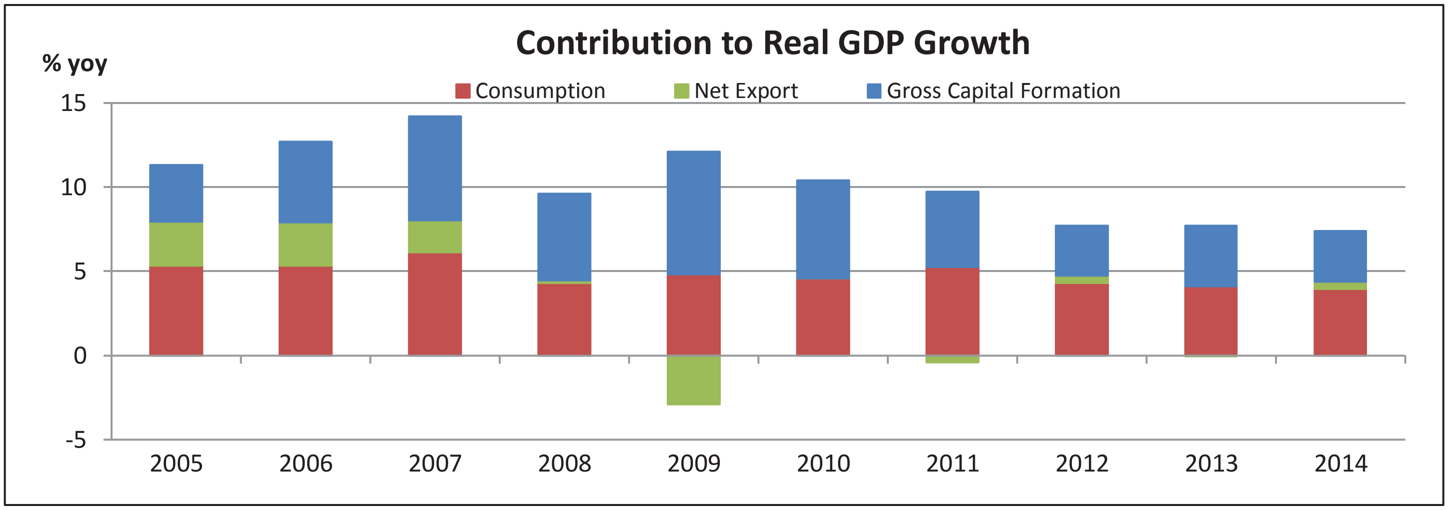
SeaBridge Asia Strategy
September 2015
Commentary

Although the recent severe volatility in Asian markets is unwelcome, we do not believe it presages a bear market for bourses in the region. Rather, sharp price movements of late reflect a nervousness over slowing growth in China, disappointing global growth generally and the expectation that the Federal Reserve will raise U.S. interest rates this year. These conditions should rise to the level of concern. We would argue, though, that the panicked trading we have seen of late has been an overreaction to sensational headlines and the media's fascination with catastrophe. We acknowledge that China's growth is slowing. Growth estimates in the region are being revised down. Regional currencies are lower, having responded to China's liberalization of its currency regime and the weakening of the yuan. China's stock market has been particularly frenetic of late, but the Shanghai Exchange has always been a casino of sorts and should not be used to interpret economic conditions in China. Taken together, these developments do not amount to catastrophe, just changing circumstances and new challenges which investors, particularly in the emerging markets, always confront. Our view on the attractiveness of Asia as an investment destination has not changed.

China is in the midst of a fundamental economic transition that slowly deemphasizes central planning and incorporates laissez faire principles. The old way was characterized by prodigious fixed asset investment and strong exports; the new model is based on domestic consumption. There has been some clear evidence of success. Since 2012, the service sector has become the largest economic driver in the country and now accounts for 52% of the economy (as of 2015 Q1), up from 41% a decade ago. In this time, China has become a major force in new economy sectors including e-commerce and financial technology; low value-added manufacturing has, deservedly, become a casualty in the transition. We have always accepted that the transformation of China's economy would be neither straightforward nor easy. For the most part, however, it has been thoughtful and deliberate and, except for the stock market gyrations, not uncontrolled. Higher quality economic growth will characterize the new order. We accept that to reach its goal, China's growth momentum must slow. In fact, if there were a return to the heady double digit growth rates of yesteryear, we would turn negative since accelerating growth would signify wanton credit creation and, ultimately, capital destruction.

While we should accept a slowdown, we neither want nor expect a meltdown. On our numbers, even in an unlikely bear case scenario where China's fixed investment growth grinds to a halt and consumption growth slows from an average of 9-10% in the past ten years to 7-8% per annum, China would still achieve a respectable 4-5% GDP growth rate.

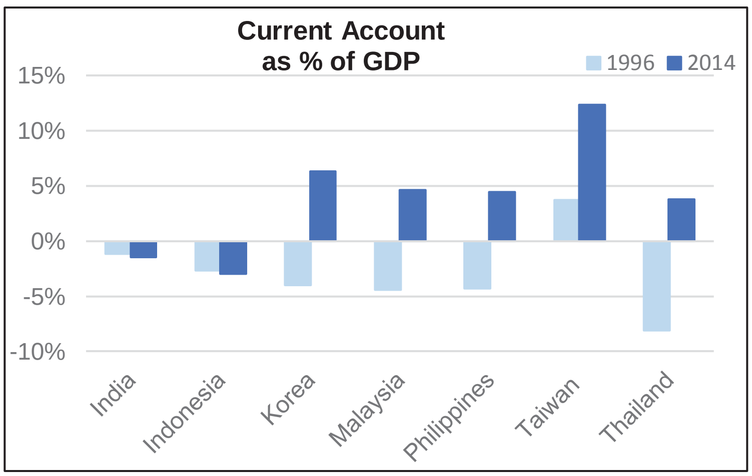


Source: Bloomberg, JWCAE. Data as at August 2015.

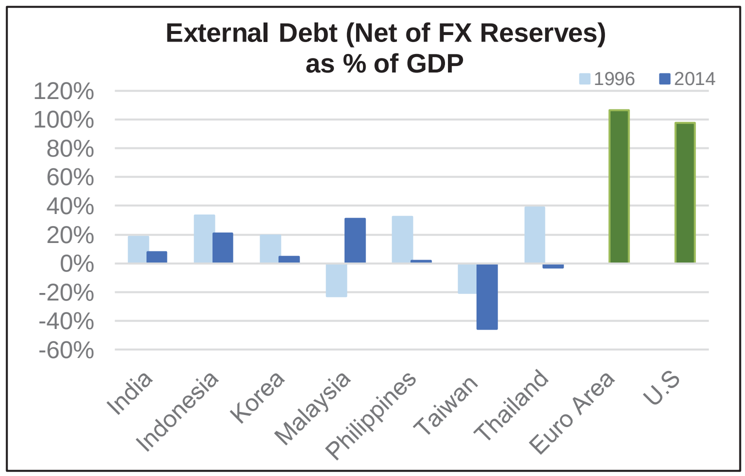
While uncertainties may persist in the near term, policymakers appear to be positioning the economy for the long term. We view the recent liberalization of the exchange rate and a more market driven level for the yuan as a positive reform. China has also just committed to a new targeted stimulus plan which provides capital, with return hurdles, to productive borrowers in the private sector in order to fund necessary, higher quality infrastructure projects. In our view, the scheme is disciplined and practical, unlike the broad based, easy money approach to stimulus which western nations have adopted. Again, if China were to open its money spigots in a way resembling quantitative easing, we would turn negative.

Because the yuan has devalued as a result of China's new rate setting regime, it is perceived that Asian currencies will be pressured to keep pace with a falling yuan, instigating a possible 'currency war' in the region. Our belief is that Asian currencies could become more volatile in the near term and then settle at lower levels in the not too distant future. We think China will not allow a wild depreciation of its currency; it is not in its best interest to suffer large capital outflows and asset price turbulence at home.

The current situation in Asia is erroneously being compared to the1997 financial crisis. We would assert that the Asia of today in no way resembles that of 1997. Economies are far stronger; balance sheets are much less dependent on foreign debt borrowing and FX reserves are sufficient, we believe, to address any short-term instability in the capital markets. Profligate governments learned their lessons in the '97 crisis; budgets are generally in good shape; sovereign debt levels are manageable and compare favorably to their Western counterparts. Pegged in 1997, exchange rates are now flexible in the region and the banks there are among the best capitalized in the world. Unlike 1997, balance of payment conditions are favorable; FX reserves are extraordinary.

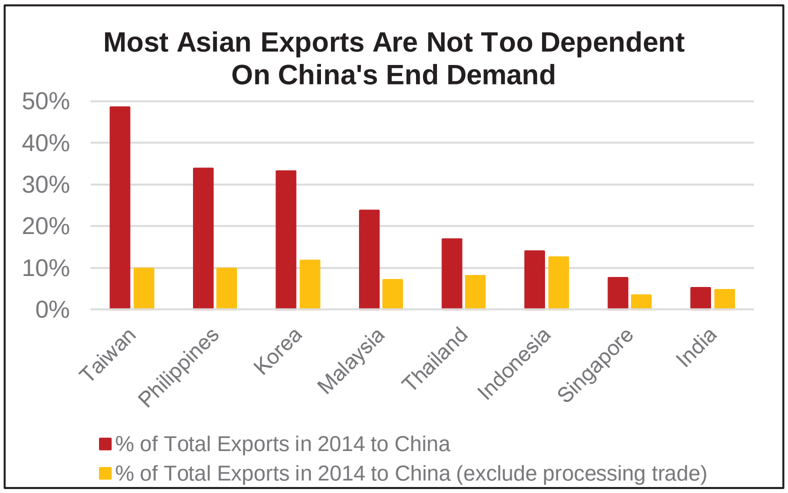


Source: IMF. Data as at April 2015.



Source: IMF, World Bank, JWCAE, Government Statistics. Data as at April 2015.

On the trade front, many have assumed that a slowing China will prove contagious to the region and derail the Asian growth story. On an absolute level, Asian countries' trade with China is rising, but a good portion of this is related to the processing trade, or those goods destined for export from China. Eliminating this component, we find that trade with China is not that meaningful. Moreover, Asian countries are not very reliant on foreign direct investment (FDI) from China. This independence from China reinforces our view that a China in transition will not pose significant risks to the region. Similarly, since exports to China represented just 7.1% of total U.S. exports in 2014, or .96% of U.S. GDP, a slowing China should have a negligible, macroeconomic impact on the U.S.



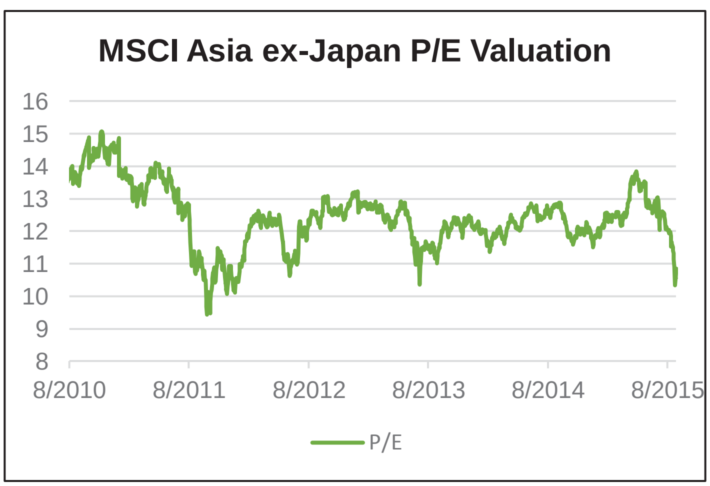
Source: China Customs Information, JWCAE. Data as at August 2015.

FDI Net Inflows In ASEAN From Partner Countries/Regions	
Partner Country/Region	Share to Total Net Inflows
European Union	21.5%
ASEAN	17.9%
Japan	9.8%
USA	9.6%
China	**6.5%**
Australia	4.2%
South Korea	3.3%
Others	27.2%

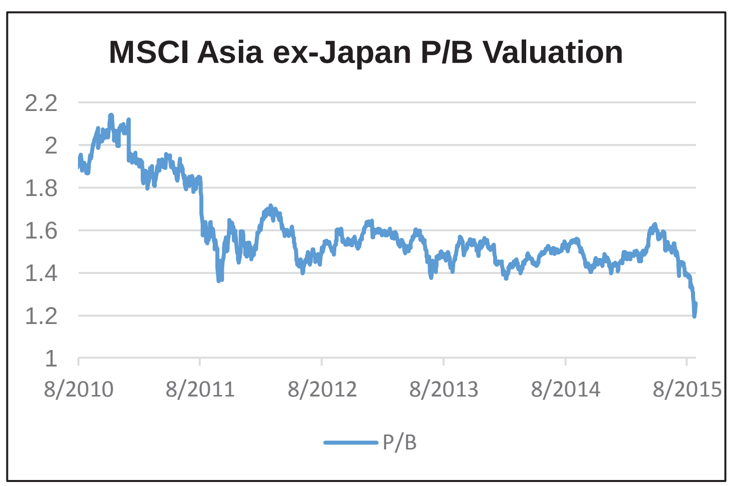
Source: ASEAN Statistics Database. Data as at May 2015.

In summary, we maintain our conviction on Asia as the underlying fundamentals have not changed. We believe the recent sell-off has provided better entry points for investment. With a higher cash level than normal, we believe we are positioned to capture the upside in the markets by increasing our investment in companies that have been caught in the downdraft. Furthermore, we are initiating positions in high quality companies, formerly off limits to us because of valuation, now available at more reasonable prices.

We would like to end this commentary with two thoughts. 1.) Your portfolio is not a China portfolio; it is Asian. With few exceptions, our direct exposure to China is limited in that it involves portfolio companies who have some, but certainly not all revenue, originating in China. Approximately 20% of the portfolio's revenue sources in total comes from China. 2.) Asia remains, with the US, the most dynamic economic region in the world and should be the global economic growth leader. We believe the long term promise of Asia remains.



Source: Bloomberg. Data as at 27 August 2015.



Source: Bloomberg. Data as at 27 August 2015.

David Descalzi
August 31, 2015

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