SeaBridge Investment Advisors, LLC

International Strategy Q2 2022

Portfolio Manager: Dave Descalzi
Investment Style: International Equities

The International strategy seeks investment in companies that are domiciled outside the U.S. or U.S.-based companies with substantial international operations. It is a broad market, style agnostic strategy that includes companies across the market cap spectrum with investments in value, growth, and growth-at-a-reasonable price companies.

Outlook and Positioning:
By any historical standard, the past few years have been a tumultuous period for global markets. The pandemic and the response of governments to it in the form of massive subsidies and unprecedented monetary stimulus enabled economic recovery. More recently, as Covid ebbed, these fiscal and monetary excesses combined with consumers' propensity to spend, first on hard goods and now services, are causing uncomfortably high inflation not only in the U.S. but also overseas. Markets now worry that interest rates will rise and economic activity will slow, perhaps dramatically, in the coming quarters.

We are now in bear markets just about everywhere. Additionally, there is the Russia/Ukraine conflict to consider. In terms of the human toll, the war has been horrific. From an economic perspective, it has exposed Europe's over-reliance on Russian oil and gas. The supply of these fuels will likely be constrained and cause elevated prices for years to come. We are particularly concerned with the German business environment. The German export machine is flagging under the weight of increased energy costs, slowing overseas orders because of a worldwide slowdown, and a restless labor force that seeks higher compensation likely due to the outsized increase in the cost of living. Should Germany falter, there may be negative repercussions throughout Europe.

Japan wants to hold steadfastly to its free money model, but with inflation picking up, it may be unable to do so if domestic buyers of Japanese bonds look overseas for higher yields. The extraordinarily weak yen may already be reflecting these phenomena. Given its history of current account surpluses, a weak yen has never been a concern, but we have never had such distortion in the fixed income markets. Japanese growth is anemic even in the best of times. Given sluggish domestic consumption, growth prospects may worsen if the export sector disappoints based on slowing worldwide demand. On the other hand, Asia ex-Japan could surprise to the upside as China finally appears to be ready to jettison some of its draconian Covid zero policy.

We are cautious but not entirely grim. There is an upside scenario to having felt so much pain already. The best we can say about world markets is that they are cheaper now on an absolute basis and seem even cheap on a relative basis versus 10-year averages. Much should be determined by the coming earnings season. We may be buyers in the coming weeks if certain market depressing conditions ameliorate and corporate outlooks in the coming earnings season appear less dire than what markets currently suspect. We are looking for the inexpensively priced company that generates cash, with a strong balance sheet, and the wind of secularly themed growth at its back.

Contributors and Detractors:
After a difficult first quarter, the challenges have continued and even intensified during the second quarter. On the positive side, we did pick up a good bit of ground versus the MSCI AC World ex U.S. Index. This brought the portfolios roughly back in line with the benchmark year to date. Most of the relative differences on the positive side came from our financial holdings. The sector as a whole was roughly in line with the broad indices. Still, we were able to sift out a few names such as AIA Group (insurance – Hong Kong) and Standard Chartered (bank – U.K. based with a strong presence in Asia Pacific region) that managed to finish the quarter in positive territory. The lack of energy exposure was the most notable detractor on a relative basis for the strategy as the energy sector generally performed well during the quarter. Correlations among the different sectors, geographies, styles, etc., tend to increase during these periods of stress, so aside from the areas mentioned, our active exposures did not lead to any other significant deviations.

Portfolio Activity:
As was the case in the first quarter, portfolio activity in the second quarter remained low. This reflected a generally conservative, lower beta positioning of the portfolio. The selling was limited to the taxable accounts as we harvested losses in names such as iFast, Tencent, Techtronic, Johnson Electric, and Amada. We will likely repurchase these holdings after the wash sale period expires during July. Our buying was limited to cash management activity. Expecting interest rates to rise, we had not in recent years been taking duration risk with the cash. More recently, the rapid rise in rates has prompted us to use two shorter-term Treasury ETFs to earn some yield while we search for stock ideas.