SeaBridge Asia Strategy

Third Quarter 2018
Commentary

We are going to do something unusual with our quarterly commentary and open with our conclusion, as follows. We think it is the right time for investors to consider an additional investment in the region. We have jumped the gun on our conclusion hoping that you may be now more inclined to put aside your frustration with a poor return thus far this year and continue on with the rest of the commentary which contains a rationale for our proposal.

There is no question that, after a very promising start to the year, Asian markets, like virtually all their international counterparts, have badly lagged the U.S. market, whose major indices recently reached all-time highs. Even for those who have only a passing familiarity with Asia, the reason for the poor performance is apparent. Asian markets reflect fears that a steady roll out of tariffs imposed by the U.S. on Chinese goods will escalate to an all-out trade war with tariffs ultimately levied on all Chinese goods imported into the U.S. It is expected that China would retaliate with its own tariffs and other measures designed to impede the flow of U.S. goods into China's enormous domestic market.

So, we'll go out on a limb and say that, in our opinion, there will not be a trade war. China simply has too much to lose. Such a conflict would put continuing significant downward pressure on China's currency A chronically weak RMB would make it more difficult for dollar borrowers to service their debt, while exporters, normally weak currency beneficiaries, would not reap the benefits of selling lower priced goods to their dollar customers because tariffs would consume the discount that would otherwise be available. And their costs, denominated in RMB, would rise, pressuring margins. With China a big importer of dollar priced commodities, inflation expectations would rise. The policy response to all this would be either to raise interest rates to defend the currency, which helps on the inflation front but slows the economy, or open the credit spigots and flood the economy with liquidity, a tactic which usually produces a false dawn of growth but exacerbates inflation and ultimately devolves into an exercise in non-performing loan creation.

There are ancillary downsides to a trade war. China aspires to be a world leader in intelligent manufacturing in the next decade. The initiative, known as "Made In China 2025", targets ten industries among which are robotics and automation, biotechnology and aerospace. The plan involves a forced technology transfer by foreign companies seeking market access in China. To the extent there is a full-blown trade war, this access will almost certainly be curtailed, and the technology transfer would slow. We have concerns that general confidence would wane. Capital and people would increasingly seek to leave, inviting authoritarian policy responses.

On the other hand, America is in a stronger position to endure the pain of a trade war. The U.S. economy is strong and shows no sign of slowing. The cap ex cycle is finally kicking in. The savings rate is up. Unemployment is low, and wages are finally rising in real terms. Consumer and business confidence is soaring. New, mutually beneficial trade deals with S. Korea and Mexico have been negotiated. On a most simplistic level, as President Trump reminds us, China, with just over half the nominal GDP of the U.S., exports $500 billion of goods to the U.S. and the U.S. sells China $180 billion. Just on the numbers, the U.S. wins.

But the U.S. should not overplay its hand. U.S. farmers will be particularly hurt by a trade war. China is one of the largest markets for U.S. agricultural goods and related products representing 15% of U.S. agricultural exports. Domestic manufacturers' supply chains would be disrupted. Input costs would rise. The American consumer would pay more for a host of goods.

So, if rationality prevails, we will see a deal between the U.S. and China. The economic benefits to both countries are clear, including a freer market for goods and capital and the licit transfer of technology. But we must concede that the dustup may be about something more than economics. It may be that the U.S. sees China and its ascent to superpower status as an existential economic, geo political and military threat to American interests worldwide. From the buildout of an artificial atoll in the middle of the South China Sea, to a deployment of 100,000 military personal to Africa and South Asia, to its funding of air and space installations in Greenland and Argentina, China is altering the political and commercial landscape beyond its borders. If this is the case, the U.S. may feel compelled to confront China with a view toward containing it.

The pressure Asian markets have been under this year is incommensurate with the economic promise of the region. The looming trade war is undoubtedly the primary reason for this. But even a protracted conflict cannot dim the fundamental attractiveness of the region which is grounded in favorable demographics, a strong work ethic, a propensity to save that is greater than that of the West, and a fanatical devotion to education. The current differential between the U.S. and Asian market valuations does not reflect either Asia's prospects nor U.S. risks. Asia ex Japan trades at a P/E multiple of 12x 2018 earnings while the U.S. is at approximately 18x. This difference is at its widest in recent memory. Even if the worst-case scenario, which is not our base case, happens on the trade front, we believe China and the rest of Asia will adapt. The investment case for Asia is not reliant on export markets but rather on the explosive expansion of the middle class expected in the coming decades and the hyper growth in domestic consumption that accompanies it. With interest rates relatively low and earnings growth high, the U.S. market may not be priced to perfection, but it appears to be priced to a dubious perception that the U.S., among its global counterparts, is and will remain the only world economy performing to potential. And, the U.S. market is almost certainly not priced to political and social polarization. Should Democrats regain the majority in the House and or Senate in the mid-term elections, there will likely be attempts to slow or reverse business friendly policy initiatives that have been put in place over the past two years. This may not be good for the U.S. market. We believe the valuation differential between Asia and the U.S. will close.

There is no doubt that trade tensions will be felt by many of the companies in our portfolios, especially our manufacturers with large China installations. However, we would point out that none of our China-based manufacturers have 100% of their production inside China. Many have operations in SE Asia, Mexico and Europe where they can reassign order flow for product bound for the U.S. that would otherwise be subject to tariffs. Additionally, a trade war between the U.S. and China may be beneficial to those companies domiciled outside of China that offer some tariff avoiding advantage to affected firms. We have, for example, an industrial park company in Thailand that has recently indicated it has received many more overtures for land from Chinese manufacturers seeking to diversify their factory base outside of China. Our conclusion is that the worst case is not so bad.

So, we end this commentary the way we began it. It may be time to think about increasing investment allocation to the region.

We have attached comments on portfolio changes during the quarter.

David Descalzi
9/28/18

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This is not a recommendation to buy any security or sector*. SeaBridge may buy or sell securities for client or personal portfolios at any time in the future depending on individual circumstances or changes in SeaBridge's conclusions about the outlook. There is no representation about the future performance of the stocks mentioned in the Commentary. There are other stocks in the portfolio that performed worse than the examples presented here. SeaBridge's opinion of the economic and market prospects may change in the future.*

There are differences among portfolios managed by SeaBridge in each strategy based on client-specific factors. Not all portfolios hold the same securities. Not all stocks held in the portfolio perform similarly. SeaBridge manages portfolios in several styles.

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Transaction Summary

Note: some accounts may not have participated in some of the trades mentioned in this summary due to client-specific factors.

Purchases

We increased our holding in **Fanuc**, a Japanese manufacturer of automation equipment and robots. The stock has been under pressure of late for a variety of reasons including concerns over order flow for smartphone manufacturing. The stock was weak during the quarter and was recently downgraded to neutral by Goldman Sachs. We believe the decline in shares is overdone as is the concern over the smartphone product cycle. Their robo-drilling machines, used in phone casing manufacturing, experienced some softness. On the other hand, the factory automation segment continues to produce impressive results. Asia ex Japan is 45% of revenue so trade war fears have definitely weighed on the shares giving us the opportunity to accumulate.

We initiated a position in **ASM Pacific Technology**, which manufactures back end semiconductor equipment. Its competitor in Europe has been affected by the slowdown in cryptocurrency chip sales, an area of the industry where ASM has a much more modest presence. The stock has dropped significantly recently mainly, we believe, because of concerns over U.S./China trade. We believe there is a new cycle of equipment upgrade in the space looming as customers will need to migrate from traditional wire bonding to new technology. We see this as a 2019 event.

We also re-entered **Bank of the Philippines Islands**, a Philippines-based commercial bank. This is a bank which we had previously held and then sold on strength when we felt the risk reward tradeoff no longer warranted a position. This is a stock that has been a casualty of fears over emerging market contagion. The Philippines runs both primary and current account deficits so fears are not entirely unjustified. However, the Philippines are neither Argentina nor Turkey where inflation and interest rates are multiples of their counterparts in the Philippines. As for the bank, it is reasonable to expect net interest margin expansion over the next few years as a recent rights issue sources funds without the burden of an interest cost. The Central Bank is raising rates which should also help NIM. Additionally, loan growth should be helped by a capex cycle that appears to be turning up in the Philippines. The bank has reinvigorated its approach to certain consumer sectors and this should also spur loan growth. At the time of purchase, the bank was trading at 10-year lows in terms of P/E and P/B.

We added to our position in **Hi-P International,** a Singapore based integrated contract manufacturer with capabilities in both component manufacturing and product assembly. Hi-P had its IPO in 2003. It is a fully fledged ODM and EMS service provider with competencies in both plastics and metals, which allows the company to fabricate products in their entirety beginning with the design stage. Notable clients include: Apple, Amazon, Keurig, Colgate, Braun, Gillette, Fitbit, Ofo and Motorola. We have been waiting for a pullback in the stock to add. Because its manufacturing base is in China, the shares have retreated as trade war rhetoric has intensified. The stock has stabilized at a low level. As we do not believe that a trade war is inevitable, we are taking the opportunity to add to our very modest position at attractive valuations. It trades at about 9x forecast 2018 earnings.

We initiated a position in **Broadcom**, which develops and markets digital and analog semiconductors. The stock had been falling on the basis of some softness in second quarter performance in their wireless segment. This weakness, however, was more than compensated for by growth in cloud and data centers, artificial intelligence and ethernet connectivity chips. The stock took another leg down during the quarter on the basis of its proposed acquisition of CA Technology, a slow growing enterprise software company. We were not as negative on this $18 billion acquisition as was the market. The stable cash flow of CA will smooth out the cyclicality that is inherent in the semiconductor business while at the same time should create a stronger market for the company's chips. The company is a prodigious cash flower. CA only enhances cash flow generation. The stock trades cheaply relative to the market and to the chip sector.

Sales

We trimmed positions in each of **AIA Group**, the leading insurance company in the region, and **Chroma**, a maker of measurement and testing equipment for assorted technology hardware. We had large positions in both stocks, which have held up well in the downturn. We raised some cash to deploy in stocks that now represent better value in our opinion.

We exited entirely out of **Telstra,** an Australian telecom company, and **Dah Sing Financial**, a Hong Kong bank. These are stub positions which we have no intention of increasing at this point.

We also raised some cash with our trim of **SIA Engineering**, a Singapore-based airplane maintenance and repair company. The company is a solid, trusted company in its field, but it is producing lackluster results, on the basis of fewer services required for newer fleets. Specifically, airframe and fleet management revenue is subdued. On the other hand, the engine component side of the business is thriving. This translates into a challenged topline but better margins. We would be content to hold but again would like to raise some cash to deploy in undervalued stocks with what we see as better growth prospects.

David Descalzi
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