SeaBridge Asia Strategy
Second Quarter 2015
Commentary

In writing these commentaries over the years, we have tended to focus on China, with good reason. Despite its many problems and structural deficiencies, China has for years produced the world's best economic growth under relatively stable conditions. It has become the world's second largest economy. China is now engaged in perhaps the most ambitious reform initiative of the past thirty years, nothing less than the wholesale restructuring of its economy. At a high level of abstraction, this means more consumption, more private enterprise, more corporate transparency, less reliance on exports to the West and fixed asset investment generally. The changes have been coming fast and furious. Mandated increases in the minimum wage are yeast for a burgeoning middle class and the bane of corporations endlessly seeking efficiencies to counter rising labor costs. There has been a full bore attack on systemic corruption unsettling entrenched interests in a command economy, but making that economy more accommodating to private enterprise. More recently, the government has turned its attention to credit creation and capital flows with a view toward broadening the public equity and fixed income markets and inviting more risk taking by both domestic and foreign investors. In November 2014, a scheme known as the Hong Kong Shanghai Connect, was launched that provided Mainland investors access to shares listed in Hong Kong and allowed foreigners to trade Shanghai listed shares through the Hong Kong Exchange. Later this year, a similar scheme is scheduled to be launched for the Shenzhen Exchange. In October 2014, China launched the Asia Infrastructure Investment Bank that would provide capital for the buildout of rails, port and other infrastructure throughout the region. On the currency front, China is swiftly moving toward full convertibility of the yuan. As evidence, we note that in 2006, one percent of China's external trade was denominated in the yuan; today, it is 25%.

China's ambitions now officially know no physical boundary. In contrast to Putin who merely seizes land, China creates it in various remote locations in the South China Sea, an international body of water China claims as its own. China is clearly starting to punch its weight in the world arena.

While China engages in the really big things listed above, it must also deal with the consequence of its reform effort - slowing growth. It is widely acknowledged that the growth in domestic consumption cannot completely fill the void created by falling net exports and declining fixed asset investment. In this regard, China has demonstrated that it is not averse to deploying fiscal or monetary stimulus to promote economic growth. However, it will likely eschew the big bang approach it used in the financial crisis of 2008 when US$600 billion was wantonly pumped into the economy. Rather, if growth decelerates to an uncomfortable level, China will likely stimulate it in a measured way, through the banking system, with adjustments to deposit and lending rates and the reserve ratio and by increasing lending quotas

For the investor, all this maneuvering, big and small, has had the effect of increasing the volatility of price movements of Chinese securities. For example, some stocks on the Shanghai Exchange rose more than 50% one day during the quarter, only to fall by the same magnitude the next. The magnitude of this deviation and the extraordinary Price/Earnings level achieved in Shanghai (20x) and Shenzhen (44x) are sufficient to keep most institutional investors on the sideline (Source: Bloomberg, June 8, 2015).

There has been a knock on effect of this volatility in the Hong Kong market. Many of the constituent stocks of the Hong Kong Exchange have a Chinese pedigree. In 1997, only two members of the 33 stocks of the

Hang Seng Index were Mainland companies. Today, more than half of the index members fit the bill. Money flows in and out of Hong Kong now more than ever reflect sentiment and arbitrage opportunities surrounding China listed shares on the Hong Kong exchange. Consequently, the volatility of Hang Seng Index and its sub-indices has risen.

We are discussing the current trend in China shares because of the profound effect it has on our portfolio management. We have long been leery of Mainland companies largely because of their unpredictable treatment of minority shareholders and the loose application of the rule of law. On a more fundamental level, these firms' prospects are clouded by current subdued economic conditions in China. For these reasons, we have been reluctant to add significantly more China to the portfolio, tempted though we may have been by the impressive run up of share prices early in this quarter. Our underweight in China-specific shares is the primary reason for our underperformance against the index in the quarter.

We would note that we have not stayed on the sidelines entirely. We have bought a number of China companies listed in the U.S. where the compliance bar is set high and valuations are generally more attractive. These U.S. listed China shares did not run up with their counterparts listed on the Hong Kong Exchange in preceding months and did not fall when the China market showed cracks in the months of May and June.

In addition to our cautious approach to Chinese equities, we would make the following observations on our management of the portfolio:

1. South East Asia (Thailand, Indonesia, Malaysia, and Singapore) has performed particularly poorly this year. The strong dollar and adverse political developments in Thailand and Indonesia have weighed on markets there. With investor interest directed to China and north Asia, some of the strong fundamentals of ASEAN are being ignored. We will likely add to our holdings in this part of the region.
2. Increasingly, we are turning our attention to Japan. While we find the macro backdrop of poor demographics and deflation unsettling, there is no denying that corporations have been a beneficiary of a weak yen that is the result of very loose monetary policy there. Earnings have improved. Additionally, we are seeing evidence that corporations, breaking with precedent, are making more rational capital allocation decisions. We have two Japanese companies in the portfolio and are looking to add.
3. India has corrected. We hold India stocks primarily through companies listed in Singapore and elsewhere but with substantial India operations. Should the Modi government demonstrate success with its own reform program, we would look to increase our weight there either through ADR's or a country ETF.
4. We have long been attracted to the higher dividend yields of Asia ex. Japan. We are mindful that rising interest rates in the U.S. will pressure fixed income securities and their proxies. While free cash flow and dividends will likely continue to figure prominently in portfolio construction, we would like to add more growth at a reasonable price. This may be difficult in a slow growth world.

At the time of the writing of this commentary, the world finds itself in the throes of a high stakes negotiation between the European Union and Greece that could determine not only Greece's place in the federation but the integrity of the union itself. Greece is ground zero for a condition that bedevils the West – too many promises and insufficient resources to fulfill them. Europe now joins the U.S. and Japan's central banks in printing gobs of money in a concerted effort to manufacture inflation and growth. The consequence of these bond buying programs known as quantitative easing has been a lot more debt, a little more growth and virtually no inflation. Public officials in profligate countries who find it too difficult to do the heavy lifting of liberalizing labor markets, reforming pensions and rationalizing tax policy can find refuge in quantitative easing.

We would be surprised if China resorted to the blunt instrument of quantitative easing. On the other hand, China's economic slowdown and, more acutely, recent stock market gyrations in Mainland bourses, have increased the probability of further government interventions and the risk of a policy mistake. Our belief is that China will make it through this turbulent period because it has the time and resources to do so.

While current times may appear unsettled, we continue to believe that, for investors, the incredible growth of the middle class will differentiate Asia from all other regions of the world. Finally, we are convinced that the reforms we note above do represent some heavy lifting for China and will put China on a sounder economic footing for years to come.

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Note this version of the Asia commentary includes updates as of 7/8/15. SeaBridge clients received an earlier (7/6) version in their client packages.
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