adjusted sharply lower. The acute phase of the high-yield bond problem may be behind us as we enter 2016, but **if the high-yield bond market were to continue to deteriorate, we would likely make some meaningful changes to our equity strategy**. At a minimum, we would re-evaluate our investment in U.S. banks, which currently include Citigroup (C), Bank of America (BAC) and Regions Financial (RF).

In summary, private sector final demand is strong and at a level that is very near its historical average. Both residential construction and non-residential construction are still below normal and are likely to continue to bolster economic activity. State and local spending is also gaining strength, and the federal government is, at long last, poised to contribute to economic growth. From a stock market perspective, offsetting this favorable backdrop are rising interest rates, recession-like conditions in the manufacturing sector, and illiquidity in the high-yield bond market, which is an ominous caution flag.

What does all of this mean for equities in 2016? Hopefully, the combination of continued economic growth and rising interest rates will cause a rotation back to the more value-oriented stocks in our portfolios. Value investing has been out of favor periodically in the past, but if history serves as a guide, sooner or later rational equity valuation prevails.

John Conti
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1/4/2016

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