SeaBridge Investment Advisors LLC

SeaBridge Asia Strategy

Second Quarter 2013

Commentary

In the second quarter, three powerful market moving forces converged to roil a perfectly respectable quarter from a return perspective: rising long term interest rates in the U.S., increasing doubts that the Bank of Japan ("BOJ") could achieve for Japan an historically elusive inflation target despite the bank's unprecedented expansion of the money supply, and a looming economic slowdown in China.

Federal Reserve chairman and chief antagonist in all the market drama, Ben Bernanke, initiated the quarter end sell-off by suggesting in a news conference that he would slow the Fed's printing press, commonly referred to as quantitative easing, at some point this year. The market understood this talk of "tapering" to mean the unconditional withdrawal of liquidity from the financial system. Treasury yields spiked; equities fell.

In Japan, the BOJ, in an attempt to jumpstart a moribund economy enervated by decades of deflation, launched its own aggressive expansion of its balance sheet during the quarter. By cheapening the currency, the central bank seeks to make Japanese manufactured goods more competitive globally, create some inflation, instill some confidence and grow the economy. For much of the quarter, investors were positively enthralled with the BOJ's game plan. The Nikkei was on a tear, having risen 26 % in yen terms in the quarter to the day of Bernanke's comments. But if one major market for Japan's goods, Europe, is depressed and another, the U.S., is now suddenly compromised by a steepening yield curve, then the BOJ's worthy objectives may prove unachievable. Over the course of the next month, the Nikkei declined 17%, in yen terms.

Finally, there is the special case of China. According to a legion of vocal outside observers, everything is wrong with China. It's too dirty, too corrupt, too many bridges to nowhere, too many empty flats. And now there appears to be the mother of all liquidity crises brewing. The Shanghai Interbank Offered Rate ("Shibor rate": the cost of funds in China's interbank market and a barometer of financial system liquidity), spiked in June to the untenable level of 12%. If credit creation were to slow because of the unavailability of liquidity, China's growth rate would have to come down. This, understandably, has made investors uncomfortable.

The China liquidity situation deserves some attention. Among the items on the "What's wrong with China?" list, the shadow banking system in China ranks high. The shadow banks are non-banks, such as trusts, that intermediate savings and investment outside the banking system in China. China's shadow lenders, unlike the commercial banks, are unconstrained in the interest rate they can pay depositors and demand from borrowers. Because it falls outside the regulatory framework governing the commercial banks, the shadow banking industry has grown at an alarming rate and is large enough today to pose a threat to the safety and soundness of the entire financial system of China. But all this doesn't mean that the system is on the verge of collapse. We would point out the following:

There is a difference between a credit crisis and a liquidity crisis. Credit crises occur when borrowers default and the properties underlying loans decline in value. A liquidity crisis arises when obligations due cannot be refinanced. Liquidity strains often occur despite the obvious solvency of the obligor. While there are undoubtedly many bad loans made in the shadow banking network in China, there is little evidence today that we are about to return to the bad old days of the early nineties when half the loans on the books of China's banks were non-performing.

What is going on in China today amounts to a procurement challenge for short term funding and we think would only rise to the level of crisis through gross incompetence or negligence on the part of the Central Bank. Much of the worry has come about as a result of the spike in the interbank rate as liquidity dried up a few weeks ago. Rates have trended toward normalcy recently, but have currently settled at higher than historical levels. The central bank has the capacity to satisfy easily the demand for funds in the banking system by reducing still very high reserve requirements that the People's Bank of China ("PBOC") is currently requiring of member banks and by injecting funds through reverse repurchase agreements into the banking system and thus lower the interbank rate to an accommodative level.

So why don't they? PBOC recalcitrance sends two messages: 1.) If China is serious about weaning itself off of low return fixed asset investment, it must better regulate the spigot that has been feeding the beast, and 2.) there are consequences to participants in flawed investment schemes.

We have conflated shadow banking and commercial banking in China in the above analysis. This is appropriate as shadow banking is most often used a means for commercial banks to circumvent regulatory restrictions. We believe the high cost of interbank funds reflects the inability of non-bank lending vehicles to roll paper over in the shadow banking network and China's reluctance to continue to support an intrinsically corrupt system.

The main problem in the shadow banking system is an asset/ liability mismatch. This is not comforting but doesn't mean a credit crisis is imminent. The PBOC will likely maintain a tight bias, but we expect that liquidity will be made available at a good price to the more responsible borrowers and withheld from the abusers. Undoubtedly, some borrowers will go belly up and while this may unsettle some markets, it should not threaten the financial system.

The long string of unsettling news, starting with the completely rational musing by Bernanke that the Federal Reserve cannot buy Treasuries and mortgage backed securities forever and the indiscriminate, synchronized market rout that followed, suggested to some that the world was heading into a darker place. We do not share this view. We believe that the prospect for Fed tapering means only that the underlying economic fundamentals in the U.S., most importantly its private economy, are improving. The gauge of manufacturing activity, the ISM survey, has consistently pointed to an expansion in manufacturing. Confidence surveys show an improvement in sentiment. Jobs are being created at a steady if unspectacular rate. And most importantly, housing, without which the U.S. economy would continue to labor, is gaining momentum with housing starts, sales of existing homes and prices all rising nicely.

A stronger U.S. is positive for Asia. Conditions are in place for a stronger dollar and are an attenuator on chronically strong Asian currencies including the Yuan. China's exports should improve. This would be accretive to GDP and help ease the economic strain felt in the decline of fixed investment, which we expect because of tighter liquidity. Rapidly rising wages should be supportive of consumption in China. We are optimistic, therefore, that, within a quarter or two, economic conditions in China will improve. More importantly, we believe that the showdown currently underway in the financial system in China is a strong indication of the reforms necessary for China to advance beyond its emerging status. The long term gain from a more market-driven banking system will mean that credit is more efficiently allocated, leading to healthier and more sustainable economic growth. This is a credible start to the ambitious reform agenda unveiled by the new leadership. If this is a harbinger of other reforms to come, the future for China has suddenly brightened.

Dave Descalzi
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