SeaBridge Investment Advisors, LLC

SeaBridge Asia Strategy

Fourth Quarter 2014

Commentary

Prognostication is a confounding endeavor. In the investment business, it takes the form of economic, market and company forecasts that are really an amalgam of expected human behavior that may or may not conform to precedent under circumstances which may or may not transpire. Forecasts tend to coalesce around a mean with a tight distribution, reflecting an understandable risk aversion on the part of the professional forecaster. The consensus is usually wrong, sometimes spectacularly, as has been the case with the recent dramatic free fall in the price of oil. Consumers of forecasts often tolerate inaccuracy due to the difficulty inherent in the task of trying to divine the future.

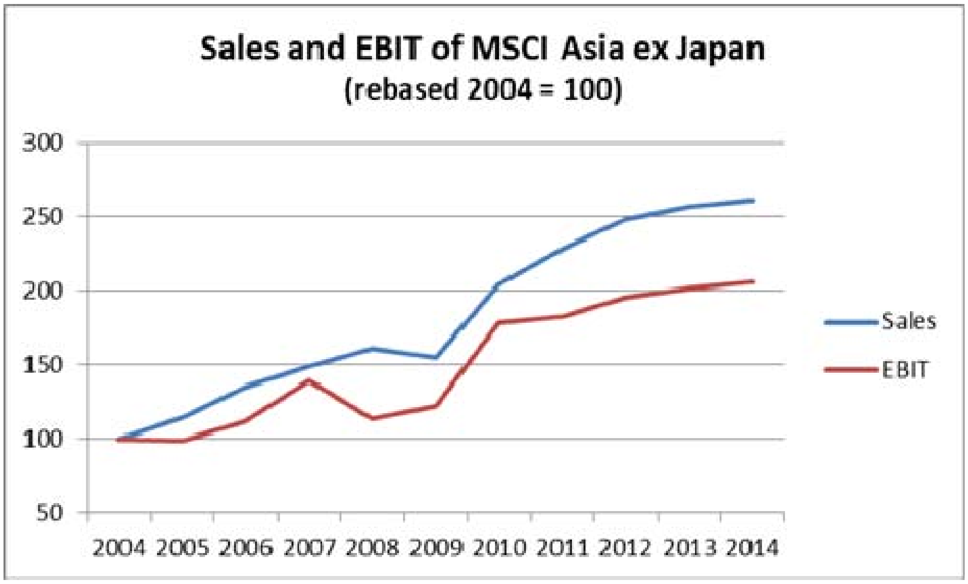
On the other hand, it is disconcerting when a historical review of a particular period fails to confer the benefit of clarity. In an assessment of the investment landscape of Asia in 2014, ambiguities persist. Generally, we can look back and see conditions for a decent investment year. When the final numbers are in, economic growth should be approximately 6.9%, according to the World Bank, which is far in excess of that of the rest of the world and more than twice the rate of the US, the year's best performing developed economy. Inflation, an old nemesis of the region, generally remained subdued. Exports, now a less important factor in economic growth in the region, certainly didn't detract from growth. The US remained a vibrant export market and intra-regional trade is booming despite the slowing in China. There have been well received, pro free market election outcomes in India and Indonesia. So why has there been no rerating of the Asia stock market in 2014 as was the case in the US?

The answer may be contained in the following two charts:

Source: IMF, Bloomberg, JWCAE

The above exhibit tracks economic growth in the region against sales over the past ten years. It shows that since the region exited the financial crisis of 2008 and 2009, sales growth has kept pace, more or less, with growth in GDP.

However, corporate profits have not kept pace with sales:



Source: Bloomberg, JWCAE

We believe that with earnings lagging, stock market returns of Asia ex Japan of late have been muted, which is particularly disconcerting during the economic rebound following the financial crisis of 2008 and 2009.

We have pointed out in past commentaries that there is a concerted effort underway in the region to raise minimum wages aggressively as a matter of social policy. Rising wages are fundamental to the great pivot in Asia away from its export centered, mercantilist past toward a vibrant, consumer dominated economy. It is clear now that companies have not passed through this wage inflation to their customers and instead have absorbed much of it through margin compression.

It is reasonable to ask if we can expect more of the same in 2015. We think not. While wages should continue to rise, they will likely do so at a slower pace. Corporate surveys indicate that Asia ex Japan salaries will increase 7%, down from an annual growth of 9% between 2010 and 2013, the slowest pace since 2010 and a level that should be less damaging to the bottom line.

There has been one unintended benefit of the rapid rise in wages in the region. The wage shocks of the past few years have been very instructive to corporations and necessitated operational efficiencies through a variety of capital equipment and automated processing solutions Unlike their US counterparts, Asian corporations have invested steadily in their own firms despite the damage to confidence that was a casualty of the financial crisis and Great Recession of 2008 and 2009. We expect companies to reap the benefit of this investment for years to come.

We think there are other reasons to be optimistic about 2015:

1. China and the rest of Asia consume a disproportionate share of the world's hard commodities, such as aluminum, copper, and iron ore. Adjusted for GDP, the country buys four to ten times as much of these commodities as the rest of the world. Commodities have fallen hard during the past year and the well documented slowing in China along with the growth challenges in Europe and Japan should help contain commodity price inflation, with the savings flowing through to the bottom line of most of the companies in our universe.
2. Countries in Asia consume more than three times more oil than they produce and are more dependent on imported oil than any other region of the world. Thailand's oil deficit was almost 10% of GDP in 2013, while other economies ran deficits ranging from 7.2% of GDP for Singapore to 2.8% of GDP for Indonesia. Only Malaysia among all countries in the region is a net exporter of oil. Merrill Lynch estimates that for every 10% decline in the price of oil, economic growth is impacted by 15 bps to 45 bps. If true, we can expect additional growth of 0.6% to 1.8% to GDP growth in Asia ex Japan, given oil's 40% fall in the last quarter of the year, everything else being equal.
3. The US dollar has strengthened significantly against all currencies particularly the euro and the yen. Asia ex Japan currencies have weakened to a more modest extent against the greenback reflecting the relatively good economic fundamentals of the region. We believe resilient currencies position Asia well for continued growth in that interest rates should not need to rise to defend currencies and choke off economic growth in the process.
4. With the fall in the price of oil, the necessity for fuel subsidies throughout the region will weaken, freeing up fiscal resources for infrastructure.
5. We see a political environment conducive to freer trade both inside and outside the region. The recent APEC meeting emphasized trade as a growth driver and a number of bilateral and multilateral trade agreements are likely. Additionally, if there is one area that a Republican Congress and President Obama can agree on, it is the liberalization of trade, generally considered to be low hanging fruit in the in the endless, thus far fruitless quest for bipartisanship in the US.
6. Occupy Central, the Hong Kong weeks long protest that impeded physical movement throughout Central and other areas, has receded. The retail sector and tourism, the biggest commercial casualties of the demonstration, can now trend toward normal.
7. Despite an economic slowing that is a byproduct of real political and financial system reform, China has been rightly reluctant to use the blunt instrument of massive fiscal stimulus to juice its growth numbers. We find this comforting. China instead will likely modify restrictive regulations and administrative measures and gently loosen monetary policy enacted in headier times to conform to more subdued economic conditions. Recently, for example, it has expanded its definition of "deposits" to include certain types of institutional funds custodied at commercial banks. This should have the effect of raising the lending limits at commercial banks, which in turn should be stimulative to economic growth.
8. Reforms in China, India and Indonesia are proceeding apace creating a strong foundation for growth in the three most populous nations in the region.

We see the following macro risks to the region:

1. Japan may continue to struggle with deflation despite extraordinary government interventions designed to combat chronically falling prices and stagnant growth. If Abenomics fails, Japan could descend into an uncheckable deflationary spiral. A huge yen carry trade that has been put in place could unwind causing considerable havoc in global financial markets.
2. Russia may unravel with the collapse in the price of oil. Western creditors could feel the pinch of non-performing Russian debt and become capital deficient. Confidence in the financial system particularly in Europe, painstakingly rebuilt since the crisis of 2008, could once again be tested. Economic instability in Russia could have untoward geopolitical consequences.
3. US may tighten monetary policy in a way that is hostile to market equanimity, i.e., too much too soon, without adequate forewarning.

4. China may enter a crisis phase as bad investment piles up in the banking system.
5. The tents in Hong Kong have come down, but Occupy Central is by no means a spent movement. There will likely be periods of unrest along the way to the election of Hong Kong's next Chief Executive in 2017.
6. Taiwan, on the heels of an election victory by the pro independence Democratic party, may be entering a new contrarian relationship with China. Along with a likely resurgence of Occupy Central in Hong Kong, political tensions may rise in Greater China.

So we too have succumbed to an unavoidable occupational hazard of a year- end letter that includes forward looking thoughts for 2015. Generally, we are optimistic about Asia because we are more optimistic about earnings.

David Descalzi

January 7, 2015

See general disclosures at the end of the document.

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