SeaBridge Investment Advisors, LLC

SeaBridge Asia Strategy

Third Quarter 2016
Commentary

The quarter began soon after Britain's decision to leave the European Union. Concerns abounded that trade and capital flows between the UK and Europe would be disrupted and that the UK, one of the better performing economies to that point, would enter recession. When the worst fears of Britain's exit from the EU were not realized, markets everywhere responded positively. Risk premiums for financial assets fell. Equities turned in credible performance in the period. Market sentiment generally was helped in the quarter by steady if unspectacular economic performance in the U.S. and a continuing Federal Reserve reluctance to raise the fed funds rate. But there is another reason for the strong quarter. We would not underestimate the role of China in the markets' steady advance.

We have written in previous commentaries about our concerns regarding the state of affairs in China. The following excerpt from a recent article in the Wall Street Journal is a good summary of how economic conditions there have evolved over the past year:

> "A year ago, global investors were bracing for a Chinese collapse. The Shanghai stock market had crashed and capital was flooding out. The property market looked shaky and sinking factory prices and corporate profits threatened to squeeze wages and consumption. Currency speculators bet on a sharp depreciation of the yuan.
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> Instead, property transactions are on track for an annual record this year. In August, car sales grew at a double digit rate for the fourth consecutive month. Meanwhile, capital outflows have shrunk and factory prices are recovering. The yuan has fallen only moderately."*

It is unsurprising that this benign synopsis of the current conditions in China was taken from an article that was another alarm sounding in the media on a potential collapse of the Chinese economy. And indeed, the article references the largest risk facing the country – the extraordinary pace of credit creation that has been in place really since the middle of the last decade. China's debt binge is all the more disturbing since we know that China is slowing, providing the evidence that the efficacy of new debt on economic activity is diminishing. China is floating on a sea of debt and, unless measures are taken to moderate credit creation, that China risks recession and a banking crisis down the road.

It could be a long road. For all of its progress in liberalizing its trade, capital and currency accounts, China remains an insulated nation by design. It is both a debtor and creditor nation to itself. China is largely an economy that runs on bank credit. The big banks are predominantly state owned. The biggest deadbeat borrowers are old economy companies that are largely state owned. Workouts of bad debt amount to deal making between related parties. We think this allows for the luxury of time in the restructuring process, increases the probability for an orderly disposition of bad loans and the avoidance of a banking crisis.

As an aside, it should be noted that despite the shadow of government ownership across the commercial landscape in China, it is possible for a private company to thrive there. Yum, Nike and Starbucks are three U.S. examples. With few exceptions, our China exposure is limited primarily to such companies, domiciled outside China, with non-Mainland ownership, operating in China and benefiting from secular tailwinds of growth which we believe will be in place for decades.

Here is what is on our mind for the coming quarter:

1. A rise in the Fed Funds rate may lead to short term volatility in the stock market. The consensus view is for a December hike.

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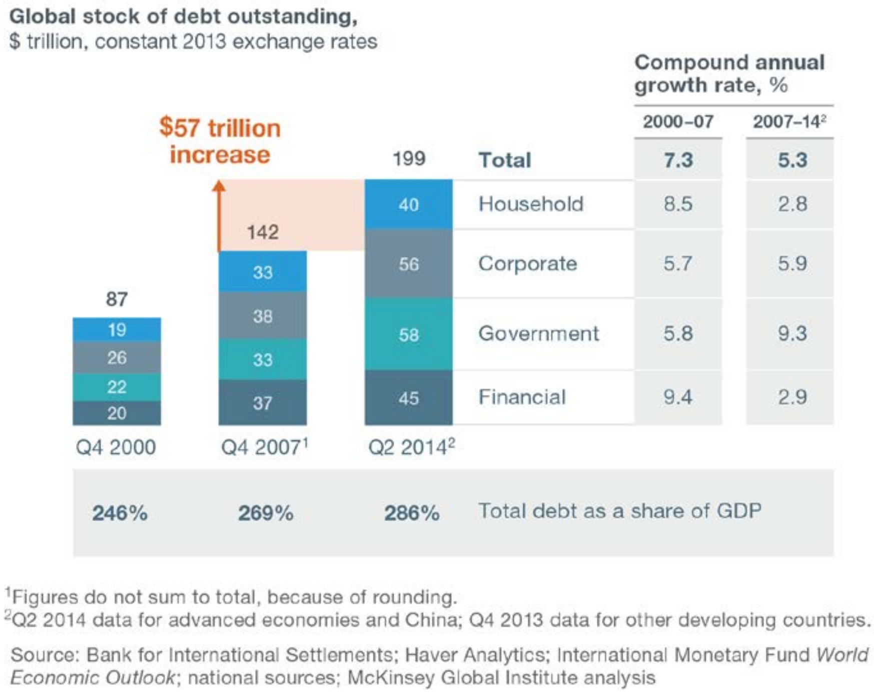
* China's Astronomical Credit Binge: "How Will It End" Wall Street Journal, September 13, 2016.

2. China is not alone in taking on huge amounts of debt since the financial crisis. According to a McKinsey study, debt worldwide increased by $57 trillion, or 40% between 2007 and 2014.



Much of this debt is a direct result of central banks printing money and monetizing government debt through a technique known as quantitative easing. Rapidly rising debt levels are currently being tolerated by markets. Debt is deflationary in nature and it is becoming clearer that, despite a massive amount of monetary stimulus since the financial crisis, central bank activism thus far has not been able to counter the depressive effect of debt to create the velocity of money needed to achieve the banks' goal of stoking inflation and growth. Global growth remains subdued. Despite our uneasiness with overall debt levels and China's recent credit excesses, Asia remains the one region of the world that is in relatively good shape in its leverage profile and is a fundamental reason why we expect Asia to be the fastest growing region of the world for years to come.

3. Presently, Japan seems particularly challenged. Public debt levels are a multiple of that of other developed countries and options for further stimulus appear limited. Although Japan has long ago ceded its status as the most important country in the region to China, there would likely be some repercussions felt in the region and elsewhere if Japan were to falter badly.

4. There have been adverse political developments in two countries in the region – North Korea and the Philippines. In September, North Korea tested its most powerful nuclear device claiming that the warhead could be mounted on ballistic rockets. In the Philippines, a strong- man president is running amok condoning state sponsored vigilantism against drug traffickers involving extrajudicial killings and the incarceration of hundreds of thousands of Filipinos who have surrendered to authorities, preferring jail to the morgue. There have been no real effects on markets thus far of these developments, but they warrant monitoring.

5. The U.S. election and the market reaction to it are unknowns with profound implications. We are at a loss to forecast economic and market impacts of the election outcome. One thing seems certain. Given the ambitious infrastructure buildout and entitlement expansion plans included in both candidates' platforms, an increase in government spending is likely. This will be stimulative to the U.S. economy in the short term, but add to the already uncomfortable debt levels noted above.

6. We want to see reported earnings improve in the third quarter. This would be a sign to us that the deflationary concerns may be overstated.

Looking at the portfolio, we would observe the following:

1. Many of our stocks have done well in the year thus far. We have taken profits on many names as target prices are reached. At the same time, our search for replacement stocks has been labored. With valuations stretched in the short term, we are having some difficulty finding the undiscovered gem. As we continue to harvest gains, it may be that cash levels rise until attractive investment candidates are found.

2. Despite the impending Fed Funds rate increase, we believe that it is "lower for longer" for U.S. rates and that the U.S. dollar will be stable to weak in the short term. Because of the region's growth profile and its resistance to extraordinary monetary intervention, we believe Asia ex China currencies generally will hold up well relative to the U.S. dollar. On the other hand, the yuan will likely continue to weaken by design over a period of time. This weakening would be stimulative to China's economy. Overall, we do not expect currencies to have a major impact on our portfolio.

3. In terms of country exposure, we are more inclined to prospect in Southeast Asia. Singapore is of major interest to us. It is a market that has lagged for a variety of reasons but whose economy has recently shown more vitality. It is also a mecca for higher yielding stocks which we believe will be a much sought after asset class given our belief that interest rates will stay lower for longer.

4. We may initiate some exposure to India. We will have a better understanding of the business environment there after visiting in October. We are not able to invest directly in securities listed on the India exchange but can gain exposure through ADR's and exchange traded funds.

As we noted above, the U.S. presidential election looms as a large unknown, the outcome of which could have significant implications for the portfolio. Neither of the major candidates is a free trader, or so it seems from the rhetoric. We believe that the worst fears about global trade will not be realized as the entrenched, far reaching reality of globalization sets in. Still, there exists the risk of trade wars, which would seriously damage the world wide supply chain and threaten the free movement of capital. If this happened, we would be more inclined to further adjust the portfolio toward companies with a domestic consumption orientation and away from companies exposed to global trade.

We have included an attachment which provides details on portfolio activity during the quarter.

Dave Descalzi
October 4, 2016

Please see disclosures at the end of this document.

SEABRIDGE
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SeaBridge Asia Strategy
Third Quarter 2016
Transaction Summary

Purchases

We increased the position in **CK Hutchison**, a leading Hong Kong conglomerate with interests in telecommunications, infrastructure, energy, ports and retail. It has a significant European presence with approximately half of its 2015 revenue emanating from Europe including the UK. The shares had been unfairly penalized by a failed attempt to acquire O2, a British mobile operator, a transaction that was blocked by the European Commission. Brexit also put downward pressure on the stock, with both events creating a good buying opportunity in our opinion. While a slowdown in Europe may affect growth prospects, we believe that any damage is likely to be contained given the track record of cash flow generation by this company.

We added to our position in **Puregold**, an Asian consumer play. According to the Asia Development Bank, the Philippine economy posted solid growth of 5.8% in 2015 generated by strong domestic demand, despite a drag from net exports. Growth is forecast to be 6% driven by higher investment and consumption in 2016. The company operates hypermarkets, neighborhood stores that sell general merchandize and food and a members-only price club division. The company has distanced itself from competitors on the ecommerce front. We've met them and believe that they are good operators.

We increased our holding in **Johnson Electric**, 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. In its first quarter update, the company indicated that business grew in all regions.

Given global growth concerns, we find this very encouraging. This is a very good company that traded at 9x multiple at the time of purchase, less than its historical level of 11.3x. We think it could be rerated beyond even its past levels if the market begins to believe, as we do, that it is much more than an auto components supplier. It is a company that provides the nuts and bolts, as it were, for industrial processes that are done with no or little human intervention as in an internet of things environment. The company devotes significant resources to R& D.
If Johnson succeeds in migrating more out of low-priced, highly competitive commodity products into premium niche products, there could be earnings upgrade plus a PE re-rating down the road.

We bought a position in **Techtronic Industries,** which designs, manufactures and markets power tools, outdoor power equipment, and floor care and appliances for consumers, professional and industrial users in the home improvement, repair and construction industries.

The stock sold off after posting a good set of results, in general, for the six months ending June 30, except for the decline in floor care. Revenue was up 8.6%, driven by 12.6% yoy growth. Particularly noteworthy was the strong growth for power equipment driven by Milwaukee products, which grew >20% yoy. Power tools are 83% of the company's revenue. Weakness in floor care & appliances due to temporary factors: the exiting of OEM business, product launch delays due to EU regulations, and the ordinary lag that occurs in the transitioning into new products. We believe floor care will cease to be a drag in 2017. The company constantly refreshes and expands upon its power tool offerings, which have a loyal following in the building trades in the US. The pullback in the stock was a buying opportunity.

Sales

We continued trimming our large position in **Navitas**. We like the company, but the share price has been strong and warrants taking more off the table. This is our pathway program provider for foreign students interested in a Western university education. We view the shares as fairly priced at these levels.

We reduced our weighting in **Dah Sing Holdings**, a holding company for Dah Sing Bank and Dah Sing Life Insurance Co, on high valuation and some concern that the sale of the insurance company to a Chinese buyer may not happen. The stock has stayed elevated despite challenging operating conditions both at the bank and the insurance company because of the expected closing of the sale of Dah Sing Life to Fujian Thai Hot, a Chinese Investment firm which we are not alone in thinking is not a top tier firm. We believe that the sale, and the special dividend that would follow, is vulnerable given the uncertain quality of the purchaser. On further strength, we will likely eliminate the name.

We trimmed on strength our positions in Link REIT, our Hong retail mall and car park operator, and Pakuwon Jati, a diversified real estate developer in Indonesia.

We eliminated our small remaining positions in Samsonite, the luggage company, and Vtech, a Hong Kong based electronic learning toys company, on unfavorable corporate developments.

Dave Descalzi
September 30, 2016

Disclosures

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