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2012 has arrived, and, alas, the issues are largely unchanged. There is plenty to worry about. Specifically, there is too much debt to be repaid in the U.S., Japan, and Europe. But a “we will muddle through” outcome still seems most likely to us. The worries and reassurances line up as follows:

## Worries:

1. Europe appears to have solved the immediate debt roll-over problems of its banks, Italy, and Spain. But, the future solvency problems of both countries and banks look more daunting than ever. The currently proposed solution is widespread austerity. This kills growth and a recession in Europe seems unavoidable in 2012. (More below)
2. China’s tight money policy seems to have pricked its “major cities’ real estate bubble.” With exports to Europe slowing, can Beijing keep growth in the eight per cent range for 2012? We think so, based on China’s highly controlled financial system and \$3+ trillion in financial reserves. But others are doubtful, and we are watching developments cautiously.
3. U.S politicians fear they will not be reelected if they take the steps needed to bring our longer term fiscal deficits into balance. This is destabilizing and probably means that the short term deflation risk will translate into a longer term inflation risk in 2012-13. (Also more below)
4. In the next decade, a “world aging problem” is coming over the horizon. Countries representing 80% of world GDP (China, U.S., Japan and Europe) will have fewer workers relative to a growing number of retired citizens. This depletes savings and investments, strains retirement funds, and places government medical benefit programs in jeopardy. The net results are probably slower growth and rising interest rates as savings become more scarce.
5. The “Arab Spring” political changes are resulting in a rising influence by Islamic conservatives in almost all countries with deposed governments. While the eventual outcome is unclear, it seems unlikely that the resulting governments will be as inclined to look to the U.S. for leadership as were the deposed despots. The immediate risk here is that uncertainty in the Middle East raises the price of oil.

## Reassurances:

1. It appears that the European Central Bank will print money as needed to allow debt to be refinanced. This permits the slow and conflicted political process to seek minimally destructive modifications to the EU treaties. We are not optimistic that major debt write-offs can be avoided, but the resolution time looks like months rather than days. (More below)
2. U.S. corporations are in robust financial health. Profit margins are at record highs, and dividends and distributions of cash to shareholders are growing. Margins may contract in a slow growth world and taxes on companies or dividends will almost certainly rise. But for most companies and the employed, current conditions are not bad.
3. The U.S. economy appears to be accelerating gradually. Slowing exports to Asian and European countries with weakening growth will likely be a drag. Housing remains a serious weight on consumer confidence at home. But emerging market growth looks solid and the excess housing inventory will be eventually worked down. As time passes and China shows it can manage its housing downswing, the U.S. economy should be able to head back toward a more normal recovery.
4. Emerging market countries are growing three times as fast, on average, as the old leaders – the U.S., Europe and Japan. Many U.S. corporations are putting more and more emphasis on their investment and marketing programs in the developing world, and growth there will supplement weak growth at home. So the bad news of economic leadership passing to Asia is not necessarily bad news for our leading corporations.

We have been watching Europe carefully and have learned a lot more about the inner workings of the EU financial systems than we wanted to know. At the risk of telling you more than you want to know, let us recite the facts as we understand them. Essentially, inter-EU trade deficits are settled via “Target Balances” (TARGET is an acronym for Trans-European Automated Real-time Gross Settlement Express Transfer). When Mercedes makes a truck and sells it to a Greek olive oil processor, the credit whistles from the olive processor’s Piraeus Bank, through the Greek Central Bank and the European Central Bank, to the Bundesbank, where it rests as a credit available for Mercedes at its commercial bank. But, with Germany’s export boom and peripheral country (for example: Portugal, Italy, Ireland, Greece and Spain) excess spending, roughly 400 billion Euros of Target Balances have accumulated in the Bundesbank. These claims are now largely uncollectable. The Germans traded a good truck for uncollectable credit.

These E400 billion TARGET claims sit on top of whatever loans the German banks themselves made to Greek borrowers, plus the sovereign debt the German banks hold from other European countries (together about E500 billion.) They stand beside Germany’s own debt to GDP of 92% or E3 trillion, and beside the present value of German social programs’ future commitments of some E10 trillion. So with the TARGET claims in the front of the mind, and their questionable bank assets in the middle of their minds, and their government debt and commitments in the back of their minds, there is a near-unanimous political mind in Germany which says, “Not one more pfennig for these spendthrifts.”

So to stay in power, Chancellor Merkel has to come home from each EU crisis summit with a “not one additional pfennig committed” solution. Until the Brussels summit of 9 December, this intransigence had extended to not allowing the ECB to extend direct credit to sovereign countries. Much has been written about the December 9 outcome, the UK veto, etc. But the important result is that the ECB is now lending heavily to EU central and commercial banks, which are buying the sovereign and bank debt which must be rolled over in 1Q12. The ECB has already extended almost 500 billion Euros to banks since December 9<sup>th</sup>, and there are another 400 billion Euros in sovereign debt which must be rolled over in the next three months. As the deepest pocket standing behind the ECB, the Germans are getting hooked for many billions of pfennigs as this process rolls forward. But, it buys time for Europe’s leaders to try to find some acceptable solution to the problem. For the future, the beleaguered peripheral countries are supposed to suck in their belts, raise taxes and cut imports. Financial Times columnist Gideon Rachman has written, “Instead of funding more bail-outs the Germans want to impose their ‘culture of fiscal stability’ on the rest of Europe.” That philosophical transfer is problematical, to say the least.

Our conclusion is that, with the ECB printing money furiously, the EU will probably not blow up immediately – which had been our fear in the past 60 days. However, the “growth-killing austerity” programs are more likely to cause riots than make the struggling countries’ economies competitive, so sometime during 2012 a new solution will have to come forward. That solution will likely be traumatic for the EU, will probably deepen the EU recession, and could have backlashes on both Chinese exports and the world financial system. We are keeping our exposure to EU assets low.

Meanwhile, at home, the economic reports have been favorable. Consumer spending has exceeded income growth but, on that strength, the Christmas season was solid. Job creation news is a bit better. We will see how earnings reports come in for the fourth quarter; domestic business is solid-to-improving and we expect earnings from Asia to continue to grow while earnings from Europe will be weak. Money has continued to move from equities to bonds and from money market funds to bond funds. Until confidence is restored, that pattern is likely to continue even though many equities now have yields above bond funds. If one takes a modestly positive view of U.S. growth over the next few years, the returns from stocks appear very compelling versus bonds.

The long term inflation risk continues. With heavy debt and slow growth plus Europe joining the U.S. and Japan in printing money to finance deficits, the political solution points evermore toward inflation rather than increased taxes. We held gold in some of our investment styles during most of the year and replaced it with a Treasury bond ETF (a first time for us) in the face of the EU blow-up risk in December. We expect to reduce the Treasury ETF in those styles and replace it with gold as an EU solution becomes clearer. (Our thinking is that the U.S. Dollar is the flight to safety currency rather than gold, and in an EU blow-up the Dollar would rise and gold would fall. But the long term inflation risk is better hedged via gold.)

Our portfolios are positioned as described in our November letter. Our Asia strategy portfolios are in larger, stronger companies with good yields as China seeks to slow its economy – but not too slow. International portfolios hold significant bond and other defensive positions so long as money is flowing out of emerging markets (we have little motivation to try to pick stocks in Europe or Japan as they try to fix their internal problems.) Core Global portfolios are fully invested in companies which we think should do well in a slowly growing U.S. economy. (See the attached commentary by John Conti on this strategy.) Yield

Growth portfolios hold fewer equities than usual and more fixed income and other “reliable claims.” Cautious Core portfolios are “very cautious” right now with fewer equities than usual and more short maturity bond funds.

The “internal returns” from our companies (bond and dividend yields, plus returns on equity for companies retaining earnings for investment) appear to be quite attractive. We cannot be sure how the markets will respond in the face of needed European adjustments. (See below for a recap of how markets did in 2011.)<sup>1</sup> However, our expectation is that the world will muddle through, and the U.S. will do better than that. So, we advance into 2012.

Happy New Year and best wishes to you,

*Garnett 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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*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](http://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.*

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<sup>1</sup> For the quarter, the S&P 500 index returned 11.8%, the Russell 3000® Index was up 12.1%, the MSCI World Index increased by 7.3% and the MSCI World Index ex the USA was up 3.8%. For the year, the S&P 500 index had a positive 2.1% return, the Russell 3000® Index was up 1%, the MSCI World Index was down 6.9% and the MSCI World Index ex the USA had a negative 13.3% return.

*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.*

# *SeaBridge Investment Advisors LLC*

## **SeaBridge Core Global Strategy**

January 2012 Commentary

Amidst the specter of modestly accelerating economic growth, U.S. equities produced nothing more than extreme volatility in 2011 as sovereign debt woes shackled the stock market. In the short-term, it is possible that equities may continue to be extremely volatile as the European Central Bank (ECB) and the European fiscal authorities have not acted as decisively as bond investors would like them to have acted, thus keeping Italian and Spanish funding costs dangerously high. Nonetheless, we remain constructive regarding the intermediate-term outlook for U.S. equities based on an economy that seems to be gaining strength, and the potential for a demographically driven housing recovery to sustain economic momentum. Longer-term, we believe the abundance of natural gas that is being developed through shale fracturing in the United States has the potential to supercharge the economy.

The final revision to third quarter U.S. GDP was reported to have been a disappointing, but sequentially improving, 1.8% rate of growth. Economic data reported thus far in the fourth quarter, however, suggest that growth may have accelerated to as much as 3%. Importantly, growth may at last be strong enough to drive job creation to a level that can change the dynamics of the housing market. In recent years, we have developed the argument that the echo-boom segment of the population was rising in age to the point at which they will leave their nests and establish their own households. (See the attached illustration of that phenomenon). The demographics are unmistakable, but low confidence on the part of both mortgage borrowers and lenders, coupled with property appraisals below actual transaction prices have conspired to stifle the budding demand for housing. If the U.S. economy is, at last, creating jobs at a pace sufficient to tighten the slack labor market, then perhaps borrowers will find the confidence to take on mortgage obligations. The excessively conservative appraisal challenge will likely eventually equilibrate to a true market level after transaction velocity improves. When, as, or if the latent housing demand manifests itself, the U.S. economy has the potential to grow at a rate above 3% for an extended period of time. It is possible that this will occur in 2012.

In the past, we have made reference to the dramatically rising spread between the U.S. price of natural gas and the price of oil. The heat generating capacity of a barrel of oil (bbl) versus a thousand cubic feet of natural gas (mcf) suggests that a bbl of oil should trade at 5.6 times an mcf of natural gas. Historically, oil has typically traded in a range of 8 to 10 times natural gas. Recently, the price differential has dramatically widened to a multiple of more than 30! (See the attached graph). We think this exceptional price differential is the result of both geopolitical issues that have sustained a high price of oil, and the abundance of natural gas that has been developed through shale fracturing. We can't forecast political events, such as an attempt by Iran to disrupt the flow of oil out of the Persian Gulf, but we know with a high degree of certainty that shale fracturing has the potential to produce a lot more natural gas. Therefore, we think it is likely that natural gas in the U.S. will remain very cheap versus both oil, and natural gas in markets outside of the U.S.

Over time, if the cost of generating heat through natural gas remains substantially cheaper than through oil, then industrial companies, electric utilities and, ultimately, consumers have the potential to reduce their cost of energy by more than half, and potentially, as much as two thirds! Since the U.S. is years ahead of other nations in exploiting shale hydrocarbons, it has the potential to substantially reduce its cost of energy consumption, thus offsetting the cost advantage enjoyed by emerging economies due to lower labor costs. There are also favorable implications for consumer discretionary spending and, ultimately, the U.S. merchandise trade deficit. While there is currently a very limited capacity to compress natural gas into liquid form, within three to five years, the U.S. could be prepared to sell liquid natural gas into Asian and European markets where the price of natural gas is 3 to 4 times the price in the U.S. Furthermore, full exploitation of the shale resources in the U.S. would require a lot of labor and could serve as a source of job growth for many years to come.

While cheap natural gas has the potential to drive the U.S. economy to a new level of productivity, we must remember that this story would likely unfold over a long time frame. We think some benefit is likely within 3 to 5 years, but an export capability substantial enough to reduce the trade deficit is likely only beyond the 5 year horizon. In the short-term, geo-politics in general, and specifically, Iran, will determine the price of energy in the U.S. and around the globe. The price of oil may be the greatest risk facing equity investors in the coming year.

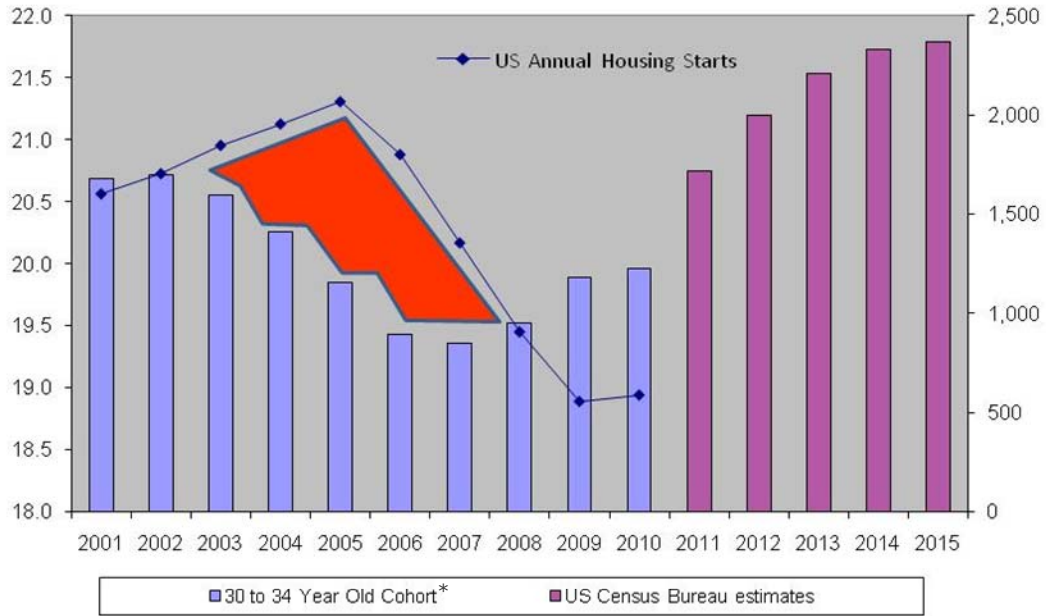
In addition to oil price risk, the European sovereign debt issue still lingers. It is also possible that bond market vigilantes will turn their attention to the profligate United States after the European issue fades from the headlines. Last, but not least, let's not forget that 2012 is an election year. As the Republican party decides who it wishes to oppose President Obama in November, public opinion polls regarding the likely winner have the potential to produce extreme stock market volatility.

John Conti  
1/6/12

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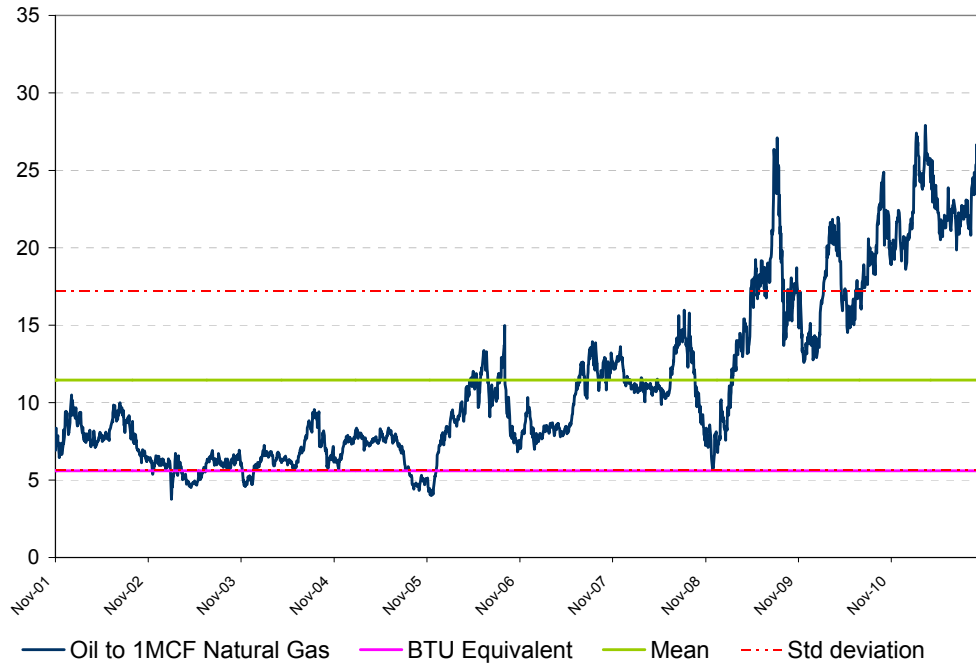
## Housing Demographics



\* The average age of the first-time home buyer is 30 to 34.  
The bars on this chart plot the size of the cohort over time.

Source : Bloomberg and U.S. Census Bureau

## Oil to Natural Gas



Source : FactSet, SeaBridge Investment Advisors