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INVESTMENT ADVISORS, LLC

SeaBridge Asia Strategy
Second Quarter 2018
Commentary

Normally, in our quarterly commentaries, we focus on the future. We provide our view on what to expect out of Asian markets in the coming quarters. Given the abnormal nature of the period just ended, we thought it would be useful to examine the macro conditions underlying the severe downturn in Asian markets during the quarter, suggest reasons for the market's reaction to these conditions and gauge prospects for a recovery.

Trade War:

The Trump administration, apparently not content with the rejuvenation of a long dormant domestic economy recently energized by tax cuts and deregulation, turned its attention to trade. Would that it had left well enough alone. At first, there was harsh rhetoric and rumors of war around unfair trade practices. Then, the shooting began in the form of tariffs and regulatory foot dragging on approvals of cross border deals. The market became concerned, not without reason, that we may be entering a very dark period for global relations.

The markets' worry over a full-fledged trade war cannot be overestimated. Trade restrictions are inherently inflationary as tariffs and other barriers effectively shrink the supply of goods. Hiring and capital spending decisions within companies are put on hold. Supply chains are disrupted. If the imagination is allowed to run wild, it's easy to see an endless cycle of retaliatory measures that would adversely affect capital flows, intellectual property development and technology transfer, visa processing, the application of national security imperatives on just about any kind of cross border transaction or initiative -- all of which amounts to hitting the breaks on economic growth. The market in its worst moments fears a kind of paralysis that would greatly curtail global commerce. We believe without question, the trade standoff is the single most important reason that Asian markets have moved lower.

Emerging Market Fallout:

We have long made the case that Asia ex Japan learned some very important lessons on fiscal and monetary stewardship as a result of the Asian Crisis of 1997. Even with China joining the ranks of heavily indebted developed countries worldwide since that time, Asia generally is in much better financial shape than it was at the end of the last century when the region's stocks, real estate and currencies were routed. The trade dispute noted above refocused attention of investors away from progress made to deficiencies still unaddressed. A still relatively closed capital account in China that invites currency manipulation is a case in point.

If there is an external culprit in this reassessment, it is Argentina, which having suffered through its own crisis of 2005, failed to learn durable lessons. Its external debt level is currently about 40% of GDP, creating a servicing burden that puts significant downward pressure on the peso. Rates should rise to alleviate the pressure. However, it almost impossible to defend the currency through higher rates without affecting economic growth. Choosing between a stable currency and economic growth through interest rate policy is the classic developing market macro dilemma. Consequently, Argentina has become ground zero for investor skepticism over all emerging markets, broadly defined. Some of the hardest hit markets include Brazil, Turkey, Mexico and South Africa. Despite markedly different macro conditions prevailing in Asia, the region has been a casualty largely through "guilt by association" with all emerging markets having seen capital outflows reversing gains of earlier in the year.

Profit Taking After Last Year's Runup:

Because of the pain experienced in the quarter, it is easy to forget the extraordinary runup up of the region's markets in 2017. The MSCI Asia ex Japan gained 55% in a bit over 12 months. A partial retracement should not be unexpected.

Rising Interest Rates:

Rising interest rates in the U.S. place upward pressure on rates in the region. This will likely raise the discount rate for financial assets and thus depress valuations. Higher rates will likely also have the effect of slowing growth in the region. The burden of higher current and expected rates is being felt in Asia as they are in the rest of the world.

The Strong Dollar:

In the quarter, the U.S. dollar has strengthened considerably against all the major currencies including the Euro, yen, the British pound and the yuan. The dollar's rise against some emerging currencies like the real and the rand has been even more dramatic. Economic growth in the U.S. is clearly accelerating while growth elsewhere is noticeably softer. The dollar's strength suggests a new divergence in economic prospects accompanied by disparate central bank policy on monetary accommodation. With the tax cuts in the U.S. providing a huge stimulus for the U.S. economy and a Fed that is proceeding with plans to tighten money policy, we believe that the dollar will maintain its upward trajectory.

This creates a problem for Asia. Commodities, priced in U.S. dollars, have been rising. Asia is a big importer of most commodities with the effect of dollar strength putting stress on current accounts. With the trade situation as is, the weaker currencies which normally should stimulate exports may not be a source of strength for Asian economies. With the dollar's rise, U.S. dollar debt has become more expensive to service. While a strong dollar hurts other emerging economies in a more profound way, a strong dollar nevertheless puts pressure on the region's economy.

A Slowing China:

China's growth slowed toward the second quarter with the deceleration apparent in retail sales, industrial production and fixed asset investment. As China continues its journey to developed status by transitioning to a much more consumption-oriented model, slower growth should be expected, even welcome by the market. However, while the quality of this growth should be higher because it is less reliant on fixed asset investment (e.g. bridges to nowhere), softer headline economic data may disappoint, creating downward pressure on equities. We believe this fear crept into the market during the quarter.

So, given these concerns, why are we optimistic about the rest of the year and periods beyond? First, it is our belief that the first three concerns listed above are temporary. Despite the ratcheting up of trade war rhetoric and the tit-for-tat imposition of tariffs on ever increasing amounts of trade, our belief remains that a grand, mutually beneficial bargain on trade is the most likely outcome of the current dispute. On the emerging market front, we believe that Asia has developed to a point where investors should be able to differentiate between Asia and other emerging countries with more serious macro imbalances and political dysfunction such as Brazil and South Africa. We expect portfolio flows to become more discerning within the emerging category as the year progresses. Clarity on trade should be the catalyst for returning to a region where stocks now trade at deep discounts to intrinsic and relative value. As for profit taking, well, the act itself sows the seeds of its own demise.

The other headwinds are more enduring. The Fed has signaled at least two more rate increases this year; and the market expects higher rates next year. Given this backdrop, as we note above, it is hard to see how the dollar reverses course. And China is slowing. We have gotten used to it. These conditions existed for most of the last year and into January when Asian markets sharply rose. This further supports our contention that the present downturn is mostly trade-related.

What does this all mean for managing the portfolio? In the quarter, the short answer is not much. We have learned over the years not to react to volatile short-term trading patterns. However, with markets in the region considerably off their highs primarily, we believe, on the basis of transient issues, we expect to become much more avid buyers in the coming quarters.

As we enter a new earnings season, we are keen to learn what the companies have to say about evolving conditions.

We have attached comments on portfolio changes during the quarter.

Dave Descalzi
July 6, 2018

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There are differences among portfolios managed by SeaBridge in each strategy based on client-specific factors. Not all portfolios hold the same securities. Not all stocks held in the portfolio perform similarly. Some client accounts may not have as much cash reserved as other accounts managed in the strategy due to client withdrawals or other issues. SeaBridge manages portfolios in several styles.

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Transaction Summary

Note: some accounts did not participate in some of the trades mentioned in this summary due to client-specific factors.

Purchases

We increased our position in **Boral**, an Australian-based manufacturer and supplier of construction material. The company's revenue update for the March quarter was lower than expected because of severe weather conditions in Texas and Australia. In addition, there was an unexpected kiln outage in Australia. Both conditions should prove transitory. We continue to believe that the company's two end markets (Australia and the U.S.) could each be entering into a substantial, much needed infrastructure buildout period, a development which would obviously benefit the company. The residential part of the business should be strong in the U.S.

Knauf's recent acquisition proposal for USG allows Boral to acquire USG's interest in a joint venture with Boral in the Asia Pacific region, which we believe over time will be accretive to Boral.

We took advantage of a price pullback to increase our position in **Delta Electronics,** which manufactures components widely used in automotive, medical, telecommunications, IT, and factory automation applications. It is a quintessential Asian manufacturer in that it is domiciled in Thailand, has plants in Thailand and Eastern Europe, research centers in Asia and Germany, and a large part of its customer base in the developed markets. After a good run, we had sold some near its high at the beginning of last year.

The company had a bad first quarter because of adverse foreign exchange movement and contract timing issues. While first quarter numbers were weak, the actual performance of the company was in fact encouraging. The company reported constant FX revenue growth of 15%. Furthermore, the short-term impact of raw material shortages was partially offset by well-contained SG&A expenses, suggesting admirable management attentiveness to the income statement. It is our expectation that negative external conditions affecting the company will recede in the coming quarters. The stock is cheap on a historical basis, trading at about 12x next year's earnings.

Hi-P is an integrated contract manufacturer with capabilities in both component manufacturing and product assembly. Hi-P had its IPO in 2003. It is a fully fledged ODM and EMS service provider with competencies in both plastics and metals, which allows the company to fabricate products in their entirety beginning with the design stage. Notable clients: Apple, Amazon, Keurig, Colgate, Braun, Gillette, Fitbit, Ofo and Motorola. HIP has 13 manufacturing plants worldwide and a workforce of 15,000 employees. Most plants are in China (Tianjin, Chengdu, Shanghai, Nantong, Suzhou and Xiamen) as this is where their main clients' supply chains are based. The company also has operations in Thailand, Singapore and Poland. Revenue by category: Wireless (~20%), Computing & Peripherals (~20%), Consumer Electronics, (~40%), Medical & Industrial (<5%), IoT and Accessories (15%-20%).

Although a modestly sized manufacturer, Hi-P can offer the same services as the big contract manufacturers albeit as a smaller scale. This should enable the group to service clients who have been rejected by the larger EMS players (the Taiwanese) who only accept large volume orders. As a result, Hi-P has crafted a niche characterized by smaller volumes but better margins.

The company is a strong cash flow generator with a major capex cycle behind them. Capacity utilization is at 70%. The company has significant operational leverage.

We have been waiting for a pullback in the stock to add. Because its manufacturing base is in China, the shares have retreated as trade war rhetoric has intensified. As we do not believe that a full-blown trade war is inevitable, we are taking the opportunity to add to our positions at attractive valuations. It trades at about 9x forecast 2018 earnings.

Johnson Electric is a global leader in motion products, control systems and flexible interconnects. The company serves a broad range of industries including automotive, building automation and security, business machines, defense and aerospace, food and beverage, home technologies, HVAC, industrial equipment, medical devices, personal care, power equipment and power tools. The stock trades like an auto parts supplier, and a run-of-the-mill one at that. The trade war fears have driven the shares down to the bargain basement level of about 8x March 2019 forecast earnings. We think the stock could substantially rerate. We took advantage of price weakness surrounding the trade issue to add to our position. We will look to continue to add.

Pakuwon Jati, one of the largest property companies in Indonesia, is a diversified real estate developer with a strong presence in Jakarta and Surabaya. The Company's portfolio of prime properties includes retail, residential, commercial and hospitality developments. The Company is vertically integrated across the full real estate value chain from land acquisition, property development, marketing and operational management.

Pakuwon is the pioneer of the Superblock concept in Indonesia, a large-scale integrated mixed-use development of retail shopping mall, office, condominium and hotel. The company has developed in prime locations, has a successful track record and an excellent reputation within the property industry. While the company has some lumpiness to its earnings profile, its mixed use developments produce recurring investment income from rental and service apartments, hotels, malls and parking garages. This recurring income anchors future earnings and provides a measure of stability for investors.

The Indonesian market has gotten caught in the downdraft of emerging markets exposed to a strong dollar, not without reason. Corporates do have some U.S. dollar debt which, because of the weak rupiah, will be more difficult to service. Additionally, Pakuwon does have lessees in its malls that import from overseas, putting them in a more precarious financial position. However, the company’s virtues, including its prime mall locations in Jakarta, its diversified operating segments and its earned reputation as a good operator should win out over the longer term. We added to our position.

Sales

The first quarter results for Ascott Residence Trust were a mixed bag, as usual, but there seems to be an increasing number of markets in which there are Ascott properties that are not doing well. Downward pressure on revenue per available room is evident from new supply (existing + looming) in more markets.

We’ve liked the idea of Ascott but have been disappointed over time with results. A decent dividend yield has sustained us. However, with quite a number of divestment and acquisitions, plus the rights issue, it's getting complicated to estimate unit distributions for FY2018. Based on the first quarter number, and the murkier outlook for the remaining quarters, we thought it prudent to reduce. Other high yielding equities in Asia now appear more attractive to us. We will look to reduce further and replace with other names.

Fisher & Paykel is a New Zealand based company that is a world leader in providing invasive ventilation products to in-hospital patients almost exclusively in intensive care units and systems designed to alleviate the deleterious effects of obstructive sleep apnea (OSA). It is a company that should benefit from an aging developed world demographic and the growth of the middle class in Asia. As it migrates out of ICU with its ventilation products, particularly into emergency rooms, the pathway to in-hospital growth seems clear.

On the other hand, the company is experiencing more competition in OSA and history has shown that it will take a few quarters to counter new products put on the market by its main competitors Resmed and Philips. While its ventilation systems should show very good growth in the next earnings release because of the severe flu season just experienced, OSA, about 40% of the company, might appear pressured. The stock has done well for us and we have good sized positions in a few accounts in the Asia strategy. It is an expensive stock given our more subdued growth expectations over the next few quarters. We think it prudent to trim in those accounts that hold larger positions.

Tencent's results were in line to slightly disappointing. Revenue came in a bit lower than consensus and costs are ramping reflecting the cost of acquisition of content and investment in the new growth drivers of the firm including cloud and banking.

With some built-in growth drivers, the company is a reasonable alternative for investors who are worried about Facebook-related data issues affecting other U.S. tech companies. Tencent is fairly well insulated from all of that. We trimmed largely because of our large position size.

David Descalzi
07/06/18