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Mindy L. Ying, MBA
President & CEO

Arthur T. French, CFA, CIC
Chief Investment Officer

Sonny C. Lin, CFA, CIC
Senior Portfolio Manager

Kendra D. Baranko, CFA
Portfolio Manager

Lily L. Ku, CFP®
Financial Planner

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 L. Pon
Operations Manager

George F. Huang, JD
Project Manager

Jeremy W. Chang, MBA
Financial Consultant

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

~OUR CHIEF INVESTMENT OFFICER'S COMMENTARY~

In the aftermath of the financial crisis of 2008, economist Hyman Minsky achieved the recognition which he had been denied in his lifetime. **His theory, the "financial instability hypothesis," is an examination of how long stretches of prosperity sows the seeds of the next crisis, largely through the overuse of financial leverage.** Indeed, Minsky's theory of economic cycles so well described the 2008 financial crisis that it was called a "Minsky Moment."

As the new administration came into office in 2009, President Obama proclaimed that every effort would be undertaken to break these boom-bust economic cycles. Throughout the developed world, central bankers agreed that this was feasible. **Thus, the world embarked on a loosely coordinated strategy using monetary policy to stimulate growth, combined with austerity or restrictive regulatory policies, such as Dodd-Frank in the U.S., which effectively held growth in check.**

The unintended consequence of these policies has been a slower than normal economic recovery with a lower labor participation rate and continued wage deflation in the developed markets. Tepid growth may have been acceptable without political risk, had it not followed decades of stagnating wages. With no wage growth, households in most developed economies have increased household debt in order to keep up with the rising costs of the staples of a middle class lifestyle.

While not entirely the culprit, globalization has unsurprisingly become the target of middle class anger. Globalization was perhaps the greatest supply side shock of the past two decades and it exerted a strong deflationary force on wages. **While it lifted hundreds of millions of people out of poverty in developing countries, it came at the expense of low income and middle class workers in the developed world, those whose jobs were most easily exported.** In the developed world, this is the demographic which increasingly supports populism and anti-globalization policies.

The new administration is inheriting an economy in the late stage of its economic growth. The belief in the new President's ability to provide promised fiscal stimulus is essential to restore economic growth. Eventually, the scope of this stimulus will be challenged by fiscal conservatives in Congress and will be offset, to an uncertain degree, by Federal Reserve policy. **Assuming the new administration is both timely and successful, this late cycle fiscal stimulus will be positive for economic growth in the near term and more positive for inflation in the long term.** We do not see Federal Reserve policy as much of an obstacle at this time. We think that a neutral Fed Funds rate should be about 2% or higher, instead of the current target rate of 0.75%. So, we think the Fed will continue to accommodate by following inflation up for the next couple of years.

Looking out over the next decade, we see certain trends forming like storm clouds on the horizon, which will shape the longer term future. BCA Research was early to identify the rise of global multi-polarity, which evolved from the relative stability provided by American hegemony after the collapse of the Soviet Union. BCA believes multi-polarity will reach a peak in the next 12 to 24 months as Trump's isolationist policies extend Obama's aloof foreign policies and lead several regional powers to overextend themselves. Peak multi-polarity will be characterized by global conflict and disequilibrium. **Since multi-polarity is anathema to globalization, the economic consensus of globalization will give way to mercantilism, where each country pursues its own interests in a zero sum game, and where economic policy is an extension of geopolitics. In this environment, laissez-faire capitalism will evolve into a form of capitalism where the state adopts a directing rather than a merely regulatory role.** BCA calls this "dirigisme," and Europe is cited as an example of this form of capitalism. In some measure this evolution is brought about by a failure of laissez-faire capitalism to distribute the gains from globalization more equitably. So, in a sense, the decline of globalization is a function of structural rather than cyclical factors.

America has always profited from geopolitical chaos; we benefit from geographical isolation. For the next couple of years, BCA Research expects "the chief investment implications of multi-polarity- volatility, tailwind to safe haven assets, emerging market underperformance, and de-globalization- to continue to bear fruit." Investors may see the deflationary impact of globalization evolve into state intervention in the domestic economy and the return of inflation. In general, global economies and sectors will underperform domestic; developed markets will outperform emerging, particularly as populism spreads to developing economies which fail to meet the expectations of their middle class. **Over the next decade these changes will leave the U.S. as the most powerful country in the world. Its economy, markets, demographics, natural resources, and security are the least exposed to the rest of the world.**

But, the challenge will not be easy. We need to transition from an extended, stagnant economic cycle to economic growth driven, initially, by investment in infrastructure and increased consumer spending. The past two national elections saw incumbent spending on public works temporarily boost economic activity. Since spending ended with the elections, the stimulus was short-lived. The Trump administration needs to implement a stimulus strategy early in order to avoid a slowdown in the first half of 2017. **Longer term, we need to see projects undertaken to meet the needs of our country, not just repair existing infrastructure, while avoiding the speculative exuberance which could lead to another "Minsky Moment."**

Fixed Income

The expected increase in the federal funds rate in mid-December pushed the rate to a target between 0.5% and 0.75%. The 25 basis point hike was the only increase for the year after the target was first raised from a near-zero range in late 2015. Members of the Federal Open Market Committee (FOMC) had initially forecast greater increases in 2016, but during the year they shifted from the view that a lower unemployment rate would result in rising inflation and instead shifted emphasis to current and expected inflation to determine rate increases. **For 2017, it is largely anticipated the Fed will continue to focus on inflation and the pace of tightening may accelerate if inflation levels increase due to major fiscal stimulus; i.e. increased federal spending on infrastructure and lower taxes.**

However, we enter 2017 with uncertainty regarding the timing and policies which will be implemented by the Trump administration. Adding to the uncertainty is how President Trump may influence monetary policy with his nominations to fill two vacancies on the Federal Reserve Board of Governors. **We do not know whether the new administration will want a more hawkish or dovish Fed, but many anticipate Trump's view on monetary policy will echo the campaign comments which condemned the Chair for keeping rates too low for too long.**

Based on the Fed's most recent meeting, three additional rate increases are expected in 2017, bringing the target to a range between 1.25% and 1.5%. The higher range would still be well below the Fed's estimate of the neutral rate and therefore still unusually accommodative. **If the Fed turns more hawkish next year and responds to potential higher inflation with faster than anticipated increases, we expect short-term rates to rise more than long-term rates; i.e. a flattened yield curve. Conversely, if the Fed remains accommodative and allows inflation levels to creep up, which is generally positive for the equity market, long-term yields could potentially rise further than expected; i.e. a steeper yield curve.**

Perhaps the bigger story, and possibly a less anticipated event during the quarter, was the backup in yields that occurred post-election. The 10- and 30-year rates rose +0.53% and +0.44% in November and +0.85% and +0.74%, respectively for the quarter. This extraordinary upward move was largely fueled by a combination of prospects for a better economy, higher expected inflation, and the possibility of an increased pace of future rate hikes. The market experienced a rotation out of bonds and into stocks as prospects for the stock market improved relative to the U.S. bond market. Higher inflation expectations stemmed from projections that Trump may cut taxes and increase federal spending, which are both stimulus policies. The resulting budget deficit would mean more borrowing and thus higher interest rates. **Despite rates having a large move to the upside, during the quarter, the benchmark 10-year and 30-year bonds ended at 2.45% and 3.06%, almost where they began the year at 2.27% and 3.01%, respectively.**

International Market

Despite the uncertainty surrounding the new administration's policies, one thing we do know for certain is that Trump's U.S. foreign policy and trade negotiations will have significant lasting impacts. Trump campaigned as an unorthodox Republican on an overtly protectionist platform. This platform won the support of the traditionally Democratic-leaning "Rust Belt" states in the Midwest and Northeast, ultimately paving the road to the White House. Trump is now bound to these pivotal supporters who expect policies that will deliver on "Bringing Jobs Back to America."

Policies embracing a mix of isolationism and anti-trade appear to be the prescription Trump has ordered, and China has been blamed for the decline of U.S. manufacturing jobs. Trump repeatedly attacked China during the campaign, declaring he would name the country a currency manipulator and impose a 45% punitive tariff on imports. Once he takes office, we will gain clarity on how much of Trump's threat was campaign rhetoric versus what will actually be implemented as policy. **However, if anti-trade policies are in fact carried out, the impact on the Chinese economy may not be as significant as anticipated.**

The transformation of China's economic system over the last decade has greatly reduced its reliance on being an export-driven economy. According to the World Bank, exports currently comprise only 19% of China's GDP, nearly half compared to the prior decade. **As such, the current Chinese economy has become less reliant on exports. It is also fair to assume that government stimulus and the disposable income of the Chinese middle-class could play a more important role for domestically driven growth versus external demand.** While a 45% punitive tariff, if enacted, would be harsh for Chinese exporters, the overall economic impact may be relatively muted. Further, companies which focus solely on the Chinese domestic market may benefit for two reasons: (1) in China's controlled economy, the government would likely implement stimulus to compensate for any decline in exports in order to maintain its targeted growth rate; and (2) the government could impose a retaliatory tariff policy which would further block foreign competition from its domestic industries.

Another important factor to consider is China's rising debt burden. China executed a rather loose monetary policy throughout 2016 which helped to revive economic growth. Consequentially, the stimulus policies have increased its debt burden and caused concern that the underlying financial health of the economy may be worsening. Although these concerns are valid, the creditor and borrower arrangement in China is not a typical structure between separate entities. The government, in essence, owns both the main lending and borrowing institutions. **Therefore, as long as the Chinese government still has room to loosen policy to support demand, a traditional financial crisis is unlikely to happen.**

The Republican majority in both the Senate and the House provides the new administration with the ability to enact significant policy changes. A fiscal stimulus strategy, intended to increase U.S. economic growth and fuel inflation, may be passed. The Fed's anticipated interest rate increases will continue to push U.S. Treasury yields higher, further strengthening the U.S. dollar. This combination of increased spending, lower tax rates, tighter monetary policy, and U.S. dollar appreciation could be troublesome for emerging markets. As you may recall, these underlying factors are similar to the policy environment that contributed to the Latin American debt crisis in the 1980s, initiated by Mexico's default on its sovereign debt. **With this in mind, our view on global asset allocation still favors developed markets given the attractive valuations, accommodative monetary policies, weak local currencies, and the growth potential from a reversal to stronger economic fundamentals.** This view is mindful of the potential political surprises that may arise given a crowded calendar of upcoming elections, particularly in France and Germany.

Lastly, the greatest risk for investors may be a further deterioration in Sino-American relations that reintroduces geopolitical tension between the two nations. Heightened tensions alongside increased military activity in the South China Sea could translate into armed conflict. The past may not predict the future, but history may help us to understand the potential threat of further strained relations. In 2001, a Chinese J-8II fighter jet collided with a U.S. EP-3E reconnaissance plane mid-air, resulting in the death of the Chinese pilot and the emergency landing of the U.S. spy plane. If a similar incident were to repeat itself today, aggressive conflict could ensue and ignite a Black Swan event in 2017.