SEABRIDGE
INVESTMENT ADVISORS, LLC

SeaBridge International Strategy

First Quarter 2017
Commentary

We are pleased to report a positive start in 2017 for the International Strategy. As we enter the ninth year of a slow and much distrusted recovery, a broad array of economic indicators and data points remains pointed in the right direction. The data give optimism for the remainder or the year, but expanding valuations across the globe and record political uncertainty in the U.S., Europe and Latin America introduce a dose of caution.

Equity markets have had quite a run since Donald Trump won the presidential election in early November. Despite the strong U.S. dollar during this post-election period, developed markets including the U.S. and the major European bourses 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 monetary accommodation by the world's major Central Banks, but the data are starting to tell a different story. The global economy looks to be in the most synchronous expansion since coming out of the depths of the Global Financial Crisis.

Since the onset of the Global Financial Crisis, Europe has had trouble maintaining consistent stretches of growth and has battled deflationary fears. Recently, economic data are turning positive. Real GDP growth has been in the 1.5 – 2% range over the last two years. Inflation ex energy and food 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. Economic sentiment reached a nearly six-year high in February, and the composite PMI also hit 56 in March, the highest level in almost six years. This plethora of positive data is accompanied by a cloud of political uncertainty. Populist sentiment that threatens the stability of the European Union has morphed into a potent political force 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, it would be foolish to rule out a Le Pen victory. Nonetheless, accelerating growth in Europe and a large valuation discount versus the U.S. have us looking carefully at European stocks.

In China, it has been a quiet quarter. Producer prices have been rebounding and manufacturing data have been stronger. Anecdotal evidence has been encouraging as well. Both autos and home appliance sales have been positive. Macau gaming revenue is starting to pick back up. There has been a reinvigoration of outbound tourism. China's factory floor is being rapidly reoutfitting with the most sophisticated automation equipment. An even larger valuation gap exists between Southeast Asia and the U.S. than between Europe and the U.S. Turnover in the portfolios during 1Q17 has been on the low end, but most of our trading activity has been focused in this region.

In the U.S., the private economy is gaining momentum. Housing data maintains a positive trend. Even after several years of recovery, housing starts remain below the demographic needs of the population. 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 the current level of "ample affordability" will allow several rate increases before mortgage rates become a significant drag on housing growth. While "hard data" (quantifiable) such as manufacturing activity and housing starts have been good, the "soft data" have been spectacular. Industrial and Service PMI's have consistently demonstrated strength particularly in new orders. 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. 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 pro-business Cabinet secretaries 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.

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 given funding constraints. A less strident posture on Mexico by the Trump administration combined with the Bank of Mexico raising interest rates has stabilized the Peso.

In Japan, the market has looked past continuing economic disappointments, specifically with respect to machine orders and domestic consumption, with the hope that easy money from the Bank of Japan and the reflation going on elsewhere will gradually lift the world's longest lasting, most frustratingly tepid, economy. Stabilized debt levels, easing deflation, and nominal growth above 2% give us a mild level of optimism. Combining these with accelerating global growth, stronger Japanese exports, global rates drifting upwards are presenting possible conditions for a weaker Yen and stronger equity market. We continue to watch developments closely.

With growth set to accelerate and inflation expectations rising, the Fed has become the first major 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 reign 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 post-election 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, but like other emerging markets, have turned positive, believing that the U.S. president, though at times volatile and loutish, is not crazy and has put forward a pro-business agenda which will be worked through a Republican congress when necessary or promulgated by a pro-business cabinet when possible.

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 perhaps has changed the trajectory and timing of interest rate increases. So long as the market does not get the sense that the Fed is "behind the curve" the markets can 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 turned up.
4. Despite the run-up in value among our companies, Southeast Asia still trades at a significant discount to the U.S. The region should continue to draw attention from U.S. dollar investors so long as this gap persists.
5. There is receding risk posed by the deglobalization trend. Countries are 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.
6. A reform agenda continues 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 congress referenced above.

We see the following risk as follows in descending order of probability:

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 several populist candidates posing serious challenges in a few countries. The probability for these 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.

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

Amata Corporation was our best performing holding for the quarter (up roughly 60% in US dollar terms). We touched on this stock in last quarter's commentary. Amata's main business is developing industrial estates in export-oriented areas in Thailand. The company creates industrial cities with a standard road system, private security system, reliable utilities and waste disposal, and green areas for large corporations to build manufacturing facilities. We took advantage of a soft earnings report in the prior quarter to build a position at valuation levels that we viewed as very attractive for a company with a recurring revenue stream from rentals and utilities as well as potential upside from land sales. The EEC (Eastern Economic Corridor) initiative in the regions in which Amata operates is an added tailwind for the stock. The Thai government is targeting over $40 billion in FDI in three east coast provinces to help facilitate growth in many high-tech industries. A high-speed rail is planned connect these provinces with the major international airports and additional railways will be built to connect to the deep-sea ports. This will take years to complete and certainly entails a high degree of execution risk, but it could benefit Amata for many years to come if the plan comes to fruition. Even with the large price move this quarter, the stock still looks reasonably valued as the earnings estimates have moved up as well. We think it still has some runway at 14 times earnings and a 2.5% dividend yield.

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.

HollySys Automation Technologies offers programmable logic controllers and distributed control systems solutions which are primarily used in nuclear power installations. It also sells products that facilitate high-speed rail signaling systems. These two segments make up the bulk of revenue. While the company falls somewhat short of its multinational counterparts, like Siemens, in terms of brand recognition, it more than makes up for this shortfall in the Chinese market with pricing, service, and customization as well as being able to hold its own in quality. We believe that the soft results for the quarter can be attributed mainly to contract timing issues rather than any longer-term business fundamentals. The order backlog looks to be strong, and we think that the company has substantial runway in China. It is our hope that with leadership stability at the Chinese rail ministry, high speed rail contracts will come back. We also believe that the nuclear power plant business will be a big driver for years to come. The company is heavy into R&D, is well run and has a clean balance sheet. It is very attractively valued at about 9 time earnings. We used the weakness during the quarter to add to the position.

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 customers 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.

Regards,

Dave Descalzi
Matt Falkowski
Garnett Keith
4/3/17