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INVESTMENT ADVISORS, LLC

SeaBridge International Strategy

Third Quarter 2016
Commentary

The third quarter had a significantly different tone from that of the first half of the year. Assorted macroeconomic issues and market shocks plagued both the first and second quarters. In December of 2015, the Federal Reserve had raised the Fed Funds rate for the first time in nine years, and the market had come to believe more increases would follow. At the beginning of the year, China, the world's second largest economy, was teetering under the stress of currency flight. The Yuan and China's stock market were under tremendous pressure. The Chinese government made several interventions to stabilize their market, but these seemed clumsy and frightened markets everywhere. Commodity markets reflected the nervousness over world growth prospects. Oil and copper made new lows. Against this backdrop, markets around the globe sold off sharply.

There were sharp policy responses to these deteriorating circumstances. The Fed quickly backtracked on its hawkish rhetoric. China injected $1 trillion into their economy to keep the de facto world growth engine moving in the right direction. The Yuan stabilized, and oil rebounded as shale rigs were taken off line. These factors helped calm the markets and set the stage for a rebound off the mid-February lows. In June, Britain voted to leave the European Union. This was accompanied by significant volatility as the markets tried to sort out what this meant for the global economy. It quickly became apparent that Brexit was a localized shock and not one risking a near term global contagion. The immediate effect on the markets, outside of a 10% devaluation of the pound sterling, has been small.

After three months, it is hard to determine what the long-term implications will be for Europe. If, over the next two years, Britain and the European Union can find mutually acceptable terms of separation, Britain's exit from the Union could be relatively painless. This is in everyone's interest, but old jealousies and individual vested interests may make this impossible.

The relative calm of the third quarter has been a welcome development following the turbulence. The quarter was light on globally significant macro data; there have been no macro shocks to roil markets. Aggressive money printing by the Bank of England lifted market spirits globally. The U.S. Presidential election in November, the Italian referendum in December, and a probable Fed rate hike of ¼ of one percent in December remain at the top of our watch list of factors that can upset the market.

The U.S. Presidential race is on everyone's mind – with strong opinions on both sides. Hillary Clinton appears to stand for "the status quo," which many find objectionable; Donald Trump appears to want to "scrap everything," which is both exciting and very frightening to those who feel he is unprepared to understand the implications of the changes he advocates. Fearing the unknown, Wall Street seems to back Secretary Clinton. But the outcome is unclear; we should expect more volatile markets in late October and early November.

On September 21st, the Fed once again left rates unchanged but the vote indicated growing dissent among voting members over the current extremely dovish policy. The market implied probability for a December rate hike now stands at roughly 60%. The BoJ recently shifted its emphasis from interest rates and quantitative easing toward managing the yield curve, -- targeting negative rates at the short end and a modestly positive 10-year rate. This manufactured yield curve would presumably benefit banks and help promote both inflation and economic growth. Whether it can be achieved is unclear. The European Central Bank kept both interest rates and its asset purchase level unchanged at the most recent meeting. A consensus view is forming that the increasing reliance on unconventional initiatives (negative interest rates) is a sign that monetary policy is fast reaching the limits of its effectiveness.

With the lack of significant news and the large amounts of liquidity still being pumped in the global economy by central banks, the markets advanced slowly during the quarter. The MSCI AC World ex US Index rose 7.0% during this period bringing the YTD performance to a positive 6.3% after a negative first half of the year. But this positive market momentum is only partially comforting because it is not backed by any real evidence of an earnings uptrend. Consensus 2016 and

2017 earnings estimates have been declining as the year has progressed. Both are down roughly 5-6% from the beginning of the year. Given higher equity prices and lower earnings estimates, valuations are near the highest levels for the year.

On the portfolio front, we have been actively working to reduce concentration risk at both the sector and the individual stock levels. We have trimmed some names -- **CP All, Zojirushi, HDFC, Delphi, Cimpress, Man Wah, Alphabet, Astellas, Allergan, Celgene** -- and eliminated others -- **Softbank, Baidu, CK Infrastructure, SunPower**. As a result of our trading activity, the cash level has grown, but given higher valuations, it is becoming more difficult to find good companies with reliable growth and cash flow profiles trading at attractive levels. We have deployed some of the proceeds from our sales into starter positions in companies that may benefit from reasonable growth prospects in the Asia region (e.g. **Ascott, Venture Corp, HollySys, CK Hutchison, Johnson Electric, Taiwan Semi, HSBC, Morgan Stanley India Fund, Bangkok Bank, Techtronic**). We also added **IBM** which has a vibrant Asia business but whose real attraction is its potential to become a dominant high-value-added cloud service provider. Despite these purchases, the cash level remains elevated. We are comfortable having a net cash increase for the period to serve as "dry powder" for the volatility we expect around the election and December Fed meeting. We further increased cash at the end of the quarter as rumors of Qualcomm's interest in purchasing **NXP Semiconductor** circulated– the stock jumped 15%, prompting us to trim our NXP Semiconductor position.

The healthcare sector remains a double-edged sword. While the overall growth prospects for this sector are backed by the strong tailwind of aging populations across the world, there are both industry and company risks that have given us pause about the sector. Secretary Clinton has been vocal about controlling drug costs, although her detailed suggestion of a panel to review price increases is less alarming than some of the "stump rhetoric." Republicans are less in favor of price controls, but the egregious actions of some of the pharmaceutical companies almost invite government intervention. Even with earnings reports across the sector generally coming in fairly weak (mainly in the form of lower guidance for the coming quarters), these holdings have only been a minor drag on performance. Although we trimmed **Celgene, Astellas, and Allergan** during the quarter, we still have roughly a 10% position in healthcare because we think the sector is very cheap on a price to growth basis. However, we are watching both company news flow and political developments carefully.

At 20%+ of the portfolio, technology stocks remain one of our most heavily weighted areas. Strong quarters from **NXP Semiconductor**, **Tencent**, and **Apple** led to this portion of the portfolio contributing over half of the overall portfolio performance. The combination of being overweight and relatively good stock selection drove performance.

We exited **SunPower**, our sole remaining solar power stock, in early August. The company simply was not able to participate in the rapid growth of solar power installations. Although a very disappointing investment for us, we did manage to off load the shares before there was a 30% drop in solar stocks generally when it became clear to all that China had found a way to dump excess production into the U.S. market. We continue to follow the industry, which is in disarray, but have no inclination to reenter solar stocks at this point.

In the prior quarter's letter, given our view that interest rates would stay low in a slow growth environment, we touched on increasing our holdings in companies that produce strong free cash flow and reliable dividends. While we have added above-market-yielding names such as **IBM, Bangkok Bank, Venture**, and **HSBC**, we have not abandoned our search for attractively priced growth. We will continue to search for reasonably priced companies that should be able to grow in a low growth environment.

Although we gain international exposure through U.S. based companies with significant revenue abroad, we continue to focus overseas for stocks. While foreign markets are cheaper, economic and political realities make the search challenging:

- Europe's growth is improving, but it has very weak banks, growing political discord, migrant problems, and weakened leaders.
- Brexit was not solved with the UK referendum; an agreement on terms of a new relationship with Europe has been deferred. Until there is more clarity on terms, Brexit will be an overhang on markets.
- Japan's "Abenomics" have failed. A weaker yen has proved elusive; neither inflation nor growth is meeting the target level. The BOJ is groping for a new policy.

- Latin markets have been the strongest in the world this year, led by Brazil. But the bounce from deep lows, so far, is based on hope rather than improved fundamentals. The markets seem very expensive given the risks.
- Because of a rapidly growing middle class, Asia seems better positioned. China remains the biggest risk in the region. If China can work through its credit excesses, the region should continue to stand out for its relative attractiveness
- Against an uncharacteristically favorable political backdrop, India seems particularly promising.

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