SeaBridge Investment Advisors LLC

SeaBridge Core Global Strategy

January 2014

Commentary

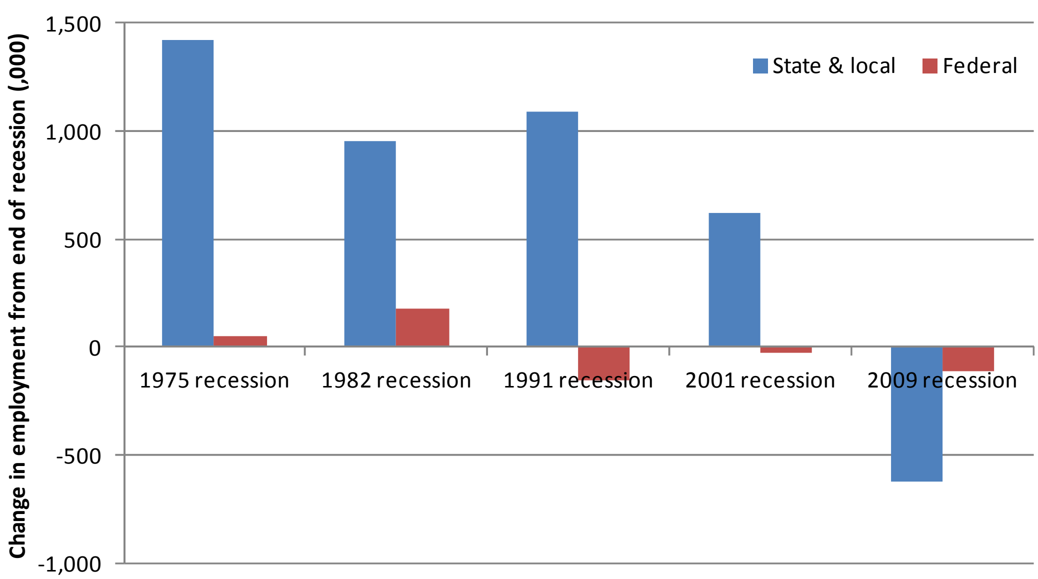
After a six month gestation period, the Federal Open Market Committee (FOMC) finally gave birth to the taper. On December 20, 2013, the FOMC formally ended market speculation about its plans to begin the process of winding-down its open-ended commitment to buy US Treasury and Agency securities (QE3). Initially, the FOMC will reduce its bond acquisition program by $10 billion from a rate of $85 billion per month to $75 billion in January. In addition, the Committee implied its intention to further taper QE3 by $10 billion after each regularly scheduled meeting of the FOMC. If the data continue to support the view that the US economy is getting stronger as recent data have shown, then the FOMC would be able to stick to the above noted schedule for tapering bond purchases and end QE3 by October 2014. Pursuant to that schedule, they will still likely purchase $315 billion Treasury and Agency securities, which would further bloat the Fed's balance sheet by nearly 8% to $4.3 trillion. The FOMC also expressed its intention to peg short-term interest rates near zero for "a considerable time after the asset purchase program ends and the economic recovery strengthens." In fact, in the Q&A session after his press conference, Chairman Bernanke implied that the FOMC may not foster higher short-term interest rates until near the end of 2015.

Although long-term interest rates have moved higher over the past six months as the FOMC sensitized the markets to expect the end to QE3, we believe monetary policy is still extremely accommodative. In our opinion, the combination of gradually rising long-term interest rates combined with short-term rates near zero will have the effect of actually increasing monetary stimulus as the steepening yield curve gives banks a greater incentive to lend money. Indeed, virtually all of the economic stimulus that the FOMC intended to provide through QE3 ended up back on the Fed's balance sheet as excess bank reserves, which are now $2.4 trillion! A further incentive for banks to lend combined with an unprecedented quantity of excess bank reserves has the potential to substantially accelerate the money creation process. Initially, this should result in an increase in the rate of growth of real GDP as both labor and capital stock remain slack four years after the recession. As GDP accelerates, however, both the labor market and capacity utilization could tighten more quickly than the FOMC currently anticipates. Therefore, it is possible that the dialogue regarding inflation could suddenly shift from one of disinflation to one of rising inflation. This, in turn, could cause the bond market to bring forward its expectations for an increase in short-term rates into our investment horizon.

As we noted several times during 2013, we have been of the opinion that the US economy has been considerably stronger than the reported economic data have implied. From our perspective, political machinations in Washington combined with unusual austerity by state and local governments have masked the underlying strength of the private sector since the economic recovery began four years ago. In fact, a reasonable case can be made that the economic recovery post-credit crunch hasn't been significantly less than the historical average rate of US economic growth. Since the end of WW II, the US economy has grown at a real rate of 3.41% (beginning 1947 and ending before the credit crunch in 2007). The continual expansion of federal, state and local government contributed 0.57 percentage points to growth during the post-war period. Therefore, ex-fiscal stimulus the private sector grew at a rate of 2.84%. In contrast, since the last recession, the US economy grew at an average annual rate of 2.42% (beginning in 2010 and ending in the third quarter of 2013). However, rather than adding to growth, fiscal austerity at the federal, state and local levels of government impeded growth by 0.28 percentage points. Therefore, the private sector has grown at a rate of 2.7% since the recession, which is only marginally different from the post-war average rate of 2.84%.

We started this note by postulating that the FOMC was actually stimulating the economy by steepening the yield curve through bond purchases. We have also noted previously that the housing recovery could add to growth by as much as one third of one percentage point per year over the next three years. At the same time, incremental fiscal austerity at the Federal level is unlikely, and it appears as though state and local spending is no longer detracting from growth. In fact, in the second quarter of 2013, state and local growth added 0.05 percentage points to growth. In the third quarter, the increment to growth accelerated to 0.19 percentage points. After several years of reducing the number of teachers, fire fighters and police officers, municipalities appear poised to add staff and negotiate higher wages for employees. Indeed, in the press conference following the most recent FOMC meeting, Chairman Bernanke's comments seemed to support our view of the economy. Specifically, Bernanke noted that "despite significant fiscal headwinds, the economy has been expanding at a moderate pace, and we expect that growth will pick up somewhat in the coming quarters, helped by highly accommodative monetary policy and waning fiscal drag." In the question & answer session following the press conference, the Chairman estimated that fiscal drag impeded GDP growth by as much as 1.5 percentage points in 2013!

The subtle point that has been continually glossed-over by economic pundits who claim the recent economic recovery in the US has been sub-par by historical standards is the significant behavioral change by the government sector following the most recent recession compared with past recessions. This is displayed in the chart below.

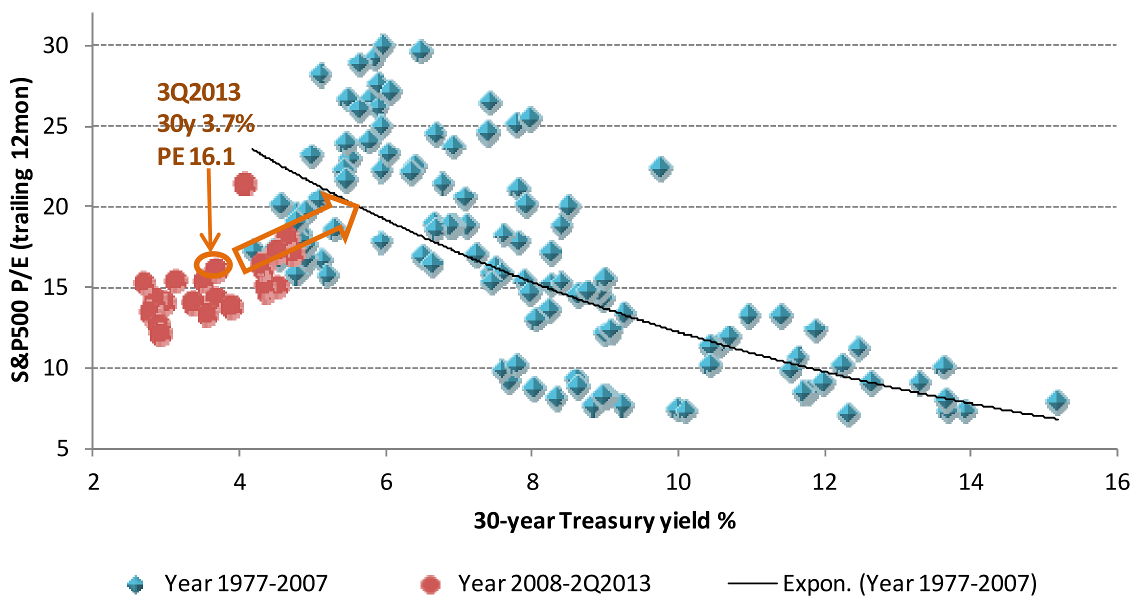


Represents the cumulative change in government employment 53 months subsequent to the end of each recession

Source: Bureau of Labor Statistics (up to Nov.2013)

Normally, following a recession, state and local government employee labor unions have been strong enough to maintain staff levels and negotiate pay increases. The most recent recession, however, was so severe that tax payers could not shoulder the burden of higher property taxes or state income taxes. Therefore, for the first time in modern history, state and local austerity slowed economic growth.

In conclusion, we remain quite constructive regarding the outlook for the US economy. In fact, we believe the economy is poised to grow at or above its potential. We also remain constructive regarding the outlook for the stock market. An accelerating economy should lead to an increase in corporate revenue growth, which has been a bit anemic of late. In addition, we believe there is room for the market multiple to expand. Below we present a chart depicting the relationship of the market multiple relative to interest rates. (This same chart was first presented in February 2013). The blue dots represent observations during periods of normal monetary policy (i.e., before 2007). The red dots represent observations after the 2008 credit-crunch. The line of best fit only describes the blue dots. Our main observation from this chart is that the normal market multiple for the current level of long-term interest rates is higher than the current multiple. As the Fed fosters the belief that the US economy can stand on its own without the support of extraordinary monetary measures, investors may continue to increase the rate at which earnings are capitalized because of increased confidence in the sustainability of the earnings stream. Indeed, we believe this is the phenomenon that drove the strong move in the stock market in 2013.



Source: Bloomberg, and SeaBridge Investment Advisors

While this P/E to interest rate analysis suggests that the market can handle higher interest rates, we need to be mindful that as the dialogue shifts from accelerating real growth to one of modestly increasing inflation market volatility may increase substantially.

John Conti
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December 24, 2013

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