SeaBridge
Investment Advisors, LLC

SeaBridge Core Strategy

Fourth Quarter 2018
Commentary

To prove that Wall Street is an early omen of movements still to come in GNP, commentators quote economic studies alleging that market downturns predicted four out of the last five recessions. That is an understatement. Wall Street indexes predicted nine out of the last five recessions! And its mistakes were beauties.

Paul Samuelson, PhD
(September 19, 1966), "Science and Stocks", Newsweek, p. 92

In the middle of October, we distributed a note that attributed the increasing volatility in the stock market to rising interest rates. Subsequently, stock market volatility increased substantially and prices are now painfully lower. The second leg down in the current stock market correction appears to have been caused by prolonged trade negotiations; Trump's mounting legal woes; a messy separation between the UK and the EU; Italy's budget being rejected by the EU; and, France's economic reform agenda being rejected by "yellow vest" protesters. Declining equity prices caused by the aforementioned factors were compounded by unrelenting tax-loss selling in December. Indeed, individual investors withdrew capital from mutual funds and index funds at a record rate. Taken together, these factors created a market that went straight down in the fourth quarter of 2018. The stock market is interpreting all news as bad news and seems to be implying that the U.S. economy is headed into an imminent recession. We see the U.S. economic environment a bit differently.

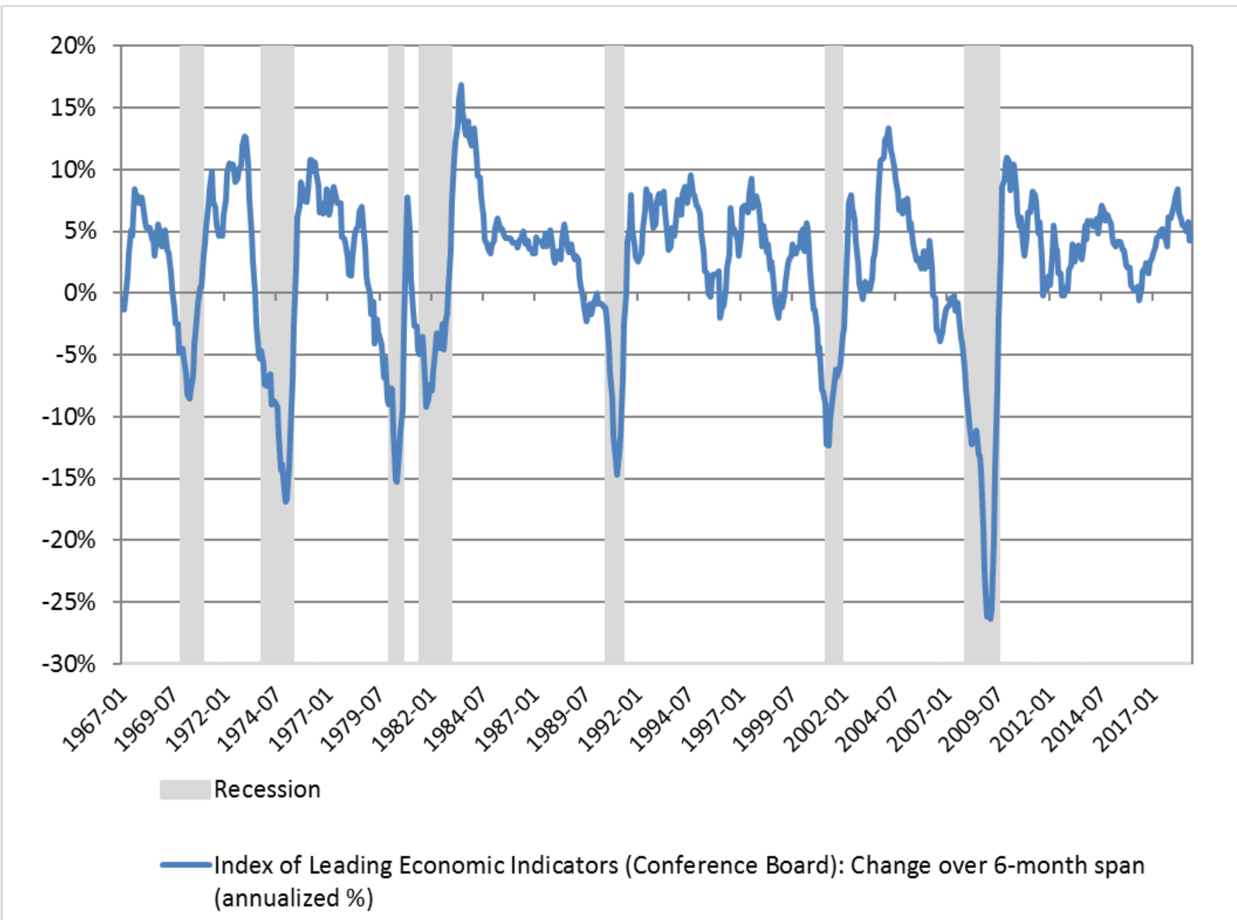
To be clear, no one has an ability to forecast the economy accurately. The path that the U.S. economy will take over the coming year is the sum total of the individual daily decisions of the 330 million people within our borders and 7 billion people outside of our borders. Moreover, the stock market is not the harbinger of future events that it pretends to be. In fact, the market is no more than a nervous Nellie that is wrong nearly as often as it is right. Based on the math in Samuelson's quote above, the stock market is barely better at predicting the future than tossing a coin. In fact, subsequent to 1966 when Professor Samuelson popularized the notion above, CNBC researchers updated his observation that the market predicted 9 out of the last five recessions. According to their research, "There have been 13 bear markets in the postwar era. These 13 bear markets have led to recessions seven times within about 12 months. So instead of Samuelson's 9 of 5 (think about like shooting 55%), it's really 13 of 7 (53%)."

Although a 53% predictive power is barely above the 50% accuracy one would expect from tossing a coin, in the world of investments, a 3% advantage is helpful but far from conclusive. Our economic analysis incorporates many variables that we have found useful in gauging the economy in the past. Some of these variables are economic data provided by the Bureau of Economic Analysis, the Bureau of Labor Statistics and the Federal Reserve, as well as other governmental agencies and trade associations.

We then cross check the hard data provided by our primary resources with data and anecdotes about current and expected business conditions from companies in our portfolio.

One of our core economic measures is the Conference Board's Index of Leading Economic Indicators (LEI). The index is comprised of 10 data series that have a reasonable predictive power when evaluated together. In fact, the stock market, with its possibly 3% predictive power, is one of the Leading Indicators. Although the stock market is currently screaming recession, when aggregated with the other 9 indicators, the LEI points towards continued economic growth. The LEI is published in the form of a monthly index and a six-month index. The monthly data series is a bit twitchy so we prefer the six-month series, which is represented in Chart 1 below.

Chart 1



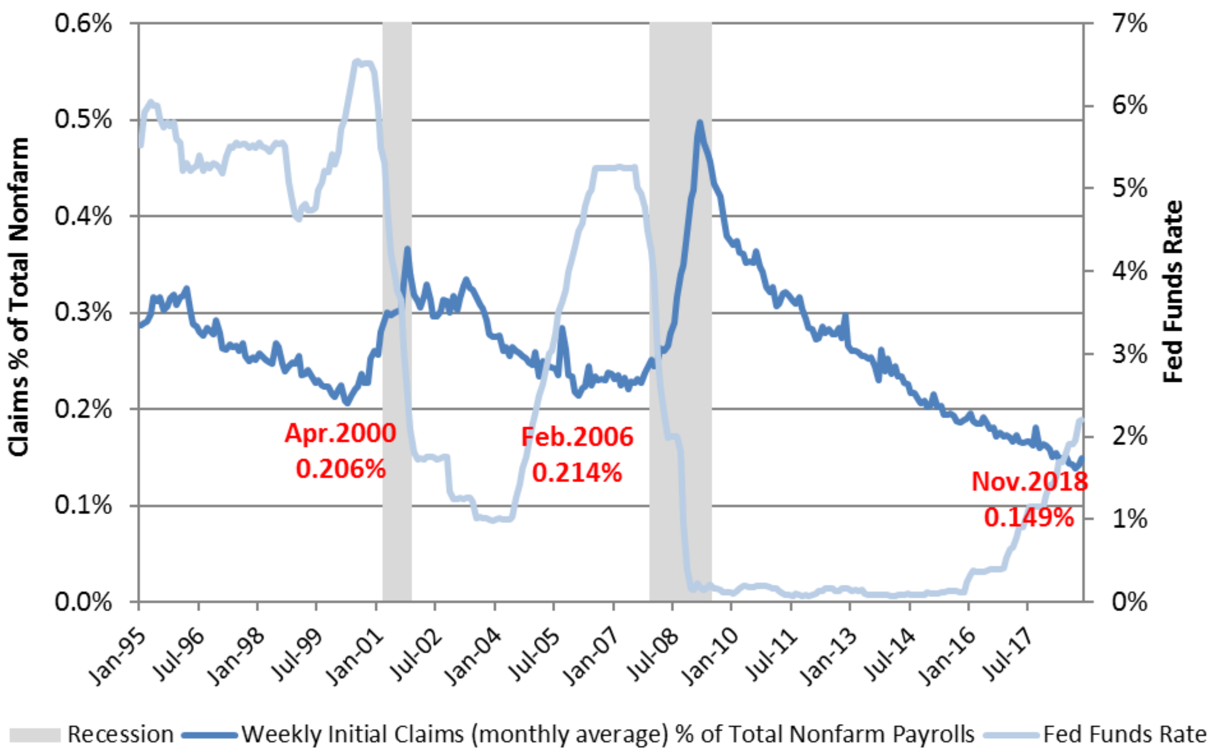
Source: Bloomberg and St. Louis Federal Reserve

As can be observed from the chart above, the 6-month LEI strongly suggests that the U.S. economy is likely to continue to grow in the near future. With seven full business cycles depicted in one chart, the graph appears a bit compressed. When expanded to reveal one business cycle at a time it becomes clear that the 6-month LEI generally gives fair warning of looming recessions.

Also suggestive of continuing growth are the two bell-weather indices from the Institute of Supply Management (ISM). Both the ISM Manufacturing Index and the ISM Non-Manufacturing Index are at very high levels. In fact, in early December both measures increased on a month over month basis despite the hysteria in the stock market that began in October. With these two indices generating readings at or near 60, both should be expected to decline when next reported in January as readings near 60 are unsustainably high. Readings above 50 support continued economic expansion.

The final of our four primary economic measures is the report of Initial Unemployment Claims, which is produced by the Department of Labor. In Chart 2, we present initial unemployment claims as a percentage of total jobs in the economy. This measure is currently producing the lowest readings on record, which strongly suggests that employers are loathe to discharge employees.

Chart 2



Source: St. Louis Federal Reserve

In addition to the quantitative data noted above as well as other economic series, we cross-check our observations in the real world through anecdotes from business executives of companies in our portfolios as well as companies that we monitor closely. As luck would have it, earnings reports for companies that have calendar quarter reporting periods gave us a clear look at economic conditions at the end of October, which was a full month after the stock market rout began. Although business conditions vary based on industry and issues specific to each company, we're comfortable generalizing the commentary from September quarter reports as follows:

- Business activity in the U.S. remains strong, although not as strong as earlier in 2018
- Price increases implemented to offset raw material cost increases and tariffs seem to be sticking
- Transportation and labor costs are still increasing, but other input costs are moderating, which could support margin expansion
- In the U.S., housing activity has softened, but seems to be stable
- Business conditions outside of the U.S. have softened considerably more than in the U.S. In particular, Europe, China and Korea have slowed a bit, and Japan is flirting with a recession. Overall, global growth has slowed, but the world economies as a whole are still growing at a solid rate

More recently than the companies that reported September quarter results, two of our portfolio companies, NCI Building Systems (NCS) and Steelcase (SCS), reported earnings for the quarter ending in October and November, respectively. Steelcase reported earnings above expectations and had very encouraging comments about their current order book. On the conference call following the Company's earnings report in late December, Steelcase CEO, James Keane, noted that Steelcase "grew orders by 10% in Q3 which is supporting our 9% to 12% organic revenue growth estimate for the fourth quarter." Keane went on to say "Orders remained strong in the first two weeks of Q4 and we expect December shipments to be the highest we've seen in many years." Commenting on the economic environment, Keane noted that "Despite the obvious stock market volatility, we see a supportive economic environment in the U.S. CEO confidence has taken a hit because of trade concerns, but it's still very strong versus historical benchmarks."

In contrast to the strong economic environment observed by Steelcase, which is the world's leading maker of office furniture, NCI Building Systems, which manufactures building materials for both commercial and residential construction, noted "slowing market trends." On their earnings conference call the same day as Steelcase's call, CEO Don Riley, noted that he has "moderated our projection" for 2019. Notwithstanding his attenuation of expectations for the coming year, Riley still believes revenue growth will be in the low to mid-single digits.

We find these comments by SCS and NCS to be supportive of what we are hearing from other company executives and what we observe in the economic data. The U.S. economy appears to be on solid ground, but there has been a noticeable slowing of activity in construction-related industries. Interestingly, throughout 2018, the U.S. economy has been growing at a rate averaging above 3%, which is above the norm for the current economic recovery, despite the drag from housing. In fact, 2018 is the only year in the 61 years since WW II in which the overall economy grew at a rate above 3% with housing actually detracting from the increase in the rate of growth over the previous year. This phenomenon is indicative of a very vibrant U.S. economy that can grow without any contribution from one of the sectors that has traditionally driven growth.

We view the pause in housing activity as a positive in that it has contributed to the case for the Federal Reserve to moderate its trajectory of interest rate increases. Following the meeting of the Fed's Federal Open Market Committee (FOMC) on December 19th, Chairman Powell indicated that the FOMC was contemplating only two more ¼ point increases in 2019 vs. three previously. Moreover, Powell indicated that the FOMC is now "data dependent" and could further moderate its interest rate outlook if the economy were to slow or if events outside of the U.S. were to cloud the domestic growth outlook. We can't emphasize enough that it is extremely unusual for the FOMC to acknowledge outside factors in its monetary policy alchemy. Of course, the FOMC always considers factors outside of our borders, but they seldom directly relate them to U.S. monetary policy. Given the ongoing trade dispute with the European Union (EU) and China, the possibility of a messy exit by Great Britain from the EU, and the general slowing of growth around the globe, it is conceivable that the FOMC has already reached the end of its program of allowing short-term interest rates to find their natural level after 10 years of abnormally easy monetary policy.

If the FOMC is close to the end of the current interest rate cycle, then equity valuations could be poised to rise after a very punishing three-month period at the end of 2018, which was likely driven by the fear that the U.S. economy was headed into recession. Moreover, if housing activity were to reaccelerate, as we believe is likely, earnings growth for many stocks in our portfolio could end-up higher than levels that appear priced into stocks at present. In late December, SeaBridge distributed an economic presentation to clients through an e-mail. That presentation is also available on our web site (http://seabridge.com/media/Outlook_Dec_2018.pdf). Without reproducing all of those slides in this note, we will summarize the housing related slides:

- The echo-boom generation represents the peak of the population curve and they are currently moving into their prime house-buying years in large numbers (page 6 of the presentation)
- Houses are very affordable on average in the U.S. In fact, the most recent reading of the Housing Affordability Index is 147. This means that a family with the median household income has 47% more income than needed to buy a median priced home with a 20% down payment and a conventional 30-year mortgage (page 7)
- House price appreciation since the recovery began in 2010 has been in line with disposable income growth (page 9)
- Housing transaction activity will likely not be robust because inventory remains very low (page 10)
- Despite low inventory, demand is well underpinned by demographics, employment, household balance sheets, and wage growth (pages 6, 3, 4, 5 and 14)

Over the years, we have mentioned the discipline that we apply to the management of our Core Global portfolios. In the past two years, as the stock market got carried away and assigned excessive valuations to some companies, we watched from the sidelines and muddled through with what we believed to be more reasonably priced stocks in our portfolios. Of course, from a financial perspective, this means that our performance was below the market for longer than we would like to admit. Now that turbulence has developed in the world economy and interest rates search for their natural level, the over-valued, momentum driven stocks that powered the market in recent years have begun to descend to earth and brought the whole market down with them. This provoked a feeling among investors that a recession was imminent and funds rotated from momentum stocks to defensive stocks. We don't hold defensive stocks in great quantity as we generally view them as too expensive (think utilities). Cyclical stocks received an extra measure of punishment in the recent market rout because investors feared a recession that we believe won't occur until 2020 at the earliest, and more likely sometime beyond. The resulting calamity was exacerbated by vicious tax-motivated selling in December.

So where does that leave us? As we enter the new year, tax selling will surely abate. If we are correct in our assessment of the strength of the U.S. economy, investors should soon begin the process of reassessing the valuation of equities given the prospect of continued growth, rather than recession. In early February, corporate earnings reporting season will begin. We expect those reports to support our view that the U.S. economy is on solid ground. We also believe there is a strong possibility that earnings reports may be revised above expectations based on very aggressive share repurchase activity in recent weeks, as well as the likelihood that price increases have been realized while input costs have stabilized. We believe the stock market rotation that we have anticipated may now be underway and that old-fashioned stock-picking based on demonstrated value will again prevail as it has after all periods of market lunacy. Accordingly, we have been investing cash reserves into the market carnage. While investing our cash reserves into market distress as we have done in recent weeks can be harrowing, we believe the key to producing superior investment returns is to implement a portfolio strategy with unemotional discipline. Valuation discipline is the hallmark of the SeaBridge Core Global strategy. This means that we buy when we think stocks are cheap as they are now, and watch with patience as we have done for the last few years when stocks were not cheap.

We conclude with a word about tax-loss harvesting for our taxable portfolios. Earlier in 2018, we realized a sizeable amount of gains as stocks in our portfolios approached or eclipsed our price targets. Later in the year, we began booking losses on some stocks to offset the gains. In some cases, we were able to book losses and subsequently re-establish investments in the same companies. When December arrived, the market went straight down like an anchor in the ocean and we were hard pressed to book losses on some of the stocks we had earmarked for further tax-loss harvesting. While we are happy to match gains with losses where practicable, we are not of a mind to book losses at any price just to get the tax liability down to zero. In some situations, the trading value of stocks that were earmarked for tax-loss harvesting were so depressed that we actually increased our position in the stock as others sought to book losses into a highly illiquid market.

We look forward to greener pastures ahead and wish you well in the New Year!

John Conti
Angell Xia
12/22/18

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