SeaBridge Investment Advisors, LLC

SeaBridge International Strategy

Second Quarter 2018
Commentary

Normally, in our quarterly letters, we focus on the future. We provide our view on what to expect out of global 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, European, and Latin American markets during the quarter, suggest reasons for the markets' reaction to these conditions, and gauge prospects for 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, and the application of national security imperatives on just about any kind of cross border transaction or initiative, all of which amounts to hitting the brakes 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 has pressured global markets and is the single most important reason that all markets, particularly in the emerging world, have moved lower.

Emerging Market Fallout:

Emerging countries have a policy template for economic recovery following an economic downturn. It is Asia, in 1997. 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. Because it deleveraged and allocated capital more efficiently post-crisis, Asia now is in much better financial shape than was the case in the nineties when the region's stocks, real estate, and currencies were routed. However, largely because of the trade dispute, the market seemed to focus on Asia's deficiencies like a slowing China rather than on the enviable stability that now characterizes the region. In fairness, China has put on fair amount of debt since the global financial crisis of 2008, but so has the U.S., Japan, and the European Union. The market is painting Asia with a very broad emerging markets brush.

But not all emerging countries are created equal. 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 almost 40% of GDP, creating a servicing burden that puts significant downward pressure on the peso. Rates should rise to alleviate the pressure. But it is almost impossible to defend the currency through higher rates without affecting economic growth. Short sellers very much understand this dilemma. 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 international region in which we have the most interest as investors, it has been a casualty largely through "guilt by association" with all emerging markets and has seen capital outflows reversing gains of earlier in the year.

Rising Interest Rates:

Rising interest rates in the U.S. place upward pressure on rates globally. This will raise the discount rate for financial assets and thus depress valuations. Higher rates will also likely have the effect of slowing growth. The burden of higher current and expected rates is being felt around 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 emerging economies. 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 it is, the weaker currencies which normally should stimulate exports may not be a source of strength for Asian economies.

A Slowing Europe and Political Uncertainties:

Europe's outlook isn't terrible but far from robust as it continues to struggle to meet growth targets. Inflation remains weak despite extremely accommodative monetary policy. The ECB, albeit at a slowing rate, continues to expand its balance sheet by buying government and corporate European bonds at a rate of 30B euro per month. Furthermore, the official ECB overnight benchmark rate remains negative with the futures market implying it will not turn positive until 2020. German bonds, a safe haven for Euro investors, have negative yields out to seven years, more than a decade after the Great Financial Crisis of 2008. This is extraordinary. The bond market is telling us to brace for an extended period of slow growth, at best.

Against this backdrop, many member nations are clamoring for change. Notably among them is Italy, Europe's third largest economy. We're not sure what Italy wants from the EU, but it certainly is not behaving like a stalwart member. Pushback on the migrant issue may be a first salvo in a list of demands for Brussels. Italy is chafing under the stress of its massive external debt and sending a message to the Union that it will not tolerate the austerity that may be required for EU assistance. Italy's precarious financial condition is reminiscent of that of Greece a few years ago, except for the fact that Italy has an economy that is roughly 10 times the size of Greece. Italy's debt stands at 2.7T euros or 132% of GDP which is many times the size of Greece's debt level at its peak of 310B euro. As the relationship between Italy under new management and the EU evolves, there will be clues as to the durability of the EU itself. If Italy leaves, the EU as we currently know it will no longer exist. And markets will react.

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, softer headline economic data may disappoint, creating downward pressure on equities. We believe this fear crept into the market during the quarter.

The Portfolio

We **initiated** new positions in:

- **DAIFUKU** is a Japanese company that makes factory automation equipment. The stock was roughly 25% off the highs and trading under a P/E of 20 when this trade was initiated. For a company that is at the forefront of a big secular theme, we felt it was a good entry point for a starter position in our strategy. We will likely add on weakness. The most recent quarter was encouraging. The Factory Automation and Distribution Automation segments look to be firing on all cylinders. The industry as a whole is growing mid to high-teens and growing even faster domestically. Supply looks to be tight as orders are taking close to two years to fill rather than the twelve-month historical norm. Margins are improving as some of the recently added plant capacity becomes more utilized. The company continues to solidify its position as one of the leaders in the logistics automation industry. It exited a partnership with Knapp in Europe. Plans to gain a foothold in the region did not come to fruition, and focus was moved back to the North American and Asian regions where the company excels. We also believe the lack of capex spending during this cycle, which may be forthcoming because of recently enacted tax reform, adds an additional catalyst to the stock.

- **Singapore Technologies Engineering –** The firm operates across four verticals: Aerospace, Electronics, Land Systems, and Marine. The bulk of revenue is derived from the first two segments where STE provides Maintenance, Repair, and Overhaul (MRO) to both commercial and military aviation as well as communication technologies for rail systems, satellites, cyber security, and more. The core aviation and MRO business has the Singaporean defense force as a reliable anchor client which justifies a higher multiple than some comparable companies. The stock is roughly 20% off the highs and trading at 18-19x earning with a 4+% dividend yield. We are bullish on the aerospace industry. A rising oil price should benefit the struggling marine segment. We feel this was a good opportunity to initiate a position.

We **added** to an existing position in:

- **Boral Ltd.** – We added to our position in the Australian-based manufacturer and supplier of construction materials. The company provided a revenue update for the March quarter which was lower than expected due to severe weather conditions in Texas and Australia. In addition, Boral experienced an unexpected kiln outage in Australia. We believe these are transient events and provide a great opportunity to increase exposure to the position.

- **Johnson Electric Holdings** is a global leader in motion products, including micro motors, 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. Although at a different level from DAIFUKU, the company also fits in the secular automation theme. Johnson Electric provides the nuts and bolts, as it were, for industrial processes that are done with no or little human intervention. If Johnson succeeds in migrating out of low-priced, highly competitive commodity products into premium niche products, there could be earnings upgrades. The stock has suffered of late due to trade war rhetoric, allowing us to add to our existing positions. It trades at a dirt cheap multiple of roughly 8x earnings.

- **Omron Corporation** – We initiated a small position in this Japanese provider of sensing and control technologies that are key to industrial automation during the first quarter. Recent earnings report showed strong growth in the industrial automation business. Demand for robots across auto, semiconductor, and tv display sectors was robust. China continues to be a growth driver. A slowdown in the smartphone markets and cost increases remain a concern, but we believe the broad demand across sectors outweigh this risk. The second quarter provided a modest pullback that allowed us to add to the position.

We fully **exited** position in:

- **Credicorp Limited -** Part of the initial thesis on this Peruvian banking stock centered around the election of Pedro Pablo Kuczynski (PPK) as president of Peru. He is an economist with experience at both the IMF and World Bank. A few months ago, he resigned after multiple impeachment hearings regarding questionable payments received during his time as Peru's Minister of Economy. His vice president Vizcarra has taken over as president and seen multiple Ministers resign (including the Minister of Finance a couple weeks ago) during this short period. Combining this political risk with dollar strength and stretched valuations led us to eliminate this position.

- **Calbee -** The stock trades a premium to peers in the snack food industry. While growth expectations for the domestic Japanese market seem reasonable, the expansion into North America and China appear quite lofty. Overseas initiatives have repeatedly disappointed. The stock looks fully valued following the recent earnings report. At 27x earnings, we believe that that premium being paid is too high given the uncertainty.

- **Delphi Technologies** – This is a non-core position (a stub leftover from DLPH/APTV spinoff) being offered at reasonable valuation for the legacy automobile drive-business. However, we see better opportunities elsewhere in the portfolio.

- **Zojirushi -** We sold on the basis of a stretched valuation. Zojirushi is a Japanese rice cooker company that has both significant opportunities as well as significant hurdles as the company tries to crack the China market.

- **Deutsche Bank** – The stock still may have an attractive risk/reward profile trading at less than 0.5 times book value, but recent news that the bank is on the Federal Reserve's "troubled condition" list caused us to move to the sidelines. This label forces the bank to get Fed approval for any number of bank initiatives.

We **trimmed** positions in:

- **TenCent Holdings, MasterCard, Alphabet, and Aptiv** –These are four of our largest holdings in the strategy, and we felt it was prudent to take some profit as they are all at or near all-time highs.

So, given these concerns noted above, why are we optimistic about the rest of the year and periods beyond? 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 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 regions where stocks now trade at deep discounts to intrinsic and relative value.

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 in 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? We have learned over the years not to overly react to volatile short-term trading patterns. However, with international markets considerably off their highs primarily, we believe, because 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.

Regards,

Dave Descalzi
Matt Falkowski
7/6/18