SeaBridge Investment Advisors, LLC

International Strategy Q3 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:

In the face of significant macro headwinds, international markets fared poorly during the quarter. Interest rates across the credit spectrum rose sharply in response to central banks' clear intent to withdraw liquidity from the global financial system. Accordingly, financial assets were repriced at substantially lower levels. How dramatic has this adjustment been? Many major international stock indices have posted declines upwards of 30%, year to date, in U.S. dollar terms. Bonds have fared little better, making 2022 a rare year of substantial losses in both asset classes.

In addition to inflation and interest rates, each region has its own adverse conditions with which to contend. In Europe, it is the Russia/Ukraine war and the risk of a broader conflict involving NATO. In the U.K., it is a fiscal plan involving unfunded tax cuts and the soaring energy cost. In Japan, a surprisingly weak yen reflects monetary policy notably out of sync with that of the rest of the world. In China, a residential property bubble deflates, one hopes, in an orderly fashion.

Given the macro uncertainties and lower stock valuations, we seek to add to our holdings but are not in a hurry. We would first like to see more evidence that global inflation has peaked. Given the looming global economic slowdown, this development may persuade bankers to pivot away from excessively restrictive policy.

While we have primarily avoided European companies in the portfolios to date, we cannot continue to ignore them in good faith when compiling a watch list. We continue to look for world-class companies that can weather the coming cyclical downturn and whose shares are now trading at steep discounts to intrinsic value. We specifically look to Asia for technology hardware companies that will be under pressure near term because of the slowdown but whose longer-term prospects are solid. In Japan, we continue to focus on exporters, companies that can benefit from the weak yen. Except for the energy and agricultural sectors, we have little interest in the commodity producers as they are likely to be negatively impacted by the coming slowdown.

Contributors and Detractors:

While the third quarter was not quite as bad as the second for the MSCI All Country World ex U.S. Index, it was still down a staggering 9.8%. Much of this move occurred in the closing weeks of the period. The portfolios were not immune to this downdraft. Slightly elevated cash levels helped dampen some of the price declines. Absolute contributors were hard to come by, but our strategy of accessing foreign exposure through domestic companies with high levels of revenue abroad was helpful on a relative basis, given that the U.S. outperformed both Europe and Asia. Stock selection in two of our more heavily exposed sectors, information technology and real estate, were also relative contributors but being overweight hurt from an allocation standpoint as they lagged the overall index. FedEx and Stanley Black & Decker both struggled, which caused our industrial exposure to be one of the largest detractors on an absolute and relative basis.

Portfolio Activity:

Cash levels increased as we exited our positions in Mohawk and FedEx. Mohawk's residential flooring segments have struggled likely due to increased interest rates and a slowing housing market. These factors and higher energy costs have hurt the business, which has caused management to substantially lower guidance. This sale reduces exposure in the strategy to cyclical industrials. FedEx is a cheap stock of a bell weather company but one that always seems to be in a perpetual state of restructuring. We have lost patience with it. Given the expected softening of the global economy, the shares probably have more downside even after the swift downward price action post-earnings reports.