PILLAR PACIFIC
CAPITAL MANAGEMENT, LLC

Quarterly Newsletter

Volume XXI, Issue IV

January 2018

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~OUR CHIEF INVESTMENT OFFICER'S COMMENTARY~

Called a "Goldilocks" environment, 2017 has been characterized by a near perfect combination of steady global growth, low inflation, and accommodative monetary policies. For the first time since 2010, the world economy outperformed most yearend 2016 predictions and all major asset categories produced positive returns. The U.S. and global equity markets registered double digit gains, also well above expectations.

During the year, stocks hit 61 all-time highs, on extremely low volatility, the greatest run since 1952. The market benchmark S&P 500 Index experienced no calendar month of negative returns in 2017, and only one in the past 21 months. Technology shares were responsible for nearly 40% of S&P performance during the year; the expansion of the price to earnings multiple, a measure of valuation, contributed only modestly to 2017 returns, **while earnings growth and foreign sales were the primary drivers of stock returns in the U.S.**

As 2017 ends, the consensus forecast for 2018 is for this fairly rapid growth to continue. Manufacturing output and global trade is accelerating, business surveys signal continued growth, and consumer confidence shows little sign of fading. Economic expansion is broad based with advanced economies all benefitting and most emerging markets gaining momentum. There is little evidence of a pickup in inflation. The financial markets have taken in stride the Fed plan to unwind Quantitative Easing and the European Central Bank (ECB) plan to taper (the slowing of bond purchases to stimulate their economy). While easy global monetary policies have spurred liquidity growth, dampened asset price fluctuations, and supported higher asset prices, the Fed's plan to reduce its balance sheet is very benign and spread out over many years. And, even though the ECB plans to end tapering in September of 2018, some think they will continue to purchase bonds well into 2019. Meanwhile, the Bank of Japan (BOJ), having experienced the greatest economic growth in decades, as a result of Quantitative Easing, shows no inclination to modify its ultra-loose monetary policy.

Last year, as the mature U.S. economic recovery was given new life by the stimulus of the global recovery, participation in the recovery was enhanced by the decline of the dollar. Although the dollar is off its lows for the year, it is still down more than 7% against major currencies. In spite of its recent recovery, many analysts believe it could be down even more by the end of next year. Some even see the dollar losing ground to as many as 13 of the 16 most widely traded currencies through year end 2018. This is not necessarily bad, in so far as U.S. goods sold abroad are more competitive after a dollar decline. But the decline of the dollar is likely to be, at least, partially offset by monetary policy divergence on the part of the central banks; i.e. as the U.S. raises rates, funds will flow to the dollar.

The recently enacted tax reform could provide an additional boost to an already strong economy in 2018. Corporate tax cuts are expected to add an additional 5 to 8% to S&P 500 earnings growth, or 0.4 to 0.8% to GDP growth, next year. Besides this fiscal stimulus, global monetary growth is expected to accelerate. Broad monetary growth is currently about 4-5% rate in the UK, Euro-zone, and Japan, but growth currently exceeds 6% in the U.S., due to higher short term rates increasing the demand for money market holdings in addition to the effect of higher oil prices boosting dollar deposits held abroad.

In the U.S., recent growth has seen a shrinking of spare capacity along with a rebound in productivity. But, even though unemployment is at or near multi-decade lows, wage growth has yet to accelerate; in part this may indicate there is more slack in the labor market than what is captured by the unemployment rate.

While we start this New Year with a positive outlook for continued strong global growth, we have concerns. Although we see a low probability for near term recession, the business cycle continues to mature and, eventually, global activity will peak. While high inflation is unlikely, we anticipate it will be enough to keep policy makers moving toward a reduction of monetary accommodation which will slow liquidity growth. In that scenario, we might also see a slowdown in employment growth. Tighter monetary policy dampens spending and we could see concern about a cyclical downturn begin to build in late 2018, with the risk of a mild recession in 2019 or 2020.

Fixed Income

The Treasury yield curve ended the year "flatter" as short-term yields rose higher and long-term yields finished lower. The curve flattening has drawn investor and media attention given that, historically, an inverted yield curve, where short-term rates are higher versus long-term yields, has often been a leading indicator of an economic slump or recession. Although, in a much different rate environment than the present, an inverted yield curve has been a reliable recession signal, **a flattening of the yield curve doesn't necessarily imply a weaker economy or negative indicator of the future.**

For the year, two-year Treasury yields rose +69 bps while 10-year and 30-year yields ended the year slightly lower by -5 bps and -32 bps, respectively. The rise in short-term yields was driven by the Fed's three rate hikes for a total of +75 bps in 2017. Where short-term rates are guided by Fed policy, long-term yields are established by market supply and demand. Lower long-term yields have been a function of a decline in the term premium. The term premium by definition is a residual which captures all of the various economic factors which impact interest rates. **The primary factor, in the current environment, is the tepid outlook for inflation.** Longer-term yields have declined on lower inflation expectations due to Fed policies designed to keep inflation risk low and the Fed's stated intention to pursue balance sheet normalization at a cautiously slow pace. Accommodative policies by global central banks, resulting in increased demand for U.S. Treasuries, have also pressured longer-term rates lower. **With the prospect of 50-75 bps of rate hikes by the Federal Reserve in 2018, we should expect the yield curve to flatten even more in the coming year, so long as inflation expectations remain muted.** Further, it may take the Fed at least another two years to finish the rate-hike program to reach its 2.75% neutral rate target, and possibly seven years to reduce the Fed's balance sheet to $3 trillion, a level twice as large as the balance sheet before Quantitative Easing began. **We therefore emphasize that a continued flattening of the yield curve does not necessarily imply an inverted yield curve signaling a recession.** We view a higher short-end of the curve as a sign that the effects of the 2009 global financial crisis are fading and the Treasury curve is slowly returning to some semblance of market based "normalcy". Further, despite the fact that historical data indicates an inversion of the yield curve is a sign of recession, it is hard to draw from history given the current circumstances of the arbitrarily low interest rates which characterize the fixed income market.

Changes to the composition of the FOMC, the monetary policy members of the Federal Reserve, will take effect in 2018. The appointment of current Fed Governor Jerome Powell to succeed Fed Chair Janet Yellen has thus far been widely regarded as a continuation of current Fed policy to gradually normalize interest rates. Mr. Powell has voted reliably with Ms. Yellen during his five years on the Fed board which indicates no dramatic new policy change from current monetary policy is likely to occur. We expect the Fed to continue to raise short term rates next year even though the makeup of the committee will change once vacancies on the board of governors are filled. Even though the risk of a policy mistake or mishandled communication has potentially increased with the change in leadership and future composition of the Fed board, market reaction remains subdued as few signs have emerged that any change of approach to current monetary policy will occur.

International Market

The "Goldilocks" state of the economy, coined from the 19th century fairytale "Goldilocks and the Three Bears" has been frequently used to describe the current state of the global economy, economic growth which is neither too hot, nor too cold. **Our outlook for 2018 sees a continuation of this trend, where the global economic environment is likely to remain in this "sweet spot" and global growth will continue to support the global equity markets.** This "Goldilocks" economy with subdued inflation and a market-friendly monetary policy will continue to provide a framework for the steady economic growth environment that has supported a sustained rise in asset prices. This low inflation, low interest rate environment will continue to support moderate yet respectable growth in 2018.

Global inflation will eventually make a modest comeback, but is expected to stay relatively stable for 2018. Although economic activity has gathered pace this year and many advanced economies are approaching full employment, there is still no evidence of a pick-up in wage inflation. Average earnings growth has remained exceptionally sluggish in major economies amid structural changes that have altered the relationship between inflation and spare capacity; hence, core inflation will conceivably remain below target, particularly in the Euro-zone and Japan.

In contrast to the current rising interest rate environment in the U.S., where balance sheet normalization and continued rate hikes by the Fed will push rates higher in 2018, global interest rates will remain relatively low as other major central banks are still in stimulus mode. The ECB will continue its quantitative easing program with reduced bond purchases until September of 2018. The BOJ has pledged to proceed with its quantitative easing program indefinitely; an action which has succeeded in holding the yield on 10-year Japanese government bonds at its zero percent target and produced modest gains in economic activity.

Coinciding with a low inflation and low interest rate global economic background, capital expenditures and fiscal policy will be the other main drivers of global economic growth in 2018. Recent data published by the S&P Global Ratings' Corporate Capex Survey points to a genuinely positive outlook for capital investment following four years of collective contraction for the global economy. The recovery is broad-based, with positive growth expected in all regions and in nearly all sectors. We expect this upswing will accelerate into 2018, resulting in sustainable global economic growth underpinned by healthy long-term growth of the corporate sector.

Since the 2009 financial crisis, investors have grown accustomed to the narrative that monetary policy has carried the weight of the recovery while fiscal policy has been absent. This may change in 2018. Fiscal policy may very well offset the impact of the reversal of monetary stimulus and drive economic growth going forward. This potential reversal is already showing evidence in Germany, where austerity measures during the euro debt crisis was caricatured as a tight-money fortress of higher taxes and lower government spending. As Chancellor Merkel forms a new coalition government, there is evidence of a more relaxed German fiscal policy with talks to reduce taxes and allocate more government spending on schools, highways and research.

This cautiously optimistic view of the global economy is accompanied by challenges. In our view, one economy that deserves a lot of attention is China. In our last newsletter, we commented on the agenda to address medium-term risk, including shadow banking, capital outflow, and a high debt to GDP ratio, without impairing near-term economic growth. This remains a delicate balancing act for Xi. **A recent report by the International Monetary Fund claims that China's ballooning levels of debt and its dependency on credit to fuel growth, are a major threats to financial stability for the global economy and a potential catalyst for another worldwide financial crisis.** Zhou Xiaochuan, the country's long-serving and respected governor of the People's Bank of China, also cautioned, "The country could have a Minsky Moment, if we are too optimistic when things go smoothly." His reference to a "Minsky Moment" means that China could reach a tipping point where a prolonged period of stability leads to excess and unsettling financial volatility.

We believe the current "Goldilocks" environment of synchronized, above-trend global economic growth with low but gently rising inflation will likely persist in the coming year. However, 2018 could very well mark the peak for global economic growth in this current cycle. **Throughout numerous market cycles, we have cautioned our clients to maintain their investment discipline and prepare for an unforeseeable market correction.** We must remember the lesson from the "Goldilocks" fairytale, where a comfortable nap in the baby bear's bed is, inevitably, interrupted by the return of the "BEAR".

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.