

SEABRIDGE
INVESTMENT ADVISORS, LLC
SeaBridge International Strategy
Fourth Quarter 2016
Commentary

2016 has been an eventful year for investors. It has been a particularly challenging period to be invested in international equities. We began the year in the throes of deflationary fears and ended with everyone seeming to scurry to make the proper reflation trade. The U.S. has been at the center of this volatility. At the start of the year, we found ourselves in a mode we had been in since the Great Recession – on intense Fed watch, waiting for the first moment of the most modest tightening of monetary policy, believing that perhaps one Fed Funds rate increase might occur at some point later in the year. Slow growth, although improving, was still the consensus view among market participants. With the election of Donald Trump and with the enactment of a pro-growth agenda now possible, even likely, with Republican control of the executive and legislative branches of government, there has been a 180 degree shift in mood over the course of the year.

This reorientation signals a market belief in a true and perhaps durable resuscitation of private demand in the U.S. which has had derivative effects on the rest of the world. With the Treasury curve steepening dramatically and the U.S. dollar soaring, growth stocks everywhere gave up their market leadership position to value stocks. Commodities and commodity exporting countries once again found favor with investors, and stocks that were formerly bought for yield lost a little of their luster. With the yen, Euro and yuan depreciating significantly against the dollar in the fourth quarter, foreign stocks were particularly hazardous to dollar investors, who might have been right on the stock but hurt by the currency translation.

The International Strategy portfolios have not been immune to the volatility that has accompanied the Trump victory. Despite some success with individual names, generally we found ourselves on the wrong side of the Trump trade. We were underweight sectors in which there is now more optimism such as financials and had reasonable positions in areas about which questions abound, for example, health care.

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 development as it relates to the portfolios:

1. 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 now feel more comfortable adding to companies in that region that make everything from micro motors to embedded computing modules as well as prospecting 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 Trump 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. Still, with China 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.
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". All the major currencies have weakened post-election as the dollar has marched higher in the new U.S. rate regime. If currencies continue to weaken in Southeast Asia and elsewhere, there could be an upward bias to rates outside the U.S., which will have two ramifications. Given weak currencies, these countries 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 certain foreign companies. These lower exchange rates have hurt

performance as the foreign holdings are being translated back to fewer dollars. On the other side of the coin, the weak currencies should be a positive for exporters particularly in Southeast Asia but Japan and Europe as well.

4. With rates rising in the U.S., interest may continue to wane in high dividend securities. Thus, we are inclined to deemphasize our exposure to yield in the portfolio and stay more focused on growth, at a reasonable price, of course.
5. Europe has myriad economic and social problems all of which, to a greater or lesser degree, call into question the durability of the Union itself. Without political union, there cannot be a united states of Europe. Brexit is but one sign among many that the goal of a true federation is now harder to attain. We will be reminded in the coming year about the region's fragility when presidential and parliamentary elections are held in Germany and France. Current polls suggest that Euro skeptic candidates may do well. Against this uncertain political backdrop, we believe that European markets may struggle. We recognize valuations are more attractive on an absolute basis than those in the U.S. Additionally, the European Central Bank is still pumping money into the system, perhaps putting a floor under prices. Still, despite these salutary conditions, count us among Euro skeptics. We will likely place more emphasis on the region if it continues to underperform the U.S. and valuation differentials widen.
6. Japan, for us, remains a conundrum. The country cannot seem to dispel a sense of pessimism that comes with years of deflation and deteriorating demographics. The BOJ has flooded the economy with massive amounts of liquidity, to no great avail. The country grows at an anemic pace and had even slipped into recession in late 2015 despite the huge monetary stimulus in place. We view Japan as a country with intractable long term issues but with some good companies, particularly in the industrial and machine equipment area, that are of interest to us.

The MSCI AC World ex U.S. Index fell 1.2% during the quarter bringing the 2016 full year performance to a positive 5.0%. But this moderately positive year for the index is only partially comforting because it is not supported fundamentally by an earnings uptrend. Consensus 2017 and 2018 earnings estimates declined as the year progressed with both down roughly 8-10% from the estimates at the beginning of the year. Unless the projections for earnings discernibly improve, the markets may labor to move higher. This holds true in the U.S., where the strong market advance since the election has been driven by a conjecture that the Trump pro-business agenda will be enacted and earnings upgrades occur.

We were active in the period, initiating positions in **iShares MSCI Mexico**, **Amata Corporation**, and **InterXion**, among others. Below we will highlight the investment case for these new holdings.

Prior to the election we took a starter position in **iShares MSCI Mexico**. Peso weakness gave us a good opportunity to increase exposure to Latin America. We believed some of this weakness to be justified due to rising rates in the U.S. However, we think the 13% decline in the peso since the election, capping a 20% decline since April of last year is overdone. It is our assumption that while President-elect Trump wants to seal the border and prevent U.S. companies from relocating operations to Mexico, he does not want a trade war with a country that is the most important supplier of durable goods to the U.S. We believe NAFTA will be reworked to the satisfaction of both the U.S. and Mexico. As such, we expect the peso to strengthen and thus justify this investment.

Amata's main business is developing industrial estates in export-oriented areas in Thailand. They build industrial cities with a standard road system, private security system, reliable utilities and waste disposal, and green areas for companies such as BMW, Nestle, BASF, Hitachi, and Sony to build manufacturing facilities. A moderately disappointing Q3 report from the company provided an opportunity to buy into weakness. Slow land sales, which are historically lumpy, were responsible for the poor showing in the quarter. However, recurring income driven by utilities and rental income was strong, providing an underpinning for the stock. We believe it is only a matter of time before land sales resume and investor interest returns to the stock. The stock looks cheap to us trading at 12x depressed 2016 earnings and at book value.

InterXion is a European data center provider. During the first half of 2016, data center REITs and providers appreciated rapidly due to elevated buildout activity from the hyperscale cloud computing providers. When companies started reporting softer bookings in the 2H of the year, the group experienced a 10-20% correction and the shares we believe are now attractively valued. Even though booking levels will likely not gather the same momentum as early 2016, we believe the migration of companies to the cloud is at a very early stage. Global IP traffic is growing over 20% per year. Computing and storage capacity available for sale are at a 4-year low, and pricing metrics are slowly ticking up from the lows made in mid-

2015. Given the favorable industry dynamics, a solid presence in Europe and a cheap valuation, the company is attractive to us and may draw the attention of corporate suitors looking to expand their geographic footprint.

During the quarter we exited positions in a number of holdings most notably **Amgen**, **Novo Nordisk**, **Proshares Short MSCI EAFE**, **Proshares Short FTSE China50**, and **Fairfax Financial**, as well as trimmed **Misumi Group**.

We have commented on pricing pressures in the biotechnology space in past letters. While **Amgen** bucked the trend reporting double digit price increases in its biggest drug, Enbrel (Rheumatoid Arthritis), volumes fell, which is a cause for concern even if Trump were to adopt a hands-off approach to the industry. Acting further on our general concerns, we exited our position in **Novo Nordisk** which reported both pricing headwinds in the U.S. diabetes market as well as volume decline due to higher competition from generics in the hormone replacement segment. Management downgraded long-term growth targets from 10% to 5%. We decided to exit the position prior to the election.

As markets were firming, we exited our positions in **Proshares Short MSCI EAFE** and **Proshares Short FTSE China50**. These investments were purchased for downside protection in a struggling market. Changing conditions warranted their elimination.

Fairfax Financial is a financial services holding company. We believed that through its holdings, we were putting in place a hedge against deflation. With the deflationary threat much reduced since the U.S. election, the need for such a hedge is much reduced and thus we exited Fairfax.

Misumi sells a wide range of mechanical components and maintenance and repair equipment used in the fabrication and maintenance of precision machinery. The company has a stellar reputation. Recently, it has aggressively expanded its e-commerce presence and now efficiently sells online the 9 million different products listed in the company's catalog. The stock rose over 30% from the beginning of the year to October causing valuations to become a bit stretched, so we decided to take some profit.

Notes on 2016 Performance:

We had a number of holdings that went against us and unfortunately fewer that went in our favor in 2016. While our sector concentrations were a mild detractor to the portfolio, a small number of poorly performing individual holdings led to the majority of the lag in overall portfolio performance. We have included a brief discussion on these stocks as well as stocks that outperformed below.

We had owned **Wasion Group** (a Chinese electrical grid equipment supplier) and **SunPower** (a solar developer in the U.S.) to take advantage of the secular shift to cleaner and more efficient energy and were disappointed in both instances. We misjudged the rapidly changing landscape and sold them in January and August respectively, at losses. Because of government involvement in the industry, the supply-demand and pricing dynamics in the industry proved hard to gauge. There is almost a randomness of government activity in clean energy, making companies in the industry highly difficult to model.

Early in the year, we held **WisdomTree Japan Hedged Equity Fund**, which is a currency-hedged Japanese market proxy. We expected the BOJ to cut rates in March and the Yen to weaken. Against these conditions, we projected that the Japanese stock market would rise. We were right about the rate cut but wrong about the consequences. We covered at a loss.

We sold the travel booking leader, **Priceline**, due to a plethora of risks affecting the travel industry at the beginning of the year not the least of which was a general economic malaise that seemed to be setting in. The slower growth proved ephemeral however and Priceline shares recovered.

There have been other disappointments. We owned and still own two John Malone companies. **Liberty Global**, a cable company with extensive holdings in Europe, has been hurt by the weak Euro. **Liberty Global LiLAC**, a Caribbean and Latin American cable consolidator, has been weighed down by a disappointing quarter and poor emerging market sentiment. We think there is value in these companies but will be careful not to allow our respect for Malone and his reputation for creating shareholder value cloud our judgment on the fundamentals of these businesses. Upcoming earnings reports and commentary from the companies will determine our course of action on them.

Health care holdings have been a drag on performance. Our view on the sector is conflicted. We like the industry because of the demographic tailwinds. The world is getting older, and the demand for medical care should grow nicely. On the other hand, the government overlay to the industry is a threat. With governments worldwide the largest buyers of health care services, pricing power in the industry is illusory. Governments to a large extent will determine services covered and the pricing of those services. Under the right conditions, we may increase our exposure to the industry. If it becomes apparent to us that the heavy hand of government weighs too heavily on health care providers generally, we would be inclined to reduce exposure.

In the positive category, our big winner was **CP ALL**. It is the 7-Eleven convenience store operator in Thailand, which dominates the market. We took profit in an oversized position. Additionally, our holding in **Deutsche Post**, the former German Postal Service which has been privatized, performed well. It is now competing successfully with FedEx in package delivery (the DHL Brand). The company had a solid 2016. We also had gains from our technology holdings, **TenCent** (gaming and social media in China) and **Broadcom** (mobile chips and chipsets). These two companies are leaders in the segments of the industry in which they operate.

As we discussed above, the Trump victory and the nativist sentiment that seems to be taking hold in other parts of the world have complicated the global investment picture. This does not mean that we lack for opportunity in investing outside the U.S. Currencies in particular have always been extremely sensitive to sentiment shifts. Often there is an overreaction. Great Britain is a case in point. While the final chapter on Brexit has not been written, economic performance in the U.K. since the vote to leave the European Union has consistently exceeded expectations. The precipitous decline of the British pound post vote suggests to dollar investors that equities in the U.K. may be on sale. Likewise, the strong, post Trump dollar will weigh on certain U.S. companies, particularly the exporters. We believe those regions whose currencies have been particularly hard-hit since the U.S. election now offer a risk reward tradeoff that demands our focus. We think the U.K., Mexico and Asia fit this category. There are bargains to be had in these regions and we hope to find them.

Best Wishes in 2017,

Dave Descalzi
Matt Falkowski
Garnett Keith
1/06/17

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