SeaBridge Investment Advisors, LLC

SeaBridge Core Strategy

June 2015
Commentary

Preparing for Emerging Wage Pressures

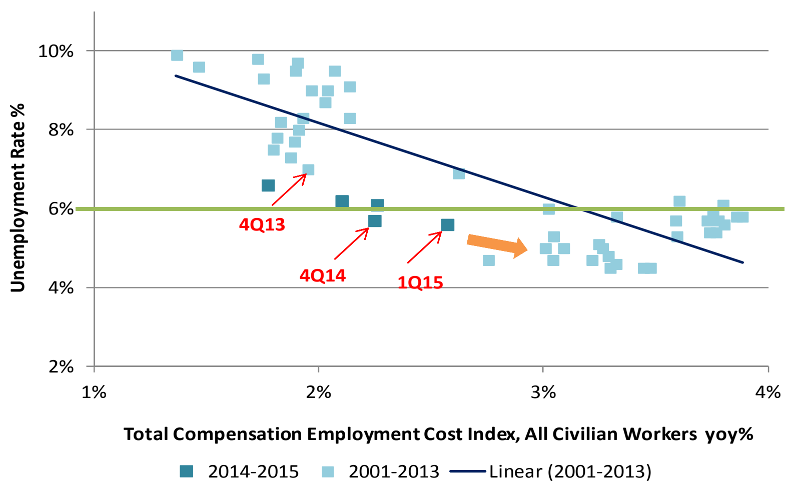
According to The Bureau of Economic Analysis (BEA), US GDP contracted in the first quarter of 2015. Although we were expecting anemic growth in the first quarter, growth, as reported, was softer than we anticipated. Our expectation for a soft quarter was the result of extremely severe winter weather; labor issues at the West coast ports; the sharp appreciation in the value of the dollar; and, reduced capital spending in the oil patch. However, a pause in capital spending beyond the oil industry was an unanticipated impediment to growth in the quarter. According to Randall Hogan, CEO of Pentair, "a global capital spending freeze and its impact on our industrial business was not foreseen." Pentair has a strong presence in many end markets and geographies through its business of manufacturing pumps, valves, and controls for water management and process industries. Mr. Hogan further stated that "We do not see this to be a Pentair specific issue as this broad-based decline was across virtually every business, every geography, and every market." It is likely, in our judgment, that the capital spending pause beyond the oil industry was a visceral reaction by corporate executives to the uncertainty ensuing from the precipitous adjustment in the price of oil and the value of currencies. As volatility in those markets subsides, we expect capital spending to normalize.

In addition to the real, but largely transient, factors cited above, first quarter GDP was also likely substantially understated by a statistical problem in the BEA's data collection and reporting process. While we have written about this issue several times since 2011, the Federal Reserve Bank of San Francisco (FRBSF) has finally published a paper on the subject. According to the FRBSF, "The BEA tackles the difficult challenge of seasonally adjusting GDP by starting with disaggregated raw data obtained from a variety of sources. Some of these source data have already been seasonally adjusted. The BEA may seasonally adjust the remaining individual series or judge that they do not require seasonal adjustment." We first inquired about the BEA's seasonal adjustment technique in the early years of the current economic recovery because we noticed inconsistencies between GDP data and other economic data series. In 2011, we concluded that the BEA's seasonal adjustment process was flawed, thereby rendering quarterly GDP virtually useless in supporting real-time portfolio decisions. Over time, however, the BEA's baseline revision process cleanses the data. Therefore, in the long-run, GDP data can be used to analyze historical trends. In the short-run, however, the BEA systematically understates economic activity in the first calendar quarter of every year. According to the FRBSF report, if the BEA GDP data were adjusted using a different seasonal adjustment technique, growth in the first quarter of 2015 was more likely 1.8%. While still below trend, 1.8% is fairly respectable given the severe weather, port slow down, sharp rise in the value of the dollar, and precipitous drop in the price of oil. (See the link at the end of this note for further reference to the FRBSF report).

Given our belief that the GDP data are not accurate at the time they are reported, we have placed greater emphasis on other economic data series that are less subject to major revisions. In particular, we favor the Index of Leading Economic Indicators (LEI) six month, annualized data series. The April reading for the six month LEI increased at an annual rate of 4%. As recently as October of 2014, the six month LEI was growing at a rate of 7.2%. It declined modestly in November and December, and then dropped to the current 4% level over the winter months, which seems reasonable given the issues previously mentioned that disrupted growth in the March quarter. Now that the winter weather is behind us, and the value of the dollar and the price of oil have somewhat stabilized, we believe the US economy can resume its march towards economic potential of between 3% and 3.5%. However, given the ongoing strength of the dollar, the lower end of the range seems to be more likely. We continue to believe the incremental drivers of growth will be residential housing, non-residential construction, and state and local spending. We also continue to believe the labor market in the US is much tighter than the unemployment rate implies, and that the Federal Open Market Committee (FOMC) is very late in fostering a more normal monetary environment.

After a transient dip in March, additions to nonfarm payroll returned to a level above 200,000 in April with gains in Professional and business services, Healthcare and Construction, partly offset by losses in Mining. More encouragingly, wage growth accelerated in the first quarter with the Employment Cost Index (ECI) increasing 2.6%. Early in the year, we suggested that a 6% unemployment rate could be the magic number for wage growth to accelerate to a 3-4% level from the 2% level experienced since 2010 (Chart 1). We further elaborated that declining energy and healthcare costs appear to have impeded wage growth due to reduced inflation expectations.

<u>Chart 1:</u>



Source: Bureau of Labor Statistics

Underlying the headline ECI number, we observe a particularly large jump for the Sales related occupations (Chart 2). The Bureau of Labor Statistics (BLS) reports an ECI breakdown for nine occupations including Management, Professional, Sales, Office support, Construction, Maintenance, Production, Transportation and Service. Earnings for the Sales occupations tend to be more cyclical because of the incentive pay component linked to performance. Wage growth for this job category averaged 3.3% prior to the recession and declined significantly during the recession. Despite the first quarter pause in capital spending, the recent acceleration in compensation for Sales related occupations could signal employers' improving confidence in the near-term business outlook and presage a broadly-based acceleration in wages. Supporting this observation, the job switching trend also points to wage acceleration ahead. Chart 3 depicts the "quit rate," which is already near the prerecession norm. The quit rate reflects the propensity of individuals to voluntarily leave their jobs in pursuit of higher-paying jobs. If, as we suspect, confidence among corporate executives increases as the price of oil and the value of the dollar stabilize, we'll have greater confidence in the sustainability of the wage growth thesis.

Chart 2:

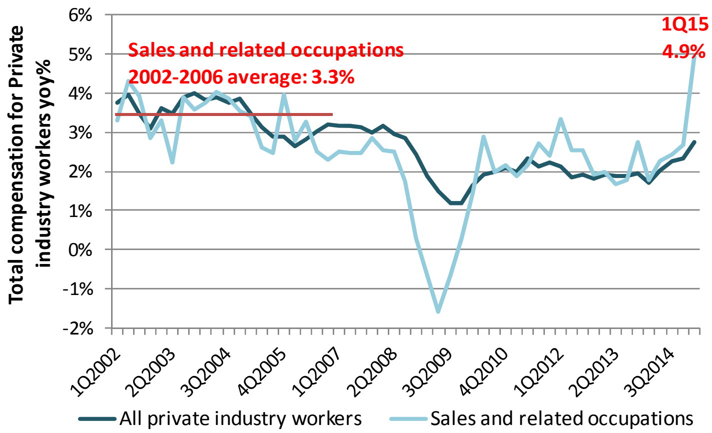
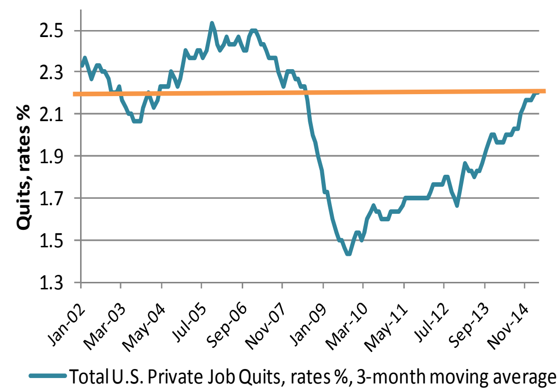


Chart 3:



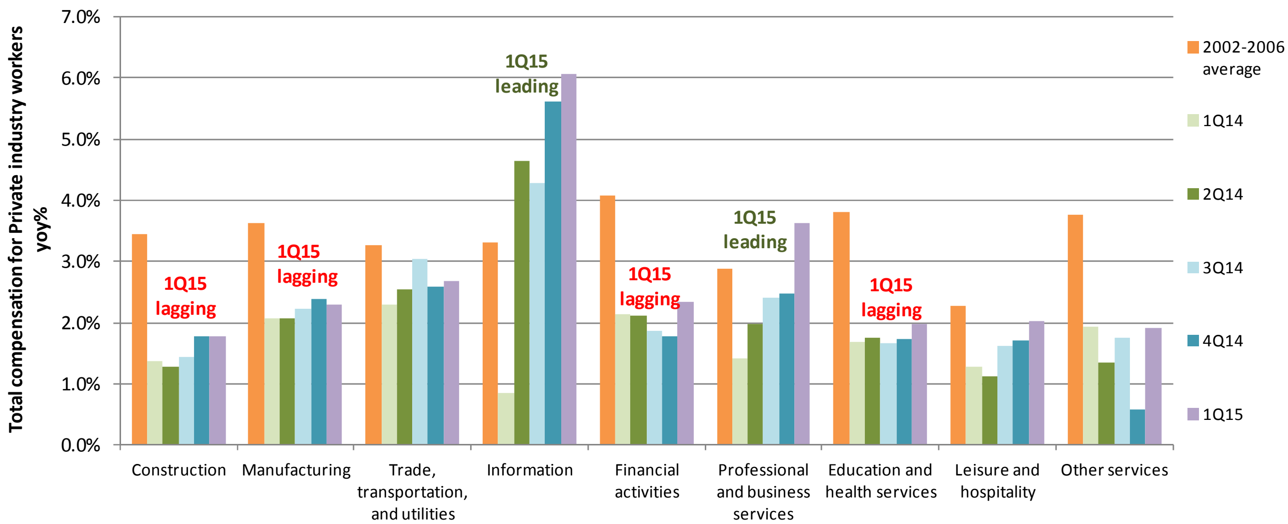
Source: Bureau of Labor Statistics

The acceleration in wage growth could be a double-edged sword, however. While economic expansion should drive better revenue growth, companies could experience margin erosion if wage growth outpaces sales growth. In Chart 4, we take a further look at the ECI trend by industry. Information and Professional and business services are leading (in 1Q 2015) with wage growth significantly surpassing the prerecession average (2002-2006). Lagging industries include Construction, Manufacturing, Financial activities, and Education and health services, perhaps due to both cyclical and structural factors. In the near-term, we believe moderate acceleration, yet below trend wage growth in the Manufacturing and Financial industries is likely. We expect margin trends in our industrial and financial companies to remain healthy due to productivity enhancing technology advancements and cost cutting measures. In addition, the gradual return of the oil market and the construction market to their respective long-term equilibrium should provide tailwinds to the performance of our portfolio as revenue growth accelerates.

One of our long-term holdings, Hubbell Inc. (HUB-B) is a manufacturer of a broad range of electrical and electronic products for non-residential and residential construction, industrial and utility applications. During the first quarter earnings call, David G. Nord, Chairman, President and Chief Executive Officer, said, "Hubbell had a solid start to the year, with a 7% sales increase driven by a balance of organic and acquisition growth. End markets performed largely as expected, as notable strength in non-residential was partially offset by ongoing weakness in energy-related industries. We are progressing nicely with our cost reduction efforts, which include rationalizing facilities, reducing personnel cost, and streamlining back-office processes. We are focused on continuing to identify and execute opportunities to improve our cost structure and position the Company over the long-term for strong conversion on top line growth." Hubbell's comments were typical of our industrial investments in first quarter earnings reports.

In general, we believe companies that are manufacturing oriented and have a global business mix are more likely to be able to maintain or improve margins as the US labor market continues to tighten because they are already in the process of reducing costs. On the other hand, companies that are more service oriented and have a business mix skewed to the US are more likely to have difficulty maintaining margins in a tightening labor market environment because, in general, they are not currently in austerity mode as are industrials. The latter companies will have to increase capital investment to achieve the productivity leverage needed to offset rising wage growth. For example, Bed Bath & Beyond (BBBY), a retailer of home accessories, is experiencing temporary margin erosion as they invest in systems that will enable the company to increase sales through the internet channel to leverage its existing big-box store base. Longer-term, we expect their investment to enhance margins through sales leverage.

Chart 4:



Source: Bureau of Labor Statistics

**Other services include repair and maintenance, personal and laundry services, and membership associations/organizations*

More importantly, however, we believe rising labor costs will force the FOMC to begin the process of fostering a monetary policy that is more normal for the current economic environment. The strength of the dollar, decline in the price of oil, and weak first quarter GDP have conspired to give the FOMC some leeway to let their first step to normalizing monetary policy slip from the June meeting to September. Nonetheless, unless world events change the path of US growth in the next few months, we believe the FOMC is poised to act. Although the stock market may react to a move by the FOMC with increased volatility, a normalization of interest rates should lift bank lending spreads and incentivize greater lending activity. Oddly, because interest rates have been abnormally low for so long, a return to a normal interest rate environment may actually prove to be a stimulant to the US economy.

Reference:

The Puzzle of Weak First-Quarter GDP Growth, San Francisco Fed, May 18, 2015
http://www.frbsf.org/economic-research/publications/economic-letter/2015/may/weak-first-quarter-gdp-residual-seasonality-adjustment/

John Conti
Angell Xia
Adrian Morffi

5/29/15

The views presented here represent the opinions of SeaBridge Investment Advisors based on analysis of publicly available information. The opinions of other analysts based on these data may differ, including other analysts in SeaBridge. ***The conclusions of the analysis may not be realized in the future****. There may be other factors which have more influence on future growth, economic recovery and market performance than those presented here. There may be errors in the data referenced in this analysis. Investment involves risk and* ***past performance is not indicative of future performance.***

This is for information only and should not be considered a solicitation or offering of any specific investment products or services.

This is not a recommendation to buy any security or sector*. SeaBridge may buy or sell securities for client or personal portfolios at any time in the future depending on individual circumstances or changes in SeaBridge's conclusions about the outlook. There is no representation about the future performance of the stocks mentioned in the Commentary. There are other stocks in the portfolio that performed worse than the examples presented here. SeaBridge's opinion of the economic and market prospects may change in the future.*

There are differences among portfolios managed by SeaBridge in the Core Global Equity strategy based on client-specific factors. Not all portfolios hold the same securities. Not all stocks held in the portfolio perform similarly. SeaBridge also manages portfolios in other styles. These portfolios differ from the Core Global Equity strategy portfolios.