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"Everything looks permanent until its secret is known."

This line from Ralph Waldo Emerson's 1841 essay "Circles" has been intruding into my thoughts over the year-end holidays. Except in moments of crisis, the immediate situation usually has an appearance of stability, yet, over any period of time, almost everything is changing and events are falling into a kaleidoscope of new relationships and "new stabilities." Emerson's essay has many complex themes, but one is man's limited perception of the world beyond his immediate vision and the extent to which our minds impose a stabilizing interpretation on an unstable and turbulent world.

In the short run, we are heading back to a world which feels familiar. Consumer spending has rebounded for the holiday season; production of goods and services is rising; employment statistics seem to have turned better; the fiscal compromise reached to continue the Bush tax cuts was a double win. First, it breeds hope that President Obama is becoming more supportive of business and more bi-partisan solutions may be within reach. Second, payroll tax cuts and bonus depreciation for investment give the economy a much needed fiscal stimulus to replace the run-off of the early 2009 stimulus package. This means that Fed Chairman Bernanke is getting the help from Congress he has been pleading for since mid-summer, and "quantitative easing" (printing money) by the Fed is not the only support for a faltering economy.

This new year-end pattern feels much better to savers and investors, and savers have begun to repatriate their savings from cash and bonds to equities. As equity prices rise, savers' sense of well-being increases further and that feeds into spending in a positive way. This virtuous circle could have a long way to run, and 2011 could be a very good year for both consumer confidence and equities. But this is where the Emerson quote keeps bursting in on my good feelings.

One secret we have learned since 2007 is that the spending boom of the past 25 years was fueled significantly by rising consumer indebtedness and importantly, by money extracted from rising home valuations on the assumption that home prices could be relied on to keep levitating. Unfortunately, housing remains sick, and the borrowing excesses of past decades are far from remedied. Even if the consumers' debt service commitments are now no greater a portion of income than they were ten years ago, this new "stable position" depends on interest rates remaining at today's unprecedented low levels. Hence future spending growth will not likely return to rates of the past decade, and could fall if interest rates start to rise.

A second "discovered secret" is that Federal debt, rising inexorably as we fight foreign wars without tax increases, has now skyrocketed to support a collapsing economy. The Bush Tax Cut extension adds trillions more in the next two years. State budgets are also seriously off balance for 2011. If our currency is not to lose value at an accelerating rate, we must stem the Federal and State fiscal hemorrhages. But special interest groups will fight that in every way possible. Do we have political leadership to deal with our over-spending before we have a Dollar funding crisis?

A third secret is that Europe's prosperity for 20 years has been based on a single currency and monetary policy, with fiscal judgments left to the individual member countries. If that single monetary policy was too stimulative for some regions – Ireland and Spain come to mind - bubbles can be a serious problem. In both the periphery (think Greece) and the core countries (think France), government promises on health care, pensions and required work weeks defy reality. In addition, profligate private spending in some countries built a gigantic pile of debt

obligations. French and German banks holding that debt are threatened. Their governments do not want to impose a government bailout of the banks on their taxpayers. Governments are now casting about to find some citizen-earner to pay the taxes to make good on questionable debt and excessive future welfare promises. The austerity programs being imposed on the weak countries will likely kill growth and reduce VAT tax revenues, undermining any hope of financial stability. There is no solution in sight so long as Germans resist paying the bill. With all this swirling around, Europe does not have even the short term appearance of stability.

So how does this all work out? We do not know. The "recovery equilibrium" feels familiar – even adjusting for the missing real estate construction sector, my memory says this is how recessions are supposed to end. But the now-known answers to secrets say there was no permanence in the prior homeostasis, and we cannot return. Moreover, governments cannot continue funding the illusions, indefinitely.

Imbalances (deficit spending, foreign borrowing, and currency interventions) have never been higher
Some countries are saving too much and lending savings to countries which are spending too much.
The U.S., U.K., and a few of the troubled European peripheral countries are over-spending, and China, Germany, Japan, and the Middle Eastern Oil producers are over-saving and over-producing. Focusing on the U.S. alone, to fund our Federal fiscal deficit, we are borrowing about $1.5 trillion per year. Half of this is funded by U.S. savers and half (roughly 5% of our GDP) is being borrowed from foreigners. At some point they doubt our willingness to control our spending and cease to lend us money.

Another form of imbalance is the extent to which Governments, led by the U.S., have reduced interest rates below the rate of inflation – a state referred to as negative real interest rates. This stimulates the economy, but is highly punitive to persons holding money market funds and Treasury securities. This lowers deposit costs and thereby enriches banks, whose profits need bolstering to help them absorb the mortgage defaults. At some point negative real interest rates become highly inflationary as people take money out of savings to buy things whose price is appreciating.

If the imbalances cannot continue to grow, how do they end? These are *uncertainties*, not *risks*. (*Uncertainties* are unknowns about which we can speculate, but there are no meaningful historical data to help us put odds on the timing and shape of the outcome. *Risks* involve probabilistic outcomes regarding events which fall into a normal bell curve distribution of outcomes. For *risks* we can marshal past data and get meaningful predictions of future outcomes. The late Herb Stein said, "That which can not go on forever, will surely end." That is about as accurate as we can get predicting the outcome of *uncertainties*.)

As fears of a double dip recession diminished, and hopes for quantitative easing increased, the markets did well in the fourth quarter. For the fourth quarter, the S&P 500 was up 10.76%, the broad U.S. market Russell 3000® Index gained 11.6%, the global MSCI World Index returned 8.8% and the MSCI World Index ex USA was up 7.25%. For 2010, the S&P 500 index returned 15.09 %, the Russell 3000® Index was up 16.9%, the MSCI World Index gained 13.2% and the MSCI World Index ex the USA was up 11.6%.[1] This let 2010 go into the books as a second year of solid gains, following the 2008 collapse.

Growth in the U.S. is looking better as we enter 2011, and equity prices are quite reasonable for the level of corporate earnings. Growth in the emerging markets looks even better, although inflation problems are widespread and many emerging market Central Banks are tightening credit to fight inflation. This will dampen their equity markets, but stock prices in most emerging market countries look attractive relative to the growth outlook for the next few years. The outcome in Europe is particularly hard to predict. However, many

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[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.

European companies invest heavily overseas, and a weak euro will boost their reported earnings. So what we have in Europe is high uncertainty.

We are investing in the belief the markets will avoid another panic in 2011 as the imbalances are addressed. But the answers to secrets revealed in the past three years give the current appearance of "a return to stability" a decidedly tentative tone.

Good wishes to all of you for the New Year,

Garnett L Keith

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 or interests in any fund.

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