SeaBridge Asia Strategy

Third Quarter 2015

Commentary

The third quarter was a difficult period for global equity markets, with Asian markets no exception. The region was buffeted by exogenous developments beginning in the quarter with the standoff between the European Union and Greece over terms of the Greek bailout; it ended with a battering of the shares of Glencore, perhaps the world's leading integrated producer and marketer of commodities. Glencore is particularly instructive for understanding recent market psychology in Asia and other emerging markets. In 2010, the company had global market share of 60 percent in the internationally tradeable zinc market, 50% in copper, 9% in grains, and 3% in oil. With incremental demand for virtually all natural resources emanating from emerging locales, investors naturally associated troubles at Glencore with deteriorating emerging economies, slowing growth generally and perhaps hidden systemic financial risk.

The market pullback in Asia was obviously caused by more than just external factors. China's slowdown and the government's mishandling of the stock market contributed to poor market sentiment during the quarter. Investors, we believe, generally accept a slowdown as an unavoidable consequence of much needed reform in the world's second largest economy as it transitions from a fixed asset, export oriented economy to one based more on domestic consumption. They generally approve of the use of traditional policy tools, such as lowering interest rates and the reserve ratio on deposits, which was done twice during the quarter, as sensible interventions. We also think they appreciate the fact that China, unlike the U.S. and Japan, has not resorted to the extraordinary option of the quantitative easing of the money supply.

This is all well and good; China's handling of its stock market is another matter. Here China demonstrated an uncharacteristic incompetence in addressing a crisis of its own making. In recent months, China has vacillated between strongly promoting stocks as a deleveraging tool for the economy generally and as an alternative to bank deposits and property for the retail investor and reining in the bubble it created. Coming into the quarter, China had vastly expanded margin lending and the Shanghai and Shenzhen markets soared. In June, worried about a market bubble, China's regulators announced new limits on the total amount of margin lending stock brokers could provide, while also reiterating the ban on illicit margin trading through mechanisms like umbrella trusts. China's markets fell sharply. Attention then turned to stemming the fall. Over the course of the next few months China instituted a number of measures in support of the market including lowering securities transaction fees, relaxing rules on margin trading, expanding brokers' funding channels, investigating some prominent short sellers and requiring direct investment in the market by security firms and pension funds, to name a few.

The response to these slapdash measures was extreme stock market volatility. Most importantly, this volatility spilled over into the currency markets. On August 11, China took the extraordinary measure of bowing to market forces and establishing a market oriented mechanism for setting the exchange rate. In the attachment "Thoughts on the Renminbi", we discuss the significance of this move and why we see a "soft landing" to the yuan at lower levels.

For all of the quarter's eventfulness, it was the non-event of the Federal Reserve maintaining its zero interest rate policy that roiled markets at period end. Given the strength of the U.S. economy, the market signaled its belief that the Fed is "behind the curve" by not raising the target Fed Funds rate at the September meeting of governors.

We summarize our views on these developments as follows:

1. The selloff in Asia equity markets may be overdone. The focus on China has obscured the positive fundamentals including economic and earnings growth rates higher than the rest of the world, healthy corporate balance sheets, and a strong dividend paying culture. We believe the market decline has been accentuated by the proliferation of co-mingled investment vehicles such as ETFs which invite momentum without differentiation. There has been a herd mentality to the selling of emerging markets even though not all emerging market risk is the same. (See number 6 below.)

2. Equity valuations in the region on an historical basis and relative to other markets appear attractive.
3. The selloff in Asia currencies also may be overdone. Slowing growth in the region and China's moves on the RMB have pressured other Asian currencies. Because the trading balance is positive in the region as a whole, broad based currency weakness probably reflects the unwinding of the long Asia currency/short the U.S. dollar carry trade which had worked well for so long. This repatriation of U.S. dollars tends to flame out over time and we expect currencies to firm at some point, in keeping with the fundamentals of the region.
4. The slowdown in China is a major concern and will remain one for an extended period. China is attempting to do the difficult, but its economic restructuring is far from impossible, which is the way markets seem to be trading. Our base case is that China will muddle through.
5. Exporters in Asia should benefit from lower currencies.
6. Asia, as a net importer of commodities, benefits from the decline in the price of agricultural products and natural resources unlike other ex-Asia emerging economies, such as Brazil, which can be badly damaged by commodity deflation. Lower cost of goods for a variety of companies in Asia could blunt the effect of rising wages and help preserve corporate operating margins.
7. Industrial companies will likely continue to be pressured by a slowing China and the disappointing growth in the rest of the world. On the other hand, the consumer in Asia appears to be holding steady, reflecting rapidly rising wages in China and elsewhere.

The following comments address portfolio positioning:

1. We had built an above-normal cash position early in the quarter in anticipation of some market turmoil; in hindsight, we should have done more. However, we did take the opportunity of the market pullback to buy depressed stocks already in the portfolio and initiate positions in some very good companies previously off limits to us because of valuation.
2. We anticipate that currencies which have been a drag on performance during the quarter at some point should be a strong tailwind and accretive to dollar returns.
3. With the focus on China, less attention is being paid to the rest of Asia, whose dynamism is being unfairly discounted. China's troubles can in fact benefit its neighbors insofar as companies which previously have been fixated on China look to expand operations outside the Mainland. We are actively looking for these growth stories in Asia and are particularly interested in Southeastern Asia, where geographic proximity to China and similarity of culture and dynamic demographics make it a natural destination for this type of expansion.
4. Dividends remain an important component of portfolio construction. In anticipation of rising interest rates in the U.S. over the course of the past few years, higher yielding stocks have occasionally fallen out of favor with U.S. investors. We now believe that interest rates worldwide will be "lower for longer", a point of view which, if accurate, should attract buying interest in Asia's dividend payers.

In summary, this is not 1997 all over again. Asia is in much better shape. We see the region's flexible market oriented currency markets as an improvement on the fixed regimes of the 1990's. Since currencies can now adjust on an incremental basis given market conditions, we think a currency collapse like the Thai baht debacle that began the Asia crisis in 1997 is unlikely to be repeated today anywhere in the region. For us, it is just a matter of time before the region is rediscovered for what it is worth and more normal markets resume.

David Descalzi
October 5, 2015

Attachment to Asia Strategy Commentary

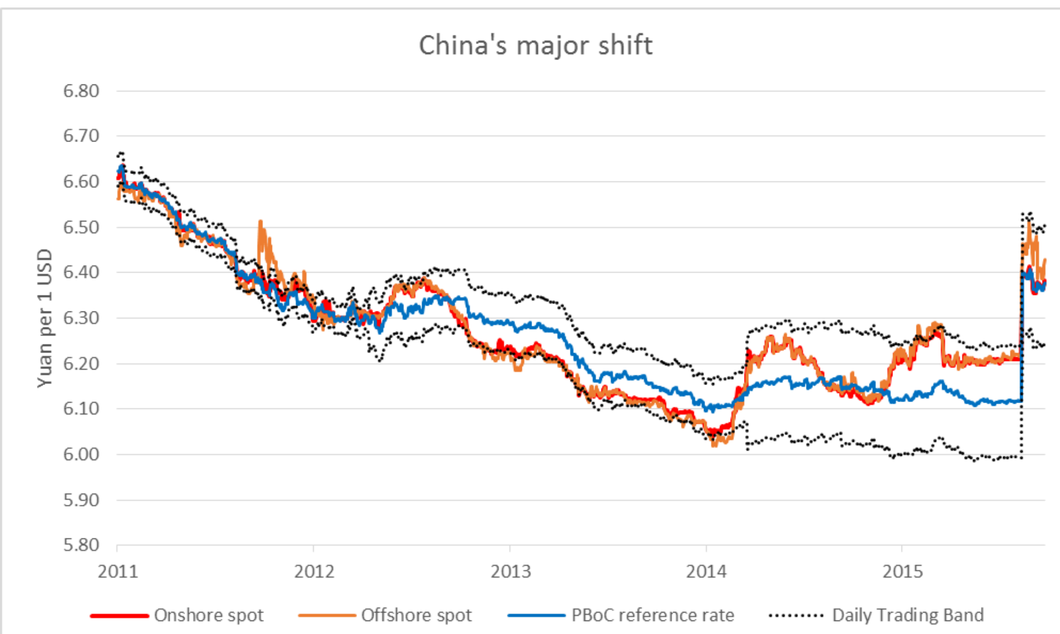
Thoughts on the Renminbi

We believe that the fast growing market in renminbi, China's currency, provides the clearest indicator of the progress China is making in reforming its economy from top down state control to a more laissez faire orientation. For all the success in the battle against corruption or reform of the state owned enterprise system, there is no better coincident gauge of the state of things inside China than a market determined rate of exchange of the renminbi (RMB) versus foreign currencies. Because the RMB market is open for business to hedgers and speculators, both onshore and offshore[1], we believe this gauge provides a timely, accurate reflection of the supply demand dynamics of the currency and is a window on China's economic growth expectations among market participants.

The management of China's currency has changed in two important ways in the last decade. Prior to 2005, the RMB was strictly pegged to the U.S. dollar at an exchange rate of 8.28. In July of 2005, the People's Bank of China (PBOC 2005a) announced a revaluation of the currency and the institution of a floating rate regime ostensibly linked to a basket of world currencies. In actuality, this managed float was quite arbitrary and allowed China, which was coming under increasing pressure from the U.S. in the middle of the last decade for having an undervalued currency, to strengthen, slowly, its currency against the U.S. dollar. On August 11 of this year, China changed the way the reference rate was set away from a managed float to one that references the prior day's close of the RMB. This construct theoretically takes into account market forces in establishing the rate.

So why the change?

The simple answer is that the change reflects a capitulation to the reality of a currency trending to the downside. The following graph illustrates the point:



Source: Bloomberg, JWChilds Asia Equity LLC

From late 2012, China's renminbi traded to the strong side of the trading band of the reference rate, indicating market expectations of a strengthening RMB and foreign inflow.

[1] The RMB traded offshore, called CNH, is totally unregulated and freely traded. The RMB traded onshore, called RMB, is freely convertible in the trade account but still heavily controlled in the capital account. Cross-border arbitrage activities exist between RMB & CNH. This is why the RMB is subject to market forces despite a semi-closed capital account.

Since early 2014, expectations started reversing and RMB began to trade closer to the weak side of the trading band (except for a few months in the second half of 2014). Beginning in late 2014, capital which had previously flowed inward rapidly reversed direction resulting in consistent drawdowns of China's FX reserves. Short dollar positions began to unwind, putting pressure on the RMB. It was becoming increasingly clear that China was unable to manage to a rate that did not reflect the market for the currency.

There is a more complex answer to the question. China may benefit from a weaker currency if it is in the context of a controlled depreciation, which may be stimulative to exports. By allowing a modest depreciation, China was simply catching up with other currencies ex the U.S. dollar racing to the bottom in in a very active competitive devaluation exercise.

Another possible reason for the August 11 change is China's interest in having the RMB become a reserve currency. Two criteria determine whether a currency can be part of the IMF SDR basket, which is a proxy for real reserves. The issuing country must be a major exporter, and the currency must be freely usable. No one disputes that China meets the first criterion. In 2014, China was the world's leading exporter, sending $2.2 trillion of goods and services abroad. As for the second criterion, the international use of the RMB has grown rapidly in recent years, albeit from a low base. In 2014 it accounted for 1.1% of countries' official reserve assets, up from 0.7% in 2013. Some 0.6% of international debt securities are now denominated in RMB, up from just 0.1% in 2010. For cross-border payments, 1% are conducted in RMB, up from 0.2% in 2012. International trading of the RMB has had a similar, if slightly slower, ascent: 0.8% of currency transactions in the global spot market involved RMB in 2013, up from 0.3% in 2010. Although full year data is not yet available, we have no doubt that the sharp upward trajectory of RMB use has continued in 2015. Together with the proliferation of RMB off shore, allowing the market substantially to determine the exchange rate of the RMB bolsters a claim for meeting the second criterion.

The SDR is neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members. Members can hold their SDRs as part of their international reserves or sell part or all of their SDR allocations. Members can exchange SDRs for freely usable currencies among themselves and with prescribed holders; such exchange can take place under a voluntary arrangement or under designation by the Fund. Today, the SDR basket consists of the euro, Japanese yen, pound sterling, and U.S. dollar. China wants to be part of this club. Why?

1. Global Prestige – China is the world's second largest economy and largest exporter; it deserves reserve currency status.
2. Lower Borrowing Costs -The exchange of SDR's for reserve currency typically occurs at below market rates.
3. Lessens the attractiveness of the U.S. dollar- Mathematically, the inclusion of another reserve currency lessens the demand for the incumbents including and particularly, the U.S. dollar.
4. Drives further reform; -To insure that all other benefits are operative, the SDR country has an interest in expanding the use of its currency in international transactions.
5. Creates a perpetual demand for RMB - So long as reserve status is in place, there should be a continuing demand for the RMB as a reserve currency.

Of these reasons, the last two are the most important. More history is in order to explain this. As we noted above, China began to liberalize its currency regime in earnest in the mid 2000's. This for us happened at an accelerated pace, with substantial convertibility in place both inside China and off shore occurring sooner than we thought for two reasons. In the middle of the last decade, the "China economic miracle" was the consensus view. Clearly, China believed its economy was big enough and strong enough to tolerate some measure of free currency convertibility. There was hubris in China making the currency more available to the international community. There was also fear. At about the same time, the financial crisis precipitated in the West ensued, further eroding confidence in the world's main reserve currency, the US dollar. China saw an opportunity to distance itself from the dollar which they felt would be plagued by chronic weakness. We believe that China erred in opening up its currency accounts before it was truly ready to do so. But once opened, it needs to keep reforming in order to garner the benefits noted above.

What's next?

So China finds itself navigating on the river of swiftly flowing currencies without the proper means of locomotion. It is currently in defensive mode. Its greatest weapon is its enormous cache of foreign reserves. We know from history though that propping up currencies inclined toward weakness by using reserves is an exercise in futility. However, if China signals fatigue in supporting the RMB, it will only promote more outflow necessitating further defense. A single large depreciation might stem the outflow. However, a precipitous decline in the RMB would jeopardize the repayment capacity of Chinese borrowers of U.S. dollar debt.

The question remains, therefore, how does China manage the downward trajectory of the RMB without destabilizing consequences for its economy. Is this outcome even possible? We think yes. We concur with the consensus view that the RMB will decline, but believe the likelihood of a massive selloff of the currency is low for the following reasons:

1. Certain parts of China still operate as a command economy. SOEs, though dwindling in importance, are still the largest group of borrowers. (More than ¾ of listed company liabilities are with SOEs). These dollar borrowers will be "encouraged" not to rush for the exit despite uneasiness over their dollar debt. In fact, some smarter borrowers have already closed out their short dollar positions since 2014, as evidenced by the rapid decline in outstanding loans owed to foreigners from U.S.$678 billion in June 2014 to U.S.$434 billion in June 2015, according to data from the State Administration of Foreign Exchange. The downward forward pressure on the RMB should be less than it otherwise would be without these preemptive actions.
2. Traders may be "discouraged" from launching speculative attacks on the RMB as China can impose various administrative measures that will minimize the speculating. For example, on September 2, the PBOC announced a 20% reserve requirement for one year on banks that enter into RMB forward contracts. On September 18, the PBOC required some banks to increase their fees on spot RMB FX trades from 0.001-0.002% currently to 0.3%.
3. The current account remains in surplus and should continue to be so as import needs are depressed by subdued investment activities. As noted above, outbound investments (by SOEs) may slow should the government prefer that capital remain within the country. These flows provide support for the RMB.
4. Above we discussed the effect on RMB demand of being named an SDR currency. There are U.S.$12 trillion in foreign reserves held by the world's central banks, very little of which is currently in the form of RMB. If just 5% more of these reserves were allocated to the RMB, incremental demand for the currency in the amount of U.S.$600 billion would be created. Additionally, Shanghai "A" share inclusion in MSCI indices should generate incremental demand for the Chinese currency, thereby offsetting some of the pressure from China's dollar borrowers. (China stocks are currently excluded from the MSCI Emerging Markets Index because of regulatory impediments preventing full participation in China's markets among global institutional investors.) An A Share allocation in the MSCI has been much discussed in 2015. We think the change will occur next year at the latest.

In conclusion, we believe that over the next year or so, there will be more demand for dollars than for RMB and therefore we expect the RMB to weaken further. The government will use all of the financial and administrative tools available to intervene from time to time to moderate the pace of decline. The real attenuator to RMB depreciation will be a stronger Chinese economy and more evidence of success of China's reform agenda. Once the RMB adjusts to a level where expectations for depreciation vs appreciation are more balanced it should be a welcome sign of stable economic conditions inside China and an all clear signal to portfolio managers. We believe this will happen; we just don't know when.