SeaBridge Investment Advisors, LLC

SeaBridge International Strategy

Second Quarter 2017

Commentary

The International Strategy continues to build on the positive momentum from the first quarter. Most major markets across Asia, Europe, and Latin America have outpaced the United States in dollar terms at the halfway point of 2017. The weakness in global currencies against the dollar post Trump's election has reversed course with most at or above pre-election levels. This retracement has been a tailwind as the foreign holdings in the portfolio are translated into dollars. While the market momentum is positive, the economic backdrop is becoming a bit more mixed.

For much of the first half of the year, a synchronized global expansion and strong economic data validated our optimism for global markets. More recently, we have concerns over some softening of the data, especially in the U.S. Additionally, we are worried about several geopolitical developments particularly the nuclear standoff with Korea, some important elections that will take place in Europe this year and the hyper-partisan political atmosphere in the U.S. Despite these concerns, we remain optimistic about the second half of the year.

In the U.S., the job market is strong with unemployment at its lowest levels since May of 2007. Manufacturing and service survey data suggest a continuing expansion. Confidence surveys are at the highest levels since the last recession. However, other data points such as slowing retail sales, declining new housing starts, and slowing auto sales temper our enthusiasm. Still, with no recession in sight, we remain optimistic about the U.S. economy. GDP growth in the first quarter was 1.4%; the Atlanta Fed is forecasting 2.7% for the second quarter. Although these numbers remain well below the average in prior expansions, they are generally in line with the rates of growth posted since the last recession. On the political side, a portion of the Trump premium priced into equity valuations after the election has receded, reflecting, we believe, a disappointment in the failure to enact most of the growth agenda promised on the campaign trail. Markets should react favorably if legislation that lowers corporate taxes and promotes infrastructure is signed by the president this year. We think there is a fair chance something will get done.

Eurozone PMI registered a slight drop in June from 56.8 to 55.7; still, this was the strongest quarter of economic growth in six years. Other data points that we touched on in the Q1 commentary (retail sales, economic sentiment, capacity utilization, inflation, unemployment) all moved in a positive direction over the last three months. A confrontational populism underpins political uncertainty in the region, but there was a positive political development for Europe during the quarter. In a critical presidential election in France that could impact the fate of the European Union, centrist Emmanuel Macron handily defeated right-wing candidate Marine Le Pen. Even with low voter turnout, the Macron victory was a welcome indication to the markets of the stability of the Union. On the other hand, snap elections called for by Theresa May in the UK shockingly left her Conservative party eight seats shy of a majority and necessitated some coalition building between the Conservatives and Liberal Democrats. This was a serious blow to May and will likely make it more difficult to achieve a clean break with the EU. Brexit uncertainty may weigh on the UK market. German and Italian elections slated for this year are proxy contests on the ongoing struggle between nationalism and globalism in Europe. The outcomes of these elections will give us more insight into the durability of the EU and the Euro. For the time being, developments in Europe are trending positive.

While some of the economic data in Asia for the second quarter have 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. Regional trade continues to improve. While intra-regional trade has not recovered to levels seen before the last recession, there has been a steady, at times

dramatic improvement 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.
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. For example, in what may become an important element in the handling of non-performing loans, China, on July 3, allowed one way capital flows into China via Hong Kong in the domestic fixed-income market.

Although short of the ambitious goals set by Prime Minister Abe, Japan is moving in the right direction. Growth is better, inflation is creeping higher although the pace is such that domestic-oriented companies may continue to have a hard time growing the top line. Exporters may do better as the cheapening yen (even with the recent strength in global currencies, the yen has depreciated roughly 30% against the dollar over the last 5 years) will make their products, which are of generally high quality, more competitive in international markets. Despite our skepticism about longer term prospects for Japan on the investment front, we are mildly optimistic that conditions there generally will continue to improve.

The rotation into international equities and away from the U.S. equity market continues and seems justified. Foreign markets across the board are somewhat more appealing compared to the U.S. Price to earnings valuation spreads remain near the widest levels seen over the last five years although there may be some distortion created by the overweight of financials in ex-U.S. indices. Still, there is a consensus view, correct, we think, that there is more value outside the U.S. now than there has been in the past few years. This was discussed in an Interim Commentary as well as highlighted in the accompanying slide deck that we posted on our website in May. It can be found at seabridge.com under Commentary → SeaBridge 2017 Interim Commentary.

The International Strategy

Turnover in the International Strategy was low for the period, with a bias toward the sell side:

- **Man Wah** – We sold out of our position. We initiated the trade based on a small concern that the company would be named as a short sell candidate by Carson Block, an influential short seller, who, through in depth analysis on companies, seeks to uncover operational conditions that are inconsistent with public disclosure. Muddy Waters, Block's research firm, has a credible track record, particularly in Asia. His named companies usually suffer precipitous decline in share price, often are suspended from trading or, worst case, never recover and go out of business. Block had warned investors that he would announce his new short sell target on June 7 at 2 p.m. HK time. The stock had traded erratically in the prior week, leading some to believe that it was a candidate, among others, that might be named by Block. The International portfolios owned a modest position in the shares, which had performed well. Surveying market conditions, we felt that the upside downside to the shares, despite the low probability that the company would be named by Block, favored our exit. Consequently, we placed an order to sell our entire positon in the International portfolios in the morning session of trading in HK. We successfully sold all our shares by 11:30 a.m. HK time. At 2 p.m., the company was named by Block as the short sell target. The shares immediately traded down 20% and were suspended from trading early in the afternoon session. The price has bounced back and is roughly at the same level we sold the shares as management promptly responded and refuted Block's claims (margins are an industry outlier, undisclosed debts, tax inconsistencies, overstatement of China sales). This last chapter in this story has not been written.
- **Gilead Sciences** – Revenue is rapidly declining in its core Hepatitis C franchise. Writedowns in Merck's HCV business offer more evidence of the severity of the slowdown in hepatitis treatments. We felt that the company would use the ample cash on the balance sheet for a large acquisition to help replace the declining cash flow. There were rumors of a deal with Incyte, but the stock had little reaction. Even with the stock trading at 8-9

times earnings, we viewed the risk of overpaying for an acquisition or the failure of a deal to materialize to outweigh the benefits.

We trimmed positions in:

- **NXP Semiconductors** – We reacted to news that Elliot Management and other large shareholders are looking to pressure the company to renegotiate its previously announced merger agreement with Qualcomm. The stock was trading less than a $1 below the current deal price ($110 cash per share). We decided to take some profit while we wait to see how the renegotiation unfolds.
- **Apple** – The stock had a strong run over the six months prior to the trim. Its price/earnings expanded nearly 4 turns over this period. The stock is pricing in very strong growth assumptions (high teens) and some margin expansion surrounding the upcoming release of the iPhone 8. We took some profit given the high expectations leading up to the release. Should the release disappoint in any way, Apple shares may be vulnerable. Together with Broadcom, a chip set maker for smart phones, we feel we have enough exposure to the cellphone cycle.
- **HDFC Bank** – The emerging market Indian bank has been one of the strongest performers in the portfolio YTD. The stock is up roughly 40% with roughly half of this appreciation due to multiple expansion (P/B moved from 3.7 to 4.5 over the period). The company has a solid balance sheet, a low level of NPLs, and a long runway to grow loans at 20% so we are still positive on the stock but more comfortable with a slightly reduced position.

We added to one existing position:

- **IBM** – The company reported disappointing earnings. This provided an opportunity to add to our position on weakness. Although many investors are perhaps more skeptical about the firm's transformation from a company that provides a full range of local network system solutions to corporate enterprises to one that extends its reach into the corporate and government sectors through a unique capability for analyzing proprietary data to produce actionable, cloud based outcomes for their clients, we remain convinced that the transformation, though not occurring immediately, will over time be successful. They are putting in place the pieces to produce gross margin expansion, a metric which disappointed this quarter.

At a high level, our financial and technology holdings were the largest contributors to performance. Names like **AIA Group** and **HDFC Bank** as well as **Tencent** and **Alphabet** helped drive the gains. From a geographical standpoint, holdings in Asia ex Japan were the largest positive for the period. Being overweight the region as well as our individual stocks outperforming the regional benchmarks led this group to contribute to roughly half of overall portfolio performance.

iShares MSCI Mexico Index Fund. Mexico has rebounded from the beating it took during the U.S. presidential campaign and post-election. The Mexican Peso is currently near its 52-week high. NAFTA is now considered necessary by Trump. The border adjustment tax which, if enacted, would damage both the U.S. and Mexican economies seems no longer to be under serious consideration as a component of prospective tax reform legislation in the U.S. "The Wall" may not materialize as a true physical barrier between the two countries but rather serve as a metaphor for more border security. This has been beneficial for our position in the ETF which has had a positive return for the period. We will likely trim or eliminate the position if the strength of the Peso continues.

Kennedy-Wilson, a global real estate company, was one of the bigger detractors for the period. This is likely due to the pending deal to acquire Kennedy-Wilson Europe in which it currently owns a minority stake. The uncertainty surrounding Brexit is also an issue for the company which has substantial UK holdings. We view the pull back in share price as a buying opportunity. The acquisition terms are moderately dilutive. Additionally, the company will no longer be receiving the roughly $1 per share in service income from Kennedy-Wilson Europe. We believe the dilutive factors are outweighed by the following: 1) the transaction should be immediately accretive to net income per share. 2) the dividend was increased by 12% and is well covered. 3) there has been no executive management change so the integration risks are lower. 4) management owns roughly 17% of the company (Chairman & CEO own over 10%) so we believe they would not be undertaking this dilutive deal if they were not confident it will benefit the company in the long run. 5) the purchase adds diversification to the property portfolio much of which is tied to the West Coast of the U.S. These factors make this an interesting company. A clean Brexit plan would help. Merger arbitrage activity will likely weigh on the stock in the near-term until the deal closes. We are prepared to add when we think it is appropriate

In summary, we believe that international markets are in relatively good shape underpinned by sound economic fundamentals and company earnings. But there are concerns. Central banks must find a way to reverse the easy money policy that has been in place since the last recession. The shrinking of major central banks' balance sheets bloated by quantitative easing, a heretofore untested policy tool for money creation, will be a particular challenge. There are the political risks discussed above. Markets are generally not cheap, although international markets do appear to be a better value than their U.S. counterpart. Given this backdrop, complacency may be our biggest risk. The VIX (which calculates market-implied expected volatility of S&P 500) is at all-time lows. For these reasons, we are content to have higher cash levels in the portfolio. We plan to skew conservative in portfolio construction and not chase high priced growth stocks. On market pullbacks, we should be in good position to add shares at better prices.

Regards,

Dave Descalzi
Matt Falkowski
7/7/17