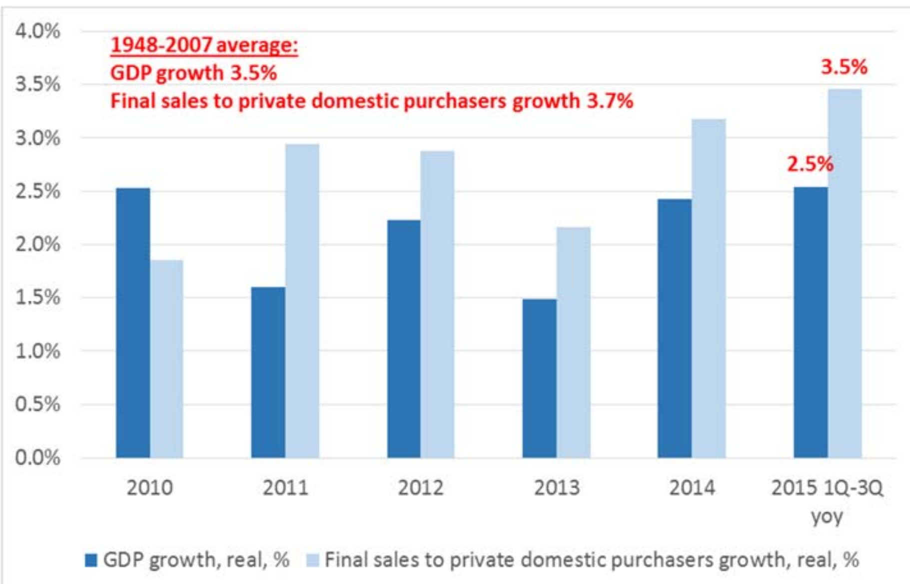
SEABRIDGE
INVESTMENT ADVISORS, LLC

SeaBridge Core Strategy

November 2015
Commentary

Despite volatility in the financial markets, the U.S. economy is accelerating slowly supported by continued strength in consumption and a gradual recovery in investment. In the private sector, demand has stepped up considerably (Chart 1). This is likely attributable to a significant improvement in the labor market. In fact, private sector demand growth has outpaced overall GDP growth since 2011. Moreover, in the first three quarters of 2015, the growth in final sales to private, domestic purchasers was nearly 3.5%, which is, essentially, in line with the post WWII average.

Chart 1



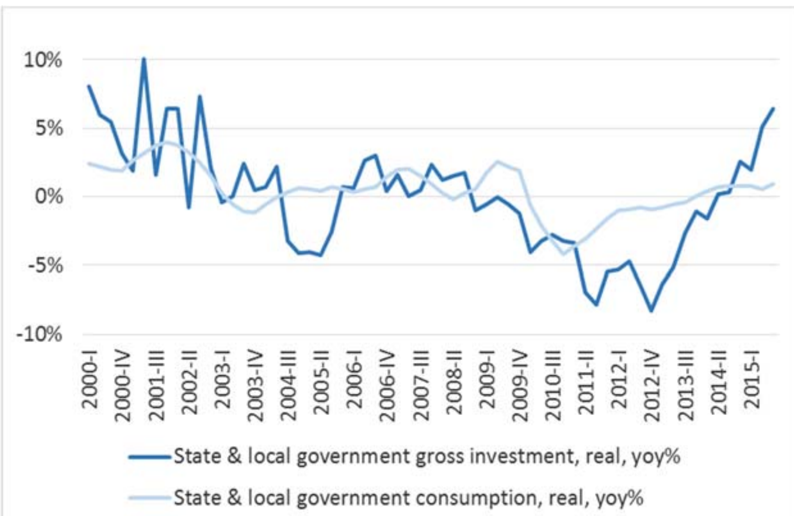
Source: Bureau of Economic Analysis

The gap between the growth rate of GDP and final sales to private, domestic purchasers is related to weak exports and lagging government spending. In the first three quarters of 2015, weak foreign economic conditions and a strong dollar likely deterred exports, which grew at a rate of only 1.9% year-over-year, and is significantly below the long-run average of 5.4%. In addition, contrary to every other postwar recession, state and local government spending did not help the recovery. In fact, state and local spending contracted from the first quarter of 2009 through 2013, thus detracting from the GDP calculation (Chart 2 sidebar shows the cumulative effect from 2010, which was the first full year of economic recovery, through 2014). More recently, however, increasing tax revenue seems to be driving state and local spending as shown in Chart 2. For the second quarter of 2015, tax revenue for the four largest categories, individual income, sales tax, property tax, and corporate income, increased 6.9% year-over-year. Individual income tax collections, which is the largest category and represents about 30% of the total, increased most at approximately 14% year-over-year.

In addition to state and local spending, economic growth likely will be enhanced by a labor market that continues to tighten, and shifting demographic trends. These dynamics will likely pressure wages upward in the coming years, thus boosting demand. (We elaborate further on demographic trends at the end of this commentary). It is our view that a better demand outlook should boost business confidence in investment, which should in turn revive labor productivity and contribute to economic growth.

Thus far in the current economic recovery, nominal wage growth has been disappointing despite a decline in the unemployment rate to 5.0% as of October 2015. Although this is partly attributable to low inflation, poor labor productivity growth likely also contributed to wage stagnation in recent years. In the long run, economic growth is determined by the combined growth rate of the labor force, capital stock and technological progress. Despite a better working age population outlook compared with other advanced economies, the U.S. labor force is projected to grow more slowly than in the past thus contributing less to output growth than in the past. Therefore, the contribution to economic growth from progress in technology and growth in capital stock will become increasingly more important.

Chart 2

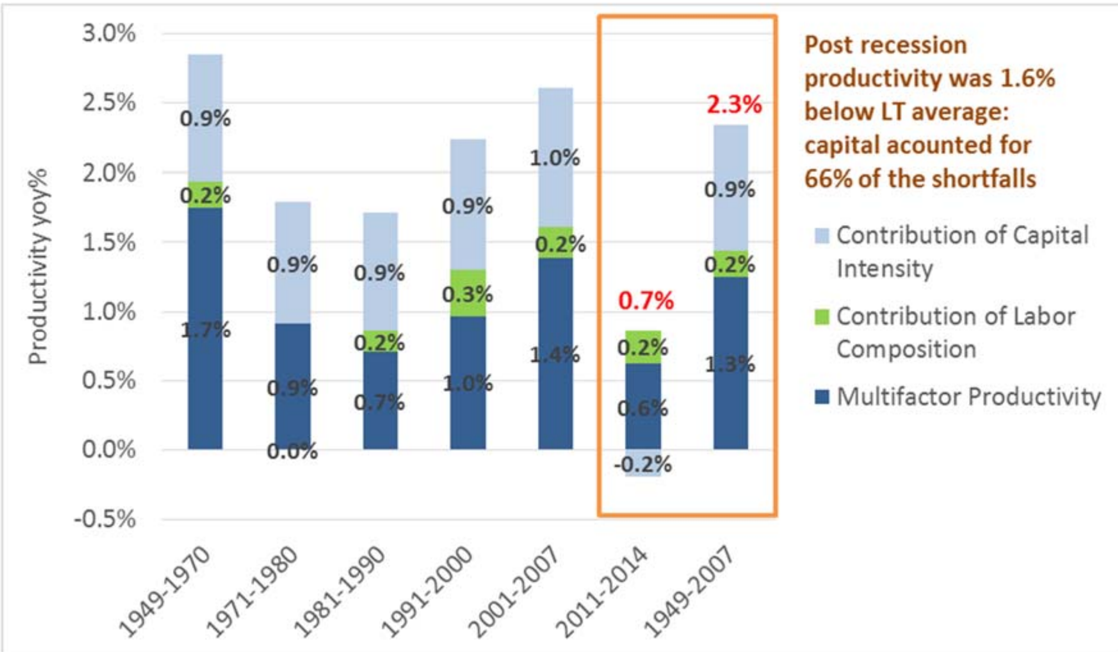


	1947-2007	2010-2014
GDP	3.41%	2.04%
Federal	0.23%	-0.13%
State and local	0.34%	-0.21%
GDP ex. Government	2.83%	2.38%

Source: Bureau of Economic Analysis

Unfortunately, labor productivity growth in the wake of the most recent recession has been more modest at a 0.7% rate than the long-run average of 2.3%. To understand this issue, we take a closer look at the drivers of productivity. Our analysis of the underlying components of labor productivity growth suggests that during the five post war periods, the contribution from changes in labor quality and capital intensity have been quite constant at about 0.2% and 0.9%, respectively. The third component, multifactor productivity (MFP), the efficiency at which labor and capital inputs are utilized in production, accounted for nearly all the variation in labor productivity growth. However, from 2011 to 2014, although MFP growth was as low as the 1980's, a reduction in capital intensity accounted for 66% of the productivity shortfall. Despite a positive investment contribution to GDP, growth in capital in relation to labor input (measured as capital relative to the labor/hour ratio after adjusting for labor quality changes) declined 0.9% year-over-year on average from 2011 to 2014. In comparison, the long-run average growth for this ratio was 2.6%. This shortfall calls for an acceleration in investment in order to boost labor productivity and, therefore, output. Businesses could be poised to begin a new phase of growth as labor market slack diminishes and the demand outlook brightens. After all, investment is not only a principal contributor to productivity growth, but also an important source of technological progress, potentially returning MFP back to a stronger growth trajectory. Admittedly, a risk to this view pertains to the excess capacity outside the U.S. due to weak economic activity. A strong dollar could also impede domestic investment recovery.

Chart 3



Definitions:

- *Contribution of capital intensity: The portion of labor productivity change attributed to capital services.*
- *Contribution of labor composition: The portion of labor productivity change attributed to the composition of the labor force (the degree to which shifts in the age, education, and gender of the work force affect measures of labor input.)*
- *Multifactor productivity: The efficiency at which measured inputs are utilized in producing output of goods and services, measured as output per unit of combined input.*

Source: Bureau of Labor Statistics

Chart 4

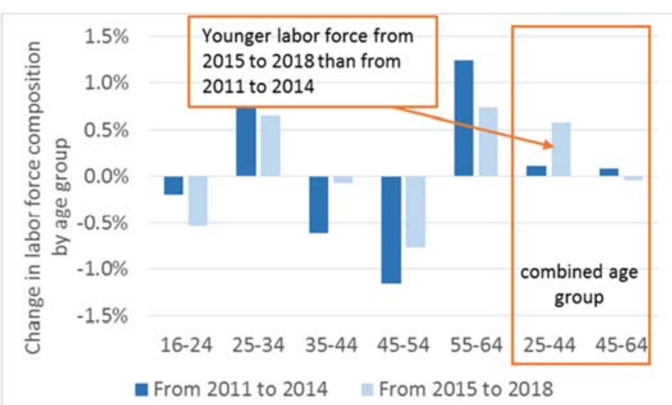


Chart 5

Source: Bureau of Labor Statistics

Beyond diminishing labor market slack, demographic shifts in the coming years also point to stronger wage growth ahead. Chart 4 compares labor force composition by age group between two periods, 2011 to 2014 and 2015 to 2018. As echo boomers age, they will advance into the sweet spot of their careers, thus wage growth could accelerate materially from 2015 to 2018 compared with the prior period from 2011 to 2014. This is illustrated by median weekly earnings by age group. As seen in Chart 5, wage growth tends to step up strongly for cohorts age 25-34 and 35-44 years old.

In summary, despite noisy and misleading headline macro statistics resulting from a long list of transient issues experienced in recent years, final sales to private sector, domestic purchasers have been rising steadily over the past three years and are now growing at a normal rate. As the labor market continues to tighten, and the echo-boom generation of workers moves into their higher wage earning years, final demand should continue to grow. In addition, state and local government spending is coming out of hibernation and should further drive demand growth. Growing demand, in turn, should lead to improved business confidence and spur increased capital investment, which should lead to rising productivity. This emerging virtuous cycle could drive an acceleration in GDP growth. As noted in our July 2015 commentary, our portfolios are structured to benefit from a continued and accelerating economic growth environment.

Angell Xia
John Conti
11/6/15