

SeaBridge Investment Advisors LLC

450 Springfield Avenue, Suite 301 • Summit, NJ 07901-2610
Garnett Keith, John Conti, David Descalzi, Susan Boyd
Tel: (908) 273-5085 • Fax: (908) 273-6297

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Copy of letter sent to individual clients of SeaBridge Investment Advisors for the Third Quarter 2009.

The second quarter rally was a huge relief and its continuation through the third quarter was more than we had hoped for or reasonably deserved. Most of our client portfolios are now ahead of where they were a year ago.

We are not alone; markets almost everywhere had a good quarter. With rising confidence and the premia for risk-taking narrowing, more risky assets generally did better than safer assets. For the third quarter, the S&P 500 was up 15.6%, the broad U.S. market Russell 3000® Index rose 16.3%, the global MSCI World Index returned 18% and the MSCI World Index ex USA was up 19.8%. For the year to date, the S&P 500 index had a positive 19.3% return, the Russell 3000® Index was up 21.9%, the MSCI World Index returned 29.3% and the MSCI World Index ex the USA was up 37%.¹

The panic of the last quarter of 2008 and the first quarter of 2009, followed by soaring markets since March, beg the question of how long can this continue? We have at work some powerful positive forces, but also some very significant counter forces:

- In the positive column, we start with monetary stimulus of unprecedented proportions. This is not just in the U.S. but in all countries in the world. Monetary policy works with a lag and we have not yet felt the full force of the power of .5% short-term Treasury rates. The Fed's balance sheet has soared from negligible excess reserves to \$800 billion of excess reserves as the Fed has created new reserves and banks have kept them at the Fed, rather than using the new reserves as a basis for new loans. In addition, the Fed has injected liquidity into the markets via other programs, the largest of which has been their purchase of \$1.45 trillion of government guaranteed mortgages. The U.S. has never seen liquidity created in such magnitude. Essentially, the Fed has replaced the asset holding power of hedge funds, special investment vehicles, and other entities in the substantially reduced "shadow banking system."
- Fiscal stimulus relative to the size of world economies is also at never-seen-before levels, with the possible exception of Egypt building the pyramids. ISI, a New York economic service, keeps a global scorecard on this, and the number of global fiscal initiatives is now 738. Some of these – for instance China's program – are larger relative to the size of their economy than the U.S. program.
- The corporate sectors, in the U.S. and world generally, are in flush condition. (This obviously excludes the financial intermediaries.) Corporate borrowing was not excessive following the 2001 recession, and many corporations have cut back capital spending as demand has

¹ Results for these indices (S&P 500, Russell 3000®, Morgan Stanley Capital International All Country (MSCI) World Index and MSCI World Index ex USA) are quoted as being somewhat representative of the broader equity markets for comparison to SeaBridge U.S., global, and foreign portfolios. The SeaBridge portfolios differ from these indices (in number of securities held, industry, sector and country weightings, etc). Therefore, in any given period, results for SeaBridge portfolios are likely to differ from the results for these market indices.

collapsed. Corporate cash flow generally exceeds depreciation charges. Corporations have the financial strength to spend if they see that demand justifies it. However, with U.S. capacity utilization less than 70%, corporate spending will likely be slow to recover at home but stronger in emerging markets.

- Demographics in the U.S. are excellent. The “echo baby boom,” plus immigration of the past decade have our work force rising at about 1.8 million per year for the foreseeable future. Moreover, these new workers are not heavily indebted and will generally spend money for family formation and housing if and as they get jobs.
- The growth outlook for emerging markets is good. While the drop in demand from the U.S. slows consumer goods exports, that loss can be made up with growth of domestic demand in the emerging markets in a few years. So we have probably seen the worst of the excess-world-supply versus world-demand imbalance. Growth in China, India, Indonesia and Brazil, with three billion people between them, will probably grow at a 6-11% annual rate for the next few years, and that will help a lot.
- The capital markets are working again. Much of the crisis and panic of 4Q08 and 1Q09 came about because banks and capital markets froze and solvent but illiquid borrowers faced bankruptcy. In the past five months, many corporate bonds have been issued to refinance existing bonds with a short maturity. In addition to refinancings, new bond issuance has increased the bond par values in the Bank of America-Merrill Lynch bond indices by \$290 billion year-to-date. With the capital markets working, there is a good chance that growth can accelerate. With luck, the looming problem in commercial real estate debt can be refinanced before it hits the banks in 2011.
- Bank failures continue, with more banks failing in 2009 than 2008 (98 versus 25), but with substantially smaller assets involved (\$105 billion versus \$373 billion). The largest banks have been stabilized via Government capital injections or guarantees, and the risk of a collapse of the financial system seems more remote. All banks are benefitting enormously from the spread between deposit rates of less than 1% and their typical lending rate of prime rate plus 1%, or 4.25%. Over time this will recapitalize the banks but at the expense of retired persons and other deposit and money market fund savers.

That is the good news. In the counter-force column we have looming challenges, some of which are new to our experience:

- U.S. consumer debt is “a bit out of bounds” to put it euphemistically. Mortgage, home equity loan, auto loan, and credit card foreclosures are likely to continue to rise well into 2010. The upper class can still spend if they want to – although they, too, are sobered by their net-worth collapse last winter. But for most Americans we need to cut back spending more than we have already. Consumer savings is calculated a couple of different ways by the Government’s Bureau of Economic Analysis. Using disposable personal income less personal consumption expenditures, savings peaked at 4% with the tax rebates in July, and then fell back toward 3%. To work off our massive consumer debt, consumer savings needs to get above 6% and stay there for several years.
- Unemployment, the child of collapsed demand, is bad and getting worse. Unemployment is measured in several ways, ranging from those out of work and actively looking for it, to those

who are out of work and stopped looking, to those who are working part time but need to work full time, etc. The best of these numbers is now 9.8% and the worse of these numbers is in the high teens. The only cohort where the number of workers is increasing is the 55+ age group, where people are delaying retirement because they have to keep working. Youth unemployment exceeds 20%.

- With robust labor force growth and delayed retirement by those who can no longer afford to retire, we need to create something like 2.5 million jobs a year for the next five years to get back to a comfortable 5% unemployment. The peak rate of job creation between 2004-06, when housing was booming and creating jobs like never before, was an average of 2.2 million jobs created per year. In the last year, we have been destroying jobs at a rate of about 300,000 per month on average, and the 263,000 job loss figure for September is only a small improvement. So we have a huge employment challenge for the now upturning economy.
- I will not bemoan housing - you all read the papers. The facts are that the Case Shiller 20 City Housing Index has turned up for three months and, in the strongest cities, is getting back to the January 2009 level. However, in the worst markets – generally sandy places – the prices are still falling and, for roughly 25% of U.S. homes, the value is now below the mortgage. The most-scary statistic is the “shadow housing inventory.” This is mortgages which are five or more months past due; the most recent number is 6.7 million. If half of those are made current (probably wildly optimistic), the current rate of home absorption of about 500,000 per year will take 6.5 years to absorb the overhang, even if new housing construction stays at its current low level. (The demographics call for about one million new homes a year and we are currently building about 500,000 per year.) This oversimplified math would leave the market in 2014 with about an eleven month supply of houses for sale, versus a more normal seven month supply. If those seeking jobs can get jobs, the oversupply will be absorbed faster. But, on any broad brush calculation, excess houses will take a long time to work off.
- The final challenge is currency – the level of the Dollar relative to the currencies of our goods suppliers. We have exported many jobs. Ford and GM are still exporting jobs to Asia, even after their U.S. reorganizations. It will be very hard for us to lift our exports to the level needed for balanced world trade unless the Dollar is devalued significantly. A program of devaluation is made much more difficult by our need to borrow somewhere between \$300 billion and \$700 billion per year from foreigners. (The range is a function of both the size of our deficit and the amount funded by increased savings at home.) So long as we have that need, our actions must appear to support a strong currency. Foreign countries want to create jobs too, so they intervene in markets to keep their currencies cheap relative to the Dollar. A strong Dollar means weaker exports, fewer jobs, and a weaker domestic economy.
- We have major under-funded obligations in the future. Social Security, Medicare, foreign wars, and a new health program imply undiminished fiscal deficits. Our federal, state, and government agency debt is now about 90% of our gross domestic product. If you add personal and business debt we get to three times GDP. If we add projections of the funding short-fall for Social Security and Medicare, the total debt figure will be over ten times gross domestic product. We worry about our economy’s ability to carry debt, but do not have the political process to control it, especially at the Federal level. With this looming in the future, it will be hard to keep the confidence of our creditors. The risk of a collapse of the Dollar in 2010 is low, but not out of the question. We do not have the answer, other than holding some assets outside the Dollar, in all our portfolio styles.

Those are the major issues. The economy is recovering and there is powerful monetary and fiscal stimulus to keep it growing for awhile. In a recovering economy, the surprises tend to be in the favorable column. However, unless we can solve the jobs and housing and excess net import problems, the sustained recovery beyond 2Q10 will likely be much slower and more “downturn prone” than the recoveries we have enjoyed since WWII.

We continually think about these factors in structuring your portfolio. Despite the headwinds, we do see opportunities for all of our clients, from the most risk-averse to the most risk-tolerant, ranging from fixed-income proxies to emerging markets securities. Across the various SeaBridge styles, we have been reducing cash balances as we find appropriate, attractive investments.

While we are investing your assets in accordance with your choices among our investment strategies, we realize that we are only part of your overall financial picture. Let us know if we can do anything to help you keep your personal finances in good order as we continue through times like we have never seen before.

P.S. On September 29 and 30, Paul Volcker was a guest on Charlie Rose. You can see a replay at www.charlierose.com. I recommend it. For those without a computer connection, Paul says we need a very slow recovery, brought about by a substantially increased personal savings rate, and reduced government spending – and, if that is politically impossible, increased taxes. No surprise, but he is very wise and thoughtful.

Note: this is a copy of a quarterly letter sent to clients of SeaBridge Investment Advisors. It is presented in order to illustrate the current thinking of the investment manager. This does not represent an offer to buy or sell securities.

This letter discusses, in general, client portfolios. SeaBridge manages portfolios for clients in several different styles. Results for individual clients may differ. Results in the future are likely to be different. Please contact Susan Boyd if you wish to see more details on the after-fee returns for any of our investment styles. Please refer to the Form ADV Part II for SeaBridge Advisors LLC (or our website www.SeaBridge.com) for a complete fee schedule. The views presented here represent the opinion of Garnett Keith, Dave Descalzi, John Conti and Susan Boyd of SeaBridge Investment Advisors based on their analysis of publicly available information. The opinions of other analysts based on these data may differ. There are no guarantees that the expectations expressed here will be realized in the future.