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Edited copy of letter sent to individual clients of SeaBridge Investment Advisors for the Third Quarter 2017

Global equity markets were mostly strong in the third quarter of 2017, continuing the trend experienced in the first half of the year. Asia Pacific and many emerging markets set the pace. Among the major markets, Hong Kong led the pack with an 8.6% return in the quarter and 28.9% YTD. The U.S. also advanced an impressive 4.5% during the quarter, which brings the tally for the first nine months to 14.2%. Within the overall U.S. market, growth strategies were the better performers, while value strategies lagged. Very late in the quarter, however, value seemed to recoup some relative performance. We attribute the reversal to a rebound in interest rates.

As in the first half of the year, we attribute the strength in global equities to a continued outlook for improving earnings growth. Corporate earnings growth, in turn, is likely attributable to a synchronized global recovery that shows signs of acceleration. At the margin, however, many new variables came into view during the third quarter based on a cacophony of information with which investors were confronted.

In the U.S., economic activity was clearly accelerating in the third quarter until growth was partially impacted by the series of hurricanes that devastated first Houston, then Florida and the Caribbean islands, and then Puerto Rico. While these events will likely impede economic activity in the short term, we believe the structural investment that will be required due to the damage from the storms will likely result in increased economic activity over the long run. That's the economic perspective. On a more personal level, the team at SeaBridge would like to express our heartfelt sympathy for our many friends who were affected by the devastation.

On the political front, deep political division has slowed the legislative process. Health care reform failed to find its way into reality despite several attempts. Trade bills are being renegotiated, but no final agreements have been reached. An infrastructure bill and the repatriation of overseas funds have been put on the back burner. Taxes are now front and center in Washington. The Administration has advanced an ambitious tax reform proposal which, by some very speculative estimates, could add up to $2.2 trillion to the ten year deficit. While some provisions may be positive for business, we cannot pass judgment on the bill until we see the details on provisions addressing expensing and the deductibility of interest. Given the track record in Washington thus far under the Trump administration, we would have to assign a relatively low probability to the passage of a comprehensive tax bill.

Despite the continued lack of progress regarding fiscal policy, during the third quarter monetary policy experienced a seminal event. With little fanfare, on September 20th, the Fed's Federal Open Market Committee (FOMC) announced the beginning of the end of quantitative easing (QE). As we have noted in past commentaries, QE has been an important driver of the exceptionally low interest rates experienced in recent years. Moreover, we believe low interest rates have been a primary factor in reducing stock market volatility to a near record level of calm. Astute market observers will know that the S&P 500 has not suffered a price correction of more than 3% thus far in 2017. This is very unusual! By ending QE, the Fed is essentially reducing the size of its balance sheet. The process of disgorging Treasury and mortgage backed securities to reduce the Fed's balance sheet will likely put upward pressure on long-term interest rates, which is likely to persist for several years. It is possible that stock market volatility will increase substantially as interest rates rise. In addition, price-to-earnings ratios (P/E) may compress as interest rates rise. Essentially, as interest rates move higher, the present value of future cash flows decline. To continue advancing in a declining P/E environment, earnings growth will need to accelerate to keep equity prices from declining.

In addition to P/E multiples, rising interest rates will put upward pressure on the value of the dollar against other currencies. In particular, we are monitoring the value of the dollar vs. the euro. The European Central Bank (ECB) has been implementing its own quantitative easing program. As a result of the ECB increasing the size of its sovereign bond holdings, European interest rates have plunged into negative territory. As the U.S. Fed shrinks its balance sheet, the ECB may also take the opportunity to begin curtailing its accumulation of bonds and, ultimately, reduce the size of its balance sheet.

In Germany, Angela Merkel was recently elected to a fourth term as Chancellor of Germany. In this election, however, her party gave up seats in the German Parliament to the right wing, which follows the populist trend we've already witnessed in the U.S. and Great Britain. From an economic perspective, this shift to the right in Germany has significance for European monetary policy. The Deutsche Bundesbank (German central bank) has been steadfastly opposed to the quantitative easing undertaken by the ECB. Nonetheless, Mario Draghi (head of the ECB) had made a compelling case that QE was necessary to keep the Euro Zone from slipping into a devastating deflation. Draghi won and QE has been open-ended since the end of 2014. The German shift to the right may cause the ECB to reverse QE sooner than they would like. While this may be an unwelcome development for European equities, in general, European banks should flourish as they have had a challenge earning adequate returns on capital with negative interest rates.

Clearly, Asia was a bright spot in the quarter. Led by China, Asia's equity markets, like most emerging markets, turned in a strong performance during the quarter. The Shanghai composite continued its recent run posting strong gains in the quarter. The impressive market advance represents a significant turnaround in sentiment surrounding Chinese stocks. Recent strong economic performance has been the most important catalyst for the Chinese market. Data from key areas of the economy including industrial production, retail sales, corporate profitability and exports have shown improvement in the quarter and exceeded expectations. Although China's is the region's most important economy, economic data are improving throughout Asia.

The Asia investment case is a long-term story. There is no better justification for our commitment to the region than its superior demographics, which can be summed up by the following statement. According to a Brookings Institution forecast, of the 2.4 billion people expected to enter the middle class between 2015 and 2030, 2.1 billion will come from Asia. Of the US$29 trillion of incremental consumption this new middle class group represents, US$24.3 trillion will be spent by Asians. SeaBridge has invested in the region for many years and continues to believe that Asia will be an important investment destination for years to come.

Despite our optimism about the region, we must make note of the threat posed by North Korea. We have no greater insight into this issue than what is currently being analyzed and debated in the media. We'd like to think that there is too much at risk for the U.S. to intervene militarily. We may be wrong. Let's hope that cooler heads prevail and a diplomatic solution found.

With best regards,

Your SeaBridge Team