

SeaBridge Asia Strategy

Fourth Quarter 2016

Commentary

In early November, as we neared the end of a raucous campaign season, we in the U.S. were once again settling into a world we had come to understand over the course of the past eight years of the Obama administration. Hillary Clinton would win the election and we would have more of the same for the next eight years -- a highly taxed, heavily regulated U.S. economy that would grow at less than the historical trend rate but at a level higher than that of the rest of the developed world. Interest rates, although set to rise a bit with the U.S. at full employment, would not increase to a level that would damage either the economy or the financial markets. Divided government would ensure gridlock, preventing the enactment of new fiscal or regulatory policy that could be disruptive to the economy's growth trajectory. The Federal Reserve would remain the government agency of consequence for markets which would continue to have a neurotic fascination with the next possible 25 bp move in the Fed Funds rate. Despite the change signal of Brexit, the old global order would still be firmly in place. Not much would change.

And then the U.S. election happened and everything changed. The U.S. markets almost immediately began to discount faster growth in the U.S. driven by enhanced prospects for lower taxes and regulatory reform. It was as if the genie of animal spirits, given detention for his perceived role in the financial crisis of 2008, was suddenly liberated. Equities soared and the bond market sold off on the belief that pro-growth policy was likely from a government where both the legislative and executive branches now shared the same economic vision.

The Trump victory is without question the dominant factor now being considered by markets as we head into the new year. Here is what we think about this startling development as it relates to the portfolio:

1. With private demand in the U.S. already trending higher before the election, and given better growth prospects courtesy of the president-elect, the U.S. economy should continue to be a region of relative strength into next year. Much of the proposed Trump agenda is business focused and includes lower corporate taxes and reduced regulation. Importantly, all variations of the Trump tax plan include a fuller, current expensing of capital goods purchases. If enacted, such a provision increases the probability that the much awaited capex cycle in the U.S., absent since the Great Recession, will materialize. Asia is still an important source of capital equipment. Thus, we will now feel more comfortable adding to our roster of companies that make everything from micro motors, to embedded computing modules, to power supply systems and the equipment that tests all of this equipment and their components. We will also spend more time prospecting in the capital equipment supply chain for new ideas.
2. The Trump effect on China has not been helpful. The dollar has strengthened, complicating China's objective to slowly depreciate its currency and curtail capital flight. Additionally, the strong protectionist rhetoric coming out of the Trump camp portends the possibility of a devastating trade war. We do not believe such a trade war will occur and, in fact, are hopeful that the instinct for deal making on both sides will prevail with the result that trade between China and the U.S. would be

enhanced. Still, with China is in the midst of a multi-year workout of past credit excesses, Trump's election presents complications that China would rather have avoided. We remain China cautious and will likely limit our direct exposure to that country to no more than a few names.

3. The Federal Reserve has sent stronger hawkish signals on the Fed Funds rate post- election. Together with the Trump boost to the long end of the Treasury curve, it is clear that "lower for longer" has morphed into "higher, more quickly". Asia is now dealing with weaker currencies that reflect a slowing China and the new U.S. rate regime. If currencies continue to weaken, there will likely be an upward bias to rates in the region, which will have two ramifications on the portfolio. Given weak currencies, most countries in Asia will find it difficult to lower interest rates to counter any unwanted softness in their economies and may have to raise rates to defend currencies. The monetary stimulus transmission mechanism is thus put at risk. Economies may slow, making it a more difficult operating environment for our companies. Additionally, with rates rising in the U.S. and perhaps elsewhere, interest may wane in high dividend Asia stocks that have long been attractive to investors, especially foreign investors. Thus, we are inclined to deemphasize our exposure to yield in the portfolio and gravitate toward growth, at a reasonable price, of course. It should be noted that most companies in the portfolio are net cash so rising rates are not a cash flow issue for them.
4. As domestic consumption booms in Asia, exports have long ceased to be the main driver of economic growth. However, the Trump victory encourages us to focus once again on companies who manufacture in the region and export to the U.S. for three reasons -- 1.) weaker currencies should stoke demand in the U.S., Asia's biggest export market by far; 2.) intra-regional trade should remain robust, driven by strong demand for goods and services in the region and the re-export market; 3.) we think fears of Trump-inspired trade wars are overblown.

There are two other major themes that even President-elect Trump could not take credit for. The first is that **internet and wireless connectivity** have been spectacularly exploited by the consumer from social media to gaming to ecommerce. We are now seeing increased utilization on the commercial side, both intra- and inter-company. We are at the beginning of the cloud computing and internet of things ("IOT") revolution, and the ramifications will be profound. The buildout of cloud eco system and IOT will involve companies that provide premises, equipment, connectivity, chip sets, power management and the consultants and software to make it all work. The migration to the cloud may be a key element that spurs productivity which has been the missing element to stronger global growth since the Great Recession. The investment potential is huge, to borrow a now overused word.

Finally, **demographics** are still the most important macro factor affecting investment. With over 4 billion people, Asia lays claim to being the most populous world region. Asia can be divided into two demographic hemispheres. The north is older with birth rates low; the south is generally younger with birth rates sufficient to replace the dying population. We know that retirement security and elder care, for example, will become increasingly important investment themes in north Asia; the south will need more infrastructure, for example, to accommodate the burgeoning population. The region is underserved by companies that provide the goods and services necessary to accommodate the region's demographic profile. This essentially constitutes the investment case for Asia and the reason for being for the portfolio.

We close with the thought that global investors typically like the tailwind of synchronous global growth, but we are clearly living in an asynchronous world. Suddenly, the U.S. has a brighter future while Europe, Japan and, to a certain extent, China are weighed down by structural deficiencies that are part political, part cultural. However one feels about the U.S. election, it is hard to dispute that the U.S. just exhibited an enviable capacity for change, to tack away from what may not be working and attempt a different way. Europe's bureaucracy is impenetrable and Japan is inscrutable. We wonder if China can learn a lesson on how a country renews itself from the U.S. Can Trump be a catalyst for reform in China? We wonder. We wonder and hope.

We have included an attachment which provides details on the most notable portfolio activity during the quarter.

Dave Descalzi
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