SeaBridge Investment Advisors, LLC

SeaBridge Core Strategy

Third Quarter 2017
Commentary

With little fanfare, an historic event in the annals of monetary policy occurred late in the third quarter. On September 20, 2017, the Federal Open Market committee (FOMC) announced the beginning of the end of quantitative easing (QE-see footnote 1). As we have noted in past commentaries, QE has been an important driver of the exceptionally low long-term interest rates experienced in recent years. Moreover, we believe low interest rates have been a primary factor in reducing stock market volatility, which has contributed to over-valuation in stocks of companies that produce either stable revenue growth or high revenue growth. This, in turn, has resulted in a momentum-oriented stock market in which the stocks that are doing well continue to do well irrespective of valuation. The primary difference between active equity management and passive equity management is that the former makes some sort of valuation judgment whereas the latter does not. Since companies are weighted in index funds as a function of their market capitalization, as investors withdraw money from active management to invest in index funds, expensive stocks become increasingly important to an index's performance and propel the indices higher. This self-fulfilling dynamic causes active equity managers to underperform index funds, which has certainly been the case in recent years.

As we learned from Isaac Newton's Third Law of Motion, every action has an equal and opposite reaction. Collectively, the FOMCs three rounds of QE have increased the Fed's balance sheet from $900 billion to $4.5 trillion (see addendum). This has had the effect of removing Government and Agency securities from the competitive funding markets, thus reducing long-term interest rates. With the FOMC now officially in the mode of disgorging securities, interest rates will likely begin to increase slowly. The FOMC has gone to great lengths to assure investors that they will shrink their balance sheet as slowly as needed to maintain stability in the capital markets. Nonetheless, with an increasing supply of Treasury and Agency securities coming onto the funding markets as the Fed regresses back to a more normal balance sheet, absent a disaster that results in a flight to safety, the direction of interest rates should be up. In effect, just as Newton's Third Law of Motion explains lower interest rates as the Fed accumulated securities, higher interest rates should be the result of disgorging securities. Concurrently, expensive stocks should give way to cheaper securities as higher interest rates reduce the present value of future cash flows. If our hypothesis regarding active vs. passive management is correct, as interest rates rise, momentum driven index funds should give way to active managers. Indeed, as interest rates have risen modestly in recent weeks, our Core Global strategy has performed better than it did in the second quarter and the beginning of the third quarter.

If we're correct in our assertion that low interest rates have reduced volatility in equity markets then, as the Fed shrinks its balance sheet and interest rates rise, stock market volatility should increase. From the perspective of an active manager, market volatility represents an opportunity to invest in the shares of companies that temporarily become undervalued. As in the past, we welcome such opportunities to invest our cash reserves. Of course, we're not waiting around for stocks to become mispriced in a more volatile market. Despite the generally fully valued market we've experienced throughout 2017, we have been able to make equity investments in companies that we believe offer the prospect of a favorable reward for the perceived risk taken. In fact, we have invested excess cash reserves at a pace of two companies per quarter. In the third quarter, we added investments in Seagate Technologies (STX) and Deutsche Bank (DB).

Seagate is a major player in the highly consolidated hard disk drive (HDD) industry. The primary competitors are Western Digital and Toshiba. Artificial Intelligence (AI) will likely become one of the more important applications of information technology in the years to come. AI is a highly data intensive technology. Essentially, an AI engine, such as IBM's Watson, gathers data and applies algorithms to find patterns. The more data that can be gathered, the more useful the algorithms become. Along with gathering data comes an exponential need to store data. The two primary tools for storing data are semiconductor based devices and hard disk drives. With its strong market presence in the HDD industry, we believe STX offers a reasonable opportunity to participate in the high growth data storage industry. Moreover, Seagate trades at a modest multiple of 9 times earnings, and consistently returns capital to shareholders through a substantial dividend yield plus a strong share repurchase program.

Deutsche Bank may be the cheapest stock we've found since the years immediately following the financial crisis. DB is Germany's flagship bank with a strong presence in its home country, Europe overall and the United States. It presently trades at less than ½ of book value and has a Tier 1 capital ratio that is higher than most US banks. As interest rates in the U.S. rise as the FOMC unwinds QE, the European Central Bank (ECB) should feel more comfortable ending its quantitative easing program, which succeeded in driving European interest rates below zero. As rates go from negative to positive in Europe, Deutsche Bank should have fertile ground to put its excess capital to work and improve profitability.

In our last commentary, we noted that our three retail stocks were under review. During the third quarter, we eliminated our position in both Urban Outfitters (URBN) and Bed Bath & Beyond (BBBY). We have decided to keep Coach (COH) for now.

Although both URBN and BBBY are cheap stocks, we are concerned that the retail sector may be structurally impaired. Of course, Amazon is an issue, but both URBN and BBBY have a competitive e-commerce platform and are arguably better equipped than Amazon to compete in an environment characterized by "bricks and clicks." Indeed, Amazon's recent acquisition of Whole Foods demonstrates that a combination of physical store foot print combined with a strong on-line presence is the winning formula.

Our comment about possible structural impairment of the retail sector again harkens back to Newton's Third Law of Motion; every action has an equal and opposite reaction. In this case the action is the never ending increase in the cost of health care in the form of insurance, co-pays and deductibles. As health care costs have grown at a rate well above wage growth, consumers are reacting by curtailing discretionary spending, such as the merchandise found at BBBY and URBN. We continue to hold Coach, however, for three reasons: 1) Coach has a strong brand, 2) its target customer likely has an income that is high enough to minimize crowding-out by health care, and 3) Coach is has a strong presence outside of the United States where the health care issue is not a factor.

As always, we remain patient and disciplined as we look for opportunities to invest your assets.

John Conti
Angell Xia
10/2/17

Footnote 1

For those who don't spend every waking moment thinking about monetary policy, we offer the following simple recap of the concept of quantitative easing and some related data (see addendum). QE was an important element of the Federal Reserve's (FEDs) plan to keep capitalism from sinking into an abyss following the credit crunch in late 2008. During normal economic conditions, the Fed acting through its FOMC controls liquidity in the banking system through the purchase or sale of mostly short-term Treasury securities with a goal of adjusting short term interest rates. Bank liquidity, in turn, determines the amount of loans that can be introduced into the economy. After Lehman Brothers failed in 2008, a major money market fund failed to maintain a net asset value of $1 per share. A financial panic ensued and the credit markets quickly went dry. As loans defaulted at an increasing rate, banking system capital declined precipitously and the U.S., and indeed the world, economy began to spiral into a debt collapse. In an attempt to reverse the direction of the debt collapse, Ben Bernanke, then Chairperson of the Federal Reserve and its FOMC, began buying Treasury and Government backed mortgage securities in an attempt to improve bank liquidity and provide capital to the mortgage market, as well as other asset backed securities markets. Rather than focusing on short term interest rates, the Fed's goal in implementing QE was to target supply of money. Effectively, the Federal reserve and the FOMC circumvented the banking system. The act of buying longer-dated Treasury securities was termed quantitative easing. A fuller description of the history of QE post the credit crunch is contained in the 4th quarter 2015 commentary, which was published in January 2016 and is available on our web site www. Seabridge.com.

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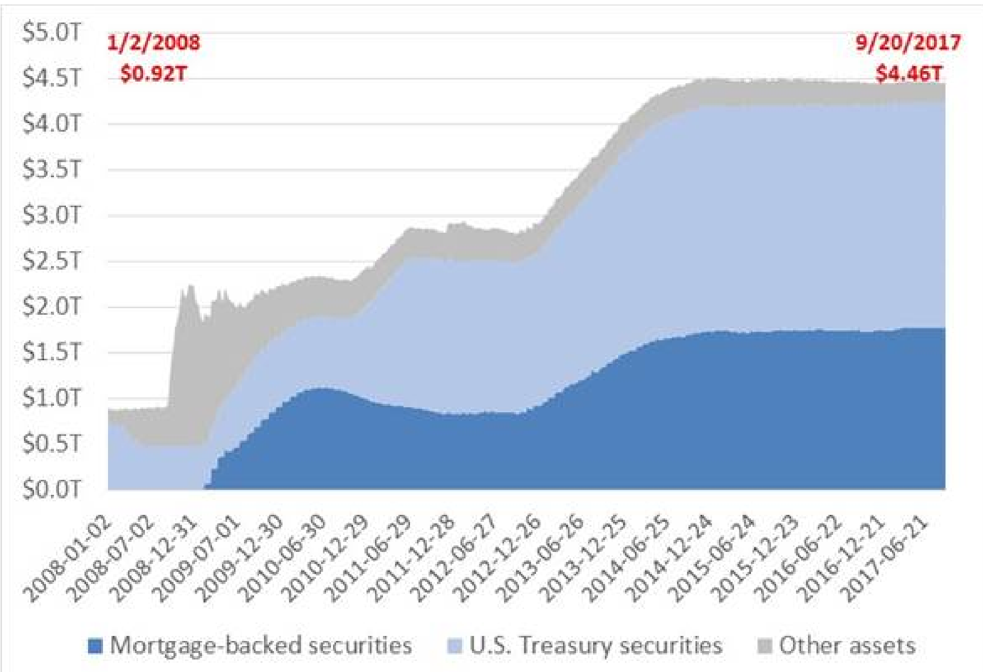
Addendum

1. What was the size, composition and maturity distribution of the Federal Reserve's balance sheet before quantitative easing began? What is the current size, composition and maturity distribution of the Fed's balance sheet?



U.S Treasury securities held on Fed's Balance Sheet by maturity as of 1/2/2008

U.S Treasury and Mortgage-backed securities held on Fed's Balance Sheet by maturity as of 9/20/2017

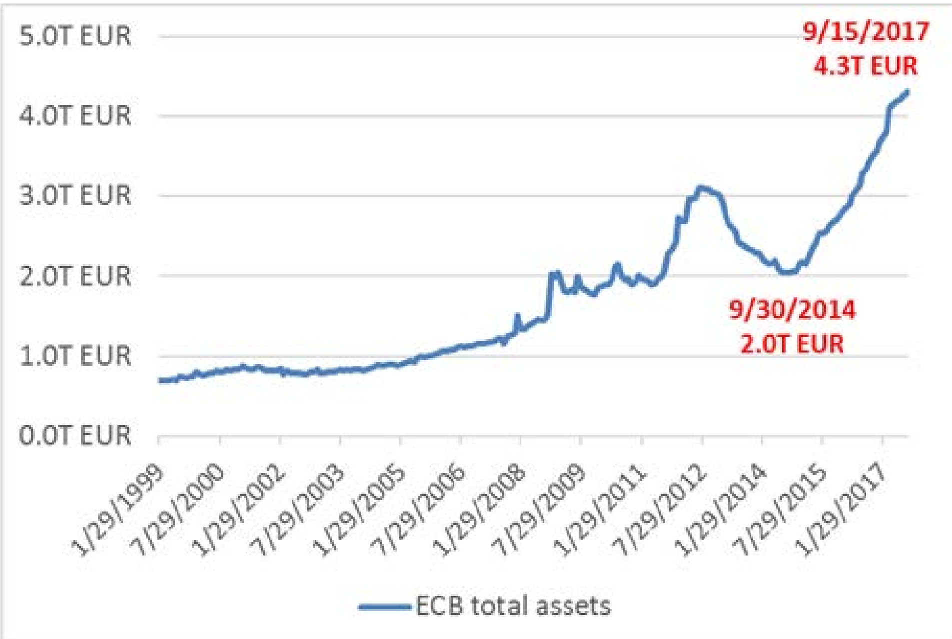
Source: Federal Reserve

2. What is the estimated pace of balance sheet reduction over the next two years?

$B	Treasury Redemptions	MBS Redemptions	Total Redemptions
2017	18	12	30
2018	229	141	370
2019	273	157	430

Source: Federal Reserve

3. How much has the ECB increased its balance sheet?



Source: Bloomberg

4. How much is the ECB currently buying per month?

Monthly net purchases in public and private sector securities amount to €60 billion on average. They are intended to be carried out until the end of 2017 and in any case until the Governing Council sees a sustained adjustment in the path of inflation that is consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term. From April 2016 until March 2017 the average monthly pace was €80 billion while from March 2015 until March 2016 the average monthly pace was €60 billion.

Source: European Central Bank as of Sept.25, 2017

5. What types of securities are they buying?

The expanded asset purchase programme (APP) includes all purchase programmes under which private sector securities and public sector securities are purchased to address the risks of a too prolonged period of low inflation. It consists of the

- third covered bond purchase programme (CBPP3)
- asset-backed securities purchase programme (ABSPP)
- public sector purchase programme (PSPP)
- corporate sector purchase programme (CSPP)

The APP is part of a package of measures that also includes targeted longer-term refinancing operations.

Eurosystem holdings under the expanded asset purchase programme						
	ABSPP	CBPP3	CSPP	PSPP	APP	
Holdings* August 2017	24,424	227,788	106,898	1,704,041	2,063,151	
*At amortised cost, in euro million, at month end.						
Figures may not add up due to rounding. Figures are preliminary and may be subject to revision.						

Source: https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html
Obtained Sept.27,2017

ECB balance sheet assets of Sept.15, 2017:

	Assets (EUR millions)	Balance	Difference compared with last week due to transactions
1	**Gold and gold receivables**	**379,078**	**0**
2	**Claims on non-euro area residents denominated in foreign currency**	**302,937**	**984**
2.1	Receivables from the IMF	74,523	−23
2.2	Balances with banks and security investments, external loans and other external assets	228,415	1,007
3	**Claims on euro area residents denominated in foreign currency**	**31,039**	**−2,697**
4	**Claims on non-euro area residents denominated in euro**	**16,640**	**1,518**
4.1	Balances with banks, security investments and loans	16,640	1,518
4.2	Claims arising from the credit facility under ERM II	0	0
5	**Lending to euro area credit institutions related to monetary policy operations denominated in euro**	**772,476**	**−357**
5.1	Main refinancing operations	3,986	−324
5.2	Longer-term refinancing operations	768,382	0
5.3	Fine-tuning reverse operations	0	0
5.4	Structural reverse operations	0	0
5.5	Marginal lending facility	109	−33
5.6	Credits related to margin calls	0	0
6	**Other claims on euro area credit institutions denominated in euro**	**61,522**	**544**
7	**Securities of euro area residents denominated in euro**	**2,484,140**	**12,396**
7.1	Securities held for monetary policy purposes	2,199,978	14,046
7.2	Other securities	284,162	−1,650
8	**General government debt denominated in euro**	**25,735**	**0**
9	**Other assets**	**235,309**	**−3,288**
Total assets		**4,308,875**	**9,099**

Totals/sub-totals may not add up, due to rounding

Source: https://www.ecb.europa.eu/press/pr/wfs/2017/html/ecb.fs170919.en.html
Obtained Sept.27.2017

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9/29/2017