SeaBridge Investment Advisors, LLC

SeaBridge Asia Strategy

First Quarter 2017
Commentary

Equity markets have had quite a run since Trump won the presidential election in early November. Despite the strong U.S. dollar during this intervening period, developed markets including the U.S., the major European burses, and Australia, have generated strong U.S. dollar returns. Even the U.K. (in the face of well-founded concerns surrounding the terms of its exit from the European Union) and Japan (which finds itself still searching to solve its seemingly intractable deflation dilemma) posted strong returns in U.S. dollar terms. Many would argue that the rise in markets was simply a function of a world reflating after eight years of massive, synchronous monetary accommodation by the world's major Central Banks post the Great Recession of 2008. And indeed, for the first time since the financial crisis of the last decade, there seems to be evidence that world growth is accelerating and perhaps is on a more sustainable upward trajectory. In Europe, GDP growth picked up in the second half of 2016 on the back of solid domestic conditions and recent data suggest that momentum has firmed in the first quarter. Economic sentiment reached a nearly six-year high in February and the composite PMI also hit the highest level in almost six years in March. In the U.S., the private economy is gaining momentum. Industrial and Service PMI's have consistently demonstrated strength particularly in new orders. Construction, both residential and commercial, has been a bright spot. Business confidence surveys have gone through the roof. In Australia, construction and consumer confidence have been trending in the right direction. In Japan, the market has looked past continuing economic disappointments, specifically with respect to machine orders and domestic consumption, with the hope that BOJ easy money and the reflation going on elsewhere would gradually lift the world's longest lasting, most frustratingly tepid, economy. The U.K. has defied the dire prognostications of economic disaster post the Brexit vote and turned in a credible performance driven by the U.K. consumer.

With growth set to accelerate and inflation expectations rising, the Fed has become the first Central Bank to signal tighter money ahead by raising the Fed Funds rate by 25 bps in March while forecasting at least another two increases this year. Once the political calendar clears in Europe, the ECB may announce the end to their quantitative easing program through which the Bank makes monthly bond purchases in the amount of U.S. $60 billion from European commercial banks. China has also made money more expensive in an attempt to rein in credit excesses that threaten the macro environment. So, with the world skewing tighter and with corporate earnings forecasts largely unrevised, it would not be a stretch to suggest that there is a Trump effect in the markets. It stands to reason that the market has expected fiscal stimulus and/or an improvement in the regulatory environment. We believe the Trump effect has extended, to a certain extent, overseas, primarily through the transmission mechanism of weaker foreign currencies against the U.S. dollar and stronger export growth.

The reaction to the Trump victory has been more ambivalent in the emerging markets with those markets at first selling off on fears that protectionist and nativist policy would negate the salutary effects of fiscal stimulus in the U.S. Asia markets were at first skeptical like other emerging markets but have since turned positive, believing that the U.S. president, though at times volatile and loutish, is not crazy.

Here's what we expect.

1. There is enough business momentum in the universe of our portfolio companies to suggest that market advances can continue. First quarter earnings have generally come in better than expected. Outlooks have decidedly improved particularly among industrial companies.

2. The Federal Reserve and failure of healthcare reform perhaps have changed the trajectory and timing of interest rate increases. So long as there is a sense that the Fed is not "behind the curve" the markets should be able to continue to perform despite rising interest rates.

3. With a solid U.S. outlook providing a strong global foundation for growth, the focus may again turn to China which has been in a quiet period since the second half of last year when concerns over a fast depreciating currency and

capital flight roiled markets everywhere. We expect the relatively tranquil period to continue for two reasons: China's national conference is in October and leadership historically has not permitted domestic turmoil or unmet goals to cause an international embarrassment to the ruling junta. Secondly, macro indicators have definitely turned up. Here we place more credence in anecdotal evidence than in published official data:

a. Strong auto sales;
b. A sizeable increase in home appliance sales and luxury items such as Swiss watches;
c. A strong rebound in global apparel brands;
d. A strong rebound in Macau gaming revenue;
e. A reinvigoration of outbound tourism;
f. Notable K-12 tutoring revenue growth;
g. Visible revenue per available room improvement in economy and mid-tier hotels;
h. Fast food same store sales growth that exceeded expectations;
i. The rapid reoutfitting of China's factory floor with the most sophisticated automation equipment;

4. Despite the run up in value among our companies, there remains a valuation gap between Asian shares vs U.S. listed equities. We think the region should continue to draw attention from U.S. dollar investors so long as this gap persists.

5. A continuing reform agenda in China. We argue that the command economy and the relatively closed capital account hurts China more than helps it. We view the problem of capital flight as evidence of this. Although China theoretically controls capital flows, it suffered the consequences of uncontrolled outflow without being reformed enough or open enough for the country to benefit more from foreign direct investment. China wants and needs more FDI to dilute the investment risk which the banking system as primary intermediary of capital in the country faces. This can only happen through reform. We expect the opening of the capital account to be a major item coming out of the national congress.

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6. Receding risk posed by the deglobalization trend. Countries are just too dependent on each other for capital and the functioning of the global supply chain. Trade arrangements may become more bilateral in nature but they will not disappear. Capital flows will not be impeded, in our opinion.

We see the following risks as follows in descending order of probabilities:

1. Europe has another European Union dissolution scare or, worse, one or more countries leaves the federation calling once again into question the Union's viability. A Greek debt crisis some time mid-year seems the most likely catalyst for such a development. European elections are another threat with certain populist candidates posing serious challenges in a number of countries, particularly France. The probability for negative outcomes is low but not zero.

2. China falters and finds it cannot achieve growth objectives by its customary continued inflation of the property bubble through more debt. China financial systemic risk creeps into risk premiums in global markets prompting a flight to safety that would be damaging to the portfolio.

3. Trump disappoints. Protectionism reigns. Stimulus fails.

The relative lengths of the lists above reveals our optimism for Asian markets in 2017. We think it is going to be a very good year. We hope we are right.

As has become customary in our quarterly commentaries, we include a supplement on portfolio activity during the quarter.

Dave Descalzi
April 4, 2017