SeaBridge Investment Advisors, LLC

SeaBridge Core Global Strategy

February 2015 Commentary

In January, we commented that there is an abundance of data to support the notion that the US economy is growing strongly. In particular, 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). In 2014, the monthly job creation rate made a step-function increase to 260,000 per month from a level below 200,000 in the period 2011 through 2013 (see Chart 1-1). Looking at the labor picture from another perspective, we reach the same conclusion. Initial unemployment claims expressed as a percent of the total number of jobs reveals that the job market is getting much tighter than we believe is commonly perceived (see Chart 1-2). Initial unemployment claims as a percentage of total jobs are nearly as low as they have been over the past 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 rate of 3.4% may be poised to accelerate to a level above trend.

Chart 1-1:

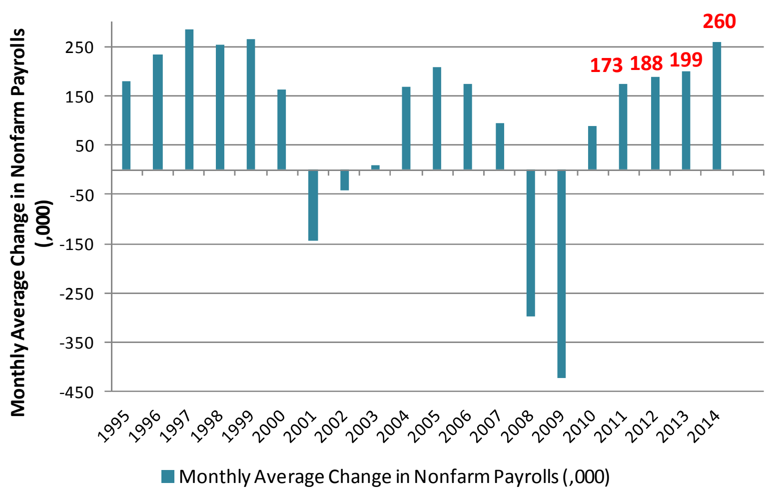
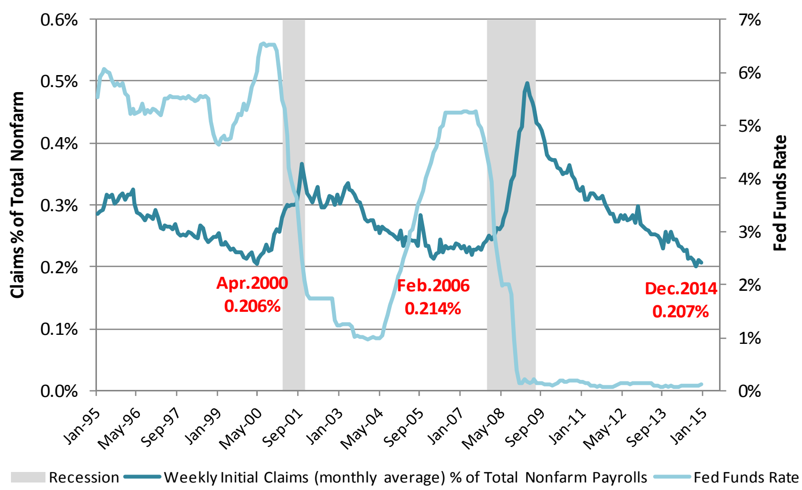


Chart 1-2:



Source: St. Louis Federal Reserve

Despite an improving economy, intermediate and long-term interest rates available in the US Treasury market have continued to decline as a result of soft economic conditions around the world. Meanwhile, on the short end of the yield curve, the Federal Open Market Committee (FOMC) is maintaining the Fed Funds rate at the zero lower bound, where it has been since December 2008. The FOMC has stated that the timing and speed of policy rate hikes remain dependent on macroeconomic data. Since the labor market appears to be approaching normal, why is the Fed Funds rate still at a level that implies the labor market is in distress?

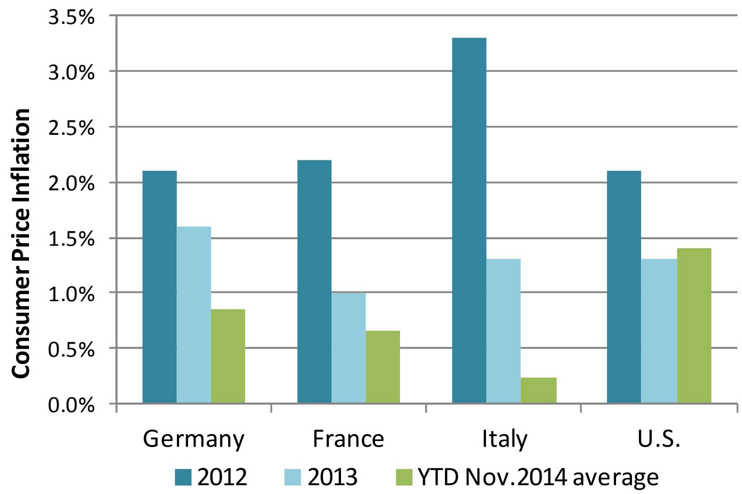
In this commentary, we intend to explore the other component of the Fed's monetary policy objective: to achieve a long-run inflation target of 2%. Inflation below the Fed's target could keep the Fed patiently waiting for the dissipation of residual risk of deflation associated with the Great Recession before they take the first step to normalize monetary policy. Indeed, Personal Consumption Expenditures (PCE) inflation was below the Fed's target rate of inflation in both 2013 and 2014. However, our analysis suggests that PCE inflation in recent years was largely dragged down by energy goods (gasoline) and health care services. Moreover, reduced price growth in energy goods and health care services should enhance consumer discretionary spending and provide additional tailwinds to an economy that is already recovering based on an improvement in residential construction, non-residential construction, and state and municipal spending. This supports our view that the US economy may now be poised to accelerate to a rate above trend.

Before we provide our analysis on PCE inflation in the U.S., we would like to present inflation trends within the context of major European economies. The European Central Bank (ECB) aims to maintain Consumer Price Inflation (CPI) below, but close to, 2% over the medium term. We evaluate the CPI in the euro area as measured by the Harmonized Index of Consumer Prices (HICP), which is compiled by Eurostat. In Chart 2, we observe that the HICP across major European economies, increased at a declining rate for the European nations in both 2013 and 2014, but increased at a rising rate in the U.S. for 2014. In a low inflation environment, a lower-than-normal Fed Funds rate perhaps could be justified. In light of the strengthening US labor market, however, a Fed Funds rate near zero poses a significant inflationary risk. Therefore, the FOMC may be poised to begin the process of normalizing monetary policy at some point in 2015. If the labor market were to continue to strengthen, the FOMC could begin the process of normalizing the Fed Funds rate as early as mid-year. Market volatility during the rate hike process could represent opportunities for putting cash reserves to work in equities.

In the U.S., the FOMC changed its focus on PCE inflation from the CPI in 2000. Their rationale was based on two observations: 1) PCE inflation allows consumers to substitute some goods and services for others as relative prices change, thus changing the expenditure weightings; 2) more comprehensive coverage of goods and services are included in PCE inflation (e.g. PCE inflation includes health care services paid for by employers and government, while the CPI only includes consumer out-of-pocket expenses).

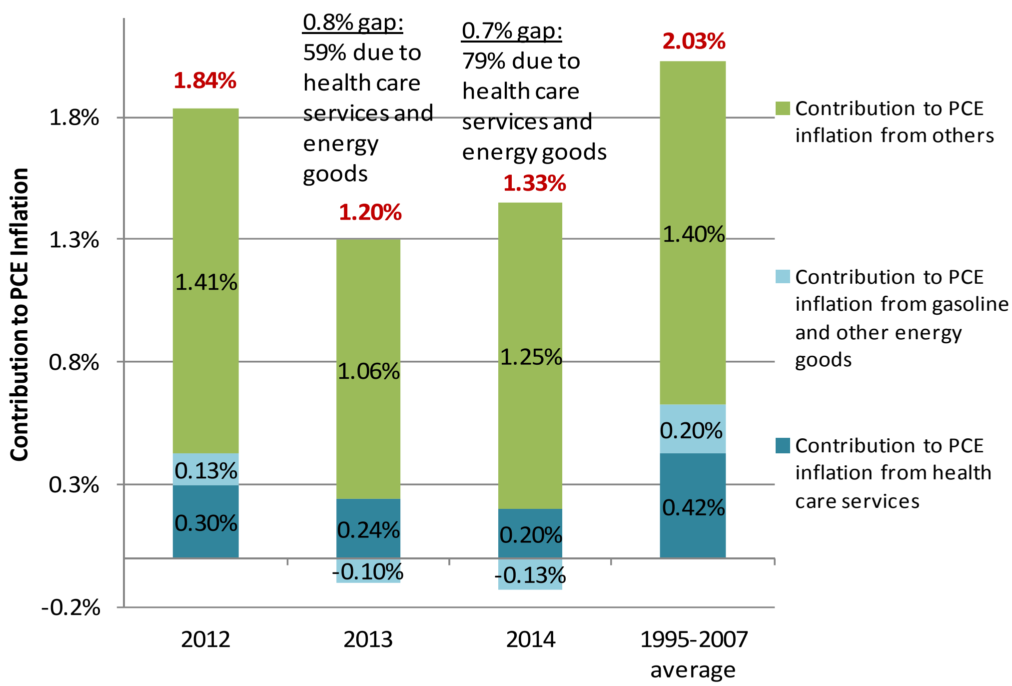
Our analysis of the components of PCE inflation indicates that energy goods and health care services contributed much less to overall inflation in recent years than the historical average (see Chart 3). A stronger economy in 2014 lifted inflation despite significant deflationary headwinds outside the U.S. Out of the 0.7% gap between the 1.3% inflation rate in 2014 (1Q to 3Q year over year average) and the 2.0% long-run average, 79% could be attributed to the below trend price growth of energy goods (motor vehicle fuels, lubricants, and fluids) and health care services (outpatient, hospital and nursing home services).

Chart 2:



Source: Eurostat (harmonized index of consumer prices)

Chart 3:



Source: Bureau of Economic Analysis

While oil prices are volatile, we believe the supply and demand outlook favors a long-run average price between \$80-\$90per barrel barring supply disruptions. More stable oil price growth in the future could keep the contribution of energy goods to PCE inflation subdued compared to the historical average. Similarly, health care services price growth has steadily outpaced overall inflation for the past 20 years (see Chart 4-1). Recent market intervention in the Medicare market by the federal government, however, has reduced health care inflation in the public sector and indirectly impacted private sector price growth (Federal Reserve research: http://www.frbsf.org/economic-research/publications/economic-letter/2014/september/medicare-cuts-reduce-inflation-budget-control-act/). As can be seen in Chart 4-2, health care inflation has been consistent with the overall level of inflation in recent years. Although the long run trend remains to be seen, public policy aimed at making health care more accessible to a greater portion of society could continue the recent trend of restrained growth in the cost of health care services.

Chart 4-1:

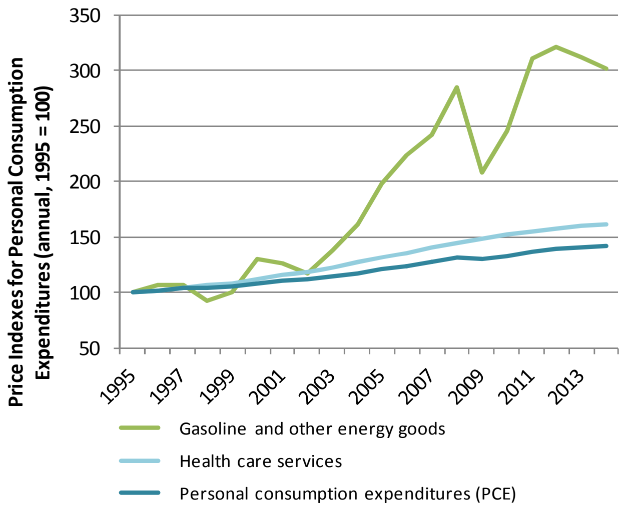
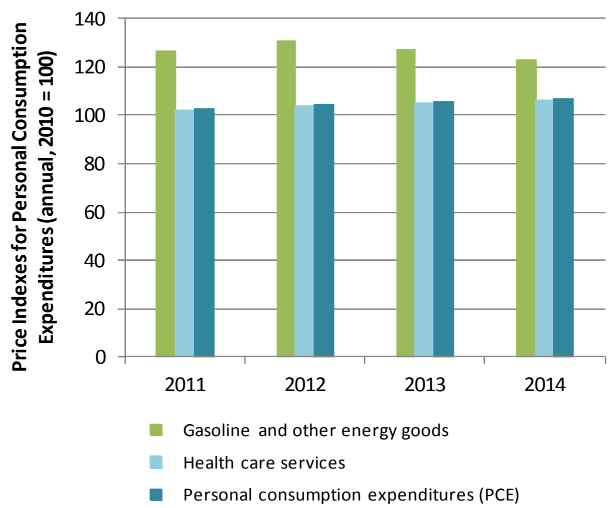


Chart 4-2:



Source: Bureau of Economic Analysis

Excluding these two categories, PCE inflation appears to be on track to close the modest gap between the current rate of inflation and the Fed's 2% target. As more discretionary dollars are allocated away from energy goods and health care into non-energy / health care goods and services, stronger demand could translate into faster price growth for consumer discretionary items, thus adding strength to the inflationary forces driven by tightening labor markets. As a result, despite the drag from energy goods and health care services, overall inflation in the U.S. could approach the Fed's target more quickly than currently implied by intermediate and longer-term interest rates. Potential upside risks to the current rate of inflation could be a rebound in the price of oil later in 2015, which might hasten the process of policy rate hikes. Offsetting this risk could be continued strengthening of the U.S. dollar. In theory, a stronger dollar should reduce the cost of imported goods and increase demand for foreign goods.

In our view, the US economic environment is one of visible growth, moderate inflation and low interest rates in the first half of 2015, and likely beyond. An encouraging validation of our economic assessment arises from recent inflection points in the monetary indicators. Both the money multiplier (the amount of money that banks generate with each dollar of reserves) and monetary velocity (the number of times a dollar is spent to buy goods and services) have turned up recently, suggesting positive lending and spending environment ahead. This is likely a good backdrop for economically sensitive equities, such as financials, real estate, consumer discretionary, industrials, and energy. As the year progresses, we'll keep a sharp eye on the data and make portfolio adjustments accordingly. In particular, we are keenly focused on the shape of the yield curve. At present, the yield curve is less steeply sloped than we would expect given the strength of the US economy. If the FOMC begins the process of normalizing the Fed Funds rate, we would expect longer-term interest rates to increase as well reflecting an increased demand for money and, possibly, a higher inflation premium. If, however, longer-term rates remain captive to the ECB's quantitative easing program and lower interest rates in Europe, the US yield curve could continue to flatten. At some point, a flattening yield curve could become a problem for both the US economy and the stock market. Essentially, the US Treasury curve has evolved into a barometer measuring two great pressures: European deflation and American inflation. In 2014, the stock market moved in a way that placed greater emphasis on the former. We hope that in 2015 it places more emphasis on the latter.

2/6/2015
Angell Xia
John Conti

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