SeaBridge Investment Advisors, LLC

SeaBridge International 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 outside of the U.S., specifically in Asia.

We'll begin with a review of portfolio activity for the quarter.

We **initiated** new positions in:

- **FANUC –** The company is 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 weighed on the shares giving us the opportunity to enter at what we believe is an attractive price.

- **Mohawk Industries –** The global flooring manufacturer produces roughly 40% of revenue outside the U.S. This is the fastest growing segment. The company's problems are mainly cost-related. We believe, however, that with commodity prices stabilizing, these costs may be plateauing. Recent investment in new plant and equipment should start to pay dividends in 2019. Demographics suggest that housing demand is growing and will benefit the residential side of Mohawk's business. The stock is cheap on an historical 5-year P/E basis. $13.8M insider purchases by a board member, Filip Balcaen, further reinforce our confidence in the company. The downside risk is a general slowdown in the U.S./global economy, but we feel the current valuation adequately compensates for the risk.

We **added** to existing positions in:

- **Crown Holdings –** The company experienced a mixed quarter, but metal can volumes, especially abroad, continue to grow nicely. The pass-through of rising costs has been successful except for freight. While still a work in progress, the first read on the integration of Signode Industrial, a company specializing in transit packaging systems, looks good. The company has high debt levels, but they are a solid free cash flow generator and look to get the D/E ratio, now at 4.6x, down a multiple of .5, debt/equity, per year for the next number of years. The first significant bond repayment occurs in 2022, so they have some time. Input cost inflation could be a risk but, with the packaging industry as a whole trading at the widest discount to the broad market in over a decade, we believe this pullback provided a good point to add to the position.

- **Broadcom -** The company develops and markets digital and analog semiconductors in the wireless, wired, enterprise storage, and industrial segments. The stock had been weak based on 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 with its proposal to acquire CA Technology, a slow growing enterprise software company. Analysts were somewhat blindsided on two accounts by this announcement. The company had indicated that it would be pursuing acquisition in the ~$10B range, and CA Technology would be nearly double this figure. Secondly, this moved the company into a new segment outside its core chip competency. We were not as negative as was the market. The stable cash flow CA should smooth out the cyclicality that is inherent in the semiconductor business while at the same time create a stronger market for the company's chips. The company is a prodigious cash flower. CA only enhances cash flow generation. Management has since confirmed the notion that cross-selling chips into CA's entrenched enterprise customer base was a large part of the motivation behind the transaction. The stock trades cheaply relative to the market and to the chip sector.

- **Omron –** We believe this Japanese industrial automation company has been weighed down by trade war fears with little change to the positive fundamentals. We are putting money to work in one of the weaker holdings YTD.

- **Johnson Electric –** We believe that the stock of this Hong Kong-based micro motor and motion control company has been pressured by trade war fears. With a global footprint, Johnson Electric has the capacity to shift production outside of China to other plants domiciled in countries unaffected by the U.S./China dispute.

We **trimmed** positions in:

- **Alphabet –** The company had a strong earnings report and the stock reacted positively. Despite the trim of a very large position, we are still positive on the fundamentals.
- **Microsoft –** The company had a very a solid second quarter. Azure and Office365 are continuing to put up strong numbers. We thought it prudent to take some profit on a very large position.
- **AIA Group -** We had large positions in the Hong Kong-based insurance company, which has held up well in the downturn. We raised some cash to deploy in stocks that now represent better value, in our opinion.
- **HDFC Bank -** This high quality Indian commercial bank held up fairly well in the emerging market selloff despite its elevated valuation. While we believe much of this premium valuation is justified due to the superior deposit and loan growth as well as below average NPLs for the region, it is prudent to reduce some exposure to the high multiple names in the current environment.

Here is a rationale for our conclusion about the outlook for Asian investments. Emerging markets have been a crucible of sorts for the convergence of toxic global macro concerns that have been a source of volatility in financial markets this year. The binding agent is the substantial amount of debt taken on by countries which had been enabled by extraordinary monetary stimulus promoted by the world's central banks since the great financial crisis of ten years ago. Emerging markets are almost always in a less stable position to withstand the effects of the withdrawal of the monetary "punch bowl". Most vulnerable are those countries which run both fiscal and current account deficits. The Federal Reserve is now leading the way in scaling back its monetary accommodation by raising interest rates and shrinking its balance sheet. A consequence of its actions has been a strengthening of the dollar. A strong dollar puts many emerging countries in a precarious position since their dollar denominated external debt has become much more expensive to service. Investors are clearly aware of this vulnerability. Argentina and Turkey stand out among dual deficit emerging market countries; each country has seen its stock market plummet by more than 40% this year in U.S. dollar terms.

Unfortunately, all emerging countries have been caught in the downdraft including some countries that have current account surpluses, many of them are found in Asia. Markets in Asia ex Japan have retreated about 5% on average year to date on a dollar basis yet Korea, Taiwan, Singapore, Thailand and Hong Kong all run current account surpluses. The relative stability of the currencies in the region reflect this happy circumstance. So, we must conclude one of two things in assessing the region's markets' decline. Emerging markets are indiscriminately being painted with a very broad brush, or there is another reason for the downdraft.

The one obvious alternative explanation is the potential trade war between China and the U.S. While the market is right to worry about such a conflict, which would be damaging on many levels to China's economy, we don't believe one will happen. 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:

1. raise interest rates to defend the currency which helps on the inflation front but slows the economy or
2. 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.

While the U.S. is in a strong position to withstand a protracted conflict, it also has much to lose in the form of reduced markets for its agricultural products, supply chain disruption, and higher prices paid by consumers for a whole host of goods.

But even if trade becomes less free between China and the U.S., the pressure Asian markets have been under this year is incommensurate with the economic promise of the region. 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 next twelve month estimated earnings while the U.S. is at approximately 17x. 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 markets. We believe the valuation differential between Asia and the U.S. will close. We are looking to increase our Asia exposure in the portfolio.

If there is a tail risk out there, in our opinion, it will not come from Asia or the emerging markets but from the European Union where growth is slowing, easy money is still flowing, and from which Britain is leaving.

Specifically, Italy may be the first economy in the EU to crack under the stress of excessive debt and the socialism-tinged restrictions on business, characteristic of the Union, that prevent market-based solutions to its significant economic problems. On the surface, Italy appears to be no worse than certain other members of the EU including France. A comparison between the economies shows remarkable similarities including the GDP growth rate, about 1.5%, and a budget deficit that is running about 2.5% of GDP. Interestingly, Italy runs a small current account surplus while France is in deficit during the recent years. The similarity ends with debt, where Italy is much more like its economically challenged Mediterranean counterparts in the EU, Greece and Portugal. But Italy's GDP is about 10x the size of either of those two countries. Italy has the third biggest economy in the Euro area. The market harbors a deep suspicion that Italian banks are undercapitalized, particularly those of the Mediterranean countries making them vulnerable to credit downgrades of Italian bonds and to exogenous shocks such as a collapse of Turkish debt which is held by many of these institutions.

In truth, Italy is not alone among heavily indebted countries where a debt crisis of global significance might occur. What differentiates it are the political circumstances in which the country finds itself. A populist government has recently been installed with big fiscal plans including spending for infrastructure and universal income which will only extend the budget shortfall, making it virtually impossible for Italy to stay within an EU imposed budget deficit cap. Italy may be emboldened to demand fiscal and political concessions from the EU. If those concessions aren't granted, Italy may wonder aloud about leaving the Union which, given the turmoil surrounding Brexit, will not inspire confidence in the markets about the durability of the EU.

Global debt is and will remain a long-term concern. On the other hand, a catalyst for international markets generally will be trade deals between the U.S. and its major trading partners. As of this writing, the U.S. arrangement with Korea and the Nafta countries have been renegotiated, and Japan and Europe have been teed up. China looms large as an outlier, but we believe ultimately something will get done. We believe a better trade environment will be the necessary condition for a closing of the valuation gap between the U.S. and the rest of the world. We are encouraging our clients to consider additional investment outside the U.S. Given the underperformance of the Asian markets thus far and our macro concerns in Europe, we are looking to increase our weighting in Asia and maintain our significant underweight in Europe in the International strategy.

Regards,

Dave Descalzi
Matt Falkowski
10/1/18