SeaBridge Asia Strategy
Second Quarter 2017
Commentary

Asian equity markets, like nearly all global markets, performed well during the quarter. Here are some of the reasons for the strong showing:

1. While some of the economic data in the second quarter has been mixed, fears of a sharp China slowdown proved unfounded. This has been a very positive development for China and the region generally and may be the single biggest reason for a contraction of the risk premium associated with Asia investing.
2. Regional trade continues to improve. While global trade has not recovered to levels seen before the last recession, there has been a steady, at times dramatic, improvement in intra-regional trade over the past two years. This is a clear signal that the region is increasingly capable of reducing its reliance on the West for its economic wellbeing.
3. China has not been labeled a currency manipulator by the U.S., one in a series of incendiary, but, thankfully, unfulfilled Trump campaign promises. This is a positive development for China and the region generally.
4. China finally appears to be serious about taming its credit excesses which are probably the biggest macro concern in the region. The rate of credit creation is now commensurate with the rate of China's economic growth. Additionally, China is implementing market-based mechanisms for handling their significant non-performing loan problems. The markets appreciate these market-oriented initiatives. In what may become an important element in the handling of non-performing loans, China, for example, on July 3, allowed one way capital flows into China via Hong Kong in the domestic fixed-income market.
5. The rotation into international equities and away from the U.S. equity market continues. There is a building consensus view that there is more value outside the U.S. now than has been the case for the past few years. Asia, like other global regions, is benefitting from this rotation.
6. The run-up in the U.S. dollar was pronounced in the quarters prior to this one. Our suspicion is that Asian securities have been bid up as part of a U.S. dollar diversification strategy among international investors based on the expectation that the dollar might weaken given some recent relatively soft economic data coming out of the U.S. and continuing strength out of Asia.
7. First quarter earnings for Asian companies have been robust. Despite modest sales growth of 1.2%, earnings grew 20.4% year on year, ("yoy") for MSCI Asia ex Japan. There is a sound fundamental underpinning to the markets' advance in the quarter.

Reviewing the portfolio, we note that our China stocks were among the leading performers during the quarter. China Lodging is a U.S. listed Chinese company that operates economy and mid-level hotels in China. The company has an asset light model and has found success in branding and managing other people's properties. Tencent, China's leading social media and online gaming company, did not disappoint in its last earnings announcement, posting revenue growth of 55% and eps growth 57%, yoy. This is an impressive performance for a company its size. They are about to begin exploiting other growth vectors in news and non-gaming entertainment. Given both companies' sharp share price increase in the quarter we will be looking to reduce exposure in both names.

Among our laggards was Ginko, China's leading contact lens manufacturer and distributor. The company has had some growing pains with its new Taiwan based factory. Additionally, some working capital issues need to be worked through. Still, this is the leading company in potentially the world's largest market for a product that is incredibly under-penetrated. Zojirushi, our high-end Japanese rice cooker and thermos company, also disappointed. Sales in Japan in the first quarter did not impress. The outlook was somewhat cautious. Still, sales in China, the company's most important growth market were up 18% in the quarter. The opportunity in China is huge, so we are willing to live with the company a while and see what happens.

We do have some concerns:

1. If there is a problem with markets in the next few quarters, it will probably be an imported one. Europe looks the likeliest driver of potential future stress. Should the European Central Bank make a misstep with policy, particularly as it begins reversing quantitative easing, Asia markets, and probably all markets, would have a tough time.
2. Markets have advanced pretty far, pretty fast. This makes us cautious. There is bound to be a plateauing out; a pullback should not be unexpected. We would view such a development as an opportunity to selectively build full positions in our holdings that have not fully participated in the markets' recent advance.
3. North Korea is a wild card. President Trump may show a lot less patience than did previous administrations over the flouting of UN imposed restrictions regarding the development of nuclear weapons and a delivery system for those weapons. It is not a stretch to say that there may be a preemptive strike against the rogue regime should there be no movement toward compliance with UN mandates. If there were to be a U.S. military response to North Korea's recalcitrance, Asian markets would most likely fall, but so would all other markets.

Nonetheless, we remain optimistic about our portfolio. There is a reasonable expectation that small caps will catch up to their large cap counterparts, which drove index performance in the quarter. This would be an important development for the portfolio which contains many small, underfollowed companies.

China's inclusion in the MSCI emerging markets index is a watershed event for China in its march to developed status. After nearly four years of discussions over whether to add yuan-denominated shares listed in Shanghai and Shenzhen to the MSCI Emerging Markets Benchmark, the country finally won inclusion in June. China was able to demonstrate to MSCI that it had improved its regulatory framework in a way that affords shareholders protections available in other MSCI-vetted markets

We continue to feel very strongly that the region is at the very beginning of long secular trend of phenomenal expansion in the number of the middle class, which, we believe, will be the single most important factor in the rise of equity markets there for years to come.

Dave Descalzi
July 5, 2017