

SeaBridge Yield Growth Strategy
Second Quarter 2018

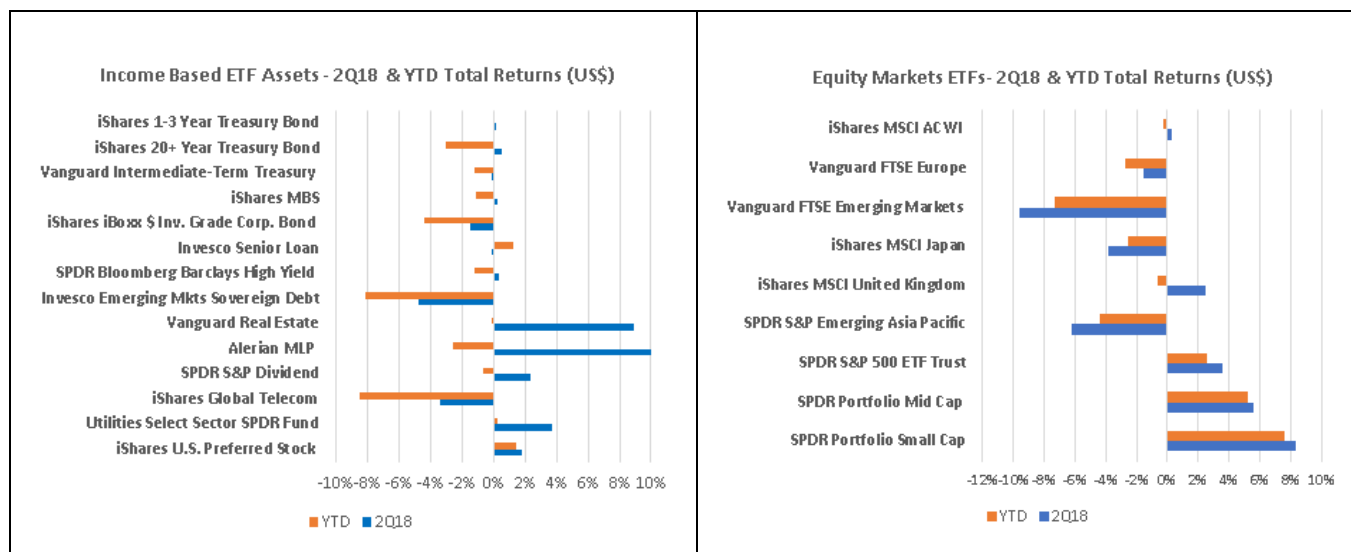
Fireworks started a little early this summer as escalating trade tensions between the U.S. and the rest of the world offset the positive momentum of the U.S. economy in the 2Q18. Trade tensions weighed heavily on asset prices around the globe. The U.S. stood out as a bright spot in the second quarter.

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.

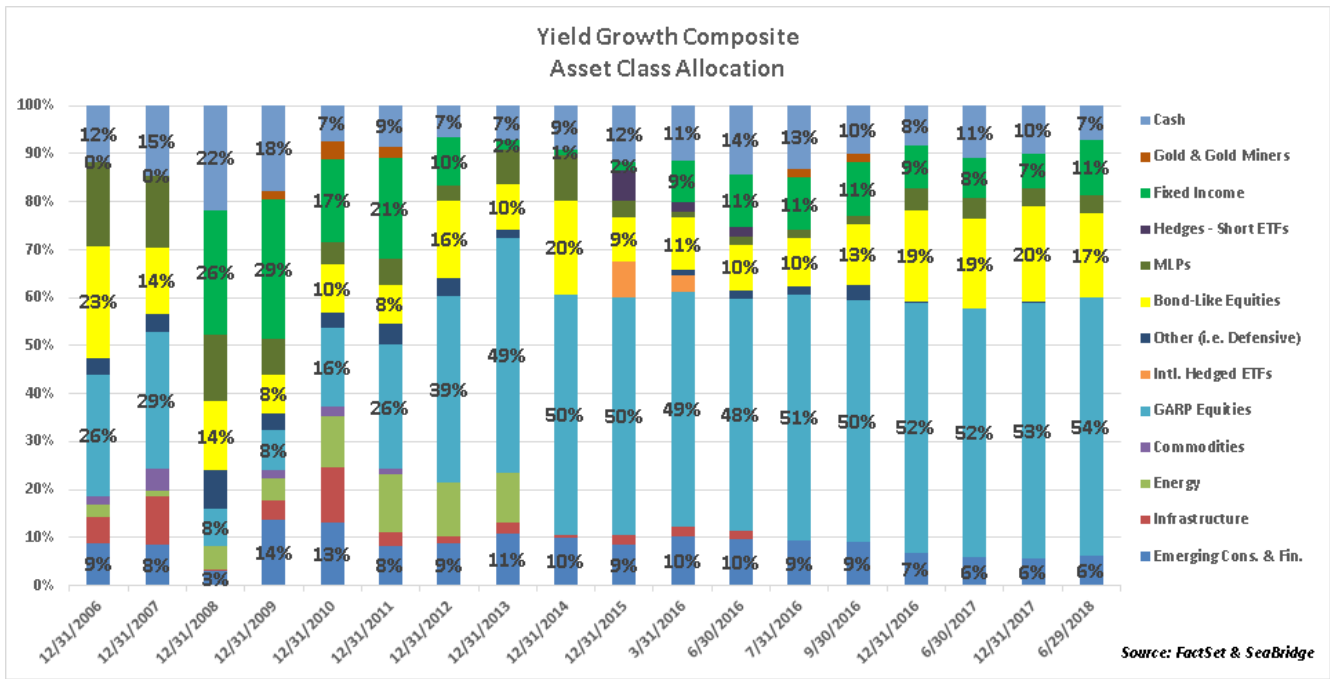
In addition, trade tensions between the United States and China continue to escalate. This has been the biggest source of volatility this year and a persistent counterweight to positive U.S. economic data. The probability of a full-blown trade war is low, but the risks are rising. We expect trade tensions 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

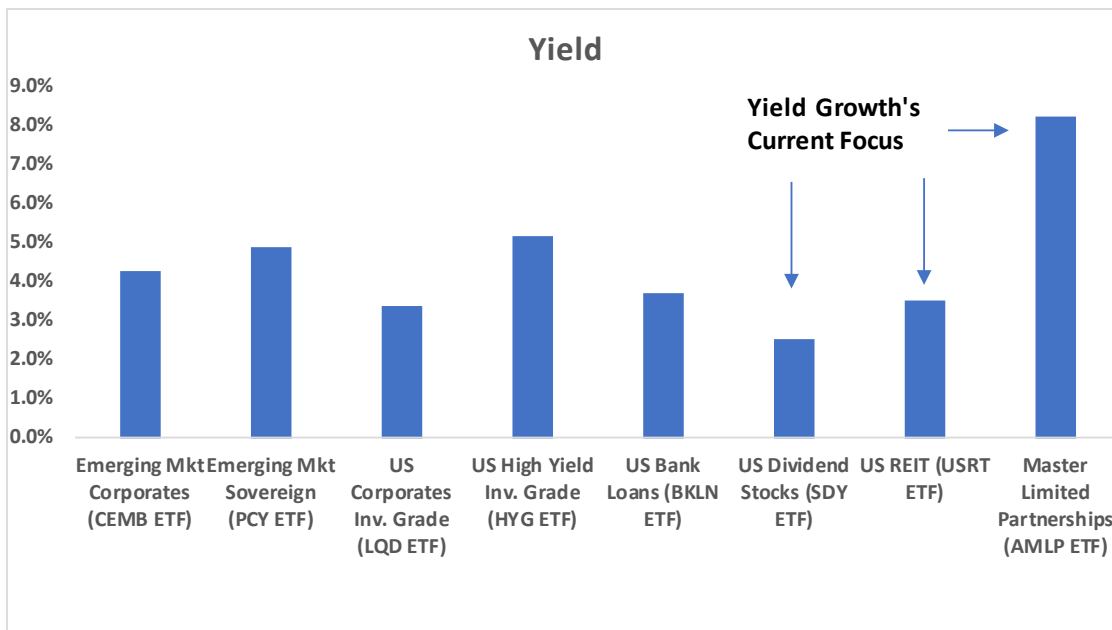
The objective of the Yield Growth strategy is to provide a total return over a full market cycle that benefits from global equity exposure but with dampened volatility, so that the risk of a major drawdown in value is less than that of the equity market. Of course, we cannot guarantee that we will achieve this objective.

In the chart below, we attached the asset allocation of the Yield Growth Composite. This chart shows the current allocation as of 6/29/2018, but more importantly, it also shows how the asset allocation has changed over the last decade in response to the investing environment.



The Yield-Growth composite is yielding 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. We have a healthy level of cash to deploy in certain yield names when the opportunity arises.

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 that are offering attractive yields.



Source: Factset

Equities make up about 53% 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.

We still prefer **bond-Like equities** and **high quality equities** over **Fixed Income** for this strategy at this time of the cycle. **Fixed income** is approximately 11% of the portfolios, with 50% of fixed income in T-Bills and short duration instruments. Including cash, these income-based assets (**Bond-Like equities, MLPs, and Fixed Income**) provide some defense in a market downturn and make up 40% of the Yield Growth composite. Our international exposure is 19.6%, but may be reduced if trade tensions and/or a stronger dollar lead to a risk-off environment.

Portfolio Activity

During the quarter, we initiated starter positions in **BOC (Bank of China) Aviation (HK 2588)** and **Singapore Tech Engineering (STE SP)**.

BOC Aviation is the #1 ranked aircraft lessor (in terms of value of owned aircraft) in Asia. The company (originally called Singapore Aircraft Leasing Enterprise) was 100% acquired by Bank of China (BOC) in 2006, and went public in Hong Kong in 2016. BOC remains the controlling shareholder of the company with a 70% stake. BOC Aviation mainly acquires aircraft from OEMs (Boeing and Airbus) and places aircraft on long-term operating lease contracts.

We think BOC Aviation is a solid way to play the growth market for aviation in the Asia Pacific region. The company has a visible growth of pipeline of aircraft deliveries that is supported by a well-funded A- rated conservative balance sheet (vs. BB- to BBB for U.S. listed peers). The yield and growth forecasts are also very attractive. The company earnings are projected to grow 12% in the next 4 years and the stock has a healthy dividend yield of 5%-5.5% (30-35% payout of earnings).

ST Engineering is a Singaporean conglomerate (market cap of \$8 billion and a dividend yield of 4.1%) that operates in four areas: aerospace, electronics, land systems, and marine sectors. Earnings growth has been underwhelming for the last four years primarily from cost overruns in its Land Systems business (i.e. Military vehicles) and weak demand in the marine business (i.e. ship building). These two areas make up 28% of sales, but only 14% of EBIT.

Meanwhile, earnings prospects are beginning to turn more favorably in the aerospace unit. ST Engineering is one of the largest aerospace Maintenance, Repair, and Overhaul (MRO) providers in the world and a major player in passenger to freighter conversions (PTF). These two areas are benefiting from passenger traffic growth and e-commerce/global trade. Other growth areas include electronics solutions (Singapore \$2.2 billion of new orders in F2017), where they are focused on transport, satellite communication services, and smart city infrastructure. Aerospace and Electronics make up 68% of sales and 85% of EBIT. We get a high quality (ROE of 23% with room for improvement) and fairly defensive holding in **STE SP**, with an earnings recovery story, while trading at what we think is a reasonable valuation of 18x next year's P/E.

We also initiated a position in the **iShares 0-5 Year High Yield Corporate Bond ETF (SHYG)**. 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.

Thank you for your continued confidence in SeaBridge.

Happy Summer!

Howard Chin

7/9/18

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