Quarterly Newsletter

PILLAR PACIFIC CAPITAL MANAGEMENT, LLC

Volume XIX, Issue 1 April 2015

Mindy L. Ying, MBA
President & CEO

Arthur T. French, CFA, CIC
Chief Investment Officer

Sonny C. Lin, CFA, CIC
Senior Portfolio Manager

Lily L. Ku, CFP®
Financial Planner

Britt M. Joyce, CFA
Portfolio Manager

Chih-Lin Su, MBA, MSF
Financial Consultant

Jennifer S. Ying, CPA
Financial Consultant

Corey H. Liu, MBA
Financial Consultant

Joseph Fontamillas
Client Service Manager

Carmen Pon
Operations Manager

Offices:

Southern California:
2650 Mission Street,
Suite 205
San Marino, CA 91108
Tel: (626) 286-4029
(888) 295-4419
Fax: (626) 286-0624

Northern California:
210 Eureka Square
Pacifica, CA 94044
Tel: (650) 758-0130
Fax: (650) 758-0131

www.PILLARPACIFIC.com

SPECIAL EDITION: PANEL QUESTIONS & ANSWERS

We recently gave a presentation in the form of a panel Q&A, soliciting and answering questions from our audience. We thought the questions and our answers might interest readers of our newsletter. Many thanks to audience members who contributed these questions, and as always, we welcome your feedback.

Q: Since the market has gone up for several years, how will you protect us from a market crash?

A: The stock market is a leading indicator of the economy. The current economic expansion has evolved more slowly than past cycles, without straining capacity and with ample financial liquidity for the expansion to continue for years into the future. But the stock market is fundamentally volatile, reacting to news headlines as though each new development will force the economy into recession. The best way to deal with this volatility is to be sure that we have created the very best asset allocation to balance the goal of growing your assets with the peace of mind which comes with the confidence that you can weather the inevitable volatility.

Q: What is your outlook for energy stocks, after they have sold off so much?

A: Crude oil prices declined by 50% during the second half of last year. In the past, after declines of this magnitude, the recovery has been drawn out. As prices rise, supply comes back on stream, effectively dampening future increases in price. We expect this pattern to prevail after the current downturn. To the extent that energy companies are integrated, involved in refining & marketing and petrochemicals, feedstock costs will be lower and profit centers will shift away from exploration & production. There is another silver lining to lower energy prices. If the average retail price of gasoline can hold at $2.60 a gallon for a year, it is estimated that it would result in a $125 billion stimulus to the economy, a greater benefit to the consumer than any tax cut over the past 25 years.

Q: What is your outlook for gold prices?

A: It is impossible to accurately estimate gold's value since it doesn't produce positive cash flow. People buy gold as a store of value when they are concerned about the stability of fiat currencies. Our macro outlook does not put a high likelihood on a breakdown in the value of the dollar. As a long term investment, gold has provided a very low return.

Q: What can we do to protect against inflation?

A: Stocks are a good defense against moderate inflation, since their earnings tend to grow with inflation. Given the current economic environment, with low energy prices and a strong U.S. dollar, we think we could avoid higher inflation for the foreseeable future.

Q: What is your outlook for real estate?

A: Since 2008, new construction has not kept pace with household formations, resulting in unmet demand and higher prices. At the same time, lending restraints have prevented new home purchases. These factors alone give us confidence that real estate is likely to do fairly well. Over the long run, however, real estate returns have lagged stock market returns.

Q: What changes do you see for interest rates and how will this impact our portfolio?

A: It is generally expected that the Federal Reserve Bank will begin to raise interest rates later this year. Once they begin to do so, they will probably continue to raise rates incrementally over time. We expect a low impact on your bond holdings due to the short duration ladder structure of your portfolio.

Q: With bonds offering such low yields, should we hold more cash or foreign investments?

A: Low single digit returns aren't very exciting, but investment grade bonds still offer a higher return than cash and they will help to protect your portfolio from unforeseen weakness in the economy and equity markets. U.S. yields are currently higher than any other developed country yields. Although bond volatility is higher due to historically low yields, bonds are still less risky than and negatively correlated to stocks, reducing portfolio volatility.

Q: How does the European Central Bank's bond buying program impact your view on markets here and abroad?

A: European quantitative easing might have little impact on the European economies, but evidence has shown that it is likely to lift asset prices and it could help financial markets both in Europe and worldwide. Your portfolios might also benefit if some of this stimulus money finds its way into U.S. assets. The program will likely depress the euro and strengthen the U.S. dollar. U.S. companies with exposure to overseas revenue might be negatively affected. Also, there is a very real concern that, if countries and regions only look after their own interests, the lack of coordination of Central Banks' quantitative easing could devolve into a variation of the trade wars of the 30's.

Q: China has reported a series of disappointing economic numbers. What is your take on the future of China and its impact on U.S. markets?

A: Much of the slowdown can be attributed to self-imposed structural shifts; although this slowdown in investment could lead to a slowing of China's growth rate, this may be viewed as a long-term positive for a healthier economy. Indeed, a series of weak economic data could be beneficial as it gives the authorities the justification for further stimulation. So far Chinese policymakers have been content to allow growth to soften rather than implement stimulus policies which would undermine their effort to address growing credit risks. In either case, they are confident that, if necessary, they have plenty of fiscal and monetary tools at their disposal. With the Chinese market stabilizing and improving, the impact on the U.S. market should also be positive.

Q: Are conflicts in the Middle East likely to impact global markets?

A: No, geopolitical risks rarely cause a global correction, especially if the risk remains regional in nature. The IS threat still remains regional despite all the media coverage it has received. One of the major concerns was that IS might cause the disruption of shipments of Iraqi crude. But, with global supply of crude plentiful now, this worry has subsided substantially. Although we can't rule out the possibility that these conflicts could lead to possible terrorist attacks in the West, empirical evidence has shown that these events are usually one-time occurrences. The market discounts them rather quickly and reverts to normal.

Q: What's your outlook for emerging markets and developed international markets? How are you positioning our portfolios for this?

A: Both markets face distinctly different challenges; for developed international markets, the main challenge comes from deflationary pressure, while emerging markets face a lingering inflationary threat. In both theory and practice, deflation is easier to deal with than inflation. But, emerging markets face other challenges besides inflation. For example, the huge external debt these countries have accumulated over the years is now even more difficult to pay back due to the weakening of their local currencies. Since we prefer to invest in stocks in markets with favorable valuations, where financial conditions are improving and growth has the potential for positive surprise, we currently see more opportunity in developed markets. We especially like the euro-zone in developed markets and China in emerging markets.

Q: What will happen to the stock market and global economy if Greece eventually is not able to fulfill its debt obligation?

A: The media has focused on this so-called "Greek sovereign default" or "Grexit," i.e. Greece exiting from the euro-zone. There is no doubt that "Grexit" makes a catchy headline but in reality, the possibility of it actually happening is slim. One of the potential benefits for Greece to elect to default on its debt obligations and exit from the euro-zone would be for Greece to regain a competitive edge through depreciating its own currency. However, from 2001 to now, Greece has already achieved a substantial devaluation as shown by the decrease of its unit labor cost. We do not see much additional benefit for them to leave the euro-zone now. Looking from the lenders' side, since almost all the debt obligations Greece currently owes are to the International Monetary Fund, European Union, and European Central Bank and the ultimate goal of these multilateral institutions is for economic stability, it is not in their best interest to force Greece to default. Since there is no advantage to either side in a Greek default, we see the whole drama as a bargaining strategy over austerity measures.

Q: What are your comments on the creation of Asian Infrastructural Investment Bank (AIIB) and its likely impact?

A: While poor infrastructure remains a key constraint on economic development across emerging Asia, the formation of the China-led Asian Infrastructure Investment Bank (AIIB) is hardly a solution. Asia's infrastructure financing gap is estimated by the Asian Development Bank to be about $8 trillion between 2010 and 2020. With AIIB's initial capital base of only $50 billion, this fund is unlikely to have much of an impact on the region's long-term infrastructure needs. Therefore, we see AIIB as more of a symbolic gesture of China's desire to advance its influence in the region.