SeaBridge Core Strategy

Fourth Quarter 2019
Commentary

During the 4th quarter of 2019, the stock market stretched to a new all-time high based on the assumption that the U.S. will experience a Goldilocks economy in 2020. Below the surface, however, a Witch's Brew may be in the making. Since we don't have a crystal ball, the best we can do is to structure the Core Global portfolios based on the decision-rules that define our value-based strategy; rules that have been developed over the course of 36 years and have witnessed virtually every market environment imaginable. As the result of our experience and an assessment of stock valuations within the context of the current economic environment, we are waving the yellow flag of caution for the first time since the summer of 2008.

Goldilocks and the Three Bears is, of course, a folk tale that morphed into a fairy tale. The antagonist of the tale, a young girl named Goldilocks, enters the home of three bears and samples their porridge. You'll remember that one bowl of porridge was too hot, the second bowl was too cold, but the third was just right. The metaphor for the economy is very neat and tidy. It has, therefore, become cliché in the world of investing. If the economy is too hot, then inflation will rise thus causing the Federal Reserve to raise interest rates for the purpose of cooling the economy. Along with taking the economy off the boil, higher interest rates also reduce stock valuations. If the economy is too cold, then earnings growth will be too slow or, worse, negative. This is also not a great economic backdrop for stocks. The best scenario for stocks is an economy that is just right; an economy that grows enough to produce earnings growth and low inflation. This begs the question: What sort of economy are we experiencing at the moment?

In the second half of 2019, the Federal Open Market Committee (FOMC) of the Federal Reserve eased monetary policy substantially by inducing three ¼ point reductions in short-term interest rates. This act alone is enough to stoke the economic fire and spark a strong stock market rally. Adding fuel to the fire, in recent months many of the bricks in the proverbial wall of worry were removed. Brexit seems to be moving along at long last. The USMCA trade pact is in the final stages of being enacted, the trade war between China and the U.S. may have achieved a détente, and the extreme left wing of the Democratic Party has lost some steam. All the above propelled the stock market to an all-time high on the assumption that Goldilocks had entered the cabin.

So, what's a Witch's Brew and why are we concerned?

Shortly before the FOMC began lowering interest rates in July, money supply (M2) growth accelerated. Easy Monetary Policy further stimulated growth and propelled the rate of growth in M2 to 7.5%. Although the growth in the supply of money has moderated a bit in recent weeks, M2 is still growing at more than 7%, which is nearly twice the rate of growth in nominal GDP (i.e. real growth + inflation). Chart #1 below depicts the rate of growth in the supply of money throughout the current business cycle. One can easily observe that the acceleration in the rate of money growth in the second half of 2019 is second only to the early years of the ten-year period of growth that has, thus far, followed the Great Recession. The explosion in money growth following a recession the likes of 2008/09 can be easily absorbed by an economy that has slack capacity in both labor (see chart #2) and capacity utilization (chart #3). At present, however, the U.S. economy has neither. The unemployment rate is 3.5%, which is an all-time low for the modern economy (post WWII). Capacity utilization is at 77%, which is a touch lower than the recent peak of 80% that we experienced in 2018. This leaves a little room for growth, but if real growth is going to accelerate, then capital spending will also need to accelerate as there are only two drivers of economic activity, labor and the tools used by labor to produce output.

Chart #1

Chart #2

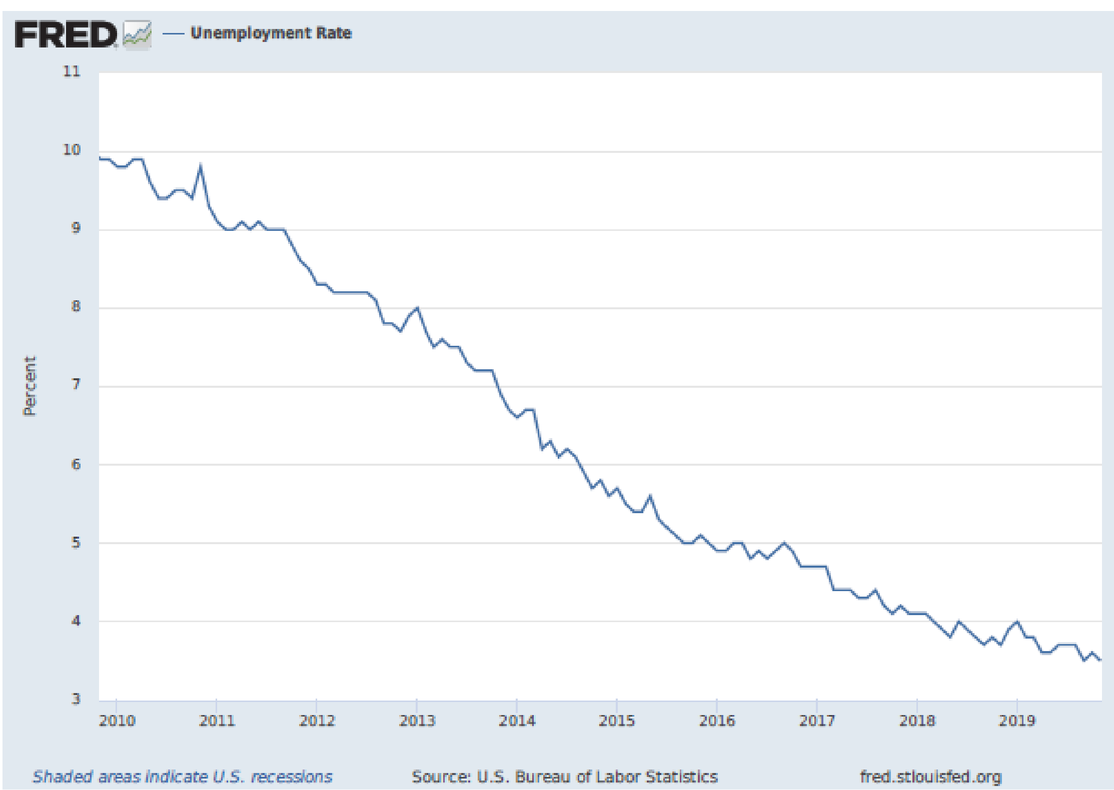
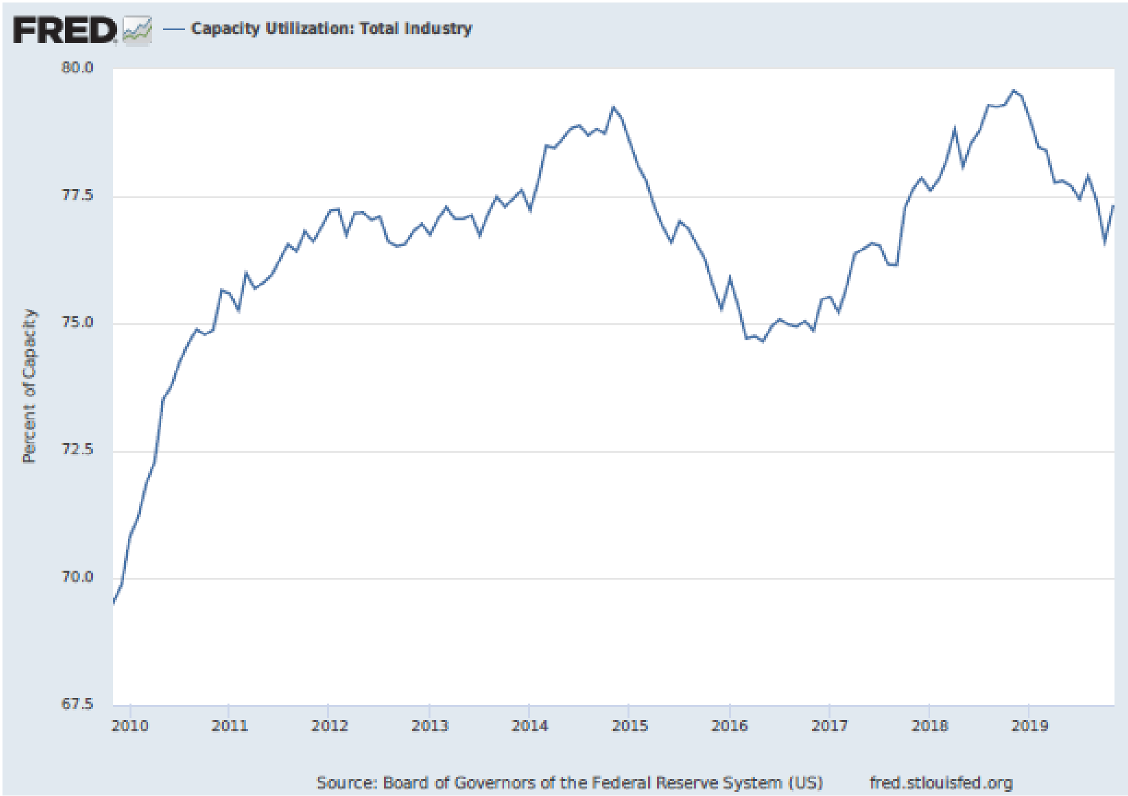


Chart #3



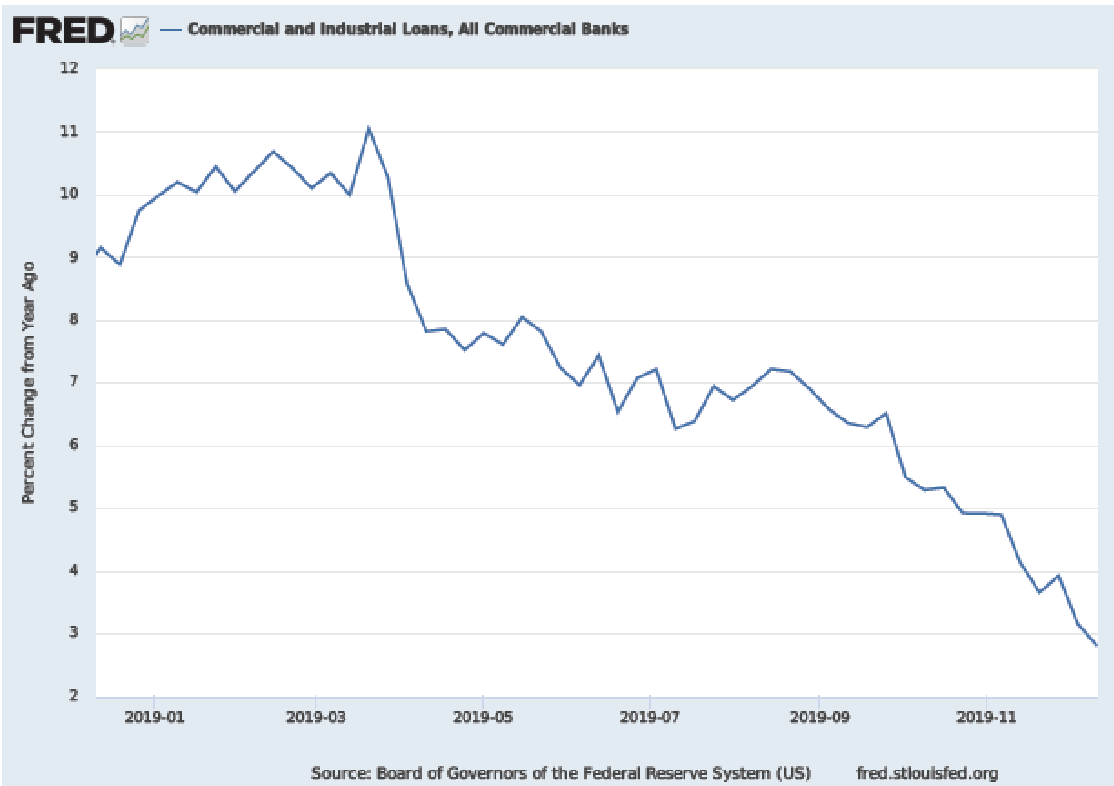
Unfortunately, capital investment declined throughout 2019 as corporate executives grew cautious. Trump's style of negotiation may have enabled him to amass a great fortune, but in the complex world of global politics, it created a great deal of economic uncertainty. Uncertainty led corporate executives to covet shareholder capital, thus resulting in a reduction in investment over the past year. Despite the lack of capital investment, the U.S. economy chugged along at a rate above the post-recession average, nonetheless, on the back of strong consumer spending as well as growth in state and local government spending. As we enter 2020, however, the rate of economic growth has the potential to slow to a rate below the average rate of the last ten years. Along with slower growth, inflation may be poised to accelerate to a rate above the FOMCs target rate of 2%. The question we'll need to ponder is: How much above the Fed's target will inflation rise?

As noted earlier, growth in nominal GDP has two components, real growth and the growth in inflation. Referring to Chart #1, the sharp acceleration in the rate of money supply growth suggests nominal GDP will accelerate in 2020. A slight speed-bump will impede first quarter growth as Boeing halts production of the 737 Max. Some economists estimate the Boeing production curtailment has the potential to trim economic growth by as much as ½ of 1 percentage point. However, after the Boeing effect falls out of the GDP calculation in the second quarter, the sharp acceleration in the supply of money should lift nominal GDP. The proportion of nominal GDP growth that accrues to real growth vs. inflation is critical to determining if we are, in fact, experiencing a Goldilocks economy or if a Witch's Brew is bubbling.

With the unemployment rate at 3.5%, it will become incrementally more difficult to find a lot more labor to fuel growth. Compounding the labor problem, the Trump administration has discouraged immigration, which further constricts the growth in the labor force. If the labor component of the economy remains constrained, the productivity component would have to increase in order to increase the rate of growth in real GDP. Productivity is a function of capital investment which, as previously noted, has been declining throughout 2019. Moreover, for the moment, capital spending looks to be curtailed in 2020 as well.

Chart #4 below depicts the rate of growth in Commercial and Industrial Loans (C&I). C&I loans are short-term loans by banks to corporations. These loans are used to finance inventories, and to provide short-term financing for capital investment or mergers until permanent financing can be arranged. The image created by Chart #4 speaks volumes. As the trade war escalated throughout 2019, corporate borrowing plummeted. This is a clear indicator that corporate confidence in the economy is diminishing. If this were to continue into 2020, we would have little reason to believe that capital investment will be enough to leverage the labor force through productivity.

Chart #4



In summary, the rapid increase in the supply of money is likely to spur nominal GDP growth. More money likely equals more demand for goods. Without an increase in labor growth and/or productivity growth, the incremental supply of goods and services can't keep pace with incremental demand. Consequently, the price of goods and services would increase. We call that inflation and it is that simple. In other words, full employment and diminishing capital investment in the presence of rapid money supply growth is an economic Witch's Brew.

Implications for the stock market

With the stock market at an all-time high level, stock valuations seem to be broadly near the top of what we believe to be the fair value range given the current, abnormally low level of interest rates. If inflation were to increase, as is likely given tight labor market conditions and anemic capital spending, then interest rates will likely rise. As interest rates rise, stock investors will likely differentiate between higher rates driven by accelerating real GDP vs. accelerating inflation. As the year progresses, we will need to closely monitor the leading indicators of growth and inflation. If the data favor the latter, we'll need to keep a tight rein on the valuation parameters that we use to make stock purchase and sale decisions.

Implications for Core Global portfolios

As the market stretched to new heights throughout 2019, some of the investments in our portfolio approached our price targets. Consequently, we trimmed several positions. Although we have several stocks that we are monitoring closely for possible addition to the portfolios, we only added one new investment in recent months, Iron Mountain, Inc (IRM), which is the leader in the business of storing, archiving and managing records for business and governmental enterprises. Our main attraction to IRM is its 7.75% dividend yield, which we believe will grow at a modest rate. Beyond Iron Mountain, we must admit that finding cheap stocks ten years into a bull market is a bit of a challenge. As a consequence of this fully priced stock market, we are continuing to hold cash reserves well above our normal level.

We hope to find evidence that real economic activity will increase in 2020. This could drive an acceleration in corporate earnings growth, which would make stock valuations more reasonable. If, on the other hand, rising inflation takes center stage, valuation multiples will likely decline, and stocks would suddenly look expensive. We believe the case for the latter is stronger than the former, hence our tight valuation parameters and large cash reserves. While we had a very good year in 2019, our cash reserves restrained our performance vs. the broader market. Investors who are uncomfortable with carrying large reserves in their portfolios may want to consider other SeaBridge portfolio strategies that have greater valuation latitude to buy stocks in the current market environment. Any member of the SeaBridge team would be pleased to guide you through the many portfolio strategies that we have available.

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