SeaBridge Investment Advisors, LLC

SeaBridge Asia Strategy

Fourth Quarter 2017
Commentary

Equity markets finished the quarter on a high note, capping a very strong year for the asset class. The advance in Asia is particularly noteworthy because markets there had been generally lackluster in the years preceding this one, in sharp contrast to the strong performance of their developed market counterparts. In thinking about the reasons for this breakout performance in Asia, we would note the following in descending order of importance in our view:

1. **China.** Over the course of the last few years, China has migrated from being a harbinger of an imminent worldwide downturn to again being looked to as an engine of growth. Investors fretted over excessive fixed asset investment and debt, capital flight, a rapidly depreciating currency and rising corporate insolvencies particularly among state owned enterprises. But China has managed to stabilize its financial system and introduce just enough free enterprise reforms into the real economy to calm investors. Against a more optimistic outlook for global growth generally, China is poised to add its considerable weight to the economic momentum we are seeing worldwide.

2. **Synchronized global growth.** For the first time since the Great Recession, all regions of the world are on an above-trend economic growth trajectory with the U.S., the EU and even Japan performing better than consensus expectations. It is no surprise that corporate profits are trending higher and that risk premiums have receded.

3. **Easy money.** Readers of this letter might object to the relatively low ranking we place on very favorable liquidity conditions that have undoubtedly been the major catalyst for the run-up in financial assets worldwide. As justification, we note that Asia had underperformed miserably in the years preceding this one in a world also awash in liquidity. Financial assets may have been bid up but the specter of a China collapse had capped the flow into Asia. This psychology reversed this year.

4. **The absence of an exogenous shock.** The excessive liquidity mentioned above tends to tamp down volatility as selloffs are exploited by investors vigilantly poised to enter the markets at lower price points This is especially true in an era of algorithmic trading We would also note that there were few shocks to exploit during the year. There were none from the Federal Reserve or other central banks that had consistently and successfully communicated policy moves well in advance of their implementation. North Korea did occasionally test a nuclear weapon or launch an ICBM in 2017, but unless a rocket lands on hard ground someplace and not just in the Sea of Japan, the world may continue to ignore the provocations of an unstable regime. On the political front, there were no Brexit like events in 2017 as there were in 2016. In fact, elections results in Japan and a number of countries in the European Union skewed conservative, but not populist, as had been originally feared. Trump was an unknown going into the year but his pro-business agenda has obviously been market supportive in the U.S.

As for the portfolio, the uplift was broad based across sectors and countries. Our industrials, financial services companies and property firms were the standout performers. Among the laggards were consumer products companies where specific company issues weighed on stock performance.

2018 is setting up to be a pretty good year in our opinion. While the Fed is tightening and the ECB should begin to taper next year, we still expect relatively easy money conditions in Europe, Japan and the rest of Asia. We think only an inflation scare would encourage central banks to move to a more restrictive policy than that which they have already signaled. Until that happens, the synchronized global recovery currently underway has enough momentum to extend into the new year and perhaps beyond. Additionally, the stimulus that comes with the new tax legislation will likely be an accelerant for growth extending beyond the borders of the U.S.

Against this favorable economic backdrop, here are our thoughts on the portfolio.

1. The rise and enrichment of the middle class are a dominant theme in the portfolio. Asia, home to four and a half billion people, will likely be responsible for 90% of the world buildout of the middle class as forecast by the Brookings Institute. The buying power associated with an expanding class of consumers should certainly drive economic growth and, consequently, corporate earnings in the region. The creation of more buying power in the U.S. from the tax cuts and better wages should only enhance demand for Asian exports, further brightening the investment picture.

2. With unemployment low and wages rising, the drive for efficiencies in the production and delivery of goods and services will likely only increase. Information that makes useful, relevant available knowledge will increasingly be gathered, analyzed and acted upon. The demand for the new technology needed in the manufacture of next generation goods and services creates a cycle of its own outside a normal business cycle that historically has been determined by the central banks' interest rate policy. For example, while unlikely on a world-wide basis, it may be that auto sales soften over the next few years, while the chips, sensors, micro motors and battery content of automobiles see exponential growth. Consequently, our attention in terms of portfolio construction would naturally be directed to the designers, manufacturers, testers, certifiers and distributors of components and software that comprise the latest innovative technology. Asia is the world's workshop for the nuts and bolts of the new technological order.

3. While we've had taper tantrums at various points post the Great Recession, there was never a real sense that the Federal Reserve and other Central Banks were behind the curve in their interest rate regimen. This may change in the new year. Inflation data will be followed closely. But despite the euphoria, it is not pre-ordained that inflation will flare up and that the Federal Reserve rate increases will occur more rapidly and in greater increments. Deregulation is a supply side stimulus. Additionally, because technological innovation has a depressing effect on the cost of goods and services, we believe that interest rates will normalize at lower than historical levels. Because of this we will not shy from investments that can be considered interest rate proxies. If a company has a 4% yield where it appears that that yield is secure and can grow, we would have interest in that company. Furthermore, we would view such a company as providing some downside protection to the portfolio should growth and inflation expectations disappoint.

4. We expect margin enhancement among a number of our companies. Products and services offered in a more complex world are themselves more complicated to produce. They command higher prices and offer more margin to the manufacturer.

5. We will look to add to laggards, many of which have hit an air pocket in their evolution brought on by investing ahead of the realization of demand. When a firm builds a factory or adds stores or assembly lines, that firm in a sense installs capacity underutilization with margin pressures accompanying. However, it is also putting in place operational leverage which should be margin enhancing at some point in the future. We have a number of such companies and will look to increase our exposure in these companies so as to be able to participate in the upside.

We, like everyone else in our business, worry about valuations after a very strong market year. On the other hand, we note that the earnings yield of our companies, at 5% on average, is still attractive against a 2.4% current 10-year Treasury yield. We expect earnings growth of about 10% in our portfolio companies.

It is not all clear sailing. Easy money policy has led to some distortions. We see some evidence of bubbles that we would characterize as minor but are bubbles nonetheless. Bitcoin, Hong Kong property and Renaissance art probably fit into this category. However, these markets are too small to matter even if they were to collapse. Our longer-term concern is debt. According to the Institute of International Finance (IIF), global debt hit a new record high of about US$220tril in the second quarter this year. Countries continue to pile on debt, but corporates are following suit. The IIF notes that the percentage of "stressed" firms that cannot cover interest expense has reached some 15%-25% of corporate assets in countries such as Brazil, India, Turkey and China. Many mature markets too have seen a rise in stressed firms, including Canada, Germany, France and the U.S. Any major default in the debt market could ignite volatility in global equity markets. As an aside, we note that our portfolio companies together are net cash.

So, on the whole, we are constructive heading into the new year. North Korea is worrisome despite our comments above and the possibility of a Trump-inspired trade war with China cannot be discounted. Still, while it is not reasonable to expect the same returns next year as we've achieved this year, we believe that current investment fundamentals in the region warrant continued engagement.

David C Descalzi
1/5/18

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Transaction Summary

Note: some accounts did not participate in some of the trades mentioned in this summary due to client-specific factors such as a restriction on trading in Taiwan.

Purchases

In the quarter, we added to **Kerry Logistics**, the largest logistics service provider in Greater China and Asean. It is a total solutions company whose services include freight forwarding, warehousing and supply chain management. It is a direct play on the rapid rise of the middle class in Asia. Because of the cost of the expansion of its network and the inefficiencies associated with integrating newly acquired hubs in its network, margins had softened in the latter half of the year, pressuring the stock and thus providing a buying opportunity. We expect margins to improve in the first half of next year, producing double digit eps growth on high single digit top line growth. The stock has not participated in the uplift of Asia shares this year. We look forward to a better year in 2018.

We added to our existing position in **Aerospace Industrial Development Corporation** which is a Taiwan-based company engaged in the manufacture of aircrafts and engines. The Company operates its business through its defense business, commercial aviation business and industry technology service business. The Company manufactures military aircrafts and commercial aircrafts, as well as aero and industrial engines. It also provides aircraft and avionic maintenance services, flight services, information services and technology services. The Company distributes its products within the domestic market and to overseas markets. We believe the stock is undervalued.

Sales

We again trimmed **China Lodging** in the quarter. Incorporated as a budget hotel chain, the company has migrated into to the mid-level segment and found greater success. The stock has reacted strongly to improving operating metrics. Although we like the company, the rapid advance of the stock price and a more challenging valuation warranted a trim.

We sold out of **Wharf**, which is the residual company post spinoff of Wharf REIT. While there are territorial and real estate segment overlaps between the two companies, Wharf can be thought of as a PRC (People's Republic of China) residential developer and mall operator while the REIT is a Hong Kong-centric commercial real estate investment company. Despite its portfolio of mature assets, we prefer the REIT to Wharf as we believe rent reversions of the Hong Kong properties will continue to skew positive. We are wary of malls in China.

We are trimming **Chroma**, the Taiwanese manufacturer of testing equipment for power supply components and semiconductors. The company posted impressive earnings results for the quarter and raised guidance driven by end demand for 3D sensing components and electronic vehicles. The stock was up 50% in the quarter. We thought it was prudent to trim.

We trimmed **RHT Health Trust**, our Singapore-listed, India-based hospital REIT. The trust received a proposed offer from Fortis Healthcare to buy out all RHT's assets at INR46,500mn or INR34,980mn net of debt which translates to ~S$0.90 per share at 11% premium to the closing price, pre-announcement. We believe the price is at fair valuation based on the implied valuation. We trimmed at this level. The stock has since settled back below the offer price. We plan to trim further on strength.

We sold out of two consumer products companies, **Ginko**, a Taiwanese company that is the largest seller of contact lenses in China, and **Zojirushi**, a Japanese manufacturer of rice cookers and thermoses. Ginko is making a difficult transition from higher margin long term wear lenses to lower margin daily wear lenses. Earnings have disappointed and the stock has reacted accordingly. While posting impressive sales increases in China, the company's most important overseas market, Zojirushi is struggling in its home market of Japan. We expect to revisit both companies later.

David Descalzi
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