SeaBridge Asia Strategy

Fourth Quarter 2015

Commentary

Equity markets in Asia performed poorly in 2015. The prospect of rising US interest rates in the context of tepid economic growth world-wide weighed on investor sentiment and all equity markets including those in Asia. According to the current IMF forecast, global growth for 2015 is projected at 3.1 percent, down 0.2 percentage points from its July forecast for 3.3 percent growth. In April the IMF had predicted global growth of 3.5 percent this year. The IMF expects stronger growth in 2016 but has taken down its 2015 mid-year forecast for next year as well. China, of course, figures prominently in these projections. The IMF now believes that China will grow at 6.3% next year, down from 6.5% this year. Softening commodity prices seem to confirm the new IMF outlook. Oil, in particular, trending toward $30 at year end has been a signal to investors of global growth woes. Growth concerns were most manifest in the third quarter when equity markets sold off, with emerging Asia hit hard in US dollar terms.

Despite the full year disappointment, we are encouraged by performance in the last quarter of the year. Commodities firmed in December. The dollar retreated. Equities advanced. Looking at the portfolio, the advance was broad based across both emerging Asia and the more developed markets represented in the portfolio including Australia and New Zealand. It is too early to tell if we've had a technical bounce or if we are at the beginning of an uptrend. For the advance to be sustainable into the new year, we believe three conditions must prevail. The advance of the US dollar against the yuan and other regional currencies must cease or minimally slow to a rate that is tolerable for investors; the US, a bright spot of strength in private demand, must not falter; and, most importantly for Asia, China must demonstrate that it can grow despite an economic reform program that correctly deemphasizes capital investment in sectors where over-capacity abounds.

Money for the most part flowed out of emerging markets in 2015. We believe that funds may flow back into Asia in 2016 for the following reasons:

1. Valuation differential is too large to ignore. Despite a lower interest rate environment that has resulted from world-wide central bank easing, Asian market multiples have moved sideways since 2010 and have the potential either to rerate with other markets such as the US or hold value if rates were to rise.
2. The one way bet in the dollar in 2015 might revert once the market realizes that the trajectory of rate increases in the US is more moderate than what the Fed is currently indicating. This would make investors more comfortable holding non-dollar denominated assets.
3. The market finally recognizes that Asia is not like other emerging markets. For example, unlike other large emerging economies such as Russia, Brazil and South Africa, Asia is a net consumer of hard and soft commodities and should benefit from price declines across the commodity complex generally. Inflation, which has long been a regional nemesis, should remain subdued and margins earned by industrial companies should expand, everything else being equal.
4. Because the level of dollar denominated obligations in Asia is small relative to domestic debt, we believe that these obligations generally do not pose a financial threat to the region either at the corporate or government level.
5. The region is much less dependent on the rest of the world for its economic well-being. Intra-regional trade is fast becoming more important to the economic health of the region than is intercontinental trade. The increasing economic self-sufficiency of the region better insulates it from global risks.
6. Despite inevitable setbacks, investors may come to believe as we do that China is making progress instituting reforms. That said, its experience with economic transformation will be uneven; there will be setbacks but there is clear evidence that consumption is taking up some of the slack created by slowing fixed asset formation as an economic driver.

We close with some thoughts on the portfolio. Our model shows that the intrinsic value of our holdings has risen and, because of poor market conditions, the price discount to these values has widened. Because we are careful not to buy overleveraged stocks, we feel that the portfolio generally is conservative. In fact almost 60% of our current holdings have net cash on their balance sheets. Additionally, our companies generate substantial cash, much of which is reinvested in their businesses. We think there is enough left over to be distributed and generate a dividend yield of about 3% on the portfolio. We remind our investors that our holdings are well diversified: by market cap, industry and country of domicile. Our direct China exposure is limited and skews toward domestic consumption including retail, health care and insurance. We currently have no direct commodity exposure. We expect earnings to grow at a rate of 11.5% on a holdings-weighted basis.

We believe that the portfolio is well positioned for the coming year. We expect no wholesale changes. The volatility that we have experienced in the region creates opportunities in companies that have been sold down as part of the general retreat from emerging markets. This creates substantial opportunities for us to add names that have been unfairly penalized by the downdraft. We intend to exploit these anomalies in the new year.

David Descalzi
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