



SeaBridge International 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 international markets is particularly noteworthy because they had been generally lackluster for the last number of years preceding this one, in sharp contrast to the strong performance of the U.S. markets. In thinking about the reasons for this breakout performance, we would note the following in descending order of importance in our view:

1. **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., Europe, and even Japan performing better than consensus expectations. It is no surprise that corporate profits are trending higher and that risk premiums have receded.
2. **Easy money.** Favorable liquidity conditions have undoubtedly been the major catalyst for the run-up in financial assets worldwide. As justification, we note that international markets had significantly underperformed U.S. markets since the Global Financial Crisis in a world also awash in liquidity. Financial assets may have been bid up but the specter of a China collapse, stagnant growth in both Europe and Japan, and European political uncertainties had capped the flows into many of these markets. Much of the data and psychology have reversed this year.
3. **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.
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 technology, financial service, and industrial companies were the standout performers. Asia ex Japan followed by holdings in Europe led the way from a geographic perspective. Our laggards, which were thankfully few in number, were our holdings in health care, Japan, and Latin America. We are underweight the first two and have a small allocation to the third.

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. Only an inflation scare will encourage central banks to move to a more restrictive policy than that which they have already signaled. Until that happens, we think 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. 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 will likely 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.
3. 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. But 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.
4. 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.

The Portfolio

We **initiated** new positions in:

- **Fairfax India Holdings** -- This is an investment vehicle sponsored by Fairfax Financial, with an explicit mandate to invest in public and private Indian assets. Launched in Q1 2015, the fund has raised US\$1.5 billion to date including \$450 million from the sponsor. The company has deployed more than 85% of its funds into assets ranging from an agricultural commodity trader to a leading diversified investment banking company. Weakness in the stock provided an opportunity to initiate a position at a small premium to asset value (<1.1x price to book) and provide exposure to a diversified set of Indian assets which are difficult to directly access while benefiting from a skilled management team that is aligned with shareholders. Recent moves by the Indian government to recapitalize the state-owned banks and revise the Insolvency and Bankruptcy codes to prevent debtors from abusing the workout process could provide additional opportunities for Fairfax.
- **General Electric** – We initiated a starter position in GE late in the fourth quarter following a poor year for the stock. The weakness has likely been driven by a confluence of factors including leadership transition, end market deterioration, and liquidity challenges that ended in a dividend cut. GE has an attractive asset portfolio largely comprised of products with dominant market positions operating in stable and consolidated industry structures where GE splits market share with 1-3 other competitors. These franchise assets include gas turbines, airplane engines, medical imaging technology (e.g. MRI machines), and locomotive manufacturing. We consider the new CEO and company veteran, John Flannery, to be honest and transparent about the company's challenges. We also view positively the restructuring of the GE board with 9 existing members likely to resign as the board size is reduced from 18 to 12 with 3 new directors expected to be added. We were encouraged by the heavy insider buying during Q4, which included the CEO and key directors including admired investor James Tisch, CEO of Loews and GE Director, who purchased \$53M of stock on the open market. We consider the risk/reward attractive. We view the breakup value of the company as much higher than the valuation providing a margin of safety for our capital given our confidence in the new leadership and our aligned incentives.
- **Kerry Logistics** -- This is 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 2018, producing double digit earnings growth on high single digit top line growth. The stock did not participate in the uplift of Asia shares this year. We look forward to a better year in 2018.

We **added** to existing positions in:

- **Aerospace Industrial Development, Celgene, Deutsche Bank, HSBC, InterXion, Fisher & Paykel, and Pacific Hospital Supply**

We **sold** positions in:

- **Shire** – The company continues to struggle with high debt levels, senior management turnover, and increasing uncertainty around its drug portfolio. One of its key drugs, Xiidra used for dry eyes, appears to be facing increasing competition from rival drug makers. Despite its attractive valuation, we prefer to watch from the sidelines until we gain confidence in management's LT targets for the business.
- **NXP Semiconductor** – Given Broadcom's hostile takeover bid for Qualcomm, we have decided to exit our position in NXP. The company is set to be acquired by Qualcomm in a roughly \$50B transaction that has been stalled by regulatory issues and an activist lobbying for a higher deal price. The deal largely expected by the market to close as evidenced by the premium on the stock price relative to the offer price. It is not completely clear how the Broadcom/Qualcomm deal will affect the NXP transaction as Broadcom has expressed indifference to the asset. Due to its size, we do not see many other natural buyers for NXP so we exited our position to ensure we capture the M&A premium included in the current stock price.

We **trimmed** positions in:

- **Broadcom** – A strong run in the name provided an opportunity to reduce our overweight allocation as the company launches a hostile takeover of another chip company (Qualcomm). The current capitalization structure of the proposed transaction would leave the company with a high level of debt on an asset base with a large cyclical exposure. Further, it is not clear how the \$50B+ in debt financing required will be structured. We consider it prudent to reduce our allocation as we learn more about the company's strategy and financing plan for the asset. On a standalone basis, Broadcom continues to appear attractively valued relative to the growth outlook for most of its end markets warranting an allocation in the portfolios.
- **Deutsche Post** – We reduced our allocation to the company given the increasingly rosy outlook for this cyclical business and related multiple re-rating (moved from roughly 12x to 16.5x price to earnings). It no longer warrants an oversized position in the style.

For taxable accounts, we harvested losses in Zojirushi, Allergan, Kennedy-Wilson, and Liberty Global during November and December.

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 roughly 5% on weighted average, is still attractive against a 2.4% current 10-year Treasury yield. We expect blended earnings growth in the low double digits for 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\$220 trillion 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.

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. We believe that current investment conditions abroad are generally positive, and prospects for the coming year appear favorable. Continued engagement in international markets is warranted in our view.

Regards,

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1/4/18

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