SeaBridge Asia Strategy

First Quarter 2016
Commentary

We noted in the 2015 year-end commentary that we were encouraged by the strong performance of the portfolio in the last quarter of a sub-par year. We identified three conditions necessary for further advances in Asian markets:

1.) The strengthening of the U.S. dollar against the yuan and other regional currencies must cease or minimally slow to a rate that is tolerable for investors;
2.) The U.S., a bright spot of strength in private demand, must not falter;
3.) China must demonstrate that it can grow despite an economic reform program that correctly deemphasizes capital investment in sectors where over-capacity abounds.

Despite an unnervingly weak beginning to the quarter for markets when questions surrounding these issues were at their highest, markets turned around nicely during the period when the yuan stabilized against the dollar, U.S. economic data, particularly regarding housing and labor, improved and China reaffirmed its growth prospects. With the risk premium for equities receding, equity markets benefited.

We welcome the respite from the volatility that plagued the markets earlier in the year. However, as fundamental investors, we place greater emphasis on the operating environment of the companies in our portfolio than we do on macro conditions. Recently, we've sampled roughly one half of our portfolio companies in three categories that can tell us something about existing conditions for these companies and what we might expect from them in the near future -- growth in revenue, margin improvement, and outlook. In the first quarter, these companies reported earnings for 2015 and provided guidance for the coming year. We simply graded them on a plus or minus basis in each category. We then separately totaled the pluses and minuses. In our sample, there were twice as many positives as negatives for this most recent reporting period. We get a sense from our simplistic exercise that operating conditions, generally, are improving for the companies in the portfolio.

We believe there are a number of reasons for this improvement:

1. Host country currency weakness helped the top line of many of our companies, especially those domiciled in South East Asia;

2. Our companies have been living with wage inflation for a number of years now and have been forced to get more efficient. Unlike in the U.S., there has been a cap ex cycle in Asia and we may be seeing the fruits of it in margin expansion. Total factor productivity ("TFP") for all of Asia including China experienced an average annual rate of growth of 1.7% per annum and labor productivity increased 5.0% between 2010 and 2013. (In comparison, TFP in the U.S. post the Great Recession is running at about .6% per annum.) The Asian Productivity Organization, a regional think tank influential in governmental circles, is considering an annual average of 3.6% improvement in labor productivity as its target for productivity improvement by 2020 for Asian member economies. This bodes well for continued margin expansion.

3. We are seeing pockets of strength, although unevenly distributed, among the end markets of many of our companies. Many are involved in high growth industries including the buildout of the internet, mobile sensory connectivity, logistics and a cleaner environment. We also note that, generally, the Chinese consumer is in relatively good shape and has been a bright spot in a slowing economy. We are particularly optimistic about prospects for the companies in the portfolio that cater to Chinese tourism both inside and outside the country, with Hong Kong, for specific reasons, a notable exception. Because of rising wages both inside and outside the region, companies will increasingly be forced to automate. Firms in the portfolio that provide automation solutions including robots, flow control systems and components, including valves, actuators and sensors, the

computers and software necessary to integrate and manage equipment installations and the testing equipment manufacturers and service providers should benefit from this trend.

While company performance has undoubtedly helped drive Asian markets in the first quarter, it is impossible to ignore the Federal Reserve's contribution to a better overall tone. It is clear from recent comments from chairwoman Janet Yellen that not only is the Fed risking falling behind the curve in raising rates, it may be that she desires to do so. You can't help but feel that inflation is being viewed as curative rather than damaging to the global economy. The risk is that the Fed moves beyond its 2% inflation on the belief that higher inflation will stoke real growth. Additionally, because inflation effectively shrinks leverage in the system, with more than 50 trillion dollars of new debt incurred since the financial crisis of 2008 and, in the absence of the political resolve to address this world wide borrowing binge, the Fed may believe that an otherwise uncomfortable level of inflation is needed to effectively deleverage. Such a stance puts downward pressure on the U.S. dollar, is supportive of commodities and other cyclical assets, and improves near term prospects for equities.

There are risks. Debt is the long term concern. Near term, we are focused on Europe. As we review the investment landscape there, we are hard pressed to see any bright spots. In November, the European Commission cut its growth forecast by 0.1% to 1.7% for the full year 2016 and warned that this number may come down further. In early March, the European Central Bank surprised financial markets by cutting interest rates in the Eurozone to zero, expanding its money printing program and reducing a key deposit rate further into negative territory as it seeks to revive the economy and fend off deflation. Recent terrorist events and the flow of migrants from the Middle East threaten social cohesion and make a true fiscal union harder to achieve. Furthermore, despite the ECB's recent action, the Euro has strengthened threatening the two pillars of strength in the region, exports and tourism. Finally, Britain is scheduled to vote in June on exiting the union. If the vote is to leave, it will call into question the durability of the European model. Markets will not like this uncertainty. At the same time, should Britain decide to stay, and the odds now are that it will, markets should be relieved.

In the meantime, we will soon have another earnings reporting season under our belts. If the traction we are seeing in our companies continues into the first quarter and beyond, we are hopeful that we can look forward to a better year.

David Descalzi
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