SeaBridge Investment Advisors, LLC

SeaBridge Asia Strategy

Second Quarter 2016
Commentary

As we approached the end of the quarter, we were greatly encouraged by the way markets were behaving in the face of a number of challenges. With the U.S. economy out of intensive care, there was a growing expectation that the Federal Reserve would raise the Fed Funds rates at the June or July meeting of the Board of Governors. Unlike past poor reactions to Fed signals of tighter money, the market seemed to take solace in a prospective rate increase. The Fed finally would take a necessary step on the road to normalcy and away from the extraordinary monetary regime in place since the Great Financial crisis of 2008. China, whose erratic responses to economic slowing and currency volatility roiled markets in the Fall of last year and first quarter of this year, turned quiet. Capital outflows that had put significant downward pressure on the currency subsided. (It should be noted that China has become so critically important to world growth prospects, that its currency the yuan is now an important leading indicator of how world markets might trade. Any precipitous decline in the yuan is a dependable harbinger of a selloff in financial markets.) During the quarter, the stocks in our portfolio were rising or falling on company fundamentals, and that was fine with us. And then there was Brexit.

Brexit refers to the June 23, 2016 referendum by British voters to exit the European Union. It was a much watched vote for its global economic and political implications. Bookmaking odds before the vote had pointed to a 'Remain' outcome. The actual vote to leave took markets by surprise. Equities on the day after the vote sold off significantly, but have since rebounded.

There is nothing that we can say with certainty about Brexit except that the British political scene has turned upside down. Conservative and Labour leaders are resigning from government creating a leadership vacuum that only adds to the uncertainty. Here's what we don't know:

1. The terms of the divorce. The Lisbon Treaty contemplates a withdrawal of a European Union member in Article 50, which specifies that a leaver should notify the European council of its intention, negotiate a deal on its withdrawal and establish legal grounds for a future relationship with the EU. On the European side, the agreement needs a qualified majority of member states and consent of the European parliament. Negotiators have two years from the date of article 50 notification to conclude new arrangements. Failure to do so results in the exiting state falling out of the EU with no new provisions in place, unless every one of the remaining EU states agrees to extend the negotiations. Will Article 50 be invoked as written; invoked as modified or not invoked at all?
2. The arrangement that replaces the Lisbon Treaty and establishes the terms of trade and capital flows between the UK and Europe. The UK runs a significant current account deficit with the EU and needs to fund this deficit. Will the trade continue? How will it be funded?
3. The status of London as a preeminent world financial center, if the European banks leave for the continent.
4. The effect on the buoyant UK housing market.
5. The effect on capital investment in both the UK and the EU. How much will investment suffer in the absence of a renegotiated arrangement?
6. The status of EU nationals in the UK and Brits in the EU. Must they be repatriated?

7. The durability of the United Kingdom itself. Scotland and Northern Ireland each voted against Brexit. There is some speculation that Scotland, which only last year affirmed their preference for remaining in the UK itself, will seek another vote on its exiting the UK and joining the EU on its own. A similar dynamic applies to Northern Ireland, which also voted to remain. Does the UK itself dissolve?
8. The durability of the EU itself. Will individual countries now begin to look to Brussels for better deals from the EU in exchange for a continuing commitment to the Union? Is this the beginning of the end of the European federation?

The market does not like unknowns so it was no surprise that a broad based sell off followed the Brexit vote. What was surprising was the bounce back in the last few trading days of the quarter. And perhaps in this reaction, there are clues as to what Brexit really means. Possibilities include:

1. The economic fallout from the divorce is absorbed with help from the BOE and the ECB
2. A political accommodation can be found and, as is the case of most divorces, an amicable parting is better than an acrimonious one. European bankers are neither expelled nor called home. London as haven for foreign money looking for safety is reaffirmed. In this rapprochement, terms of trade are renegotiated in a way that is satisfactory to both Britain and the EU.
3. There is little credence being given to the breakup of Great Britain. Scotland and Northern Ireland will remain in the United Kingdom.
4. There may be no divorce at all between the UK and the EU. This might be accomplished in any number of ways but the most likely one is a new prime minister winning a mandate on a platform of real renegotiation with the EU for a reform of terms that meaningfully addresses the UK's concern with the heavy hand of Brussels.

Or the market, as it was in the lead up to Brexit, could simply be wrong. Still, the trading response to Brexit in Asia should be viewed as encouraging. On the first trading day post Brexit, Asia traded down but less so than other markets around the world. On the second day following the referendum, Asia was flat; it rose on the third day, each day outperforming other markets. Asia has historically been very sensitive to exogenous shocks. The muted response to a significant event may have been a precocious recognition of its benignity. Or it may be a sign that Asia is achieving something that it has long sought – a decoupling from the West. We don't want to overstate the case for decoupling. No country in a world where there is fluid movement of goods, capital and people can isolate itself from what is going on outside its borders. Still, the subdued response to a very large external event perhaps suggests that the Asia region, which is increasingly looking to domestic solutions for its economic wellbeing, has acquired some ability to stand on its own. Upon request, we would be happy to send you a presentation on the shift in emphasis in Asia away from a mercantilist economic model toward a consumption orientation, a transformation that is key to decoupling.

Following are comments on activity in our Asia strategy portfolios during the quarter. Note that not all accounts participated in some of the trades due to client-specific factors.

We trimmed some stocks whose prices rose sharply for a variety of reasons:

1. **Minth** is a manufacturer of external trim parts for automobiles for both the China domestic market and for export. Despite recent strong operational performance and impressive ascent up the product value added chain, we think it prudent to take some shares off the table.

2. We also reduced our holding in **Pacific Hospital Supply**, a Taiwanese manufacturer of disposable medical tubing. Shares advanced sharply in the first half of the year on a strong rebound in sales at the firm and we decided to trim an outsized position.

3. **Navitas** is a leading higher education pathway provider for Asian students seeking a college degree in, primarily, Australia, the U.S., Canada and the UK. The stock has been very strong of late as the market digested the loss of a university partner opting to go it alone in the foreign student market. Although we believe that the company's strong growth profile remains intact, we thought it prudent to take some shares off the table.

4. **SM Prime** is a mall operator in the Philippines and a beneficiary of one of the stronger economies in the region. It's an excellent operator with an ambitious growth plan in its home country. Operating metrics have been very good of late and the market has come to believe that its plan to double earnings in three year is achievable. We trimmed into strength.

5. We reduced our exposure to **Syngenta**, our agricultural chemical and seeds company, based in Switzerland. Syngenta has agreed to be acquired by China National Chemical Corp., China's largest chemical company, in a transaction that currently values Syngenta shares at a price 20% higher than the current share price. This is the market's way of telling you that there is substantial risk that the deal does not happen. If it falls apart because of regulatory roadblocks, Syngenta's share price will fall. We believe shares are overvalued, absent the ChemChina deal.

6. **Fisher & Paykel Healthcare** is a New Zealand based company that offers humidification therapies for use during the treatment of respiratory conditions and sleep apnea. The stock trades at a high multiple, despite very good near term growth prospects. The company has a solid operating record and an enviable growth profile. We trimmed on high valuation.

We trimmed two other stocks because of what we believe are adverse developments within the companies:

1. **Vtech** is a Hong Kong based company that is the world leader in electronic learning devices for young children. A proliferation of alternative devices and software now available to parents makes this business vulnerable, and we've decided to exit the stock.

2. **Samsonite** is the world leader in luggage across a number of price points. We think its rapid growth through acquisition changes the risk profile of the company and are eliminating our position.

On the buy side:

1. We purchased shares of **Puregold Price Club,** a fast growing, Philippines supermarket chain.

2. We bought **Sporton,** a professional product testing and certification services company, based in Taiwan but with a growing presence in China. It is particularly strong in certifying products related to the internet of things, defense and aerospace.

3. We added to **Johnson Electric**, one of the largest producers of micro motors in China. Micro motors are used in autos and consumer products and, increasingly, in industrial applications. The company recently released its FY16 results. While sales growth met expectations, margins disappointed due to adverse currency effects and the teething pain associated with acquisition of Stackpole, a leading

manufacturer of oil pumps and powder metal components. We expect the company to perform better into next year.

4. **Delta Electronics** had a bad quarter because of adverse foreign exchange movement and contract timing issues. After a good run, we had sold some near its high in the middle of last year. The stock has retreated based on this most recent result giving us an opportunity to rebuild our exposure. The company manufactures power supplies and electronic components including cooling fans, EMI filters and solenoids, power converters and solar inverters. The products are widely used in automotive, medical, telecommunications, IT, and factory automation applications.

5. Finally, we bought **Ascott Residence Trust,** a real estate investment trust that invests primarily in long term stay service residences across geographies. Although mostly in Asia, it has properties in the UK and France and so has felt the effects of Brexit. We do not believe that London will lose its cache as an international financial center, so a main draw for its properties there should remain in place. In France, the company is on a master lease arrangement that guarantees a base level of performance. The trust's yield now exceeds 7%.

Although we've devoted a fair amount of space in this correspondence to Brexit, we'd like to close this letter with the thought that we don't own economic growth or inflation expectations or monetary policy in the portfolio. We own companies. We will discuss portfolio companies in greater detail in future communications. We also plan to harvest tax losses for taxable accounts where appropriate before year-end.

David Descalzi
July 6, 2016