SeaBridge Investment Advisors, LLC

SeaBridge International Strategy

Third Quarter 2017
Commentary

Markets across the globe advanced nicely in the quarter amidst signs of accelerating economic growth across regions. While improving growth provides fundamental support for markets, stocks everywhere undoubtedly benefited from extraordinarily easy monetary conditions promoted by the world's central banks. We are pleased to report that our International Strategy participated in the advance and performed well in the quarter and year to date.

Without diving into the minutiae of economic data that supports a strong global economic growth outlook, we note the following from a September issue of the Financial Times: *"… the growth rate in the world economy is being maintained at the firmest rate recorded since the early days of the recovery in 2010. The growth rate throughout 2017 has been well above trend for both the advanced and emerging economies, and the acceleration has been more synchronized among the major blocks than at any time since before the Great Financial Crash*." Given this backdrop, Central Banks appear oddly reluctant to announce plans to rein in accommodative monetary policy. Sometime in 2018, the European Central Bank (ECB) may begin winding down its more than 2 trillion Euro (US$2.34 trillion) quantitative easing program that has increased the balance to roughly US$5 trillion. The ECB has shown no sign that it is prepared to raise short-term interest rates. In Japan, the short-term rate is near -0.1% and the 10-year bond yield around 0%. The Bank of Japan (BOJ) is adding 80 trillion yen (US$714 billion) per year in bonds to the balance sheet. The BOJ has given no indication that it is committed to tighter policy. Only in the U.S. has the Federal Reserve shown firm intent to withdraw accommodation, pare down its bloated $4.5 trillion balance sheet, and raise short-term rates. Given strong economic growth accompanied, perhaps enabled, by easy money, it is unsurprising that markets have performed well.

Emerging markets have been particularly strong. In the International Strategy, our emerging market exposure is largely in Asia. Consequently, we tend to follow developments in China closely. Recent strong economic performance has been the most important catalyst for a turnaround in sentiment in Chinese markets. Data from key areas of the economy, including industrial production, retail sales, corporate profitability and exports have shown improvement in the quarter and exceeded expectations.

Chinese equities have long been weighed down by concerns over slowing growth and soaring debt levels. We believe slowing growth need not be feared since the quality of growth should improve as the country rebalances toward a more consumption oriented economy. Over the past decade, we have been constantly reminded by naysayers of the property bubble, the off-balance sheet financing schemes, the bridges to nowhere, the corruption, the phony accounting. We do not deny the existence of China's excesses. We simply believe that China's obituary has been written many times since the financial crisis of 2008 and that rumors of its death, like Mark Twain's, as the writer himself noted, have been grossly exaggerated.

Asia's presence in the International strategy has increased in the past year. There is no better justification for our commitment to the region than its superior demographics, which can be summed up by the following statement. According to a Brookings Institution forecast, of the 2.4 billion people expected to enter the middle class between 2015 and 2030, 2.1 billion will come from Asia. Of the US$29 trillion of incremental consumption this new middle class group represents, US$24.3 trillion will likely be spent by Asians. The Asia investment case is a long-term story and we intend to participate as investors along the way.

The Portfolio

We **initiated** new positions in:

- **Aerospace Industrial Development** – The Taiwan-based company is engaged in the manufacturing of military aircraft, commercial aircraft, aero industrial engines, as well as providing aircraft and avionic maintenance, flight, information, and technology services. Taiwan is one of the top 10 engine suppliers to General Electric and is the #2 supplier in Asia after Japan. It is going through some growing pains as it builds out its plant footprint in anticipation of strong order flow from Boeing and Airbus. Because of its pedigree and success as a defense contractor, the company should have a base level of business from the Taiwanese government. Beyond Taiwan, defense budgets are fast expanding in Asia and the company should be a beneficiary of this this upswing. Additionally, we expect the company to become an increasingly large supplier to private global aircraft OEMs. We believe there is a long runway for this company. Pardon the pun. The balance sheet is a little stretched now, but free cash should help over the next two to three years. The risk-reward skew seems to favor the upside with the stock trading at about 13x next year's earnings with mid-teens estimated growth.

- **Deutsche Bank** –Germany's flagship bank has a strong presence in its home country, Europe overall, and the United States. It presently trades at less than ½ of book value and has a Tier 1 capital ratio that is higher than that of most U.S. banks. As interest rates in the U.S. rise as the FOMC unwinds QE, the ECB should feel more comfortable ending its quantitative easing program, which succeeded in driving European interest rates below zero. As the Fed and ECB normalize policy, the move from negative to positive interest rates in Europe will likely benefit banks.

We **added** to existing positions in:

- **HollySys** – The company is involved in developing industrial control systems, signaling systems, logic controllers, and motion controllers in the high-speed rail, nuclear power, and factory end-markets. It reported disappointing fiscal year 2017 figures during the quarter due to delayed rail orders, some market share losses, and weak sales in its Industrial Automation division. Much of these headwinds have subsided. The decline in rail order appears to have bottomed. Strong secular tailwinds in Chinese high-speed rail and factory automation should provide ample room for growth as we believe the Chinese will favor "homegrown" products as they continue the buildout in these areas. The stock looks cheap to us at 10-11x earnings.

- **Allergan** – Allergan is a well-diversified global pharmaceutical company. We think the fear over patent competition to Restasis is overstated, and the pipeline of drugs is under appreciated. Branded aesthetic products (Botox – which also is gaining traction in a few other verticals – nervous system and urology) should be solid growers for many years. The stock pulled back in August and September bringing the valuation down to 13x earning (a 2 or 3 multiple discount to peers). A sum-of-the-parts analysis has the stock significantly undervalued. There are several catalysts on the horizon. A court decision involving Restasis patents should be delivered in October. We believe a negative outcome has already been priced into the stock. Phase 2 and 3 data on various migraine drugs should be released in the first half of 2018. These drugs belong to a $2 billion dollar plus segment. Phase 2 data on a drug to treat NASH (nonalcoholic fatty liver disease) was released a few weeks back with mixed results. Phase 3 data is still a few years away from being released. This could be close to a billion-dollar drug.

- **Standard Chartered** – The bank is based in London but primarily operates in Asia. It reported a decent set of results for the half year ending June 2017. Operating income was up 9% driven by strength in China and North Asia. Trade-related finance and wealth management were important product drivers. The loan portfolio looks to be improving as the bank continues its restructuring. It is not out of the woods yet on its turnaround. The ASEAN region performed below expectations. Any rise in interest rates should significantly add to the bank's bottom line. Investors have been disappointed that a dividend has not been declared. Despite a healthy CET1 ratio, excess cash is being kept on hand for fines that may be levied for possible money laundering violations that occurred in prior years involving Iran. We are not bothered by this dividend deferral. We think it prudent. With the stock trading at 0.7x book value, the stock looks attractive.

- **Kennedy-Wilson** – We outlined the possibility of adding to this position in the 2Q17 commentary. Brexit uncertainties are likely still weighing on the stock, but we believe we are being well compensated for these risks at current valuation levels.

We **sold** positions in:

- **Naspers Limited** – The valuation of this company is largely driven by its investment in **Tencent** (also held in International Strategy) which represents >90% of its net asset value. Chinese technology giant Tencent reported strong earning across the gaming, advertising, and payment segments. The stock reacted well to the report. Given our large positon in the stock and the terrific run it's had, we thought it prudent to trim exposure in Tencent through the sale of Naspers.

We **trimmed** positions in:

- **Apple** – The stock has performed very well in 2017. Even with a rather unassuming valuation (14.5x earnings, less if you back out cash), we feel that there is more risk to the downside associated with consensus growth expectations. Analysts are predicting more units of the newest generation of iPhones to be sold than those of the peak sales year of 2015 when the iPhone 6 was released. The company faces increased competition in the global mobile phone market. In 2015, Apple had a 14% market share in China, Apple's second largest market. It has since decreased to roughly 10%. Combining this with the $1,000 price of the new phone, the longer replacement cycle, a growing used phone market, and some possible delays of the new phones due to production issues, we believe these growth targets will be hard to achieve.

- **Estee Lauder** – We believe the strong run in 2017 will limit forward returns for the cosmetics giant as outlook has only been moderately revised upward with mid-single digit sales growth and low-single digit EPS growth, leading to a lower risk premium for the equity that trades at roughly 27x earnings. Given our overweight position, we viewed this as a good opportunity to reduce exposure.

- **Cimpress** – The company offers customized orders of print, signage, and other similar products. Share price strength provided opportunity to reduce exposure to a volatile holding heading into the earnings period.

- **Liberty Global Plc LiLAC –** We trimmed/eliminated this Latin American cable and broadband operator in taxable accounts to harvest tax losses as we head into the final quarter of the year.

The drivers of performance in the quarter were similar to the prior period. Information processing platforms and hardware manufacturers were the largest contributors to performance on a sectoral basis. **Tencent**, **Venture Corp, and MasterCard** were the standouts from this group. From a geographical standpoint, holdings in Asia ex Japan were the largest positive for the quarter. We remain overweight to Asia ex Japan as we believe the region still offers the most compelling current valuations and risk-reward profiles.

The main risk to markets given a generally favorable global economic story is a policy misstep by one or more central banks. We know that the Fed will tighten monetary policy in the coming months and years. The other major Central Banks will almost certainly follow on a currently unknown timetable. The ultra-easy money policy that all central banks have enacted since the Great Recession will likely be unwound. How this is accomplished will bear greatly on the investment environment everywhere.

A second risk, of course, is North Korea. On this subject, we have no greater insight than what is currently being analyzed and debated in the media. We'd like to think that there is too much at risk for the U.S. to intervene militarily. A military confrontation would not be welcomed by markets, in Asia or anywhere else. Let's hope that cooler heads prevail and a diplomatic solution found.

As for the portfolio, our concern is valuation. We are reluctant to add to most positions at these lofty levels post the strong advance in the markets. However, we do find the occasional company whose potential is not fully appreciated by the market, such as Aerospace Industrial Development Corp. We are also ready to add to positions of companies whose share price is hurt by a bad quarter if our original investment theses remain intact.

Regards,

Dave Descalzi
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10/06/17