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Edited copy of letter sent to individual clients of SeaBridge Investment Advisors for the Second Quarter 2016.

"Should I stay or should I go?"

That song title from British band The Clash was present on the minds of all Britons on June 23 as they clashed at the ballot box on the question of whether to stay or leave the European Union (EU). A referendum on Britain's status within the Union was called to address a growing feeling that the UK had ceded too much of its sovereignty to the EU. While Scotland, Northern Ireland, Manchester and metropolitan London were strongly for remaining, almost all other regions voted for independence by wide margins. The "Leave" outcome has created a huge setback for European unity experiment conducted over the past four decades. Although markets dropped sharply the first couple of days after the shocking results (e.g. S&P 500 down ~5%), they made a strong about-face and have fully recovered as of quarter-end.

So far, even though equity markets have steadied, there has been a big impact of Brexit in the weakness of the pound and Euro against the dollar and lower interest rates generally. The assumption is that world growth will be slower, with the UK slowing significantly (possibly entering a recession). Europe will likely see a smaller slowdown, with a more limited impact in the U.S. In the long run, we think neither the long treaty renegotiation period nor the example of a member deciding to leave will be good for the EU. In the short run, the markets appear to have confidence that that Central Banks can increase support and avoid an immediate crisis.

How does the shock of the UK leaving the EU fit into the world as it existed on June 22, 2016? PIMCO, a prominent bond manager with a strong research capability, finished their annual outlook conference and published their report in early June. Their conclusion was that the world appears to be stable but it is not secure. The monetary easing by Central Banks which has kept world economies moving forward for the past four years is becoming less effective. China's policy transition is uncertain. Europe has growing internal frictions. Political gridlock and rising populism threaten stable governments. The "left tail risks" are larger than they were a year ago, and portfolio policies should shift in the direction of capital preservation. ("Left tail risks" refer to an increased proportion of unfavorable outcomes in future events.) Within the month BREXIT appears as an example of a "left tail event".

Notwithstanding an environment with heightened uncertainty, we believe the U.S. economy will continue to expand slowly. Unless there is some additional large shock from abroad, we believe the likelihood of the U.S. entering a recession over the next 12 months is low. This is due to a healthy consumer, a slowly accelerating housing recovery, stable corporate investment, and a recovery in fiscal spending. We see continued improvement in household financial positions driven by improving levels of employment and higher wages. Household finances have been helped by a modest debt pay-down and especially by the sharp fall in interest rates. We expect the housing recovery to continue. This is important and supported by a favorable demographic profile, good housing affordability, record low mortgage financing rates, and improving access to credit. Lastly, we expect fiscal policy to slowly shift from an economic headwind to a tailwind as state and local spending accelerates due to rising tax receipts driven by rising employment, wages, and real estate values.

After all the volatility the quarter ended with the S&P 500 up 2.5%, the Russell 3000® Index up 2.6%, the MSCI All Country World Index up 1.2%, the MSCI World Index ex the U.S. down 0.4%, and the MSCI AC Far East ex Japan Index up 0.2%. For the first six months of 2016, the S&P 500 was up 3.8% and the Russell 3000® Index was up 3.6%. The MSCI All Country World Index rose 1.6%, the MSCI World Index ex U.S. fell 0.7%, and the MSCI AC Far East ex Japan Index was up 2.5%.[1]

As PIMCO points out, the risks to our benign outlook are shocks which could come from unanticipated events. The loss of control of center-right and center left politics in the U.S. and Europe means that surprises are more likely. Our Presidential election campaign could cause a jolt to confidence. Overseas, the EU, Russia, the Middle East, China and Japan are all in various states of disarray. We are seven years into a recovery supported by an easy money policy which has driven an historic boom across the asset spectrum. Our 10 year Treasury bond rate has fallen to 1.40%, which is the lowest level sine 1912. But, in spite of the recovery for people of means, the middle class has not participated. There is a growing belief that monetary policy has done about all it can do to support our

[1] Results for these indices (S&P 500, Russell 3000®, Morgan Stanley Capital International All Country (MSCI AC) World Index, MSCI AC World Index ex USA and the MSCI AC Far East ex Japan Index) are quoted as being somewhat representative of the broader equity markets for comparison to SeaBridge U.S., global, foreign and Asian 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.

growth, and further support must come either from a rise in confidence in the electorate, or from infrastructure rebuilding programs from government.

As equity managers, we continue to evaluate investments which we believe will deliver attractive returns on capital. But we acknowledge that, with assets more fully valued relative to their yields and growth outlook, it is harder to find investments with more "upside than downside." Across most SeaBridge styles, we currently hold relatively high cash balances (although, due to client-specific factors, some accounts have lower levels of cash). This is both to dampen the volatility of portfolios and to have buying reserves if shocks take asset values down as they did last August and again in January. In examining companies, we continue to look for growing cash flow in the hands of management teams that we trust to work in the interest of shareholders. We believe diversification continues to be wise across asset classes and geographies. We have also begun working on new strategies to try to reduce volatility in portfolios if some of the "left tail risks" go critical.

Many of you received our June 27 "SeaBridge Thoughts on Brexit" e-mail and we appreciate the feedback you shared. The conversations are interesting and useful. Going forward, we can continue to e-mail our thoughts on significant events as they occur. We welcome comments on anything we can do to improve our communication with you.

You can contact Garnett Keith, David Descalzi, John Conti, Howard Chin or Susan Boyd if you would like to discuss your current portfolio. Bobby Henebry would also welcome a conversation with you on how your portfolios fit within SeaBridge's array of investment strategies and whether you would like to make any adjustments given the current environment or your changing circumstances. You can reach him at BHenebry@SeaBridge.com.

We hope you enjoy the rest of your summer plans, wherever your travels may take you.

Best Wishes,
Your SeaBridge Team

Note: this is a copy of a quarterly commentary sent to clients of SeaBridge Investment Advisors. It is presented in order to illustrate the current thinking of the investment manager and is for information only. It should not be treated as investment advice with respect to any potential investment.

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