SeaBridge Investment Advisors LLC

SeaBridge Asia Strategy

Third Quarter 2013
Commentary

Taper or no taper. That is the question. This poor pun on a self reflection of literature's most analytical and indecisive figure does characterize the current dilemma, existential in its own way, faced by Ben Bernanke at the Federal Reserve. Like Hamlet, Bernanke spent the quarter pondering, in his case, a reduction in the Fed's extraordinary bond purchase program. While tapering did not occur during the quarter as forecast in the previous quarter, the threat of it has forced the long end of the yield curve upward. With long rates higher but feeling more "normal", investors acclimated to a new rate regime, deemed the yield movement tolerable and put a bid in under equities. Asian markets participated in a worldwide bounce for the asset class.

In Asia, it was more than a tolerance for tapering that drove markets higher. Fears of a China economic slowdown had cast a pall over the larger north Asian markets earlier in the year. With China economic data generally coming in stronger over the past few months, these fears have, for the time being, dissipated. China and the China related markets like Hong Kong and Taiwan surged during the quarter. The portfolio is well represented in these markets and our holdings there contributed to our out-performance. The best Asia Strategy performers in a variety of industries including retail, manufacturing, property, automation, and commodities all had substantial earnings streams coming out of China.

Conversely, among our worst performers in our Asia Strategy portfolios were our ex-China companies including a number of holdings in South East Asia, which was the epicenter of the "risk-on" trade encouraged by global easy money conditions. With tapering a matter of when and not if, South East Asia will generally be more affected by rising interest rates, as the need for external funding of public and private debt and deficits is greater in south Asia than in the north.

During the period, we benefited from some repositioning of the portfolios that began in the second quarter and continued into the third. Specifically, in anticipation of rising interest rates, we reduced our overall exposure to stocks we deemed to be interest rate sensitive. Among these were property and hotel real estate investment trusts and companies whose return potential depended more on dividend yield rather than growth of earnings. The maneuvering worked as these stocks did prove vulnerable in the quarter.

We are not planning significant restructuring in our Asia Strategy portfolios at this point. The selloff in the South East Asian markets has made a relatively expensive part of the region more attractive. We will revisit companies we have been monitoring there but have so far avoided because of excessive valuation. We will also take advantage of market overreactions to company specific news, trimming the winners and adding at depressed levels to names we continue to believe in. The low, normalized turnover of our portfolios has allowed us to live with most of our companies through the ups and downs of at least one business cycle and thus understand them in a way that helps us take the emotion out of price movements and make better decisions in what we believe will continue to be a stock picker's market. Markets in Asia are neither expensive nor cheap. And the volatility that we can expect from exogenous events like tapering or the commotion surrounding the US government shutdown and debt limit discussions in Congress should provide us with opportunities to make beneficial changes to the portfolio on the margin.

The one factor internal to the region that will always have the capacity to move markets there is China's economy, which has now stabilized after a period of noticeably slower growth. China is currently embarking on a set of reforms that should be transformative for the world's second largest economy. The content of these reforms and the quality of their implementation will likely drive investor sentiment in the medium to longer term. We expect major changes to the urbanization initiative long in effect in China involving the movement of the masses from the countryside to cities. Land, financial system and state owned enterprise reforms are also largely expected from the Third Plenary Session of the 11th CPC Central Committee to be held in December of this year. The objective of these reforms is nothing less than to redirect the Chinese economy away from the boom and bust of exports and fixed asset investment toward a greater reliance on domestic consumption in order to achieve a more consistent, uniform raising of living standards.

Even while China has its focus on its future, it must deal with the legacies of its past, one of which is the enormous amount of credit created in the last few years. Much of this credit was made available in the so called "shadow banking" network, which broadly defined simply means outside the commercial bank channel of credit creation. Many China observers are concerned that shadow banking lending is of such size and poor quality that it presents a systemic risk to the financial system in China. We have taken a brief look at shadow banking taking into account the various concerns. Our analysis is attached.

Dave Descalzi
October 2, 2013

SeaBridge Investment Advisors LLC

SeaBridge Asia Strategy

Comments on Shadow Banking

Charles Darwin, that icon of empiricism, once curiously observed that a mathematician is a blind man looking for a black cat in a dark room that isn't there. Perhaps Darwin was expressing a frustration with the inability of mathematics to lead to a deeper understanding of the underlying realities of human existence, a quest which consumed many western intellectuals in the nineteenth century. With the less lofty objective of grasping the underlying realities of China in mind, Darwin's statement could easily apply to any China watcher today. Despite all the statistics and data that are now available from a variety of agencies monitoring economic activity in China, getting to the bottom of what is really going on in the Middle Kingdom is like trying to grab the black cat that isn't there.

In no other venue is the proverbial feline more elusive than in the world of "shadow banking" in China. Broadly defined, shadow banks are non-bank entities that come in different forms but are alike in that they are non-deposit taking institutions and are, therefore, relatively free from onerous regulations designed to protect those deposits. "Shadow banks" are not as their name implies illegitimate or insubstantial. They are collectively the finance companies, hedge funds, trusts and other special purpose vehicles that intermediate credit outside the banking system. They are found in all countries where there are banking regulations to circumvent, which is a way of saying that they are found in all countries. In many of these countries, the size of the shadow network is larger than that of the commercial banks.

In China, shadow banking is a component of the recently invented barometer TSF or Total Social Financing, an indicator that consists of all manners of financing including banks, trusts, financing companies, trade credit, corporate bonds, certain kinds of interbank lending and informal lending by individuals, among other kinds of credit. Estimates gleaned from data supplied by the People's Bank of China and the China Banking Regulatory Commission, among other agencies, suggest that TSF as of the end of 2012 was 94 trillion RMB or about US$15 trillion, representing 180% of China's GDP. According to CLSA, China's total debt, including all government debt is estimated to be 105 trillion RMB or about US$17 trillion, amounting to 200% of GDP. While the numbers appear large, put in perspective, China would not make the list of the ten largest mature economies ranked by either measure of indebtedness.

While the numbers perhaps suggest an immoderate use of debt markets by borrowers in China, they do not signify a country riding off the rails. One is even tempted to give it a pass on its debt record over the past five years since a good portion of the credit created was prescribed as a monetary cure for the ill effects of the global financial crisis of 2008 and 2009. Still, TSF financing has accumulated at a rate 30% per annum on average over the past five years. This torrid pace of growth coupled with China's reputation for misallocating capital has understandably made investors nervous.

With this nervousness in mind, we would make the following observations:

1. **(Borrower Group A)** The bulk of TSF borrowing is done by corporates in China, mostly in the form of loans provided by commercial banks. We believe these loans to be among the higher quality, private debt instruments in China if for no other reason that this marketplace is one step removed from the abject cronyism and senseless use of funds that characterize local government borrowing. There will be write offs in this area, but they should be far less than those generated by non banks to local government discussed in Item 3 below.

2. **(Borrower Group B)** Also less concerning are borrowings by consumers where incidents of defaults are historically low and where banks, historically among the better credit assessors, are the providers of funds.

3. **(Borrower Group C)** Ground Zero for credit concerns in China is the creative financings that have been extended to junk status borrowers and local government funding vehicles, which then extend credit to pet projects and connected corporations. The obligors in both cases are generally unable to source funding from banks on their own creditworthiness. Unregulated wealth management products have been a big provider of funds in these areas. We expect significant losses. Commercial banks, who supply a depositor base for wealth management vehicles but no explicit guarantee, will probably be made to take the schemes back onto their balance sheets as the clean-up occurs.

We estimate system wide losses as follows:

Borrower Group	**Estimate (RMB Billion)***	**Non-Performing %**	**Loss on Non-Performing %**	**Est Loss Amount (RMB Billion)**
A	50,000	20%	20%	2,000
B	13,000	20%	20%	520
C	31,000	50%	70%	10,850
Total	94,000			13,370

*Total credit but does not include sovereigns and local government municipal bonds.

Source: SeaBridge Investment Advisors

The loss estimate above represents 24% of 2013 GDP. If one considers that workouts of bad investment involve a multi-year process, the shock of dealing with the above number will be mitigated over a longer horizon. China's banks will need to be recapitalized at some point, but their existing provisioning, profit making ability, and strong capital position should lessen the trauma of capital raising. We should also remember that China has foreign reserves far in excess of these theoretical losses.

China has been here before. With a view toward supercharging fixed asset investment, China opened the credit spigots in response to the Asian Crisis of 1997. Goldman Sachs has estimated that the cleanup of

China's banking system from the excesses of that period cost China about 20% of 2004 GDP. Not only did China successfully deleverage its balance sheet, broadly defined, and recapitalize its banks at the beginning of the last decade, but did so at a time when the Shanghai markets rose, the currency strengthened, and China surpassed Germany as the third biggest economy of the world. We expect the same success today as China confronts its current debt situation.

In order to win back favor with investors, China must demonstrate more than an ability to climb back from a debt crisis. It must show progress toward a more open economy, with more capitalism and less command economy, more rule of law and less arbitrary cronyism, more domestic consumption and fewer bridges to nowhere. We are convinced that significant economic reforms are coming; our concern is that the change they augur can produce a backlash, especially among conservatives, in the form of more restrictive social policy. But that is a black cat for another letter.

David Descalzi
September 9, 2013
