SeaBridge Investment Advisors, LLC

SeaBridge Inflation Fighter Strategy

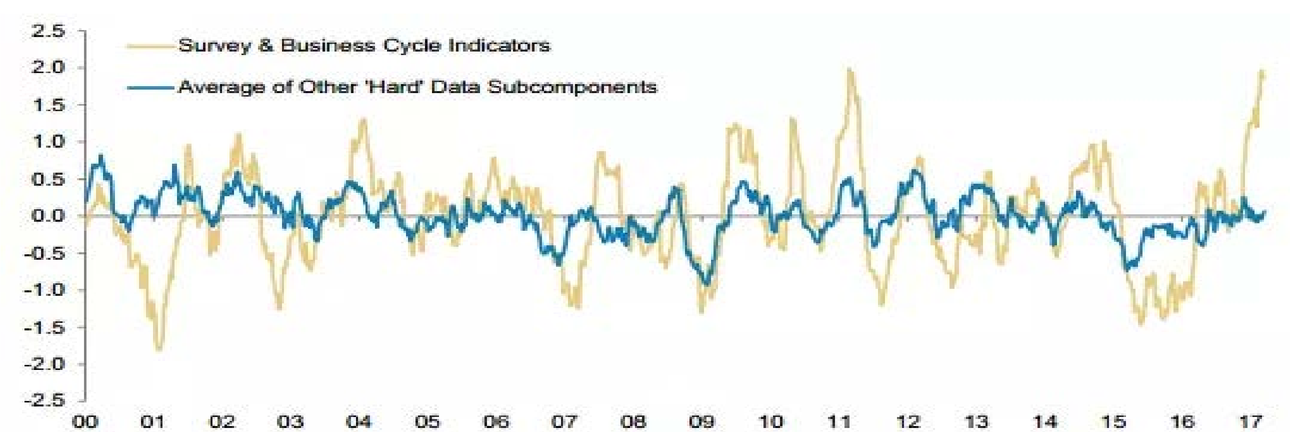
First Quarter 2017
Commentary

We are pleased to report a positive start in 2017 for the Inflation Fighter Strategy. As we enter the ninth year of a slow and repeatedly distrusted recovery, a broad group of economic indicators and data points remain pointed in the right direction. The data gives optimism for the remainder of the year, but expanding valuations, globally, and record political uncertainty in the U.S. and Europe introduce a dose of caution.

The global economy looks to be in the most synchronous expansion since coming out of the depths of the Global Financial Crisis. With the U.S. leading the recovery parade, the Fed has now started the credit tightening which has been long anticipated. Coming into the quarter – following the second Fed increase in December – people feared a strong Dollar caused by rising rates, with the risk that a border adjustment tax would cause a huge Dollar spike. However, that trade was heavily anticipated by speculators, and following dovish Fed language around the 25bps increase in March, the Dollar has actually depreciated somewhat versus other currencies during the quarter. This helps U.S. exporters and gives the Fed more room to raise rates during 2017. It also helps the reported earnings of our global companies traded in the U.S.

In the United States, housing data maintains a positive trend. Even after several years of recovery, housing starts remain below the demographic needs of the population. Post crisis there was a large shortfall between the growing size of the first-time homebuyer age cohort and the number of homes being built. This backlog still exists and is still increasing as sales of new homes, existing homes, and building permits remain below the growth of the 25-34 age group. With rising house prices, the Affordability Index has come off the high made in 2012-2013, but the median family income still has roughly 160% of the income necessary to qualify for a mortgage on a median-priced home. So, while interest rate increases could be a headwind for further housing recovery as the Fed tries to "normalize" interest rates, we are optimistic that rising family incomes and current level of "ample affordability" should allow several rate increases before mortgage rates become a significant drag on housing growth. We have added positions in three timber companies (**West Fraser Timber, Weyerhaeuser, and Canfor**) and **iShares U.S. Home Construction ETF** to increase exposure to this theme.

While "hard data" (quantifiable) such as manufacturing activity and housing starts have been good, the "soft data" has been spectacular. Business and consumer confidence surveys have gone through the roof! A graph recently published by Morgan Stanley shows that the gap between the hard and soft data is at record levels.



Sources: Bloomberg, Morgan Stanley Research, Financial Times

Further digging into why this exists seems to point to confidence in the Trump Administration's ability to reduce government regulation and "meddling" in business. Much of the hoped-for reduction of regulation can be affected by the attitude of Administration Departments in administering existing laws. However, the failure to bring the repeal of ACA (The

Affordable Care Act) to a vote raises questions about major legislation. So, while optimism remains high, it could be eroded if health care reform and tax legislation remain beyond the grasp of the Republican Party.

We have been surprised by the way the U.S. market has remained strong following the ACA repeal failure. The best explanation we have heard is that with so much liquidity in the global system and with the Fed raising rates, money wants to flow out of bonds and into equities. So, any brief back-up in stock prices brings in “buy the dips” bond money waiting on the sidelines. With prices already full, this is sounding “bubbly” to us and we are keeping somewhat more cash than we would if valuations were more attractive. We mentioned adding starter positions in **Facebook, Amazon, Red Hat**, **Cognizant Technology, and Regeneron** during the last two quarterly letters. We sold **Regeneron** as increased competition for their blockbuster drug Eylea has emerged. With the growth in question, we no longer felt the risk-reward was positively skewed in this high multiple company. A small position in **Accenture** was recently added during a price drop. We are glad we got starter positions in past “back-ups” and hope to add if some misadventure brings the market down and/or sustained earnings increases from these high growth companies outpace the prices and bring multiples down.

Post Global Financial Crisis, Europe has had trouble maintaining consistent stretches of growth and has battled deflationary fears. Recently the data is starting to show sustained positive trends. Real GDP growth has been in the 1.5 – 2% range over the last two years. Inflation ex energy and food, while still below 2%, has stabilized around 1%. Unemployment figures continue to improve. Capacity utilization figures are back to levels that the region has not seen in close to a decade. Credit growth is picking up and pent up consumer demand is reflected in increasing retail sales figures. As with the United States, the soft data is coming in very strong. Economic sentiment reached a nearly six-year high in February and the composite PMI also hit 56, the highest level in almost six years in March.

Much like the United States, a cloud of political uncertainty is hovering over European data. Populist factions that threaten the stability of the European Union exist all over the region. A key Greek debt repayment is coming due this summer. The populist Five Star Party in Italy has moved ahead of the incumbent Democratic Party in recent polls. Happily, a poor showing by the populist Geert Wilders in recent Dutch elections helped calm some of the fears in the region. Marine Le Pen seems unlikely to win the second run-offs in France, but she is using social media very effectively, and gathering a growing bloc of young voters. After BREXIT and the Trump victory, no one wants to take a bold position that rules out a Le Pen victory. Nonetheless, accelerating growth in Europe and a large valuation discount versus the U.S. has us looking carefully at several European stocks. The European market has been performing better, and we added a small position in the **iShares MSCI Eurozone ETF** late in the quarter.

In China, it has been a quiet quarter, and we expect the Peoples Bank of China to maintain high liquidity in the economy leading up to 19th People Congress Plenum in October. Producer prices have been rebounding and manufacturing data has been stronger. Both autos and home appliance sales have been strong. An even larger valuation gap exists between Southeast Asia and the United States. We exited our small position in **Man Wah Holdings Limited**. The company has executed well over the years selling motion recliner sofas in the United States and China. Going forward, we saw risks in the U.S. as Chinese exporters were taking down prices to gain market share. The other threat has been the Trump Administration’s flirtation with a Border Adjustment Tax. That seems less likely after the ACA debacle, but until the possibility clears completely, Chinese exporters to the U.S. have an extra hurdle to clear.

In Mexico, the peso is back near levels not seen since prior to the election. As mentioned above, the reduced probability of a border adjustment tax is a large positive for the country. Even Trump’s signature promise of “A Big Beautiful Wall” is open to question as the financing of tax reforms is looking very tight. A less strident outlook combined with the Bank of Mexico raising interest rates has stabilized the Peso. In early February, we sold our position in **iShares MSCI Mexico ETF** at a loss and replaced it with the bank **Grupo Financiero Santander Mexico**. The
bank is well run and benefits from the higher Mexican interest rates – it has been a big winner in the portfolio so far.

Below we will discuss a few of our contributors and detractors for the period.

Broadcom Limited (formerly Avago) is a global semiconductor company headquartered in Singapore that serves the wired infrastructure, wireless communication, and enterprise storage end markets. It holds the top market share in many of these areas. Avago Technologies acquired Broadcom Corporation in a 2016 transaction that formed one of the world largest, most diversified semiconductor companies. The stock has been a solid performer both before and after the acquisition. The legacy Avago business was most heavily tied to the wireless communication segment which has a much lumpier revenue stream due to the yearly cell phone cycle. The wired infrastructure segment is now the largest source and has helped smooth out revenue. The first quarter of the year has traditionally been a soft period, but the diversification benefits have become apparent in the most recent reporting period as both top and bottom line beat expectations. The significant gains in **Broadcom Limited** have been almost entirely based on earnings growth with little to no multiple expansion. It is trading at 15 times earnings (a discount to many peers) with mid-teens growth and close to a 2% yield. As the company moves out of the acquisition phase and continues to squeeze synergies from the Broadcom, we believe there is room for significant dividend increases over the coming years.

HDFC Bank Ltd is one of the premier banks in India and was one of our better performing holdings for the period. In November, India removed the 500 and 1,000 rupee notes in an effort to curb counterfeiting, reduce black market transactions, and improve tax collection. This effectively reduced the currency in circulation by over 80%. This was hotly protested in a society that is heavily based on cash transactions. The Indian market was weak as investors sorted out the degree which this demand shock would impact growth which led to a poor finish for the stock in 2016. As more data has been released over that last three months, it looks like the shock will be more temporary in nature. Indian markets have bounced back nicely. Although the bank trades fairly expensively on a price to book basis, it is still growing at high-teens rates with a high-teens return on equity and low levels of non-performing loans. We view this as a core long-term holding for the strategy.

Cimpress NV was one of the weaker holdings for the period. It is a printing services company providing customized orders of print, signage, and other similar products. The goal is to create a mass customization platform leveraging scale to drive down costs per order. The company is a combination of its legacy Vistaprint business and a newer Upload and Print segment in which it has been investing heavily. The former caters to the do it yourself customer by providing standardized templates for things like business cards, stationary, and signs frequently advertised on CNBC. The latter largely accommodates commercial graphic designers and local printers/copy shops. Even though the company still delivered 9% organic growth, the stock had a roughly 12% drop due to a soft report in the most recent quarterly earnings. We used this opportunity to add to the position. We think Cimpress can grow revenue at a high single digit rate for the next 3-5 years as it captures share in a highly fragmented industry.

Terraform Power, the solar YieldCo, owns and operates contracted clean power generation assets. The company's objective is to acquire assets with contracted cash flows primarily from owning solar and wind generation assets serving utility, commercial, and residential customers. SunEdison was the parent/sponsor of this YieldCo vehicle. Numerous issues including China finding ways to dump excess panel production into the U.S. market and the SunEdison bankruptcy weighed heavily on companies across the industry. We misjudged the rapidly changing landscape early in the decline. We maintained the position as several bidders for Terraform emerged, but the winning bid from Brookfield Asset Management was disappointing. We continue to follow the industry, but it remains in disarray for the foreseeable future.

Thank you for your continued support and confidence in the Inflation Fighter strategy.

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3/31/17