SeaBridge Investment Advisors, LLC

SeaBridge International Strategy

First Quarter 2018
Commentary

The pattern of trading in international markets followed that of U.S. bourses in the first quarter. It was a tale of two tapes with most world market indices soaring in January before swooning in February and then struggling to regain momentum as the quarter closed out. Although the International Strategy followed these movements, we are pleased that it produced marginally positive performance in a generally down quarter for markets.

Volatility has returned to global financial markets. Using the VIX index as a proxy, we saw volatility spike to its highest level in more than two years and end the quarter 81% higher YTD. We think this is evidence that correlation across financial assets may begin to decline after years of elevated levels. From a macro-economic perspective, we retain our generally constructive view expressed in our 4Q17 commentary. We continue to see accelerating economic growth in the U.S. accompanied by rising consumer confidence which is underpinned by stable advances in employment and income levels, moderate inflation, and low long-term interest rates which remain <3.0% (based on the 10-year Treasury Bond).

Despite the overhang of a possible trade war between China and the U.S., Asia remains our favorite international region for investment. Since the financial crisis of 2008, Asia, collectively, has arguably been the most responsible global region in terms of disciplined economic stewardship. Current account balances, for the most part, have reversed, currencies stabilized, and while debt levels have increased, the portion of that debt denominated in U.S. dollars declined. More recently, Asian central banks did not board the quantitative easing train like those in the U.S., Europe and Japan. Since the banks in the region did not participate in the grand experiment that exploded balance sheets of their global counterparts, there should be no market angst attached to an unwinding exercise.

If it is not quite yet fully developed, Asia, led by China, can now be considered a fast maturing strapping adolescent. Relative economic stability, the burgeoning middle class, the proliferation of world class companies by size and sophistication of goods and services rendered, and the leadership position in a connected, digital world are all signs that the region’s reliance on external markets is no longer as crucial to its economic wellbeing as has previously been the case. Asia is increasingly able to stand on its own.

Other global regions are more challenging for us from an investment standpoint. On the surface, the data coming out of Europe are encouraging. Eurozone Composite PMI, while off the highs, is still firmly in expansionary territory. Real GDP growth has maintained positive figures since mid-2013 and has been above 2% since the beginning of 2017. Economic sentiment indices are at level not seen since prior to the Global Financial Crisis. Deflationary worries have subsided with 3-years of modest inflation readings. Retail sales growth is positive and looks to be trending in the right direction. The aggregate indices are also trading at roughly a 15% discount to the S&P 500 on a price-to-earnings basis. While these data points paint a very constructive picture, political and monetary issues still give us pause on the region. Italy has veered decidedly right in its recent election results and is now somewhat out of step with the more centrist governments of Germany and France. The rise of the right and the tapering of the BOE’s bond purchase program may, as was the case during the Greek crisis of 2015, call into question the durability of the

European Union. Also in Europe, the terms of Brexit have yet to be announced. Those terms could signify an amicable parting of ways or a post Brexit relationship between the two regions that damages one or both entities. While there are world class European companies in which we would have interest, Europe is weighed down by huge structural impediments including poor demographics, a socialist pedigree that often favors labor over shareholders, and a loose set of principles of association that makes a region comprised of 28 countries a union in name only.

We view Japan in much the same way as we see Europe with one difference. We like some Japanese companies but the country less because of its own poor demographics and a propensity to misallocate capital. However, with Asia in its backyard, Japanese companies can fairly easily expand their reach beyond their own tepid domestic market. For this reason, we are always searching for a high quality, Japanese exporter.

We have almost no interest in Latin America. Our view has more to do with the unsettled politics of the region than it is a reflection of our concerns with Nafta, which we believe will be reworked to the satisfaction of all parties.

The Portfolio

We **initiated** new positions in:

- **Boral Ltd. –** The company is an Australian-based manufacturer and supplier of construction material. The company's two end markets (Australia and the U.S.) could each be entering into a substantial infrastructure buildout period, a development which would obviously benefit the company. The residential part of the business should be strong in the U.S., although we have greater concerns that the residential side in Australia could be vulnerable to the interest rate increases we expect there. It is notable that household debt in Australia as a percent of GDP is significantly higher than it is here. A reversal of the recent weakness of the dollar would be beneficial to the company. Although the stock is trading at the upper end of its five-year P/E range, with the company poised to take advantage of growing demand from public and private investment for infrastructure and property, we suspect that, with its operational leverage, the P/E ratio will contract making the stock appear attractively valued.
- **Omron Corporation –** The Japanese company provides sensing and control technologies that are key to industrial automation, making it possible to extract necessary data from a variety of detected information. It ranges from movement, location, biometrics, facial expressions, and environmental conditions. This data is converted into information which machines can use for precise and optimally controlled outcomes of automated processes. Major divisions include Industrial Automation, Electronic & Mechanical Components, Automotive Electronic Components and Healthcare. We initiated a small position in early February following a roughly 20% pullback from January 2018 highs as the stock re rated from a 23 P/E multiple to 18 P/E. In the most recent quarterly report, the company announced its 2017-2020 plan which emphasizes both Automation and Healthcare. We believe we are paying an attractive valuation for a company that fits two of our major secular themes (IoT enabled factory modernization and aging populations globally).

We **added** to an existing position in:

- **Taiwan Semiconductor ADR –** The company is one of the largest semiconductor foundries in the world. Near the beginning of January, the company had a small pullback from all-time highs. It was possibly driven by security issues found in most of the processors that run our computers and smartphones. This was a design issue rather than a manufacturing issue, so we believe it should not directly impact Taiwan Semi. Although the company is behind schedule on the next generation 7nm chips, they are still widely viewed to be the major supplier of such chips over the coming years which should be a major growth driver. The proliferation of IoT should continue to drive growth in the next gen chips as well as the larger node predecessors. At less than 17x earnings, over 3% yield, and low double-digit growth we viewed this as a good place to add to the position.

We **trimmed** positions in:

- **Venture Corp –** The Singaporean company's success in this division is driven by its competency as a contract manufacturer that goes beyond just assembly but includes some design capability that helps the OEMs. It has benefitted from strong demand in its testing and measurement/life science division. Among the customer base are Illumina, Agilent, Danaher, and Keysight. Its products are part of a feedback loop of data collecting, testing, measuring the effectiveness of processes and products, and the improvement of those processes and products for its customers. This is part of the powerful secular trend that starts with data and ends with better, smarter products. The stock popped in late February when news was released that the company may be a manufacturer of a leading consumer device which has potential for significant revenue increases. The stock is one of our larger positions and has roughly tripled in value over the course of less than two years, so we decided to take the opportunity to trim a small piece of the holding on the back of this news.
- **TenCent Holdings –** The Chinese gaming and social media giant is one of the largest positions in the portfolio. Although we still feel the pipeline for 2018 and 2019 is strong in the gaming segment, 4Q17 came in a little weaker than hoped. Analyst expectations for continued monetization of both social and media advertising are high. Same can be said about the expected revenue coming from the online and offline payment platforms as the heavy investment phase starts to wind down. Concerned about the company being able to meet these lofty expectations, we decided to start to trim our large position. We were only able to execute a fractional portion of our intended trim due to price falling below our targets. We will likely look to reduce further our position in Tencent at the appropriate time.

The outcomes of some currently large, unresolved issues, including but not limited to, a possible trade war (obviously involving Asia but instigated by the U.S.), the line in the sand on a nuclear-armed North Korea, the Mueller investigation and the 2018 Mid Term elections, which could see a flip of one or both of the currently pro-business legislative branches of the U.S. government, may have a profound effect on the way markets behave across the globe. We cannot say how these issues will resolve. We can only say that as news-flow on these issues veer between hope and despair, volatility will likely increase, perhaps dramatically.

We will end on positive note. The economies across the globe for the most part and their companies are basically healthy. Earnings are strong, despite some expected softness in the first quarter that has more to do with seasonality than anything else. Valuations in the Pan-Asian region are attractive on an absolute basis and stunningly so on a relative basis to other parts of the world. As we always keep some cash in the portfolio, we would not hesitate to use that cash to buy stock on pullbacks. We will not shy away from exporters as we are of the mind that the current trade dispute will resolve favorably for all parties. We like industrials as we believe they are in the sweet spot of the current economic cycle. We are still attracted to high yield equities because their combination of dividends and growth is attractive even in a rising interest rate environment. In short, we believe the markets will continue to advance, but with more volatility.

Regards,

Dave Descalzi
Matt Falkowski
4/6/18

The views presented here represent the opinions of SeaBridge Investment Advisors based on analysis of publicly available information. The opinions of other analysts based on these data may differ, including other analysts in SeaBridge. ***The conclusions of the analysis may not be realized in the future****. There may be other factors which have more influence on future growth, economic recovery and market performance than those presented here. There may be errors in the data referenced in this analysis. Investment involves risk and* ***past performance is not indicative of future performance.***

This is for information only and should not be considered a solicitation or offering of any specific investment products or services.

This is not a recommendation to buy any security or sector*. SeaBridge may buy or sell securities for client or personal portfolios at any time in the future depending on individual circumstances or changes in SeaBridge's conclusions about the outlook. There is no representation about the future performance of the stocks mentioned in the Commentary. There may be other stocks in the portfolio that performed worse than the examples presented here. SeaBridge's opinion of the economic and market prospects may change in the future.*

There are differences among portfolios managed by SeaBridge in each strategy based on client-specific factors. Not all portfolios hold the same securities. Not all stocks held in the portfolio perform similarly. Some client accounts may not have as much cash reserved as other accounts managed in the strategy due to client withdrawals or other issues. SeaBridge manages portfolios in several styles.