SeaBridge
Investment Advisors, LLC

SeaBridge Cautious Core Strategy

Second Quarter 2018

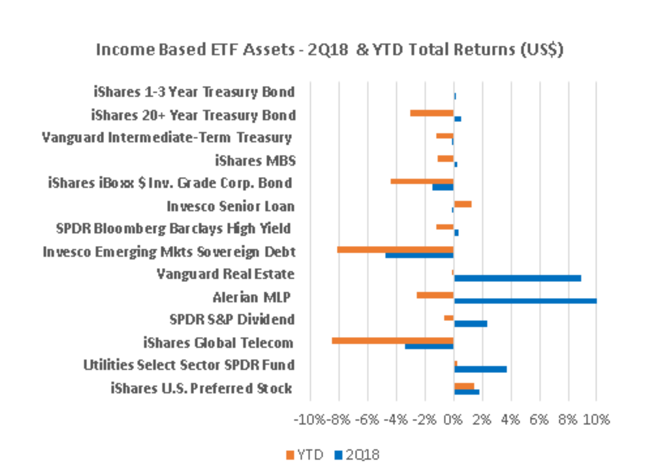
Fireworks started a little early this summer as escalating trade tensions between the U.S. and the rest of the world offset the positive momentum of the U.S. economy in the 2Q18. Trade tensions weighed heavily on asset prices around the globe. The U.S. stood out as a bright spot in the second quarter.

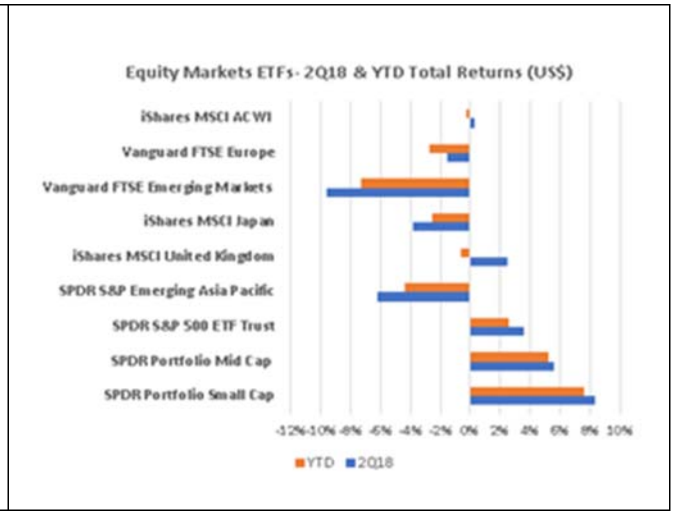
Market Results

The S&P 500 (SPY ETF) delivered a total 2Q18 return of 3.56%, while most international indices were negative. **U.S. Small Caps** (SPSM ETF) were up 8.31%, outperforming the U.S. large-cap multi-national proxy, the S&P 500, by 4.7% in the quarter. However, although small caps are seen to be less at risk from the impact of trade tariffs as well as benefiting more than large cap companies from the new tax code, they are not entirely insulated as they are customers to larger multi-nationals.

Emerging markets were hurt by the escalating trade tensions, strengthening dollar and ETF outflows. Not shown in the charts below, the Shanghai index has entered a bear market, down more than 20% from its high.

Income-based assets, such as dividend equities, MLPs, REITS, and Utilities rebounded nicely from a terrible first quarter. Most fixed income assets are still posting small negative returns YTD, reflecting the impact from rising interest rates. Bank loans with their shorter duration, floating rate nature, and higher correlation to economic growth have registered small gains YTD.





Source: Factset

Economic Environment

The U.S. economic cycle, in the ninth year of economic expansion, is experiencing broad-based growth that is fueled by tax cuts, deregulation, and capital expenditures investing. Although the economy may be long in the cycle on a historical basis, it has not displayed late cycle characteristics such as high inflation, elevated interest rates, or significant wage pressures. Profit growth trends remain stable and positive. Credit (i.e. businesses' ability to service debt) has not shown any signs of deterioration that usually occurs during the late cycle phase. Domestic sectors, fueled by a stronger consumer, continue to spur economic growth. Meanwhile, the U.S. labor market is strengthening and tightening as the unemployment rate hit 3.8% in May, the lowest since 2000. (In the latest report, unemployment notched back up to 4%).

Earnings should continue to provide valuation support to stocks. As they were in the first quarter, we expect 2Q18 earnings to be strong. Sales and earnings are expected to have grown 8.8% and 20.0% year over year, respectively. However, we think that CEOs who run global companies will be reluctant to issue strong forward guidance until global trades issues are resolved. Also, the rising dollar may also weigh on forecasts.

Global economic activity appears to have peaked with Europe, Japan, and China all experiencing deceleration in recent months. Inflationary pressures are starting to brew, which may act as a restraint on corporate profit margins and have prompted the Federal Reserve to continue to increase interest rates. The Fed could raise interest rates about five times through 2019 based on the most recent economic activity and inflation projection. It is also in the midst of a transition toward a less accommodative monetary policy stance through quantitative tightening. The move toward global monetary policy tightening is beginning to slow liquidity growth and should continue to result in higher volatility in the financial markets.

In addition, trade tensions between the United States and China continue to escalate. This has been the biggest source of volatility this year and a persistent counterweight to positive U.S. economic data. We think the probability of a full-blown trade war is low, but the risks are rising. We expect trade tensions are likely to get worse before they get better. Uncertainty caused by tariffs is likely to slow down the economy, freeze investment decisions by companies, and offset some of the benefits of the tax cuts. Until trade tensions are alleviated or resolved, we think the markets will be range-bound with risk to the downside.

Volatility is always unnerving, but we think our disciplined approach that relies on fundamentals will continue to benefit our investors. Our goal is to remain defensive and opportunistic to investing as we navigate a more difficult macro environment, characterized by stretched valuation across all asset classes, a shift toward less central bank support, and a potential rise in inflationary pressures.

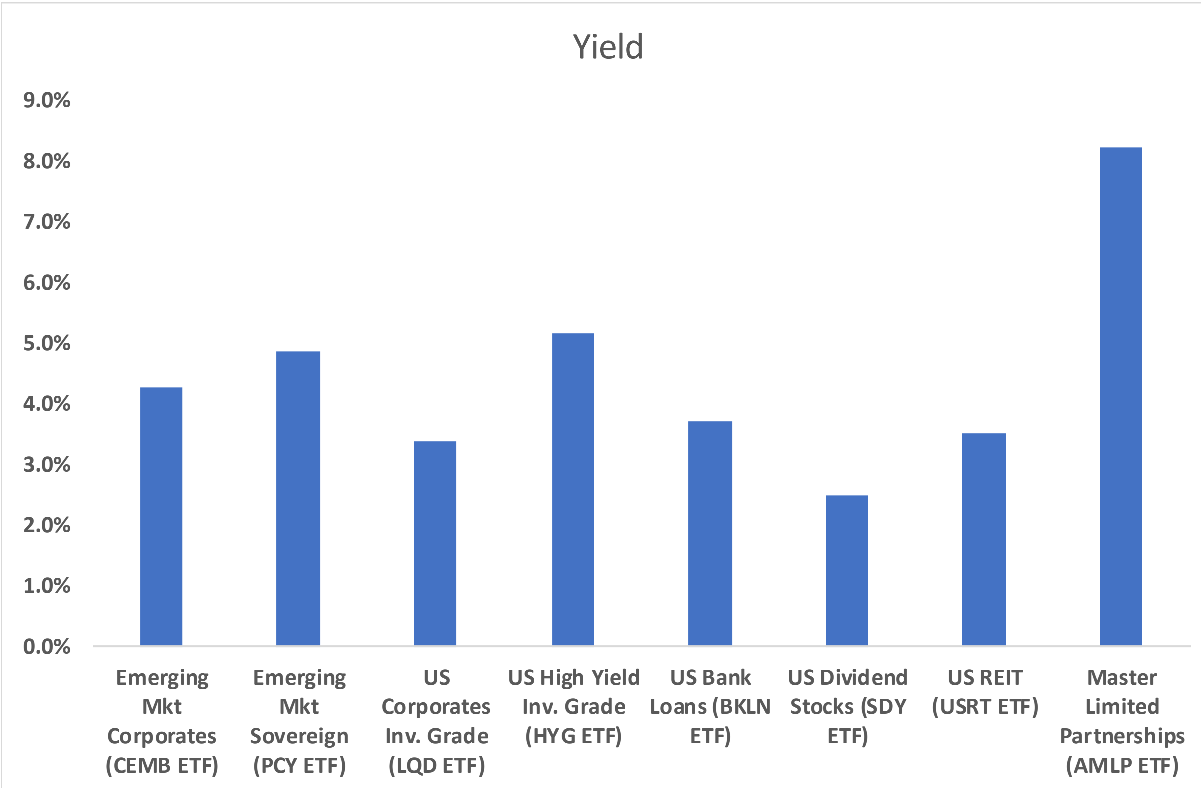
Positioning

We use diversification and income dampening assets (i.e. fixed income, closed-end funds, master limited partnerships, and other bond-like surrogates) to try to achieve lower volatility (historically, an annualized volatility of 6.2%) and higher income in the Cautious Core Strategy. The current yield for the Cautious Core composite portfolio is about 3.1% versus the S&P 500 (SPY ETF) yield of 2% and an investment grade bond index (LQD ETF) yield of 3.27%. We look to increase the yield of the portfolio as interest rates are expected to rise in the coming year.

In Cautious Core portfolios, we generally allocate 20-30% to cash and cash alternatives, 25-40% to fixed income and bond-like equities, and the rest to high-quality equities.

Our income-based assets in **bond-Like equities** --U.S. REITs (tower stocks and commercial and residential mortgages), Business Development Companies, and international commercial real estate-- and **MLPs** (Master

Limited Partnerships) offer not only a solid income stream but also some growth to offset the impact of rising interest rates. MLPs are one of the few asset classes offering attractive yields.



Source: Factset

Fixed income is approximately 46.6% of the portfolios, with 71% of that in short duration fixed or floating rate instruments. We initiated a position in the **iShares 0-5 Year High Yield Corporate Bond ETF (SHYG)** this quarter. **SHYG** (5.3% yield) offers exposure to short-term U.S. high yield corporate bonds, which are correlated to economic growth and less sensitive to interest rates. In the pursuit of protecting capital, our short duration fixed income holdings may provide a cushion during periods of market dislocation. Including cash, these income-based assets (**Bond-Like equities, MLPs, and Fixed Income**) make up 67.6% of the Cautious Core composite.

Equities make up about 33% of the portfolio. In equities, we heavily favor high quality companies that, in our opinion, can generate consistent free cash flow and dividend growth, have strong balance sheets to weather a downturn, and are less susceptible to the negative impact of higher interest rates. We use equities to primarily help grow the principal of the portfolio.

Thank you for your continued confidence in SeaBridge.

Happy Summer!

Howard Chin

7/6/18

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