PILLAR PACIFIC
CAPITAL MANAGEMENT, LLC

Quarterly Newsletter

Volume XVIII, Issue 3 — October 2014

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~ OUR CHIEF INVESTMENT OFFICER'S COMMENTARY ~

In our last quarterly newsletter, we addressed the issue of stock market valuation (reprints available on request). We continue to believe that domestic U.S. equities are some of the most attractive financial assets in the global market place. In our article we also discussed market corrections and concluded, **"Corrections, when they occur, come as a surprise and are relatively short lived."** Since we have been in a market recovery since 2009 and have not experienced a meaningful correction in a couple of years, we thought it would be useful to reflect on where we are in this economic and market cycle by examining broad categories of potential risk for the U.S. markets. Since September represents a return to business for Wall Street analysts, we have drawn on vast amounts of opinion, contained in numerous reports, summarizing recent investment conferences.

One source of uncertainty for the U.S. markets is the mid-term elections scheduled for this fall. While we do not claim any advantage in forecasting the outcome of these elections, some historical patterns are worth noting. Since mid-term elections are local, compared to general elections where the emphasis is national, incumbents seeking reelection tend to stimulate their local economies with public works projects and highway maintenance. **The impact of this stimulus has produced positive stock market returns, for six months, following each of the past 16 elections going back to 1950, regardless of the outcome of the election.** These returns are not trivial, averaging 16% for the six months following each election. After this initial rally, the market tends to pause, with one year returns averaging 17%.

This fiscal stimulus is in contrast to the shrinking of government spending we have seen since the current expansion began. Indeed, during this current cycle, real federal, state, and local spending has been cut significantly. Cuts in public spending since 2009 have been a primary factor in slower economic recovery and higher unemployment. Of course the impact has been partially offset by the Federal Reserve Bank's quantitative easing programs. But this introduces the risk that the Fed cuts off this stimulus by raising rates too soon. To quote my former professor, Rudi Dornbusch, **"Expansions don't die of old age; they are murdered by the Fed."**

We have experienced many examples of geo-political risk this past summer. In a recent presentation by Charles Dolan, BNY Mellon credit strategist, he notes that the bank monitors and analyzes 3000-6000 financial media news items per week, classifying these articles by subject. In recent quarters, unusually but maybe not surprisingly, geopolitical headlines comprise 6 of the top 10 categories, by subject, in the financial press. While each of these hotspots could represent a potential shock to the financial markets, they are symbolic of an even more troubling trend. What has become known as a multi-polar world, without a clear balance of power, is inherently less stable and hence more risky than a world where there is a clearly delineated balance of power. When "trade" and "war" are used in the same sentence, as in the case of U.S. retaliation against Russia's incursion into Ukraine, markets, which assume principles of free trade, become unsettled. **When barriers to global trade arise, pricing becomes less efficient with uncertain, but presumably negative, consequences to corporate profit.**

At a recent investment conference sponsored by BCA (formerly Bank Credit Analyst), the role of the new technology "wave" was examined. **During this cycle, investing in BRAIN stocks, firms developing Bio-tech, Robotics, Artificial Intelligence, and Nano-technology, has been very profitable for investors.** In recent years, we have seen the development of machines capable of performing tasks which it was once thought only people could perform. Self driving cars and air transport devices are already a reality and computers are increasingly capable of visually recognizing patterns, processing nuanced questions, and solving complex tasks. Robotics have radically changed the automotive industry. The downside is that these new technologies are "hollowing out" the middle class by displacing workers with machines. While this trend has been evolving for decades, the pace of change has been accelerating, contributing to the dismal jobs data of the current cycle and the widening economic divide.

While these are but a few of the areas capable of spawning the "surprise" catalyst for a correction, corrections are generally not the result of a specific cause. We tend to believe that the market goes up because of a specific event, or declines because of another event. We are human and thus comfortable understanding simple cause and effect relationships. These explanations ascribe order to chaos. However, markets are extremely complex entities and stocks are fundamentally volatile. Think of flocks of birds or schools of fish which for no apparent reason suddenly change direction. They might be on a migration from one place to another; e.g. birds migrating south in fall, north in spring. **Along the way the flock will wheel and turn, changing direction numerous times, but always returning to their primary goal. So it is with stocks.**

Fixed Income Market

Since banks started to accumulate excess reserves several years ago, we have been concerned that when these funds begin to circulate, inflation and interest rates could rise dramatically. We are no longer so concerned. While fixed income investors have enjoyed 14 years of "equity-like returns with CD-like volatility," investors now are overpaying for perceived low volatility. When investors in long bonds have seen low current yield, unrealized capital gains from principal appreciation have been the source of bond returns. **As rates rise, the same volatility which produced equity-like appreciation will begin to erode the principal value of long term bonds.**

One of our concerns for the bond market is that the persistently elevated debt levels, which characterized developed countries at the end of the last cycle, have not been paid down. This lack of de-leveraging remains a chronic problem on an aggregate global basis.

Most of these measures of debt to GDP remain near record highs due to high fiscal deficits and the unwillingness of creditors to write down debt. Without stronger growth and/or debt write-offs, de-leveraging will take a long time and may require regulatory changes to create captive demand from pensions and banks for government debt. Under such a scenario, it is not inconceivable to envision the Federal Reserve extinguishing the liability represented by bank excess reserves with the assets they have accumulated through quantitative easing. In any case real interest rates could spend a significant amount of time in negative territory.

It is good to remind our readers that our strategy with fixed income is to maintain a short duration portfolio for our clients, matching portfolio assets against liquidity needs and lowering the volatility of your total portfolio. These articles focus on the investing landscape for longer duration fixed income assets, but we want to assure our readers that while we do not see a compelling case for extending duration at this time, we want to remain vigilant to the investment impact a rise in interest rates and the reversal of a 14-year bull market in bonds may have on your portfolio.

International Market

The global economic recovery is facing headwinds on two fronts. The quarter saw a renewed concern that Europe needed more stimulus to prevent a slide into recession and deflation. This added to the now chronic slowdown in China, where authorities are trying to correct long-term fundamental economic issues. At the same time, geopolitical concerns in both the Middle East and Ukraine linger on. No doubt eye-catching headlines concerning these developments introduce volatility into the marketplace, but when analyzed in detail, evidence is lacking that any of these events would trigger a meaningful fundamental change on the global economy. **Hence, any market impact has been and should continue to be short-lived.**

Tension between Russia and the West has overshadowed the European market for some time; however, we believe we might be seeing the beginning of the end now that a cease-fire has been implemented. Countering the sanctions placed by the West, the energy card seems to be the last play in Moscow's hand. **However, considering the Russian government's widening budget deficit and dependence on oil and natural gas receipts for more than half of revenues, it is extremely unlikely that Russia will use its energy exports to challenge the West.** Without an effective countermeasure, finding a face-saving exit strategy seems to be the only logical solution. Perhaps that is why the cease-fire has gained traction so far.

With tension on Ukraine abating, there will be renewed opportunity for European equities as, in our opinion, the media has overplayed Russia's relevance to the European economy. The underlying fundamental case for Europe remains strong due to relatively decent valuations, successful banking deleveraging, modest political risk, an improving outlook on structural reform, and most importantly, supportive monetary policy by the European Central Bank (ECB). In addition to cutting rates, the ECB plans to utilize unconventional instruments similar to the quantitative easing employed by the Fed by buying covered bonds and asset-backed securities. **In combating the deflation threat, the ECB stands ready to keep monetary policy loose in order to push inflation back towards the 2% level.**

It might be apparent to the world that Chinese economic growth is decelerating, but the main cause of its growth slowdown in recent years has been the self-imposed restraints aimed at correcting long-term fundamental economic issues. To keep up with the targeted 7.5% growth rate, Chinese authorities have quietly removed some of these restraints and introduced new measures of stimulus. That said, these initiatives have not been publicized aggressively and China's policy outlook appears murky at best. The most recent example is that only days after the People's Bank of China injected RMB 500 billion of liquidity into major commercial banks, raising hopes that the PBoC was becoming more aggressive in monetary easing to support growth, Finance Minister Lou Jiwei dampened expectations with comments that the government would not dramatically alter policy based on only a few economic indicators. With such conflicting messages, the rest of the world is left to wonder.

Experts on Chinese politics believe that due to the unintended consequences of massive stimulus programs undertaken by the previous administration in the wake of the global financial crisis, such as unaffordable housing and skyrocketing inflation, the current government under Premier Li Keqiang has been working hard to distance itself from its predecessor. With the current environment in China, especially among the working class, a broad-based "stimulus policy" has essentially become an ideological taboo because of the perception that such action would deteriorate their standard of living. **Therefore, the necessary measures to jump start the economy again are being implemented quietly, with a strategy which has become known as "stealth easing."**

In addition to the quiet injection of liquidity, China's four largest state-owned banks and the State Council have relaxed the financing requirements for the purchase of a second home and announced further tax relief for small and micro businesses. China's consumer inflation has also eased in recent periods, allowing more room for government stimulus to support the economy, if necessary. **With the valuation for Chinese stocks still extremely depressed, effectively providing downside protection, the anticipated further easing of monetary policy should lift stock prices.**

Although it is our view that positive fundamentals for the global equity markets are still intact, threats to the recovery need to be closely monitored. Many new hot spots could weigh on the markets. Recently, the U.S. launched airstrikes on Islamic State of Iraq and the Levant (ISIL) strongholds in both Iraq and Syria. Initial results seem encouraging with minimal impact to the markets, especially energy. However, this conflict may drag on for months, if not years. The Ebola outbreak in West Africa has been spreading quickly. Now a first case of the virus' migration has been confirmed in Dallas, Texas. **As situations evolve, and as others emerge, we remain watchful to ensure necessary actions are taken proactively.**

Our vision is to provide sound financial management for each client, always placing the best interests of the clients first. We aim to preserve and enhance every client's wealth while providing peace of mind and financial security, now and for future generations.