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For the first nine months of 2018, U.S. equity markets were up across the board (Large Cap, Small Cap, Growth and Value), while most of the global markets were flat to down. The U.S. markets have been fueled by strong GDP growth and corporate profits. While trade tension was a dominant theme in the third quarter, U.S. investors appear to be less "tariffied" on expectations that the U.S. economy is strong enough to be able to absorb the negative costs of tariffs. However, a confluence of worries, from weaker growth to trade wars to Italy, have weighed on non-U.S. markets. U.S. dollar strength has also caused pain in the emerging markets. Argentina is in crisis mode. China's Shanghai Index tumbled in the 3Q and is down for the year due to a slowdown and trade dispute. Yields in the U.S. are up, with Treasury yields at 3.06% by the end of the quarter.

Year-to-date, Information Technology, Consumer Discretionary and Healthcare (comprising 54% of the S&P 500 before the sector realignment) are outperforming the remaining sectors by a very wide margin. Bond-like proxies, Consumer Staples and Telecommunications are still down for the year. However, 3Q18 performance was more balanced among both cyclical and defensive sectors, with all 11 sectors posting positive returns. The run up of technology stocks has been very strong in the last few years, but we do sense some fatigue in the space. Technology darlings such as Facebook disappointed and plummeted on weak margin guidance while Netflix crumbled on weak subscriber growth targets. Other technology companies outperformed expectations, but still sold off as forward expectation may have been priced in, a sign that investors are beginning to rotate away from high priced growth names to areas of greater value such as healthcare, financial and industrial names.

U.S. economic data is showing considerable strength and resilience though concerns about trade, global growth, and politics have tempered positive sentiment**.** Second quarter gross domestic product (GDP) was revised upward to 4.2%. The August's employment report remained solid with unemployment holding near cycle lows and wage growth of average hourly earnings (2.9% year over year) hitting the highest level since May 2009. In quarterly conference calls, some CEOs highlighted tight labor markets and difficulty in finding qualified workers. Purchasing Manager Indices from the Institute of Supply Management (ISM) in both manufacturing (the August index of 61.3 was the strongest reading since May 2004) and non-manufacturing sectors also strengthened. Animal spirits are roaring in small businesses as the small business optimism index (NFIB index) rose to 108.8 in August, a new record in the survey's 45 year history. Housing and auto sales are the relative weak spots in the economy.

The U.S. consumer is still the engine of growth driving the economy, fueled by a strong job market, lower taxes, and household income gains. U.S. consumer confidence is near an 18-year high. Latest retail spending was healthily up 6.6%, outpacing the rate of inflation. Brian Cornell, CEO of Target, highlighted the strength of the U.S. consumer in its 2nd quarter earnings call: **"***There's no doubt that, like others, we're currently benefiting from a very strong consumer environment — perhaps the strongest I've seen in my career***."**

Top line earnings growth continues to support higher equity prices. Organic growth, which has only picked up in the last year and a half, continues to surprise to the upside. Pricing has also been strong, but primarily as a response to higher input costs. In the second quarter, S&P 500 sales and earnings increased 10% and 25%, respectively, on top of first quarter sales and earnings growth of 8.6% and 25%, respectively. The remainder of the year also looks strong. Third and fourth quarter year-over-year sales are projected to increase 7.2% and 6.1%, respectively, while third and fourth quarter earnings are estimated to rise 19% and 17%, respectively, according to FactSet.

Along with organic growth and lower taxes, share repurchases have surged to drive earnings growth this year. Increased cash flow from lower taxes, cash repatriation, and low interest rates are fueling the buyback binge. According to a Bloomberg article, Goldman Sachs estimated that share buybacks increased by 48% to $384 billion in the first half of 2018, topping the capital expenditure of $341 billion, which also grew at a healthy pace of 19% year over year. The majority of the buybacks have come from mega-cap multinational companies in the technology and health care industries. Goldman Sachs estimates buybacks to exceed $1 trillion by the end of this year.

Increased trade tension, political discord, retreating capital flows, higher U.S. rates, and a stronger U.S. dollar are driving the divergences between U.S. market and emerging markets (EM). The last time we experienced this wide divergence between the U.S. and EM occurred during mid 2014 – 2/2016. During that time, China's plan to deleverage the economy slowed economic growth more than expected. The Yellen Fed was on a path of normalization and the strengthening dollar created stress points for EM. While the U.S. market was resilient relative to the rest of the world, the economy experienced a profit recession (oil and industrial sectors got hit hard) as the result of dollar strength, China slowdown, and a severe drawdown in energy prices hurting highly indebted companies involved in the shale industry. Since inflation was below target and economic growth was anemic, the Fed eventually backed down from interest rate normalization. China unleashed stimulus in early 2016 and the dollar weakened, providing a backdrop for EM and commodities to recover.

The main difference today is that the U.S. is experiencing a profit resurgence driven by fiscal stimulus. Inflation is also making a comeback. The Powell Fed is operating in a very strong U.S. economy and is on a path to normalizing rates. We do not expect the Fed to change its course of tightening unless EM volatility impacts the U.S. market and/or the U.S. suddenly hits a soft patch from escalating trade tensions. Without the Federal Reserve backing off and coming to the rescue, this scenario leaves some emerging markets very few options but to make difficult internal policy decisions. While the volatility from EM has so far been contained to a few countries, we do think the real risk to emerging markets is a more sustained slowdown in the Chinese economy (not our base case scenario). Although volatility is likely to persist in emerging markets, we think the current situation is also creating divergence between price and value at the company level. In some of our portfolios, we are beginning to nibble in good companies with exposure to these markets at what we believe to be temporarily depressed prices.

Although the U.S.-China trade relations appear to be escalating based on current and threatened tariffs, global markets have reacted to the latest trade development with relative calm. The Trump Administration imposed a 10% tariff on $200 billion of Chinese goods, a rate that was actually lower than what the market had feared. That 10% could turn into 25% by year end, leaving investors with some hope that both parties would resume negotiations before higher tariffs kick in. As expected, China retaliated on tariffs on $60 billion of U.S. goods. Since a trade war is in no one's interest, we believe that the tough rhetoric and current tariffs are strategies directed ultimately at reducing unfair trade practices and protecting and enforcing U.S. intellectual property against China. That scenario of open trade, if it comes to fruition, would be positive for global growth, in our opinion. Unfortunately, getting to that goal will likely be difficult and unpredictable, especially with the upcoming midterm elections and President Trump having to prove to its base that he is making progress on the trade front.

Although recession risk now appears quite low, 2019 may present a more challenging economic and market environment. Monetary policy around the world is likely to continue to be less accommodative. Uncertainty in monetary tightening policy and inflation are expected to continue to weigh on risk appetite. Inflation is slowing brewing and is, in our opinion, the biggest threat to U.S. equity markets outside of an escalating trade war. We note that the market took a dive in early February after a hot inflation data point. Unless we get some productivity growth, inflation may force the Fed to become more aggressive in taking interest rates higher than current expectations. Earnings growth and dividends are now the key drivers of returns going forward and may need to offset a potential compression in P/E multiples from higher interest rates.

SeaBridge's goal is to deliver high quality investment management services to its clients, providing access to investment opportunities which fit within their target asset allocation and meet their needs. SeaBridge investment strategies are grounded on macroeconomic analysis of global markets and economies and fundamental analysis of individual businesses with risk mitigation in mind. We have managed our strategies this way through many macroeconomic scenarios since SeaBridge started in 1997.

We thank you for investing alongside us in our SeaBridge strategies.

With best regards,

Your SeaBridge Team